POTEMKIN VILLAGES ONCE AGAIN: PONZI-STYLE ECONOMIC SYSTEMS OF EASTERN EUROPE

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Aim of paper

- **The aim of this paper is to address causes of the current crisis in EEC and to explain why, in contrast to past crises in emerging markets, debt-deflation has been avoided so far.**

Credit crunch in core economies

- Sudden stop of international capital flaws in autumn 2008.
- Fall in aggregate demand in developed countries.
- Including their demand for export products of developing countries.

Ponzi nature of EEC

- Sudden stop of international capitals flows revealed Ponzi nature of most EEC.
- On average, they could not continue to function without a permanent credit doping.
- Consequence of uncontrolled rise in debt and unsound local macroeconomic policies and practices.

Ponzi nature of EEC

- Economies of Eastern Europe subject to our analysis are: the Czech Republic, Slovakia, Poland, Hungary, Latvia, Lithuania, Estonia, Ukraine, Russian Federation, Romania, Bulgaria, Croatia, Turkey and Slovenia.

FIH as theoretical background of the crisis in EEC

- We reject mainstream financial paradigm.
- Efficient market hypothesis is not a theory of financial crisis.
- We embrace Minsky's Financial Instability Hypothesis (FIH) as theoretical explanation of the crisis.
- Core proposition of FIH is that in an environment of fundamental uncertainty stability is destabilizing: after prolonged period of stability system becomes dominated by speculative and Ponzi units and is consequently fragile.

FIH as theoretical background of the crisis in EEC

- In such fragile situation occurrence of “not unusual” (Wolfson) event is capable of pushing the system over the brink into financial instability.
- Realized profits are disappointing.
- Escape to liquidity: demand for ultimate means of payment rise exponentially.
- Described by Shakespeare in Richard III:

“A horse, a horse, my kingdom for a horse!”

FIH as theoretical background of the crisis in EEC

- Fisher debt-deflation episode: the more debtors try to decrease their debt, the more value of their debt rises.
- Kregel (1998) expanded Minsky's model of crisis generation in closed economy on open economy in which most of the debt is foreign short-term debt denominated in hard currency.

FIH as theoretical background of the crisis in EEC

- To potentially dangerous exogenous shocks Kregel (1998) adds three more:

1. Increase of interest rates and interest rate differentials in international markets.
2. Depreciation of local currency.
3. Worsening of terms of trade or decrease of a demand for core exports products.

- Local banks are exposed to one additional risk – risk of reducing their credit rating.

Macroeconomic indicators in EEC before Lehman Brothers shock.

- Average of 14 EEC in period 2001-mid 2008:

1. Rapid economic growth
2. High current account deficits
3. Dynamic rise in net foreign debt to GDP ratio
4. Fast credit growth – dynamic growth of ratio of domestic credit to private sector to GDP and of domestic credit to private sector to deposit ratio.
5. High rate of loan euroization
6. Stable and appreciating nominal foreign exchange rates and appreciating real foreign exchange rates
7. Relatively high inflation rate
8. Share prices bubbles
9. Real estate bubbles
10. Moderate fiscal deficits

