

Transition Countries and the International Financial Turmoil

Fabrizio Coricelli

Director of Policy Studies

“Macro Risks and Micro Responses”,

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Financial turmoil or financial meltdown?

- Hard to tell but the scenario is gloomy
- Huge losses in the core financial sectors
- Bust of real estate bubble in the US, but not only (UK, Spain...)
- Recession in the US not yet fully discounted by the stock market: further fall in stock prices
- Knock-on effects on other risky markets, including Emerging Market not yet completed



Effects on Emerging Europe

- Re-pricing of risk
- Fall in stock markets
- Little direct effects from subprime
- Little indirect effects through exposure to subprime of main banks present in transition countries
- But, the worst still to come



Further potential risks

- Meltdown of financial markets: Contagion: from West to East
- Intermediate scenario: closing positions in risky markets (emerging markets) due to huge volatility in core markets, sharp increase in funding costs
- Soft landing: localized problems in countries with imbalances only weakly related to international financial turmoil



Vulnerability to external shocks

- Vulnerability to external shocks has sharply increased in all regions.
- In CEB and SEE, risks of contagion from problems in parent banks and adverse effect on demand due to a slowdown of growth in EU.
- In CIS, risks of sudden stop in capital inflows
- Reliance on foreign funding for credit growth a key source of risk in the current financial turmoil



Which countries are more vulnerable?

- Some are victims of their success: Baltics, Hungary, Romania, perhaps Bulgaria
- Huge external imbalances, foreign debt by private sector, mainly banks, large debt in FX
- Energy exporters insulated? No, look at Kazakhstan, which is suffering a sudden stop
- Strength of Russia overstated



Mitigating factors

- Low public debt
- Large foreign reserves
- More solid institutions
- But look at Iceland!



Government steps in (Kazakhstan, Russia)

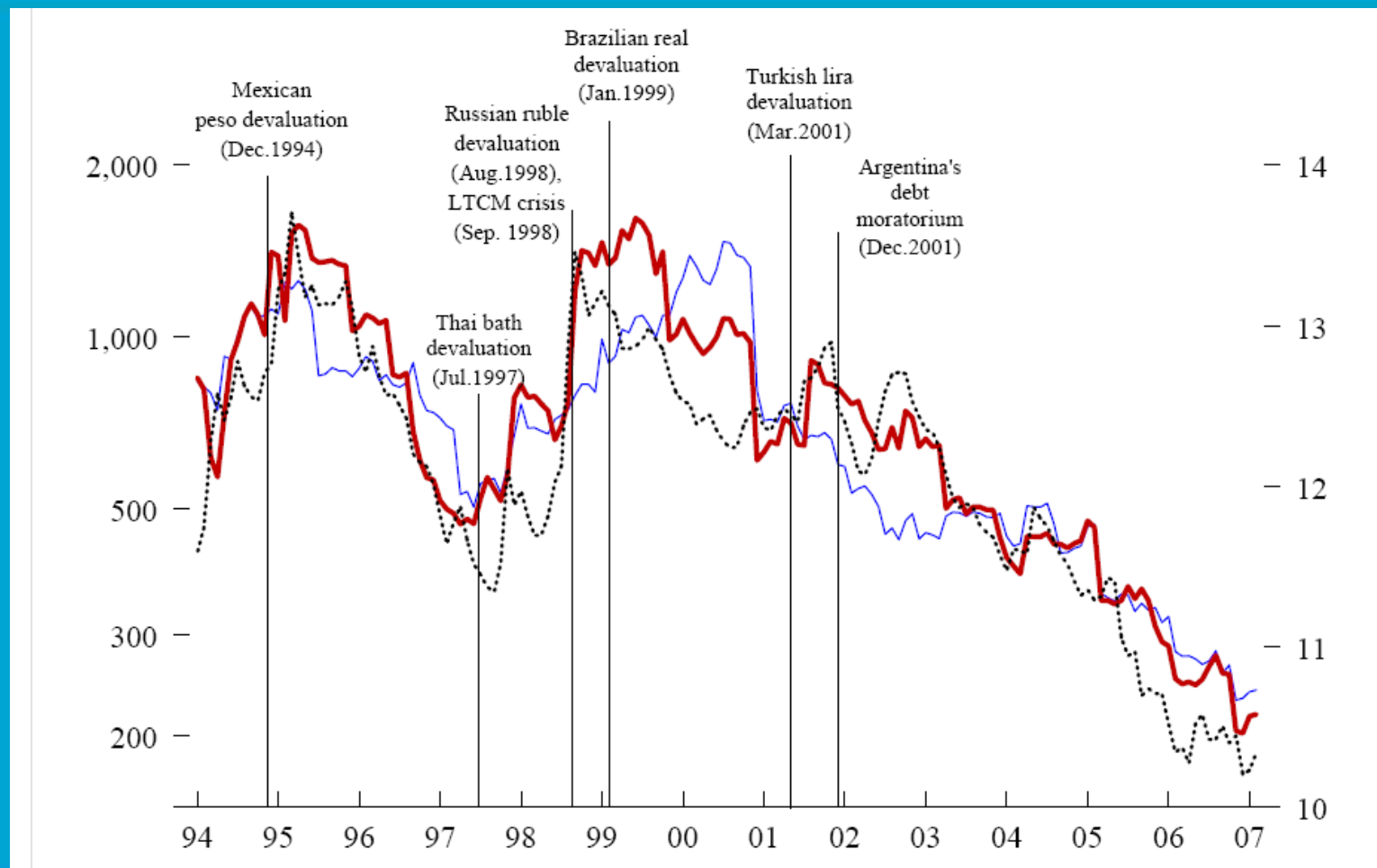
- Targeting of resources raised from the energy sector to other sectors in needs of financing
- Pledge budgetary funds for construction sector
- Announce readiness to use oil stabilization fund to support banking sector
- Benefits in the short run, but risks in the longer run



