How Emerging Europe Came Through the 2008/09 Crisis

An Account by the Staff of the IMF's European Department

EDITORS
Bas B. Bakker and Christoph Klingen

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Foreword

With the continued turmoil in the euro area, one might easily forget that only a few years ago the other part of the continent, emerging Europe, went through a deep economic and financial crisis. The global financial crisis and its aftermath were challenging the world over, but emerging Europe was particularly hard hit. After a long stretch of prosperous years, a sudden stop of capital inflows in the fall of 2008 triggered a sharp contraction of domestic demand, just when the slump in global trade hit the region's exports. This "perfect storm" resulted in an unprecedented economic contraction. By the time the region started to turn the corner, GDP in some countries had declined by as much as 25 percent, although a few economies managed to escape relatively unscathed.

This book recounts the crisis—its origins and the precrisis policy setting, the crisis triggers and the scramble by governments and the international community to avoid meltdown, stabilization and the subsequent recovery, and the remaining challenges. It distills the lessons for the future from the diversity of country experiences within the region. The book argues that while the crisis was triggered by external shocks, its seeds were sown over many years as economic policies failed to recognize and address the buildup of vulnerabilities.

The policy response to the crisis was swift and forceful. Countries' determined adjustment programs and unprecedented financing from the international community prevented looming financial meltdown, but it was too late to forestall a deep recession. Corrective action was not easy and often demanded that societies make extraordinary sacrifices, but in 2011 economic growth had returned to all countries in the region and income convergence with western Europe had resumed.

Nonetheless, continued efforts are needed to bring down further long-standing vulnerabilities and firmly entrench robust growth. Many of the imbalances that characterized much of emerging Europe prior to the crisis have disappeared. But public finances are significantly weaker than in 2008, nonperforming loans have increased in all countries, and high external debt continues to expose the region to spillovers from volatile global financial markets. Growth needs to be reoriented toward the tradable sector in many countries and the region will have to adapt to the reality of more muted cross-border bank financing.

This book should be viewed as an interim stock-taking exercise by a team of IMF staff that worked on emerging Europe during the crisis. It contains information on what happened in individual countries, and aims at being a useful reference for economists and historians studying the crisis in emerging Europe. Its analysis is by no means the final word, and insights will inevitably evolve further in the years ahead. Many important lessons have nonetheless already emerged, both in crisis prevention and crisis resolution, which makes this book relevant not only for emerging Europe but for many other countries as well.

Reza Moghadam
Director
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Acknowledgments

This book brings together the extensive work that has been done in the IMF's European Department on the 2008/09 crisis in emerging Europe. It is written by a group of IMF staff who worked on emerging Europe during the crisis. It contains both a regional perspective, which builds on the work done in the Emerging Europe Regional Division of the European Department, and detailed country-by-country accounts, authored by the respective IMF country teams.

The authors include, in alphabetical order, Athanasios Arvanitis, Ruben V. Atoyan, Bas B. Bakker, Gerwin Bell, Alina Carare, Chuling Chen, Lone Christiansen, Costas Christou, Milan Cuc, Xavier Debrun, Peter Dohlman, Arbër Domi, Christoph Duenwald, Natan Epstein, Jeffrey Franks, Michael Gorbanyov, Manuela Goretti, Mark Griffiths, Nikolay Gueorguiev, Anne-Marie Gulde-Wolf, David Hofman, Plamen Iossifov, Albert Jaeger, Christopher Jarvis, Phakawa Jeasakul, James John, Yuko Kinoshita, Christoph Klingen, Dimitry Kovtun, Julie Kozack, Mark Lewis, Eliza Lis, Ricardo Llaudes, Wes McGrew, Tokhir Mirzoev, Pritha Mitra, James Morsink, Zuzana Murgasova, Jürgen Odenius, Catriona Purfield, Jesmin Rahman, Christoph Rosenberg, Stephane Roudet, Linda Spahia, Gabriel Srour, Alexander Tieman, Anita Tuladhar, Jérôme Vandenbussche, Delia Velculescu, Johannes Wiegand, and Daria Zakharova.

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Introduction and Overview

THE PRECRISIS YEARS

Between 1995 and 2007, emerging Europe grew faster than all other emerging market regions, with the exception only of China and India. As the region made the transition from central planning to market economies, institutions were modernized, often in the context of an EU accession process. Foreign direct investment poured in to benefit from highly skilled and inexpensive labor.

Until 2003, growth was driven largely by exports, but from 2003 onward, growth in the region was increasingly due to a credit-fueled surge in domestic demand. Rapid credit growth partly reflected catch-up, with less prosperous countries experiencing faster credit growth and financial deepening. However, in many countries the speed of credit growth was too rapid and jeopardized macroeconomic stability.

The domestic demand boom was fueled and financed by unprecedented capital inflows. Emerging Europe as a whole had been the beneficiary of large capital inflows since the late 1990s. With low wages and low capital-labor ratios, returns on investment in emerging Europe were highly attractive. Capital inflows were further stimulated by post-transition reforms. From 2003 onward, push factors—low interest rates in advanced economies and low global risk aversion—added more fuel to capital inflows, as did the dismantling of barriers to capital flows in the context of EU accession, and the expectation of euro adoption. As a result, capital flows to emerging Europe became very large by historical standards and compared with other emerging market economies.

The size of the capital inflows varied significantly across countries, and some countries managed to avoid excessive capital inflows altogether. Capital inflows were particularly large in the Baltic countries and southeastern Europe, whereas the more mature economies of the Czech Republic and Poland, which had flexible exchange rate regimes and small interest rate differentials with the euro, as well as Russia and Turkey, received much more moderate inflows.

Capital flows from western European banks were a key conduit for the credit and demand boom in emerging Europe. Western European banks expanded aggressively in emerging Europe, aiming to gain market share in a growing region. 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. Western European banks financed much of the credit increase through loans, deposits, and capital provided to their local subsidiaries.

The credit booms contributed to rapid GDP growth, but the flip side was overheated economies and sharply increased current account deficits. Overheating was particularly pronounced in the Baltic countries, in Bulgaria and Montenegro, and in the European countries of the Commonwealth of Independent States (CIS).[1] Overheating was not only visible in inflation and wages, housing prices were also increasing rapidly.

By 2007, the growth pattern of many countries was 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, and any slowdown or reversal of foreign financing was bound to hit the economy hard.

Procyclical fiscal policy further exacerbated imbalances. Indeed, 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 buoyant government revenues—a windfall that was generally recycled right back into public spending.

Many country authorities grew concerned about the unfolding credit boom, but the prudential measures that were adopted in response generally proved toothless. Restrictions on credit growth were easily circumvented as inflows moved to less supervised channels.

Until mid-2007, risk premiums in the region continued to decline uniformly, and some countries with very high vulnerabilities continued to enjoy investment grade status. The high ratings received intellectual endorsement by many economists who argued that rapid credit growth and large current account deficits were part of rapid catch-up—an equilibrium phenomenon. Even when vulnerabilities were recognized, it was difficult to envisage a shock severe enough to trigger an actual crisis, and few recognized the risk that a shock to the region could originate from the western financial system. Had risk premiums risen in line with the increasing imbalances, capital flows would have slowed, credit growth would have been more moderate, and private sector demand would not have expanded as rapidly.

GATHERING CLOUDS

Between the onset of the global financial crisis in August 2007 and the default of Lehman Brothers in September 2008, the region was little affected by the global turmoil. Capital continued to flow into emerging Europe, and credit was still growing strongly. As inflation was rising rapidly, controlling inflation was seen as the most pressing challenge for policymakers.

The Baltic countries and Hungary were the only economies in which the impact of the global financial crisis made itself felt well before the default of Lehman Brothers. The former experienced an economic slowdown when Swedish banks, concerned about their exposure, started to rein in credit growth in the summer of 2007. The housing bubble burst, and domestic demand started to decline, with Estonia and Latvia already entering a recession in the first half of 2008.

[1] Belarus, Moldova, Russia, and Ukraine.

Hungary experienced a short episode of financial stress in March 2008, when a government debt auction ran into trouble. Although Hungary was not showing signs of overheating and its private sector flow imbalances were smaller than elsewhere, public debt stock vulnerabilities were unsettlingly high. Public debt at end-2007 amounted to 66 percent of GDP, and about one-third of it was held by footloose foreign investors.

THE DEFAULT OF LEHMAN BROTHERS AND THE AFTERMATH

It was in mid-September 2008, when Lehman Brothers collapsed, that the global crisis arrived in emerging Europe with a vengeance. Global financial markets froze; international trade came to a standstill; and commodity prices collapsed, hitting the whole region on a scale beyond the most pessimistic expectations. Sovereign credit default swap (CDS) spreads jumped; issuing of international sovereign bonds became next to impossible; and countries with relatively more developed markets faced a reversal of international portfolio flows. In countries with floating exchange rate regimes, currencies fell sharply, while most countries with fixed exchange rate arrangements suffered significant reserve losses.

Emerging Europe's banks came under funding pressures when the capital flows of western European banks to the region dropped sharply. In a change of strategy, many advanced-country banks, which were confronted with liquidity and capital shortages, gave their subsidiaries and branches in emerging Europe new marching orders: new credit would henceforth need to be financed solely from local deposit growth. They also halted cross-border loans to nonbanks. Banks' funding pressures were further exacerbated by the freezing of the international syndicated loans market and by local deposit withdrawals in October and November, in particular in the European CIS countries, the Baltic countries, and non-EU southeastern Europe.

Output in most countries declined very sharply when the collapse in global trade caused exports to plummet, just when domestic demand reeled from the sudden slowdown in credit growth and the bursting of the real estate bubbles. The output decline in emerging Europe as a whole was larger than in other emerging market regions, mainly because capital inflows corrected from a higher level in emerging Europe than elsewhere. Countries that had the largest credit and domestic demand boom in the precrisis years experienced the largest contractions in GDP in 2009. A few countries escaped severe recession—Poland due to its contained precrisis boom and fortuitously countercyclical policies, as well as the less interconnected economies of Albania, Belarus, and Macedonia.

POLICY REACTIONS

Stabilizing the financial sectors was the first order of the day. The most commonly used tool to provide systemic liquidity was the relaxation of reserve requirements. Several countries also introduced new domestic and foreign currency liquidity supply operations. To contain the risk of bank runs, deposit insurance coverage was increased. To strengthen banks' capital positions, many supervisors urged a zero-dividend policy and sometimes requested preemptive recapitalizations based on stress tests. National authorities also intervened directly in selected individual distressed institutions to provide them with fresh liquidity or capital.

Monetary policy reactions were circumscribed by depreciation pressures and the exchange rate risks on balance sheets. Where large 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 Hungary, Russia, Serbia, and Ukraine) or put on hold (as in Latvia and Romania). In other countries, policymakers decreased policy rates (the Czech Republic, Poland, and Turkey). Monetary and exchange rate policy frameworks were generally maintained, but circumstances in Belarus, Russia, and Ukraine necessitated steep depreciations of their heavily managed exchange rates.

The immediate fiscal policy response depended on precrisis fiscal buffers, the exchange rate regime, and the position in the political cycle. Few could afford fiscal expansion, and many needed to implement fiscal adjustment. Russia, Turkey, Poland, and the Czech Republic were exceptions because of flexible exchange rate regimes, small deficits, and limited debt.

Large, front-loaded financial assistance packages from the IMF, often in close cooperation with the European Union and other multilateral institutions, provided external funding and smoothed the required policy adjustments in several countries. A total of 10 countries secured critical external financing under IMF-supported arrangements. Considerably larger amounts of financing were made available than in earlier crises. Moreover, disbursements were much more front-loaded in the programs in emerging Europe, with the first disbursement accounting for a very large share of overall financing committed under the programs.

FROM CRISIS TO RECOVERY

By early 2009, the panic that had gripped global financial markets began to abate. As tensions in global financial markets eased, financial conditions in emerging Europe started to improve as well. In some countries, CDS spreads fell to half their peak levels during the spring months. At the same time, global economic activity started to rebound, while the forceful and internationally coordinated policy response further bolstered confidence and reduced uncertainty.

The resurgence of world trade and global manufacturing output led to an export-led recovery in emerging Europe, and in 2010 GDP in the region grew by 4½ percent, after having contracted by about 6 percent in 2009. Domestic demand, however, remained weak in many countries, particularly in those that had seen the strongest domestic demand booms in the precrisis years. Domestic demand in countries where imbalances in the precrisis years had been more contained (including Poland and Turkey) remained quite strong and received further support from an early revival of capital inflows.

By 2011, the recovery had broadened from exports to domestic demand, and all crisis-affected countries had emerged from recession. The recovery of domestic demand was particularly strong in the Baltic countries, while it remained more subdued in southeastern Europe. Despite the economic recovery, large differences in cyclical positions and growth rates remained, with GDP flat in Croatia and growth hitting 8½ percent in Turkey.

The crisis left much of the region with three legacies: deteriorated public finances, high unemployment, and increased nonperforming loans.

- *Public finances deteriorated sharply*. Before the crisis, headline fiscal balances in the region looked much better than in other emerging market regions. In 2007, the average headline balance in the region showed a surplus of about 2 percent of GDP. By 2009, the fiscal balance in the region had deteriorated to a deficit of 6.2 percent of GDP—despite significant fiscal adjustment. In Latvia and Lithuania, deficits approached double digits. Significant fiscal consolidation, together with the economic recovery, reduced the region's deficit to 4.4 percent of GDP in 2010 and 0.5 percent of GDP in 2011, but fiscal vulnerabilities remain high in a number of countries. Some countries still had a deficit in 2011 in excess of 5 percent of GDP (Poland, Croatia, Lithuania, and Montenegro), and some countries (notably Hungary, Albania, and Poland) continued to have high public debt. In Hungary and Albania relatively high shares of short-term debt further exacerbated vulnerabilities.
- *Unemployment rates shot up sharply.* This was most dramatically the case in the Baltic countries. Unemployment rates dropped in 2010 and 2011 but remain well above precrisis levels. The rise in unemployment in southeastern Europe was less dramatic, but with that subregion's much weaker recovery, unemployment had declined only little by 2011 and had been uncomfortably high even before the crisis.
- *Banks' nonperforming loans increased sharply*. The average reported nonperforming loan ratio in emerging Europe increased from 3½ percent at end-2007 to over 11 percent at end-2011. Ratios peaked at about 20 percent in Montenegro, Lithuania, and Serbia. While considerable provisioning and strong capitalization provide important buffers, it is likely that the high nonperforming loans will hold back credit growth and economic recovery if allowed to linger.

HOW MELTDOWN WAS AVOIDED

In the aftermath of the Lehman Brothers collapse, concerns about meltdown were not far-fetched considering the many vulnerabilities that had built up in most countries of the region in the precrisis years. Yet the feared financial meltdown did not materialize. The fixed exchange rate regimes weathered the crisis, and floating exchange rates generally rebounded quickly from their troughs (except in the large European CIS countries). Similarly, the strain in banking systems morphed into outright systemic banking crises only in Latvia and Ukraine.

Why is it, then, that emerging Europe escaped financial meltdown? Decisive domestic policy responses certainly played a key role. However, they would have stood much less of a chance had it not been for large-scale international support, policy easing in the advanced economies, and western banks that remained committed to the region.

- Large external financing packages helped reassure jittery financial markets that exchange rates and the funding of domestic spending plans were indeed sustainable. When it became clear that the financial crisis was spreading from the advanced economies to emerging markets, the international community acted quickly to shore up the economies in emerging Europe. One prime vehicle of assistance was large IMF-supported programs, which were joint with the European Union in the case of EU member countries. Other international financial institutions also stepped up their efforts.
- Policy easing in advanced economies also helped. The interest rates of the major currencies were cut to extremely low levels, and fiscal stimulus measures were put in place in most of the advanced economies. Both had positive spillover effects to emerging market economies.
- The commitment of foreign banks to stay in the region was another key stabilizing factor during the crisis. No parent bank allowed a single one of its subsidiaries to fail in the entire region, and in most cases parent banks provided additional liquidity and capital to their subsidiaries in emerging Europe, as needed. IMF-supported programs and the so-called Vienna Initiative helped avoid an uncoordinated pullout of western banks from emerging Europe. The large-scale programs significantly reduced the odds of financial meltdown occurring, but there were also more direct efforts to keep banks engaged. As part of an overall effort to coordinate the crisis response under the Vienna Initiative, key foreign banks pledged in writing that they would keep net exposure to their subsidiaries at prespecified levels.

COUNTRY EXPERIENCES

How did the events surrounding the 2008/09 crisis play out concretely at the country level of the 19 economies that make up emerging Europe? What exactly were the pressure points, were they recognized at the time, what kind of policy response did they engender, and what were the economic outcomes? The broad thread—easy global financing conditions and an optimistic perspective on income convergence with western Europe that allow imbalances to persist or escalate so that a soft landing becomes extremely difficult—runs through all country experiences. However, there were important cross-country differences in the size of the boom-bust cycles and economic outcomes, and these differences reflected the strength and type of linkages with the rest of the world, precrisis policies, and the crisis response.

Ten countries in emerging Europe availed themselves of IMF-supported arrangements during 2008–10. Hungary, Ukraine, Latvia, Belarus, Serbia, Romania, Bosnia-Herzegovina, and Moldova received critical financial support under adjustment programs designed to forestall financial meltdown, mitigate the fallout from the crisis, and lay the foundations for lasting recovery. Poland secured a Flexible Credit Line (FCL) from the IMF to provide additional cover for its crisis-response policies, although no need arose to draw on it. The primary purpose of the program with Kosovo was to provide a framework for its large post-independence infrastructure spending, rather than to respond to the crisis.

Three weeks after the collapse of Lehman Brothers, Hungary became the first country to request financial assistance from the IMF and the European Union when it found its gross financing needs impossible to meet on its own. Long-standing vulnerabilities from high public and external debt were the key problem rather than a pronounced precrisis demand boom. A €20 billion external financing package and a determined policy response restored financial stability and mitigated the downturn. However, a change of government led to partial policy reversals and the premature lapse of the program in mid-2010, leaving Hungary ill-prepared to weather the spillovers from the euro area crisis.

Ukraine was particularly hard-hit by the crisis and was next to approach the IMF. It not only faced a sudden stop of capital inflows and a collapse of exports like everybody else in the region—on top of that it suffered a major terms-of-trade shock as prices for its key metals exports plummeted and Russia cut its subsidies on Ukraine's energy imports. Ukraine suffered the second-largest output drop in emerging Europe, a banking crisis, and the demise of its exchange rate peg. The IMF-supported program focused on repairing the financial sector and tightening monetary policy to contain inflation in the wake of the depreciation. Fiscal policy cushioned the downturn. Ukraine recovered strongly in 2010–11, but structural and institutional reforms are still needed to underwrite economic success for the long haul.

Latvia was arguably the most overheated economy in the region, with a current account deficit that peaked at well over 20 percent of GDP and several years of double-digit output growth. The Latvia program supported by the IMF and the European Union was put in place in late December 2008. Unprecedented external financial support equivalent to more than 30 percent of its GDP, austerity measures worth some 15 percent of GDP, nominal wage cuts, and a host of structural reforms came together in a program that was designed around preserving Latvia's quasi currency-board arrangement—a key policy anchor since the early days of transition. The costs in terms of peak-to-trough output loss were the largest in the region, and the second largest bank in the country failed. However, notwithstanding Latvia's enormous precrisis challenges, financial meltdown was avoided, external balance was restored, and the economy grew by over 5 percent in 2011. Defying the skeptics, the exchange rate peg held. The very real risk that a collapse of Latvia's exchange rate arrangement would set off a contagious domino effect throughout the region's many fixed exchange rate regimes did not materialize.

Belarus is a tale of missed opportunities. It was also beset by large precrisis imbalances with persistently high current account deficits and very high growth. Given its limited integration with global financial markets, risks arose mainly from a persistent drain of reserves from the trade account and dependence on substantial energy subsidies from Russia. The stand-by arrangement of January 2009 with the IMF sought external adjustment through a 20 percent devaluation, macroeconomic tightening, and steps to improve the competitiveness of the still largely state-controlled economy. Good progress was made, and Belarus was among the few countries in the region to escape recession in 2009. However, significant policy loosening after the end of the program triggered a major currency crisis in 2011, which raged through much of the year.

Large structural external imbalances were the Achilles heel of Serbia. The drying-up of external financing put strong pressure on the dinar, and the banking system experienced heavy withdrawals of foreign currency deposits. Large current account deficits predated the boom years and reflected income and consumption habits that were no longer realistic. The stand-by arrangement of January 2009 and a bail-in agreement with foreign banks helped stave off financial instability. Large, front-loaded fiscal adjustment created room for automatic fiscal stabilizers to operate through the remainder of the crisis period. And a significant real depreciation restored external cost competitiveness. These successes notwithstanding, the crisis exposed deep flaws in Serbia's consumption-based growth model that were still being addressed in late 2011.

Like Latvia, Romania is another straightforward example of the boom-bust cycle in emerging Europe, but under a flexible exchange rate regime and not quite so extreme. Exuberance about its clear prospects for EU membership in conjunction with ample global liquidity led to internal and external imbalances that were forced to correct abruptly in the wake of the global financial crisis. Despite limited public debt and a generally well capitalized banking system, the government ran into difficulties financing the rapidly widening fiscal deficit, and banks experienced an incipient deposit run. The €20 billion financial support program by the IMF and the European Union of May 2009 forestalled a banking crisis, together with a bail-in arrangement with banks. Measures to address the short- and long-term sources of fiscal deficits, steps to strengthen the prudential framework, and prudent monetary policy restored macroeconomic stability. As elsewhere in southeastern Europe, economic recovery was slow to take hold, but GDP expanded by 2½ percent in 2011.

The global crisis quickly exposed the fragility of Bosnia and Herzegovina's growth, which relied on ample foreign-financed credit, inward remittances, and donor-financed reconstruction of the war-torn economy. Balance-of-payments pressures escalated in the first half of 2009 when remittances declined and foreign banks and investors became unwilling to provide the customary funding. The authorities' stabilization program, supported under the July 2009 stand-by arrangement with the IMF, stabilized public finances and shored up confidence in the currency board and the domestic banking system, thereby limiting the output loss.

Contrary to initial hopes, the global financial crisis did not bypass Moldova. The international linkages of its banking system were limited, but a sharp drop of critical remittances and plunging exports put severe pressure on the balance of payments. After an initially incoherent policy response, the IMF-supported program of January 2010 put in place a strategy to correct the structural imbalances at a pace matching the speed of the economic recovery, accelerated a transition to inflation targeting and exchange rate flexibility, and strengthened banks' capital and liquidity buffers through proactive supervision. Moldova recorded strong growth of 7 and 6½ percent in 2010 and 2011, respectively.

Poland came through the global financial crisis perhaps the best of all countries in the region. It entered the crisis with relatively contained imbalances and vulnerabilities, owing to relatively tight macroeconomic policies, prudential measures to limit foreign-currency lending, and convergence with western Europe that was already well advanced at the beginning of the boom period. It used its policy space aggressively to minimize the impact of the crisis, using the FCL of May 2009 to bolster confidence further and maintain access to international capital markets throughout. Poland famously became the only country in the European Union to avoid recession in 2009 and posted strong growth of some 4 percent in 2010 and 2011.

The remaining nine countries of emerging Europe weathered the crisis without arrangements with the IMF, although they too likely benefited from the demonstrated willingness of the international community to step in with large-scale financial support if necessary. Bulgaria, Estonia, and Lithuania all went into the crisis with massive external imbalances, necessitating a vigorous policy response. Precrisis overheating had been less pronounced in Albania, Croatia, and Macedonia, and their economies were less integrated with the rest of the world, so that immediate pressures were less intense. Tiny Montenegro went through its own roller-coaster developments in its brief post-independence history. Russia and Turkey are both special cases because of the key role of oil prices and the precrisis history, respectively.

Developments in Bulgaria, Estonia, and Lithuania were all marked by deep recessions in 2009, strong fiscal austerity, and sharp external adjustment. Precrisis commonalities across the three countries include currency-board arrangements, a strong foreign-financed credit boom that had spawned outsized current account deficits (some 25 percent of GDP in the case of Bulgaria), bank loans that were primarily euro-denominated in anticipation of accession to the currency bloc, and public finances that looked solid on the surface with Bulgaria and Estonia even posting surpluses. In 2009, all suffered large domestic-demand-driven output contractions as foreign financing for new bank loans was no longer forthcoming. The recession led to a sharp contraction of imports, a key factor in the swift correction of the external imbalances. In Bulgaria, external adjustment also had a self-correcting component, as the sharp decline of hitherto large foreign direct investment was accompanied by an equally sharp decline of the associated imports.

The recession also unmasked the underlying weakness of public finances, and all countries had to adopt extensive austerity measures to contain the rise of the fiscal deficit. Estonia managed the remarkable feat of keeping the deficit below the Maastricht limit in 2009, allowing it to adopt the euro in 2011. Bulgaria, by contrast, had to withdraw its European Exchange Rate Mechanism II (ERM-II) application and postpone entry to the European Economic and Monetary Union. A high degree of economic flexibility in the Baltic countries fostered the return to strong economic growth in 2011. The recovery was much weaker in Bulgaria, reflecting the shallower recession.

The crisis impact on Albania, Croatia, and Macedonia was muted by more limited external linkages, although to different degrees. Croatia was least insulated owing to extensive reliance on foreign bank financing of its domestic financial system. Moreover, its stable exchange rate policy and limited fiscal space ruled out a countercyclical crisis response. It suffered the deepest recession of the three countries, and chronic competitiveness problems left it with the weakest recovery in all of emerging Europe. Albania's banks are much less reliant on foreign financing, and its flexible exchange rate regime allowed a more elastic crisis response. Albania managed to avoid recession in 2009. Macedonia's international economic ties are weak, but its fixed exchange rate regime and financing constraints to the fiscal deficit limit its policy space. It suffered a mild recession in 2009.

Russia's changing fortunes were closely linked to the price of oil. Its precrisis boom was driven by ever-rising prices for Russia's oil and gas exports, further egged on by procyclical economic policies and capital inflows. The economy overheated, but the current account remained in surplus thanks to favorable terms of trade. By the same token, the economy was hard hit when oil prices collapsed in the wake of the global financial crisis. Russia aggressively deployed its fiscal buffers and ample international reserves built up during the good years to cushion the impact of the crisis. Nonetheless, the recession was deep and the recovery unimpressive, speaking to the slew of longstanding fundamental shortcomings that stand in the way of better economic performance in Russia.

Turkey suffered only a very brief recession in 2009, and its growth went into overdrive thereafter. Turkey largely avoided overheating in the years prior to the global financial crisis as it was still recovering from its own crisis of 2001. The extensive repair of public finances, disinflation policies, and financial sector reform kept domestic demand in check. Despite reasonably solid fundamentals, Turkey's long history of economic crisis meant that confidence evaporated quickly in the wake of the Lehman Brothers bankruptcy. But when the banking sector held up, public finances remained in order, and the authorities deployed countercyclical policies, confidence returned equally fast. The result was a V-shaped recovery. As the global financial crisis eased, Turkey's newly demonstrated resilience made it a magnet for capital inflows. Growth surged to 8–9 percent in 2010 and 2011, with the policy challenge shifting to managing the success and avoiding overheating.

LESSONS FROM THE CRISIS

Four important and interrelated lessons can be distilled from the pronounced boom-bust cycle that emerging Europe experienced in the past decade:

- *Strive for more balanced growth*. Growth that is driven by capital inflows fueling domestic demand creates a series of vulnerabilities, inflates the non-tradable sector, and is ultimately unsustainable. While policymakers cannot and should not mandate a particular growth model at the micro level, there is much they can do to nudge broad developments in the right direction.
- *Keep credit growth in check*. Rapid credit growth is not only a chief culprit for unbalanced growth, it also plants the seeds for future problem loans that complicate recovery from economic downturns. Building safeguards against excessive credit growth requires combining macroeconomic and supervisory measures. Effective coordination of home and host supervisors is essential if cross-border banking groups are important.
- *Discourage lending in foreign currency*. The surge in foreign currency loans in the precrisis years created credit risks for banks and limited macroeconomic policy space during the crisis. During the boom years, with exchange rates either fixed or appreciating as a result of convergence, the risks associated with foreign currency lending were not taken seriously.
- *Fiscal policy needs to limit expenditure growth*. The rate of precrisis public expenditure growth in many countries was imprudent. With booming revenues, the large increases in fiscal spending fueled overheating and set the stage for large deficits when part of the revenue surge turned out to be temporary. Fiscal policy could play a much more active role—building buffers when revenues are growing instead of increasing spending and boosting public wages. This may mean that during boom times small fiscal surpluses are not enough—large surpluses are called for.

Many of the imbalances that characterized much of emerging Europe prior to the crisis have unwound, but some precrisis vulnerabilities remain, and new vulnerabilities have emerged as a result of the crisis. Current account deficits in most countries have come down, inflation has receded, and excessive credit growth has given way to flat or declining credit. Gross financing requirements in many countries remain important, rollover risk in the domestic debt markets persists, and the share of foreign currency loans remains close to peak levels. Public finances are significantly weaker than in 2008, and nonperforming loans have increased in all countries.

This crisis made plain that policymakers need to reconsider how best to achieve lasting convergence. "As fast as possible" is not always the best approach. A holistic approach is called for, in which policies in a broad range of areas may need to be adjusted to achieve the desired goal. Key planks of a policy agenda for resilient convergence include:

- *Policies to contain domestic consumption and strengthen domestic saving*. They include tax policy, pension plans, and not least fiscal savings, especially in cases where the change in private savings behavior is difficult to achieve. Supporting measures include the development of domestic debt markets, to encourage private savings and foster the emergence of institutional investors for an efficient allocation of savings.

