



Credit Development in Central and South-Eastern Europe and Several Policy-Related Issues

Speech Delivered at the Central and South-East European Financial Forum

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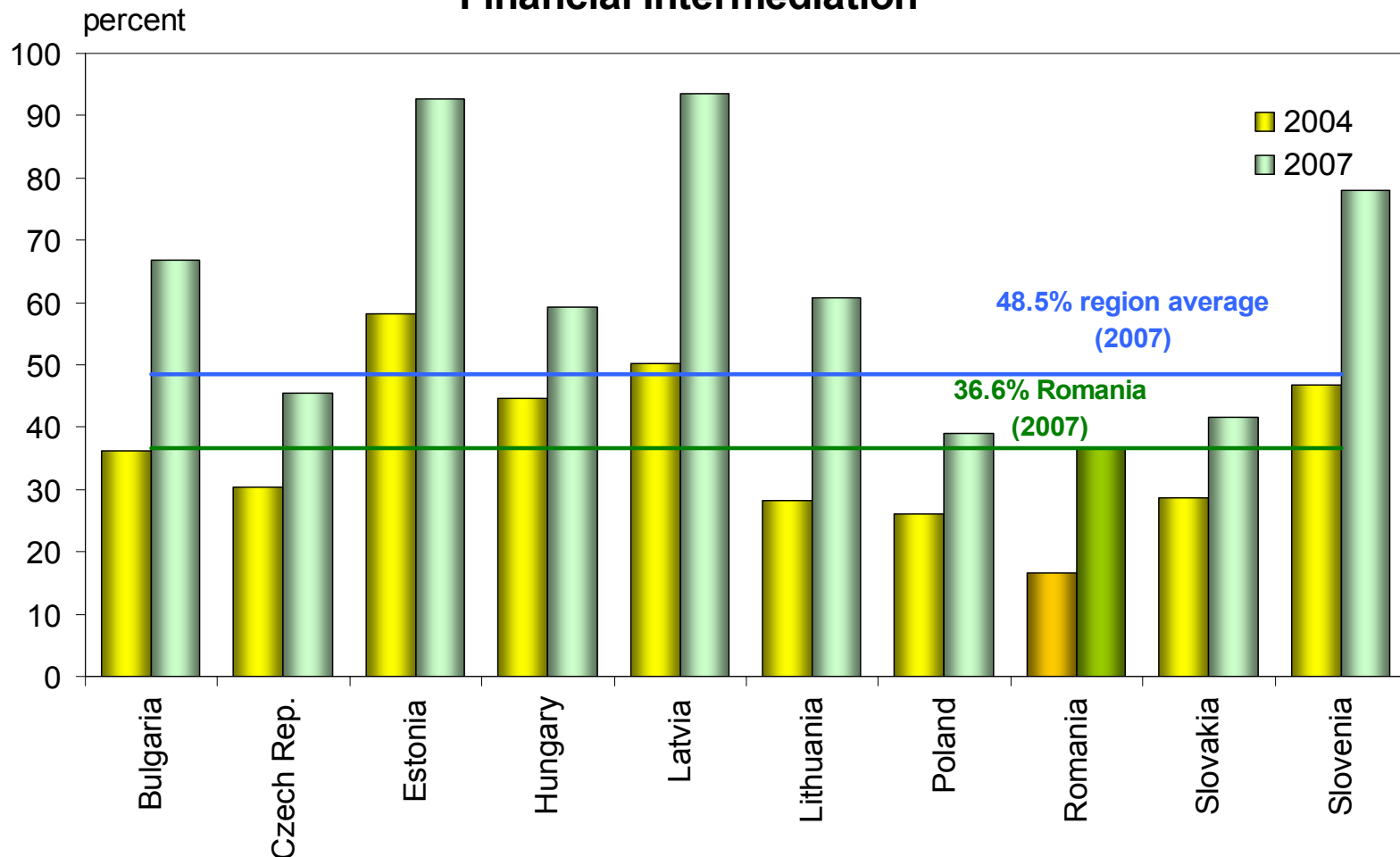
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Financial Intermediation in Central and South-Eastern Europe

Main Features

- Privatization of the banking system accomplished mainly through foreign banks
- Rapid credit growth
 - ✓ by debtor (corporate/households)
 - ✓ by currency (local/forex)
- Strengthening of banking regulation and supervision according to EU rules
- Banking systems challenged for the first time by international financial turbulences: how will they withstand?

