

12 & 13 – Financial Crisis and Central Eastern Europe

Global Economics

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What is a financial crisis?

- Reasons for economic crises
 - Exogenous shocks on supply or demand side (e.g. Oil crisis or Finnish crisis in the 1980s)
 - Macro-economic imbalances (fiscal-monetary)
 - Systemic crisis
 - “Bubbles” created through technological innovations, financial innovations, ...
 - Insufficient regulations to avoid market failures (lack of transparency, asymmetric access to information, moral hazard, ...)
- Turmoil in the financial system leading to a decrease in production and consumption
 - ⇒ **Economic Crisis**

Intro ➤ Origin ➤ Burst ➤ Remedy ➤ Effects ➤ LT ➤ PL

Three generations of crises

- **First generation crises**
Expansive monetary or fiscal policy and fixed exchange rate
⇒ current account deficit and downwards pressure on currency
Examples: Latin America (80s), Russian crisis (1998)
- **Second generation crises**
Speculative attacks on healthy economies – investors ‘bet’ on the ability of a Central Bank to defend an exchange rate
Examples: EMS crisis 1992-3 (Italy and UK), Hongkong 1998
- **Third generation crises**
structural and institutional weakness, combined with inefficient financial system
Examples: Czech Crisis 1996 and Asian Financial Crisis 1997

Intro ➤ Origin ➤ Burst ➤ Remedy ➤ Effects ➤ LT ➤ PL

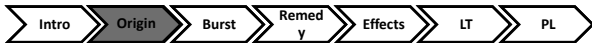
Origins of the present Financial Crisis

- Central banks keep interest rates too low
 - Japan’s economy is facing deflationary pressure
 - FED under Greenspan oversupplies the economy with money
 - Other Central Banks have to follow, to prevent appreciation of currencies
 - Financial institutions create even more “money” – hedge funds, private equity work with large leverage
- ⇒ **oversupply with money**

Intro ➤ Origin ➤ Burst ➤ Remedy ➤ Effects ➤ LT ➤ PL

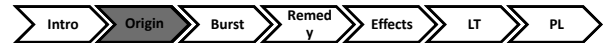
Origins of the present Financial Crisis

- Technical innovations
 - Real time trade world wide (e.g. carry trade)
 - Traders and institutional investors have buying and selling automatised (similar algorithms)
- Market innovations
 - Sub-prime mortgages are financed through complex non-transparent financial products (e.g. certificates)
 - Credit default swaps (insurances on credits) are considered high-yield and risk-free
 - CSD are not traded on stock exchange (price is in transparent)



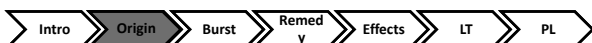
Origins of the present Financial Crisis

- Lack of check and balance
 - Rating auditors and agencies fail in their role
 - Equilibrium lost:
 - US double deficit (budget and trade) financed by bonds sold to sovereign wealth funds (*T-Shirts for T-Bonds*)
 - Moral hazard of business – “too big to fail”



From Real estate to ...

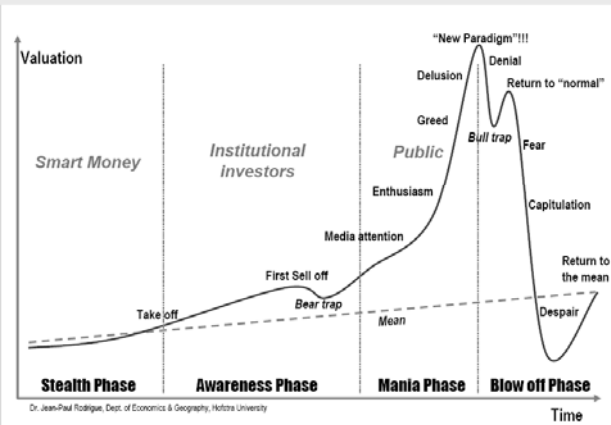
- Real estate market reaches saturation ...
 - Investors spread out into other markets ...
 - Shares
 - Commodities (oil price rise, food price crisis)
 - Emerging economies (currencies, shares, bonds, ...)
- ⇒ The whole economy is overheated and the boom becomes a bubble



Blowing Bubbles: From Technology to Commodities



Main Stages in a Bubble

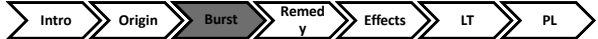


From financial to economic crisis

- Many financial products included sub-prime mortgages
- Assets have to be written off
- Financial institutions can't assess the risk in balance sheets
- ⇒ distrust between banks
- Banks do not give credits to other banks, industry and consumers
- ⇒ "Credit crunch" and run for liquidity
- Selling off everything that is not core business and risky (commodity options, shares in emerging markets, ...)

