Economic Gaps and Crises in South-East Europe

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Present and Past

Edited by

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and George Virgil Stoenescu

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CONTENTS

LIST OF FIGURES

LIST OF TABLES

FOREWORD

SEEMHN (South-Eastern European Monetary History Network) is an international network that brings together economists, statisticians and historians from the central banks of seven South East Europe countries (Austria, Bulgaria, Greece, Romania, Turkey, Serbia and Albania). Its mission is to shed light on the monetary history of the countries included in the network and to compensate an arguably, scarcity of international economic literature on this European area. SEEMHN was established in April 2006 upon the initiative of the Bulgarian National Bank and the Bank of Greece and over time it has built up its visibility through conferences, seminars and written work—proceedings and volumes.

A SEEMHN conference focusing on subjects related to the economic history in South-East Europe is organized every year. The annual conferences focus on the study of specific phenomena and events connected with South-Eastern European countries, both from a historical and a comparative perspective. In 2016, the annual conference took place in Bucharest, on October 28 and its topic dealt with "Economic Gaps and Crises in South-East Europe: Present and Past". Apart from Austria, the other countries in the region, be they inside the EU or outside it, face major development challenges; they still need "Big pushes", to paraphrase a famous notion used by the development economist Paul Rosenstein Rodan, many decades ago. The conference in Bucharest had its conceptual impulse in a *prise de conscience*: that most of South East Europe has still much to catch up economically with the advanced states of Europe, that the Great Recession as well as major trends and shifts in the global economy pose formidable new challenges.

This volume is made up of seven presentations made at this conference and an additional paper that the editors consider to fit the topic under debate. In their papers, researchers put the spotlights on economic and financial developments, the links between crises and the economic gaps between Europe's core and peripheral economies, the Great Recession, new development challenges, etc. The work covers quantitative and qualitative research, as well as national case studies and cross-country comparative studies. The papers in this volume are: "Domestic Cycles, Financial Cycles and Policies. What Has Gone Wrong?"—by Daniel Dăianu; "Principles, Circumstances and Constraints: The Austrian National Bank as Lender of

Last Resort from 1816 to 1931"—by Clemens Jobst and Kilian Rieder; "Monetary Crisis in Romania in the First Years after the Great Union (1919–1921). Case Study: "Albina" Bank of Sibiu"— by Mihai Drecin; "A Century of Monetary reform in South-East Europe: From Political Autonomy to the Gold Standard, 1815–1910"—by Matthias Morys; "Filling the Gap in Historical Statistics: Macroeconomic Indicators of the Debt Burden of the Kingdom of Yugoslavia during the Great Depression"—by Dragana Gnjatović; "The Role of the Central Bank in Supporting Romania's Economic Catching-up Prior to WWI"—by George Virgil Stoenescu, Adriana Aloman, Elisabeta Blejan, Brînduşa Costache; and finally, "Which Way Goes Romanian Capitalism?—Making a Case for Reforms, inclusive Institutions and a Better Functioning European Union"— by Daniel Dăianu and Bogdan Murgescu.

This volume is intended for the use of central bankers, members of the academia and researchers interested in European economic history with a focus on the South-Eastern European experience.

We feel bound to mention that that SEEMHN set up a Data Collection Task Force (DCTF) in 2006. Recognizing the need for reliable data as a basis for empirical studies, the seven central banks mentioned have cooperated since 2006 to establish a database of 19th and 20th century monetary and financial data for South-Eastern Europe. This data volume represents, arguably, a milestone in the joint endeavor to publish harmonized long-run time series on monetary, financial and other macroeconomic variables. The data volume is entitled South-Eastern European Monetary and Economic Statistics from the Nineteenth Century to World War II and was published in 2014.

We thank the National Bank of Romania, Governor Mugur Isărescu and his collaborators, for the support given in order to have the event of 2016 in Bucharest happen in good conditions and hope that this volume will add to the knowledge about this region of Europe.

The Editors

INTRODUCTION

This volume comprises papers that were presented at the SEEHMN annual conference which took place in Bucharest in 2016 plus an additional piece that the Editors felt fits the topic under debate. The focus of the Conference was “Economic Gaps and Crises in South-East Europe: Present and Past”.

The conference in Bucharest had its conceptual impulse in a stark reality: that most of South East Europe has, still, so much to catch up economically, that the Great Recession as well as major trends and shifts in the global economy pose formidable new challenges, that a *middle income trap* can be very much alive in this region, that poor institutions are a huge handicap for economic development. In their papers, researchers put the spotlights on economic and financial developments, the links between crises and the economic gaps between Europe’s core and peripheral economies, the Great Recession, globalization, etc.

In a keynote speech entitled “Domestic Cycles, Financial Cycle and Policies: What Has Gone Wrong?”, **Daniel Dăianu** takes a longer term, historical perspective at economic dynamics—under the impact of structural trends, globalization and policies. This author 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 European emerging economies 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.

Clemens Jobst and **Kilian Rieder** are the authors of the chapter “Principles, Circumstances and Constraints: The Austrian National Bank as Lender of Last Resort from 1816 to 1931”. This chapter provides a discussion of the role the Austrian central bank played as a lender of last resort (LLR) during selected episodes of financial distress from the Nationalbank’s foundation in 1816 until the Creditanstalt crisis of 1931. Based on evidence, free lending as advocated by British economist Walter Bagehot was historically the exception rather than the rule in Austria, and no clear evolution toward more "free lending" is observable over time. The panic of 1912, a particularly fascinating example of a "forgotten" crisis that has never been investigated in detail, serves as our benchmark because the Nationalbank's crisis management during this specific episode comes very close to an effective case of free lending. Instances of credit rationing during other financial crises seem to have emerged as a consequence of public doubts about the value-storing capacity of banknotes and due to a lack of discountable or pledgeable assets resulting from the Nationalbank's regulations and/or risk management framework. This study echoes earlier literature in the field, underlining the importance of the microeconomics of last resort lending, including the incentive structure of lending programs and the *ex ante* supervision of counterparties.

