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CASE Network Studies & Analyses

The East European Financial Crisis

Anders Åslund

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Contents

Abstract	6
1. Introduction.....	7
2. What Was the Problem?.....	9
3. Causes of the Financial Crisis.....	16
4. International Financial Support: IMF and EU Cooperation	21
5. Conclusion: Euro Adoption or Inflation Targeting	24
References	28



Anders Åslund is a senior fellow at the Peterson Institute for International Economics in Washington, D.C since 2006. He is a leading specialist on post-communist economic transformation with more than 30 years of experience in the field. He is the author of nine books, most recently, *How Ukraine Became a Market Economy and Democracy* (2009), *Russia's Capitalist Revolution* (2007) and *How Capitalism Was Built* (2007), and he has edited 14 books. Dr. Åslund has also worked as an economic advisor to the Russian, Ukrainian government, and Kyrgyz governments. Previously, he was the Director of the Russian and Eurasian Program at the Carnegie Endowment for International Peace. He teaches at Georgetown University. He was born in Sweden and served as a Swedish diplomat in Russia, Poland, Geneva and Kuwait. He earned his PhD from Oxford University.



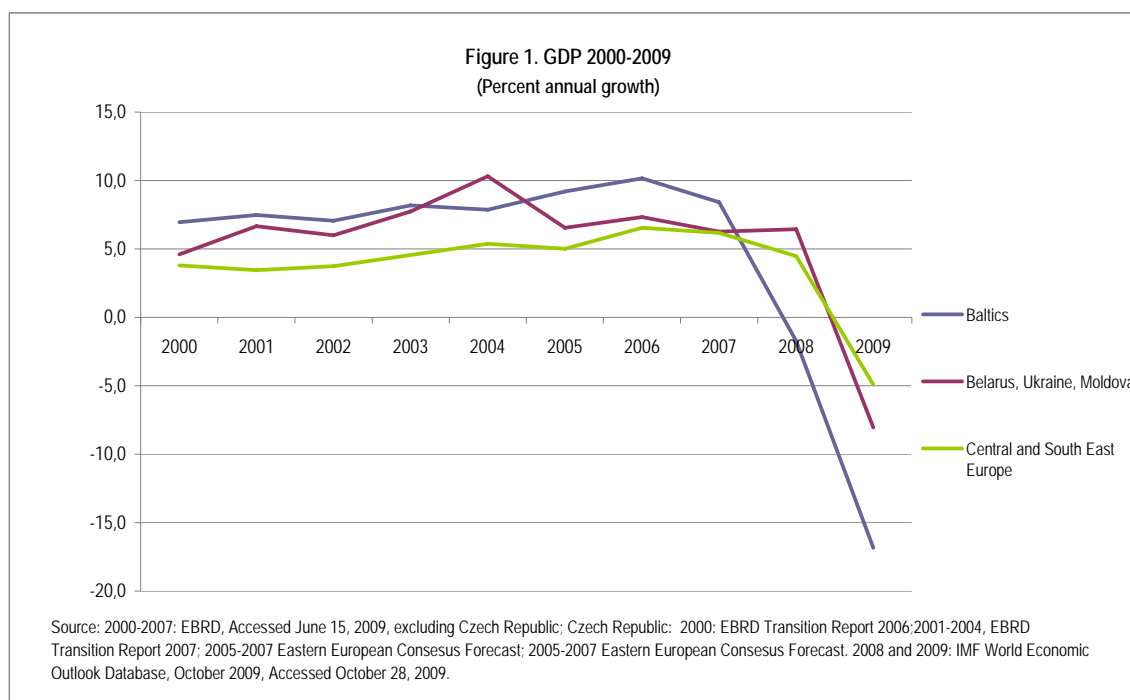
Abstract

This paper discusses the global financial crisis of 2008/9 in thirteen countries, the ten new EU members that previously were communist and the three countries of Western former Soviet Union. Their problems were excessive current account deficits and private foreign debt, currency mismatches, and high inflation, while public finances were in good shape. The dominant cause was fixed exchange rates. Many lessons can be drawn from this crisis. A dollar peg makes no sense in this part of the world. The five currency boards in the region have lacked credibility. By contrast, inflation targeting has worked eminently. The euro has proven credible both in the countries that officially adopted it and in the countries that adopted it unilaterally. With the exception of Hungary, all the countries in the region have displayed decent fiscal policies. No government should accept large domestic loans in foreign currency and they can be regulated away. The IMF has successfully returned to the original Washington consensus with relatively few conditions: a reasonable budget balance and a realistic exchange rate policy, while focusing more on bank restructuring. The most controversial issue is the role of the ECB. The ECB should facilitate the accession of willing EU members to the euro by relaxing the ERM II conditions.

1. Introduction

Central and Eastern Europe had a wonderful period of economic growth and stability from 1999 until 2008.¹ It carried out an excellent transformation to capitalism, deregulating prices and trade, stabilizing prices, and privatizing state property faster than anybody could have imagined.

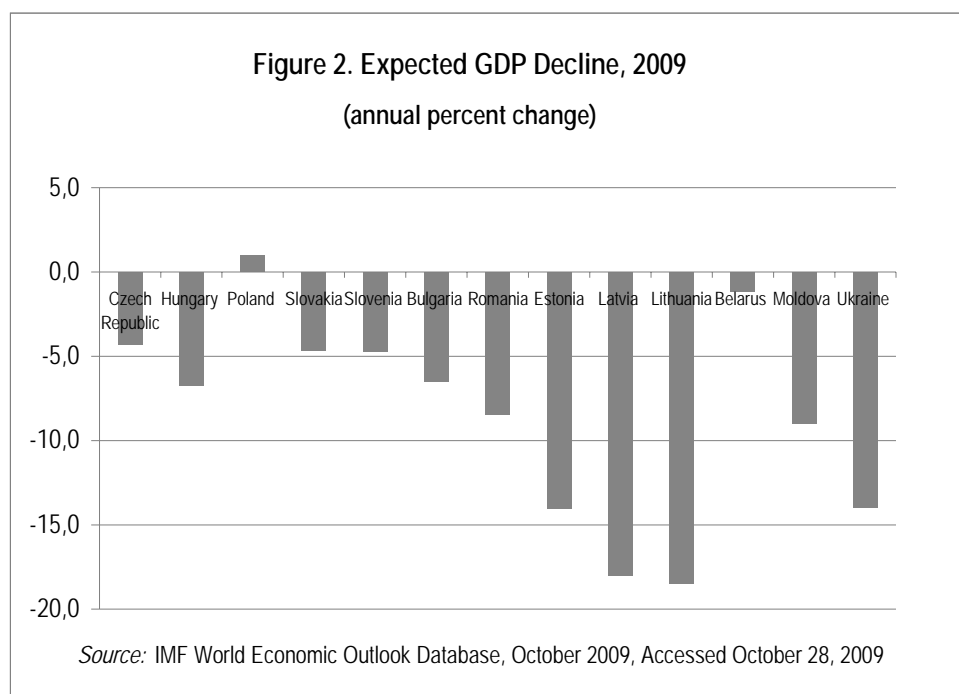
The years 2000-8 represented a period of unprecedented economic growth. It is convenient to look upon the region as four subregions. The turbo-region was the three Baltic countries (Estonia, Latvia and Lithuania) that had an average unweighted annual growth of 7 percent, peaking at 10 percent in 2006.² In 2006-8, Latvia saw an extraordinary spurt of an average 11 percent a year. Belarus, Ukraine and Moldova had a similar expansion of 7 percent. Central Europe (the Czech Republic, Hungary, Poland, Slovakia, and Slovenia) and South-East Europe (Bulgaria and Romania) had a more moderate growth of 4.8 percent, but the region as a whole was overheating (figure 1).



