Emerging Europe and the Great Recession

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By

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- "Limits of Openness", *Europäische Rundschau*, no. 4, 2009, pp. 93–101 (which is an expanded version of a text published by Politico (*European Voice*) in August 2008);
- "When models crumble", *Hotnews* and *Stratfor*, 25 May 2013;
- "When high finance cripples economy and corrodes democracy", *Eurozine* and *Dilema veche*, 27 July 2011;
- "Who creates Money?", *Opinii BNR* (blog) and *World Commerce Review*, June 2017;
- "The New Protectionism", *World Commerce Review*, Spring 2017;
- "Robustness and Resilience of Social Systems", presentation made at the World Policy Conference, 14 December 2013;
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- "Regaining financial stability': taming financial markets is a must", *Romanian Journal of Economic Forecasting*, no. 2, 2011;
- "Euroarea crisis and EU governance: tackling a flawed design and inadequate policy arrangements", *Acta Oeconomica*, 62(3), 2012; an updated version in D. Dăianu, C. D'Adda, G. Basevi, and R. Kumar, *The Euroarea Crisis and the Future of Europe* (Palgrave Macmillan, 2014);
- "The Governance of the Euroarea: Do external imbalances matter?", *World Commerce Review*, December 2014, and *Central Bank Journal of Law and Finance*, no. 2, 2015;
- "Rediscovering the Logic of Bretton Woods", *Europe's World*, Autumn 2013;
- "A Central Bank's dilemmas in highly uncertain times", *NBR Occasional Paper*, no. 13, 2015 and in Ewald Nowotny *et al.*, *The Challenge of Economic Rebalancing in Europe: Perspectives for CESEE Countries* (Cheltenham: Edward Elgar, 2015);

- "Whither Romanian Capitalism" (with Bogdan Murgescu), *FES International Policy Analysis*, June 2013;
- "Euroarea accession: The question is under what terms" (with Ella Kallai, Gabriela Mihailovici, and Aura Socol), *Romanian Journal of European Affairs*, December 2017;
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Certainly, I bear sole responsibility for the views expressed in this volume.

Last but not least, I thank my son, Matei, whose candour, joy alternating with disappointments, and vibrancy constantly remind me that, however much I am fond of books, life around me is richer and is “alive”.

Preface

Why This Volume?

My experience as a member of the European Parliament (EP) is vivid in my mind. Together with a colleague of mine, the German MEP Wolf Klinz, we organised what was probably the first seminar on the financial crisis in the EP, in March 2008. At that time, quite a few members of the European Commission and many top European policy-makers were in a state of denial as to the magnitude of the financial crisis; for them, the latter was, simply put, “an American affair”. The Lehman Brothers’ collapse and its reverberations across the Atlantic came as a shock that forced a reality check. Since then, disbelief and policy disarray have been highly on display.

An economic recovery has been underway in Europe during recent years. But much of it has, arguably, cyclical roots and has also been driven by unconventional policies of the ECB. We continue to live in a period dogged by “tail events” and high uncertainty. The meltdown of the financial system was averted, but at enormous costs to public budgets. Private debts are still at staggering levels. Claudio Borio, Ken Rogoff, and others are right to highlight the implications of over-debt. The ECB’s unconventional interventions since late 2011 and the Banking Union project seem to have silenced existential worries, but there is still a long way to go in order to end the Euroarea troubles. There is talk about “secular stagnation” in industrialised economies, a notion that we owe to Alvin Hansen and that was resuscitated by Lawrence Summers in Jackson Hole in 2013. Social systems are under siege because of proliferating shocks and rising economic inequality; robustness and resilience remain a huge policy challenge in spite of efforts to create buffers of all sorts. There is also a spreading sentiment that the international financial system is not working well.

