Contagion and Vulnerability

The Waves of Global Rebalancing in CEE

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WIIW Round Table on the
'Global Imbalances and Consequences for Transition Countries'
27 March 2008, Vienna

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Outline

I. The ‘rebalancing’ and the subprime crisis.

II. Factors influencing the macro-scenarios.

III. Channels of contagion.

- Fears of recession.
- Fall in global risk appetite and re-pricing risks.

IV. Sources of vulnerability.

- Domestic factors (macro-, structural and policy).
- Financial stability issues: national institutions and markets.

V. Conclusions.

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Whatever explanation of global imbalances is accepted…

1. ‘Saving glut’ in emerging (Asia) countries.
2. Investment strike rather than saving glut in non-US regions.
3. Debt unsustainability – investment strike in US (business caution at home).
4. Policy mistakes: fiscal loosening & too low US interest rates for too long.

⇒⇒ US current account adjustment will come sooner rather than later;

⇒⇒ Financial integration/innovation allows bigger and more protracted US deficits;

⇒⇒ When US CA adjustment comes, the exchange rate adjustment will be massive.

Subprime mortgage bubble burst was just a “spark”.

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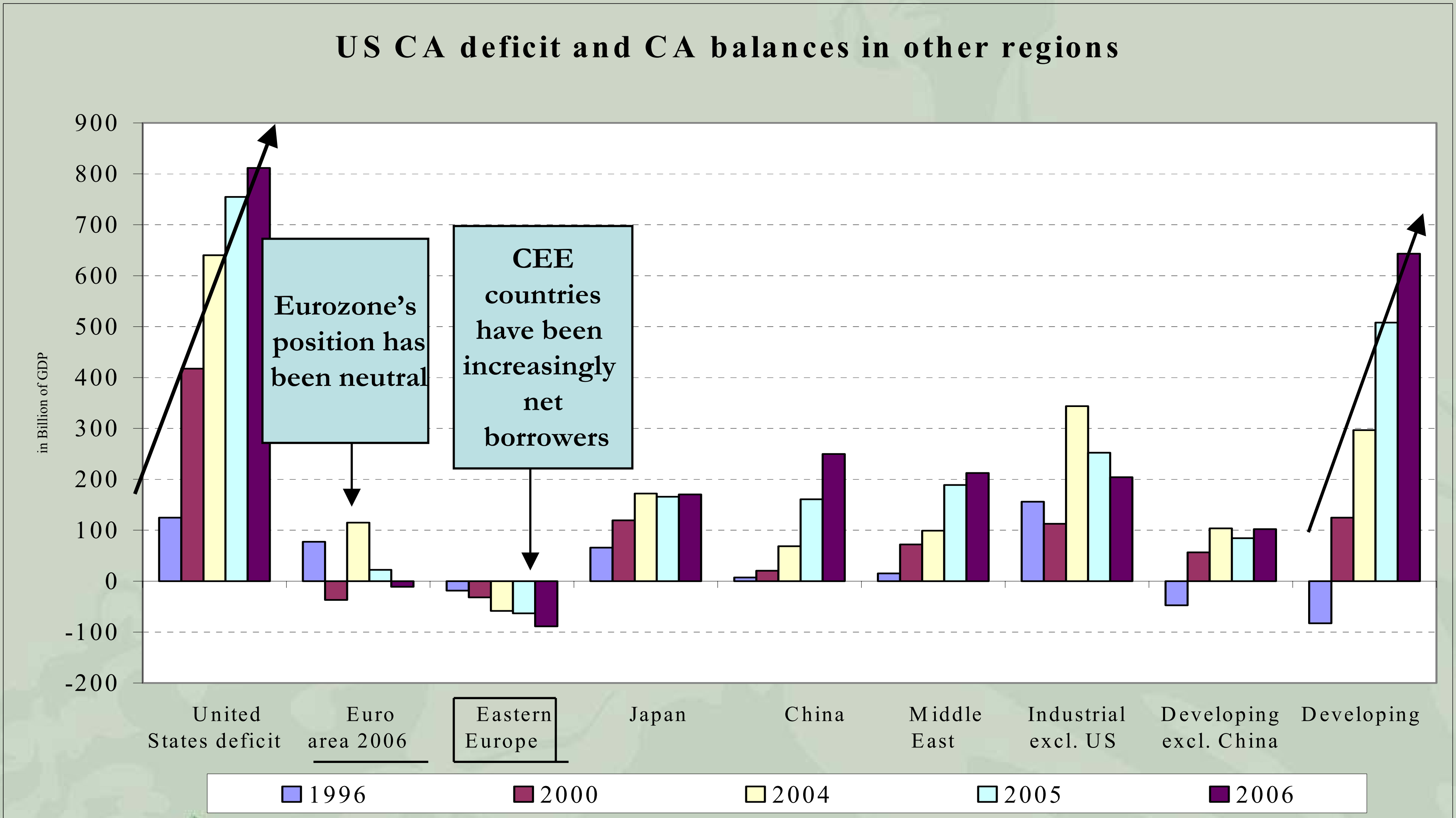
Growing global imbalances – low risk aversion



Factors influencing the macro-scenarios

1. **Real adjustment - Dominated by US prospects.**

- US ‘hard’ or ‘harder’ landing? – recession.
- Europe ‘soft’ or ‘hard’ recoupling – slowdown.
- CEE is highly integrated with the EU – slowdown or slowing catch up?

2. **Common exogenous shocks to the inflation.**
3. **Financial contagion.**

- The epicenter of the turmoil are subprime mortgage-related securities;
- However, dollar weakness shocked financial investors, exporters and policy makers.
- Re-pricing risks, fall in risk appetite, disclosed losses & lack of confidence: - liquidity problems;
  - increasing volatility,
  - sudden stops (?).

Key questions in CEE:

1. What are the consequences for the catching up of CEE?
2. Is there any room for manoeuvre in national policies? (economic and monetary)
3. How central banks will keep inflation expectations entrenched in this environment?
4. Euro anchoring does/would help or not?

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New EU members* are characterized by:

Dynamic catching up.

- strong domestic demand, private consumption;
- relatively disciplined (fiscal) policies;
- low public indebtedness, growing private debt.

- Financial deepening
  - private (equilibrium?) credit boom.