Atmosphere of insecurity in the world economy

Source: <http://www.zeit.de/online/2008/44/bg-finanzkrise>



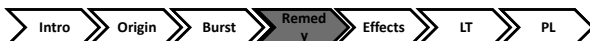
What can the state do?

Monetary support

- Liquidity for banks (buying back of state bonds, reduction of minimum reserve, short-term loans)
- Lowering of interest rates (inflationary pressure is also reduced through crisis)
- State directly increases money supply with credits or guarantees

Fiscal Expansion – Stimulation Package:

- Reduction of income tax
- Increasing consumption or investment with financial incentives



What can the state do?

Stabilisation

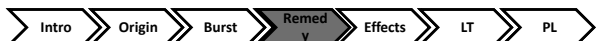
- Guaranteeing for savings
- Nationalising banks in crisis or other form of bail out
- States in imbalance are supported by other countries and IFI (international financial institutions)

Regulation

- New rules for financial market (hedge funds, bonuses)

Protectionism

! Important is to recreate trust !



End of neo-liberalism?



This crisis discredited monetarist supply-side economics
 Orthodox theories have problems to explain money supply through financial system
 Rise of heterodox economic theories – esp. non-rational choice theories (without *homo economicus*) e.g. New Institutional Economics, Behavioral Economics, ...

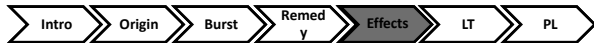
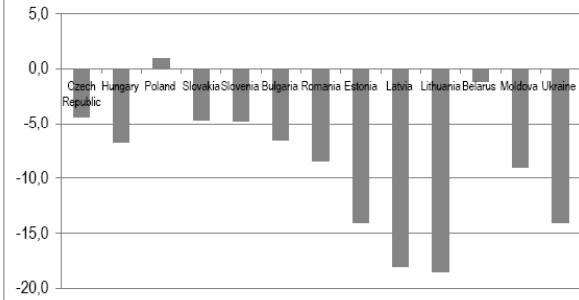


Figure 2. Expected GDP Decline, 2009
 (annual percent change)



Source: IMF World Economic Outlook Database, October 2009, Accessed October 28, 2009

Table 1. Current Account Balance, 2000-2009
 Percent of GDP

	2006	2007	2008	2009 Forecast
Czech Republic	-2,6	-3,1	-3,1	-2,1
Hungary	-7,5	-6,4	-8,4	-3,0
Poland	-2,8	-4,0	-5,5	-2,2
Slovakia	-6,2	-4,8	-6,5	-8,0
Slovenia	-2,6	-4,2	-5,5	-3,0
Bulgaria	-17,9	-25,4	-25,5	-11,4
Romania	-11,8	-14,4	-12,4	-5,5
Estonia	-16,8	-18,0	-9,3	1,9
Latvia	-22,7	-22,5	-12,6	4,5
Lithuania	-10,7	-14,6	-11,6	1,0
Belarus	-3,9	-6,8	-8,4	-9,6
Moldova	-11,7	-15,2	-17,7	-11,8
Ukraine	-1,5	-4,2	-7,2	0,4

Table 2. Current Account Deficit and Net Foreign Direct Investment (FDI), 2002-2007
 Percent of GDP

	Net FDI	CA	Residual
Czech Republic	5,4	-4,2	1,2
Hungary	2,5	-6,9	-4,4
Poland	3,0	-3,0	0,0
Slovakia	7,5	-5,5	2,0
Slovenia	0,9	-1,8	-0,9
Bulgaria	11,6	-11,1	0,5
Romania	6,0	-8,3	-2,3
Estonia	6,9	-12,3	-5,4
Latvia	4,8	-14,4	-9,6
Lithuania	3,4	-8,6	-5,2

Economic Crisis in Central Europe

Current account – those countries with the largest CA deficit before the crisis were hit the hardest (Baltic Republics, Ukraine, Moldova)

- FDI inflow was smaller than CA deficit = inflow of foreign capital for other purpose, e.g. Private consumption and construction sector (real estate bubble and high level of private debts)
- Crisis led to collapse of construction sector and people resigned from consumption

