Key Economic Issues in CESEE

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

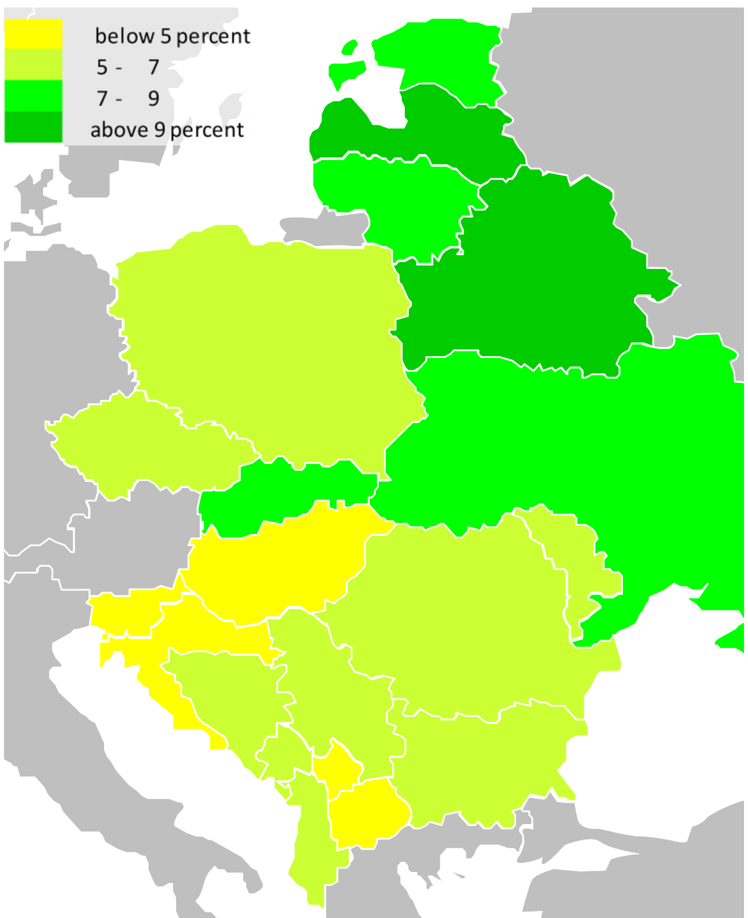
Outline

- 1. The Boom-Bust in CESEE
- 2. Crisis legacies (NPLs, public finances)
- 3. Outlook for 2016
- 4. Longer-Term Challenges
- 5. Conclusion

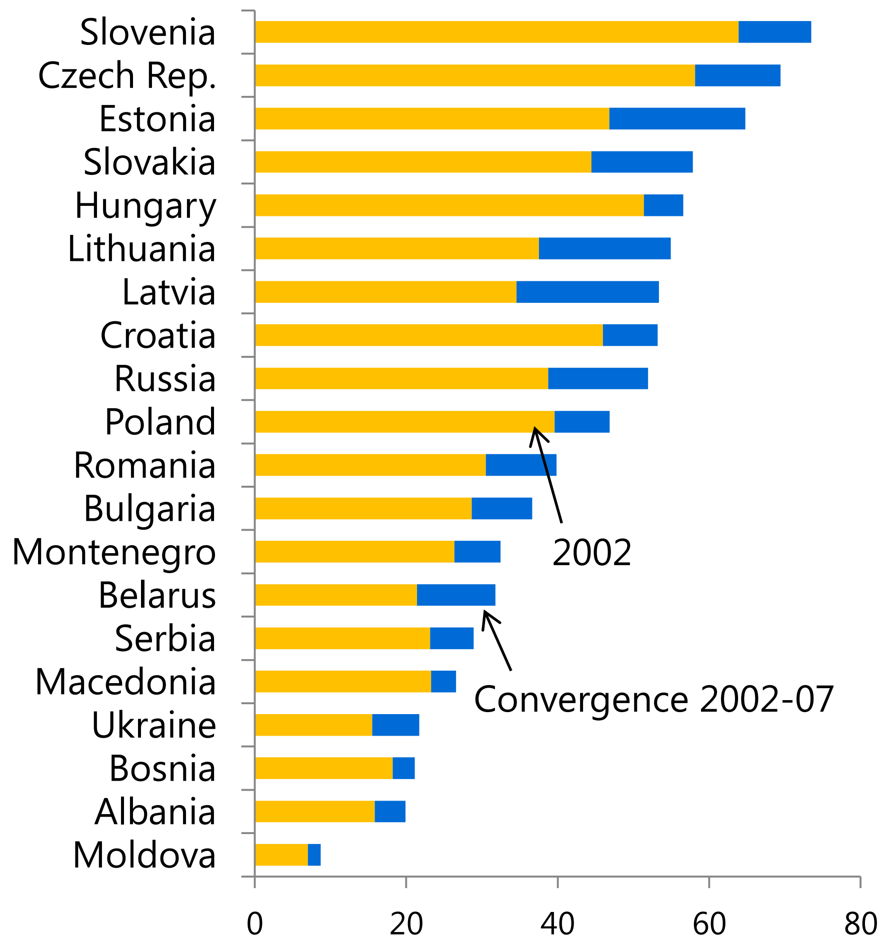
1. The Boom-Bust in CESEE

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

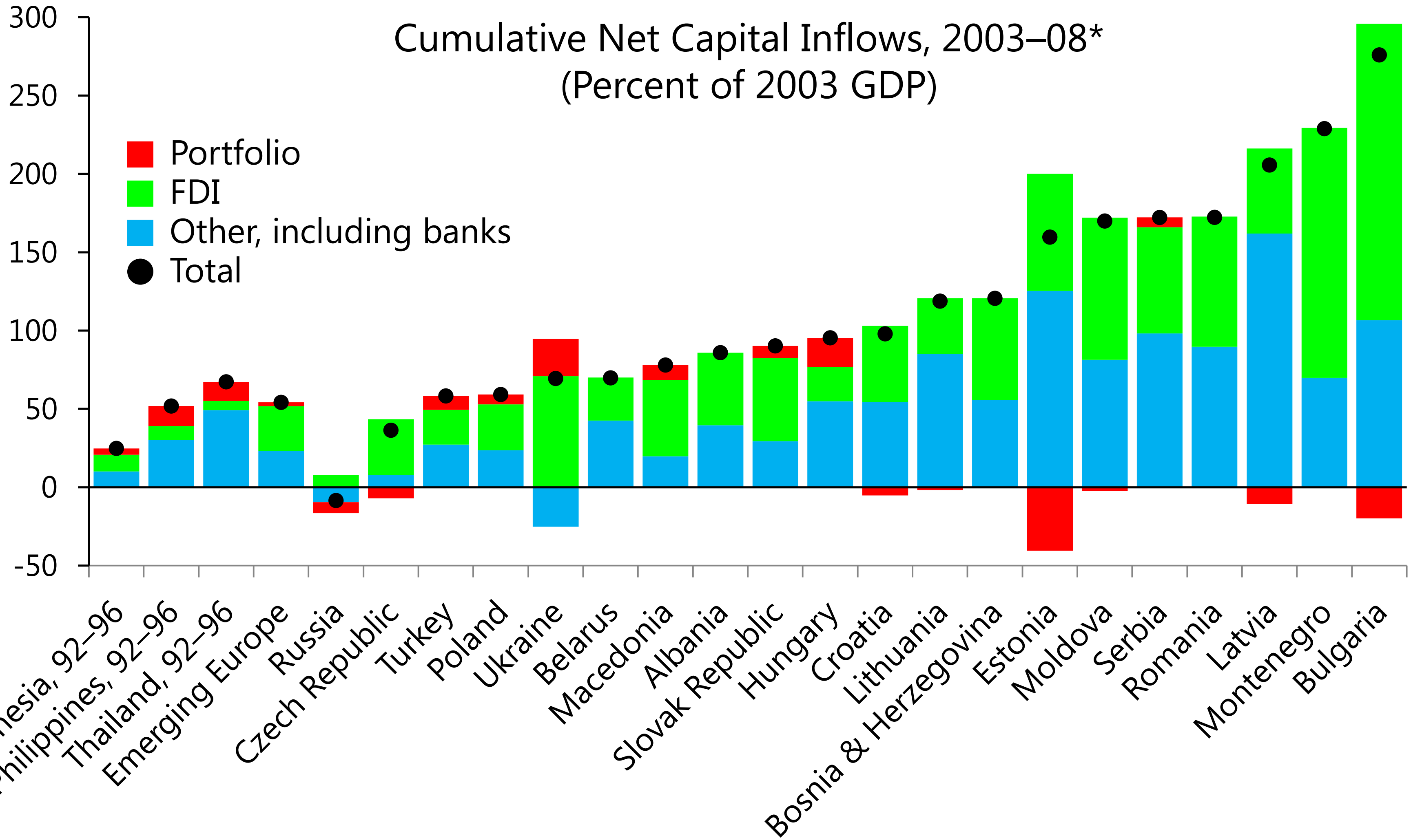
Average annual GDP growth (percent)



GDP per capita level relative to Germany (percent)



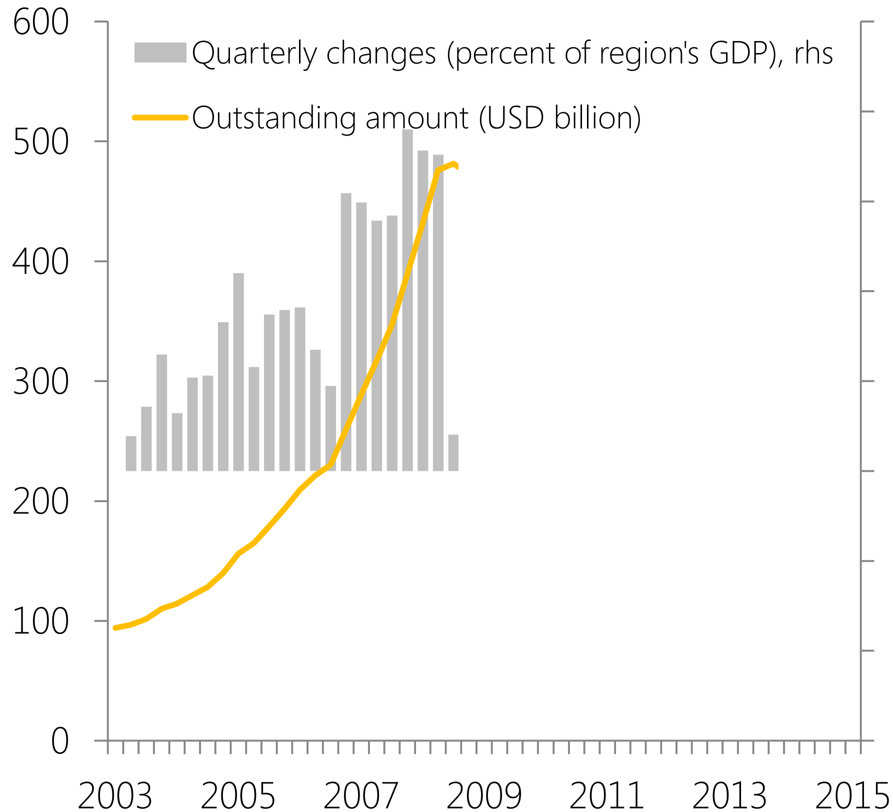
...fueled by strong capital inflows.



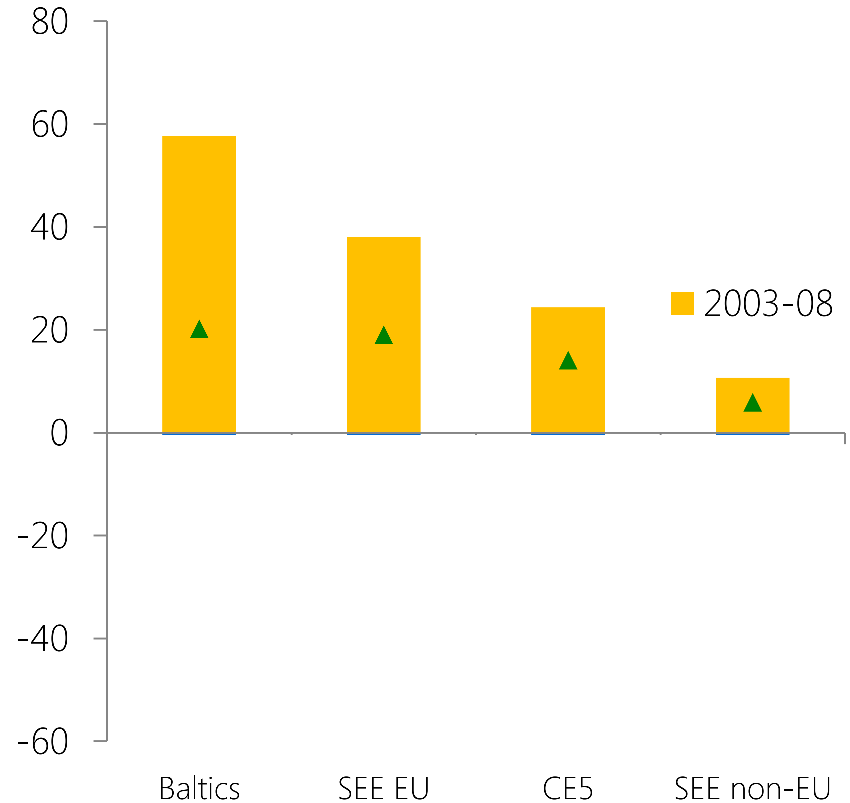
*As the boom in the Baltic states ended in 2007, data for the Baltic states refer to 2002–07 in percent of 2002 GDP.

Western European banks were an important source of capital flows

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

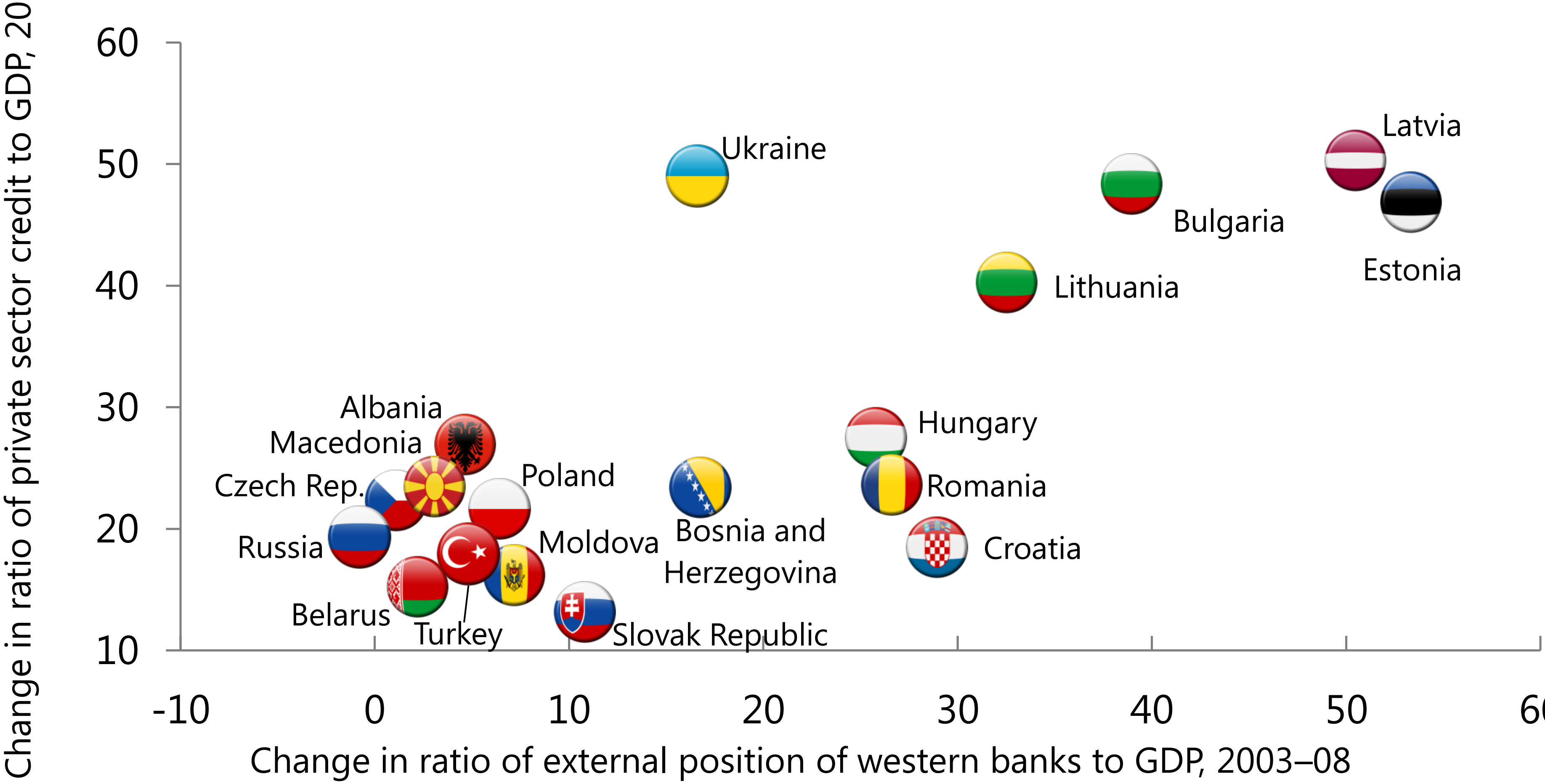


Changes in exposure of BIS-reporting banks (percent of 2015 GDP)

