FINANCIAL STABILITY IN EASTERN EUROPE – A MACROECONOMIC PERSPECTIVE

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Summary

• While differing from one another to a considerable extent, Eastern European countries still share common financial stability challenges: rapid credit growth starting from a low base; the implications of dollarization; the steep pick-up in mortgages and the prospect of EMU membership.

• Financial stability means more than robust bank balance sheets. It is a macroeconomic feature that concerns as diverse actors as governments, households, firms and the external sector. With this approach in mind, key issues in the region are: the relatively modest inflation levels, the small size of international reserves, and the unpredictability of private sector behaviour.

• If these remain static indicators of economic stability, early warning systems would convey a dynamic view on the situation of Eastern European countries. Here, the key variable is the external current account, not necessarily its figures but rather the final use of both domestic credit expansion and capital inflows.

• To be sure, current account positions vary enormously from country to country but there are numerous cases in which credit allocation is biased towards households. This is potentially disruptive. By taking resources away from firms, such a bias in credit retards productivity and innovation. Moreover, it leads to persistent real exchange rate appreciation where foreign savings end up being consumed domestically.

• Finally, any meaningful evaluation of financial stability in the region should include a reference to balance sheets risks, focusing on public debts, the unhedged foreign currency exposure in the non-bank private sector, and gross and net external liabilities.

• Policy can offer a valuable contribution to financial stability. Governments in Eastern Europe should stick to sound fiscal policies, but also foster macroeconomic policy coordination, factor in the potential for ample cycles, as well as focus on micro design of policies (e.g. maturities, currency exposure, tax deductibility of mortgage finance, etc).
Introduction

A macroeconomist surveying Eastern Europe is struck, first of all, not by the vestiges of a common past but by the extent of current diversity. Even in the eight EU Member States, Estonia’s balanced budget, currency board and steep import of foreign savings contrast with, say, Poland’s inflation targeting, low external deficits, and major fiscal challenges. The diversity is far greater if we include not just imminent EU candidates but the “Thessaloniki” countries of the West Balkans – which also have an EU destiny but in some of which institution-building and regional integration have far to go.

Nonetheless, it is intriguing to ask – as this workshop invites us – whether common financial stability challenges run across such a diverse region. These might result, for example, from the shared experience of real and financial sector catching-up; from inherent difficulties in building the institutions of a fully-fledged market economy; or from the challenges of euro adoption at some point in the future. Indeed, four issues that exercise policy-makers from Tallin to Tirana encourage such an exploration:

• Until transition, these economies experienced an idiosyncratic form of financial repression. Now, emerging from initial banking crises and reforms, most share a common experience of rapid credit growth from a low base.

• Typically, we find the original sin of emerging markets: a zest to borrow in foreign currency, sometimes compounded by the dollarization legacy of past inflation – and comforted by prospects of euro adoption at some future point.

• We see a very strong growth in mortgages and other loans to households: it is unclear if this goes beyond normal consumption-smoothing and could reflect some distortions in risk premia or in the institutional setting.

• As actual or potential EU members, these countries face the question what approach to take toward the euro – factoring in not just traditional optimal currency area considerations but the Maastricht criteria and key financial market dimensions that the fathers of the OCA literature reckoned without.

So some potential for common financial stability challenges may well be present.

Defining Financial Stability

Before we proceed further, we should define financial stability. It is a fashionable term. But some financial stability assessments are in truth barely more than banking system surveys with a macroeconomic preface. The analyst’s dilemma arises because financial stability is an emergent feature – a property of the economic system, not of its parts. It has to do with resilience in key sectors, notably the banks. But the key is to probe strengths and vulnerabilities that arise across the sectors of the economy, with their evolving links, and to explore policy influences on this system over time.

More concretely, we cannot be comforted by well-matched banks if their clients are unhedged, or by low public debt if bank assets are impaired. We have to be concerned not just with banks but with the condition of governments, households, firms, and the external sector. In other words, robustness in bank balance sheets is a necessary but not sufficient condition for financial stability. Nowhere are such interdependencies more crucial than in emerging (or converging) economies that are still embedding creditworthiness, and which are
– and should be – dependent on external savings.

So we should also be chary of exploring financial stability through techniques and models that centre on a single sector. Early Warning Systems capture exchange market pressure – but not the key issue whether this threatens output through balance sheet risks. Or, if we view financial stability mainly through the windows of banks, as do some financial stability reviews, we must construct stress-tests of pre-Copernican complexity to internalize evolving patterns of risk in other sectors. Public or external debt stress tests, equally, tell us much about vulnerability – but only if designed and interpreted in a country-specific context. We need a realistic sense what compound shocks could affect the public debt; and we must assess the meaning of external liabilities (very different in nature across, say, Latvia, Hungary or Slovenia) in terms of risk, taking into account any potential for contagion in the region or sub-regions.

