Post-Crisis Challenges in Emerging Europe's Financial Sector

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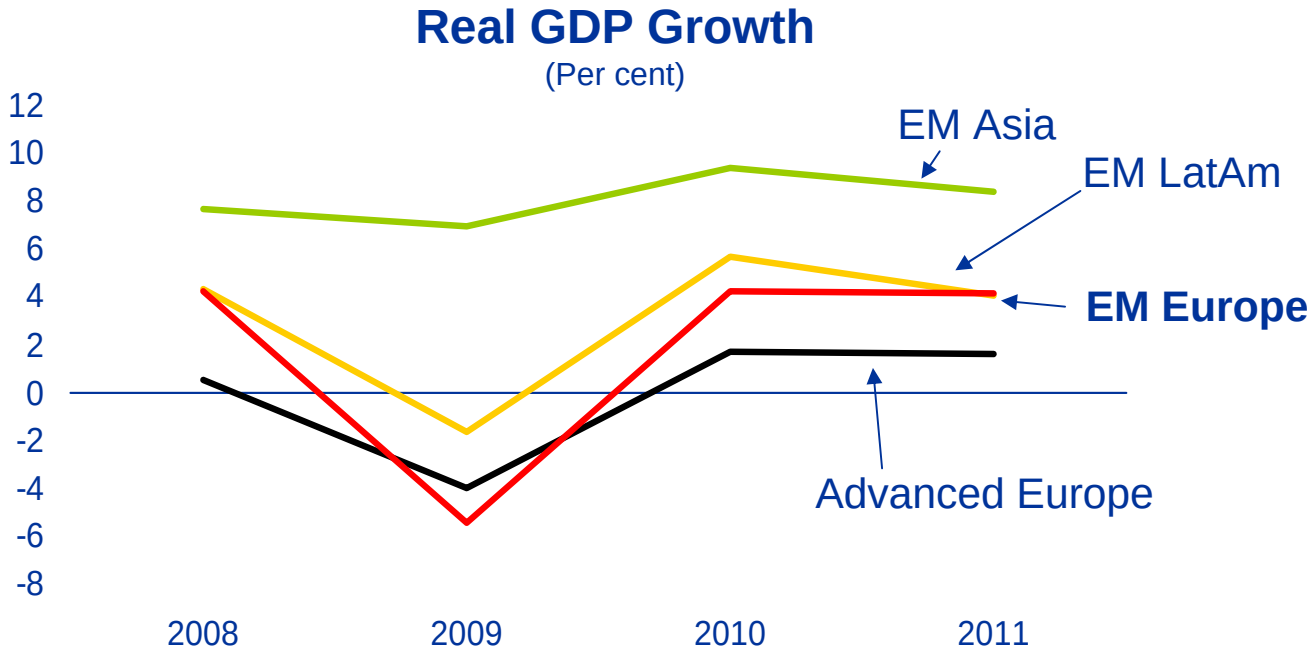
Key points

- **Post-crisis recovery underway – but is the region out of the woods?**
- **Post-crisis policy responses – enough for the needed new growth agenda?**
  - Compare with post-Asia crisis 1997/8
- **Will capital inflows return to the region?**
- **A new 'banking model?'**
- **No room for complacency**

Post Crisis Recovery

The recovery is underway and convergence play is back - although at a slower pace

- Slower recovery despite much sharper output collapse
- Large dispersion among countries

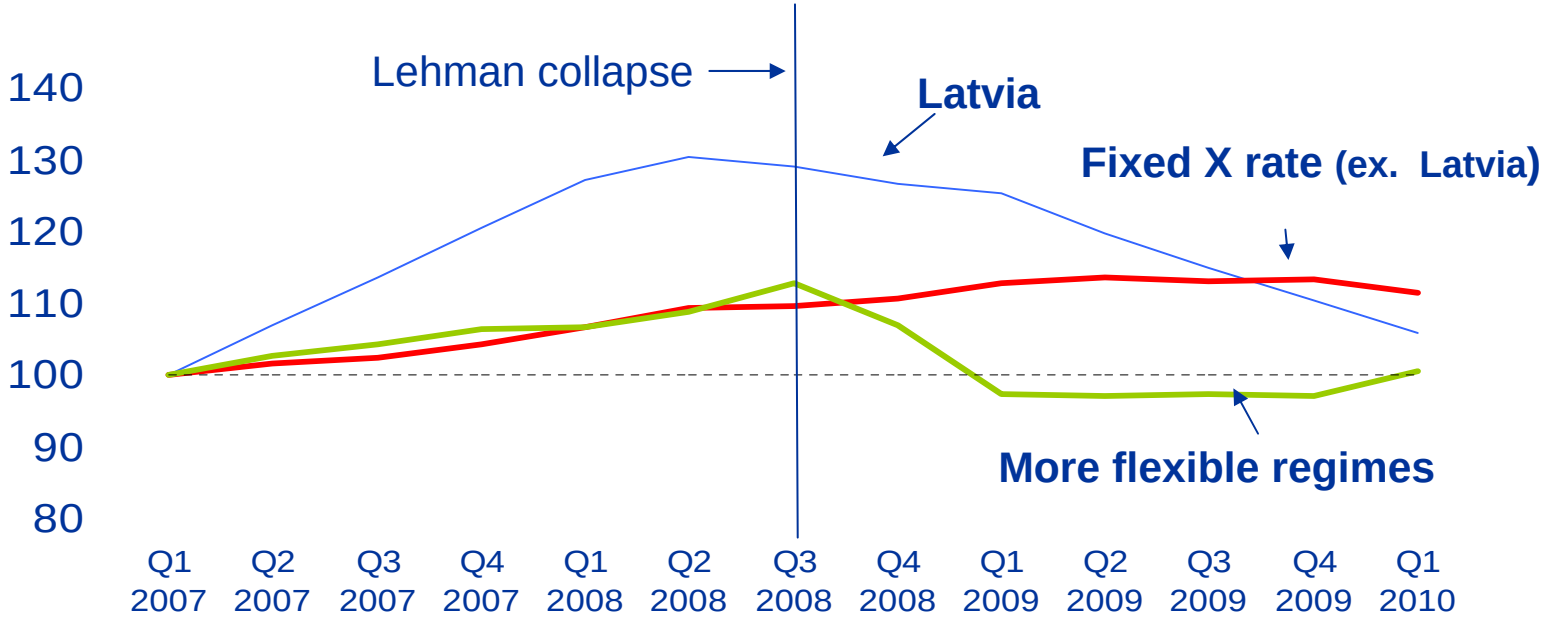


Sources: EBRD Regional Economic Prospects October 2010; IMF WEO October 2010.

