CROATIAN NATIONAL BANK

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New Perspectives on the Financial Stability of the SEE Countries:

Primarily a Macroeconomic Issue

By

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The views expressed in this presentation are of the author and should not necessarily reflect the position of the CNB.

- Most of the charts in the presentation are updated versions of those appearing in the Financial Stability Report No. 5, prepared by the Croatian National Bank.

How has the financial crisis affected the SEE countries and their financial stability?

- Direct effects of the global financial crisis on the SEE countries
- Macroeconomic channel and the repricing of risk
- The sovereign debt phase

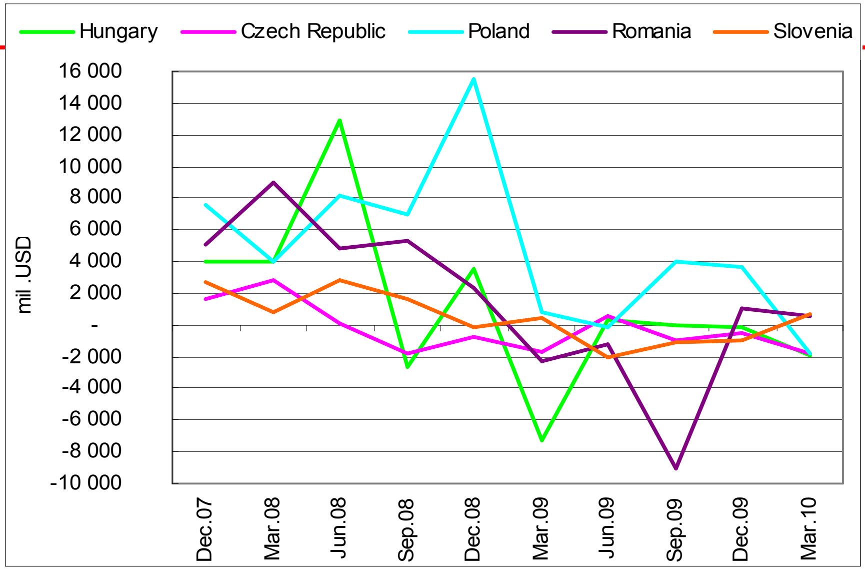
- The bottom line: Financial stability in the SEE countries today is primarily issue of macroeconomic performance, fiscal adjustment, and global conditions. Regulatory reform is of a lesser importance, but the enforcement of adequate provisions is important to avoid surprises and facilitate recovery.

