



JVI Policy Research Conference

“Economic Governance and Sustained Growth in Southeastern Europe”

Growth, Risks and Governance: the Role of the Financial Sector

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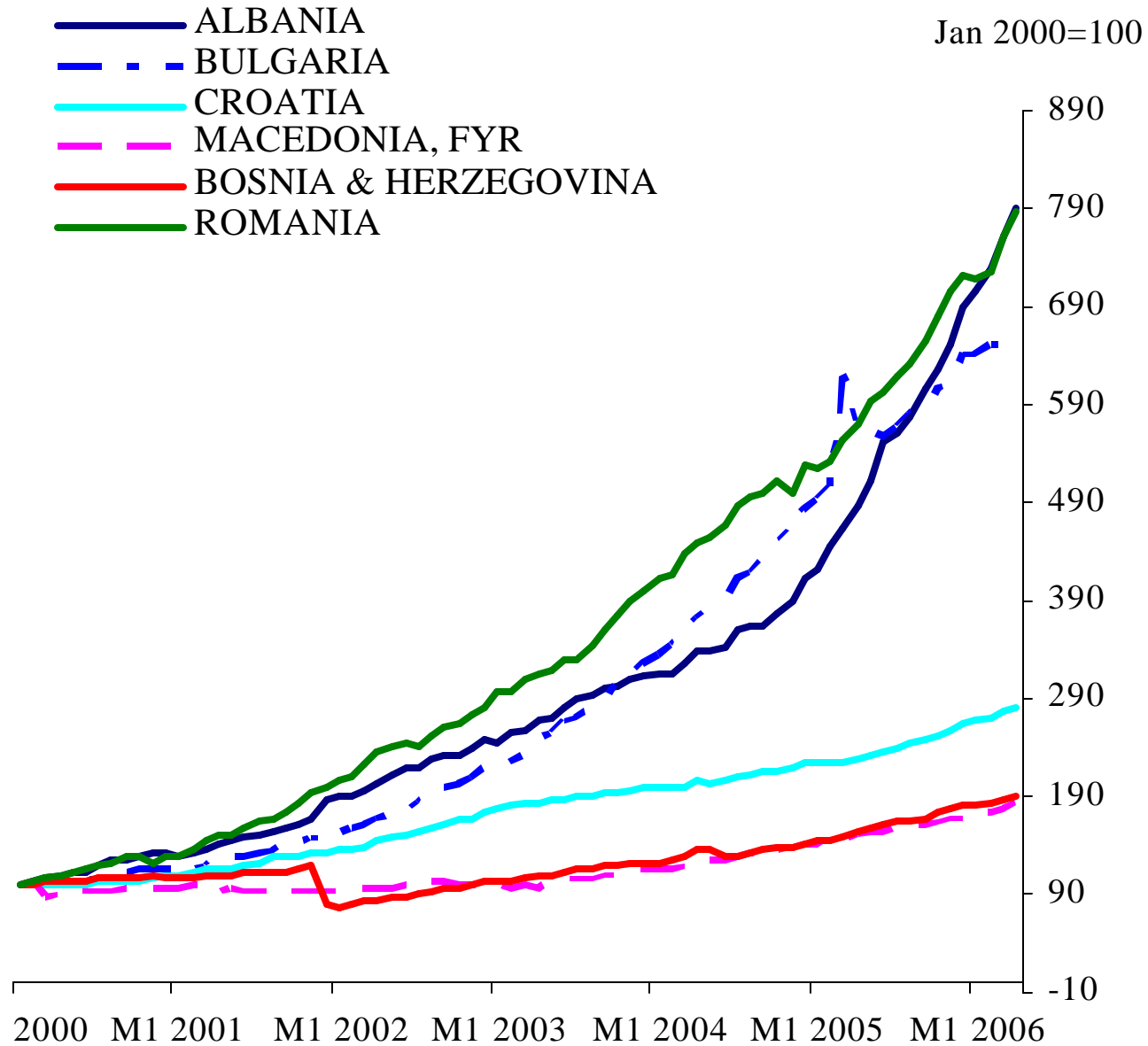
Based on a paper by Valerie Herzberg (EIB) and Max Watson (DG ECFIN and St. Antony's College, Oxford). Views are those of the authors and do not represent official positions of the EIB or the European Commission.



