EBRD Transition Report 2010: Focus on Local Currency Finance in Emerging Europe

Compiled by
Mariya Hake

On January 24, 2011, the Oesterreichische Nationalbank (OeNB) hosted the presentation of the EBRD Transition Report in Vienna. At the press conference (which was chaired by Doris Ritzberger-Grünwald, Head of the OeNB's Foreign Research Division), Jeromin Zettelmeyer, the EBRD's Director of Research, summarized the January update of the EBRD's growth forecasts for emerging Europe and outlined the main findings of the "EBRD Transition Report 2010: Recovery and Reform."[1] In the second part of his presentation, Zettelmeyer focused on country-specific strategies for the development of local currency financial markets to counterbalance the instabilities caused by the widespread use of foreign currency loans in most emerging European countries.[2]

Part I: From Crisis to Recovery

Notwithstanding the slow recovery of credit growth and FDI inflows as well as austere fiscal consolidation policies in the region, export-led rebounds were well on track in 2010 in most countries under review. As of January 2011, growth in the EBRD region was projected to come to 4.2% on average in 2010 and 2011. Still, the process of recovery is expected to be heterogeneous across countries owing to differences in pre-crisis credit booms and in the degree of financial fragility. In 2011, the recovery of the economies of Central Europe and the Baltic countries is expected to be supported by the rebound in the euro area, with the highest growth projected for Estonia (+3.6%), Slovakia (+3.7%) and Poland (+3.9%). The countries in Southeastern Europe are forecast to still lag behind in 2011, with average GDP growth coming to 1.9% as of January 2011 due to austere fiscal consolidation measures that dampen domestic demand. The economies of Central Asia are expected to grow by 6.6% on average in 2011, those of the Eastern European and Caucasus region by 4%. However, growth prospects in the EBRD region are still overshadowed by (both external and domestic) macrofinancial downside risks, such as capital outflows from EU countries triggered by restrictive monetary policy, negative spillovers from the crisis in the euro area through both real and financial channels, and risky domestic policy actions in response to fiscal and social pressure.

Part II: Development of Local Currency Finance

In the second part of his presentation, Zettelmeyer elaborated on a country-specific review of the traditional growth model, which is based on trade and financial integration as well as on market-supporting government institutions. Despite the fact that this model proved to be a source of growth and prosperity over the past two decades, its weaknesses – incomplete reforms, unbalanced growth (mainly financed externally) but also financial fragility – became especially evident in the current crisis and need to be addressed. To achieve stronger and safer economic growth, policies should focus on improving the business environment (e.g. by strengthening innovation and human capital), but also on developing domestic

[1] *See www.ebrd.com/pages/research/publications/flagships/transition.shtml for the full report.*

[2] *The EBRD region covers 29 countries in Central and Eastern Europe and central Asia, including Turkey. Effective from 2008, the Czech Republic was the first country to graduate from the EBRD.*

capital markets and local currency finance. The latter reform area aims at counteracting the instabilities caused by the widespread use of foreign currency loans in the transition economies and would lower the dependence on foreign capital inflows. Moreover, the adequate policy response depends crucially on the country-specific causes for lending in foreign currency. These causes include a lack of macroeconomic stability (i.e. low credibility of monetary and fiscal policy affecting inflation and exchange rate volatility as well as interest differentials), a low level of financial development combined with abundant foreign funding, and the mispricing of foreign currency risk.

Accordingly, the EBRD Transition Report 2010 outlines three main strategies, depending on a country's status quo and the policymakers' preferences. First, countries with a lack of macroeconomic stability should improve the credibility and quality of monetary policy and ensure solid public finances. The EBRD does not recommend the implementation of aggressive regulations that would discourage foreign currency lending but the development of a functioning money market. Second, countries with a reasonable track record of stable inflation and floating exchange rates should implement macroeconomic and regulatory reforms and develop a local capital market. Moreover, policy efforts should also concentrate on the improvement of money and government bond markets. Finally, the third group of strategies considers countries with fixed exchange rate regimes (particularly aspiring euro area countries). The downside risk of foreign currency borrowing in these countries should be managed through a combination of regulatory measures and prudent macroeconomic policies to help them withstand an unanticipated shock to external financing.

In conclusion, Zettelmeyer pointed out that the national regulatory measures to support financial sector reforms in the transition countries, and in particular the development of local currency markets, are complemented by international initiatives such as the "Vienna Initiative" and the "Vienna Initiative Plus." Thus, the main challenge was to not impede these developments as external pressures subsided and fiscal policy issues came to the fore.