Figure 1. Quarterly GDP growth

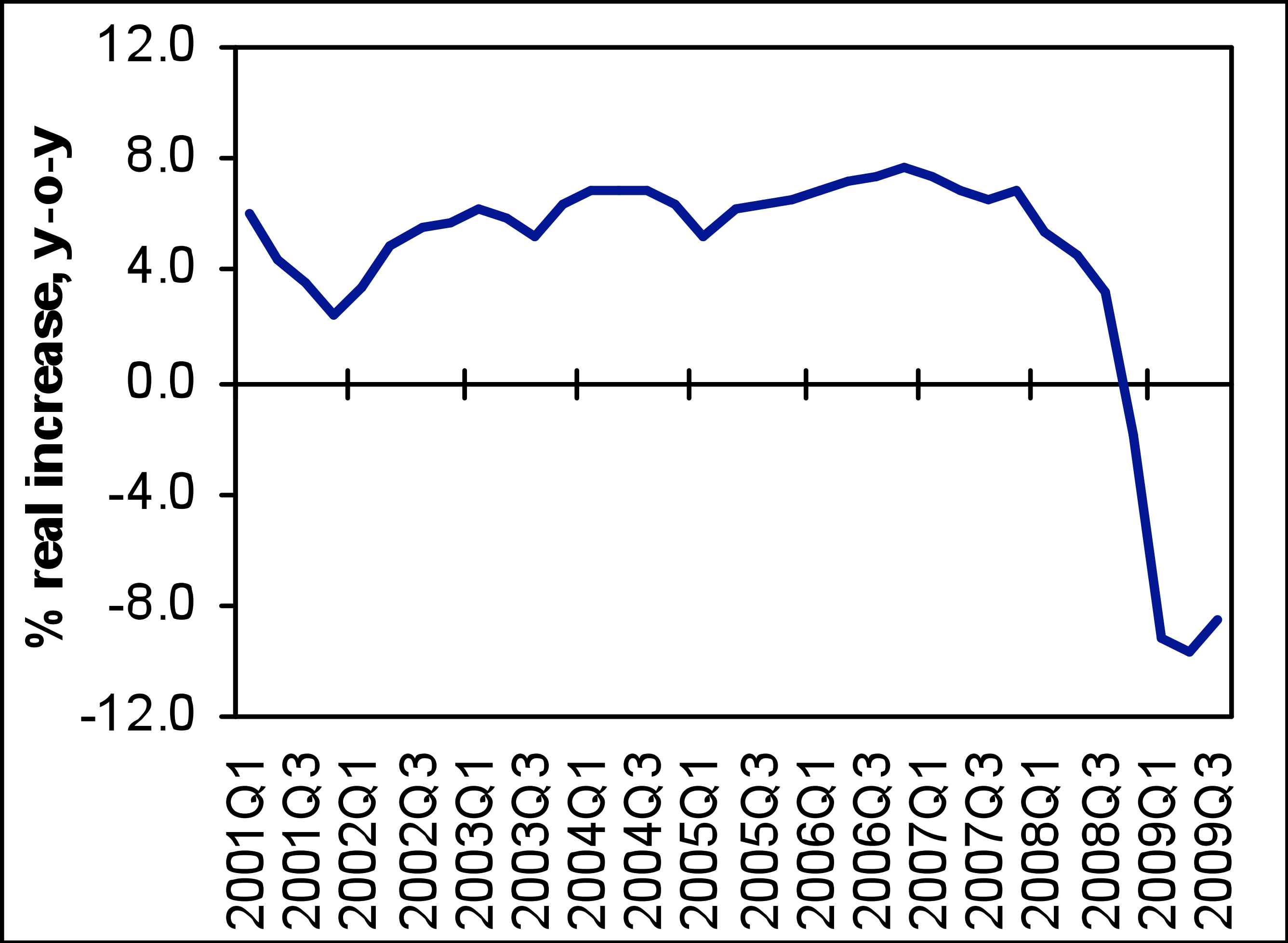
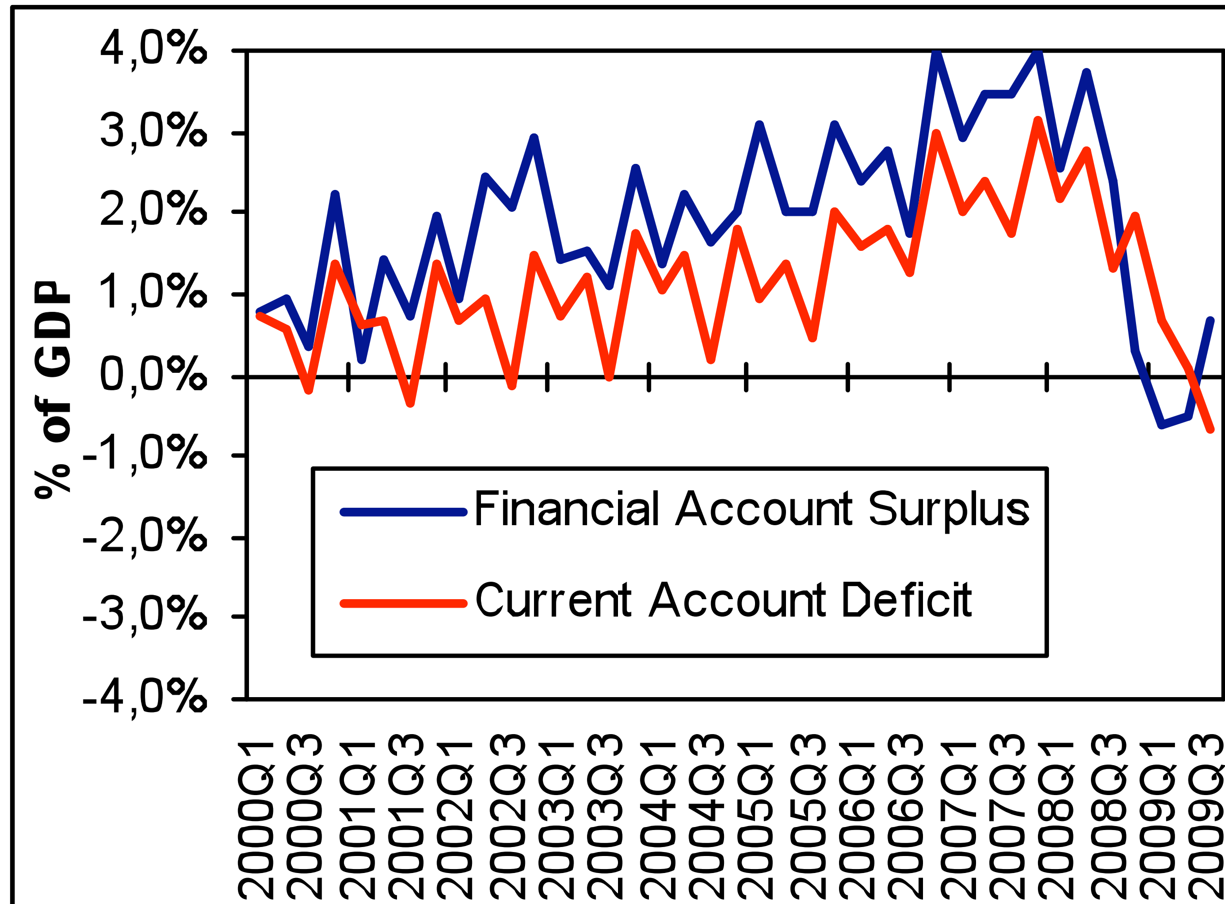