The EU and the Euroarea troubles severely impact the New Member States (NMSs), countries that joined the European Union (EU) in 2004 and 2007, or, as this volume uses as a term, *Emerging Europe*. Apart from the impact of the financial crisis, NMSs also have to cope with the flip side of a growth model that relied on massive capital imports, external indebtedness, and a relative neglect of tradable sectors (see also Becker *et al.* 2010). This growth model is rooted in the logic of the single market (ex.: the complete opening of the capital account) and major economic discrepancies; and it contrasts with the evolving model in Asian emerging economies after the crisis of 1997–1998. It is true that economic convergence has been a hallmark of NMSs' evolution in the EU, in spite of the fracas also produced by the financial crisis in these countries. In this respect, it is worth pointing out that NMSs have resumed their convergence towards EU benchmarks in recent years, which is in contrast to divergence and cleavages inside the Euroarea. Nonetheless, the "middle income trap" is looming on the horizon. Therefore, prospects of economic catching up in the EU, in the Euroarea, have to be re-examined under the new circumstances, in the wider frame of what ails Europe and longer term trends in the global economy.

During the past decade, I have been involved in efforts to tackle the current crisis, as a legislator (in the EP) and as a member of the Romanian authorities for the regulation and supervision of financial markets. Together with the late Ieke van den Burg, I co-authored the EP report "The Lamfalussy Follow Up", that deals with the reform of the regulation and supervision of financial markets and that can be seen as in line with other key pieces of reform legislation. I have also attended international policy meetings (as a member of ESMA, IOSCO, ESRB boards, etc.) and academic meetings, and I have written on issues pertaining to the *Great Recession*, Europe's major problems.

The volume *Emerging Europe and the Great Recession* tries to sum up my thinking on where the Union's and Euroarea's pains come from and what lies ahead; it blends my experience as a policy-maker, legislator, and academic. In a way, this volume is a sequel to my *Which way goes capitalism?* (CEU Press, 2009). This new volume aims also at providing an analysis of policy issues that concern the EU's less developed/emerging economies (NMSs), and it is made up of three parts which comprise 15 chapters (including afterthoughts).

The first part of the volume, "Society and the Great Recession", illustrates my thinking on the roots of the financial crisis and its impact on society; the six chapters refer to limits of openness, a crisis of cognitive and operational models, the relationship between finance and economy, money creation, trends that cripple the robustness and resilience of systems, and an "inward-looking syndrome" (a new protectionism) in advanced economies.

The second part is "The European Union and the Great Recession"; its five chapters refer to the linkages between domestic economic cycles and the European financial cycle, the reform of the regulation and supervision of financial markets as a means to regain financial stability, the Euroarea crisis, external imbalances and the governance of the Euroarea, and the international policy regime.

The third part focuses on European Emerging Economies (NMSs) and Romania in particular. Its three chapters refer to policy dilemmas and trade-offs during highly uncertain times, the dynamics of Romanian capitalism, and Euroarea accession.

A final chapter contains afterthoughts on what ails Europe and what should be done about it.

The paradigm I espouse is that markets are a must for entrepreneurship and economic dynamism. But market failures are part and parcel of reality, and these can cause a lot of misery in society unless they are reined in. The approach in this volume is multi-perspective since it embeds NMSs' experience into a wider European context; it also looks at the wider financial picture in order to get a grasp of how derailed finance and rules of the game in the EU have favoured a boom and bust cycle in European economies.

The volume brings together texts that were published in various publications; some of them have been updated or slightly revised for this volume.

In a sense, one could wonder what this volume adds to the current literature on the Great Recession, on the Euroarea troubles, and what lies ahead for NMSs, which is enormous. The IFIs, central banks, European organisations, major international and European think tanks (Bruegel, CEPS, Friends of Europe, Bertelsmann, Notre Europe, CEPR, etc.), universities, individual scholars, etc. are all engaged in a frantic effort to answer the "Big Questions" (*Die Grossen Fragen*). Edward Elgar publishes proceedings of conferences hosted by the Central Bank of Austria, which are dedicated to challenges facing NMSs. It does likewise with volumes issued under the aegis of the European Association for Comparative Economic Studies. Other publishing houses have been involved in similar efforts. But there are reasons to believe that the value added by this volume will not be nil. First, it provides the views of someone who has been (and still is) in the trenches. Second, it tries to blend policy and academic experience. Not least, it voices concerns and dilemmas from the perspective of New Member States, of Romania in particular, in a period of rising uncertainty and policy trade-offs. The volume relies on a relevant literature and the author's own experience.

