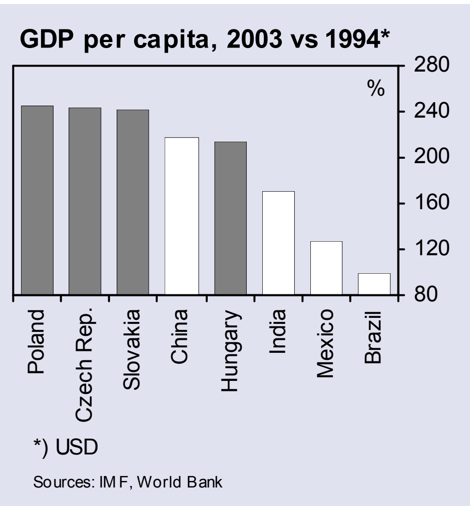
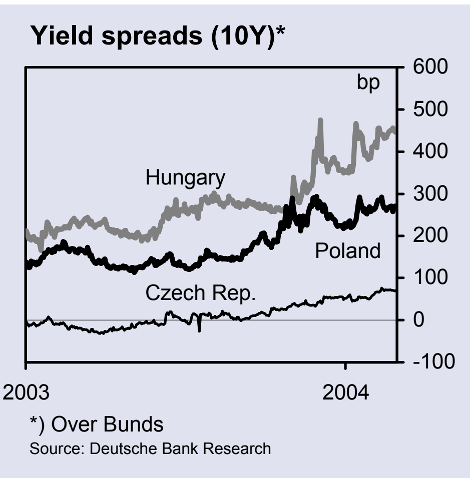
Stability risks on the road to the euro

For many emerging markets the past decade was certainly turbulent: between Bangkok and Buenos Aires, scarcely a year passed without at least one of the large economies getting into financial difficulties. In the EU accession countries of Central and Eastern Europe the transition process went comparatively smoothly. With the exception of the Czech Republic, which had to cope with a currency and banking crisis in 1997, they largely escaped any spill-over from the big international financial crises with their repercussions on growth. As a consequence, the catch-up process has produced very respectable results: per capita GDP at market prices (in USD) has more than doubled in the past ten years. Some countries left even China behind.



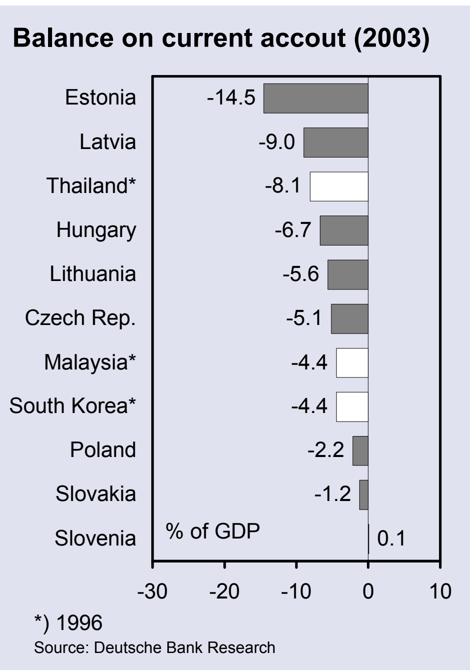
Despite this, fears have been growing for some time – not only in academic debate, but also at central banks and international financial institutions – that the most difficult stretch of the road is still to come: the period of membership in ERM II in preparation for the euro. In these circles, it is by now a widely held view that ERM II is an unstable, intermediate exchange rate regime that aggravates the risks to financial stability. The aim from the outset should therefore be to keep participation in ERM II as short as possible. But the markets, too, seem to be losing their faith in a smooth currency changeover. The spreads between yields on government bonds of the accession countries and Bunds have widened in the past year.



Mobile capital and pegged exchange rate – a recipe for disaster?

