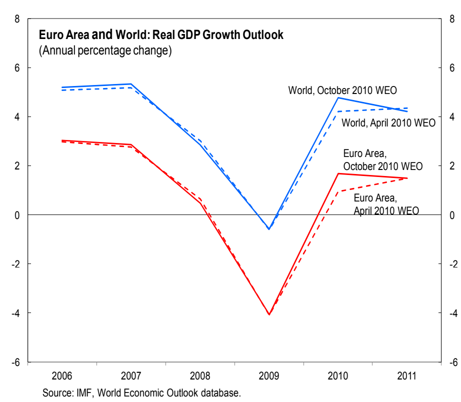
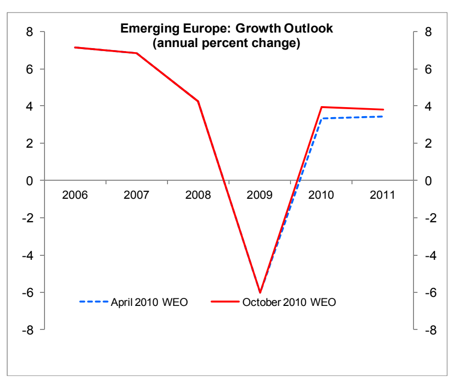
Emerging Europe and the Global Crisis: Lessons and Policy Issues

Roadmap

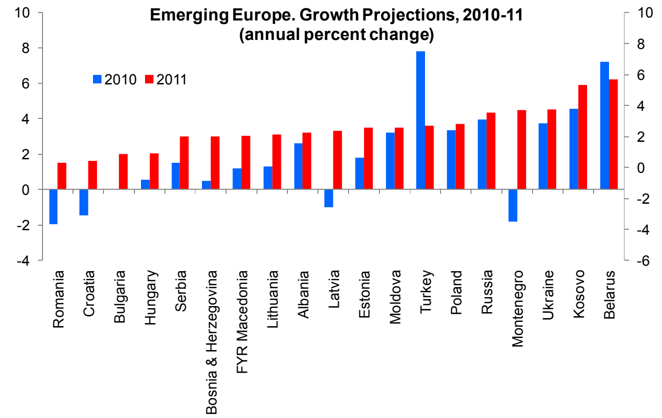
- Outlook
- Lessons from the Crisis
- Policy Issues

Against backdrop of a global and regional recovery, Emerging Europe is expected to expand by 3.9 percent in 2010, after a 6 percent contraction in 2009





Near-term outlook is benign: all countries are expected to grow in 2011.



Sources: IMF *World Economic Outlook*, October 2010; and IMF staff calculations

Growth has been mostly led by exports in 2010, while domestic demand will play larger role next year.

Emerging Europe: Real Growth of GDP, Domestic Demand, and Exports (percent)

	GDP			Domestic Demand			Exports		
	2009	2010	2011	2009	2010	2011	2009	2010	2011
Emerging Europe	-6.0	3.9	3.8	-11.0	4.0	4.9	-7.4	8.5	5.4
Russia	-7.9	4.0	4.3	-14.1	4.6	6.7	-4.7	9.8	4.6
Ukraine	-15.1	3.7	4.5	-23.0	4.0	5.3	-25.6	7.0	4.9
Romania	-7.1	-1.9	1.5	-12.6	-2.7	1.5	-5.5	17.3	7.5
Moldova	**-6.5**	**3.2**	**3.5**	**-17.1**	**4.9**	**3.6**	**-7.8**	**6.4**	**9.6**
Memorandum									
New EU Member States	-3.4	1.8	2.9	-7.0	0.2	2.7	-9.4	10.0	6.6
EU - 27	-4.1	2.0	2.2	-3.7	0.8	2.2	-10.8	11.4	6.2
Euro area	-4.1	1.7	1.5	-3.4	1.0	0.9	-13.1	10.5	5.6

Source: IMF, World Economic Outlook Database.

