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Small Open Economies and the International Financial Crisis: Any Lessons to Be Learnt?

The unfolding of the international financial crisis which erupted in full after the collapse of Lehman Brothers in September 2008 had a strong impact on a range of small open European economies. Some of these were Western European economies, such as Iceland and Ireland, which were strongly involved in the international banking crisis per se, often also characterised by strong prior residential asset price inflation. The other group of small, open economies consisted of the economies of Central and Eastern European Countries (CEECs). Their banking systems were initially judged as not being directly linked to the sub-prime mortgage and securitisation processes which had sparked the financial crisis in the United States and in other financial centers. Finally, there were those economies which were strongly linked through close banking relationships to the economies of Central and Eastern Europe; this group encompasses countries such as Austria and Sweden.

What were the features which characterised developments in small, open economies before and during the crisis? Which lessons can be learnt from these experiences?

What is clear from developments in the build-up to the crisis and during the crisis is that small, open economies are in a number of ways particularly vulnerable to the types of shocks which the international financial crisis generated. We shall go over some of the issues which single out the specific vulnerability of small open economies.

(i) Small Open Economies as Locations for Internationally Operating Banks:

Small open economies might become important locations of internationally operating financial institutions which evidently happened to Iceland, Switzerland, but also to Austria and Sweden in relation to their banks operations in Central and Eastern Europe. There is a priori no reason that this should not be the case as location factors (skills, geographic location, etc.) could favour such countries and in an integrated European market such location does not need to be discouraged. The problem, of course, arises when there are suddenly increased probabilities of insolvency appearing in the wake of a crisis and such – relatively large – financial institutions are backed only by national (monetary and fiscal) authorities. The discrepancy between national regulation as well as nationally defined fiscal authorities in the current set-up of the European Union, on the one hand, and the trans-border reaches of the activities of the bigger European financial institutions, on the other hand, can cause severe problems and sub-optimal outcomes.

One of the results of the current crisis will be to strengthen the intra-European cooperation between financial regulatory authorities, although the prospects of joint fiscal responsibility in the case of bail-outs are very slim. This creates also another problem: as long as national authorities are responsible for bank rescue operations, it will continue to be the case that the definition of what constitutes a *systemically relevant financial institutions* will be done with a view of the national spillover effects

and not overall European spillovers. Given that the Single Market is fully integrated this would be the wrong definition and would lead to a too generous definition of the range of *systemically relevant institutions*.

(ii) Small Open Economies as Net Borrowers:

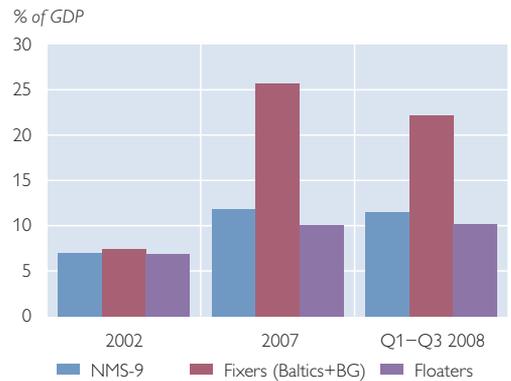
In a significant number of *emerging European economies* in Central and Eastern Europe we have seen a very strong increase in the debt levels of the private sector prior to the crisis. Public debt levels had (with the exception of Hungary), on the other hand, declined to quite low levels due to the fast growth period leading up to the crisis. Hence, the main vulnerability with regard to debt was the strong accumulation of debt in the private sector. Why has this taking place?

A careful analysis shows that the build-up of private debt was particularly strong in countries which had, in different ways, adopted a fixed exchange rate regime: such regimes ranged from complete Euroisation (Montenegro, Kosovo) to Currency Boards (Bulgaria and some of the Baltic states) to various forms of *hard* or *soft* pegs (e.g. Croatia). Amongst the most recent EMU Member States (Slovenia and the Slovak Republic), Slovenia also experienced fast rising private sector debt prior to the crisis. There were also instances of very rapid build-up of private sector debt in some of the other economies (such as Romania) but in general the group of *fixers* had a more dramatic build-up of private debt (a high proportion of which was denominated in foreign currency) than the *floaters* (see chart 1).

What was the reason for the very rapid increase of foreign, private debt, particularly in the case of the *fixers*? I would mention three such reasons:

Chart 1a

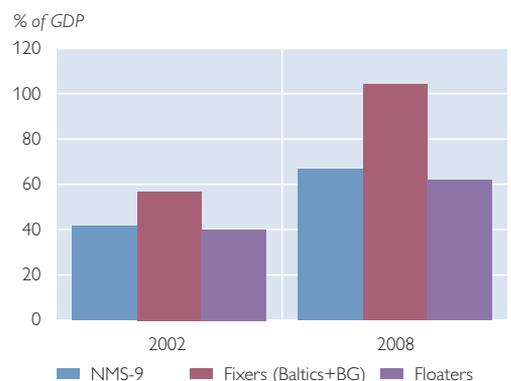
Net Capital Inflows (Surplus on the Capital Account and Financial Account of the Balance of Payments without Reserves)



Source: wiw database incorporating national statistics, Eurostat.

