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Lessons from the East European Financial Crisis, 2008–10

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In the fall of 2008, Central and Eastern Europe became a flashpoint in the global financial crisis. The ten new eastern members of the European Union were in a state of severe overheating in all regards. Inflation surged everywhere and to double digits in Bulgaria, Estonia, Latvia, and Lithuania. Wages and real estate prices skyrocketed, rendering these countries ever less competitive, which further undermined their current account balance. Output plunged and unemployment soared.

The two countries with the greatest overexpansion, Latvia and Estonia, were feeling a credit crunch already in 2007, as their banks reduced their lending, leading to a sudden and sharp fall in real estate prices. As a consequence, both consumption and investment plummeted, and thus output. The ensuing credit losses threatened the sustenance of the banking system.

The financial crisis was already well advanced, when the big blow occurred: the Lehman Brothers bankruptcy on September 15, 2008. All of a sudden, world liquidity dried up, and vulnerable Eastern Europe faced a "sudden stop," being left with no credit or liquidity.[1]

The East European financial crisis was a standard credit boom-and-bust cycle leading to a current account crisis. There is little to say in defense of the overheating and the policies that bred it. Yet loose monetary policy was a global phenomenon and it was difficult for these small and very open economies to defend themselves against abundant capital inflows.

The positive surprise, however, is that after about two years, in the second quarter of 2010, the crisis in the region had more or less abated. Public attention moved from Latvia, Estonia, and Lithuania—the three countries that had suffered the biggest output contraction—to the PIIGS (Portugal, Ireland, Italy, Greece, and Spain), in particular to Greece. The issue was no longer why Latvia must devalue but what Greece could learn from Latvia.

What lessons can be drawn from the resolution of the financial crisis in Eastern Europe for the rest of the European Union and the world at large? What happened during the East European financial crisis, and how was it resolved so quickly? This policy brief aims to bring home the lessons from this episode before it fades from public memory, because nothing is more easily taken for granted than success. I shall avoid unnecessary statistics and focus upon relevant policy conclusions.

Crisis resolution in these countries was decisive and successful, and the entire region save Romania had returned to economic growth by the second half of 2010. At that time, the stabilization program of the International Monetary Fund and the European Union with Hungary had ended and the program Romania was replaced with a precautionary program in March 2011, while Latvia's program continues but successfully so. Overall, the output contraction has been great, in

Box 1 Countries in Focus

This policy brief focuses on the ten new eastern members of the European Union: Estonia, Latvia, Lithuania (the three Baltic countries), Poland, the Czech Republic, Slovakia, Hungary, Slovenia (the five Central European countries), Romania, and Bulgaria (Southeastern Europe). Bulgaria and Romania acceded to the European Union in January 2007. The other eight joined in May 2004.

Slovenia and Slovakia adopted the euro in 2007 and 2009, respectively. Estonia successfully adopted the euro on January 1, 2011. Latvia, Lithuania, and Bulgaria have fixed exchange rates based on currency boards, and Poland, the Czech Republic, Hungary, and Romania have floating exchange rates and essentially pursue inflation targeting.

particular in the Baltics, while Poland saw no contraction in any single quarter (figure 1).

The lessons from this crisis are many and in this brief I focus on 18 of them, which are drawn from my two recent books.[2] Some may seem obvious, while others are not. The Central and East European countries, and especially the Baltic countries, have proven that much old wisdom sometimes forgotten still holds.

No country changed exchange rate policy. One of the most striking outcomes of the East European crisis is that none of the four countries with pegged exchange rates—Latvia, Lithuania, Estonia, and Bulgaria—were forced to devalue contrary to claims by a broad chorus of economists. Instead, these countries pursued what they called "internal devaluation," cutting wages and public expenditures, which rendered their cost levels competitive and allowed them to turn their large current account deficits swiftly into substantial surpluses. Not one single country in the region changed exchange rate policy during the crisis, underlining that both inflation targeting and pegs remain viable exchange rate policies.

