



Central and Eastern Europe: Global spillovers to the financial sector

18th Economic Forum in Krynica

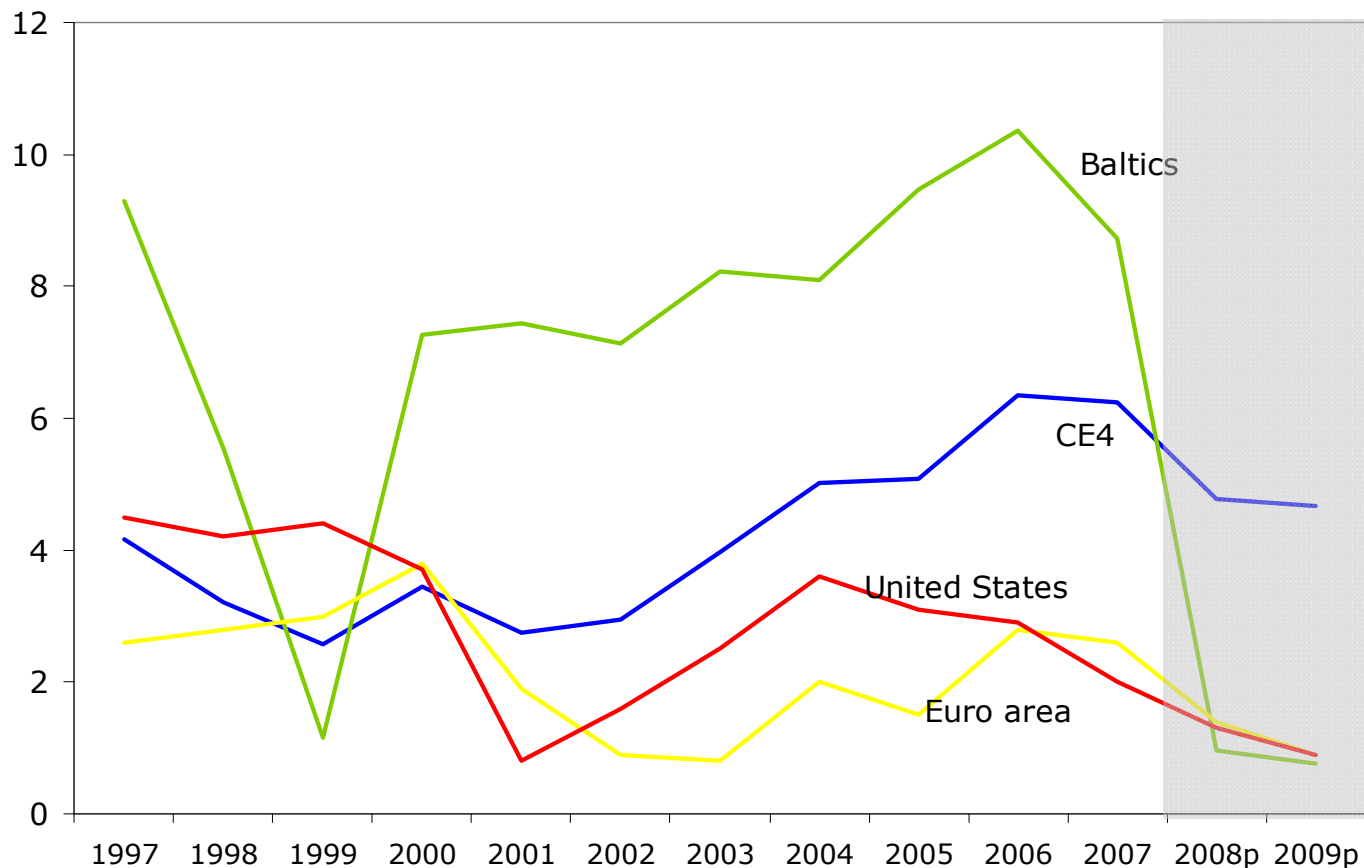
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Overview

- The CEEs' macro picture is increasingly affected by the global credit crunch and commodity price inflation
- Large external imbalances in some CEE countries are raising concerns
- The presence of foreign banks creates possible contagion channels
- What drives FX borrowing?

