Growth, Finance and Integration in Europe

An Enviable Development Opportunity with Tail Risks

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Outline of Presentation

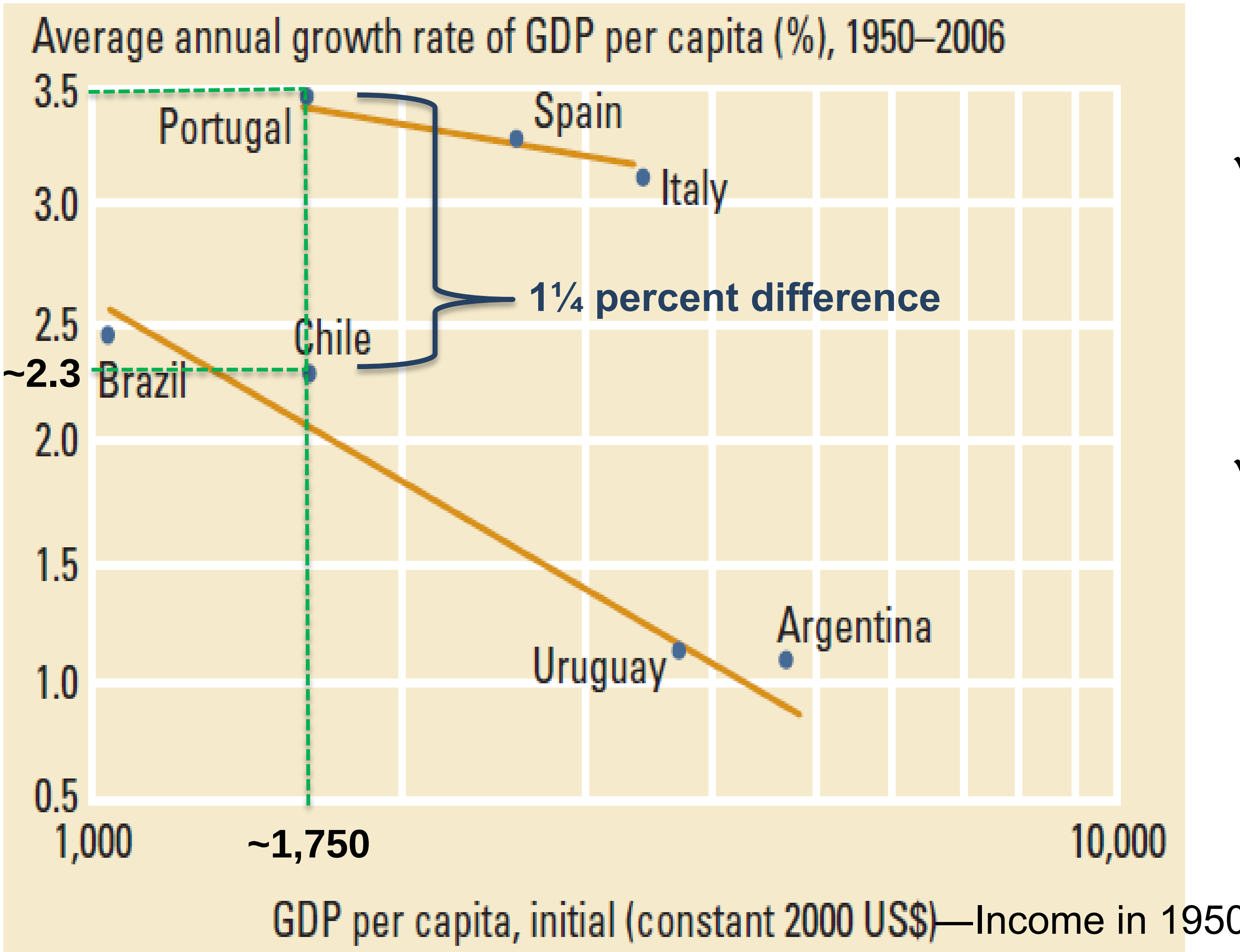
1. **Europe is Unique**
   - Capital inflows support growth; how and why
   - But can lead to excesses

2. **What are the Lessons?**
   - Current account deficits need to be managed
   - **How?** Lesson 1: Boom-proof public finance
     Lesson 2: Crisis-proof private finance

3. **Is Emerging Europe Over-Indebted?**
   - Aggregate approach: * Private and public sector balance sheets
   - Micro approach: * Stress-testing of firms and households
     * Banks and de-leveraging