Great integration renders devaluation ineffective. A corollary is that depreciation is a much over-advertised cure in current macroeconomic discourse. Regardless of exchange rate policy, monetary policy and bank regulation, no small open economy can safeguard itself against sudden capital inflows and outflows. Large currency mismatches are inevitable in small and open market economies with many currencies. No bank regulation is strong enough to take care of that, and if it were, banking could just migrate to a neighboring country.

In early 2009, one of the greatest concerns was that the Polish banks would go under because of sharp depreciation of the Polish zloty and large currency mismatches. A substantial depreciation causes large balances sheet losses, especially hurting banks.

It made little sense for countries with far-reaching euroization to devalue. Any devaluation would be huge, because the local currency was used for few purposes, rendering all local currency markets very thin. The blow to state finances, the standard of living of the population, and the banks would be great, because local currency was mainly used for tax payments, wage payments and retail transactions. The absence of devaluation salvaged the banking system in the worst exposed countries. The beneficiaries would be limited to large exporters, and also their benefits would not last for long, as the pass-through of inflation inevitably would be large, because commodity prices are international and many international enterprises set the same prices for the region rather than individual countries. Moreover, a devaluation could only be forced by a combination of a bank run and a currency run by ordinary citizens.

The prosaic conclusion is that different exchange rate policies offer varied risks, and that each country needs to make its individual choice of risks. Devaluation poses risks of large bank crashes and bankruptcies, while a pegged exchange rate entices excess capital inflows before a crisis. Estonia ran a persistent large budget surplus of about 2 percent of GDP in the good years from 2003until 2007, but even so it suffered a total GDP decline of 19 percent, showing that no fiscal policy can salvage an economy from external financial crisis. During a crisis, a pegged exchange rate compels a country to carry out more reforms, while devaluation often amounts to a postponement of reforms. Which policy causes the greatest cost is not evident.

A series of recent International Monetary Fund (IMF) papers show the new openness—or confusion. One empirical study argues that intermediate exchange rate regimes have generated the best growth performance.[3] Another paper shows that exchange rate flexibility helped buffer the impact of the crisis.[4] During the boom years, the currency board countries in Eastern Europe had better fiscal balance and higher growth than the countries with floating exchange rates, and the Baltic cases show that internal devaluation is a viable option.[5] The pragmatic wisdom from the early 1990s has been restored: There is no universally preferred exchange rate policy. The best choice depends on the concrete circumstances of the country in question.[6]

No risk of deflationary cycle in a small open economy. The international economic literature warned about the risk of a deflationary cycle ensuing after severe wage and budget

Figure 1 GDP Development in Central and Eastern Europe, 2000–11 (percent annual growth)