Mihai D. Drecin is the author of the chapter "Monetary Crisis in Romania in the First Years after the Great Union (1919–1921). Case study: The "Albina" Bank in Sibiu". The documents retained in the archives, the economic press of the time, and the specialized published literature show that the Albina Bank of Sibiu, the oldest and most important Romanian credit institution in Transylvania, played a significant role in the country's overcoming the economic and monetary crisis in the first years after the Great Union. The Romanian banking system in Transylvania established a connection with the national banking system managed by the National Bank of Romania (NBR) headquartered in Bucharest, and replaced the Austro-Hungarian korona with the NBR leu. Iosif Lissai, the Director General of the Albina Bank of Sibiu between 1915 and 1920 also played a very important part in the strengthening of the national spirit of the young Unified Romania.

In the chapter "A Century of Monetary Reform in South-East Europe: from Political Autonomy to the Gold Standard, 1815–1910", **Matthias Morys** documents and analyses monetary reform in Bulgaria, Greece, Serbia and Romania from 1815 (Serbian autonomy within the Ottoman Empire) to 1910, when Greece became the last country in the region to join the gold standard. He explains five key steps of monetary reform which the four countries passed in the same chronological order, and ask why national coinage and the foundation of a bank of note issue came late in the reform process. The South-East European countries tried to emulate West European prototypes, yet economic backwardness meant such institutions were often different from the onset, remained shortlived or both.

Dragana Gnjatović is the author of the chapter "Filling the Gap in Historical Statistics: Macroeconomic Indicators of the Debt Burden of the Kingdom of Yugoslavia during Great Depression". This chapter focuses on the specific causes of the sovereign debt default of the Kingdom of

Yugoslavia in 1932. In the first part of the paper, the time series of the public debt with the subcategories of domestic and foreign public debt for the period from 1929 to 1939 were constructed on the basis of data from the Statistical Yearbooks of the Kingdom of Yugoslavia and the League of Nations. In the second part of the paper, the sustainability of the Kingdom of Yugoslavia's public debt is measured with the help of relevant macroeconomic indicators: public debt-to-GDP ratio and debt-service-to-public-revenue ratio. In the third part of the paper, the decomposition of public debt data has been carried out in accordance with the methodology used in the Statistical Yearbook of the Kingdom of Yugoslavia. This decomposition shows that public debt accumulation had to do little if anything with the Great Depression, and was to a large extent caused by the political, economic and financial consequences of the Great War.

George Virgil Stoenescu (coordinator), Adriana Aloman, Elisabeta Blejan, and **Brîndușa Costache** are the authors of the chapter "The Role of the Central Bank in Supporting Romania's Economic Catching-up prior to WWI". The authors show that the latter half of the 19th century, especially the last four decades, saw a far-ranging process of modernisation undertaken in several areas, institutions as well as social and economic relationships. Agriculture, a traditional and prevalent sector of the Romanian economy, was least supported by the modern state's institutions compared to its share in national output. Nevertheless, the central bank attempted to sustain farming and this paper focuses on the instruments used by the NBR in supporting credit institutions that ensured funds for farming (Agricultural credit institutions, Creditul Agricol bank, Central House of Credit Cooperatives, Collateralised Credit Institutions for Agriculture and Industry, Rural Real-Estate Credit, Agricultural Bank). The most used instruments were discounting farming-related drafts, granting loans backed by land certificates, granting loans in the current account/government-backed loans—loans backed by drafts signed by the farmers and guaranteed by the state. The main sources for the data were the NBR's balance sheets from 1881 to 1916 and the "Reports of the Board of Directors and of the Audit Committee submitted to the General Meeting of Shareholders of the National Bank of Romania".

Daniel Dăianu and **Bogdan Murgescu,** in "Which Way Goes Romanian Capitalism?—Making a Case for Reforms, inclusive Institutions and a Better Functioning European Union", intend 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 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/head went up from approximately 23-24 percent (in PPP terms) of the EU average at start of this century to about 57 percent 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 the rural area. The domestic output is, to a large extent, made 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, more or less.

CHAPTER ONE

DOMESTIC CYCLES, FINANCIAL CYCLES AND POLICIES: WHAT HAS GONE WRONG?

DANIEL DĂIANU*

Abstract

The financial crisis and its ensuing effects have brought back into the limelight the issue of cycles and of policies which fuel or mitigate crises. Cognitive and operational models in economics and business are questioned. There is a specter of much lower economic growth in the industrialized world. Central banks are over-burdened. This makes central bankers' lives much more complicated and obfuscates the boundaries between monetary policy and fiscal policy, especially when financial stability gets to center stage. New systemic risks show up in capital markets. The eurozone has escaped collapse owing to the European Central Bank's extraordinary operations and large macro-imbalance corrections in its periphery, but major threats persist. This paper focuses on economic cycles and policies in an international (European) context.