Why are many observers so pessimistic just shortly before the home straight to the euro? Economic theory, for one thing, calls for caution: countries that, despite high capital mobility, link their currency to a reference currency quickly find themselves in difficulties if the markets begin to question the credibility of the peg. The market anticipates possible inconsistencies between the country's national economic policy and the peg which can trigger attacks on the currency. This is not just dry theory, as can be seen from the major crisis in the European Monetary System in 1992 and the painful experience of emerging economies with pegged currencies in the past decade. Fixed exchange rates and target corridors or fluctuation bands can generally not deliver the stability they promise. On top of that, the costs of a crisis escalate if domestic business relies on the supposedly stable exchange rate.

The central banks may intervene in the market to keep the exchange rate stable and hike interest rates to attract new capital and make currency speculation more expensive. But once the confidence of the markets has been dashed, such action generally lacks the necessary credibility since reserves are limited and higher interest rates take their toll on the domestic economy. Clearly, ERM II can be seen as an arrangement that is fraught with risk. It is one of those hybrid regimes that, in a world of highly mobile capital, can exacerbate crises. Three main fears are often expressed:



- The currency peg will not be credible if the economies are economically and financially vulnerable. If the markets do not have confidence in the central bank's ability and determination to defend the exchange rate, there will be speculative attacks.
- A fixed exchange rate (even if adjustable) may make the domestic financial sector more prone to crises if the banks, relying on

the stability of the exchange rate, take on foreign currency debt abroad in order to meet booming domestic demand for credit. This would increase the risk of balance-sheet problems at banks and major distortions in the real economy. There could be similar risks in the corporate sector.

- Huge capital inflows – often in the form of short-term portfolio investments – may hamper macroeconomic management and make a country more likely to suffer a rapid loss of confidence in bad times. Large-scale convergence plays in interest-rate-sensitive securities, for example, could lead to such inflows.

The view now prevails that the risks to financial stability will increase greatly in ERM II owing to the combination of soft exchange rate peg and high capital mobility. It has become a central consideration for the acceding countries in weighing up whether to join ERM II earlier or later (see the article of Prof. Berger in this issue). Nonetheless, the advantages that ERM II membership also offers should not be underestimated: the countries will step under the "umbrella" of the ECB; confidence in their economic policy will grow when they have made this move; and the alternatives to membership naturally also harbour risks. Besides, the example of Denmark shows that, if a country's national policy is sound, membership in ERM II can be virtually friction-free even over a lengthy period of time. Whether the extreme fears are justified is something that time alone will tell.

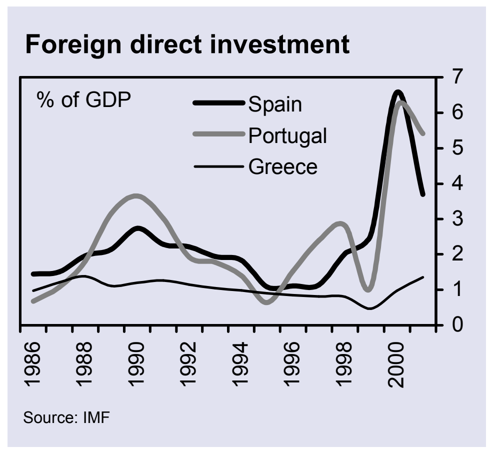
Accession countries still fundamentally vulnerable

The fears regarding the risks of ERM II membership spring to a large extent from weaknesses in the macroeconomic fundamental data of the acceding countries. The budget situation in the large countries is, in particular, a constant cause for concern: in Hungary and Poland the deficit is close to 6% of GDP, and that of the Czech Republic is even higher at nearly 7%. As seen in Hungary last year, such chronic deficits can shake investor confidence. The financial crisis in Argentina painfully underscored the effect of lax fiscal policy on the confidence of the markets.

