OESTERREICHISCHE NATIONALBANK
EUROSYSTEM

The Impact of the Financial Crisis on Central, Eastern and South-Eastern Europe

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Outline

- **Stylised facts on growth and convergence in CESEE countries since 2000 (this paper covers Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland and Romania)**
- **Vulnerabilities in CESEE at the beginning of the crisis**
- **The impact of the financial crisis on CESEE countries**
  - **Financial transmission channels**
  - **Real transmission channels**
  - **The policy response so far**
- **Conclusions**

Stylised facts on growth and convergence

- **The CESEE countries experienced (very) strong real GDP growth since the start of the decade, increasingly driven by domestic demand.**

- **Domestic demand was in turn fuelled by rapid financial deepening with strong credit growth, in some countries to a large share denominated in foreign currency.**

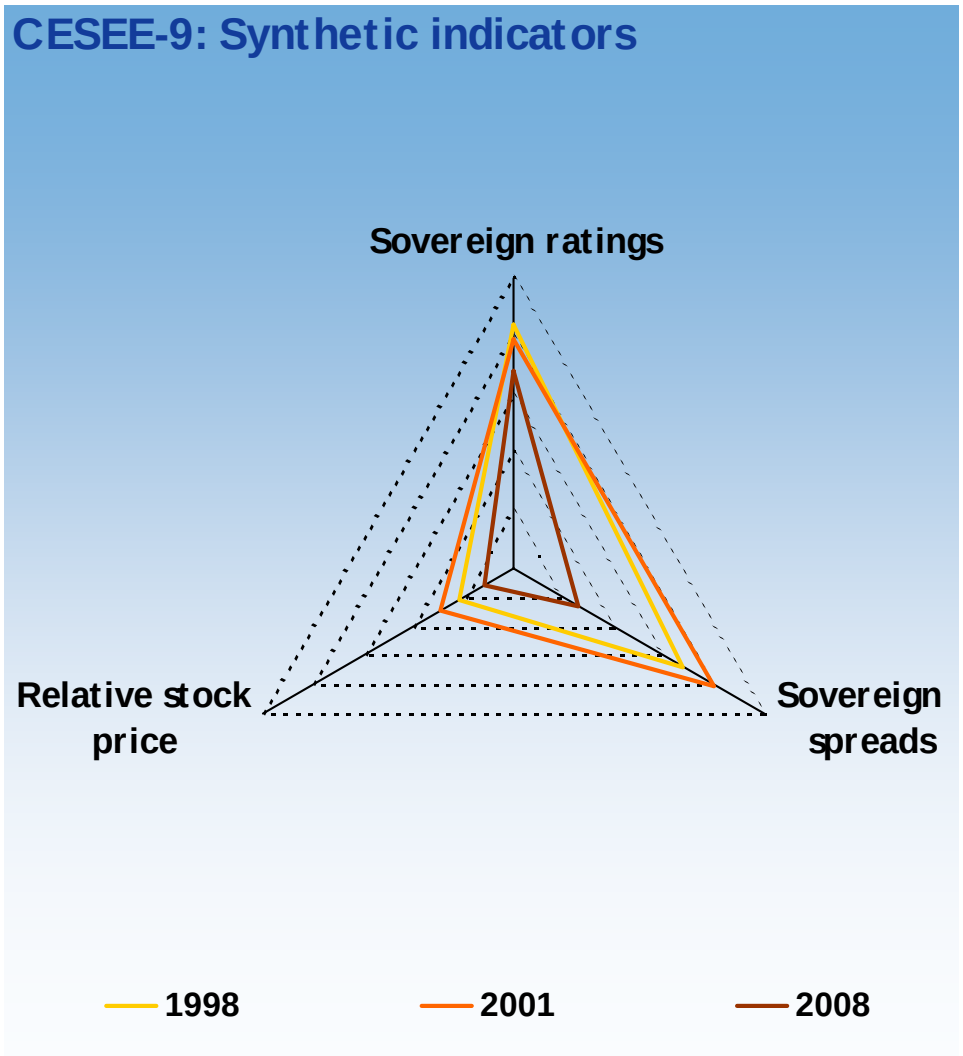
- **Financial deepening was largely financed by capital 'imports' with foreign direct investments (FDI) playing a major role compared to other types of financial flows. In some countries FDI covered the current account deficits - at least a large share.**

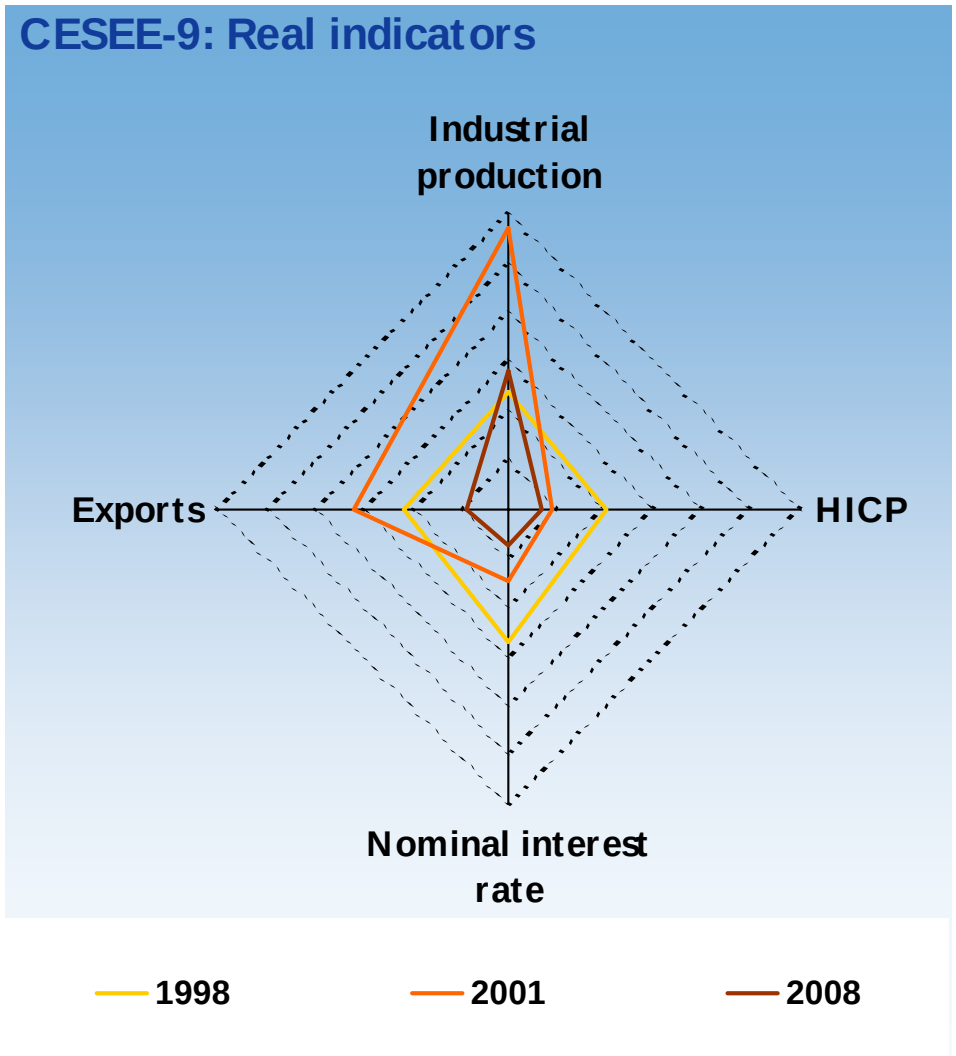
- **The foreign capital based growth model of the CESEE countries resulted in a rapid increase in external liabilities.**

Vulnerabilities at the onset of the crisis

- **How vulnerable was the CESEE region at the onset of the Subprime crisis compared to previous points in time?**
- **Selected points in time correspond to previous crises impacting emerging markets: 1998 (Russian crisis) and 2001 (Argentine crisis)**
- **Group of indicators: (1) synthetic, (2) real, (3) fiscal, (4) banking, (5) money & credit and (6) external indicators (comparable approach to BdE)**
- **‘Real’ and ‘synthetic’ vulnerability indicators suggest that the region became less vulnerable over time. ‘Public sector’ indicators provide a mixed picture. ‘External sector’, ‘money and credit’ and ‘banking’ indicators suggest higher vulnerabilities.**

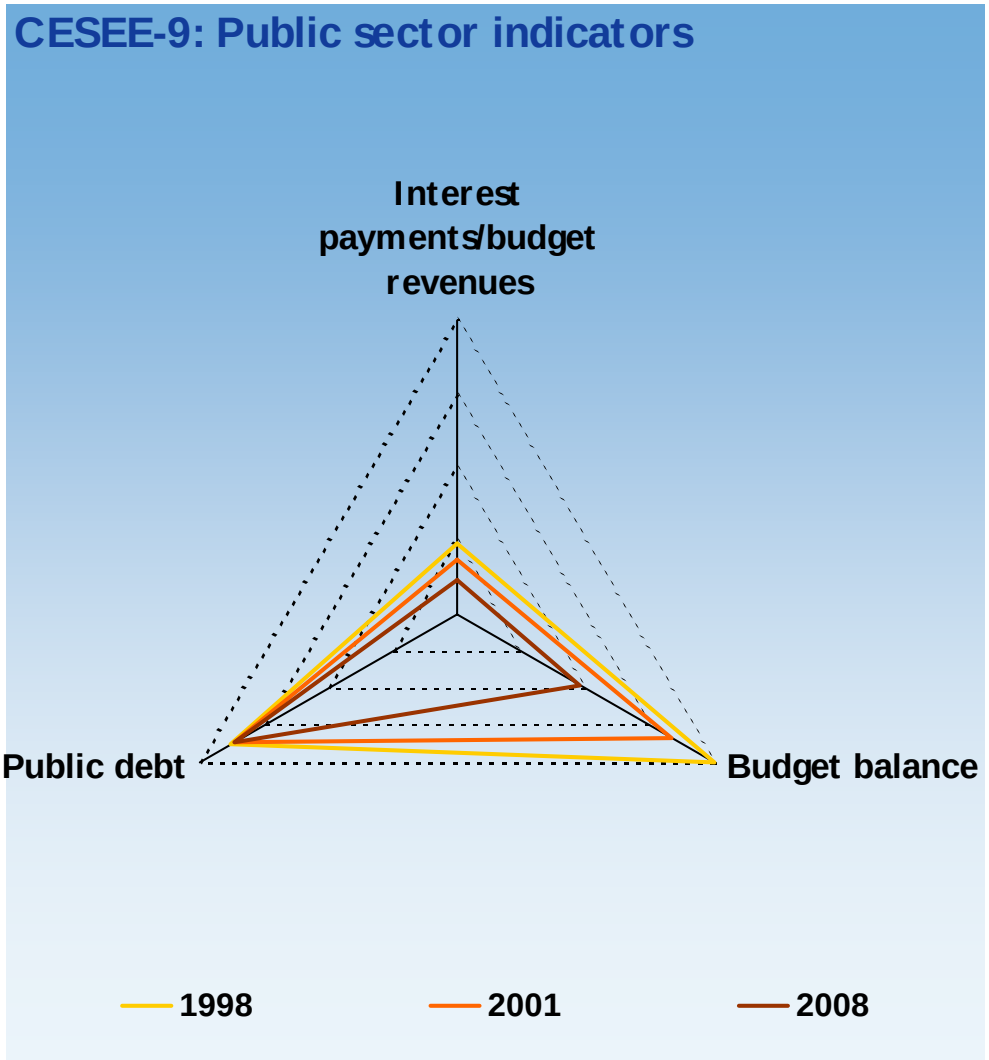
Synthetic and real indicators

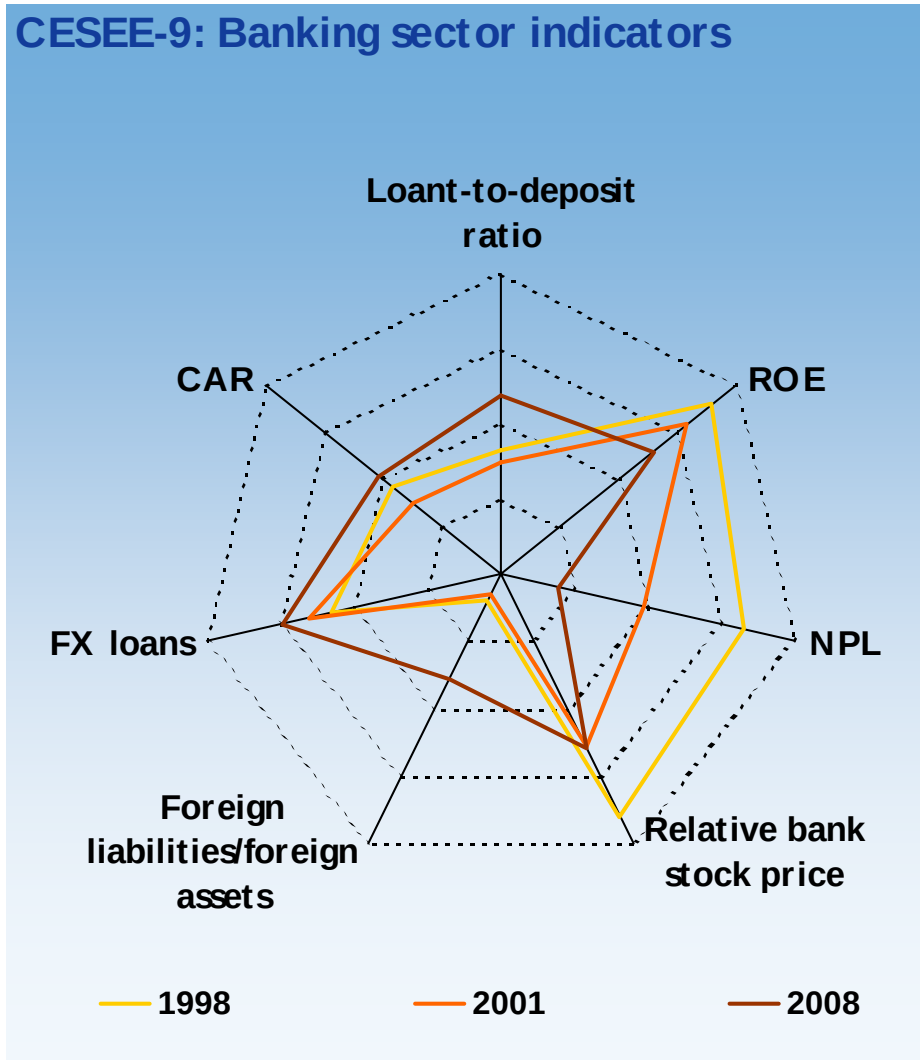




Source: Bloomberg, Datastream, Eurostat, OeNB.

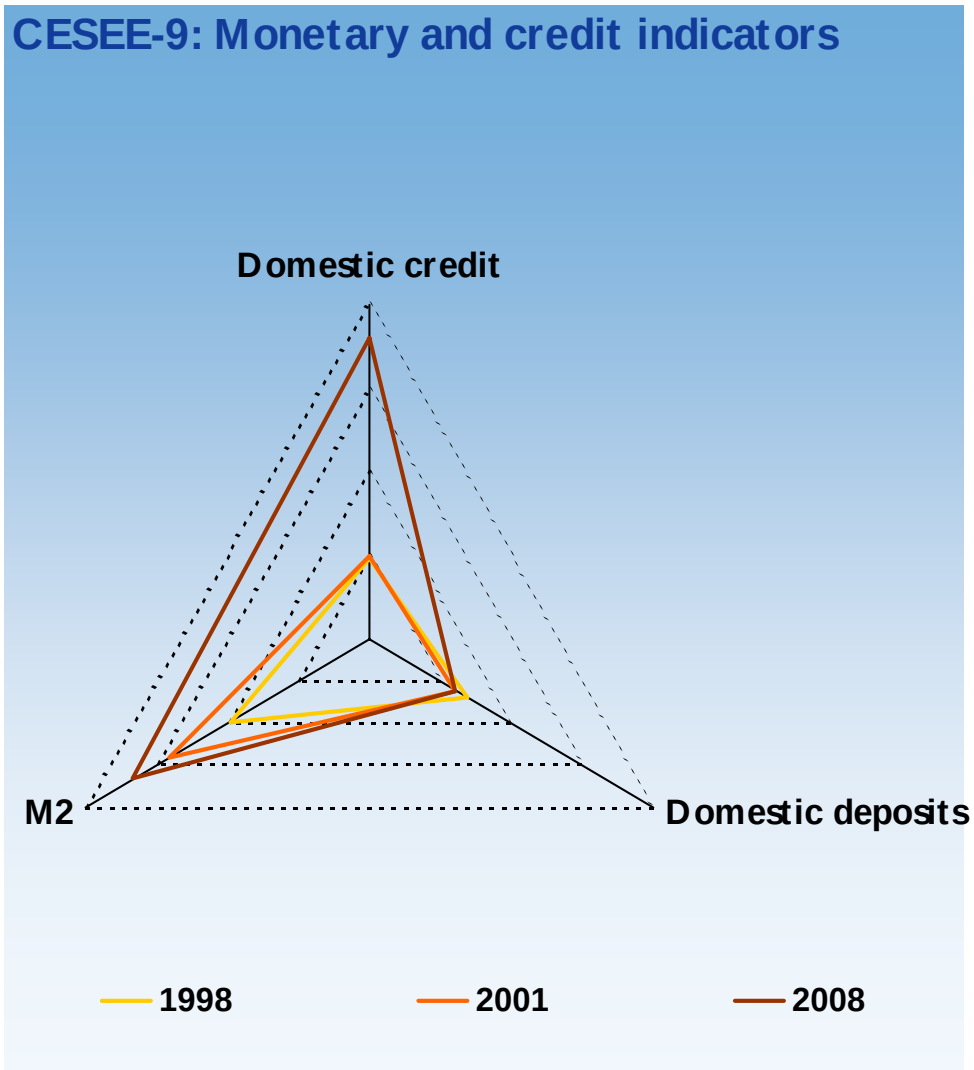
Fiscal and banking indicators

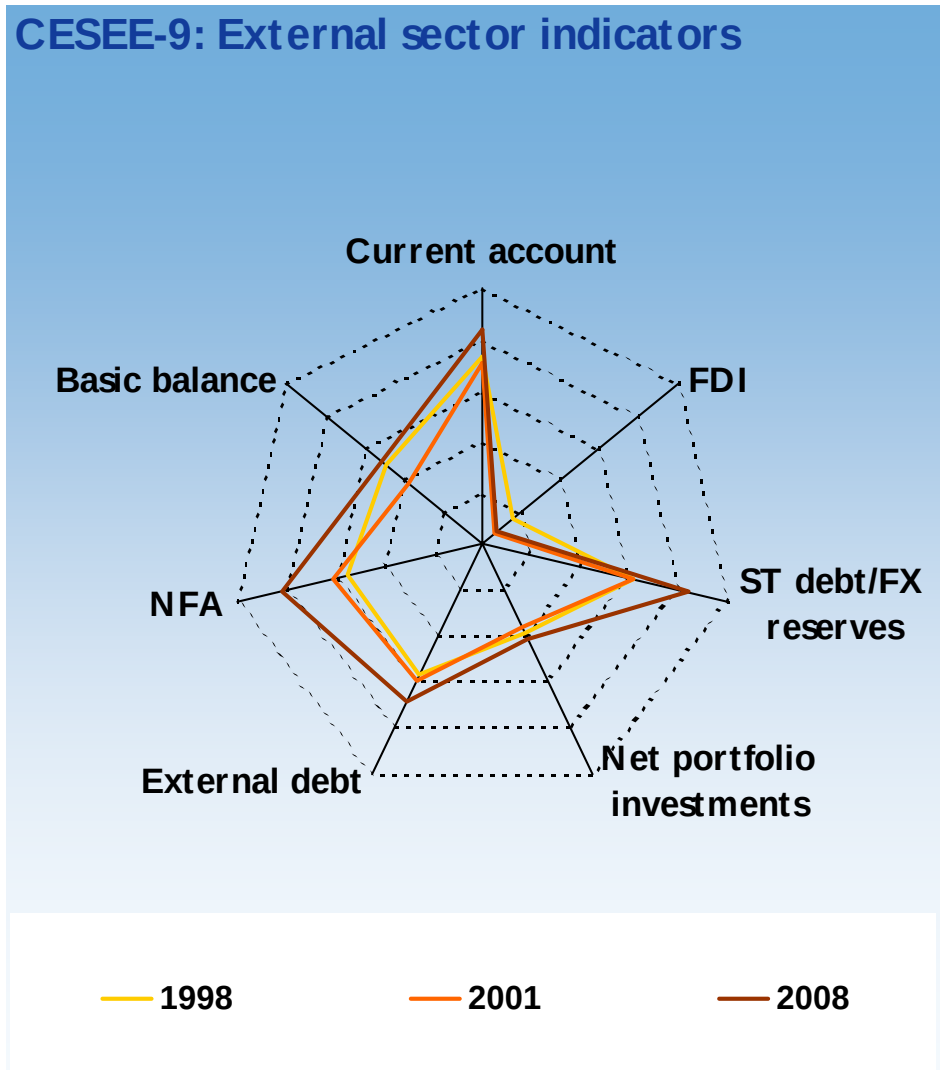




Source: Eurostat, NCBs, OeNB.

