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POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICIES

SPECIAL COMMITTEE ON THE FINANCIAL, ECONOMIC AND SOCIAL CRISIS

THE IMPACT OF THE CRISIS ON NEW MEMBER STATES

WORKSHOP

Abstract

A workshop on the "The impact of the crisis on New Member States" will be held in the European Parliament in Brussels on 1 March 2010. This document contains the programme and presentations of that workshop. This same document will be published during March 2010 as an updated workshop proceedings document, containing the final versions of all presentations and briefings that are not all yet available.

Background Papers

Understanding the Impact of the Crisis on New Member States

by Stanislaw Gomulka

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1. The questions

The purpose of this paper presentation is to discuss, possibly answer, the following three questions:

- What were the reasons that certain New Member States (NMS) have been particularly hard hit by the financial crisis and others less?
- Did the crisis affect NMS and Member States (MS) who are part of the euro area to a different degree than those who are not part?
- Were domestic policy responses constrained to follow responses in old MS?

In my response to these questions I shall discuss developments in 10 NMS, that is in all NMS except Cyprus and Malta.

The world financial crisis affected NMS mainly through 3 channels:

(a) a large fall of exports to old MS,
(b) large depreciations of currencies in some NMS, and
(c) large falls of energy and row material prices.

2. The question of large variation in GDP falls among the NMS

Factor (a) was stronger in the economies dependent more on export markets. Typically, these were small economies. Poland is by far the largest among the NMS, so suffered somewhat less. Factor (b) reduced both the financial strain on exporters and the volume of imports, with the implication that employment and investment fell less than would have otherwise. But this shock absorber was absent in the 5 countries with fixed exchange rate to the euro. One of them was Slovakia, a new member of the eurozone. The others were the 3 Baltic States and Bulgaria. Of these, Bulgaria, Estonia and Lithuania operate for many years formal currency board-like systems, while Latvia informally and roughly follows currency board-type rules. Finally, factor (c) was possibly the main cause of large GDP falls in Russia and Ukraine, which affected negatively exports to those countries. On the other hand, lower cost of energy and raw material imports was helpful to NMS. But the balance of costs and benefits of this factor varied considerably, from evidently positive for Poland (low exports to Russia and Ukraine anyway, large imports of energy and row materials) to probably negative for Baltic States, Romania and possibly Bulgaria.

However, my main point is that in 6 NM States there were also powerful internal causes of the large GDP falls which occurred in 2009. These are the Group A countries in my Tables I and II. For several years before 2009 there were taking place, in those countries, developments of the boom-bust category. The bust phase, by accident, more or less coincided with the negative impact of the external shock. The two destabilizing mechanisms reinforced each other in the 2nd half of 2008 and the 1st half of 2009, producing exceptionally large output falls in the Baltic States, and quite large also in Bulgaria, Hungary and Romania.

In the 4 countries with currency board rules, as the charts 1-4 show and as Professor Hanke noted (Globe Asia, 1 March 2010, p. 22) "changes in a country's monetary base move in approximately a one-to-one correspondence with changes in foreign reserves". In the years 2004-2008 capital inflows to those 4 countries were exceptionally large, igniting a credit-driven boom in investment and consumption. This boom was unsustainable, as it led to exceptionally large increases in the current account (CA) deficit and huge foreign debts.

Governments of those 4 countries responded by reducing public debt to almost zero. However, public debt was small to begin with. To maintain macroeconomic stability in the years 2002-2007, a much more restrictive fiscal policy was required, namely a large – not small - general government (GG) fiscal surplus.

Developments in those 4 countries can be compared to those which happened in South-East Asia in the autumn 1997, where and when the combination of fixed exchange rates to the US Dollar and negative domestic real interest rates induced large CA deficits and large private sector foreign debts. The resulting falls in GDP in 1998 were in some economies in excess of 10 %.

The case of Hungary is different. In that country it was not a monetary policy, but an expansionary fiscal policy of the government, conducted over several years before 2008, which was a key destabilizing factor. The policy led to a sharp increase in the cost of servicing public debt, which in turn forced the government to reduce significantly, by some 4% of GDP, the GG budget deficit in 2008, just when a more relaxed fiscal policy would be helpful. This restrictive fiscal stance was maintained also in 2009, which therefore reinforced the negative impact of the external shock. A comparison between Hungary (Table II) and the 4 countries of Group B (Table IV) is instructive. Particularly striking is Hungary's large total external debt. By the standards of emerging economies, the GG public debt has also become quite large. It is therefore not surprising that financial markets reacted in the way that did, by demanding significantly higher interest on Hungary's new public debt. This market discipline proved effective, though quite costly to Hungarians.

