Re-establishing growth after the crisis

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Views expressed do not necessarily reflect those of the Bank of Finland
I. Introduction

♦ Two aspects in the movement from crisis to growth
  – Recession has created large output gaps in most countries.
    • This gap needs to be closed.
  – The growth processes must be restarted.
    • Growth of potential output has slowed.
♦ Lessons from earlier financial crises
  – Crisis in Nordic countries in 1990s
    • Finland, Norway and Sweden
♦ Prospects and challenges for CEEI countries
II. The 1990’s Nordic crises

♦ Background:
  – financial liberalization created a boom and overheating
  – large increases in asset prices
  – current account problems

♦ Classic financial crises
  – combined banking and currency crisis
  – recession/depression
    • significant period of negative growth (except in Norway)
  – big increase in unemployment
  – public debt shot up, but was gradually controlled
Figure 1. Real GDP growth

Sources: Eurostat and IMF.
Figure 2. Current account

% of GDP

Source: European Commission.
Loan losses/lending in the Nordic countries' banking sector 1985-1999, %

- 1 Norway
- 2 Sweden
- 3 Finland

Source: Central banks.
General government gross debt of Finland
1980–2009

Source: Statistics Finland.
III. Why did Finland and Sweden recover so well?

♦ Closing the output gap
  – Correcting the competitiveness problem
    • Nordic countries floated their currencies
  – Re-establishing credibility of monetary policy
    • Inflation targeting (Finland later joined the euro area)
  – Clear fiscal strategy
    • Gradual consolidation after initial deficits

♦ Reattaining rapid growth
  – Focus on labor productivity growth
    • Capital intensity and TFP
  – Roles of human capital and R&D
  – ICT revolution as an example of successful structural change
Reattaining growth I: TFP more important over time (labor productivity in Finland)
Reattaining growth II: education, R&D and ICT

♦ Nordics had scope to improve quality of labor as older age cohorts were significantly less educated.
♦ Nordics had high rates of R&D and significantly increased these rates after the crisis.
  – Norway is an exception here.
♦ Role of ICT was and is hugely important in Finland and also Sweden.
  – Growth accounting with ICT capital
## Growth accounting for selected countries

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<th></th>
<th>GDP growth</th>
<th>Contributions to GDP growth by</th>
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<td></td>
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<td>ICT capital growth</td>
<td>Non-ICT capital growth</td>
<td>Labour growth</td>
<td>TFP growth</td>
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<td>FINLAND</td>
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<td>1995-2000</td>
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<td>2000-2004</td>
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<td>0.6</td>
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<td>SWEDEN</td>
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<td>1995-2000</td>
<td>3.5</td>
<td>0.8</td>
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<td>THE US</td>
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IV. Restarting growth in CESEE countries: GDP

Source: Eurostat.
Economic environment

♦ Future domestic environments are challenging:
  – Risk perceptions remain high, finance is more difficult.
  – Deleveraging and higher saving in household sector.
  – Fiscal positions worsened, consolidation process will take a long time.

♦ Future international environment:
  – Trend growth will be slower in Western Europe and globally.
  – Reforms of financial architecture may improve CESEE financial systems.
  – Current tensions in the international financial system.

For CESEE economies:
  • Flexible exchange rate vs. Euro membership objectives
Restart I: closing the output gap

♦ Modest recovery in capital imports is likely
  – Higher domestic saving helps in narrowing S-I gaps
♦ Domestic finance of investment more important
♦ Challenges in the public sector
  – Focus on high-quality of public spending in view of fiscal sustainability concerns
  – Political stability and credibility are crucial for success
♦ Tackle unemployment to avoid decline in labor skills
Restart II: growth in potential output

♦ Relatively high human capital is a strength.
♦ EU membership continues to be central.
  – Some CESEE countries have weak tradable sectors.
♦ Maintaining competitiveness is key to success
  – cost control
  – productivity growth
♦ Continuing processes of structural change is vital.
  – Crises provide good timing for reform
  – Recessions are conducive to innovation
  – Important to find new comparative advantages
Competitiveness in CEE countries – Cumulative % 2004-2008 and % change 2008-2009

Source: Ameco and EU Commission
Thank you.