Competitiveness improving only gradually to spur growth

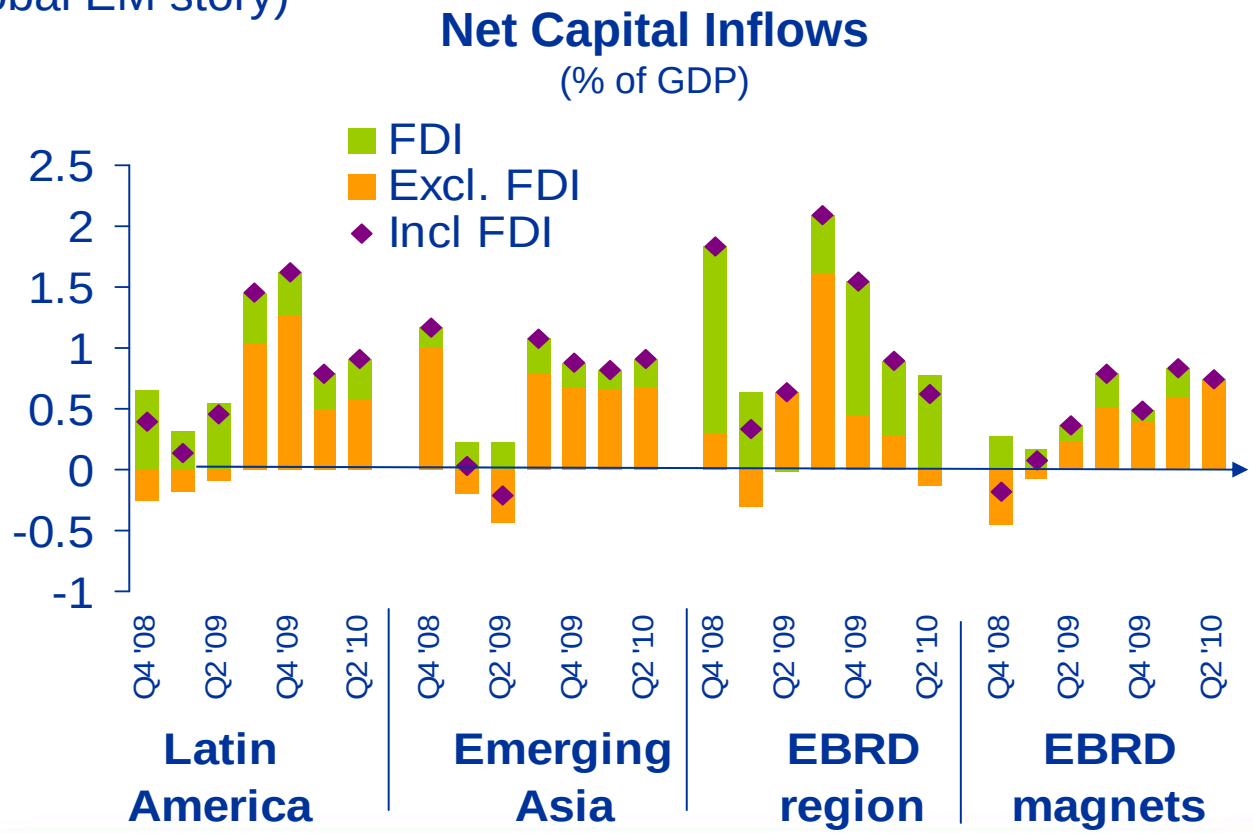
- Post-Lehman, real effective exchange rates depreciating, less for "fixers" (except Latvia) than for "floaters"
- Need reforms + investment + cost containment

Real effective exchange rate (Q1 2007=100)



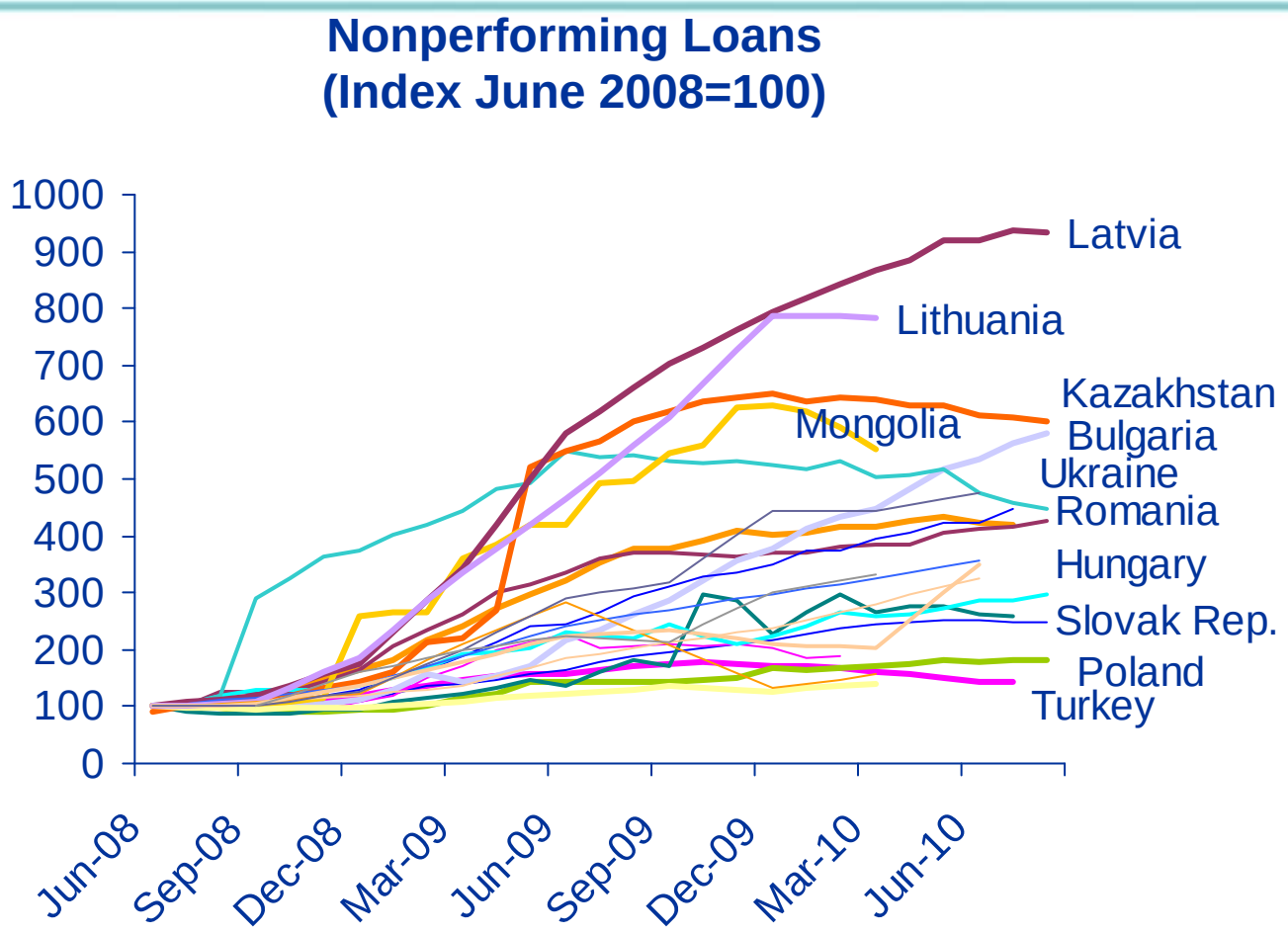
Slow return of capital inflows led by FDI