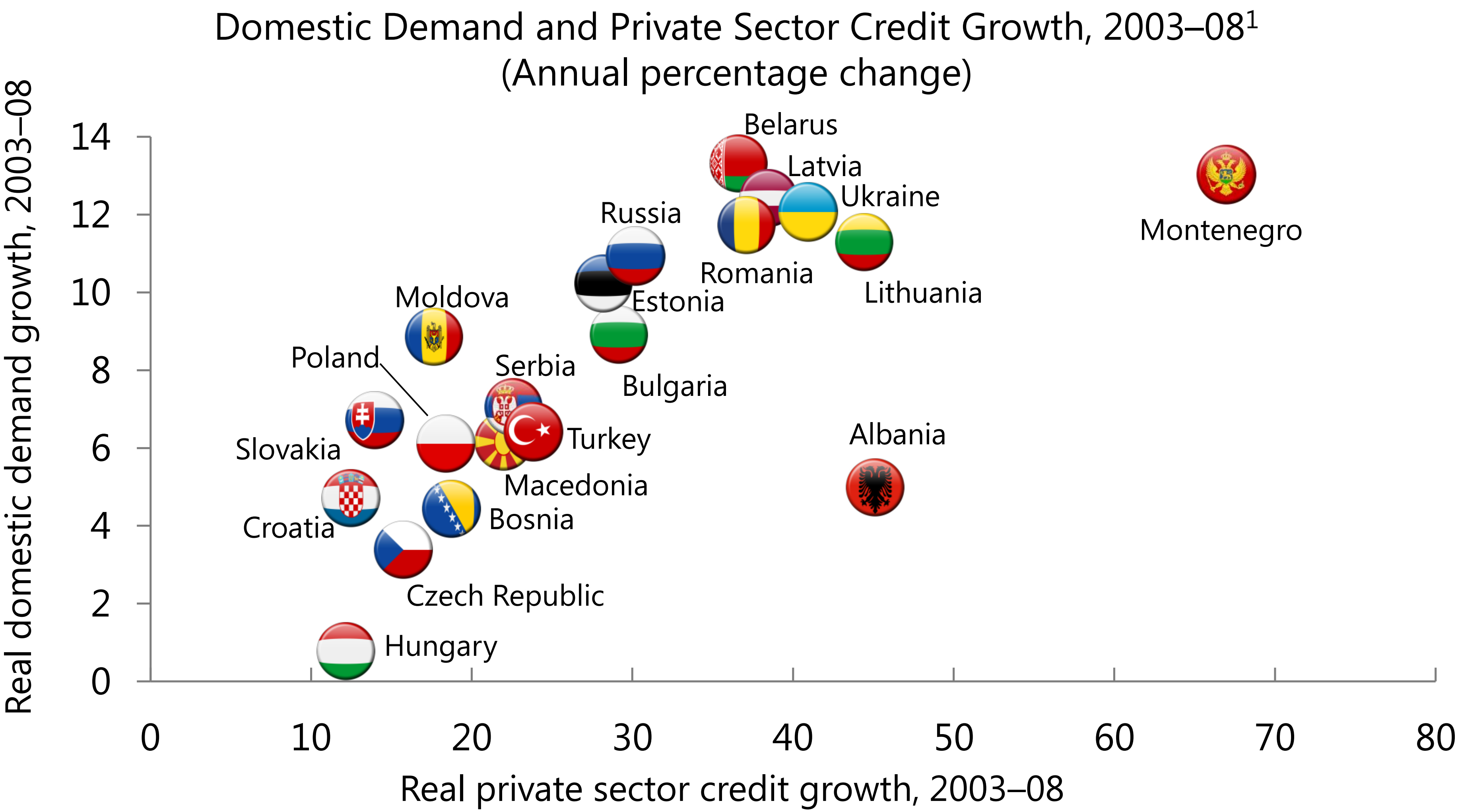


Bank flows fueled a credit boom…

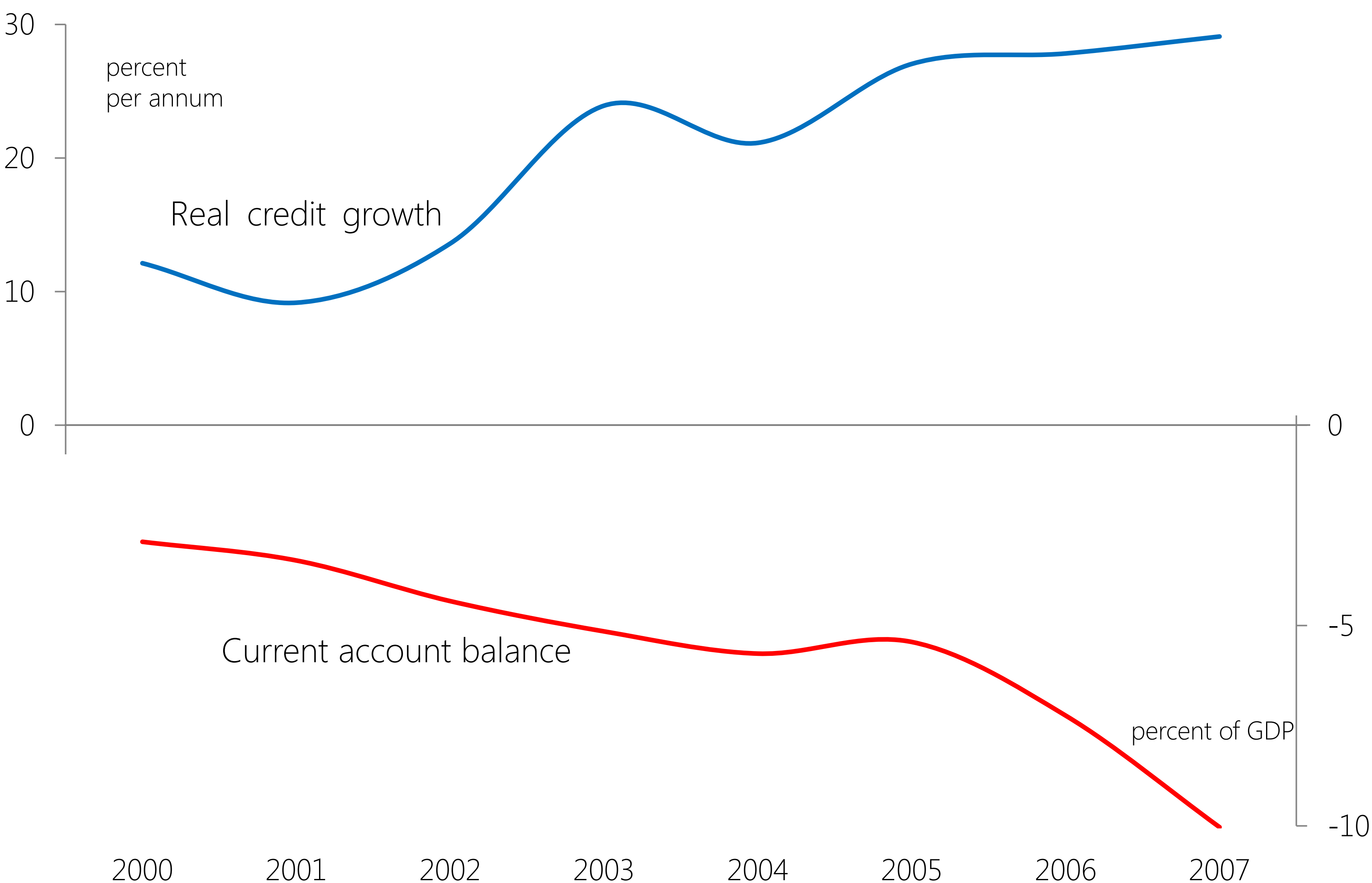
Change in external position of western banks and in private sector credit



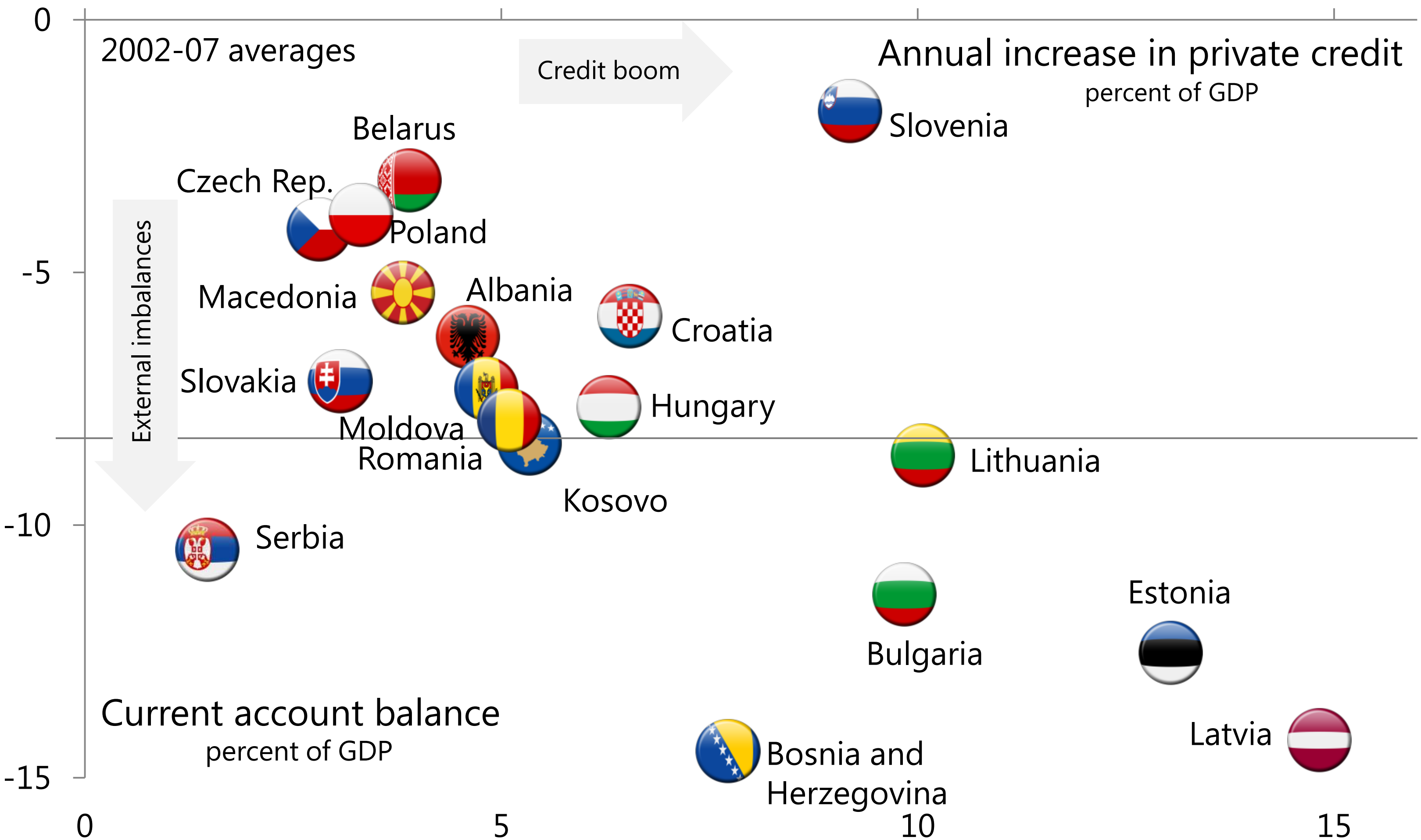
… which boosted domestic demand.



Rapid credit growth was associated with rapidly rising current account deficits



Current account deficits in some countries reached very high levels

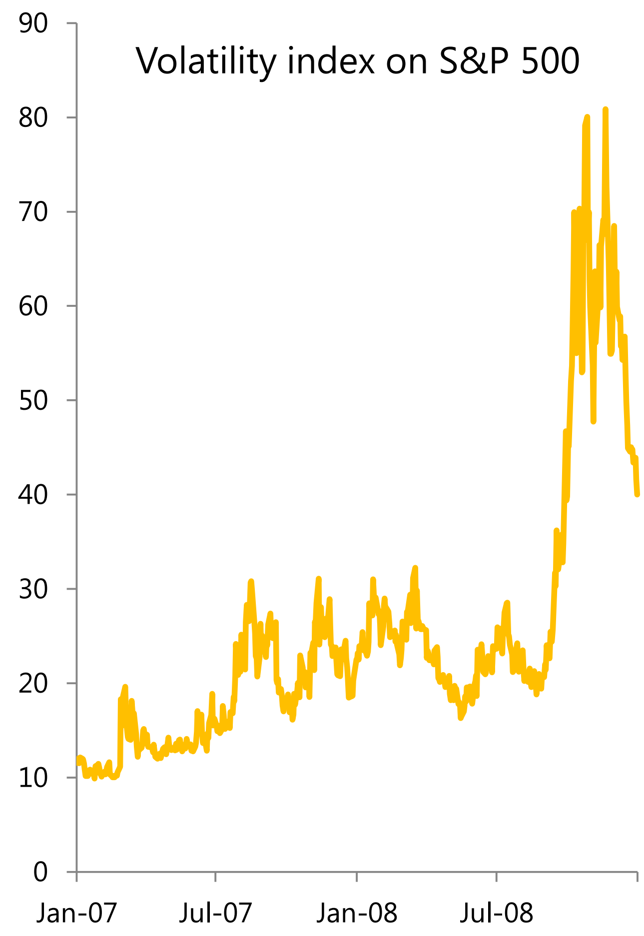


But views differed on how to interpret these imbalances

- Abiad, Leigh, and Mody (2007): "International Finance and Income Convergence: Europe is Different"➔
  - Current account deficits are benign.
  - Capital flowing from rich to poor countries
- Bakker and Vladkova-Hollar (2006): "Asia 1996 and Eastern Europe 2006: Deja-vue all over again"?

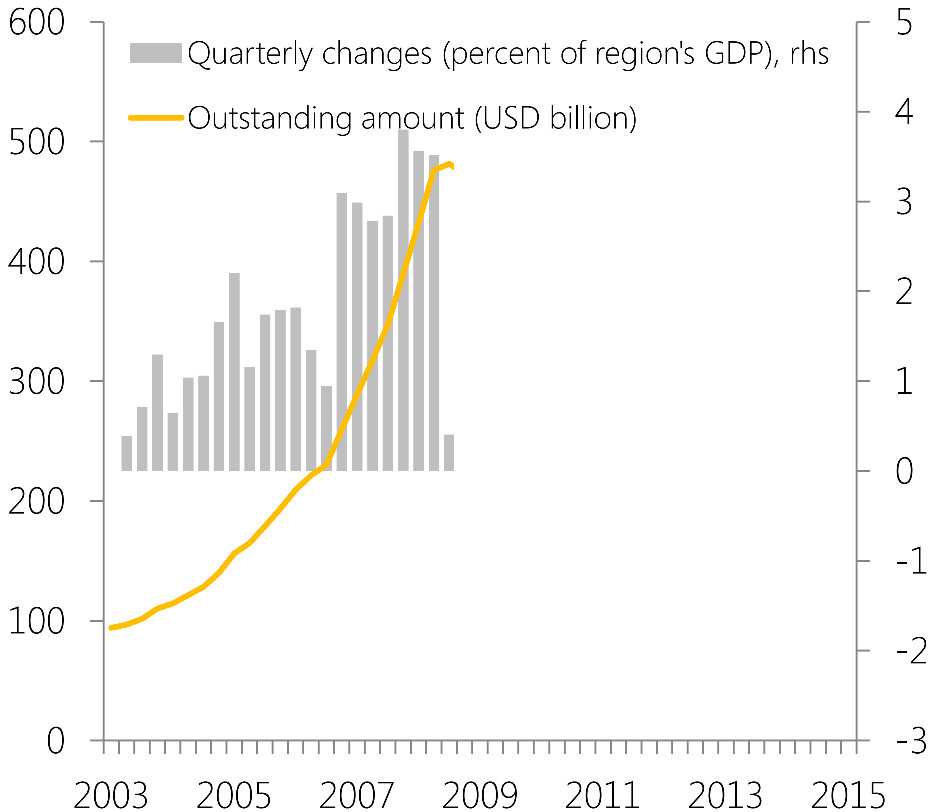
In September 2008, Lehman Brothers defaulted

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

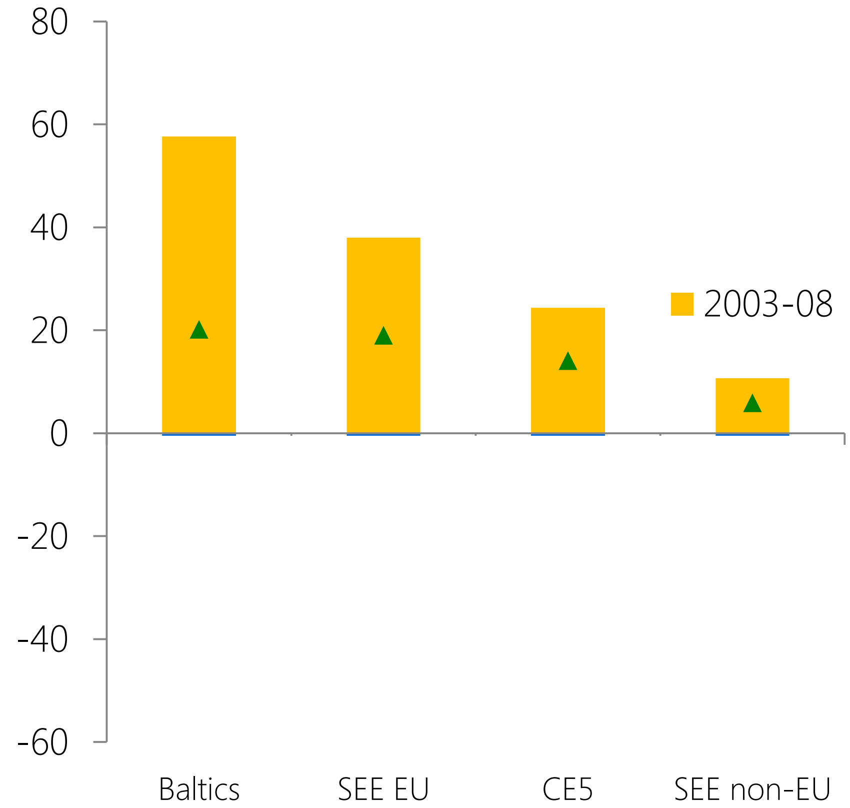


The result was a sudden stop—and then reversal—of bank flows

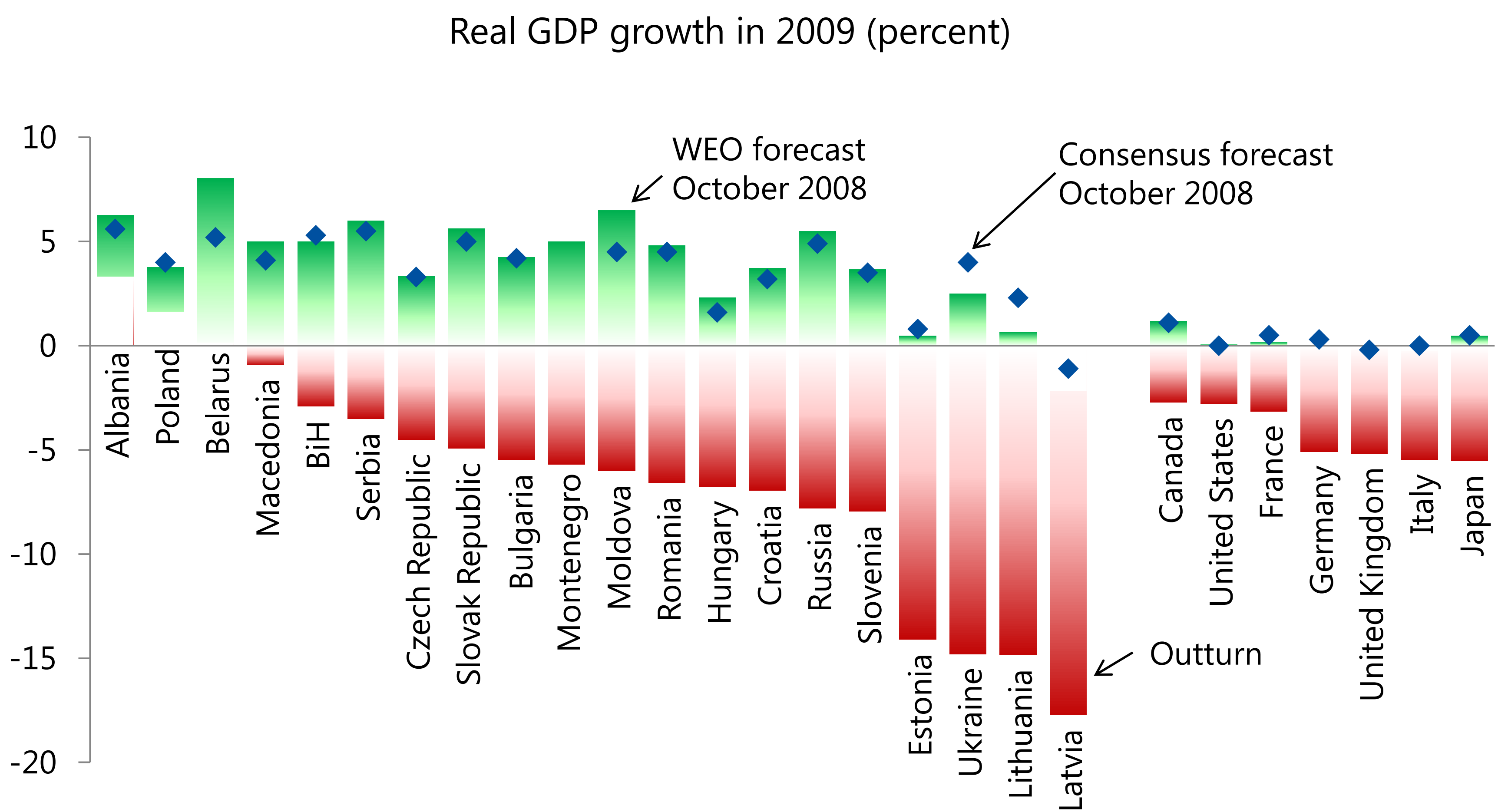
Exposure of BIS-reporting banks to CESEE vis-a-vis all sectors (exchange-rate adjusted)



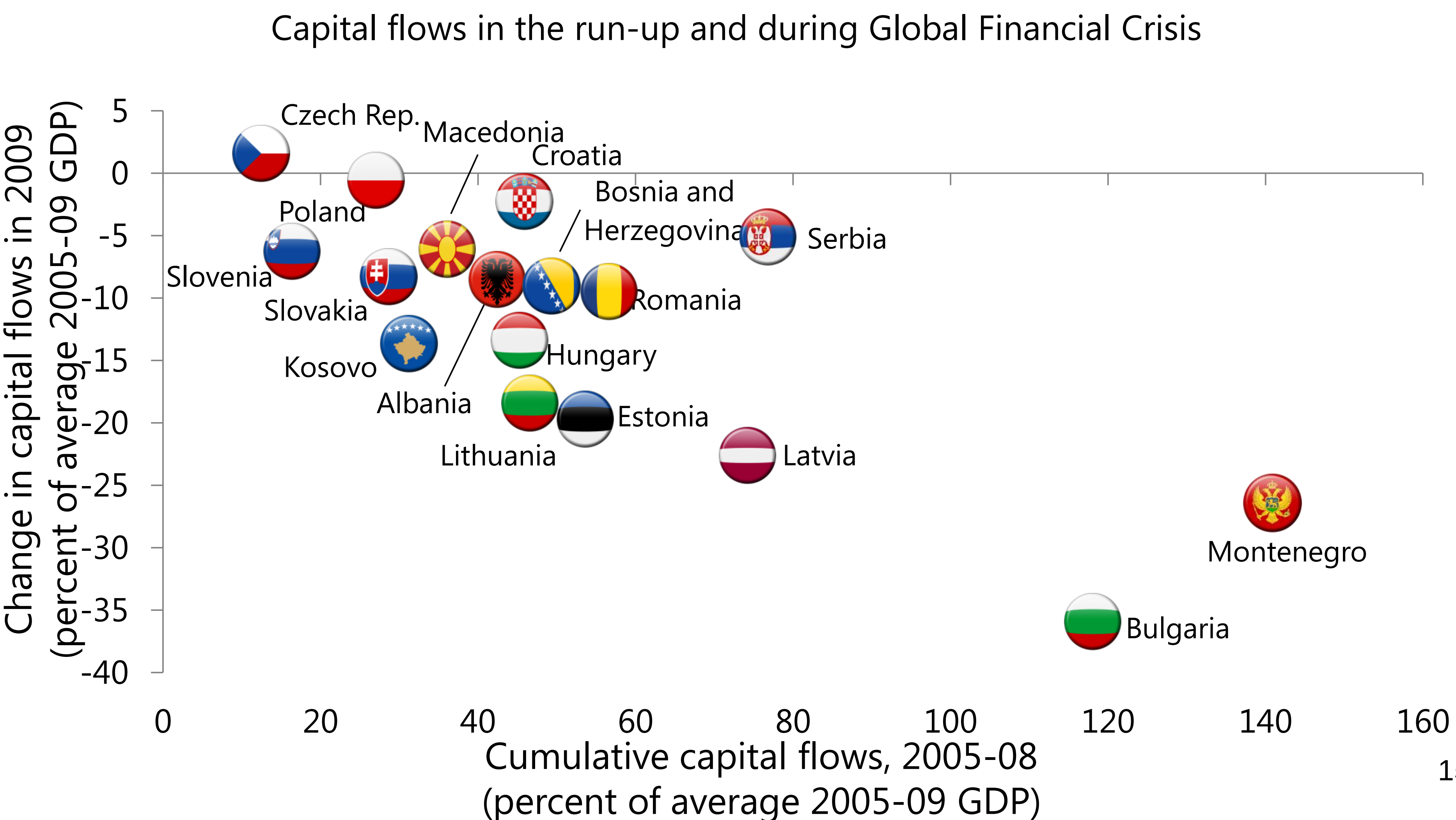
Changes in exposure of BIS-reporting banks (percent of 2015 GDP)