Risks to growth in Emerging Europe

- Revival of sovereign stress in advanced Europe could lower exports and capital flows
- Market financing costs could rise, and financial sectors could come under pressure
- On the other hand, strong growth in Germany could boost growth further

Questions two years after the collapse of Lehman Brothers…

1. Why was the slump in emerging Europe so deep?

2. Why did the banking and currency crises that many predicted not happen?

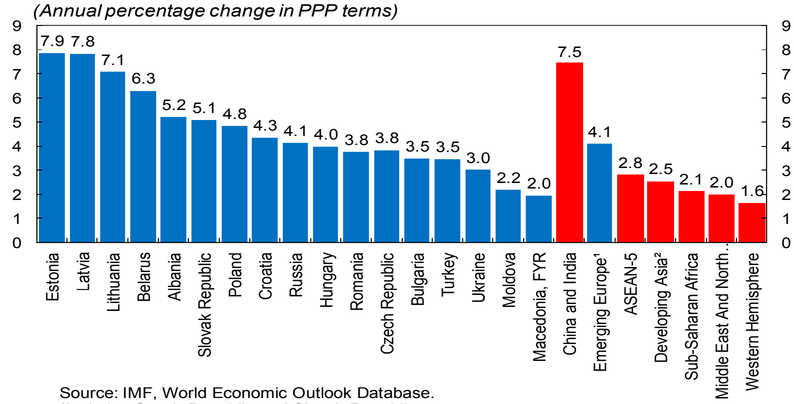
3. Lessons from a crisis – how to avoid a repeat.

Why was the slump in emerging Europe so deep?

- The seeds for the crisis were planted during the five years before the crisis
  - Buoyant growth in domestic demand led by credit booms
  - Overheating of the economy
  - Build-up of large imbalances and vulnerabilities

Emerging Europe grew very rapidly before the crisis…

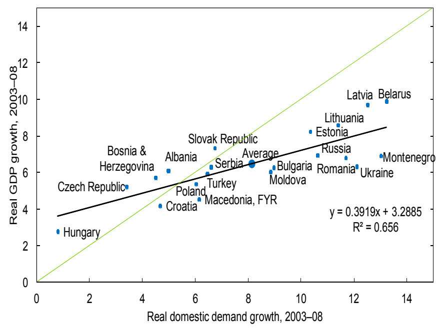
Figure 38. Emerging Europe and Selected Regions: Real Per Capita GDP Growth, 1995–2007
(Annual percentage change in PPP terms)



Source: IMF, World Economic Outlook Database.
[1]Includes Czech Republic and Slovak Republic.
[2]Excludes China and India.

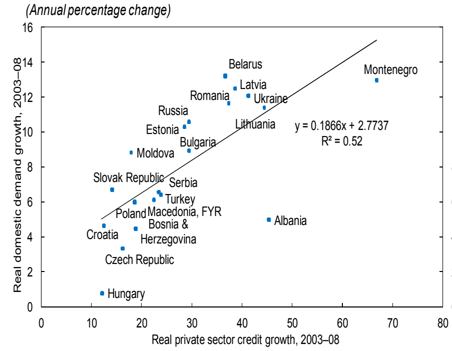
…as credit booms fueled a domestic demand boom.

Figure 39. Emerging Europe: Domestic Demand Growth and GDP Growth, 2003–08[1]
(Annual percentage change)



Sources: IMF, *International Financial Statistics* and World Economic Outlook Database.
[1]As the boom in the Baltic states ended in 2007, data for the Baltics refer to 2002–07.

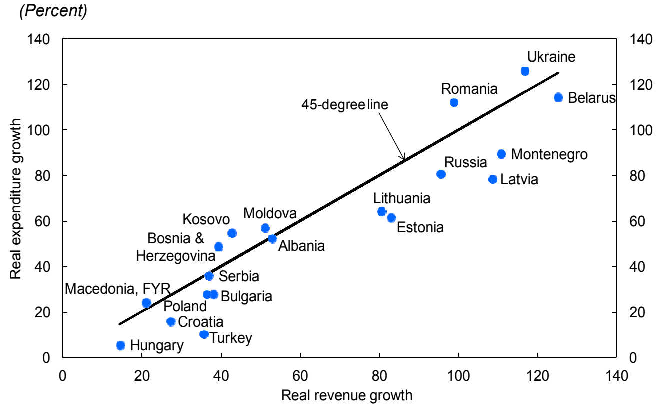
Figure 40. Emerging Europe: Domestic Demand and Private Sector Credit Growth, 2003–08[1]
(Annual percentage change)



Sources: IMF, *International Financial Statistics* and World Economic Outlook Database.
[1]As the boom in the Baltic states ended in 2007, data for the Baltics refer to 2002–07.