- FDI returning, especially because of bank recapitalizations
- Exception: Poland and Turkey: large inflows with portfolio (part of the global EM story)

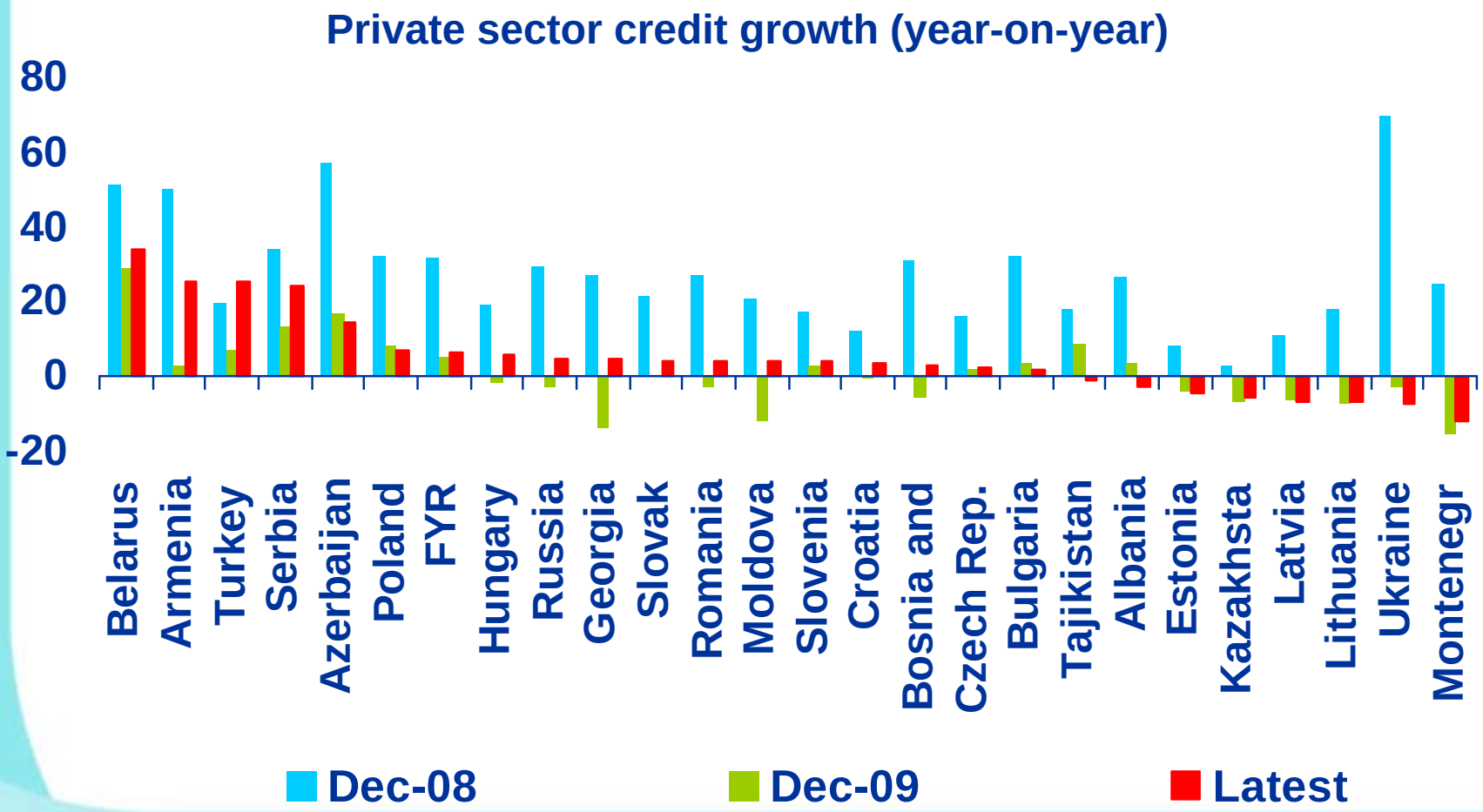


Latin America: Brazil, Colombia, Mexico; Asia: India, Indonesia, Thailand; EBRD region: 24 out of 29 EBRD countries of operations; EBRD magnets: Poland, Turkey

