The IMF and Eastern Europe

Warsaw University of Technology

June 13, 2017

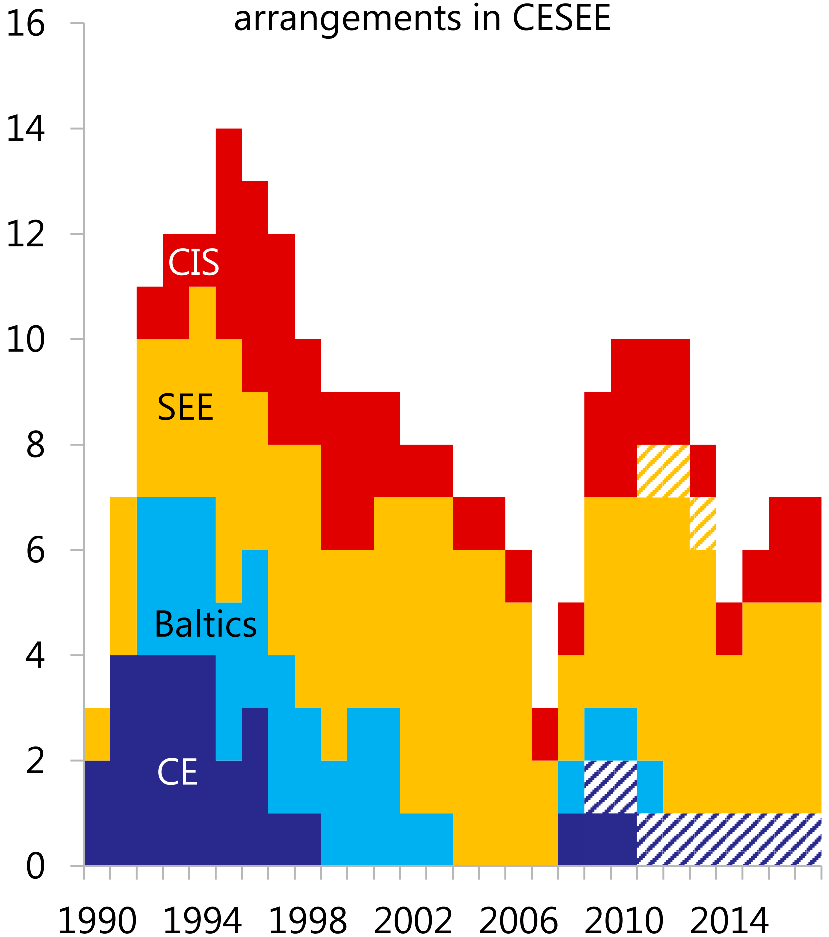
Bas B. Bakker
Senior Regional Resident Representative
for Central and Eastern Europe

The IMF has had close involvement with CESEE since early transition

- It supported the transition to market economies with
  - Financing
  - Technical Assistance
  - Training
- It provided financial help and TA during the 2008/09 crisis and beyond

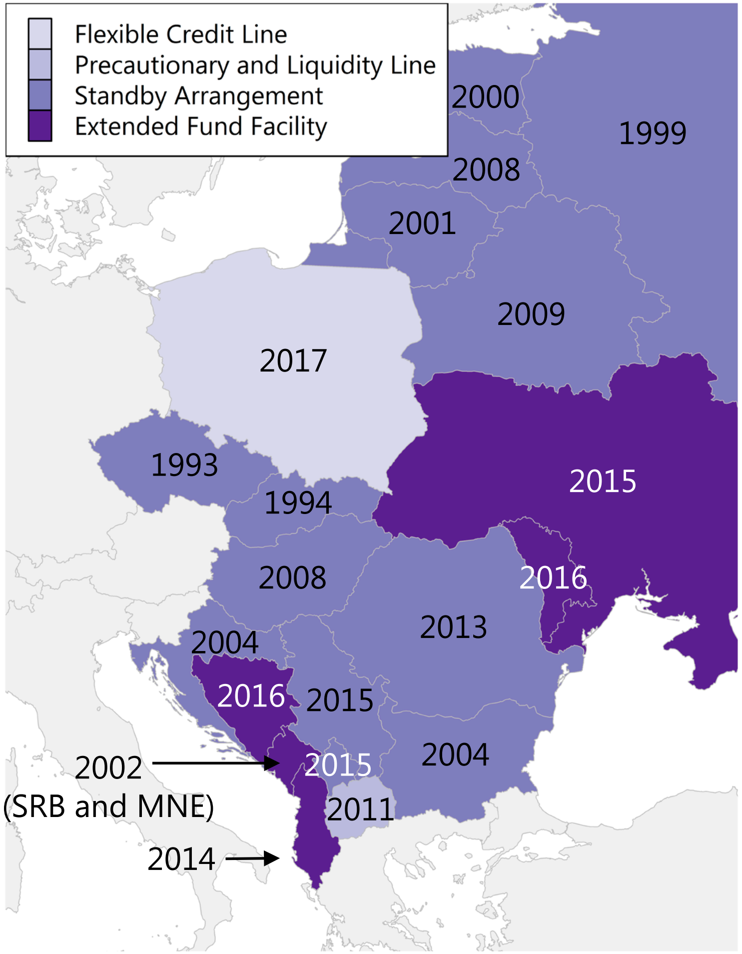
Two waves of IMF programs: early transition and post-2008

Number of countries with active IMF arrangements in CESEE



Note: Dashed pattern shows precautionary programs.

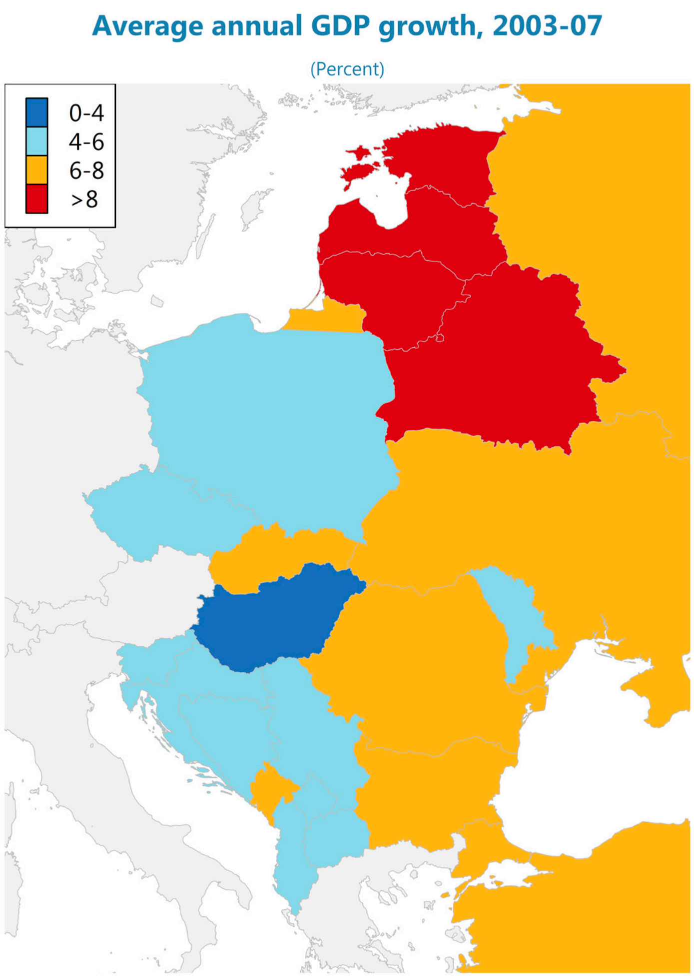
Latest IMF arrangements by country

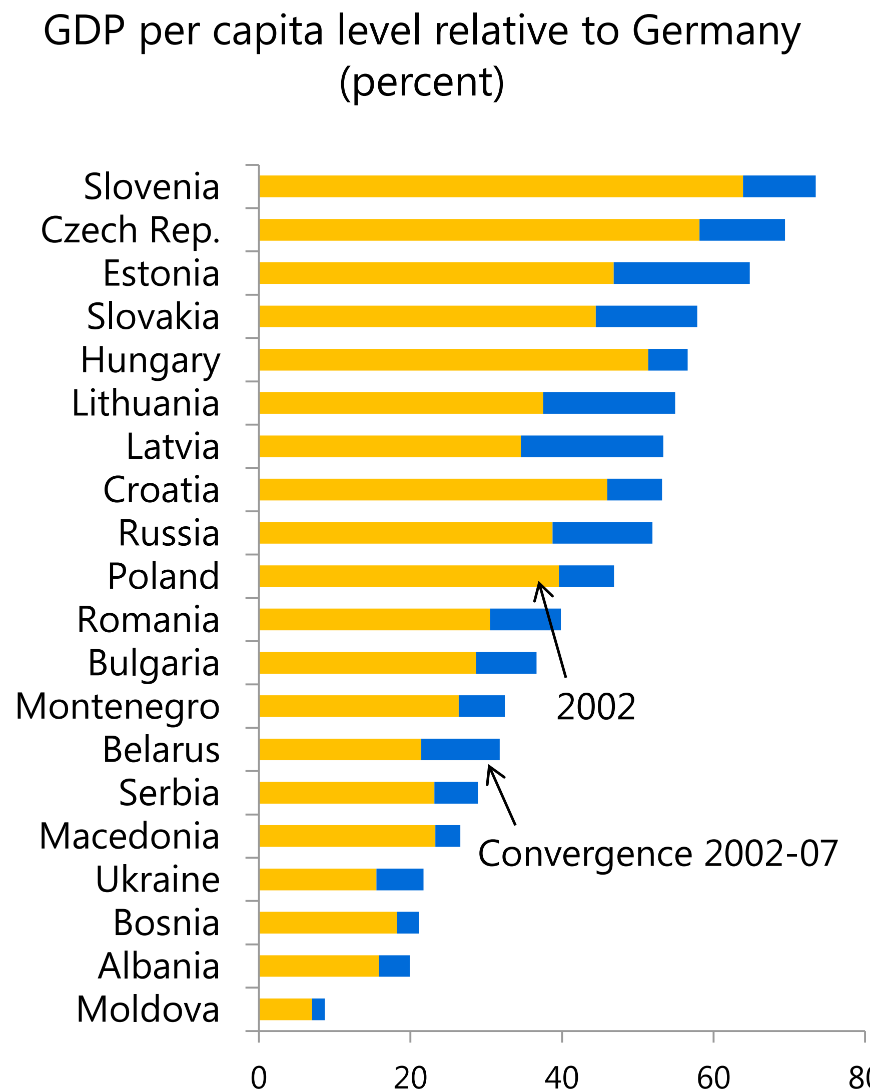


Note: Years indicate start date of arrangement.

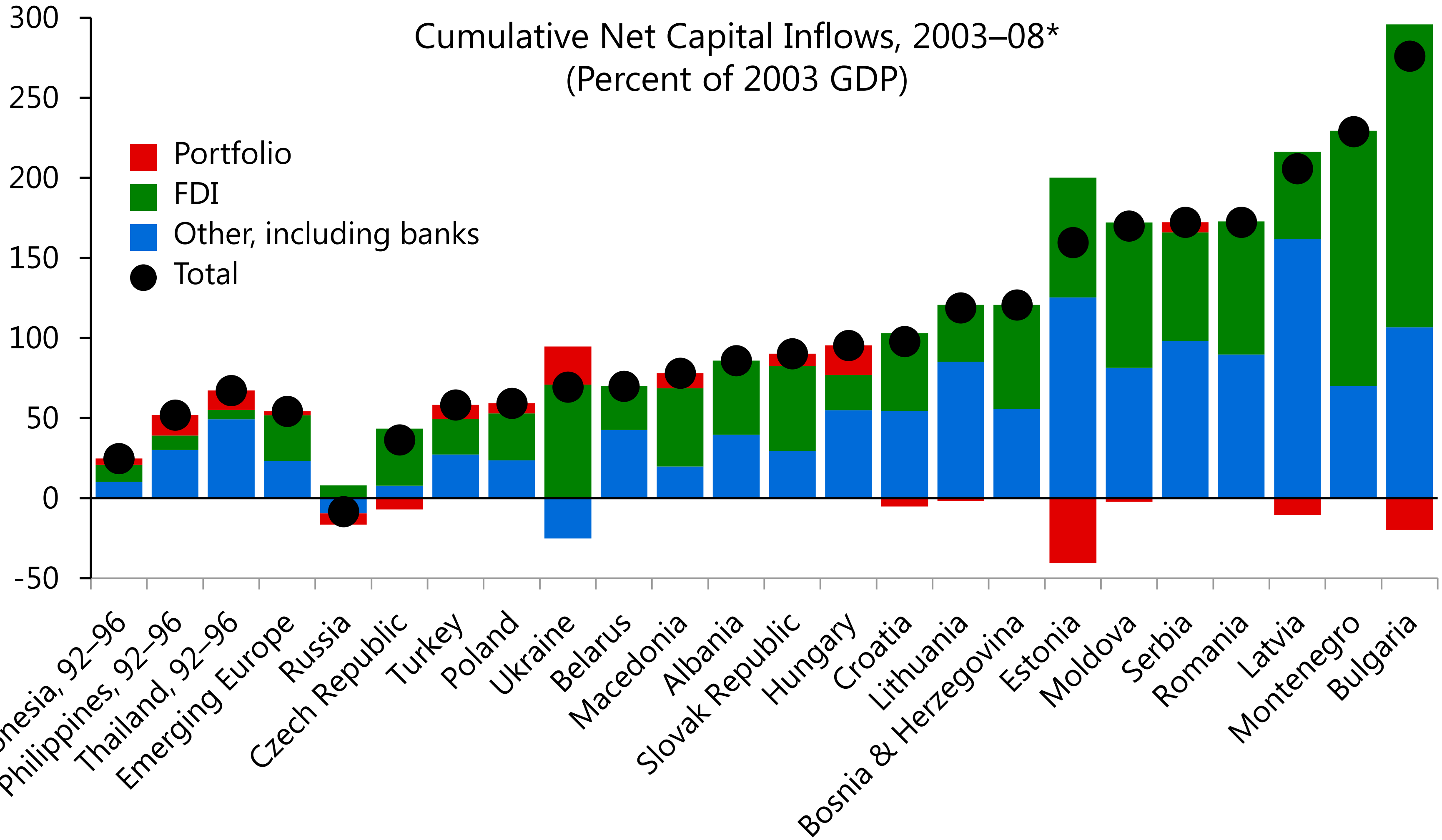
The 2003-10 Boom-Bust in CESEE

Pre-crisis, income levels in CESEE converged rapidly with Western Europe…



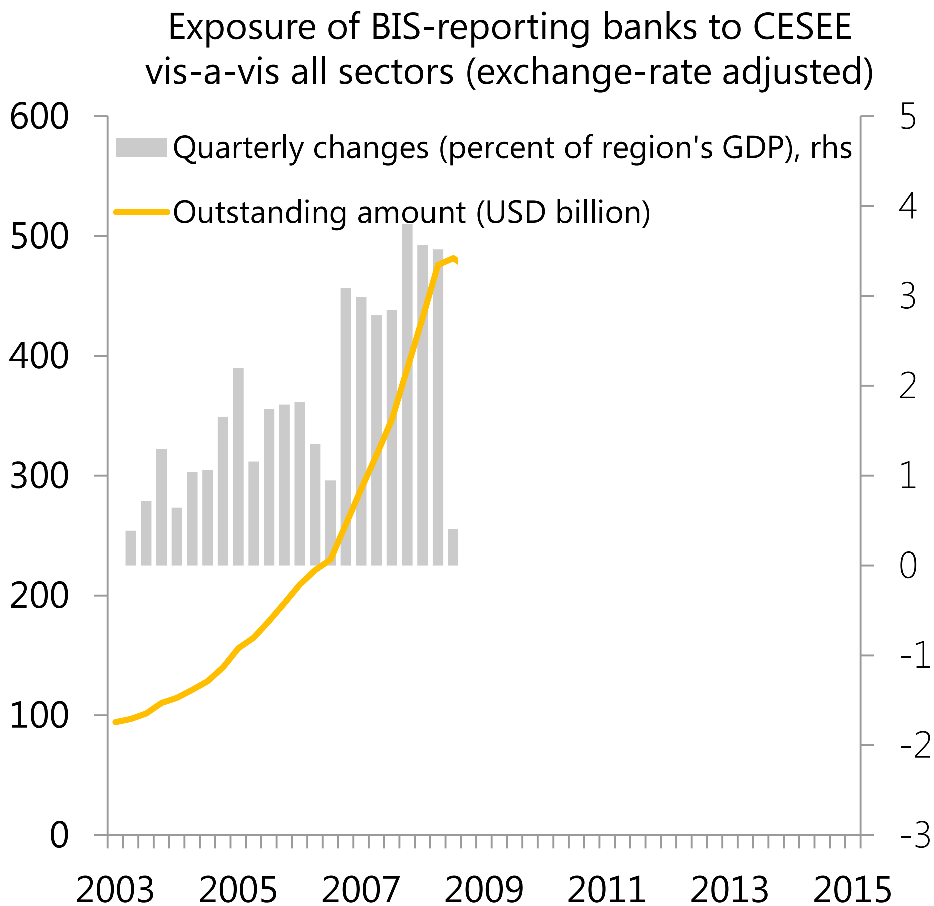


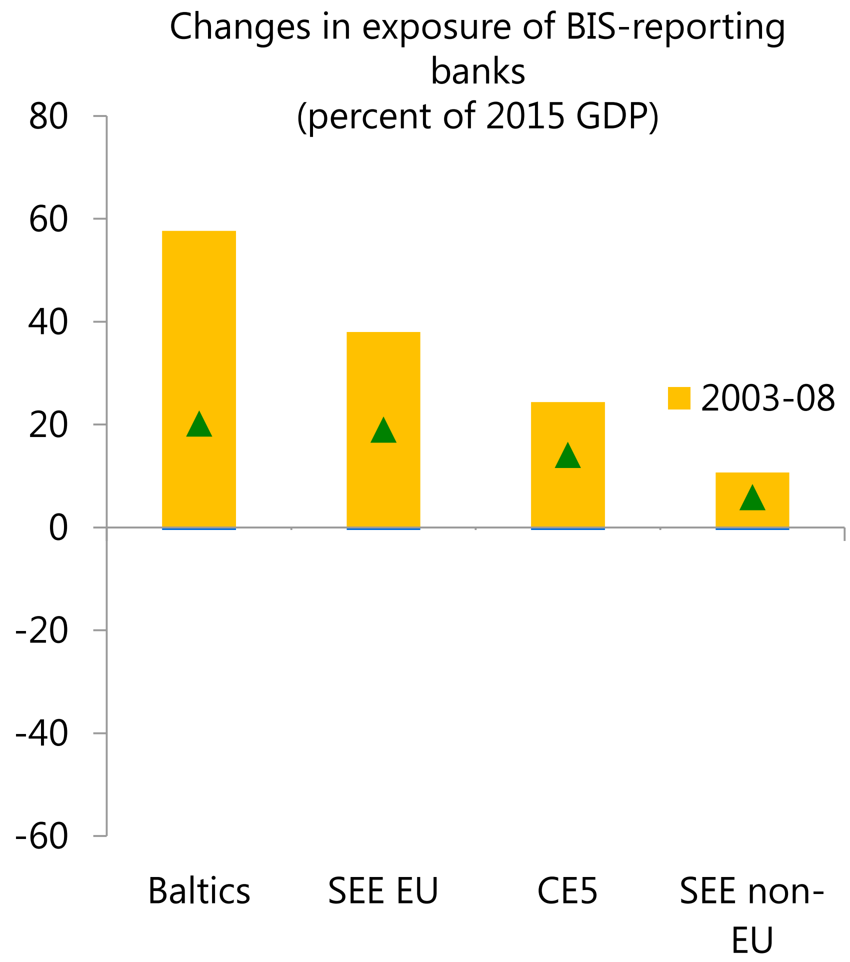
…fueled by strong capital inflows.



