The International Crisis and Future Economic Challenges

Dear Prime Minister, Deputy Prime Ministers, Governor of the Central Bank, honorary guests, distinguished ladies & gentlemen:

It is my great pleasure to be here today and say a few words on Weathering through the World Economic Crisis.

1) I will begin with the question of whether or not the crisis is over.

2) Then, I will give you my view on the evolution of the financial industry and world growth during the next decade in order to describe the global macroeconomic environment that the region will face in the future.

3) My discussion will subsequently concentrate on the South Eastern European region and the effects the crisis has had so far.

4) Lastly, I will focus on the new – more balanced - model of development for the region and for Serbia, given the changes that this international crisis has brought on the world economy.

1. Is the crisis over? The global view

In the last seven months, thanks to the previous drastic intervention of governments, central banks and international organizations, we have managed to escape a major collapse of the global financial system.

Yet, is the crisis over? And should we proceed with business as usual? The answer, especially to the latter question, is a **clear no**.

First, even tough the collapse was avoided, the markets themselves are not convinced the crisis is completely over. As an example, the credit default swap spreads for buying insurance against bankruptcy of a major bank, although a lot lower than in March 2009, are not yet at their pre-crisis low levels.

Second, the recovery of Western economies is sluggish and the hard data that keep coming out provide a fuzzy picture. Sustainability of the recovery depends critically on governments and central banks maintaining their support.

Third, the crisis changed many fundamental parameters driving the world economy. It caused a big structural break on the evolution of the financial industry, on consumer behavior, on economic relations among nations, on the free market ideology and on government behavior. So it will not be business as usual. The next decade is bound to be a period entirely different from the decade that preceded the crisis. I come to this point next.

2. The future of the global economy

We are facing a new world ahead. Global economic growth is expected to slow down, the shift of political power towards Asia and the G-20 will gain speed, and a new global regulatory architecture will form, with the Financial Stability Board taking the lead in this effort.

The financial landscape will change in the future as well. The task for regulators is to increase global financial stability without hurting the good side of the banking business, which promotes healthy and needed intermediation. In the process of re-regulating the global financial system, regulators ought to observe two main principles.

(1) First, Cross-country level – playing field among financial institutions. This seems to be understood by the G-20, as they promote identical accounting standards and common restrictions on liquidity and leverage.

(2) Second, Capital is costly. Current initial proposals on countercyclical capital buffers or the need for quality capital, that is, a larger stock component in capital adequacy rules, are in the right direction. Yet, they should not lose sight of the fact that the same economic result of financial stability could be accomplished with fewer capital restrictions. For example, instead of requiring banks to issue more equity during an expansion in order to prepare for a rainy day, banks could simply be forced to issue convertible debt during an expansion, with pre-fixed ex ante rules of converting this new debt into equity if a crisis were to occur.

The structural break on the evolution of the world economies comes from many sources. The **first** and major source is higher global real interest rates. Credit risk will be higher in the future, implying higher required rates of return on all risky investments. The credit default swap spreads I showed you earlier are not expected to decline to their June 2007 level. The financial market will price risk in a more rational way than in did prior to the crisis. Bank intermediation will become more costly, hence lending rates will carry higher interest rates. The higher government debt levels imply bigger competition with the private sector for borrowed funds, putting upward pressure on rates. And of course, in the next 3 years, as the economies gradually recover in the West, the central bank intervention rates will go back up to more normal levels. Hence, all factors point to permanently higher real interest rates, a force that goes against current consumption and, especially, investment.

A **second** force against global growth originates from the rapid rise in sovereign debt in the West. It implies that in the future, say 2-3 years ahead, western governments will start a process of de-leveraging, gradually generating fiscal surpluses to pay back for today's deficits. In a sense, we avoided the collapse by trading off today's rapid fiscal expansion for tomorrow's lower but longer fiscal contraction.

A **third** force is the anticipated mediation of global imbalances. The American household is expected to increase its savings rate, thus reducing consumption. It follows that exports of third countries to the US will not expand as rapidly as they did before the crisis. Global aggregate demand will decline, because the American gap cannot be filled by the Chinese, Indian, or the more cautious European consumer.

3. <u>The regional view on the crisis</u>

South Eastern European economies were overheating at the time the crisis hit. Aggregate demand was rising faster than aggregate supply, as the large current account deficits reveal. Credit expansion was huge. Easy credit and low interest loans to households and corporations – especially in FX - led economic activity. The real estate market was booming. FDI was flowing into the region at unprecedented rates.

The crisis prevented further overheating. It stopped the credit bubble relatively early. Had the crisis occurred with one or two years of delay, imbalances would have grown larger and the household and corporate debt burden bigger, perhaps unmanageable. The events in the Baltic countries give us a taste as to what could have happened.

In view of the sudden stop in capital inflows and the collapse of export markets in 2008:Q4, two forces prevented the collapse of output in our region. The first was the strength of the domestic financial system. The foreign banks present in the region were prudent banks. They had not invested in toxic assets. 28 months after the eruption of the financial crisis, this prudence is transparent in the history of capital write-downs. European banks wrote off a total of €315 billion thus far, but very little of that amount originates from banking activities in the SEE region or the players here.

The second reason was the prudence of domestic regulators. Prior to the crisis, the region was already well capitalized, especially here in Serbia. And the response of regulators to the crisis was quick. The amount of minimum deposit insurance was raised, the percentage of minimum reserve requirements was relaxed, central bank intervention rates declined, foreign banks signed the Vienna initiative for the countries of Romania and Serbia, the IMF and other international organizations were brought in to support lending. Serbia, in particular, was the first country to quickly secure €3 billion of IMF funding.

Today, the market fears of a collapse in the region are long gone. Since February-March 2009, sovereign risk premia have declined a lot. Yet, as emphasized earlier, these premia remain above their levels prior to the crisis and will stay high in the future. The region will stagnate in 2010,

lagging behind even the sluggish recovery of Western Europe, but showing significantly better performance than the Baltic region. Serbia, in particular, is expected to perform better than its neighbors.

4. Looking ahead: A more balanced economic model for the region

Looking ahead, beyond 2010, it should be pointed out that the demand driven growth model of the region worked well until the time the crisis hit. The living standards in the SEE countries were raised significantly. Serbia, in particular, showed an impressive improvement during the last five years, despite the fact that, due to the war, it began its economic reforms with a significant delay.

Yet, I believe the demand-driven growth model has reached its limits. Credit expansion is more or less flat and should not be expected to lead the recovery. Nowadays, credit is the problem, not the solution. As loans exceed deposits and as NPLs are rising, bankers are fearful of providing new credit.

A more balanced growth model is needed for the long-run, which would depend on improving the domestic savings rate, shifting domestic demand from consumption to investment, focusing a bit more on the export markets (especially Serbia), and fostering competitiveness and total factor productivity. Numerous studies have shown that TFP benefits from the rule of law, the quality of institutions, the quality of infrastructure, or the matching of human capital development and job training with the modern needs of our globalized market economies. Of course, the specific growth prescription can vary from country to country as the comparative advantages differ across the region.

International comparisons can reveal weaknesses that should be cured. For example, in Serbia and the region, infrastructure requires major attention and funding, as countries rank very low in the World Economic Forum rankings. Similarly, the annual World Bank analysis shows that there is a lot of room for improving the business environment, especially when it comes to construction permits, registering property, closing a business or paying taxes. The taxation environment, in fact, worsened during last year, when every other process – particularly the cost of opening a business - improved.

While attending to the supply characteristics of the economy, it is important to ensure simultaneous macro-economic stability. Fiscal and monetary prudence with low rates of inflation and low fiscal deficits are closely watched by the IMF, the rating agencies, fund managers and greenfield investors. If achieved, they result in low real interest rates, low risk premia and significant FDI inflows.

Bear in mind that in this ambitious journey forward, the SEE countries share a common anchor on their domestic political and policy decisions. This anchor is the process leading to EU or EMU entrance, which forces the economically rational decisions on politicians and the public. In Serbia, the decision to unilaterally implement the EU Stabilization and Association Agreement points to the seriousness of its effort to reform its economy and participate in the European family.

