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Unwinding spontaneous euroisation in CEE: a European success

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During the Great Financial Crisis, countries in Central and Eastern Europe were infamously labelled "the subprime of Europe" due to a combination of excessive debt in foreign currencies, including for households, and a lack of trust on their ability to respond to the crisis. Eleven years later, the region is facing a recession of comparable magnitude, with the shock of the pandemic amplified by the dependence in the supply chain to western Europe. But the region is facing this recession without the previous "subprime" stigma, and with strengthened financial sectors.

This has been facilitated by the reduction in the level of euroisation of these economies. As a sign of this achievement, there is presently no need in the region for emergency external financial assistance and several Central banks in the region were able to secure foreign currency swap lines with the European Central Bank. This study reviews both the spontaneous euroisation process during the initial economic transition and the reversal hereof that was coordinated under the auspices of the "Vienna initiative".

Launched at the height of the Great Financial Crisis in January 2009, the Vienna Initiative[1] aimed to prevent a "run to the exit" of the EU parent banks operating in Central, Eastern and South- Eastern Europe, in the various countries severely hit by the crisis and in need of multilateral financial assistance. At that time, a withdrawal strategy by the EU parent banks would have led to capital outflows and to full-blown balance of payments crises.

While most EU parent banks at the time rapidly reaffirmed their commitment to the region, the issues at stake were aggravated by the high degree of euroisation of the banking sectors which were thus exposed to currency depreciation against euro. Beyond stabilising the balance of payments, one unofficial objective of the international financial assistance was to avoid a sharp depreciation of domestic currencies and the negative balance sheet effects on local banks portfolios. In some countries, such as Hungary, the use of the Swiss franc had introduced an additional

[1] *"The Vienna initiative is a coordination platform that first met under a proposal of EBRD and National Bank of Austria, bringing together the relevant public and private sector stakeholders of EU-based cross-border banks active in emerging Europe.* https://vienna-initiative.com/

dimension to the nature of the risks. The Vienna Initiative was decisive in order to navigate through the resulting challenges. Its initial aim was to align the actions of national authorities in the region with those of local foreign-owned banks and their parent entities and regulators so that disorderly financial deleveraging would be prevented. This proved successful, with exposures in many countries at the end of the two-year voluntary commitments exceeding initial ones. Beyond this initial success, it was crucial to put in place incentives to reverse the euroisation process. This study reviews both the passive euroisation process during the initial economic transition and the reversal of this trend that was coordinated under the auspices of the "Vienna initiative".

Spontaneous euroisation: a legacy of the transition

The lessons of dollarisation in Latin America

Looking at the dollarisation process in Latin America is useful for our purpose. If the circulation of several currencies within a territory is an old phenomenon, illustrated by the history of metallism, dollarisation in Latin America was usually the consequence of an acute crisis of confidence in the domestic currency. The alternative for the monetary authorities was then either to impose currency controls and financial repression, or to tolerate a much higher degree of dollarisation. The outcome was rarely a policy choice and more often imposed by the political circumstances of the moment. The economic literature referring to dollarisation is rather laconic as to the practical consequences. Dollarisation allows for the expansion of the financial sector but can only be described as a second-best solution. It implies a lasting loss of monetary policy autonomy. A greater exchange rate risk is embedded in the domestic economy. The emerging market crises of the 1990s focused the attention of economists on the prevalence of foreign currency debt in emerging markets. Hausmann described with Eichengreen and Panizza the "original sin hypothesis"[2] as a situation in which the domestic currency is not used to borrow long term. With Dollarisation, the situation can be aggravated.

The process of dollarisation is most often measured by the share of US dollar loans and deposits in the banking sector, due to the lack of a more refined measure (for instance regarding its use for payments, or by industries). Its dangerousness is difficult to assess because it depends on all the factors that can increase the embedded exchange rate risk in the economy: the overall balance of funding and net external position of the country, the position of the various agents, the external environment and the factors determining confidence. The lessons of the past are not

[2] *"Original Sin: The Pain, the Mystery, and the Road to Redemption, Barry Eichengreen, Ricardo Hausmann and Ugo Panizza November 2002* http://www.financialpolicy.org/financedev/hausmann2002.pdf

easy to generalize: Some countries have been able to navigate smoothly for long periods with a degree of dollarisation above 50% (such as Peru) or even with full unilateral dollarisation (such as Panama, Ecuador). Others (such as Brazil) have managed to keep dollarisation below 30% despite acute crises of confidence in the domestic currency. The Argentine experience of the 1990s - that allowed firms and individuals a large freedom of choice of the currency to use - began with a miracle before ending up in disaster. Through this diversity, one general lesson can nevertheless be drawn: a high degree of dollarisation is more sustainable for small open economies with strong banking systems, moderate external debt and close economic links to the United States, the reverse characteristics being each of them sources of fragility. For the countries aiming at regaining monetary policy autonomy, the process was always very lengthy, as monetary and supervisory authorities had to deliver a comprehensive monetary stabilization, rebuilding confidence in the value of the local currency.

