Financial Integration

Lessons from CEE and SEE

THE WORLD BANK

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Outline of Presentation

Forthcoming World Bank report: Golden Growth—Restoring the Lustre of the European Economic Model

Focus is on the financial integration of NMS, candidate countries, the EU eastern partnership

1. **Are capital inflows good for growth?**
   Where? How? Why?
   But financial integration has risks: can build vulnerabilities

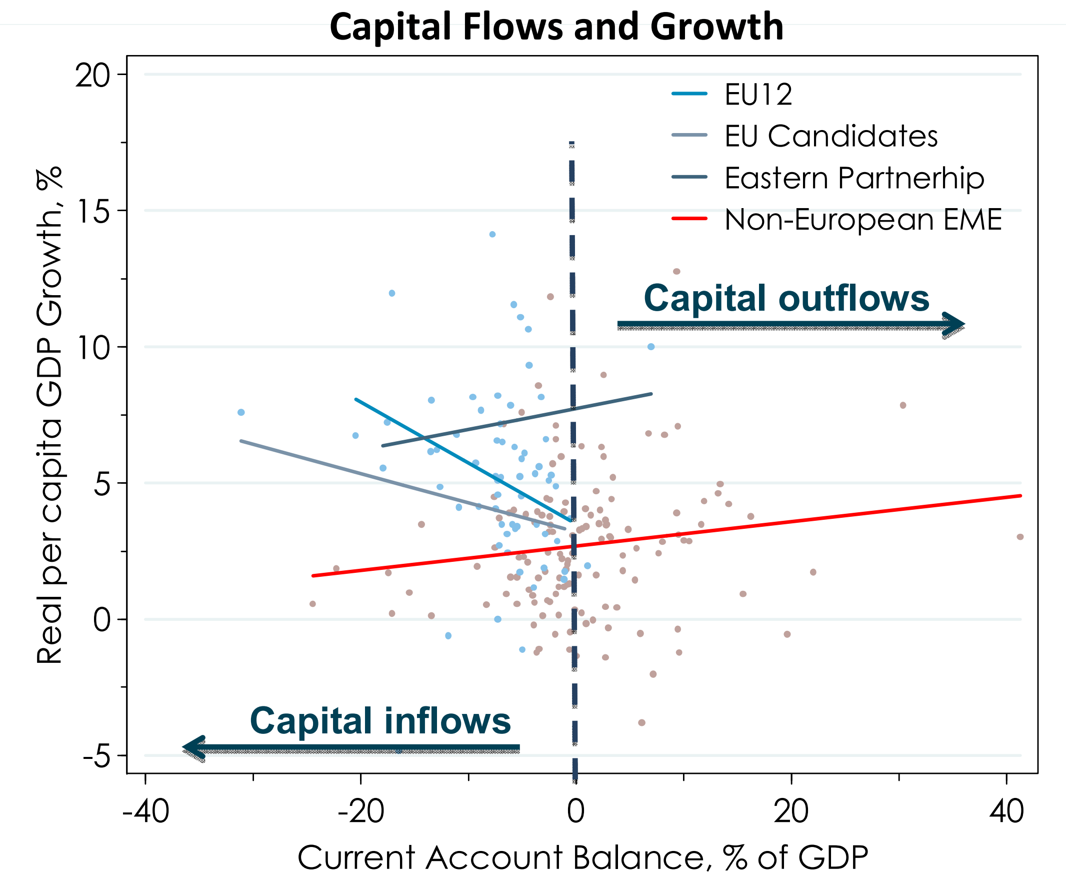
2. **What are the lessons from CEE and SEE?**
   Manage external imbalances, but do not self-insure
   - Boom-proofing public finance
   - Crisis-proofing private finance
     - Macroprudential policies
     - Supranational policies

Are Capital Inflows Good for Growth?

Where?

