Central and Eastern Europe: Vulnerabilities in the Run-Up to Euro Adoption

NBP Conference

“Common Currency and its Future: Lessons for the New Member States”

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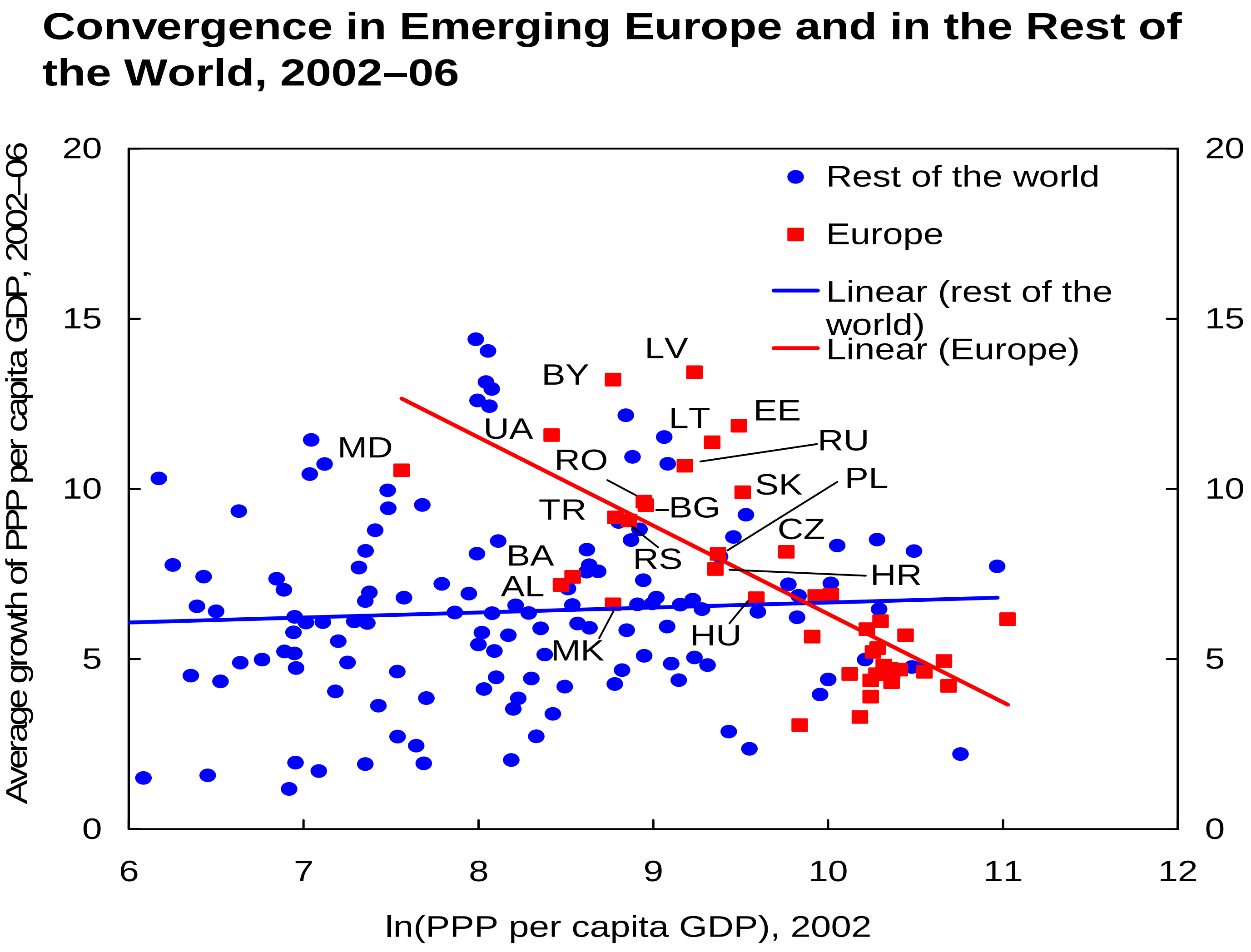
Overview

1. Convergence and financial deepening on the path to the Euro
2. Related vulnerabilities
   - Rapid credit growth
   - Large current account deficits
   - Cross-border contagion risks
   - Foreign currencies mismatches
3. Conclusions