5. Conclusion

Ladies and gentlemen,

In a nutshell, this severe crisis has wakened us all up to the dangers of an unregulated and uncoordinated global financial system that is vulnerable to extreme behavior. The crisis will leave its permanent imprints on future growth, as risk premia stay high, western governments sooner or later begin a delevaraging process, while over-extended consumers try to build up their savings. A new financial architecture will increase the cost of financial intermediation in the hope of achieving long-run global intertemporal financial stability, and hence economic stability.

Our region was lucky not to host banks involved in toxic assets or the pursuit of extraordinary profits at any risk. The crisis was imported in 2008:Q4 through the sudden stop of capital inflows and the collapse of export markets. Yet the crisis revealed the dangers of unbalanced growth, when demand pushes forward faster than supply, when citizen's desire for a quick increase in their standard of living is not matched by equally quick advances in the economies' potential output and total factor productivity.

As we look ahead to the future, a more balanced growth model is required, by emphasizing investment instead of consumption, competitiveness, exports and the comparative advantages of each country. This switch can easily be done by the region and Serbia, in particular. Serbia has done well thus far. Its eclectic and successful policy approach of the past few years reveals that the country does have the cultural, social and political flexibility to be able to quickly adopt the new required growth model for the post-crisis world. I am, therefore, optimistic about the future.

Thank you very much.

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THE INTERNATIONAL CRISIS
AND
FUTURE ECONOMIC CHALLENGES

Gikas A. Hardouvelis*

Belgrade, November 2, 2009

"Weathering through the World Economic Crisis"

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THE INTERNATIONAL CRISIS AND FUTURE ECONOMIC CHALLENGES

MAIN THEMES

I. IS THE CRISIS OVER? THE GLOBAL VIEW

II. THE FUTURE OF THE GLOBAL ECONOMY

III. THE REGIONAL VIEW ON THE CRISIS

IV. A MORE BALANCED ECONOMIC MODEL FOR THE SEEEs & SERBIA

V. CONCLUSION

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I.

IS THE CRISIS OVER? THE GLOBAL VIEW

"From the future of capitalism to the future of capital requirements"

What a difference 7 months have made in our discussions!

The Economist, October 3-10, 2009

I. Is the crisis over? Risk aversion down but not at 2007 pre-crisis levels

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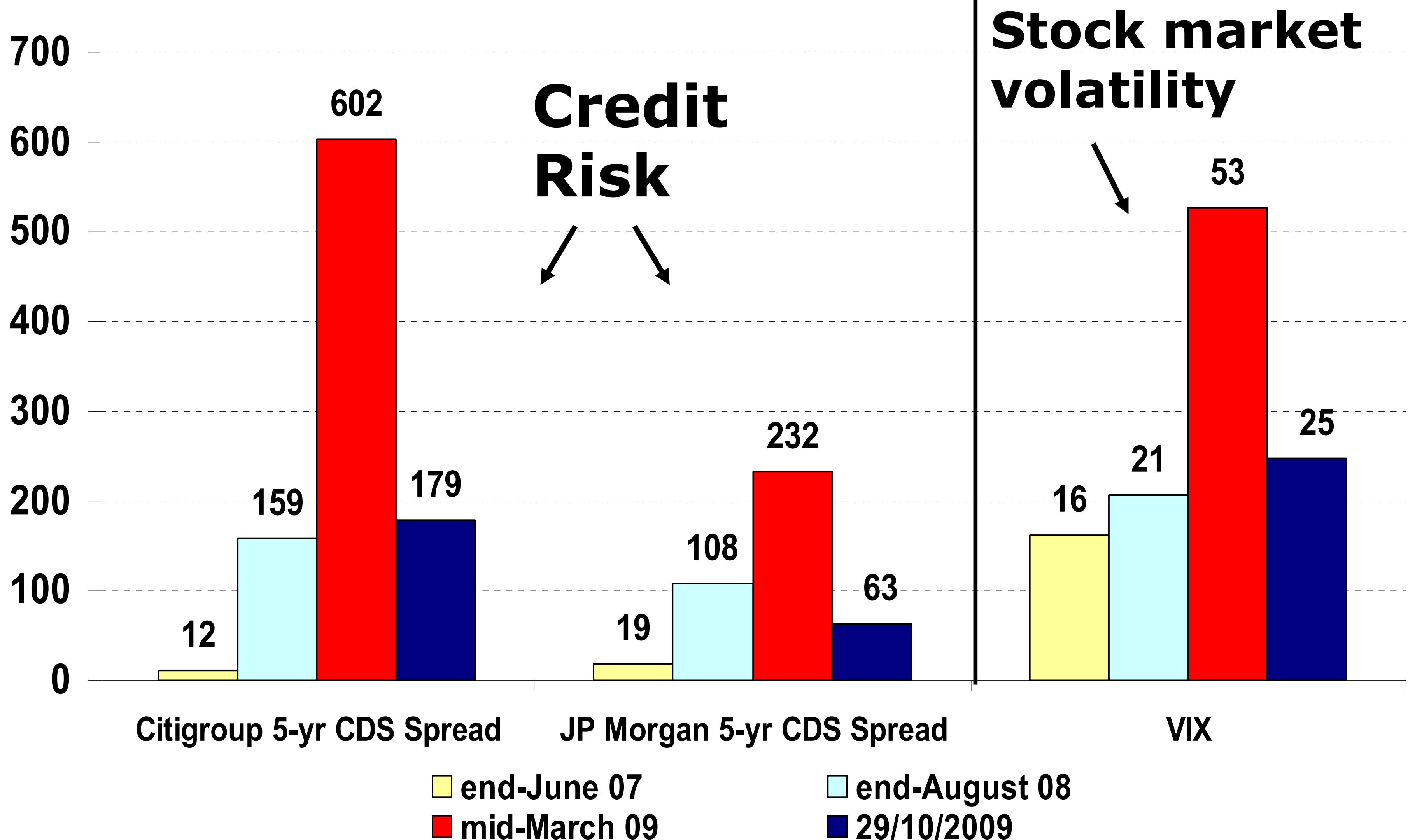

Source: Bloomberg

I. Sluggish recovery in 2010

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Real GDP growth

	2008	2009f	2010f
USA	0.4	-2.6	2.4
Euro Area	0.6	-3.9	1.0
Japan	-0.7	-6.0	0.8
China	9.0	8.3	9.4
Brazil	5.1	0.0	3.8
Russia	5.6	-7.9	2.5
India	7.4	5.5	6.3

Source: EFG Research

- ✓ Recovery depends on central banks maintaining liquidity and governments maintaining fiscal stimulus

II.

THE FUTURE OF THE GLOBAL ECONOMY

The crisis will leave its permanent imprints

II. A different world ahead

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- ✓ Economics: **Slower global growth due to the crisis:** We are trading off current & future stability against future average growth
- ✓ Politics: Economic & political power ➔ Asia and G-20, with the **crisis expediting the shift**
- ✓ Global Regulation: The Financial Stability Board gains power among IFIs
- ✓ **A different financial landscape,** as G-20 decisions will affect banks and increase the cost of financial intermediation
  - ✶ Aim should be to avoid the excesses of the financial sector without imposing too much unnecessary cost
  - ✶ Restrictions should be uniform across the globe and respect the **level-playing field**
  - ✶ Onerous restrictions may cause a new wave of future de-regulatory fervor
  - ✶ **Capital is costly**. Some smart proposals by academics that bear a minimum cost, e.g. *during economic expansions, instead of forcing banks to issue additional equity, which is costly, force them to issue debt convertible to equity during a crisis*
- ✓ **Wall Street** continues to hold considerable **political power against future regulatory restrictions**

