

Book review

The Review of *Emerging Europe and the Great Recession* by Daniel Dăianu, Cambridge Scholars Publishing, Cambridge 2018, pp. 332.

Reviewed by Dániel Palotai*

We are living in uncertain times. The world economy is transforming rapidly due to technological changes, the turning tide of globalization and shifts in geopolitical power. The financial crisis accelerated the transformation and drastically changed the global status quo in many ways. It is clear that the pre-crisis world cannot (and should not) be restored. The decline in resilience of economic systems may prevail, as the overcomplexity and interconnectedness of the world economy is increasing.

Daniel Dăianu's book, *Emerging Europe and the Great Recession*, is aiming to provide some guidance on what the roots and consequences of the financial crisis are and what can be the steps forward. As the author has extensive policy and academic experience both at international and national level, his insights are valuable contribution to the existing literature. He studies the global and European challenges from various angles and elaborates extensively on the outlook of European emerging economies in the changing global environment.

The book comprises and revises important pieces of previous works of Dăianu. To organize thoughts, the chapters are bunched together into three parts. First the Great Recession and its implications for the global economy is discussed, then the author is studying European issues, and finally he is turning to the challenges faced by the European emerging economies.

The global economy and the Great Recession

The world economy went through one of the deepest recessions in modern times. The financial crisis was not just an exceptionally deep cyclical downturn, but also a sign of fundamental changes in the global economy. The pre-crisis period was characterized by continuous globalization where in economic thinking neoliberalism and market fundamentalism emerged as the mainstream view. The global economy became more and more interlinked by trade and finance.

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The rise in global trade, specialization and the emergence of value chains certainly increased efficiency globally and have been the drivers of growth before the crisis. However, trade networks became extremely complex and multinational corporations became so large, that governments basically lost control over them, which led to growing security and systemic risks. One important aim of New Protectionism, as the author argues, is to decrease these risks and regain national control over companies. This is very likely to hurt the growth of the global economy. According to Dăianu, the way to preserve as much as possible of the benefits of global trade can be the creation of three trading blocs (around the United States, the European Union and China) with strong internal and somewhat looser external linkages. Meanwhile, it is also essential to maintain some structure and common rules of trade. If ad hoc protectionist measures and currency wars became the new norm in trade policy, then the negative impact on the global economy would be sizeable.

Turning to the evolution of finance before the crisis, Dăianu expresses very critical views – with reason. During the decades before the crisis the finance industry had been growing enormously. The main reason was financial liberalization and abolishment of capital controls. Finance became more and more detached from economic fundamentals and the flow of capital was increasingly influenced by valuation methods and financial cycles. The banking industry gained unprecedented influence and its profitability was unmatched by other industries. However, Dăianu points out that its real value creation was substantially lower than its profitability, and a significant share of profit was based on asymmetric information, market abuse and selling products of dubious quality to misinformed clients. Although the financial crisis was a blow to the reputation of finance, the way how the crisis was managed was, in general, not against the interests of the financial industry. It is true that regulation has become stricter to make the sector more resilient, but even in this respect the financial industry is efficient in regaining influence.

Dăianu emphasizes in several chapters of the book that much more has to be done for taming the financial sector: He proposed to return to the spirit of Bretton Woods and constrain destabilizing capital flows in order to reduce harms from international finance. The new macroprudential instruments can partially fulfill this task, but the efficiency of the new policy framework is to be tested. Furthermore, to mitigate the risk from the financial industry, Dăianu argues that the size and complexity of the financial institutions should be decreased. Anti-trust legislation has already forced several industries through this process, so this is just a question of political willingness. Finally, it should be also avoided, that the same risks emerge in less regulated parts of the financial sector. Regulatory

authorities should put more emphasis on regulating shadow banking and fintech industry properly to ensure a level playing field.

It is a widely shared view among policy makers that the global economy should be transformed in many ways, but it is far from clear how the new setup will look like. It is alarming that policy coordination at the global level is weak, a new international regime has not emerged. As Dăianu sees it, G20 is not competent, G2 (US, China) does not work. Due to its internal problems the EU lost its importance and influence. The great transformations in the global economy will also lead to the continued shrinking of the EU in an international comparison, unless decision-makers address challenges and strategic issues facing the European integration. However, in many important questions we have clashes of views globally and do not see which road should be taken. We do not have answers how inequality within societies will evolve, what will be the consequences, how technology will transform the way we work and live in general. Our knowledge has been questioned even in those fields where previously we thought to have reached a consensus view. For that a clear example is the conduct of monetary policy, where even the major central banks have different views on the necessity of sustaining low rates for prolonged period. The revision of economic theories and rethinking of economic policies also seem to be needed in many aspects taking the crucial lessons of crisis into account.

The European Union

The author explores the unresolved crisis of the European Union. Mistrust is growing between citizens and governments, between governments and EU institutions and also between citizens and EU institutions. The crisis had been caused by numerous factors, including uncontrolled immigration, excessively skewed income distribution, erosion of the middle class, terrorism, unethical conduct of business and politics, tax evasion and avoidance. The crisis pressed politicians to focus more on domestic politics, to put national interests into the fore while the solidarity principle among the Member States has been reconsidered in some cases.

Some problems of the European Union, which deepened the recession through the financial crisis significantly and prolonged the recovery, are related to structural flaws. In this respect some progress has already been made. The Single Supervisory Mechanism and a common resolution mechanism was set up. However, the financial sector is still far from being adequately regulated. The flaws of the new systems should be adjusted to make them more operational.