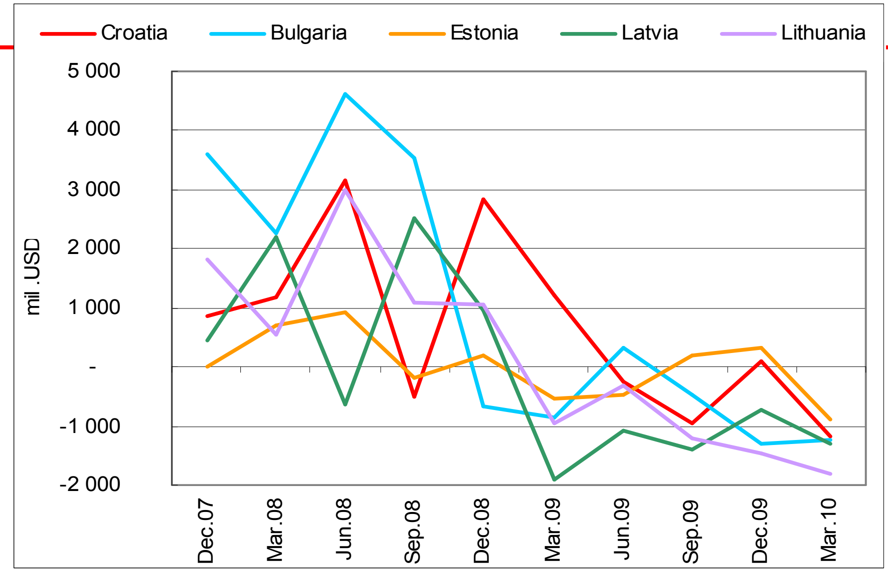
The onset of the crisis

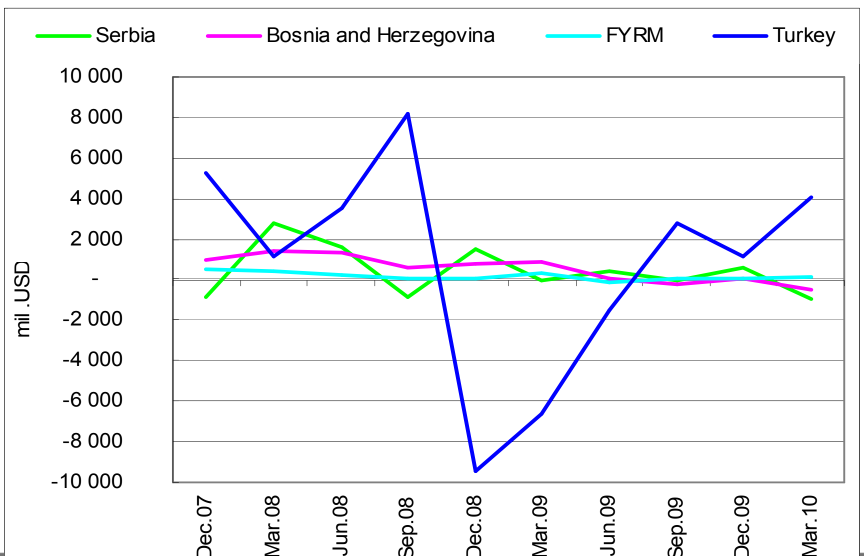
- Financial sectors in the SEE countries at the onset of the crisis:
  - High capital adequacy ratios (low leverage)
  - No exposure to exotic instruments
  - Substantial foreign ownership in the banking sector facilitated had improved management practices, and the quality of loan portfolio relative to previous crises.
  - At the peak of the Lehman Brothers' shock, subsidiaries suffered from the reputational risk. But mother banks supported the subsidiaries, and the pressures disappeared.
  - The cross-boarder banking helped in avoiding big capital account reversals, although now the BIS reporting banks are gradually reducing their exposure to the CEE and SEE regions.

- Conclusion: Limited direct effects of the original earthquake in the financial system on the SEE countries

Net flows of exposure by BIS reporting banks to CEE and SEE countries







The second phase: Trade channel

- SEE and CEE region highly dependent on foreign trade: Sharp drop in exports in 2009
- But now recovery is in progress, although not uniform at a uniform pace.

Export growth, percentage change

	2009	Q1/2010	Q2/2010*
Czech Republic	-10,8	13,0	n.a.
Slovakia	-16,5	16,8	n.a.
Slovenia	-15,6	4,5	11,4
Poland	-9,1	10,4	18,3
Estonia	-11,2	11,3	n.a.
Latvia	-15,5	4,6	n.a.
Lithuania	-14,3	5,8	21,1
Hungary	-9,1	13,7	n.a.
Bulgaria	-9,8	5,9	11,4
Croatia	-16,2	3,6	n.a.
Romania	-5,5	21,6	n.a.
