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The Financial Crisis in the European Emerging Economies

Presentation for the Tokyo workshops
March 19, 2009

The main questions and presentation outline

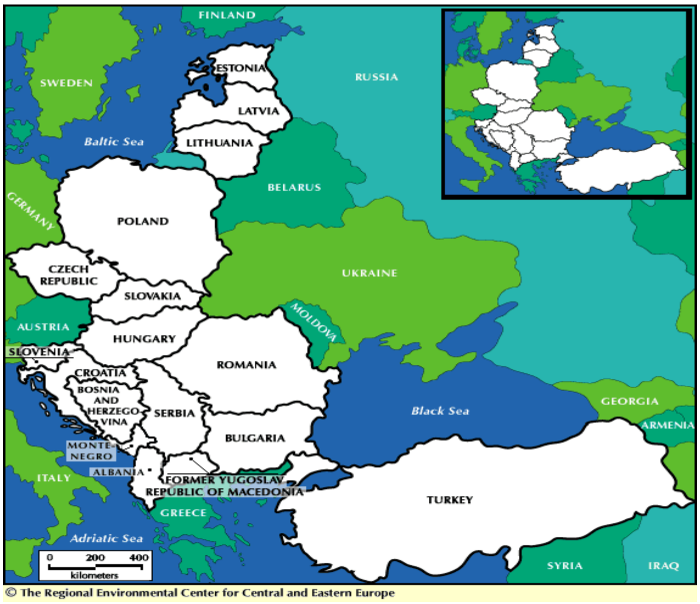
(1) Why have some European emerging economies been hit harder than others in Q4 of 2008?

(2) How will the crisis affect the rest of the EU-10?

Presentation outline

- Pre-crisis similarities and differences between the EU-10
- The main channels through which the crisis has spread
- The case of Bulgaria: main risk factors, buffers, the currency board, etc.

The EU-10 on a map of CEE



The EU-10: pre-crisis similarities I

Similarities

(1) Former socialist countries, transition to capitalism and parliamentary democracy, catch-up with the advanced EU economies

(2) “Europeanization”

(3) *“Semi-peripheral capitalism*” characterized by a strong dependence on FDI and a banking system dominated by foreign banks (from the *EU-15*)

(4) Catch-up with the advanced EU countries by opening to international trade and foreign capital ➔ deep integration in the European and international economy

The EU-10: pre-crisis similarities II

Consequences of the opening

- Growth of exports to/imports from the EU-15
- Large current account deficits (CADs)
- Increase of FDI and cross-border bank lending (from the parent banks in EU-15 to their subsidiaries in EU-10) ➔ domestic credit expansion (the private sector credit/GDP ratio)
- Direct external borrowing by EU-10 companies
- As a result, large external debt of the private sector (e.g. EU-10 banks and companies)

The EU-10: cross-country differences I

Pre-crisis differences

(1) *GDP growth rates*: high vs. medium

(2) *Exchange rate regimes*: "*hard pegs*" (currency boards or CBA) vs. "*flexible*" ➔ in the latter, pre-crisis appreciation of domestic currencies

(3*) CADs*: "*rapidly widening*" vs. "*stabilizing*"

(4) *Sectoral composition of FDI*: export manufacturing vs. non-tradable sector (construction, real estate, services) see Table 6

(5) *Main sources of financing of the domestic credit expansion* (2004-2008): external (foreign borrowing) vs. domestic (domestic bank deposits)

(6) *External indebtedness*: high vs. medium gross external debt/GDP (%)

The EU-10: cross-country differences II (according to the impact of the crisis)

- The hardest hit countries (so far): Hungary and the three Baltic countries (especially Estonia and Latvia)
- Negative GDP growth in the above 4 countries in the last quarter of 2008, increase of unemployment
- IMF-led bailout packages for Hungary (20 bln. euro) and Latvia (7.5 bln. euro)
- Currency depreciation in the countries with flexible exchange rate regimes (Hungary, Poland, Czech Republic, Romania) → snowballing of private sector debt (due to foreign currency denominated loans)
- Forecasts about "*hard landing*" in Bulgaria and Romania in 2009. Nouriel Roubini: "the currency boards in Bulgaria and the Baltics (the BELL countries) are not sustainable"

The main channels through which the global crisis has spread to EU-10

I. *Decline of export earnings* due to: (1) the economic recession in EU-15; (2) the fall of international energy and commodity prices

II. *Dwindling of FDI, cross-border bank lending* (from the EU-15 parents to their EU-10 subsidiaries), and direct external borrowing by EU-10 companies

