# Special Report 2011/21

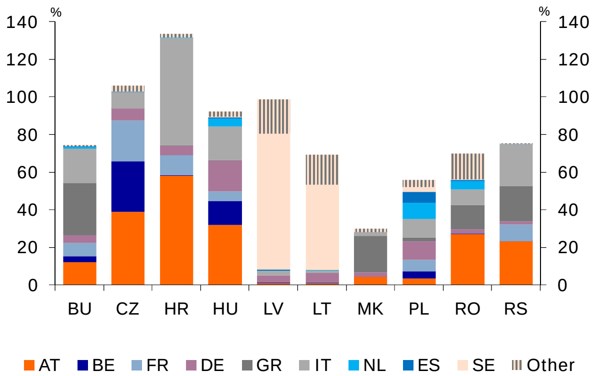
## Emerging Europe: caught without an umbrella

*While eurozone members are fighting to keep their heads above water, Central and Eastern European (CEE[1]) countries are rapidly becoming the first casualties in the war on debt. CEE was dealt the first blow in 2009, when the global crisis reduced both available funds and demand for CEE exports. Since then, recovery has been slow, leaving the countries ill-prepared to weather the upcoming storm. And even though weather reports are subject to change, the upcoming storm looks to be a heavy one, causing Poland's foreign minister to claim that neither terrorism, nor German tanks, but an eurozone break up forms the greatest risk to his country's stability.*
*This Report considers the various channels through which the euro zone crisis is affecting or could come to affect the economic stability of CEE. In addition, we present a ranking of the most vulnerable CEE countries, which are least able to harness their economies.*

### Foreign banks look for the exit

One of the most pronounced risks to CEE's economic stability is the region's dependence on foreign banks. Over the past decade, many eurozone banks branched out to CEE, in search of unexplored markets. The relatively undeveloped financial sectors in the former communist countries meant that there was a large gap to be filled, while overbanked western markets left many banks in search for higher profit margins. A match made in heaven, or so it seemed. As the eurozone debt crisis intensifies, the large presence of western banks in the CEE is rapidly transforming into a vulnerability, rather than a strength.
Eurozone banks are heavily exposed to the sovereign debt crisis and as a result, confidence in and among eurozone banks has fallen sharply, obstructing their ability to acquire funding. Simultaneously, new capital requirements necessitate eurozone banks to obtain a minimum core tier one ratio of 9% by mid-2012. In order to bolster their balance sheets, banks need to obtain additional funding or deleverage. And, as funding has become expensive, many banks already started to deleverage.
Eurozone bank deleveraging will impact liquiddity in CEE, as it will likely motivate banks to cut exposure with their subsidiaries in the region. Roughly 75% of all CEE financial assets are held by foreign banks, averaging 79% of GDP. And, although the Vienna accord in 2008 promised to minimize the sell-off of CEE assets, recent developments suggest otherwise. This month, Austrian regulators instructed their banks to limit future lending to CEE. They will have to obey a 1.1 capital ratio, meaning that new loans can amount to no more than 1.1 times the deposits and wholesale funding that local subsidiaries are able to raise independently. Although their subsidiaries could attempt to obtain local funding, this seems unlikely to be realized in the short run.
Instead, we expect a liquidity squeeze that will weigh down on economic growth and could even result in deflation. Among the worst hit will be Croatia, Hungary and Romania, where

**Graph 1: Consolidated bank claims CEE**




Source: BIS, 2011

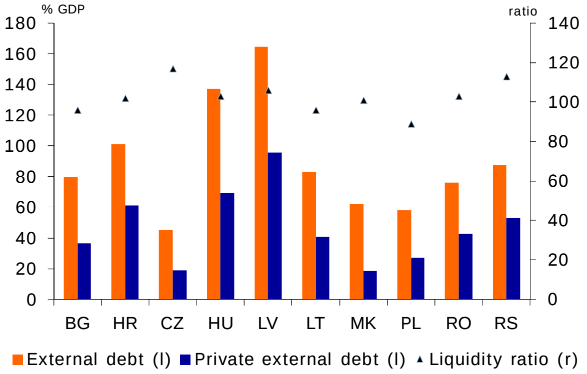
[1] For the purpose of this report, CEE refers to Bulgaria, the Czech Republic, Hungary, Latvia, Lithuania, Macedonia, Poland, Romania and Serbia (unless stated otherwise).

Austrian banks have a large presence. Moreover, Croatia and Serbia rely heavily on loans from Italian banks, which are also distressed. Finally, Greek banks have a more prominent presence in Bulgaria,Macedonia, Romania and Serbia. In contrast, Poland is expected to be less affected, as it can rely on a more robust domestic financial sector.

## Expensive foreign debt

The large presence of foreign banks helps explain why over the last five years, borrowing in non-local currencies increased sharply in the CEE countries. Moreover, as many countries were expected to join the eurozone in the short term, perceived exchange rate risk was low.