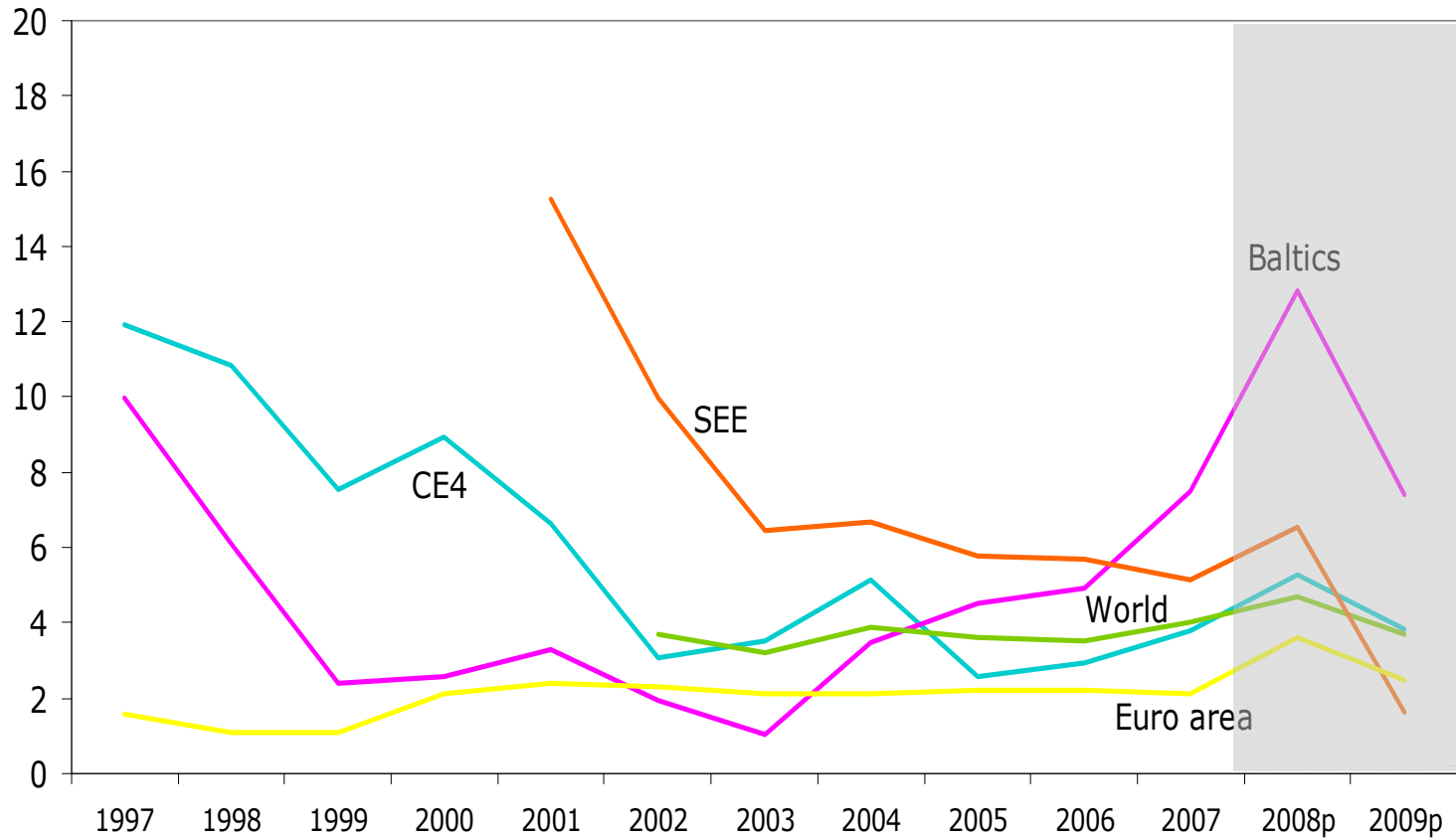
Growth is expected to slow, due to spillovers from the US and the Eurozone

Annual GDP growth (percent)



