



Southeast Europe in the light of the financial crisis

Dubravko Mihaljek

Bank for International Settlements

European Fund for Southeast Europe Annual Meeting 2008

Keynote Address – Opening Panel with Representatives of Central Banks

Sibiu, 7 May 2008

The views expressed are those of the author and not necessarily those of the BIS.



Outline of presentation

1. Are SEE economies decoupling?
2. Spillovers from global financial markets
3. How might the SEE region be affected?
4. Policies that should help
5. Special topic: changing the composition of bank lending
6. Conclusions



Main questions examined

- Are SEE economies “decoupling” from other CEE economies and the euro area?
 - Has the real sector decoupled / will it stay more or less unaffected?
 - Has the financial sector decoupled?
- If so, what is special about this region?
- If not, how will the region be affected



Are SEE economies decoupling?

- SEE follows different growth cycle from new member states
- Grow faster than central Europe, slower than the Baltics
- Growth projected to accelerate in half of SEE economies in 2008

- Inflation accelerating
- Higher and lower inflation countries

- Very high current account deficits
- External financing: high share of FDI, generally high share of bank-intermediated capital inflows



Table 1 **Developments in real GDP growth¹**

	2005	2006	2007				2008
			Q1	Q2	Q3	Q1–Q4 ²	
Albania	5.6	5.0	...	...	...	5.5	6.0
Bosnia & Herzegovina	4.3	6.2	...	...	...	5.7	5.8
Bulgaria	6.2	6.1	6.2	6.5	4.5	6.0	5.7
Kosovo	-1.0	2.6	...	...	...	2.8	...
Macedonia	4.1	3.2	7.0	4.0	...	4.3	4.1
Moldova	7.5	4.0	...	...	...	5.0	7.0
Montenegro	4.2	8.1	6.6	6.9	7.1	7.0	6.0
Romania	4.4	7.7	6.0	5.6	5.7	5.7	5.3
Serbia	6.2	5.7	8.1	7.5	7.2	7.2	6.0
Average³	4.6	5.4	6.8	6.1	6.1	5.5	5.7
Central Europe ⁴	4.8	5.9	6.7	6.5	6.1	5.8	5.0
Baltic states ⁵	9.6	10.3	9.6	8.7	9.7	9.0	6.4
Memo: Euro area	1.6	2.9	3.2	2.5	2.7	2.6	1.8

¹ Annual changes, in per cent. ² Estimates and forecasts. ³ Simple average of the economies listed. ⁴ Czech Republic, Hungary, Poland, Slovakia and Slovenia. ⁵ Estonia, Latvia and Lithuania.

Sources: Consensus Economics; European Commission, *Candidate and Pre-Accession Countries' Economies Quarterly*, April 2008; national data.


 Table 2 **Developments in consumer prices¹**

	2005	2006	2007					2008	
			Mar	Jun	Sep	Dec ²	Average	Forecast	Deviation from MC ³
Albania	2.4	2.4	2.7	2.0	4.4	3.0	2.9	3.0	-0.4
Bosnia-Herzegovina	3.0	6.2	0.7	0.0	1.6	3.0	0.9	2.5	-0.9
Bulgaria	5.0	7.3	4.1	5.6	13.1	12.5	8.4	7.7	4.3
Kosovo	-1.4	0.6	0.7	1.1	6.5	10.5	4.4	...	3.2
Macedonia	0.5	3.2	0.8	1.3	3.6	4.6	1.9	2.5	-0.9
Moldova	11.9	12.7	10.9	10.3	14.1	13.3	12.6	11.4	8.0
Montenegro	2.4	3.0	2.4	1.6	6.5	7.7	4.2	3.0	-0.4
Serbia	16.1	11.8	5.7	4.7	6.5	9.1	7.0	6.5	3.1
Romania	9.0	6.6	3.7	3.8	6.0	6.6	4.8	6.3	2.9
Average⁴	5.4	6.0	3.6	3.4	6.7	7.8	5.2	5.4	2.1
Central Europe ⁵	2.6	2.9	3.7	4.0	3.6	5.0	3.8	4.3	0.9
Baltic states ⁶	4.5	4.9	6.3	6.5	8.6	10.6	7.5	8.4	5.0
Maastricht benchmark ⁷	2.5	2.9	...	...	...	...	2.8	3.4	...

¹ Annual changes, in per cent; period averages (for 2007, quarterly and whole-year averages). ² Or latest month available. ³ Forecast inflation minus the Maastricht benchmark; in percentage points. ⁴ Simple average of the economies listed. ⁵ Czech Republic, Hungary, Poland, Slovakia and Slovenia. ⁶ Estonia, Latvia and Lithuania. ⁷ Average of the three EU countries with the lowest inflation (from 2005–06, EU-25; from 2007, EU-27), plus 1.5 percentage points.

Sources: IMF; European Commission; EBRD; Consensus Economics; national data.



