

New Member States: Global Financial Crisis and Euro

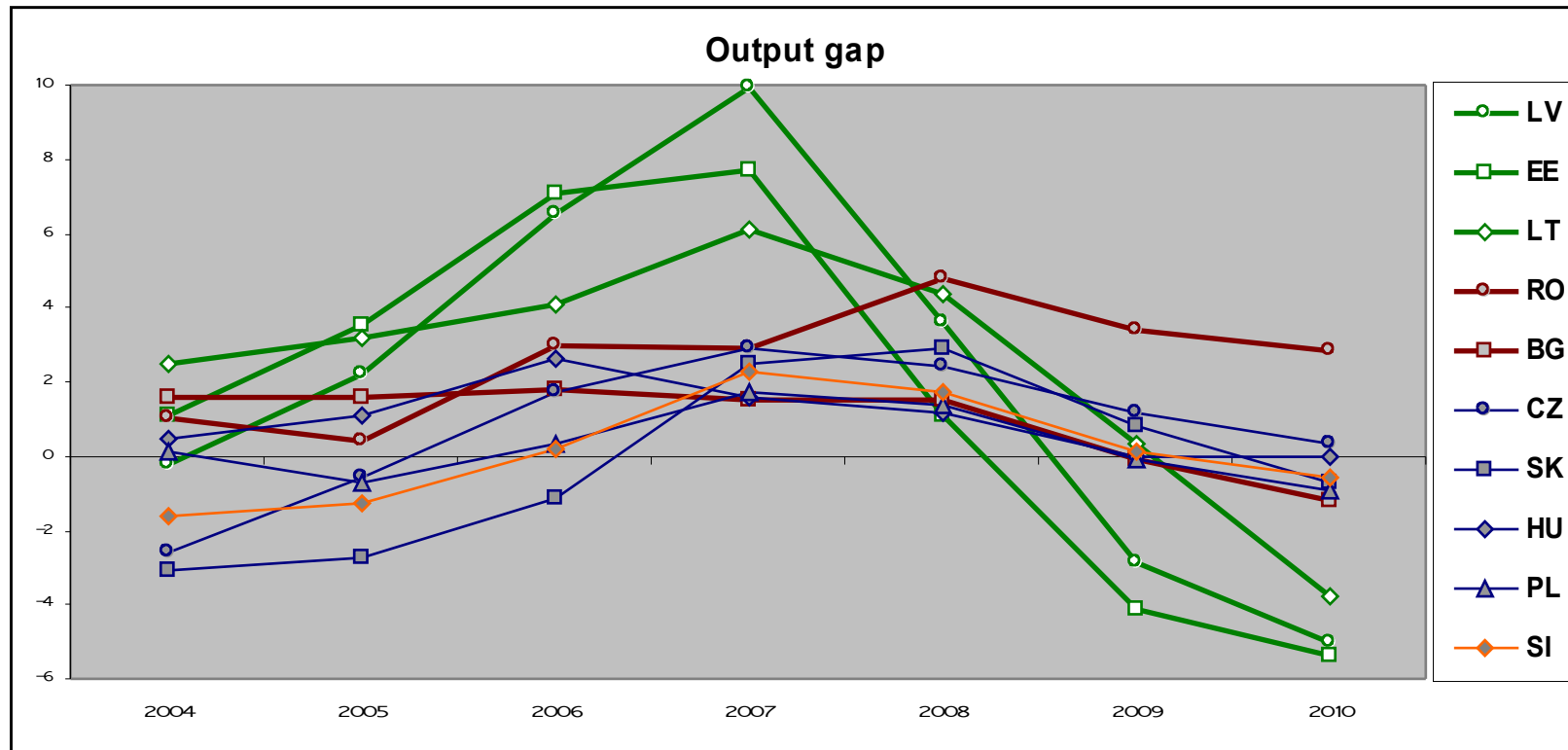
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Prague, December 9, 2008

