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CENTRAL AND EASTERN EUROPE : HOW IS IT IMPACTED BY THE GLOBAL FINANCIAL CRISIS ?

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I - Why has the impact on Central Europe of the global financial crisis been, up to last September, relatively limited?

Three reasons can be put forward:

1. **The local banking system in this region had not engaged in sophisticated structured financial products.** Therefore local investors had not been encouraged to put such assets in their portfolios.

2. Moreover the fact that **the bulk of the banking systems of most of those countries is owned by large foreign institutions** has, up to now, been a source of confidence.

3. **The 'convergence factor'** has also played a significant role in this resiliency. Indeed Central European economies have been performing rather well in terms of their economic management.

In the years 2007-2008, budget deficits have been on the whole kept under control at around 2.5 % of GDP (Hungary, which had derailed to 9 % in 2006, is now back to 4-5 %).

As for inflation, Poland, the Czech Republic and Slovakia have maintained it around 3 % in 2007, the exception being the Baltic states (6 to 10 %), Hungary, Bulgaria and Romania (respectively 7.9 %, 7.6 % and 4.9 %). With the rise in commodity prices, inflation has gone up to more than 4 % in the most 'virtuous' countries, but around 7-15 % in the others. Lower commodity prices and recession will curb inflation in 2009.

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So, in spite of significant current account deficits (especially in the Baltics, Romania and Bulgaria 14 to 23 % of GDP), there have been no major macroeconomic concerns for the region.

Growth actually remained sustained at an average rate of 6 % in 2007 (the eurozone grew that year by 2.6 %).

This explains that private capital flows to the region (including Russia and the CIS) peaked to a record of USD $393 billion in 2007 (equity flows representing $83 billion while bank lending rose to $310 billion).

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II – But things have been changing since September 2008

It is important to understand the causes and the magnitude of those recent changes and to try and answer the question: 'are these new trends going to affect the whole region or will they be selective in their impact ?'

1. The manifestation of a liquidity squeeze

Interest rate spreads have gone up, but in a very differentiated way : Hungary has moved close to 900 b.p. (cost of borrowing 3 month liquidity), Poland to 700, while Slovakia and the Czech Republic hover around 500 but Romania skyrocketed to 1.300 b.p. So it is a fact that interbank liquidity is more scarce in some of these countries and that the risk premium has gone up.

2. This liquidity strain is, in large part, the result of foreign banks curbing their lending

Foreign banks (often parent banks of local subsidiaries) seem to be more reluctant, over the last two months or so, to extend credit to some of these regional banks and subsidiaries.

Credit expansion in the region has been extremely strong during the years 2006-2007. Credit to the private sector grew by 6.5 % of GDP during that two year period (the highest growth in all emerging countries).

By contrast, from December 2007 to June 2008, the figure has dropped to 0.1 % of GDP.

Why this brutal reversal ? There is not one single explanation. In some countries (e.g. the Baltics) the pace of credit growth has come down markedly from earlier -excessive - peaks (which go back to November 2006 in the case of Estonia and Latvia, i.e. well before the crisis). This slowdown in credit expansion is a 'normal' evolution after unsustainable booms and current account deficits.

But the curbing of credit expansion in other –healthier- countries is directly linked to the present global credit crunch. Bank inflows that had held up remarkably until the summer of 2008 are significantly slowing down. Parent banks that are engaged in a process of deleveraging are indeed not inclined to increase significantly across the board their exposures to their subsidiaries in the region. But, this evolution is not affecting all countries (Slovenia, Slovakia, Czech Republic, Poland, in particular are relatively untouched).

Some observers are even arguing that liquidity enhancements and guarantees recently provided by Western governments to their banks at home are unintentionally producing negative effects on countries that are not fiscally able to provide such assistance to their own banks.

3. **These credit declines are hitting GDP's**

Indeed, there is a very strong link between credit expansion and growth in the region (e.g. the spectacular decline in credit growth in Estonia has coincided with a stagnation of GDP). If credit growth were to slow down at the same pace as in Estonia (70 % decline in monthly credit extension from peak), economic growth in countries like Bulgaria and Romania could be flat in the second part of 2009.

But, in countries like the Czech Republic, Poland and even Hungary, credit expansion still continues to be high, albeit at a slower pace in Hungary. Fundamentals are, no doubt, playing a role in this resilience.

4. **The liquidity crunch has also influenced exchange rates and stock markets**

Currency depreciations have been significant from January to October 2008 :

- 9.7 % for the Slovak Krone,
- 8.3 % for the Czech Krone,
- 10.0 % for the Florint.

After the long lasting appreciation of those currencies over the past years, such a correction is to be welcome and flexible currency countries are faring better than 'fixed' ones.

As for stock markets, fluctuations have been large since early 2008: in the order of – 30 % to – 50 %. But this is comparable to Western markets (slide page 7).

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III – What does this suggest for the years to come ?

1. **GDP growth is bound to decelerate in the near future**

Indeed, the marked slowing down (and the beginning of a recession in some Western European countries) is inevitably going to affect the growth rates of Central Europe through trade channels.

The slide on page 4 illustrates this evolution quite vividly. Countries that were growing by 6-7 % in 2007 will probably decelerate to 3-4 % in 2009 (the most vulnerable to 1-2 %). And there are further downward risks if the financial crisis gets worse.

2. **The most vulnerable countries will be the most affected** (Page 8 & 9)

By 'most vulnerable' I mean countries that combine :

- unsustainable current account deficits (Baltics, Bulgaria, Romania) that have to be financed by external capital flows in the context of fixed exchange rates ;
- high public indebtedness (Hungary – see slide page 9);
- high net bank open forex currency positions to capital (Baltics, Romania) ;
- high shares of loans denominated in foreign currencies (Baltics 50 to 87 %, Hungary 50 %, Bulgaria, Romania).

3. **The countries who seem to be the most resilient**

The countries who seem to be the most resilient feature the 'core' of converging Europe : Slovenia (already a euro member), Poland, Czech Republic, Slovakia (and probably Hungary after its strong backing by the IMF and the pursuit of its economic reform).

Those are the countries (most of them have flexible exchange rates) that have the highest growth potential (after the inevitable slowing down in 2009). On the other side of the spectrum are the Baltics, Romania and Bulgaria.

But other countries, more south, are also promising like Croatia and Serbia. Serbia in particular has made considerable progress in macroeconomic stabilisation during recent years. Now that elections have brought to power a new pro-European government, many opportunities are offered by that country in terms of privatisation and economic diversification. (Low corporate taxes of 10% and a plentiful labour pool with relatively low wages are significant factors).

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I believe, to conclude, that we should not be too pessimistic. These countries have accumulated, over the years, strong structural reforms and sensible macroeconomic management. Their level of reserves on imports remains significant (30 %). Their inflation rates have been affected by high commodity prices. But this is now changing. Of course, the financial crisis is affecting them to some degree. Much will depend on the improvement in general market conditions. And, in this respect, further downward risks cannot be excluded.

On the whole, the countries of the region are strongly anchored to Europe and therefore will depend on the economic trends of their neighbours. But they are also a source of growth and are bound to resume their catching process in the coming years. Their strong productivity gains auger well in this respect.