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I N T E R N A T I O N A L M O N E T A R Y F U N D

Managing Rapid Financial Deepening in Emerging Europe

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Overview

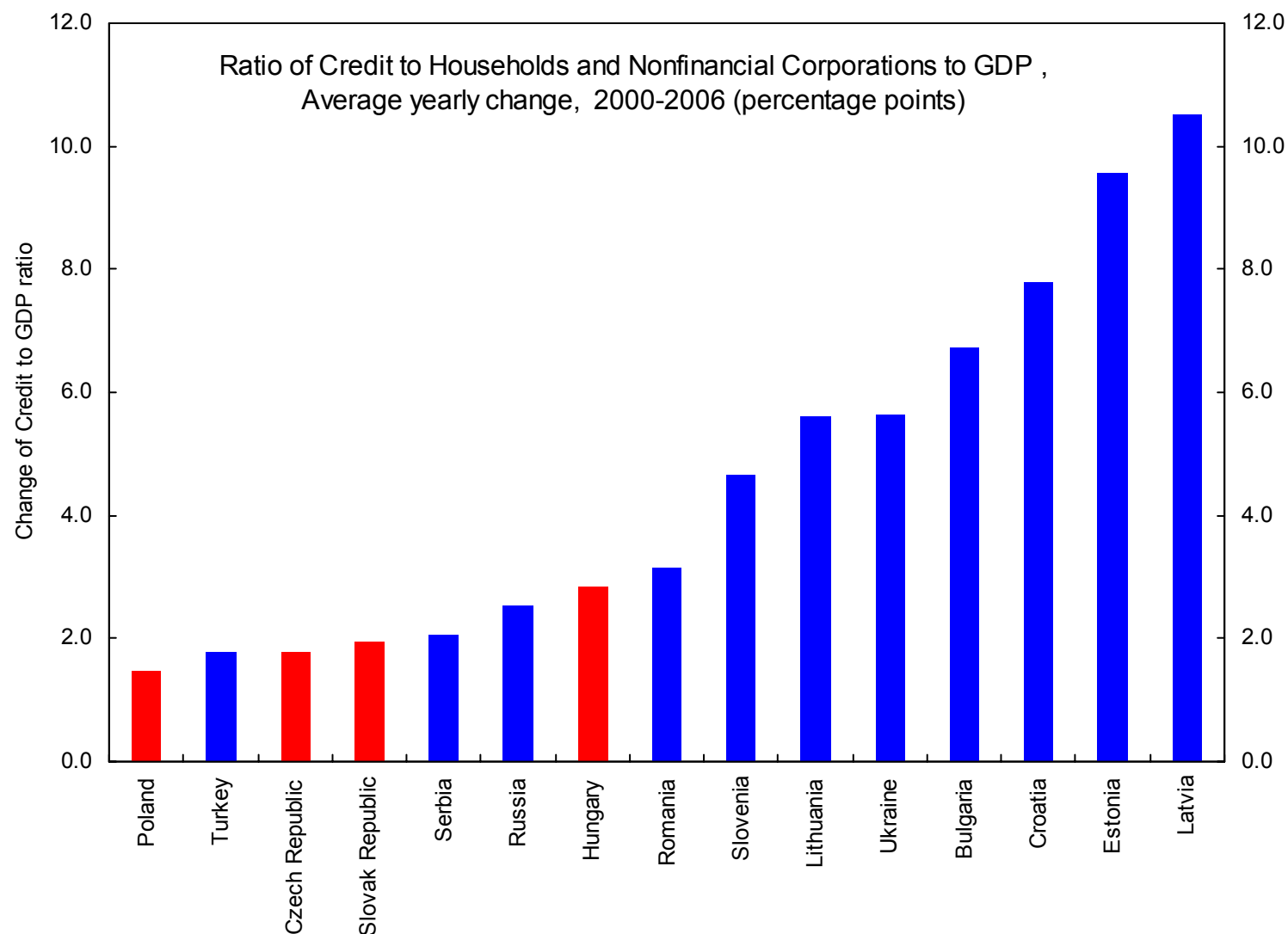
- What are the common patterns of rapid financial deepening?
- How do we interpret these common patterns?
- What are the risks and challenges of rapid financial deepening?
- How can policymakers best manage the risks and meet the challenges?

What are the common patterns
of rapid financial deepening?

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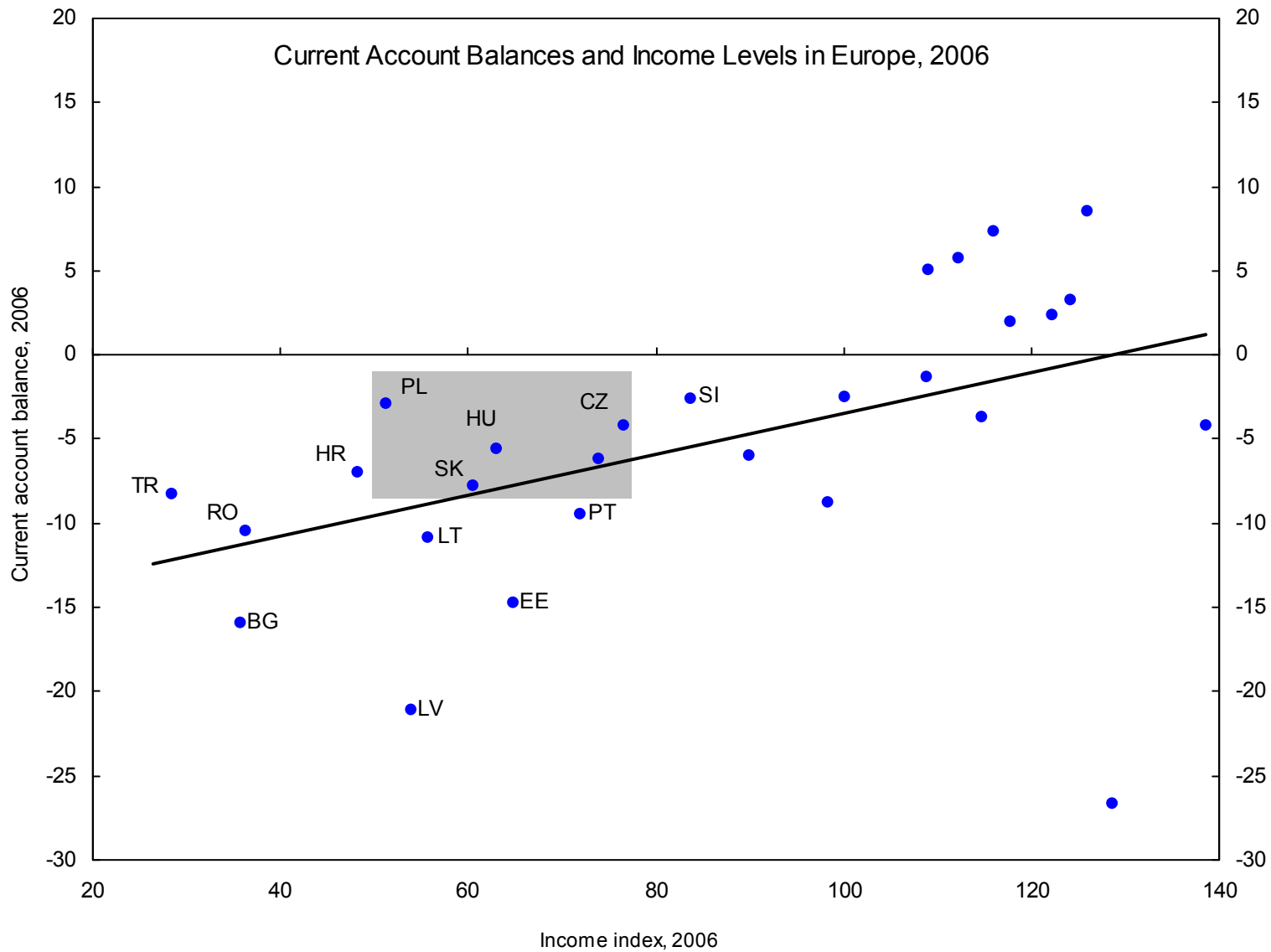
- Reflects rapid growth of credit as the result of large inflows of foreign capital
- Is especially evident in the expansion of credit benefiting the nontradables sector
- Occurs against the beneficial backdrop of income convergence and increasing financial integration

