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Regional Economic Outlook

Europe

Building Confidence

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This *Regional Economic Outlook: Europe—Building Confidence* was written by Helge Berger, Christoph Duenwald, Yuko Kinoshita, Johan Mathisen, Srobona Mitra, Jérôme Vandenbussche, and Ivanna Vladkova-Hollar under the guidance of Bas Bakker and Christoph Klingen, with contributions from Xavier Debrun, Wim Fonteyne, Andrzej Raczko, Johannes Wiegand, and Boriana Yontcheva. This *Regional Economic Outlook: Europe* was coordinated by the Emerging Europe Regional Division of the IMF's European Department and overseen by Adam Bennett (Senior Advisor) and Ajai Chopra (Acting Director) of the European Department. Cleary Haines, Pavel Lukyantsau, and Xiaobo Shao provided research assistance; and Amara Myaing and Martha Bonilla provided administrative and editorial assistance, respectively. Joanne Blake of the External Relations Department oversaw the production. The report is based on data as of September 27, 2010. The views expressed in this report are those of the IMF staff and should not be attributed to Executive Directors or their national authorities.

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Introduction and Overview

Europe is recovering from its deepest recession in the postwar period. Following a 4.6 percent contraction in 2009, GDP is projected to increase by 2.3 percent in 2010 and 2.2 percent in 2011 (Table 1). With the exception of Greece and Portugal, growth in all countries will be positive next year—a stark difference from 2009, when only Albania, Belarus, Israel, Kosovo, and Poland saw positive growth.

The recovery in Europe has been boosted by the resurgence of the world economy. Global GDP growth is approaching precrisis growth rates (4.8 percent in 2010 and 4.2 in 2011), and European exports are benefiting. Export growth is especially strong in countries that export capital goods, which had earlier seen a very steep drop in external demand. Germany grew at an annualized rate of 9 percent in the second quarter, driving a resurgence of exports from its main suppliers—including in emerging Europe.

Advanced Europe is projected to grow by 1.7 percent in 2010 and 1.6 percent in 2011 (Chapter 1). The eruption of sovereign troubles in early 2010 threatened confidence and shook a still weak financial system. Yet, as the euro weakened and global stock markets tumbled, policy actions helped contain the problem and the recovery endured. Despite recent strength, however, the upswing in advanced Europe is projected to remain weak by historical standards and also compared with other advanced economies. In part, these growth differentials are due to the lingering impact of the crisis and the accelerating fiscal adjustment in 2011. But they also reflect well-known structural rigidities in the labor, product, and services markets that will limit the euro area's potential growth now that the inventory cycle has run its course.

Although the outlook has brightened, significant risks remain. The surprisingly strong growth in the first half of 2010 could continue longer than expected and provide an additional short-term thrust to the recovery by boosting private demand. Activity in the United States or emerging Asia might still exceed expectations and keep exports up. At the same time, however, global growth could very well turn out to be weaker than predicted, with a tail risk of a double-dip recession. Renewed volatility in European financial and sovereign markets is also a possibility.

In view of these risks, it will be crucial to get policies right. Fiscal consolidation, while inevitable, should be undertaken in a way that minimizes the negative impact on growth; monetary policy must steer carefully between the need to normalize policies on the one hand and the necessity to mitigate sovereign market volatility and ensure bank liquidity on the other; and the recent checkup of European banks must be followed by rapid action to eliminate remaining weaknesses in balance sheets while continuing to safeguard lending capacity. In addition, if the confidence of financial markets, consumers, and investors is to be stabilized beyond the short term, the governance of the European Union (EU) and the euro area will need to be fundamentally improved.

Table 1. European Countries: Real GDP Growth and CPI Inflation, 2007–11
(Percent)

	Real GDP Growth					Average CPI Inflation				
	2007	2008	2009	2010	2011	2007	2008	2009	2010	2011
Europe[1]	4.0	1.4	-4.6	2.3	2.2	3.6	5.7	2.7	2.9	2.8
Advanced European economies[1]	3.0	0.5	-4.0	1.7	1.6	2.1	3.4	0.7	1.8	1.7
Emerging European economies[1]	7.0	4.1	-6.0	3.9	3.8	7.8	12.0	8.5	6.1	6.1
European Union[1]	3.2	0.8	-4.1	1.7	1.7	2.4	3.7	0.9	1.9	1.8
Euro area	2.9	0.5	-4.1	1.7	1.5	2.1	3.3	0.3	1.6	1.5
Austria	3.7	2.2	-3.9	1.6	1.6	2.2	3.2	0.4	1.5	1.7
Belgium	2.8	0.8	-2.7	1.6	1.7	1.8	4.5	0.0	2.0	1.9
Cyprus	5.1	3.6	-1.7	0.4	1.8	2.2	4.4	0.2	2.2	2.3
Finland	5.3	0.9	-8.0	2.4	2.0	1.6	3.9	1.6	1.4	1.8
France	2.3	0.1	-2.5	1.6	1.6	1.6	3.2	0.1	1.6	1.6
Germany	2.7	1.0	-4.7	3.3	2.0	2.3	2.8	0.2	1.3	1.4
Greece	4.5	2.0	-2.0	-4.0	-2.6	3.0	4.2	1.4	4.6	2.2
Ireland	5.6	-3.5	-7.6	-0.3	2.3	2.9	3.1	-1.7	-1.6	-0.5
Italy	1.5	-1.3	-5.0	1.0	1.0	2.0	3.5	0.8	1.6	1.7
Luxembourg	6.5	0.0	-4.1	3.0	3.1	2.3	3.4	0.4	2.3	1.9
Malta	3.7	2.6	-2.1	1.7	1.7	0.7	4.7	1.8	1.9	2.1
Netherlands	3.9	1.9	-3.9	1.8	1.7	1.6	2.2	1.0	1.3	1.1
Portugal	2.4	0.0	-2.6	1.1	0.0	2.4	2.7	-0.9	0.9	1.2
Slovak Republic	10.6	6.2	-4.7	4.1	4.3	1.9	3.9	0.9	0.7	1.9
Slovenia	6.8	3.5	-7.8	0.8	2.4	3.6	5.7	0.9	1.5	2.3
Spain	3.6	0.9	-3.7	-0.3	0.7	2.8	4.1	-0.2	1.5	1.1
Other EU advanced economies										
Czech Republic	6.1	2.5	-4.1	2.0	2.2	2.9	6.3	1.0	1.6	2.0
Denmark	1.7	-0.9	-4.7	2.0	2.3	1.7	3.4	1.3	2.0	2.0
Sweden	3.3	-0.4	-5.1	4.4	2.6	1.7	3.3	2.0	1.8	1.9
United Kingdom	2.7	-0.1	-4.9	1.7	2.0	2.3	3.6	2.1	3.1	2.5
EU emerging economies[1]	6.0	4.4	-3.0	1.6	2.9	4.6	6.5	3.9	3.2	3.1
Bulgaria	6.2	6.0	-5.0	0.0	2.0	7.6	12.0	2.5	2.2	2.9
Estonia	6.9	-5.1	-13.9	1.8	3.5	6.6	10.4	-0.1	2.5	2.0
Hungary	1.0	0.6	-6.3	0.6	2.0	7.9	6.1	4.2	4.7	3.3
Latvia	10.0	-4.2	-18.0	-1.0	3.3	10.1	15.3	3.3	-1.4	0.9
Lithuania	9.8	2.8	-14.8	1.3	3.1	5.8	11.1	4.2	1.0	1.3
Poland	6.8	5.0	1.7	3.4	3.7	2.5	4.2	3.5	2.4	2.7
Romania	6.3	7.3	-7.1	-1.9	1.5	4.8	7.8	5.6	5.9	5.2
Non-EU advanced economies										
Iceland	6.0	1.0	-6.8	-3.0	3.0	5.0	12.4	12.0	5.9	3.5
Israel	5.3	4.2	0.8	4.2	3.8	0.5	4.6	3.3	2.3	2.8
Norway	2.7	0.8	-1.4	0.6	1.8	0.7	3.8	2.2	2.5	1.4
Switzerland	3.6	1.9	-1.9	2.9	1.7	0.7	2.4	-0.5	0.7	0.5
Other emerging economies										
Albania	5.9	7.7	3.3	2.6	3.2	2.9	3.4	2.2	3.4	2.9
Belarus	8.6	10.2	0.2	7.2	6.2	8.4	14.8	13.0	7.3	10.8
Bosnia and Herzegovina	6.1	5.7	-3.1	0.5	3.0	1.5	7.4	-0.4	2.4	2.5
Croatia	5.5	2.4	-5.8	-1.5	1.6	2.9	6.1	2.4	1.9	2.8
Kosovo	4.0	5.4	4.0	4.6	5.9	4.4	9.4	-2.4	1.7	3.2
Macedonia	6.1	5.0	-0.8	1.2	3.0	2.3	8.3	-0.8	1.9	3.0
Moldova	3.0	7.8	-6.5	3.2	3.5	12.4	12.7	0.0	7.4	6.0
Montenegro	10.7	6.9	-5.7	-1.8	4.5	4.2	8.5	3.4	0.6	1.0
Russia	8.5	5.2	-7.9	4.0	4.3	9.0	14.1	11.7	6.6	7.4
Serbia	6.9	5.5	-3.0	1.5	3.0	6.5	12.4	8.1	4.6	4.4
Turkey	4.7	0.7	-4.7	7.8	3.6	8.8	10.4	6.3	8.7	5.7
Ukraine	7.9	2.1	-15.1	3.7	4.5	12.8	25.2	15.9	9.8	10.8

Source: IMF, World Economic Outlook database.
[1]Average weighted by GDP valued at purchasing power parity (PPP).

Emerging Europe is also recovering, growing by 3.9 percent in 2010 and 3.8 percent in 2011 (Chapter 2). Emerging Europe had been hit hard by the global crisis, as it was affected not only through lower exports, but also through a sharp drop in capital inflows, which brought an end to the domestic demand boom that many countries had experienced in the precrisis years. The region is now recovering on the back of resurgent exports, but domestic demand remains subdued, particularly in countries where the deflation of precrisis asset and credit booms has been most severe.

The outlook in emerging Europe will depend crucially on developments in western Europe. Renewed turmoil in western Europe could affect emerging Europe not only through trade channels; it could also hurt capital flows to the region and domestic credit growth, which would further weaken domestic demand.

Policymakers in emerging Europe face the difficult challenge of dealing with the legacies of the crisis while not hurting the recovery. Headline fiscal deficits rose sharply during the crisis, and have remained high in 2010. To a large extent, these deficits are structural: although headline deficits were low in most countries before the crisis, a temporary boom in revenues masked the underlying deterioration that resulted from the rapid growth of public expenditure. Credit growth has been weak since the onset of the crisis. This is the result of lower capital transfers from advanced Europe, increasing nonperforming loans (NPLs)—which necessitate an increase in provisioning—and weak demand. With demand for credit now recovering, public policies could reduce supply-side constraints on credit growth by reducing uncertainty about macroeconomic policy. Credible fiscal consolidation plans could help preempt sovereign debt concerns, which would be particularly damaging in countries where banks have substantial exposure to sovereigns. Beyond the short term, the region will need to find new growth engines, as the growth model of the boom years—driven by capital inflows, rapid credit growth, and domestic demand booms—will need to shift toward greater reliance on the tradable sector as an engine of growth.

Although the crisis in emerging Europe has been deep, the banking and currency crises that many had initially feared have largely been avoided—the result of strong domestic policy responses, rapid and large-scale financing packages of international institutions, and the continued support of western banks (Chapter 3). The boom-bust cycle provides important lessons in crisis prevention. Although the crisis in emerging Europe was triggered by external factors (the recession in advanced Europe and the sudden stop in capital inflows), domestic imbalances and vulnerabilities played a key role. Indeed, countries that have largely managed to avoid the capital-inflows-driven credit and domestic demand booms have had a much less severe recession.

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1. Advanced Europe: Beyond Crisis Management

With strong policy action to contain sovereign debt problems in the euro area, the recovery continues. But lingering uncertainties and market pressures make for moderate and unequal growth across advanced Europe. In the short term, in addition to dealing with weak banks and supportive monetary policy, this calls for credible fiscal consolidation, adjusted to country needs and designed to minimize the impact on growth. It will be just as important to address the governance issues revealed by the crisis. Better fiscal frameworks at the national and the EU levels will enhance the credibility of fiscal adjustment. And energizing and coordinating structural policies should help sustain and balance growth, supporting public finances in the longer term. Although the political economy of such reforms is complicated, they promise a much stronger Europe. Policymakers should seize the moment and act boldly.

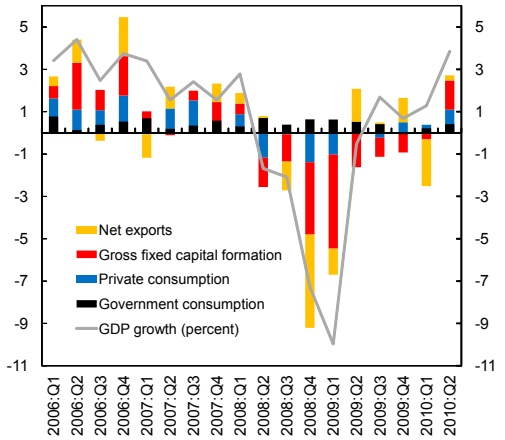
The Recovery Continues

The Recovery Has Withstood Sovereign Debt Troubles . . .

The recovery in advanced Europe is well into its fourth quarter, but it was not an easy year. The eruption of sovereign debt troubles in early 2010 threatened confidence and shook a still weak financial system. Triggered by Greece's public debt problems, fiscal sustainability concerns quickly spread in the euro area and beyond—first to other southern European countries and Ireland, then more widely—and euro area interbank markets seized up once more. Yet, as the euro weakened and global stock markets tumbled, policy actions helped contain the problem and the recovery endured (Figure 1).

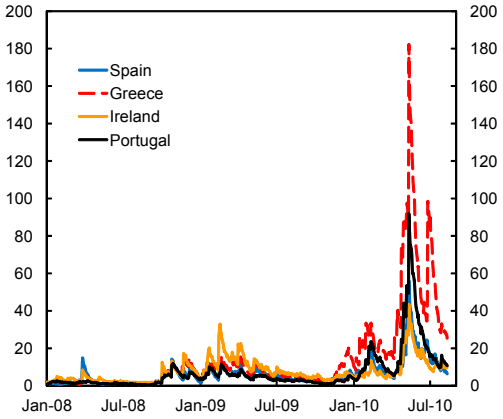
Far-reaching policy interventions were crucial. The Greek program co-signed by the EU and the International Monetary Fund in early May gave Greece time to put its public finances in order. However, when sovereign and financial markets did not calm immediately and tensions escalated to dangerous levels (Figure 2), even stronger measures were required. In early May, the European Central Bank (ECB) installed a Securities Markets Program

Figure 1. Euro Area: Contribution to Growth, 2006:Q1–2010:Q2
(Quarter-on-quarter annualized growth rate, percentage points; seasonally adjusted)



Sources: Eurostat; and IMF staff calculations.
Note: Contributions from inventories not shown.

Figure 2. Selected European Countries: Conditional Standard Deviation of Changes in 5-Year Sovereign CDS Spreads, January 2008–August 2010
(Basis points)



Sources: Datastream; and IMF staff calculations.

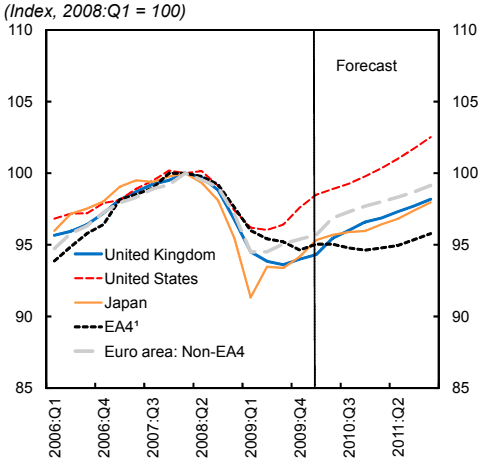
Note: The main author of this chapter is Helge Berger.

(SMP) allowing it to buy private and public securities in secondary markets, and the ECOFIN Council (the Council) and euro area governments established the European Stability Mechanism (ESM) to provide the means and a mechanism to support governments and preserve financial stability. The ECB has accumulated some €61 billion through the SMP between May and September, albeit at relatively low levels recently. The European Financial Stability Facility (EFSF), which at a nominal €440 billion provides for the bulk of the ESM's funding capacity, has been operational since early August. In addition, the ECB has taken steps to bolster liquidity, including with the help of central bank swap arrangements, in U.S. dollar markets.

. . . But Proceeds Unevenly

In many countries, the second bout of crisis slowed the rebound, and real GDP levels remain well below their precrisis peaks (Figure 3). With few exceptions, advanced European countries have seen output recuperating much slower than in the United States. By mid-2010, GDP in the United Kingdom, Sweden, and the majority of euro area countries remained well below its precrisis level, with those hit hardest by the crisis lagging behind even further.

Figure 3. Selected European Countries and the United States: Real GDP, 2006:Q1–2011:Q4
(Index, 2008:Q1 = 100)



Sources: IMF, World Economic Outlook database; and IMF staff calculations.
¹ Greece, Ireland, Portugal, and Spain.

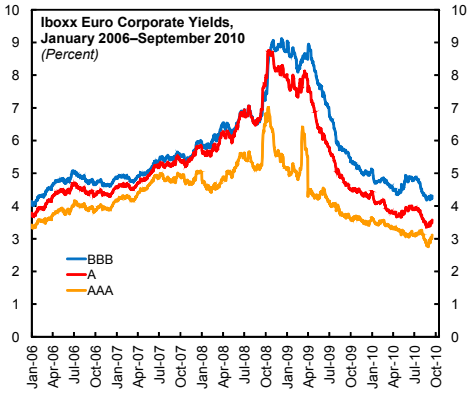
The lack of momentum is also visible in the composition of growth. Looking at the euro area, while growth was strong in the second quarter of 2010, driven mostly by Germany, this reflected the unfreezing of past investment decisions rather than increasing overall momentum (Figure 4). Exports continued to lift growth also, driven by some of the same temporary factors operating at the global level—stronger overall expansions in other regions of the world, and the euro's depreciation earlier in the year. However, the euro's weakening (later reversed, to some degree) was also a worrying sign of changing financial market sentiment in light of fiscal and financial problems. Indeed, financial growth conditions tipped down slightly after a long period of improvement (Figure 5). These developments, combined with high unemployment in parts of the region and volatile confidence, contributed to lackluster domestic consumption and investment. And while an expansionary budget in Germany continues to buoy growth, the crisis-induced front-loading of budget consolidation in southern Europe has started to impact aggregate public consumption and investment.

The Outlook Remains for Moderate Growth . . .

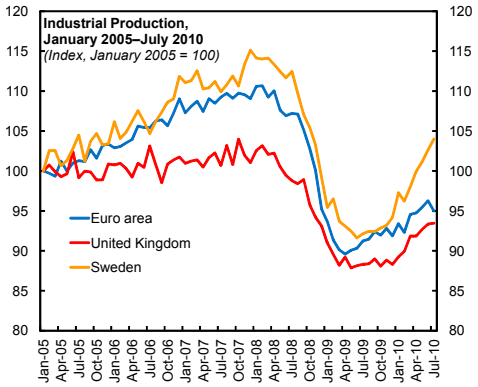
Against this background, the forecast remains for a very modest expansion. Real GDP is projected to expand at 1.7 percent in 2010 and 1.5 in 2011 in the euro area (Table 1). At this speed, the euro area will continue to trail the United States and Asia's emerging economies. In part, these growth differentials are due to the lingering impact of the crisis and the accelerating fiscal adjustment in 2011. But they also reflect well-known structural rigidities in the labor, product, and service markets that will limit the euro area's potential growth now that the inventory cycle has run its course.

Intra-European growth differentials are set to widen. At between -2.6 and 0.7 percent in 2011, growth in Greece, Portugal, and Spain is projected

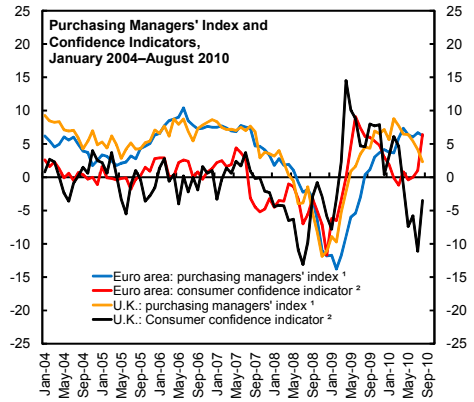
Figure 4. Selected European Countries: Key Short-Term Indicators



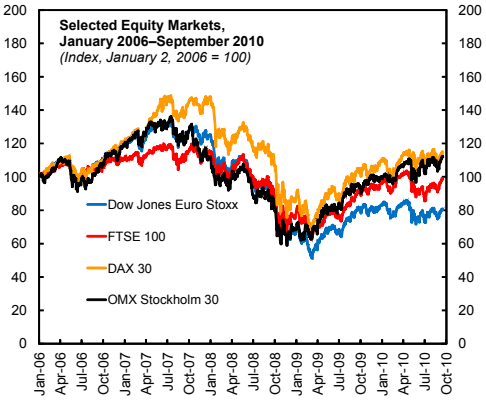
Source: Datastream.



Sources: Eurostat; Haver Analytics; and IMF staff calculations.

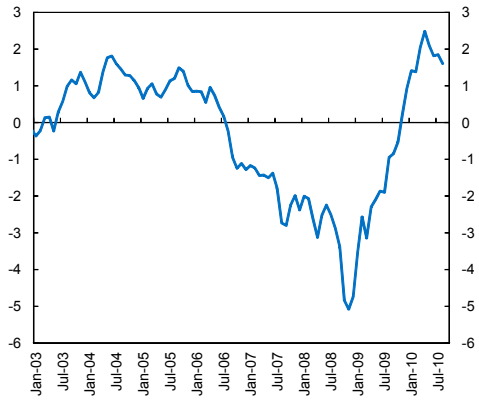


Sources: Eurostat, European Commission Business and Consumer Surveys; Haver Analytics; and IMF staff calculations.
¹ Seasonally adjusted; deviations from an index value of 50.
² Percentage balance; difference from the value three months earlier.



Source: Datastream.

Figure 5. Euro Area: Financial Conditions Index, January 2003–August 2010
(July 1999 = 0)

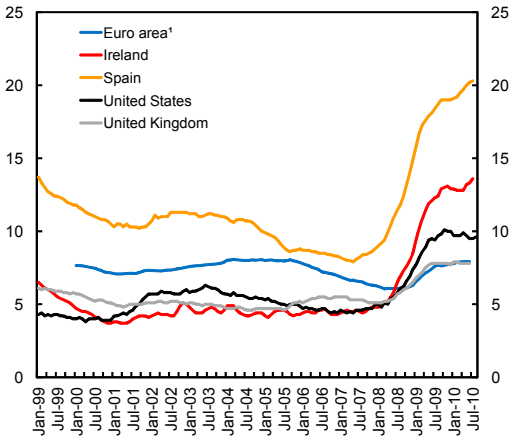


Sources: Datastream; Haver Analytics; and IMF staff calculations.
Note: The Financial Conditions Index (FCI) is a summary measure of developments in various financial variables and their impact on growth four quarters ahead. Higher readings imply easier financial conditions and higher growth. The FCI is constructed as the weighted average of euro area-wide measures of the real short-term interest rate, the term spread, the risk spread, equity market capitalization, and the real effective exchange rate, with the weights based on the coefficient estimates of a regression of real GDP growth on these variables.

as lagging growth in the euro area's larger northern economies, reflected also in diverging labor market developments that could lead to higher long-term or structural unemployment (Figure 6). As discussed earlier (IMF, 2010g), these differences are driven by the deflation of precrisis asset and credit booms and the degree to which countries' export sectors profit from the rebound in global trade. Fiscal austerity may have been a critical crisis reaction and prevented things from getting worse where market pressures were the highest. But this austerity, combined with elevated interest rate spreads, is also taking its toll on growth.

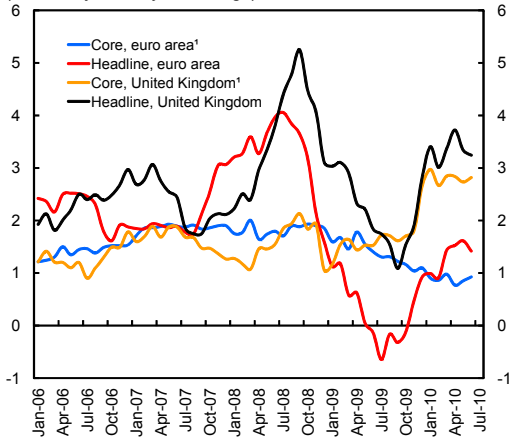
Some of the same forces are at work outside the euro area, albeit in different ways. With the effects of recently scaled up plans for fiscal consolidation

Figure 6. Selected European Countries and the United States: Unemployment Rate, January 1999–August 2010
(Percent)



Sources: Eurostat; Haver Analytics; and IMF staff calculations.
¹ Excluding Ireland and Spain.

Figure 7. Selected European Countries: Headline and Core Inflation, January 2006–August 2010
(Percent; year-on-year change)



Sources: Eurostat; Haver Analytics; national authorities; and IMF staff calculations.
¹ Harmonized index of consumer price inflation (excluding energy, food, alcohol, and tobacco).

partly offset by a still depreciated currency (more than 20 percent in real effective terms since the beginning of the crisis), the United Kingdom is likely to see growth of about 1.7 percent in 2010 and 2.0 percent in 2011. Switzerland, facing opposite circumstances of a stable fiscal outlook and a strongly appreciated safe-haven currency, should see growth of around 2.9 percent in 2010 and 1.7 in 2011. Sweden, which also operates at very moderate deficit levels and has seen financial growth conditions improving since the early phase of the crisis, can expect real GDP to expand by approximately 4.4 percent in 2010, among the strongest performances in Europe, cooling down to 2.6 percent in 2011.

Although the forecast is not without upside risks, downside risks have increased, with some of these being associated with the way in which announced policies are (or are not) implemented. The positive growth surprise in Germany could provide additional short-term thrust to the recovery by boosting private demand, and activity in the United States or emerging Asia might still exceed expectations. At the same time, however, global growth could very well be weaker than predicted, with a tail risk of a double-dip recession. Renewed volatility in European financial and sovereign markets is also a possibility.

More than ever, however, the recovery depends on policymakers getting it just right: fiscal consolidation, while inevitable, must seek to minimize the negative impact on growth and employment; monetary policy must steer between the need to normalize policies on the one hand and the necessity to mitigate sovereign market volatility and ensure bank liquidity on the other; and the recent checkup of European banks must be followed by rapid action to eliminate remaining weaknesses while safeguarding lending capacity. In addition, to stabilize the confidence of financial markets, consumers, and investors beyond the short term, EU and euro area governance will need to improve fundamentally (see below).

. . . With (Mostly) Low Inflationary Pressure

Inflation will remain low in most of advanced Europe. In the euro area, with the output gap slowly closing, headline inflation is expected to rise to 1.6 percent in 2010 and 1.5 percent in 2011 (Figure 7). Long-term inflation expectations remain well anchored at about 2 percent, close to the ECB's comfort zone. Switzerland, which has seen its currency appreciate in real terms since the beginning of the crisis, is expected to see very low inflation rates below 1 percent in both years. In contrast, in

the United Kingdom, where inflation has been surprisingly high following a series of price level shocks and the strong depreciation of the pound, inflation is expected to nudge higher, averaging 3.1 in 2010 and 2.5 in 2011. Sweden, despite its more volatile growth path, will show more steady inflation of just below 2 percent in both years.

Policies to Sustain the Upswing

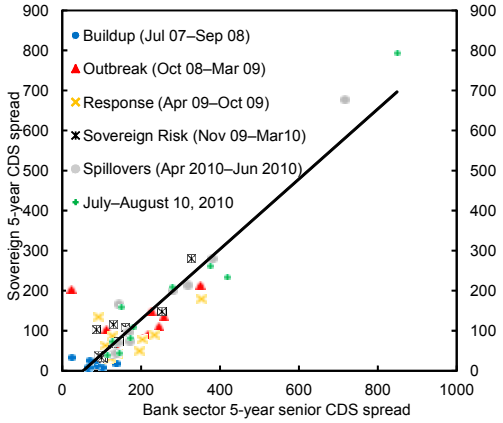
Massive policy intervention has helped stabilize Europe's economies during the recession, but managing the recovery is just as demanding. The task of securing growth and containing risks involves financial and monetary policies and—crucially—fiscal action.

Financial Sector Cleanup Not to Be Delayed . . .

The recent sovereign bond market volatility has made dealing with remaining weakness in the banking sector even more urgent. In the euro area, banks' holdings of government paper tightly link perceived sovereign and financial sector risks (Figure 8), limiting access to interbank lending for some institutions. In addition, banks face the anticipated (if phased-in) increase in regulatory capital, continued problems of low profitability, high loan loss provisions, and low capital ratios. These factors are fueling concerns about a credit crunch (IMF, 2010d). Indeed, with aggregate flows of corporate credit yet to show consistent signs of life, there are indications that smaller firms lacking access to bond-based financing could be constrained on the credit market (IMF, 2010b, Chapter 1) (Figures 9A and 9B).

This summer's EU-wide stress tests provide a road map. The tests were well coordinated—implemented in just four weeks, encompassing more than 90 banks from 19 member states, representing about two-thirds of the EU banking sector assets—and provided a wealth of information for financial markets (Table 2). The next step is to follow up by

Figure 8. Euro Area Countries: Sovereign and Banking Sector 5-Year CDS Spreads, 2007–10
(Basis points)



Sources: Datastream; IMF, *Fiscal Monitor*, May 2010; and IMF staff calculations.

Figure 9A. Euro Area: Real Bank Credit and GDP Growth, 2000:Q1–2010:Q2
(Percent)

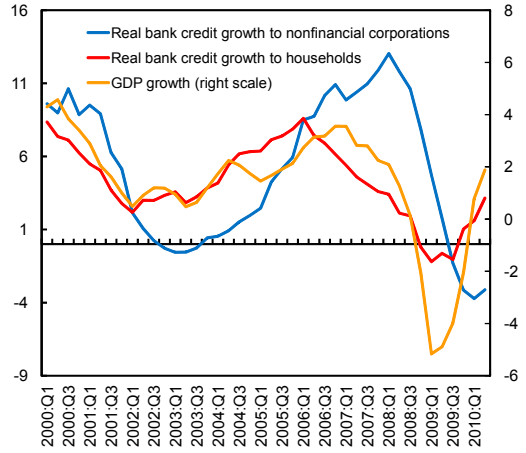
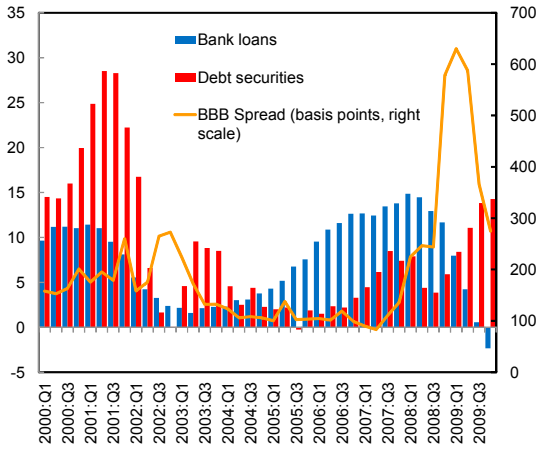


Figure 9B. Euro Area: Bank Loans and Bond Issuance, 2000:Q1–2009:Q4[1]
(Percent; unless otherwise noted)



Sources: Eurostat; European Central Bank; Haver Analytics; IMF, *International Financial Statistics;* and IMF staff calculations.
[1] Unweighted averages of annual growth rates.

Table 2. Selected Countries: Net Exposure of Banks to Sovereign Debt as Reported in CEBS Stress Test, March–July 2010
(Billions of euro)

	Sovereign Debt of:					
	Greece	Ireland	Italy	Portugal	Spain	Total
Banks in:						
France	11.0	2.4	47.1	4.6	6.3	71.4
Germany	9.7	2.0	36.3	6.3	20.5	74.8
United Kingdom	4.3	5.1	11.0	2.5	5.3	28.3
Netherlands	3.2	0.6	10.3	2.3	2.9	19.2
Spain	0.8	0.1	9.4	6.5	…	16.9
Ireland	0.0	…	0.7	0.3	0.4	1.4
Italy	1.8	0.2	…	0.3	1.4	3.7
Portugal	1.7	0.8	1.2	…	0.4	4.1
Total	32.5	11.3	116.1	22.7	37.2	219.8

Sources: CEBS; national sources; and IMF staff calculations.
Notes: The figures only cover net exposure as reported by the banks that were part of the CEBS stress test and should be treated as indicative. On average, these banks represented about 65 percent of total banking assets. Data are as of March 2010 in most cases.

resolving, restructuring, or recapitalizing the banks identified as vulnerable (IMF, 2010d, Chapter 1). Early progress in that direction in Spain, where an existing government program was available to shore up banks where needed, have rightly been welcomed by the markets. However, similar action is required elsewhere, including in some cases for banks that only narrowly cleared the hurdle.

. . . And Monetary Policy to Remain Supportive and Flexible

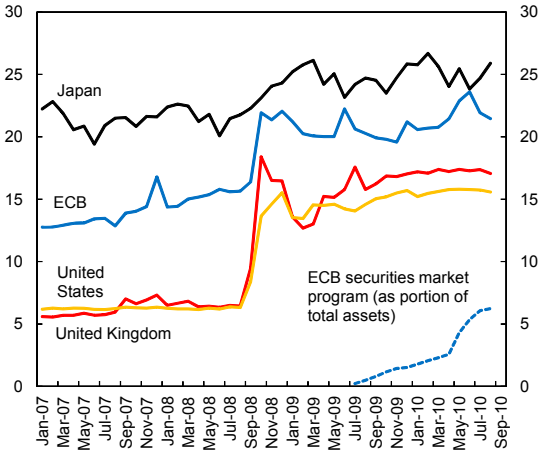
With financial sector strengthening on its way and little inflationary pressure on the horizon, monetary policy can and should remain supportive and flexible. For example, while the ECB seems comfortable with market forces bringing overnight rates up closer to the level of the policy rate at times, it has signaled its intention to keep the policy rate low. Moreover, with the risk balance of the recovery having shifted downward and fiscal policy options increasingly limited, the ECB should remain ready to adjust the time horizon of its low-interest-rate policy and redeploy extraordinary monetary measures if the recovery should stall unexpectedly. The Bank of England, in turn, has appropriately maintained a very expansionary stance and indicated that it will respond flexibly to incoming data, while paying close attention to the risk that recent above-target inflation outturns might adversely affect medium-term inflation expectations. In Switzerland, the main policy challenge will be to allow interest rates to increase over time, in an environment where the currency faces appreciation pressures.

