EXPERIENCES OF THREE EASTERN EUROPEAN COUNTRIES DURING THE RUSSIAN CRISIS - AN ANALYSIS OF 'CONTAGION[1] '

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[1] The authors wish to thank Gabor Bognar, Alexander Perjessy and Mariko Sugi of Goldman Sachs, Steven Gilmore, Masako Matsuyama-Smith and Mitsumasa Choji of Morgan Stanley, Stuart Parkinson of Deutsche Bank, Paul Kelly, Bank of England and Cemile Geyik for their contributions to this work. Needless to say however, any remaining errors in the paper are the authors'. Views expressed here are those of the authors and do not necessarily reflect those of the Bank of Japan or any of the above companies.

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I. Introduction

1. The liquidity crisis triggered by last August's Russian default made international financial markets shiver. The fallout has extended its reach to have an effect on Latin American countries. On 13th January, Brazil was driven to devalue her currency. The Brazilian crisis has served to rekindle the fear of an international liquidity crisis and global deflation[1].

2. Despite such turmoil, however, Eastern European countries (especially Poland, Hungary and the Czech Republic) are riding over last year's Russian crisis almost unscathed. Their currencies sustained most of their value (Chart 1). The result has been a surprise to most market participants.

3. Comparison among sovereign spreads alone gives a fair measurement of the aftermath. For example, Russian sovereign spreads widened by nearly 12 times. This resulted in 4 to 5 times wider sovereign spreads in Turkey and South Africa, whereas the spreads of the three Eastern European countries remained within two times the range (Chart 2).

4. Some regard the phenomena as merely contingent. However, we cannot ignore that the Eastern European effort to transform themselves into market-orientated capitalist economies after democratisation, as well as the building of a stronger relationship with EU countries, have fostered the region's resilience to "contagion." Such evidence may serve as a strong reservation to the arguments that favour strengthened market intervention and re-regulation, which have gathered momentum since the Asian crisis in 1997.

5. Given that a commonly accepted theory of the cause, occurrence and process of "contagion" has not been established, it is not easy to conduct a theoretically solid analysis of the phenomenon[2]. However, the experiences by Eastern European countries could submit useful viewpoints in studying a global "contagion" process at the time when concern over the effects of a Brazilian crisis is increasing.

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[1] Although the assessment of the Brazilian crisis since the turn of the year warrants due account of future developments, at least the contagion effect of the crisis hitherto on the securities market looks limited (Among the three Eastern European countries Hungary appears to have been the most vulnerable due to its narrow exchange rate band. This is exacerbated by relatively low foreign exchange reserves, liquidation of foreign holdings of domestic bonds and closing of futures contracts by locals). While the yields of the Polish and Czech bonds increased by a mere 20-40bp, that of the Hungarian bonds increased by 140bp.

[2] The theoretical models of contagion vary from the one that focuses on the intensity of the trade and capital transactions relationships, the one that focuses on the differences among market participants in the interpretation of the same information and the following correction processes (so-called "information cascade") to the one that focuses on the role of financial institutions as a liquidity provider (for instance, a variation of the traditional bank-run model by Diamond-Dibvig). For further detail, see Eichengreen, et al (1997), "Contagious Currency Crises."

6. This report tries to extract from discussions with experts and analysts on Eastern European countries' ability to shelter from global "contagion." The report focuses on three major Eastern European countries in order to make analysis simpler. We also break down different market views on contagion into three different categories of 1) views stressing market sentiment; 2) difference in fundamentals; 3) the role of short-term capital movements.

II. The Role of Market Sentiment

7. The prevailing view among traders immediately after the Russian crisis was that "Eastern European countries could escape from attacks on their currencies as they happened to be outside the chain-reaction zone of global 'contagion'." Especially, the fact that the Czech Republic, which underwent a currency attack in the spring of 1997 due to delay of structural reforms, weathered the latest crisis despite relatively fragile fundamentals, is reinforcing the view that stresses market sentiment over economic fundamentals.

