Central and Eastern Europe: Global spillovers to the financial sector

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Christoph Rosenberg
International Monetary Fund
Regional Office for Central Europe and the Baltics
Overview

• The CEEs’ macro picture is increasingly affected by the global credit crunch and commodity price inflation
• Large external imbalances in some CEE countries are raising concerns
• The presence of foreign banks creates possible contagion channels
• What drives FX borrowing?
Growth is expected to slow, due to spillovers from the US and the Eurozone.

Rising inflation is a concern

**Annual average CPI (percent)**

Against this background, financial intermediation has considerable scope to deepen and broaden, although the pace may slow.

Source: IMF REO 2008
Financial deepening has been accompanied by an increase in foreign liabilities.

Sources: National authorities; and IMF staff calculations.
Current account deficits are especially high in the Baltics and South-Eastern Europe.

**Current account deficit**

*in percent of GDP*

![Graph showing current account deficit in percent of GDP for Emerging Asia, Latin America, CE4, SEE, and Baltics from 2000 to 2008Q1.]

Source: National authorities.
C/A deficits in some countries are much higher than supported by fundamentals (Rahman IMF WP 08/92)

Current Account Balances and Model Predictions (Percent of GDP)

Sources: IMF, World Economic Outlook; and IMF staff calculations.
Countries with large external imbalances face higher financing cost

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

Concentration of Emerging Europe Exposure to Western Europe, 2007 (Percent)


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.
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**

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

Note: All figures were previously transformed to euros.

Source: national authorities, Eurostat, IMF staff calculations.
This has led to large currency mismatches in the non-financial private sector

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.
Empirical results (Rosenberg and Tirpak, 2008):

- *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, but 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

• The CEE countries have weathered the subprime crisis fallout well so far, but a (healthy) slowdown is in the offing. Increased inflation is a concern.

• 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.

• Foreign currency borrowing constitutes a vulnerability, but few policy remedies are at hand.
Thank you!

Dr. Christoph B. Rosenberg
Senior Regional Representative

International Monetary Fund
Regional Office for Central Europe and Baltics

Ul. Zielna 37C
0-108 Warszawa
Tel.: + 48 22 338 67 00
E-mail: crosenberg@imf.org
Visit our website at: www.imf.org/cee