The transition region in the shadow of the Eurozone crisis: regional prospects and fiscal implications
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Key points & outline

1. Regional growth outlook and fiscal vulnerabilities
2. Exposure to risks in the euroarea and deleveraging
3. Sensible tax policies in a shrinking and foreign-owned banking sector

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Eurozone developments have already contributed to a marked slowdown in emerging Europe

- Exports from the region substantially down
- Capital outflows since Q3 2011 in all asset classes, by banks, portfolio and direct investors
- Hence significant projected slowdown in 2012 relative to 2011 (which has been evident since Q3 2011)
- Cross-border deleveraging, resulting in credit contraction the key external threat. Large downside risks if Eurozone crisis deteriorates

Healthy transition region growth in 2011 projected to slow down this year and next

A clear weakening in growth by early 2012…

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Difference between Q1 2012 and Q2 2011 SA q-o-q real growth, %

1
0.5
0
-0.5
-1
-1.5
-2
-2.5
-3
-3.5
-4

Lithuania
Hungary
Croatia
Estonia
Latvia
Slovakia
Bulgaria
Romania
Serbia
Ukraine
Russia
Kazakhstan
Kyrgyz Rep.
Tajikistan
Mongolia

Source: National Sources via CEIC data service

…which presages slower projected growth at least in the next two years

Slowdown has come primarily through weaker exports …

Export growth, m-o-m, SA (%)

6
5
4
3
2
1
0
-1
-2

Jan-11 Mar-11 May-11 Jul-11 Sep-11 Nov-11 Jan-12

Transition region
Central Europe
South-eastern Europe

Source: National Sources via CEIC data service

…as well as capital outflows

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Private capital flows, % of GDP

