OESTERREICHISCHE NATIONALBANK
EUROSYSTEM

# WORKSHOPS

## Proceedings of OeNB Workshops

# Recent Developments in the Baltic Countries – What Are the Lessons for Southeastern Europe?

March 23, 2009

Stability and Security.

**No. 15**

# Financial Stability in a Brave New World:
# The Challenges for Southeastern Europe

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## Introduction

In the first half of 2009, the impact of the global financial crisis began to reach Southeastern Europe. Insulated at first by somewhat lower levels of financial integration, the economies of the region are now feeling a major impact of the crisis through traditional channels (exports and remittances) as well as capital market linkages. Already, Bosnia-Herzegovina (BiH), Romania and Serbia have arrangements with the IMF. Other countries in the region are now also experiencing varying degrees of financial stress, albeit from somewhat stronger starting positions.

This paper discusses the short and medium-term challenges and options facing policy-makers in Southeastern Europe, taking account of recent experience in other converging economies in Europe. The paper explores in turn the outlook for capital flows; the varied nature of regional transmission mechanisms; the nature and implications of recent financial support packages; the trade-offs facing authorities in terms of adjustment and financing options; and the policy requirements in order to safeguard medium-term financial stability in a changed global setting for capital flows.

## The Outlook for Capital Flows

The present global crisis is qualitatively and quantitatively different from the business cycles and credit booms of the past 50 years.

- The sources of the crisis are deep-rooted, reflecting the interaction of market innovations with weaknesses in monetary, fiscal and regulatory policies in many economies, including countries with the strongest systemic impact. These policy and market influences built up over nearly a decade, and will take time to fully reverse.

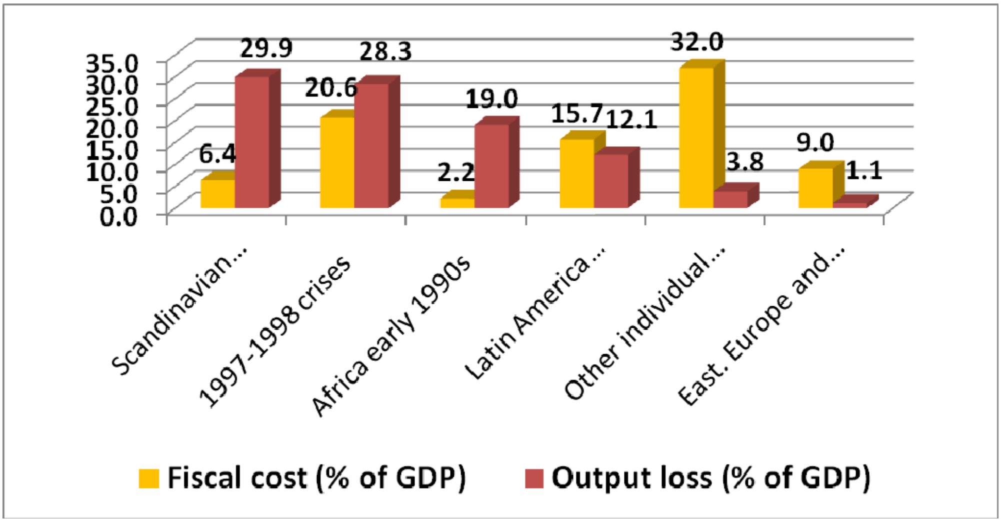
- In a financially integrated global economy, the crisis is affecting all major regions simultaneously, leaving none as a locomotive to help pull others out of recession.
- In those countries, including the United States, that have experienced major asset booms, there is now a need to replace the "wedge" of household savings that were built up in the ephemeral form of wealth increases, and this restoration of liquid savings will exercise a dampening effect on consumption over several years.
- The crisis is being addressed in some cases through major fiscal and monetary stimulus packages, and these will need to be unwound over time, placing a drag upon economies over the medium term. Moreover, as the crisis recedes, it will still take time to wind back the role of state intervention in national economies. And these endeavours will take place against the backdrop of demographic changes that are negatively affecting potential rates of growth.

Evidence presented in the October 2008 IMF World Economic Outlook confirms the unusual breadth and duration of financial stress among world economies, and also underscores that economic downturns and recessions have historically lasted nearly twice as long when preceded by periods of financial stress.