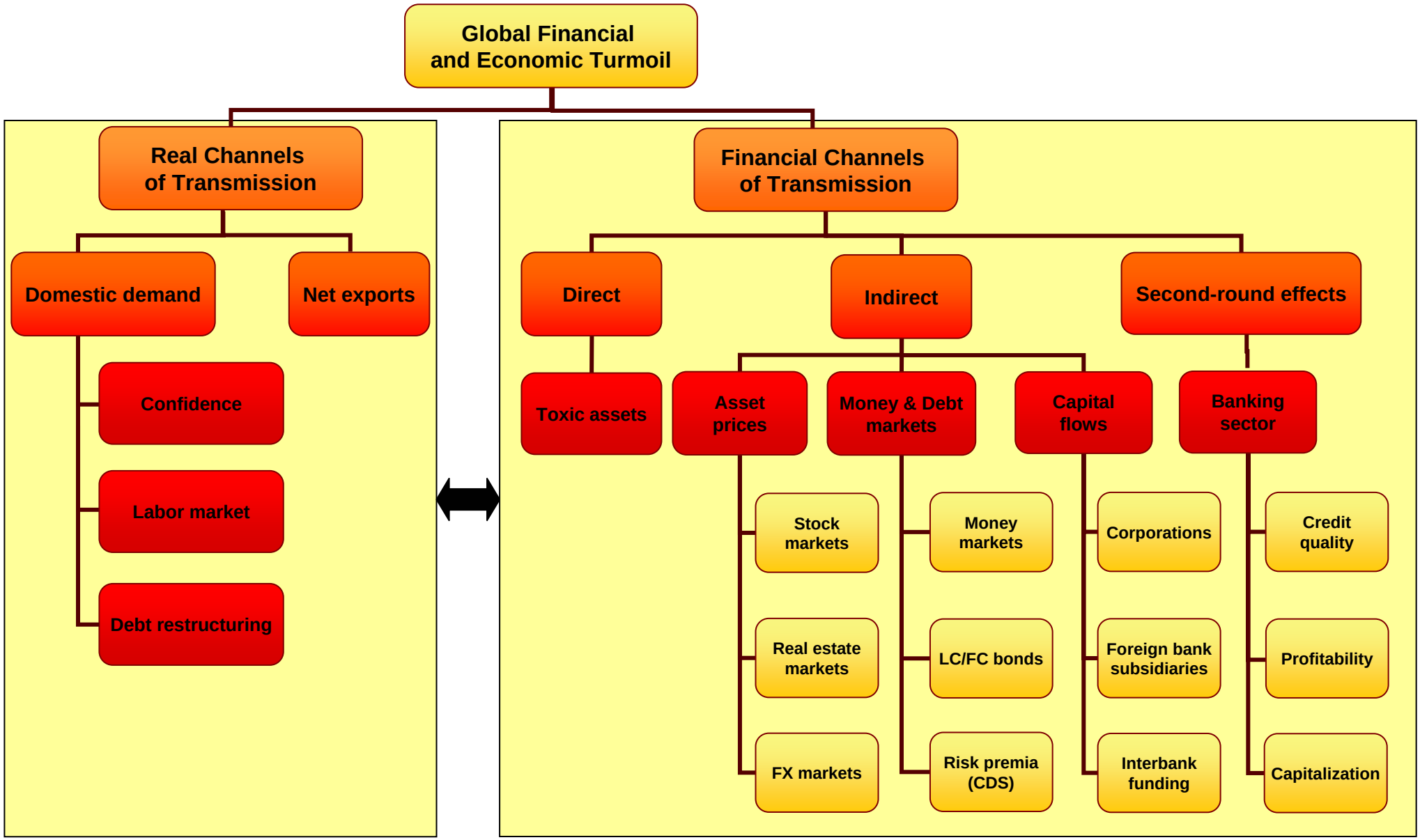
Monetary and external indicators





Source: NCBs, OeNB.

The impact of the financial crisis on CESEE



Financial transmission channels – direct / indirect

Direct effects

- **The CESEE countries have little direct exposure to toxic assets – which initially fuelled the pre-Lehman hope of regional 'de-coupling'.**

Asset prices

- **Stock markets experienced significant downward corrections. In Emerging Europe these were worse than in other emerging market regions and worse than average global developments.**
- **Sectoral stock market analysis shows that banks and real estate were among the hardest-hit sectors.**
- **Pre-crisis house price developments particularly dynamic in some CESEE countries, which now face major price falls - with repercussions on credit quality and the construction sector.**
- **Pre-Lehman appreciation trends of free-floating CESEE currencies reversed, resulting in major depreciations by Spring 2009 (now partly reversed).**

Financial transmission channels – indirect

Money and debt markets

- **Various factors including waning investor confidence, lack of interbank liquidity – and most likely speculative activities – increased money market spreads vis-à-vis the euro area, especially in Latvia and Romania.**
- **CESEE local currency and eurobond market tensions were at times and for some countries severe, more than in other emerging market regions. Lithuania and Romania experienced the sharpest hikes.**
- **CDS spreads peaked in late 2008/early 2009. Countries with largest imbalances at the beginning of the crisis most affected (Baltics, Hungary, Romania).**

Financial transmission channels – indirect

Capital flows

- At the turn of 2008/09 all CESEE economies recorded portfolio investment withdrawals. Net FDI flows remained positive but decelerated.
- Corporations direct access to foreign funding appears to have become more limited. Data on intercompany loans suggest, however, that parent companies maintained or stepped up funding to their subsidiaries.
- Looking at BIS-reporting banks, some capital outflows from the CESEE countries took place in late 2008/09 and some assets of CESEE banks abroad were recalled.

Financial transmission channels – 2nd-round effects

- **Credit growth in many CESEE countries decelerated sharply or came to a halt in 2008/early-2009, in the Baltics already in 2007.**
- **Deposit growth decelerated as well, especially in fixed ER countries and Romania due to negative changes in disposable income but likely also due to (temporarily) waning public confidence in banks.**
- **The worsening real economy and exchange rate depreciation affect NPL shares in all CESEE countries, especially Romania and Latvia.**
- **Second-round effects now affect profitability. In early 2009, profitability deteriorated particularly strongly in Poland, Bulgaria, Estonia and Latvia (!).**
- **Capitalization levels (CAR) remained mostly unchanged or even increased.**

Real transmission channels

- **The impact on the real economy first materialized via a worsening of industrial production, exports and business and consumer confidence.**
- **This led to strong falls in GDP growth, driven mostly by negative domestic demand. Net exports turned positive due to a steep decline in imports.**
- **The EC Spring forecast assumes the trough of the economic downturn in 2009. In 2010 GDP growth around zero is envisage in most CESEE countries, only GDP in Latvia and Lithuania is expected to contract by more that 3%.**
- **The length and depth of the recession depends on how quickly domestic demand will recover and how positive the contribution of net exports will be.**

Real transmission channels

- **As regards domestic demand, there is no evidence yet of a re-acceleration of credit growth. Moreover, the rapid rise in NPLs suggest increasing difficulties to service existing debt.**
- **Unemployment increased recently in all CESEE countries and wages are on a declining trend in most of them. The most dynamic developments can be observed in the Baltic countries.**
- **Changes in price competitiveness show clear differences between ‘fixers’ and ‘floaters’. REER in floating exchange rate countries depreciated notably since summer 2008, in line with nominal exchange rate depreciations.**

The policy response so far

- **Measures to stabilise financial systems and minimise real economy spillovers such as deposit guarantee schemes, recapitalisations and state loans for MFIs, measures to handle impaired assets and (temporary) nationalisation of MFI's.**
- **Central banks needed to stimulate demand while preventing 'excessive' ER depreciation. Monetary policy was thus heterogeneous. In addition, some CESEE central banks intervened verbally or through market operations.**
- **Fiscal policy varied depending on the degree of 'external' leakage, the impact on investor confidence and the state of government balances at the beginning of the crisis. The economic downturn curtails the room for fiscal stimuli.**
- **Hungary, Latvia and Romania received international financial support. So far only a fraction of the committed funds has been paid out as the strong economic weakening makes it difficult to meet in particular deficit limits.**

Conclusions

- **‘Real’ and ‘synthetic’ vulnerability indicators suggest that the region became less vulnerable over time. ‘Public sector’ indicators provide a mixed picture. ‘External sector’, ‘money and credit’ and ‘banking’ indicators suggest higher vulnerabilities.**
- **Early warnings were complicated by analytical problems, e.g. catching-up versus ‘exuberance’ and benevolent banking performance indicators.**
- **The CESEE region weathered the first phase of the financial crisis well but indirect financial transmission was strong. Countries with largest economic and financial vulnerabilities were most affected.**
- **Real transmission channels started to come into force with further lag, ‘overlapping’ with the stabilisation and recovery in financial markets. In some countries (Baltics) on-going ‘endogenous’ adjustment processes were exacerbated.**
- **Second-round effects on the banking sector clearly visible since early 2009.**

Conclusions

- **Parent companies of of CESEE firms subsidiaries seem committed to sustain their exposure. This seems to hold also for the banking sector!**
- **Length and depth of the recession remains uncertain. Domestic demand depends e.g. on private debt restructuring and credit supply. Net exports depend on external competitiveness - likely to be a bigger problem for fixed ER countries.**
- **The crisis has an ambivalent impact on monetary integration. The ‘euro shelter’ argument may increase the political ambition to join the euro area but the dramatic worsening of public finances will make it harder to meet the criteria.**

Thank you for your attention!

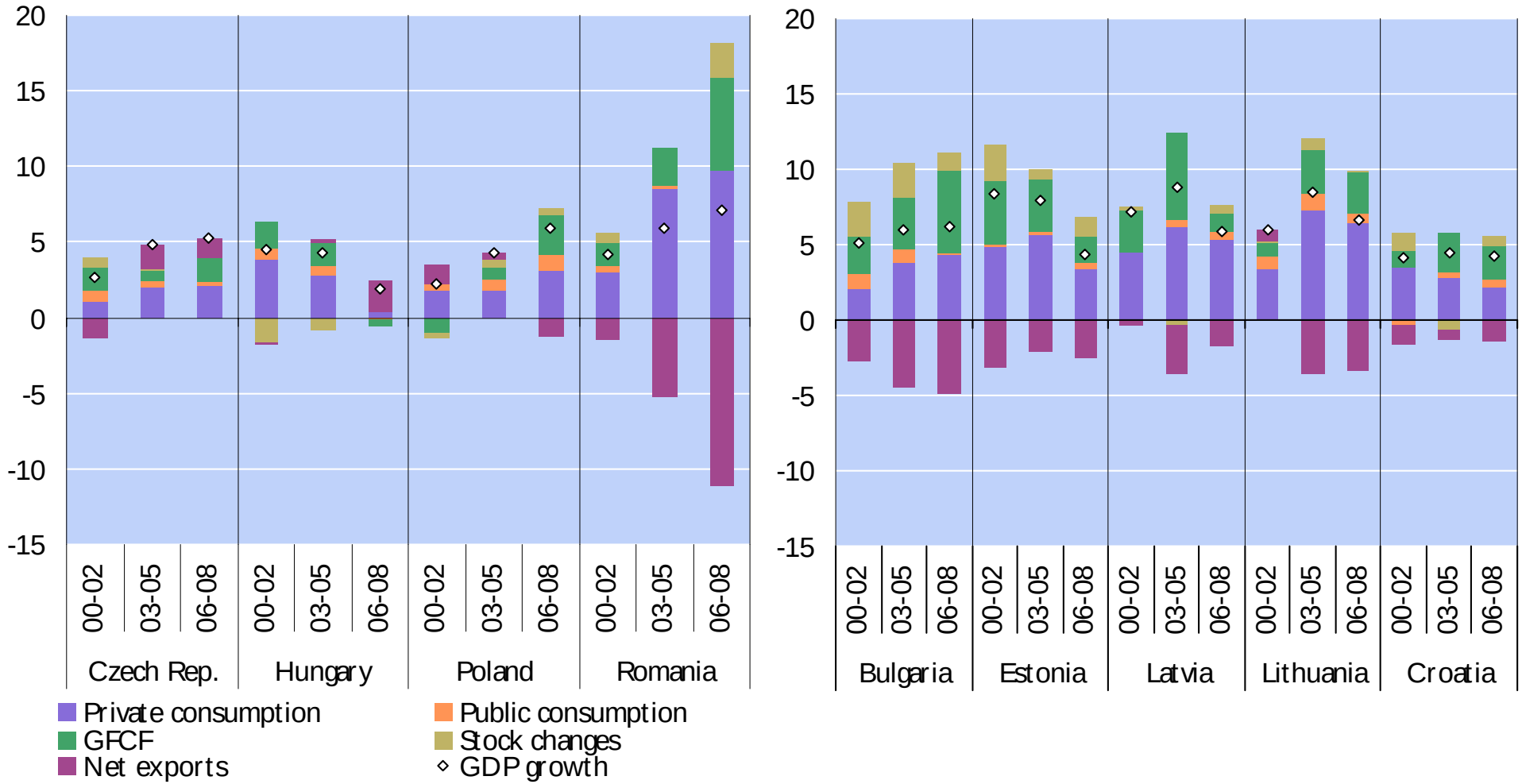
Disclaimer

The views expressed in this presentation
do not necessarily reflect the official viewpoint
of the Oesterreichische Nationalbank (OeNB).

Strong GDP growth driven by domestic demand

GDP growth and its components

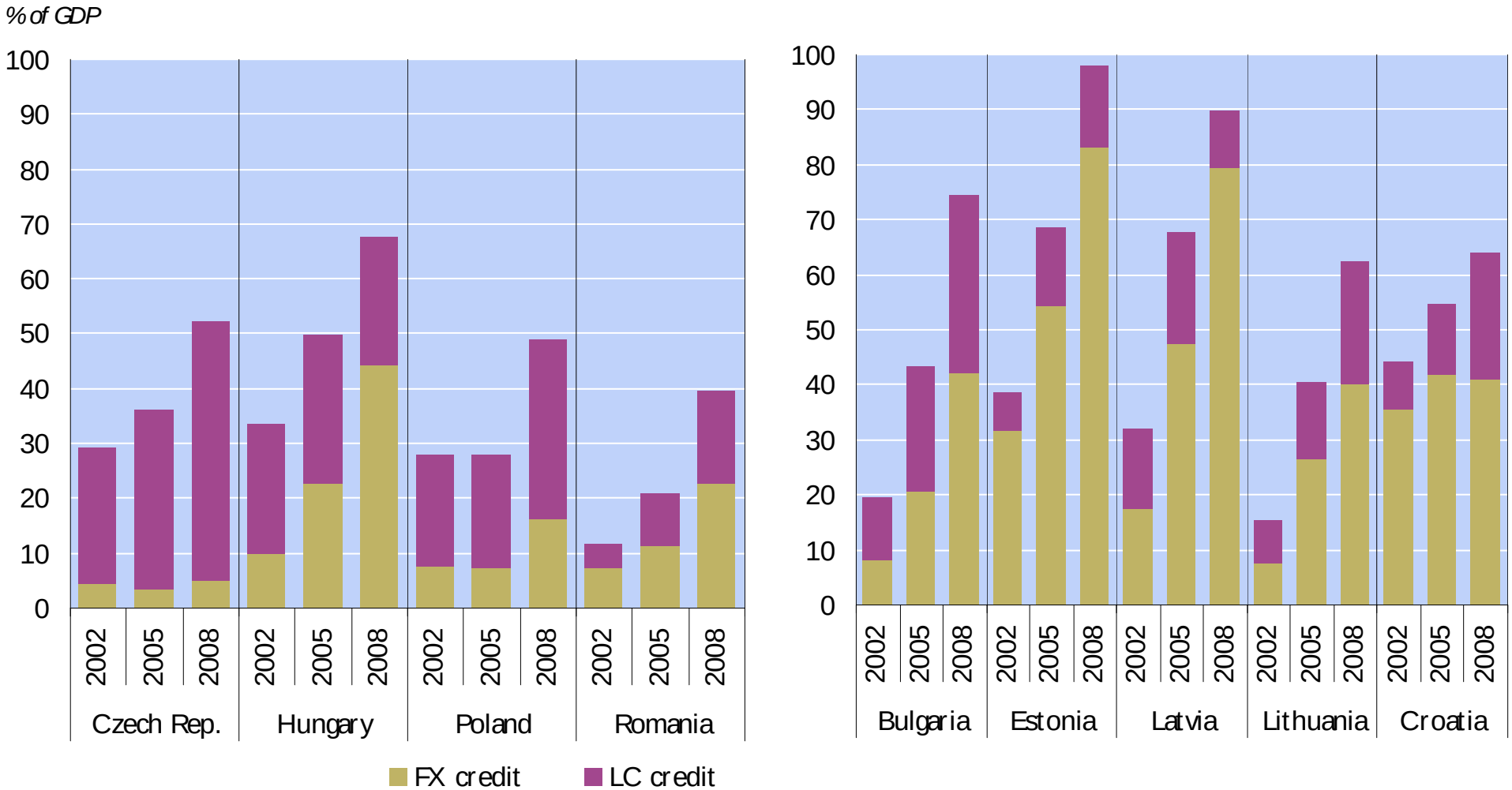
GDP growth: yoy change, %. Components: Percentage points contribution to growth



Source: Eurostat. OeNB.

Rapid financial deepening based on FX-lending

Domestic credit

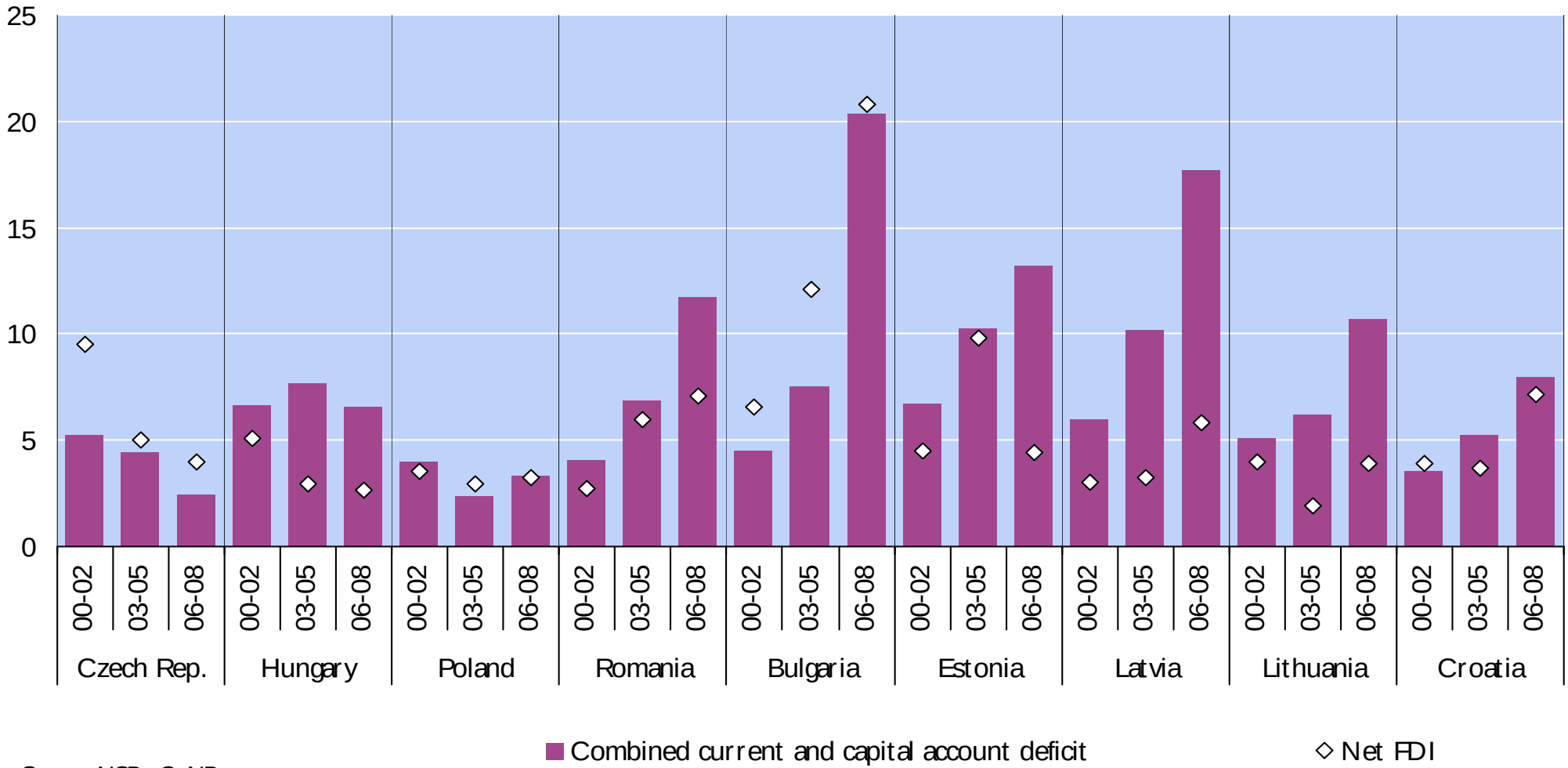


Source: NCBs, OeNB.

Widening external imbalances, strong FDI inflows

Current account deficit and FDI flows

% of GDP

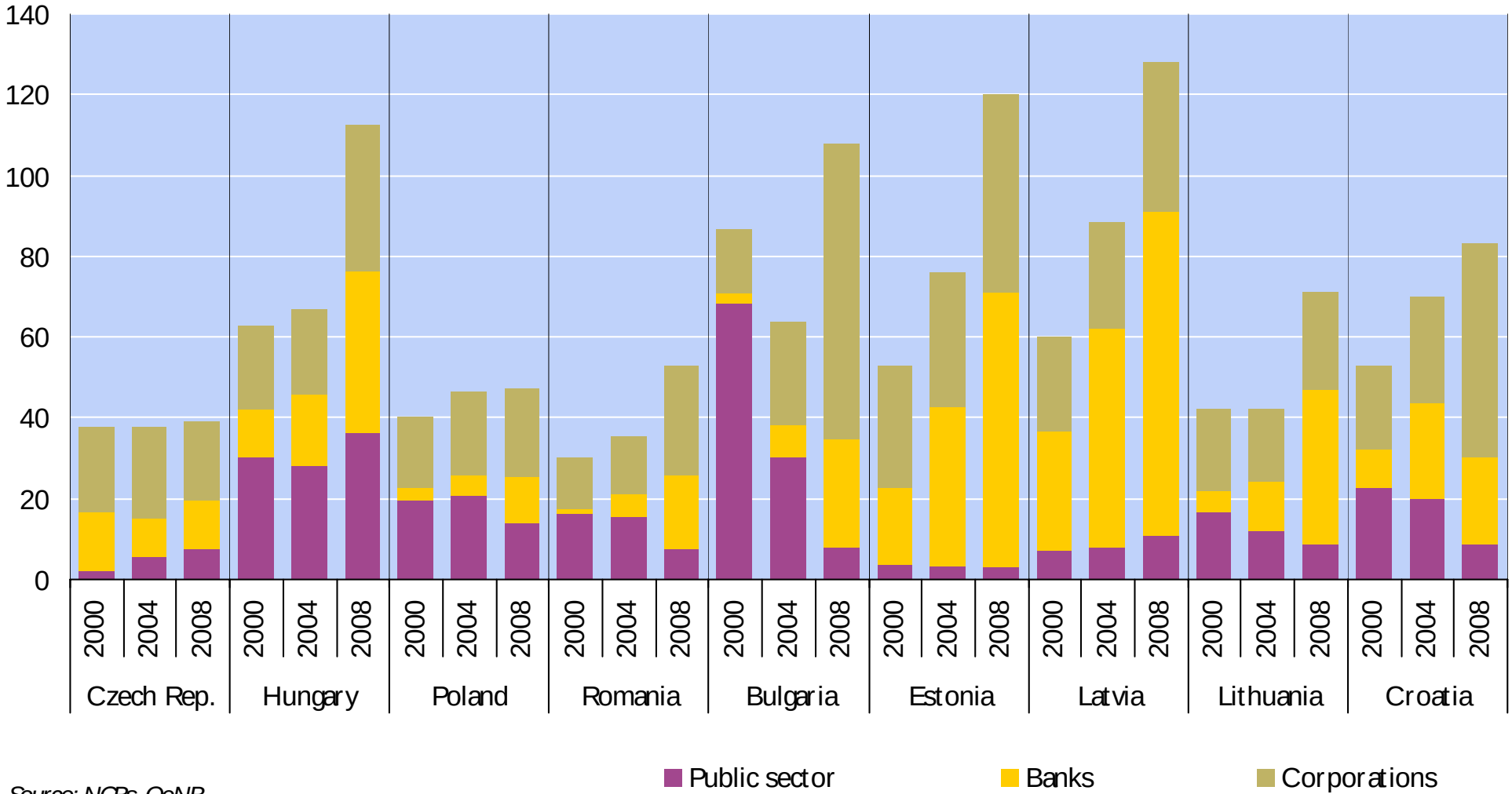


Source: NCBs, OeNB.