⇒⇒ Where NMs are as compared with the equilibrium path?

*Hungary is an outlier. See last chart.

Real economy: recoupling EU→CEE

In EU old MSs:

- External demand (US and other) is declining.
- Appreciation of the euro vis-à-vis US dollar and other dollar-zone currencies hit Eurozone’s competitiveness (?).
- Weakening domestic demand:
  - European investor and consumer confidence indicators are falling.
  - Negative wealth effects trough dollar denominated assets.
- Common global shocks: oil, energy, mineral, food prices (but appreciation of the euro).
- Financial conditions are tightened.

⇒⇒Declining external demand for CEE + danger of European ‘traditionally’ slow recovery.

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Financial sector contagion: EU→CEE

- No direct exposure to the subprime.
- The banking sector is privatized to foreigners. Parent institutions are secured (until now).
- Higher risk aversion, jump in risk premia, danger of credit crunch.
- Market imperfections due to lack of confidence – liquidity problems.
- Market turbulences (stock exchanges, fixed income, forex) – quick, sometimes inexplicable reactions everywhere.
- Declining profitability of parent and home banks.

⇒⇒ Costs of credit - cost of catch up will be increasing.

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Vulnerability depends basically on domestic conditions…

No CEE 'prototype-country'!

- Macrostability is of primary importance - overheating and widening current account deficit.
- Regime choice – exchange rate and monetary regimes.
- Institutional background: financial supervision, stock exchanges, public debt management.
- Financing pattern: - the changing role of the FDI;
  – foreign ownership of the banking sector.
- Exchange rate risks: high share of FX denominated loans and/or cross border borrowing.
- 'Inside' sub-prime problem might emerge in some countries.
- The danger of sudden stop is higher if:
  - cross border credit is important and/or
  - government securities and derivative markets are developed.

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The effects of sub-prime: drop in global risk appetite and re-pricing (emerging market) risks

- Market imperfections (‘drying up’ markets) and the danger of sudden stop.
- Equity and fixed income markets turbulences. Drop in equity prices and increasing government bond spreads.
- Yield curve shocks - movements with no fundamental reasons.
- Exchange rates might also be sensitive to non-European events, however, there are fears of regional contagion as well.

Conclusions

The name of the game is: WHO PAYS THE (NEW) PRICES?

- Losses are huge and we cannot yet see the end.
- Rebalancing will make CEE integration more expensive.
- Catching up by NMs and candidates will be slowing down.
- Each country is different and has its own responsibility.
- Vulnerability is conditional on domestic factors, but
- contagion might arrive from both developed & emerging markets.
- Public debt is under control everywhere, but
- the build-up in risk arising from rapid private credit growth is underestimated in some countries.
- The share of non-performing loans will grow, as well as the danger of moral hazard.
- The risk of a solvency crisis is relatively low,
- but the risk to the sustainability of bank intermediated capital inflows and government securities markets is higher.
- Euro ASAP – might reduce above risks, but….

Epilogue:

‘There is nothing new except what we have forgotten.’*

Old and new responsibilities should be reconsidered and reinforced.

- Supervisory authorities,
- Credit rating agencies,
- Central banks.

Monetary policy in CEE:

- Room for manoeuvre has always been constrained;
- especially in countries where money and capital markets are relatively developed.
- Contagion from emerging markets might be stronger where stability is not convincing.
- Inflation target continues to be first priority, but
- responsibility for financial stability is stressed.

* Mlle. Rose Bertin (Marie Antoinette’s milliner) – invoked in Carmen Reinhart’s testimony to the Congress 2008.

HUNGARY – a special case

- Different cyclical characteristics since 2000.
- Huge fiscal adjustment in 2006-2008.
- Low & slowly recovering growth – falling domestic demand – high but declining inflation.
- Twin deficit declined to a sustainable level. Risk premium should be declining – in principle!
- Further fiscal adjustment according to EDP.
- Sustainability doubts - still high public debt to GDP;
  - political/policy risk is growing.
- The share FX and foreign owned debt is relatively high but under control.
- Markets are relatively developed – more vulnerabilty in addition to fundamentals.

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Equilibrium financial deepening

"Early Birds, Late Risers, and Sleeping Beauties"*

Central Europe – Western European Banks

Balkan – Scandinavian banks

- Increasing competition for markets, clients and profits.
- Fast bank credit growth – housing credit boom.
- Artful product innovation.
- Spontaneous and policy induced euroization.

⇒⇒ **Growing macro- and financial vulnerability**.