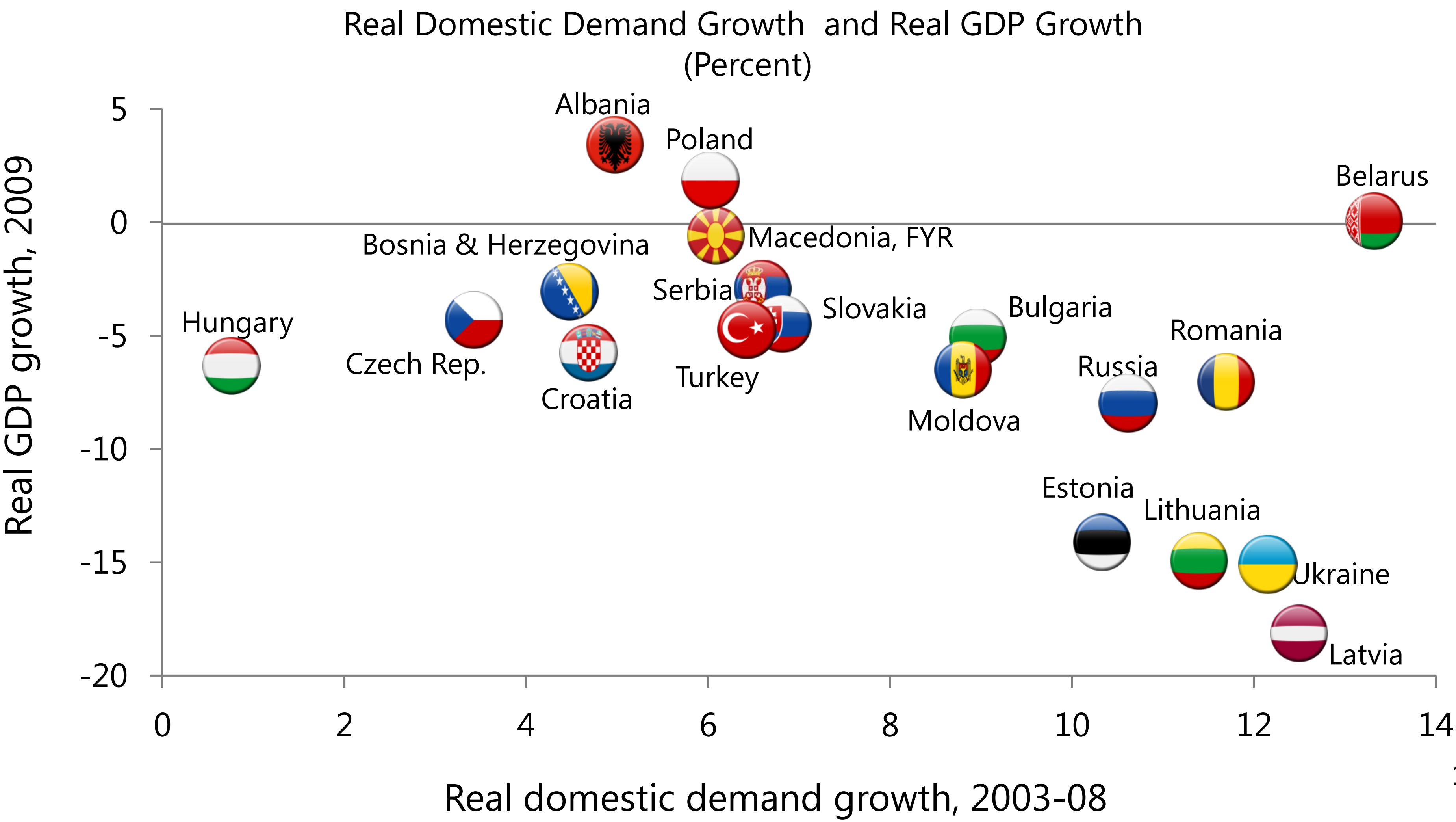
The result was a deep recession—which was not projected by most observers



The larger previous capital inflows, the sharper the reversal



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



The IMF was quick to provide assistance

EU countries:

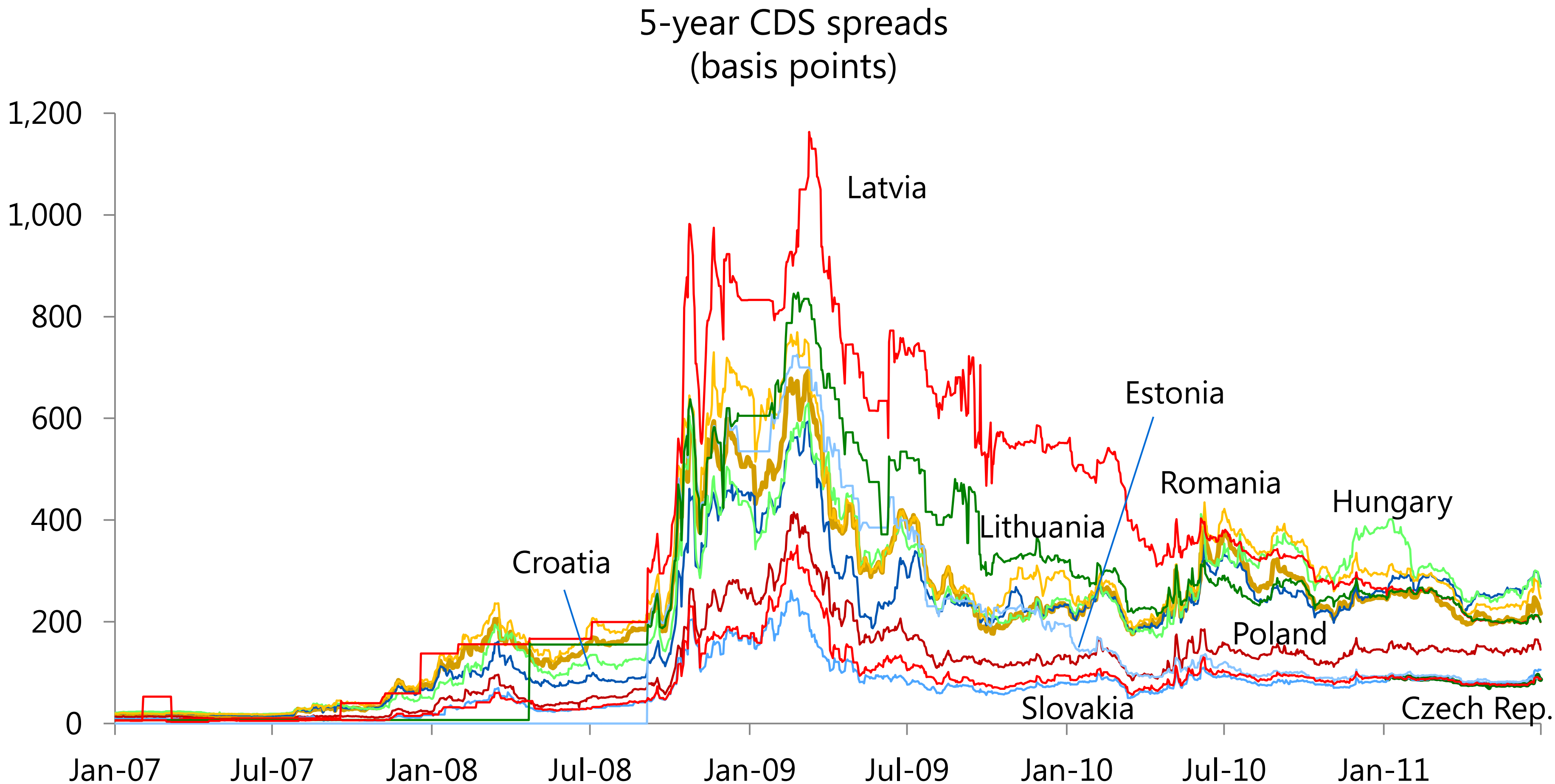
- EU member countries
- SBA program
- FCL program

Non-EU countries:

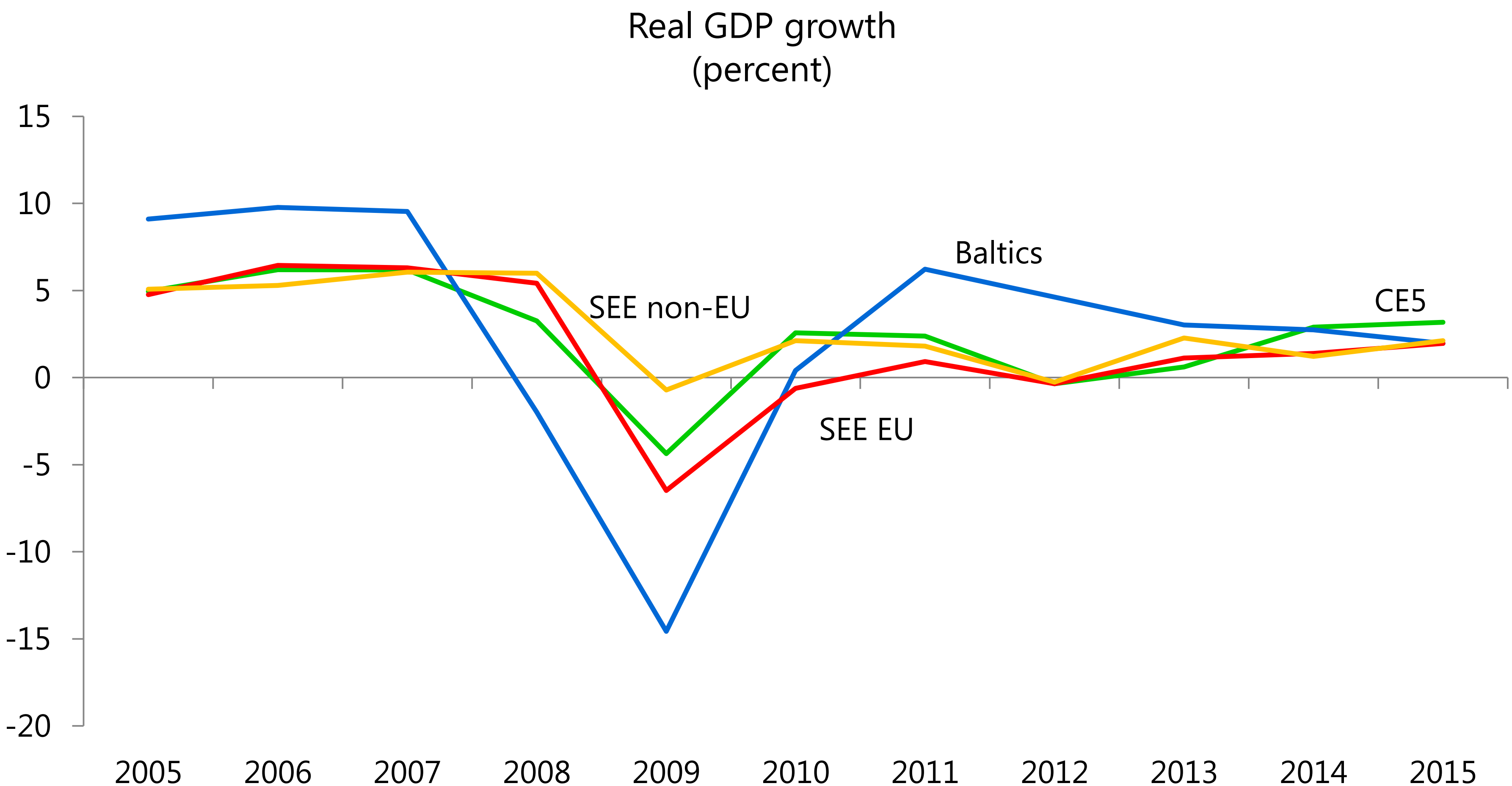
- SBA program
- EFF program
- PCL program

Precautionary programs

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



Growth turned positive in 2010



Note: Unweighted averages.

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

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

- The boom was hard to stop
  - Countries took extensive macro-prudential measures
  - They did not stop the credit boom
  - They helped create buffers in the banking system

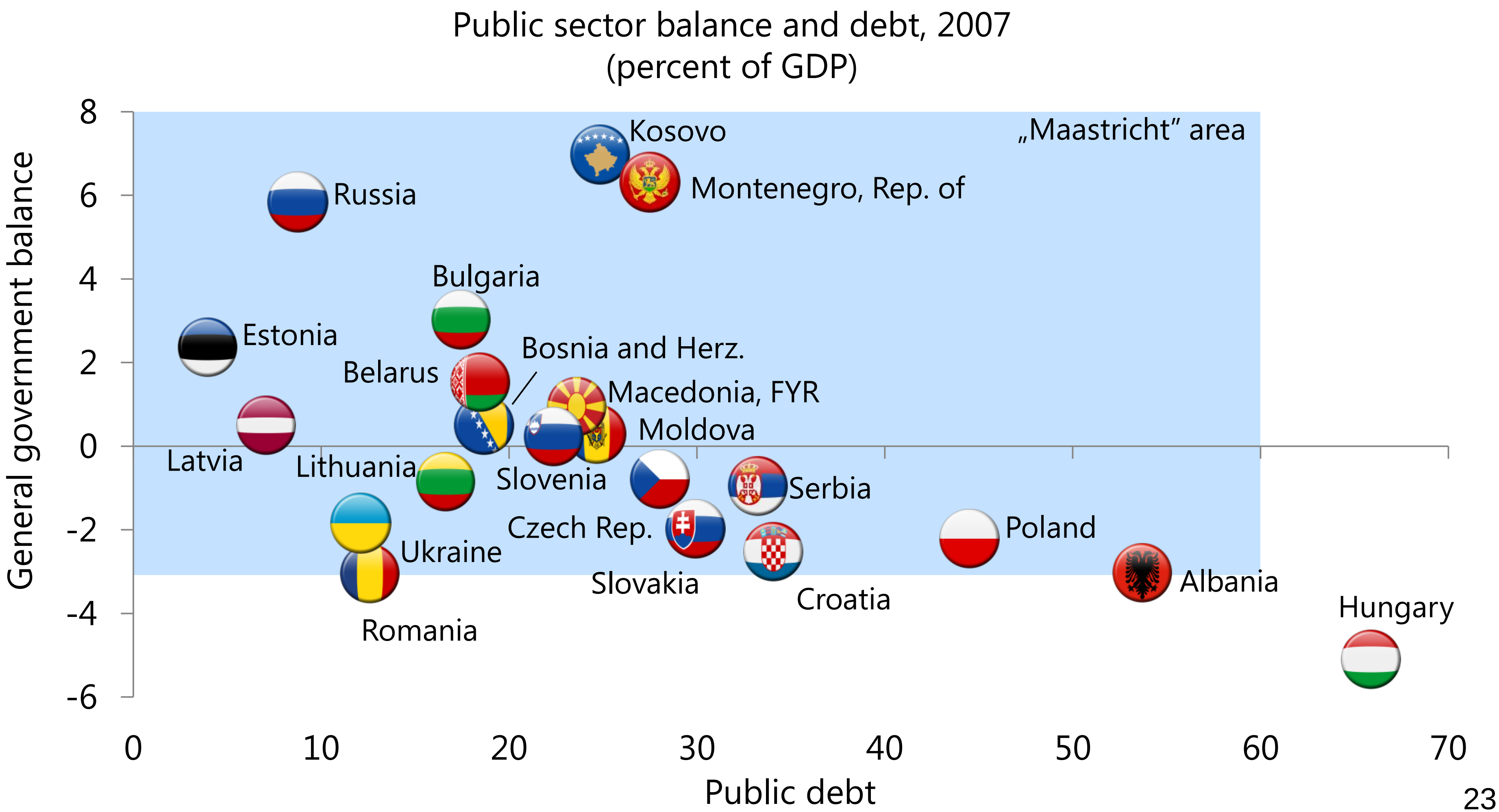
The boom would have been mitigated by rising risk premia

- Rising risk premia would have been automatic stabilizer (increased financing costs would have slowed credit growth)
- Problem was that risk premia *fell* during boom

Fiscal policy did *contribute* to the boom-bust

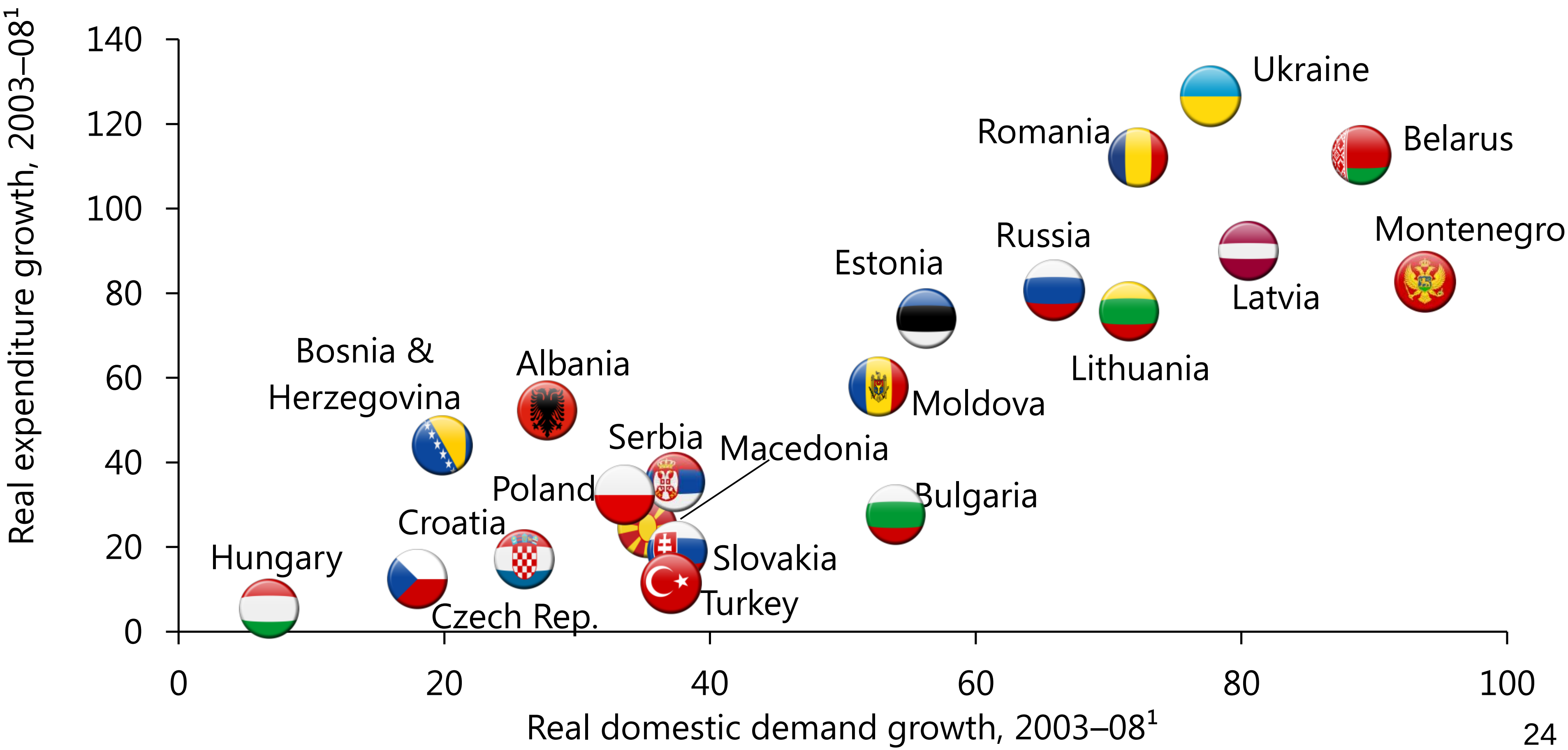
- Fiscal policy was very pro-cyclical:
  - Public expenditure grew very rapidly during the boom years
  - Fiscal policy was very contractionary during the bust.