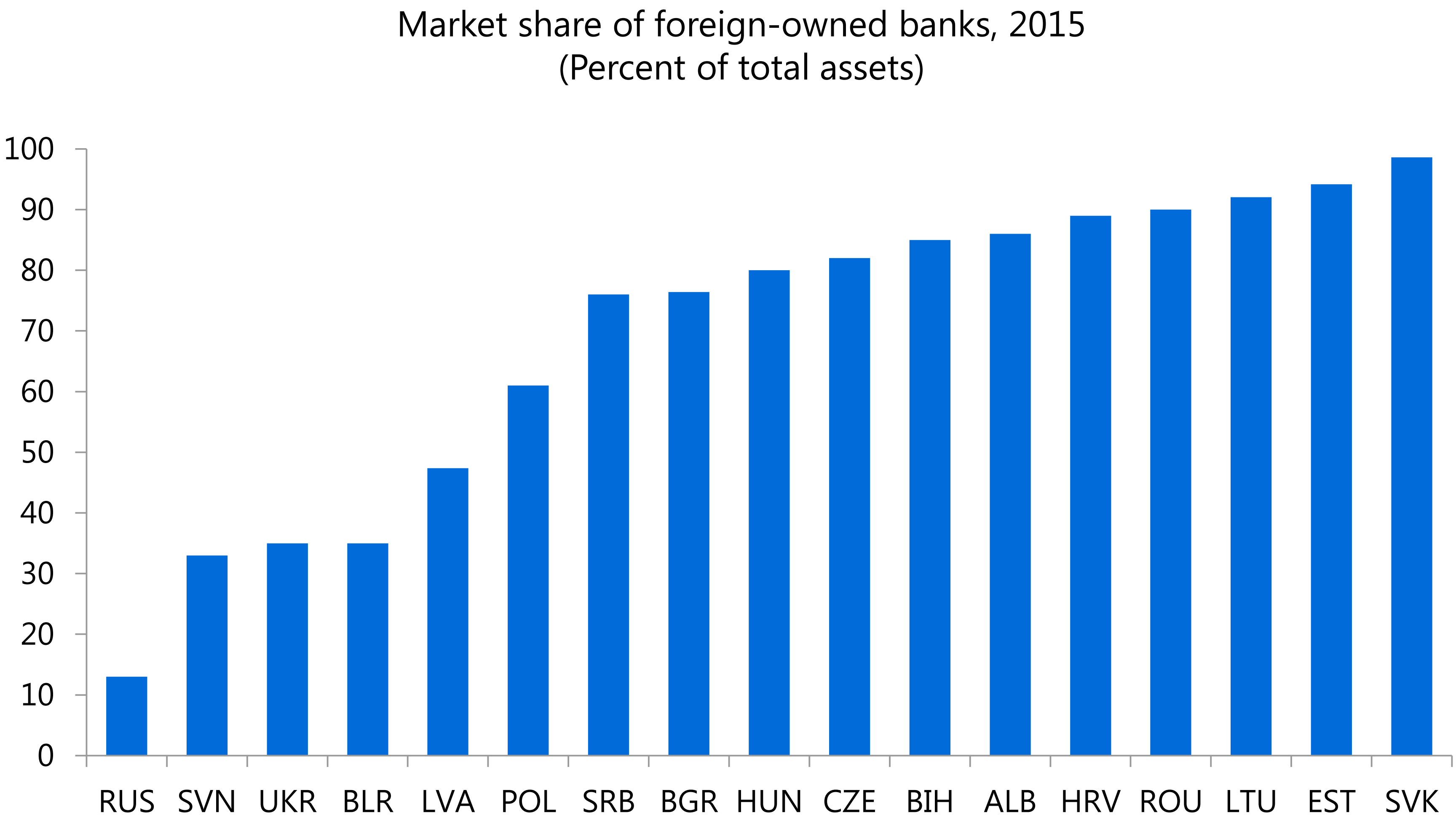
*As the boom in the Baltic states ended in 2007, data for the Baltic states refer to 2002–07 in percent of 2002 GDP.

Western European banks were an important source of capital flows



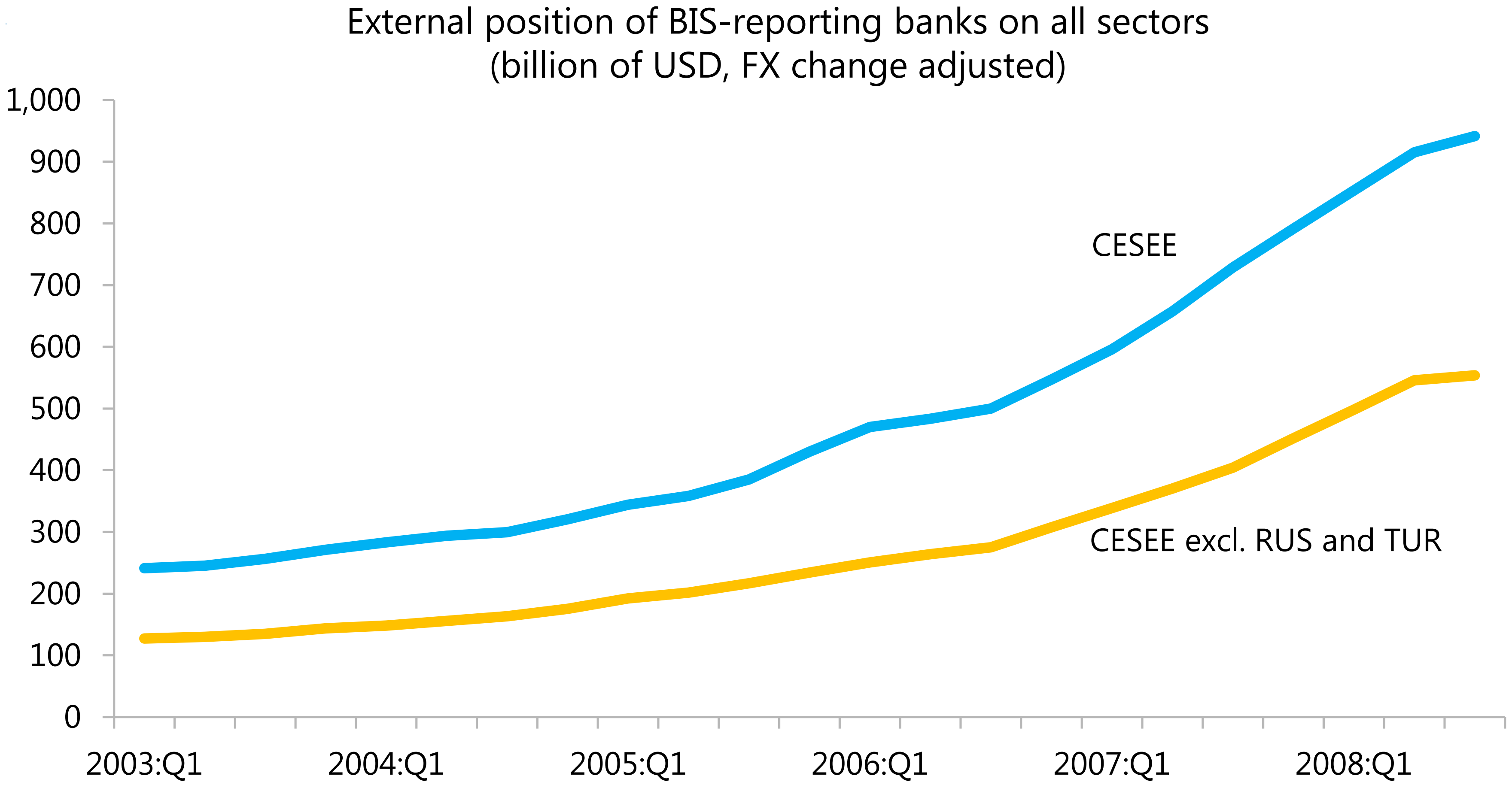


This was because much of banking system in CESEE is foreign-owned…



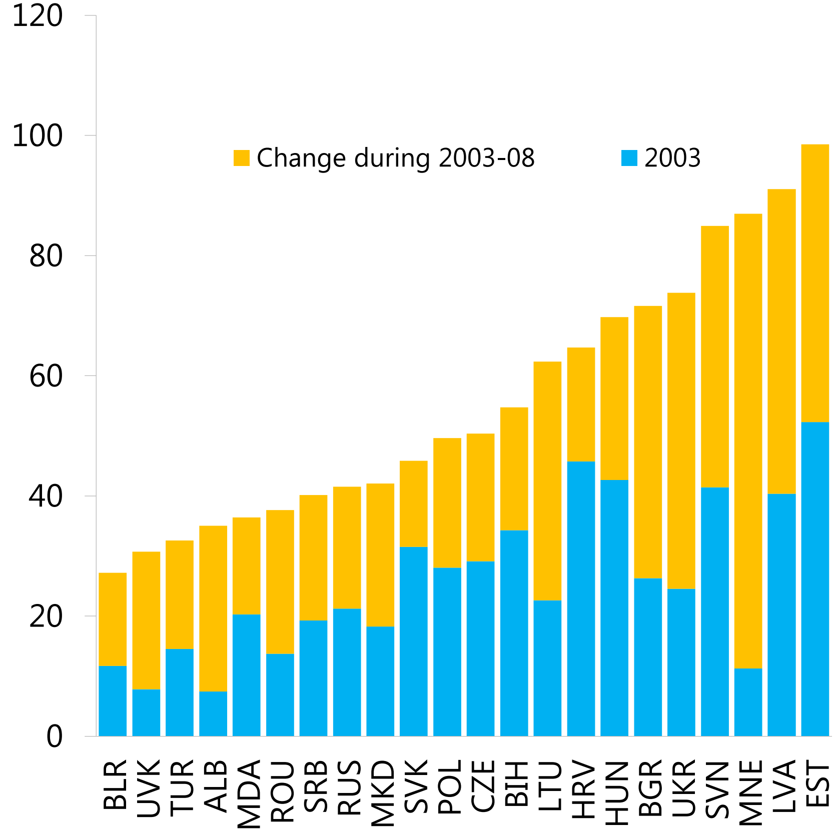
Note: for BLR and LTU data for 2014.

As banking in CESEE was very profitable, there were large funding flows of Western European banks to CESEE (Not just to own subsidiaries but also to other banks)

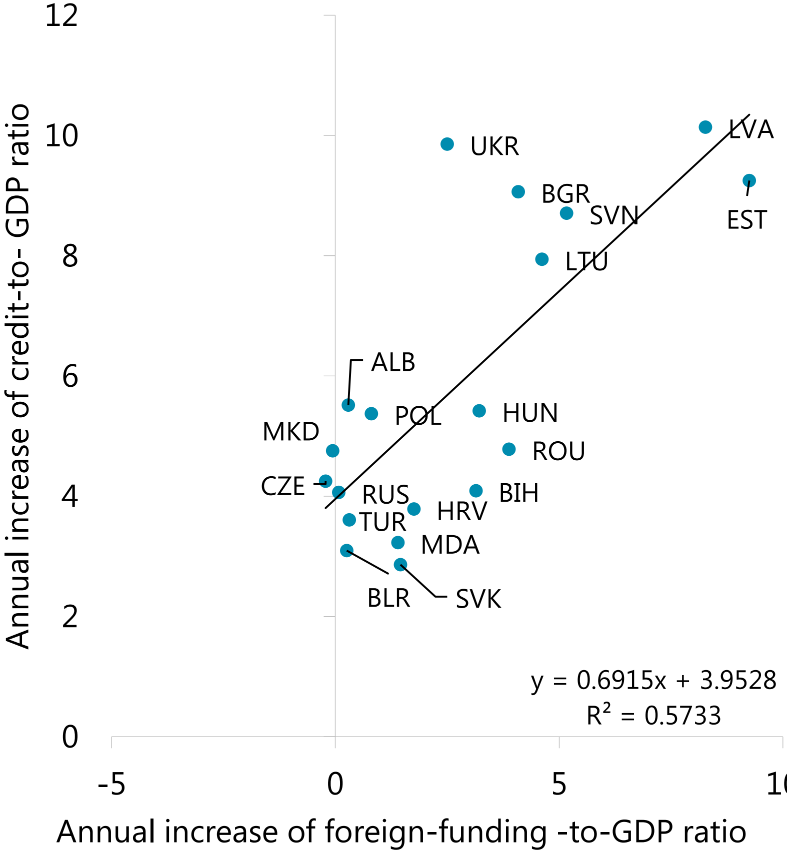


…which fueled and financed a credit boom…

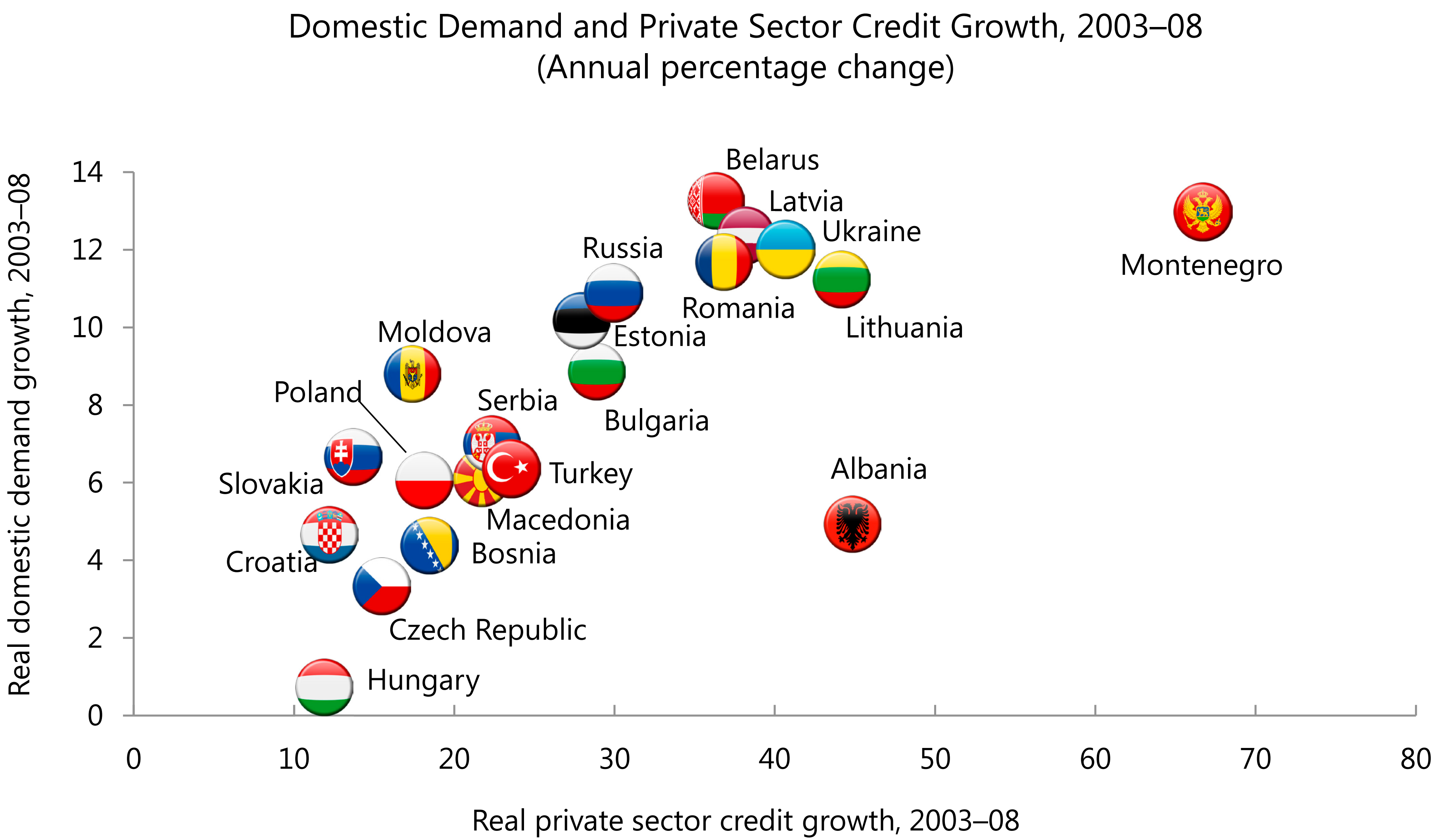
Credit-to-GDP ratio and its change
(Percent of GDP)



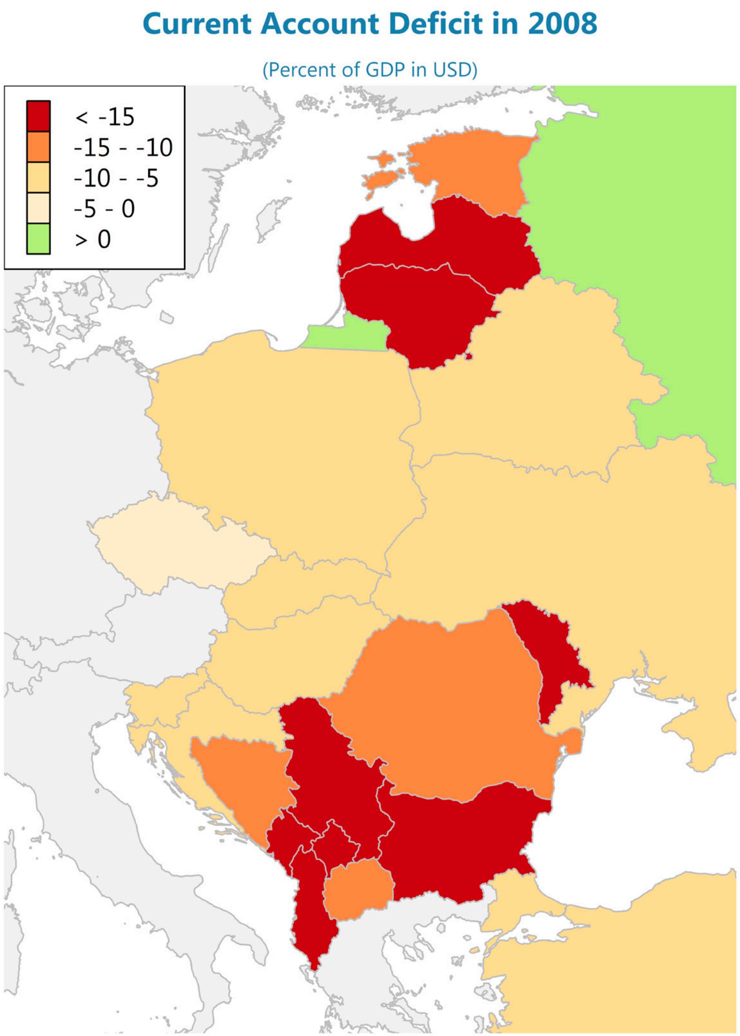
Increase of credit-to-GDP ratio and increase of foreign funding to banks



… which boosted domestic demand.



…which led to high current account deficits and overheating economies

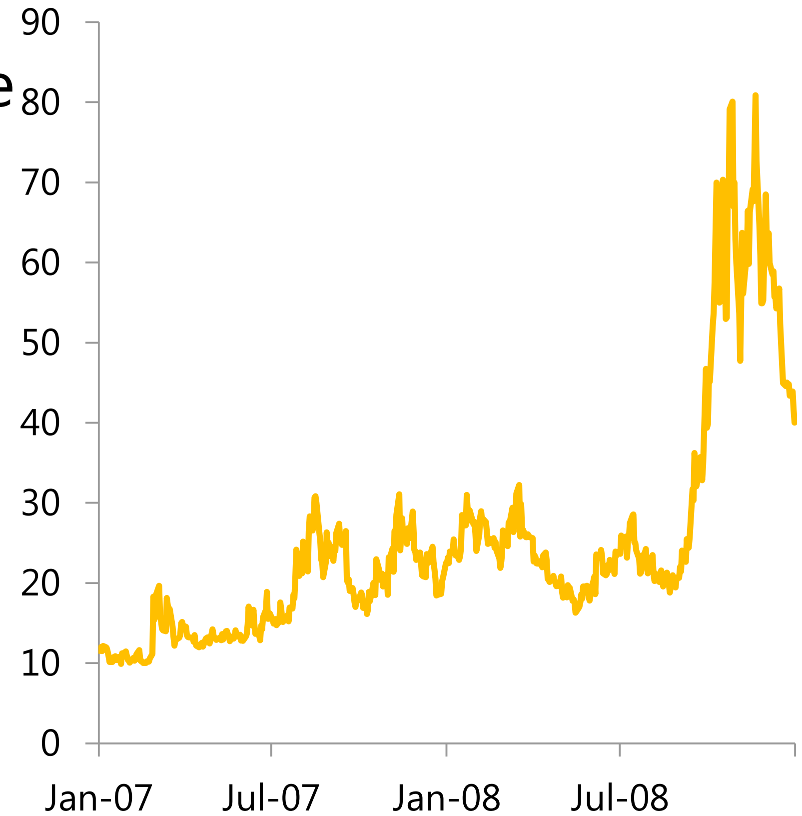


Note: For EST, LVA and LTU: 2007.

