# POST- CRISIS BUSINESS MODEL OF BANKS IN THE REGION

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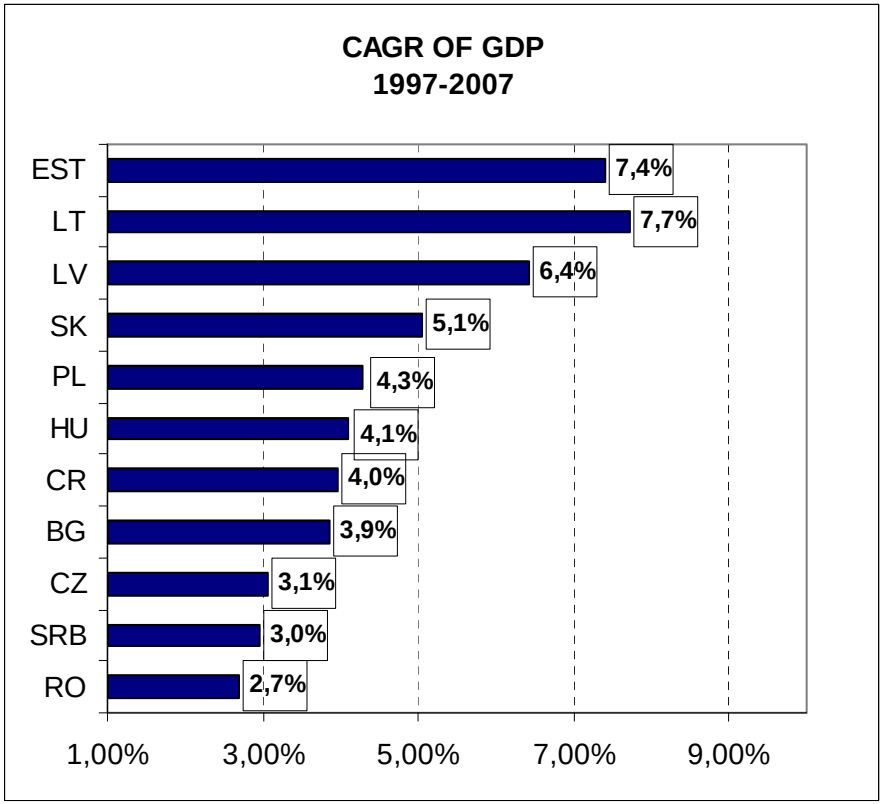
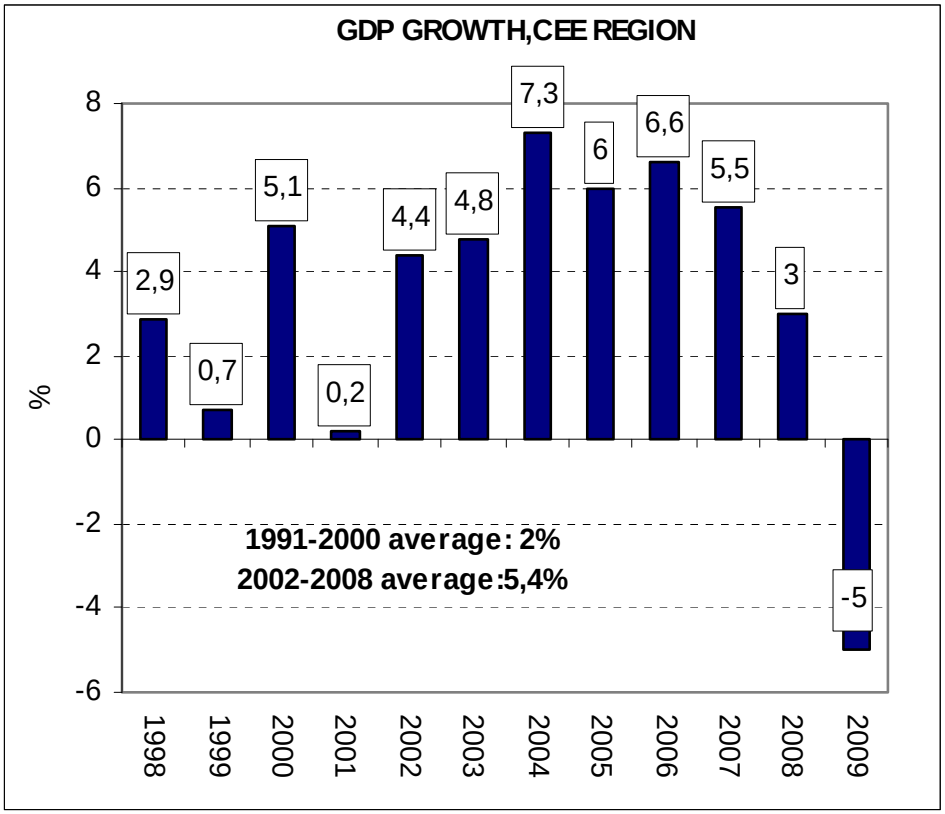
# BEFORE THE CRISIS:

# A MACROECONOMIC OVERVIEW

# GDP GROWTH RATES WELL ABOVE THE EMU AVERAGE...

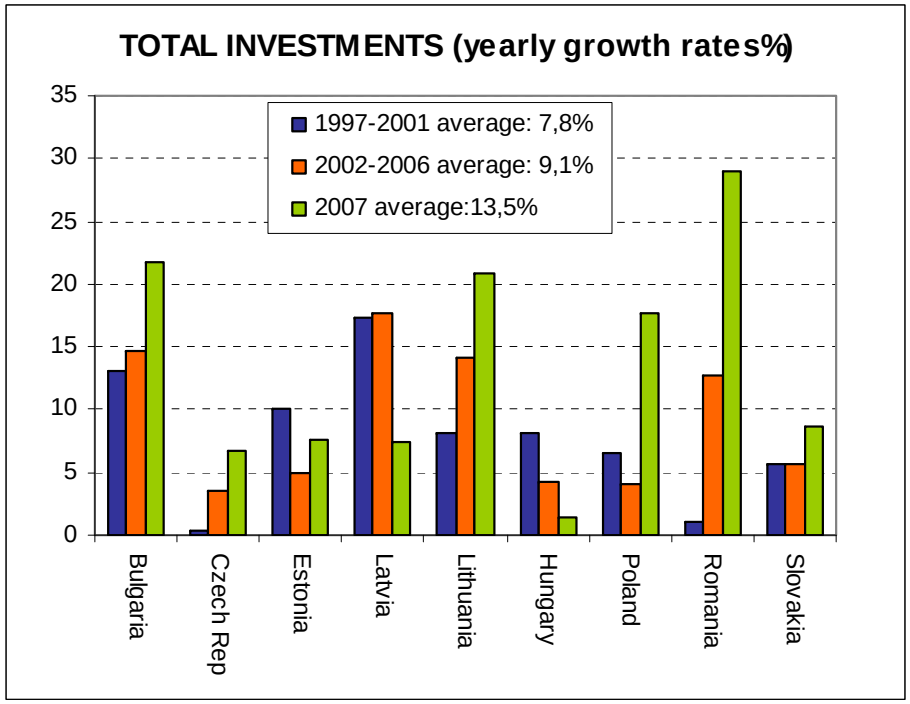


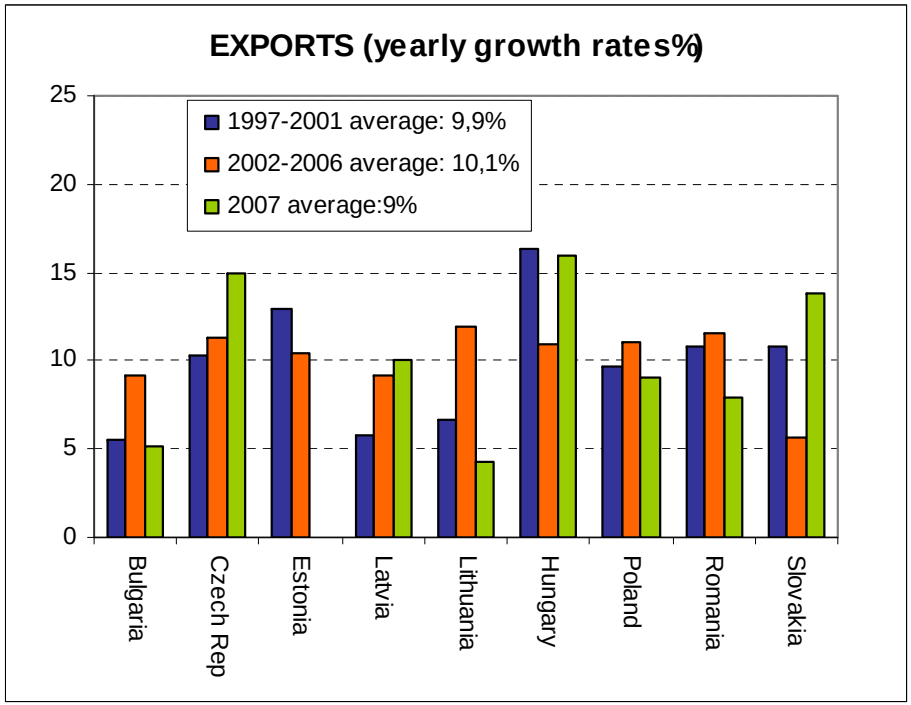




**Before the crisis the consensus view was that in case of small, open, converging economies the sustainable growth strategies are export and investment-driven growth strategies –actively supported by capital inflows (both debt- and non-debt type financing) (C/A deficits!)**