We need, therefore, to integrate such financial stability tools in a bird’s eye view of risk behaviour across the sectors of the economy, and its interaction with policy. To appraise financial stability in Eastern Europe, in other words, a macroeconomic assessment is not a bad place to start, if it can help integrate such an analysis.

A Macroeconomic Perspective

In this perspective, three features of the region are striking – at least as stylised facts:

- Macroeconomic stability (in an old-fashioned sense of inflation/imbalances) is typically fairly well-entrenched. Especially if we take into account that these countries should be importing savings, so large external deficits are expected.

- We do not see countries building up unusually high levels of reserves; and there is little effort to maintain very competitive exchange rates (at times, the reverse). We are not in Asia. Does this reflect some shared EU umbrella? It is potentially benign, at all events, but only if vulnerability is watched carefully.

- In the stronger reformers (Estonia or Slovakia, for instance) the role of the public sector is shifting. It has been moving from being a potential source of instability to facilitating growth through a strong policy mix and regulatory framework. Stability challenges lie growingly in private sector behaviour.

There are important exceptions – including cases of old-fashioned fiscal and monetary mix problems that, combined with the exchange regime, which clearly prompt concerns about external vulnerability. But, by and large, macroeconomic management has been impressive across the region. And crucially, in most economies, the hidden deficits – quasi-fiscal losses in banks and state enterprises – were also rooted out. In the EU Members, especially, the late 1990s saw a class act in terms of integrated macroeconomic and structural reforms.

Early Warning System Aspects

Suppose we expand our analysis from static indicators of economic stability to, first, early warning systems – which are also predominantly macro in character. One can include, along with foreign exchange pressure models, the work of Borio and Lowe (extended by Fox and Nagy) on leading indicators of credit booms.

There are a few cases of warning lights flashing in terms of variables that feature in foreign
exchange pressure models (such as real exchange rates, Guidotti ratios or fiscal deficits). But in regional terms – our optic here – one’s eye is caught more systematically by the Borio/Lowe and Nagy/Fox suspects of rapid credit growth accompanied by real appreciation or rising asset prices. The issue typically is not the level reached, which may mostly be within confidence intervals for an equilibrium trend, but the continuing dynamic of financial sector behaviour. The concern is the potential for boom-bust experiences – termed “endogenous financial system risk.”

Now, this concern brings us face-to-face with an intrinsic dilemma when we try to assess financial stability risks in converging economies such as those of Eastern Europe. It is always hard to distinguish irrational exuberance from a warranted market response to productivity or disinflation shocks. But this is especially difficult in the East European environment, which inherently features financial sector catch-up, converging asset markets, and trend real appreciation in the real exchange rate. We need to face squarely this diagnostic risk. If we curb warranted financial growth, we may end up killing the goose that lays the golden egg. Indeed imperfect markets may need a modest degree of financial verve, if not exuberance, if credit is to reach projects that the poorly developed institutional settings tinge with externality risks.

We should therefore pay close attention to the macro and structural context in which these Early Warning System indicators are embedded, including the key policy drivers that are affecting risk behaviour. Specifically, we should focus sharply on the external current account, with its counterparts and financing. Convergence experience in Portugal gives some useful pointers here. Excessive fiscal deficits in Portugal, and a rapid expansion of credit to households (fuelled by perceived implicit guarantees on short-term cross-border inter-bank borrowing), conspired to divert external savings away from productive uses and fuelled unwarranted appreciation of the real exchange rate. At the end of the fiscal/credit cycle in Portugal, a global economic slowdown and abrupt financial retrenchment in all sectors of the economy brought convergence to a dead stop. These events took place under the euro, so (as with currency boards) financial stress emerged in the first instance as a growth rather than a fragility risk. With a floating rate the cycle would probably have been shorter.

More generically, which sector is using external savings (and whether these savings are responding to returns on real investment or perceived guarantees), matters hugely in assessing the risks involved in rising credit, asset prices, and real exchange rates. We must assess, in other words, whether credit expansion and capital inflows are feeding projects that enhance productivity, which would show real appreciation in a more favourable light. Man and woman cannot live by consumption-smoothing alone.

Patterns of Resource Allocation

When we look at developments in Eastern Europe in this perspective, we rediscover the diversity of the region that was our starting point. Current account positions vary widely. In some Central European cases, the government has at times been the major user of external savings. But some of the widest current account deficits are in the private sector, in cases ranging from Estonia to Bulgaria. To a fair degree, such private sector deficits have been covered by FDI. This is a healthy sign, though it has been privatisation dependent, and a continuation of this dynamic is not guaranteed.

