



Central and Eastern Europe: Global spillovers and contagion risks

Second Banking Forum for CIS and Eastern European Countries

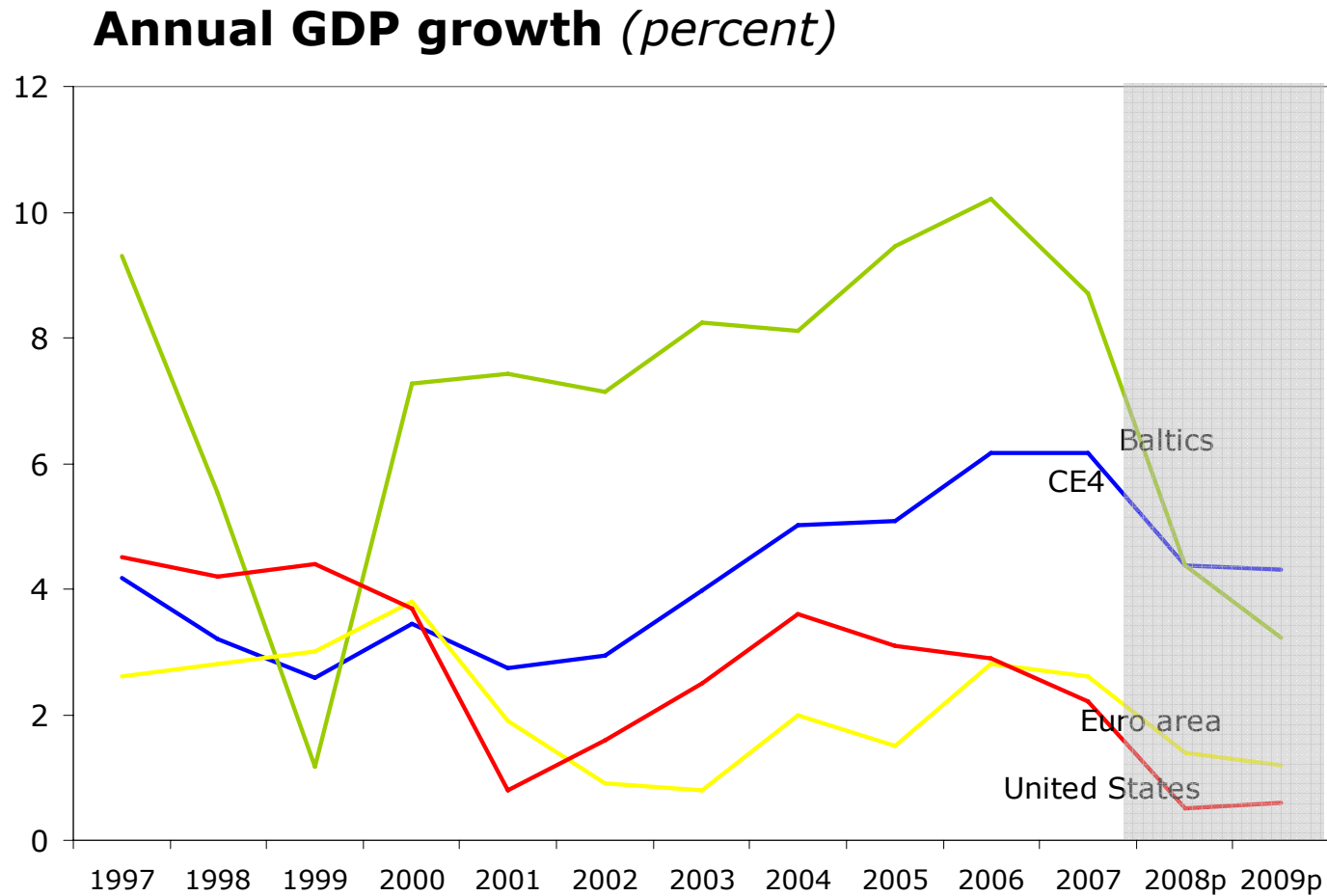
Vienna, April 2008

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Overview

- The CEEs' macro picture is still largely unaffected by the global credit crunch
- Large external imbalances in some CEE countries are raising concerns
- Foreign banks and possible contagion channels