During boom years most—but not all—countries had low debt and deficits



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

Domestic demand and government expenditure during the boom years

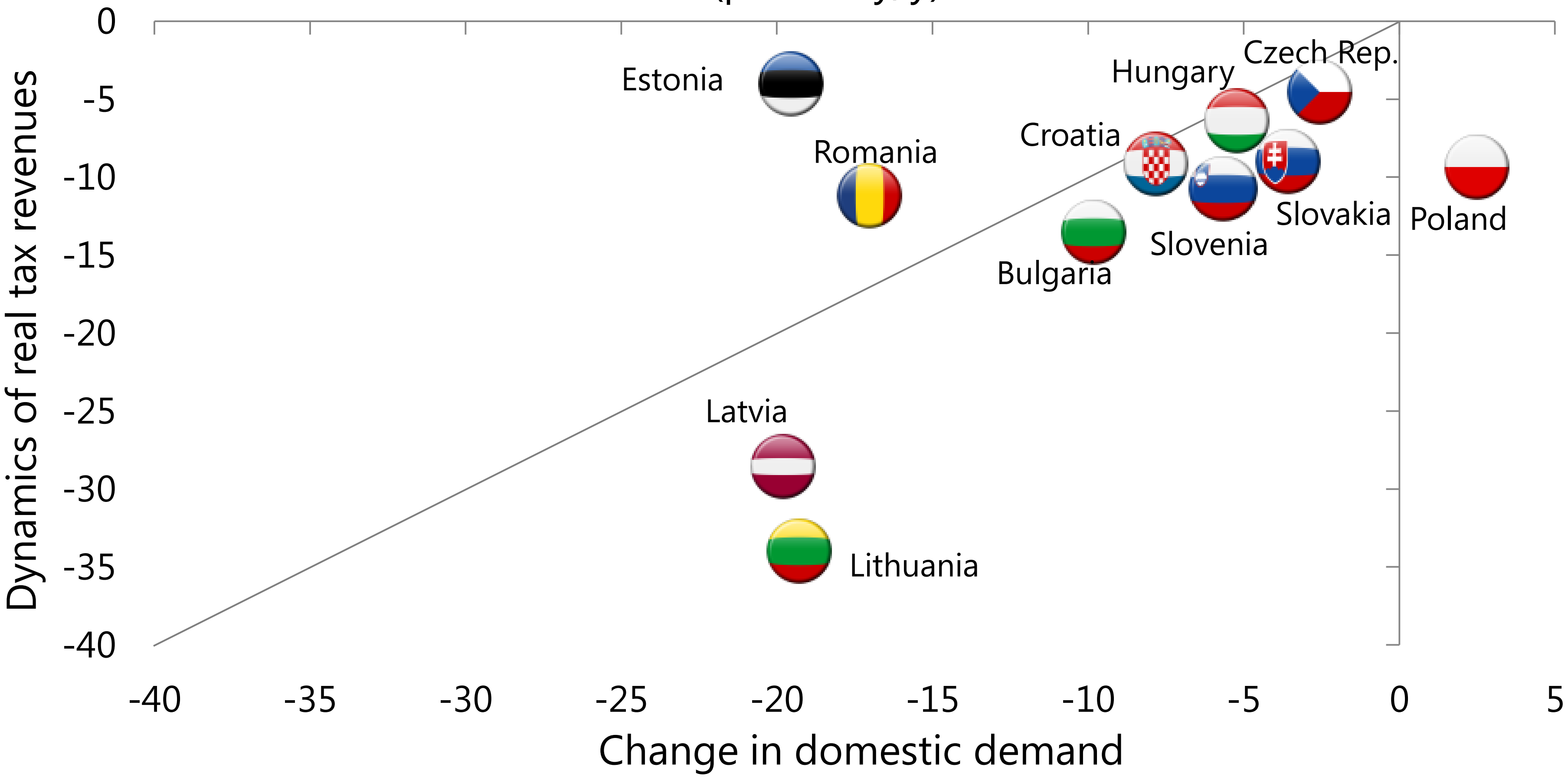


However, public expenditure was growing rapidly

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

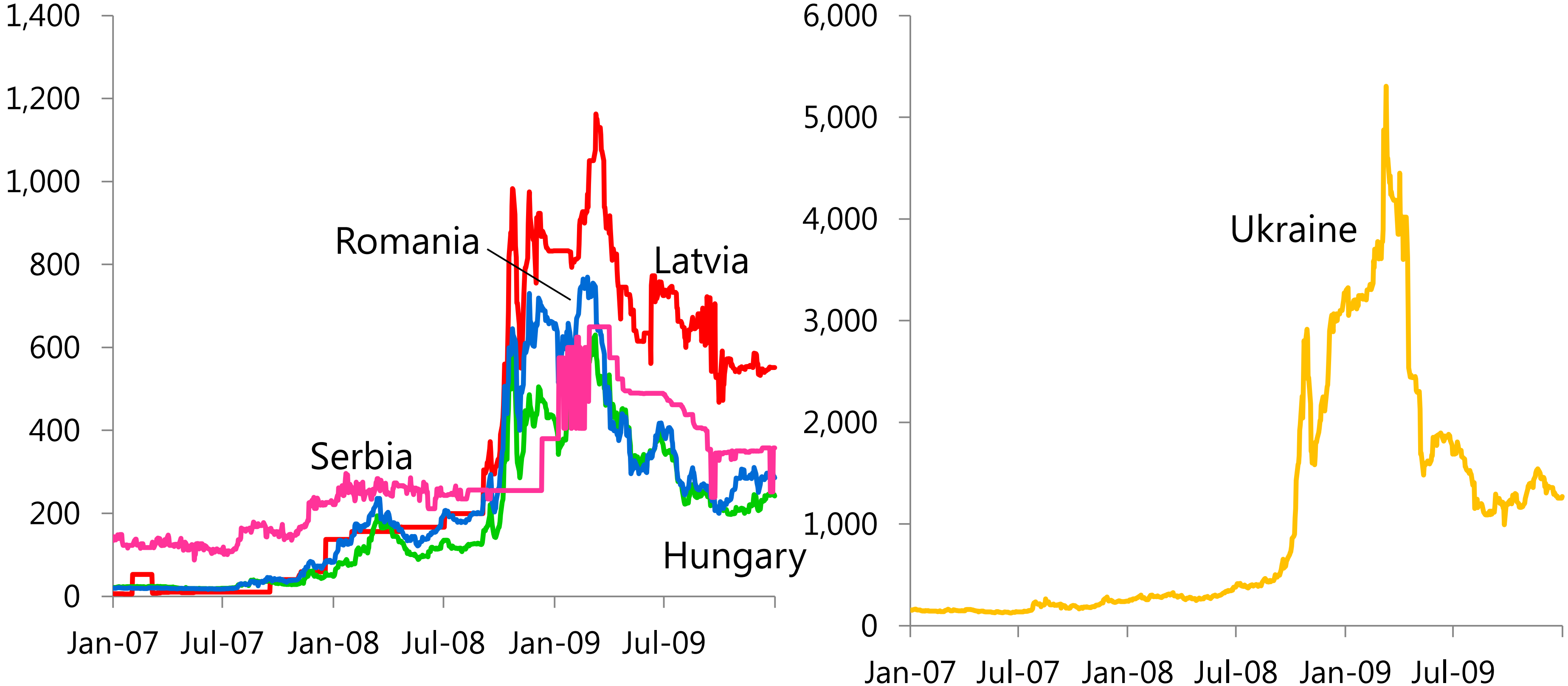
The end of the domestic demand boom led to a sharp decline of revenue…

Tax revenues dynamics in 2009 recession (percent y/y)



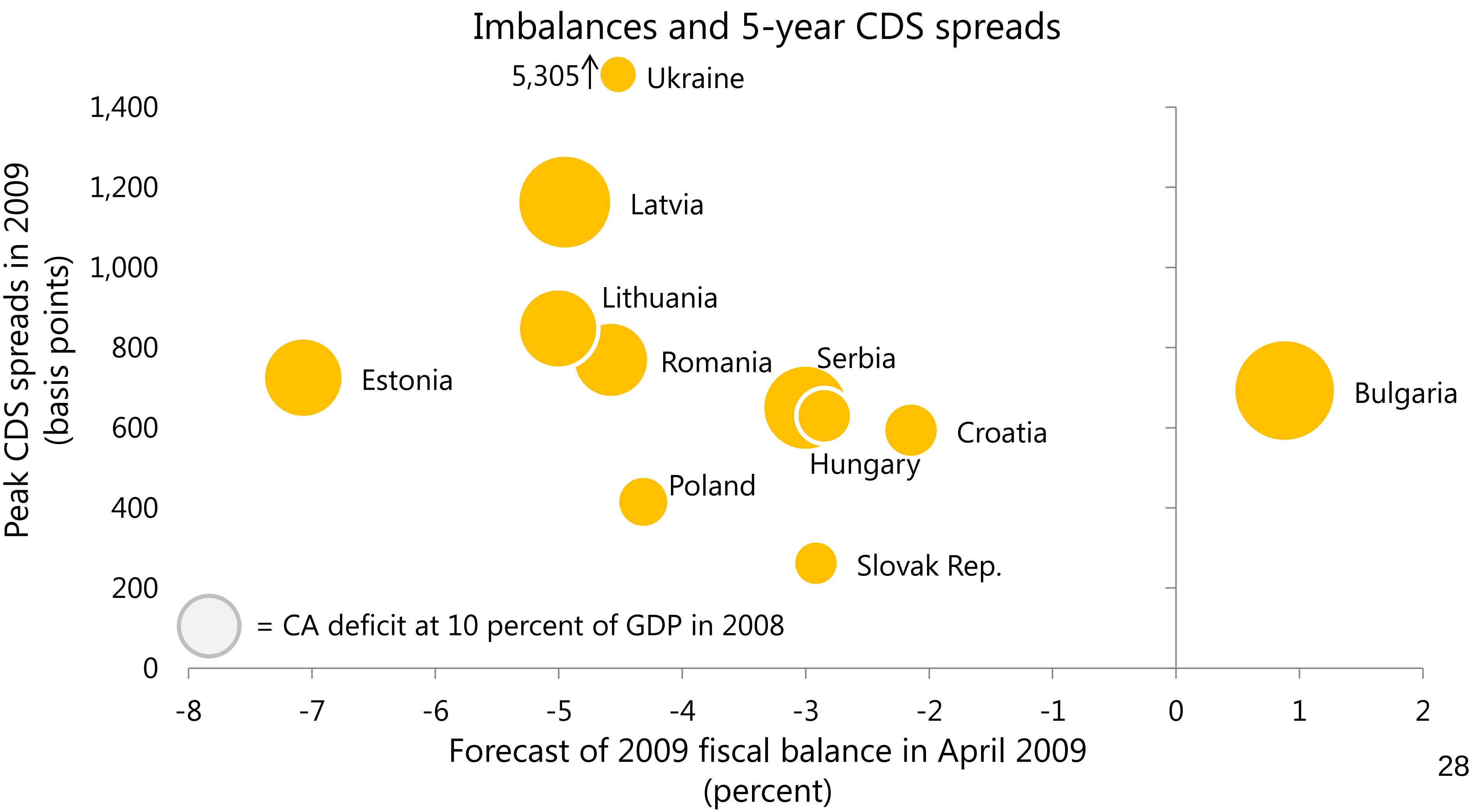
Risk premia rose sharply

5-year CDS spreads
(basis points)

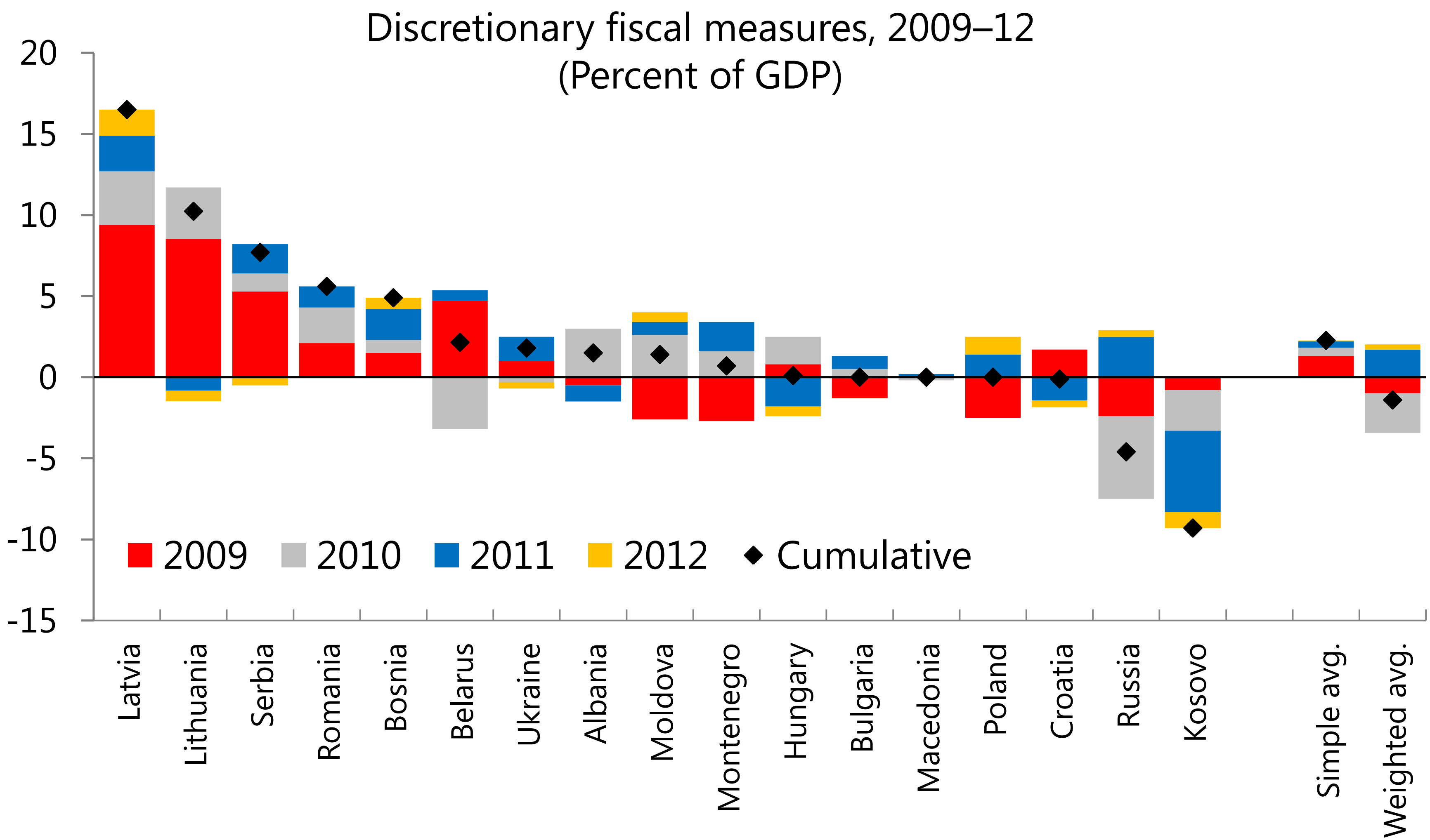


Note: 5-yr CDS spreads at 600 basis points translate into 10 percent probability of default over the next 5 years, assuming 40 percent recovery rate.

Particularly in countries with high projected deficits



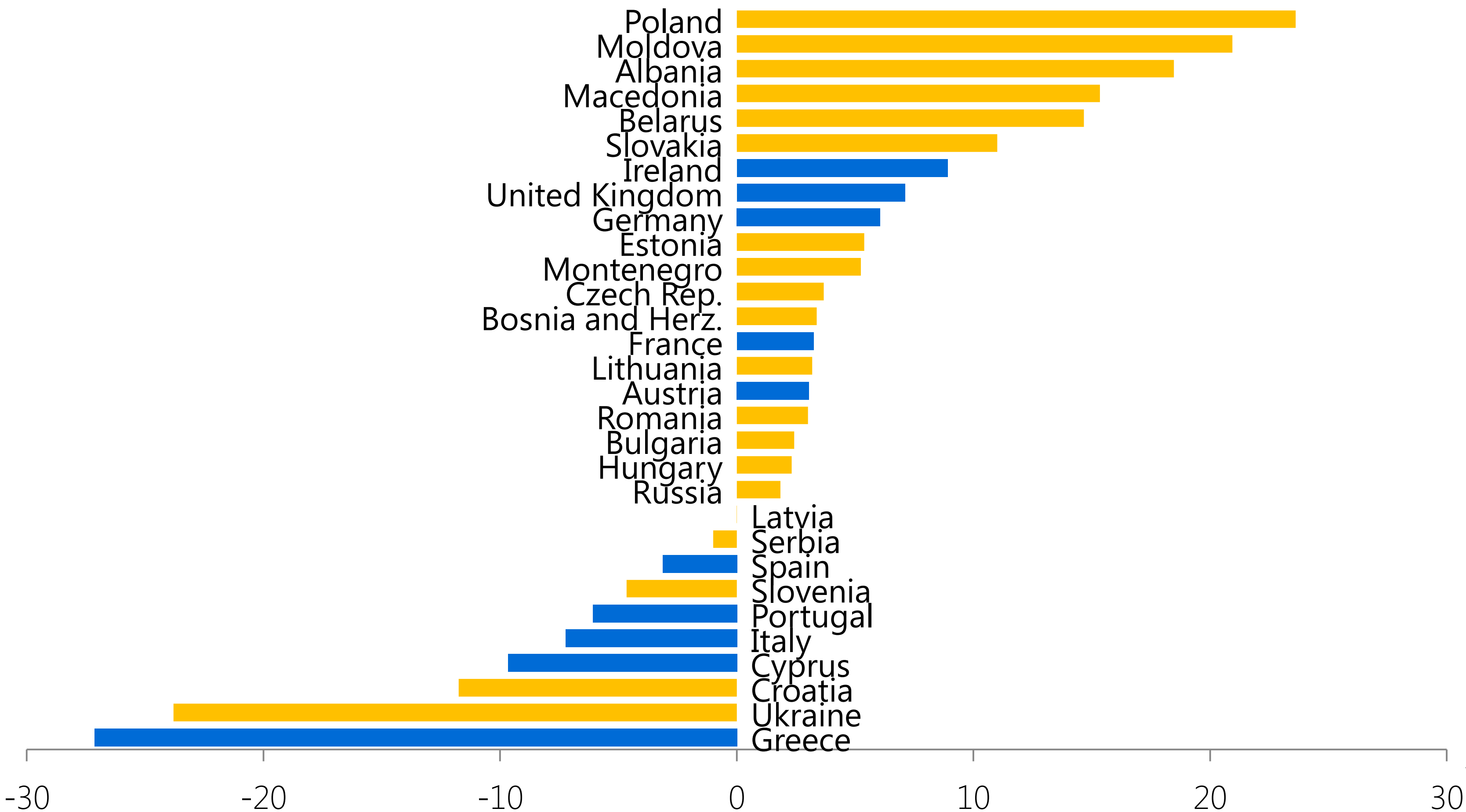
Some countries took very strong measures to contain rise in deficits



2. Crisis Legacies

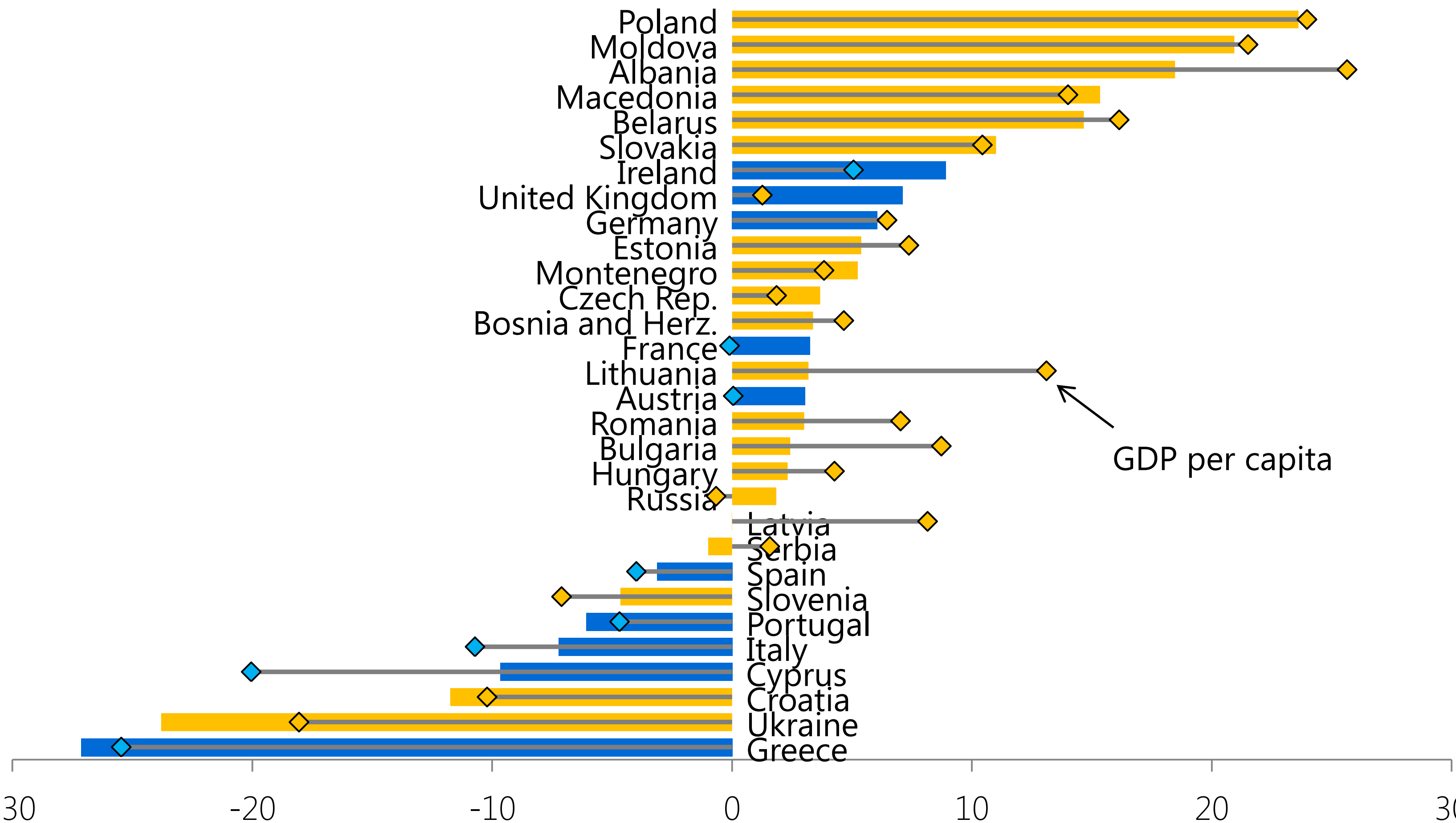
The crisis was deep, but most countries have recovered to above pre-crisis levels (unlike the euro area periphery)