The region has been converging fast

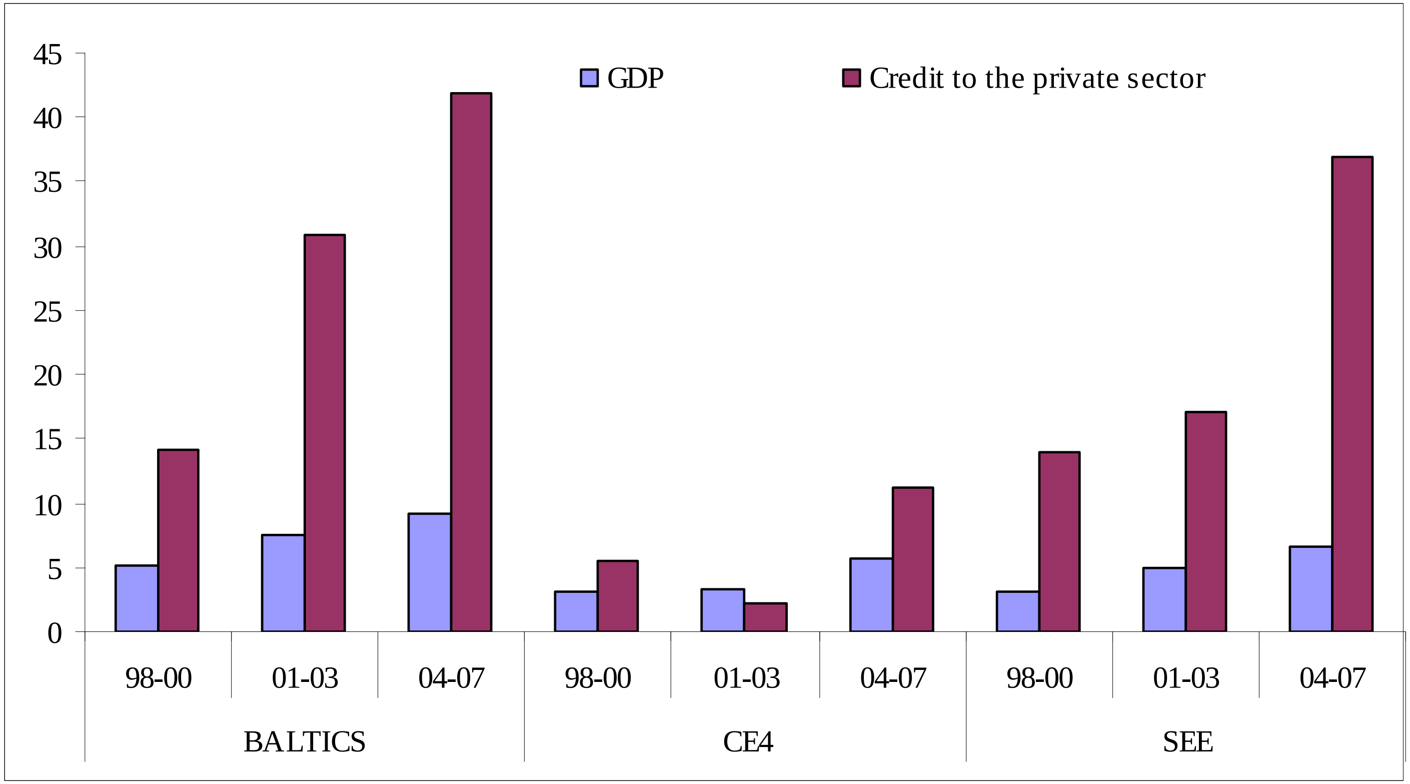


Source: REO, April 2008

This has been closely related with financial deepening…

Growth in GDP and credit to the private sector

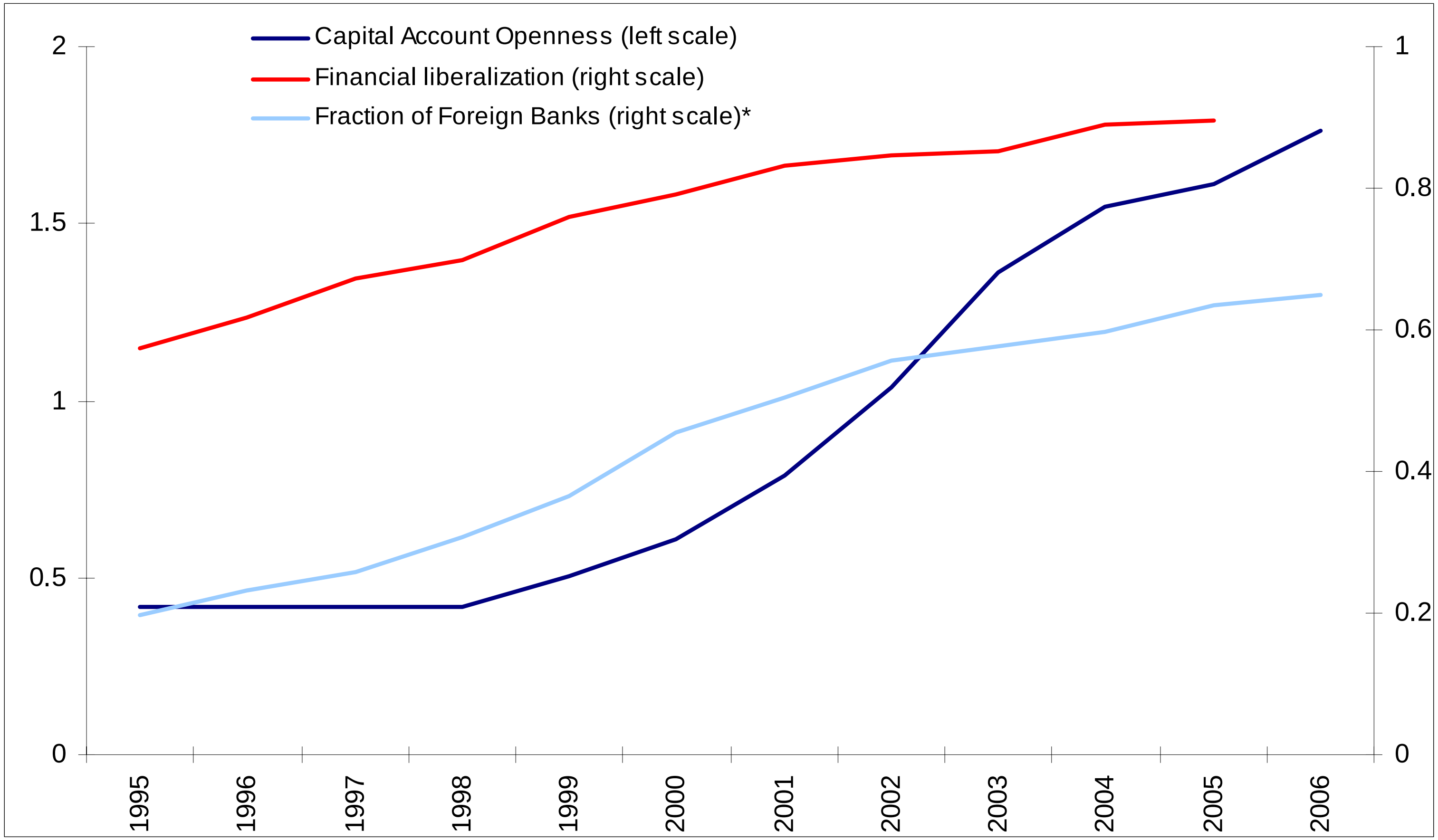
Annual average



Source: Eurostat, national authorities

Financial deepening has been driven by closer cross-boarder financial integration

Emerging Europe: Increases of financial integration



Source: IMF WEO, October 2008

*- as percent of total banks

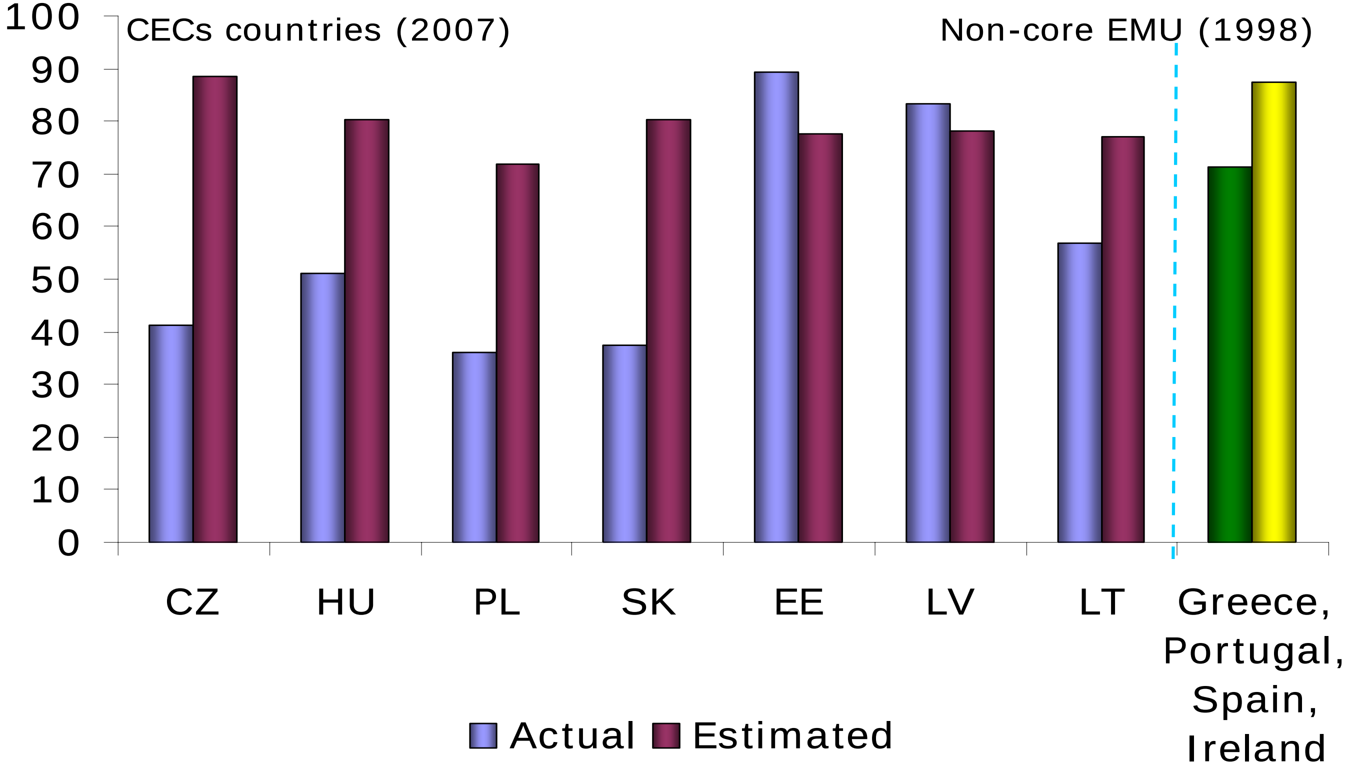
Index of domestic financial liberalization that combines information on interest rate controls, credit controls, competition restrictions, state ownership, quality of the banking supervision and regulation, policies to encourage the development of bond and equity markets, and policies to permit access by foreigners to the domestic stock market. The capital account openness index is from Chinn and Ito (2006).