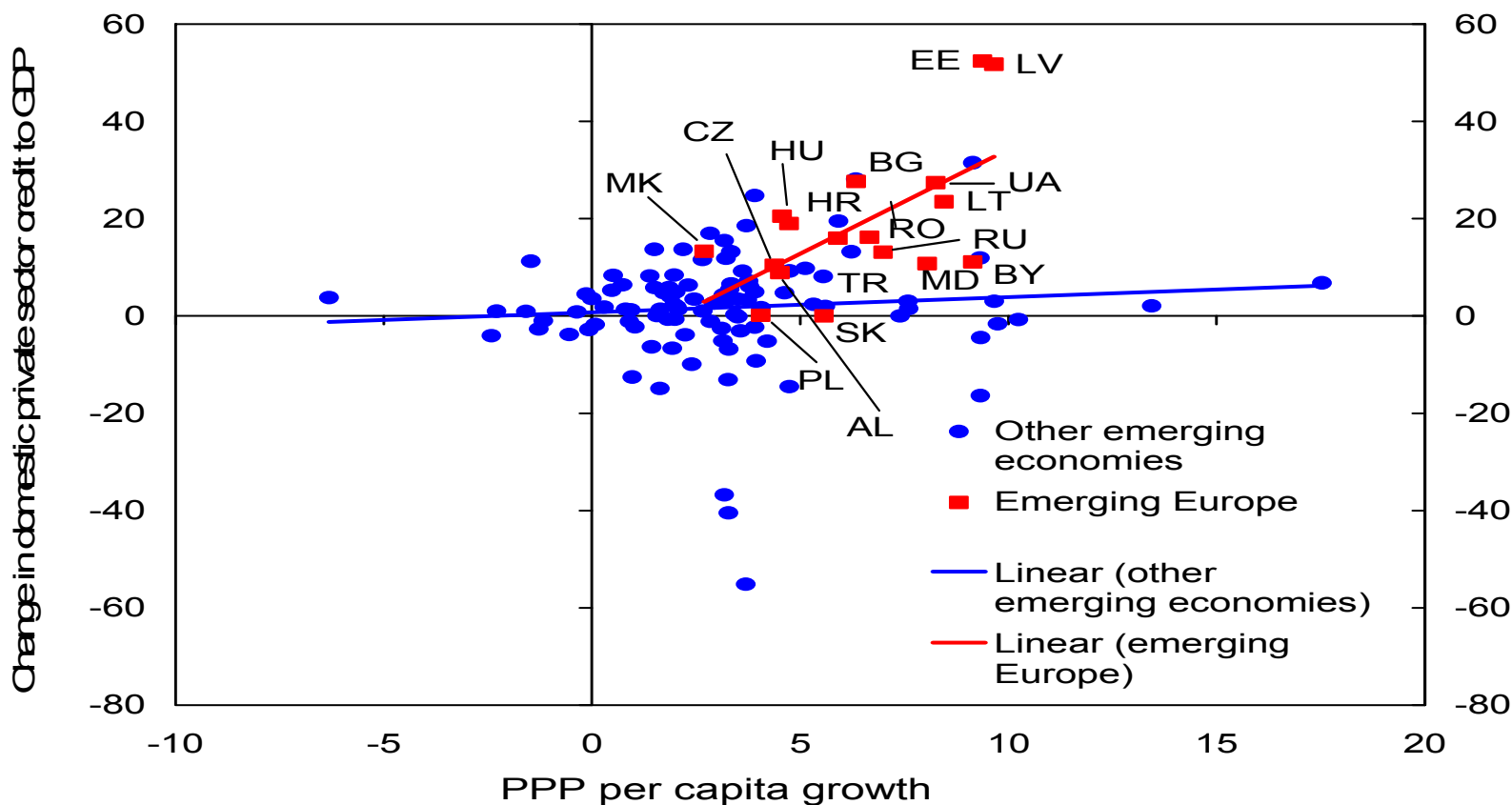
Rising inflation is a concern

Annual average CPI (percent)