GDP, 2015
(percent change since 2008)



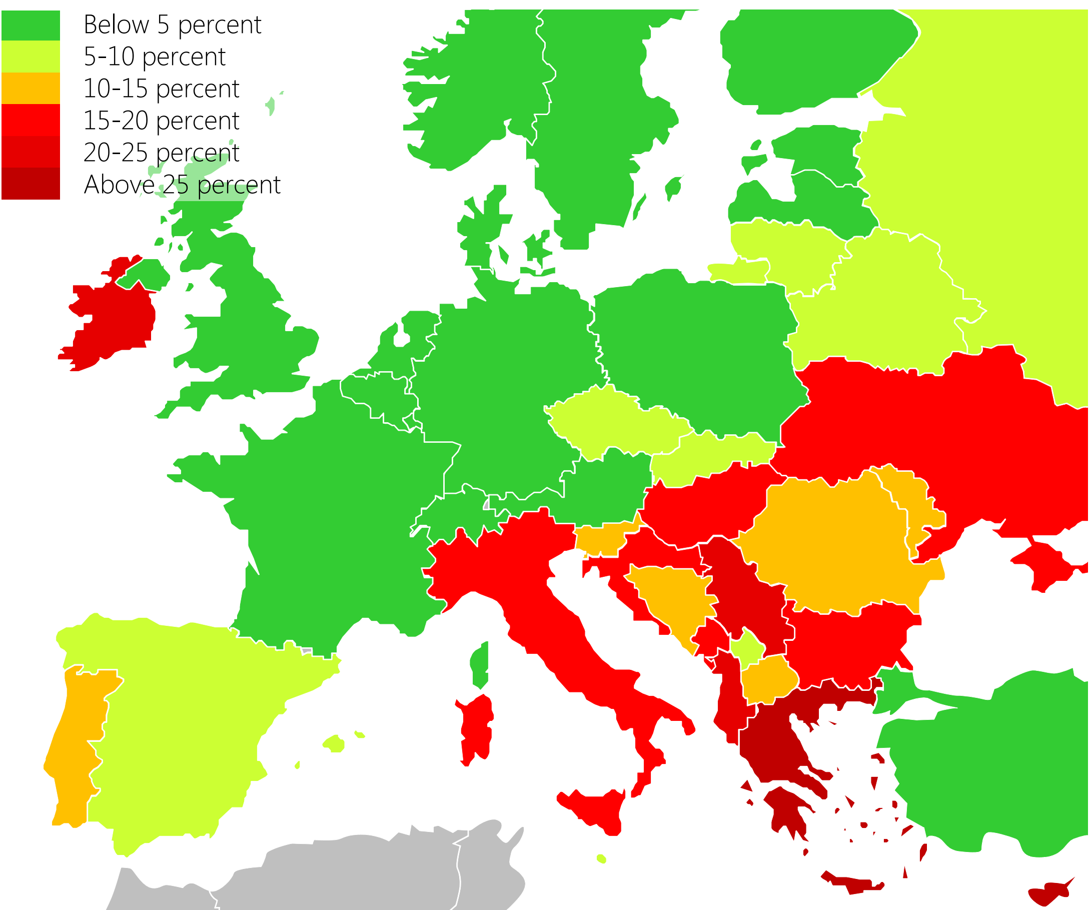
In per capita terms, growth has been faster—although of course tepid by pre-crisis standards

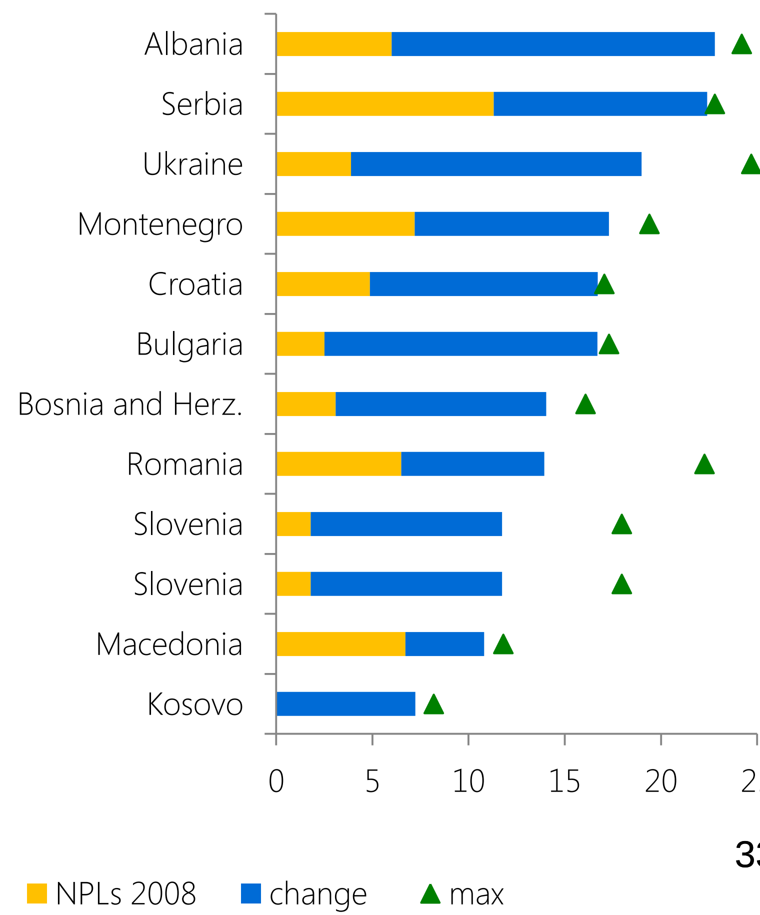
GDP and GDP per capita, 2015
(percent change since 2008)



Two main crisis legacies: high NPLs

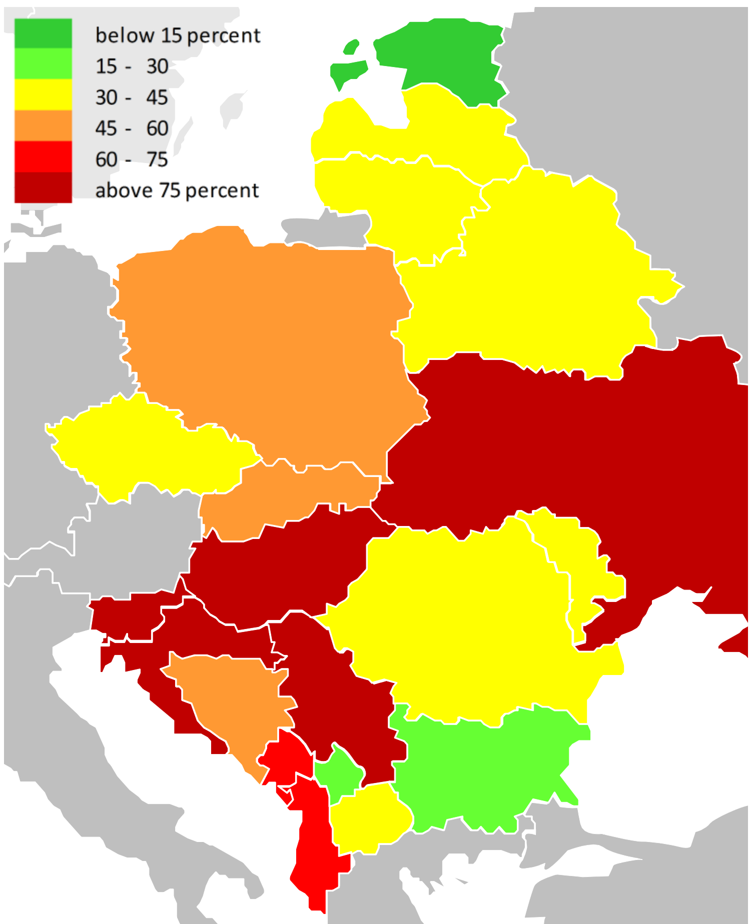
Non-performing loans
(latest available data, percent of total loans)



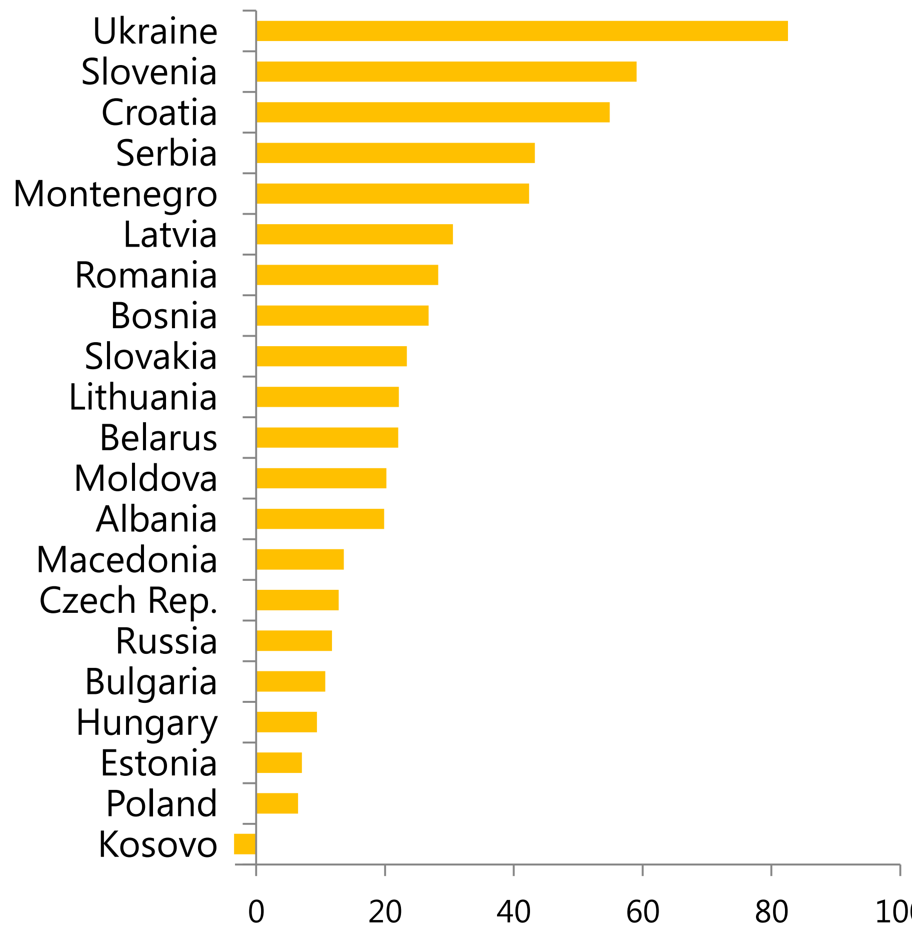


High public debt

Public debt
(percent of GDP)

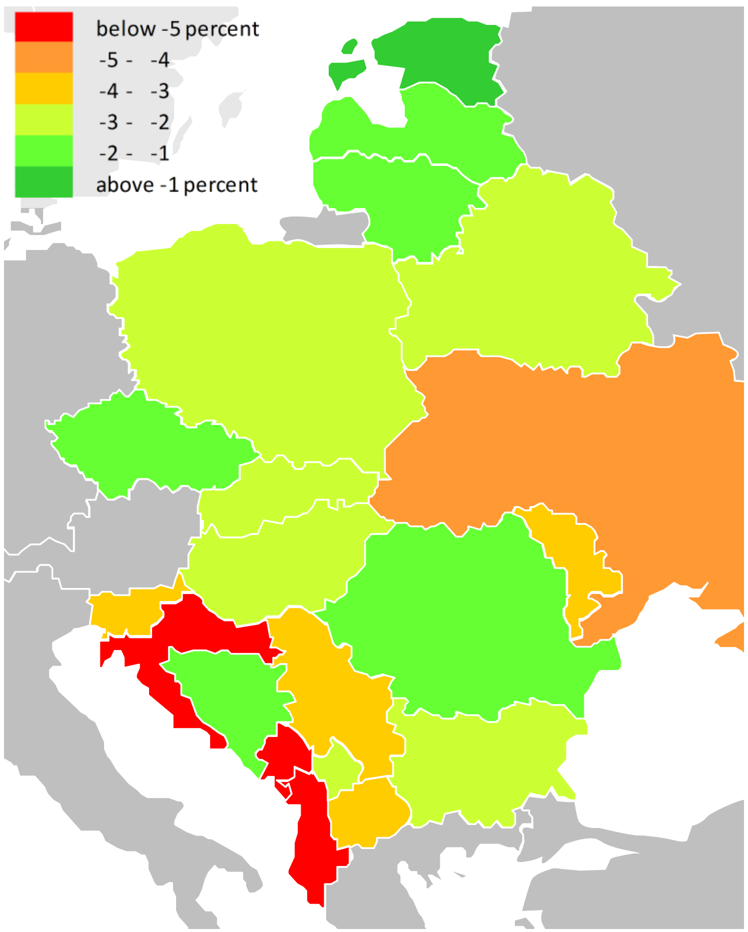


Change in public debt, 2007-15
(percent of GDP)

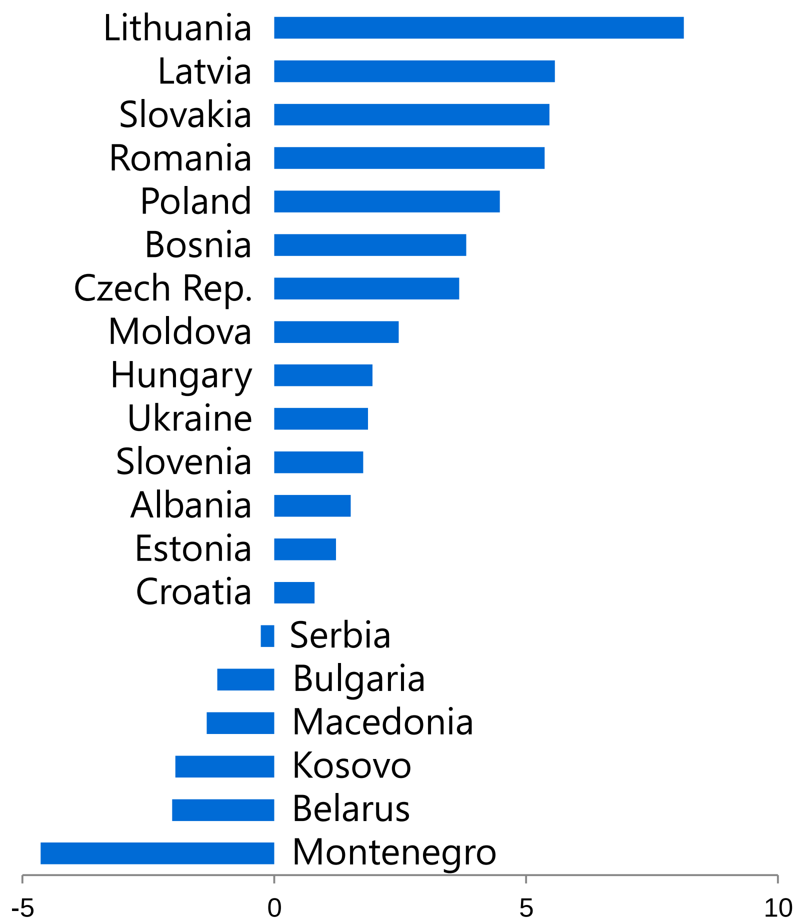


Fiscal deficits have declined to more modest levels…

Fiscal balance
(percent of GDP)

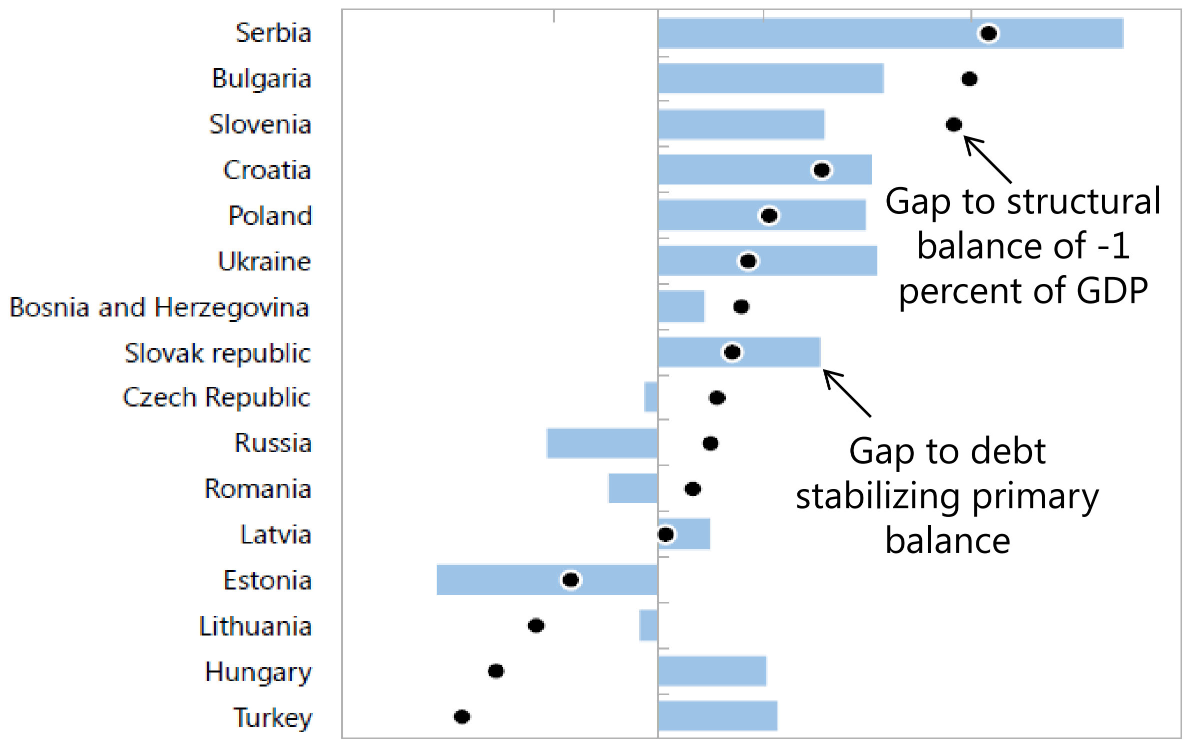


Change in fiscal balance, 2009-15
(percent of GDP)

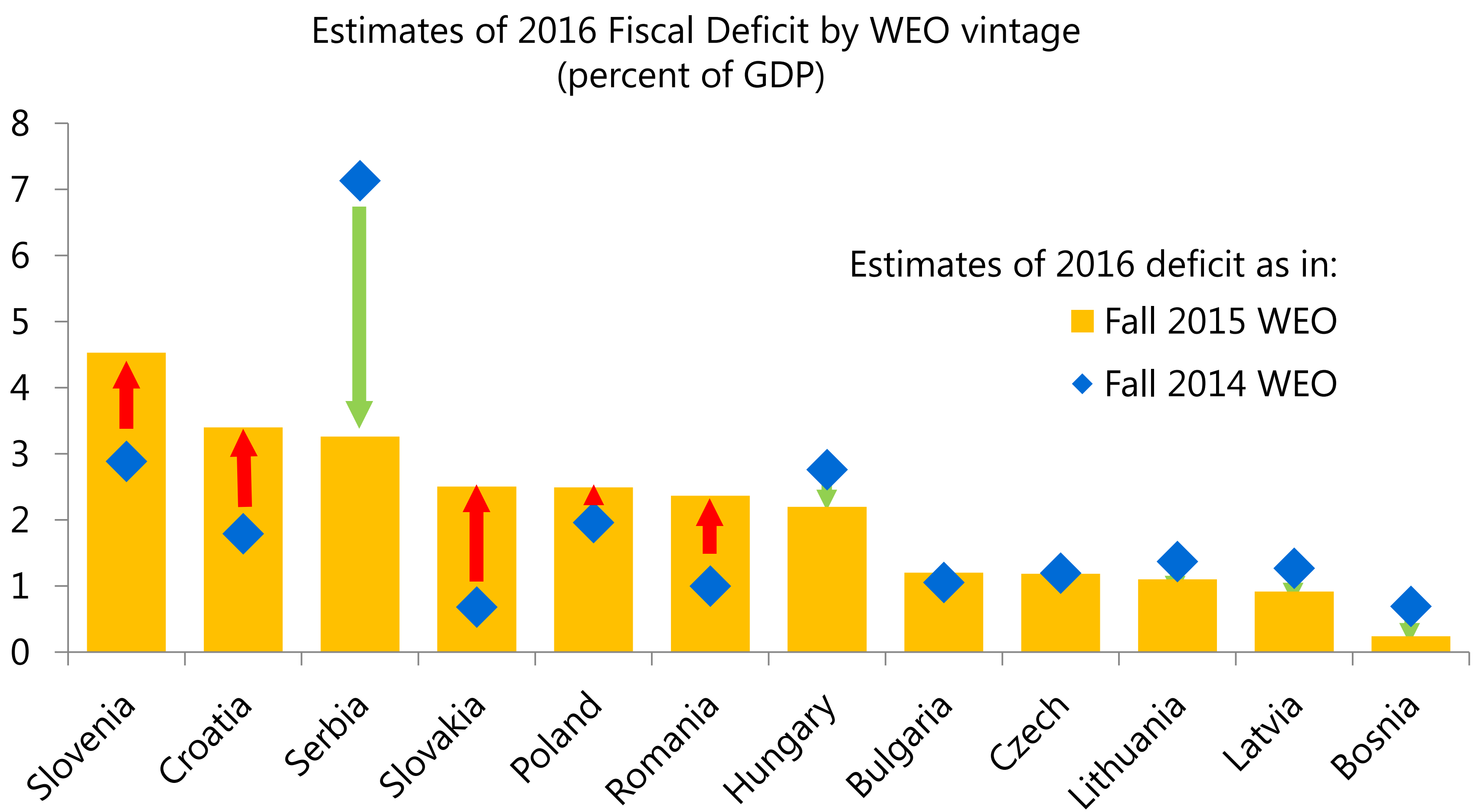


...but adjustment is not yet over.