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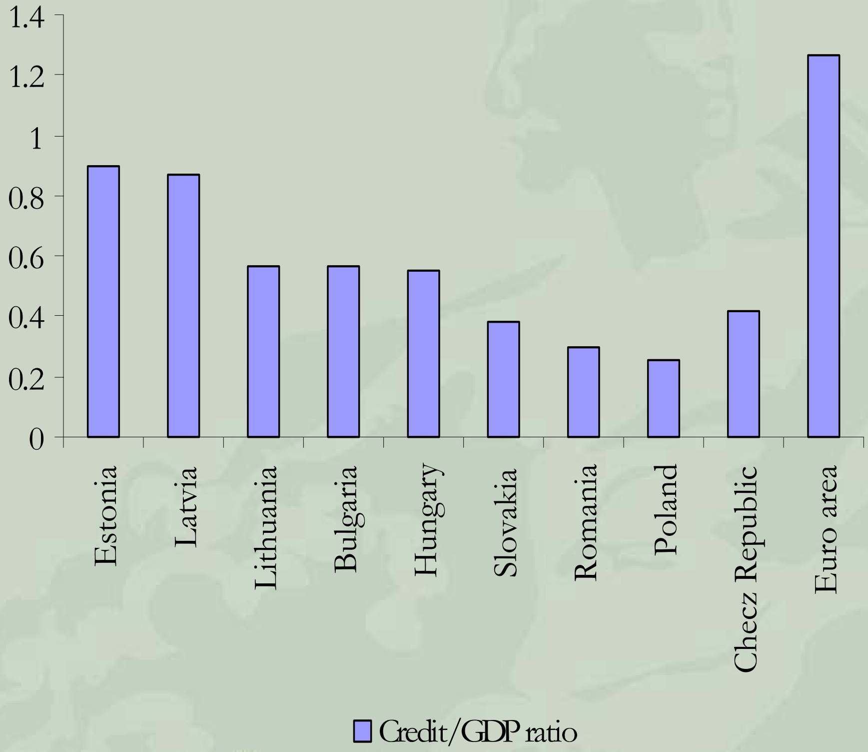
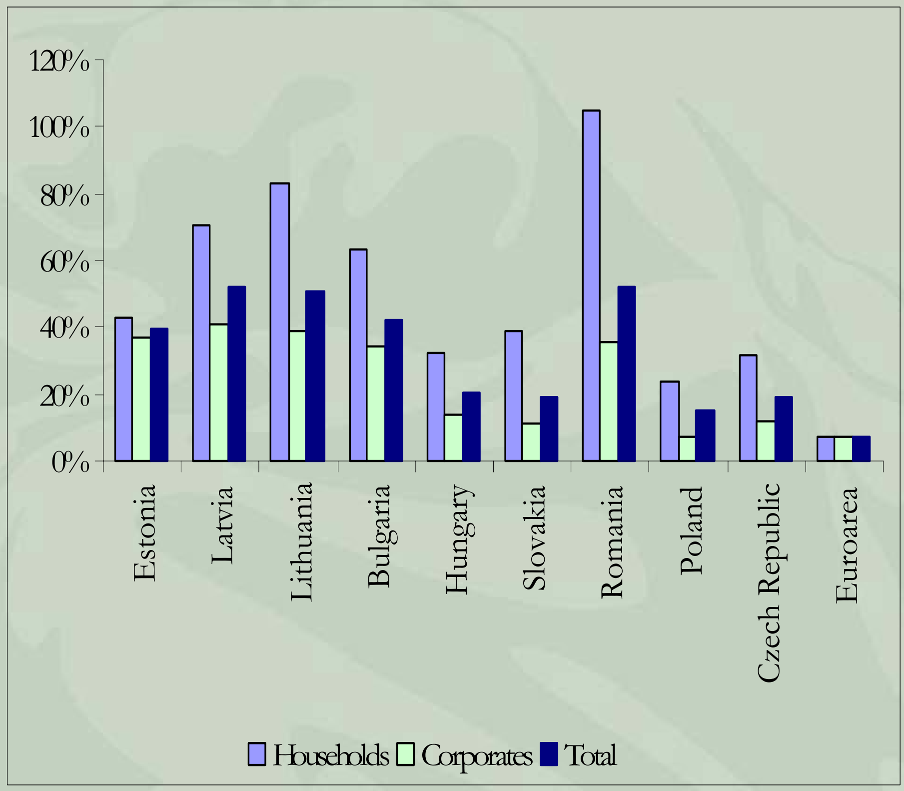
* Cottarelli, C. et al. (2003) IMF WP/03/213

Domestic bank credit-to-GDP ratios approaching the euro area
(2006)