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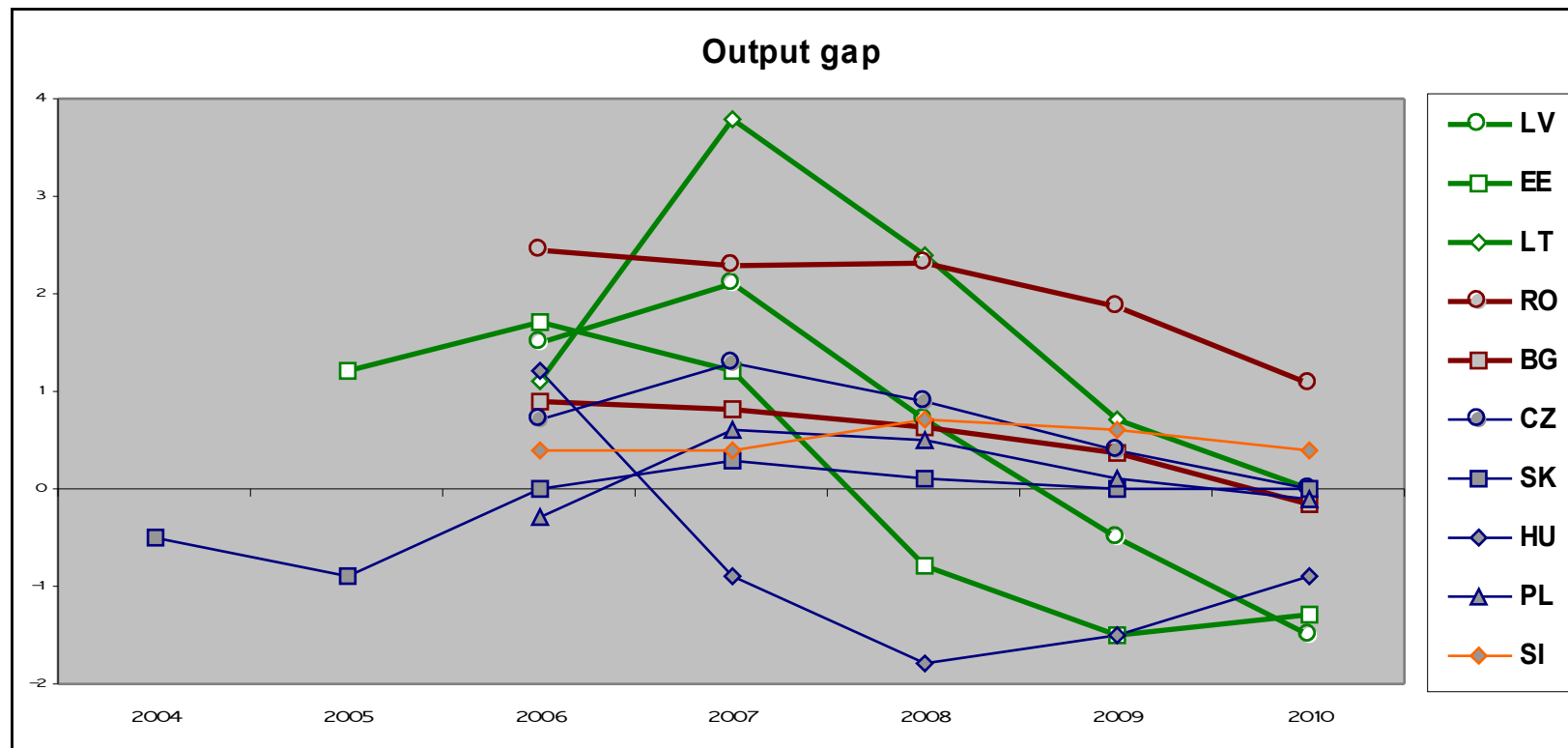
EC (Oct2008) forecasted drastic slowdown in the Baltics and overheating in Romania