8. The background of the logic is an existing view that "attacks on currencies are triggered by changes in the market sentiment, and failure to defend a currency may develop into a self-realising collapse of the market with no bearing on fundamentals[3]."

9. By taking this viewpoint, two reasons have been pointed out as to why the markets in these three Eastern European countries did not suffer from such changes in sentiment.

10. Firstly, there was a suggestion that the Eastern European capital markets were fortunate enough to be relatively small and illiquid. "Big players" such as major hedge funds, which were hit by the Russian crisis have the tendency to take interest only in the markets that offer not only fat profit margins but also a size and liquidity sufficient enough to digest relatively big orders as they pledge to investors extremely large returns.

11. This view explains why the Russian crisis rapidly spilled over into Latin America. It is reported that investors who had been adversely affected in the Russian market resorted to liquidating their positions in the relatively large capitalised markets, such as Latin America, in order to meet further margin calls and cover their loss-cutting operations. The stock markets in these three Eastern European countries also saw stock prices fall temporarily. However, sellers were fundamentally a different sort of player. This fact favoured the East European markets, leaving them scarcely hurt by the panic, which ran through the world.

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[3] Since the fiscal condition of the Czech Republic was relatively benign immediately after independence, fiscal reform did not attract adequate attention from the country's policy makers. As a matter of formality, bankruptcy laws were enacted and national enterprises were privatised, but in reality, stocks of privatised companies were held among the government and its affiliates and the structural reform delayed. As a result, the efficiency and competitiveness of the private sector had not improved, which led to the non-performing loan problem, and the increase in external and fiscal deficits. Under such circumstances, in the spring of 1997, the Czech Koruna crisis took place. After this crisis, the Czech government has started fiscal reform and rationalisation of the private sector.

12. Secondly, some people emphasised the fact that the Eastern European countries belonged to the DM, and now the Euro, currency zone. To elaborate, the recent success in the management of monetary policy by the central banks of the major countries has made foreign exchange rates increasingly more volatile. The confidence of the markets towards monetary policy has tended to stabilise the volatility in the long-term interest rates. In turn, the volatility in the foreign exchange rates has increased because they have been increasingly used as an adjustment bulb (Chart 3)[4]. As a result, the volatility of peripheral currencies has also had to increase in tandem with their pegged currencies. The Asian currencies, which have intensified the tendency to synchronise with the yen during the Currency Crisis, suffered the most from this effect because the yen is the most volatile among major currencies and also because yen reserve assets are too inaccessible to hold as a means to mitigate such effect. Accordingly, the vulnerability of the Asian currencies (or the changeability of the market sentiment) to the currency attack has increased significantly. In contrast, the Eastern European currencies have enjoyed relatively low volatility of the dollar/DM exchange rates and the readily accessible DM (DM was chosen by the markets as the currency for flight-to-quality during the Russian crisis). Thanks to these factors, negative sentiment has been less likely to be generated in Eastern Europe during the Russian Crisis.

III. Difference in Fundamentals

13. Some analysts who stress the importance of economic fundamentals commonly referred to the successful macro-micro economic policies undertaken by Eastern European countries (Chart 4). Their views, though they are not necessarily contradictory to one another, can be grouped into several categories.

(1) shift of the anchor economy from Russia to Europe

14. The most commonly held view by market participants currently is that serious efforts made by the three Eastern European countries to establish stronger ties over political and economic fundamentals with the EU played an anchor role in the wake of the recent financial crises - It should be noted that this view does not rely on the passive conception of peripheral currencies belonging to a stable currency zone as mentioned above. After winning their independence these three countries have hastened to intensify the trade relationship with EU countries. As a result, about 60 per cent of their trade now relies on EU countries. Even if one admits the existence of 'suitcase trade' between these countries and Russia," the economic relationship with Russia is rapidly thinning out.