Serbia	n.a.	n.a.	n.a.

Sources: Eurostat

The second phase: Repricing of risk:

- The crisis prompted a repricing of country risks
- This differentiated between individual CEE/SEE countries based on few variables:
- Countries least affected:
  - Czech Republic,
  - Slovakia,
  - Slovenia,
  - Estonia
  - somewhat more Poland.
- Conditions for the benevolent treatment by markets:
  - Public debt below 30% of GDP
  - Budget deficit at the onset of the crisis (2007) smaller than 2% of GDP
  - Current account deficit at the onset of the crisis of less than 6%.
- One strike – out. Exception: Estonia, where markets tolerated the current account deficit. But Estonia’s public debt was less than 4% of GDP, while the budget was in substantial surplus.

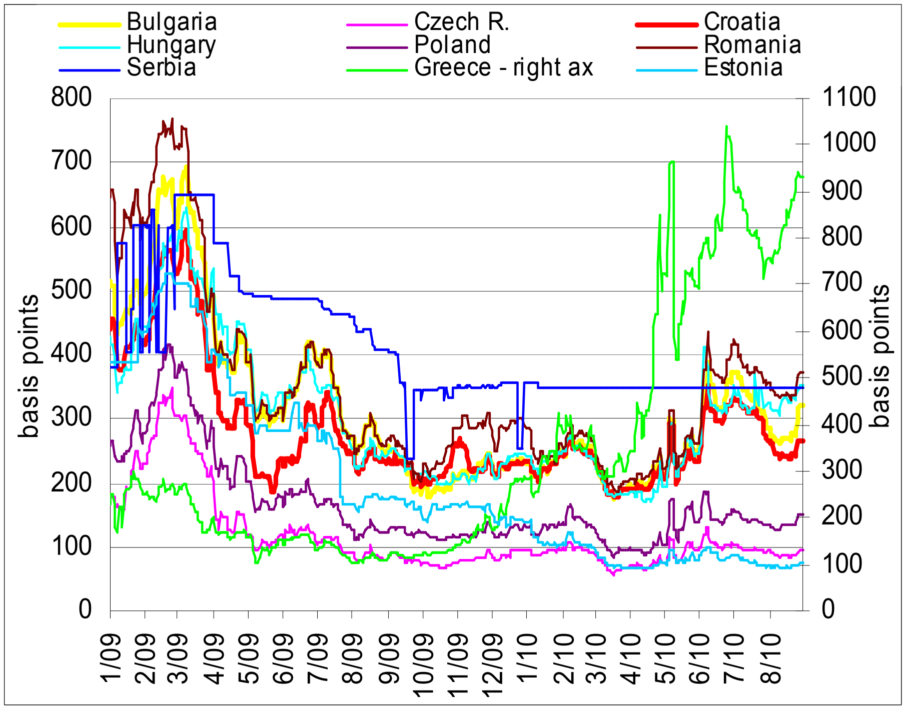
The third phase of the global crisis

- As Greece lost access to private capital markets, the focus of crisis moved to the sovereign debt market. Markets also realized the astonishing size of prospective deterioration in public debt position of advanced economies.
- This has led to a renew surge in the spreads for the SEE and some CEE countries starting from May 2010.
- This is also the case for cross-border banks operating in the region, which affects region's financing costs.
- It has also increased focus on fiscal imbalances in these countries.
- Despite all the measures taken by the EU and the ECB, markets remain worried and the spreads are still at an elevated level.