Romania is the 6th member of the Group A. In that country there took place, in the 4 years 2005-2008, the fastest growth of domestic credit among all NMS. The result was a very rapid, unsustainable, growth of domestic demand, including a 2-digit growth of private consumption. This impressively expansionary monetary policy was taking place despite a relatively high inflation rate and a high CA deficit. Again, a needed correction of that policy coincided with the external shock.

3. The role of the euro membership

The comparison between the Czech Republic and the Slovak Republic, the countries dependent on external markets to about the same extent, may indicate a limited role of the exchange rate policy in explaining the size of the GDP contraction. However, in the export sector of the Slovak Republic a dominant role is played by large foreign firms. Such firms are more immune to the exchange rate than other firms, at least so in the short term. The Slovak Republic has gained from membership the benefits of lower interest rates on private and public debt, and this should help the country in the recovery and subsequent growth.

4. Old Member States and domestic policy responses

The discussion above shows a quite large differentiation in monetary and fiscal policies that NMS have conducted so far. This indicates a rather limited role of old MS in the formation of policy by NMS. The main channel of influence remains the Maastricht Treaty. The NMS generally intend to enter the eurozone "as soon as possible". The financial crisis confirmed the earlier evaluation that macroeconomic credibility of the NMS is significantly lower than that of old MS. Moreover, as judged by changes in interest spreads and currency rates, post-crisis this credibility gap has widened.

In some countries, notably in Poland, public investment has increased thanks to the increasing participation of EU financing in infrastructure and environmental projects. Also helpful has been the response of the financial institutions. In particular, parent commercial banks located in old MS acted in the critical 2nd half of 2008 to provide more liquidity to their affiliates in NMS. There has been also helpful activity by the European Central Bank, and by the old MS directly and through the IMF.

5. Variation among the countries of the Group B category

Tables III and IV show a significant difference between Poland and the 3 other countries of the Group in the GDP response to the crisis. This is despite the fact of a substantial similarity of their solid macroeconomic foundations in the few years before the crisis. All 4 countries experienced a recession in industry in 2009, but in Poland total industrial output fall was comparatively small, and in some branches – notably in chemical and electric products, computers, electronic and optical products, there were large increases in output. Domestic demand declined by 1%, but mainly as a result of destocking. Gross fixed capital formation remained virtually unchanged and private consumption increased by 2.3%. While exports declined sharply, imports declined even more, so net exports lifted Poland's GDP by 2.7 pp to 1.7% above the 2008 level.

The relatively much better performance of the Polish economy remains somewhat of a puzzle. Several differences between Poland and the 3 other countries of the Group should be noted:

- Poland is a much larger country and therefore less dependent on exports;
- Polish financial sector is, relatively, a much smaller part of the economy, and both households and firms rely much less on bank credits;
- Taxes (including insurance contributions) were reduced significantly in the years 2007-2009, just before the crisis started , helping to maintain positive outlook of households during the crisis;
- Pension and other social transfers were also increased in real terms;
- A relatively large depreciation of the zloty exchange rate helped to keep profit margins high, which reduced the pressure on firms to freeze investment projects.

However, the highly expansionary fiscal policy of Poland, adopted in the years 2008 and 2009, increased the GG deficit to 7.2% in 2009, with potentially costly implications in the medium term.

Group A: countries where crisis partly in response to internal causes (EBRD's Transition Report 2009 and EUROSTAT for 2005-2008, and estimates or forecasts reported by EUROSTAT for 2009 as of 19. 02.2010)[1]