Estimated remaining adjustment needs
(percent of GDP)

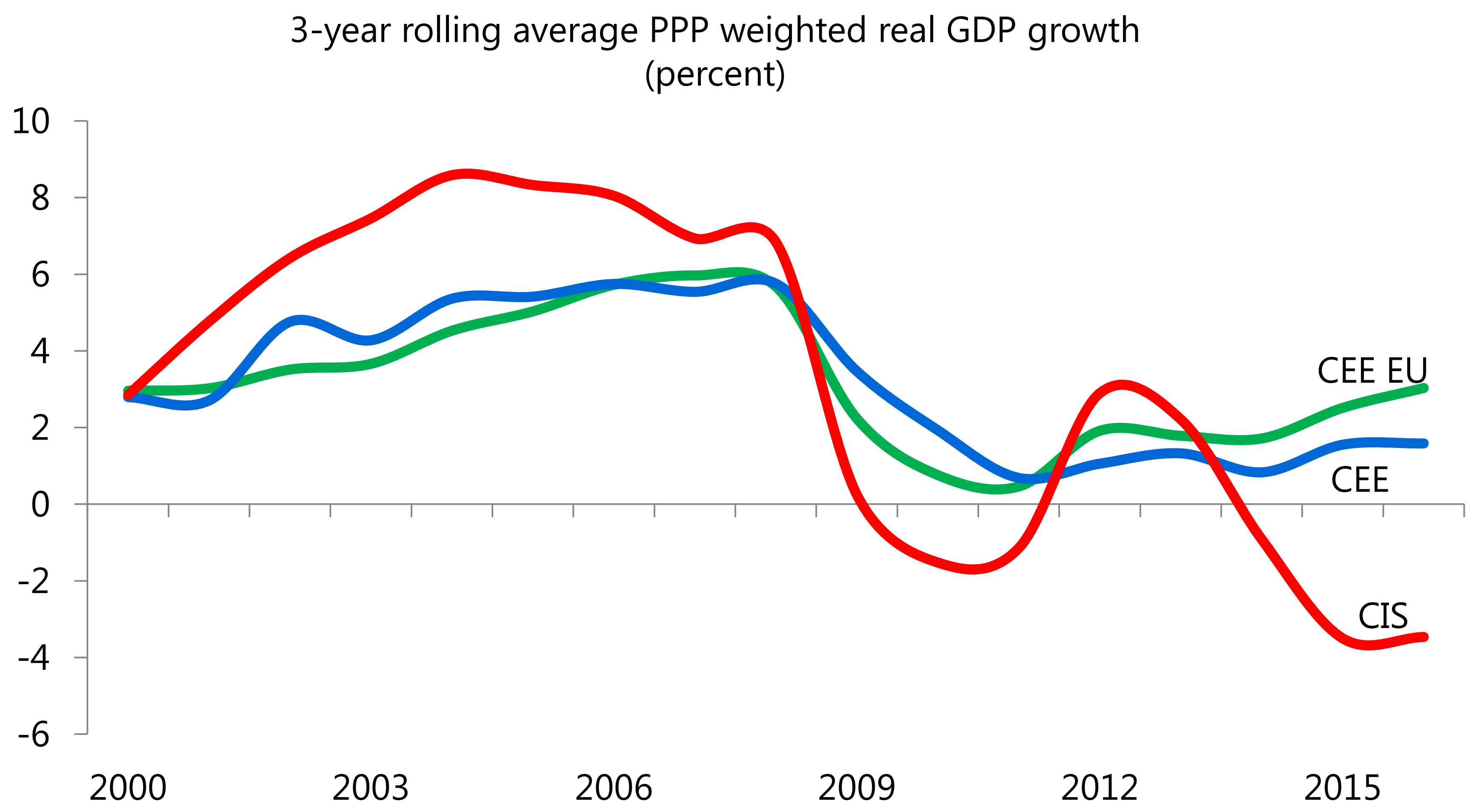


However, adjustment fatigue seems to have set in.

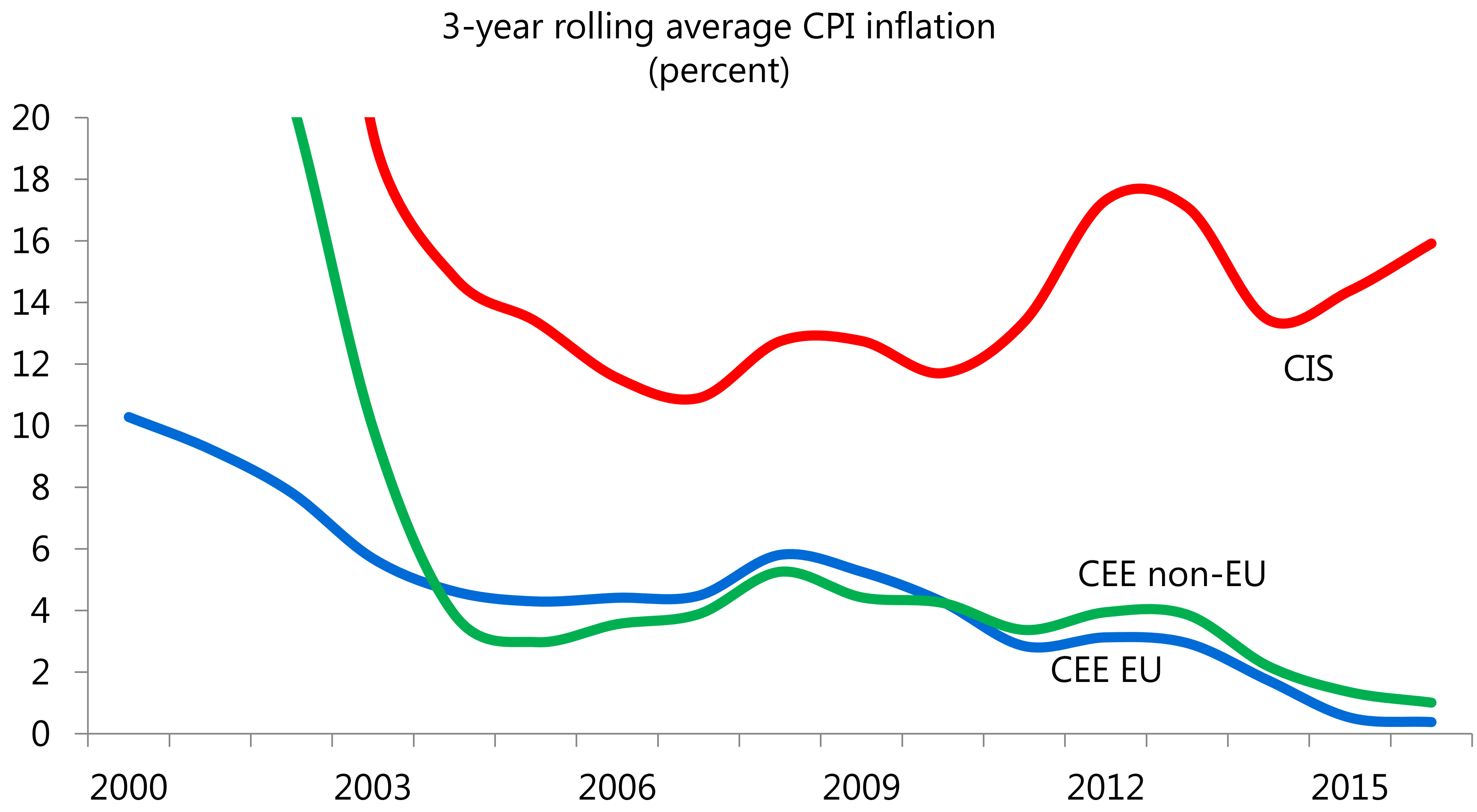


4. Outlook for 2016

Big picture—GDP growth: CIS in recession; rest of CEE doing better



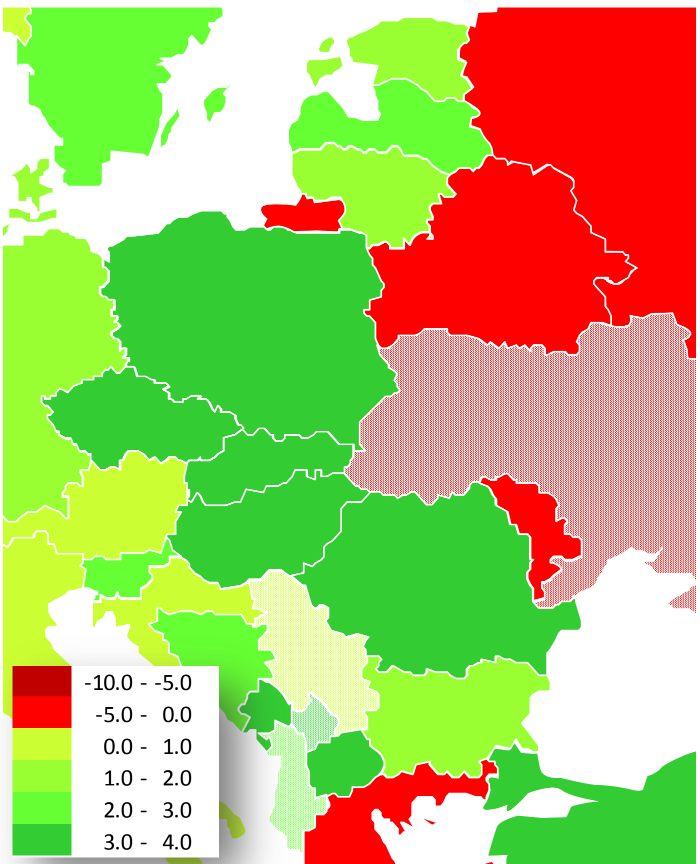
Big picture—Inflation: High in CIS; low in rest of CEE



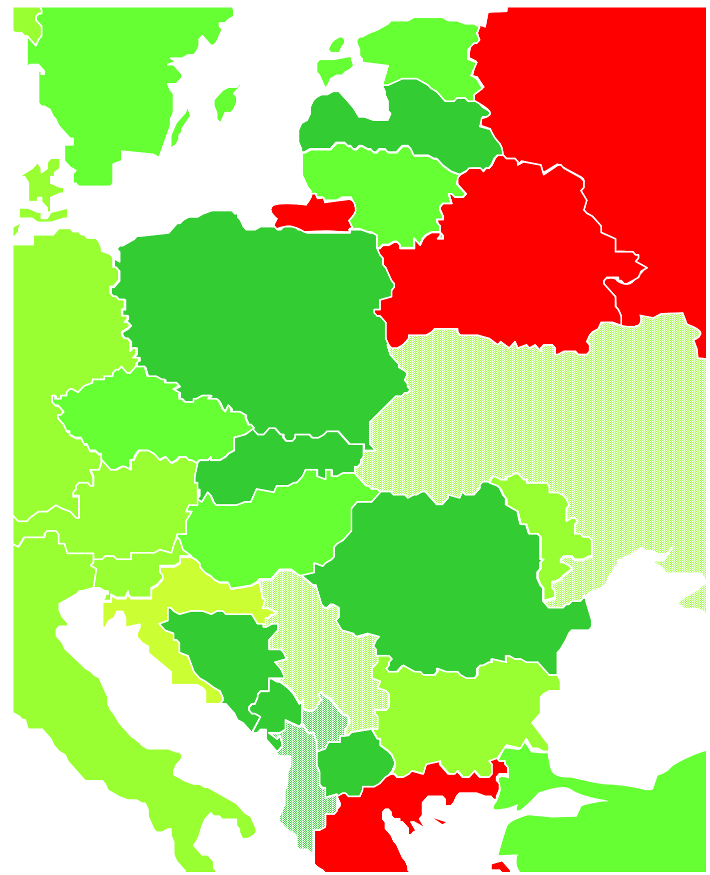
Outside of CIS, most countries moderate to fairly strong growth

GDP growth
(percent)

2015



2016

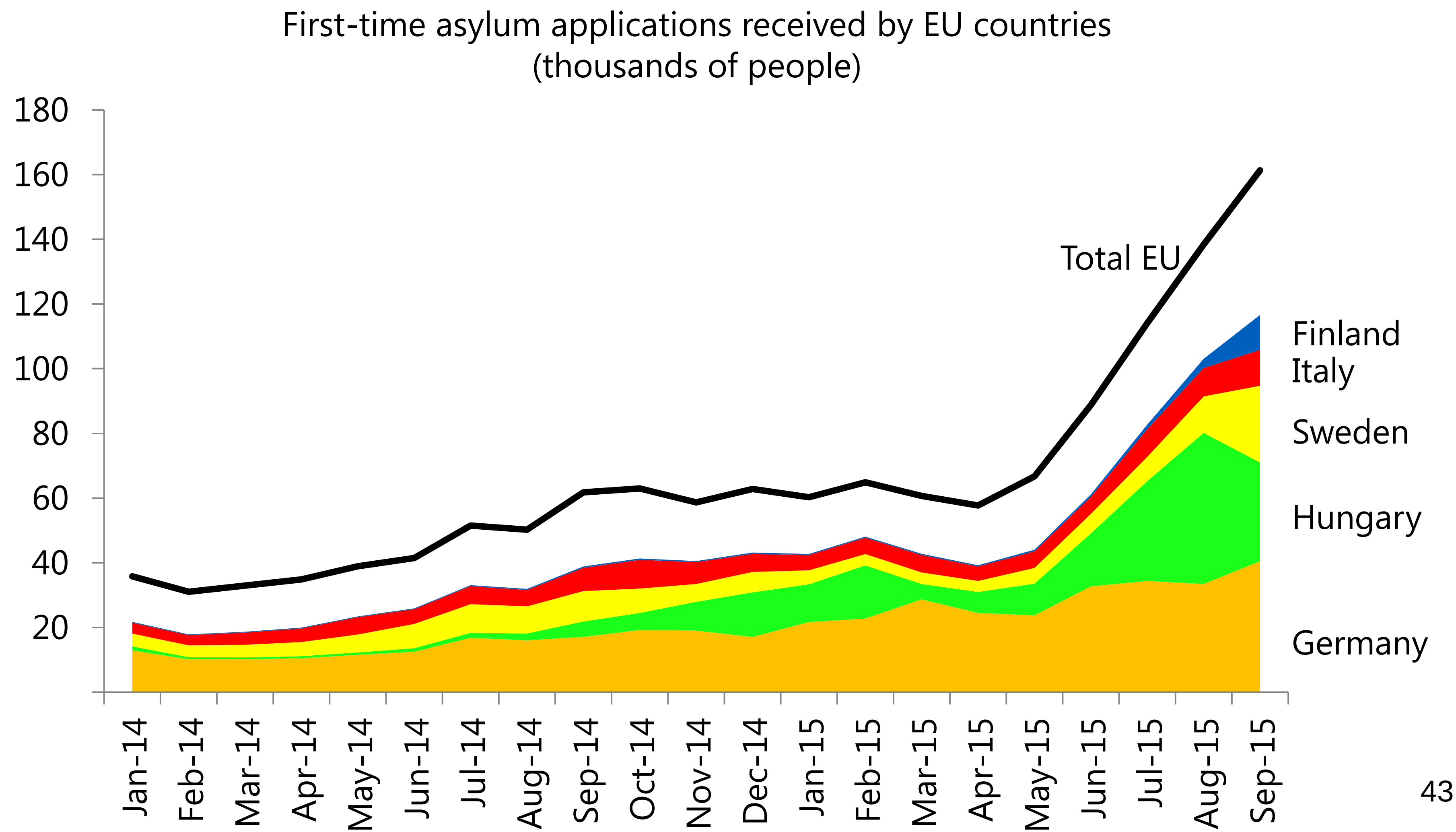


Note: Striped fill denotes CESEE country under IMF programs.

Risks for the Region

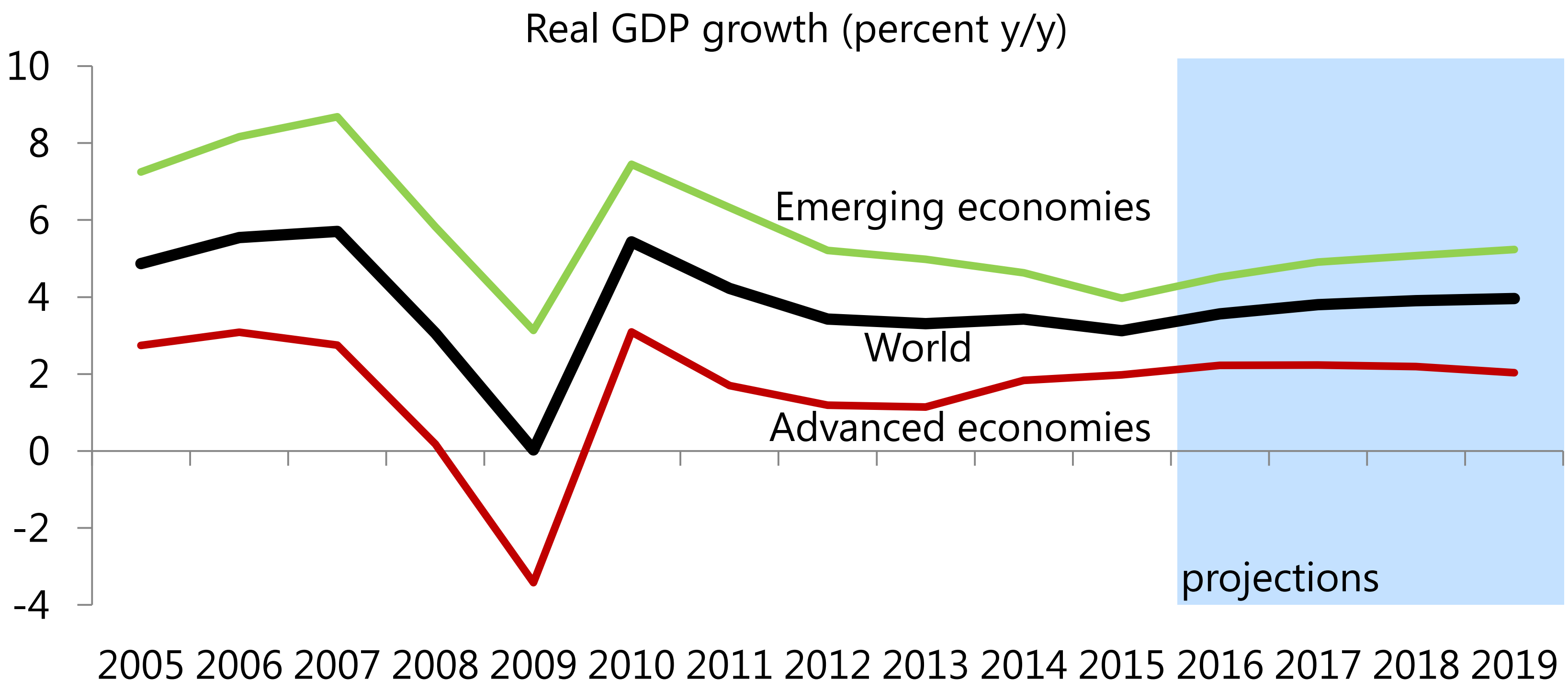
- Recent financial market volatility—what will be the impact?
- Hard landing in China
- Prolonged recession in Russia
- Disappointing Euro Area growth
- Geopolitical tensions