Figure 2. Current account deficits and financial account surpluses



Motivation factors to finance the region

- Risk diversification opportunities
- Expectation of high and sustainable export revenues of indebted countries due to free trade arrangements and geographical proximity of EU.
- High real interest rate differentials

Figure 3. Real interest rate differential

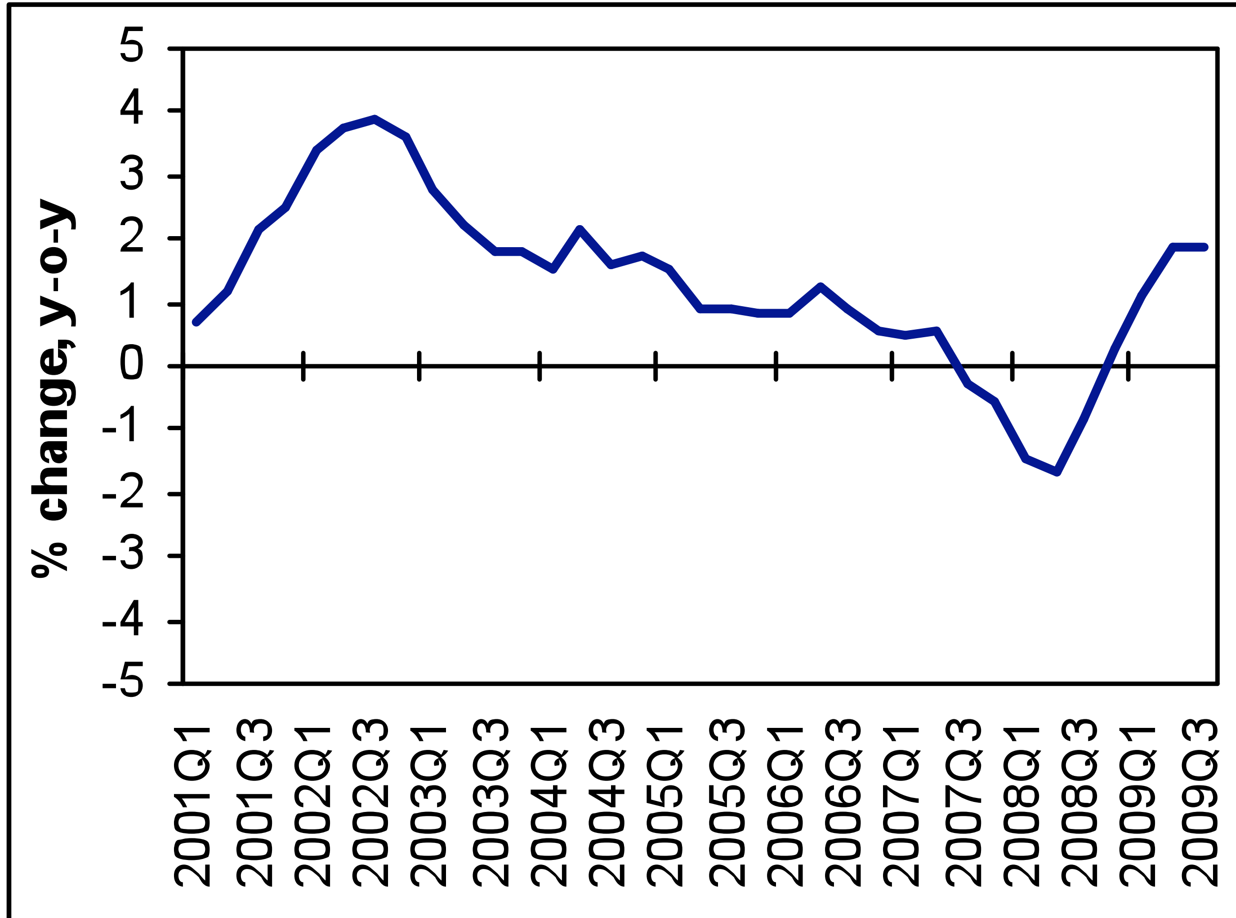


Figure 4. Net foreign debt, including debt securities less foreign exchange reserves as % of GDP

