

External Vulnerabilities in the New EU Member States.

Implications for Dealing with the Financial Crisis



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KBC Advisory Council, Brussels, November 7, 2008

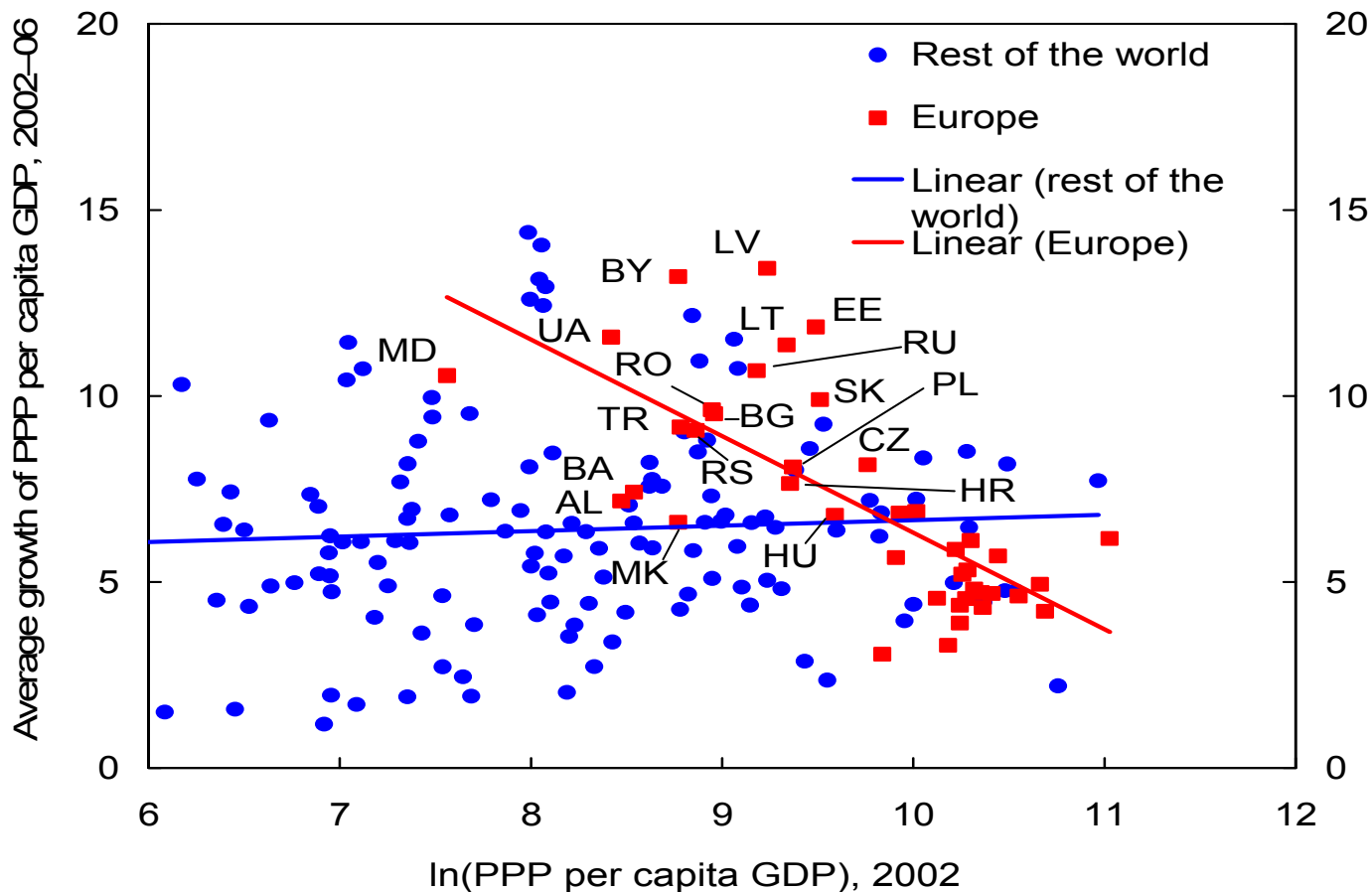
Overview

- Convergence, financial deepening and the build-up of external vulnerabilities
- Sudden stop? The CEE countries after Lehman
- Short-term issues:
 - Securing external financing
 - Dealing with the downturn
- Long-term issues
 - Safeguarding external sustainability
- Conclusions

Convergence, financial
deepening and external
vulnerabilities

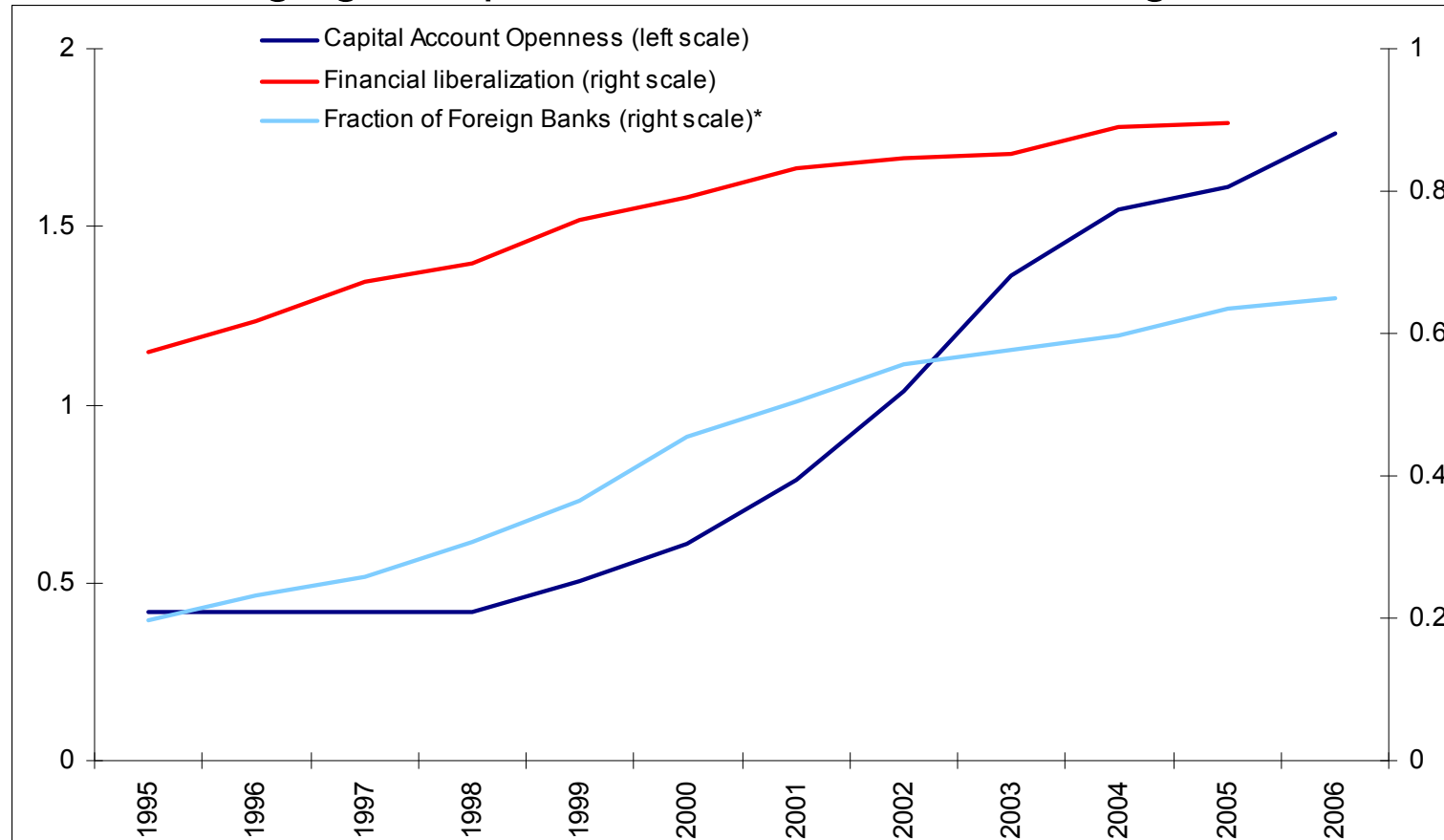
The region has been converging fast...