Outline

- **Accelerated financial integration**
- **Opportunities for real convergence**
- **Risks to growth and stability**
- **Private sector imbalances**
- **Evidence on allocation**
- **Key dilemmas for policy**
- **Fiscal institutions and frameworks**
- **Supervisory institutions and frameworks**
- **Real sector institutions and frameworks**
- **Monetary institutions and frameworks**

Growth in Credit to Private Sector (2000-06)



Opportunities for Real Convergence

Chart 1. Current Account Deficits and Real Private Sector Credit Growth

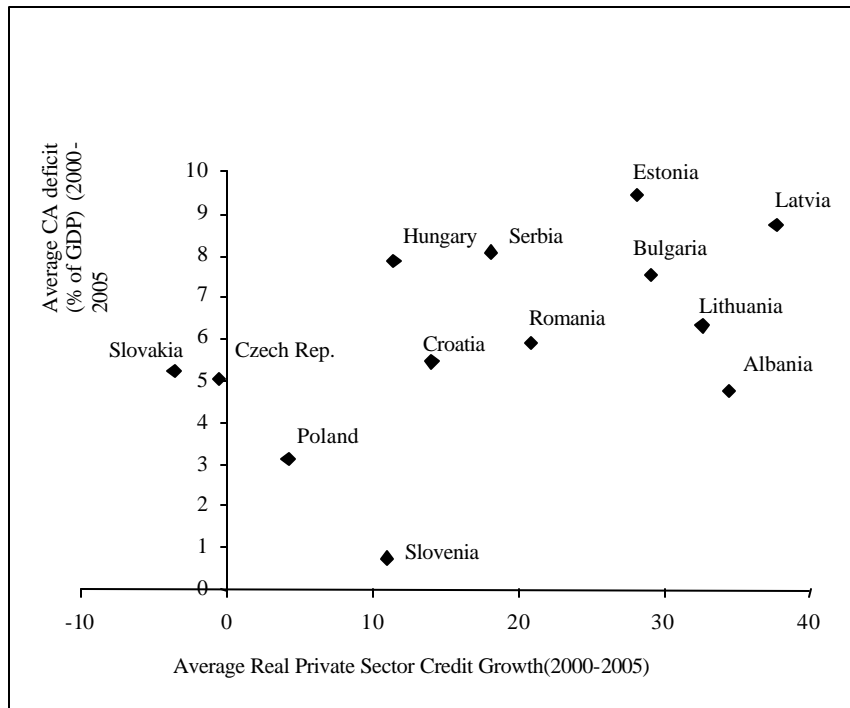
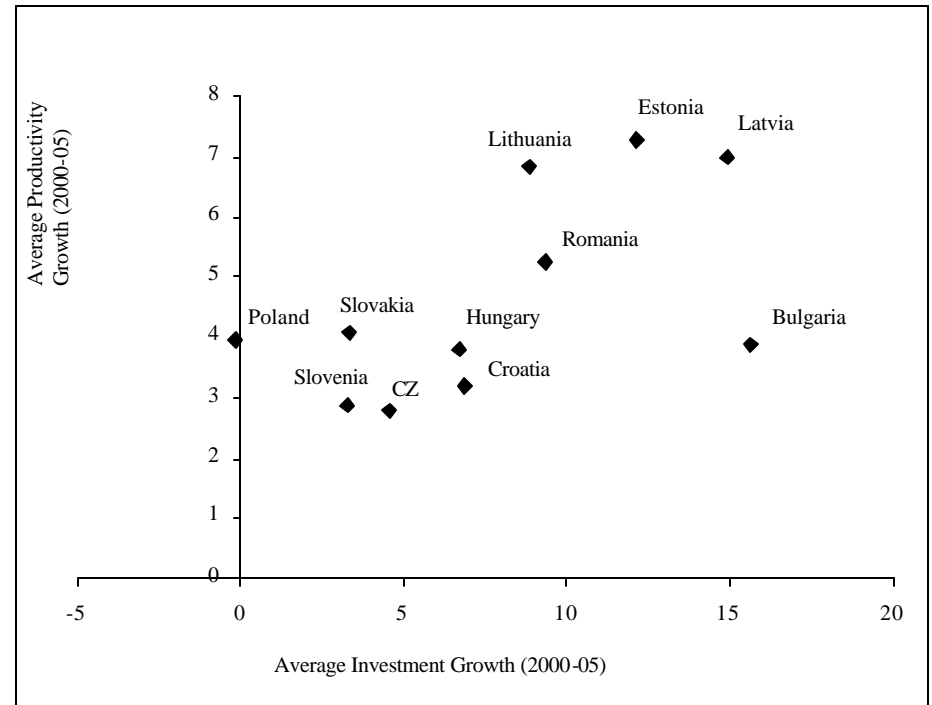