The same flexibility should govern the exit from extraordinary crisis measures. Liquidity operations, such as the ECB's full allotment refinancing, are still needed in light of the recent fiscal and financial sector turbulence, but their benefits should be balanced against the cost of distorting marked-based bank financing, the moral hazard invited by unlimited liquidity provision, and the risks accumulating on central bank balance sheets (Figure 10). This suggests a resumption of the gradual exit once systemic liquidity conditions have reliably returned to normal. In the same vein, the ECB will have to tread carefully when phasing out its sovereign bond purchases. The task of exiting from these particular crisis measures should be made easier with the ESM now operational.

Fiscal Policy Must Focus on Consolidation without Jeopardizing the Recovery

Getting fiscal consolidation right is the most crucial of the short-term tasks facing Europe's policymakers—and among the most difficult. The current willingness of governments to support demand through higher deficits is still an important ingredient of the recovery (Table 3). And if growth weakened markedly more than projected, additional support might yet be needed. However, this is

Figure 10. Selected Countries: Central Banks' Total Assets, January 2007–August 2010
(Percent of GDP, unless otherwise noted)



Sources: National central banks; Haver Analytics; and IMF staff calculations.

subject to there being fiscal space and market acceptance—it is precisely the fear that increasing debt could make public finances unsustainable that could put the recovery at risk. Elevated interest rate spreads and a steady stream of rating downgrades (or the fear thereof) serve as a case in point. The solution is a strong and credible fiscal consolidation effort, suitably phased in, differentiated across countries in size, speed, and timing (depending on existing market pressures), and designed to minimize the negative impact on growth and employment that comes with the reduction of government deficits.

Deficits are being reduced in many countries, with efforts broadly mirroring the pressure felt in sovereign bond markets (Figure 11). Among the countries scrutinized by markets most, Ireland has started early, but Spain and Portugal have recently also implemented ambitious and front-loaded consolidation efforts, with the announcement of additional efforts in the future. In Greece, the government is on track to reduce its deficit by about 5½ percentage points of GDP in 2010 in line with the guidelines agreed with the EU and IMF.

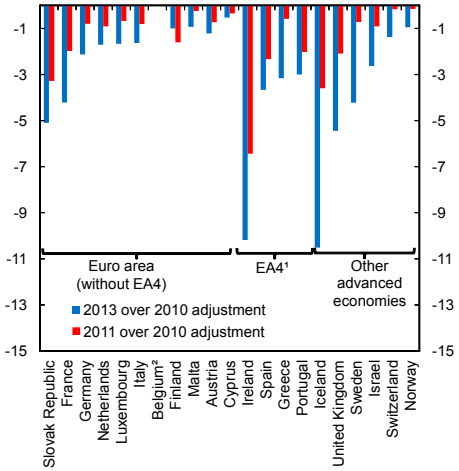
But the summer's budget season has also brought signs of fiscal consolidation elsewhere in Europe. This is most visible in the United Kingdom, where the new government has laid out a strong consolidation agenda. France, too, has announced measures to significantly reduce the deficit over the next three years. Also, Italy has approved a fiscal

Table 3. Advanced European Countries: Main Macroeconomic Indicators, 2007–11
(Percent)

	Current Account Balance to GDP					General Government Overall Balance to GDP[2]				
	2007	2008	2009	2010	2011	2007	2008	2009	2010	2011
Europe[1]	**0.2**	**-0.4**	**0.3**	**0.7**	**0.8**	**0.2**	**-1.3**	**-6.2**	**-6.0**	**-4.8**
Advanced European economies[1]	0.6	-0.1	0.4	0.8	1.1	-0.3	-1.9	-6.3	-6.4	-5.0
European Union[1]	-0.4	-1.0	-0.3	-0.1	0.1	-0.8	-2.4	-6.7	-6.9	-5.5
Euro area	0.2	-1.7	-0.6	0.2	0.5	-0.6	-1.9	-6.3	-6.5	-5.1
Austria	3.5	3.3	2.3	2.3	2.4	-0.5	-0.5	-3.5	-4.8	-4.1
Belgium	1.6	-2.9	0.3	0.5	1.8	-0.2	-1.2	-5.9	-4.8	-5.1
Cyprus	-11.7	-17.5	-8.3	-7.9	-7.4	3.4	0.9	-6.1	-6.0	-5.6
Finland	4.3	3.1	1.3	1.4	1.6	5.2	4.2	-2.4	-3.4	-1.8
France	-1.0	-1.9	-1.9	-1.8	-1.8	-2.7	-3.3	-7.6	-8.0	-6.0
Germany	7.6	6.7	4.9	6.1	5.8	0.2	0.0	-3.1	-4.5	-3.7
Greece	-14.4	-14.6	-11.2	-10.8	-7.7	-3.7	-7.7	-13.6	-7.9	-7.3
Ireland	-5.3	-5.2	-3.0	-2.7	-1.1	0.1	-7.3	-14.6	-17.7	-11.2
Italy	-2.4	-3.4	-3.2	-2.9	-2.7	-1.5	-2.7	-5.2	-5.1	-4.3
Luxembourg	9.7	5.3	5.7	6.9	7.2	3.6	2.9	-0.7	-3.8	-3.1
Malta	-6.2	-5.6	-6.1	-5.4	-5.3	-2.1	-4.4	-3.8	-3.8	-3.6
Netherlands	8.6	4.8	5.4	5.7	6.8	0.3	0.4	-5.0	-6.0	-5.1
Portugal	-9.0	-11.6	-10.0	-10.0	-9.2	-2.8	-2.8	-9.3	-7.3	-5.2
Slovak Republic	-5.3	-6.6	-3.2	-1.4	-2.6	-1.9	-2.3	-6.8	-8.0	-4.7
Slovenia	-4.8	-6.7	-1.5	-0.7	-0.7	0.3	-0.3	-5.6	-5.7	-4.3
Spain	-10.0	-9.7	-5.5	-5.2	-4.8	1.9	-4.1	-11.2	-9.3	-6.9
Other EU advanced economies										
Czech Republic	-3.3	-0.6	-1.1	-1.2	-0.6	-0.7	-2.7	-5.9	-5.4	-5.6
Denmark	1.6	1.9	4.2	3.4	3.0	4.6	3.4	-2.8	-4.6	-4.4
Sweden	8.4	7.6	7.2	5.9	5.7	3.7	2.4	-0.8	-2.2	-1.4
United Kingdom	-2.6	-1.6	-1.1	-2.2	-2.0	-2.7	-4.9	-10.3	-10.2	-8.1
Non-EU advanced economies										
Iceland	-16.3	-26.0	-6.5	-0.9	2.1	5.4	-0.5	-12.6	-9.2	-5.6
Israel	2.9	0.7	3.8	6.2	5.7	-0.2	-1.9	-5.4	-4.2	-3.3
Norway	14.1	17.9	13.1	16.6	16.4	17.7	19.3	9.9	11.1	11.3
Switzerland	9.0	2.0	8.5	9.6	10.3	2.1	0.7	1.4	-1.0	-0.9

Source: IMF, World Economic Outlook database.
[1] Weighted average. Government balance weighted by PPP GDP; current account balance by U.S. dollar-weighted GDP.
[2] Net lending only. Excludes policy lending.

Figure 11. Selected Advanced European Countries: Changes in General Government Fiscal Deficits, 2010–13
(Percentage points of GDP)



Source: IMF staff calculations.
¹ Greece, Ireland, Portugal, and Spain.
²2013 over 2010 adjustment - 0.5 percent; 2011 over 2010 adjustment - 0.3 percent.

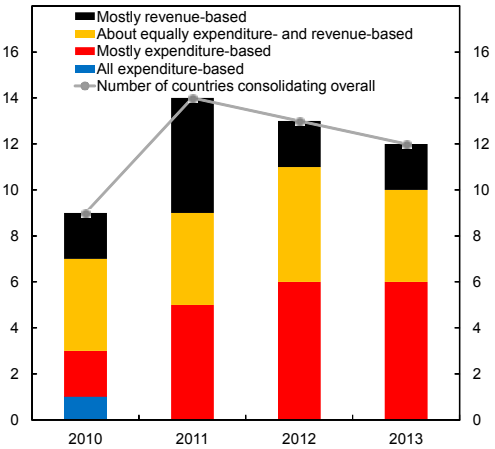
consolidation package, based on expenditure savings, aimed at reducing the fiscal deficit to below 3 percent by 2012. Appropriately, countries with better starting positions are approaching the task at a slower pace. Germany, for example, has let its deficit increase in 2010, but plans to bring the general government deficit under the Stability and Growth Pact (SGP) limit by 2013, at the latest. For the euro area as a whole, the fiscal stance is about neutral in 2010, turning mildly contractionary in 2011 (Table 3).

Although the overall fiscal path is broadly in line with the need to support the recovery, securing its credibility will require additional work. In some cases, the underlying macroeconomic assumptions will need to be changed. And in many countries the details behind the announced consolidation effort remain to be specified, allowing uncertainty about the actual size and nature of the adjustment to persist. Some countries—such as Greece, Portugal, and Spain, but also France, Germany, Italy, and the United Kingdom—have already elaborated their consolidation plans beyond next year; others have yet to start that process.

Designing fiscal consolidation to minimize the negative impact on growth and employment is just as imperative. Cutting government spending or increasing taxes to reduce a deficit will generally have a detrimental impact on aggregate demand and GDP growth in the short term. However, households and firms affected by these measures will adjust their demand and supply decisions to the government's actions, and, based on the precise composition of the fiscal consolidation package, this adjustment could mitigate the short-term impact on economic activity (Box 1). For example, a lasting reduction in public spending might convince households that future taxation will be lower and permanent net income higher, which can bolster private demand. Indeed, the historical record suggests that credible expenditure-based consolidations tend to be associated with lower GDP reduction and lower unemployment than tax-based consolidations, especially when investment spending cuts are avoided (IMF, 2010i, Chapter 3).

Compared with this benchmark, the expected structure of consolidation in the euro area and other European countries is broadly reassuring (Figure 12). The vast majority of euro area members' fiscal adjustment plans are based on either mostly expenditure cuts or a broadly balanced mix of expenditure and revenue cuts, and the picture for other advanced European economies is fairly similar. That said, to maximize long-term fiscal sustainability gains and minimize any short-term impact on growth, adjustments should generally

Figure 12. Euro Area: Structure of Expected Fiscal Consolidation, 2010–13
(Number of countries consolidating)



Source: IMF staff calculations.

Box 1. Fiscal Consolidation: Minimizing Side Effects

Public debts and deficits in most advanced economies are unsustainable. Large adjustments are needed to preserve, and in some cases restore, confidence in the ability of governments to face current and future obligations, including the payment of pensions and the guarantee of acceptable health care for all.

Does the situation imply a need for shock therapy? Or could softer treatments work? And is there a way to minimize side effects? The debate on this issue is ongoing, but two salient truths have emerged. First, denying the need to adjust or unduly delaying adjustment are not viable options, despite the difficult choices that lie ahead. Second, the economic literature, regardless of the methodologies used, suggests that certain therapies entail less unpleasant short-term side effects than others.

By far the most feared side effect of fiscal retrenchment is that sharp cuts in government spending or tax increases would reduce aggregate demand to a point that could cause a relapse into recession. However, an ample literature has qualified the simple Keynesian version of the argument, suggesting the existence of feedback effects that depend on the phasing, composition and institutional underpinnings of the adjustment strategy. In principle, fiscal adjustment can have expansionary effects that work from both supply and demand sides.

On the supply side, lower transfers to households may encourage job search, thereby reducing labor costs and boosting employment. By contrast, labor tax hikes would have the opposite effect, and cuts in public investment could dampen private investment (if private output depends in part on public capital). This illustrates very clearly the importance of the composition of the adjustment, pointing to the likely superiority of selected spending cuts over tax increases. That said, if the scale of the adjustment requires revenue measures in addition to spending cuts—as is likely to be the case in a number of countries—increases in indirect taxes should generally be preferred, especially in an environment where tax rates are at already high levels, firms have little or no pricing power, and where monetary policy is likely to remain expansionary or neutral for some time.

On the demand side, adjustments may have positive effects on private expenditure if agents believed that a no-adjustment scenario would lead to catastrophic outcomes and much more damaging consolidations in the future (Blanchard, 1990). Compared with a scenario of no or late adjustment, this would lead to lower precautionary savings, lower interest rates, and a lower probability of negative shocks to wealth. This would ultimately lead to higher consumption and investment. As a consequence, early adjustments are likely to be less painful in terms of foregone demand than textbook linear multipliers may suggest.

The extent to which policymakers succeed in devising adjustment strategies that minimize the side effects of fiscal consolidation is largely an empirical question. There is considerable empirical evidence that large and persistent changes in fiscal policy are indeed associated with strong offsetting forces, to the point of making fiscal contractions expansionary (see Giavazzi, Japelli, and Pagano, 2000, for a comprehensive cross-country analysis). Composition appears to matter a great deal, with expenditure-based adjustment being more likely to trigger only a small negative or even a positive response of output (Alesina and Ardagna, 2009; and Giudice, Turrini, and in't Veld, 2007). More recent evidence using real-time data on policy actions strikes a note of caution on the strength of non-Keynesian effects, suggesting that most consolidations lead to some output loss (IMF, 2010b). But the study also confirms that expenditure-based adjustments—especially those relying on transfers—are likely to hurt the economy less than revenue-based adjustments. The same applies to countries under market pressure, pointing to the important role of particularly adverse counterfactuals in the absence of adjustment.

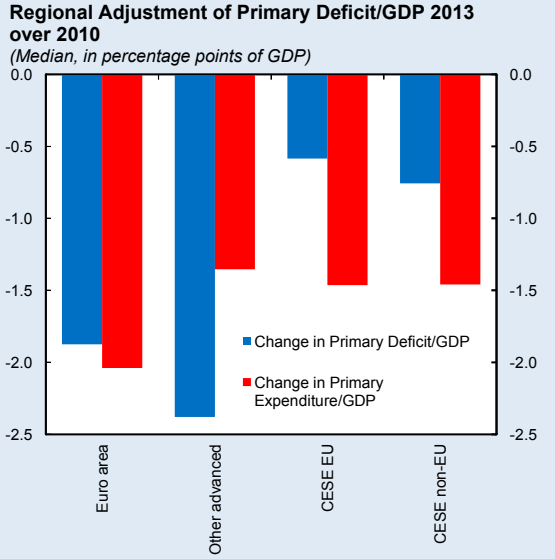
…continued

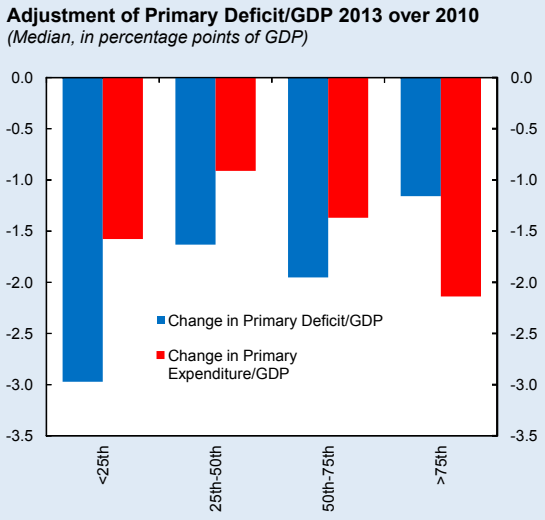
Note: The main author of this box is Xavier Debrun.

Box 1. *(concluded)*

How do fiscal adjustment plans in Europe fare compared with these broad criteria? In current circumstances, theory and empirical evidence suggest that adjustments should be (i) phased in (except when credibility has been lost as evidenced by market pressure), and (ii) expenditure based. Surveying current plans, the adjustment looks broadly appropriate (see figures below). First, the size and degree of front-loading of the proposed adjustment clearly reflect the magnitude of the initial problem (Ireland, the United Kingdom) and the extent of market pressures (Ireland, Portugal, Spain). Second, expenditure plays a considerable role in the planned retrenchment, especially in countries under strong market pressure. That said, the credibility of the adjustment plans could be improved. Although a number of countries have already backed their adjustment plans by clearly identifying or already adopting measures beyond the very short term, others have yet to do so, leaving room for uncertainty about the actual size and nature of the adjustment.

Overall, fiscal consolidations currently planned or implemented in Europe are mostly in line with a few key features that the economic literature tends to associate with successful and growth-friendly fiscal adjustments.





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

avoid reducing investment, including in education, and focus instead on distortive subsidies and better targeting social transfers. Entitlement reforms such as increasing the effective retirement age along the lines of France's recently announced plans will not only deliver cost savings but also support aggregate demand by increasing lifetime income and consumption.

Steps to Complete the European House

The financial crisis and sovereign debt troubles have revealed a number of gaps in the governing framework supporting financial markets—in the EU and the euro area. As envisaged by the EU's architects, building the "European House" was to be a work in progress, with some parts to be completed faster than others. However, while the development of the single goods market built upon an appropriate structure of intensifying coordination and gradual centralization of competition policies, financial integration outpaced the development of a common financial stability framework.

Moreover, it has become clear that the institutional safeguards put in place to support the functioning of the common currency in the areas of

fiscal and structural policy have been less than complete. The SGP, lacking both effective surveillance and enforcement, largely failed to deliver the kind of "good-times" fiscal discipline that would have lowered debt levels and secured fiscal space for when it was needed. Efforts to accelerate and coordinate structural reforms in labor, service, and product markets under the Lisbon agenda also fell short, so there was little improvement in the euro area's ability to deal with intra-area imbalances in the absence of nominal exchange rate flexibility.

Policymakers have scrambled to make the most of the opportunity posed by the crisis to fill these gaps—but the momentum has differed across policy areas. The completion of the financial stability framework is clearly farthest advanced (Box 2). In contrast, the discussion on how to improve fiscal governance is ongoing and the least tangible progress is visible in the area of structural policies. There is widespread consensus, however, among policymakers and observers alike, that it will take a wholehearted effort along all three dimensions to sustain confidence in the recovery and the long-term success of European integration.

Completing the Push for European Supervision and Macroprudential Policies

In the most visible sign of progress along these lines, the forthcoming establishment of European Supervisory Authorities (ESAs) will bring long-desired tighter coordination of financial supervision within the EU and euro area. As the crisis amply demonstrated, financial risks travel quickly across European borders and markets, and the desire of national authorities to act alone can add to the uncertainty and confusion of financial markets in times of turbulence. While shortcomings in the financial stability framework remain—in particular in the area of crisis resolution—the new institutional arrangements constitute significant progress by providing a European platform for cross-border information sharing, rulemaking and implementation, and supervision.

The European Systemic Risk Board (ESRB), also set to be established in 2011, is another important step in that direction. The ESRB should provide essential coordination in crisis prevention across countries and markets, including by guiding preventive macroprudential policies to prevent the buildup of liquidity and credit risks. Given that the ESRB will operate with limited resources and without own policy tools, a key to its success will be access to information and effective interaction with other European and national policymakers. Given their joint European mandate, the ESRB will also profit from a strong coordinating role of the ESAs.

Strengthening Fiscal Governance

Fiscal governance reform is coming into focus amidst extensive discussion.[1] The van Rompuy task force on economic governance installed by the European Council,[2] the European Commission, and the ECB all have supported the necessary strengthening and widening of financial and nonfinancial sanctions to ensure compliance not only with the Excessive Deficit Procedure (EDP), but also with the requirements under the preventive arm of the SGP. More effective enforcement is crucial and should go along with sound economic judgment in the application of rules. An excellent example is the proposed extension of the EDP's focus beyond formal compliance with the deficit ceiling on troublesome debt dynamics. There is also the notion of introducing or bolstering national fiscal rules conforming to EU targets as recently in Germany and under consideration in France and elsewhere. Finally, there is the welcome suggestion to equip the euro area with permanent crisis management capabilities, with current proposals leaning toward transforming the EFSF into a permanent scheme. But while the ECB has called for a "quantum leap" in reforms, the Commission and the task force prefer somewhat less ambitious

[1] IMF, 2010b (Chapter 2) provides further details.
[2] The European Council comprises the heads of government and state, along with its President and the President of the European Commission.

Box 2. Toward a More Integrated Financial Stability Framework for the EU

The EU's new financial stability framework is taking shape. In recent months, final agreement has been reached on a more integrated supervisory framework, and the Commission has announced plans for greater harmonization and cooperation in the areas of crisis management and resolution, as well as deposit insurance. These are important steps toward the integrated financial stability framework that the EU's single financial market needs.

The New Supervisory and Regulatory Framework

The EU's new supranational supervisory and regulatory framework will formally be established on January 1, 2011. It comprises macroprudential and microprudential institutions, brought together in a European System of Financial Supervisors (ESFS), and new rule-making procedures. It offers the opportunity for a fundamental shift toward dealing with risks to financial stability at the EU level.

Macroprudential Supervision

The ESFS's macroprudential body is the European Systemic Risk Board (ESRB), which will be closely linked organizationally to the European Central Bank (ECB). The ESRB will not have binding powers but it will have a broad mandate to issue risk warnings and recommendations to European or national authorities. Follow-up will be sought through an "act or explain" rule and through the Economic and Financial Affairs Council (ECOFIN). The latter and the microprudential authorities will likely be the ESRB's main counterparts.

The modus operandi of the ESRB still remains to be clarified. Ideally, its agenda should cover at least three broad areas of risk, namely those related to (i) the largest and most interconnected financial institutions; (ii) financial imbalances, such as credit-fueled asset bubbles, at the aggregate level and for particular countries or sectors; and (iii) changes in the structure and technology of the financial system.

Microprudential Supervision

The microprudential arm of the ESFS comprises the existing national supervisors, three new sectoral European Supervisory Authorities (ESAs), and a cross-sectoral Joint Committee.[1] The ESAs will be charged with harmonizing supervisory practices, and will have binding powers to mediate and settle disputes between supervisors. Cross-border groups will be supervised by standardized colleges of national supervisors in which the ESAs will have an enabling role. Compared with the Level 3 committees under the Lamfalussy structure that they will replace, the ESAs will have increased resources, greater powers, and improved governance systems. Key challenges they will face include making judicious use of their binding powers, establishing a workable balance between these powers and the scope of the fiscal safeguard clause,[2] achieving effective and harmonized oversight of cross-border groups through the colleges, building a systemwide *esprit de corps*, and ensuring that information flows freely within the system to all who are entitled to it. In this regard, a general review of the appropriate level of confidentiality of prudential data is warranted, given how a perceived lack of transparency has exacerbated the crisis in Europe.

Note: The main author of this box is Wim Fonteyne.
[1] The three ESAs are the European Banking Authority (EBA), the European Securities and Markets Authority (ESMA), and the European Insurance and Occupational Pensions Authority (EIOPA).
[2] The fiscal safeguard clause states that the ESAs should make sure that their decisions do not impinge in any way on the fiscal responsibilities of Member States. The scope of this clause will likely be established by precedent, through Council decisions in particular cases.

Rule Making

The ESAs are expected to work toward establishing a single rulebook for the financial sector. To do so, they will be able to establish technical regulatory and implementing standards that will be given force of law by the Commission and that will be directly applicable in the member states. The work of the ESAs is expected to be complemented by efforts, led by the Commission, to achieve greater harmonization in existing and future legislation. This legislative work will be essential for the emergence of a true single rulebook, including because it will determine the extent to which the ESAs can establish technical standards. As in the past, many key elements of the rulebook will be based on international standards. Notably, "Basel 3" is expected to constitute the basis for the EU's regulatory reforms in the banking sector.

Crisis Management and Resolution

Progress in crisis management and resolution is slower and more complex than on the supervisory front. The Commission's approaches amount mainly to harmonizing and improving national systems, and leaving the question of integrated frameworks to be revisited in 2014 along with the planned review of the supervisory arrangements. However, the European Parliament is insisting on quicker and more substantial progress.

As outlined in a May 26 position paper,[3] the Commission intends to seek the EU-wide introduction of harmonized early intervention tools, bank resolution regimes, national resolution funds, and deposit guarantee schemes. Harmonization would strengthen national regimes and improve their interoperability, but additional work toward a separate EU-wide regime for cross-border financial institutions is also urgent. Meanwhile, the European Parliament on July 7, 2010, adopted a resolution requesting the Commission to come up with a legislative proposal for an integrated framework by end-2010.[4]

IMF staff has argued for a European Resolution Authority (ERA) that is armed with the mandate and the tools to deal cost effectively with failing cross-border banks. This ERA should be supported by an industry-financed European Deposit Insurance and Resolution Fund (EDIRF) and a fiscal backstop. Given the fundamental reforms that would be needed to establish such a system, it is important that preparatory work start without delay and that the main parameters of the long-term system be established as early as possible.

Deposit Insurance

On July 12, 2010, the Commission adopted a legislative proposal on deposit guarantee schemes (DGS).[5] The basic thrusts of the proposal are harmonization of systems and coverage (at €100,000); standardized funding relying primarily on ex ante, risk-based contributions by banks; a mutual lending duty between systems; and an oversight role for the EBA. The Commission deferred making a decision on a pan-European scheme and wants to keep deposit insurance and resolution funds separate. It envisages DGS paying up to the level of the insured deposits in resolution cases. DGS would also be obliged to lend to each other when liquidity needs arise and have back-up liquidity arrangements in place. However, the draft directive does not have provisions for back-up solvency support and leaves the question of government responsibility for shortfalls open.

[3] Available at http://ec.europa.eu/internal_market/bank/docs/crisis-management/funds/com2010_254_en.pdf

[4] Available at http://www.europarl.europa.eu/sides/getDoc.do?type=REPORT&reference=A7-2010-0213&language=EN&mode=XML

[5] Available at http://ec.europa.eu/internal_market/bank/docs/gurantee/comm._pdf_com_2010_0368_proposition_de_directive_en.pdf

approaches that could be implemented more quickly and securely within the existing EU treaty.

Either way, the reform of the fiscal framework will need to entail a shift of policy authority to the center. A stronger center would make surveillance more effective, which could help to detect problems early and align policies in a key area of common concern. The planned introduction of a "European semester" in 2011 is a useful step in that direction. This proposal includes intensified monitoring of medium-term budgetary strategies and policy advice from the Council and European Council (anchored by a Commission report) to national governments timed to influence the budgets for the following year. A stronger center could also help the enforcement of EDP and SGP rules. Here the Commission, as guardian of Europe's treaties, could play a larger role in guiding the process, to provide a better balance with individual national interests, toward the more effective implementation of common fiscal rules. A larger role for the center could be supported by a larger central budget which would aim to provide, among other things, insurance against asymmetric country shocks through larger transfers and additional incentives for favorable economic and structural policies by giving strong performers enhanced access to EU funds. The resources for a larger central budget could come from higher VAT taxes, with the proceeds going to the center, or possibly from a tax on carbon emissions.

A Framework and Policies for Sustained and Balanced Growth

Accelerating structural reform policies and effectively coordinating them is clearly the greatest governance challenge facing EU and euro area policymakers. Some countries have moved ahead in the wake of the crisis. For example, Greece has recently passed substantive labor market reforms and is set to liberalize professional services and to lift regulatory barriers in tourism and retail, and Spain has taken important steps to improve the flexibility of its labor market.[3] However, the overall track record is meager at best.[4] The euro area's collective commitment to structural reforms under the Lisbon agenda, relying on soft coordination and peer review, has produced disappointing results, in particular in the labor markets. As a result, potential growth remains too low in most countries and large differences in structural competitiveness persist, leading to differences in growth and unbalanced trade. Any strategy devised to finally overcome these problems will not only have to identify the most promising areas for reform, it will also have to address the governance problems that so far have stood in the way of implementing them.

Most EU and euro area countries could improve their structural characteristics along a number of dimensions compared with the U.S. benchmark (Figure 13), but comprehensive measures to improve market flexibility promise the most significant gains. For example, abolishing the privileges of protected professions in the services sector or remaining rigidities in product markets will have a stronger impact on employment when they are met by a flexible labor supply supported by adequate but not excessive employment protection (Figure 14).[5] Portugal and (pre-reform) Greece and Spain remain among those with the highest potential to grow employment in this regard, reflecting their still fairly segmented and inflexible labor markets and limitations in the business environment (Box 3). But similar reforms could also profit a country such as Germany, where the service sector remains

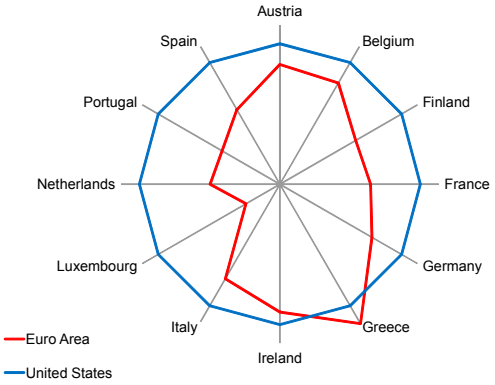
[3] Among other things, Greece has reduced severance costs for white-collar workers and increased considerably the threshold for activating rules for collective dismissals. See Jaumotte (forthcoming) for a discussion of Spain.

[4] See, among others, European Commission (2008) and IMF (2010b, Chapter 3).

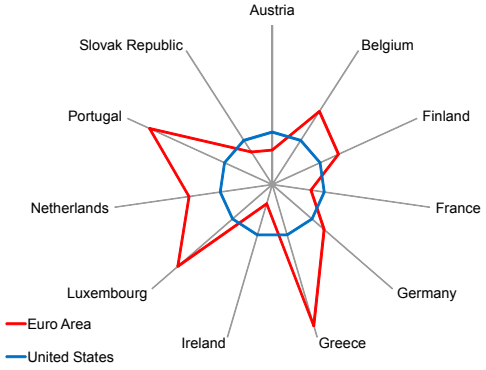
[5] This is easily illustrated in Figure 14: for any country or starting combination of labor and product market flexibility, a simultaneous reform (moving straight north-east) will increase employment growth faster—that is, reach the next higher level of employment growth faster—than a partial reform (moving either east or north). Note that the indicators shown in the figure are the latest available and do not incorporate the most recent or planned regulatory reforms.

Figure 13. Selected Countries: Structural Indicators

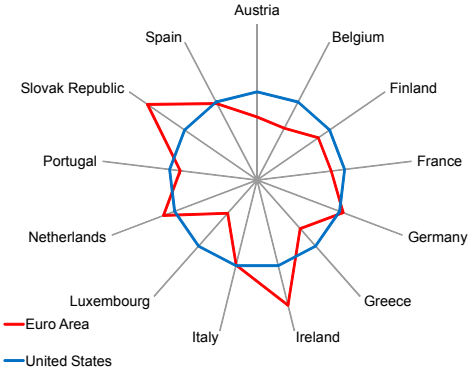
Net Income Replacement Rate for Unemployment Benefits After One Year
(Higher toward the center)



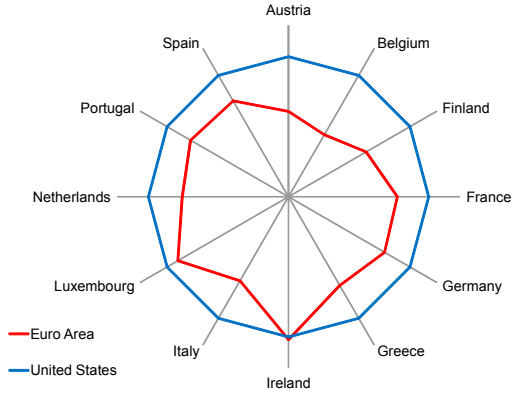
Implicit Tax Rate on Returning to Work for a Second Earner
(Percent of gross earnings, 67 percent of average wage)
(Higher toward the center)



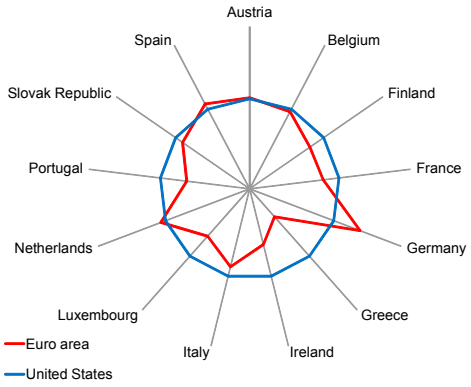
Regulatory Conditions in the Retail Sector
(More regulated toward the center)



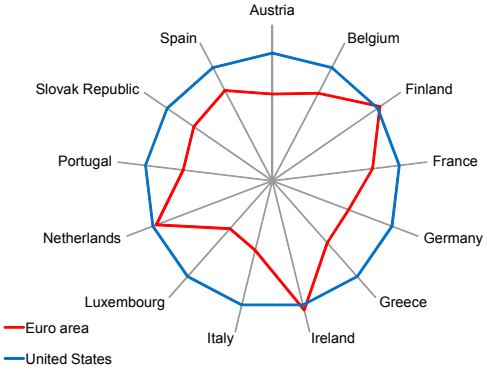
Marginal Tax Wedge
(Principal earner of family of 4)
(Higher toward the center)



Regulatory Conditions in Nonmanufacturing Industries[1]
(More regulated toward the center)



Regulatory Conditions in Professional Services
(More regulated toward the center)



Source: Organization for Economic Co-operation and Development (OECD).
Note: Indicators are latest available.
[1] Airlines, telecoms, electricity, gas, post, rail, and road freight.

relatively small, being stifled by restrictions, high wage costs, and labor taxes.

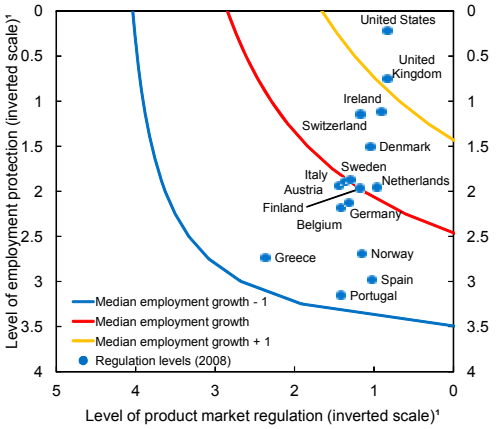
The rewards of comprehensive reforms can be large: IMF (2010c) simulations suggest that the growth impact could be as high as ½ percentage point per year for the euro area over the 2011–15 period—no small number.

