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The Finance-Growth Nexus: Implications for CESEE

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Financial Cycles and the Real Economy: Lessons for CESEE

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Agenda

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- Finance and Growth – A new post-crisis perspective?
- The role of foreign banks
- Finance and Growth in CESEE and the Euro Area Periphery
- Conclusion

Finance and Growth

–

A new post-crisis perspective?

What did we know before the crisis?

- More finance – higher growth (Levine 1997)
- However:
  - Long-term data
  - Causality unclear (Beck 2009)

- "Speed kills" (Kraft and Jankov 2005)
  - Rapid credit growth one of the most significant indicators explaining financial crises
  - Rapid credit growth driven by (gross / net) capital inflows indicator for financial and currency crises ("sudden stop")

Finance and Growth – a new post-crisis perspective?

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- There is a need to limit vulnerabilities related to strong capital inflows
  - Asian approach: reserve built-up, cautious opening up to capital flows
  - CESEE approach: financial integration based on foreign banks, macroprudential policies (in some countries, Vandenbussche et al. 2012)
  - Euro area – basically no mentioning: credit growth based on (net) capital inflows leading to catching up “seen as part of a well-functioning monetary union” (Gros and Alcidi 2013)

Finance and Growth – a new post-crisis perspective?

What do we know now? (Beck 2013)

- Effect of finance and growth has become weaker (Rousseau and Wachtel 2011)
- More finance does not necessarily lead to higher growth: Non-linear relationship (Arcand et al. 2012; Cecchetti and Kharroubi 2012, Manganelli and Popov 2013)
- Threshold at a Credit-to-GDP ratio of about 100% (or even lower)
- Explanations:
  - Financial crisis effects
  - Rising importance of "non-productive" creditors (households) or non-productive uses of credit (mortgage lending)
  - Misallocation of resources

Finance and Growth – a new post-crisis perspective?

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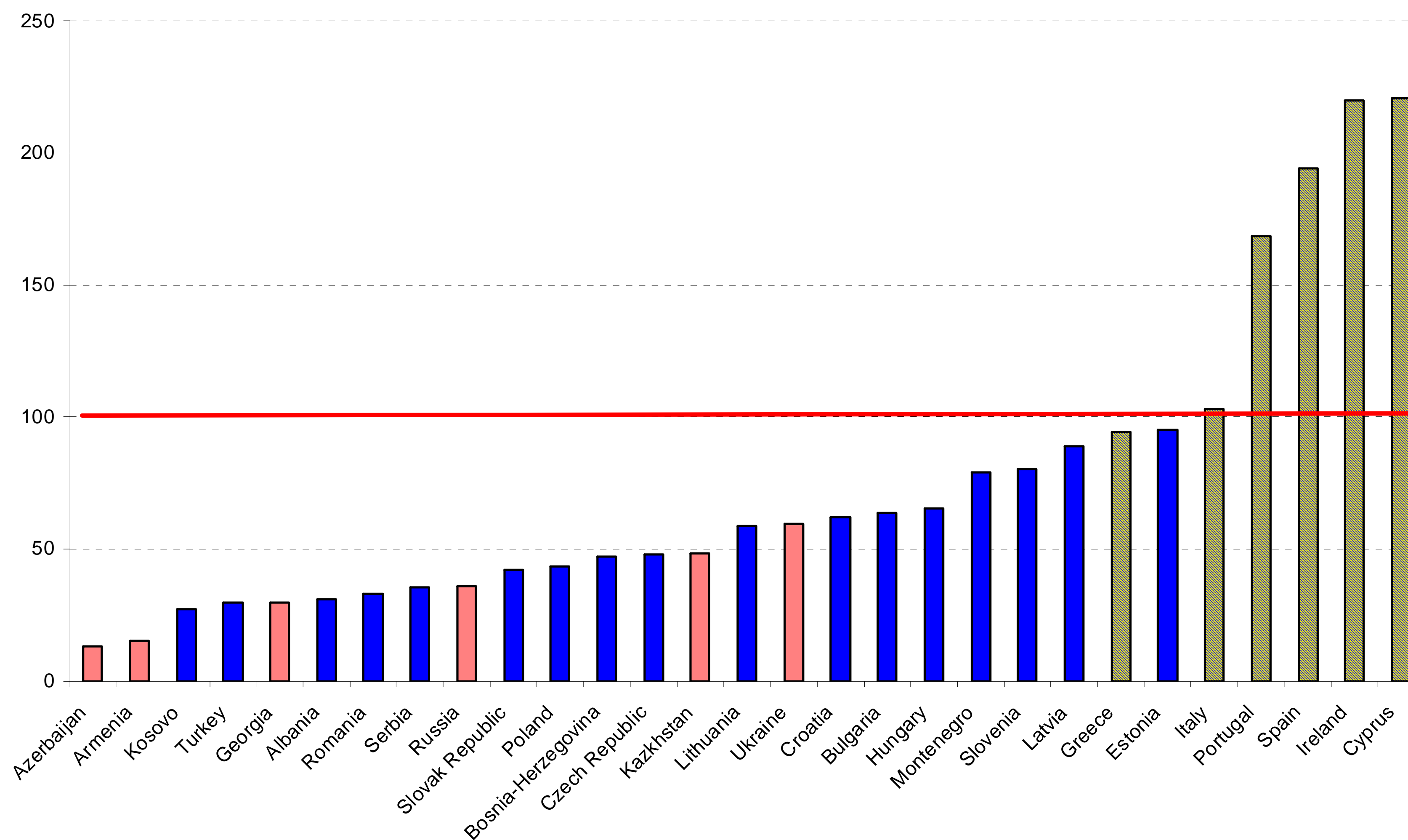
Private Sector Credit to GDP Ratio, 2008