Some consequences for EU-10

- Credit crunch → adverse impact on the real sector
- Bad loans → concerns about the stability of banks
- The large CADs cannot be financed anymore by FDI and overseas remittances → decline of central banks' forex reserves

Pre-crisis country vulnerabilities: Hungary and the Baltic countries

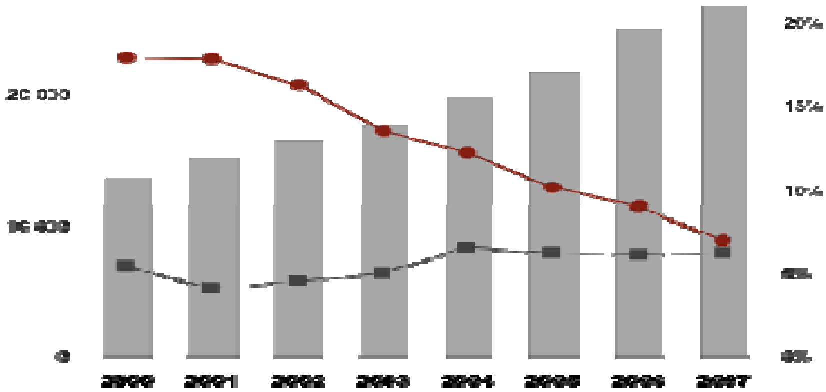
- Hungary: high budget deficit, foreign holdings of government bonds, large external debt (esp. short-term external debt), flexible exchange rate and a high proportion of foreign currency denominated loans
- The 3 Baltic countries: huge credit expansion in 2004-2007 mainly financed by external borrowing, widening CADs, large external debt (esp. short-term external debt), FDI into the non-tradable sector leading to bubbles in the real estate and construction sectors
- *What about Bulgaria*?

The Market Transition in Bulgaria

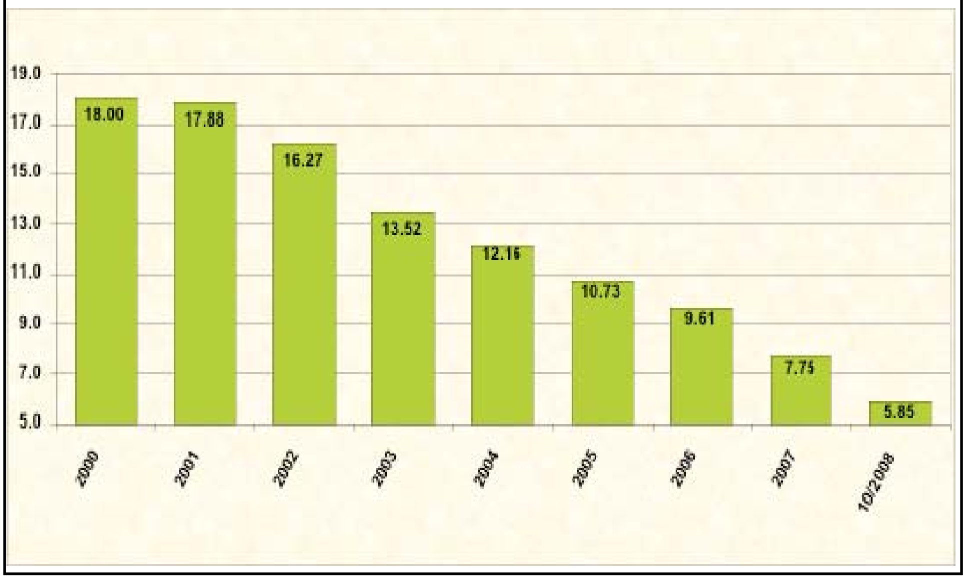
- November 1989: fall of the communist regime
- February 1991: start of radical economic reforms (led by the IMF)
- December 1995: application for EU membership
- 1996-1997: deep economic crisis (GDP decline, hyperinflation, closure of 15 banks)
- July 1997: introduction of the currency board (the Bulgarian lev is fixed to the DM, later to the euro)
- 1998-2003: economic recovery
- 2004-2008: economic boom (economic growth of 6% or higher, decrease of unemployment, lending boom)
- January 2007: EU accession