**Graph 2: External debt**




Source: World Bank and IMF, 2010

Finally, interest costs on euro-, yen and Swiss franc-denominated loans were much lower than those on local currency loans. As a result, many households opted for foreign currency denominated mortgages and consumption loans (see graph 2).

Unfortunately, as the crisis unfolded, entering the euro became a distant dream (or nightmare), rather than a short term reality. Moreover, as investor confidence in the region dropped (see below), CEE currencies weakened vis-à-vis the euro, Swiss franc and yen. Consequently, overleveraged households are struggling to repay their debt. At this moment, only countries that maintain a (semi-) floating exchange rate are suffering from increased debt costs induced by weakening currencies. These include Hungary, Poland, Serbia, the Czech Republic and, to a lesser extent, Romania. However, in the medium term, also countries that have pegged their currencies to the euro are at risk, as depleting FX reserves may force them to devalue their currencies. In that case, they too will see their debt repayment costs rise.

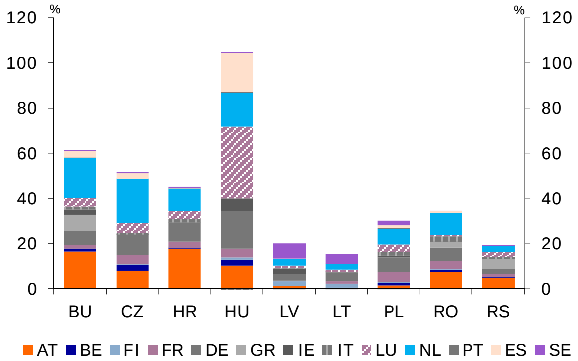
## Investors pull away

The expected credit squeeze combined with an already fragile recovery is also affecting investor confidence in CEE countries. Over the past year, we saw an increase in both public and corporate bond yields in CEE. Although this trend is partly explained by poor fundamentals, it does appear that CEE countries are punished for their proximity to the euro zone.

More worrisome, however, is the potential impact of reduced investor confidence on inflows of foreign direct investments from the eurozone. Its proximity to and integration with the eurozone had made CEE an attractive destination for inward direct investments. As shown in table 3, end-2009 FDI stocks averaged 43% of GDP.

The good news is that inward direct investments are much harder to withdraw than for example portfolio investments. We therefore do not expect a rapid decline in stock values of FDI. Nonetheless, continuing stress in eurozone capital markets will diminish investor' confidence, which will likely reduce future FDI inflows. The repercussions of reduced FDI inflows will be most pronounced for countries

**Graph 3: Inward FDI stocks**



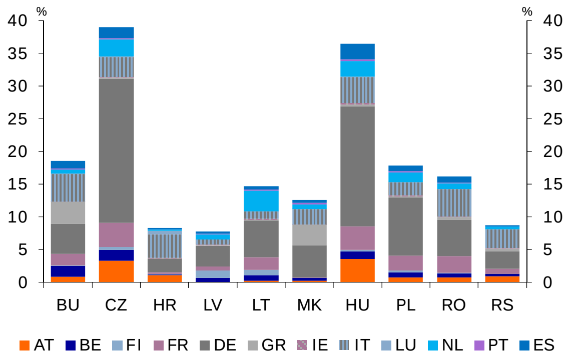

Source: IMF, 2010

that depend heavily on FDI and/or are already struggling to keep their economies afloat.
As shown in graph 3, especially Hungary, Bulgaria, the Czech Republic and Croatia are at risk. Not only because of the large presence of FDI in these countries, but also because investments are concentrated in export sectors. As exports have been driving the recovery in these countries, a withdrawal of FDI could thus prove especially harmful.

### Demand for exports slows

With domestic demand crippled by high debt repayment costs and fiscal austerity measures, post-2009 recovery in much of CEE has been driven by external demand. Unfortunately, the region is extremely dependent on demand in the eurozone, which is the single most important export destination for all the countries considered (graph 4).
The previous recession was a stark reminder of CEE's vulnerability to demand shocks in the eurozone. Between 2008 and 2009, exports plummeted, falling by 22% across the board. Especially the relatively nascent automotive industries in Hungary and the Czech Republic and, to a lesser extent, in Romania and Poland were hurt, as new car registrations fell by 2.5 million. As the automotive industry has been an important driver of growth in these countries, the results were disastrous. A new recession in the eurozone, combined with slowing demand from China (an important destination for the CEE's cheaper cars) would only aggravate the situation. Furthermore, a new recession would most likely also cause a drop in the exports of raw materials and tourism inflows. As shown in graph 4, especially the Czech Republic and Hungary could suffer severely. However, the news is not all bad. Over the past years (and also since the crisis), western car manufacturers have been expanding their operations in CEE countries. Cheap labor makes for cheaper cars that are well-suited for especially Asian consumers. Therefore, although a new recession would lower demand for cars, the relocation of production plants to the CEE will likely cushion the blow.