I thank my colleagues Ella Kallai, Gabriela Mihailovici, Bogdan Murgescu, and Aura Socol, who were kind enough to accept the inclusion

in this volume of papers we co-authored. I am also grateful to all publications which accepted that texts of mine be brought together in this volume.

I express my gratitude to the Center for Transylvanian Studies of the Romanian Academy for accepting that a restructured and revised version of a previous work of mine (*New Europe and the Great Recession*, 2017) be published by Cambridge Scholars Publishing.

This volume would be of interest to all those who wish to get additional insights on the challenges the Union, the Euroarea, and the European emerging economies have faced since the eruption of the financial crisis and will face in the years to come. Its target audience is academia, research outfits, policy-making circles, business circles, and NGOs.

Daniel Dăianu
December 2017

INTRODUCTION

The *Great Recession* engulfed Europe, as it did with most of the industrialised world, about a decade ago. All of a sudden, a simplistic paradigm which equates price stability with financial stability fell into disrepute, and major flaws of finance, as it has evolved during the last few decades, came glaringly into the limelight. Oversized finance, a growing shadow banking sector, and destabilising capital flows, against the backdrop of over-indebted and stagnant economies, test the ability of policy-makers to manage disequilibria and deliver essential public goods. Policy choices are complicated by rising inequality, the erosion of the middle class, and a spreading sentiment of declining fairness in society at large. This set of circumstances strains economies and societies, and foments political extremism.

The financial crisis shed light on basic weaknesses of the Euroarea design and of its policy arrangements. The Euroarea is in a prolonged phase of crisis management; the QE (quantitative easing) programmes of the ECB, in general, are symptomatic of policies having sailed into uncharted territory. The ongoing Greek drama is only the tip of the iceberg; non-existing solid fiscal underpinnings and improper policies have favoured a growing fracture between North and South in the Euroarea. Deep reforms of the Euroarea's institutional setup and structural reforms in its Member States are badly needed in order to make it viable. The refugee crisis adds to a sense of policy stalemate and inadequate ad hoc measures.

"The Five Presidents' Report" of June 2015 is bold when it talks about a joint treasury, a *Fiscal Capacity*, but it still bets on incrementalism in proceeding with institutional and policy change. The same can be said about the reflection paper of the European Commission of May 2017. Thence, the ambivalence of several New Member States (except those which have or had currency boards) regarding a quick Euroarea accession, apart from the need to achieve a critical mass of real convergence.

For the emerging economies of Europe, the New Member States, the Great Recession came as a formidable blow that was felt via several channels. One is a growth model that relied extensively on debt and external borrowing. The crisis entailed quasi *sudden stops*, which hit the Baltic countries, Romania, and Hungary in Central and Eastern Europe.

These countries had to get financial assistance from the IFIs and the EU in order to avert a liquidity crisis turning into a solvency crisis. Another channel of transmission is made up of the trade and financial linkages with the Euroarea, during a period when the latter is being afflicted by intensive deleveraging and is threatened by secular stagnation—a notion resuscitated by Larry Summers in order to emphasise the impact of declining productivity gains, demographics, and prolonged hysteresis phenomena in the industrialised world. This situation is illustrated by very feeble new credit flows and dim prospects of growth in the years to come (as OECD and IMF studies indicate). An economic recovery has been underway in Europe in recent years, but high uncertainties regarding longer term prospects and unintended consequences of unconventional policies (as these are implemented by major central banks) heighten concerns about the future.

The abovementioned context provides the background for the volume *Emerging Europe and the Great Recession*, which deals with the impact of the financial crisis and the Euroarea crisis on the European Union and on the New Member States (viewed as emerging economies) in particular.