Dăianu also highlights the need for a common deposit insurance to dampen the negative feedback loop between the financial sector and public finances. Furthermore, similarly as at the global level, the European Union should put more emphasis on decreasing systemic risks and regulating the shadow banking system to ensure a level playing field in the financial sector.

Dăianu explains that even if the European Union succeeds in taming the financial industry, its structure will remain flawed. Since its creation, the euro area has never been an optimal currency union because fiscal policy within the currency area remained overwhelmingly national. The author sees it indispensable to strengthen fiscal capacity for the European Union, which may prove to be very challenging politically. To start with Dăianu proposes the introduction of a common unemployment insurance scheme (as also in the US, the unemployment insurance is provided at the federal level). This could enhance stability, burden sharing and solidarity, dampen the impact of asymmetric shocks on national economies and help to make it realistic to keep fiscal rules. As the EU should strengthen its security and foreign policy, the common fiscal capacity may increase further and, in the medium term, even issuing common bonds could make sense.

Although a number of problems of the European Union were rooted in its flawed structure, also inappropriate policies and weak leadership deepened the crisis significantly. A striking example was the impotence of European institutions during the immigration crisis, where the low response capacity of the Union has been a shocking revelation. The European institutions were extremely slow to recognize, that the inadequate policy response led to further fragmentation in Europe. If the EU's external borders are not protected, then the individual Member States shall protect their own borders. The EU failed to find a wise balance between solidarity, humanitarian concerns and pragmatism. This must change, and the EU should put much more effort into working together with the affected states (Turkey and several North African countries) next to its borders to permanently stop illegal immigration.

New shocks, turbulent times will certainly come. To manage new challenges the relation between citizens and EU institutions should be changed. The author points out that nowadays few politicians have the guts to speak honestly about the new economic and social environment and the EU has disturbing democratic deficits. The European Union should put much more effort to communicate with its citizens to make them feel involved in the European project.

Emerging Europe

The countries of emerging Europe joined the European Union with high expectations. The example of the Western European economies was attractive and with the adoption of the European institutions the convergence seemed to be automatic. Substantial FDI flowed in and the economies became integrated into the global value chains of the German and other developed countries' multinational companies. Thanks to the import of technology and the know-how transfer from abroad, the new Member States indeed showed convergence and the gap between old and new members of the European Union narrowed.

However, the financial crisis highlighted that the convergence process has its limits. The example of the South European economies was a clear indication, that above a certain level the catching up slows down or stops. The failure to understand the convergence process properly led to inadequate structural policy measures and overoptimism in these countries before the crisis, and painful correction afterwards. The author of this review highlights that the crisis management of the EU Mediterranean countries also proved to be unsuccessful as the austerity measures entailed enormous real economy sacrifices in this region. The wave of New Protectionism and the slowdown in global trade also highlights that emerging Europe needs to find stronger domestic drivers for growth. As previously the source of productivity gains was to a great extent external, the transformation is not expected to happen smoothly. The reviewer calls for strong macroeconomic fundamentals and well-designed, innovative policy measures to boost productivity and enhance competitiveness.

The new Member States had to learn that the EU should not be idealized. Although in general they followed the rules, even more than some old Member States because of the flaws in the structure of the Union they were severely hit by the financial crisis. The most important source was that in Europe capital flows could not be managed properly because of which cheap credit flowed to the new Member States. A significant share of the inflow financed non-productive investments, therefore it caused severe resource misallocation. As financial flows reversed during the financial crisis, the negative consequences on growth were sizeable.

Furthermore, the new Member States also had to realize that in Europe various economic models exist, and it is far from clear which one of them, if any, could serve as the benchmark to be targeted in the future. It is quite possible that the new Member States have to find their own models and place within the European Union.

Dăianu argues that, as uncertainty has increased, the accession to the euro area should be judged cool-headedly. Nominal criteria are, in general, fulfilled by the new Member States. but more real convergence is needed. He rightly points out that the huge development gaps between the Members States may lead to significantly different consequences of economic shocks, and also the business cycles of some new Member States are not correlated enough with the European cycle. While Dăianu argues that the development gap should be less than 25 percent point, the author of this review would call for even higher degree of convergence.

Concluding remarks

World is transforming fast and the future is uncertain. No one can tell how the world will look like in 20 years. However, that does not mean that our future will evolve randomly. Future is indeed shaped by people and policies. Therefore, policymakers shall do whatever is viable to ensure the highest degree of resilience and sustainable growth. The book by Dăianu has some very clear messages also in this respect: Moral and ethical business is indispensable for the cohesion of societies and the resilience of economies. The involvement of citizens in shaping the future is essential. The hopes for better times should be preserved even in difficult circumstances. In Europe the social model shouldn't be abandoned, and we should stick to the principle of equal opportunities.

Keeping these principles in mind it is worth highlighting Dăianu's main policy proposals once more: First, international finance should be regulated, disruptive capital flows should be tamed. To regain control over the financial sector, antitrust legislation should be used, the size and complexity of the financial institutions should be decreased. Furthermore, the lessons from the crisis should be learned. The structure of the European Union should be strengthened. In Dăianu's view, sizeable common fiscal capacity and the introduction of common unemployment insurance is needed for addressing asymmetric shocks and enhancing solidarity within the European Union. For steering economies through the turbulent times of the future each proposal is worth considering, while policymakers should engage in structural reforms and targeted policies.