The challenge of rebuilding capitalism without capital in Central and Eastern Europe

After the initial shock of the transition, GDP growth in CEE was mainly driven by a catch-up process with "old" Europe stimulated by rising commercial and financial integration with the EU. The situation of the new or aspiring EU members was for this reason quite specific. Their development pattern often associated high growth with high imbalances such as rapid credit expansion and significant current account deficits. The imbalances partly stemmed from the initial choice of rapidly ensuring full convertibility of the currencies (a requirement of EU adhesion) in order to attract FDI, thus disconnecting investments from domestic savings and leading to current account deficits. It was ingrained in the need to rebuild capitalism, with a low initial stock of domestic capital at the early stage of the transition. This historical juncture, rebuilding capitalism without capital, was bearing many consequences.

A regional euroisation trend driven by the catch-up process…

Kick-started in the 1990's by the restructuring and privatization of the banking sectors, credit expansion started from a low base, with loans to households (consumer and mortgage loans) often growing more rapidly than loans to the corporate sector. Foreign currency lending expanded, including for households. The rational to take out debt in foreign currencies was strong as agents anticipated the appreciation of their local currencies in real terms against euro, as well as rising incomes in local currency. As an anecdote reflecting this mood, high ranking officials in the region often privately highlighted that they were personally indebted in euros, confident that they would be winners over the long term. The euroisation process was further fostered by the desire to save in euros and by the lower interest rates for borrowers in euros. The perception that exchange rates should on average continue to appreciate in real terms in the long term was supported by the “Balassa-Samuelson effect” linked to the catch-up process: high productivity gains associated with FDI were expected in the tradable sector.

In 2008, rapid credit growth had been registered for several years. Since 2003, credit to the private sector had grown annually in real terms by around 5% in Poland and Slovakia, 10% in the Czech Republic, about 15% in Hungary and Slovenia, and between 30 and 50% in the Baltics and the Balkans. In some countries, the bulk of domestic credit was denominated in or indexed to foreign currencies (see table 1, sourced from central banks).

Table 1

Loans in foreign currency (% of total loans)

	1998	2000	2002	2004	2006	2008
Slovenia		77	84	90	90	
Estonia	76	79	83	80	78	86
Latvia		51	53	66	70	85
Lituania	56	58	49	59	53	65
Hungary	55	49	37	40	43	61
Poland	21	21	27	25	27	34
Czech Rep.	20	16	15	11	10	9
Romania		45	50	58	49	58
Bulgaria	39	36	42	48	0	57
Croatia*			91	86	88	77
Serbia*					85	71

*FX + FX indexed loans

Source: National Central Banks, SG Economics and Sector Studies

The share of loans in foreign currencies did increase through the region, except in the Czech Republic that managed to avoid the trend, thanks to early monetary stabilization and a well calibrated subsidy program for domestic savings in local currency. At the other end of the spectrum, Former Yugoslavian countries were already deeply euroized after the crises and wars of the 1990’s, with few benchmarks in local currencies. These foreign currency loans were predominantly in euros, but Swiss franc and Japanese yen were also popular in Hungary and Poland.

…AND BY POWERFUL MICROECONOMIC FORCES

Large sectors of the domestic economies were more significantly euroized. This was notably the case of the real estate sector, both commercial and residential, where contracts, transaction prices, rents and values for collateral were most often calculated and settled in euro. The action of large foreign investors whose business models were connected to the more mature markets of the Euro area had the effect of pushing further the trend. It was true also in the automobile sector, with input costs incorporating imported spare parts, and in the distribution sector, with contracts for imported brands and shopping centres rents denominated in euros. Large European players were at the time powerfully reshaping these sectors and had the ability to impose price targets in euros on their local subcontractors, with an objective to control costs and reduce the exchange risk. Many tariffs for utilities were also de facto linked to costs in euros. Only the more local activities and the public sector did escape this trend.