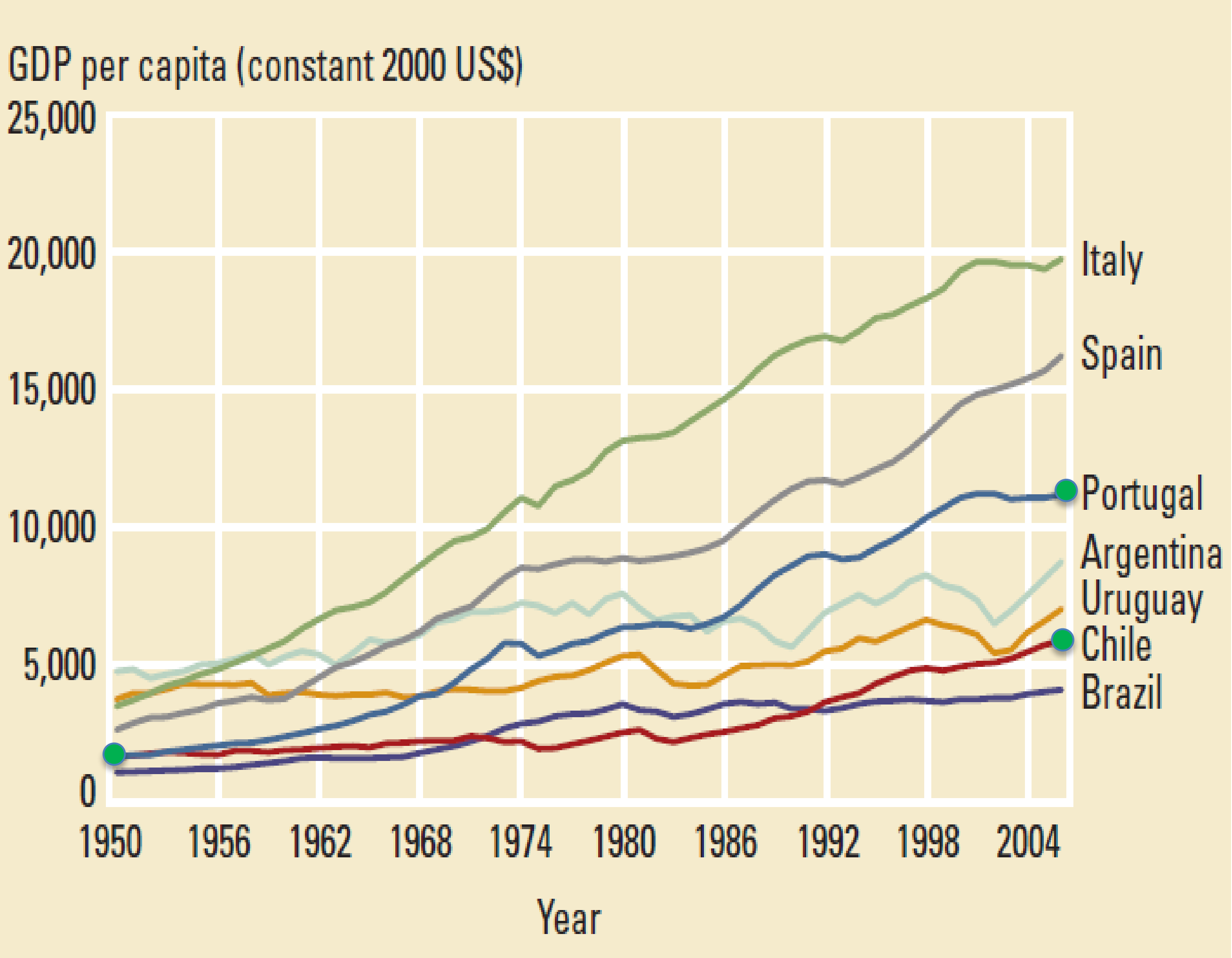
Europe is Unique

Europe as a Convergence Engine



- ✓ Chile; Latin America's best performer
- ✓ Portugal; poorest among EU15

Better to be in Latin Europe than in Latin America



- ✓ Latin Europe escapes middle income trap
- ✓ Other countries that did so required

  (i) luck (oil, mining)

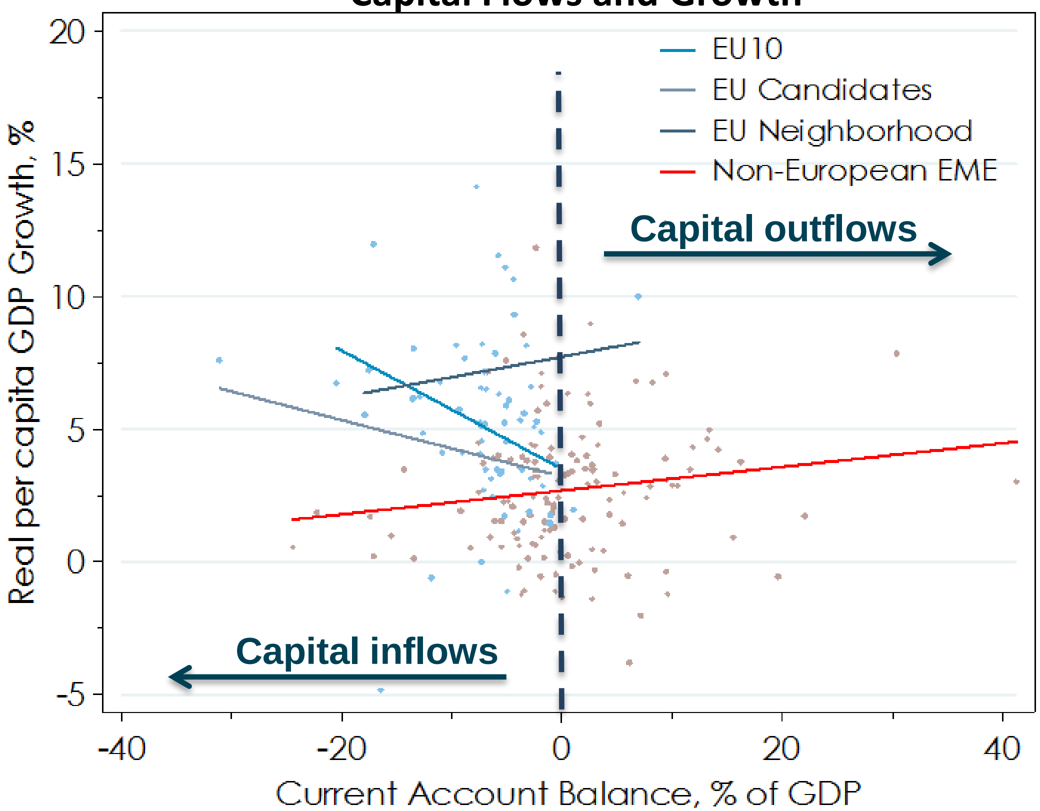
  (ii) sacrifice (export-led strategies)
- ✓ Europe requires neither in excess
- ✓ A different path to development

