# The Eurozone Crisis: Financial Stability Challenges for Emerging Europe

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# Eurozone Crisis: Key Policy Challenges

All over the world and particularly in the Eurozone all policy makers are wrestling with the following three economic challenges:

- Sovereign Creditworthiness — Fiscal Deficits and Public Debt.
- Economic Growth — How and when?
- Financial Stability

# Eurozone Crisis: What Happened?

- Crisis stemming from deterioration in sovereign debt's creditworthiness, led to a loss of confidence in banks (given their large exposures to sovereign debt), an interbank lending freeze, and a liquidity crisis in the region. Additionally, EBA required banks to meet a 9% CET1 ratio by June 30, 2012.

- Pressures driven by market constraints and regulatory measures are forcing Eurozone banks to restructure their balance sheets, reducing cross-border lending, selling non-core assets, and slowing down credit extension.

- Numerous downgrades: France and Austria lost their AAA status. Currently, only 4 countries in the region are still top-rated: Germany, Finland, Luxembourg and the Netherlands.

# Eurozone Crisis: Official Responses

- EU members signed a “fiscal pact” on Mar. 2, 2012, agreeing on longer-term fiscal and economic policy coordination.
- Greek €206bn debt restructuring on Mar. 8, 2012, and subsequent approval of EU/IMF second bailout to Greece for €130bn on Mar. 13, 2012.
- Two ECB Long Term Refinancing Operations (LTRO), on Dec. 2011 and Feb. 2012, which provided a total of €1,019bn of three-year funding to European banks.
- Vienna Initiative 2.0, seeking to bring together national and international authorities with IFIs to stimulate policy coordination for emerging Europe.

# Eurozone Crisis: Where are we now?

- Eurozone countries softening their commitment to fiscal targets and austerity policies, driving up sovereign yields, undermining efforts to create a credible firewall for Spain and Italy.

- Eurozone overall indebtedness rose to a record 87.2% of GDP in 2011.

- Elections in France — Socialists likely to win, will demand renegotiation of fiscal pact. Further downgrade expected in the medium term.

- Elections in Greece — Recession (7% in 2011, 5% in 2012), public fatigue, program may get derailed.

- Spain — Deficit at 8.5% of GDP in 2011, unemployment soaring (24%, 50% among the youth), sovereign yields reaching unsustainable levels (6%).

- Similar pressures on other Eurozone countries — Austerity talks collapsed in the Netherlands, PM tendered resignation, country may lose AAA status.