High and sometimes still rising NPLs

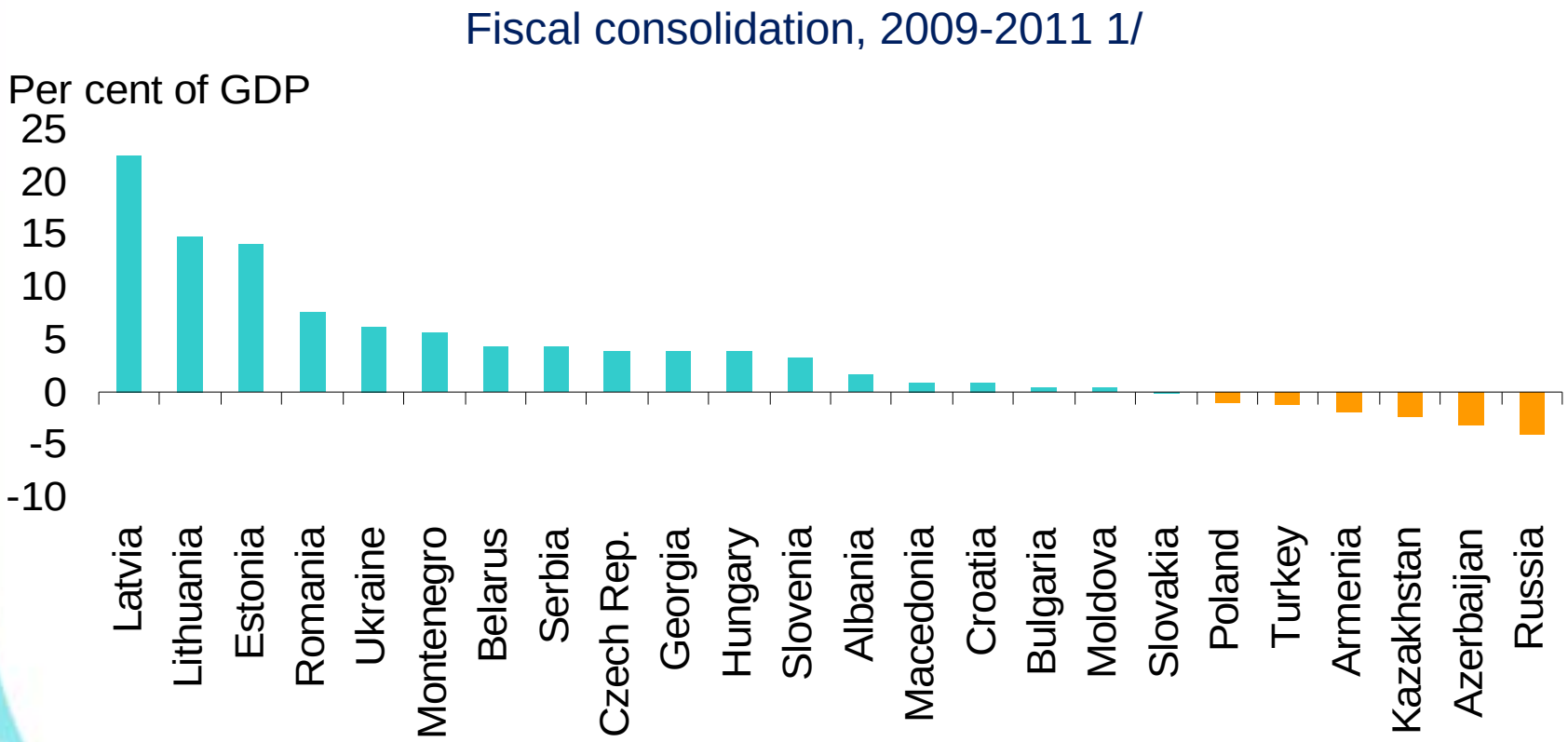


Hence, slow recovery in credit growth



Widespread fiscal consolidation weighs on domestic demand

- But necessary after large deficits from crisis in some countries



1/ Budgetary impact over three years of announced measures to reduce expenditures or raise taxes.

New Growth Agenda – Is Enough Happening?

Sustaining growth under a ‘New Growth Agenda’

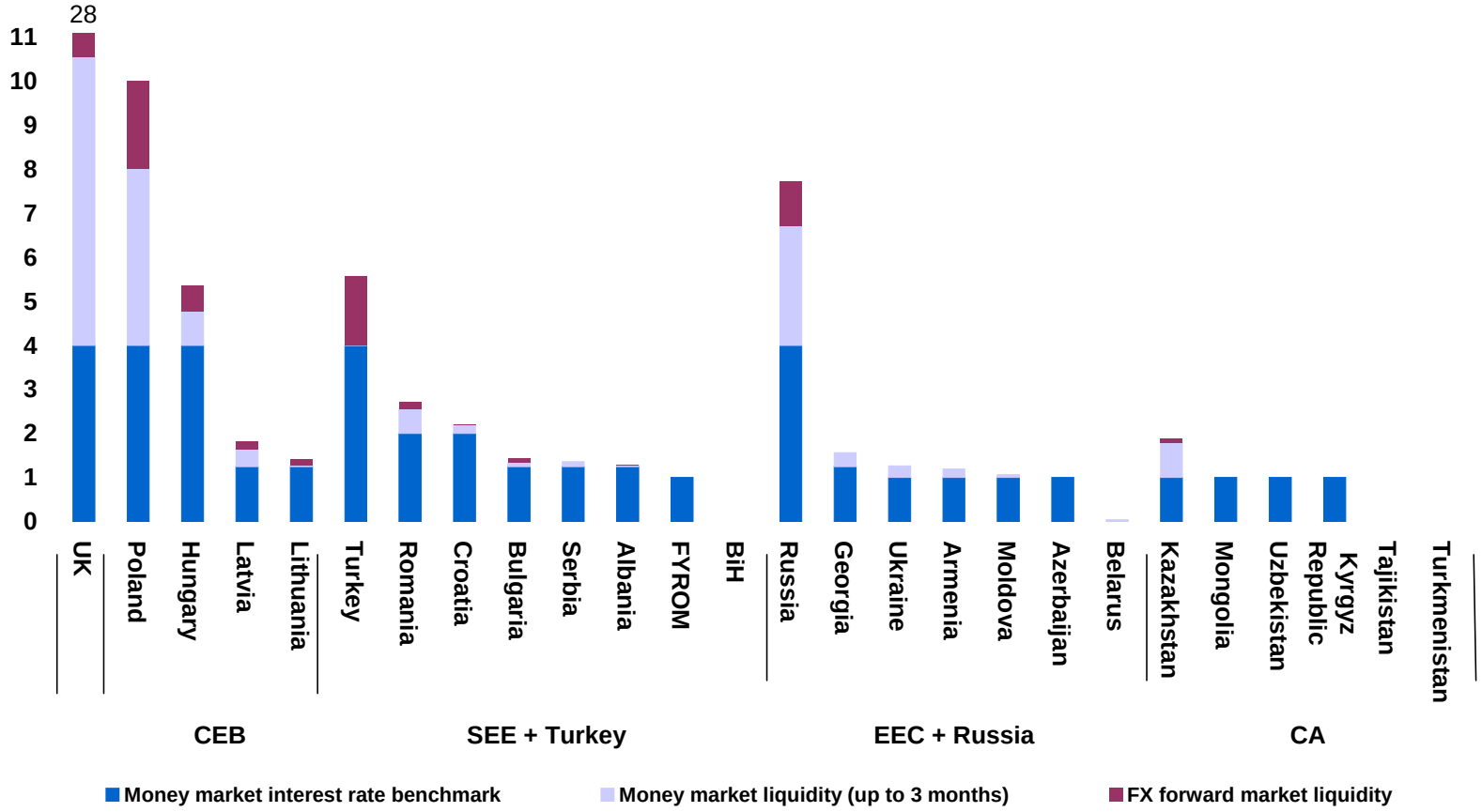
- Pre-crisis growth model based on domestic demand, fuelled by capital and commodity export inflows
- Post-crisis this looks neither desirable nor feasible
- New growth agenda:
  - More domestic savings, less foreign (currency) borrowing
  - Sustained competitiveness boosting trade integration and exports
  - Improving business environment and institutional setup (regulation, state involvement)