Convergence in Emerging Europe and in the Rest of the World, 2002–06



... driven by ever closer cross-boarder financial integration

Emerging Europe: Increases of financial integration



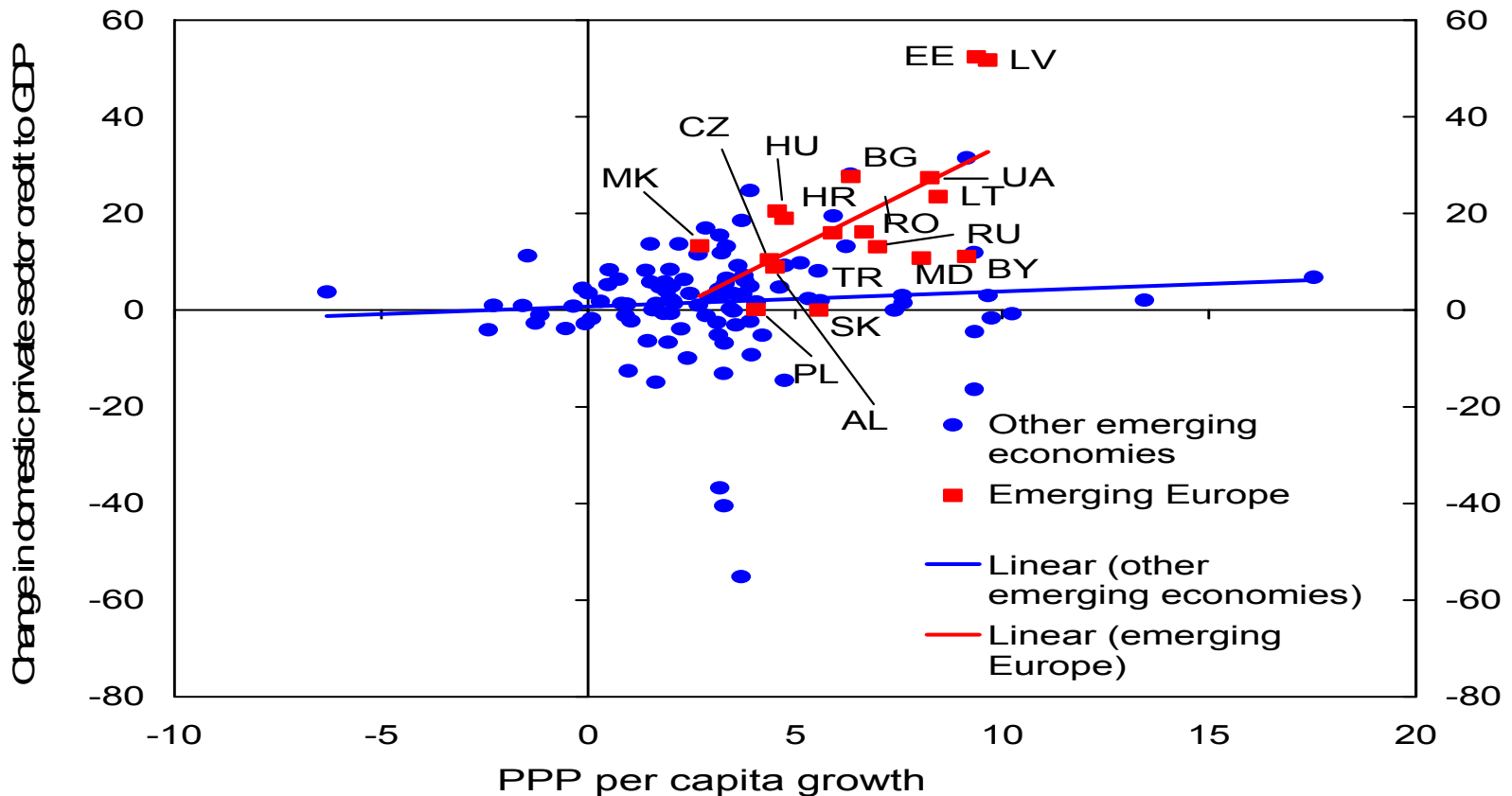
Source: IMF WEO, October 2008

*- as percent of total banks

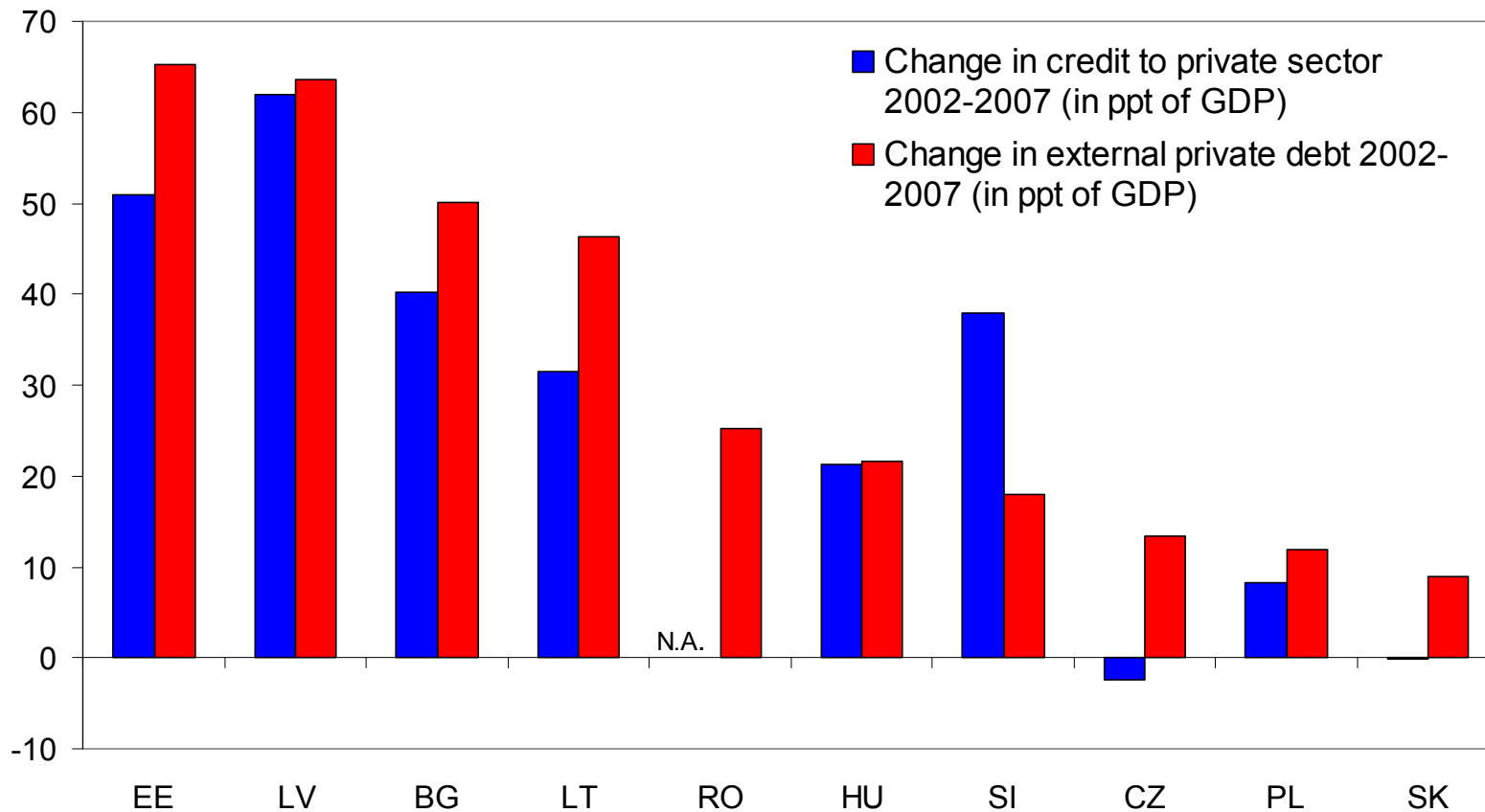
Index of domestic financial liberalization that combines information on interest rate controls, credit controls, competition restrictions, state ownership, quality of the banking supervision and regulation, policies to encourage the development of bond and equity markets, and policies to permit access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

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)

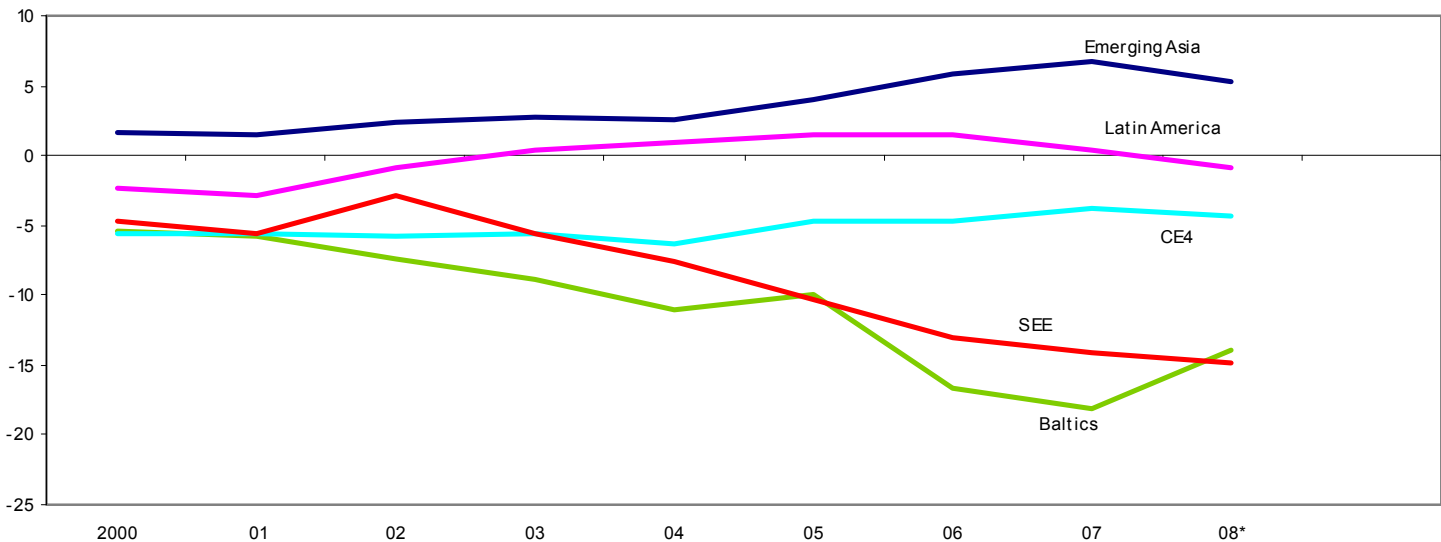


The credit boom has been largely financed from abroad...



... contributing to large current account deficits...

Current account deficit *in percent of GDP*



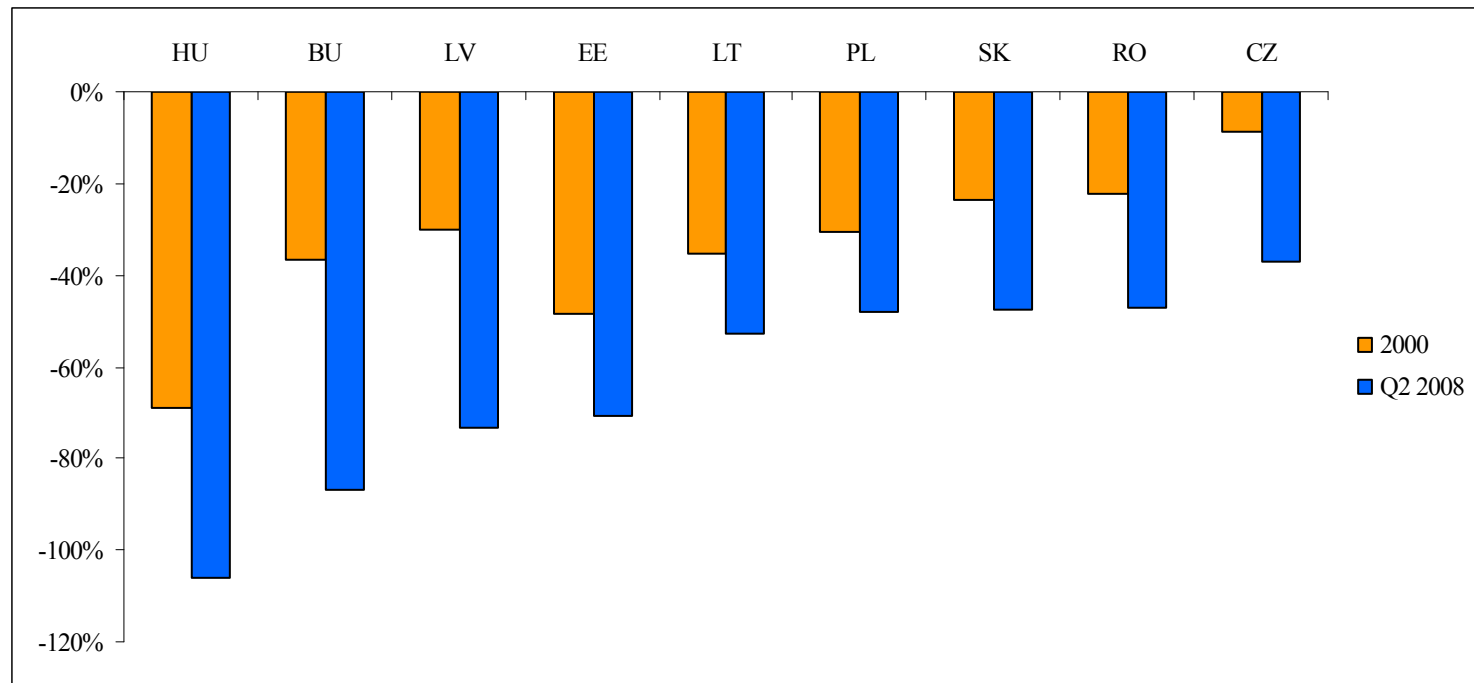
Source: National authorities.