Credit growth

Most studies find that the stock of credit is still below its equilibrium level in Central Europe (but not in some Baltic and SEE countries)

e.g. Boissay, Calvo-Gonzalez and Kozluk (2007), Bache, Egert and Zume (2007), Schadler al. (2005), Cottarell et al.(2005)

EU countries: Bank credit to the private sector:
Actual and estimated equilibrium levels (percent of GDP)

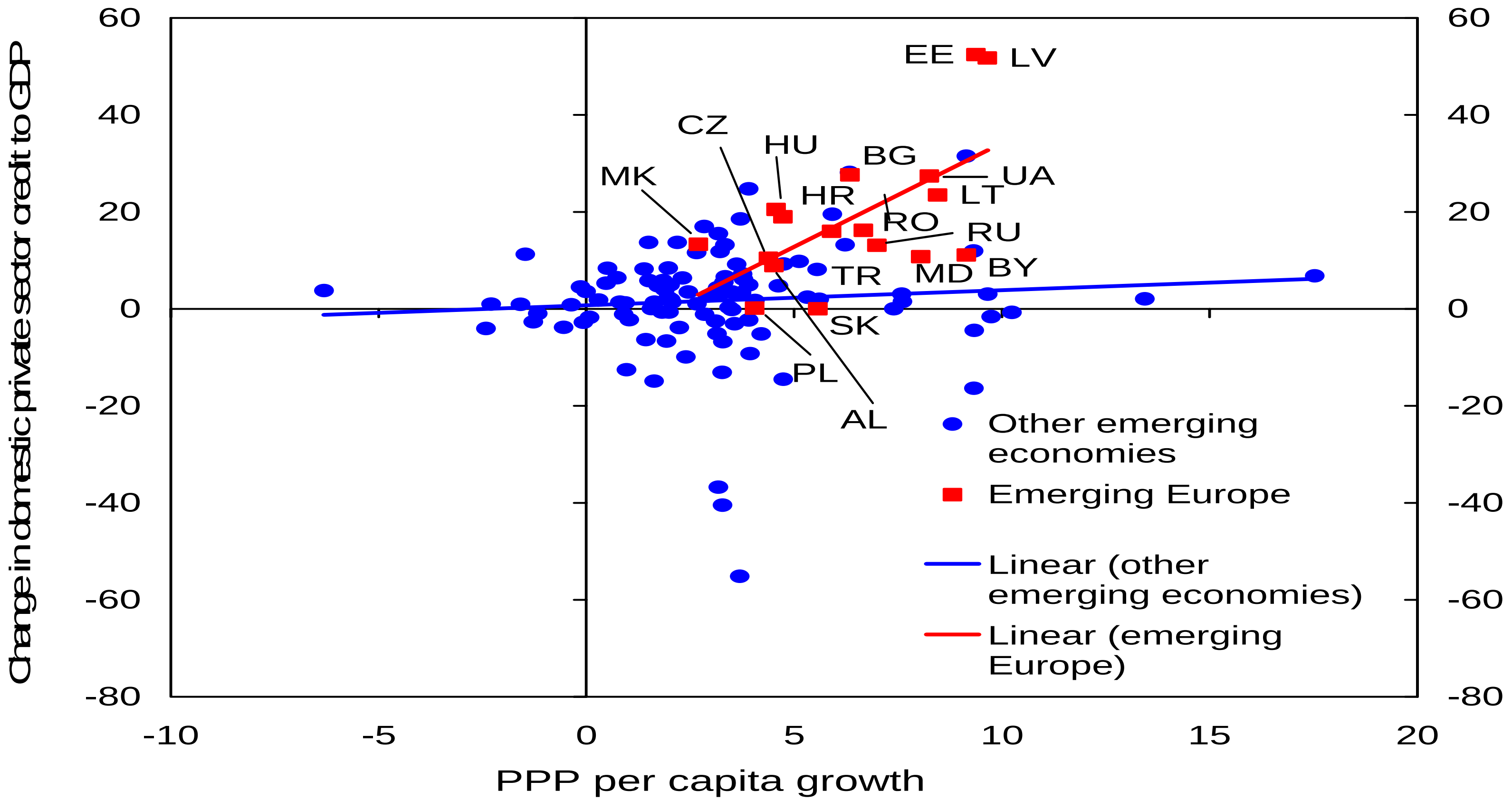


*Greece (Q1.1999)
Source: National authorities, calculations based on Schadler et al. (2005)

The pace of credit expansion relative to per capita GDP growth has exceeded that in other emerging market countries