Rapid financial deepening mainly reflects the fast expansion of bank credit

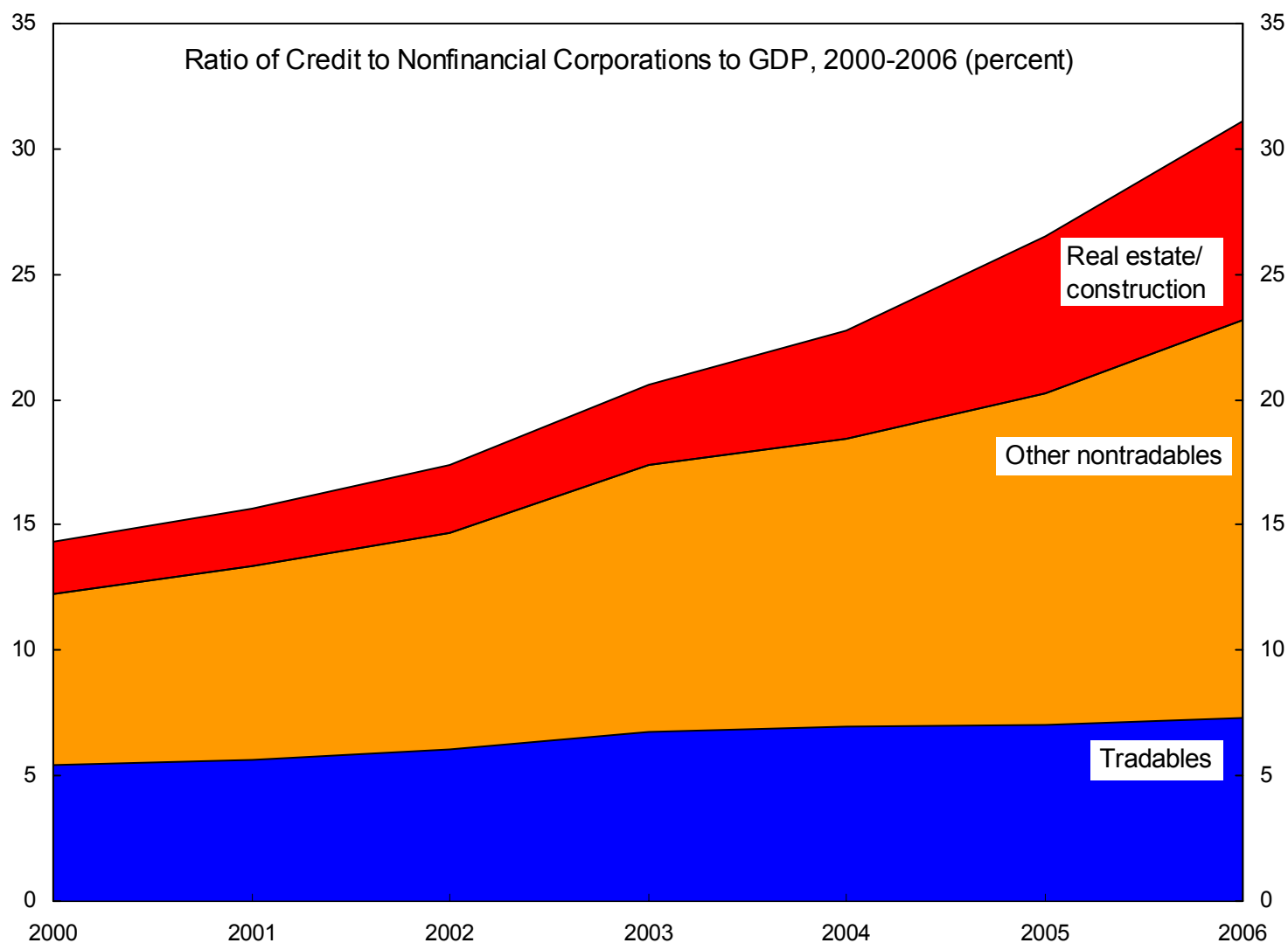


Note: Czech Republic and Serbia: 2001-2006; Slovak Republic: 2003-2006.

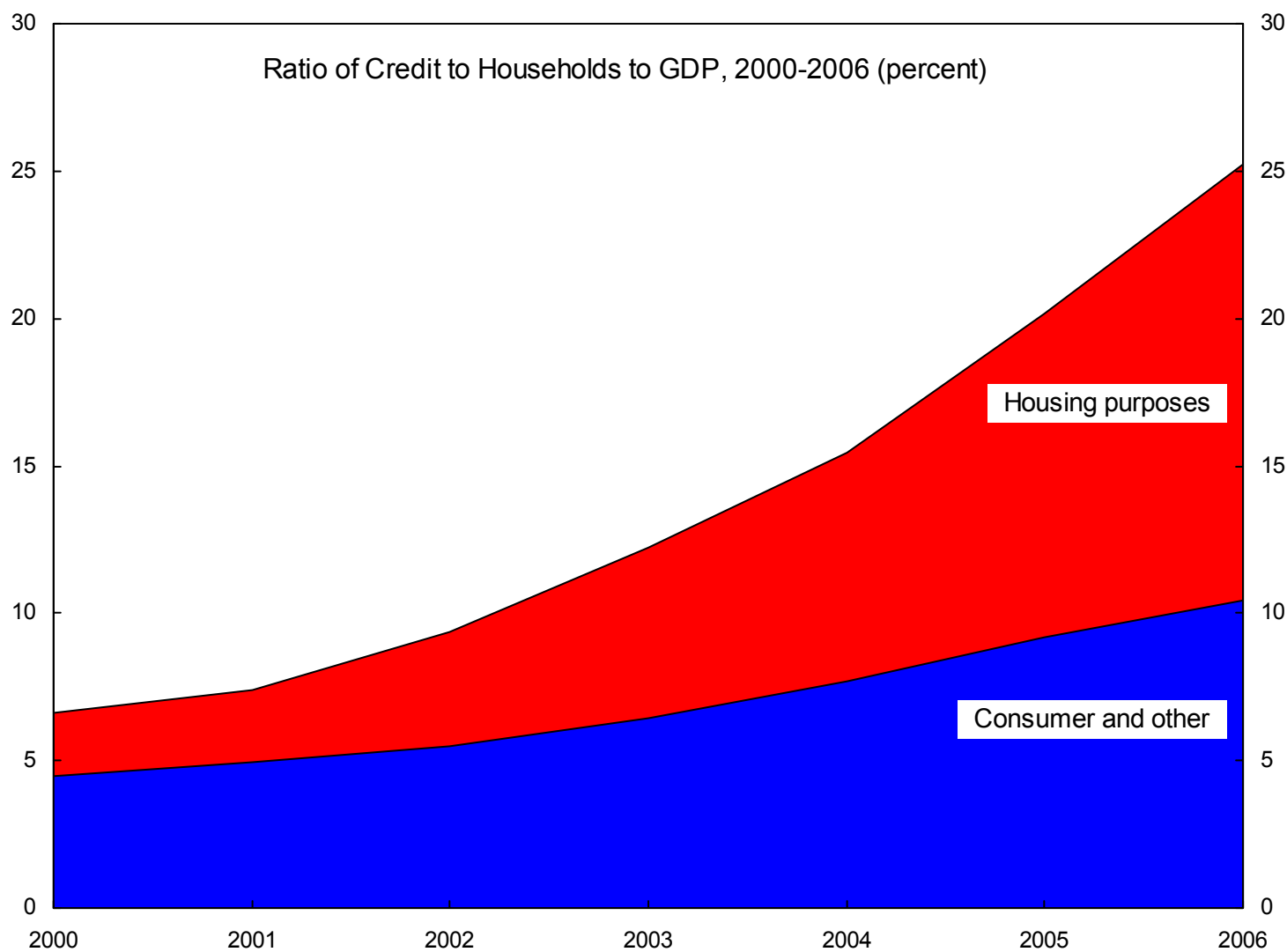
...triggered by the sizeable flow of foreign capital into emerging economies