Composition of private credit boom: households take the lead
(average annual growth 2003-07)



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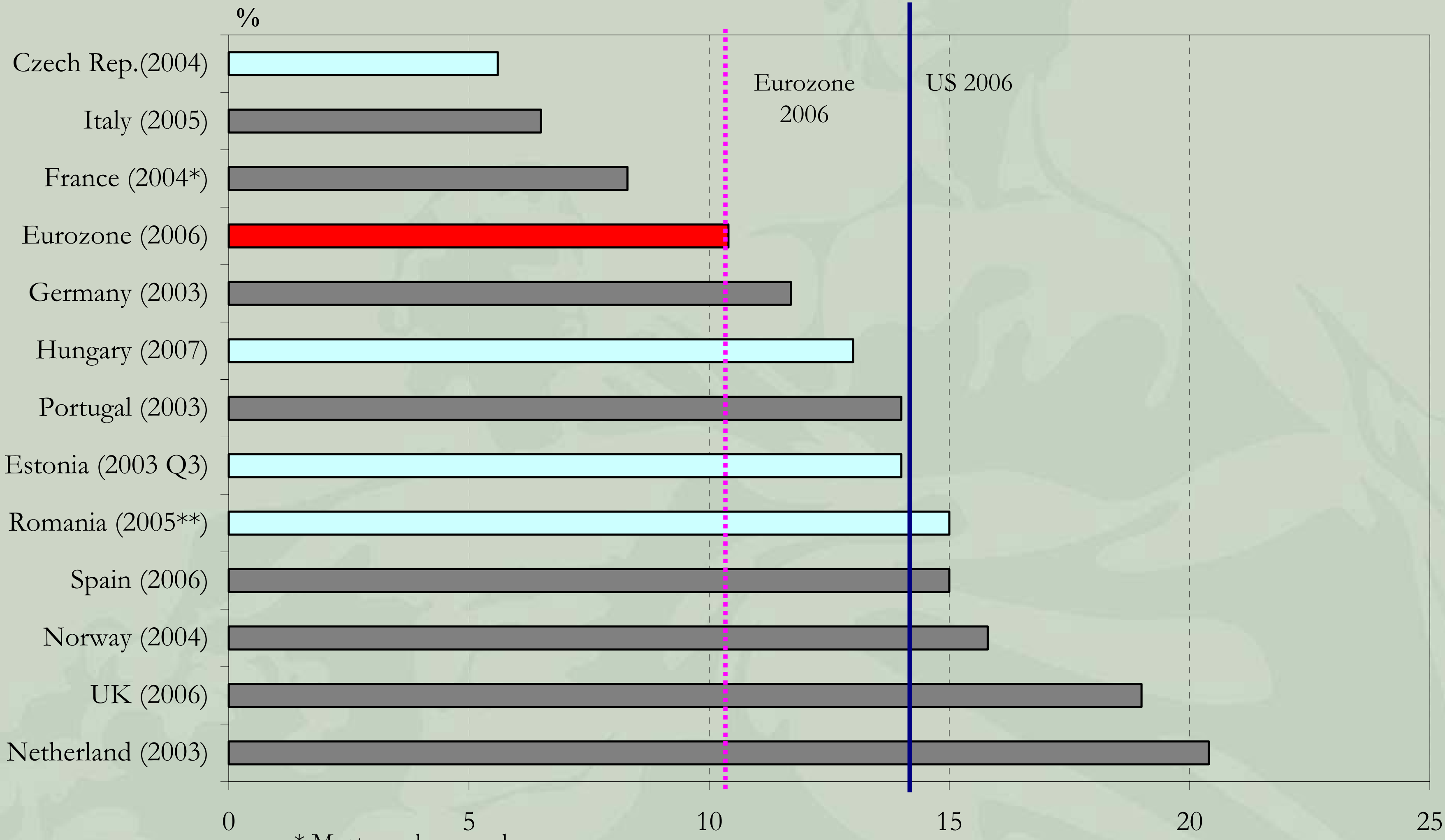
Households debt services to the disposable income



* Mortgage loans only.

