ECONOMIC AND FINANCIAL RISK TAKING IN CENTRAL AND EASTERN EUROPEAN COUNTRIES

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Abstract

The need to ensure competitiveness and access to finance and new opportunities as a support for growth, entails countries to take economic and financial risks. One solution for economic growth is innovation and investment, which is equivalent with risk taking behavior. In this paper we intend to present the current economic and financial challenges for Central and Eastern European Countries, members of the European Union. As countries had to face specific challenges, the whole picture is mixed, but common threats still remain.

Keywords: CEE, economic and financial challenges

JEL Classification: G01, G32

Introduction

In a way or other, the new member states joined the European Union based on a prosperity perspective, a promise for economic growth. The need to ensure competitiveness and access to finance and new opportunities as a support for growth entails countries to take economic and financial risks, risks that are evolving and interblending in more sophisticated ways. In a general approach, risk taking implies decisions with perilous potential, but in the same time bring new opportunities with positive results. For example, innovation is considered to be a risks bearer, by developing new products and services with the capacity to create new markets and contribute to the economic growth.

The central banks may decide to adopt monetary policies to foster considerably spending from consumers and businesses by diminishing the interest rate and thereby making money affordable.

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When growth is slowing, some central banks (starting with Federal Reserve that first announced in September 2012, and continuing with The Bank of Japan that used it also in the early 2000s, and European Central Bank) may decide to use quantitative easing (the policy of assets purchase) to boost the economy. By buying government securities or other types of securities from the market, money is released in the economy with the aim to lower the interest rate and increase the nominal spending and the liquidity. Albeit it has already a history, this form of monetary policy is called unconventional and the debate about its efficiency and objectionable side effects. Previous research has acknowledged the existence of significant impact of quantitative easing news on the dynamics of financial markets (Albu et al. 2014) and particularly on UK gilt yields (Joyce et al., 2010).

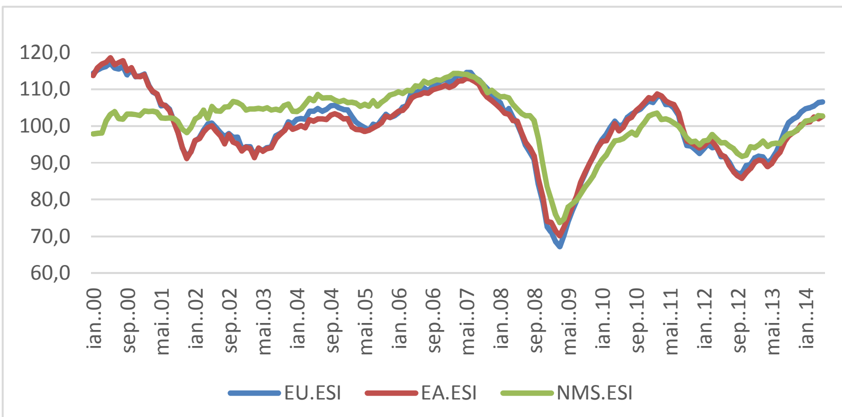
As mentioned in Bank for International Settlements report (2013), after the last crisis "At the same time as central bank measures may have become less effective, accommodative monetary policies have produced various side effects […]. Prolonged low policy rates tend to encourage aggressive risk-taking, the build-up of financial imbalances and distortions in financial market pricing." In different words, the accommodative monetary policy, known also as "easy monetary policy" used mostly for stimulate economic growth has also some side effects and when not supported by structural reforms may be even more dangerous, affecting economically and socially the entire society.

The role of central banks received more attention after the crisis, as many expect solutions for a bunch of key economic and financial issues. The central banks have to find a way to pursue the price stability objective while promoting financial stability (Criste and Lupu, 2014), are setting the framework for exchange rate and are linked with capital fluctuations (Milea, 2013) and liquidity. The lack of symmetry of business cycles in Central and Eastern European countries (Chirilă and Chirilă, 2012) is also a cause for a different matrix of risks.