¹ Anna Borshchevskaya has provided me with valuable research assistance. I have benefited from comments at the CASE conference.

² Throughout this paper, all averages are unweighted.

Its fall was all the starker. In 2009, all countries except Poland are expected to experience large economic slumps, but the differences are evident. Although these transition countries have much in common, it is striking how differently they have come out in the current financial crisis. Poland will suffer no decline, while the other four Central European countries have moderate decline of around 5 percent of GDP. Bulgaria and Romania faced significant decline of 7-8 percent, while the Baltics with a 14-18 percent slump, and Moldova and Ukraine with some 12 percent have been very badly hit (figure 2). Why have the outcomes varied so greatly?



The purpose of this paper is to establish the nature and causes of the economic problem, survey the international response, and draw policy conclusions: What lessons can be drawn and what policies can help avoiding this situation in the future. Importantly, some countries suffered less, and Poland even grew. Thus, this historic episode offers an illuminating counterfactual narrative that is rarely evident.

The approach of this paper is regional, ten new EU members that previously were communist and the three countries of Western former Soviet Union. To be discussed are, in alphabetic order, 13 countries: Belarus, Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Moldova, Poland, Romania, Slovakia, Slovenia, and Ukraine. Only two (Slovenia and Slovakia) have adopted the euro. The countries of the former Yugoslavia and Albania had similar problems and they could be included, but they would hardly add any qualitative aspects.

With its large currency reserves and persistent budget and current account surpluses, Russia is very different and therefore excluded.

2. What Was the Problem?

The financial problems are easily detected from overall statistics. The immediate cause of the financial crisis was a so-called “sudden stop” (Calvo 1998, Edwards 2005). After the Lehman Brothers bankruptcy on September 15, 2008, global liquidity froze, and the worst exposed countries, especially Ukraine and Latvia, found themselves beyond the range of global finance. Four symptoms of crisis were evident: excessive current account deficits, huge credit expansion, large capital inflows, and rising inflation (Goldstein 2007).

The East European economic growth was originally export-driven (Åslund 2007), but increasingly all these countries ratcheted up ever larger current account deficits. In 2002, Estonia pioneered a double-digit current account deficit as a share of GDP and in 2007 six of these 13 countries had such deficits. They were Bulgaria, Estonia, Latvia, Lithuania, Moldova, and Romania. Two of them, Bulgaria and Latvia had deficits exceeding 20 percent of GDP (table 1).

Table 1. Current Account Balance, 2000-2009
Percent of GDP

	2006	2007	2008	2009 Forecast
Czech Republic	-2,6	-3,1	-3,1	-2,1
Hungary	-7,5	-6,4	-8,4	-3,0
Poland	-2,8	-4,0	-5,5	-2,2
Slovakia	-6,2	-4,8	-6,5	-8,0
Slovenia	-2,6	-4,2	-5,5	-3,0
Bulgaria	-17,9	-25,4	-25,5	-11,4
Romania	-11,8	-14,4	-12,4	-5,5
Estonia	-16,8	-18,0	-9,3	1,9
Latvia	-22,7	-22,5	-12,6	4,5
Lithuania	-10,7	-14,6	-11,6	1,0
Belarus	-3,9	-6,8	-8,4	-9,6
Moldova	-11,7	-15,2	-17,7	-11,8
Ukraine	-1,5	-4,2	-7,2	0,4

Moldova is peculiar as much of its current account deficit was financed by remittances from Moldovans working abroad, but the other five countries were clearly vulnerable. The current account deficit gives a good indication of the countries with trouble, though Bulgaria has done better than the others.

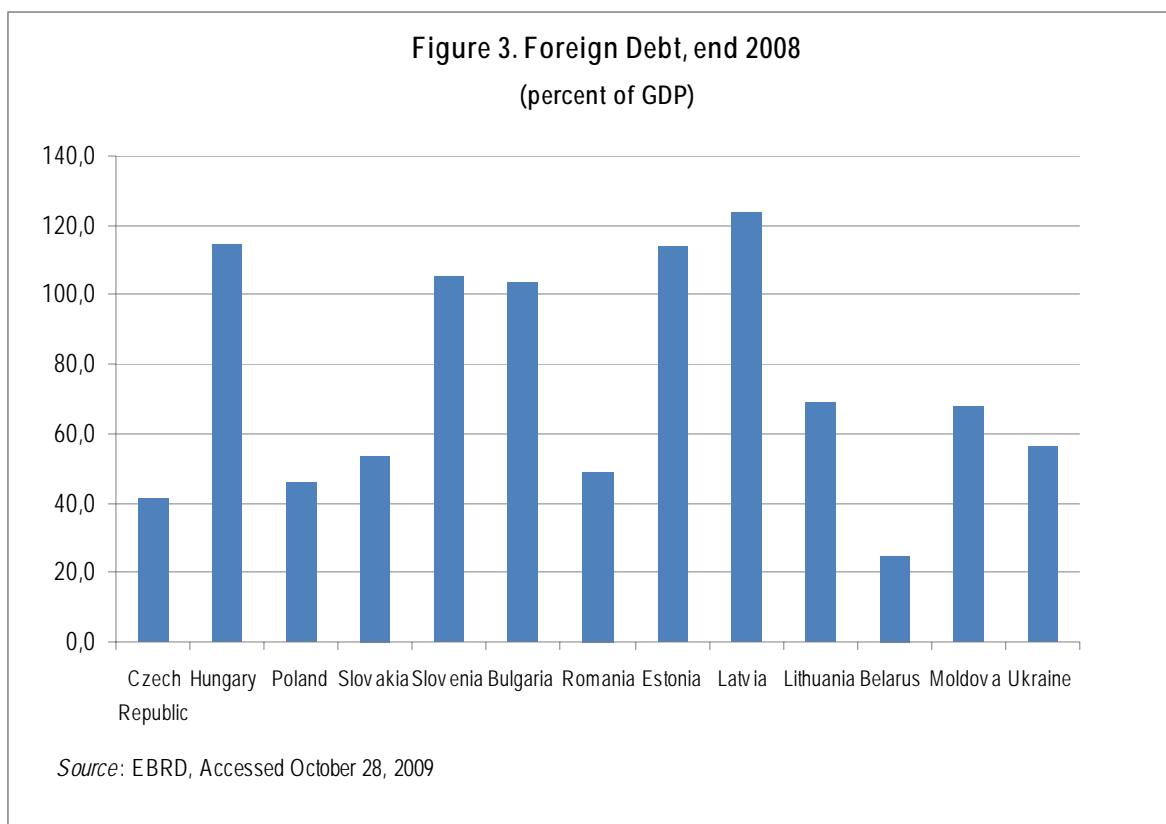
A frequent argument is that a current account deficit is not really dangerous as long as it is financed with foreign direct investment (FDI; Dabrowski 2008). This argument carries some weight.