** To the annual wages.

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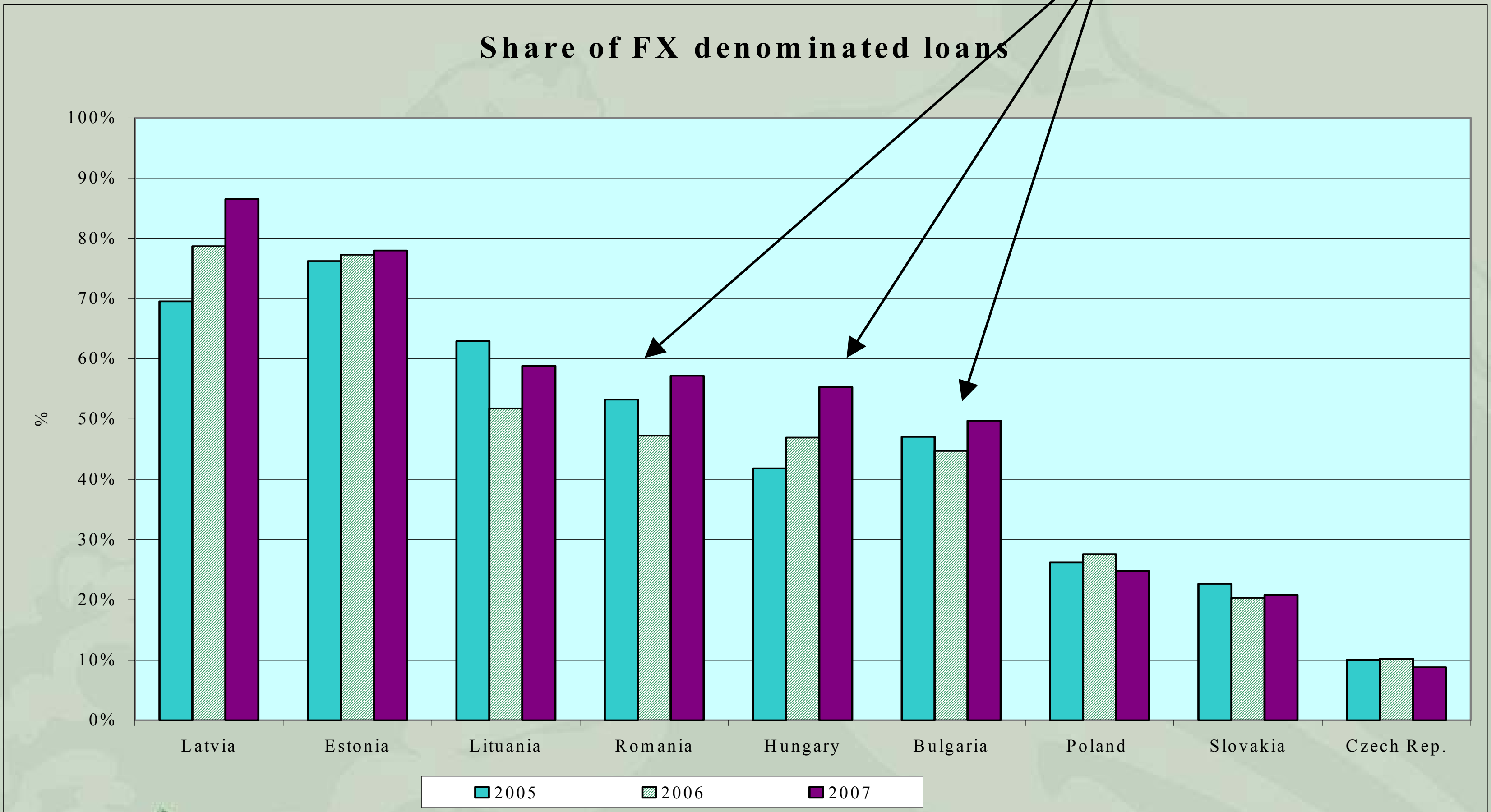
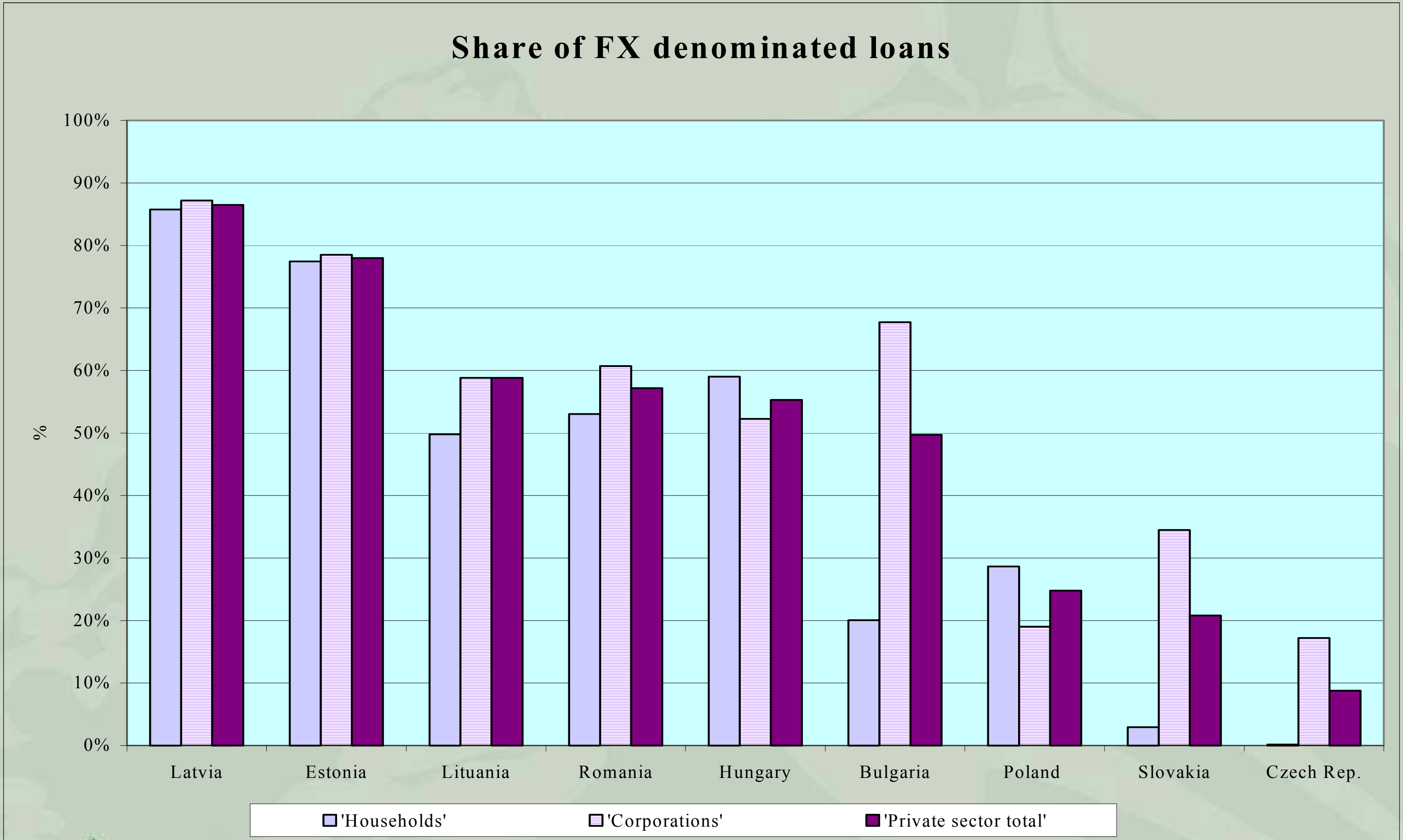
Source: MNB, CB annual report, OECD.