Real GDP growth and unemployment since 2000

- GDP increased, unemployment decreased



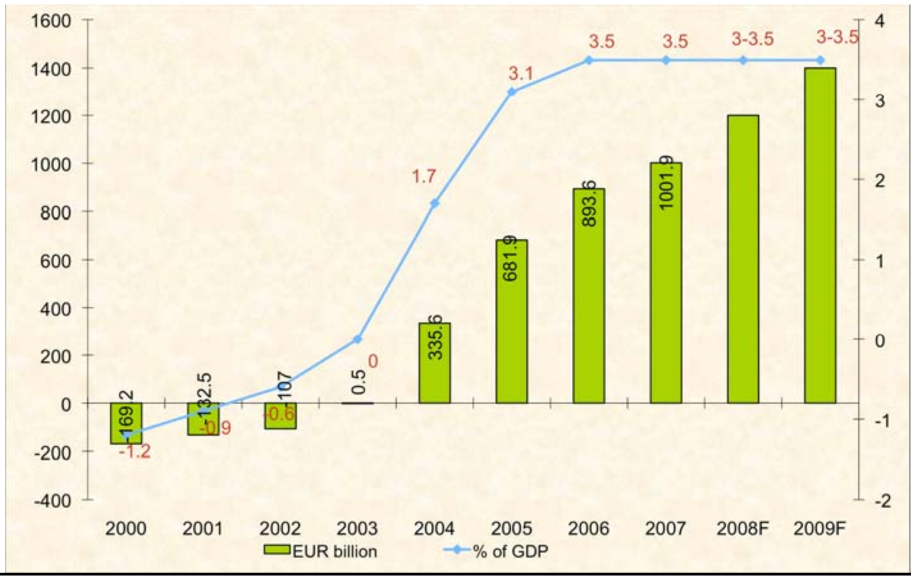
Decrease of unemployment



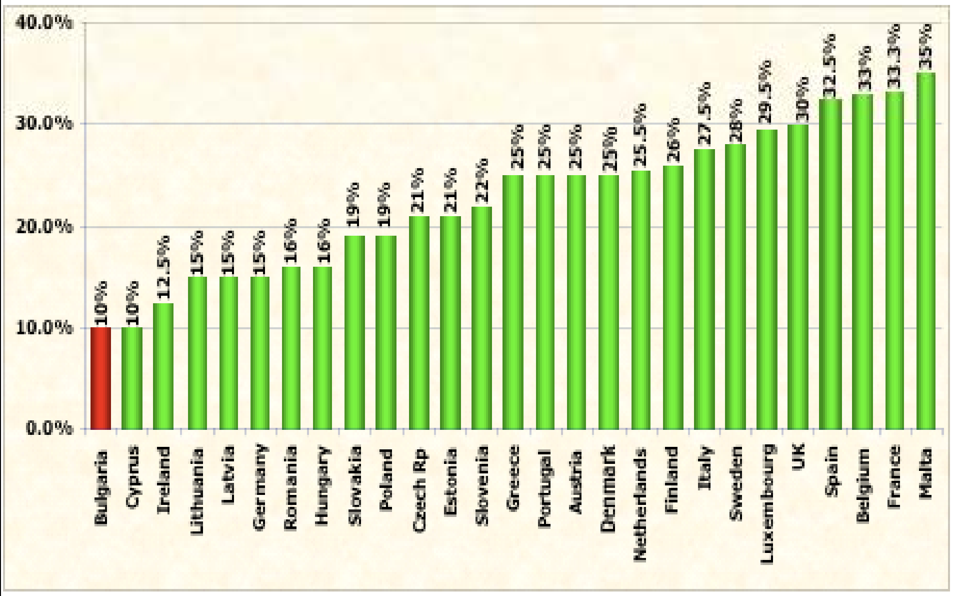
Relatively low inflation in 2001-2006

Smaller government debt

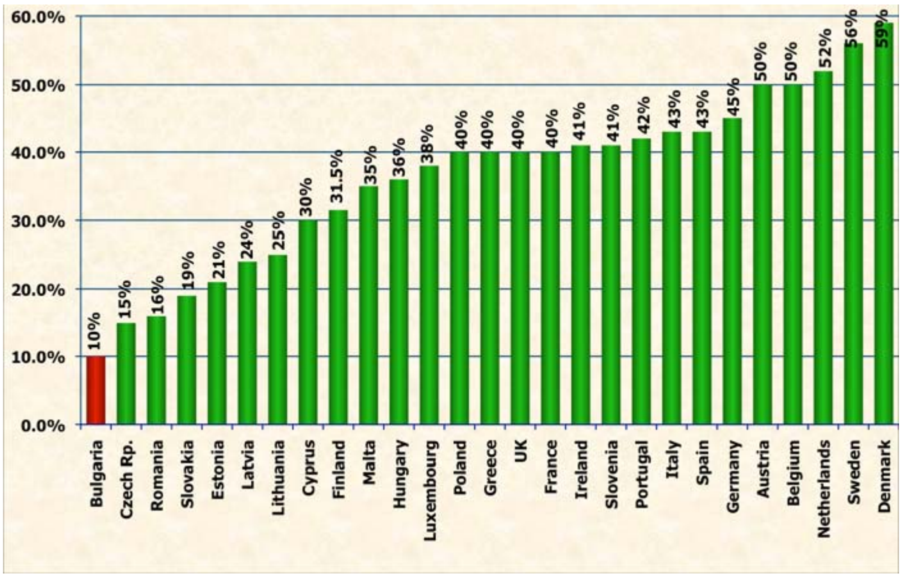
Fiscal surpluses since 2005



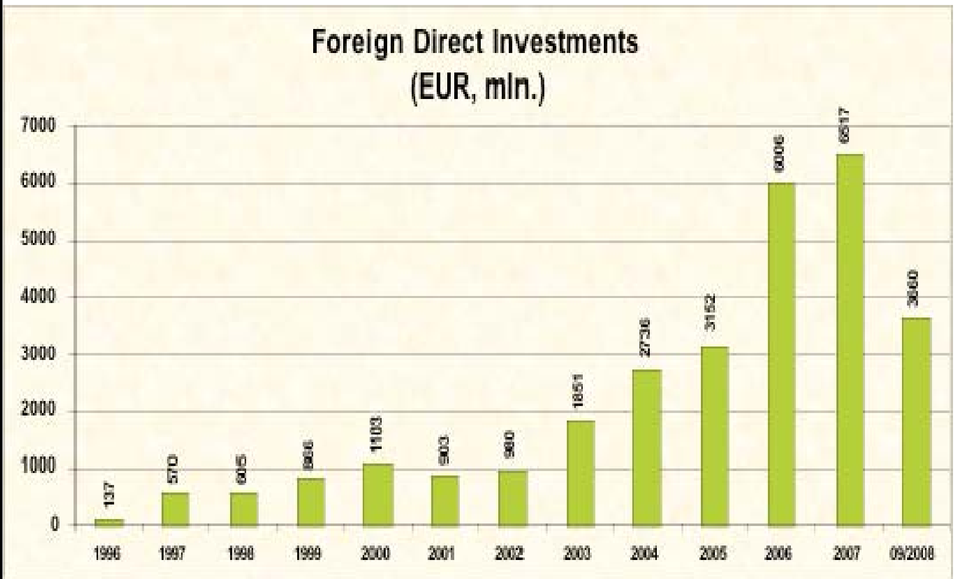
Low corporate tax



Low individual income tax



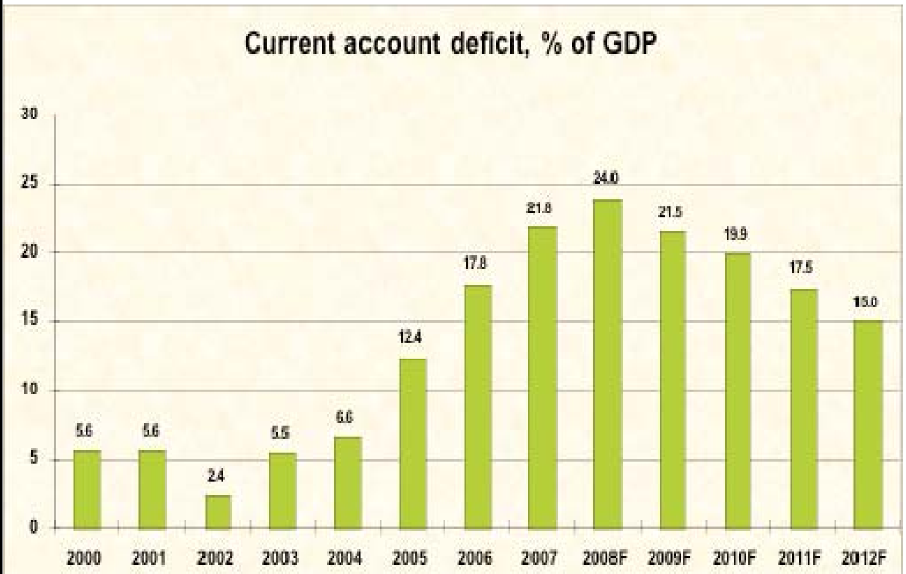
Expansion of FDI since 2003



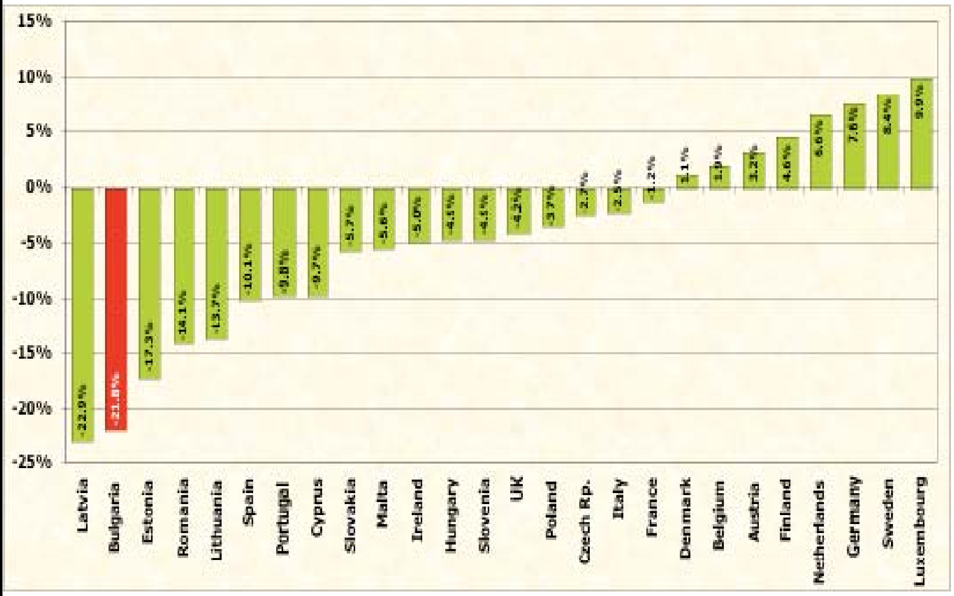
Pre-crisis country vulnerabilities: Bulgaria

