Addressing Emerging Europe's Vulnerabilities: Weak Domestic Markets and Excessive Forex Exposures

A Coordinated Approach – "Vienna Plus"

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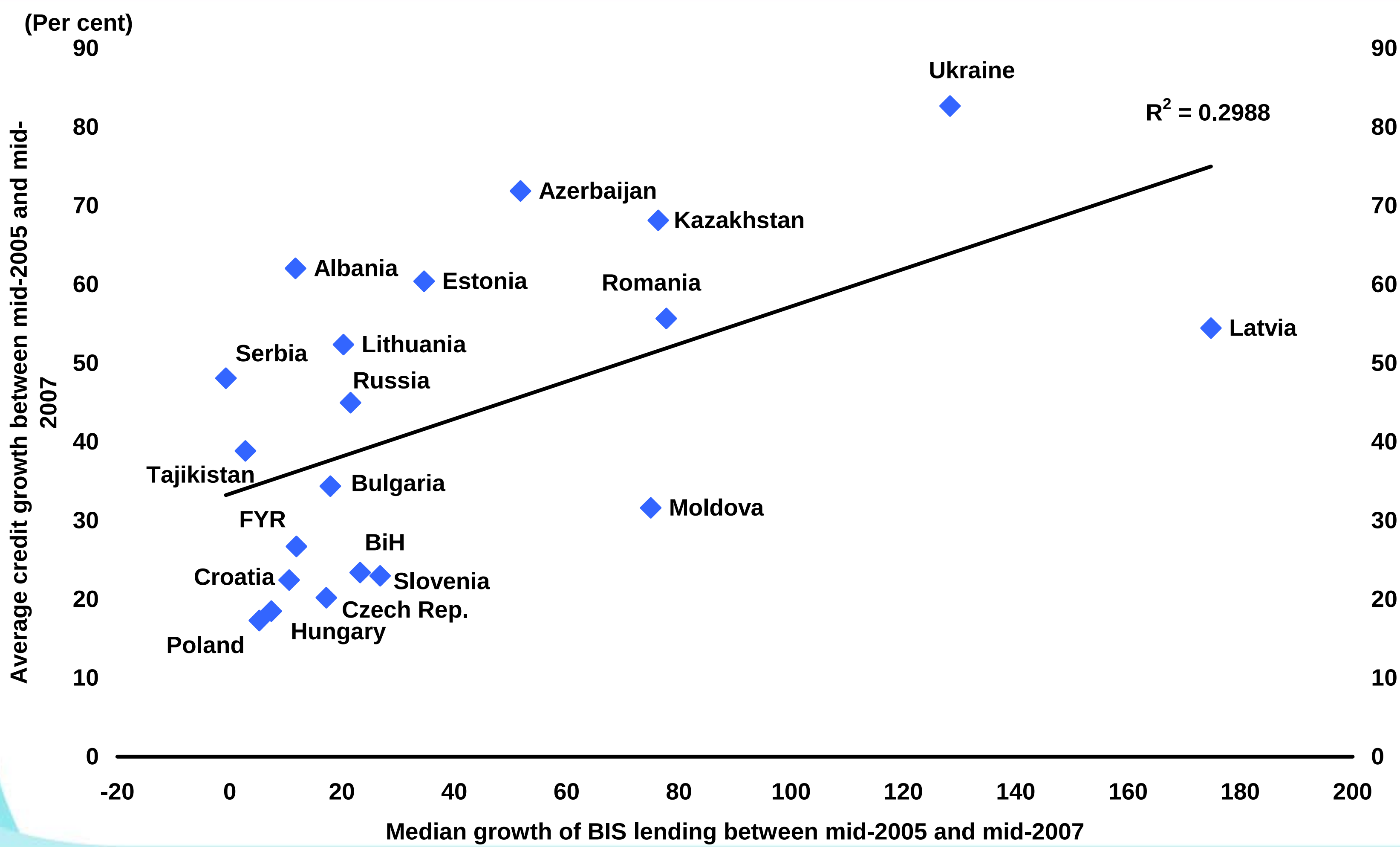
Key messages