Table 2. Current Account Deficit and Net Foreign Direct Investment (FDI), 2002-2007
Percent of GDP

	Net FDI	CA	Residual
Czech Republic	5,4	-4,2	1,2
Hungary	2,5	-6,9	-4,4
Poland	3,0	-3,0	0,0
Slovakia	7,5	-5,5	2,0
Slovenia	0,9	-1,8	-0,9
Bulgaria	11,6	-11,1	0,5
Romania	6,0	-8,3	-2,3
Estonia	6,9	-12,3	-5,4
Latvia	4,8	-14,4	-9,6
Lithuania	3,4	-8,6	-5,2

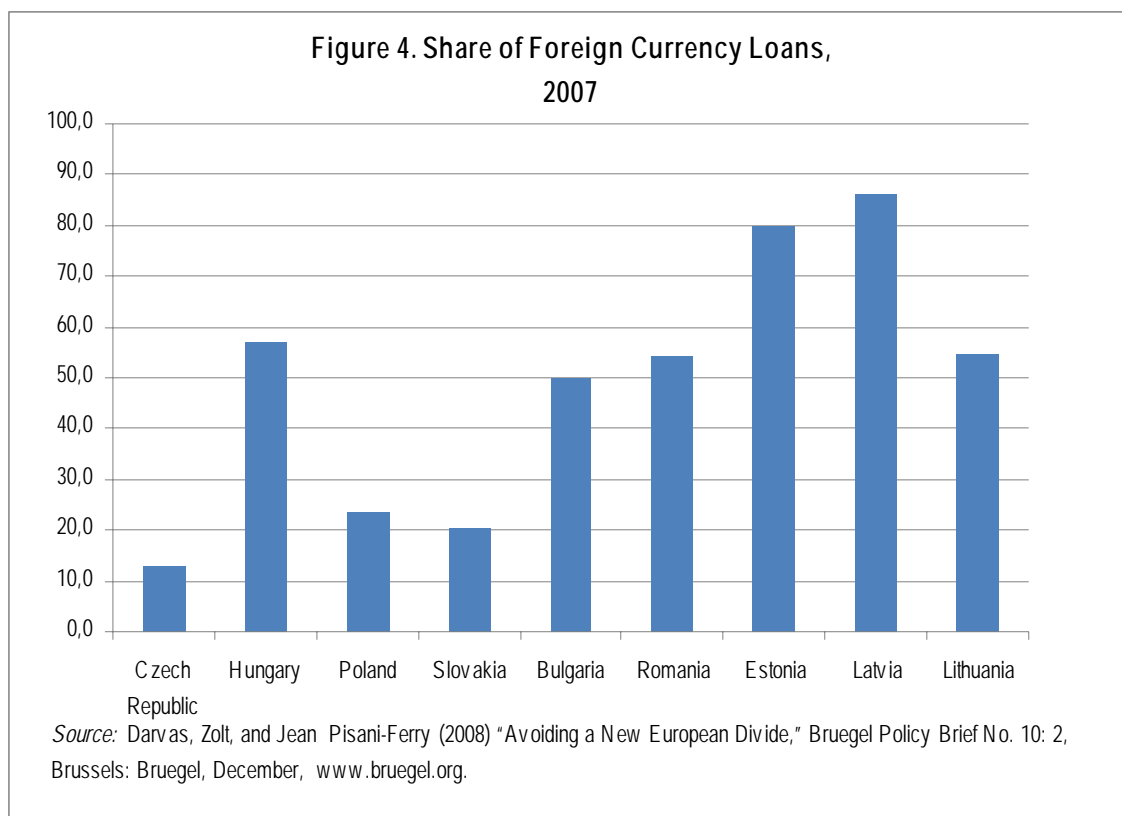
Table 2 shows that among the EU members only the three Baltic countries had current account deficits that were not financed with FDI by more than 5 percent of GDP. FDI more or less balanced the current account deficit in Slovakia, the Czech Republic, Bulgaria, Poland, and Slovenia. The five countries with current account deficits not financed by FDI are the problematic ones: Latvia, Estonia, Lithuania, Hungary, and Romania. This appears the single best means of singling out countries in crisis.

The current account deficits accumulated into an increasing foreign debt. By 2008, five countries had foreign debts amounting to more than 100 percent of GDP. These countries were Bulgaria, Estonia, Hungary, Latvia, and Slovenia (figure 3).



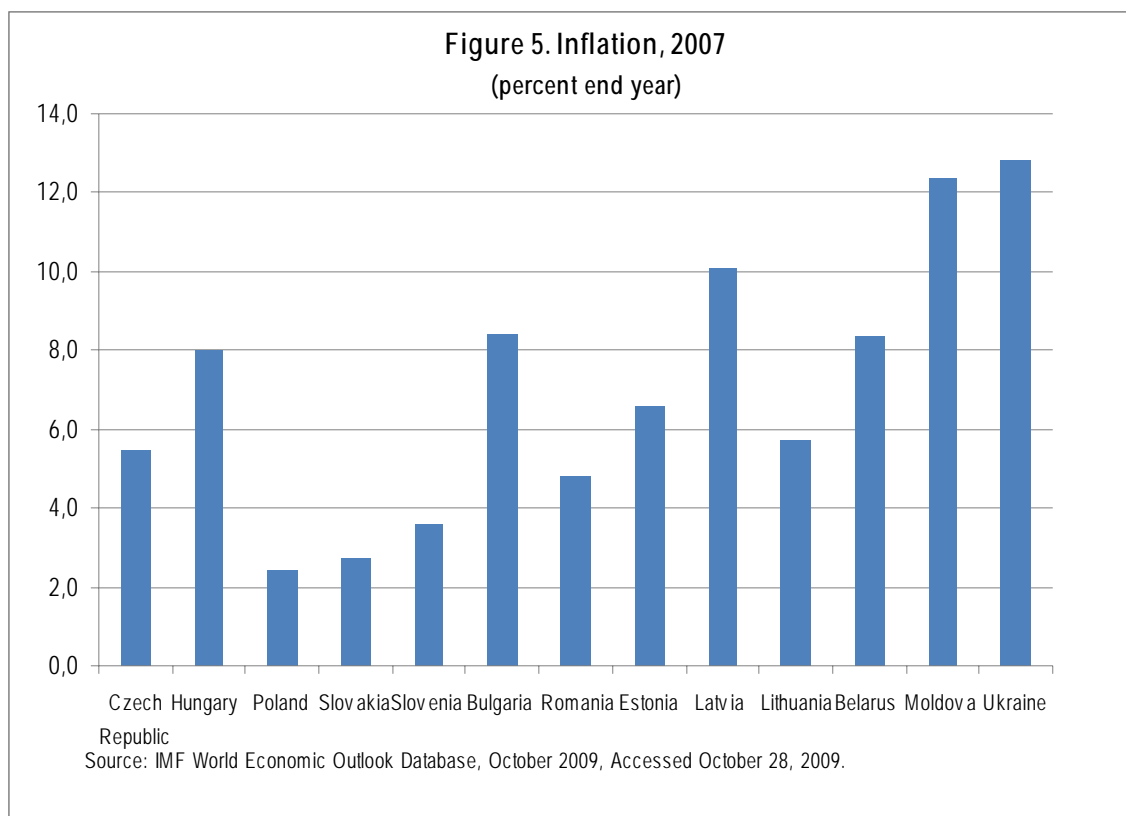
The surprise here is that Slovenia, which has largely escaped crisis, was so exposed. Evidently, Slovenia was saved by its early adoption of the euro.