*- forecast

... and a deterioration of international investment positions.

Net IIP

*in percent of GDP**

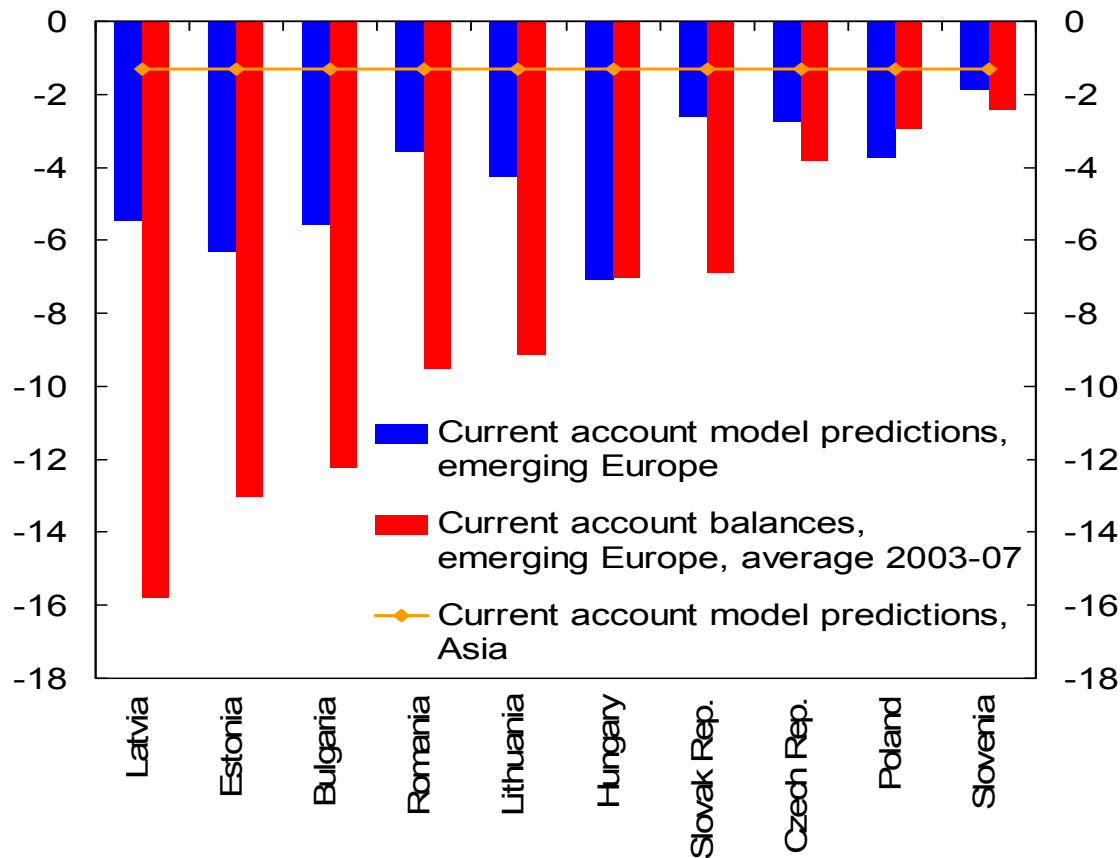


Source: National authorities.

- forecast for 2008

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

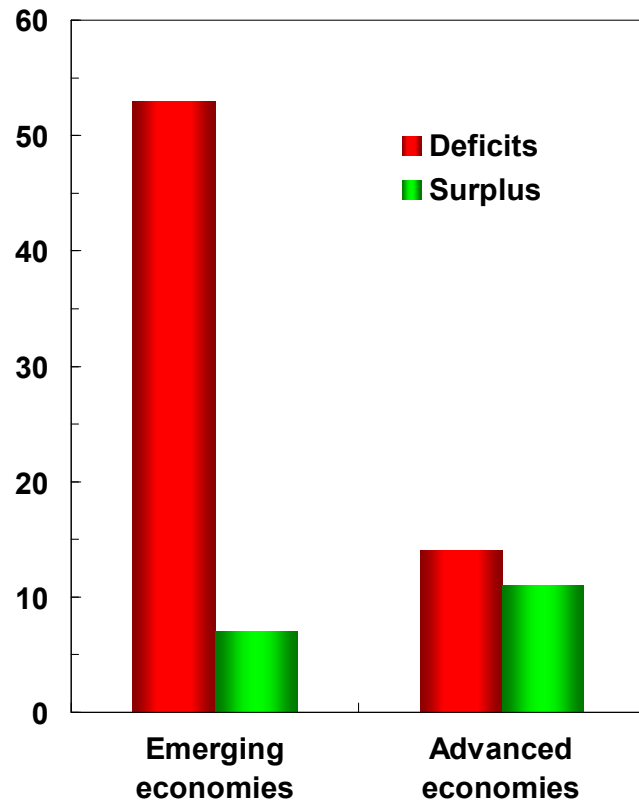
Current Account Balances and Model Predictions
Percent of GDP





...and they have already lasted longer and been larger than typical

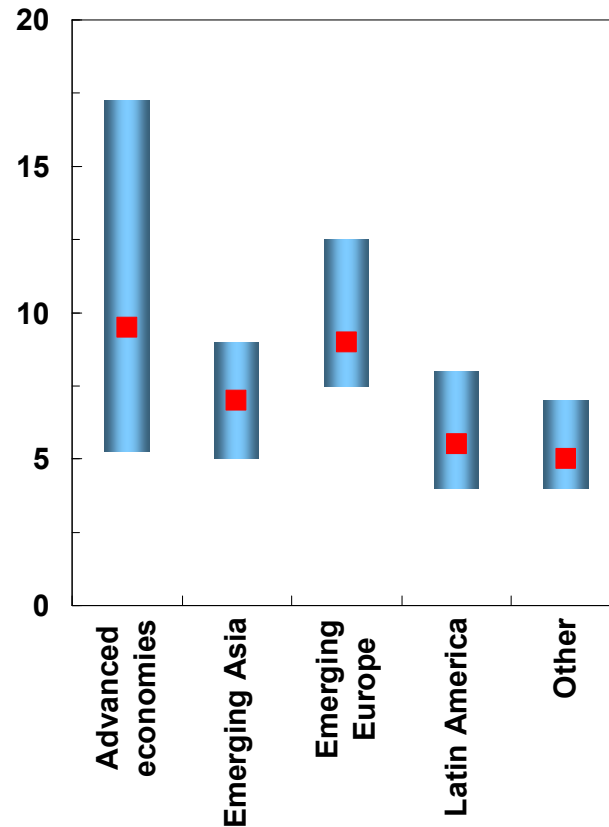
Number of Episodes
(1960 – 2007)