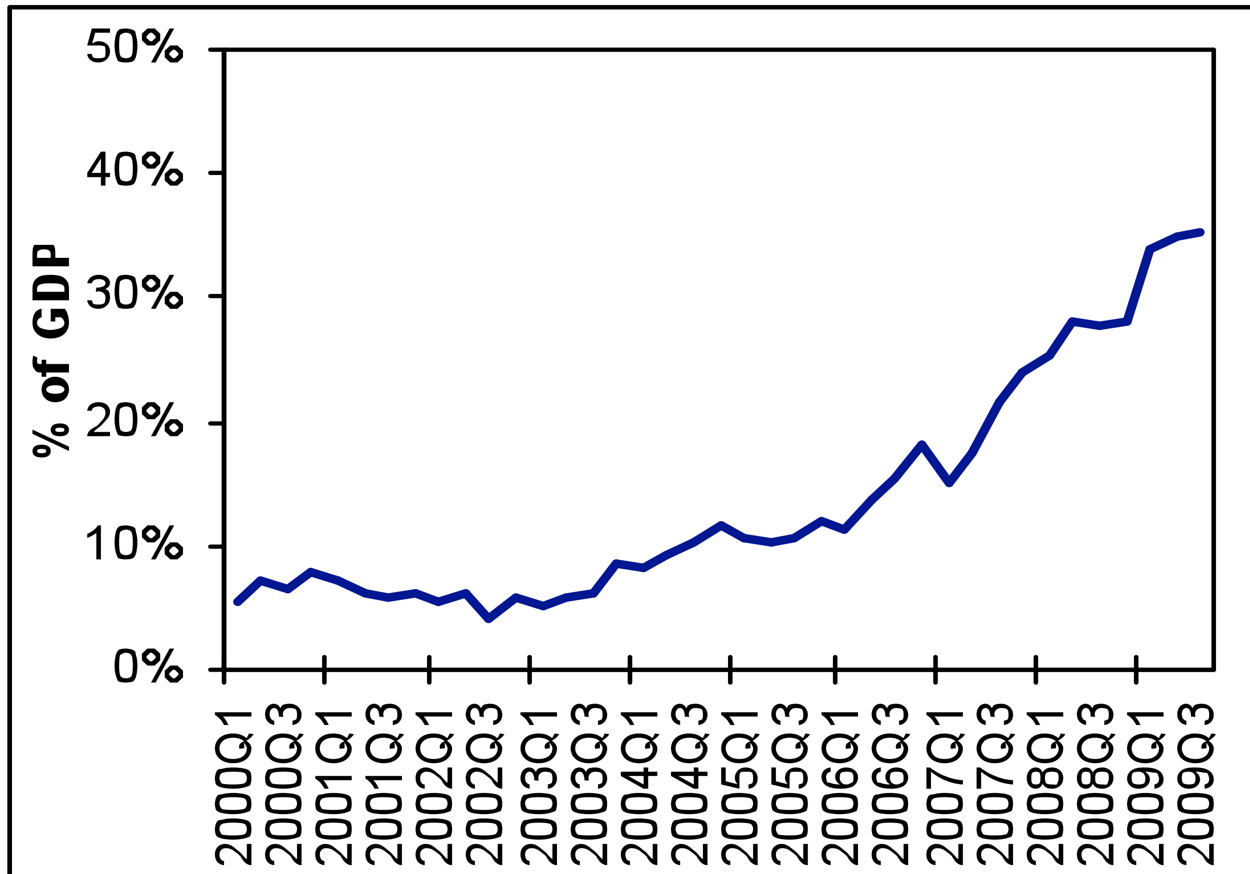


Figure 5. Domestic credit to GDP