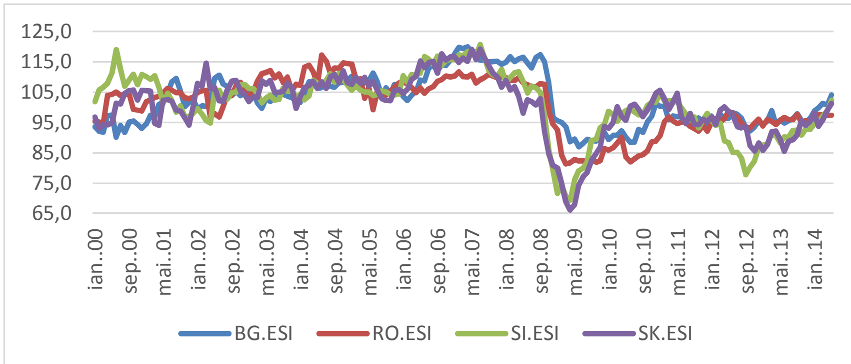
Economic risk taking

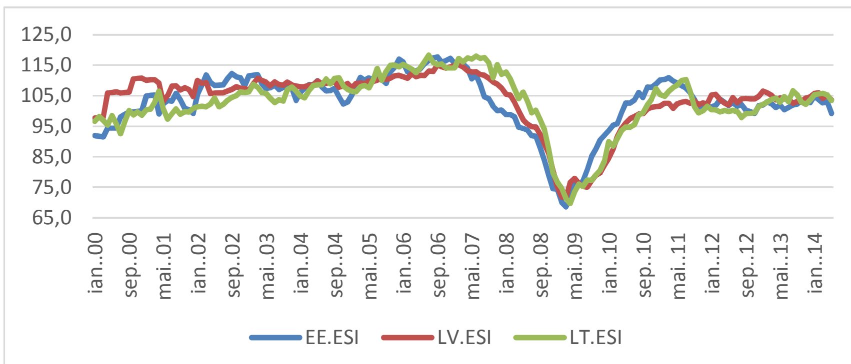
The economic sentiment indicator[1] is a quantified measure of the economic confidence and at a first glance may offer an image that reflects the difference between countries. Looking at a longer trend that starts in the year 2000, can be observed that till the begging of 2008, almost all new member states of the European Union had a smooth evolution, slightly positive. The dramatic drop from 2008 affected all countries, but on average (except Hungary) the new member states were above the level of euro area countries. From the second half of 2012, all new member states started to recover, following the bigger European trend. Hungary is much above the common trend, strengthening its fluctuant evolution.

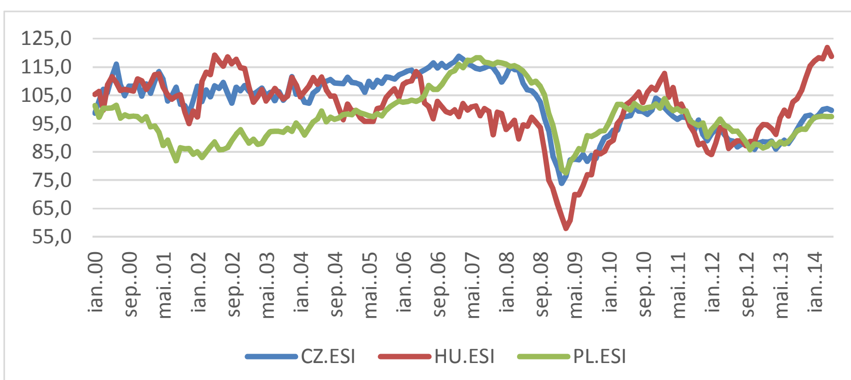
Figure 1 - Economic Sentiment Indicator in the New Member States (January 2000-May 2014)



[1] *A composite indicator designed by the European Commission based on judgments and attitudes of producers and consumers; investors and analysts may see how optimistic or pessimistic the market conditions are. It is a compered with a long term average (=100) and consists in a withed average of 5 indicators representing different components of the economy: industrial confidence indicator (40%), service confidence indicator (30%), consumer confidence indicator (20%), construction confidence indicator (5%), and retail trade confidence indicator (5%).*