# Eurozone Crisis: Latest Figures and Projections

| | Real GDP (annual percent change) 2011 | Real GDP Projections 2012 | Real GDP Projections 2013 | Current Account Balance (percent of GDP) 2011 | Current Account Balance Projections 2012 | Current Account Balance Projections 2013 | Government Gross Debt (percent of GDP) 2011 | Government Gross Debt Projections 2012 | Government Gross Debt Projections 2013 | Fiscal Balance (percent of GDP) 2011 | Fiscal Balance Projections 2012 | Fiscal Balance Projections 2013 | 5 year CDS Rates (bp) 17-Apr | 10 Year Bond Rates (%) 17-Apr |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| European Union | 1.6 | 0.0 | 1.3 | 0.1 | 0.3 | 0.5 | 82.4 | 84.5 | 85.5 | -4.6 | -3.8 | -3.1 | | |
| Euro Area | 1.4 | -0.3 | 0.9 | -0.3 | 0.7 | 1.0 | 88.1 | 90.0 | 91.0 | -4.1 | -3.2 | -2.7 | | |
| Germany | 3.1 | -0.6 | 1.5 | 5.7 | 5.2 | 4.9 | 81.5 | 78.9 | 77.4 | -1.0 | -0.8 | -0.6 | 78 | 1.8 |
| France | 1.7 | 0.5 | 1.0 | -2.2 | -1.9 | -1.5 | 86.3 | 89.0 | 90.8 | -5.3 | -4.6 | -3.9 | 191 | 3.0 |
| Italy | 0.4 | -1.9 | -0.3 | -3.2 | -2.2 | -1.5 | 120.1 | 123.4 | 123.8 | -3.9 | -2.4 | -1.5 | 432 | 5.5 |
| Spain | 0.7 | -1.8 | 0.1 | -3.7 | -2.1 | -1.7 | 68.5 | 79.0 | 84.0 | -8.5 | -6.0 | -5.7 | 490 | 5.9 |
| Belgium | 1.9 | 0.0 | 0.8 | -0.1 | -0.3 | 0.4 | 98.5 | 99.1 | 98.5 | -4.2 | -2.9 | -2.2 | 249 | 3.4 |
| Austria | 3.1 | 0.9 | 1.8 | 1.2 | 1.4 | 1.4 | 72.2 | 73.9 | 74.3 | -2.6 | -3.1 | -2.4 | 164 | 2.8 |
| Greece | -6.9 | -4.7 | 0.0 | -9.7 | -7.4 | -6.6 | 160.8 | 153.2 | 160.9 | -9.2 | -7.2 | -4.6 | n.a. | 21.0 |
| Portugal | -1.5 | -3.3 | 0.3 | -6.4 | -4.2 | -3.5 | 106.8 | 112.4 | 115.3 | -4.0 | -4.5 | -3.0 | 1101 | 12.5 |
| Ireland | 0.7 | 0.5 | 2.0 | 0.1 | 1.0 | 1.7 | 105.0 | 113.1 | 117.7 | -9.9 | -8.5 | -7.4 | 581 | 8.2 |
| United Kingdom | 0.7 | 0.8 | 2.0 | -1.9 | -1.7 | -1.1 | 82.5 | 88.4 | 91.4 | -8.7 | -8.0 | -6.6 | 65 | 2.1 |

*Source: World Economic Outlook (IMF), Bloomberg.*

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# Impact and Implications for Emerging Europe

- The impact of the Eurozone crisis on Emerging Europe has led to:
  - Economic growth decline, primarily driven by reduced external demand and trade;
  - Fiscal and Sovereign Debt pressure, driven by lower growth, higher social costs, and increasing debt;
  - Funding constraints, due to limited growth in internal resources and limited external inflows, particularly cross-border lending to banks (non-parent funding).
  - Deterioration in bank lending conditions, fueled by high NPLs in some countries, deleveraging, and a low deposit base to finance credit (high LTD ratios).

