Lessons from the Crisis in Emerging Europe

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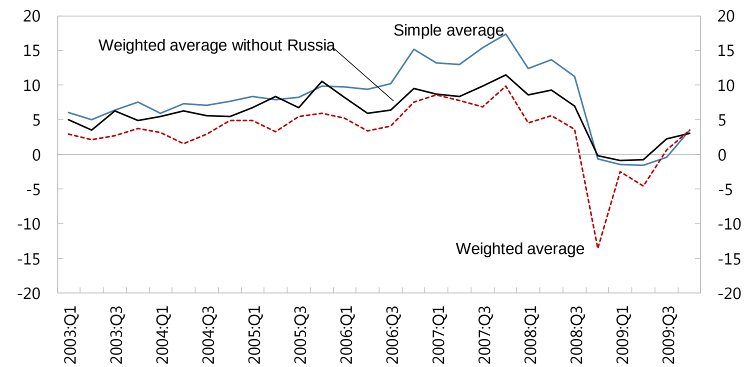
The 2008/09 crisis in CESEE was *triggered* by the global economic and financial crisis

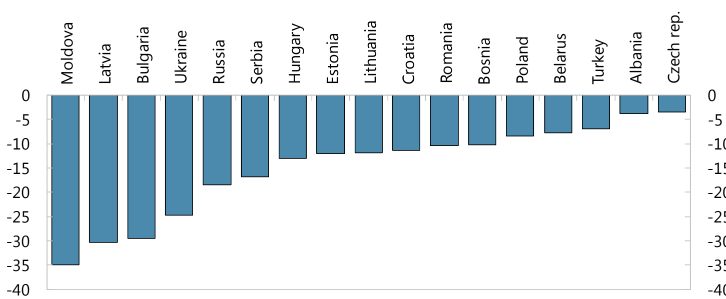
- Sudden stop of capital flows to Emerging Europe after Lehman Brothers
- Collapse of global trade flows, as worldwide recession ensued

Emerging Europe: 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.

Emerging Europe: Reduction of Net Capital Flows during the Crisis of 2008–09[1]

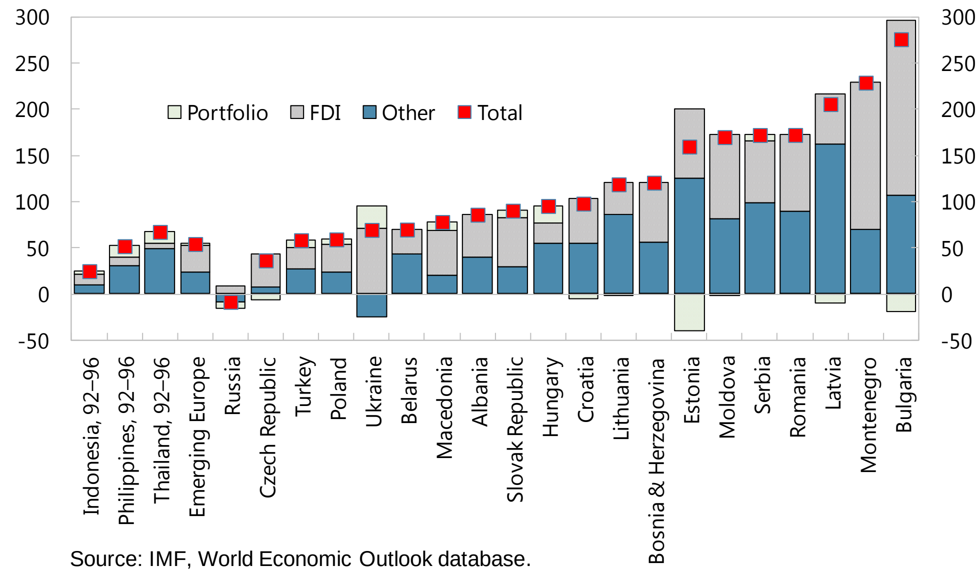


Sources: IMF, *International Financial Statistics* and World Economic Outlook database.
[1]Net capital flows are measured as the financial account balance, excluding reserve assets and IMF and EU balance of payment support, plus errors and omissions. Change shown is the maximum reduction of capital flows as a percent of GDP during 2008–09. Quarterly data are