15. Especially in Eastern European countries, participation in the EU has become a major goal. Such circumstances tend to engender political support for economic and structural reform in order to make EU entry possible[5]. Many Eastern European

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[4] In theory, it is known that there is a trade-off among independent monetary policy, free capital flow and stable foreign exchange rates and that the government can only pursue two of the three targets at the same time. In this sense, under the current situation where the governments of major countries maintain free capital flow and enjoy independent monetary policy, it is natural to experience volatile foreign exchange rates.

[5] In 1994, Poland and Hungary applied for EU membership and substantive negotiation is in progress. By now there are ten East European countries applying for EU membership. To these countries, subsidies on

governments have, after independence, adopted "shock therapy" in accordance with IMF requirements and have succeeded in the promotion of economic reform despite the fact that such a policy may entail a cut in real income. This frictionless transition compares with the failures repeated by Latin American countries in the 1980's when the governments could not get the nations' support for economic reform required by the IMF.

16. In turn, the EU member countries have increased foreign direct investment in Eastern Europe after independence because the region is seen as an attractive production base for the EU in terms of the standard of education, the level of wages, social infrastructure and geographical conditions. Such foreign direct investment has promoted economic growth of the Eastern European countries whilst creating the synergy by interacting with the economic and structural reforms. It has also offset trade deficits generated in the process of rapid economic development (especially during the mid-1990's, foreign direct investment into the three Eastern European countries more than offset current account deficits), which enabled them to continue strong growth without resorting to the short-term foreign borrowing observed in Asia (Chart 5).

(2) the importance of economic and structural reforms

17. Those close to international financial organisations and monetary authorities tend to cite the importance of successful fiscal reform, restructuring and containment of inflation as reasons for these countries having overcome the latest crisis. For example, with respect to fiscal reform and restructuring, Poland and Hungary enacted strict bankruptcy laws and undertook audacious privatisation plans. As a result, they have succeeded in a sizeable reduction of their fiscal deficit and a strengthening of the competitiveness of the private sector. In Hungary, approximately 45,000 inefficient government enterprises were said to be closed down (thanks to which the privatisation programme has been almost completed). In Poland, 30% of the major enterprises are still state-owned but the government released a guideline last May aiming at completing privatisation by the year 2001. Foreign investors have shown a strong appetite toward such privatisation plans, which have played the role of catalyst for the influx of foreign direct investment.

18. With respect to inflation, the independence of the central bank in the three countries was legally assured under the aegis of the IMF and, in practice, the governments of the respective countries, aware of the importance of the Maastricht Treaty as a condition for EU membership, are committed to respect the independence. Technically, each country has succeeded in importing the discipline of the monetary policy in the US and

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agricultural products and free labour movement within the region provide a strong incentive to participate in the EU. The outline of the eligibility conditions for EU membership stipulated under the Copenhagen agreement of 1993 is the following:
(1) The candidate country has achieved stability of institutions guaranteeing democracy, the rule of law, human rights and respect for the protection of minorities.
(2) The existence of a functioning market economy, as well as the capacity to cope with competitive pressure and market forces within the union.
(3) The ability to take on the obligations of membership including adhering to aims of political, economic and monetary union.

Germany by adopting the crawling peg against the dollar and the DM(Euro) as their foreign exchange rate regime[6].

19. On top of these, efforts to develop financial and capital markets and improve market infrastructure were also noted. For example, the three countries established a well-organised stock exchange and Eurobond issuance soon after independence. These stock exchanges are said to be considering a settlement link with the Vienna Securities Exchange. In the early 1990's, many privatised companies experienced management difficulties and as a result, financial institutions accumulated a large sum of non-performing loans. Under these circumstances, the Polish government injected capital into the troubled banks in exchange for restructuring and the Hungarian government allowed foreign capital to acquire domestic banks in order to dispose of non-performing loans. The Hungarian approach was especially successful. It is estimated that approximately 65% of the domestic banks has become fully or partially foreign-owned. The existence of such foreign banks has provided both tangible and intangible market infrastructure such as IT, transaction techniques, research skills and the standard of disclosure. Moreover, it should also be noted that these banks are helping to increase the liquidity of the market by aggressively taking risks under the aegis of the strength of their parent companies. Foreign investors also feel confident of the consolidated supervision of the parent companies by respective home supervisors.

