POST- CRISIS BUSINESS MODEL OF BANKS IN THE REGION

Dr. György Surányi

Resident Regional Head

16-17, November, 2009
BEFORE THE CRISIS:

A MACROECONOMIC OVERVIEW
Before the crisis the consensus view was that in case of small, open, converging economies the sustainable growth strategies are export and investment-driven growth strategies –actively supported by capital inflows (both debt- and non-debt type financing) (C/A deficits!)

Source: Eurostat, IMF
EXPORT AND INVESTMENT DRIVEN GROWTH STRATEGIES

Source: Eurostat
STRONG GROWTH RATES PUSHED AHEAD REAL CONVERGENCE

Source: Eurostat

GDP/CAPITA (PPP, EU27 average=100)

- Poland: 54,6 (2007), 46,8 (1997)
- Slovakia: 68,6 (2007), 51,3 (1997)
- Czech Republic: 81,3 (2007), 72,9 (1997)

Source: Eurostat
In the CEE region almost all countries run external deficits or to put it another way: net domestic savings were negative.

Before the current crisis it was considered sustainable

A natural “side effect” of the catching up process

Source: IMF
DISCIPLINED FISCAL POLICIES

The external deficit was not the result of loose fiscal policies (SGP, Maastricht!)

Source: IMF
LOW DEBT LEVELS

GOVERNMENT DEBT (as a % of GDP)

Source: Eurostat
The first group: low inflation, healthy fiscal balances, acceptable external position, no asset price bubble

The second group: high inflation, huge external imbalances, asset price bubbles, consumption driven growth financed by cheap external funding

BUT DUE TO THE GLOBAL CRISIS ALL COUNTRIES FACE ALMOST SIMILAR CHALLENGES
In some countries domestic demand rose strongly in spite of disciplined fiscal policies.

Source: Eurostat
THE CRISIS: THE REGION ENTERED A DEEP RECESSION
THE CRISIS: THE REGION ENTERED A DEEP RECESSION

Source: IMF
EXPORT MARKETS COLLAPSED

Exports are down ~25-35% y-o-y

Source: IMF
SUDDEN STOP OF CAPITAL INFLOWS

NET CAPITAL INFLOWS TO THE CEE REGION
1990-2014* (as a % of GDP)

Source: IMF, IMF sraff estimates
FISCAL POLICIES ARE NOT ABLE TO PROVIDE A SHELTER

Sustainability fears (even in case of low debt countries), the appearance of rollover risks!

Fiscal policies are not in a position to give a countercyclical boost to the economy

Source: Eurostat, Brussel Commission
RISING UNEMPLOYMENT, FALLING CONSUMPTION

Source: Eurostat, Brussel Commission

**HOUSEHOLDS' CONSUMPTION (%)**

<table>
<thead>
<tr>
<th>Country</th>
<th>2007 Average</th>
<th>2008 Average</th>
<th>2009* Average</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bulgaria</td>
<td>-23.0%</td>
<td>-15.0%</td>
<td>-38.0%</td>
</tr>
<tr>
<td>Czech Rep</td>
<td>-18.0%</td>
<td>-12.0%</td>
<td>-32.0%</td>
</tr>
<tr>
<td>Estonia</td>
<td>-25.0%</td>
<td>-16.0%</td>
<td>-40.0%</td>
</tr>
<tr>
<td>Latvia</td>
<td>-27.0%</td>
<td>-15.0%</td>
<td>-37.0%</td>
</tr>
<tr>
<td>Lithuania</td>
<td>-20.0%</td>
<td>-10.0%</td>
<td>-25.0%</td>
</tr>
<tr>
<td>Hungary</td>
<td>-25.0%</td>
<td>-17.0%</td>
<td>-33.0%</td>
</tr>
<tr>
<td>Poland</td>
<td>-22.0%</td>
<td>-14.0%</td>
<td>-31.0%</td>
</tr>
<tr>
<td>Romania</td>
<td>-24.0%</td>
<td>-16.0%</td>
<td>-36.0%</td>
</tr>
<tr>
<td>Slovakia</td>
<td>-21.0%</td>
<td>-13.0%</td>
<td>-30.0%</td>
</tr>
</tbody>
</table>