In September 2008, Lehman Brothers defaulted

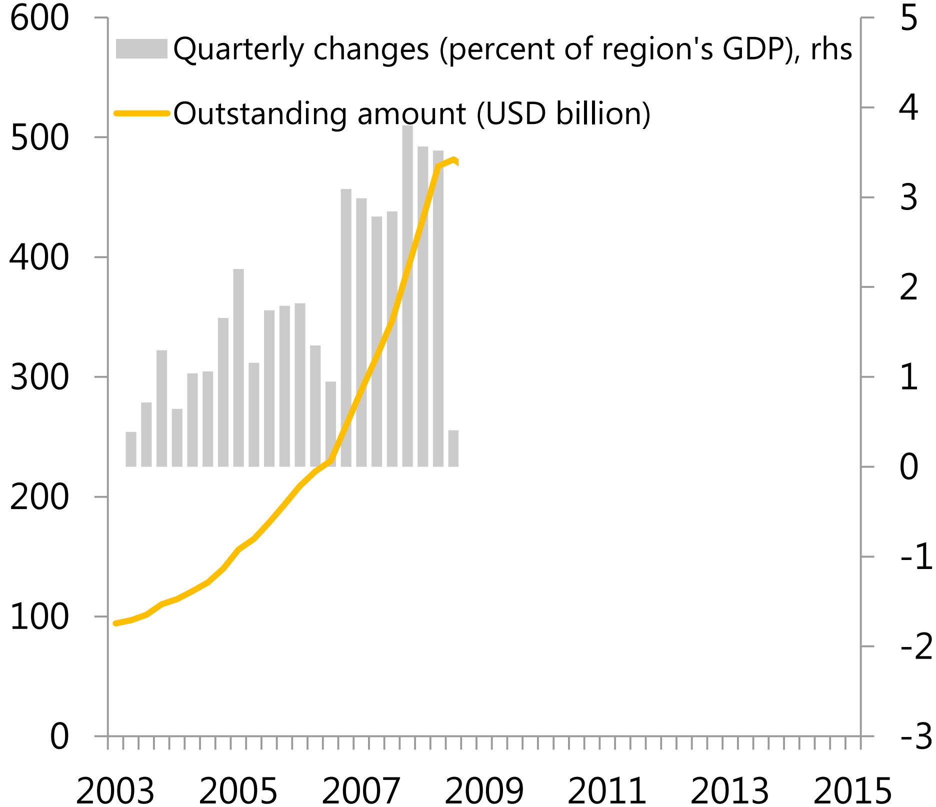
- Global risk aversion spiked
- Western European banks came under financing pressure
- As a result they suddenly stopped sending large amounts of capital to CESEE
- Domestic demand collapsed just when exports dropped because of global recession

Volatility index on S&P 500

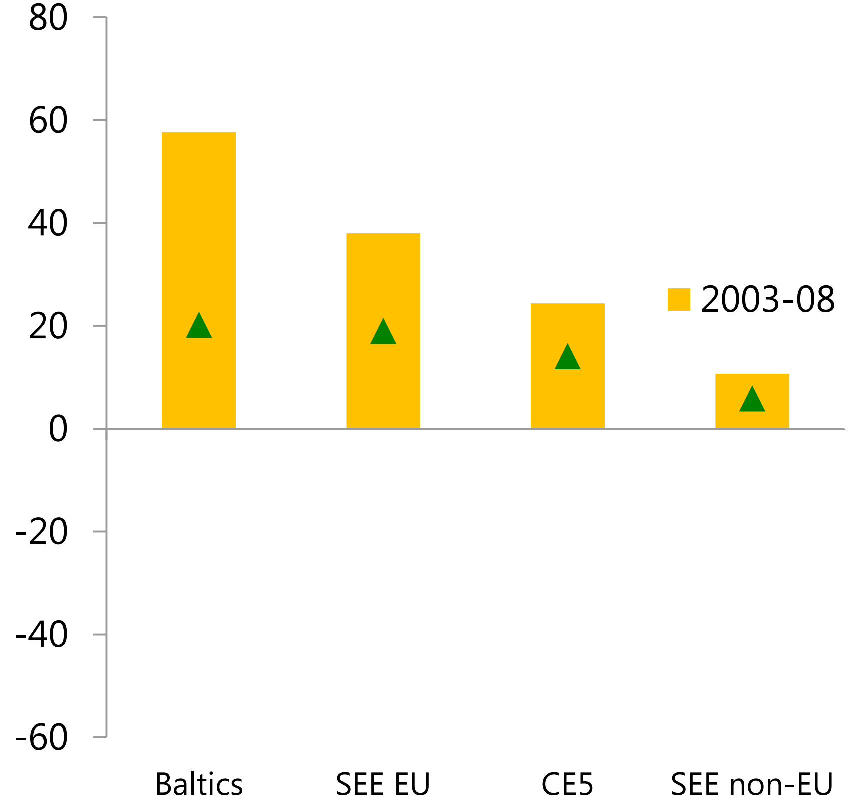


The result was a sudden stop—and then reversal—of bank flows

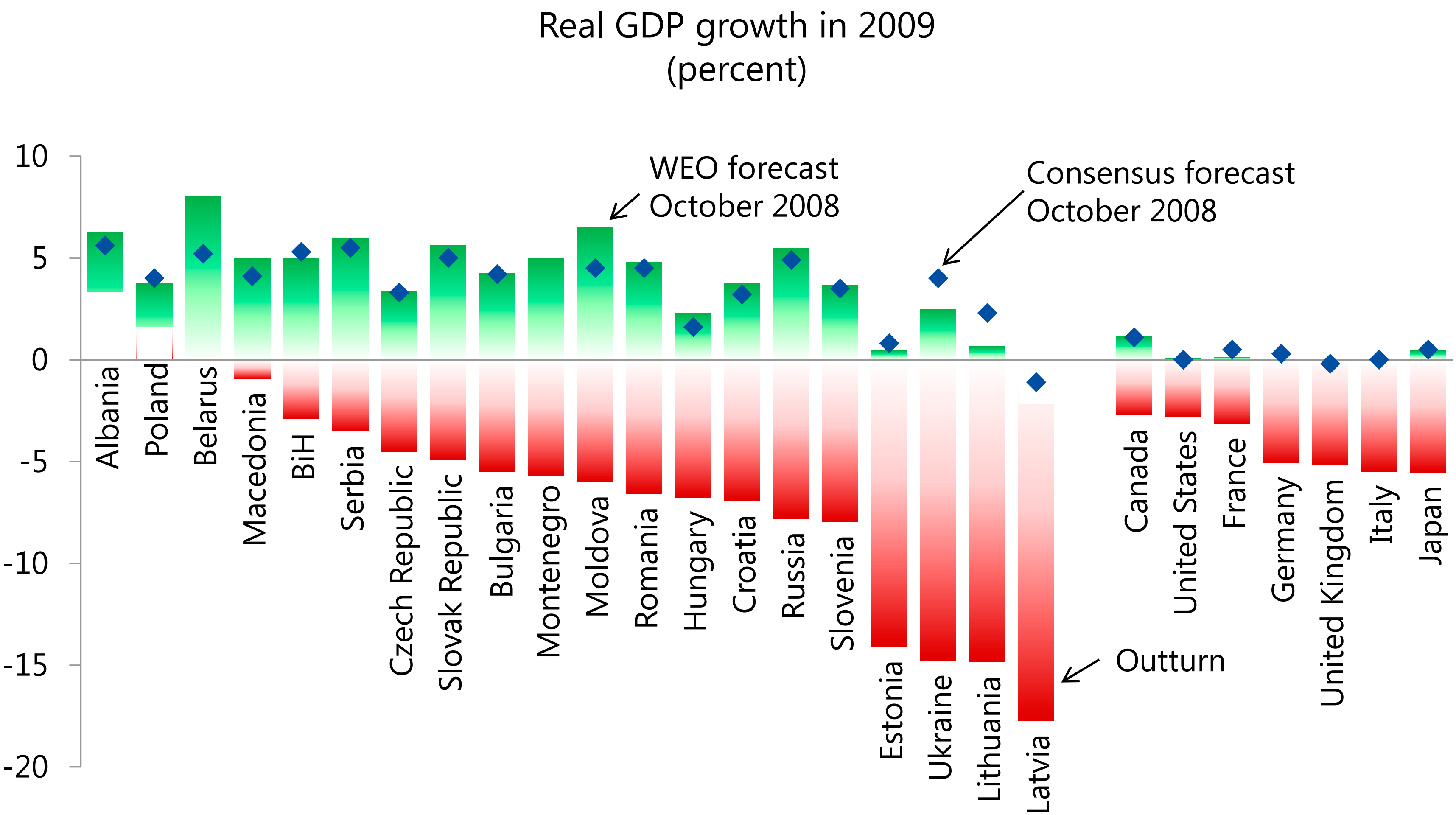
Exposure of BIS-reporting banks to CESEE vis-a-vis all sectors (exchange-rate adjusted)



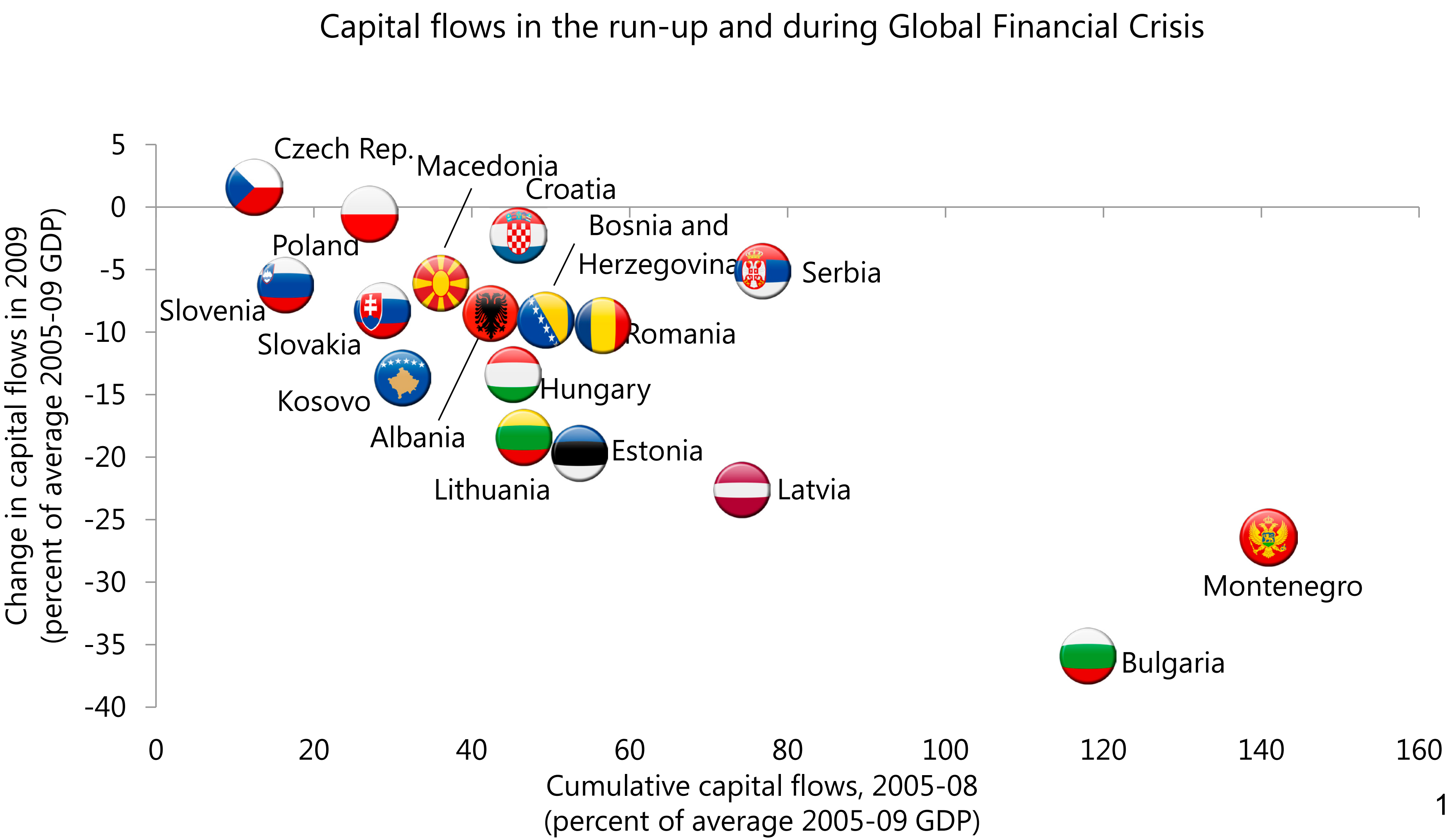
Changes in exposure of BIS-reporting banks (percent of 2015 GDP)



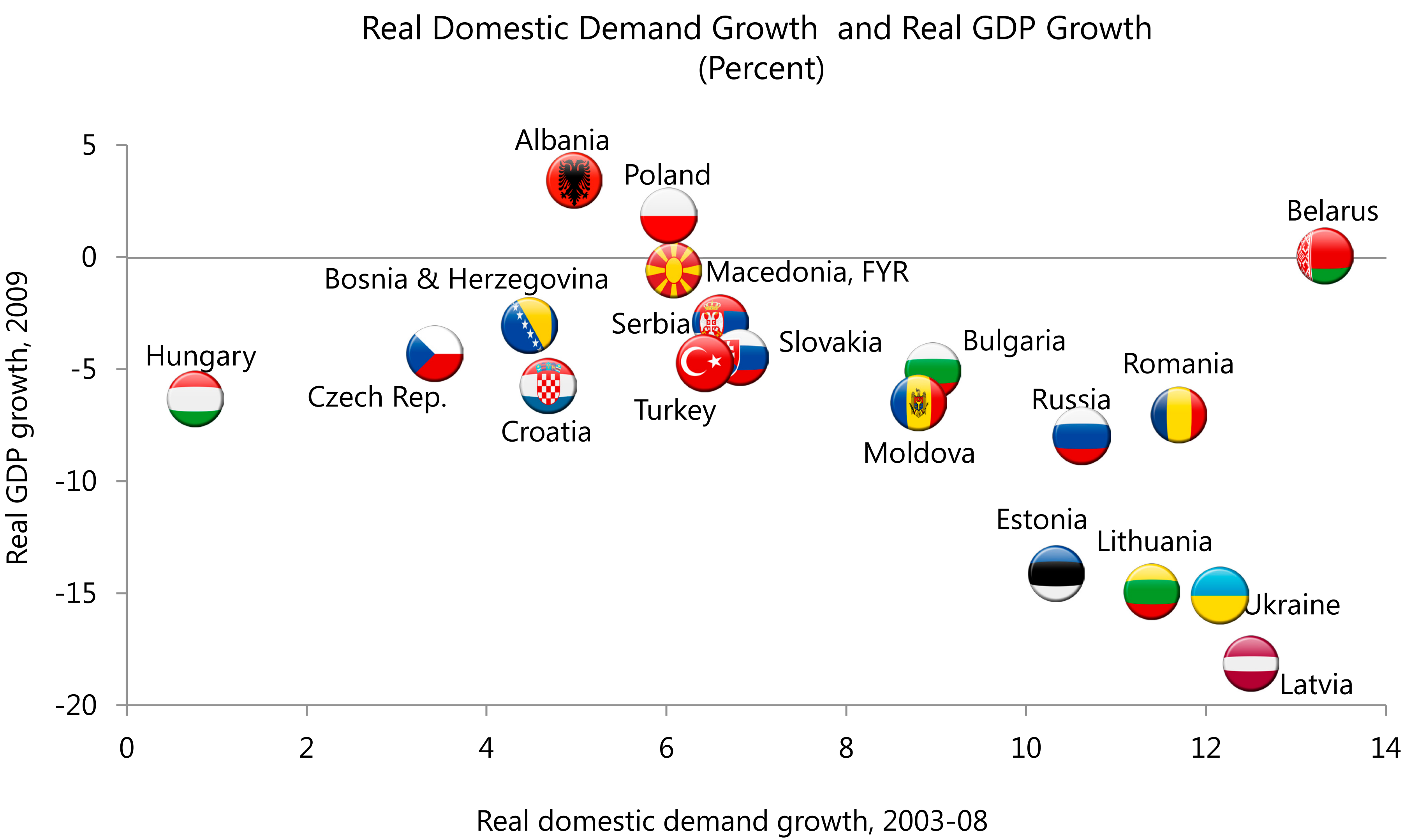
The result was a deep recession—which was not projected by most observers



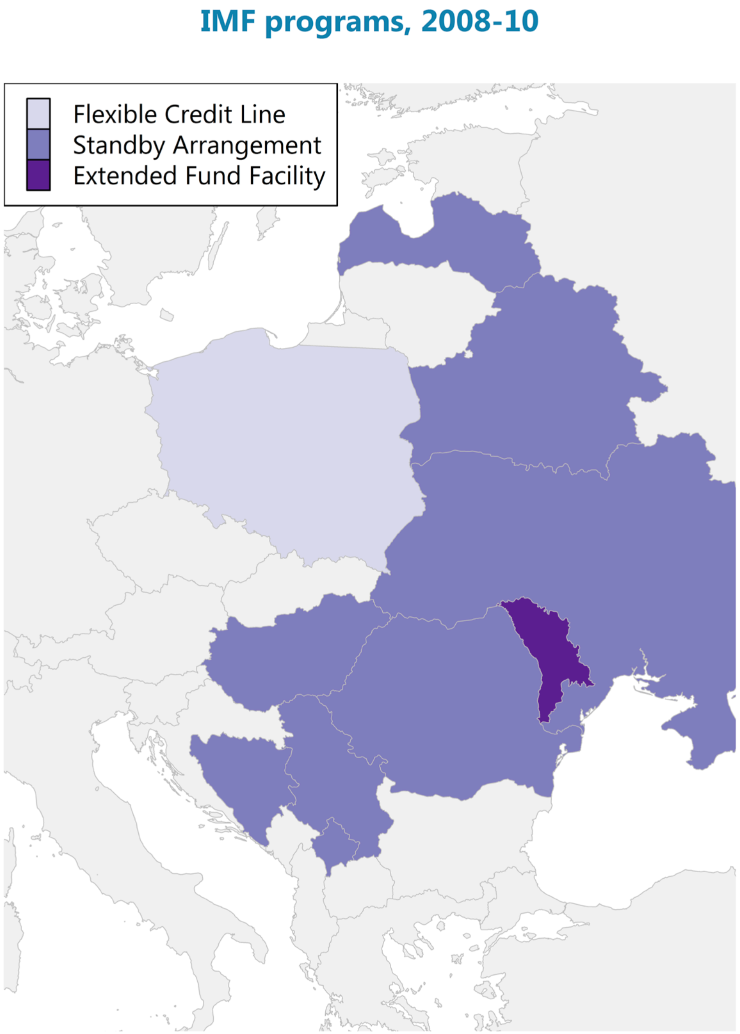
The larger previous capital inflows, the sharper the reversal



Countries which had large domestic demand booms, now saw deep recessions



IMF provided financial assistance to many countries



The boom-bust was a *private-sector* phenomenon

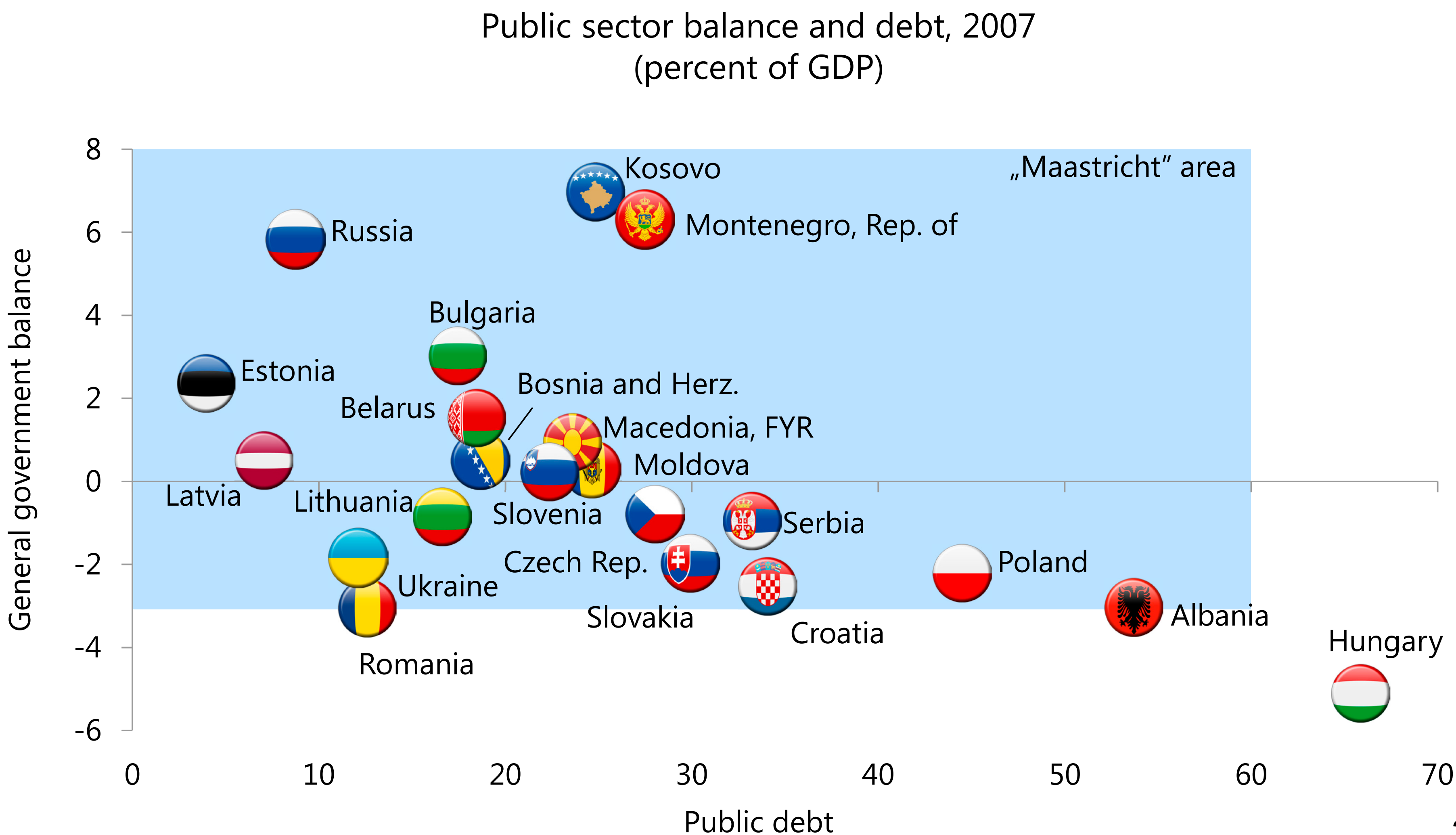
- They were NOT the result of fiscal imbalances
  - (with the exception of Hungary)