- Huge CAD, though covered 100% by FDI until 2007 (the CAD/GDP ratio in 2008 was - 24.3% of GDP, the highest among EU-10)
- Rapid increase in credit growth (32% on average in 2004-2007) partly as a result of external borrowing
- Expansion of private sector's external debt (97% of GDP in 2008). A large part of it is short-term!
- High degree of dependence on foreign capital inflows (esp. loans by the Western European parent banks to their subsidiaries in Bulgaria)
- Excessive rise of real wages since 2006 (20.2% rise in 2008 relative to 2007)

The rise of CAD/GDP (%) since 2004



The CAD/GDP (%) in the EU-27 in 2007

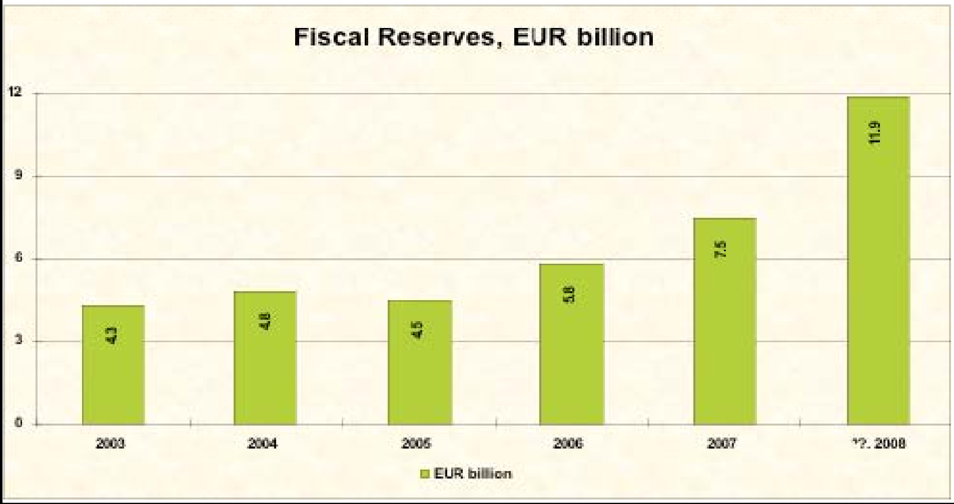


Country vulnerabilities after the start of the crisis: Bulgaria

- CAD financing in an environment of declining foreign capital inflows ➔ loss of foreign exchange reserves
- Loss of foreign exchange reserves ➔ doubts about the sustainability of the currency board (will Bulgaria become "Argentina on the Danube"?)
- Depreciations of other EU-10 currencies ➔ weakening international competitiveness of the Bulgarian industry
- Slump in the real estate and construction sectors, as well as unwillingness of Western parent banks to support their Bulgarian subsidiaries ➔ concerns about bank stability