II. Slower future world growth ahead

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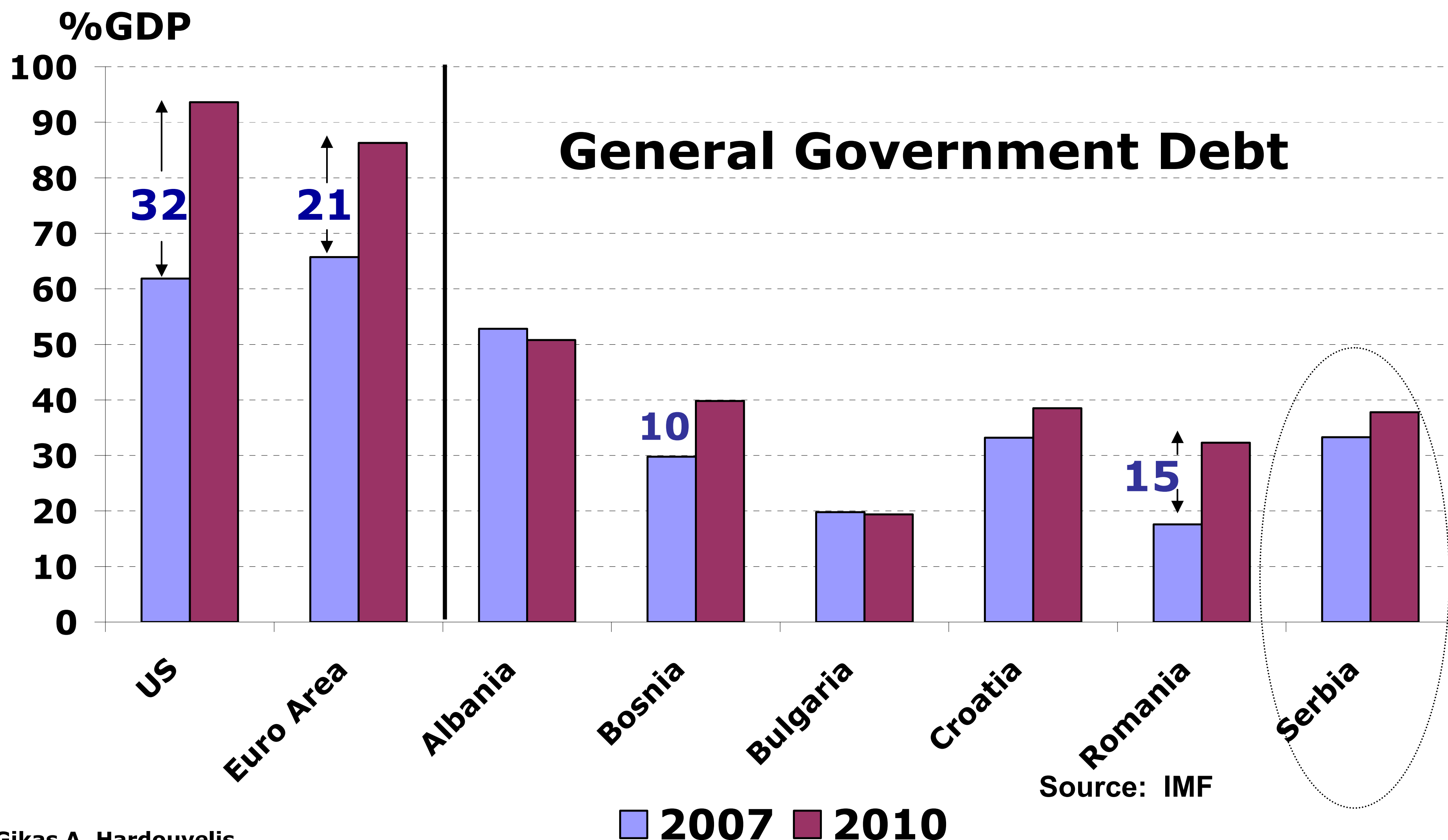
It was not the Great Depression or Capitalism's 1989, but this Great Recession is likely to leave its permanent marks

My long-term view is for lower growth than the period leading up to the crisis

1. Higher real interest rates ahead
   - ✓ Risk premia to stay high
   - ✓ Higher demand for new bank equity capital will increase the cost of intermediation
   - ✓ Fiscal debt will compete with private debt for funding
   - ✓ Central bank intervention interest rates expected to go back up
2. Future de-leveraging of the government sector, hence restrictive fiscal policy
3. Mediation of global imbalances: The US consumer is forced to reduce leverage and increase savings – hence lower exports by third countries to the US
   - ✓ The Chinese consumer is not ready to close the gap yet
   - ✓ India is still a closed economy
   - ✓ Europe depends on exports

II. Current aggressive response by Western governments implies future restrictive fiscal policy



III.

THE REGIONAL VIEW ON THE CRISIS

SEEEs imported the crisis, but thanks to their strong domestic financial systems and quick response by regulators, avoided a collapse

III. SEE economies were overheating when the financial crisis hit in 2007

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Current Account % GDP	2006	2007	2008
Bulgaria	-18.5	-25.2	-25.5
Romania	-10.4	-13.5	-12.4
Serbia	-10.1	-15.6	-17.3
Turkey	-6.0	-5.8	-5.7
Estonia	-16.9	-17.8	-9.3
Latvia	-22.7	-21.6	-12.6
Lithuania	-10.7	-14.6	-11.6

Source: IMF

III. SEE economies were overheating when the financial crisis hit in 2007

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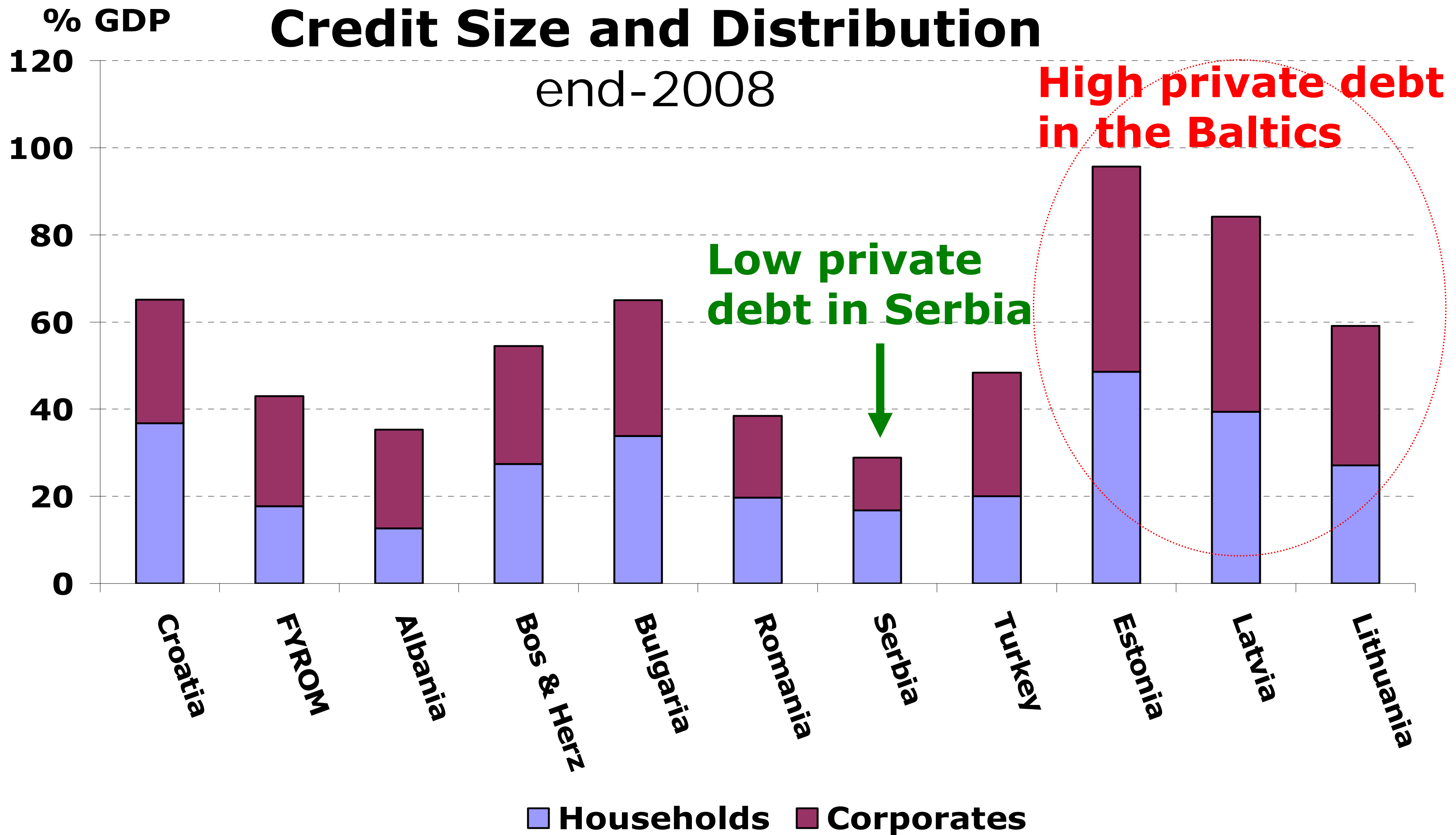
	Annual Credit Growth Avg (2005-2007)	Δ(Credit/GDP) end2004-end2007
Bulgaria	41.0	30.8
Romania	49.3	21.2
Serbia	36.0	13.0
Turkey	42.5	16.8
Estonia	37.4	39.0
Latvia	42.0	42.0
Lithuania	47.8	31.1