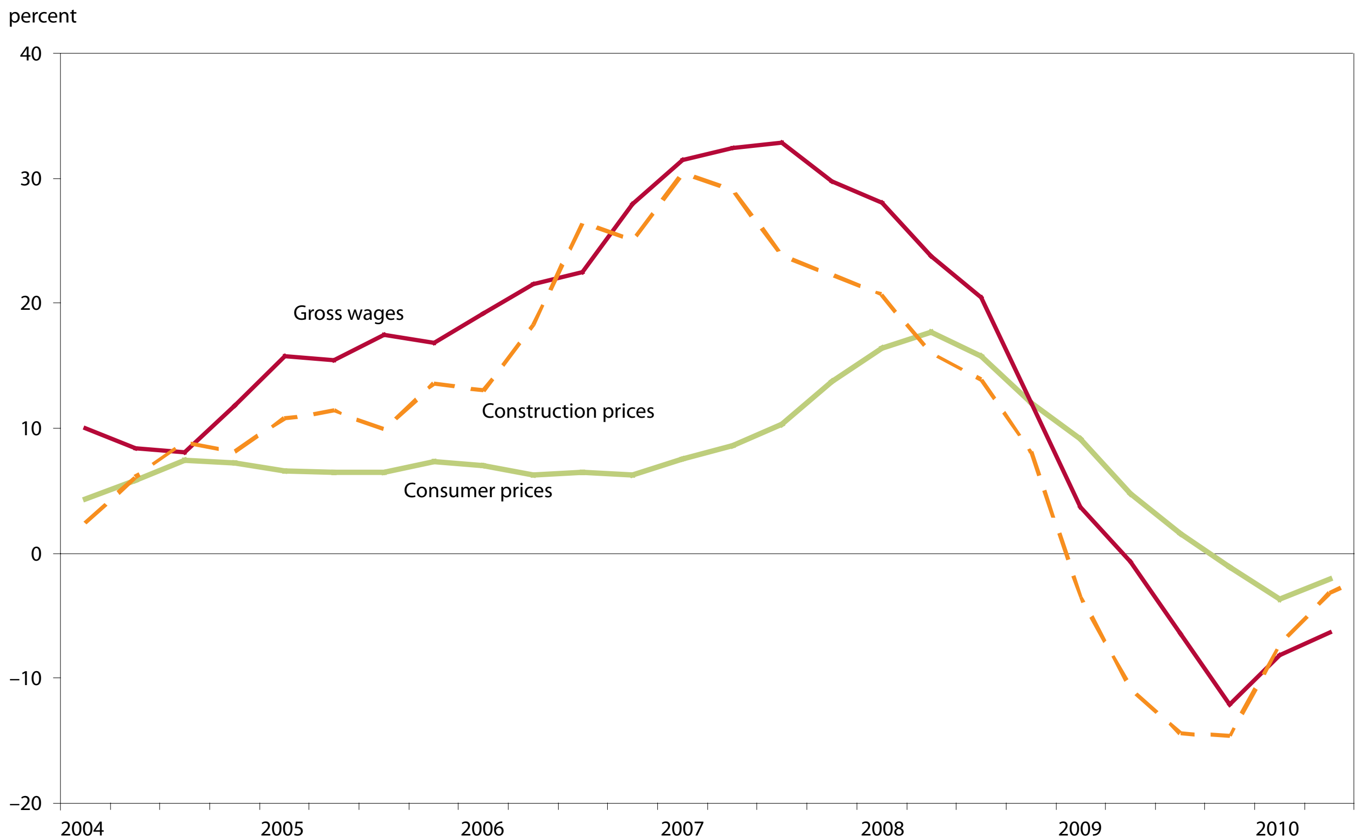
Sources: IMF, *World Economic Outlook* database (accessed on March 31, 2011).

cuts in crisis countries.[7] The evidence shows that no such risk existed. In Latvia, public wages fell by an average of 26 percent in 2009, and private wages by 8 percent. Unit labor costs in manufacturing declined by 21 percent from mid-2008 until end-2009 (figure 2). Even so average deflation in 2010 over 2009 was merely 1.1 percent, and by the end of 2010, Latvia had annualized inflation of 2.5 percent.[8] The explanation is that the prices in these small open economies were given by adjacent markets to such an extent that inflationary pass-through eliminated all risks of deflationary cycles and rendered devaluation ineffective.

The goal of euro accession is valuable. Euro accession as a goal is beneficial in at least three ways. First, it disciplines the policy especially of the four countries with currency boards. Their desire for full European integration with early adoption of the euro led them to focus on two nominal anchors: a fixed exchange rate and a budget deficit below 3 percent of GDP, in their ambition to accede to the Economic and Monetary Union (EMU) as early as possible. These two anchors brought stability and clarity to their economic policy. Second, for small, fast-growing countries on the European periphery, higher market interest rates than in the eurozone were natural, and only the Czech Republic had low interest rates in comparison with the eurozone. Then, it is cheaper in nominal terms to borrow in euro, and euroization with ensuing currency mismatches was close to inevitable for these open economies with no capital regulation. The only sensible way to reduce currency risks and currency mismatches is to adopt the euro. Finally, only membership in the EMU would provide these economies with the full liquidity support of the European Central Bank.