The *root* of the crisis was in the imbalances that built up during the pre-crisis boom years

- Between 2003 and 2008, emerging Europe received large capital inflows

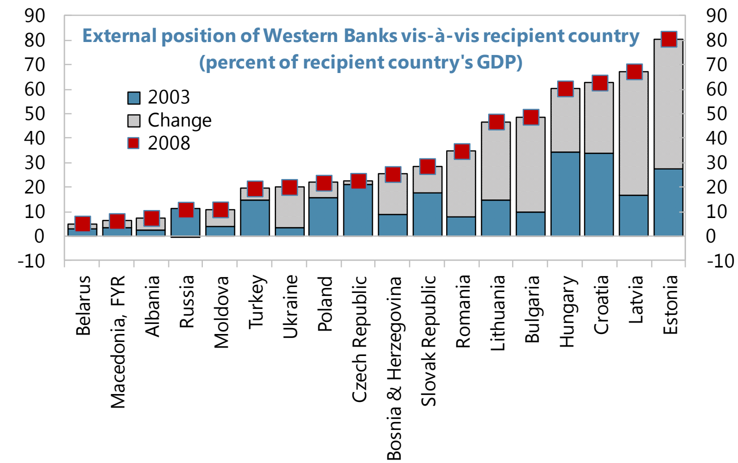
Emerging Europe: Cumulative Net Capital Inflows, 2003–08[1]
(Percent of 2003 GDP)



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 in percent of 2002 GDP.

Much of the capital flows came from Western European banks

- Western banks expanded aggressively
- Provided loans, deposits and capital to their subsidiaries
- Credit-to-GDP ratio increased sharply

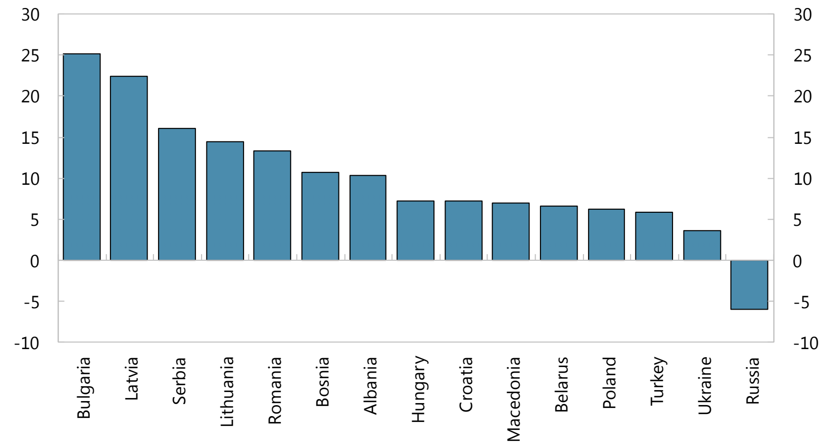


Emerging Europe: Change in Ratio of Private Sector Credit to GDP, 2003–08
(Percentage points)

Result was rapid GDP growth, but flipside rising imbalances

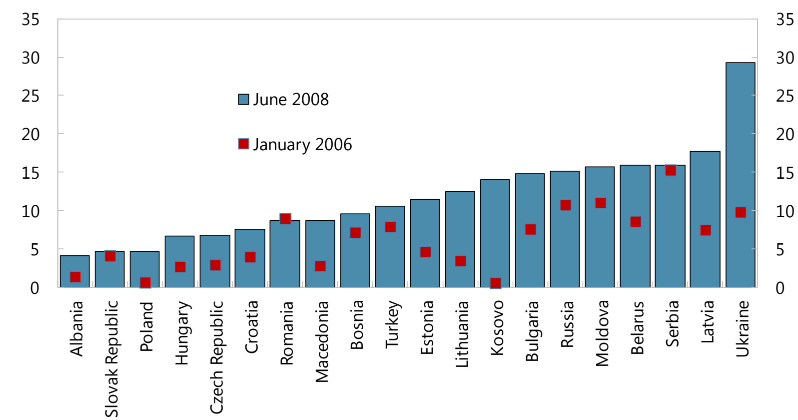
- Booming housing prices and rising inflation
- Large current account deficits, especially in the Baltics and the Balkans
- Unbalanced growth, with booming nontradable sector