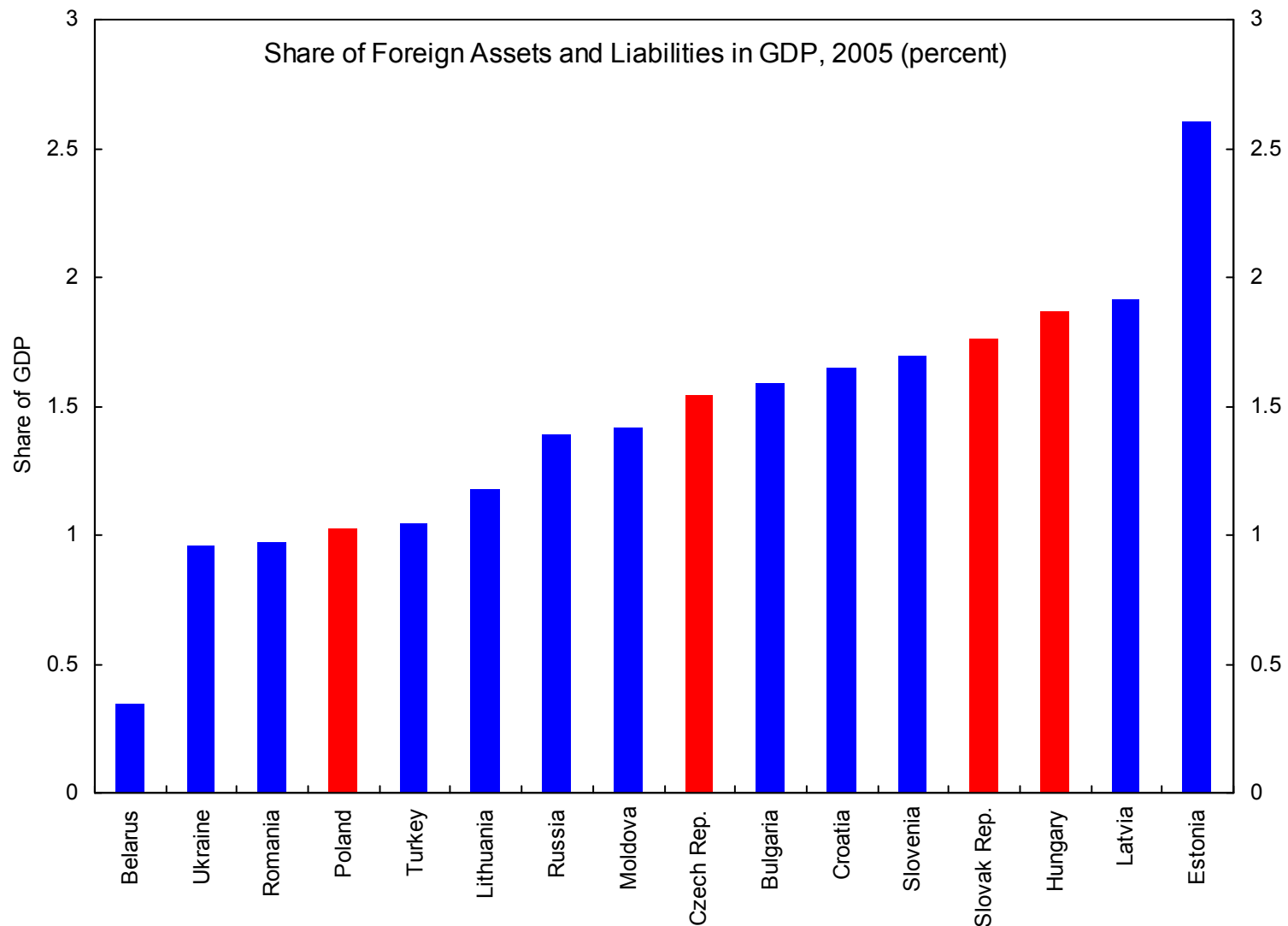
Rapid financial deepening is evident in the expansion of corporate credit to the nontradables sector...



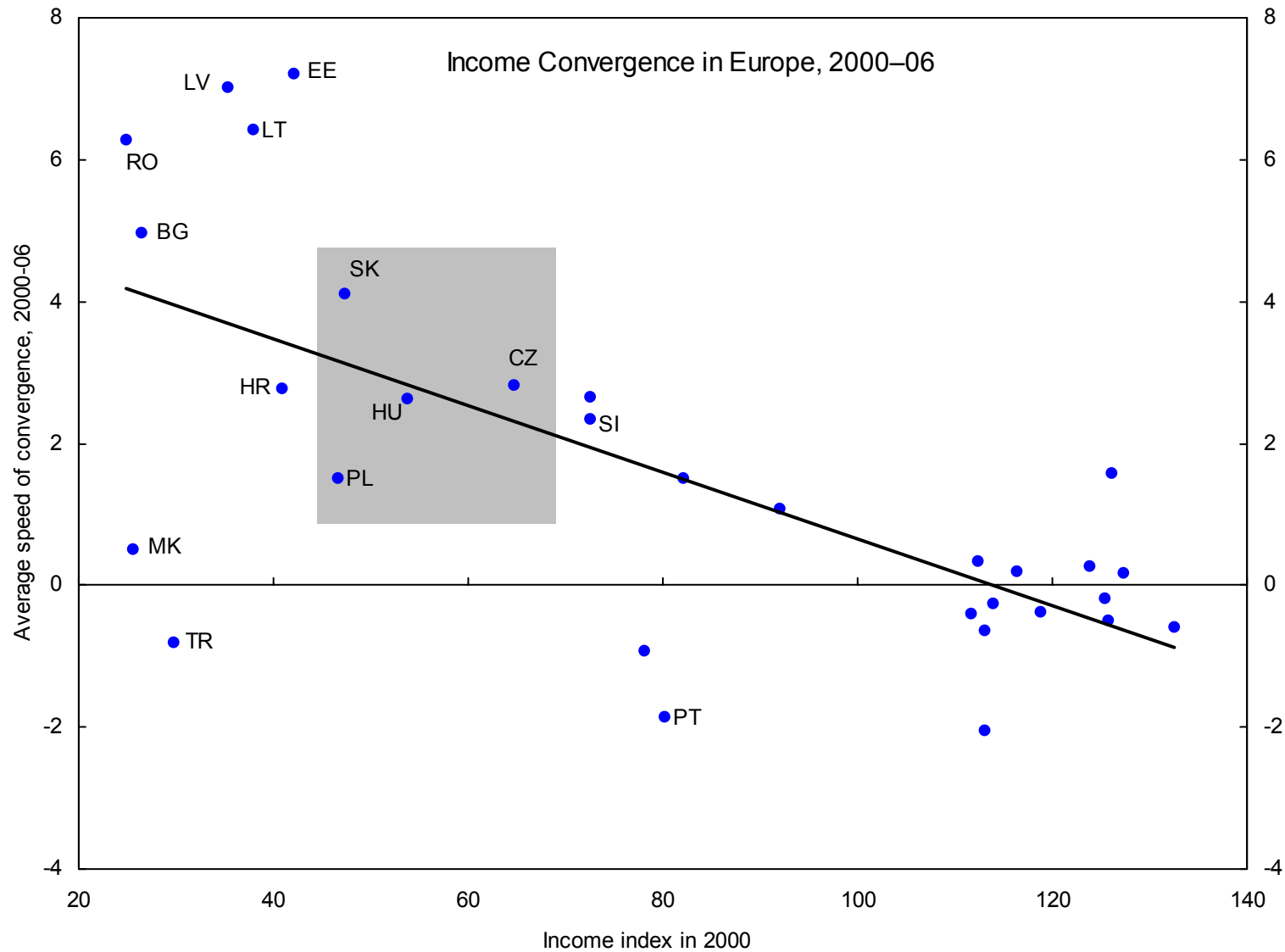
... and the exceptional increase of household credit for housing purposes



Rapid financial deepening takes place against the beneficial backdrop of increasing financial integration...