Source: Eurostat, IMF

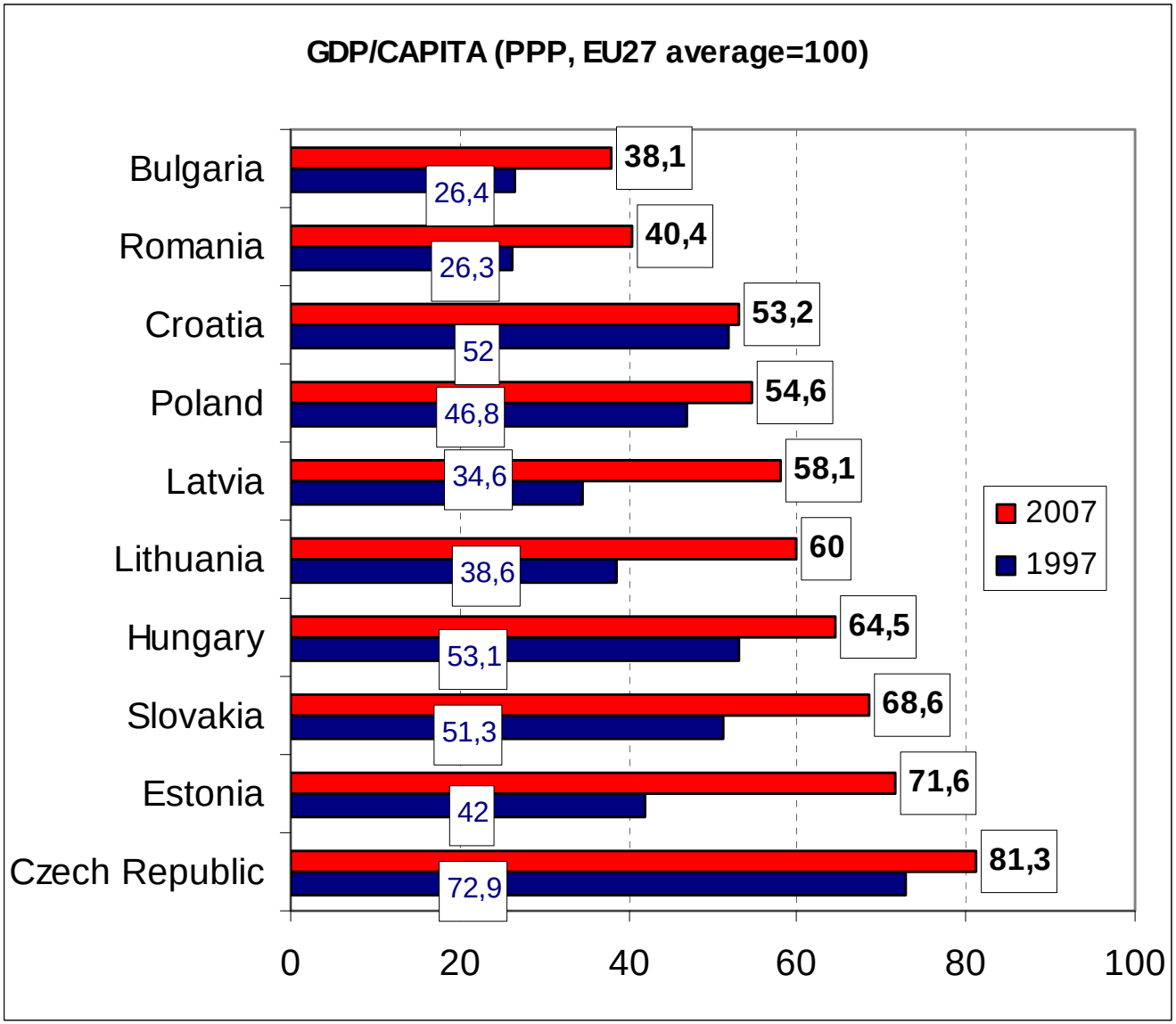
# EXPORT AND INVESTMENT DRIVEN GROWTH STRATEGIES



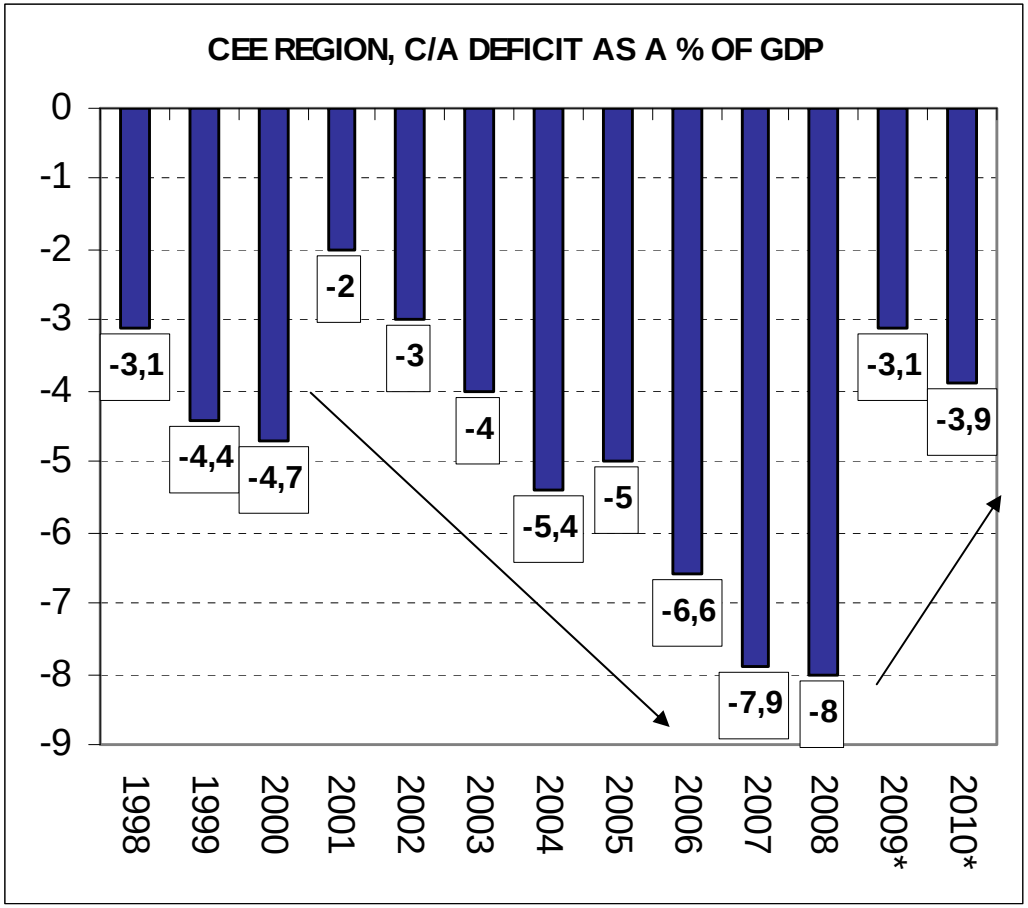

Source: Eurostat

# STRONG GROWTH RATES PUSHED AHEAD REAL CONVERGENCE




Source: Eurostat

# C/A DEFICIT A REGIONAL PHENOMENON

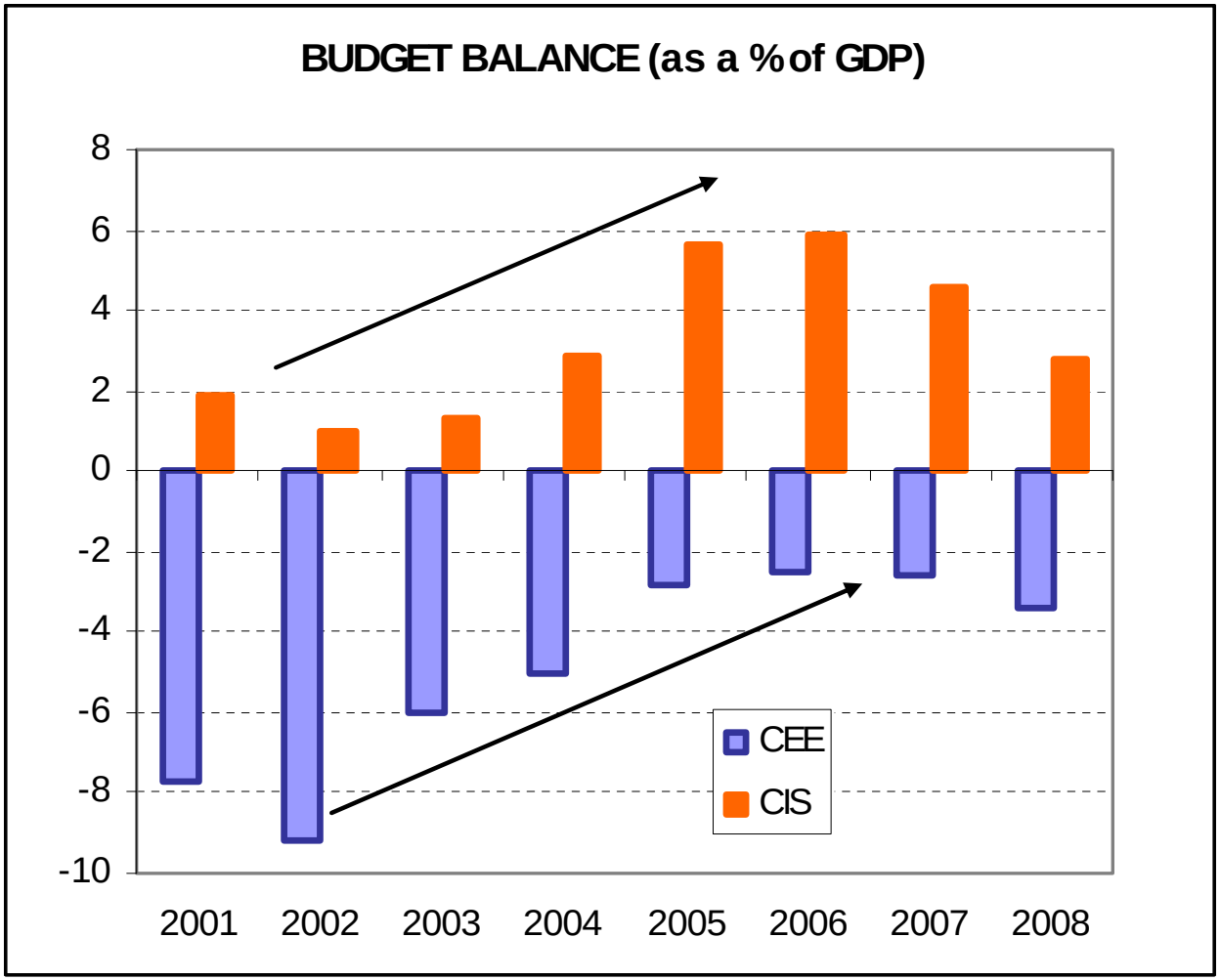



**In the CEE region almost all countries run external deficits or to put it another way: net domestic savings were negative**