Local currency development

- High foreign currency lending and excessive reliance on foreign savings have proven a source of vulnerability during the crisis
- Encouraging a shift towards local currency requires country-by-country approach with coordination
  - Macroeconomic stabilization
  - Regulation
  - Capital market development

Money markets lack depth and liquidity

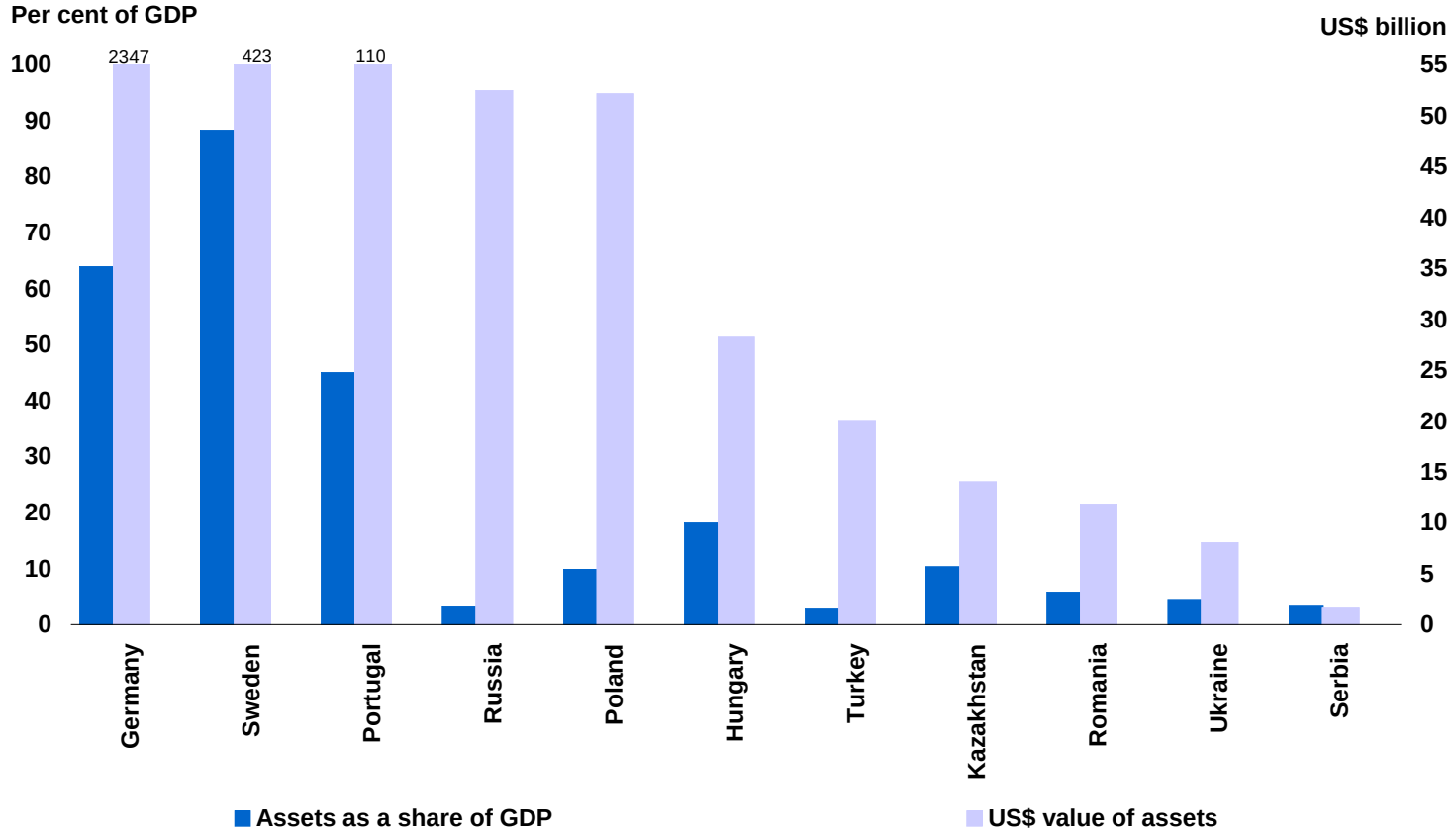
EBRD money market development index



Source: EBRD Transition Report 2010

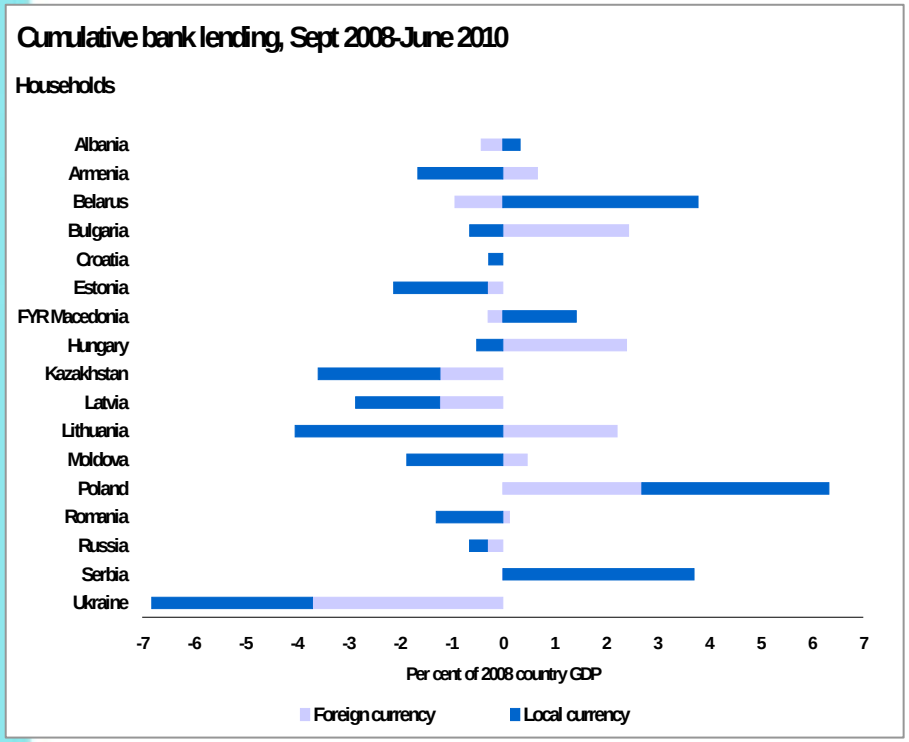
Institutional investor base still underdeveloped – but new threat to private pensions?