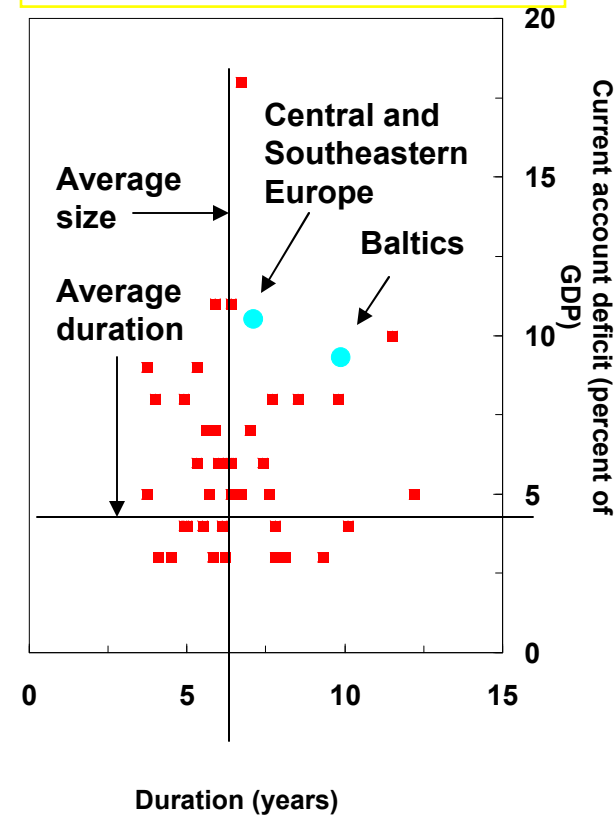
Source: IMF WEO, October 2008

*- ± 2 st.devations

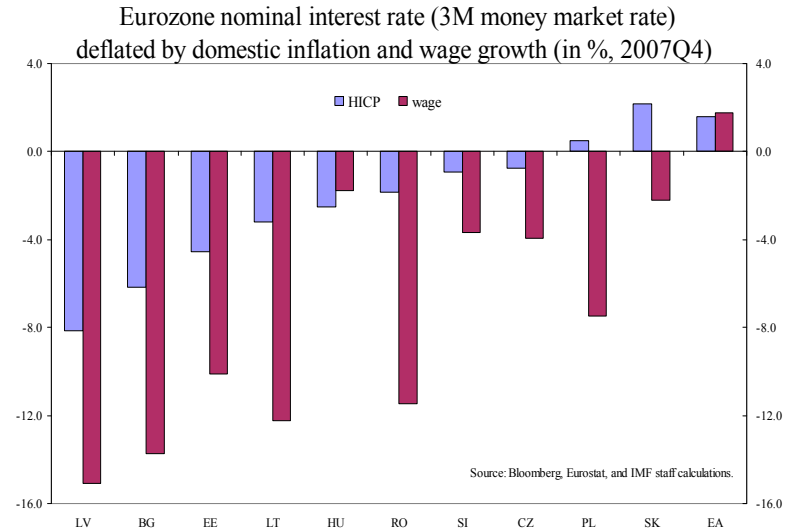
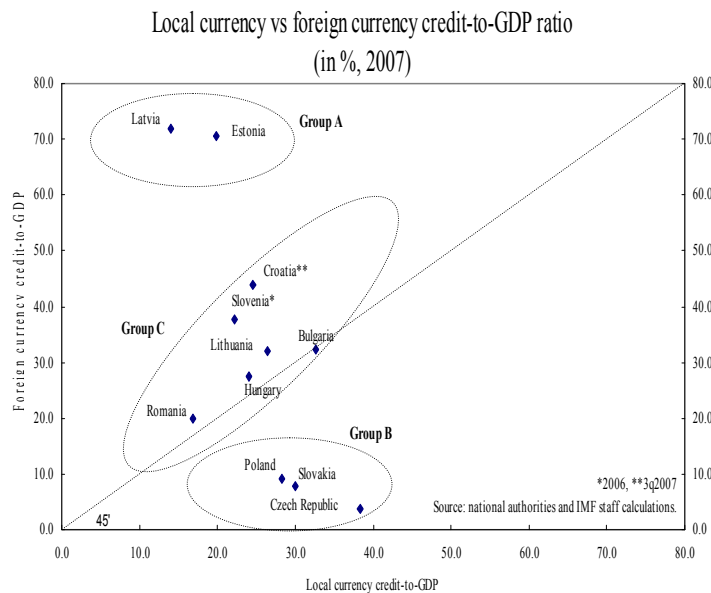
Episode Length of Deficits (years)*



Duration and Average Size of Deficit Episodes



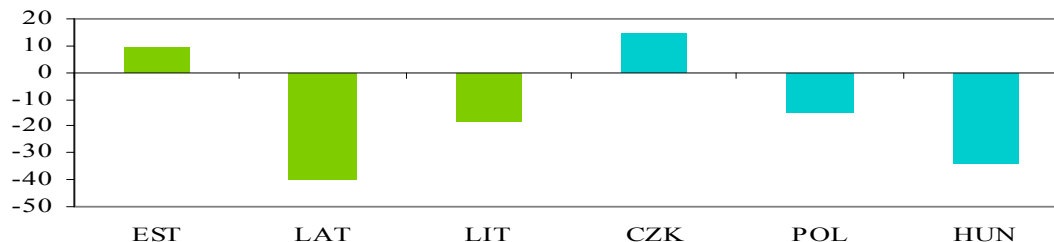
Rapid credit growth has been accompanied by a growing share of fx-denominated loans, driven by both demand and supply factors



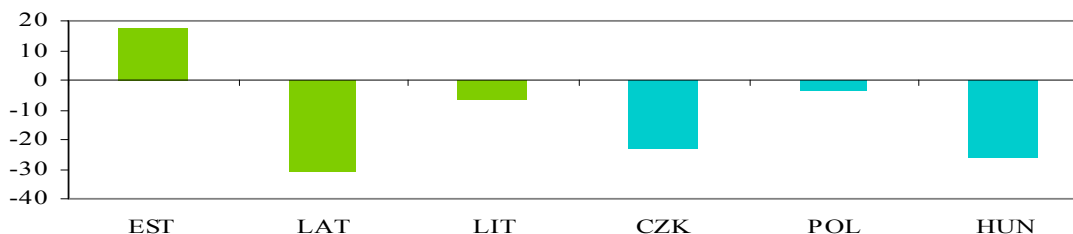
Source : Rosenberg and Tirpak, IMF WP/08/173

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

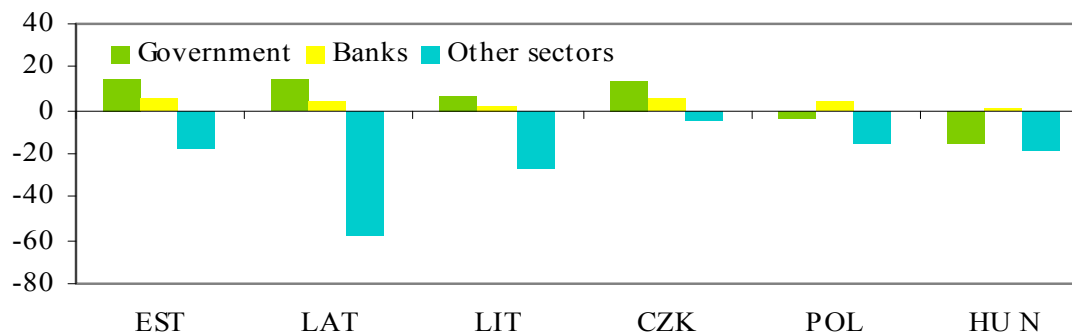
Net FX position, 2007 percent of GDP



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



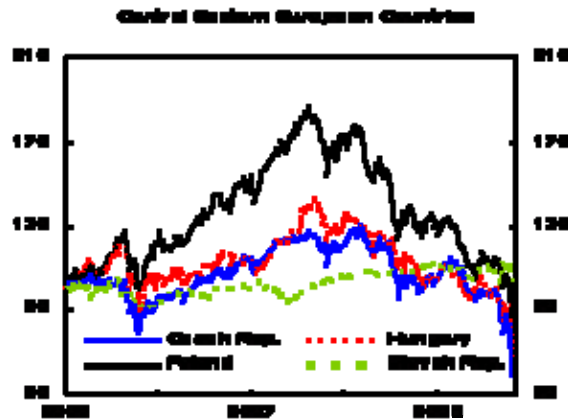
Sectoral net FX position, 2007, percent of GDP



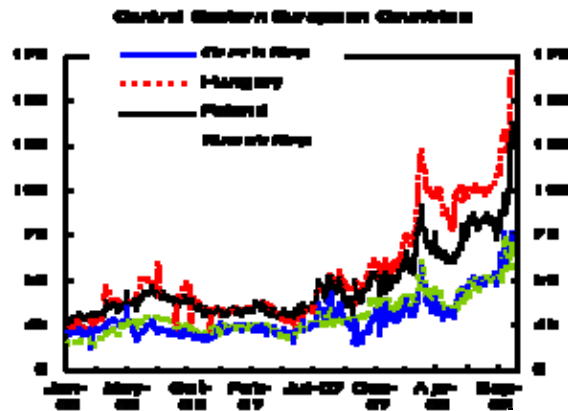
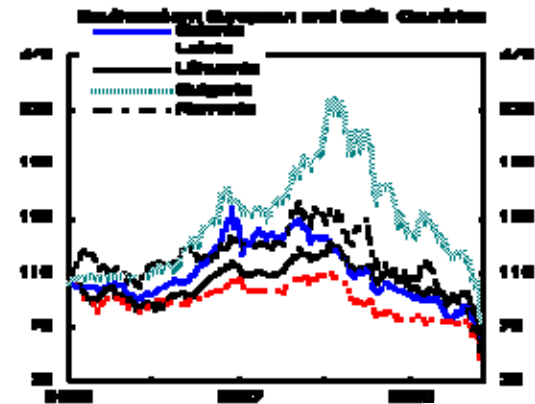
The CEE countries after Lehman

Financial markets in CEE have been hit hard

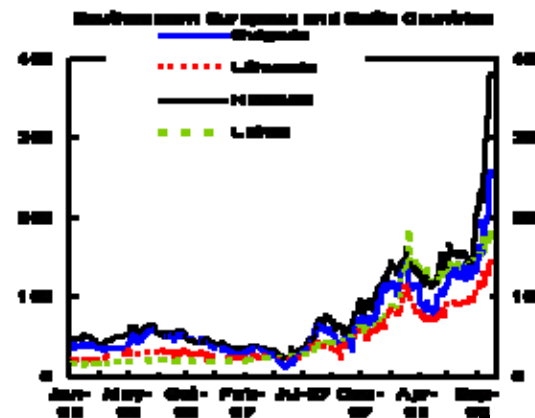
Financial Indicators in New Member States