**Before the current crisis it was considered sustainable**
**A natural „side effect" of the catching up process**

Source: IMF

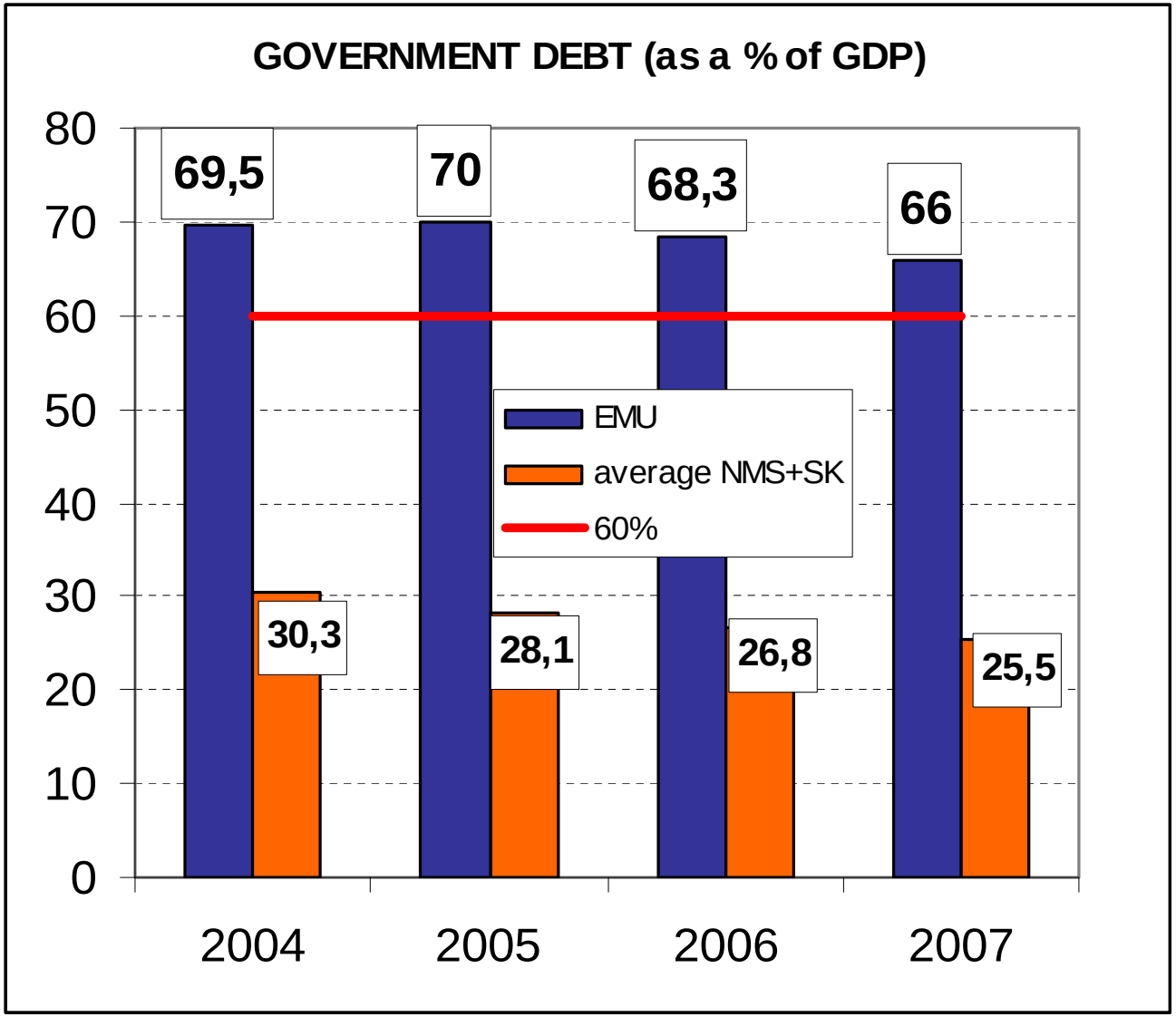
# DISCIPLINED FISCAL POLICIES




**The external deficit was not the result of loose fiscal policies (SGP, Maastricht!)**

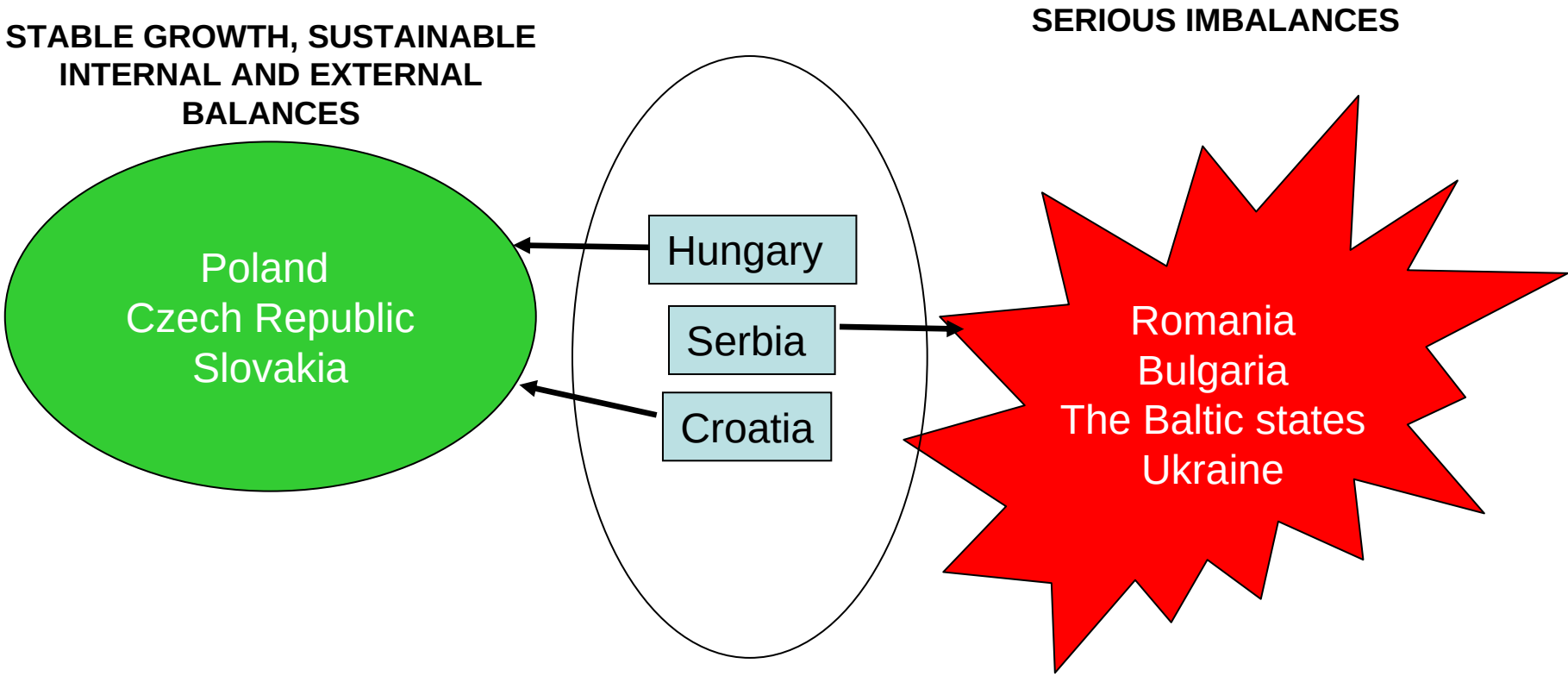
Source: IMF

# LOW DEBT LEVELS




Source: Eurostat

# BUT THERE WERE DIFFERENCIES ACROSS THE REGION

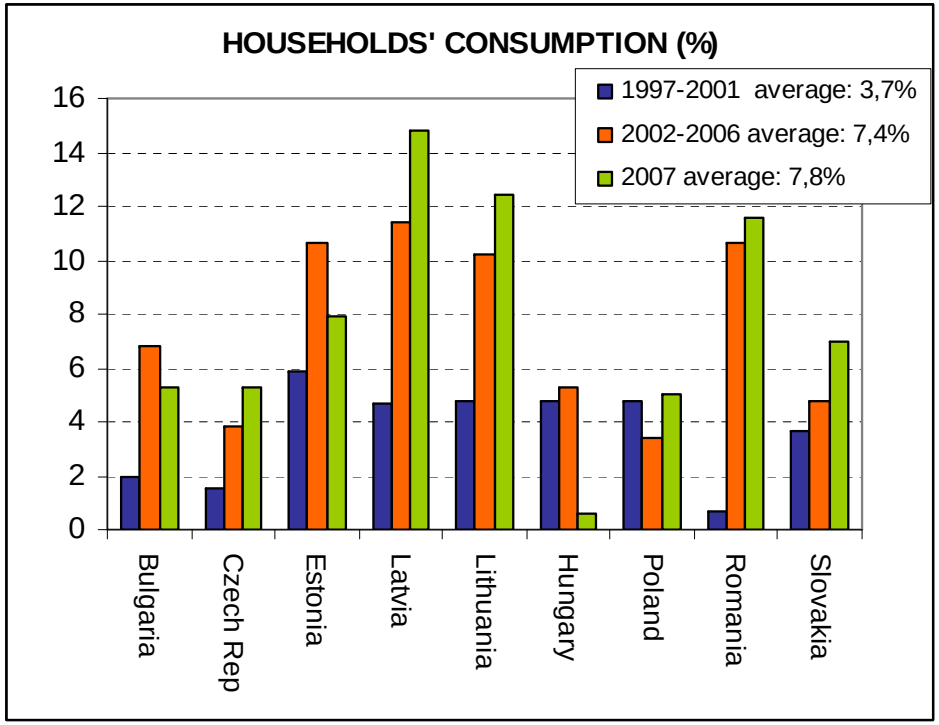


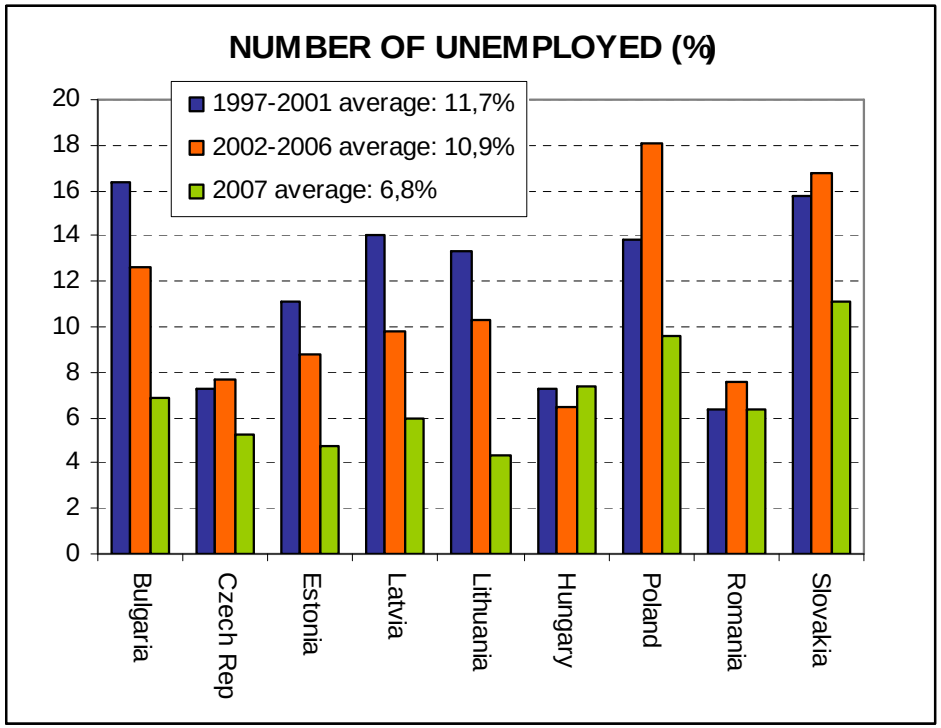

**The first group: low inflation, healthy fiscal balances, acceptable external position, no asset price bubble**

**The second