Growth and Private Sector Credit Growth, 2002–06

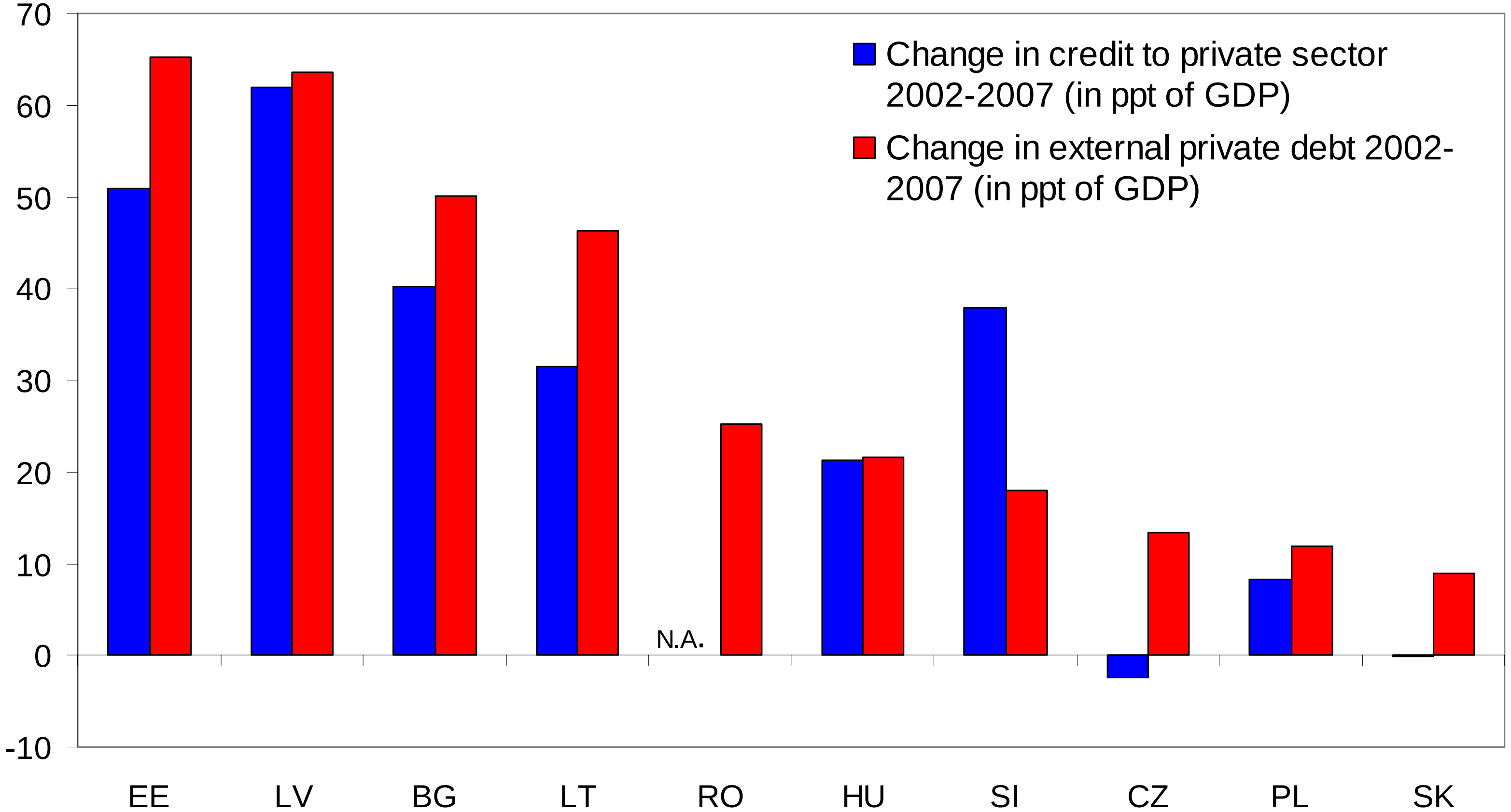
(Percent)



Source: IMF REO 2008.

Current Account Deficits

The credit boom has been largely financed from abroad…

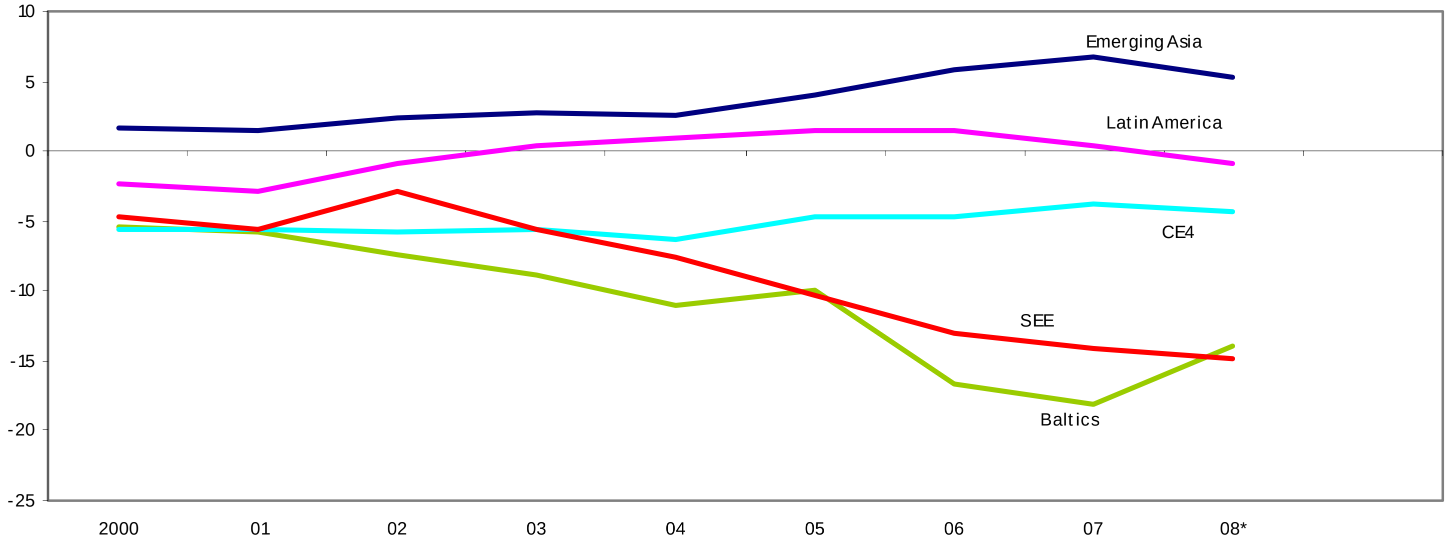


Sources: National authorities; and IMF staff calculations.

… contributing to large current account deficits

Current account deficit

in percent of GDP

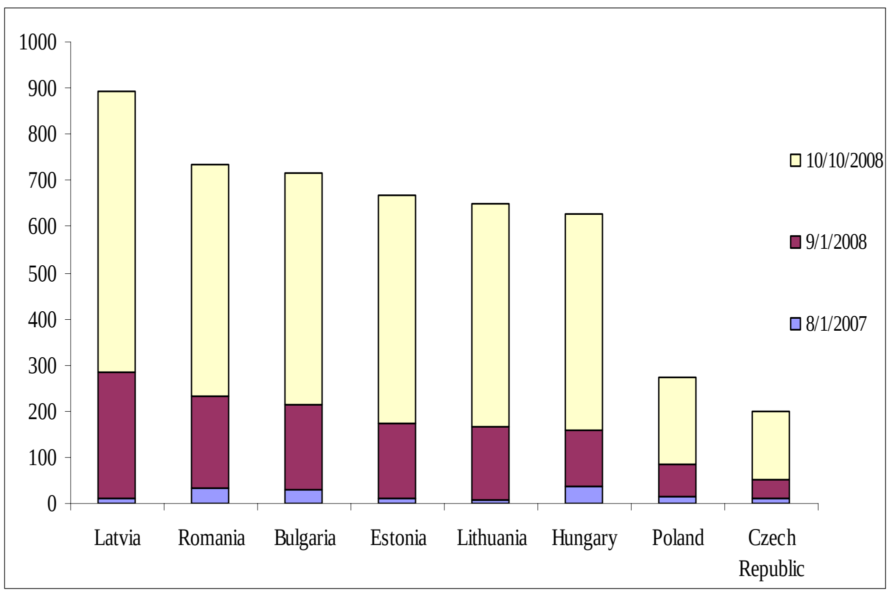


Source: National authorities.