Part 1, "Society and the Great Recession", takes a look at the broad picture, at how finance serves, or not, the economy, and is made up of six chapters.

Chapter 1, "Limits of openness", stresses that globalisation (and liberalisation) can be understood in a different vein, which looks at the actual functioning of markets—with their pluses and minuses—and which takes into account insights of economic theory such as information asymmetries, increasing returns (while technological progress is intense—*endogenous growth*), agglomeration effects (clusters), multiple (bad) equilibria, coordination failures, the role of economic geography, and so on. As these theoretical constructs and, a fortiori, the effects of the current financial crisis suggest, there are lessons to be learned: the need for effective regulation of markets; the role of the state in providing public goods; the role of institutions (structures of governance); the need of public goods and effective governance in the world economy; the importance of variety and policy ownership in policy-making.

A combination of two dynamics will arguably develop as a means to preserve an open global economic system, albeit in a restrained form. One dynamic refers to a partial domestication of market forces in national governments' quest to cope with systemic risks and social strain. This would involve more state presence in the economy and broader regulations; elements of "war economy" conduct in public policy will also be quite visible, in liberal democracies too. Ideological propensities are less involved here, for governments act, basically, out of sheer necessity. The other dynamic refers to blocs of countries that decide to use a common currency and trade more intensively among themselves; such arrangements would be a means to avoid brutal disruptions to their internal activities were a global crisis to occur. This is like saying that the global system needs several sub-global clusters in order to mitigate the potentially devastating effects of a completely open world system that would be prone to recurring major crises.

Chapter 2, "When models crumble", observes that the current crisis questions cognitive and operational models that organisations, big and small, private and public, have used in the pursuit of their goals. Much of the rethinking of models is induced by the role played by finance in this crisis. The rethinking of models/paradigms is either deliberate, or it will be forced upon organisations by forces and pressures from outside; it will take place at micro, macro, and international level, be it in a forceful or a protracted and confusing manner. The light touch regulation model has brought havoc in the financial industry and in economy/society at large. Business models have proved inadequate on a massive scale, with their overemphasis on trading and speculation, the use of fancy (toxic) derivatives, and the neglect of risks and of complexity as a trait of contemporary systems. Likewise, regulators and supervisors succumbed to the reasoning that a low inflation rate is equivalent to financial stability and that the spread of derivatives is a means to diminish risks throughout the economic body. Systemic risks have skyrocketed and have compelled central banks and governments to come to the rescue of banks as a means to avert a financial meltdown. What has brought organisational patterns into disrepute, in the end, is a blatant misunderstanding of risks—as the latter were entailed by expanding financial markets. The problem, therefore, is to deal with the very object of regulation and supervision and, consequently, to tame financial markets.

Chapter 3, "When finance corrodes economy and undermines democracy", observes that the "too big to fail" syndrome would maintain a captivity status towards these financial groups on the part of governments. The very logic of a fair market economy is seriously perverted. This is because it is totally unacceptable that losses of the financial industry be recurrently socialised, at the expense of taxpayers, while gains of employees and capital providers of the financial industry be protected in view of "systemic risks". The financial and economic crisis is reinforcing a worrying tendency in Europe and the US: the erosion of the middle class. This erosion can be linked with technological change (which has favoured highly skilled labour in advanced economies), Asia's phenomenal economic growth (which has dented the Western countries' market shares), public policies that have underestimated the role of industrial policies, and, not least, an overexpansion of the financial industry in several economies, at the expense of other sectors. The excessive growth of finance has entailed a marked change in profit distribution in the corporate world and in income distribution in society at large. There is also a huge ethical problem which is exposed by this crisis as well. Big companies are fond of speaking of corporate social responsibility. But where is it when investment banks sell financial products to investors which they short at the same time? Where is corporate social responsibility when companies that make billions of dollars (or euros) in net income pay almost nothing to national fiscal authorities? The way financial markets have functioned in recent decades is not God-given. Public policy can and should change it, as it did after the Great Depression and after the Second World War.