Capital Inflows Support Growth

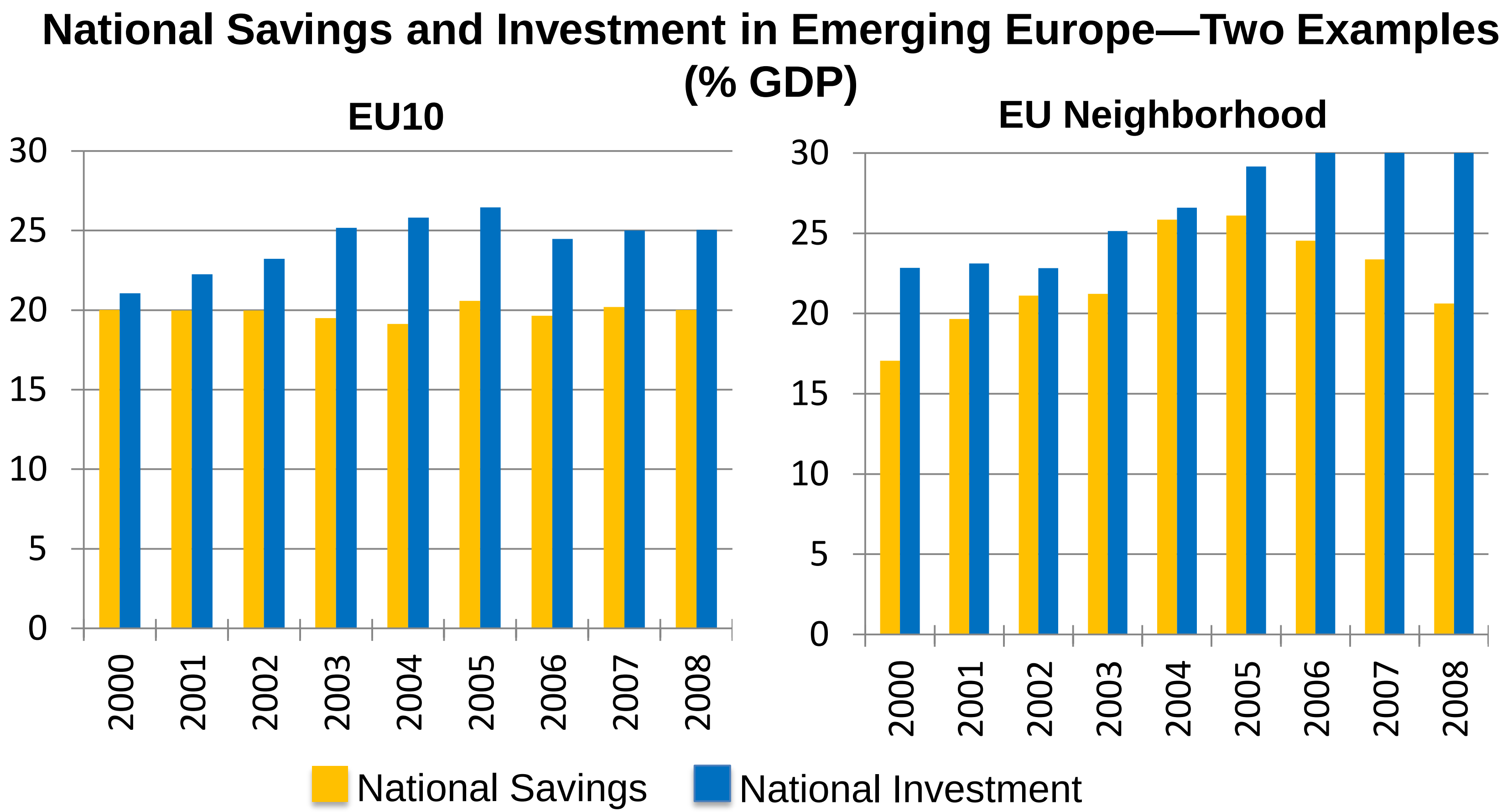
- Capital flows in Europe: → from rich to poor countries
  → from low growth to high growth countries

- Caveats? → non-European EMEs: a positive correlation
  → EU neighborhood is like non-European EMEs
  → stronger link in EU10 than in EU candidates

Capital Flows and Growth



How?



- Increase in investment; both in EU10 and EUN
- Limited national savings substitution; flat in EU10, increasing in EUN
- Exceptions in 2006-08; consumption boom in some countries

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Why?

