

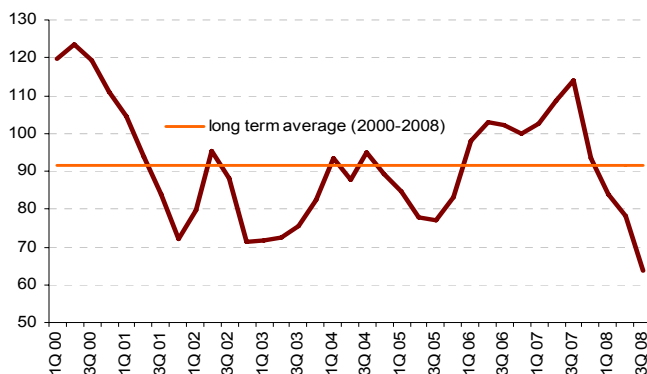
franc, the yen or the dollar is picking up creating a concern for some central banks. In case of the Swiss franc, the currency has hit its highest level since early 2003 against the euro.

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.

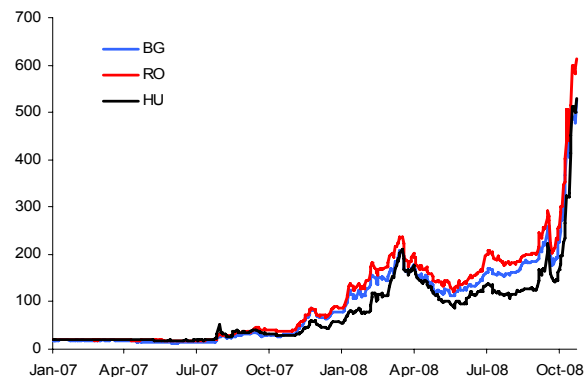
Figure 5. Ifo Economic Climate for the Euro Area



Source: Ifo Institute.

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

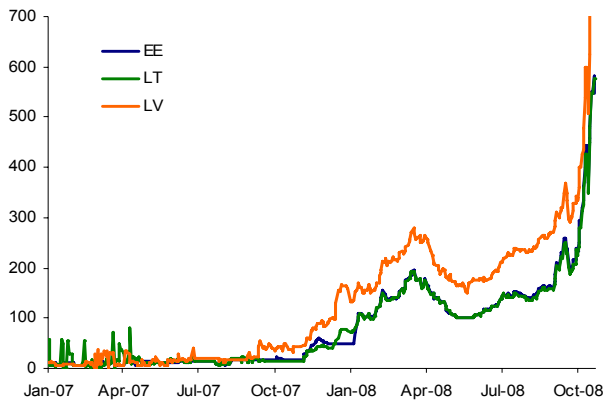
Figure 6. Credit Default Swaps, Bulgaria, Romania and Hungary (in basis points)



Source: Morgan Markets

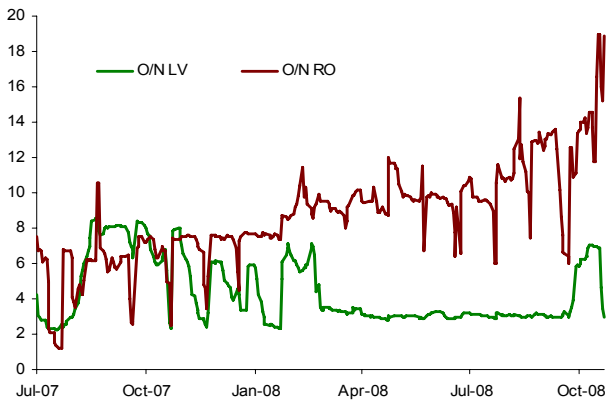
Given the integration of the EU10 countries in global product and financial markets, the financial turmoil has spread quickly to the region. Credit default swaps (CDS) widened by most in the Baltic countries, Bulgaria, Romania and Hungary. In Latvia, for example, the 5 year CDS rose to over 900 basis 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.