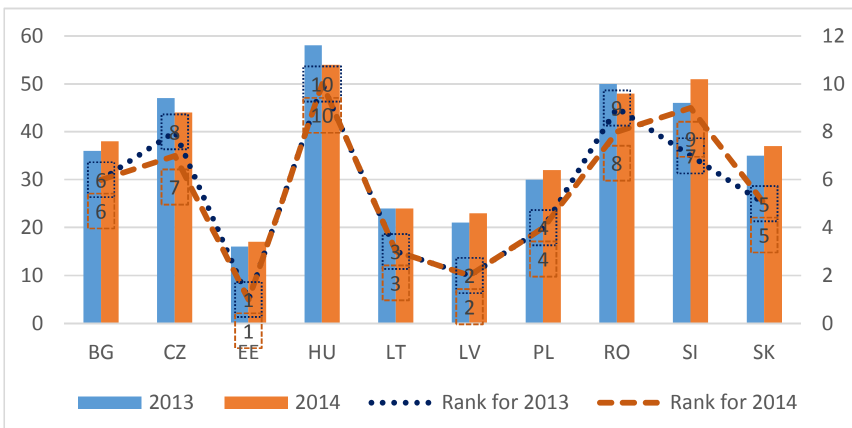




Source: European Commission, AMECO database and author's calculations

Another well-known index for measuring the climate for business is published by World Bank. Even if uses a criticized methodology, the researchers involved in constructing the index are arguing that the improvement of the elements taken into account (starting a business, property rights, protecting investors etc.) may favorable influence the economic growth. Looking at our group of countries for the available data – 2013 and 2014, although the first six positions are kept in 2014 by the same countries, in the same order (Estonia, Latvia, Lithuania, Poland, Slovak Republic and Bulgaria), with the exception of Lithuania that has the same index, the others are losing 1 or 2 points. Slovenia is declining from 7th position to the 9th, allowing Czech Republic and Romania to advance with 1 position, Hungary remaining on the last place, albeit the index is improving with 4 points.

Figure 2 - Ranking for Ease of doing business index

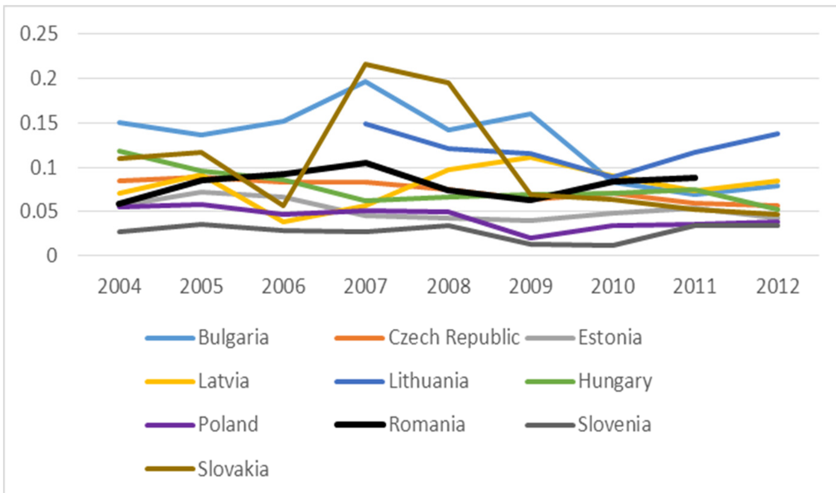


Source: World Bank database, Doing Business and author's calculation Note: 1 = most business-friendly regulations, 189 = worse

The number of SMEs is generous in European Union at large and in Central and Eastern European Countries, but their main challenge is to enlarge and to survive in the next years. Romania and Poland are leading when looking at the number of their new created companies with 10 or more employees, but when scaling with population, Romania is somewhere in the middle of the group and

Poland is the penultimate and Bulgaria is leading till 2010 (excepting Slovakia for a short period in 2007 and 2008 when was recorded an abnormal situation). Starting with 2009 and more obvious after 2010, the number of new created enterprises at 1000 population is converging to a narrow interval between 0.03 and 0.08 (except Lithuania), demonstrating a more risk averse behavior.