- V4: just getting back to the potential



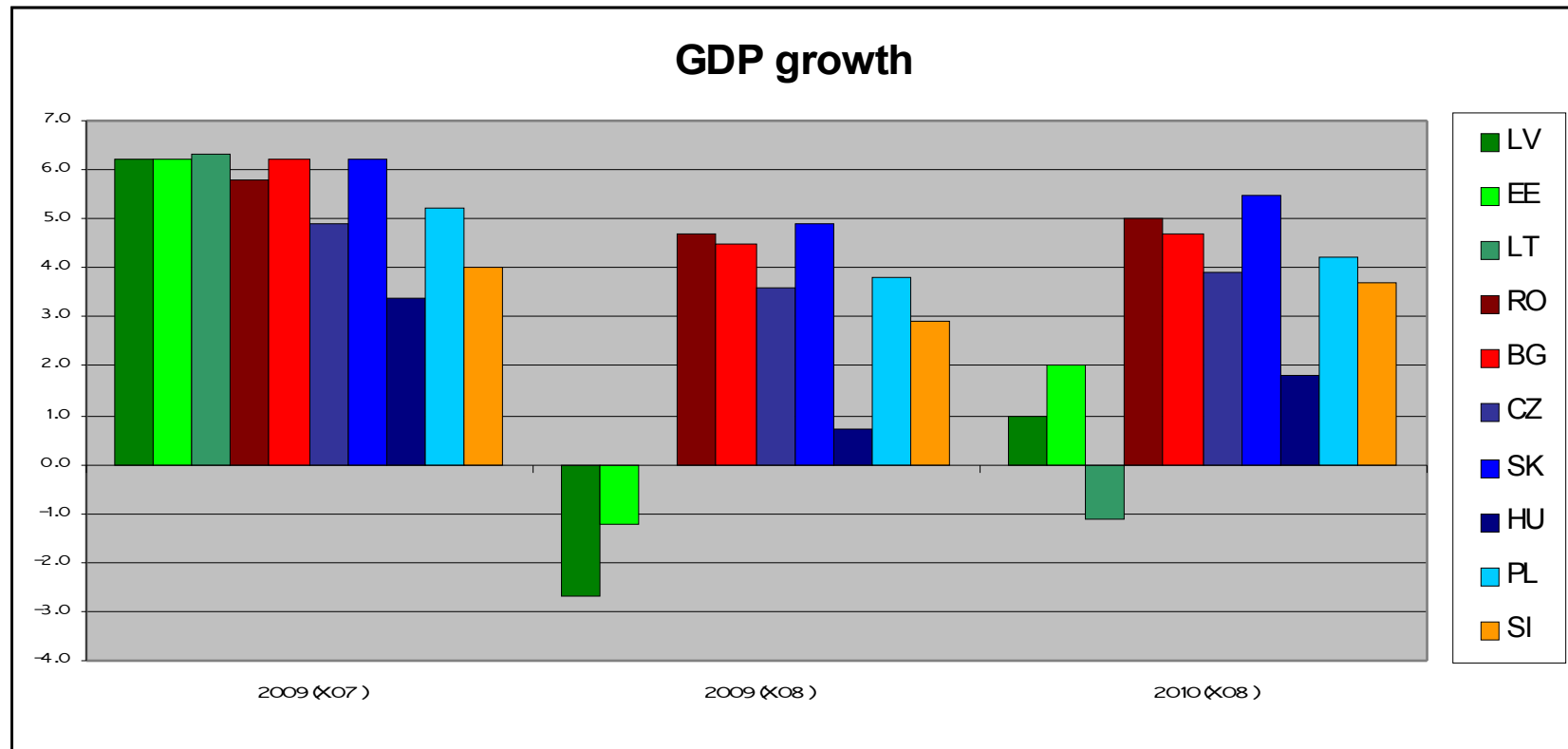
...while the expectations were softer

- Convergence programs (November 2007):
 - Output gap range [-2, 4] much thinner than the one suggested by the EC
 - Deceleration in Hungary, Estonia and Latvia; Lithuania just at the potential
 - But V4 (-Hungary) in [0, 1]



However, despite the crisis, growth prospects are (were) good

- While EC (Oct2007) forecasted high growth for all NMS (-HU), EC(Oct2008) reduced the forecasts – especially for the Baltics and Hungary. Other NMS to enjoy high growth.
- NMS catching up with the older EU members



Unlike the prospects of the NMS' export markets

(Although Some markets will continue to grow fast:

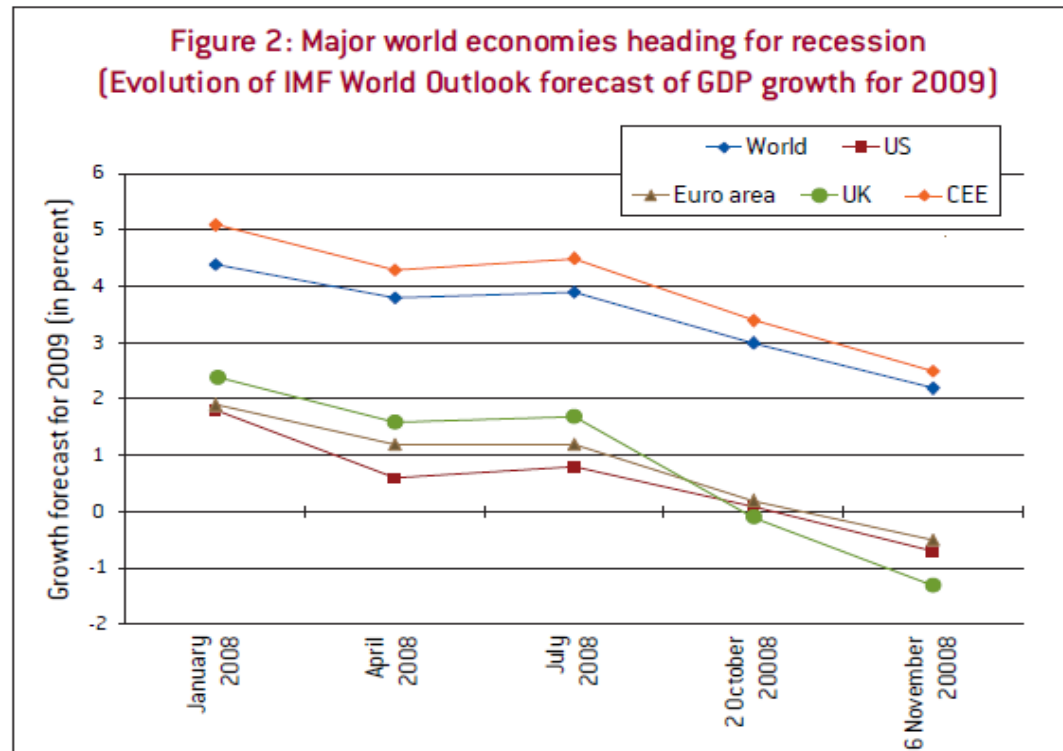
Africa 4.7%

CIS 3.2%

Developing Asia 7.1%

Middle East 5.3%)

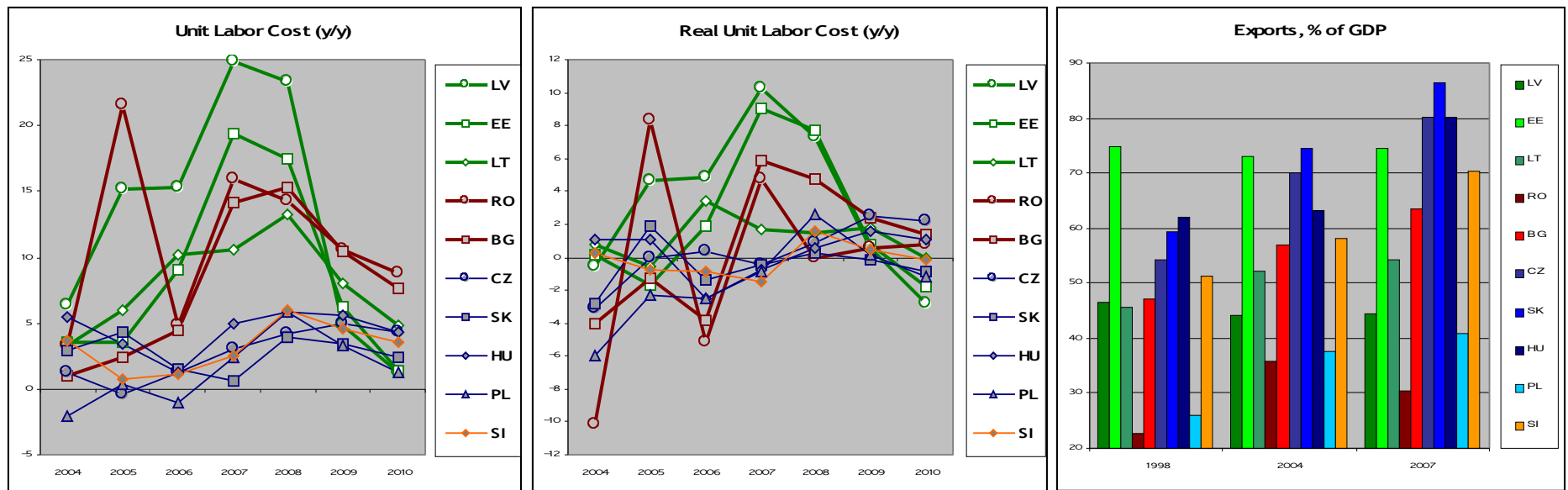
IMF November 2008
WEO update



Source: IMF. CEE: central and eastern European countries.