**Graph 4: Export destinations in the eurozone**




Source: IMF, 2010

### Less money to send home

The CEE economies also rely on remittances sent by nationals living and working abroad. CEE access to the European Union, combined with a need for unskilled labor in the eurozone, helps explain the large number of CEE residents working abroad. However, the recession in the eurozone caused many to return home, as jobs became scarcer. As a result, remittances dropped. A new recession could lead to a further reduction in remittances. Among the worst hit will be Serbia, where remittances stood at 12.6% of GDP in 2010. In addition, Bulgaria and Romania are also expected to take a hit.

### Without an umbrella

While the storm is brewing, CEE governments find themselves without an umbrella. In 2009, the crisis revealed many structural problems that had been veiled by high growth and increased welfare. But, as growth rates plummeted, corruption, high debt and an overall lack of competitiveness entered the spotlight. And, as slowing economies recorded high unemployment rates, the populations became increasingly irritated with their leaders. Nonetheless, in 2009, CEE governments could at least rely on speedy IMF and EU support to help fend off a depression. This time around, things will be different and not in a good way. While the eurozone is strapped for cash and busy cleaning up its own mess, the IMF will require harsher conditions that may not be supported by electorates. Meanwhile, already high public debt levels have only risen further, reaching levels as high as 80% of GDP in Hungary (2010). Governments are thus forced to implement budget cuts, rendering them ill-equipped to face another crisis.

## The most vulnerable

Combining dependency on foreign banks, eurozone demand, remittances and FDI inflows, with public debt levels and GDP's, we obtain an idea of which countries will be hit the hardest. The unweighted average of these normalized indicators presents us with a ranking, as shown in table 1. Admittedly, this ranking is overly simplistic and only

**Table 1: From most to least vulnerable**

| | Final rank | Foreign bank claims | Exports | Remittances | FDI | GDP | Public debt |
|---|---|---|---|---|---|---|---|
| Hungary | 1 | 4 | 2 | 8 | 1 | 6 | 1 |
| Czech Republic | 2 | 2 | 1 | 9 | 3 | 8 | 7 |
| Croatia | 3 | 1 | 8 | 5 | 4 | 5 | 4 |
| Serbia | 4 | 5 | 7 | 1 | 8 | 3 | 3 |
| Bulgaria | 5 | 6 | 3 | 2 | 2 | 4 | 9 |
| Latvia | 6 | 3 | 9 | 6 | 7 | 1 | 5 |
| Lithuania | 7 | 8 | 6 | 4 | 9 | 2 | 6 |
| Romania | 8 | 7 | 5 | 3 | 5 | 7 | 8 |
| Poland | 9 | 9 | 4 | 7 | 6 | 9 | 2 |

Source: Rabobank

takes account of a small number of relevant factors. Nonetheless, we are able to draw some preliminary conclusions. As expected, Poland is ranked least vulnerable, as its large domestic market (accounted for by including GDP scores in the ranking) will likely shelter it from some of the turmoil. More remarkeable is Romania's good performance in our index. The performance is explained by the fact that Romania's economy is less dependent on the eurozone than the other countries considered. Moreover, Romania's public debt stood at a low 26% of GDP in 2010. Nonetheless, the crisis in 2009 hit the Romanian economy especially hard and IMF support was needed to help bolster the economy. In addition, recovery has been very slow. We therefore hold that, despite its favorable placement on our index, Romania remains vulnerable to external shocks. The two non-eurozone Baltic states, Latvia and Lithuania, both score relatively well, despite the fact that their economies were among the hardest hit in 2009. For Latvia, this outcome is explained by the fact that the country depends less on FDI and remittances, while Lithuania is less dependent on foreign banks. Moreover, both countries' poor performance in 2009, was partly explained by the fact that already before the crisis, both economies were overheating. Hungary, the Czech Republic and Croatia all score poorly on most counts and therefore rank highest on our vulnerability index. Croatia's economy is among the least competitive in the region and has experienced a sluggish recovery. The economic performance of the Czech Republic has been better, but its dependence on the eurozone is expected to force it into recession in 2012. Finally, Hungary is the region's worst performer. Not only did the country experience a heavy recession in 2009, subsequent economic mismanagement and political blunders further erupted economic recovery, while undermining investor's confidence in the country. Consequently, rating agencies Moody's and S&P already downgraded the country's sovereign rating to junk.

## Conclusion

*While CEE economies are still overcoming the effects of the 2009 crisis, a new crisis is well under way. As eurozone bank deleveraging will reduce funds available to the CEE, slowing export demand will reduce industrial activity in these countries. Meanwhile, high private indebtedness continues to weigh down on domestic demand. The result will be another recession, which is likely to be most pronounced in Hungary, the Czech Republic and Croatia. In contrast, we expect Poland's large domestic market to shield it from at least some of the turmoil.*

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