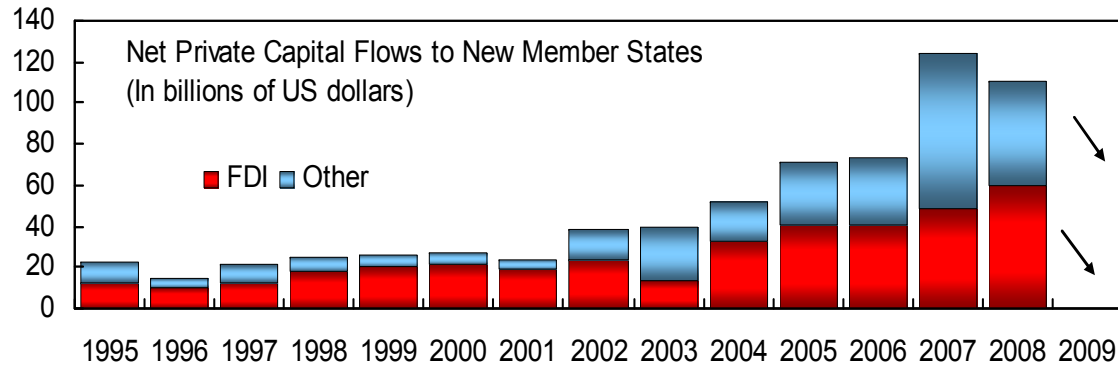
Stock Markets



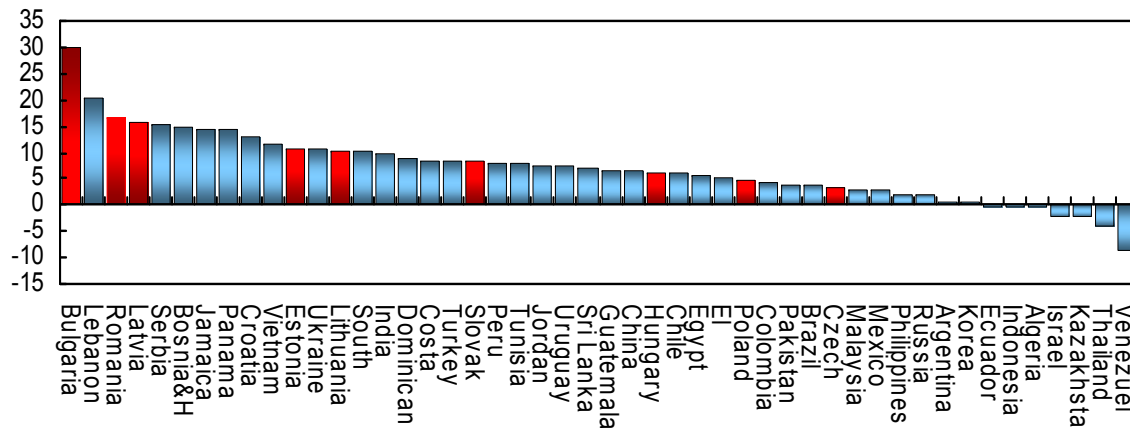
Euro EMBI Spreads



As a result of global deleveraging, capital inflows are likely to slow sharply



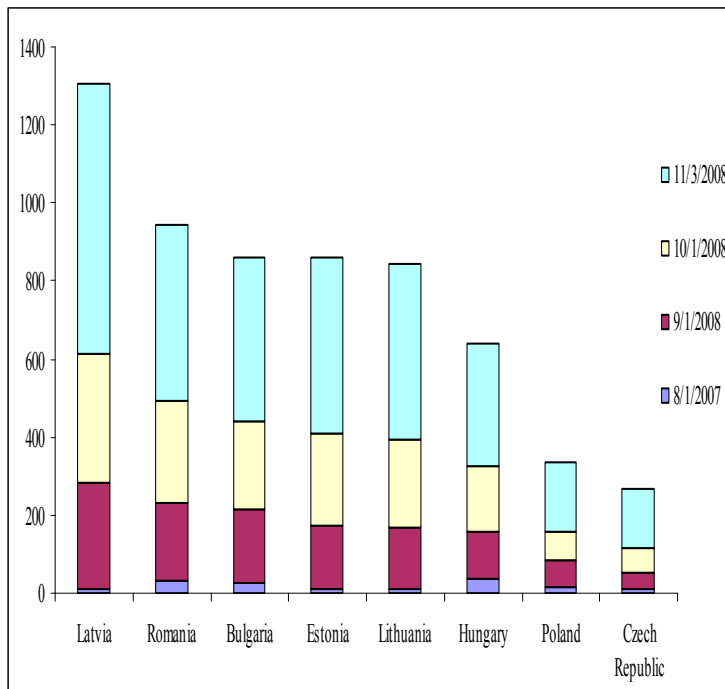
Net private capital inflows, 2008
(In percent of GDP)



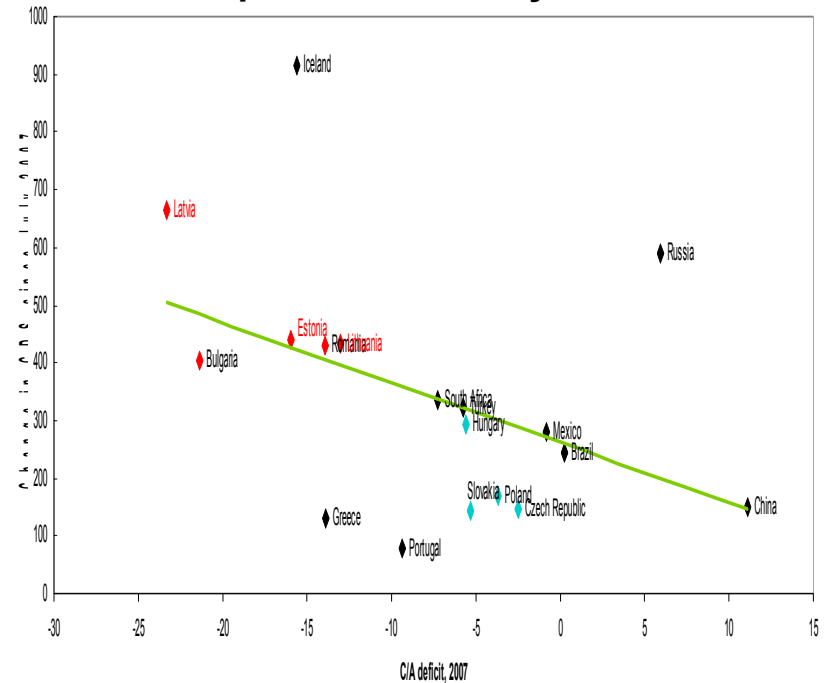
Source: IMF

Risk premia have increased roughly in line with external vulnerabilities

CDS spreads (5Y)



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

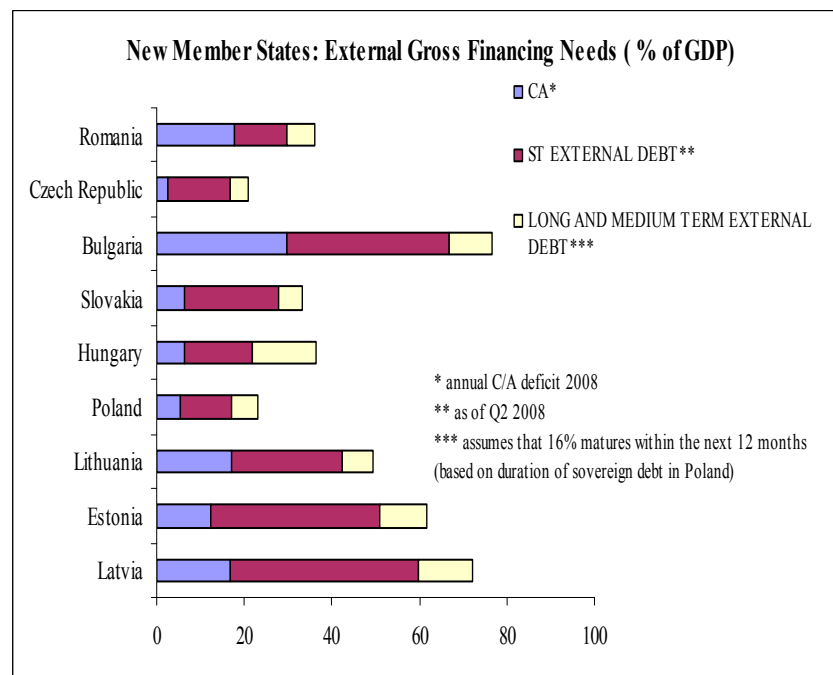
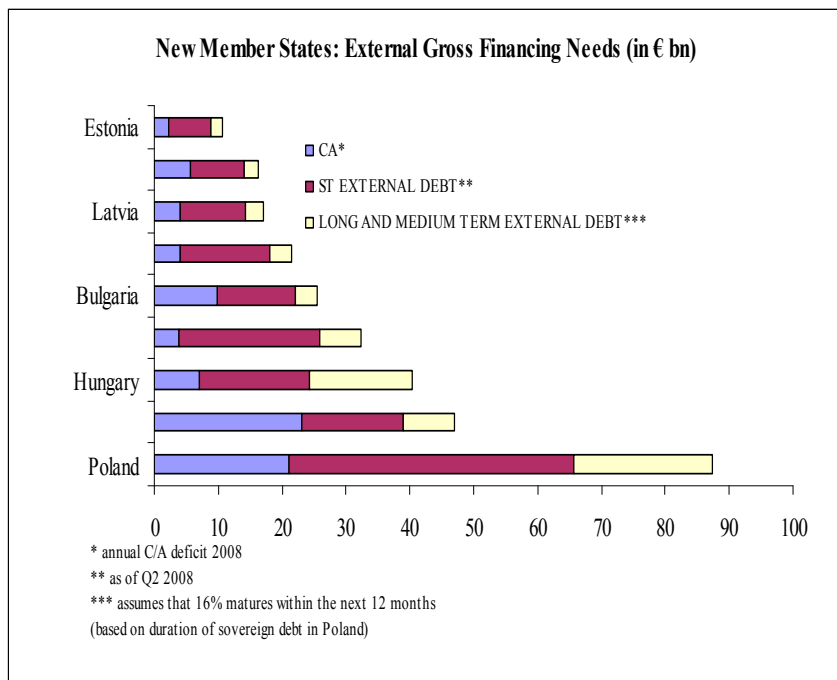


Policy responses in the Eurozone to the financial crisis entail additional risks for CEE countries

- **Deposit and interbank guarantees** put countries with weak fiscal credibility at a disadvantage
- **Spillover effects of ECB policies:** discrimination between EMU and non EMU countries (liquidity facilities, sovereign bonds as collateral)
- **Bank recapitalization:** implicit call to shrink balance sheets in CEE subsidiaries rather than at home

Securing external financing

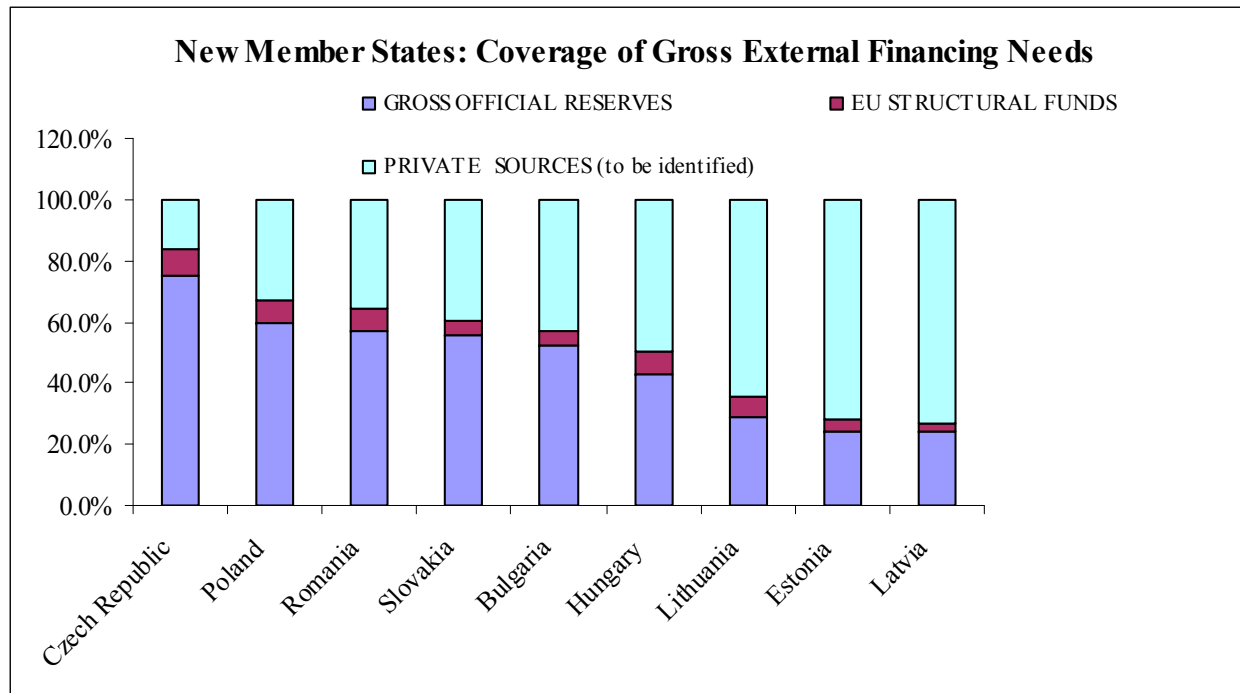
Gross external financing needs are large