III. Yet, compared to the Baltics, credit did not reach unprecedented levels



Source: Central Banks, Eurobank Research

III. Serbia: Sudden stop in capital inflows in 2008:Q4

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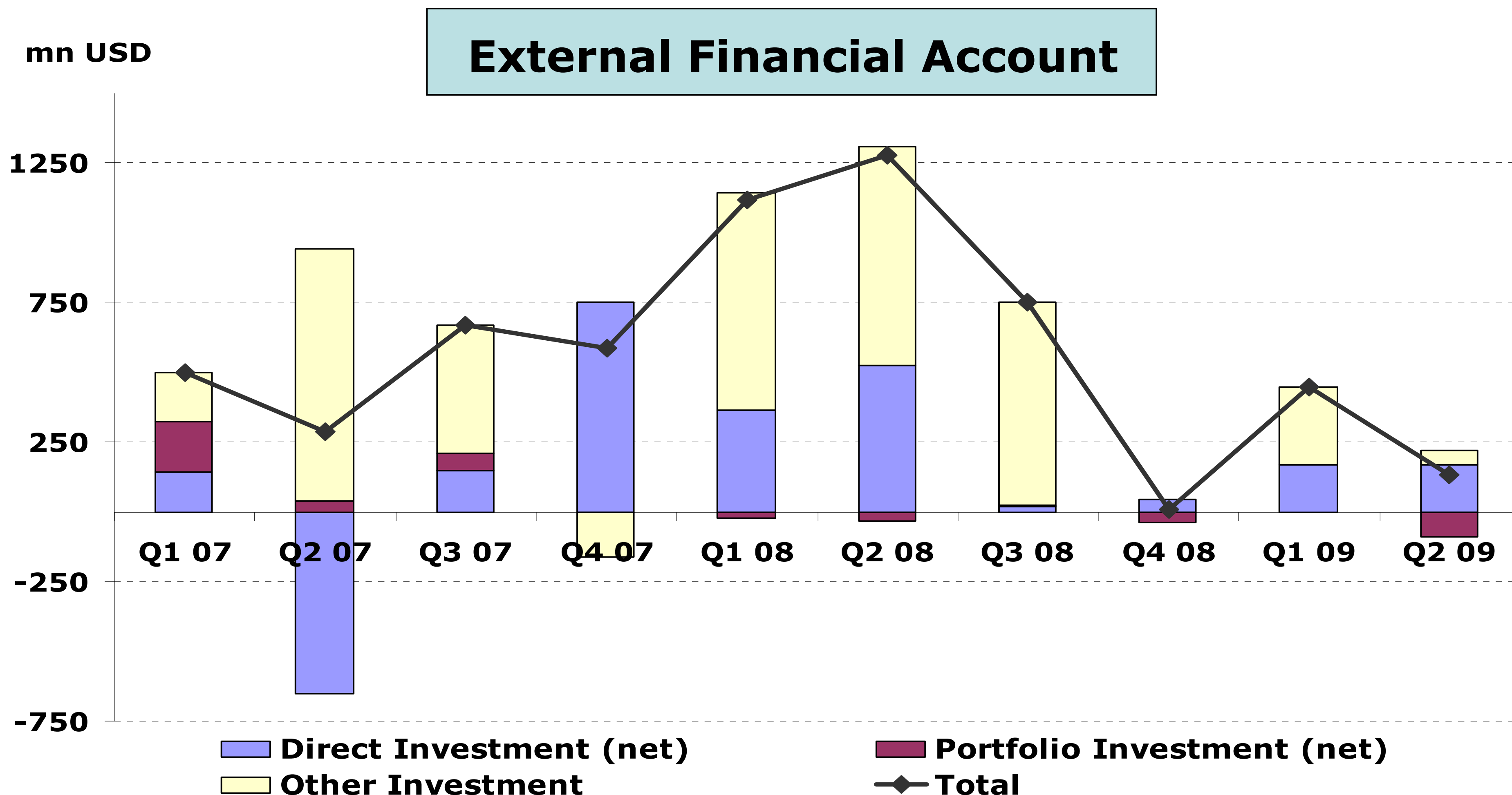

IMF: External financing gap projected to reach EUR 3.5bn (11.5% of GDP)

III. Serbia: Trade flows declined sharply in 2008:Q4

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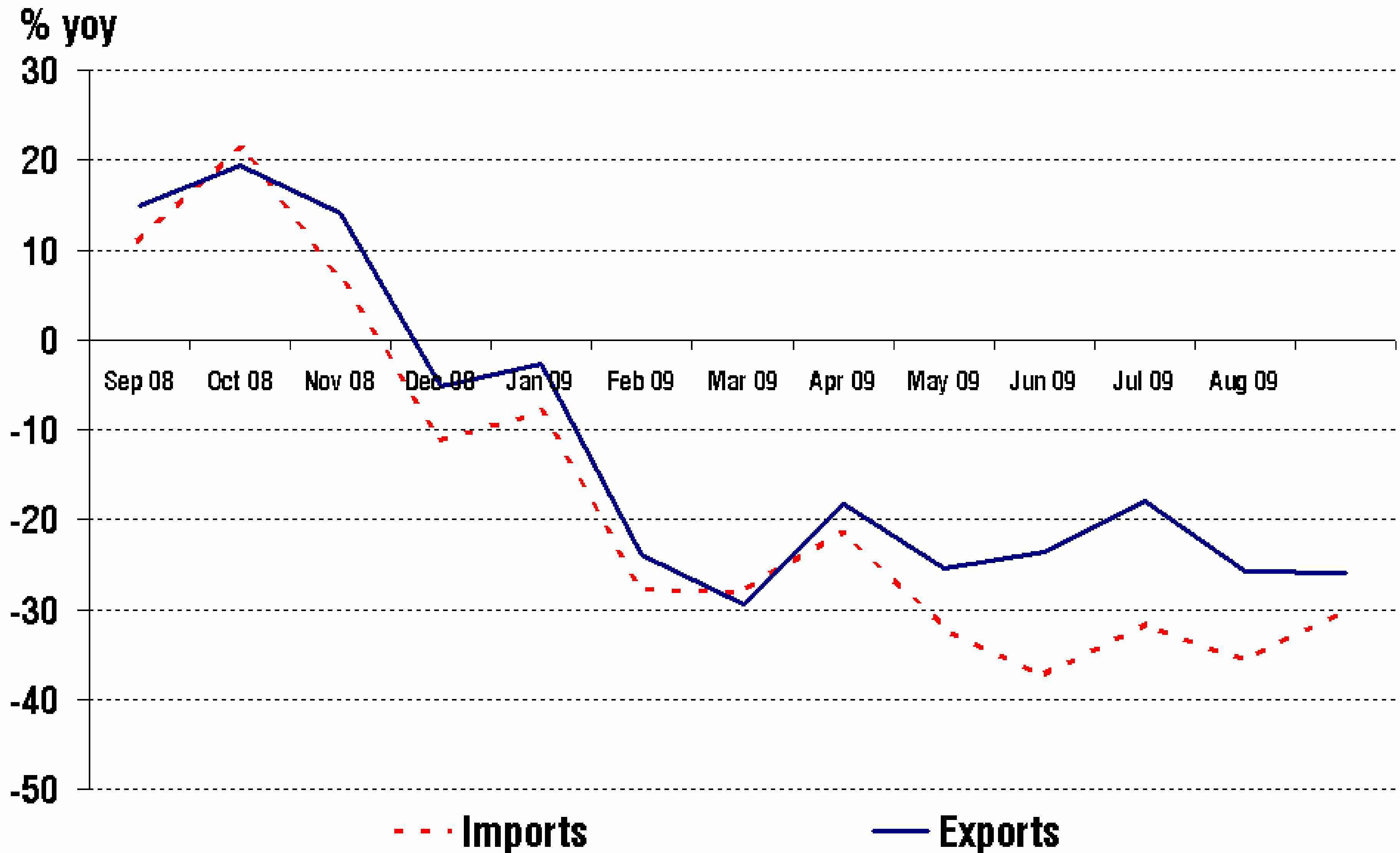