Source: World Bank

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- "Speed kills"
  - Rapid credit one of the most significant indicators explaining financial crises (Schularick and Taylor 2012)
  - Rapid credit growth driven by (gross / net) capital inflows indicator for financial and currency crises ("sudden stop") (Rey 2013)

Finance and Growth – a new post-crisis perspective?

- Asian approach seems to have worked well to limit vulnerabilities related to strong capital inflows (Goldstein and Xie 2009)
- CESEE approach: recession, but no deep, full-fledged banking crisis
- Euro area: recession and full-fledged banking crisis (Gros and Alcidi 2013)

The role of foreign banks

The role of foreign banks

- Pre-crisis debate: Many arguments in favor of / against foreign bank presence in emerging markets
- CESEE banking sectors: dominated by foreign-owned banks
- Financial stability aspects: shock absorber
  or shock transmitter?

The role of foreign banks

CESEE evidence for global financial crisis:

- sudden stop: shock absorber (Vogel and Winkler 2012, Hameter et al. 2012; De Haas and Van Horen 2013, Gros and Alcidi 2013))
- domestic credit growth (relative to locally owned institutions): mixed evidence leaning towards shock absorber (De Haas et al (2012) [but mainly Vienna Initiative banks], Clarke et al (2012) ["well established foreign banks"]**)**
- domestic credit growth (foreign bank vs. local bank dominated sectors): no shock absorber, no shock transmitter (Vogel and Winkler 2012)