In addition to bolstering growth, more flexible markets could also help to reduce intra-euro area trade imbalances. The introduction of the common currency has shifted much of the burden of adjustment to trade shocks from the exchange rate to product and labor markets. Although market prices do react to changes in nonprice competitiveness, these adjustments can take a very long time. And indeed, there is evidence that bilateral trade imbalances (that is, the absolute size of deficits or surpluses) within the euro area have increased and become more persistent since the late 1990s, reaching levels last seen during the Bretton Woods period (Figure 15).

But policymakers are not without choices. Imbalances tend to be smaller and less permanent among euro area countries characterized by more flexible labor and product markets, and countries with higher relative market flexibility often have lower trade deficits (Berger and Nitsch, forthcoming) (Figures 16A and 16B). Making labor markets more flexible, supported by complementary reforms such as improved portability of pensions and active labor market policies, could also serve to enhance labor mobility between countries, which will further ease the adjustment to shocks (Wasmer and Janiak, 2008).

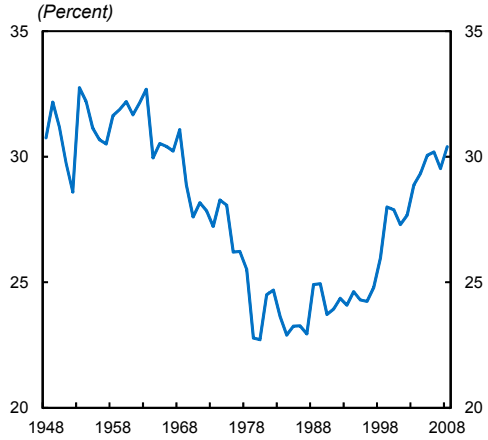
Reforms will be most effective when coordinated across countries. Labor market reforms currently remain the prerogative of national governments. By contrast, many facets of product and service markets regulation are determined jointly at the EU level. Regional coordination could help the implementation of comprehensive reforms across markets.

Figure 14. Selected Countries: Product and Labor Regulation and Employment Growth Simulations
(Indices of regulation; employment growth in percent)



Sources: OECD; Berger and Danninger (2007); and IMF staff calculations.
Note: Lines connect different combinations of product and labor market regulation that generate the same level of employment growth based on an empirical model that also controls for various other factors, including fixed effects. The implied employment growth differences between countries are based on differences in product and labor market regulation alone. Country observation notes current regulatory levels.
¹ Index ranges from 0 (lowest) to 6 (highest level of regulation).

Figure 15. Trade Imbalance as Fraction of Total Bilateral Trade, 1948–2008
(Percent)



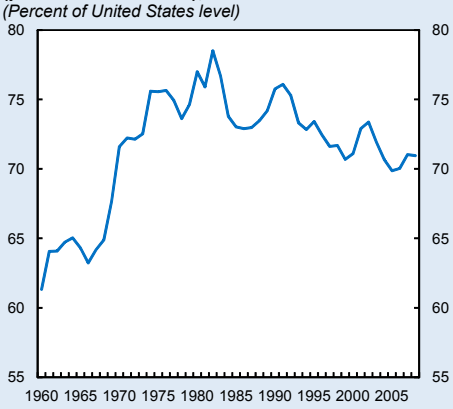
Sources: Berger and Nitsch (forthcoming); and IMF staff calculations.

Coordination is also key when it comes to ensuring the proper mix of structural and macroeconomic policies in the euro area. Structural policies that succeed in reducing differences in economic and—in particular—inflationary developments within the euro area will make the ECB's monetary policy a better fit for all member countries (Figure 17). And the ECB will be more inclined to keep interest rates low and accommodate

Box 3. Why Is Economic Growth Lagging in Europe and What Can Be Done About It?

Convergence of European GDP per capita toward U.S. levels stopped in the early 1980s, leaving a persistent level gap of close to 30 percent (figure at right). Convergence of output per capita levels was swift during the postwar period, driven by catch-up growth, technology assimilation, product standardization, trade liberalization, and economies of scale. However, the process of convergence slowed markedly and even reversed somewhat after the 1970s.

Euro Area's per Capita GDP Level (percent of U.S. level), 1960–2008
(Percent of United States level)

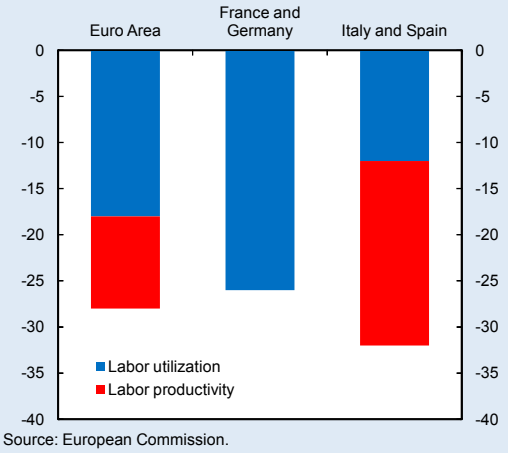


Source: AMECO database; European Commission; and IMF staff calculations.

Lower per capita income in the euro area reflects, to different degrees, lower labor utilization and to a lesser extent lower hourly productivity. The reason for the shortfall in GDP per capita vis-à-vis the United States differs markedly across the euro area (second figure). For Germany and France, and some smaller euro area countries, the shortfall is mostly due to lower labor market utilization. Hourly productivity in these two countries is similar or even slightly higher than in the United States. For southern European countries, however, productivity is relatively worse than in the United States in addition to labor utilization being lower.

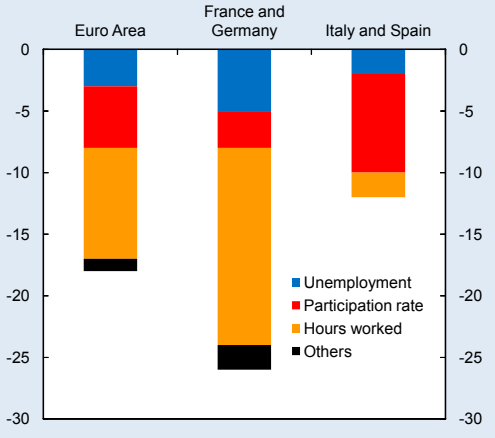
Although differences in hours worked could reflect preferences, reducing unemployment and raising labor participation would significantly reduce the income gap with the United States. Lower labor utilization not only reflects that people work fewer hours but also that unemployment is higher and participation weaker (and this is not necessarily by choice). As can be seen from the second figure, improving employment and labor market participation could close the GDP per capita gap with the United States by about 10 percentage points.

Differential in the GDP Per Capita, 2000–08
(Percentage points)



Source: European Commission.

Differential in Labor Utilization, 2000–08
(Percentage points)



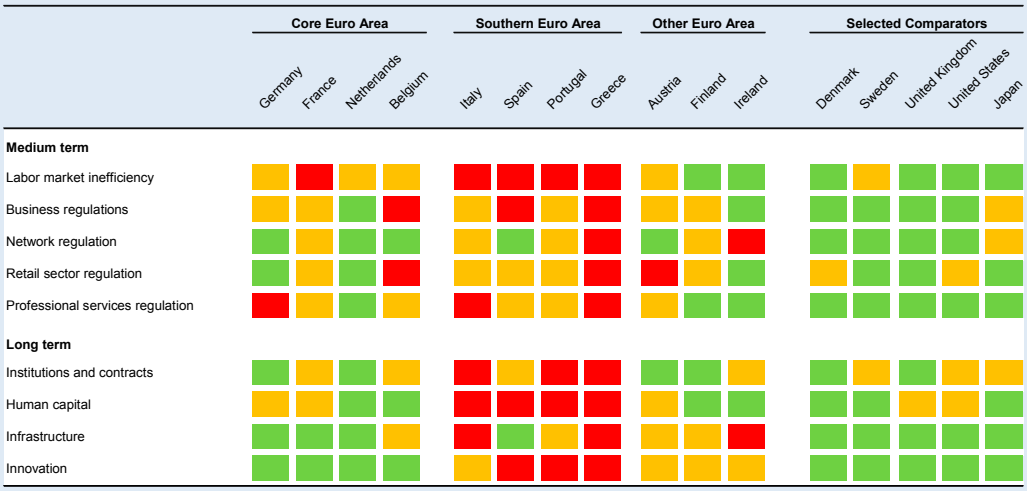
…continued

Note: The main author of this box is Boriana Yontcheva. See IMF (forthcoming) for details.

Box 3. *(concluded)*

Addressing the euro area's reform gaps would help to close the GDP gap (table). All but a few euro area countries exhibit severe labor market rigidities compared with their advanced economy peers, including the United States. Binding regulations for businesses and in the services sectors are also prevalent across the euro area while southern countries are lagging in terms of human capital, institutions and contracts, a result that is consistent with the productivity gap in the subregion underscored earlier. Moreover, once the core euro area countries achieve higher labor utilization and solve productivity issues, they will also need to deal with impediments to long-term growth and promote innovation.

Structural Reform Gaps in European Economies: A Heatmap



Sources: Fraser Institute; OECD; World Economic Forum; and IMF staff calculations.
Note: Indicators are latest available.

To live up to its growth potential and ensure viability of its social model, the euro area must provide more jobs, with higher productivity. Complementary labor and services sector reforms will boost investment and growth. Initially, demand-friendly measures should include increasing the incentives to hire by lowering the tax burden on labor, stimulating employment of vulnerable categories, and freeing up retail trade, network industries, and the professional services sector. A successful reform package would combine (i) a shift from labor to VAT taxes, (ii) a reduction in the level and duration of unemployment benefits and in early and old-age retirement schemes, and (iii) a reduction in entry barriers in network services (gas, electricity, telecoms), retail distribution, and professional services. In addition, fixing the financial system will be essential to avoid a credit crunch that would stifle economic recovery. For the longer term, focus should be on innovation and education, as well as on continuing financial sector reforms.

Figure 16A. Euro Area: Bilateral Trade Deficits and Regulatory Differences in Employment Protection, 2003

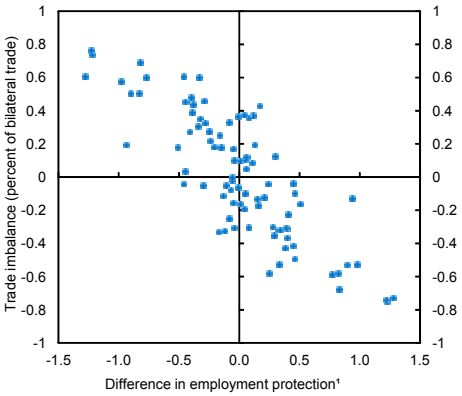
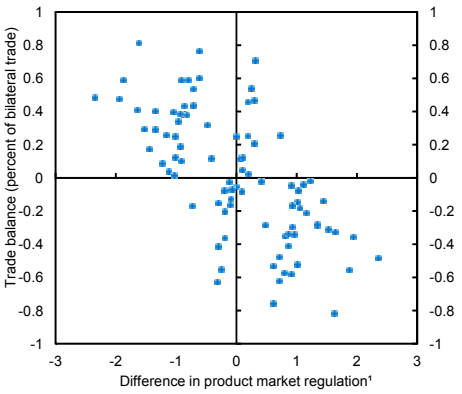
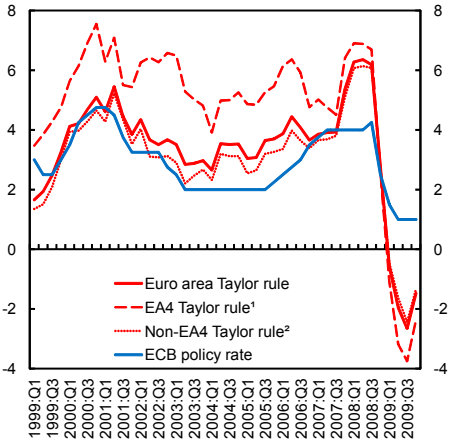


Figure 16B. Euro Area: Bilateral Trade Deficits and Regulatory Differences in Product Market Regulation, 2005



Sources: OECD; and Berger and Nitsch (forthcoming).
¹ Difference between OECD indices of trading partners. Indices range from 0 (lowest) to 6 (highest level of regulation).

Figure 17. Selected Euro Area Countries: Taylor Rule Implied Rates and Actual Policy Rate, 1999:Q1–2009:Q4
(Percent)



Sources: IMF, World Economic Outlook database; and IMF staff calculations.
Note: Taylor rule implied rates use the same rule coefficients but different (weighted) rates of inflation and output gaps.
¹ Greece, Ireland, Portugal, and Spain.
² Other euro area countries except Cyprus, Malta, and the Slovak Republic.

investment if comprehensive structural reforms take place everywhere in the euro area, promising higher aggregate productivity and lower inflation overall.[6] And higher growth resulting from a well-coordinated reform effort will facilitate fiscal consolidation across the region. This strengthens the case for integrating fiscal and structural policy making at the EU level.

Realizing these gains will require a well-functioning structural governance framework. Taking a cue from the failure of the Lisbon agenda, any such framework should give a larger role to central EU institutions, provide for more effective surveillance, and include stronger reform incentives for national governments than in the past. Among the approaches floated by the European Commission, Council, and ECB, which all broadly follow these guidelines, is the proposal for an alarm system based on the timely surveillance of macroeconomic and competitiveness indicators. This alarm system would trigger the issuance of country-specific policy recommendations by the Commission and be backed by the EU budget. Under such a system, EU funds could perhaps be withheld from offenders or redirected to support structural reform efforts. Moreover, more explicitly integrating structural with fiscal surveillance in terms of timing (both should take place during the "European semester") and calibration (SGP and EDP already allow taking into account the costs of structural reforms) would boost visibility and generate better outcomes overall.

Finally, similar to the area of fiscal policy, closing the structural governance gap will require governments to internalize the structural reform agenda at the national level. This should include the development of sufficiently ambitious and country-specific reform agendas. There should also be a public commitment to see them through, perhaps

[6] See, among others, Estevaõ (2005), Berger and Danninger (2007), and Everaert and Schule (2008) for a discussion of reform coordination.

underlined by the establishment of independent commissions to monitor progress.

Completing the European House may not be easy, but it must and can be done. The two years that have elapsed since the collapse of Lehman Brothers have not only shown just how essential the improvement of governance will be for the long-term success of European economic and monetary integration, but have also demonstrated that policymakers can act boldly when necessary. And now is the time to apply the same energy and determination to complete the EU's and the euro area's governance system. This will take a very determined effort. The political economy of the necessary reforms is complicated, with privileged households and firms pondering the consequences of coordinated structural reforms, national parliaments ambivalent about more intrusive fiscal surveillance at the EU level, and governments wary of a more assertive role for the European Commission. But closing the remaining governance gaps promises large benefits for the EU and beyond. With the memory of the crisis still fresh, policymakers should seize the moment and act boldly.

2. Emerging Europe: Toward Self-Sustained Growth

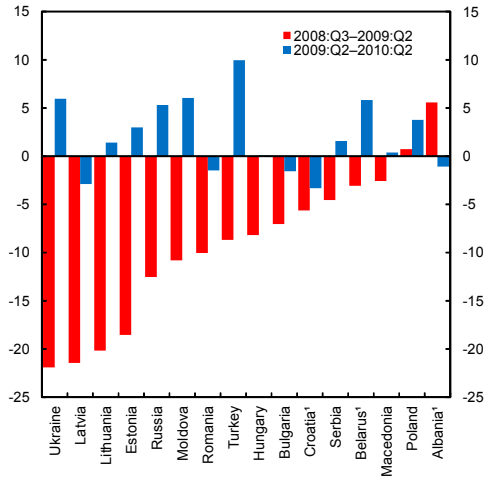
Emerging Europe (EE)[7] is recovering from its deepest recession in the post-transition period. GDP in the region is likely to grow by 3.9 percent in 2010 and 3.8 percent in 2011—a marked difference from the 6 percent contraction in 2009. The recovery is export-led, while domestic demand remains subdued, particularly in countries where the deflation of precrisis asset and credit booms has been most severe. Policymakers in emerging Europe face the difficult challenge of dealing with the legacies of the crisis, while not hurting the recovery. Fiscal consolidation is needed to bring down fiscal deficits, which rose sharply during the crisis, and remain high in 2010. To a large extent, these deficits are structural: although headline deficits were low in most countries before the crisis, a temporary boom in revenues masked the underlying deterioration that resulted from rapid expenditure growth. Beyond the short term, the region will need to find new growth engines, as the capital flows-driven domestic demand boom needs to give way to more balanced growth. In sum, the region faces difficult adjustments in the short term, but the adjustments will help set the stage for a more durable catch-up with advanced Europe.

Outlook for 2010 and 2011

The Region Is Recovering . . .

Year-on-year real GDP growth for the region turned positive in the first quarter of 2010, for the first time since the third quarter of 2008, and strengthened further in the second quarter of 2010.[8] The recovery was led by the European CIS countries,[9] Turkey, and central European countries, while real GDP in southeastern Europe and Latvia continued to fall (Figure 18). However, real GDP levels remained far below the precrisis levels in all countries, except for Albania, Belarus, Poland, and Turkey (Figure 19).

Figure 18. Emerging Europe: Real GDP Growth
(Seasonally adjusted annualized rate, in percent)



Sources: Eurostat; Haver Analytics; and IMF staff calculations.
[1]Data refer to 2009:Q2–2010:Q1.

. . . On the Back of Higher Exports . . .

So far, the recovery has been based mostly on a rebound in exports, with the exception of Turkey (Figure 20).[10] Exports had fallen very sharply in the fourth quarter of 2008 and the first quarter of 2009.

Note: The main authors of this chapter are Christoph Duenwald, Srobona Mitra, and Ivanna Vladkova-Hollar.

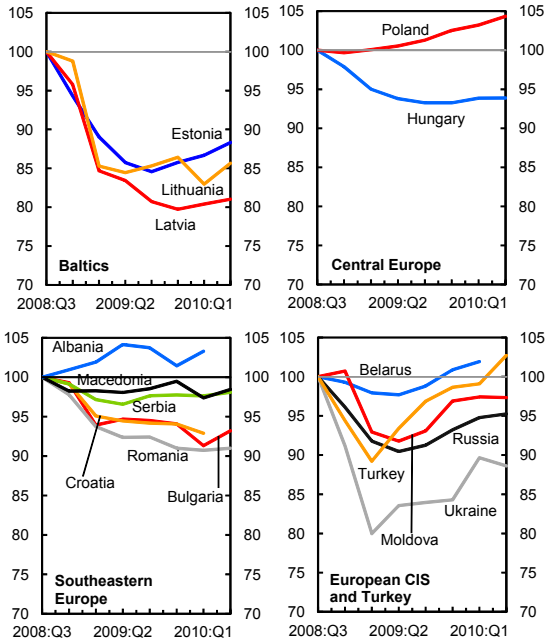
[7] Emerging Europe refers to the following countries: Albania, Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, Estonia, Hungary, Kosovo, Latvia, Lithuania, FYR Macedonia, Moldova, Montenegro, Poland, Romania, Russia, Serbia, Turkey, and Ukraine.

[8] Quarter-on-quarter GDP growth had first turned positive in the second quarter of 2009, and has remained positive since.

[9] The European CIS countries comprise Belarus, Moldova, Russia, and Ukraine.

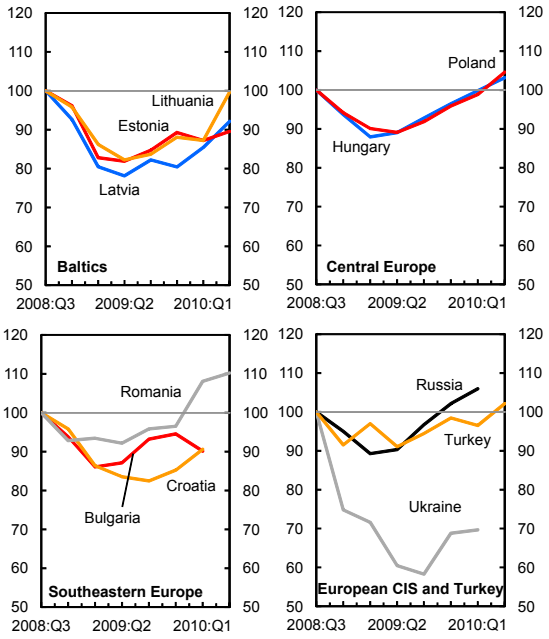
[10] For most EE countries, exports remain overwhelmingly tied to demand conditions within Europe. Exports to the euro area account for some 50 percent, on average, of total EE exports, and intraregional trade accounts for a further one-third of total exports. Trade shares with Asia are low, even accounting for indirect linkages, although demand from Asia appears to be playing an important role in the recovery of exports during this particular upswing (Box 4).

Figure 19. Emerging Europe: Real GDP, 2008:Q3–2010:Q2
(Seasonally adjusted, index 2008:Q3 = 100)



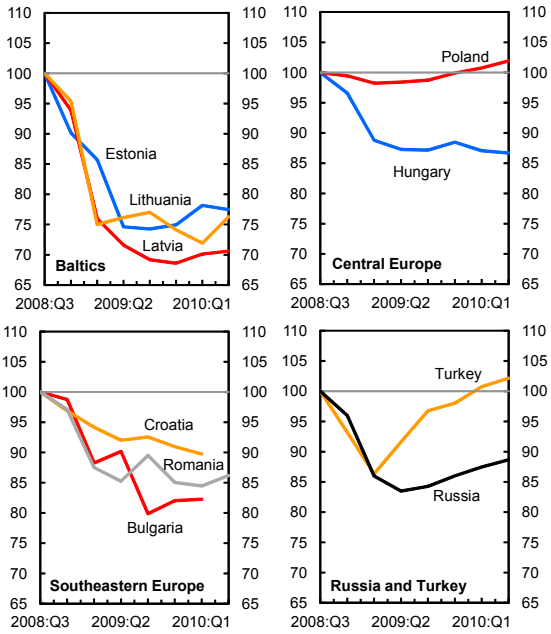
Sources: Eurostat; Haver Analytics; and IMF staff calculations.

Figure 20. Emerging Europe: Real Exports, 2008:Q3–2010:Q2
(Seasonally adjusted, index 2008:Q3 = 100)



Sources: Eurostat; Haver Analytics; and IMF staff calculations.

Figure 21. Emerging Europe: Real Domestic Demand, 2008:Q3–2010:Q2
(Seasonally adjusted, index 2008:Q3 = 100)



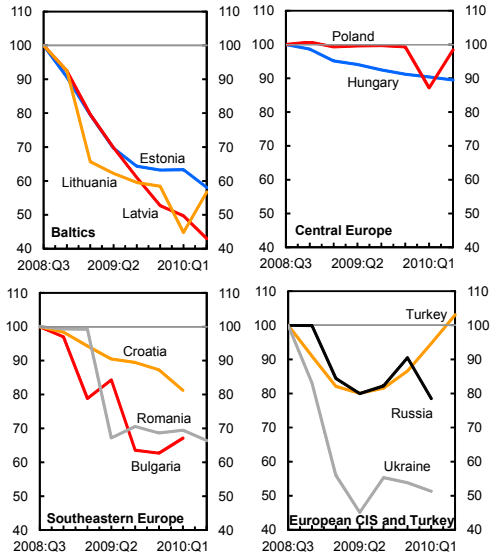
Sources: Eurostat; Haver Analytics; and IMF staff calculations.

Starting in the second half of 2009, trade volumes started to rebound, boosted by a recovery in output growth in both the advanced and emerging economies and a rebound in demand for trade-intensive capital and durable goods. Nominal export growth for some countries has been further boosted by the rise in oil and nonfuel commodity prices, which resulted in strong terms-of-trade improvements in the region's commodity exporters—primarily Russia and Ukraine.

. . . Rather than Domestic Demand

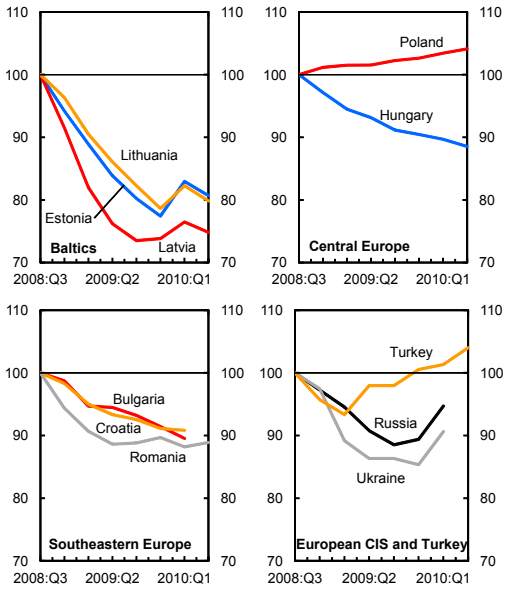
Domestic demand growth, however, has remained weak in most countries. Domestic demand continues to fall in Croatia, Estonia, and Hungary, and, following only a mild recovery in the last few quarters, remains some 20–30 percent below precrisis levels in the Baltics and Bulgaria (Figure 21). Only in Poland and Turkey has domestic demand recovered to precrisis levels. Fixed investment is particularly weak in most countries in the region, although there was an uptick (quarter-on-quarter basis) in the second quarter in Lithuania and Poland, and a continuing rebound in Turkey

Figure 22. Emerging Europe: Real Investment, 2008:Q3–2010:Q2[1]
(Seasonally adjusted, index 2008:Q3 = 100)



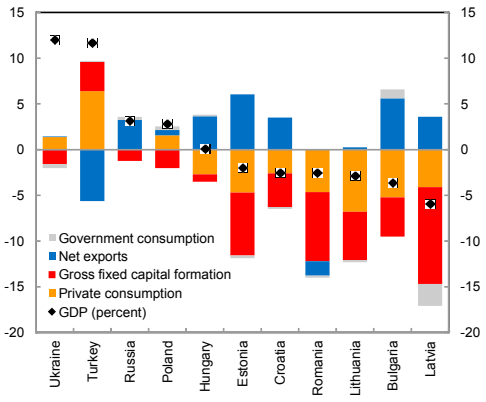
Sources: Eurostat; Haver Analytics; and IMF staff calculations.
[1]Real investment is private and public excluding inventories.

Figure 23. Emerging Europe: Real Private Consumption, 2008:Q1–2010:Q2
(Seasonally adjusted, index 2008:Q3 = 100)



Sources: Eurostat; Haver Analytics; and IMF staff calculations.

Figure 24. Emerging Europe: Contributions to Year-over-Year GDP Growth, 2010:Q1[1]
(Percentage points)



Sources: Eurostat; and Haver Analytics.
[1]Contributions from inventories and statistical discrepancy not shown.

(Figure 22). Private consumption shows signs of recovery in the first half of 2010 in a number of countries, but continued to decline on a quarter-on-quarter basis in the Baltics, Bulgaria, Croatia, and Hungary (Figures 23 and 24).

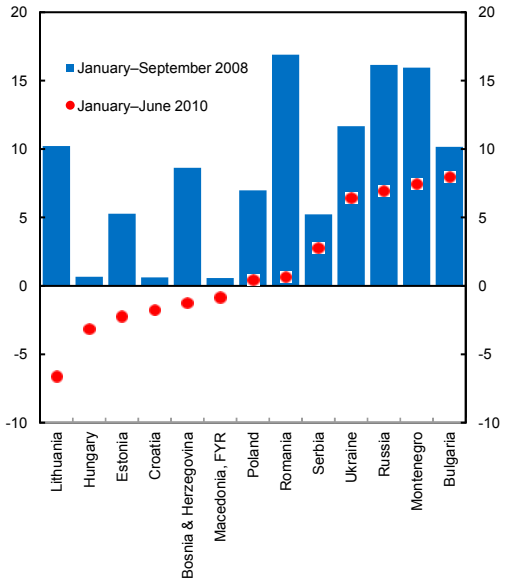
There are several reasons for the weakness in domestic demand:

- Net capital inflows remain weak in most countries, and private sector credit growth is subdued. Net foreign direct investment (FDI) inflows are well below precrisis levels, and other investment flows are negative in many countries, notably in Bulgaria, Estonia, and Lithuania, likely reflecting continued deleveraging by banks and corporations. Private sector credit growth remains subdued as high nonperforming loans (NPLs) and funding costs (especially from overseas sources) are likely constraining loan supply (see section on reviving credit growth, page 34).

- Investment is likely to have been held back by excess capacity, as output is still below precrisis levels in most countries. This may be the case particularly in the nontradable sector, where the precrisis boom has come to an end (see also Chapter 3).

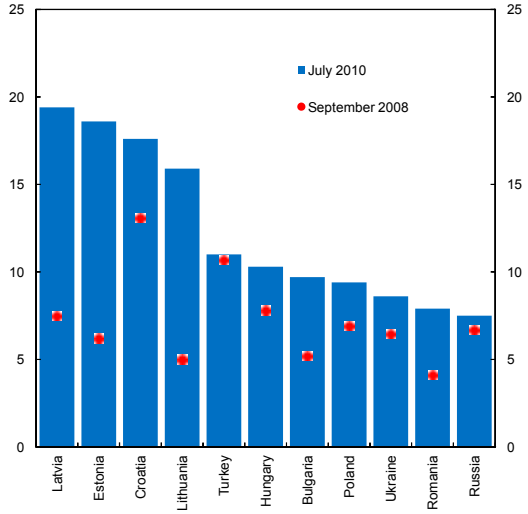
- Consumption is being restrained by poor labor market conditions, low confidence, and the destruction of consumer wealth. Real wages are falling in many countries (Figure 25), and the unemployment rate has increased sharply

Figure 25. Emerging Europe: Gross Real Wage Growth
(Average of the year-over-year growth for the months, in percent)



Sources: Haver Analytics; EMED Emerging EMEA; and IMF staff calculations.

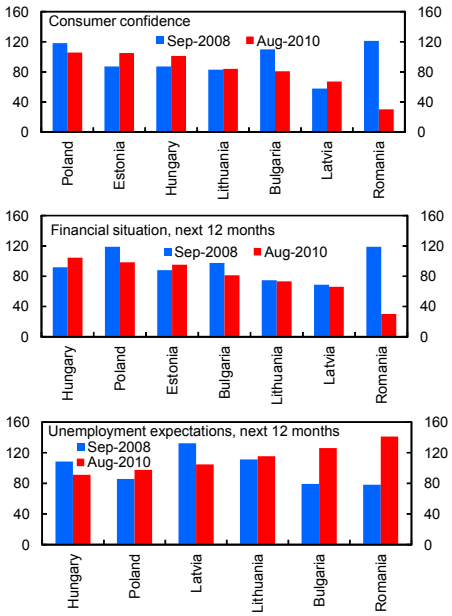
Figure 26. Emerging Europe: Unemployment Rate
(Percent)



Sources: IMF, World Economic Outlook database; Haver Analytics; EMED Emerging EMEA; and IMF staff calculations.

(Figure 26). Private sector confidence remains low compared to historical levels, even after the recent improvement (Figure 27). Stock exchanges in the Baltics and Romania have lost about half their value (up to 80 percent in Bulgaria, since end-2007), and real estate prices are down some 30 percent from their peak.

Figure 27. Emerging Europe: Confidence Indicators
(January 2001–June 2007 average = 100)



Sources: IMF, *International Financial Statistics*; Haver Analytics; EMED; and IMF staff calculations.

Projections for 2010 Have Been Revised up—although Differences within the Region Remain Substantial

For 2010 as a whole, output in the EE region is now projected to grow by 3.9 percent, a half percentage point upward revision from the projections in the April 2010 *World Economic Outlook* (IMF, 2010h) and the May 2010 *Regional Economic Outlook: Europe* (IMF, 2010g) (Table 4). The upward revision is largely the result of better-than-expected outcomes in the first half of 2010 and is in spite of this spring's financial market turbulence. The regional growth average masks wide variations in prospects for individual countries or subregions, reflecting different economic structures and imbalances built up during the boom years.

Growth Will Be Strongest in the European CIS Countries and Turkey

Russia and Ukraine are poised for relatively strong recoveries on the back of rebounding commodity prices. Strong growth in Russia will have spillover effects on the rest of the CIS subregion, whose links with Russia are far more important than with the euro area.

