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A Note on the Changing Nature of Financial Vulnerability in the Transition Economies

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by
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Recent financial developments in the former planned economies of Eastern Europe and the Commonwealth of Independent States (CIS) suggest that questions remain about the financial soundness of the region although the nature of any vulnerability has changed considerably since the Russian currency crisis of 1998. The financial sectors in the economies that undertook the transition from plan to market have undergone significant changes in the last several years; the ownership structure of the banking industry has now been largely privatised and the regulatory environment correspondingly adjusted. The overall economic health of region appears relatively robust in that GNI growth has been quite high, government debts and deficits reasonably low and falling (except perhaps for a few such as Hungary), and inflation well under control. Over the last several years, however, there have been several new developments that raise questions about the financial vulnerability of the region.

Specifically these include the rapid growth of both domestic credit and private sector borrowing from abroad. Bank credit, especially to households, has been growing extremely fast over the last several years; most recently, in a number of countries bank loans increased between 25 to 50 per cent over the year ending in the second quarter of 2006 and for some the growth has been even higher such as in Georgia where loans almost doubled. Although rapid credit growth is a normal process and characteristic of financial deepening in developing countries, it has recently been much faster in the transition economies than in most other emerging markets, especially those in Asia. In addition, much of the complementary regulatory framework and institutional structure supporting the financial sector such as credit rating agencies, unambiguous ownership registers, appropriate legal instruments for repossessing collateral, and instruments for securitization of risks have in many cases only been recently created and credit histories for properly evaluating risks are not always available. Recent empirical research, such as that of Racaru, Copaciu and Lapteacru has found that the growth of non-government credit as a percentage of GDP is a significant factor in predicting financial crises, although that is not to say that most credit booms ultimately result in a crisis. On the positive side, even where this growth of private credit has been rapid, the overall stock is not particularly high.

There has also been a rapid increase in external borrowing by the private sector undertaken by banks and other commercial enterprises which has resulted in a doubling of the private external debt of the region from just over $200 billion in 2002 to over $450 billion in 2005; this trend has increased further in 2006. To some degree, these private capital inflows reflect the increased perceived credit worthiness of the region. In contrast, public sector debt has remained essentially constant at about $250

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billion over this period. Thus the overall trend for the economies of the region in their foreign position is towards increasing soundness for the public sector matched by increasing debt for the private sector. This trend has been most apparent in the CIS, especially Kazakhstan, Russia and Ukraine, and mildly apparent in the most of the New EU Member States including Bulgaria and Romania. Russia is a prominent example where substantial pre-payment of its external public debt only partly offset the impact of large private borrowing on its overall indebtedness. Between December 2003 and June 2006 Russian private sector debt more than doubled increasing by $128.3 billion to $208.3 billion, while public debt decreased by $26.7 billion to $79.1 billion.

Other than for the energy-rich CIS, this private sector external borrowing is associated with fairly large current account deficits. After the Asian financial crisis, many developing nations became much more cautious about foreign borrowing and have actually been running current account surpluses along with accumulating significant additional international reserves. This has not been the case for the non-energy exporting transition economies; for example in 2006 the average current account deficit for Bulgaria, Estonia, Georgia, Latvia, Moldova, and Romania was over ten percent of GDP while several others including Hungary, the Kyrgyz Republic, and the Slovak Republic have sizable deficits as well. These are increasingly being financed by short-term debt instead of inward FDI as in the past. The implications of growing private debt are somewhat mitigated, in some cases, by the fact that a significant part of external debt represents liabilities in favour of foreign parent companies. For example, in Kazakhstan, intercompany debt represents around 40% of the total.

The situation of Russia with its current account surplus of 11 percent of GDP and $289 billion in reserves (the third largest in the world) is an important exception. However, Russia and the other energy-rich economies have been only partially successful in limiting the appreciation of their currencies and containing inflation that results from their trade surpluses; this has only prompted additional foreign capital inflows and encouraged further unhedged foreign borrowing by residents.

Although neither of these developments might warrant particular concern viewed in isolation, what is worrisome is that these developments have occurred in a number countries which also possess other ingredients often associated with financial or currency crises. Foremost is the fact that both the private sector external borrowing and the domestic credit expansion are both characterized by a large predominance of foreign-currency denominated loans. At the beginning of 2006, over half of all outstanding domestic loans were denominated or indexed to foreign currency in a number of countries including (but limited to) Armenia, Bulgaria, Croatia, Estonia, Georgia, Hungary, Kazakhstan, Latvia, Lithuania, the Kyrgyz Republic and Romania. A currency depreciation can be problematic for borrowers of foreign-currency denominated loans, as the domestic currency costs of servicing these loans would increase. This might have only a limited direct impact on the banks since they generally have followed a risk management strategy which has limited their net foreign currency exposure. However, many of the borrowers of these loans are increasingly consumers (often for mortgages) who have no natural hedge against currency movements and a sufficient number of defaults could place strains on the banking system. At the same time, in several economies the public sector has been able to counter this trend by reducing its reliance on foreign-currency loans and issuing debt in local currency, thus diminishing their vulnerability to an adverse currency movement.

Additional aggravating factors include fixed or managed exchange rates, already open or increasingly open capital accounts, and rapidly rising prices for financial and real estate assets. A significant share of this borrowing is being used to purchase assets, largely housing but financial assets as well, whose underlying value is subject to substantial uncertainty if for no other reason than its rapid appreciation in recent years. Despite the very positive fundamentals for the region, it is, nevertheless, reasonable to ask if a bubble might have formed in these markets. For example between 2000 and 2005 while stock markets were generally flat in the advanced economies, they doubled or even quadruped in the New EU Member States, and were up over 757 per cent in Romania and up 833 per cent in Ukraine. Over the same time period, house prices have also increased substantially in most markets by more than doubling in the less robust markets and appreciating several hundred per cent in some markets such as the Baltic states, Russia and Ukraine. An eventual correction in these asset markets could pose risks for the banking industry where these assets have been purchased with borrowed money or where loans were collateralized with these assets.

The changing nature of the financial vulnerability for the region corresponds to the changing academic models of financial and currency crises. The early models, often referred to as first generation models, explained these crises as being due to excessive government borrowing which led to current account deficits. More recent models, the so-called third generation models, however, emphasize financial liberalization, capital inflows, and asset price booms and analyze how sudden credit stops lead to depreciations which create a crisis through balance sheet effects on private borrowers resulting from debt which is denominated in foreign currency.

The extent to which these factors entail financial risks for these countries obviously varies considerably; however, in a number of cases, especially those with relatively underdeveloped regulatory infrastructures, the financial sector may have been allowed to grow too fast over the last five years and this, in combination with the other factors listed above, may now pose a significant financial vulnerability for a number of countries. Overall these newly developing areas of financial vulnerability are unlikely to become apparent if the global economy is able to sustain its recent growth performance along with relatively low interest rates. However a deterioration in the global economy could act as a trigger which could expose this fragility in some these countries' financial systems. Impact analysis of possible shocks to the global economy shows that a number of the transition economies are particularly vulnerable to higher world interest rates. These financial risks are mitigated to some degree by the presence in a number of countries of foreign multinational banks.

References and Further Reading

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