Chart 1b

Gross External Debt



Source: wiw database incorporating national statistics, Eurostat.

- The first reason applies both to *fixers* and *floaters* and accounts for the fact that foreign debt vulnerability in the recent crisis was particularly high in Central and Eastern European economies as compared to other *emerging market economies* (e.g. in Latin America or in Asia). This is due to the rather successful anchorage of the CEECs in the European (economic, political and institutional) integration process. Such anchorage reduces the risk for international investors and internation-

- ally operating banks so that – *ceteris paribus* – they would be willing to extend credit to a wider range of customers (and invest in a wider range of projects) than in economies in which such anchorage does not exist or to a lesser degree. Furthermore, the prospects of EMU membership (and the accompanying technical assistance in conducting monetary policy on the way to such membership) reduced the risk of exchange rate volatility (if at all it would provide a reason for an upward pressure on the exchange rate) and hence lenders were substantially discounting the risk of exchange rate devaluation.
- Catching-up in financial intermediation: This is a common argument for the rapid rise of private sector debt and was used by bank managers to justify the extraordinarily strong build-up of private sector debt in some of the CEECs. Transition economies are laggards in the process of financial intermediation and, in level terms, the private sector debt to income ratios have in most economies not yet reached the Western European levels. However, first of all such arguments do often not compare levels of financial intermediation for the same levels of economic (real income) development and, secondly, there was clear evidence in some of the economies of a speculative loop between credit expansion and residential asset prices.
 - There are special incentives for small open economies to become *fixers*: In small open economies which have given up any form of capital controls (which all CEECs with either EU membership or membership aspirations have done), the fear of either making monetary policy mistakes or suffer the impact of changing risk assessment in the form of exchange rate stability, leads many of the CEECs to become *fixers*. The incentives are stronger if the country is *small* as the impact of destabilizing capital movements and ensuing exchange rate volatility would be greater than in a larger economy. Furthermore, the weight of interest groups (multinationals who organise international production networks, companies with high levels of international transactions) which find exchange rate fluctuations costly in transactions terms is greater in smaller than in larger economies. Hence, smaller, open economies (and those in which monetary authorities were not able to build up sufficient reputation) are more likely to be *fixers*.
 - Once countries are in a fixed exchange rate regime, the scene is set for higher capital inflows, higher indebtedness of the private sector and structural current accounts deficits. The reason is that – *ceteris paribus*



- there are no exchange rate risks (except in an extra-ordinary period of shock) and hence there is much reduced need for hedging. An international financial crisis such as the one we have witnessed has very low

probability at any one point of time and hence bankers give a very low weight to this risk. With *floaters*, exchange rate risk persists and hence international financial institutions operate with more caution.



High capital inflows in fixed currency countries can lead to asset price bubbles and fast increases in private sector debt. Once a big international shock in the form of increased risk assessment with respect to *emerging markets* (whose fiscal authorities are perceived as less potent with lower access to international financial markets) hits such economies, the high degree of security about sustainability of the exchange rate regime can quickly disappear and then the fear of a much higher level of private sector default emerges. A devaluation would make *currency mismatch* apparent and the level of *bad debt* can mount dramatically. A capital flight out of such markets (or *sudden stop*) can be the consequence. Without international efforts the fixed exchange rate regime would collapse.

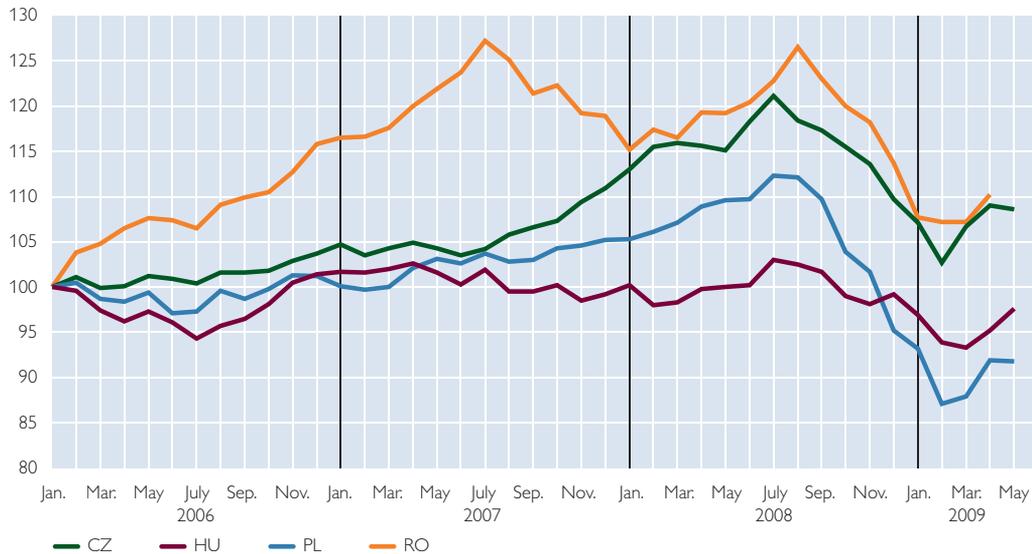
One should point to one additional element in this story: once a scenario of a break-down of a fixed currency regime is perceived as a possible scenario, even countries with very low initial public debt levels (as was the case with the Baltics or Bulgaria) are seen as risky with regard to potential public debt. The reason is that the high risk of default of private debt gets devolved to be seen as potential public debt risk, as national fiscal authorities would be seen as having to step in to avoid mass bankruptcy. To a lesser extent, this fact also constrains the room of manoeuvre of fiscal authorities in flexible exchange rate economies (*flexers*) where the impact of a devaluation also increases the likelihood of private sector defaults which puts a strain on the financial system and the national authorities would be seen as having to step in in case of a systemic breakdown of the financial system; thus private debt would become – to some extent – public debt and hence the fear in international financial markets of potentially fast rising public debt levels would prevent such economies to place public debt papers. This mechanism was at work throughout the CEE region in the course of the crisis and prevented almost all of them to undertake active counter-cyclical fiscal policies in line with those which were undertaken in Western Europe, the USA, Japan and China.

