Key Economic Issues in CESEE

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1. The Boom-Bust in CESEE
2. Crisis legacies (NPLs, public finances)
3. Outlook for 2016
4. Longer-Term Challenges
5. Conclusion
1. The Boom-Bust in CESEE
Pre-crisis, income levels in CESEE converged rapidly with Western Europe...

Average annual GDP growth (percent)

GDP per capita level relative to Germany (percent)

- Slovenia
- Czech Rep.
- Estonia
- Slovakia
- Hungary
- Lithuania
- Latvia
- Croatia
- Russia
- Poland
- Romania
- Bulgaria
- Montenegro
- Belarus
- Serbia
- Macedonia
- Ukraine
- Bosnia
- Albania
- Moldova

Convergence 2002-07
fueled by strong capital inflows.

Cumulative Net Capital Inflows, 2003–08* (Percent of 2003 GDP)

- Portfolio
- FDI
- Other, including banks
- Total

*As the boom in the Baltic states ended in 2007, data for the Baltic states refer to 2002–07 in percent of 2002 GDP.
Western European banks were an important source of capital flows

Exposure of BIS-reporting banks to CESEE vis-a-vis all sectors (exchange-rate adjusted)

Changes in exposure of BIS-reporting banks (percent of 2015 GDP)
Bank flows fueled a credit boom...

Change in external position of western banks and in private sector credit

Change in ratio of external position of western banks to GDP, 2003–08

Change in ratio of private sector credit to GDP, 2003–08
... which boosted domestic demand.
Rapid credit growth was associated with rapidly rising current account deficits.
Current account deficits in some countries reached very high levels.
But views differed on how to interpret these imbalances

- Abiad, Leigh, and Mody (2007): "International Finance and Income Convergence: Europe is Different"
  - Current account deficits are benign.
  - Capital flowing from rich to poor countries

In September 2008, Lehman Brothers defaulted

- Global risk aversion spiked
- Western European banks came under financing pressure
- As a result they suddenly stopped sending large amounts of capital to CESEE
- Domestic demand collapsed just when exports dropped because of global recession
The result was a sudden stop—and then reversal—of bank flows.

Exposure of BIS-reporting banks to CESEE vis-a-vis all sectors (exchange-rate adjusted)

Quarterly changes (percent of region's GDP, rhs)

Outstanding amount (USD billion)

Changes in exposure of BIS-reporting banks (percent of 2015 GDP)

Baltics

SEE EU

CE5

SEE non-EU

2003
2005
2007
2009
2011
2013
2015

0
100
200
300
400
500
600

0
100
200
300
400
500
600

-3
-2
-1
0
1
2
3
4
5
60
50
40
30
20
10
0

2003-08
The result was a deep recession—which was not projected by most observers.
The larger previous capital inflows, the sharper the reversal

Capital flows in the run-up and during Global Financial Crisis

Change in capital flows in 2009 (percent of average 2005-09 GDP)

Cumulative capital flows, 2005-08 (percent of average 2005-09 GDP)
Countries which had large domestic demand booms, now saw deep recessions.
The IMF was quick to provide assistance.
Crisis was deep, but by late 2009, CDS spreads in Eastern Europe had come down sharply.
Growth turned positive in 2010

Real GDP growth (percent)

Note: Unweighted averages.
The boom-bust was a *private-sector* phenomenon

- They were NOT the result of fiscal imbalances
  - (with the exception of Hungary)

- The boom was hard to stop
  - Countries took extensive macro-prudential measures
  - They did not stop the credit boom
  - They helped create buffers in the banking system
The boom would have been mitigated by rising risk premia

- Rising risk premia would have been automatic stabilizer (increased financing costs would have slowed credit growth)
- Problem was that risk premia fell during boom
Fiscal policy did *contribute* to the boom-bust

- Fiscal policy was very pro-cyclical:
  - Public expenditure grew very rapidly during the boom years
  - Fiscal policy was very contractionary during the bust.
During boom years most—but not all—countries had low debt and deficits.
Thus, in countries where private demand grew rapidly, public demand did so too.
However, public expenditure was growing rapidly

- Domestic demand boom led to public revenue boom
- Revenue boom led to public expenditure boom
  - Unfortunately, much of the revenue boom turned out to be temporary
  - While the increase in expenditure had a more permanent character.
The end of the domestic demand boom led to a sharp decline of revenue...

![Graph showing tax revenues dynamics in 2009 recession](chart.png)
Risk premia rose sharply

Note: 5-yr CDS spreads at 600 basis points translate into 10 percent probability of default over the next 5 years, assuming 40 percent recovery rate.
Particularly in countries with high projected deficits
Some countries took very strong measures to contain rise in deficits.
2. Crisis Legacies
The crisis was deep, but most countries have recovered to above pre-crisis levels (unlike the euro area periphery)
In per capita terms, growth has been faster—although of course tepid by pre-crisis standards.
Two main crisis legacies: high NPLs

Non-performing loans
(latest available data, percent of total loans)

- Below 5 percent
- 5-10 percent
- 10-15 percent
- 15-20 percent
- 20-25 percent
- Above 25 percent

Map showing the distribution of non-performing loans across different countries with color coding indicating the percentage ranges.
High public debt

Public debt
(percent of GDP)