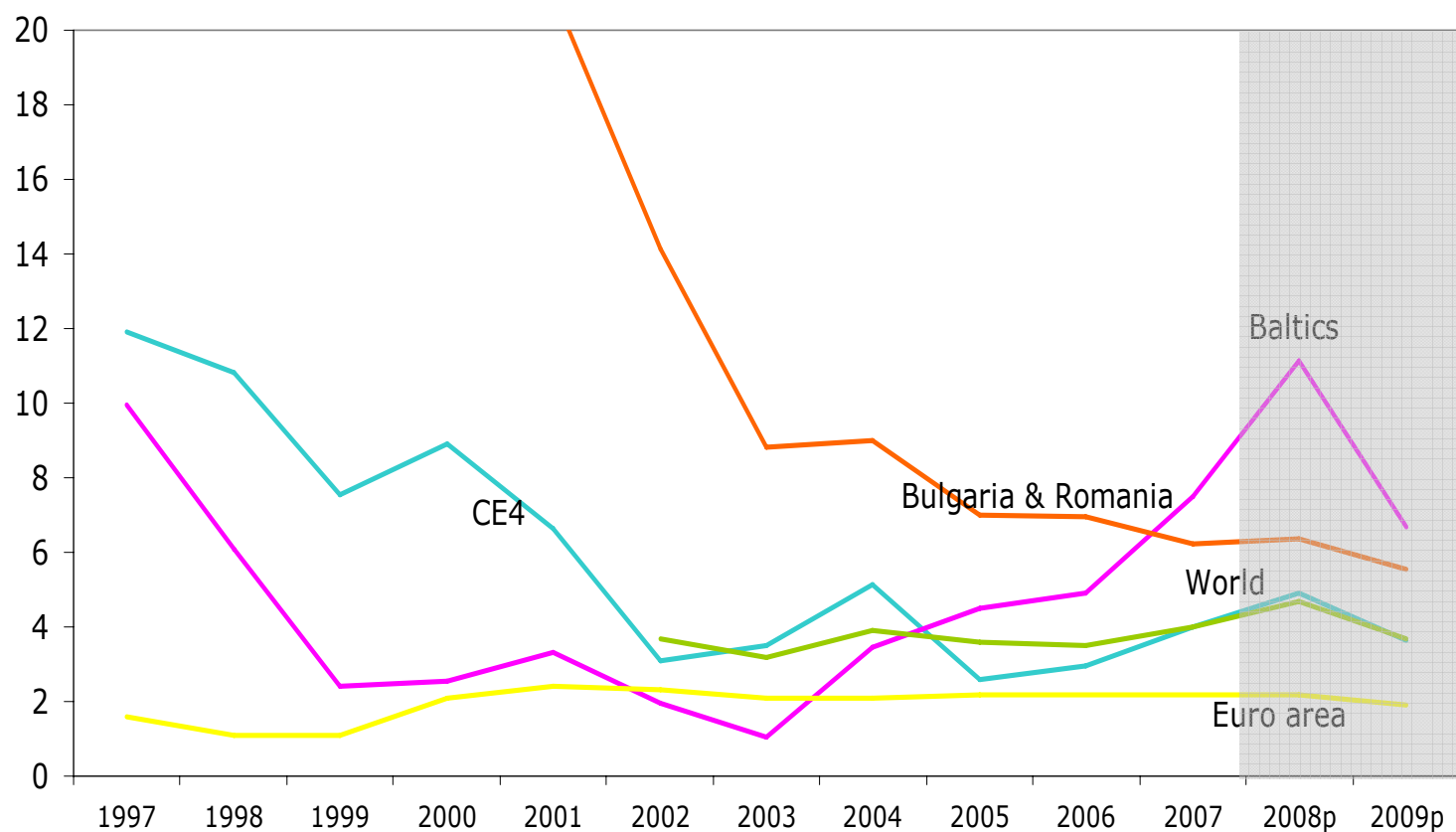
Growth is expected to slow, due to spillovers from the US and the Eurozone



Source: WEO April 2008.

Inflation is picking up, but mainly in the fixed exchange rate countries.

Annual average CPI (percent)



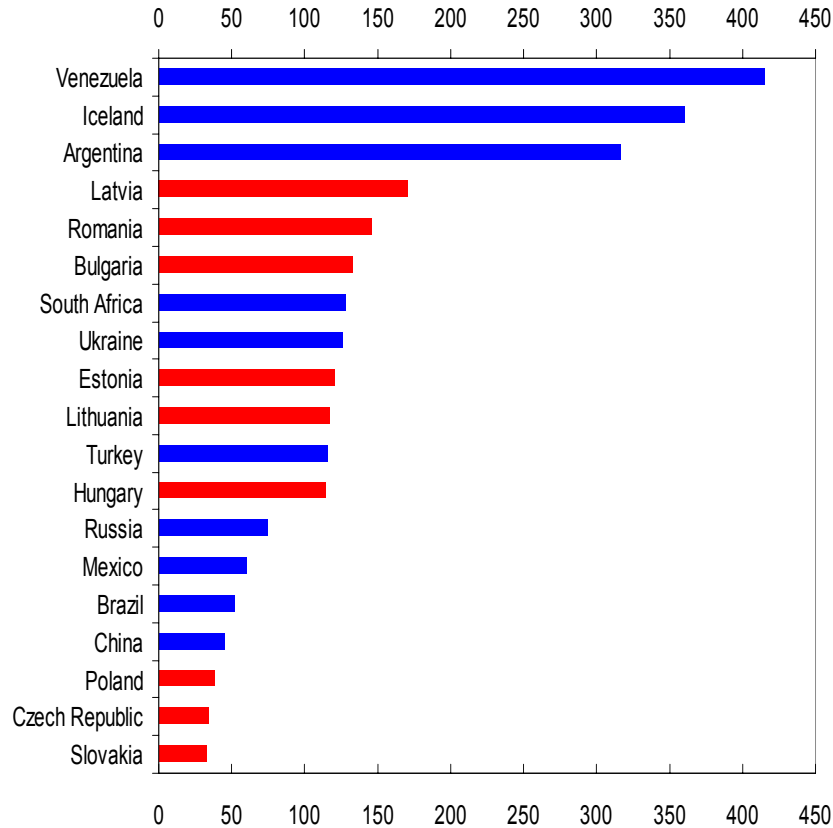
Source: WEO April 2008.