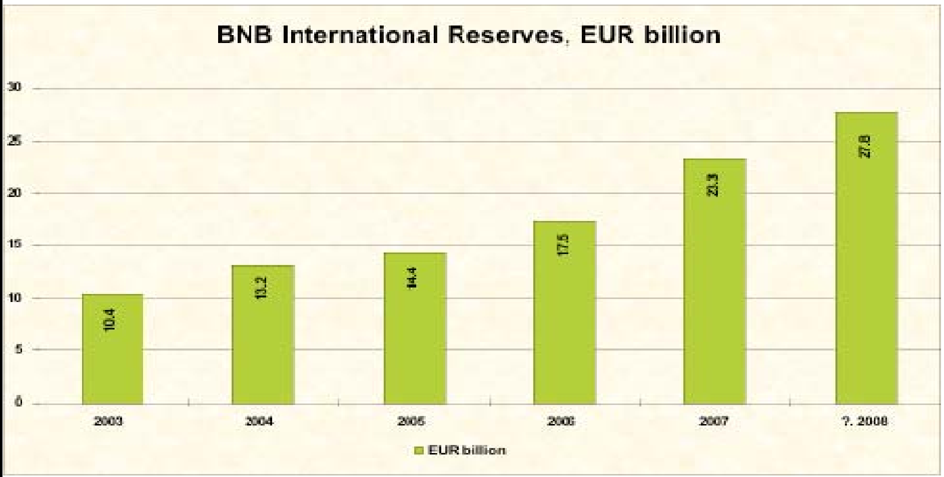
Bulgaria's buffers: (1) the fiscal reserves

- About 4. 2 bln. euro or 12.7% of GDP at the end of 2008



Bulgaria's buffers: (2) the foreign exchange reserves

- About 12.4 bln. euro or 37.5% of GDP at the end of 2008



A further examination of the second buffer

Comparison of the foreign exchange reserves in countries with currency boards, e.g. Bulgaria and the 3 Baltic countries (see Fig. 7)

・In Bulgaria, they cover more than 6 months of imports, and more than 100% of central bank's liquid liabilities (M1)

Why the Bulgarian CBA might be relatively more sustainable?

(1) its reserves exceed the S&P estimate of contingent liabilities from the financial sector in the worst-case scenario (about 28.5% of GDP, see Fig. 40)

(2) strong public support of the CBA

Policy measures taken by the Bulgarian government I

In general, the government has been rather complacent and has taken an overly optimistic attitude toward the crisis (the initial forecast was for 4.7% growth in 2009; later revised to 2%)

Policy measures taken by the Bulgarian government II

In the end of 2008

(1) Increase of the ceiling of bank deposit guarantees to BGN 100,000 (about 50,000 euro)

(2) Lowering of the mandatory reserve requirements to 10% (5% for funds attracted from abroad)

Some highlights from the "Stanishev plan" (Feb. 2009)

(1) Higher government spending on infrastructure projects in 2009 (BGN 5.6 bln, about 2.8 bln. euro)

(2) Government guarantees of SME loans (BGN 500 mln, about 250 mln. euro through the BDB)

Risk factors in 2009

(1) Populist policies aimed at winning more votes at the parliamentary elections in June

- Increased fiscal spending to win more votes might lead to the erosion of the "fiscal reserves" buffer and an even higher degree of corruption (due to further handouts to crony firms)
- The government wants to go on with the planned wage and pension increases in 2009

(2) Erosion of the "foreign exchange reserves" buffer due to accelerated foreign capital outflows and a large, though diminishing, CAD

(3) If one of the "hard pegs" in the Baltics collapses, contagion to Bulgaria could be expected

Conclusion

- The financial crisis has presented enormous challenges for the European emerging economies: some EU-10 countries have faced GDP decline, an increase of unemployment, exchange rate and banking instability
- Important characteristics of EU-10 such as *reliance on FDI as well as banking systems dominated by foreign banks*, which have been considered until the crisis as advantages, are being tested
- The case of Bulgaria: most probably a painful adjustment in terms of employment and wage growth in 2009
- The social costs of the adjustment depend partly on whether the CBA will stand the test of the crisis

Selected references

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