Fiscal revenues grew rapidly, but were mostly spent, creating a growing vulnerability.

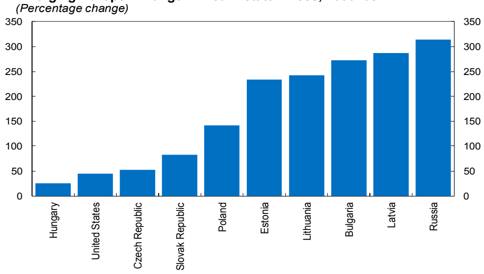
Emerging Europe: Precrisis Real Expenditure and Revenue Growth, 2003–08[1]
(Percent)



Source: IMF, World Economic Outlook database.
[1]As the boom in the Baltic states ended in 2007, data for the Baltics refer to 2002–07.

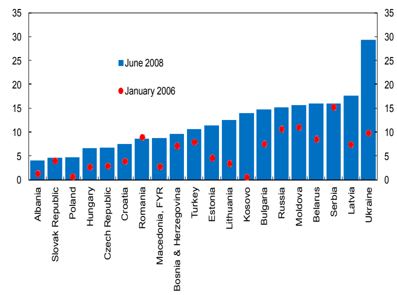
Widening imbalances were evident in surging asset prices and inflation

Emerging Europe: Change in Real Estate Prices, 2003–08[1]
(Percentage change)



Sources: Haver Analytics; and country statistical offices.
[1]As the boom in the Baltic states ended in 2007, data for the Baltics refer to 2002–07.

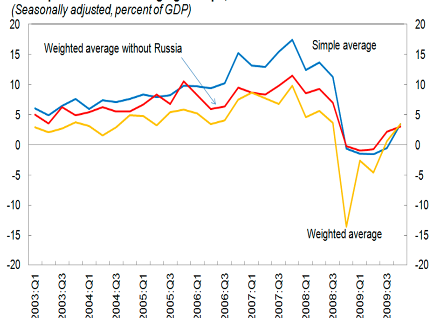
Emerging Europe: Consumer Price Inflation, 2006 and 2008
(Annual percentage change)



Source: Haver Analytics.

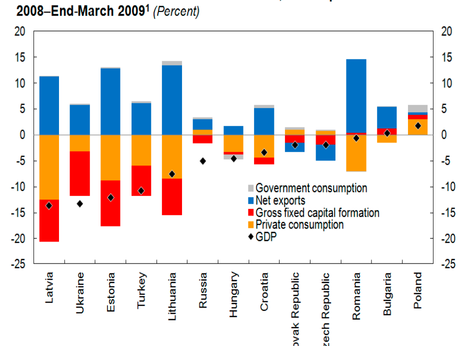
Sudden stop of capital inflows (and, in case of Moldova, remittances) and the collapse of global trade flows led to sharp adjustments

Net Capital Flows to Emerging Europe, 2003–09[1]
(Seasonally adjusted, percent of GDP)



Source: IMF, *International Financial Statistics*.
[1]Net capital flows are measured as the financial account balance, excluding reserve assets and IMF and EU balance of payment support, plus errors and omissions. Quarterly data are seasonally adjusted.

Contributions to Year over Year GDP Growth, End-September 2008–End-March 2009[1] *(Percent)*



Sources: Eurostat; and Haver Analytics.
[1]Contributions from inventories and statistical discrepancy not shown.

Why was a meltdown avoided?