- *Policies to discourage excessive foreign debt in favor of foreign direct investment*. Relevant measures include all structural efforts to increase the attractiveness of countries for investment. Those measures should be supported by regulatory and prudential measures to discourage excessive foreign borrowing by banks, including from parent banks.
- *Measures to support broader based growth*. Increasing the flexibility of the workforce through appropriate schooling will increase the resilience of economies and allow for a smoother shift from the once booming property and financial sectors to other activities. Similarly, measures to prevent unbalanced growth concentrated in a few sectors—including, for example, through a strict adherence to sectoral exposure limits in lending—will help avoid the reemergence of bubbles in narrow parts of the economy, especially in housing. Finally, an open and competitive environment fostered by deregulation of product and service markets will support the overall economic environment and allow the efficient reallocation of resources in line with changing economic opportunities.

PART I

Prelude to the Crisis

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CHAPTER 1

The Boom Years, 1995–2007

Since the onset of transition in the early 1990s, emerging Europe has seen impressive progress. In a span of less than 20 years, the region went from central planning to successful market economies (Åslund, 2007). Institutions were modernized, often in the context of an EU accession process. Foreign direct investment poured in to benefit from highly skilled labor available at low cost. Great strides were made toward trade and financial integration with western Europe.

This transition from a planned to a market economy boosted growth, and after an initial decline in output, emerging Europe grew faster than almost all other emerging market regions. Per capita income expanded by 4 percent annually from 1995 to 2007—exceeded only by China and India (Figure 1.1). 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. As a result, per capita GDP for the region rose from 28 percent of Germany's GDP per capita in 1995 to 39 percent in 2007.

Until 2003, growth was driven largely by exports, which 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 1.1 and 1.2).[1] Owing to their geographic proximity and relatively low labor costs, the central and eastern European (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.[2] During this decade, capital inflows remained moderate and went largely to the tradable sector.

From 2003 onward, however, growth in the region was increasingly driven by a domestic demand boom (Figure 1.2). During 2003–08, domestic demand growth in the region averaged 8¼ percent annually—well above GDP growth (6½ percent per year). The boom was most pronounced in the European CIS countries, the Baltics, Bulgaria, Montenegro, and Romania.[3] In these countries domestic demand grew by 9–13 percent. In other countries domestic demand growth was more moderate at 4–6 percent per year (these countries included Albania, Bosnia and Herzegovina, Croatia, the Czech Republic, Macedonia, Poland, and the Slovak

The main authors of this chapter are Bas B. Bakker and Phakawa Jeasakul.

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

[2] Russia and Ukraine remained predominantly commodity exporters.

[3] The Commonwealth of Independent States (CIS) countries are Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyz Republic, Moldova, the Russian Federation, Tajikistan, Turkmenistan, Ukraine, and Uzbekistan.

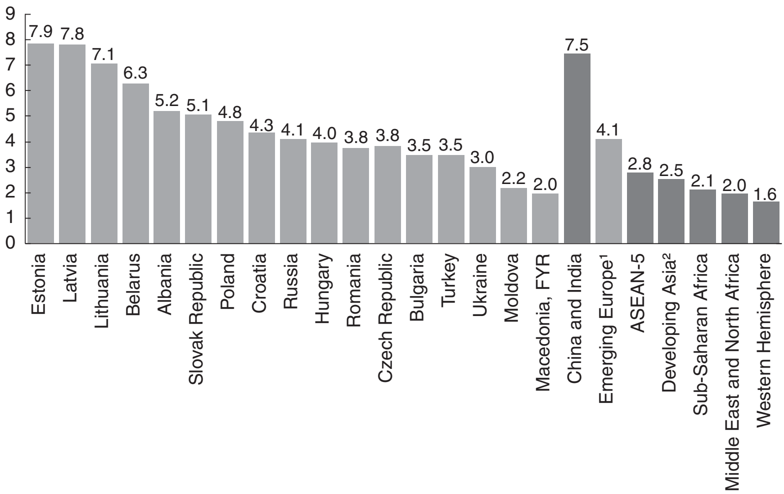

Figure 1.1 Emerging Europe and Selected Regions: Real Per Capita GDP Growth, 1995–2007 (*Annual percentage change in purchasing power parity terms*)

Source: IMF, World Economic Outlook database.
Note: ASEAN-5 = Five of the member countries of the Association of Southeast Asian Nations, including Indonesia, Malaysia, the Philippines, Thailand, and Vietnam.
[1] Includes the Czech Republic and the Slovak Republic.
[2] Excludes China and India.

TABLE 1.1

Emerging Europe: Exports of Goods, 1995–2007

	Levels (Percent of GDP)			Changes (Percentage Points)		
	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	...	...	12	...	...	...
Serbia	...	...	19	...	...	...

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

TABLE 1.2

Emerging Europe: Direction of Exports, 2007
(*Percent of GDP*)

	Euro Area	Emerging Europe and CIS	Other	Total
Albania	8	1	1	10
Montenegro	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.
Note: CIS = Commonwealth of Independent States.

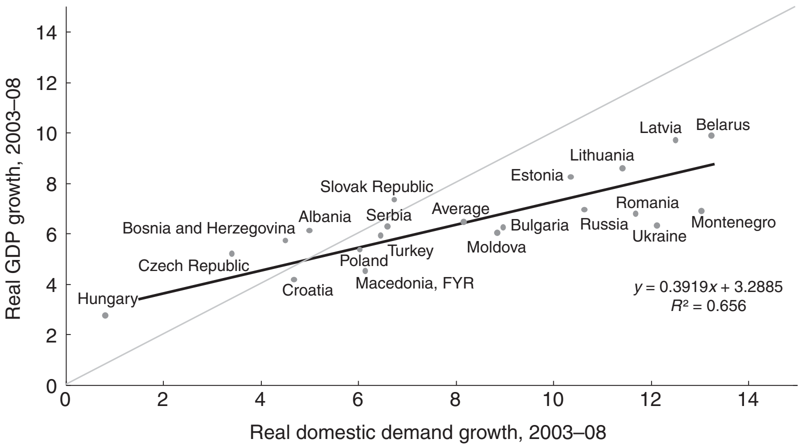

Figure 1.2 Emerging Europe: Domestic Demand Growth and GDP Growth, 2003–08[1]
(*Annual percentage change*)

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.

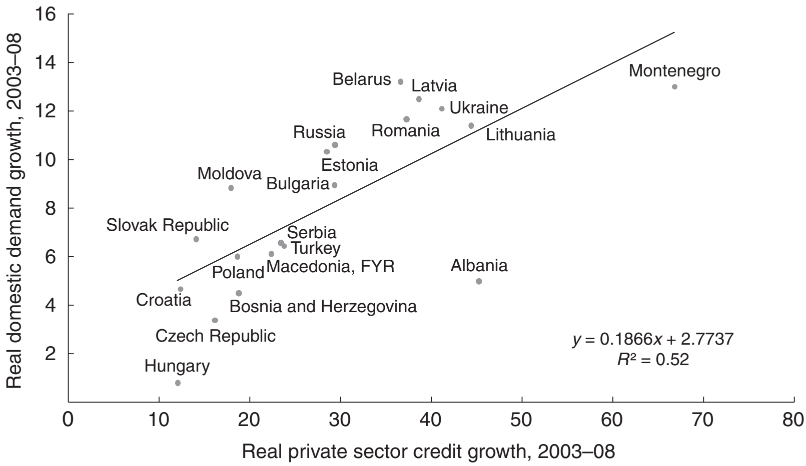

Figure 1.3 Emerging Europe: Domestic Demand and Private Sector Credit Growth, 2003–08[1] (*Annual percentage change*)

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.

Republic). Domestic demand was weak only in Hungary, partly as a result of the substantial fiscal consolidation that took place in the precrisis years.

THE NATURE AND ORIGINS OF THE CREDIT BOOM

The demand boom was the result of a surge in bank credit and asset prices (Figures 1.3 and 1.4). Credit increased to both households and firms (Figure 1.5). Rapid credit growth was fueled by catch-up, since the countries that were poorer had generally faster credit growth. However, catch-up was only part of the story, as there were large differences in credit growth among countries with similar income levels. In some countries, the speed of credit growth exceeded what could be justified by appropriate financial deepening and jeopardized macroeconomic stability.[4] By 2008, there were large differences in the credit-to-GDP ratios (Figure 1.6). Housing prices rose sharply and even equity markets surged, with an average annual increase of some 40 percent.

The credit boom was fueled and financed by unprecedented capital inflows (Figure 1.7). Emerging Europe as a whole had been the beneficiary of large capital inflows since the late 1990s. With low wages and low capital labor ratios,

[4] Becker and others (2010) argued that while the level of credit as a percentage of GDP remained well below the EU15 average, even at the peak of the precrisis credit boom, and several empirical studies suggested that the level of credit was below equilibrium, the speed at which the equilibrium level of credit is reached matters for macroeconomic stability, as rapid credit growth can fuel consumption, lead to sharp rises in house prices, and feed inflation and wage growth, which in turn can erode competitiveness and contribute to current account deficits and the buildup of external debt.

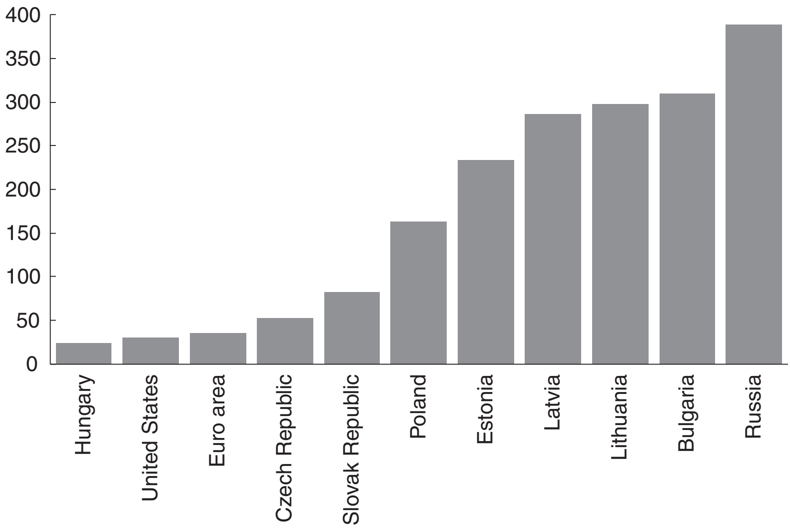

Figure 1.4 Emerging Europe: Change in Real Estate Prices, 2003–08[1] (*Percent*)

Sources: Bank for International Settlements, *Property Price Statistics*; 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.

returns on investment in emerging Europe were very high (Lipschitz, Lane, and Mourmouras, 2002). Capital inflows were further stimulated by post-transition reforms. Countries that reformed most during the 1995–2007 period received the largest capital inflows (Figure 1.8). From 2003 onward, push factors—low interest rates in advanced economies and low global risk aversion—further boosted capital inflows, as did the dismantling of barriers to capital flows in the context of EU accession (Rosenberg and Tirpák, 2008) and the expectation of euro adoption. As a result, capital flows to emerging Europe became very large both by historical standards and as compared with other emerging market economies (Table 1.3).

The size and composition of the capital inflows varied significantly across countries, and some countries managed to avoid excessive capital inflows altogether. Capital inflows were particularly large in the Baltic countries and southeastern Europe (SEE). By contrast, the more mature economies of the Czech Republic and Poland, with their flexible exchange rates and small interest rate differentials to the euro, as well as Russia and Turkey, received much more modest inflows. Capital flows to the new EU member states were generally larger than flows to nonmember states. The size of the capital inflows also exceeded the size of inflows to precrisis Asia; the unweighted average in the EU-9 (107 percent of GDP) was almost three times as large as in precrisis Indonesia, the Philippines, and Thailand (38 percent of 1992 GDP; Figure 1.9).

Regarding the type of capital inflows into the region, bank loans were the most important category, followed by foreign direct investment (FDI) (Figure 1.10). Lending by banks, statistically included in "other investment flows," was not only the most important category but also the category with the largest differences

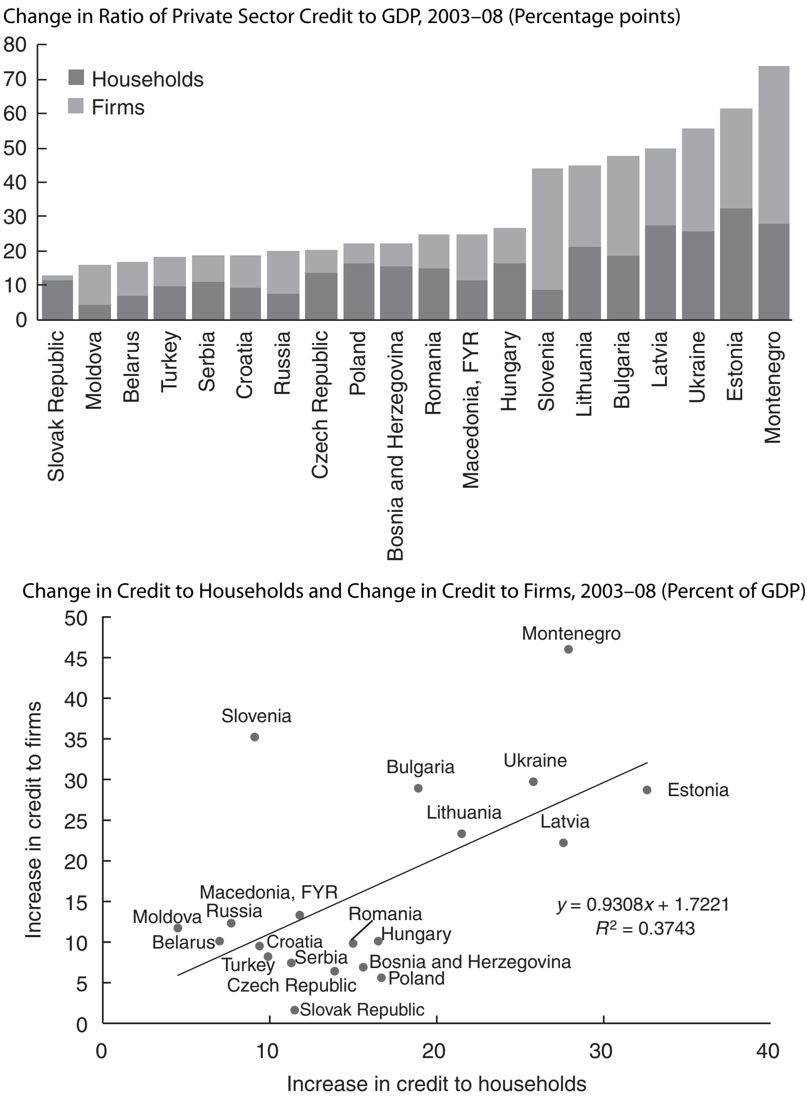

Figure 1.5 Credit Growth

Sources: European Bank for Reconstruction and Development; and IMF staff calculations.

across countries—most of the variation in capital inflows was due to "other" investment inflows rather than to FDI (with the notable exception of Bulgaria and Montenegro). Portfolio inflows were very small or even negative, with the notable exception of Hungary and Ukraine.[5]

[5] In both Hungary and Ukraine, much of the portfolio inflows went into local currency-denominated government bonds. In Ukraine, during 2006–07, foreign purchases of bonds issued by banks were important as well.

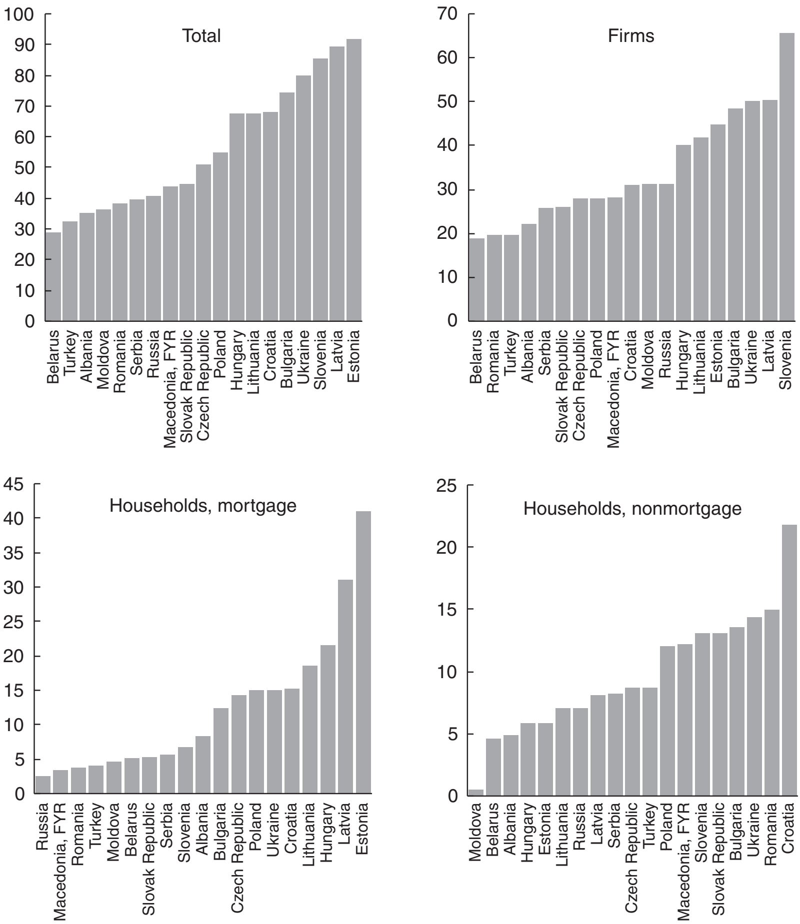

Figure 1.6 Credit to GDP Ratio, 2008 (*Percent*)

Source: European Bank for Reconstruction and Development.

Capital flows from western European banks were particularly important in fueling the credit and demand boom.[6] Western European banks expanded aggressively in emerging Europe, aiming to gain market share in a growing region. With low margins in western Europe, western banks became increasingly interested in expanding in eastern Europe, and they came to dominate many of the region's banking

[6]In the October 2011 *Regional Economic Outlook: Europe*, a study on linkages between eastern and western Europe showed that over time, about 80 percent of any exposure increase translates into additional credit, while a 1 percentage point increase in real credit growth is associated with a 0.35 percentage point increase in real domestic demand and a 0.28 percentage point increase in real GDP. According to these empirical estimates, the financing provided by western European banks added 2 percentage points to the region's annual domestic demand growth, or 1.5 percentage points to GDP growth during 2003–08.

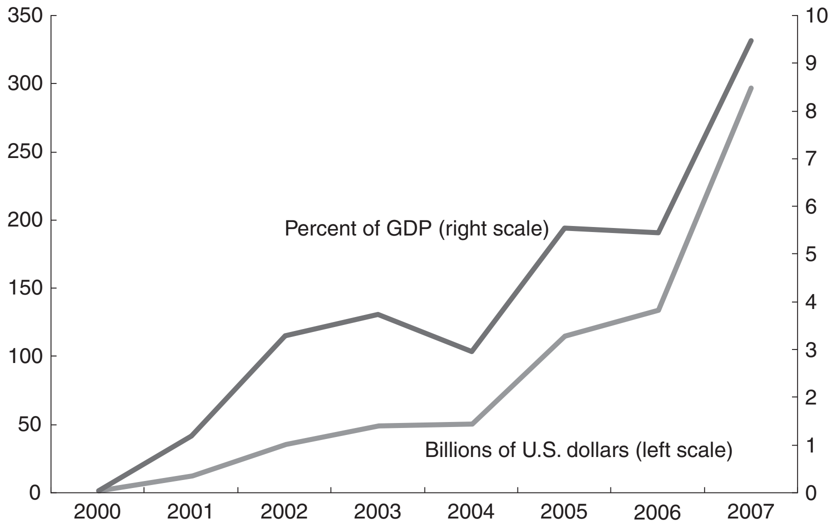

Figure 1.7 Emerging Europe: Net Capital Flows, 2000–07

Source: IMF, *International Financial Statistics*.

systems as they acquired local banks that were privatized or put up for sale by their private owners. Western European banks financed much of the credit increase through deposits and capital injections to their local subsidiaries.[7] The magnitude of the credit boom differed among individual countries, and was closely linked to the size of the influx of capital from western banks (Figure 1.11). Countries that experienced a larger influx of capital from western banks (for example, the Baltics and Bulgaria) experienced a larger increase in the ratio of private sector credit to GDP than countries where the influx was small (the Slovak Republic).

The credit booms contributed to rapid GDP growth but also led to a sharp increase in current account deficits and an overheating of the economies. Countries with the most rapid credit growth saw the largest increase in domestic demand (Figure 1.12). Rapid domestic demand growth was in turn associated with faster GDP growth, although an important part of the increase in domestic demand leaked out through higher trade deficits. The current account deterioration was pronounced in countries where domestic demand expanded by more than 8 percent per year—with the exception of Russia, where terms-of-trade improvements largely offset the impact of rising domestic demand. With rapid growth, inflation started to pick up (Figure 1.13), labor markets tightened, and wage costs accelerated. Overheating was particularly pronounced in the Baltic countries, Bulgaria, Montenegro, and the European CIS countries. Overheating was not only visible in inflation and wages; housing prices were also rising rapidly. By 2008, the external debt of many countries had reached high levels—whether measured as ratio

[7] They also provided cross-border loans directly to customers.

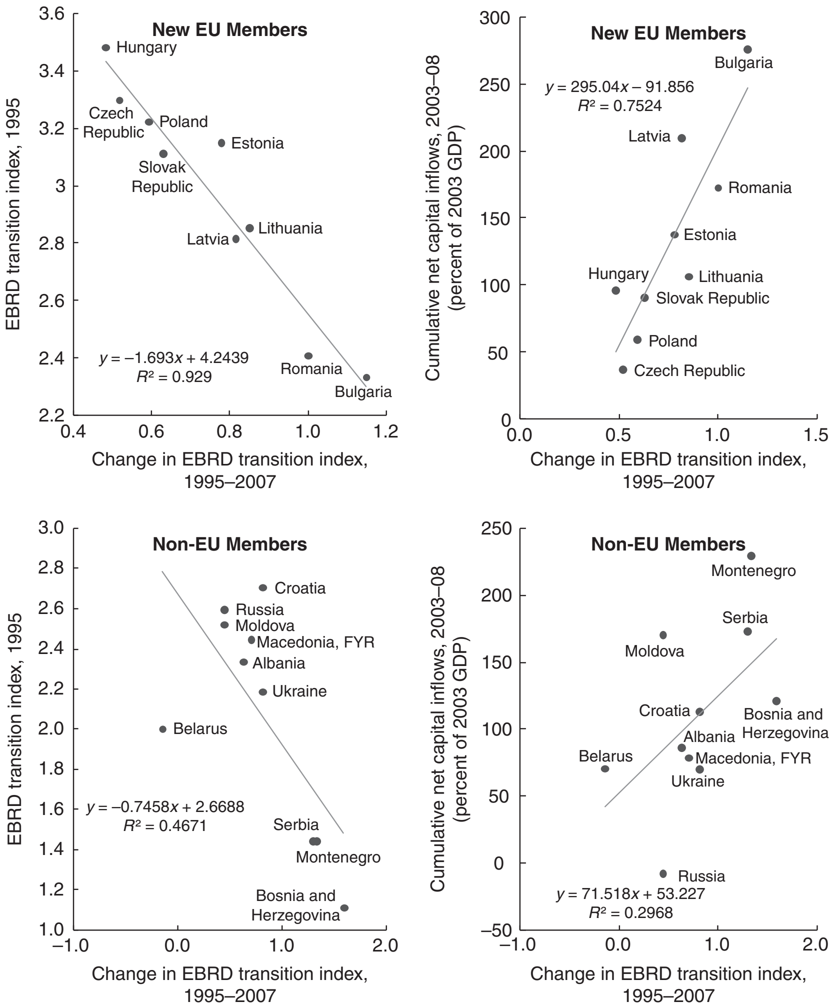

Figure 1.8 Emerging Europe: Reform and Capital Flows

Sources: EBRD; IMF, World Economic Outlook database; and IMF staff calculations.
Note: EBRD = European Bank for Reconstruction and Development.

TABLE 1.3

Net Private Capital Flows, 2003–09
(*Percent of GDP*)

	2003	2004	2005	2006	2007	2008	2009
EU-member countries	6.2	6.9	8.5	7.7	11.3	8.2	1.4
Non-EU countries	3.0	0.9	4.7	4.6	8.0	–1.8	–1.8
Emerging Europe	4.3	3.1	6.1	5.7	9.2	1.5	–0.7
All emerging markets	2.0	2.1	2.1	1.6	3.8	0.4	–0.2

Sources: IMF, *World Economic Outlook*, April 2010; and IMF staff calculations.

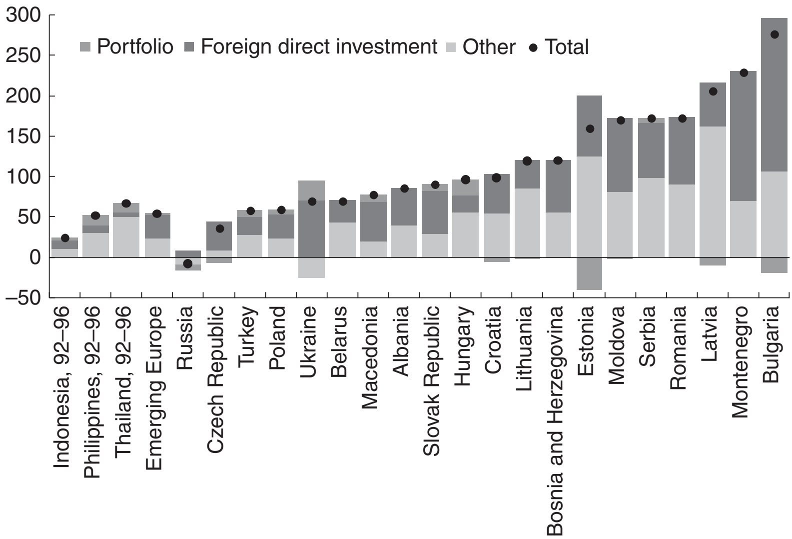

Figure 1.9 Emerging Europe: Cumulative Net Capital Inflows, 2003–08[1] (*Percent of 2003 GDP*)

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.

to GDP or as ratio to exports—and their international investment positions had become highly negative (Figure 1.14). Exceptions to this pattern were the Czech Republic, Hungary, Poland, and the Slovak Republic, which managed to avoid much of the overheating. The Czech and Slovak Republics also saw a substantial reduction in their current account deficits.

Even where current account deficits were mostly financed by FDI inflows, these FDI inflows increasingly went to the nontradable sector (financial services, real estate, and construction). As more resources were drawn to the nontradable sector, growth became unbalanced. By 2007, the share of nontradable FDI was significantly higher in SEE countries and the Baltics than in CEE (Figure 1.15). A problematic shift to the nontradable sector did not arise in all countries: in CEE, where the share of FDI that went to manufacturing was high, the shift was largely avoided.

By 2007, the growth pattern of many countries had become vulnerable to a sudden decline in capital inflows.[8] Growth had become reliant on domestic demand, supported by a continued rapid credit expansion, large capital inflows, and continued asset price appreciation. Since demand depended so heavily on credit growth financed from abroad, any slowdown or reversal of foreign financing was bound to hit the economy hard. Moreover, since the majority of loans in

[8] A similar point is made by Anastasakis and Watson (2011) in a study of the crisis in southeastern Europe. "This analysis of the pre-crisis period highlights the ways in which the pattern of growth in the region [southeastern Europe] was unbalanced, allowing significant external and financial vulnerabilities to emerge. Capital inflows did not sufficiently feed into productive investment, and the competitiveness of economies was not upgraded to assure sustainable growth. Even without the capital market aftershocks of the Lehman Bros episode, a day of reckoning was to be faced at some point" (p. 5).

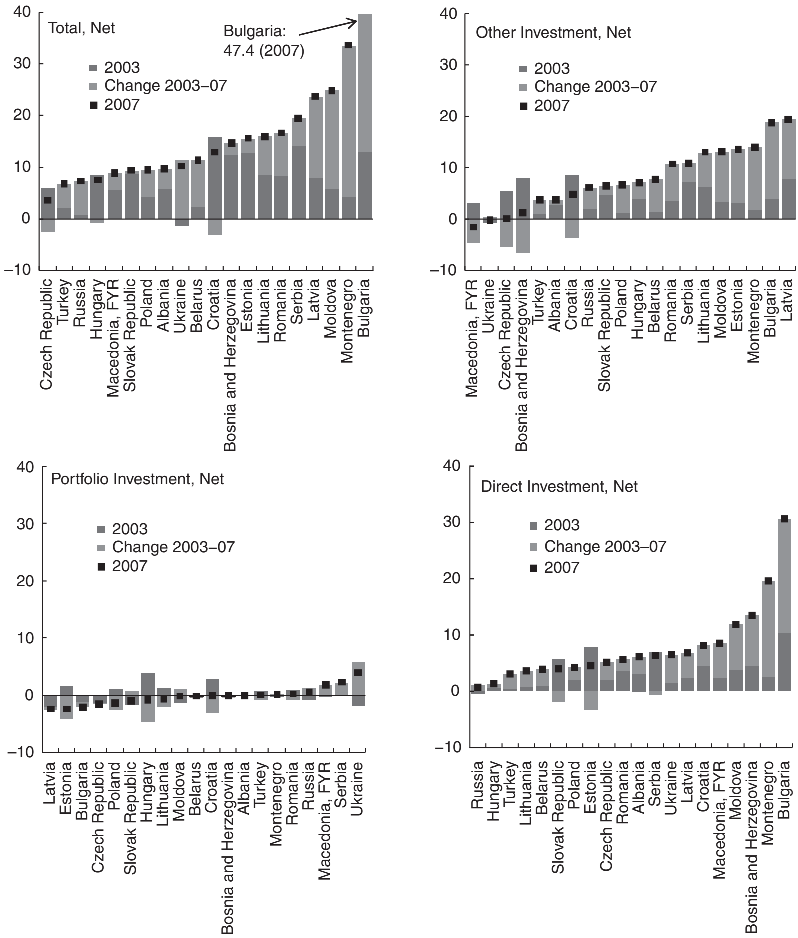

Figure 1.10 The Surge in Capital Inflows by Type of Capital, 2003–07 (*Percent of GDP*)

Sources: IMF, *World Economic Outlook*, October 2010; and IMF staff calculations.

the region were foreign currency denominated, an exchange rate depreciation resulting from a slowdown of capital flows would have had powerful adverse effects on balance sheets and could have undermined financial stability (Figure 1.16). The 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 also potentially at risk, from this perspective.[9]

[9] In a study of the 2008/09 crisis in the 10 new EU member states, Åslund (2010) also argues that the Lehman Brothers bankruptcy and the ensuing credit crunch was only the catalyst of the crisis—not the cause. "Financial problems in the CEE-10 were profound and ubiquitous. Multiple preconditions of crisis were evident: excessive current account deficits, huge credit expansion, sharp real estate prices, and rising inflation" (p. 16).

