

## Selling the Drama: A Research Note

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The core of policy recommendations toward emerging market and transition economies comprises a package of stipulations on public finance and the liberalisation of trade and capital accounts usually in conjunction with fixed exchange-rate arrangements to achieve internal price stabilization. Nevertheless, the performance of catch-up economies is rather mixed: After periods of successful stabilization and exceptional growth in the private sector countries in Latin America, South-East Asia and Central Eastern Europe defaulted. The purpose of this research note is to put an alternative line of argument on the table that helps to explain the *drama* of lending booms and busts in transition economies albeit such countries may apparently have implemented the right policies.

Emerging market and transition economies avail themselves of commitment devices for credible macroeconomic stabilization policies and capital market liberalisations, for instance, in the form of political agreements towards membership or partnership with the European Union and any kind of exchange-rate pegging to an anchor currency such as the US-Dollar. A key to the understanding why such economies may ultimately bust is the question whether such reforming countries can grow up to expectations in the private sector, which have been attached to these commitment devices. In this respect, emerging market and transition economies, in which positive productivity shocks can frequently be observed seem to be prone to lending booms. Especially the divergence of productivity growth rates and hence inflation between the tradable and the non-tradable sector may heavily affect the extent and stability of a lending boom. Increasing productivity and correspondingly wages thus result in rising income levels of domestic households. Accordingly, wealth effects imply that economic actors will increase their current consumption and monetize this wealth effect. In presence of financial market frictions - a systemic feature of most financial markets – the impact of these productivity shocks on the economy are amplified via a financial accelerator. This way any market-oriented commitment device may additionally boost overoptimistic expectations about rapidly increasing earnings and profits.

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The frequently invoked stipulations on fiscal discipline and capital market liberalisations may even spur the financial accelerator impact and lending booms in emerging market and transition countries. For example, fiscal retrenchment policies may exert influence on current consumption behaviour via the Ricardian equivalence mechanism: Expected dips in future public debt may relieve future tax burden and thus trigger higher current consumption. In addition, successful price level stabilization lowers inflation expectations and thus real interest rates. Accordingly, the private sector may be even more inclined to borrowing for investment purposes. In addition, imperfect financial markets and an opening of the capital account in conjunction with a pegged exchange rate will stimulate lending booms: If catch-up processes are financed via international savings, shocks in domestic productivity might lead to a surge in foreign capital inflows, producing spill-over effects to the non-tradable goods sector and exacerbate business cycle swings. However, the catch-up bubble will burst immediately, once expectations of foreign investors on the profitability of investments turn sour.

As in most cases governments in emerging markets and transition economies conducted well perceived policies, such as improving the level of central bank independence, restraining expenditure policies and other economic stabilisation efforts these policies failed in the long run. To date there is no unique explanation for the occurrence of international over-borrowing and lending booms in general.

At the same time, a simple politico-economic argument might explain the occurrence and prevalence of lending booms: Since committed governments of catch-up economies have no tools to stimulate the economy in the short run *via* money creation and excessive public spending as central banks are independent and budgetary balances have to be consolidated, a simple way out strategy for politicians is to privatize public debt and leave the monetization of over-optimistic future earnings to the private sector. This is to say that private investment and consumption can be stimulated via deposit subsidy schemes, financial deregulation and several forms of financial market development measures. In this respect, governments can directly influence the level of credit in the economy. For that reason, stimulating aggregate demand with the help of these well perceived market-oriented measures bares the great advantage that the risk of default lies within financial markets and cannot be rolled over to the government unless a financial crisis emerges. In addition, as most lending booms are financed via current account deficits and thus foreign resources, the risk of default can be overruled to international financial markets and tax payers in other countries.

Lending booms are often accompanied by increases in consumption, investment and GDP accelerations without any signs of excessive inflationary pressures as the latter effects are mostly concentrated in asset markets and in the non-tradable sector, so that inflationary pressures remain unobserved in aggregate inflation measures until the lending boom goes into bust. Because of the political-economic incentive for having front-loaded benefits and delaying costs, a sourcing out of public debt to international financial markets seems to be a viable option to gain political support for incumbencies.

This research note depicts arguments for lending boom-bust cycles in emerging market and transition economies. We set forth, first, that there is a natural inclination of catch-up economies to lending booms; second, the stipulated market-oriented macroeconomic policy may push such booms; and, third, there are political-economic incentives for governments in these countries to press ahead with excessive credit expansion in the private sector. Although this line of argument seems to be in contrast to the existing literature, it reveals a new perspective on the root causes of lending booms in emerging market and transition economies.