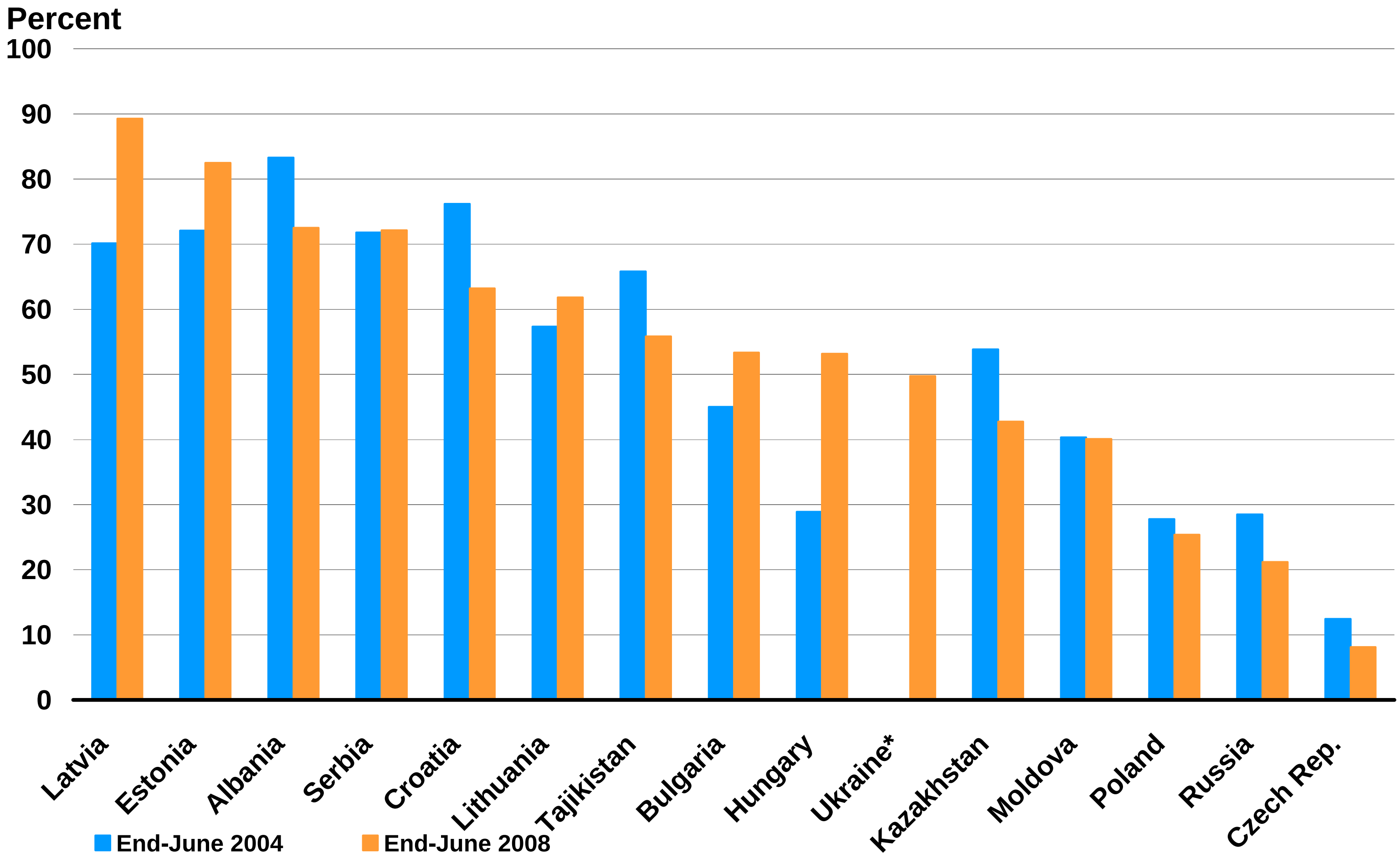
- Strong and sustained growth in emerging Europe is in the interest of each and every stakeholders present
- Time is right to address the region’s twin vulnerabilities: excessive reliance on foreign capital and forex lending to unhedged borrowers → reforming the growth model
- There is, again, a collective action and coordination problem: for banks; regulators; IFIs
- Call for “Vienna Plus”
- A road map - let’s do it!