Comments made by Adrian Alter (IMF), Mihai Copaciu (National Bank of Romania), Mojmir Hampl (The Czech National Bank), Laurian Lungu (Cardiff Business School), Pawel Samecki (National Bank of Poland), Gyorgy Szapary (National Bank of Hungary), and Radu Vrânceanu (Paris, ESSEC) are much appreciated. Data assistance provided by Wilhelm Salater is acknowledged. I bear sole responsibility for the views expressed in this paper, which was published as a CASE Working Paper 5 (129), 2017; an earlier version appeared also as an NBR Working Paper, No. 26, 2016.

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Attention is paid to linkages between domestic cycles and the European financial cycle, drivers of financial cycles, finance deregulation and systemic risks, ultra-low interest rates, the international policy regime, and global stability. The experience of European emerging economies is taken into account.

Keywords: financial crisis, financial cycle, secular stagnation, debt overhang, low interest rates, policy rates, fiscal policy, monetary policy, emerging economies

JEL classification: E31, E32, E44, E51, E62, F21, F34, F44, F62

1. Introduction

The last decade was dominated by a financial crisis that engulfed the industrial world—the "Great Recession" to differentiate it from the *Great Depression,* which plagued the fourth decade of the past century. Averting the meltdown of the financial sector, which was seen by most policy-makers and academics as a must in order to prevent a generalised depression, forced governments and central banks to resort to highly increased budget deficits and massive injections of base money (quantitative easings).

This financial crisis and its ensuing effects have brought back into the limelight the issue of cycles and of policies which fuel or attenuate crises. The glorious decades of post-war economic reconstruction after the Second World War and Keynesian policies, which were a hallmark of that period, came to a halt in the 1970s. *Stagflation* and the excesses of Keynesian policies led to a rethinking of the dominant paradigm. Central banks gained more independence, and monetarism, which was based on rules (control of monetary aggregates, or the inflation targeting regime with Taylor-type rules), gained prominence. But the Great Recession has highlighted the limits of a thinking that equates price stability with financial stability. "The problem of depression prevention" has resurfaced strongly[1].

Cognitive and operational models in economics and business are questioned, and how to model non-linearities (tail events) is a big challenge, as is the integration of finance into macroeconomic models (Brunnermeier *et al.*, 2011; Borio, 2012). There is a paradigm shift underway. Conventional and non-conventional shocks (including cyber-attacks and big frauds) proliferate and harm system robustness and resilience. Rising complexity

[1] Dani Rodrik quotes Robert Lucas, who asserted in 2003 that the problem of "depression prevention" had been solved (2016).

and the inability to understand it is further proof that there is a need for simple, more transparent finance. Once again, the realm of influential ideas and policies is going through a period of “soul searching”—of re-examination and rethinking of models.

There is a spectre of much reduced economic growth (stagnation) in the industrialised world: *balance-sheet recession* (Koo, 2011), *secular stagnation* (Summers, 2014), and *supercycles* (Rogoff, 2015) all are linked with, among others, demographics, debt overhang, income inequality, technical change, and zero-sum games in the world economy[2]. There are massive social and political implications from the economic slowdown and rising economic inequality. International policy coordination is often ineffective, although the G20 does play a role in the reform of finance. Finance continues to have destabilising features (Stiglitz, 2010; Blanchard and Ostry, 2012) despite efforts undertaken to reform its regulation and supervision.

Central banks are overburdened in many countries; they can no longer rely on simple rules (like Taylor’s rule). This makes central bankers’ lives much more complicated and obfuscates the boundaries between monetary policy and fiscal policy, especially when financial stability gets to centre stage. Shadow banking brings about new systemic risks.

The Euroarea has escaped collapse owing to the European Central Bank’s (ECB’s) extraordinary operations and large macro-imbalance corrections in its periphery. But major threats persist: debt deflation could rekindle the menace of a break up; the link between sovereign debt and bank balance-sheets has not been severed (and it may be quite unrealistic to think that a total delinking is feasible)[3]; market fragmentation is still alive, although the periphery pays much less currently for issuing its debt (primarily due to the ECB’s special operations); and internal demand in most of the Euroarea is suffering from negative loops between weak activity, fragile banks, weak firms, diminished incomes, and the need for fiscal consolidation, among other things.

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[2] Paul Samuelson has talked about such type of economic competition in the global economy where emerging economies combine modern technologies with very cheap labour (2004).

[3] The only entity which has taxation power, irrespective of how financial markets deem its reputation, are governments. Safe bonds (based on the securitisation of sovereign bonds, as Brunnermeier *et al.* (2016) propose) may help weaken the “diabolic loop” between sovereign and bank balance sheets, but a final solution demands, arguably, genuine fiscal integration in the euro area. Moreover, safe assets cannot be increased by securitisation in a fundamental sense; their amount hinges on how sound economies are.

Policy-makers in European emerging economies (EEEs) are facing major policy dilemmas. Can catching up be resumed under the "new normal"? Is "secular stagnation" the probable scenario for the industrial world and how would that impact EEEs? Can the economic growth model be reengineered and rely more on domestic savings? Can policies be devised to mitigate the amplitude of financial cycles? What is the role of macroprudential policies in this regard? Is banking going to change profoundly?[4] Such questions concern EEEs tremendously. Most of them have benefited considerably from the proximity of the European Union (EU) and from becoming Member States. However, despite impressive catching up during the past 10–15 years, economic gaps are still significant, and there is substantial variation among the EEEs. The Czech Republic, Slovakia, and Hungary seem to be well inserted into the EU's core industrial networks; their GDP/capita is quite high among the EEEs. Poland is a special case because it avoided a recession after the crisis erupted. Conversely, because of very large external imbalances and massive short-term borrowing, Romania and two of the Baltic economies went through very hard times once the crisis erupted and the freeze of financial markets forced them to ask for financial assistance from the EU and International Financial Institutions (IFIs). Currently, the broad picture is much better in these economies, too.