Chapter 4, "Who creates Money?", argues that what matters most for individuals and for society as a whole is what money is used for. There is an older debate, on "who creates money", on the relationship between base money/*outside money* supplied by central banks and the *inside money* created by commercial banks. This dispute should be linked with the equally old observation that the financial system is prone to crises, to instances of panic—to "runs". Is money creation given an additional life by crypto-currencies? It is not clear that crypto-currencies are as trustworthy as some claim them to be. And, in the end, what matters for money to be accepted and used on a big scale is the trust one puts in the issuer and its capacity to deliver what it claims to do. As we can see, central banks have been—as Mohamed El Erian put it—"the only game in town", and the rescuer of last resort—as they are supposed to be. And this is likely to stay so for a long time. This said, however, finance has to change its behaviour, and central banks and governments have a long way to go in order to redeem their reputation when it comes to the regulation and supervision of banks and non-banks alike.

Chapter 5, "Resilience and robustness: when systems are under siege", argues that the world seems to be caught in a vortex of bifurcations, which may land us in a very different environment with much more uncertainty and perils. What may be striking is that a very deep financial and economic crisis has hit most of the industrialised countries, which are presumed to have solid institutional arrangements (though one could argue that no system is immune to the accumulation of tensions over time and that cyclicality is part and parcel of economic dynamics). Economic decline in many economies has caused enormous strain, which shows up in social life and in the political process, too (e.g. stalled institutions of dialogue/negotiation/decision, and extremist manifestations in the politics of mature democracies including augmented chauvinism and xenophobia). The current financial/economic crisis deepens social dislocations that were already at work in quite a few industrialised countries. The crisis of the welfare state, in conjunction with rising income inequality, has weakened a social milieu that was dealt further blows by the financial crisis. Social strain, which shows no sign of abating, is spreading around. There is also the dramatic climate change of the last couple of decades, which indicates basic disorders in the human–nature relationship. Some of these disorders are rooted in societies' disregard for or misunderstanding of ecological needs. The proliferation of extreme events questions the very perception of them being rare. Even though we have ever more information, scientific and technological advance never stops, and societies do not automatically have superior cognitive capacities and capabilities to respond to shocks and challenges. This hypothesis is examined and some avenues for strengthening robustness and resilience are outlined.

Chapter 6 deals with "The inward-looking syndrome" (the new protectionism), which is manifest in more than a few advanced economies (societies). The New Protectionism (NP) can be interpreted in a narrow sense, along the lines of trade/economic relations and in a broader sense, when it covers a vast array of measures targeting national security (which has other dimensions than the pure economic one). In both senses, the liberal order, as it was set following WWII, is questioned. It should be emphasised, however, that a liberal order is not synonymous with market fundamentalism. The world that we seem to be bumping into shows signs of fragmentation, with societies more polarised. More than a few developed states feel threatened and seek self-protection via various measures; protectionist measures are part of a return of the state in the economy. There is a competition between the developed world and the one that is arising, and this contest needs to be managed through clear rules. And rules imply a world order. What would be the result of NP as an economic defence response? It may probably open the door to a prolonged interregnum, with a corrosion of international, global institutional arrangements. Such an evolution is likely to lead to a precarious balance—an unstable equilibrium in international relations.

Part 2 makes an assessment of the main causes of the Great Recession and how it has hit the European Union; it includes five chapters.

Chapter 7, "Domestic cycles, the financial cycle, and policies: what has gone wrong?", takes a longer term, historical perspective on economic dynamics—under the impact of structural trends, globalisation, and policies. This chapter focuses on economic cycles and policies in an international (European) context. The financial cycle is a key concept in the logic of this chapter. The experience of NMSs is amply taken into account. Attention is paid to the linkage between domestic cycles and the European financial cycle, drivers of financial cycles in the global economy, finance deregulation and systemic risks, the international policy regime, and global stability. The Great Recession is examined through the lenses of financial cycles, and likely causes of this very deep crisis are pointed out. The syndrome of ultra-low interest rates is also examined.

