Spillovers of the Greek Crisis to Southeastern Europe: Manageable or a Cause for Concern?

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During the boom years in the run-up to the global financial and economic crisis, Greece established close economic ties with the Southeastern European (SEE) region. As a consequence, the current Greek sovereign debt crisis could potentially have adverse economic implications for SEE. Both real and financial transmission channels might have a bearing, though in most countries real economic linkages do not seem as strong as the degree of interconnectedness in the realms of banking and finance, where risks might materialize both directly and indirectly (i.e. via changes in expectations and risk perceptions). So far, the Greek crisis has only had a relatively limited impact on SEE. Available buffers and policy tools have helped SEE to cope with the related risks and also provide some more room for the region to address vulnerabilities caused by the Greek crisis that may materialize in the future. Possible challenges appear to be largest in the realm of banking, even though banking sector adjustment during the crisis has been fairly orderly so far. However, the recent intensification of the sovereign debt crisis in euro area countries may put the macrofinancial resilience of SEE countries to a much stiffer test, given its ramifications on external demand, potential negative feedback loops affecting European banks and a further rise in global risk aversion.

JEL classification: F36, G2, O52, P2
Keywords: Financial stability, banking sector, sovereign debt crisis

1 Introduction

Taking advantage of its geographical proximity, Greece rapidly developed close economic and financial ties with many Southeastern European (SEE)[2] economies in the years before the global financial and economic crisis. As Greece slid into a severe sovereign debt crisis,[3] this raised questions about possible spillovers to SEE, at a stage when the region had begun to recover from the crisis that had hit it in the fall of 2008.

Addressing these questions, this paper aims to capture and assess the impact of the Greek crisis on the SEE region. To this end, section 2 illustrates the potential channels for spillovers to SEE. Section 3 then examines the real economic ties between Greece and the SEE region, aiming to identify the relative importance of individual real transmission channels and gauging the size of the economic spillovers on individual SEE countries. Section 4 deals with banking and financial transmission channels. Section 5 concludes.

2 Potential Transmission Channels

What are the main transmission channels through which the Greek sovereign debt crisis may spill over to the SEE region? Chart 1 gives an overview of potential transmission channels, distinguishing between real and financial avenues of crisis

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[2] *The SEE region covers the EU Member States Bulgaria (BG) and Romania (RO), the EU candidate countries Croatia (HR), the former Yugoslav Republic of Macedonia (MK, FYR Macedonia) and Montenegro (ME), as well as the potential EU candidate countries Albania (AL), Bosnia and Herzegovina (BA), Serbia (RS) and Kosovo (XK).*

[3] *For recent accounts of the Greek crisis, see European Commission (2011), IMF (2011d), OECD (2011) and http://www.ecb.int/press/html/crisis.en.html.*

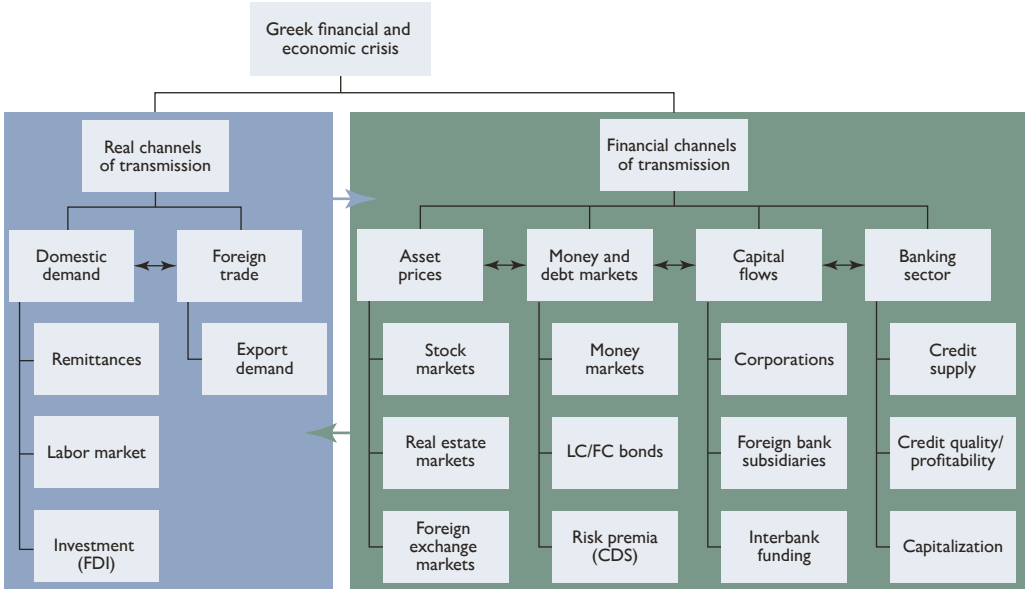
transmission. It is important to note that these channels can interact in various ways. Moreover, there can be feedback loops from affected SEE economies back to Greece, as well as contagion effects among SEE economies. This bears the potential for mutual reinforcement, so that the overall impact, in a dynamic perspective, may well become substantially larger than the initial impact through one or the other channel. Furthermore, all these channels, in particular the financial channels, can work both directly, i.e. through their immediate effects on real and financial variables, and indirectly, namely via their impact on expectations, confidence and risk aversion. Thus, direct spillovers can trigger a much wider impact through indirect knock-on effects set into motion through the change in perceptions generated by the original shock.

Let us look at these transmission channels in greater detail. To start with the real economy channels, adverse economic and labor market developments in Greece may hurt Greek demand for imports from SEE, but – via multiplier effects – also domestic demand in SEE. Second, investment activity may suffer not only due to the slowdown in FDI from Greece but also, more generally, as a result of worsening economic prospects in SEE.[4] Third, declining workers' remittances from Greece may negatively affect disposable income in SEE, thereby dampening private consumption (and investment in housing). Finally, if there were to be reverse migration from Greece to home countries in SEE, this would negatively impact on SEE labor markets.

Financial channels are multi-faceted, operating via falling asset prices, increasing risk premiums, adverse effects on capital flows as well as negative implications for

Chart 1

Potential Channels of Transmission of the Greek Crisis to SEE



Source: Authors' compilation.

Note: CDS = credit default swap; FC = foreign currency; LC = local currency.

[4] *For more details on this issue, see Cocozza et al. (2011).*

SEE banking sectors. More specifically, potential sales of SEE financial assets by Greek investors (which may trigger sales of financial assets by other foreign investors as well) or deteriorating foreign investor sentiment vis-à-vis SEE may lead to falling asset prices. This may in turn undermine economic activity in SEE. At the same time, a weakening of local currencies in countries with flexible exchange rate regimes (Romania, Albania, Serbia), even though it would temporarily increase export competitiveness, may pose a challenge for banks that have granted sizeable foreign currency-denominated or -indexed loans to unhedged borrowers.

An increase in foreign investors' risk aversion toward the SEE region would lead to higher risk premiums, which would raise financing costs or might even limit access to funding. This would result in a slowdown or sudden stop of capital inflows, which would in particular hit nonfinancial corporations and banks in countries with strong reliance on foreign funding. The public sector might experience financing difficulties, too, in particular where government financing (via international or domestic bond markets) is heavily dependent on foreign investor participation. Finally, there could be a deleveraging by Greek banks in SEE or possibly even a (partial) withdrawal of Greek banks from the region. This could potentially have a negative effect on credit supply and thus economic activity in SEE, which in turn could have repercussions on credit quality, profitability and bank capitalization in the region.

3 SEE's Real Economic Linkages with Greece

In order to gauge the relative importance of individual transmission channels, one needs to take stock of the degree of economic and financial interconnectedness

Chart 2

Exports of Goods by Destination

Source: National central banks, national statistical offices, OeNB.