Chart 2. Productivity and Investment Growth





Risks to Growth and Stability

- Convergence with open capital accounts potentially implies surge of inflows (Lipschitz et al, 2002)
- Financial market procyclical behaviour (Borio et al, 2001)
- EMCs prone to «original sin» (unhedged borrowing)
- Common lenders and bank-centered systems: shut-off risk
- If resources flow heavily to non-traded goods sector, then wide cycle in current account, NFA, r.e.e.r....
- ...and slow productivity growth may hamper adjustment, especially with pegged regime or balance sheet risks

Weak structural policies (even with strong macro?) may put pressure on pegs/lead to slow growth à la Portugal

**Table 4. S.E. Europe: Fiscal deficits and Private sector balances
(In percent of GDP)**

	Fiscal balance		Private Sector Balance	
	2000	2005	2000	2005
Albania	-9.2	-4.7	+1.8	-0.9
Bih	-3.1	0.0	-14.4	-24.1
Bulgaria	-1.0	+2.3	-4.6	-17.2
Croatia	-6.5	-4.2	+3.9	-1.8
Frmr. Ygslv. Rep. of Macedonia.	+2.5	-1.5	-4.5	-5.0
Romania	-3.8	-0.8	+0.2	-8.6
Serbia & Montenegro	-0.9	+0.2	-3.0	-8.7

Table 1: Real Change in Credit to Households**(In percent)**

	2002	2003	2004	2005
Bosnia & Herzegovina			33.5	29
Bulgaria	40.2	76.5	64.7	50.8
Croatia	38.9	23.7	14.9	17
Czech Rep.	26.6	31.9	29.1	30.3
Estonia	36	52.9	43.7	64
F.Y. Rep. Macedonia	34	-	62.4	41.6
Hungary	58.9	53.5	19.5	22.2
Latvia			64.6	72.3
Lithuania	70.2	11.5	94.1	81.9
Poland	6.5	12.8	9.3	19.4
Romania	120.4	218.4	49	61
Slovakia			27.2	27.4
Slovenia	0.3	5.5	16.8	23

Table 2. Cross-border loans to non-banks**(Stocks, 2000-05; % GDP)**

	2002	2003	2004	2005
Bulgaria	2.3	2.2	6.3	7.1
Croatia	11.4	12.2	13.1	21.4
Czech Rep.	6.2	7.3	6.7	6.9
Estonia	6.8	6	6.6	8.9
Hungary	6.4	7.2	6.9	8.3
Latvia	1.8	2.4	2.2	3.5
Lithuania	2.9	2.9	2.7	2.7
Poland	4	4.8	4.4	4.4
Romania	5	4.7	5.8	5.7
Slovakia	5.6	4.4	3.7	4.6
Slovenia	8.7	8	7.2	10.5