(3) the role of moral hazard among investors

20. Some economists argue that in the three Eastern European countries (especially Poland and Hungary) the principle of self-discipline has been respected among market participants and as a result excessive investments that overwhelmed Asia and Russia have been avoided. It is pointed out that in the cases of Asia and Russia, investors became morally hazardous and soft on risk assessment due to the following reasons:

21. 1) In the Asian countries, risk assessment is difficult because the bond markets are underdeveloped and the disclosure of the governments and financial institutions are insufficient. In addition, some view that the crony relationships between industry and government peculiar to Asia, as well as their fiscal surpluses until shortly before the crisis misled investors and rating agencies to believing that these governments were capable and implicitly promising to provide a "safety net."

22. 2) In Russia, many point out that the illusion among investors that the international community would not forsake the second largest nuclear country allowed excessive investment. Though the Russian financial and capital markets such as the government bond market were relatively developed, the monetary economy that is a prerequisite for market capitalism had not been well-developed; that is, the economy was based on barter trades. As a result, its taxation system which relies on a monetary economy did not function well and the government chronically suffered from the shortage of revenue. However, most foreign investors disregarded this problem on the ground that "Russia is too nuclear to fail."

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[6] It should be noted that the Czech Republic gradually diverted from the floating peg after the Koruna crisis of 1997 and has adopted the managed float regime. Incidentally, Poland has reshuffled its basket from 5 currencies to 2 currencies, namely the dollar and the Euro (which is the same as Hungary). Hungary is planning to peg the Forint entirely to the Euro in the year 2000.

23. Having relatively weaker powers to influence the markets, the governments of the three Eastern European countries tried hard to gain the confidence in investors by maintaining open dialogues with the markets. For instance, the Eastern European countries have generally been committed to improving statistics and disclosure. Some point out that despite the fact that the coverage and accuracy are not satisfactory, economic and financial statistics compiled by these governments are articulate in their definitions and therefore enable analyses that allow for such limitation. Moreover, the standard of disclosure in Eastern Europe is generally viewed as being much more advanced than Indonesia which had not disclosed the total amounts of external debts before the crisis.

24. In contrast, some expressed that though to a differing degree, the statistics of the emerging economies are still amid the process of improvement and therefore, it is not meaningful to focus on minor technical differences in considering the effects of contagion. In fact, the recent Brazilian case implies that an emerging economy under a relatively advanced disclosure regime can still be susceptible to contagion. Nevertheless, in terms of basic attitude towards disclosure, the governments of Eastern Europe are aware of the importance of the markets and have been trying to ensure timely disclosure and clear explanation. Such continuous effort may have materialised as a meaningful difference from other emerging economies, in terms of gaining confidence among foreign investors.

IV. The Role of Short-Term Capital Movements

25. Recently, market participants have started to pay more attention to the fact that countries under strict capital controls such as the Philippines, Taiwan and India, succeeded in repelling currency attacks during the Asian Crisis. These people are readier to support the view that precipitate liberalisation of short-term capital controls caused the financial crises. Such observers also argue that in the case of the Russian crisis, the liberalisation of short term government bonds to foreign investors in 1996 caused an excessive influx of hot money from abroad. They also point to the fact that in Hungary, where the overall foreign borrowing ratio is as high as in Thailand and Indonesia, foreign investors are not allowed to invest in short-term financial instruments (with maturity of less than one year) and argue that Hungary weathered currency attacks thanks to the limited reliance on short-term financial borrowing (Chart 5).