Chapter 8, “Regaining financial stability”, highlights the need for a radical overhaul of the regulation and supervision of financial markets. Something pretty wrong has occurred with financial intermediation in recent decades. This is like saying that *structure* has been no less important in derailing economies than misconceived policies and unavoidable cyclical dynamics. By *structure* is meant the configuration of rules and practices in the realm of regulation and supervision, on the one hand, and the evolution and practices of financial institutions, including securitisation and the growth of the so-called shadow banking sector (which has escaped regulations), on the other hand. *Structure* has, arguably, influenced policies in view of the relative neglect of systemic risks and the almost blind belief, by some, in the self-regulatory virtues and clairvoyance of financial markets. For a long time, financial stability was relegated, *de facto*, to a second tier policy priority—especially in advanced economies. The economies of new EU Member States in Central and Eastern Europe have been strongly hit by this financial crisis, although these economies’ exposure to toxic products was quite minimal and their budget behaviours, with some exceptions, were not profligate. What this chapter argues is that this dynamic can be explained by considering the implications of deep financial integration. The latter can bring benefits and rapid growth, which did take place in the region until 2008, but is can also do harm unless proper institutions and policies operate. Moreover, the impact of the current crisis on NMSs illustrates the role of *structure*, of the rules of the game in the EU (complete capital account liberalisation), the nature of regulation and supervision, and not least, massive cross border operations. The case of NMSs is all the more significant since these economies imported capital on a large scale as a means to foster growth—while in Asia and Latin America, the episodes of crisis of the past two decades induced countries to attach a high premium to the accumulation of foreign exchange reserves and the reduction of current account deficits. NMSs look like they have tried to defy the lessons of previous crises by betting on the virtues of deep financial integration.

Chapter 9, “The Euroarea crisis”, focuses on the roots of the huge strain in the Union and on policy issues ensuing from the current crisis. It remarks that the sovereign debt crisis has created enormous anguish in the European Monetary Union (EMU), and emergency measures are being used in order to prevent its breakdown. The European Council summit of October 2010 considered a report with a telling name: “Strengthening economic governance in the EU”. This document should be examined in conjunction with the governance reform proposals issued by the European Commission and related documents. In March 2011, the Council adopted the Euro Pact and the European Parliament approved the “Six pack” measures later in the year. A Treaty on Stability, Coordination, and Governance was signed by 25 governments in March 2012. At the end of 2011, the European Central Bank (ECB) embarked on extending ultra-cheap credit lines aimed at keeping banking groups afloat. And in 2012, the ECB announced its determination to help Euroarea governments via purchases of sovereign bonds in secondary markets. Several meetings of the European Council focused on the setting up of a banking union. However, this *démarche* to reform governance is not an attempt to deal with a *terra incognita*. From the very beginning of the Euroarea, there was some discomfort with its institutional underpinnings, and there were misgivings regarding its optimality as a currency area. This explains why a train of thought also underlines a political rationale for its creation. Likewise, criticism over the way regulation and supervision were established in the Union is not of recent vintage. Moreover, insufficiencies of the Stability and Growth Pact (SGP), with almost all Member States flouting its rules at various points in time, were repeatedly pointed out. This said, however, the flaws of financial intermediation have been less considered by policy-makers and central bankers for reasons which, partially, are to be found in a paradigm which has dominated economic thinking in recent decades.

Chapter 10 deals with “External imbalances and the governance of the Euroarea”. Recent years have brought to the fore a salient feature of the Euroarea and of the global economy: Germany’s current account surplus, with an ensuing debate on its impact on neighbouring economies. This surplus was above 8% of Germany’s GDP in recent years; at about 200 billion euros, it was the largest in the world. Is this surplus a problem, especially when there is such a diminished ability to grow in the economies of the Euroarea, and when there is a need for burden sharing when it comes to the costs of adjustment in a single currency area? The way the Euroarea functions now resembles the gold standard regime of the interwar period, and this should be quite alarming, for we know what that international policy regime contributed to. The talk about a looming economic stagnation in Europe is motivated by a very serious situation. Unconventional monetary policies aimed at breaking the deadlock of the transmission mechanism need to be combined with bold public investment policies which should prop up aggregate demand at the Euroarea level and structural reforms in national economies. What may look optimal at a national level may not be optimal for the Euroarea as a whole. And this is arguably the crux of the matter right now. Structural reforms fully fit the logic of individual responsibility. But however responsible national policies may be, a union still asks for a lender of last resort and tools for dealing with asymmetric shocks.