Capital inflows strongly correlated with credit growth during 2005-08



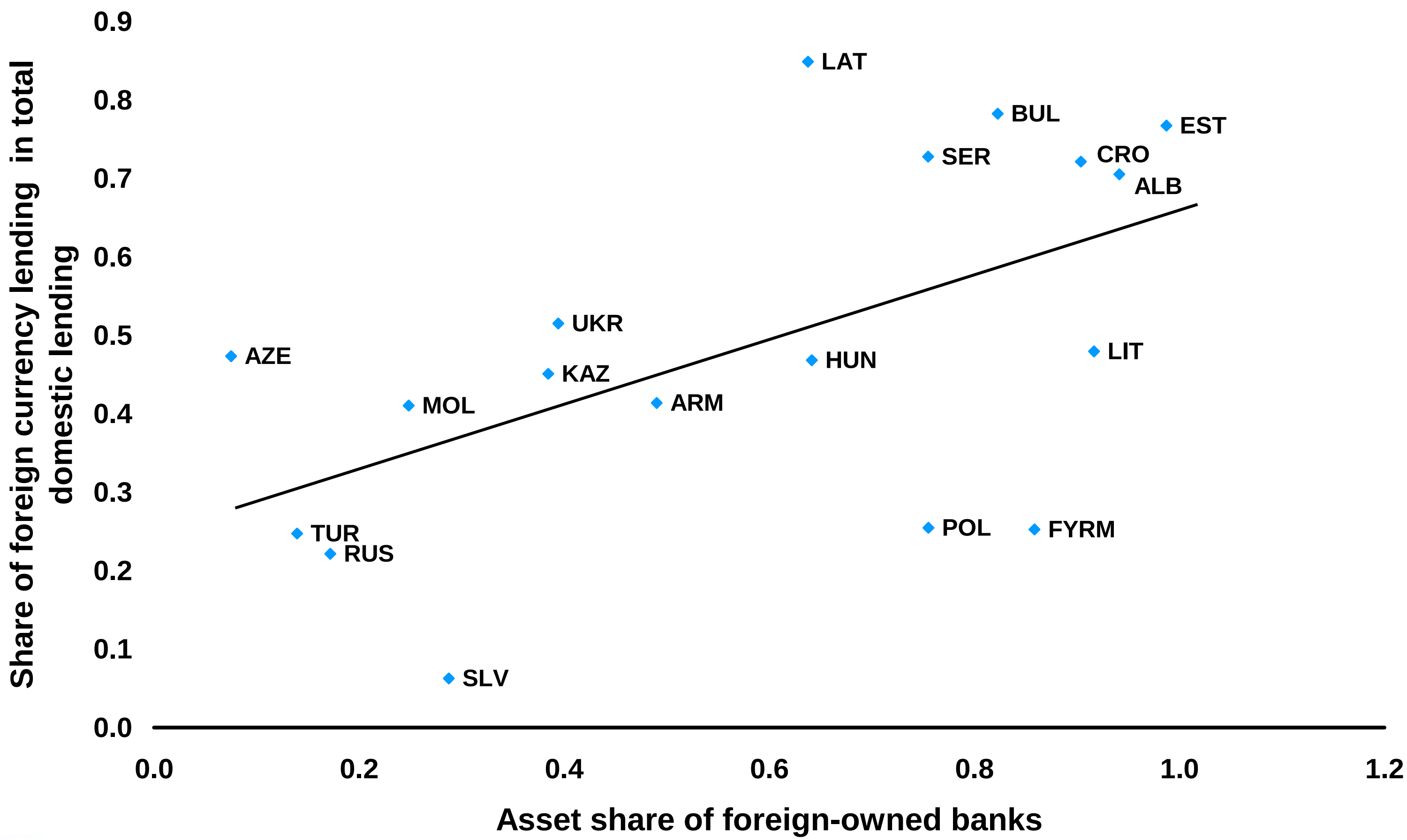
Source: EBRD Transition Report 2009

Share of FX borrowing is high in many countries – significant part is unhedged



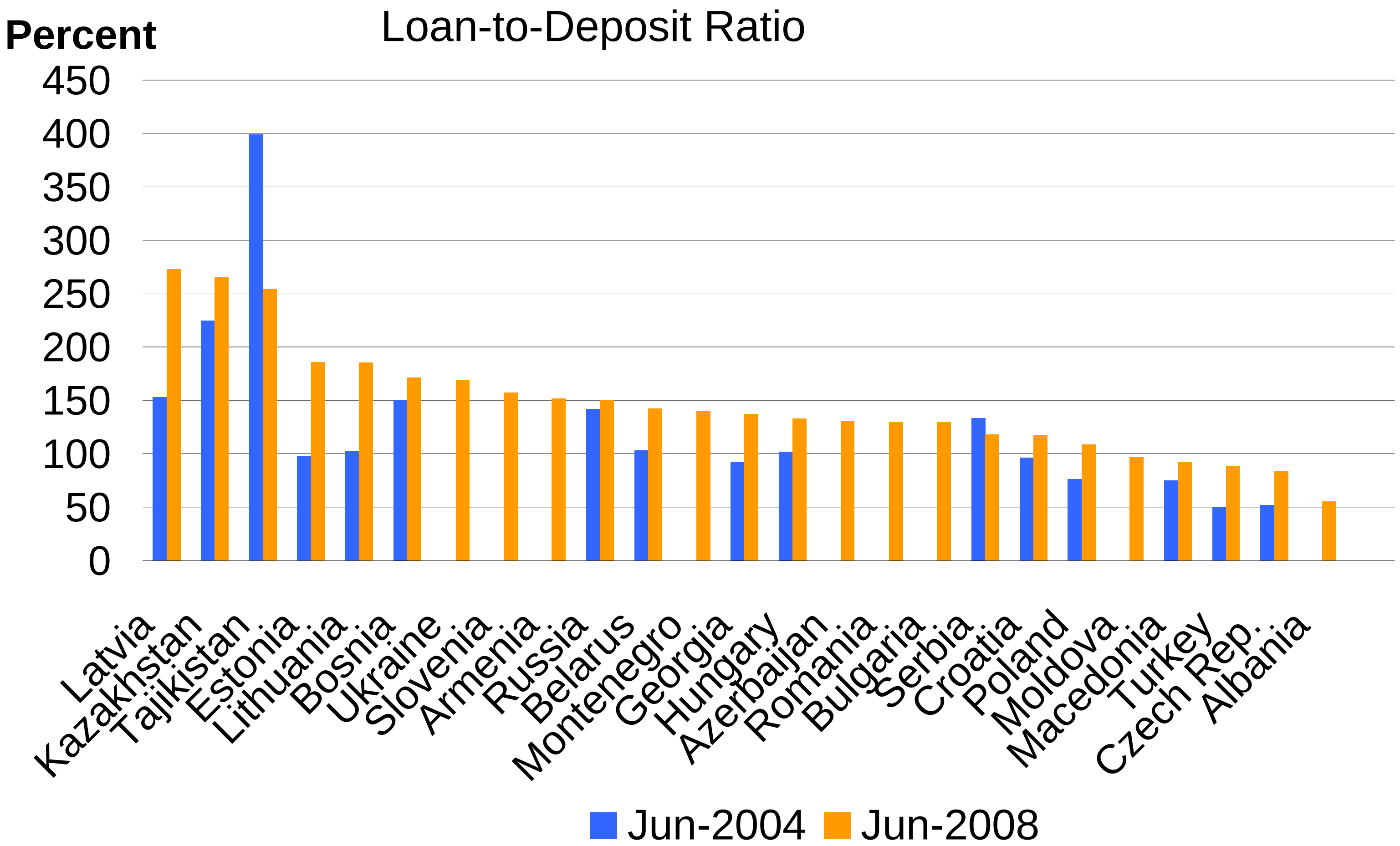
Source: EBRD Transition Report 2009

Foreign bank presence is correlated with a higher share of lending in FX



Source: EBRD Transition Report 2009

Weak reliance on domestic savings



Source: EBRD Transition Report 2009

A unique opportunity to move on FX vulnerability and capital markets

- Significant post-crisis common ground:
  - Large FX exposures have limited use of the exchange rate in crisis response: under-pricing fx risks at the individual level
  - Need to rely more on domestic sources of funding → LC market development can be a source of strength even after euro adoption.
  - This is thus *not a detour* on the way to the euro
- Macro conditions becoming "local currency-friendly"
- Regulatory action – albeit still uncoordinated (Hungary, Poland, Austria, etc)
- With recovery underway, it is time to focus on correcting vulnerabilities

We have another collective action/coordination problem

- Regulators/central banks of home and host countries: urge to act but coordination is difficult
- Banks operating in the region: fear of market share loss
- IFIs, EC, ECB: need for coordinated move to make the market
- There is, again, a collective action and coordination problem: for banks; regulators; IFIs
- Call for “Vienna Plus”