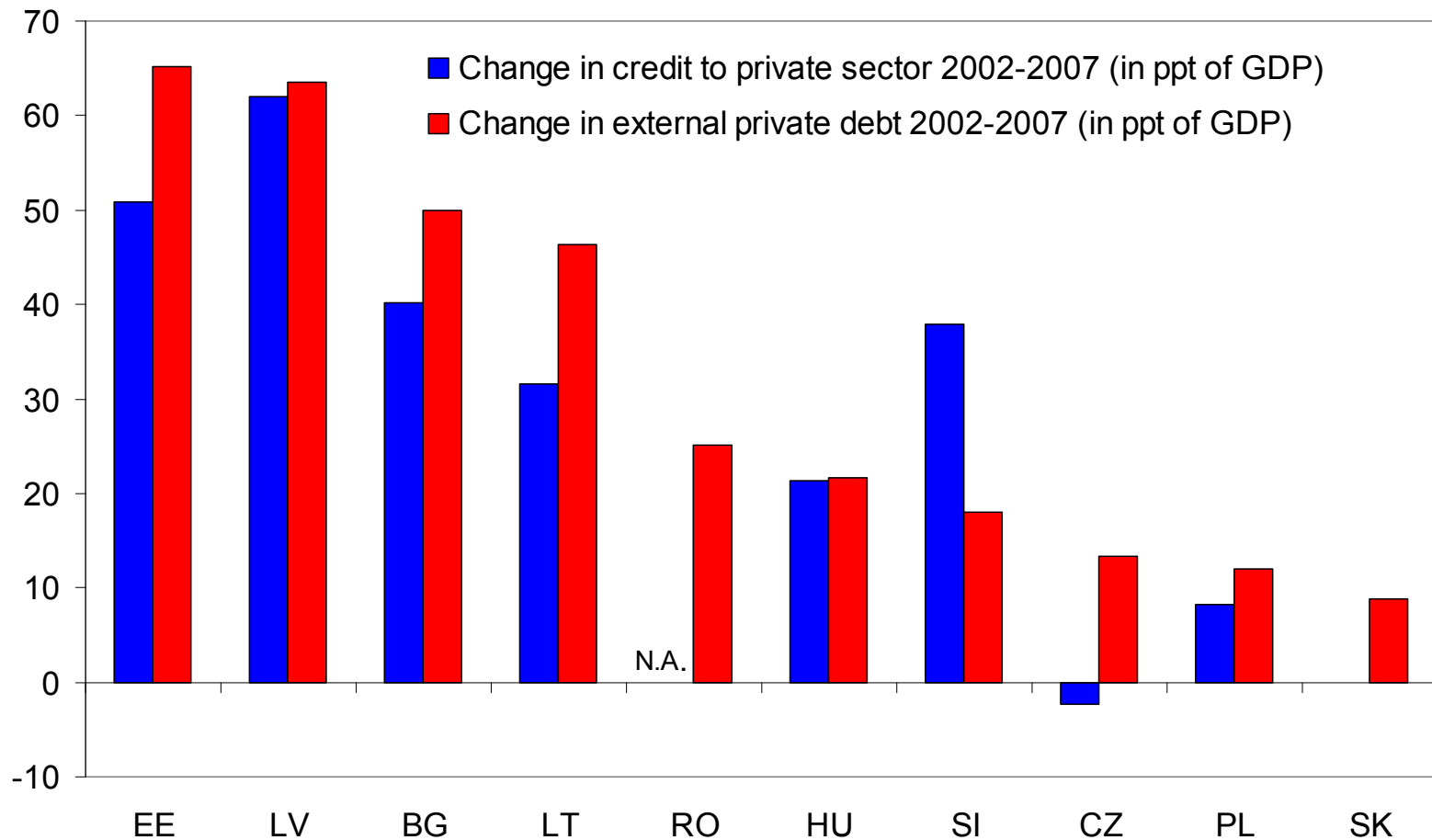


Against this background, financial intermediation has considerable scope to deepen and broaden, although the pace may slow

Growth and Private Sector Credit Growth, 2002–06
(Percent)

