

TO THE CORE OF THE CRISIS

Juraj Karpiš talks on the causes and consequences of the financial crisis and its impact on Slovakia's business environment



Juraj Karpiš

On February 24th, the Netherlands Chamber of Commerce in the Slovak Republic, in cooperation with the Swedish Chamber of Commerce, held a business breakfast seminar with the main topic "FINANCIAL CRISIS IN SLOVAKIA AND EXPECTED DEVELOPMENT IN 2009". One of the speakers of the event was economic analyst Juraj Karpiš of the Institute of Economic and Social Studies, who kindly gave an interview for Bulletin on the current topic.

INESS is informing about the consequences of the financial crisis in all ways, either in the media, in conferences, or via its website. But do you think – though the crisis is being mentioned in the media over and over again – that the public is well informed and aware of what it really means, and what it means for them in particular?

I think the public is more informed now than it was in December last year. Then even top politicians denied future problems for the Slovak economy, which can be seen on the overly optimistic GDP growth estimate of Ministry of Finance from that time. The crisis and measures against it occupy the front pages of newspapers everyday so many people are aware now of the main features of the crisis. People are also becoming afraid of insecurity of their jobs and therefore public interest is growing. The causes for the crisis are still being misinterpreted in a way which suits the ideological predispositions of Slovak politicians though.

If you sum it up, what triggered the crisis and what are the main, direct and remote consequences of the melt-down of the American mortgage

market and consequently the financial market?

The crisis is a complex phenomenon; to become global, more factors had to be present at the same time. I would label as the primary mover behind today's problems the loose monetary policy of the American Central Bank after 2000. Alan Greenspan tried to save the capital markets after the bursting of the technology stocks bubble, and to pull the American economy out of recession in 2001 by dramatically lowering interest rates and injecting huge amounts of money into the economy. Money for nothing (inflation was much higher than the FED interest rate) was tunneled into housing where it inflated another huge bubble. The reason why the new money flew this time into houses and not into stocks lies mainly in the massive political support for housing through quasi-government agencies Fannie Mae and Freddie Mac and other political measures that were to promote homeownership, like the Community Reinvestment Act. The innovation of financial products that took place at the same time made it possible that investors from all over the world invested their savings in US houses by means of mortgage-backed securities. The growth of the US economy in the past years was

based on the housing bubble and cheap credit, and so was unsustainable in the long term. The growing prices of houses made it possible for Americans to extract more and more equity from their houses, spend it on consumption and fall deeper into debt. Cheap credit, the housing bubble, complex financial products, dubious risk management and corporate governance made financial speculation possible in an until now unseen scope. With the burst of the housing bubble American consumption lost ground and massive and painful de-leveraging in the financial sector started. High debt of the American citizen and massive losses in the financial system indicate that the coming years will be characterized by restricted consumption and higher savings, to undo the losses.

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Although our commercial banks have remained relatively stabile, the crisis did affect Slovakia too. In what way and what factors enabled it? How much did the crisis play its part in Slovakia and what is yet to come?

Although we feel some effects of the

credit crunch as well, the main effect came through decreased external demand for our products. The Slovak economy is very open and depends on foreign demand for our products. Losses in the financial sector and decreases in the wealth of Europeans led to restrictions in business orders for Slovak companies. The cost-cutting process and decision-making process on how to adapt to the new situation take time, that's why we are starting to feel the bad effects only now and that's what made possible the short illusion of some Slovak politicians that we won't be affected very much. I am afraid that we haven't seen everything yet, and we have to expect higher unemployment and some business liquidation in the coming months.

"As the crisis is global and very complex, nobody really knows how long it will take to unwind. What you hear are just plain guesses."

Are there ways how to balance these negative aspects (mentioned in the answer above)? What is your opinion on the arrangements proposed by the government – such as lowering taxes etc.?

As the reason for the halt in growth lies outside Slovakia, we are limited in influencing how long the slowdown in the economy will last. We can though decrease the pain from the massive restructuring of the economy by improving the business environment. Lowering payroll taxes, income taxes, abolishing administrative barriers and liberalizing the labor code will make hiring fired people into new jobs easier and quicker... That way we can make our business environment more adaptable and competitive so it can attract some foreign cost-cutting investors looking for cheaper alternatives.

Although the Slovak government shifted its focus in its latest proposals finally on the employers, who will be the most important factor in fighting the crisis, some of the measures are just going to waste public money and will not have positive and lasting effects on

the economy. The money spent on so called "social businesses" are just a waste as they, as experience and logic show, don't bring about any sustainable jobs based on real demand and will become subject to corruption and rent seeking. I also disagree with governmental financial support for jobs that will have to be closed out due to demand decrease. An effort to save existing job positions of selected businesses is not that effective as creating a flexible entrepreneurial environment that would help all private businesses in Slovakia. The government effort to fight external market forces is futile and will just cost valuable money that will be lacking in other sectors.

Is it predictable when the ongoing process will stop? For how long will we be facing the crisis?

As the crisis is global and very complex, nobody really knows how long it will take to unwind. What you hear are just plain guesses. Even if some of them are based on macroeconomic models, these models weren't calibrated for events like we are now witnessing, so they are basically useless. Looking at global decreases in wealth, I think that to expect a turnaround this year is very optimistic.

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Recently, the FDIs were creating a significant ratio in the GDP. As the investors were struck by the crisis, this ratio was lowered vastly. Has the common currency the potential to draw back the current development of the FDI inflow, as was predicted?

De-leveraging, the credit crunch and decreased risk appetite led to a flight of foreign capital from emerging markets. Recent estimates show that FDI decreased even faster in Slovakia than in our neighboring countries. As a percentage of GDP, FDI was lower in Slovakia in 2008 (only 1,1%), than in all other V4 countries, even though we were leading in

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this indicator in 2006 (7,5%). So if there are any positive effects of the euro, on FDI as our government expected, these data don't show them.

Due to the crisis, a large number of companies have lost their contracts/orders, or were indirectly affected in other ways, many people lost their savings... what measures of "Corporate Social Responsibility" come into consideration within the present possibilities? How shall companies act on behalf of the society in times when they are fighting to save their own existence?

I think the most a company can do in the field of social responsibility is to stay profitable (offer demanded products at reasonable prices) or to minimize losses from the crisis, so it can provide sustainable jobs for its employees.

Do you maintain the opinion that companies do not have a "social responsibility", just the "responsibility to their shareholders"? If both of these responsibility principles worked in practice, wouldn't it lower the consequences and the curve of the crisis process?

A company's primary objective is to make a profit. It does so by selling products that increase the wellbeing of consumers. If the company follows other goals, at the cost of losses, it just means that scarce capital is being wasted, and could have been used more effectively in other places in the economy. Therefore losses indicate that a company is not responding to the new economic reality and the benefits to society could be higher if the capital was shifted to other uses.

Thank you. 