Financial Intermediation*

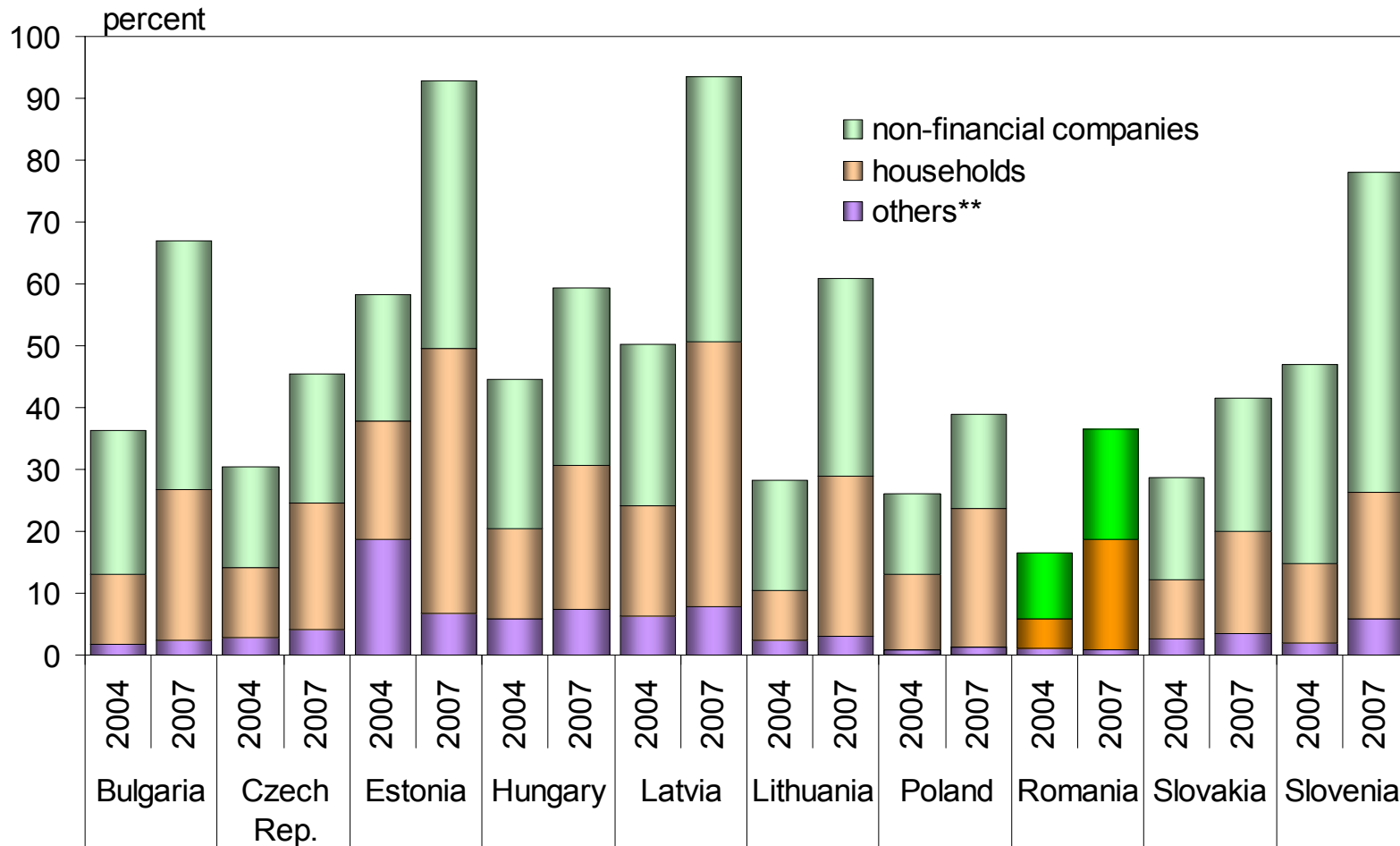


Source: Websites of central banks and EUROSTAT

for Romania: National Bank of Romania, National Institute of Statistics

*) loans to the private sector/GDP

Financial Intermediation*



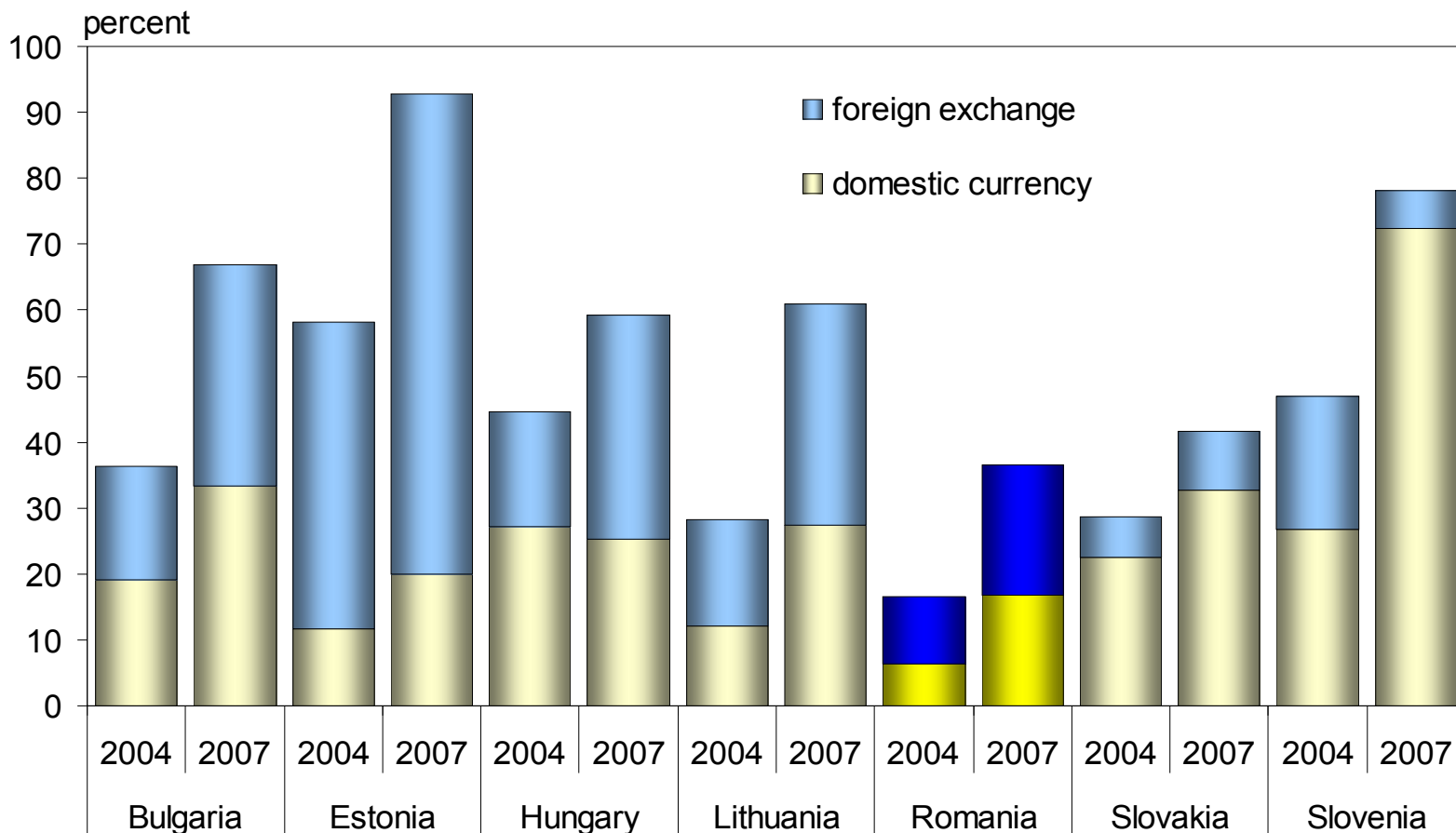
*) loans to the private sector/GDP

***) insurance corporations, other financial intermediaries and financial auxiliaries

Source: Websites of central banks and EUROSTAT

for Romania: National Bank of Romania, National Institute of Statistics

Financial Intermediation*

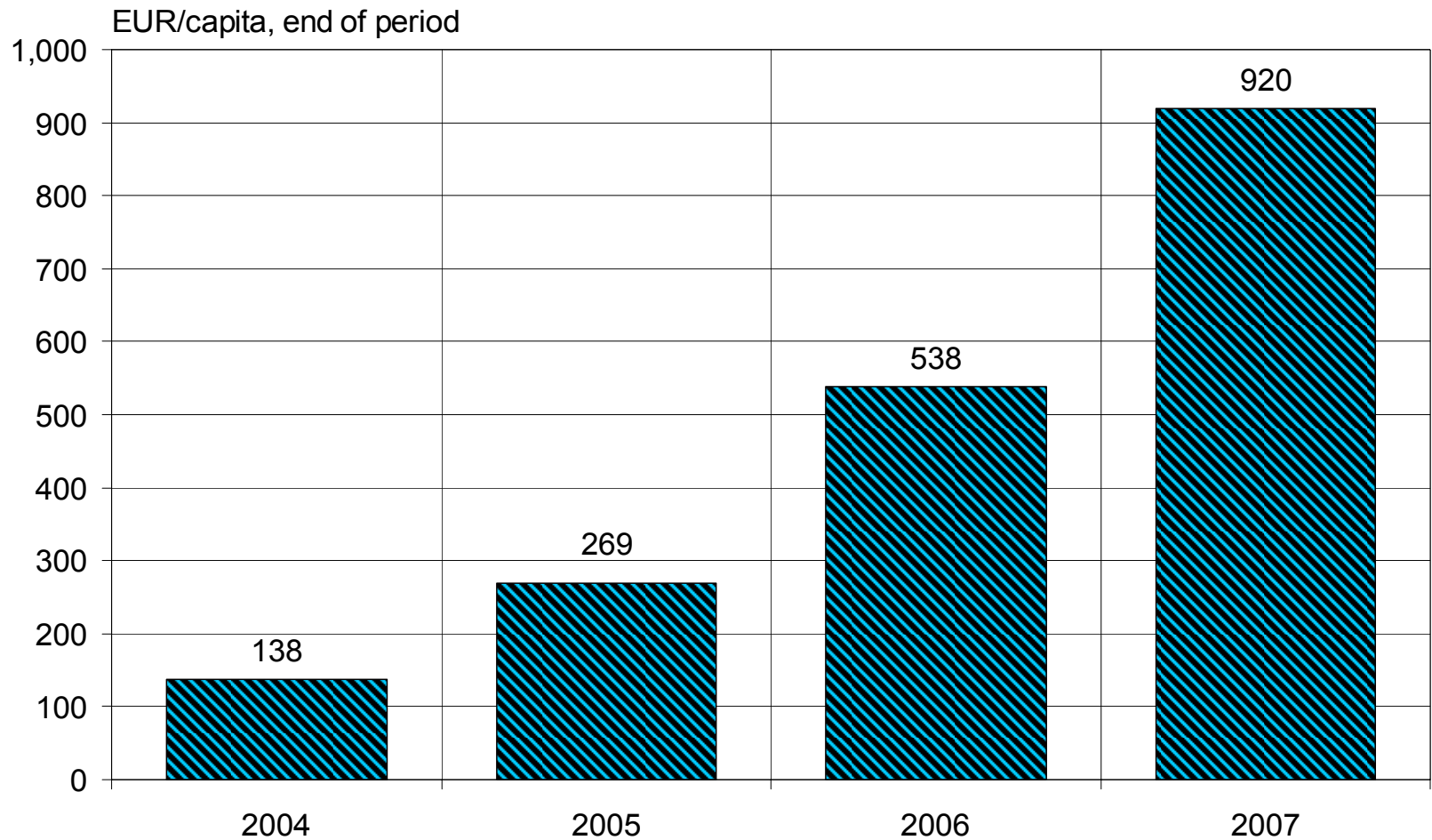


*) loans to the private sector/GDP

Source: Websites of central banks and EUROSTAT

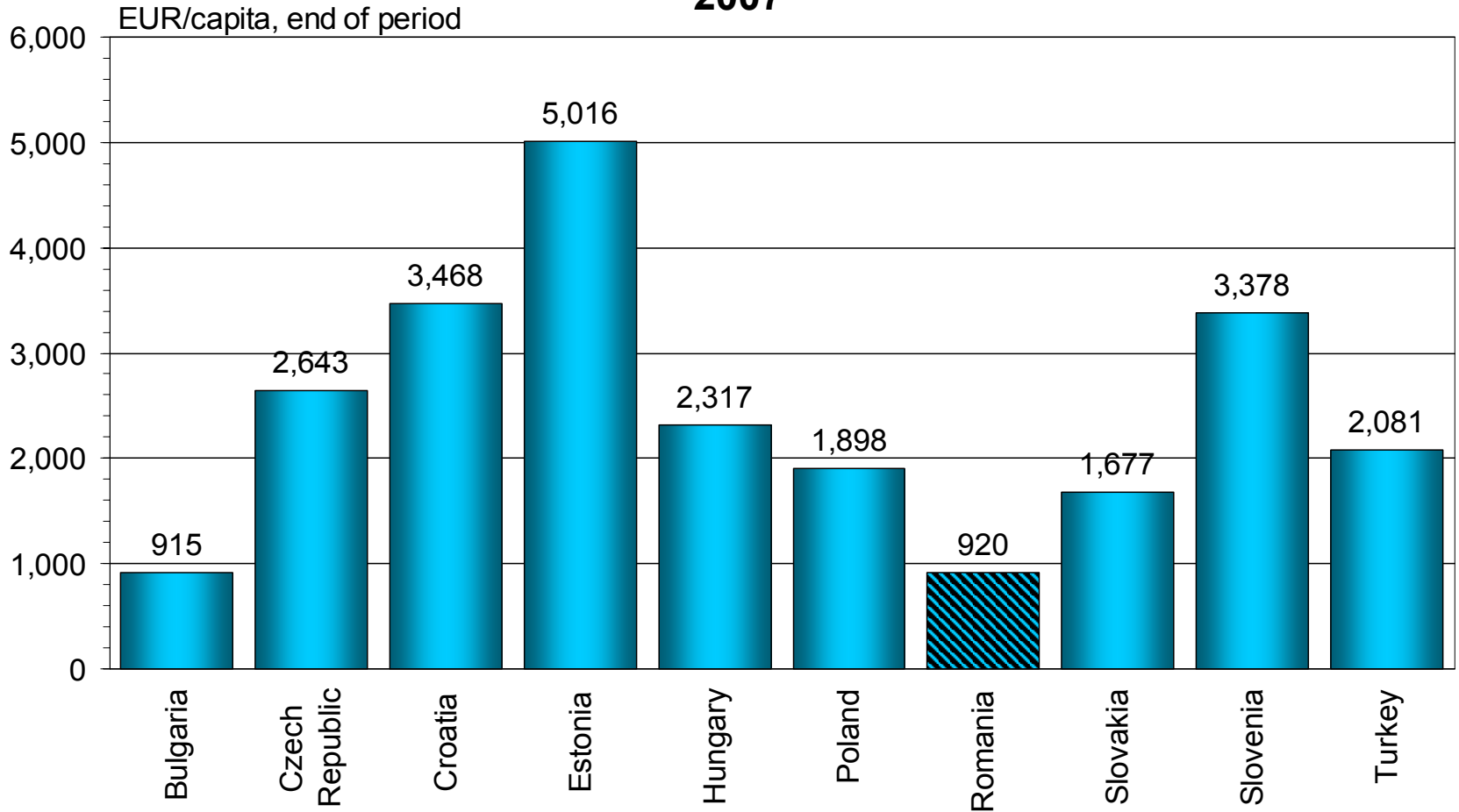
for Romania: National Bank of Romania, National Institute of Statistics