group: high inflation, huge external imbalances, asset price bubbles, consumption driven growth financed by cheap external funding**

**BUT DUE TO THE GLOBAL CRISIS ALL COUNTRIES FACE ALMOST SIMILAR CHALLENGES**

# BUT THERE WERE DIFFERENCIES ACROSS THE REGION




**In some countries domestic demand rose strongly in spite of disciplined fiscal policies**

Source: Eurostat

# THE CRISIS: THE REGION ENTERED A DEEP RECESSION

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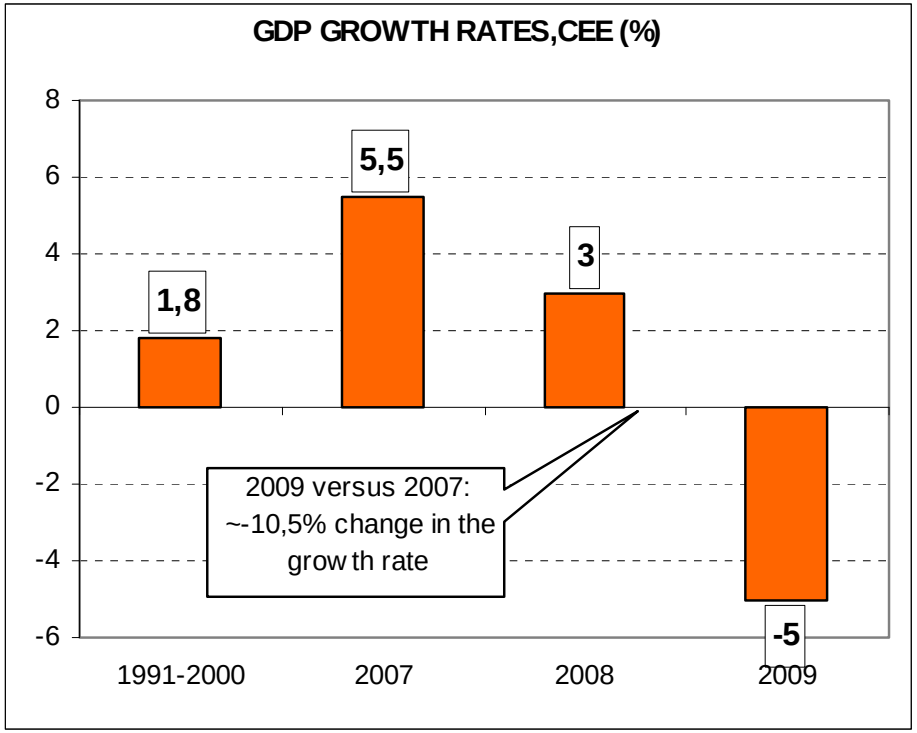
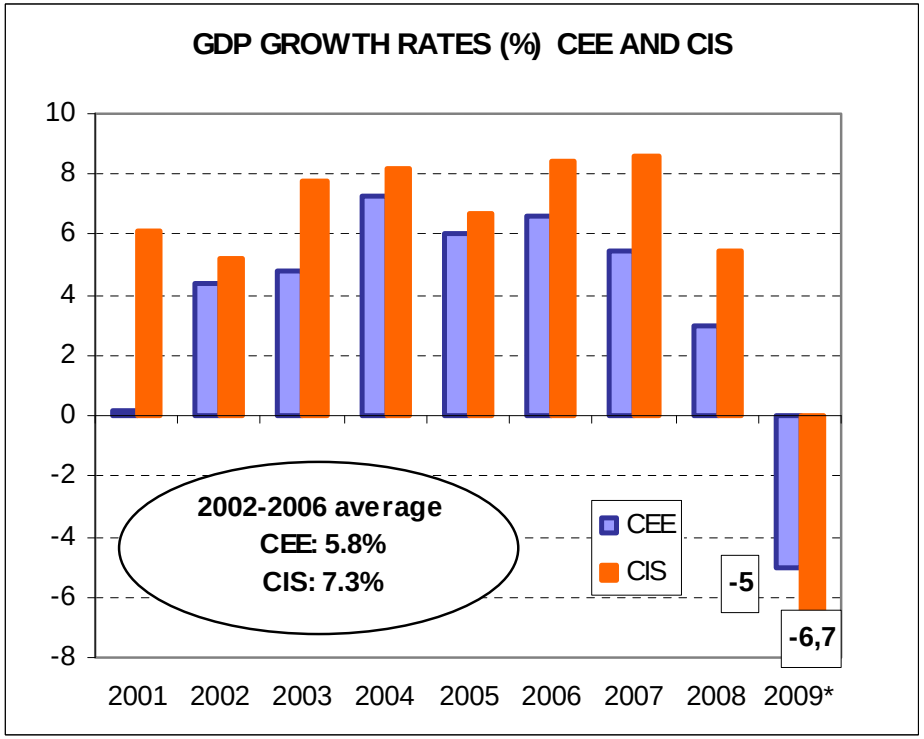
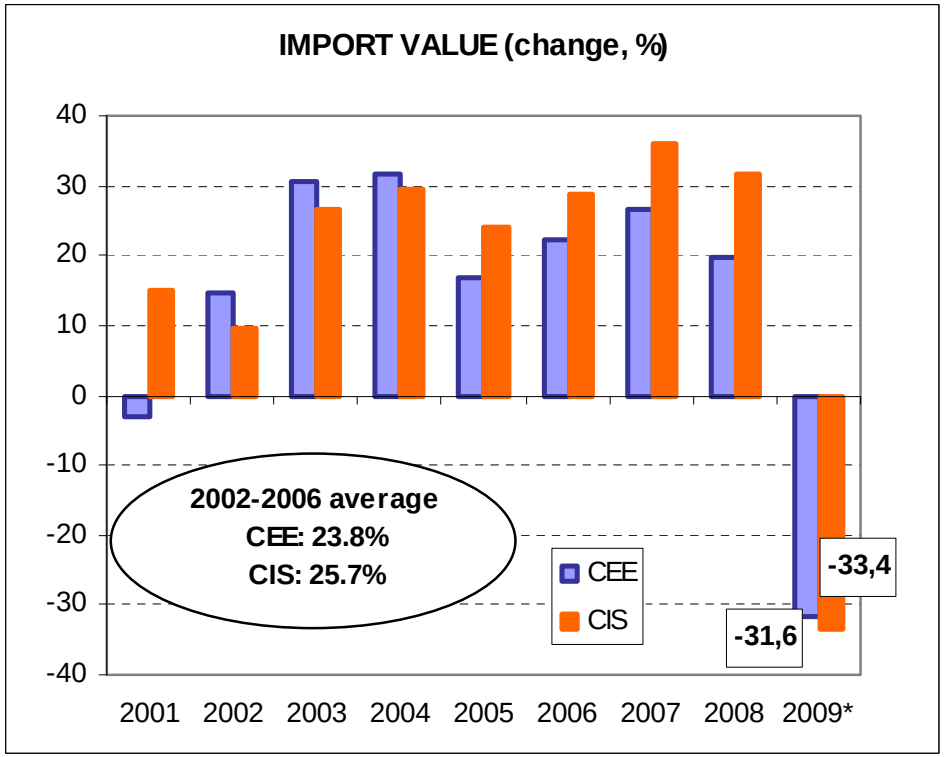
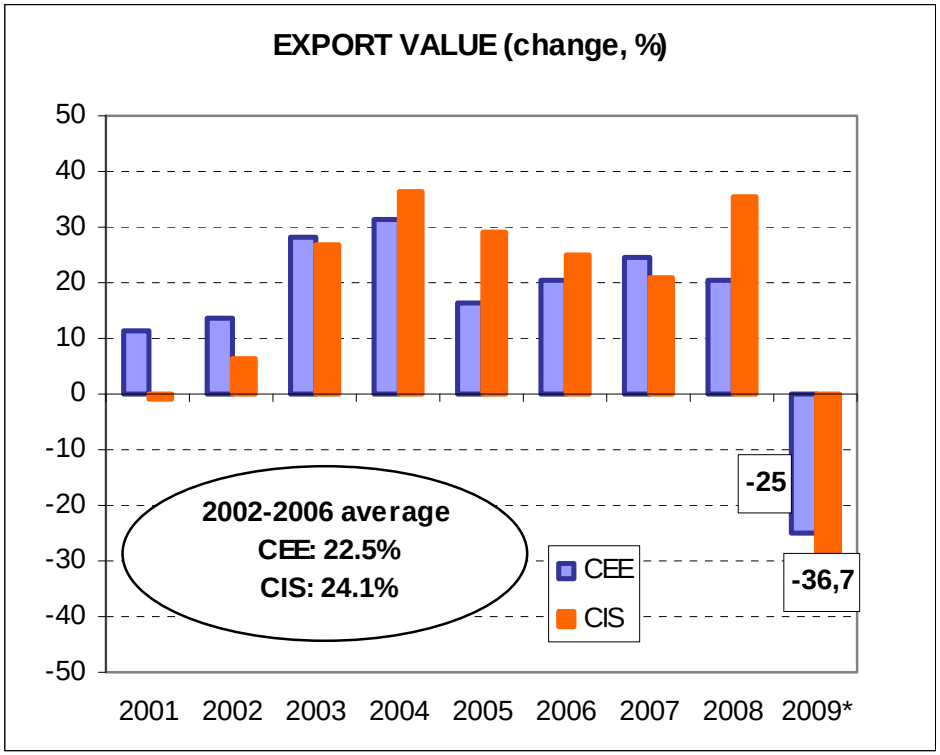