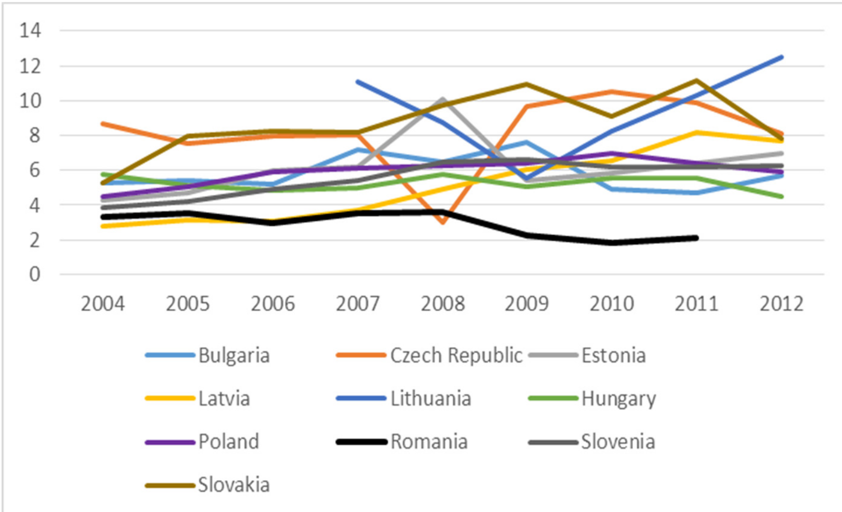
Figure 3 - New enterprises with 10 or more employees at 1000 population in the period 2004-2012 (business economy except activities of holding companies)



Source: Eurostat and author's calculations

As for creation of new smaller enterprises at 1000 population, the places of Romania and Poland are changing, Romania placing last and Poland in the middle of the group. The evolution in the other countries is chaotic, the interval narrowing in 2012, in a range between 4 and 8 (except Romania – at a lower level, and Lithuania, again with a number of new created enterprises much higher than the average – more than 12), the aversion toward risk having a 1-2 years lag comparing with the case of enterprises with 10 or more employees.

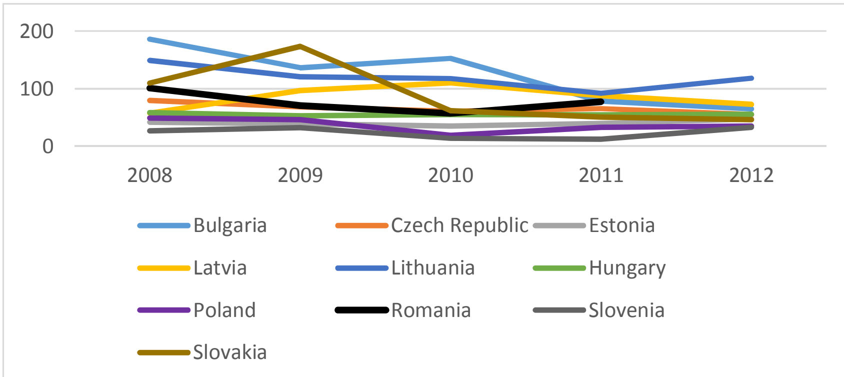
Figure 4 - New enterprises with less than 10 employees at 1000 population in the period 2004-2012 (business economy except activities of holding companies)



Source: Eurostat and author's calculations

Together with the narrowing of interval for the new created enterprises with 10 or more employees at 1000 population, the number of newly born enterprises in t-1 having survived to t with 10 or more employees at 1000000 population, is also converging to values between 30 and 70, except again Lithuania, confirming an unfriendly environment.