Romania: Loans to Households per Capita (1)



Source: National Bank of Romania, National Institute of Statistics

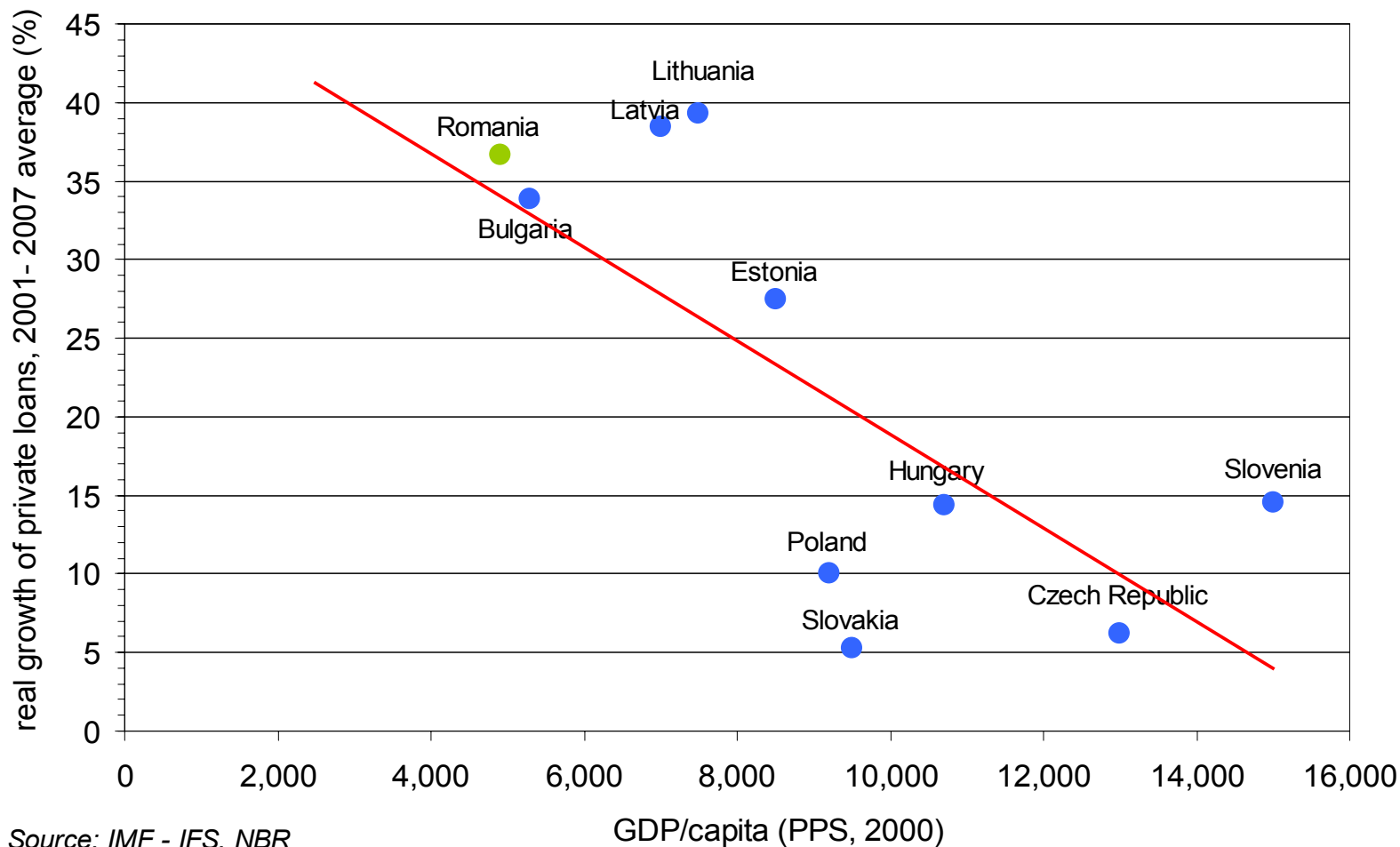
Loans to Households per Capita (2) 2007



Source: Websites of central banks and EUROSTAT

for Romania: National Bank of Romania, National Institute of Statistics

Negative Correlation between the Standard of Living and Credit Dynamics



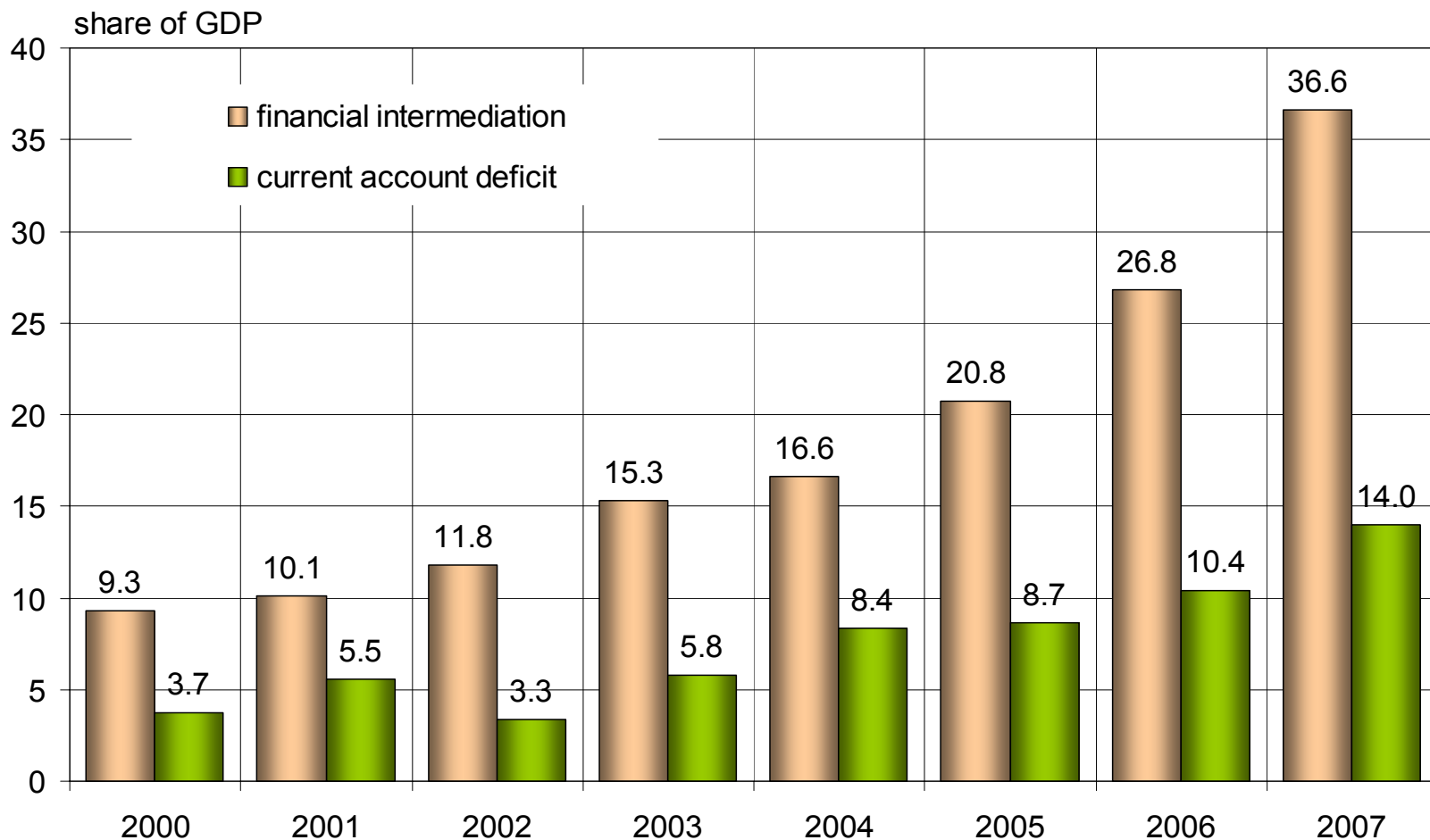
Source: IMF - IFS, NBR

Facing Credit Boom

Why is Rapid Credit Growth a Source of Concern?

