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Current Economic Challenges and Regional Co-operation in Southeast Europe
Diagnosing the Economic Challenges

Economic Lessons from the Crisis for the Region

Remarks by:

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I. INTRODUCTION

It is a great honour for me to be invited to this seminar and even more to speak at it. I have to admit that I was in a way humbled by the title of this presentation, which sounds very ambitious. I decided to leave it as it was suggested by the organizers, but I immediately have to start with several disclaimers. You might call this "intellectual hedging" or maybe the truth is that I am simply trying to diminish your expectations. So, here are the reasons why it is extremely difficult to draw economic lessons from the crisis for the region:

- First, I am not sure which crisis we have in mind and, consequently, I am not sure if it is over. If we refer to the global crisis, we may argue that the worst is over. Plus, one can only hope that Dr. Doom (for those who still do not know his real name: Nouriel Roubini) and his latest forecast of a double dip in 2013 is again wrong, but let us be patient. Second, if we refer to the European sovereign debt crisis, it is still unfolding as we speak. Finally, countries in the region are in a different status regarding their exit out of the crisis. Croatia does not expect any growth this year (probably at most 1%) while Albania might see a growth of more than 3%. For the Albanians the crisis was over last year, while we in Croatia still had a fall in GDP in Q1 2011. So, my first disclaimer is that it may be a little bit premature to draw definite lesson from this crisis or, in other words, we still lack the perspective for such an exercise.
- Second, I have not seen an agreement within the economic profession that clearly identifies the causes of this crisis[2]. If we are not absolutely certain about its causes, how can we draw lessons from it? It is my understanding that at this point there are a lot of different theories around. I will mention but a few: a) the neoliberal approach in general and, more specifically, the so-called light-touch financial regulation (which was highly praised only a couple of

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[2] See for example: Rajan (2010), Andersen (2011), Paulo (2011) or Blugnell-Wignall et al (2008), Truman (2009) etc.

years ago); b) some are more specific and point out the "Greenspan put" in particular and too loose monetary policy with low interest rates, especially after the 2002 dot.com bubble burst, which according to this narrative created the new, real estate bubbles; c) some, more generally, attribute this to crony capitalism; d) others (like Ragu Rajan) put a lot of blame on growing income disparities (in the US) and politicians trying to rectify this by government subsidized mortgages; e) others blame financial innovation and, in particular, derivatives ("financial weapons of mass destruction", as Warren Buffet called them already in 2003 in his now famous letter to shareholders); (one more financial icon, Paul Volcker, could be put into this category with his statement that the ATM has been the most useful financial innovation in the last 25 years; f) some say it was greedy bankers and their skewed incentive/ bonus structure (which can be described as "head I win, tail you lose"); g) some in general blame the originate-to-distribute banking model and securitization, as opposed to the originate-to-hold model; h) for others the main culprit is the "mispricing of risks"; i) academics, in more general terms, blame the unaddressed build-up of macroeconomic imbalances (bad fundamentals); j) and finally, the "leftists" see the market economy (capitalist system) itself as the root cause of crises. And of course, there is an almost infinite variety of any linear combination of the mentioned factors (plus other ones), differing only in relative weights attributed to them. Furthermore, I have deliberately mixed up the factors that should be labelled as the starting points with those that are the deep underlying causes. But, the "inconvenient truth" for the economic profession is that we do not know for sure what the causes of the crisis are and what the exact transmission mechanisms from advanced economies to the crisis in the region were. It may take decades of work to come to some sort of common understanding of those issues.

- Third, the title of this presentation is quite specific, lessons for the region, not lessons for the economic profession in general. And here I have another set of dilemmas. First, the object of the observation is not always well defined. It is not uniquely defined which countries belong to this club, which is sometimes called the Western Balkans, sometimes the Yugosphere (The Economist), SEE, etc. But a bigger problem is that the countries in this group are somewhat different macroeconomically (from GDP per capita, the size of the economy, the exchange rate regime to inflation, etc.) so I do not think it is appropriate to have very specific "one size fits all" lessons for each and every one of them.

As a consequence of all of this, but frankly first and foremost because of my own constraints, I would like to set the bar for this presentation much lower than the original title might suggest. What I would like to do is to share with you my personal take on what could be some interesting points to ponder about for future policy making in the region, based on the events still unfolding from 2007 in the world and in the region.