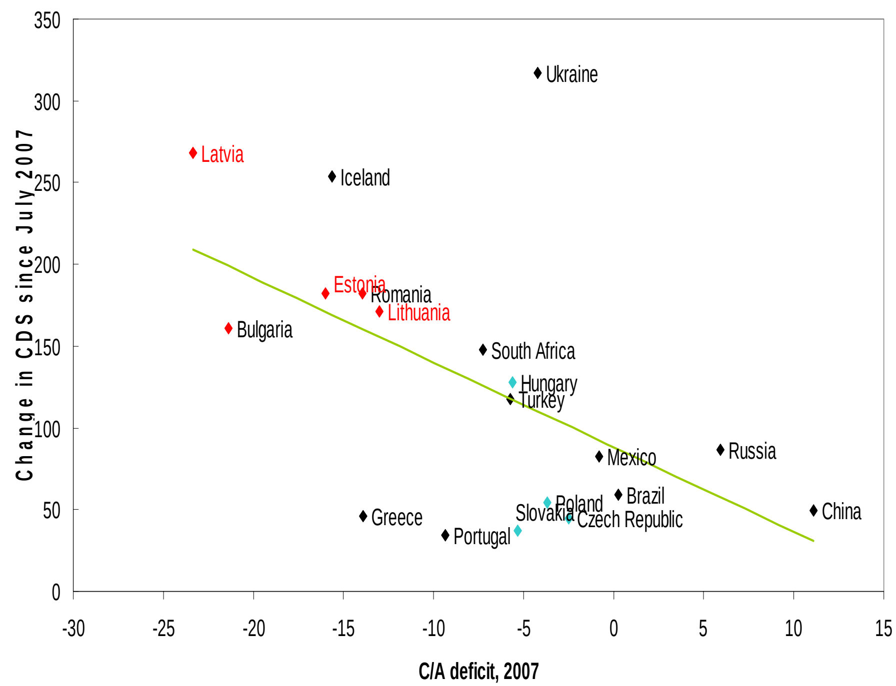
•- forecast

Financial markets have punished countries with large C/A deficits

CDS spreads



C/A deficit and increase in CDS spreads since July 2007



Source: Bloomberg

Determining CA sustainability in the new member states (Rahman, IMF WP 08/92)

Macroeconomic balance approach: estimate current account norms based on macro fundamentals (59 countries, annual data 1971-2007)

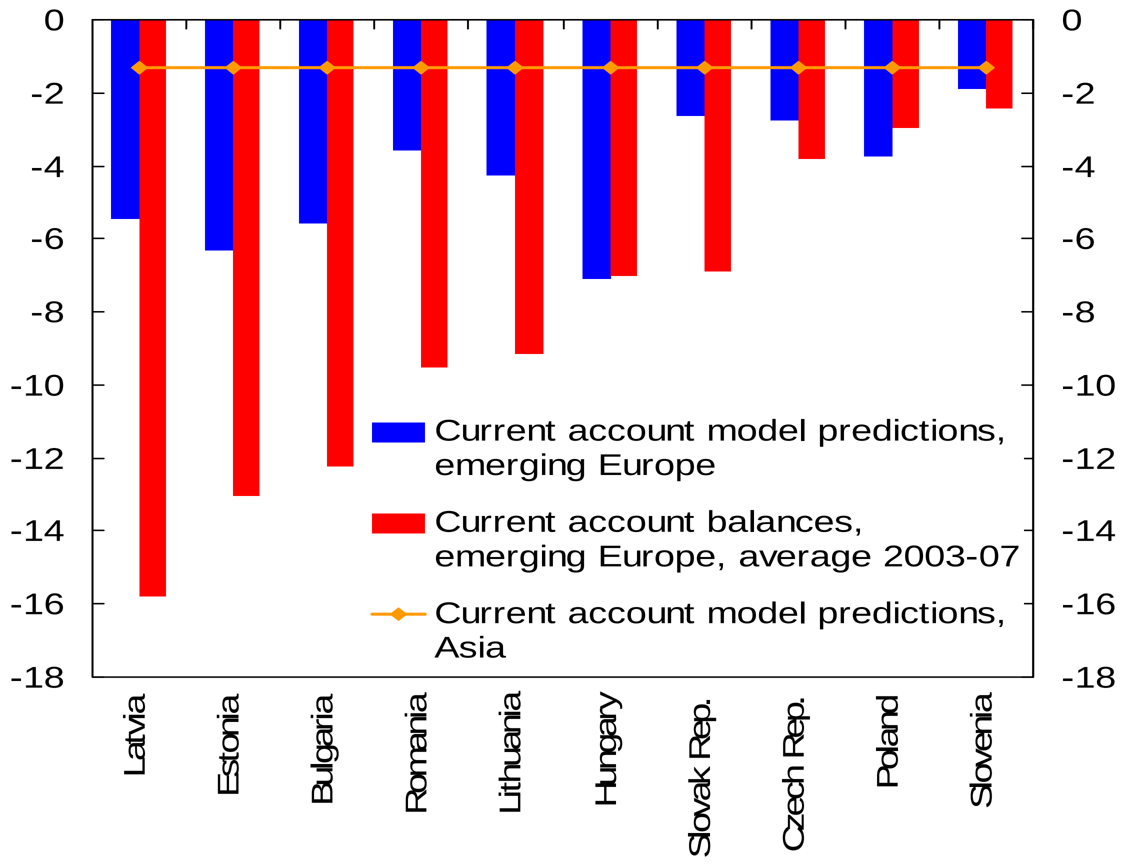
CA norm = f (fiscal balance, demographics, net foreign assets position, relative per capita income, etc.)

$\Rightarrow$ CA norm in the new member states are higher than elsewhere because:

- Large share of dependent population (=> lower national savings => higher CA)
- Lower net foreign asset position (greater dependence on foreign capital for growth)

CA deficits in the Baltics and SEE exceed what would be consistent with macro fundamentals

Current Account Balances and Model Predictions
Percent of GDP



Source:Rahman 2008.

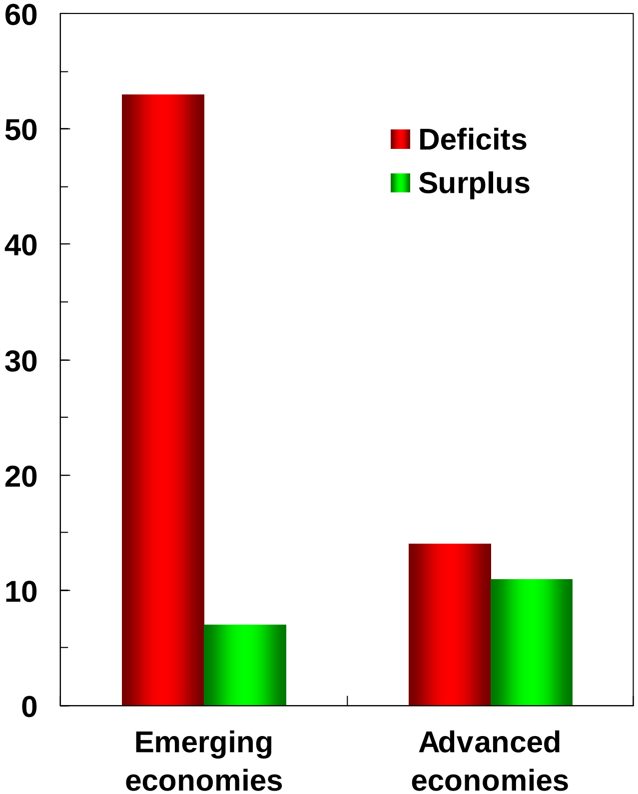
What drives the divergence from CA norms?