- **It fuels excess aggregate demand ⇒ inflationary pressures**
- **Higher risks to financial stability:**
 - ✓ Positive correlation with the current account deficit
 - ✓ Increased share of households' debt service in their income
 - ✓ Proliferation of currency risk
 - ✓ Need for enhanced ability of banks to manage increasing risks
 - ✓ Escalating real estate asset prices, with additional risks transferred through bank collateral

Romania: Financial Intermediation and Current Account Deficit



Source: National Bank of Romania, National Institute of Statistics

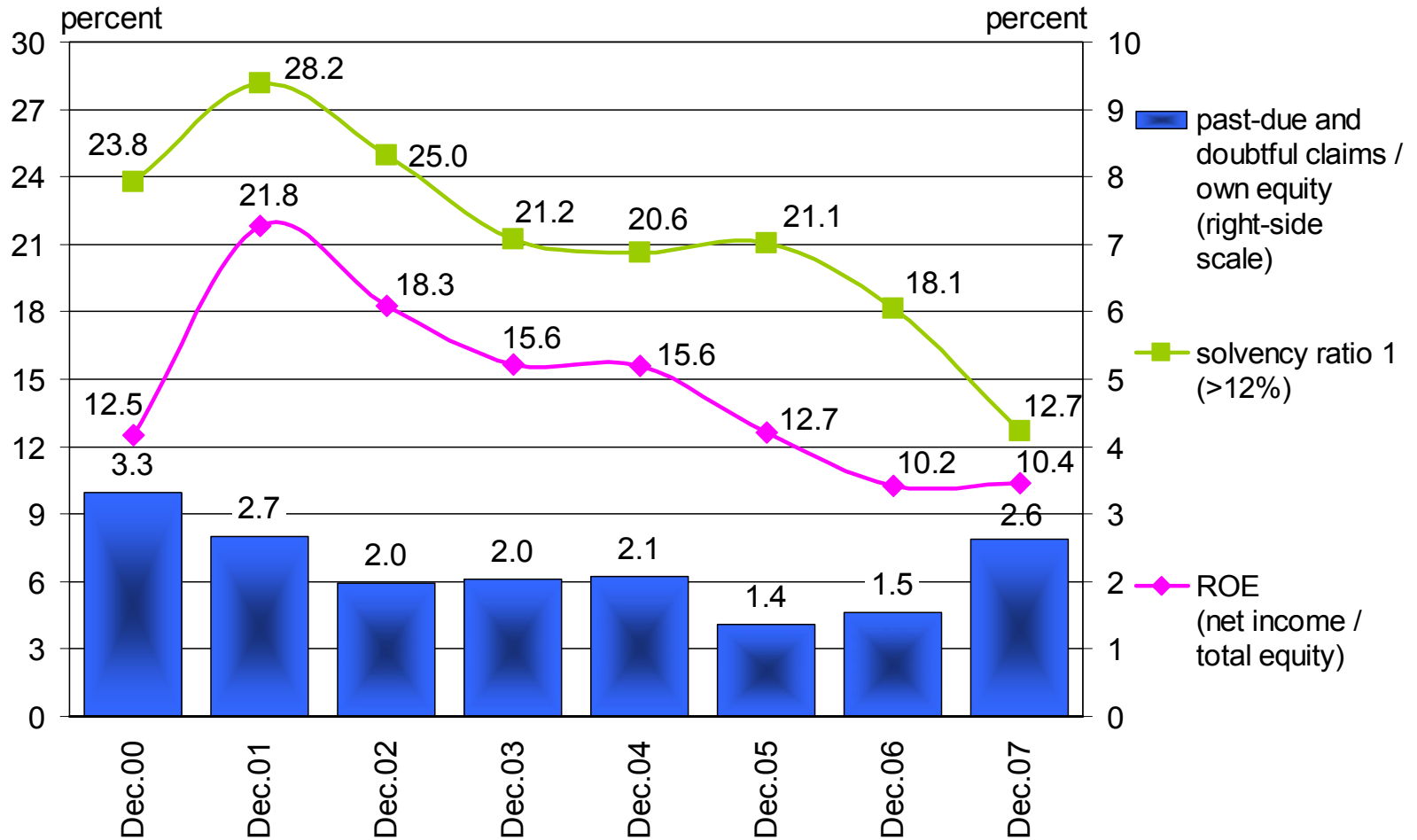
Non-Performing Loans

The share of non-performing loans in total loans ranged between 2% and 4% over the last four years in most New Member States

BUT

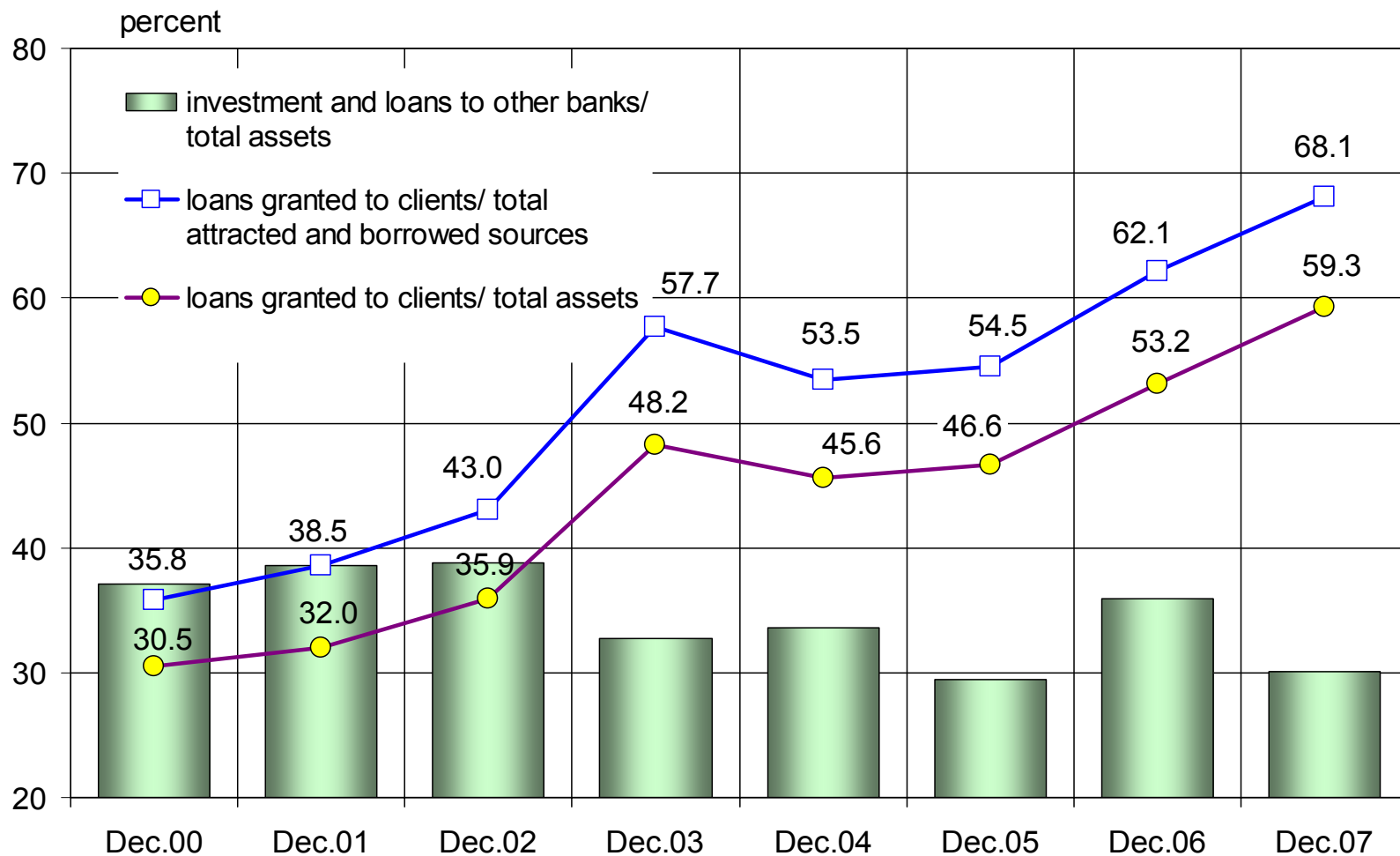
- Rapid credit growth might conceal worrisome developments in non-performing loans
- The ratio of loans granted to clients to total attracted and borrowed sources rose quite rapidly

Romania: Banking System Indicators (1)



Source: National Bank of Romania

Romania: Banking System Indicators (2)



Source: National Bank of Romania

Steps to be Taken over the Short- and Medium-Term (1)

