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 of the euro and the sharp increase in headline inflation, driven by food and energy prices, is adding to the troubles. In emerging European markets GDP growth is projected to decline from 6.9% in 2007 to 5.5% in 2008 and 5.2% in 2009.

Thus, growth in emerging economies will remain quite robust and the convergence towards more advanced European peers will continue, although at a slower pace.

What are the main challenges for the emerging market economies?

Tighter integration with the more advanced European economies has allowed emerging European economies to grow considerably faster than countries with similar income levels in other regions. A very good growth performance over the last five years was achieved thanks to technological progress and increasing investment. Besides, there has been a very strong link between growth and financial deepening.

Yet, many emerging economies in Europe have current account deficits and levels of external debt that, as a share of GDP, are considerably higher for their income levels than the rest of the world's. This increases vulnerabilities to external shocks — risks that have been rising considerably with the ongoing global financial turbulence. In some of the countries, primarily in the Baltic countries, Bulgaria, Romania and Slovakia, the current account deficits are excessive.

In many cases, loose fiscal and monetary policies have contributed to large current accounts deficits and increases in external vulnerability. On the positive side, foreign direct investments contributed a lot to financing the current account deficits. Besides, it was domestic demand rather than real effective currency appreciation that was the main reason for this worsening of current account deficits. This suggests that it will be less difficult to reverse the current account deficits and improve the situation without major changes in real exchange rates.

What should policy response be?

The challenges facing policymakers in advanced economies are to restore confidence in the financial system and minimize the impact of the financial sector crisis on the real economy, while maintaining inflation credibility and safeguarding long-term fiscal sustainability.

In emerging European economies, policies need to focus on reducing vulnerabilities and strengthening the resilience of the financial system. Our policy recommendations for the emerging market economies in the region can be summarized as follows:

- Enact structural reforms to increase potential growth by ensuring fair market competition, reducing the role of the state in the economy, improving the business environment, cutting red tape, reforming the judiciary, and progressing in the EU harmonization process in EU-candidate countries;
- Implement policies to ensure macroeconomic stability, address external imbalances, and reduce vulnerabilities, including tightening monetary policies, and advancing fiscal consolidation;
- Implement policies to strengthen the financial sector and create buffers to help adjust to shocks, including prudential measures. Establishing credit registries and strengthening non-bank financial sector supervision would substantially increase the effectiveness of these measures.

Based on presentation of the April 2008 IMF report "Regional Economic Outlook: Europe — Reassessing Risks" by Neven Mates, the IMF Senior Resident Representative in Russia. **BT**

Economic Outlook: Regional Perspective

Real GDP, Consumer Prices and Current Account Balance in Selected ECA Countries
(annual percent change unless noted otherwise)

	Real GDP			Consumer Prices (Annual Average)			Current Account Balance (% of GDP)		
	2007	2008	2009	2007	2008	2009	2007	2008	2009
Estonia	7.1	3.0	3.7	6.6	9.8	4.7	-16.0	-11.2	11.2
Latvia	10.2	3.6	0.5	10.1	15.3	9.2	-23.3	-15.0	-10.5
Lithuania	8.8	6.5	5.5	5.8	8.3	6.1	-13.0	-10.5	-8.8
Czech Rep.	6.5	4.2	4.6	2.8	6.0	3.5	-2.5	-3.0	-2.8
Hungary	1.3	1.8	2.5	7.9	5.9	3.5	-5.6	-5.5	-5.1
Poland	6.5	4.9	4.5	2.5	4.1	3.8	-3.7	-5.0	5.7
Slovak Rep.	10.4	6.6	5.6	1.9	3.3	3.1	-5.3	-5.0	-4.7
Bulgaria	6.2	5.5	4.8	7.6	9.7	6.0	-21.4	-21.9	-18.9
Romania	6.0	5.4	4.7	4.8	7.0	5.1	-13.9	-14.5	-13.0
Russia	8.1	6.8	6.3	9.0	11.4	8.4	5.9	5.8	2.9
Ukraine	7.3	5.6	4.2	12.8	21.9	15.7	-4.2	-7.6	-9.7
Kazakhstan	8.5	5.0	7.0	10.8	17.1	8.3	-6.6	-1.7	-1.0

Source: IMF World Economic Outlook April 2008