To sum up: the current international financial crisis has shown that small open economies are particularly vulnerable to shocks which lead to a re-assessment of emerging market risks. Particularly countries with fixed exchange rate regimes will undergo a dramatic re-evaluation, especially since they are more prone to a fast increase of private sector debt levels (plus potential real estate bubbles) prior to the crisis.

Chart 2a

Real Exchange Rate Developments from 2006 to 2009 Euro/National Currency Unit – PPI Deflated¹

January 2006 = 100



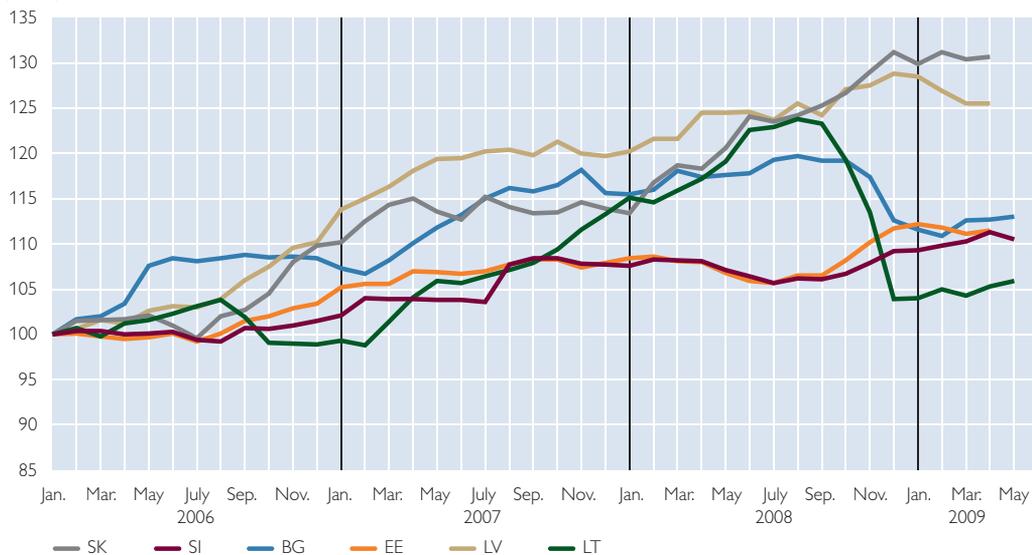
Source: wiw monthly database incorporating national statistics.

¹ Values over 100 indicate appreciation relative to January 2006.

Chart 2b

Real Exchange Rate Developments from 2006 to 2009 Euro/National Currency Unit – PPI Deflated¹

January 2006 = 100



Source: wiw monthly database incorporating national statistics.

¹ Values over 100 indicate appreciation relative to January 2006.

This severely constrains their ability to counter-act the crisis through fiscal means and, should they attempt to maintain their fixed exchange rate regime, the entire brunt of adjustment would have to be born by an adjustment of real income levels as the possibilities for real exchange rate adjustment is very limited in periods in which global inflation rates are close to zero (see chart 2 on real exchange rate developments in fixed and flexible exchange rate economies).

As to lessons to be learnt from this crisis, we would single out three:

- There is a need of adding effective regulatory measures to constrain the build-up of private sector debt levels in catching-up economies, es-

pecially those with fixed currency regimes.

- The cost-benefit calculation of fixed exchange rate regimes in European catching-up economies should be reassessed; this includes the analysis of the path and accompanying policies for eventual EMU membership.
- There is a need to counteract potential *negative spill-over* effects of bank rescue operations from fiscally stronger Western European economies and euro area Member States on *emerging Europe*. The latter is perceived as being fiscally weaker and hence significant support mechanisms (such as a *Stabilisation Fund*) should be set up at the European level.