# Emerging Europe: Latest Figures and Projections

| | Real GDP (annual percent change) | | | Current Account Balance (percent of GDP) | | | Government Gross Debt (percent of GDP) | | | Fiscal Balance (percent of GDP) | | | 5 year CDS Rates (bp) |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | Projections | | | Projections | | | Projections | | | Projections | | |
| | 2011 | 2012 | 2013 | 2011 | 2012 | 2013 | 2011 | 2012 | 2013 | 2011 | 2012 | 2013 | 17-Apr-12 |
| Central and Eastern Europe | 5.3 | 1.9 | 2.9 | -6.0 | -5.6 | -5.5 | 46.0 | 44.9 | 43.9 | -2.2 | -2.5 | -2.3 | |
| Bulgaria | 1.7 | 0.8 | 1.5 | 1.9 | 2.1 | 1.6 | 17.0 | 21.3 | 17.6 | -2.1 | -1.9 | -1.6 | 285 |
| Croatia | 0.0 | -0.5 | 1.0 | 0.9 | 0.4 | -0.2 | 45.6 | 52.8 | 55.7 | -5.5 | -4.7 | -4.7 | 411 |
| Czech Republic | 1.7 | 0.1 | 2.1 | -2.9 | -2.1 | -1.9 | 41.5 | 43.9 | 45.4 | -3.8 | -3.5 | -3.4 | 110 |
| Estonia | 7.6 | 2.0 | 3.6 | 3.2 | 0.9 | -0.3 | 6.0 | 5.7 | 5.4 | 1.0 | -2.1 | -0.5 | 113 |
| Hungary | 1.7 | 0.0 | 1.8 | 1.6 | 3.3 | 1.2 | 80.4 | 76.3 | 76.0 | 4.0 | -3.0 | -3.4 | 573 |
| Latvia | 5.5 | 2.0 | 2.5 | -1.2 | -1.9 | -2.5 | 37.8 | 39.1 | 41.6 | -3.4 | -1.2 | -0.5 | 250 |
| Lithuania | 5.9 | 2.0 | 2.7 | -1.7 | -2.0 | -2.3 | 39.0 | 40.9 | 41.1 | -5.2 | -2.9 | -2.6 | 250 |
| Poland | 4.4 | 2.6 | 3.2 | -4.3 | -4.5 | -4.3 | 55.4 | 55.7 | 55.2 | -5.2 | -3.2 | -2.8 | 201 |
| Romania | 2.5 | 1.5 | 3.0 | -4.2 | -4.2 | -4.7 | 33.0 | 34.2 | 33.0 | -4.1 | -1.9 | -1.0 | 332 |
| Slovakia | 3.3 | 2.4 | 3.1 | 0.1 | -0.4 | -0.4 | 44.6 | 47.1 | 48.8 | -5.5 | -4.2 | -3.7 | n.a. |
| Slovenia | -0.2 | -1.0 | 1.4 | -1.1 | 0.0 | -0.3 | 47.3 | 52.5 | 55.9 | -5.7 | -4.7 | -4.2 | n.a. |
| Albania | 2.0 | 0.5 | 1.7 | -13.3 | -13.2 | -12.5 | 58.9 | 61.7 | 62.9 | -3.5 | -3.7 | -3.6 | n.a. |
| Bosnia and Herzegovina | 1.7 | 0.0 | 1.0 | -8.3 | -7.8 | -7.1 | 40.6 | 43.4 | 42.2 | -3.1 | -3.8 | -2.4 | n.a. |
| Kosovo | 5.0 | 3.8 | 4.1 | -20.3 | -18.3 | -18.3 | n.a. | n.a. | n.a. | -1.9 | -2.7 | -3.3 | n.a. |
| Macedonia | 3.0 | 2.0 | 3.2 | -2.8 | -5.0 | -6.2 | 28.1 | 30.5 | 29.2 | -2.6 | -2.6 | -2.5 | n.a. |
| Montenegro | 2.5 | 0.2 | 1.5 | -19.4 | -19.7 | -20.0 | 45.8 | 48.9 | 51.1 | -6.5 | -5.0 | -4.6 | n.a. |
| Serbia | 1.8 | 0.5 | 3.0 | -9.1 | -8.6 | -7.9 | 47.9 | 53.7 | 52.9 | -4.0 | -4.1 | -4.0 | n.a. |
| Turkey | 8.5 | 2.3 | 3.2 | -9.9 | -8.8 | -8.2 | 39.4 | 36.0 | 34.6 | -0.3 | -1.7 | -2.0 | 235 |

*Source: World Economic Outlook (IMF), Bloomberg.*

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# Emerging Europe: End-2011 Banking Sector Indicators