<table>
<thead>
<tr>
<th>Country</th>
<th>Public Debt (percent of GDP)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Kosovo</td>
<td>34</td>
</tr>
<tr>
<td>Poland</td>
<td>30</td>
</tr>
<tr>
<td>Estonia</td>
<td>20</td>
</tr>
<tr>
<td>Hungary</td>
<td>20</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>20</td>
</tr>
<tr>
<td>Russia</td>
<td>20</td>
</tr>
<tr>
<td>Czech Rep.</td>
<td>15</td>
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<tr>
<td>Albania</td>
<td>15</td>
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<td>Macedonia</td>
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<td>Croatia</td>
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<td>Serbia</td>
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<td>Montenegro</td>
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<td>Latvia</td>
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<td>Lithuania</td>
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<td>Bosnia</td>
<td>15</td>
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<tr>
<td>Slovakia</td>
<td>15</td>
</tr>
</tbody>
</table>

Change in public debt, 2007-15
(percent of GDP)

- Ukraine: 80
- Slovenia: 60
- Croatia: 40
- Serbia: 40
- Montenegro: 30
- Latvia: 20
- Romania: 20
- Bosnia: 20
- Slovakia: 20
- Lithuania: 20
- Belarus: 20
- Moldova: 15
- Albania: 15
- Macedonia: 15
- Czech Rep.: 15
- Russia: 15
- Bulgaria: 15
- Hungary: 15
- Estonia: 15
- Poland: 15
- Kosovo: 15

Below 15 percent: Kosovo
15 - 30 percent: Slovenia, Croatia, Serbia
30 - 45 percent: Montenegro, Latvia, Romania, Bosnia, Slovakia, Lithuania, Belarus
45 - 60 percent: Moldova, Albania, Macedonia, Czech Rep., Russia, Bulgaria, Hungary
60 - 75 percent: Ukraine
Above 75 percent: Kosovo

Change in public debt, 2007-15 (percent of GDP)
Fiscal deficits have declined to more modest levels...

Fiscal balance (percent of GDP)

Change in fiscal balance, 2009-15 (percent of GDP)

- Lithuania
- Latvia
- Slovakia
- Romania
- Poland
- Bosnia
- Czech Rep.
- Moldova
- Hungary
- Ukraine
- Slovenia
- Albania
- Estonia
- Croatia

Serbia
Bulgaria
Macedonia
Kosovo
Belarus
Montenegro
...but adjustment is not yet over.

Estimated remaining adjustment needs (percent of GDP)

- Gap to structural balance of -1 percent of GDP
- Gap to debt stabilizing primary balance
However, adjustment fatigue seems to have set in.
4. Outlook for 2016
Big picture—GDP growth: CIS in recession; rest of CEE doing better

3-year rolling average PPP weighted real GDP growth (percent)
Big picture—Inflation: High in CIS; low in rest of CEE

3-year rolling average CPI inflation (percent)


CIS

CEE non-EU

CEE EU
Outside of CIS, most countries moderate to fairly strong growth

GDP growth (percent)

<table>
<thead>
<tr>
<th>Year</th>
<th>-10.0 - -5.0</th>
<th>-5.0 - 0.0</th>
<th>0.0 - 1.0</th>
<th>1.0 - 2.0</th>
<th>2.0 - 3.0</th>
<th>3.0 - 4.0</th>
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<tbody>
<tr>
<td>2015</td>
<td></td>
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<td>2016</td>
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Note: Striped fill denotes CESEE country under IMF programs.
Risks for the Region

- Recent financial market volatility—what will be the impact?
- Hard landing in China
- Prolonged recession in Russia
- Disappointing Euro Area growth
- Geopolitical tensions
And of course the Refugee Crisis

First-time asylum applications received by EU countries (thousands of people)
Key Issue: Slowdown in Emerging Markets

- Growth in emerging markets has slowed down
- Is this temporary?
- Or is it more structural?
Growth in the large EMEs has been fueled by a credit boom

Credit to private non-financial sector (percent of GDP)

- Brazil
- Russia
- Turkey
- China

China: +80 percent of GDP
Resilience of CESEE

- CESEE has been much less affected by global financial turmoil

5-year CDS spreads (basis points)
CESEE—excl Turkey and Russia—has not had a credit boom post 2008!

Change in claims on non-financial private sector, 2010-2014 (percent of GDP)
Post 2009, capital inflows have been low

Capital flows to CESEE* (percent of GDP)

*excluding Russia and Turkey
5. Longer-term Challenges
Longer term challenge: boosting productivity and employment rate

Labor utilization and productivity, 2015

Note: Bubble color reflect regional groupings. Bubble size reflect GDP per capita level (PPP adjusted)

*2014
Productivity has increased, but remains relatively low.

Labor productivity
(percent of labor productivity in Germany)
Employment has increased in CESEE-EU countries
Employment has increased in CESEE-EU countries

Employment rate (percent)
But remains low in SEE non-EU
But remains low in SEE non-EU

Employment rate (percent)

Albania
Macedonia
Bosnia
Serbia
Montenegro

CESEE-EU average

2014
2000
Aging will be strong headwind for per capita GDP growth

- Population will shrink
  - → will reduce GDP growth

- Working age population will shrink even faster
  - → will reduce GDP *per capita* growth
Population and Working Age Population will decline strongly in many countries!

Demographic trends 2016-30

Population change < working age population change

Population change > working age population change
Taken everything together, overall GDP growth may remain modest at best.

Example: Poland

- Assume 3 percent annual labor productivity growth in 2016-20, 1 percent more than during 2011-15
- Assume no change in employment rate
- Average annual GDP growth will be around 2 percent only!
6. Conclusion
Conclusion

- CESEE has gone through a deep crisis
- But most countries have recovered
- Going forward, the challenge is to continue catching-up with Western Europe
- This will not be as easy—much of the “low hanging fruit” has been picked
- In all countries in CESEE, productivity needs to rise further
- In the SEE non-EU countries, employment rate also needs to increase
Thank you