All the most indebted countries also suffered from currency mismatches. Foreign currency, primarily euro, was used extensively for domestic loans, both corporate loans and household mortgages, because interest rates were significantly lower for foreign currency loans and borrowers did not expect any depreciation (figure 4).



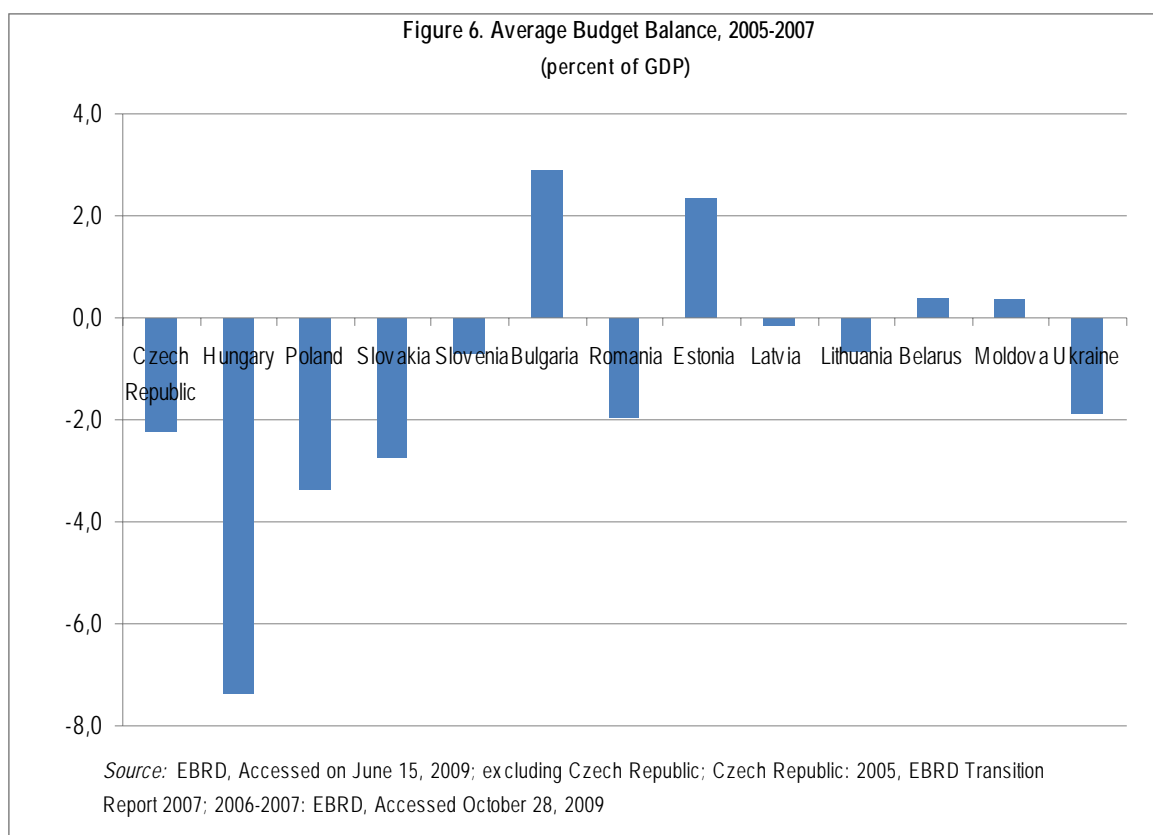
Yet, the Czech Republic, Poland, and Slovakia largely avoided such practices thanks to bank regulation, and this seems to have helped their financial sustenance.

The large capital inflows boosted the domestic money supply. As a natural result, inflation started rising again after disinflation in the early 2000s. In 2007 only two countries had less than 3 percent in annual inflation (Poland and Slovakia), while three had double-digit inflation, namely Latvia, Moldova, and Ukraine (figure 5).