[1] *EU Member States in Central, Eastern and Southeastern Europe.*
[2] *EU candidate and potential EU candidate countries: HR, IS (Iceland), MK, ME, TR (Turkey) and AL, BA, RS, XK.*

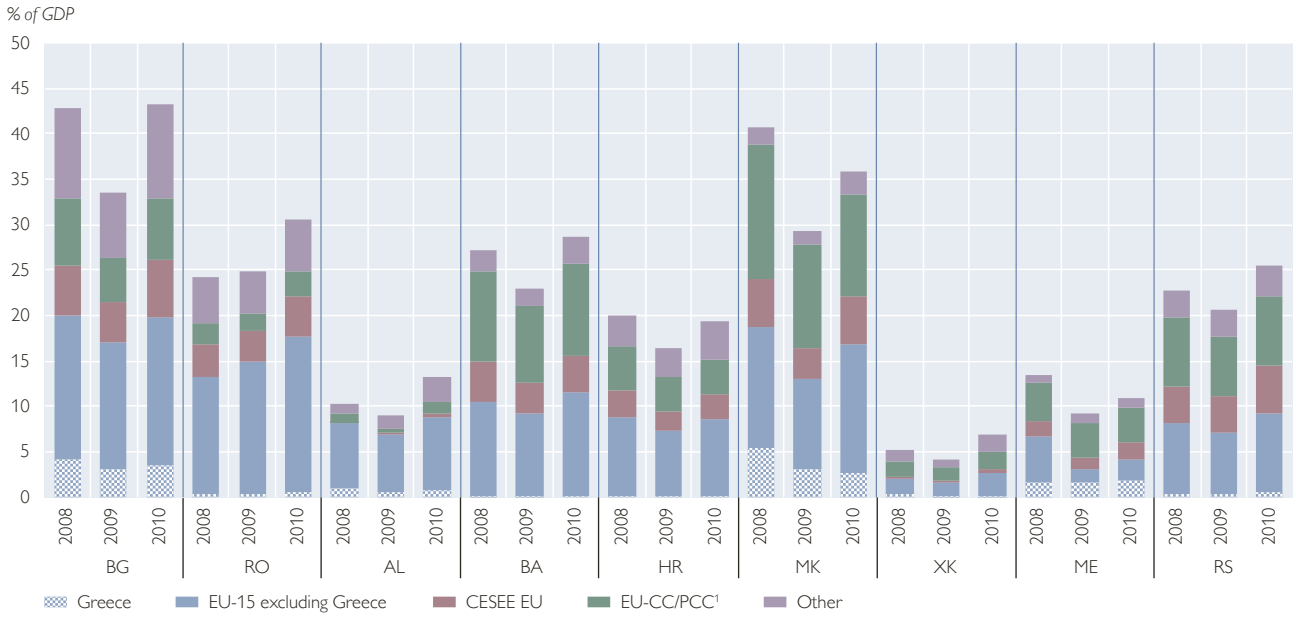
between Greece and the SEE region. With regard to real economic ties, let us first consider foreign trade linkages, focusing in particular on the export channel. Data show that Greece is a major export market for Montenegro (see chart 2). There are also rather important trade linkages with Bulgaria and the former Yugoslav Republic of Macedonia (FYR Macedonia), and to a somewhat lesser extent with Albania. From 2009 to the first half of 2011, the share of exports to Greece decreased in most SEE countries, as the latter benefited from strong export demand from other major trading partners which were experiencing a fairly dynamic recovery from the 2009 recession.

However, export shares need to be seen in the context of trade openness. Given the relatively low export bases of most SEE economies, the share of exports to Greece relative to GDP is fairly small in all SEE countries (see chart 3). Thus, a possible further decline in exports to Greece would in itself not be expected to hurt SEE countries substantially. Moreover, SEE countries' exports to Greece predominantly consist of resource-based and low-tech goods, the demand for which is likely to be affected less by the economic turmoil in Greece than demand for medium- or high-tech products. Furthermore, in the case of Bulgaria there is evidence that a large part of goods exports to Greece are destined for re-export via Greek harbors, which means that these exports are not directly affected by the economic crisis in Greece.[5]

Evidence on recent export activity directed toward Greece is mixed. Following the slump in 2009, the growth rate of exports to Greece picked up gradually during 2010 and the first half of 2011 in most SEE countries. However, exports to

Chart 3

Exports of Goods by Destination



Source: National central banks, national statistical offices, OeNB.

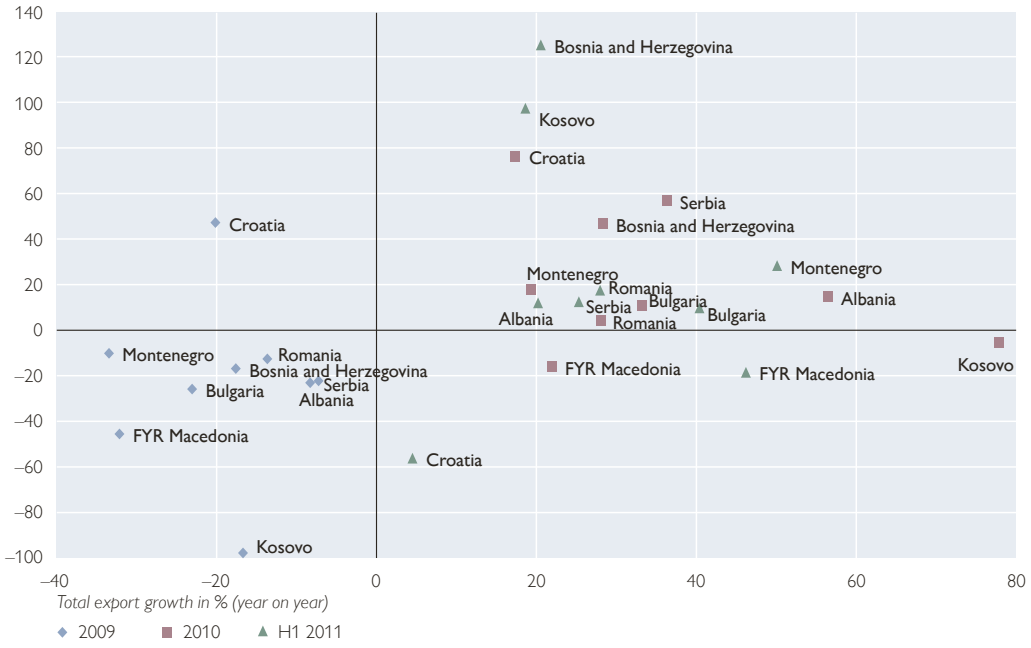
[1] EU candidate and potential EU candidate countries: HR, IS (Iceland), MK, ME, TR (Turkey) and AL, BA, RS, XK.

[5] *We are grateful to Director Mariella Nenova (Bulgarian National Bank) for this information, which is based on internal work at the Bulgarian National Bank.*

Chart 4

Export Developments

Growth of exports to Greece in % (year on year)

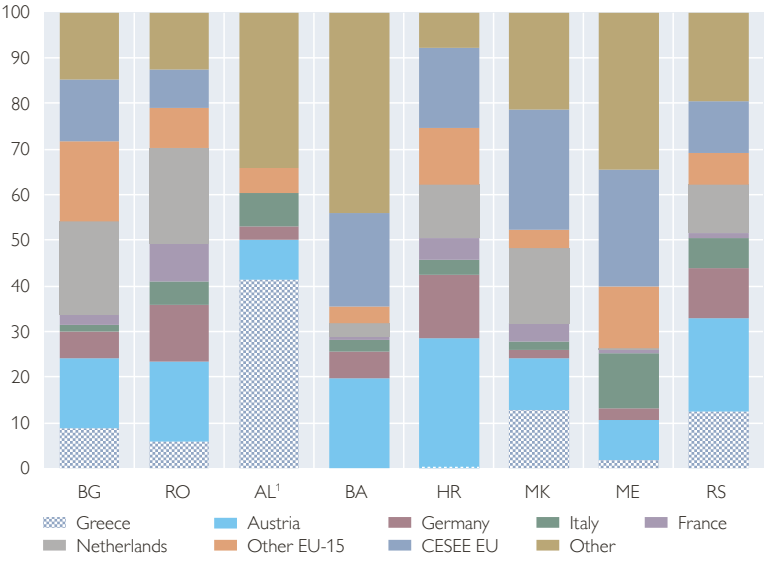


Source: National statistical offices.

Chart 5

Inward FDI Stock by Country of Origin

% of total, 2010



Source: wiiw, OeNB.

[1] *Data for 2008.*

Greece tended to grow less strongly than overall export volumes, so that the share of exports to Greece in total exports has decreased in most countries (see chart 4). In Albania, Croatia and Serbia exports rebounded in 2010, but seem to have lost momentum again in the first half of 2011. Only in FYR Macedonia did exports to Greece contract during the whole observation period.