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European banks: Write-downs and capital increases June 2007 – October 2009

	Banks	Loss	Capital Raised	Present in N.E.
1	UBS	€ 35.2	€ 27.0	
2	HSBC Holdings	33.3	19.0	
3	HBOS	19.3	16.8	
4	RBS	18.9	50.5	✓
5	Barclays	15.5	20.1	
6	Bayerische	13.4	14.8	
7	Credit Suisse	13.2	8.6	
8	Deutsche Bank	13.1	7.4	✓
9	ING Group	12.4	14.3	✓
10	BNP Paribas	11.9	9.4	✓
11	IKB Deutsche	10.3	8.5	
12	KBC Groep	8.7	5.5	✓
13	Soc Gen	8.6	15.7	✓
14	Banco Santander	7.6	19.7	
15	Fortis	6.5	16.0	
16	Credit Agricole	6.4	8.9	✓
17	Natixis	€ 6.2	€ 5.7	
18	DZ Bank	5.4	0.0	
19	Anglo Irish	5.2	0.1	
20	Hypo Real Estate	4.9	0.1	
21	Dexia	4.7	6.4	✓
22	Unicredit	4.4	10.3	✓
23	Commerzbank	4.3	18.2	✓
24	Dresdner Bank	3.6	0.0	
25	Landesbank Baden Wurttemberg	3.3	0.0	
26	HSH Nordbank	2.9	1.3	
27	WestLB	2.7	5.0	
28	Rabobank	2.4	1.0	
29	Lloyds Banking Group	2.4	9.5	
30	Northern Rock	2.2	3.7	
31	Bank of Ireland	2.0	3.5	

III. No toxic assets

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	Banks	Loss	Capital Raised	Present in N.E.
32	Allied Irish Banks	€ 1.8	€ 3.5	
33	Intesa Sanpaolo	1.8	4.0	✓
34	Landesbank Sachsen	1.8	0.0	
35	Deutsche Postbank	1.7	1.0	
36	Banco Bilbao Vizcaya Argentaria	1.7	0.0	
37	Alliance & Leicester	1.7	0.0	
38	Banco Popolare	1.7	0.0	
39	ABN AMRO Holding	1.6	0.0	✓
40	DNB NOR ASA	1.6	1.7	
41	Bradford & Bingley	1.3	2.0	
42	Banco Popular Esp	1.2	1.2	
43	Groupe Caisse d'Epargue	0.8	3.6	
44	EFG Eurobank	0.7	0.0	✓
45	Landesbank Hessen-Thueringen	0.5	0.0	
46	HVB Group	0.5	0.0	

	Banks	Loss	Capital Raised	Present in N.E.
47	Standard Chartered	€ 0.4	€ 0.0	
48	Norddeutsche Landesbank	0.4	0.0	
49	Danske Bank	0.4	0.0	✓
50	Piraeus Bank	0.4	0.0	✓
51	Roskilde Bank	0.4	0.5	
52	Alpha Bank	0.3	0.0	✓
53	Landesbank Berlin	0.3	0.0	
54	NIBC Bank	0.3	0.0	
55	SEB	0.3	1.5	
56	Kommunalkredit Austria	0.1	0.0	
57	Aareal Bank AG	0.0	0.0	
58	Kaupthing Bank	0.0	0.0	
59	Erste Group	0.0	0.4	✓
	Total	**315**	**346**	

III. Adequate capitalization

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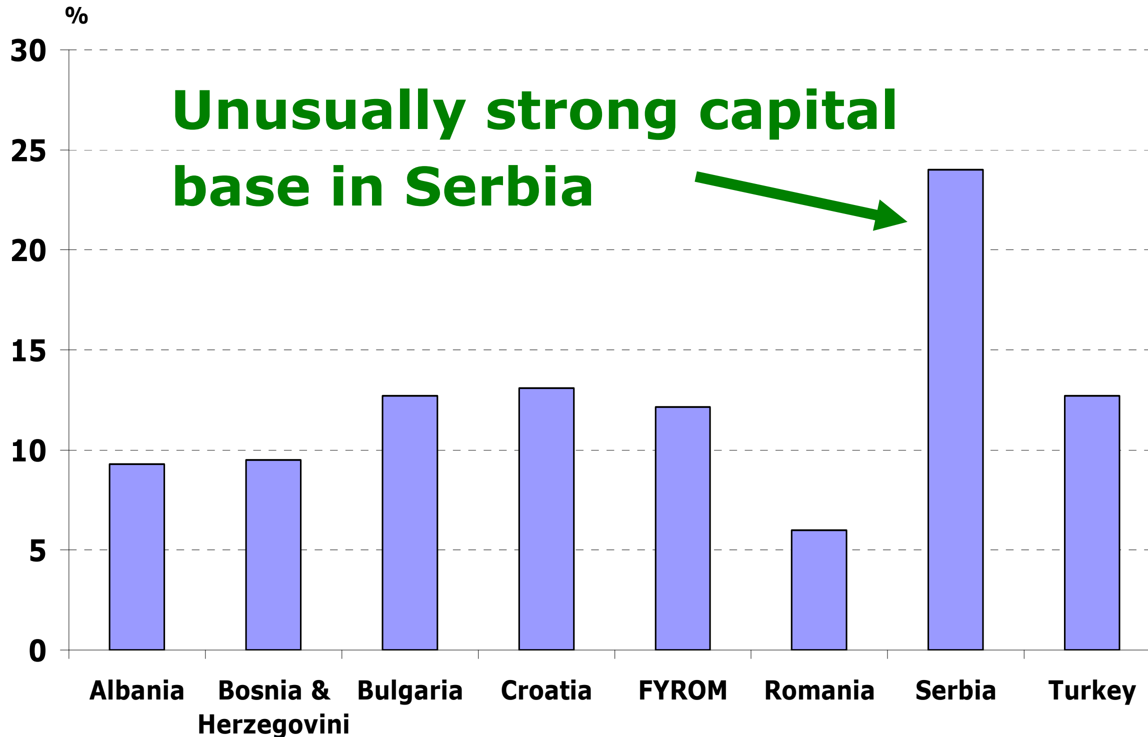

*FYROM, Romania and Serbia as of Q1 2009

Source: Central Banks, Eurobank Research

Capital/Assets		
Austria	6.3	Q1 09
Belgium	3.4	Q1 09
Ireland	5.1	Q1 09
Germany	4.5	2008
Portugal	6.1	2008
Norway	4.2	2008
Sweden	4.7	2008
UK	4.4	2008
Greece	4.5	2008
Spain	6.4	2008
Estonia	8.5	Q2 09
Latvia	7.4	Q2 09
Lithuania	10.4	Q2 09