Source: IMF staff calculations, national authorities

Non-private sources can cover only part of funding needs

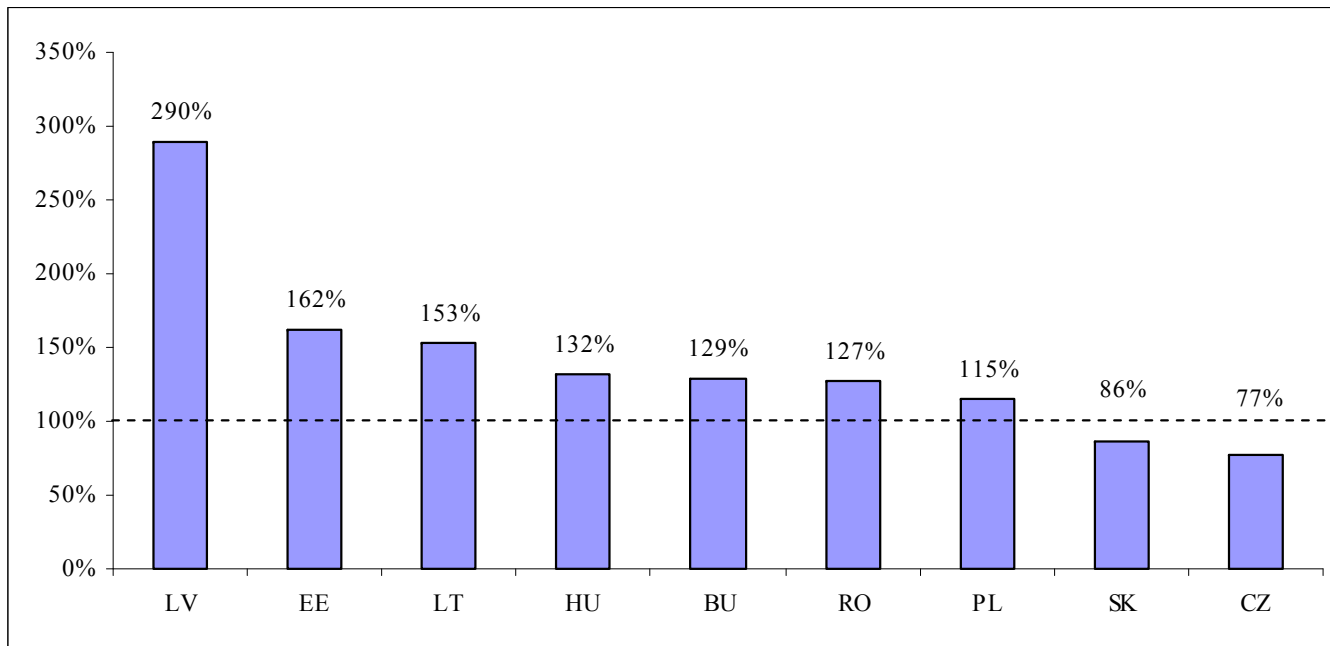
Gross reserves and EU structural funds as % of gross external financing needs



Source: IMF staff calculations, national authorities

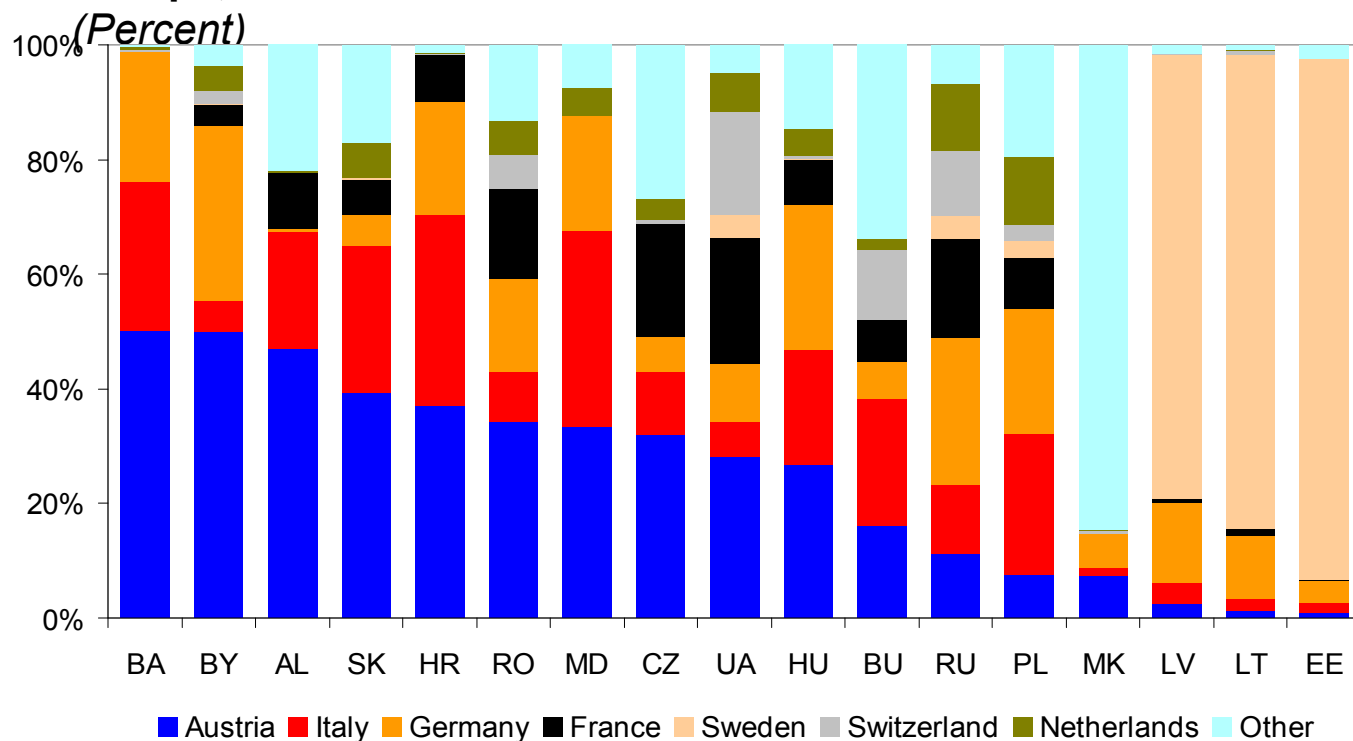
Few banking systems are self-sustaining

Loan-to-deposit ratio, July 2008



Securing residual financing needs: Resolving the collective action problem among parent banks

Concentration of Emerging Europe Exposure to Western Europe, H1 2008



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.

Securing residual financing needs:

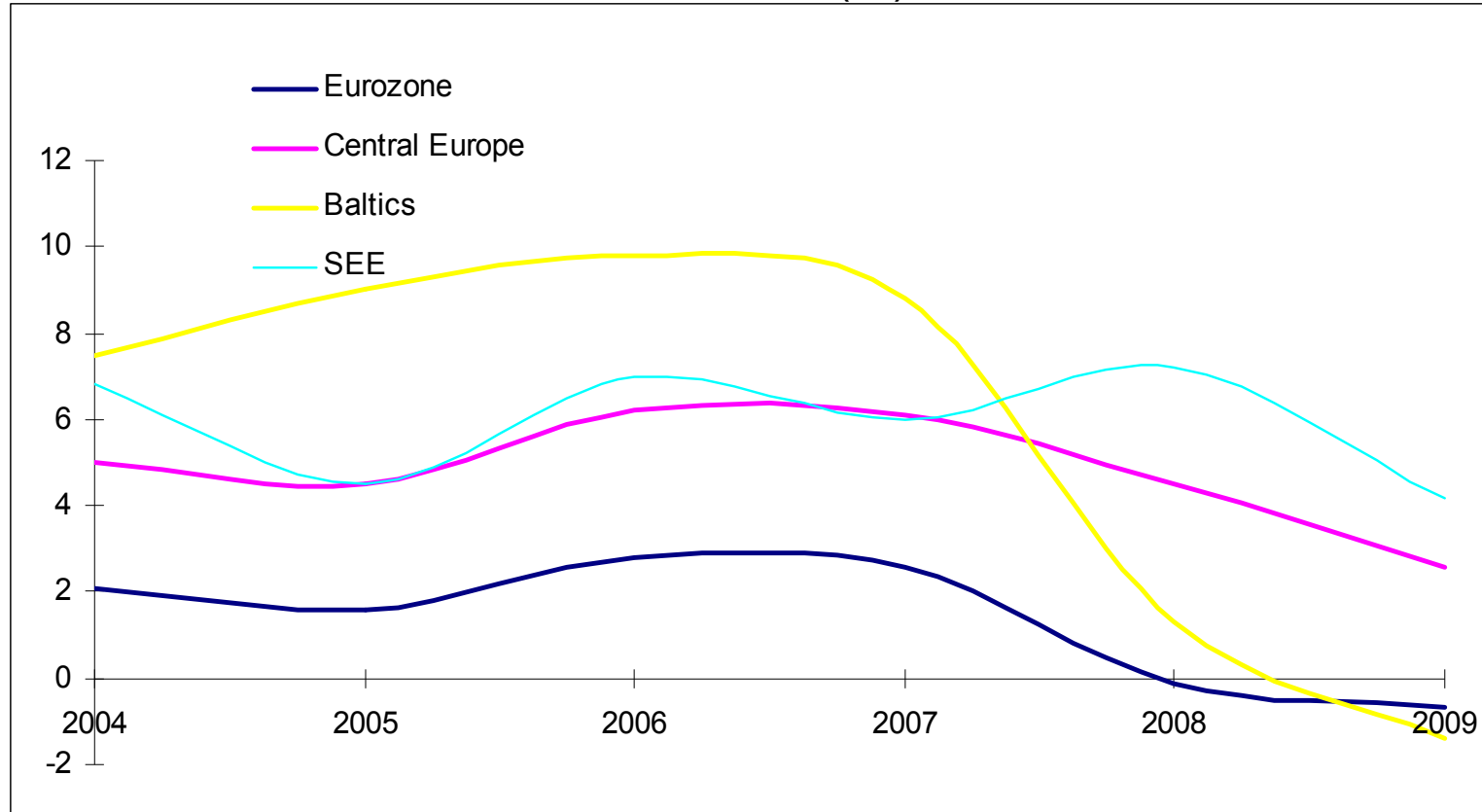
Multilateral emerging lending can prevent negative feedback loops

- IMF: SBA, new short-term liquidity facility
- EU: BoP facility, ECB swap lines?
- Other IFIs: World Bank, EIB, EBRD
- Bilaterals?

