Imbalances in CESEE: Past and Future

Bostjan Jazbec
University of Ljubljana

Vienna
February 18, 2013

Contents

Foreword

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 disproportionaly 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

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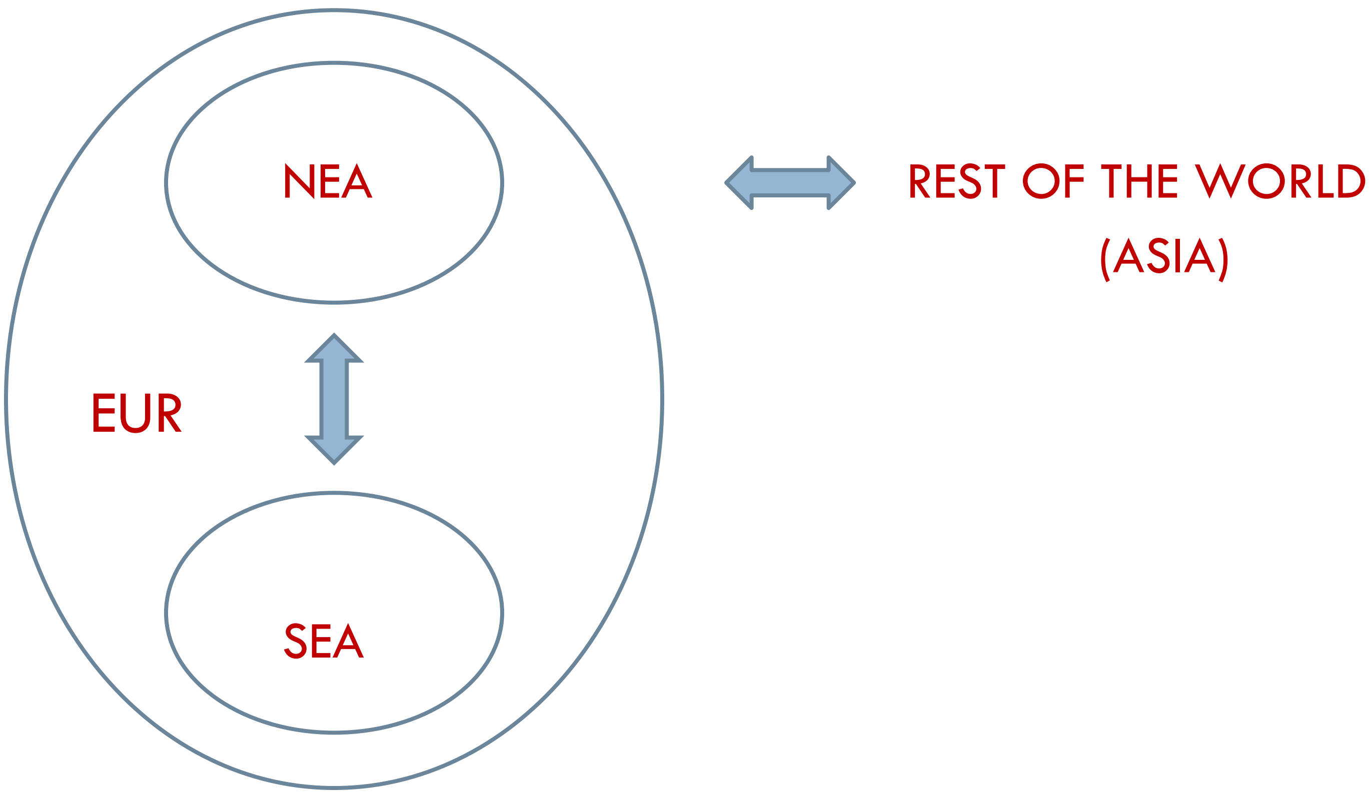
Twin Deficits