In terms of other crises in the past half century, the present turmoil has closest resemblances with the Asian crisis of the late 1990s, due to the scale of balance sheet problems among both banks and nonbanks. A notable feature of that period was the simultaneous impact of the crisis on both public debt positions and on output, by comparison with other crises (chart 1). This double impact is likely to be mirrored in the current period, given the heavy incidence of balance sheet risk exposures among lending banks as well as firms and households in the countries of the region.

Against this backdrop, the medium-term outlook for capital flows is likely to differ sharply from the environment of the past decade. The need for balance sheet retrenchment by banks in many advanced economies will probably act as a brake on lending flows. The weaker prospects for demand growth in the EU-15 is likely to dampen export-driven direct investment in Southeastern Europe. And remittance flows have already been significantly curtailed in some cases. While FDI and remittances are likely to pick up once a durable recovery in the advanced economies sets in, the same may not be true of bank lending flows (and hence the overall volume of private external financing). This shift puts into question some aspects of the recent pattern of integration in the region, and calls for significant changes in its growth model over the medium term.

*Chart 1: Fiscal and Output Costs of Financial Crises*




*Source: Laeven and Valencia (2008), "Systemic banking crises: A new database".*

## Regional Transmission Mechanisms

Across the economies of the Baltic region and Southeastern Europe, a number of common features have led to some similarities in transmission mechanisms of the crisis. The over-arching feature of the region is, of course, its close real and financial integration with the EU-15, which implies a simultaneous setback in regional exports. Equally notable was the prevalence of wide current account deficits in Southeastern Europe at the time that the financial crisis began to emerge in 2007.

These current account deficits largely had their origin in private sector saving-investment balances, and they were financed to significant – though varying – degrees by cross-border lending within banking groups based in the EU-15. The deficits have been widest, typically, in those countries with fixed exchange rates and in those where levels of economic catching-up showed the steepest gaps (table 1). As banks faced liquidity constraints and became more risk averse, the scale of this current account financing shrank, resulting in a sharp slowing of consumption and investment.

Despite these basic similarities, transmission channels of financial stress across the region are likely to show some marked differences over time as a result of differing monetary and exchange-rate regimes. In economies with floating exchange rates, an important potential channel of financial stress is the balance sheet exposure of firms and households through unhedged borrowing in foreign currencies, which can result in a strong upfront contractionary impact.

*Table 1: Current Account Deficits in 2007 (% of GDP)*

| Hard Peg Regimes | Floating / Intermediate Regimes |
|---|---|
| Bulgaria25.1 | Czech Republic –3.2 |
| Estonia –18.1 | Hungary –6.4 |
| Latvia –22.6 | Poland –4.7 |
| Lithuania –14.6 | Slovakia –5.1 |
| | Romania –13.9 |
| BiH –12.7 | Albania –9.1 |
| | Croatia –7.6 |
| | FYR Macedonia –7.2 |
| | Serbia –15.3 |

*Source: IMF Regional Economic Outlook for Europe, May 2009.*

By contrast, those economies with hard peg exchange regimes are more likely to experience financial stress through the impact of a prolonged period of depressed growth as relative prices adjust to restore competitiveness after a period that featured heavy imports of foreign savings. The experience of Portugal after its financial boom is often referred to. However, the depth and duration of recessions in these latter cases will depend in large parts on the extent of sector shifts required, and on the flexibility with which costs adjust. In this respect, it is to some degree reassuring that fiscal positions typically improved during the boom period (table 2), although there were some notable lapses in the later years.

Moreover, across the former transition economies there has been a broad correlation between the pace of financial integration and the track records of productivity and investment growth (charts 2 and 3), which bodes well for their adjustment capacity compared with some earlier crisis countries.