- 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

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

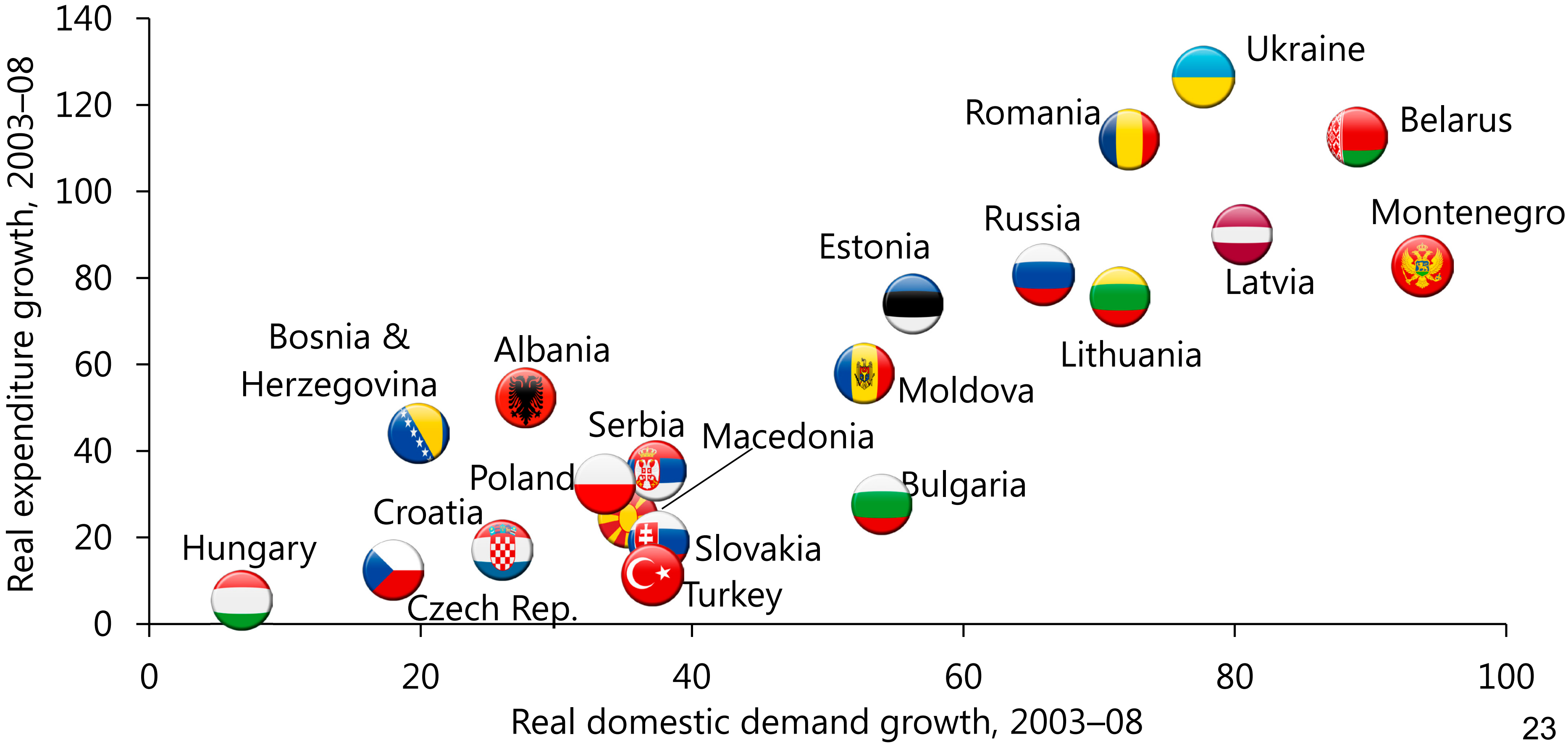


However, public expenditure was growing rapidly

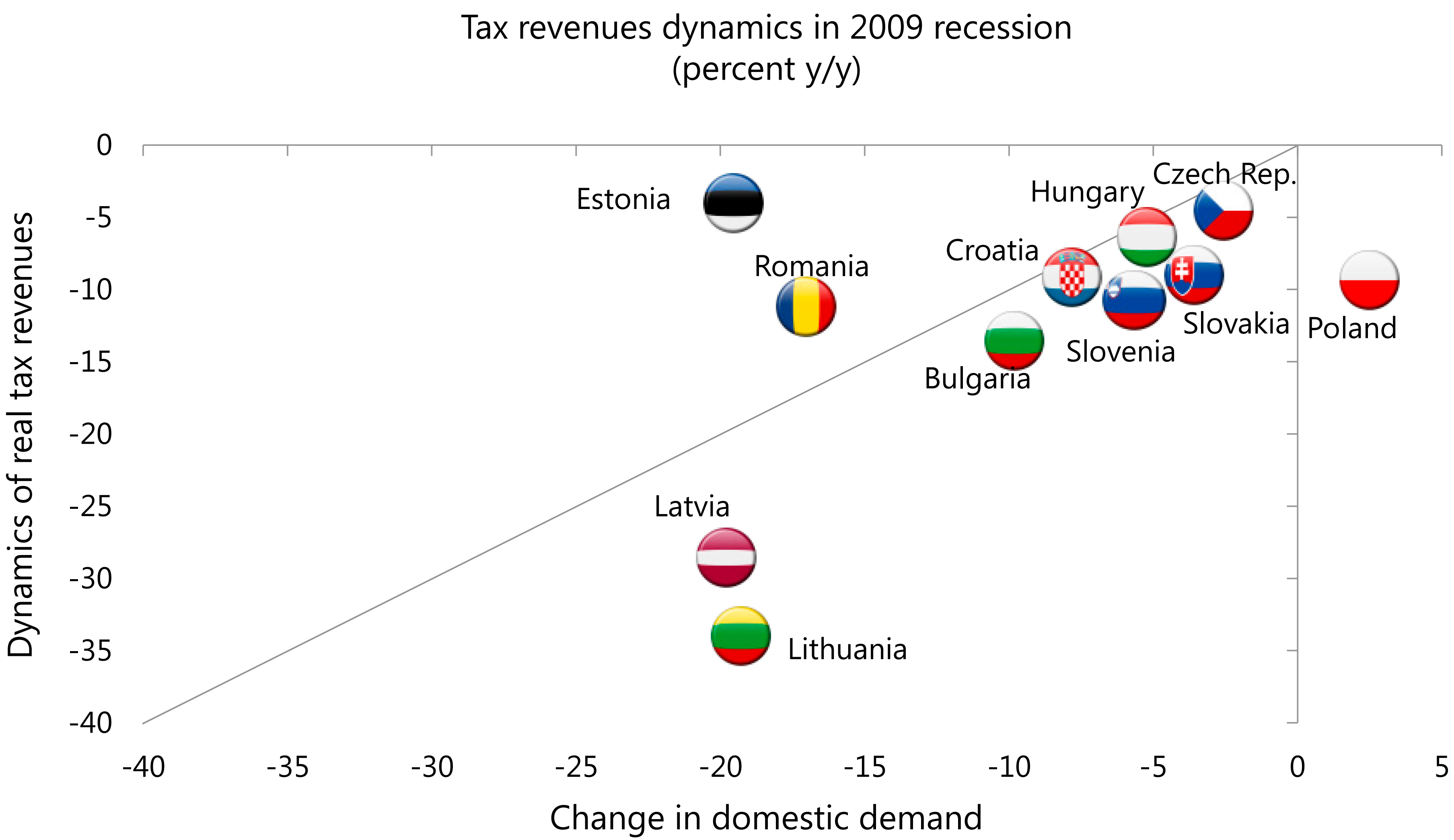
- Domestic demand boom led to public revenue boom
- Revenue boom led to public expenditure boom
  - Unfortunately, much of the revenue boom turned out to be temporary
  - While the increase in expenditure had a more permanent character.

Thus, in countries where private demand grew rapidly, public demand did so too.

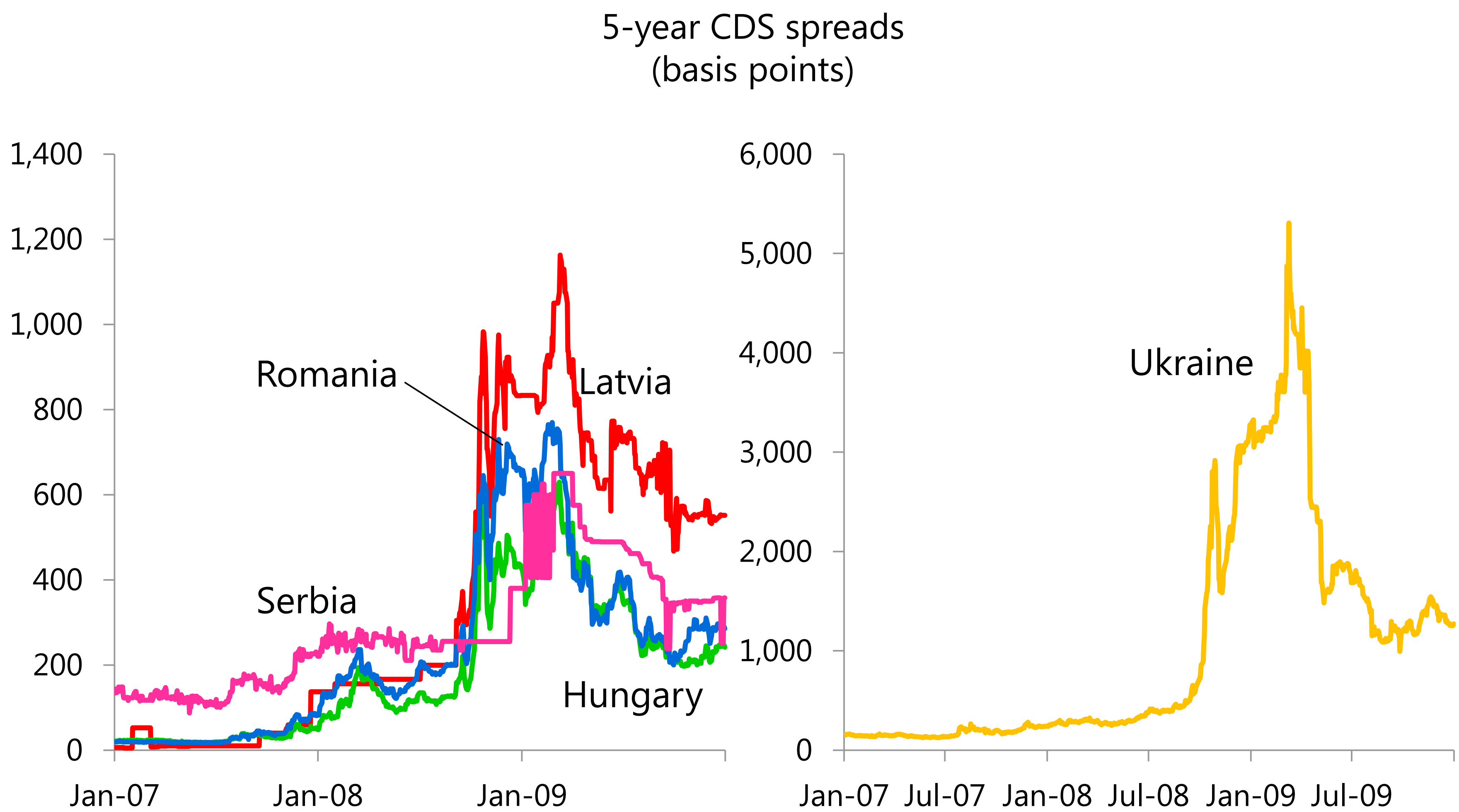
Domestic demand and government expenditure during the boom years



The end of the domestic demand boom led to a sharp decline of revenue…

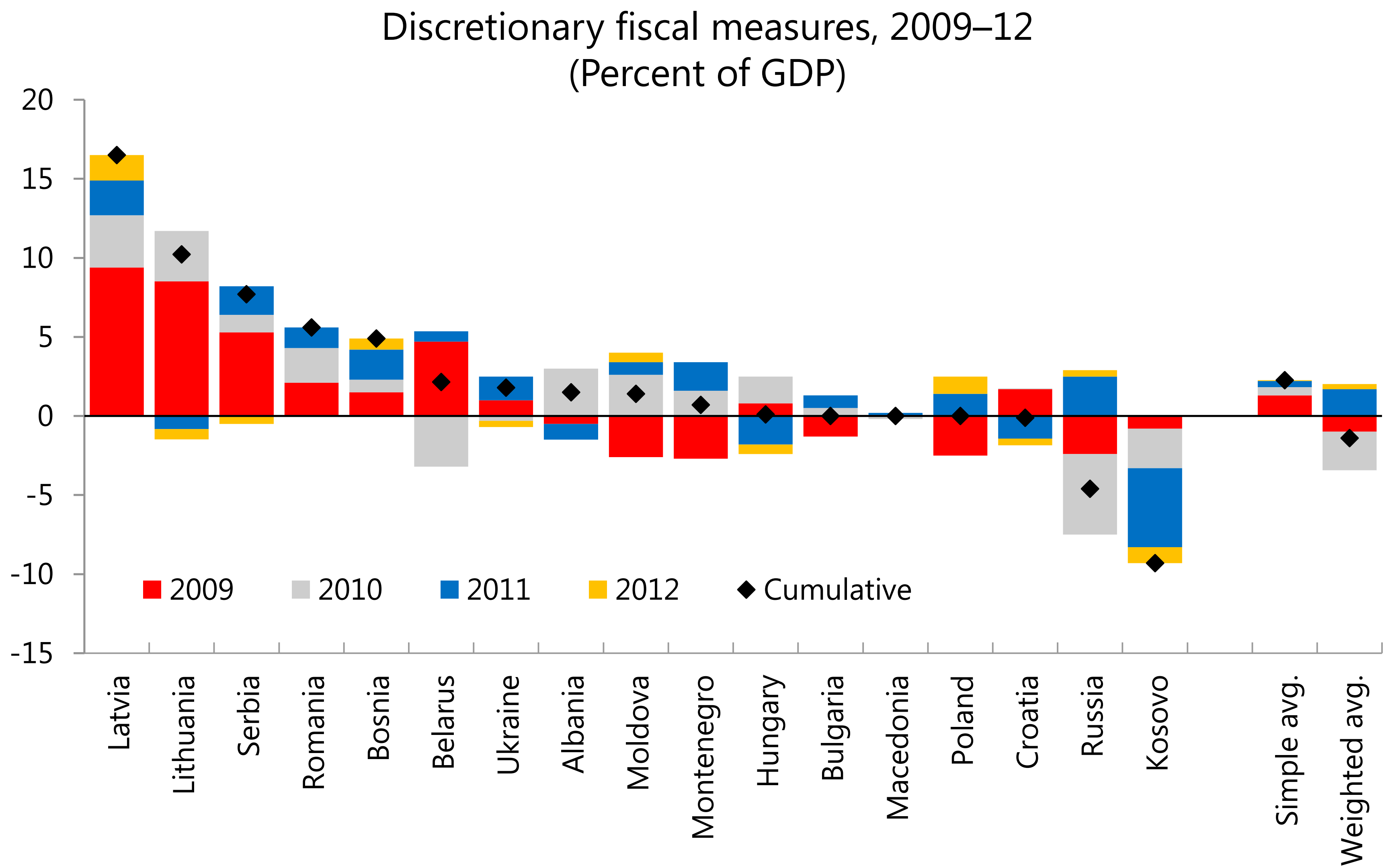


Risk premia rose sharply as large fiscal deficits threatened to emerge

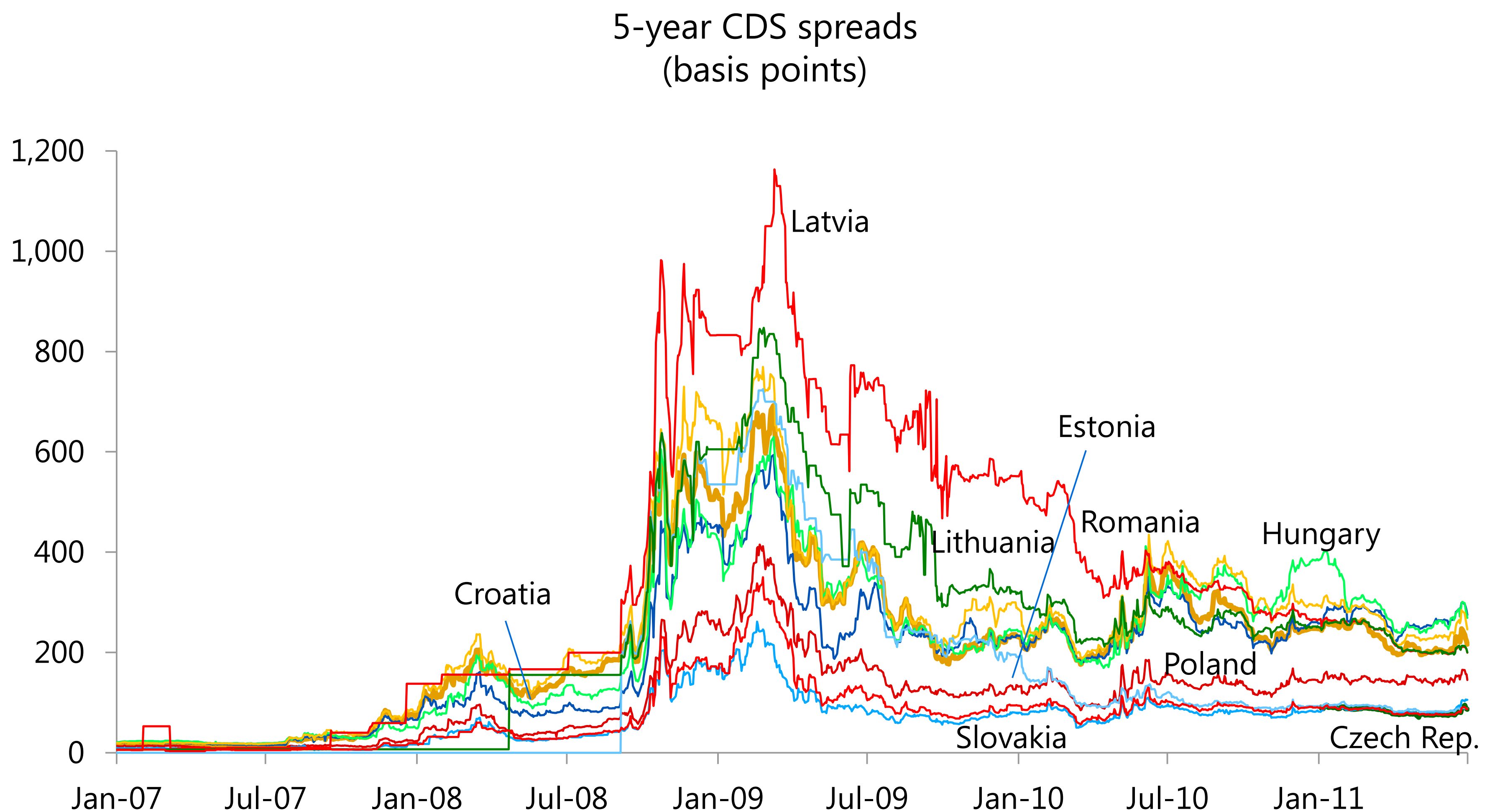


Note: 5-yr CDS spreads at 600 basis points translate into 10 percent probability of default over the next 5 years, assuming 40 percent recovery rate.

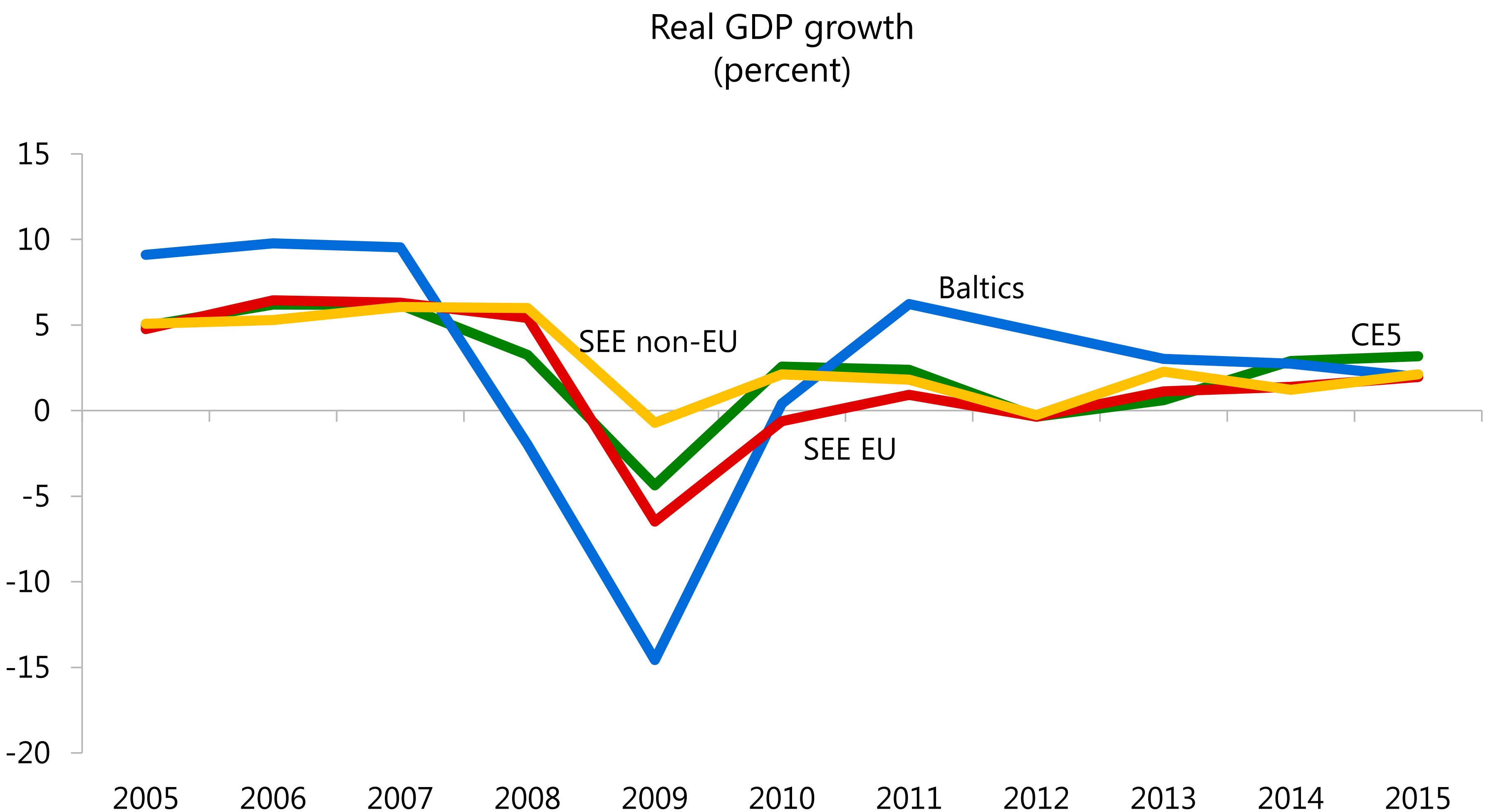
Some countries took very strong measures to contain rise in deficits



Crisis was deep, but by late 2009, CDS spreads in Eastern Europe had come down sharply



Growth turned positive in 2010, and crisis seemed over.