... and rapid income convergence throughout Europe



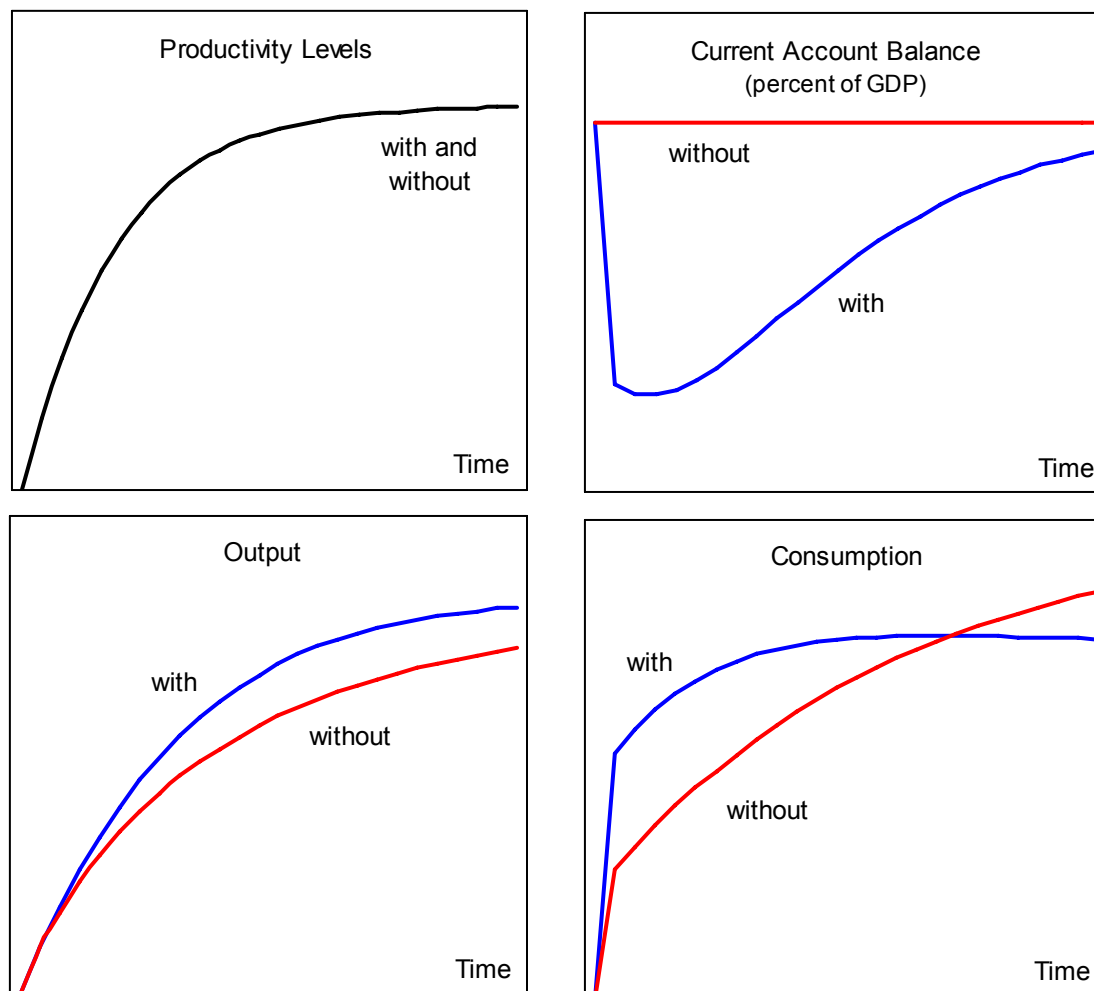
How do we interpret the common patterns of rapid financial deepening?

How do we interpret the common patterns of rapid financial deepening?

- Bright growth prospects attract capital inflows, which help consumption smoothing
- Convergence to bright prospects proceeds in two stages: the current account deficit first expands and then gradually declines
- The expansion of the nontradables sector is a natural outcome

Bright growth prospects attract capital inflows, which help consumption smoothing

Convergence With and Without Capital Inflows: Illustrative Model Simulations



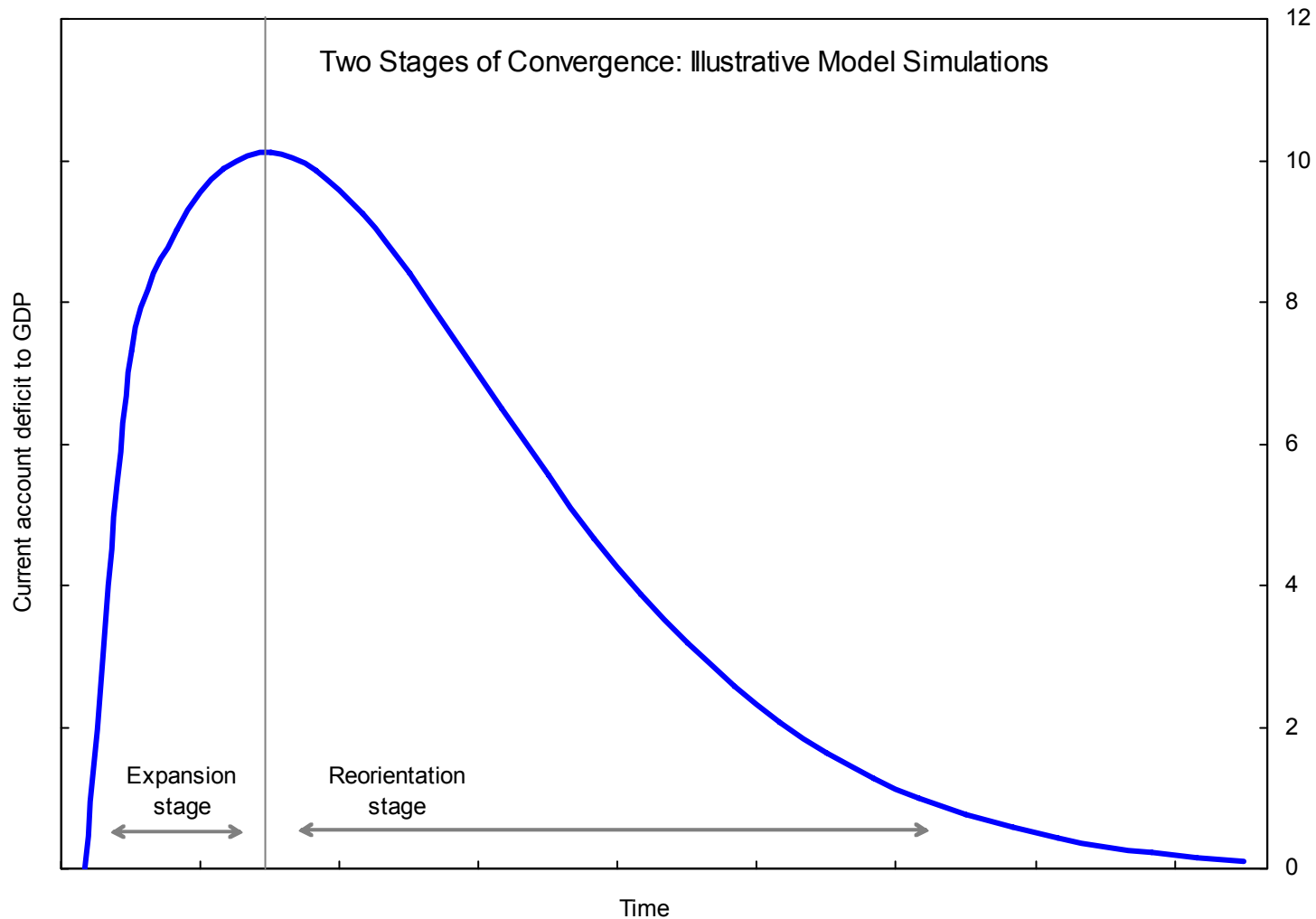
The Expansion Stage of Convergence

- **Booming demand**
 - Demand for tradable and nontradable goods rises
 - Rising expenditure is financed by borrowing abroad
- **Limited supply**
 - Tradables can be imported, but nontradables can't be
 - Local production capacity needs to be built up
- **Price adjustment**
 - The relative price of nontradable goods rises
 - Resources are channeled to the nontradables sector

