The global financial crisis has ruthlessly demonstrated how important financial factors are for developments in the real economy as a whole, and even more broadly for the sustainability of market-based economic systems. This basic point of wisdom had been sidelined during the extended period of great moderation that preceded the financial crisis, presumably also because of successful management of financial stress, for example during the dot-com crisis. Developments like the protracted stagnation of Japan were not understood as warning signals. But again, as became crystal clear in the autumn of 2008, this time was not very different after all.

Given today’s global financial linkages, Europe was hit particularly severely by the crisis, even though the latter originated in the subprime market of the United States. In a number of European Union (EU) and euro area countries the financial crisis turned into a sovereign debt crisis, challenging for some time even the cohesion of Economic and Monetary Union. Even in late 2013, more than half a decade after its onset, Europe is still dealing with the fall-out of the financial crisis and grappling with the challenge of fully resolving it. While considerable progress has been achieved to this end, including the ongoing revamping of institutional and regulatory set-ups in the EU and the euro area, the recovery in Europe has been very gradual and fragile. Moreover, the spectre of an extended period of anaemic growth casts a shadow on future prospects.

Not only Western Europe, but also many emerging economies from Central, Eastern and South-Eastern Europe (CESEE) were strongly affected by the crisis, much more intensely and lastingly than emerging economies outside Europe. Here, too, crisis resolution remains a key issue of the policy agenda in many countries, and will certainly continue to do so for some time. The process of per capita income convergence with Western Europe has largely stalled and the outlook for a future acceleration of the catching-up process has become more elusive. At the same time, recovery paths across individual CESEE countries have been diverse. This raises the question to what extent these differences reflect variations in the pattern of the financial cycle prior to the crisis, or varying policy responses to financial busts.
Against this backdrop, this book provides a comprehensive account of the discussion about the link between the financial cycle – the notion of financial booms followed by busts – and the real economy, together with the respective policy challenges, as it has re-emerged and evolved in recent years. In doing so, it focuses mainly on Europe, and in particular on Central, Eastern and South-Eastern Europe.

Much of the recent analytical work on the broader role of financial cycles has been pioneered by the Bank for International Settlements, the central bank of the central banking community. Key findings of this seminal work suggest that financial cycles can be parsimoniously described by credit and property prices and are characterized by both low frequency and high amplitude. Most importantly, financial cycles are reliable leading indicators for financial crises, which historically triggered permanent losses in output and slow and protracted recoveries. This leads to the proposal to replace standard measures of cyclical fluctuations by ‘finance-neutral’ output gaps, which are seen as more reliable indicators for the current stance of the economy as compared to common measures that ascribe deviations from potential output solely to inflation. This line of thinking also argues that the design of policies is key to successfully managing and resolving crises and makes concrete recommendations for how to prevent financial cycles from becoming excessive and thus harmful for growth, as well as for how to address financial busts if they still occur. More specifically, it is argued that policy measures should aim at leaning more aggressively against the build-up of imbalances in the boom phase, and at easing less during the bust phase. In the bust, crisis management needs to prevent a meltdown and then give way swiftly to crisis resolution, that is to say to measures to establish the basis for self-sustained recovery. To this end, it is key to quickly ensure full loss recognition, to recapitalize financial institutions and resize the financial sector. More generally, policy-makers need to fully recognize the existence of financial cycles and to lengthen their policy horizons given the longer-term nature of financial cycles.

Most macroeconometric models used before the crisis did not include appropriate representations of the financial sector, and they did not capture the transmission of financial frictions on to the real economy. Consequently, most economists failed to predict the crisis and come up with early warning exercise systems. This book succinctly reviews recent trends in macroeconomic modelling that are geared to incorporating issues related to the financial system and the banking sector and to better modelling the links between micro- and macroeconomic developments so as to capture human behaviour more appropriately than in the past. It shows that the economics profession has responded to the crisis in many
promising directions, while also conceding that the jury is mostly still out
on which of the new approaches will prove successful over a longer time
period. Clearly, more work is needed to refine existing models and to
develop new modelling approaches in macroeconomics, especially with a
view to slotting in financial factors.

Research before the crisis established a positive nexus between financial
depthening and growth, while more recent debates have questioned the sus-
tainability of debt-financed growth, given the deleveraging process set off
by the crisis. Against this background, a key theme that this book explores
is to what extent the positive link between finance and growth is empiri-
cally still valid and whether the effect of finance on growth differs between
regions depending on the stage of economic and financial development
and the length of the time horizon.