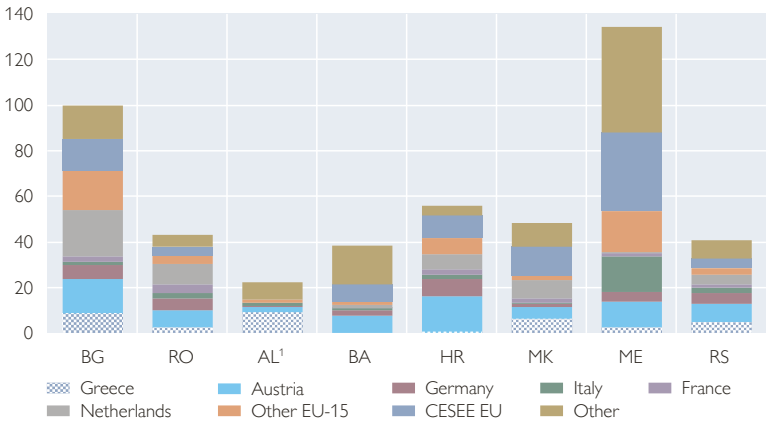
FDI flows to the SEE region first gained momentum in Bulgaria and Romania, which both entered the EU in 2007. In most other SEE countries, this did not happen until the last few years before the crisis, when economic and political reforms started and long-term EU accession prospects materialized for the region. Tax policies may also have affected FDI decisions. Besides Austria and the Netherlands,[6] Greece became

[6] *In the case of the Netherlands, a large part of FDI stems from holding companies based in the Netherlands.*

Chart 6

Inward FDI Stock by Country of Origin

% of GDP, 2010



Source: wiiw, OeNB.

[1] Data for 2008.

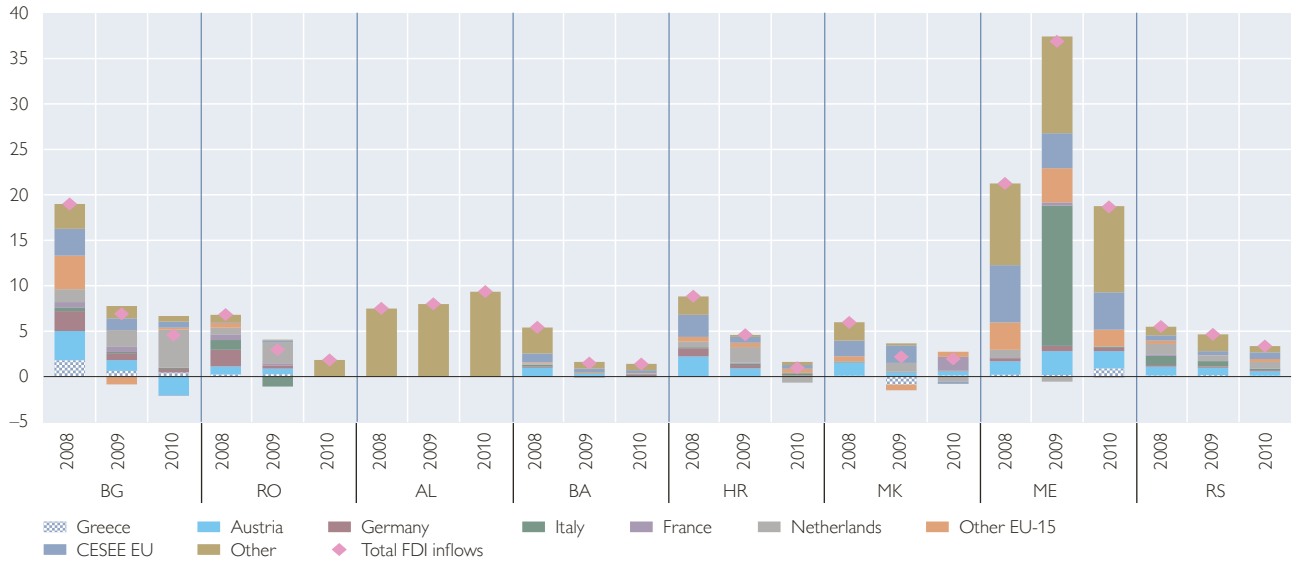
one of the most important foreign investors in the SEE region, however with considerable variation across countries (see chart 5). Greek FDI in SEE was particularly strong in the banking and finance sector and in the telecommunication segment. In terms of GDP, the highest share of Greek FDI stock is observed in Albania, followed by Bulgaria and FYR Macedonia (see chart 6).

Inward FDI flows to most SEE countries have decreased considerably during the global financial crisis, but remained positive in net terms in all countries over the review period. Similarly, Greek FDI kept flowing to the SEE region in 2009 and 2010, but in line with overall FDI inflow dynamics often on a reduced scale (see chart 7). A substantial withdrawal of Greek investment occurred only in FYR Macedonia in 2009 (see chart 8), as Greece's leading telecommunications company had to sell its mobile and retail operations in FYR Macedonia (not due to the crisis, however, but because of a decision by the local competition authorities). Preliminary data for the first half of 2011 show that total FDI inflows to the majority of SEE countries slowed further, while FDI from Greece came to a halt in some countries or even turned negative (e.g. in the case

Chart 7

Inward FDI Flows by Country of Origin

% of GDP

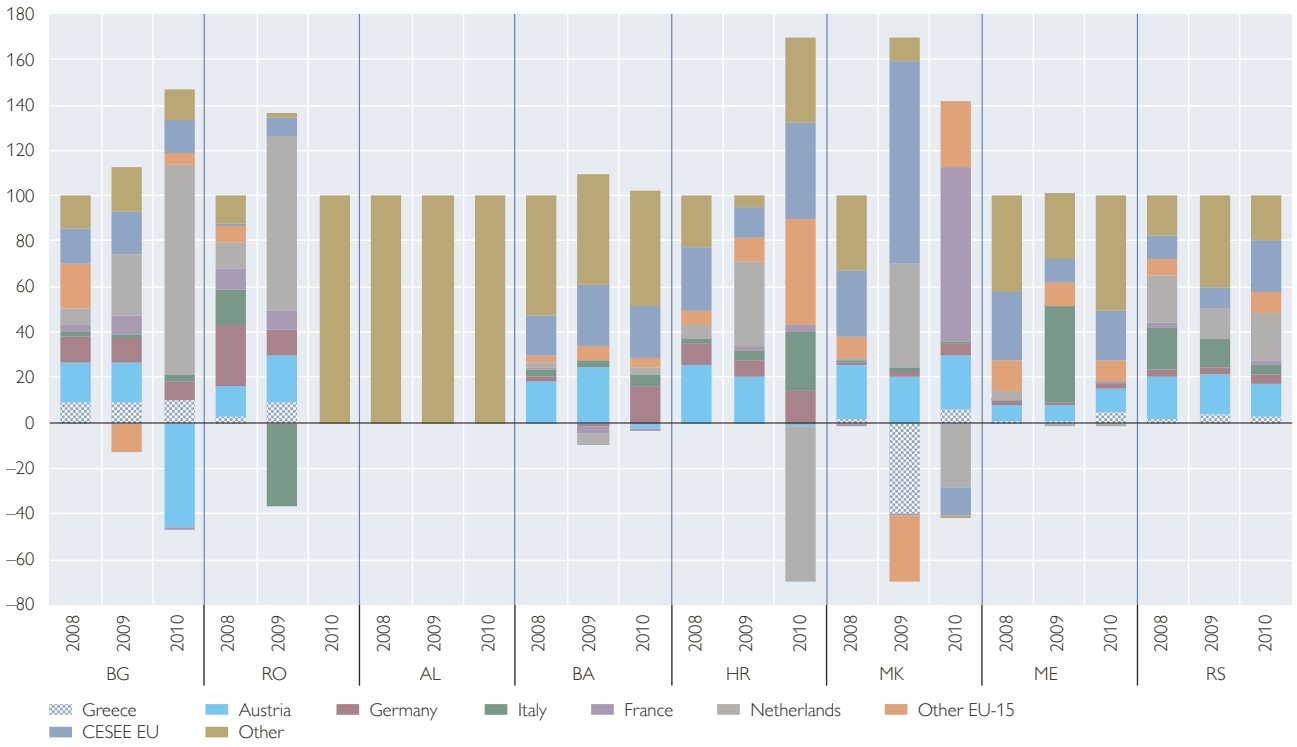


Source: wiiw, Eurostat, OeNB.

Chart 8

Inward FDI Flows by Country of Origin

% of total FDI inflows



Source: wiw, Eurostat, OeNB.