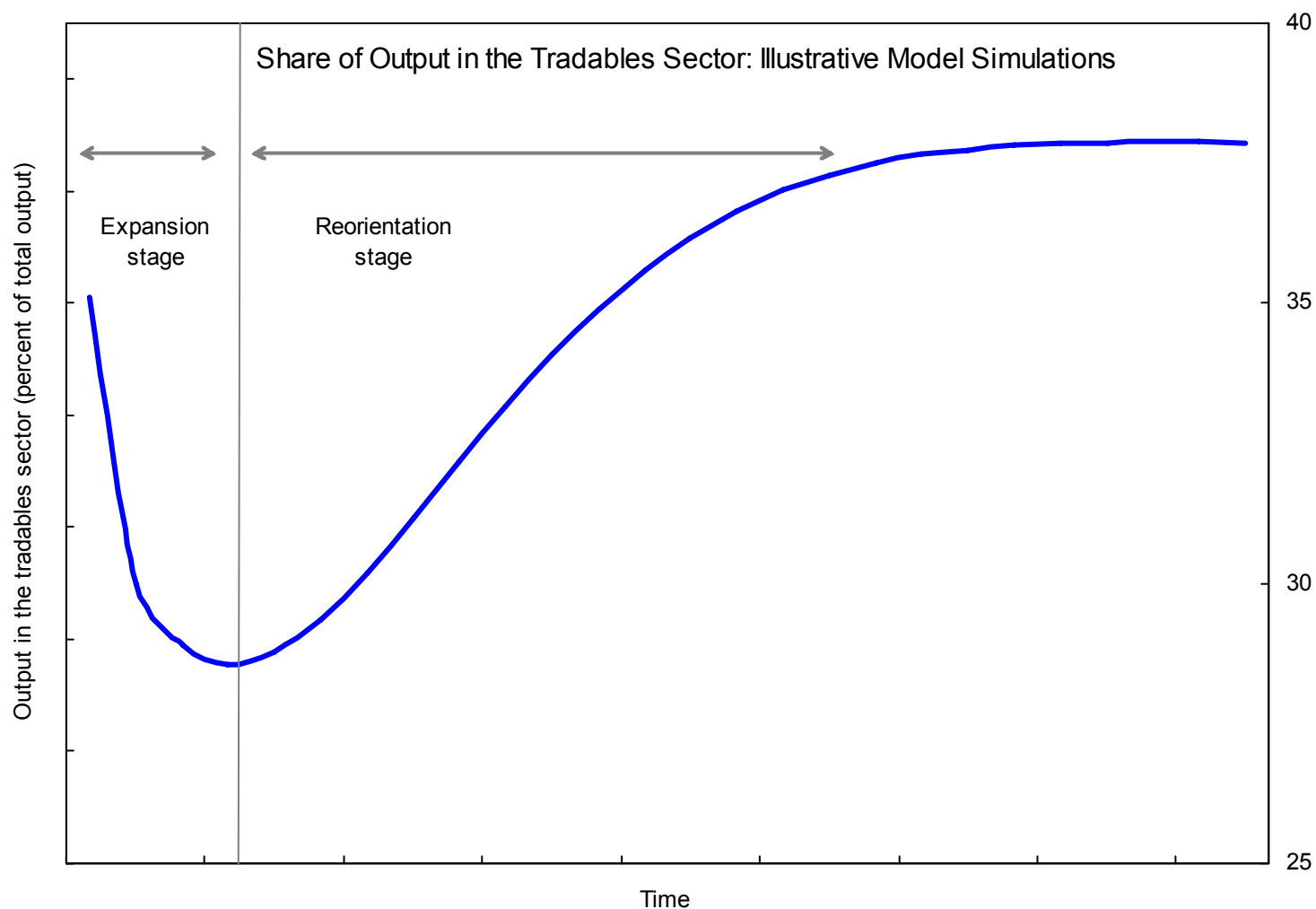
The Reorientation Stage of Convergence

- Dampening of price pressure
 - As capacity in the nontradables sector is built up...
 - ... excess demand is gradually reduced
- Reorientation of production
 - The relative price of nontradables will fall
 - Production of tradables becomes more attractive
- Rebalancing the current account
 - Tradables sector expands to meet domestic demand
 - ... and service the foreign debt.

The initial expansion and subsequent decline of the current account deficit is a natural outcome



The expansion of the nontradables sector is natural too, but the tradable sector needs to take over eventually



What are the risks and challenges of rapid financial deepening?

What are the risks and challenges of rapid financial deepening?

- Risks of the expansion stage
 - While the speed limits to expansion depend on many factors which are hard to measure...
 - ... breaking them leads to macroeconomic concerns and financial vulnerabilities
- Challenges of the reorientation stage
 - Large current account deficits require large reversals and also large shifts in the structure of production
 - Only countries with high levels of economic flexibility can afford to run large imbalances

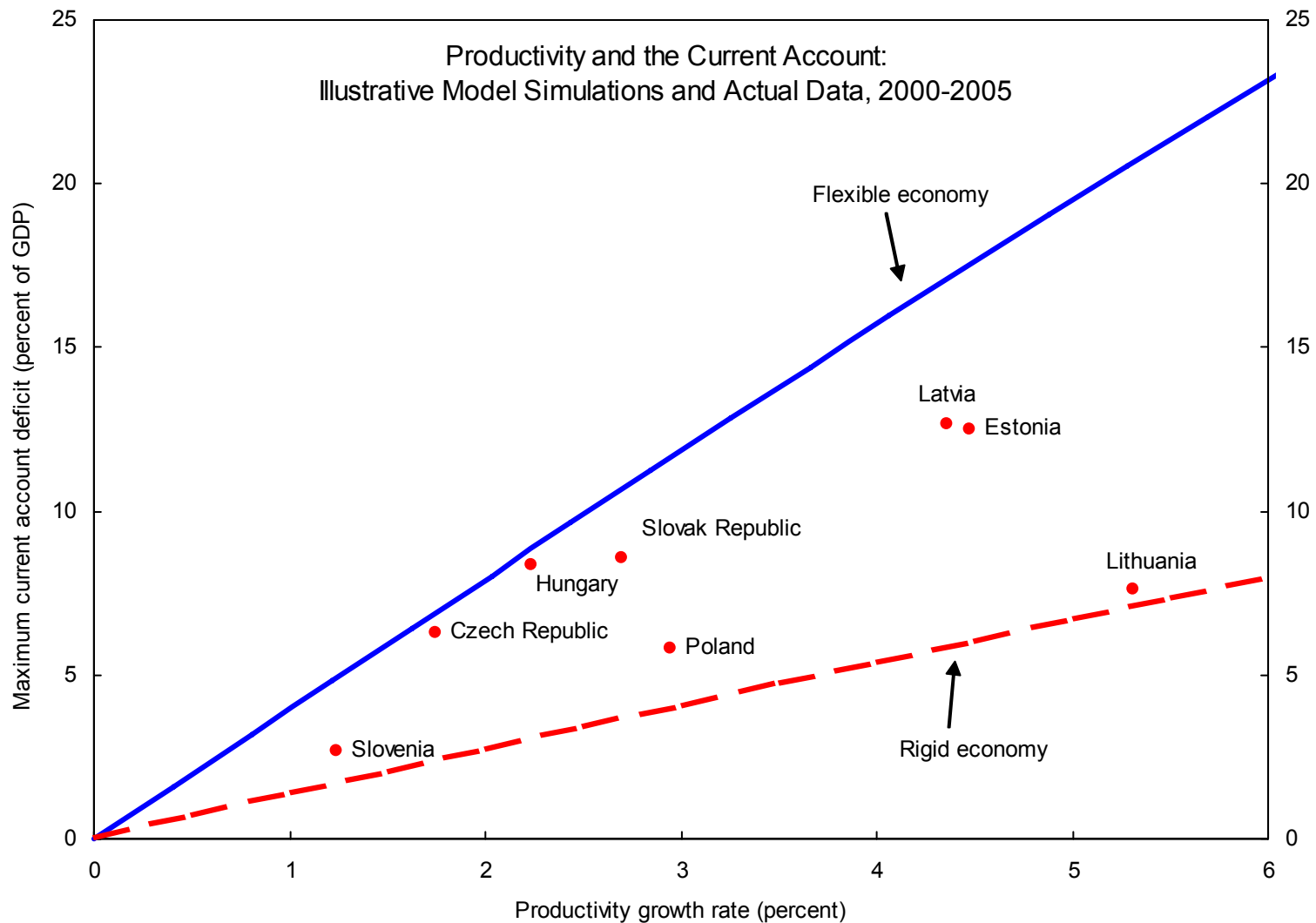
The risks of the expansion stage closely relate to the speed limits of finance and convergence

- Large capital inflows and rapid financial deepening fast forward convergence but also engender risks
- The challenge during the expansion stage is to drive safely at high speed
- But what are the speed limits? And what are the costs of breaking the speed limits?

What are the speed limits?

- While theory provides qualitative guidance...
 - productivity
 - factor market flexibility
 - financial development
 - risk appetite
- ... speed limits remain hard to quantify
 - risks during both stages of convergence
 - variation over time
 - variation across countries