International liquidity is crucial. After the bankruptcy of Lehman Brothers on September 15, 2008, global credit froze. Access to liquidity was key to escaping deep recession. The US Fed performed a very important service by offering swap loans to a large number of countries around the world.[9] The European Central Bank (ECB), on the contrary, hardly provided any swap loans, save to Sweden and Denmark long

Figure 2 Latvia's consumer price index, gross wages and construction prices, 2004–10 (percent change over the corresponding period of the previous year)



Source: Central Statistical Bureau of Latvia, www.csb.gov.lv (accessed on November 23, 2010).

after the height of the crisis. The new eastern EU members were left without access to liquidity other than their own central banks and their trading partners were prepared to offer. The ECB did nothing to stabilize the economies of these euro candidate countries. It could have offered swap credits to eastern EU economies outside the euro area, but it did not.[10] Slovenia and Slovakia were lucky to be in the eurozone already and benefited from ECB's ample liquidity. Those that suffered the most were small countries outside the eurozone, notably, the Baltic countries. Because of the extraordinary dearth of liquidity, national savings ratios skyrocketed – in Latvia from 20 percent of GDP in 2008 to 31 percent of GDP in 2009, explaining most of the decline of output.[11]

Large and early international assistance is vital. The scarcity of liquidity rendered early and big international financial assistance vital. Given the very low levels of public debt before the crisis in all countries but Hungary, the East European financial crisis was essentially a liquidity crisis and not a solvency crisis, and that was evident from the outset. Consequently, the international community should follow Walter Bagehot's adviseto lend freely but demand collateral in the midst of the crisis. Traditionally, the IMF has rarely given a country more than three times its quota with the IMF, but it gave Latvia 12 times its quota in credits. In hindsight, it appears strange that anybody was concerned about the IMF giving a country like Latvia such large credits, or that the international finance package to Latvia amounted to 37 percent of its GDP in 2008. Great globalization means that larger volumes of credits will be needed. Instead more of the credit should have been given earlier to avoid the sharp output contraction, and other countries, primarily Lithuania, could have benefited from international financial support, but it feared intrusive demands for devaluation.

New cooperation between the IMF and the EU worked well. As is usually the case in a financial crisis, the IMF took the lead in the international rescue efforts. It had learned its lessons from the East Asian crisis in 1997–98. It revived the old Washington Consensus of a few rudimentary financial conditions, such as tenable exchange rate policy and reasonable fiscal and monetary policy, but abandoned multiple structural demands. In addition, it allowed well-governed countries larger public deficits during the crisis and offered much more financing, also for budgets, than before with the understanding that this was a temporary current account crisis. It acted even faster than usual. The European Commission entered into a partnership with the IMF in Eastern Europe. It let the IMF take the lead, while providing substantial financing, more than the IMF in the case of Latvia, and it checked the work of the IMF. For the recipient countries, it was an advantage to have two parties to deal with, avoiding possible arbitrariness of IMF staff. In July 2009, the European Commission disbursed funds to Latvia when the IMF held back.

The source of financing matters. One of the least relevant pre-crisis indicators was foreign indebtedness. Even the current account deficit said surprisingly little about the risk of financial crisis. The case in point is Bulgaria, which had the biggest current account deficit of all of 25 percent of GDP in 2007 and a foreign debt exceeding its GDP. Even so, Bulgaria did not suffer more than other European countries during the crisis. The dominant explanation is that Bulgaria had huge net foreign direct investment that financed the whole current account deficit. This runs counter to Guillermo Calvo's view: "Large current account deficits are dangerous independently on how they are financed."[12]

