The recent economic crisis and its Europe wide consequences

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Published online: 5 August 2012
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This special issue includes a number of selected papers that have been presented in the 13th annual INFER (International Network for Economic Research) conference held at the University of East London on the 12th and 13th of September, 2011. The selected papers have in common that they take into account the recent economic crisis, but analyse it from different perspectives. For example, they cover different topics on the debate on economic policy in a globalized and highly integrated world; they address issues concerning the difficulties of small countries competing in highly integrated markets in the EU where fewer macroeconomic policies are available to deal with asymmetric shocks; and they address the issue of the convergence process and in a non-optimal currency area. They also cover the links between the EU countries and the small open economies of the Baltic zone and how these links affect the economic performance of the individual countries. Moreover, the existence of political business cycles in the OECD countries can impose some limitations on the independence of central banks in election periods and may lead to inappropriate monetary policies aiming to obtain political gains. All these issues are discussed taking into account the recent economic crisis and the consequences on the national policies to be taken.

In particular, in the first paper of this special issue *Marjan Senjur* analyses the problems that Small Middle Income Countries (MIC) face when joining the eurozone. Using a descriptive macroeconomic model he shows the difficulties these countries

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have in order to handle with asymmetric shocks provided that monetary and exchange rate policies are not available and fiscal policy is limited. In this scenario, wages should be more flexible and a more active income policy will be needed to keep price and cost competitiveness in order to compensate for the absence of an exchange rate policy. Increases in productivity are also crucial for fostering exports and helping these countries in their effort to catch up with the more advanced ones. The disadvantages small MIC's face in terms of competitiveness and limitations in monetary policy may be eliminated, at least in part, by a national fiscal policy and a national industrial growth policy. The author's opinion is that the new framework for the European Stability Mechanism (ESM) should respect national fiscal responsibility and that a monetary union should not be extended into a fiscal union. A national fiscal policy is crucial for the implementation of national policies to preserve economic stability and competitive growth as well as to handle with external asymmetric shocks.

The paper by *Caraballo M. A. and Efthimiadis T.*, analyses the relationship between Relative Price Variability (RPV) and inflation for the Euro Area (EA) as a whole and for selected EA countries for the 1997–2010 period using semiparametric estimations. The regressions are estimated using kernel functions and applied to monthly data for 118 subcategories of the Harmonized Indices of Consumer Prices (HICP). The main finding is that the relationship between inflation and RPV exhibits a U-shape functional profile for all countries examined in the sample. The empirical analysis shows that although the European Central Bank's "below but close to 2 %" inflation target is optimal for the EA average, it is not the optimum inflation rate for the individual countries. In fact the 2 % ECB's target is too low for Spain and too high for France and Germany. These results raise the question as to whether a common monetary policy is appropriate for the Euro Area.

The paper by *Joscha Beckmann and Michael Kühl* investigates the relationship between domestic stock prices, income and market sentiments, and takes into consideration the external effects stemming from the EMU, the US stock prices and the foreign market sentiments. The link between domestic and foreign sentiments is explained through trade and the degree of integration of financial markets. The empirical analysis estimates a system of behavioral equations by considering a VAR econometric approach applied to three new EU members, namely to Latvia, Estonia and Slovenia. The authors' results show that European sentiments (consumers and investors expectations) are important for domestic income and domestic market sentiments in these countries (to a lesser extent in Estonia). The explanation is that market sentiments reflect expectations affecting the decisions on expenditure and investment. Furthermore, the authors are able to establish important linkages between foreign share prices and domestic income. More specifically, they provide evidence of a significant positive influence stemming from domestic share prices on market sentiments. They also detect a positive influence on domestic income stemming from foreign sentiments. In general it is shown that Latvia is influenced by foreign factors to a higher extent than Estonia.

The paper by *Jens Klose* employs an econometric framework to analyze whether there is a relationship between political business cycles and monetary policy designed by central banks. The empirical approach uses a two-dimensional asymmetric Taylor reaction functions to account for different reactions to the inflation rate and output by central banks before or after an election. Based on a Panel-GMM estimation approach

the author finds that in the OECD-countries there are political business cycles in monetary policy with respect to the inflation and output response, and concludes that central banks in these countries are not completely independent in election periods. He provides empirical evidence showing that there are significant differences in the reaction to inflation and the output gap given there is a pre- or post-election period. The interest rate reaction of central banks takes into account the deviations of inflation and output from target and potential levels. He also finds that for long periods before elections, there is a political business cycle in monetary policy only for inflation rates below target. The reverse is true for shorter periods where only states above target support the theory of political business cycle. The exclusion of the euro area and the adjustment of the US elections to be every 4 years do not change the results found when the full sample is used, confirming that the evidence of political business cycle are robust.

This paper by *Péter Halmai and Viktória Vásáry* provides a descriptive statistical analysis on the growth perspectives of the EU countries with special references to the new member states of the Central and Eastern Europe and in particular the Baltic States. The growth projections are made using the growth accounting approach and showing the contribution of the productive factors, such as, labour, capital and total factor productivity on the growth pattern. The statistical details given take into account the financial crisis after 2008 and how this crisis affects the growth trends in the specific groups of countries. They also discuss the convergence and catch-up issues making projections for the future development of these dynamic processes. They conclude that the financial crisis might generate significant decrease in the potential output and it might have a remarkable negative impact on labour, capital and total factor productivity. In certain new member states the real convergence might stop in the short run and even divergence might be a probable result for some countries. According to their projections the Baltic States will diverge in absolute terms from the average income level of the EU in the 2008–2013 period. The final disappointing conclusion is that the trajectory of the permanent shocks threatens with the complete collapse of the European growth and catch-up principle.

All these selected papers make a significant contribution in the economic literature by discussing, providing empirical evidence and suggesting policies on different topics which are of a great concern in economic analysis especially in a new globalized world and high market integration. Issues of how to deal with asymmetric shocks, which monetary and fiscal policies are appropriate to stabilize the economies, which policies can help countries to catch-up with the advanced ones, how to deal with political business cycles that could destabilize the economies, and the special attention that must be given to the small and open economies in the EU, are all analyzed in this special issue. The discussion of all these subjects is also very pertinent in the present days where the financial crisis started in the end of 2007 and expanded over the world, dominates the political and economic debate, trying to find solutions to overcome the consequences of the economic decline. We hope that this special issue contributes to this debate.