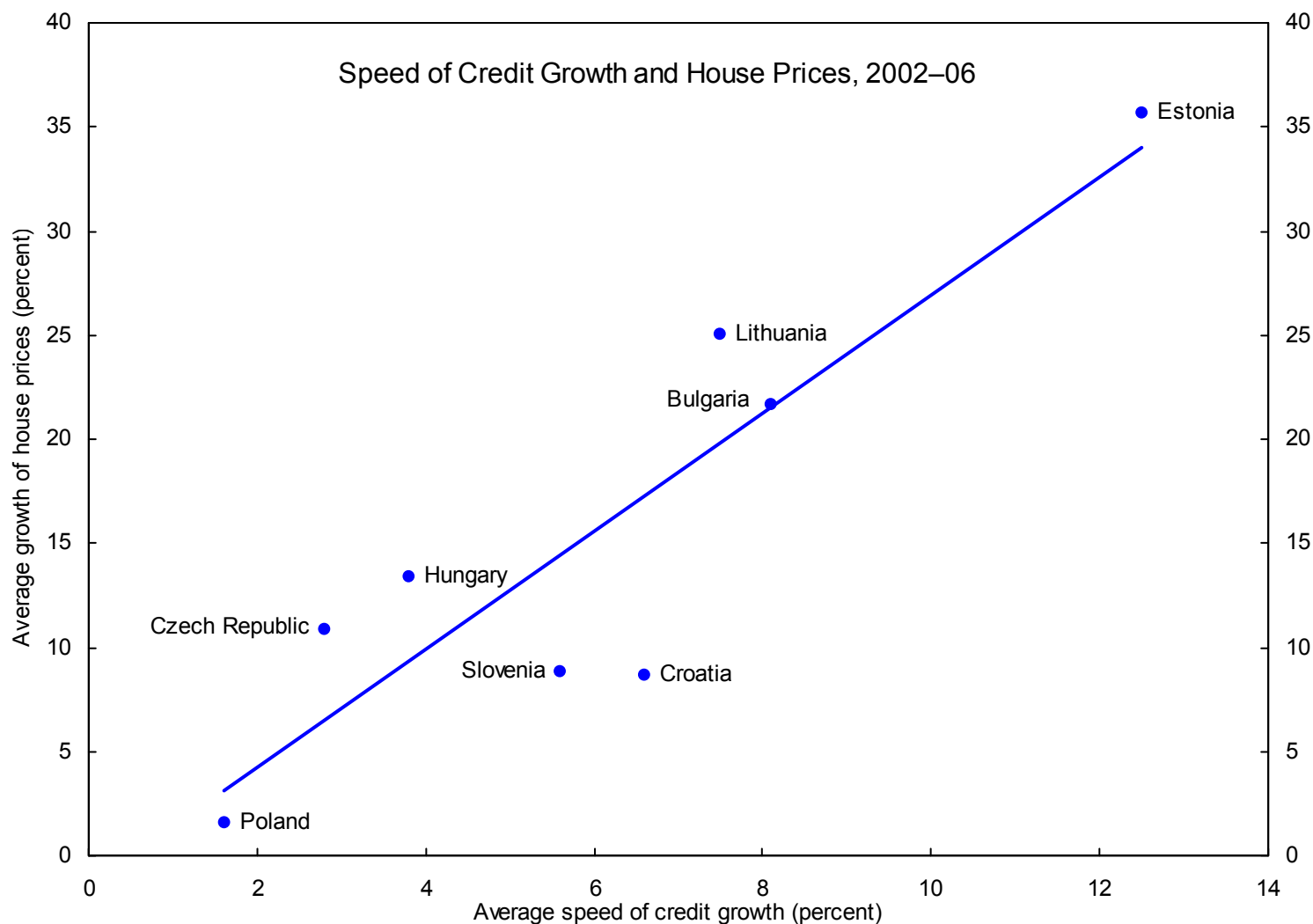
Many factors, such as economic flexibility and productivity, need to be considered simultaneously



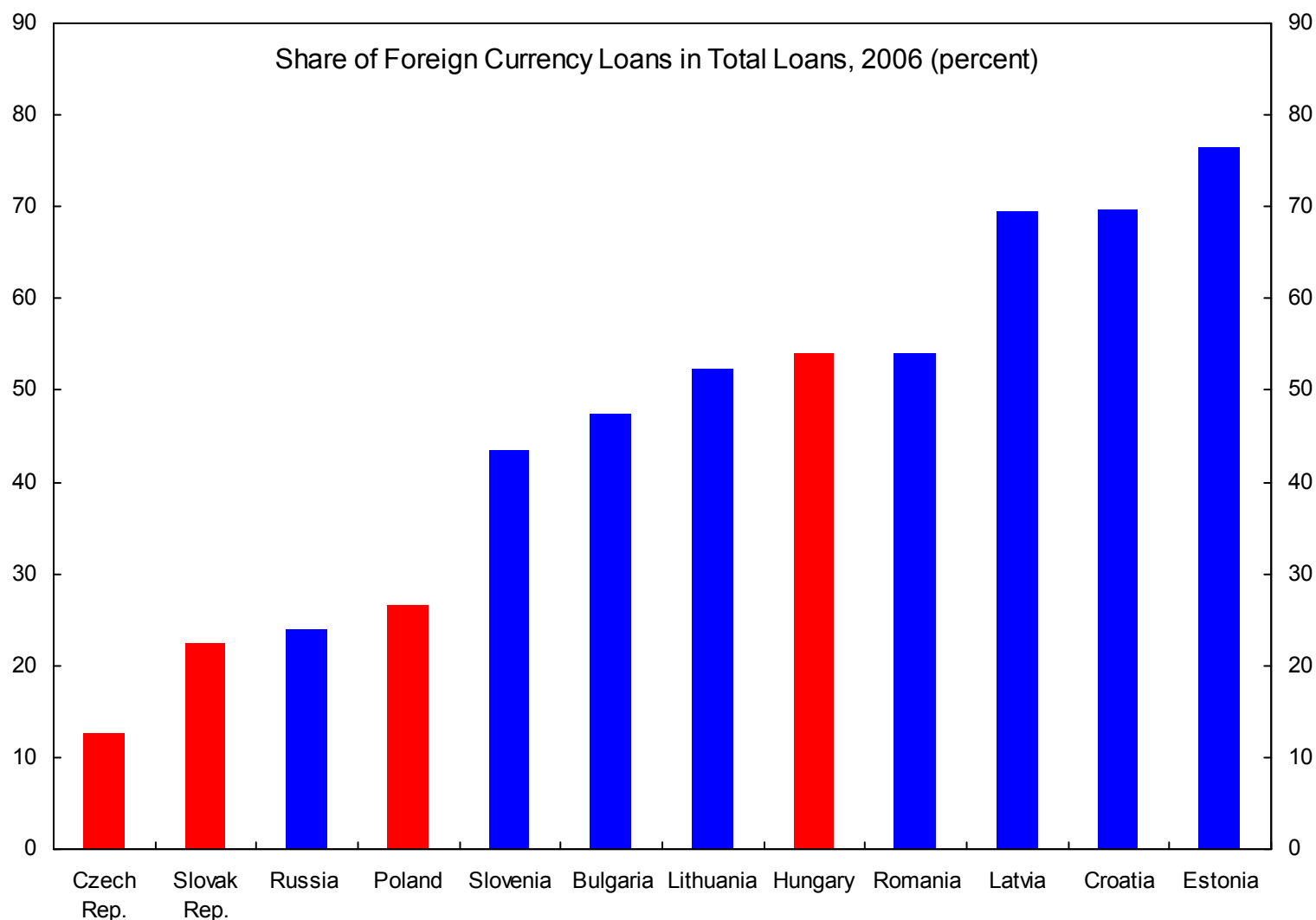
What are the costs of breaking the speed limits?

- The macroeconomic concerns are well known
 - overheating
 - competitiveness
 - asset price inflation
- Financial sector may exacerbate vulnerabilities
 - overconfidence
 - financial accelerator
 - lending standards
 - common-lender contagion