Roots: drivers of the growth

- Cheap and skilled labor: still cheap?
- Geography
- Business environment friendly enough to attract FDI and generate exports: progress?
- Macro stability

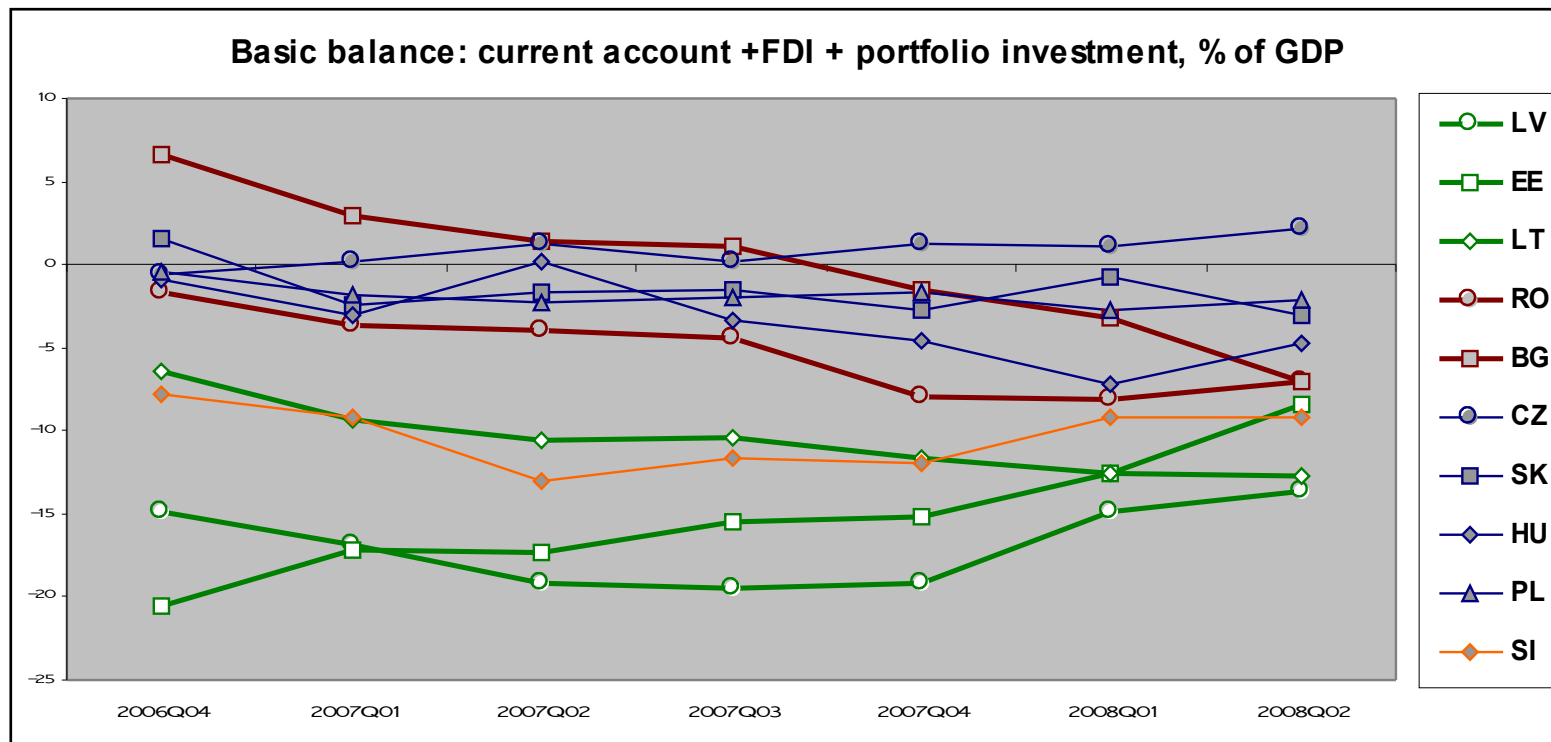


Hungary: a lesson of the macro for all?

- Was not perceived as the most vulnerable country in the region
- Fiscal expansion and high government debt
 - maturity of the debt 2008-09; high budget rigidity
- High foreign debt of households
 - currency mismatch
- But Hungarian story may be more difficult (and similar to those of other NMS)
 - 1st phase, a successful reformer, FDI
 - 2nd phase, reform stagnation, pro-cyclical fiscal policy, rising public gross foreign debt

Foreign credit financing of current account deficit: too much can be too much

- FDI more than covers CAD in CZ, almost in PL
- Significant portfolio investment inflow in Hungary in 2006-07, continuous outflow from Slovenia
- Debt financing of CAD: the Baltics, Slovenia, Bulgaria and Romania, less in Hungary



Making business more difficult (WB 2009 Doing Business)

- V4 should offer pretty good business environment to compensate for a lack of capital, smart labor and modern know how