Repricing of risk – The third phase

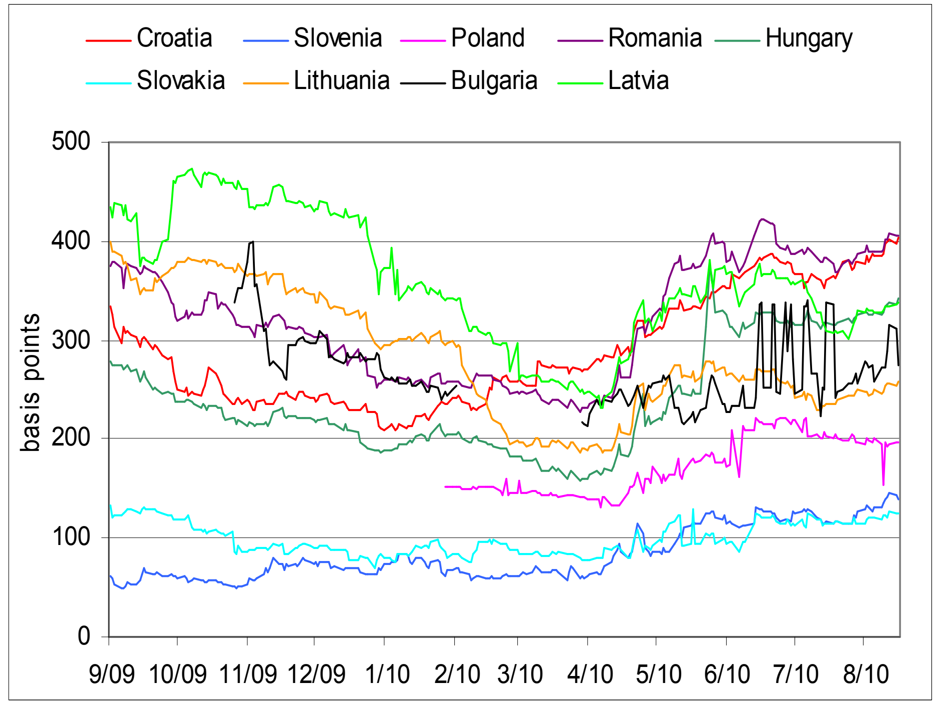
MD1

CDS spreads for 5-year bonds of selected countries



Countries with CDS spread levels between 350 and 600 b.p. – Bulgaria, Croatia, Hungary, Serbia and Romania.

Spreads of similar euro-denominated bonds of selected countries compared with the benchmarks German bond DBR 3.5 07/04/19



Source: Bloomberg

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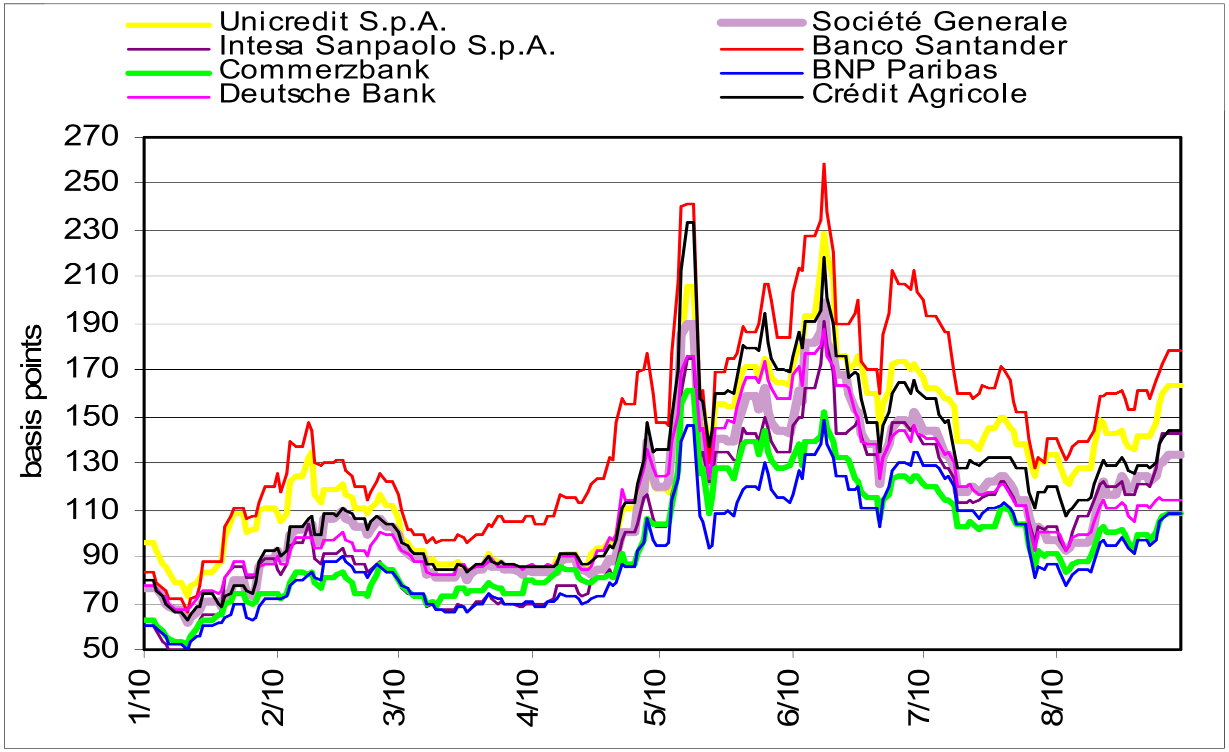
MD1 Mirna Dumičić, 8/30/2010