Share of FX denominated loans are high in CB countries and where interest differential is large



Source: Convergence Report 2008, MNB

Share of FX loans by sectors



Source: Convergence Report 2008, MNB

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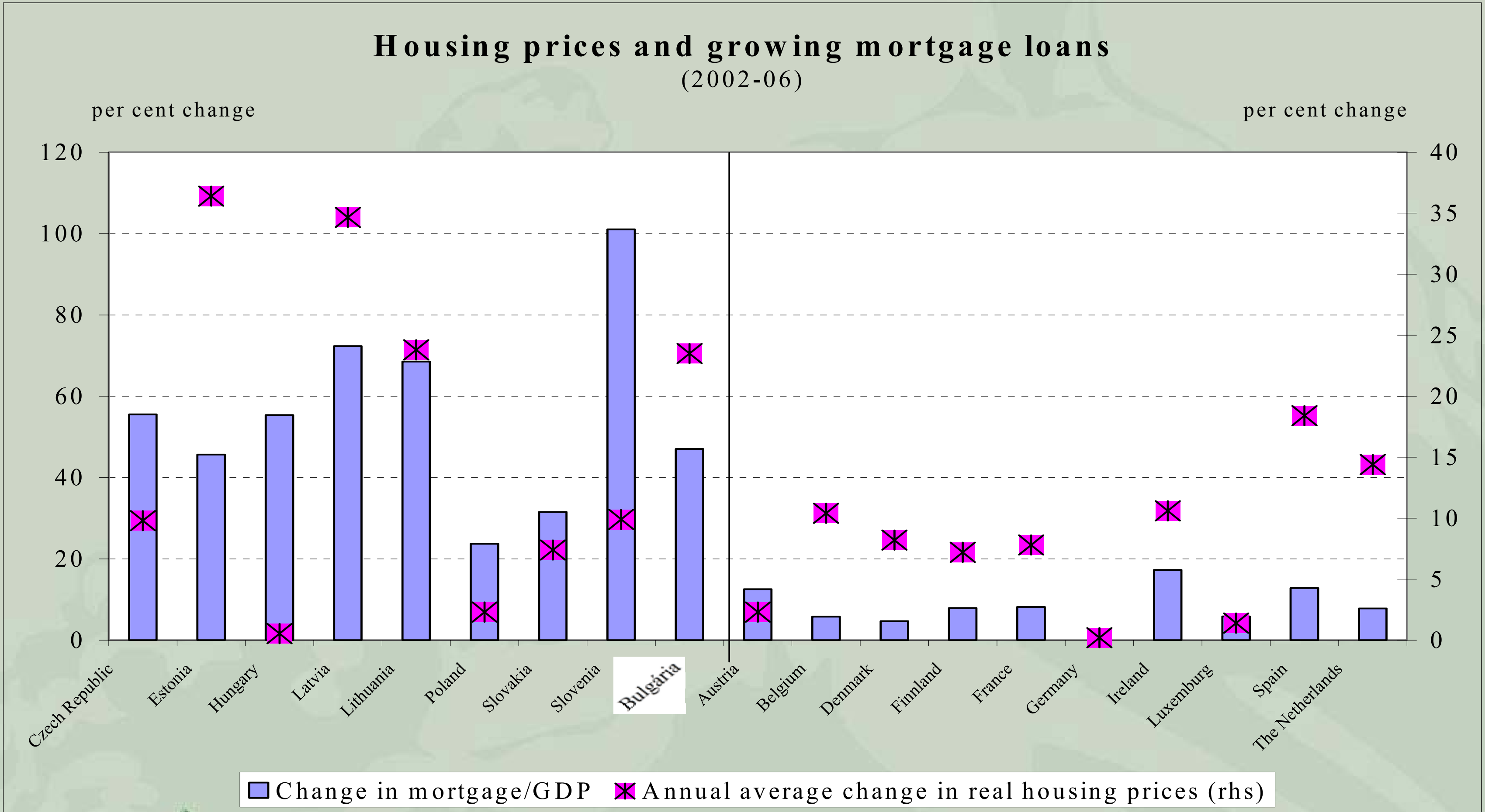
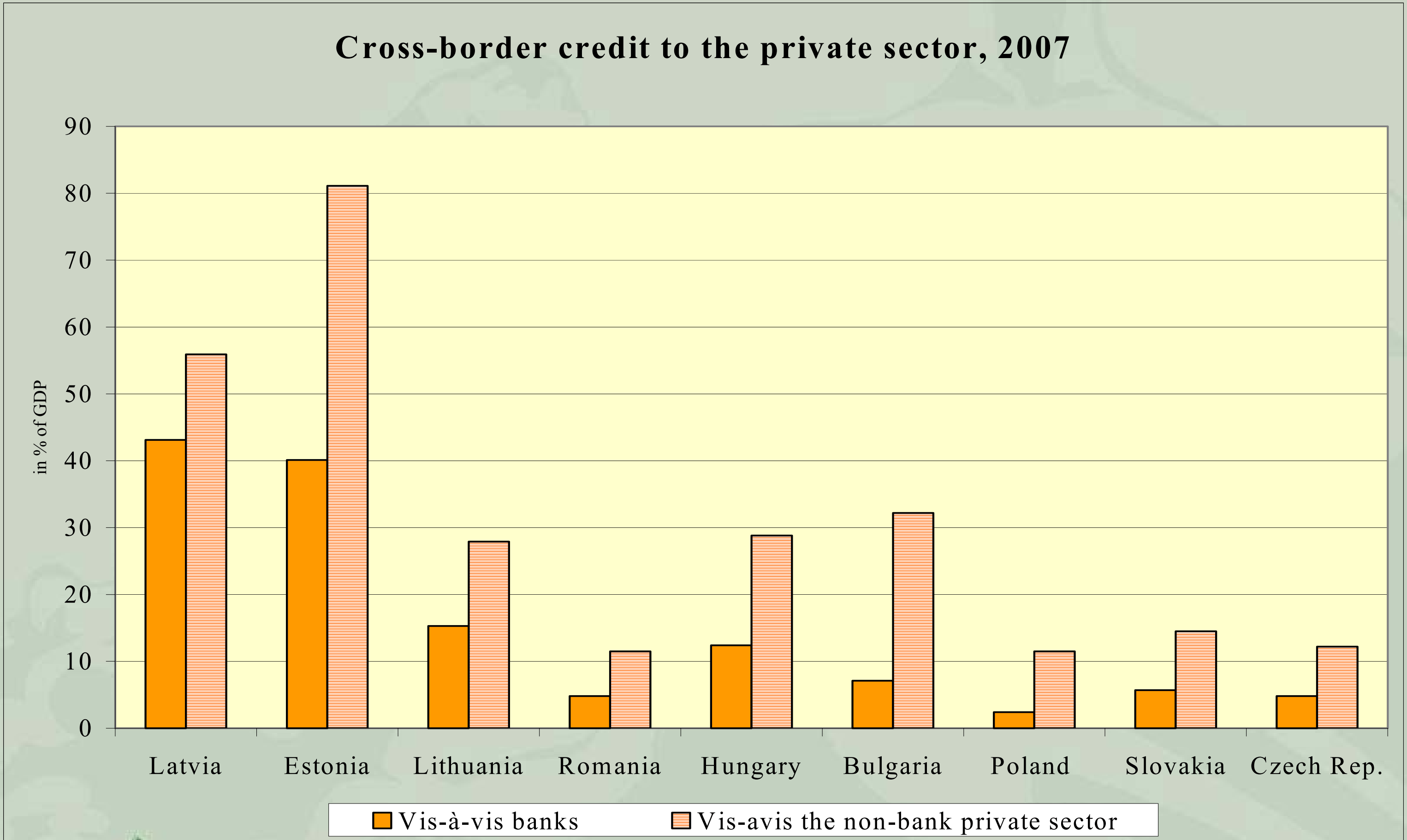
„Home made” subprime crisis?