II. Lessons from the crisis for the region:

1. **There is no substitute for hard work**. T.A. Edison. This, I think is the most important lesson I have drawn so far. Let me be more specific about what I have in mind here. When I was working in the region (Bosnia in particular) there was a lot of discussion on the exchange rate regime and competitiveness. Like what is the “exit policy” for a currency board or fx risk in the region (in relation to foreign exchange lending at the time)? In most cases the answer was: We need to enter the EU and EMU as soon as possible. Once we have the euro (officially, not unilaterally like Montenegro and Kosovo today) our problems will be “over”. Portugal has taught us an important lesson: there is no substitute for structural reforms, sound macroeconomic policies and competitive companies capable of exporting to globalized markets. When the euro was introduced some claimed that by definition there is only “one inflation in the eurozone” or that the balance of payments (more specifically, current account deficits) does not make sense in the eurozone (only on an aggregate level) because the state of Montana in the US does not have a BoP either, etc. Today we know better. Portugal’s growth rate was below 1% in the first decade of the euro. I will not elaborate on the causes or remedies for the eurozone and its troubles today (is it an optimum currency area, do we need a fiscal union or more fiscal transfers for a sustainable monetary union, etc.). What is clear is that the euro is not a substitute for sound economic policies. I would even argue provocatively that entering the euro zone prematurely can aggravate the problems for a country. The euro created an illusion that there was no “exchange rate risk”, creditors were willing to borrow much more and at lower rates due to the euro. Of course, banks-creditors could refinance any sovereign papers at the ECB under the same condition as say, German papers (usually treated as benchmark ones). BTW this is true even today, when Greece is a CCC country. My point is that markets would not “allow” those levels of either public and/or external debt and would “punish” those countries much before, were it not for the euro.
2. For my second lesson I would like to paraphrase a famous saying from Bill Clinton’s 1992 presidential campaign**: It’s the politics, stupid.** One big lesson that I learned in this crisis is that politics is much more important in economic policy making than I had anticipated. Yes, pure and simple politics. And until we economists start addressing it explicitly when discussing measures and actions, I doubt we will ever end up with successful economic reforms. Let me explain: Good economics should lead to an increase in welfare for the society (otherwise it would not make sense). But we all know that people do not like change (the tyranny of the status quo), have very high discount rates (i.e. want it all now), will fight hard for their acquired “rights” and benefits etc. Every measure of economic policy redistributes income (if it does not, it is useless). So,

someone will always be against any measure. And in democratic societies the only real power comes from elections. Even central bank governors with all their independence are elected by parliaments, i.e. political institutions par excellence, and are ultimately accountable to voters. Of course, some professional skills are necessary, no doubt. But, for tough reforms of your economies you need to build support for them. Again, in democratic societies power comes from elections. So, ultimately you need a mandate for tough reforms. And you can implement reforms only by explaining this regularly. So, the lesson that I have drawn from this is that while a necessary precondition for good policy making is, of course, "technical excellence", to implement it you need political support. So I would even argue that the need for political support is the most disregarded area of economic policy making. And one must work on this support. As in the "world of real economy", it is the responsibility of a producer to inform the customers (the general public and politicians) of the benefits of a new product (new policy measure) and sell it successfully. Otherwise, in spite of the product being excellent, we might end up with insufficient demand for it (which actually is the case). I am arguing that there are a lot of information asymmetries regarding what I would call sound economic policies and their benefits for societies in the long run. No doubt that these are fundamental questions of political economy[3].

3. My lesson number three is**: One can "defy" economic laws as much as those in physics**. If you can defy the law of gravity and "walk on water" then please do not listen to me anymore. Actually, if you can do that, you should not be sitting in this room at all. The point I am trying to make here is that in spite of the crisis and its causes, the main economic forces that shaped the economic landscape in the past will continue to do so both on the micro and macro levels. There is no time for a detailed elaboration, but let me point out just two of these forces. First, globalization is to a large degree driven by scale economies. The more of something you produce the cheaper it is. In our individual countries we tended to produce steel. How can we, from our small economies, compete with Korea or China in steel production today? The answer is, we cannot. And scale economies will continue to exist regardless of the degree of state intervention. Second, the laws of supply and demand are still the best allocators of resources. This does not mean that we are not aware of market failures, but my additional point here is: **Do not throw out the baby with the bath water**. Market economies work. Economic agents still make decisions based on relative prices. Private sector driven economy is still the best "development engine that we know". Of course we should be aware of market limitations and not believe blindly in market efficiency[4], but in spite of some

[3] A recent discussion on these political economy issues in economic reforms can be found in: Bonfiglioli and Gancia (2011).

[4] See Blanchard (2011) and Andersen (2011).

deficiencies, I would like to remind you of our common socialist past and its failures.