Table 3

Financing of current account deficits, 2007¹

As a percentage of GDP

	Current account balance	Net private capital inflows					Capital flows / CA balance (%) ⁴	Increase in official reserves
		Total	FDI	Portfolio equity ²	Portfolio debt ²	Other inflows ³		
Albania	-8.3	4.7	3.5	0.0	0.4	0.9	57	3.2
Bosnia–Herzeg.	-13.0	15.9	13.7	0.0	0.0	2.2	122	7.8
Bulgaria	-21.4	26.4	17.4	0.0	0.4	8.5	123	14.0
Kosovo ⁵	-24.0	0.4	10.7	...	-5.6	-4.6	-1.8	17.3
Macedonia	-2.7	0.1	3.5	0.0	0.0	-3.4	3	4.4
Moldova ⁶	-17.7	22.5	10.6	-0.1	...	12.0	127	8.7
Montenegro	-37.0	38.3	24.5	0.3	...	13.5	104	7.8
Romania	-13.9	10.8	6.9	0.3	0.1	3.6	78	5.5
Serbia	-16.5	12.8	5.3	0.0	0.0	7.6	78	5.4
Average⁷	-13.2	14.7	10.7	0.1	-0.7	4.5	77	8.2
Cent. Europe ⁸	-4.4	4.9	2.4	-1.4	0.9	3.0	117	3.8
Baltic states ⁹	-17.4	20.9	5.5	-0.7	-0.7	16.8	117	3.9

¹ Annualised figures based on latest available four quarters and IMF-WEO estimates. ² Portfolio equity and debt securities. ³ Comprises other investment inflows to banks and to the non-bank private sector. ⁴ Net private capital flows (total) as a percentage of the current account balance. ⁵ Capital flows data for 2006. ⁶ Capital flows data for 2005.

⁷ Simple average of the economies listed. ⁸ Czech Republic, Hungary, Poland, Slovakia and (for current account deficit only) Slovenia. ⁹ Estonia, Latvia and Lithuania.

Sources: IMF; national data.



How are SEE economies currently doing? (2)

- Financial markets still underdeveloped
- Very rapid growth of bank credit to the private sector
- Credit expanding to both firms and households
- Changing composition of private sector credit

- Fiscal balances mostly solid
- Fiscal revenue and expenditure levels fairly high
- Public debt mostly at uncomfortable levels

- Labour markets slowly improving
- Structural unemployment remains extremely high



Table 4 **Developments in domestic bank credit to the private sector¹**

	In nominal terms ²			In real terms ^{2, 3}			Credit / GDP	Broad money ⁴ / GDP
	2005	2006	2007 ⁵	2005	2006	2007 ⁵	2007 ⁵	
Albania	73.4	57.3	49.1	69.9	53.4	44.7	28.0	72.8
Bosnia-Herzegovina	27.4	23.3	29.3	23.7	16.1	28.1	59.1	71.6
Bulgaria	32.4	24.6	58.6	24.4	17.0	41.0	60.8	70.7
Kosovo	37.5	23.9	40.0	39.4	23.2	34.1	37.5	47.4
Macedonia	19.7	24.3	39.0	18.2	20.8	32.7	36.0	48.3
Moldova	35.5	37.8	51.7	20.7	22.3	34.7	40.7	53.3
Montenegro	30.1	142.4	182.9	27.1	135.3	171.5	95.7	114.3
Serbia	53.9	17.4	40.5	31.5	10.8	32.8	34.1	36.4
Romania	45.8	54.5	60.4	34.3	47.2	50.5	37.6	38.0
Average⁶	39.5	45.1	61.3	32.1	38.5	52.2	47.7	61.4
Cent. Europe ⁷	20.6	22.0	25.5	17.7	18.2	19.4	54.0	57.1
Baltic states ⁸	64.0	53.6	41.1	57.0	45.7	27.6	79.8	45.5

¹ End of period. ² Annual changes, in per cent. ³ Deflated by consumer prices. ⁴ Defined as M2 for all except Slovenia and the euro area (M3). ⁵ Or latest available data, in percent. ⁶ Simple average of the economies listed. ⁷ Czech Republic, Hungary, Poland, Slovakia and Slovenia. ⁸ Estonia, Latvia and Lithuania.



Table 5 Growth and composition of domestic bank credit to corporations and households

	Growth of credit ¹				Composition of credit	
	Corporate sector		Households		Percent of private sector credit , 2007	
	2006	2007	2006	2007	Corporate	Household
Albania	52.9	43.0	67.7	59.1	73.8	36.2
Bosnia- Herzeg.	20.3	25.3	26.6	30.0	51.1	48.9
Bulgaria	19.4	72.4	30.6	52.3	62.4	37.6
Kosovo	26.5	40.8	16.0	37.3	77.5	22.5
Macedonia	25.3	29.5	48.8	56.5	61.3	38.7
Moldova	...	...	...	...	...	...
Montenegro	102.3	187.3	198.3	155.5	63.7	36.3
Romania	45.4	54.1	83.8	82.1	50.5	49.5
Serbia	...	33.2	...	50.4	62.4	37.6
Average²	36.9	60.7	65.7	65.4	62.8	38.4
Cent. Europe ³	18.8	19.8	30.2	31.0	58.3	41.7
Baltic states ⁴	51.6	34.0	69.3	43.8	51.8	48.2

¹ Twelve-month percentage changes; in nominal terms; end of period. ² Simple average of the economies listed. ³ Czech Republic, Hungary, Poland, Slovakia and Slovenia. ⁴ Estonia, Latvia and Lithuania.