Repricing of risk – The third phase

- Cross-border banks active in the region have also been affected.

CDS spreads for 5-year bonds of selected banks

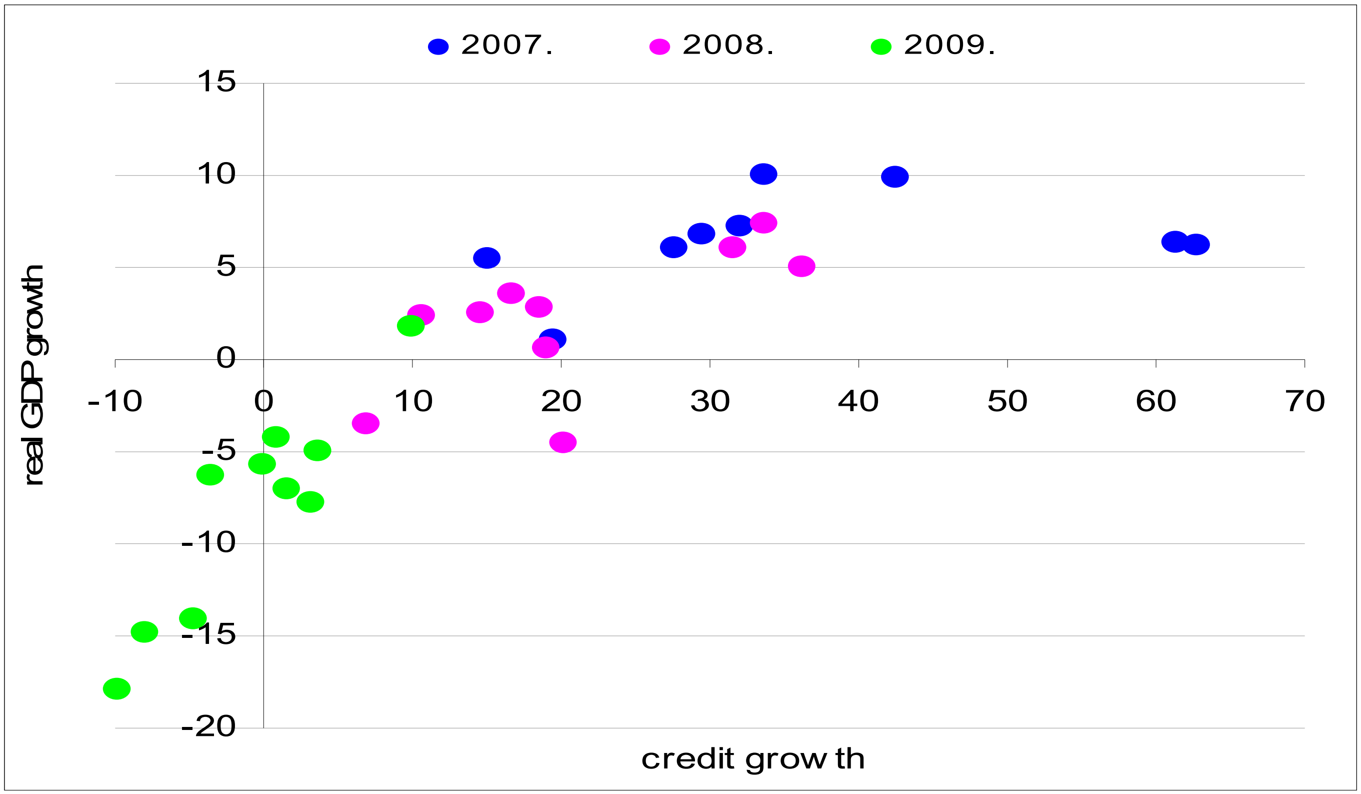


Source: Bloomberg

Effects of the crisis on the credit risk in CEE/SEE countries

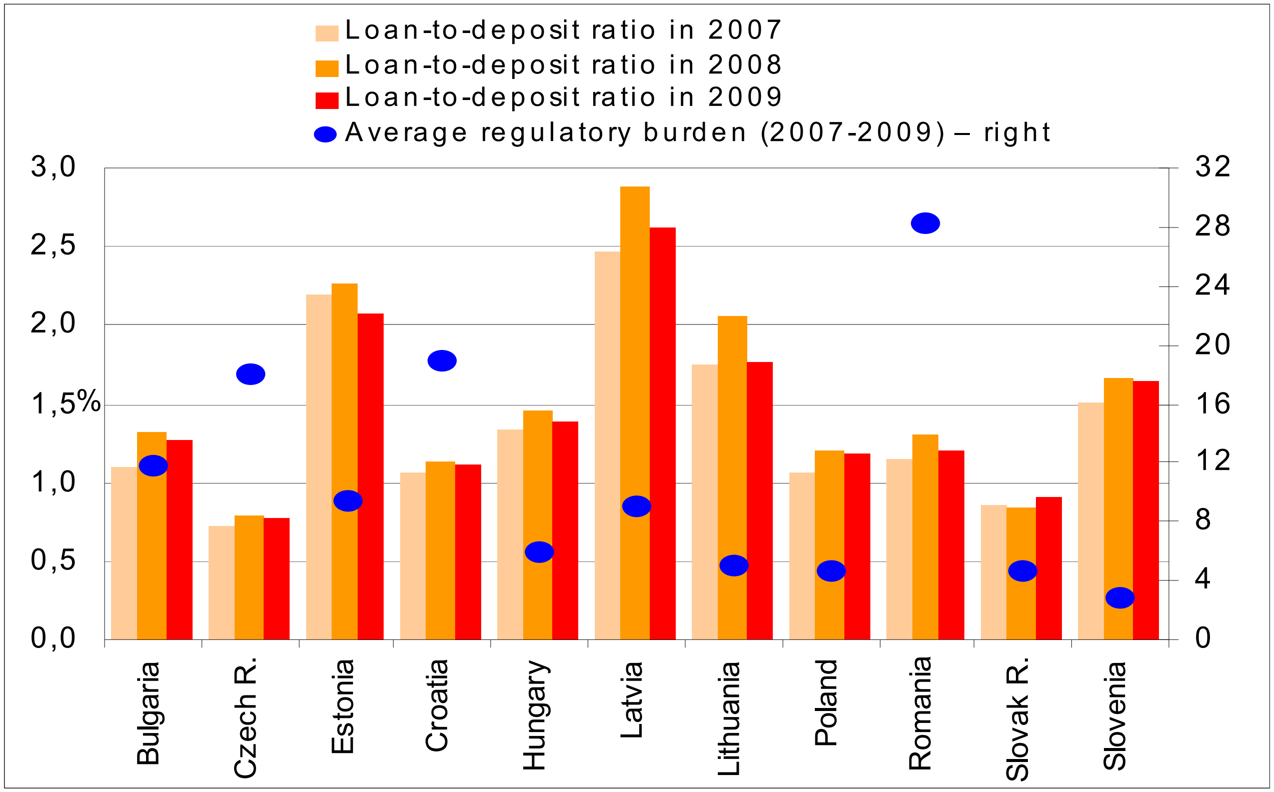
- Before the crisis, SEE and some CEE countries were in a vulnerable macroeconomic position.
- Rapid credit expansion in the region had supported strong but unsustainable GDP growth
- Banks in the region were heavily dependent on foreign resources
- Some countries tried to slow down capital inflows and growth in loan-to-deposit ratios by various regulatory restrictions (Particularly the Czech Republic, Croatia, Romania). They were only partially successful, as other forms of capital flows were not under central bank control.
- Except for the 4 of the best performers (Czech Republic, Slovakia, Slovenia, Poland), all other countries in the CEE/SEE region had entered the crisis with large current account imbalances.
- On the back of the output boom, deficits in some of them at the onset of the crisis were also excessive (Hungary, Croatia, Romania).

Economic and credit growth in selected CEE/SEE countries



Countries: Bulgaria, Czech R., Estonia, Croatia, Latvia, Lithuania, Hungary, Poland, Romania, Slovak R. and Slovenia
Sources: Eurostat; national central banks