	Ease of Doing Business Rank	Starting a Business	Dealing with Construction Permits	Employing Workers	Registering Property	Getting Credit	Protecting Investors	Paying Taxes	Trading Across Borders	Enforcing Contracts	Closing a Business
United States	3	6	26	1	12	5	5	46	15	6	15
Hong Kong, China	4	15	20	20	74	2	3	3	2	1	13
Thailand	13	44	12	56	5	68	11	82	10	25	46
Malaysia	20	75	104	48	81	1	4	21	29	59	54
Korea	23	126	23	152	67	12	70	43	12	8	12
Austria	27	104	46	50	36	12	126	93	19	13	20
France	31	14	18	148	166	43	70	66	22	10	40
Slovakia	36	48	53	83	7	12	104	126	116	47	37
Botswana	38	80	119	73	29	43	38	17	149	92	26
Hungary	41	27	89	84	57	28	113	111	68	12	55
Bulgaria	45	81	117	60	59	5	38	94	102	86	75
Czech Republic	75	86	86	59	65	43	88	118	49	95	113
Poland	76	145	158	82	84	28	38	142	41	68	82

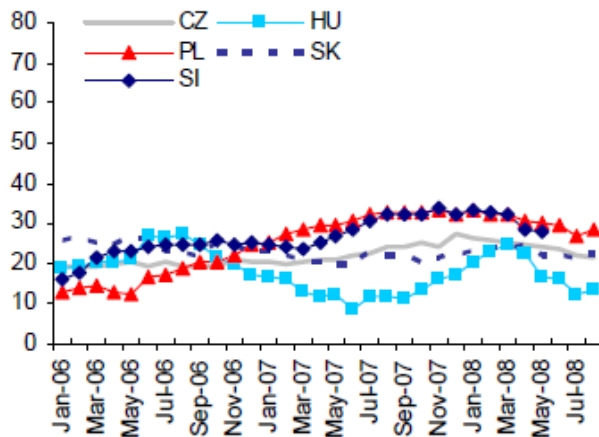
Rank: 1-45 46-90 91-135 136-181

The crisis: uncertainty, risk aversion

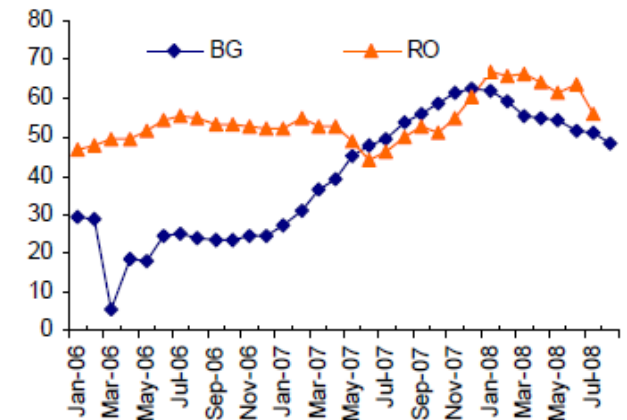
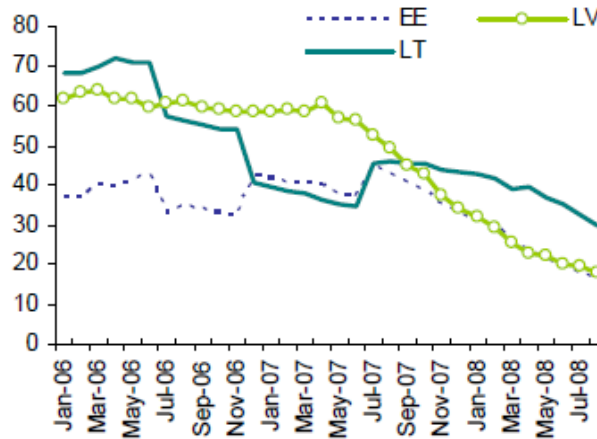
- **Financial market** (no direct exposure to toxic securities)
 - Credit default swaps (Baltics, Bulgaria, Romania, Hungary)
 - Frozen credit and interbank markets /sharp drop in equity prices: lack of “good project”
 - Sharp increases of interbank rates (Latvia, Romania)
 - Depreciation of currencies (Poland, Czech Republic, Hungary)
 - High share of FX credits (Baltics, Hungary, Bulgaria, Romania)
- **Foreign trade** – decline of foreign demand
- **Foreign financing needs** (BoP, gross debt)
 - Baltics, Romania, Bulgaria, Hungary
- **Domestic demand** /deflation: have also some positives, like bursting price bubble in real estates
 - DD to slow down in the Baltics and Hungary