Some figures

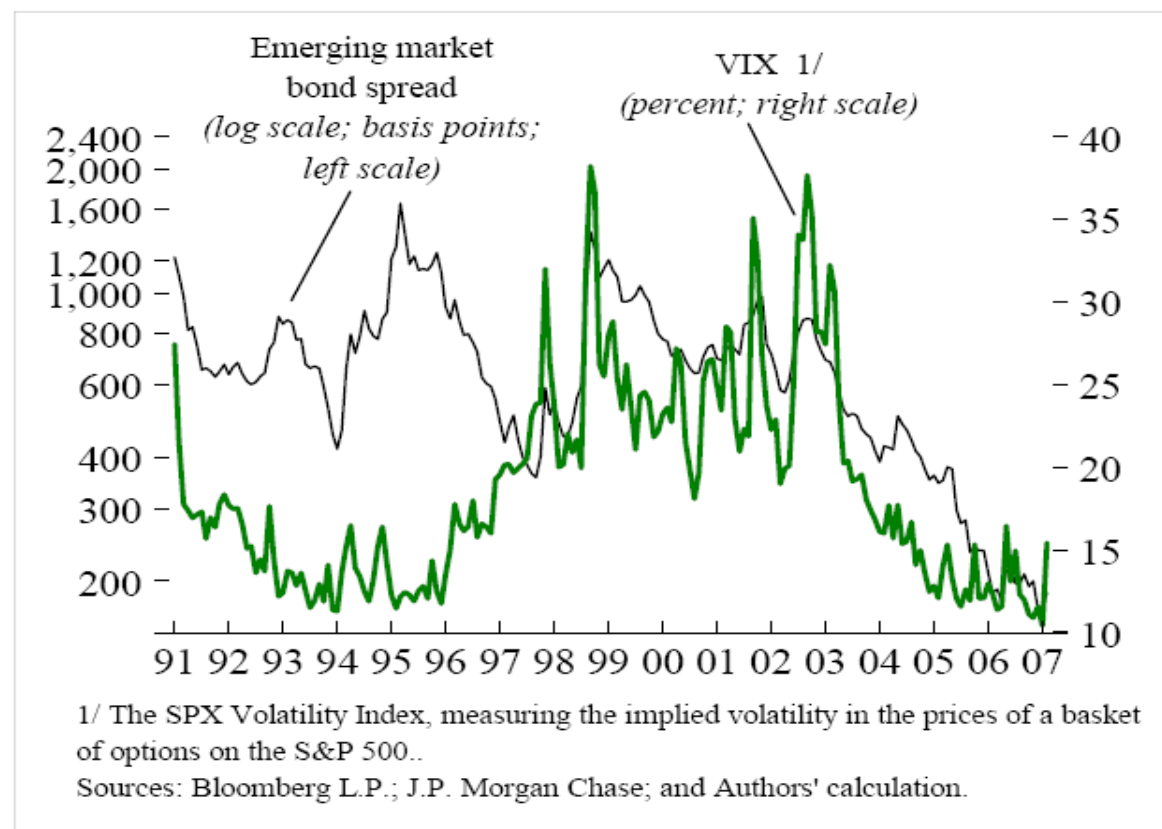


Re-pricing of risk still incomplete: huge margin for tightening

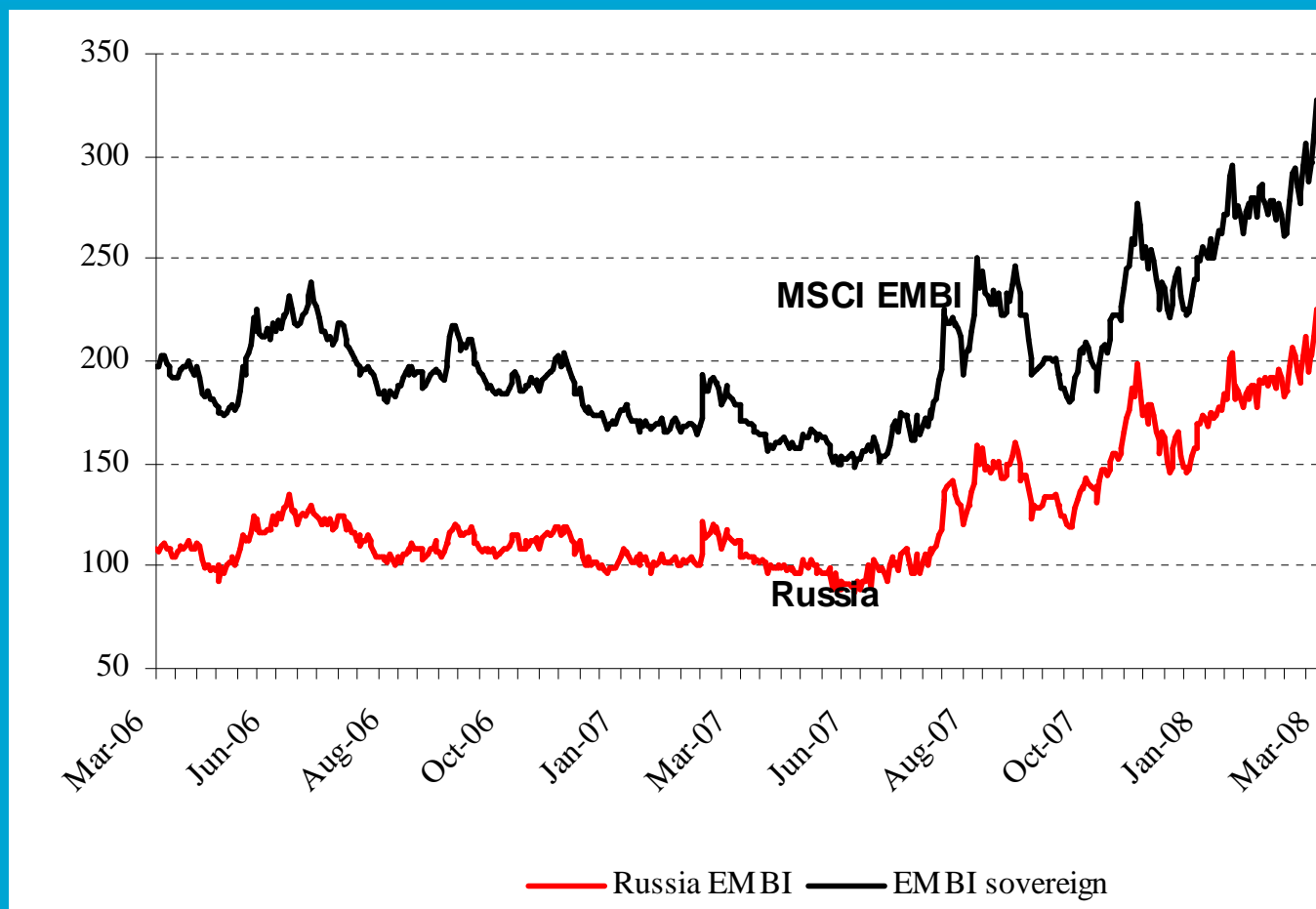


