Central **Europe Economic Letter**

October 2002 economic trends • comparative analyses Krzysztof Bledowski elakrzys@pol.pl

In this issue

Is disintermediation (moving funds outside the banking system) a problem? A simple exercise………....pg 1

Why is public equity in retreat? Some arguments for why it may not matter…………………….….…..…pg 2

Poland has been the sick man of CEE lately. Is there light at the end of the tunnel?………………….pg 3

Is Disintermediation a Threat to Monetary Policy?

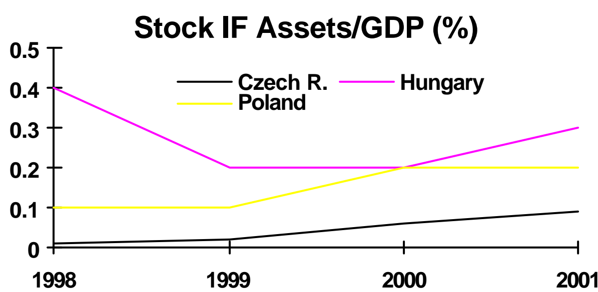
As the CEE economies develop and diversify their capital base, funding sources become key ingredients of faster growth. Generally, capital is looked at from the viewpoint of quantity and/or quality. In this brief note, I look at neither angle. Instead, having observed a slight shift of who originates the provision of capital, I ask these questions: (i) is disintermediation a fact?; (ii) whether yes or no, how much does it matter?

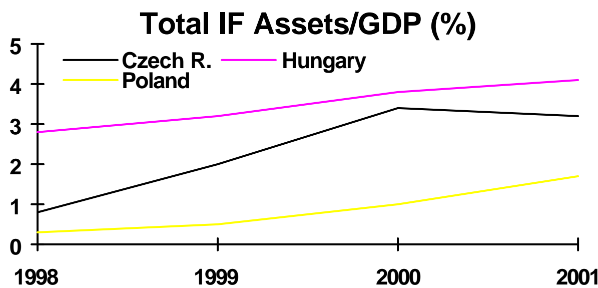
Over the past five years we have witnessed a steady transfer of bank equity to (mostly) foreign owners, an expansion of banking services, and an overall improvement in banks' balance sheets. As a result, one would expect a sharp runup of deposit taking and loan creation. Indeed, in the three economies examined here (Czech R., Hungary, Poland), banking assets grew. But the ratio of M2 (which includes cash, demand, and term deposits) to GDP inched up insignificantly when set in relation to the quality changes mentioned above (graph 3). If the money didn't flow to the banks, where did it go?

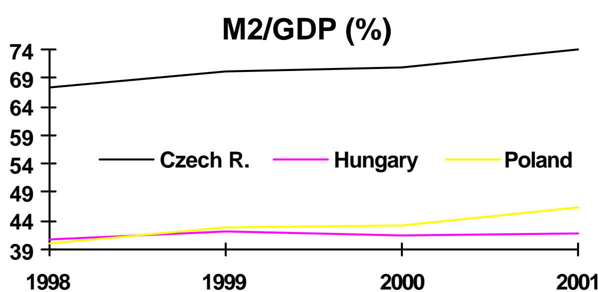
The usual suspect are investment funds (IF) because they offer the closest substitutes to banking products. Investors in CEE are not sufficiently risk-loving to have fled to portfolio equity (capitalization figures match this supposition), and neither did they pile into public bonds, real estate or foreign assets. So, how much money did veer off to the funds? Some, but not much (see graphs 1 & 2). Over the past five years (the initial five years of transition had produced virtually no fund vehicles), in no country did total IF assets relative to GDP grow by more than two percentage points (see graph 2). And assets relative to M2 (call it a "loss ratio") are low and increasing at a slow pace (see graph 4). This is certainly no disintermediation to speak of as a negative phenomenon – in the sense of constraining the effectiveness of monetary policy.

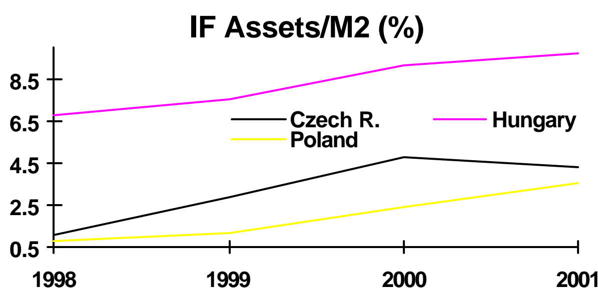
So, shall we rest the case? No, because in a perverse way, this "marginal" disintermediation has a negative twist to it. As graph 1 illustrates, virtually all the money went into fixed income, cash, and mixed funds. And since in no country is the corporate bond market really developed, the switch to IFs benefited the state, not the private sector.