| | CAR (%) | NPLs / Total Loans (%) | ROA (%) | ROE (%) | Credit / GDP (%) | Annual Credit Growth (%) | LTD (%) |
|---|---|---|---|---|---|---|---|
| Central and Eastern Europe | | | | | | | |
| Bulgaria | 17.5 | 14.9 | 0.8 | 7.1 | 72.5 | 3.9 | 113.4 |
| Croatia | 19.2 | 12.3 | 1.2 | 8.8 | 72.2 | 5.1 | 109.5 |
| Czech Republic[1] | 15.3 | 5.5 | 1.2 | 18.7 | 57.2 | 5.8 | 89.2 |
| Estonia | 18.6 | 4.0 | 3.5 | 33.3 | 84.6 | -4.1 | 151.0 |
| Hungary | 14.2 | 13.3 | -0.4 | -3.9 | 68.5 | -0.7 | 150.1 |
| Latvia | 16.5 | 13.9 | 0.5 | 5.1 | 86.1 | -7.7 | 226.6 |
| Lithuania | 14.0 | 16.4 | 1.4 | 15.3 | 56.6 | -4.5 | 148.9 |
| Poland | 13.1 | 4.7 | 1.3 | 16.6 | 58.3 | 14.6 | 115.2 |
| Romania[2] | 13.4 | 14.1 | -0.3 | -3.4 | 38.0 | 6.2 | 121.1 |
| Slovakia | 13.4 | 5.6 | 0.7 | 6.9 | 49.7 | 8.4 | 90.7 |
| Slovenia | 11.9 | 11.8 | -0.9 | -11.7 | 91.3 | -2.7 | 154.7 |
| Balkans | | | | | | | |
| Albania | 15.6 | 18.8 | 0.1 | 0.8 | 39.1 | 10.4 | 58.4 |
| Bosnia and Herzegovina | 17.2 | 11.8 | 0.7 | 5.9 | 55.1 | 64.5 | 115.7 |
| Kosovo | 17.6 | 5.7 | 1.4 | 14.5 | n.a. | n.a. | n.a. |
| Macedonia | 16.8 | 9.5 | 0.4 | 3.4 | 46.3 | 8.5 | 89.4 |
| Montenegro | 16.5 | 15.5 | -0.1 | -0.6 | 55.3 | -13.2 | 119.3 |
| Serbia[1] | 19.7 | 18.8 | 1.3 | 6.5 | 49.0 | 5.5 | 118.1 |
| Turkey | 16.4 | 2.6 | 2.2 | 18.9 | 49.7 | 33.7 | 99.6 |

*[1] CAR, NPLs, ROA and ROE as of September 2011.*

*[2] CAR, ROA and ROE as of September 2011.*

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*Source: Financial Soudness Indicators (IMF), International Financial Statistics (IMF).*

# Possible Scenarios

**Scenario 1: Greece needs a third bailout, Portugal a second, and Spain may have to be rescued – Most likely case – Medium/High Probability – Europe muddles through**

- A new Greek and Portuguese bailout triggered by the inability to drive down their debt levels due to failed austerity measures, plus an emergency loan to Spain driven by unsustainable borrowing costs and budget deficits, would create economic and financial spillovers to other troubled economies (i.e. Italy) and the Eurozone as a whole.

- Funding costs would increase, and access to wholesale funding by Emerging European banks would be severely constrained, having to rely on scarce domestic sources.

- Lending conditions would deteriorate materially, due to rising NPLs and funding constraints. In some cases, national authorities would be forced to step in to recapitalize the most troubled banks.

# Possible Scenarios

**Scenario 2: Greece defaults after the elections in May, but Eurozone holds – Mini-disaster – Medium Probability**

- Greek default, triggered by rejection of the European bail out and fiscal plan after the elections, would put Emerging European countries at considerable risk.
- There will be substantial capital flight out of Greece, run on Greek banks and their subsidiaries leading to the collapse of the Greek banking sector.
- Emerging Europe would face increased fiscal pressures (including potentially from the need to support struggling domestic banks or corporations).
- Emerging European countries would see weaker demand and slower to negative growth, creating further fiscal pressures.
- Severe deleveraging due to both demand and supply side shrinkages.
- External financing difficulties, financing gaps estimated at over $77bn.

# Possible Scenarios

**Scenario 3: Eurozone unravels – Catastrophic event – Low probability**

- Recent events in peripheral Europe suggest that a worse case euro-zone break-up scenario cannot be excluded, characterized by systemic fiscal and sovereign debt crisis, followed by banking sector crises across Europe and a disorderly collapse of (part of) the eurozone.

- Contagion to Western European banks could lead to further depositor panic, potential collapses, and further deleveraging across emerging Europe.

- Emerging Europe will suffer from catastrophic growth and financing shocks, severe recessions, bank failures, fiscal defaults and unknown consequences.