Hard to escape the hit from core markets

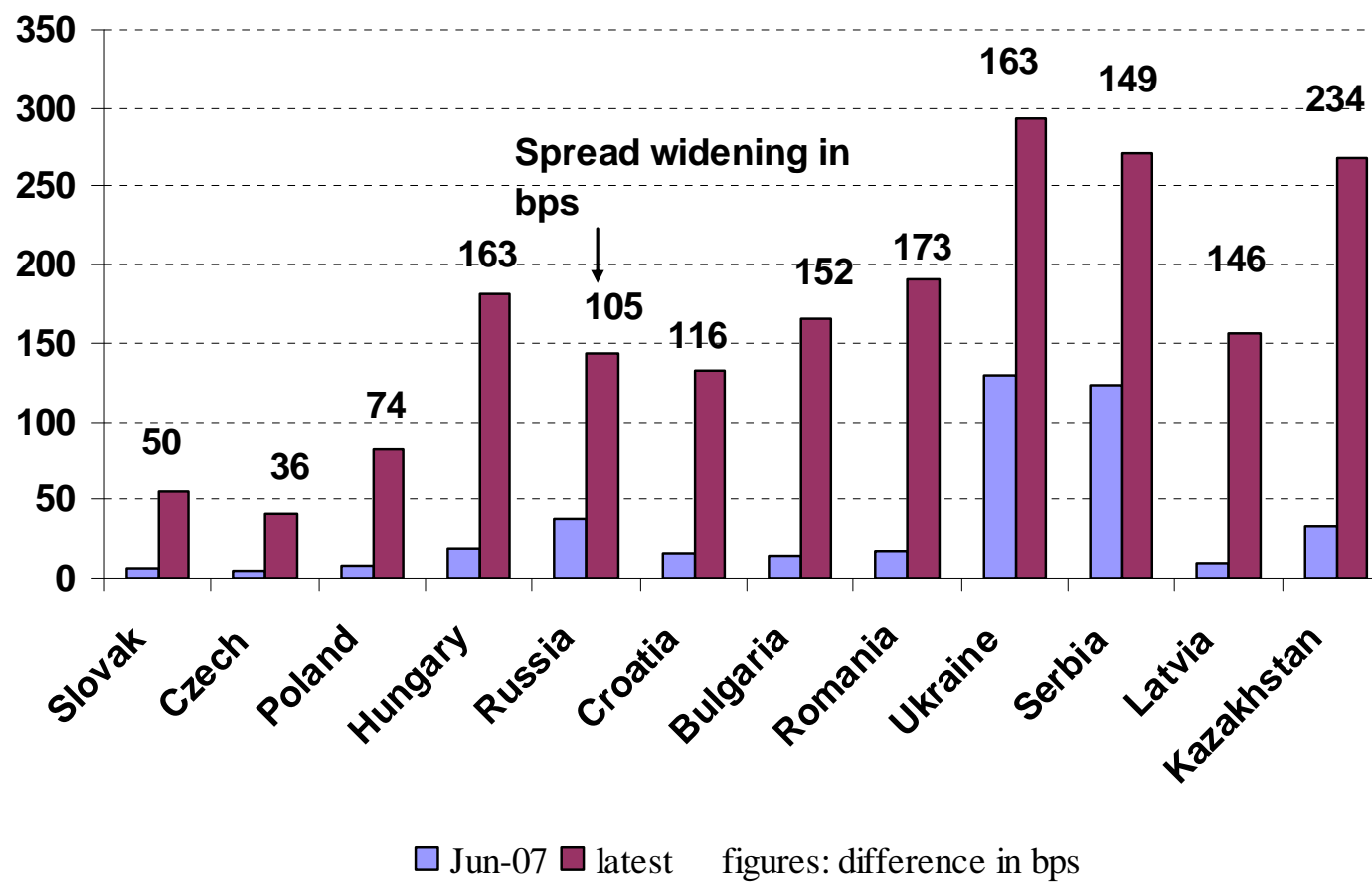
Figure 3. VIX and Emerging Market Bond Spread