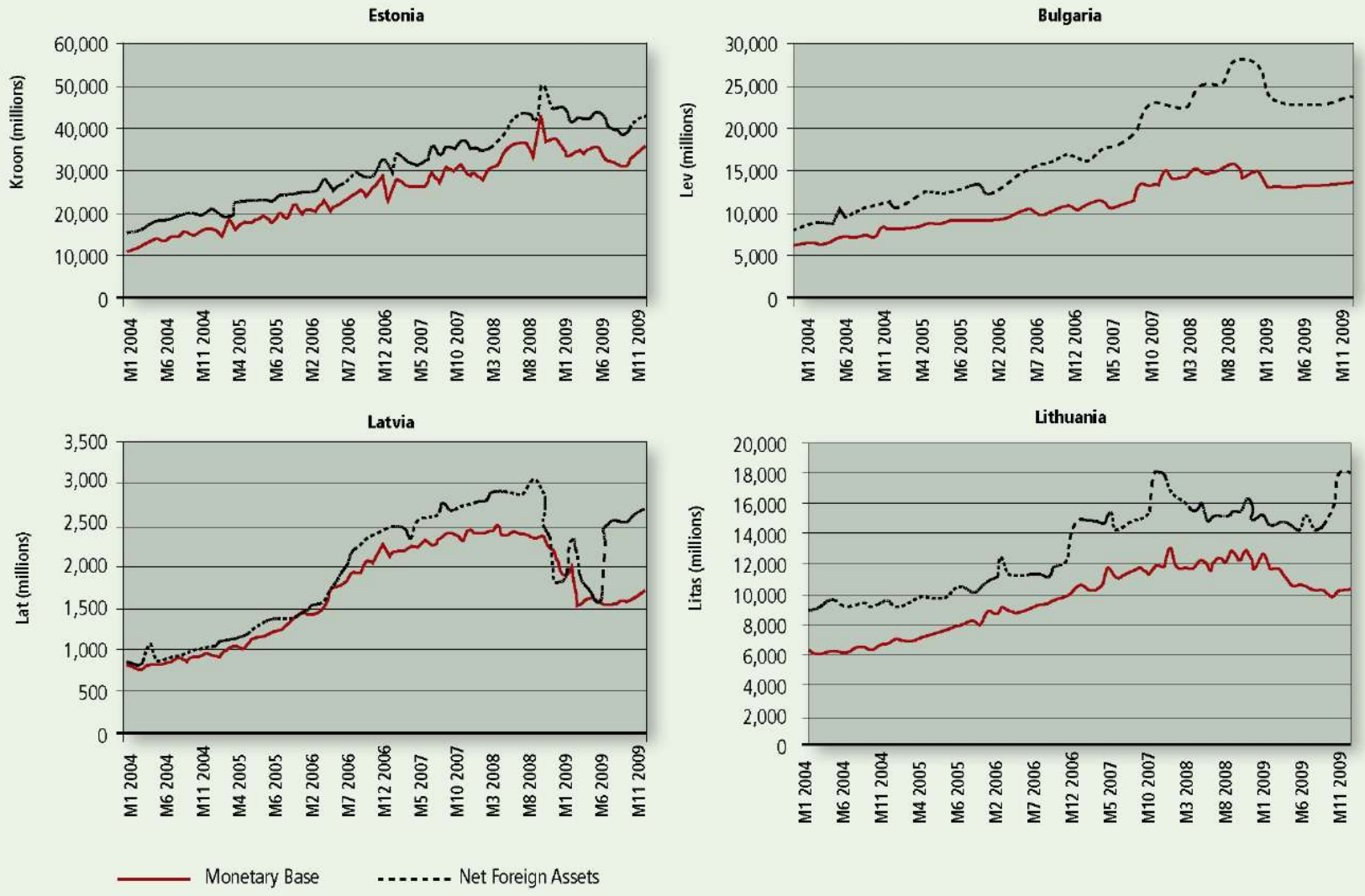
Table I: Macroeconomic performance 2005 – 2009

	GDP growth			Private consumption growth			Investment growth			Inflation rate		
	2005-2007	2008	2009	2005-2007	2008	2009	2005-2007	2008	2009	2005-2007	2008	2009
Estonia	8.9	-3.6	-13.7	10.7	-4.8		14.3	-12.1		5		
Lithuania	8.5	2.8	-18.1	11.8	3.6		3.5	7.9		4.1		
Latvia	11	-4.6	-18.0	15.7	-5.4		15.8	-4.6		7.8	15.4	
Bulgaria	6.2	6	-5.9	6.4	6		19.9	20.4		7		
Romania	6	7.3	-8.0	11.1	10.8		20.3	8.3		7.1	7.9	
Hungary	3	0.6	-6.5	1.9	-0.5		1.4	-2.6		5.2	6.1	