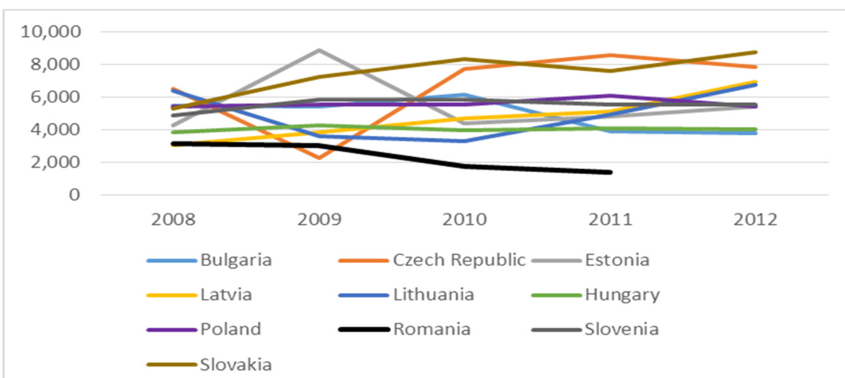
Figure 5 - New enterprises with 10 or more employees at 1000000 population in the period 2004-2012, newly born in t-1 having survived to t(business economy except activities of holding companies)



Source: Eurostat and author's calculations

The number of newly born enterprises with less than 10 employees at 1000000 population in t-1 having survived to t, in an unexpected way, is even increasing after 2010 (except Romania) and these numbers are much higher than in the previous case.

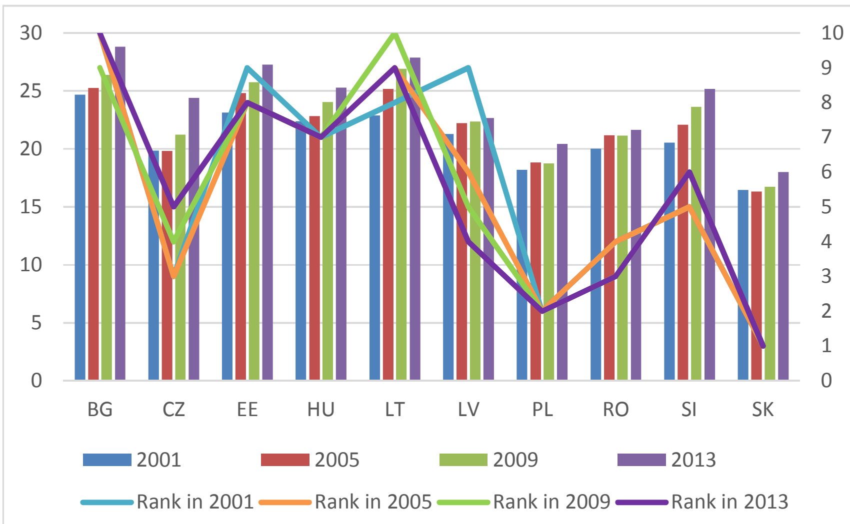
Figure 6 - New enterprises with less than 10 employees at 1000000 population in the period 2004-2012, newly born in t-1 having survived to t (business economy except activities of holding companies)



Source: Eurostat and author's calculations

A real threat for the current moment is the population ageing (Ciumara and Lupu, 2014; Ciumara et al., 2013), more advanced in the Western European economies. In the group of analyzed countries, the bigger problem seems to be in the case of Bulgaria, with highest level of old age dependency ratio, followed by Lithuania and Estonia. The smallest rate is in Slovakia, followed by Poland and Romania, almost all countries registering a slight increase.

Figure 7 - Ranking for Age dependency ratio, old (% of working-age population)