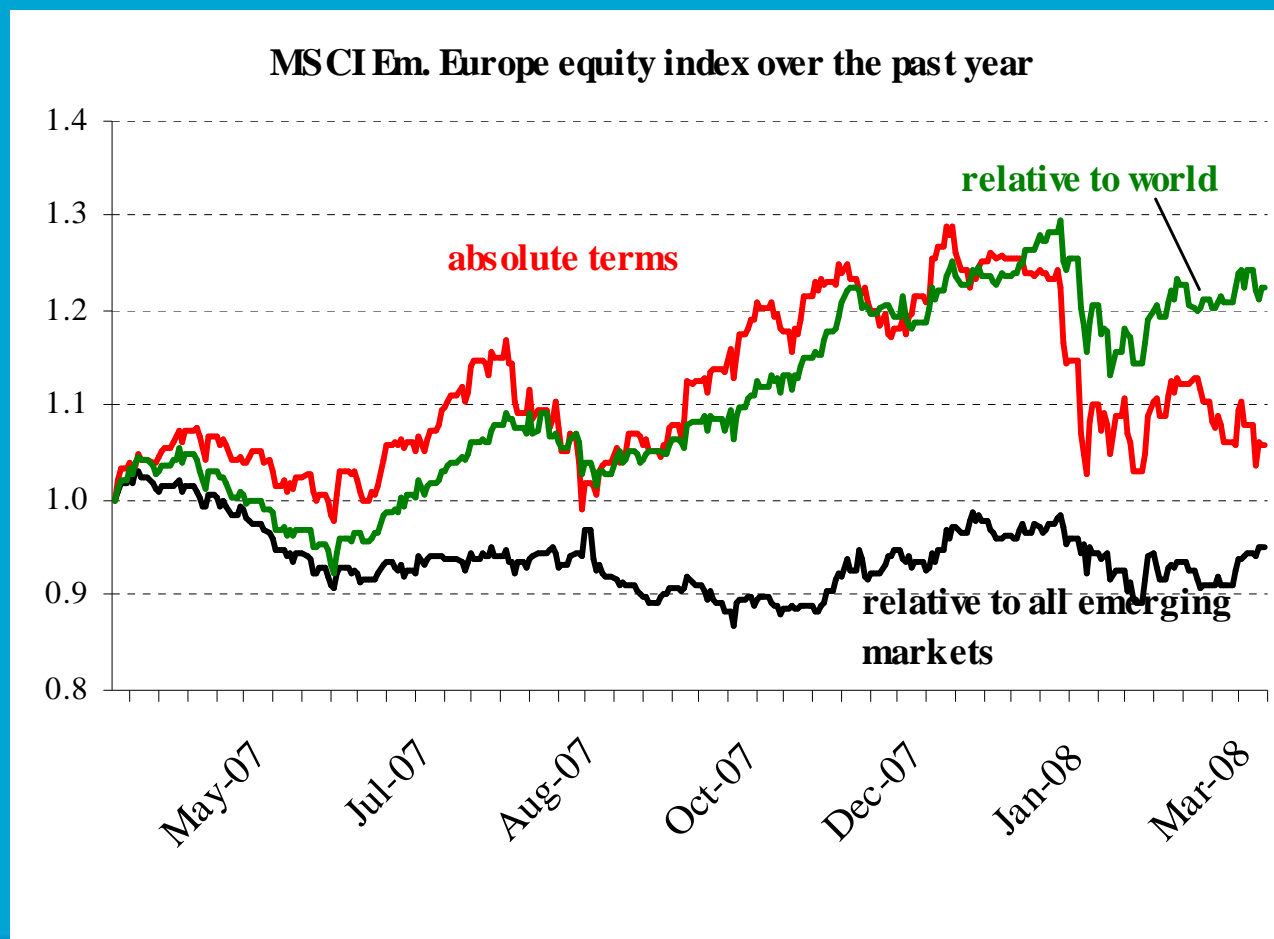
Eastern Europe: Bond spreads



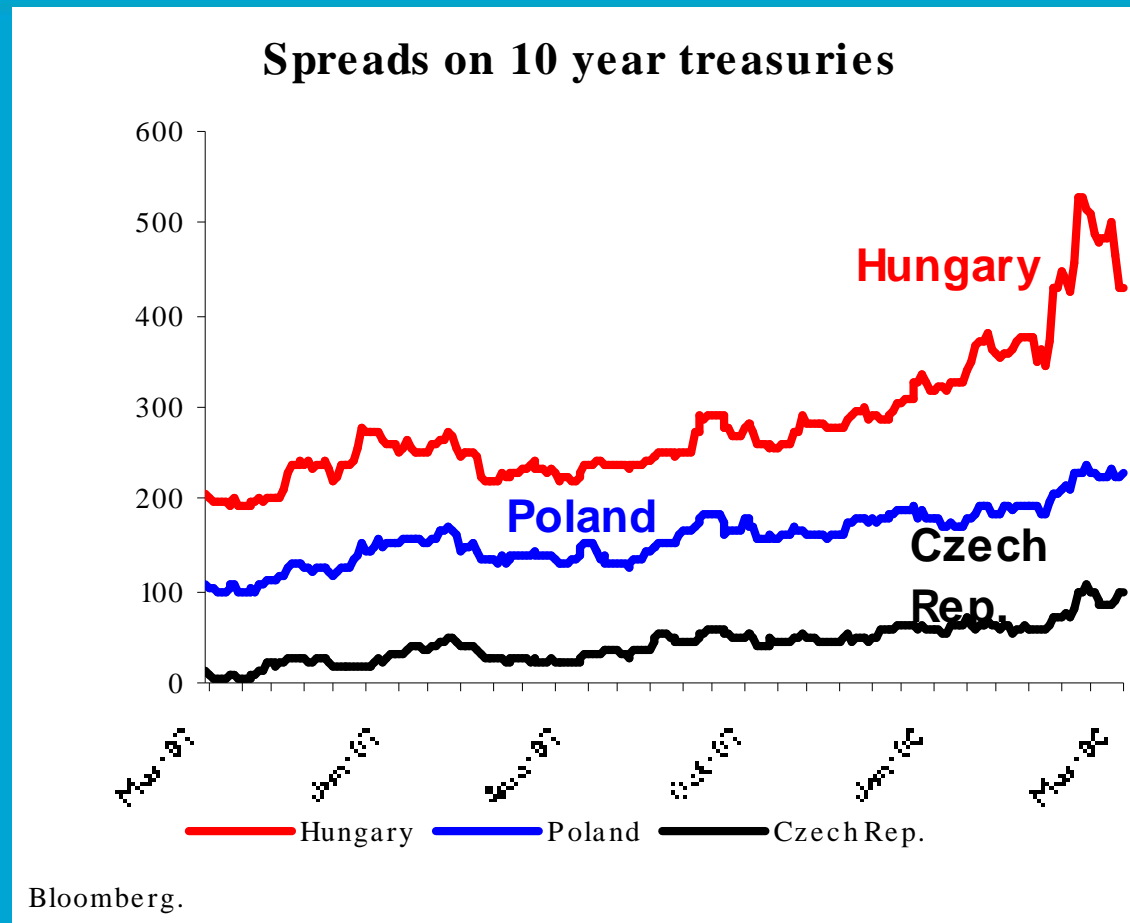
CDS spreads



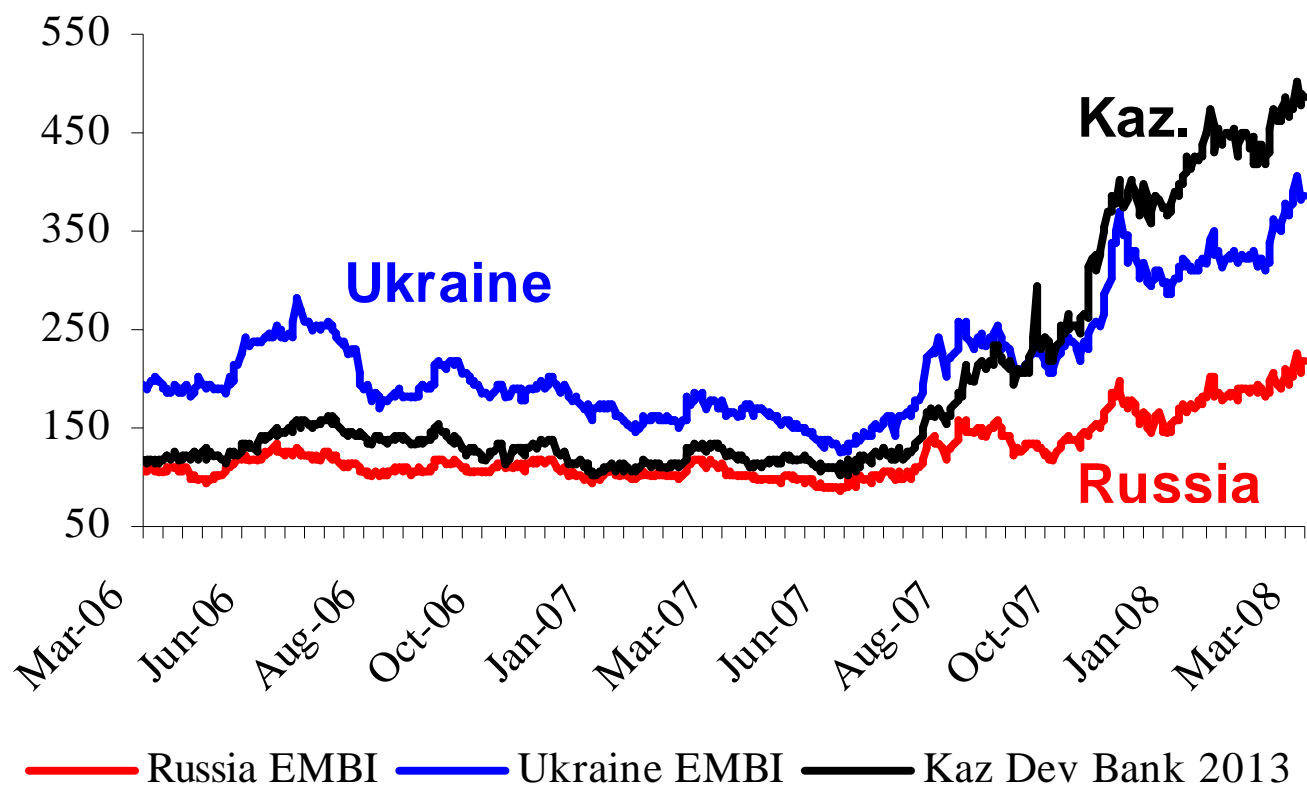
Equity markets



Heterogeneous response: CEE