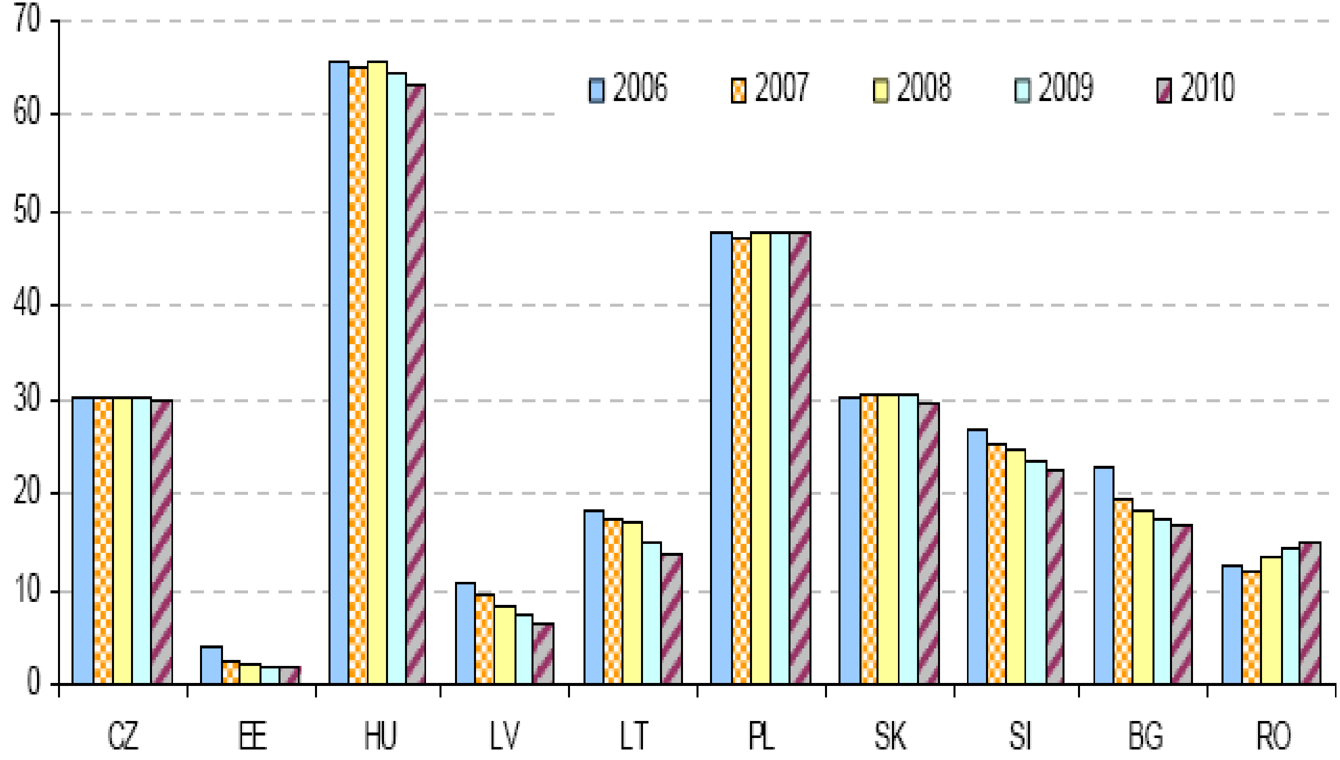
Source: Convergence Report 2008, MNB

Sudden stop: exposure through the banking sector – Baltic countries, Bulgaria and Hungary



Source: BIS

Sudden stop: via government securities markets
Gross public debt to GDP in CEE – Hungary and Poland



Source: Convergence Programs, November, December, 2007, and staff calculations.

Source: The World Bank Regular Report, Jan. 2008

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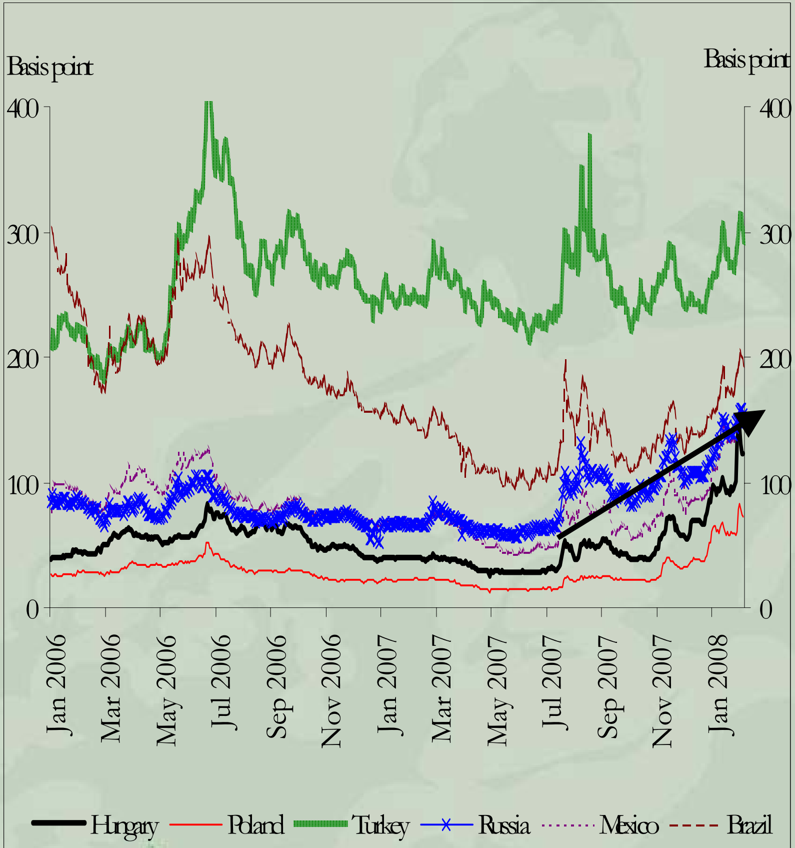
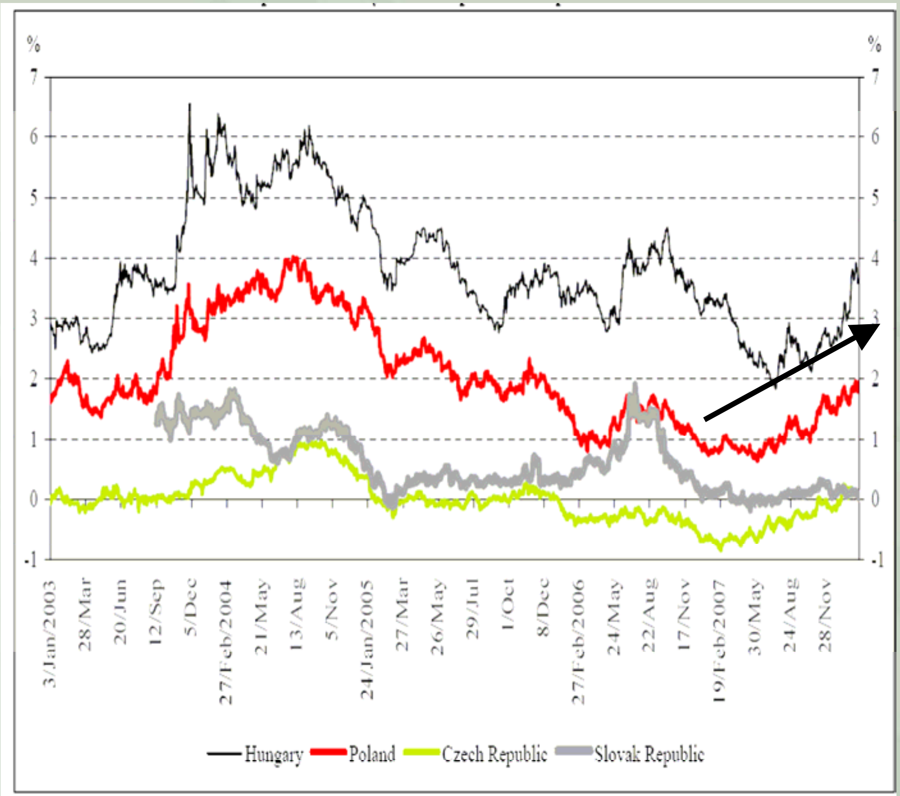
10-year CDS in selected emerging countries



Spreads over 5 year euro spot zero market coupon interest rate



Source: Reuters

Zero coupon interest rate curve calculated by Reuters.