Rapidly increasing external indebtedness

Gross foreign debt according to debtors

% of GDP, incl. intercompany loans



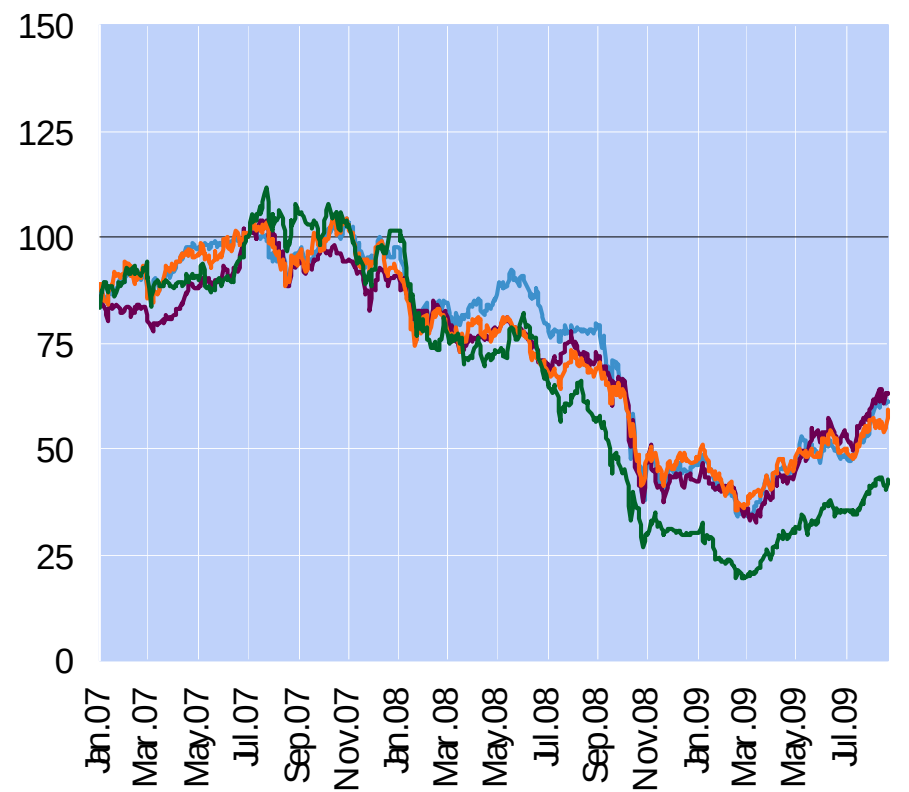
Source: NCBs, OeNB.

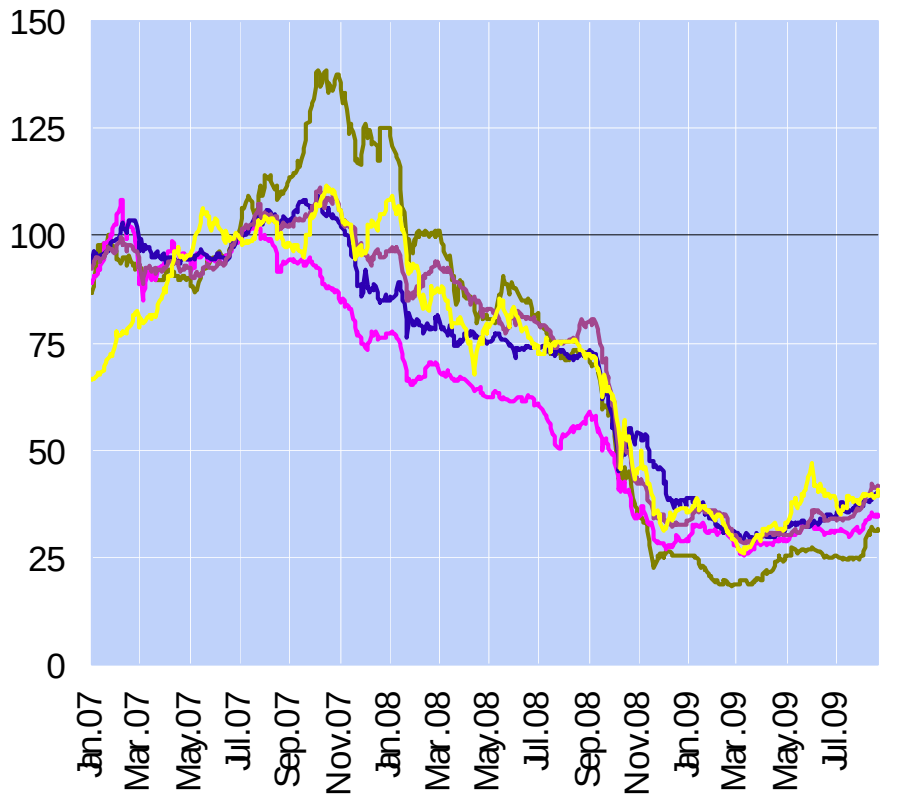
Stock markets particularly affected after Lehman

Stock market developments

29.06.2007 = 100

Cut-off date: 21/08/2009





Czech Republic — Hungary — Poland — Romania — Bulgaria — Estonia — Latvia — Lithuania — Croatia

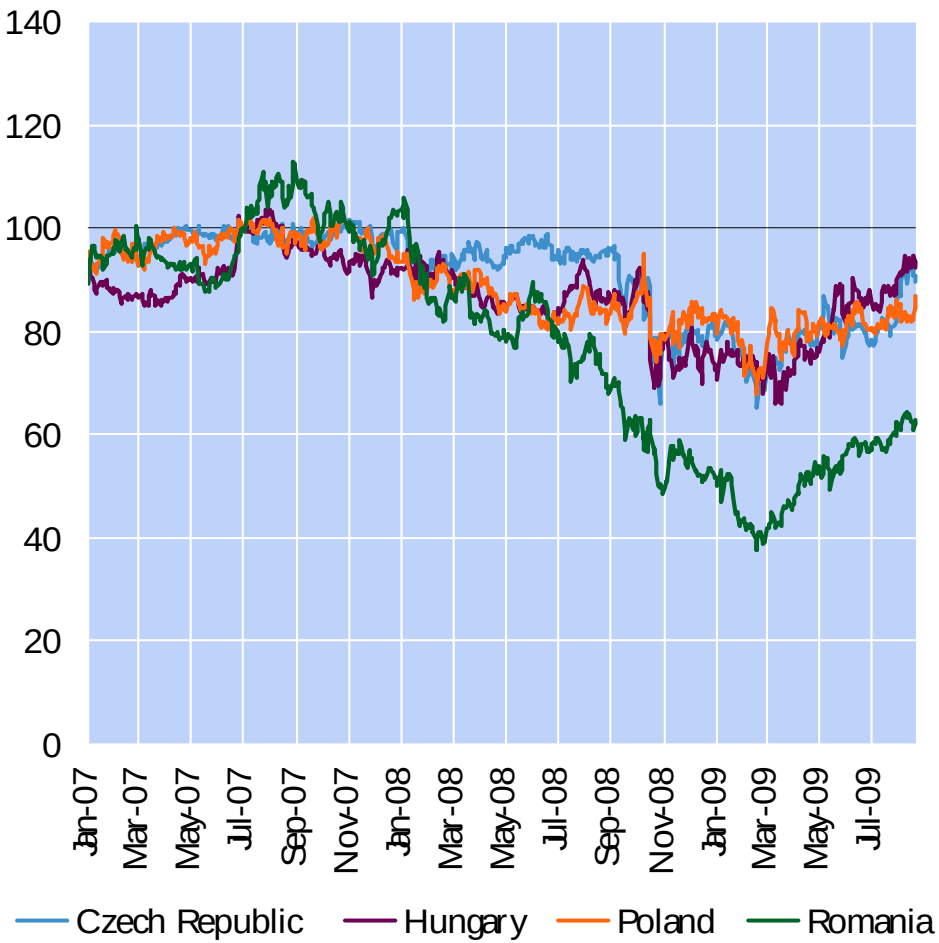
Source: Datastream. OeNB.

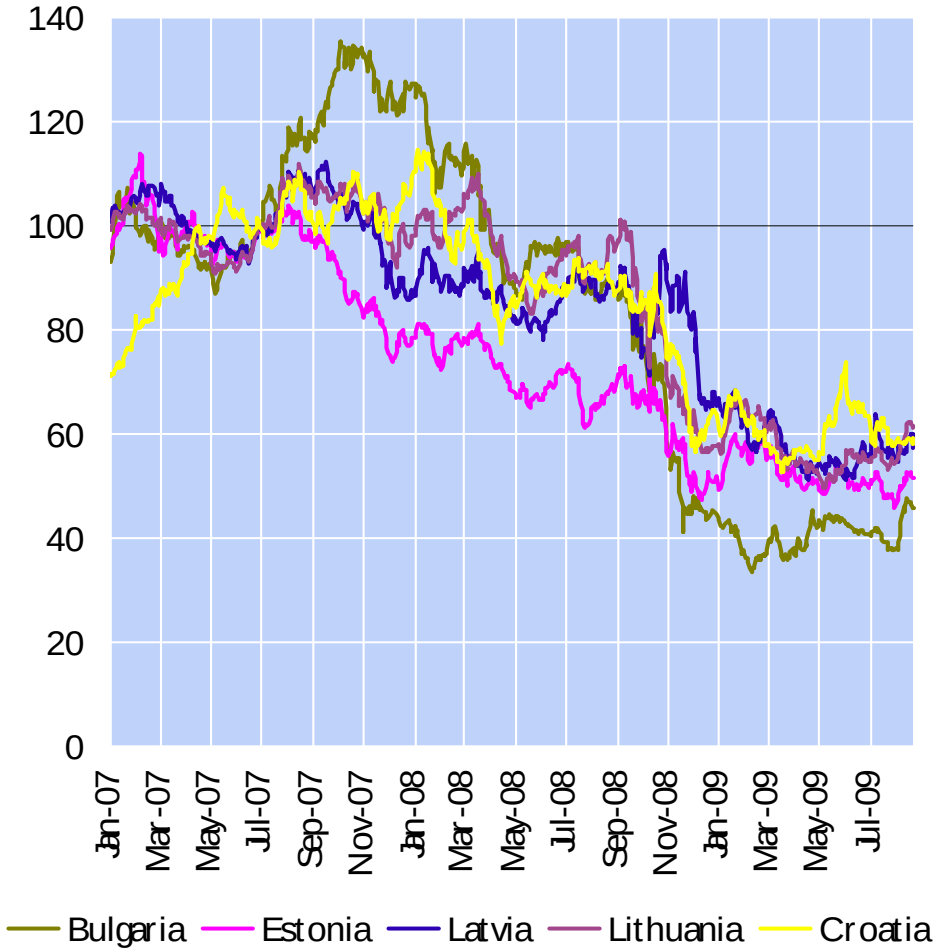
CESEE stock markets relative to World Index

Performance of CESEE stock markets relative to World Index

29.06.2007 = 100

Cut-off date: 21/08/2009





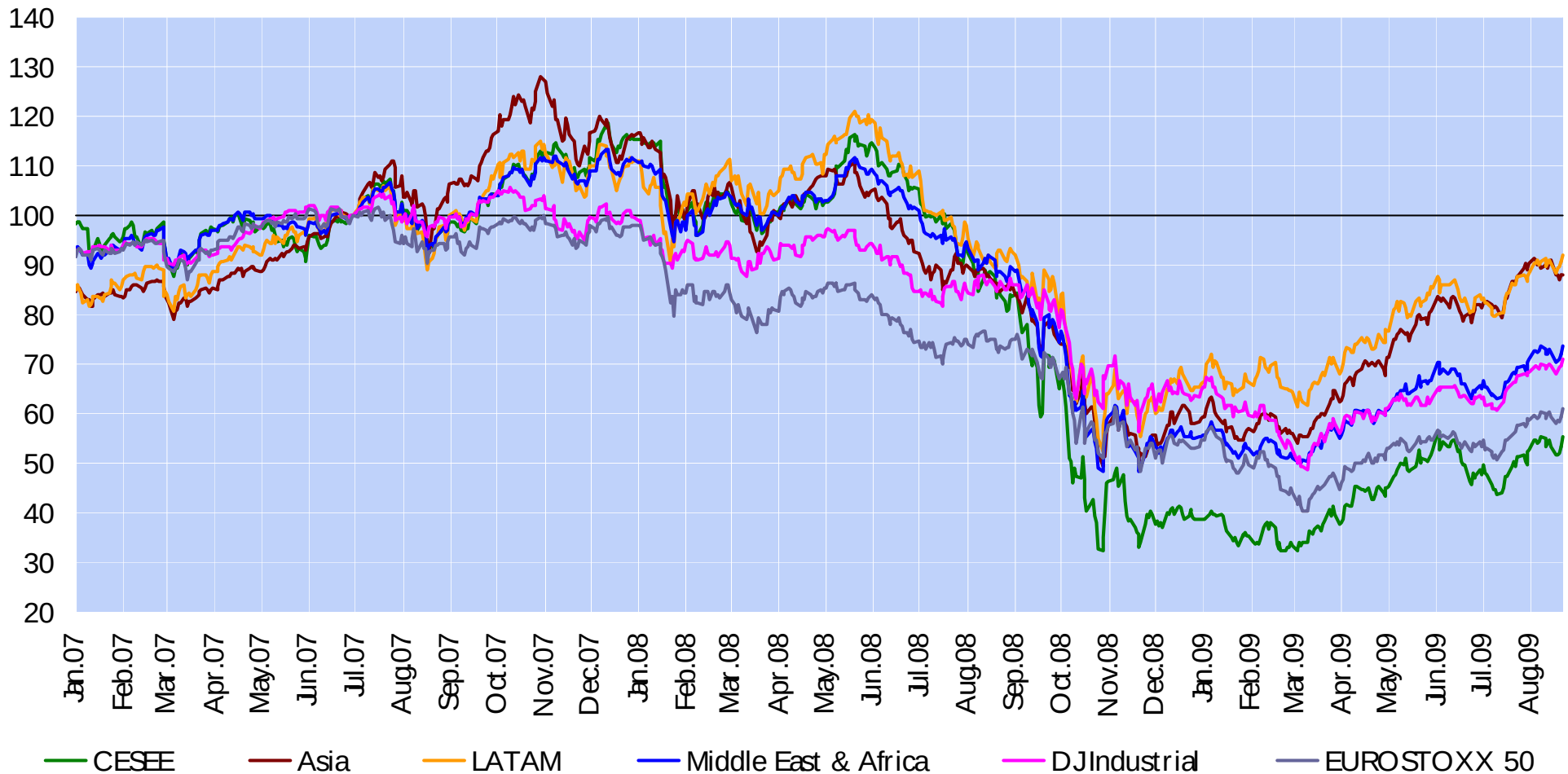
Source: Datastream. OeNB.

CESEE stock markets in an emerging market context

Stock market developments in an international comparison

29.06.2007 = 100, MSCI EM indices

Cut-off date: 21/08/2009

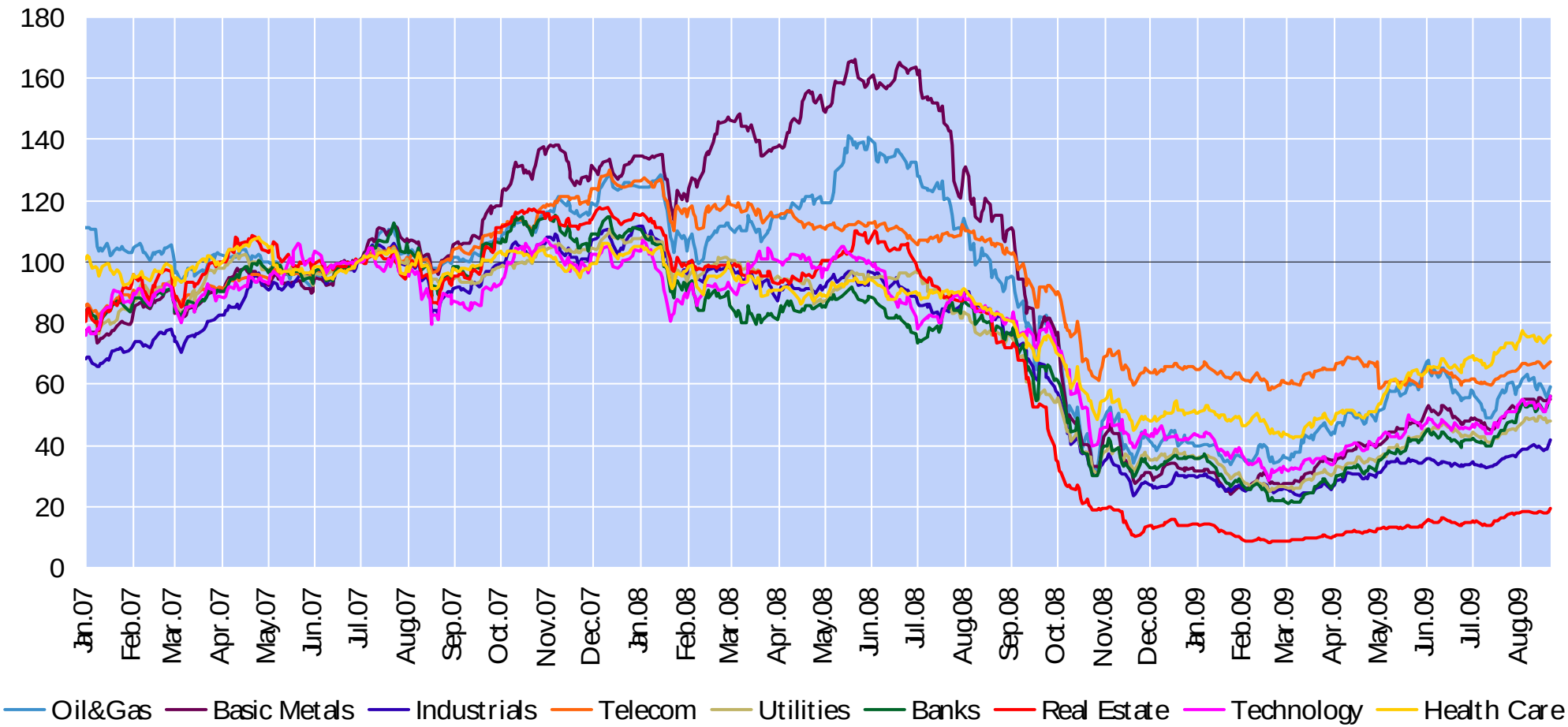


Source: Datastream, OeNB.