There are two implications. First, IFs are no crucibles for private sector development, at least not yet. Second, the CEE economies generate little fresh domestic savings despite fast income growth. If propensity to save remains low, policy makers will be compelled to work harder to stoke it up. Disintermediation is not a problem but lack of funds to intermediate might be (see also next note).









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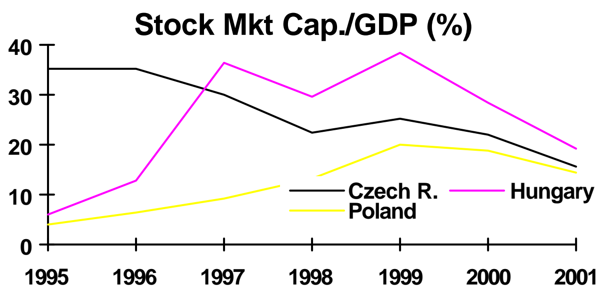
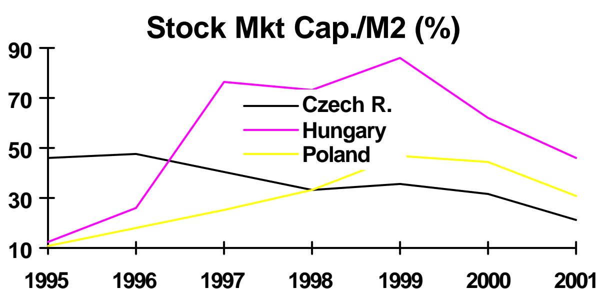
Why Are Public Capital Markets Failing to Deliver?

The brief on page 1 showed that monetary policy has nothing to fear from seepage of savings away from banks and into investment funds. The latter's assets in relation to GDP topped 4% in Hungary but are less than half that in Poland. If any country does stand out, however, it is in fact Hungary: its monetization ratio has been stagnant for three years running while the IFs' size reached 10% of M2. Yet the economy continued to expand steadily, supported by transparent if somewhat loose monetary policy. If we agree that banking disintermediation is not a problem for allocation of capital, could it be that we are witnessing stagnant capital market *intermediation?* I believe this is indeed the case.

Public stock markets exploded in the mid-1990s, reaching as much as 40% of GDP in the Czech Republic and Hungary (graph 1). Riding the wave of privatization, new offerings were snapped up by domestic and foreign investors alike. It appeared that popular holdings of equity capital would open up new channels of financing. "Peoples capitalism" was a great new hope for the region, and a possible example for the rest of the world.



Alas, half a decade later traded equity represents no more than 20% of GDP and less than 50% of M2 in all three countries (graph 2). The number of listings is down as is the average daily trading volume. On both the supply and demand side interest in new issues is waning. Why is this the case? And does it matter?

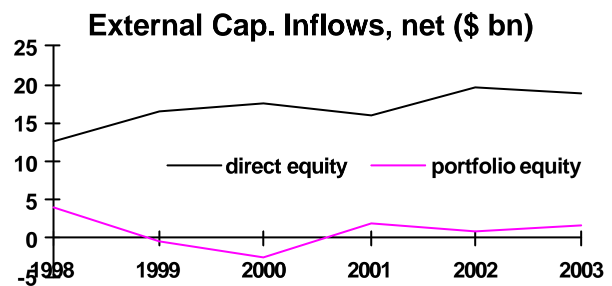


I see four reasons for the underdevelopment of public capital markets (which are tantamount to the equity side since hardly any corporate credits trade).

(i) A **culture of non-transparent management** at closely-held companies which discourages outside investors. This is equivalent to stakeholders having unusual power relative to shareholders.

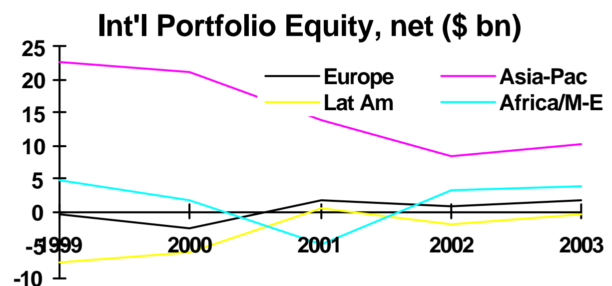
(ii) **High listing costs relative to issue size**. Coupled with ongoing public disclosure requirements, the benefits of open capital often outweigh the costs of procuring it, particularly for small companies.

(iii) A **vibrant market for domestic and cross-border direct acquisitions**. A worldwide preference for direct equity over portfolio investments has dried up international inflows to CEE (graph 3 – note IIF data include Russia, Turkey and some smaller CEE economies).