Foreign-owned banks have proven beneficial. Foreign-owned banks have been a major bone of contention in Eastern Europe, where about 80 percent of banking assets belong to foreign-owned banks. Foreign investors preferred to buy large banks with significant market power in Eastern Europe, which were on average less profitable but better capitalized than banks that remained domestically owned.[13] With access to cheaper funding than local banks, they became more profitable than domestic banks over time,[14] which made them committed to stay. About one dozen West European banks have specialized on Eastern Europe, both inside and outside the EU. They have rightly been blamed for having lent too much in the good times, but they were also the first to sense the impending crisis and reduced their loan expansion starting in mid-2007. In the midst of the crisis, credit shrank considerably throughout the world, as only some central banks could expand liquidity. The ECB expanded its credit supply to salvage the European banking system in the fall of 2008, also propping up their subsidiaries in Eastern Europe. Without foreign-owned banks, Eastern Europe would not have had access to this important lifeline. Tellingly, the only significant bank in Eastern Europe that went under was Parex Bank in Latvia, which was the domestically-owned bank with the largest market share, financing itself with credits from the short-term European wholesale markets that froze during the crisis. Amazingly, not one foreign bank withdrew from any eastern country during the crisis, and they steeled themselves bearing substantial losses themselves. Today after the crisis, integrated international banks appear advantageous, but effective, pan-European bank regulation is needed.[15]

Bank collapses have been minimal. Apart from Parex Bank, no significant bank has gone bankrupt in any of the eastern EU countries. There are three explanations to this surprising tenacity. First, leverage was limited in all these countries, and toxic assets such as credit debt obligations were basically not allowed by national bank regulators. Second, thanks to the absence of devaluation in the worst hit countries, the balance sheet losses were contained. Third, for the big West European banks these losses were bearable. As a consequence, the public cost of bank losses has been far smaller than anticipated. While the IMF initially expected bank losses amounting to 15 to 20 percent of GDP in Latvia, they have been limited to some 5 percent in 2008–09, essentially the initial cost for the recapitalization of Parex Bank.[16] Moreover, this is a gross cost, much of which may be recovered when the government eventually sells Parex Bank.

Distinguish between public and private debt! The point is often made that if debts are excessive, it does not matter in the end if they are public or private, because private debts tend to become public in a crisis.[17] But the nationalization of private debt is not necessary, and the East European countries largely avoided it. After the crisis, private foreign debt remains considerable in many countries, but it can be refinanced without significant problems. As before the crisis, only Hungary exceeds the Maastricht public debt limit of 60 percent of GDP, while the average in the eurozone is 80 percent of GDP.

Equally laudable was the political economy of this crisis. Instead of widely predicted social unrest, the East European public has accepted their considerable hardship with minimal protests. Multiple factors contributed to social peace. Large majorities favored wage cuts over devaluation as the lesser evil, because the benefits of devaluations would mainly accrue to wealthy exporters. After many years of high economic growth, people were prepared for some suffering. These states had recently become free and were prepared to stand up for their nations, and they were all used to crisis from the postcommunist transition.

Radical, early and comprehensive adjustment is beneficial. As the global financial crisis hit the United States, President Barack Obama's chief of staff Rahm Emmanuel made the pointed statement: "A crisis is a terrible thing to waste." This is born out by a substantial academic literature that crisis often offers opportunities for profound changes.[18] In particular, the Baltic countries lived up to that wisdom. All three carried out fiscal adjustment of close to 10 percent of GDP in 2009 alone. Their experience of fiscal adjustment has brought out the universal advantages of carrying out as much of the belt-tightening as possible early on. Hardship is best concentrated to a short period, when people are ready for sacrifice, what Leszek Balcerowicz calls a period of "extraordinary politics."[19] The Balts succeeded because they concentrated the fiscal adjustments to the first year of crisis combat. Later rounds of belt-tightening have been more limited but politically more cumbersome.