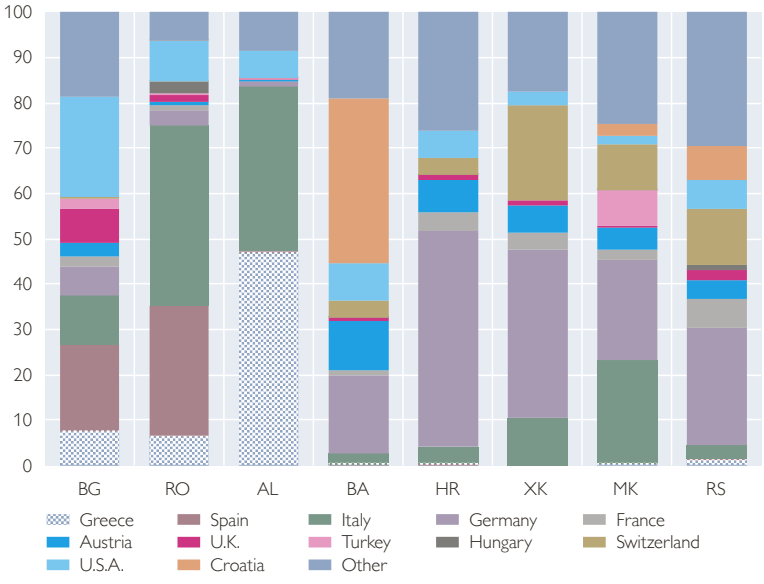
of Bulgaria). This contrasts with developments seen in the trade sector.

A number of countries in the SEE region are highly dependent on transfers from abroad, not only from a financing but also from a spending point of view. While official transfers play a more prominent role only in a few countries, private transfers, consisting predominantly of remittances, represent an important source of income. Due to data gaps, it is hard to quantify the impact of reduced remittances from Greece to SEE, even more so as remittances are only partially transferred through official channels. However, available Eurostat data on Bulgaria and Romania suggest that only a small fraction of total (official) remittances originate from Greece (see chart 9), and this share is negligible in GDP

Chart 9

Workers' Remittances by Country of Origin

% of total, 2009

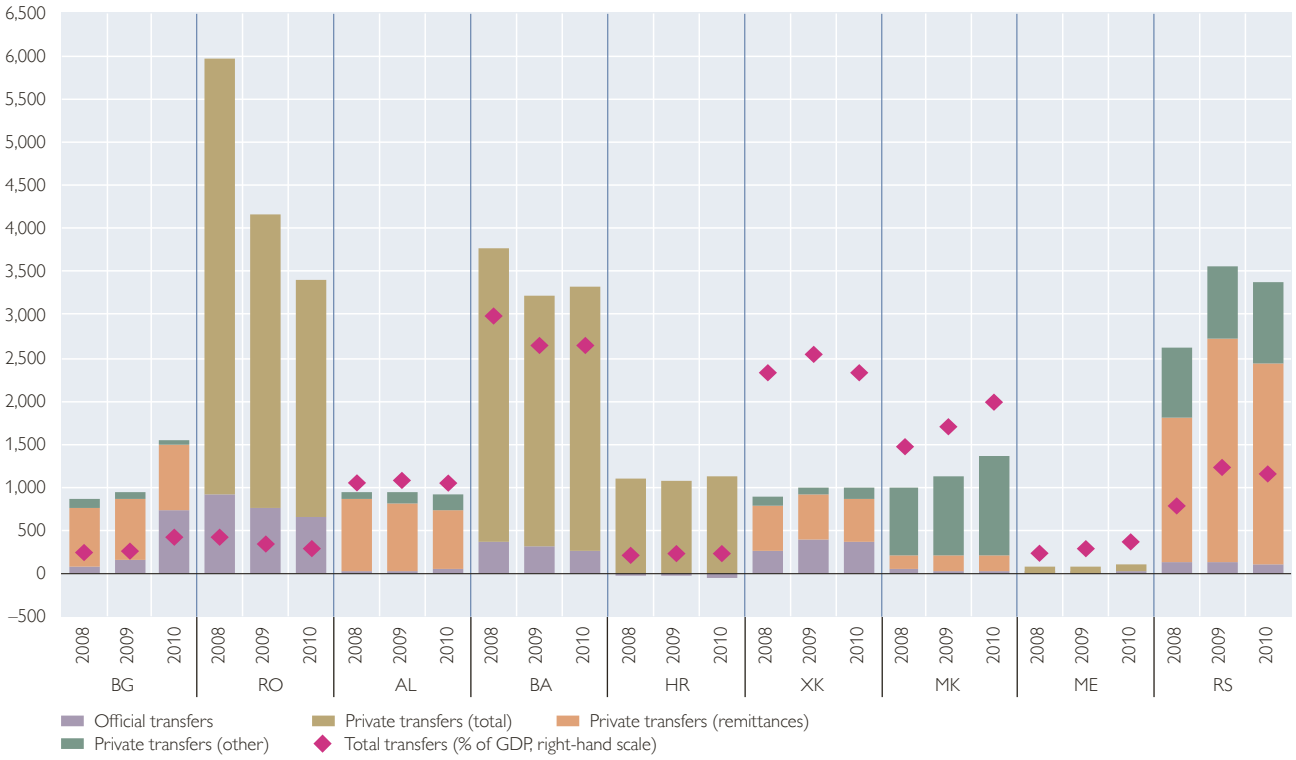


Source: BG, RO: Eurostat; XK: Central Bank of the Republic of Kosovo; RS: Narodna banka Srbije; AL, HR, MK, BA: World Bank.

Chart 10

Current Transfers

EUR million

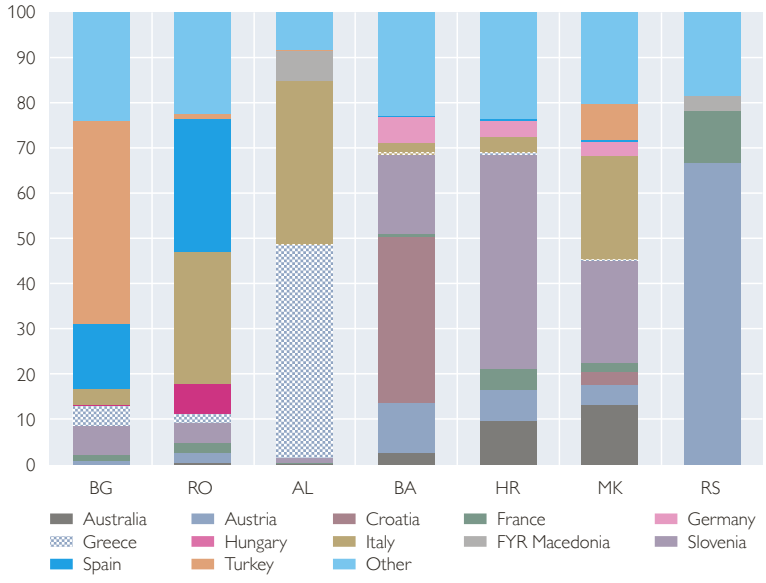


Source: National central banks, OeNB.

Chart 11

Migrant Stocks by Country of Destination

% of migrants, 2010



Source: World Bank.

terms. Only in the case of Albania, remittances from Greece are economically significant, corresponding to some 4% of Albanian GDP (see chart 9).

Despite adverse labor market conditions in the EU, where most of the workers' remittances to SEE countries originate from, private transfers (including workers' remittances) to the SEE region have proved remarkably robust in all countries during the global crisis (see chart 10).

The remittance channel is also related to possible contagion via the labor market, in particular if lower remittance inflows are a result of reverse migration. As chart 11 shows, the potential for reverse migration from Greece is marginal for most SEE countries. Only Albania constitutes an exception, with about 675,000 Albanian

migrants in Greece, accounting for approximately half of the total number of Albanian migrants.

Disaggregated country-by-country data on inward/outward migration to/from Greece is not available. Thus, there is no hard and fast evidence on how migration flows to and from Greece have developed during the crisis.

4 SEE's Banking and Financial Ties with Greece[7]

4.1 Direct Linkages

As regards *direct banking linkages,* alongside Austrian banks, Greek banks are among the most active in the SEE region, holding notable market shares in a number of SEE countries (see chart 12). Depending on the depth of banking intermediation, Greek banks' market positions (in terms of total banking sector assets) vary considerably across the region, from 11% of GDP in Romania to 30% in Bulgaria, but can be considered as substantial in all countries in which Greek banks are present, i.e. in all countries but Bosnia and Herzegovina, Croatia, Kosovo and Montenegro.

