



Should American Business Worry About Europe's Eastern Periphery?

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While analytical spotlights shone on Europe's southern periphery during the recent financial turmoil, Central Europe largely escaped attention. Should American business worry about the Eastern periphery as well? This note sketches risk profiles based on selected indicators spanning the past decade and zeroes in on the role and depth of finance in the economy in that region. We can gain some insight from comparing data for similarly sized countries located at opposite ends of the European Union (EU).

The short answer is that the Central and Eastern European Three (CEE3, or Czech Republic, Hungary, and Poland) rest on somewhat more solid financial footing than the South and Western European Three (SWE3, or Greece, Portugal, and Spain). However, the East's poorer financial infrastructure, combined with lower overall monetization of the economy and lower wealth, present separate risks that are difficult to quantify and compare. What emerges are the Eastern group's more solid public finances and lower propensity to leverage, both of which act as natural firewalls to possible future conflagrations.

The analysis uses simple comparative statics to gauge change over two discrete periods: from around 2000 to 2004 (the year of EU accession for the East), and from 2004 to the present.¹ To simplify, we break down the indicators into three groups: foreign exposure, financing requirements, and depth of financial intermediation (see tables).

The extent of foreign exposure can be captured by the size of liabilities of all sectors of a given country held by foreign creditors (Table 1). Accumulated foreign official reserves would offset some of this handicap but their impact is uncertain. For example, SWE3's currency represents a safe haven (the euro), so their treasuries can readily borrow in it. Consequently, the region's official reserve cover has been thin. By contrast, the CEE3 maintain

sizeable cushions of foreign currency reserves, although they are probably not large enough to defend their own currencies in a possible crisis. All in all, a better gauge of exposure is given by the size of liabilities held by foreigners. We observe two trends: (1) over the decade the SWE3 hiked reliance on foreign capital to fund their borrowing needs; and (2) the Czech Republic and Poland lowered theirs quite noticeably, while at the same time Hungary's appetite for foreign money outstripped all others. Portugal and Hungary emerge as the most exposed to foreign creditors, with Hungarians mostly borrowing from multilateral institutions.

An economy-wide financing requirement is a variation on the previous theme. Here it represents a net lending/borrowing position of all sectors of the economy (corporations, households, and government) and is equivalent to the balance on current account (Table 2). Three trends stand out: (1) in Spain and in Greece, we detect a secular trend of ever greater deficits, (2) the Czech Republic is the only country which currently lends rather than borrows on an aggregate basis (it runs a current account surplus), and (3) the CEE3 uniformly book lower borrowing requirements than the SWE3. A subset of the total borrowing requirement is the government balance. The SWE3 and the CEE3 consistently widened their budget deficits over time although the trend in the East was less pronounced. Looking deeper still, we examine the primary balance, which captures current expenditures and income only (omitting interest payments). The data show that in both regions the first period was marked by prudent fiscal management. Yet over the past five years primary balances shot up (with the exception of Hungary). Again, the Southwest proved to be much less frugal than the East. Public debt—our final measure in this group—paints a more nuanced picture. In this ranking, Greece recorded consistently high public indebtedness whereas the more elevated debt ratios of Hungary and Spain are rather recent phenomena. Overall, Greece emerges in a precarious light but the two parts of Europe end up being net borrowers, particularly in the public sector.

Finally, let's look at the role that financial intermediation plays in an economy. We capture it here two ways: through the extent to

¹ On rare occasions when comparable data for a given period were missing for some countries, we substituted data points from adjacent periods, with some loss of decimal accuracy but little damage to the crux of arguments.

which the various sectors borrow and through change in equity capitalizations. The quick upshot is that the SWE3 are more monetized than the CEE3. Mortgage lending started from a very low base in the East but grew quickly over time. Whereas penetration of corporate loans was similarly low in Greece and the Czech Republic in 2000, it was already far higher for Spain and Portugal than in any other country. Corporate leverage rose broadly but not excessively, and remained elevated in 2009. However, among financial institutions, leverage was about twice as high in the Southwest as in the East in 2000, and that order of magnitude also prevailed nine years later. What this tells us is that despite faster economic growth and catching up in the East, the CEE3 managed their financial deepening more conservatively through the banking sector. An inverse trend can be observed in the equity market. Here, CEE3's equity valuations—which incorporate a supply of new issues—rose steadily over time, doubling its ratio to GDP in the case of Poland, while these ratios stagnated among the SWE3.