This chapter focuses on economic cycles and policies in an international (European) context. The financial cycle (Borio, 2012) is a key concept in the logic of the discussion. Attention is paid to the linkage between domestic cycles and the European financial cycle, drivers of financial cycles, finance deregulation and systemic risks, the international policy regime, and global stability. The experience of EEEs is amply taken into account. Section 2 deals with the impact of financial cycles on domestic economic cycles and considers the past decade in the EU in this respect; Section 3 considers the *Great Recession* through the lenses of financial cycles and points out likely causes of this very deep crisis; Section 4 examines the syndrome of ultra-low interest rates; Section 5 judges macroprudential policies when markets are deeply interconnected; and Section 6 sketches a policy agenda under the "new normal". Final remarks conclude the chapter.

[4] The disenchantment with debt-fuelled growth and credit-fuelled financial cycles make some think that a fundamental change is needed in banking. Some air again the Chicago Plan idea (Benes and Kumhof, 2012) by criticising fractional reserves systems. Mervyn King, the Governor of the Bank of England until 2013, is also highly critical of current banking models (2016). See also John Kay (2015) and Adair Turner (2016, a).

2. Domestic cycles and the financial cycle: The story of a big bubble

There are several perspectives from which to judge EEEs after the fall of the Berlin Wall. One is the transition to a new economic and political regime, which has called for privatisation, price liberalisation and the opening of the economy, institutional reforms, and the introduction of *hard budget constraint*[5]. The "transformation recession" (Janos Kornai, 1994) of the years 1990–1992, following a series of deep institutional changes and the introduction of market-based mechanisms, portrays the transition to a new economic regime. In Hungary and Poland, transition was, to a certain extent, much easier due to reforms which had been undertaken before the fall of the command system. In other countries, reforms followed a more tortuous path and a new episode of recession visited some of them (e.g. Romania and Bulgaria) during the first decade of this transition. Overall, it became increasingly clear that the burden of the past, structural rigidities, and the power of habits condition change considerably. Post-command transition can be seen as a peculiar long cycle, which can be compared with "Kondratieff cycles"[6] to the extent that regime change brought about inflows of new technology and entailed better resource allocation and higher efficiency.

Another approach for reading transition in EEEs is the EU accession process. Not only did the EU accession process help the EEEs build their new institutional setups, but the big rise of investment in the past two decades can also be explained by their coming closer to and joining the EU. An EU integration-related cycle can, therefore, be detected for the economies that joined the EU in 2004 and 2007.

It is also worth focusing on the cycle that links national economies with the Single Market, with the dynamic of the financial system and of credit; this is the financial cycle, which refers to the expansion and the ebbing of credit (Borio, 2012). This cycle is longer (10–15 years, or possibly longer) than a business cycle. As Kenneth Rogoff (2015), Claudio Borio (2012, 2014), and others show, financial cycles are accompanied by over-borrowing (debt overhang). The financial cycle concept is key to understanding the role of finance in the motion of

[5] Janos Kornai pointed out that in command economies, soft budget constraints are ubiquitous (1980).

[6] Nikolai Kondratieff is a Russian economist who died in a gulag in the 1920s. He is known for his research on very long waves of economic activity which can be seen similar with Schumpeter's description of secular cycles, and which are linked with clusters of key (revolutionary) technologies.

economies, with their upswings and downswings, which are caused by money non-neutrality in a deep sense. The financial cycle approach should be contrasted with the real business cycle (RBC) approach, for which money (finance) plays an insignificant role.

The New Keynesian macro modelling, on which the inflation targeting regime is based (Clarida *et al.*, 1999; Galli, 2015), has, arguably, underestimated the role of finance, of its overexpansion in amplifying cycles and augmenting systemic risks. As the current deep crisis shows, the neglect of finance, the almost blind belief in the self-regulatory virtues of markets and in the non-existence of major market failures, has crippled the ability to think of and mitigate systemic risks, leading to major misunderstandings of what drives economies up and down. Borio puts it quite ominously by saying that "without finance, macroeconomic models are like Hamlet without the prince" (VoxEU, 2013)[7]. Central Banks have been implementing inflation targeting while paying insufficient attention to monetary aggregates (see also Weber, 2015).

As Borio says, financial cycles are shaped by self-reinforcing interactions among perceptions of value and risk, which translate into booms followed by busts (2012). This evolution is correlated with a big rise in debt (private) relative to income (GDP). A key tenet of the financial cycle paradigm is that financial liberalisation enhances the amplitude of financial cycles. Another tenet is that a one-sided (focused exceedingly on inflation) monetary policy is inadequate because it precludes the adoption of macroprudential measures (MPMs) that could mitigate boom and bust dynamics and resource misallocation. Borio and Disyatat (2012) talk about a "policy drift" when there is maintenance of low interest rates for too long. Such a drift would accentuate over-borrowing and debt overhang. The financial cycle, as an analytical construct, provides an illuminating explanation for boom and bust dynamics. This is clearly evident in Europe during the past decade, and not just in a few EEEs, but in the Euroarea as well. In the Baltic economies of Romania, Bulgaria, and Hungary, credit expansion was staggeringly high in real terms over a period of several years. Figure 1–1 illustrates the evolution of credit and economic growth in various groups of European countries; the explosion of credit in the pre-crisis years and its implosion after markets froze are quite visible.