Finance and Growth in CESEE and the Euro Area Periphery

Finance and Growth in CESEE and the Euro Area Periphery

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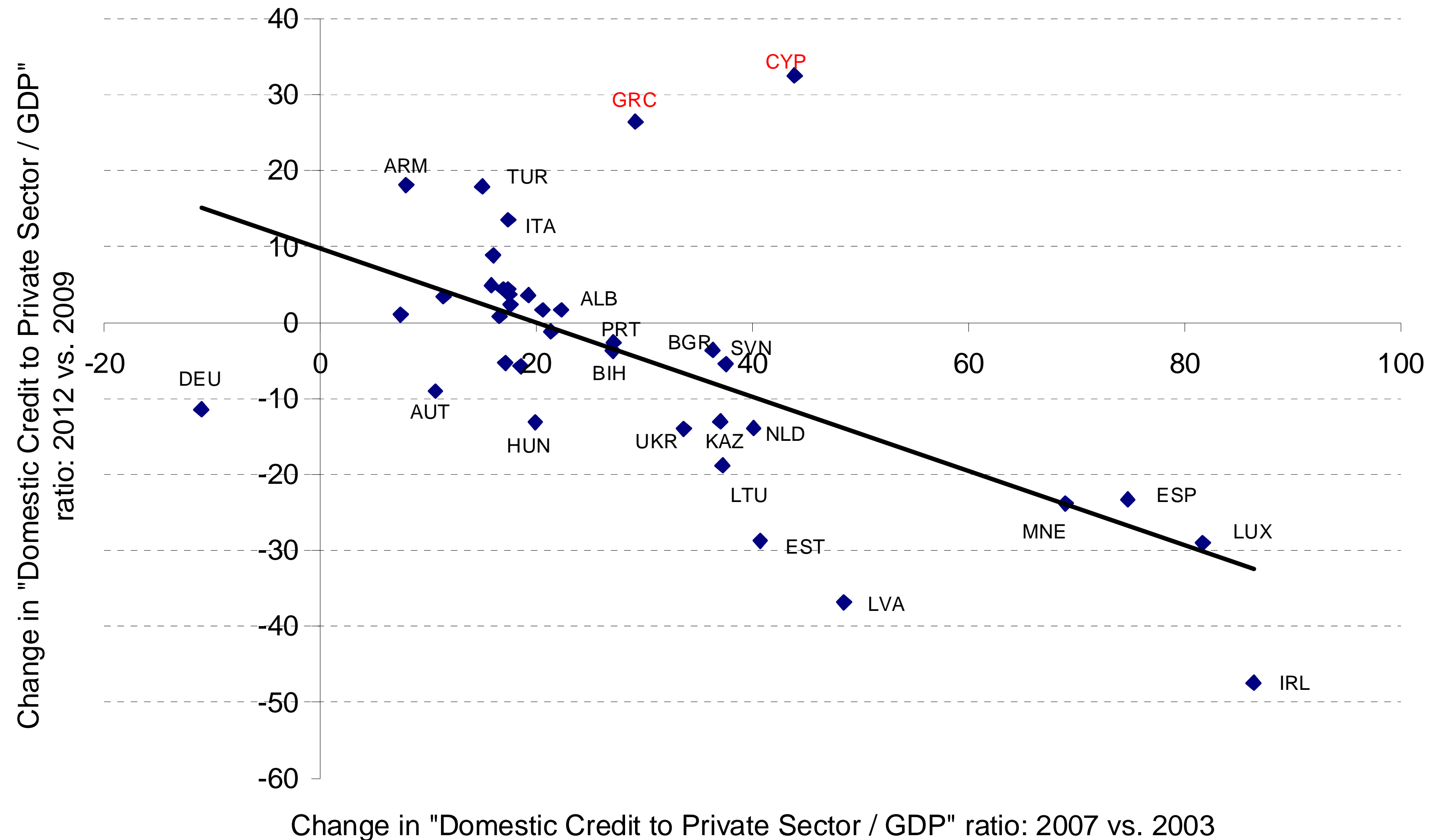
Similarity: Credit boom – credit bust



Source: World Bank, own compilation

Many differences

- Timing: Crisis and adjustment process started in CESEE earlier
- Pattern of crisis and recovery: Larger initial output losses in CESEE. However, some CESEE countries show already positive growth (and are expected to do so in the future, while growth prospects for euro area periphery looks more bleak)

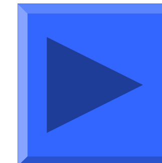
Differences between BELL (as a subgroup of CESEE) and EA Periphery reflect (Gros and Alcidi, 2013):

- Economic and structural country characteristics
- Financial integration pattern: institutional integration (foreign banks) versus wholesale market integration

