Comments

Anwar Nasution: I appreciate the opportunity to discuss this paper, which focuses on the impacts of the U.S. sub-prime mortgage crisis on the European financial system. The purpose of this comment is to supplement the paper by discussing the current crisis in Eastern Europe, which is not covered by the paper. The latter crisis bears similarities to the banking crisis in the four Nordic countries in the 1980s and the Asian crisis of 1997–98, and is different from the present sub-prime crisis, which began in the U.S. shadow banking system.

The banking crisis in the Nordic countries in the 1980s and in Asia in the 1990s occurred because of the lax implementation of prudential rules and regulations on the banking industry, particularly regulations on Net Open Position (NOP) and Legal Lending Limits (LLL). The lax implementation of NOP, combined with fixed exchange rate policies and high domestic interest rates, encouraged banks and the corporate sector to borrow from overseas and invest in the non-traded sector of the economy. Violations of LLL regulations were more prevalent in Asia as either a small number of business conglomerates or the state mainly owned banks and the corporate sector. Under this business structure, private or state owners used their banks to mobilize funds for financing their subsidiaries.

After the fall of the Berlin Wall in the 1980s, the former socialist countries in Eastern Europe adopted the market-based economic system, opened up their economies, and privatized state-owned enterprises (SOEs). Through acquisitions, investors, and financial institutions from the Nordic countries, Benelux, Austria, Switzerland, France, and other Western Europe countries took control of banks and corporations in Eastern Europe. Through their subsid-

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iaries, many Western European banks provided huge amounts of loans to the corporate sector and households in the former socialist countries in Eastern Europe, around the Baltic Sea, and in Central Europe. In other words, Western banks brought in capital to the transition economies of Eastern Europe and lent freely. The massive capital inflows have raised the current short-term external debt to GDP ratio to over 120 percent in the cases of Estonia, Latvia, and Croatia. Large portions of the loans are denominated in foreign currencies, such as the Swiss franc and Japanese yen, with low interest rates. As those countries have adopted the euro, both lenders and borrowers perceived there would be no currency risk. The funds are being used to finance real estate developments and other long-term projects. Like the Nordic and Asian countries earlier, such lending has caused problems in Eastern Europe, namely, twin maturity and currency mismatches. These, in turn, have caused twin currency and banking crises. The crises affecting subsidiary banks in Eastern Europe have also caused financial problems for their head offices in Western Europe.

In fact, many of the Eastern European countries (such as Estonia, Latvia, Lithuania, and Bulgaria) are ill-prepared for stringent EU membership rules with a single currency and stability pact, which limits the annual budget deficit to no more than 3 percent of GDP and the maximum ratio of public debt to GDP to 60 percent.

Unlike the Nordic and Asian countries in previous decades, the transition economies of Eastern Europe cannot tap their economic potential by devaluing their currencies or by introducing fiscal stimulus. Export promotion has become more difficult as the global economy is in recession. Unlike in the 1980s and 1990s, it is more difficult to get new credit lines from either official sources or capital markets because of the global financial crisis. The same global financial crisis makes it more difficult to sell non-performing loans (NPLs), banks, and companies.

Currently, Eastern European countries cannot expect financial assistance from the EU to stabilize their financial systems and stimulate their economies. At present, the Eurozone, with one currency for 15 sovereign member countries, lacks (i) a single supervisory authority; (ii) integrated supervision of euro area banks; (iii) a lender of last resort facility; and (iv) a plan to deal with the failure of a systemically important cross-border European bank, such as Fortis Bank in Benelux, or Dexia. Only recently has the EU begun to discuss the possibility of promoting closer cooperation among the financial supervisory agencies of individual member countries and of establishing an EU-wide financial supervisory agency.

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There is also no euro-wide fiscal or stimulus policy. Within the limitations of the stability pact, each member country is free to adopt its own fiscal program. Each member country supervises the financial institutions within its own jurisdiction and acts individually to resolve the liquidity and solvency problems of its own financial system.

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