2. Emerging Europe: Reducing Vulnerabilities to Prevent Financial Turmoil

Emerging Europe's recovery from the deep crisis of 2008/09 continued in the first half of 2011, and growth also picked up in the Baltic countries and Southeastern Europe—the regions most affected by the crisis. But the region is now caught in the downward trend of advanced countries, and the euro area turbulence creates significant risks. Growth is likely to remain stronger than in advanced Europe, but policymakers will need to make headway with addressing the legacies of the 2008/09 crisis, which include large fiscal deficits and high nonperforming loan (NPL) ratios.

Developments in the First Half of 2011

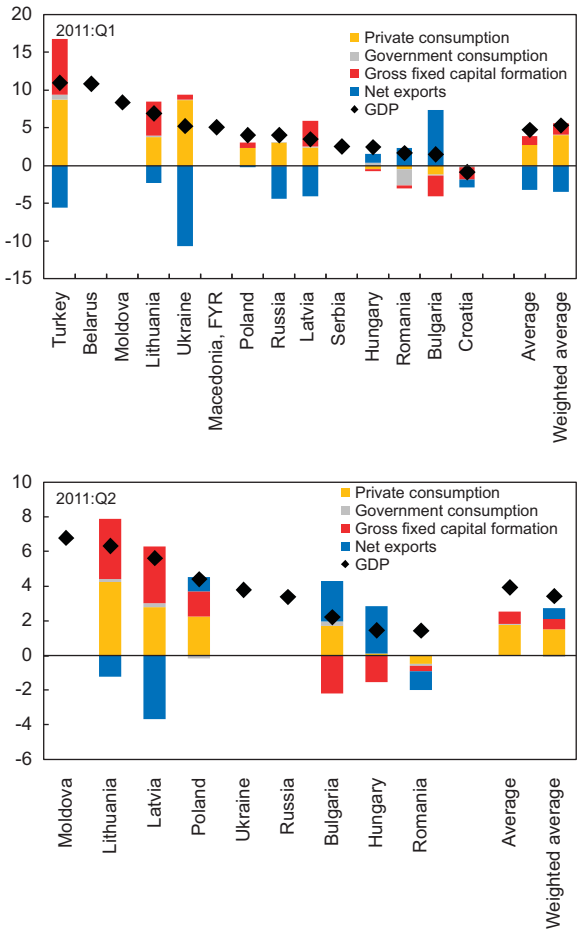
The recovery in emerging Europe strengthened further in late 2010 and early 2011. Year-over-year growth reached 5.4 percent in the first quarter of 2011—the highest growth rate since the 2008/09 crisis. The high regional growth rate was in part driven by double-digit growth in Turkey, but other countries saw strong expansions as well (Figure 2.1). Particularly encouraging was the recovery in countries that had been most affected by the crisis. Romania saw positive year-over-year growth for the first time since end-2008, while growth in the Baltic countries came to almost 6 percent. The only country where year-over-year growth remained negative was Croatia.

The recovery also broadened in terms of demand components, with domestic demand playing an increasingly important role. Domestic demand grew by 16 percent year over year in Turkey, reflecting a credit boom fueled by capital inflows. Domestic demand also remained strong in Russia and Ukraine, buoyed by favorable prices for their energy and metals exports, respectively, and in Poland (Figure 2.2). It recovered strongly in the Baltic countries, even in the absence of a recovery in credit, and remained weak only in Southeastern

Figure 2.1

Emerging Europe: Contributions to GDP Growth[1]

(Year-over-year growth rate, percentage points)

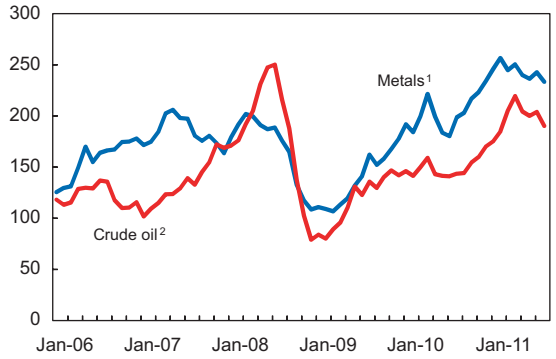


Sources: Haver Analytics; national sources; and IMF staff calculations.
[1]Contributions from inventory investment and statistical discrepancy not shown.

Europe (Figure 2.3). Significant differences remained in cyclical positions, and while in some countries output is now at or above potential, many other countries still have large output gaps. The output gap has closed in Poland, the only EU country that managed to avoid a recession in 2008–09, and turned positive in Turkey, where significant demand pressures have led to a sharp widening of the current account deficit. Excess demand came to a head in Belarus where loose fiscal policy and excess credit

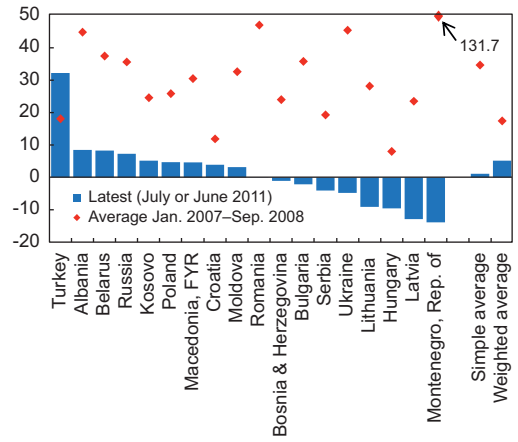
Note: The main authors of this chapter are Lone Christiansen and Yuko Kinoshita.

Figure 2.2
Global Markets: Commodity Prices, January 2006–August 2011
(Index, 2005 = 100)



Sources: Bloomberg; and IMF, Global Data Source.
[1]Includes copper, aluminum, iron ore, tin, nickel, zinc, lead, and uranium price indices.
[2]Simple average of three petroleum spot prices: Dated Brent, West Texas Intermediate, and the Dubai Fateh.

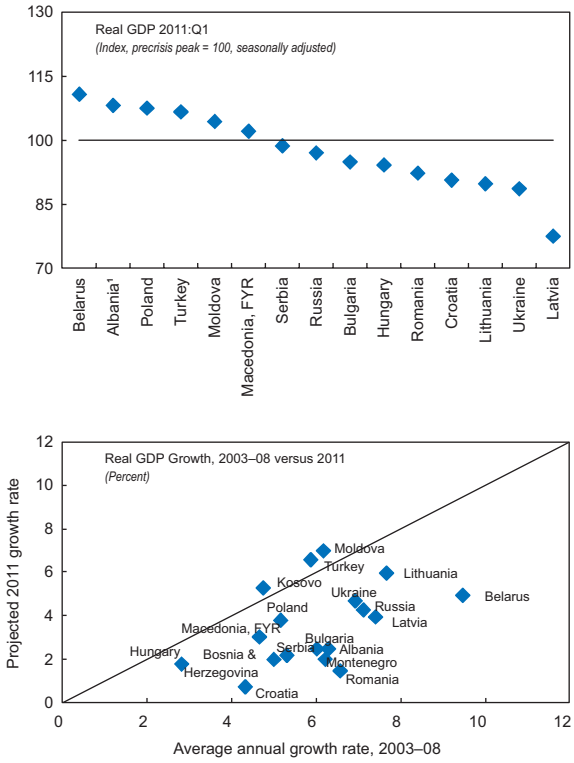
Figure 2.3
Emerging Europe: Real Private Sector Credit Growth, 2007–08 versus Latest[1]
(Percent, 12-month change)



Sources: IMF, *International Financial Statistics*; and IMF staff calculations.
[1]Derived from stock data in domestic currency, adjusted by CPI inflation. May include valuation effects from foreign-currency-denominated loans.

growth culminated in an exchange rate crisis. The Belarusian ruble lost one-third of its value when the central bank suspended intervention to support it in May 2011. But output gaps remain negative in many other countries, including the Baltic countries, which had suffered very deep recessions, and in Southeastern Europe, where the recovery is less advanced. Most countries have not yet reached their precrisis output levels and growth

Figure 2.4
Emerging Europe: Real GDP



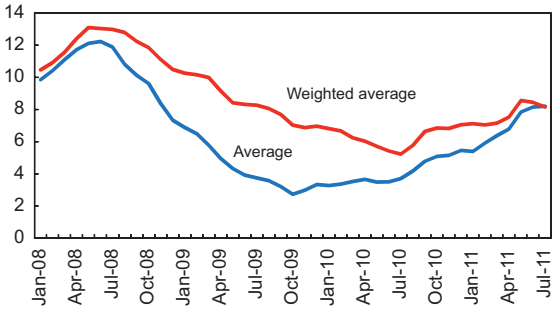
Sources: Haver Analytics; IMF, World Economic Outlook database; national sources; and IMF staff calculations.
[1]2010:Q4 instead of 2011:Q1.

rates often remain lower than those prior to 2008, suggesting not only that the 2008/09 crisis has left the region with a level shift in output, but also that growth rates during the boom years were artificially high (Figure 2.4).[1]

Inflation picked up in the first half of 2011, driven by rising food and energy prices (Figure 2.5). Countries with a large share of food and energy in the basket for the consumer price index (the Baltics and Southeastern Europe) saw a particularly strong rise: in the Baltics, year-over-year inflation reached 5 percent in May. Exchange rate depreciation contributed to rising inflation in Belarus. In addition to food price inflation,

[1] Recessions associated with credit crunches and asset price busts tend to be particularly deep and protracted (Claessens, Kose, and Terrones, 2008).

Figure 2.5
Emerging Europe: Inflation, January 2008–July 2011
(Percent, year-over-year)



Source: IMF, Information Notice System.

strong domestic demand added to inflationary pressures in Russia and Ukraine.

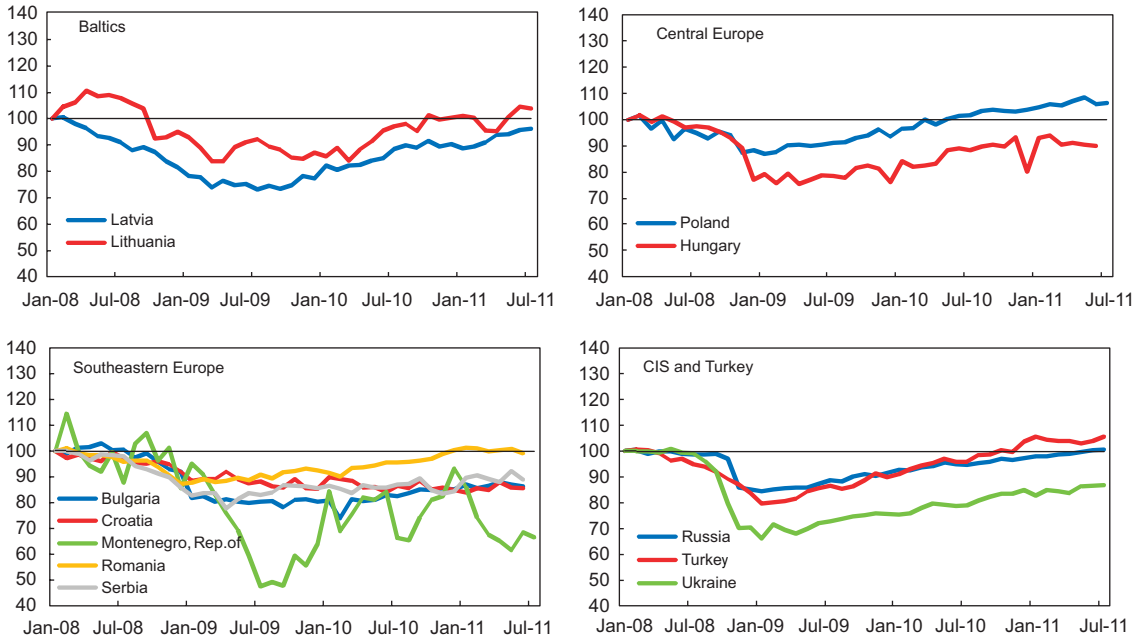
A strong start in 2011 fizzles out in mid-year

A barrage of shocks buffeted the global economy in the first half of the year. Japan was struck by a devastating earthquake and tsunami, which led to disruptions in global supply chains; unrest swelled in some Middle Eastern oil-producing countries, further driving up oil prices; and the euro area ran into major financial turbulence.

By mid-2011, clear signs of a slowdown had surfaced. The financial turmoil intensified in July and August, when the euro area crisis started to affect spreads in Spain and Italy, and Standard & Poor's stripped the United States of its AAA sovereign credit rating. The turmoil was stirred further by concern over new GDP growth figures, which showed that the U.S. economy had been much weaker in the first half of 2011 than previously recognized.