Table 4. Emerging Europe: Real GDP, Domestic Demand, Exports, and Private Consumption, 2009–11
(Percent)

	GDP PPP (Bln. U.S.$)	Real GDP Growth			Real Domestic Demand Growth			Real Exports Growth[1]			Real Private Consumption Growth		
	2009	2009	2010	2011	2009	2010	2011	2009	2010	2011	2009	2010	2011
Baltics[2]	111	-15.5	0.7	3.3	-25.1	-0.7	3.4	-15.6	11.1	5.1	-19.3	-3.4	2.8
Estonia	24	-13.9	1.8	3.5	-20.5	-2.9	3.2	-18.7	10.7	3.8	-18.8	-3.3	2.0
Latvia	32	-18.0	-1.0	3.3	-28.1	-1.6	5.2	-15.5	10.2	6.5	-24.0	-1.0	5.5
Lithuania	55	-14.8	1.3	3.1	-25.3	0.7	2.5	-14.3	11.7	4.9	-16.8	-4.9	1.5
Central Europe[2]	874	0.0	2.8	3.4	-3.3	1.1	3.0	-8.1	8.6	6.6	0.2	0.9	3.0
Hungary	186	-6.3	0.6	2.0	-11.5	-5.3	0.4	-9.1	14.5	9.0	-6.7	-3.2	1.5
Poland	688	1.7	3.4	3.7	-1.0	2.7	3.7	-7.9	7.0	6.0	2.0	2.0	3.4
Southeastern Europe-EU[2]	345	-6.6	-1.4	1.7	-13.2	-3.3	1.8	-6.6	12.0	7.2	-9.4	-3.8	1.4
Bulgaria	90	-5.0	0.0	2.0	-15.0	-4.9	2.4	-9.8	-2.7	6.1	-6.3	-6.8	1.5
Romania	255	-7.1	-1.9	1.5	-12.6	-2.7	1.5	-5.5	17.3	7.5	-10.5	-2.8	1.4
Southeastern Europe-non-EU[2]	239	-3.1	0.5	2.7	-6.7	-2.4	1.8	-11.4	3.2	6.6	-3.7	-2.1	1.9
Albania	23	3.3	2.6	3.2	3.2	-8.1	3.5	-1.7	13.9	0.0	6.8	-5.5	2.3
Bosnia and Herzegovina	30	-3.1	0.5	3.0	-6.7	-1.4	3.5	-4.0	4.2	3.3	-2.6	0.2	4.6
Croatia	78	-5.8	-1.5	1.6	-9.3	-3.6	1.2	-16.2	-3.3	2.4	-8.5	-3.0	0.8
Kosovo	4	4.0	4.6	5.9	...	...	...	...	...	...	...	...	...
Macedonia, FYR	19	-0.8	1.2	3.0	-2.5	1.0	2.4	-7.9	3.1	5.2	0.2	2.0	2.3
Montenegro, Republic of	7	-5.7	-1.8	4.5	-22.1	-1.9	1.0	-18.8	6.6	11.6	-7.7	-0.1	2.0
Serbia, Republic of	78	-3.0	1.5	3.0	-6.7	-0.9	1.3	-12.4	5.7	13.7	-3.0	-2.4	1.7
European CIS Countries[2]	2,536	-8.3	4.1	4.5	-14.4	4.6	6.4	-7.3	8.7	4.7	-8.0	6.2	6.2
Belarus	121	0.2	7.2	6.2	-0.2	5.8	4.7	-9.0	-7.0	6.3	0.4	7.1	5.9
Moldova	10	-6.5	3.2	3.5	-17.1	4.9	3.6	-7.8	6.4	9.6	-7.9	3.9	2.7
Russia	2,116	-7.9	4.0	4.3	-14.1	4.6	6.7	-4.7	9.8	4.6	-7.6	6.7	6.5
Ukraine	289	-15.1	3.7	4.5	-23.0	4.0	5.3	-25.6	7.0	4.9	-14.1	2.7	4.0
Turkey	879	-4.7	7.8	3.6	-7.2	10.1	4.3	-5.3	7.5	5.5	-2.2	6.1	3.2
Emerging Europe[2,3]	4,984	-6.0	3.9	3.8	-11.0	4.0	4.9	-7.4	8.5	5.4	-5.7	4.0	4.5
New EU Member States[2,4]	1,753	-3.4	1.8	2.9	-7.0	0.2	2.7	-9.4	10.0	6.6	-3.1	-0.2	2.6
Memorandum													
Czech Republic	253	-4.1	2.0	2.2	-3.7	0.8	2.2	-10.8	11.4	6.2	-0.2	1.4	1.9
Slovak Republic	115	-4.7	4.1	4.3	-6.2	3.3	3.9	-16.5	14.0	8.2	-0.7	1.3	3.8
Slovenia	55	-7.8	0.8	2.4	-9.6	0.9	2.2	-15.6	3.3	5.2	-1.4	0.4	2.4
United States	14,119	-2.6	2.6	2.3	-3.6	3.0	2.2	-9.5	11.6	5.9	-1.2	1.5	2.0
Euro Area[2,5]	10,519	-4.1	1.7	1.5	-3.4	1.0	0.9	-13.1	10.5	5.6	-1.1	0.6	0.9
EU-27[2,6]	14,759	-4.1	1.7	1.7	-4.2	1.1	1.2	-12.8	9.1	5.5	-1.7	0.6	1.2
World[2]	70,041	-0.6	4.8	4.2	-0.5	4.9	4.3	...	...	...	1.0	3.9	4.4

Source: IMF, World Economic Outlook database.
[1]Real exports of goods and services.
[2]Average weighted by GDP valued at purchasing power parity (PPP).
[3]Includes Albania, Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, Estonia, Hungary, Kosovo, Latvia, Lithuania, 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, Cyprus, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Malta, Netherlands, Portugal, Slovak Republic, Slovenia, and Spain.
[6]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.

Turkey is projected to post the highest growth rate in the region this year (7¾ percent). Prior to the crisis, the more restrained magnitude of foreign inflows, better focus of macro policies on leaning against the cyclical upswing, and a more restrictive regulatory environment for credit preserved the strength of bank and household balance sheets. This—as well as weaker dependence on EE export markets (see Box 4)—helped Turkey set the stage for a strong rebound.

Outside the CIS Countries and Turkey, Growth Will Be Weakest in the Countries That Had Deep Recessions and Strongest in Countries with Mild Recessions

The dichotomy in the recovery reflects the different nature of the downturn. Countries with the deepest recessions are those that experienced not just a decline in exports, but also a collapse of domestic demand, as the credit-fueled domestic demand boom of the precrisis years came to a

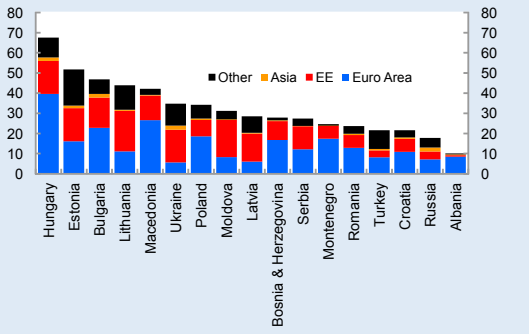
Box 4. Emerging Europe Trade Linkages: The Pull from Within?

The main export market for emerging Europe (EE) countries is Europe—advanced and emerging (see figure below on left). On average, half of all EE exports go the euro area, while intraregional trade accounts for a further third of exports.

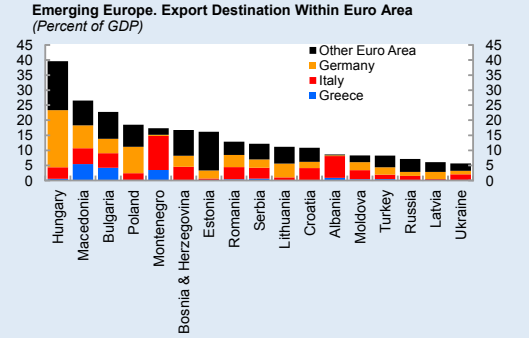
Germany is a key market for EE countries, including through strong automotive industry linkages. About half of Hungarian exports go to Germany—equivalent to about 20 percent of GDP (see figure). Italy is another important export destination, particularly for southeastern Europe. Trade links with Russia are important for the Baltics—Russia absorbs some 15 percent of exports from Latvia and Lithuania. Turkey is an important export market only for Bulgaria; more generally, Turkey's intra-EE trade links are the second weakest among EE countries—only 15½ percent of Turkey's total exports go to the region.

Direct and indirect exposures to the Asian market are both small. In 2008, 7 percent of all EE exports went to Asia, of which 40 percent went to China. In addition to Russia's oil exports to China, wood, lumber, and cork, chemicals and fertilizers, metal and metal scrap account for about 80 percent of exports to the Chinese market. Indirect trade links raise the importance of Asia; about 10 percent of euro area exports go to Asia,[1] and it is likely that at least part of the inputs for these exports is imported from EE.

However, Asia is playing an important role in the current recovery, as its contribution to export growth has been picking up sharply (second figure). Some of this historically high contribution is likely to be temporary, reflecting a postcrisis rebound in demand. However, indirect exposure to the Asian market (not accounted for in



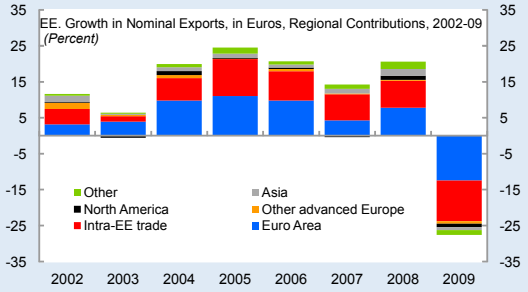
Emerging Europe. Geographical Orientation and Export Share
(Percent of GDP)

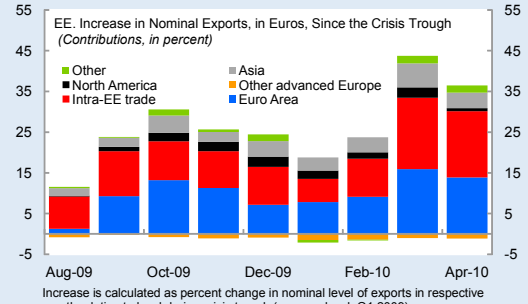


Emerging Europe. Export Destination Within Euro Area
(Percent of GDP)

Sources: IMF, Direction of Trade Statistics database and World Economic Outlook database; and IMF staff calculations.

Historical and Current Contribution to Exports Growth, by Region





Increase is calculated as percent change in nominal level of exports in respective month relative to level during crisis trough (average level, Q1 2009).

Sources: IMF Direction of Trade Statistics database; and IMF staff calculations.

Note: The main author of this box is Ivanna Vladkova-Hollar.

[1] Share of Asia trade in total exports, including intra-euro area exports. Euro area exports to Asia rise to 20 percent if intra-euro area exports are excluded from the total.

the above decomposition) could be increasing, as Germany's market share in a few key import categories has been steadily rising, with transport equipment rising to over a quarter of total Chinese transport equipment imports (text table). Exports in these categories could stand to benefit further from a growing luxury items market in China, particularly as a rebalancing away from high savings rates takes place in the future.

China, Imports, by Trading Partner and Commodity Group

	2004	2005	2006	2007	2008	2009
Top Chinese Imports (In percent of total imports)						
Chemicals	12	12	11	12	11	11
Electrical machinery, apparatus and appliances	25	26	28	27	23	24
Machinery, other than electric	17	15	14	13	13	13
Metalliferous ores and metal scrap	4	5	5	7	9	9
Petroleum and petroleum products	8	9	11	10	14	11
Scientific and controlling instruments, photographic goods, clocks	7	7	7	7	7	6
Transport equipment	3	3	4	4	4	4
Total for subcategories	**77**	**78**	**80**	**80**	**80**	**78**
Imports from EE (In percent of total Chinese imports for commodity group)						
Chemicals	3	4	3	3	3	2
Electrical machinery, apparatus and appliances	0	0	0	0	0	0
Machinery, other than electric	1	0	1	1	1	1
Metalliferous ores and metal scrap	2	3	2	3	3	3
Petroleum and petroleum products	9	11	11	10	7	8
Scientific and controlling instruments, photographic goods, clocks	0	0	0	0	0	0
Transport equipment	2	1	0	1	1	1
Imports from Germany (In percent of total Chinese imports for commodity group)						
Chemicals	4	4	4	4	5	5
Electrical machinery, apparatus and appliances	3	3	3	3	4	4
Machinery, other than electric	13	13	12	12	13	14
Metalliferous ores and metal scrap	1	1	1	1	0	2
Petroleum and petroleum products	0	0	0	0	0	0
Scientific and controlling instruments, photographic goods, clocks	4	3	3	3	4	4
Transport equipment	25	21	24	23	26	26

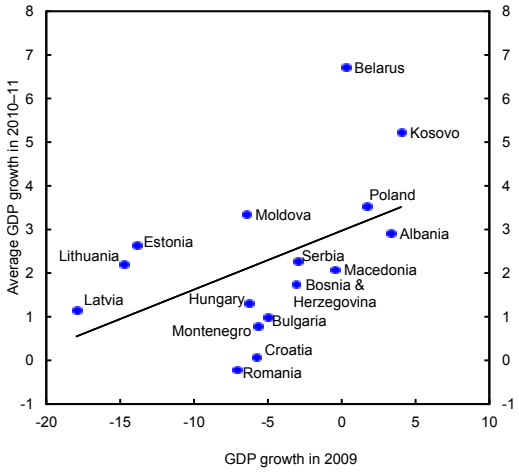
Sources: UN COMTRADE database; and IMF staff calculations.

sudden end (see Chapter 3). Such countries include Latvia (where output fell the most in 2009 and is expected to decline once more in 2010), Bulgaria, Croatia, Estonia, Lithuania, and Romania. In contrast, countries that had the mildest downturn are now seeing the strongest recovery (Figure 28).

The Recovery Is Expected to Broaden in 2011

GDP growth for the region in 2011 is projected at 3.8 percent. Although the growth rate is virtually the same as in 2010, the recovery is expected to broaden, with all countries projected to see positive growth in 2011 (Table 4). Indeed, growth differentials among countries would be the lowest since 2006, with no country in recession and few standouts in terms of strong growth. The recovery is expected to broaden also in terms of drivers of growth: domestic demand is projected to contribute about 1.5–3.5 percentage points to growth in 2011 in most countries; private consumption should resume positive growth, although it will likely

Figure 28. Emerging Europe: GDP Growth 2009 vs. 2010–11[1]



Source: IMF, World Economic Outlook database.
[1]Excludes Russia, Turkey, and Ukraine.

remain subdued in Bulgaria, Croatia, Hungary, Lithuania, Romania, and Serbia (Table 4).

Growth Could Be Stronger than Projected . . .

There are upside risks to the projection. The recovery's momentum could be stronger than

projected as financial conditions normalize, precautionary savings fall as household balance sheets improve, and firms raise investment more quickly than expected. The recovery in Germany in the second quarter of 2010 was particularly dynamic, and the much stronger growth outlook is likely to spill over to the region.

. . . But Downside Risks Remain Significant—and Would Be Particularly Harmful if They Materialized

The main downside risk for emerging Europe is the revival of sovereign stress in advanced Europe, which could depress growth in the euro area and lead to adverse spillovers for the region:

- Transmission to emerging Europe would be not only through lower exports; lower growth in the euro area could also increase banking sector stress in advanced Europe, and reduce capital flows to emerging Europe, delaying the revival of credit growth and domestic demand. If reduced capital inflows were to be accompanied by depreciation of domestic currencies, household and corporate balance sheet mismatches could further weigh on the recovery.[11]
- It would be even more harmful if the market turbulence itself were to spill over to emerging Europe. The consequences of such sovereign risk contagion would include both higher financing costs and greater difficulty in financing still high deficits. In addition, financial sectors would be particularly affected, especially in those countries where banks hold a large portion of their assets in the form of government securities (Albania, Hungary, Poland, and Turkey). In such countries, bank capitalization could be significantly impacted if the value of government securities declined. This in turn could curtail the supply of bank credit.

[11] See Bakker and Gulde (2010b), and Box 3 in the October 2009 *Regional Economic Outlook: Europe* (IMF, 2009c) for a discussion of household and corporate balance sheet currency mismatches.

Inflation Is Projected to Remain Benign . . .

Despite pressures from rising food prices, with still large output gaps and high unemployment, average 2010 headline inflation is projected to fall from 8.5 percent in 2009 to about 6 percent in both 2010 and 2011 (Table 5). Countries with fixed exchange rates are projected to have the lowest inflation rates, with the consumer price index (CPI) in Latvia projected to decline by 1½ percent in 2010 and rising by only 1 percent in 2011, reflecting the strong adjustment that has occurred in these countries. Inflation in the CIS countries is also declining sharply, to 7 percent in 2010. An exception is Turkey, where large excise increases, in combination with a strong recovery, are exerting upward pressure on prices.

. . . While the Current Account Balance of the Region Is Near Zero

Current account deficits are projected to show little change in 2010 and 2011, following a substantial crisis-induced narrowing in 2009. For the emerging Europe region as a whole, a zero average current account balance is projected for 2010, unchanged from 2009 (Table 5). In the Baltics, current account surpluses are projected through the medium term, reflecting the very sharp improvement in its trade balance that has taken place.[12] One exception to this trend is Turkey, where a rapid rebound in domestic demand is leading to a wider current account deficit.

[12] The internal devaluations that have taken place, and continue to take place, in the Baltics have brought about notable improvements in competitiveness. Wages in the Baltics rose between 60 and 100 percent from mid-2005 to mid-2008, far outpacing productivity growth. Nominal wage adjustment since, however, has been significant. In Latvia, unit labor costs (ULC) have come down 20 percent since the beginning of 2009, resulting in about a 14 percent depreciation of its ULC-based real effective exchange rate since its peak.

Table 5. Emerging Europe: CPI Inflation and Current Account Balance, 2009–11
(Percent)

	CPI Inflation (Period average)			Current Account Balance to GDP		
	2009	2010	2011	2009	2010	2011
Baltics[1]	3.0	0.7	1.3	5.7	3.5	1.8
Estonia	-0.1	2.5	2.0	4.5	4.2	3.4
Latvia	3.3	-1.4	0.9	8.6	5.5	2.9
Lithuania	4.2	1.0	1.3	4.2	1.9	0.2
Central Europe[1]	3.6	2.9	2.8	-1.2	-1.7	-1.9
Hungary	4.2	4.7	3.3	0.2	0.5	0.7
Poland	3.5	2.4	2.7	-1.7	-2.4	-2.6
Southeastern Europe-EU[1]	4.8	4.9	4.6	-5.6	-4.7	-4.9
Bulgaria	2.5	2.2	2.9	-9.5	-3.0	-3.1
Romania	5.6	5.9	5.2	-4.5	-5.1	-5.4
Southeastern Europe-non-EU[1]	3.7	3.0	3.3	-7.8	-6.9	-7.1
Albania	2.2	3.4	2.9	-14.0	-9.2	-8.9
Bosnia and Herzegovina	-0.4	2.4	2.5	-6.9	-5.5	-5.5
Croatia	2.4	1.9	2.8	-5.3	-3.8	-4.7
Kosovo	-2.4	1.7	3.2	-18.6	-18.5	-18.2
Macedonia, FYR	-0.8	1.9	3.0	-7.2	-3.9	-4.4
Montenegro, Republic of	3.4	0.6	1.0	-30.3	-17.0	-12.0
Serbia, Republic of	8.1	4.6	4.4	-6.7	-9.6	-9.4
European CIS Countries[1]	12.2	7.0	8.0	2.9	3.7	2.7
Belarus	13.0	7.3	10.8	-13.1	-14.0	-13.9
Moldova	0.0	7.4	6.0	-8.1	-11.2	-11.4
Russia	11.7	6.6	7.4	4.0	4.7	3.7
Ukraine	15.9	9.8	10.8	-1.5	-0.4	-1.3
Turkey	6.3	8.7	5.7	-2.3	-5.2	-5.4
Emerging Europe[1,2]	8.5	6.1	6.1	0.0	-0.1	-0.6
New EU Member States[1,3]	3.2	2.8	2.8	-1.7	-1.7	-1.9
Memorandum						
Czech Republic	1.0	1.6	2.0	-1.1	-1.2	-0.6
Slovak Republic	0.9	0.7	1.9	-3.2	-1.4	-2.6
Slovenia	0.9	1.5	2.3	-1.5	-0.7	-0.7
United States	-0.3	1.4	1.0	-2.7	-3.2	-2.6
Euro Area[1,4]	0.3	1.6	1.5	-0.6	0.2	0.5
EU-27[1,5]	0.9	1.9	1.8	-0.3	-0.1	0.1
World[1]	2.5	3.7	3.1	0.4	0.3	0.5

Source: IMF, World Economic Outlook database.

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

[2]Includes Albania, Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, Estonia, Hungary, Kosovo, Latvia, Lithuania, 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, Cyprus, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Malta, Netherlands, Portugal, Slovak Republic, Slovenia, and Spain.

[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.

What Can Policymakers Do to Sustain the Recovery and Minimize Risks?

Resolute domestic policy responses to the crisis—as well as large official financing packages from multilateral institutions—helped prevent a cascade of bank and currency crises (see Chapter 3). Still, these policies themselves, and the deep economic downturns, have had some side effects that policymakers in the region will now have to deal with. The short-term policy challenges—which are similar to those in advanced Europe—present difficult balancing acts, along the following dimensions:

- *Reducing fiscal deficits to ensure sustainable public debt while minimizing the negative impact on growth.* Several emerging European countries need to rein in large public sector deficits to secure debt sustainability and avoid negative market reactions as experienced earlier in 2010. The timing and pace of the consolidation will ultimately need to be tailored to individual country circumstances, and countries at high risk of market concerns about sovereign debt sustainability may need to proceed with fiscal consolidation at a faster rate.
- *Repairing banking systems while reviving credit.* The crisis has weakened the EE region's financial sectors, with many countries experiencing sharp increases in NPLs. The dilemma facing banks is how to strengthen their balance sheets while reviving their lending operations.

Beyond the short term, most of the EE region will need to find new growth engines. In a number of countries, the growth model of the boom years—driven by capital inflows, rapid credit growth, and domestic demand booms—will need to shift toward a model more reliant on the tradable sector as an engine of growth. While this shift will in large part be the result of private sector decisions, government policies, in particular structural reforms and prudent wage policies, can also help.

Restoring the Health of the Public Finances

Prior to the Crisis, Headline Fiscal Deficits Were Low in Most EE Countries . . .

In 2007, emerging Europe as a group recorded a fiscal surplus of about 2 percent of GDP. Moreover, debt levels—at roughly 23 percent of GDP for EE countries—were low compared with other emerging market economies, with the important exception of Hungary (Table 6).

. . . But the Underlying Fiscal Position Worsened Due to Rapid Expenditure Growth

However, these seemingly healthy fiscal balances were inflated by high temporary revenues related to domestic demand booms; the underlying fiscal positions had actually deteriorated as a result of rapidly growing expenditures (Figure 29). The rapid growth of expenditures during the boom years had set the stage for large deficits when revenues collapsed with the implosion of credit and domestic demand.

The Deterioration of the Fiscal Position Became Visible in 2009, when Large Deficits Emerged . . .

As a result of the crisis, public sector deficits and debt levels shot up in 2009. EE countries' average headline balance deteriorated from about zero in 2008 to a deficit of 6 percent of GDP in 2009, with a wide range—from a low of 0.7 percent in Belarus to a high of nearly 9 percent in Lithuania (Table 6).[13] Average public debt levels rose from about 24 percent of GDP in 2008 to nearly 30 percent of GDP in 2009, again, with substantial intraregional variation. Those countries that had allowed their expenditures to grow more rapidly during the boom

[13] We focus on overall deficits since it is difficult to distinguish between cyclical and structural components of the fiscal balance in emerging market countries owing to uncertainty about potential output. This argument applies in normal times, but even more so during and following the crisis.

Table 6. Emerging Europe: Evolution of Public Debt and General Government Overall Balance, 2007–11[1]
(Percent of GDP)

	General Government Overall Balance					Public Debt				
	2007	2008	2009	2010	2011	2007	2008	2009	2010	2011
Baltics[2]	0.3	-4.3	-7.1	-7.5	-6.4	11.2	13.8	25.7	33.5	36.7
Estonia	2.9	-2.3	-2.1	-1.1	-1.7	3.7	4.6	7.1	8.1	7.8
Latvia[3,4]	0.6	-7.5	-7.8	-11.9	-7.6	7.8	17.1	32.8	42.2	49.0
Lithuania	-1.0	-3.3	-8.9	-7.7	-7.7	16.9	15.6	29.5	39.5	42.3
Central Europe[2]	-2.6	-3.7	-6.5	-6.8	-6.2	49.9	52.9	56.7	60.0	61.8
Hungary[5]	-5.0	-3.7	-4.1	-4.2	-4.5	65.8	72.9	78.3	78.4	78.8
Poland	-1.9	-3.7	-7.1	-7.4	-6.7	45.0	47.1	50.9	55.2	57.4
Southeastern Europe-EU[2]	-1.4	-2.8	-5.7	-6.3	-4.3	19.8	20.0	26.3	30.9	33.3
Bulgaria[3]	3.5	3.0	-0.9	-4.9	-4.2	19.8	16.1	16.1	18.2	21.1
Romania	-3.1	-4.8	-7.4	-6.8	-4.4	19.8	21.3	29.9	35.5	37.7
Southeastern Europe-non-EU[2]	-1.5	-2.3	-4.5	-4.7	-4.2	34.7	32.5	36.9	41.0	43.0
Albania[3]	-3.6	-5.1	-7.4	-4.1	-5.0	53.8	55.2	59.5	60.6	61.9
Bosnia and Herzegovina	-0.3	-3.6	-5.7	-4.5	-3.0	32.9	30.8	35.4	39.1	43.0
Croatia[3]	-2.4	-1.3	-4.1	-5.3	-4.7	33.2	29.3	35.4	40.0	42.6
Kosovo[3]	4.9	-0.2	-0.8	-3.4	-5.5	...	...	...	...	...
Macedonia, FYR	0.6	-0.9	-2.6	-2.5	-2.5	22.8	20.8	23.5	24.9	25.4
Montenegro, Republic of[3]	6.3	1.5	-4.4	-7.1	-7.7	27.5	29.0	38.2	43.5	49.4
Serbia, Republic of[3]	-1.9	-2.6	-4.1	-4.8	-4.0	35.2	33.4	35.6	40.5	41.6
European CIS Countries[2]	5.4	3.2	-6.0	-4.8	-3.6	15.3	15.5	14.3	15.3	17.1
Belarus[3]	0.4	1.3	-0.7	-3.4	-3.5	11.5	11.5	25.1	29.3	33.4
Moldova[3]	-0.2	-1.0	-6.4	-5.4	-3.4	26.9	21.3	30.7	33.8	35.1
Russia[3]	6.8	4.3	-6.2	-4.8	-3.6	8.5	7.8	10.9	11.1	12.9
Ukraine[3]	-2.0	-3.2	-6.2	-5.5	-3.5	12.3	20.0	34.6	39.5	40.6
Turkey[3,6]	-2.1	-2.9	-6.2	-4.0	-3.1	39.4	39.5	45.5	43.4	42.4
Emerging Europe[2,7]	1.8	0.2	-6.0	-5.2	-4.1	23.3	23.8	29.4	30.8	32.1
New EU Member States[2,8]	-1.7	-3.2	-6.3	-6.6	-5.6	35.7	37.4	43.4	47.9	50.4
Memorandum										
Czech Republic	-0.7	-2.7	-5.9	-5.4	-5.6	29.0	30.0	35.3	40.1	44.4
Slovak Republic	-1.9	-2.3	-6.8	-8.0	-4.7	29.3	27.7	35.7	41.8	44.0
Slovenia[3]	0.2	-0.3	-6.1	-5.8	-4.4	23.3	22.5	29.4	34.5	37.2

Source: IMF, World Economic Outlook database.

[1]As in the WEO, general government overall balances reflect staff's projections of a plausible baseline, and as such contain a mixture of unchanged policies and program effort.

[2]Average weighted by GDP valued at purchasing power parity (PPP).

[3]Reported on a cash basis.

[4]In Latvia, the widening of the 2010 headline deficit reflects one-off bank restructuring costs of about 3.5 percent of GDP.

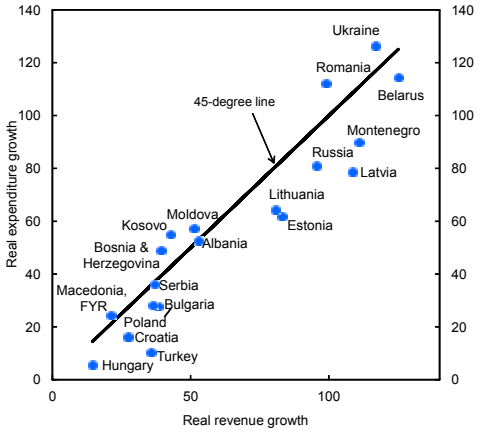
[5]For Hungary, the general government overall balance projections include staff projections of the macro framework and of the impact of existing legislated measures, as well as fiscal policy plans as announced by end-August 2010. To meet the recently announced commitments of the government to balances of 3.8 percent of GDP in 2010 and 3 percent of GDP in 2011, the authorities will need to approve additional measures.

[6]Fiscal projections assume the authorities adhere to the 2010 and 2011 targets set in their September 2009 medium-term program.

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

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

Figure 29. Emerging Europe: Precrisis Real Expenditure and Revenue Growth, 2003–08[1]
(Percent)



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.

years tended to experience a larger fiscal deterioration. Thus, in hindsight, fiscal policy was too loose in most EE countries, reducing the scope for countercyclical fiscal policy during the crisis.[14]

. . . And in 2010, when Deficits Remain High

Deficits remain high in 2010—with only a modest reduction—while debt levels continue to rise (Table 6). EE countries' average headline deficit is projected to fall to 5¼ percent of GDP in 2010, but there is considerable intraregional variation. While deficits in some countries, notably Bulgaria, but also in Belarus, Kosovo, Montenegro, and Serbia, are projected to widen significantly, in several others, particularly those facing binding financing constraints, large fiscal adjustments are taking place in 2010. In Latvia, the widening headline deficit masks substantial fiscal effort: Latvia is on track to take another 4 percent of GDP in fiscal consolidation measures in 2010, following measures of approximately 8 percent of GDP in 2009.

[14] Hungary is a case in point. Deficits and debt levels were high going into the crisis; as the crisis erupted, Hungary was forced to procyclically reduce its deficit (Chapter 3).

Substantial Fiscal Consolidation Is Needed over the Next Few Years

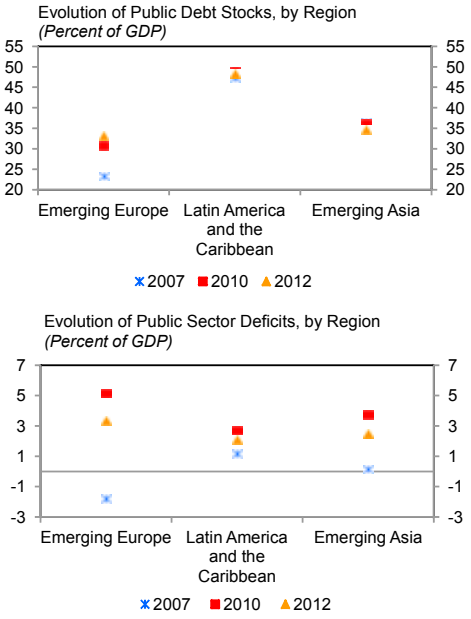
With deficits generally still at very high levels, and a permanent loss in revenues resulting from the end of the demand boom, it is clear that substantial fiscal consolidation is needed over the next few years to reduce vulnerabilities. Deficits and debt levels in EE countries are generally not as high as in euro area countries, but deficit levels are high by emerging market standards (Figure 30). Moreover, several countries in the region face difficult medium-term debt dynamics, reflecting an aging population,[15] while medium-term growth prospects for most EE countries have worsened significantly after the crisis.

Although Fiscal Consolidation May Hurt Growth in the Short Term, Market Concerns about Weak Public Finances Could Be Even More Damaging…

Even though fiscal consolidation is likely to be beneficial over the long term, fiscal retrenchments tend to have contractionary effects on output in the short term.[16] At the same time, recent events have shown how weak public finances can destabilize financial markets. Financial markets are increasingly focusing on fiscal vulnerabilities.[17] In emerging Europe, in the early stages of the crisis, investors were more focused on external imbalances and private sector credit growth and the nature of its funding, and sovereign credit default swaps (CDS) spreads were not associated with the level of fiscal vulnerability at that time (see the May 2009 *Regional Economic Outlook: Europe*; IMF, 2009b). However, since the outbreak of sovereign debt concerns in western Europe in May 2010, this seems to have changed, with the level of sovereign CDS spreads

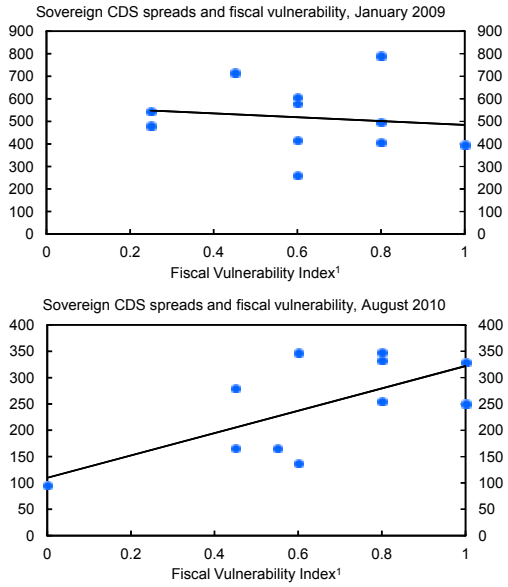
[15] This issue is explored in depth in Velculescu (2010).
[16] See the October 2010 *World Economic Outlook* (IMF, 2010i), Chapter III, for a detailed discussion of the macroeconomic impact of fiscal consolidation.
[17] See the May 2009 *Regional Economic Outlook: Europe* (IMF, 2009b) for an analysis of the role of fiscal vulnerabilities in driving spreads among advanced economies pre- and post-Lehman Brothers.

Figure 30. Selected Regions: Deterioration of Public Finances



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

Figure 31. Emerging Europe: Financial Markets and Fiscal Vulnerabilities



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

[1]The Fiscal Vulnerability Index is a weighted summary indicator of fiscal vulnerability using a number of fiscal variables, including the overall fiscal balance, the primary gap, debt ratio, and exposure to currency and rollover risks.

increasingly associated with the levels of fiscal vulnerability (see Figure 31).

. . . Suggesting that Fiscal Consolidation Is Most Urgent in Countries with Weak Public Finances

To prevent the emergence of market concerns, countries with high fiscal vulnerabilities may need to proceed with fiscal consolidation at a faster rate. Indeed, EE countries faced with relatively high deficits are generally projected to make larger fiscal adjustments, and in Bulgaria, Romania, and Ukraine the consolidation is front-loaded (Figure 32). Countries with low debt and deficit levels, and hence low perceived risk of sovereign default, could delay fiscal consolidation, especially where recoveries are fragile.

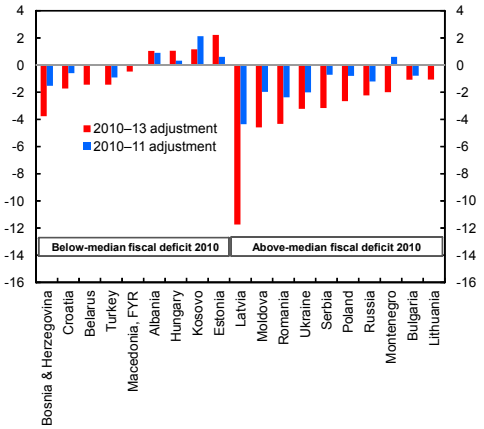
Expenditure-Based Consolidation Is Likely to Be Less Harmful for Growth

As discussed in Chapter 1, fiscal contractions that rely on spending cuts tend to have a less contractionary impact than tax-based adjustments. Current fiscal adjustment plans across the region are to a significant degree expenditure-based, although large adjustments, especially in the face of revenue erosion, would inevitably contain some tax-based components (Figure 33).