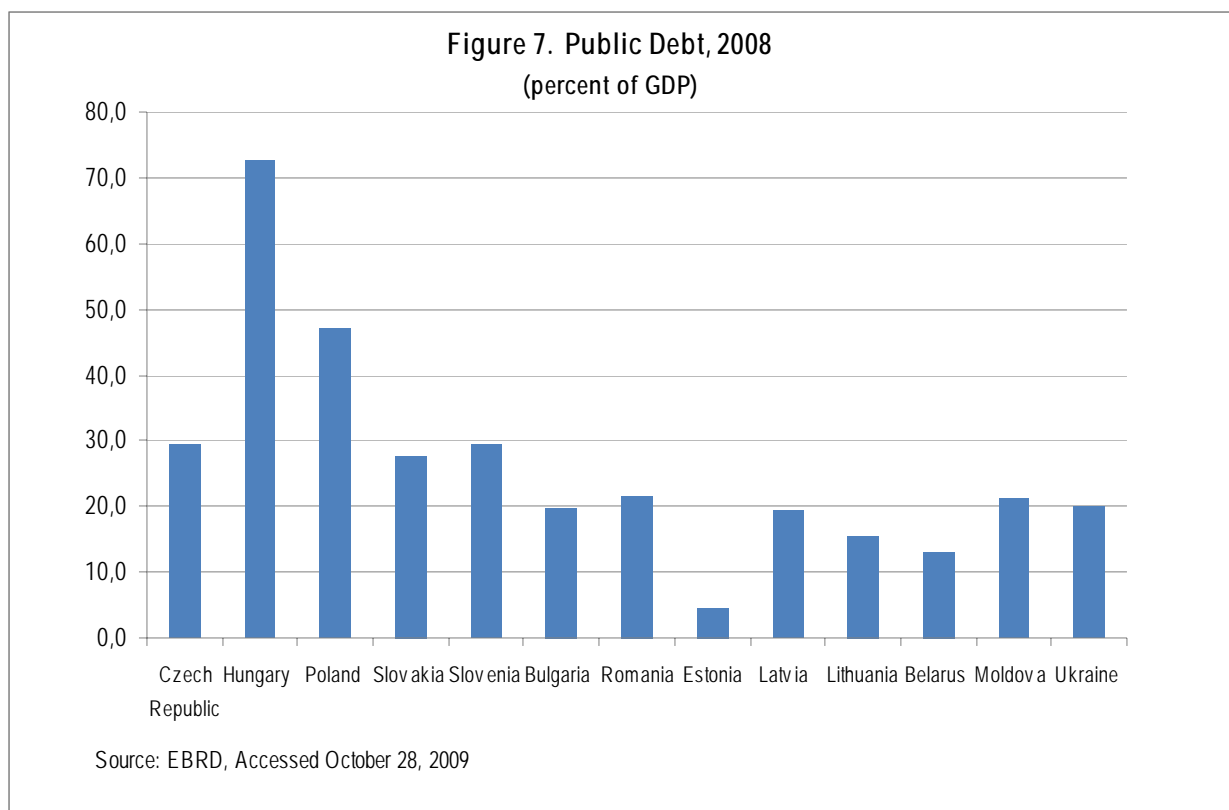
Clearly, double-digit inflation was a recipe for disaster. The expansion of the money supply was even greater, for example 40-50 percent a year in Ukraine, but it did not result in more inflation because the demand for money and monetization grew sharply, and thus the velocity of money was steadily declining.

One big surprise has been how insignificant public finances have been in the crisis. The financial problems were concentrated to the interaction of the private sector with the international economy. Throughout most of this period, one single country, Hungary, suffered from a large budget deficit. Two countries, Bulgaria and Estonia, had significant budget surpluses of close to three percent of GDP. The other countries tended to hover close to budget balance (figure 6).



Thus their fiscal discipline was better than that of the European Union as a whole. Neither Bulgaria nor Estonia have needed an IMF program, and their persistent budget surpluses saved them, but even so they suffered big output slumps.

As a consequence, all these countries but Hungary had very limited public debts. Only Hungary's public debt exceeded the Maastricht ceiling of 60 percent of GDP. For most countries, the public debt as a share of GDP fell steadily until 2008, when the average had fallen to 26 percent (figure 7).



The conclusion of this survey is that a significant current account deficit that was not financed by FDI was bad. Another negative indicator was double-digit inflation caused by excessive credit expansion, and a third was a large share of domestic loans in foreign currency, while the state of public finances was good but did not save countries with a precarious foreign balance in the private sector.

3. Causes of the Financial Crisis

So why did some countries end up with too large current account deficits, foreign debts, credit expansion, and inflation? The whole region was characterized by great openness both to foreign trade and finance.

Only Hungary suffered from irresponsible fiscal policy. Its fiscal mismanagement culminated in a budget deficit of 9.2 percent of GDP in the global boom year of 2006. Therefore Hungary is a special case as a crisis country.

The cause of the financial crisis was a long-lasting credit expansion that eventually became excessive, essentially in the Baltic states, Bulgaria, Romania, and Ukraine. This credit bubble was financed with capital inflows, and the larger the share of bank credit as opposed to foreign direct investment, the worse the crisis became. Not all transition countries had such massive credit expansions. The outstanding exceptions were the Czech Republic, Slovakia, and Poland (Mitra, Selowsky, and Zalduendo 2009, 5).

Central Europe, the subregion most integrated in the European Union, largely escaped the financial crisis (apart from fiscally-irresponsible Hungary). Thus, deep integration into the European economy appears to have been an advantage. The European Union, however, does not mark any dividing line, as evident by the Baltic countries being the worst hit. Nor did the euro zone. Poland has fared better than Slovakia and Slovenia.

Postcommunist transition has not been negative. The Central Europeans were star reformers, and they did reasonably well. Looking at countries such as Ukraine and Romania, it is easy to suggest that the reform laggards were doing worse, but that is hardly true because the Baltic countries were star reformers and they suffered the most (Åslund 2007). Moreover, most post-Soviet countries did not suffer much. Thus, the success of postcommunist transition does not appear to have been a central issue either way.

The dominant cause of the East European financial crisis of 2008-9 boils down to one single factor: the exchange rate policy. The countries in Central and Eastern Europe pursued five different exchange rate regimes.

The first, reasonably successful group was the inflation targeters with floating exchange rate. This group includes Poland, the Czech Republic, Hungary, and Romania. The latter two ended up in financial crisis, but Hungary primarily because of a large fiscal deficit, and Romania's economic policy was wanting in several regards. The overall analysis of Sebastian Edwards (2006) of inflation targeting stands: countries that have adopted inflation targeting have experienced less pass-through from exchange rate changes to inflation, and they have not faced any increased exchange rate volatility.

Another successful group consisted of the two countries that had adopted the euro, Slovenia and Slovakia. They escaped capital flight, as the ECB guaranteed their financial stability and liquidity. Their problem was that their costs became disproportionately high relative to their competitors, such as Poland and the Czech Republic that undertook large devaluations, so their output fell significantly.

The third group was worst hit. It consisted of the four countries with currency boards and fixed exchange rates from their financial stabilizations in the 1990s: The three Baltic states and

Bulgaria. Before the crisis these four countries (beside Ukraine) were the most overheated economies with the largest current account surpluses and the highest inflation, and they suffered the greatest output falls. Clearly, these countries were the most vulnerable, and they received no support from the ECB. The currency boards lacked credibility. Admittedly, only Latvia has needed an IMF program, and Estonia and Bulgaria were helped by their persistent large fiscal surpluses. As none of these countries has devalued, it can be argued that the market operators were wrong in believing that they would be forced to devalue, but these states suffered materially from the belief of the marketers.

The fourth group was also badly injured, the three non-EU countries that entered the crisis with a dollar peg, Ukraine, Belarus, and Moldova. All three countries have adopted IMF programs and they have been forced to devalue. Their exchange rate and monetary policies made little sense. All three countries had simple pegs to the dollar, which had no particular planned exit, such as the adoption of the euro. The pegs were only remnants of a financial stabilization policy, which enjoyed popularity. They stand out as examples of “Fear of Floating,” countries that officially favor a floating exchange rate, but never get around to implement it (Calvo and Carmen Reinhart 2002).