[7] See also Brunnermeier *et al.*, 2012.

Fig. 1–1. Bank lending and GDP growth

Source: Eurostat, European sector accounts (national central banks; other monetary financial institutions), own calculations (see Dăianu in Nowotny *et. al,* 2016, p. 201)

Notwithstanding the lessons of the Asian crisis of 1997–1998 and similar episodes of crisis in Latin American economies, international financial institutions and the European Commission continued to urge quick financial liberalisation. While Romanian policy-makers did try to sequence the opening of the capital account, the EU rules of the game (the Single Market) forced a faster pace which, ultimately, enhanced a boom-and-bust cycle[8]. Central Banks' attempts in EEEs to stem the skyrocketing pace of credit growth was offset due to euroisation (especially where it was massive) and parent bank funding, and possibly also due to little experience with what are now called macro-prudential tools and the sheer size of capital inflows (Dăianu, 2015). Hélène Rey's insight that the *impossible trinity* (trilemma) turns, when a global financial cycle operates, basically into a "dilemma" (2013), and that capital controls could play a useful role in mitigating the destabilising features of massive capital flows is quite relevant. This is why major central banks have a key responsibility in considering their monetary policies and the ensuing externalities. Both Rey's "dilemma" and the "Tošovský dilemma" indicate how hard it is to conduct an effective monetary policy in small open economies when facing substantial capital flows.

The ample boom-and-bust cycle was not limited to EEEs, but also hit other large parts of the EU (see Figure 1–1). While making sense as a direction of movement, downhill flows did not move into tradable sectors in the main. Romania, the Baltic economies, Bulgaria, and Euroarea economies like Spain and Ireland received enormous amounts of private capital which drove up external imbalances. It may be that a European financial cycle[9] was reinforced in the EU after the introduction of the euro and against the backdrop of financial markets' myopia regarding the performance differences among various economies (Dăianu, 2015). Much of the inflow was private borrowing, and, as in the Asian crisis of 1997–1998, financial markets were found to care, in the end, about the overall external indebtedness of an economy, albeit driven by the private sector[10].

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[8] In a domestic debate at the time on the pace of financial liberalisation, which went beyond the implications of the "Tošovsky dilemma", supporters of fast financial liberalisation faced proponents of a cautious approach (Dăianu and Vrânceanu, 2002) which considered the structural features of emerging economies, the threats posed by hot money, and the need to sequence financial liberalisation. For an analysis of the economic cycle in Romania, see the Annex.

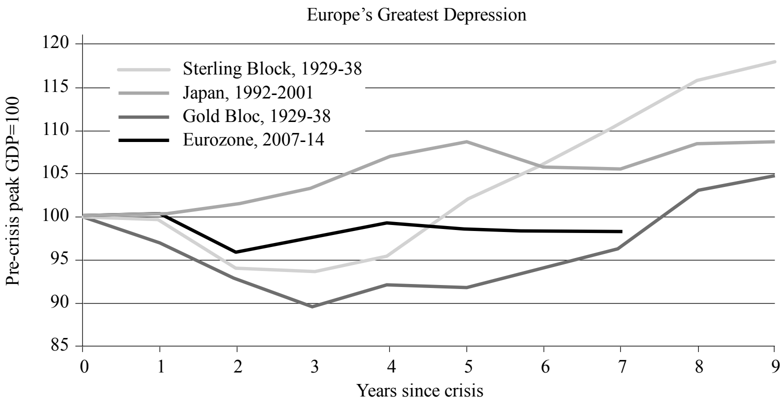
[9] Were it to operate, a European financial supercycle would mix with what the Bank for International Settlements experts (Borio, 2012) call the *global financial cycle*.

[10] This part of the analysis relies on Dăianu (2015), especially when it deals with the pace of financial liberalisation.

One can draw an inference about the importance of private borrowing in judging resilience to shocks and the triggering of balance of payments crises. Some new EU Member States faced a liquidity crisis as markets froze, with external financial support and the *Vienna Initiative* being instrumental in averting a worst-case scenario.

How serious the situation has been in Europe during this crisis is illustrated by Figure 1–2, which compares the *Great Recession* in the EU with the crisis of the sterling bloc (1929–1938), the crisis of the gold standard bloc (1929–1938), and the crisis in Japan during 1992–2001. By 2014, the level of output in the Euroarea was below that of 2007. And, as IMF and OECD studies suggest, there is a high chance of a significant economic slowdown in the years to come due to demographics, technological change, the burden of over indebtedness, and hysteresis, among other things. One should not forget that in several Member States, unemployment has risen above 20 percent during these years, which can be compared with the fall of employment in the US in the Great Depression (when a quarter of the workforce was jobless). And the average rate of unemployment in the Euroarea is still hovering around 9 percent, while it is below 5 percent in the US.

Fig. 1–2. "The big impasse" in Europe



Source: Wonkblog, Barrelperday (5 September, 2014)

3. When the financial cycle meets "secular stagnation"

The Great Recession has stunned many policy-makers and academics, for the Great Moderation period obscured the significance of a big rise in indebtedness (both public and private) and the exponential growth of finance against the backdrop of financial deregulation.