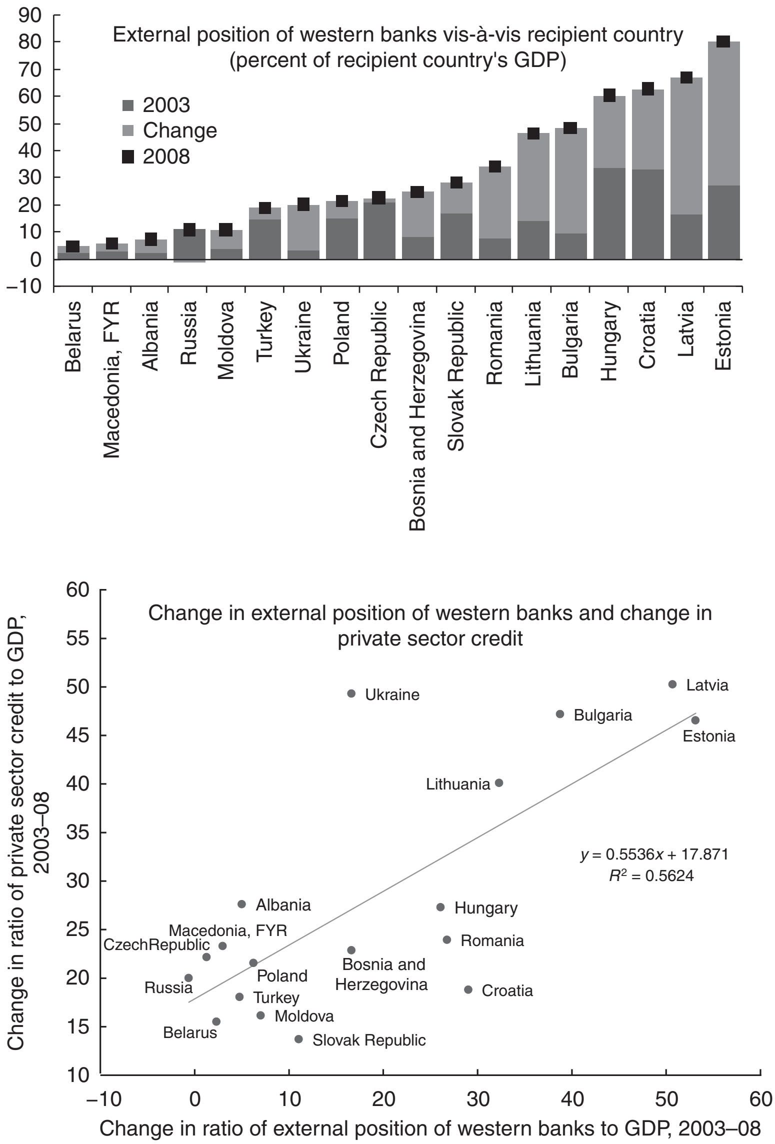

Figure 1.11 Capital Inflows and Private Sector Credit (*Percentage points*)

Sources: Bank for International Settlements, *Locational Banking Statistics*; IMF, *International Financial Statistics*; IMF, World Economic Outlook database; and IMF staff calculations.

POLICY REACTIONS THAT MADE A DIFFERENCE

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.

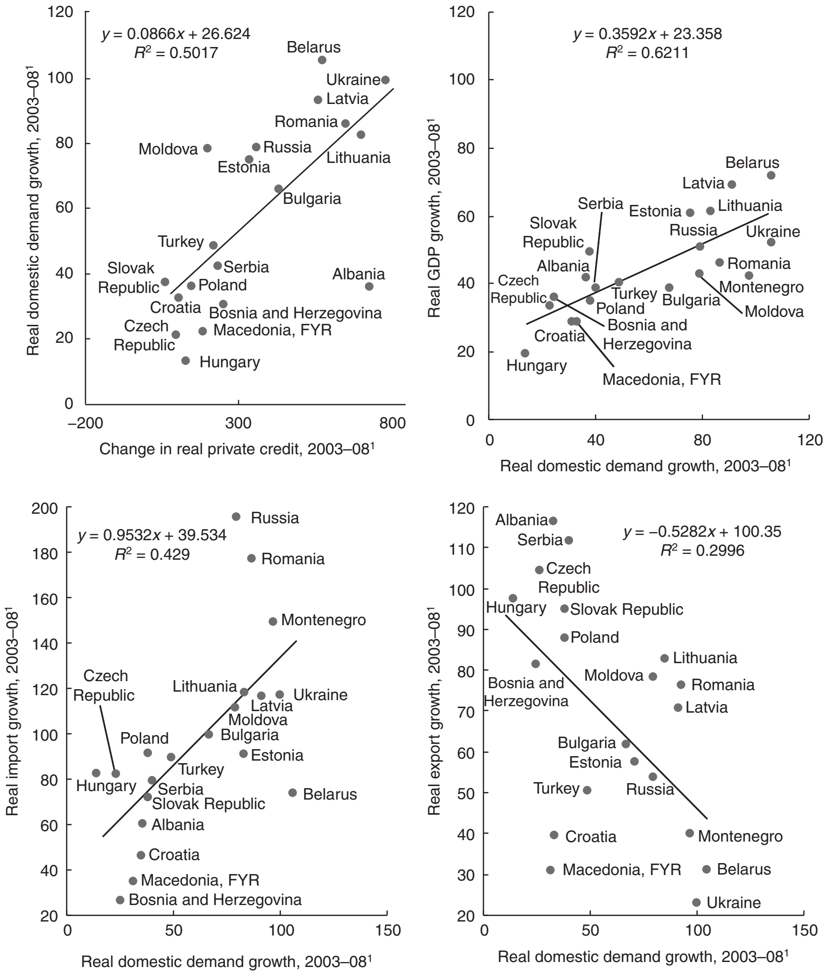

Figure 1.12 Credit, Domestic Demand and GDP (*Percent*)

Sources: IMF, *International Financial Statistics*; *World Economic Outlook*, October 2010; and IMF staff calculations.
[1] For the Baltic states data refer to 2002–07.

Monetary and Exchange Rate Policy

Countries with floating exchange rates were generally less affected than countries with fixed exchange rates.[10] Indeed, it is striking that the strongest credit growth during the boom years took place in countries with fixed exchange rate regimes

[10] Becker and others (2010) note that "imbalances were more pronounced in countries with fixed exchange rates. Fixed exchange-rate countries tended to experience higher current account imbalances and external debt, the share of loans was larger and the share of foreign direct investment was lower in total capital inflows, the composition of FDI inflows was biased in favour of finance and real estate-related activities, credit growth was faster, inflation was higher, unit labour costs rose faster, and real interest rates were lower than in floating exchange rate countries, on average" (pp. 74–75).

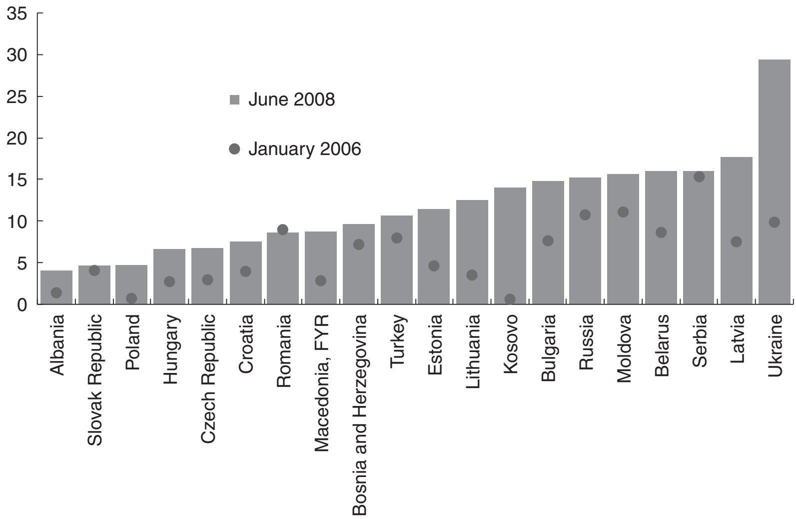

Figure 1.13 Emerging Europe: Consumer Price Inflation, 2006 and 2008 (*Annual percentage change*)

Source: Haver Analytics.

(Figure 1.17). 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 managed to avoid a credit boom. The countries with floating exchange rates during this boom period had a lower outstanding credit-to-GDP ratio at the end of 2008, as well as lower 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. Countries with flexible exchange rates, on the other hand, can dampen booms by letting the nominal exchange rate appreciate (Bakker and Gulde, 2010). Such appreciation helps prevent an economy from overheating 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 (including the Czech Republic, Poland, and the Slovak Republic) saw a substantial appreciation of their nominal exchange rates during the boom years.

Nevertheless, some countries with fixed exchange rate regimes also did not experience massive credit booms (including Bosnia and Herzegovina and Macedonia). Indeed, in non-EU SEE there seems to be 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.

All of this suggests that fixed exchange rates in themselves need not be a problem. Indeed, an IMF study by Ghosh, Ostry, and Tsangarides (2010) on exchange rate regimes worldwide has reached that conclusion. But fixed exchange rates do make it harder to deal with excessive capital inflows. Capital inflows during

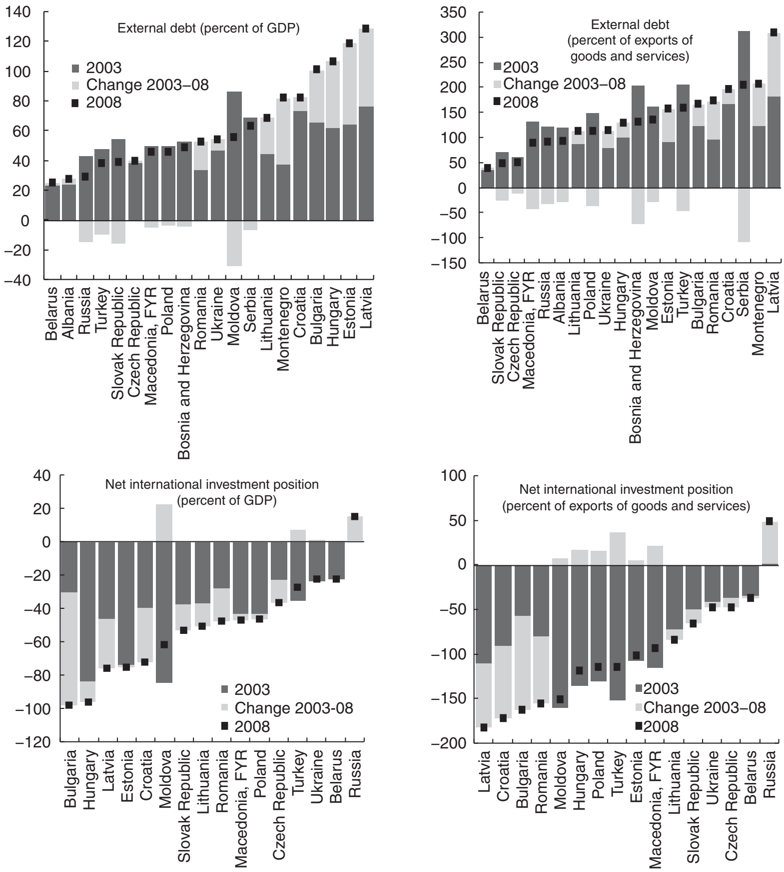

Figure 1.14 External Debt and International Investment Position, 2003–08

Sources: IMF, Balance of Payments Statistics; *World Economic Outlook*, October 2010; and IMF staff calculations.

2003–07 were excessive because of a "perfect storm" of push and pull factors favoring capital inflows.[11] In such circumstances, having a floating exchange rate provides an additional safety valve.[12]

Fiscal Policy

During the boom years, public finances in most countries appeared to be in good shape, as headline balances were mostly improving, reflecting strong revenue

[11] Capital flows were excessive because of the interaction of strong push factors (low global risk aversion and the search for yields by western European banks) and pull factors (EU accession and an expectation of euro adoption).

[12] It should be acknowledged though that there are also examples of countries with floating exchange rates where large capital inflows generated serious imbalances (Iceland).

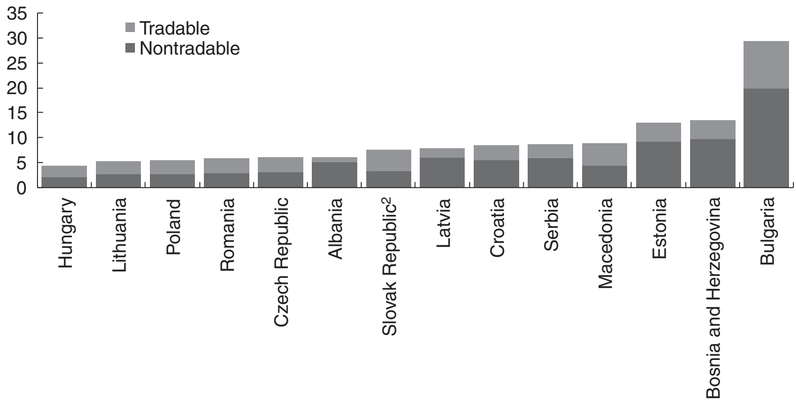

Figure 1.15 Emerging Europe: Foreign Direct Investment Flow in Tradable and Nontradable Sectors, 2007[1] (*Percent of GDP*)

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

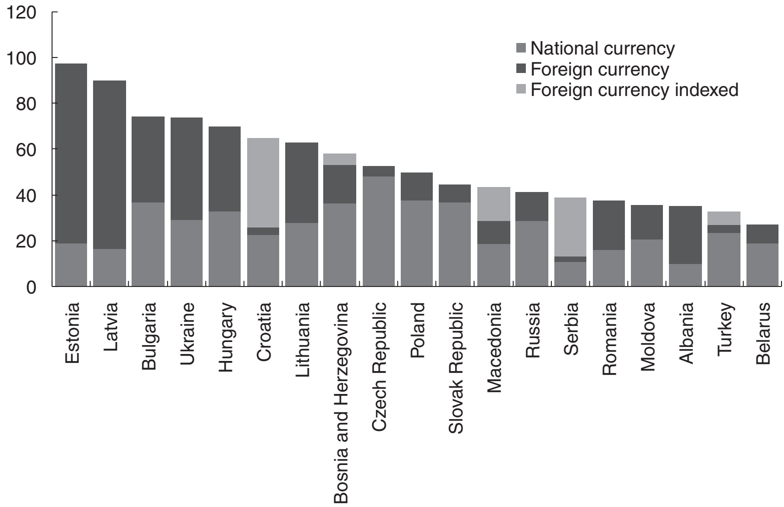

Figure 1.16 Emerging Europe: Total Private Sector Credit by Currency, 2008 (*Stock in percent of GDP*)

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

performance (Figure 1.18 and Table 1.4). This was particularly pronounced in countries that relied heavily on domestic absorption.

Yet in most of emerging Europe, fiscal policy during the boom was procyclical, with the notable exception of Hungary, which began tackling long-standing fiscal weaknesses in 2007. Indeed, in most countries 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

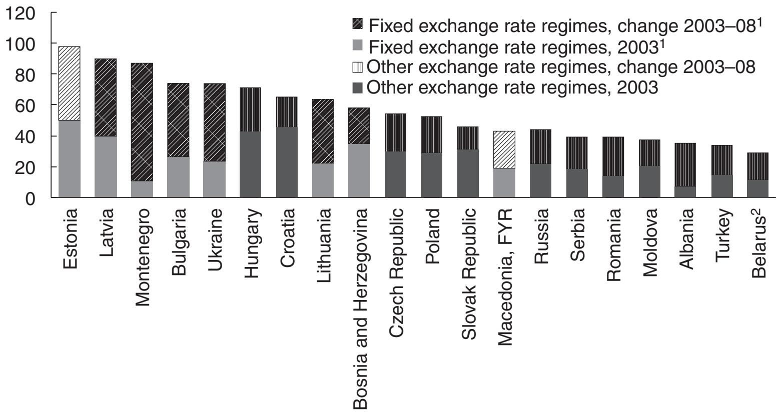

Figure 1.17 Emerging Europe: Private Sector Credit, 2003 and 2008 (*Percent of GDP*)

Sources: IMF, *International Financial Statistics*; *Annual Report on Exchange Arrangements and Exchange Restrictions* (AREAER, various years); and IMF staff calculations.
[1]Fixed exchange rate countries are classified in the 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.

such as Russia) led to sharp increases in government revenues. Only part of this revenue surge was used to improve fiscal balances.[13] 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.[14] Real expenditure growth exceeded real GDP growth in every country except Macedonia. By 2008, only Belarus, Bulgaria, Montenegro, and Russia ran fiscal surpluses.[15]

The large increases in public expenditure not only further fueled overheating, they also set the stage for large deficits when part of the revenue surge turned out to be temporary.[16] As a result, countries with lax fiscal policy during the boom years were not in a strong position when the crisis hit in 2008. Notably, Romania, which ran persistent fiscal deficits in the boom period, did not have much room

[13]Rahman (2010) also notes that countries made limited fiscal efforts during the boom years in terms of improving their structural fiscal positions and reducing public debt. Most countries experienced revenue procyclicality during the boom years, but only a few (Bulgaria, the Czech Republic, and Estonia) managed to use some of these procyclical revenues to generate their fiscal space.

[14]Rosenberg and Sierhej (2007) find that EU-related transfers also contributed to procyclical fiscal policy in the new EU member states.

[15]Although Russia's fiscal policy had been procyclical, the fiscal balance improved, primarily owing to rising oil prices.

[16]Becker and others (2010) argue that "fiscal policies were by and large as adequate as they realistically could be" (p. 17). They acknowledge that fiscal policy was procyclical in many CESEE (central, eastern and southeastern European) countries and that tax instruments were not used to dampen the boom, but they argue that fiscal policy was not the main culprit behind the buildup of vulnerabilities, and that fiscal policy could counterbalance neither the strongly expansionary effect of credit growth nor the savings shortfall corresponding to current account deficits amounting to 10–25 percent of GDP, which were prevalent in some countries.

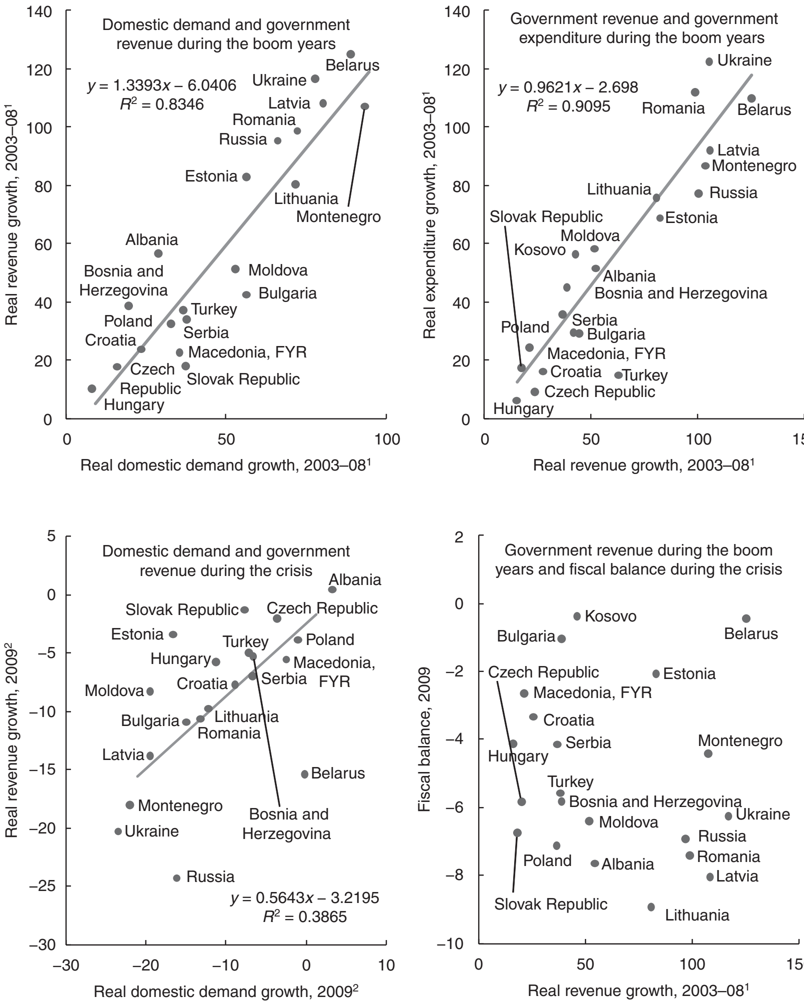

Figure 1.18 Fiscal Policy (*Percent*)

Source: IMF, *World Economic Outlook*, October 2010; and IMF staff calculations.
[1] For Baltic states, growth rate is based on 2002–07.
[2] For Baltic states, growth rate is based on 2008–09, annualized.

for fiscal expansion during the crisis. Countries like Bulgaria and Estonia that built up larger buffers were in a better position than those that did not, like Latvia and Lithuania.

Financial Sector Policy

Many countries had taken prudential and supervisory measures by tightening the existing regulations to stem credit growth, but these had limited effect (IMF, 2010b; and Enoch and Ötker-Robe, 2007). In Bulgaria, Croatia, and Serbia,

TABLE 1.4

Emerging Europe: General Government Overall Balance
(*Percent of GDP*)

	2003	2004	2005	2006	2007	2008
Baltics						
Estonia	2.2	1.6	1.6	3.2	2.9	–2.3
Latvia[1]	–1.7	–1.2	–1.3	–0.5	0.6	–7.5
Lithuania	–1.3	–1.5	–0.5	–0.4	–1.0	–3.3
Central Europe						
Hungary	–7.2	–6.4	–7.9	–9.4	–5.0	–3.7
Poland	–6.2	–5.4	–4.1	–3.6	–1.9	–3.7
Southeastern Europe—New EU member states						
Bulgaria[1]	0.0	1.7	2.4	3.5	3.5	3.0
Romania	–2.2	–3.4	–0.7	–1.4	–3.1	–4.8
Southeastern Europe—Non-EU member states						
Albania[1]	–4.6	–5.0	–3.5	–3.3	–3.6	–5.1
Bosnia and Herzegovina	–1.7	–0.5	0.6	1.1	–0.3	–3.6
Croatia[1]	–4.8	–3.4	–2.8	–2.6	–2.4	–1.3
Kosovo[1]	1.6	–4.9	–3.1	2.5	4.9	–0.2
Macedonia, FYR	–0.1	0.4	0.2	–0.5	0.6	–0.9
Montenegro[1]	–2.9	–1.8	–1.1	2.6	6.3	1.5
Serbia[1]	–2.9	0.0	0.8	–1.6	–1.9	–2.6
European CIS and Turkey						
Belarus[1]	–1.0	0.0	–0.7	1.4	0.4	1.3
Moldova[1]	0.7	0.7	1.5	0.0	–0.2	–1.0
Russia[1]	1.4	4.9	8.2	8.3	6.8	4.3
Turkey[1]	–10.4	–4.4	–0.6	–0.6	–2.1	–2.9
Ukraine[1]	–0.9	–4.4	–2.3	–1.4	–2.0	–3.2
Emerging Europe[2]	–2.7	–0.3	2.2	2.4	1.8	0.2
Memorandum						
Czech Republic	–6.6	–2.9	–3.6	–2.6	–0.7	–2.7
Slovak Republic	–2.8	–2.4	–2.8	–3.4	–1.9	–2.3
Slovenia[1]	–1.4	–1.4	–1.1	–0.8	0.2	–0.3

Source: IMF, *World Economic Outlook*, October 2010.
Note: CIS = Commonwealth of Independent States.
[1] Reported on a cash basis.
[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. Average weighted by GDP valued at purchasing power parity.

administrative measures had been taken through direct credit controls or marginal reserve requirements on foreign borrowing. However, such efforts to slow credit often diverted inflows to 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. 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.

One problem was that externally funded credit growth was particularly hard to control. Many western banks in emerging Europe operate their subsidiaries as if they are branches,[17] with risk management centralized at the group level

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

and local supervisors relying on parent banks' home supervisors to monitor the changes in the risk profile of their foreign affiliates.[18] 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). Foreign-owned banks are also less likely to be influenced by domestic monetary policy measures, such as the raising of domestic interest rates. Often, these banks are systemically important in the host country although only a small part of the overall bank group.

A related problem was insufficient collaboration between home and host supervisors. In particular, the activities of foreign banks in the region did not get enough scrutiny from supervisors in western European home countries. As a result of bank privatizations and the resolution of banking crises in the early 1990s, foreign banks became significant or even dominant players in the banking systems in many CEE countries. In the context of consolidated supervision, those banks were subject to home country oversight, leaving host supervisory agencies under the impression that the institutions were monitored also at the home country level. However, individual CEE subsidiaries were mostly small compared to the overall size of their consolidated groups, which limited the extent and intensity of home country supervision of individual subsidiaries. Since home country supervisors had little knowledge of local market conditions in host countries, and since operations in emerging Europe were typically the most profitable for the banks, home country supervisors may have been reluctant to "overregulate" and thereby reduce group profitability.

Yet while the macroprudential measures did not manage to slow down credit growth significantly, they did help to create large capital and liquidity reserves in the banking system. These reserves proved their value when the crisis broke. While many countries in advanced Europe experienced significant banking crises, in emerging Europe only Ukraine experienced a full-fledged banking crisis.[19]

THE MISPRICING OF RISK

Despite the buildup of vulnerabilities and imbalances, until mid-2007 risk premiums in the region continued to decline. Markets failed to differentiate between

[18]The reliance on parent banks' home supervisors was not always by choice, as there was too little cooperation on the side of home regulators.

[19]Two individual banks (OTP in Hungary and Parex in Latvia) experienced difficulties as well. However, OTP suffered only liquidity problems, whereas Parex suffered a major solvency problem and was later restructured as part of the program supported by the IMF and the EU.

countries as vulnerabilities increased, and some of the countries with the highest vulnerabilities continued to enjoy investment grade status (IMF, 2010b).[20]

An important reason why risk premiums did not increase was that it was unclear at the time whether rapid credit growth and large current account deficits should be seen as signs of an imbalance or as the result of rapid catch-up—that is, as an equilibrium phenomenon.[21] Some economists warned that the increasing imbalances posed considerable vulnerabilities. They noted that current account deficits had reached unprecedented heights, external debt had become very high, credit growth had been extremely rapid, and vulnerability indicators looked high not only from a historic perspective, but also compared to levels seen in other emerging market countries.[22] Many others, however, argued for a more benign interpretation of the imbalances, suggesting that they were in line with what economic theory would predict. They noted that in Europe capital flowed from rich to poor countries—as economic theory suggested it should—and that the capital inflows had accelerated income convergence.[23] They also argued that the rapid credit growth reflected a catch-up of credit-to-GDP ratios to equilibrium levels.[24] Consequently, they were less worried about the vulnerabilities that resulted from rapid credit growth and large current account deficits, and they were convinced that the improvement in institutional and legal frameworks resulting from integration with western

[20] Luengnarumitchai and Schadler (2007) note that a "perception gap" existed between conventional vulnerability analyses and market interpretations of risks: "despite several classic signs of growing imbalances, markets are pricing foreign currency denominated sovereign assets of central European countries below levels suggested by an analysis of measurable fundamentals in a fairly robust model for bond yields across emerging markets" (p. 25). They left open the question whether vulnerability analyses or markets were "right," and argued that yields lower than fundamentals could reflect either market exuberance or economists' inability to measure and therefore account for some key factors differentiating the new members of the EU from other emerging markets—including, for instance, confidence imparted by EU membership itself or high prospects for euro adoption.

[21] See Banerji and Kähkönen (2007) for an overview of the debate prior to the crisis.

[22] For example, Bakker and Vladkova-Hollar (2006) argued that vulnerabilities in eastern Europe looked worse than in precrisis Asia. A similar view could be found in Menegatti and Roubini (2006), and Sorsa and others (2007). Duenwald, Gueorguiev, and Schaechter (2005) examined three cases (Bulgaria, Romania, and Ukraine) and argued that credit growth was excessive and caused macroeconomic instability. Sirtaine and Skamnelos (2007) worried that "the emerging European countries have experienced very rapid credit expansion over several years and are subject to significant macroeconomic imbalances, largely fueled by this rapid credit growth" (p. 31). Rahman (2008) showed that precrisis current account deficits were above their equilibrium levels for most countries in emerging Europe.