Fiscal Consolidation Is Likely to Be More Successful if It Is Embedded in Medium-Term Plans

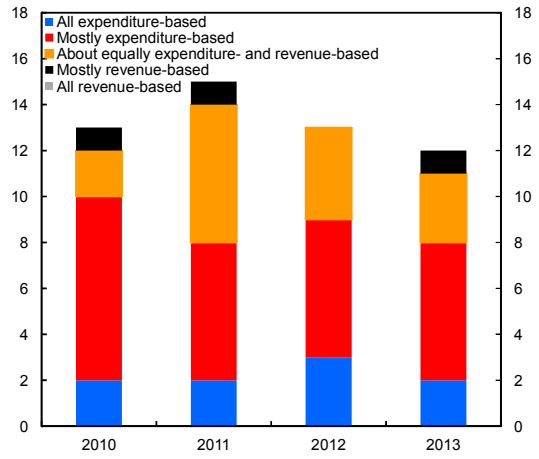
The pace of fiscal adjustment in some countries is likely also driven by the trade-offs between speed of adjustment on the one hand and quality and durability of adjustment on the other. Some consolidation measures could have an immediate impact that quickly translates into improved market confidence, but these measures might not be sustainable and could possibly be harmful in the medium to long term. Other measures could involve more fiscally sustainable, "high quality" adjustments, but their substantive effect on the budget deficit might not materialize until later years. Given this trade-off, it is all the more important to anchor fiscal policy in the context of a well laid out medium-term fiscal strategy. In that context, some countries are

Figure 32. Emerging Europe: Fiscal Adjustment, 2010–13
(Change in general government deficit as a percent of GDP)



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

Figure 33. Emerging Europe: Composition of Adjustment Plans, 2010–13
(Number of countries)



Source: IMF staff calculations.

also trying to bolster fiscal credibility by adopting fiscal rules.[18] Indeed, past experience shows that fiscal rules—in particular those that have expenditures as a focus in combination with deficit rules—can have a positive impact on the effectiveness and duration of the consolidation effort, especially when accompanied by stronger monitoring and enforcement mechanisms (IMF, 2009a).

[18] For example, Hungary has started implementing the fiscal responsibility law adopted in late-2008, which will become fully effective by 2012. In addition, Latvia and Lithuania are preparing a fiscal responsibility law and a new deficit rule, respectively.

Reviving Private Sector Credit

Private Sector Credit Growth Has Been Weak since the Onset of the Crisis

The credit boom in many EE countries came to an abrupt end after the Lehman Brothers collapse and its aftermath (see also Chapter 3). Credit growth in 2009 was very low, and in many countries even turned negative. Private sector credit levels continue to decline in 2010 in the Baltics, and have remained flat at end-2009 levels in Bulgaria (see chart in Box 5).

Initially, Weak Credit Was the Result of Supply Factors, in Particular the Decline in Capital Transfers from Western European Banks . . .

Credit growth stopped when banks in advanced countries, confronted with liquidity and capital shortages, advised their subsidiaries and branches in the EE region that new credit would henceforth need to be financed from an increase in local deposits. This effect was compounded by the freezing of the international syndicated loans market and the halt in the growth of direct cross-border loans.

. . . And the Increase in NPLs . . .

As NPLs rose with the recession and exchange rate depreciations, the supply of credit was further affected by increases in banks' provisioning needs. The increase in provisions was particularly high for countries with double-digit percentage drops in real GDP in 2009 (Figure 34), but even for countries with less severe recessions, such as Hungary, Moldova, and Russia, provisioning has more than doubled since 2007. The increase in provisioning led to a drop in retained earnings, further reducing the room for credit growth. Banks that had already built loan loss reserves (as a precaution against future NPLs) fared better. Indeed, higher loan loss reserves

in 2007 are associated with a lower drop in (nominal) credit growth in 2009 (Figure 35). Part of the reason is that there was less of a need for banks with higher reserves to form extra provisions during the crisis.

. . . But Demand Factors Have also Played a Role

Analysis of large banks shows that while supply-side factors were very important in explaining loan growth in 2009, declining credit demand played a role as well (Box 5). In the first half of 2010, the effect of both supply and demand factors on private sector credit continued to be felt: bank deleveraging continues, increasing net credit to the public sector likely reflects some rebalancing of banks' portfolios towards safer assets, and lending rates, particularly in those countries with weak credit growth, continue to fall.

The Revival of Credit Growth Would Help Support the Recovery

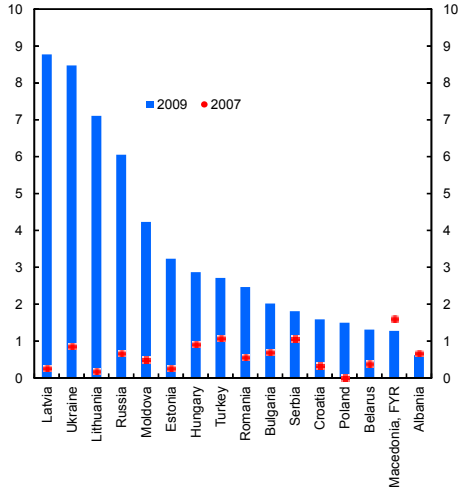
"Creditless" recoveries in GDP growth are generally slow and shallow.[19] It is therefore important that credit growth picks up to support financing to firms that cannot access funding from capital markets.

Looking ahead, as the Economy Recovers, Supply Factors Are Likely to Be the Main Constraint on Credit Growth

As capital inflows are likely to remain weak, the funding of credit growth will have to rely more on domestic deposit growth, which could remain subdued due to the relatively high unemployment levels.

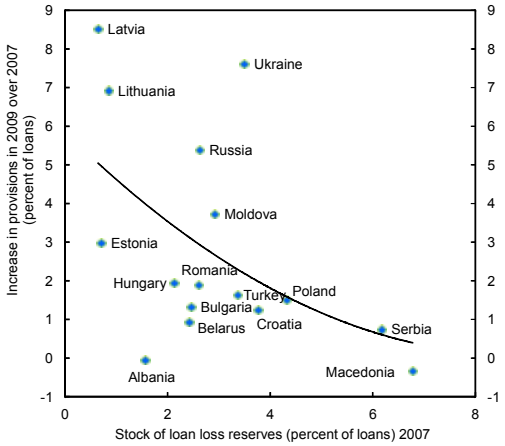
[19] Evidence from Claessens, Kose, and Terrones (2008) shows that on average, the recession ends two quarters before the credit crunch ends and nine quarters before housing prices bottom out; equity prices tend to bottom out just as the associated recession ends. Such "creditless" recoveries are usually slow and shallow.

Figure 34. Emerging Europe: Loan Loss Provisions[1]
(Percent of loans)



Sources: Bankscope; and IMF staff calculations.
[1]Data on biggest banks (accounting for 60–90 percent of banking system assets) are aggregated (weighted by assets) to derive a figure for the country. The number of banks reporting data for 2009 is less than those in 2007.

Figure 35. Emerging Europe: Provisions and Loan Loss Reserves[1]



Sources: Bankscope; and IMF staff calculations.
[1]Data on biggest banks (accounting for 60–90 percent of banking system assets) are aggregated (weighted by assets) to derive a figure for the country. The number of banks reporting data for 2009 is less than those in 2007.

NPLs typically react with a considerable lag to changes in GDP. They continue to rise in most of emerging Europe (with the notable exception of Turkey), from levels that are already high (Table 7). The related provisioning for these new NPLs will further weigh on banks' capital and their ability to lend.

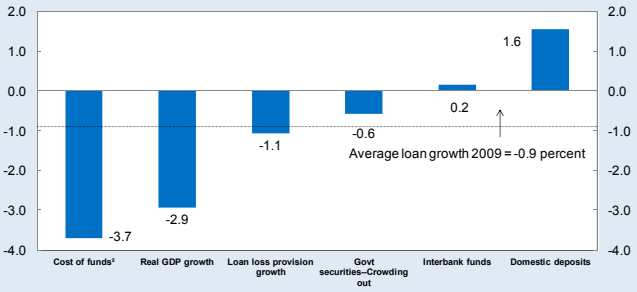
If sovereign debt concerns were to increase, banks with sizable exposures to government

Box 5. Why Is Credit Growth Weak—Demand or Supply?

Why did credit growth slow down in 2009—was it lack of demand or lack of supply? And why did it remain weak in 2010?

To disentangle demand and supply factors in 2009, a bank-level regression was run, using data on 63 big banks in the region—the largest banks in each country accounting for assets comprising 60–90 percent of banking system assets in each country. The analysis suggests that in 2009 supply-side factors (in particular higher costs of funds and higher loan loss provisioning) were the most important factors holding back loan growth, although the contraction of GDP also played a role (first figure). The higher cost of funds is likely to have been the result of the drop in cross-border funds, as domestic deposit growth was still positive.

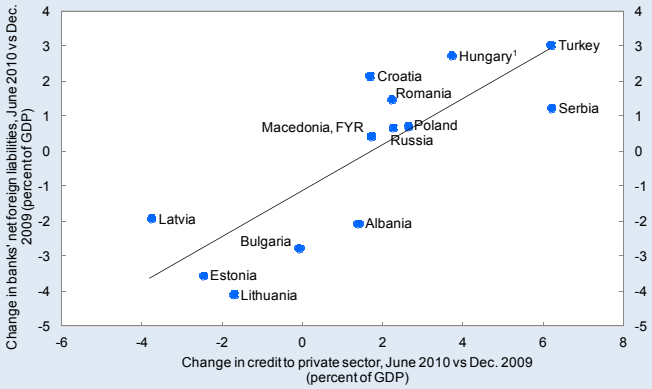
Emerging Europe: Factors Explaining Nominal Bank-by-Bank Loan Growth in 2009[1]
(Percent)



Sources: Bankscope; and IMF staff estimates.
[1]Derived from an OLS regression of 2009 loan growth in 63 largest banks in the region. Each bar denotes the amount by which loan growth would change following mean percentage point change in each of the factors in 2009.
[2]Cost of funds derived by dividing interest expenses by total funds in each bank, multiplied by 100.

Disentangling demand and supply factors in 2010 is more difficult, as bank-by-bank data are not yet available. Weak demand is likely to have gained in importance, as lending rates, which had increased during the crisis, came down in a number of countries. On the supply side, aggregate banking system data show that bank deleveraging continued (second figure), especially in the Baltics and Bulgaria. Crowding out by the public sector could have played a role as well, as net credit to the public sector has increased in a number of countries, but it is difficult to disentangle potential crowding out effects from portfolio rebalancing toward safer assets. Evidence from Senior Loan Officers' surveys (available for only a few countries) shows that banks are continuing to tighten standards in 2010:Q2 but significantly less so than in Q1, amidst rising demand for loans, particularly from firms. Higher capital and funding costs in Lithuania and a high nonperforming loans ratio in Romania are contributing to tighter lending standards for corporate loans.

Emerging Europe: Private Credit Growth and Bank Deleveraging



Sources: IMF, *International Financial Statistics*; and IMF staff calculations.
[1]For Hungary, credit growth to the private sector in H1 2010 reflects largely exchange rate changes.

Note: The main authors of this box are Srobona Mitra and Ivanna Vladkova-Hollar.

Table 7. Emerging Europe: Selected Financial Soundness Indicators, 2007–09[1]
(Percent)

Country	Capital Adequacy Ratio			Provisions to Nonperforming Loans			Nonperforming Loans to Total Loans		
	2007	2008	2009	2007	2008	2009	2007	2008	2009
Albania	17.1	17.2	16.2	47.2	42.8	51.3	3.4	6.6	10.5
Belarus	19.3	21.8	19.8	61.5	70.0	44.9	1.9	1.7	4.2
Bosnia and Herzegovina	17.1	16.3	16.1	37.2	37.9	34.4	3.0	3.1	5.9
Bulgaria	13.8	14.9	17.0	100.4	109.0	78.3	2.1	2.5	6.4
Croatia	16.9	15.4	16.6	54.4	48.7	42.5	4.8	4.9	7.8
Estonia	10.8	13.3	15.7	110.9	57.2	83.5	0.4	1.9	5.2
Hungary	10.4	11.2	12.9	64.8	58.9	53.2	2.3	3.0	6.7
Kosovo	17.4	16.5	17.9	…	…	…	4.1	3.3	4.3
Latvia	11.1	11.8	14.6	129.8	61.3	57.4	0.8	3.6	16.4
Lithuania	10.9	12.9	14.2	…	…	…	1.0	4.6	19.3
Macedonia, FYR	17.0	16.2	16.4	117.0	120.3	101.4	7.5	6.8	8.9
Moldova	29.1	32.2	32.7	113.8	94.2	59.2	3.7	5.2	16.3
Montenegro	17.1	15.0	15.7	73.6	55.6	46.3	3.2	7.2	13.5
Poland	12.0	11.2	13.3	68.8	61.3	50.2	5.2	4.5	7.6
Romania	13.8	13.8	14.7	61.6	60.3	50.6	4.0	6.5	15.3
Russia	15.5	16.8	20.9	144.0	118.4	94.8	2.5	3.8	9.7
Serbia	27.9	21.9	21.3	…	187.8	168.1	…	11.3	15.5
Turkey	18.9	18.0	20.6	86.8	79.8	83.6	3.6	3.8	5.6
Ukraine[2]	13.9	14.0	18.1	...	132.4	65.1	13.2	17.4	40.2

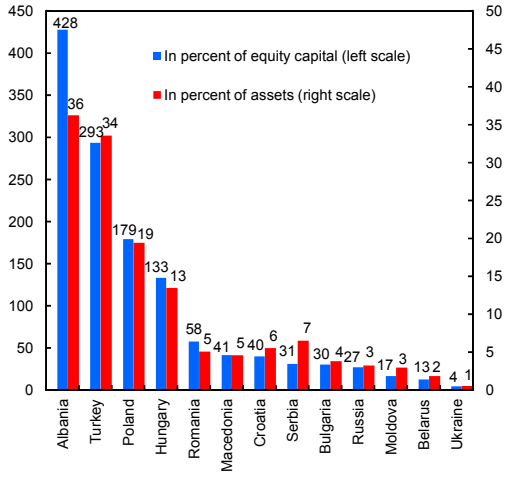
Source: IMF, *Global Financial Stability Report* (October 2010).
[1]Please refer to the *Global Financial Stability Report* (October 2010) for detailed notes on cross-country variations in the definitions of the variables.
[2]The National Bank of Ukraine's approach to the loan portfolio classification is stricter than in other countries as, in addition to servicing status, loan classification also depends on borrower's financial conditions and collateralization level.

securities (Figure 36) would need higher capitalizations to sustain large increases in sovereign risk premiums, and would need to rely less on sovereign bonds as liquid assets.

Repair of Banks' Balance Sheets Will Help Alleviate Supply Constraints. . .

A key precondition for credit growth to revive is the repair of bank balance sheets. The sooner banks recognize loan losses and raise additional capital, the sooner they will be able to regenerate loan growth—and the sooner also will uncertainty about financial sector health be reduced. At the same time, current market conditions could make it more difficult to raise fresh capital. Moreover, there may be competition for funds, as many banks need to raise capital to meet the strengthened Basel requirements.[20]

Figure 36. Emerging Europe: Holdings of Government Securities by Banks, 2009
(Percent)



Sources: Bankscope; National Bank of Serbia; and IMF staff calculations.

. . . And Policymakers Can Contribute by Reducing Policy Uncertainty

Credible fiscal consolidation plans should reduce sovereign debt concerns and put less pressure on

[20] At its September 12, 2010 meeting, the Group of Governors and Heads of Supervision, the oversight body of the Basel Committee on Banking Supervision, announced a substantial strengthening of existing capital requirements, to be phased in over several years. These capital reforms, together with the introduction of a global liquidity standard, will increase the minimum common equity requirement from 2 percent to 4.5 percent. In addition, banks will be required to hold a capital conservation buffer of 2.5 percent to withstand future periods of stress, bringing the total common equity requirements to 7 percent.

(continued)

both capitalization and liquidity in banks. Credible macroeconomic policies would also make it possible to keep policy interest rates low, which would not only stimulate demand for credit but would also encourage bank funding through domestic sources and support lending in local rather than foreign currency.

Enhanced International Cooperation on Financial Sector Policies Would Help Further Reduce Uncertainty

Cross-border cooperation on the amount and duration of new financial sector levies would reduce speculation on regulatory arbitrage as is the case in Hungary (Box 6). Cross-border agreements on cooperation to prevent future crises could build on the example set by the recent Nordic-Baltic Cooperation Agreement. The latter not only provides clearly delineated rules for burden sharing but also establishes a permanent regional institution to discuss financial stability issues of regional interest.

Shifting Growth Toward the Tradable Sector

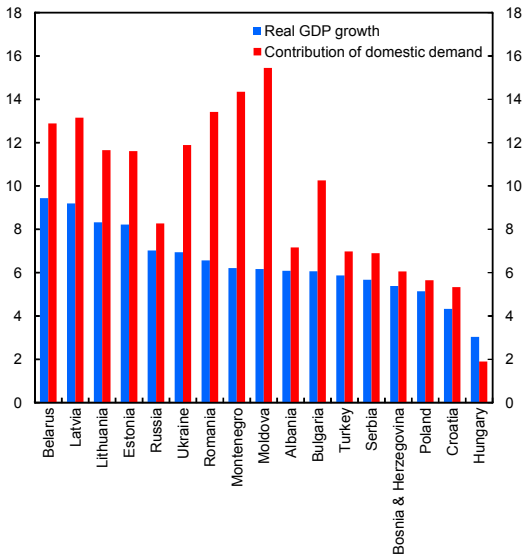
During the Boom Years, Growth in Many Countries in Emerging Europe Was Driven by the Nontradable Sector

During the boom years, a capital inflows-fueled domestic demand boom resulted in strong GDP growth, particularly in the nontradable sector, a growth pattern that contributed to rising current account deficits, increasing imbalances, and significant vulnerabilities (Figure 37 and Chapter 3).

Growth Will Need to Shift to the Tradable Sector

Capital inflows are unlikely to return to precrisis levels, and domestic demand is likely to remain depressed. Future growth must rely more on the tradable sector and less on the nontradable sector—especially in countries that had built up large imbalances during the boom.

Figure 37. Emerging Europe: Precrisis Real GDP Growth and Contribution of Domestic Demand
(Average 2003–08, percent) [1]



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

The Adjustment Will Need to Be Made by the Private Sector . . .

Restructuring should be helped by market signals that will change as profits in the nontradable sector shrink and investments seek more promising venues in the tradable sector. But the process may be difficult. Even in the tradable sector, new projects may have to compete for much scarcer financing. Inflows will remain subdued as banks in advanced Europe struggle to rebuild their balance sheets and risk-adjusted returns in emerging Europe seem less attractive.

. . . But Public Policies Should Aim to Prevent a Repeat of the Overheating that Pulls Resources from the Tradable to the Nontradable Sector

Fiscal policy in particular could play a much more active role—saving money when revenues are growing instead of increasing spending and boosting public wages. This may mean that during boom times small fiscal surpluses are not sufficient—that large surpluses are needed. Policymakers may prefer to spend in boom times, but the payoff from savings that a large fiscal buffer will reduce the need to cut

Box 6. Financial Sector Levies in Europe

Across Europe, governments have been exploring ways to involve the financial sector in sharing the burden of the crisis, and in meeting the costs of future financial crises. Several EU countries have moved ahead with financial sector levies. In western Europe, Austria, France, Germany, Sweden, and the United Kingdom have all taken steps in this direction (both actual and proposed). In emerging Europe, so far only Hungary has introduced a financial sector levy, while Poland and Croatia may be considering it in the near future. The approaches vary, but there are some common elements. In general, the tax is applied to some portion of liabilities, and applies to both banks and nonbank financial institutions. In some countries (Germany and Sweden), the proceeds from the tax flow (or are expected to flow) to an ex ante fund to finance future crises, while in others (Austria, France, Hungary, and the United Kingdom) they flow into general government revenue. Hungary's financial sector levy stands out in terms of size (0.7 percent of GDP each year, more than three times higher than the largest tax among the other countries), and the lack of an exact timetable for scaling it back risks further deleveraging.

A fully harmonized approach is still lacking, but international coordination is under way. The lack of a common approach reflects (i) the recognition that a one-size-fits-all approach is unlikely to work; and (ii) the lack of consensus (including in the public finance literature) on how taxation should address the distinct problems posed by the financial sector. Nevertheless, given the need to ensure a level playing field, some degree of international coordination has taken place at the G-20 and EU levels. The G-20, at its leaders' June 2010 summit in Toronto, discussed an IMF staff report it had commissioned in 2009, and agreed that the financial sector should make a "fair and substantial contribution" toward paying for any burdens associated with government interventions to repair the banking system or fund resolution in a financial crisis.[1,2]

Looking ahead, further efforts at international coordination would be beneficial to promote a level playing field. Unilateral actions by governments risk being undermined by tax and regulatory arbitrage. Effective cooperation does not require full uniformity, but agreement on broad principles, including bases and minimum rates. Given their close integration with the rest of Europe, emerging European countries would be well advised to await the outcome of ongoing discussions at the EU level—which may, however, be protracted—before implementing financial sector levies.

Note: The main authors of this box are Christoph Duenwald and Jérôme Vandenbussche.
[1] IMF (2010a). The report proposes two forms of contribution from the financial sector: (i) a "financial stability contribution" (FSC), a levy to pay for the fiscal cost of any future government support to the sector; and (ii) any further contribution from the financial sector that is desired should be raised by a "financial activities tax" (FAT) levied on the sum of profits and remuneration of financial institutions.
[2] France, Italy, and the United Kingdom have also adopted taxes on bonuses in the financial sector. In early 2010, the U.S. government discussed the introduction of a "financial crisis responsibility fee" in the form of a 0.15 percent tax on uninsured liabilities (defined as total assets net of tier I capital and insured deposits).

expenditure sharply during a recession—as several countries had to do during this crisis.

Wage Restraint Is Essential . . .

Over time, wages will catch up with those in western Europe. But they cannot do so overnight—wage increases need to go hand in hand with productivity increases.

. . . But Emerging Europe Should Not Compete on Low Wages Alone

Although wages in EE are lower than in advanced Europe, other emerging markets have

even lower wages. If it cannot compete on low wages alone, the region should instead aim to produce increasingly sophisticated products. Structural reforms could take advantage of the export-led recovery currently under way. This is the time to urgently undertake labor market reforms to address skill mismatches between workers in the nontradable sector looking for jobs and the jobs in the tradable sector waiting to be filled.[21]

Foreign Capital Inflows, Especially FDI, Can Also Play an Important Role, if They Are Aimed at Enhancing Supply, Especially in the External-Trade-Oriented Sector

Such investment would support growth, transfer technology, and help contribute to an improvement of labor force skills. Recent research shows that for emerging Europe, increases in the share of FDI going to the tradable sector corresponds to an increase in the export-to-GDP ratio (Kinoshita, forthcoming). Improvements in infrastructure and an educated labor force should help attract FDI to the tradable sector.

Balanced Growth Is More Sustainable in the Long Run

In countries where growth during the boom was much more balanced, credit growth was more restrained, and current account deficits were small. They also experienced a less pronounced reversal in growth (Chapter 3). Countries that relied on domestic demand booms for growth, fed by rapid credit growth, were left without sufficient expansion of the economies' supply potential. Indeed, the average growth over the cycle in these countries is no higher, and in some cases lower, than in countries with more restrained credit increases.

[21] The EE region has large skill mismatches, compared to advanced Europe. See Mitra and Pérez Ruiz (forthcoming).

3. Emerging Europe and the Global Crisis: Lessons from the Boom and Bust

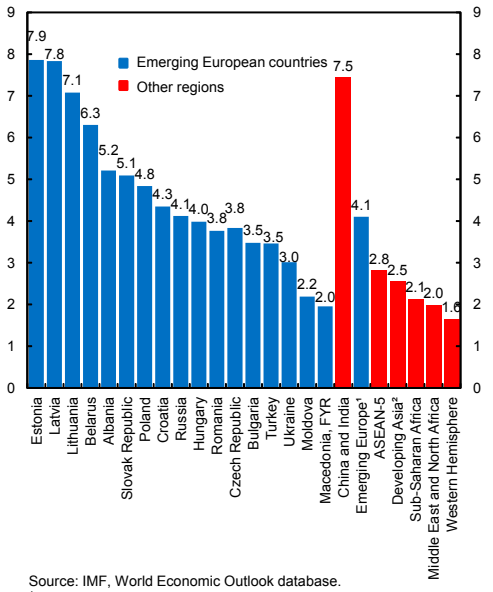
Two years after the collapse of Lehman Brothers, emerging Europe[22] has begun its recovery from its deepest post-transition recession. While the recovery remains uneven and export-led (Chapter 2), the banking and currency crises that many initially feared have largely been avoided. This chapter addresses three questions: Why was emerging Europe so severely affected by the global crisis? Why were the banking and currency crises that many had feared avoided? What lessons for crisis prevention can be drawn from the boom-bust cycle?

How the Global Financial and Economic Crisis Affected Emerging Europe—A Narrative

The Run-up to the Crisis

In the decade and a half prior to the global economic crisis, emerging Europe grew faster than almost all other emerging market regions. Per capita income in the region grew by 4 percent annually during 1995–2007—exceeded only by China and India (Figure 38). Growth was helped by the transition from a planned to a market economy. Institutions were modernized, often in the context of an EU accession process. Foreign direct investment poured in to benefit from highly skilled labor. Great strides were made toward trade and financial integration with western Europe. Economic growth was further stimulated by the anticipation of rapid future income growth, declining real interest rates, and increasingly buoyant global economic and financial conditions.

Figure 38. Emerging Europe and Selected Regions: Real Per Capita GDP Growth, 1995–2007
(Annual percentage change in PPP terms)



Source: IMF, World Economic Outlook database.
[1]Includes Czech Republic and Slovak Republic.
[2]Excludes China and India.

Until 2003, growth was driven largely by exports. Exports grew rapidly, as trade became integrated with the West. By 2007, the euro area had become the main trading partner of most countries in the region (Tables 8 and 9).[23] Owing to their geographic proximity and relatively low labor costs, central and eastern Europe (CEE) countries became part of an integrated cross-border production chain, with western European manufacturers shifting the production of components and intermediate goods to the east. German automakers were particularly active in outsourcing to CEE countries.[24] During this decade capital inflows remained moderate and went largely to the tradable sector.

Note: The main authors of this chapter are Yuko Kinoshita, Johan Mathisen, and Jérôme Vandenbussche.

[22] Two advanced countries (the Czech and Slovak Republics), which until 2009 were classified as emerging markets, have been included in this analysis as well, given the valuable lessons their experiences provide.

[23] Commodity exporters such as Russia and Ukraine trade with a broader set of countries. The Baltics trade mainly with Russia and their neighboring countries.

[24] Russia and Ukraine remained predominantly commodity exporters.

Table 8. Emerging Europe: Exports of Goods, 1995–2007
(Percent of GDP)

	Levels			Changes		
	1995	2003	2007	1995–2003	2003–07	1995–2007
Moldova	51	41	31	-11	-9	-20
Ukraine	41	48	35	8	-14	-6
Croatia	21	18	21	-3	3	1
Romania	23	30	24	7	-6	1
Albania	7	8	10	0	2	2
Lithuania	42	38	44	-3	5	2
Russia	25	31	27	6	-3	2
Estonia	49	57	51	8	-6	3
Latvia	26	26	29	0	3	3
Turkey	10	16	17	6	1	7
Bulgaria	40	37	47	-3	10	7
Macedonia, FYR	27	30	36	3	6	9
Belarus	44	56	54	12	-2	10
Poland	16	25	33	8	8	17
Czech Republic	39	53	70	14	17	32
Slovak Republic	44	61	78	17	17	34
Hungary	28	51	69	23	18	41
Bosnia and Herzegovina	...	14	21	...	7	...
Montenegro, Rep. of	...	...	12	...	...	...
Serbia	...	...	19	...	...	...

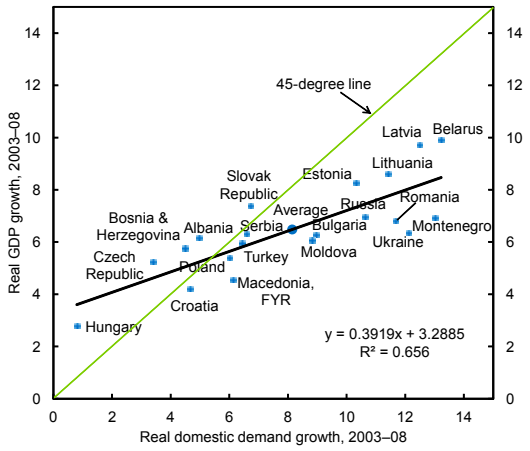
Sources: IMF, Direction of Trade Statistics database and World Economic Outlook database.

Table 9. Emerging Europe: Direction of Exports, 2007
(Percent of GDP)

	Euro Area	EE and CIS	Other	Total
Albania	8	1	1	10
Montenegro, Rep. of	8	3	0	12
Turkey	6	3	8	17
Serbia	9	8	2	19
Bosnia and Herzegovina	13	7	1	21
Croatia	11	7	4	21
Romania	13	7	4	24
Russia	11	8	9	27
Latvia	6	15	8	29
Moldova	15	13	3	31
Poland	18	9	6	33
Ukraine	6	18	11	35
Macedonia, FYR	22	10	3	37
Lithuania	11	22	11	44
Bulgaria	23	16	9	47
Estonia	16	17	19	51
Belarus	12	31	10	54
Hungary	40	20	9	69
Czech Republic	46	17	7	70
Slovak Republic	40	27	11	78

Sources: IMF, Direction of Trade Statistics database and World Economic Outlook database.

Figure 39. Emerging Europe: Domestic Demand Growth and GDP Growth, 2003–08[1]
(Annual average percentage change)



Sources: IMF, *International Financial Statistics* and World Economic Outlook database.
[1]As the boom in the Baltic states ended in 2007, data for the Baltics refer to 2002–07.

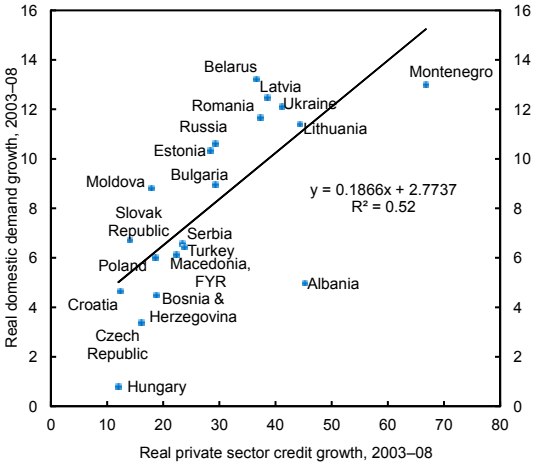
From 2003 onward, however, growth in the region was driven increasingly by a domestic demand boom (Figure 39). During 2003–08, domestic demand growth in the region averaged 8 percent annually—well above GDP growth (6½ percent per year). The boom was particularly pronounced in the Baltic and European CIS countries, together with Bulgaria, Montenegro, and Romania, where domestic demand grew by 9–13 percent. In other countries (including Albania, Bosnia, Croatia, Czech Republic, Macedonia, Poland, the Slovak Republic), domestic demand growth was more moderate (4–6 percent per year). Domestic demand was weak only in Hungary, partly as the result of the substantial fiscal consolidation that took place in the precrisis years.

There was not only a boom in *private* sector demand; public expenditure grew rapidly as well. The boom in domestic demand and the increase in commodity prices (in commodity exporters such as Russia) led to a sharp increase in government revenues. Only part of this revenue surge was used to improve fiscal balances.[25] Over the five-year period, only Bulgaria, Croatia, the Czech Republic, Hungary, Montenegro, and Turkey improved their fiscal balance by 3 percentage points of GDP or more. Instead, buoyant revenues were used mainly to increase public expenditure.[26] Real expenditure growth exceeded real GDP growth in every country, except in Macedonia. By 2008, only Belarus, Bulgaria, Montenegro, and Russia ran fiscal surpluses.[27]

The demand boom was the result of a surge in bank credit and asset prices (Figures 40 and 41). Although

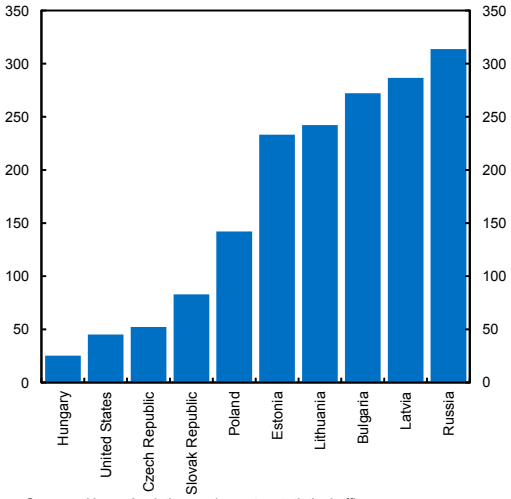
[25] See Rahman (2010).
[26] Rosenberg and Sierhej (2007) find that EU-related transfers also contributed to procyclical fiscal policy in the New Member States.
[27] Although Russia's fiscal policy had been procyclical, the fiscal balance improved, primarily owing to rising oil prices.

Figure 40. Emerging Europe: Domestic Demand and Private Sector Credit Growth, 2003–08[1]
(Annual average percentage change)



Sources: IMF, *International Financial Statistics* and World Economic Outlook database.
[1]As the boom in the Baltic states ended in 2007, data for the Baltics refer to 2002–07.

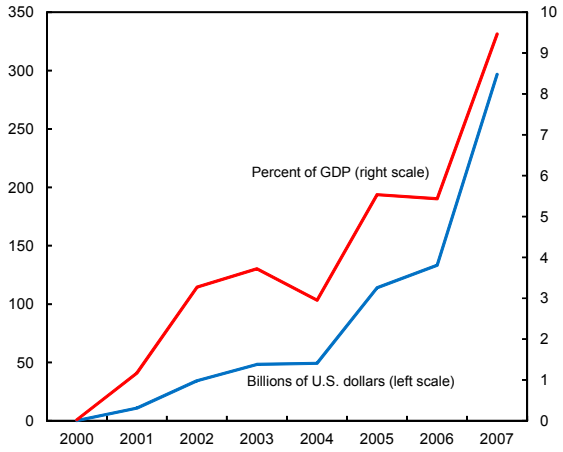
Figure 41. Emerging Europe: Change in Real Estate Prices, 2003–08[1]
(Percentage change)



Sources: Haver Analytics; and country statistical offices.
[1]As the boom in the Baltic states ended in 2007, data for the Baltics refer to 2002–07.

much of the credit increase reflected the development of an initially undersized financial sector, the speed of credit growth exceeded what could be justified by appropriate financial deepening and jeopardized macroeconomic stability (WIIW, 2010). Housing prices rose sharply (Figure 41), and even equity markets surged, with an average annual increase of some 40 percent.