Loan-to-deposit ratio in selected countries and regulatory burden

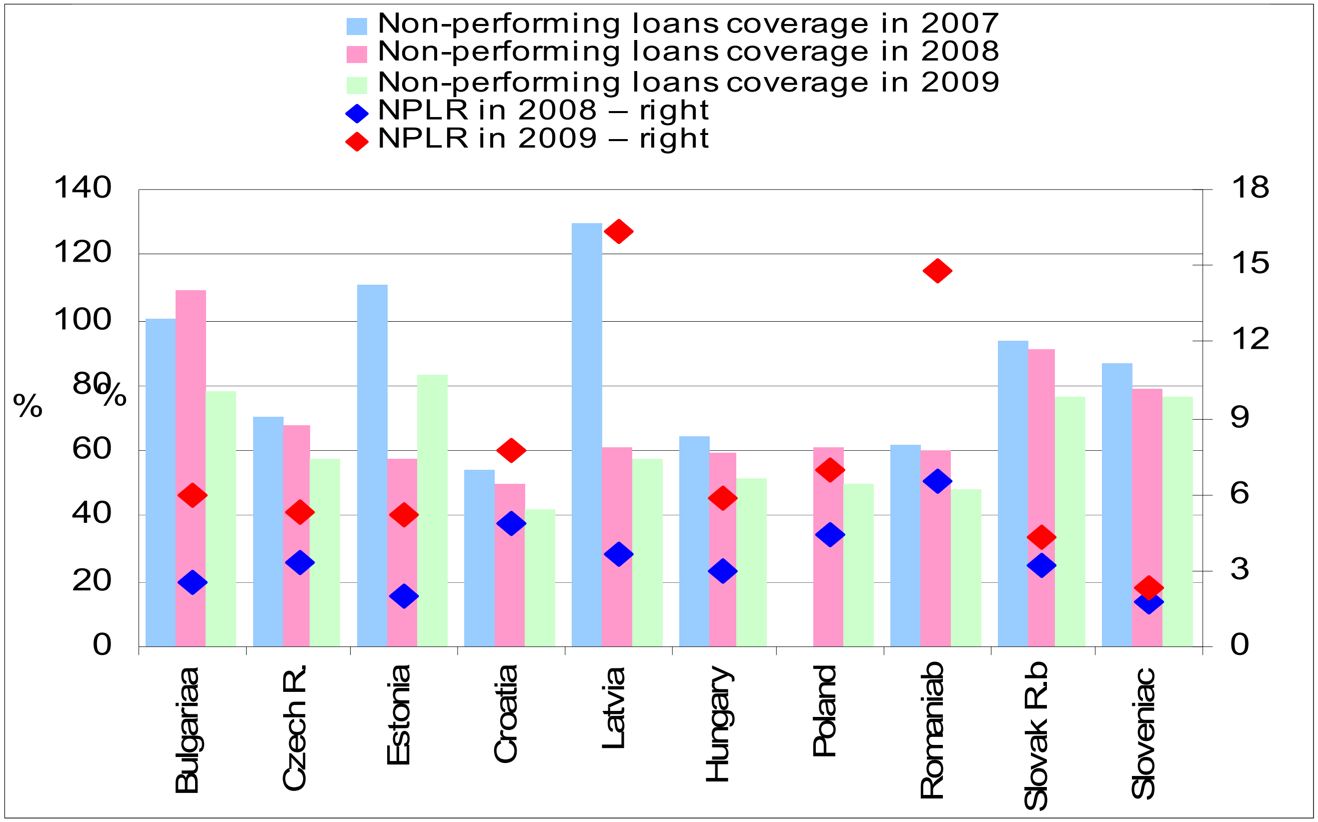


Source: National central banks

Macroeconomic factors are now strongly affecting the quality of credit

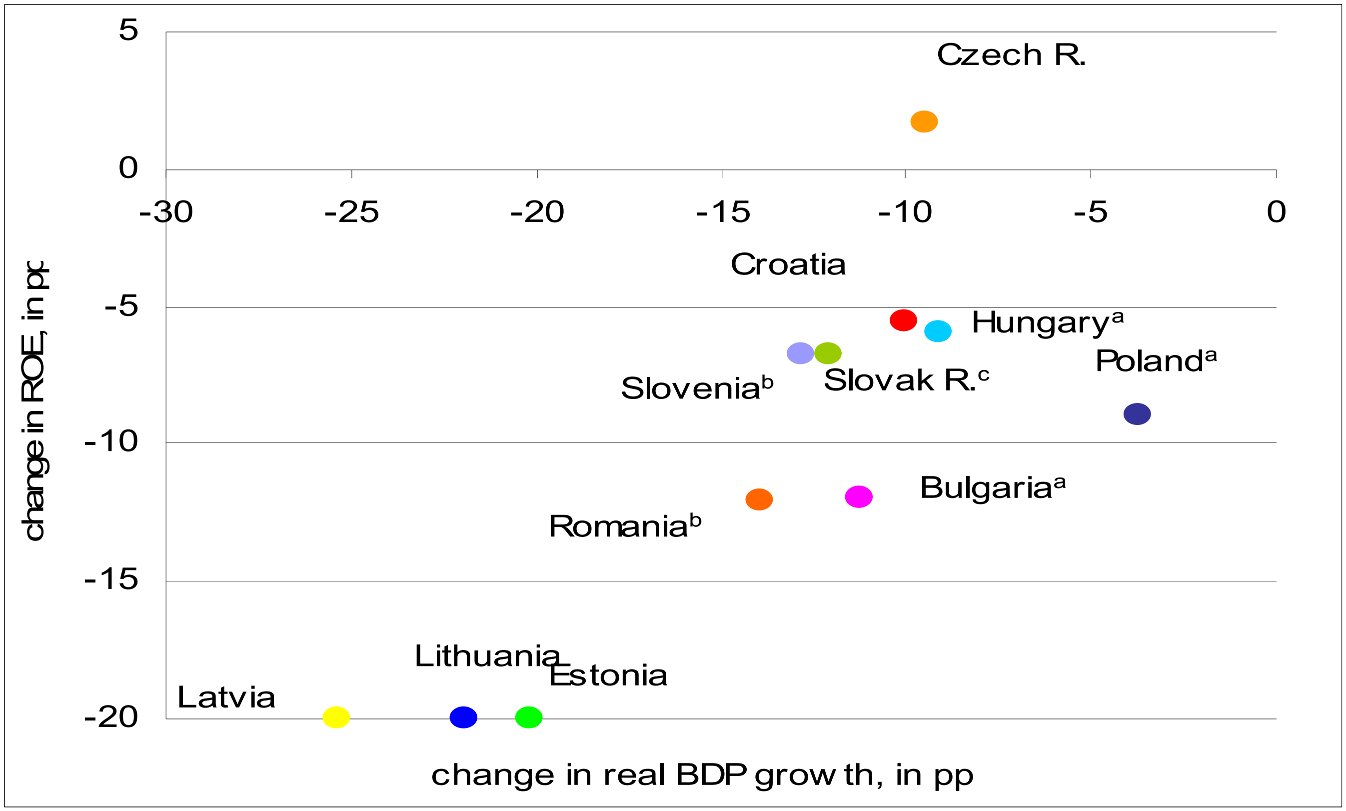
- Repricing of risk, part of which is permanent, has put pressure on the region to change the model of growth. As small open economies, they have to shift the structure of production toward tradable goods and services, and rely less on domestic demand fuelled by credit expansion.
- First the drop in output, now slow recovery, and prospects for permanent downward adjustment in potential growth, combined with the adjustment in relative prices, are now strongly affecting the quality of credit portfolios. The process of recognition has not yet come to the end.