- Does it reflect financial sector size/development?

  ✓ No

  ✓ Financial sector is deeper than in other developing regions

  ✓ But does not explain growth in emerging Europe

- Is it because of financial sector/institutional efficiency?

  ✓ More likely

  ✓ EU membership provides a roadmap for reforms

  ✓ Investors know what institutions to expect even before these are put in place—EU reduces uncertainty

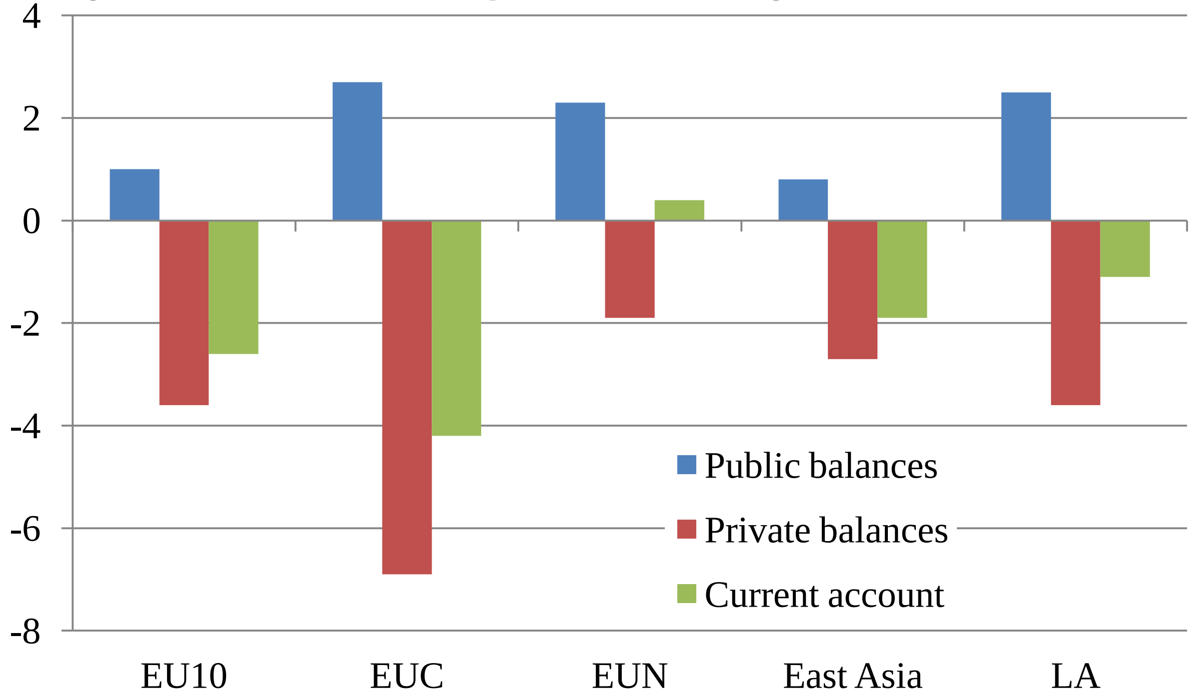
Be Aware of Excesses

- But not all countries in emerging Europe, or Europe, followed reform map at same pace
  - ✓ Czech Rep., Slovak Rep., Poland are good reform examples
  - ✓ Reform momentum stalled elsewhere; e.g. Romania
- Not all high foreign savings events (capital inflows) support growth
- Greece also raises questions about the future
  - ✓ Markets likely to watch more closely progress with reform roadmap
  - ✓ More effort for less payoff going forward

What are the Lessons?

Manage Current Account Deficits

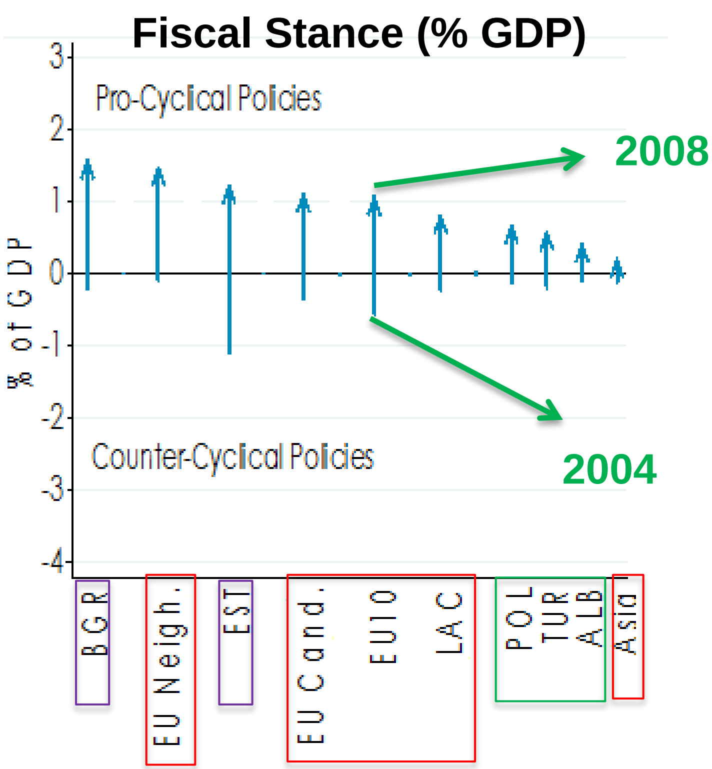
Changes in S-I Balances (% GDP; change between 2004 and 2008)