[23] Abiad, Leigh, and Mody (2007) argued that "with increasing financial integration, capital in Europe has traveled 'downhill' from rich to poor countries, and has done so with gathering strength. These inflows have been associated with significant acceleration of income convergence" (p. 5).

[24] Backé, Égert, and Walko (2007), in a study of credit growth in the 10 new EU member states and Croatia, argued that "private sector credit-to-GDP levels in 2006 were still below equilibrium in Poland and Romania, and marginally below equilibrium also in the Czech Republic. In the other countries under review, they were within the estimated equilibrium range, though with considerable differences across countries" (p. 73).

Europe made the countries of emerging Europe very different from other emerging market countries.[25]

These opposing views left policymakers with unclear directions. Lorenzo Bini Smaghi, a member of the European Central Bank's (ECB's) Executive Board, wondered aloud in a 2007 speech to the ECB:

> Should policy makers get comfort from the fact that the imbalances in central, eastern and southeastern Europe are in line with standard economic theory? Or should we be worried that these imbalances can be very disruptive for convergence if they prove to be unsustainable, as corrections can be painful and costly? (Bini Smaghi, 2007)

Financial markets seemed to support the "benign" view of capital inflows, which made the more worried view less compelling. As public debt ratios in the region dropped (Table 1.5), the perceived riskiness of the region continued to fall and credit default swap spreads dropped to very low levels (Figure 1.19). Indeed, in the boom years, financial markets seemed to focus on the risks emanating from public sector imbalances rather than those from private sector imbalances. Since countries with credit booms had also experienced a surge in revenues, their public finances generally seemed in good shape—even though, as it subsequently turned out, a large part of the revenue boom would prove to be temporary.

Even when vulnerabilities were recognized, it was difficult to envisage a shock severe enough to trigger an actual crisis, and few recognized the risk that a shock to the region could originate from the financial system in western Europe. While western banks' exposure to the region had built up in ways similar to their exposure to Latin America in the late 1970s and early 1980s and to Asia in the mid-1990s (Figure 1.20), the increased exposure to emerging Europe was thought to be less risky since it was largely exposure to local subsidiaries that foreign parent banks would not willingly abandon. Of course, this view failed to consider the fact that some parent banks themselves were small in international comparison, limited in their liquidity, and dependent on global interbank markets, and that disruptions from outside the home country ("third country shocks") could therefore have severe contagion effects. This view also failed to consider that even if western banks did not abandon the region, a sudden stop in capital flows from those banks would still have a very large impact on domestic demand.

Thus, the predominant view during the boom years was that rapid GDP growth would continue. In the March 2007 issue of *Consensus Economics*—which

[25] In practice, economists' views often incorporated elements of both views—they recognized that the developments were driven by convergence, yet worried that they came with vulnerabilities. A good example is Enoch and Őtker-Robe (2007, page 365): "the rapid credit growth of recent years has been pervasive and in many ways welcome. To some extent, this trend reflects a catch-up of the region, assisted by a favorable conjuncture, including rapid economic growth and low interest rates in the region. Nevertheless, studies of past crises show that these have nearly all been preceded by rapid credit growth, so at a minimum one needs to monitor the situation carefully to ensure that such a situation does not recur."

TABLE 1.5

Emerging Europe: Public Debt, 2003–07
(*Percent of GDP*)

	2003	2007	Change
Baltics			
Estonia	5.6	3.7	–1.9
Latvia	14.6	7.8	–6.8
Lithuania	21.1	16.9	–4.2
Central Europe			
Poland	47.1	45.0	–2.1
Hungary	58.3	65.8	7.5
Southeastern Europe—New EU member states			
Bulgaria	48.1	19.8	–28.3
Romania	21.5	19.8	–1.7
Southeastern Europe—Non-EU member states			
Albania	60.7	53.8	–6.9
Bosnia and Herzegovina	28.4	32.9	4.5
Croatia	35.8	33.2	–2.6
Macedonia, FYR	39.0	22.8	–16.2
Montenegro	47.8	27.5	–20.3
Serbia	77.3	35.2	–42.0
European CIS and Turkey			
Belarus	9.1	11.5	11.5
Moldova	58.9	26.9	–32.0
Russia	30.4	8.5	–21.8
Turkey	67.4	39.4	–27.9
Ukraine	29.4	12.3	–17.0
Other advanced economies			
Czech Republic	29.8	29.0	–0.9
Slovak Republic	42.4	29.3	–13.1
Slovenia	27.5	23.3	–4.1

Sources: IMF, *World Economic Outlook*, October 2010; and IMF staff calculations.
Note: CIS = Commonwealth of Independent States.

reflected mainstream economic thinking at the time—it was projected that average GDP growth during 2008–12 of all of the region's major countries would not be much lower than their average GDP growth during 2002–07 (Table 1.6). In the Baltics, growth was projected to slow more, but even there it would remain strong.

This started to change once the global crisis began in August 2007, and by late 2007 the vulnerabilities were starting to be better recognized. The IMF's April 2008 *Regional Economic Outlook: Europe* warned that

> …the heavy dependence on foreign capital leaves the region exposed to an abrupt retrenchment of capital inflows [and] economies with large current account deficits or high external debt ratios would be especially vulnerable if foreign financing dried up. (IMF, 2008a, p. 15)

The mispricing of risk was an important reason in explaining why imbalances could get so far out of hand. If risks had been priced more adequately, it

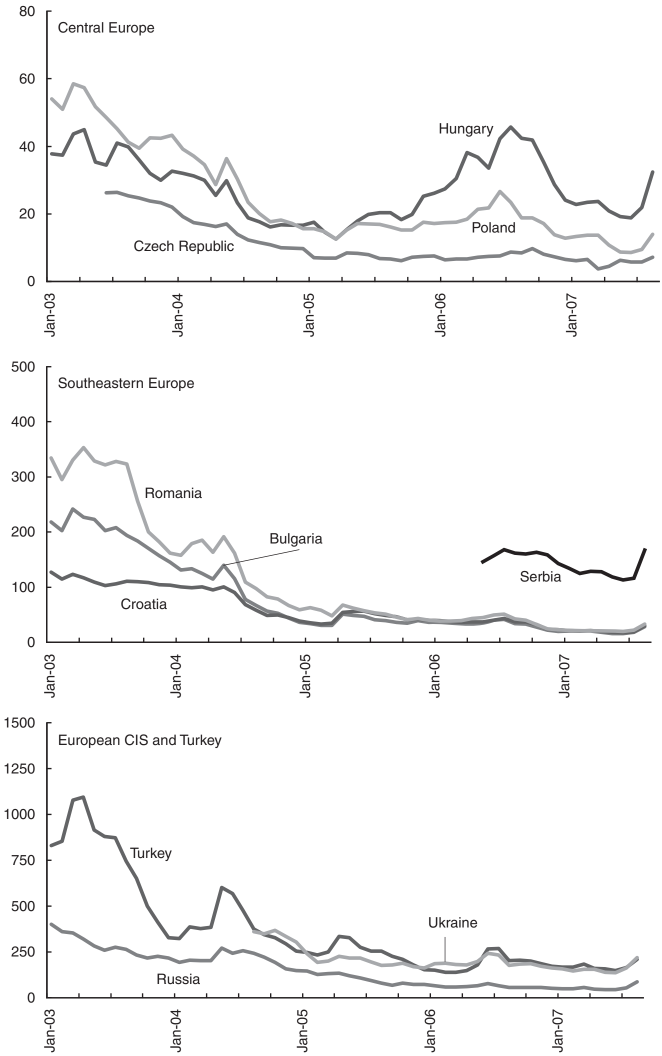

Figure 1.19 Emerging Europe: Credit Default Swap Spreads (*Basis points*)

Sources: Bloomberg; and Thomson Reuters Datastream.
Note: CIS = Commonwealth of Independent States.

is likely that the boom-bust cycle would have been less pronounced. Had risk premiums increased in line with growing imbalances, capital flows would have slowed, credit growth would have been more moderate, and private sector demand would not have grown as rapidly. A rise in risk premiums would also have given an earlier signal to the public sector that the boom was unsustainable, which would likely have led to a more cautious path of public expenditure during the boom years. The insight that a mispricing of risk could create problems

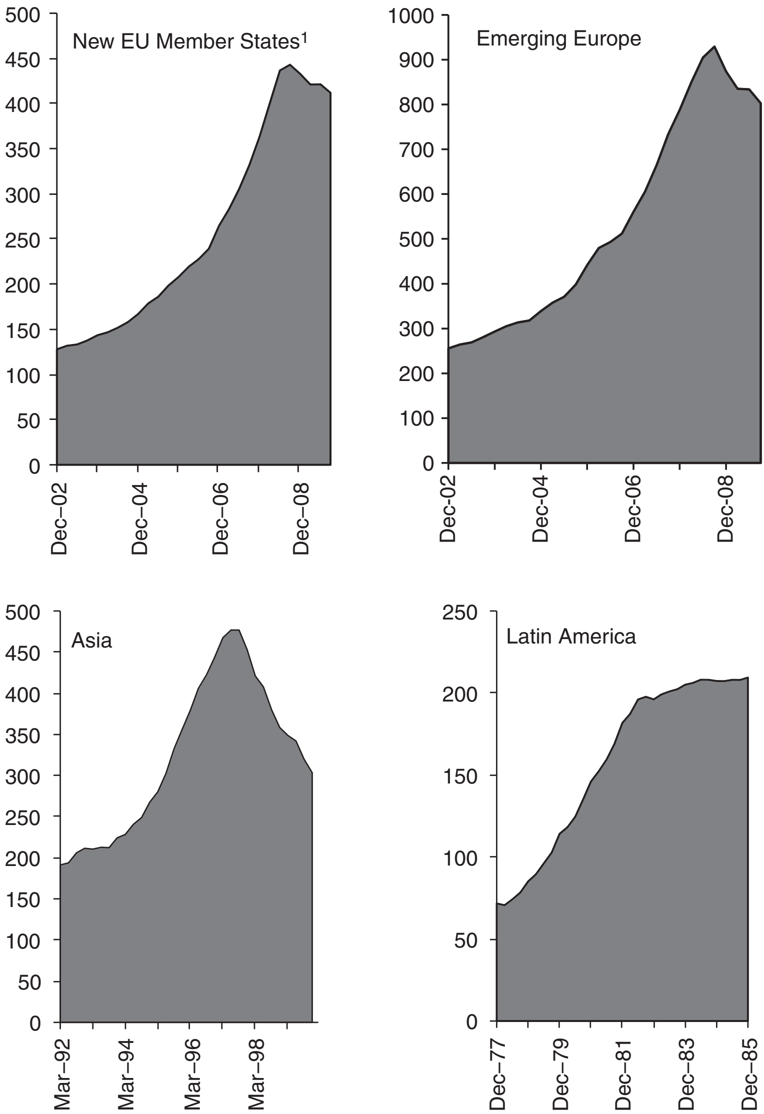

Figure 1.20 External Position of Western Banks vis-à-vis Selected Regions (*Billions of U.S. dollars, adjusted for exchange rate changes*)

Source: Bank for International Settlements, *Locational Statistics*.
[1] Excludes the Slovak Republic, as its entry into the European Monetary Union in 2009 distorted the statistics.

for the region is not new—it was already predicted in 2002, well before the surge in capital inflows. In that year, Lipschitz, Lane, and Mourmouras (2002) noted that because of the high marginal productivity of capital, emerging Europe was likely to attract large capital inflows. They warned that if risk premiums did not rise in line with rising current account deficits, the region could be overwhelmed

TABLE 1.6

Real GDP Growth Consensus Forecast[1]
(*Percent*)

	2006[2]	2007	2008	2009–12[3]
Czech Republic	6.1	5.0	4.7	4.6
Hungary	3.9	2.4	3.0	4.2
Poland	5.8	5.7	5.2	4.8
Romania	7.7	6.2	5.7	5.5
Russia	6.7	6.3	6.0	5.6
Slovak Republic	8.2	8.6	6.7	5.5
Turkey	5.5	4.6	5.7	5.3
Ukraine	7.1	5.9	6.0	5.7

Sources: Consensus Economics; IMF, *World Economic Outlook*, April 2007; and IMF staff calculations.
[1] As of March 2007.
[2] *World Economic Outlook*, April 2007.
[3] Average for period.

by large and erratic capital inflows, which could result in balance-of-payments crises.[26]

In retrospect, the mispricing of risk seems to arise from underestimating the adverse consequences of overheating as well as potential sudden stops of capital inflows. While convergence is supposed to occur, it should not be so fast that economies overheat, unit labor costs rise rapidly, the economies become less competitive, and production factors are pulled from the tradable to the nontradable sector. Similarly, while consumption should rise as a result of higher permanent income (provided that successful convergence occurs), one should not overestimate the level of permanent income, because the convergence process might not be rapid.

Furthermore, if the economy needs to rely significantly on foreign funds to facilitate convergence, one should not overlook the possibility that capital inflows could slow down or even stop abruptly at some point. This could occur due to changes in conditions in the world economy, even when countries administer perfectly fine policies. When a sudden stop occurs, disruptions are unlikely to be avoidable due to relative price changes and resource reallocations.

[26] Lipschitz, Lane, and Mourmouras (2002) noted that if risk premiums rose in line with current account deficits, the emergence of excessively large current account deficits and overheating could be prevented. As the current account deficits increased and risk premiums rose, the domestic interest rate could rise above those abroad. At some equilibrium level of the current account deficit, risk premiums would be large enough to permit the authorities to set domestic interest rates at a level that would equilibrate domestic saving and investment. Lipschitz and coauthors worried that in practice, risk premiums might not be as well-behaved. "The real world, however, is seldom this benign. In practice, risk premiums will be a function of a broad array of variables, some obvious—domestic economic, financial, and political developments—some beyond domestic influences—such as global capital market conditions—and some seemingly erratic—bandwagon effects, contagion, and the like" (p. 13).

PART II

The Crisis: Regional Perspectives

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CHAPTER 2

Gathering Clouds: August 2007–September 2008

For the first year after the start of the global crisis in August 2007—until the default of Lehman Brothers in September 2008—emerging Europe seemed to be little affected by the global turmoil. At the time there was a general belief that emerging economies would remain resilient to the ongoing global crisis. Thus, the projections for 2008 real GDP growth published in the April 2008 *World Economic Outlook* (WEO) were very similar to those published in the April 2007 WEO (Table 2.1). For the European countries in the Commonwealth of Independent States (CIS), growth projections were even revised upward, reflecting the increase in global commodity prices.

TABLE 2.1

Emerging Europe: World Economic Outlook Real GDP Growth Rate Projections
(*Percentage change, year-over-year*)

	2007			2008			2009		
	Apr. 07	Oct. 07	Apr. 08	Apr. 07	Oct. 07	Apr. 08	Apr. 07	Oct. 07	Apr. 08
Estonia	9.9	8.0	7.1	7.9	6.0	3.0	6.5	6.0	3.7
Latvia	10.5	10.5	10.2	7.0	6.2	3.6	4.0	3.6	0.5
Lithuania	7.0	8.0	8.8	6.5	6.5	6.5	6.0	6.0	5.5
Hungary	2.8	2.1	1.3	3.0	2.7	1.8	3.4	3.3	2.5
Poland	5.8	6.6	6.5	5.0	5.3	4.9	4.3	4.5	4.5
Bulgaria	6.0	6.0	6.2	6.0	5.9	5.5	6.0	5.2	4.8
Romania	6.5	6.3	6.0	4.8	6.0	5.4	5.3	5.6	4.7
Albania	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.1	6.1
Bosnia and Herzegovina	6.0	5.8	5.8	6.0	6.5	5.5	5.5	5.5	5.5
Croatia	4.7	5.6	5.8	4.5	4.7	4.3	4.5	4.5	4.0
Macedonia, FYR	4.5	5.0	5.0	4.5	5.0	4.5	4.5	5.5	5.0
Serbia	5.0	6.0	7.3	5.5	5.0	4.0	5.0	5.0	6.0
Belarus	5.5	7.8	8.2	3.9	6.4	7.1	2.5	5.7	6.8
Moldova	4.5	5.0	5.0	5.0	5.0	7.0	5.0	5.0	8.0
Russia	6.4	7.0	8.1	5.9	6.5	6.8	5.7	6.4	6.3
Ukraine	5.0	6.7	7.3	4.6	5.4	5.6	5.2	4.3	4.2
Turkey	5.0	5.0	5.0	6.0	5.3	4.0	5.5	5.5	4.3
Czech Republic	4.8	5.6	6.5	4.3	4.6	4.2	5.0	5.2	4.6
Slovak Republic	8.2	8.8	10.4	7.5	7.3	6.6	7.0	6.9	5.6
Region Total	6.0	6.4	6.7	5.5	5.6	5.1	5.1	5.2	4.9

Source: IMF, World Economic Outlook database.

The main author of this chapter is Yuko Kinoshita.

TABLE 2.2

Emerging Europe: External Positions of Western Banks vis-à-vis Emerging Europe
(*Percent of 2008 GDP, adjusted for exchange rate changes*)

	Stocks			Flows		Change in Flows
	2006:Q3	2007:Q3	2008:Q3	2006:Q3–2007:Q3	2007:Q3–2008:Q3	
Bulgaria	20.7	26.3	49.0	5.6	22.7	17.1
Montenegro	4.8	13.6	32.2	8.9	18.5	9.7
Hungary	41.4	48.3	62.5	7.0	14.2	7.2
Lithuania	26.5	33.9	47.2	7.4	13.3	5.9
Serbia	16.4	18.4	23.9	2.0	5.5	3.6
Ukraine	9.4	14.0	21.8	4.6	7.8	3.2
Moldova	4.6	5.9	10.3	1.3	4.4	3.2
Romania	17.6	25.0	35.1	7.4	10.1	2.7
Czech Republic	16.8	19.6	24.8	2.7	5.2	2.5
Poland	14.1	17.8	24.0	3.7	6.2	2.5
Turkey	14.5	17.0	21.2	2.5	4.2	1.7
Macedonia, FYR	3.2	4.1	6.4	1.0	2.3	1.3
Bosnia and Herzegovina	17.1	21.4	25.6	4.3	4.2	–0.1
Belarus	2.6	4.1	5.1	1.6	1.0	–0.6
Albania	1.7	4.0	5.2	2.3	1.2	–1.1
Russia	7.0	11.0	12.9	4.0	1.9	–2.0
Latvia	37.8	55.0	68.9	17.2	13.9	–3.3
Croatia	47.0	59.5	63.7	12.6	4.2	–8.4
Estonia	57.1	73.7	81.9	16.6	8.1	–8.5

Sources: Bank for International Settlements, *Locational Statistics*; and IMF, World Economic Outlook database.

Continued strong growth was the result of the continuation of large capital inflows, in particular from banks. Despite the market turmoil in the United States and uncertainty in the global economy, capital continued to flow into emerging Europe. The exposure of western European banks to the region increased sharply between September 2007 and September 2008 (Table 2.2).

The impact of the global crisis was most visible in financial markets, but apparently without repercussions for real activity. Credit default swap (CDS) and bond spreads in the region rose (Figure 2.1), albeit only moderately in most countries and with more differentiation across countries, with spreads widening more in countries that had more pronounced vulnerabilities and imbalances. Most stock markets in the region lost steam (Figure 2.2), but this did not seem to affect the economy more broadly.[1]

Indeed, since credit was still growing strongly and inflation was rising rapidly, controlling inflation became the main challenge for policymakers in the region (Figure 2.3). By mid-2008, inflation had reached double-digits in the Baltics, Bulgaria, the European CIS countries, Turkey, and several SEE countries. Rising inflation was partly the result of surging food and energy prices, but was further boosted by overheating labor markets. In the summer of 2008, wages were grow-

[1] By September 2008, stock markets in Bulgaria were 48 percent off their peak, but domestic demand was still growing by 3.3 percent year over year.

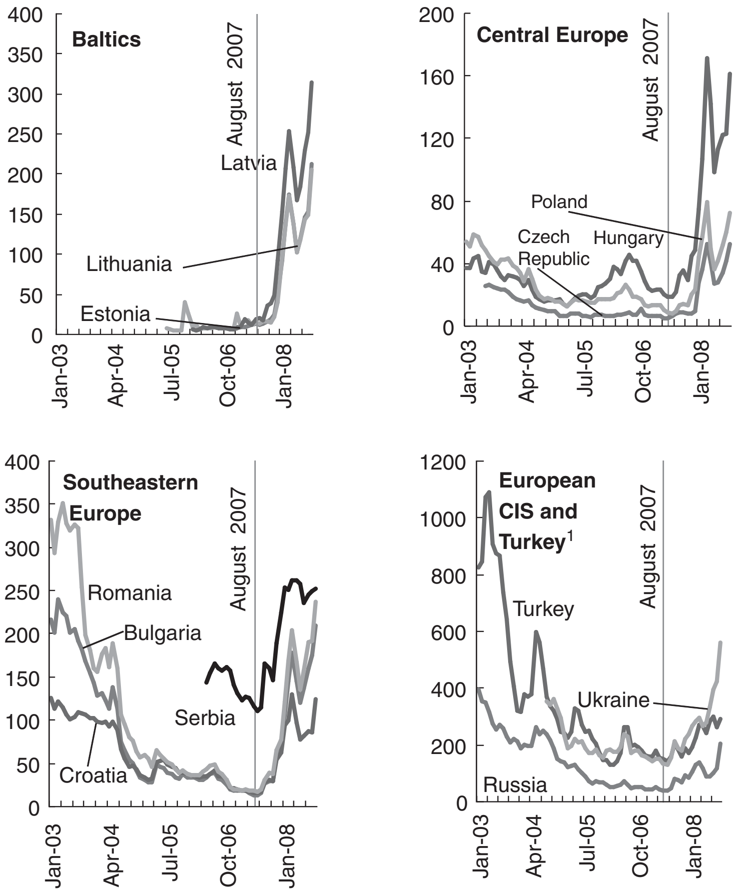

Figure 2.1 Emerging Europe: Credit Default Swap Spreads (*Basis points*)

Sources: Bloomberg; and Thomson Reuters Datastream.
[1] European CIS = Belarus, Moldova, Russia, and Ukraine.

ing by 20 percent year over year in Latvia, and 24 percent in Bulgaria and Romania. In the new EU member states with flexible exchange rates, where the boom had been more contained and overheating was less of a concern, inflation remained more moderate, within the 4 to 7 percent range.

The Baltics and Hungary were the only countries that felt the impact of the global crisis well before the default of Lehman Brothers.

THE BALTICS

The Baltic countries were the first to experience a slowdown. Swedish banks, which had become concerned about their exposure to the Baltic countries, started to rein in credit growth in the summer of 2007 in an effort to engineer a soft

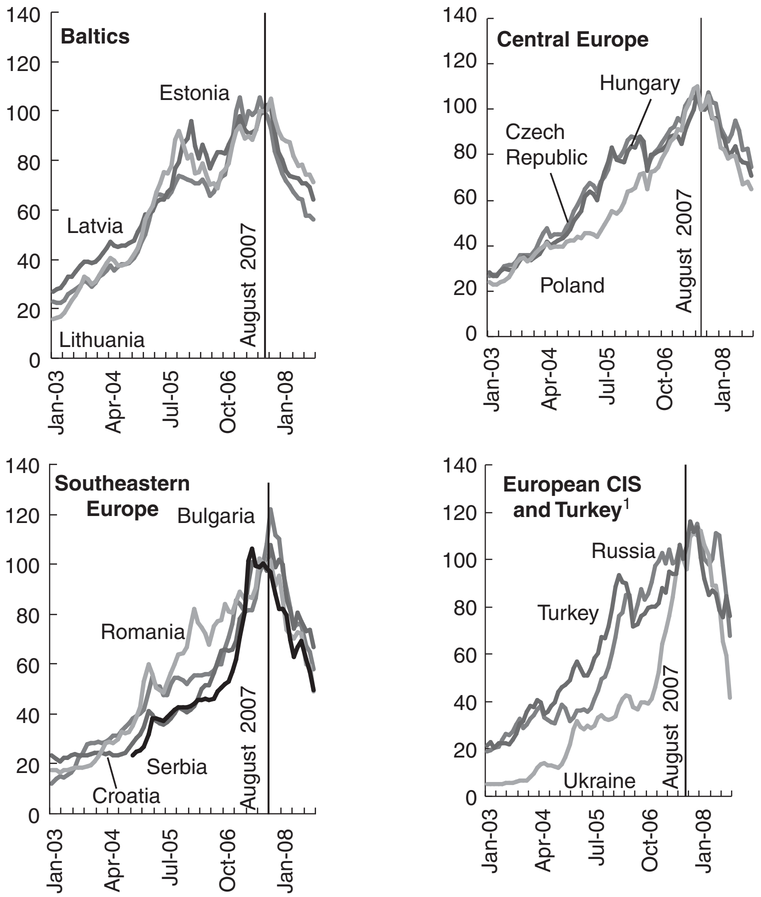

Figure 2.2 Emerging Europe: Stock Market Indices (*Index August 2007 = 100*)

Source: Bloomberg.
[1] European CIS = Belarus, Moldova, Russia, and Ukraine.

landing.[2] While these concerns were not directly related to the global crisis, the increase in global risk aversion had no doubt helped raise awareness among Swedish banks that imbalances in the Baltic countries had increased to dangerous levels.

As Swedish banks tightened credit conditions, credit growth slowed, the housing bubble burst, housing prices began to come down, and domestic demand started to decline. The slowdown was most pronounced in Estonia and Latvia (Figure 2.4), the two countries with the largest imbalances.

By the second quarter of 2008, year-over-year real credit growth in Latvia had fallen to near zero, housing prices were 16 percent lower than a year earlier, and domestic demand had fallen by 11 percent. As a result, Estonia and Latvia entered

[2] See Purfield and Rosenberg (2010) for a discussion of the boom-bust cycle in the Baltics.

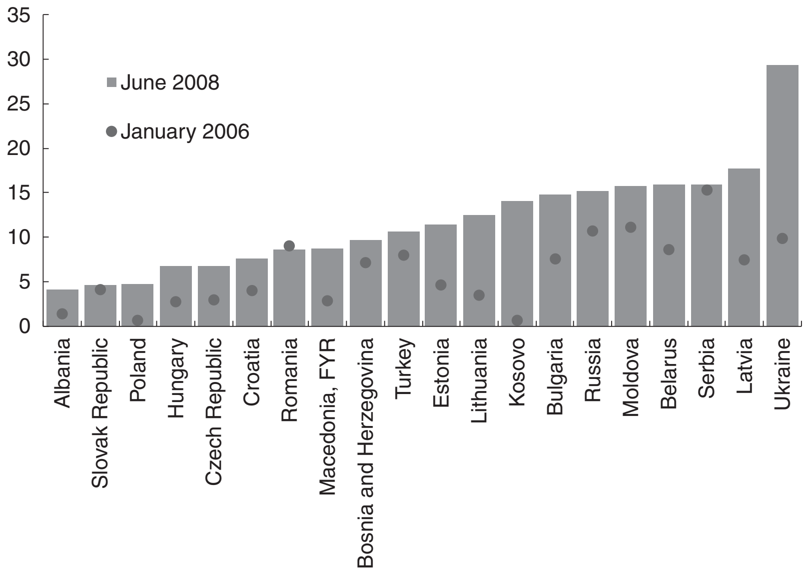

Figure 2.3 Emerging Europe: Consumer Price Inflation, 2006 and 2008 (*Annual percentage change*)

Source: Haver Analytics.

a recession in the first half of 2008—well before the Lehman Brothers crisis hit.[3] By the third quarter, real GDP in Latvia was 4.7 percent lower than a year earlier, and in Estonia it was 3.2 percent lower. In Lithuania, the slowdown was less drastic, and GDP growth year over year was still positive (2.1 percent).

The end of the domestic demand boom reduced private sector imbalances but took its toll on public finances. Current account deficits in Latvia started to come down from the third quarter of 2007. The end of the domestic demand boom led to a sharp drop in tax revenues. In Latvia, the general government's overall fiscal balance worsened from a surplus of 0.6 percent of GDP in 2007 to a deficit of 7.5 percent of GDP in 2008.[4] The deterioration of public finances in turn contributed to a widening of risk premiums. By August 2008, CDS spreads in Latvia had climbed to 230 basis points, up from 16 basis points in July 2007.

HUNGARY

Hungary experienced a short episode of financial stress in March 2008, when government bond markets were briefly thrown into turmoil in the wake of a troubled government bond auction. The exchange rate depreciated by 5 percent and CDS rates shot up to almost 200 basis points and remained elevated.

[3] For a discussion of the situation in precrisis Latvia, see Åslund (2010).

[4] Between 2007 and 2008, the overall fiscal balance declined from +2.4 to –2.9 percent of GDP in Estonia and from –1 to –3.3 percent of GDP in Lithuania.