The baseline outlook is for a soft landing, but downside risks have increased:

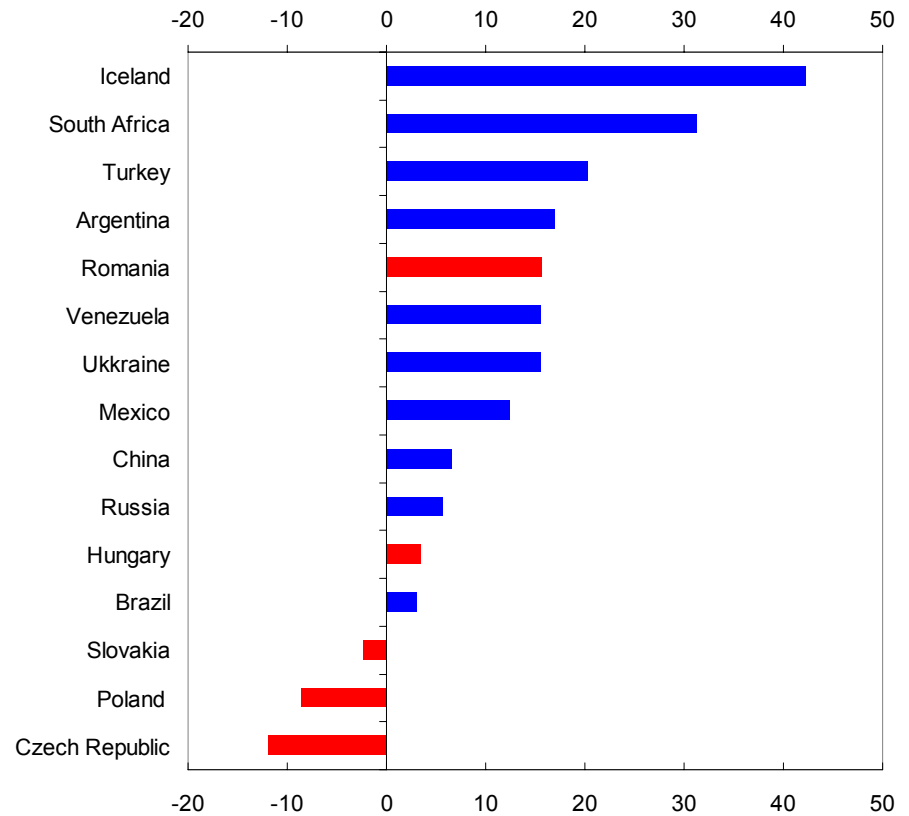
- **Exports:** slowdown in Europe and US could be more protracted than in the baseline
- **Inflation:** global commodity price boom, domestic wage pressures
- **Profitability and asset quality:** wage pressures and housing bubbles may make FDI less attractive
- **External funding:** vulnerable to a slow-down of petrodollar flows
- **Financial contagion:** tighter lending standards, increased funding cost

Since the onset of the crisis, markets have differentiated between emerging market countries