**Table 3. Credit to households and firms,
and cross-border credit
(Stocks, 2005; % GDP)**

	Households	Firms	Firms plus cross-border
Bulgaria	16.5	26.4	33.5
Croatia	35.4	30.2	51.6
Czech Rep.	14.1	17.9	24.8
Estonia	32.8	30.5	39.4
Hungary	17.4	26.2	34.5
Latvia	32.4	27.5	31
Lithuania	13.2	22.5	25.2
Poland	14.6	13.1	17.5
Romania	7.5	12.4	18.1
Slovakia	11.5	11.9	16.5
Slovenia	15	38.7	49.2



Key Dilemmas for Policy

How respond to “excessive” credit growth/current account?

- Assessment of risk needs to factor in (1) allocation of resources, and (2) risk of changed global market conditions
- Assignment issues: if budget in balance or surplus; inflation on track; microprudential standards sound...
- Traction problems: with open capital account and foreign-owned banks, hard to gain traction over credit growth
- Fiscal/prudential policy help contain risk (internalising macrofinancial risks), including strong institutions
- Structural and policies and market institutions influence resource allocation... or question on monetary regime?



Pushing out Risk-Return Frontiers

- *Turning conventional financial stability arguments on their head, we could ask: how can one make it safer to run the economy with high rates of domestic demand?*
 - ⇒ Macroeconomic and financial policies must emphasize risk containment, including strong institutions
 - ⇒ Structural policies raise returns in traded goods sector, including strong institutional frameworks for markets
 - ⇒ Given speed of financial dynamics, reforms in lending environment need to be bold and fiscal policy tight
 - ⇒ If this cannot be achieved, a flexible and truly variable exchange rate may ease adjustment stress



Fiscal Institutions and Frameworks

- *Maastricht 3% ceiling not target, especially during booms*
- *Care impact of asset booms, consumption-rich GDP, high nominal growth on underlying fiscal balance*
- *Microeconomics matter: tax deductions for real estate...*
- *...typically major scope for pro-growth consolidation*
- *To enhance stability/guide expectations, institutions key:*
 - => Single agent for budget formation/control; multi-year frameworks; sound and transparent fiscal data, integrating extra-budgetary funds; agree how use revenue overshoots; stronger practices for evaluating spending; key consistency checks in accounting areas such as stock-flow adjustments



Supervisory Institutions and Frameworks

- Key priority typically implementation – e.g., in risk-based supervision, credit assessment and consolidated oversight
- Need better information on health of firms and households
- Supervision of non-banks/markets, including governance
- Administrative controls over credit not durably effective, and tend to divert credit to unsupervised channel
- Tough stress-tests needed (including of indirect fx risk).
- Anti-cyclical loan provisions? (Tax/accounting obstacles)
- Minimum loan-to-value or loan-to-income ratios
- Co-operation with home supervisors: include systemic risk