There are several issues for debate when considering how a financial cycle ends up in such a deep financial and economic crisis. One issue is related to structural trends, which predate the start of the financial crisis, and which have, arguably, fuelled the financial cycle. Finance deregulation has been a key driver in this respect. While cycles and crises are unavoidable (Minsky's *financial instability hypothesis*, which has its roots in Keynes' works), their amplitude depends on various factors and on the functioning of finance.

While the financial crisis plays a major role in the current economic malaise, *secular stagnation* (Summers, 2014) should be judged in terms of a long-run decline in productivity, demographics, technological change, and rising income inequality, among other things. OECD studies[11] show that potential growth in the EU slowed from about 2.5 percent in the late 1990s to 2 percent during 2005–2007, while the growth trend in the 1970s and 1980s was around 5 percent on average. An analogous evolution can be ascribed to the US economy, too, over that period of time (see also Gordon, 2014). The impact of the financial crisis is also significant: estimates are that the Great Recession has brought GDP potential growth below 1.5 percent in the EU for the next 5–10 years (Rawdanowicz *et al.*, 2014). Low and ultra-low interest rates come into the picture in this context (see Section 4) as they juxtapose the dynamics of saving and investment over the longer term (William and Laubach, 2003, Figure 1–3, quoted by Summers, 2014; Figure 1–4), which are also shaped by the financial crisis. Technological optimism (e.g. robots, information technology) versus pessimism is also an issue for contention. Finally, what is the role played by debt overhang (Rogoff, 2014)—of big debts in the public and private sector? Balance-sheet recession (Koo, 2011) is to be highlighted in this context.

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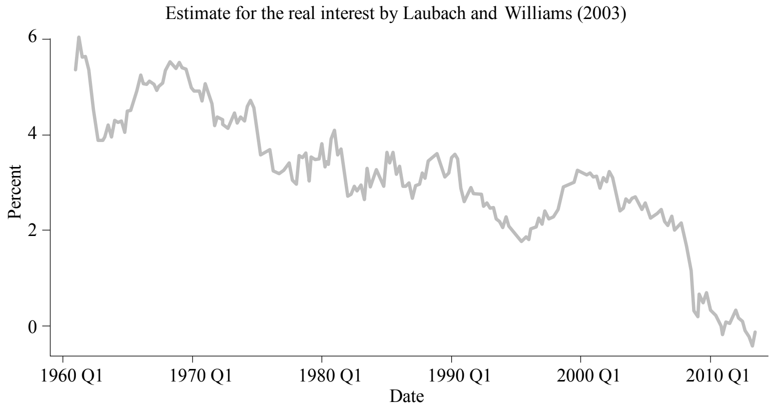
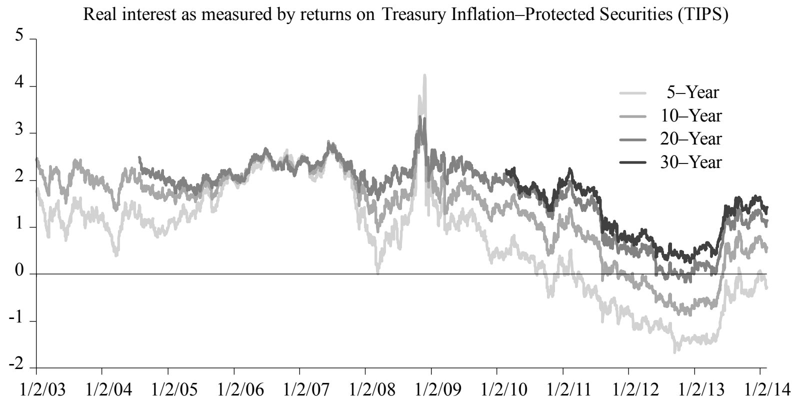
[11] Rawdanowicz *et al.* (OECD, 2014).

Fig. 1–3. Evolution of real interest rates (William and Laubach, 2003)



Source: Summers (2014)

Fig. 1–4. Real interest rate



Source: Summers (2014)

It is common sense to say that cycles cannot be avoided. But their amplitude is, arguably, influenced by policies. And it is a fact that, for the past four decades, a simplistic paradigm underpinned the policies of central banks and regulators. This paradigm (based on *the efficient markets hypothesis*) equates price stability with financial stability and has under-estimated systemic risks. And as the financial crisis shows, it has also downplayed the role of debt in the funding of economic activity

(Modigliani–Miller theorem[12]) and could not capture tail events (non-linearities).

Competing narratives try to explain the current economic malaise, among which are:

- the deregulation of financial markets;
- lax monetary policies: a long cycle of boom and bust in advanced economies (the Great Moderation), which was littered with episodes of possible major tremors, which were prevented by central bank intervention (e.g. the Long Term Capital Management debacle and the indirect Federal Reserve (Fed) intervention); and
- structural tendencies, including the *glut of savings* (Bernanke, 2005) and the scarcity of safe assets (Caballero and Fahri, 2014).

These narratives can be brought to a common denominator. A "drifted" financial cycle has, arguably, been at work in the global economy during the past two decades. This drifted cycle is reflected by *oversize finance* (Pagano *et al.*, 2014), rising debt overhang, and huge fragilities in highly interconnected markets. As BIS experts point out, the Great Moderation years hid a huge resource misallocation (Caruana, 2014)[13], which shows up in "debt overhang" and a "balance-sheet recession".

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[12] The Modigliani–Miller theorem says that equity and debt are equivalent in funding a business. This may have bolstered the inclination to borrow and to use high leverage.