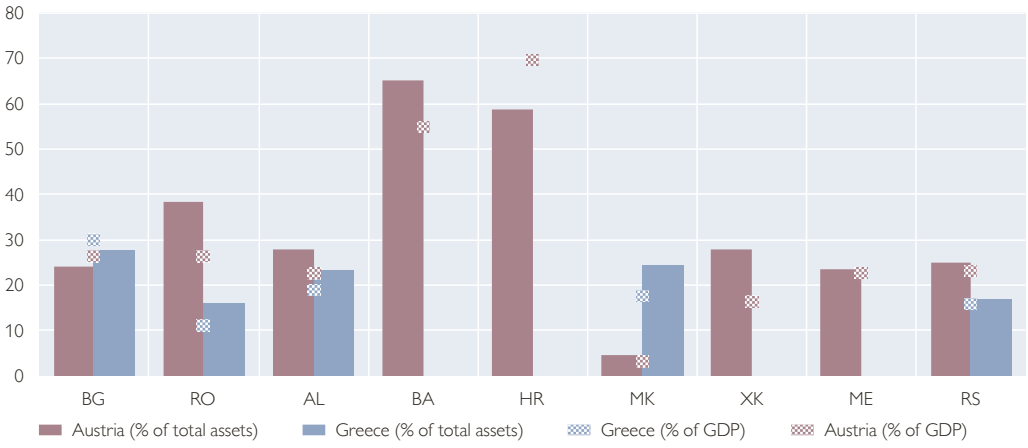
The depth of SEE countries' direct financial interconnectedness with Greece is also reflected by the structure of consolidated foreign claims of BIS reporting banks vis-à-vis individual SEE economies. As at year-end 2010, Greece was FYR Macedonia's largest creditor and also a major creditor of Bulgaria, Albania and Serbia (see chart 13). The economic importance of these Greek claims relative to GDP was most pronounced in Bulgaria, FYR Macedonia and Serbia; they also corresponded to a sizeable share of GDP in Albania and Romania (see chart 14).

In most SEE countries, Greek exposure levels decreased gradually during 2010 and/or the first half of 2011 (see also IMF, 2011a). This reduction in exposures

Chart 12

Market Shares of Austrian and Greek Banks in SEE

% of total banking sector assets and % of GDP, 2010



Source: National central banks.

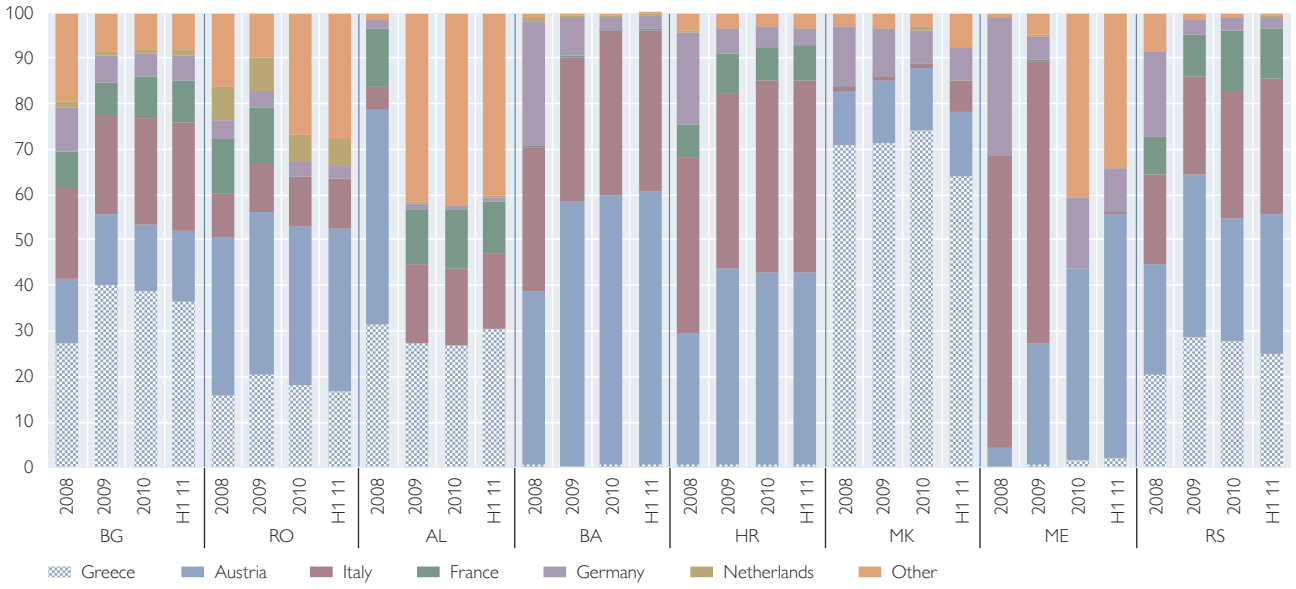
Note: Austrian banks include Bank Austria, which is a member of Italy's UniCredit Group.

[7] *This section focuses on the most important linkages and transmission channels in the financial realm. Due to space limitations, we do not explicitly cover those aspects that appear less relevant in a comprehensive stocktaking of all data available.*

Chart 13

Consolidated Foreign Claims of BIS Reporting Banks by Country

% of total foreign claims of BIS reporting banks, ultimate-risk basis



Source: BIS, OeNB.

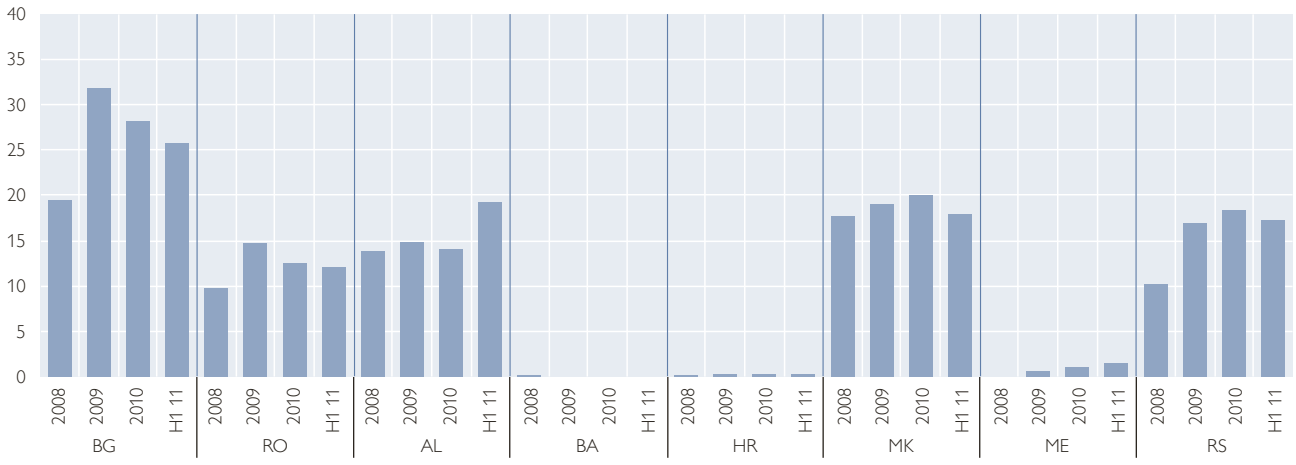
came after a marked increase in 2009, with the result that, in the majority of cases, as at mid-2011 Greek exposure levels were still above their end-2008 levels in both absolute and relative terms (more often than not by a large margin).

The stocktaking exercise above raises the question: How vulnerable is SEE to spillovers via the banking sector, given the fairly deep banking linkages between Greece and SEE and the rather strong presence of Greek banks in a number of

Chart 14

Consolidated Foreign Claims of Greek Banks

Amounts outstanding, in % of recipient country's GDP, ultimate-risk basis



Source: BIS, OeNB.

countries of the region? To assess this issue in greater depth, it is useful to set out some further facts:

First, given that (risk-adjusted) margins in SEE are higher than in Greece, Greek banks will want to stay in the SEE region, if and as long as their capital and funding situation allows them to maintain their operations there. Thus, while a retreat from the region is certainly a possibility, it would typically not seem to be a first-hand option as long as Greek banks have other measures at their disposal to cope with distress at the group level.

Second, Greek subsidiaries in SEE remained well-capitalized during the crisis years of 2009 and 2010. According to end-2010 figures (not shown here due to space limitations), their capital adequacy ratios remained at levels similar to those of other banks in the region, some of them even exceeding the sectoral average. But even in cases where Greek subsidiaries' capitalization was below the sectoral average at end-2010, they comfortably met the regulatory requirements in all countries they were present in.