Figure 42. Emerging Europe: Net Capital Flows, 2000–07

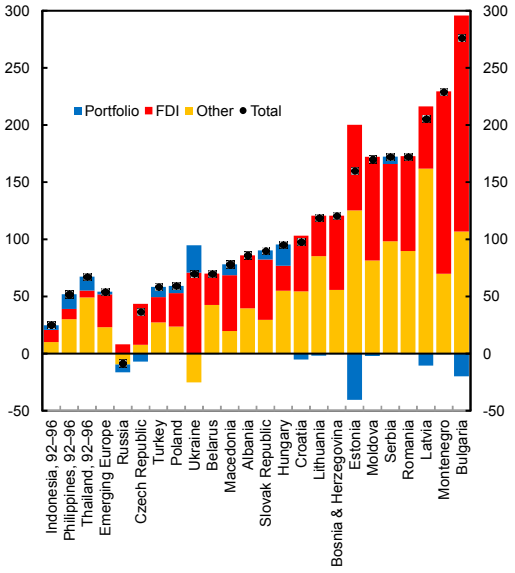


Source: IMF, *International Financial Statistics*.

The domestic demand boom was fueled and financed by unprecedented capital inflows (Figure 42). Emerging Europe as a whole has been the beneficiary of large capital inflows since the late 1990s. Initially, the region's post-transition reforms, growth prospects, and integration with western Europe were the main factors that pulled foreign capital into the region. From 2003 onward, push factors—low interest rates in advanced countries and low global volatility—further boosted capital inflows, as did the expectation of euro adoption and the dismantling of barriers to capital flows in the context of EU accession (Rosenberg and Tirpak, 2008). Capital inflows became very large by historical standards and compared with other emerging market economies. The size and composition of the capital inflows varied significantly across countries, and some countries managed to avoid large capital inflows altogether (Figure 43). Capital inflows were particularly large in the Baltic countries and southeastern Europe (SEE), whereas the more mature economies of Poland and the Czech Republic with flexible exchange rates and small interest rate differentials to the euro received much more modest inflows.

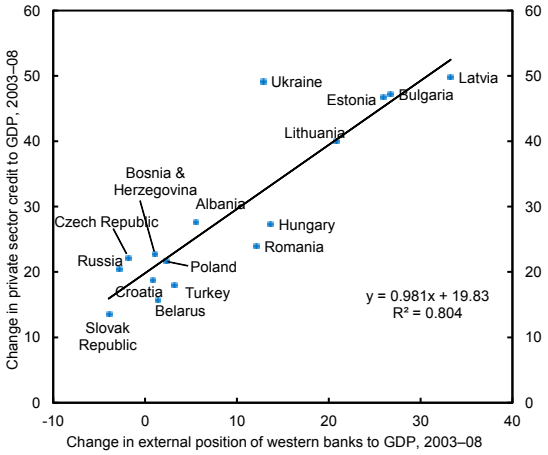
Capital flows from western European banks were particularly important in fueling the demand boom.

Figure 43. Emerging Europe: Cumulative Net Capital Inflows, 2003–08[1]
(Percent of 2003 GDP)



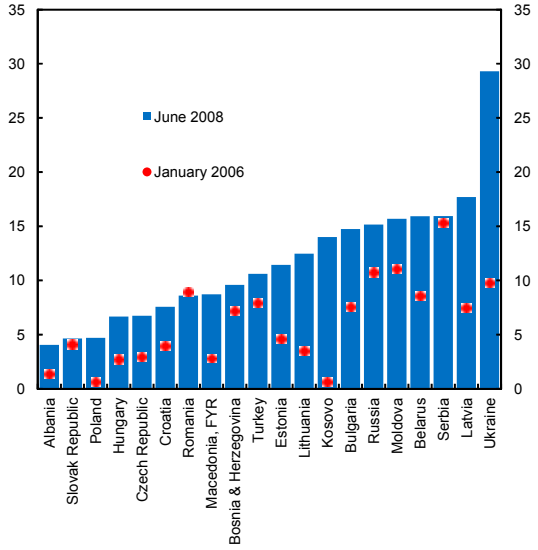
Source: IMF, World Economic Outlook database.
[1]As the boom in the Baltic states ended in 2007, data for the Baltics refer to 2002–07 in percent of 2002 GDP.

Figure 44. Emerging Europe: Change in External Position of Western Banks and Private Sector Credit, 2003–08[1]



Sources: IMF, World Economic Outlook database and *International Financial Statistics*; and BIS locational banking statistics (Table 6A).
[1]As the boom in the Baltic states ended in 2007, data for the Baltics refer to 2002–07.

Figure 45. Emerging Europe: Consumer Price Inflation, 2006 and 2008
(Annual percentage change)



Source: Haver Analytics.

Western European banks provided direct cross-border lending and financed much of the credit increase through deposits and capital injections to their local subsidiaries (Figure 44). With low margins in western Europe, western banks became increasingly interested in expanding in eastern Europe, and came to dominate much of the region's banking systems as they acquired local banks that were privatized or put up for sale by their private owners.

The domestic demand boom contributed to rapid GDP growth but also led to a sharp increase of current account deficits, and an overheating of the economy. The current account deterioration was particularly pronounced in countries where domestic demand expanded by more than 8 percent per year—with the exception of Russia, where terms-of-trade improvements to a large extent offset the impact of rising domestic demand.[28] With rapid growth, inflation started to pick up (Figure 45), labor markets tightened, and wage costs accelerated. Overheating was particularly pronounced in the Baltic countries, Bulgaria, Montenegro, and the CIS countries. The Czech Republic, Hungary, Poland, and the Slovak Republic managed to avoid much of the overheating—the Czech and Slovak Republics also saw a substantial reduction in their current account deficits.

While current account deficits were to a large extent financed by FDI inflows, these FDI inflows increasingly went to the nontradable sector (financial

[28] In some countries with less pronounced demand booms, such as Albania and Bosnia and Herzegovina, current account deficits were already high prior to 2003.

services, real estate, and construction).[29] As more resources were drawn to the nontradable sector, growth became unbalanced. By 2007, the share of nontradable FDI was significantly higher in SEE and the Baltics than in CEE (Figure 46). The shift to the nontradable sector was not a problem in all countries: in CEE, where the share of manufacturing in FDI is high, the shift was largely avoided.

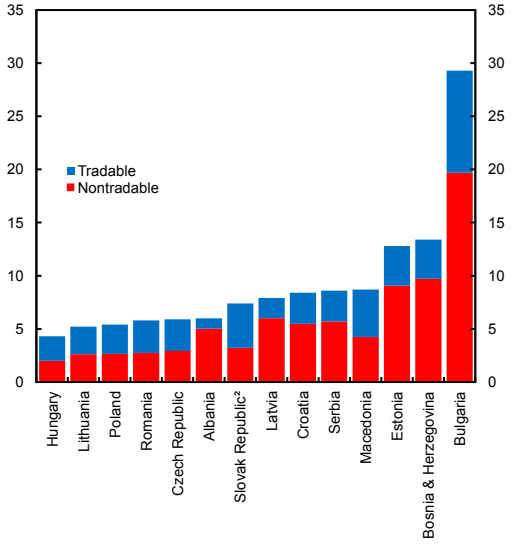
By 2007, the growth pattern of many countries seemed unsustainable and vulnerable to a sudden decline in capital inflows. Growth had become reliant on domestic demand, supported by a continued rapid expansion of credit, large capital inflows, and continued asset price appreciation (Figure 47). As demand depended so much on credit growth that was financed from abroad, any slowdown or reversal of foreign financing was bound to hit the economy hard. Moreover, since the majority of loans were foreign currency denominated in much of the region, an exchange rate depreciation resulting from a slowdown of capital flows would have had powerful adverse balance sheet effects and could have undermined financial stability (Figure 48). Large external debt that had built up over years of substantial current account deficits meant that a decline of roll-over rates would have put debtors in a tight spot. Because much of the external debt was owed by banks, financial stability was potentially also at risk from this perspective.

Not all countries were equally affected by these imbalances and vulnerabilities, and some countries managed to avoid them altogether. These differences were in part the result of different policy reactions and institutions.

- *Monetary and exchange rate policy:* Countries with fixed exchange rate regimes and deep financial integration with western Europe had few instruments to stop the credit boom. Moreover, inflation in the wake of the credit boom drove real interest rates lower, further fueling the demand boom. Countries with floating exchange rate regimes were able to tighten monetary conditions by letting the nominal exchange rate appreciate.
- *Fiscal policy:* Fiscal policy was procyclical during the boom in most of emerging Europe, with the

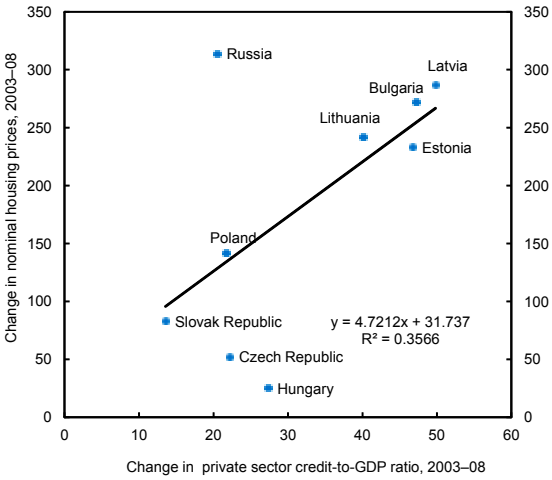
Figure 46. Emerging Europe: Foreign Direct Investment Flow in Tradable and Nontradable Sectors, 2007[1]

(Percent of GDP)



Sources: IMF, World Economic Outlook database; and WIIW Database on Foreign Direct Investment.
[1]The tradable sectors consist of manufacturing, agriculture, mining, retail, hotels, and restaurants, while the nontradable sectors are construction, electricity, transport, communication, real estate and financial intermediation.
[2]Data refer to 2006.

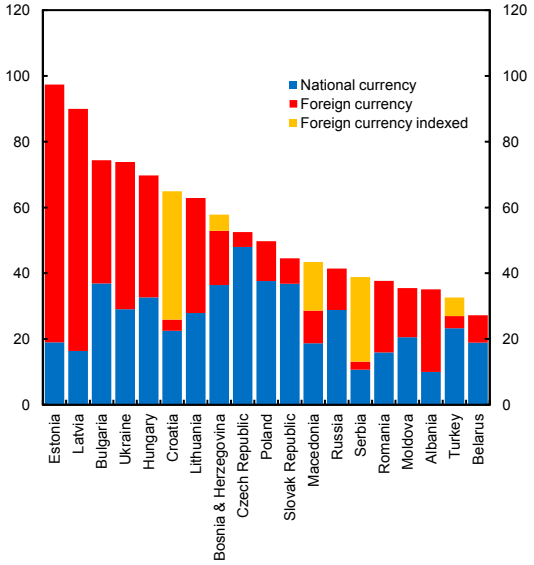
Figure 47. Emerging Europe: Private Sector Credit and Housing Prices, 2003–08[1]



Sources: IMF, *International Financial Statistics*; and country statistical offices.
[1]As the boom in the Baltic states ended in 2007, data for the Baltics refer to 2002–07.

[29] Kinoshita (forthcoming).

Figure 48. Emerging Europe: Total Private Sector Credit by Currency, 2008
(Stock in percent of GDP)



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

notable exception of Hungary, which began tackling long-standing fiscal weaknesses from 2007. During the boom years, public finances were mostly improving, reflecting a strong revenue performance (Table 10). This was particularly pronounced in countries that relied heavily on domestic absorption.[30] By 2008, countries with the most rapid public expenditure growth were showing the most pronounced signs of overheating. In these countries, fiscal policy was procyclical in the sense that it further exacerbated private sector demand pressures.

- *Financial sector policy:* Many countries had taken prudential and supervisory measures in the form of tightening the existing regulations to stem credit growth but they had limited effects.[31] In Bulgaria, Croatia, and Serbia, administrative measures had been taken through direct credit controls or marginal reserve requirements on foreign borrowing. However, such efforts to slow down credit often diverted inflows into less supervised channels. For example, Bulgaria introduced bank-by-bank credit ceilings in 2005–06, which seemingly reined in credit growth but also accelerated direct cross-border borrowing by firms. Also in Croatia corporate entities turned to direct borrowing from parent banks abroad instead of channeling loans through the domestic banking system where restrictions were high.

Despite these large variations in vulnerabilities, markets failed to differentiate between countries. Indeed, as vulnerabilities increased, risk premiums declined, and some of the countries with the highest vulnerabilities continued to enjoy investment grade status (IMF, 2010g).

The First Stage of the Global Crisis

Between the start of the global crisis in August 2007 and September 2008, GDP growth in emerging Europe remained generally strong. Despite the market turmoil in the United States and uncertainty in the global economy, capital continued to flow into emerging Europe and CDS and bond spreads in the region rose only moderately. Most equity markets lost steam from late summer 2007, but apparently without repercussions for real activities. Indeed, as inflation was rising rapidly, in part driven by booming food and fuel prices, controlling inflation became the main policy challenge. The focus of policymakers in the region remained to engineer a soft landing of their economies rather than preparing for an impending crisis.

The Baltic countries were the first to experience a slowdown, albeit initially for reasons unrelated to the global turmoil.[32] Swedish banks had started to slow credit growth in the summer of 2007, as they became increasingly concerned about their exposure to the region.

Hungary experienced a short episode of financial stress in March 2008. It embarked on a fiscal consolidation program starting in mid-2006 to tackle long-standing twin deficits. The fiscal deficit and the

[30] Rahman (2010).

[31] See Chapter 2 of the May 2010 *Regional Economic Outlook: Europe* (IMF, 2010g) on managing capital flows.

[32] See Purfield and Rosenberg (2010) for a discussion of recent crises in the Baltics.

Table 10. Emerging Europe: General Government Overall Balance[1]
(Percent of GDP)

	2003	2004	2005	2006	2007	2008	2009	2010
Albania[2]	-4.6	-5.0	-3.5	-3.3	-3.6	-5.1	-7.4	-4.1
Belarus[2]	-1.0	0.0	-0.7	1.4	0.4	1.3	-0.7	-3.4
Bosnia and Herzegovina	-1.7	-0.5	0.6	1.1	-0.3	-3.6	-5.7	-4.5
Bulgaria[2]	0.0	1.7	2.4	3.5	3.5	3.0	-0.9	-4.9
Croatia[2]	-4.8	-3.4	-2.8	-2.6	-2.4	-1.3	-4.1	-5.3
Estonia	2.2	1.6	1.6	3.2	2.9	-2.3	-2.1	-1.1
Hungary[3]	-7.2	-6.4	-7.9	-9.4	-5.0	-3.7	-4.1	-4.2
Kosovo[2]	1.6	-4.9	-3.1	2.5	4.9	-0.2	-0.8	-3.4
Latvia[2,4]	-1.7	-1.2	-1.3	-0.5	0.6	-7.5	-7.8	-11.9
Lithuania	-1.3	-1.5	-0.5	-0.4	-1.0	-3.3	-8.9	-7.7
Macedonia, FYR	-0.1	0.4	0.2	-0.5	0.6	-0.9	-2.6	-2.5
Moldova[2]	0.7	0.7	1.5	0.0	-0.2	-1.0	-6.4	-5.4
Montenegro[2]	-2.9	-1.8	-1.1	2.6	6.3	1.5	-4.4	-7.1
Poland	-6.2	-5.4	-4.1	-3.6	-1.9	-3.7	-7.1	-7.4
Romania	-2.2	-3.4	-0.7	-1.4	-3.1	-4.8	-7.4	-6.8
Russia[2]	1.4	4.9	8.2	8.3	6.8	4.3	-6.2	-4.8
Serbia, Republic of[2]	-2.9	0.0	0.8	-1.6	-1.9	-2.6	-4.1	-4.8
Turkey[2,5]	-10.4	-4.4	-0.6	-0.6	-2.1	-2.9	-6.2	-4.0
Ukraine[2]	-0.9	-4.4	-2.3	-1.4	-2.0	-3.2	-6.2	-5.5
Emerging Europe[6]	-2.7	-0.3	2.2	2.4	1.8	0.2	-6.0	-5.2
Memorandum								
Czech Republic	-6.6	-2.9	-3.6	-2.6	-0.7	-2.7	-5.9	-5.4
Slovak Republic	-2.8	-2.4	-2.8	-3.4	-1.9	-2.3	-6.8	-8.0
Slovenia[2]	-1.4	-1.4	-1.1	-0.8	0.2	-0.3	-6.1	-5.8

Source: IMF, World Economic Outlook database.

[1]As in the WEO, general government overall balances reflect staff's projections of a plausible baseline, and as such contain a mixture of unchanged policies and program effort.

[2]Reported on a cash basis.

[3]For Hungary, the general government overall balance projections include staff projections of the macro framework and of the impact of existing legislated measures, as well as fiscal policy plans as announced by end-August 2010. To meet the recently announced commitments of the government to balances of 3.8 percent of GDP in 2010 and 3 percent of GDP in 2011, the authorities will need to approve additional measures.

[4]In Latvia, the widening of the 2010 headline deficit reflects one-off bank restructuring costs of about 3.5 percent of GDP.

[5]Fiscal projections assume the authorities adhere to the 2010 and 2011 targets set in their September 2009 medium-term program.

[6]Includes Albania, Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, Estonia, Hungary, Kosovo, Latvia, Lithuania, Macedonia, Moldova, Republic of Montenegro, Poland, Romania, Russia, Republic of Serbia, Turkey, and Ukraine. Average weighted by GDP valued at purchasing power parity (PPP).

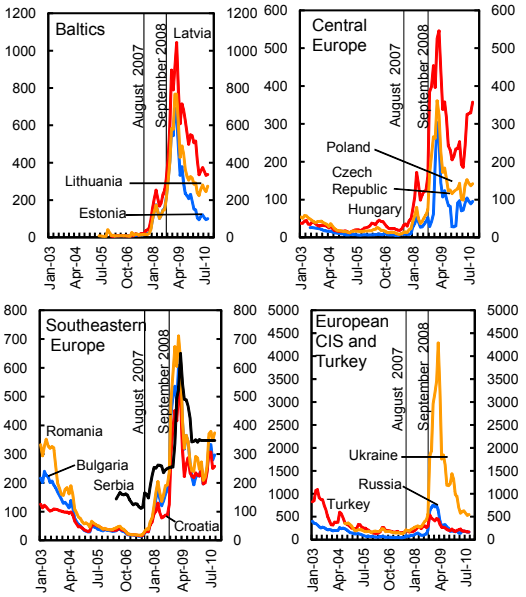
current account deficit narrowed in 2007, and real GDP growth slowed from 4 percent in 2006 to 1¼ percent in 2007. However, Hungary's debt stock vulnerabilities were unsettlingly high. Government bond markets were briefly thrown into turmoil in the spring of 2008 when a government auction ran into trouble. The exchange rate depreciated by 5 percent, and CDS rates shot up to almost 200 basis points and remained elevated.

The Collapse of Lehman Brothers and Its Aftermath

The global crisis spilled over to emerging Europe in September 2008, after Lehman Brothers filed for bankruptcy, through financial and trade channels. In a matter of weeks, global financial markets froze and international trade collapsed.

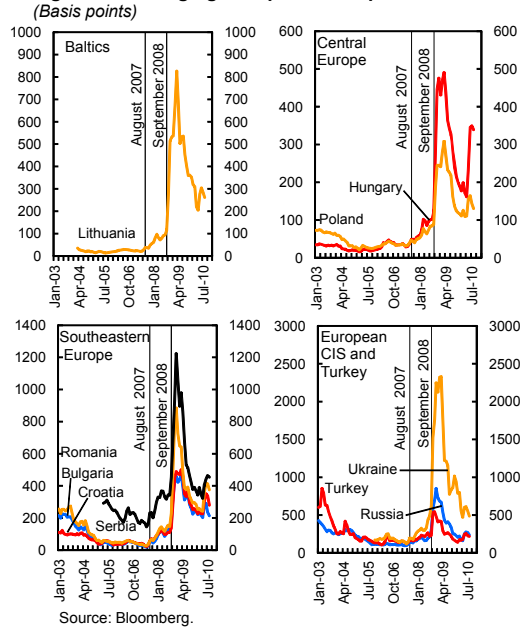
Risk aversion rose sharply, and equity markets plunged. Sovereign CDS spreads jumped by several hundred basis points in a matter of days in the Baltic countries, Hungary, Romania, Russia, Turkey, and Ukraine (Figure 49). The size of this increase was not indiscriminate but amplified pre-Lehman cross-country differences. CDS and the Emerging Markets Bond Index (EMBI) spreads remained very high through the end of the first quarter of 2009 and then started a slow, gradual decline (Figure 50). Equity markets, which had corrected since the summer of 2007 (or the fall of 2007 in the case of Russia and Turkey), suddenly plunged as both domestic and international investors retreated and only bottomed out in February or March 2009 after falling by more than 60 percent (and up to 85 percent in Bulgaria) (Figure 51).

Figure 49. Emerging Europe: CDS Spreads
(Basis points)



Sources: Bloomberg; and Datastream.

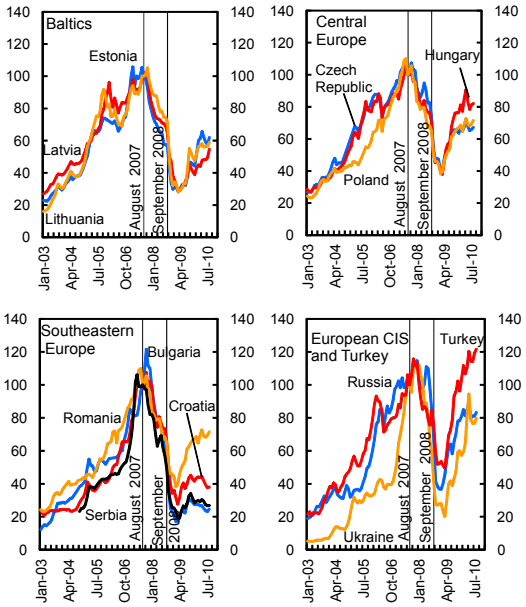
Figure 50. Emerging Europe: EMBI Spreads
(Basis points)



Source: Bloomberg.

Some governments faced financing problems. Countries with relatively more developed financial markets (Czech Republic, Hungary, Poland, Russia, and Turkey) witnessed a reversal of international portfolio flows, which in the case of Hungary translated into a drying up of the domestic bond market and looming financing problems for the government as early as October 2008. In addition,

Figure 51. Emerging Europe: Stock Market Indices
(Index Aug. 2007 = 100)



Source: Bloomberg.

Table 11. Emerging Europe: Gross International Sovereign Bond Issuance, 2008:Q1–2010:Q1
(Millions of U.S. dollars)

	2008				2009				2010	
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Total
Macedonia	0	0	0	0	0	244	0	0	0	244
Latvia	608	0	0	0	0	0	0	0	0	608
Croatia	0	0	0	0	0	1050	0	1500	0	2550
Romania	0	1163	0	0	0	0	0	0	1429	2592
Slovak Republic	0	0	0	0	0	2648	0	0	0	2648
Lithuania	0	0	0	105	188	700	0	1500	2000	4493
Czech Republic	0	3106	0	0	0	1986	438	492	0	6022
Hungary	0	2668	0	0	0	0	1397	0	2000	6066
Turkey	2000	500	1500	0	1000	1500	1250	0	3000	10750
Poland	474	3311	0	0	1292	1003	4208	1828	6444	18560
TOTAL	3081	10748	1500	105	2480	9132	7293	5320	14873	54532

Source: Dealogic.

issuance of international sovereign bonds, which had already shown signs of weakness during the third quarter, came to a near-freeze during the fourth quarter when the total issuance volume for the region was only US$105 million (Table 11). This reflected both supply and demand factors because governments in the region, such as Poland's, opted to stay away from the euro market hoping that the increase in spreads would only be temporary, and turned instead to the domestic market.

Banks experienced funding pressures. Many advanced-country banks, which were confronted with liquidity and capital shortages, sharply curtailed new lending or even deleveraged at the group level.

In a change of strategy, they advised their subsidiaries and branches in emerging Europe that new credit would henceforth need to be financed solely from an increase in local deposits.[33] This effect was compounded by the freezing of the international syndicated loans market (Table 12), as well as a halt in the growth of direct cross-border loans. As a reflection of these developments, the external positions of banks reporting to the Bank for International Settlements vis-à-vis countries in the region stagnated or started to decline (particularly in Estonia, Latvia, and Ukraine; see Table 13).

Banks' funding pressures were further exacerbated by deposit withdrawals in October and November of 2008, in particular, in Montenegro, Russia, and Ukraine (Table 14). Foreign parent banks responded by providing liquidity support when and where necessary, but deposit rates started to creep up from that moment on. Nevertheless, a banking crisis could not be avoided in Latvia and Ukraine, where depositor confidence faltered and large domestic banks had to be taken over and recapitalized by the government (Box 7).

Net capital inflows dropped, sometimes very sharply (Figures 52 and 53). However, they remained positive in most countries, with the notable exception of Russia where large net capital outflows occurred. The highly indebted Russian corporate sector took advantage of the inflexible exchange rate framework to hedge its foreign currency exposure while Russian banks built up their net foreign assets. Foreign investors meanwhile reversed their carry trades when rapidly declining oil prices pointed to a likely exchange rate depreciation for the ruble.

Table 12. Emerging Europe: Volume of International Syndicated Loans Issuance to Banks in 2008[1]
(Millions of U.S. dollars)

	2008:Q1	2008:Q2	2008:Q3	2008:Q4
Albania	0	0	0	14
Belarus	43	123	162	15
Bosnia and Herzegovina	0	47	0	0
Bulgaria	22	430	299	43
Croatia	0	0	155	0
Czech Republic	0	0	0	0
Estonia	0	78	32	0
Hungary	279	0	0	0
Latvia	508	23	297	0
Lithuania	0	31	0	0
Macedonia, FYR	0	0	0	0
Moldova	31	0	0	26
Montenegro	0	0	0	0
Poland	78	16	244	0
Romania	51	16	0	316
Russia	1118	4239	2363	1877
Serbia	0	0	0	0
Slovak Republic	0	0	0	0
Turkey	0	1033	4947	1585
Ukraine	349	592	809	200
TOTAL	2479	6628	9309	4075

Source: Dealogic.
[1]Data include loans from the EBRD, EIB, and IFC, and exclude loans from parent banks.

Table 13. External Positions of Western Banks vis-à-vis Emerging Europe
(Percent of 2009 GDP, adjusted for exchange rate changes)

	Stocks			Flows		Change in flows
	2007: Q3	2008: Q3	2009: Q3	2007:Q3–2008:Q3	2008:Q3–2009:Q3	
Latvia	71	89	80	18	-10	-28
Bulgaria	28	52	50	24	-2	-26
Ukraine	22	34	25	12	-9	-21
Hungary	58	75	72	17	-3	-20
Lithuania	43	60	58	17	-2	-19
Estonia	91	101	93	10	-8	-18
Romania	32	44	39	13	-5	-18
Montenegro	15	36	40	20	4	-16
Czech Republic	22	28	24	6	-4	-10
Poland	22	29	28	8	-1	-9
Turkey	20	25	21	5	-4	-9
Russia	15	17	12	3	-5	-8
Moldova	7	12	11	5	-1	-6
Serbia	21	28	28	6	1	-6
Bosnia and Herzegovina	23	28	29	5	2	-3
Croatia	65	70	72	5	2	-3
Belarus	5	6	5	1	-1	-2
Macedonia, FYR	4	7	7	2	0	-2
Albania	4	6	10	1	5	4

Sources: BIS, *Locational Statistics*; IMF, World Economic Outlook database.

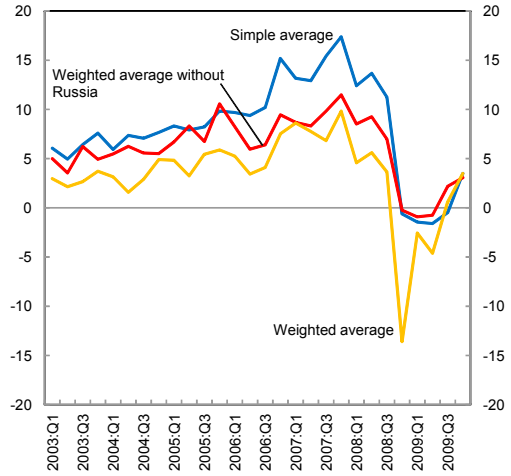
[33] Parent banks continued to support their subsidiaries, and when liquidity pressure emerged they temporarily increased their exposure.

Table 14. Emerging Europe: Private Sector Domestic Currency Deposits, Oct 2008–Mar 2009[1]
(Index Sep 2008 =100)

	Oct 2008	Nov 2008	Dec 2008	Mar 2009
Montenegro[2]	92	86	83	69
Ukraine	91	86	85	74
Russia	96	86	82	76
Moldova	97	96	98	77
Belarus	99	96	99	77
Macedonia, FYR	99	92	94	81
Latvia	99	93	93	82
Croatia	96	96	100	87
Lithuania	94	92	96	89
Serbia	99	98	100	91
Bosnia and Herzegovina	92	90	95	91
Albania	97	96	98	93
Estonia	98	96	99	95
Bulgaria	96	95	104	100
Romania	96	96	102	101
Czech Republic	99	101	104	103
Slovak Republic	101	104	116	107
Turkey	105	106	109	111
Hungary	104	107	112	111
Poland	101	103	108	112

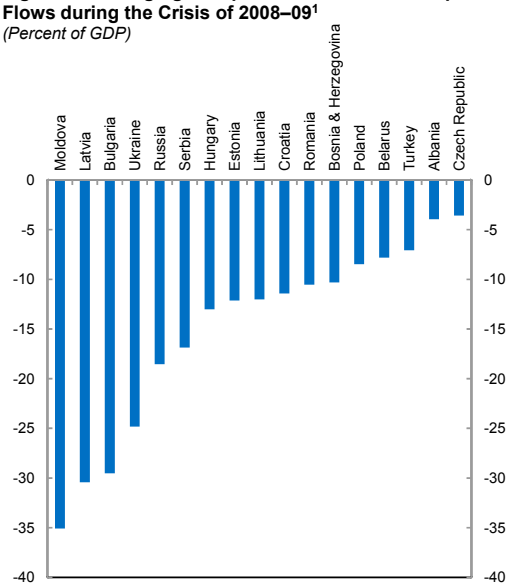
Sources: IMF, *International Financial Statistics*; Haver Analytics; and IMF staff calculations.
[1]Deposits of households and nonfinancial corporations.
[2]Deposits in all currencies.

Figure 52. 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.

Figure 53. Emerging Europe: Reduction of Net Capital Flows during the Crisis of 2008–09[1]
(Percent of GDP)



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 seasonally adjusted.

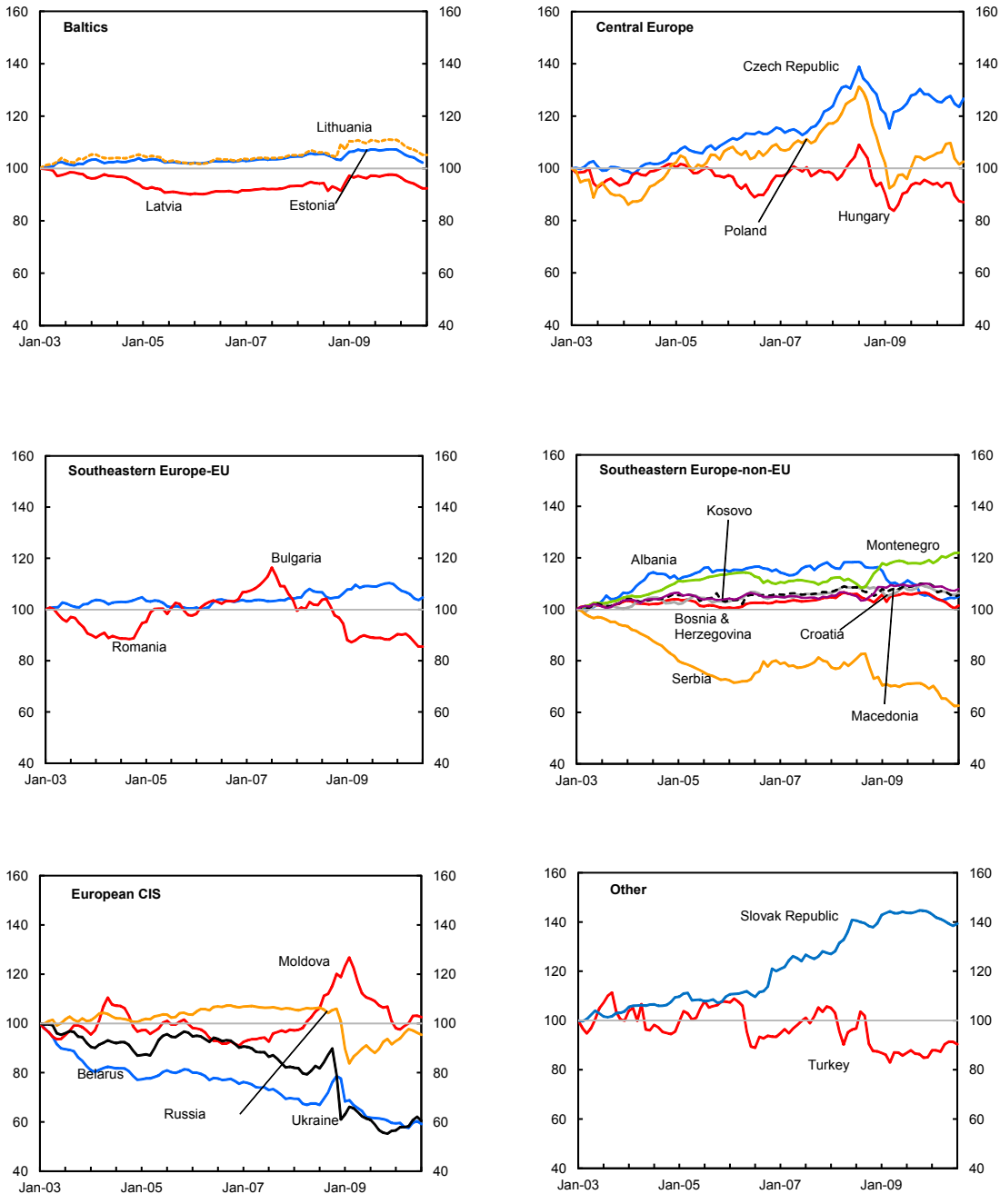
Exchange rates generally came under pressure (Figure 54). In countries such as the Czech Republic, Hungary, Poland, Romania, Russia, Serbia, and Ukraine, exchange rates fell sharply even while (some) central banks attempted to slow the pace of the depreciation. Most countries with a fixed exchange rate regime lost significant amounts of reserves. The evolution of an exchange rate pressure index based on monthly changes in nominal exchange rates and in international reserves suggests that pressures were broad-based in October 2008 (Table 15). By the end of November pressures were greatest in Latvia and Ukraine, perhaps owing to the brewing banking crises in these countries. Early pressures in October on the Hungarian forint were relieved thanks to the prompt corrective actions of the government in the context of an IMF-supported program (see the next section), while Russia first engineered a controlled and very gradual depreciation of the ruble during the last quarter of 2008, before letting the exchange rate go in the first quarter of 2009. But in the end, only Ukraine suffered from both an exchange rate and banking crisis.