Similarity or difference: Monetary union versus fixed exchange rate

Key messages

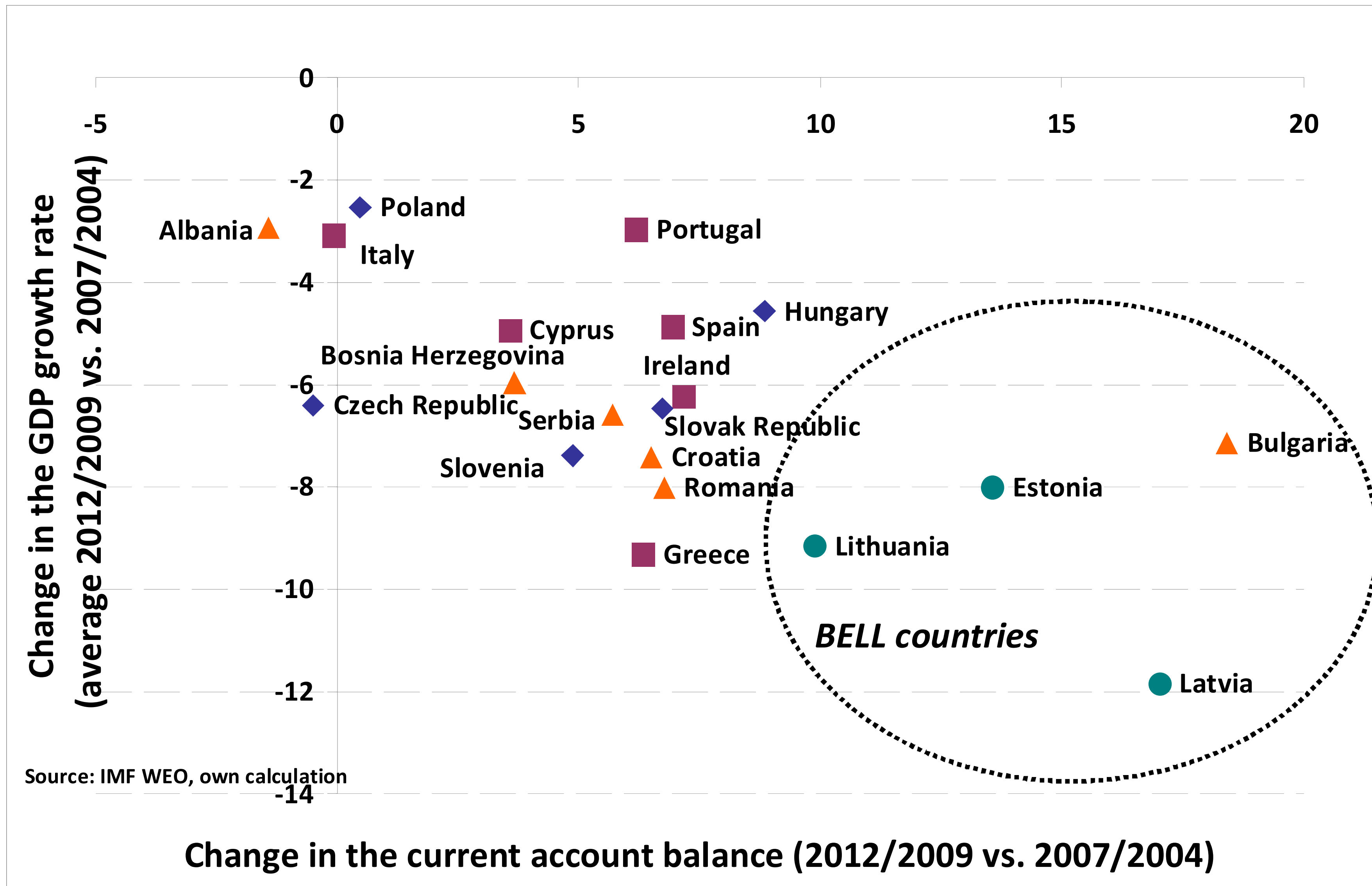
- BELL countries benefit from being small, open, flexible economies which had (comparatively) little public debt / deficits when hit by the sudden stop
- Foreign banks as shock absorbers in CESEE
- Euro area: shock absorption via public institutions (ESM, TARGET2)
- Public shock absorbers less strict on adjustment (private sector credit, current account)



Key messages (continued)

- Slower adjustment in the euro area periphery compared to CESEE
- However, this does not pay off in terms of output and employment
- CESEE have an advantage compared to euro area periphery to respond to the sudden stop
- This advantage rests in the fact that the adjustment process is driven by market forces.

