

Collapse in Eastern Europe?

The Rationale for a European Financial Stability Fund

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As if core Europe did not have enough problems of its own, a new threat has arisen: the collapse of the European periphery. The deteriorating foreign exchange and financial conditions of satellite countries in the euro area – from the Baltic region, to Eastern Europe, Turkey and Ukraine, not to mention the imploded Icelandic financial system – add yet another source of uncertainty.

The problems in Eastern Europe weigh particularly heavily on the financial solidity of EU banks since they provided the backbone of the banking and financial system in those countries, and therefore are now much exposed to the consequences of mounting flights of capital and currency attacks in those countries. EU banks are not yet strong enough to face additional losses from this front since, despite huge government rescue plans, they have in aggregate received little new capital (less than €200 billion for the entire euro zone). BIS estimates indicate that European banks hold somewhat more than \$600 billion of cross-border claims on emerging European economies (probably 90% of the reported total of around \$700 billion).¹ When all European banks run for the exit (e.g. by refusing to roll over credit lines that come due or to extend further credit to their subsidiaries), they are increasing their own losses.

But there is a collective action problem here. If all European banks were to recapitalise their subsidiaries and not cut off credit lines, the inevitable adjustment in Eastern Europe would be much less disruptive and the losses would be much lower. But EU banks would need to coordinate such actions, and this would run afoul of EU competition rules. Moreover, no individual EU government has an incentive to provide its banks with the funds necessary to support Eastern Europe during these difficult times.

What is the problem in Eastern Europe?

Almost all Eastern European countries have been running large current account deficits, which are no longer sustainable in the current environment. In the Baltics and the Balkans, these deficits run into double-digit figures as a percent of GDP so that these countries face an extremely painful adjustment problem. However, the deficits of the larger among the new member countries (Poland and Hungary) have been much more modest. The total for the new Eastern European member states runs at only about €60 billion, about 0.5% of EU GDP.

¹ Some press articles have suggested that the total might be much higher, over \$1,500 billion. But these figures refer to a different aggregate, which includes domestic lending of subsidiaries, which is indeed much larger than the exposure of EU banks. But the limit of the losses to EU banks is given by their direct exposure to banks and enterprises in Eastern Europe. Other foreign debt is in securities, official loans, FDI inter-company loans, etc, which do not directly concern EU banks.

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Is there a need to finance these deficits, or could they be quickly reduced via depreciation, which has already happened? It is often argued that a large depreciation might create more problems because of the balance sheet dislocations it can cause.

One aspect that has been emphasised in this context is the high proportion of mortgages in Poland and Hungary denoted in foreign currency. This is true, but in both countries mortgages account for less than 15% of GDP (see table below). So the balance sheet problems for the household sector should be manageable even if all mortgages were in foreign currency and one takes into account some additional consumer credit also denominated in foreign currency. In the case of Hungary and Poland fluctuations in the exchange rate should thus not create unmanageable balance sheet problems.

Residential mortgage debt as a % of GDP

Czech Republic	15.3	Bulgaria	9.9
Hungary	12.4	Estonia	36.3
Poland	11.7	Latvia	33.7
Romania	3.5	Iceland (in memoriam)	121.0