Figure 7. Credit Default Swaps, Baltics (in basis points)



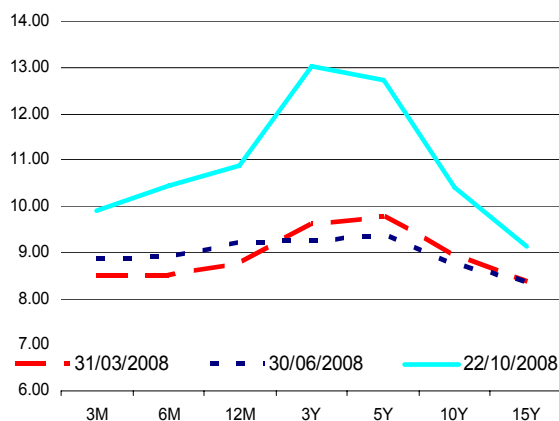
Source: Morgan Markets

Figure 8. Interbank Rates, Latvia and Romania (in percent)



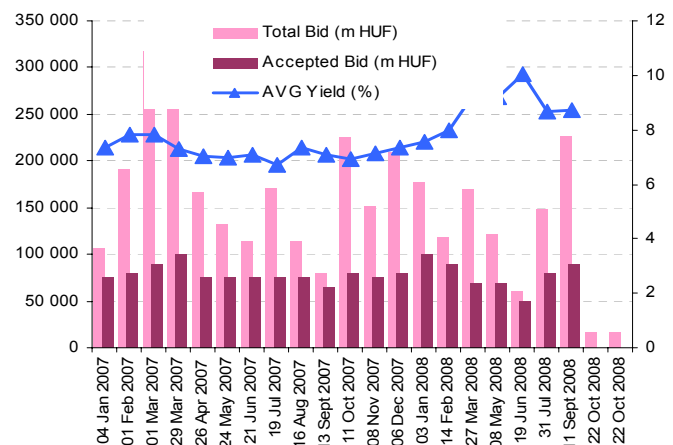
Hungary has so far been the worst affected, although it has not been perceived as the most vulnerable country in the region. Despite subsequent reductions of its budget deficit and external financing needs, the economy's strong reliance on export growth to the EU and the high share of FX-denominated private sector credit stock are key weaknesses in the current environment of high risk aversion and global slowdown. While Hungarian gross external debt reached 100 percent of GDP, the net external exposure was only 54 percent of GDP in Q1 2008, significantly less than in Latvia, Estonia or Iceland (270 percent). Furthermore, short-term debt amounts to only 10 percent of Hungarian external debt and it is fully covered by the FX reserves. It is the strong demand for FX funding (particularly Euro and CHF), caused by a maturity and a currency mismatch in the banking sector, that remains a concern. Hungary, like some other countries, suffered from the global CHF liquidity shortage, which has created pressure on the liability side and increased local investors' concerns about the future ability of Hungarian banks to provide less-costly loans in Swiss francs (see Box 1). While the equity market collapsed following the global trend, the liquidity has dried up in the bonds market with the forint depreciating by more than 13 percent m/m versus Euro. Yields have reached unrealistic, fundamentally unjustified levels, due to the lack of demand for the government papers, including from foreign investors that have reduced their exposure to government bonds below the usual value of Ft 3,000-3,400 billion. The yield curve edged up as compared to end of June, in particular in 3Y segment (Figure 9).

Figure 9. Hungary: yield curve



Source: Reuters

Figure 10. Hungary: 3-year govt bond auctions



Source: AKK

The Hungarian government and the central bank have taken bold steps to stabilize situation and regain market confidence. In the short term, the National Bank of Hungary (NBH) focused on resuscitating the markets that have not been functioning properly in recent days (including the FX swap market and the government bond market); it introduced the two-way daily O/N FX swap tenders and overnight FX-swap facility providing euro liquidity (under an agreement with the European Central Bank). Moreover, NBH signed an

agreement with primary dealers of government securities and offered to provide liquidity in the form of secured loans to banks and primary dealers in the exchange of continuous bid-offer prices at the stock exchange for all publicly issued forint-denominated government securities. The NBH has also introduced two new lending facilities: a weekly tender for two-week, fixed-rate secured loans, without a limit on the amount; and a regular tender for six-month, variable-rate secured loans, for a pre-specified amount. At the same time, the government prepared the plan aimed to push the fiscal deficit below 3 percent of GDP in 2009, as well as is concluding its new arrangement with the IMF.