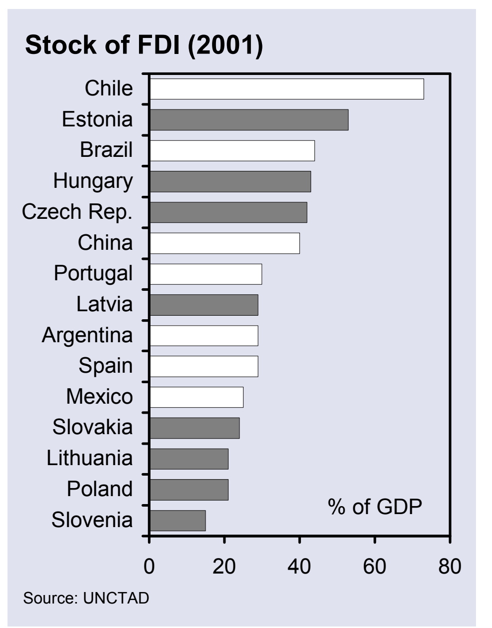
The persistently high current account deficits are grounds for similar fears. Estonia topped the list last year with a deficit equal to 14% of GDP. In Poland and Slovakia, on the other hand, the situation eased somewhat. The current account deficits in many of the acceding countries are as high as (or even higher than) those in some Asian countries – before the major crisis. A large part of the deficits is still soundly "financed" through foreign direct investment (FDI). But some uncertainty lingers with regard to FDI flows in future. In 2003 FDI in the acceding countries fell for the first time. Some observers expect a further decline as the countries' wage cost advantages have dwindled rapidly, the era of large-scale privatisation is over, and the first companies from acceding countries are beginning to expand abroad themselves. Also the expectation that FDI flows are more stable in times of financial distress might prove wrong. A growing proportion of the funds classified in the statistics as direct investment is in reality retained profits from past investments. In the event of a financial crisis these profits might be booked instead at the parent company abroad.

However, it can also be argued that FDI could continue to be a source of stability as the growth outlook and institutional factors speak in favour of further inflows. Moreover, in the 1990s foreign direct investment in Spain, Portugal and Greece declined after an initial boom, but it quickly recovered. Judging the outlook for future FDI flows on the basis of an international comparison of the stocks of inward FDI, measured as a percentage of GDP, it seems that the prospects could still be bright for a number of countries. Only some

Source: Deutsche Bank Research



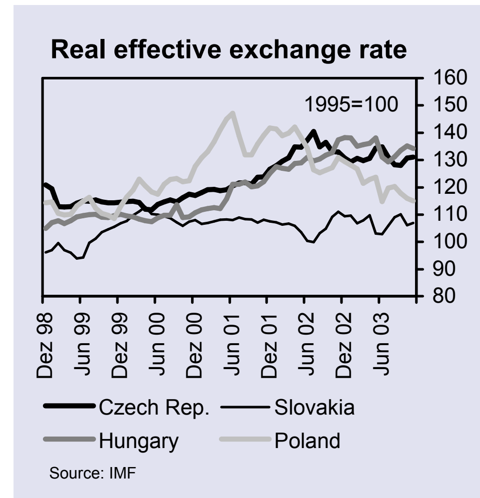
Source: IMF



Source: UNCTAD

of them (Estonia, the Czech Republic and Hungary) are already in the top group worldwide, roughly on a par with Brazil and China, and ahead of Portugal and Spain. Others, such as Poland and Slovakia, appear to still have considerable upside potential, which should tend to support the capital account and the exchange rate.

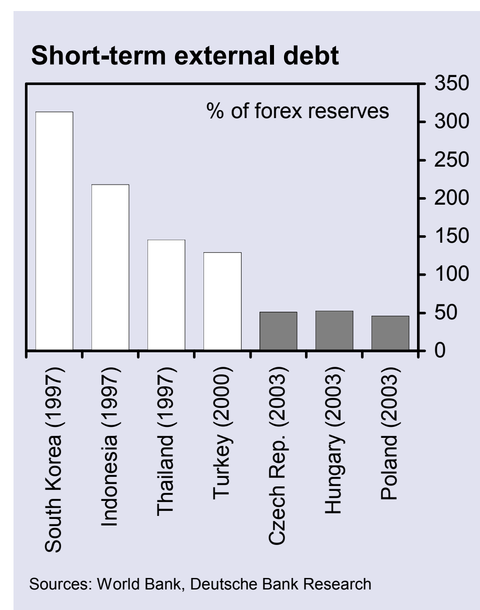
Finally, the outlook for the real exchange rate (going by the inflation-adjusted development) is not free from risks either. Almost all the Eastern European currencies have tended to appreciate on balance in recent years, even though the trend in Poland has been pointing downward since 2002. Rapid productivity growth, and hence changes in the equilibrium rates, may explain the upward tendencies to some extent. But it is difficult to judge whether the real exchange rates are sustainable – this uncertainty is in itself relevant.