The Impact on the Real Economy

The collapse in global trade soon led to a very sharp drop in exports. For large commodity exporters such as Russia (oil) and Ukraine (steel), the decline in export volumes was compounded by the sharp correction of commodity prices.

At the same time, domestic demand was affected by a sharp slowdown in credit growth and the

Figure 54. Emerging Europe: Nominal Effective Exchange Rates
(Index August 2008 = 100)



Source: IMF, *Information Notice System*.

Box 7. Banking Problems in Emerging Europe during 2008–09

In looking for instances of systemic banking crises in emerging Europe, we follow Laeven and Valencia's (2010) definition. They define a banking crisis as a situation in which at least three types of significant public interventions were necessary to stabilize a banking system (see table). According to this methodology, only two countries in emerging Europe, Latvia and Ukraine, had a systemic banking crisis during 2008–09. Two other countries, Hungary and Russia, had some symptoms of a systemic banking crisis but they were of a lesser magnitude.

Banking Crises in Emerging Europe during 2008–09

Country	Extensive liquidity support	Significant restructuring costs	Significant asset purchases	Significant guarantees on liabilities	Significant nationalizations
Systemic crises					
Latvia	√			√	√
Ukraine	√	√			√
Borderline cases					
Hungary	√			√	
Russia	√			√	

Source: Laeven and Valencia (2010).

Note: Systemic banking crises are defined as cases where at least three of the listed interventions took place, whereas borderline cases almost met the definition of systemic crisis.

Latvia—Latvia's banking sector was particularly vulnerable to a sudden stop in capital flows because of its high loan-to-deposit ratio and the overheating of the domestic economy long before the Lehman Brothers bankruptcy. From end-August to end-November 2008, systemwide banking deposits fell by 10 percent. Parex Bank, the largest domestic bank and second largest bank overall, faced the greatest problems, losing one-fourth of its deposits. On November 10, the Latvian authorities passed a Parex-specific package of measures consisting of a state guarantee covering certain existing and new loans, a one-year government deposit to support the bank's immediate liquidity needs, and subordinated loans to strengthen its capital base. Initial responses to Parex Bank's growing illiquidity failed to stem the deposit run. On December 1, the authorities also imposed a partial freeze limiting withdrawal amounts from large noncommercial private deposits, then on December 5, they completed the takeover of 85 percent of the shares. On December 23, the European Commission approved a Latvian support scheme providing guarantees to eligible banks to ensure their access to financing.

An agreement was reached in March 2009 to reschedule Parex's syndicated loans. The bank was then recapitalized in May 2009 by converting government deposits into equity and subordinated debt. Deposit outflows then stabilized. The European Bank for Reconstruction and Development (EBRD) provided loans and acquired a 25 percent stake in September 2009. In October 2009, deposit withdrawal restrictions were partially lifted and the government made another injection into the bank in exchange for nonvoting shares. On August 1, 2010, Parex was split into a good bank (Citadele) and a bad bank. There have not been any disruptions to date. The government also provided two capital injections into state-owned Mortgage and Land Bank in 2009.

Ukraine—Large banking sector risks were built up during the boom years as a result of the exceptionally rapid credit growth that brought the loan-to-deposit ratio to 140 percent. Major strains started showing in the banking system in the fall of 2008. After the sixth largest bank (Prominvest Bank) was put under receivership, a widespread deposit outflow began. The authorities responded by imposing limits on early withdrawal of time deposits, which slowed the outflow, but confidence remained very fragile.

Note: The main author of this box is Jérôme Vandenbussche.

Persistent concerns led to the outflow of over 20 percent of deposits between October 2008 and March 2009, which accelerated the capital flight and devaluation pressures, with severe repercussions on the FX-denominated loan books. In response, the National Bank of Ukraine (NBU) extended large-scale liquidity support to the banking system. A forward-looking diagnostic study of a number of large banks was performed during the fourth quarter of 2008 and revealed large capital deficiencies. Following completion of the study, shareholders of all the foreign-owned banks injected the necessary capital as did those of most of the domestically owned banks. However, for five of the domestically owned banks the shareholders were unable or unwilling to bring in additional capital and the banks (Ukrprombank, Nadra Bank, Ukrgasbank, Rodovid Bank, and Kyiv Bank) were put under administration. For three of them a resolution strategy was implemented, including recapitalization by the government and appointment of a new management team. Ukrprombank is currently being liquidated, while the resolution of Nadra Bank is still pending.

Aggregate deposits stabilized in the spring of 2009, allowing the authorities to lift the ban on the early withdrawal of time deposits. A second diagnostic study for the smaller banks was completed in the spring of 2009. The shareholders of 27 banks undertook to provide additional capital by December 2009. As of the first quarter of 2010, the NBU was in the process of finalizing resolution strategies for those banks that were unable to raise the necessary capital.

Hungary—Hungary's largest bank, OTP, is listed on the Budapest Stock Exchange, has a dispersed ownership structure and a significant presence throughout emerging Europe through local subsidiaries. During the boom years, OTP had relied more and more on international borrowing at arm's length. When the crisis hit the region, OTP thus was at risk of loss of both investor and depositor confidence. To support confidence, the government issued on October 22, 2008, a political commitment for a blanket guarantee on all bank deposits.

As part of the IMF-supported program, the authorities then created in November 2008 a Capital Base Enhancement Fund, making available new capital to credit institutions in exchange for preferential shares. The scheme was open to all credit institutions of systemic importance on the market. It was extended twice and is now scheduled to expire on December 31, 2010. As of August 2010, only one credit institution, the mortgage lender FHB, had taken advantage of the recapitalization scheme.

In addition, in March 2009, Hungary enacted a liquidity scheme aimed at providing foreign currency loans to Hungarian financial institutions to enable them to maintain lending to the real economy in spite of the severe domestic and international liquidity shortage. Three Hungarian banks without a foreign parent (OTP, FHB, and MFB, the state-owned development bank) benefited from the scheme.

Russia—The sudden change in exchange rate expectations triggered by the collapse in oil prices in September 2008 led Russian banks and firms to seek to hedge their foreign currency exposures, exacerbating pressure on the ruble. The banking system was put under additional pressure by deposit outflows and some bank failures early on. Several small banks (Kit Finance, Svyaz Bank, Globex Bank, and Sobinbank) had to be rescued by state-owned banks or companies between mid-September and mid-October 2008.

On October 20, the government announced that it would widen the remit of the Deposit Insurance Agency (DIA) by injecting budgetary funds and that these funds would be used to bail out medium-sized banks. Soon after, on October 29, VEFK Bank was put under temporary administration. In April 2009, it received an equity injection and a subordinated loan from the DIA.

The authorities' efforts to stabilize the banking system during the fourth quarter of 2008 were aimed at providing significant liquidity while keeping the exchange rate stable to offset the abrupt loss of foreign financing. Starting in October 2008, the government auctioned excess budgetary funds to banks, while the Central Bank of Russia (CBR) provided an ever-widening array of liquidity facilities, including uncollateralized loans. The CBR also

…continued

Box 7. *(concluded)*

offered guarantees for interbank lending to qualifying banks, covering losses in the event that the license of a counterparty was withdrawn. In March 2009, another bank recapitalization scheme was announced which entailed an exchange of preferred shares for government bonds. With an improvement in overall bank liquidity, however, demand for this facility was relatively subdued, and it has been effectively shelved.

By and large, the Russian authorities' efforts proved successful in stabilizing their financial system. By late June 2009, with renewed inflows, local liquidity conditions and interbank lending had improved, while the stock of uncollateralized loans provided by the CBR at the height of the crisis was being rapidly repaid ahead of schedule.

Table 15. Emerging Europe: Exchange Rate Pressure Index, September 2008–May 2009

Country	Sep.08	Oct.08	Nov.08	Dec.08	Jan.09	Feb.09	Mar.09	Total
Russia	2.9	3.2	2.6	5.5	7.8	5.5	-0.8	26.8
Poland	4.4	6.7	2.6	3.3	3.4	2.2	0.1	22.6
Ukraine	-0.3	2.1	5.0	9.4	1.7	0.2	1.0	19.1
Serbia	1.4	6.9	4.7	0.3	5.6	0.4	-0.4	19.0
Romania	2.8	4.5	1.6	0.2	6.0	1.2	-0.5	15.8
Croatia	2.2	6.4	1.9	-0.7	5.9	2.3	-2.3	15.6
Albania	2.7	5.0	-1.4	-1.7	5.0	3.4	1.6	14.7
Bulgaria	2.0	6.0	2.0	-0.1	4.2	1.2	-1.7	13.8
Moldova	0.2	1.8	-0.2	1.7	2.1	0.8	5.0	11.5
Lithuania	2.9	3.9	4.8	-3.9	2.5	2.5	-1.6	11.2
Czech Republic	2.3	3.8	1.8	-0.3	4.0	1.5	-3.0	9.9
Latvia	0.0	5.6	6.0	-4.6	1.7	-0.2	1.3	9.7
Bosnia and Herzegovina	2.1	5.5	2.0	-3.5	2.8	1.6	-1.9	8.6
Macedonia, FYR	1.4	3.2	2.7	-1.5	1.6	1.5	-0.3	8.5
Estonia	3.4	1.5	3.4	-2.0	2.5	1.7	-1.9	8.5
Hungary	2.0	5.3	-2.3	-2.7	3.7	2.6	-2.1	6.5
Turkey	0.1	2.7	0.9	0.7	1.0	-0.2	0.8	5.9
Belarus	-0.2	-1.5	0.0	3.2	6.5	-0.7	-1.4	5.9

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

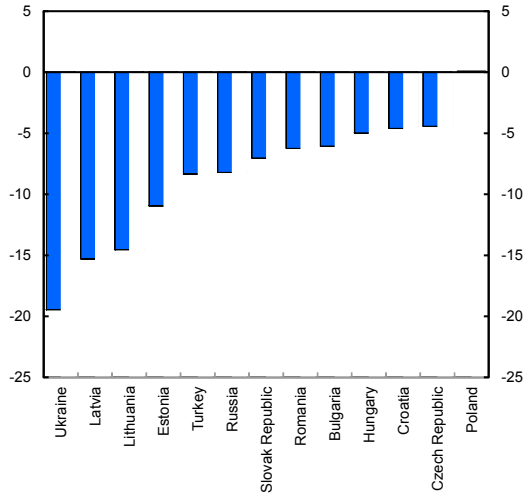
Note: The index is the sum of the deviation of monthly changes in the nominal exchange rate vis-à-vis the Special Drawing Right (SDR) from its mean and the deviation of the monthly change in international reserves in SDRs from their mean. Both changes are normalized by their standard deviation. A higher index indicates more pressure.

bursting of the real estate bubbles. The domestic demand decline was particularly pronounced in the Baltics and Ukraine, driven by a sharp fall in both consumption and investment. In the Czech Republic and Poland, which had been less affected by the credit-fueled domestic demand boom in the region, consumption remained stable or even marginally increased, thereby cushioning the overall domestic demand fall.

As a result, output in most countries declined very sharply (Figure 55). Seasonally adjusted GDP in Latvia, Lithuania, and Ukraine contracted by 16 percent, 15 percent, and 19 percent, respectively, between September 2008 and March 2009. A few countries escaped severe recession—Belarus, Macedonia, and Poland were only mildly affected by the downturn, while Albania continued to grow. The output decline in emerging Europe as a whole was larger than in other EMC regions, mainly because capital inflows corrected from a higher level in emerging Europe than elsewhere.[34]

[34] Emerging market countries were primarily affected through financial channels (Blanchard, Das, and Faruqee, 2010).

Figure 55. Emerging Europe: Real GDP Growth, 2008:Q3–2009:Q1
(Seasonally adjusted, in percent)



Sources: Eurostat; and Haver Analytics.

Policy Reactions

To contain the crisis, governments took a host of policy measures. Emergency measures were taken to support confidence in the banking sector. Rapid adjustments in monetary and fiscal policies were also implemented. In several cases, external funding was secured through IMF-supported programs and/or swaps and other arrangements with western European central banks. The policy mix depended on country-specific pressure points and constraints on policies.

Stabilizing the financial sector was key

As in the United States and western Europe, stabilizing the financial sectors was a priority. The financial sectors in emerging Europe benefited from measures taken by home country authorities in western Europe as well as both conventional and unconventional policy measures taken by the ECB and the Riksbank. Domestic policy measures also helped maintain the confidence of depositors and debt holders. These measures included loosening of reserve requirements, introduction of new domestic and foreign liquidity provision operations, debt guarantee schemes, as well as (almost universally) increases in deposit insurance coverage. Many supervisors strongly recommended a zero-dividend policy and sometimes requested preemptive recapitalizations based on stress tests (as in Romania and Ukraine). The authorities also intervened directly in selected individual distressed institutions to provide them with fresh liquidity or capital (as in Latvia, Montenegro, Russia, and Ukraine). Foreign currency liquidity support was sometimes made possible thanks to swap arrangements with western European countries' central banks, such as Estonia's arrangement with the Swedish Riksbank, Latvia's arrangement with Sweden and Denmark's central banks, and Hungary's and Poland's arrangements with the Swiss National Bank. The ECB entered into repo agreements with the Hungarian National Bank in October 2008 and with the National Bank of Poland in November 2008.[35]

Monetary and fiscal policy reactions differed: some countries had to give priority to financial market stabilization, while others could provide stimulus

Adjustments in official policy interest rates depended on the strength of downward exchange rate pressures. Where fast exchange rate depreciations or devaluations would have threatened private sector balance sheets because of direct or indirect foreign exchange risk, policy rates were temporarily increased (as in Croatia, Hungary, Russia, Serbia, and Ukraine) or put on hold (as in Latvia and Romania) in spite of the severity of the shock to the real economy. In other countries, policymakers were able to decrease policy rates (Czech Republic, Poland, and Turkey). Monetary and exchange rate policy frameworks were maintained, with the exception of Belarus, Russia, and Ukraine.[36]

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[35] See Allen and Moessner (2010).

[36] Russia devalued by about 20 percent and substantially widened the band for the ruble vis-à-vis the currency basket; following a 32 percent devaluation, Ukraine's de facto exchange rate regime was reclassified to "managed floating" from a

(continued)

The immediate fiscal policy response depended on precrisis fiscal buffers, the exchange rate regime, and the position in the political cycle. Countries with an already fragile fiscal situation, such as Hungary, accelerated fiscal adjustment measures. For the Baltic countries, maintaining the credibility of their pegged exchange regimes required large-scale consolidation measures despite low public debt, and even fiscal reserves in the case of Estonia. By contrast, others were able to let automatic stabilizers work or even allow discretionary fiscal relaxation. Poland chose to only partially offset the effects of previously planned tax cuts in 2008 and 2009. Russia and Turkey adopted fiscal stimulus packages. Bulgaria drew on its fiscal buffers and postponed most of the adjustment until the summer of 2009 when a new government took office. The Czech government put in place expansionary anticrisis measures in 2009, but quickly reversed course with the 2010 budget.

International official financing provided relief

Several countries secured IMF-supported programs. Large, front-loaded financial assistance packages from the IMF, in close cooperation with the EU and other multilateral institutions, provided external funding and smoothed the required policy adjustments in several countries. The design of the underlying economic programs in each country reflected its circumstances—the amount of fiscal space available and the nature of the exchange rate regime—and the preferences of its authorities (Box 8).[37]

pegged exchange rate regime; and Belarus devalued its currency by about 20 percent and repegged to a euro-dollar-Russian ruble basket (instead of the dollar) in early January 2009.

[37] Compared with previous crisis programs supported by the IMF, these programs differed in a number of key features: (i) financing was generally larger and more front-loaded, allowing countries to maintain supportive macroeconomic policies whenever possible; (ii) program conditionality was considerably streamlined, focusing more on measures addressing the vulnerabilities that magnified the impact of the shock; and (iii) top priority was given to financial sector stabilization, including guarantee schemes backed by IMF

(continued)

Why Was a Meltdown Avoided?

Although the crisis was deep, the large-scale regional banking and currency crisis that some had feared was avoided. In October 2008, market observers and analysts started worrying that western European parent banks would soon start to shrink their emerging European subsidiaries' balance sheets or even walk away from their subsidiaries' commitments, putting severe pressure on exchange rates and/or international reserves.[38] Investment banks and rating agencies worried that banking sector losses in emerging Europe would be so large that the soundness of several parent banks would be jeopardized.[39] Despite these worries, there were no banking panics, and, unlike in many advanced economies, governments did not have to step in to save entire banking systems. Except for Ukraine, western European parent banks maintained their presence in emerging Europe despite a decline in profitability of their operations in the region. There was no collapse of any fixed exchange rate regimes either—which is what had often happened in earlier crises in emerging economies. It was widely believed that if Latvia had broken its hard peg, contagion would have spread to other countries with a currency board. But in the end, Latvia managed to maintain its peg, although it suffered the largest recession in the region in doing so.

Domestic Policy Actions Played a Role . . .

Much of the relative calm was due to decisive domestic policy implementation (see above). Concerns had been voiced in early 2009 that some of the new democracies in emerging Europe would not be able to withstand a sharp economic downturn, harsh adjustment measures, and dashed

resources, initiatives to enhance bank supervision, and emergency liquidity support.

[38] See, for example, Economic Intelligence Unit (April 2009), Citigroup (2008), and Deutsche Bank (2008).

[39] See, for example, Merrill Lynch (2008), Morgan Stanley (2008), Barclays Capital (2009), and Fitch Ratings (2009).

Box 8. IMF-Supported Programs

Several countries turned out to be particularly vulnerable from the beginning of the crisis and entered into an IMF-supported program in the fourth quarter of 2008.[1]

- Hungary's foreign exchange and government securities markets were particularly affected because of the country's underlying stock vulnerabilities (public and external debt) and the high level of development and integration of these markets with the rest of the EU. In addition, the developed Hungarian FX swap market quickly froze. Hungary entered into an IMF program in November 2008.
- Substantial problems in Ukraine's large steel sector (due to sharply lower external demand), growing concerns about the ability of its banks and firms to roll over existing international credit lines, and troubles at its sixth largest bank weakened confidence in the country's banking system and currency. Ukraine entered into an IMF program in November 2008. In July 2010, a new Stand-By Arrangement (SBA) was approved, with a cancellation of the old program.
- In Latvia, the availability of external finance fell very sharply, owing to global developments and downgrades to Latvia's sovereign credit rating. The country's largest domestic bank and second largest bank (Parex Bank) suffered a significant outflow of deposits after September 2008, compelling the Latvian authorities to partially nationalize the institution and provide liquidity support. Other domestic banks and firms found it increasingly difficult to roll over their international liabilities. Latvia entered into an IMF program in December 2008.
- Similar to other countries in the region, Serbia had an overheated economy. Its exchange rate came under pressure, households withdrew some of their deposits, and external financing became more difficult. The Serbian authorities decided to enter into a precautionary program with the IMF in January 2009.
- Prices for Belarus's commodity exports fell, and demand for its products dropped off. Lingering effects of past booming domestic demand and the rapid appreciation of the U.S. dollar, to which it pegged its currency, put further pressure on the country's trade balance. At the same time, Belarus faced much less accessible and more expensive credit markets. It first used its currency reserves as a temporary response, then started negotiating an IMF program in late October 2008. The program was officially approved in January 2009. One of the prior actions was a one-off devaluation by 20 percent of the Belarusian ruble.

As economic conditions had worsened sharply, several other countries sought assistance from the IMF in the second quarter of 2009:

- Serbia augmented the size of its program in May 2009.
- In Romania, capital inflows had slowed sharply and international reserves had begun to decline. The Romanian authorities felt that the effects of the global crisis had not been especially pronounced in Romania compared with elsewhere in the region, but that the vulnerability to a sudden drop in capital flows was higher due to the weak fiscal position and high current account deficit. They entered into an IMF program in May 2009.

…continued

Note: The main author of this box is Jérôme Vandenbussche.

[1] As discussed in the main text, many of these programs were also supported by other international institutions such as the European Union. See also Table 16.

Box 8. (*concluded)*

- Notwithstanding its favorable fundamentals and the authorities' strong policy response, Poland's economy was being severely affected by the global financial crisis through both the export and financial sector channels. Poland had maintained access to international capital markets but with foreign direct investment (FDI) coverage of the current account deficit declining rapidly and continued portfolio outflows, the zloty had come under significant pressure and depreciated by about 35 percent against the euro in the fourth quarter of 2008. Poland received a Flexible Credit Line from the IMF in May 2009.
- In Bosnia, the rapidly deteriorating external and financial environment created substantial external and budget financing needs, thus necessitating a rapid adjustment. Agreement on an IMF program was reached in May 2009 (the program was officially approved in July).
- In Moldova, falling demand in trading partners led to a severe downturn in exports and remittances. Domestic demand collapsed, causing GDP contraction and deflationary pressures. External and budget financing shortfalls due to a decline in capital inflows and structural fiscal deterioration necessitated a large adjustment. Arrangements under the Extended Credit Facility and the Extended Fund Facility were approved in January 2010.
- Kosovo's economic performance has been hampered severely by infrastructure bottlenecks, and rapid expenditure has undermined fiscal sustainability. The IMF program for Kosovo was approved in July 2010 to help restore fiscal sustainability and safeguard financial stability.

A summary of key program features for each country is provided in the table below.

IMF Support for Countries Affected by the Global Crisis (As of September 10, 2010)

Country	IMF Loan Size, Approval Date	Key Objectives and Policy Actions	Additional Information[1]
Hungary	$15.7 billion, November 2008	Address the main pressure points in public finances and the banking sector: • Substantial fiscal adjustment to provide confidence that the government's financing need can be met in the short and medium term. • Up-front bank capital enhancement to ensure that banks are sufficiently strong to weather the imminent economic downturn, both in Hungary and in the region. • Large external financing assistance to minimize the risk of a run on Hungary's debt and currency markets.	In addition to financial assistance from the IMF, the program is supported by $8.4 billion from the European Union and $1.3 billion from the World Bank. On completion of the third review in September 2009, the arrangement was extended for 6 months, with a rephasing of the undisbursed amount. The fifth review of the program was completed in March 2010. The authorities have announced their intention not to draw additional resources. www.imf.org/external/country/HUN/index.htm
Ukraine	$16.9 billion, November 2008	• Help the economy adjust to the new economic environment by allowing the exchange rate to float, aim to achieve a balanced budget in 2009, phase in energy tariff increases, and pursue an incomes policy that protects the population while slowing price increases. • Restore confidence and financial stability (recapitalizing viable banks and dealing promptly with banks with difficulties). • Protect vulnerable groups in society (an increase in targeted social spending to shield vulnerable groups).	November 2008 SBA was canceled and replaced by a new SBA with the new government in July 2010. Under the November 2008 SBA, $10.5 billion was disbursed. www.imf.org/external/country/UKR/index.htm
	$15.2 billion, July 2010	• Restore confidence and fiscal sustainability by reducing the general government deficit to 2.5 percent of GDP by 2012 and setting public debt firmly on a downward path below 35 percent by 2015. • Initiate reforms to modernize the gas sector and phase out Naftogaz's deficit, including through gas tariff increases and a price mechanism that depoliticizes price setting of public utilities. • Restore and safeguard banks' soundness through completion of recapitalization plans by end-2010 and strengthened supervision. • Develop a more robust monetary policy framework focused on domestic price stability with greater exchange rate flexibility under a more independent National Bank of Ukraine.	
Latvia	$2.4 billion, December 2008	• Take immediate measures to stem the loss of bank deposits and international reserves. • Take steps to restore confidence in the banking system in the medium term and to support private debt restructuring. • Adopt fiscal measures to limit the substantial widening in the budget deficit and prepare for early fulfillment of the Maastricht criteria in view of euro adoption. • Implement income policies and structural reforms that will rebuild competitiveness under the fixed exchange rate regime.	In addition to financial assistance from the IMF, the program is supported by €3.1 billion from the European Union, €1.8 billion from the Scandinavian Countries (Denmark, Finland Norway, and Sweden,), €0.2 billion from Poland, €0.1 billion from the Czech Republic, €.01 billion from Estonia, €0.4 billion from the World Bank, and $0.1 billion from the European Bank for Reconstruction and Development . The third review of the program was completed in July 2010. The arrangement was extended by 9 months, until December 2011. www.imf.org/external/country/LVA/index.htm
Belarus	$2.5 billion, January 2009; augmented to $3.5 billion in June 2009	• Facilitate an orderly adjustment to external shocks and address pressing vulnerabilities. • Adopt a new exchange rate regime to improve external competitiveness—a steep devaluation of the rubel against the dollar of 20 percent and a simultaneous switch to a currency basket with a trading band of ±5 percent. • Support policies to strengthen the monetary framework, balance the budget, and impose strict public sector wage restraint.	The fourth and final review was completed in March 2010. www.imf.org/external/country/BLR/index.htm

Country	IMF Loan Size, Approval Date	Key Objectives and Policy Actions	Additional Information[1]
Serbia	$0.5 billion, January 2009; augmented to $4.0 billion in May 2009	• Tighten the fiscal stance in 2009–10: limit the 2009 general government deficit to 1¾ percent of GDP and adopt further fiscal consolidation in 2010. The tightening involves strict income policies for containing public sector wage and pension growth and a streamlining of non-priority recurrent spending, which helps create fiscal space to expand infrastructure investment. • Strengthen the inflation-targeting framework while maintaining a managed floating exchange rate regime.	Since the program was designed, Serbia's external and financial environment has deteriorated substantially. In response, the authorities have (1) raised fiscal deficit targets for 2009–10 while taking additional fiscal measures, (2) received commitments from main foreign parent banks that they would roll over their commitments to Serbia and keep their subsidiaries capitalized, and (3) requested additional financial support from international financial institutions and the EU. The fifth review was completed in September 2010. www.imf.org/external/country/SRB/index.htm
Romania	$17.1 billion, May 2009	• Cushion the effects of the sharp drop in private capital inflows while implementing policy measures to address the external and fiscal imbalances and to strengthen the financial sector: • Strengthen fiscal policy to reduce the government's financing needs and improve long-term fiscal sustainability. • Maintain adequate capitalization of banks and liquidity in domestic financial markets. • Bring inflation within the central bank's target.	IMF support is coordinated with the EU and the World Bank. The fifth review was completed in September 2010. www.imf.org/external/country/ROU/index.htm
Poland	$20.6 billion Flexible Credit Line, May 2009	The Flexible Credit Line (FCL) is an instrument established for IMF member countries with very strong fundamentals, policies, and track records of implementation. Access to the FCL is not conditional on further performance criteria.	The arrangement for Poland, which has been kept precautionary, has helped stabilize financial conditions there, leaving room for accommodative macroeconomic policies and improving access to market financing. www.imf.org/external/country/POL/index.htm
Bosnia and Herzegov-ina	$1.6 billion, July 2009	Safeguarding the currency board arrangement by a determined implementation of fiscal, income, and financial sector policies.	The staff-level agreement for the second and third reviews was reached in September 2010. www.imf.org/external/country/BIH/index.htm
Moldova	$0.6 billion Extended Credit Facility and Extended Fund Facility, January 2010	• Reverse the structural fiscal deterioration that occurred in 2008–09 while safeguarding funds for public investment and priority social spending. • Keep inflation under control while rebuilding foreign reserves to cushion the economy from external shocks. • Ensure financial stability by enabling early detection of problems and strengthening the framework for bank rehabilitation and resolution. • Raise the economy's potential through structural reforms. To promote poverty reduction, the program sets a floor on priority social spending. Moreover, social assistance spending will be increased by 36 percent in 2010 relative to 2009 to support vulnerable households.	The first review was completed in July 2010. www.imf.org/external/country/mda/index.htm
Kosovo	$139.6 million, July 2010	Achieving fiscal stabilization, while accommodating large infrastructure investments, and safeguarding financial sector stability: • Limit the overall budget deficits in 2010 to 3.4 percent of GDP by raising select excise taxes and by restraining current primary spending in 2010 to 18.7 percent of GDP and holding it broadly constant thereafter. • Bolster the government's bank balances held with the Central Bank of Kosovo (CBK) to provide scope for emergency liquidity assistance (ELA), and provide the CBK with a mandate for ELA, and further strengthen the banking system. • Improve the financial position of the energy sector to limit its costs to the budget.	Kosovo became the 186th member of the IMF on June 29, 2009. The first review is scheduled in December 2010. www.imf.org/external/country/uvk/index.htm

[1] More detailed information available at indicated Web sites.

hopes of convergence. In reality, political institutions proved much stronger than feared, thanks in part to EU membership or prospects of EU accession. The resilience was remarkable, especially in the fixed exchange rate countries.

. . . As Did International Support

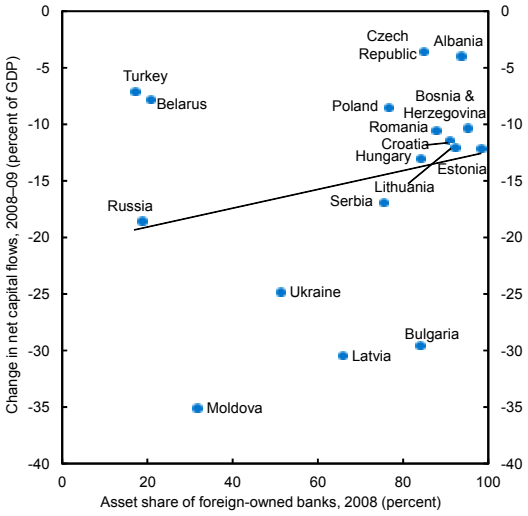
Large-scale and timely international financial support was also crucial in supporting market confidence and avoiding sharp currency depreciations (Table 16). The global financial crisis in emerging Europe reshaped the role played by international financial institutions (IFIs) in crisis prevention and resolution. The IMF—for EU members jointly with the EU—acted quickly to extend large front-loaded loans to the affected countries. This was made possible partly by reforms to the IMF's lending framework undertaken at the onset of the global financial crisis.[40] Early involvement of the IMF before the collapse of currencies reduced tail risks and helped bring down borrowing costs for emerging markets that had spiked following the bankruptcy of Lehman Brothers. The EU enhanced access to its structural funds as part of the European Economic Recovery Plan of December 2009, concluded parallel programs with EU member countries, which substantially increased overall financing, and extended its support to nonmember countries with fiscal support and broad support for banks and small and medium-sized enterprises. The World Bank, the European Bank for Reconstruction and Development (EBRD), and the European Investment Bank (EIB) also stepped up their support to the affected countries in bank restructuring. In some cases, bilateral financial support was provided by other European countries.[41]

Table 16. Financing Packages for Emerging European Countries Under IMF-Supported Programs[1]
(As of August 2010, billions of U.S. dollars)

	IMF	EU	WB	Other	Total
Kosovo	0.1	0.1	0.1	0.0	0.3
Moldova	0.6	0.3	0.3	0.1	1.3
Bosnia and Herzegovina	1.6	0.1	0.2	0.1	2.0
Serbia, Republic of	4.0	0.2	0.4	0.0	4.6
Belarus	3.5	0.3	0.2	1.0	5.0
Latvia	2.4	4.4	0.6	3.3	10.6
Hungary	15.7	8.4	1.3	0.0	25.4
Romania	17.1	6.6	1.3	1.3	26.3
Ukraine[2]	25.7	1.3	3.4	2.1	32.5
TOTAL	70.7	21.7	7.7	7.8	107.9

Source: IMF staff calculations.
[1]Figures indicate programmed amount, unless indicated.
[2]For Ukraine, IMF column includes the sum of two Stand-By Arrangement (SBA) programs (i.e., the amount actually disbursed under the November 2008 SBA plus the amount committed under the July 2010 SBA).

Figure 56. Emerging Europe: Foreign Bank Ownership and Change in Net Capital Flows, 2008–09



Sources: EBRD; IMF, *International Financial Statistics*; and IMF staff calculations.

The Western European Banks' Presence Contributed to Financial Stability during the Crisis

Although western European banks played a major role in providing the capital flows to emerging Europe, they also helped stabilize the region during the crisis (Figure 56).[42] Outflows were more contained in countries with higher penetration of foreign banks, and some countries even experienced

[40] The IMF increased its resources for loans from about $250 billion to $750 billion, following the April 2009 G-20 summit in London. The IMF also conducted a major overhaul of its lending framework by offering higher loan amounts and further tailoring loan terms to countries' circumstances.
[41] The Nordic countries, the Czech Republic, Estonia, and Poland provided financial support to Latvia.
[42] The EBRD's 2009 Transition Report also argued that there is little evidence that financial integration per se caused the credit boom.

inflows. Contrary to the skeptics' early concerns, all foreign banks remained in the region, which had a stabilizing effect.[43]

Although western banks generally stopped providing new financing to their subsidiaries, they broadly maintained their exposure and provided fresh equity when necessary or required by local supervisors, as in Romania and Ukraine.[44] Early in the crisis it became clear that all large foreign banking institutions operating in the region would benefit from explicit and implicit guarantees from their home country governments and would not be allowed to fail. This strong backing by western sovereigns certainly supported depositor confidence across the region and was instrumental in preventing panics.

