Building resilience to global economic shocks in the Czech Republic, Peru, and Kenya

While the recent global economic downturn did not spare many developing countries, they were more resilient to the 2008 global crisis than to previous crises. The East Asian countries managed systemic risk especially well, but the performance of several countries in Central Europe, Latin America, and Sub-Saharan Africa has also been remarkable. The experiences of three of them—the Czech Republic, Peru, and Kenya—offer two main lessons. First, pursuing macroprudential policies in good times, while continuously strengthening the domestic financial system, is key to building resilience to severe economic downturns. Second, timely countercyclical macro policies not only help manage macroeconomic and financial cycles after crises hit but also boost preparation by building or preserving the necessary resources (fiscal space) to respond to a crisis.

A difficult period of reform

The Czech Republic started building stronger foundations for aggregate risk management following major lessons learned from the 1997–98 banking crisis. In 1997 the country abandoned its fixed exchange rate regime in favor of a monetary policy framework based on inflation targeting. In part thanks to its increased financial and political independence, the Czech National Bank managed to increase the credibility of monetary policy and achieve greater price stability. These achievements translated into low interest rates that, along with better fiscal discipline, helped the country maintain a sound external position, which benefited from a trade surplus and a modest current account deficit.

In addition to the strengthened policy framework, the Czech banking system was able to finance its lending activities mainly from local deposits and extended loans to households in domestic currency. Thus borrowers avoided unhedged exposures in foreign exchange, and the banks avoided the associated indirect credit risk.

Starting in 2006, all microprudential regulators were integrated under the Czech National Bank, which was already the monetary authority and macroprudential supervisor. Bringing microprudential and macroprudential supervision under one institution enabled the Czech Republic to conduct prudential supervision in a more comprehensive manner and to better monitor how the risks from individual financial institutions translate into systemic risk in the financial sector. Integrated financial sector supervision should also bring improvements to the coordination and timeliness of policy response in future crises.

Unlike the Czech Republic, until 2008, Peru had not been hit by a major economic turmoil for almost two decades. But until the late 1980s, the country experienced hyperinflation, severe macroeconomic imbalances, and massive capital outflows. In the 1990s, Peru put in place key reforms to stabilize the economy. It brought hyperinflation under control through explicit targets on the monetary base. Once inflation was reduced to single digits, the central bank adopted an inflation-targeting regime with a flexible exchange rate that kept inflation in check. The tax system and the financial sector were reformed. As a byproduct of these reforms and to safeguard against regional contagion from crisis episodes in emerging markets, banks built up adequate levels of capitalization and sufficient levels of liquidity.

Peru liberalized foreign trade in the early 1990s, drastically reducing tariff rates and eliminating nontariff barriers. A more favorable economic environment from 2002 to 2007 fueled economic growth. Increasing demand for the country's commodities (mineral ores and metals) from large dynamic emerging markets in East Asia produced a large positive income shock. Peru saved part of the revenues from natural resources. International reserves grew to the equivalent of more than 17 months of imports in 2007, and the fiscal primary surplus increased. Sustained annual gross domestic product (GDP) growth of nearly 7 percent from 2002 to 2008 helped reduce poverty. In light of these macroeconomic achievements, the international rating agencies upgraded Peru's sovereign rating, paving the way for major foreign investment.

Like Peru, Kenya successfully built resilience by strengthening both its financial and macrofiscal systems. Although it did not have to deal with a specific economic crisis before 2008, its economy was in trouble during the 1980s and early 1990s, after experiencing two decades of high growth. From 1991 to 1993, Kenya's GDP growth stagnated, agricultural production sharply contracted, and hyperinflation flared. The government decided to implement economic reforms to stabilize the financial sector and regain sustainable growth. The banking system was strengthened, notably through substantial capitalization of the banks, and access to finance for the population was improved. Kenya also managed to decrease its public debt and accumulate high international reserves (up to four months of import coverage) by adopting prudent fiscal policies and maintaining a healthy external position, with strong surpluses in the service balance (mainly tourism and information technology) and massive inflows of foreign capital that compensated for the trade deficit.

