EU10 October 2008 Main Report

External Environment

The international financial crisis has intensified in early October, resulting in a tightening of interbank markets and conditions, and numerous bank failures and takeovers in developed economies. Equity prices have dropped sharply in both developed and developing countries, while volatility has increased dramatically for equities, commodities and currencies. With the global economy likely to experience a sharp economic slowdown, led by outright recessions in the eurozone and perhaps the U.S., scope is limited for smaller emerging economies dependent on exports (see In Focus: Trade Dynamics and Patterns in EU10)to sustain the recent buoyant pace of economic growth. Slower growth will have negative implications for living standards and fiscal developments. Tighter financial conditions, moreover, are likely to challenge those countries that rely most on external finance to fund growth in credit, fiscal and current account deficits. Overall, the external environment for the EU10 will remain uncertain this year and most likely, well into 2009.

Affected by the financial turmoil, tighter financial conditions and still elevated commodity prices, global growth is slowing rapidly. In the U.S., higher frequency economic indicators suggest that real GDP growth has weakened substantially since midyear, with a slower expansion likely for the year as a whole (Table 1). Output in the eurozone contracted in seasonally adjusted terms in the second quarter from the first, and further contraction is probably underway in the second half of the year.

Commodity prices appear to have peaked, but there is tremendous uncertainty about future trends. By the summer of 2008, energy and grain prices had risen some 80 percent from a year earlier in dollar terms, boosting inflation to multiyear highs in mature and emerging economies, squeezing real household incomes and consumption. Large and abrupt declines in oil and food prices since the summer peak have helped slow inflation and offer some respite to consumers. In the eurozone, consumer price inflation eased to 3.8 percent year-on-year in August after surging to 4 percent in July, well above the ECB's target of "close but lower than 2 percent."

Table 1. Economic Growth (in percent)

	Real GDP Growth			
	2007	2008f	2009f	2010f
World	3.7	2.8	1.3	3.2
U.S.	2.0	1.7	0.2	2.1
Eurozone	2.6	1.3	-0.4	1.7
Japan	2.0	1.0	-0.1	1.9

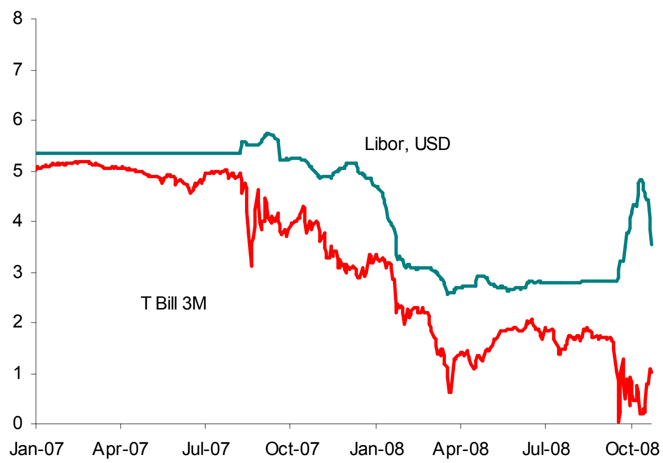
Source: World Bank, October 2008.

The turbulence in international financial markets has been extraordinary (Figure 1-Figure 4). The financial turmoil, which has its roots in declining prices for mortgage-related securities in the US due to falling housing prices and rising defaults, has spread to the broader capital and credit markets in many countries. Equity prices have fallen across the world, with declines in the larger markets ranging from above 40 percent from the start of the year in the U.S. and the eurozone to around 70 percent in Russia and China. Currencies have weakened substantially in many parts of the world and commodity prices, until recently on an oversized increase, have fallen substantially. These developments have been accompanied by rapid deleveraging, tightening of lending standards and flight to cash. With investors fleeing to the safety of U.S. government bonds, yields on short-term U.S. government securities fell in late September to a quarter of 1 percent, to recover to 1 percent a month later, while interbank rates surged to record highs relative to short-term treasury rates.

The policy response to the panic in financial markets has been dramatic. It started with two of the largest commercial banks in the U.S. being taken over by rivals with government encouragement, and the authorities in Europe taking over or prop up several large institutions. Fannie Mae and Freddie Mac, the huge government sponsored enterprises that underpin about half of U.S. mortgages, have been placed under conservatorship. Central banks have poured extraordinary amounts of liquidity in interbank markets through outright monetary ease. The result was a sudden collapse in confidence between financial institutions, with the resulting extreme evolution of interbank lending spreads, when Lehman Brothers was allowed to fail on September 15th. This has followed by the U.S. adopting a $700 billion package to buy troubled financial assets and the UK approving a £50 billion bank bailout package. Some countries like Spain and Switzerland have also taken measures to take illiquid assets off bank balance sheets; others have focused on providing support to bank liabilities, either directly through massive use of the central bank balance sheet or indirectly through new bank debt guarantees (e.g., Spain, UK, USA, France, Ireland, Netherlands, Sweden, Australia and Korea), while some have been injecting equity into the banking system (e.g. Switzerland, Netherlands, UK, Germany, France). By the time of the writing the total estimated cost of interventions of all natures across developed economies amounted to approximately $8,600 billion, half of which to be attributed to the U.S.

