Preface

Six years after the outbreak of the global financial crisis in 2008–2009, debt overhangs and balance sheet repair continue to be important drivers of weak economic growth. Even worse, some countries are still in the middle of a deep recession. Here, self-enforcing negative feedback loops between indebted private sectors, a weak financial sector, and a sovereign under stress constrain aggregate demand and credit supply conditions. When faced with the need to repair balance sheets, economic agents have been placing more attention on reducing debt rather than on increasing consumption or investment. In Europe, balance sheet adjustment seems to be more challenging than in other regions or in previous episodes. Consequently, the rebalancing process is far from complete. While significant progress has been made with the repair of banks' balance sheets, controversial issues such as the difficulty of achieving simultaneous rebalancing across countries and sectors still remain unsolved. In some European countries, simultaneous deleveraging has so far led to negative spillovers, further amplifying the harmful impact of country-specific deleveraging on economic activity.

Against this backdrop, this book examines the multiple challenges and potentially conflicting objectives of sectoral rebalancing in Europe, with a special focus on Central, Eastern and South-Eastern Europe (CESEE).

Part I frames the discussion on rebalancing challenges. Views seem to converge along the following lines. Economies tend to escape the dilemma of either chronic disequilibria or contractive deleveraging by strengthening their industrial base. In order to make rebalancing work all over Europe, they will need to fundamentally improve the macroeconomic environment, presumably by combining supply-side, factor productivity-enhancing measures with policy instruments focusing on the demand side. The remarkable progress of external adjustments observed in countries at the Southern and Eastern European periphery came at the price of high unemployment and a collapse in aggregate demand. The decline in investment was particularly high in those countries. Hence the top priority for Europe, in particular CESEE, is to invigorate innovation, given the exceptionally low levels of public and private spending on research and development, and to reverse the precipitous decline in both public and private

investment. In addition, it may be important to address the debt overhang directly, for instance by encouraging financial restructuring of debt of the private sector.

Part II turns the attention to balance sheet recessions, debt overhangs and the associated question of the optimal sequencing of adjustment across institutional sectors. Basically, we can distinguish between ‘passive’ deleveraging, which is characterized by still positive net credit flows associated with even faster (nominal) growth of gross domestic product, and the much more painful ‘active’ deleveraging, which is driven by negative net credit flows. Importantly, the cost of private sector deleveraging is apparently considerably higher when it is combined with public sector deleveraging. In almost all European countries, the corporate sector has considerably increased its financial surplus since the outbreak of the global crisis in 2008–2009. The scaling-down of investment went hand in hand with a significant increase of cash holdings among large firms. This indicates that large firms aim at becoming more independent from external funding sources in an environment of high uncertainty.

In a balance sheet recession, despite low interest rates, households are paying down their loans instead of maximizing profits. Following the proponents of a ‘balance sheet recession’, the government is the only sector still willing to borrow and should therefore step in to increase aggregate demand. However, the Stability and Growth Pact and other restrictive fiscal rules, which have been implemented during the crisis years, are setting narrow limits for government spending. While some of these rules have been too restrictive, hindering growth-enhancing investments, others have been helpful in stabilizing the debt crisis.

Part III deals with an aspect very often overlooked in discussions: the link between macroeconomic imbalances and economic inequality. When comparing the pre-1929 and the pre-2008 decades in the United States, we can observe sharply increasing income and wealth inequality and mounting debt leverage of low- and middle-income households in both episodes. Rising inequality was probably an important driver of debt growth, as top earners save the additional funds while bottom earners borrow to increase consumption. With top earners’ rapidly rising income shares, the savings rate in the United States declined and debt increased as low-income households dissaved and borrowed to increase consumption. This resulted in rising current account deficits. The German case is different as it is dominated by small and medium-sized family-owned firms which retained profits within the company instead of distributing bonuses and dividends. Thus the top income shares hardly increased in the boom years, while corporate financial balances increased strongly. Just as in many advanced economies, in some CESEE countries inequalities contributed to

credit growth, bubble formation and imbalances, which in turn cemented inequality.

Part IV discusses the future of (central) banking in Europe with a special focus on the interaction between monetary policy and financial stability. It may be argued that in normal times, monetary policy and financial stability should be conducted independently, whereby each policy should be fully informed of, and take into account, the conduct of the other. Cooperation between both types of policy is needed in times of crisis. With the establishment of a Single Resolution Mechanism (SRM) and the Single Supervisory Mechanism (SSM) for banks resident in the euro area and opt-in countries, Europe has made a major step forward.

Finally, Part V looks at the poles between national and global perspectives. This part comprises the views of high representatives of CESEE central banks on their experiences when faced with multiple challenges in the course of the crisis.

As a consequence of the ongoing weak economic performance, the remarkable convergence process of Eastern and Western Europe observed in the two decades prior to the crisis has slowed down, and convergence between the North and the South was reversed. The massive decline in investment further jeopardizes the European convergence process, as the cuts in investment were disproportionately high in the poorer countries. Reversing the decline in investment will be critical to achieving recovery and sustainable growth over the longer term. We hope that this volume will contribute not only to the debate on rebalancing but also provide policy makers with insights helping to improve the chances of prosperous convergence in Europe.

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