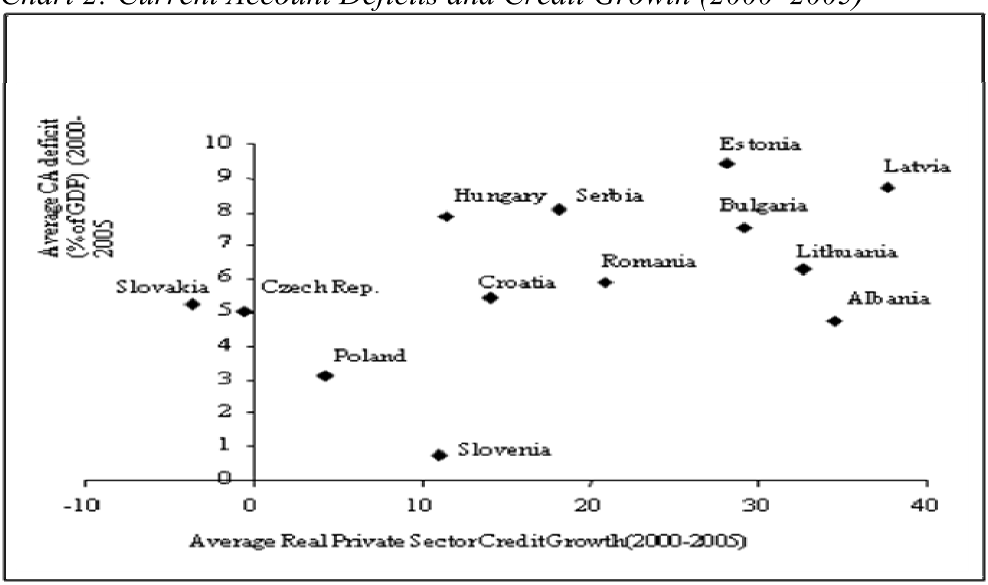
*Table 2: Fiscal Deficits and Private Sector Imbalances 2000–2007*

*in % of GDP*

| | Fiscal Deficits 2000 | 2007 | Households and Firms 2000 | 2007 |
|---|---|---|---|---|
| **Albania** | **-9.2** | **-3.8** | **+5.5** | **-5.3** |
| **BiH** | **-3.1** | **-0.1** | **-3.8** | **-12.6** |
| **Bulgaria** | **-1.0** | **3.5** | **-4.6** | **-21.6** |
| **Croatia** | **-6.5** | **-1.2** | **+4.0** | **-6.4** |
| **Frmr. Ygslv. Rep. of Mac.** | **+2.5** | **0.6** | **-4.4** | **-7.8** |
| **Montenegro** | **-6.9** | **6.2** | **+2.4** | **-35.5** |
| **Romania** | **-3.8** | **-3.1** | **+0.1** | **-10.8** |
| **Serbia** | **-0.9** | **-1.9** | **-0.9** | **-13.4** |
| | | | | |

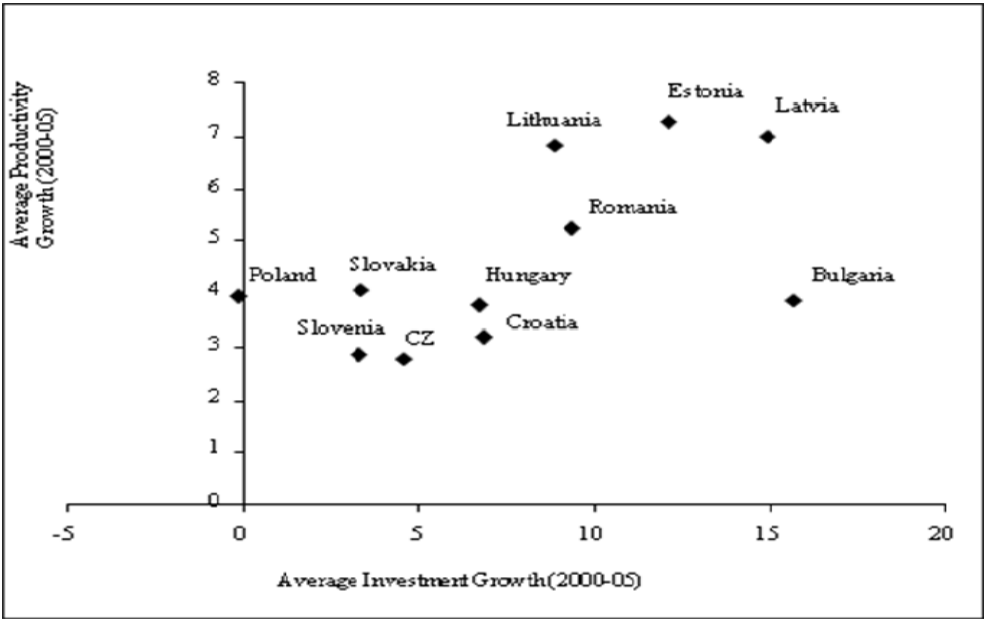
*Source: IMF Regional Economic Outlook for Europe, May 2009 and WEO Data Base; European Economy Occasional Paper No. 29, European Commission DG ECFIN, April 2007.*

