Imbalances in CESEE: Past and Future

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Macroeconomic Imbalances in EUR

- Introduction of EUR
  - Maastricht Criteria
  - Stability and Growth Pact

Fiscal Constraints
Early EUR Period

- Optimum Currency Area
  - Labor mobility
  - Capital mobility with price and wage flexibility
  - Risk sharing
  - Business cycle synchronization
Capital Flows and Current Accounts

Northern EUR Area (NEA)
Austria, Belgium, Finland, France, Germany, Ireland, Luxembourg, the Netherlands

Southern EUR Area (SEA)
Cyprus, Greece, Italy, Malta, Portugal, Slovak Republic, Slovenia, Spain
Convergence Process

Two Stages:

- **Expansion stage**: large capital inflows, growing CA deficit and increased consumption of tradables and disproportionately more of non-tradables

- **Reorientation stage**: rebalancing of CA, dampening the non-tradable price pressure and shift back to the tradables
Not really?

- IntraEUR imbalances
- Increasing CA deficits in SEA financed by capital flows from NEA
- Decoupling of domestic savings and investment

2008
Financial Crisis

- Slowdown of capital flows to SEA from NEA
- Import demand substituted by debt burden

Twin Deficits

+ Rest of the World
EUR + RTW

EUR

NEA

SEA

REST OF THE WORLD (ASIA)
Policy Options for SEA

- Fiscal consolidation to increase government saving
- “Internal devaluations“
- Structural policies to increase productivity and growth
- Raising prudential standards to curb credit growth and improve loan quality
EUR + RTW + CESEE

Hungary, Ukraine, Latvia, Belarus, Serbia, Romania, Bosnia-Herzegovina, Moldova, Poland, Kosovo, Bulgaria, Estonia, Lithuania, Albania, Croatia, Macedonia, Montenegro, Czech Republic
Capital Flows to CESEE

- Low income levels
- Implementation of reforms
- Foreign-owned banks seeking high yields
- Positive outlook for global environment
- Institutional set up?

EU Convergence Play?
Not Entirely

- Faster credit growth with faster import growth
- Growing imbalances
  - CA deficit
  - Inflation and wages
  - Housing prices
  - External debt
2008

- Financial turmoil
- Increase of global risk aversion
- Reversal of credit flows to SEA + CESEE
  - Deleveraging
  - Credit ceilings
  - Turn to local deposits (but where to find them?)

Home vs. Host Problem
EUR + RTW + CESEE + IMF

EUR
NEA
REST OF THE WORLD (ASIA)
SEA

Hungary, Ukraine, Latvia, Belarus, Serbia, Romania, Bosnia-Herzegovina, Moldova, Poland, Kosovo, Bulgaria, Estonia, Lithuania, Albania, Croatia, Macedonia, Montenegro, Czech Republic
Capital Flows: SEA and CESEE

USEFUL

or

„WASTEFUL“
Increased Bank Lending: Demand and Supply Factors

- Previously suppressed demand
- Consumption smoothing
- Financial innovations
- Bank competition
- Positive economic outlook
Increased Bank Lending:
Institutional Factors

- Improvement in regulatory powers of host central banks
- Strengthening of prudential regulations and supervision
- Strengthening of creditors‘ rights
- Introduction of international accounting standards
Risks for Banking Sector Stability

- Two Channels:
  - Macroeconomic imbalances
    - CA deficit, fiscal deficit, inflationary and exchange rate pressure lead to sudden reversal in capital flows
  - Prudential
    - Deterioration of loan quality

Pronounced risks in CESEE?
Transition Process
Transition Process by the Book

- Macroeconomic stabilization
- Price liberalization
- Trade liberalization and current account convertibility
- Privatization
- Development of the institutional and legal framework for a market economy
Should it be the other way around?

- Remember?
  - ‘Shock Therapy’ vs. ‘Gradual Approach’
  - Importance of Foreign Direct Investments
  - Puzzles about the exchange rate regime

- Unsyhchronized trade and financial liberalization
- The institutional setting was greatly overlooked
Institutional Setting

- Properly defined property rights
- Rule of Law
- Consistent legal framework

EFFICIENT JUDICIAL SYSTEM
Why would that be important?

Loans for trade, construction and non-tradables

COLLATERAL
(Tangibility of Assets)
Distortions in Banking Sector: CESEE

As long as you can provide a collateral, you get a loan.

- Institutional setting
- Useful vs. „Wasteful“
- Bias in distribution of output

LACK OF REPAYABLE POTENTIAL
Evidence from Developing Countries

- Borrowers‘ access to credit may be limited where legal rights, property rights, corruption, and asymmetric information are problematic.

- Physical capital in developing countries is mostly of the wrong kind
  - Lucas-Schultz Paradox
  - De Soto’s ‘Mystery of Capital’
Unlocking Growth Potentials
Doing Business in CESEE

- Investor Protection
- Contract Enforcement

IMPROVEMENT 2007-12
Policy Options for SEA + CESEE

- Fiscal consolidation to increase government saving
- “Internal devaluation“
- Structural policies to increase productivity and growth
- Raising prudential standards to curb credit growth and improve loan quality
- Supervisory co-operation and co-ordination
- Institutional setting improvement
Conclusions
- Banking Union
- EU fiscal consolidation

- Trade vs. Financial integration
  - Institutional setting

- Further financial deepening
  - Bank domination vs. ‘is-there-anyhting-else’

- National industrial policies?


Lothian, J. R.“Institutions, capital flows and financial integration”. Journal of International Money and Finance 12, 2006