Interestingly, the cost of public borrowing converged over time between the two parts of

Europe. Whereas in late 2000 governments in SWE3 paid between 5 percent and 5.5 percent for long-term borrowing, the CEE3 had to pay anywhere between 300 and 500 basis points more. Fast forward to today, and it costs Poland roughly the same to borrow as it does Portugal, and similar equivalence holds for the Czech Republic and Spain. Greece pays about 300 basis points more than Hungary and both countries face weary creditors.

To sum: the Central European trio is less in hock to foreign creditors than their Southwestern European peers (except Hungary). On a net basis, the CEE3 have run their balance sheets (private and public) somewhat more conservatively than their more developed Southwestern counterparts. The CEE3 treaded more cautiously in expanding financial intermediation relative to their growth potential, with the exception of public equity. All the same, it is important to note that the CEE3 remain relatively poorer, implying narrower domestic saving pools. This would represent a separate type of risk should a sudden external shock or a crisis erupt.

Table 1
Measures of External Financial Exposure

	SWE3			CEE3		
	Greece	Portugal	Spain	Czech R.	Hungary	Poland
GDP Per Capita, PPP (EU27=100)						
2000	84	81	97	68	55	48
2004	94	77	101	75	63	51
2009	95	78	104	80	63	61
Official FX Reserves (% of GDP)						
2004	1.1	5.7	1.7	24.2	13.9	15.3
2009	1.6	6.6	1.9	21	33	17.8
Foreign Liabilities (% of GDP)						
2000	65	58	99	96	26	124
2004	56	156	109	56	92	26
2009	110	190	127	66	226	32

Sources: Eurostat and Manufacturers Alliance/MAPI

Table 2
Measures of Financing Requirements

	SWE3			CEE3		
	Greece	Portugal	Spain	Czech R.	Hungary	Poland
Net Borrowing (% of GDP)						
2000	-9.6	-9.2	-3.2	-4.7	-7.4	-5.4
2004	-8.8	-6.6	-4.8	-5.4	-9.0	-3.9
2009	-12.3	-9.3	-9.1	0.6	-5.9	-4.1
Government Balance (% of GDP)						
2000	-3.7	-2.8	-1.0	-3.7	-3.0	-3.0
2004	-7.5	-3.2	-0.3	-3.0	-6.4	-5.4
2009	-13.6	-9.2	-11.2	-5.9	-4.0	-7.1
Primary Balance (% of GDP)						
2000	3.6	0.1	2.2	-2.9	2.1	0.0
2004	-2.6	-0.7	1.7	-1.8	-2.0	-2.6
2009	-8.5	-6.4	-9.4	-4.6	0.7	-4.5

Sources: Eurostat and Manufacturers Alliance/MAPI

Table 3
Measures of Financial Intermediation

	SWE3			CEE3		
	Greece	Portugal	Spain	Czech R.	Hungary	Poland
Housing Loans (% of GDP)						
2001	17	65	48	8	8	9
2004	30	80	64	14	20	14
2009	52	99	84	28	37	32
Corporate Loans (% of GDP)						
2001	43	117	82	41	58	29
2004	43	113	94	42	66	27
2009	58	143	134	43	114	38
Loans to Finance Co's (% of GDP)						
2001	193	332	263	171	124	86
2004	177	344	296	150	134	93
2009	260	465	415	169	214	136
Stock Capitalization (% of GDP)						
2000	87	51	85	13	25	16
2004	50	49	82	25	26	25
2009	33	n/a	86	23	22	34
Long-term Interest Rate(%)						
Dec 2000	5.5	5.3	5.2	7.4	8.1	10.4
Dec 2004	3.8	3.6	3.6	4.1	7.2	6.0
Jul 2009	10.3	5.5	4.4	4.0	7.4	5.8

Sources: Eurostat and Manufacturers Alliance/MAPI