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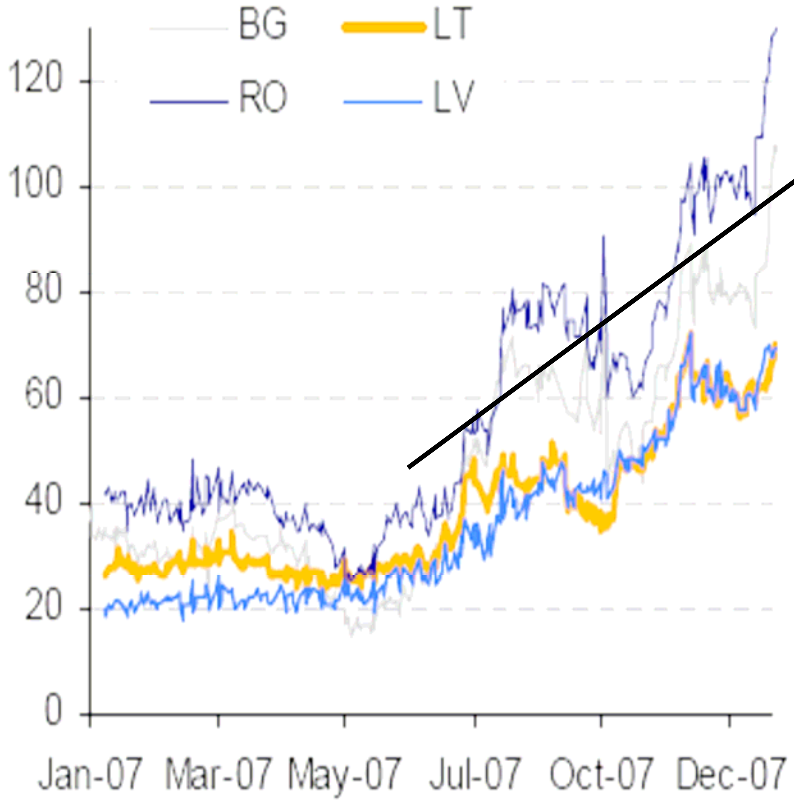
Selected Eu8+2 Eurobond Spreads, in bp

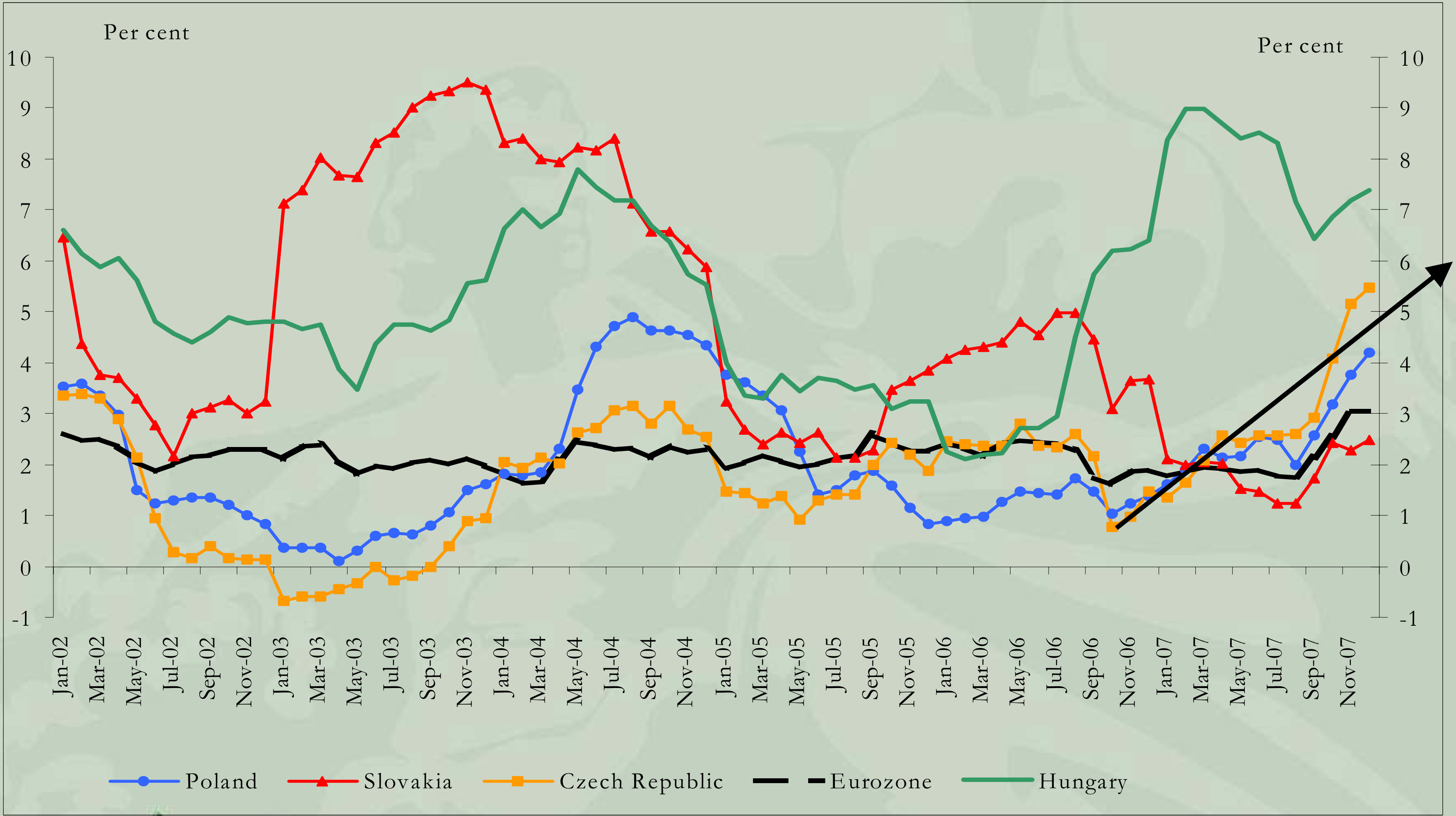


Notes : 10Y eurobonds, vs. Eurozone

Source: Reuters.

Source: The World Bank Regular Report, Jan. 2008

Monetary policy challenges: general slowdown – exogenous shocks + IT regimes



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