Finance and Growth in CESEE and the Euro Area Periphery



A different / additional interpretation

- CESEE (reasonably) prepared for sudden stop (but different than emerging Asia)
- Euro area periphery completely unprepared for sudden stop

	Capital account openness	Foreign exchange reserves	Foreign banks	Macropru-dential policies
CESEE	-	+	+	(+)
Euro area	-	-	-	-*
Emerging Asia	+	+	-	-

** But dynamic provisioning in Spain*
Source: own compilation

Why was the euro area unprepared?

- No sudden stops within a currency union that overlaps with a nation state.
- Assumption: Creating a multi country currency union reduces the risk of sudden stops (as witnessed in various EMS crises) to zero like in a currency union composed of a single country.
- This assumption has turned out to be wrong.
- It needs much more than creating a common currency to prevent sudden stops in a currency union.

How can the euro area prepare for sudden stops?

A thought experiment:

Banks in euro area periphery had been owned by banks in euro area core

Implications:

- Zero TARGET balances (assuming banks in core country were considered as "safe")
- Government deficits and debt in key periphery countries substantially lower than it is the case now (in particular Ireland and Spain)
- Feedback effects between banks and governments limited if parent banks are domiciled in fiscally strong EA member states
- Banking union still needed if banking rescue schemes would overburden core EA governments (but "geographical demand patterns" for banking union would be different)

How can the euro area prepare for sudden stops?

Alternative option: By becoming a full-fledged monetary union

- It needs all instruments that currency unions overlapping with nation states employ to fight a “normal” banking crisis” on a union level
- These instruments were not available as the initial institutional set-up of the euro area was characterized by the absence of any form of fiscal union and banking union
- Creation of institutions going in this direction (ESM, SSM) controversially debated
- Even lender of last resort activities by the ECB have been severely criticized when crisis became asymmetric (OMT, TARGET)

Poor performance of euro area periphery also reflects

- Euro area unpreparedness for a sudden stop within the euro area
- Hesitance to establish euro area institutions needed to successfully manage the sudden stop
- Hesitance to use the instruments once the institutions have been established to manage the sudden stop successfully

Conclusions

Conclusions

What have we learnt?

- Finance can be too much of a good thing
- It is good to prepare for sudden stops
- In case of a multi-country currency union, the kind of preparation that is in line with the character of a currency union is to have a full-fledged currency union that includes decisive steps towards fiscal and banking union
- If such a currency union is not established it is more vulnerable to sudden stops than a prepared emerging market country with a fixed exchange rate

➢ A currency union is more than an exchange rate regime. It has to be more than an exchange rate regime in order to be sustainable.

Thank you very much for your attention

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Average real GDP growth: CESEE, BELL and EAP

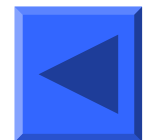
6
4
2
0
-2
-4
-6
-8
-10
-12
-14

2009 2010 2011 2012 2013 2014 2015 2016 2017 2018

CESEE
BELL
EAP

Sharp adjustment

Source: IMF, own calculations



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2009 - 2012

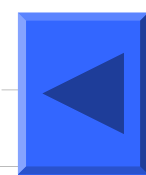
Serbia
Greece
Cyprus
Italy
Czech Republic
Albania
Poland
Portugal
Croatia
Slovenia
Romania
Bulgaria
Bosnia Herzegovina
Spain
Lithuania
Estonia
Ireland
Hungary
Latvia

10
8
6
4
2
0
-2
-4
-6
-8

-12 -10 -8 -6 -4 -2 0 2 4

Average growth rate of the "domestic credit to private sector / GDP ratio"

Average current account balance (as a percentage of GDP)



Source: IMF, World Bank, own calculations