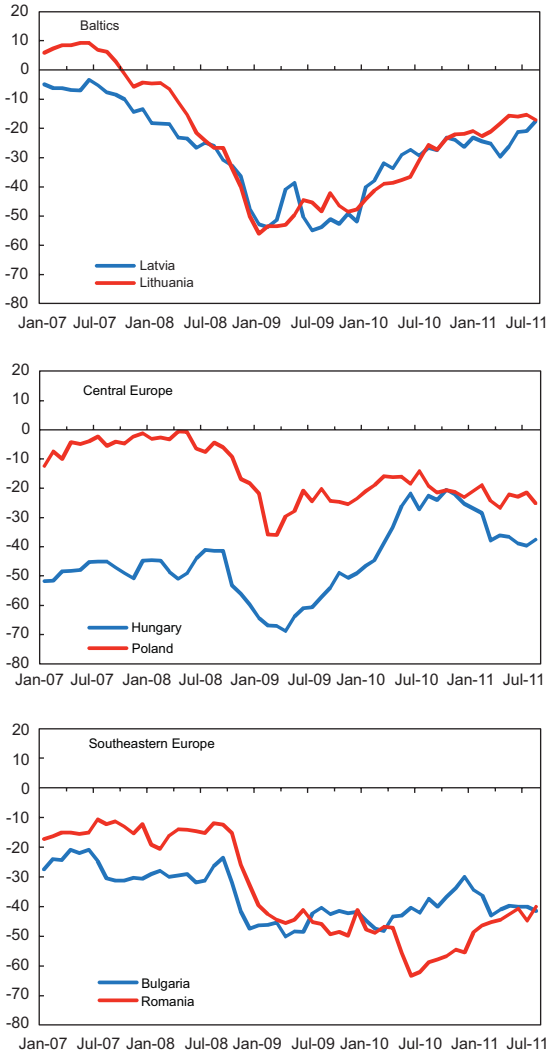
High frequency indicators for emerging Europe started to reflect the worsening external environment by mid-2011. In August, the manufacturing Purchasing Managers Index for Russia and Turkey was in contractionary territory and declined in Hungary and Poland. Industrial production growth also weakened in a number of countries, including Bulgaria, Hungary, and Romania (Figure 2.6),

Figure 2.6
Emerging Europe: Industrial Production, January 2008–July 2011[1]
(Seasonally adjusted, index, January 2008 = 100)



Sources: Haver Analytics; national sources; and IMF staff calculations.
[1]June 2011 for Bulgaria, Croatia, Hungary, Romania, and Serbia.

Figure 2.7
Emerging Europe: Consumer Confidence, January 2007–August 2011
(Seasonally adjusted, percent balance)



Source: Eurostat.
Note: The consumer confidence indicator is the average of the results for four questions: (1) financial situation over the next 12 months; (2) general economic situation over the next 12 months; (3) unemployment expectations over the next 12 months; and (4) savings over the next 12 months. Percent balance equals percent of respondents reporting an increase minus the percent of respondents reporting a decrease.

and consumer confidence worsened in Central Europe, while remaining depressed in Southeastern Europe (Figure 2.7). GDP releases for the second quarter confirmed the decline in economic momentum. Year-over-year growth generally softened for an average decline from 3.9 percent in the first quarter to 3.4 percent in the second quarter in the countries for which data have been released.

Outlook for the Remainder of 2011 and 2012

Emerging Europe's outlook is for a slowdown of growth with heightened downside risks. Developments through mid-2011 attest to a lack of vigor in the global economic recovery and continued fragilities of real developments to financial market turmoil. On a positive note, though, adverse effects from some of the shocks that held back growth in many advanced countries in the second quarter of 2011 should gradually ease (IMF, 2011i). Global manufacturing should rebound as the disruptions to the supply chains emanating from Japan's earthquake and tsunami dissipate, and the headwinds from higher oil prices fade now that prices have receded from their peaks.

Despite the clouded global economic outlook, this *Regional Economic Outlook* revises emerging Europe's full-year growth projections for 2011 slightly upward, to 4.4 percent from 4.3 percent projected in the previous edition, owing to strong growth in the first quarter (Table 2.1). Growth has been revised upward most markedly in Turkey (from 4.6 percent to 6.6 percent), and also in Lithuania and Moldova. By contrast, growth projections have been marked downward in some countries in Southeastern Europe, as well as in Belarus, reflecting its ongoing exchange rate crisis. The upward revisions reflect both higher export growth (from 5.4 percent to 7.1 percent) and higher domestic demand (from 5.6 percent to 6.3 percent). Domestic demand is fairly strong for the year as a whole everywhere, except for Southeastern Europe (Figure 2.8).[2]

[2] Household consumption has made a strong recovery in the European CIS countries, Poland, and Turkey; but recently, consumption growth in Lithuania has also improved markedly. At the same time, fixed investment has grown strongly in Poland, Russia, Turkey, and the Baltic countries.

Table 2.1

Emerging Europe: Growth of Real GDP, Domestic Demand, Exports, and Private Consumption, 2009–12

(Percent)

	Real GDP Growth				Real Domestic Demand Growth				Real Exports Growth[1]				Real Private Consumption Growth			
	2009	2010	2011	2012	2009	2010	2011	2012	2009	2010	2011	2012	2009	2010	2011	2012
Baltics[2]	-15.9	0.7	5.3	3.2	-26.2	1.2	8.4	5.0	-13.2	14.8	12.0	7.0	-20.1	-2.9	4.9	3.4
Latvia	-18.0	-0.3	4.0	3.0	-27.6	-0.9	5.3	4.1	-14.1	10.3	8.7	5.5	-24.1	-0.1	3.0	3.3
Lithuania	-14.7	1.3	6.0	3.4	-25.4	2.5	10.2	5.5	-12.7	17.4	13.9	7.8	-17.7	-4.5	6.0	3.5
Central Europe[2]	-0.1	3.3	3.4	2.7	-3.1	2.6	2.6	2.8	-7.4	10.9	8.1	5.9	0.1	-1.8	2.4	2.5
Hungary	-6.7	1.2	1.8	1.7	-10.8	-4.4	0.2	0.7	-9.6	14.1	9.7	8.5	-6.8	-20.6	0.8	1.0
Poland	1.6	3.8	3.8	3.0	-1.1	4.4	3.2	3.3	-6.8	10.1	7.7	5.2	2.0	3.1	2.8	2.8
Southeastern Europe–EU[2]	-6.6	-0.9	1.8	3.4	-12.8	-1.9	-0.3	3.3	-6.9	14.0	13.8	5.7	-9.5	-1.5	0.7	2.3
Bulgaria	-5.5	0.2	2.5	3.0	-12.7	-4.5	-1.9	3.2	-11.2	16.2	8.1	1.6	-7.6	-1.2	0.9	1.7
Romania	-7.1	-1.3	1.5	3.5	-12.9	-1.0	0.3	3.4	-5.3	13.1	16.0	7.3	-10.2	-1.7	0.7	2.5
Southeastern Europe–non-EU[2]	-3.1	0.7	1.9	2.9	-7.3	-2.8	0.8	1.7	-13.5	12.9	7.1	7.9	-4.3	-1.5	0.4	1.4
Albania	3.3	3.5	2.5	3.5	2.9	-5.1	-0.9	2.6	-0.9	15.2	12.0	9.0	6.4	-2.6	0.4	1.3
Bosnia and Herzegovina	-2.9	0.7	2.2	3.0	-6.8	-1.6	1.4	2.2	-5.7	7.0	1.7	5.9	-4.4	0.4	1.1	2.0
Croatia	-6.0	-1.2	0.8	1.8	-9.0	-3.8	-0.1	1.0	-17.3	6.0	2.4	3.4	-8.5	-0.9	0.2	0.5
Kosovo	2.9	4.0	5.3	5.0	...	...	...	...	...	...	...	...	...	...	...	...
Macedonia, FYR	-0.9	1.8	3.0	3.7	-3.3	-0.1	3.9	4.3	-16.0	24.1	11.4	11.1	-4.9	0.5	1.5	3.8
Montenegro, Republic of	-5.7	1.1	2.0	3.5	-16.9	-3.3	-1.2	1.2	-22.4	9.0	8.2	5.3	-13.4	6.8	-2.3	-0.1
Serbia, Republic of	-3.5	1.0	2.0	3.0	-9.0	-2.2	1.5	1.4	-14.9	19.1	11.2	12.3	-2.3	-3.8	0.2	1.7
European CIS countries[2]	-8.2	4.2	4.4	4.0	-14.4	7.6	7.6	5.1	-6.9	6.8	5.6	3.8	-5.8	3.8	6.8	5.9
Belarus	0.2	7.6	5.0	1.2	-1.4	11.2	-0.2	-1.4	-9.0	7.3	29.6	4.9	0.0	10.1	-1.7	3.5
Moldova	-6.0	6.9	7.0	4.5	-18.6	9.6	9.8	5.6	-12.1	12.8	18.3	9.4	-8.0	9.0	9.6	4.7
Russia	-7.8	4.0	4.3	4.1	-13.9	7.4	8.1	5.3	-4.7	7.1	4.1	3.5	-4.8	2.9	7.2	6.0
Ukraine	-14.8	4.2	4.7	4.8	-23.9	7.1	7.2	6.2	-21.6	4.6	6.0	4.7	-15.0	7.0	7.2	6.3
Turkey	-4.8	8.9	6.6	2.2	-7.4	13.3	9.4	0.4	-5.0	3.4	7.4	6.4	-2.3	6.6	8.0	1.2
Emerging Europe[2,3]	-6.0	4.4	4.4	3.4	-11.0	6.5	6.3	3.6	-7.1	7.8	7.1	5.0	-4.6	2.6	5.5	4.0
New EU member states[2,4]	-3.5	2.2	2.9	2.8	-7.0	1.3	1.9	3.0	-9.0	13.0	10.8	5.8	-3.1	-1.3	1.7	2.5
Memorandum																
Czech Republic	-4.1	2.3	2.0	1.8	-3.7	1.1	0.5	2.7	-10.8	18.0	15.5	5.5	-0.2	0.1	-0.3	2.1
Estonia	-13.9	3.1	6.5	4.0	-20.5	-3.8	6.9	3.9	-18.7	21.7	16.9	4.9	-18.8	-1.9	2.8	4.1
Slovak Republic	-4.8	4.0	3.3	3.3	-7.9	2.7	0.0	3.7	-15.9	16.4	12.6	6.5	0.3	-0.3	0.9	3.4
Slovenia	-8.1	1.2	1.9	2.0	-10.1	0.5	0.8	2.1	-17.7	7.7	6.9	5.2	0.1	0.7	1.3	2.2
European Union[2,5]	-4.2	1.8	1.7	1.4	-4.3	1.4	0.9	1.0	-12.5	10.0	7.3	4.2	-1.8	0.6	0.4	1.0

Source: IMF, World Economic Outlook database.

[1] Real exports of goods and services.

[2] Weighted average. Weighted by GDP valued at purchasing power parity.

[3] Includes Albania, Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, Hungary, Kosovo, Latvia, Lithuania, FYR Macedonia, Moldova, Republic of Montenegro, Poland, Romania, Russia, Republic of Serbia, Turkey, and Ukraine.

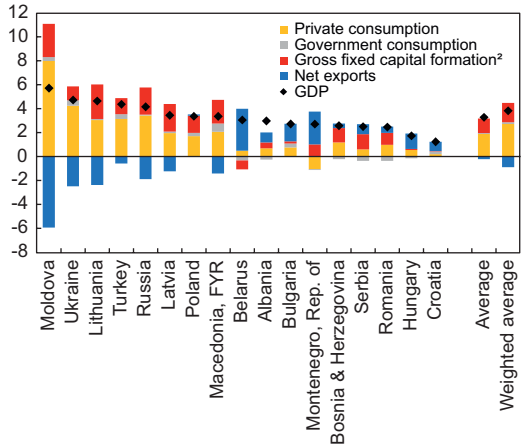
[4] Includes Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovak Republic, and Slovenia.

[5] Includes Austria, Belgium, Bulgaria, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, Netherlands, Poland, Portugal, Romania, Slovak Republic, Slovenia, Spain, Sweden, and the United Kingdom.