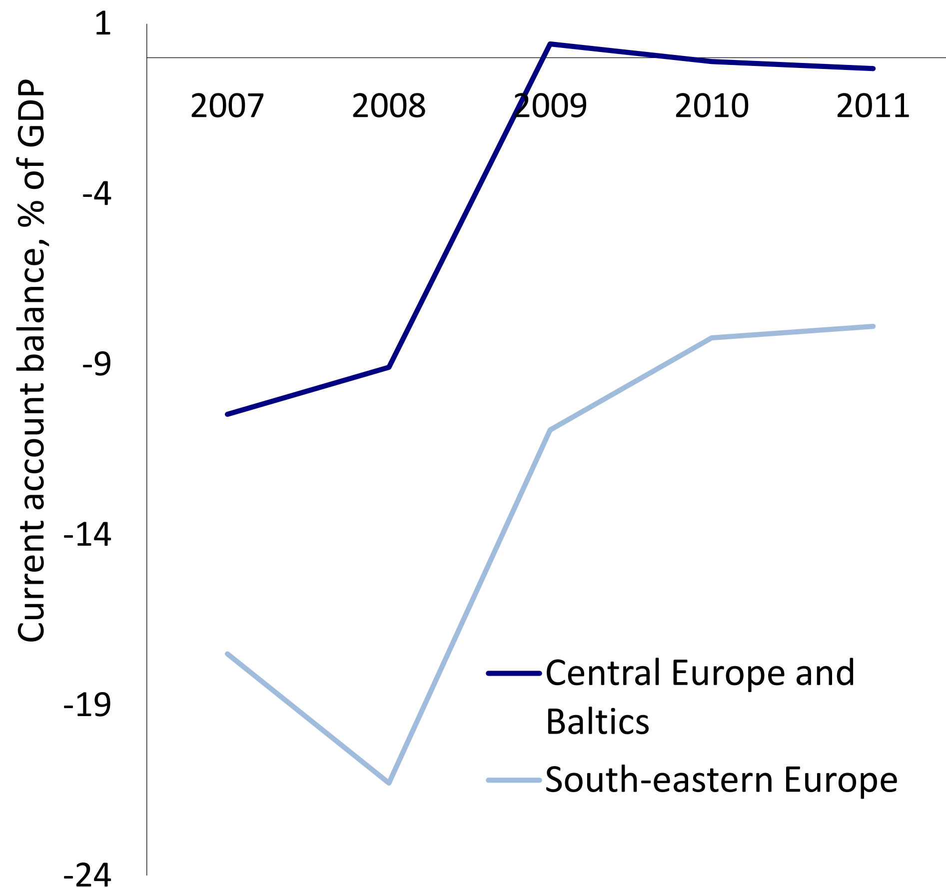
2
1
0
-1
-2
-3

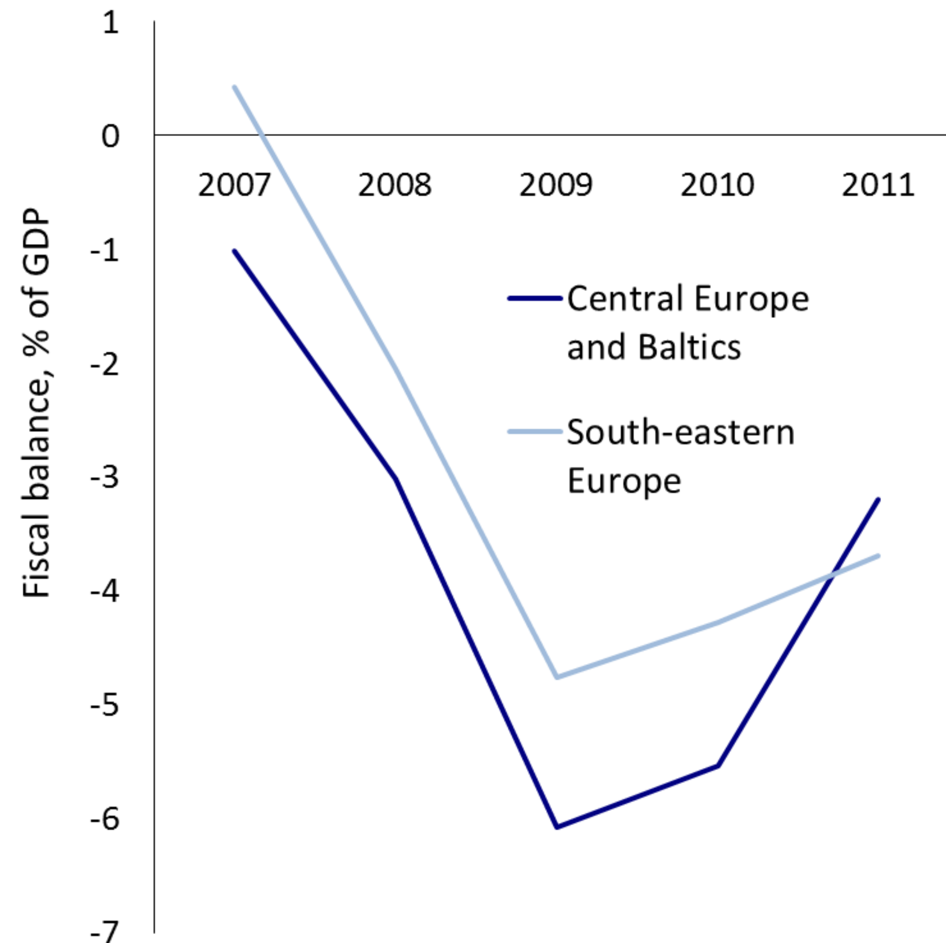
Q4 2008 · Q1 2009 · Q2 2009 · Q3 2009 · Q4 2009 · Q1 2010 · Q2 2010 · Q3 2010 · Q4 2010 · Q1 2011 · Q2 2011 · Q3 2011 · Q4 2011

FDI
Excl. FDI
Incl FDI

Source: National Sources via CEIC data service

Most transition economies started 2012 with vulnerabilities much reduced





* Charts show *unweighted averages* within CEB and SEE regions

Fiscal adjustment has been largely in sync with path of the Eurozone

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Fiscal tightening last year was on a similar magnitude as in the euroarea…

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Fiscal Impulse
(Change in Structural Balance from as a % of GDP)

8
6
4
2
0
-2
-4

Hungary
Lithuania
Slovenia
Ukraine
Turkey
Bulgaria
Slovak Republic
Romania
Poland
Russian Federation
Italy
Spain
France
Euro Area
Ireland
Germany
Greece
Portugal

Source: IFS

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…despite significantly lower levels of debt.