- Decisive domestic policy
- Large-scale international financial support (IMF, EC, World Bank, EBRD, EIB etc.)
- Western European banks' presence – foreign banks remained in the region during the crisis
- Countercyclical policy in Western Europe – policy rate cuts, liquidity provisions from the ECB, accommodating fiscal policy
- Self-correction of external imbalances (lower inflows were offset by lower domestic demand and current account deficits)

Financing Packages for Emerging European Countries Under IMF-Supported Programs[1]
(As of August 2010, billions of U.S. dollars)

	IMF	EU	WB	Other	Total
Kosovo	0.1	0.1	0.1	0.0	0.3
Moldova	0.6	0.3	0.3	0.1	1.3
Bosnia and Herzegovina	1.6	0.1	0.2	0.1	2.0
Serbia, Republic of	4.0	0.2	0.4	0.0	4.6
Belarus	3.5	0.3	0.2	1.0	5.0
Latvia	2.4	4.4	0.6	3.3	10.6
Hungary	15.7	8.4	1.3	0.0	25.4
Romania	17.1	6.6	1.3	1.3	26.3
Ukraine[2]	25.7	1.3	3.4	2.1	32.5
TOTAL	70.7	21.7	7.7	7.8	107.9

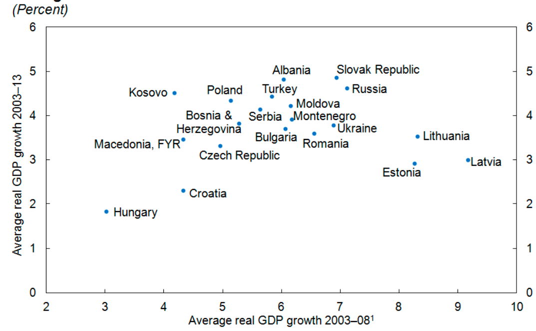
Source: IMF staff calculations.
[1]Figures indicate programmed amount, unless indicated.
[2]For Ukraine, IMF column includes the sum of two Stand-By Arrangement (SBA) programs (i.e., the amount actually disbursed under the November 2008 SBA plus the amount committed under the July 2010 SBA).

Lessons from the crisis—how to avoid a repeat

Lesson #1. Credit booms can be costly

Seen over a longer time period, countries with credit booms have not only seen higher *volatility*; in many cases they have also seen lower *average* growth.

Average Real GDP Growth
(Percent)



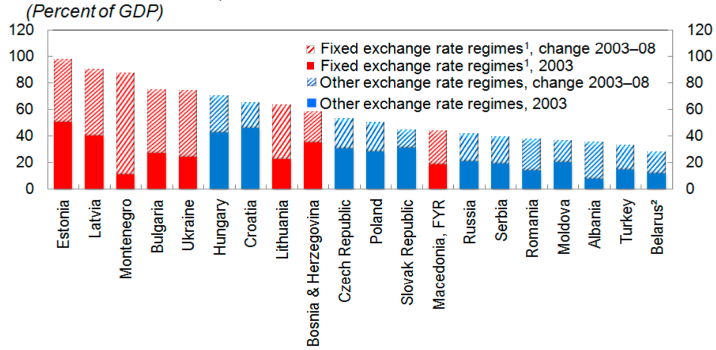
Sources: IMF, World Economic Outlook Database; and IMF staff calculations.
[1]As the boom in the Baltic states ended in 2007, data for the Baltics refer to 2002–07.

Lesson #2: Slowing credit growth through prudential measures is challenging

- Most host country measures can be easily circumvented, especially in banking systems dominated by foreign affiliates
- Cross-border supervisory coordination key
- That is not to say prudential measures don't work: stronger discouragement of foreign-currency loans would have cooled credit growth and prevented build-up of balance sheet risks

Lesson #3: Credit booms especially hard to stop under fixed exchange rate regimes

Private Sector Credit, 2003 and 2008
(Percent of GDP)



Sources: IMF, *International Financial Statistics* and *AREAER*; and IMF staff calcualtions.

[1]Fixed exchange rate countries are classified in AREAER as exchange arrangements with no separate legal tender, currency board arrangements, or other conventional fixed peg arrangements.