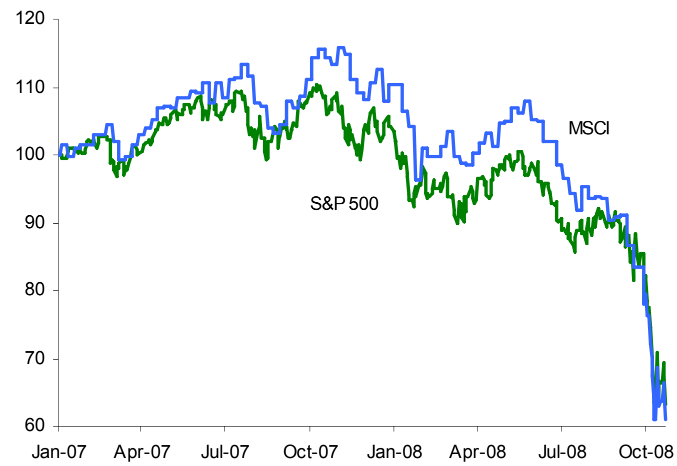
In order to secure depositors' trust and prevent the bank-run, an increase in the insured deposit limits has been implemented as a priority across all the euro zone countries and the U.S. The U.S. has temporarily raised the limit for insuring bank deposits to $250,000 from $100,000. The EU countries have been increasing the minimum limit for insuring bank deposits to €50,000 from €20,000. Several EU countries, including Germany, Ireland, and Greece, followed by some new member states (like Slovenia), have moved to protect all bank deposits.

Figure 1. 3-month US Treasury Bill and 3-month LIBOR (in percent)



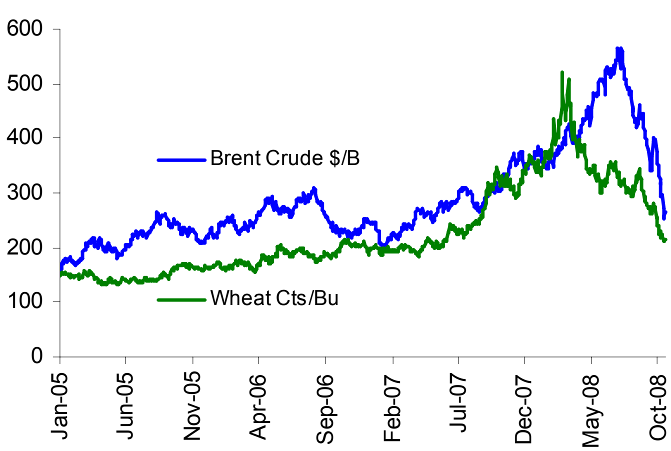
Source: Reuters

Figure 2. Equity Prices, S&P 500 and MSCI (January 2007=100)



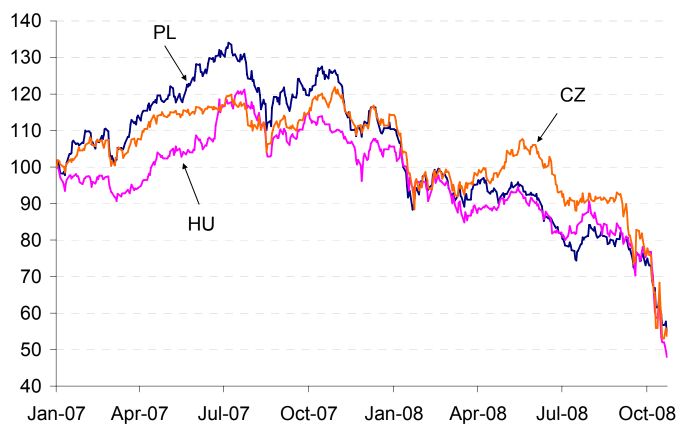
Source: Reuters

Figure 3. Food and Petroleum Prices (index, 2000=100, US$, and dollars per barrel)



Source: World Bank, GEM database

Figure 4. Stock Exchange Index (Jan 2007=100)



Source: Reuters.