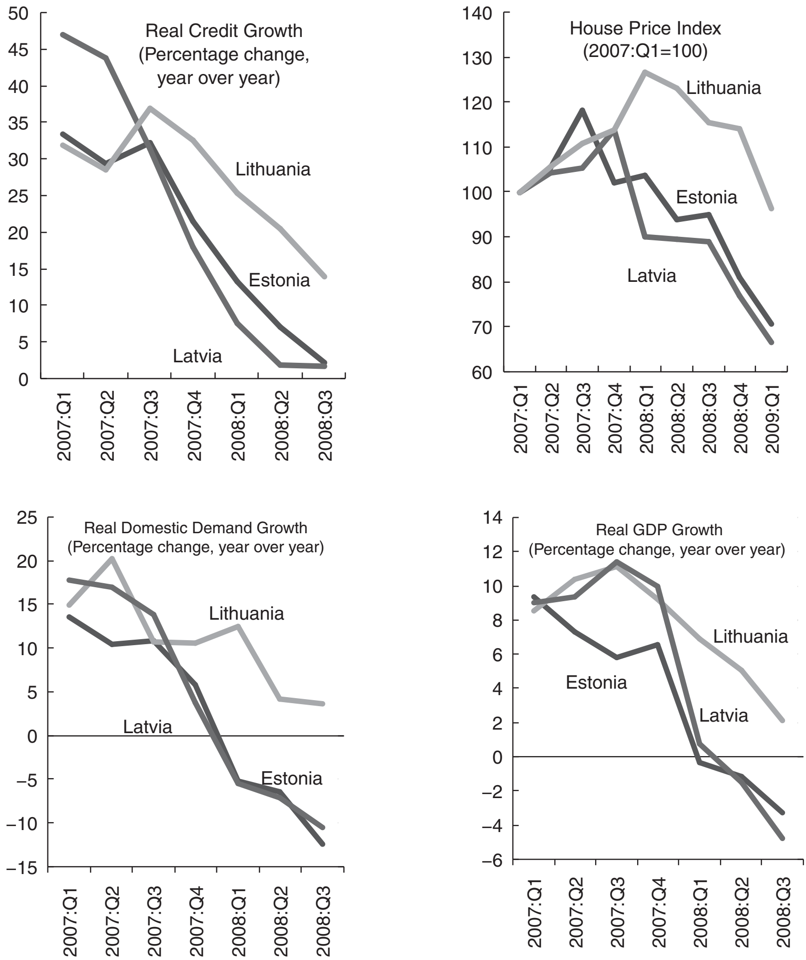

Figure 2.4 Baltics: House Price Index, Credit, GDP, and Domestic Demand Growth, 2007:Q1–2008:Q3[1]

Sources: Bank for International Settlements, *Global Property Guide*; Haver Analytics; IMF, World Economic Outlook database; and IMF, *International Financial Statistics*.

[1] House price index is shown for 2007:Q1–2009:Q1.

Unlike other countries, Hungary was not showing signs of overheating, and its private sector flow imbalances were smaller than in many other countries. Economic growth in Hungary had slowed down from about 4 percent in 2006 to 0.1 percent in 2007 as it embarked on a fiscal consolidation program in 2006 to tackle twin deficits. The fiscal deficit fell from 9.4 percent of GDP in 2006 to 5.1 percent of GDP in 2007, while the current account deficit narrowed only marginally.

The problem in Hungary was that stock vulnerabilities in public debt were unsettlingly high. Public debt at end-2007 amounted to 66 percent of GDP—the highest level in emerging Europe. Since about one-third of that debt was held by foreign investors and the Hungarian debt market was very liquid, Hungary was very vulnerable to swings in international risk aversion. There were also significant vulnerabilities in private sector balance sheets. With domestic interest rates well above the interest rates for euro- and Swiss franc-denominated loans, the share of foreign currency loans in private sector credit had increased sharply.

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CHAPTER 3

The Collapse of Lehman and Its Aftermath

When the IMF's October 2008 *World Economic Outlook* went to press in early September of that year, signs had appeared showing that activity and domestic demand had started to moderate in the emerging Europe region, leading to lower projected growth rates for 2009 (Figure 3.1 and Table 3.1). The region had been relatively resilient to the financial turmoil in advanced countries until then, but it was now facing tighter financial conditions, and the Baltic economies were slowing sharply against a backdrop of large economic imbalances and more discerning investors.

Risks to the outlook were seen as tilted to the downside, stemming primarily from external demand and external financial conditions. Moreover, in some countries worries emerged that asset price declines would significantly hurt the balance sheets of households, enterprises, and financial institutions, further undermining growth. Yet short-term projections for the region remained upbeat, with the relatively soft patch of 2009 followed by a return to growth rates above 5 percent in 2010.

The global crisis spilled over to emerging Europe with full force in mid-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, hitting the whole region particularly hard and on a scale beyond the most pessimistic expectations.

Risk aversion rose sharply, and equity markets plunged. Sovereign credit default swap (CDS) spreads jumped several hundred basis points in a matter of days in the Baltic countries and in Hungary, Romania, Russia, Turkey, and Ukraine (Figure 3.2). CDS and 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 3.3). Equity markets, which had corrected since the summer of 2007 (or the fall of 2007 in the cases 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 3.4).

Analysis by the IMF (2009a) shows that while sovereign spreads in the region were influenced to a large extent by global factors, country-specific factors played an important role as well. Countries with large domestic imbalances (high inflation) and high external vulnerability indicators (high current account deficits and large bank-related capital inflows) saw larger increases in spreads. Thus, the size of

The main author of this chapter is Jérôme Vandenbussche.

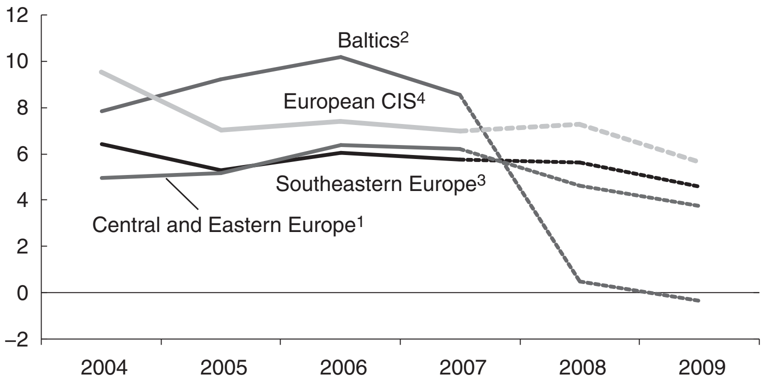

Figure 3.1 Emerging Europe: September 2008 Real GDP Growth Projections, 2004–09 (*Percentage change*)

Source: IMF, *World Economic Outlook*, October 2008.
Note: Data for 2008 and 2009 are projections.
[1] The Czech Republic, Hungary, Poland, and the Slovak Republic.
[2] Estonia, Latvia, and Lithuania.
[3] Albania, Bosnia and Herzegovina, Bulgaria, Croatia, FYR Macedonia, Romania, and Turkey.
[4] Belarus, Moldova, Russia, and Ukraine.

TABLE 3.1

WEO Real GDP Growth Projections for Emerging Europe, 2007–10

Date of projection	2007	2008	2009	2010
Apr. 07	5.8	5.5	5.3	5.1
Oct. 07	6.3	5.8	5.6	5.2
Apr. 08	6.7	5.4	5.2	5.3
Oct. 08	6.7	5.6	4.3	5.3
Apr. 09	6.7	4.1	–4.8	0.7

Source: IMF, World Economic Outlook database.

the increase in spreads was not indiscriminate but, rather, amplified pre-Lehman cross-country differences.

As the global financial crisis spread to emerging market countries, their debt markets came under severe strain, with conditions deteriorating markedly in both primary and secondary segments. Countries with relatively more developed markets (the Czech Republic, Hungary, Poland, Russia, and Turkey) witnessed a reversal in their 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. In addition, 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 3.2). This reflected both supply and demand factors, since governments in the region (such as Poland's) opted to stay away from the euro-bond market, hoping that the increase in spreads would only be temporary, and turned instead to the domestic market. Also, front-loading of borrowing earlier in the year had helped relieve some of the

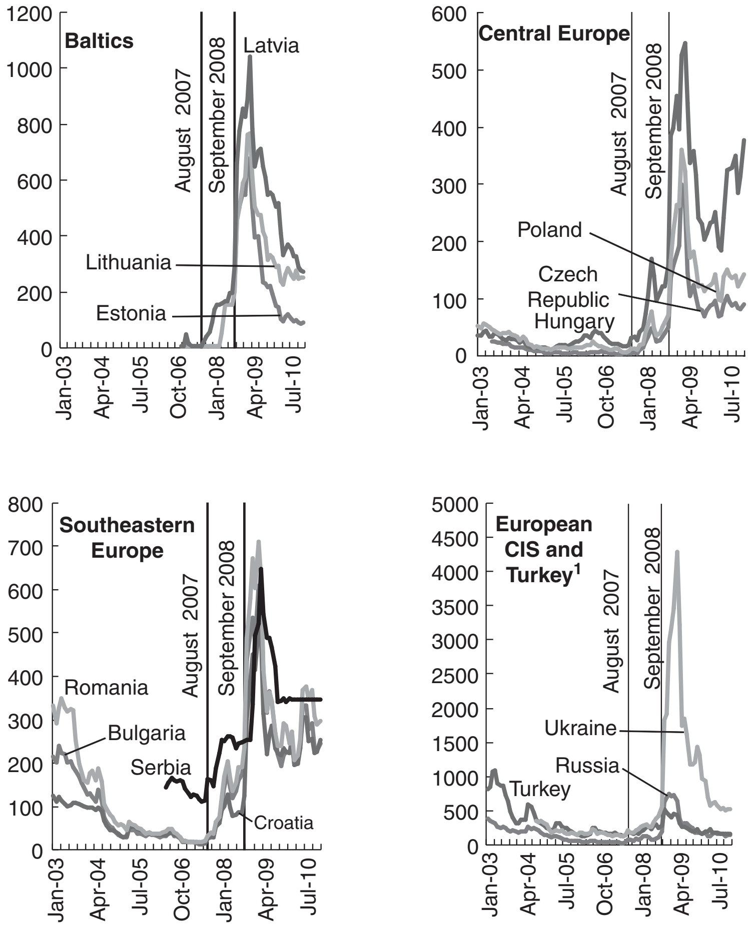

Figure 3.2 Emerging Europe: Credit Default Swap Spreads (*Basis points*)

Sources: Bloomberg; and Datastream.
[1] European CIS = Belarus, Moldova, Russia, and Ukraine.

pressure on debt managers' operations. For example, Turkey had already covered its planned fiscal and debt amortization needs for the next eight months.

Emerging Europe's banks experienced funding pressures when capital flows from western European banks into the region dropped sharply. In a change of strategy, many banks in advanced economies, confronted with liquidity and capital shortages, advised their subsidiaries and branches in emerging Europe that new credit would henceforth need to be financed solely from an increase in local deposits.[1] They also halted direct cross-border loans. As a reflection of these devel-

[1] Balance sheet conservatism was summarized by the CEO of Swedbank's Baltic operations in late September with the statement, "Loans will grow by as much as it's possible for us to increase deposits" (*Baltic Business News*, September 28, 2008).

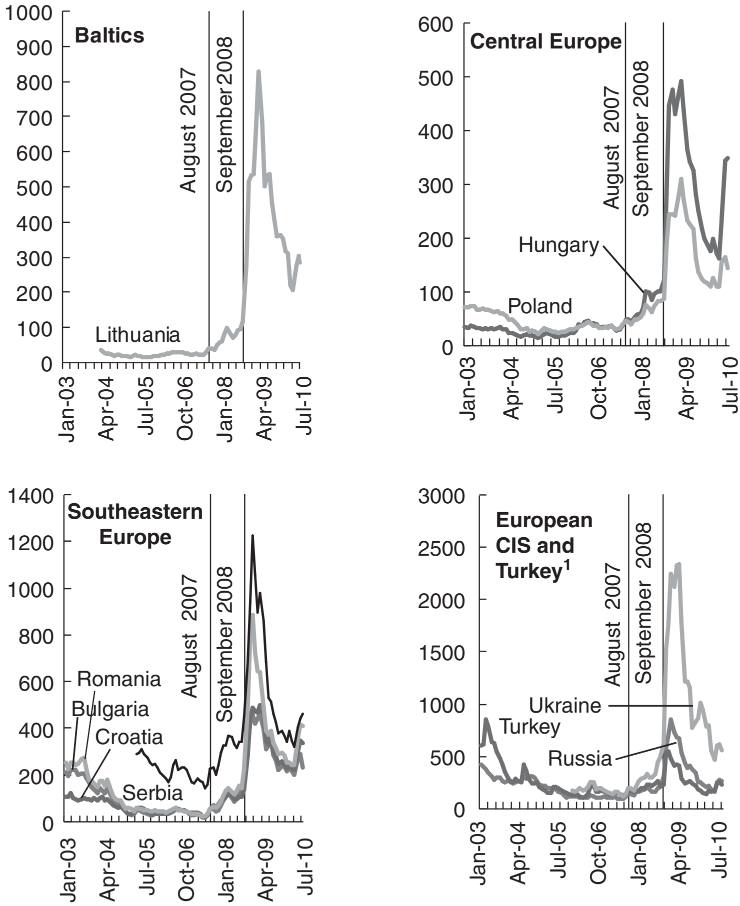

Figure 3.3 Emerging Europe: Emerging Market Bond Index Spreads (*Basis points*)

Source: Bloomberg.
[1] European CIS = Belarus, Moldova, Russia, and Ukraine.

opments, the external positions of Bank for International Settlements (BIS) reporting banks vis-à-vis countries in the region stagnated or started to decline (particularly in Estonia, Latvia, and Ukraine; see Table 3.3).

Banks' funding pressures were further exacerbated by the freezing of the international syndicated loans market (Table 3.4) and by deposit withdrawals in October and November 2008, in particular in the former Commonwealth of Independent States (CIS) countries, the Baltics, and non-EU southeastern European countries (Table 3.5).

The pressure on banks posed a major risk to the region. The fear was that sharply lower credit growth and sizeable currency adjustments would combine in

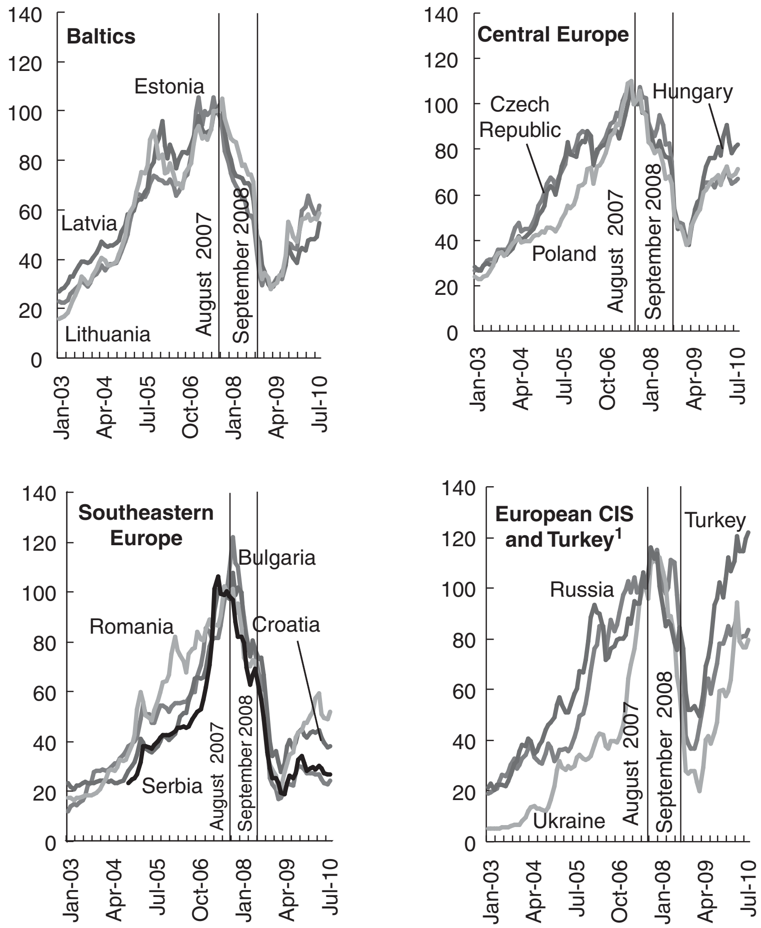

Figure 3.4 Emerging Europe: Stock Market Indices (*Index August 2007 = 100*)

Source: Bloomberg.
[1] European CIS = Belarus, Moldova, Russia, and Ukraine.

a vicious circle of rising nonperforming loans, eroding capital adequacy ratios, and deteriorating liquidity in both banks and the nonbank private sector.

Some market participants even envisaged a scenario in which a few foreign owners of emerging European banks would simply abandon their subsidiaries. Although it was widely understood that western European banks had invested in emerging Europe for the long term, attracted by the convergence prospects of this part of the continent, there was a discomforting precedent. After the third largest Croatian bank, Rijecka, had suffered large foreign exchange losses between 1998 and 2000, its foreign owner, Bayerische Landesbank of Germany, had preferred to sell it to the Croatian government for US$1 rather than recapitalize it. Extreme reactions by parent banks therefore could not be completely ruled out.

TABLE 3.2

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

	2008:Q1	2008:Q2	2008:Q3	2008:Q4	2009:Q1	2009:Q2	2009:Q3	2009:Q4	2010:Q1	Total
Macedonia	…	…	…	…	…	244	…	…	…	244
Latvia	608	…	…	…	…	…	…	…	…	608
Croatia	…	…	…	…	…	1,050	…	1,500	…	2,550
Romania	…	1,163	…	…	…	…	…	…	1,429	2,592
Slovak Republic	…	…	…	…	…	2,648	…	…	…	2,648
Lithuania	…	…	…	105	188	700	…	1,500	2,000	4,493
Czech Republic	…	3,106	…	…	…	1,986	438	492	…	6,022
Hungary	…	2,668	…	…	…	…	1,397	…	2,000	6,066
Turkey	2,000	500	1,500	…	1,000	1,500	1,250	…	3,000	10,750
Poland	474	3,311	…	…	1,292	1,003	4,208	1,828	6,444	18,560
TOTAL	3,081	10,748	1,500	105	2,480	9,132	7,293	5,320	14,873	54,532

Source: Dealogic.

TABLE 3.3

Emerging Europe: External Positions of Western Banks vis-à-vis Emerging Europe, 2007–09
(*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: Bank for International Settlements, *Locational Statistics*; and IMF, World Economic Outlook database.

It was not clear at the time whether all of the region's supervisors and central banks had the resources to deal with the large-scale withdrawals or capital flight that could result from parent bank failures and/or liquidations of local operations.

TABLE 3.4

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	...	...	...	14
Belarus	43	123	162	15
Bosnia and Herzegovina	...	47	...	...
Bulgaria	22	430	299	43
Croatia	...	...	155	...
Czech Republic	...	...	...	...
Estonia	...	78	32	...
Hungary	279	...	...	...
Latvia	508	23	297	...
Lithuania	...	31	...	...
Macedonia, FYR	...	...	...	...
Moldova	31	...	...	26
Montenegro	...	...	...	...
Poland	78	16	244	...
Romania	51	16	...	316
Russia	1,118	4,239	2,363	1,877
Serbia	...	...	...	...
Slovak Republic	...	...	...	...
Turkey	...	1,033	4,947	1,585
Ukraine	349	592	809	200
TOTAL	2,479	6,628	9,309	4,075

Source: Dealogic.
[1] Data include loans from the European Bank for Reconstruction and Development, the European Investment Bank, and the International Finance Corporation, and exclude loans from parent banks.

TABLE 3.5

Emerging Europe: Private Sector Domestic Currency Deposits, October 2008–March 2009[1]
(*Index September 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.

It turned out that foreign parent banks were able to respond in the fourth quarter of 2008 by providing liquidity support when and where needed, but deposit rates started to creep up from that moment on.

Although net capital flows dropped sharply, they remained positive in most countries, with the exception of Russia (Figures 3.5 and 3.6), 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

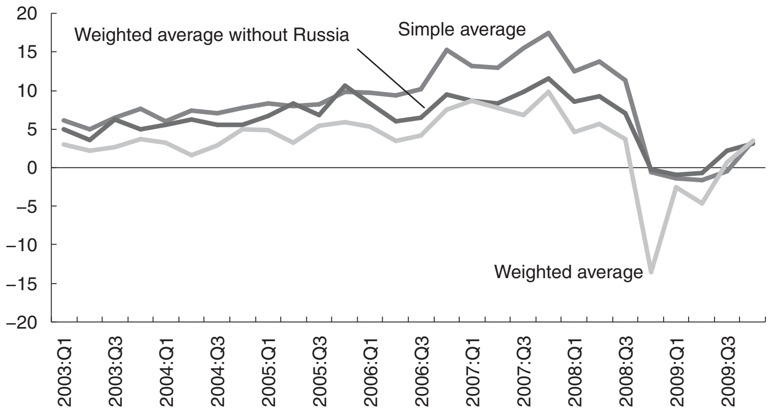

Figure 3.5 Emerging Europe: Net Capital Flows to Emerging Europe, 2003–09[1] (*Seasonally adjusted, percent of GDP*)

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.

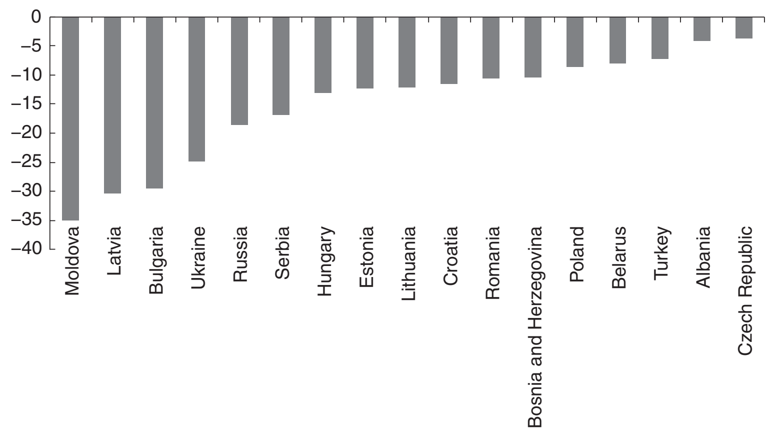

Figure 3.6 Emerging Europe: Reduction of Net Capital Flows during the Crisis of 2008/09[1] (*Percent of GDP*)

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.

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.

Exchange rates generally came under pressure (Figure 3.7). 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 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 3.6). By the end of November, pressures were greatest in Ukraine, perhaps owing to the brewing banking crisis in that country. Early pressures in October on the Hungarian forint were relieved thanks to the prompt corrective actions of the

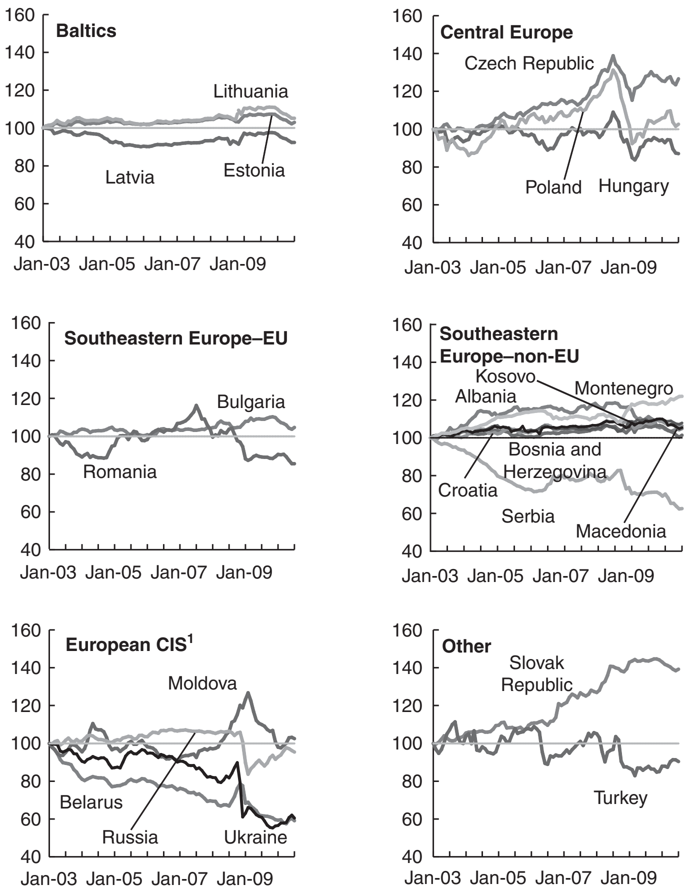

Figure 3.7 Emerging Europe: Nominal Effective Exchange Rates (*Index August 2008 = 100*)

Source: IMF, *Information Notice System*.
[1] European CIS = Belarus, Moldova, Russia, and Ukraine.

TABLE 3.6

Emerging Europe: Exchange Rate Pressure Index, September 2008–March 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
Ukraine	–0.3	2.1	5.0	9.4	1.7	0.2	1.0	19.1
Poland	3.1	3.9	1.3	5.9	1.7	1.7	1.3	18.9
Serbia	–0.3	4.9	4.3	3.0	4.8	–0.5	0.9	17.1
Moldova	0.2	1.8	–0.2	1.7	2.1	0.8	5.0	11.5
Romania	1.2	1.2	0.0	2.9	4.2	0.3	0.7	10.5
Croatia	–0.6	1.6	–0.3	4.6	3.2	1.7	–0.2	9.9
Albania	0.5	–0.2	–3.5	2.3	2.0	2.4	3.6	7.1
Czech Republic	0.6	0.0	0.3	4.0	2.2	1.4	–2.3	6.2
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
Bulgaria	0.0	1.3	–0.2	7.8	–2.4	–0.3	–0.6	5.6
Hungary	1.0	3.5	–3.4	–0.3	2.7	2.7	–0.8	5.3
Macedonia, FYR	–0.1	–0.3	1.4	1.7	–1.2	0.8	1.1	3.5
Lithuania	0.5	–1.2	2.5	0.0	–0.2	1.1	0.3	3.1
Bosnia and Herzegovina	0.2	1.4	–0.1	–0.1	0.4	0.7	–0.6	1.9
Estonia	1.5	–3.0	1.3	2.9	–1.6	0.6	–0.2	1.6
Latvia	–2.4	–0.1	3.1	–0.1	–1.2	–1.9	3.4	0.8

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 a reference currency from its mean and the deviation of the monthly change in international reserves in a reference currency from their mean. Both changes are normalized by their standard deviation. The reference currency is the euro for all countries except Belarus, Moldova, Ukraine, Russia, and Turkey, for which it is the special drawing right (SDR). A higher index indicates more pressure.

government in the context of an IMF/EU-supported program, 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.

THE IMPACT ON THE REAL ECONOMY

The collapse in global trade soon led to a very sharp drop in exports (Figure 3.8). As described in Baldwin (2009), the collapse in global trade was mostly caused by demand factors, in particular by the sudden, recession-induced postponement of purchases of durable consumer and investment goods on a global scale. This trend was reflected in the plunge of the global manufacturing Purchasing Managers Index (PMI) and eurozone manufacturing PMI in September. The trade impact of these decisions was amplified by the presence of highly integrated and tightly synchronized production networks throughout the region. For large commodity exporters such as Russia (oil) and Ukraine (steel), the decline in export volumes was compounded by a sharp correction in commodity prices.

At the same time, domestic demand was affected by a sudden slowdown in credit growth (Figure 3.9) and the bursting of the real estate bubbles (Figures 3.10 and 3.11). The domestic demand decline was particularly

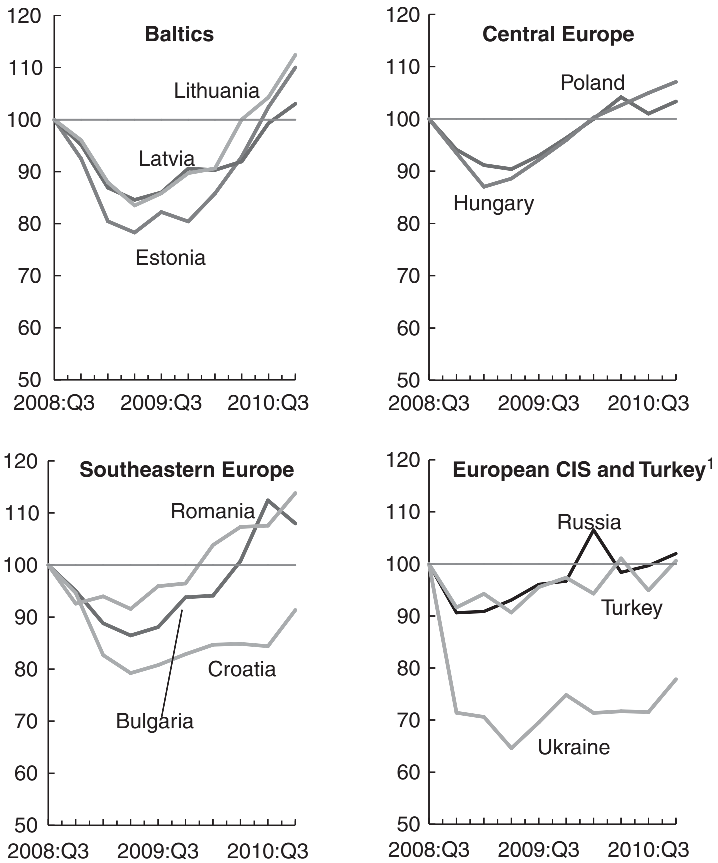

Figure 3.8 Emerging Europe: Real Exports, 2008:Q3–2010:Q4 (*Seasonally adjusted, index 2008:Q3 = 100*)

Sources: Eurostat; Haver Analytics; and IMF staff calculations.
[1] European CIS = Belarus, Moldova, Russia, and Ukraine.

pronounced in the Baltics and Ukraine, driven by a steep 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 increased marginally, thereby cushioning the overall domestic demand fall.