Third, Greek subsidiaries' (but also other domestic and foreign players') holdings of Greek sovereign debt are very limited, so that any related valuation losses would be negligible. This is because Greek sovereign debt cannot be used as collateral in repo transactions with national central banks in SEE.

Fourth, as regards their funding structure, most Greek subsidiaries financed themselves by a combination of domestic deposits and credit lines from parent banks in 2009 and 2010, and were thus less dependent on foreign wholesale funding. In some cases, Greek subsidiaries were in fact largely funded domestically. Some Greek subsidiaries have apparently experienced liquidity pressures since 2010, partly as a result of deposit shifts from Greek subsidiaries to other banks in the region, and in a few cases also because of reduced credit lines by parent banks. Greek subsidiaries have frequently reacted by raising deposit interest rates in order to keep up domestic funding and, possibly, to substitute domestic for foreign funding. Moreover, some of them have tended to reduce asset growth by restraining lending activities and deleveraging non-core assets (albeit not in all countries). All this has led to falling loan-to-deposit ratios, a development which, however, is largely in line with general banking sector developments in most SEE countries. This downsizing process has been rather smooth so far, with no major credit supply bottlenecks.

In fact, as Greek (parent) banks scale down their operations in some countries, other foreign banks fill in the gaps left behind, thereby offsetting a fall in (domestic and cross-border) credit supply. As long as this is the case, the impact on individual economies' overall financing situations should not be overly grave. Also, international organizations (e.g. the EBRD) stand ready to help ease Greek banks' possible financing needs if necessary, as was the case in late 2010, when the EBRD granted long-term credit lines to selected local subsidiaries of several Greek banks in Albania, Bulgaria, Romania and Serbia.

Much greater problems would be caused by a situation in which neither international institutions nor foreign banks are willing to step in for Greek banks' activities (for whatever reasons, e.g. heightened risk aversion, own financing problems, etc.). Under such a scenario, governments would need to act, which would most likely entail an additional fiscal burden. However, so far there has been no need for such government intervention.

Fifth, low loan-to-deposit ratios provide for the possibility to channel domestic savings abroad to support parent institutions. However, the need for more substantial liquidity (or capital) transfers by subsidiaries to parent institutions is expected to be limited as parent banks facing liquidity pressures have access to liquidity facilities in their home markets, such as liquidity from the ECB, national central banks and/or any other available national government support scheme. In addition, more substantial liquidity transfers from subsidiaries to parent banks would most likely also call SEE central banks into action, should the violation of regulatory (liquidity and capital) requirements imposed by SEE central banks be imminent (see IMF, 2011c). But even if there were to be larger transfers, they would still be small relative to the official exchange rate reserves of SEE countries, unless such flows were part of a broader shock to the banking system in Europe and/or to risk perceptions regarding SEE countries.

Sixth, if Greek parent banks were to experience persistent strains, they might eventually be forced to sell subsidiaries in SEE to redress capital and liquidity positions. In such an event, it would be crucial that the sale proceeds in an orderly way (as e.g. in the case of a Greek subsidiary in Poland that was sold in 2011). Otherwise, the fallout on the real economy of the respective SEE country could be substantial. Moreover, such a shock could be transmitted to other SEE countries in which the relevant parent bank has subsidiaries via the common creditor channel. Therefore, the health of parent banks is a key determinant of the size of potential spillovers (see European Central Bank, 2010) and depends to a large part on whether Greece will stabilize and ensure adequate capitalization of parent banks.

In this context, it is noteworthy that two of the Greek banks with subsidiaries in SEE were among the eight European banks which did not pass the European Banking Authority's (EBA) stress test of July 2011 (they took corrective measures after the cut-off date for the stress test, however[8]). As revealed by the recent EBA exercise on the capitalization of banks conducted in late 2011, Greek banks (no single-bank data available) have a total recapitalization need of some EUR 30 billion, the financing of which is to come both from the private and public sectors (in the latter case fully funded by the EU-IMF program). In fact, the need for parent bank recapitalization may induce the sale of foreign subsidiaries. One of the two Greek banks mentioned above has announced that it is reviewing its positioning in Turkey (but not in SEE), while the second bank is now offering its Romanian unit for sale.

Finally, it is worth recalling that during the crisis period following the collapse of Lehman Brothers, the risk of substantial exposure reductions by foreign banks in SEE was also mitigated by the European Bank Coordination Initiative (also known as the "Vienna Initiative"), through which foreign parent banks committed themselves to keep their exposures at pre-crisis levels and to see to adequate capitalization of their subsidiaries (see EBRD, 2011a, and Federal Ministry of Finance, 2010). In SEE, such formal arrangements have only been concluded for Bosnia and Herzegovina, Romania and Serbia as part of stabilization programs with the IMF, but presumably other SEE countries have also benefited from them

[8] *Compensating measures (such as sales or mergers of subsidiaries, issuance of convertible bonds, etc.) and accumulated generic provisions to cover future losses were implemented after the cut-off date of April 30, 2011. According to the Bank of Greece, both banks would have passed the test had these measures already been taken by the April 2011 cut-off date. Furthermore, one of these two banks (the Agricultural Bank of Greece) has only minimal presence outside Greece.*

via indirect positive spillover effects. In case of renewed global financial market tensions, an arrangement along the lines of the Vienna Initiative could again be used to avoid an uncoordinated large-scale outflow of foreign (including Greek) capital and liquidity from the region in the future. However, this will presumably require that the countries concerned have stabilization programs with the IMF in place, as was the case in 2009 and 2010. Moreover, it could be more difficult to obtain commitments by parent banks in the present context, as they strive to achieve the new capital standards the European Banking Authority has prescribed for mid-2012.

Despite these arguments, it is also clear that a more comprehensive shock to the European banking system – which entered the financial crisis with a comparatively high degree of leverage and is currently grappling with the implications of the sovereign debt crisis – would pose a much more complex challenge for SEE countries than the vulnerabilities that could possibly originate from distressed Greek parent banks. A broader shock would certainly make it more difficult to replace financial services previously provided by Greek subsidiaries with services offered by other foreign-owned banks in the region. Such a shock would have adverse implications for external funding and for domestic credit supply and it could also affect the expectations, in particular risk perceptions, of financial markets vis-à-vis the countries of the SEE region.

4.2 Indirect Linkages

Looking at *indirect financial transmission channels,* foreign investors' general risk perceptions with respect to SEE countries were not shaken as the Greek crisis unfolded. More recently, since late summer 2011, risk aversion has risen globally and the SEE region has not been spared from this development. However, there are no indications that recent currency and spread movements in SEE have been characterized by a distinct idiosyncratic element that could be traced back to the Greek crisis or increased direct spillovers from Greece to SEE. Quite the contrary, the recent financial market tensions seem to have affected SEE countries with negligible real economic and financial ties with Greece more substantially. This suggests that alongside rising global uncertainty, country-specific factors (mainly related to public finances) have been important in shaping financial market developments in SEE. The charts below (15 to 19) provide a concise overview of important financial market segments so as to corroborate these stylized facts.

To provide further details: Exchange rate developments in SEE (chart 15) show no major impact of the Greek crisis so far. Countries with fixed or quasi-fixed exchange rate regimes maintained their pegs in the review period despite some temporary pressures in a few cases. Currencies in countries with flexible exchange rate regimes (Albania, Romania and Serbia) became somewhat more volatile but there were no sharp changes in valuation, and developments were mostly driven by country-specific factors such as the monetary policy cycle.

Stock markets in the region (chart 16) remained fairly stable over most of the review period. Though increased downward pressures emerged in particular after August 2011, the related losses still seem fairly contained as compared to those of the Greek stock market. However, it should be noted that stock markets are rather small in some SEE countries, with only a limited number of listings. This calls for added caution in interpreting developments in this market segment.