Global developments cast long shadows in emerging Europe

The clouded economic outlook becomes visible in projections for 2012, which now put growth in emerging Europe at 3.4 percent, compared with 4.3 percent in the May 2011 *Regional Economic Outlook*. The markdowns are strongest for Turkey, where decelerating capital inflows slow domestic demand growth, and Belarus, where external

Figure 2.8
Emerging Europe: Contributions to GDP Growth, 2011–12[1]
(Percentage points, annual average)



Sources: IMF, World Economic Outlook database; and IMF staff estimates.
[1]Annualized percent change from 2010 to 2012. Contributions from inventories and statistical discrepancy not shown.
[2]Investment in the case of Macedonia, FYR.

adjustment proceeds. Downward revisions are more modest for other countries.

Growth differentials within emerging Europe will likely narrow further in 2012. The fortunes of the economies in emerging Europe had diverged strongly during 2009 and 2010, but growth differentials are set to diminish in 2011 and 2012. This reflects a slowdown of domestic demand growth in the countries that used to expand the fastest, such as Turkey and the European CIS countries, combined with a pickup in the hitherto slow-growing countries in Southeastern Europe.

Inflation is projected to decline gradually from current levels. The regional average peaked at 8½ percent earlier in 2011 but has since started to come down. This trend is projected to continue with inflation rates averaging 7.9 percent and 6.8 percent in 2011 and 2012, respectively (Table 2.2). Retreating commodity prices from recent highs are important factors as is the general economic slowdown. Monetary policy tightening in a number of countries, such as Moldova and Poland, was also important in guarding against any unhinging of inflation expectations. The slowing of economic activity tempers inflation risks in the future, although monetary policymakers need to remain vigilant, especially in countries where central bank credibility is less firmly entrenched, or exchange rates have recently depreciated.

Despite some widening, the region's current account deficit remains small. It is projected to widen from 0.6 percent of GDP in 2010 to 0.8 percent of GDP in 2011 and 1.2 percent of GDP in 2012. In 2011, strong domestic demand continues to deteriorate the current accounts, especially in Turkey (to around 10 percent of GDP), but also in Ukraine and the Baltic countries. In Russia, the current account effect of strong import demand is counterbalanced by export prices for oil and gas that are on average higher in 2011 than in 2010. External debt ratios are projected to be above 80 percent in 2011–12 in Bulgaria, Croatia, Hungary, Latvia, and Montenegro.

Risks to the Outlook

Downside risks to the outlook are significant and larger than at the time of the previous edition of the *Regional Economic Outlook*. Although more sluggish global economic growth has always been a possibility, quelling the tensions in euro area debt markets has proved increasingly challenging (Chapter 1). If tensions were to escalate further, the economic and financial outlook for the euro area would darken considerably and the repercussions for emerging Europe would be dire. Exports and cross-border production chains with emerging Europe's premier partners would suffer.

More importantly, much of emerging Europe's financial sector would likely come under pressure. Strained banks in advanced Europe would likely scale back exposure to subsidiaries, nonaffiliated banks, and nonbanks in emerging Europe. A large and sudden disengagement from subsidiaries, though, is unlikely even in a highly adverse scenario. Western banks would first turn to domestic support mechanisms, including liquidity from the European Central Bank (ECB) as collateral allows, lending-of-last-resort from their central banks, and any government schemes that would be put in place in the circumstances. Scope for recourse to funding from subsidiaries would be rather limited as host

Table 2.2

Emerging Europe: CPI Inflation, Current Account Balance, and External Debt, 2009–12

(Percent)

	CPI Inflation (Period average)				CPI Inflation (End of period)				Current Account Balance to GDP				Total External Debt to GDP			
	2009	2010	2011	2012	2009	2010	2011	2012	2009	2010	2011	2012	2009	2010	2011	2012
Baltics[1]	3.8	0.3	4.2	2.5	0.2	3.2	3.4	2.3	6.2	2.5	-0.7	-1.9	121.4	117.2	106.0	98.4
Latvia	3.3	-1.2	4.2	2.3	-1.4	2.4	3.7	1.8	8.6	3.6	1.0	-0.5	164.1	164.8	145.6	134.5
Lithuania	4.2	1.2	4.2	2.6	1.2	3.6	3.2	2.5	4.5	1.8	-1.9	-2.7	91.4	85.7	80.8	76.0
Central Europe[1]	3.6	3.1	4.0	2.9	3.9	3.4	3.5	2.6	-3.0	-3.0	-3.3	-3.7	85.6	82.6	79.2	78.9
Hungary	4.2	4.9	3.7	3.0	5.6	4.7	3.5	3.0	0.4	2.1	2.0	1.5	154.3	138.8	133.6	130.6
Poland	3.5	2.6	4.0	2.8	3.5	3.1	3.5	2.5	-4.0	-4.5	-4.8	-5.1	65.1	67.0	64.1	65.2
Southeastern Europe–EU[1]	4.7	5.3	5.6	3.9	4.0	7.0	4.4	3.5	-5.3	-3.6	-3.1	-3.4	81.9	80.8	79.4	75.3
Bulgaria	2.5	3.0	3.8	2.9	1.6	4.4	3.1	2.8	-8.9	-1.0	1.6	0.6	113.4	101.6	91.5	86.1
Romania	5.6	6.1	6.4	4.3	4.8	8.0	5.0	3.8	-4.2	-4.3	-4.5	-4.6	72.6	74.6	75.8	72.2
Southeastern Europe–non-EU[1]	3.6	3.1	6.1	3.1	3.0	5.0	5.0	2.9	-7.7	-5.4	-6.5	-6.9	79.7	80.0	75.5	72.8
Albania	2.2	3.6	3.9	3.5	3.7	3.4	3.5	2.9	-13.5	-11.8	-10.9	-9.8	33.4	36.6	38.5	37.5
Bosnia and Herzegovina	-0.4	2.1	4.0	2.5	0.0	3.1	4.0	2.5	-6.2	-5.6	-6.2	-5.6	54.9	56.9	59.4	60.1
Croatia	2.4	1.0	3.2	2.4	1.9	1.9	3.6	2.7	-5.2	-1.1	-1.8	-2.7	102.7	102.1	99.5	99.2
Kosovo	-2.4	3.5	8.3	2.6	0.1	6.6	6.2	1.9	-17.1	-16.3	-25.0	-20.5	...	...	...	...
Macedonia, FYR	-0.8	1.5	4.4	2.0	-1.6	3.0	3.7	2.0	-6.7	-2.8	-5.5	-6.6	59.1	59.0	59.7	61.3
Montenegro, Republic of	3.4	0.5	3.1	2.0	1.5	0.7	3.0	1.8	-30.3	-25.6	-24.5	-22.1	97.8	100.2	99.0	97.5
Serbia, Republic of	8.1	6.2	11.3	4.3	6.6	10.3	7.9	3.5	-7.1	-7.2	-7.7	-8.9	81.6	83.1	71.5	63.1
European CIS countries[1]	12.2	7.2	10.5	8.8	9.2	8.9	10.7	7.9	2.9	3.5	4.2	2.4	42.8	38.0	30.8	28.4
Belarus	13.0	7.7	41.0	35.5	10.1	9.9	65.3	20.0	-13.0	-15.5	-13.4	-9.9	44.8	52.1	68.2	72.3
Moldova	0.0	7.4	7.9	7.8	0.4	8.1	9.5	6.0	-8.5	-8.3	-9.9	-10.3	65.5	68.1	65.2	67.9
Russia	11.7	6.9	8.9	7.3	8.8	8.8	7.5	7.1	4.1	4.8	5.5	3.5	38.2	33.0	25.6	23.0
Ukraine	15.9	9.4	9.3	9.1	12.3	9.1	10.7	8.5	-1.5	-2.1	-3.9	-5.3	88.2	85.1	76.2	73.2
Turkey	6.3	8.6	6.0	6.9	6.5	6.4	8.0	5.7	-2.3	-6.6	-10.3	-7.4	43.7	39.5	43.7	45.8
Emerging Europe[1,2]	8.5	6.3	7.9	6.8	7.0	7.1	8.2	6.0	-0.3	-0.6	-0.8	-1.2	57.4	52.0	47.5	45.5
New EU member states[1,3]	3.1	2.9	3.9	2.8	2.9	3.8	3.3	2.7	-2.8	-2.8	-2.8	-3.2	79.5	78.0	74.6	73.5
Memorandum																
Czech Republic	1.0	1.5	1.8	2.0	1.0	2.3	1.6	2.2	-3.3	-3.7	-3.3	-3.4	45.5	47.4	44.9	46.6
Estonia	-0.1	2.9	5.1	3.5	-1.7	5.4	4.6	3.3	4.5	3.6	2.4	2.3	125.8	117.6	94.5	89.2
Slovak Republic	0.9	0.7	3.6	1.8	0.1	1.3	2.7	2.9	-3.2	-3.5	-1.3	-1.1	71.9	72.4	72.5	72.0
Slovenia	0.9	1.8	1.8	2.1	1.8	1.9	2.1	2.3	-1.3	-0.8	-1.7	-2.1	81.9	85.6	80.6	80.5
European Union[1,4]	0.9	2.0	3.0	1.8	1.2	2.5	2.8	1.7	-0.1	-0.1	-0.2	0.0	...	...	...	...

Source: IMF, World Economic Outlook database.

[1] Weighted average. CPI inflation is weighted by GDP valued at purchasing power parity, and current account balances and external debt are weighted by U.S. dollar GDP.

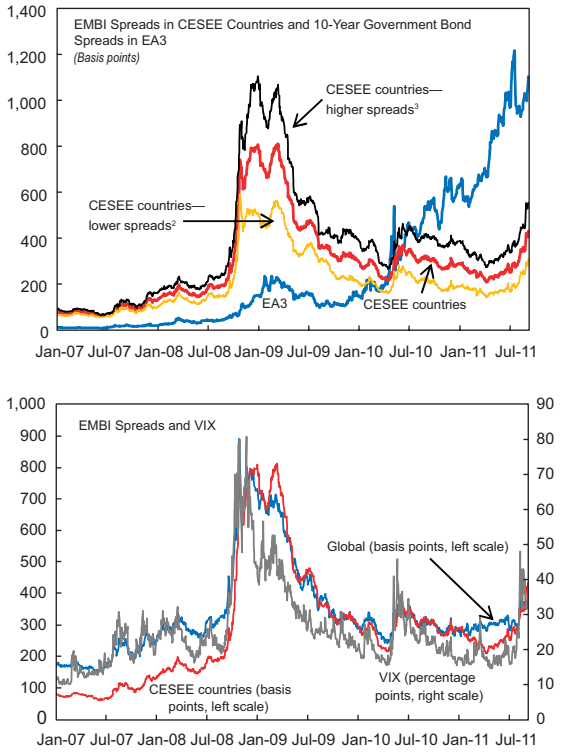
[2] Includes Albania, Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, Hungary, Kosovo, Latvia, Lithuania, FYR Macedonia, Moldova, Republic of Montenegro, Poland, Romania, Russia, Republic of Serbia, Turkey, and Ukraine.

[3] Includes Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovak Republic, and Slovenia.

[4] Includes Austria, Belgium, Bulgaria, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, Netherlands, Poland, Portugal, Romania, Slovak Republic, Slovenia, Spain, Sweden, and the United Kingdom.

Figure 2.9

CESEE and EA3 Countries: Funding Costs, January 1, 2007–September 6, 2011[1]



Sources: Bloomberg; Datastream; and IMF staff calculations.
[1]CESEE comprises Bulgaria, Croatia, Hungary, Lithuania, Poland, Romania, Russia, Serbia, Turkey, and Ukraine. EA3 comprises Greece, Ireland, and Portugal.
[2]Simple average for Bulgaria, Lithuania, Poland, Russia, and Turkey.
[3]Simple average for Croatia, Hungary, Romania, Serbia, and Ukraine.

country regulators would step in if regulatory liquidity or capital limits were at risk.

The most likely impact would therefore be a renewed credit crunch. Subsidiaries would see a measured but persistent funding drain from their parents, and nonaffiliated banks that rely on wholesale funding would have to struggle even more. Both would have little choice but to curtail their own lending activities. A reduction of cross-border lending to nonbanks in emerging Europe would compound the credit crunch further.