Kosovo and Montenegro are outside of our region, but qualitatively they form a fifth group because they adopted the euro unilaterally, which granted greater credibility to their economies than to, for example, Bosnia, which had a currency board. The euro adoption had this stabilizing effect, although the ECB did not grant Albania or Montenegro any financial support.

The starkest example of overheating because of short-term capital inflows was Ukraine. The dollar peg attracted excessive capital inflows, which increased by 40-50 percent a year from 2002 to 2007. In spite of rising monetization, inflation rose to the double digits inflation in 2004, and in May 2008 inflation peaked at 31 percent year over year. The National Bank of Ukraine (NBU) was locked in an impossible situation as long as it did not let the exchange rate float. In April 2008, Ukraine had a refinance rate of only 16 percent a year and a negative real interest rate of 15 percent a year. Large currency inflows were provided by European banks with subsidiaries in Ukraine. They were caught in a speculative squirrel's wheel. The high inflation allowed commercial banks to charge over 50 percent a year for certain consumer loans in hryvnia, which they could finance at about 6 percent a year in Europe. Large consumer expenditures boosted imports. As a consequence, trade and current account deficits expanded fast, as did private foreign debt (Åslund 2009a).

Of the eight countries in the region with the highest inflation in 2007, we find all the seven countries with pegged exchange rates. A pegged exchange rate attracted short-term capital, that



was monetized and boosted inflation, and the central bank could do little as long as it maintained the peg.

By contrast, Poland stands out as the true success, being the only EU country growing in 2009, and it did so in every single quarter. The reasons for its success are multiple. Thanks to a floating exchange rate, its capital inflows were comparatively limited. The National Bank of Poland (NBP) was adamant about inflation targeting and maintained a very low inflation by keeping positive real interest rates when virtually all other countries failed to do so. The NBP leaned against the wind, when it perceived that asset prices, notably housing prices, were rising too steeply. Unlike other East European countries, Poland introduced special regulations to limit the volume of mortgages in foreign currency, which slowed their growth (Leszek Balcerowicz in Pisani-Ferry and Posen, 2009, 193). With its stellar monetary policy for many years, Poland could get away with a comparatively large budget deficit. Today, it is ironic to read Jiri Jonas and Frederick Mishkin's (2005, 409) words: "Undershoots of the inflation targets have resulted in serious economic downturns that have eroded support for the central bank in both the Czech Republic and Poland." Who would repeat such criticism today?

The countries with currency boards or elementary pegs, the third and fourth groups, were caught in the "impossible trinity" of fixed exchange rates, free capital movements and independent monetary policy. Because of the fixed exchange rate and free capital movement, they could not pursue an independent monetary policy. Their interest rates were determined by the eurozone, which meant that their nominal interest rates were too low and their real interest rates negative. If these countries had hiked their interest rates, the effect would not have been monetary contraction but further attraction of short-term foreign capital given the fixed exchange rate (Åslund 2009b).

The cases of Ukraine, Moldova, and Belarus are not very interesting, because all these countries pursued an elementary policy mistake. They should have opted for floating exchange rates and inflation targeting as their pegs had not clear goal or exit, and they could have done so at any time. A peg without evident exit appears indefensible if inflation starts rising into the double digits.

The three Baltic countries and Bulgaria are more intricate. The Baltic countries fixed their exchange rates when they adopted their currency board regimes in the aftermath of communism in 1992-4,³ and Bulgaria did so during its hyperinflation in 1997. In all four countries, the currency boards had proven highly successful. They had brought down inflation, provided a transparent monetary regime, and achieved high economic growth. None of these countries had

³ Latvia does not have a real currency board regime, but it large imitates a currency board.

been tempted to pursue budget deficits. On the contrary, Estonia and Bulgaria had steady budget surpluses while Latvia and Lithuania had almost balanced budgets. The currency boards held during the Russian financial crisis in 1998.

The dilemma arose when the Baltic countries joined the European Union in May 2004. All three countries wanted to adopt the euro as soon as possible, which was natural as their national currencies were already tied to the euro. Estonia and Lithuania immediately joined the European Exchange Rate Mechanism (ERM II) and Latvia did so in 2005. An EU country that wants to adopt the euro must belong to the ERM II for two years and fulfill a number of conditions before it can be allowed to adopt the euro. These conditions are:

- Average inflation rate one year prior to entry not exceeding the average of the lowest three inflation rates of the EU member countries by more than 1.5 percent.
- The average long-term nominal interest rate must not exceed the average of the corresponding rates of the three lowest inflation countries by more than 2 percentage points.
- The public sector deficit should not exceed 3 percent of GDP and public debt should not exceed 60 percent of GDP.

The ERM II rules prescribe a currency band of +15%/-15% around a “stable but adjustable central rate to the euro” or a pre-announced, fixed exchange rate to the euro, but new entrants, the ECB and the European Union (the ERM II committee) can negotiate the exact exchange rate regime.⁴ The Baltic countries wanted to enter the ERM II with their existing currency boards, presuming that they would be able to adopt the euro within two-three years. The ECB and EU accepted that, but they reneged on the standard ECB commitment to supply automatic and unlimited foreign exchange intervention and financing whenever an exchange rate in ERM II reached its fluctuation margins. At the time, nobody thought much about this, since the Baltic economies were Europe’s star performers, but it turned out to be extremely important.

When the Baltic countries entered the EU, they received a huge and unanticipated capital inflow, which they had no possibility to stop as they had relinquished capital controls and had a fixed exchange rate. Lithuania had planned to adopt the euro from 1 January 2007, but the average annual inflation in Lithuania was marginally higher than the reference value established by the Maastricht Treaty because it included Sweden and Poland that were not euro countries. Therefore, in May 2006 the European Commission concluded that Lithuania was not allowed to adopt the euro (Lietuvos Bankas 2008).

⁴ Marrese 2009, European Union, “Acceding Countries and ERM-II,” Athens, April 5, 2003, EFC/ECFIN/109/03.

Suddenly, inflation caught on, and the euro adoption strategy of the three Baltic countries was blocked. Admittedly, rather than thinking of an alternative strategy they were dizzy with success and weak coalition governments in Latvia and Lithuania could hardly hit the brakes. The IMF warned repeatedly about the overheating in the Baltics and elsewhere in eastern and southern Europe as did independent economists, but to no avail. For example, “By conventional standards, the external imbalances of many of the Central and Eastern European countries are large enough to justify serious concern” and they “stand out for having relatively small official reserves compared to their short-term external debt” (Schadler 2008, 38; cf Lane and Milesi-Ferretti 2007). Few listened in the midst of a tremendous boom. Yet the IMF also warned about large current account deficits in the euro area of Portugal, Spain and Greece, but there nothing happened. Many countries have actually managed large current account deficits for many years.

In effect, the EU entry of the Baltic states put them in an untenable situation. Their decade-old currency boards had won public acclaim, and it was politically impossible to abandon them. Yet, their EU entry led to an excessive capital inflow, rendering control of inflation impossible, and because of their inflation they were not allowed to adopt the euro. The EU and the ECB had no solution to offer.