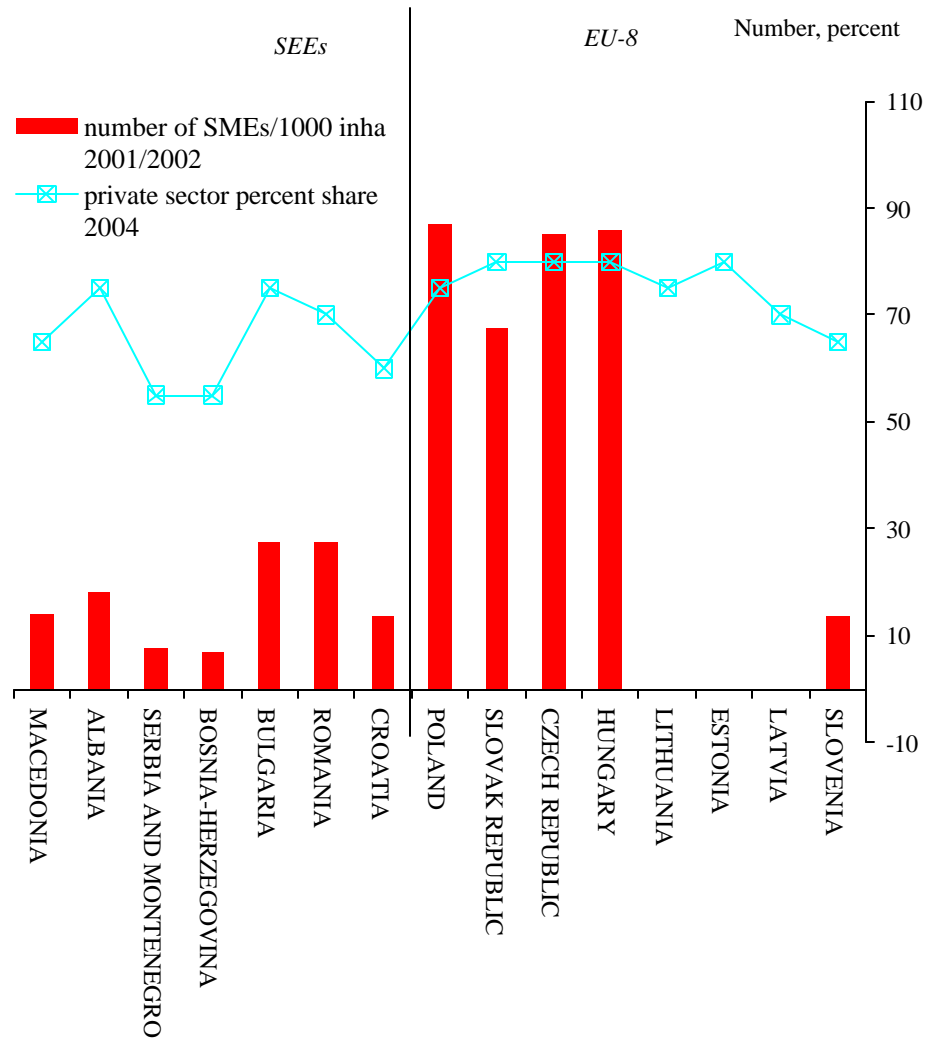


Real Sector Institutions and Frameworks

- Improving infrastructure, networks, regional links
- Addressing competition, reforming state-owned enterprises
- Reforming labour markets, including lower tax burden
- Enhancing legal process and judiciary environment
- Addressing property rights, including to facilitate collateral (and thus also making formal sector more attractive)
- Are more activist policies justified by small firms and markets, weak institutions, and political uncertainty?

Possibilities include => *Credit registers; codes of conduct for debtor-creditor relations; microfinance banks; but question mark over guarantee programmes and subsidies*