- **Cyclical or temporary factors**: output gap, capital inflows due to EU accession
- **Structural factors:** export composition, cost competitiveness in manufacturing sector
- **Policy-related factors:** exchange rate regime, financial sector policies

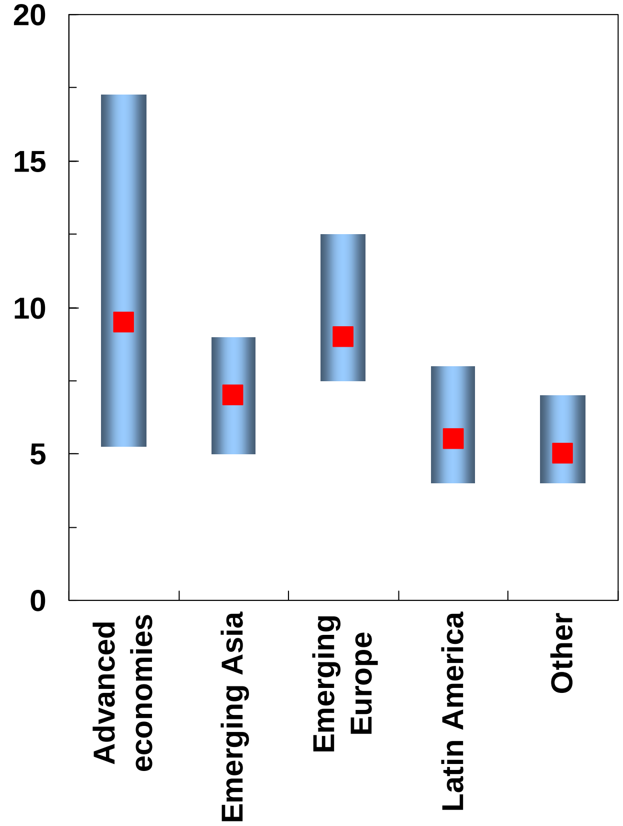
C/A deficits in Emerging Europe have already lasted longer and have been larger than typical

(IMF WEO, October 2008)

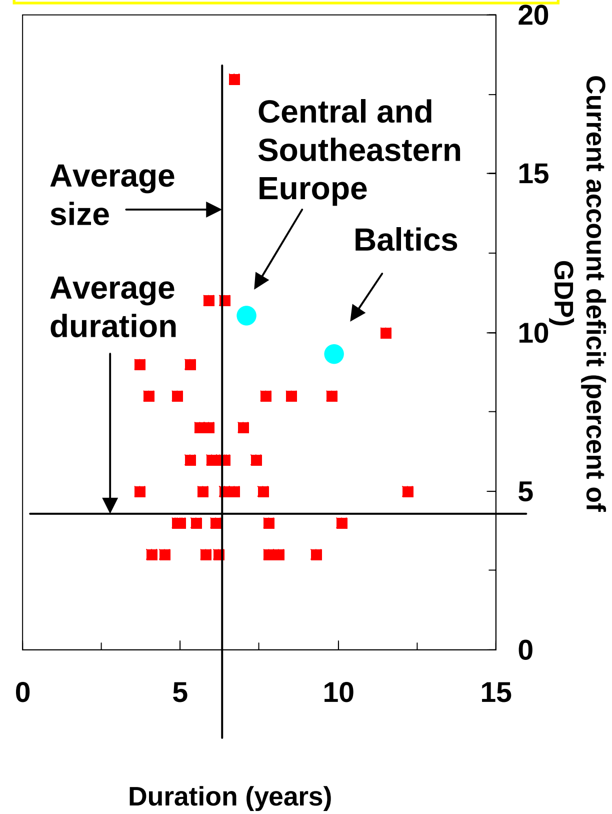
Number of Episodes
(1960 – 2007)



Episode Length of Deficits *(years)**



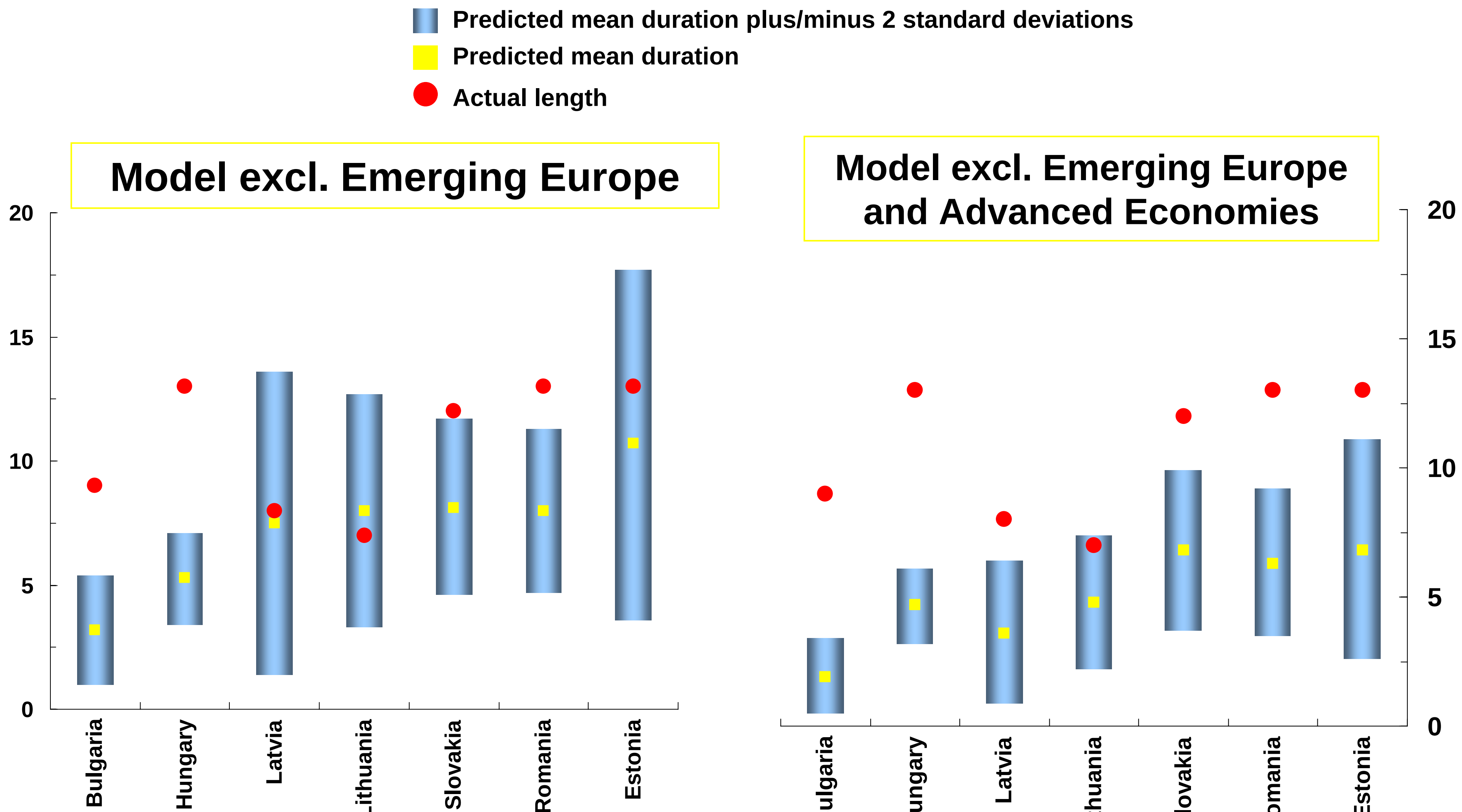
Duration and Average Size of Deficit Episodes