The recent problems experienced by the Hungarian economy and the sell-off on the financial markets have caused a dramatic increase in risk aversion towards the region. As a result, yields have increased significantly over the last two-three weeks, reaching record highs. In addition, the bond market in Poland and Czech Republic is facing liquidity problems and an outflow of the capital in investment funds. In an attempt to support the bond market and to prevent other negative consequences from the global financial crisis, the Czech National Bank (CNB) started reverse repo operations with government bonds as collateral.

Box 2. FX borrowing vulnerabilities

As a result of the global crisis, some of the well-known vulnerabilities of EU10 financial markets have been exposed. For examples, in a number of countries in the region (Baltic countries, Hungary, Romania, and Bulgaria), foreign currency loans were very popular, in particular in the euro and the Swiss franc (see Figure 11 and Figure 12). In the light of the rise in external credit spreads and the increased risk of a sudden-stop external financing, policy makers in the region responded quickly with a wide range of measures aimed at restoring confidence and enhancing liquidity on the interbank markets. Eligibility criteria for new loans have also tightened and lending in foreign currencies in some instances has been cancelled. Additionally, both at the EU and national level, higher guarantees of bank deposits were introduced in order to ensure an adequate deposit base. In particular, the latter was important in countries with relatively high loans-to-deposits ratios (see Figure 13).

Figure 11. Contribution to real credit growth in 2002-2007, (in percent)

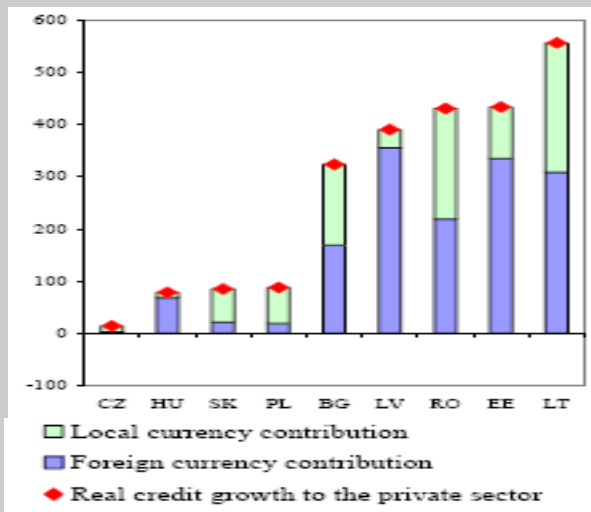
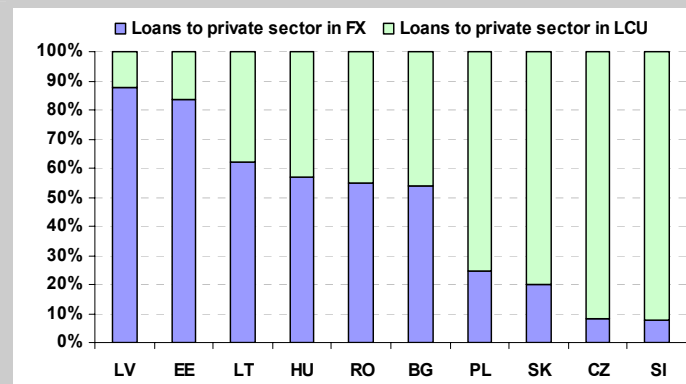


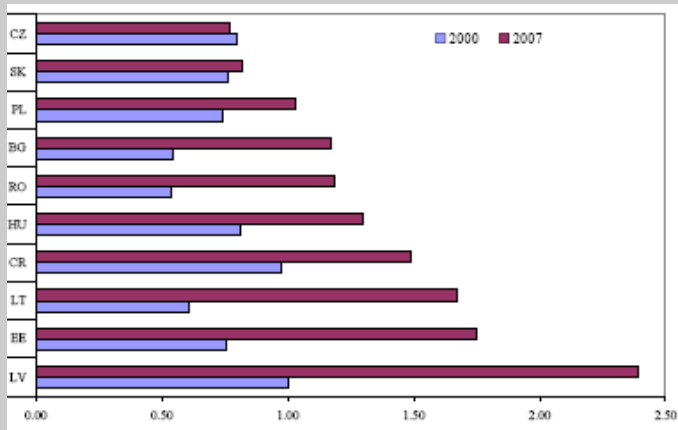
Figure 12. Currency structure of bank loans to the private sector in the EU10 in 2Q 2008



Source right-hand chart: Central Banks
 Source: Rosenberg C., Tirpák M. Determinants of Foreign Currency Borrowing in the NMS of the EU, IMF Working Paper, July 2008.