Table II: Macroeconomic (in)stability indicators 2005 - 2009

	Domestic credit growth			CA balance, %GDP			GG fiscal balance, %GDP			GG debt, %GDP			Total external debt, %GDP		
	2005-2007	2008	2009	2005-2007	2008	2009	2005-2007	2008	2009	2005	2008	2009	2005	2008	2009
Estonia	36.1	8.1		-14.9	-9.5		2.2	-2.7		4.6	4.6		80.9	114.1	
Lithuania	43.9	17.4		-10.7	-12.3		-0.6	-3.2		18.4	15.6		47.6	68.9	
Latvia	51	17.9		-19.1	-13.2		-0.4	-4.1		12.4	19.5		94.7	124	
Bulgaria	35.7	33		-18.5	-25.2		1.7	1.8		29.2	14.1		70	104	
Romania	53.4	33		-12.1	-12.2		-2	-5.5		15.8	13.6		38.9	49	
Hungary	15.9	18.5		-7.4	-7.7		-7.9	-3.8		61.8	72.9		111	140.5	

[1] CA current account, GG general government, GDP gross domestic product



Source: International Monetary Fund, International Financial Statistics, February 2010

Group B: countries with strong initial fundamentals, growth slowdown or mild recession in response to the external shock only (sources the same as for Group A)

Table III: Macroeconomic performance 2005 - 2009

	GDP growth			Private consumption growth			Investment growth			Inflation rate					
	2005-2007	2008	2009	2005-2007	2008	2009	2005-2007	2008	2009	2005-2007	2008	2009			
Czech Republic	6.4	2.5	-4.8	3.4	2.8					2.4					
Poland	5.5	5	1.7	4	5.9	2.3	13	8.2	-0.3	1.9	4.2				
Slovak Republic	8.5	6.2	-5.8	6.4	6.1		11.9	6.8		3.3	4.6				
Slovenia	5.7	3.5	-7. 4	3	3		8.4	7.7		2.9	5.7				

Table IV: Macroeconomic stability indicators 2005 - 2009

	Domestic credit growth			CA balance, %GDP			GG fiscal balance, %GDP			GG debt, %GDP			Total external debt, %GDP		
	2005-2007	2008	2009	2005-2007	2008	2009	2005-2007	2008	2009	2005	2008	2009	2005	2008	2009
Czech Republic	16.7			-2.8	-3		-2.3	-2.1		29.7	30				
Poland	21.3	32.5	-3.8	-2.8	-5.1	-0.8	-3.2	-3.6	-7.2	47.1	47.2	50.7	43.7	54.8	46.2
Slovak Republic	19.5			-5.8	-6.3		-2.7	-2.3		34.2	27.7		43.4	53.3	
Slovenia				-3	-6.2		-0.9	-1.8		27	22.5				

Background notes to the presentation

by Kateřina Šmídková

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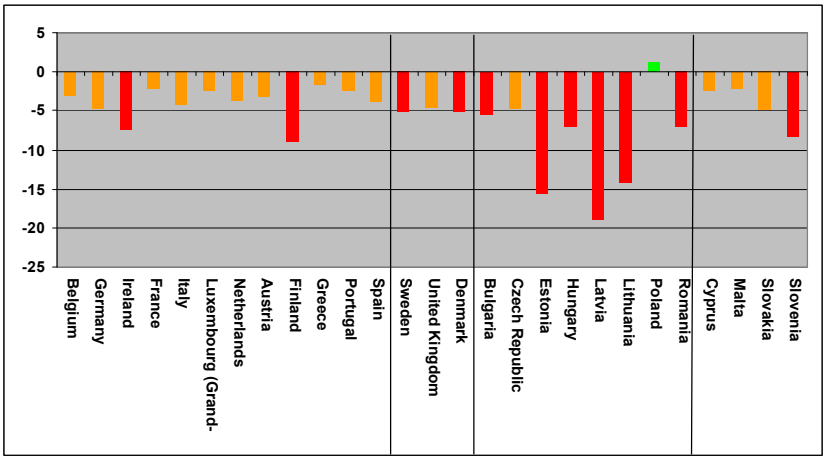
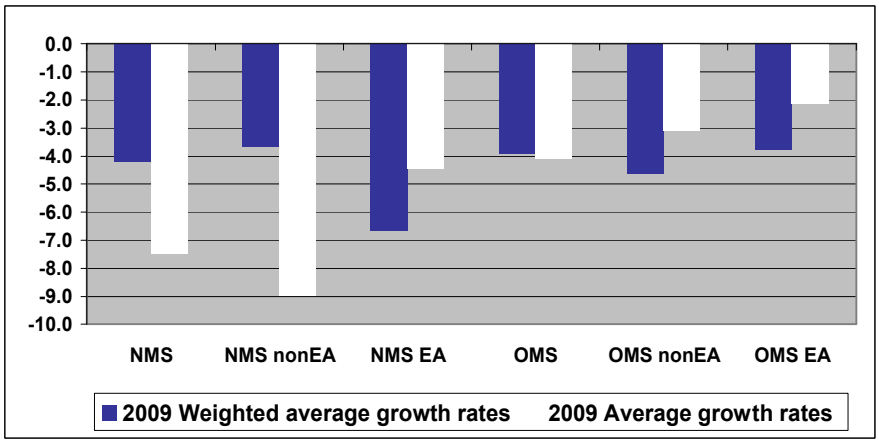
At first glance, the so-called New Member States (NMS) were hit harder by the financial crisis than the so-called Old Member States (OMS). In 2009, the average growth rate for the OMS was -4% (-2% for the euro area members (EA) and -3% for the rest (non-EA)), while that for the NMS was -8% (-5% for the EA group and -9% for the non-EA group) – see Figure 1.



