South-Eastern Europe: Impacts from the crisis, vulnerabilities and adjustments

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Helsinki, November 2012
Content:

• **Focus on the SEE-6** (Macedonia, Albania, Bosnia and Herzegovina, Croatia, Montenegro, Serbia);

• **Initial conditions in the region before the crisis**;

• **The impacts from the crisis over the region**;
  
  • Macedonian economy in the regional framework;

• **Looking ahead: possible adjustments and growth enhancement**.
The main commonalities of SEE countries before the crisis

- **Growth accelerated sharply in SEE-6 countries before the crisis**, mostly driven by domestic demand, supported by the rapid credit growth and rising capital inflows;

- **Accumulation of external vulnerabilities at varying degrees**: widening current account deficits and growing external indebtedness in some of the countries;

- **In general, sound financial system**: well-capitalized and liquid banks, though rising reliance on external financing in some countries.

**GDP growth rates before the crisis**

Source: WEO database - October 2012

**CAD in % of GDP**

Source: Central banks websites and IMF IFS database.
The impacts from the crisis: sharp reversal in economic trends

- Crisis spillover effects mainly due to strong trade linkages
- Massive fall in exports, mainly due to reduced external demand, and lower capital inflows undermined the pre-crisis growth model

Volume of exports of goods and services, y-o-y change, in %

FDI in % of GDP

GDP levels before and after the crisis (2008=100)

Source: WEO Database October 2012

Source: Central banks websites, WEO database
Increased credit risk and eroded profitability of the banking systems

- Sound initial conditions, traditional banking operations and low exposure to riskier financial instruments contained direct spillovers during the early stage of the crisis.

- Considerable second-round effects as the worsened economic outlook pushed credit markets into bust cycle and triggered a rise in NPLs.

- In the midstream of the crisis profitability eroded.
Overall, the financial stability was not under threat

- Sound capitalization levels strongly contributed to banking sector’s resilience
- Stable liquidity ratios of the banking systems
Public finances under pressure contributing to external vulnerabilities build-up

- Larger public deficits – automatic stabilizers’ effect and counter-cyclical expansionary spending
- External debt on a rising track, partly due to governments’ increased accumulation of foreign debt

Fiscal balance (% of GDP)

Gross public debt (% of GDP)

Gross external debt in % of GDP

Source: WEO database - October 2012

Source: WEO database, October 2012.

Source: Central banks websites, WB, WEO database and IMF Country reports.
Monetary Policy Response

- Stronger countercyclical responses only in the countries with floating exchange rate, where a currency depreciation was allowed in order to mitigate the impact of the crisis.
- Conventional and unconventional measures undertaken, balancing between the need for mitigating the crisis impact and maintaining stable currency.
- Interventions on the forex market, while bolstering foreign reserves level with external financing (IMF support to part of the region).

Central Bank policy rate
(end-period, in %)

Source: Central banks websites.
Vulnerabilities in the SEE-6 before and during the crisis

- Vulnerability analysis* of the NBRM pointed out the external sector, strong credit growth and slowdown of deposits growth (first round impact of the crisis) as main vulnerabilities areas before the crisis;

- During the crisis vulnerabilities moved to the government sector, non performing loans and sources of financing of the banking sector.

*Analysis is based on historical data, where thresholds are based on the data variability and deviation from the historical mean value.
Macedonian economy within the framework of the regional profile

- Decline in GDP in 2009 (by 0.9%), followed by moderate recovery in the next two years, with positive effects from the FDI inflows before the crisis;
- Inflation mainly driven by the supply side factors, that enabled monetary policy relaxation during the crisis;
- Smaller trade deficit, strong private transfers inflows and without sudden stop in the FDI, which combined with the borrowings from abroad resulted with an increase in the foreign reserves;
- Moderate credit growth, mild deterioration of the assets quality, improved liquidity, strong capital adequacy and lower profitability of the banking sector;
- Higher budget deficit and gradual increase in the public debt.

**Main risks and challenges** (in general, common for the region):
- growth enhancement;
- keeping sound public finance;
- taking care on the level of the external debt;
- stimulating credit growth, while maintaining banking sector soundness.
Macedonian economy – some country specific issues

- New export destinations and more diversified export structure, reflecting higher flexibility and some structural improvements, with positive countercyclical effect.
Looking ahead: A need for growth-enhancing model, but limited space for policy maneuver?

- The room for growth-oriented macro-policies is rather limited
- Fiscal consolidation – inevitable for medium-term fiscal sustainability
- Pro-cyclical tightening in structural terms already in place, anyway the SEE-6 fiscal outlook is still facing numerous challenges
- Fiscal rules, embedded within the legislation (Croatia and Serbia)

Buffers in foreign reserves need to be built further, or to be maintained in countries with fixed exchange rate, in order to counter external vulnerability risks – narrowed room for countercyclical monetary policy

At the current juncture, when inflation pressures in the region are building up, the room for accommodative monetary policy might be limited even in countries with a flexible exchange rate
Looking ahead: the role of the domestic banking system at the current juncture

- The role of foreign financing diminishing - more focus on domestic sources
- Most countries have a room for additional financial support of the real economy (anyway credit / deposit ratio decreased from 122 in 2008 to 109 in 2011 for the SEE6)
- The deteriorated portfolio quality and the weak economy constrain a stronger credit growth
- Potential risk to the credit growth: deleveraging of the foreign parent banks could impose additional constraints to subsidiaries in the SEE countries

Source: Central banks websites.
Looking ahead: A need for growth enhancing model - dealing with structural rigidities

- Redefining the economic growth model towards more balanced growth - moving away from consumption-based towards investment and export led growth
- Attracting non-debt capital inflows in the tradable sector – increasing competitiveness
- A need for enhanced competiveness and removing bottlenecks in the investment climate
- Structural reforms necessary for income convergence and EU integration
- Main issues to be addressed: infrastructure enhancement, increase of institutional quality, increase of efficiency and innovations...

*Source: Cetral banks' websites. Data refers to the FDI stock at the end of 2011. For Albania, latest available data (end of 2010) are used. For Serbia, data on FDI flows are used.

Source: Doing Business database.
Concluding Remarks

- Growth acceleration – remains as a main challenge for the region;

- The fiscal space for countercyclical response is rather limited, expected adjustment for a medium run sustainability;

- Constraints on conventional monetary policy, but unconventional measures can be undertaken in a countercyclical manner;

- The soundness of the banking system – strength of the region, with existing space for the further banking support for growth;

- Enhancing structural reforms, strengthening competitiveness and allocating / attracting capital in tradable sector – a key priority of the region in devising a sustainable new growth model.