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Debt to GDP % 2011

180
160
140
120
100
80
60
40
20
0

Estonia
Russian…
Kazakhstan
Bulgaria
Romania
Ukraine
Latvia
Lithuania
Turkey
Slovak…
Slovenia
Poland
Hungary
Netherlands
Spain
Germany
France
Euro Area
Ireland
Portugal
Italy
Greece

Source: IFS

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In many transition countries, headline deficits are close to Eurozone averages

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Net Lending % of GDP 2011

8
6
4
2
0
-2
-4
-6
-8
-10
-12

Slovenia
Slovak Republic
Lithuania
Poland
Romania
Latvia
Ukraine
Bulgaria
Turkey
Estonia
Russian Federation
Hungary
Kazakhstan
Ireland
Greece
Spain
France
Netherlands
Euro Area
Portugal
Italy
Germany

Source: IFS

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Exposure to the Eurozone through exports, financing, and investment linkages

Note: The index is calculated as the sum of the share of eurozone countries in exports weighted by the share of exports in GDP, the share of eurozone in cross-border claims on the EBRD country GDP weighted by the short term external debt as a share of GDP, the share of eurozone countries in FDI weighted by the share of FDI in GDP .

With concentrated bank ownership now the key risk

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Sources: Bankscope, Bankers Almanac, Central Banks, Banks' Annual Reports, European Bank for Restructuring and Development, the World Bank.
Note: Data only include banks with at least 50% ownership in the respective subsidiaries
*"Other foreign" for these countries was calculated with 2009 data on asset share of foreign-owned banks.

Cross-border deleveraging continues

FX adjusted change in cross-border claims, % of previous quarter's stock

6
4
2
0
-2
-4
-6
-8

2010-Q1 2010-Q2 2010-Q3 2010-Q4 2011-Q1 2011-Q2 2011-Q3 2011-Q4

CEB total
SEE total
Transition region total

Source: BIS Locational Statistics

… most countries have continued to experience outflows in the first months of 2012

Source: National Sources via CEIC data service

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However, local deposit growth has to some extent compensated for foreign funding outflows

Change in Banks' Funding Sources: September 2011-April 2012

- External Funding: BOP Liabilities: Other Investment Banks
- Domestic Funding: Total Deposits
- Total Credit
- Balance

Change September 2011-April 2012 as % of PY GDP

7% 6% 5% 4% 3% 2% 1% 0% -1% -2% -3% -4% -5% -6%

Bulgaria Estonia Latvia Lithuania Macedonia Poland Romania Serbia Slovenia Turkey Ukraine

ia CEIC data service

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Deleveraging is reinforced by tightening credit conditions

Source: IIF

This implies shrinking credit in the countries most integrated with the Eurozone

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* For Croatia, Montenegro, Armenia, Georgia, and Russia chart shows average from January to March

Source: National Sources via CEIC data service

Further deterioration of the eurozone crisis clearly the key risk to the region

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Quarterly year-on-year real output growth

8
6
4
2
0
-2
-4
-6

90th percentile
50th percentile
Baseline

Mar 10
Jun 10
Sep 10
Dec 10
Mar 11
Jun 11
Sep 11
Dec 11
Mar 12
Jun 12
Sep 12
Dec 12
Mar 13
Jun 13
Sep 13
Dec 13