The benefits of good preparation

The relatively strong resilience of these three countries to the global crisis in 2008 was the result of an arduous process undertaken a decade or more before the shock. Although political leaders may have been tempted to adopt procyclical measures during good economic times, these three countries understood the necessity of strengthening their financial and macrofiscal systems to prepare for serious economic turmoil. This awareness proved its worth when the world economy crashed.

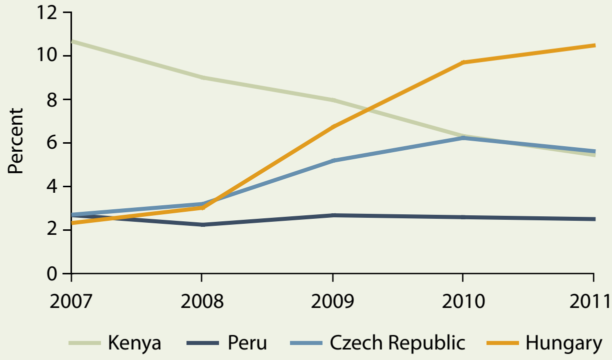
The Czech Republic demonstrated the utility of establishing an integrated supervisor at the national level within a strong and independent central bank. Overall, the Czech government did not have to undertake any major measures, and a simple relaxation of monetary policy proved sufficient to ensure adequate liquidity. The adequate loan-to-deposit ratio of the banking sector and low dollarization of loans through adequate pricing of foreign exchange risk by the banks were also key factors in weathering the global economic shock. Despite decreased lending during the crisis period, Czech banks continued to generate profits and further strengthen their capital buffers, which helped them cope with a notable increase in the share of nonperforming loans (figure S6.1). Other countries in the region, including Hungary and Ukraine, faced higher risk because of higher dollarization of loans.

Given the good conditions that Peru had created since the mid-1990s, the government was able to respond in an efficient and countercyclical manner to sustain the national economy during the global crisis. The central bank injected liquidity into the financial system, in both local currency (nuevos soles) and U.S. dollars, to prevent a liquidity squeeze and a credit crunch. The monetary policy rate was lowered to 1.25 percent, and the first package—equivalent to 3.4 percent of GDP—of a threefold stimulus plan was enacted in 2009, financed by fiscal savings. By investing in roads, housing, and hospitals; by giving incentives to nontraditional exporters; by supporting small and medium enterprises and farms; and by increasing expenditures in social programs, the government aimed to sustain domestic demand, boost business confidence, and extend guarantees to support firms, exporters, and smaller financial institutions. Peru also benefited from a key external factor: favorable terms of trade, with a rapid recovery of exports to Asia (particularly China).

Kenya's demonstration of risk management is arguably even more impressive, considering the quadruple shock it faced within a very short period: postelection violence in early 2008, oil and food price increases, catastrophic drought, and the global financial crisis. Although an increased perception of risk in the market was reflected in the commercial bank lending rates, with a particularly large impact on the agriculture sector, the central bank successfully implemented countercyclical monetary policies, reducing its rate, as well as the cash reserve ratio, to inject liquidity into the market. The banking sector was strong enough to maintain capital adequacy ratios (19.8 percent in 2009—well above the statutory requirement of 12 percent) and a low share of nonperforming loans. With public debt under control, and buoyed by large international reserves, the government was able to implement an ambitious fiscal stimulus program of $300 million, thereby protecting key expenditures. The stimulus boosted employment and economic activity, notably by increasing spending on infrastructure.

While many countries are still suffering from the crisis, the Czech Republic, Peru, and Kenya, have all demonstrated an impressive ability to manage macrofinancial risks—offering lessons that would benefit even developed countries.

FIGURE S6.1 *Bank nonperforming loans to total gross loans ratio, 2007–11*



Source: WDR 2014 team based on data from World Bank Global Finance Development Database.

Note: While the share of nonperforming loans fell in Kenya during the crisis and remained relatively low and flat in Peru, it increased significantly in the Czech Republic; however, the country managed to stop the rise at the end of 2010. This can be considered a good performance in comparison with other Eastern European countries such as Hungary, where the share quadrupled over the same period and was still increasing at the end of 2011.

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