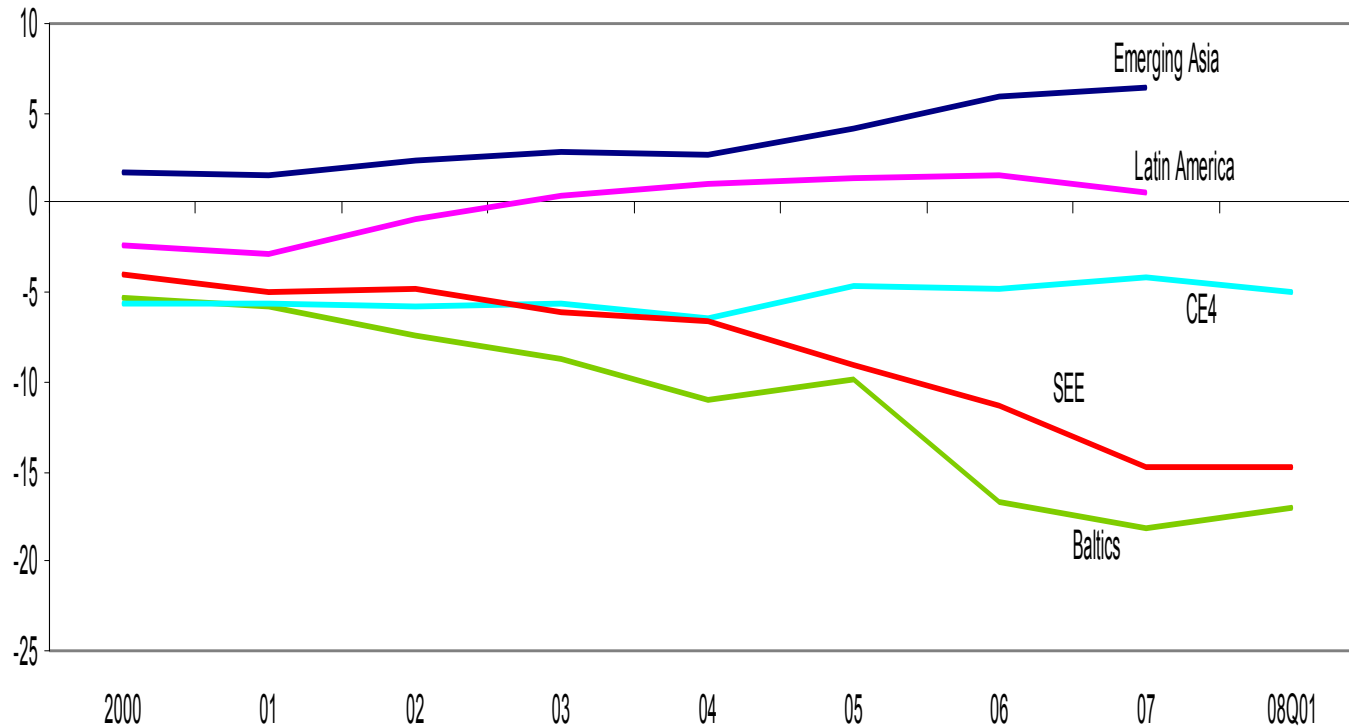


Financial deepening has been accompanied by an increase in foreign liabilities



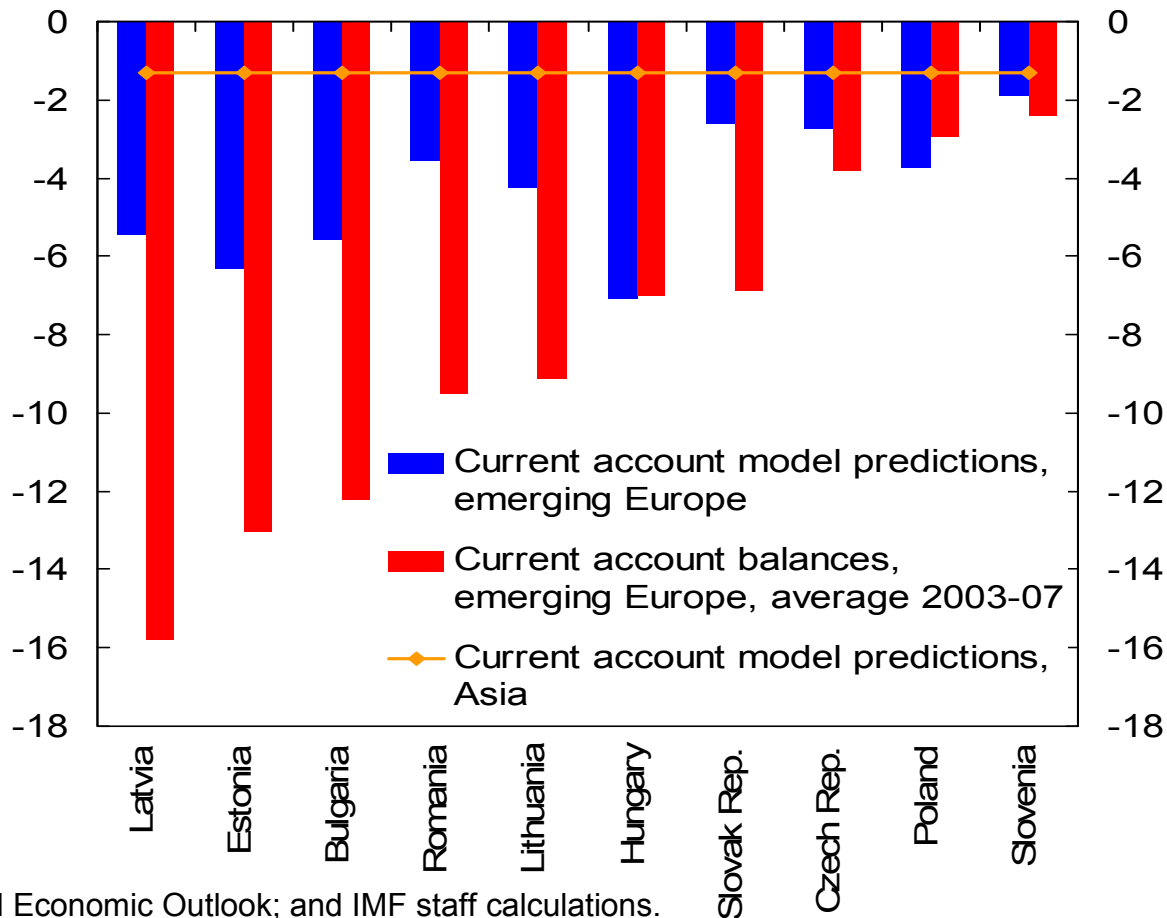
Current account deficits are especially high in the Baltics and South-Eastern Europe

Current account deficit
in percent of GDP



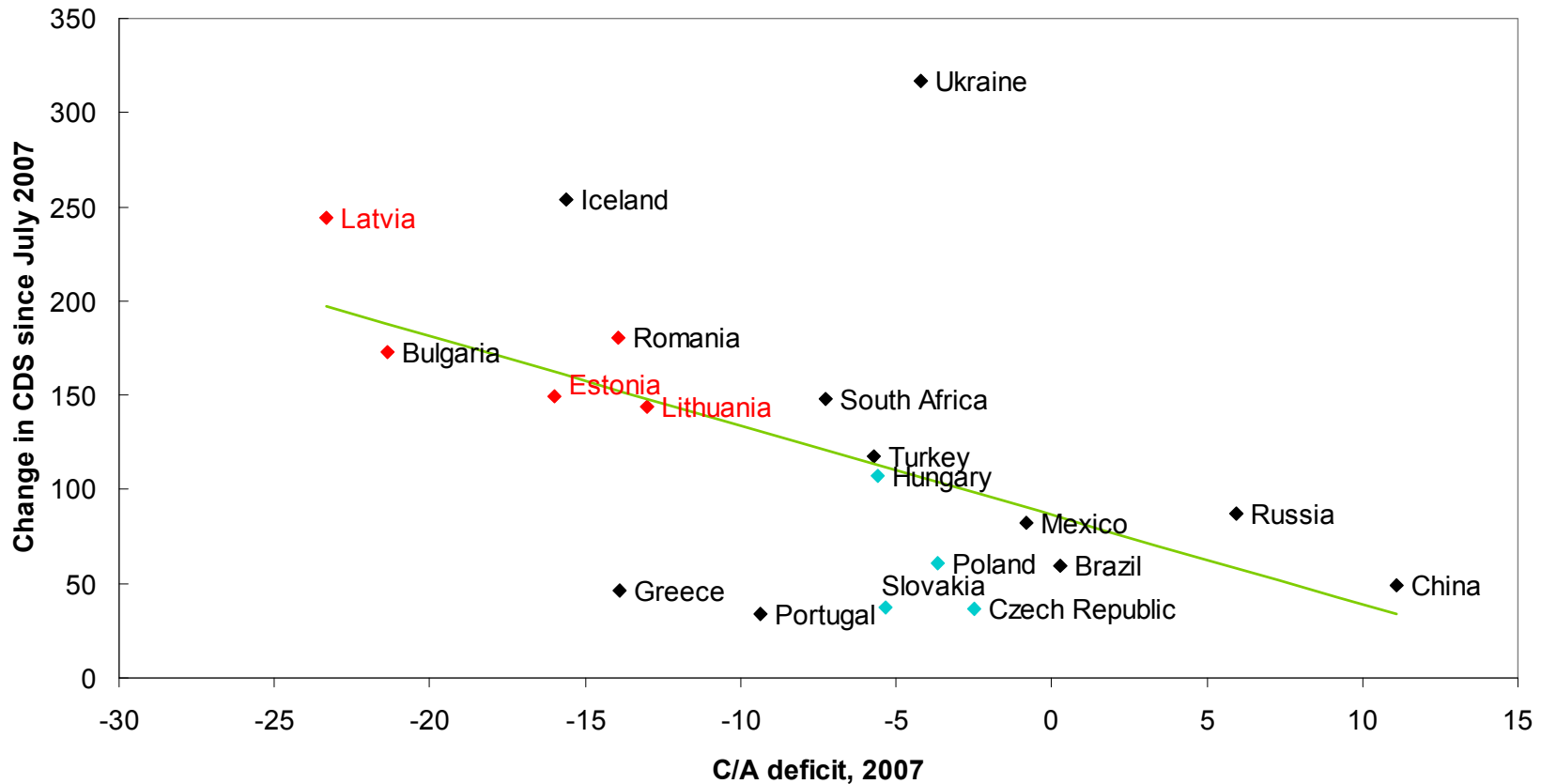
C/A deficits in some countries are much higher than supported by fundamentals (Rahman IMF WP 08/92)