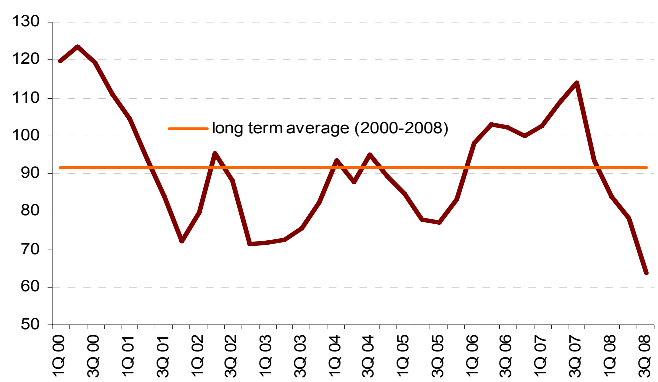
Further consolidation of the banking system, as banks will need to increase capital ratios; along with the regulatory framework strengthening could be expected in the near to medium term. This would parallel the likely surge in government debt issuance needed to finance banking sector rescue packages and broader efforts at fiscal support (See Fiscal Policies). Demand for 'safe heavens', i.e., carry-trade currencies like the Swiss franc, the yen or the dollar is picking up creating a concern for some central banks. In case of the Swiss franc, the currency has hit its highest level since early 2003 against the euro.

Implications of the Financial Turbulence for the EU10

The EU10 countries' monetary authorities and government have been prompt to adopt appropriate measures in a response to recent global financial turmoil. Following the euro zone countries' emergency meeting in Paris on October 12, a number of pan-European measures aimed at recovery of the battered financial sector was adopted and the EU10 countries followed suit. In addition to increasing insured deposits' limit generally towards €50,000 (except Lithuania to €100,000 or unlimited in Slovenia), measures taken by the central banks have been mostly focused on ensuring appropriate liquidity conditions for financial institutions through FX credit lines and swaps, reversed repo auctions, including with state bonds as collateral, enhancing cooperation with parent supervisors and ensuring readiness to facilitate the funding of the banks in case the international inter-bank market remains frozen in 2009 (i.e. Slovenia will set aside €8 billion for credit institutions refinancing if the market situation does not improve; Bulgaria, Hungary, Lithuania and Romania have contingency plans as well).

The full impact of the financial turbulence on the EU10 is yet to be realized and substantial uncertainty remains, given the rapidly changing international environment and rapidly changing macroeconomic and financial conditions. The direct impact on the EU10's financial systems through exposure to "toxic" securities appears to be nil. Banks in the EU10, moreover, are owned by foreign banks, most of which do not appear to have been affected seriously by the crisis. The indirect effect is likely to be substantial, however, through the slowdown in global demand for EU10's exports, the tighter financial conditions and the possibility of contagion. Countries with large external financing needs, notably the Baltics, Bulgaria, Romania and Hungary, will be experiencing tighter external financing conditions.

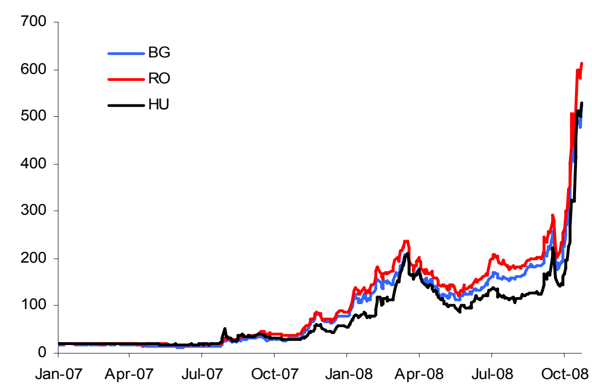
Figure 5. Ifo Economic Climate for the Euro Area



Source: Ifo Institute.

Notes: Arithmetic mean of the judgment about the present and expected economic situation

Figure 6. Credit Default Swaps, Bulgaria, Romania and Hungary (in basis points)



Source: Morgan Markets

Given the integration of the EU10 countries in global product and financial markets, the financial turmoil has spread quickly to the region. Credit default swaps (CDS) widened by most in the Baltic countries, Bulgaria, Romania and Hungary. In Latvia, for example, the 5 year CDS rose to over 900 basis points. Similarly, spreads on foreign currency denominated bonds have also risen substantially. Some countries in the region are also experiencing a shortage of liquidity reflected in sharp increases in interbank rates. Latvia's overnight interbank rate more than doubled in the first two weeks of October; while the lat remained at the lower end of its 1-percent band against the euro. The 3-month interbank rate surged to 14.6 percent in Romania in the same period (Figure 5-Figure 8). The repricing of risk and withdrawal of foreign investors has caused equity markets to plummet. Equity prices were down by an oversized 22-25 percent in September in Bulgaria, Romania and Hungary to be falling further to three- and four-year lows in other EU10 countries as well during October. The decline in equity markets throughout the EU10 countries has also reduced household wealth, but the relatively small size of equity markets and the rather concentrated ownership among wealthier domestic investors should limit the impact on overall household spending.