26. However, if the Eastern European countries are chosen as an example, it appears difficult to definitely conclude that the existence of short-term capital controls has contributed to repelling the contagion effects of the Russian Crisis. For example, in Poland, the infrastructure of the financial and capital markets is already very close to international standards and there is no practical short-term capital control that impedes free capital movements[7]. There, the continuation of resilient foreign direct investments

[7] It should be noted however that there is a “real demand principle” in foreign exchange transactions (which is the same as Hungary) and speculative and hedging transactions have to be done in the form of non-deliverable forward (NDF)

and a benign economic performance have made foreign borrowing unnecessary[8]. In the Czech Republic too, short-term capital controls have been generally liberalised since the Koruna crisis in 1997[9].

27. The anti-short-term borrowing camp has recently been gaining support from various sides including international organisations such as the IMF. Market participants are also increasingly readier to accept temporary controls on short-term capital flows as a necessary evil. Of course, there is no denying completely the possibility that short-term capital controls are called for if a country fails to defend the currency attack. However, an easy introduction of short-term capital controls will increase the cost of capital and risk, undermining long-term economic growth. Those against such controls argue that even if a country relies on long-term borrowing (e.g. long-term bonds and equities), the existence of deep and liquid short-term capital markets that provide smooth settlement means and flexible hedging instruments is a prerequisite for deep and liquid long-term capital markets.

V. Conclusion - some lessons to be learned from the East European experience

28. Except for the effects of short-term capital controls from which this paper abstains evaluation, all the factors mentioned above seem to have interacted with each other and played some roles to protect the markets of the three Eastern European countries from international contagion. It is especially interesting to note the importance of the role of the EU in both the view that stresses market sentiment and the view that stresses fundamentals. These observations may be summarised by saying that the three East European countries, as peripheral economies, imported the discipline of the economic policies from the EU, or a core economy, and thereby locked in their economies to the EU. This seems to have enhanced market confidence and led to successfully maintaining a favourable market sentiment during the Russian crisis. From this perspective, it can be generalised that disciplined economic policies and open financial and capital markets on the part of a core economy are the important prerequisite for peripheral economies to defend currency attacks. Open financial and capital markets are an indispensable channel to transfer economic policies from the core economy to the peripheral economies.

29. Of course, it may be too naive to conclude that every policy that the three Eastern European countries have adopted was a success. There may have been fortunate factors. It is needless to say that there are some downside risks in the future. First, in the Czech Republic, where the banking sector is suffering from a credit crunch and a survey shows that the inflation rate has turned into negative at the moment, if the market judges that the close relationship with the EU is just an illusion, the currently overvalued Koruna may become the target for another attack. Second, there is a concern over the adverse effect on the countries if Brazil should declare default on its foreign debts. Third, if the slowing of the EU economy is more significant than

[8] It should also be noted that the London and Paris Clubs granted Poland a sizeable reduction of the accumulated debts incurred during the Socialist regime with a view to supporting the democratisation process after independence.

[9] The Czech Republic enjoys a relatively low level of external debts, thanks to a relatively benign fiscal condition right after independence. However, since the country's domestic banking sector is currently fragile with the non-performing loan problem, the level of foreign borrowing is gradually creeping up.

expected, the sentiment towards the Eastern European countries may suddenly deteriorate and trigger a chain of contagion.