Private sector share and SME density

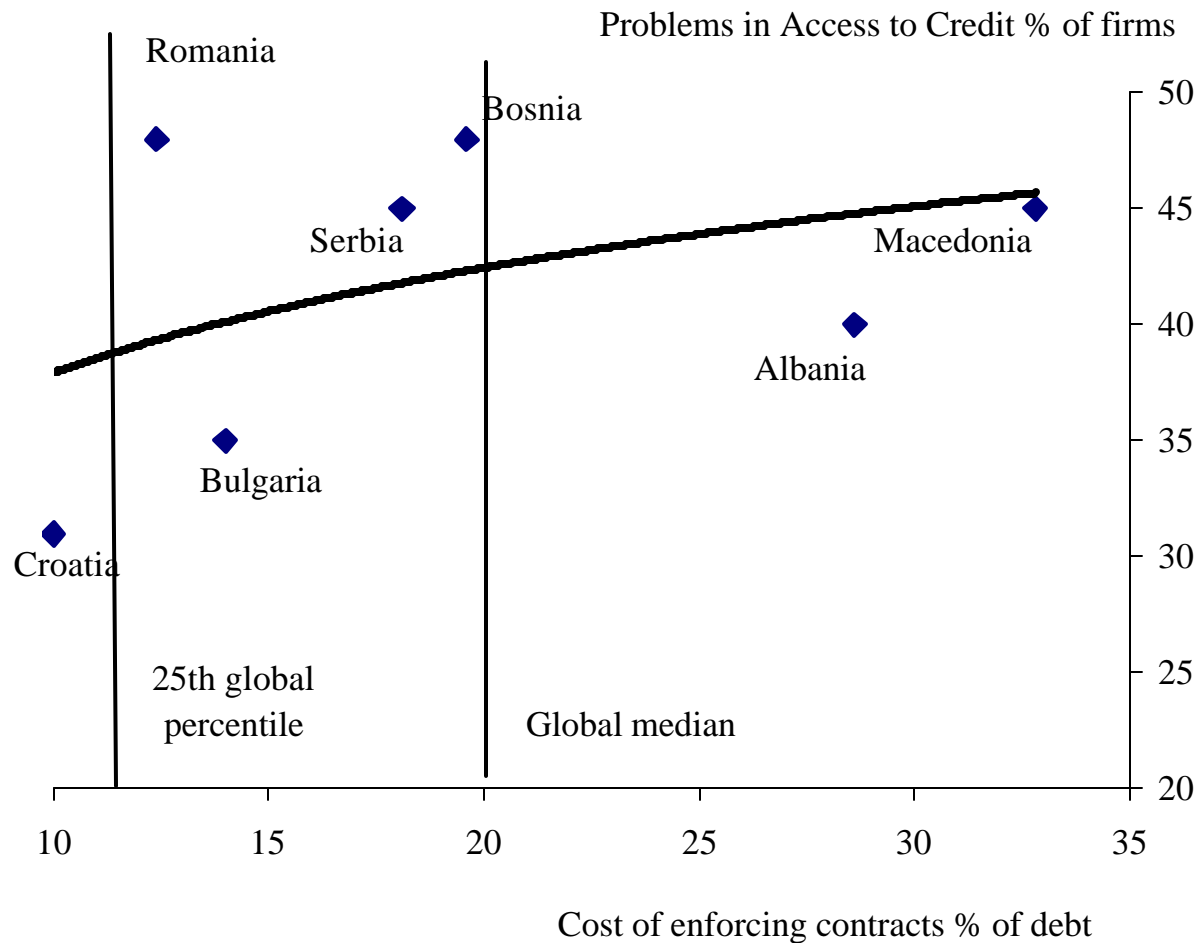


Source: EBRD (2005) and (2004). Data unavailable for the three Baltic states.