- Capital flows downhill in Europe: → from rich to poor countries
  → from low to high growth countries

- Exception? EU eastern partnership; similar to EMs in LAC and Asia



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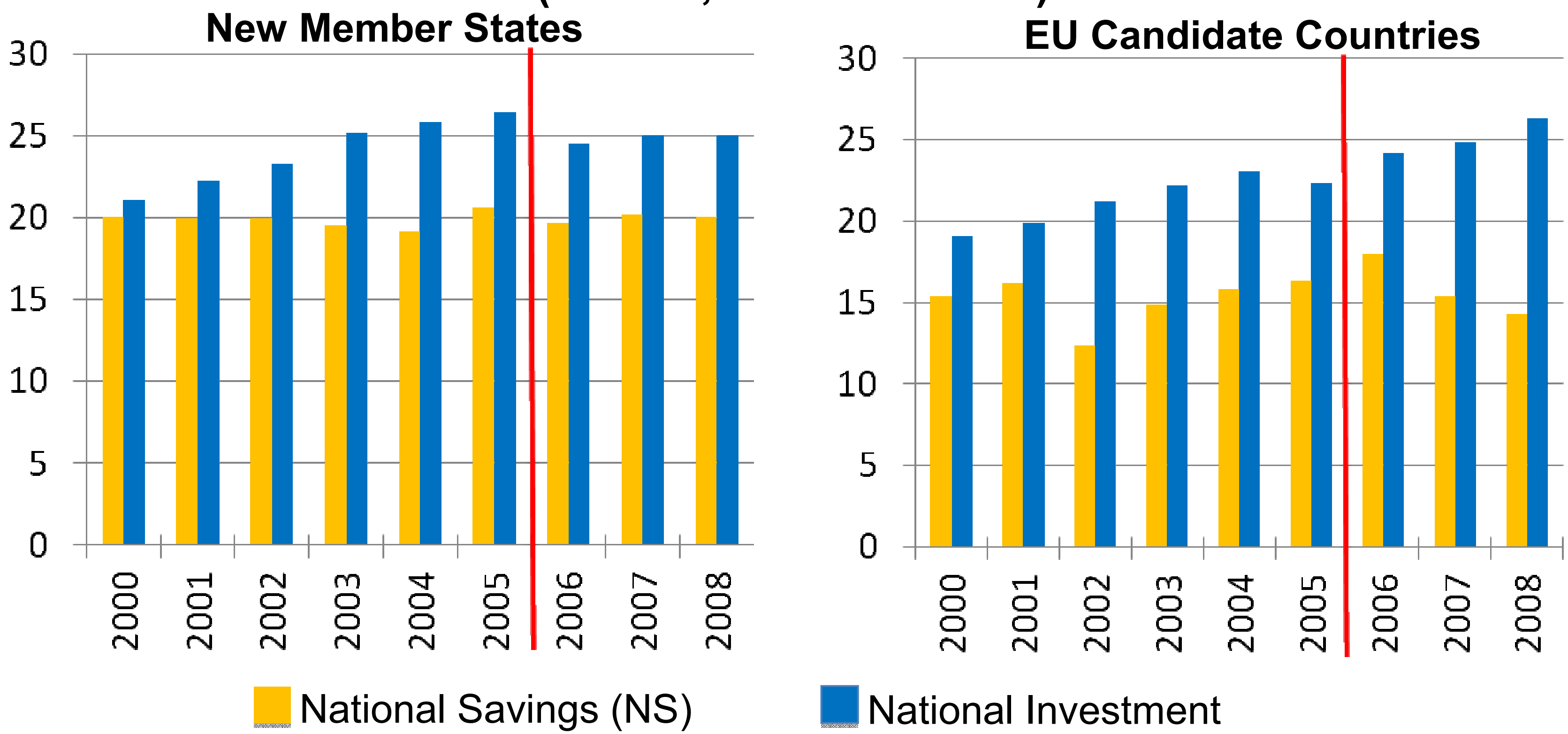
How?