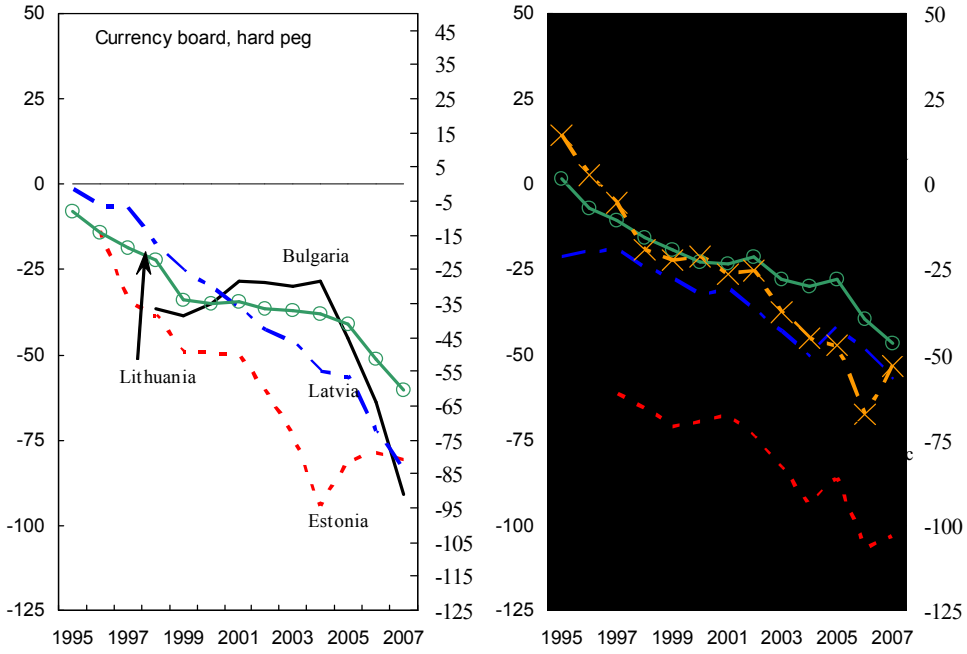
However, at second glance, the populations in all groups (NMS, OMS, EA, non-EA) were burdened with comparable costs in terms of lost GDP growth. This is well illustrated with population-weighted average growth rates. In this case, we observe comparable rates for the OMS (-4%) and NMS (-4%) in 2009 (see Figure 2). In this context, it is worth noting that the only EU member with a positive growth rate was Poland from the NMS group.