- ✓ Public sector accounts (S-I balances) → improved
- ✓ Private sector accounts (S-I balances) → deteriorated
- ✓ Large current account deficits → need to be managed
- ✓ But do not become Asian

Boom-Proofing Public Finance

Lesson 1: Fiscal policy not the cause → but should have played a counter-balancing role



- Emerging Europe was more pro-cyclical than other regions
- EST and BGR had fiscal surpluses but were still very pro-cyclical
- ALB, POL, TUR were cautious pre-crisis and created room for a fiscal impulse during the crisis

What is needed? **At a minimum**: do not spend revenue over-performance (BGR, EST)

More likely: a deliberate counter-cyclical fiscal policy is needed

Crisis-Proofing Private Finance

Lesson 2: Use pro-actively macro-prudential (MP) policies

- Motivations for MP policies:
  - ✓ Contain system-wide risks to financial system
  - ✓ Introduced: * following a re-assessment of the economic cycle
    * to contain specific business line risks; e.g. FX risk

- Three types of MP policies
  - ✓ Increase buffers: both in capital and liquidity
  - ✓ Limit credit growth: e.g. increasing the cost of credit
  - ✓ Improve loan quality: one transaction at a time (loan-to-value ratios)

Crisis-Proofing Private Finance

- Experience with macro-prudential policies—eight country studies
  - ✓ No MP policies: Czech Republic, Hungary
  - ✓ Moral suasion approach to MP policies: Estonia, Poland
  - ✓ Pro-active use of MP policies before crisis: Romania, Croatia, FYR Macedonia

Pre-crisis Use of Macro-prudential Policies

	CZE	EST	HRV	HUN	MKD	POL	ROM	TUR
Buffers and credit growth containment								
Capital-adequacy ratios	No macro-	•	•	No macro-	•	•		•
Risk weights	prudential	•	•	prudential	•	•	•	
Liquidity requirements	policies		•	policies	•	•	•	•
Constraints on total credit growth	were		•	were	•			
Regulations on lending in FX	applied		•	applied	•		•	
Other		•	•			•	•	
Credit quality								
Loan-to-value ratios							•	
Debt service-to-income ratios							•	
Eligibility criteria							•	
Other		•			•	•		

Crisis-Proofing Private Finance

- Things to keep in mind when using macro-prudential policies

✓ Initial conditions matter → Czech Rep. vs. Hungary; cases of interest rate differentials at origin

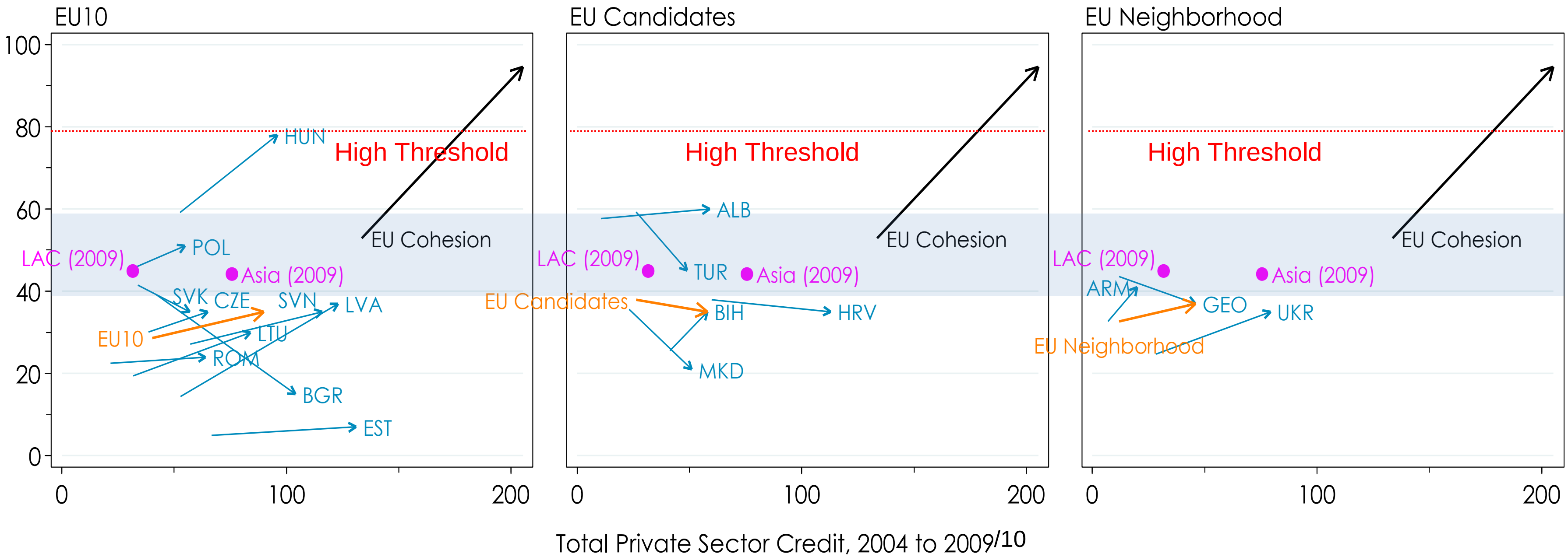
✓ Effectiveness varies across
→ business lines (Croatia)
→ financial institutions (Macedonia)
→ adapt MPs as loopholes emerge

✓ MP to "improve loan quality" need to be used more

Is Emerging Europe Over-Indebted?

