The two pieces below discuss the impact of the ongoing financial crisis on the emerging markets in Europe, and these countries' prospects in the medium term.

Robert Shiller, Yale University: "Crisis is an Opportunity to Advance Financial Markets"

The financial crisis that has started in the US and spread to other countries is the biggest in decades. Failures of banks and building societies in the US, Germany, France, and the UK (the bank run on Northern Rock was the first in the UK since 1866) point to the severity of the situation. About one million homes in the US are now in default, and the number is rising. No country should feel immune from the crisis, as it has started to come around the world.

I believe this crisis is caused by human psychology and a boom mentality, speculative excess and the correction of that. In just nine years from 1997 to 2006 home prices in the US nearly doubled, and in some cities, such as Los Angeles or New York, prices went up by 3 to 3.5 times. At the same time, construction costs in the US actually went down in real terms; the population was growing steadily; interest rates had been falling for 20-30 years, and real rents stayed unchanged (so demand for housing services did not increase).

Interestingly, these events occurred simultaneously in many countries, both developed and developing. This is no coincidence, as this indicates that the economy is globalizing and a certain way of thinking tends to become pervasive amongst everyone as humans communicate so much with each other. Many people in different countries believe that real estate prices can only increase as there is only so much land, the population is growing, and so is the economy. But why should housing be a good investment? It has to be maintained, it depreciates, goes out of style... While there had indeed been a lot of land speculation before, the popular view that investments in homes are the best way to secure one's future is a new one.

In the recent boom the BRIC countries have played a role. Their rapid growth spooked people in developed countries, as well as spreading anxieties about how to fit in to the new capitalist world.

Financal markets can indeed be improved to better deal with some of these psychological problems, such as social contagion and wishful thinking. The current crisis is providing us with the opportunity to advance our financial markets. After the 1929 stock market crash the US took some radical measures, by for example creating a Securities and Exchange Commission, Federal Deposit Insurance Corporation, Fannie Mae, and Home Owners Loan Corporation. These are all government institutions that supported the financial markets and made them work again. This time this is not as bad a crisis, but it should also be dealt with properly.

Despite negative events recently, there is a number of very positive things going on in the financial markets, including:

- great advances in financial theory;
- advances in behavioral finance in the past 20 years;
- a revolution in information technology;
- the democratization of finance, i.e. making sophisticated financial instruments available to more people.

Yet we need better markets for risks that really matter to people, such as personal income risks, longevity risks (the risk of outliving one's wealth), and mortgage risks (i.e. a decline in home price). We can also expand the scope of markets for energy, and manage the risks of GDP decline by issuing GDP-linked securities. There is enormous potential for improvement in human welfare from radical financial innovation in these areas.

Robert J. Shiller is Professor of Economics, Yale University, and Co-Founder and Chief Economist, MacroMarkets LLC. The piece is based on his presentation at New Economic School in Moscow in March 2008. **BT**

Neven Mates, IMF: "Convergence will Continue, Albeit at a Slower Pace"

What impact will financial turmoil in some developed countries have on economic growth in Europe?

Europe will not be able to avoid the effects of global shocks. Historically there has always been a spillover effect of US economic slowdown onto the European economy. For one percentage point drop in growth in the US the growth in Europe will slow down by on average 0.5 percentage points. We expect that growth in the advanced European economies will decline by 1.25 to 1.5 percentage points in 2008 and will weaken further in 2009.

Emerging European economies may be more vulnerable to a global slowdown than the advanced economies. The direct trade effect from a sharp downturn abroad is likely to be significant because countries in the region are highly open, with exports accounting for 30-80% of GDP. Moreover, the heavy dependence on foreign capital leaves the region exposed to an abrupt retrenchment of capital inflows. The appreciation