[13] "Structural strain" can provide an analogy to overburdened monetary policy during the current financial and economic crisis. Following the collapse of the command system and a dramatic change in relative prices, many enterprises were found to be unprofitable and faced increasingly hard budget constraints. The system, due to its rigidities, was incapable of undergoing massive resource reallocation rapidly. Hence the need to subsidise firms and even sectors involving the monetisation of quasi-fiscal deficits. Firms themselves created their own pseudo-money via inter-enterprise arrears. This quasi-fiscal task of central banks during the initial stage of post-command transition resembles the quantitative easing practiced during the current financial crisis by major central banks in advanced economies—a similar fiscal dominance takes centre stage, blending two policy tools. But inflation is very low in the economies afflicted by the financial crisis, whereas money printing after price liberalisation in post-command economies created high inflation (since inflation expectations were fairly high after years of suppressed inflation and because money balances were considerable). This is due to an overwhelming liquidity trap and low or even declining inflation expectations in advanced economies. This difference explains why tolerating high inflation, in the initial years of transition, entailed the threat of entrenched high inflation expectations (Dăianu, 1994, 1997).

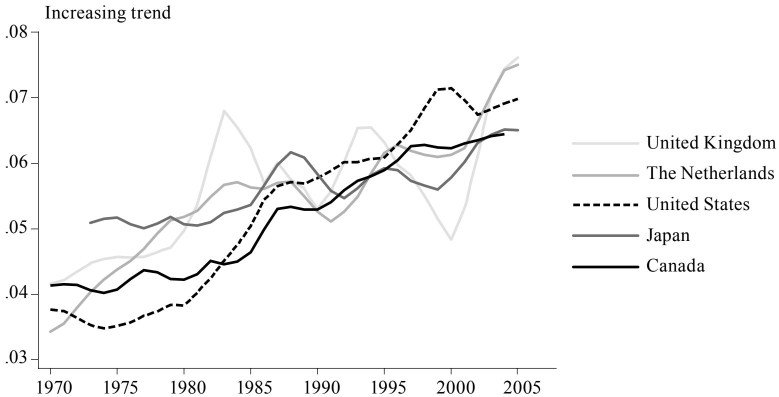
3.1. Finance deregulation

Finance deregulation, arguably, has played a major role in derailing the financial cycle. Key moments were in 1986, 1998, and 2000 (the Big Bang in the UK and the promotion of "light touch regulation", the repeal of the Glass–Steagall Act, and the Commodity Futures Modernization Act in the US, among other moments). As Greenwood and Scharfstein (2013) show, finance has grown enormously during the last three decades. In 2006, finance contributed 8.3 percent to US GDP, compared to 4.9 percent in 1980 and 2.8percent in 1950; the financial share of GDP increased at a faster rate since 1980 (13 basis points of GDP per annum) than it did in the previous 30 years (7 basis points of GDP per annum).

Oversized finance and volatile financial markets make the whole system more unstable and prone to sudden stops; financial deregulation amplifies financial cycles, booms and busts. It is likely that there is an optimal degree of economic/financial openness (Stiglitz, 2010). The recent backlash against globalisation is proof in this regard.

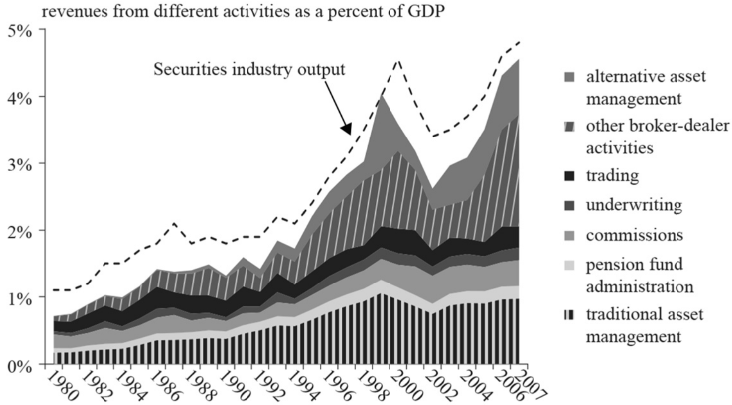
Financial deregulation stimulated credit expansion (Reinhart and Rogoff, 2010), the development of shadow banking (Figure 1–5), a rise in interconnectedness, and an increase in the fragility of the international financial system.

Fig. 1–5. Value added shares of finance in GDP



Source: Phillipon and Reshef (2013, p. 81)

Fig. 1–6. Growth of securities industry 1980–2007



Source: Greenwood and Scharfstein (2013, p.9)

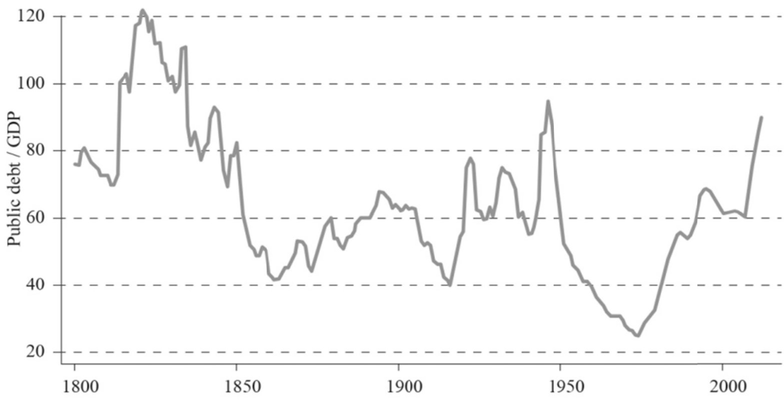
3.2. Debt overhang

When is debt too much? It depends on the circumstances, as the current financial crisis amply shows. This crisis, itself, was invited by the binge of borrowing during the Great Moderation period. Balance of payments crises, too, signal too much indebtedness (and the latter itself can trigger such crises). *Debt overhang* harms sustainable economic growth, as too feeble a growth rate can lead to debt overhang.