Source: Central banks.



Table 6

Selected fiscal indicators, 2005-09¹

As a percentage of GDP

	General government balance					Budget structure, 2007		Public debt, 2007 ²
	2005	2006	2007	2008	2009	Revenue	Expenditure	
Albania	-3.6	-3.2	-3.9	-3.9	-3.6	26	30	54
Bosnia-Herzegovina	1.0	3.0	-1.4	-1.6	-1.9	49	50	39
Bulgaria	2.0	3.2	3.0	3.1	3.1	40	37	19
Kosovo	-3.2	3.6	6.5	...	...	37	30	...
Macedonia	0.3	-0.6	-1.0	-1.2	-1.5	33	34	32
Moldova	1.3	0.2	-0.3	-0.5	-0.4	43	44	29
Montenegro	-1.7	4.5	7.4	2.3	1.3	51	44	38
Romania	-1.4	-1.9	-2.7	-3.2	-3.9	34	37	13
Serbia	0.7	-1.5	-1.0	-1.8	-1.5	41	42	38
Average³	-0.5	0.8	0.7	-0.9	-1.1	39	39	33
Cent. Europe ⁴	-4.0	-4.2	-3.2	-2.7	-2.6	40	43	40
Baltic states ⁵	0.3	0.9	1.0	0.4	0.2	37	36	10

¹ Official estimates and projections. Costs of second pillar pension reforms are excluded from budget balances. ² Gross debt on a general government basis. ³ Simple average of the economies listed. ⁴ Czech Republic, Hungary, Poland, Slovakia and Slovenia. ⁵ Estonia, Latvia and Lithuania.

Sources: European Commission, *Economic Forecasts*, Autumn 2007; IMF country reports; national data.



Table 7 **Labour market developments, 2005-07**

	Employment ^{1,2}			Unemployment rate ¹		
	2005	2006	2007	2005	2006	2007
Albania	0.9	4.2	0.2	14.1	13.6	14
Bosnia-Herzegovina	0.8	2.3	3.3	...	31.1	29
Bulgaria	2.7	2.4	2.2	10.1	9	7.5
Kosovo	-4.6	...	...	41.4	44.9	...
Macedonia	4.3	4.6	3.7	37.3	36	35.2
Moldova	-0.6	-3.5	...	6.4	7.4	...
Montenegro	0.6	4.5	3.7	18.5	14.7	11.9
Romania	0.2	2.8	1.2	7.2	7.3	7.1
Serbia	-6.7	-3.8	-1.1	20.8	20.9	21.2
Average³	0.9	2.3	1.9	15.1	13.8	12.3
Cent. Europe ⁴	0.0	1.9	1.8	17.3	18.3	15.6
Baltic states ⁵	0.9	1.7	2.5	11.1	9.6	7.7

¹ 2007 refers to latest available data or estimates. ² Annual changes, in per cent. ³ Simple average of the above.

Sources: European Commission, *Economic Forecasts*, Autumn 2007; European Commission, *Candidate and Pre-Accession Countries' Economies Quarterly*, January 2008; national data.



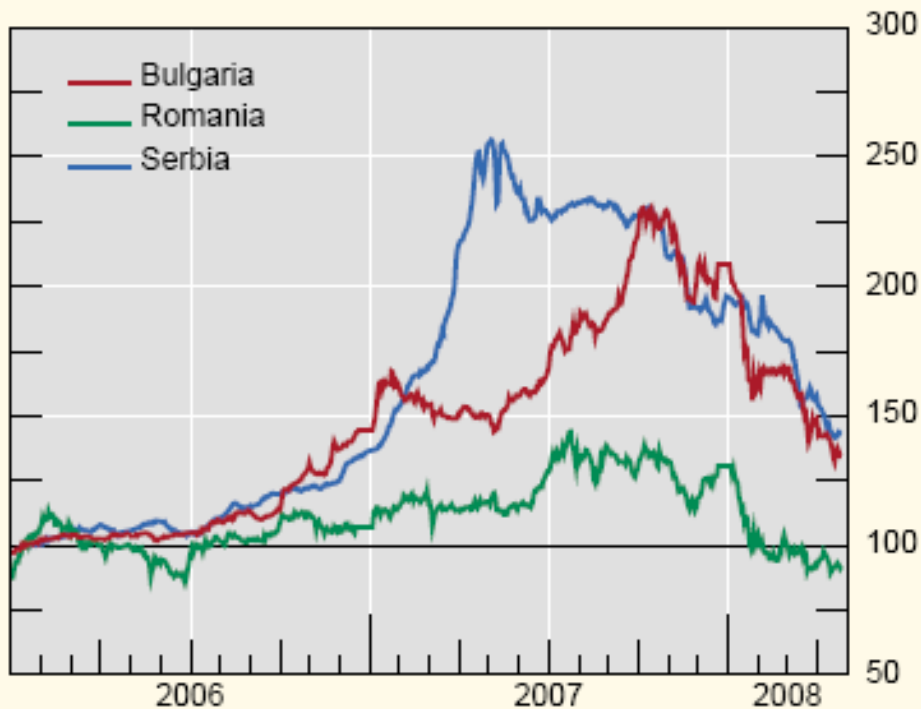
Spillovers from global financial markets