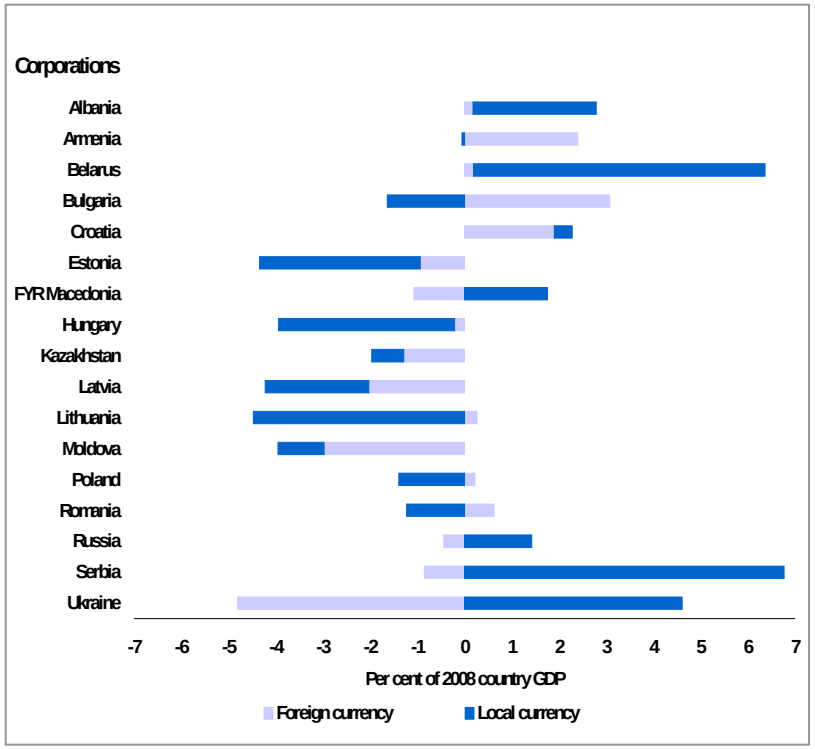
Assets of insurance corporations and pension funds



Source: EBRD Transition Report 2010

What happened to currency composition of lending during crisis?





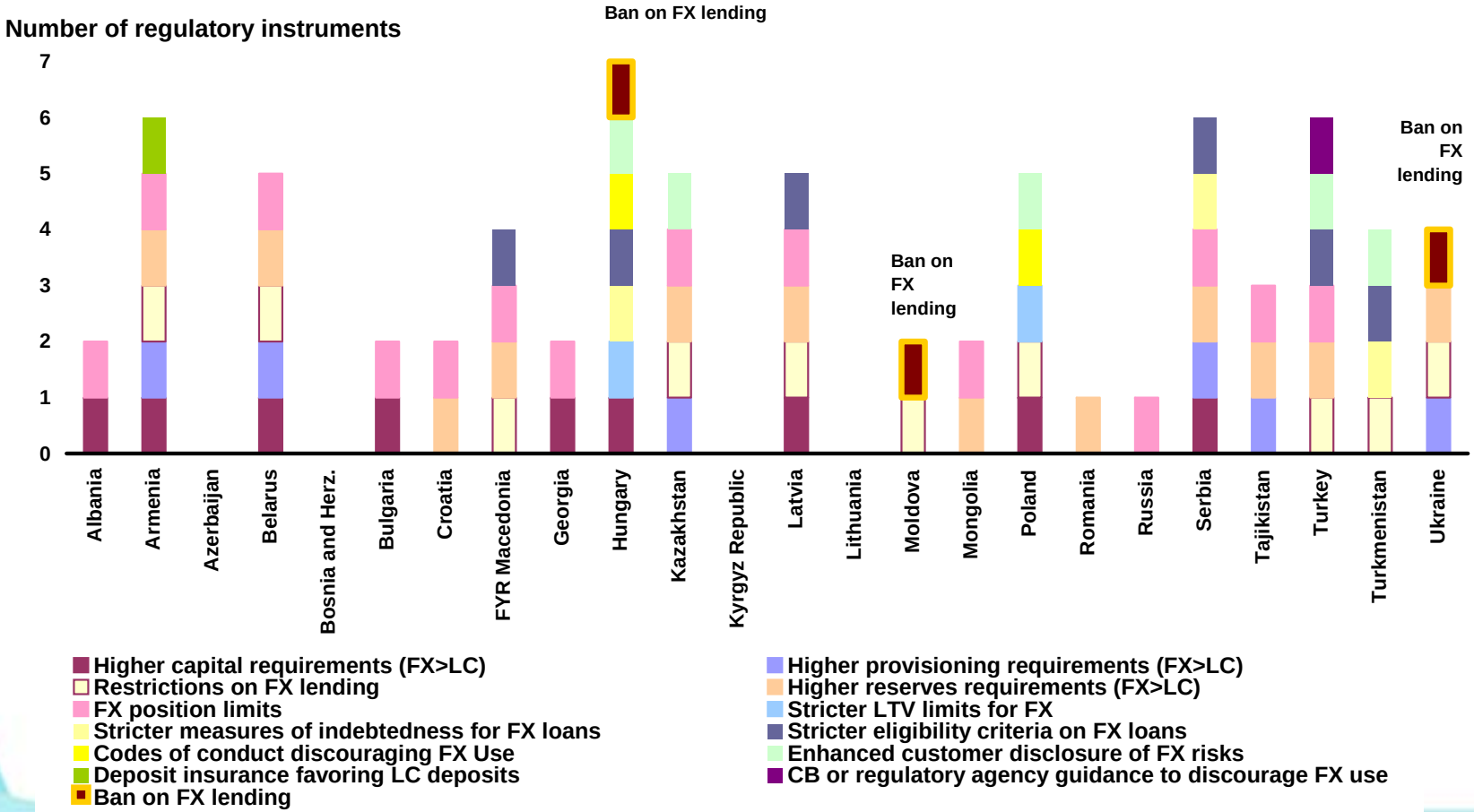
→ **Large LC credit flows to some countries reflect state-subsidised or state-directed lending**