Reinhart and Rogoff (2010) suggested 90 percent of GDP as a threshold beyond which debt is menacing. Some scholars (Herndon, Ash, and Pollin, 2013) had qualms about the data used by Reinhart and Rogoff, but it is unquestionable that the bigger debt is, the more of a handicap it is likely to be under similar conditions. Whether very low interest rates change the analytical picture is a sensible question, especially when monetary policy and non-standard measures turn ineffective and there is a need to enlarge aggregate demand. But even then, the nature of spending is key for such a course of action to make sense.

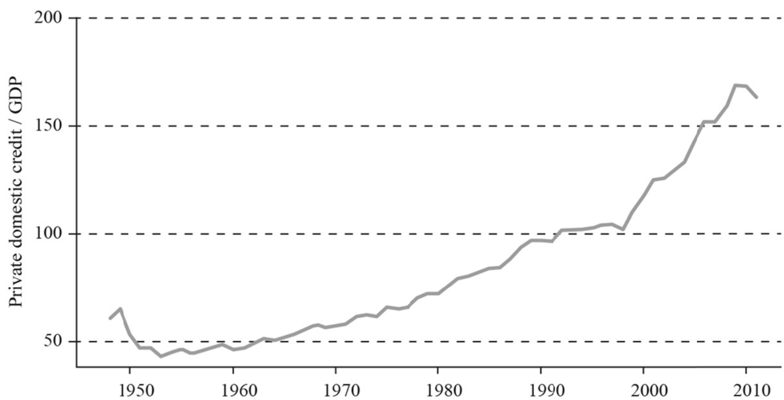
Data on the rise in debt in recent decades are quite telling. There was a big rise in indebtedness—public and private—in the developed world, which was accentuated by the crisis—the stock of debt went over 250 percent of GDP in many developed economies in recent years. At the end of 2014, public debt in the Euroarea stood at 91 percent of GDP, corporate debt at 105percent of GDP, and household debt at 62 percent of GDP[14]. Figure 1–7 below shows the evolution of debt in 22 advanced economies over two hundred years; the data are provided by Reinhart and Rogoff (2010) and are quoted by Lo and Rogoff (2015).

Fig. 1–7. Public debt/GDP in advanced economies



Source: Lo and Rogoff (2015)

Fig. 1–8. Private domestic debt in advanced economies

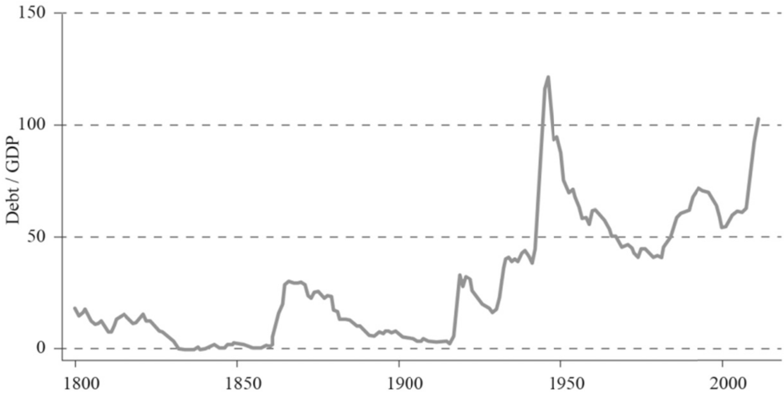


Source: Lo and Rogoff (2015)

[14] Jens Weidmann, speech at a Bundesbank conference on debt and financial stability, March 27, 2015.

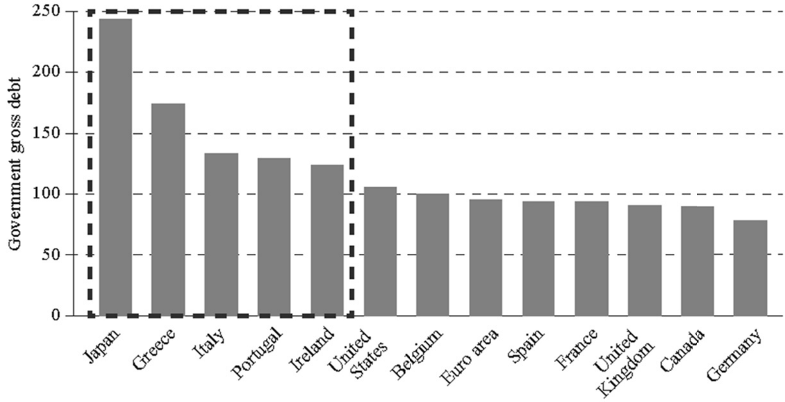
Figure 1–8 shows the big rise in private domestic debt in advanced economies since 1950, while Figures 1–9 and 1–10 illustrate the growth of overall debt in the US and advanced European economies, respectively.

Fig. 1–9. Debt/GDP ratio in the United States



Source: Lo and Rogoff (2015)

Fig. 1–10. Government gross debt (% of GDP), 2013



Source: Lo and Rogoff (2015)