- Starting with January 1, 2008 the provisions of Basel II are being implemented
- Further monitoring financial stability
 - ✓ A stable financial system should be capable of ensuring efficient resource allocation, absorbing potential shocks and preventing them from having a detrimental effect on real economy
 - ✓ Ensuring financial system stability has become an essential prerogative of the central bank, supportive of its primary objective, i.e. to ensure price stability

Steps to be Taken over the Short- and Medium-Term (2)

- Enhancing the quality of supervision
 - ✓ Greater involvement of credit institutions' executives in risk management
 - ✓ NBR regulations will be better tailored to the specific risk profile of each credit institution
 - ✓ Shift to consolidated supervision requires assessment of a credit institution's financial standing based on prudential indicators calculated at a consolidated level

Co-operation with Supervisory Bodies in Europe

- The NBR is represented in the Committee of European Banking Supervisors and in its subcommittees
- The NBR is involved in the activity of the Group of Banking Supervisors from Central and Eastern Europe
- The NBR has so far signed 10 bilateral memoranda and one multilateral memorandum of understanding for increasing the efficiency of supervision
- Negotiations between the NBR and the Central Bank of Cyprus are underway for a new co-operation agreement, given that both countries are now EU Member States
- Negotiations with Banco de Portugal started in early 2008 with a view to concluding a co-operation agreement in the field of supervision

Financial Stability and Price Stability

Approaching Financial Stability (1)

- In a broader sense, it focuses on the overall financial system functioning
 - ✓ Financial stability = an environment in which the financial system is capable of efficiently attracting and investing funds while also withstanding shocks without hurting real economy

IMPLICATION FOR THE CENTRAL BANK:
prudential supervision is essential to safeguarding financial stability

Approaching Financial Stability (2)

- From a narrower perspective, it focuses on avoiding crises
 - ✓ Financial stability = an environment in which:
 - no banking crises occur
 - asset prices and particularly interest rates are highly stable

IMPLICATION FOR THE CENTRAL BANK:
the interest rate policy is very important to financial stability => it may even come down to a conflict between the objective of price stability and that of financial stability

Relation between Price Stability and Financial Stability

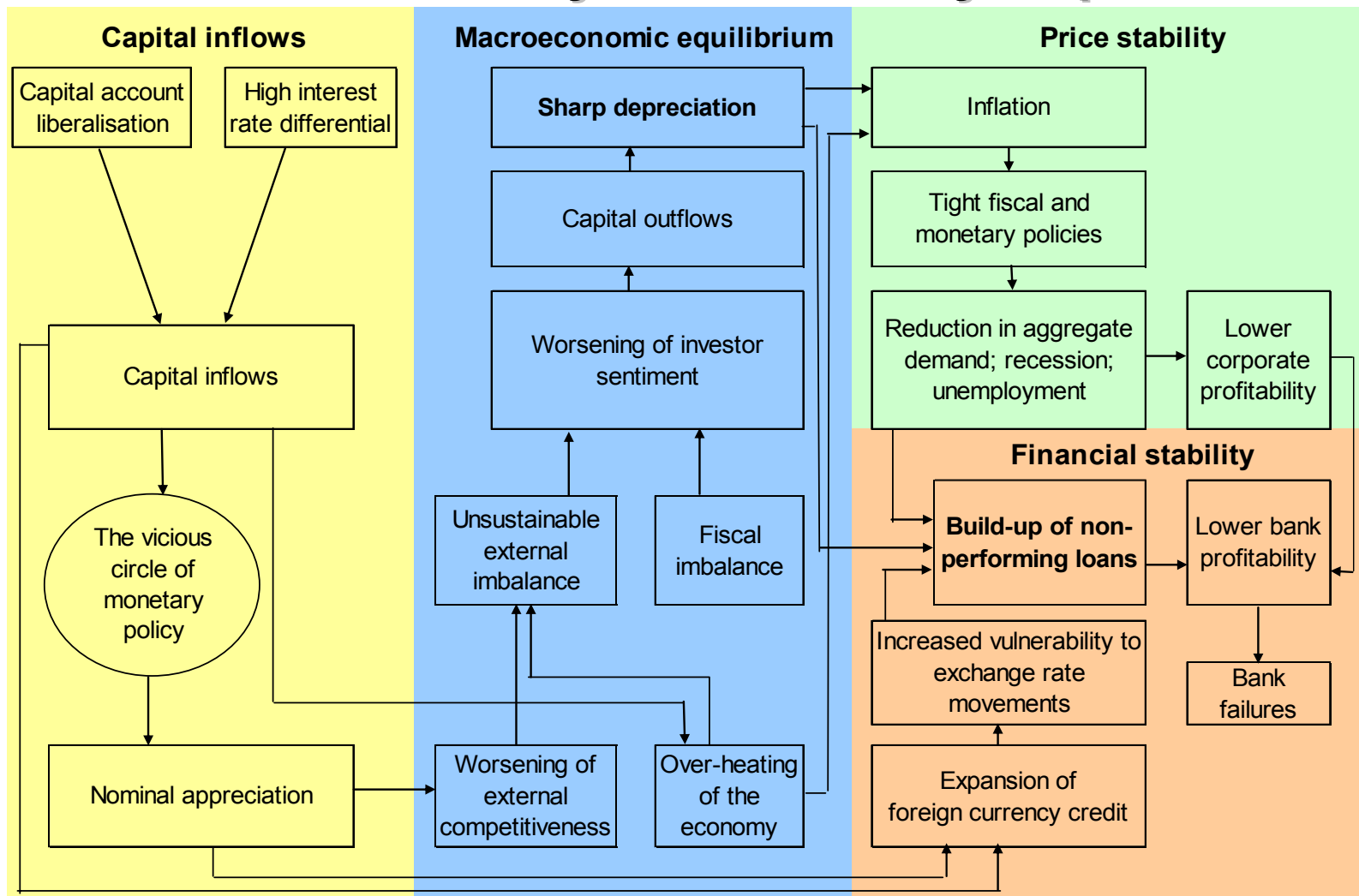
- Conventional approach: the two types of stability complement and strengthen each other over the long run
- “New environment” hypothesis: low and stable inflation may foster the creation of a new economic environment wherein financial stability is not warranted

Complementarity between Financial Stability and Price Stability

Discharging monetary policy of conflicting objectives

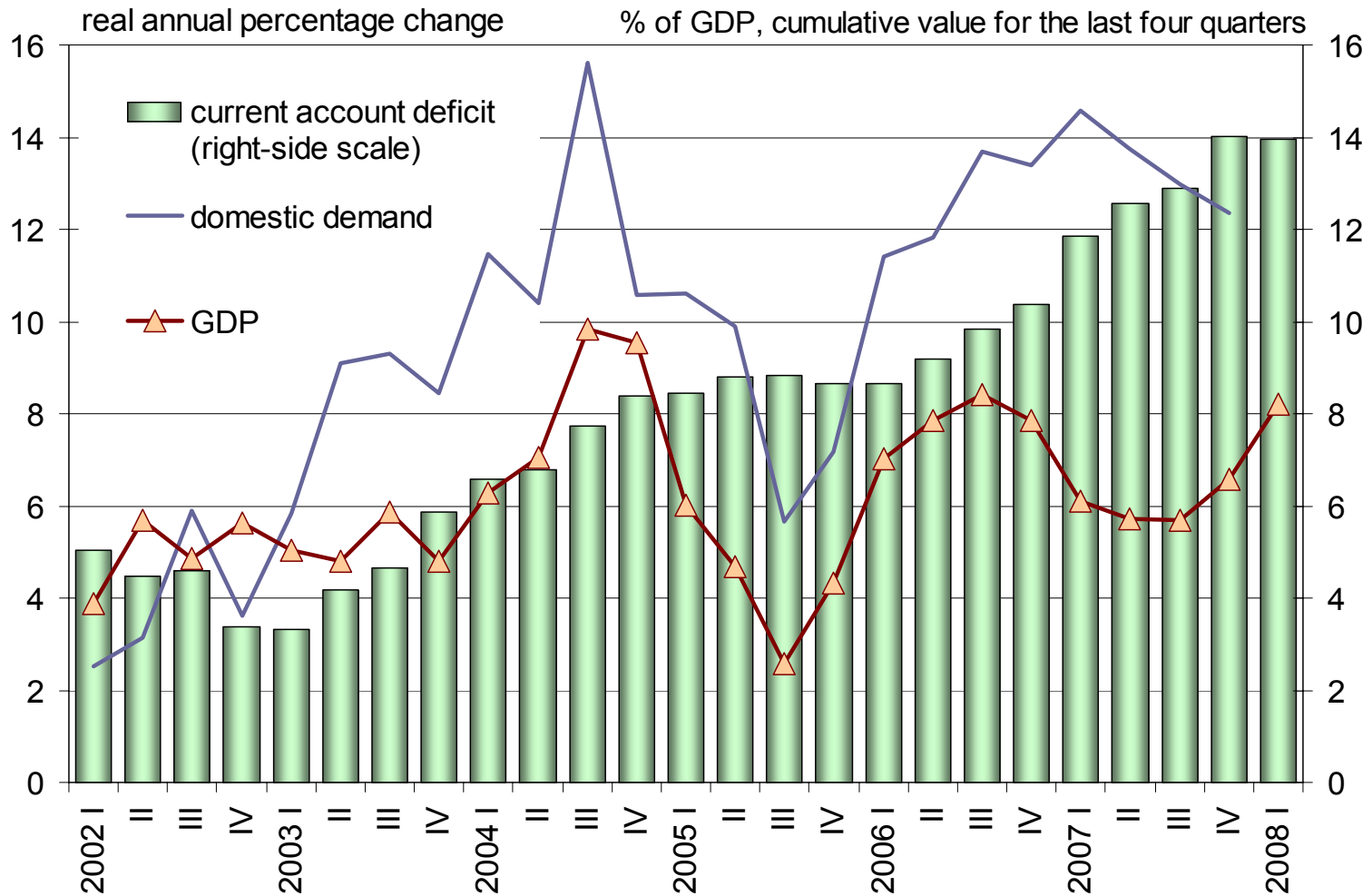


Vulnerabilities to Price Stability and Financial Stability Generated by Capital Inflows