Renewed regulatory attention

- Effort thus far failed at the EU level; ECB concerns
- Nation-based efforts mainly by host authorities but also home (Austria's lead)
- Host efforts
  - Higher reserve and capital requirements on FX loans
  - Quotas on FX lending
  - Macro-prudential and risk management instruments
    - Higher creditworthiness and disclosure requirements
    - Limits on the open foreign currency position of banks
  - Effective ban on foreign currency lending (Hungary (recently), Ukraine, Moldova)
- Need for coordinating host-home (Vienna Initiative umbrella)

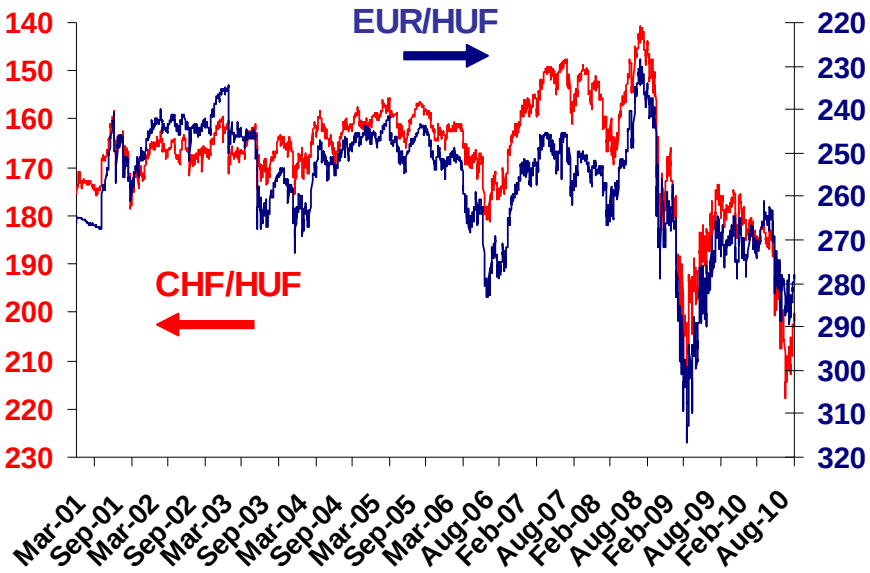
Discouraging foreign currency lending

Regulatory instruments to discourage foreign currency lending



FX stocks can still be a problem in some cases

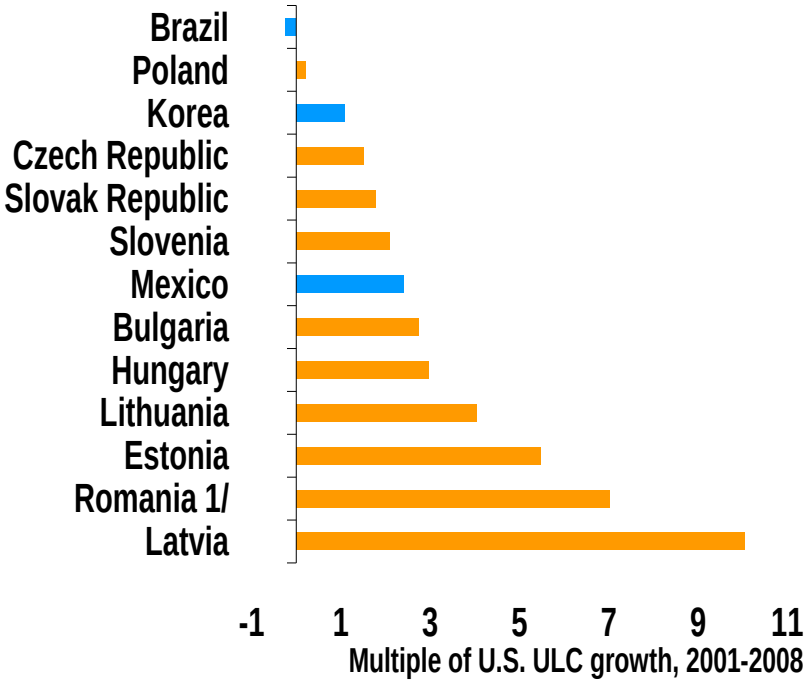
- Austria has managed
- Depends on size, currency, and maturity
  - Fx denominated household credit at about 20% of GDP in Hungary, but at 10-11% in Poland, Romania
  - Hungary: 82% of all Hh fx loans in CHF
- It can become a "political" problem → preventive solutions?



Sustaining trade integration and export growth

- Export growth has been rapid…
- …but based in part on one-off factors (new trade agreements, low initial unit labour cost, rapid global trade expansion)
- Sustaining export growth will require
  - improving competitiveness
  - overcoming/dismantling nontariff barriers
  - enhancing business climates

Growth in Unit Labour Cost 2001-2009



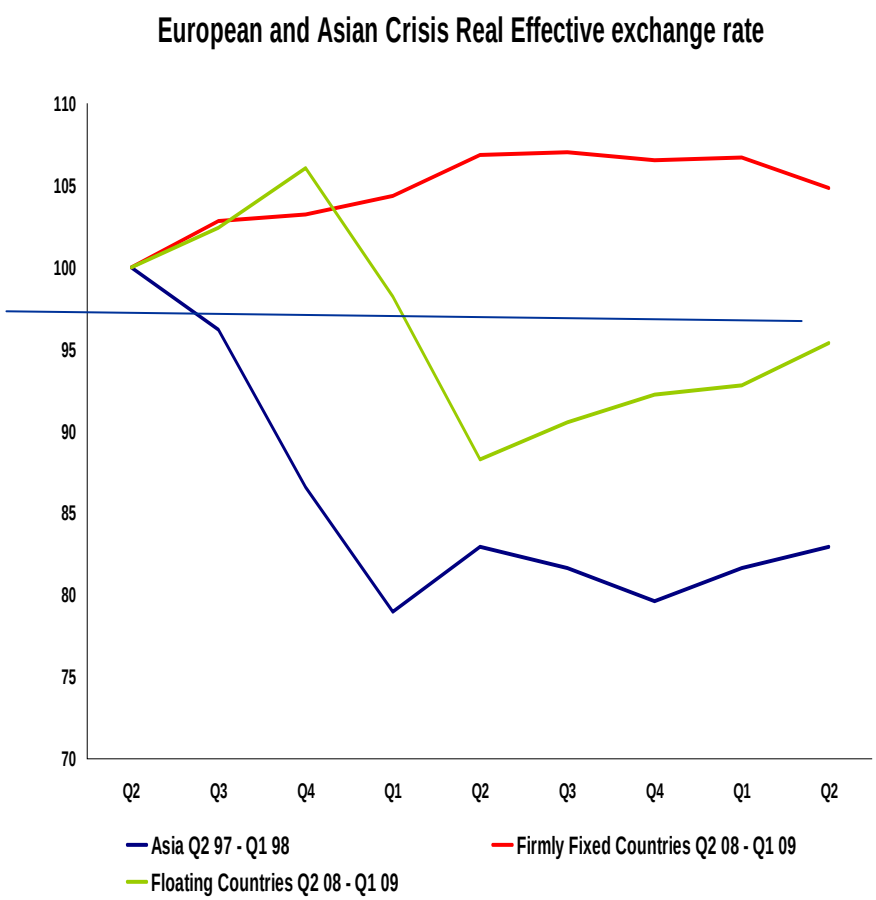
Sources: ILO (2006); IMF DOTS.