**Change in CDS
July 17 – April 17 (bps)**

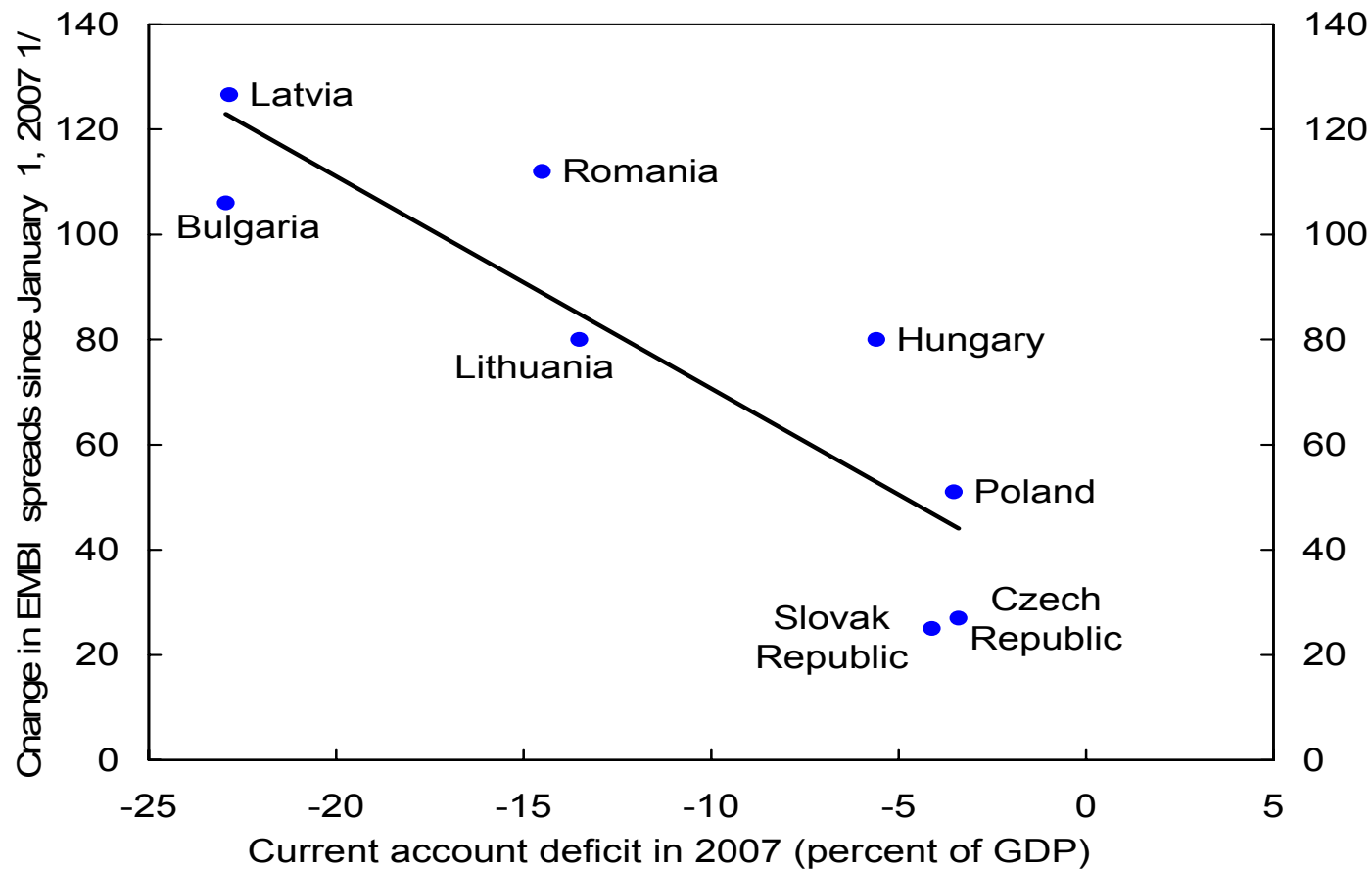


**Change in the EURO exchange rate
July 17 – April 17
(+= depreciation, percent)**



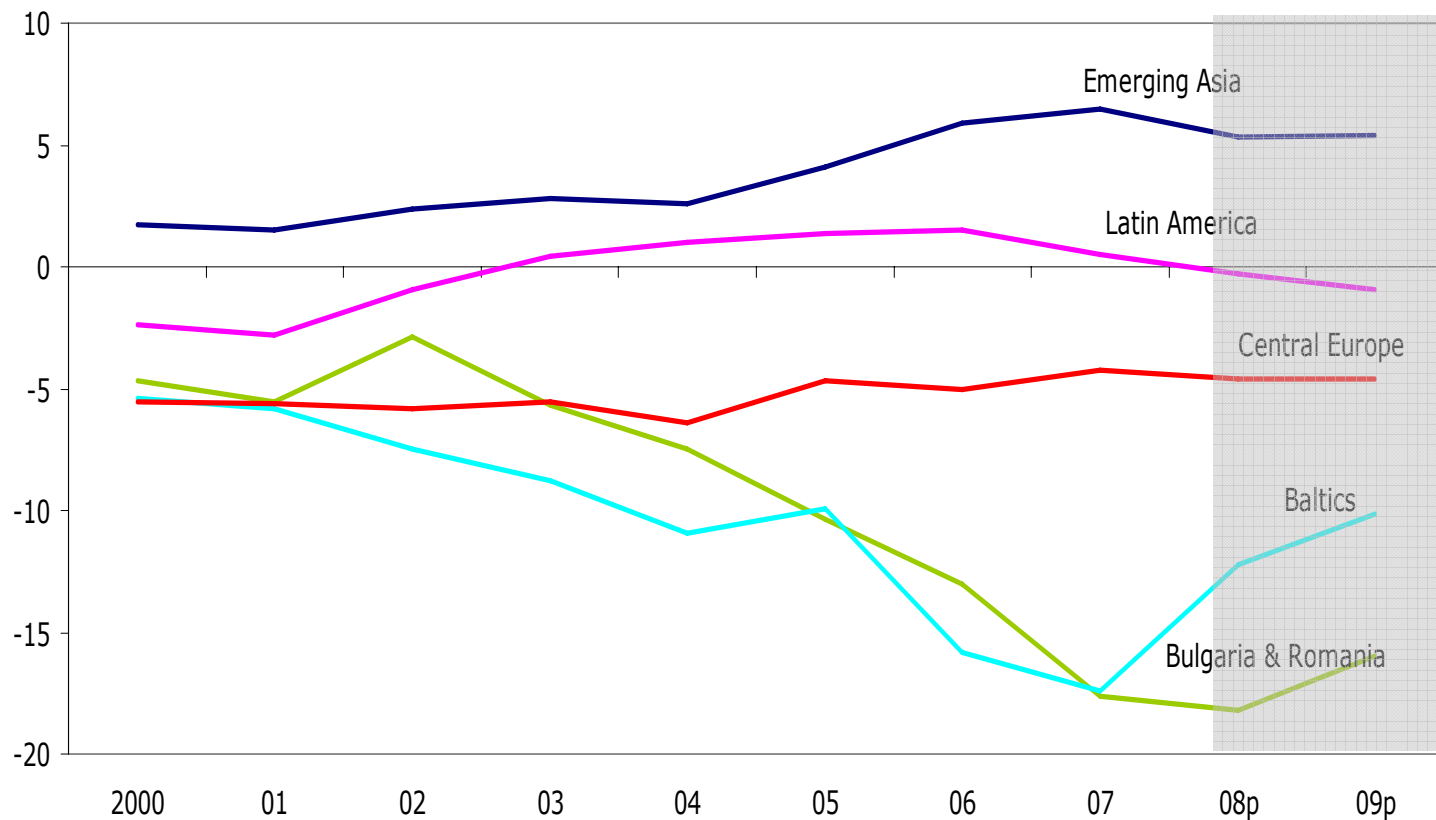
Particularly countries with large external imbalances face higher financing cost