Source: World Bank database and author's calculations

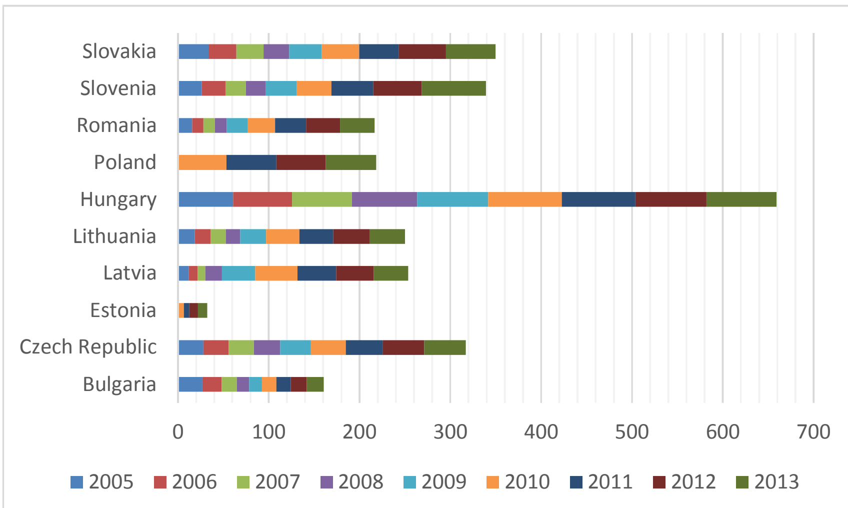
Financial risk taking

Bank for International Settlements (2013) drew the attention on currently used aggressive easy-money policies by many central banks, policies that fostered investors and financial institutions to take more risks - "Abundant liquidity and low volatility fostered an environment favoring risk-taking and carry trade activity".

While confronting the own challenges, the Central and Eastern European countries imported some problems through the banking system that is mostly held by countries from the euro zone (IMF, 2014; EIB, 2013; Ailincă, 2014).

The debt stock (private debt accumulated mostly prior to the crises and public debt that increased after the crises) raised the need for refinancing; this conjuncture (Miclăuş and al., 2010) combined with the dependence on external financing make these countries vulnerable. The currency risk is elevating in some cases their weakness, albeit this risk is differentiating across various sectors of the economy (Horobet and Lupu, 2005).

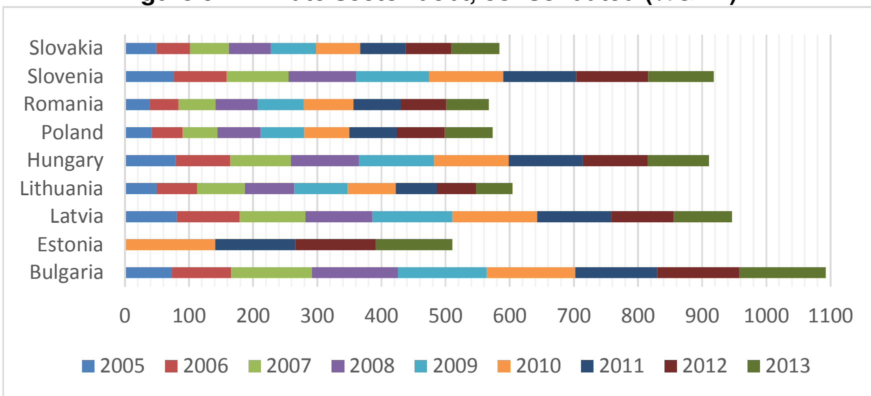
Figure 8 – General government gross debt, consolidated annual data (%GDP)



Source: Eurostat database

Note: Data not available for Estonia and Poland between 2005 and 2009

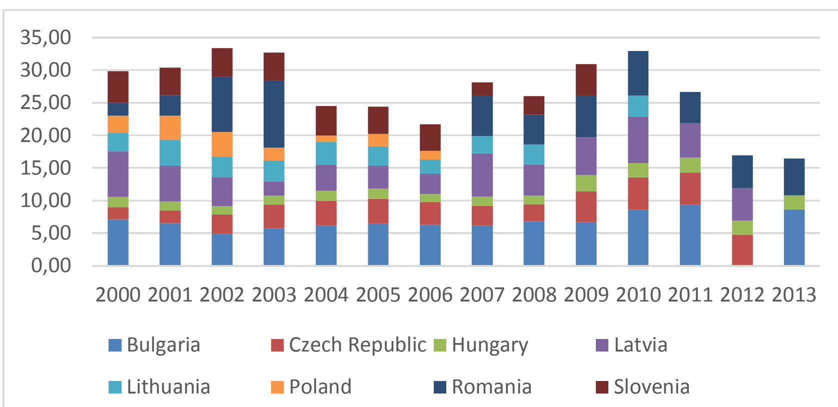
Figure 9 – Private sector debt, consolidated (%GDP)