Source: IMF

# EXPORT MARKETS COLLAPSED

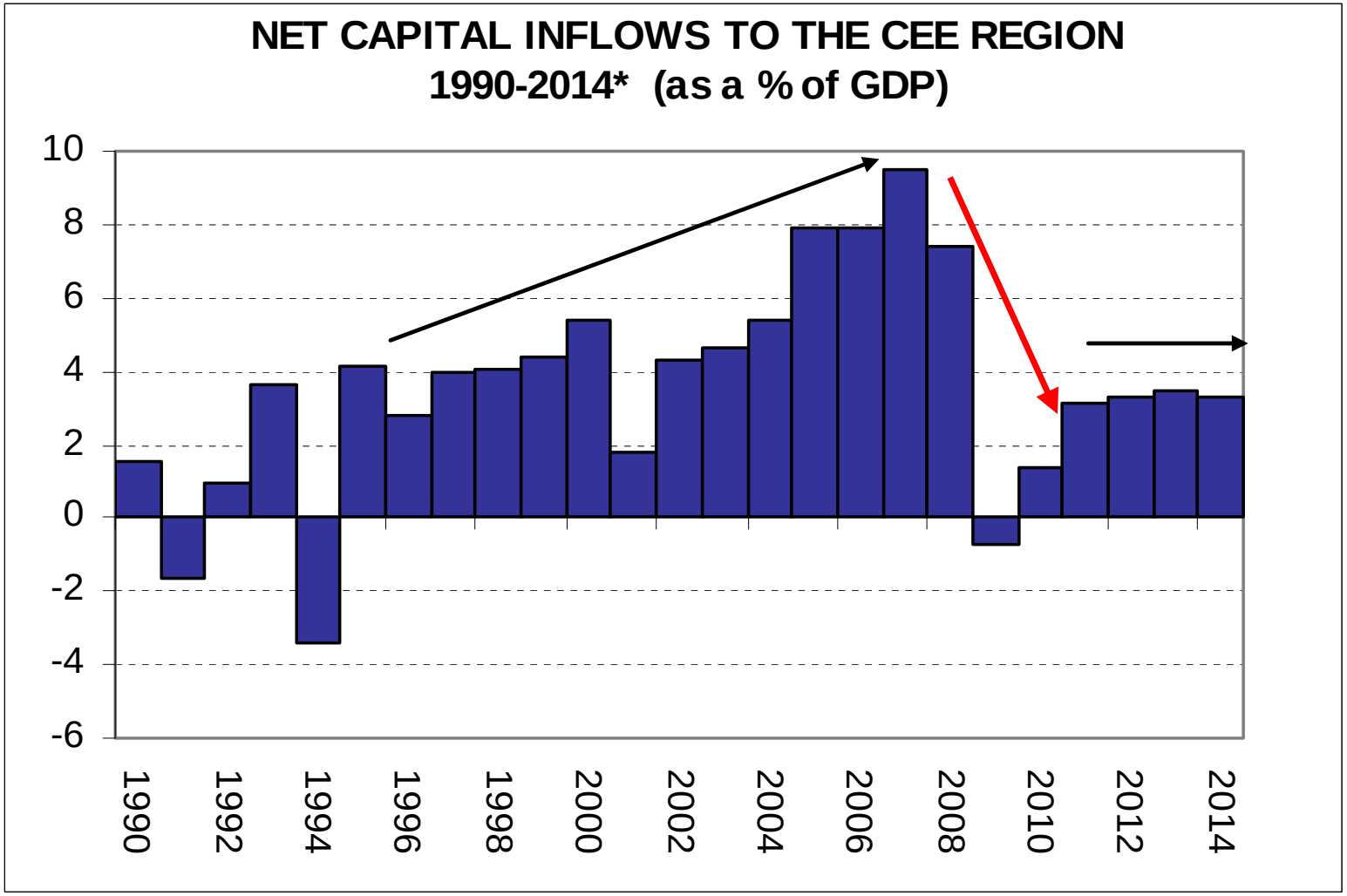



**Exports are down ~25-35% y-o-y**

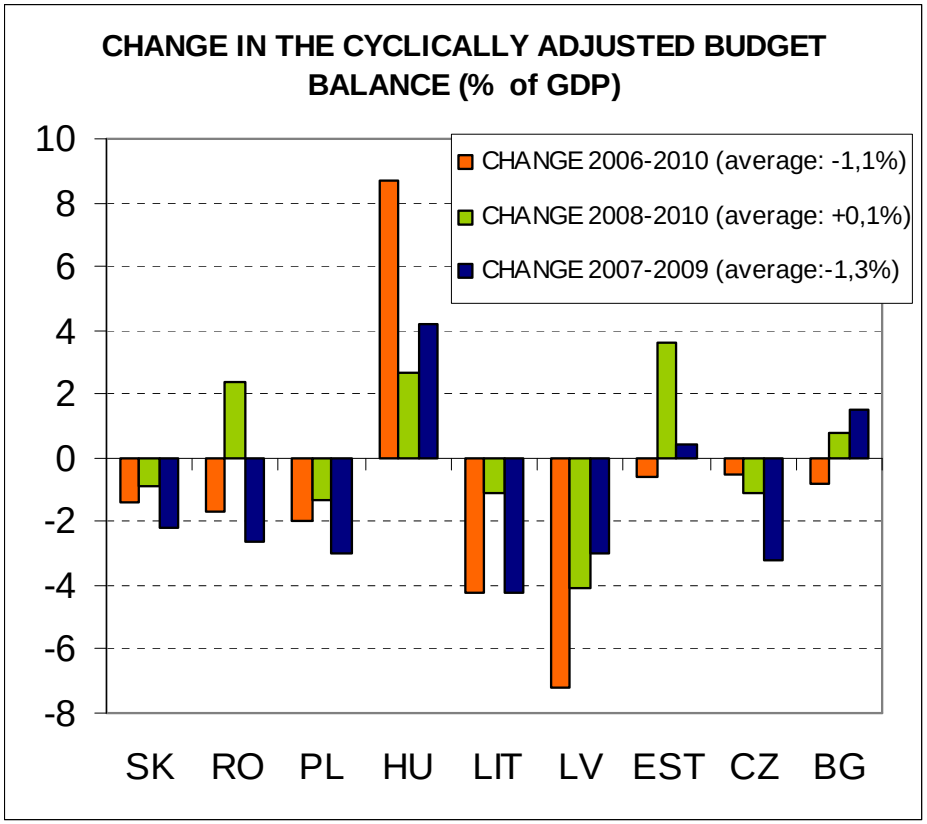
Source: IMF

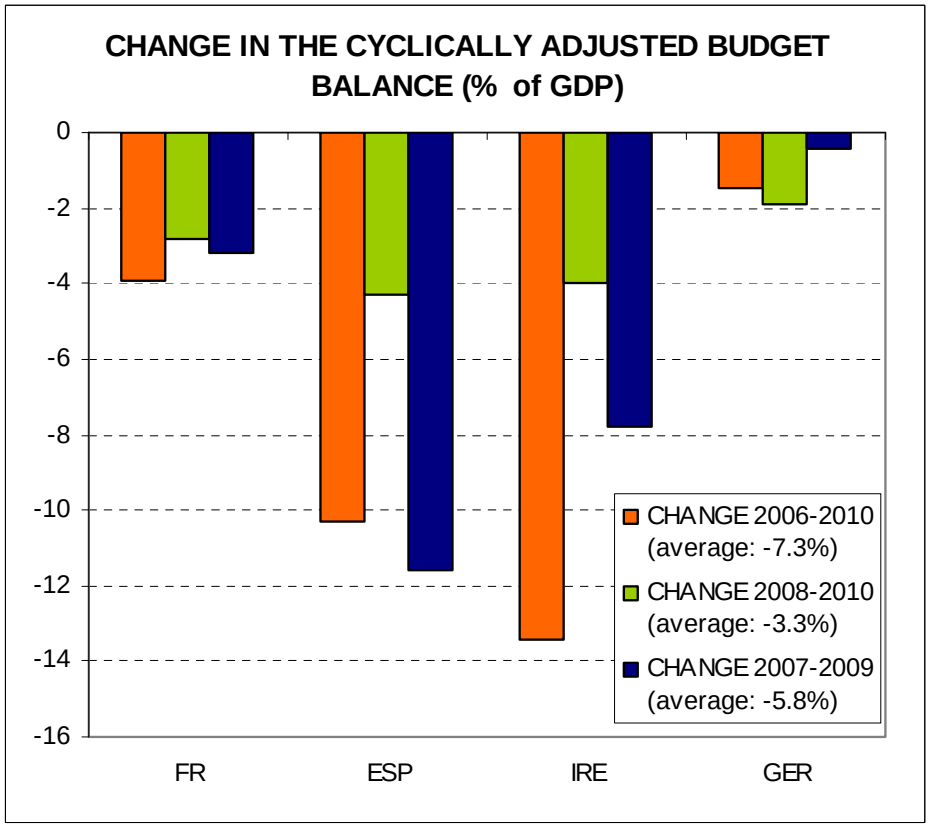
# SUDDEN STOP OF CAPITAL INFLOWS




Source: IMF, IMF sraff estimates

# FISCAL POLICIES ARE NOT ABLE TO PROVIDE A SHELTER



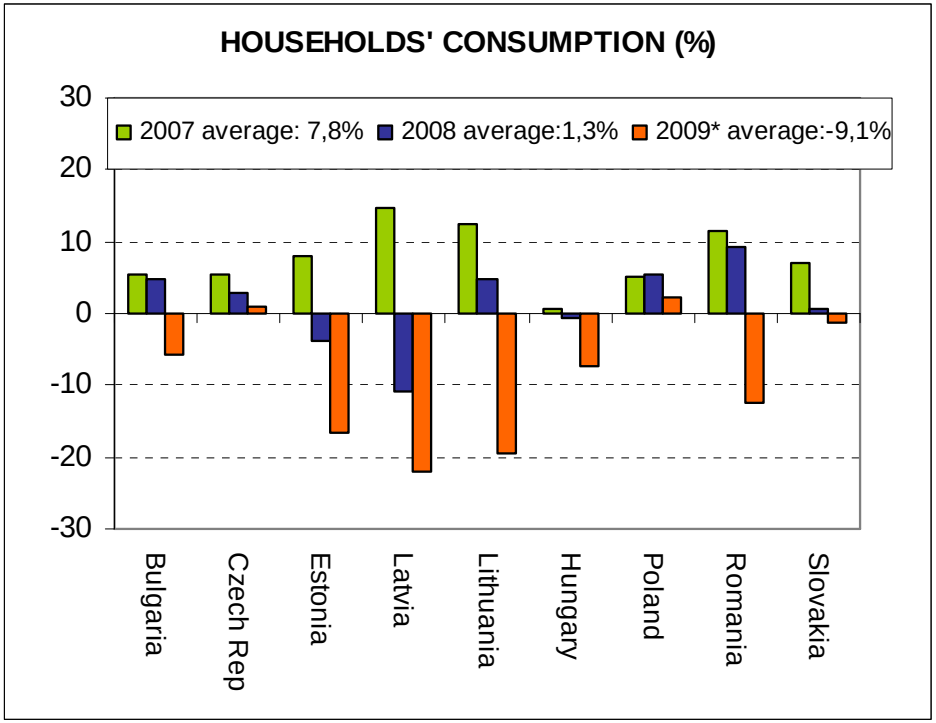