Aggregate Approach to Over-Indebtedness

Public and Private Debts (% GDP, arrows begin 2004 and end 2009/10)



Note: Private sector credit through both domestic banking system and direct cross-border banking flows.

Public sector debt:
- Risk range: * 40-60% GDP in emerging markets
  * 80% GDP in countries with strong institutions
- Risk countries? * HUN at risk; ALB and POL borderline

Private sector debt:
- Higher than in other emerging markets, but below 'old' EU cohesion
- Risk countries? * EST, LVA, HRV, SVN, BGR; also HUN, UKR

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Micro Approach to Over-Indebtedness

- A survey approach provides new insights

- Advantages of surveys?

  ✓ Macro data precludes distinction between those with and without debt

  ✓ Surveys allow us to examine → debt incidence levels
  → characteristics of firms/households with debt

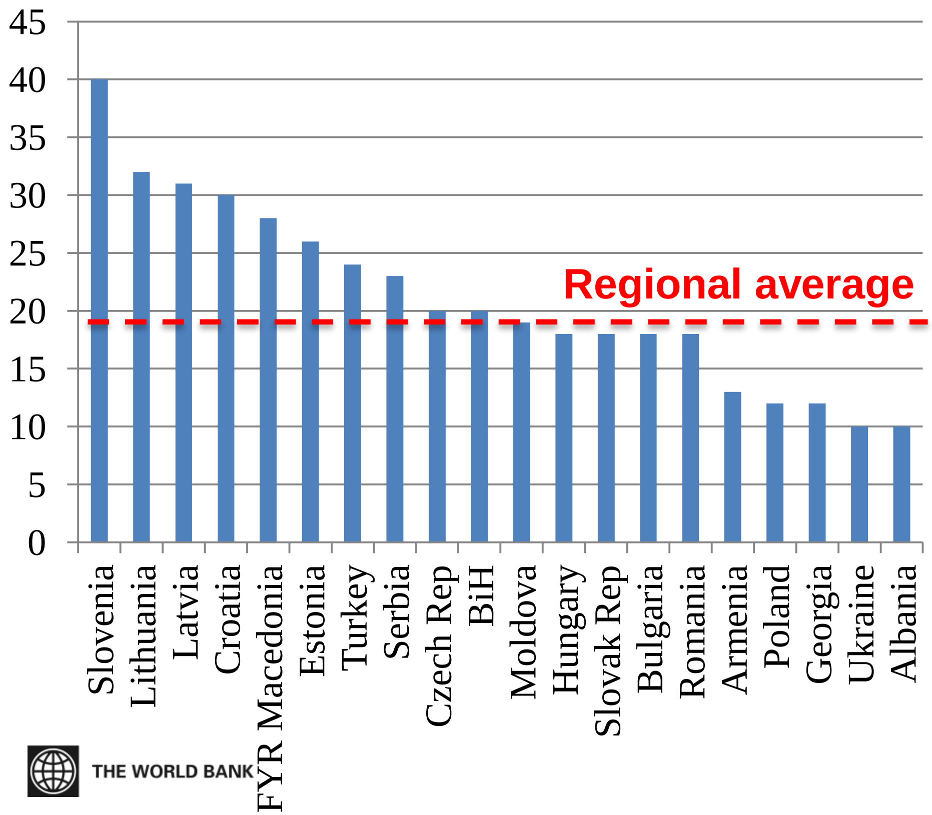
- Three different survey methodologies: * assessment of debt levels
  * risk-shock combinations
  * stress-test households

Debt Levels of Firms and Households

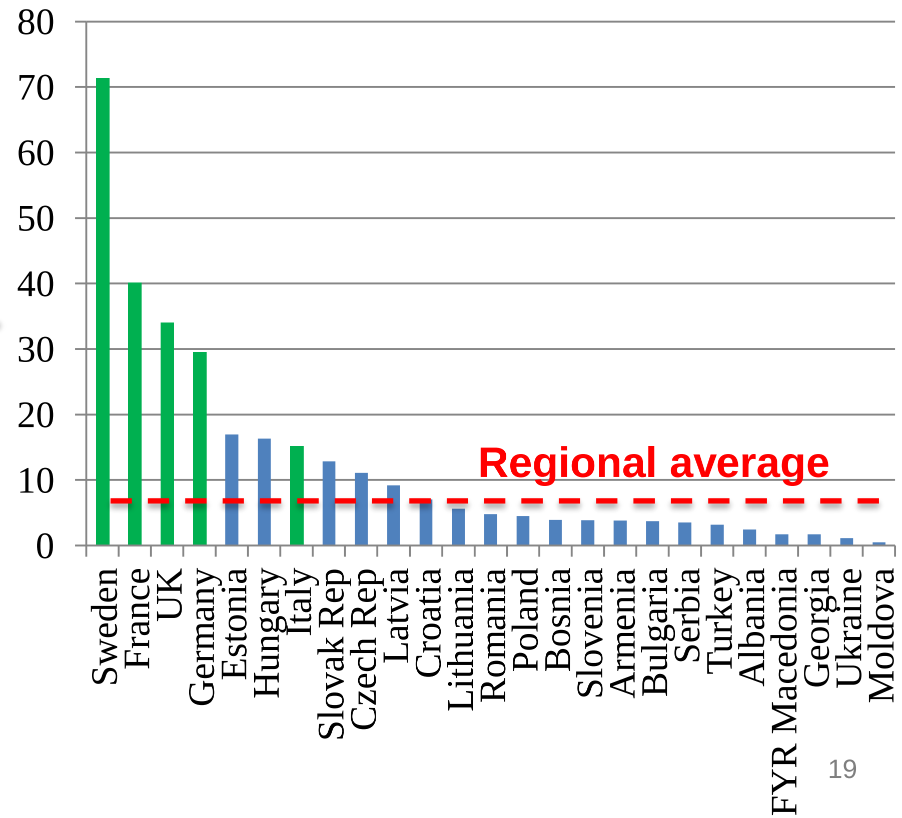
<u>METHODOLOGY 1 (firms and households)</u>: Assessment of debt levels