Making bad things worse:

- The Baltic countries and Bulgaria have their exchange rate fixed to the Euro –therefore no **automatic adjustment** to business cycle

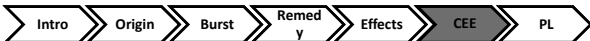
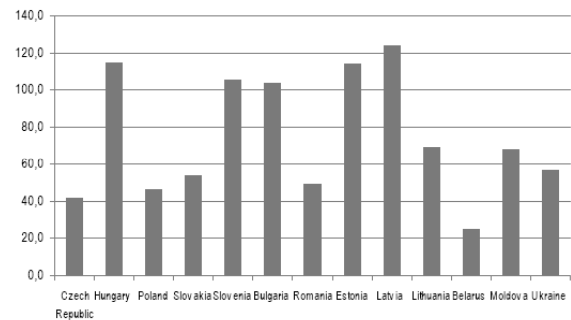
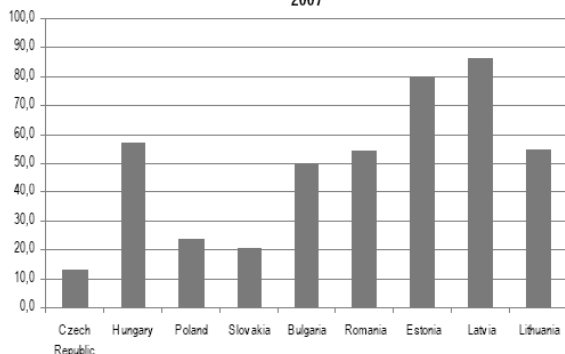


Figure 3. Foreign Debt, end 2008
(percent of GDP)



Source: EBRD, Accessed October 28, 2009

Figure 4. Share of Foreign Currency Loans,
2007



Source: Darvas, Zolt, and Jean Pisani-Ferry (2008) "Avoiding a New European Divide," Bruegel Policy Brief No. 10: 2, Brussels: Bruegel, December, www.bruegel.org.

Economic Crisis in Central Europe

Level of debt

- Public deficit is mainly financed from abroad because of low domestic saving rates
- Loans are taken in foreign currencies (mainly Euro and CHF)
- Baltic countries / Bulgaria fixed their exchange rate, but interest rate for Euro loans was lower than those in domestic currency
- In case of other countries currencies appreciated – loans in Euro lost real value and had lower interest rates (helps to explain Romania and Hungary)
why did this not happen in Poland, Czech Republic and Slovakia ?

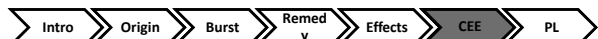
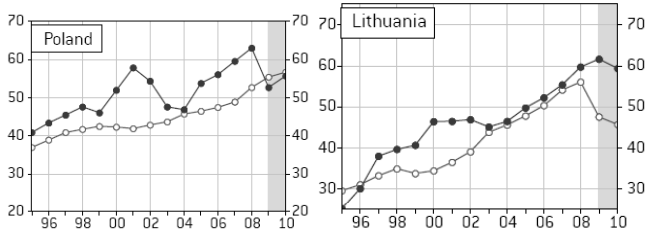
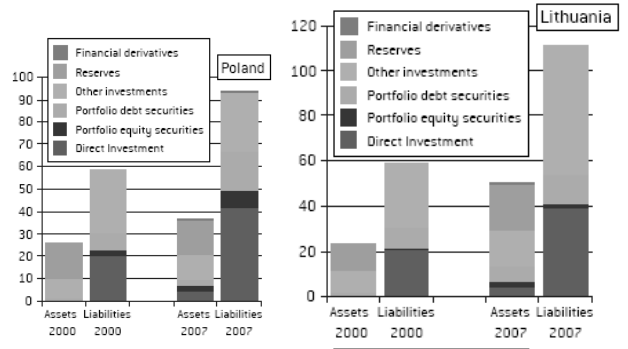


Figure 3: GDP per capita and price level (euro area 12 = 100), 1995-2010*



Line with full dots is GDP per Capita compared to Euro-12
 Line with empty dots is price level compared to Euro-12

Figure 6: External assets and liabilities (% of GDP), 2000 and 2007



Poland vs. Lithuania

Free floating currency

- Lower GDP growth rate
- Prices and GDP in Euro depend on exchange rate
- Lower level of inflation in domestic currency (as appreciating Zloty absorbed price rise)
- Depreciation lowered prices in Euro and made Polish products again competitive
- Poland keeps moderate Current account deficit because of stable domestic consumption and decline of export to Germany