This tended to create an illusion of deeper "de facto" euroisation of the economy that also responded to the psychological needs of hoarding. But the real revenues in euros were of course only coming from exports and transfers that represented a significantly lower share of the economy. This illusion was undoubtedly a risk factor in the event of a deep crisis. Other types of income, including wages, while sometimes denominated in euros did not have the same quality. In the event of a balance of payment crisis, they could fall sharply versus the euro. While informal revenue was often cited as a factor of resilience of the economies, this type of income was clearly not always available to repay debts in euros.

The dilemma faced by commercial banks

As previously examined, the euroisation process in the region was shaped by powerful micro and macro-economic forces. Domestic banks were of course key players in this process. As credit demand in foreign currency was exceeding deposit accumulation, they started to rely increasingly on external funding in euro, sometimes provided by EU parent banks, building thus negative external positions. EU parent banks could also book some loan portfolios at their head office, pushing further the trend. It was a way to respond rapidly to the new market opportunities.

While the financial deepening process was ongoing at high speed, it was nurturing in some countries a worrying combination of features such as a widening current account deficit, a negative net external financial position of the domestic banking sector and a rising share of foreign currency denominated loans. Some countries displayed all these features (the Baltics, countries in South Eastern Europe), others only some of them. Various academic papers started to underline these concerns[3], raising the question of the resilience of banking sectors to the risk of an exchange rate shock or a prolonged economic downturn. Central banks in the region had already started to action a panel of measures to try to slow the pace of foreign

[3] *"Too much of a good thing?", IMF working paper May 2005; "The foreign currency gamble", S&P, August 2006; "What do the sources of fund tell us of credit growth in Central and Eastern Europe ", EU occasional paper November 2006 ; "Credit expansion in Emerging Europe, a cause for concern ?", World Bank , January 2007.*

currency lending, mainly through increases in reserve requirements, tighter loan classifications and higher risk weights for these types of lending, albeit with very limited results. It was very much like trying to lean against a dominant wind. They were also wary not to introduce too many competitiveness handicaps versus non-resident financial players who were not submitted to the same restrictions.

For commercial banks riding the optimistic wave, the financial deepening was rational. The client base was expanding from a low level and included selectively the most solvent borrowers in the countries. A degree of comfort was also provided by specific regional factors seen as mitigating the risks.

SPECIFIC FACTORS WERE SEEN AS MITIGATING THE RISKS

For most countries, the prospect of joining the euro area sooner or later mitigated the perceived currency risks by providing a credible exit strategy out of the danger zone. Euro adoption was not an option but was compulsory for new and aspiring EU members. In Slovenia, once the country entered the ERM II mechanism, foreign currency lending increased rapidly as the corporate sector seized the opportunity to finance acquisitions abroad. Entering the euro area as of January 2007 led to the conversion of local currency in euros which eliminated the risks associated with the currency mismatches. In 2008, prospect of euro adoption by 2010 was estimated quite likely for Baltic countries and early in the next decade for many other countries.

Specific micro economic features were also expected to mitigate the risks. Banks in the region were overwhelmingly foreign owned, by supposedly strong pair of hands, and enjoying thus financial backing from their western parent institutions. Strong capital ratios provided a cushion that seemed to make a homegrown systemic crisis unlikely. The traditional channels of contagion (asset bubbles, short-term liabilities, high public external borrowing requirements) were not spotted through the region and strong parent banks were expected to play a stabilizing role in the event of a crisis of confidence.

However, it was also remembered that banking crises in emerging markets had often been preceded by rapid growth of credit in the context of semi fixed exchange rate regimes. Thus, a question remained whether excessive imbalances could derail the process of joining the euro area and hurt the banking sectors in countries where it was a more distant prospect. The view at that time was that this risk could be assessed through a stress test scenario that would entail significantly weaker growth and a 20% to 30% currency depreciation in real terms for a period of up to two years, somewhat like what Poland had been through at the beginning of the decade, which had dented bank's profits for two years but had not been lasting. A more severe stress was considered extreme, requiring a mechanism of contagion, deep doubts on the long-term catch up process or wide-ranging euro-scepticism.

Indeed, the impression prevailed that new and aspiring EU members were going through an exceptional historical period. Even sceptical observers were not ready to question the long-term catch-up perspective. Only the speed of catch up seemed questionable, not its direction, nor its duration likely to continue for 10 to 15 years, nor the continuation of the microeconomic transformation stimulated by accession process to the EU. All these assumptions were put to the test of the Great Financial Crisis.

