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

Latest IMF arrangements by country

Note: Dashed pattern shows precautionary programs.

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...
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)

External position of BIS-reporting banks on all sectors (billion of USD, FX change adjusted)
...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

Annual increase of credit-to-GDP ratio

Annual increase of foreign-funding-to-GDP ratio

y = 0.6915x + 3.9528
R² = 0.5733
... which boosted domestic demand.

![Graph showing Domestic Demand and Private Sector Credit Growth, 2003–08 (Annual percentage change)](chart)

- Countries included: Albania, Belarus, Bosnia, Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Macedonia, Moldova, Montenegro, Poland, Romania, Russia, Serbia, Slovakia, Slovenia, Turkey, Ukraine, and Turkey.
...which led to high current account deficits and overheating economies

Current Account Deficit in 2008
(Percent of GDP in USD)

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

Real expenditure growth, 2003–08

Real domestic demand growth, 2003–08
The end of the domestic demand boom led to a sharp decline of revenue...

![Graph showing the change in domestic demand and tax revenues dynamics in 2009 recession.](image)
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

Discretionary fiscal measures, 2009–12
(Percent of GDP)
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.
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

CESEE excl. RUS and TUR

US$319b (9% of 2016 GDP)

US$224b (15% of 2016 GDP)
CESEE’s economy experienced another downturn
Many SEE countries asked for IMF assistance
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)

Non-performing loans to total loans, end 2016 (Percent)

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
Another challenge: convergence has slowed.
Further convergence will require both higher labor *input* and labor *productivity*.
Employment rates are still well below Germany—with the exception of Baltics.

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)
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 the big picture: in past 25 years, region has made tremendous progress.
Thank you