As a result, output in most countries declined very sharply (Figure 3.12). Seasonally adjusted GDP in Estonia, Lithuania, Latvia, and Ukraine contracted by 13 percent, 13 percent, 16 percent, and 19 percent, respectively, between the third quarter of 2008 and the first quarter of 2009. A few countries escaped severe recession—Belarus, Macedonia, and Poland were affected by the downturn, while Albania continued to grow. The output decline in emerging Europe as a whole was larger than in any other emerging market region, mainly because capital

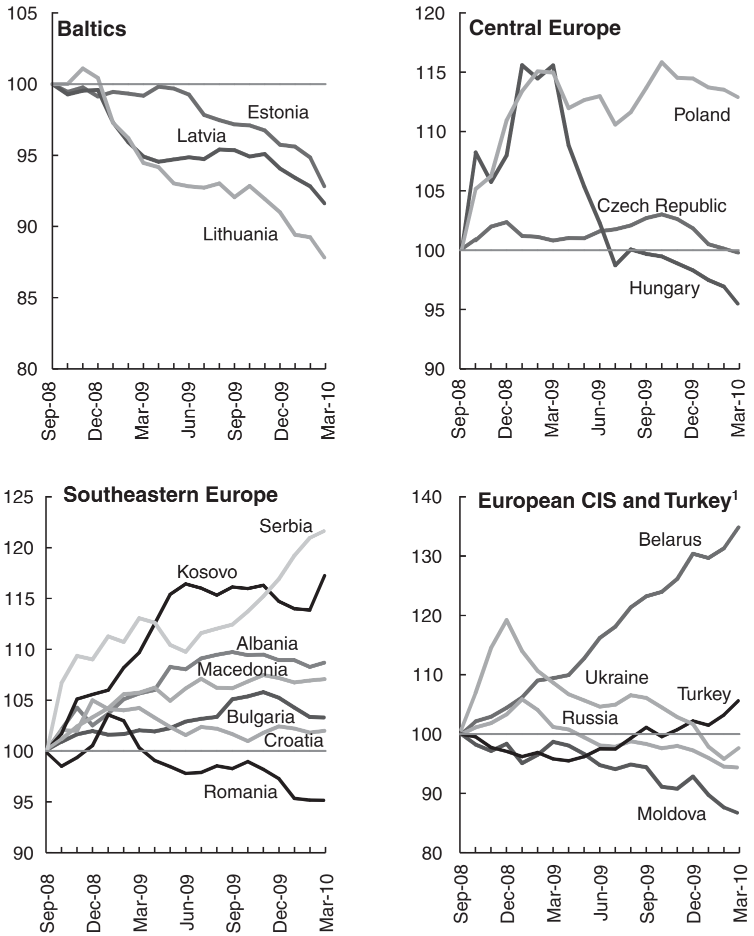

Figure 3.9 Emerging Europe: Real Credit Stock, September 2008–March 2010 (*Index September 2008 = 100*)

Sources: IMF, *International Financial Statistics*; Haver Analytics; and IMF staff calculations.
[1] European CIS = Belarus, Moldova, Russia, and Ukraine.

inflows underwent a correction from a higher level in emerging Europe than elsewhere.[2]

The size of domestic imbalances before the crisis played the most important role in accounting for diverse individual outcomes. Countries that had the largest increases in the credit-to-GDP ratio before the crisis experienced the largest contractions in GDP in 2009 (Figure 3.13). Indeed, the decline in GDP in 2009 was mainly due to the bust in domestic demand (Figure 3.14). Countries that had the

[2] Emerging market economies were primarily affected through financial channels (Blanchard, Dell'Ariccia, and Mauro, 2010).

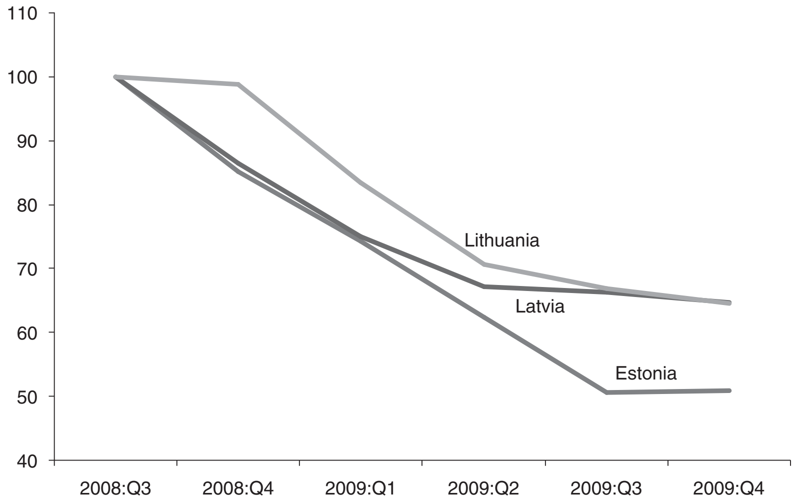

Figure 3.10 Baltic Countries: Real Estate Prices, 2008:Q3–2009:Q4 (*Index 2008:Q3 = 100*)

Sources: Bank for International Settlements, *Property Price Statistics*; and IMF staff calculations.

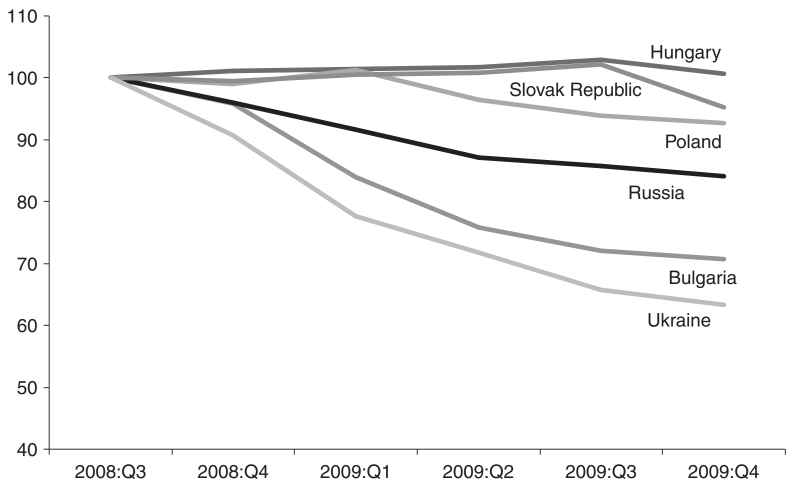

Figure 3.11 Selected Emerging Europe Countries: Real Estate Prices, 2008:Q3–2009:Q4 (*Index 2008:Q3 = 100*)

Sources: Bank for International Settlements, *Property Price Statistics*; and IMF staff calculations.

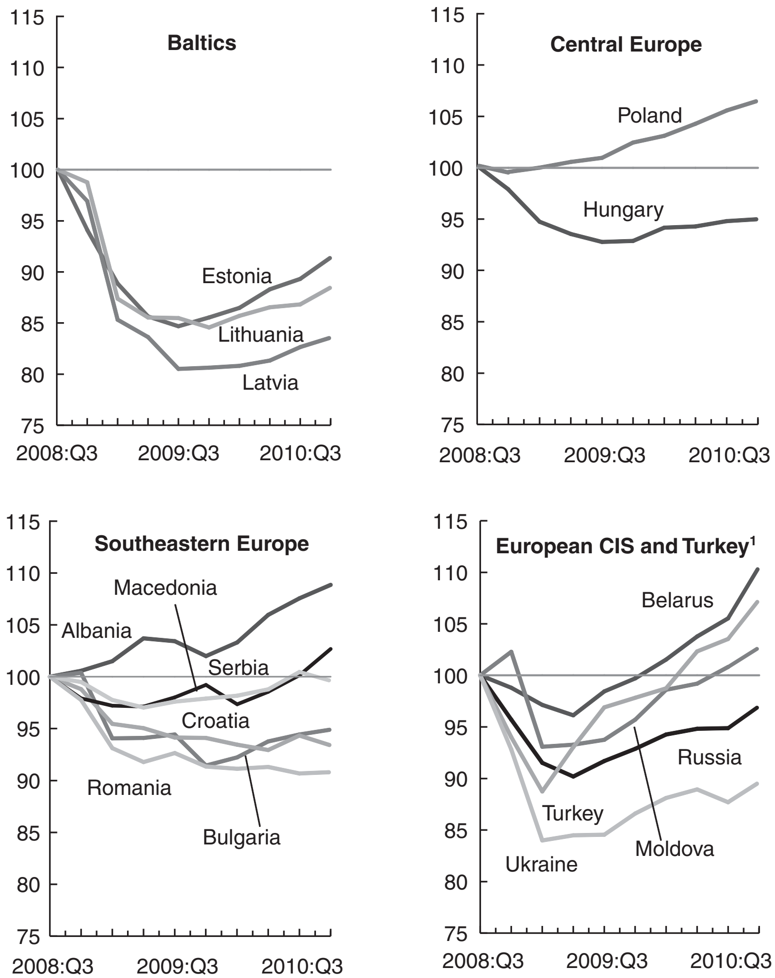

Figure 3.12 Emerging Europe: Real GDP, 2008:Q3–2010:Q4 (*Seasonally adjusted, index 2008:Q3 = 100*)

Sources: Eurostat; Haver Analytics; and IMF staff calculations.
[1] European CIS = Belarus, Moldova, Russia, and Ukraine.

largest increase in domestic demand in the precrisis years saw the sharpest decline in GDP in 2009 (Figure 3.15).

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

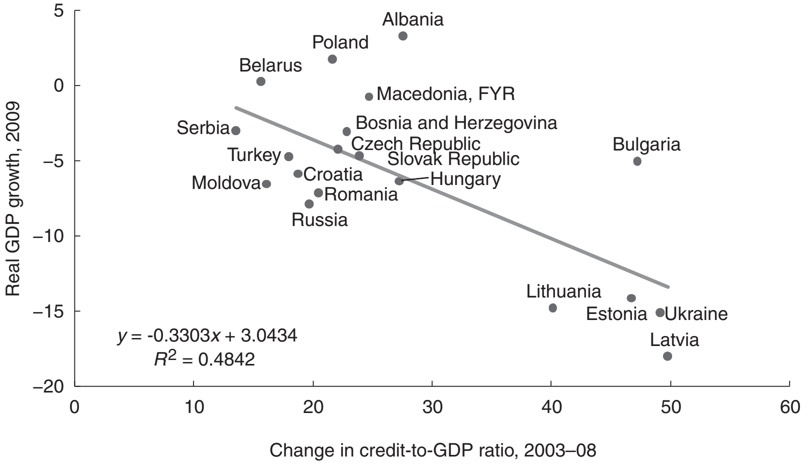

Figure 3.13 Emerging Europe: Change in Credit-to-GDP Ratio and Real GDP Growth (*Percent*)

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

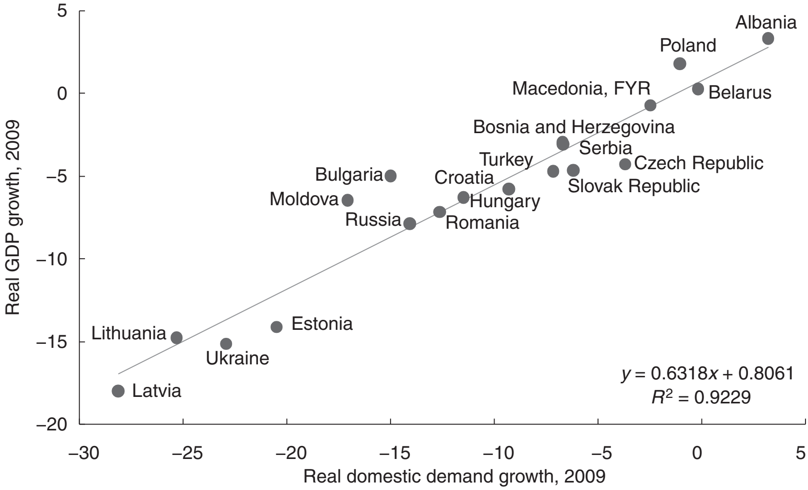

Figure 3.14 Emerging Europe: Real Domestic Demand Growth and Real GDP Growth, 2009 (*Percent*)

Source: IMF, World Economic Outlook database.

adjustments in monetary and fiscal policies were also implemented. In several cases, external funding was secured through programs supported by the IMF and often also the EU, and/or swaps and repo arrangements with western European central banks. The policy mix depended on country-specific pressure points and constraints on policies.

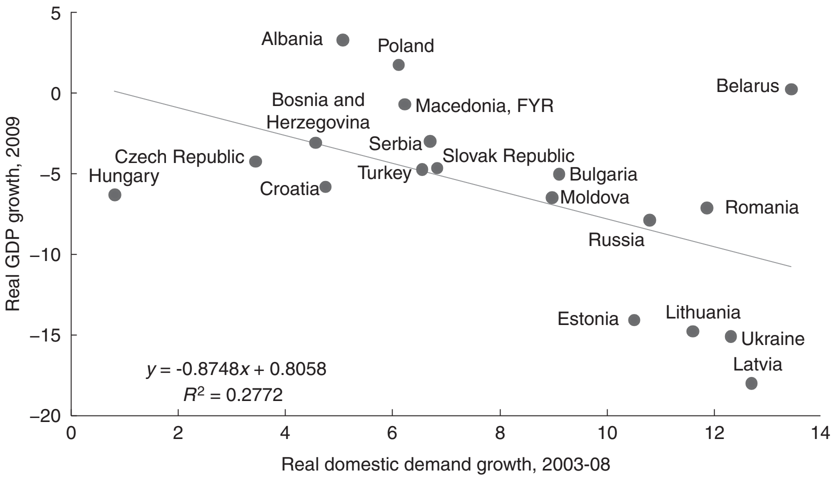

Figure 3.15 Emerging Europe: Real Domestic Demand Growth and Real GDP Growth (*Percent*)

Source: IMF, World Economic Outlook database.

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 there and from both conventional and unconventional policy measures taken by the European Central Bank (ECB) and the Riksbank. Domestic policy measures also helped maintain the confidence of depositors and debt holders.

The most commonly used tool to provide systemic liquidity was the relaxation of reserve requirements, which was implemented almost universally across the region (Table 3.7). Several countries also introduced new fixed-term domestic and foreign currency liquidity supply operations, and some countries, such as Ukraine, also widened the range of collateral accepted for monetary operations. To contain the risk of bank runs, deposit insurance coverage was increased.

Strengthening banks' capital positions was also a priority. Many supervisors strongly recommended a zero-dividend policy and sometimes requested preemptive recapitalizations based on stress tests (as in Romania and Ukraine). Recapitalization funds were set up in Hungary and Russia, while other countries implemented a countercyclical relaxation of loan classification and provisioning requirements (Bulgaria, Romania) thus making it less costly for banks to renegotiate loan terms with their customers (Table 3.8).

National authorities also intervened directly in selected distressed institutions to provide them with fresh liquidity or capital. This was most obvious in Latvia, Ukraine, and Russia. In response to persistent deposit withdrawals, Latvia's largest domestic bank and second largest bank overall (Parex Bank) benefited both from

TABLE 3.7

Emerging Europe: Banking System Liquidity Policy Measures, 2008:Q4–2009:Q2

	System-wide Policy Measures						Interventions in Individual Institutions
Country	**Relaxation of reserve requirements**	**Domestic currency liquidity injections**	**Foreign exchange liquidity injections**	**Foreign exchange interventions**	**Increase in deposit insurance coverage**	**Debt guarantee scheme**	**Liquidity injection**
Albania		Nov. 08 onward		Yes	Mar. 09		
Belarus	Dec. 08, Feb. 09, Mar. 09			(Peg)	Jan. 09		Yes
Bosnia and Herzegovina	Oct. 08, Dec. 08, May 09			(Peg)	Dec. 08		
Bulgaria	Oct. 08, Dec. 08, Jan. 09			(Peg)	Nov. 08		
Croatia	Oct. 08, Nov. 08	Yes		Yes	Oct. 08		
Czech Republic	Oct. 08	Oct. 08 onward			Oct. 08		
Estonia				(Peg)	Oct. 08		
Hungary	Nov. 08		Oct. 08 onward, Mar. 09	Yes	Oct. 08		
Latvia	Oct. 08, Nov. 08, Dec. 08			(Peg)	Oct. 08		Nov. 08, Feb. 09
Lithuania	Nov. 08			(Peg)	Oct. 08	Dec. 08	
Macedonia, FYR				(Peg)			
Moldova	Oct. 08, Nov. 08, Dec. 08, Jun. 09						
Montenegro	Oct. 08. Feb. 09, Jun. 09						Yes
Poland	Jun. 09	Oct. 08 onward	Oct. 08 onward		Oct. 08		
Romania	Nov. 08, May 09	Oct. 08 onward	Yes	Yes	Oct. 08		
Russia	Sep. 08, Oct. 08	Sep. 08 onward	Sep. 08	Sep.–Dec. 08	Oct. 08	Sep. 08	
Serbia	Oct. 08	Apr. 09	Apr. 09	Yes	Dec. 08		
Turkey[1]	Dec. 08			Yes			
Ukraine	Oct. 08, Dec. 08, Feb. 09	Oct. 08 onward		Yes	Oct. 08		

Sources: Bloomberg; central bank websites; and IMF staff reports.
[1] For Turkey, foreign exchange interventions refer to a limited number of preannounced foreign exchange sales in October 2008 and again in April 2009.

TABLE 3.8

Emerging Europe: Policy Measures to Protect Bank Solvency, 2008:Q4–2009:Q2

	System-Wide Policy Measures		Interventions in Individual Institutions
Country	Recapitalization fund	Relaxation of capital/provisioning requirements	Capital injection
Albania			
Belarus			Yes
Bosnia and Herzegovina			
Bulgaria		Mar. 09	
Croatia			
Czech Republic			
Estonia		Yes	
Hungary	Feb. 09		
Latvia			Nov. 08
Lithuania			
Macedonia, FYR			
Moldova			
Montenegro		Aug. 09	
Poland			
Romania		Yes	
Russia	Oct. 08, Mar. 09	Yes	Sep.–Oct. 08, Apr. 09, Jun. 09
Serbia			
Turkey		Oct. 08, Jan. 09	
Ukraine			Apr. 09

Sources: Bloomberg; central bank websites; and IMF staff reports.

a state guarantee covering existing and new loans and from fresh government deposits (later converted into equity) and subordinated loans. In Ukraine, several large domestic banks that were unable or unwilling to bring in additional capital as requested by the authorities were put under administration, and three of them were recapitalized with public funds. In Russia, several small banks had to be rescued by state-owned banks or state-owned companies or received equity injections from the Deposit Insurance Agency.

Foreign currency liquidity support was sometimes made possible as a result of swap and repo arrangements with the central banks of western European countries. In October 2008, the National Bank of Hungary secured a €5 billion repurchase agreement with the European Central Bank (ECB) and a foreign exchange swap facility of undisclosed size with the Swiss National Bank. The Polish National Bank followed with a €10 billion ECB arrangement and, a month later, an arrangement with the Swiss National Bank similar to Hungary's. In December 2008, Latvia entered into an arrangement with the central banks of Sweden and Denmark to swap up to €500 million against Latvian lats. Estonia was allowed to obtain up to SEK10 billion (about €0.9 billion) against Estonian kroons in an agreement struck with the Central Bank of Sweden in February 2009 (Allen and Moessner, 2010).

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. Following Laeven and Valencia (2010), a banking crisis can be defined as a situation in which at least three types of significant public interventions become necessary to stabilize a banking system (see Table 3.9). According to this definition, Latvia and Ukraine had a full systemic banking crisis during 2008–09, while Hungary and Russia had some symptoms of a systemic banking crisis but of a lesser magnitude.

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 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 (Table 3.10). In other countries, policymakers were able to decrease policy rates (the Czech Republic, Poland, and Turkey).

Monetary and exchange rate policy frameworks were maintained in nearly all countries, with the exceptions being Belarus, Russia, and Ukraine. Russia devalued by some 30 percent and substantially widened the band for the ruble vis-à-vis the currency basket. Following a 35 percent devaluation, Ukraine's de facto exchange rate regime was reclassified as a "managed floating" regime from a pegged regime. 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.

Countries' immediate fiscal policy response varied, depending on their precrisis fiscal buffers, their exchange rate regimes, and their positions 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 the use of 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

TABLE 3.9

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 meet the definition of systemic crisis.

TABLE 3.10

Emerging Europe: Monetary Policy Rate Changes, 2008:Q4–2009:Q2

	Policy Interest Rate Change	
	Cut	Increase
Albania	Jan. 09	
Belarus	Apr. 09	Nov. 08, Jan. 09, Jun. 09
Bosnia and Herzegovina	(currency board)	
Bulgaria	(currency board)	
Croatia		
Czech Republic	Aug. 08 onward	
Estonia	(currency board)	
Hungary	Nov. 08 onward	Oct. 08
Latvia	Mar. 09, May 09	
Lithuania	(currency board)	
Macedonia, FYR	Sep. 08 onward	
Moldova	Sep. 08 onward	
Montenegro	(de facto euroization)	
Poland	Nov. 08 onward	
Romania	Feb. 09–May 10	
Russia	Apr. 09 onward	Nov. 08–Feb. 09
Serbia	Jan. 09, Apr. 09, Jun. 09	Nov. 08
Turkey	Nov. 08 onward	
Ukraine	Jan. 09, Jun. 09	Nov. 08, Dec. 08, Feb. 09

Sources: Bloomberg; central bank websites; and IMF staff reports.

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 its 2010 budget.

International Official Financing Provided Relief

Several countries secured IMF-supported programs. Large, front-loaded financial assistance packages from the IMF, EU, and other multilateral institutions provided external funding and smoothed the required policy adjustments in several countries. In each country, the design of the underlying economic programs reflected its circumstances—the amount of fiscal space available and the nature of the exchange rate regime—as well as the preferences of its authorities.

Compared with previous crisis programs supported by the IMF, these programs differed in a number of key features. First, financing was generally larger and more front-loaded, allowing countries to maintain supportive macroeconomic policies whenever possible. Second, program conditionality was considerably streamlined, focusing more on measures to address the vulnerabilities that had magnified the impact of the shock. Finally, top priority was given to financial sector stabilization, including guarantee schemes backed by IMF resources, initiatives to enhance bank supervision, and emergency liquidity support.

While more details are provided in the country-specific chapters, a short summary of the chronology of and rationale for these programs is given below.

Hungary

Hungary entered into a program supported by the IMF and the EU in November 2008. Hungary's foreign exchange and government securities markets were particularly affected early on 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 foreign exchange swap market on which Hungarian banks relied to fund foreign currency loans quickly froze (see Box 3.1). The program aimed to address the main pressure points in public finances and the banking sector through substantial fiscal adjustment, up-front bank capital enhancement, and large external financing assistance.

BOX 3.1 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, the 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, and that in turn 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-day) 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 were kept in operation, even after conditions in the FX swap market had normalized.

Ukraine

Ukraine entered into a program later in November 2008 as confidence in the country's banking system and currency was weakened by substantial problems in its 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. The program's objectives were to help its economy adjust to the new environment, in particular through greater exchange rate flexibility, and to restore confidence in the financial system. A new stand-by arrangement (SBA) was approved in July 2010 with a cancellation of the old program.

Latvia

Latvia entered into a program supported by the IMF and the EU in December 2008 as the availability of external finance had fallen very sharply owing to global developments and downgrades to Latvia's sovereign credit rating. The second largest bank suffered a significant outflow of deposits after September, 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. Key policy actions under the program included taking immediate measures to stem the loss of bank deposits and international reserves, taking steps to restore confidence in the banking system in the medium term, adopting fiscal measures to limit the substantial widening of the budget deficit, and implementing income policies and structural reforms to rebuild competitiveness under the fixed exchange rate regime.

Belarus

Prices for Belarus's commodity exports fell and demand for its products dropped off. Lingering effects of earlier 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, and then started negotiating a program with the IMF in late October 2008. The program, which was officially approved in January 2009, supported policies to strengthen the monetary framework, balance the budget, and impose strict public wage restraint. One of the prior actions was a one-off devaluation by 20 percent of the Belarusian ruble against the dollar and a simultaneous switch to a currency basket with a trading band of ±5 percent.

Serbia

Similar to other countries in the region, Serbia had large external imbalances. 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. The size of the program was augmented in May 2009. The key objectives were to tighten the fiscal stance in 2009–10 and to strengthen the inflation targeting framework.

Romania

In Romania, capital inflows had slowed sharply and international reserves had begun to decline. The Romanian authorities felt that although the effects of the global crisis had not been especially pronounced in Romania compared with elsewhere in the region, the country's vulnerability to a sudden drop in capital flows was higher due to its weak fiscal position and high current account deficit. They entered into a program supported by the IMF and the EU in May 2009 with a view to cushioning the effects of such a drop while implementing policy measures to address fiscal and external imbalances and to strengthen the financial sector.

Poland

Notwithstanding its favorable fundamentals and the authorities' strong policy response, Poland's economy was being severely affected by the global financial crisis through both 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.

Bosnia-Herzegovina

In Bosnia-Herzegovina, the rapidly deteriorating external and financial environment created substantial external and budget financing needs, necessitating a rapid adjustment. Agreement on an IMF-supported program was reached in May 2009 (the program was officially approved in July), aimed at safeguarding the currency board arrangement through a combination of fiscal, income, and financial sector policies.

Moldova

In Moldova, falling demand in trading partners led to a severe downturn in exports and remittances. Domestic demand collapsed, causing GDP contraction. 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. The main objectives were to reverse the structural fiscal deterioration, keep inflation under control while rebuilding foreign reserves, strengthen financial sector monitoring and the bank resolution framework, raise the economy's potential growth rate through structural reforms, and promote poverty reduction.

Kosovo

Kosovo's economic performance has been hampered severely by infrastructure bottlenecks, and rapid expenditure has undermined fiscal sustainability. The IMF-supported program for Kosovo was approved in July 2010 to help restore fiscal sustainability and safeguard financial stability.

CHAPTER 4

From Stabilization to Recovery

THE REBOUND OF FINANCIAL MARKETS

By early 2009, the panic that had gripped global financial markets began to abate (Figure 4.1). Global equity prices rebounded, risk aversion declined, and sovereign bond spreads narrowed, particularly in emerging markets. At the same time, commodity prices, which had declined sharply in the second half of 2008, began to rebound.

The improvement in financial market conditions reflected increasing confidence that the sharp decline in economic activity was bottoming out and that policymakers were taking strong corrective action.[1] High-frequency indicators suggested that activity was rebounding,[2] and consumer confidence indicators in the euro area started to recover, while the forceful and internationally coordinated policy response further increased confidence and reduced uncertainty. The announcements made after the G-20 meeting in April 2009—including a sharp increase in IMF resources—reinforced market views that policymakers from major countries were making a concerted and coordinated effort to put an end to the crisis. Central banks cut policy interest rates and implemented unconventional measures, including expanded credit-easing actions and purchases of large quantities of government bonds. Many governments launched major fiscal stimulus programs. Finally, the publication of details on the U.S. and UK bank rescue plans and of the results of the bank stress tests conducted by the U.S. Federal Reserve also reduced uncertainty.

As tensions in global financial markets eased, financial conditions in emerging Europe started to improve. Equity markets rebounded in early March 2009, and the MSCI Emerging Europe Index[3] rose about 30 percent in one month. Credit Default Swap (CDS) spreads—which at the height of the crisis varied from 5000 basis points in Ukraine to 400 basis points in Poland—narrowed; in some countries, spreads fell to half their peak levels during the spring months.

The main authors of this chapter are Lone Christiansen and Christoph Duenwald.

[1] See also Chapter 5.

[2] The Global Purchasing Managers Index had begun to rise by January 2009.

[3] The MSCI Emerging Europe Index includes the Czech Republic, Hungary, Poland, Russia, and Turkey.