Key Policy Issues

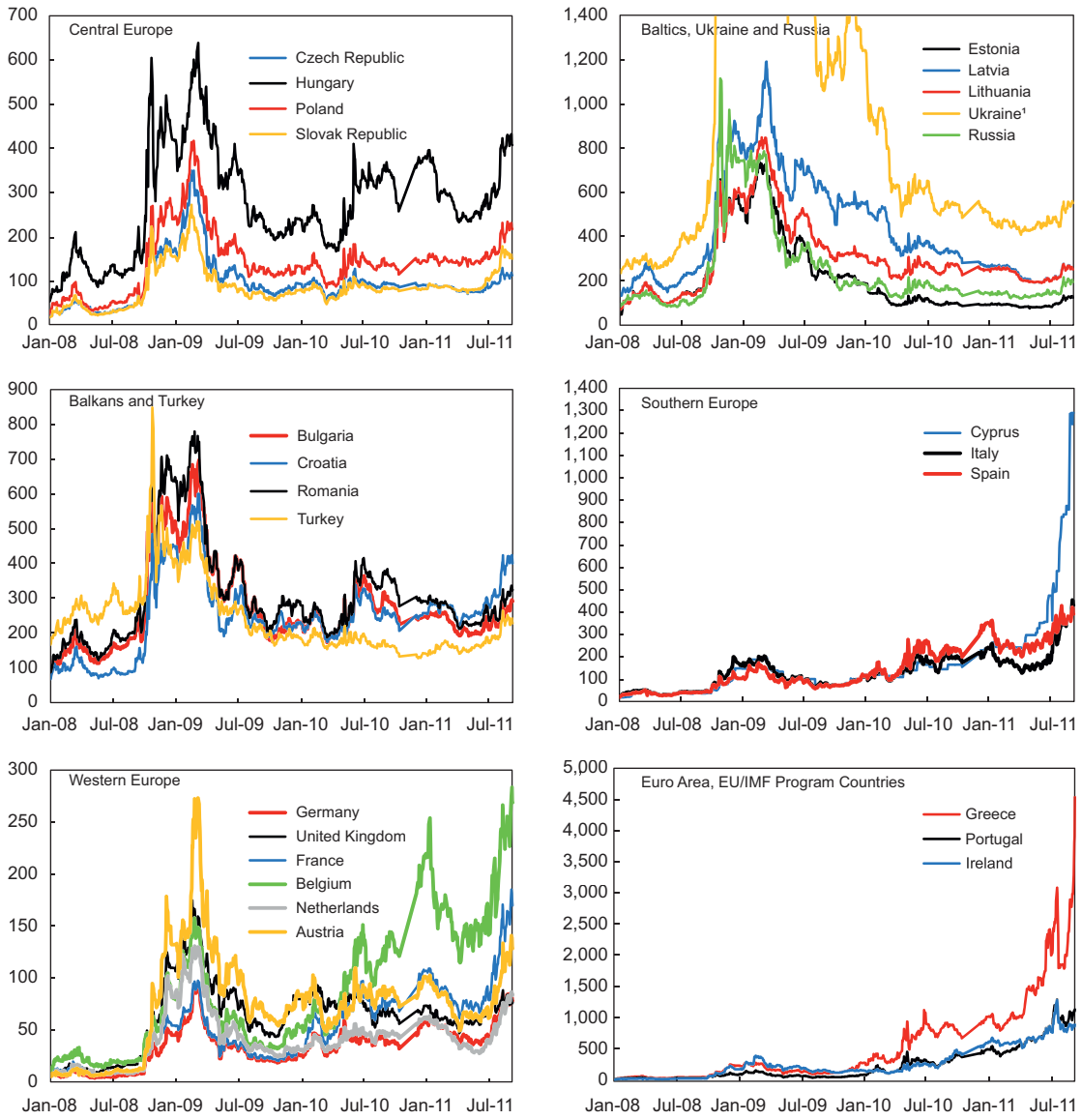
In the past year and a half, financial contagion from the crisis in advanced Europe has largely bypassed emerging Europe. While spreads in the euro area periphery were on an upward trend, spreads in emerging Europe did not follow suit. Flare-ups of turmoil in the euro area often led to increases in spreads in emerging Europe, but those episodes largely reflected increases in global risk aversion rather than increased concerns vis-à-vis the region.[3]

In mid-2011, there are some indications that this may have started to change. Sovereign spreads in some countries have responded to the sharply widening spreads in the euro area (Figures 2.9 and 2.10). Croatia and Hungary were particularly affected, with spread increases during July and August matching those in Italy and Spain. Spreads in the rest of emerging Europe were out by about half as much. The risk that financial tensions will spread to emerging Europe is heightened by a number of legacies left by the 2008/09 crisis: fiscal vulnerabilities that were low before the crisis have increased sharply, and nonperforming loans (NPLs) have shot up. And western European banks continue to play a key role in emerging Europe's financial sectors. In addition, the strong Swiss franc remains a challenge for households and banking sectors in Croatia, Poland, and especially Hungary, where a large share of mortgages are denominated in that currency.

In a global environment where risk aversion toward individual countries can suddenly rise, emerging Europe should aim to reduce its vulnerabilities by addressing the remaining legacies of the 2008/09 crisis. Policymakers will need to make headway in repairing public finances, including through the strengthening of fiscal frameworks to underwrite lasting fiscal discipline and lower the high ratios of banks' NPLs to improve conditions for lending. Good policies matter not only because they will reduce vulnerabilities, but also because they will boost convergence. Given the still large income differences between emerging and advanced Europe, there remains significant scope for further catching-up with advanced Europe, but it will not be automatic. It is contingent on a combination of sound macroeconomic policies and structural

[3] For a further discussion, see IMF (2011e).

Figure 2.10
Selected European Countries: 5-Year CDS Spreads, January 1, 2008–September 6, 2011
(Basis points)



Source: Credit Market Analysis Datavision.
[1]Ukraine CDS spreads reached above 5,400 bps during crisis.

reforms that help ensure balanced growth and rising potential.

Rebuilding fiscal buffers

The region's fiscal deficit is projected to decline below 2½ percent of GDP in 2011 and 2012, from 4.5 percent of GDP in 2010 and 6.2 percent of GDP in 2009 (Table 2.3). Behind this improvement in the regional average, however, are large differences across countries. Although some countries are seeing rapid improvements, others make much less headway, and some none at all.

Among the countries seeing rapid improvements in their fiscal position is Poland, which is undertaking substantial fiscal consolidation in 2011 and 2012.

Table 2.3

Emerging Europe: Evolution of Public Debt and General Government Balance, 2009–12[1]

(Percent of GDP)

	General Government Balance				Public Debt			
	2009	2010	2011	2012	2009	2010	2011	2012
Baltics[2]	-8.7	-7.4	-5.0	-3.6	30.9	39.2	41.6	43.1
Latvia[3]	-7.8	-7.8	-4.5	-2.3	32.8	39.9	39.6	40.5
Lithuania	-9.2	-7.1	-5.3	-4.5	29.6	38.7	42.8	44.6
Central Europe[2]	-6.7	-7.1	-3.9	-3.7	57.2	60.5	60.3	60.4
Hungary[4]	-4.5	-4.3	2.0	-3.6	78.4	80.2	76.1	75.5
Poland	-7.3	-7.9	-5.5	-3.8	50.9	55.0	56.0	56.4
Southeastern Europe–EU[2]	-5.8	-6.0	-4.0	-2.7	22.0	28.5	30.6	31.3
Bulgaria[3]	-0.9	-3.9	-2.5	-2.2	15.6	17.4	17.8	20.5
Romania	-7.3	-6.5	-4.4	-2.8	23.9	31.7	34.4	34.4
Southeastern Europe–non-EU[2]	-4.5	-4.4	-4.6	-4.0	37.3	42.2	45.1	46.1
Albania[3,8]	-7.4	-4.2	-3.7	-4.5	59.8	58.2	59.4	59.2
Bosnia and Herzegovina	-5.5	-4.3	-3.0	-1.6	35.9	39.7	39.6	38.4
Croatia[3]	-4.1	-5.0	-5.7	-5.1	34.5	40.6	47.5	50.0
Kosovo[3]	-0.6	-2.6	-5.0	-3.5	...	...	...	...
Macedonia, FYR	-2.7	-2.5	-2.5	-2.2	23.8	24.6	26.3	28.2
Montenegro, Republic of[3,8]	-6.5	-3.8	-3.4	-2.5	40.7	44.1	43.1	42.2
Serbia, Republic of[3]	-4.5	-4.6	-4.6	-3.9	38.2	44.9	44.1	44.5
European CIS countries[2]	-6.1	-3.6	-1.2	-2.0	13.5	14.6	14.8	15.2
Belarus[3]	-0.7	-1.8	-0.9	-1.0	21.7	26.5	46.3	45.6
Moldova[3]	-6.3	-2.5	-1.9	-1.2	29.1	26.6	23.6	21.7
Russia[3]	-6.3	-3.5	-1.1	-2.1	11.0	11.7	11.7	12.1
Ukraine[3]	-6.3	-5.7	-2.8	-2.0	35.4	40.1	39.3	39.4
Turkey[3]	-6.2	-3.7	-1.4	-1.4	46.1	42.2	40.3	38.1
Emerging Europe[2,5]	-6.2	-4.5	-2.1	-2.3	30.5	31.0	29.9	29.2
New EU member states[2,6]	-6.5	-6.4	-3.9	-3.5	42.6	47.3	48.6	49.2
Memorandum								
Czech Republic	-5.8	-4.7	-3.8	-3.7	35.4	38.5	41.1	43.2
Estonia	-2.1	0.2	-0.1	-2.3	7.2	6.6	6.0	5.6
Slovak Republic	-8.0	-7.9	-4.9	-3.8	35.4	41.8	44.9	46.9
Slovenia[3]	-5.8	-5.8	-3.4	-3.8	35.5	37.3	43.6	47.2
European Union[1,7]	-6.7	-6.4	-4.5	-3.5	74.3	79.8	82.3	83.7

Source: IMF, World Economic Outlook database.

[1] As in the WEO, general government balances reflect IMF staff's projections of a plausible baseline, and as such contain a mixture of unchanged policies and efforts under programs, convergence plans, and medium-term budget frameworks. General government overall balance where available; general government net lending/borrowing elsewhere.

[2] Average weighted by GDP in U.S. dollars.

[3] Reported on a cash basis.

[4] Fiscal surplus in 2011 reflects revenue from rollback of pension reform. Assets of 11 percent of GDP are transferred from private-sector to public pension funds.

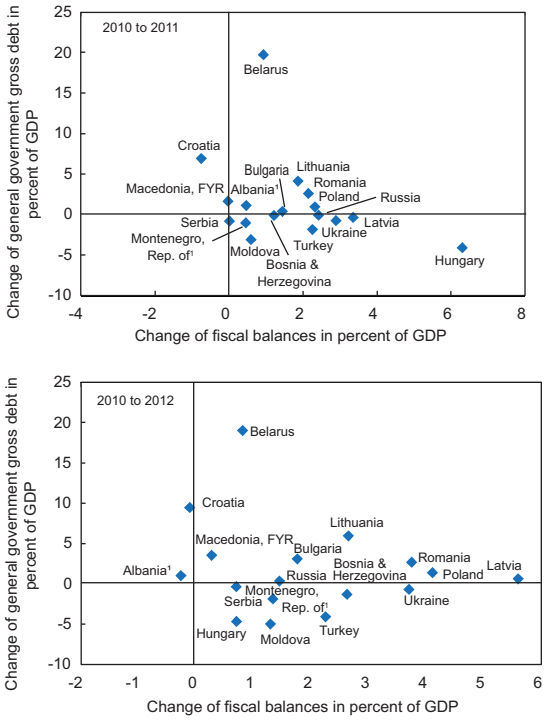
[5] Includes Albania, Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, Hungary, Kosovo, Latvia, Lithuania, FYR Macedonia, Moldova, Republic of Montenegro, Poland, Romania, Russia, Republic of Serbia, Turkey, and Ukraine.

[6] Includes Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovak Republic, and Slovenia.

[7] Includes Austria, Belgium, Bulgaria, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, Netherlands, Poland, Portugal, Romania, Slovak Republic, Slovenia, Spain, Sweden, and the United Kingdom.

[8] The data may differ from those in other published sources owing to a conversion to GFSM 2001. For Albania, the non-converted 2010 fiscal balance is –3.7 percent of GDP. For Montenegro, the equivalent values in 2009 and 2010 are –5.3 and –3.9 percent of GDP, respectively.

Figure 2.11
Emerging Europe: Change in Overall Fiscal Balances and General Government Gross Debt, 2010–12
(Percentage points of GDP)



Source: IMF, World Economic Outlook database.
[1]Data may differ from those in other published sources owing to conversion to GFSM 2001.