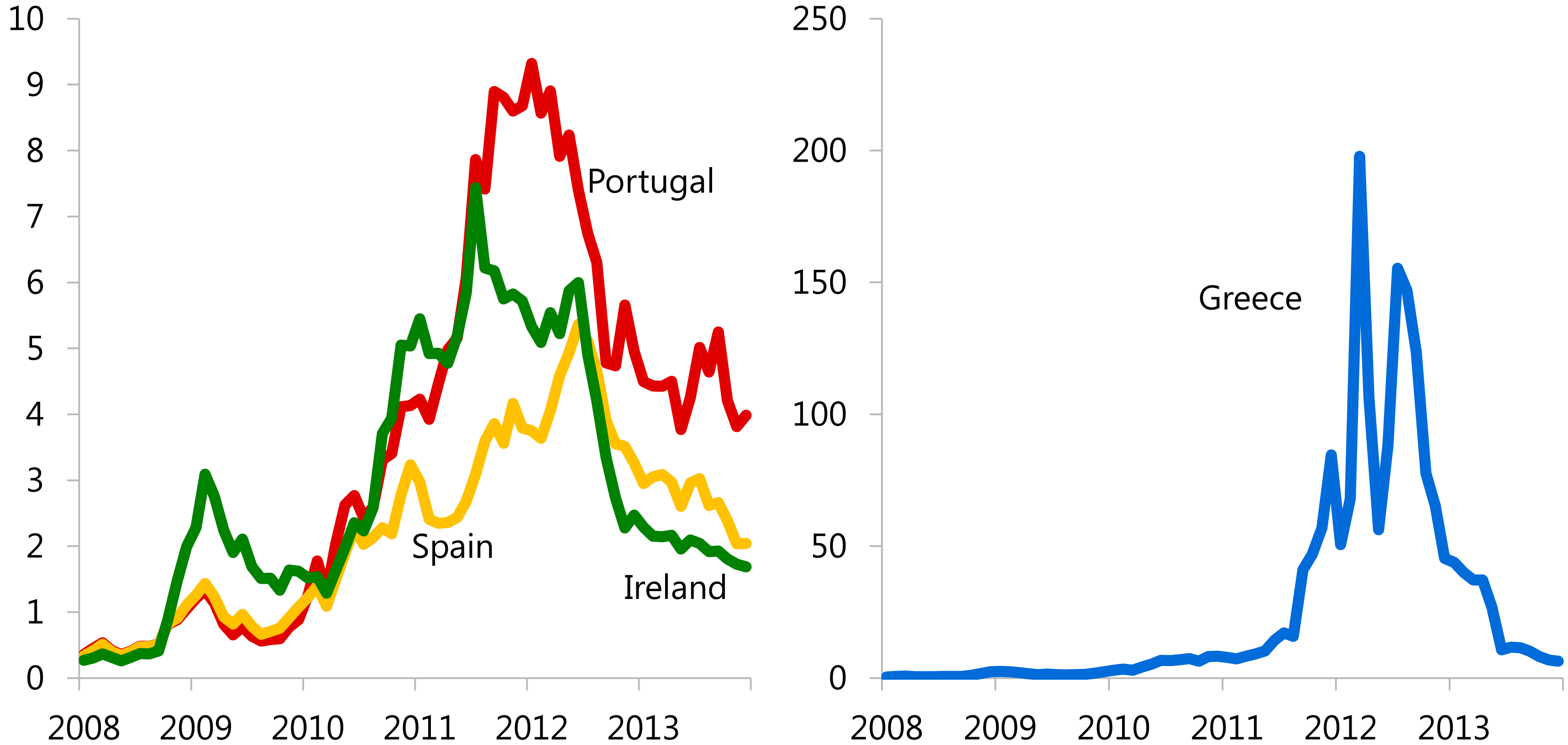


Note: Unweighted averages.

The Euro Area Crisis and Beyond

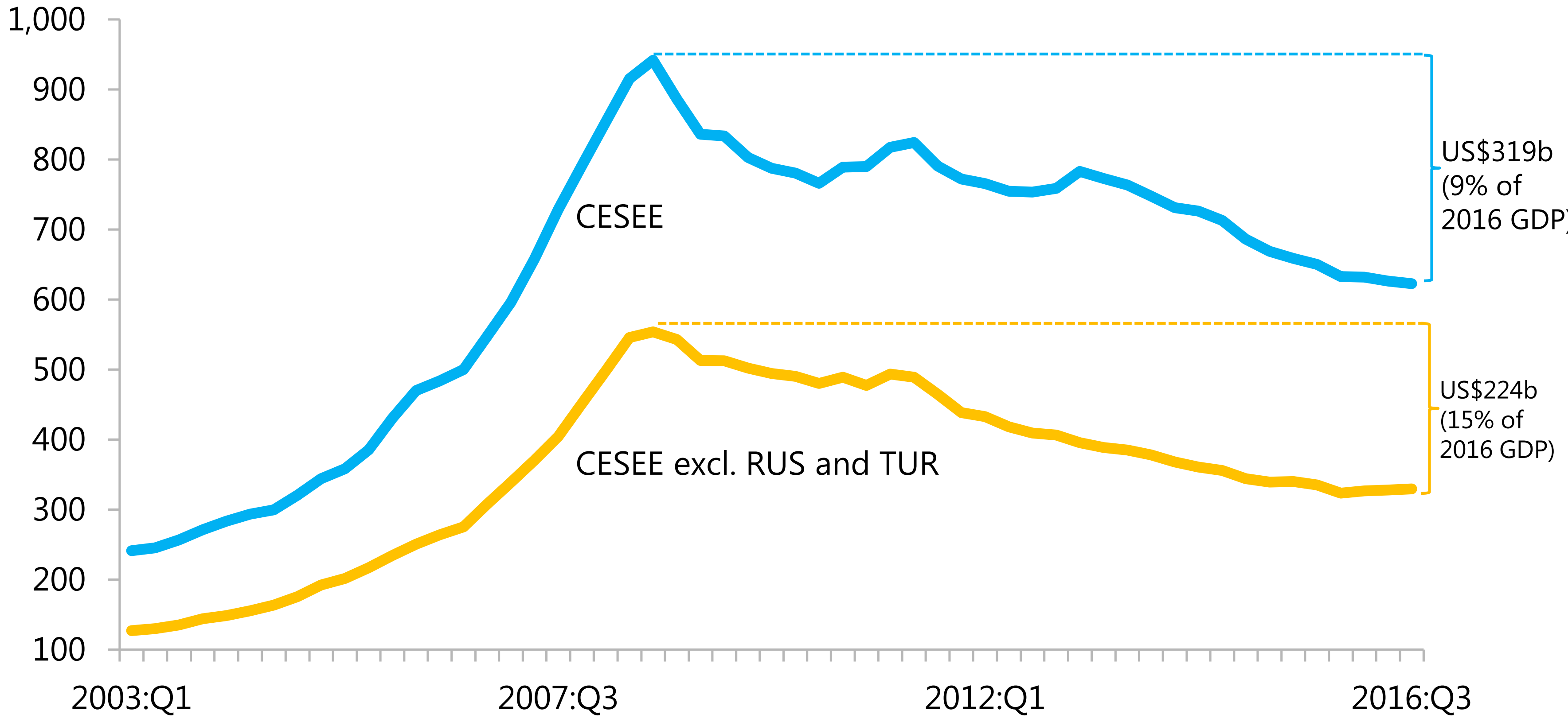
Then euro area crisis broke

10-year Government Bond CDS spreads
(Percent)

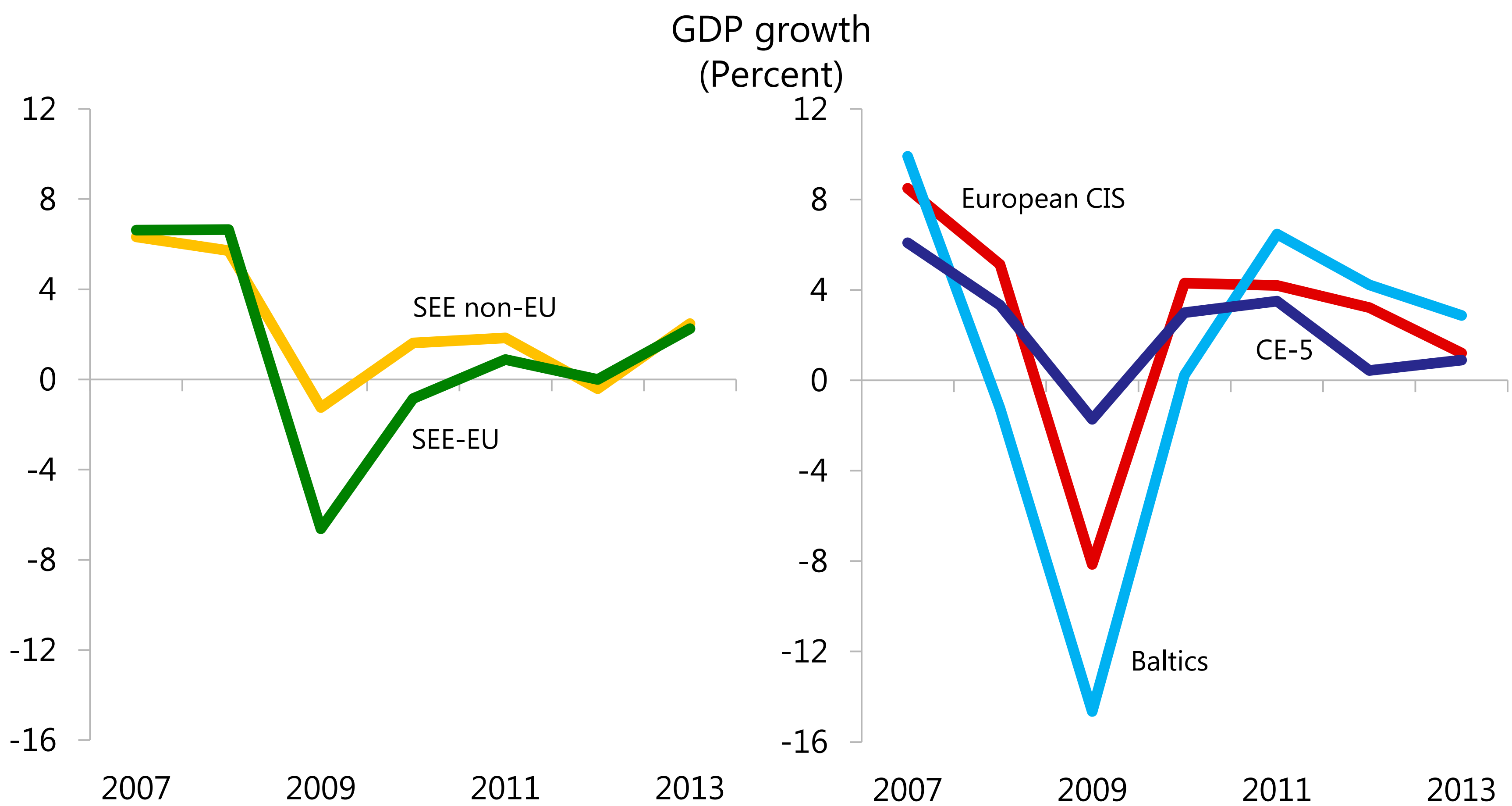


Bank deleveraging resumed

Bank's external claims on all sectors
(billions of USD, FX change adjusted)



CESEE's economy experienced another downturn

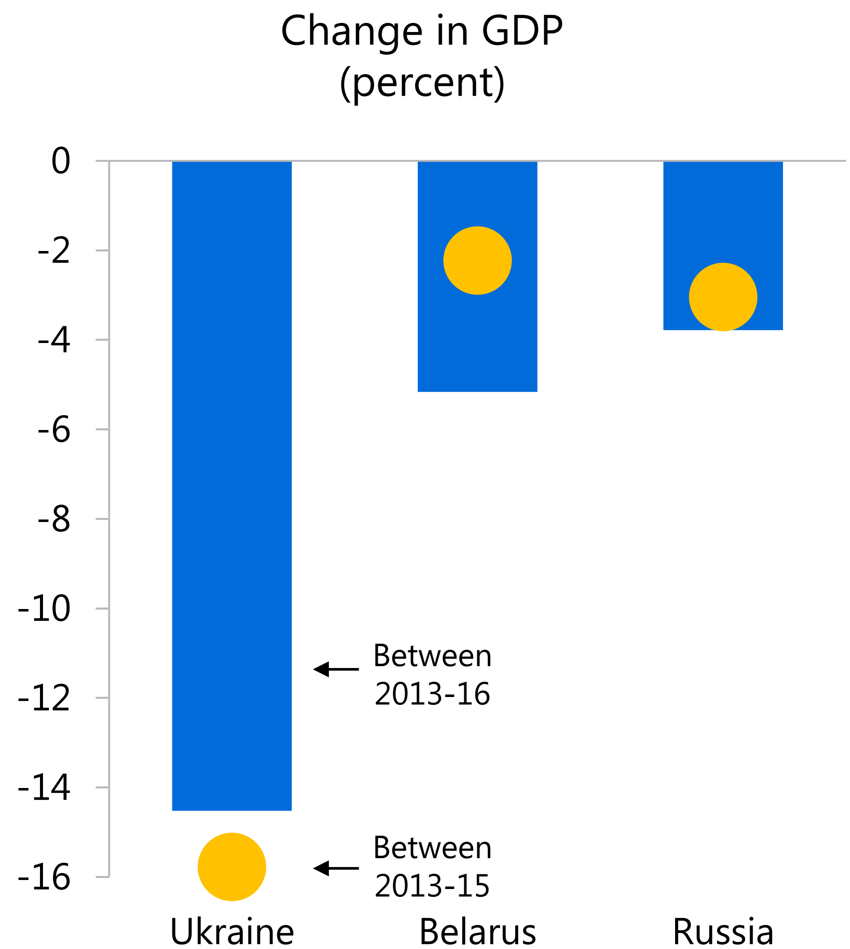


Many SEE countries asked for IMF assistance

SEE countries with IMF program, 2011-16

In 2014-16 CIS was hit by recession

- Collapse of commodity prices
- Sudden stop in capital flows to Russia, result of sanctions on Russia
- Conflict in Ukraine

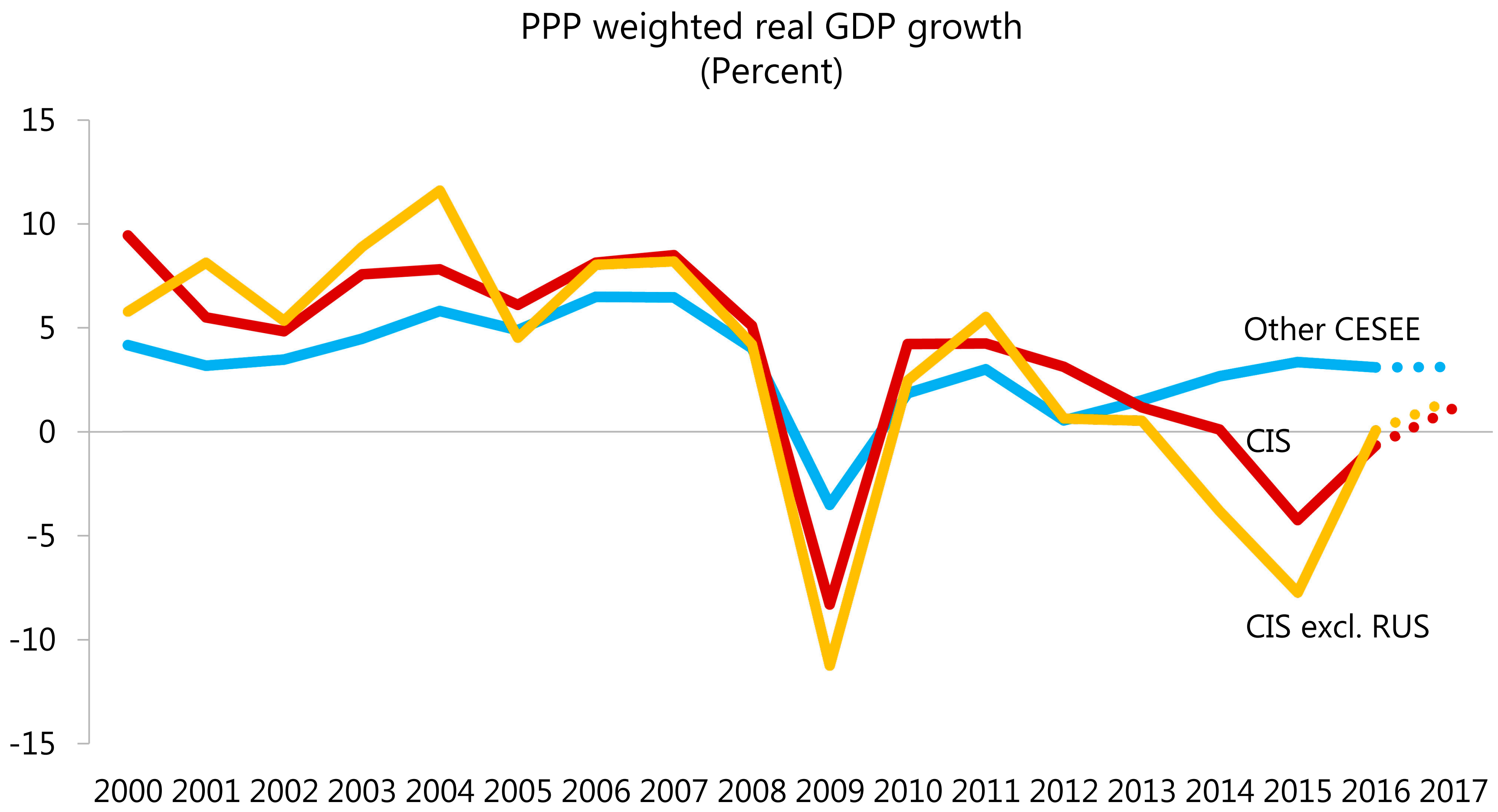


Moldova and Ukraine got help from the IMF

European CIS countries with
Extended Fund/Credit Facility program in 2016

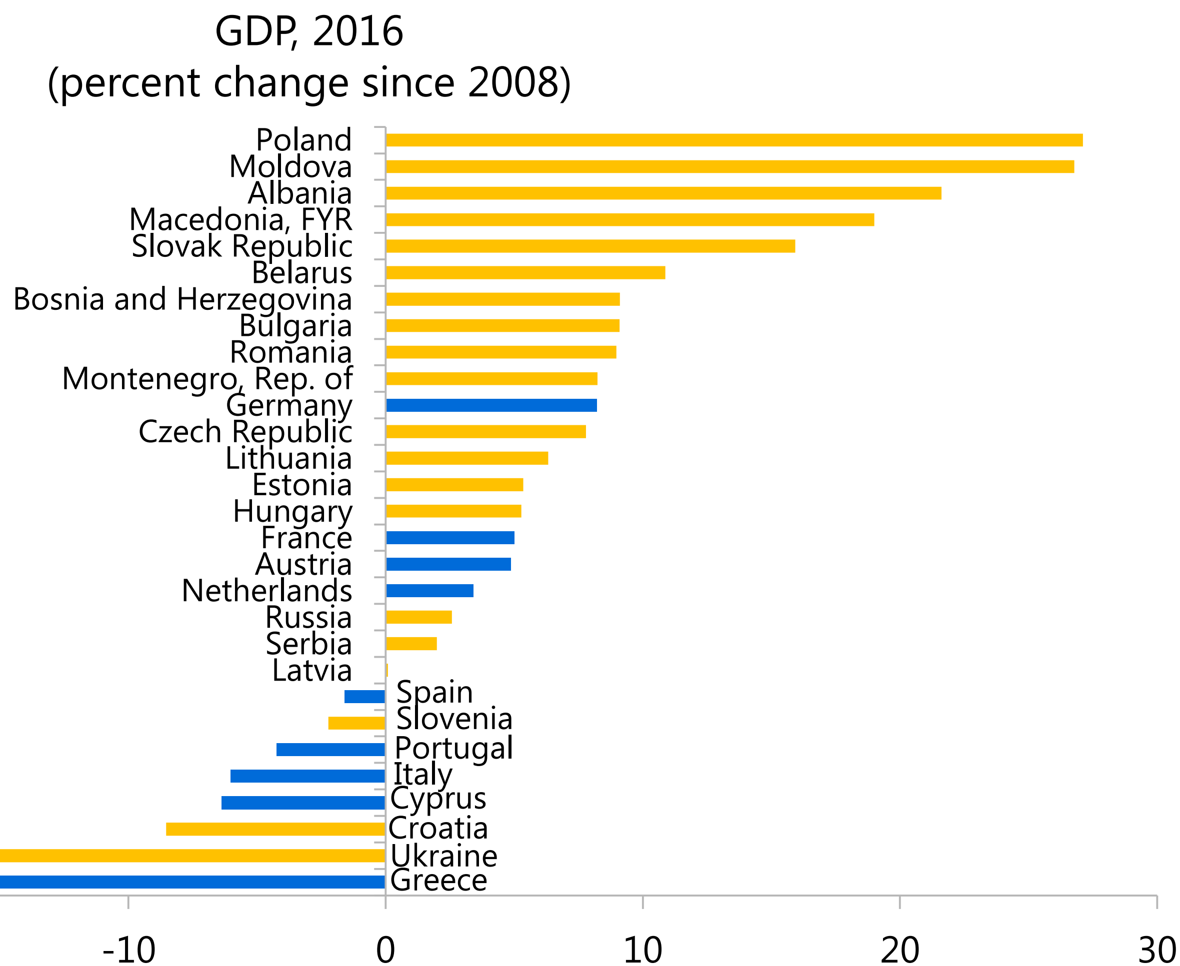
Note: UKR had a Stand-By Arrangement program in 2014-15.