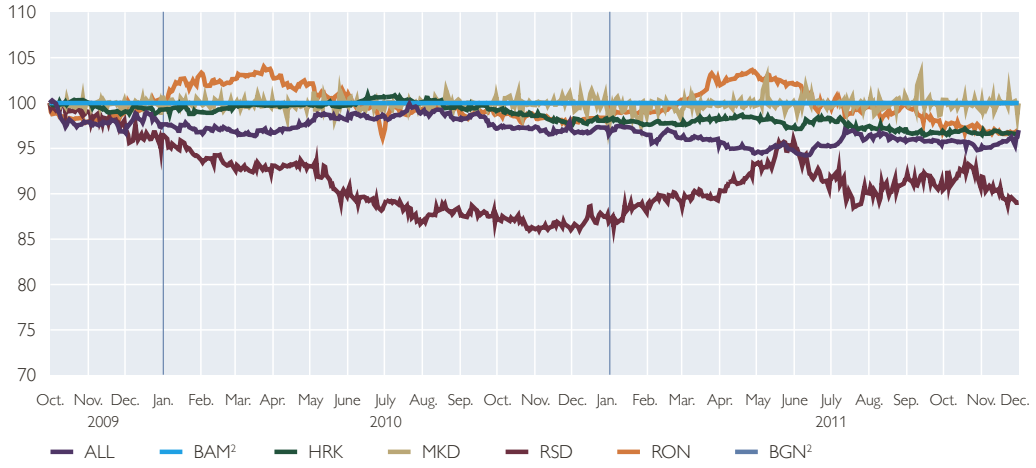
Sovereign risk premiums, as measured by five-year sovereign CDS premiums (charts 17 and 18), trended upward in SEE, in particular in the second quarter of

2010, when Greece was downgraded to below investment grade by two major rating agencies; nevertheless, the increase in risk premiums was by far not as pronounced as for Greece. Then, risk premiums in SEE fell again until mid-2011, thereby further uncoupling from developments seen in Greece. However, from August 2011 risk premiums also started to pick up again in SEE, although they remained well below the peaks observed in the aftermath of the collapse of Lehman

Chart 15

Exchange Rate Developments vis-à-vis the Euro[1]

September 30, 2009 = 100



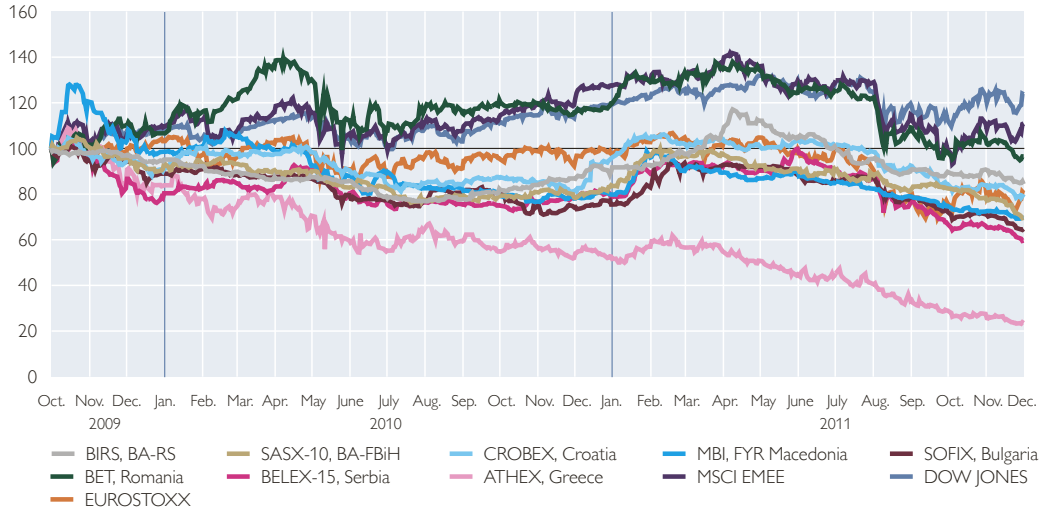
Source: Eurostat, OeNB.

[1] An increase in value represents a nominal appreciation.
[2] Bosnia and Herzegovina and Bulgaria operate under a currency board arrangement.

Chart 16

Development of Selected Stock Market Indices

September 30, 2009 = 100



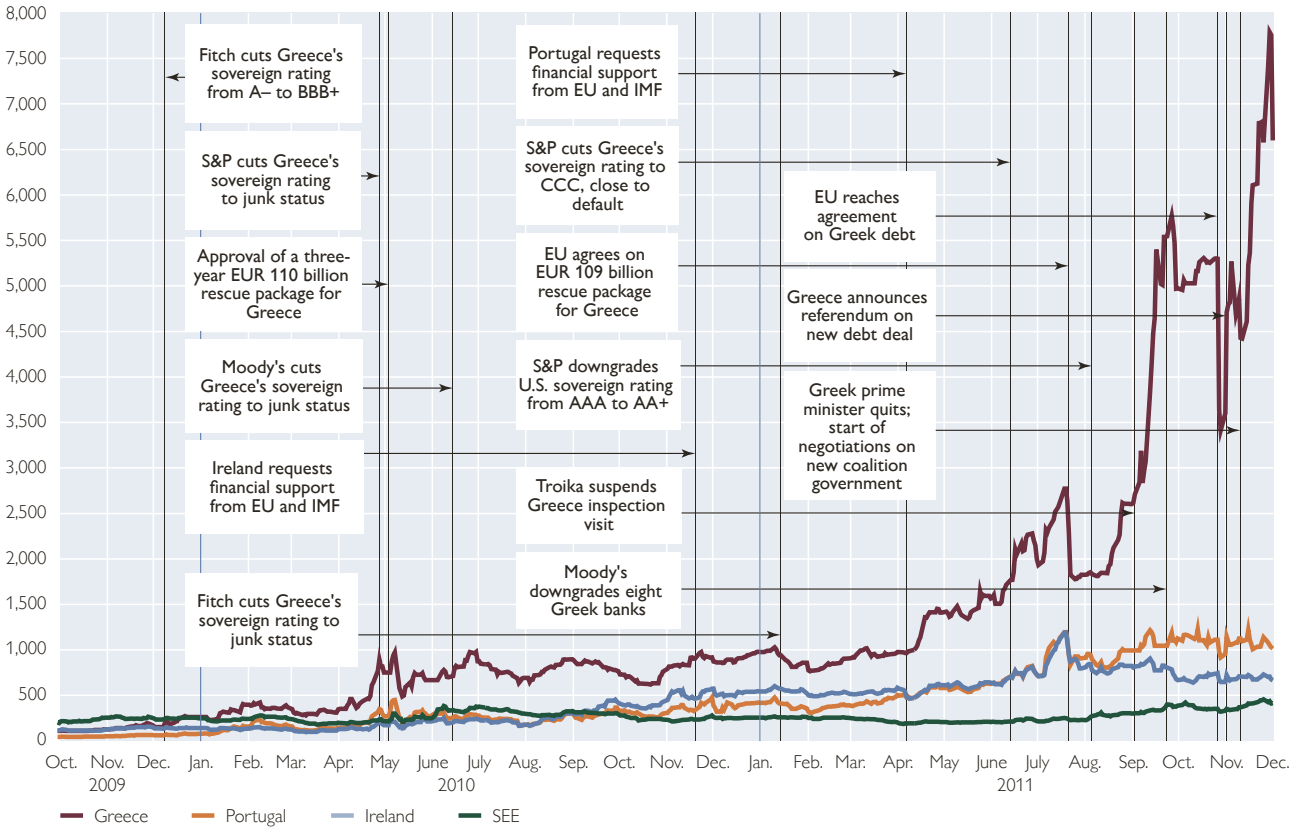
Source: Bloomberg, OeNB.

Note: BA-RS = Bosnia and Herzegovina – Republika Srpska ; BA-FBiH = Bosnia and Herzegovina – Federation of Bosnia and Herzegovina; EMEE = Emerging Markets Eastern Europe.

Chart 17

Sovereign Five-Year CDS Premiums

Basis points

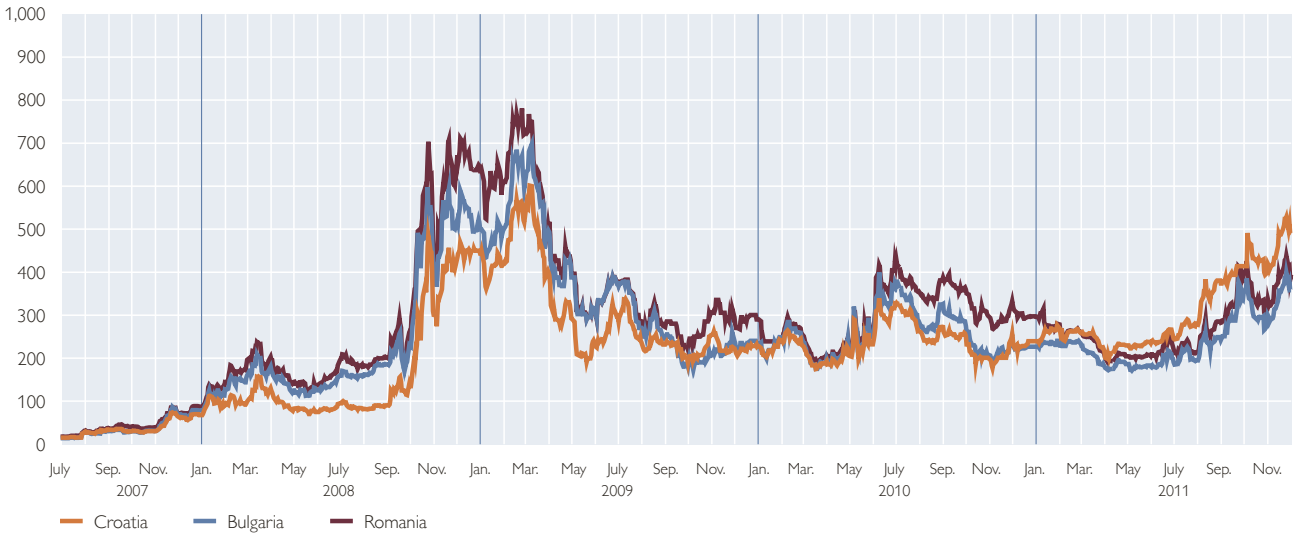


Source: Datastream, OeNB; SEE: unweighted average of country data for Bulgaria, Croatia and Romania.