Current Account Balances and Model Predictions
(Percent of GDP)



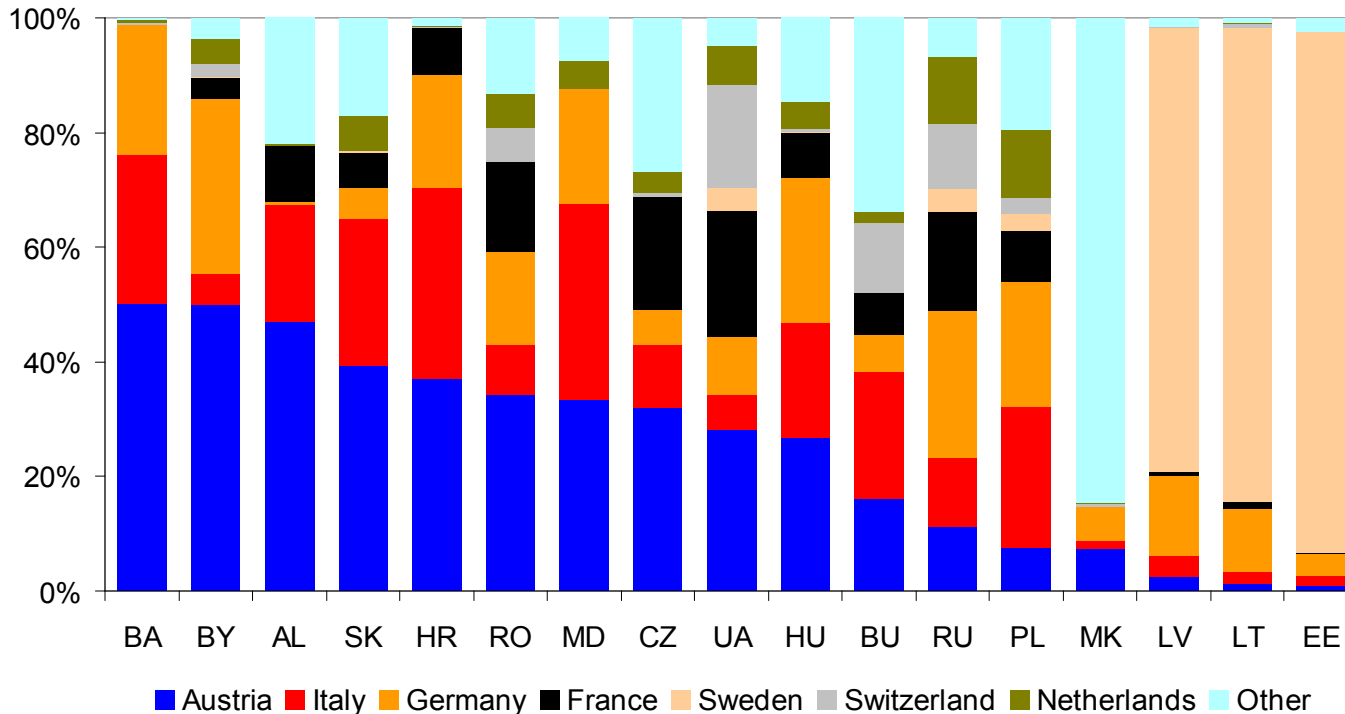
Sources: IMF, World Economic Outlook; and IMF staff calculations.