Chapter 11, "The European Union and the international policy regime", focuses on the international policy regime. The Bretton Woods arrangements could be seen as the epitome of a hegemonic shaping of the international economic regime after the end of the Second World War. But such a view would be questionable for two reasons, at least. First, because there is always a need for an effective international regime, which should foster peaceful interactions among sovereign states. Second, the Bretton Woods arrangements were rooted in the lessons of a huge financial and economic crisis, the Great Depression, and tried to combine regulations applied to domestic affairs with rules covering international relations. The logic of the Glass–Steagall Act (which separated investment banking from commercial operations) and Keynesian macroeconomics applied to domestic finance, whereas pegged but adjustable exchange rates and capital controls were used for the sake of enhancing economic recovery and world trade. What is called the "impossible trinity" (concomitant stable exchange rates, free flow of capital, and independent monetary policy) was taken care of through those arrangements. However, once the USD was delinked from gold in the 1970s, a dynamic was put in motion that gathered tremendous speed via waves of financial deregulation. The Big Bang in the City of London in 1986, the rescinding of Glass–Steagall in 1999, the Commodity Futures Modernization Act of 2000 in the US, etc. have brought in a new era, a rapid growth of finance in the industrialised world, and fuelled deep financial integration in the EU. But darker sides of the new financial system were poorly understood and largely dismissed due to a blind belief in the virtues of market self-regulation and of derivatives. And we have, gradually, got into another huge financial and economic mess, which harms the social fabric of society, and even democratic politics. Add to this the profound Euroarea crisis. As was the case almost 60 years ago, in order to create adequate policies, one has to come to grips with the profound roots of the financial and the Euroarea crises and, arguably, rediscover the Bretton Woods spirit and logic.

Part 3 focuses on emerging economies in general and Romania in particular; it comprises three chapters.

Chapter 12, “A Central Bank’s dilemmas during highly uncertain times”, frames its analysis in a European and historical context. Some of the policy dilemmas are of an older vintage, such as how to deal with massive capital inflows and outflows, or how to combat high inflation when resource misallocation is a burdensome legacy and expectations of high inflation are well entrenched. Other dilemmas are pretty new, or have acquired more salience during the Great Recession. Romania has had to undertake a painful correction of its large macroeconomic imbalances, under very unfavourable international circumstances. Its macroeconomic situation is much better now than when the financial crisis hit during 2008–2009, but a highly uncertain European environment is a major source of concern. The NBR’s monetary policy arrangements (“light” inflation targeting) have provided leeway for mitigating the fallout from the financial crisis, although high euroisation has dented their efficacy. When easing monetary policy, central bankers cannot afford to underestimate the wealth effect and the balance sheet impact which a significant exchange rate depreciation entails. The spectre of stagnation in the Euroarea, financial deleveraging, and unconventional monetary policies pursued by key central banks, combined with the ongoing reform of banking regulation and supervision, a growing shadow banking sector, and the uncertainties regarding the evolution of the Banking Union make up a very complex European context and pose a range of big challenges for the central banks of New Member States (NMSs).