CIS is now recovering; growth in non-CIS CESEE continues to be strong

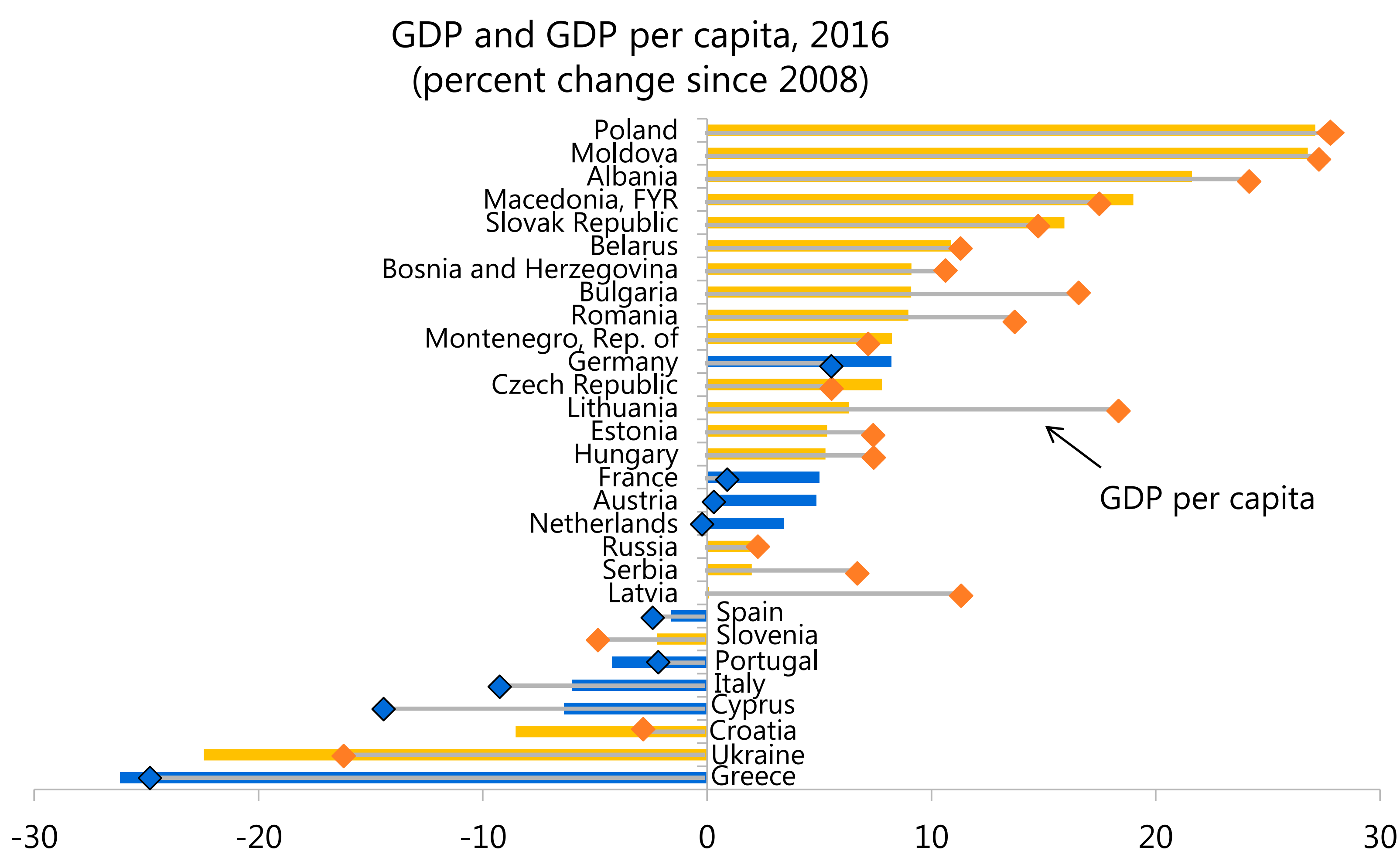


Crisis Legacies and Future Challenges

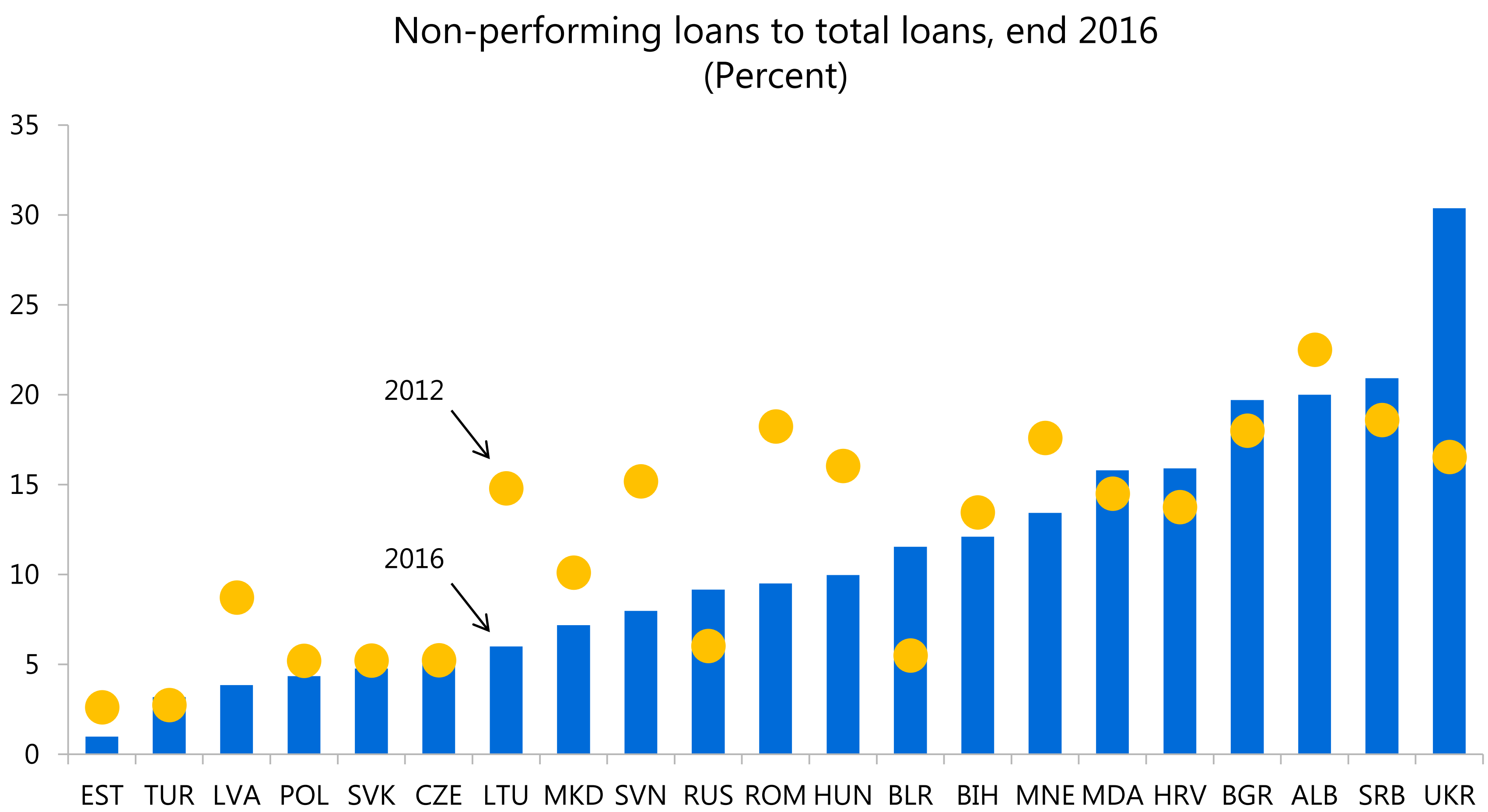
The crisis was deep, but most countries have recovered to above pre-crisis levels (unlike the euro area periphery)



In per capita terms, growth has been faster—although of course tepid by pre-crisis standards



Crisis legacies remain: high NPLs (especially in SEE and UKR)

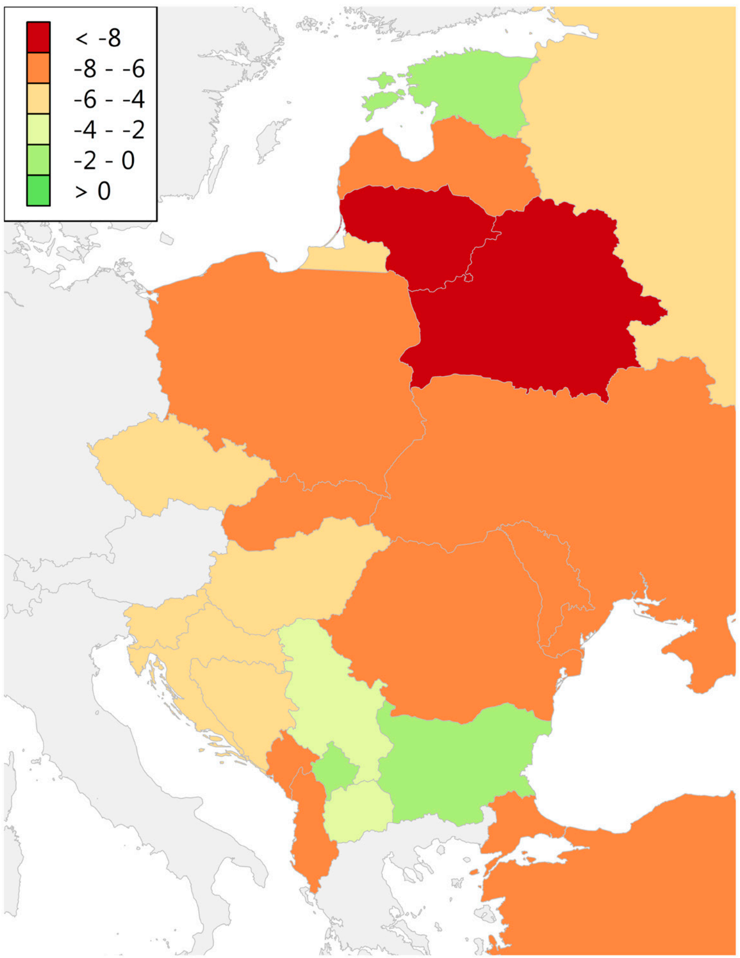


Note: for MNE data for 2012 and 2015.

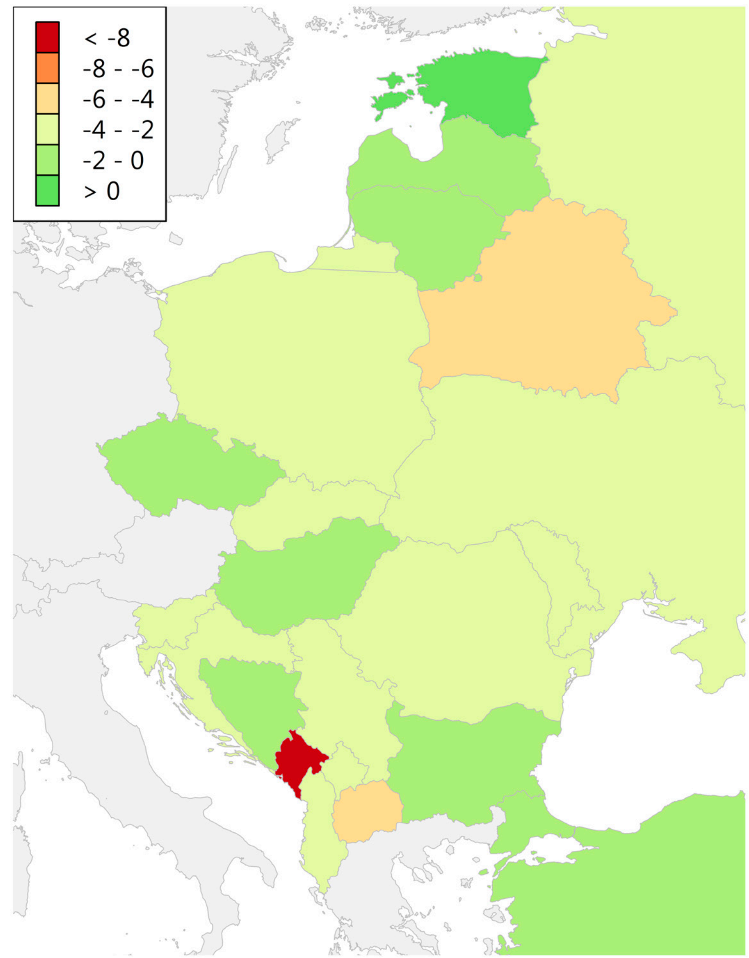
Fiscal deficits have declined to more modest levels…

Fiscal balance
(Percent of GDP)

In 2009



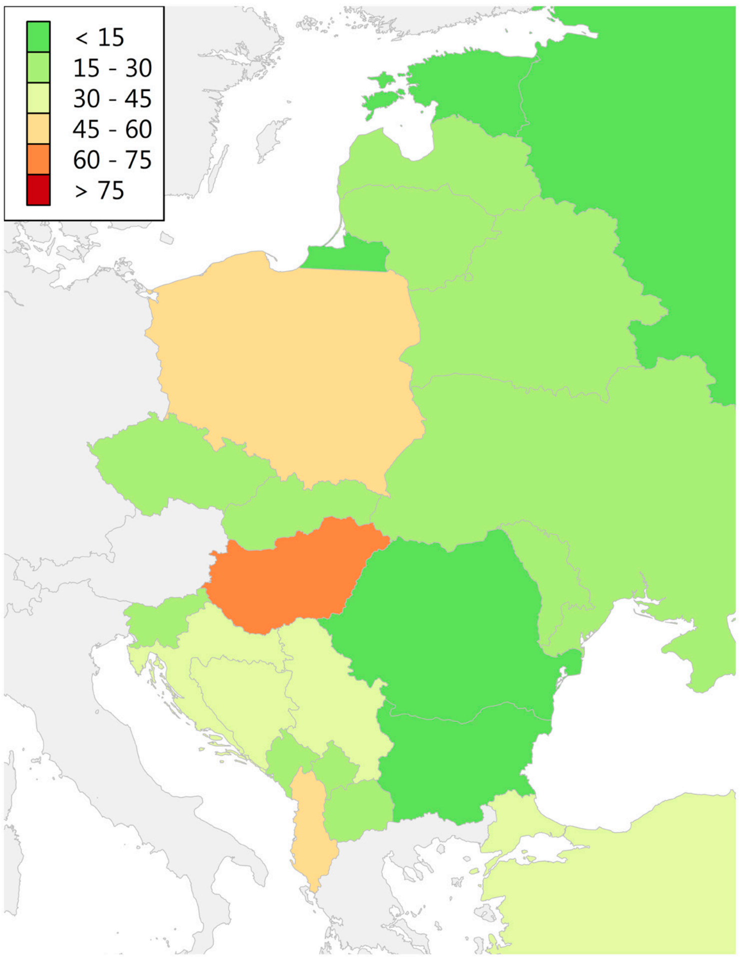
In 2016



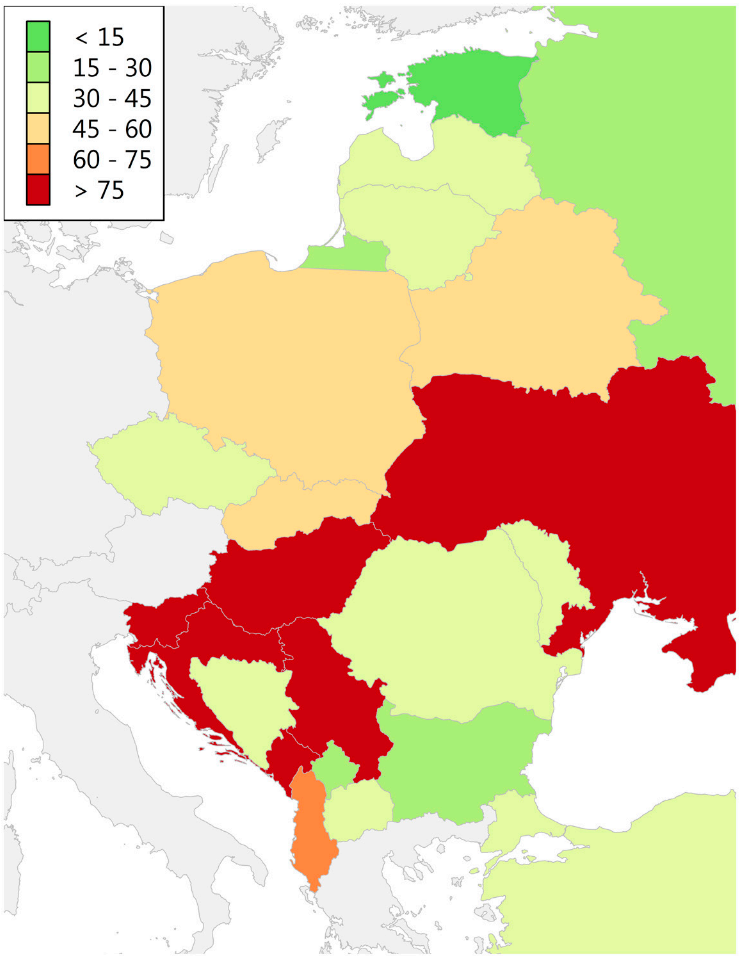
But public debt is no longer low

Public debt
(Percent of GDP)