Capital is likely to return to the whole EE region

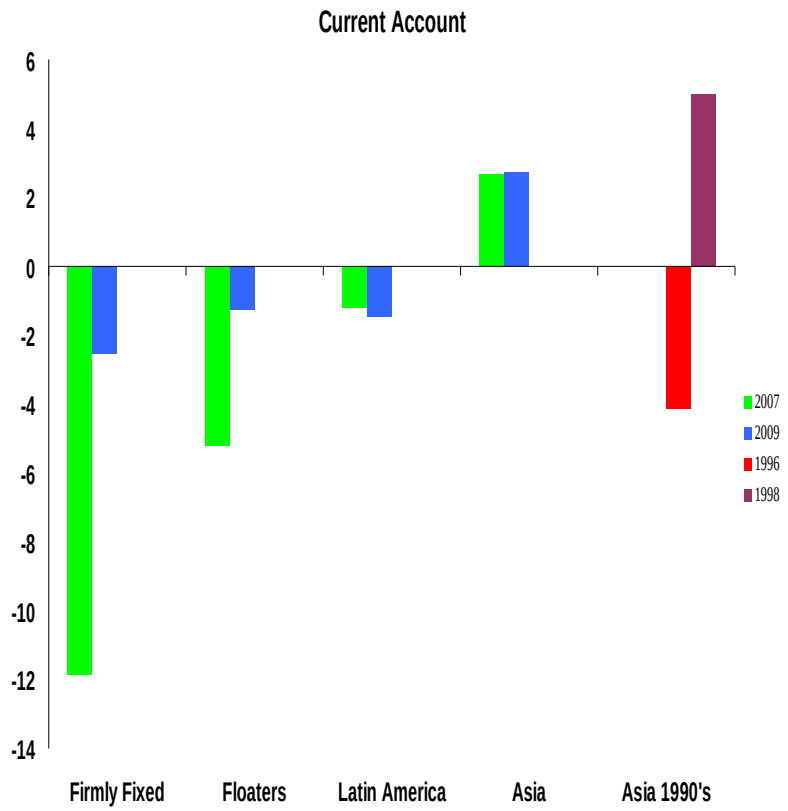
- **Sort term: possibly welcome**
  - Return of much needed capital can help recovery
  - Unlikely to be massive as the traditional channel through bank groups is impaired by weak balance sheets and still rising NPLs
  - Will help build reserves which are needed (intervention with sterilisation although with usual risks)
    - Little room for appreciation – this is not China or Brazil
    - Capital controls are difficult in the region (EU, candidates)
- **But an escalation into a "trade war" would be damaging even in the short term**
- **Longer-term: same issues as in other EMs**

Comparison with Asia 1997/8: massive competitiveness gains

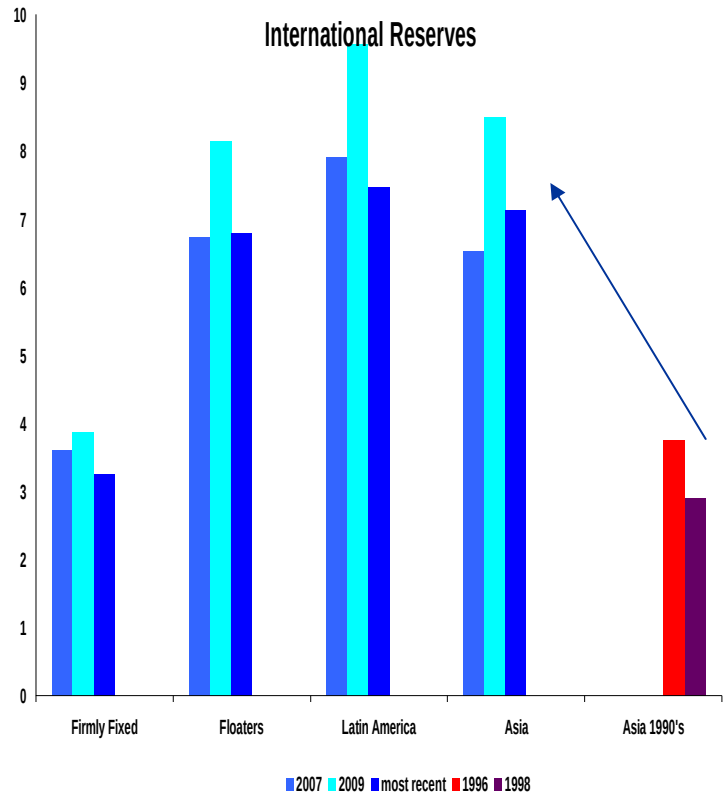
- Supported by a combination of policies
  - Closing and restructuring/cleanup of balance sheets of banks and corporates
  - Structural reforms: labour market, trade and current account liberalisation
  - Corporate governance
  - Dramatically improved banking regulations
- Deliberate 'self-insurance'



Self-Insurance



Note: Latin America includes Brazil, Colombia, Mexico. Asia includes Korea, Indonesia, Thailand.



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“New banking model”

- First clean up your balance sheet if needed
- Return to the “basics”:
  - Era of cheap liquidity to fuel boom should be over
  - more reliance on LCY deposits and lending in LCY
  - “know your customer”
- Participate in what is new : local capital market development (covered mortgage bonds etc) → look beyond banking
- Many countries are still under-monetised: lot of business opportunities - but within a stricter regulatory environment
- Regulatory uncertainties not over : cross border issues – deal with it: ESRB, Vienna Initiative Plus?

Conclusion:
Well Done - but No Complacency

- After successful crisis response need a successful recovery
- Thus far focus is on (limited) balance sheet clean-up, LCY markets and fiscal sustainability
- Not enough done to unleash the potential for more sustainable growth
- Reforms are also needed to build up buffers to enable countries for countercyclical policies for future shocks
- Continued significant business opportunities in the <u>financial</u> sector → look beyond banking
- Time is of the essence: reforms to be entrenched before growth can resume or capital inflows return

Thank you!

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