Heterogeneous response: CIS

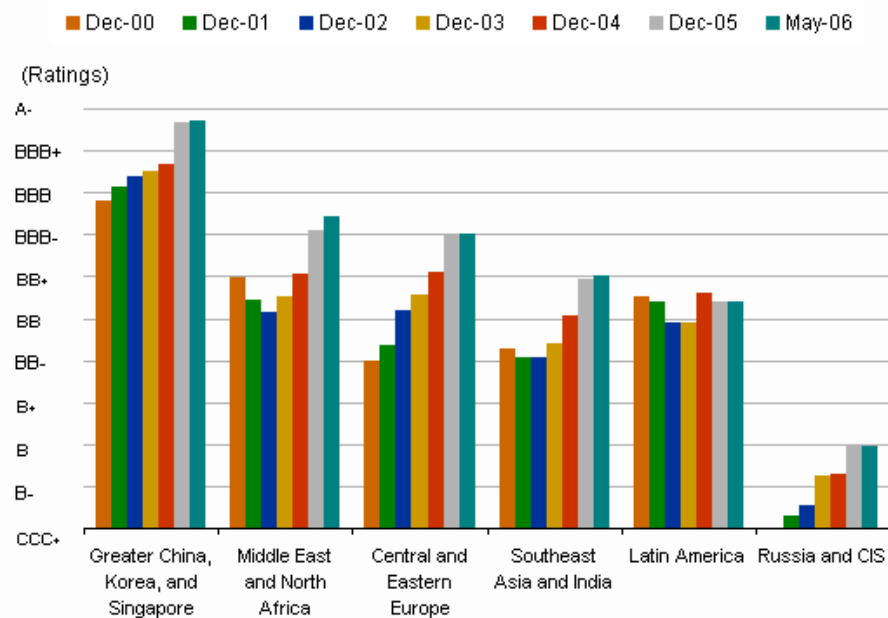


Banking sectors in the CIS: still poorly reformed.

Key weaknesses:

- Lack of transparency in accounts,