This should reduce its deficit by about 4 percentage points of GDP in two years, although further consolidation will be needed to put public debt firmly on a downward path in the medium term. Fiscal deficits are also declining rapidly in Romania, Ukraine, and the Baltic countries. Given that Ukraine's fiscal adjustment in 2010 was kept modest because of concerns about the fledgling recovery, the currently envisaged structural tightening is both necessary and timely, considering the rebound in private sector activity and the need to build credibility. Likewise, Romania is continuing fiscal consolidation under the IMF-supported program, and recently saw encouraging tax revenue performance. Nonetheless, improvements in revenue collection, optimization of expenditures, and further discretionary measures remain critical to underwrite the projected budget deficit of less than 3 percent of GDP in 2012.

Other countries are seeing less improvement, if any at all. Albania and Croatia are experiencing deteriorations (Figure 2.11). In Turkey, the headline fiscal balance has improved, reflecting transient revenues from the import and domestic demand boom, while spending has grown rapidly. In Russia, the non-oil fiscal deficit—which is the relevant measure of the fiscal stance in oil-producing countries, given the volatility of oil prices and the nonrenewable nature of oil reserves—will remain substantially higher than its precrisis levels, despite consolidation measures. In addition, the composition of fiscal consolidation is not supportive of growth, as it relies heavily on increased payroll taxes and cuts to public investment.

Despite fiscal consolidation in emerging Europe, fiscal vulnerabilities remain high in a number of countries (Figure 2.12). Fiscal deficits in 2011 are above 4 percent of GDP in Croatia, Kosovo, Latvia, Lithuania, Poland, Romania, and Serbia. Public debt exceeds 50 percent of GDP in Albania, Hungary, and Poland. Albania and Hungary have relatively high shares of short-term debt that account for more than 10 percent of GDP. Furthermore, a significant share of public debt in a number of countries is denominated in foreign currency, exposing public finances to currency risk.

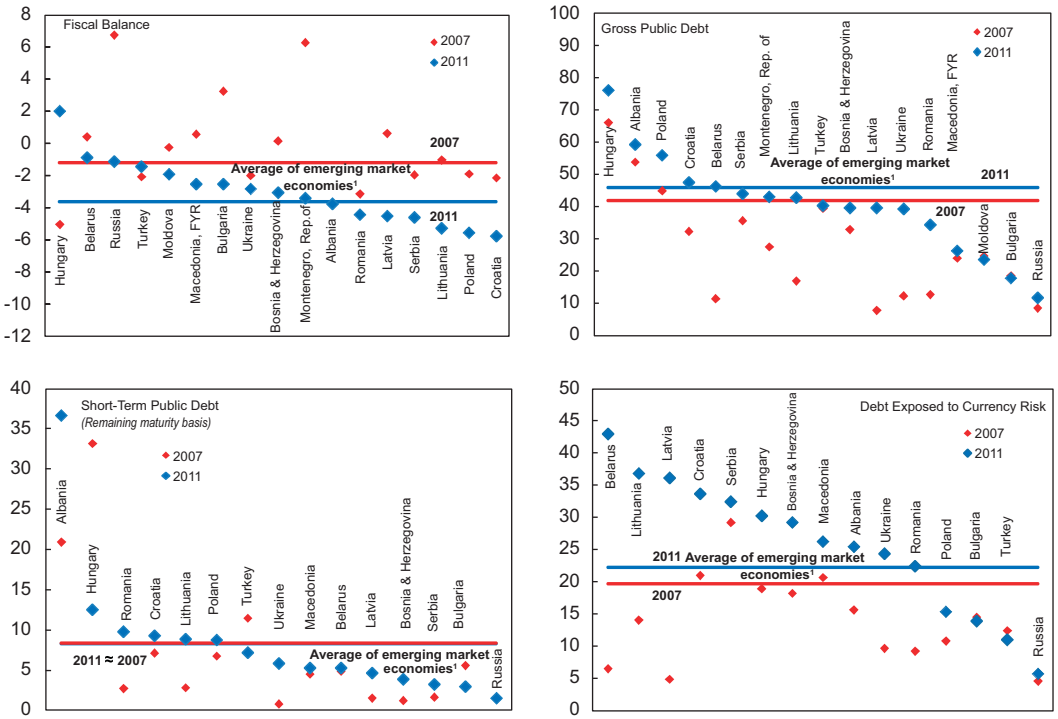
It is imperative that these vulnerabilities be reduced further. Countries should not take solace in the fact that spreads have remained relatively low so far. Past experience in countries with significant public finance problems shows that spreads can remain low until a very late stage.

One of the lessons from the crisis in 2008/09 is that fiscal policy should be more prudent in good times to build adequate buffers to be used when the cycle turns. In the run-up to the crisis, fiscal balances were inflated by high cyclical revenues related to demand booms. These fiscal revenues were primarily used to increase government spending. Consequently, many countries barely had any fiscal surplus on the eve of the crisis despite strong GDP growth. When revenues collapsed during the crisis, this led to large fiscal deficits, forcing a procyclical fiscal tightening that compounded the contraction in domestic demand.

Figure 2.12

Emerging Europe: Fiscal Vulnerability Indicators in Perspective

(Percent of GDP)



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

[1]Covers 50 major emerging market economies worldwide.

Fiscal rules can help…

Fiscal rules can help ensure that this mistake is not repeated in future upswings. Fiscal rules can enhance the credibility of consolidation plans and entrench fiscal discipline (Debrun and Kumar, 2007a). Empirical studies for EU countries suggest that national fiscal rules have been generally associated with improved fiscal performance.[4] Setting up nonpartisan fiscal agencies (that is, fiscal councils) that provide macroeconomic forecasts for budget preparation can reduce further the optimistic biases that are found in official government forecasts and contribute to greater transparency (Debrun and Kumar, 2007b; Council of the European Union, 2010).

Among various fiscal rules, an expenditure rule can be particularly useful in reducing the tendency to increase public spending during good times (Box 2.1). An expenditure rule can limit the growth of expenditures to potential growth or to a prudent level of medium-term output growth. If such a rule is adequately designed, the expenditure-to-GDP ratio would fall during good times, rise during bad times, and be constant over the entire cycle. Empirical evidence suggests that rules can also be effective in ensuring strong fiscal consolidation (Box 2.2).

Fiscal rules originated in advanced countries, but increasingly they are also applied in emerging market countries. Eighty countries now have fiscal rules in place, up from just seven in 1990 (IMF, 2010b). In Latvia and Lithuania, fiscal responsibility laws and new deficit rules are being planned. In Poland, the revised Public Finance Act (effective since January 2010) has defined corrective measures to be taken if the thresholds under the debt rule are breached.

[4] Fiscal rules have also been identified as a factor for successful fiscal consolidation. An IMF study shows that 24 episodes of large fiscal adjustments since 1980 benefited from formal budgetary constraints (IMF, forthcoming).

Box 2.1

The Appeal of Fiscal Expenditure Rules in Countries of CESEE

This box seeks to illustrate the benefits that rules-based fiscal expenditure policy would have in countries of central, eastern, and southeastern Europe (CESEE). The numerical simulations use a basic rule to bring out the effects on public finances in broad terms. In practice, one would want to apply more refined expenditure rules, supplement them with other fiscal reforms, and take into account country idiosyncrasies to achieve optimal fiscal outcomes. For example, in oil-producing countries, a permanent income oil model rule may be the best way to ensure long-term fiscal sustainability and equitable intergenerational use of the oil wealth (Medas and Zakharova, 2009).

The simulations suggest that expenditure rules could help make fiscal policy less procyclical and lower public debt in CESEE countries (first figure).[1] Had the real growth rate of primary expenditure been limited to a prudent estimate of medium-term real GDP growth, fiscal policy would have been significantly less expansionary in good times. Larger fiscal buffers would have been accumulated when economic growth was above trend, thereby reducing the need for strong fiscal tightening during downturns. Moreover, thanks to the large fiscal surpluses achieved during good times, public finances would in general have remained in better shape than the actual outcomes, despite much higher real expenditure growth induced by the rule in bad times. Setting the rule in nominal or real terms does not affect the results much as long as inflation remains reasonably predictable. A nominal rule tends to deliver stronger countercyclical policies if inflation surprises on the upside in booms and on the downside in bad times. This could usefully reinforce the countercyclical character of the rule. However, nominal rules do not perform well in the rare circumstances in which unexpectedly high inflation coincides with cyclical downturns. Latvia is a point in case—expenditure growth is much lower under a nominal rule than under a real one.

The expenditure-smoothing feature of the rule is particularly apparent in countries that experienced a pronounced boom-bust cycle, such as the Baltics or Romania, and in countries where fiscal revenues were inflated by surging oil prices (second figure). Most notably in these countries, fiscal rule-based expenditures would have been significantly below actual expenditures in good times. And the fiscal buffers accumulated in boom periods would have permitted maintaining high expenditure growth without leading to excessive fiscal deficits in bad times. Interestingly, the rule would have been much less binding in countries that had an expenditure-type fiscal rule already in place (for example, Finland, the Netherlands, Sweden, and Switzerland) or in countries with more restrained expenditure growth in the boom period (for example, Czech Republic and Slovenia).

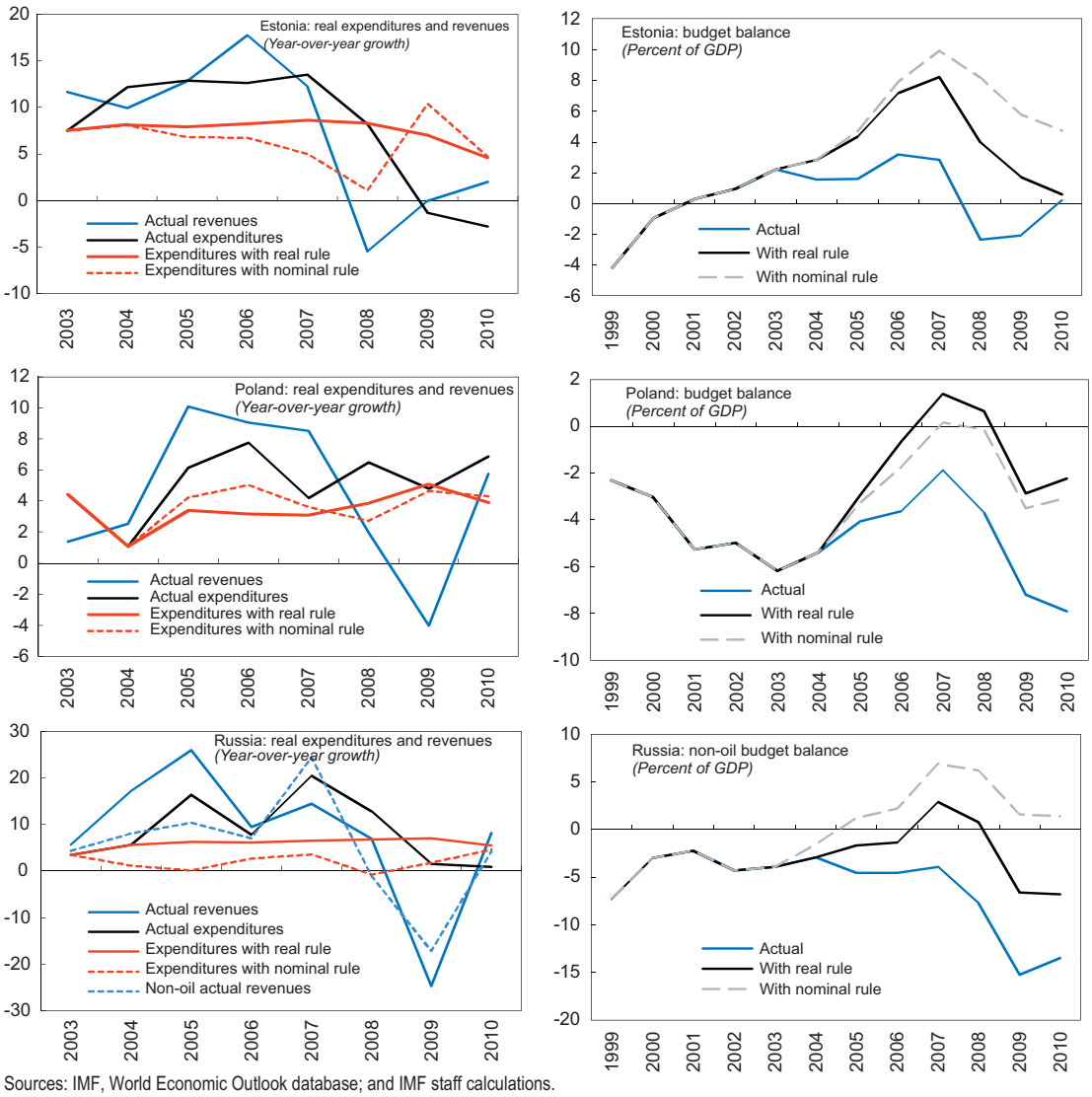
Past experience, however, shows that an expenditure rule, like other fiscal rules, only works if there is a genuine political commitment to fiscal discipline. Without that commitment, the expenditure rule risks leading to creative accounting and to off-budget operations, reducing transparency while failing to genuinely improve fiscal policy. Only superficial commitment to the expenditure rule could also undermine the quality of public spending, as easy-to-cut expenditures are targeted regardless of the implications for long-term growth.