Financial sector's vulnerability

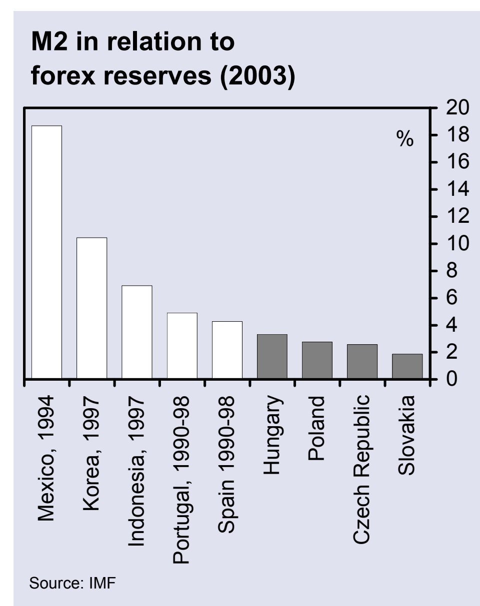
A look at the experience of other emerging markets in recent years shows that external deficits and budget problems alone seldom trigger a confidence crisis in the foreign exchange market. Whether and when a crisis occurs depends on factors relating specifically to the capital market, not least on the stability of the financial sector.

How much are the acceding countries at risk in this respect? As regards their levels of short-term external debt (in relation to their foreign exchange reserves), the acceding countries are currently well below the critical threshold of 100%, and still far below the historical values of crisis countries. An equally comfortable liquidity picture emerges from the fact that the forex reserves provide relatively high cover for the liabilities of the domestic banking sector – higher, incidentally, than the levels in Spain, Portugal and Greece in the 1990s. Despite high nominal growth of lending to the private sector, there are only moderate signs of a credit boom in most of the acceding countries. In relation to GDP, private-sector lending expanded by 1.8% per year from 1996-2002 in Poland and by 1.5% in Hungary (average annual figure). In the Czech Republic it even declined after the crisis of 1998 (-3%). The Baltic countries Estonia and Latvia have had the highest growth rates, but even these have remained well below the numbers registered in Asian crisis countries before the crises (over 10%). The lending growth also looks moderate in comparison with the Southern European countries. In Portugal the commercial banks' claims on the private sector rose by an average of 8% per year (relative to GDP) between 1990 and 1998, while the increase in Spain and Greece (approx. 1% per year) was roughly comparable with that in the current accession countries.



Even so, systemic risks cannot be ruled out, if only because these aggregated statistics may conceal risks in individual sectors or banks. Definite warning signs of a marked deviation from the trend can be seen in lending to households in Hungary: since 2000 it has risen each year by more than 30%.

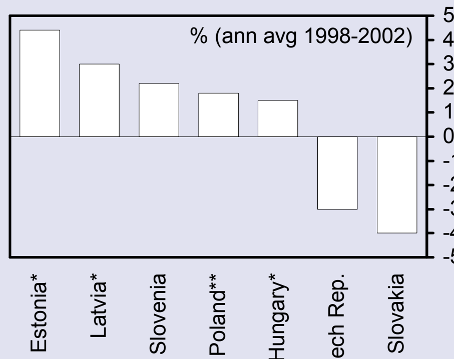
For the financial sector, a particularly serious risk inherent in fixed exchange rates is the potential for an imbalance between foreign currency liabilities and domestic currency assets: the higher the ratio of foreign liabilities to total liabilities, the greater the impact of a devaluation on the banks' balance sheets. The Hungarian banking system in particular has a relatively high proportion of external liabilities (20%). The corresponding figures in the Czech Republic and Poland are only about half as high. Roughly one-quarter of the loans granted by Hungarian banks are already denominated in foreign currency, especially in euros; again, the proportions in the Czech Republic and Poland are lower.