- Only 1 in 5 firms are over-leveraged; mostly large and exporting firms
- Only 6 percent of all households have mortgage debt; compared to 40 percent (average) in France, Germany, Italy, Sweden, UK

Over-leveraged firms (% total)



Households with mortgages (% total)



Over-Indebted Firms and Households are Limited

- Emerging Europe is not southern Europe; origin and size

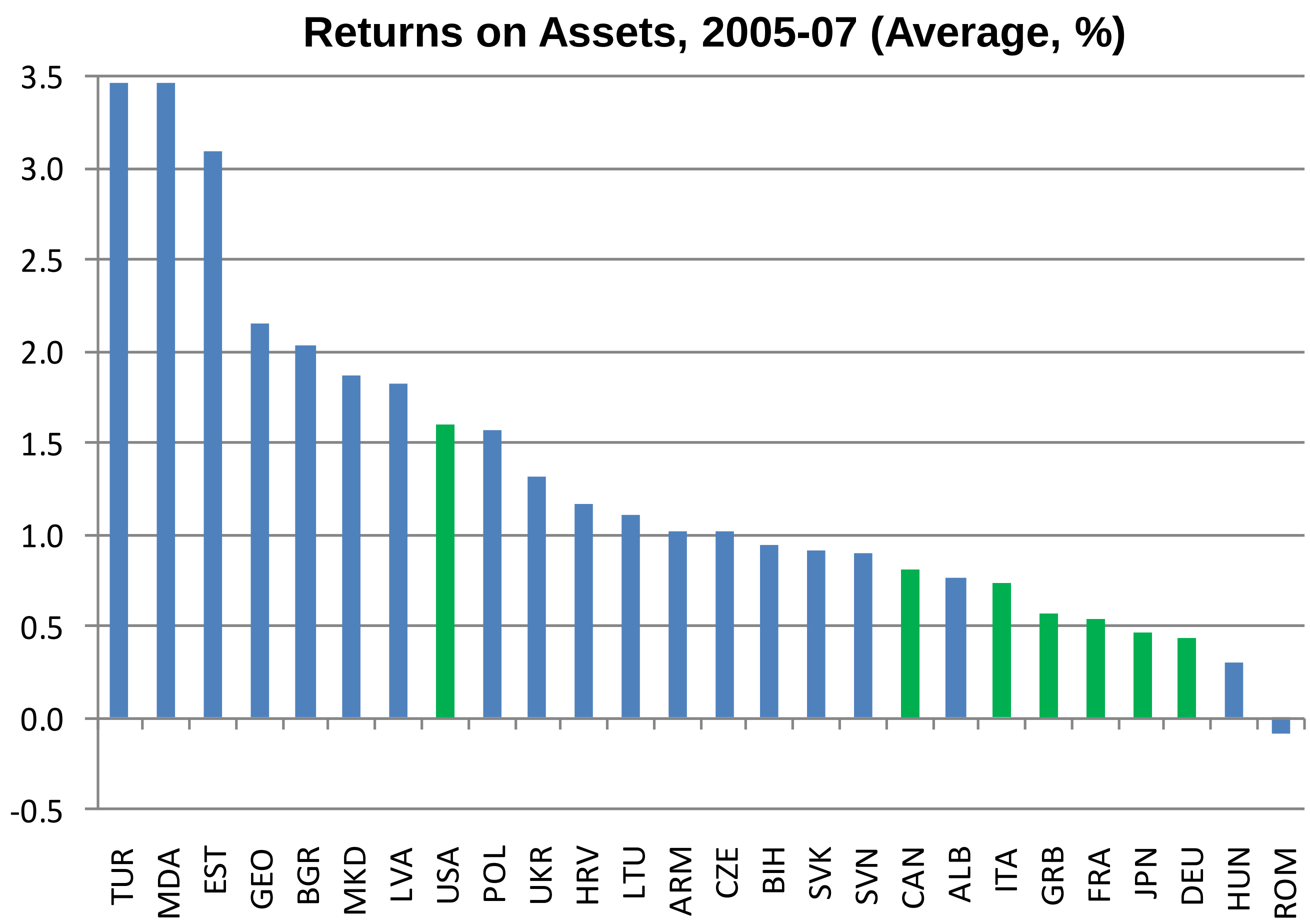
- Very few firms are over-leveraged
  - ✓ Most financially sophisticated; large and exporting firms

- Very few households are over-indebted
  - ✓ Few have debt and most are wealthy

- Some concerns do exist in private debt
- But unlikely to become drag on activity and economic recovery

What about Banks?