*Chart 2: Current Account Deficits and Credit Growth (2000–2005)*




*Source: European Economy Occasional Paper No. 26, European Commission DG ECFIN, October 2006.*

*Chart 3: Productivity and Investment (2000–2005)*




*Source: European Economy Occasional Paper No 26, European Commission DG ECFIN, October 2006.*

## Financial Support Packages

The differing external adjustment profiles, as well as variations in the severity of financial stresses, has been reflected in some degree of diversity in the support packages concluded so far with the IMF and other providers of financing. The financial support packages launched by the IMF and the European Union have in common, of course, that they have aimed to cushion economies against the full impact of external financial shocks, while in most cases also calling for significant fiscal adjustment to help restore financial confidence. However, the nominal exchange rate and financing profiles of the packages have differed significantly.

In Latvia, the design of the support package reflected the authorities' commitment to maintain their currency peg against the euro, thus shielding the economy from any large, immediate balance sheet shock due to unhedged currency exposure in the non-bank private sector. It is acknowledged, however, that Latvia may face a prolonged period of slow growth as relative prices adjust and the economy reorients to a changed real and financial environment. Similarly, the support package for Bosnia-Herzegovina does not envisage any change in the euro parity of the Convertible Mark.

In Romania and Serbia the current adjustment programmes involve measures to contain fiscal deficits, but are taking place against the backdrop of significant nominal exchange rate depreciation. This should help restore competitiveness, but may also result in some balance sheet stresses in the corporate and household sectors. A further innovation in these cases has been a stronger initiative to secure rollover commitments from foreign banks and sizable corporate investors, thus reducing the net financing gap to be covered by official resources.

These support packages have been put into place swiftly, and represented a large-scale response to the financing stresses in these economies, compared with the average size of past IMF-supported packages. Nonetheless, questions remain how far the initial assumptions of the programmes will stand the test of time in all cases.

Most obviously, the initial packages assumed a less sharp contraction of output than is evident now across the region, and this raises a question how far structural fiscal deficit goals can be maintained in the face of declining private sector demand. There could also be limits to the political acceptability of very slow adjustment through relative price movements, in the hard peg cases – although the shocks to corporate and household balance sheets of any parity changes would themselves have dramatic and discouraging short-term implications for growth.

More subtly, there are questions to reflect on concerning the design and balance of conditionality. In many ways the underlying challenge for these economies is a change in the growth model. This implies that adjustment success may depend even more on structural reform programmes than on the headline fiscal adjustment that countries are aiming for in their efforts, undeniably important in themselves of course, to preserve private sector financial confidence.

As the economic and financial outlook becomes gradually clearer, such questions may need to be revisited. In doing so, policy-makers will need to consider carefully the trade-offs involved in any departure from the first-round design for financial support packages. Moreover, the pattern of official financing for the economies of the region may also need to be revisited over time. If indeed private financial flows fail to pick up quickly, then the replacement of some expiring IMF financing with longer-term bilateral official flows, including export credits and project loans may need to be considered.

## Policy Trade-offs and Options

The different profiles of the recent support packages point to a number of potential trade-offs that country authorities need to consider as they design responses to the current financial crisis.

A first set of trade-offs concern the profile of adjustment implied by the decision to retain the existing exchange rate regime. As an illustration, the potential benefits of avoiding devaluation of a fixed exchange rate will be greatest where two conditions hold (table 3). The first is that costs are relatively flexible (as a result of nominal wage flexibility and/or rapid productivity growth). The second is that unhedged foreign exchange exposures are relatively high.

*Table 3: Adjustment Trade-offs*

| | Low Balance Sheet Risk | High Balance Sheet Risk |
|---|---|---|
| **Flexible costs** | | Clear case to hold peg |
| **Rigid Costs** | Clear case to depreciate | |

A second set of trade-offs concern the approach to relations with creditors – in IMF terminology, "financing assurances." A key choice here is the extent to which pressure is put on existing sources of private financing to avoid cutting back exposure to the economy – or in other words committing to roll-over a high proportion of existing loans. The attractions of seeking firm roll-over commitments is that this reduces the call on official financing sources and national exchange reserves to cover gross financing requirements. There is a cost, however, in terms of the "scar tissue" this may leave in terms of relations with private creditors, which may jeopardise the scope for an early re-emergence of new spontaneous financing – suggesting problematic trade-offs in this strategy if a combination of official financing and some depreciation can help close the external gap without departing from spontaneous market relations (table 4).

