"Central and Eastern European Financial Systems in the Crisis"

FINANCE FOCUS BREAKFAST

With
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On December 2nd 2008, Bruegel welcomed Jean Lemierre and György Surányi to give their views on the challenges driven by the current crisis to the financial systems in Central and Eastern Europe. Both speakers shared a pessimistic outlook for the region due to the build up of important channels of difficulties for the real economy and the likely insufficiencies of policy action. They gave special attention to the role of foreign-owned banks in the region and the importance of foreign-currency lending. They also highlighted the importance of coordination between the region and the euro zone.

Central and Eastern Europe has experienced a prosperous period of economic growth and credit expansion. The region had not suffered major tensions from the credit crunch until last September. These elements may have created a sense of complacency and an underestimation of the challenges from the crisis. They may also have contributed to ill-advised policies that exacerbated the pre-existing weaknesses. The current situation is very serious and some of the most vulnerable countries in the region – e.g. Baltic States and Hungary – have entered emergency management mode.

In this context, foreign banks stand out for several reasons. They are used by some as a scapegoat for policy inability. More important, after having imported capital foreign owned banks now have imported the liquidity squeeze from Western Europe. They also serve as channels of potential stress to the financial system in the region, which are highly dependent on foreign capital.

Even if the abrupt credit crunch is a general problem in the region, regardless ownership, many foreign parent banks have obtained funding from the region in the past and are currently facing funding difficulties at home. As a result, there might be a risk of prioritising home activities at the expense of the liquidity needs in the CEE subsidiaries.

At the moment, CEE banks are having difficulties to cover even the needs of creditworthy borrowers. Asset quality of banks is at risk of deteriorating significantly and triggering a chain of corporate bankruptcies and household defaults. In the presence of slower economic activity, contraction of export markets and increasing liquidity constraints, the whole banking system may be seriously compromised.

As concerns foreign-currency lending, our speakers argued that the build up of large liabilities of households and companies denominated in foreign currencies, mainly euro and swiss franc, had long been advantageous for banks and borrowers, and had constituted a rational response to several stimuli. One speaker characterised it as a "massive subsidy" to economic growth from Western Europe to the CEE region in the last decade. It is natural to small open economies with large current account deficits to fuel the financial system with euros, especially with the prospect of eventually joining the euro area.

But this situation creates though serious vulnerabilities that are starting to unfold. The region has no liquidity problems in domestic currencies, but the limited access to foreign money may exacerbate the liquidity constraints and adverse shocks to the financial system and the economy as a whole.

In addition, a euroised financial system restricts or even renders useless monetary policy. Central Banks in the region have acknowledged this and should pay attention to exchange rate policy and the dynamics of nominal and real variables in order to manage exchange rate risks. For the ECB, there is a need to implement innovative and non orthodox monetary policies, following the example of the Federal Reserve.

The ability of policymakers to deal with this situation varies according to the magnitude of current account deficits, inflation and asset prices bubbles. The Baltic States, Ukraine, Bulgaria and Romania are in the most delicate position, with a very limited scope for monetary and fiscal policy action. Serbia is an intermediate case and more room for manoeuvre is possible in Poland, Slovakia, the Czech Republic, and – to some extent – Hungary and Croatia.

To conclude, the speakers provided views about the future. Central and Eastern Europe is not seen yet as in recession. In spite of the fact that there are conditions for a region depression as a worst case scenario, the region has the potential to manage the situation reasonably well following the path of policies adopted in Western Europe and the system put in place to deal with the heritage from previous years.

There is a lot of effort required internally but it should be complemented with action at international level. There is a need to think about relationship between the euro area and CEE, especially in terms of liquidity provision from the euro area to CEE banks.

The ECB explored new grounds; providing liquidity to some banks and thinking about specific situations of countries. The recent EU plans address liquidity issues but may create discrimination for countries outside the euro zone. Short-sighted and selfish policies may exacerbate problems in CEE countries, which could in turn harm the financial system and economic activity in Western Europe.