Source: Institute of International Finance

(iv) **The learning process**. It could be that there are "natural" limits to how much capital can be subscribed and absorbed per unit of income in an emerging economy with often poor institutions to serve it.



Source: Institute of International Finance

When all is said and done, does the submerging state of public markets matter? The logical answer is that it does not, provided other ways of allocating capital are available. The cost of capital is independent of its source (equity, debt, retained earnings), so why should public nature of it make a difference to a corporation?

Both local currency and foreign exchange credits are available as banking services continue to expand. In all markets larger corporates can tap the commercial paper segment as well as international markets for longer notes. The sovereigns still boast commanding heights over longer public bond issues, but the Czechs have shown that this near-monopoly need not last.

The region's economies have risen from the debacle of communism in the early 1990s with no banks and capital markets to speak of. Yet for a decade now they have managed to grow handsomely with only a marginal benefit of public capital markets. So long as they continue to save sufficiently, their development seems assured.

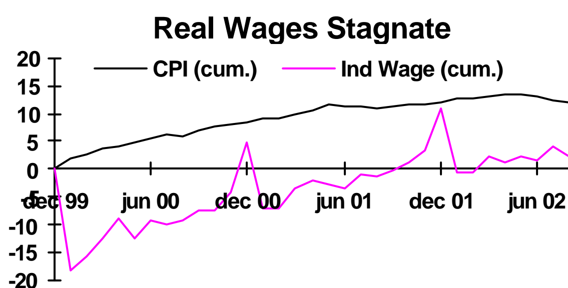
Poland: Is There Light at the End of the Tunnel?

The economic upturn, which many businesses and economists had hoped should have arrived by now, has not materialized. Worse, with every passing month there is scant evidence that the economy is anywhere near the trough. The uncertainty is killing investment plans, making politicians nervous, and instilling anxiety into consumer behavior. The resignation of Marek Belka as finance minister only added to the feeling of malaise. Suddenly, confidence in the country's economic leadership has been shaken. One can even hear investors start wondering whether Poland is the next crisis in waiting.

Is there light at the end of the tunnel? And if so, how strong is it? Let's answer these questions by looking at three elements: (i) the state of the economy today; (ii) the policy options available to government; and (iii) the drivers of future growth. The picture that emerges is by no means clear and straightforward. One can sum it up in the following adage: the sentiment is worse than the numbers; the numbers are worse than previous forecasts; but past forecasts probably understated the depth of this near-recession.

How do things shape up today?

How bad has the slowdown been so far? In three terms: unexpectedly fast, deep, and far-reaching. The economy has been winding down for almost two years now but we are not at the bottom yet. Domestic demand slid from 5% growth in early 2000 to a slight decline today.

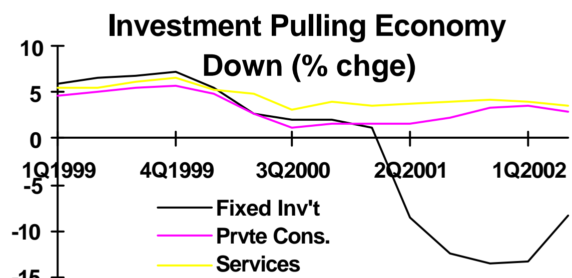


But during this period employment losses in the business sector amounted to 8%, capital formation retrenched 50%, and industrial productivity growth fell from 13% to 4%. [Worse, nominal industrial wages barely moved, pushing their earners' purchasing power down sharply]. To no one's surprise, saving propensity dipped as a countervailing trend. These drastic income losses explain consumers' unease and politicians' nervousness. Although by no means unique in the region, a correction in the standard of living of this scale will negatively affect consumer sentiment for perhaps two more years.

The flip side of this unexpected real income plateau has been an explosion of non-performing loans. From 13% of the total in early 2000 they jumped to 20% today. By banking standards, this is a massive turnaround and a very high number. All the while the contraction was seeping in, the monetary authority scored some spectacular successes - facts that are often conspicuously overlooked. Consumer inflation was crushed to under 2%, money supply growth stabilized after years of overshooting targets, and the deficit on the current side of external payments was halved to under 4% of GDP. Under these conditions, the NBP faces today perhaps the most propitious setting for applying monetary policy effectively (through interest rates, banks' reserve requirements, liquidity management etc.). What inhibits its application to the fullest, however, is the growing imbalance in public finances (a separate issue is the effectiveness of policy in the face of a low share of credit in GDP).

What will drive growth?

The figures document an economic picture that is very uneven. First, despite income losses, relatively robust consumption helped to avert a recession (at least until now), but the collapse of fixed investment augurs ill for a quick turnaround in productivity and growth. With consumption almost certainly set to slow further, this means that the external sector is the most likely – and only – driver of short-term growth now.