Emerging Europe: Current Account Deficits, 2007
(Percent of GDP)



Sources: IMF, WEO Database

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

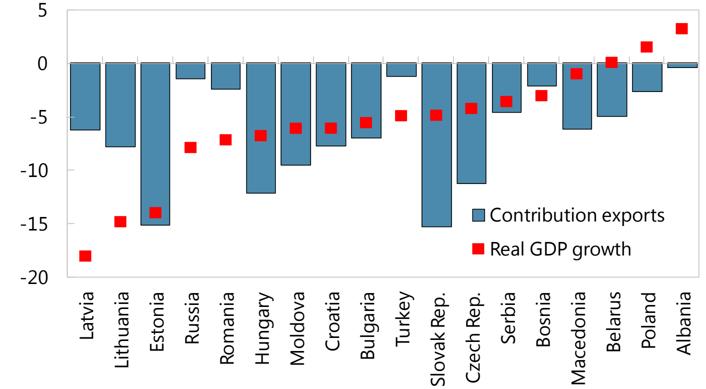


Source: Haver Analytics.

When the global crisis hit, boom turned into deep bust

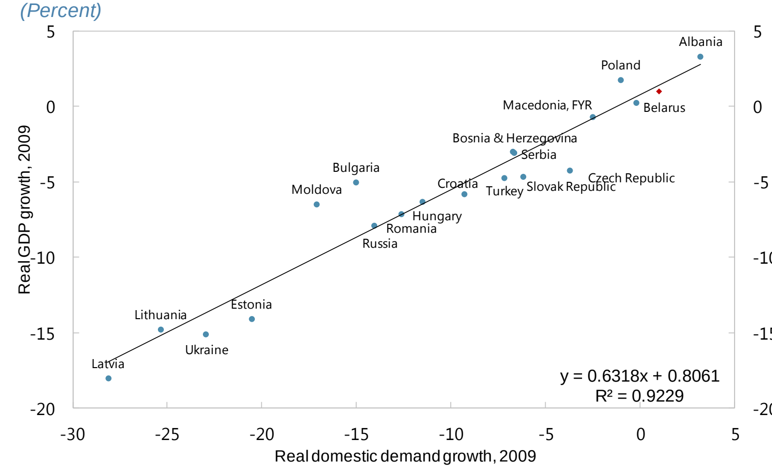
- Sharp drop in exports
- Large drop in domestic demand as credit booms stopped
- Countries with the strongest credit booms now saw sharpest drop in domestic demand and deepest recessions

Emerging Europe: Contribution of Exports to Real GDP Growth, 2009



Sources: World Economic Outlook Databse

Emerging Europe: Real Domestic Demand Growth and Real GDP Growth, 2009
(Percent)

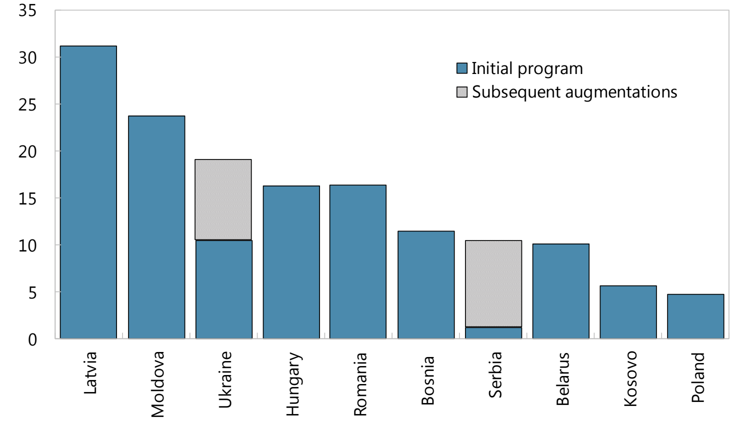


Source: World Economic Outlook database.

