Radovan Jelašić: Effects of the financial crisis on Central and Eastern Europe

Speech by Mr Radovan Jelašić, Governor of the National Bank of Serbia, at the "Global Crisis in Europe and Central Asia" panel discussion of the IMF and WB Spring Meeting, Washington, 24 April 2009.

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Dear ladies and gentlemen,

Central and eastern Europe has gone through an unbelievable development during the last two decades in all aspects: politically, economically and socially. But the financial crisis has thrown much of that progress into doubt. Some brave but at the same time unpopular steps urgently need to be taken by the governments of the region. If these choices are not made immediately, the region's macroeconomic and social stability will be at risk. Democracy, during the next couple of months, will undergo its first major test since the beginning of transition.

First, most CEE countries, including Serbia, greatly underestimated and are still underestimating the problems they will face in 2009 and 2010, as our economic models – built on foreign direct investments, foreign borrowing and, for the regional members of the European Union, additional funds from Brussels – need a complete overhaul. Today's problems cannot, and should not, be solved just by relying on financing from the IMF, WB and EU. Instead we need a long overdue adjustment, with fiscal and structural reforms, including pension, healthcare and education reform for which IMF and WB should play a key role. "Premature welfare states" as Janos Kornai would call it, based on now scarce and expensive foreign funding, nose-diving FDIs and reduced budgetary incomes, are going to face an abrupt end all over the region.

Second, banks that are majority owners of the CEE's banking sector are hesitating to take the support of their respective governments as well as the IFIs. The level of exposure in the CEE region is definitely not commensurate with the level of recapitalization carried out up till now. In the meantime, the banking sector was never ever more important than at this crucial junction of the transition process. Now its time to prove if Mark Twain was right by saying that bankers are people who offer you an umbrella when the sun is shining and want it back when it is raining. The so-to-say "taking away of the umbrella" is taking place despite the fact that margins are at the level not seen during this decade!

Third, regulators in the CEE countries have limited tools to act proactively due to the fact that a majority of the banks are owned by institutions headquartered in the EU. The home – host cooperation, let us be honest, has proven to be basically ineffective in this crisis as it a) has no predefined rules and procedures, b) is very slow, c) is burdened with legal issues such as confidentiality.

What do I expect at the end of 2009?

I am afraid, nothing good. Fiscal income will deteriorate even further while the shadow economy will gain in importance. Governments will focus almost exclusively on financing current consumption (wages and pensions), even through accumulation of fresh debt, while capital investments will be substantially cut back. Banks will face a deteriorating loan portfolio and will spend most of their time with a) refinancing or restructuring problematic debt, b) provide fresh loans to government c) cut back operating costs and d) hoard substantial amount of liquidity as a precautionary measure. Illiquidity in the economy will increase substantially, partly also due to much faster submission of promissory notes for early payment by creditors. As there is no chapter 11 type of creditors' protection scheme, the number of bankruptcies will increase as well. Interest rates will remain high despite the fact that central banks will lower reference rates. Last but not least, current account deficit will moderate substantially, although that would additionally lower budget revenues! Respective authorities in the CEE countries can only alleviate but not turn around this downward spiral. We need first the world economy the bottom out, particularly the EU, in order for the CEE countries to see the light at the end of the tunnel.

But what could be and should be done urgently?

First, governments must get fiscally much more prudent. As the region cannot wait for better times in order to implement long-overdue structural reforms, there is no alternative but under crisis conditions to undertake the very unpopular steps. I fully support the idea that EU support is conditional to an IMF program, although I do have a problem understanding why the level of support between EU members, candidates and potential EU candidate countries is so substantial. Brussels should consider not only the economic implications of a support to potential candidates but the political as well.

Second, bankers must be convinced to a) take additional capital and b) continue lending. Under current circumstances, I see a crucial role of home supervisors that should convince (push) the banks to take additional capital. I find it to some extent peculiar that host supervisors and subsidiaries of banks headquartered in the EU, as a part of the Vienna initiative, agreed regarding the carrying out of stress testing, and if necessary, recapitalization. But such an exercise is not foreseen in the home country. In addition to that, lending should be revived as well, but for this, I admit, I do not have a ready made formula how to do it.

Third, the Vienna initiative should be extended to the entire region as I in Belgrade could sleep much more calmly if the majority of the countries would have such an agreement. Once we have finalized our deal, I hope in a matter of days, the deal makers should focus on all other countries as spill over effect is very large: a rumor regarding any bank in Serbia or Croation circulates in the region in matter of hours and could cause irreversible damages.

Fourth IFIs' money should start rolling – as we are entering a crucial time period of the crisis in the second half of this year. Time of statements, commitments, letters of intent etc. is over; banks, investors, debtors need nothing more but money. The proof of the pudding is in eating, and this is now the time to proof what do the IFIs stand for.

Last but not least, politicians in the region must manage realistic expectations and get ahead of the curve. This cannot and should not be done by Brussels (EU) or Washington (IMF / WB). Politicians in most of the countries do look down to the local population although they are pretty much aware how this crisis will affect them. It is finally time to be proactive, serious and stop spreading false expectations.

The situation today in the region, to some extent, is even more serious than at the beginning of the transition process: this time tough reforms must be made just for, in the best case, to maintain the current standard of living!