Looking at the short term, findings of analytical work presented in
this book provide new empirical evidence that confirms that business
cycle measurement should take the financial cycle into account. More
specifically, empirical results from an extended structural unobserved
components model, explicitly considering private credit and house price
developments for four advanced and four emerging economies from the
CESEE region, show a considerable impact of the financial cycle on busi-
ess cycles and confirm a heterogeneous effect of the financial crisis on dif-
f erent countries. These findings demonstrate that traditional approaches
relying on the concept of non-accelerating inflation output are unable
to detect upswings caused by the financial cycle. This also highlights
the importance of incorporating financial information in the estimation
of potential output and the corresponding ‘finance-augmented’ output
gaps. As for the long-term finance–growth nexus, new pre-crisis evidence
on the banking system and the financial sector in CESEE EU member
states (excluding Croatia), using a dynamic panel model to investigate
the period 1994–2007, argues that the contribution of stock and credit
markets in these economies to economic growth was limited. Thus, while
there is broad consensus on the limited role of the stock market, the role
that the credit boom played in the years before the crisis remains disputed,
given that earlier work assigns a more important role to credit in driving
pre-crisis growth. Combining the short- and the long-term view, a key
policy implication, also highlighted in this volume, is the need to limit
vulnerabilities related to strong capital inflows into catching-up econo-
 mies, given that ‘speed can kill’ the positive finance–growth nexus. The
role of cross-border banking is crucial in this context. After all, empirical
evidence shows that foreign banks in CESEE acted as shock absorbers
after the crisis hit.

Real-estate bubbles are a pivotal factor contributing to the incidence
Financial cycles and the real economy

of financial crises, but also affecting their depth and duration. This book therefore devotes several chapters to this key theme. The respective contributions explore the incentive structures of buyers, sellers, banks and governments that may all contribute to a mounting house price bubble and the difficulty of detecting real-estate bubbles early on, while acknowledging that even past house price bubbles are often not fully understood, especially so in emerging economies like Central, Eastern and South-Eastern Europe. An important take-away from these analyses is that the various regulatory, fiscal, monetary and macroprudential measures to address house price booms need to be accompanied by appropriate central bank communication, media information and financial education to influence house price expectations. A second lesson is that policies that appear to be appropriate ex ante can easily turn out to be insufficient with hindsight. Spain is a case in point. It was considered a model case for prudent policies, given its sound public debt levels and the dynamic provisioning system in banking regulation. But these policies were neither sufficient to curb the real-estate boom nor able to prevent or cushion its bust. Thirdly, empirical evidence shows that housing cycles in large advanced economies since the 1970s have become longer over time and have come to display increasingly higher amplitudes. To reverse this disturbing trend, it is argued that macroprudential policies should be given into the hands of strong and independent authorities.

Individual country experiences contain a rich body of evidence that can inform policy-makers about which policies may be particularly useful in dealing with the financial cycle, in both the boom and the bust phase. While the effectiveness of policies is also determined by the specific institutional and structural settings in individual countries, it is still very instructive to explore country cases and draw broader policy lessons from them. This book contains country-specific accounts from Croatia, the Czech Republic, Poland, Serbia, Slovenia and also from the Netherlands. Taken together, these country experiences suggest that macroprudential policies, if well designed and properly targeted, can also be reasonably effective in small and financially integrated economies, especially with respect to household debt, including mortgage loans, and the currency denomination of credit. They also show how important institutions and governance are for avoiding or containing the build-up of bad loans in the financial sector and for raising resilience to crises more generally. Appropriate regulation and supervision should ensure that banks have to base their business models on the true cost of risk over the whole credit cycle. Likewise, effective resolution of non-performing loans, which is one of the key challenges in many CESEE countries, is contingent upon the functioning of institutions and the regulatory environment. Another key lesson
that derives from many country experiences is the need for coordination between monetary, fiscal and prudential policies.

Finally, the issues pertaining to the deepening of European integration, and especially to the completion of Economic and Monetary Union, feature prominently in the contributions to this book. The Single Supervisory Mechanism will be a key element in this new architecture. Broadening its reach beyond the euro area to as many CESEE EU member states as possible would be mutually beneficial, given the high degree of financial and banking sector integration in Europe. The future of Europe and the euro area hinge upon taking a European rather than a national perspective in dealing with and fully resolving crisis-induced policy challenges.

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