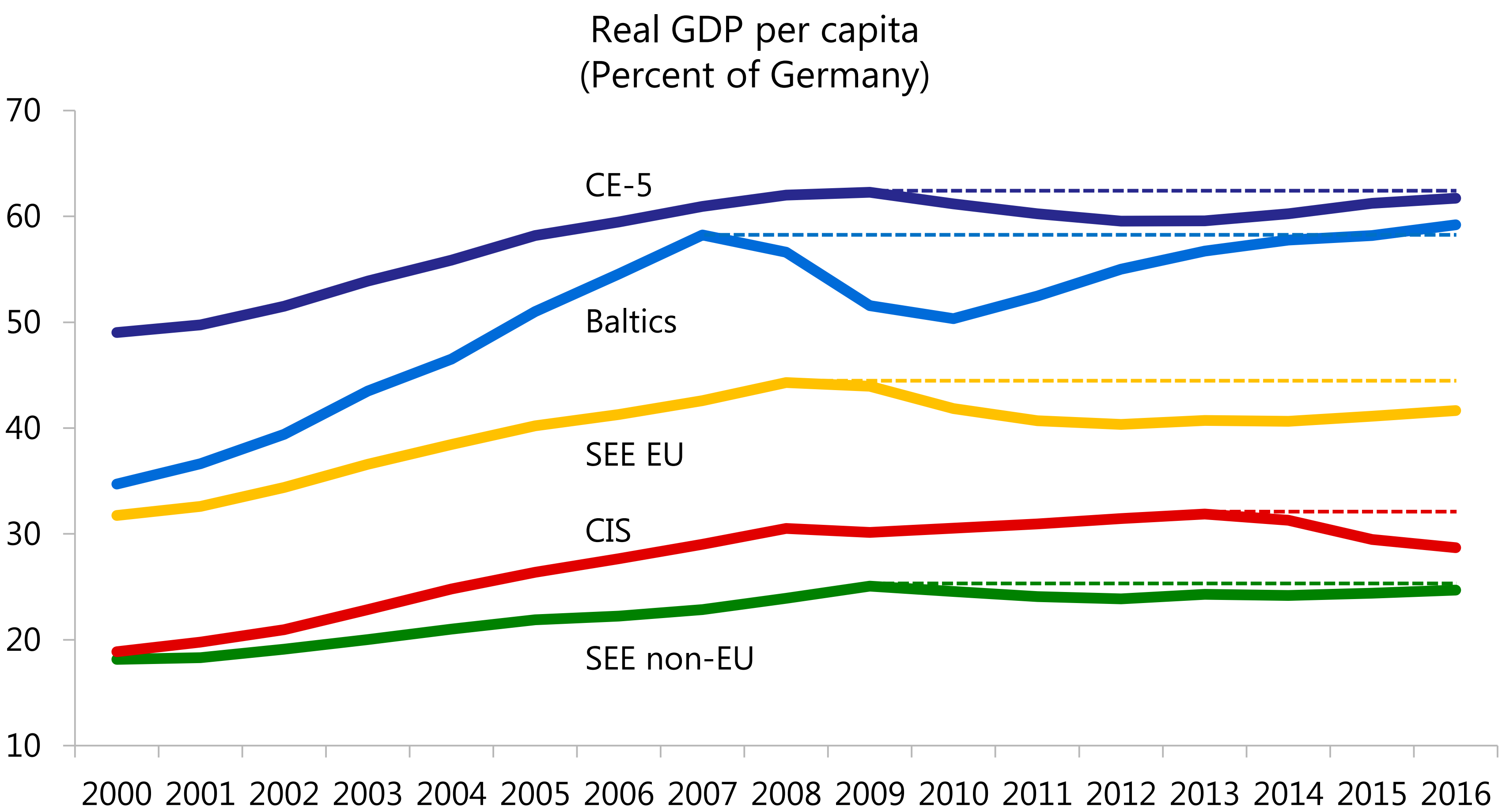
In 2008



In 2016

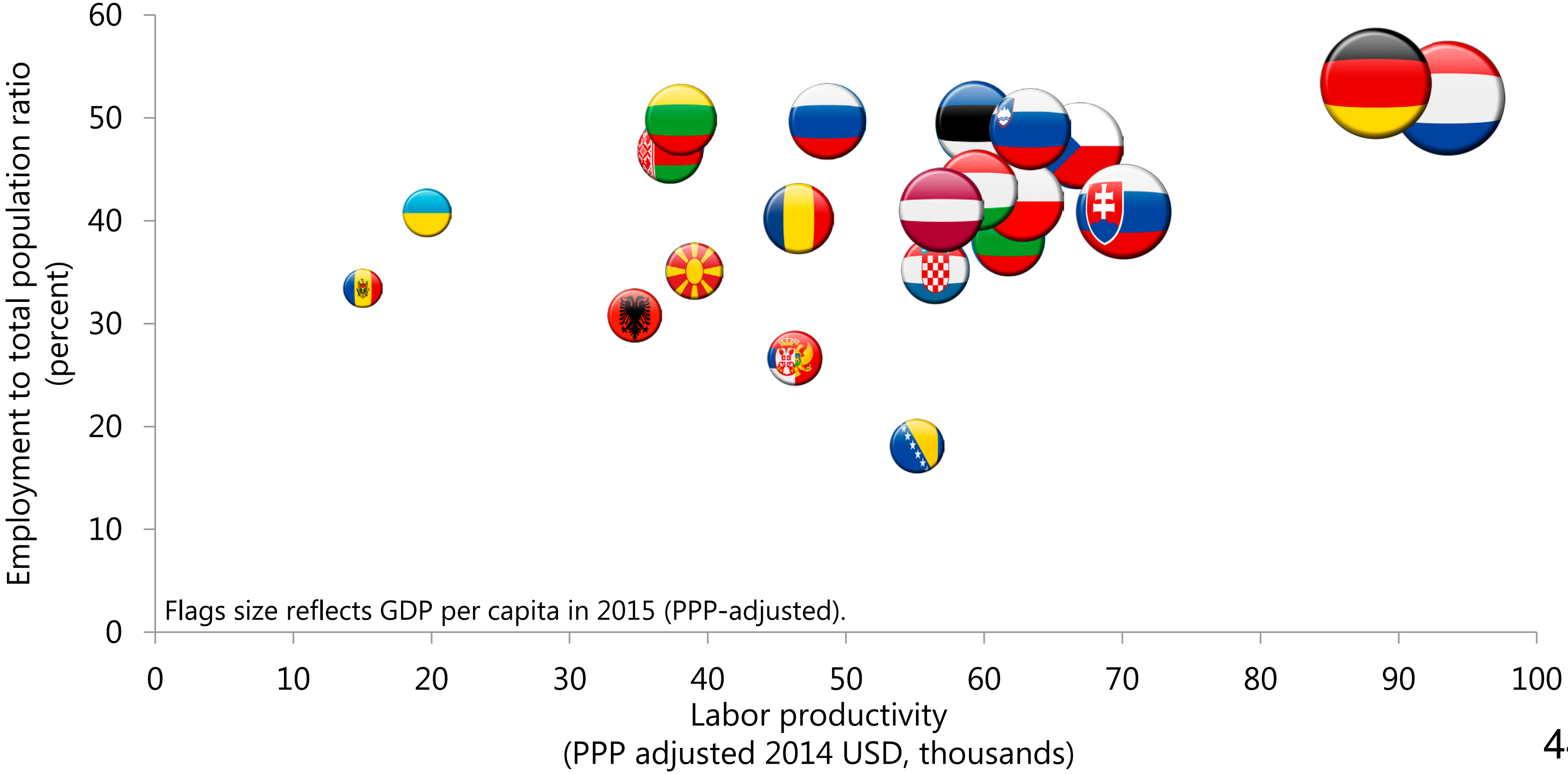


Another challenge: convergence has slowed



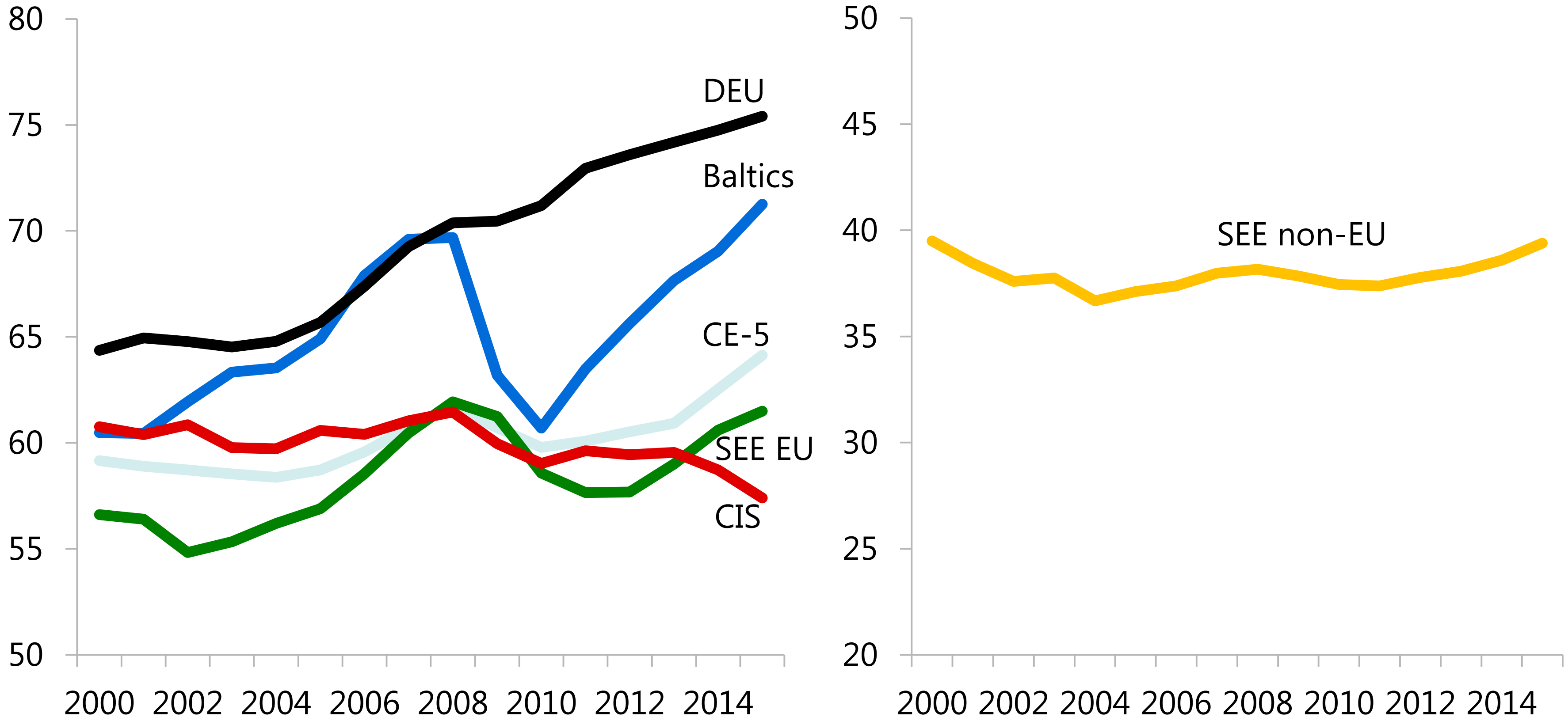
Further convergence will require both higher labor *input* and labor *productivity*

Labor productivity and employment to total population ratio, 2015



Employment rates are still well below Germany—with the exception of Baltics

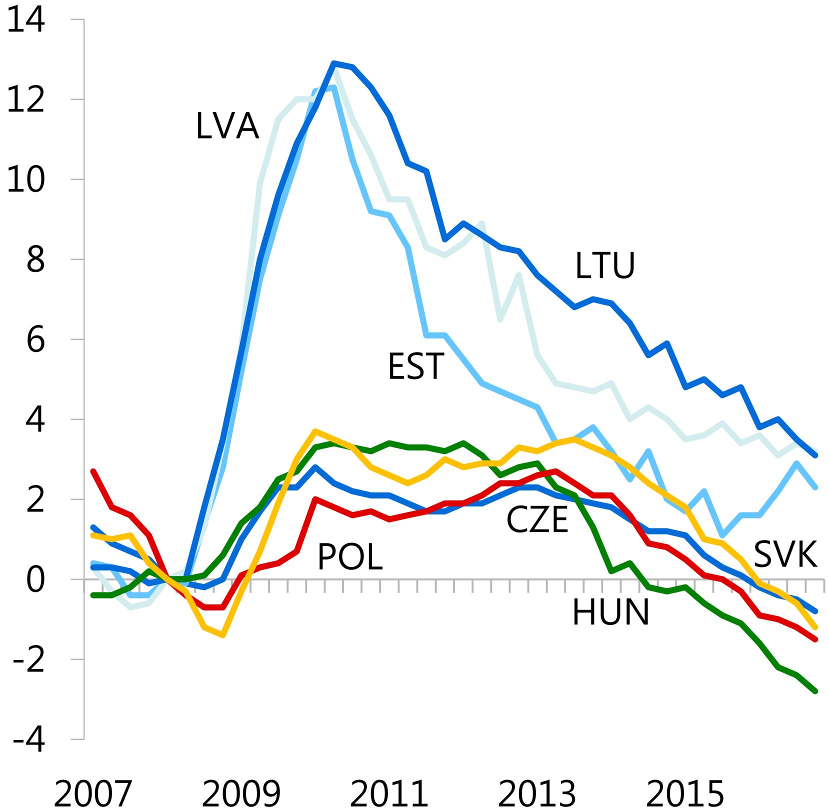
Employment rate
(percent)

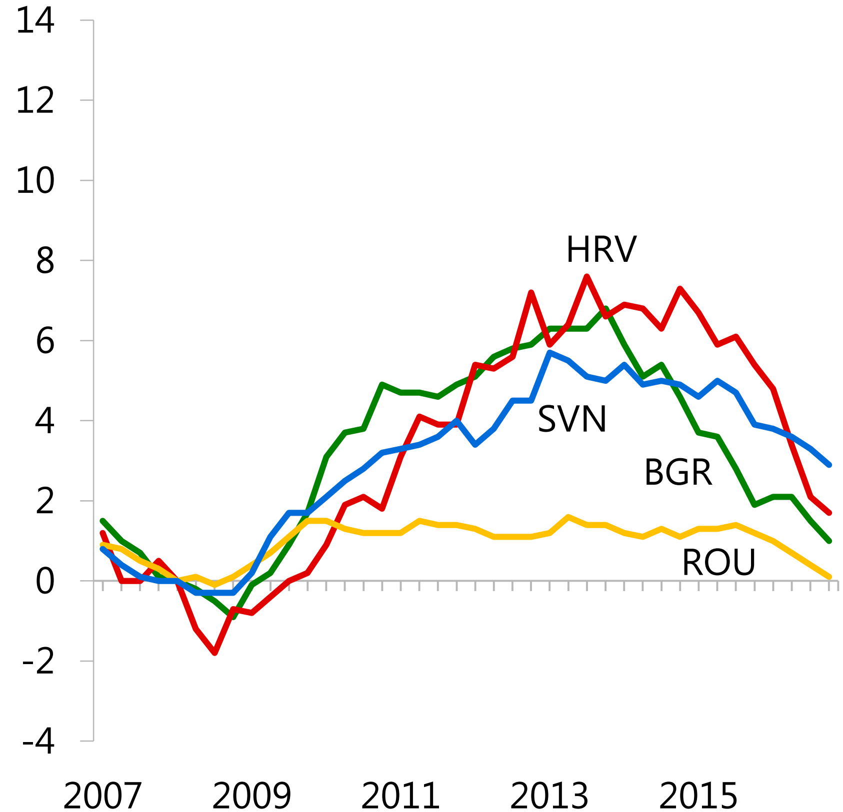


Note: Simple average of given countries.

It will be hard to raise labor input by reducing unemployment...

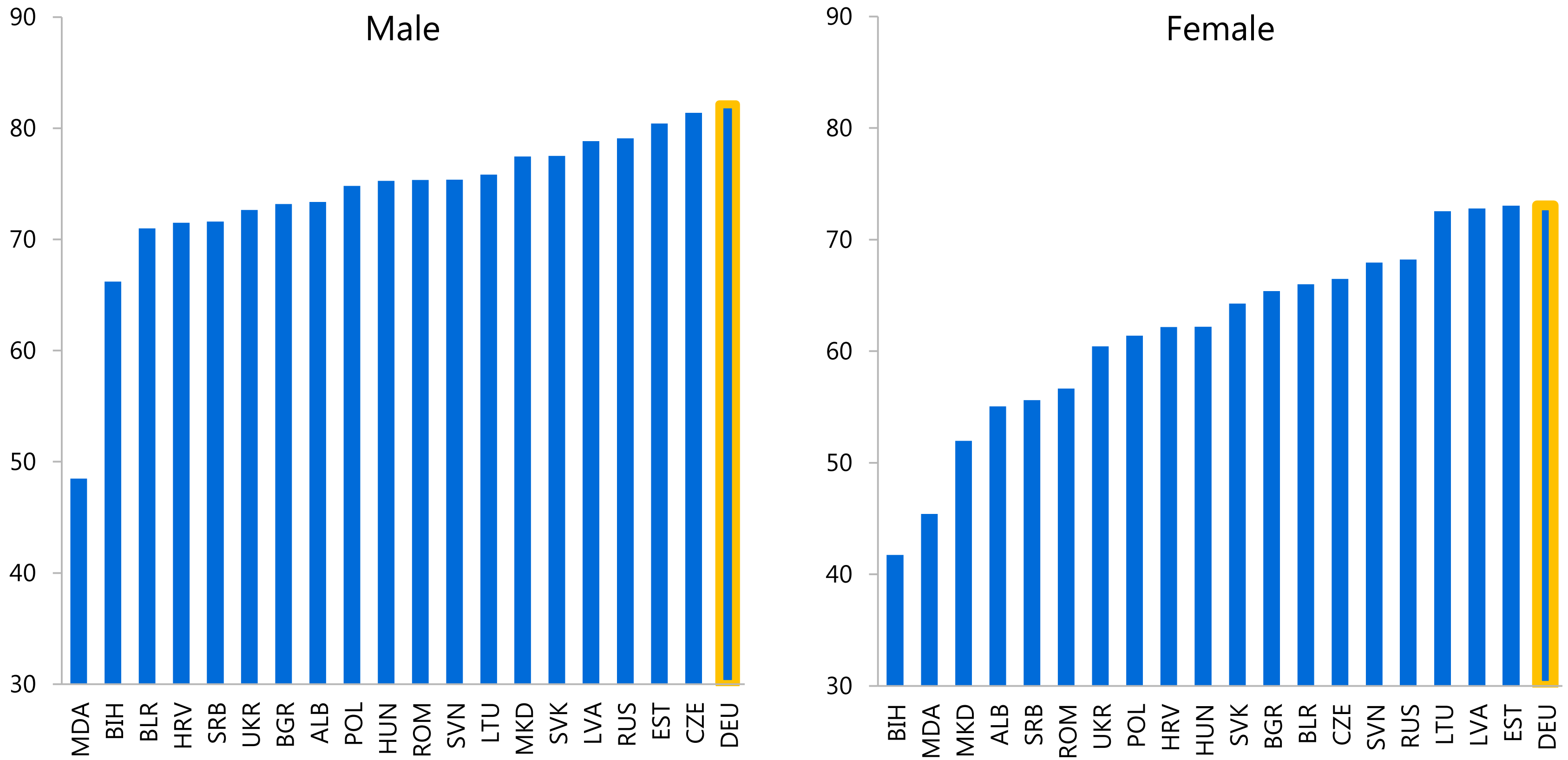
Cumulative changes in unemployment rate
(2008Q1=0, seasonally adjusted)





Labor force participation will need to rise, including of women

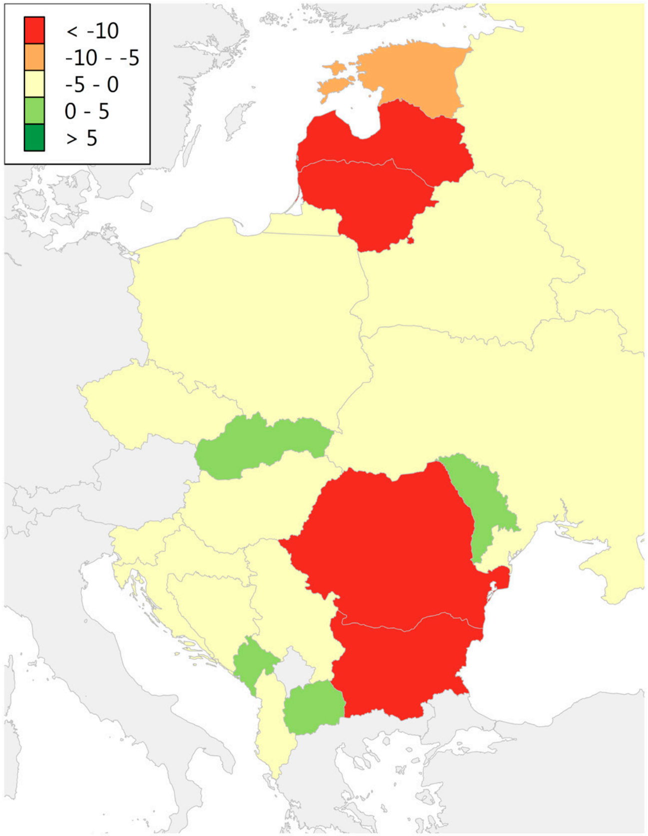
Labor force participation rate, 2015
(percent of either male or female population ages 15-64)



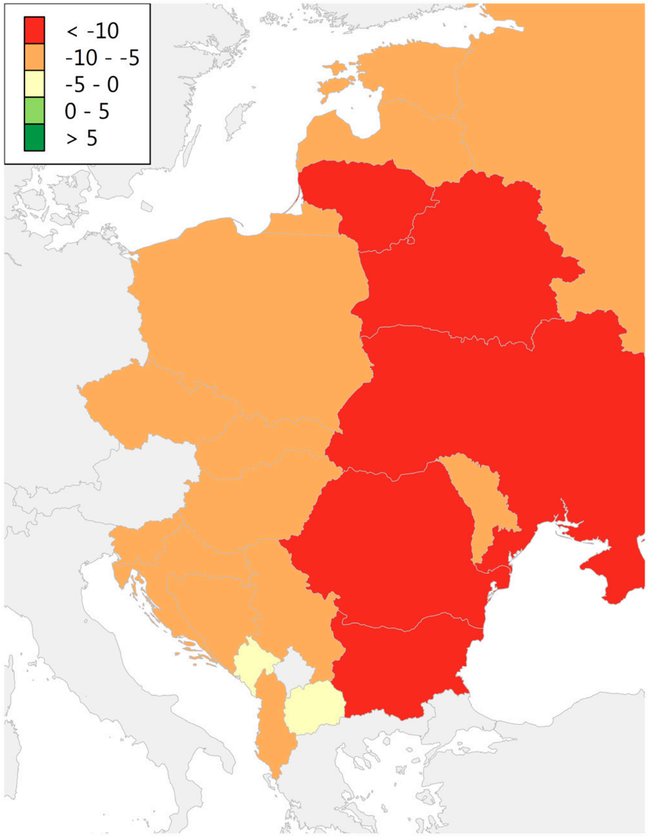
This is also needed to compensate for impact of aging

Working age (15-64) population growth
(percent)