Southeastern Europe: Reform Indicators, 2005

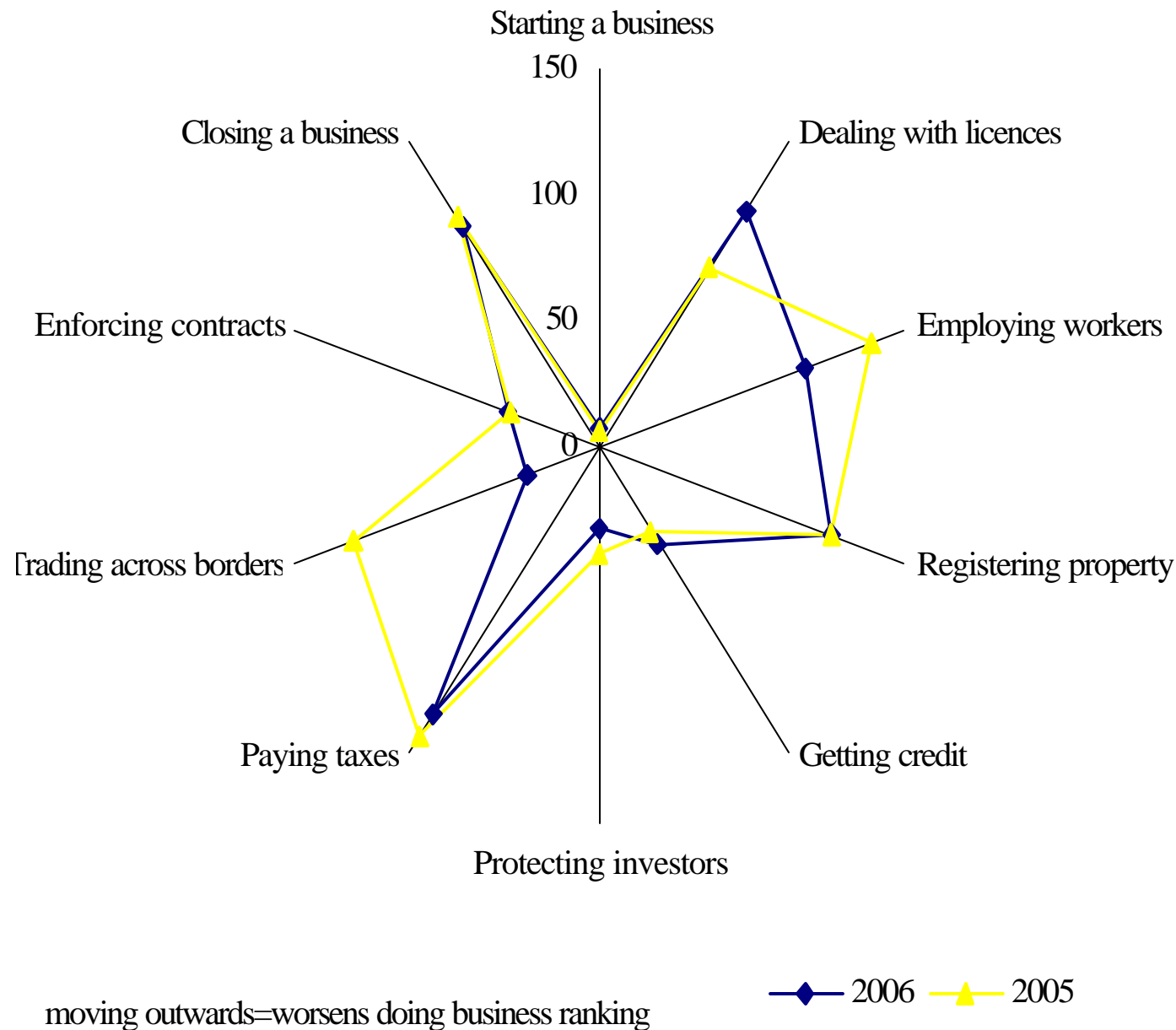
	Progress in Restructuring		Cap Mkt Nonbank <u>Devpt.</u>	Domestic Competition <u>Index</u>	Private Sector <u>% Share</u>
	<u>Banks</u>	<u>Firms</u>			
Bulgaria	4-	3-	3-	3-	75
Romania	3	3-	2	3-	70
Croatia	4	3	3	2+	60
FYR Mac.	3-	3-	2+	2	65
Albania	3-	2+	2-	2	75
BiH	3-	2	2-	2-	55
Serbia	3-	2+	2	2-	55
Montenegro	3-	2	2-	1	65
EU 8 (Av.)	4-	3(+)	3(+)	3	75