4. **Be aware of cognitive biases[5].** Groupthink and intellectual capture can be very dangerous in policy making. After all, every country is specific, which does not mean that we do not also have much in common. I have always advised governors in the region not to follow blindly modern economic fashions It is necessary to follow developments in the world (both academic and practical). But one needs to think hard, very hard, what they mean for a particular country. For example, inflation targeting (IT) for central banks was very "fashionable" some time ago. The BoA organized several conferences on this topic. I am not saying IT is "wrong" as a policy; price stability is very relevant indeed for economic development. But even the ECB is using a two-pillar system (which *de facto* means looking at assets that can help you identify bubbles). Plus, with time and experience some things change or at least we acquire a different perspective. You might remember how several years ago in this very city we were listening about the virtues of computing and following core inflation, as opposed to headline inflation which had a lot of "noise" in it. Yet, recently, one of the most academic and influential members of the ECB's Executive Board wrote a letter to FT saying that, surprise, surprise, maybe headline inflation makes more sense[6]. The lesson I am trying to distil out of this is to use common sense and your head before making a final decision.
5. My next lesson is: **Round up the usual suspects**. As some of you may remember, this is a famous line from the 1942 movie Casablanca (with Humphrey Bogart and Ingrid Bergman). What does it mean in this context, who is the usual suspects of economic troubles? The answer can be found in the fiscal sphere. I admit that I am under a strong influence of current developments and that I am biased as a former central banker, but the eurozone sovereign debt crisis which is still unfolding is an excellent case in point. I am convinced that fiscal discipline and a low public debt to GDP ratio will be the main comparative advantages of countries in the next decade. Look at Estonia, as a positive case (the last eurozone member). In the last decade (2001-2010) the average public debt to GDP ratio was not 52% (which would still put it far below the eurozone average) or 152% like that of Greece, but 5.2%. Deficit? Never more than 3% with a lot of surplus years. We need to make a strong point that orderly public finances are of extreme importance. And, after this crisis, I am sure that the "benchmarks" for a sound fiscal policy will be changed. I have to say that in my view the original Maastricht fiscal criteria were misinterpreted. The famous 3% and 60% were considered to be "average", "normal" numbers, rather than upper limits. Second, this crisis has significantly increased the level of

[5] I have borrowed these ideas from the IEO (2011).
[6] Bini Smaghi (2011).

public debt in a lot of countries. So, room for manoeuvre for the next round of the crisis (which will undoubtedly come) will be very limited, unless there is a change in policies.

6. My next lesson is**: If anything can go wrong, it will.** There is an old rule in economic policy: *Always take good news as temporary and bad news as permanent*. The point here is not to be permanently pessimistic. I have recently learned a new English word: *permabear*, meaning you are permanently in a bearish mood (or as my treasury officer would say: have a short position). But the point is that one has to take into account even improbable options. If we have learned anything in this crisis it is that, yes, tail events can happen and do happen. Look at the euro. Today we fully realize that it is a half-baked product. No sovereign defaults were envisioned in its initial design? No exit? Ever? My point is not to be pessimistic, optimism is important, but all policy makers have to think ahead and have some contingency plans ready even for the worst moments. It can be very costly and dangerous to assume only optimistic scenarios, i.e. that bad things will not happen. They might, and one is much better off if prepared for such scenarios. Again, there is a fine line between being pessimistic (which is a bad thing) and thinking ahead of the possible outcomes and being ready for them. Or to put it in a slightly different way, one has to strike a balance between too rosy approaches and crying wolf, you cannot all the time point out only the downside. But again, because of the asymmetry of the payoff matrix, it is very relevant to know what downside risks may be and prepare for them in a way. This means having sufficient cushions in macroeconomic fundamentals for unexpected external (or internal) negative shocks.
7. **If something looks too god to be true it most probably is**. There are a lot of possible examples to draw from, but I will mention only one, Irish banks. Ireland had low public debt until it had to rescue its banks. I remember that in the late nineties we in Croatia had twin programs with some Irish banks (AIB) because they were considered to be well run, experienced. And the Irish model of growth, the Celtic Dragon, was a showcase for many small economies which looked up to Ireland and its speedy convergence. And now, we have a country that has needed a bailout. In banks, the loan to deposit ratio has skyrocketed to 180%, we are talking of billions of euros in recapitalization, bank deleveraging, huge amounts due to be paid by taxpayers (and haggling still going on whether it should be the Irish, the eurozone ones or more burden should fall on creditors of different kinds). No, miracles do not happen. Real estate prices do not grow indefinitely and when trends change, the situation changes dramatically. Now banks are too big to fail. But let us remember the old economic policy dictum: *All problems that are now too big to fail started as too small to bother with*. Nobody believed in this scenario of the overexposure of Irish banks to real estate. And who is to be blamed?

According to one report the "national mania" or the "happy-go-lucky" attitude in Ireland (the Nyberg Report according to FT) are the culprits. AIB, from which we have learned so much in Croatia, lost EUR 30.4 billion and it is interesting that, according to this report: "…most Anglo board members did not appear to have sufficient experience or specialist knowledge to fully recognize the specific risk" (quoted after FT.com). If I had read something like this regarding a failure of a Croatian bank or a bank in the region, especially a government-owned one, I would not be surprised, but AIB?