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Expenditure cuts are preferable to tax hikes. The logic is simple. During a crisis people understand that the government cannot do as much as before, while they find it more difficult to understand why they should pay more taxes for less public services or why the state would not tighten its belts as much as they do. The Baltic experience with more than three-quarters of the fiscal adjustment from public expenditure cuts shows that they are politically preferable to tax hikes[20] (figure 3). It remains to be seen, but it is likely that the expenditure cuts will also promote faster growth in the future. Alberto Alesina and Silvia Ardagna have offered substantial statistical evidence for the thesis that "fiscal adjustments…based upon spending cuts and no tax increases are more likely to reduce deficits and debt over GDP ratios than those based upon tax increases."[21]

Internal devaluation is possible and viable. A strange myth has evolved that affluent democracies are politically unable to undertake large cuts in public expenditures and wages in evident ignorance of the big fiscal adjustments that Finland and Sweden carried out in the early 1990s. Latvia, as well as its Baltic neighbors, showed that these vibrant democracies were perfectly capable of reducing their public expenditures by about one-tenth of GDP in one year, 2009. Social calm prevailed. Since these large cuts had to be selective, they facilitated structural reforms, not only reducing the capacity but also often improving the quality of public services. The cuts made possible reforms of public administration, health care and education, most of which had been long prepared but previously been deemed politically impossible.

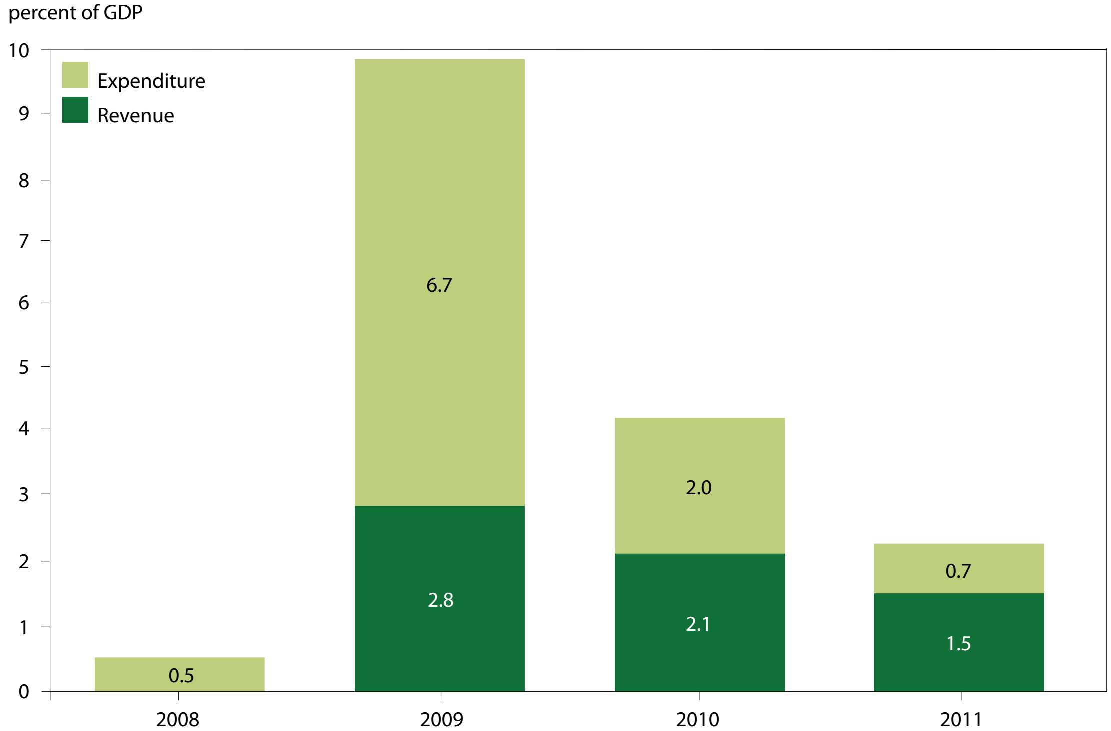
Equity is important. The most popular budget adjustments were the cuts of salaries and benefits of senior civil servants and state enterprise managers as well as the reduction in public service positions. The Latvian prime minister accepted a salary cut of 35 percent. The most unpopular measure was the value-added tax (VAT) hike, and resistance was fierce against raising income and profit taxes. Six of the ten eastern EU members had flat income taxes before the crisis, and none of them has abandoned such taxes, while the Czech Republic has introduced them, and Hungary is intent on doing so.