- Correction in equity markets, larger where the preceding run-up in prices was larger
- Bond spreads widening, but still relatively low
- CDS spreads jumped
- Some exchange rates depreciated



Equity prices fall, correcting some of the overshooting

Equity prices¹



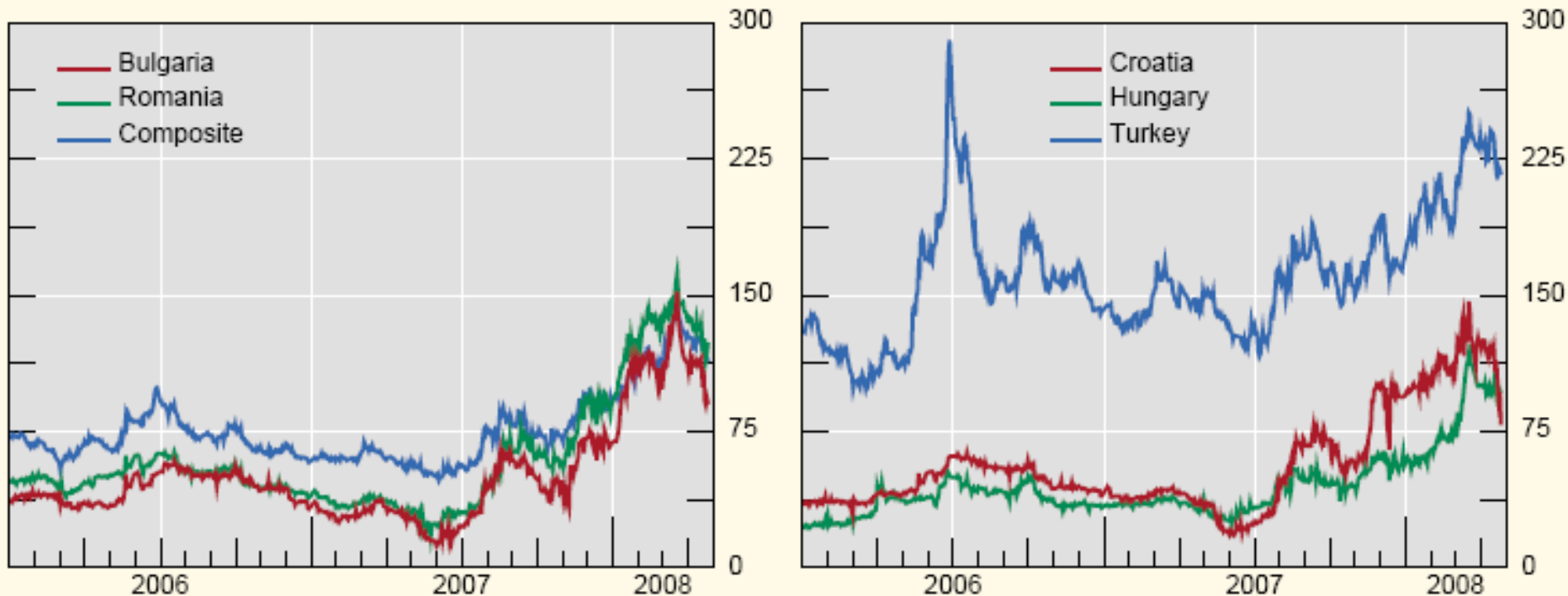
¹ January 2006 = 100; in local currency terms.

Sources: Bloomberg; Datastream.