8. We should be aware of the **"pretence of knowledge"** in economics .This is the title of the Nobel Lecture given by Friedrich von Hayek in 1974. Let me repeat it, *the pretence of knowledge*. Economies do not always function according to models. And in finance, it seems that economic agents were more inclined to reading the 1997 Nobel Lecture (Sholes and Merton) than the mentioned Hayek one. Economies are complex, non-linear, dynamic systems, to a large degree driven by human behaviour. I have to say that we need to be humble when it comes to our understanding of economic phenomena[i]. No, we have not mastered all the risks (with or without Nobel prizes); we cannot predict much of future events. Let me emphasise again, we economists need to be much more humble about what we know and what we do not know or have indications about.
9. **You can fool some of the people all of the time, all of the people some of the time, but you cannot fool all of the people all of the time**. This lesson refers to the need for excellent, precise statistics to conduct a responsible economic policy and be credible. Having the experience of working in the region, I know that this is always a big problem. Especially fiscal data, plus real sector data. And statistical data are costly. But lack of them creates the following problems.

   If you do not have good data, you do not know the situation, and without a good diagnosis, how can you react? We all go to a lab to have various tests done (a blood test, etc.) before being diagnosed and starting a treatment. Would you trust your doctor if he had the same "accurate" figures on your cholesterol, blood pressure etc. as we have today on some countries?

   If you are either ignorant of or simply lie about macro data, sooner or later this will become known and invariably result in your losing your credibility as a policy maker. I will start with a country in Latin America, which had its fair amount of crises in history. On June 15, 2011 it was published (FT) that the Argentinean government had been fining independent institutions releasing inflation data with an amount of 123,000 dollars each. Why? Well, nobody has trusted official inflation data since 2007 and the presidential elections are coming. FT reported that the differences between official and estimated inflation data for individual years were as follows:

   - for 2007, 8.5 per cent vs. 25.7 per cent;
   - for 2008, 7.2 per cent vs. 23 per cent;

- for 2009, 7.7 per cent vs.15 per cent;
- and for 2010, 0.9 per cent vs. 25.1 per cent.

Greece is another case in point. As we know, according to official Eurostat data, its budget deficit for 2009 ended up at 15.4% of GDP. However, in October 2009, when socialists won the elections, they soon announced that the budgetary deficit (for 2009) would be twice as high as earlier predicted, moving the figure from 6% to 12%. But once the IMF came in, they increased the number to 13.6%. Think about the amount of credibility that Greek policy making has lost due to this fact. How long will it take for it to regain it? How much has it increased the spread of borrowing, meaning taxpayers' money being used to service the debt? There is another famous saying about three kinds of lies: *Lies, damn lies and statistics*. Investing in macro statistics is neither good for PR nor will it gain you votes. It takes a long time to build up good and credible statistics, but lack of it can be very costly.

10. The 10th and last lesson refers to the simple dictum: **Trust yourself**. As I hinted at the beginning, general economic laws function, but when it comes to economic policy making I would argue, first and foremost, that you should trust yourself. Nobody knows your country better than you do (i.e. at least not if you are a pro). In other words, read and follow what others are doing, but in the end think, think about your own problems and the main lessons you have learned from all of this. Prioritize, distinguish the trees from the forest and find your own solutions. If this means going against the conventional wisdom (the IMF or academics) and you are confident you are right, so be it. We have identified groupthink and intellectual capture as big problems. But this requires a lot of work and, as mentioned, self-confidence.

III. SUMMING UP

- The first point is that these lessons from the crisis I have personally learned and decided to share with you today are not "new". We have all known them for a long time. Unfortunately, from time to time we tend to forget them. So, like going to church, synagogue or mosque, it is good to "regain our faith" once in a while, it is important to go back to basics.
- Second, in spite of our limited knowledge and understanding of the functioning of economics and especially of the turning points in economic cycles we should be aware that, and the same applies to modern medicine, it does not mean we are clueless. There are a lot of diseases that still lack adequate treatments, but if you exercise regularly, watch your diet (which BTW is extremely difficult in Tirana) and use some stress relaxation techniques this will benefit your overall well-being and help you weather shocks that may affect you. *Ditto* for economies with sound macroeconomic fundamentals.

- Finally, I would like to point once again that challenges before us are really huge. We are entering a: "… brave new world, a very different world in terms of macroeconomic policy making." (Blanchard, 2011). Some old dogmas are not valid any more, and new ones are not clear as yet. A lot of intellectual challenges, indeed. For policy makers the problem is that they cannot wait for the academics to "figure it out", decisions have to be taken on a daily basis. So I can only end by wishing good luck to all of you, both in central banks and in finance ministries and other areas, and by saying that: "*Policy makers earn their wages when models stop working*". Ladies and gentlemen, I am confident the time is now.

Thank you so much for your attention.

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[i] See for example Trichet (2011) or Haldane and May (2011).