The continuation of bank exposure was helped by the informal forum called the European Bank Coordination Initiative (EBCI, also known as the "Vienna Initiative"), through which foreign parent banks pledged to maintain exposure to countries with an IMF program during the crisis (Box 9). It was recognized that under the prevailing circumstances, western banks faced a coordination problem: while they had an interest in staying in the region, they would be better off exiting first lest competitors decide to leave before they do. Agreements in the context of the EBCI helped resolve the collective action dilemma and proved to be instrumental in restoring confidence among banks operating in the region.

Banking Sectors Had Considerable Buffers

Many banking sectors in the region had sizable buffers before the crisis. As shown in Table 7 (see page 37), capital adequacy ratios were generally well above 10 at end-2007 and end-2008, and profitability remained positive in 2009, except in the Baltics, Montenegro, and Ukraine. The absence of exchange rate crises, which protected borrowers' balance sheets and gave banks time to renegotiate the terms of some loans (for example, by extending their maturity) so as to avoid default, goes a long way to explain the relatively moderate deterioration of credit quality in most countries in spite of large GDP declines.[45]

Countercyclical Policy in Western Europe Helped

Western Europe's countercyclical monetary and fiscal policies also cushioned the impact of the shocks. Rapid cuts in policy interest rates and abundant liquidity provision to western European banks by the ECB and the Riksbank limited the increase in emerging European banks' funding costs in foreign currency despite the increase in CDS spreads across the region. They also lowered the debt service burden of floating-rate mortgages denominated in foreign currency. Moreover, with interest rates in the West hitting rock bottom, even moderate interest rate levels in emerging Europe helped support currencies. As a result, except for Latvia and Ukraine, the increase in average deposit rates remained moderate throughout the crisis (Figure 57). In addition, very accommodative fiscal policy in western Europe produced positive spillovers to emerging Europe as it put a brake on the decline in exports, especially for those countries with a well-developed automobile sector that indirectly benefited from various cash-for-clunkers schemes in the West.

Imbalances Were of a Self-Correcting Nature

In many countries, imbalances were of a self-correcting nature—a drop in capital inflows led to a

[43] See also EBRD (2009).

[44] OTP (Hungary) also supported its subsidiaries during the crisis by extending capital transfers.

[45] Stress tests prepared by market analysts in 2008:Q4 or 2009:Q1 often assumed that nonperforming loans would quickly reach 25 percent in all countries, leading to strong recapitalization needs. In fact, NPL ratios at end-2009 were generally well below that level, except for Ukraine (though the higher levels in part reflect a broader definition of NPLs).

Box 9. European Bank Coordination Initiative ("Vienna Initiative")

In late 2008 the global financial crisis spread to eastern Europe. Western banks with subsidiaries in central and eastern Europe (CEE) and southeastern Europe (SEE) countries faced an exceptional degree of uncertainty, and a serious coordination problem. Given countries' large share of foreign private debt, any bank recognized that if other banks left, only an early exit would ensure availability of funds to repatriate the investment. In the absence of a coordination mechanism, uncertainty could therefore have led to wholesale retreat of foreign banks, notwithstanding their declared interest in staying.

Being concerned about the possible fallout from uncoordinated withdrawal of foreign banks from CEE/SEE countries, the IMF, the European Bank for Reconstruction and Development (EBRD), and the European Union (EU) established as early as in January 2009 an informal forum called the European Bank Coordination Initiative (EBCI, also known as the Vienna Initiative). The purpose of the group was to foster a dialogue between all key stakeholders, including foreign banks, home and host supervisors, and relevant governments, and thereby reduce the likelihood of uncoordinated outcomes.

The EBCI became a truly effective and operational tool in the context of IMF- and IMF/EU-supported programs in CEE and SEE countries. Given that CEE and SEE's balance of payments problems were the result largely of private sector debt—generally capital inflows from parent to subsidiary banks—the international lenders sought assurances that the private sector would share the adjustment burden. The EBCI provided the necessary framework for such private sector involvement (PSI). In country-specific meetings for a range of program countries (Bosnia and Herzegovina, Hungary, Latvia, Romania, and Serbia), foreign banks active in the country publicly declared support for economic adjustment by maintaining exposure at predefined levels and, in most countries, recapitalizing their subsidiaries on the basis of stress tests.[1] "Quid pro quo" macroeconomic programs increased international reserves and served as policy commitments by the authorities to ensure a predictable operating environment. Banks' commitments were made for limited time periods and renewed—generally at the time of formal reviews of the lending programs.

The EBCI has been a successful vehicle for public–private sector coordination and helped avert a systemic financial crisis in the region. Follow-up meetings conducted on a regular basis found that commitments made in the country meetings were broadly honored and that both banks and the public sector felt that the dialogue had supported a more predictable economic environment and helped economic stabilization and recovery in individual countries. With the acute phase of the crisis now resolved, the role of the EBCI is increasingly shifting toward forward-looking policies for the region. Among a range of topics, key concerns include setting an appropriate prudential environment supporting renewed but balanced credit growth in the region and developing adequate policies to reduce risks from the very high level of foreign currency borrowing.

The Vienna Initiative/European Bank Coordination Inititative (VI/EBCI) countries

	Date[1]	Place	No. of participating foreign banks	Market share of foreign banks [2]	Nationality of banks
Romania	March 2009	Vienna	9	88 percent	Austria, France, Greece, Italy
Serbia	March 2009	Vienna	10	75 percent	Austria, France, Greece, Italy
Hungary	May 2009	Brussels	6	70 percent	Austria, Blegium, Germany, Italy
BiH	June 2009	Vienna	6	95 percent	Austria, Germany, Italy, Slovenia
Latvia	September 2009	Stockholm	4	56 percent	Sweden, Denmark, Finland

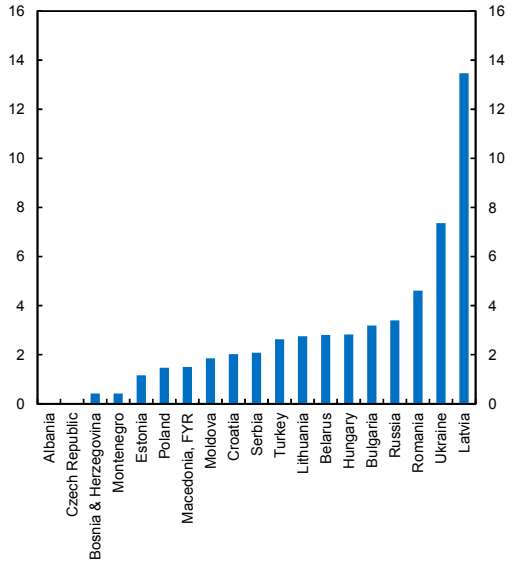
[1]The date of the first-phase meetings.

[2]In percent of banks' assets.

Note: The main author of this box is Yuko Kinoshita.

[1] For example, see Joint IMF, EC Press Release on the EBCI meeting for Romania: http://www.imf.org/external/np/sec/pr/2009/pr09178.htm.

Figure 57. Emerging Europe: Change in Deposit Rate from August 2008 to Peak
(Percentage points; peak during August 2008–December 2009)



Sources: IMF, *International Financial Statistics*; National Bank of Poland website; National Bank of Serbia website; and IMF staff calculations.

reduction of current account deficits rather than a depletion of reserves. During the boom years, capital inflows had boosted domestic demand and contributed to widening current account deficits. When the capital inflows declined, domestic demand and current account deficits adjusted, and reserve declines remained fairly moderate, even in countries with fixed exchange rates. Thus, the Baltics and Bulgaria did not experience a currency crisis, although their current account adjustment exceeded that of the Asian crisis countries (Figure 58). The SEE countries also experienced a sharp adjustment of their current account deficits, although not as severe as in the Baltics and Bulgaria. The exceptions were Moldova, Russia, and Ukraine, which experienced large capital outflows, and used a significant amount of their reserves to defend their exchange rates before they were allowed to depreciate.

Lessons for Crisis Prevention

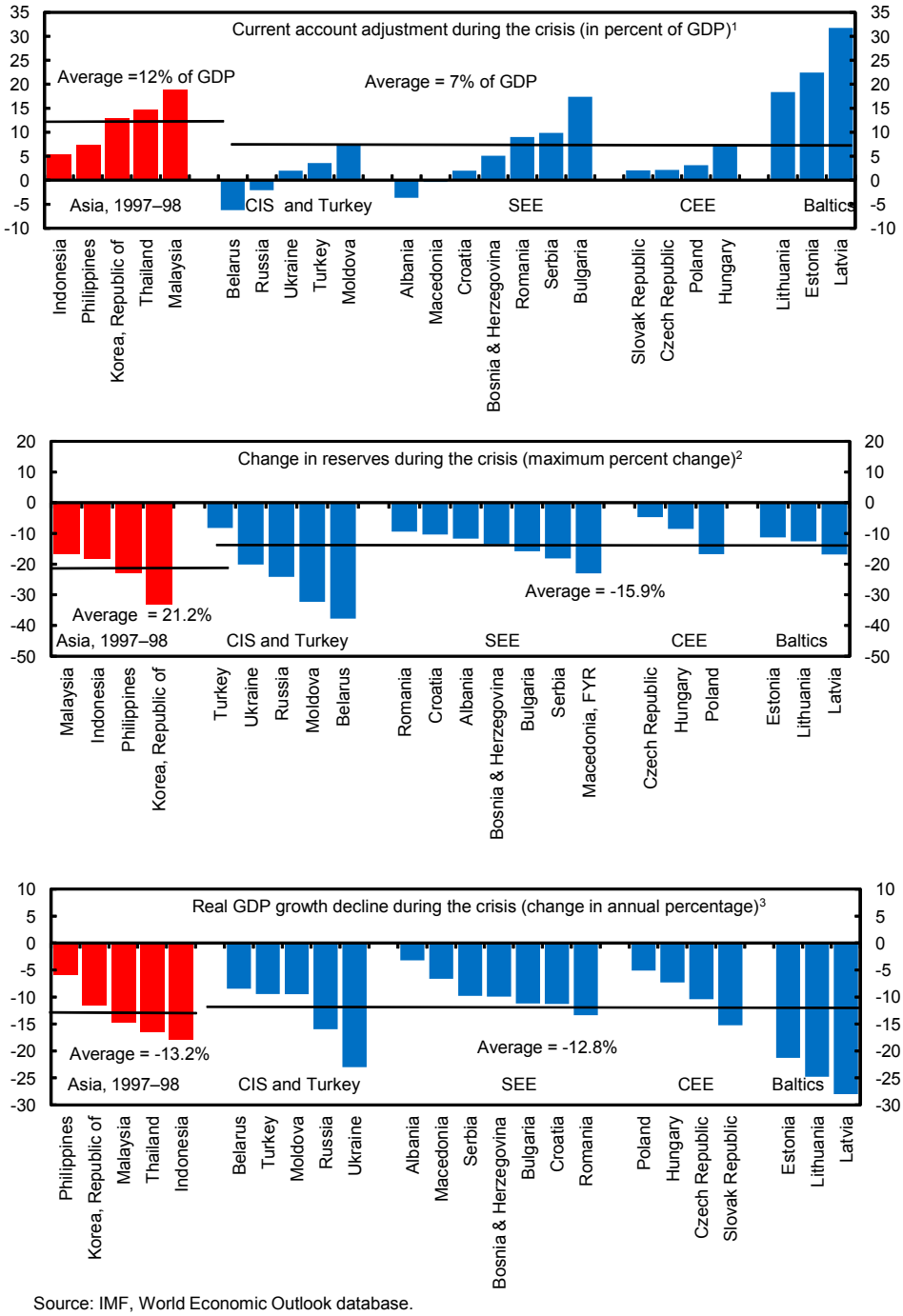
Although the crisis in emerging Europe was triggered by *external* factors (the recession in western Europe and the sudden stop in capital inflows), *domestic* imbalances and vulnerabilities played a key role. Indeed, it is striking how large the differences have been in the extent to which countries have been affected by the crisis: the Baltic states and Ukraine saw very large declines in GDP (IMF, 2010i), whereas others such as Albania, Belarus, and Poland had (if at all) short and shallow recessions. Countries that have largely managed to avoid the capital inflows-driven credit and domestic demand booms have had a much less severe recession (Box 10).

Thus, one of the main lessons of the crisis is that GDP growth that is driven by credit booms, rapid domestic demand growth, and large capital inflows into the nontradable sector is ultimately not sustainable. Bakker and Gulde (2010a and 2010b) and EBRD (2009) find that the size of the precrisis credit boom explains the depth of recessions better than any other variable.[46] Countries with very rapid credit growth not only experienced higher output *volatility* with strong growth followed by deep recessions but over a longer time period they do not seem to have experienced higher *average* growth, as the higher output losses during the recession offset the higher growth during the boom years (Figure 59).

How can countries avoid capital inflows-driven credit and domestic demand booms? What is the difference between countries that largely managed to avoid the buildup of imbalances and those that did not? One of the main lessons is that prudential measures to control credit growth would likely be more successful if they relied on better cooperation between home and host supervisors. This is particularly relevant for fixed exchange rate countries, as credit booms can be difficult to stop with conventional monetary policy instruments in these circumstances. Other policy instruments, such as fiscal policies, would have to play a more active role. During boom years, rapid revenue growth should be used to build up fiscal buffers rather than

[46] Other variables that help explain the depth of recessions are short-term external debt and trading partner growth (Blanchard, Das, and Faruqee, 2010). IMF (2010e) identifies external vulnerabilities more generally, trading partner growth and foreign bank claims, along with credit growth.

Figure 58. Emerging Europe and Asia: Adjustment during the Crisis, 2007–09



Source: IMF, World Economic Outlook database.

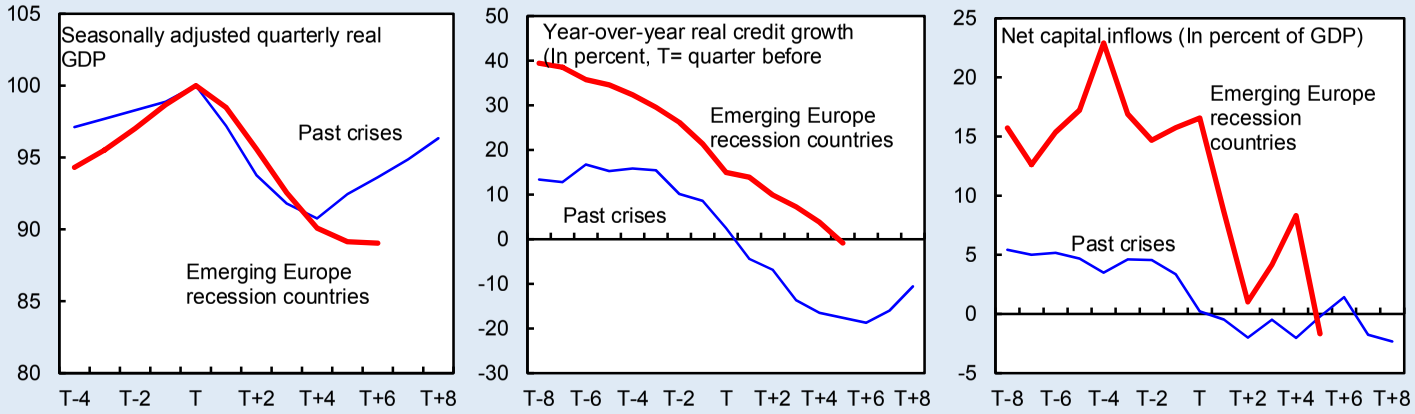
[1]Current account adjustment is the change in current account balance to GDP between 2007 and 2009 for emerging Europe, and between 1997 and 1998 for Asia.

[2] Maximum percent change between 2007 and 2009 for emerging Europe , and in 1997 for Asia.

[3] Real GDP decline is the change in real GDP growth between 2007 and 2009 for emerging Europe, and between 1997 and 1998 for Asia, except Thailand (1996 and 1998).

Box 10. Emerging Europe Crisis Compared with Previous Emerging Market Crises[1]

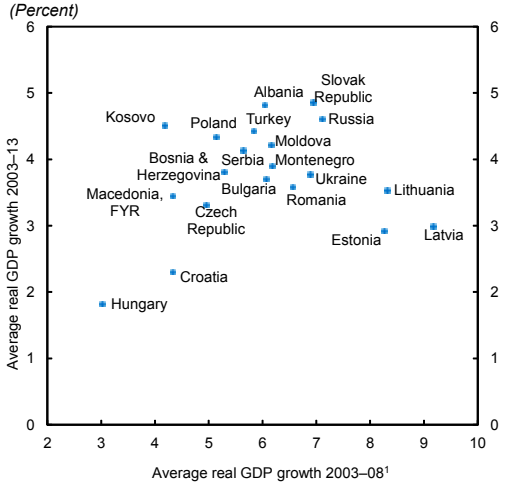
	Precrisis	Crisis	Recovery
Real activity	Emerging Europe experienced significantly stronger precrisis GDP growth than past crises countries.	The recession in emerging Europe was much deeper than past crises. Although economic activity has contracted at the same rate, the duration has been longer. The recessions in both Latvia and Ukraine have been deeper than Uruguay's recession—the deepest recent recession before this crisis.	In previous crises, the recovery was "V-shaped" and output losses were fully recovered after 10 quarters. Is seems likely that the bottom of this crisis will be flatter than in previous crises, and the recovery is projected to be longer.
Credit growth	Credit growth in emerging Europe was much higher than prior to previous crises.	Given the strong precrisis credit growth, year-over-year real credit growth in emerging Europe turned negative only after five quarters. In contrast, year-over-year credit growth in past crises quickly turned negative, but bottomed out after 6 quarters at a 20 percent fall in credit.	In previous crises, the overall credit recovery took 10 quarters, although several countries experienced an extended period of contraction of credit.
Capital flows	Capital inflows were much higher in emerging Europe than in previous crises. The inflows increased sharply just before this crisis, while inflows had fallen steadily ahead of previous crises.	The collapse in capital inflows to emerging Europe has been spectacular. However, net inflows to emerging Europe remained positive until the recession bottomed out. Part of the reason for this is that FDI inflows held up relatively well.	In previous crises, the capital outflows typically lasted several quarters and remained below precrisis levels.



Note: The main author of this box is Johan Mathisen.

[1] Past capital account crisis cases include (first quarter in recession in parenthesis): Argentina (2001:Q2), Brazil (1998:Q3), Colombia (1998:Q3), Indonesia (1997:Q4), Ecuador (1998:Q4), South Korea (1998:Q2), Malaysia (1998:Q1), Mexico (1995:Q1), Philippines (1998:Q1), Russia (1998:Q1), Thailand (1997:Q3), Turkey (2001:Q1), and Uruguay (2001:Q2). Emerging Europe recession countries include Bulgaria (2008:Q4), Croatia (2008:Q2), Estonia (2008:Q1), Hungary (2008:Q2), Latvia (2008:Q1), Lithuania (2008:Q3), Romania (2008:Q3), Russia (2008:Q3), Serbia (2008:Q2), Turkey (2008:Q2), and Ukraine (2008:Q3).

Figure 59. Emerging Europe: Average Real GDP Growth
(Percent)



Sources: IMF, World Economic Outlook database; and IMF staff calculations.
[1]As the boom in the Baltic states ended in 2007, data for the Baltics refer to 2002–07.

facilitating a surge in expenditure, and at times large surpluses may be appropriate.

Prudential Measures Require Better Home-Host Cooperation

A key lesson from the crisis is that controlling credit growth through prudential measures is challenging. Indeed, the effectiveness of the flurry of domestic prudential measures to stem overall credit growth has been mixed (IMF, 2010g, and Enoch and Ötker-Robe, 2007).

Externally funded credit growth has proven particularly hard to control. Many western banks in emerging Europe operate their foreign affiliates as if they are branches,[47] with risk management centralized at the group level and local supervisors relying on parent bank's home supervisors to monitor the changes in the risk profile of their foreign affiliates. Foreign-owned banks can often evade regulatory measures, including by switching from domestic to cross-border lending, or by switching lending from banks to nonbanks, such as leasing institutions (owned by foreign-owned banks). They are also less likely to be influenced by domestic monetary policy measures, such as raising of domestic interest rates. Often, these banks are systemically important in the host country, although a small part of the overall bank group.

Better cooperation between home and host supervisors would likely make prudential measures to control credit growth more successful. Such cooperation should include adequate mechanisms for effective communication, information sharing, and joint analysis of common concern, and the formulation of effective responses (Fonteyne and Mathisen, forthcoming). The recent advances in integrating national frameworks within the EU will help address the challenge of containing buildup of financial risks, particularly challenging in countries with an extensive foreign bank presence.[48]

One prudential measure that could have usefully been used more is the discouragement of foreign currency loans. Some countries were partially able to discourage foreign currency lending in the run-up to the crisis. For example, Belarus, Moldova, and Turkey effectively restricted household borrowing in foreign currencies through long-standing prudential regulations, while Poland relied on guidelines to stem such practices. A more widespread effective discouragement of foreign currency loans would have slowed credit growth in many countries, as much of the credit boom was financed by foreign banks, which were not allowed to take an open currency position. It would also have prevented the buildup of large currency mismatches in the private sector, which posed a severe risk during the crisis (see Figure 60 and Box 11).[49]

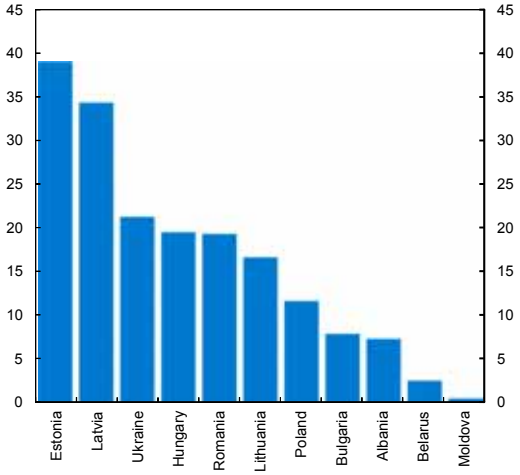
[47] Legally, most of the foreign affiliates were subsidiaries.

[48] The recent financial reforms and how they related to New Member States are described in Box 7 in IMF, 2010g.

[49] Measures to contain foreign exchange risks can be imposed directly on banks or indirectly on the borrower (Enoch and Ötker-Robe, 2007). Turkey's ban on foreign currency loans to households and the European Commission's proposed lowering of loan-to-value ratios are examples of direct measures. Such measures could also include tightening or introducing sectoral limits on banks' net open foreign currency position or imposing a limit on banks' gross foreign exposure (EBRD, *Transition Report*, 2009, p. 74). Examples of indirect measures include Hungary and Poland's requirements for banks to disclose the risks of foreign currency borrowing to potential clients. They can also take the form of consumer protection, for example, by

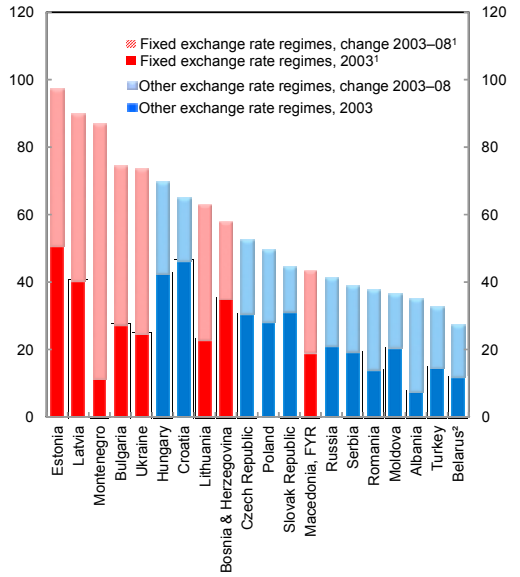
(continued)

Figure 60. Emerging Europe: Foreign Currency Loans to Households, 2008
(Percent of GDP)



Source: IMF, *International Financial Statistics.*

Figure 61. Emerging Europe: Private Sector Credit, 2003 and 2008
(Percent of GDP)



Sources: IMF, *International Financial Statistics* and *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.

limiting household borrowing in foreign currency relative to income or assets. As long any such measures (direct or indirect) are not residency-based, they would be possible also within the EU.

Fixed Exchange Rates Make Credit Booms Harder to Stop

It is striking that the strongest credit growth during the boom years took place in countries with fixed exchange rate regimes (Figure 61). While the Baltics, Bulgaria, Montenegro, and Ukraine all had annual credit growth at about 10 percent of GDP or more, many of the countries in the region with more flexible exchange rate regimes largely managed to avoid a credit boom. The countries with floating exchange rates during this period (Albania, Poland, and Turkey) had the lowest outstanding credit-to-GDP ratio at the end of 2008, as well as the lowest precrisis credit growth.

This difference exists in part because countries with fixed exchange rates have a limited set of monetary policy tools to restrain credit booms once they set in, as discussed above. Countries with flexible exchange rates, on the other hand, can dampen booms by letting the nominal exchange rate appreciate. Such an appreciation helps prevent overheating of the economy and further lowers inflation by reducing import prices, which keeps real interest rates higher. It is noticeable that many of the countries that avoided a credit boom (Czech Republic, Poland, and Slovak Republic) saw a substantial appreciation of their nominal exchange rates during the boom years.

Yet, there were also some countries with fixed exchange rate regimes that did not experience massive credit booms (Bosnia and Macedonia). Indeed, in non-EU SEE there seems little difference between countries with fixed exchange rates and those with more flexible exchange rates. Capital inflows in these countries were much lower, partly because of the memory and legacy of various conflicts in the region, and partly because they were not (yet) in the EU. This suggests that, in the absence of large capital inflows, fixed exchange rates do not necessarily pose a problem. More generally, the recent IMF study on exchange rate regimes that looks at all countries in the world has concluded that

Box 11. Foreign Currency Mortgages, Maturity Mismatches, and Foreign Currency Shortages: The Cases of Hungary and Poland

Foreign currency (FX) mortgage loans, mainly in Swiss francs, became very popular in Hungary and Poland in the years before the crisis. These loans were attractive for borrowers because they carried lower interest rates than domestic currency loans; they were profitable for banks because of extra revenues related to foreign exchange rate operations and high commissions. Of course, FX mortgage loans were only cheaper if the exchange rate remained stable, or appreciated—an expectation that was widely held at the time.

Swap markets played an important role in the funding of these loans. While subsidiaries of western European banks could obtain the foreign currency resources for these loans from their parent banks, domestic banks financed these loans in part through swapping domestic currency deposits into foreign currency resources. During tranquil times, these swap markets worked well, as sufficient liquidity was provided by foreign banks. Western banks originated FX swap contracts and closed their own open position in the Hungarian forint or Polish zloty through Treasury bond repo operations.

During the financial crisis, this funding mechanism broke down. As the cost of foreign currency funding from western parent banks went up, banks increasingly tried to obtain foreign currency through swapping domestic currency. Yet just when *demand* for FX swaps increased, *supply* of FX swaps was reduced, as the counterparties in FX swap transactions attempted to reduce their exposure to central and eastern European economies. Medium-term FX swaps became practically unavailable, while short-term swaps—the instrument of last resort—became very costly for domestic banks. Moreover, with the forint and the zloty depreciating, rolling over swaps required a growing amount of domestic currency resources. This process caused severe liquidity strains in some domestic banks, which triggered a "deposit war" in the Hungarian and Polish banking sectors, which fueled a general rise in deposit interest rates in late 2008 and 2009.

Rapidly evaporating FX liquidity on the interbank market forced the National Bank of Poland to provide short-term (7 days) FX swaps. In Hungary, the central bank also introduced short-term FX swaps as a stop-gap measure, and began offering longer-term FX swaps (3 and 6 months) in March 2009. Both facilities are still in operation, although conditions in the FX swap market have normalized.

The Hungarian and Polish experiences exemplify the risk for banking sector stability created by the expansion of mortgages denominated in foreign currency and financed by domestic currency deposits combined with swap transactions. To help contain this risk, prudential regulation should be enhanced to strengthen the management of on-balance-sheet FX liquidity mismatches.

Note: The main authors of this box are Andrzej Raczko and Johannes Wiegand.

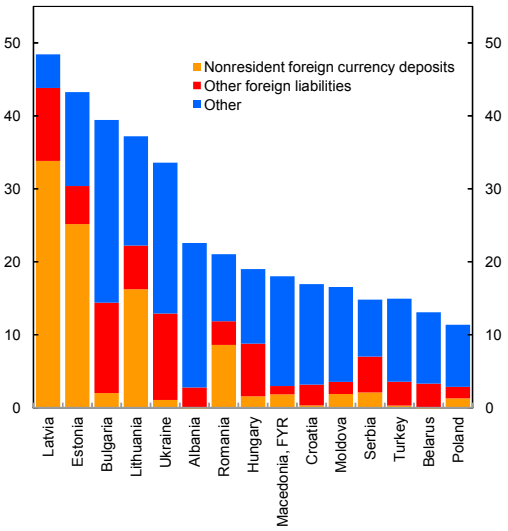
economies with pegged regimes generally fared neither better nor worse than those with floats during the global financial crisis (IMF, 2010h, Box 1.1).

Fixed exchange rates do not necessarily result in credit booms, but they do make it hard to prevent credit booms in the presence of large capital inflows. Some countries with fixed exchange rates attracted particularly large capital inflows because they had just entered or were about to enter the EU, and were seen as plausible candidates to enter the EMU. This further lowered the perceived exchange rate risk, increased overall expected growth and investment returns, and thereby contributed to excessive foreign-financed credit growth (Figure 62).

Larger Fiscal Surpluses during Boom Times?

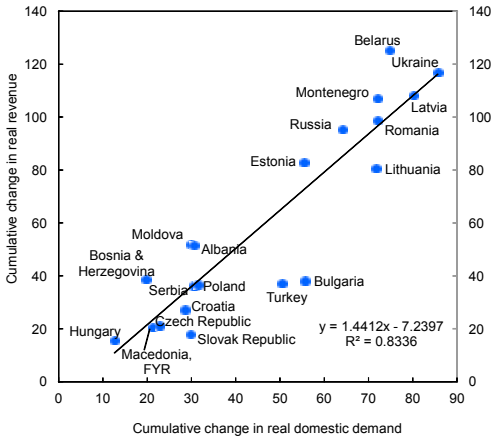
The limits of prudential policies and the role of exchange rate regimes underscore the need for a

Figure 62. Emerging Europe: Contribution to Change in Credit-to-GDP Ratio, 2003–07
(Percent of GDP)



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

Figure 63. Emerging Europe: Cumulative Change in Real Domestic Demand and Real Fiscal Revenue, 2003–08[1]
(Percent)

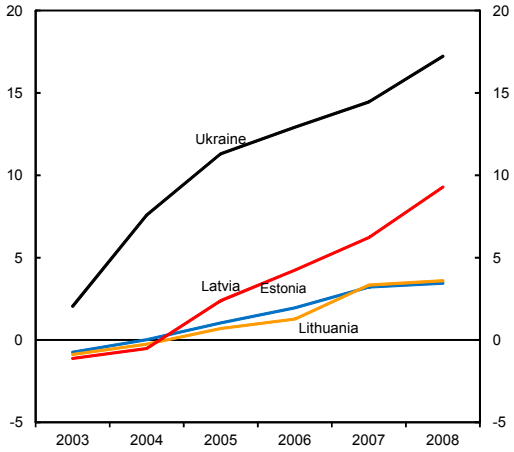


Sources: IMF, World Economic Outlook database and *Government Finance Statistics*; and IMF staff calculations.
[1]As the boom in the Baltic states ended in 2007, data for the Baltics refer to 2002–07.

decisive fiscal response to capital inflows. In particular, fiscal policy can look very good during boom years—when domestic demand booms feed fiscal revenues. This often creates the illusion of fiscal space, at a time when fiscal policy may need to play a much stronger countercyclical role, especially in countries with fixed exchange rates.

The rate of precrisis public expenditure growth in many countries now appears to have been imprudent. The large increases further fueled overheating; it also set the stage for large deficits when part of the revenue surge turned out to be

Figure 64. Selected Countries: Cumulative Fiscal Savings Assuming a Cap of 10 Percent Real Increase in Public Expenditures
(Percent of GDP)



Sources: IMF, *International Financial Statistics* and World Economic Outlook database; and Haver Analytics.

temporary (Figure 63). Indeed, countries that better managed their fiscal positions fared better during the crisis. These countries had generally higher foreign reserves as well as larger fiscal buffers. Many of the other countries had to seek external assistance because of fiscal financing problems once the crisis erupted.

Fiscal policy could play a much more active role—saving money when revenues are growing instead of increasing spending and boosting public wages. This may mean that during boom times small fiscal surpluses are not sufficient—that large surpluses are needed. This might prove a daunting task, and would require a strong political will to adhere to the overall objective of medium- and long-term fiscal sustainability (Figure 64). Policymakers may prefer to spend in boom times, but the payoff from saving is that a large fiscal buffer will reduce the more politically damaging need to cut expenditure sharply during a recession—as several countries had to do during this crisis.

Conclusion

The crisis in emerging Europe provides important lessons in crisis prevention. Although the crisis was triggered by external factors (the recession in western Europe and the sudden stop in capital

inflows), domestic imbalances and vulnerabilities played a key role. Indeed, countries that managed to avoid the capital inflows-driven credit and domestic demand booms have had much less severe recessions, and are now in much better shape as a consequence.

If crises of the type we have just witnessed in emerging Europe are to be prevented in the future, these lessons from the past must be learned. Most importantly, prudential policies will need to be strengthened, including through improved international cooperation and greater attention by home supervisors to activities of their banks in emerging Europe. Macroeconomic policies, in particular fiscal policies, will have to play a more active role to counter capital inflows-driven credit and domestic demand booms.

Finally, policies aimed at slowing credit booms should have long-term benefits in promoting more balanced and sustainable growth. Countries that experienced the most severe credit boom also saw the largest output volatility and the most pronounced output reversals. It now appears that average GDP growth over the cycle in this group was no higher and in some cases lower than in countries with more restrained credit increases. In addition, growth among the countries with the highest credit growth was often very imbalanced, resulting in an insufficient expansion of their economic supply potential. Finally, countries with the most rapid credit growth have also ended up with the highest external debt and the largest fiscal deficits.

Above all, it will be important—when the next boom comes—to be wary of stories that "this time is different." Such narratives often have some plausibility and attractiveness during booms, especially when they become prolonged and warnings from skeptics increasingly fall by the wayside. But a careful analysis of the drivers of growth, asset price developments, and competitiveness should always be used as a reality check.

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