Financials and raw material-based sectors hit hard

Sectoral stock market developments in Emerging Europe

29.06.2007 = 100



*Source: Datastream. OeNB. *Emerging Europe including Russia and Turkey.*

Strong growth in house prices

House price growth % y/y

	2000	2001	2002	2003	2004	2005	2006	2007	2008	Last quarter	
Bulgaria		0.3	1.8	12.2	47.6	36.6	14.7	28.9	24.9	-8.4	Q1/09
Czech Rep.	11.1	12.4	14.5	9.0	1.4	-0.6	6.5	21.1			
Estonia	2.5	34.2	29.5	12.9	27.8	30.9	51.8	10.1	-12.3	-20.7	Q4/08
Croatia				2.4	4.8	-0.7	0.3	25.9	7.5		
Latvia						20	159.3	45.1	-20.6		
Lithuania	-9.3	23.8	9.5	18.0	9.9	51.8	39.2	33.5	5.2	-5	Q4/08
Hungary	17.6	18.7	12.6	20.8	2.8	0.8	-1.1	1.9	1.8	2.1	Q1/09
Poland	7.3	10.0	-4.1	-6.7	7.3	20	3.8	45.3			

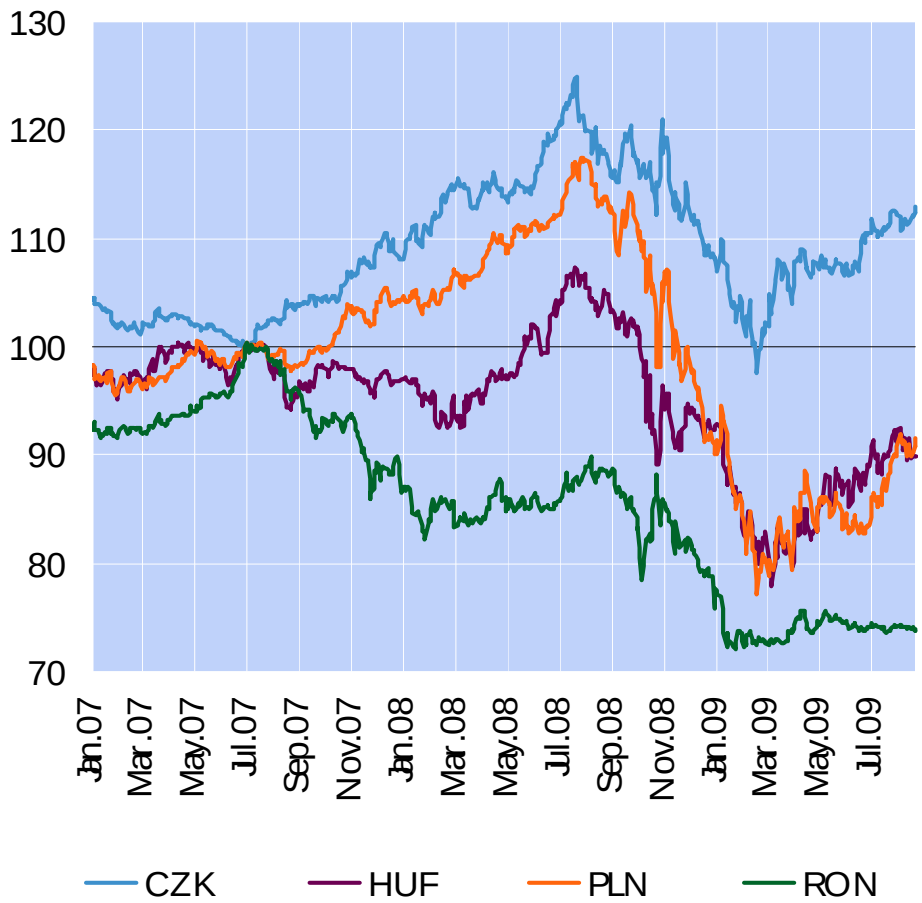
Source: Datstream, HR(CROSTAT)

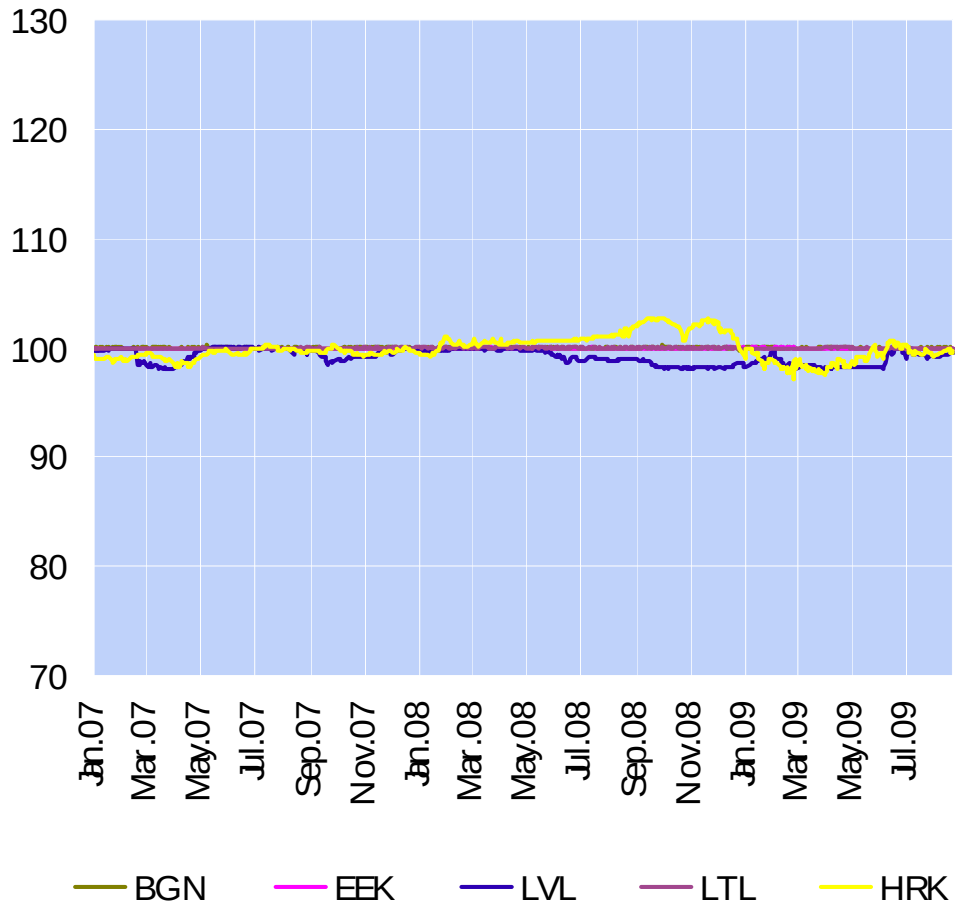
Strong downward pressures post-Lehman

Exchange rate developments versus the euro*

29.06.2007 = 100

Cut-off date: 21/08/2009





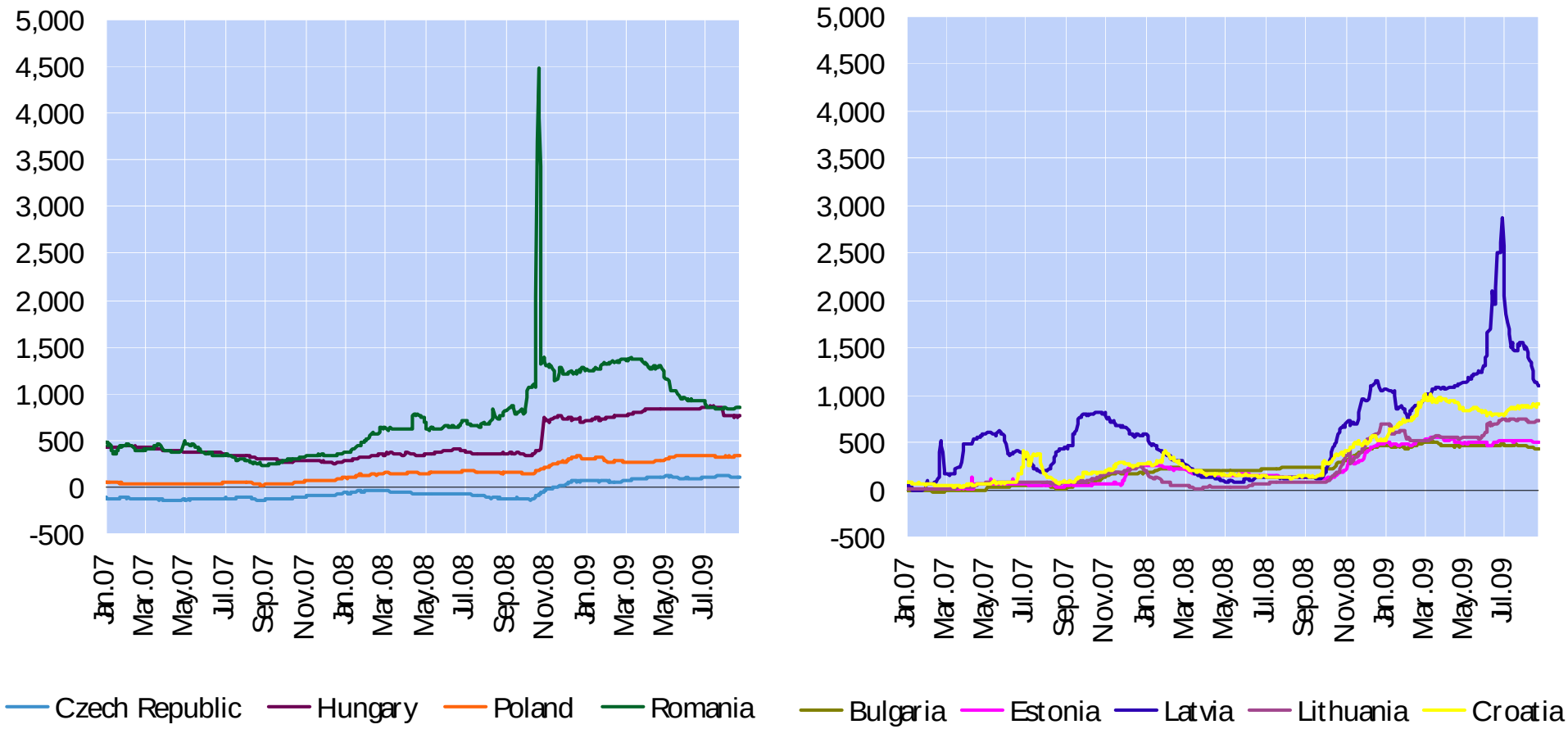
*Source: Eurostat. OeNB. * An increase in value means a nominal appreciation.*

Liquidity pressures cause money market tensions

3-month money market rate spreads versus euro area

basis points

Cut-off date: 21/08/2009



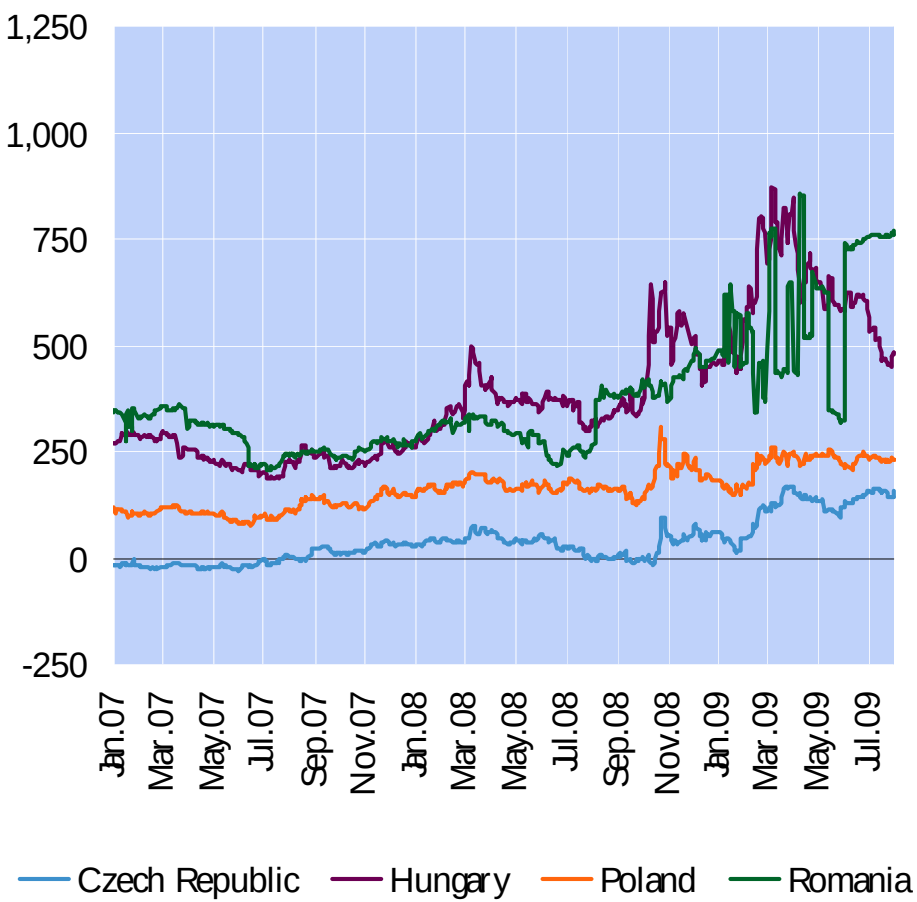
Source: Datastream. OeNB.

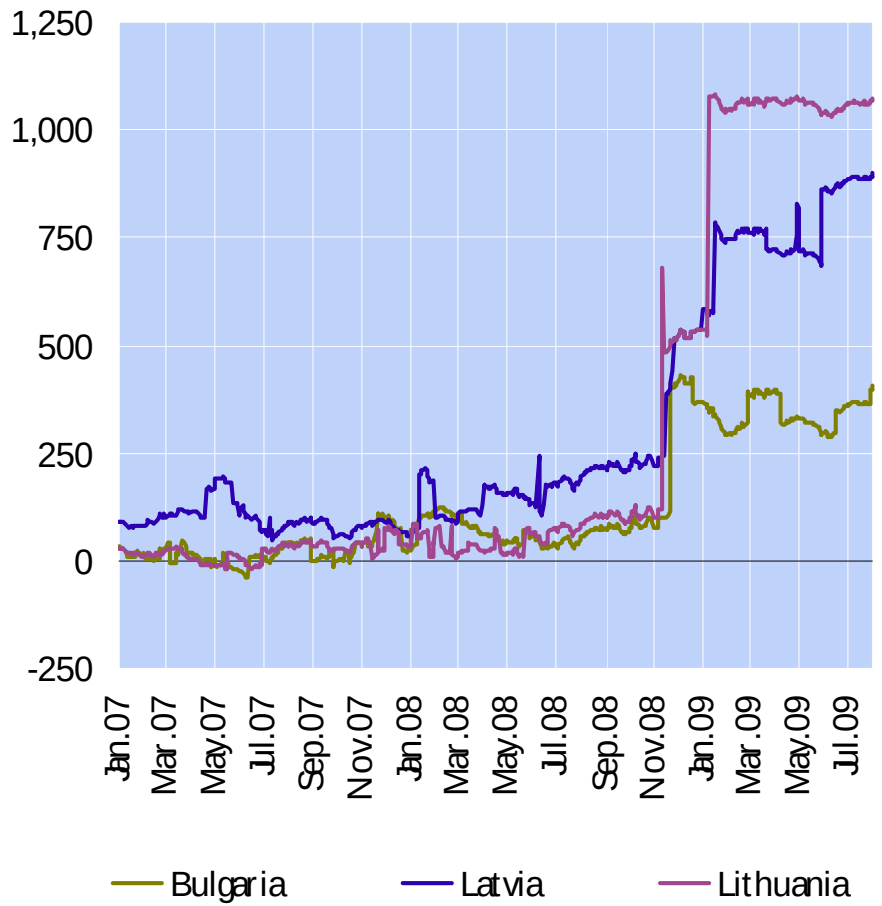
Pick-up in LC government bond yield spreads

Local currency government bond yield spreads versus euro area

basis points

Cut-off date: 31/07/2009





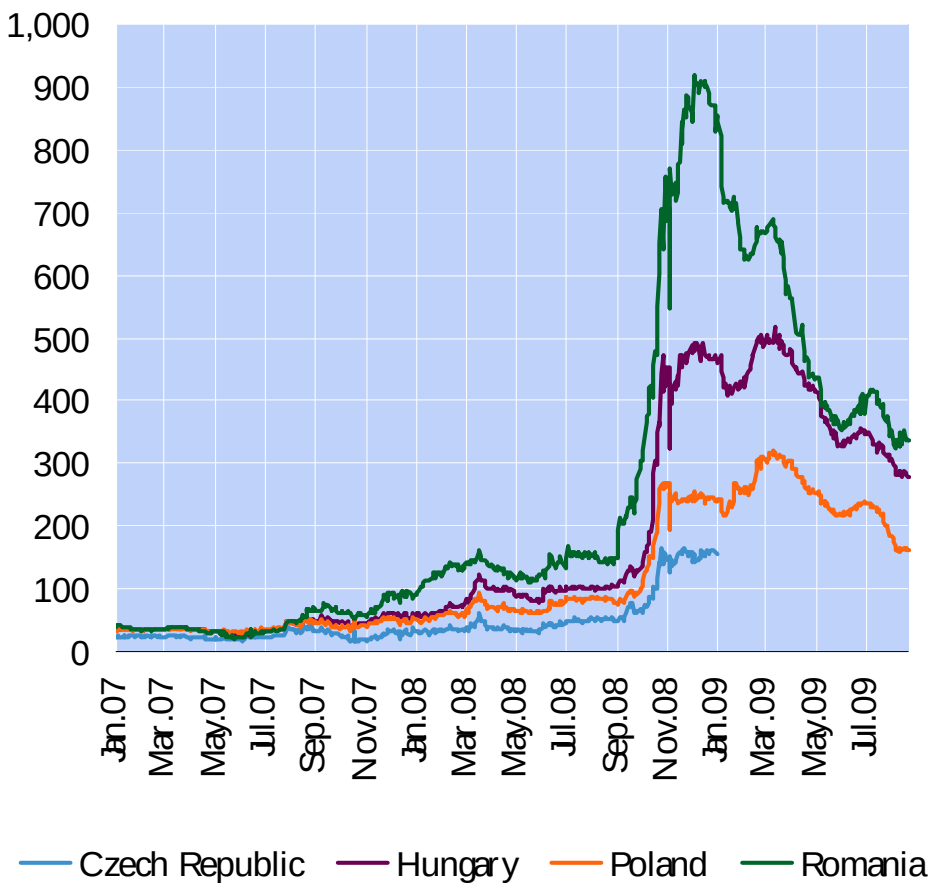
Source: Eurostat. OeNB.

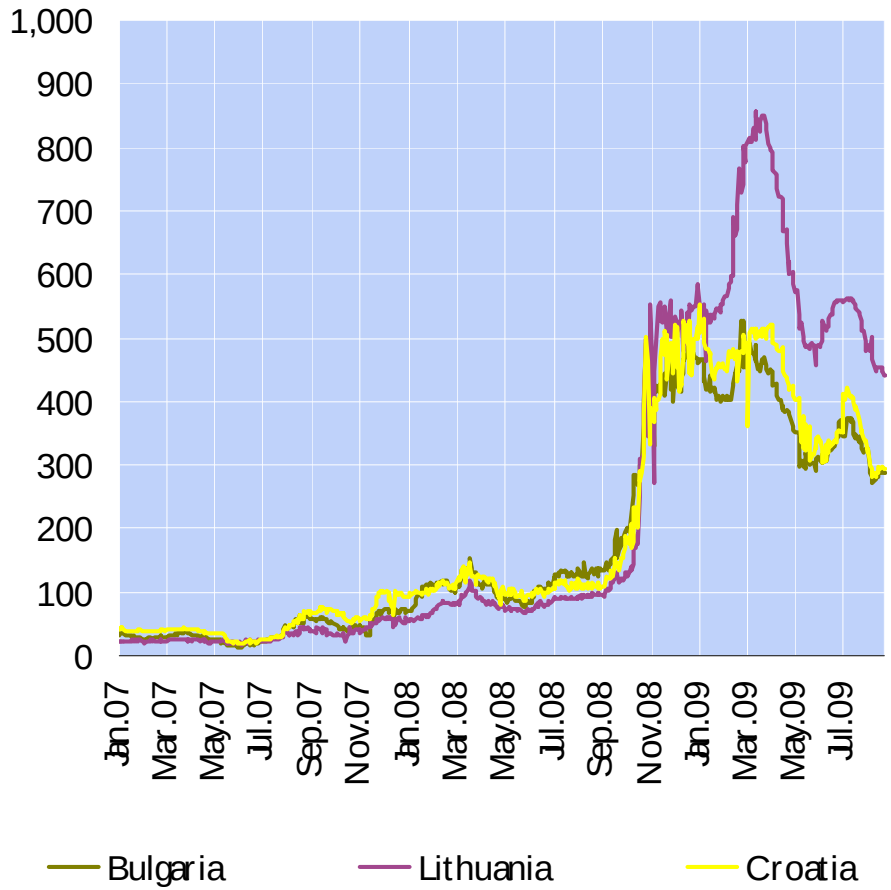
Strongly widening eurobond yield spreads

Euro-denominated eurobond yield spreads

JPM Euro-EMBI global index

Cut-off date: 21/08/2009





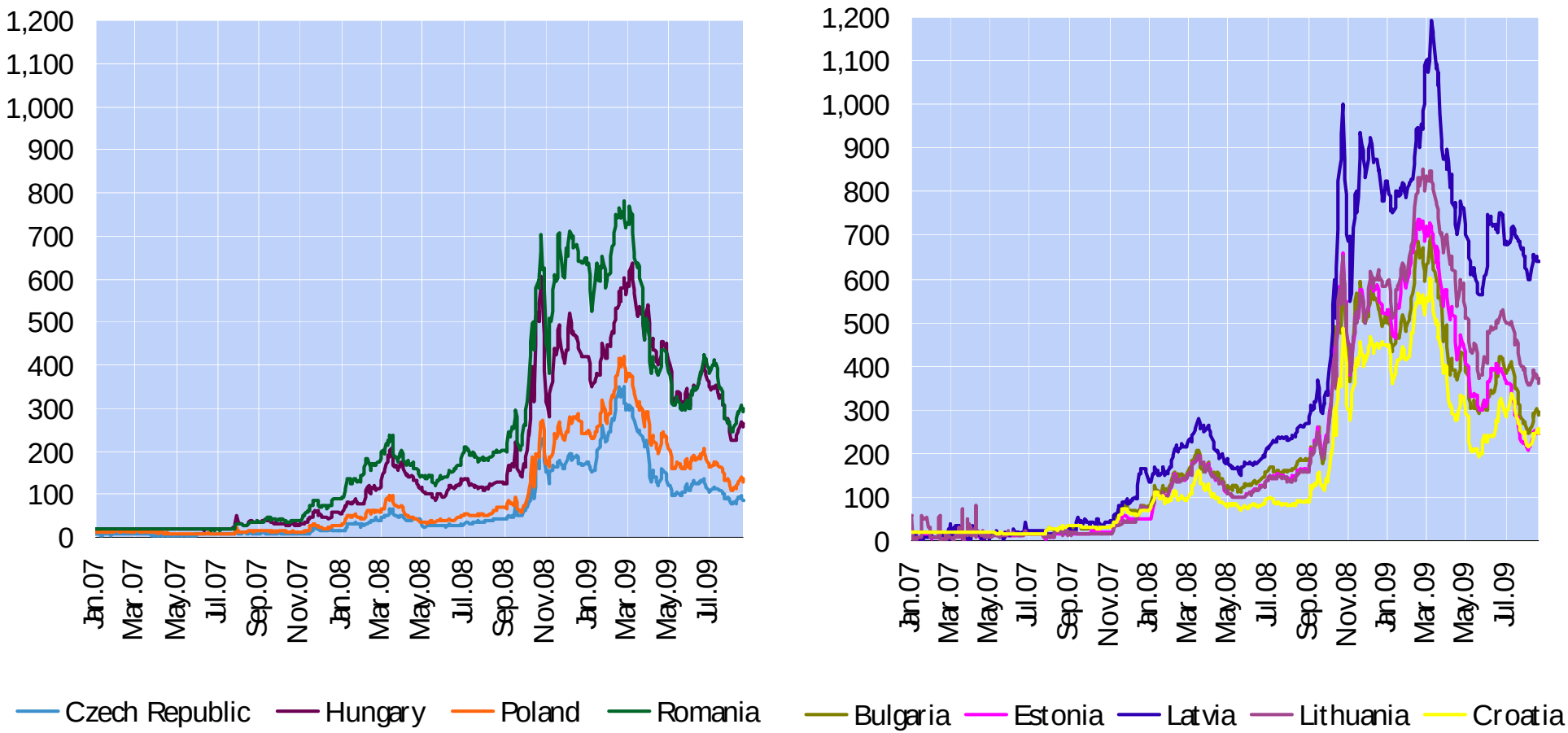
Source: Bloomberg, OeNB.