Country-by-country assessments: *Different reasons - different approaches*

Reasons for FX	Policy approach
• Lack of macro and institution credibility	✓ Improve macro policy; structural reforms
• Moral hazard – implicit guarantee	✓ Regulate or outright limit borrower exposure
• Externalities - lack of internalizing FX social costs	✓ Regulate via capital and/or prudential measures
• Underdeveloped local currency markets	✓ Develop/strengthen domestic markets (LC and forward)
• Lack of info on FX risks	✓ Regulate disclosure
• Stock issue with credible Euro exit: manage FX volatility	✓ Derivatives

“Vienna Plus”: Joint Assessments

Five policy areas critical to develop local capital markets and boost domestic savings

1. Macro economic policy
2. Financial sector regulation
3. Market structure: investors, instruments, indices
4. Physical infrastructure
5. Legal and regulatory framework and enforcement

"Vienna Plus": Identify Policies for Progress

1. Macro economic conditions: not yet stabilized; often exchange rate targeting

2. Financial sector regulations – limited basic bank prudential regulations

3. Markets/Instruments
Money markets: Interbank market needs transparent reference mechanism; limited management tools (T-bills); No equity markets

4. Physical infrastructure
Payments system – limited development of securities clearing and depositories

5. Legal framework and enforcement
Rudimentary

T=0 → T=1 → T=2

Identify policy and priorities that move a country from one stage to the other