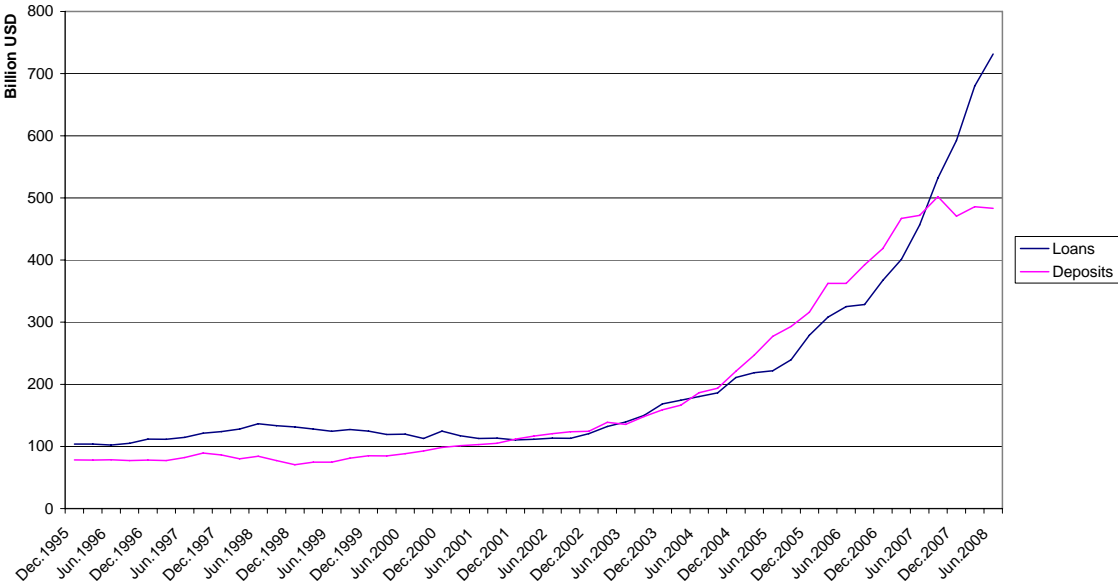
Source: European Mortgage Federation.

The Baltic and Balkan countries are in a more difficult position since mortgages are more important in the Baltics and both would face immense credibility problems should they abandon their currency boards, but their economic mass is minor compared to the others.

Foreign currency-denominated loans are more important in the corporate sector throughout the region, but one has to keep in mind that after a decade of massive FDI inflows, a large part of the corporate sector is owned in any event by firms from the ‘old’ EU-15. These firms face similar incentive problems regarding their Eastern European subsidiaries as do the banks.

The exposure of the banking sector to Eastern Europe seems to constitute a more serious problem. The total exposure of all BIS reporting banks to the entire region (including Turkey and Ukraine, but excluding Russia) is now around \$800 billion. About two-thirds of this total is in the form of loans. As the figure below shows, international bank lending to Eastern Europe started to grow briskly only when the Federal Reserve wanted to save the world from deflation in 2001-02 via its policy of permanently low interest rates. But until about the middle of 2007, lending to the regions had been growing in line with deposits from the region. It is only after the subprime crisis broke in the summer of 2007, that net lending to the region took off. This suggests that the total ‘at risk’ from the region should be around the around \$250 billion in quick credits granted since then (the last creditors typically take the first losses). It is generally assumed that the bulk (90%) of this exposure is to EU banks.

**External loans and deposits of BIS reporting banks in Eastern European countries
All sectors**



All in all, it thus appears that what is needed in Eastern Europe is not massive balance-of-payments financing to governments, but a normal flow of credit to the private sector and a substantial recapitalization of the banking sector. However, the EU banking sector is not able to finance this and faces the collective action problem mentioned above.

In this environment of continuing systemic stress on the banking system, the case-by-case approach at the national level must be abandoned in favour of an ambitious EU-wide approach. The EU should set up a massive European Financial Stability Fund (EFSF). Given the scale of the problem facing European banks, the fund will probably have to be on a substantial scale, involving about 5% of EU GDP or about, say €500–700 billion.² This is more than might be needed for Eastern Europe, but the crisis is certain to get worse before a recovery sets in and it will thus be better to have such an instrument ready to face further emergencies. Most of the funds (say, 80%) would probably be used to provide credits (or buy existing ones at a discount) and the remainder for capital injections, which would make the EIB a major shareholder in the Eastern European subsidiaries of EU banks and probably also a major shareholder in those EU banks most exposed to Eastern European risk. Eastern European banking systems would effectively be ‘europeanized’.

Practical details

Such a Fund could be set up quickly at the European Investment Bank (EIB), which already exists as a solid institution with the necessary expertise. The EIB is an agency of EU governments, whose board of governors, which includes the ministers of finance of all member countries, recently decided to increase the capital base of the EIB to €230 billion (which is more than the capital of the IMF). With a gearing of only 4:1, the EIB could thus expand its loan portfolio up to €1,000 billion. Given that its lending at present amounts to about €300 billion, it could thus expand its activities by about €700 billion even without any additional capital increase.