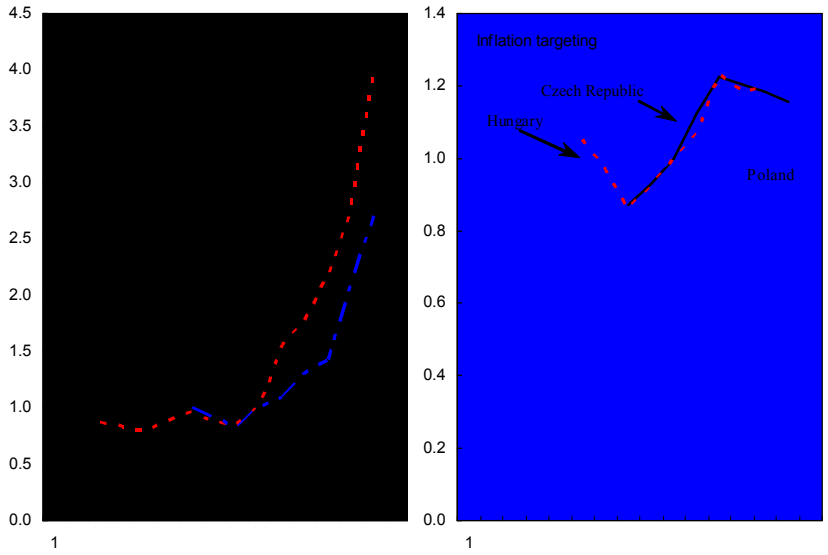
This more detailed analysis of growth rates indicates that the impact of the crisis should be considered on a country-by-country basis. The two groups (OMS, NMS) are too heterogeneous to allow for a more aggregated analysis. Also, it might suggest that the terminology of "groups" rooted in history is now perhaps obsolete. It is important to note that – if used too often – this terminology can mislead markets into reacting to bad news in one NMS with a change in their investment decisions in all NMS. Due to this, there has been a growing risk of contagion.

We need to dig deeper into the facts to see the country differences that mattered during the financial crisis. Firstly, certain macroeconomic factors increased the vulnerability of various countries in both groups (NMS and OMS). For example, large debtors were vulnerable, as were hard-peggers in comparison to some countries with floating exchange rate regimes. Secondly, certain characteristics of the financial system increased the vulnerability of various EU member states. Specifically, countries that save less and/or in which households are willing to take loans in foreign currency were hit by the crisis more severely.

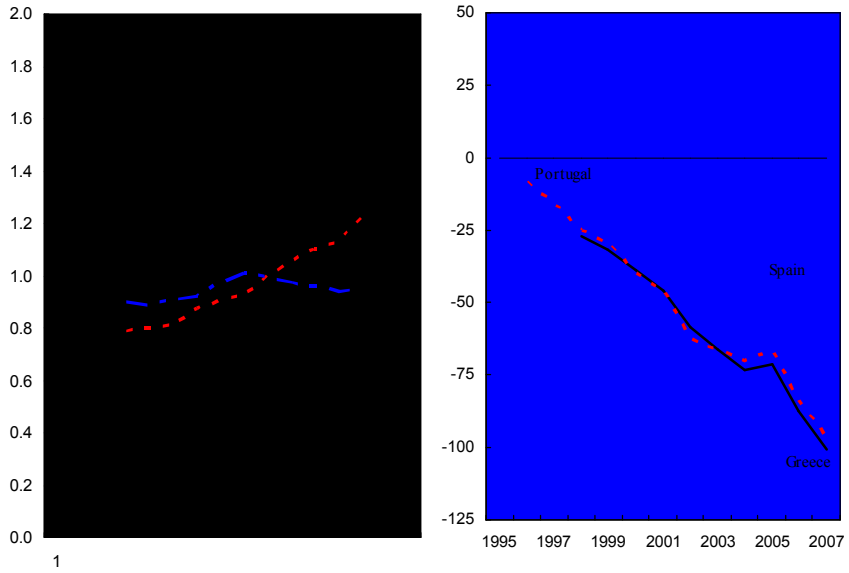
Among the NMS, the net external position (NFA) demonstrates clearly how heterogeneous the group we analyze is (see Figure 3). In several countries with hard pegs, the ratio of NFA to GDP exceeds -60%, which is considered to be the safe limit. Other countries, especially from the group of inflation targeters, weathered the crisis better due to a sustainable level of foreign debt.



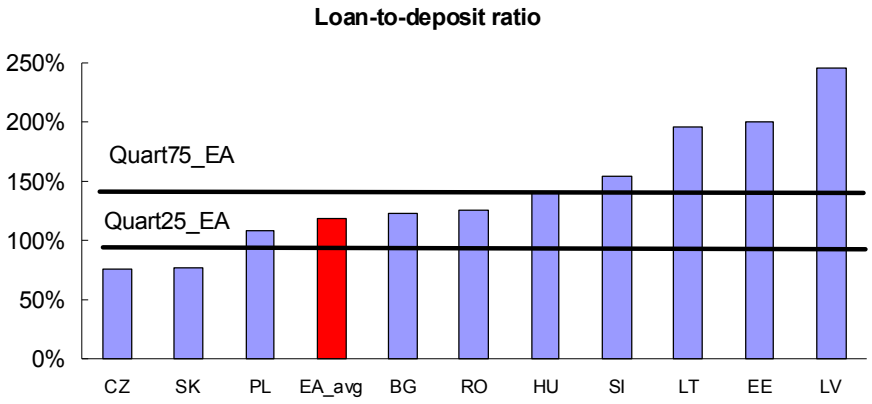
Another macroeconomic indicator that is worth considering is growth in housing prices. Despite the data limitations we face here, Figure 4 illustrates that the growth rates differed significantly across the NMS prior to the crisis. Again, countries with hard pegs seem to be more prone to housing price bubbles, while countries with floating exchange rates did not face such a risk.