And of course the Refugee Crisis



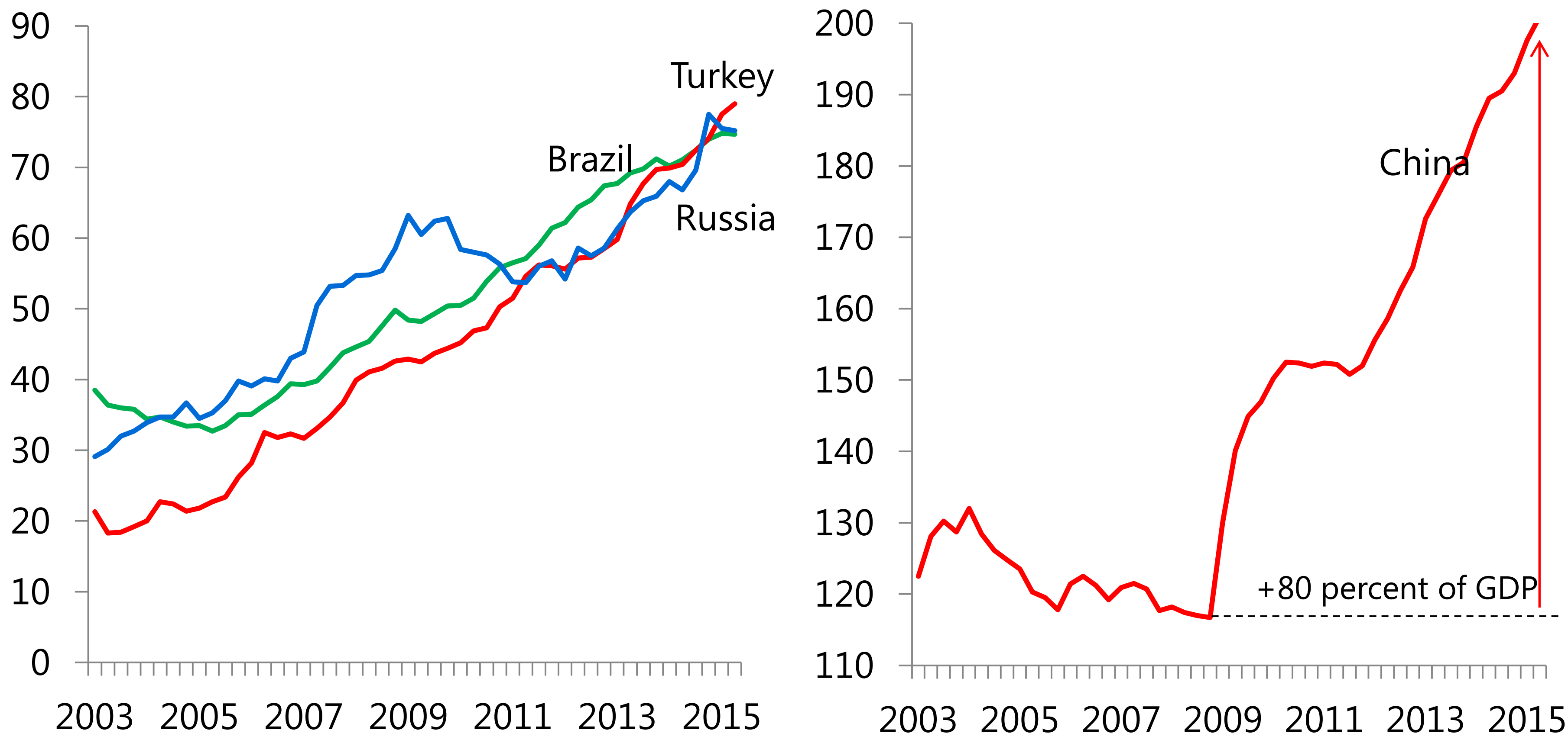
Key Issue: Slowdown in Emerging Markets

- Growth in emerging markets has slowed down
- Is this temporary?
- Or is it more structural?



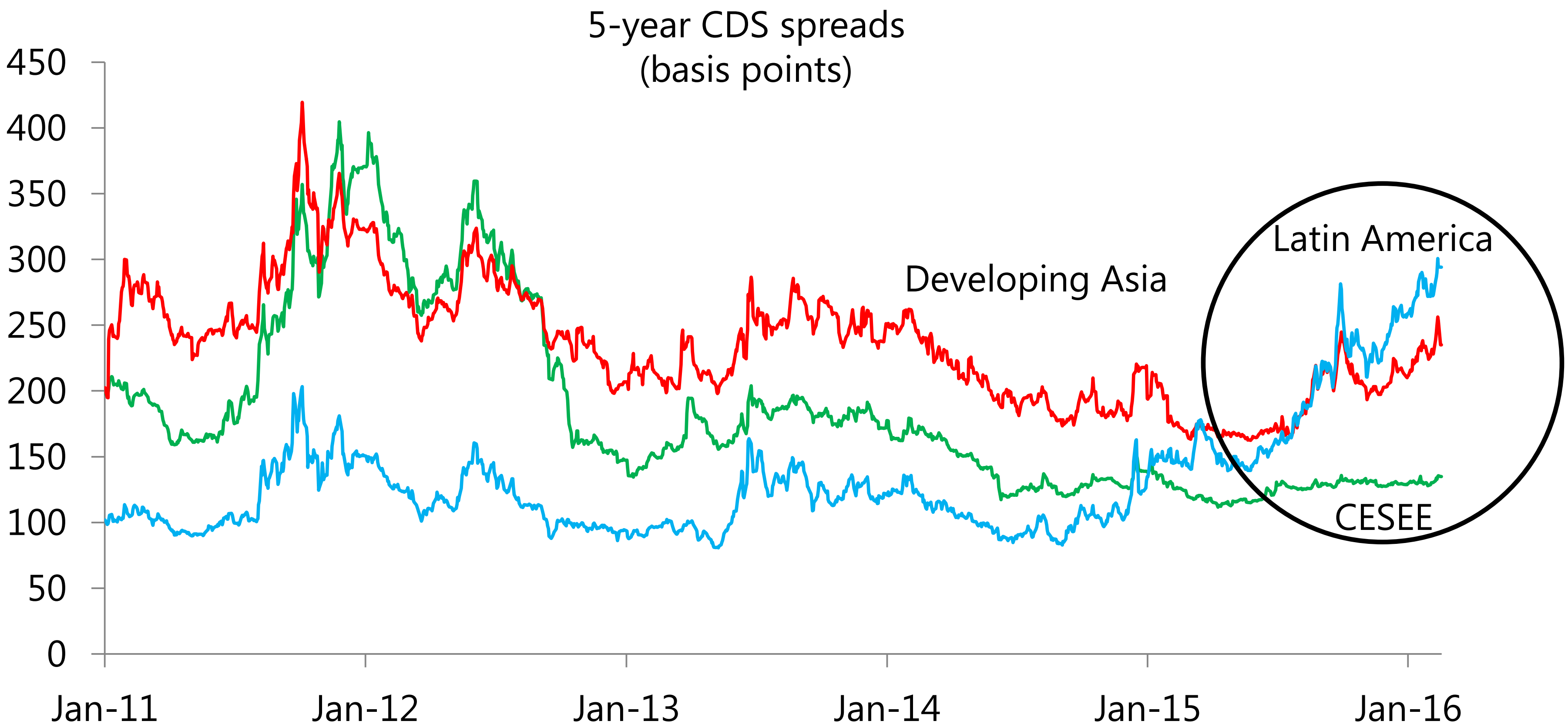
Growth in the large EMEs has been fueled by a credit boom

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

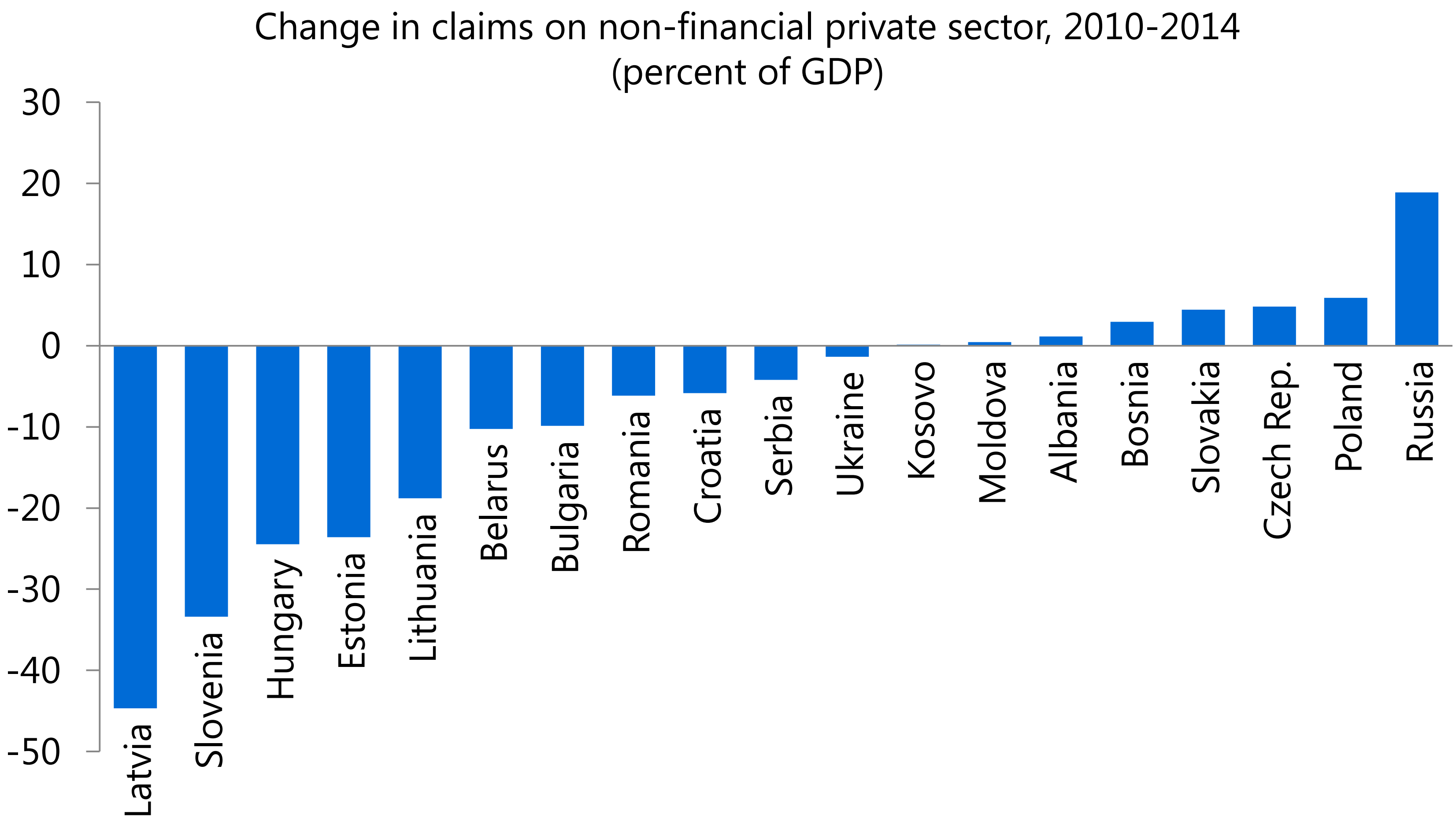


Resilience of CESEE

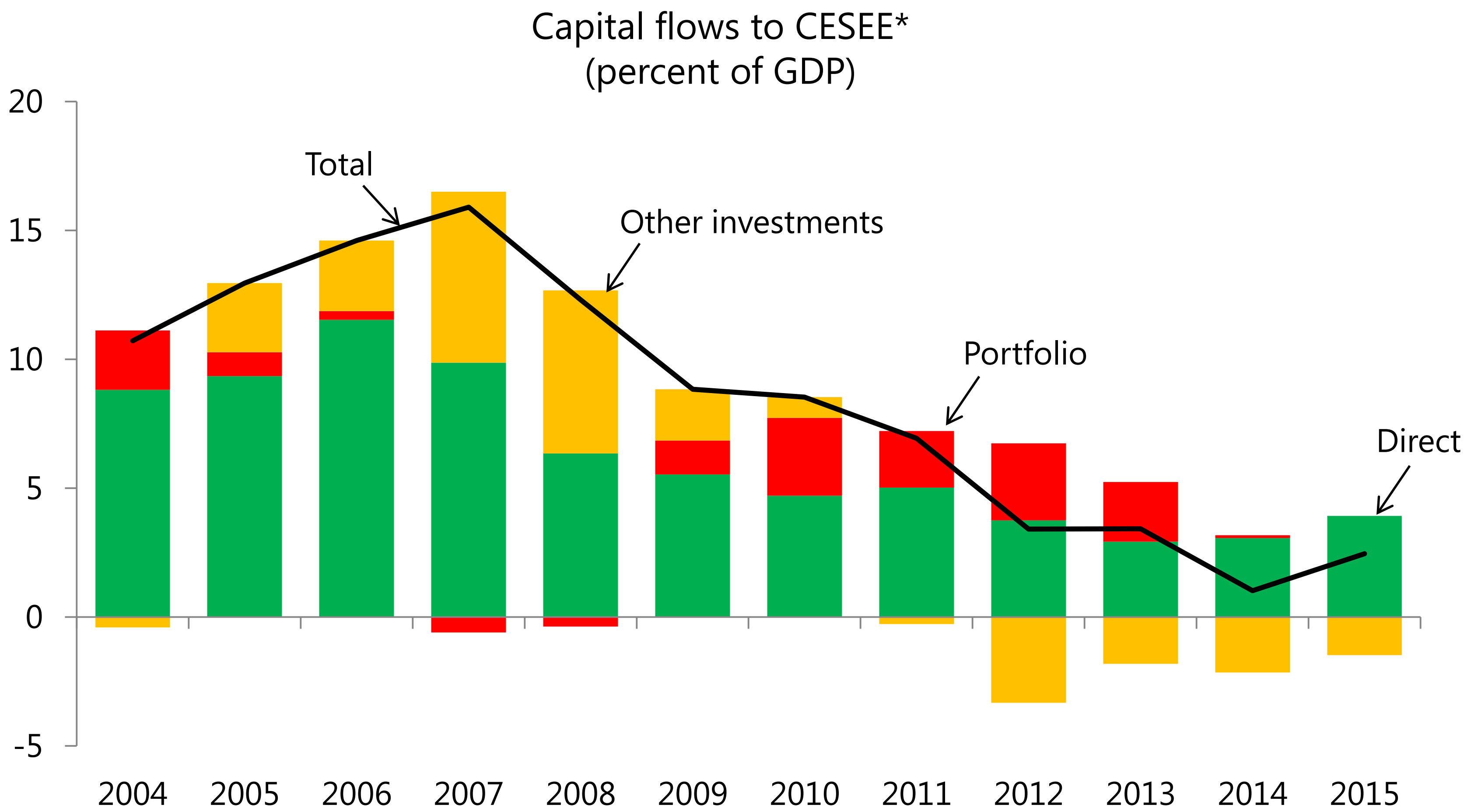
- CESEE has been much less affected by global financial turmoil



CESEE—excl Turkey and Russia—has not had a credit boom post 2008!



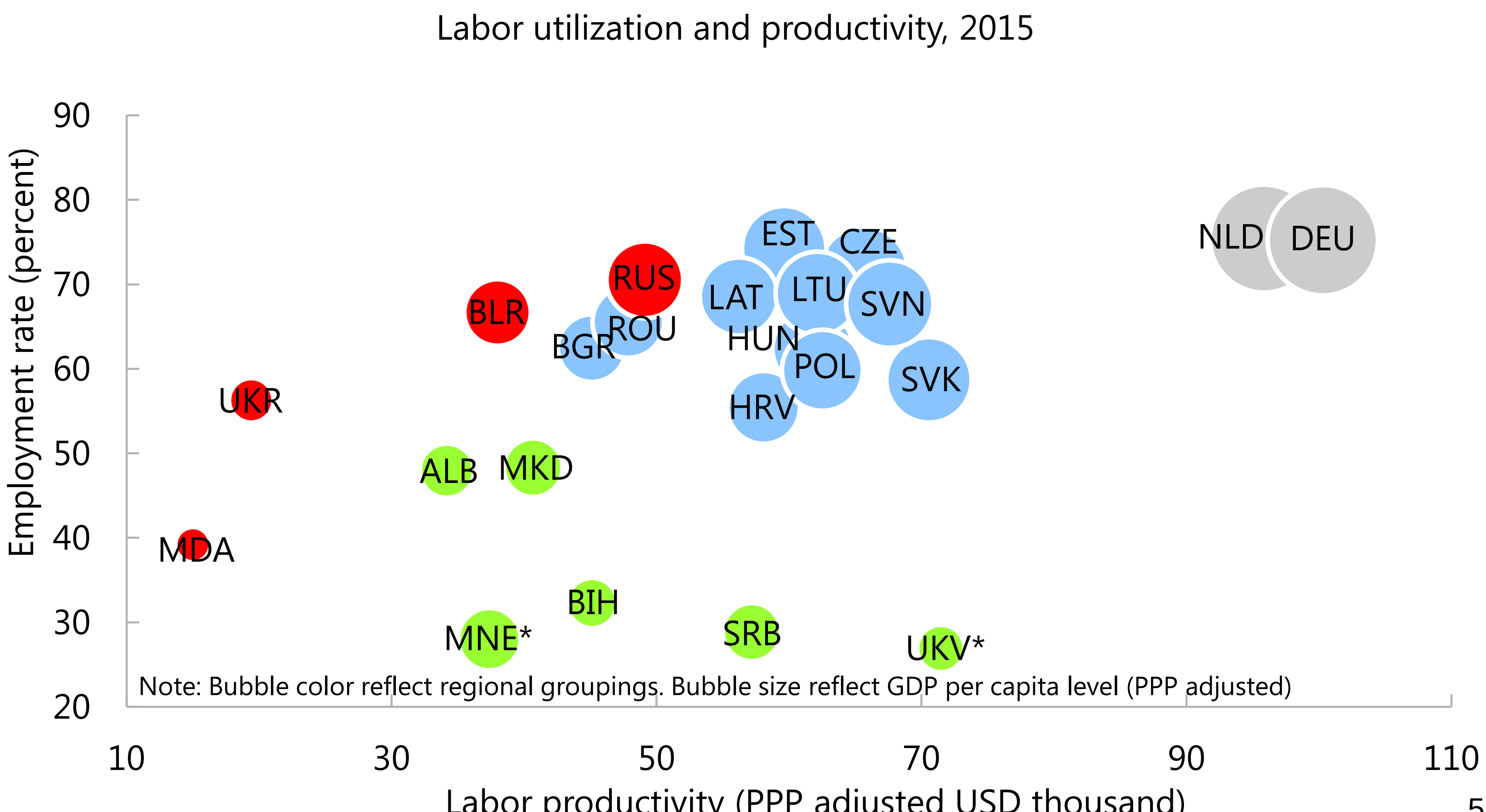
Post 2009, capital inflows have been low