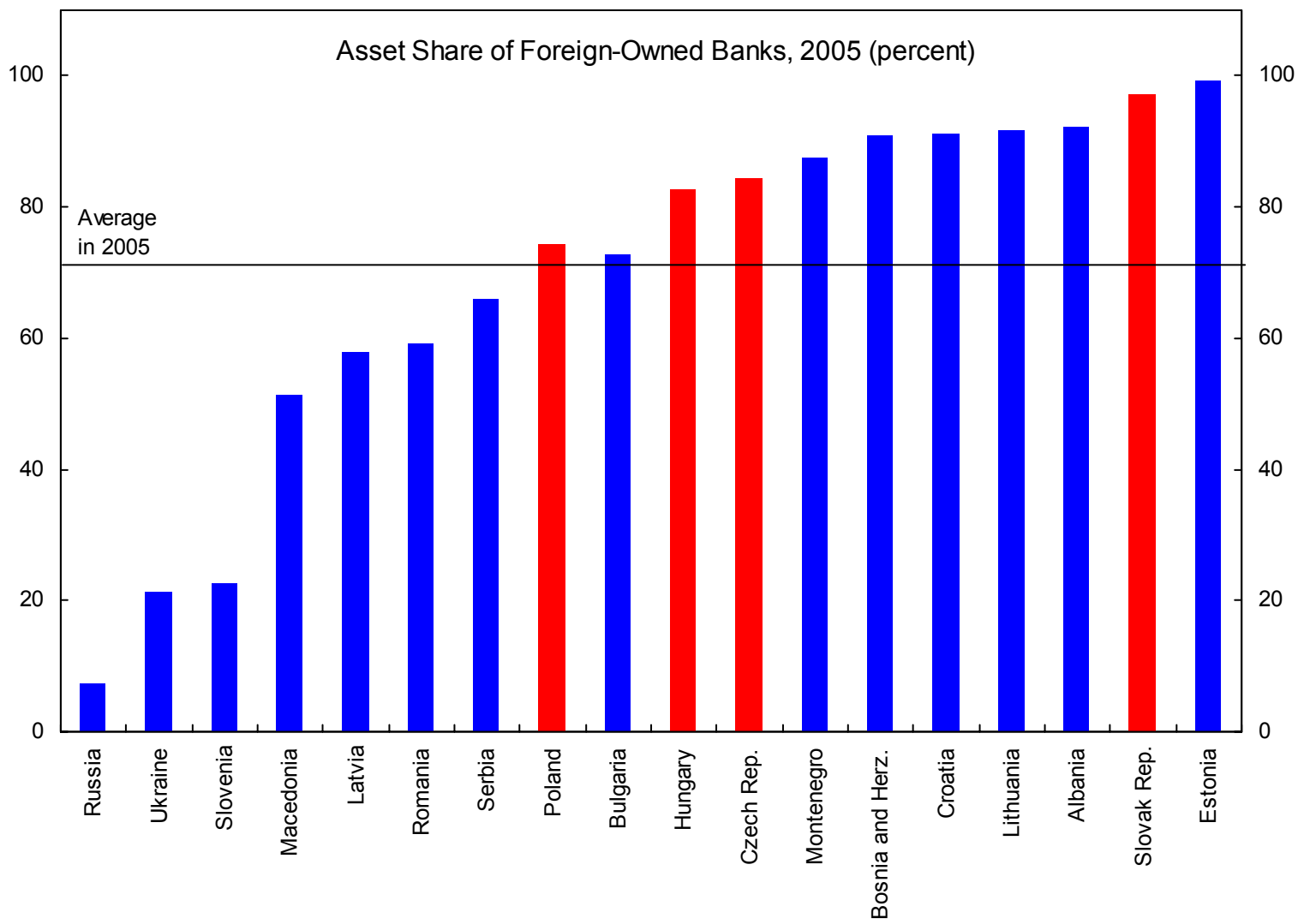
The interaction between housing prices and borrowing capacity may cause a self-feeding frenzy



When competition for market share is fierce, borrowers may end up with too much debt or too much risk



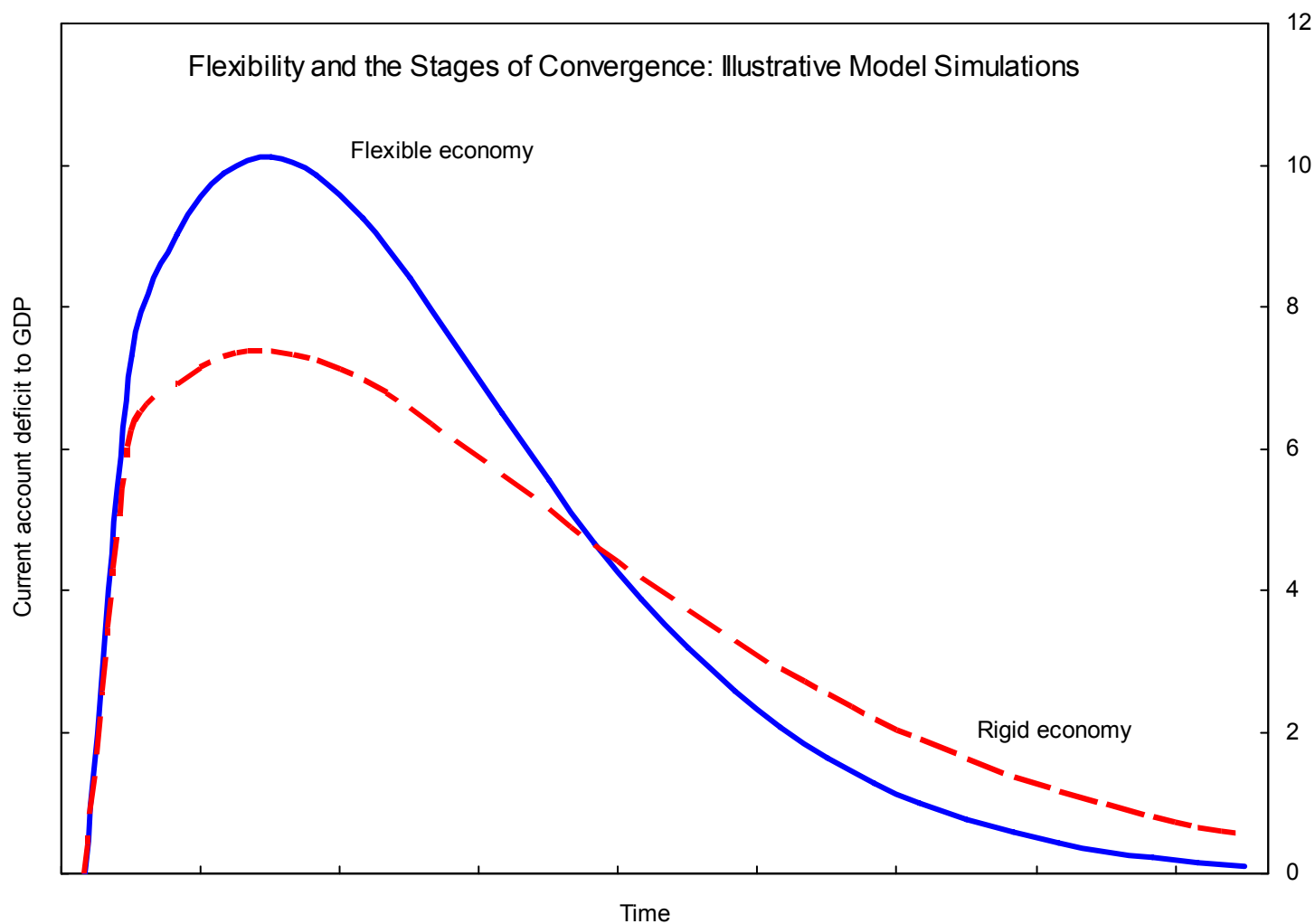
Foreign banks may help transmit shocks across countries



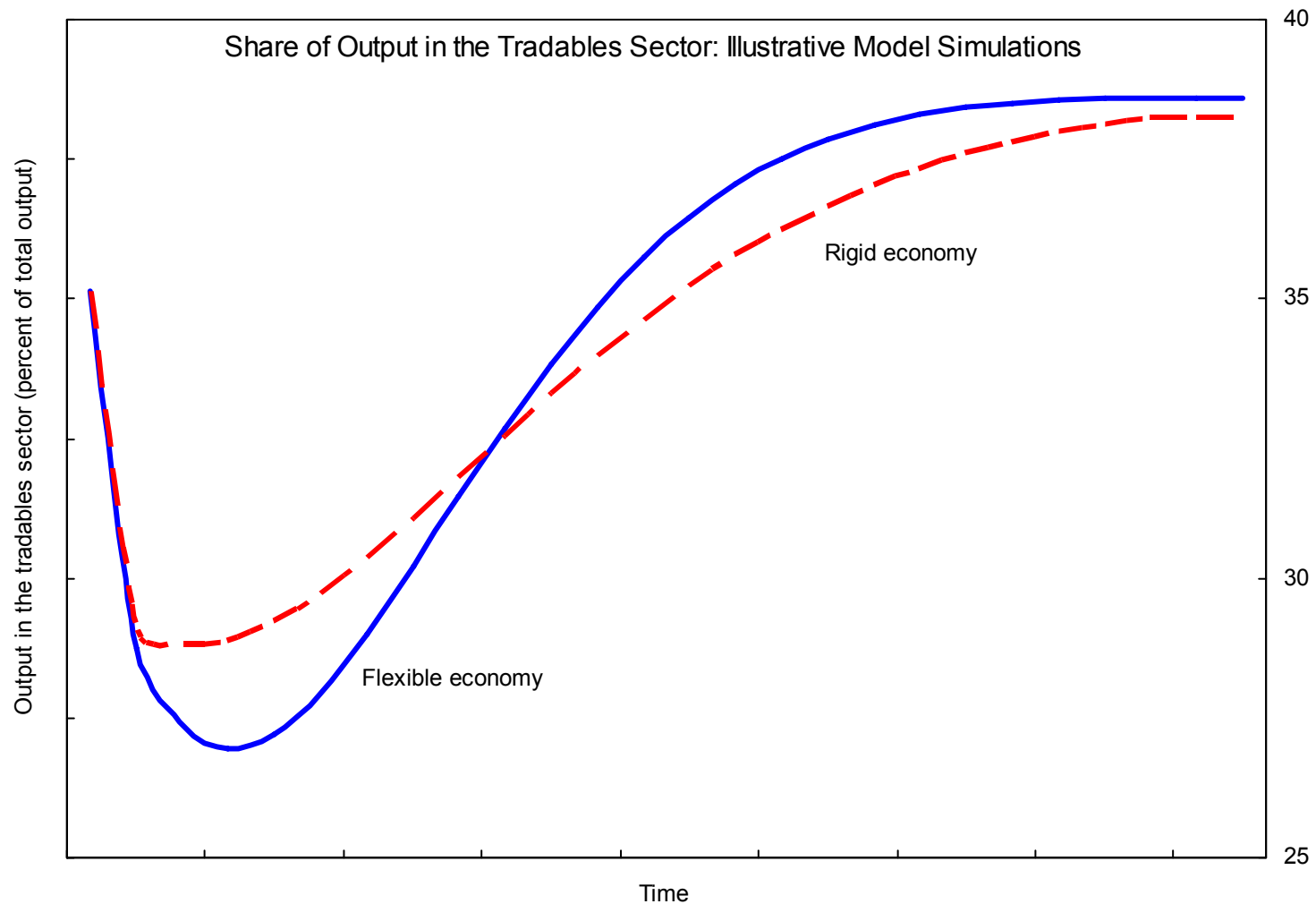
The challenges of the reorientation stage are often overlooked, yet equally important