The NMS were not alone in exhibiting these patterns. Some OMS also faced large debt as well as housing price bubbles (see Figure 5, housing prices left, foreign debt right). To sum up, certain macroeconomic factors increased vulnerability during the financial crisis in various EU members, no matter when they joined the EU.

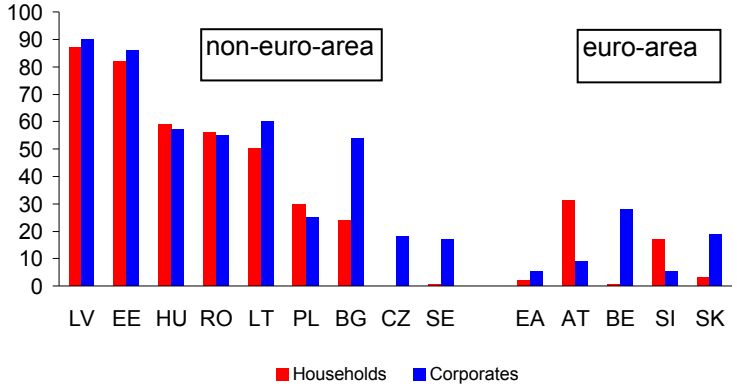


Among financial sector characteristics, the ability of the banking sector to attract enough local deposits (in comparison to loans) seems crucial. Figure 6 compares the loan-to-deposit ratio in the NMS with the benchmark constructed from the quartiles for the EA group (and with the EA average). It is immediately obvious that some NMS were able to attract more deposits than many EA members. This ability made them less dependent on foreign financial flows during the crisis, although it took the markets some time to realize that. It is not easy to determine why some countries were more successful than others in attracting local deposits. There is certainly a combination of reasons, such as credible monetary policy, no history of high inflation or devaluations, and financially aware households.



Data source: BIS, IMF

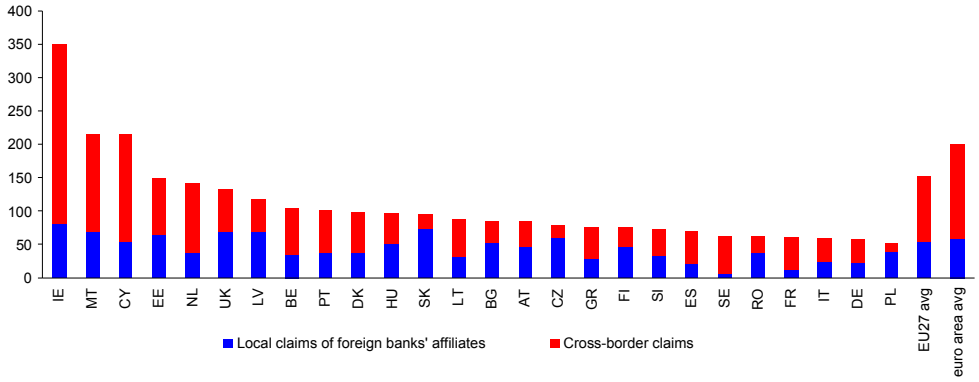
Similar observations can be made about foreign currency loans (in % of GDP – see Figure 7). Relatively large NMS from Central Europe such as the Czech Republic, Slovakia and Poland have roughly the same, or an even lower, share of foreign currency loans as some OMS, while other NMS were vulnerable during the crisis due to their exposure to foreign currency loans.