Emerging Europe: Bond Spreads and Current Account Deficits



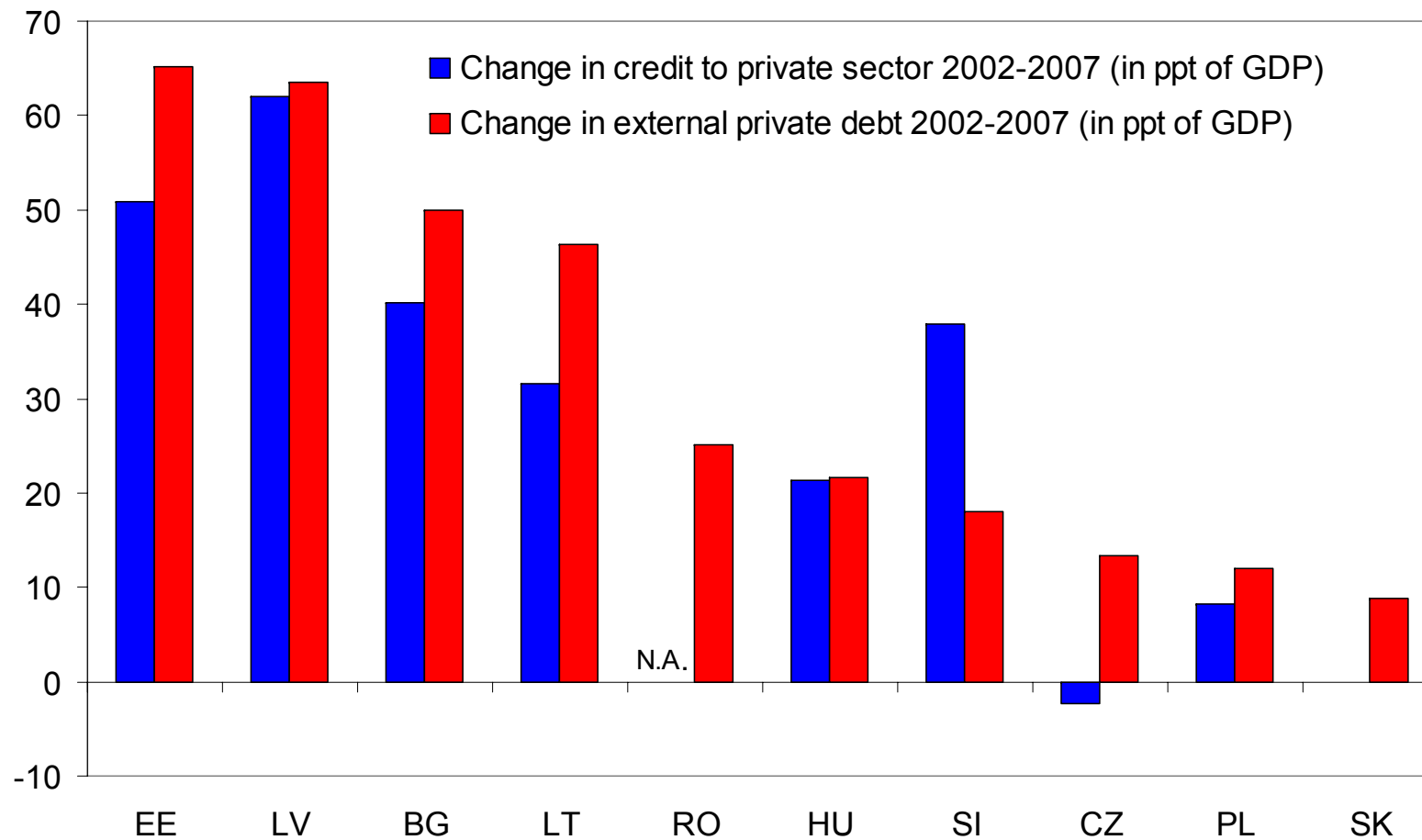
Current account deficits are especially high in the Baltics and South-Eastern Europe...

Current account deficit
(in percent of GDP)



Source: IMF WEO April 2007.