[2]During 2003–08, Belarus was reclassified from an exchange rate within a crawling band to a conventional fixed peg arrangement.

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Lesson #4: More active fiscal policy needed

- Boom flattered public finances
- Important to accumulate larger surpluses in boom years to lean against overheating and build buffers for countercyclical policies in the downturn

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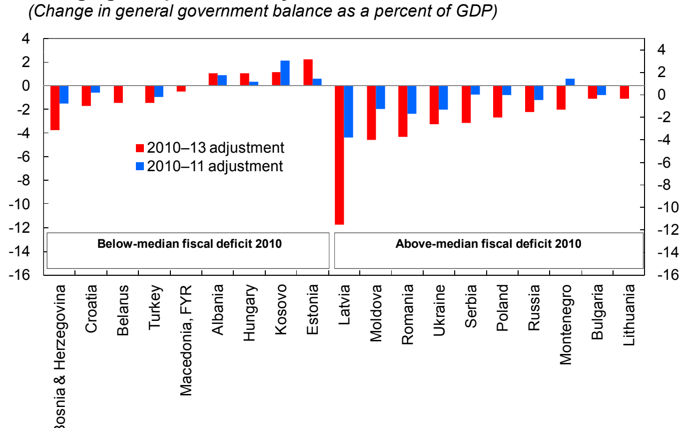
Policies to sustain the recovery and minimize risks

- Fiscal consolidation
- Repairing bank balance sheets
- Medium term: new growth drivers

Most countries are adjusting at a pace in line with vulnerability.

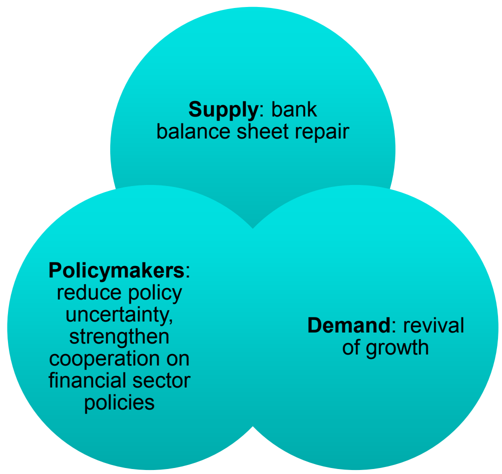
Emerging Europe: Fiscal Adjustment, 2010–13
(Change in general government balance as a percent of GDP)



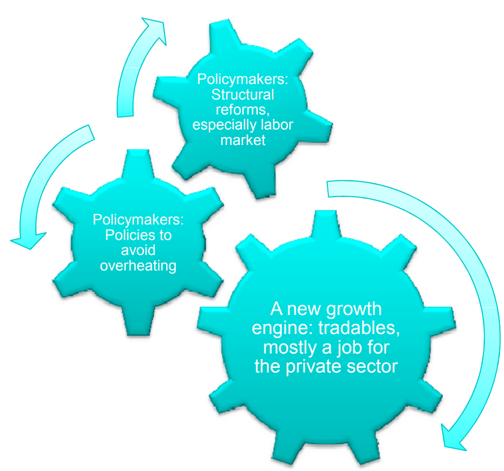
Source: IMF, World Economic Outlook database; and IMF staff calculations.

Private sector credit needs to be revived to support the recovery.

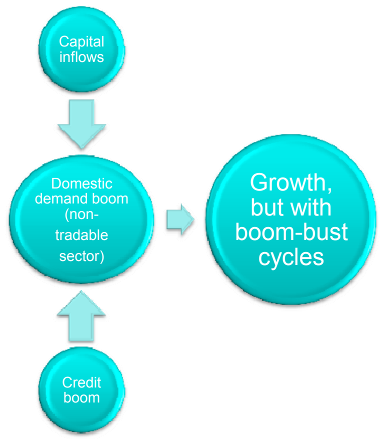
How?



Medium term: new growth drivers needed tradable sector



Why? Previous growth model produced damaging boom-bust cycle



Thank you

Comments and Questions