+

Rest of the World

EUR + RTW

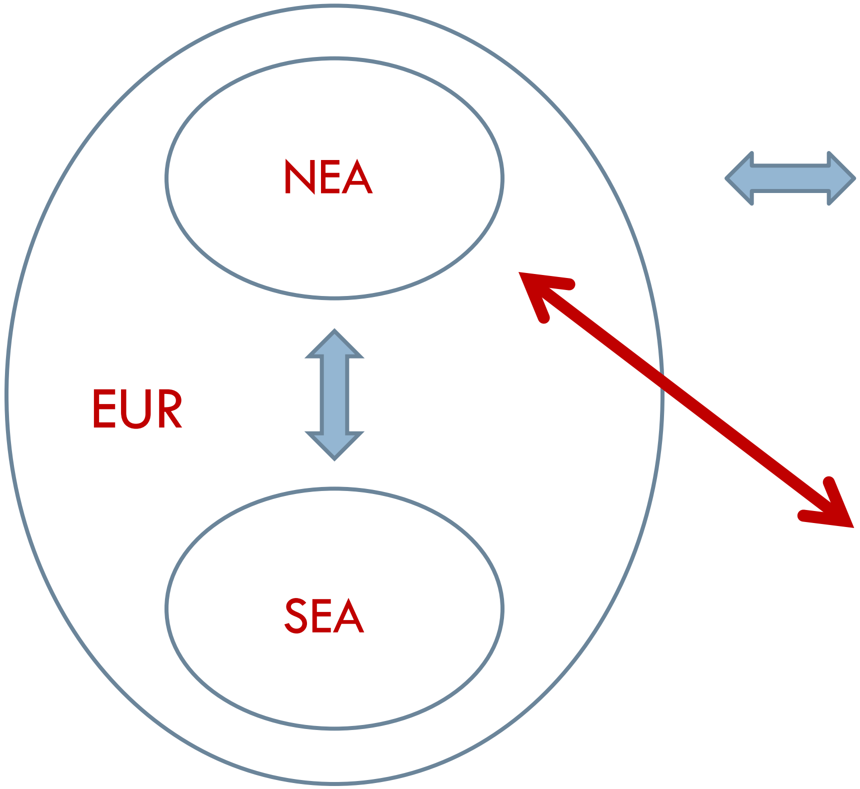


Policy Options for SEA

- Fiscal consolidation to increase goverment saving
- “Internal devaluations“
- Structural policies to increase productivity and growth
- Raising prudential standards to curb credit growth and improve loan quality

CESEE

EUR + RTW + CESEE



REST OF THE WORLD
(ASIA)

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-own banks seeking high yields
- Positive outlook for global environment
- Institutional set up?

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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?)

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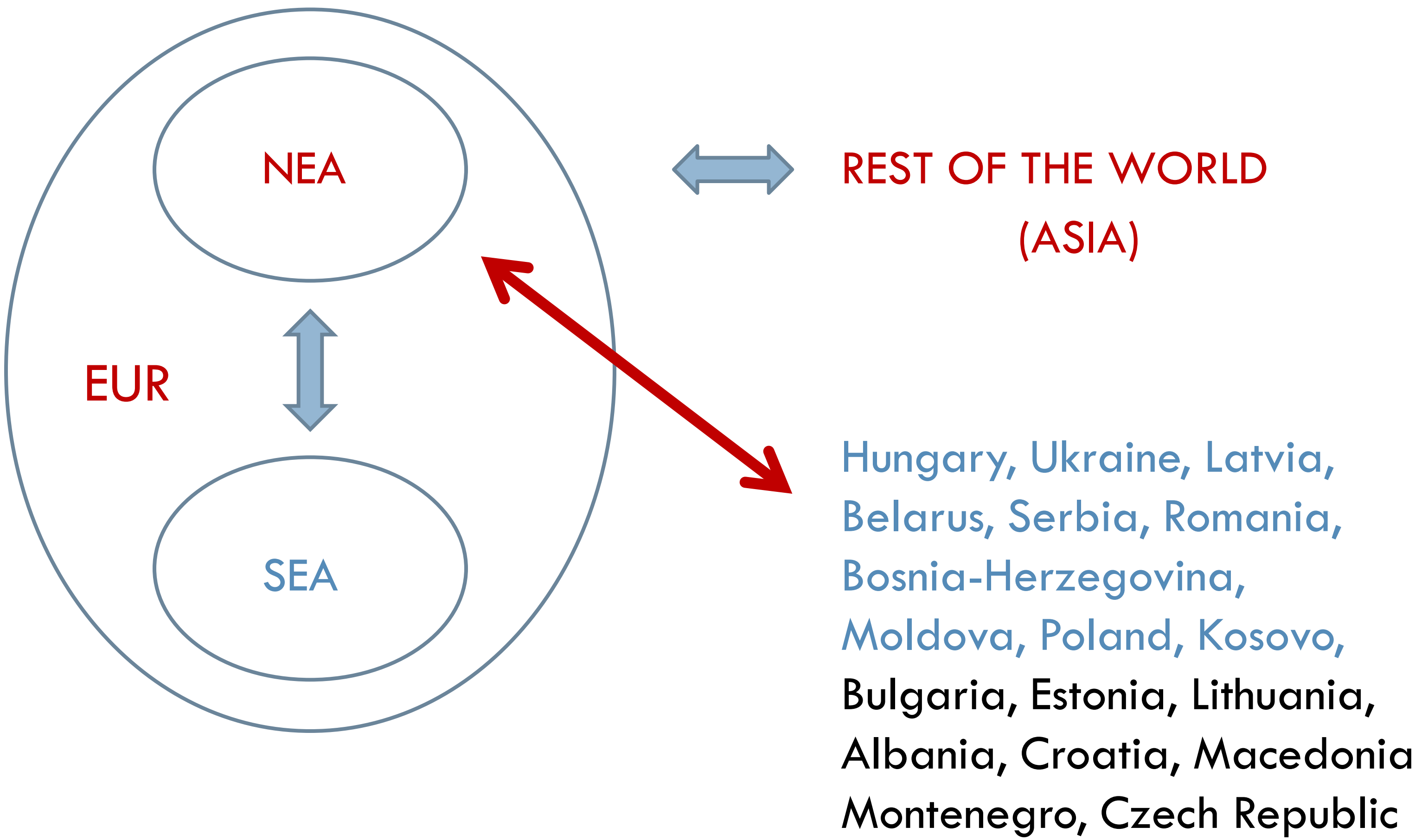
Home vs. Host Problem

EUR + RTW + CESEE + IMF



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
- Strenghtening of prudential regulations and supervision
- Strenghtening of creditors‘ rights
- Introduction of international accounting standards

Risks for Banking Sector Stability

- Two Chanells:
  - 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

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EFFICIENT JUDICIAL SYSTEM

Why would that be important?

Loans for trade, construction and non-tradables

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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

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IMPROVEMENT 2007-12

Policy Options for SEA + CESEE

- Fiscal consolidation to increase goverment 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?

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