The existing borrowing of the EIB already represents a sort of ‘euro bond’, but the magnitude involved should and could be massively increased along the lines outlined above. If capital markets do not accept a gearing of 4:1 as proposed here, it might be necessary to provide bonds issues beyond a certain ceiling with an explicit guarantee of member states.

The EFSF would in essence constitute a ‘bad bank’ for the European periphery. It could buy existing credits at a discount and recapitalize banks³ and roll over credit lines to borrowers with solid long-term prospects – credit lines that might otherwise be cut by under-capitalized and excessively risk-averse EU banks.

As the rationale for the EFSF is crisis management, its operations should be wound down after a pre-determined period (say, 5 years). For global investors, EFSF bonds would be practically riskless, given the backing of the EIB by member states.

There would thus be no need to tap national budgets in order to provide substantial support for Eastern Europe. Further East (in Ukraine, for example) the EBRD should fulfill the same task, again without large outlays by member countries.

Setting up such a fund does not imply that stronger member countries would have to pay for the mistakes of the others since at the end of its operations losses arising from lending to EU banks could be distributed across member countries according to where they arose. But in all likelihood, the Fund would not lose, but rather would make money, because its funding costs would be much lower than that of member states and because its existence would stabilize Eastern Europe.

Germany, which so far has opposed this idea, might be the biggest beneficiary because its banks are likely to be its largest customer, its automobile industry would benefit the most from a stabilization of the European banking sector and its exporters would gain the most from a stabilization of the European periphery.

² The EBRD is currently launching a useful, but modest initiative to support bank recapitalization in the region. But the sum of €10 billion allocated to this initiative is clearly insufficient to solve the problem.

³ At present the EIB statutes do not allow it to take equity stakes, but this will change when the Lisbon Treaty enters into force. In the meantime this legal obstacle would need to be circumvented by strengthening another existing vehicle, namely the EIF (European Investment Fund).

A collective European action to support Eastern Europe would have two additional advantages:

- **It would provide markets with high-quality euro public sector debt**

The overall message from financial markets is that investors everywhere have developed a strong preference for public debt. In the US and Japan, public debt carries no risk because if needed the governments could always force the (national) central banks to print the money needed to meet their obligations. But this is not the case in Europe since no European government can force the ECB to print money. For international investors there is thus no euro area government bond in which they could invest to diversify their risk away from the dollar. There is at one and the same time strong demand for 'European' bonds and a need for massive government capital infusions to prevent the crisis from getting worse in the banking sector and the European periphery.

- **Collective action would face fewer political problems**

A fund run by a European institution would lead to a different political economy dynamic. It is politically very difficult for the new member countries to accept a situation in which their banks are under stress because their euro-area headquarter banks do not have enough capital. National policy-makers in the euro area have been quite explicit in telling their banks to 'lend national'. This is understandable. Euro area governments put their taxpayers' money on the line and they thus have to look at the benefits from a purely national point of view. But this situation leads to a clear conflict between new members and euro area governments. Equity investment and loans from an EU institution would not only take care of the externality, they would also neutralize this political issue. Moreover, the EFSF could also complement existing EU instruments for balance-of-payments assistance to the European neighbourhood.

Eastern European economies have now been caught up in the global financial crisis. Massive balance-of-payments assistance would be misguided since it would transform private into public debt in a futile effort to stabilize exchange rates. Large depreciations might be unavoidable for the larger countries to correct current account deficits and the available data suggest that even if there were overshooting of exchange rates, the problem with foreign currency debt of households should be manageable.

But the banks and enterprises in Eastern Europe need access to normal credit flows, which have been impaired by the weakness in the EU banks which dominate the financial systems in the region.

A large EU-led fund (best via the EIB) could keep credit flowing by basically 'Europeanising' financial systems in Eastern Europe. The cost of the alternative, either doing nothing or limiting action to ad hoc measures that do not solve the twin problems of undercapitalization and extreme risk aversion, would be immense.