Countries with large external imbalances face higher financing cost



Cross-border exposures by international banks (especially from Sweden, Austria, Italy, Germany) create new channels of contagion

Concentration of Emerging Europe Exposure to Western Europe, 2007
(Percent)



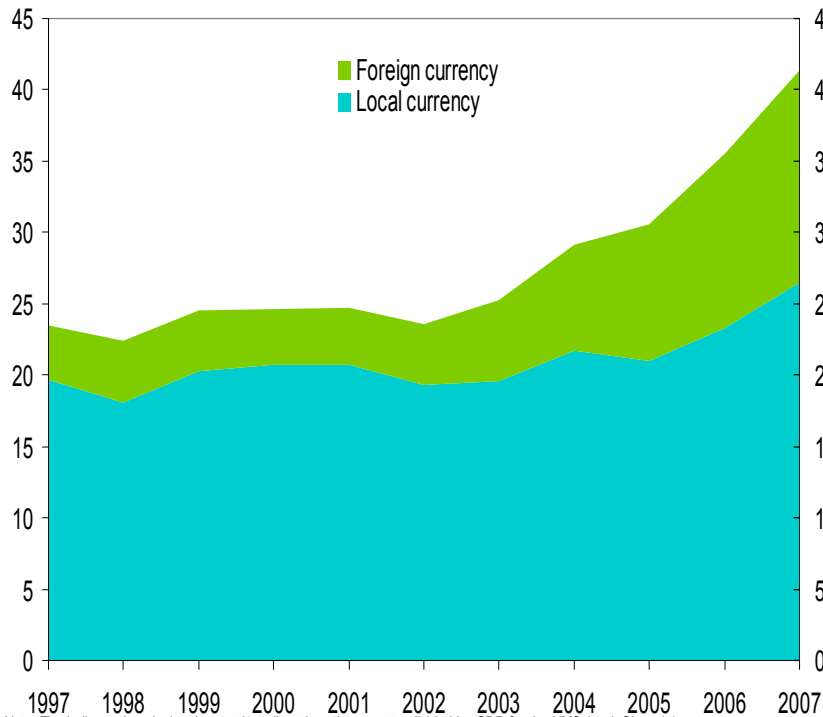
Source: Bank for International Settlements, Quarterly Review, June 2008.

Note: Country names are abbreviated according to the ISO standard codes.

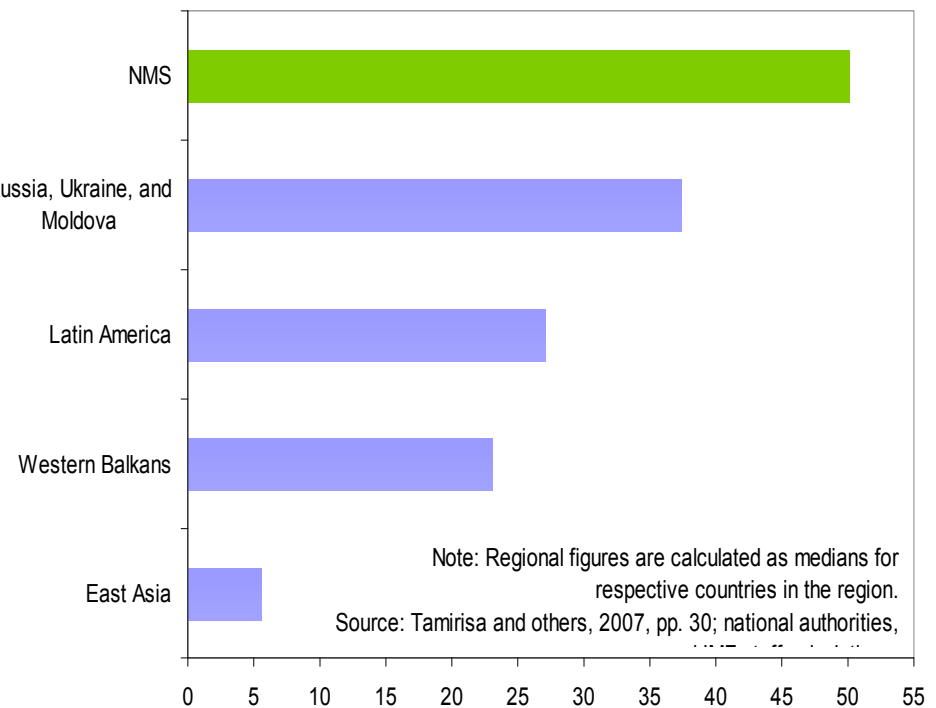
1/ Emerging Europe exposure to western European banks is defined as the share of the reporting banks in each western European country in the total outstanding claims on a given emerging European country (both bank and nonbank sectors). For example, about 42 percent of Croatia's exposures to Western European reporting banks is owed to Austrian banks, 38 percent to Italian banks, 13 percent to French banks, etc. For the Baltic countries, 85 percent or more of exposures to the reporting banks is owed to Swedish banks.