Second, while inflation expectations have been adjusted downward, even lower interest rates will do little to revive demand in the short term. As sentiments are still heading down, businesses and consumers will simply not step forward to finance spending with debt. As it is, fewer would qualify given their current income predicament.

Third, inflation has come down faster than expected. To the extent that contracts (sales, wages, leases, etc.) take forecasts of future price growth as benchmarks, lower future income and (probable) higher inflation will suppress real spending power even further. This negative real-income effect could last another year or so given slowly adapting expectations.

Fourth, much will depend on economic growth abroad. Foreign income explains better Polish exports performance than does the exchange rate. In the event of a faster turnaround of European economic prospects, the outlook for Poland looks brighter. The accounting ⇒

scandals would probably do less damage to economic growth abroad than a war with Iraq.

What can the government do?

Short-terms remedies are few and far between. Any tax stimulus to consumer spending will be constrained by feeble fiscal revenues and a budget deficit which doubled in the past year relative to GDP. Even if the government did cut income tax rates, it would be compelled to make up for the loss by raising consumption taxes -- a move in the right direction but which does little to improve the budget situation. An autonomous injection of government spending -- on infrastructure investment projects, for example -- is the right economic prescription but probably would come too late in the cycle to have meaningful impact on income creation.

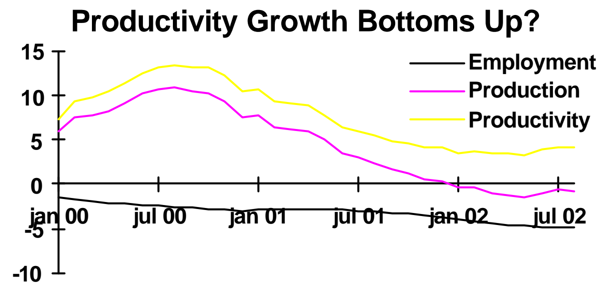
One of the few areas where the combined forces of government and central bank could deliver, albeit modestly, is the external sector. In order to divert consumption from imported to domestic goods, the government could legislate additional import duties and taxes. Unpopular as it would be internationally, the measure might find political support at home. But it is not certain that protectionism can effectively benefit domestic producers, and it certainly hurts the economy in the long term.

A permanently lower zloty -- another measure likely to undergo scrutiny -- would cut export prices at the cost of higher domestic inflation. Notwithstanding the value the central bank puts on hard-won disinflation, a cheaper zloty invites the practical question of how to bring it about in a regime of (almost) free float. Still, a cheaper zloty is one channel likely to give a short-term boost to domestic production and income.

The one thing the government can deliver is consistency in policy making. Investors have been spooked in recent past by privatization delays, sudden changes in execution of laws, or divergent approaches within government to policy making (e.g., the energy sector, labor code reform, fiscal reform). Restoring investor confidence should be top priority. In and of itself, efficient policy formulation will not turn this cycle around, but it will lay foundations for sustainable growth during the next expansion.

What does the future hold?

Even if the economy does not slide into technical recession (negative GDP growth in a quarter), it is very likely that feeble demand will persist throughout the second half of this year and rise only modestly in 2003. Domestic demand might expand as much as 2% next year, propped up by private consumption. Still, the final GDP growth number is slated to be around 2.3%-2.5%, substantially below government projections.



The consumer inflation rate has probably bottomed out or is about to in the next two months. There are indications that capacity is being mobilized and inventory demand is up. At the same time, labor costs continue to be soft. The one variable, whose impact on inflation is significant but whose trend is hard to predict in the next several months is the value of the zloty. A zloty permanently cheaper some 10% relative to the two key currencies might add 0.5% to inflation within 12-15 months. The impact of more expensive fuels is less clear, although an all-out war in the Middle East with oil prices doubling or trebling will add at least a few tenths of a percentage point to price indices in a matter of a few months.

Growth of industrial wages in nominal terms has stalled this year (graph 1), while salaries in the services sector rose. The decline of take-home industrial paychecks should slow somewhat next year, buoyed by adaptive expectations. Service workers, by contrast, will see lower overall income gains on the back of this sector's induced deceleration. All in all, pay performance will be very muted throughout 2003 and possibly in 2004 as well.

The Polish contraction might not be as deep as the Czech (1998-1999) or Hungarian (1995-1997) ones. In fact, it needn't be a recession at all. However, the downturn will be longer and at least as hard on living standards. That's because, unlike the two other economies, Poland experienced a long and uninterrupted expansion, fueled by double-digit annual investment in plant and equipment, lofty wage gains (often well above productivity), and bloated government throughout. It will take time now to work off these excesses. And given the government's unwillingness to retrench fiscally, the state has few options to fight this near-recession.

So, is there light at the end of the tunnel? Of course there is! It is not shining dazzlingly at the moment, but it gets brighter as you move along.