Slower growth in domestic credit

- True especially for the Baltics, Bulgaria and Romania



Credit to private sector, y/y %



Uncertain European response

Seems the Bruegel's Action Plan Proposal will not be accepted. The plan included:

- **Budgetary boost:** Harmonized VAT cut of one percentage point across the board plus national measures, especially targeted relief, tailored to country specific circumstances in order to reach a total of one percent of GDP, to become effective by 1 January 2009 and to be phased out in 2010.
- **Reform commitment:** Compensation for deficits above three percent of GDP through sustainability-enhancing reforms.
- **Enforcement:** Correction of excessive deficits to be implemented as early as 2010 if reform commitment is broken.
- **Prudent borrowing:** Agreement by all euro-area countries not to borrow at more than 200 basis points above the lowest euroarea government bond yield.

To be effective since January 2009, the Action Plan needs to be approved by the European Council on its 11-12 December meeting.

Pisani-Ferry, Sapir and von Weizsäcker (2008). A European Recovery Programme, Bruegel Policy Brief, November. (The text in parenthesis added by the author.)

Domestic response

- Adding liquidity – does not seem to make difference in CZ and SK; the problem is how to distinguish good projects
- Fiscal expansion, EU funds, acceleration of some investment projects
- Social safety net – a hike in unemployment is not expected (but in the Baltics)
- Reforms? “Restructuring” of public administration?

Business response

- Banks – widening interest rate margin, tightening credit conditions
- Enterprises – lower energy prices to increase profit margin; profits were high anyway
 - More business coming in a response to the new restructuring in EU15?
- Another wave of restructuring, especially in non-tradable sector
- Innovations (Starbucks-like, not high-tech)

EURO

Membership in EA reduces
one of the risks considered
by investors

Fitch Sovereign Ratings

	Long Term Issuer Default Rating	Short Term Issuer Default Rating	Local Currency Long Term Issuer Default Rating	Country Ceiling	Long term rating alert
Bulgaria	BBB-	F3	BBB	BBB+	Outlook Stable
Czech Republic	A+	F1	AA-	AA+	Outlook Stable
Estonia	A-	F1	A	AA-	Outlook Negative
Hungary	BBB	F3	BBB+	A	Outlook Stable
Latvia	BBB-	F3	BBB	A-	
Lithuania	A-	F1	A	AA-	Outlook Negative
Poland	A-	F2	A	AA-	Outlook Stable
Romania	BB+	B	BBB-	BBB	Outlook Negative
Slovakia	A+	F1	A+	AAA	Outlook Stable
Slovenia	AA	F1+	AA	AAA	Outlook Stable