Chart 18

Sovereign Five-Year CDS Premiums

Basis points

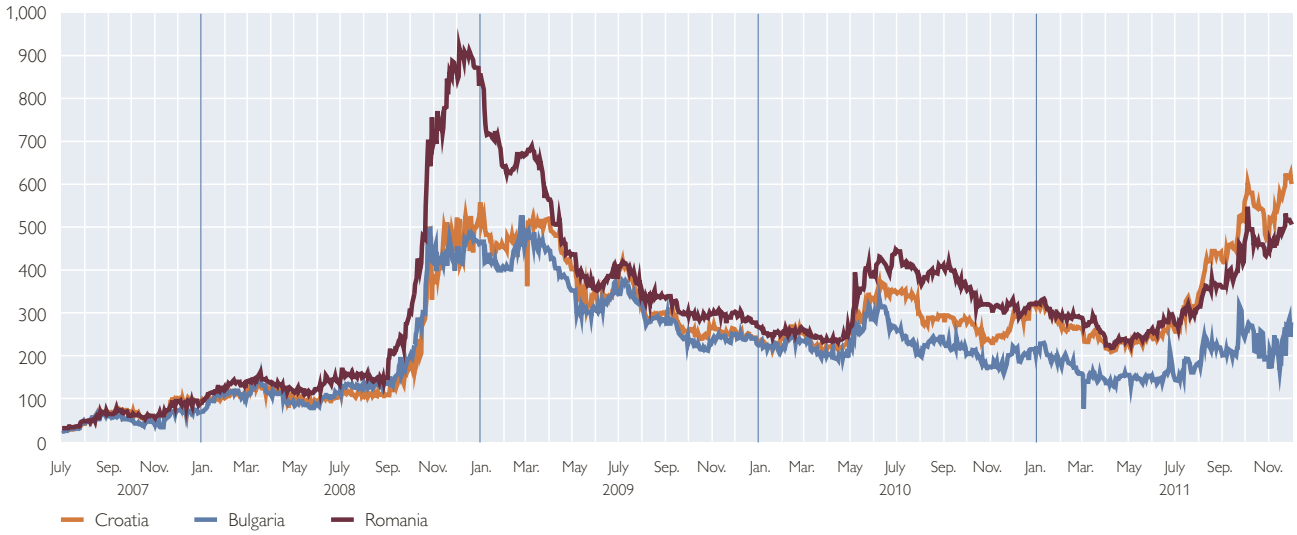


Source: Datastream, OeNB.

Chart 19

Euro-Denominated Eurobond Yield Spreads

J.P.Morgan Euro EMBI Global index



Source: Bloomberg, OeNB.

Brothers. SEE risk premiums in the review period were also much lower than risk premiums for Ireland and Portugal, i.e. countries which, like Greece, have also obtained international financial support. A similar picture can be seen with respect to euro-denominated eurobond yield spread developments (chart 19).

Chart 20

Sovereign Ratings in SEE

Average of available long-term foreign currency ratings by Fitch, Moody's and S&P

Source: S&P, Fitch, Moody's, OeNB.

Note: Investment grade ranges from BBB– to AAA in the case of S&P and Fitch, and from Baa3 to Aaa in the case of Moody's. Noninvestment grade ranges from D to BB+ at S&P, from D to BB+ at Fitch (including the rating categories DD and DDD) and from C to Ba1 at Moody's.

As is well known, the creditworthiness of Greece has suffered strongly as a result of the recent sovereign debt crisis. So far, this has not had major negative implications for the sovereign ratings of SEE countries (see chart 20). Only Croatia's and, most recently, Bosnia and Herzegovina's sovereign ratings were downgraded (in both cases by S&P and by one notch each), but these moves were explicitly based on country-specific reasons.

5 Summary and Conclusions

This paper sets out by providing a systematic overview of the main economic and financial transmission channels through which the Greek sovereign debt crisis may affect the SEE region. It then presents comprehensive information on the economic and financial linkages between Greece and SEE before and in particular during the Greek crisis. In doing so, the paper identifies the most important channels through which substantial spillovers could materialize, and then goes on to highlight the changes in economic and financial linkages between Greece and SEE since late 2009.

Overall, the analysis presented in this paper shows that, so far, effects of the Greek crisis on the SEE region and the performance of individual SEE countries have been relatively limited, even more so as recent economic developments in SEE countries may also be explained by general trends in global and European trade, FDI and remittance flows as well as financial market developments during the 2009 and 2010 crisis years. In terms of real economic linkages, Albania seems to be somewhat more exposed to spillovers of the Greek crisis than other SEE countries, given that Greece is the largest investor in the country, the main host country for Albanian migrants and correspondingly the most important country of origin for workers' remittances. Foreign trade linkages with Greece, which are strongest in Bulgaria and FYR Macedonia, do not seem a major cause for concern for the region, given the rather limited degree of trade openness of most SEE economies.

In general, there is evidence that banking and financial sector spillovers have been, and may well continue to be, more important than real economy channels, in particular in terms of potential vulnerabilities that could materialize in an adverse scenario in countries with a strong presence of Greek banks (i.e. Albania, Bulgaria, FYR Macedonia, Romania and Serbia). At the same time, the paper also argues that there are buffers (e.g. in terms of bank capitalization and foreign exchange reserves) but also market-driven and public-sector adjustment processes (e.g. Vienna Initiative) that can help avoid a large-scale materialization of such vulnerabilities. Nevertheless, challenges remain demanding, as many Greek banking groups are experiencing continued distress, even though the adjustment process in SEE banking sectors during the crisis has been fairly orderly so far. In addition, an orderly conclusion of the private sector involvement for Greece could largely relieve the liquidity pressures on Greek banks, while a subsequent program supported by the "troika" is expected to provide for a sufficient backstop facility for Greek banks.

In the realm of financial transmission channels, spillover effects stemming from a change in foreign investor sentiment seem to have played some role but, overall, financial market developments in SEE have not been strongly dissimilar from developments elsewhere in emerging Europe. Moreover, it is obviously difficult to disentangle the direct impact stemming from the Greek crisis from

rising global uncertainty or domestic country-specific factors. Also, risk perceptions can shift abruptly due to events that may be beyond the control of the authorities in a particular country. Past developments, while providing some reassurance, should not be seen as an unconditional guarantee for continued resilience.

Moreover, during the last few months it has become increasingly obvious that the Greek sovereign debt crisis is not the only external factor that is putting the macrofinancial resilience of SEE countries to a test and possibly not even the most important one. What started out as a sovereign debt crisis in Greece two years ago has become a much broader issue, both in terms of countries involved and negative feedback loops affecting European banks. In addition, there has been a considerable rise in global risk aversion recently, not only because of developments in Western and Southern Europe but because of generally reduced growth prospects and banking sector strains in advanced economies and concerns about the impact these will have on the fast-growing economies of Asia and Latin America.

While SEE seems to be broadly capable of coping with the spillovers of the Greek crisis, even if it should persist for some time to come, challenges would be much tougher if the spillovers from this local crisis "next door" were to be aggravated by major adverse effects stemming from a more substantial worsening of the external environment. Such worsening might in particular relate to the cost and availability of external funding and the continued operation of European banking groups in the region, both of which are particularly crucial to the development and convergence of SEE countries toward more affluent countries in Western Europe.

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