Romania: Sustainability of Economic Growth

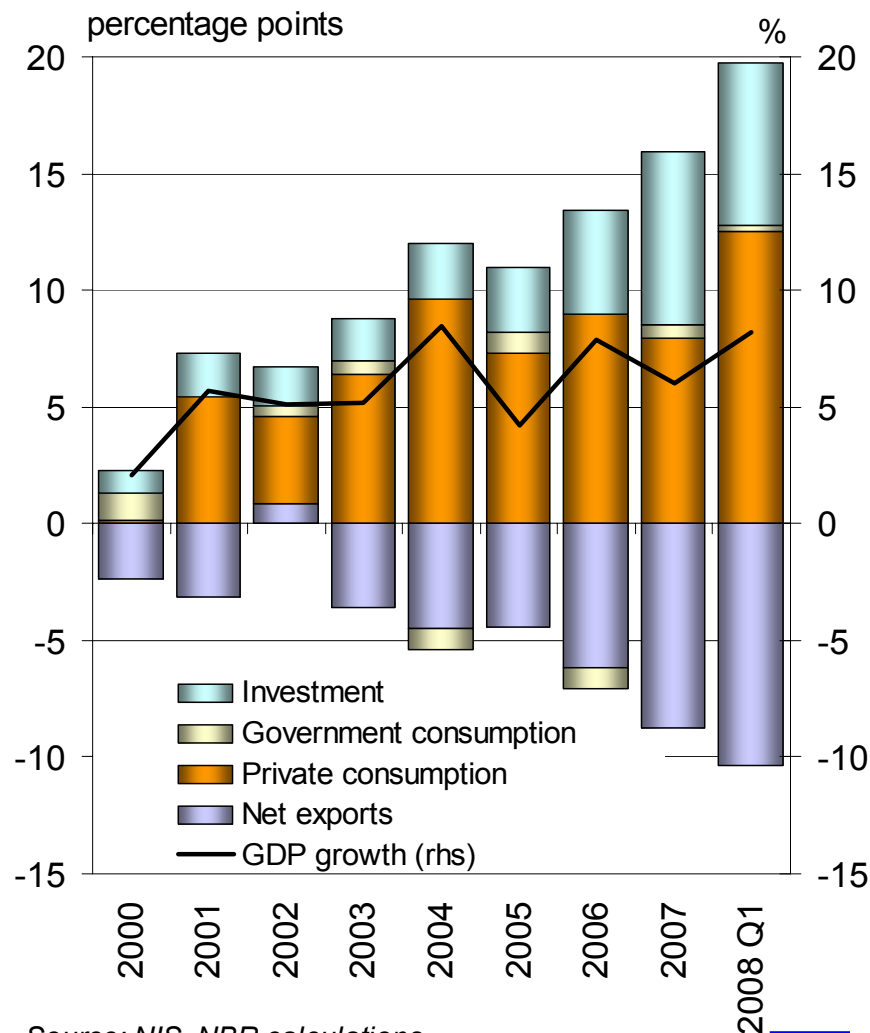
Domestic Demand and External Imbalance



Source: National Institute of Statistics, National Bank of Romania calculations

Drivers of Economic Growth

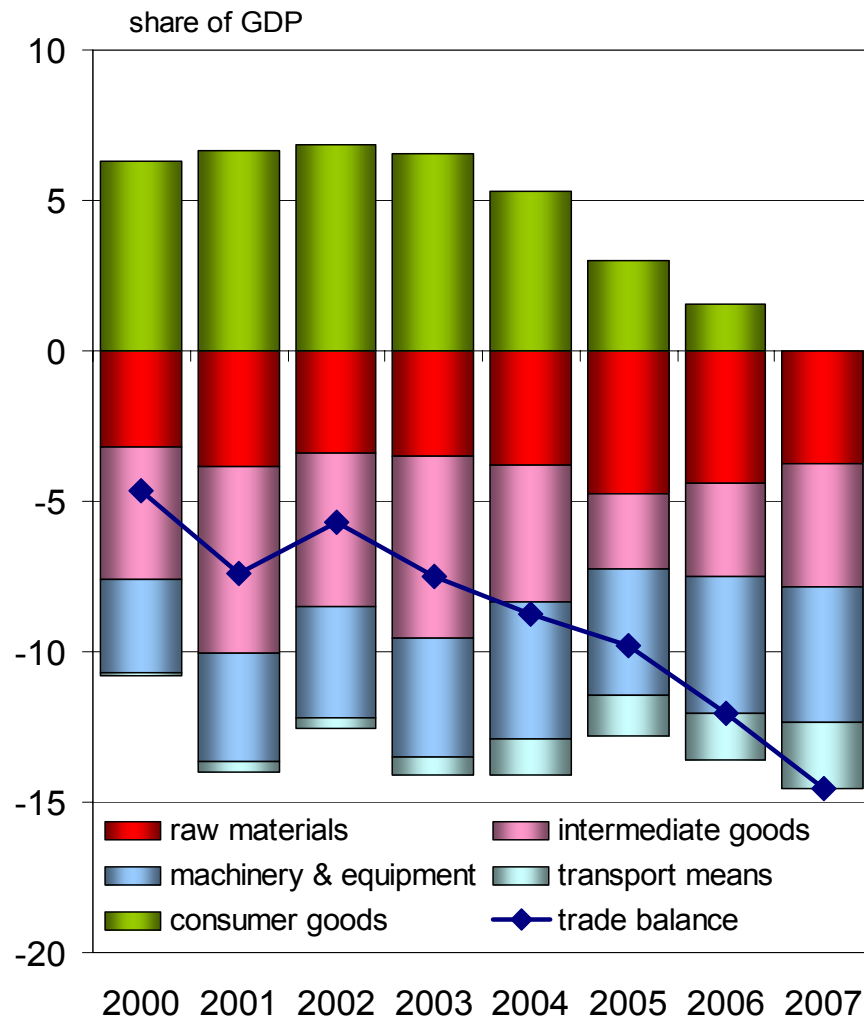
Long-term sustainability of economic growth requires a change of pattern, i.e. an enhanced contribution of exports and a less prominent role of consumption



Source: NIS, NBR calculations

Sources of Pressure on Trade Balance

- A significant part of the trade deficit is generated by capital goods, which reflects further progress in the catching-up process
- Capital goods and industrial consumption kept a broadly stable contribution to the trade deficit over the last 8 years
- The support provided by the surplus from consumer goods faded away, thus explaining the constant widening of the overall deficit

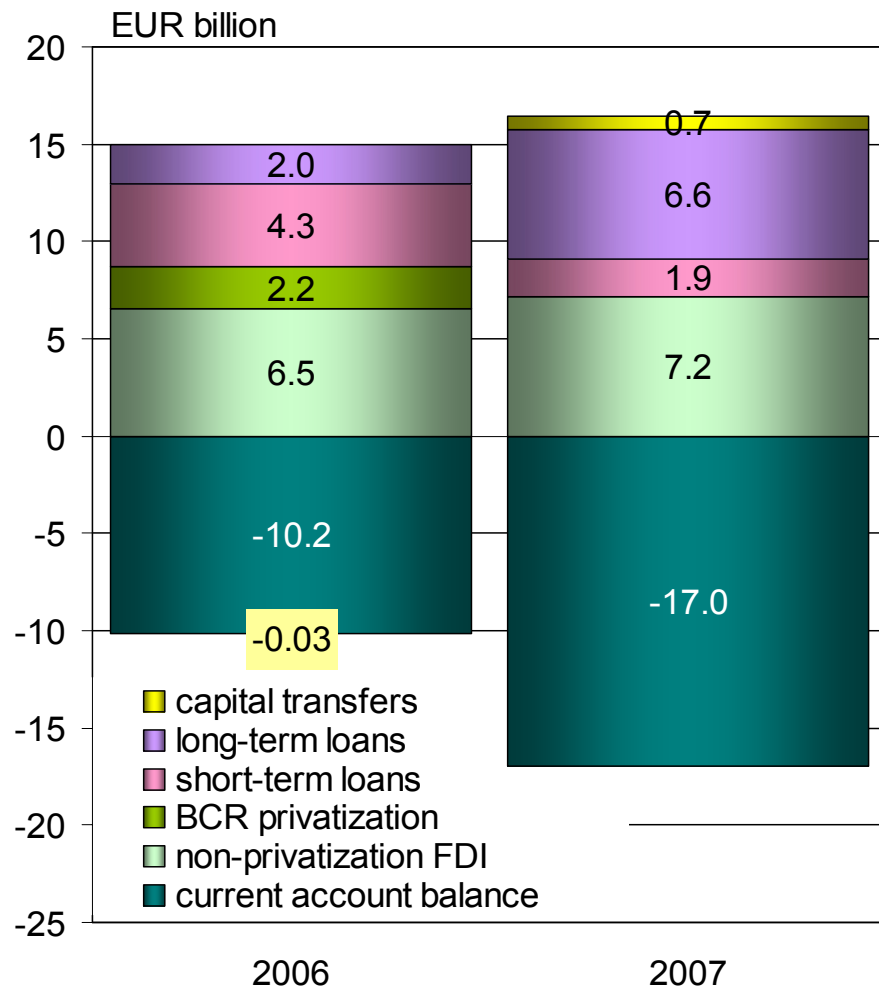


Source: NIS, NBR calculations

Current Account Deficit Financing via FDI

➤ Even though the external deficit coverage through foreign direct investment (FDI) shrank from 67.5% in 2006 (excluding proceeds from the BCR privatization) to 42% in 2007, the following encouraging developments deserve mention:

- ✓ Further rise in foreign investment not related to privatizations
- ✓ Further reinvestment of earnings from FDI
- ✓ The large share of medium- and long-term intra-group loans in total loans
- ✓ Propensity for taking medium- and long-term loans to the detriment of those with shorter maturities (manifest particularly among financial corporations)



Source: National Bank of Romania

Monetary Policy Traps

Monetary Policy Dilemmas

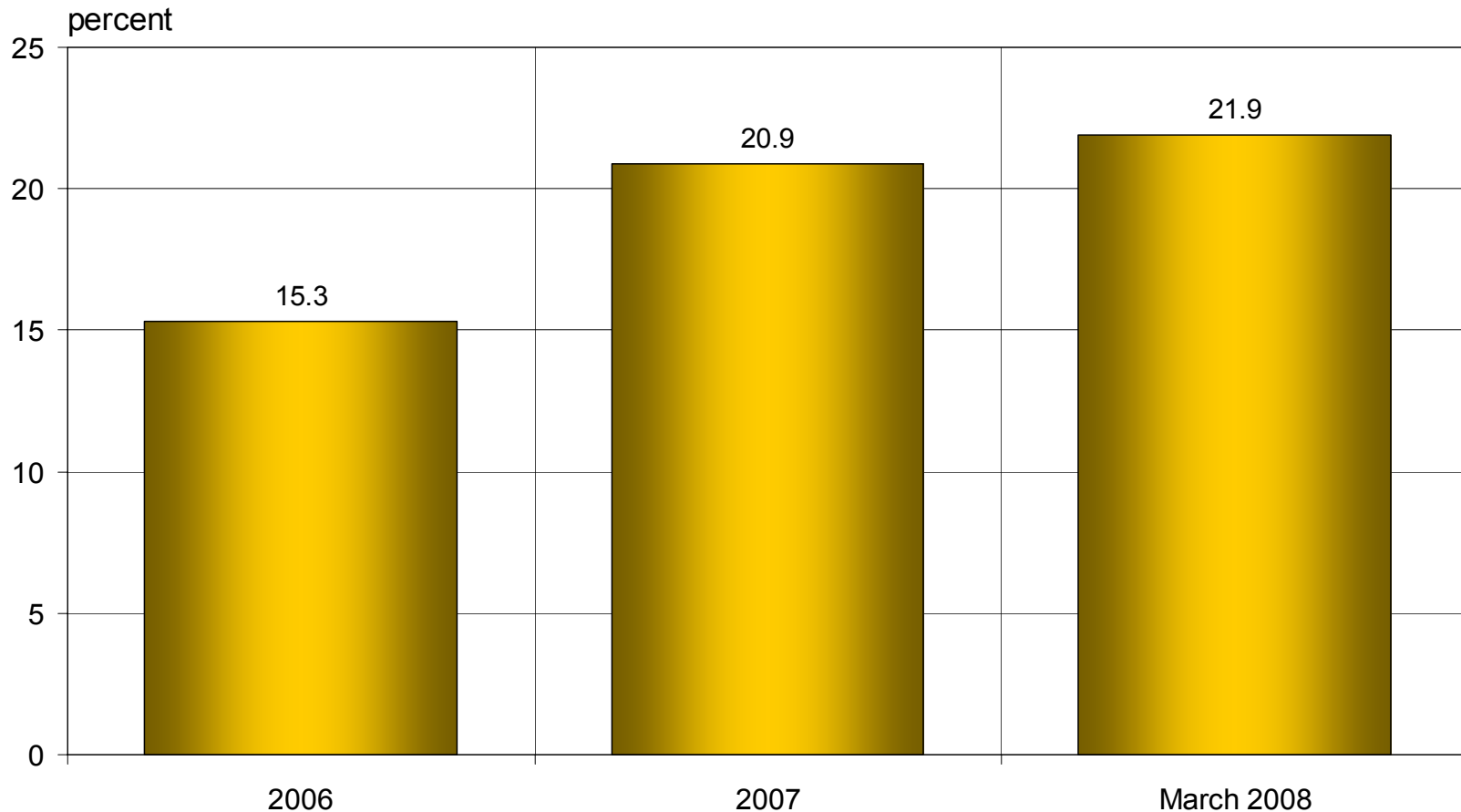
➤ Constraints:

- ✓ Interest rates either too high or too low lead to higher inflation and wider current account deficit
 - Overly high interest rates foster speculative capital, while overly low interest rates fail to ensure a balance between saving and investment
- ✓ In an economy featuring a high level of foreign currency substitution, an overly restrictive monetary policy excessively fuels forex loans
 - Factors: the drop in the relative costs of foreign currency financing and the appreciation induced by the interest rate differential

➤ Conclusion:

- ✓ A monetary policy more restrictive than that pursued by the NBR in recent years would have increased domestic and external vulnerability of the economy

Romania: Rising Inflows from Parent Banks to Local Banks



Note: the share of attracted and borrowed sources from parent banks in total liabilities

Source: National Bank of Romania

Liquidity in the Banking System: Where We Stand?

➤ **Net liquidity surplus on the downside:**

- ✓ Higher concentration of reserve surplus and more numerous credit institutions with a net reserve deficit
- ✓ The high level of required reserves provides room for maneuver to offset the related vulnerabilities

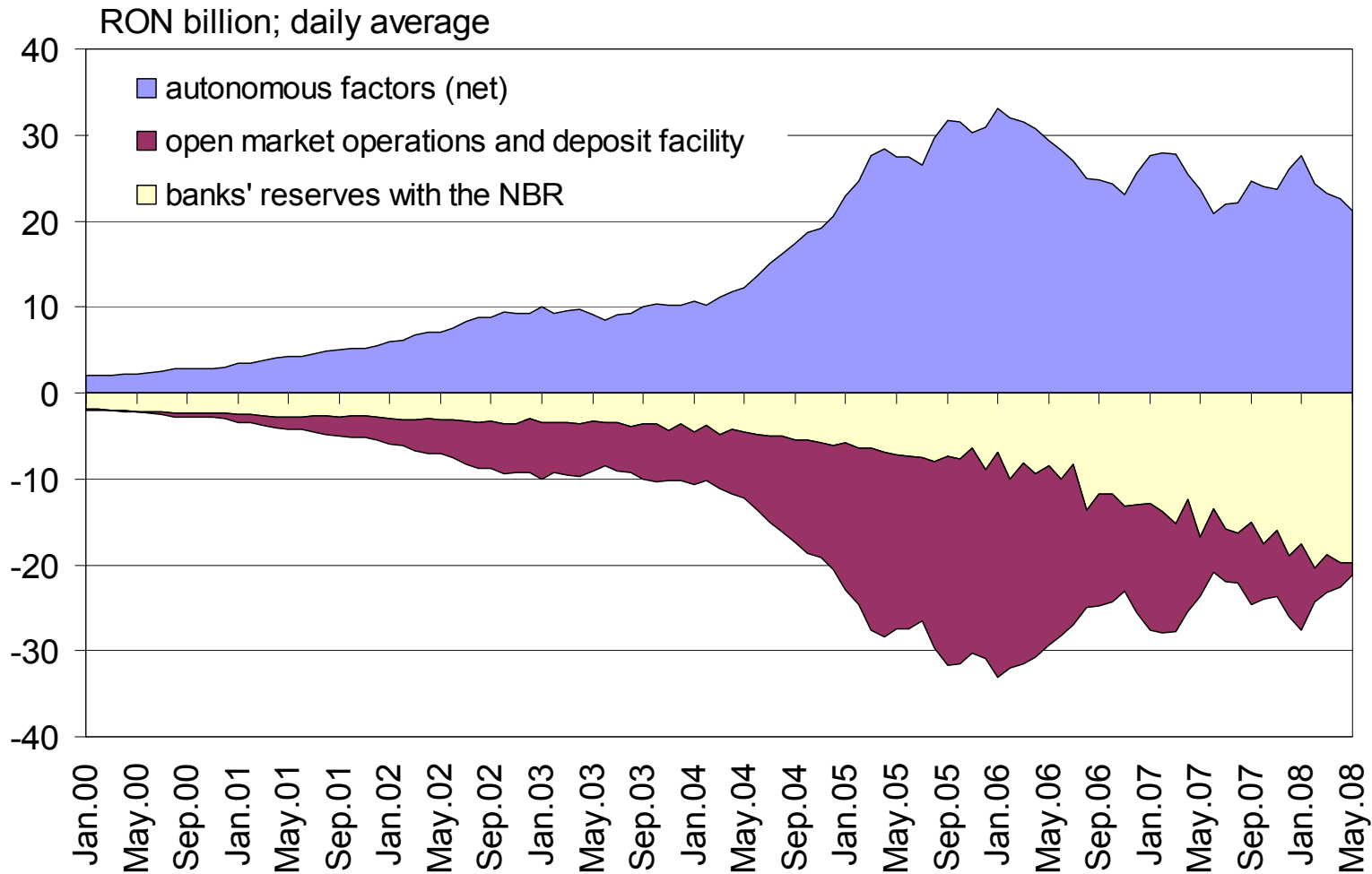
➤ **Outlook:** a broadly extended transition period, characterized by:

- ✓ The gradual decrease in the NBR's debtor position towards the banking system in favour of the creditor position;
- ✓ Initiation and/or wider resort of credit institutions to refinancing from the central bank and money market financing

➤ **Consequences:**

- ✓ Stronger interest rate channel in the monetary policy transmission mechanism
- ✓ Gradual widening and increased efficiency of money market functioning

Liquidity in the Banking System: Room for Maneuver Provided by the Current Level of Reserve Requirements



Source: National Bank of Romania

Economic Policy Mix and Macro-Stability (1)

- **The economic policy mix is more important than any of its components**



- **A restrictive monetary policy can offset only partly the lack of support from budget and fiscal policies and income policy in attaining the price stability objective:**
 - ✓ Usually, over the short term
 - ✓ By taking the risk of persistent distortions, whose subsequent correction by the authorities is costly and lengthy, a spontaneous correction could be massive and disorderly



- **The outcome is suboptimal in terms of real convergence in the medium and long term**

Economic Policy Mix and Macro-Stability (2)

The economic policy mix needs to be reconsidered all the more so as:

- Turbulence on world markets is persistent
- The increasing international prices of agri-food items and energy fuelled inflation
- Romania's external deficit has widened to unsustainable levels
⇒ need for gradual correction (to avoid disorderly correction)
- Domestic currency appreciation is unlikely to be a major contributor to disinflation
- Wage pressures will remain high in the context of EU integration

Optimal Economic Policy Mix

- Continuation of structural reforms so as to boost the growth of productivity and external competitiveness of Romanian products
- High restrictiveness of monetary policy
- Tighter-than-projected fiscal policy, likely to help narrow macroeconomic imbalances
 - ✓ Containment of public spending growth and its channelling mainly towards public investment meant to foster the production potential of the economy
 - ✓ Improved budget planning by approving multiannual budgets and ensuring a uniform and predictable budget execution
- An income policy matching productivity gains

Euro Adoption

Options for Preparing the Timetable for Euro Adoption

- Early euro adoption
- Late euro adoption
- Equilibrium solution: ERM II entry after an adjustment period

Early Euro Adoption

➤ **Benefits:**

- ✓ Earlier emergence of the benefits arising from the elimination of currency risk, fostering sustainable economic growth
- ✓ Fosters time consistency of the macroeconomic policy mix

➤ **Drawbacks:**

- ✓ Loss of autonomy of monetary and exchange rate policies
- ✓ Lack of synchronization between business cycles in Romania and the euro area, which would increase the risk of asymmetric shocks
- ✓ Difficulty of identifying a central rate representative for the RON-EUR equilibrium exchange rate, which could lead to a prolonged stay in ERM II
- ✓ Likelihood of a stronger Balassa-Samuelson effect in the early stage of the economic adjustment process after EU accession

Late Euro Adoption

➤ **Benefits:**

- ✓ Longer period of time for making the remaining structural adjustments
- ✓ Better synchronization between business cycles in Romania and euro area (a prerequisite for mitigating the risks of asymmetric shocks)
- ✓ Autonomy of monetary and exchange rate policies for a longer term

➤ **Drawbacks:**

- ✓ Persistence of higher transaction costs associated with currency risk, having a dampening impact on investment and economic growth
- ✓ Likelihood of delaying certain structural reforms and of easing macroeconomic policies (particularly income and fiscal policies)
- ✓ Mixed signals sent to international capital markets, with the delay being attributable to some structural or economic policy weaknesses rather than to the authorities' decision

Equilibrium Solution: ERM II Entry After an Adjustment Period Following EU Accession

- Combines the strengths of the two extreme options and contains their weaknesses
- Ensures an adjustment period required for:
 - ✓ Completing most structural reforms and rendering labour market more flexible
 - ✓ Bringing, in a sustainable manner, annual inflation rates into line with:
 - the specific criterion in the Maastricht Treaty
 - the ECB's definition of price stability
 - ✓ Overcoming the peak in capital inflows
 - ✓ Synchronization between business cycles in Romania and the euro area and significant progress in achieving real convergence
 - ✓ *Ex ante* fulfilment of conditions for a 2-year stay in ERM II

Romania: Proposed Time Horizon for Euro Adoption

- Strategy adopted by Romania:
 - ✓ ERM II entry: no earlier than 2012
 - ✓ Euro adoption: at the horizon of the year 2014
- The proposed time horizon is consistent with the relative reduction of risks of asymmetric shocks arising from:
 - ✓ Rapid expansion of credit to private sector
 - ✓ Persistence of wide current account deficits
- Opting for a credible adjustment period helps anchor inflation expectations more efficiently and fosters the consistency of the macroeconomic policy mix, thus contributing to faster achievement of inflation rate convergence
- Postponement of target-dates for euro adoption in some New Member States was due to non-fulfillment of some prerequisites, especially the fiscal policy criterion, rather than to a reassessment of the optimal horizon for joining the euro area
 - ✓ Only four NMS (among the smallest) were accepted in the euro area so far: Slovenia, Cyprus, Malta and Slovakia

Objectives of the Countries Joining the EU in 2004 as concerns Entry into the Eurozone (1)

Country	Current Exchange Rate Regime	Target date for entry into the eurozone	
		Announced in 2004	Most recent
Cyprus	Member of eurozone	2007	2008*
Czech Republic	Managed float	2009-2010	no official target
Estonia	Currency Board with the EUR as anchor currency	2007	2011
Hungary	Managed float	2008	no official target

*date of effective entry

Source: central banks, ECB, European Commission

Objectives of the Countries Joining the EU in 2004 as concerns Entry into the Eurozone (2)

Country	Current Exchange Rate Regime	Target date for entry into the eurozone	
		Announced in 2004	Most recent
Latvia	Currency Board with the EUR as anchor currency	2008	2012-2013
Lithuania	Currency Board with the EUR as anchor currency	2007	after 2010
Malta	Member of eurozone	2008	2008*
Poland	Free float	2007	no official target
Slovakia	Managed float	2007	2009*
Slovenia	Member of eurozone	2007	2007*

*date of effective entry

Source: central banks, ECB, European Commission

Maastricht Criteria (Nominal Convergence Indicators) - 2007 -

Nominal Convergence Indicators	Maastricht Criteria	Romania	Czech Republic	Hungary	Poland
Inflation rate (HICP) (percent, annual average)	<1.5 pp above the three best performing Member States (2.8 percent*)	4.9	3.0	7.9	2.6
Long-term interest rates (percent per annum)	<2 pp above the three best performing Member States in terms of price stability (6.4 percent*)	7.1	4.3	6.7	5.5
Exchange rate (vs. euro) (maximum percentage change vs. 2-year average**)	+ / -15 percent	+10.8 / -9.6	+13.0 /-0.9	+7.7/-6.6	+13.0 /-4.8
General government deficit*** (percent of GDP)	below 3 percent	2.5	1.6	5.5	2.0
Government debt*** (percent of GDP)	below 60 percent	13.0	28.7	66.0	45.2

*) Reference level

**) Maximum percentage deviations of the bilateral exchange rate against the euro from its April 2006 average level over the period 19 April 2006 to 18 April 2008 based on daily data at business frequency. An upward/downward deviation implies that the currency was stronger/weaker than its exchange rate level in April 2006 according to ECB's Convergence Report, May 2008.

***) according to ESA95 methodology

Source: ECB, Eurostat, National Institute of Statistics, National Bank of Romania, European Commission

Real Convergence Indicators (GDP/capita)

	EUR				PPS*			
	2000	2003	2006	2007	2000	2003	2006	2007f
EU-15	23,100	24,900	27,800	29,100	21,900	23,500	26,300	27,600
Romania	1,795	2,420	4,529	5,632	4,900	6,500	9,100	10,300
% in EU-15	7.8	9.7	16.3	19.4	22.4	27.7	34.6	37.3
Bulgaria	1,700	2,300	3,300	3,800	5,300	6,700	8,600	9,400
Czech Rep.	6,000	7,900	11,100	12,400	13,000	15,200	18,500	20,200
Hungary	5,100	7,400	8,900	10,000	10,700	13,100	15,300	15,900
Poland	4,900	5,000	7,100	8,100	9,200	10,100	12,300	13,500

*) Purchasing Power Standards
f forecast

Source: Eurostat, National Institute of Statistics, National Bank of Romania