Dealing with the downturn

Growth is set to slow markedly

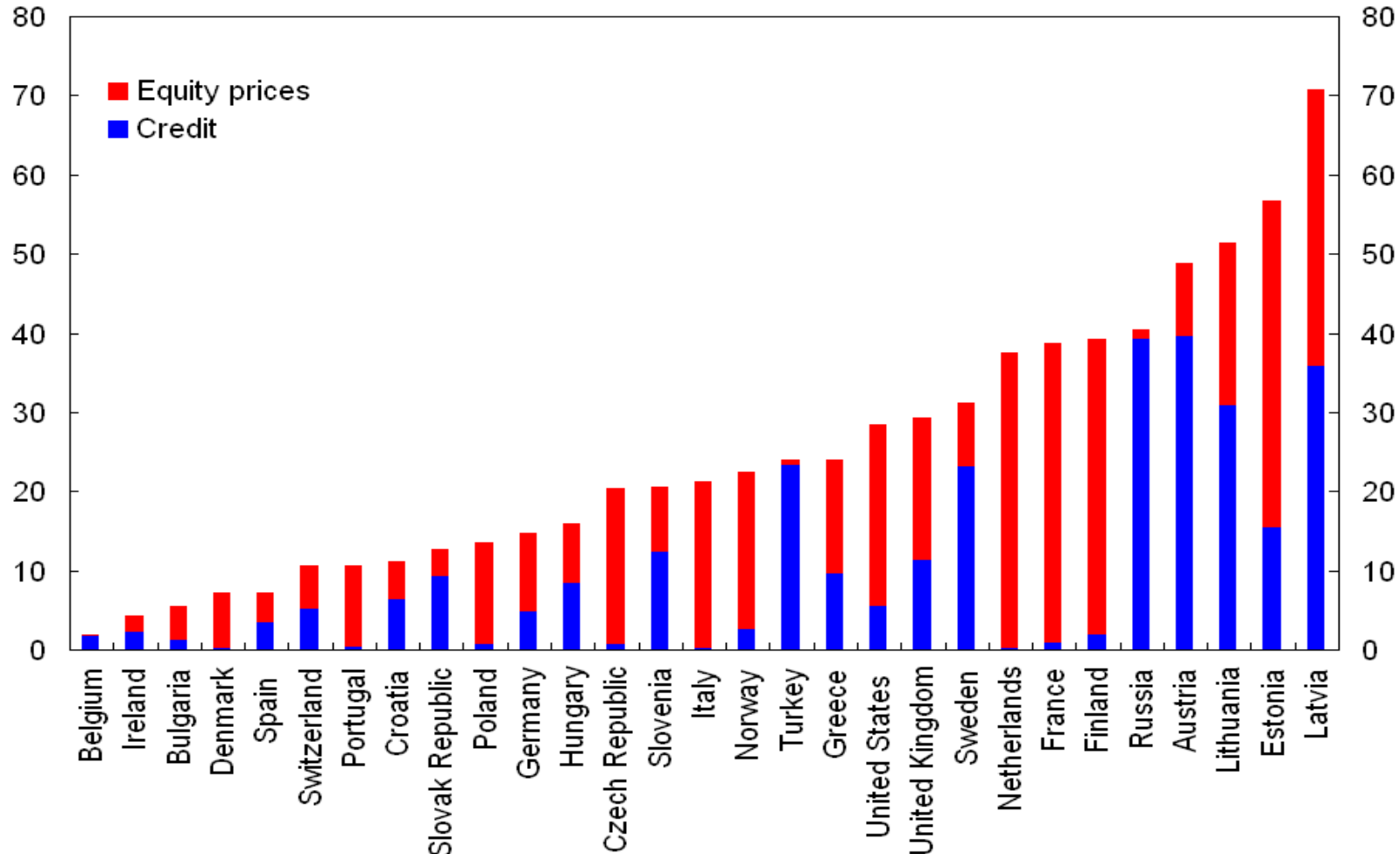
Growth, 2004-2009 (%)



Source: WEO, October 2008

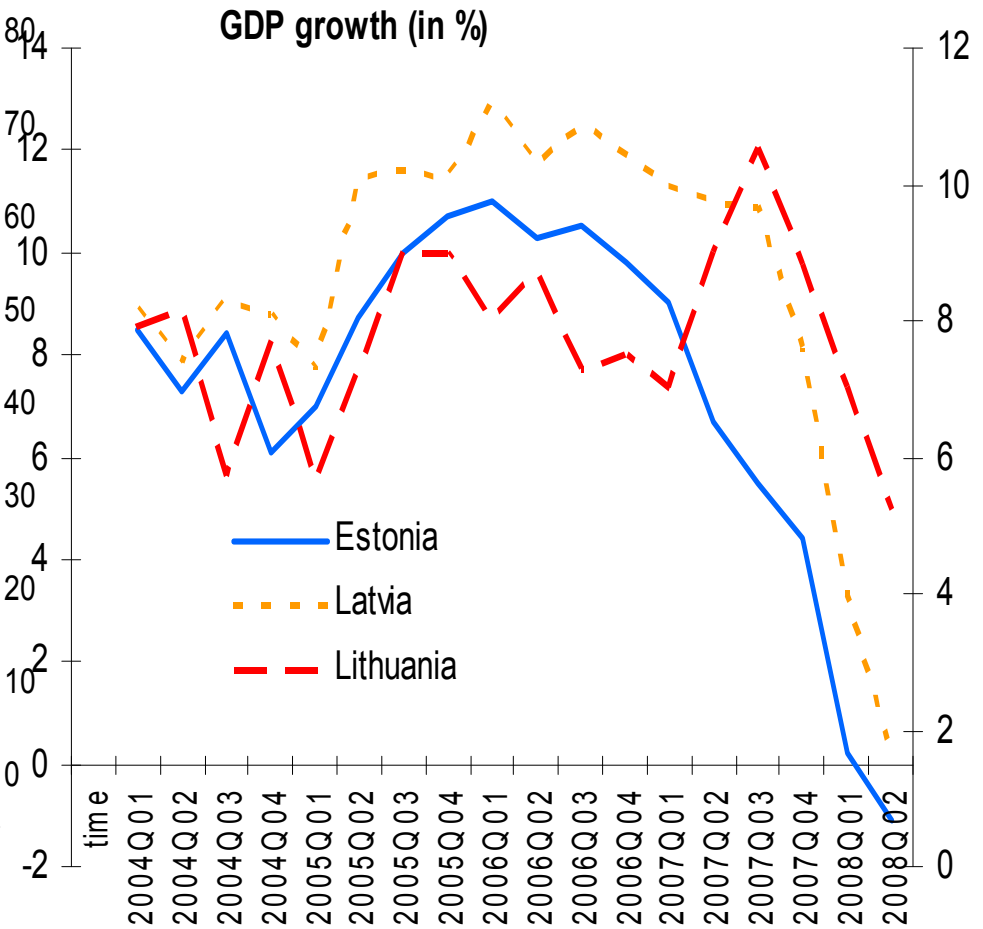
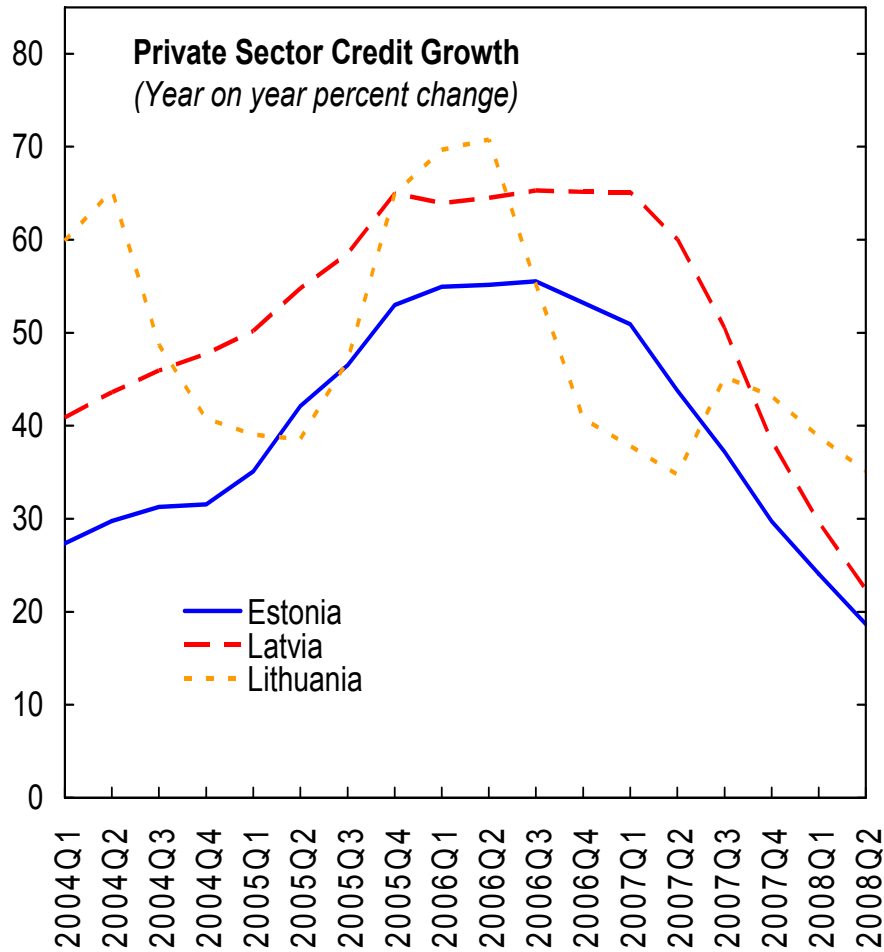
Wall Street to Main Street: a closer link in CEE countries

Share of Output Variation Explained by Credit and Asset Price Shocks
(Percent)