Non-performing loans ratio and coverage in selected countries



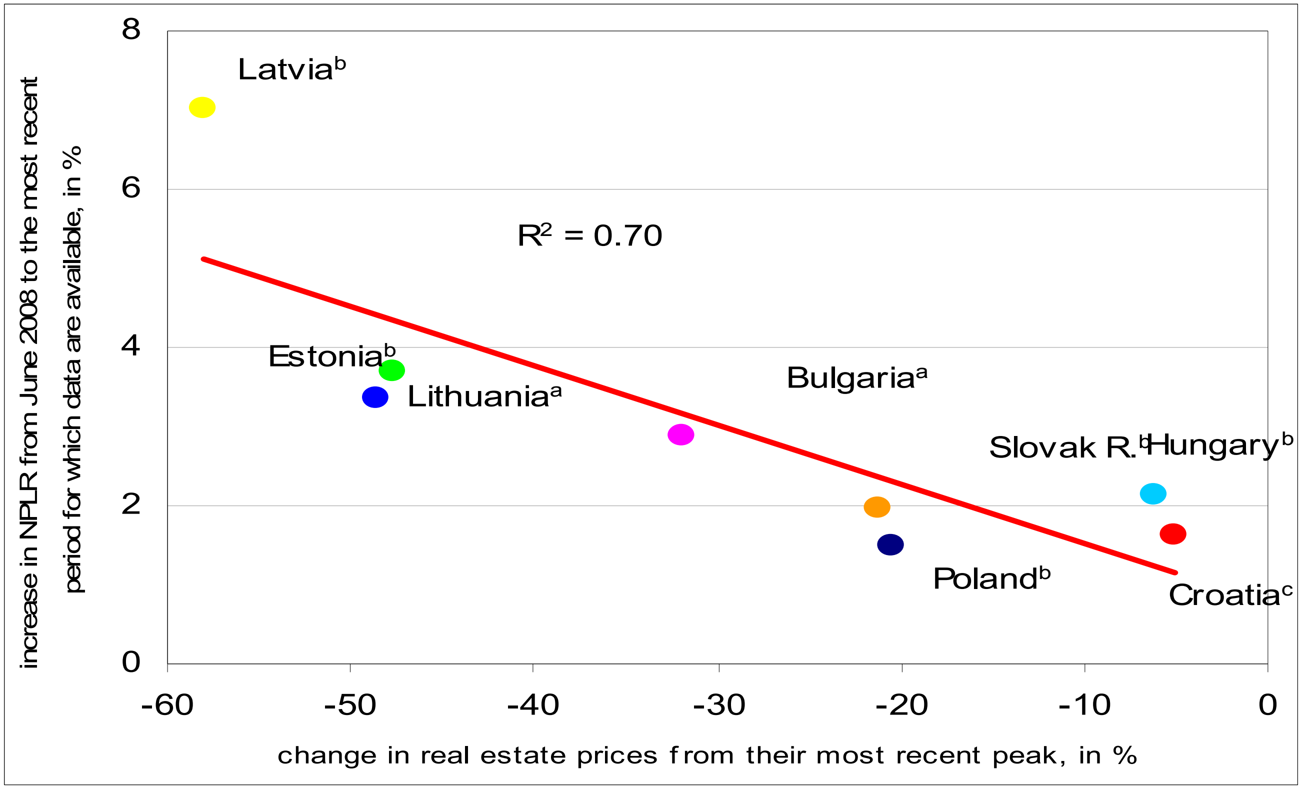
Sources: CNB and IMF (GFRS)

Economic growth and changes in bank profitability in selected countries



Note: All data refer to the end of 2009, with the exception of: a, b and c, which refer to September, October and November 2009 respectively
Sources: Eurostat and national central banks.