Source: IMF WEO, October 2008

*- ±2 st.deviations

Although economic characteristics explain longer deficit spells in emerging Europe, they are now at or beyond the upper end of expected duration



Source: IMF WEO, October 2008

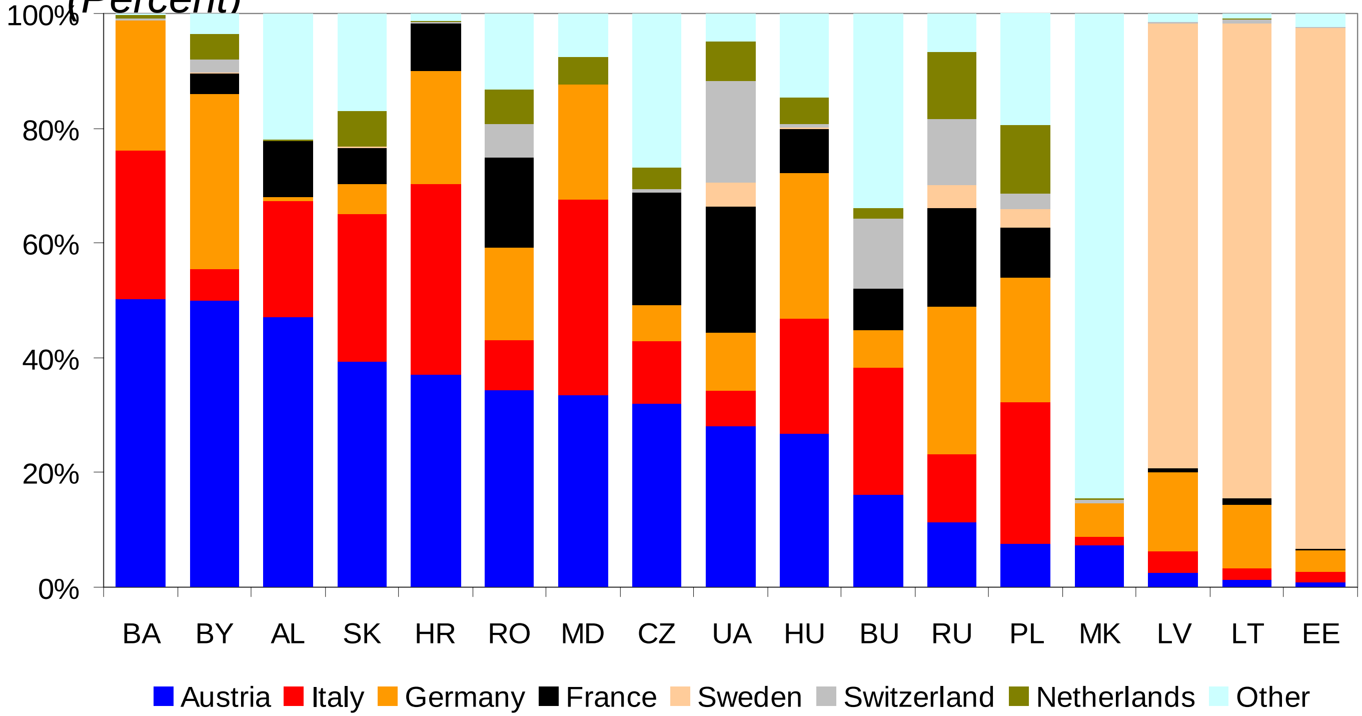
Cross-border contagion risks

Cross-border exposures by international banks (especially from Sweden, Austria, Italy, Germany) create new channels of contagion

(IMF WP, forthcoming)

Concentration of Emerging Europe Exposure to Western Europe, 2007

(Percent)

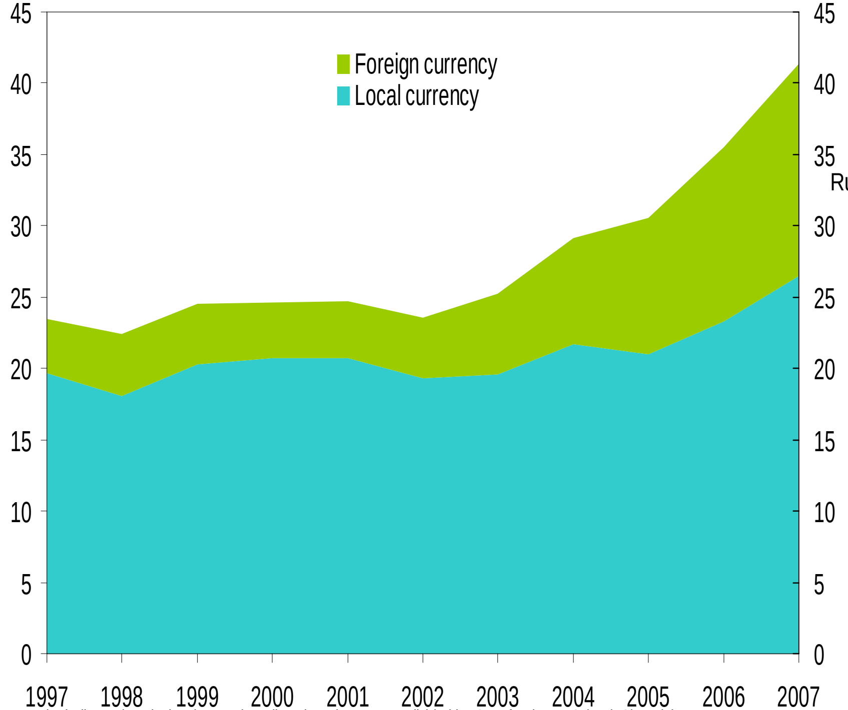


Source: Bank for International Settlements, Quarterly Review, June 2008.
Note: Country names are abbreviated according to the ISO standard codes.
1/ Emerging Europe exposure to western European banks is defined as the share of the reporting banks in each western European country in the total outstanding claims on a given emerging European country (both bank and nonbank sectors). For example, about 42 percent of Croatia's exposures to Western European reporting banks is owed to Austrian banks, 38 percent to Italian banks, 13 percent to French banks, etc. For the Baltic countries, 85 percent or more of exposures to the reporting banks is owed to Swedish banks.