Put to the test by the Great Financial Crisis

With the benefit of hindsight, we have learned that some of these assumptions were far less robust than believed. Some were even destroyed by the great financial crisis.

- EU parent banks were significantly weakened by the great financial crisis and the subsequent euro area crisis. Some of them, not only limited to Greek and Irish banks, could not anymore be considered as “strong pair of hands”. For a period, the exposure of EU parent banks to the region was seen more as a liability than an asset.
- The catch-up process came to a sudden halt for several years, except for Poland. It restarted regionally at much lower speed only after 2013. In parallel, the crisis of the euro area periphery also showed that for older EU members, the productivity catch-up had not been steady but had stalled at a fraction of the productivity of the core euro area.
- While Slovakia joined the euro area in 2009 and the exit strategy eventually worked for the Baltic states in the following years, the agenda of euro adoption was postponed for other countries, sometimes without new dates, with a growing mood of euro-scepticism. The EU enlargement process was also more or less stopped after the joining of Croatia.

In the years before the crisis, the real-term appreciation of currencies versus euro, pushed by the foreign capital inflows, had been more rapid than suggested by the Balassa-Samuelson effect linked to the catch-up process. Productivity gains in the real life had been slower than what credit and currency markets had been anticipating. When capital inflows stopped in 2009, a rebalancing was needed, and some currencies appeared to be overvalued while prospects of joining the euro area were delayed. In this new context, the need to reduce the foreign exchange risk embedded in the economies came to the fore.

The unwinding of euroisation

The response of the Vienna Initiative

While previously the sole concern of some central banks in the region, the need to reduce the foreign exchange risk embedded in the economies became more widely shared by the other institutions. The Vienna forum played a decisive role in that matter. With the recession and the financial crisis, banks were no longer pushing for further euroisation. The action of regional central banks also started to bite much more powerfully. Time was needed for an orderly rebalancing and the Vienna Initiative was crucially providing this time. The process of de-euroisation required attracting savings in local currency. Beyond the action of regional central banks, this was made progressively possible by the successful external rebalancing of the economies, and the macroeconomic and currency stabilization that followed. The spreads between the instruments labelled in local currency versus euro started to decline, diminishing greatly any previous incentive to support a foreign exchange risk. Euroisation in the region diminished progressively as shown by the table below.

Table 2

Loans in foreign currency (% of total loans)

	2008	2010	2012	2014	2016	2018
Slovenia						
Estonia	86	89				
Latvia	85	89	87			
Lituania	65	75	73	73		
Hungary	61	62	55	51	22	21
Poland	34	33	32	29	27	21
Czech Rep.	9	8	8	10	11	13
Romania	58	63	62	56	43	34
Bulgaria	61	64	64	57	45	40
Croatia*	77	73	75	74	66	60
Serbia*	71	69	72	69	69	67

*FX + FX indexed loans

Source: National Central Banks, SG Economic and Sector Studies

Some issues were more confrontational. Swiss franc loans were rightly spotted as very risky, as was illustrated in 2015 when the Swiss unpegged the franc from the euro. Hungary implemented forced conversion of these loans in local currency and was later followed by Croatia, while Poland and Romania contemplated schemes that were not eventually fully enforced. Hungary followed later by Poland and other countries started to tax more foreign capital and to question its role in their economies. While these debates have been leaving some scars, it is also clear that no major player has chosen to exit the region for this reason.

The Vienna Initiative is a case study of successful cooperative behaviour, being built on a strong basis. The fact that the same commercial banks were both large domestic players and the main external creditors did crucially help in that regard. Market funding was not prevalent in most cases and the relatively low level of public debt ratios in the region was a strength. A systemic banking crisis in the region was thus avoided to the benefit of all players. The orderly rebalancing of bank's business models reduced the levels of risks and facilitated the de-euroisation process where it was necessary. After several years of lacklustre growth, the catch up process with the core of the eurozone was reignited in the middle of the last decade.

The region is in a much stronger position to weather the current recession. The economic debate is no longer about financial stability issues but about the prospects of post-Covid catching-up. Beyond the already existing EU structural funds, which are sometimes underutilized, the administrative capacity of countries to absorb funds from the European recovery plan will be further put to the test. The trajectory of several countries could be slowed down by the notable slowdown, sometimes reversal, in their progress in terms of governance. In this new phase, regional catching up should continue but it promises to be less mechanical and more qualitative.

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