A curious correlation is apparent between public debt and limited financial crisis. The underlying cause, however, is the exchange rate regime. All the four currency board countries in our sample (Estonia, Latvia, Lithuania, and Bulgaria) have minimal debt because of the budget rules of a currency board regime. However, they were badly hit by the crisis because the currency board regime also implied fixed exchange rates, free capital flows, and thus no monetary policy. The conclusion is not that public debt is beneficial but that the exchange rate policy was the dominant concern.

4. International Financial Support: IMF and EU Cooperation

The two central international organizations at the outbreak of the financial crisis in Central and Eastern Europe were the IMF and the European Commission. Before the crisis, it was not clear how they would act. Would the EC take the lead in EU member countries, or would the IMF do so? How would they be able to cooperate?

In the event, it appeared quite easy and evident. At the annual meetings of the IMF and the World Bank around October 10, 2008, Hungary and Ukraine asked the IMF for financial assistance. The EC ceded to the IMF because the IMF had all that was needed: experienced staff, contractual procedures, controls, and large financing. Instead, the EC contributed with co-financing of the IMF agreements.

Among the countries discussed here, so far, six have adopted new IMF standby agreements during this crisis. Hungary was the pioneer in October 2008, followed by Ukraine in early November. Latvia followed in December, Belarus in December, Romania in May 2009, and Moldova in October.

Quickly, a pattern developed. The EC co-financed IMF standby program for EU members, but it did nothing for the non-EU countries. In the case of Latvia, bilateral funding from individual European countries – the Nordic countries, Estonia, Poland and the Czech Republic – played an important role. As a consequence, the IMF provided only one third of the emergency funds to Latvia, while the EU committed another third, and friendly EU countries the rest. Ukraine, Belarus and Moldova were left to the IMF, but China lent substantial bilateral clearing loans to Belarus and Moldova, and Russia offered slightly smaller bilateral credits.

Three international financial institutions apart from the IMF played an important, supportive role, namely the World Bank, the European Bank for Reconstruction and Development (EBRD), and the European Investment Bank (EIB). All three expanded their lending and focused on the banking sector.

The ECB played hardly any role. Unlike the US Fed, it provided no swaps to Central or Eastern European countries (only to Denmark and Sweden), though it did offer Hungary and Poland repurchase agreements in October and November 2008, respectively. They required highly liquid euro assets so they were of limited significance. Hungary drew on its credit line, while Poland turned to the IMF for a “Flexible Credit Line” facility instead. The ECB did provide substantial liquidity to European banks with subsidiaries in Central and Eastern Europe, but usually assistance is more effective if it goes directly to the target.

The IMF showed that it had learned its lessons from the East Asian crisis in 1997-98, and adjusted its behavior considerably. First, the IMF acted even faster than usual, cutting the time from application to delivery of funds to less than three weeks in the case of Hungary. Second, after all talk in the late 1990s of a post-Washington consensus with multiple structural conditions, the IMF went back to the original Washington consensus with a few elementary conditions, essentially reasonable budget balance, tenable exchange rate policy, decent reserve



management, and energetic bank restructuring. Third, the IMF offered much more financing than before, a natural reaction to the greater financial globalization.

In the winter of 2008-9, great worry raged that the international financial institutions would run out of funding. Both the EU and the IMF reacted. The G-20 meeting in London on April 2, 2009, decided to quadruple IMF resources to about \$1 billion, of which so far \$170 billion has been committed. From the early 1990s, the EU had a facility for balance of payment support for EU member states of €12 billion. It was raised in two steps, first, to €25 billion and then to €50 billion. So far, only €14 billion has been committed to Hungary, Latvia, and Romania. Both organizations seem to have expanded their available financing far more than has as yet proven necessary, but then monetary and fiscal policies throughout the world have been far more accommodating than anybody could have anticipated. Ukraine, however, was left by the EU entirely to the IMF and other IFIs. The EU played almost no role to the east of the European Union, and the ECB did nothing.

As the crisis evolved, all growth forecasts and thus budget predictions deteriorated until the summer of 2009. This was true of both the IMF and the EU. However, the IMF made a very embarrassing error. In its important Global Financial Stability Report published in April 2009, the IMF presented ratios of foreign debt to reserves for the East European countries that were roughly twice as high as the real ratios.⁵ It corrected its mistake, but in the October Global Financial Stability Report, the IMF left out the numbers in an apparent recognition of its weakness. The IMF undermined confidence in crisis countries at a critical time through an elementary arithmetic mistake.

The IMF adjusted by accepting increasing budget deficits and allowing a large share of its funding to be used to finance budget deficits, while IMF loans usually refurbish the international currency reserves of the central banks. Some IMF loan tranches were delayed as is often the case when client governments do not comply with the agreed IMF conditions, but this was reasonably standard.

The worst hiatus occurred in Latvia, where the quarterly tranche meant for March was not disbursed until the end of July. In this case, the Latvian government and the IMF had serious disagreements on the underlying numbers. In early June, the Latvian government foresaw a budget deficit of 9 percent of GDP in 2009, while the IMF mission predicted 15 percent of GDP. Eventually, the European Commission took the side of the Latvian government and decided to disburse on July 2, while the IMF mission made its decision on July 27. Moreover, the EU

⁵ Stefan Wagstyl and Jan Cieski, "Red-Faced IMF Fixes East Europe Error," *Financial Times*, May 7, 2009.



disbursement was several times larger than the IMF tranche, so the EU and the IMF went separate ways with the EU taking the lead (Åslund 2009b).

5. Conclusion: Euro Adoption or Inflation Targeting

Many policy lessons can be drawn from the East European financial crisis. At the time of this writing, the whole region is undergoing a remarkable economic recovery. There are all reasons to believe that this is just a repetition of the East Asian crisis of 1997-8, which was stark but brief. The single cause of both crises was pegged exchange rates, enticing excessive capital inflows and thus causing vulnerability to global disturbances. As the East Asian tiger model proved sturdy in the recovery, the East European capitalism is likely to prove its quality also in the future after this episode of financial crisis.

The first and most obvious lesson is that a dollar peg makes no sense in this part of the world. An ordinary peg lacks credibility because the government has not committed itself to defend it, nor has anybody else. If any peg would be used, it should be denominated in the dominant trade currency, that is, the euro. Hopefully, dollar pegs have now disappeared from this region.

Second, the five currency boards in Eastern Europe (Estonia, Latvia, Lithuania, Bulgaria and Bosnia) lack credibility. They attracted too large funds, leading to excessive current account deficits and inflation, but the capital flew out fast when global liquidity froze. Still, these countries have enhanced the credibility of their currency boards by standing firm. They deserve the euro and their euro adoption should be facilitated, as the IMF has argued.⁶ Concretely, the ERM II period should be minimized, as it has become a stimulus of excessive capital inflows, thus destabilizing the euro candidates.