Note: The main author of this box is Géraldine Mahieu.

[1] The expenditure rules considered in the numerical examples limit the growth rate of general government primary expenditure to a prudent estimate of medium-term real GDP growth. It is calculated as the moving average of real GDP growth since 2000 rather than potential growth, which is difficult to estimate reliably in real time. Computing average real GDP growth from 2000 excludes the transition years, where growth was arguably less representative of future economic performance. The simulations consider two variations of the expenditure rule. In the first version, real spending is targeted using the actual CPI to translate real expenditure ceilings into nominal ones. In the second version, nominal spending is targeted using the targeted inflation rate to derive nominal expenditure ceilings. For expositional clarity, any feedbacks from expenditure on real GDP growth and public revenues are assumed away. The simulations generally apply the expenditure rule from 2004. However, later starting points are used in a number of cases to ensure that public finances are reasonably sound at the outset (2005 for the Czech Republic, Hungary, Poland, and Slovakia, and 2006 in Albania, Croatia, and Turkey).

Box 2.1 *(continued)*

Impact of an Expenditure Rule on Expenditure and Revenue Growth in Selected EU Countries

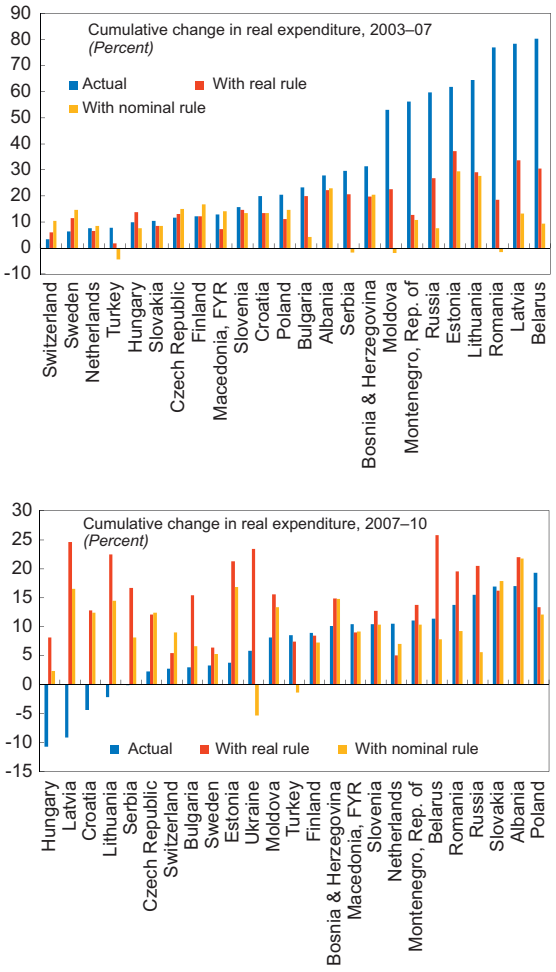


Sources: IMF, World Economic Outlook database; and IMF staff calculations.

Expenditure rules should be supplemented by a long-term fiscal anchor for the budget balance. Expenditure rules by themselves do not ensure fiscal sustainability as they do not take the revenue side into account.[2] A long-term fiscal anchor, in terms of budget balance, is therefore essential, either by linking the path of expenditures to the desired fiscal balance or by combining the expenditure rule with a budget balance rule or a deficit ceiling, to avoid excessive fiscal slippages in case of severe economic crises. The case of Latvia illustrates this point in the numerical simulations (third figure): despite Latvia's large fiscal buffers induced by the expenditure rule during the boom years (peaking at 9.5 percent of GDP in 2007 with a real rule), maintaining an expenditure growth rate in line with past average GDP growth (about 7 percent in real terms) when GDP collapsed by about 22 percent in the following three years would have led to excessive fiscal deficits (–9.5 percent in 2010).

[2] However, some expenditure rules provide for compensatory cuts in spending in case of discretionary cuts in revenues.

Expenditure Rule and Its Impact on Expenditure Growth in Good Times and Downturns

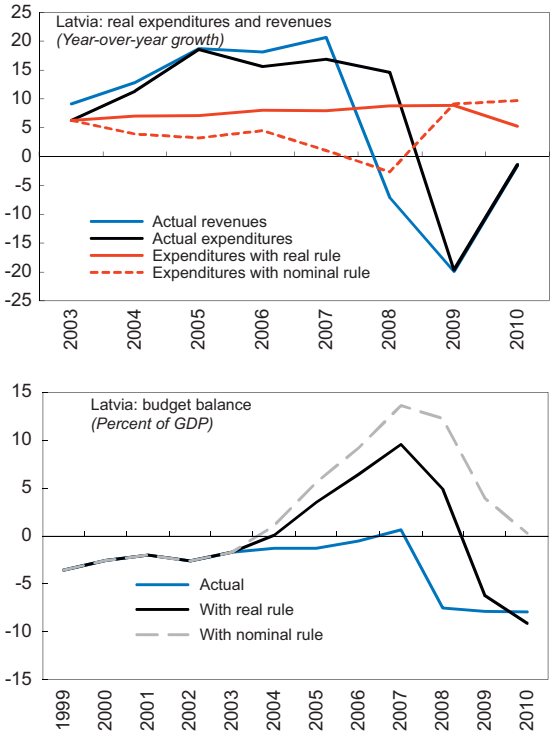


Sources: IMF, World Economic Outlook database; and IMF staff calculations.

This also implies that fiscal expenditure rules are not a good instrument for fiscal consolidation, especially in times when GDP growth is still below potential. The example of Hungary in the illustrative simulations shows that if the fiscal rule started being applied in a year with a large fiscal deficit (6.4 percent of GDP in Hungary in 2004), it worsens the fiscal deficit (fourth figure). Given that many emerging European economies are currently facing large fiscal deficits, major fiscal consolidation plans should precede the introduction of an expenditure rule. However, considering a wider set of rules, fiscal rules may be a factor of success for fiscal consolidation (IMF, 2009).

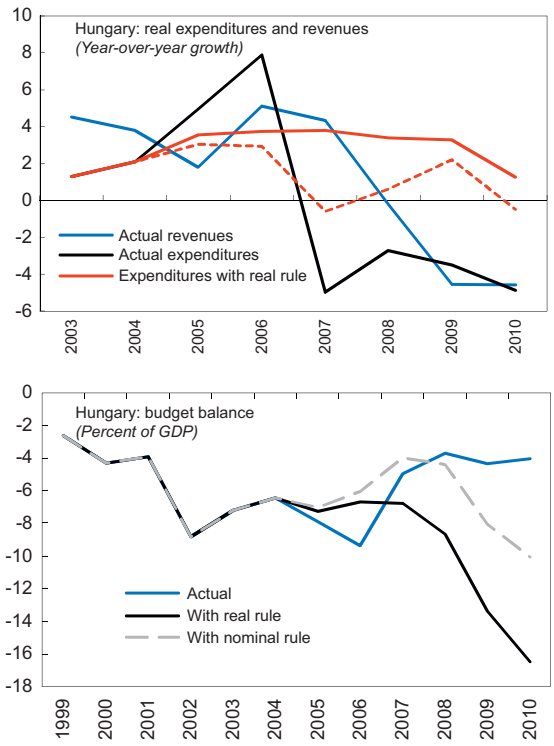
However, preparatory work on the design of an expenditure rule should commence earlier. The design of the rule and the process of reaching the necessary

Impact of Expenditure Rule in Latvia



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

Impact of Expenditure Rule in Hungary



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

Box 2.1 *(concluded)*

consensus on its parameters are likely to take time. In addition, because the global financial crisis has generally increased the population's awareness of the importance of stable and sustainable public finances, this could raise the political support for an expenditure rule. Past experience shows that the introduction of expenditure rules was indeed preceded by severe fiscal difficulties in several countries, although it came after consolidation efforts had been completed and therefore served primarily to lock in fiscal adjustment. This suggests that preparations for an expenditure rule should accompany fiscal consolidation plans so that it is ready for implementation once the repair of public finances has sufficiently advanced.

Box 2.2

Institutions That Facilitate Fiscal Consolidation

Budgetary institutions shape fiscal outcomes and notably facilitate fiscal consolidation. This has been shown by several theoretical and empirical analyses. Budgetary institutions support fiscal consolidation efforts at three stages of the policymaking process: (i) by providing policymakers and the public with a credible and transparent assessment of the scale and scope of the necessary consolidation; (ii) by helping develop a credible consolidation strategy; and (iii) by supporting the implementation of the consolidation strategy with strong institutional arrangements for the preparation, approval, and execution of the budget. This box reviews the institutions that seem to have contributed the most to fiscal consolidation.[1]

Comprehensive and rigorous reporting of government finances is needed to provide an effective basis for consolidation planning. This is supported by both the literature and past country experience. Government statistics should cover both central and local government finances and be produced by an independent statistical office, in line with harmonized standards.[2] Experience shows that contingent liabilities and tax expenditures (that is, deviations from established tax norms or benchmarks intended to provide a benefit for a specific activity or class of taxpayer) should be subjected to stricter monitoring and control arrangements, because these two items have been a major source of fiscal leakages in previous consolidation efforts.

Medium-term fiscal objectives can provide a stable anchor for fiscal consolidation. When precisely defined in terms of nominal values and timeframe, medium-term fiscal objectives have been shown to provide a stable anchor for fiscal consolidation and to raise the costs of deviating from the consolidation path. Formalizing these medium-term objectives as numerical fiscal rules can contribute to the consolidation efforts, although empirical studies tend to show that they have been more important in sustaining the pace of consolidation than in generating it. For example, some empirical evidence (see EC, 2007b) suggests that the presence of numerical rules for the deficit and debt is associated with successful consolidation episodes, but expenditure rules are not (see Box 2.1). Numerical rules for deficit and debt were introduced in Italy and Spain during their successful fiscal consolidations, which started in the 1990s. The enactment of subnational borrowing rules and limits also appears to have supported the major fiscal consolidation efforts in Canada (started in 1993) and Russia (started in 1995). Under the U.S. Budget Enforcement Act (1990–2002), stringent caps on discretionary spending and "pay-as-you-go" financing on entitlement outlays helped lock in the revenue surprise of the late 1990s until passage of the tax cut in 2001.[3]

Note: The main author of this box is Géraldine Mahieu.

[1] For more details on the impact of budgetary institutions on fiscal outcome and fiscal consolidation, see notably European Commission (2007b), Tsibouris and others (2006), Gupta and others (2005), Debrun and others (2009), Price (2010), and von Hagen and others (2001).

[2] Dabla-Norris and others (2010) shows that the comprehensiveness and transparency of the budget process particularly promote fiscal discipline in low-income countries.

[3] However, lower defense spending may have been a safety valve, since nondefense spending continued to grow.

A credible medium-term budget framework, if adequately designed, is also crucial to meet aggregate fiscal objectives and achieve consolidation success, as it encourages long-term planning and reinforces multi-year discipline. A medium-term framework consists of arrangements for formulating and presenting projections of individual revenue and expenditure items; fixing binding multi-year restrictions on expenditure aggregates; and providing clear indications of policy priorities. While the empirical support for the effectiveness of medium-term frameworks in promoting fiscal discipline is somewhat mixed, medium-term frameworks were implemented in several countries that have achieved large fiscal consolidation, such as in Brazil (1999–2003), Canada (1993–2000), Finland (1992–2000), Lithuania (1999–2003), New Zealand (1983–88), and South Africa (1993–2001).[4]

Independent fiscal agencies have been shown to be particularly helpful in developing credible fiscal consolidation. The role given to these agencies differs across countries. They can be tasked to do the following:

- Provide independent forecasts regarding both budgetary variables and other relevant macroeconomic variables, including GDP growth and inflation, thereby injecting more realism into budget plans, and/or
- Provide objective analysis of fiscal developments, long-term sustainability considerations, and cost of budgetary initiatives, thereby increasing the transparency and supporting the credibility of the consolidation process, and/or
- Provide normative assessments regarding the consistency of the government's budgetary policies with its own objectives (including recommendations of a particular fiscal measure), thereby raising the reputational cost to the government of deviating from its fiscal consolidation path.