✓ Simple capital to assets ratio stronger in SEEEs than in EU-15

III. Government & Central Bank initiatives to strengthen lending

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	Albania	Bosnia	Bulgaria	Romania	Serbia	Turkey
Deposits Guarantees	✓	✓	✓	✓	✓	✓
Minimum Reserve Requirements		✓	✓	✓	✓	✓
IMF Support		✓		✓	✓	
Special Lending Support	✓		✓	✓	✓	
Monetary policy easing	✓			✓	✓	✓
Other measures (tax, regulatory etc)	✓			✓	✓	✓

III. Gone is the fear of financial collapse, yet concerns remain for the SEE region

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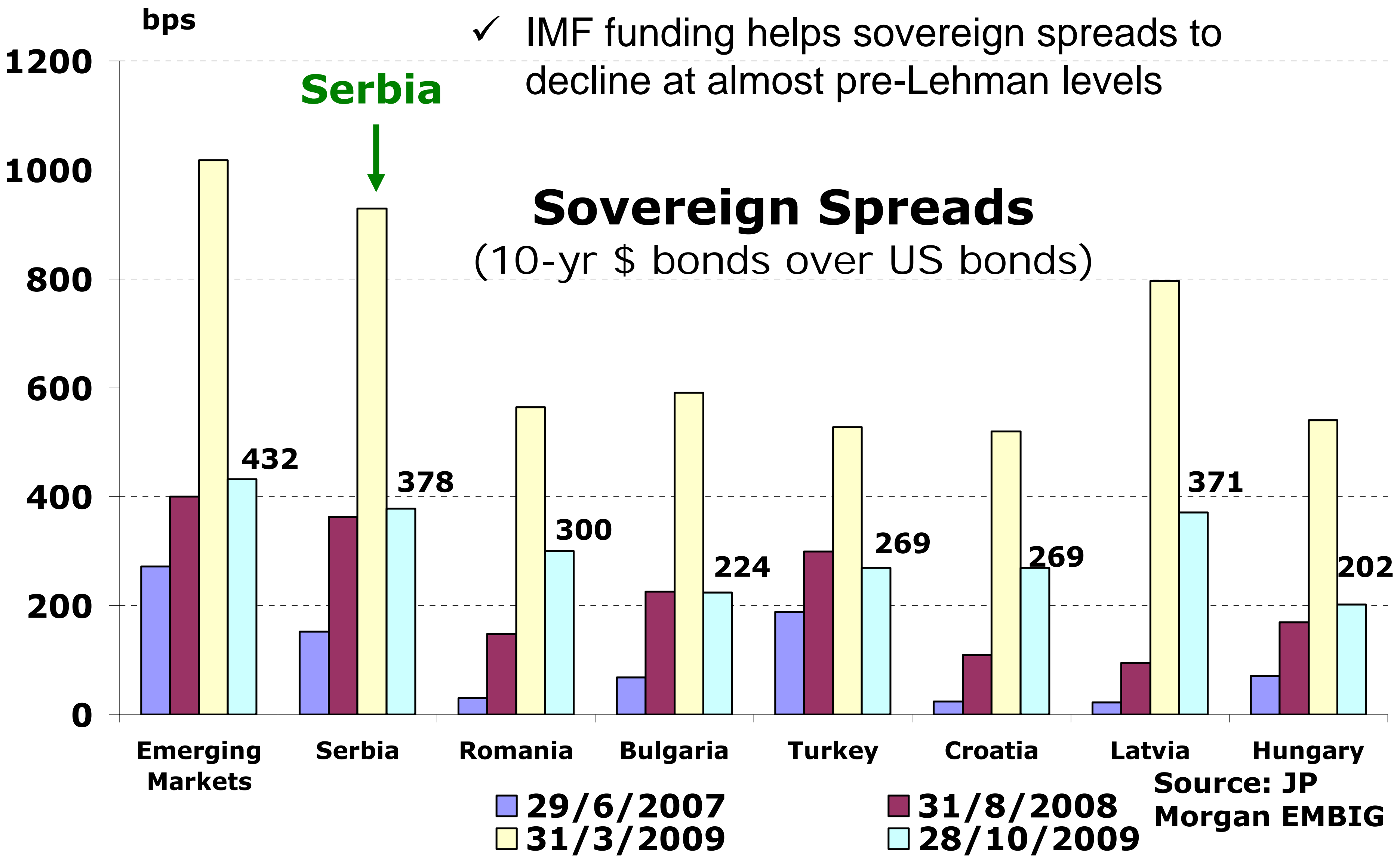

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III. SEE stagnation/recession in 2010

Real GDP (%)

	2008	2009f	2010f			
Bulgaria	6.0	-6.5	-2.0			
Romania	7.1	-7.5	-1.0			
Serbia	5.4	-3.5	0.5			
Turkey	0.9	-6.0	1.5			
Estonia	-3.6	-14.0	-2.6			
Latvia	-4.6	-18.0	-4.0			
Lithuania	3.0	-18.5	-4.0			

Source: Eurobank Research, IMF World Economic Outlook

✓ Baltic recession is deeper, started earlier, will end later

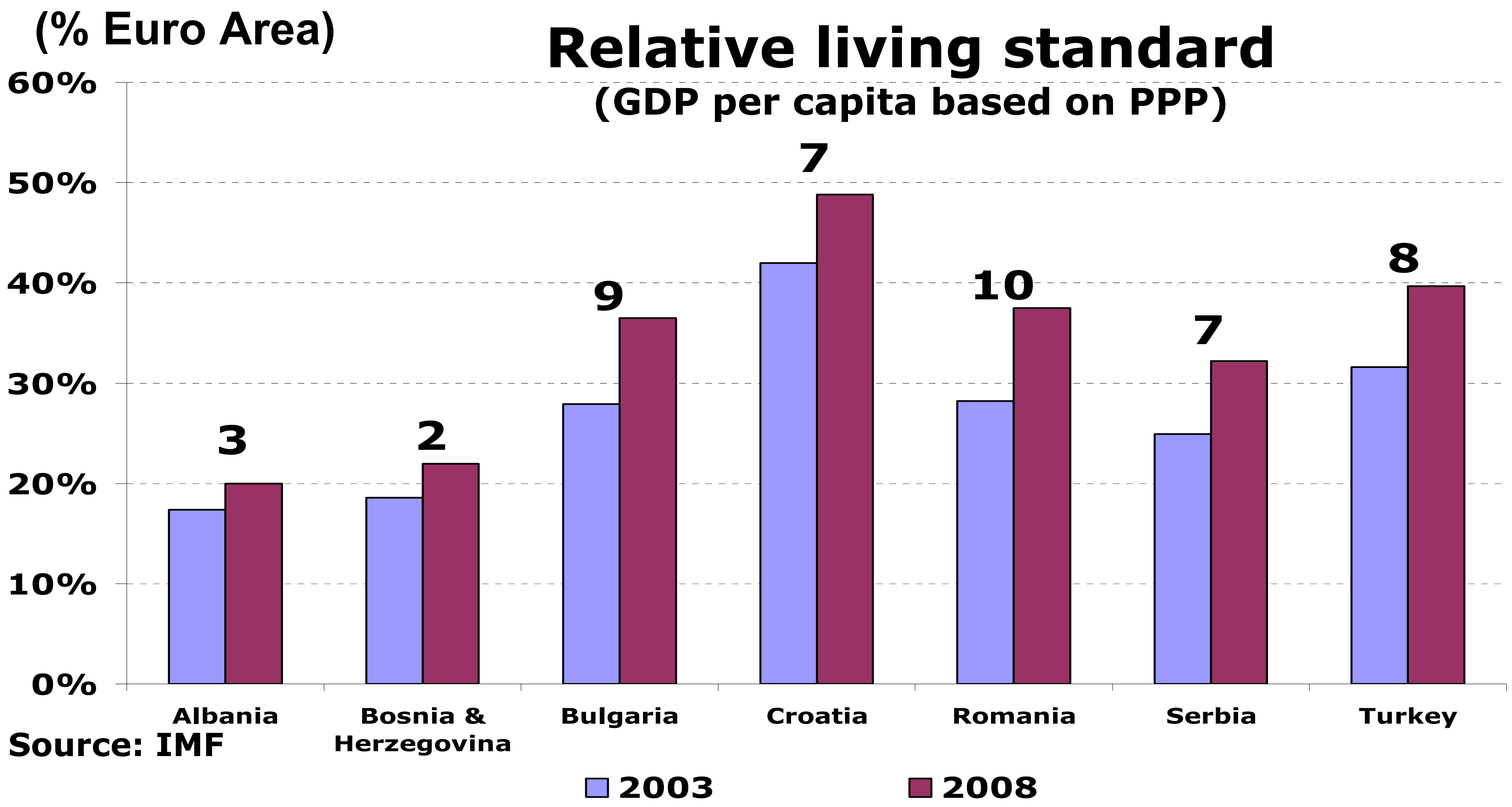
IV.