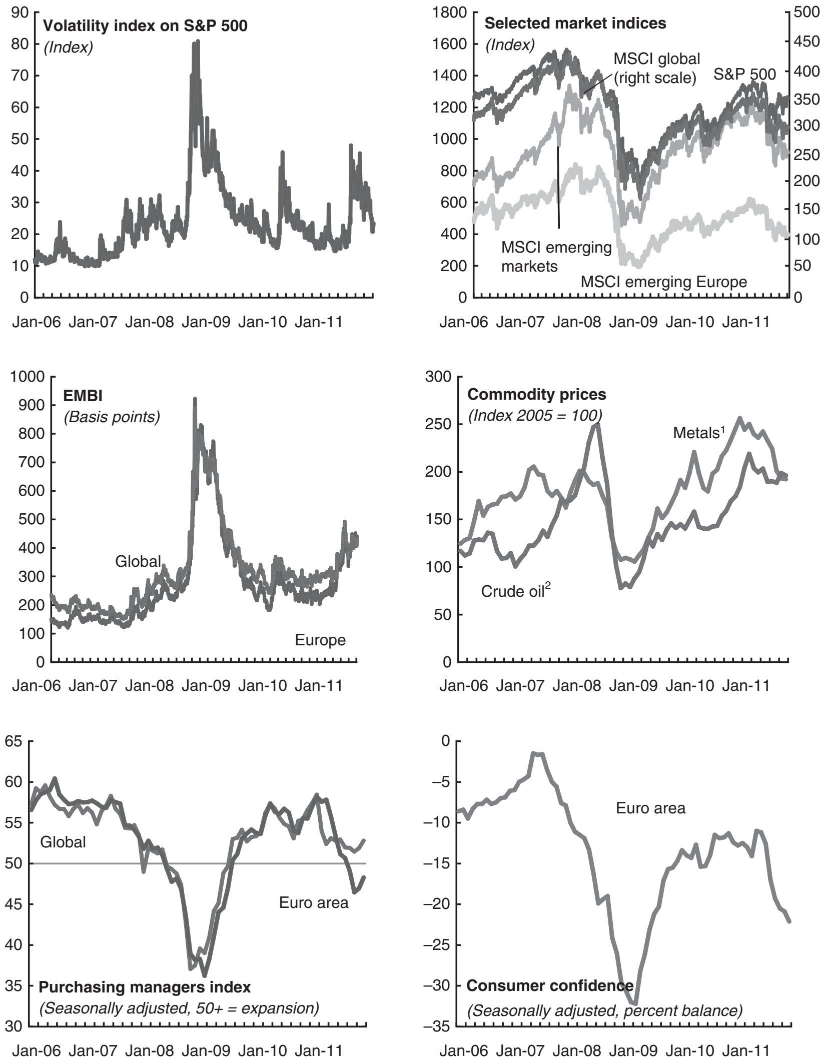

Figure 4.1 Global Market Developments, 2006–11

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

THE ECONOMIC RECOVERY

The resurgence of world trade and global manufacturing output led to a recovery in advanced Europe, with knock-on effects for emerging Europe's exports (Figures 4.2 and 4.3). Growth in the euro area—emerging Europe's most important trading partner—turned positive in the second half of 2009, boosted by rising

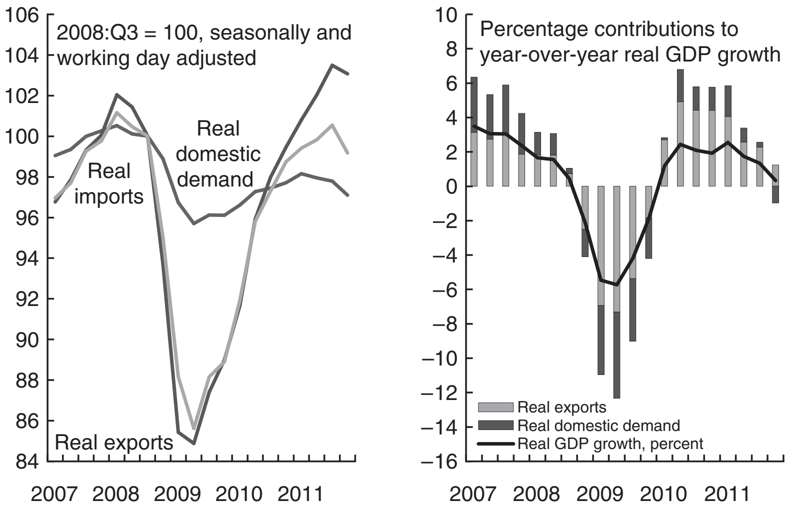

Figure 4.2 Euro Area: Real GDP and Components, 2007–11

Sources: Eurostat; and IMF staff calculations.

exports. Emerging Europe's exports benefited from the export recovery in advanced Europe, since emerging Europe provides many intermediate inputs for these exports (such as for the automobile sector).[4] Hungary and Russia were among the first countries to see their exports rebound, but by the third quarter most countries in the region reported positive export growth. Russia and Ukraine further benefited from the rebound in commodity prices.

Year-over-year GDP growth in emerging Europe turned positive in the first quarter of 2010, and for 2010 as a whole GDP grew by 4.5 percent. However, output in most countries remained below precrisis levels, with the exception of Albania, Belarus, Macedonia, Moldova, Poland, and Turkey (Figure 4.4).

The recovery in 2010 was slower in emerging Europe than in other emerging market regions, including Latin America, which was also hit hard by the crisis (Figure 4.5).[5] A key difference between Latin America and emerging Europe was the extent of precrisis vulnerabilities and imbalances. In emerging Europe they had been rising sharply, while in Latin America they had been reduced. In addition, the prevalence of commodity exporters in Latin America coupled with the sharp rebound in commodity prices helped the region recover relatively quickly.

There were large differences among emerging European countries in the strength of their recovery during 2010, differences that were linked to their precrisis imbalances:[6]

[4] Final demand in the euro area remained weak in 2010.

[5] The differences between emerging Europe and other emerging market regions are also discussed in Becker and others (2010) and Austrian National Bank (2010).

[6] GDP growth ranged from 9 percent in Turkey to −1.6 percent in Romania.

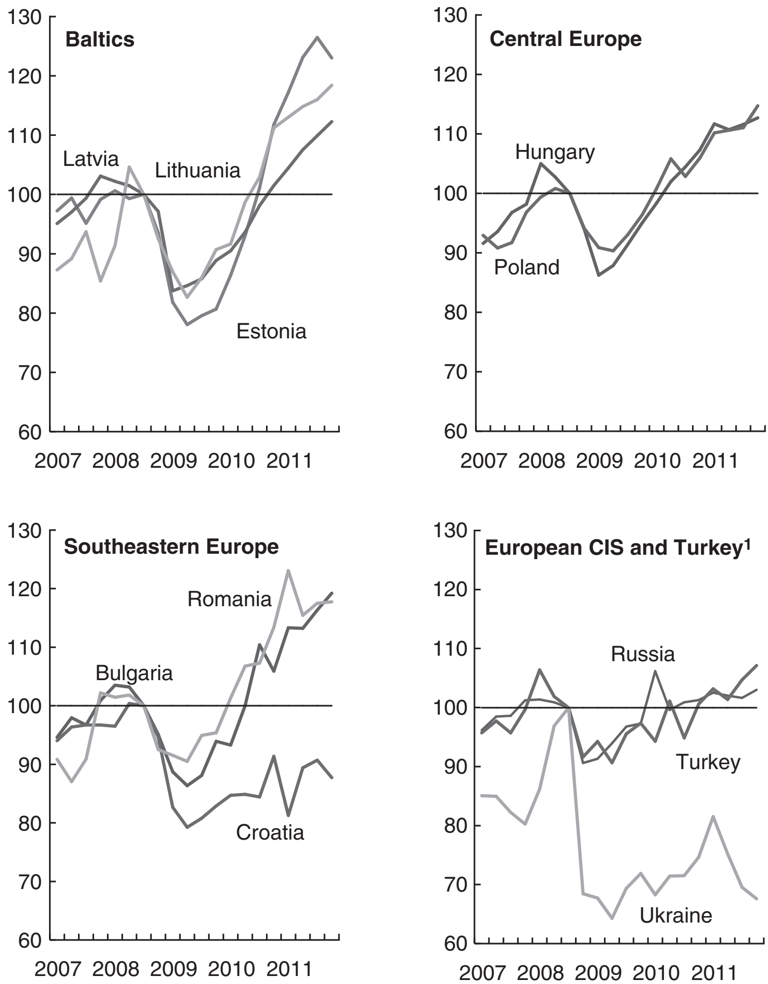

Figure 4.3 Emerging Europe: Real Exports 2007–11 (*Seasonally adjusted, index 2008:Q3 = 100*)

Sources: Haver Analytics; and IMF staff calculations.
[1] European CIS = Belarus, Moldova, Russia, and Ukraine.

- Countries with the smallest imbalances prior to the crisis experienced the strongest growth in 2010.[7] Poland was the only EU country with positive GDP growth (1.6 percent) in 2009, and its GDP growth rose to 3.9 percent in 2010. Poland had limited imbalances prior to the crisis, which gave it room for countercyclical fiscal and monetary policies.[8] In Turkey, which

[7] Russia and Ukraine—with output in the latter dropping by close to 15 percent in 2009—benefited from rebounding oil and metals prices. And positive spillovers from Russia—including through remittances—helped smaller European member countries of the Commonwealth of Independent States (CIS)—Belarus and Moldova—rebound as well.
[8] See also Chapter 12 for a discussion of the benefits of a Flexible Credit Line with the IMF.

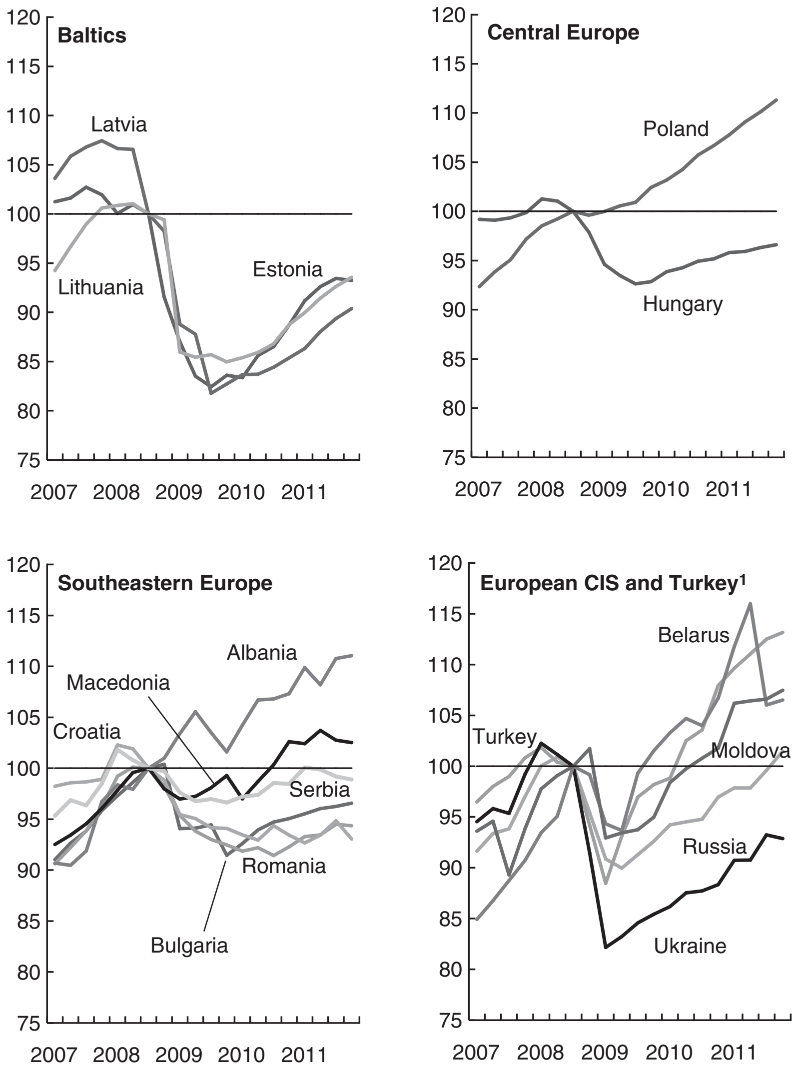

Figure 4.4 Emerging Europe: Real GDP, 2007–11 (*Seasonally adjusted, index 2008:Q3 = 100*)

Sources: Country statistical offices; Haver Analytics; and IMF staff calculations.
[1] European CIS = Belarus, Moldova, Russia, and Ukraine.

suffered a 4.8 percent decline in output in 2009 but posted the most rapid expansion in 2010, the stage for a strong, domestic-demand-driven rebound was set by the country's more restrained capital inflows prior to the crisis, macroeconomic policies better focused on leaning against the cyclical upswing, and a more restrictive regulatory environment for credit.

- By contrast, growth remained more subdued in countries with large precrisis imbalances. Croatia, Romania, and Latvia saw a further decline of GDP in 2010, while GDP growth in Bulgaria was barely positive (0.4 percent).

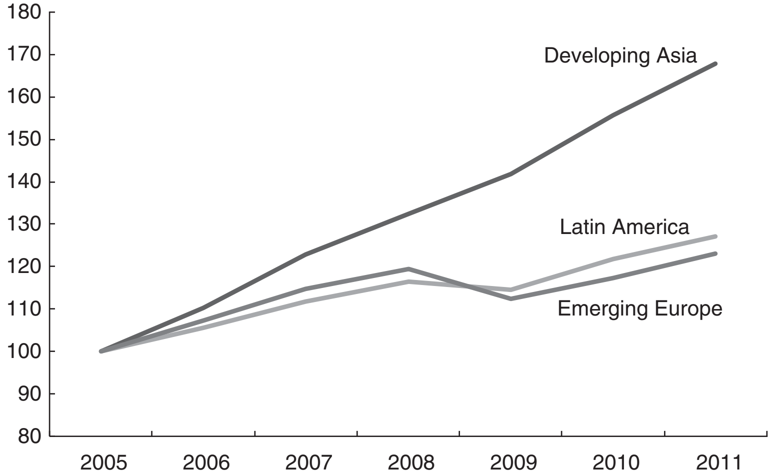

Figure 4.5 Selected Regions: Real GDP, 2005–11 (*Index, 2005 = 100*)

Source: IMF, World Economic Outlook database.

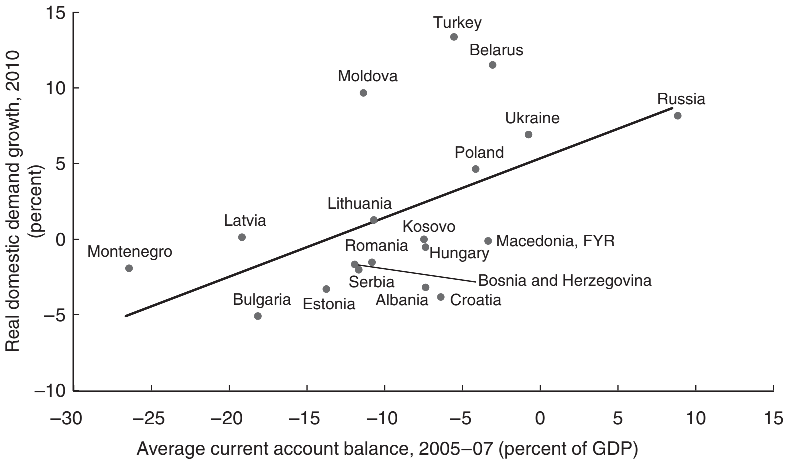

Figure 4.6 Emerging Europe: Domestic Demand and Precrisis Imbalances, 2005–10

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

These differences in the strength of recovery were due to developments in domestic demand (Figure 4.6). Countries that had the largest domestic demand boom in the precrisis years now saw the sharpest declines in domestic demand, since the large capital inflows that had fueled and financed these demand booms had disappeared.[9] Large drops in housing prices further contributed to the

[9] Capital flows remained weak in many crisis-affected countries, but returned more strongly in countries that had seen smaller imbalances in the run-up to the crisis. Poland and Turkey, in particular, saw strong capital inflows in 2010, while capital inflows in other countries were much weaker.

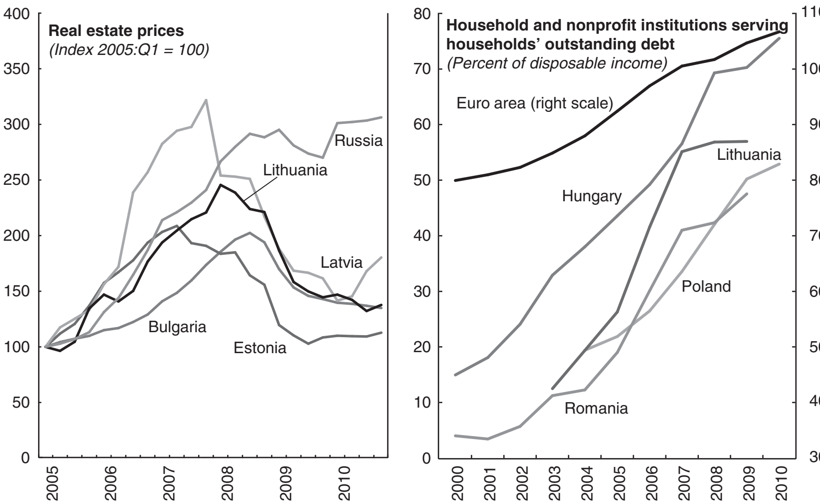

Figure 4.7 Emerging Europe: Real Estate Prices and Debt, 2005–10

Sources: Bank for International Settlements; country statistical offices; Haver Analytics; and IMF staff calculations.
Note: Linear interpolation was used to fill in a few missing data points for real estate prices.

weakness of domestic demand (Figure 4.7). Domestic demand remained quite strong in countries where imbalances in the precrisis years had been more contained (including Poland and Turkey) and was further fueled by an early return of capital inflows.[10]

Domestic demand in crisis-hit countries was further affected by fiscal consolidation. During the boom years, domestic demand booms had led to a surge in government revenues, which had been used to finance an increase in public expenditure. When the domestic demand boom ended, government revenues plunged, and many countries had to implement very large fiscal adjustments to prevent the emergence of unsustainably large fiscal deficits (Figure 4.8). In countries that did not have the same excesses before the crisis, there was much more fiscal space. Poland and Russia, for example, were in a position to implement countercyclical fiscal stimulus, which supported the recovery in domestic demand.

By 2011, the recovery had broadened from exports to domestic demand, and nearly all the crisis-affected countries had returned to positive growth.

- The Baltics saw a particularly strong turnaround, with growth ranging from 5.5 percent in Latvia to 7.6 percent in Estonia.[11] Growth in southeastern

[10]There are exceptions within southeastern Europe; for example, Albania's real GDP expanded by more than 3 percent in 2009.

[11]The recovery in the Baltics was boosted by both external factors (continued strong growth of the Nordic countries) and a rapid compression of sovereign CDS spreads, as the significant fiscal adjustment led to a sovereign ratings upgrade. In Estonia, confidence was further boosted by its euro area entry on January 1, 2011.

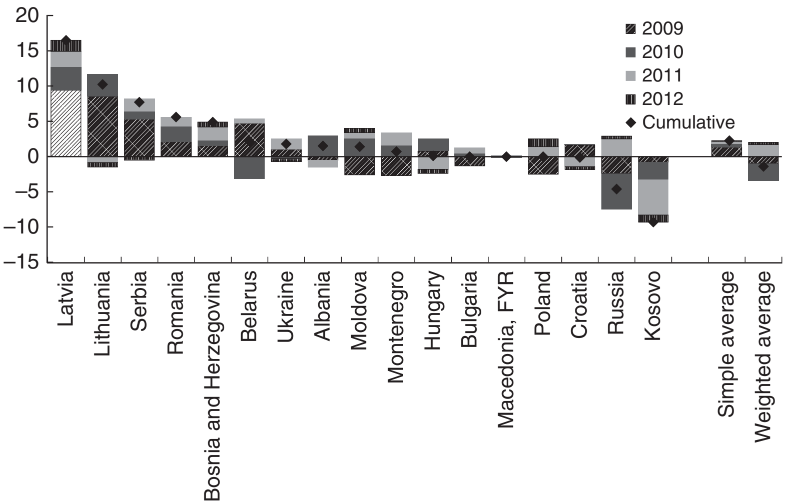

Figure 4.8 Emerging Europe: Discretionary Fiscal Measures, 2009–12[1] (*Percent of GDP*)

Source: IMF, *Regional Economic Outlook: Europe*, May 2011.
[1] Positive (negative) values indicate consolidation (stimulus) measures; discretionary policy measures as factored into the projections for the April 2011 *World Economic Outlook*. Excludes Turkey.

Europe became positive as well but remained more muted, with the EU countries growing by 2.2 percent and the non-EU countries by 1.5 percent.

- The turnaround in the most severely crisis-affected countries was helped by a recovery of domestic demand. Latvia, which had seen a contraction in domestic demand of 27.4 percent in 2009, now saw domestic demand increase by 10.2 percent. Domestic demand remained more subdued in southeastern Europe. In Bulgaria, Croatia, and Montenegro, domestic demand continued to contract.

Despite the economic recovery, large differences in cyclical positions and growth rates remained. Growth ranged from 0 percent in Croatia to 8.5 percent in Turkey, where capital inflows continued to boost domestic demand. Similar differences prevailed in labor markets; by late 2011 unemployment in Bulgaria was at postcrisis highs, while in Turkey it had fallen below precrisis levels.

LEGACIES OF THE CRISIS

The crisis left much of the region with three legacies: deteriorated public finances, high unemployment, and an increase in nonperforming loans (NPLs).

Public Finances

Before the crisis, fiscal headline balances in the region looked much better than in other emerging market regions. In 2007, the average headline balance in the region showed a surplus of more than 1.5 percent of GDP.

As a result of the crisis, the region's public finances deteriorated sharply. By 2009, the region's fiscal balance had deteriorated to a deficit of more than 6 percent of GDP, despite significant fiscal adjustment. In some countries, deficits approached double digits—more than 9 percent of GDP in Lithuania and nearly 8 percent in Latvia (Figure 4.9).

Significant fiscal consolidation, together with the economic recovery, reduced the region's deficit to 4.4 percent of GDP in 2010 and to 0.5 percent of GDP in 2011. Fiscal adjustment was most dramatic in the Baltic countries. Latvia took fiscal tightening measures of close to 13 percent of GDP during 2009 and 2010, and by 2011 had reduced its deficit to 3.4 percent of GDP. Estonia, despite a very deep recession, managed to contain its deficit in 2009 to 2 percent of GDP, setting the stage for its entry into the Economic and Monetary Union of the EU in 2011. Significant adjustment also occurred in Romania. Turkey and the European CIS countries, where domestic demand rebounded strongly, also saw a sharp decline in their fiscal deficits, although public spending in Turkey grew rapidly. Less progress was made in some southeastern European countries, including Croatia, which had a higher deficit in 2011 than in 2009.

The adjustment, which occurred at a difficult time, was instrumental in reducing risk premiums, and helped insulate the region from spillovers from the euro area's sovereign debt crisis. Thus, while CDS spreads trended upward from spring 2010 onward in peripheral advanced Europe, they did not do so in emerging Europe. By the second half of 2011, CDS spreads in Latvia at times were lower than those in Belgium—a development that was inconceivable in the fall of 2008.

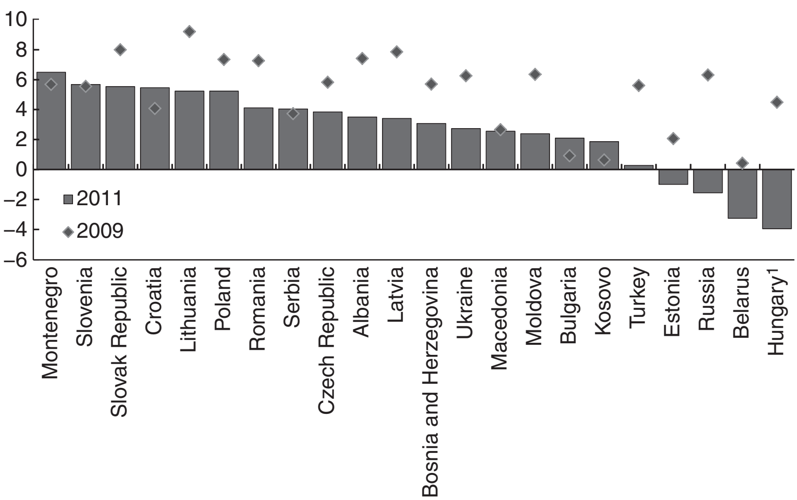

Figure 4.9 Emerging Europe: Fiscal Deficits, 2009 and 2011 (*Percent of GDP*)

Sources: IMF, World Economic Outlook database; and IMF staff calculations.
[1] Fiscal surplus in 2011 reflects rollback of pension reform, which transferred assets from private to public pension funds, thereby boosting revenues.

Despite the decline in the regional deficit, fiscal vulnerabilities remained high in a number of countries. Some countries still had deficits in excess of 5 percent of GDP (Croatia, Lithuania, Montenegro, and Poland). Some countries continued to have high public debt (notably Albania, Hungary, and Poland). And in Hungary and Albania, relatively high shares of short-term public debt further exacerbated vulnerabilities.

Unemployment

Unemployment rates generally rose sharply as a result of the crisis (Figure 4.10), while the subsequent labor market recovery was uneven. The sharp increase was particularly pronounced in the Baltic countries. In Latvia, the unemployment rate increased from approximately 6 percent at the end of 2007 to about 20 percent at the peak two years later. However, unemployment then dropped rapidly, and by the third quarter of 2011 unemployment rates in the Baltic countries had fallen to about 15 percent or lower. In southeastern Europe, the rise in unemployment was less dramatic, increasing by about 6 percentage points in Bulgaria, but the weaker recovery in most of southeastern Europe prevented a rapid decline in unemployment rates, which in some countries stood at postcrisis highs at end-2011. A similar pattern was seen also in Hungary, where the unemployment rate declined by about ½ percentage point from its spring 2010 peak to about 11 percent in 2011. By contrast, in Russia and Turkey, where economic activity had already started to rebound during 2009, the unemployment rate quickly started to decline and by late 2011 was near or below precrisis levels.

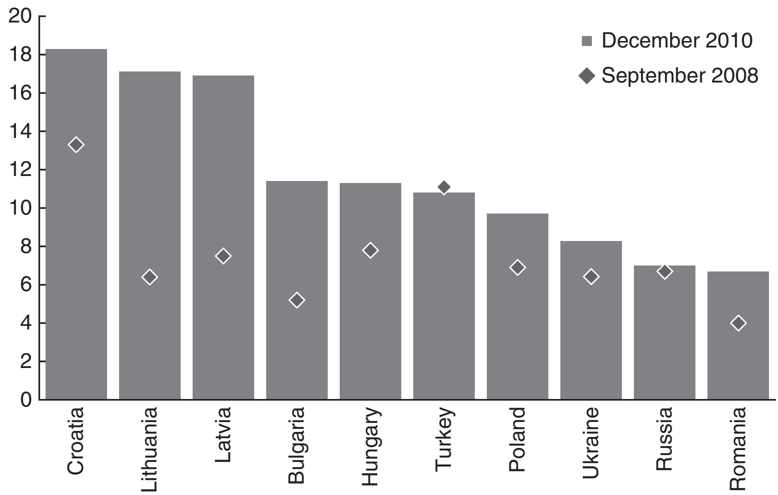

Figure 4.10 Emerging Europe: Unemployment Rate, 2008 and 2010 (*Seasonally adjusted, percent*)

Sources: Eurostat; Haver Analytics; IMF, World Economic Outlook database, and *Regional Economic Outlook: Europe*, May 2011.
Note: There may be definitional differences in the unemployment data across countries.

Rise in Nonperforming Loans

The ratio of NPLs to total loans in the region rose sharply in the aftermath of the crisis. The average reported NPL ratio increased from 3½ percent at end-2007 to more than 11 percent in 2011, reflecting the deep recession of 2009 and the preceding credit and asset price booms. In several countries, NPL ratios were above 15 percent, including in Albania, Latvia, Lithuania, Montenegro, and Serbia (Figure 4.11).

In many countries, NPL ratios have flattened or started to decline, although in 2011 they were still increasing in much of southeastern Europe (where the recovery has been late and weak) and in Hungary (reflecting widespread lending in Swiss francs). Moreover, reported NPL data are not always reliable and consistent, since there is no internationally accepted standard for their definition, and banks may engage in practices to downplay the extent of the problem.

NPL ratios in much of emerging Europe are high, but considerable provisioning and strong capitalization provide important buffers. On average, close to two-thirds of NPLs are already provisioned for, and the capital adequacy ratio stands at a strong 17 percent—about the same as prior to the 2008/09 crisis.

Given strong buffers, the high NPL ratios may not be a threat to financial stability, but high levels of unresolved NPLs may have contained credit growth in emerging Europe, thus delaying the recovery. In particular, high NPLs have likely reduced banks' capacity to finance new loans, as losses from provisioning eroded capital and as foregone debt service on NPLs was no longer available for new lending.[12] Indeed, the credit cycle in emerging Europe has been slow to turn, and as the economic recovery continued into 2011, the rebound in bank credit remained uneven. Turkey, with very low NPL ratios, saw robust credit growth, and to a lesser extent this was true of Russia and Poland. By contrast, in the Baltic countries real private credit growth continued to decline on a year-over-year basis in 2011, and it remained weak in several southeastern European countries, where NPL ratios have generally remained high.

[12] IMF (2011b, Box 2.3) provides statistical evidence that banks with high NPLs extend fewer loans.

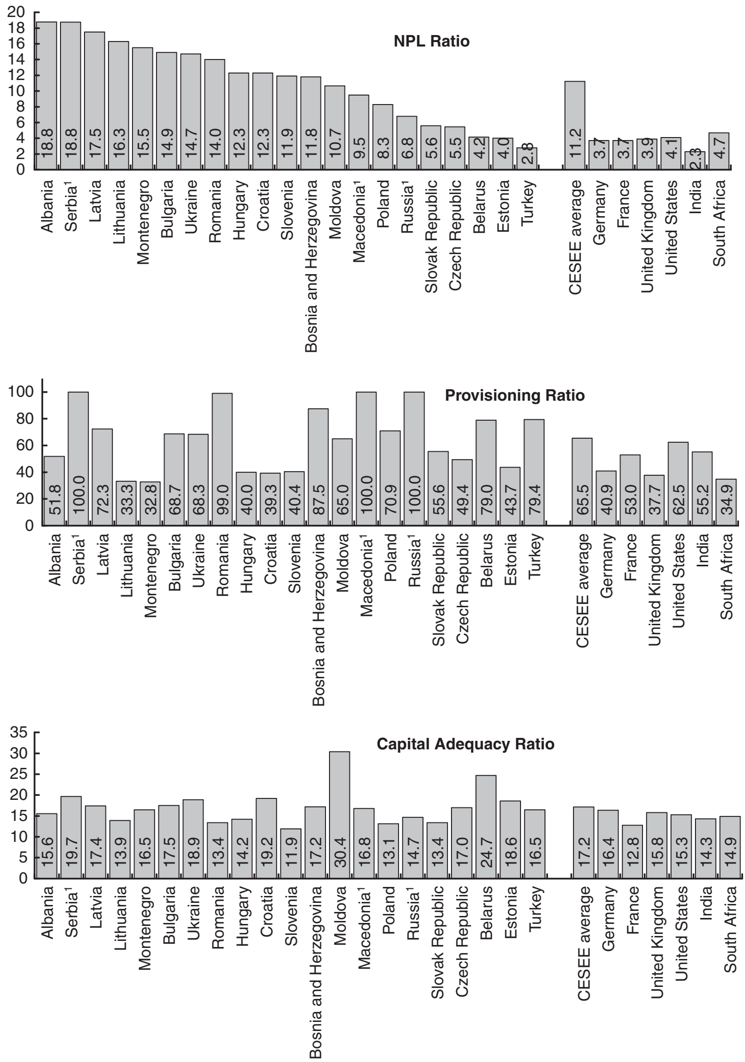

Figure 4.11 CESEE and Selected Comparators: Financial Soundness Indicators, 2011 or Latest Available

Sources: Country authorities; IMF country desks; and IMF Statistics Department.