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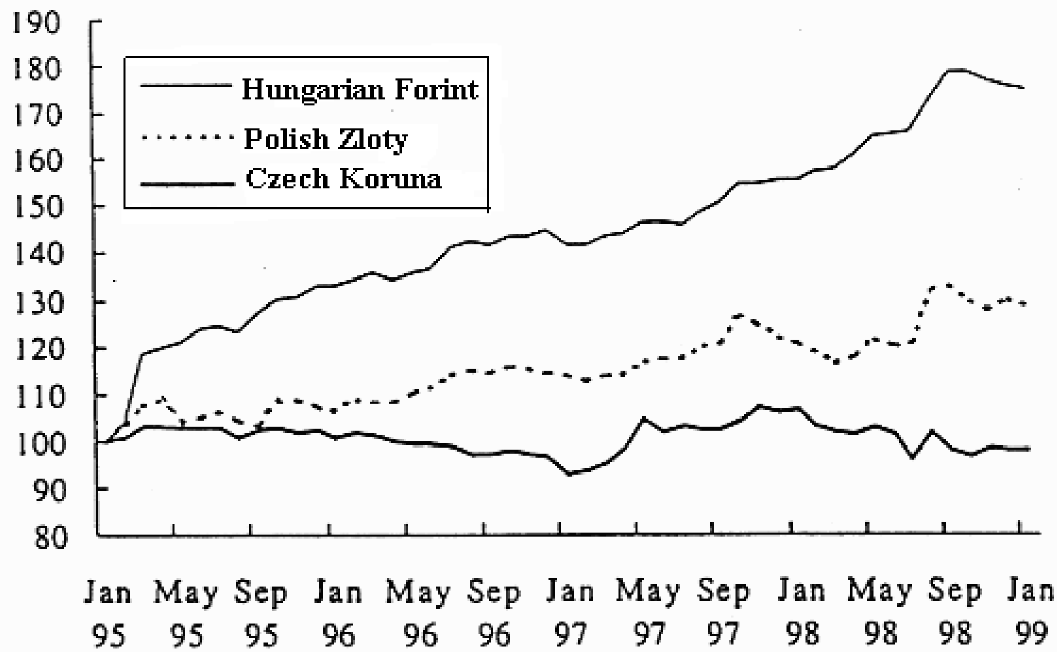
(Chart 1)

Exchange Rates against the Euro

Index. Jan 1995=100



Morgan Stanley

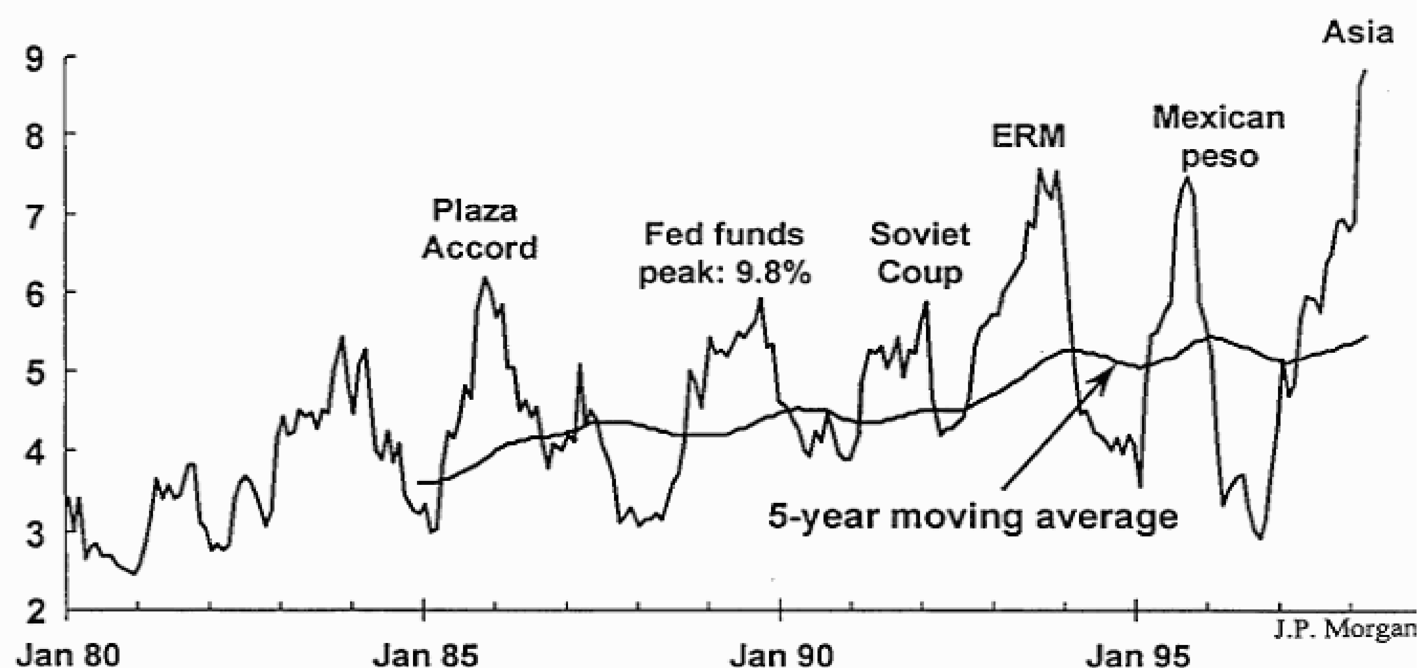
(Chart 2)