Sovereign bond spreads widen, but remain low

Euro EMBI Global government spreads¹



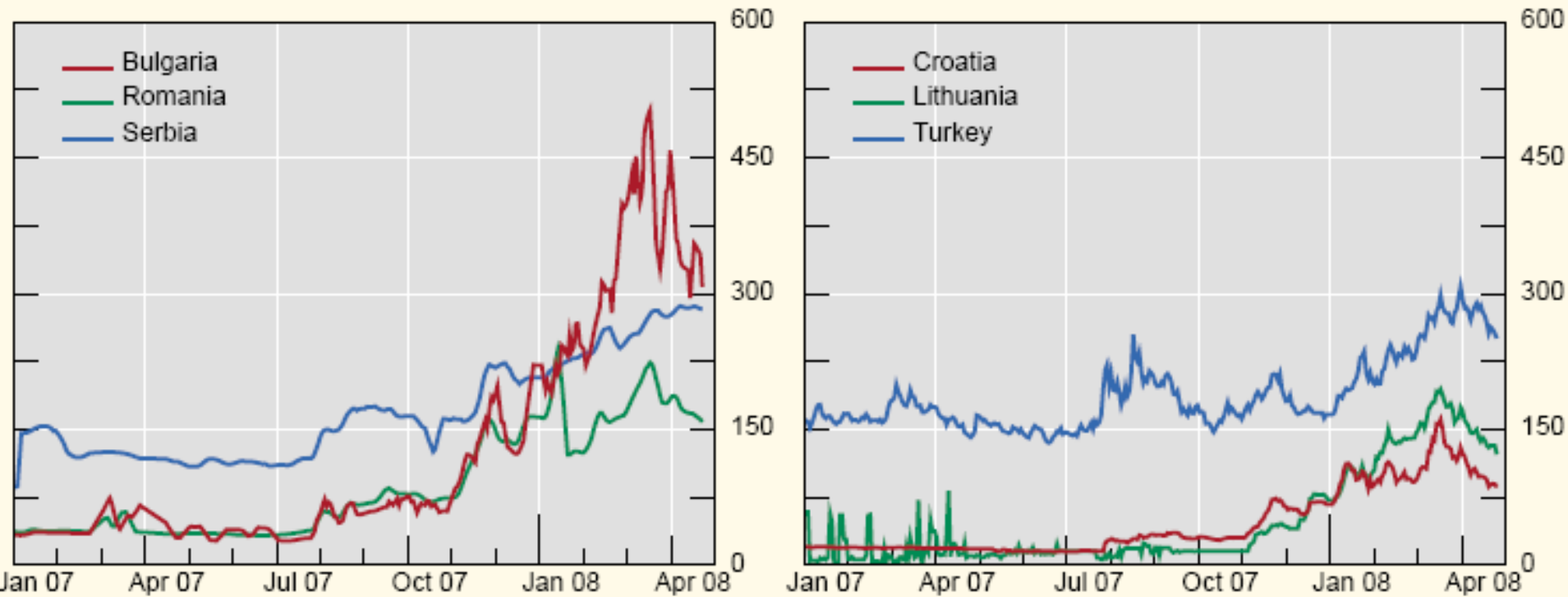
¹ Daily data; in basis points.

Source: JPMorgan Chase.



Cost of insuring against sovereign debt default jumps, reflecting global factors and underlying vulnerabilities

CDS spreads¹



¹ Five-year government CDS spread, in euros. Five-day moving averages; in basis points.

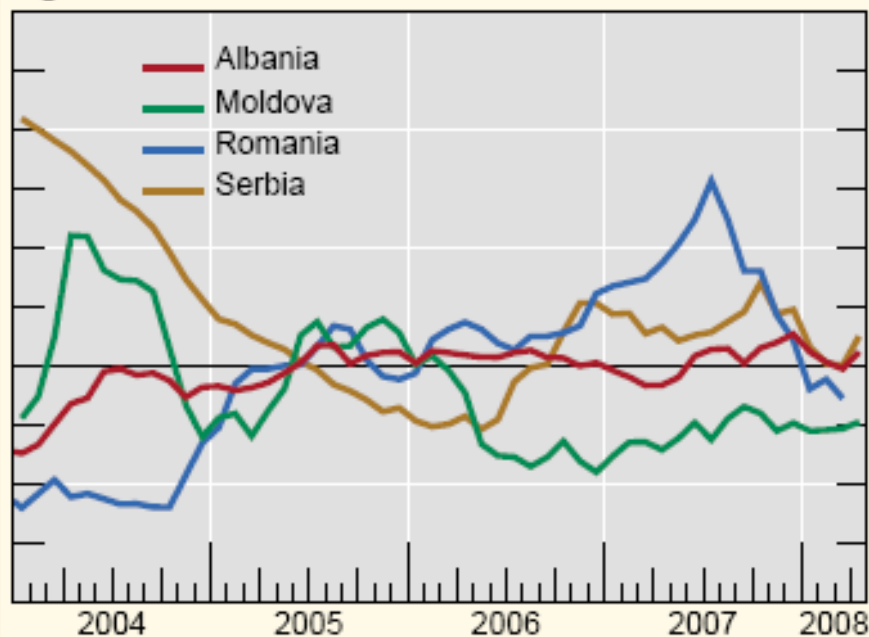
Source: Markit.