- poor bank governance, and risk management;
- Asset concentrations in few borrowers, or in risky sectors (property);
- Connected lending.

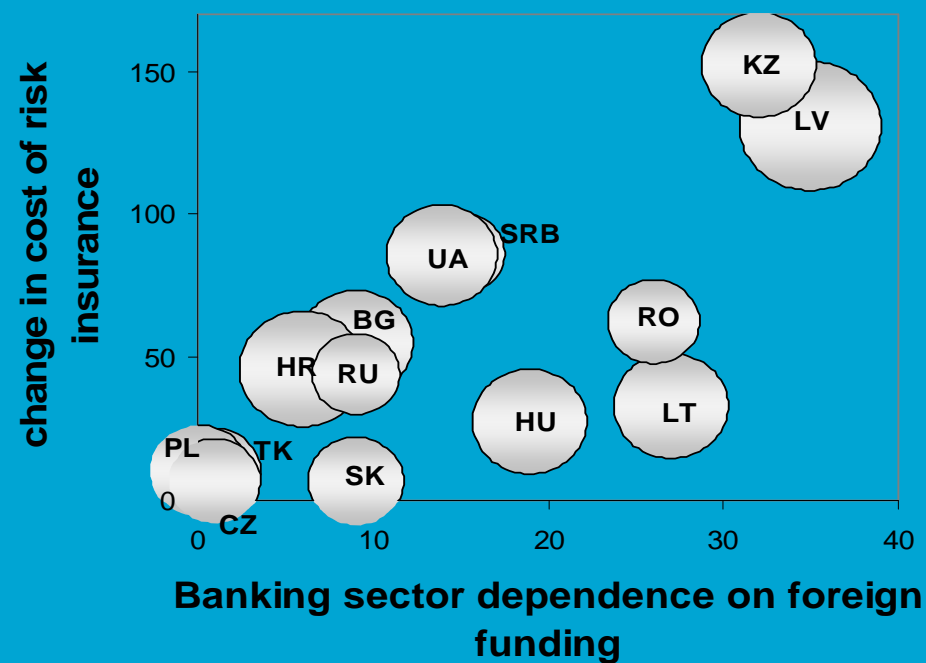
Average Bank Ratings In Emerging Markets