CDS spreads increase sharply, while becoming more volatile

Sovereign 5-year credit default swap premia

basis points

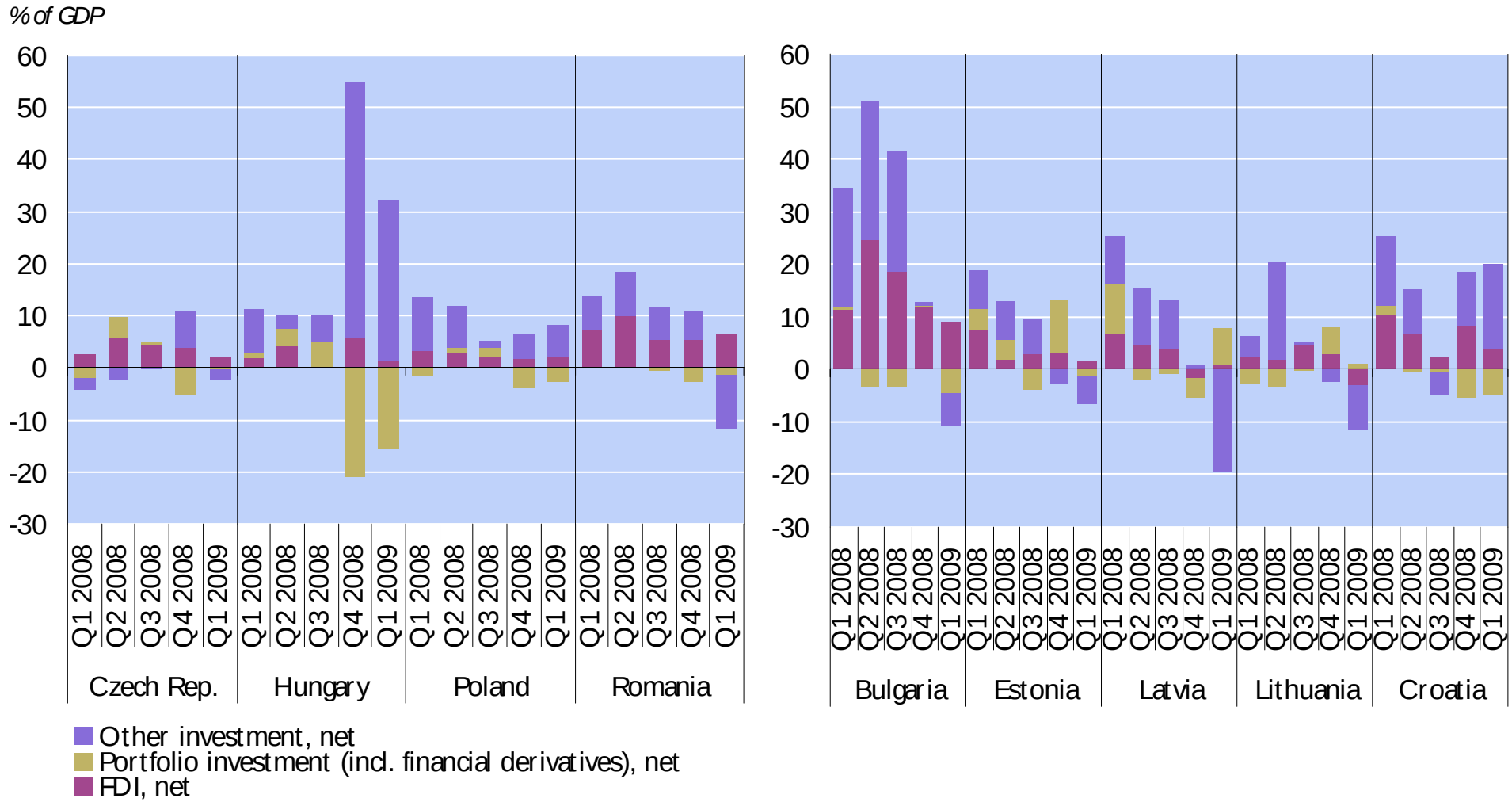
Cut-off date: 21/08/2009



Source: Datastream. OeNB.

Portfolio investment outflows after Lehman

Financial flows

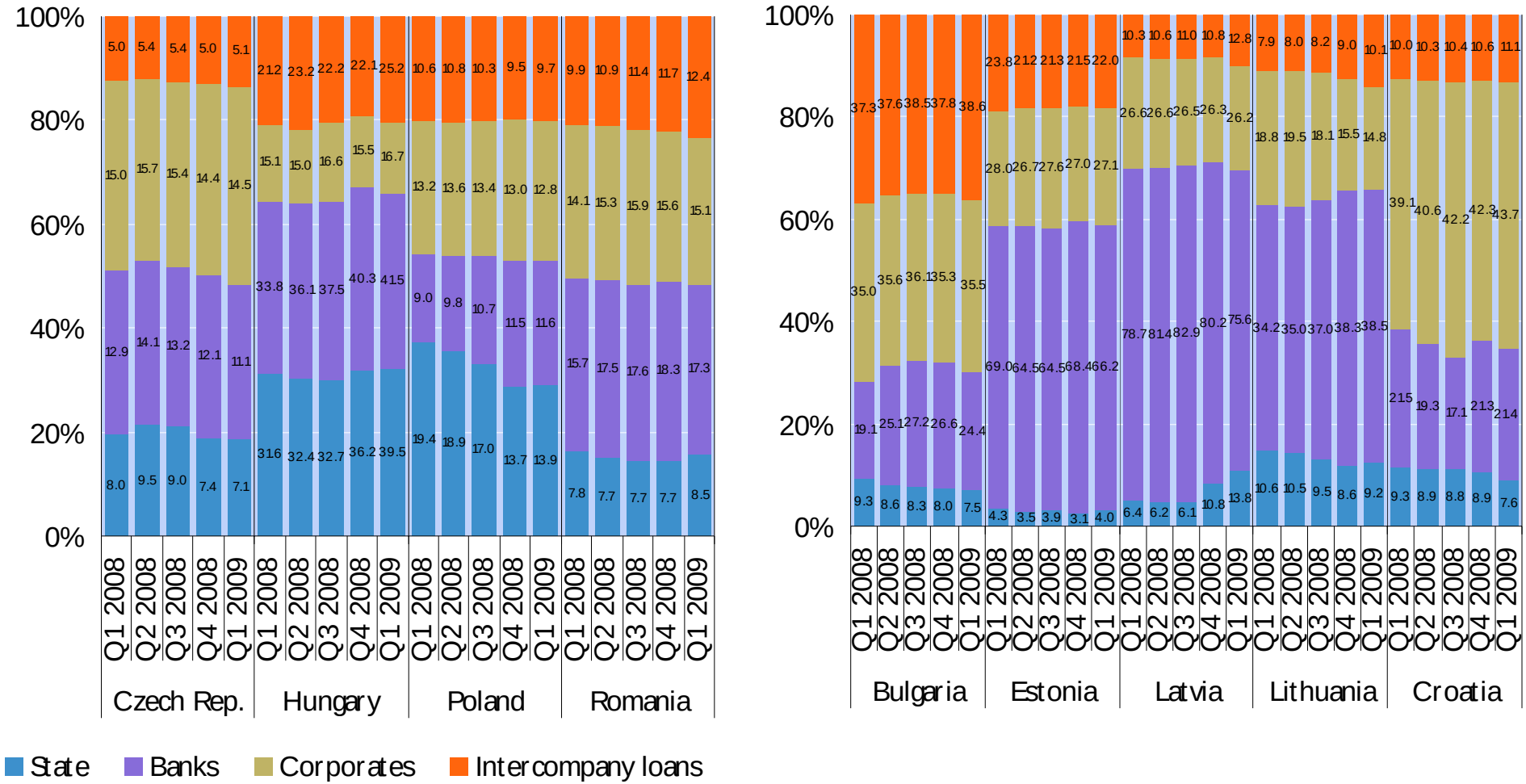


Source: Eurostat. OeNB.

Foreign financing becomes more challenging

External debt structure by debtors

% of GDP

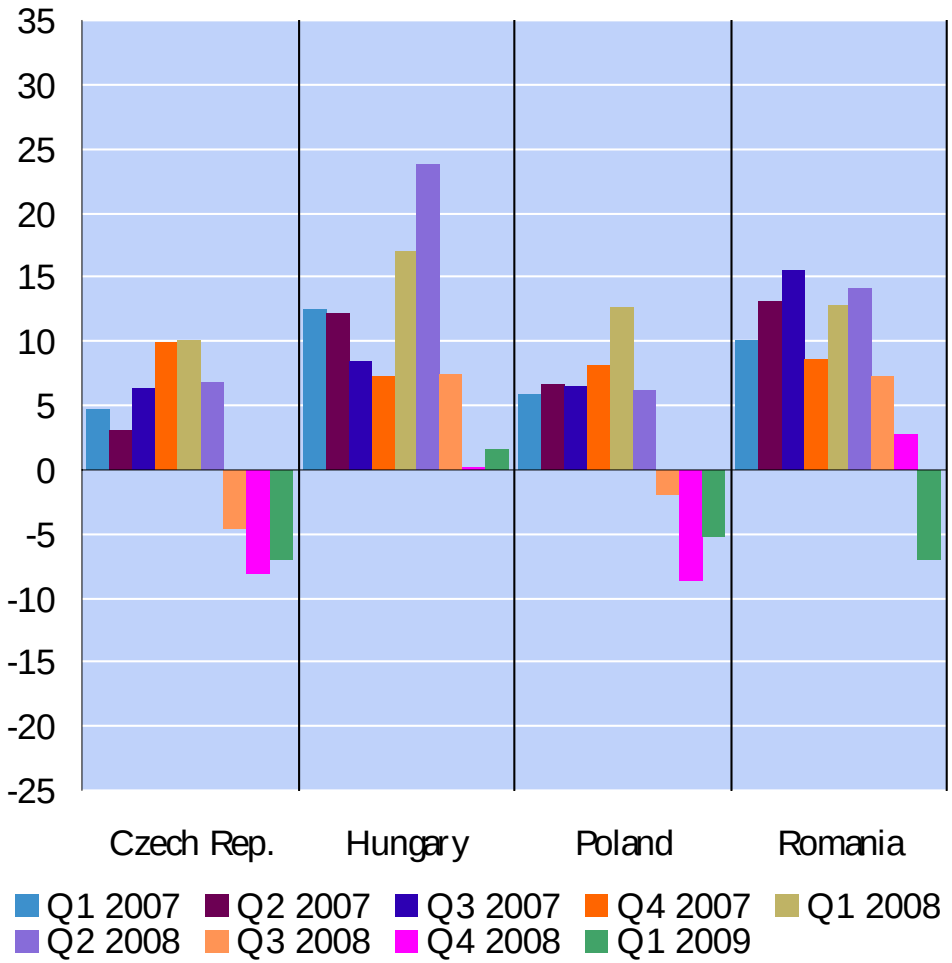


Source: NCBs, OeNB.

Capital outflows after Lehman

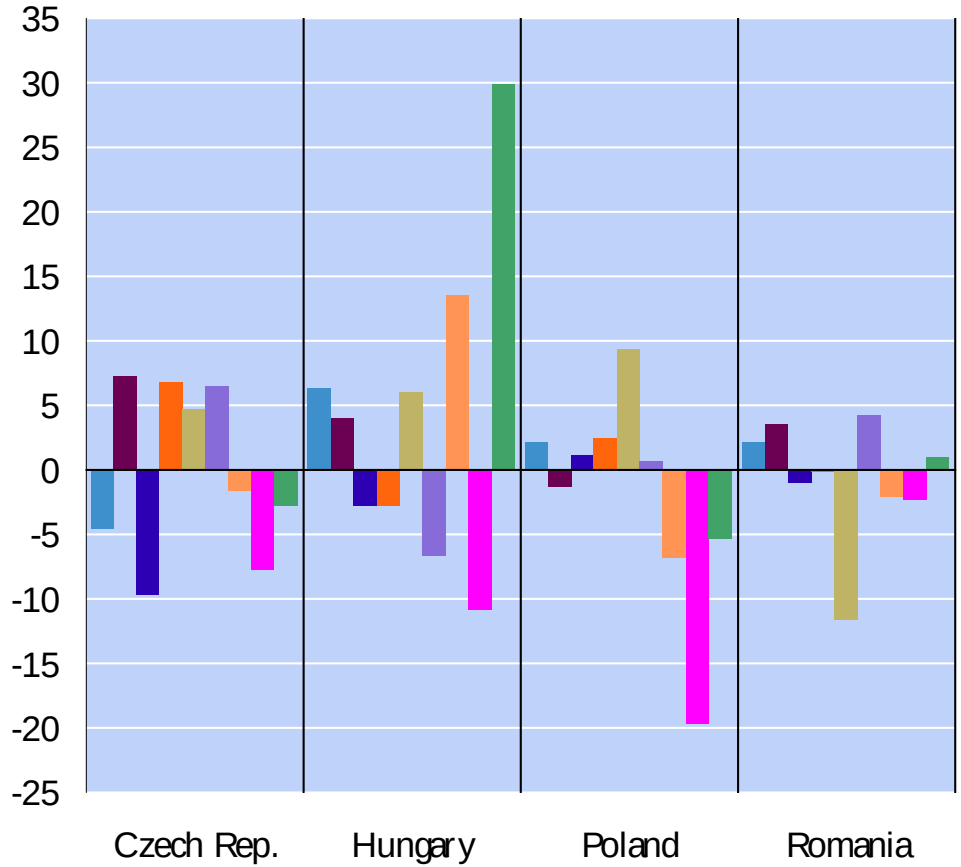
Claims of BIS reporting banks

financial flows, in % of quarterly GDP



Liabilities of BIS reporting banks

financial flows, in % of quarterly GDP

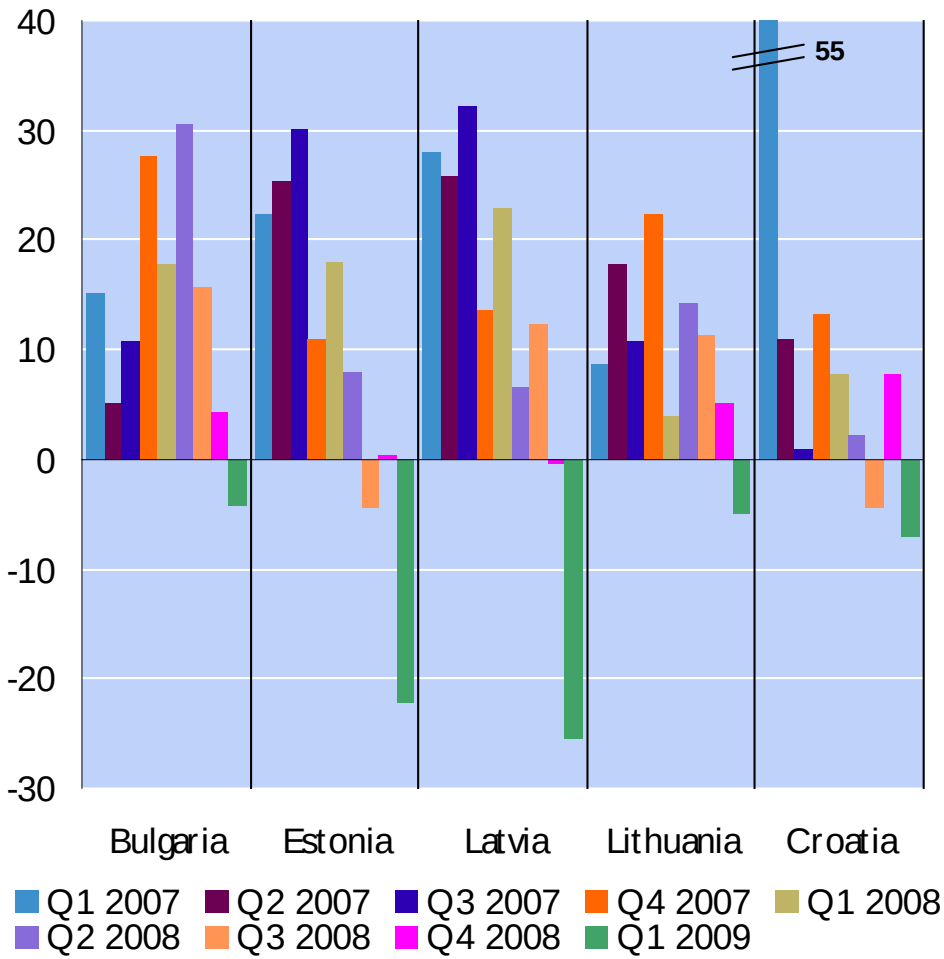


Source: BIS, OeNB.

Capital outflows after Lehman

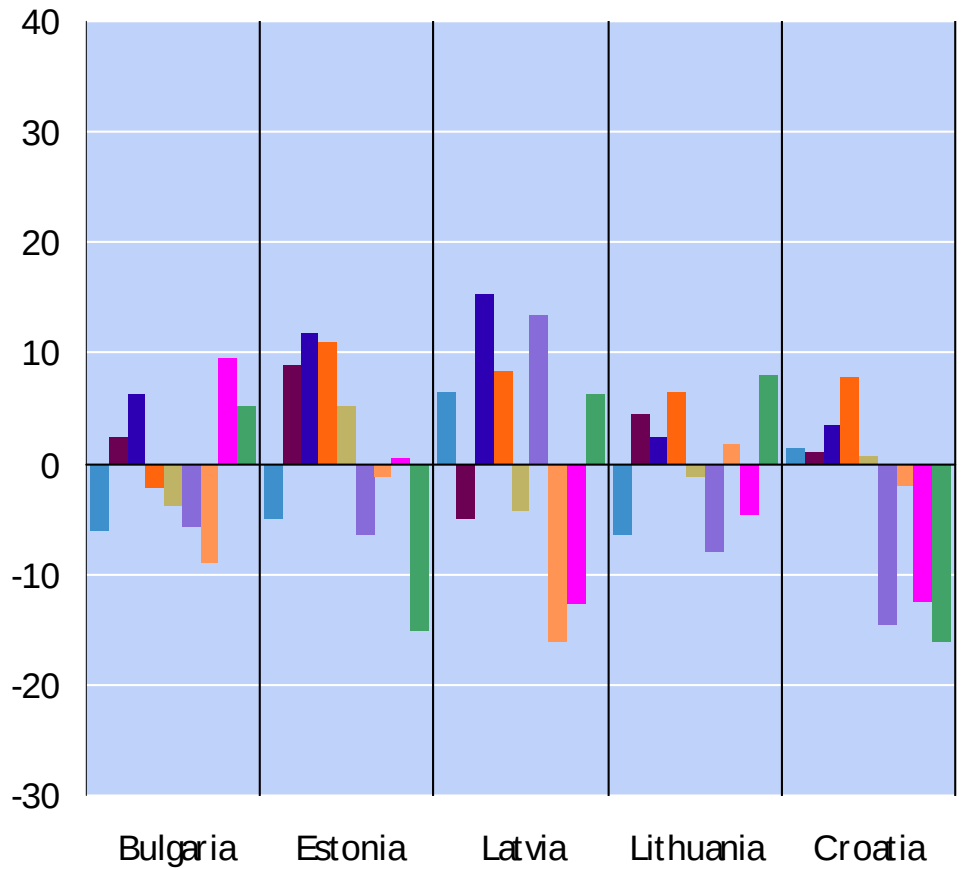
Claims of BIS reporting banks

financial flows, in % of quarterly GDP



Liabilities of BIS reporting banks

financial flows, in % of quarterly GDP

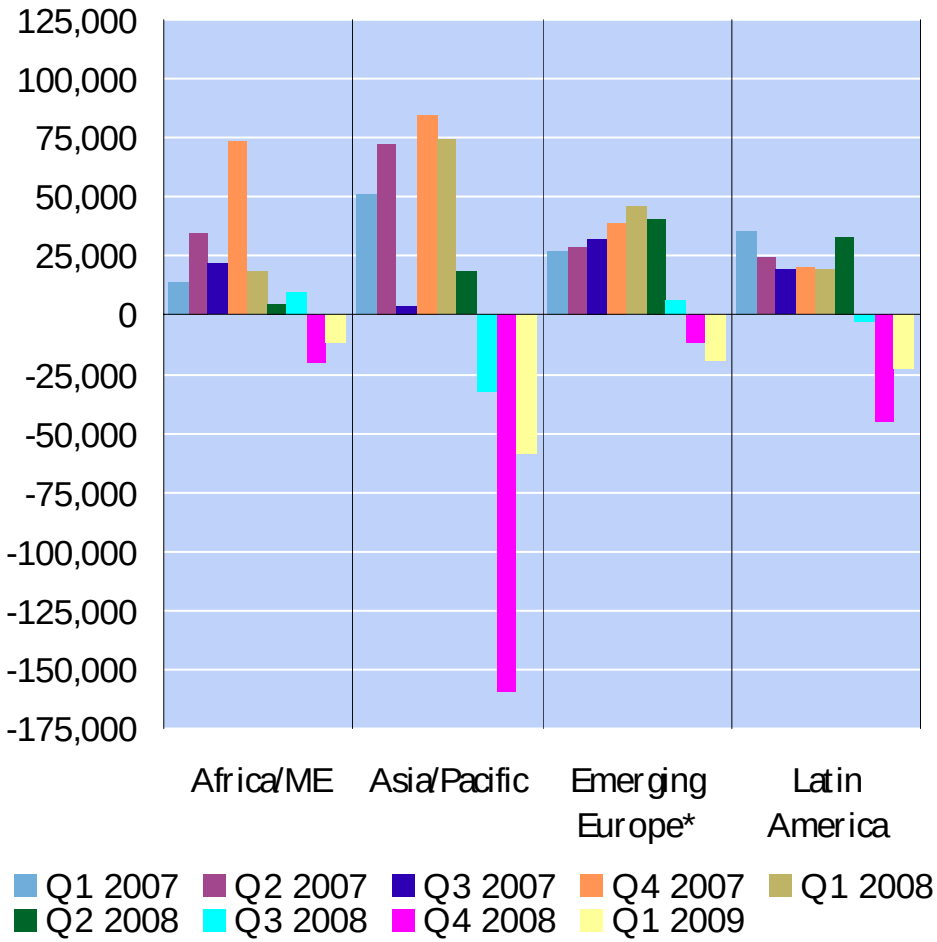


Source: BIS, OeNB.