The size of the threat from these banking-sector risks (which are not extreme, but still substantial) cannot be reliably assessed on the basis of aggregated figures. Risk management, the quality of supervision and presence of foreign banks play an important part. Many observers regard these as the real strengths of the banking systems of the acceding countries.

- The financial sectors are largely in foreign hands, often German and Austrian. It may be assumed that these foreign banks have also brought their know-how in risk management.
- The acceding countries have made considerable progress on setting up a functional supervisory system.
- Finally, privatisation and the high degree of foreign ownership have largely severed the connections between the state and the financial sector.

Growth of lending to the private sector in relation to GDP



* From 1997
** From 1996
Source: Cottarelli et. al. (2003)

Foreign & public ownership of the banking system* (2002)

	Foreign	Public
Czech Rep.	84	4
Hungary	85	9
Poland	69	23
Slovakia	89	5
Slovenia	55	45
Estonia	82	0
Latvia	70	3
Lithuania	84	12

* % of assets
Source: Cottarelli et. al. (2003)

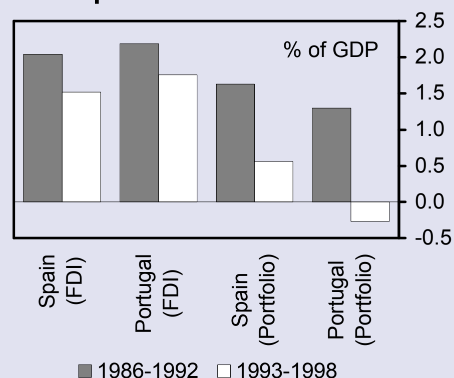
Portfolio investment and convergence play

Even if the risks mentioned above should turn out to be manageable, a static view may be inadequate in light of the dynamic development expected in the years ahead. Most warnings refer indeed to the time after the accession countries have joined ERM II, when foreign investors – relying on the presumably low currency risk – could flood them temporarily with hot money. But how realistic is the expectation of a steep rise in potentially volatile portfolio flows?

The ERM experience of the countries of the southward EU enlargement is something to go by initially. And, interestingly, it does not support the presumption that there massive portfolio investment ahead of entry into EMU should be taken for granted. On the contrary: the net inflow of portfolio capital into both Spain and Portugal was much higher from 1996 to 1992 than between 1993 and 1998. The heaviest inflows into the countries of the Iberian peninsula thus took place before the acute phase of qualification for the euro. Some of the current acceding countries have already attracted comparable volumes of investment in the past few years.

Also a look at yield spreads – which are generally cited as a major motive for portfolio investment in the form of convergence plays – raises doubts about the conventional view. In the long maturities, the spread between Hungarian government bonds and German Bunds is at the level registered in Spain in 1995 (450 bp). Yields in Poland have already converged as much as those in Spain in 1996 (to around 260 bp), and the Czech Republic is at a level not reached by Spain until 1997 (75 bp). Even though spreads have widened in recent months, as mentioned above, really large yield differentials are probably a thing of the past.