Sovereign Spreads

Goldman Sachs

(Chart 3)

The FX volatility cycle



(Chart 4)

Key Economic Indicators

	1991	1992	1993	1994	1995	1996	1997e	1998e
GDP at constant prices, %								
Czech Republic	-11.5	-3.3	0.6	3.2	6.4	3.9	1.0	-1.0
Hungary	-11.9	-3.1	-0.6	2.9	1.5	1.3	4.4	4.6
Poland	-7.0	2.6	3.8	5.2	7.0	6.0	6.8	4.8
Consumer prices, %								
Czech Republic	56.6	11.1	20.8	10	9.1	8.8	8.5	11.0
Hungary	35	23	22.5	18.8	28.2	23.6	18.3	15.0
Poland	70.3	43.0	35.3	32.2	27.8	19.9	14.9	11.8
General government balance, % of GDP								
Czech Republic	-1.9	-3.1	0.5	-1.2	-1.8	-1.2	-2.1	-2.4
Hungary	-2.9	-6.8	-5.5	-8.4	-6.7	-3.1	-4.9	-4.9
Poland	-6.7	-6.7	-3.1	-3.1	-2.8	-3.3	-3.1	-3.1
Unemployment, % of labour force								
Czech Republic	4.1	2.6	3.5	3.2	2.9	3.5	5.2	na
Hungary	7.4	12.3	12.1	10.4	10.4	10.5	10.4	na
Poland	11.8	13.6	16.4	16	14.9	13.2	10.5	na

e = estimate

National Sources, EBRD (Transition Report)

(Chart 5)

External Balances

	1993	1994	1995	1996	1997e	1998e
FDI net/current account deficit, in %						
Czech Republic	-	-	179	33	41	59
Hungary	66	28	180	118	210	94
Poland	100	-	-	215	70	61
Indonesia	36	30	25	31	31	-
Malaysia No FDI figures	NA	NA	NA	NA	NA	NA
South Korea	-	-44	-21	-10	-23	-
Thailand	19	12	8	11	100	-
Gross reserves excluding gold/current account deficit, in %						
Czech Republic	-	-	1000	288	306	NA
Hungary	191	172	480	571	840	NA
Poland	683	-	-	1369	474	NA
Indonesia	704	491	240	286	336	-
Malaysia	877	454	274	551	433	-
South Korea	-	656	385	-	257	-
Thailand	383	362	273	262	873	-
External debt/GDP, in %						
Czech Republic	25	27	33	37	41	NA
Hungary	64	69	71	61	53	NA
Poland	55	46	37	30	28	NA
Indonesia	58	60	60	58	67	147
Malaysia	59	48	41	39	46	61
South Korea	22	27	29	33	36	52
Thailand	43	47	53	55	62	79

e = estimate   - = current account surplus

IIF Database, EBRD (Transition Report)