Third, inflation targeting has proved to work eminently in Poland and the Czech Republic. The conclusion is that inflation targeting should be favored until an EU country can actually adopt the euro. As Jonas and Mishkin (2005, 410) put it: "even after EU accession, inflation targeting can remain the main pillar of monetary strategy..." it should be the obvious choice for countries such as Ukraine and Moldova.

⁶ Stefan Wagstyl, "Central and Eastern EU Nations Should Adopt Euro, Says IMF," *Financial Times*, April 6, 2009.

Fourth, the euro has proven credible both in the countries that officially adopted it (Slovenia and Slovakia) and in the countries that adopted it unilaterally (Kosovo and Montenegro). It is quite an irony that financial operators perceive the monetary regimes of Kosovo and Montenegro are perceived as more credible than those of the virtuous Baltic countries. The euro on its own seems to award the euro countries sufficient credibility even without the support of the ECB. The obvious conclusion is that the expansion of the eurozone should be facilitated, though the overheating of Ireland that is reminiscent of the Baltics provides a caveat. Also within the eurozone capital flows to poorer countries tend to be very large, leading to excessive expansion of their money supply and thus overheating with high inflation (Ahearne, Schmitz, and von Hagen, 2008).

Fifth, with the exception of Hungary, which never undertook a standard post-communist fiscal adjustment, all the countries in the region have displayed decent fiscal policies. Given the degree of overheating they should all have maintained significant budget surpluses, which only Estonia and Bulgaria did, but the standard feature of budget deficit because of pegged exchange rates have not been evident (Tornell and Velasco 1995). The main explanation is probably the Maastricht criteria or the EU's Stability and Growth Pact as most countries wanted to adopt the euro early. An additional explanation is that all remained in shock by the fiscal destabilization after communism.

A sixth obvious lesson is that no government should accept large domestic loans in foreign currency, especially not to consumers, and that they can be regulated away (Goldstein and Turner 2004, Goldstein 2007). This should no longer be a big problem.

A seventh issue is not resolved: the dominant role in Eastern Europe by a dozen of West European commercial banks. These banks greatly contributed to the development of the East European banking sector before the financial crisis and the credit boom, but they were also the engines behind the overheating. Evidently, they were not sufficiently regulated by their domestic financial authorities or by East European regulators. This observation raises the demand for pan-European regulation of multinational banks (Zajc 2006, Haselmann 2006), which the EU is now acting on. When the crisis erupted, the worry was that the West European banks would cut their losses in the east and withdraw. Yet no single western bank has done so, suggesting that they see promising prospects after the crisis. They have also been helped by financial support from their home governments, and the international financial institutions have worked collectively with them to commit not only to stay but also to recapitalize their subsidiaries in the east. Thus far, the West European banks emerge as reasonably helpful.



An eight tentative conclusion is that the IMF has successfully returned to the original Washington consensus with relatively few conditions: a reasonable budget balance and a realistic exchange rate policy, while focusing more on bank restructuring. The IMF has also provided far more money than previously, seemingly heeding Jeffrey Sachs's advice from the early 1990s. Its eventual success, however, depends on its staff's skill in crisis management.

The most controversial issue is the role of the ECB. With little doubt, the ECB has played a positive role within the eurozone by providing large and timely monetary expansion. Through the European commercial banks active in Eastern Europe, this monetary support has also benefited Eastern Europe, but only indirectly. A strong argument can be made that the European Central Bank has contributed to a greater divide between the eurozone and neighboring countries through its generosity to the insiders and stinginess to EU outsiders (Darvas and Pisani-Ferry 2008). The ECB has offered swap loans only to Denmark and Sweden, and not even to perfectly safe Poland or the Czech Republic, while the US Federal Reserve has offered large swap loans to many emerging economies (Obstfeld, Shambaugh, and Taylor 2008).

Especially worrisome is how the ECB did little to warn and nothing to help the virtuous countries with currency boards. If the ECB had provided swap loans to the Baltic states by accepting government bonds denominated in local currencies of noneuro-area EU countries as collateral, as Darvas and Pisani-Ferry (2009) advocated, the Baltic financial crisis would in all probability have been contained.

Through its spectacular inaction, the ECB has earned a black eye by not recognizing any regional responsibility. It is remarkable that the ECB paid no noticeable attention and undertook no action before, during or after the crisis. By not having tried to do anything to resolve the East European financial crisis it looks like a contributing cause, especially by offering flawed incentives in the ERM II. The rest of the world may wonder about its competence to manage European monetary affairs. As Pisani-Ferry and Posen (2009, 5) write:

...the euro did little to improve the crisis response of neighboring countries in Central and Eastern Europe.... Even if the formal mandates of the [ECB] and the Eurogroup ... do not formally include it, broader stability in the region should be a major economic and political objective as well.

Posen (2009, 93) continues:

The global financial crisis has if anything clearly displayed the geopolitical limitations on the euro's global role because the euro area authorities have failed to show leadership even as a regional anchor currency. A successful regional currency role for the euro would entail fulfilling responsibilities toward countries in the region that have adopted the euro as a monetary anchor or whose financial systems are partially euroized.

The big question going forward should be how fast and how to expand the euro. The overall answer is that all the EU countries in the region have a greater interest in adopting the euro because the crisis has proven the extreme danger of not having access to ECB liquidity, and euro countries with large current account deficits did well. The East European EU members fall into two categories, those with currency boards and those with inflation targeting.

All the countries with currency boards want to adopt the euro as soon as possible. Today that should be much easier than before the crisis, when they all had sufficiently balanced budgets and low public debt. Their only hurdle was too high inflation, which has now disappeared. Their new, temporary problem is an excessive budget deficit, but the governments can cut it down and are intent on doing so. When that has been accomplished, these four countries should be let into the eurozone. Estonia can adopt the euro in 2011, according to the IMF, and the others are likely to follow earlier than 2013-4 that is now anticipated as their vigorous anti-crisis measures are likely to lead to a quick recovery. These countries should be given access to ECB credit swaps.

For the inflation targeters, Slovakia stands out as the success model. Rather than pegging their exchange rates in a narrow band to the euro, the euro candidates should maintain the 15 percent band the ERM II allows. Then, the exchange rate can be adjusted when a country actually adopts the euro, as was the case with Slovakia. Yet, the ECB and the EU should consider a revision of the ERM II to offer a more sensible path to euro membership. First, the period of ERM II should be reduced. Second, at the very least a floor should be set for the inflation criterion to avoid the excessively harsh judgment the EU passed on Lithuania's inflation in 2006 or present deflation. Third, ERM II countries should be given ample access to credit swaps in case of need (Pisani-Ferry and Posen 2009, 13; Darvas and Szapáry 2008; Darvas and Pisani-Ferry 2008).

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