Source: BIS, ECB, national central banks

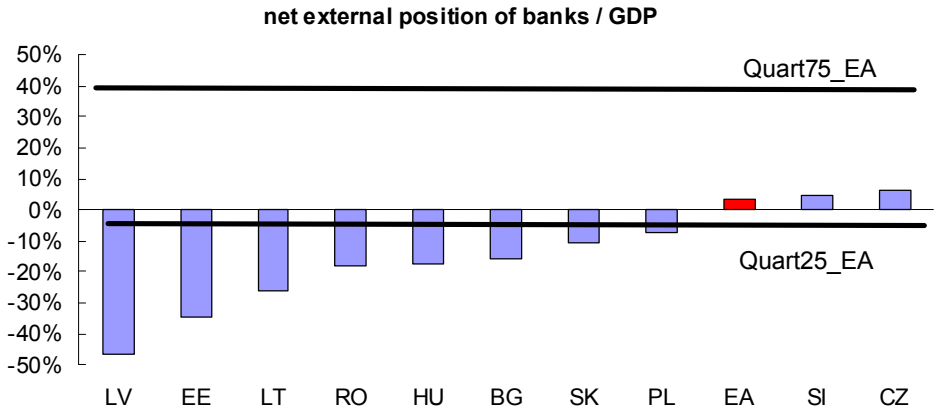
Note: EA = euro area. SI - data as of February 2008; BE - households include only housing loans, corporates include all client loans excluding housing loans.

During 2009, the international investment community focused on the role of international banks in the NMS, using the BIS consolidated banking statistics. The argument was that the NMS were prone to the risk of a "sudden stop" in external financing. However, the data across all EU countries reveal that the involvement of foreign banks in national EU economies is also large in a number of OMS, such as Ireland, the Netherlands, the UK and Belgium. Figure 8 shows the ratio of BIS-defined foreign claims to GDP, with the exception of Luxembourg (ratio around 1300%). From the BIS data, we can conclude that foreign ownership of the banking sector is not necessarily associated with large cross-border claims.



Source: BIS, IMF, Eurostat, CNB calculation
Note: Calculation based on BIS data using both available bases. The data for the EU and euro area (EA) are not consolidated.

Similarly, foreign ownership of the banking sector is not necessarily associated with large net negative external positions of domestic banking sectors (see Figure 9). The banking sectors in some NMS in which foreign ownership clearly dominates have very small negative or even positive external net positions.



Data source: BIS, IMF

Several banking sectors in the NMS passed through the global financial turmoil without any major difficulties and the national authorities in a number of countries were not forced to apply any measures to support their banking sectors (for example in the Czech Republic, Slovakia and Poland and, maybe surprisingly, even in Estonia and Bulgaria). As far as the long-term factors behind stability are concerned, the banks' focus on the traditional conservative business model, which has so far generated sufficient income for foreign owners on these countries' relatively unsaturated financial markets, was of prime importance. The banks' balance sheets mainly comprise loans to households and corporates plus some exposure to the government and central banks. The banks generally avoided investing in risky and complex securities. With this strategy, these banking sectors generated relatively high return on equity. This helped to keep capital adequacy at relatively high levels without supportive injections from the government. The main source of profits for most banks was growing income from financial activities (in particular, net interest income and net fee income), despite an increase in asset impairment due to a rise in non-performing loans.

The lessons are not trivial. We can state that sound and credible macroeconomic policies prior to the crisis reduced the vulnerabilities of EU members to the impact of the financial crisis. They contributed to lower exposure to and lower dependence on foreign funds as well as to reduced risks of housing price bubbles. We can also state that sound, systemic-risk-aware management of the banking sector and sound supervision helped. Countries with traditional banking sectors not burdened with complex products were not hit so hard by the crisis.

The challenges ahead are enormous. Firstly, hard-peggers need to find a policy mix that will prevent large balance-of-payments imbalances from accumulating. It seems that floaters adjust faster, although they have more volatile exchange rates. With a fixed exchange rate or in the EA, the balance-of-payments constraints do not disappear. Secondly, it is important to improve ways of internalizing systemic risks into risk management. For example, we need a mechanism via which parent banks can be forced to compromise their profit ambitions if the authorities in host countries identify major risks of a macroprudential/systemic nature. Thirdly, due to the extensive use of the euro in some countries outside the euro area, proper macro liquidity contingency planning should be established. National policy tools are not always sufficient. The use of the euro outside the EA inevitably means that if a crisis strikes, there will be some negative impact on the EA too – immediate liquidity facilities for countries that are obviously solvent though just hit by the outbreak of a global liquidity crisis should be viewed as helpful. Fourthly, it is too early to fully evaluate the impact of fiscal rescue packages on the euro adoption process. At first glance, if the rules stay the same, it may well be that increased fiscal deficits and debts may slow down the process.