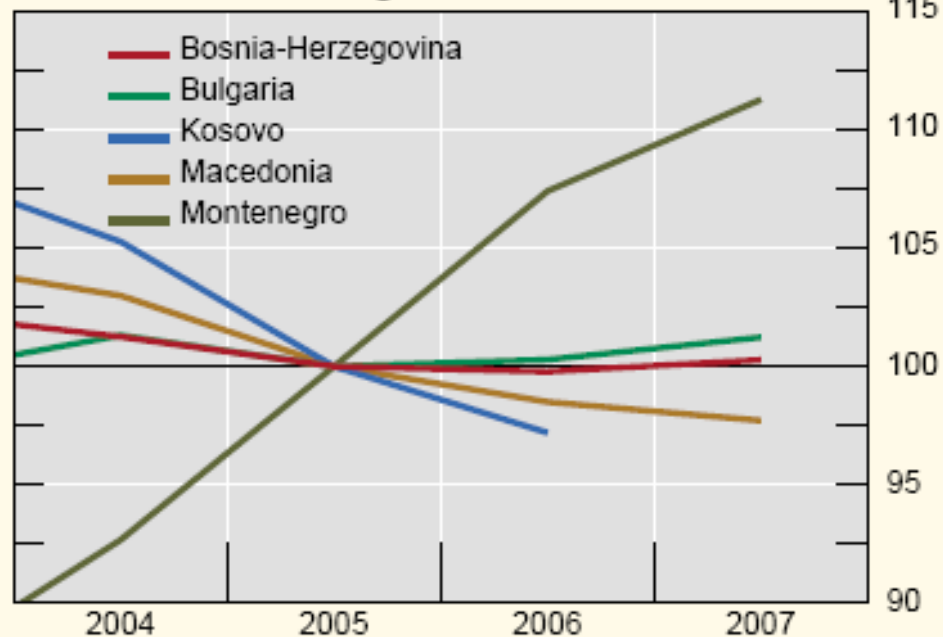
Some exchange rates started to depreciate, reflecting underlying external vulnerabilities

Exchange rates¹

Against the euro



Real effective exchange rates²



¹ 2005 = 100; an increase indicates an appreciation. ² In terms of consumer prices; for Macedonia, in terms of wages. For Bosnia-Herzegovina and Bulgaria, in nominal terms.

Sources: European Commission; IMF country reports; Datastream; BIS.



How might the SEE region be affected?

- More difficult access to foreign finance – will affect countries with large external deficits
- Sustainability of capital inflows not guaranteed
- Remittances could decrease if growth slows in western Europe (difficulties in Italy, Spain)
- Domestic demand growing too fast in some countries, slowdown would be welcome
- Achieving soft landing complicated by other vulnerabilities, financial crisis elsewhere
- But there are some mitigating factors



How might the SEE region be affected (2)

- Risk of “sudden stops” greatest for bank intermediated capital inflows
 - i. Credit risk in the banking system could have been underestimated: very rapid credit growth, shortage of qualified bank officers, currency mismatches, institutional weaknesses → difficult for banks to reliably estimate credit risk, risk-adjusted returns, recover collateral
 - ii. Asymmetry in importance of bilateral credit exposures
 - iii. Regional contagion



How might the SEE region be affected (3)

Ad asymmetry in bilateral credit exposures:

Changes in lending policies that are modest from the perspective of parent banks can have major impact on SEE host countries

Ad regional contagion:

Recognition of credit risk in one SEE (or “emerging Europe”) country could trigger reassessment of risk in the whole region

Note: a sudden stop in capital inflows could lead to major exchange rate correction → balance sheet effects



How might the SEE region be affected (4)

Other important vulnerabilities:

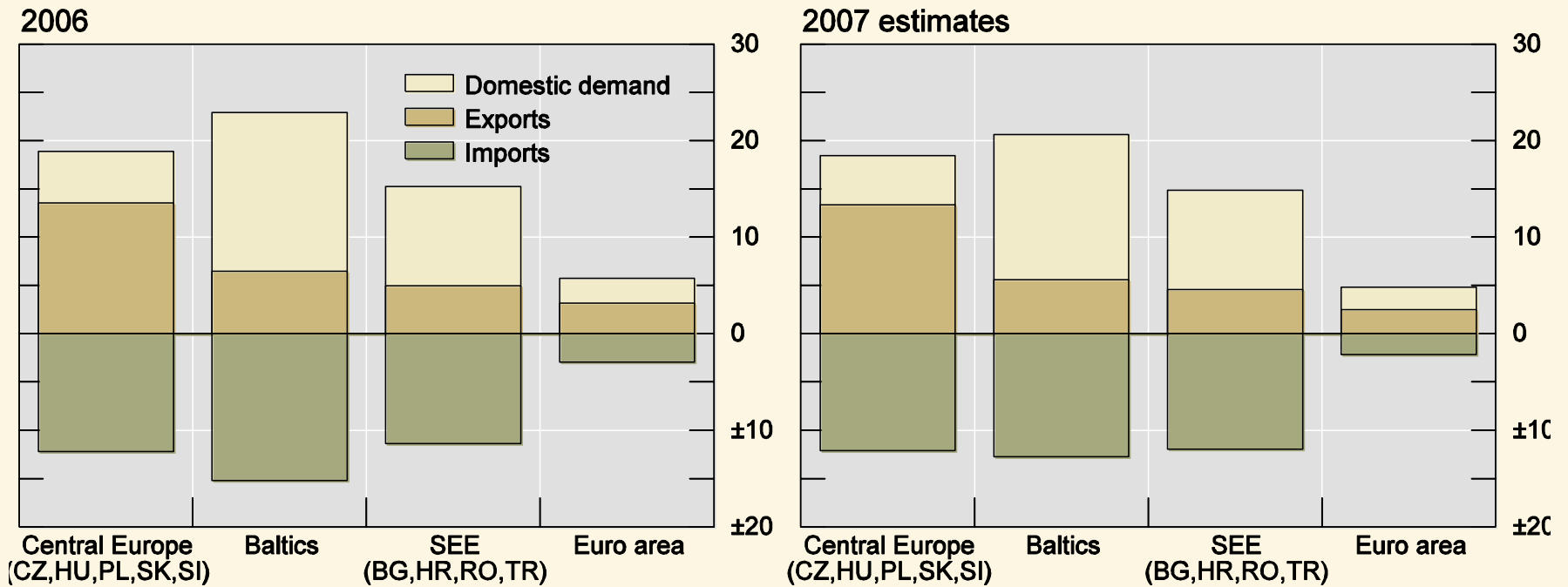
- i. Growth driven by domestic demand, while export performance is not particularly strong
- ii. Current account deficits often reflect growth of private consumption, not growth of investment
- iii. Much of investment is for construction, not machinery and equipment



Growth driven by domestic demand, export performance is weak

Domestic demand and net exports

Contributions to GDP growth, in percentage points



Source: Eurostat.



Current account deficits often reflect growth of private consumption, not investment

Changes in external balances, investment and saving during 2007¹

	Δ Current account balance	Δ Fixed investment ²	Δ Domestic saving			Δ Real effective exchange rate ⁴
			Total	Public ³	Private	
Bulgaria	-5.8	1.0	-4.8	-0.2	-4.6	6.2
Bosnia-Herzegovina	-4.6	4.0	-0.6	-4.4	3.8	7.1
Serbia	-4.0	1.0	-3.0	0.5	-3.5	10.1
Romania	-3.5	6.0	2.5	-0.8	3.3	8.8
Albania	-2.4	1.0	-1.4	-0.7	-0.7	...
Macedonia	-2.3	2.0	-0.3	-0.4	0.1	-2.6
Average (CEE 16)	-1.5	1.1	-0.5	-0.1	-0.4	5.8