*excluding Russia and Turkey

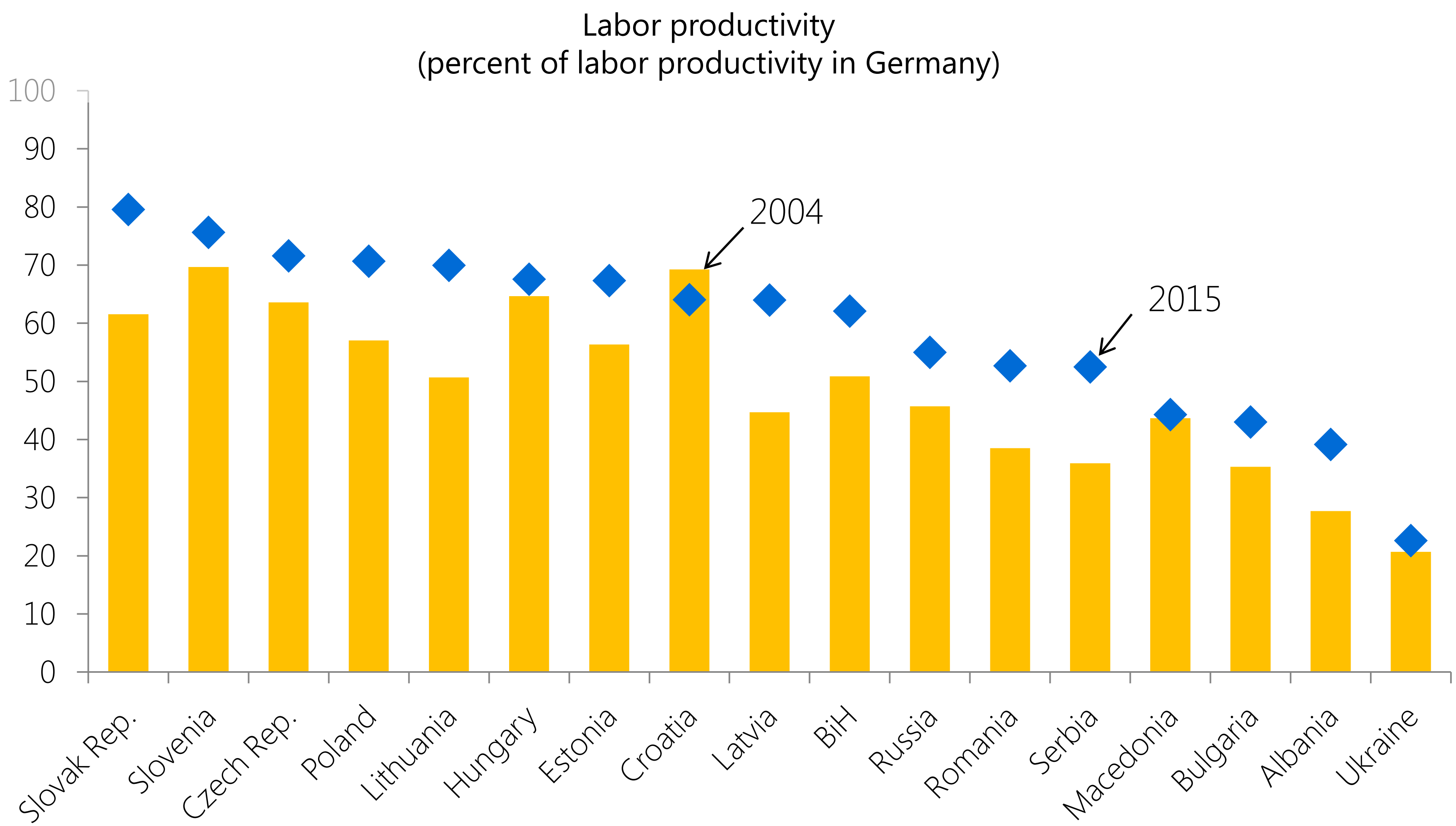
5. Longer-term Challenges

Longer term challenge: boosting productivity and employment rate

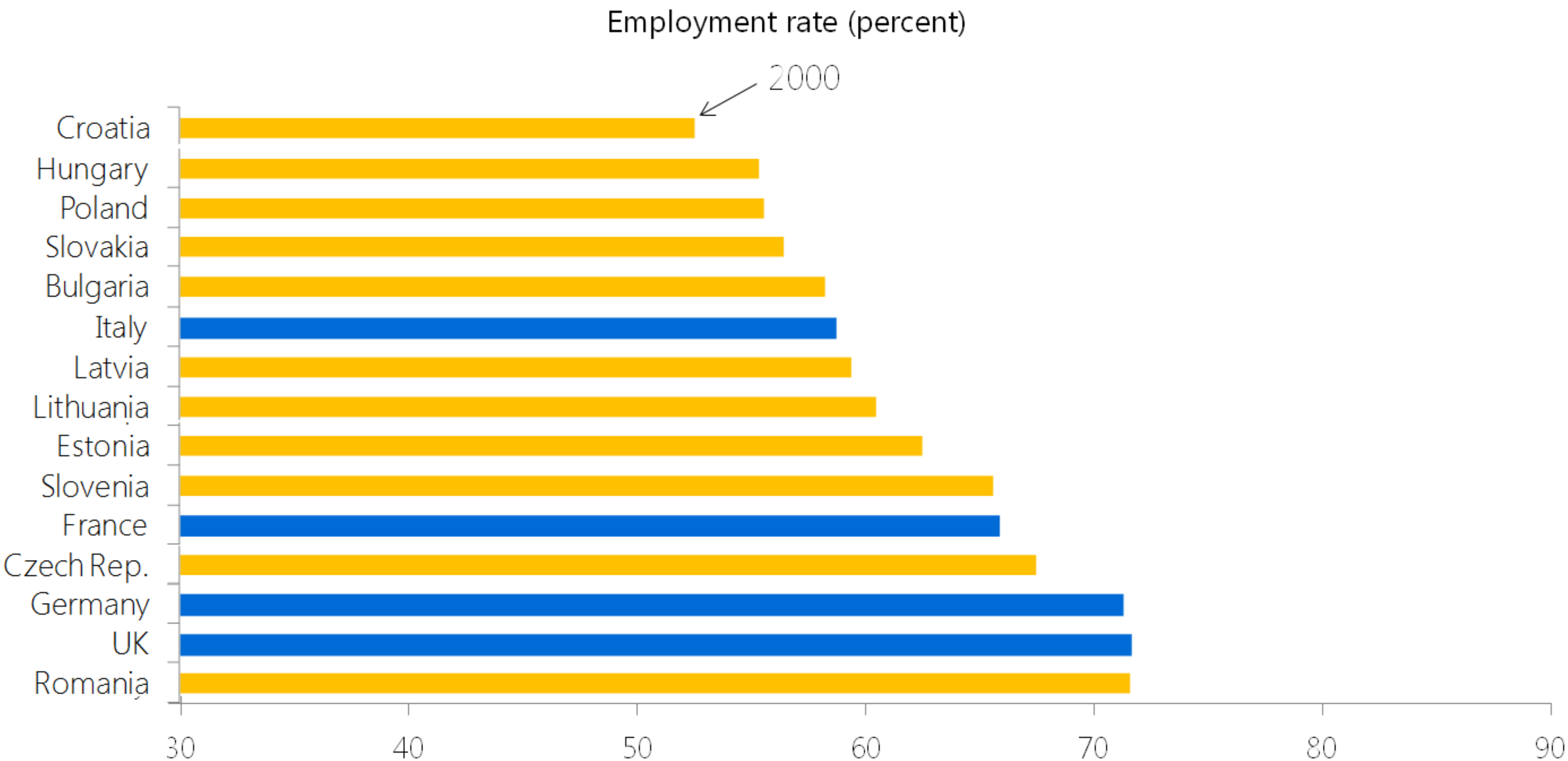


*2014

Productivity has increased, but remains relatively low



Employment has increased in CESEE-EU countries



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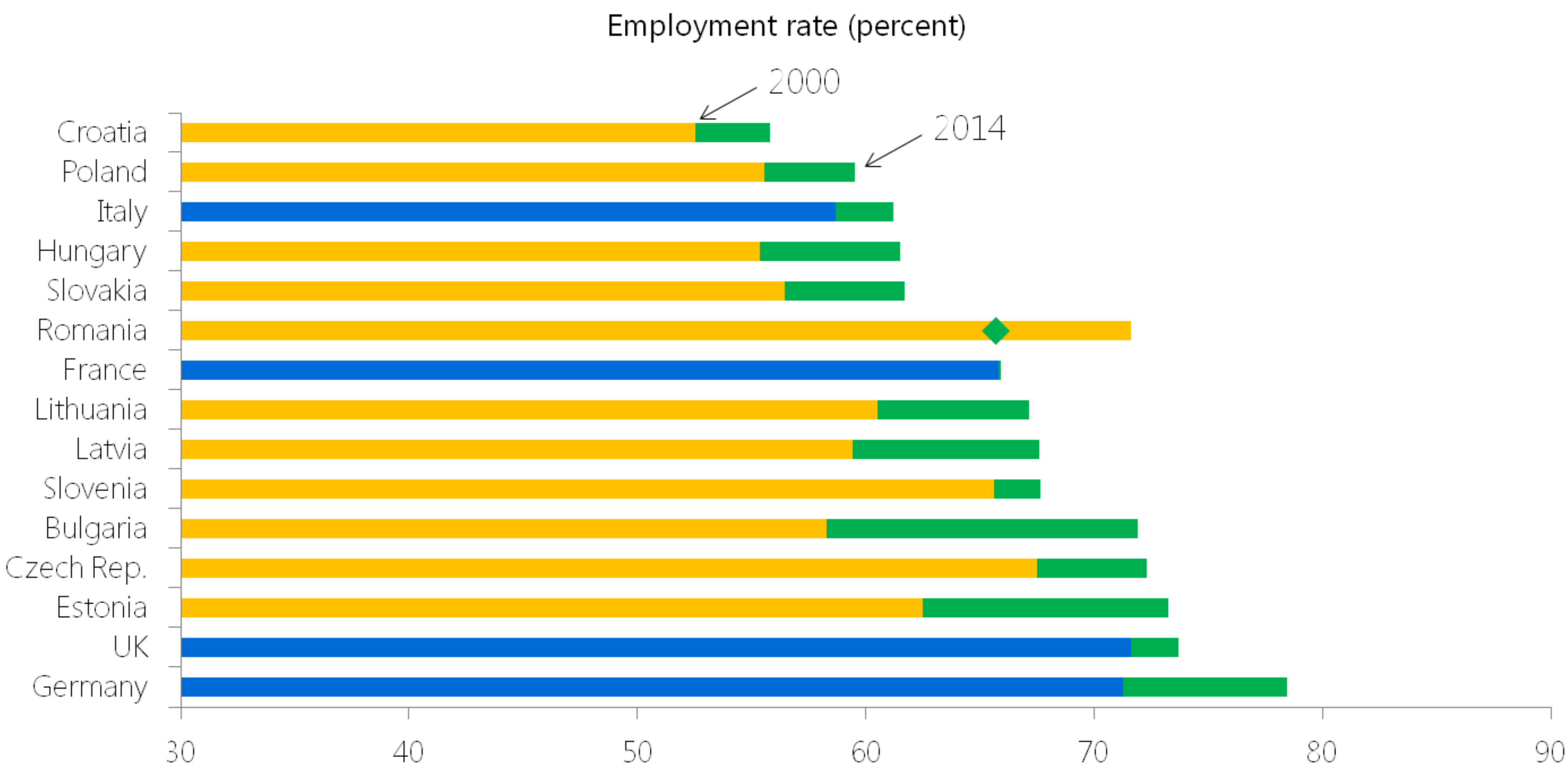
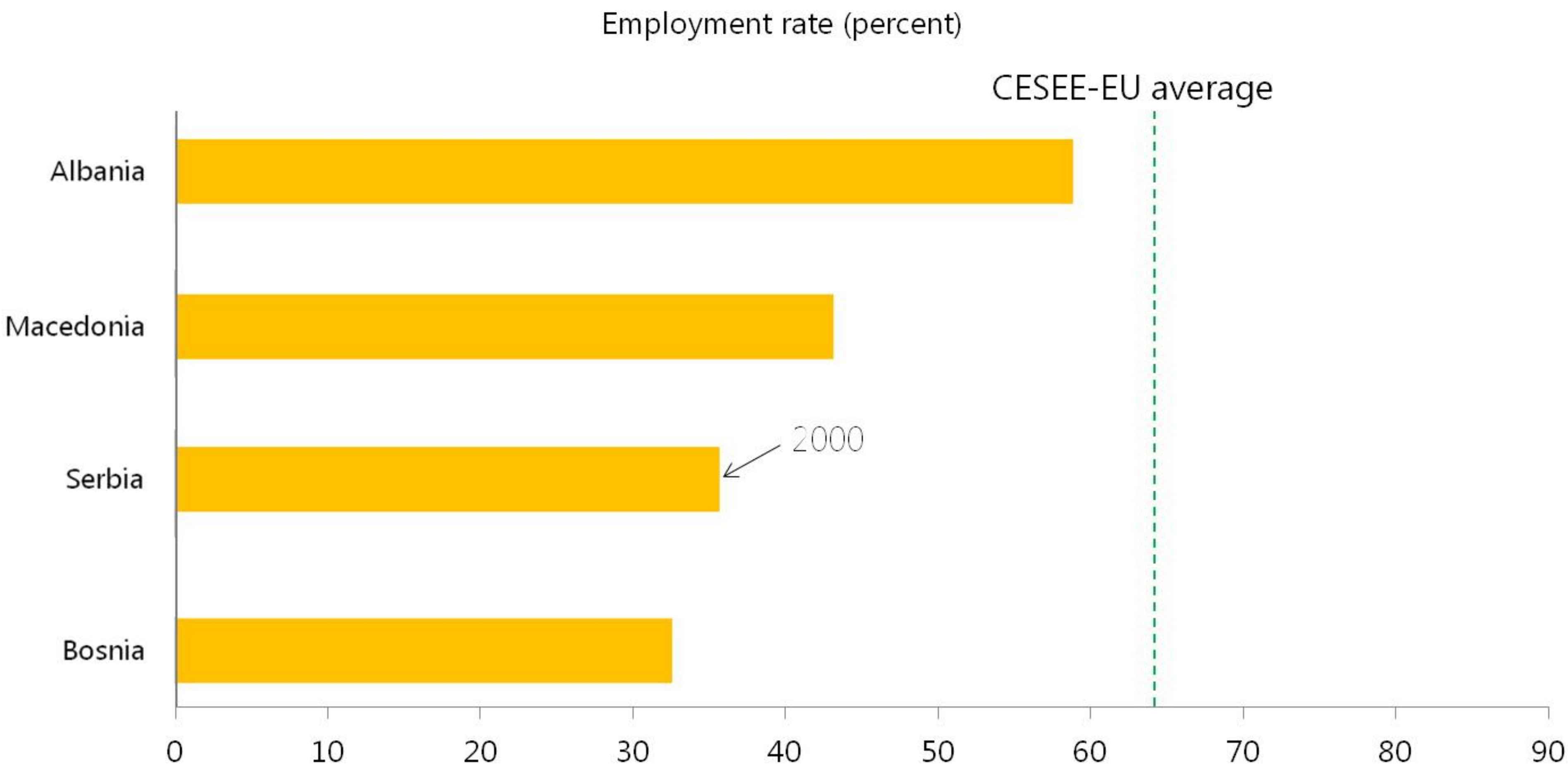
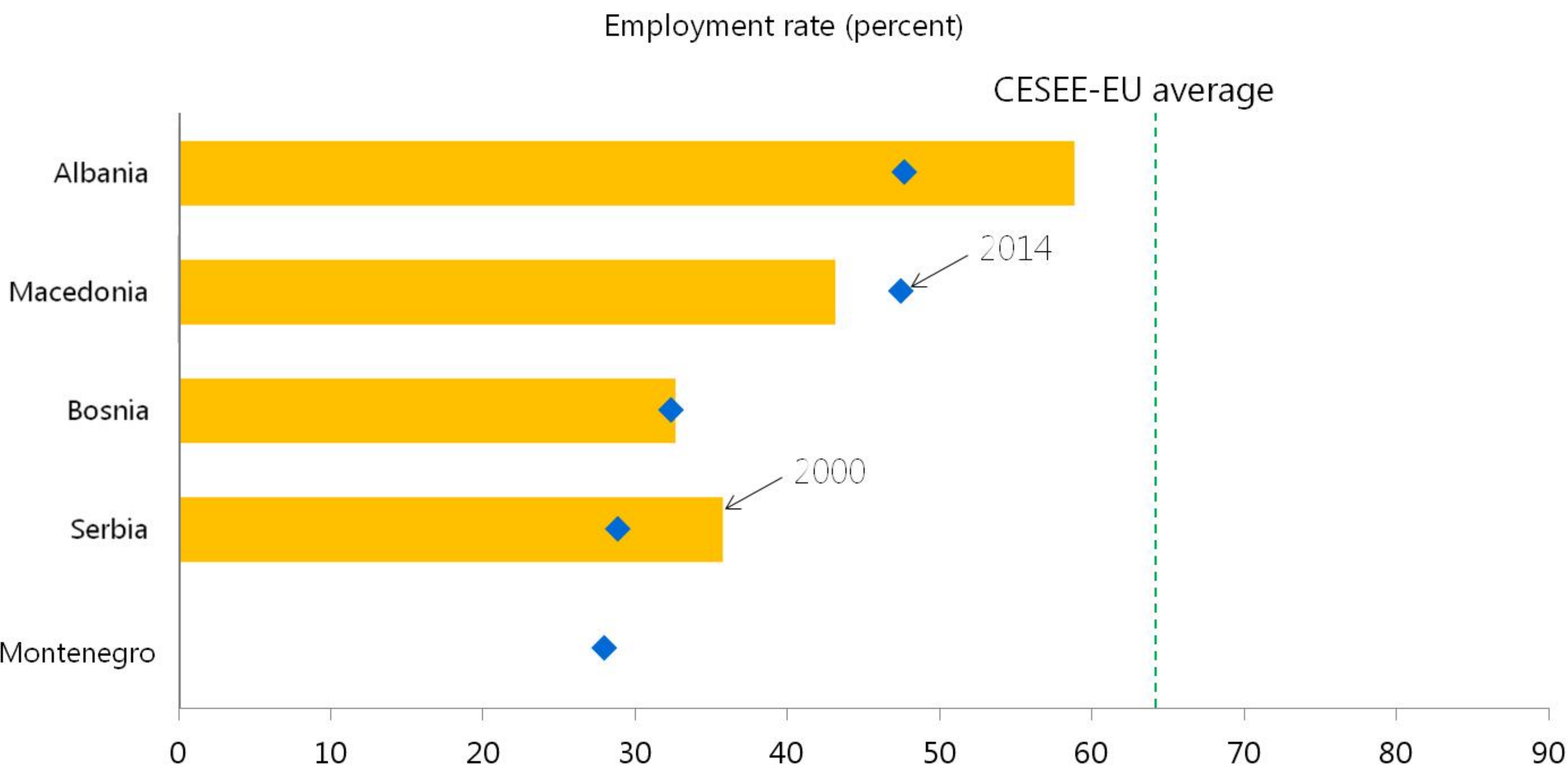


But remains low in SEE non-EU



But remains low in SEE non-EU

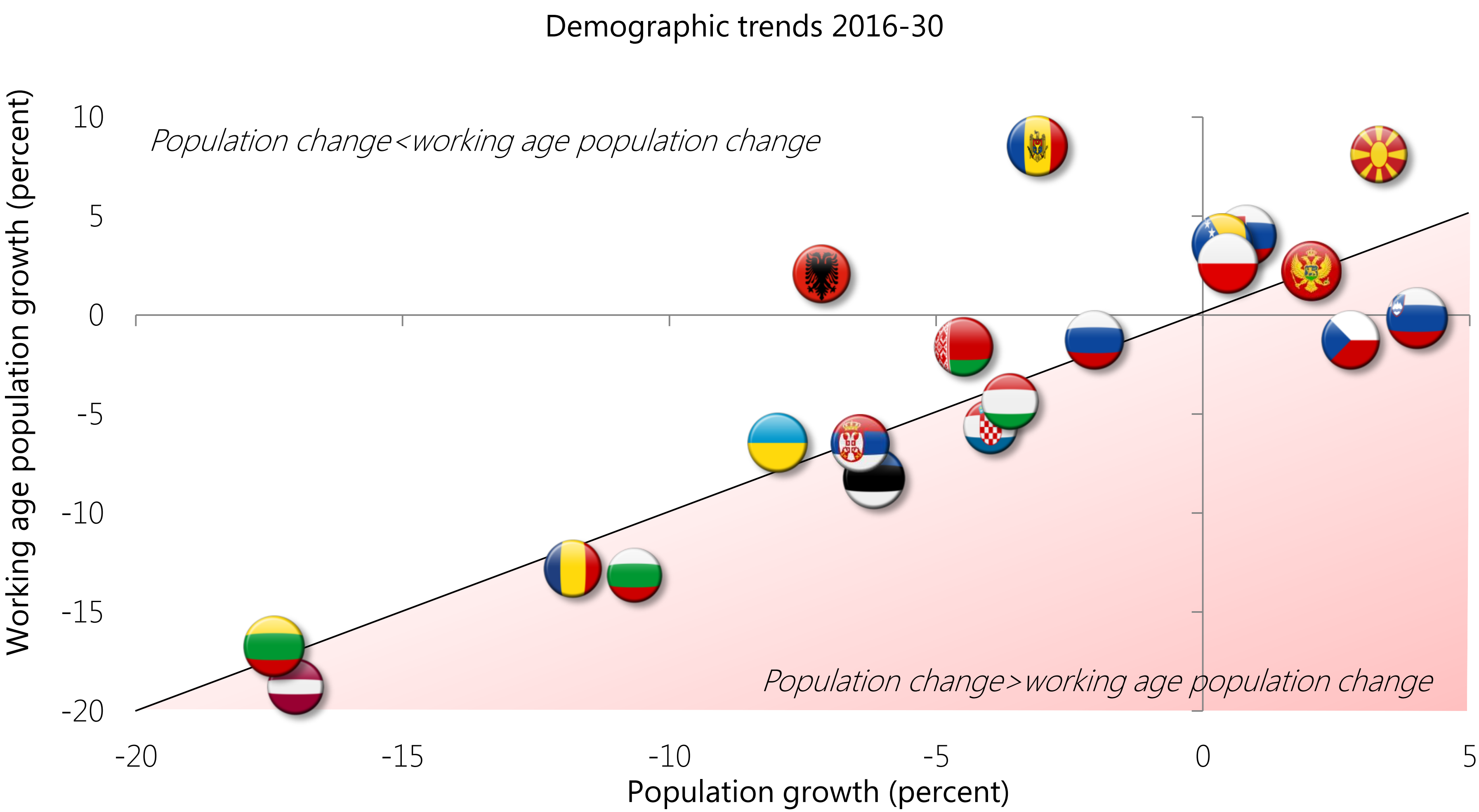


Aging will be strong headwind for per capita GDP growth

- Population will shrink
  - →will reduce GDP growth

- Working age population will shrink even faster
  - →will reduce GDP *per capita* growth

Population and Working Age Population will decline strongly in many countries!



Taken everything together, overall GDP growth may remain modest at best.

Example: Poland

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

6. Conclusion

Conclusion

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

Thank you