- Some banks might see a rising share of NPLs
- EU10/EUC was a profit center for banks; also in EUN
- Will they remain profit centers going forward? A tentative yes



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Foreign Ownership So Far a Blessing

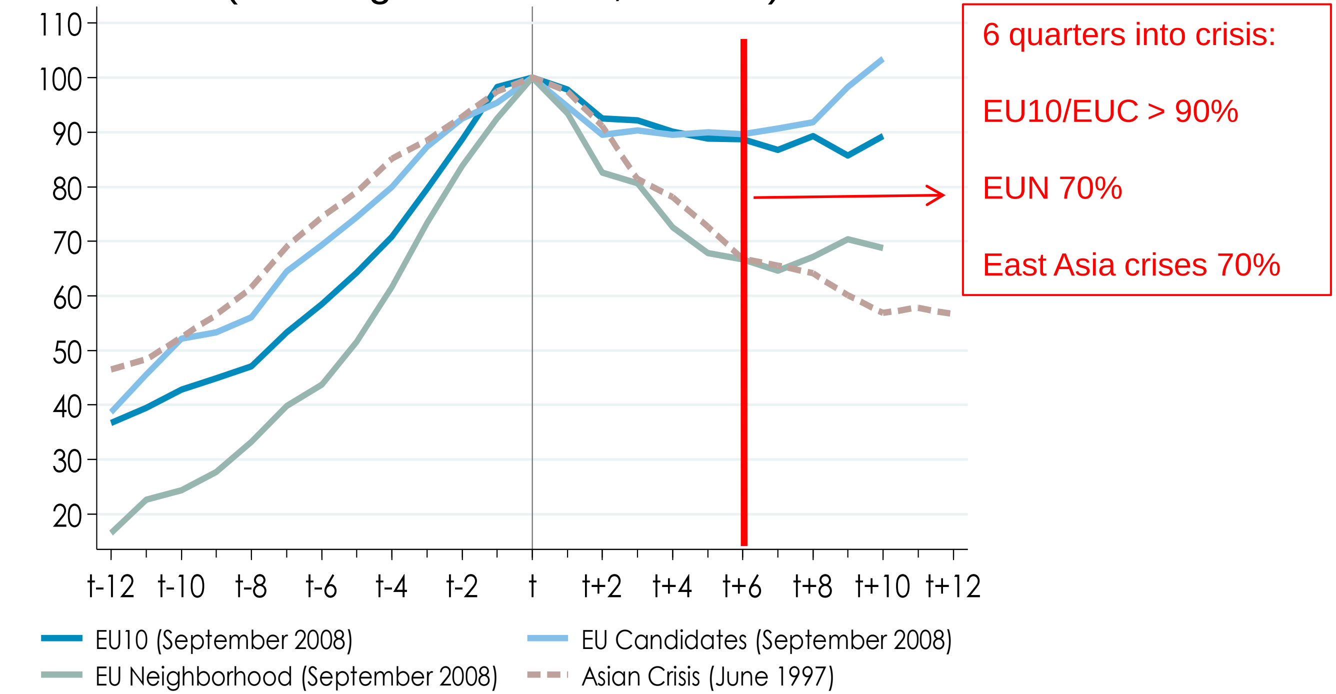
✓ Before crisis? Foreign banks helped to put an end to quasi-fiscal deficits

✓ During crisis? A source of stability

- Wholesale funding de-linked from ownership—volatile and declining
- Funding through ownership—sudden stop but no reversal

Foreign Finance is Stable Close to the EU

(Banking flow stocks; t = 100)



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De-leveraging and Risks

- De-leveraging
  - ✓Already taking place; e.g. Baltic states
  - ✓Construction sector will be hit in some countries
  - ✓Household de-leveraging limited; 5/9 out of 22

- But de-leveraging outlook seems manageable

- Real risk?
  - ✓Spillovers from southern Europe's sovereign debt problems and the impact on parent banks
  - ✓Impact of worsening risk perceptions in Europe

Takeaway Messages

Europe: An Enviable Development Opportunity with Tail Risks

1. **Europe is Unique**
   - Foreign savings support growth → do not become Asian
   - But can also lead to excesses → less complacency needed

2. **What are the Lessons?**
   - Fiscal policy must play a counterbalancing role
   - Macro-prudential policies could prove useful

3. **Is Emerging Europe Over-Indebted?**
   - Emerging Europe is not southern Europe
   - Differences in ORIGIN (private vs. public) and SIZE of debt

   <u>Aggregate balance sheets</u>
   - Public debt is low (except HUN, ALB, POL)
   - Private debt increased, but assessment remains positive

   <u>Firms and households</u>
   - Few over-leveraged—and most sophisticated or wealthy

   <u>Banks and de-leveraging</u>
   - Some risks, but foreign bank ownership so far a blessing
   - Risk? Exposure of parent banks to southern Europe