Fixed exchange rate

- Higher GDP growth rates
- Prices and GDP in Litas & Euro were proportional
- Higher level of inflation during growth (esp. pressure on wages)
- During crisis Lithuania faces economic decline and deflationary pressure on prices and wages
- Current account surplus because domestic market collapsed – rise of export

Intro

Origin

Burst

Remedy

Effects

CEE

PL

Latest (13 January 2010): EUR 1 = PLN 4.0563 -0.0275 (-0.7%)

Date range: 1m | 3m | 6m | 1y | 2y | 5y | 10y | All

See EUR vs. PLN

Change from 23 January 2004 to 13 January 2010 -0.6365 (-13.6%)

Minimum (28 July 2008): 3.2053 - Maximum (20 February 2004): 4.9346 - Average: 4.0063



Latest (13 January 2010): **PLN 1 = EUR 0.2465** +0.0016 (+0.7%)

Date range: 1m | 3m | 6m | 1y | 2y | 5y | 10y | All See PLN vs. EUR

Change from 23 January 2004 to 13 January 2010 +0.0334 (+15.7%)

Minimum (20 February 2004): 0.2027 - Maximum (28 July 2008): 0.3120 - Average: 0.2517



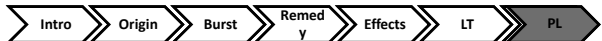
Appreciation of the Zloty

- Inflow of capital through Foreign Direct Investment
- Inflow of EU subsidies (payment for Common Agricultural Policy, Regional funding)
- Transfer of payments of Poles working abroad
- Public debt – financed through the global financial market
- Debts of private households (mortgages and consumption credits) and business (investment credits)
- Inflow of portfolio investment (stock exchange)

The surge of liquidity allowed cheap credits for Poland and investors looked for opportunities in emerging markets

Loans in foreign currencies were common

But Poland had a CURRENT ACCOUNT DEFICIT



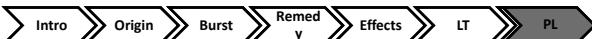
Polish Real Estate Bubble

The period 2002-2008 saw a continuous increase of real estate prices

e.g. in Warsaw price per square meter rose from June 2006 to June 2007 by 30% in Zloty and 50% in €

Reasons

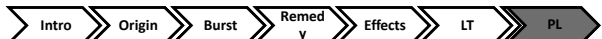
- Global liquidity surplus
- Demographic peak (*The 1980 generation is forming families*)
- Economic optimism (mortgages were granted for periods up to 50 years)
- Urbanisation and full employment in many cities
- Lack of craftsmen and administrative burdens delayed the completion of developing projects.



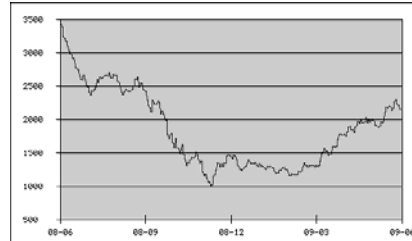
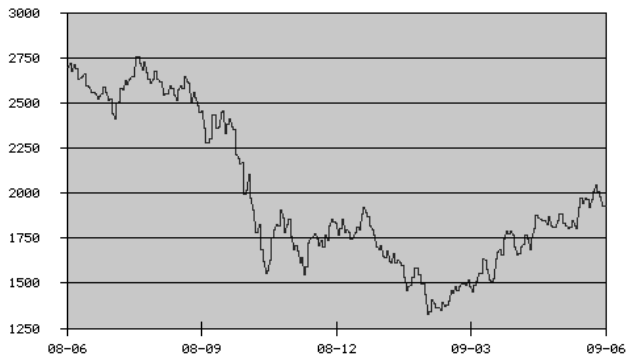
Poland in Crisis

- Decrease of FDI inflow
- Equal decline of import and export – imports got more expensive in Zloty – Polish manufacturers working for German export industry lost their markets
- Transfer payments from abroad decline, transfer abroad increases (*the small man's capital flight*)
- Investment and Hedge Funds, banks and other institutional investors withdraw short-term portfolio investment from Poland