Relationship between changes in real estate prices and non-performing loans



Note: a March, b September and c December 2009
Source: based on De Haas, Knobloch, In the wake of the crisis: dealing with distressed debt across the transition region, EBRD, Working paper, 112, January 2010

Financial stability in the SEE countries

- On the positive side, output recovery started, although the SEE region is somewhat lagging.

GDP growth rate, annual, in percent

	2009	Q1/2010	Q2/2010*	2010**
Czech Republic	-4,1	1,1	2,7	1,6
Slovakia	-4,7	4,8	4,6	2,7
Slovenia	-7,8	-1,2	2,2	1,1
Poland	1,7	2,9	4,0	2,7
Estonia	-14,1	-2,0	3,5	0,9
Latvia	-18,0	-6,0	-3,0	-3,5
Lithuania	-14,8	-2,8	1,3	-0,6
Hungary	-6,3	0,1	1,0	0,0
Bulgaria	-5,0	-3,6	-1,5	0,0
Croatia	-5,8	-2,5	-2,5	-0,5
Romania	-7,1	-2,6	-0,5	0,8
Serbia***	-2,9	0,6	1,6	2,0

•flash estimate; ** forecast; Sources: Eurostat, ***WEO database April 2010

Current account balances in selected countries

in percent of GDP

They still remain an issue in SEE

	2007	2008	2009	2010
Czech Republic	-3,1	-3,1	-1,0	-1,7
Slovakia	-5,3	-6,5	-3,2	-1,8
Slovenia	-4,8	-6,2	-0,3	-1,5
Poland	-4,8	-5,1	-1,6	-2,8
Estonia	-17,8	-9,4	4,6	4,7
Latvia	-22,3	-13,0	9,4	7,0
Lithuania	-14,6	-11,9	3,8	2,7
Hungary	-6,8	-7,2	0,4	-0,4
Bulgaria	-26,9	-24,2	-9,5	-6,3
Croatia	-7,6	-9,2	-5,4	-6,3
Romania	-13,4	-12,2	-4,4	-5,5
Serbia	-15,6	-17,5	-5,7	-8,2

Source: IFS, WEO Database, April 2010

Financial stability in the SEE countries

General government balance, in percent of GDP

	2007	2008	2009	2010
Czech Republic	-0,7	-2,0	-6,0	-5,1
Slovakia	-1,9	-2,3	-6,3	-5,8
Slovenia	0,3	-0,3	-6,1	-6,1
Poland	-1,9	-3,7	-7,2	-7,5
Estonia	2,9	-2,3	-2,1	-2,4
Latvia	0,6	-7,5	-7,7	-12,9
Lithuania	-1,0	-3,3	-8,9	-8,6
Hungary	-4,9	-3,7	-3,9	-3,8
Bulgaria	3,5	3,0	-0,8	-1,8
Croatia*	-2,5	-1,4	-4,1	
Romania	-3,1	-4,8	-7,4	-6,5
Serbia	-1.9	-2.6	-4.1	-4.8

Sources: IFS, WEO Database, April 2010; CNB

Financial stability in the SEE countries - prospects

- Further developments in financial soundness' indicators in the region will depend on a combination of external and domestic factors.
- On the external front, crucial will be the perception of sovereign credit risk in the so-called European periphery. Further pressures might have negative consequences for the CEE/SEE region.
- The output dynamics in the EU will also matter, given the strong trade links.

Financial stability in the SEE countries - prospects

- On the domestic front, crucial will be fiscal soundness and achieving a more balanced growth model.
- Further adjustment in the external current account remains an issue in the SEE countries.
- There is here a difference with Baltic countries, where the budget balances remain an issue, but the current account has sharply turned to positive numbers.
- Fiscal developments will heavily depend on the interaction of output performance and reform efforts.
- The main risk is a self-reinforcing circle of higher financing costs, lower growth, and fiscal sustainability concerns.

Financial stability in the SEE countries – Regulatory issues

- Financial stability in SEE and some CEE countries has been affected by large capital inflows that led to strong but unsustainable GDP growth and large current account imbalances, while hiding the underlying weak fiscal position.
- In some countries, national central banks tried to slow down bank credit growth, but the effectiveness of their measures was undermined by inflows via other channels.
- Their efforts were also undermined by the pressure to eliminate all forms of capital controls in the process EU accession.
- Strangely enough, Basel II has also eliminated the higher capital adequacy weights for foreign currency loans.
- Home country regulators did not seem to be paying sufficient attention to bank exposure toward countries with unsustainable current account positions, even if in monetary union. This issue still remains to be addressed in the current reform of the regulatory system.

Financial stability in the SEE countries – Regulatory issues

- But at this point, the reform of regulatory framework is of lesser importance given the absence of rapid credit expansion and capital inflows.
- Still, some proposed changes, like the elimination of national discretion in setting higher capital requirements are puzzling. Are we repeating mistakes of Basel II under the influence of the financial sector?
- More important is the management of existing credit portfolios and prudent loss recognition, which might be somewhat lagging. The problem of zombie assets is not gone.
- Strong efforts to create adequate provisions is therefore currently the most important task for avoiding surprises and facilitating recovery.