Populism is not very popular in a serious crisis. This is the bottom line because the population understands the severity of the crisis and wants a government that can handle the crisis as forcefully as is necessary. The crisis has augured the biggest strength of the liberal center-right in this part of the world ever. In the elections to the European Parliament in June 2009, in the midst of the crisis, center-right parties won a majority in all the ten eastern EU members, and all but Slovenia currently have center-right governments. Two of the most ardent anticrisis governments, the Latvian and Estonian, won parliamentary elections in 2010 and 2011, respectively, while parties with similar programs won elections in the Czech Republic and Slovakia in the spring of 2010. Voters have rationally chosen parties that have appeared to have a realistic crisis resolution to offer. The big losers in recent elections, with the exception of Hungary in 2010, have been parties that have tried to exploit populism.

The one big failure has been the reversal of pension reform. An oddity of this crisis—exactly as in the early postcommunist transformation—is that the share of GDP going to pensions has risen sharply. Moreover, public pensions have expanded at the expense of private pension schemes. Two governments—in Latvia and Romania—tried to cut pensions, but these decisions were reversed by their Constitutional Courts. Several countries—Hungary, Latvia, Poland and Romania— have reduced the funding of private cumulative pension schemes and used these funds to finance public pensions. Meanwhile, the value of private pension funds have plummeted with stock prices, and rendered them less popular. Hungary has even nationalized private pension funds.

International macroeconomics failed. The international macroeconomic discussion was of little use and even harmful. Whenever a crisis erupted anywhere, a choir of famous international economists claimed that it was "exactly" like some other recent crisis—the worse the crisis, the more popular the parallel. When the Icelandic economy blew up in early

Figure 3 Latvia's fiscal consolidation, 2008–11



Source: Ministry of Finance of Latvia, Presentation for Meeting of Finance Ministers of Estonia, Latvia and Lithuania, Riga, January 11, 2011.

October 2008, a herd of economists claimed that the same would happen to Latvia, although Iceland had a floating exchange rate, a high interest rate, and an overblown domestic banking system. Soon, prominent economists led by *New York Times* columnist Paul Krugman claimed that "Latvia is the new Argentina."[22] A fundamental problem is their reliance on a brief list of "stylized facts," never bothering to find out the real facts and therefore suggesting policies poorly adjusted to the actual problem.

The financial crisis in Eastern Europe has been remarkable for everything that did not happen. There was no significant reaction against globalization, capitalism, the European Union, or the euro. No major strikes or social unrest erupted, while the population rose against populism and unjustified state privileges. Politically and financially, crony businessmen were the biggest losers, whereas the political winners were the moderate but resolute center-right forces. The sensible public wanted decisive action from their leaders to resolve their problems. This political economy was reminiscent of the early postcommunist transition, when radical reform and democracy went hand in hand. The ideological wind was clearly liberal and free market but also socially responsible, favoring a somewhat purer market economy and a moderate retrenchment of the social welfare state. East Europeans did not object to the welfare state as such, but they wanted social welfare to be trimmed, to become more efficient, and to work for those truly in need rather than being diverted to the wealthy. It has proven politically possible to cut public expenditures, salaries, and employment, as well as rationalize health care and education.

In the end, this crisis will likely benefit both Eastern and Western Europe and thus the European Union. Western Europe will have to learn from Eastern Europe, erasing the current division between first- and second-class members within the European Union. The East European countries have persistently had much higher growth rates than the West European countries, and economic convergence between them in terms of GDP per capita has been impressive for the last nearly two decades. Thanks to the East Europeans, the West Europeans have slashed their corporate profit tax rates and have also been enticed to liberalize their labor markets. Now, they will also learn fiscal policy from the east. Rather than being the laggards, the East Europeans will be the leaders in economic policymaking.

ENDNOTES

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