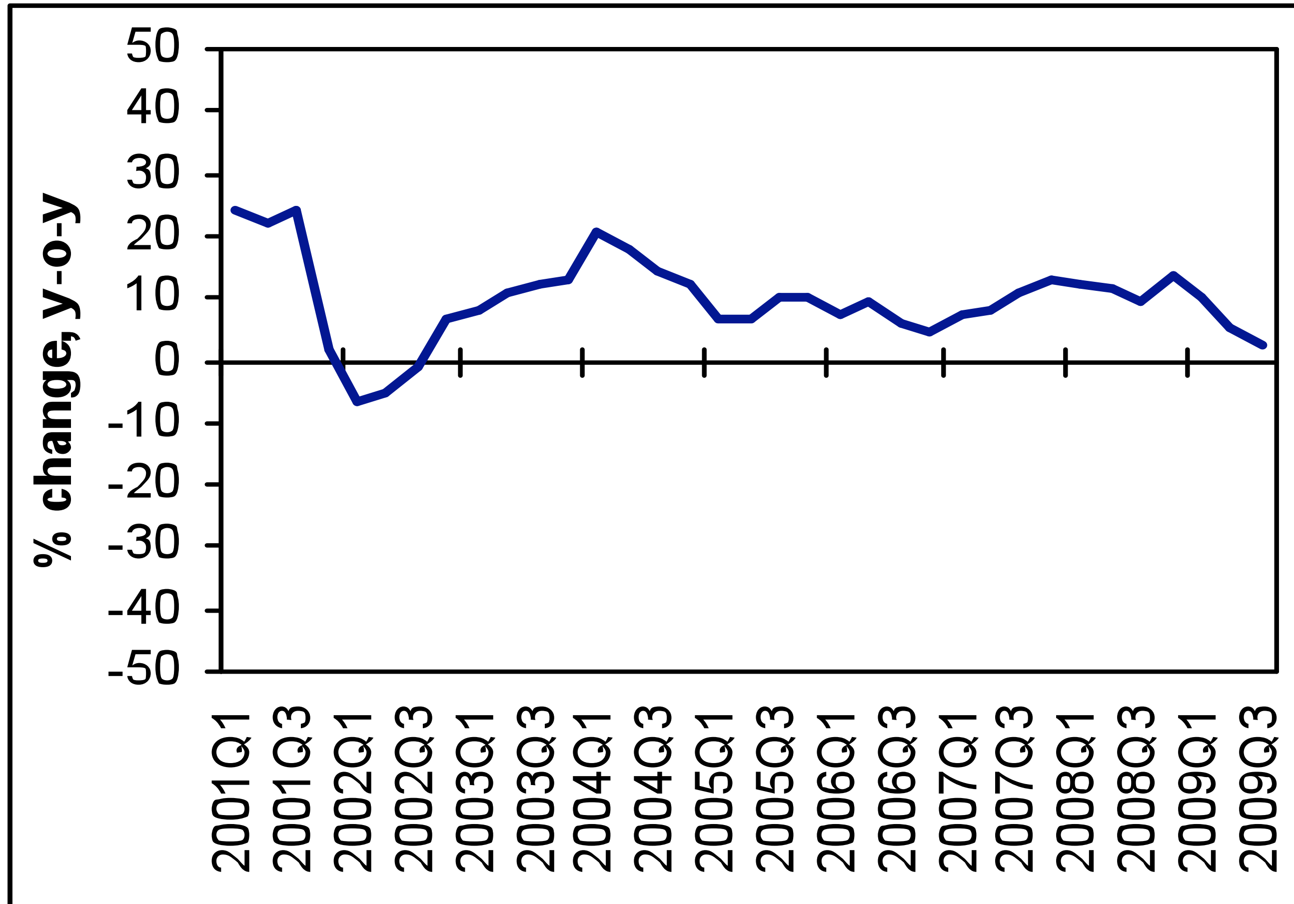