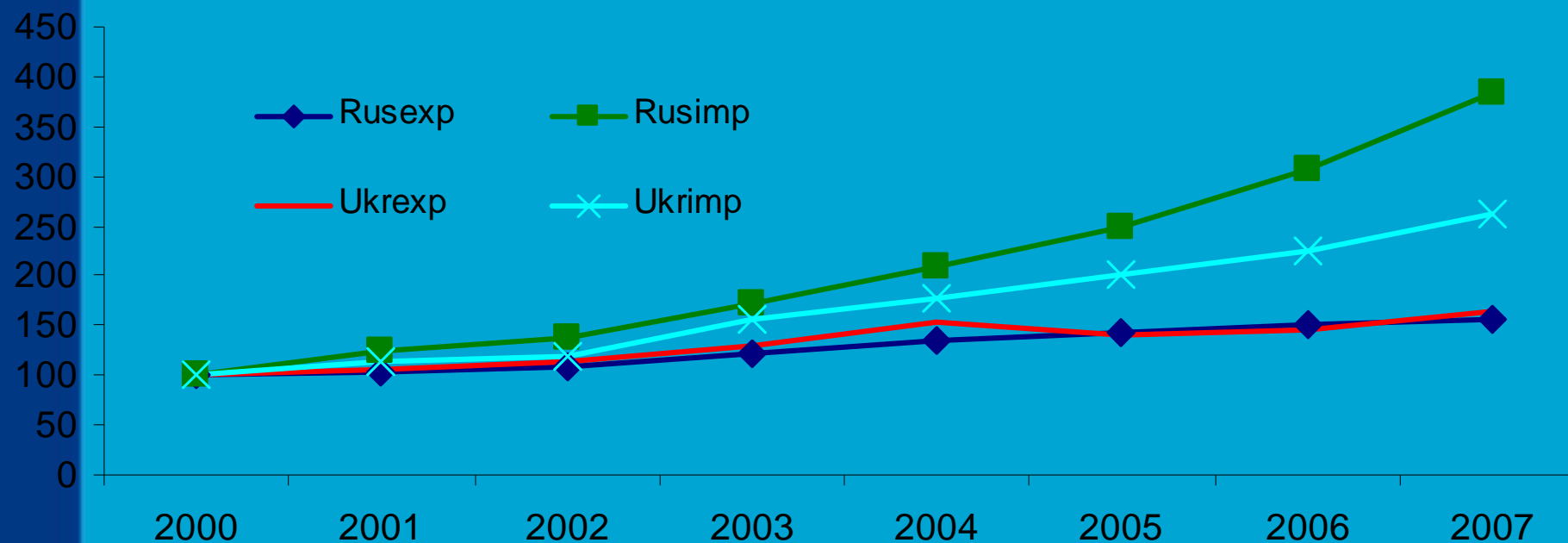
CIS--Commonwealth of Independent States. Source: Standard & Poor's.
© Standard & Poor's 2006.



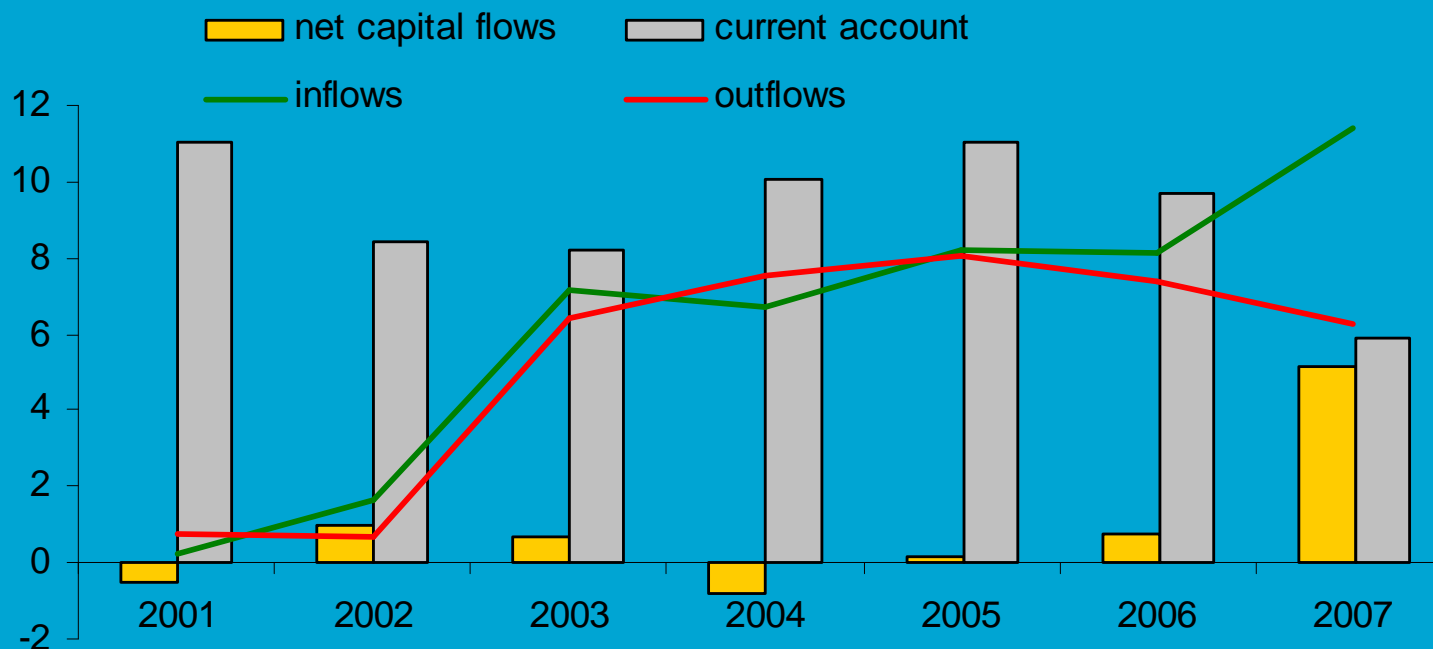
How the market is assessing risk (spreads in CDS)