*Table 4: Financing Trade-offs*

| | Manageable private/ public rollovers | Major shortfall in p/p rollovers |
|---|---|---|
| **Vulnerable to Depreciation** | | Concert rollovers even if damage future access |
| **Resilient to Depreciation** | Can seek high gross new financing, limit damage to reputation | |

The design of these recent packages also suggests patterns of explicit or implicit financial burden-sharing that may be taking shape (table 5). Specifically, the part played by each of the main actors may be formally or informally conditioned on a credible contribution by the other parties in the financial support arrangements. The home country of the main lending banks would, where needed, support those banks and encourage them to continue in their support for the host country. The host would conduct sound economic policies, with an IMF/EC seal of approval where needed, and would take on responsibilities for the support of local-owned banks and, possibly, households experiencing severe financial stress from unhedged foreign exchange credit exposures.

Foreign banks, meanwhile, would commit to maintain their exposure. And the IMF and EU would commit policy-based support financing, along with EBRD and World Bank funds. This broad pattern of burden-sharing is reminiscent of the IMF/Federal Reserve approach to financing assurances during the 1980s debt crisis, and reflects a similar pattern of interdependency, where a small group of creditor banks has as much to lose as the debtor countries in the event of a full-fledged financial collapse.

*Table 5: Illustrative Patterns of Financial Burden-sharing*

| Home Country | Host Country | Foreign Banks | EU & IMF |
|---|---|---|---|
| Fiscal/ liquidity support to banks | Responsible policies, with IFI-endorsed fiscal stance | Maintain rollover exposure at 100% | Validate country policy packages |
| Monitor bank exposure by country | Support to local banks &, possibly, unhedged households | Proceed with new project financing | Condition support on no exit by banks |

## Financial Stability over the Medium Term

For the reasons outlined at the beginning of this paper, the outlook for capital markets is probably not for a quick return to the easy financing conditions that prevailed during much of the present decade. This has important implications for the kind of policy adjustments that countries will need to make in order to return to a pattern of strong and sustainable real convergence over the medium term. There will need to be a marked change in growth models in many cases, moving towards a pattern of real convergence based on:

- a lower dependence on external savings;
- a somewhat more labour-intensive pattern of growth;
- fiscal policies that internalise macrofinancial risks as well as EU-mandated ceilings;
- monetary policies that pay greater regard to self-insurance, including through stronger reserve build-ups; and
- structural policies that trigger renewed, strong inflows of FDI rather than debt-creating financing.

In other words, the challenge of the current crisis is to achieve a systemic reorientation of macroeconomic and structural policies that will allow economies to benefit fully from a future revival of world trade, and ensure that they enjoy a sustainable pattern of financial integration.

The primary responsibility for designing policy strategies along these lines lies, of course, with country authorities. However, a crucial role of the international financial institutions and the European Union is to help set the right incentive framework to encourage national policy-makers to develop outward-looking adjustment strategies. The regional nature of the real and financial stresses being experienced in Southeastern Europe only serve to underscore the major externalities involved in ensuring win-win solutions to the challenges posed by the current crisis.

## Conclusions

The global financial crisis, in sum, cannot be viewed as a hiatus, following which real convergence can resume on a "business-as-usual" basis. The countries of Southeastern Europe need to embark on a significant recasting of growth models, which will require reorienting both macroeconomic and structural policies. As they embark on this process, a number of the adjustment and financing options they face involve important trade-offs, which need to be weighed carefully in arriving at a policy strategy that traces as rapid a path as possible to resumed growth over the medium term. Moreover, the pattern of official financing for the economies of the region may also need to be revisited in the future if private flows fail to pick up: the replacement of IMF financing over time with longer-term bilateral official flows may need to be considered. The aim of this paper has been to explore a number of these options and trade-offs, and also to stress the need to situate future approaches within a comprehensive medium-term policy strategy for the economies of the region.

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