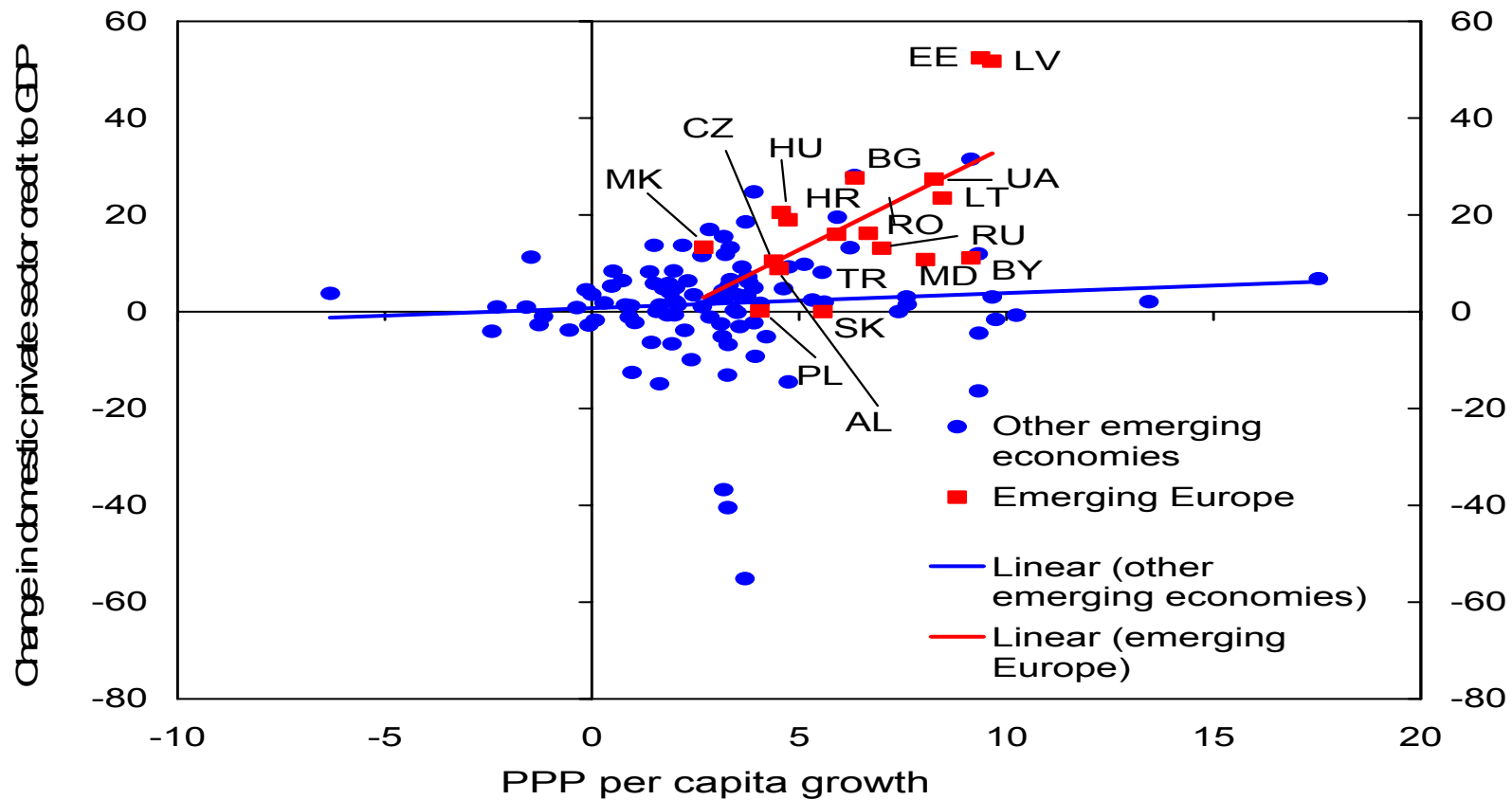
...and closely related to financial deepening



Sources: National authorities; and IMF staff calculations.

Financial intermediation has considerable scope to deepen and broaden, but the pace may slow

Growth and Private Sector Credit Growth, 2002–06
(Percent)



Are large external imbalances a risk?

Optimists:

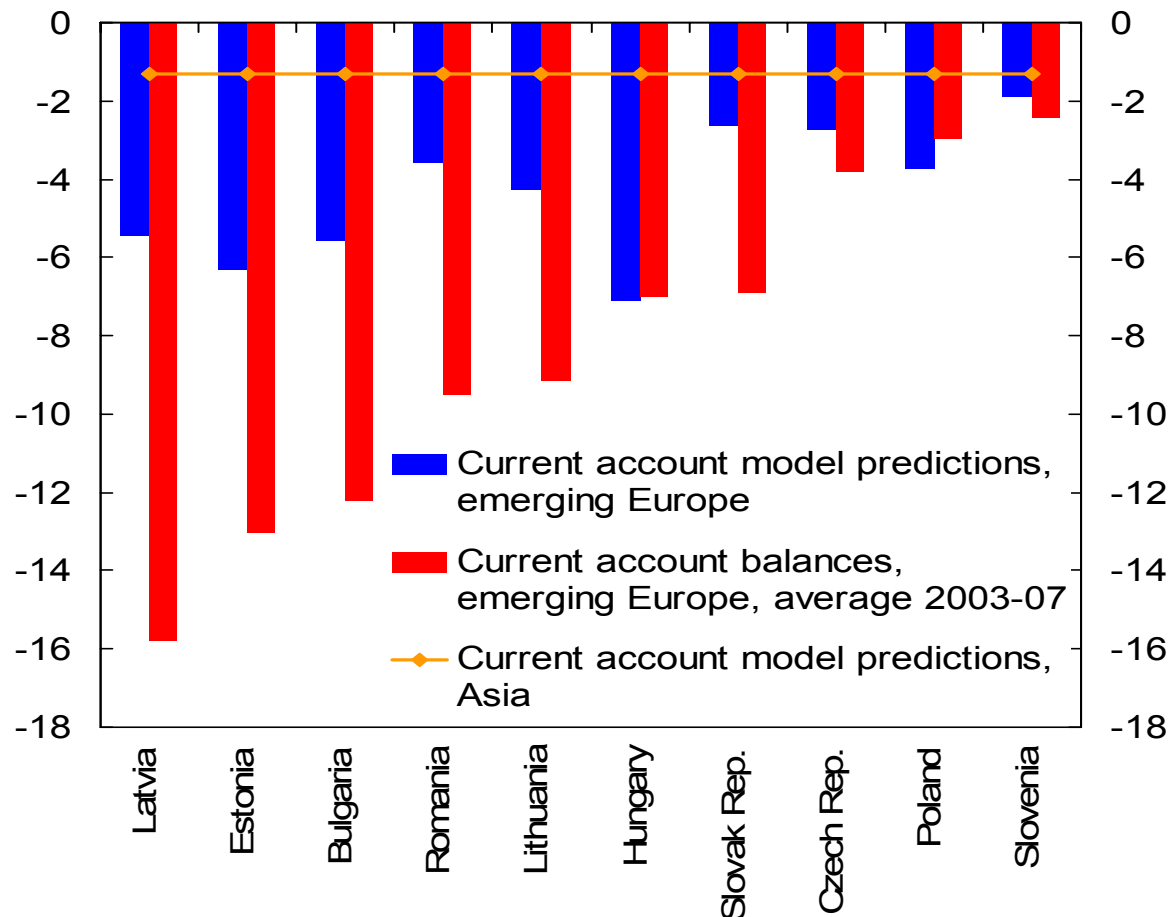
- The EU's "halo" effect (about 100 bp)
- Favorable structure of financing (EU funds, remittances, FDI, low portfolio inflows)
- Presence of large EU banks

Pessimists:

- Historical evidence of large capital inflows and sudden stops
- EU accession does not provide enough assurance of good policies and protection against financing shortfalls
- Foreign capital mainly goes to the non-tradable sector => questions about countries' long-term capacity to repay

C/A deficits in some countries are much higher than supported by fundamentals

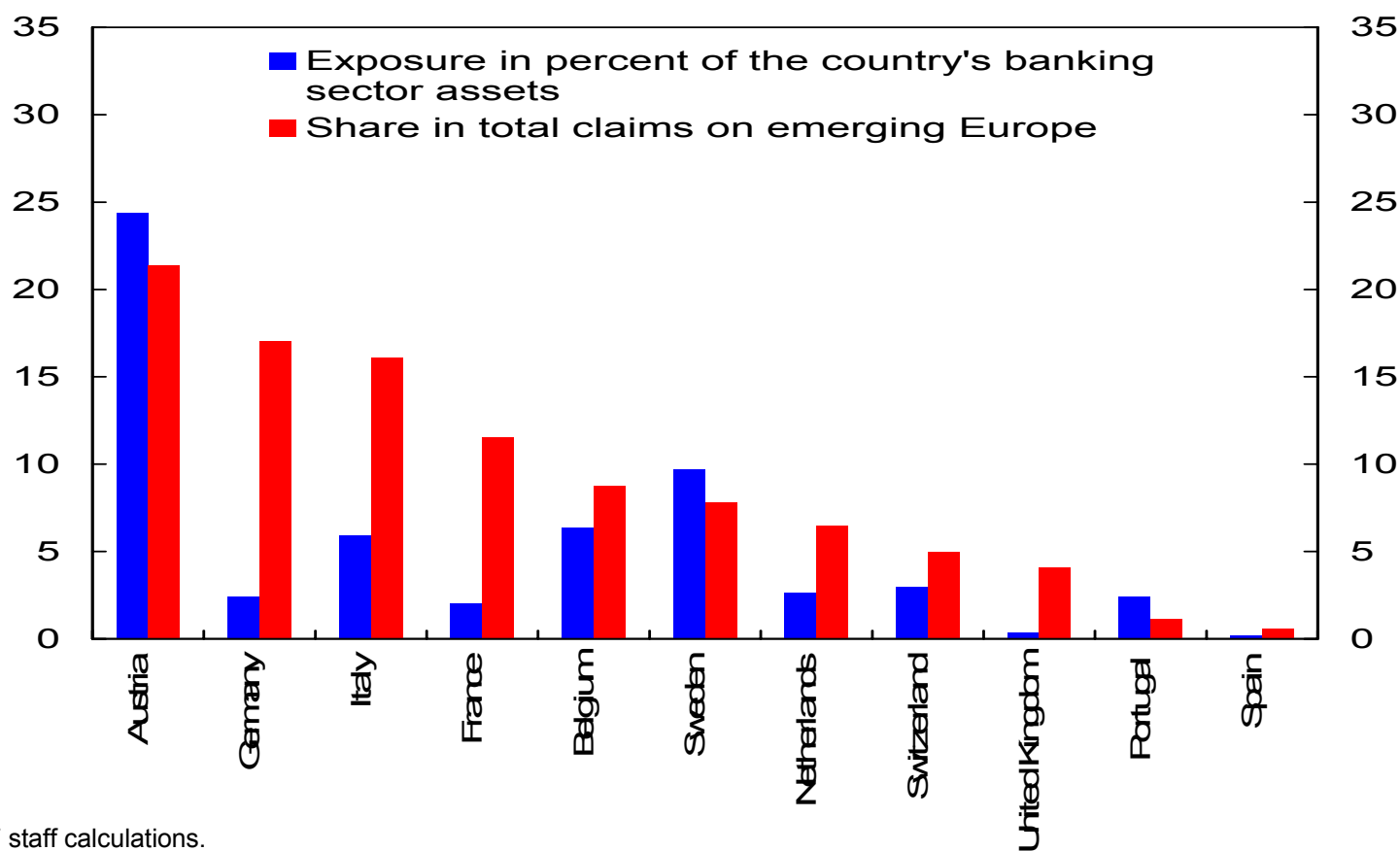
Current Account Balances and Model Predictions
(Percent of GDP)