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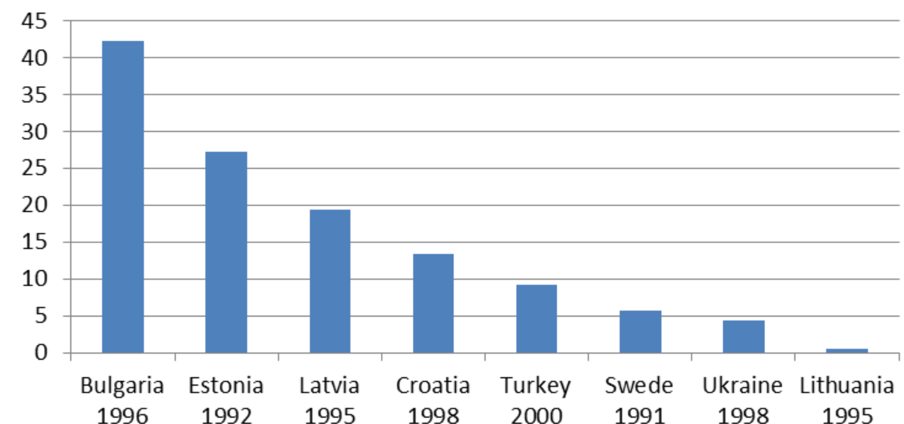
III. Tax policies in a deleveraging banking sector

Popular motivations

- Financial sector immensely profitable, but economic rents 'undertaxed'
  - ➢ Barriers to entry other lack of competition?
  - ➢ Implicit state guarantees
  - ➢ VAT exemption
- "Banks brought us into this mess" – need for a solidarity levy to support fiscal consolidation
- Financial crises are costly, need to be insured against



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Financial sector levies: current state of play in the central Europe region

- **Hungary.** First to introduce a balance sheet tax, generating 0.7 per cent of GDP in 2011. To be cut in half following introduction of a financial transactions tax for which the target is HUF 283 billion for 2013 (1 per cent of GDP) and then HUF 320 billion in 2014.
- **Slovakia.** Existing tax 0.4 per cent on liabilities net of insured deposits and equity, likely to be extended to retail deposits (though discounting insurance levy). Contributed to exit of smaller banks, which relied primarily on corporate business.
- **Slovenia.** 0.1 per cent on assets, likely to generate … per cent of GDP in revenues, though off-set in tax liabilities where corporate lending is increased.
- **Poland.** Ongoing discussions, possibly for introduction of a balance sheet tax this year, to be based on 2011 bank liabilities (likely net of guaranteed deposits). Revenue generated likely very small, less than 0.1 per cent of GDP.
- **Romania.** A 2.5 per cent solidarity tax on bank profits proposed to fund social security budget, though defeated in Senate in May.
- **Croatia.** Contemplated bank tax in 2010.

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Bank taxes: possible principles of good practice

"A fair and substantial contribution by the financial sector" (IMF, April 2010)

- Tax base: avoid conflict with risk-weighted asset calculation – tax liabilities (net of capital and insured deposits).
- Tax rate: virtue in simplicity, though possibly a case for reflecting systemic risk (e.g. interconnectedness, risks in funding structure).
- A *Financial Activities Tax* could remedy VAT exemption without distorting activities.

<u>Prudential concerns:</u>

- Erodes capital cushion of banking system; will further constrain credit creation in context of already high/rising NPLs/tight credit standards, and risk aversion.
- Risks of diversion into shadow banking sector, cross-border deleveraging.
- Minimal revenues created will not be credible as backstop for the financial system, in any case requires resolution regime.

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Bank taxes: considerations in emerging Europe

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- Decent capital cushions in em Europe a reflection of prudent bank policies, and often informal (‘pillar 2’) supervision
- Nature of highly integrated banking sectors (foreign ownership shares of 60-80 per cent) requires close coordination with home countries, and other countries in the region.
- National bank taxes risk further aggravating regulatory fragmentation of integrated capital planning and support to subsidiaries.
- Financial transactions tax may be administratively feasible (e.g. Argentina, Turkey), though is unrelated to systemic risks, and ‘cascading’ effects of taxation of series of transactions likely detrimental for financial consumers in highly open economies, such as the CEE region.
- European resolution and recovery regime will be essential for credible national backstops.

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