Problems in access to credit and cost of debt enforcement

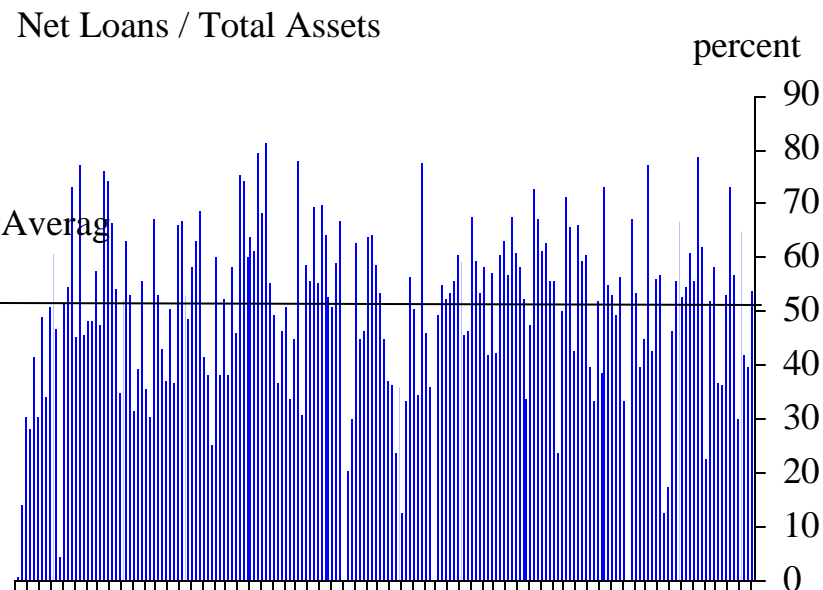


Source: EBRD BEEPS 2005 and World Bank Doing Business 2005

Doing Business in Romania (0-175)



Loan:asset ratio of 150 banks in Albania, BiH, Bulgaria, Romania, Croatia, Serbia and Macedonia (2000-2004) was compared with indicators of bank health such as net interest margin, capitalisation, loan-loss reserves, market share, & selected macro/market variables



High enforcement costs, inflation, fiscal deficits => low lending

High interest margin => high propensity to lend

Large market share => smaller loan to asset ratio (economies of scale effects may be outweighed by increased monopoly power).

With macro conditions now stable across region, structural and institutional factors likely to dominate loan volumes. Privatisation and FDI in sectors in 2005-6, and effects since, are likely to raise profit margins and desired loan to asset ratio in the future.

**Table 5. Pegs accelerate financial dynamics and deepen balance sheet risks...
...demanding exceptional policies and ideally a clear exit**

	Monetary & exchange regimes	Real credit growth (2005)	Foreign currency credit/total credit (2005)	Credit/ GDP (2004)
(In percent)				
Bih	CBA	27.7	Indexed	45
Bulgaria	CBA	27.5	45	37
Estonia	CBA	57.5	73	42
Hungary	Rigid	14.7	39	44
Latvia	Hard Peg	35.5	60	51
Lithuania	CBA	52.5	58	29
Croatia	Rigid	14.3	65	62
Slovenia	Rigid	20.2	32	48
<i>Average</i>		<i>31.2</i>	<i>53</i>	<i>44.8</i>
Czech Rep.	Float	19.6	11	32
Poland	Float	8.5	24	31
Slovakia	Float	21.8	38	24
<i>Average</i>		<i>16.6</i>	<i>24</i>	<i>29</i>
Romania	Recent Full Float	55.0	65	18



Monetary Institutions and Frameworks

- *Disinflation successful (now also in Serbia) and in many cases frameworks transparent and robust, but...*
- Even floaters have limited monetary autonomy, given open capital accounts, foreign banks, balance sheet risks
- To degree, exchange rate variability may contain scale of unhedged foreign currency borrowing – but a concern
- CBAs/balanced budget/foreign banks may «hard-wire» against market crisis – but risk can be directly to growth
- Euro seen as “exit” for CBAs –only if inflation dynamics safe, and still does not protect against “growth crisis”
- Institutions matter, but need fiscal/structural undeprinning



An Accession Umbrella?

EU perspective improves chances of good outcomes...

- Through trade and investment integration, and strengthening of institutions (*the acquis*)
- But too simple to say Accession "mitigates Asia-style risks" (balance sheets, common lenders, pegs, etc)
- Accession accelerates financial development through low risk premia; role of EU-15 banks; euro destiny; pooling of economic sovereignty/imports of savings (v. Asia)
- So it "raises the stakes" on good policies, amplifying favourable features *and* distortions
- Institutions matter both in macro and structural fields



End of Presentation