National Savings and Investment in CEE—Two Examples
(% GDP, median values)



- Increase in investment; both in EU10 and EU candidate
- Savings substitution was limited; flat NS in EU10, rising and declining in EUC
- Exception 2006-08? In some, but not all CEE/SEE countries, consumption booms, asset bubbles, and loss of competitiveness occurred

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Why?

- **Does it reflect financial sector size/development? NO**

✓ Financial sector is deeper than in other developing regions

✓ But does not explain growth in emerging Europe

- **Does it reflect financial sector/institutional efficiency? ONLY IN PART**

- **Does EU membership (actual or potential) have a role? YES**

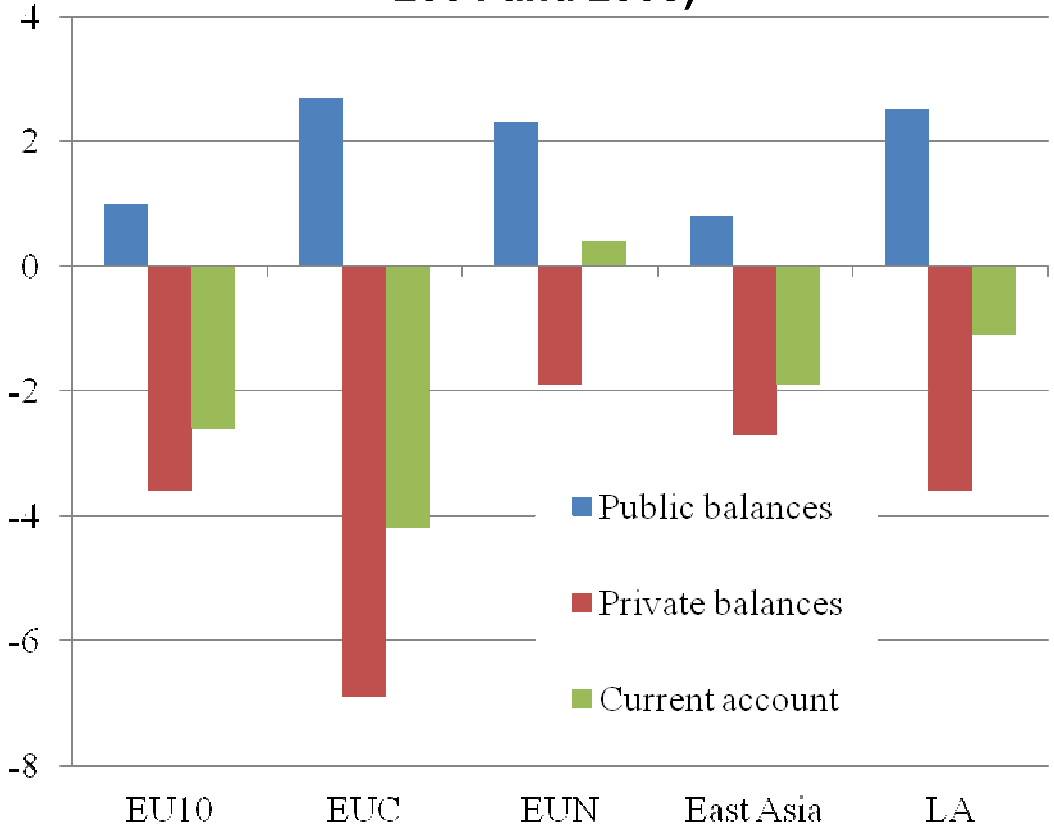
✓ EU membership provides a reform roadmap

✓ Investors know what institutions to expect

But Financial Integration has Risks

- **Not all high foreign savings driven events support growth**
  - ✓Imbalances in 2006-08
    - Private not public
    - But public did not play balancing role
  - ✓Unhedged FX lending
  - ✓Asset bubbles
  - ✓Consumption booms
  - ✓Savings substitution
- **Europe crisis makes future more challenging**
- ✓ Parent banks are facing risks
- ✓ Investors likely more cautious going forward

Δ in S-I Balances (% GDP; Δ between 2004 and 2008)



What are the Lessons from CEE and SEE?