Spain & Portugal: net capital inflows

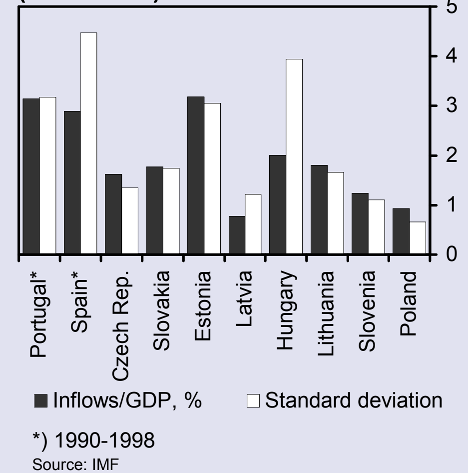


Source: IMF

Although the Iberian countries and Greece did not register huge net capital inflows in the run-up to EMU membership, and the macroeconomic consequences were therefore slight, gross inflows did increase during that period. In Spain and Portugal they were equivalent to around 3% of GDP on average in the 1990s – that was double the level in the preceding years. The gross inflows into the acceding countries in the past three years were just about half as high (approx. 1.6% of GDP), and average volatility was also somewhat lower. But individual countries, such as Estonia and Hungary, have already reached a similar level.

If history more or less repeats itself, with developments as when Spain and Portugal joined EMU, a scenario can be expected in which the net portfolio inflows motivated by yield spreads do not rise too much, but gross inflows increase markedly on the strength of the "seal of approval" of EU membership. This would have mixed impli-

cations for financial stability. The upward pressure on the currencies and the macroeconomic risks caused by boom-bust cycles in capital flows would be weaker than is widely expected: they would only materialise if net inflows were high. Even so, in this scenario the countries would remain susceptible to a loss of market confidence and a sudden withdrawal of investments.

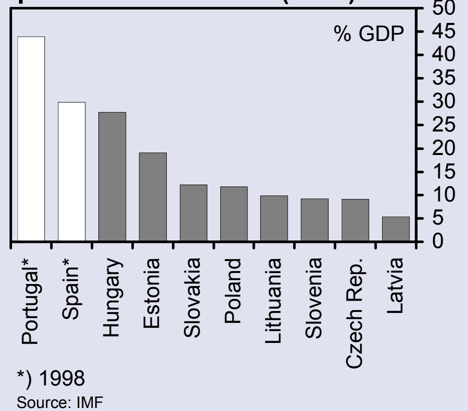


*) 1990-1998
Source: IMF

Exchange rate risks in ERM II

The financial crises of the past decade have shown that unilateral currency pegs are unstable. But the conclusion frequently drawn from this, that the ERM II membership of the acceding countries also involves high risks, is not entirely convincing. For ERM II is a relatively flexible, multilateral system in which the parties are mutually obliged to intervene.

- A relatively broad fluctuation band of +/-15% around the set parity could permit countries to make necessary adjustments to monetary and fiscal policy within ERM II. They could run the risk, though, of reaching the lower margin of the band.
- The ECB *and* the central banks of the acceding countries undertake to keep the bilateral euro exchange rates within the band (unless both sides agree to realign a central rate). The credibility of the peg is thus also assured by the ECB.
- Owing to the slight economic weight of the acceding countries, ERM II is a highly asymmetric arrangement.



*) 1998
Source: IMF

In view of the frequently portrayed danger of attacks on exchange rates in ERM II, the question of the ECB's obligation to intervene is of particular interest. The ECB itself recently stressed that "interventions at the margin will in principle be automatic and unlimited, unless they conflict with the primary objective of price stability in the Member State or the euro area" (ECB 2003). The ECB thus qualifies the statement in saying that intervention must not jeopardise price stability. Experience at the time of the ERM crisis of 1992, when the risks to German price stability were the reason cited by the Bundesbank for suspending intervention, suggests that this qualification could be important.

But just how appropriate is the analogy with the ERM crisis of 1992? In view of the enormous asymmetries between the currency areas – EMU and the acceding countries – it can be argued that the money supply of the euro area would increase only slightly even if intervention were protracted. At current exchange rates the money supply (M3) of all the acceding countries together equals less than 3% of euro-area money supply. Even assuming, purely hypothetically, that the ECB intervenes in favour of all the Eastern European currencies simultaneously in order to ward off an attack, and exchanges the entire money supply of the acceding countries into euros, the EMU money supply would increase only slightly.