Evidence suggests that fiscal councils have contributed to fiscal discipline, with those providing normative assessment generally being more effective than those limited to pure analysis (see, for instance, Debrun and others, 2009), although their effectiveness also crucially depends on the degree of the government's commitment to fiscal soundness. Examples of fiscal councils with a mandate to issue normative judgments include Belgium's High Council of Finance, Denmark's Economic Council, and Sweden's Fiscal Policy council. The recommendations of these agencies seem to have been taken seriously, contributing to constructive debates on budgetary policy issues and helping to implement difficult consolidation measures. The Netherlands' Central Planning Bureau, which provides the economic assumptions for the budget, as well as independent analyses and research on a broad range of economic issues, is also widely regarded as fully independent and as a model for an effective fiscal council.

Finally, strong institutions for the preparation, approval, and execution of budgets prevent consolidation plans from derailing when confronted with the realities of the annual budget process. A comprehensive top-down approach to budgeting—meaning that a binding decision on budget aggregates including all central government finances is taken before an allocation of expenditure is made within those aggregates—has been shown to improve fiscal discipline.[5] Similarly, restrictions on parliamentary powers to amend the government's draft budget and hand a stronger role to the prime minister or finance minister have proven to help enhance fiscal discipline.[6]

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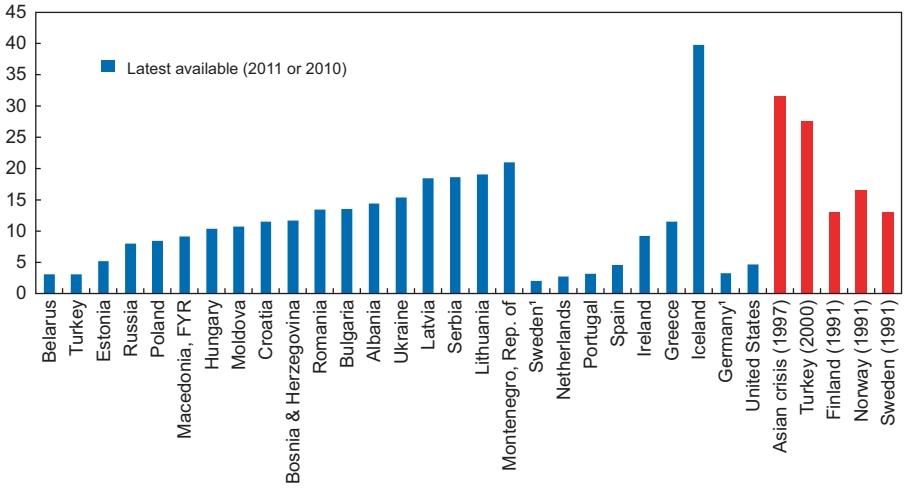
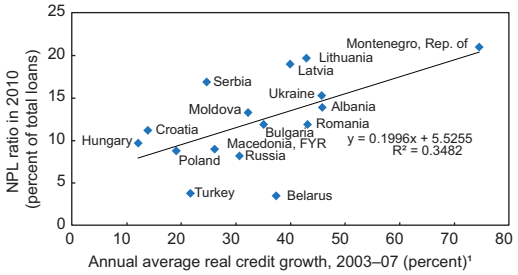
[4] The EC (2007b) finds that medium-term frameworks have a positive effect on fiscal performance in the EU as do Beetsma and others (2009), while Ylaoutinen (2004) finds less evidence of such a link in Central and Eastern European countries.
[5] Von Hagen (2005) and de Haan and others (1999) find support for the hypothesis that the comprehensiveness of the budget process improves fiscal discipline.
[6] Alesina and others (1999), Wehner (2009), and von Hagen and Harden (1994) notably demonstrate that limits on parliamentary amendment powers are positively associated with fiscal outcomes. Mulas-Granados and others (2009) shows that institutional designs that allow the finance minister to veto parliament's proposals for modifying the budget have been crucial to foster fiscal consolidation in the new EU Member States.

Figure 2.13
Selected Countries: Bank Nonperforming Loans to Total Loans
(Percent)



Sources: Iceland FME; IMF, Statistics Department; and Laeven and Valencia (2008).
[1]2009 instead of 2010.

Figure 2.14
Emerging Europe: NPL Levels and Past Credit Growth



Sources: IMF, *International Financial Statistics;* IMF, Statistics Department; and IMF staff estimates.
Note: Annual average growth is over 2004–07 for Hungary, Latvia, Macedonia, and Serbia; 2005–07 for Belarus, Lithuania, and Poland; and 2006–07 for Moldova.
[1]Derived from stock data in domestic currency, adjusted by CPI inflation. May include valuation effects from foreign-currency-denominated loans.

Fiscal responsibility legislation was approved in Serbia at end-2010. Bulgaria recently adopted a Financial Stability Pact, which caps government expenditure at 40 percent of GDP and the general government budget deficit at no more than 2 percent of GDP.

…but fiscal rules are no panacea

A genuine political commitment to fiscal discipline is key to success. In the absence of social consensus on fiscal discipline, fiscal institutions are likely to be ignored or circumvented—typically through creative accounting and off-budget operations that reduce transparency and democratic accountability. But even when an expenditure rule is not fully followed, having one can help limit expenditure growth by setting a clear benchmark for reasonable expenditure growth in good times. In emerging Europe, the crisis in 2008/09 has generally increased the popular awareness of the importance of sustainable public finances, which could help build support for introducing an expenditure rule.

Cleaning up NPLs

The crisis of 2008/09 and the boom that preceded it have left a large share of banks' loan portfolios impaired. NPL ratios are high, often at levels comparable with those seen in earlier financial crises around the world (Figure 2.13). According to the latest data available, several countries, including Latvia, Lithuania, Montenegro, Serbia, and Ukraine, report NPL ratios in excess of 15 percent (Table 2.4). NPL ratios are particularly high in countries that went through a pronounced boom-bust cycle, with rapid credit growth and housing price appreciation fueling the upswing and deep recessions and housing price slumps when the credit cycle turned (Figure 2.14). NPL ratios generally seem close to their peak in the first half

Table 2.4

Emerging Europe: Selected Financial Soundness Indicators, 2007–11[1]

(Percent)

	Capital Adequacy						Return on Assets						Nonperforming Loans to Total Loans					
Country	**2007**	**2008**	**2009**	**2010**	**2011**	**Latest**	**2007**	**2008**	**2009**	**2010**	**2011**	**Latest**	**2007**	**2008**	**2009**	**2010**	**2011**	**Latest**
Albania	17.1	17.2	16.2	15.4	14.8	Mar.	1.6	0.9	0.4	0.7	0.3	Mar.	3.4	6.6	10.5	13.9	14.4	Mar.
Belarus	19.3	21.8	19.8	20.5	16.7	June	1.7	1.4	1.4	1.7	1.6	June	1.9	1.7	4.2	3.5	3.1	June
Bosnia and Herzegovina	17.1	16.3	16.1	16.2	15.8	Mar.	0.9	0.4	0.1	-0.6	0.2	Mar.	3.0	3.1	5.9	11.4	11.7	Mar.
Bulgaria	13.8	14.9	17.0	17.5	17.7	June	2.4	2.1	1.1	0.9	0.9	June	2.1	2.5	6.4	11.9	13.5	June
Croatia	16.9	15.4	16.6	18.8	19.1	Mar.	1.6	1.6	1.1	1.2	1.2	Mar.	4.8	4.9	7.8	11.2	11.5	Mar.
Hungary	10.4	12.4	13.9	14.1	14.4	Mar.	1.2	1.2	0.6	0.1	0.7	Mar.	2.3	3.0	6.7	9.7	10.4	Mar.
Latvia	11.1	11.8	14.6	14.6	15.1	June	2.0	0.3	-3.5	-1.6	0.6	June	0.8	3.6	16.4	19.0	18.4	June
Lithuania	10.9	12.9	14.2	15.6	15.6	Mar.	1.7	1.0	-4.2	-0.3	1.3	Mar.	1.0	4.6	19.3	19.7	19.1	Mar.
Macedonia, FYR	17.0	16.2	16.4	16.1	16.8	Mar.	1.8	1.4	0.6	0.8	-0.1	Mar.	7.5	6.7	8.9	9.0	9.1	Mar.
Moldova	29.1	32.2	32.1	30.1	29.7	Mar.	3.9	3.5	-0.5	0.5	1.7	Mar.	3.7	5.2	16.4	13.3	10.7	Mar.
Montenegro, Rep. of	17.1	15.0	15.8	15.9	…	Dec.	0.8	-0.6	-0.6	-2.7	-3.0	Mar.	3.2	7.2	13.5	21.0	…	Dec.
Poland	12.0	11.2	13.3	13.8	13.7	June	1.9	1.5	0.8	1.0	1.1	Mar.	5.2	4.5	8.0	8.8	8.4	June
Romania	13.8	13.8	14.7	14.7	14.2	June	1.0	1.6	0.2	-0.1	0.1	June	2.6	2.8	7.9	11.9	13.4	June
Russia	15.5	16.8	20.9	18.1	17.2	May	3.0	1.8	0.7	1.9	2.3	May	2.5	3.8	9.5	8.2	8.0	May
Serbia	27.9	21.9	21.3	19.9	19.7	June	1.7	2.1	1.0	1.1	1.4	June	…	11.3	15.5	16.9	18.6	June
Turkey	18.9	18.0	20.6	19.0	17.4	May	2.6	1.8	2.4	2.2	1.8	May	3.6	3.8	5.6	3.8	3.1	May
Ukraine	13.9	14.0	18.1	20.8	19.2	June	1.5	1.0	-4.4	-1.5	-0.2	June	3.0	3.9	13.7	15.3	15.4	June
Memorandum																		
Middle East[2]	14.8	13.9	14.9	16.7	17.8		1.7	1.5	1.3	1.4	1.7		5.6	4.4	5.2	5.1	4.5	
Latin America[3]	15.9	15.7	17.1	16.7	16.4		2.5	1.9	2.2	2.7	2.4		2.4	2.7	3.4	2.5	2.4	
Asia[4]	14.2	14.5	15.3	15.6	15.6		1.3	1.3	1.3	1.5	2.0		5.5	3.8	3.4	2.9	2.6	

Source: IMF, Statistics Department.

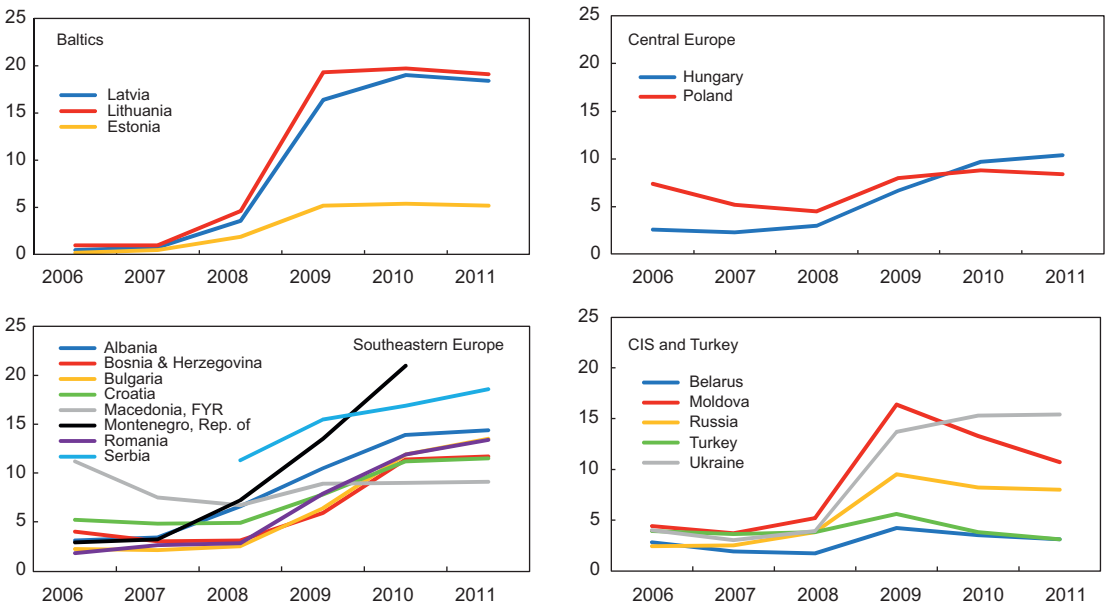
[1] Please refer to http://fsi.imf.org/fsitables.aspx for detailed notes on cross-country variations in the definitions of the variables.