**EMU 2008-2010: -2.5%**

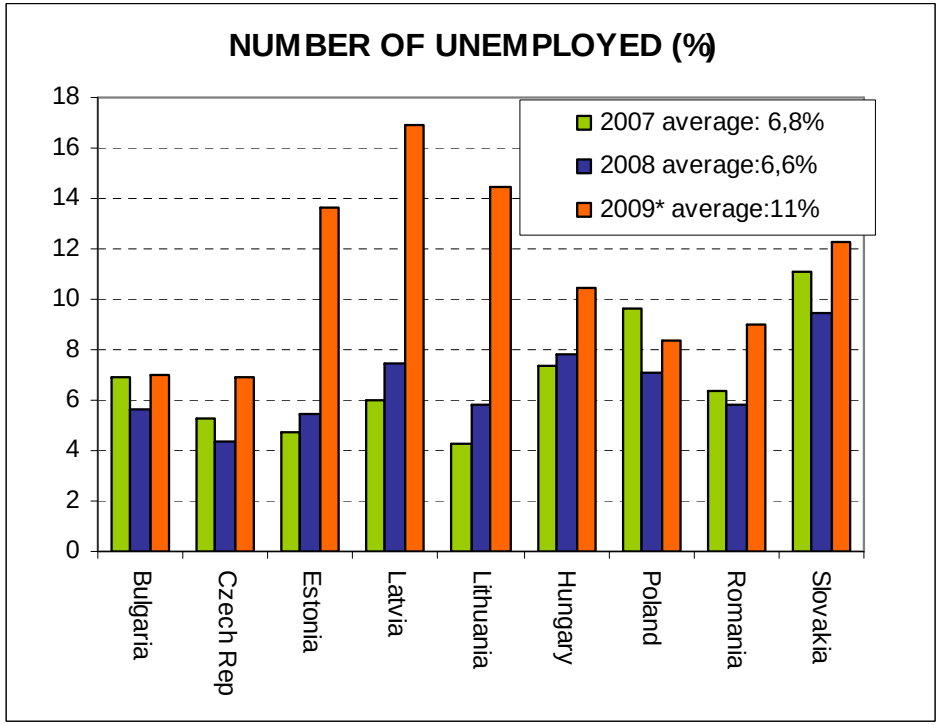
**Sustainability fears (even in case of low debt countries), the appearance of roll-over risks!**

**Fiscal policies are not in a position to give a countercyclical boost to the economy**

Source: Eurostat, Brussel Commission

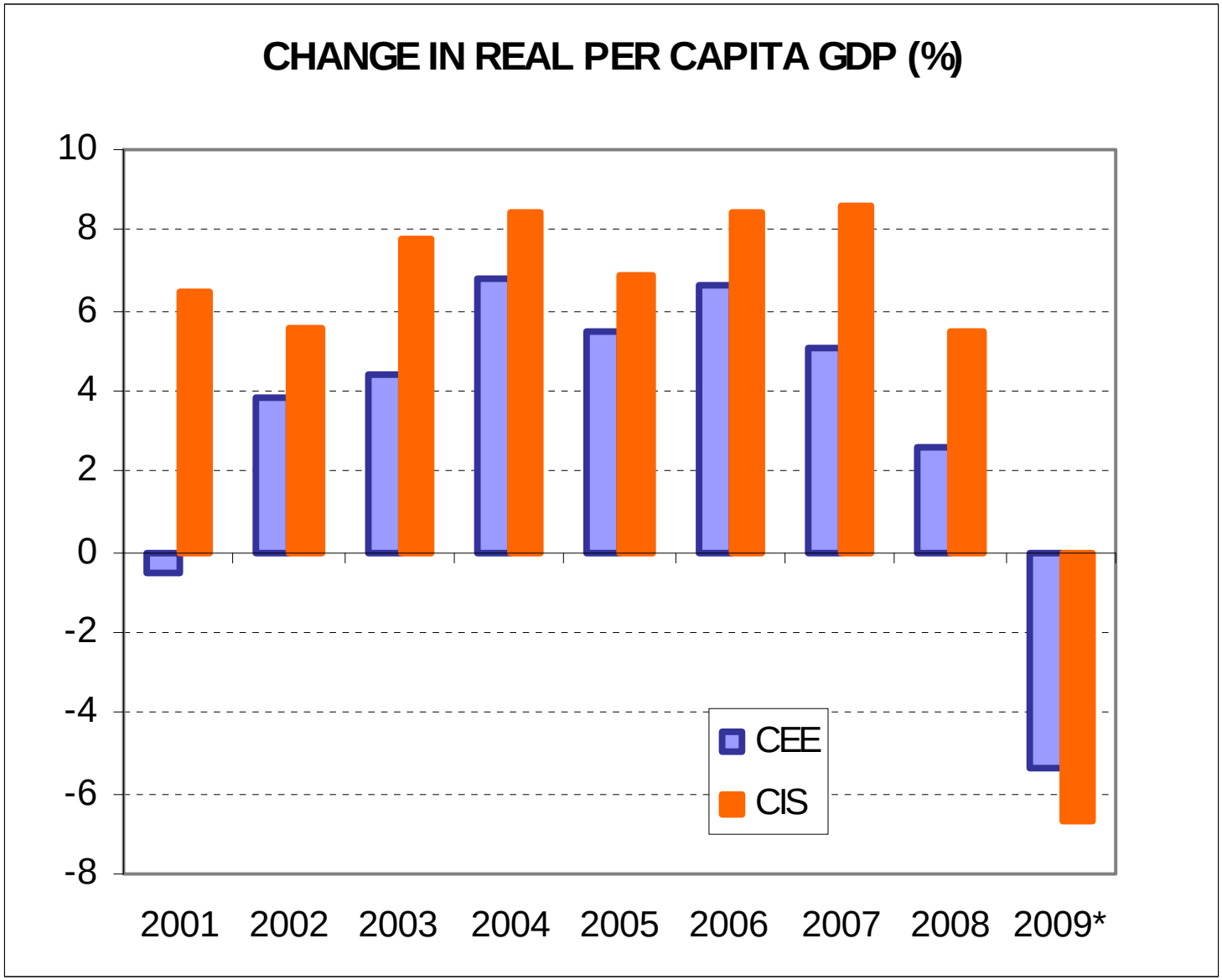
# RISING UNEMPLOYMENT, FALLING CONSUMPTION