Chapter 13, “Whither Romanian capitalism?”, intends to explore post-communist Romania—its market based economy—from a long term perspective and in a wider context. The focus is on the catch up prospects against the backdrop of the Great Recession’s impact and internal weaknesses. The emphasis is on economic issues, which are blended with social and political insights; the analysis is cast in a comparative framework. Romania joined the EU in 2007 as one of its least developed economies. A catch up process is indisputable as its GDP/capita went up from approximately 23–24% (in PPP terms) of the EU average at the start of this century to about 57% currently. But the country still has to achieve a critical mass of real convergence in order to enter the Euroarea, which is an obligation according to the Accession Treaty. Its basic infrastructure is pretty poor, and a significant portion of the population lives in rural areas. The domestic output is, to a large extent, made up of lower end value added products, although its range is amazingly large. For a long period of time, Romania was an outlier when it comes to inflation—pretty high according to EU standards. In recent years, inflation has come down dramatically owing to trends in the global economy and disinflationary (deflationary) pressures. After the crisis hit in 2009, a major fiscal consolidation took place. However, and as in the case of other EU emerging economies, huge uncertainties and challenges lie ahead; these relate to conceptual frameworks of economic policies in view of the lessons of the Great Recession, rethinking the economic growth model, preconditions for joining the Euroarea, taking stock of developments in the global economy, dealing with effects of the geopolitical strains in Europe (the war in Ukraine, rising disorder in other vicinities of the Union, the refugee exodus), etc. As a matter of fact, these are challenges that face all EU emerging economies to a greater or lesser extent.

Chapter 14, “Euroarea accession: The question is *under what terms?*”, argues that Euroarea accession should mainly depend on the achievement of a critical mass of real and structural convergence, which should diminish the risks of operating in an incomplete monetary union. Accession would also be enhanced by reforms in the functioning of the Euroarea institutions and policies which should deal with asymmetric shocks. The true issue of euro adoption in Romania should be neither “if” nor “when”, but “under what terms” and “how it will be done”. The essential prerequisite for real convergence is raising competitiveness. The analysis shows common problems regarding competitiveness in NMSs in terms of infrastructure, institutional development, business sophistication, and innovation; it points out the scale of risks attached to a premature Euroarea accession. This accession does not require the achievement of the Euroarea average level of GDP/capita (in PPP terms). One can imagine Romania’s accession after having achieved a minimum of 75% of the Euroarea GDP/capita average and the fulfilment of a series of structural conditions against the backdrop of Euroarea reforms. Solid public budget consolidation, which implies low structural deficits, is a must to this end. Geopolitical considerations can speed up accession nonetheless.

The epilogue contains a few afterthoughts on what ails Europe and what should be done about it.

PART I

SOCIETY AND THE GREAT RECESSION

CHAPTER ONE

LIMITS OF OPENNESS

The current world financial crisis compels deep soul-searching and scrutiny of where top politicians and their advisers were wrong. Never mind that stern warnings on the incoming crisis were made by astute economists and financiers years ago. Unfortunately, vested interests prevailed over the cautionary words of Warren Buffett, Edward Gramlich, Alexander Lamfalussy, Paul Volcker, and others. This crisis underlines the pitfalls and dangers of financial deregulation (lack of regulation) in global markets and raises fundamental issues for public governance; it should be seen in conjunction with the resounding fracas of the Doha trade round, with the resurrection of economic nationalism in industrialised economies, which is not of recent vintage, and not least with the geopolitical consequences of the economic rise of China and other emerging global powers. This crisis should be judged against the backdrop of the effects of climate change and of the mounting fear about nearing the limits of exhaustible resources—which raises huge security concerns.

Arguably, coming to grips with the effects of this financial and economic crisis, together with food, environment, drinking water, and energy-related concerns, forces national governments to reassess the advantages of unrestrained economic openness; systemic risks, not only of a financial nature, will increasingly be a focus of the public agenda in the years to come. This reassessment involves more government presence in the economy as well as broader regulatory frameworks; some of it is prompted by the exceptional circumstances of the crisis, but the whole context is undergoing a change of Zeitgeist and policy paradigm.

1. What went wrong?

During the last decades, rapid technological change has reduced transportation and transaction (information) costs enormously and has speeded up the transfer of know-how, albeit in a highly skewed manner, among regions of the world; the internet connects hundreds of millions of people instantaneously nowadays. World trade has expanded at a very