- Even if fast driving is safe and the expansion stage is completed without accidents...
- ...large current account imbalances may still be undesirable if they cannot be reversed easily
- The key risk during the reorientation stage is that this reversal entails a painful adjustment

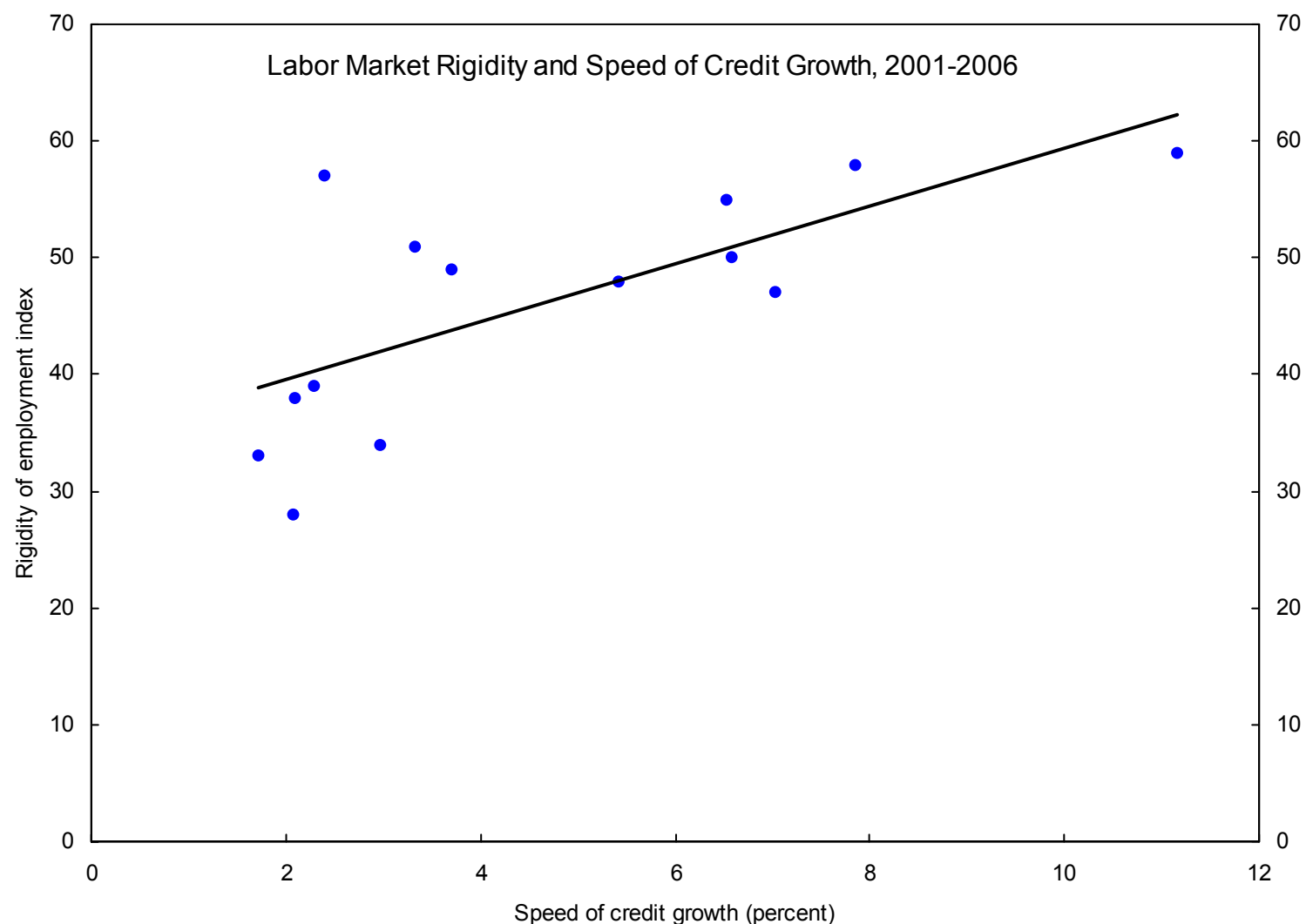
As large imbalances require large reversals, only highly flexible economies can afford to run large imbalances



Flexibility is needed to ensure that capital and labor can shift smoothly between sectors



From this point of view, the positive correlation between credit growth and labor market rigidity is worrisome



How can policymakers best manage the risks and meet the challenges?

How can policymakers best manage the risks and meet the challenges?

- Managing the risks of the expansion stage
 - As speed limits are uncertain, it is appropriate to err on the side of caution
 - Hitting the brake may be desirable but is not always possible
 - Supervisors need to stay on the ball by building buffers and reducing vulnerabilities
- Meeting the challenges of the reorientation stage
 - Fostering flexibility and financial development will help turn imbalances around smoothly

As speed limits are uncertain,
erring on the side of caution is appropriate

- Since speed limits are hard to measure, determining who is speeding is difficult
- The costs of breaking the speed limits are nevertheless likely to be significant
- The appropriate response under these conditions will be...
 - to err on the side of caution and
 - to carefully manage the risks of financial speeding

Hitting the brake may be desirable but is not always possible

- Fiscal policy tightening may improve investor confidence and attract additional capital inflows
- Rapid deposit growth or easy access to parent funding limits monetary policy effectiveness
- Raising reserve requirements creates incentives to circumvent them, giving rise to prudential concerns
- Capital controls do not have a lasting impact

Supervisors need to stay on the ball by building buffers and reducing vulnerabilities

- Raising prudential standards
 - Bank distortions
 - Capital requirements
 - Risk-based supervision
- Upgrading supervisory cooperation & coordination
 - Across borders, between home and host supervisors
 - Within borders, between bank and nonbank supervisors
- Enhancing risk disclosure
 - Disclosure requirements
 - Public awareness campaigns

Fostering flexibility and financial development will help turn around imbalances smoothly

- Fostering flexible labor and capital markets
 - Flexibility in terms of not only hiring, firing and hours but also skills is required for labor markets
 - Diverse financial systems are needed for capital markets
 - Rigid exchange rates strengthen these needs
- Improving financial infrastructure
 - Creditor protection, corporate governance, credit information help channel resources to tradable sector
 - Developing missing market segments will help mobilize domestic savings

Conclusions

- What are the common patterns of rapid financial deepening?
 - Capital inflows have triggered fast credit growth
 - Nontradables sector has been booming
 - Rapid income convergence and increasing financial integration provide a beneficial context
- How do we interpret these common patterns?
 - Capital inflows ease consumption smoothing
 - Convergence optimally consist of two stages
 - Imbalances and nontradable booms are natural outcomes

Conclusions

- What are the risks and challenges of rapid financial deepening?
 - Speed limits depend on many factors hard to measure
 - Breaking the speed limits may be costly
 - Large imbalances require large reversals
 - Only flexible economies can afford large imbalances
- How can policymakers best manage the risks and address the challenges?
 - The appropriate response is to err on the side of caution
 - Hitting the brake may be desirable but is not always possible
 - Supervisors need to build buffers and reduce vulnerabilities
 - Greater factor flexibility and financial development are key