Crisis-Proofing Private Finance

- **Manage external imbalances but do not self-insure**
  - ✓ Boom-proofing public finance—fiscal policy was procyclical everywhere, including in countries with fiscal surpluses (BGR, EST)
  - ✓ Crisis-proofing private finance; macroprudential and supranational

- **Motivations for macroprudential (MP) policies**
  - ✓ Contain system-wide risks to financial system
  - ✓ Introduced: * following a re-assessment of the economic cycle
    * to contain risks in specific business lines; FX lending

- **Three types of macroprudential policies**
  - ✓ Increase buffers; both in capital and liquidity
  - ✓ Credit growth control measures; increase the cost of credit
  - ✓ Improve loan quality; e.g. loan-to-value ratios, qualification criteria (QC)

Country Studies

- **Precrisis experience with macroprudential policies—8 country studies**

✓ No MP policies: Czech Republic, Hungary; also Turkey but no credit boom

✓ Moral suasion approach to MP policies: Estonia, Poland

✓ MP policies actively used precrisis: Romania, Croatia, FYR Macedonia

Pre-crisis Use of Macroprudential Policies

	CZE	EST	HRV	HUN	MKD	POL	ROM	TUR
Buffers and credit growth containment								
Capital-adequacy ratios	No macro-prudential policies were applied	•	•	No macro-prudential policies were applied	•	•		•
Risk weights		•	•		•	•	•	
Liquidity requirements			•		•	•	•	•
Constraints on total credit growth			•		•			
Regulations on lending in FX			•		•		•	
Other		•	•			•	•	
Credit quality								
Loan-to-value ratios							•	
Debt service-to-income ratios							•	
Eligibility criteria							•	
Other		•			•	•		

Lessons from Macroprudential Policies in CEE and SEE

Initial conditions matter	* Czech Rep. vs. Hungary; cases of interest rate differentials at origin and macro management credibility
Effectiveness varies across	* Business lines (Croatia) * Financial institutions (FYR Macedonia)
Effectiveness varies over time	* Adapt as loopholes emerge

Capital and liquidity buffers perhaps more effective than credit growth control measures; e.g., high CAR in HRV, SRB, BGR

Macroprudential policies to "improve loan quality" not widely used

* Except qualification criteria

EU Regulations and Directives

Goals? Balancing right incentives, level playing field, country-specificity

Current CRD-IV draft? * CARs (capital levels and weights), leverage and liquidity, counter-cyclical buffers for all banks

* Maximum harmonization regulation
* Only some standards to European Bkg. Authority

Flexibility still needed: * So far only for real estate lending and counter-cyclical buffers for all banks

* More needed; e.g., banking sector size, trend rate of financial deepening, regional credit disparities

Several countries advocating for: * Basel III (& CRD-IV): a maximum or a minimum threshold?

* More flexibility to use MPs: risk

Takeaway Messages

1. **Do capital inflows support growth in Europe?**
   - ✓ Capital inflows support growth in countries close to the EU
   - ✓ Primarily by enabling the pursuit of investment opportunities
   - ✓ But financial integration can also build vulnerabilities

2. **What are the lessons from CEE and SEE?**

- ✓ Manage external imbalances but do not self-insure

- ✓ Crisis-proofing private finance
- ▪ On macroprudential policies itself
  - * Buffers more effective than credit growth measures
  - * Loan quality measures barely used; explore these further
  - * Innovate and adapt
- ▪ On European wide regulatory framework
  - * Balancing single market versus country-specific factors
  - * Macroprudential policies

Dziękuję Bardzo!