

THE EXECUTIVE BOARD

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CONFIDENTIAL

VULNERABILITIES IN THE CENTRAL AND EASTERN EUROPEAN MEMBER STATES

On 20 October 2008 the Governing Council adopted a policy position with regard to the Eurosystem's
provision of liquidity assistance to non-euro area EU countries. Given the increasing requests for such
assistance, there is a need to assess to which extent Central and Eastern European EU Member States
(hereafter CEE countries) are vulnerable to a potential dry-out of capital inflows.
A potential "sudden
stop" in capital flows would have a substantial impact on the CEE economies, given their dependence on
external financing and, in some cases, large external indebtedness. In some countries, risks also stem from
an already ongoing and strong macroeconomic and asset price correction that is starting to put pressure on
their banking systems. The vulnerability of the countries depends in many cases on the extent to which
foreign parent bank funding will help to ensure continued access to liquidity in case of a "sudden stop" in
other capital inflows. As a share of GDP, funding needs are particularly high in Latvia. Vulnerabilities not
only stem from large current account deficits, but also from high degrees of external indebtedness
). Moreover, countries with large shares of
debt denominated in foreign currency, particularly the
relatively vulnerable to a "sudden stop. In case of an actual "sudden stop", the external financing need
will have to be met by some combination of domestic adjustment, private external financing and official
support.
Support.
It concludes that through the strategy of pegging and the de facto euroisation the Baltics
have created a very difficult situation in which no ideal policy option exists. At this stage, the preferred
option seems to be to maintain the current monetary policy framework for now. However, the current
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system can only be successfully pursued if it is further supported with concrete, credible and very
ambitious policy commitments that speed up the necessary domestic adjustment. The ECB's policy line
has always been that currency board or unilateral pegs by third countries are not backed in any way by
policy commitments from the ECB.

The Governing Council is invited to exchange views on these notes.