Crisis was deep, but banking and currency crisis have been largely avoided

- Systemic banking crises only in Ukraine and Latvia
- Fixed exchange rate regimes weathered the crisis (except Ukraine and Belarus)
- Decisive domestic policy responses key
- But also
  - Large financing packages (including from IMF and EU)
  - Commitment of foreign banks to stay in the region

Selected Countries: Financing Packages Under IMF-Supported Programs
(Percent of GDP in arrangement's year of approval)

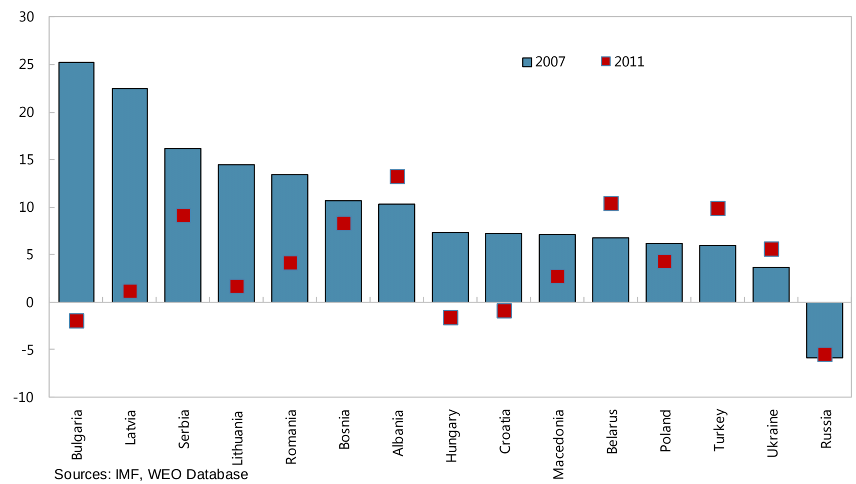


Source: IMF staff calculations

Growth has resumed, and region has adjusted

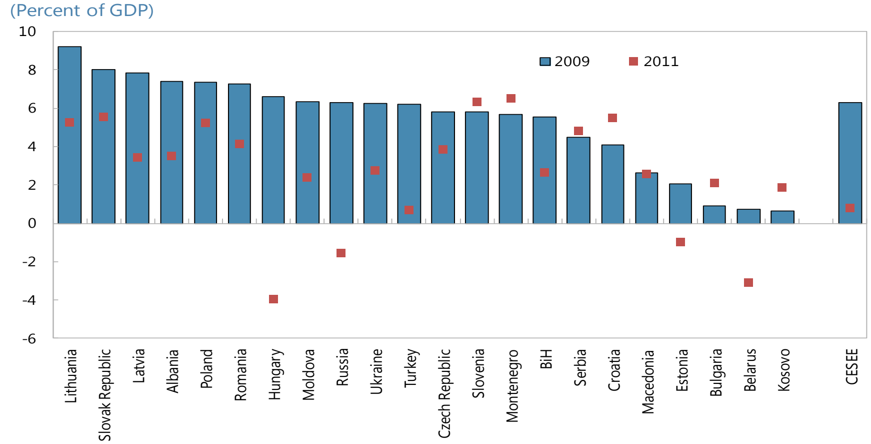
- High current account deficits have come down
- Large fiscal deficits that emerged post-crisis have been reduced

Emerging Europe: Current Account Deficits
(Percent of GDP)



Sources: IMF, WEO Database

Emerging Europe: General Government Deficit, 2009 and 2011
(Percent of GDP)

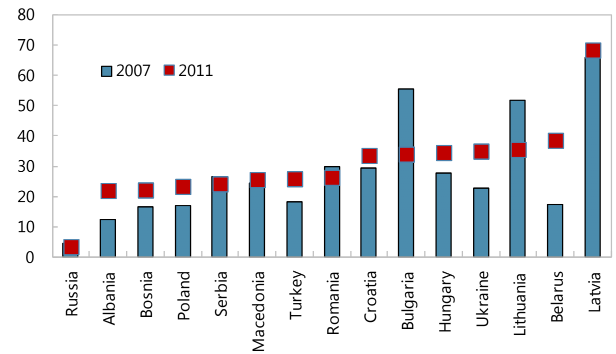


Source: IMF, WEO database.
Note: General government overall balance is as defined by WEO and corrected for policy lending where available; net lending/borrowing is used elsewhere. Hungary's 2011 surplus reflects transfers of private pension fund assets. Belarus' balance is before bank recapitalization costs and excludes substantive quasi-fiscal operations.