But it is notable also that wide private sector-driven external deficits are prominent in currency board/hard peg economies. This could reflect both benign and troubling influences of policy regimes. On the one hand, balanced budgets have avoided the crowding-out of private investment. On the other, very low real interest rates and an apparent absence of
exchange risk may have challenged risk management skills in banks, fuelling strong credit growth that is frequently denominated or indexed in foreign currency, and thus easily funded through external interbank borrowing. This is an issue we do not understand fully, but a question mark hangs over the risks to credit allocation in a very low interest rate environment with no perceived exchange risk.

More generally, in Eastern Europe, close attention is warranted where credit growth is exceptionally skewed towards mortgages and other household borrowing. When it comes to aggregate patterns in credit allocation, we need to look not only at the challenges for risk premia but at strong information asymmetries; a lack of diversity in financial systems; an absence of explicit risk pricing though securities markets; an institutional setting that varies widely in quality – and may frequently make it hard to enforce claims on domestic firms; and, of course, the familiar risk of bubbles.

A bias in credit allocation toward households and away from firms could retard productivity and innovation – a particular worry, as the comparative advantage of Eastern Europe is moving upmarket with its exports, not competing with low-cost producers. In this respect, there are encouraging signs in some of the EU Member States – which have more advanced institutional frameworks – in terms of shifting to higher value added exports. In these cases, of course, we see only part of the resource allocation picture when we look at credit growth. Cross-border flows are important, and in these cases foreign-owned firms at least have benefited from sizable equity and loan inflows. In some Southeast European cases, however, the situation has thus far been different: there are worries about medium-term competitiveness, and the risks of a boom in credit to households with less counterbalance from inward flows of FDI.

A bias in credit allocation towards consumption or real estate, for example, could also be associated with a stressful real exchange rate cycle. Of course, convergence inherently involves an initial phase of real appreciation associated inflows of foreign savings. But if these savings are consumed, then the adjustment phase of the real exchange rate cycle could see a halt to convergence. And without strongly growing productivity the real exchange rate readjustment could be protracted in economies with a fixed exchange rate (as in Portugal under the euro). Whether misallocation could lead to instability, as well as impairing growth, is less clear – especially where claims build up on households. To assess links between financial stress, instability, and growth and we need to understand better the transmission channels to output.

**Balance Sheet Analysis**

As macroeconomists, we tend to give pride of place to the analysis of prices and of flows. In converging economies, however, we need to be especially attentive to the incidence of balance sheet risks. So balance sheet analysis (as evolved by Allen and Rosenberg among others) is a key tool in the armoury. In Eastern Europe, indeed, the dynamic changes underway in balance sheets offer a number of compelling reasons for concern. We can note four watchpoint areas in particular:

- Public debt. This is not a typical concern across the region, but stress-tests in the Eastern European EU Member States (featured in both European Commission and IMF publications) highlight challenges in certain cases. Worth watching in addition, however, is the contribution of public debt and contingent liabilities to the total foreign currency exposure of the economy.
• Unhedged foreign currency exposure in the non-bank private sector. Banks are well hedged in most (but not all) cases. Much more worrying is the dynamic of borrowing by households and firms. Households are believed in many cases to be unhedged, although they may hold some foreign currency deposits. Firms may be naturally hedged through exports, but the limited evidence available suggests this is frequently not the case. In the event of sizable depreciation, household exposure may pose risks mainly to growth, but the exposure of firms indebted to domestic banks could pose stability challenges.

• Gross and net external liabilities. These raise some issues of key importance. (1) How far should offshore banking liabilities be netted off external debt in the absence of transparent data on counterpart assets? (2) Should one relax the Guidotti ratio test (liquid reserves to short-term debt) in the case of currency boards – e.g., by adjusting for liquid private sector assets? (3) If the current account deficit is heavily debt financed as domestic credit expands, at what point should we worry about external debt dynamics; how far is there concern that inter-bank market lenders are relying on implicit guarantees; and can we dismiss this latter issue in the case of intra-group claims (as a form of direct investment, driven by real sector returns)? (4) Are Eastern European banks subject to a concern about contagion among “common owners” – by analogy with the “common lender” contagion experienced during the Asian crisis?

In all these respects, balance sheet analysis is a key input to our understanding of financial stability. It is a crucial way of integrating the different sectors of the economy. It also provides insights into risks that could cause a steep or prolonged loss of output – and, in financial stability analysis, it makes sense to see the sustainability of output as the key objective function. So we should deepen our understanding of balance sheet dynamics and the policy frameworks that influence them.