Source: Eurostat, Brussel Commission

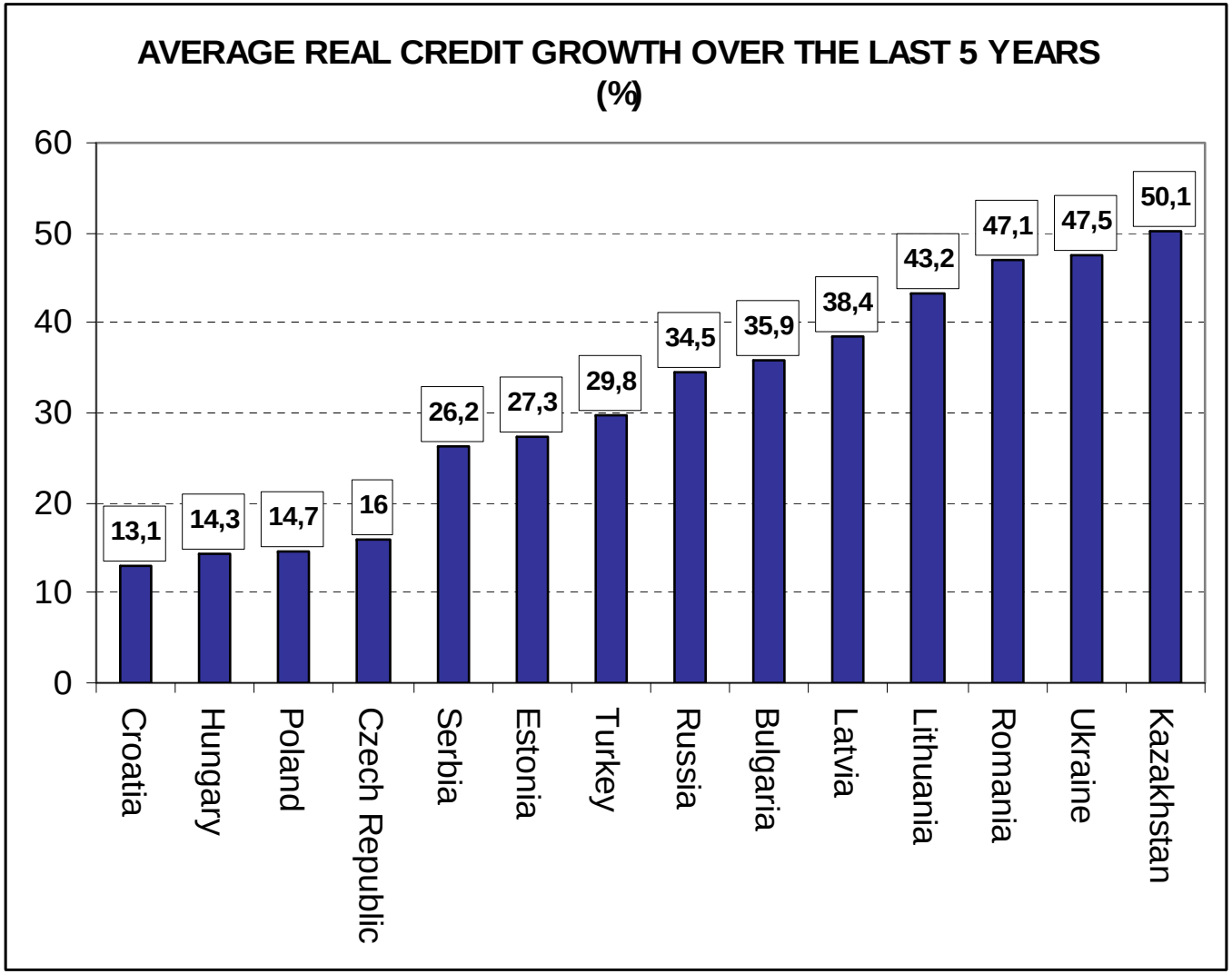
# REAL CONVERGENCE CAME TO A HALT




Source: IMF

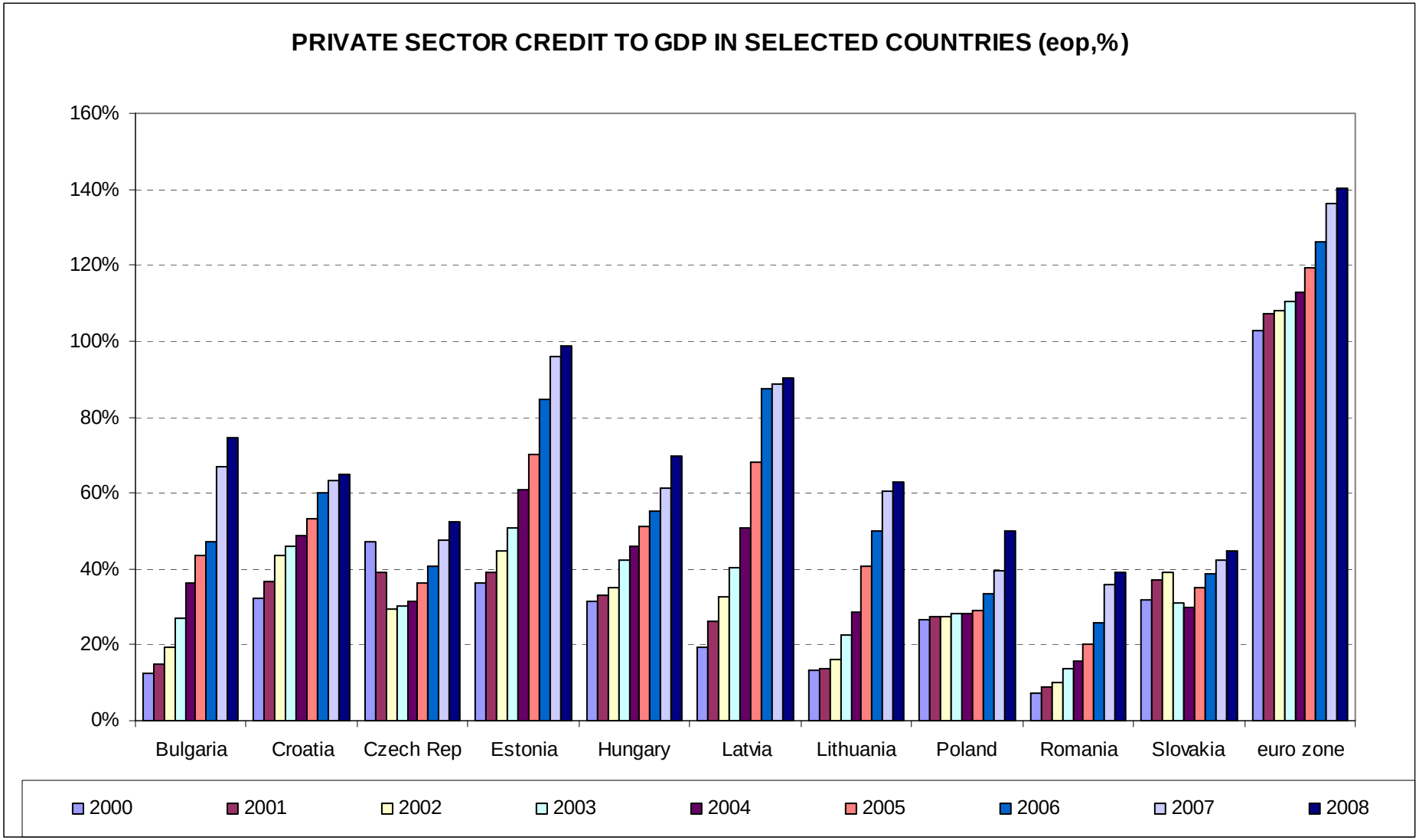
# THE BANKING SECTOR

# BEFORE THE CRISIS: STRONG CREDIT GROWTH ACROSS THE REGION



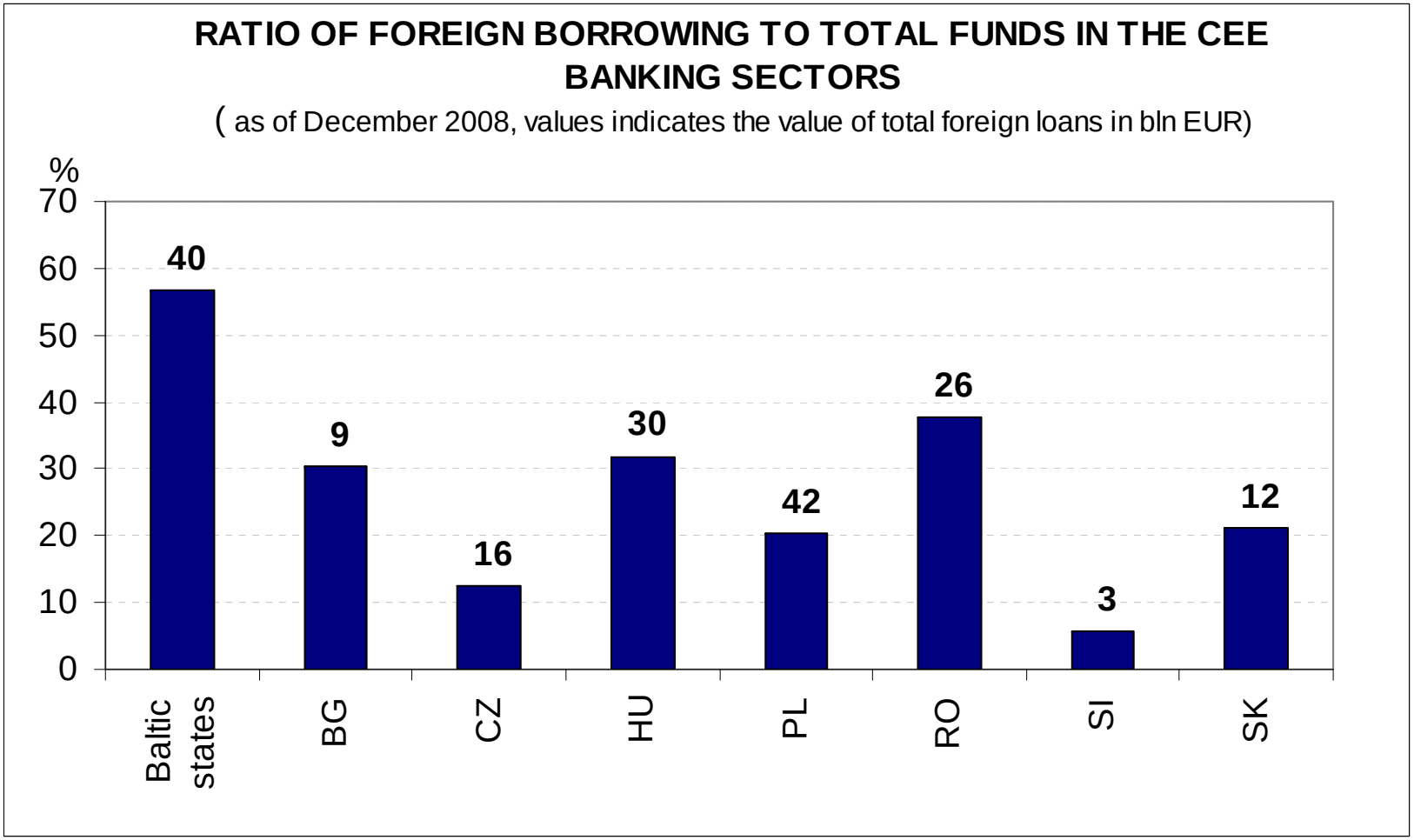

Source: IMF,2004-2008

# STILL RELATIVELY LOW LEVEL OF FINANCIAL INTERMEDIATION




Source:IMF

# THE CREDIT GROWTH WAS FINANCED BY CHEAP EXTERNAL FUNDING

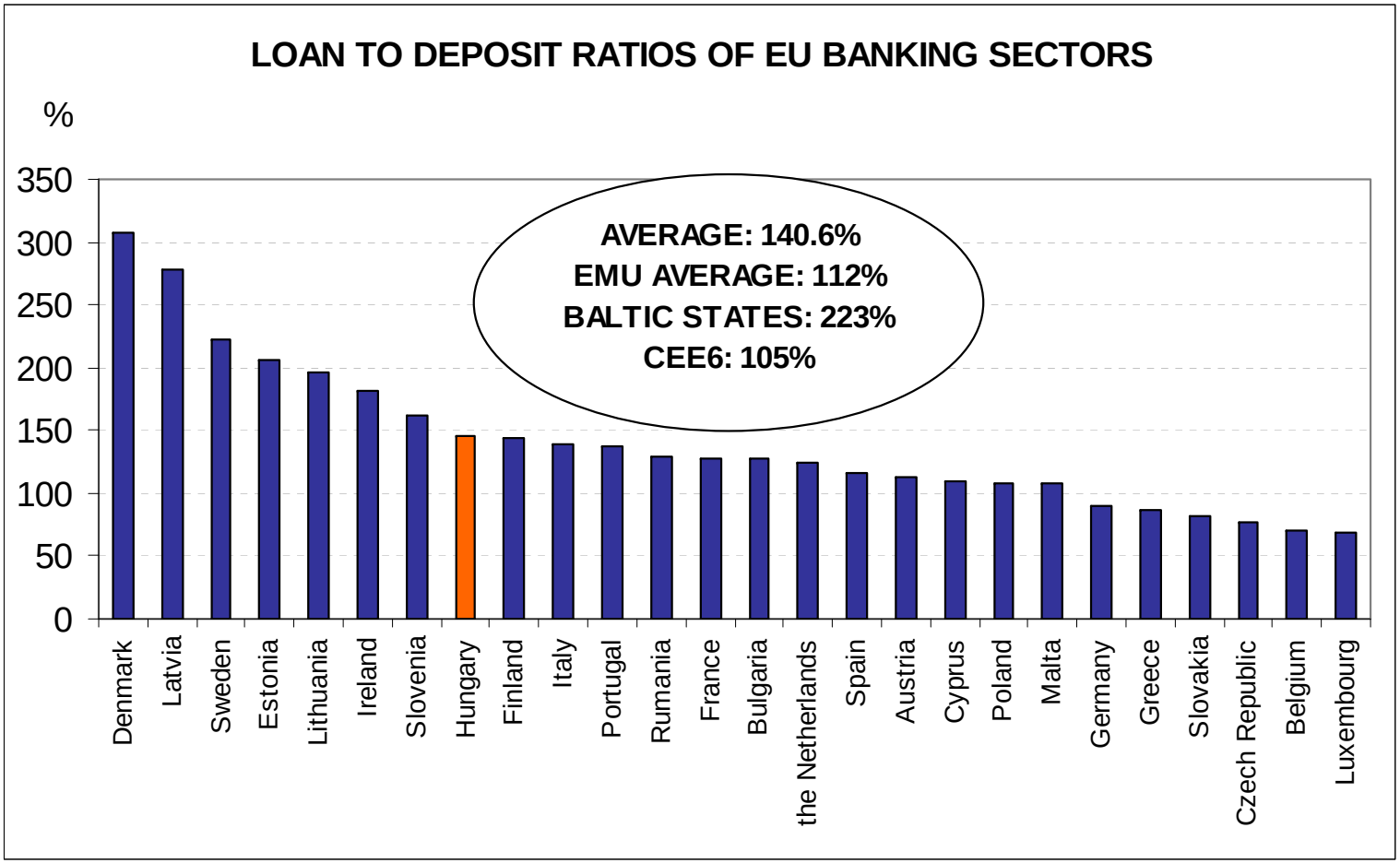



**Foreign banks play a leading role in the region**

**Foreign-controlled equity/total equity: ~70-90%**

Source: NBH

# THE CRISIS: SUDDEN STOP OF CREDIT



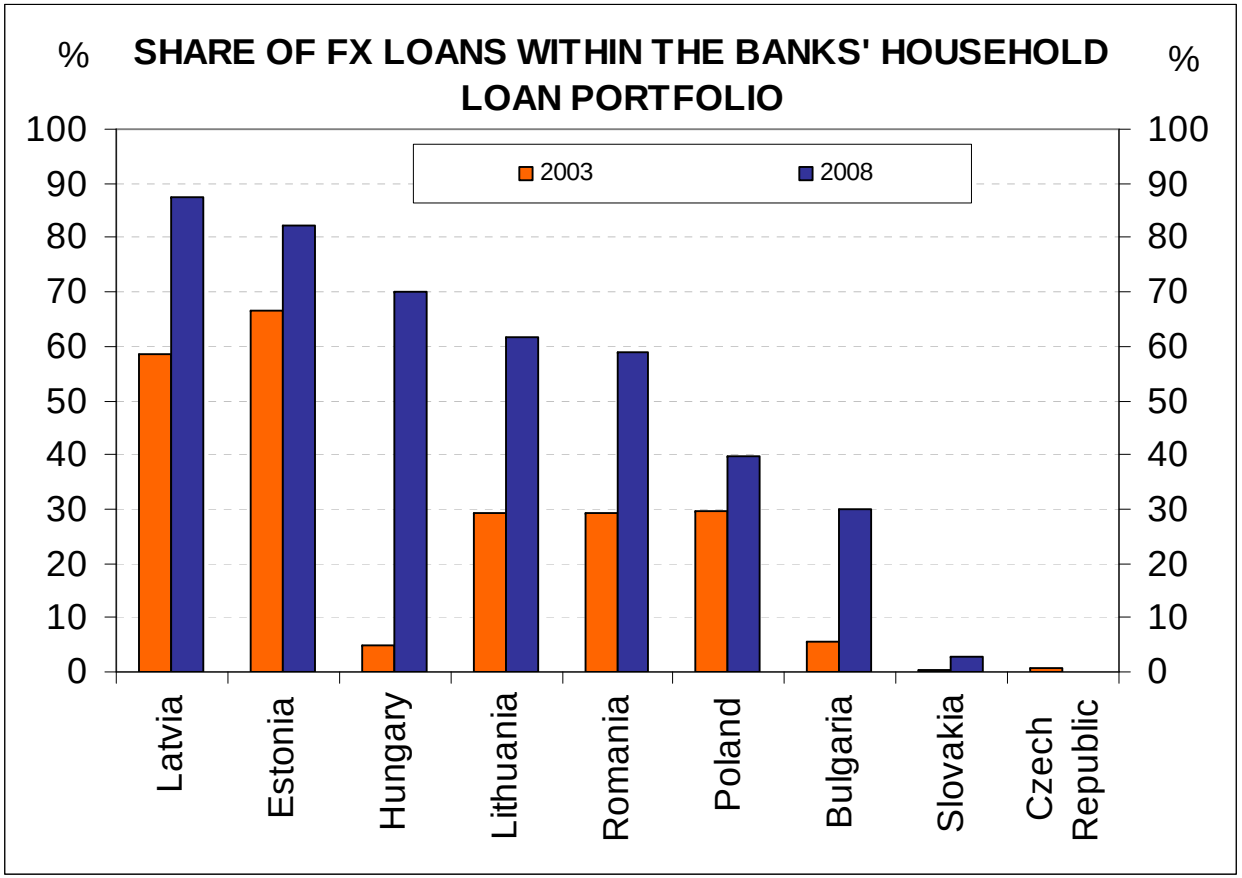

**The growth strategies built on cheap external financing are not sustainable any more**

**Domestic savings will not be sufficient to substitute external funding**

Source: ECB, NBH, data as of end-2008

**Small, open, export-driven economies, liberalized FX transaction among residents, and/or currency board or spontaneous euroization or the voluntary interpretation of IT (high interest rate differential)**

**NO LENDER OF LAST RESORT**




Source: NBH

# UNHEDGED FX POSITIONS

**A natural consequence of the permanent external deficits in the region**

**Net domestic savings were insufficient to finance investments and exports, hence external capital inflows were needed to finance the deficit.**

**The debt-generating part of the capital inflows necessarily resulted in the formation of an unhedged FX position at one or more domestic agents.**

**The balance sheet of the banking sector purely mirrors the macro imbalances.**

# THE CRISIS: IS THERE A WAY OUT?

**The region imported the financial crisis**

**Collapsing export markets: a huge shock to the real economy**

**Sudden-stop of capital inflows: financial sector shock**

**The room for fiscal maneuver is limited**

**The central banks are unable to provide the system with foreign currency liquidity**

**If –in the midst of the crisis-**

- **governments intend to improve external balances, to keep budget deficits under control,**
- **the banking sector aims for lower L/D rates,**
- **authorities, financial watchdogs demand higher capital adequacy ratios, impose limitations to FX lending**