Capital flows in emerging market comparison

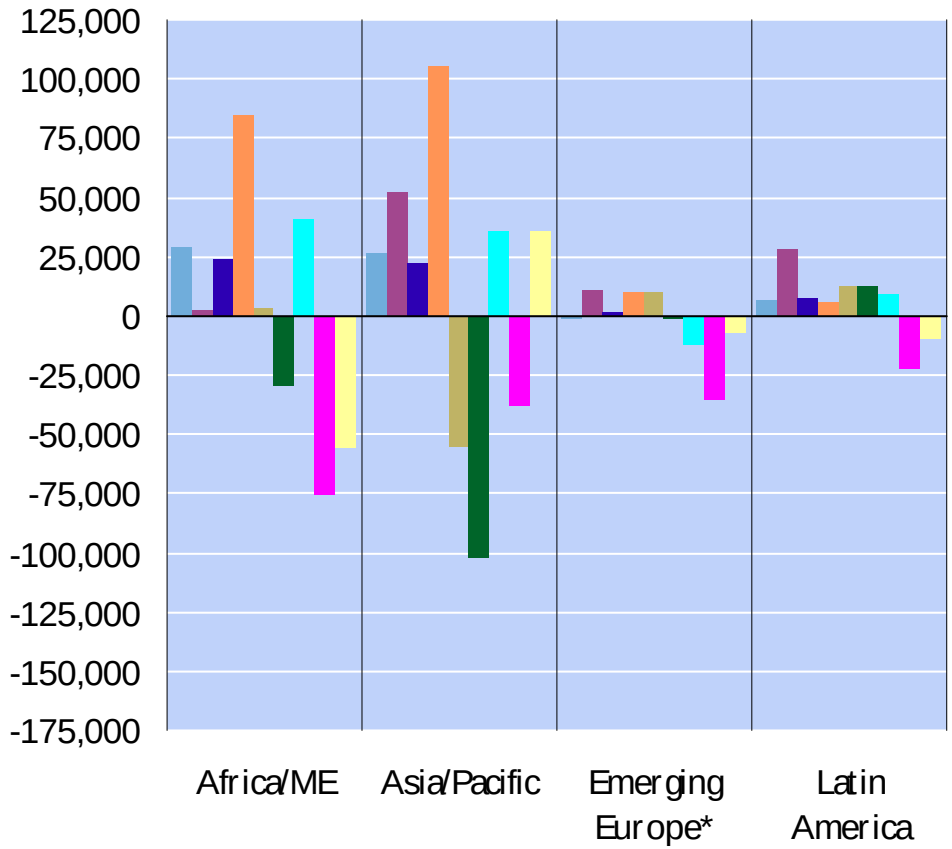
Claims of BIS reporting banks

financial flows, in USD mn



Liabilities of BIS reporting banks

financial flows, in USD mn

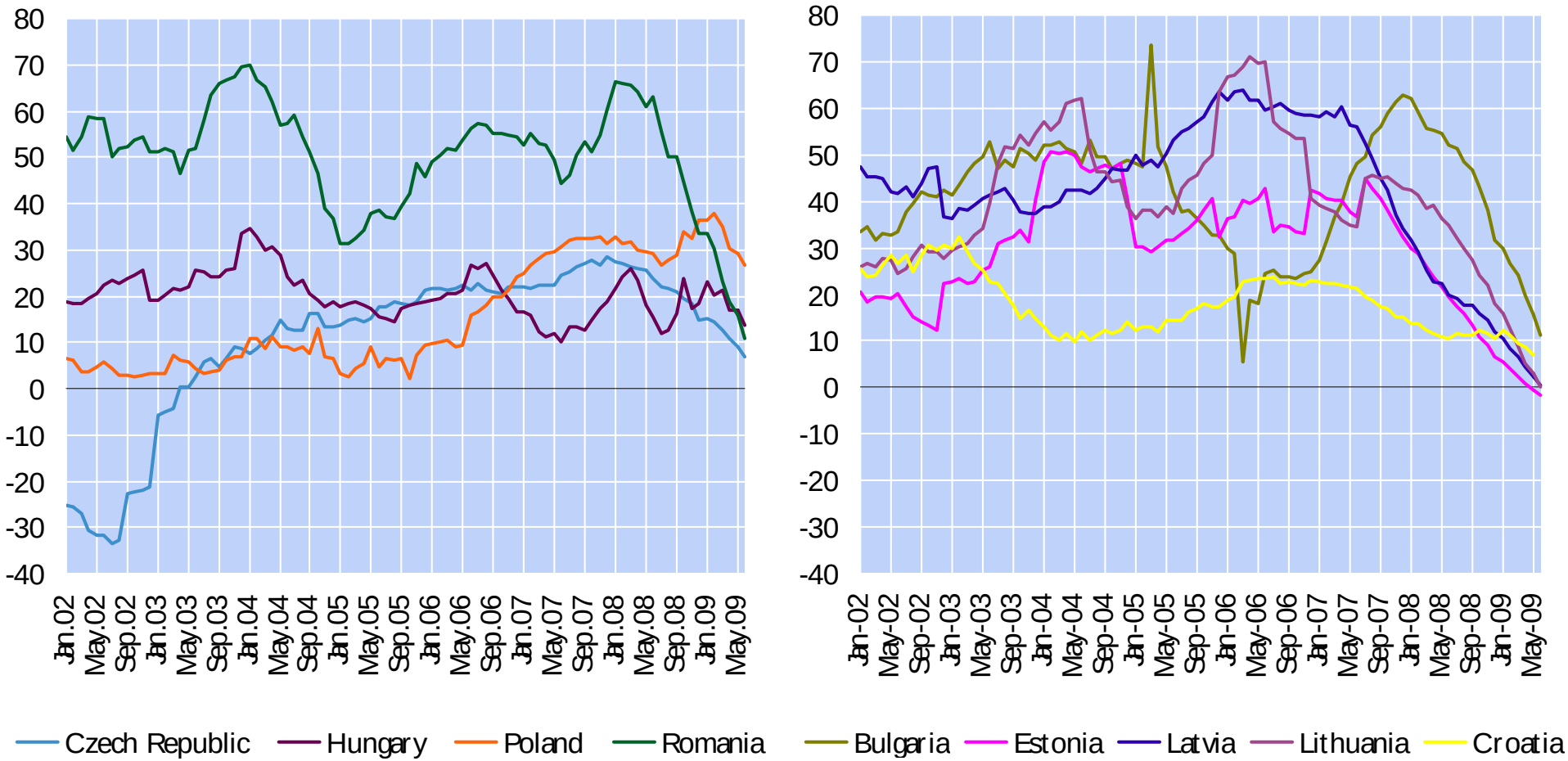


*Source: BIS, OeNB. * Emerging Europe excluding Russia and Turkey.*

Sharply decelerating credit growth

Domestic credit

yoy change, %, nominal, non-bank non-government sector

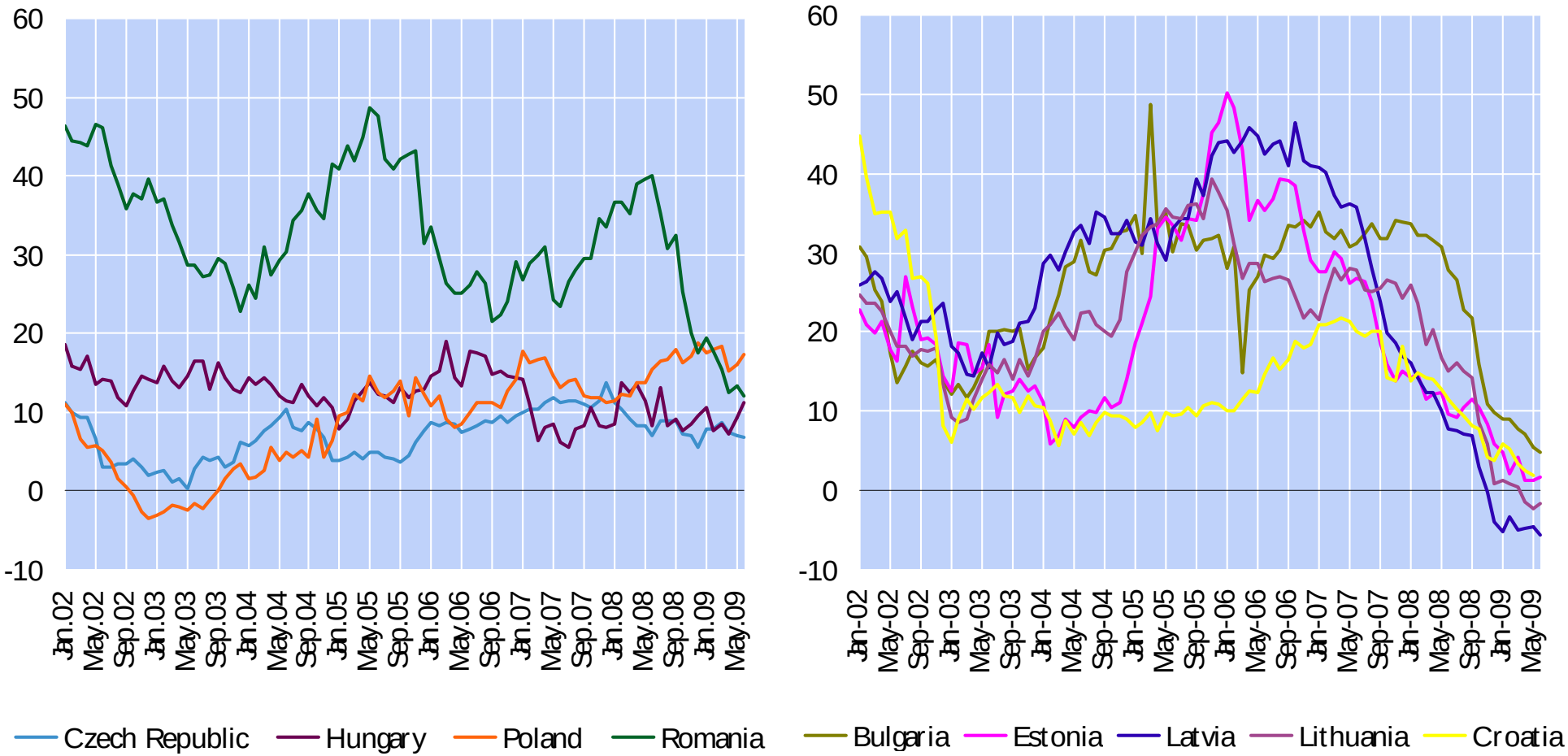


Source: Eurostat. OeNB.

Slower growth in deposits

Domestic deposits

yoy change, %, nominal, non-bank non-government sector

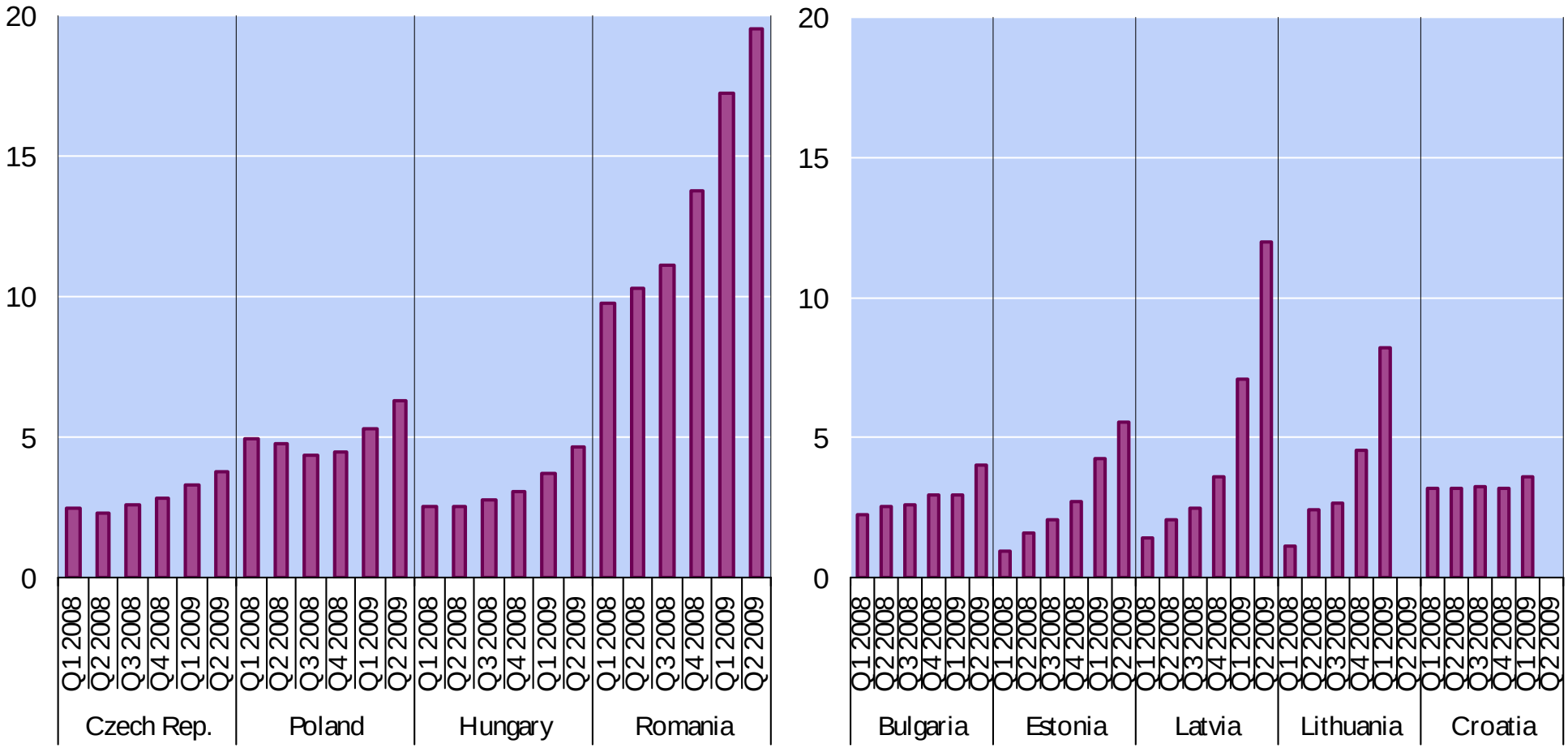


Source: Eurostat. OeNB.

NPLs pick up sharply

Non-performing loans

% of total loans

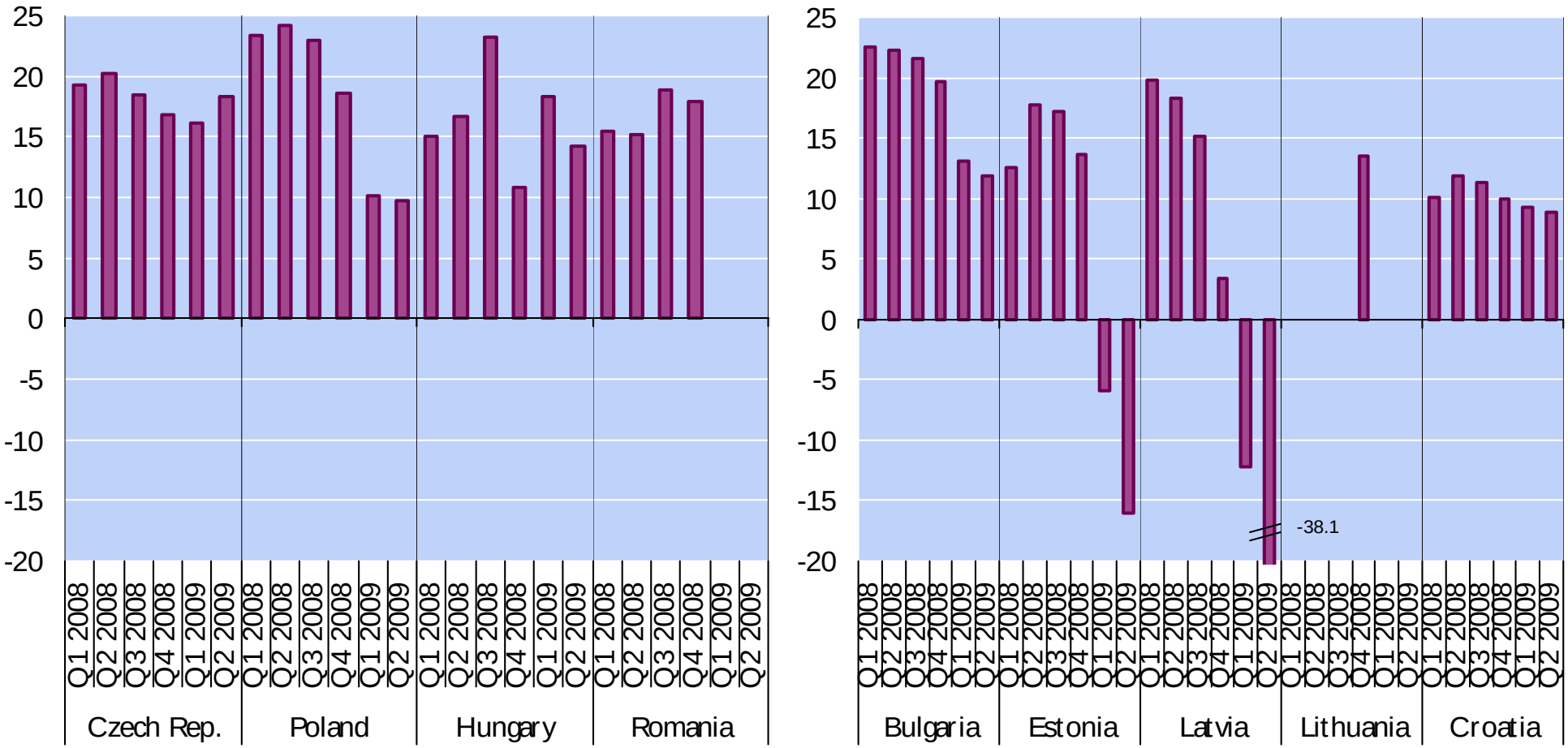


Source: NCBs, OeNB.

Decreasing profitability (esp. in the Baltics)

Return on average equity

%, after tax

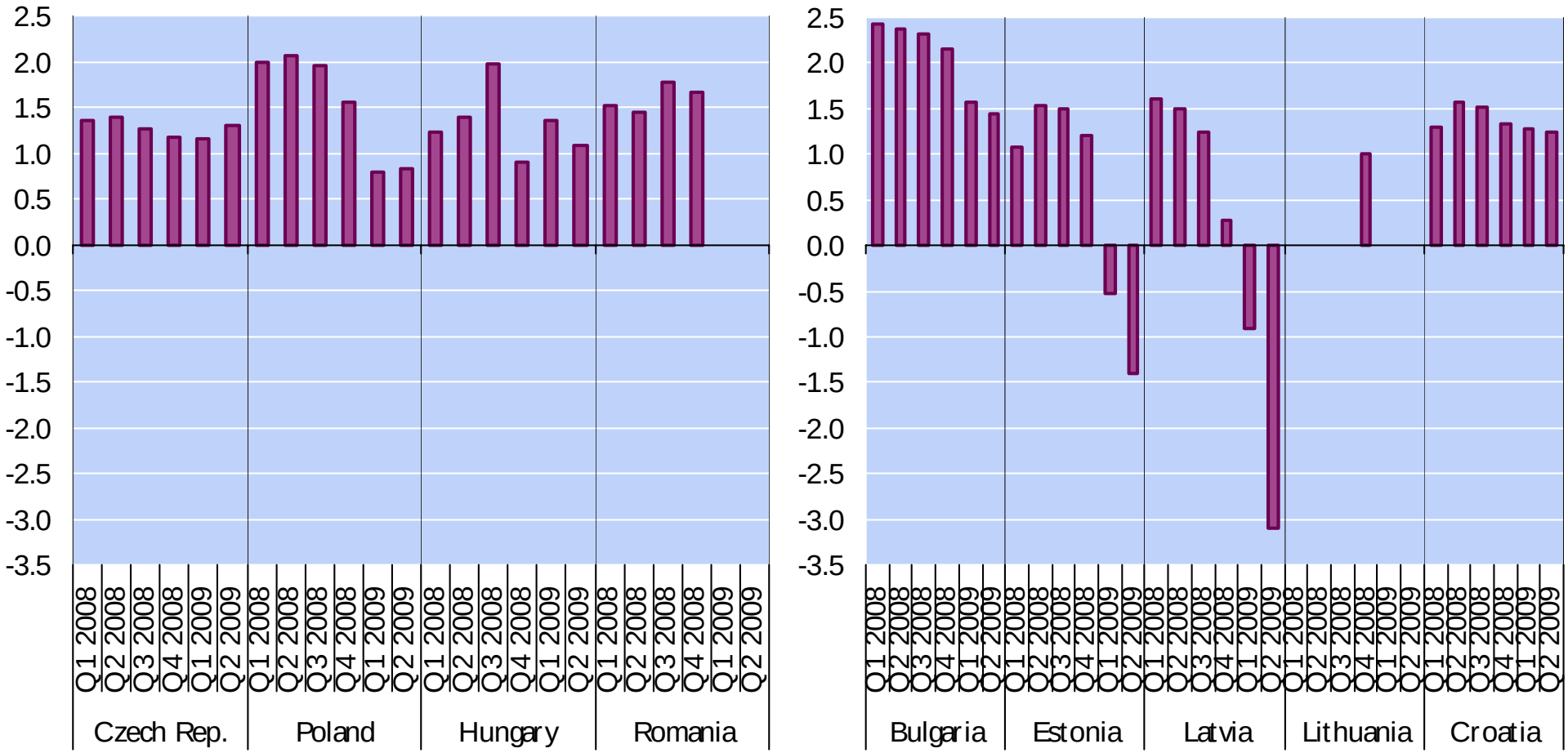


Source: NCBs, OeNB.