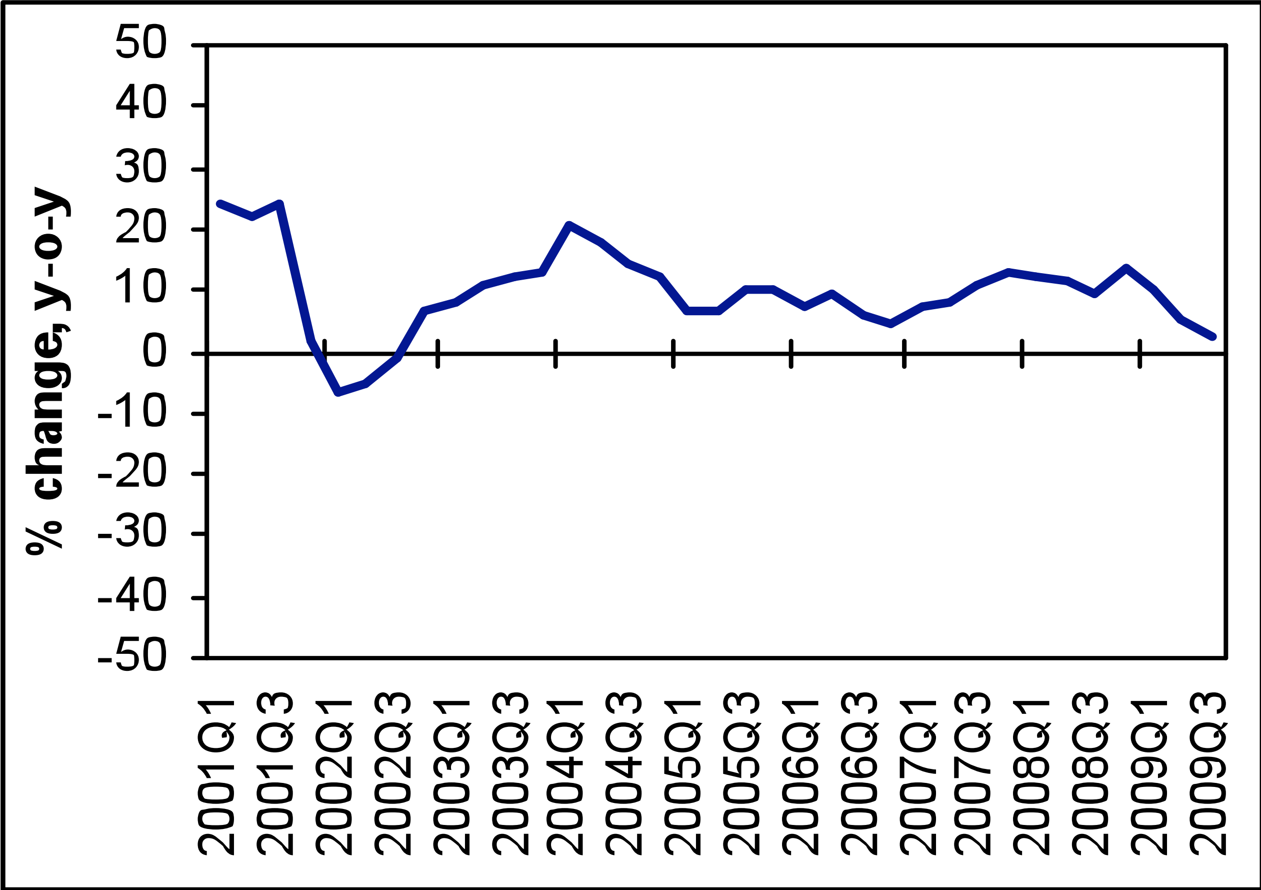
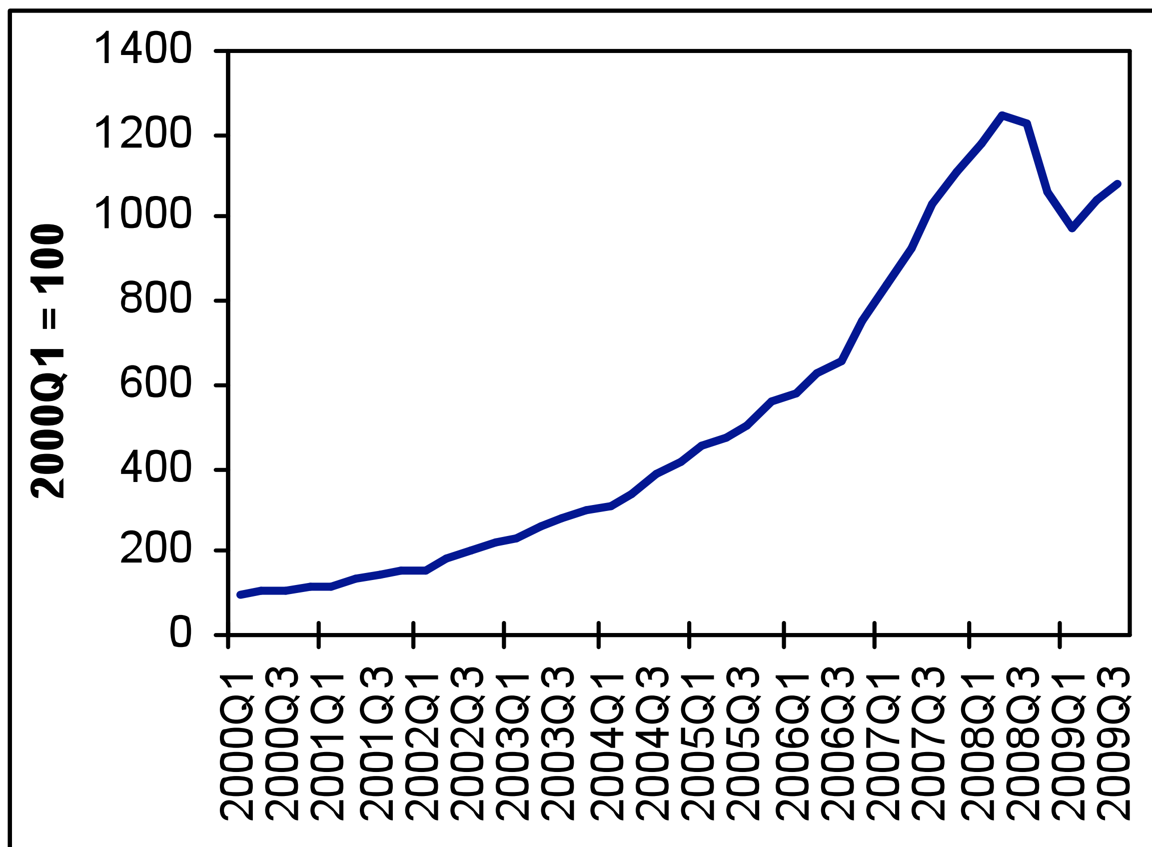