[2] Average for Jordan, Lebanon, Morocco, Oman, and United Arab Emirates.

[3] Average for Argentina, Brazil, Chile, Colombia, and Mexico.

[4] Average for China, India, Indonesia, Malaysia, Philippines, and Thailand.

Figure 2.15
Emerging Europe: Bank Nonperforming Loans to Total Loans, 2006–11
(Percent, end of period or latest)



Source: IMF, Statistics Department.

of 2011—with ratios declining in some countries, such as Poland, Russia, and the Baltics, while edging up elsewhere, such as in Bulgaria, Hungary, and Romania (Figure 2.15). This reflects differences in the strength of the economic recovery. Exchange rate movements also play a role when loans are denominated in foreign currency. For example, in Hungary, many mortgages are denominated in Swiss francs and the franc's strong appreciation against the forint makes it more onerous for homeowners to keep up with rising debt-service requirements.

High NPLs in emerging Europe are currently not a threat to financial stability…

Financial soundness indicators suggest that banking systems are generally well capitalized and that provisioning levels are generally substantial (Table 2.4). Capital adequacy ratios are in the double digits, comfortably above the minimum regulatory requirement. Loan-loss provisions cover about two-thirds of NPLs on average; but provisioning levels vary significantly across countries, with the levels in some Southeastern European countries closer to one-third of NPLs (Figure 2.16).[5]

Nonetheless, supervisors must remain on their toes as the financial turmoil in euro area debt markets evolves and further local surprises cannot be ruled out, such as the need for a bailout of the fifth largest Russian bank this July.

...but they may hold back the recovery

High levels of unresolved NPLs over prolonged periods of time are likely to hold back economic recovery and structural change for the following reasons.

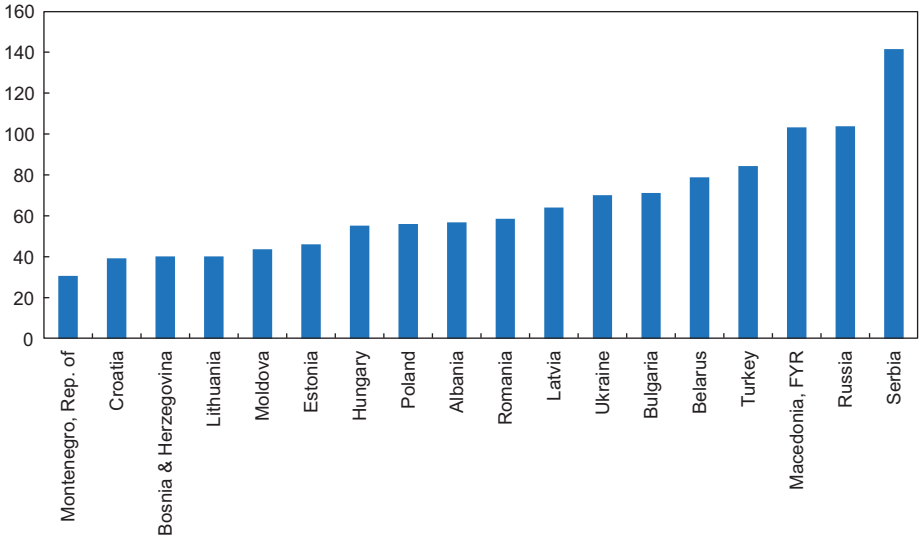
- Impaired debtors have little incentive and ability to step up economic activity as any incremental income would accrue in its entirety to creditors.

[5] The recent European stress tests found that most major banks operating in the region would be resilient to an adverse scenario: only two banks (Volksbank and Eurobank) failed the tests and two other banks (Piraeus and Banco Commercial Portugues) were found to be vulnerable to shocks (Figure 2.17).

Figure 2.16

Emerging Europe: Bank Provisions for Nonperforming Loans, 2010–11[1]

(Percent)



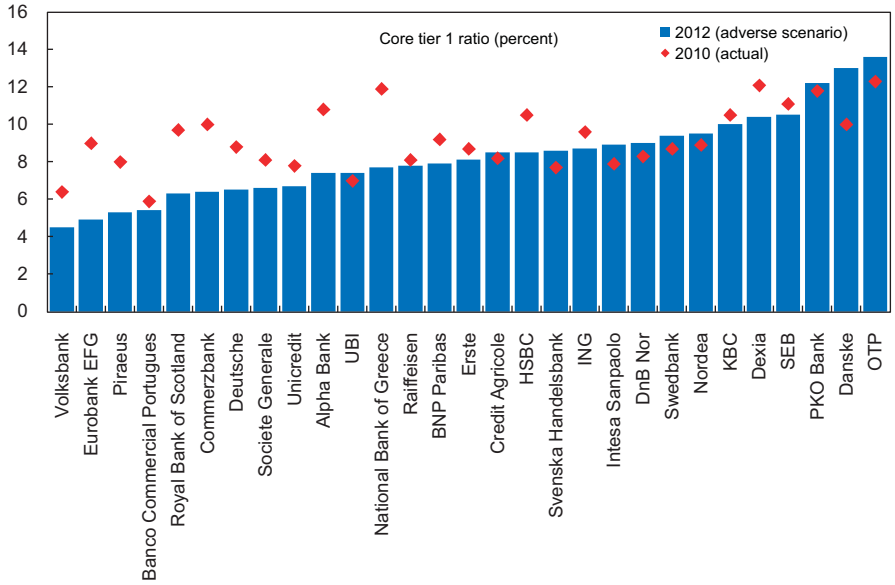
Source: IMF, Statistics Department.

[1]Latest available.

Figure 2.17

Selected Banks in Emerging Europe: European Bank Stress Tests[1]

(Results from stress tests, July 2011)



Source: European Banking Authority (EBA).

[1]The EBA stress tests simulated bank profits over a two-year period under an adverse macrofinancial scenario, based on end-2010 balance sheet data. Banks failed the test if their core tier 1 capital ratio was below 5 percent at the end of the simulation period and were deemed vulnerableif their ratio was between 5 and 6 percent. The capital ratio at the end of the simulation period took into account recognized mitigating measures (including capital raising) put in place before April 30, 2011.

At the same time, lack of financing hinders investment, as well as the conduct of normal business operations. Moreover, unresolved NPLs also mean that assets of unviable debtors are not reallocated to potentially more productive uses.

- Banks with highly impaired loan portfolios are likely to engage less in new lending. First, banks with high NPLs are likely to charge higher interest rates, and therefore attract less credit demand, as they raise spreads to recoup NPL-related losses or as they pass on higher funding costs associated with uncertainties about their true financial health. Second, high NPLs can reduce banks' capacity to finance new loans, as foregone debt service on NPLs is no longer available for new lending or as losses from provisioning erode capital. Third, high NPLs might unduly distract bank management from seeking out new lending opportunities.

A cross-country panel regression analysis of individual banks in emerging Europe shows that banks with high NPLs exhibit systematically lower lending growth (Box 2.3). As the regressions compare individual banks, they allow supply factors (higher NPLs) to be distinguished from demand factors (low GDP growth), which affect all banks in a country equally.

Resolving NPLs should be done by the private sector

Lowering NPL levels will support economic activity. With economic conditions sufficiently settled for a proper assessment of debtors' repayment capacity and banking systems resilient enough to absorb potential further losses, the time has come to push ahead with NPL resolution. There are a number of steps governments can take to foster market-based solutions.

- *Remove debt restructuring obstacles in tax codes and regulations.* A reduction of debt through debt write-downs should not be considered taxable income of troubled borrowers. Loss carry-forward should be ensured in restructurings that involve mergers or acquisitions, and the transfer of assets to third parties or dedicated workout units should not be subject to value-added tax (VAT). Regulations prohibiting banks from owning and operating businesses or requiring compulsory takeover bids should not apply in the context of debt restructuring or collateral execution.
- *Strengthen credit enforcement.* Effective credit enforcement requires not only adequate insolvency and foreclosure legislation, but also the institutional capacity and integrity for implementation.
- *Foster voluntary out-of-court restructurings.* This could be done by drawing up a code of conduct for voluntary restructuring that is endorsed by the authorities and industry associations. It could be supported further by expedited legal proceedings that make agreements reached by a qualified majority of creditors legally binding, including for dissenting creditors.
- *Avoid coercive debt restructuring and government subsidies.* Coercion would give rise to legal challenge and do lasting damage to the credit culture. Government subsidies could increase moral hazard and could redistribute to creditors who would otherwise be able to absorb losses. These measures should be used when debt overhang is widespread and severe; the capacity of the banking system to restructure is limited; and there are important concerns about financial stability (Laeven and Laryea, 2009)—none of which is currently the case in emerging Europe.

Toward Sustainable Convergence with Advanced Europe

The still large income differentials between advanced and emerging Europe suggest that emerging Europe has significant scope for further catching-up. At the same time, as discussed in Chapter 3, Europe is the only continent where

Box 2.3

Nonperforming Loans (NPLs) and Credit Growth in Emerging Europe

Credit growth remains subdued in much of emerging Europe while NPLs are high (Figures 2.3 and 2.15). Almost three years after the peak phase of the global financial crisis, real credit growth is still negative in half the countries of emerging Europe. Elsewhere, it also often remains rather low. While this likely reflects a variety of factors, including better risk awareness at the bank level, and is welcome to some extent, the rapid increase of NPLs on banks' books and the large number of overextended borrowers that it reflects may also play a role. Resolving these NPLs would likely not only spur credit growth, but also increase credit churning and unleash the economic potential of overextended but viable borrowers. Economic recovery would benefit through all three channels.

Empirical analysis of individual bank data suggests that high NPLs are indeed holding back credit growth in emerging Europe (table). Specifically, the logarithm of NPL ratios is regressed on real loan growth using 2010 data for over 900 banks in 21 countries of the region. Country-specific effects and cross-country growth differentials are controlled for, as they are potentially the most important other drivers of credit growth. The coefficient for NPLs is found to be negative and highly significant. Results are reported with and without banks' capital adequacy as additional control. A doubling of the NPL ratio tends to reduce real credit growth by between 7 percentage points and 10 percentage points. Working with individual bank data and controlling for GDP growth has the advantage of stripping out the effects that cross-country idiosyncrasies, such as the strength of credit demand, have on lending growth. Hence, the estimated coefficient for NPLs should predominantly capture the effects of NPLs on credit supply.

Regression Results for Banks' Real Loan Growth in 2010

Explanatory variables[1]	Coefficients	
Log NPL ratio (percent, 2010)	-7.100	-9.588
	(0.000)	(0.000)
Real GDP growth (percent, 2010)	1.689	1.283
	(0.120)	(0.197)
Fitch Core Capital/RWA (percent, 2010)	—	0.372
	—	(0.034)
Constant	11.902	14.632
	(0.148)	(0.070)
Observations	959	81
R-squared	0.120	0.460

Sources: IMF, World Economic Outlook database; Bankscope; and IMF staff calculations.
Note: Countries included: emerging Europe (Albania, Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, Hungary, Latvia, Lithuania, Macedonia, Moldova, Montenegro, Poland, Romania, Russia, Serbia, Turkey, and Ukraine) and the Czech Republic, Estonia, the Slovak Republic, and Slovenia. *p*-values in parenthesis.
[1] Country dummies not shown.

Note: The main authors of this box are Gregorio Impavido and Yan Sun.

strong convergence is visibly occurring, no doubt helped by strong linkages between advanced and emerging Europe (Chapter 4). However, convergence is not automatic, as is evident from countries where convergence has stalled, and some growth patterns are more conducive to sustain catching-up than others.

The experience of the past decade suggests that countries with sound macroeconomic policies and rapid trade integration with advanced Europe have seen faster catching-up than countries that have remained relatively closed. One reason for this may be that adopting foreign technology is easier for countries that trade heavily than for countries that are less integrated with the global economy. Indeed, countries with more economic activity in manufacturing and less in nontradable sectors tend to have higher total factor productivity (TFP) growth in the longer term. Another reason for the difference may be that in countries that remain less integrated, much of the growth tends to occur in the context of demand booms financed by capital inflows. While the countries that saw large capital inflows experienced rapid growth during the boom years, much of this overperformance was undone during the subsequent bust.

As discussed in Chapter 3, the interaction of sound macroeconomic policies and growth-enhancing structural reforms can, over time, make a significant difference in raising a country's growth potential by fostering balanced growth and raising TFP growth. Good macroeconomic policies help prevent unbalanced growth, and structural reforms further help raise TFP growth, which in the longer term is the key contributor to growth.