Decreasing profitability (esp. in the Baltics)

Return on average assets

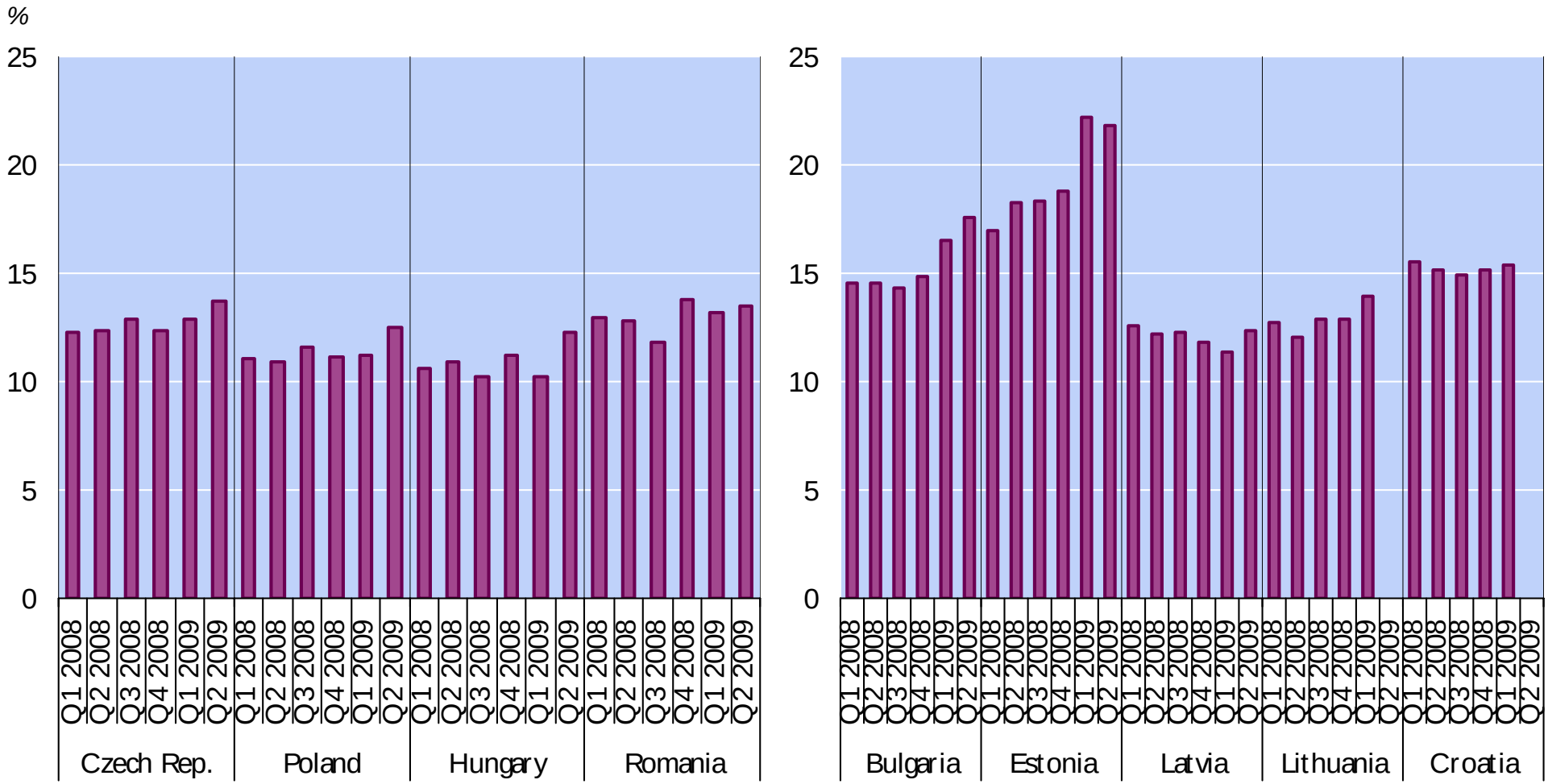
%, after tax



Source: NCBs, OeNB.

Bank capitalization remains adequate

Capital adequacy ratio

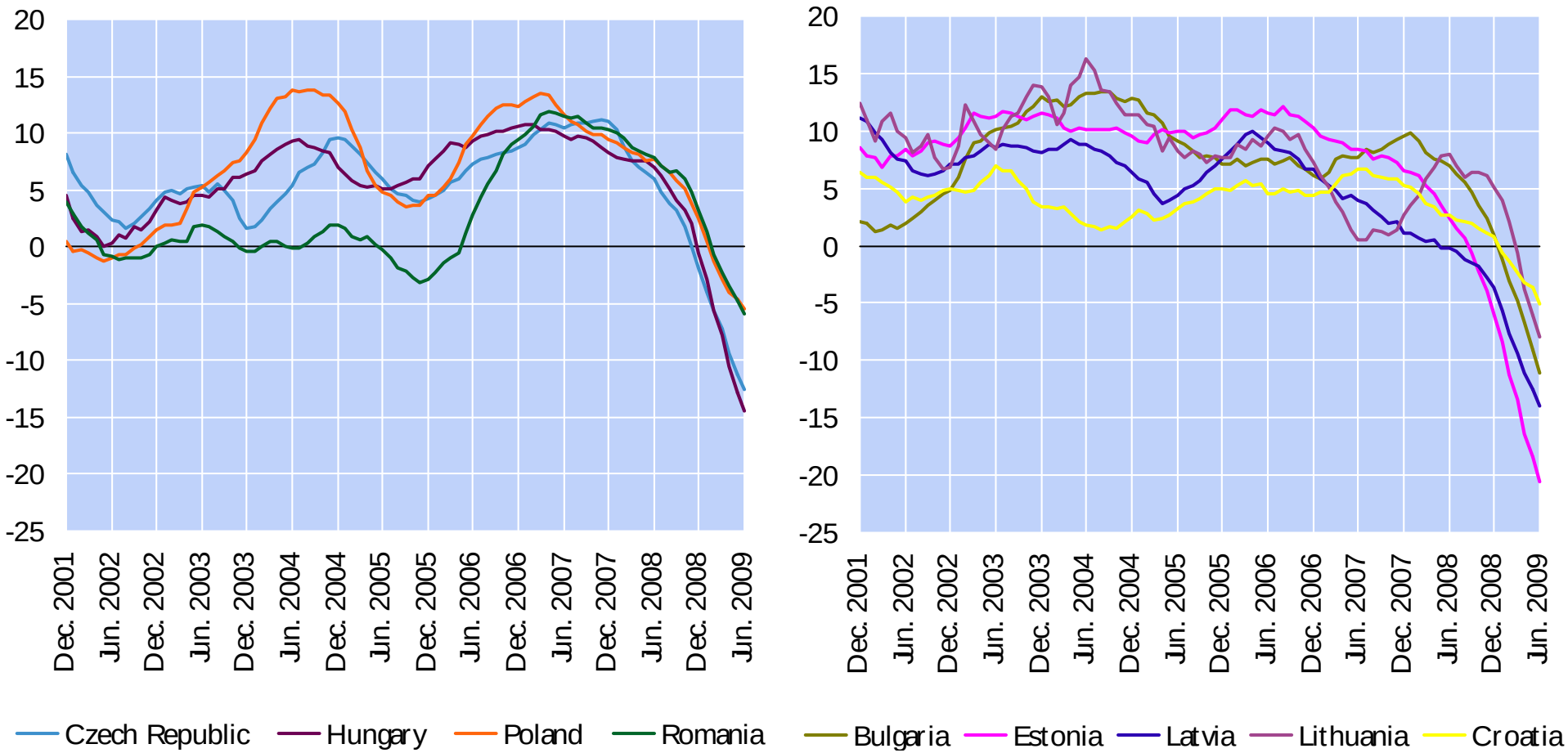


Source: NCBs, OeNB.

Slump in industrial production

Industrial production

% change yoy, working day adjusted, 12-month rolling average

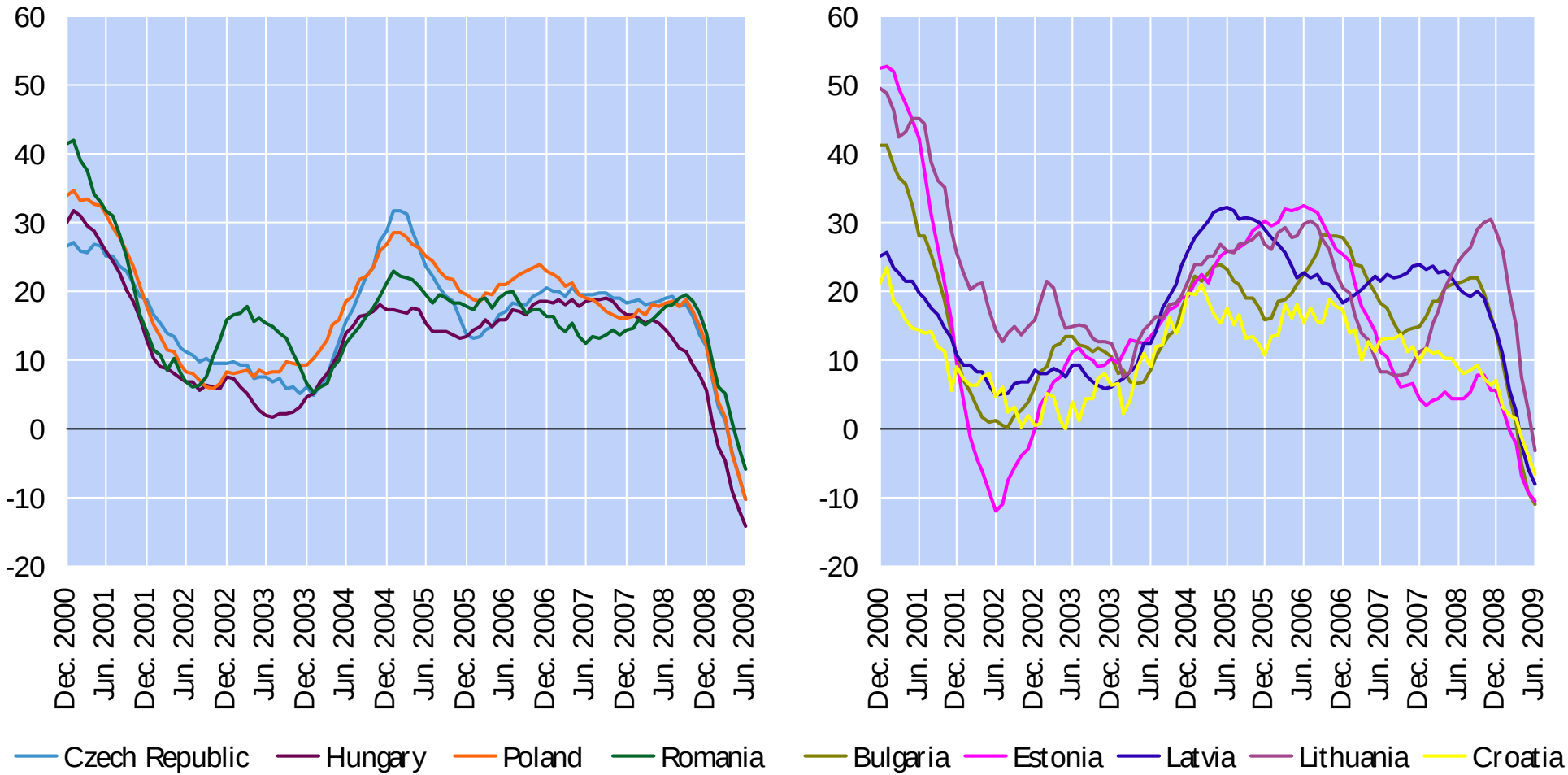


Source: Eurostat. OeNB.

Sharply decelerating foreign demand

Exports

% change, yoy, euro basis, 12-month rolling average

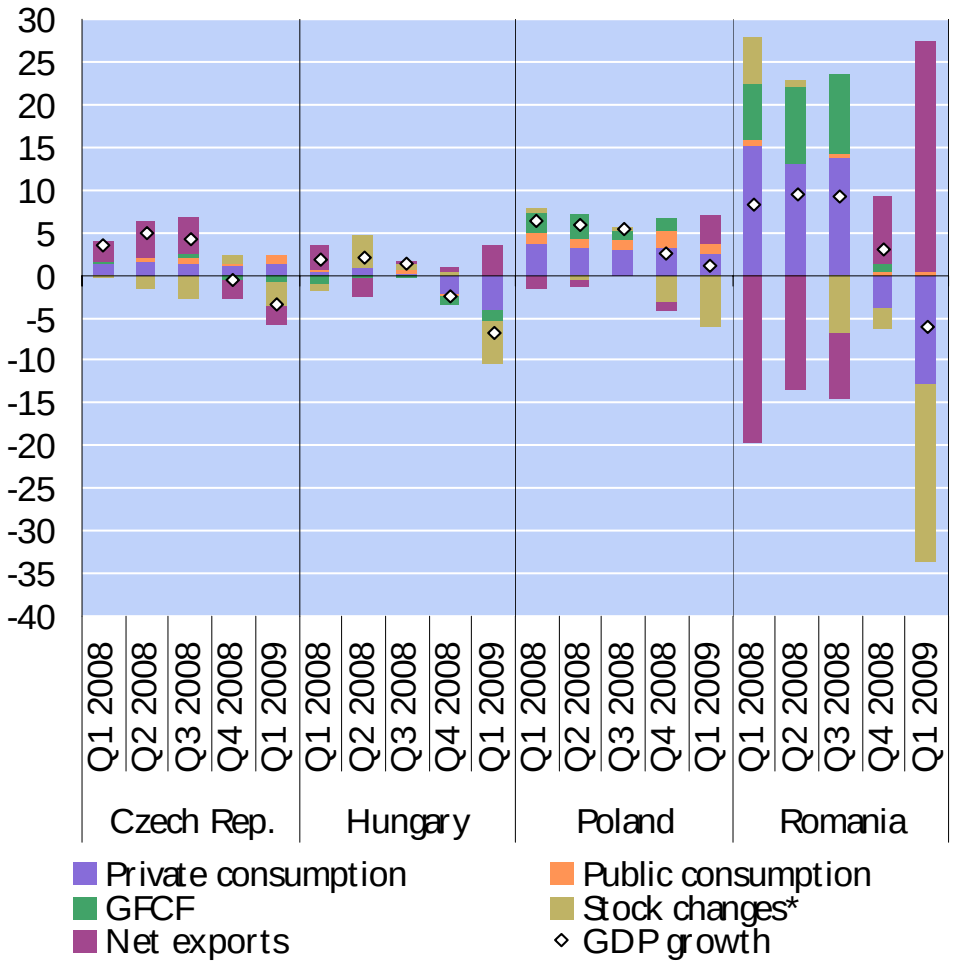


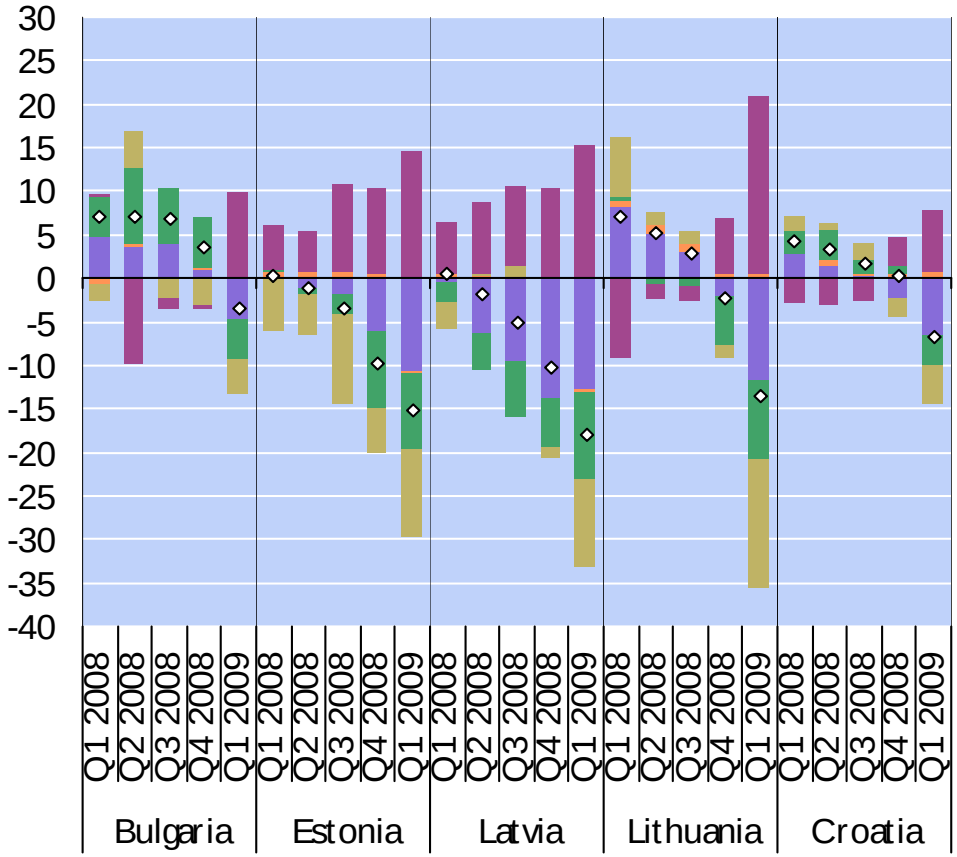
Source: Eurostat. OeNB.

Dramatic fall in GDP growth

GDP growth and its components

GDP growth: yoy change, %. Components: Percentage points contribution to growth



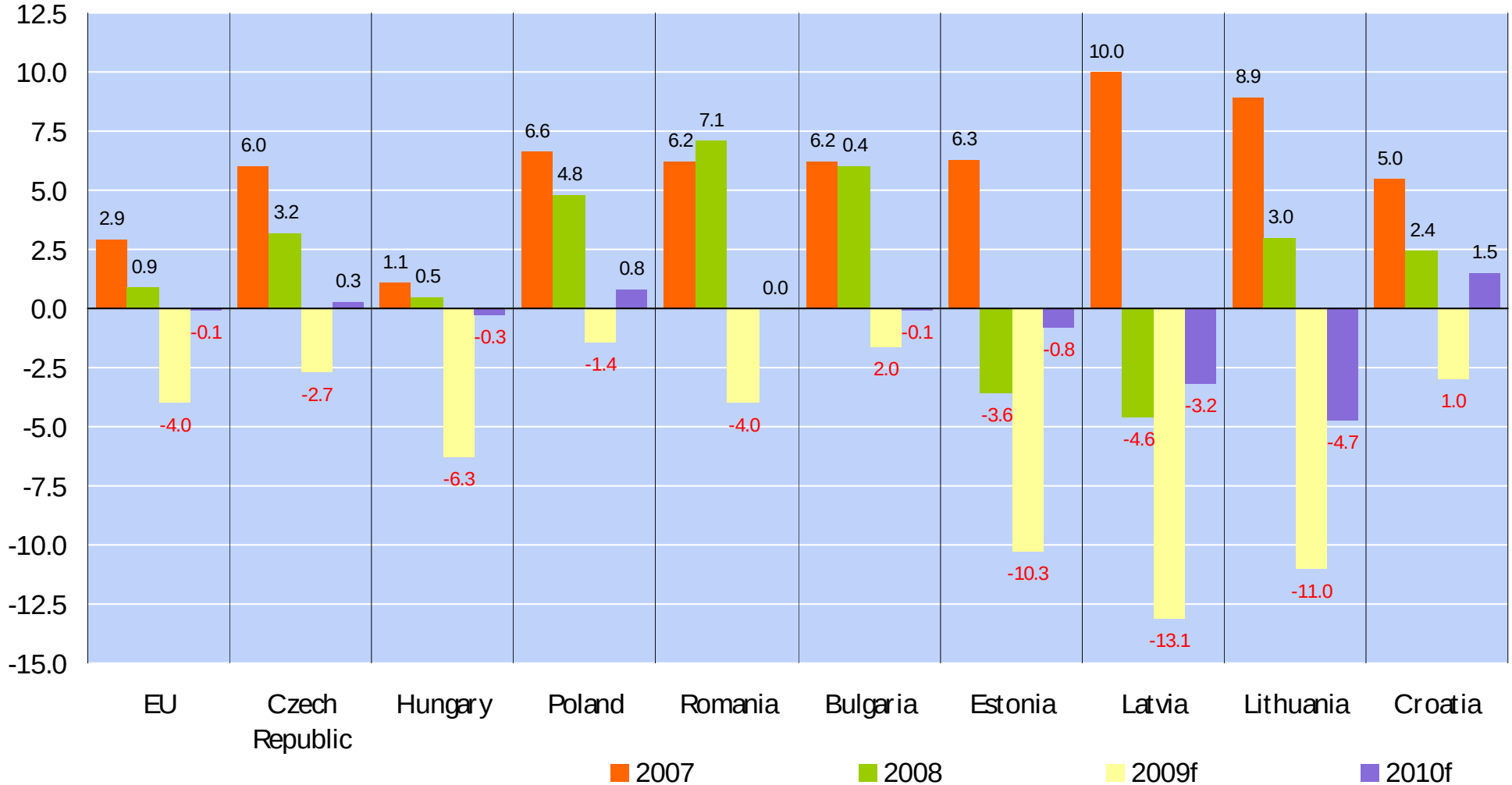


*Source: Eurostat. OeNB. * Including statistical discrepancy.*

Less favorable economic forecasts

GDP forecasts for CESEE 2009-2010

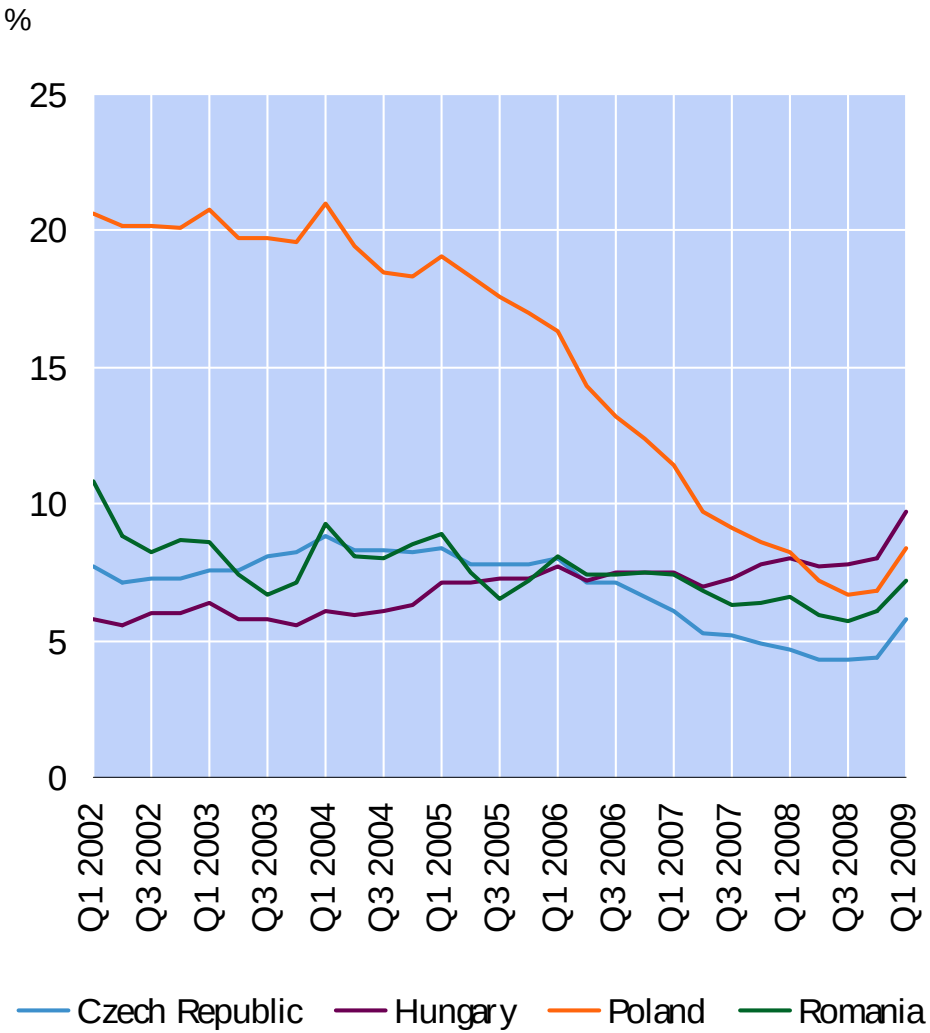
at constant prices, year-on-year percentage change