Source: Eurostat database
Note: Data not available for Czech Republic (entire period), and Estonia between 2005 and 2009

Some countries (Hungary, Lithuania) are keeping relatively low risk premium for lending, while countries like Bulgaria are maintaining a high level, even if the stock of debt (at least for public sector) is one of the smallest. Romania had a huge increase in 2002-2003, and from 2007 the level is slightly floating in the same rage.

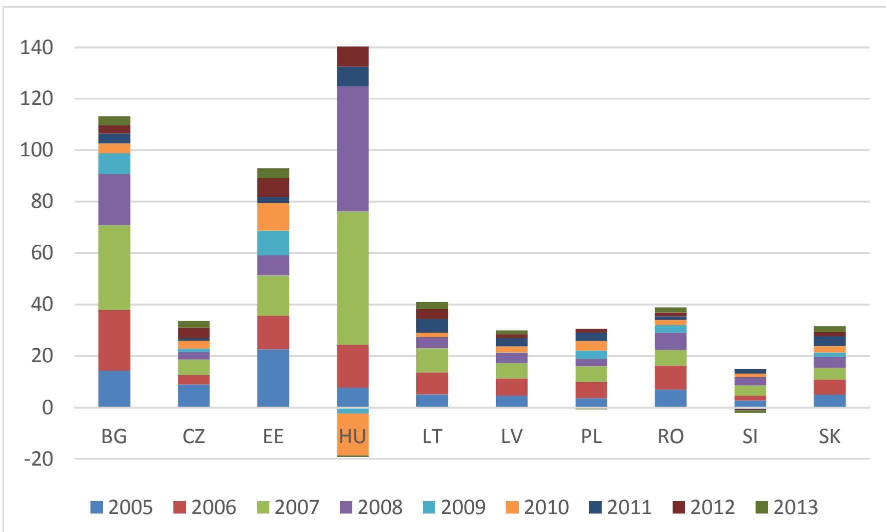
Figure 10 – Risk premium on lending



Source: World Bank database and author's calculations
Note: Lending rate minus treasury bill rate. For the years when some countries are not included in the graphic, data is not available.

Even if Hungary and Bulgaria had not very good positions for economic sentiment indicator calculated by European Commission (Bulgaria is sometime little bit better positioned than Romania, but Hungary had a lower index than other countries) or ease of doing business index published by World Bank (Bulgaria in on 6th place in the group of ten, and Hungary is on the last place), these countries attracted most of the foreign direct investments between 2005 and 2013, being followed by Estonia. Besides the fact that this kind of investments bring good and bad for the host country, depending of the quality of investors, the indexes calculated by different institutions to measure the business climate are not considered in all cases.

Figure 11 – Foreign direct investment, net inflows (% of GDP)



Source: World Bank database and author's calculations

Concluding remarks

The last crisis induced a growing risk adverse behavior in the last years. Complementary, the external financing was more volatile starting with the middle of 2013, the foreign banks reduced the external funding, and the geopolitical situations was in strong distress. The growth perspective in CEE is facing many downside risks in the near future. The tightened conditions of the financial markets due to higher market volatility are affecting all markets, including CEE that can receive less funding and investments, limiting the market liquidity. Geopolitical risks raised by tensions regarding Russia and Ukraine, very close geographically to CEE countries, currently have a negative influence with a limited impact, especially in the energy and trade sectors, but a sustained conflict may encompass serious prejudice in the entire region, affecting the confidence. As countries had to face specific challenges, the whole picture is mixed, and in the context of an increased private and public debt, they are responsive to internal and external markets' conditions changes. For a better position of banking sector there is a need for strengthening the capital and liquidity levels and for eschewing from riskiest lending's forms.

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