Foreign Currency Mismatches

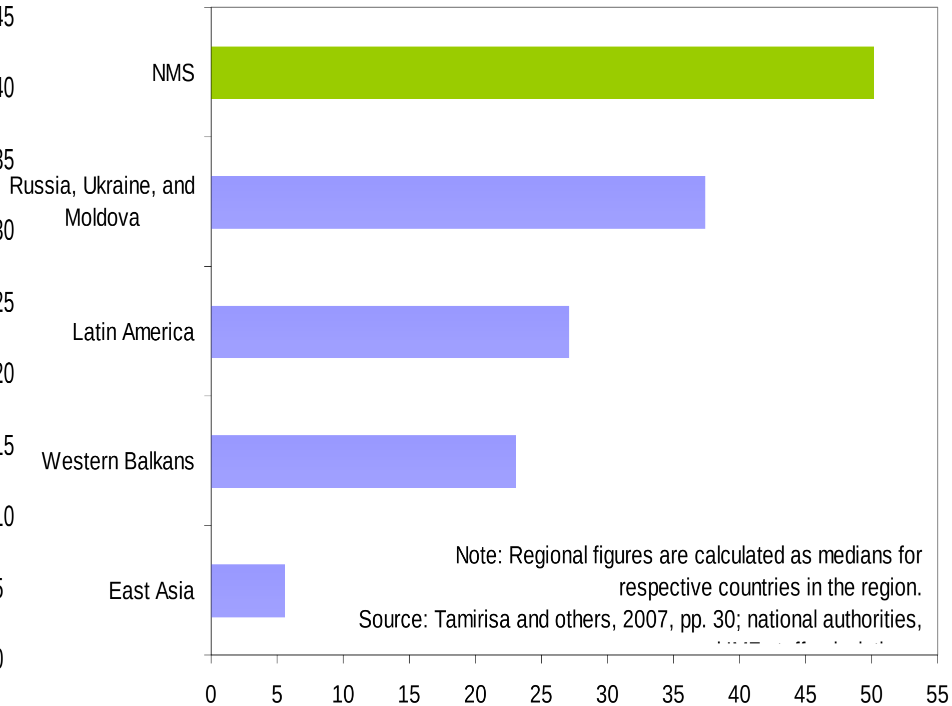
Rapid credit growth has been accompanied by a growing share of loans denominated in foreign currencies (EUR and CHF)

NMS: Credit to the private sector
percent of GDP



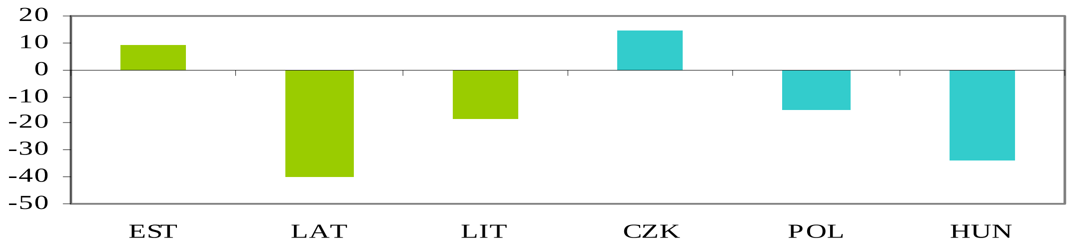
Note: The indicator is calculated as total credit to the private sector divided by GDP for the NMS (excl. Slovenia).
All figures were previously transformed to euros.
Source: national authorities, Eurostat, IMF staf calculations.

Emerging Markets: Foreign exchange borrowing
2005, as % of total loans to the private sector

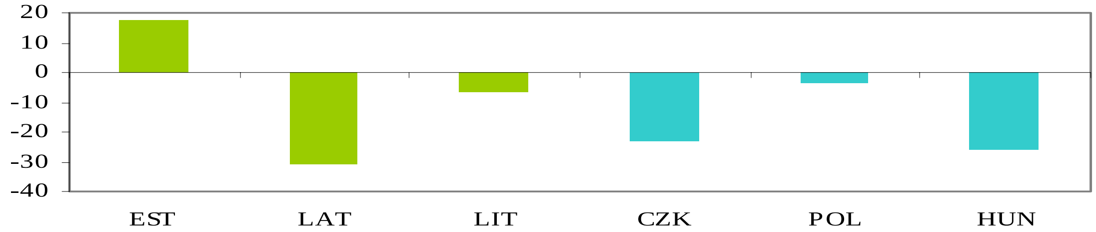


This has led to large currency mismatches in the non-financial private sector and vulnerability to disruptions in the FX swap market

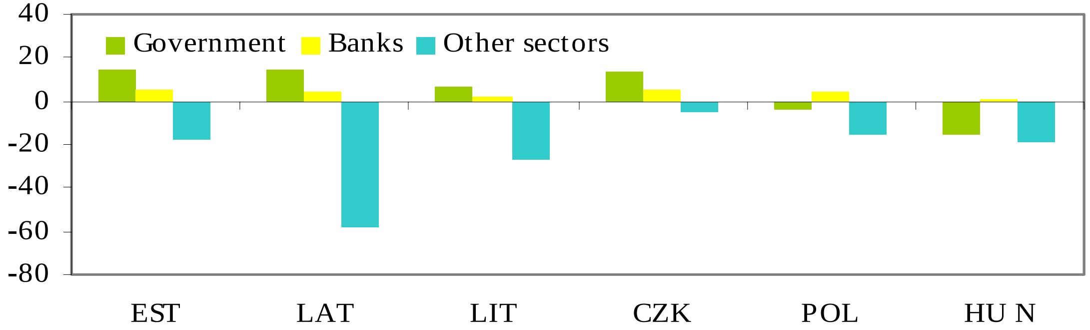
Net FX position, 2007 *percent of GDP*



Change in net FX position, 2002-2007, *percent of GDP*



Sectoral net FX position, 2007, *percent of GDP*



Source: National authorities, IMF staff calculations.

What drives Euroization in CEE countries?

(Rosenberg and Tirpak, IMF WP/08/173):

$$FXloans_{i,t} = \alpha + \beta_1 irdiff_{i,t} + \beta_2 loantodep_{i,t} + \beta_3 openness_{i,t} + \beta_4 restrict_{i,t-1} + \varepsilon_{i,t}$$

- *Euroization* is a byproduct of convergence.

- Foreign exchange borrowing is driven by:
  - access to foreign funds in a fully liberalized environment of capital flows (loan-to-deposit ratio, not foreign bank ownership per se),
  - natural hedging opportunities, through increasing trade openness,
  - a boost to the private sector’s confidence in exchange rate stability and imminent euro adoption (interest rate differentials, but not exchange rate volatility drive fx borrowing).

- Regulatory measures have limited effectiveness due to opportunities to borrow directly from abroad (i.e., for corporations).

Conclusions

- Increasing vulnerabilities in some countries are byproduct of rapid convergence, financial deepening and expected euro adoption
- Countries with high vulnerabilities are being more affected by this current crisis than others
- EU membership fundamentally changes the policymaking landscape requiring more international cooperation. The current crisis has made this more clear than ever, examples:

    - emergency lines of credit for countries that are vulnerable to capital outflows (Iceland)

    - close cooperation of financial supervisors in home and host countries

    - policy coordination, especially during crises (e.g.deposit guarantees)

    - Euro adoption

Policies to safeguard macroeconomic stability, against the background of existing vulnerabilities

- Tighten macro policies to curb inflation and reduce external imbalances (Southeastern Europe):
  - monetary policy: address second-round effects from price shocks
  - fiscal policy: offset still strong private sector demand; contingency plans for hard landing
  - targeted and temporary income support for vulnerable households (preferable to administrative measures)
- Monetary policy on hold if risks to inflation and output are balanced (Central-eastern Europe)
- Support economy during abrupt adjustment (Baltics):
  - allow adjustment to take its course
  - cushioned by letting automatic stabilizers operate
  - monitor financial sector exposures and prepare contingency measures
- Ensure crisis resolution frameworks in financial sector are operational, including cross-border dimension

Thank you!

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