Key to success

- **Right analysis and sequencing**:
  - *If* macro credibility is the problem, address that first
  - *If* underdeveloped local currency markets: address that
  - *If* moral hazard, externalities: regulate
- **Involve all stakeholders – collective action problem**
- **Keep the eye on the ball: a longer term project**

"Vienna Plus" : who could do what?

- **Governments, IMF, EC, ECB** - macroeconomic policy frameworks
- **Governments, IMF, World Bank, EBRD -** LC public debt management
- **European Commission -** regulating FX exposures and helping with legal frameworks
- **Home and host regulators -** develop/coordinate regulatory approaches to FX lending
- **EC, WB, EBRD -** advising on legal/institutional changes to develop local currency capital markets; physical infrastructure; instruments
- **Investing IFIs** (EBRD, EIB, IFC (IBRD?))
  - Issuing LC bonds
  - Lending in LC
  - Investing into market structures
  - Helping with derivatives markets when needed

“Vienna Plus” : who could do what?

- What can **banks** do?
  - Internalizing higher credit risks of FX – lower risk thus margin on unhedged LC loans
  - Jointly agreeing on
    - a common set of lending standards
    - discontinuing most risky FX asset classes (short term, unsecured consumer loans) and currencies (non-Euro)
  - Improve disclosures and stress testing
  - When conditions are right, enter the long end of the LC market.

Let's discuss!

European Bank for Reconstruction and Development

www.ebrd.com; www.ebrdblog.com