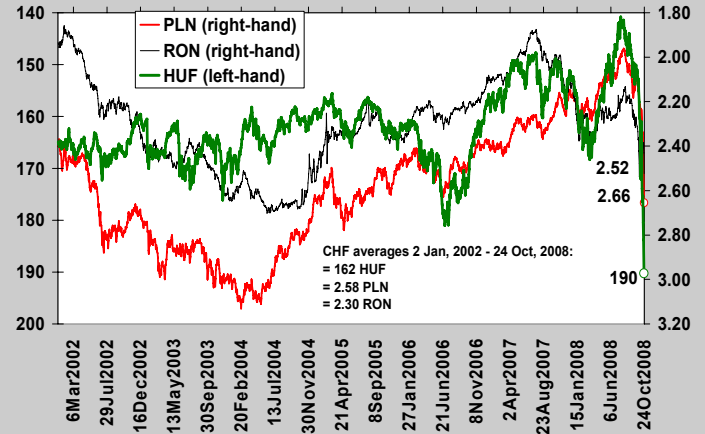
For some countries with flexible exchange rate regimes, the recent depreciation of local currencies, may not lead to as large a relative increase in debt servicing costs as the rapid reversal of market sentiment in the EU10 may suggest. For examples, on 24 October, 2008, the Polish zloty was only 3 percent weaker against the Swiss franc compared to its average level since 2002. The RON and HUF, however, were not that close long-term average - 9.5 and 17.5 percent weaker, respectively (see Figure 14). Nevertheless, after a time of extraordinary gains resulting from local currencies' appreciation against "hard" currencies, many households are exposed to the risks of unhedged currency positions. However, the exposure of the banking sector may be more limited as they tend to be backed relatively well by collaterals that are still priced above original values.

Figure 13. Loan-to-deposit ratio in the EU10



Source: Rosenberg C., Tirpák M. Determinants of Foreign Currency Borrowing in the NMS of the EU, IMF Working Paper, July 2008.

Figure 14. HUF, RON, and PLN exchange rates against CHF in Jan 2002-24 Oct, 2008



Note: reverse scale - decline denotes LCU depreciation
 Source: EBC data, staff calculations.

As argued below, weaker demand abroad and the ongoing financial turbulence will contribute to slowing output growth in the EU10. This will put pressure on fiscal balances, in many countries after years of running pro-cyclical fiscal policy. It is important for the authorities to begin reversing the pro-cyclical tendencies in fiscal policies. At the same time, governments should be careful not to widen fiscal deficits by more than investors will be ready to finance and deem sustainable at a time of more negative investor sentiment. Governments should also be careful not to adjust spending by cutting social transfers indiscriminately at a time when slower growth will clearly weigh on living standards, especially in the poorer countries and more disadvantaged regions. At a time when citizens are coming under pressure from the increased share of outlays on food in household budgets (given the earlier increase in food prices) and weaker economic activity, governments will be well advised to sustain, and where needed, better target social safety nets.

There may be some scope for monetary easing in some countries to alleviate the impact of the turbulence should liquidity issues begin to emerge. Such issues have not appeared thus far. Scope for monetary easing will be larger in countries that have been able to control better inflation thus far.

The global slowdown will put economic fundamentals at test and will penalize the slow reformers of the past the most. The time of low borrowing costs, high foreign investment, rising tax revenues and higher living standards will now have to be replaced by some painful decisions to reform public finances; increase labor force participation rates, particularly by penalizing early retirement; improving productivity by modernizing education; reducing red tapes and improving governance and investment climate.

Output and Demand

The pace of economic activity has slowed this year in all countries of the region except Romania, reflecting a combination of weak external demand and sluggish domestic spending (Figure 15). The latter is due to the surge in consumer price inflation earlier in the year and the tighter financial conditions that led to slow growth in consumer credit. The slowdown in activity among the EU10 has been led by outright contractions in output in Estonia and Latvia, as measured on a seasonally adjusted basis. From a year earlier, real GDP contracted by 1.4 percent in the second quarter in Estonia and growth was barely positive in Latvia, in both countries reflecting a broad-based decline in activity following an earlier period of overheating. The slowdown has been more moderate in Lithuania so far.