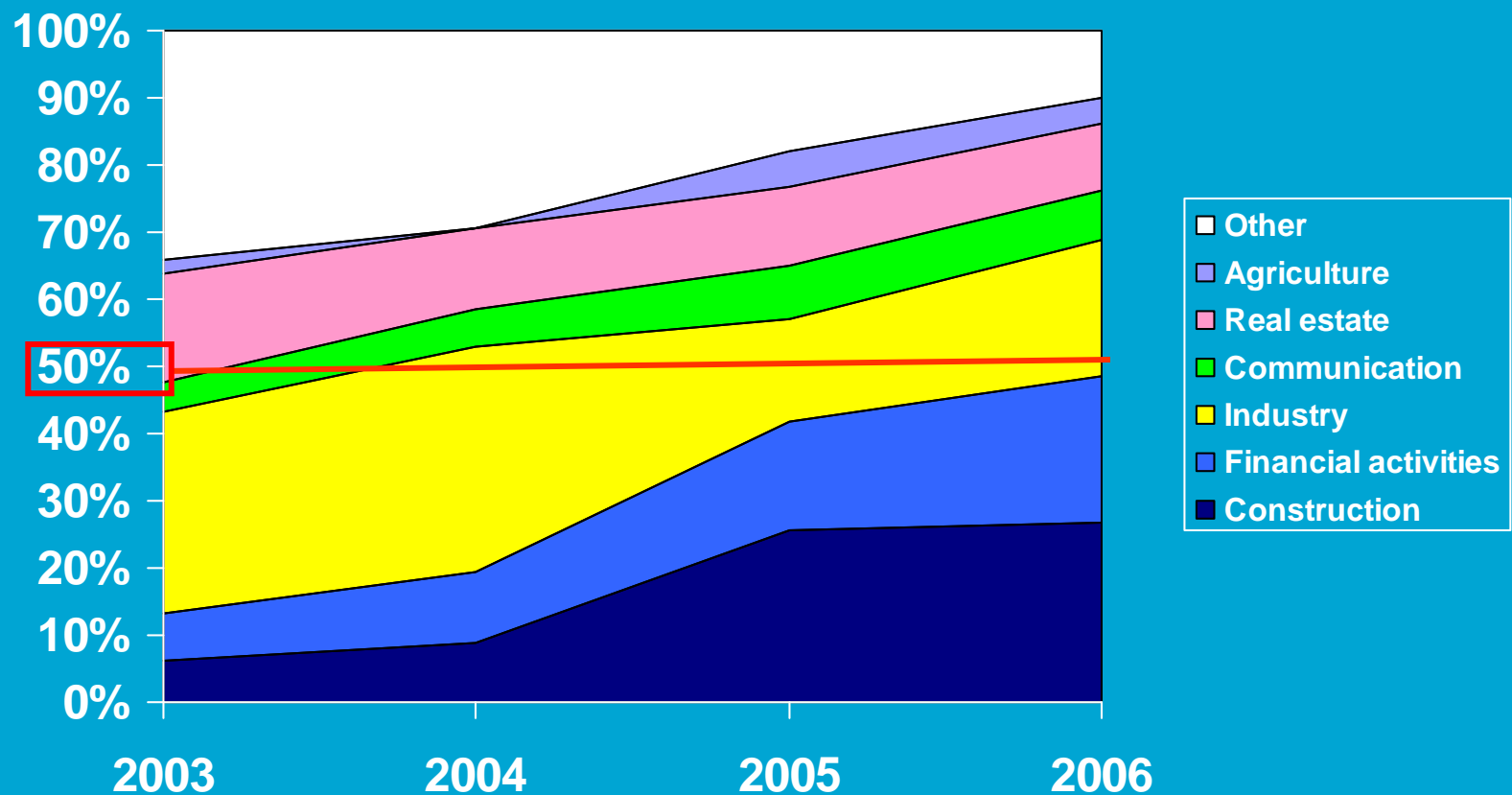
In real terms picture very different: real imports and exports, 2000=100



Russia: current account and capital flows, % of GDP



Kazakhstan: *Components of GDP growth*



Source: Statistical Agency of Kazakhstan, EBRD

www.ebrd.com

Bank lending levelling off