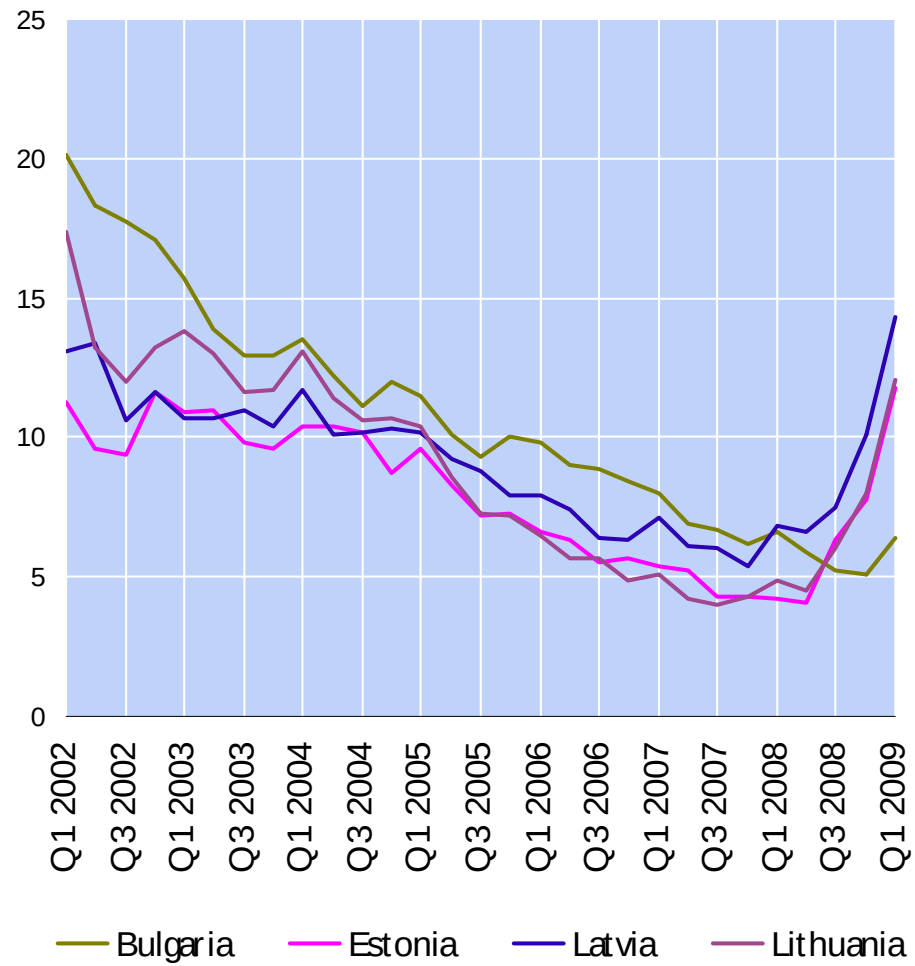


Source: European Commission (spring forecasts 2009).

Increasing unemployment

Unemployment rates



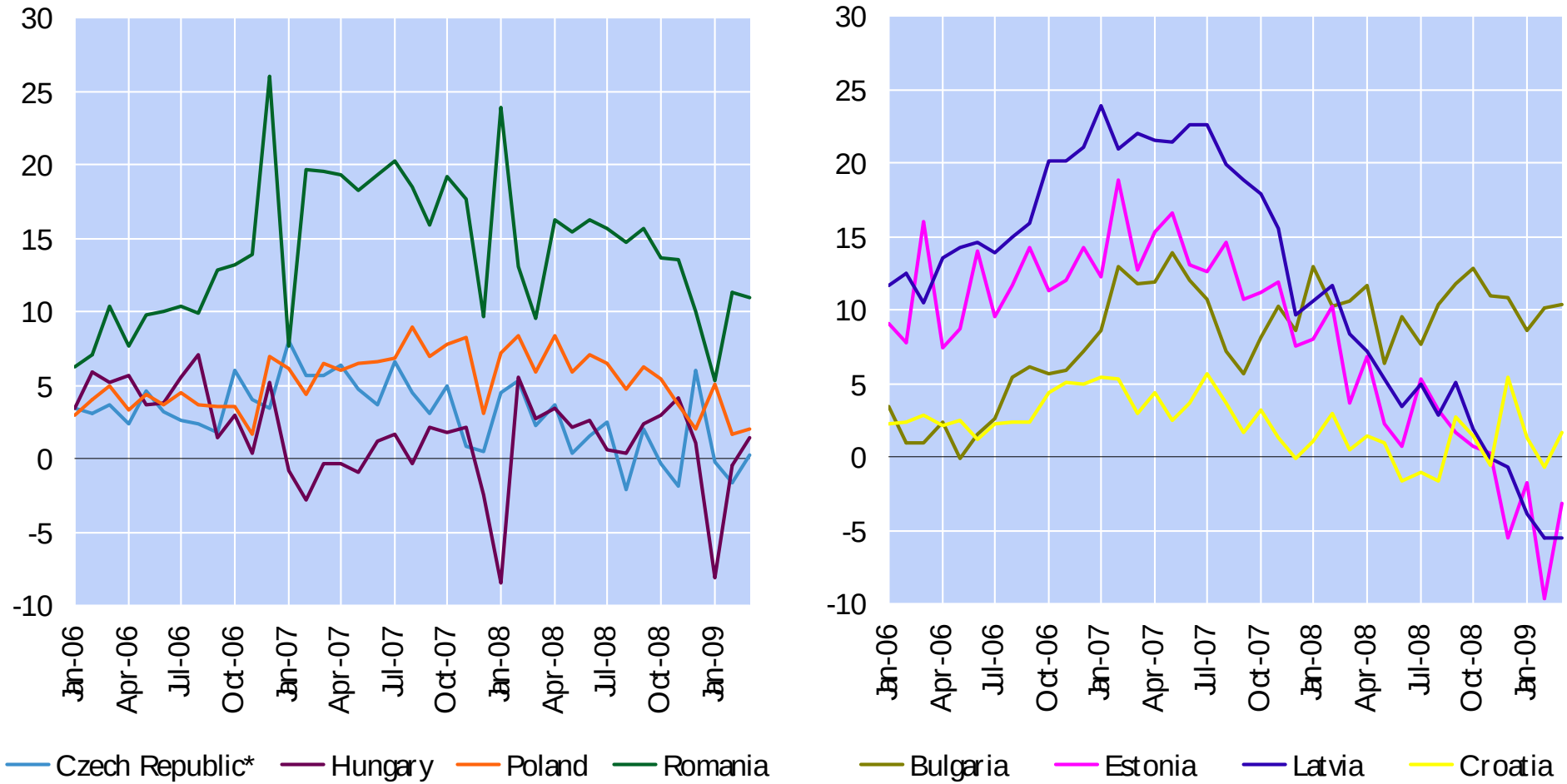


Source: Eurostat. OeNB.

Slowing wage growth

Wage developments in CESEE

Real gross wages, whole economy, monthly average, yoy, in %, HICP-deflated



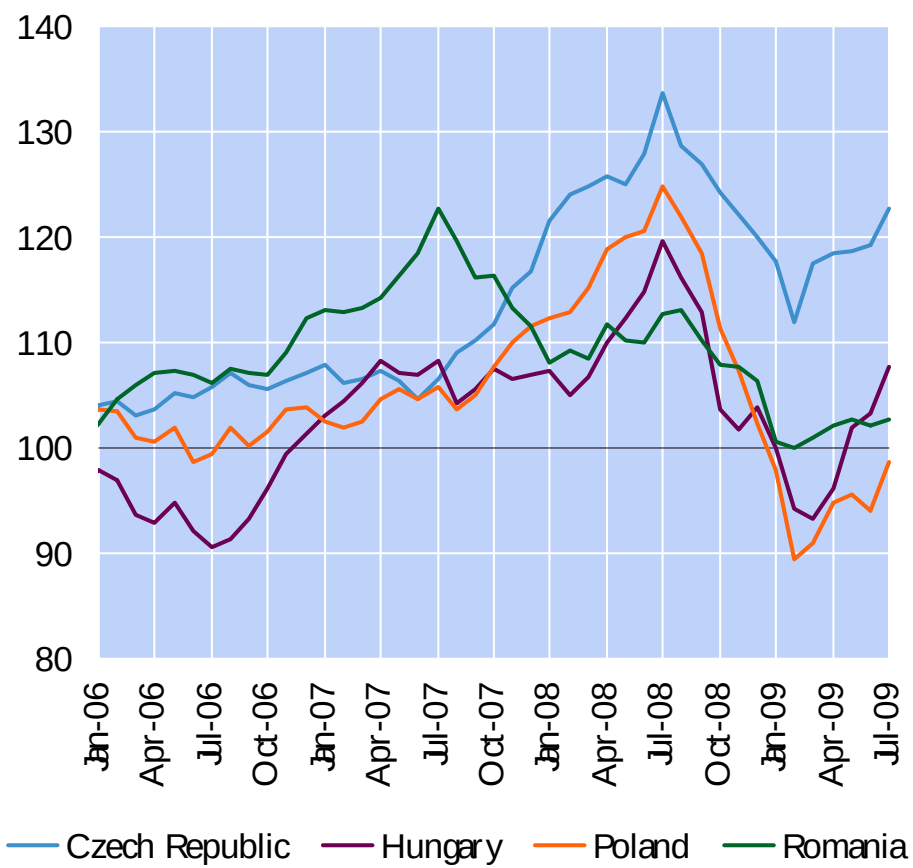
*Source: WIIW. National Statistical Offices. OeNB. *Czech Republic = wages in industry.*

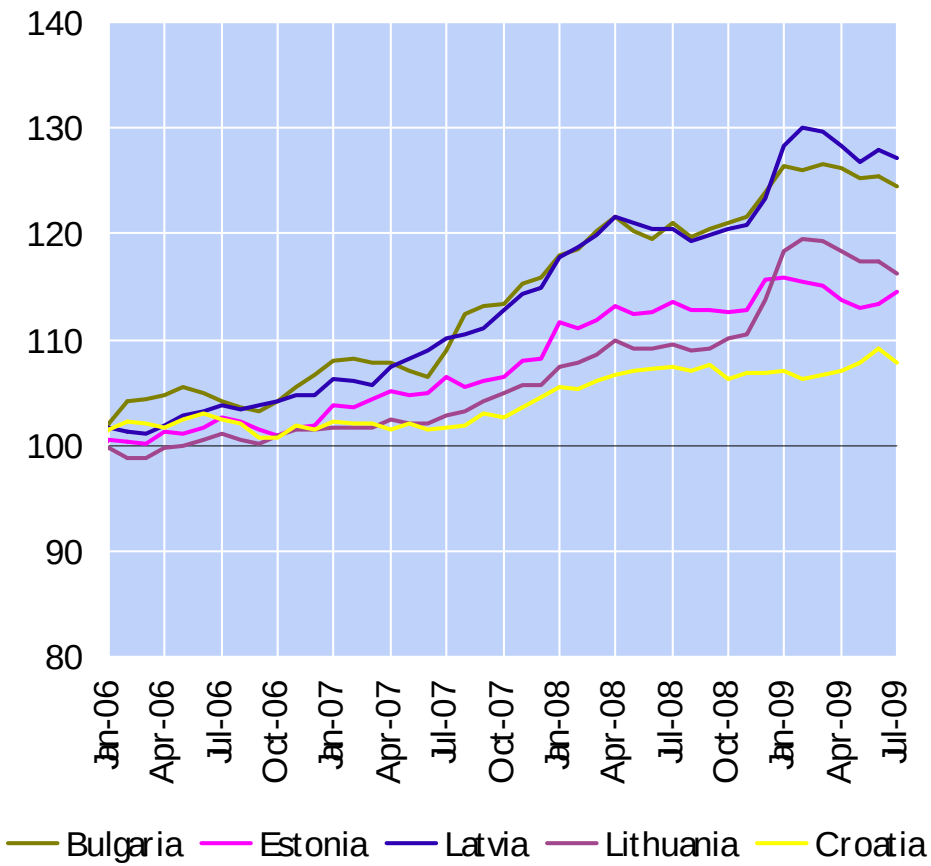
REER – mixed evidence

Real effective exchange rates in CESEE

Real (CPI-based), broad indices

Monthly averages; 2005=100



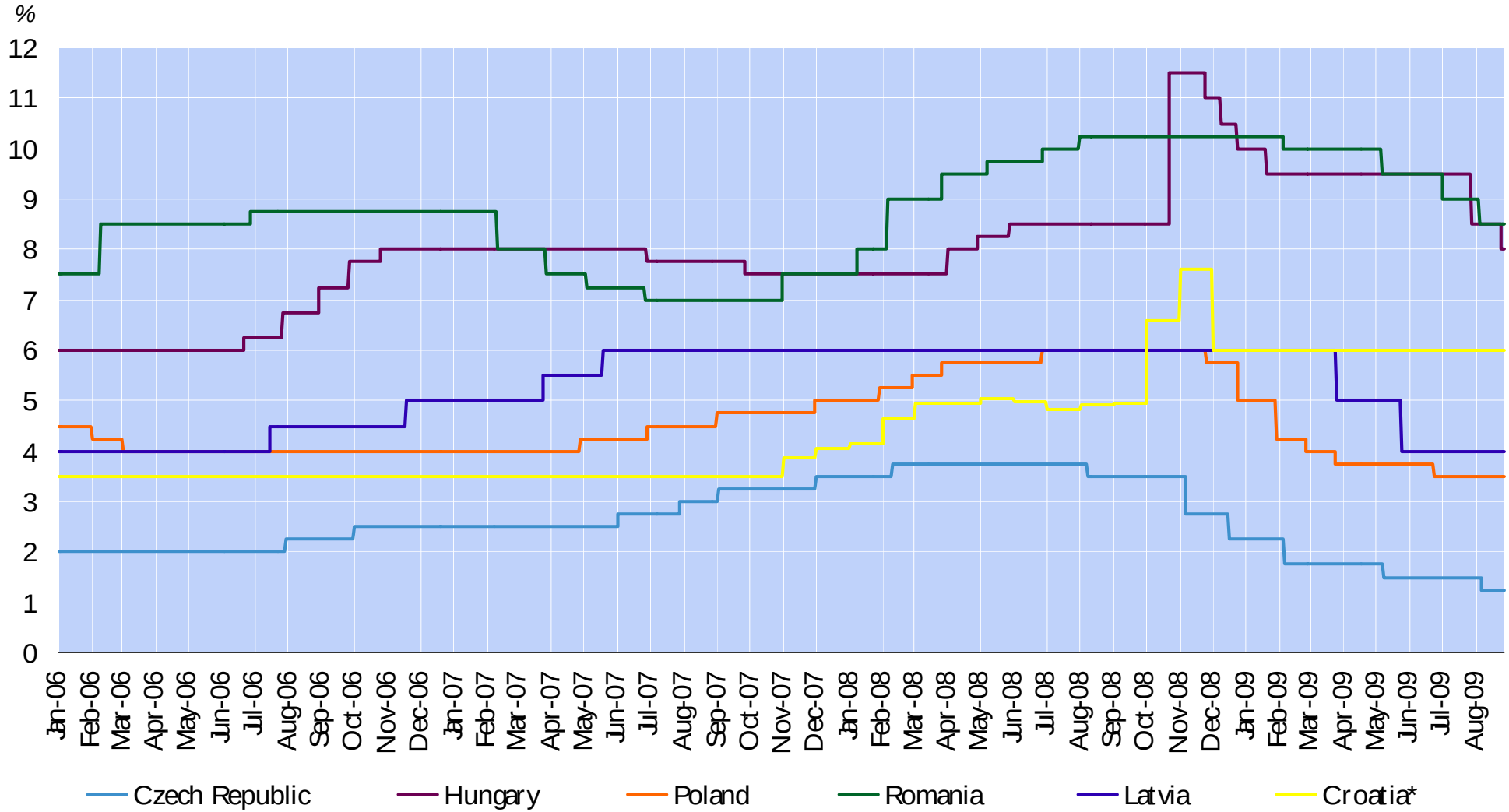


Source: BIS, OeNB.

Monetary easing continues

Policy Rate Developments in CESEE

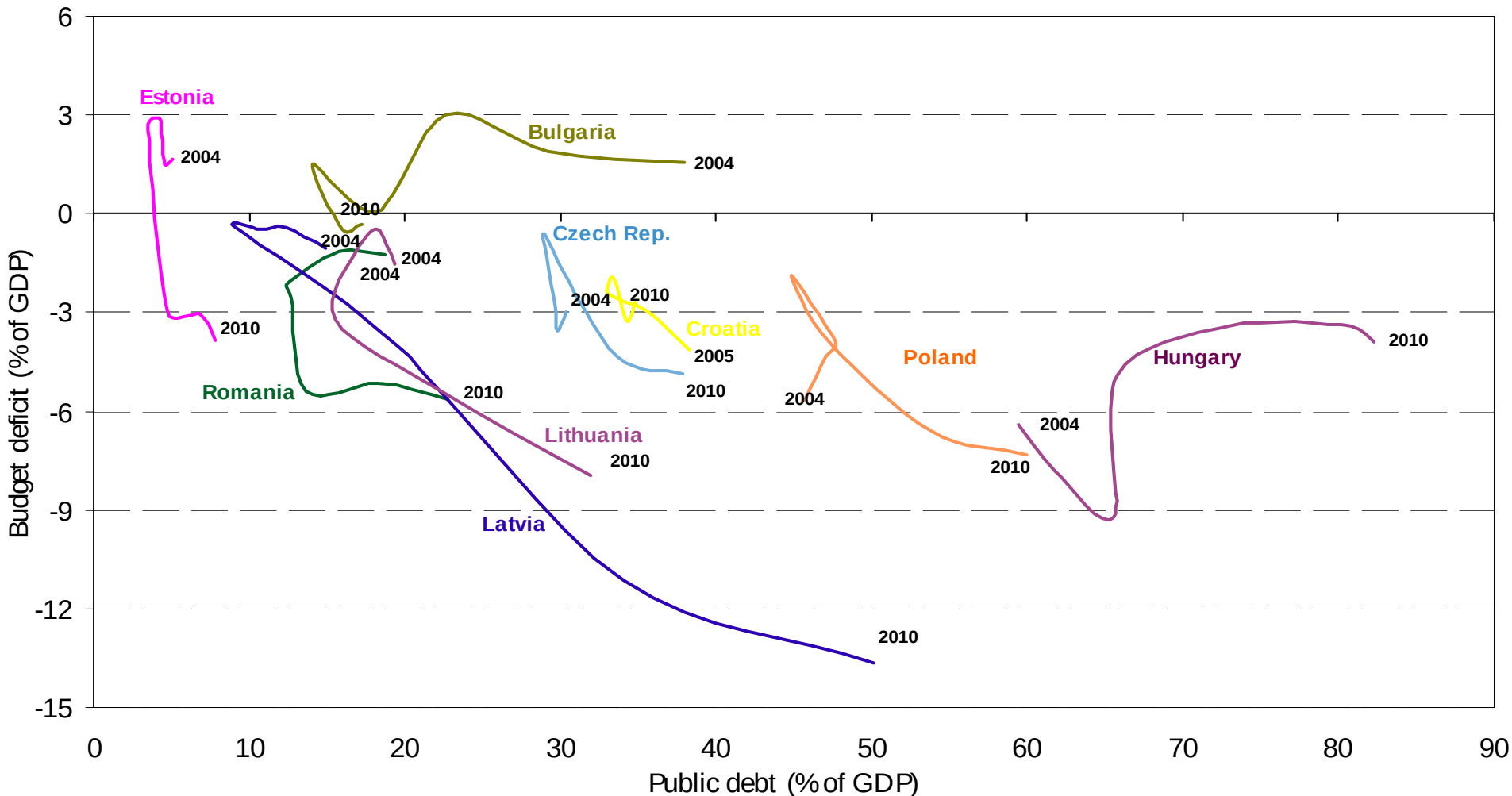
Cut-off date: 25/08/2009



*Source: NCBs, OeNB. *Weighted averages of weighted repo rates achieved at regular reverse repo auctions of the CNB in the reporting month.*

Increasing fiscal burden

Public Finances in CESEE 2004-2010



Source: AMECO. OeNB.