LOOKING AHEAD:

A MORE BALANCED ECONOMIC MODEL FOR THE SEEEs & SERBIA

From domestic consumption to investment and export driven growth

IV. SEEEs: Demand growth model improved living standards



- ✓ SEEEs improved their relative standard of living over the last 5 years
- ✓ Serbia's performance is impressive, given its late start

Source: IMF, Eurobank Research

IV. Yet now, demand-driven model outdated as credit bubble pops

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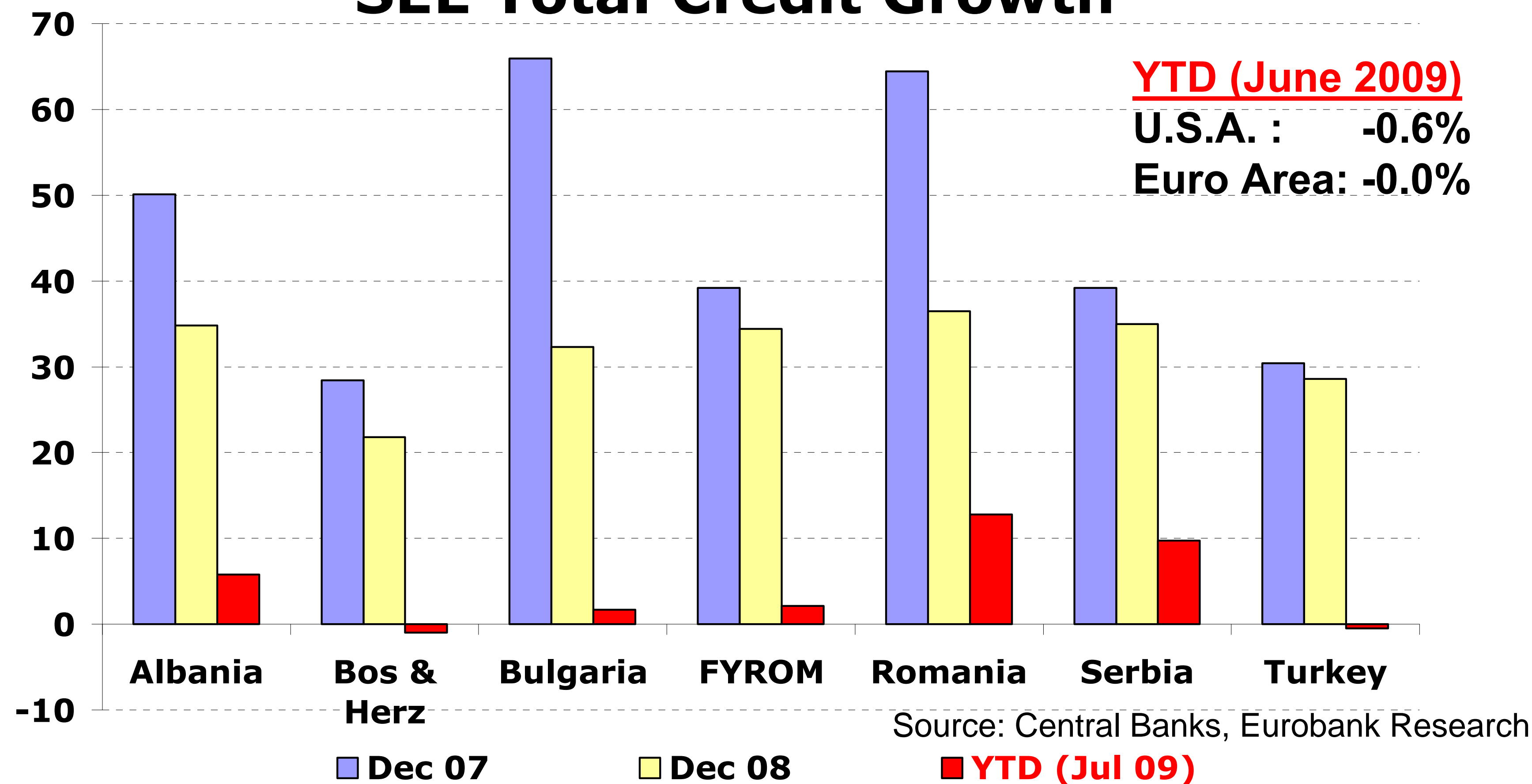

✓ **Credit expansion will follow the recovery, it will not lead it**

- "Economy recovers first and then lending unfreezes" is the Western experience with recessions
- Loans exceed deposits
- NPLs are rising and FX exposure is large

IV. A more-balanced growth model for future growth

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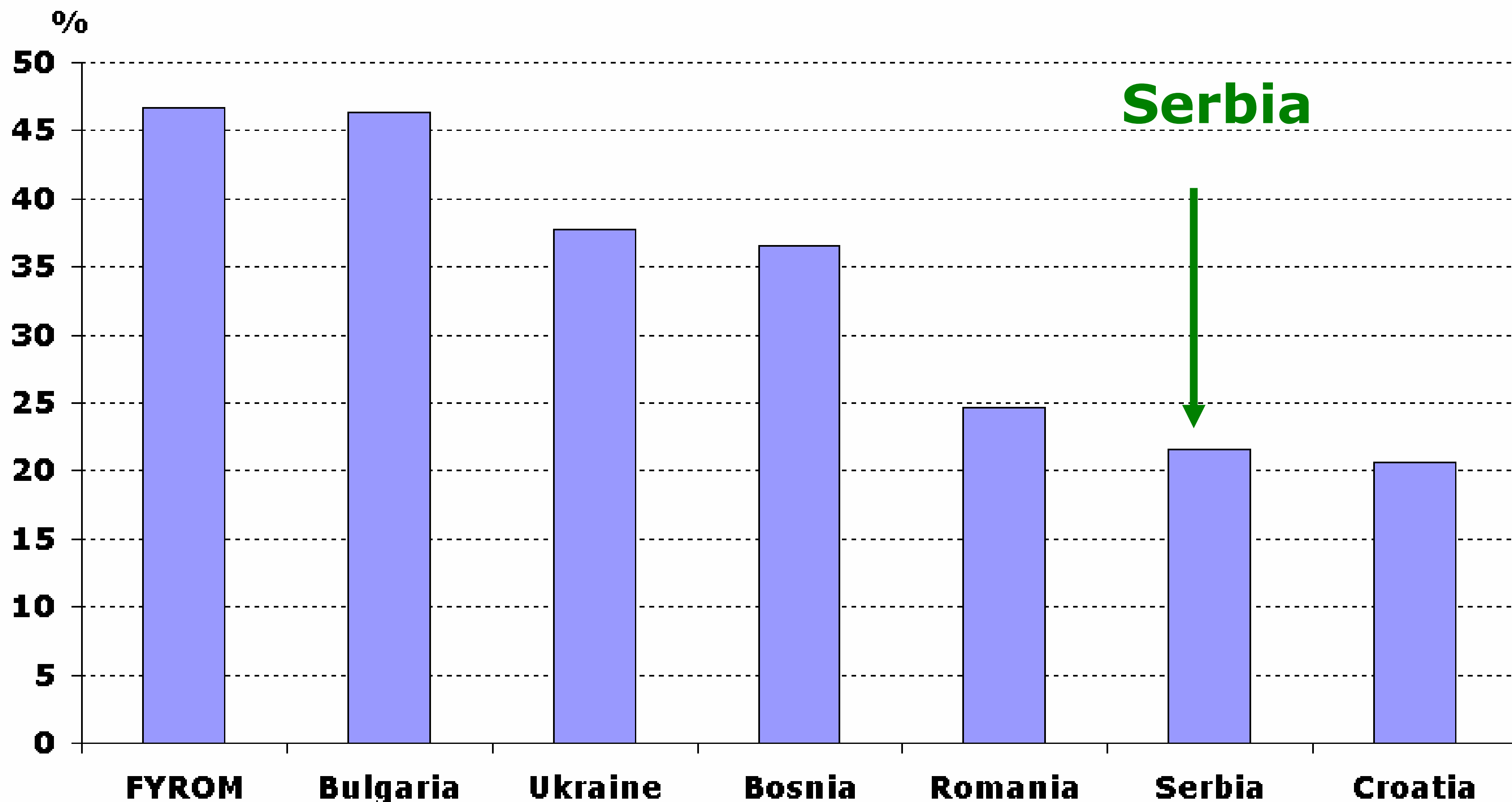
Increased emphasis on:

- ✓ Improving the domestic savings rate
- ✓ Shifting domestic demand from consumption to investment
- ✓ Focusing a bit more on the export markets
- ✓ Fostering competitiveness and total factor productivity. Numerous studies have shown that TFP benefits from:
  - the rule of law,
  - the quality of institutions,
  - the quality of infrastructure,
  - or the matching of human capital development and job training with the modern needs of globalized market economies
- ✓ Of course, the specific growth prescription can vary from country to country as the comparative advantages differ across the region.
- ✓ Macroeconomic stability is an obvious prerequisite to the new growth model (IMF, Rating agencies, Greenfield investors watch inflation and fiscal deficits)
- ✓ EU/EMU entrance acts as a powerful anchor for policy decisions. In Serbia, EU Stabilization and Association Agreement unilaterally implemented

IV. Serbia: Additional emphasis on exports required



IV. Policy priorities: Infrastructure

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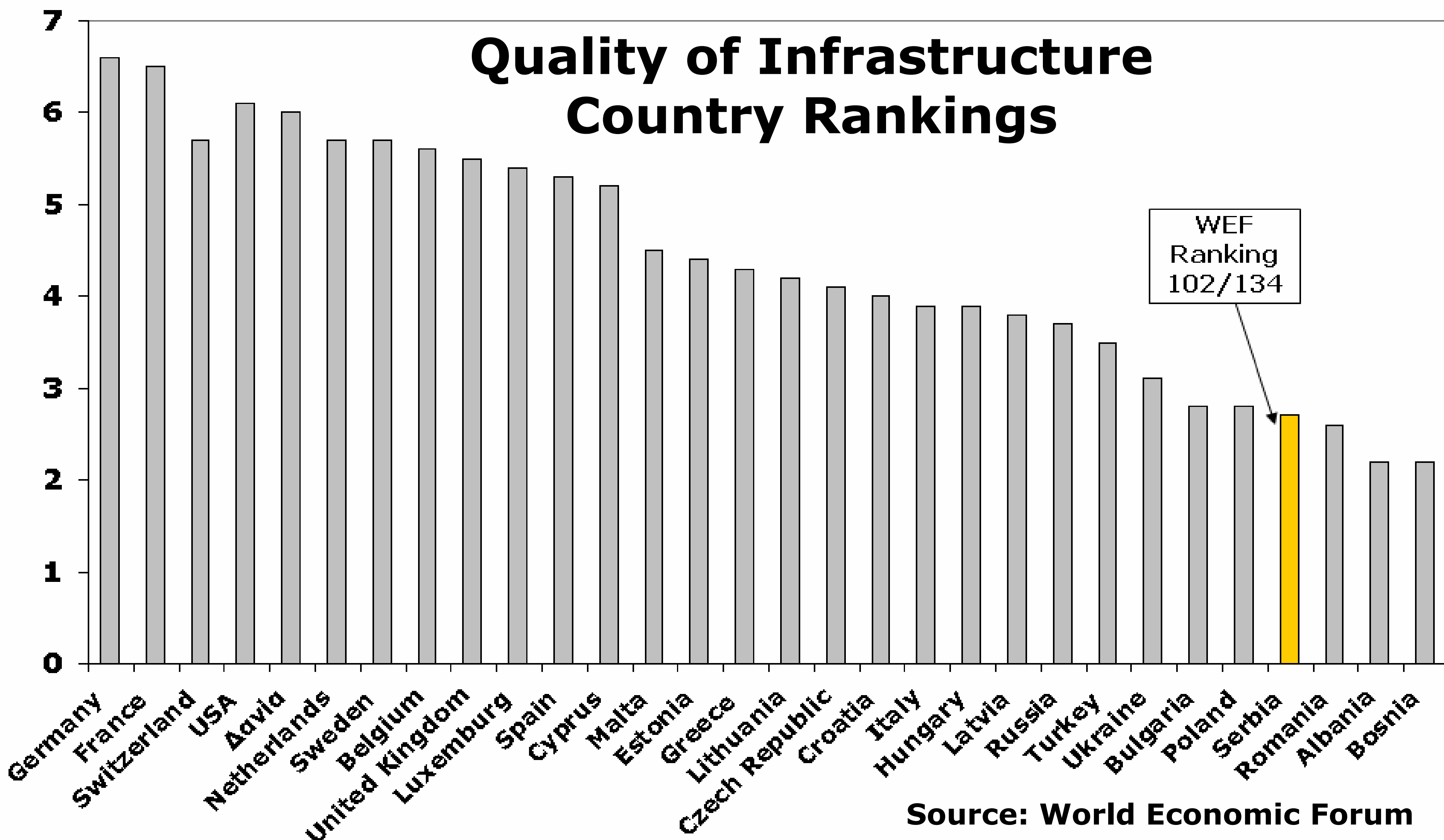

- ✓ Upgrading the infrastructure (ICT, Power, transportation, etc) is a top fiscal priority for SEE countries and Serbia

IV. Serbia: Ease of Doing Business, global rankings

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Rank (among 184 countries)	*2009**	*2010*	*Change*
Ease of Doing Business	**90**	**88**	**+2**
Starting a Business	108	**73**	+35
Construction Permits	172	**174**	-2
Employing Workers	87	**94**	-7
Registering Property	99	**105**	-6
Getting Credit	12	**4**	+8
Protecting Investors	70	**73**	-3
Paying Taxes	126	**137**	-11
Trading Across Borders	67	**69**	-2
Enforcing Contracts	95	**97**	-2
Closing a Business	102	**102**	0

* *Doing Business 2009* rankings have been recalculated to reflect changes introduced to the methodology and the addition of two new countries.

Source: Doing Business 2010 - Serbia, Doing Business Website

V. Conclusions

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- ✓ The international crisis will leave its permanent negative imprint on next decade's global growth
- ✓ A new global financial architecture will trade long-run stability against a higher cost of financial intermediation
- ✓ The SEE region was lucky not to host adventurous banks but imported the crisis through a sudden collapse of capital inflows and export markets
- ✓ The crisis revealed the need for a new more-balanced growth model in the SEE region and in Serbia, with an increased emphasis on competitiveness, investment and exports
- ✓ Entrance into EU and/or EMU play important anchoring roles to political and policy decisions
- ✓ Serbia has done well thus far despite its exogenous late start. Its eclectic and successful policy approach of the past few years shows it does have the needed flexibility for the new post-crisis growth model

THANK YOU FOR YOUR ATTENTION!!

My thanks to the Research Department of Eurobank EFG for able research assistance and support

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