**simultaneously, the result would be an even deeper recession**

# THE CRISIS: IS THERE A WAY OUT?

**Due to the cross –border dependencies coordinated actions are needed**

**The problems can not be solved on a national basis**

**Governments, central banks in the region should act jointly with the ECB, the European authorities, international organizations and foreign owners of the banking sector**

**Not to fund a credit boom, but**

**to create the conditions for a moderate 5-8% yearly growth rate in credit and avoid a long-lasting depression**

# DID THE EURO PROVIDE A SHELTER?

**The EUR on its own was not able to provide a shelter**

**The ECB could have helped by providing EUR liquidity to the region**

**The main issue was:**

**Whether the given banking sector had a liquidity buffer?**

**<u>Slovakia versus Czech Republic</u>**

**The Czech Republic managed the crisis well and so did Slovakia.**

**The pace of GDP contraction is similar in both countries.**

# FUTURE CHALLENGES

## Macroeconomic policies

**The external deficits that had been considered sustainable before the crisis are no longer sustainable**

**The region will not be able to return to the growth levels seen before the crisis, economies should adjust to a lower path.**

**Germany: should take over as the „final consumer" of Europe instead of pushing ahead with a purely export-driven growth strategy.**

# FUTURE CHALLENGES

## Banking sector

**L/D ratios should adjust, but it would be a mistake to target L/D at or even below 100%, as it would kill growth and convergence**

**Limiting FX based lending is acceptable only if medium and long-term domestic currency- based financing is available at a reasonable price**

**Killing FX-based lending and at the same time not providing domestic currency based financing would result in a prolonged economic stagnation**

**In an economy that is heading towards the euro, the dynamic expansion of CHF or JPY denominated loans in the household sector is clearly not a welcome development (especially if these loans are short-term instruments), but there are serious arguments supporting EUR-based lending in case of mortgages and investments**

**If the economy as a whole is on a sustainable path –primarily the external position is sustainable- the risk of the open, unhedged FX position is manageable, both on a macro and on a micro level.**