Conclusion: Challenges for Policy

The variables referred to most frequently in this paper – asset prices, aggregate bank credit, the external current account and the real exchange rate – are not targets or intermediate aggregates in any self-respecting policy framework. Central banks rebuff any suggestion of targeting asset prices, and rightly so. It is indeed crucial to preserve policy transparency in this environment of shifting monetary relationships and of the diagnostic difficulties inherent in convergence. Transparent policy frameworks are essential to harness expectations in the service of financial stability. But one could ask whether the disconnect between such key financial variables and the goals of the main policy frameworks leaves financial stability, operationally, a policy orphan.

Such a view would be far too pessimistic. Policymakers in Eastern Europe can take important steps to embed financial stability without jeopardizing goal or instrument transparency. First, the steady state goals of monetary, fiscal and supervisory policies are highly congruent with financial stability. It is in the transition to stable inflation, or after productivity shocks, or in the presence of clear policy mistakes (e.g., pro-cyclical fiscal policy), that tensions emerge most strongly. Second, there are major degrees of freedom to foster financial stability while fully observing the ground rules of transparent policy regimes. Three aspects of policy design are key in this regard:

• First and foremost, coordination across policies. A familiar example is the macro policy mix, where fiscal tensions can trigger volatile inflows and exchange rate instability. Another instance (crucial in Eastern Europe) is co-ordination to contain unhedged currency borrowing: fiscal policy can take pressure off interest rates; variability in the exchange rate can encourage hedging; supervision can contain
banks’ indirect exposure and monitor the build-up of external interbank debt; sound governance and disclosure can help limit firms’ risks; and consumer protection can help educate households. Policy co-ordination will, of course, be particularly important where countries are using “intermediate” exchange regimes (rather than hard pegs or free floats). This is the case for a few economies in Eastern Europe.

- Second, factoring into policy the potential for protracted convergence “cycles” of quite wide amplitude. During extended convergence booms the uptrend in credit, real activity, asset prices and the real exchange rate may be much more extended than in a conventional business cycle. It will be important to factor this into fiscal measurement, where there are serious risks of over-estimating the steady state elasticity of revenues (and indeed the underlying rate of potential growth). But it is also relevant to supervision, since stress-tests have to incorporate wider movements in key variables than in conventional cycles. Monetary policy, meanwhile, may need to factor in the need to keep traction over inflation during quite wide swings in the real and financial economy.

- Third, the micro design of policies – distinct from goal transparency, and with important stability side-effects. Variability of the exchange rate under flexible regimes was noted above. One can add public debt management (maturities and currency exposure), and micro features of fiscal policy such as the tax deductibility of mortgage finance. Crucial, too, is the approach of supervisors to stress-tests for risk exposure; their use of loan-to-value ratios and other borrower-related tools; and their co-operation with foreign supervisors of systemically important local establishments. Supervisors cannot durably restrain credit growth in an open capital account setting. But they can limit distortions in allocation if they oblige banks to internalize systemic risks that result from the local macro environment – which may not be self-evident in local subsidiaries of banking groups whose risks are well-diversified globally.

The practical implications for policy in Eastern Europe are fairly self-evident, but it is worth emphasizing five operational points in conclusion. First, in a few cases a shift in fiscal policy is urgent to reduce vulnerability. Second, we do not fully understand monetary influences over asset allocation during convergence, but caution is warranted about a bias of credit towards consumption and real estate under low real interest rates and exchange market rigidity. Third, a loss of fiscal discipline resulting in sharp depreciation could severely damage output, if unhedged currency exposure has built up to high levels. Fourth, we should bear in mind in this connection that some countries en route to euro adoption will be transiting from “corner solutions” to an intermediate exchange regime – de facto because they cannot be agnostic about the entry exchange rate, and de jure by membership of ERM II. Fifth, more generally, policy coordination is critical to foster stability, and a key role of central bank financial stability reports can be to promote a greater understanding of this challenge.

The discussion in this paper suggests a picture of some complexity. The image of diversity across the region predominates. Two areas where this is greatest emerge with particular importance indeed: the institutional setting in which markets allocate financial resources, and the capacity (not always exploited) to evolve and co-ordinate credible and transparent frameworks for policy. One key lesson must be the need for the less advanced economies to press forward strongly with the institution-building that has characterised the EU Member States, and is far advanced in Bulgaria and Romania – and to emulate the track record of their policy-makers in combining effectively key elements of macroeconomic and structural reform.
But there are common features also, relevant to financial stability, that should provoke policymakers’ attention. Foremost among these is the opportunity and challenge posed by rapid credit growth. This holds the potential to accelerate importantly the process of economic catching-up. But it will be important to watch for signs of boom-bust cycles developing, especially if these involve unhedged exposure to foreign currency risk across the economy. Probing analyses in central bank financial stability reports are called for to examine not just the quantitative but the qualitative aspects of credit. And more forward-looking policy coordination may be required to avoid periods when financial stress – in the form of instability or protracted adjustment – might cause the convergence process to stall or to move temporarily into reverse.