**NUMBER OF UNEMPLOYED (%)**

<table>
<thead>
<tr>
<th>Country</th>
<th>2007 Average</th>
<th>2008 Average</th>
<th>2009* Average</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bulgaria</td>
<td>7.8%</td>
<td>6.6%</td>
<td>11.0%</td>
</tr>
<tr>
<td>Czech Rep</td>
<td>6.8%</td>
<td>6.6%</td>
<td>11.0%</td>
</tr>
<tr>
<td>Estonia</td>
<td>8.0%</td>
<td>7.0%</td>
<td>12.0%</td>
</tr>
<tr>
<td>Latvia</td>
<td>12.0%</td>
<td>11.0%</td>
<td>12.0%</td>
</tr>
<tr>
<td>Lithuania</td>
<td>9.0%</td>
<td>8.0%</td>
<td>10.0%</td>
</tr>
<tr>
<td>Hungary</td>
<td>10.0%</td>
<td>9.0%</td>
<td>11.0%</td>
</tr>
<tr>
<td>Poland</td>
<td>7.0%</td>
<td>6.0%</td>
<td>9.0%</td>
</tr>
<tr>
<td>Romania</td>
<td>8.0%</td>
<td>7.0%</td>
<td>10.0%</td>
</tr>
<tr>
<td>Slovakia</td>
<td>9.0%</td>
<td>8.0%</td>
<td>12.0%</td>
</tr>
</tbody>
</table>
REAL CONVERGENCE CAME TO A HALT

CHANGE IN REAL PER CAPITA GDP (%)

Source: IMF
THE BANKING SECTOR
BEFORE THE CRISIS: STRONG CREDIT GROWTH ACROSS THE REGION

AVERAGE REAL CREDIT GROWTH OVER THE LAST 5 YEARS (%)

Source: IMF, 2004-2008
STILL RELATIVELY LOW LEVEL OF FINANCIAL INTERMEDIATION

PRIVATE SECTOR CREDIT TO GDP IN SELECTED COUNTRIES (eop, %)

Source: IMF
The credit growth was financed by cheap external funding.

Foreign banks play a leading role in the region.

Foreign-controlled equity/total equity: ~70-90%

Source: NBH
The growth strategies built on cheap external financing are not sustainable any more

Domestic savings will not be sufficient to substitute external funding

Source: ECB, NBH, data as of end-2008
THE RISING RATIO OF FX TRANSACTIONS AND BOOMING FX LENDING IS A REGIONAL PHENOMENON

Small, open, export-driven economies, liberalized FX transaction among residents, and/or currency board or spontaneous euroization or the voluntary interpretation of IT (high interest rate differential)

NO LENDER OF LAST RESORT

Source: NBH
A natural consequence of the permanent external deficits in the region

Net domestic savings were insufficient to finance investments and exports, hence external capital inflows were needed to finance the deficit.

The debt-generating part of the capital inflows necessarily resulted in the formation of an unhedged FX position at one or more domestic agents.

The balance sheet of the banking sector purely mirrors the macro imbalances.
THE CRISIS: IS THERE A WAY OUT?

The region imported the financial crisis

Collapsing export markets: a huge shock to the real economy

Sudden-stop of capital inflows: financial sector shock

The room for fiscal maneuver is limited

The central banks are unable to provide the system with foreign currency liquidity

If –in the midst of the crisis-
• governments intend to improve external balances, to keep budget deficits under control,
  • the banking sector aims for lower L/D rates,
• authorities, financial watchdogs demand higher capital adequacy ratios, impose limitations to FX lending
simultaneously, the result would be an even deeper recession
THE CRISIS: IS THERE A WAY OUT?

Due to the cross-border dependencies coordinated actions are needed.

The problems can not be solved on a national basis.

Governments, central banks in the region should act jointly with the ECB, the European authorities, international organizations and foreign owners of the banking sector.

Not to fund a credit boom, but to create the conditions for a moderate 5-8% yearly growth rate in credit and avoid a long-lasting depression.
DID THE EURO PROVIDE A SHELTER?

The EUR on its own was not able to provide a shelter

The ECB could have helped by providing EUR liquidity to the region

The main issue was:

Whether the given banking sector had a liquidity buffer?

Slovakia versus Czech Republic

The Czech Republic managed the crisis well and so did Slovakia.

The pace of GDP contraction is similar in both countries.
FUTURE CHALLENGES

Macroeconomic policies

The external deficits that had been considered sustainable before the crisis are no longer sustainable.

The region will not be able to return to the growth levels seen before the crisis, economies should adjust to a lower path.

Germany: should take over as the „final consumer” of Europe instead of pushing ahead with a purely export-driven growth strategy.
FUTURE CHALLENGES

Banking sector

L/D ratios should adjust, but it would be a mistake to target L/D at or even below 100%, as it would kill growth and convergence.

Limiting FX based lending is acceptable only if medium and long-term domestic currency-based financing is available at a reasonable price.

Killing FX-based lending and at the same time not providing domestic currency-based financing would result in a prolonged economic stagnation.

In an economy that is heading towards the euro, the dynamic expansion of CHF or JPY denominated loans in the household sector is clearly not a welcome development (especially if these loans are short-term instruments), but there are serious arguments supporting EUR-based lending in case of mortgages and investments.

If the economy as a whole is on a sustainable path –primarily the external position is sustainable- the risk of the open, unhedged FX position is manageable, both on a macro and on a micro level.