...but vulnerabilities remain

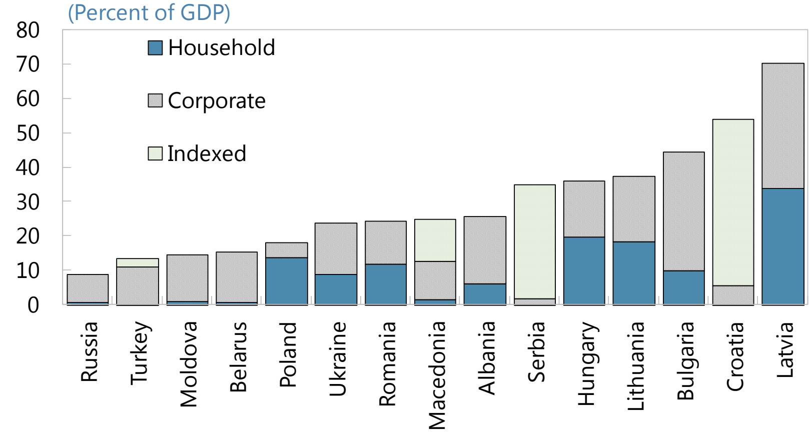
- Financing requirements remain high
- Large stock of FX loans
- NPLs have increased sharply
- Fiscal deficits still high in a number of countries; fiscal space much less than in 2007

Emerging Europe: External Financing Needs
(Percent of GDP)



Sources: National authorities; and IMF staff estimates.

Emerging Europe: Stock of Foreign Currency Loans, December 2011
(Percent of GDP)



Sources: Sources:IMF, *International Financial Statistics*; and IMF, World Economic Outlook database.
Note: No breakdown between corporate and household is available for indexed loans.

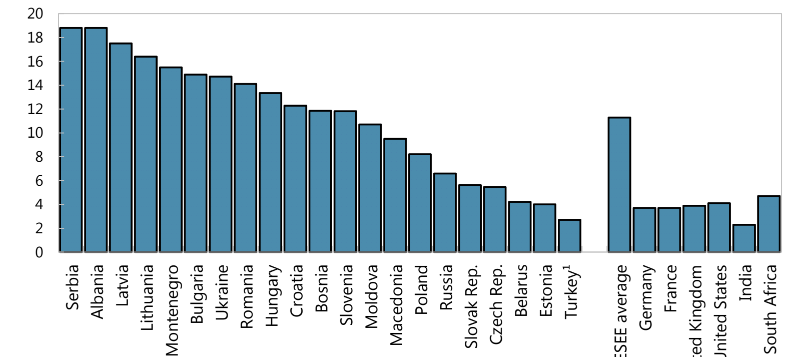
Lesson from Boom-Bust
1. Strive for more balanced growth

- Growth driven by capital inflows fueling domestic demand is ultimately unsustainable
- Credit booms are good for short-term growth—but not for longer-term growth
- New growth model cannot be mandated, but policies can nudge developments in right direction

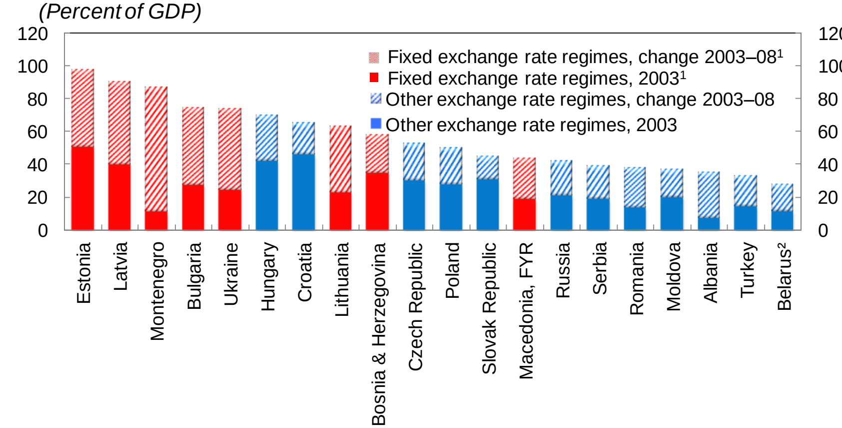
2. Keep credit growth in check

- Rapid credit growth leads to unbalanced growth and future problem loans
- Credit booms hardest to stop when fixed exchange rate and large capital inflows
- Supervisory and macroeconomic measures needed
- Also more effective coordination of home and host supervisors needed