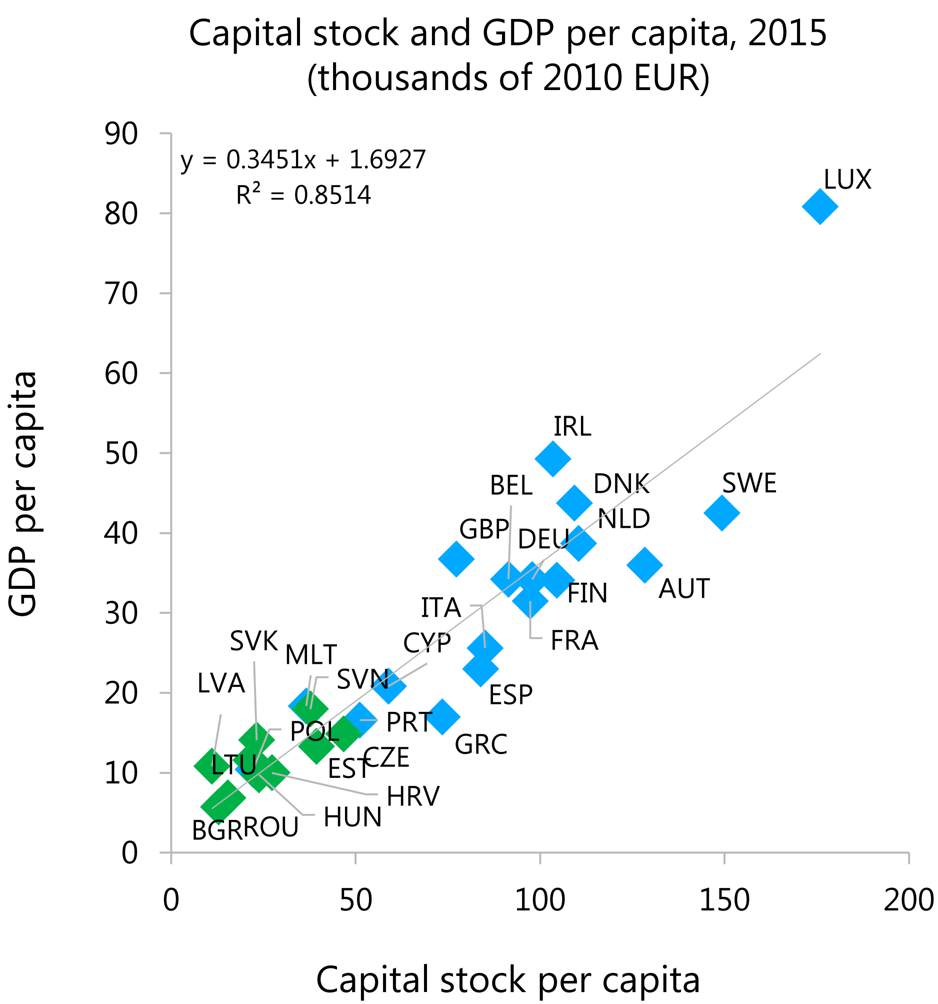
2005-15

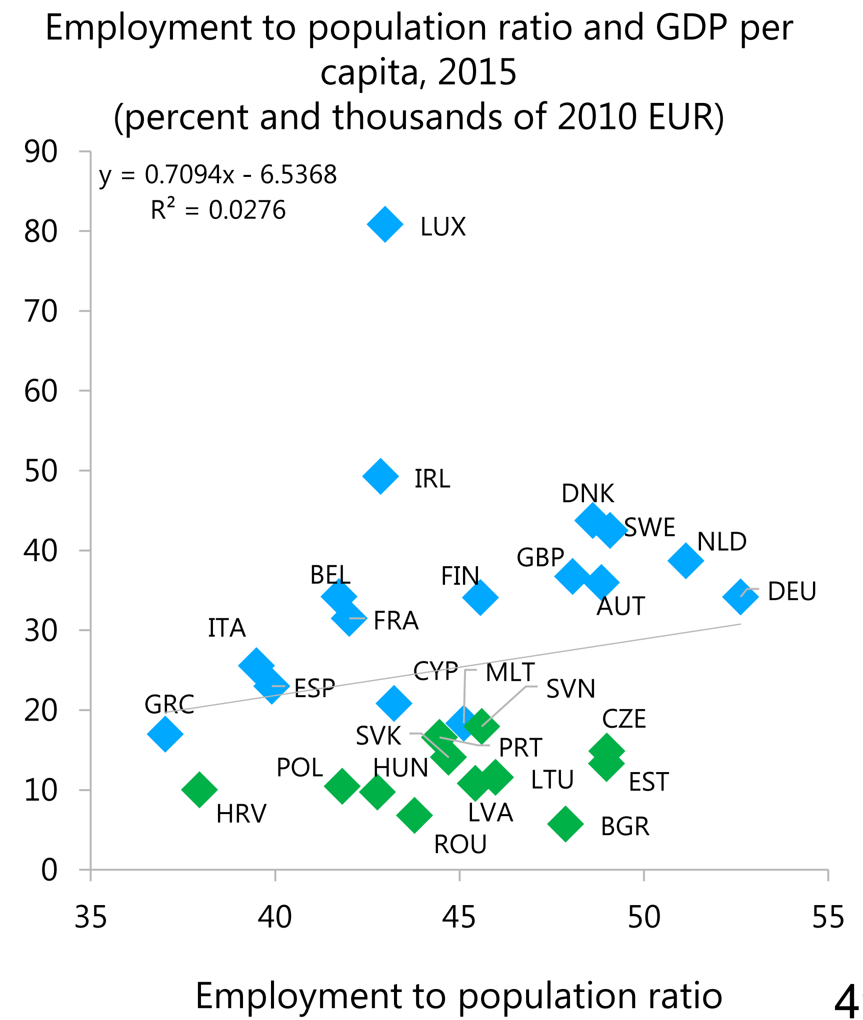


2015-2025

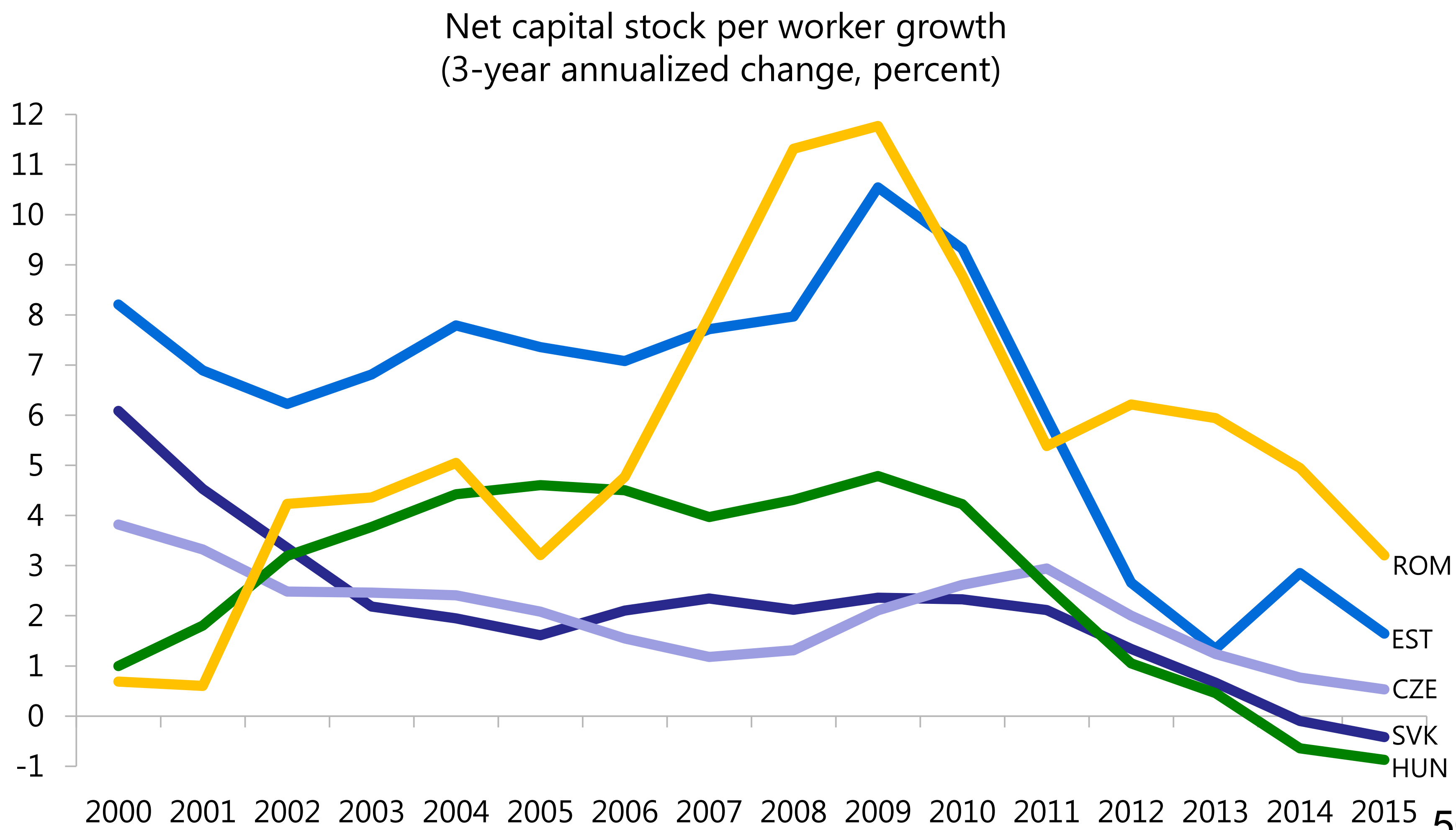


While higher labor input will help, higher capital stock and thereby labor productivity may be even more important

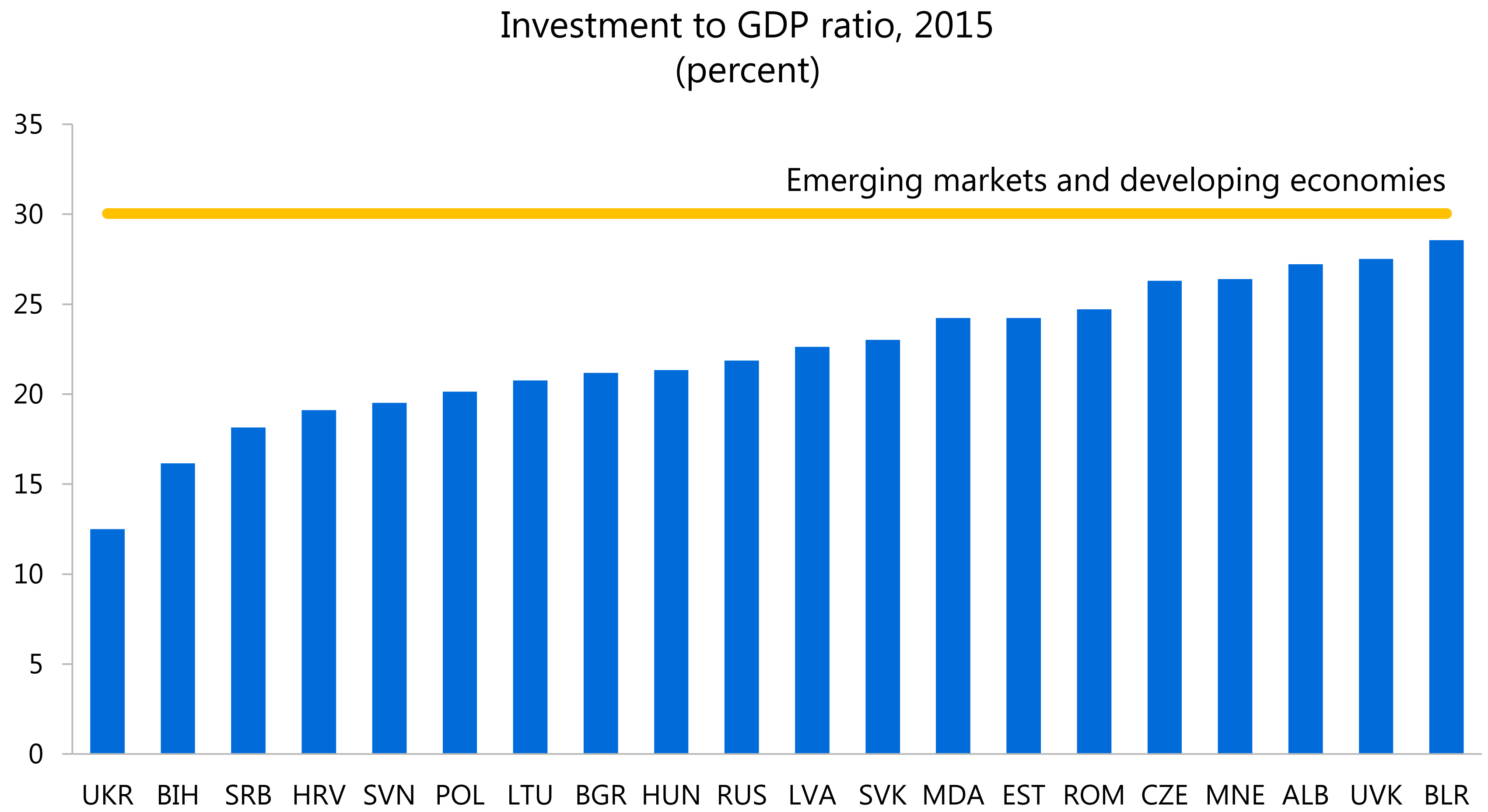




However, growth of capital stock has slowed...

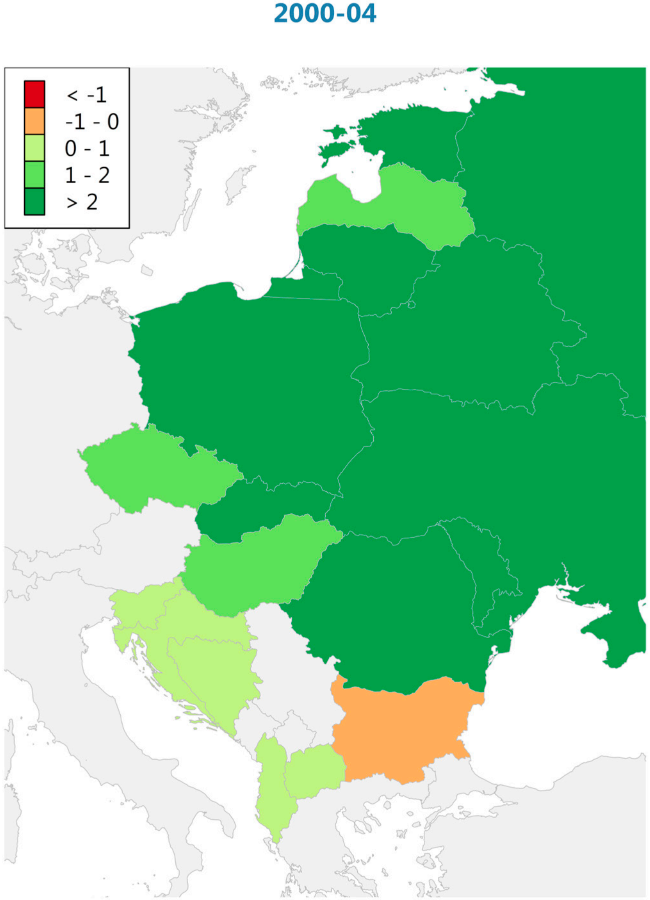


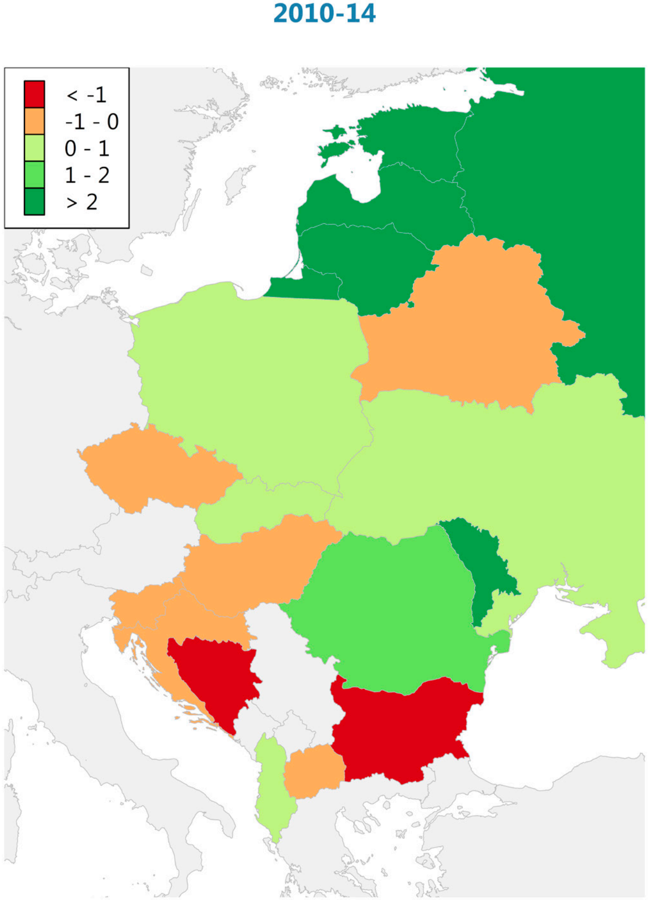
...as investment rates post-crisis are (too) low.



Low investment not only problem: TFP growth has slowed as well

Average total factor productivity growth
(percent)





So what should be done?

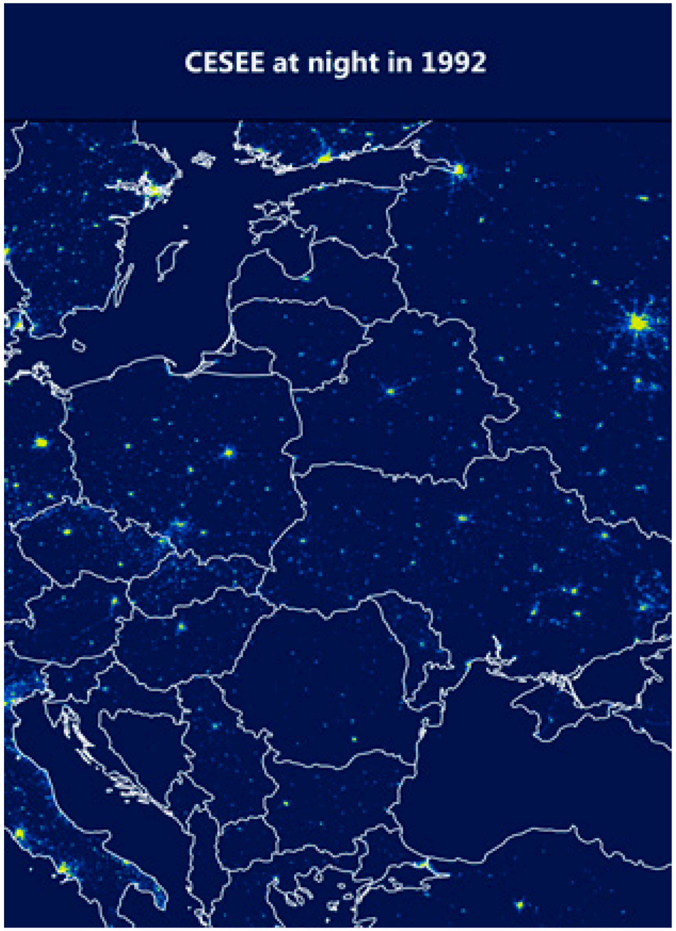
Address factors that might constrain productivity (REI May-16)

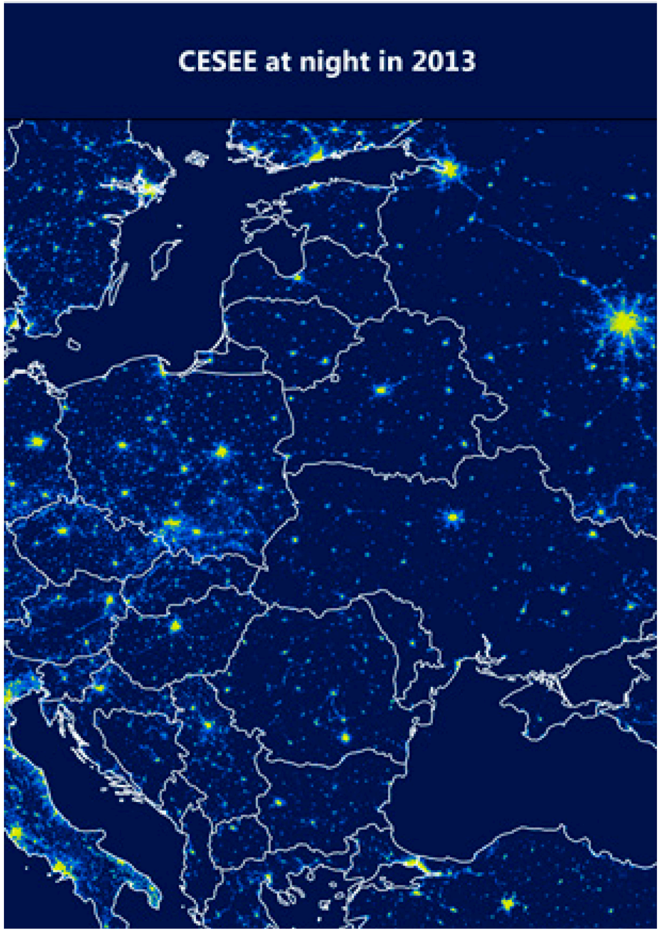
- Insufficient protection of property rights and
- Inefficient legal systems and other government services
- Limited access to financial services (e.g. for SMEs)
- Infrastructural gaps

Improve public investment management and tax administration (REI Nov-16)

- Closing efficiency gaps in public investment and tax collection could bring sizable benefits.
- Further upgrades of public investment management should focus on improving allocation and implementation frameworks and procedures.
- Improvements in tax administration should aim at reducing compliance gaps.
- Design of reforms should include elements that help reduce resistance to reforms and build the support base for their successful completion.

Despite these challenges, we should not lose track of big picture: in past 25 years, region has made tremendous progress





Thank you