S&P Sovereign Ratings

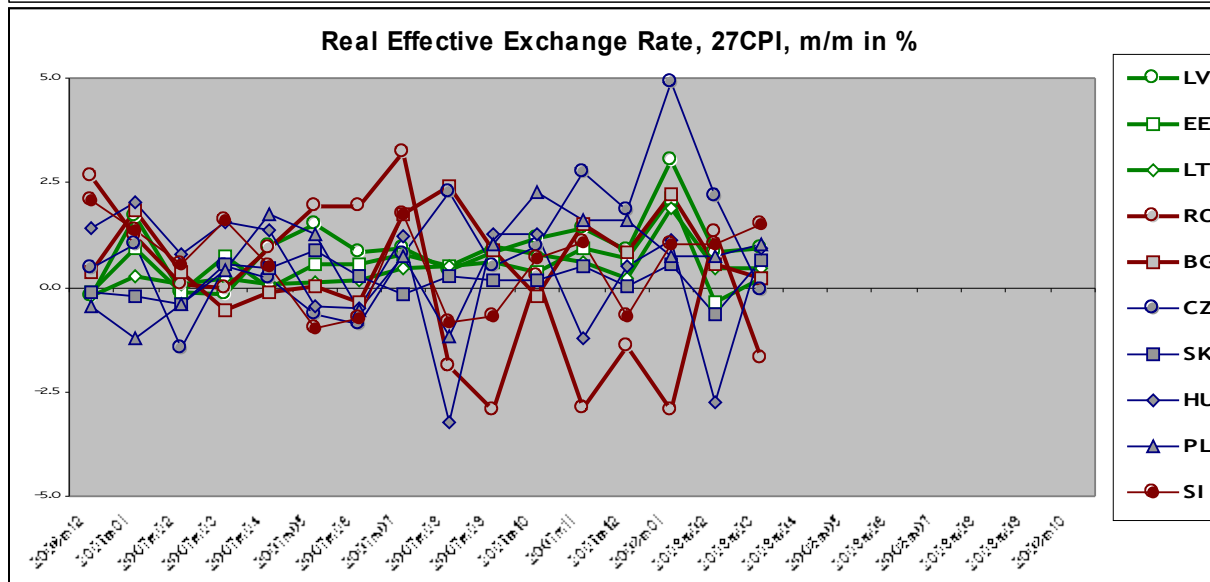
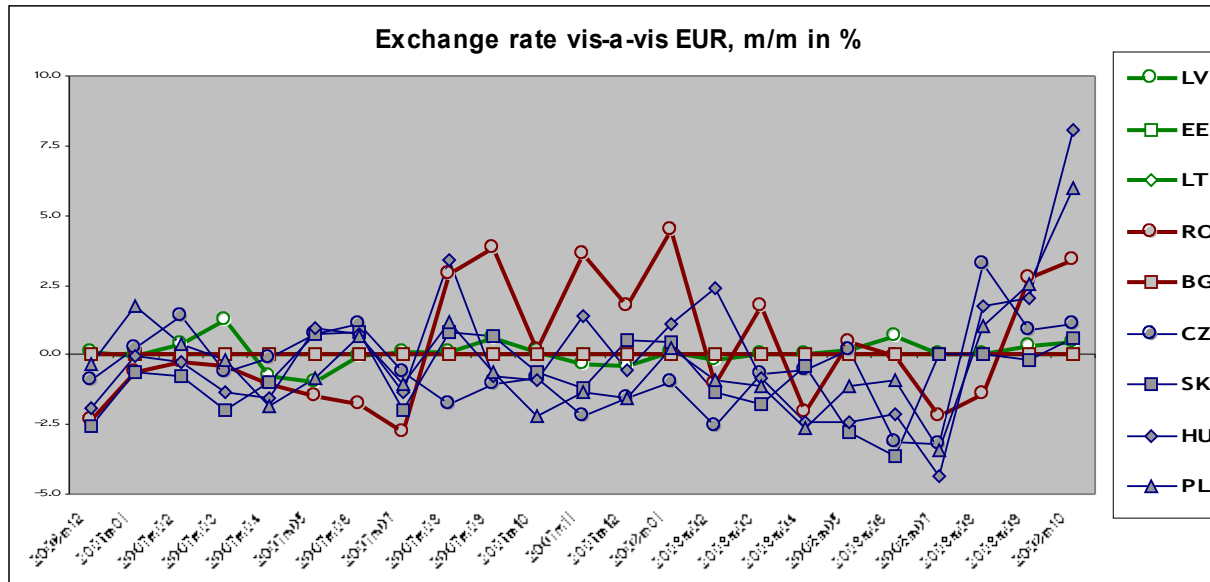
	Local Currency	Foreign Currency	T&C Assessment
Bulgaria	BBB/Negative/A-3	BBB/Negative/A-3	A/--/--
Czech Republic	A+/Stable/A-1	A/Stable/A-1	AA/--/--
Estonia	A/Negative/A-1	A/Negative/A-1	AA/--/--
Hungary	BBB/Negative/A-3	BBB/Negative/A-3	A/--/--
Latvia	BBB-/Watch Neg/A-3	BBB-/Watch Neg/A-3	A/--/--
Lithuania	BBB+/Negative/A-2	BBB+/Negative/A-2	A+/-/--
Poland	A/Stable/A-1	A-/Stable/A-2	A+/-/--
Romania	BBB-/Negative/A-3	BB+/Negative/B	BBB+/-/--
Slovakia	A+/Stable/A-1	A+/Stable/A-1	AAA/--/--
Slovenia	AA/Stable/A-1+	AA/Stable/A-1+	AAA/--/--

Moodys

	Rating	Foreign currency Outlook	Rating	Local Currency Outlook
Bulgaria	Baa3	STA	Baa3	STA
Czech Republic	A1	POS	A1	POS
Estonia	A1	NEG	A1	NEG
Hungary	A3	NEG	A3	NEG
Latvia	A3	NEG	A3	NEG
Lithuania	A2	NEG	A2	NEG
Poland	A2	STA	A2	STA
Romania	Baa3	STA	Baa3	STA
Slovakia	A1	POS	A1	POS
Slovenia [1]	Aa2	POS	Aa2	POS

[1] Country ceiling replaced by Eurozone's Aaa

FX Volatility



Conclusion

- The crisis is good timed for some (but not all) NMS
- Hungary: debt maturity and currency mismatch – lessons for all
- Back to the roots: a call for reforms
- EUR: helps to ensure macro stability