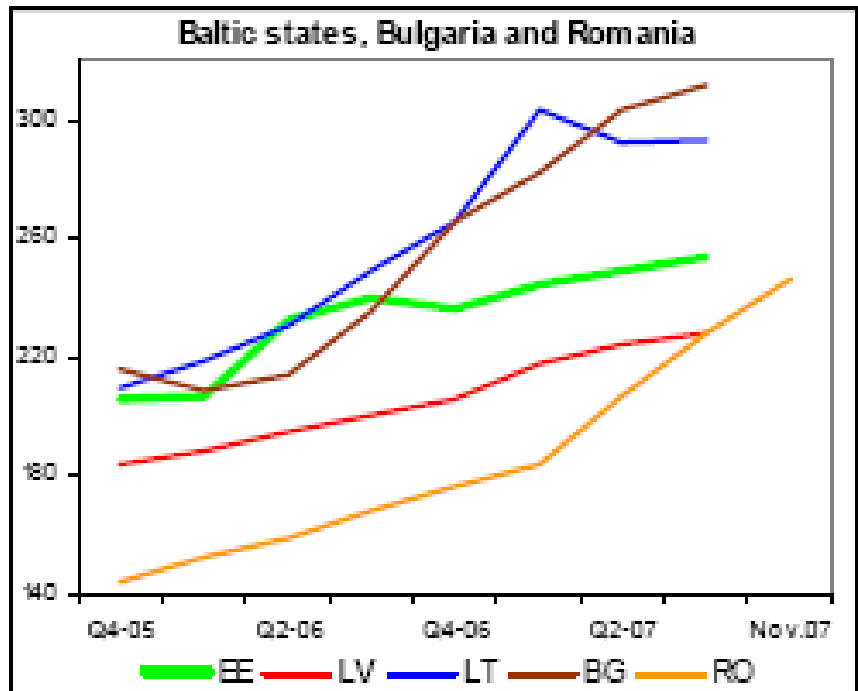
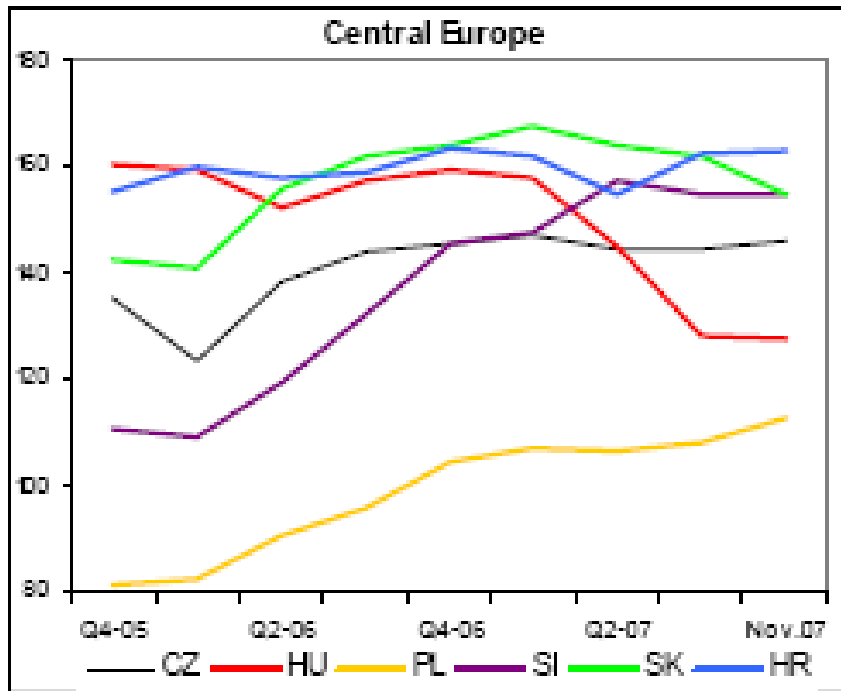
¹ In percentage points of GDP, except real effective exchange rate. The table shows cumulative changes in GDP ratios during 2007 (negative numbers indicate widening of the deficit). ² Gross fixed capital formation, except Albania and Bosnia and Herzegovina (gross investment). ³ Changes in general government budget balances; positive numbers indicate lower deficit/higher surplus. ⁴ Average of monthly year-on-year changes in REER in terms of relative consumer prices (except Albania and Bosnia and Herzegovina, end-2006 over end-2005). ⁵ Average for the countries with wider/narrower deficits.

Sources: European Commission; IMF; national data; BIS estimates.



Much of investment is for construction (20-30% real p.a.) not machinery and equipment (5-10% real p.a.)

Total construction output 2000 = 100, seasonally adjusted



Source: Eurostat.



Mitigating factors

- Huge catching-up potential
- Capital inflows taking place against rapid economic and financial integration with EU
- Region is early in the FDI cycle: still lot of state assets for sale; FDI in place is profitable
- Austrian, Italian parent banks have long-term view of growth opportunities in SEE; protect their franchise; operations very profitable
- Exposure to property markets not as large as often thought (low LTV ratios, existing housing stock not burdened by mortgage debt)



Policies that should help

- Maintain macroeconomic stability
- Use available room for monetary policy
- Fiscal discipline extremely important (health care reforms a major upcoming issue)
- Improve financial stability – regulatory regime, prudential measures, banking supervision, home-host co-operation
- Improve business climate – legal system and judiciary extremely important for local entrepreneurs, attracting FDI; competition policy; education reforms



Special topic: Changing the composition of bank lending

- Prevailing view: bank lending to households and large corporations is developing adequately
- Credit to households is perhaps even expanding too fast: *Ersparnisvernichtung* hypothesis – foreign banks aggressively expand consumer and mortgage lending, which boosts imports of consumer durables and intermediate goods related to construction
- Meanwhile, many small and medium-sized enterprises (SMEs) still have limited access to bank credit
 - Which policies might induce commercial banks to lend more to SMEs?



Special topic (2)

- Objective reasons for more limited growth of credit to SMEs than to larger firms and households:
 - Greater opaqueness of SME operations, financial accounts
 - Mortgage, consumer loans can be standardised, credit scoring techniques used
 - Lack of adequate SME collateral
 - Evaluation of credit risk for SMEs more labour-intensive, requires local knowledge



Special topic (3)

- Some experiences:
 - Small entrepreneurs find it difficult to get bank credit even in advanced economies
 - Greater competition among banks in central Europe
→ banks gradually turned to lending to SMEs, after exhausting the potential for credit expansion to larger firms, households
 - Private domestic banks in emerging markets more active in expanding credit, finding new types of customers



Conclusions

- SEE likely to be affected by the financial crisis
 - Slowdown in major export markets for SEE products
 - Foreign funding more difficult to get, more expensive
- Should be able to avoid hard landing
 - Strong built-in growth momentum
 - SEE region remains attractive for FDI, bank inflows



Conclusions (2)

- Need to maintain stability-oriented policies
- Need to maintain momentum of structural reforms, especially those improving the business climate and enhancing the long-term growth potential
- No easy solutions for expanding bank lending to SMEs