Sources: IMF, World Economic Outlook; and IMF staff calculations.

Although lending to emerging Europe is a relatively small share in the portfolio of banks in advanced Europe...

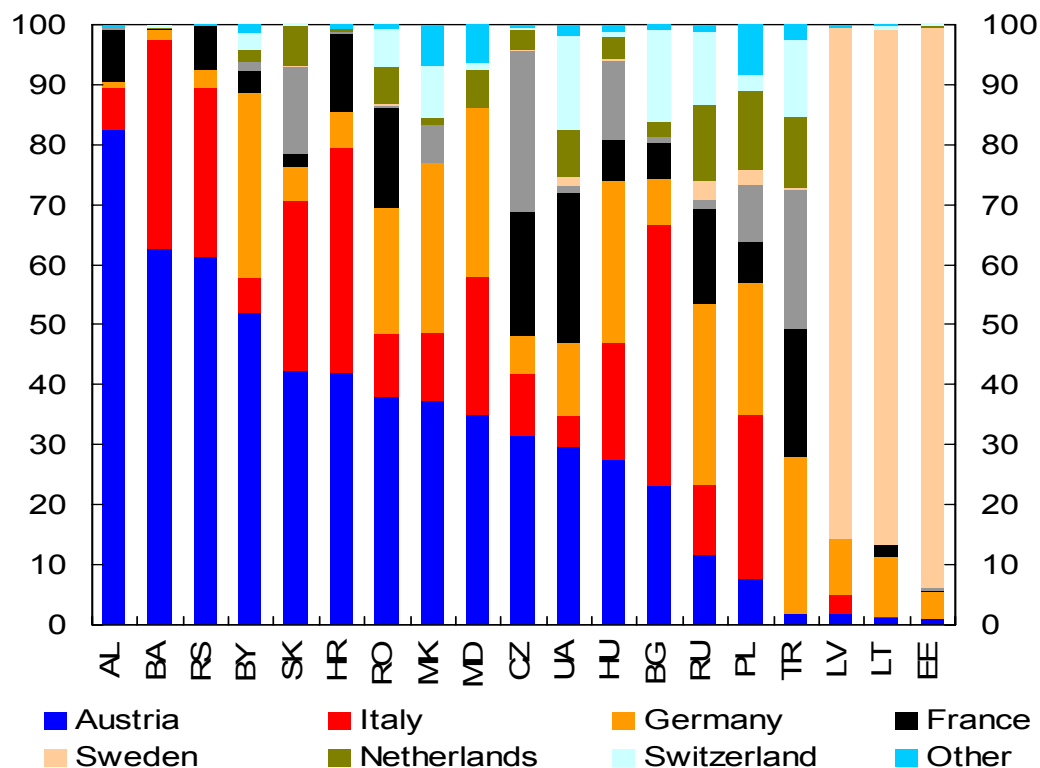
Relative Magnitudes of Funding Exposure for Emerging and Western Europe, June 30, 2007 (Percent)



... it exposes the region to common-lender contagion risk

Concentration of Emerging Europe Exposure to Western Europe, June 30, 2007

(Percent)



Source: Bank for International Settlements, Quarterly Review, December 2007.

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.

Conclusions

- The CEE countries are weathering the subprime crisis fallout well so far, although some (healthy) slowdown is in the offing
- While sizeable C/A deficits are a natural by-product of convergence, they are reason for concern in the Baltics, Bulgaria and Romania
- Foreign banks have contributed to financial deepening and growth, but open common lender contagion channels

Thank you!

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