Emerging Europe: NPL Ratio, 2011



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



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

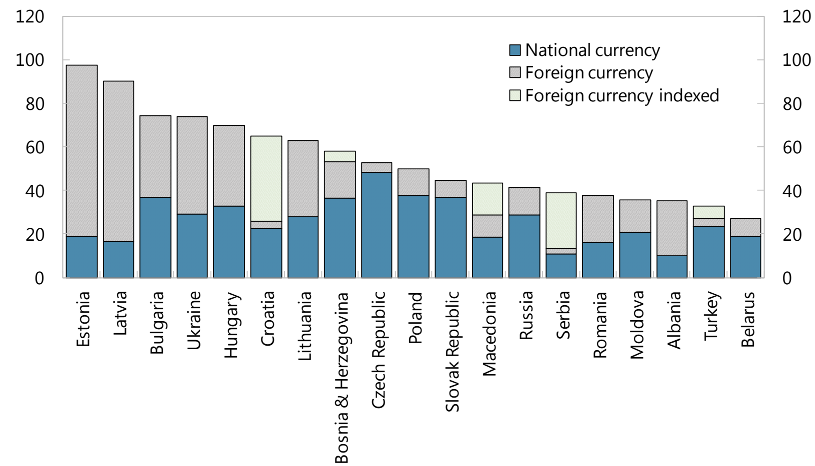
[1]Fixed exchange rate countries are classified in AREAER as exchange arrangements with no separate legal tender, currency board arrangements, or other conventional fixed peg arrangements.

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

Lesson 3. Discourage lending in foreign currency

- Surge in foreign currency loans created balance sheet risks and limited macro-economic policy space during crisis
- Risk is well understood, but before crisis, risk was perceived as theoretical

Emerging Europe: Total Private Sector Credit by Currency, 2008
(Stock in percent of GDP)

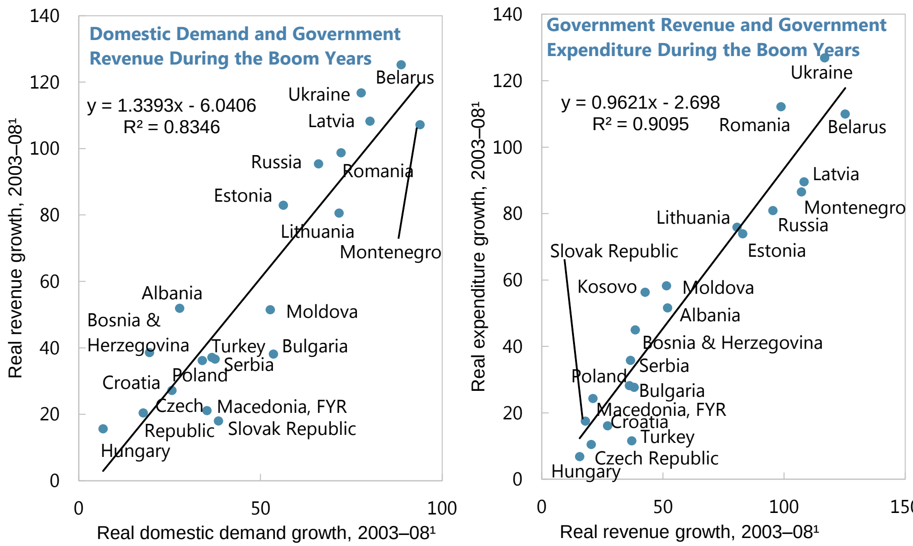


Sources: National authorities; and IMF, *International Financial Statistics*.

Lesson 4. Fiscal policy needs to limit expenditure growth

- Pre-crisis surge in spending set stage for large fiscal deficits during crisis
- Build buffers during boom times (large surpluses may be needed)
- Countries that built fiscal buffers fared better during crisis

Emerging Europe: Fiscal Policy During Boom Years



Thank you!