Figure 6. Growth of domestic credit to deposit ratio



Graph 7. Foreign exchange reserves



Graph 8. Real effective exchange rates

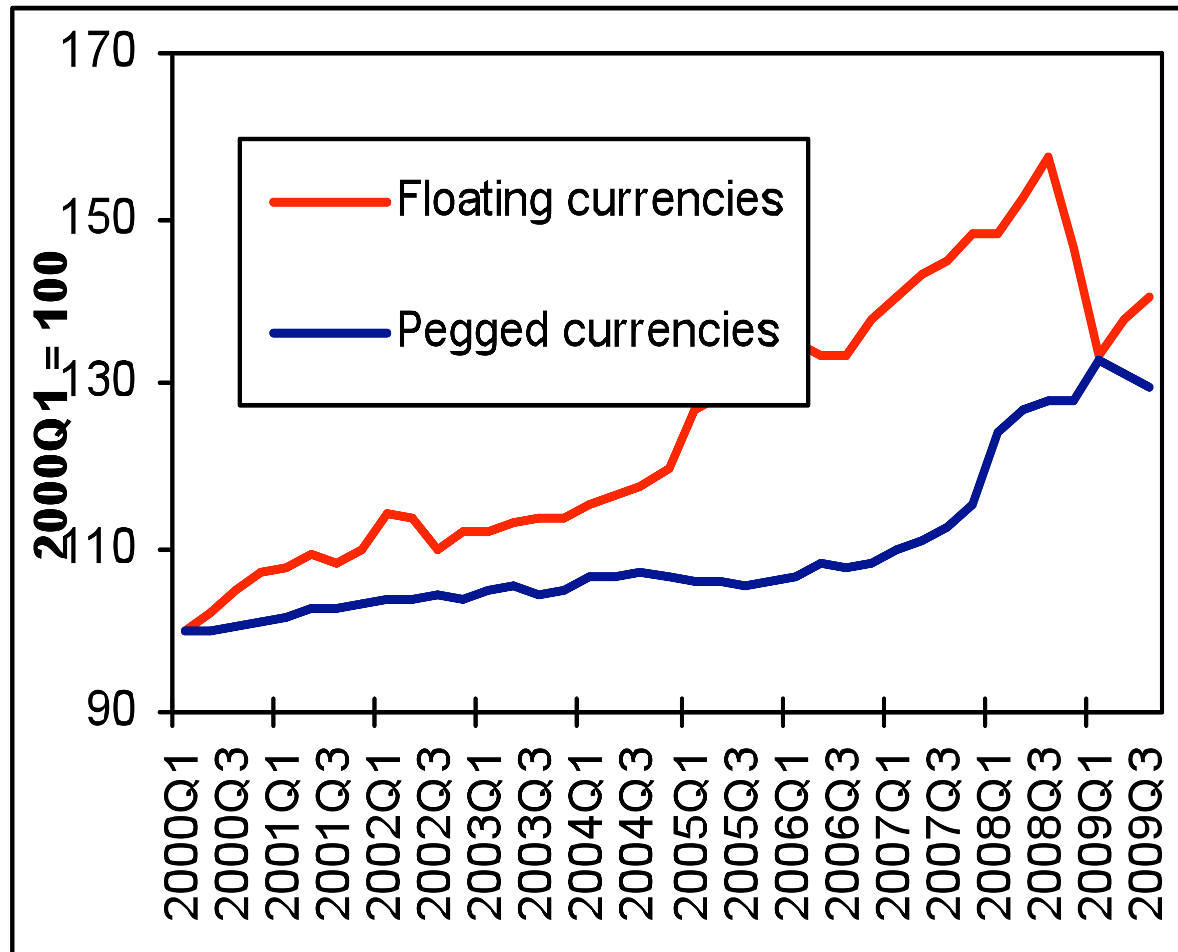
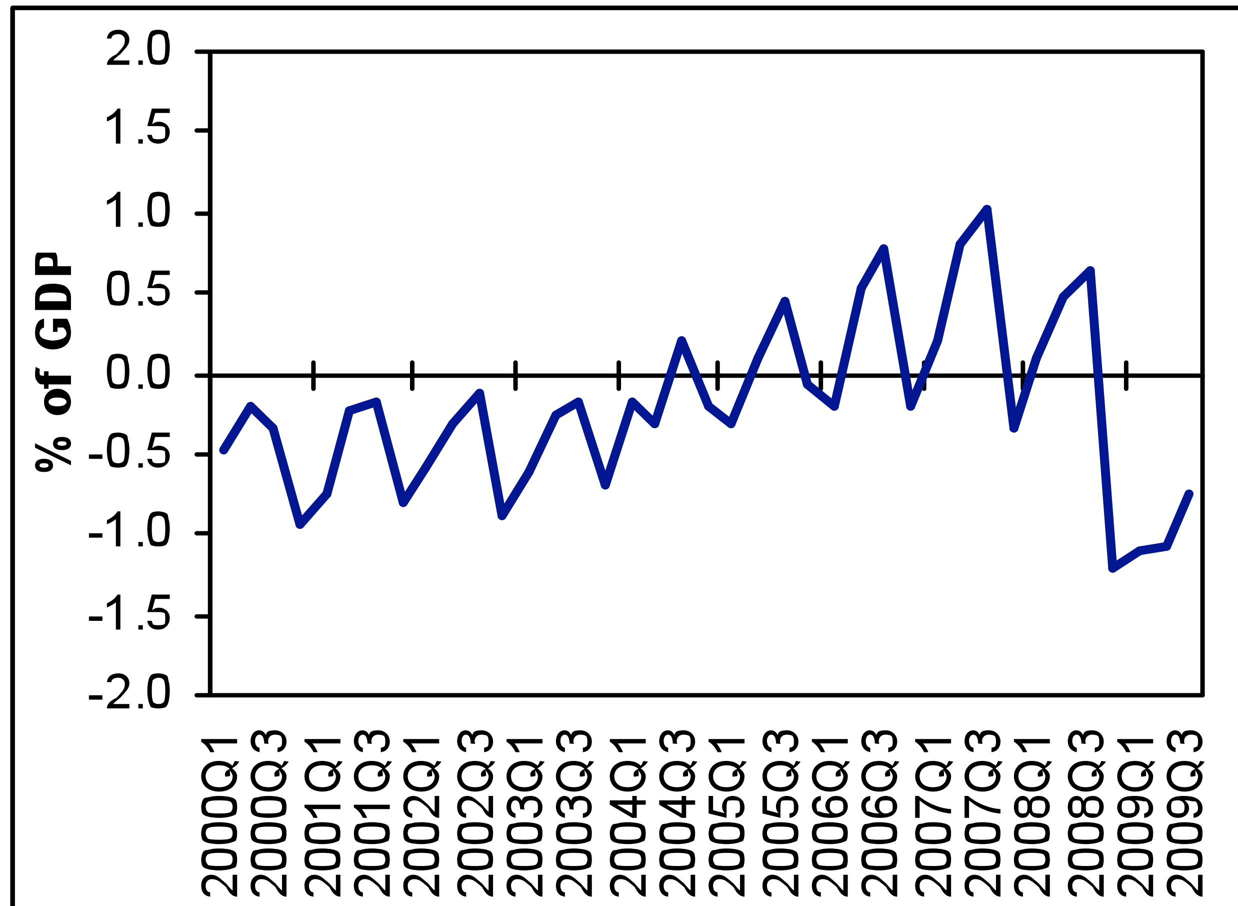


Figure 7. Quarterly fiscal balance



After the Lehman Brothers shock

- On average:

  Orderly current account adjustments

  Moderate exchange rate depreciations (24% over the period of six months following the Lehman shock) and absence of pegged currencies devaluations

  Limited capital outflows and foreign exchange reserves losses (reserves dropped approximately 21% over the period of six months following the Lehman shock)

  Absence of debt-deflation so far.

How has debt-deflation been avoided so far?

- Timely coordinated action of IMF, EU officials and EU banks in order to prevent "**It**" from happening again.
- Vienna initiative – roll over of maturing debts and abstaining of EU banks from liquidity draining.
- Action motivated by self-interest.
- In other circumstances coordinated action doubtful.

Final thoughts

- Western financiers are not the only one to be blamed
- Symbiosis with corrupted, incapable populist local governments
- Voters are in their own way real Keynesian – they have taken as granted his saying that in long run we are all dead
- They want now, and they want everything
- No matter what the costs are because these costs will be transferred into the future and the final bill will be paid by forthcoming generations
- Conspicuous lack of intergenerational solidarity