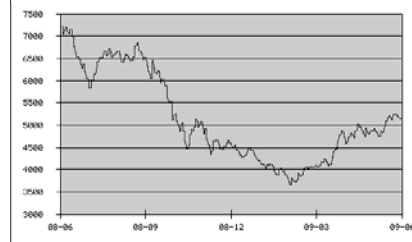
The credit crunch led to a scramble for liquidity – money is repatriated from emerging markets to US or Western Europe



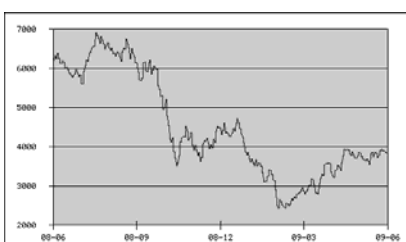
WIG-20 (Index of the Warsaw Stock Exchange)



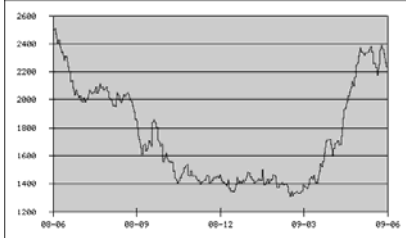
Developer Index



Construction Index



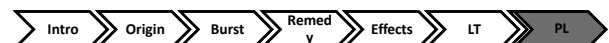
Bank Index



Food Index

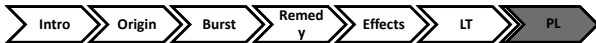
Effects of the Crisis

- Polish banks were little involved in speculative investments (sub-prime or Lehman Brothers certificates) *because in the country there were sufficient investment opportunities with high return*
- Despite the fact that Polish banks have their liability in foreign currencies and their assets in Zloty they did not collapse, because
- The liquidity crunch was cushioned through high interest on savings accounts – increase of saving rate in Poland
- The Polish banks are to 70% in foreign hands, therefore refinancing through their parent companies
- Poland got a “free ride” in bailing out (e.g. German Commerzbank and Dutch/Belgium Fortis)
- Largest bank of Poland PKO Bp is still state owned



Effects of the Crisis

- Decline of exports (most important destinations: Germany, Russia and Czech Republic)
but the diversity of exports reduces the risk (automotives, chemicals, raw materials, food, furniture, ...)
- For 2009 the European Commission 1% growth rate and no deflationary tendencies was estimated – *domestic growth*
- Increase of unemployment from 9% in 2008 to 12.5 % by end of 2009 (moderate compared to neighbouring countries)
- **Herding:** bad news from Latvia, Hungary or Romania affected also Poland – reason for major exchange rate land slides
- investment funds group „similar“ countries



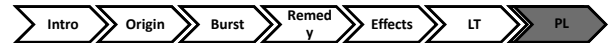
Government's countermeasures

Fiscal Expansion – Stimulation Package:

- Reduction of Personal Income Tax (from 20% to 18%) – *already planned during strong growth*
- Continuation of the “Friendly State” social spending programme ⇨ Poland is facing serious budget problems
- Pre-financing of EU projects through International Financial Institutes (World Bank, EBRD, EIB)
State owned banks (PKO Bp, Environmental Bank (BOŚ), ...) replace private banks in financing EU and other public projects

Monetary support

- NBP lowered interest rates (inflationary pressure is also reduced through crisis)
- Liquidity for banks (buying back of state bonds, reduction of minimum reserve)



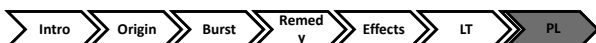
Government's countermeasures

Stabilisation

- Financial support package with EU, IMF and other financial institutions for the Polish National Bank is already negotiated
- Poland improved its negotiation position through granting support to Iceland, Latvia, Hungary, Ukraine and Romania
- Consolidation of the budget to limit public deficit – for 2009 expected 4.9% public deficit

Regulation

- Liberalisation – PO planned this before and uses the crisis to push its agenda through
- So far there are not government plans to save banks through collaterals or nationalisation



Euro?

In favour of quick accession:

- Stabilisation of the exchange rate through ERM 2
- Polish exports remain in competitive on the internal market
- Increase of credit rating through EMU membership (presently A- for bonds in € and A for bonds in Zloty)

Against quick accession

- Accession with an undervalued currency can lead to overheating of the economy and high inflation
- Poland needs high level of public investment – Stability and Growth Pact can hardly be kept
- „One-size fit all“ – monetary policy of the ECB does not fit to the requirements of a faster growing economy and can either overheat or suffocate the economies (see Ireland, Greece, ...)