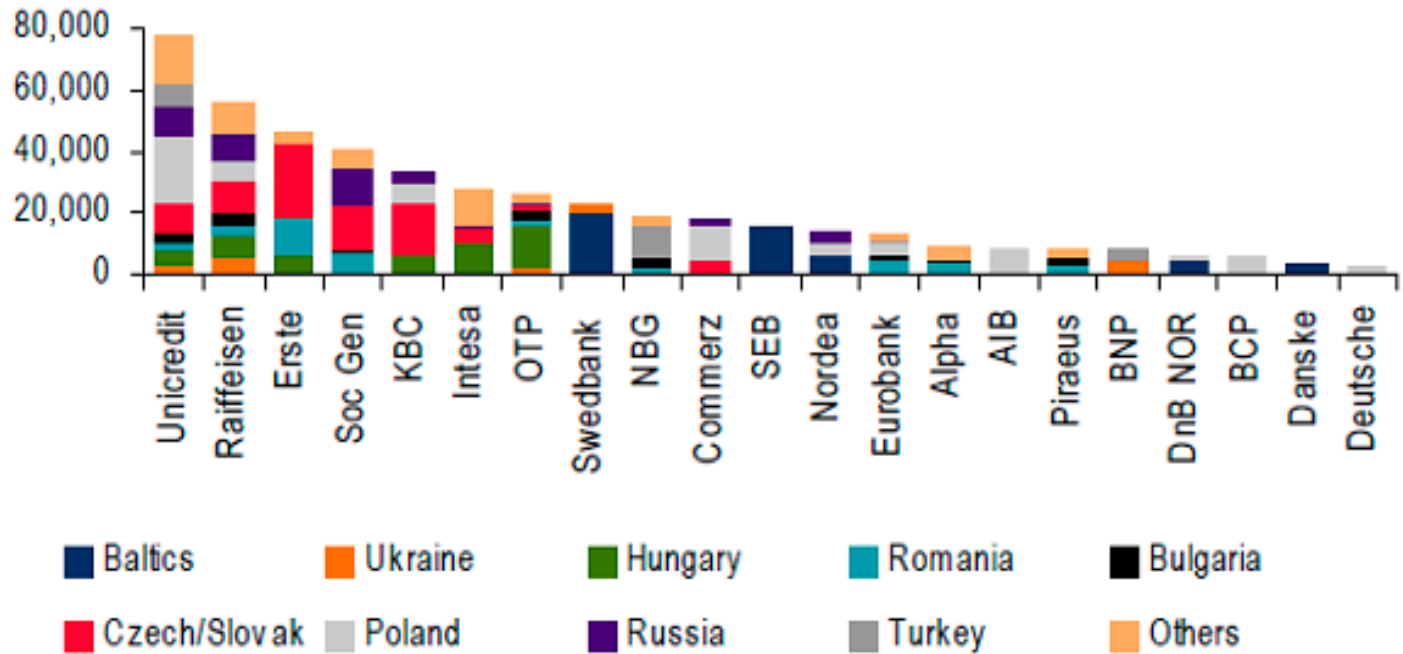
Sources: IMF, *International Financial Statistics*; Haver Analytics; national authorities; and IMF staff calculations.

The Baltics illustrate hard landing risks



Loan losses among parent banks will depend on their exposure to the most severely affected countries

Loan portfolios of West European banks' CEE subsidiaries, H1 2008 (€mn)

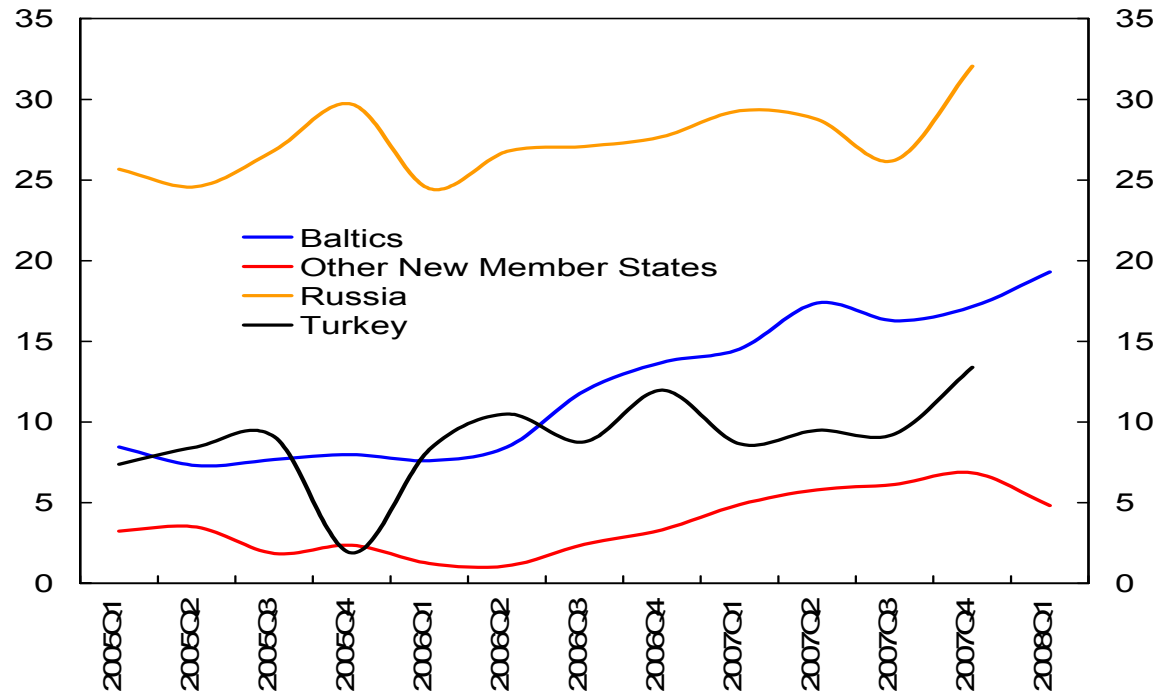


Source: Company data, Merrill Lynch estimates

Safeguarding external sustainability

Unit labor costs are rising

Changes in Unit Labor Costs, 2005–07 1/
(Percent)

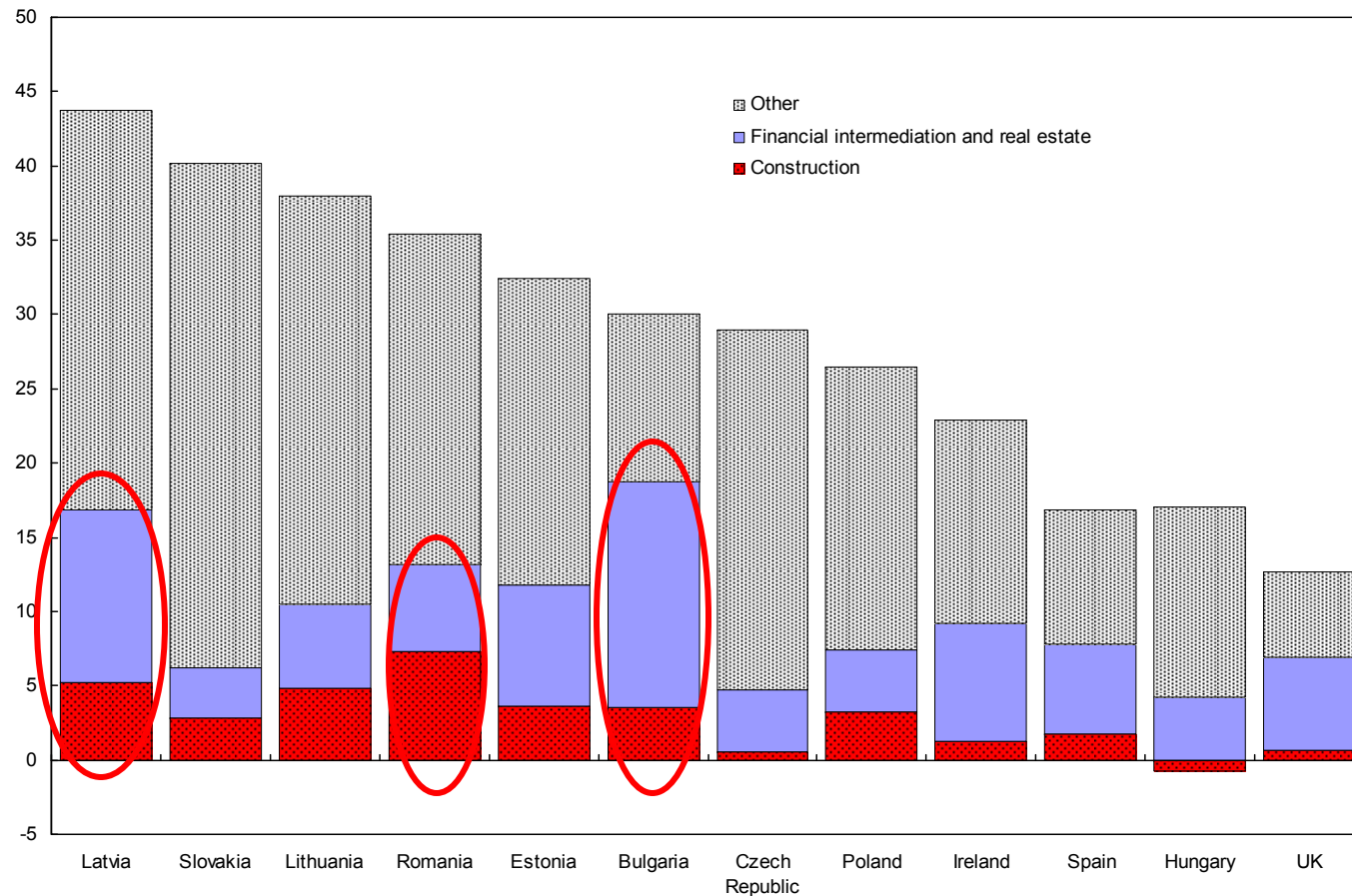


Source: OECD; and Haver Analytics.

1/ Baltics: Estonia, Latvia, and Lithuania. Other New Member States: Bulgaria, the Czech Republic, Hungary, Poland, Romania, the Slovak Republic, and Slovenia. Excludes Bulgaria and Slovenia in the fourth quarter of 2007 and Poland, Romania, and Slovenia in the first quarter of 2008.

In some countries growth needs to be reoriented towards tradables

Composition of Accumulated Real Gross Value Added Growth, 2004-H1,2008



Conclusions

- External vulnerabilities are a by-product of rapid convergence
- The global deleveraging is hitting CEE countries with large external financing needs particularly hard
- Continued exposure of parent banks is critical for CEE countries to weather the storm
- Multilateral support can help prevent negative feedback loops (Hungary)
- Better policy consolidation within the EU is essential

Thank you!

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