Rapid credit growth has been accompanied by a growing share of loans denominated in foreign currencies (EUR and CHF)

NMS: Credit to the private sector
percent of GDP



Emerging Markets: Foreign exchange borrowing
2005, as % of total loans to the private sector



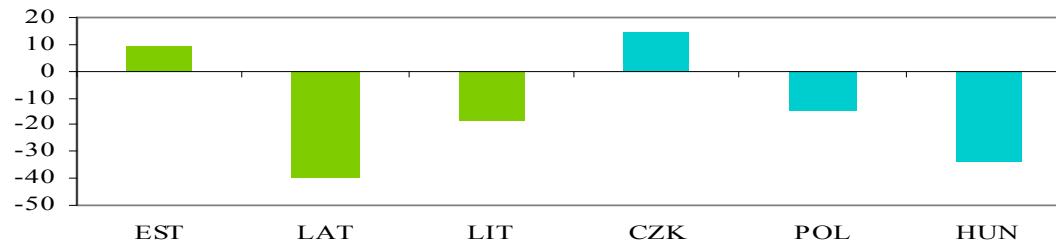
Note: The indicator is calculated as total credit to the private sector divided by GDP for the NMS (excl. Slovenia).
All figures were previously transformed to euros.

Source: national authorities, Eurostat, IMF staf calculations.

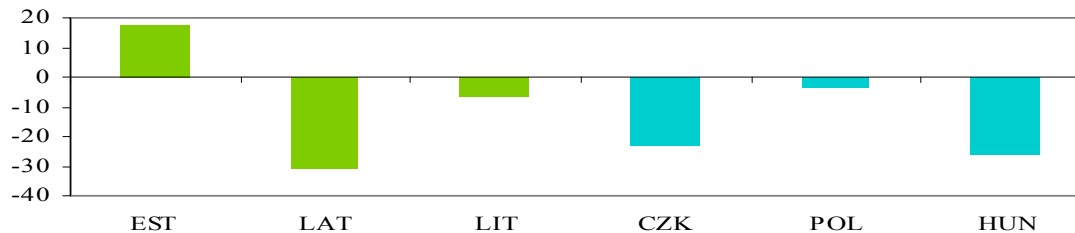
Note: Regional figures are calculated as medians for respective countries in the region.
Source: Tamirisa and others, 2007, pp. 30; national authorities,

This has led to large currency mismatches in the non-financial private sector

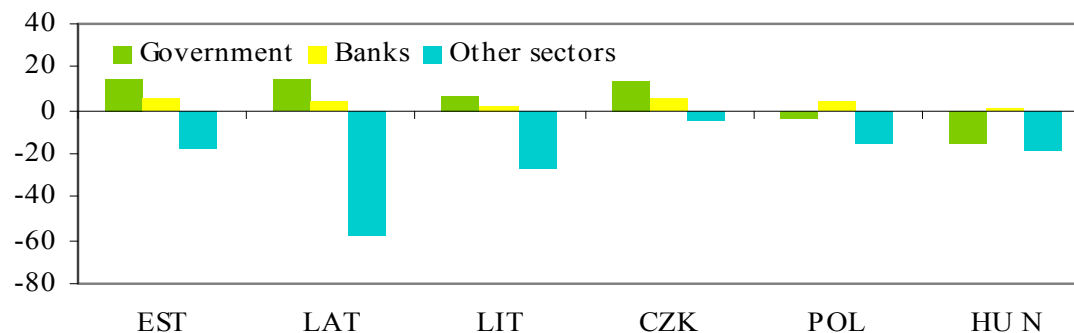
Net FX position, 2007 *percent of GDP*



Change in net FX position, 2002-2007, *percent of GDP*



Sectoral net FX position, 2007, *percent of GDP*



Empirical results (Rosenberg and Tirpak, 2008):

- *Euroization* is a byproduct of convergence.
- Foreign exchange borrowing is driven by:
 - access to foreign funds in a fully liberalized environment of capital flows (loan-to-deposit ratio, but **not** foreign bank ownership per se),
 - natural hedging opportunities, through increasing trade openness,
 - a boost to the private sector's confidence in exchange rate stability and imminent euro adoption (interest rate differentials, but not exchange rate volatility drive fx borrowing).
- Regulatory measures have limited effectiveness due to opportunities to borrow directly from abroad (i.e., for corporations).

Conclusions

- The CEE countries have weathered the **subprime crisis** fallout well so far, but a (healthy) slowdown is in the offing. Increased **inflation** is a concern.
- While sizeable **C/A deficits** are a natural by-product of convergence, they are reason for concern in the Baltics, Bulgaria and Romania
- **Foreign banks** have contributed to financial deepening and growth, but open common lender contagion channels
- **Foreign currency borrowing** constitutes a vulnerability, but few policy remedies are at hand.

Thank you!

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