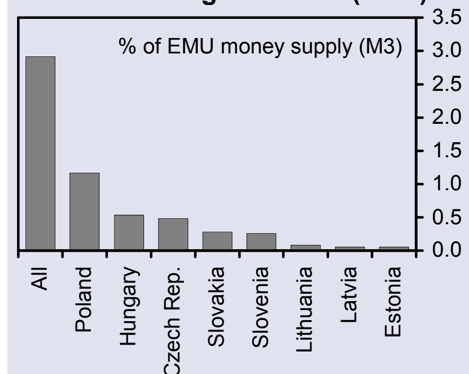
ECB intervention in favour of accession countries' currencies would have no major impact on EMU money supply

A realistically comparable measure of the scale of currency attacks in past crises can be obtained by looking at the fall in central bank reserves at such times. It came to between USD 15 and 20 bn in Korea (1997) and Mexico (1994), around USD 10 bn in Thailand (1997), Russia (1998) and Brazil (1998/99). For Hungary there are estimates that up to EUR 5 bn was mobilised within a short time last year when the forint came under attack. As large as these sums appear, the increase in money supply to ward-off such attacks would come to just thousandths of the total money supply of the euro area.

The real question, therefore, is whether such currency attacks will take place at all, if market participants anticipate ECB backing for the central rates. But there are several important considerations:

- The ECB might consider the risks to EMU price stability to be greater in light of inflation expectations. Moreover, the higher the rate of inflation in the euro area, the lower the political willingness to intervene is likely to be.
- In practice, decisions will probably depend just as much on whether the ECB attributes possible exchange rate problems to purely "speculative" attacks or to fundamental imbalances (though it is very difficult to distinguish between these in practice). In the latter case, the ECB would most certainly urge that new central rates be set; it has the right to initiate the appropriate procedure.
- Finally, market participants may have much greater means of mobilising capital against a currency than is generally assumed, through leverage in the currency futures markets.

M3 of acceding countries (2003)



Sources: National central banks, ECB

ECB "umbrella" reduces risk of confidence crises

At any rate, the ECB enjoys international credibility. Experience teaches that, in difficult times, the market watches the stance of the "strong" central bank. If the ECB signals that it considers the central rates to be fundamentally sound, this should greatly reduce the incentive for speculative attacks. For the ECB, though, there could still be a dilemma precisely because its policy stance is likely to have a strong influence on market confidence: the more clearly the ECB supports a currency, the smaller the risk of a confidence crisis is likely to be. At the same time, though, the ECB has a fundamental interest in the acceding countries being kept under pressure from the markets to pursue sound monetary and budget policies. This dilemma may be eased, however, if the EMU candidates maintain consistent economic policies aimed at fulfilling the Maastricht criteria and close cooperation is practised.

Conclusions

The acceding countries are still reform countries with all attendant risks

Our assessment of the macroeconomic and microeconomic risks in the accession countries shows that many problems still remain as regards both fundamental imbalances (especially in government budgets) as well as specific risks in the financial sector and the capital account. On the other hand it has also become clear that the theoretical extreme scenarios which are often outlined could be at odds with reality. Certainly, the accession countries are still reform countries with all the attendant risks. Yet thanks to EU integration and the prospect of membership in the monetary union they are, in some areas, no longer "normal" emerging markets. Whether this special status justifies deviating from pure doctrine and adopting a "soft" exchange rate peg for a limited period, despite high capital mobility, remains to be seen.

Credibility of national economic policies is decisive

The credibility of economic policy is the crucial element for success. Whether a convergence momentum builds up – as in the qualification for EMU in the 1990s – or ERM II membership of the acceding countries proves to be a recipe for crisis is likely to depend primarily on the determination with which policies are pursued in Warsaw and Budapest, but also in Frankfurt and Brussels. Only if the market is convinced of the political will on both sides will it be a strong ally in the convergence process. In this respect, the most important gauge on the Eastern European side will probably be its willingness to change direction in fiscal policy. The EU for its part must continue to send the clear message that the convergence criteria are final and have to be met. This applies to the exchange rate criterion, as it does to the budget criterion – notwithstanding the continuing debate about the stability and growth pact.

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