Note: Data relate to end-2011 or latest available. CESEE includes Albania, Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Macedonia, Moldova, Montenegro, Poland, Romania, Russia, Serbia, Slovak Republic, Slovenia, Turkey and Ukraine.

[1]Data shown capped at 100 percent. These countries report provision ratios above 100 percent, reflecting inclusion of general provisioning or provisions related to loans extended by nonresident parts of banking groups that also operate domestically.

CHAPTER 5

How Meltdown Was Avoided

In the aftermath of the Lehman Brothers' collapse, emerging Europe was largely spared currency and banking crises, although it could not avoid a deep recession. At the time this was far from obvious. Indeed, there was concern that the region might head for a contagious financial meltdown. *The Telegraph* saw emerging "Europe on the Brink of a Currency Meltdown" in October 2008. *The Economist* wondered in February 2009 whether there was an "Argentina on the Danube?" and caught a "Whiff of Contagion" in the air of eastern Europe.

While several trigger events, such as bank runs or the demise of a fixed exchange rate regime, were mulled, analysts were most worried about a hasty retreat of wounded western banks from emerging Europe, where their subsidiaries dominated financial systems. ". . . significant uncertainty surrounds the fate of the US$1 trillion in CEE's external liabilities to foreign banks," wrote Deutsche Bank in October 2008, warning that "even a partial cut-back in credit . . . could have far-reaching exchange rate implications and increase FX mismatch lying under the region's household and corporate balance sheets." (Deutsche Bank, 2008). Disengagement of western banks could set in motion a vicious cycle whereby "shrinking balance sheets in eastern European banks create the conditions for further capital outflows" emphasizes Citigroup (Citigroup, 2008), with outflows causing currency depreciation in the face of insufficient reserve cushions and depreciation inflicting large losses on banks in the face of ubiquitous foreign-currency loans to unhedged borrowers.

Concerns about meltdown were not far-fetched considering the many vulnerabilities that had built up in most countries of the region in the precrisis years. Standard indicators all flashed red and easily exceeded the levels seen in the run-up to earlier emerging market crises (Figure 5.1). In particular, the combination of unprecedented current account deficits coupled with currency mismatches on residents' balance sheets, low reserve coverage ratios, and fixed exchange rate regimes evoked memories of the Asian crisis of 1997–98, Turkey's crisis of 2001, and Argentina's crisis of 2001–02.[1]

These earlier crises all involved spectacular exchange rate crashes and systemic banking crises. Currencies lost between 45 and 80 percent of their nominal effective value in Indonesia, Thailand, Turkey, and Argentina as the crises swept away soft and hard exchange rate pegs alike. All four countries experienced widespread bank runs and bank failures, which ended up burdening public finances with

The main author of this chapter is Christoph Klingen.

[1] According to Åslund (2010), "a broad consensus among American economists claimed that countries with pegged exchange rates would have to devalue, which was their lesson from the East Asian crisis in 1997–98" (p. 6).

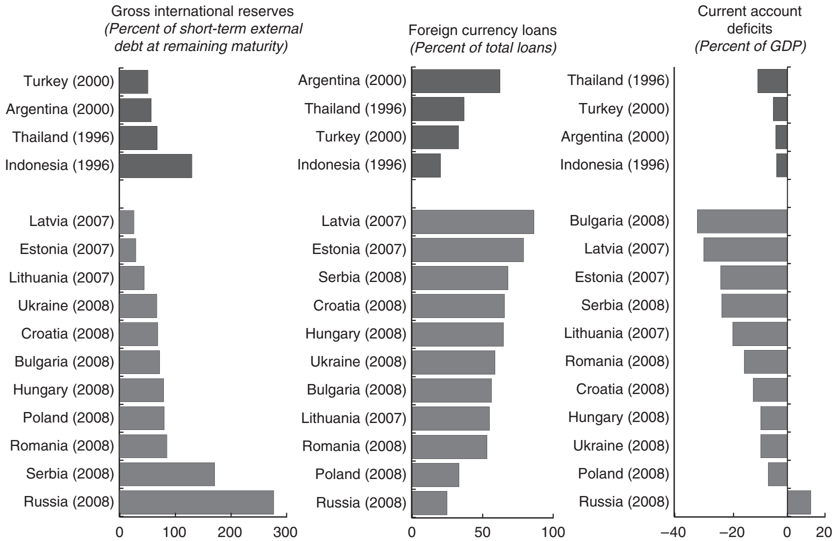

Figure 5.1 Selected Countries: Precrisis Vulnerabilities

Source: IMF staff calculations.

gross costs of between 10 and 57 percent of GDP (Laeven and Valencia, 2008). In 2008, with current account deficits even higher, currency mismatches even more pronounced, and reserve coverage even thinner in much of emerging Europe, a scenario of capital outflows, depreciation, and bank losses feeding on each other made for a plausible story.

Yet the feared financial meltdown did not materialize. While the exchange rates of the region certainly came under pressure, the fixed exchange rate regimes weathered the crisis. In particular, the currency board arrangements in the three Baltic countries and in Bulgaria and Bosnia-Herzegovina held up. Floating exchange rates depreciated by between 4 and 30 percent and generally rebounded quickly from their troughs. The only exceptions to this rule were found among the European countries in the Commonwealth of Independent States. Belarus had to revalue its exchange rate peg by 20 percent in the beginning of 2010. Russia and Ukraine saw themselves forced to allow a steep devaluation of their heavily managed exchange rates by some 30 and 35 percent, respectively, in early 2009 and late 2008.

Similarly, while banking systems throughout the region certainly came under strain, pressures morphed into outright systemic banking crises only in Latvia and Ukraine (Laeven and Valencia, 2010). In Latvia, the second-largest bank, Parex, suffered large losses and experienced a deposit run.[2] Escalating

[2] According to Åslund (2010) the key problem was that domestically owned banks in eastern Europe had no access to European Central Bank (ECB) financing when short-term funding in foreign currency dried up. Åslund noted that in addition to Parex, the biggest local bank in Hungary, OTP, was another prominent casualty, although it survived.

government intervention proved necessary, starting with liquidity injections and the extension of guarantees and culminating in a partial deposit freeze, nationalization, and government recapitalization. In Ukraine, widespread deposit runs emerged after regulators had intervened the sixth largest bank, Prominvest. It took large liquidity injections, withdrawal limitations, and a systemwide recapitalization exercise to stabilize the situation. Everywhere else in emerging Europe, strains were much more contained, and less invasive measures by governments and central banks, such as improved deposit insurance, cuts of reserve requirements, or moderate liquidity injections, were sufficient to address them. Moreover, even the systemic crises in Latvia and Ukraine entailed much lower fiscal costs, 2.5 and 4.8 percent of GDP, respectively, than had been the case in earlier crises.

Why is it then that emerging Europe escaped financial meltdown despite high precrisis vulnerabilities? The decisive domestic policy responses certainly played a key role. Many countries, such as the Baltics, were prepared to do whatever it took, including harsh fiscal measures, to preserve their long-standing fixed exchange rate regimes. Measures to stabilize financial systems were nimble and astute, while fiscal and monetary responses were tailored to country-specific needs. However, all these efforts would have stood much less chance of success had it not been for large-scale international support, policy easing in the advanced economies, and western banks that remained committed to the region.

These external factors were important in their own right, but they also provided domestic policymakers with the room to maneuver needed to avoid financial meltdown and stave off even deeper recessions. For example, it is widely believed that without the generous financing package for Latvia, its currency peg would not have held, setting off a chain reaction of collapsing fixed exchange rate regimes throughout the region. Similarly, Poland might not have been able to see through its fiscal stimulus without the cover it received from its credit line with the IMF.

LARGE-SCALE INTERNATIONAL SUPPORT

When it became clear that the financial crisis was spreading from the advanced economies to emerging markets, the international community acted quickly to shore up the economies in emerging Europe. One prime vehicle of assistance was large IMF-supported programs, which were run jointly with the European Union in the case of EU member countries (Box 5.1). Other international financial institutions, such as the European Bank for Reconstruction and Development (EBRD), the World Bank, and the European Investment Bank, also stepped up their efforts. In total, 10 arrangements were put in place throughout the region (Table 5.1). This includes a so-called Flexible Credit Line with Poland—a lending instrument that the IMF established only in March 2009 to provide contingent financing without conditionality to countries with strong fundamentals, policies, and track records of policy implementation.

BOX 5.1 IMF/EU Collaboration in Emerging European EU Members

In October 2008, Hungary faced an acute balance of payments crisis and approached the IMF and EU simultaneously for balance of payments assistance. The case of Hungary set a precedent, resolving earlier ambiguity over how a balance of payments crisis in a non-euro EU country would be handled. The ambiguity arose from the fact that the EU had a (long dormant) small facility to support non-euro members in case of a balance of payments crisis, and from the legal requirement that EU members are to consult with the European Commission prior to approaching the IMF.[1] From the IMF's perspective, EU members are independent IMF members and have the right to approach the IMF. In the event, when Hungary approached the IMF, pragmatic communication between the institutions ensured an interpretation that allowed simultaneous requests to the EU and the IMF.

Following the Hungary precedent, both Latvia and Romania entered into programs with both the IMF and the EU. All IMF/EU programs followed similar modalities, developed essentially from the example of Hungary. They included early consultation, overlapping missions, and ongoing exchange of information. However, given differing internal procedures, agreement on program revisions in the context of reviews was at times challenging, and in at least one case—Latvia—the EU agreed to a program review while the IMF was still negotiating. Since then, information exchange during missions has been increased further, with a view to avoiding "mixed messages." More recently, the IMF and the EU have entered into overlapping programs in the euro area, governed by similar procedures.

Regarding program content, the institutions cooperated closely on the macro-framework; the IMF had a somewhat greater role in financial issues, the EU in structural issues. However, this dividing line was not absolute: the EU had a role in financial sector issues, not least because the European Commission's Directorate-General for Competition (DG Comp) needed to approve state aid to the financial sector when such measures were part of the crisis resolution. At the same time, the IMF also dealt with structural issues of macro-critical importance—including, for example, tax administration reform, budgetary institutions, and banking sector restructuring.

Financing shares under the programs differed, in part due to access limits by countries on IMF funding and depending on the presence of other institutions and/or donors. In Hungary and Romania, over 60 percent of the programmed financing package came from the IMF, while in Latvia the share was only 23 percent, which—given the size of the financing gap and Latvia's small quota—was nevertheless an "exceptional access" program for the IMF. The financing share of the EU ranged from 24 percent in Romania to 41 percent in Latvia.

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[1] According to Council Regulation (EC) No 332/2002 of February 18, 2002, establishing a facility providing medium-term financial assistance for Member States' balances of payments, "If Member States which have not adopted the euro call upon sources of financing outside the Community which are subject to economic policy conditions, they must first consult the Commission and the other Member States in order to examine the possibilities available under the Community medium-term financial assistance facility. Such consultations will be held within the Economic and Financial Committee."

The sheer size of the financing packages enhanced their effectiveness. Considerably larger amounts of financing were made available than in earlier crises. The package for Latvia exceeded the equivalent of 30 percent of its GDP, and those for Hungary, Moldova, Romania, and Ukraine topped 15 percent of their GDPs. This compares favorably even with those earlier IMF-supported program packages that were considered very large at the time (Figure 5.2).

TABLE 5.1

IMF Support for Countries in Emerging Europe Including Cofinancing, 2008:Q4–2010[1] (*Billions of U.S. dollars*)

	IMF	European Union	World Bank	Other	Total
Hungary (SBA, Nov. 08)	15.7	8.4	1.3	0.0	25.4
Ukraine (SBA, Nov. 08 and Jul. 10)[2]	25.5	1.3	2.8	1.0	30.6
Latvia (SBA, Dec. 08)	2.3	4.4	0.6	3.3	10.5
Belarus (SBA, Jan. 09)	3.5	0.3	0.2	1.0	4.9
Serbia, Republic of (SBA; Jan. 09)	3.9	0.2	0.4	0.0	4.5
Romania (SBA, May 09)	17.2	6.6	1.3	1.3	26.3
Poland (FCL, May 09)	20.5	0.0	0.0	0.0	20.5
Bosnia and Herzegovina (SBA, Jul. 09)	1.6	0.1	0.2	0.1	2.0
Moldova (ECF/EFF, Jan. 10)	0.6	0.3	0.3	0.1	1.3
Kosovo (SBA, Jul. 10)	0.1	0.1	0.1	0.0	0.3
TOTAL	91.0	21.7	7.1	6.7	126.4

Source: IMF staff calculations.

Note: SBA = Stand-By Arrangement; FCL = Flexible Credit Line; ECF/EFF = Extended Credit Facility and Extended Fund Facility.

[1] Figures indicate programmed amount, unless indicated.

[2] For Ukraine, IMF includes the sum of two SBA programs (i.e., the amount committed under the November 2008 SBA plus the amount committed under the July 2010 SBA net of the undisbursed part of the November 2008 SBA).

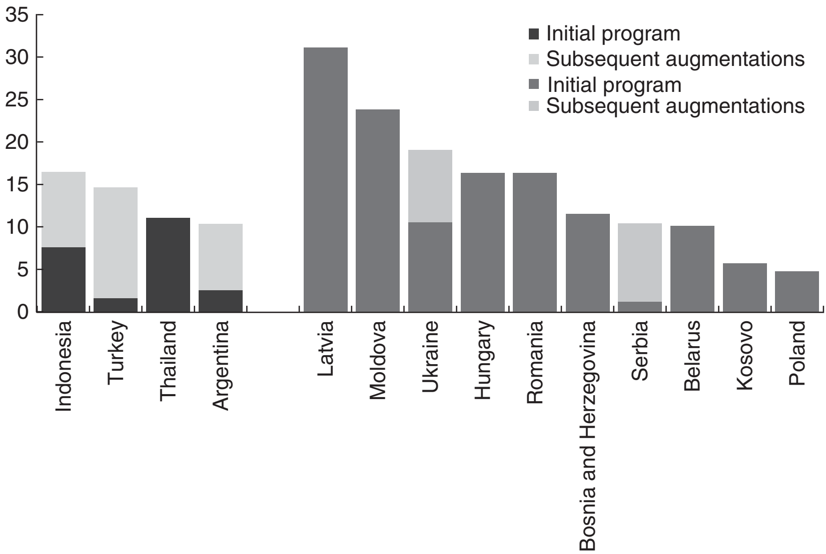


Figure 5.2 Selected Countries: Financing Packages under IMF-Supported Programs (*Percent of GDP in year of approval of arrangement*)

Source: IMF staff calculations.

Moreover, in many of these earlier programs, such as those with Indonesia, Turkey, and Argentina, the financing provided under the initial arrangement was quite modest. Only subsequent and repeated augmentations brought the packages up to considerable sizes. In contrast, almost all the programs in emerging Europe committed the full amount of financing from the outset. Moreover, disbursements were much more front-loaded in the programs in emerging Europe, with the first disbursement accounting for a very large share of the financing committed under them (IMF, 2009d). Equipped with such substantial financial fire power, program countries were well placed to reassure jittery financial markets that exchange rates and the funding of domestic spending plans were indeed sustainable.[3]

In addition, the IMF bolstered member countries' reserves through allocations of special drawing rights (SDRs). A general SDR allocation of US$250 billion had been agreed as part of a package to strengthen the IMF's finances to US$1.1 trillion at the G-20 summit in London in April 2009. It became effective in August 2009 (IMF, 2009e). Around the same time, on September 9, 2009, a special SDR allocation in the context of the Fourth Amendment of the IMF's Articles of Agreement also came into effect, providing a further US$33 billion. Both allocations counted directly toward members' international reserve assets (IMF, 2009f). Countries in emerging Europe benefited to the tune of US$23.2 billion, with US$8.9 billion going toward the 10 countries with IMF-supported programs as listed in Table 5.1. A number of them, such as Ukraine, tapped into the SDR allocation by converting it into foreign exchange to close financing gaps in their balance of payments and government budgets.

Another vehicle of support was the series of foreign exchange swap and repo arrangements that several countries in the region concluded with western central banks. During the crisis, the central banks that issue the major global currencies agreed to grant each other and selected emerging economies swap lines to address liquidity shortages in off-shore money markets and to avert dislocations in foreign exchange markets. In October 2008, the National Bank of Hungary secured a €5 billion repurchase agreement with the ECB and a foreign exchange swap facility of undisclosed size with the Swiss National Bank. The Polish National Bank followed with a €10 billion ECB arrangement and the same arrangement with the Swiss National Bank as Hungary a month later. In December 2008, Latvia entered into an arrangement with the central banks of Sweden and Denmark to swap up to €500 million against Latvian lats. Estonia was allowed to obtain up to SEK10 billion (about €0.9 billion) against Estonian kroons in an agreement struck with the Central Bank of Sweden in February 2009. The agreements augmented the access of Latvia and Estonia to foreign exchange and were thus economically equivalent to an increase of foreign reserves.

In contrast, the currency swaps with the Swiss National Bank were against euros and the ECB repos came with stringent collateral requirements that local-currency assets did not meet. Neither of these arrangements therefore improved

[3]The subsequent financial support programs for Greece, Ireland, and Portugal in 2010–11 were larger still, amounting to about 50 percent of GDP each. This was necessitated by the large gross financing needs of the public sectors, which had lost market access at reasonable terms and could not be expected to regain it for much of the program period.

overall access to foreign exchange.[4] However, they usefully backstopped orderly conditions in domestic money markets where Swiss francs and euros were heavily used, reflecting the prevalence of loans denominated in these currencies on local banks' books.

Not all the committed international support needed to be drawn down to restore confidence. Poland, for example, never accessed any funds from the IMF, the ECB, or the Swiss National Bank, since financial markets stabilized quickly and the resilience of the economy became fully apparent. Estonia's swap arrangement with the Swedish central bank was also never activated amid dissipating concerns about the possible demise of fixed exchange rate regimes in the region. Hungary made sufficient progress during the early part of its program with the IMF and the European Union to allow it to treat the arrangement as precautionary as of the fourth review in December 2009. This shows that the mere commitment of large-scale international support was sometimes sufficient to arrest and turn around a deteriorating situation. Indeed, the demonstration effect from making generous international support available where needed might well have helped other countries to pull through the crisis without ever requesting international support.

GLOBAL MACROECONOMIC POLICY SETTING

The global economic environment during the global financial crisis differed markedly from the environment prevailing during earlier emerging market crises, since the crisis originated this time in the advanced economies rather than in the emerging market economies themselves. As a result, interest rates of the major currencies were cut to extremely low levels, and fiscal stimulus measures were put in place in most advanced economies. Both actions had positive spillover effects for emerging market economies. On the other hand, the ensuing global recession made the environment for emerging-market exporters much more challenging.

Low and falling global interest rates made it easier for the central banks in emerging Europe to defend their exchange rates. During the fourth quarter of 2008 and the first quarter of 2009, all the major central banks cut their policy rates substantially to reach unprecedentedly low levels: one percent for the ECB, between 0 and ¼ percent for the U.S. Federal Reserve, and 0.1 percent for the Bank of Japan (Figure 5.3). In contrast, the Asian crisis occurred when policy rates in the United States stood at 5½ percent and were stable. True, global interest rates were also quite low and falling during the crises in Turkey and Argentina, when the Federal Reserve loosened monetary policy first to mop up after the bursting dot-com bubble and later in response to the terrorist attacks of 9/11. However, investors could still earn a decent return by parking their funds in U.S. or euro area money markets. With such options not available this time around,

[4]The National Bank of Hungary disclosed that half of the amount available under the repo with the ECB was converted into a swap line in January 2010. While this improved access to international reserves, it came well after the height of the global financial crisis.

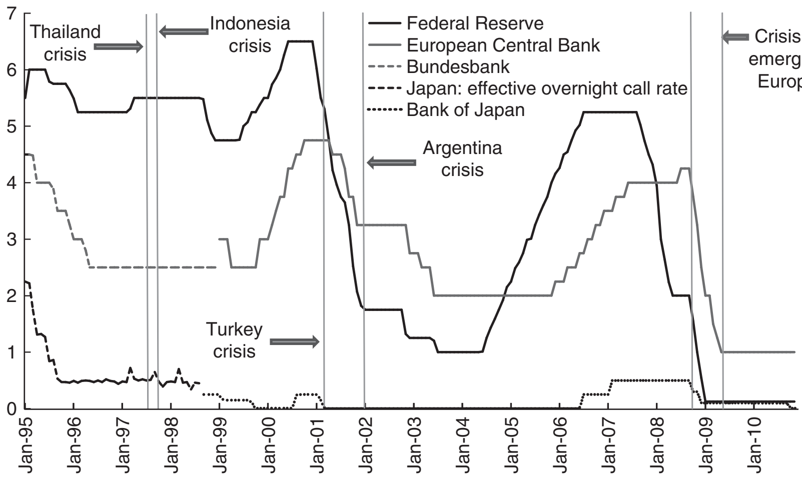


Figure 5.3 United States, Euro Area, and Japan: Policy Interest Rates, 1995–2010 (*Percent*)

Source: Haver Analytics.

central banks in emerging Europe could support their currencies by simply cutting their policy rates more slowly than the major central banks or, where needed, by rather small interest rate hikes.

In the event, only Belarus, Croatia, Hungary, Russia, and Serbia raised policy rates during the crisis. Even there the tightening was comparatively moderate. Hungary, for example, temporarily raised policy rates from 8.5 to 11.5 percent—a far cry from the hikes during the Thai and Indonesian crises when rates went from about 15 percent to 27 and 80 percent, respectively. The region thus avoided the pronounced interest rate spikes of previous crises, when monetary authorities had to "walk a narrow line, seeking to resist downward pressure on exchange rates while avoiding a crippling effect on the real economy" (Boorman and others, 2000).

Falling global interest rates also provided direct relief for many borrowers in the region. A large share of local mortgages in the region is denominated in euros, Swiss franks, and also yen. Typically, they are floating rate, so falling interest rates in the advanced economies immediately translated into a reduction of the debt service burden. This provided a welcome offset to the effect from local currency depreciation, which increased the debt service burden in local currency terms.

Emerging Europe likely benefited as well from the fiscal stimulus put in place by the advanced economies in the wake of the financial crisis. As private domestic demand plummeted in the advanced economies, their governments allowed fiscal balances to deteriorate sharply to stabilize the economies. They generally allowed automatic stabilizers to operate freely. In addition, most governments adopted discretionary stimulus measures. As a result, total domestic demand, including imports from emerging Europe, was less weak than would otherwise have been the case. For example, Germany's subsidy for a car-scrapping scheme spurred sales

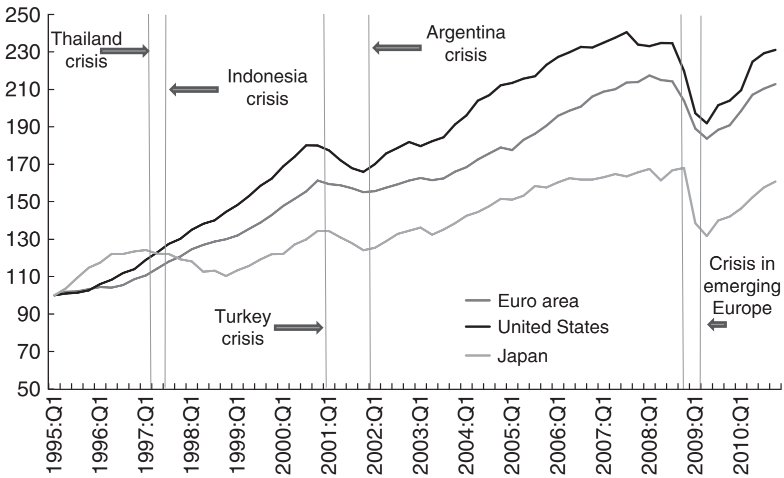


Figure 5.4 Euro Area, United States, and Japan: Real Imports of Goods and Services, 1995–2010 (*Index 1995:Q1 = 100*)

Source: IMF, *World Economic Outlook*, October 2010.

of new vehicles, many of which are assembled in emerging Europe or are produced with parts made there.

Still, overall demand conditions in the advanced economies were much less favorable for emerging market economies than in previous crises. Although the advanced economies did their best to prop up domestic demand, ultimately their imports still contracted sharply (Figure 5.4). Rather than providing support for the exporters in emerging markets, these economies became a major channel for the transmission of the crisis. In contrast, none of the earlier crises in Thailand, Indonesia, Turkey, or Argentina had taken place against the background of a deep global recession. The import demand from advanced economies was rising in most cases—only the period after the Turkey crisis of 2001 coincided with weak import demand, as the global economy was then reeling from the bursting of the dot-com bubble. Nevertheless, the decline of import demand remained comparatively contained even in this case.

THE ROLE OF FOREIGN PARENT BANKS

Emerging Europe differs from other economies in that its financial system is dominated by the subsidiaries of foreign banks, typically large financial groups headquartered in western Europe. Foreign banks account for 70 percent of the system's assets in the countries of the region. The share even exceeds 90 percent in the cases of Albania, Bosnia and Herzegovina, Croatia, Estonia, Lithuania, and Macedonia. At the other end of the spectrum are Belarus, Russia, and Turkey with shares of only about 20 percent. These countries had relied less on bringing in foreign banking expertise and capital during the transition process or, in the case of Turkey, had never been a transition economy in the first place. Still, even there, foreign banks provided important financing to domestic banks and nonfinancial firms through the interbank wholesale market and direct cross-border lending, respectively.

Foreign ownership of domestic financial systems turned out to be a mixed blessing during emerging Europe's boom-bust cycle. Opening the financial sector to foreign banks had allowed the countries of the region to transition quickly to a modern, confidence-inspiring banking system with all the attendant benefits for economic development more generally. However, as discussed in Chapter 1, foreign ownership also facilitated the unsustainable boom. Easy access to abundant foreign-currency financing from foreign banks and their local subsidiaries proved hard to contain by monetary or prudential means as the economies of the region overheated.

During the crisis, foreign banks were a stabilizing factor, thus helping to prevent the bust from turning into meltdown. Ownership in the region's financial system provided those banks with powerful incentives to preserve the franchise value of their subsidiaries. Indeed, no parent bank allowed a single one of its subsidiaries to fail in the entire region. Equally remarkable, no foreign-owned subsidiary was put up for sale, with the one exception of Allied Irish Banks selling its Polish subsidiary as part of its own restructuring. In most cases, parent banks provided additional liquidity and capital as needed to their subsidiaries in emerging Europe. But they were generally no longer willing to finance new local lending, which from that point on would have to rely on mostly elusive domestic deposit growth. Parent banks were also reluctant to roll over credit to nonaffiliated banks and nonfinancial companies.

Notwithstanding their vested interest in supporting subsidiaries in emerging Europe, western banks still had to overcome a coordination problem. True, no parent bank would have wanted to single-handedly destroy the franchise value of its own subsidiary by cutting credit lines. However, this thinking presupposes that the franchise value of local subsidiaries remained positive during the crisis. Whether this proposition was valid or not depended in turn on the reaction of other parent banks. Had they all cut credit lines, the resulting financial meltdown would have destroyed the franchise value of any local subsidiaries, and under those circumstances it would have been better for each parent bank to join the exodus rather than throw good money after bad in a vain effort to prop up local subsidiaries.

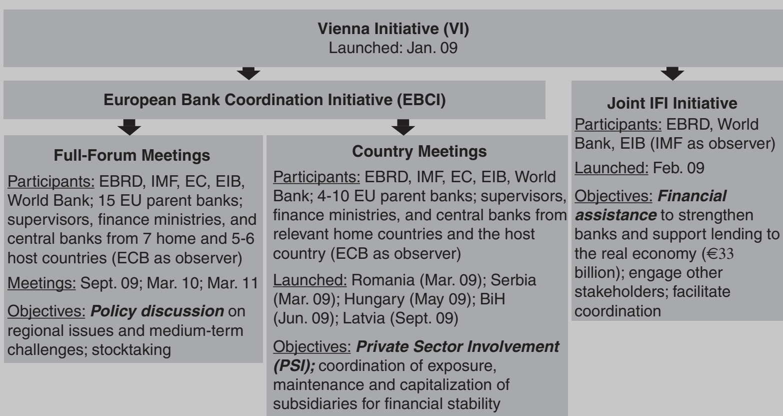
IMF-supported programs and the so-called Vienna Initiative helped avoid an uncoordinated pullout of western banks from emerging Europe. The large-scale programs significantly reduced the odds of financial meltdown occurring, but there were also more direct efforts to keep banks engaged. As part of an overall effort to coordinate the crisis response under the Vienna Initiative, key foreign banks pledged in writing that they would keep net exposure to their subsidiaries at pre-specified levels (Box 5.2). Country-specific meetings were held for Romania (March 2009), Serbia (March 2009), Hungary (May 2009), Bosnia and Herzegovina (June 2009), and Latvia (September 2009). Commitments were

BOX 5.2 The Vienna Initiative

When the global financial crisis shifted into high gear in the fall of 2008, concerns ran high that the economies of central, eastern, and southeastern Europe (CESEE) would suffer a contagious financial meltdown.[1] High external deficits and debt, widespread foreign currency lending, and foreign-dominated banking systems raised the specter of an uncoordinated "cut and run" approach, setting off a series of collapsing financial systems and exchange rates throughout the region.

It quickly became apparent that the tight banking linkages between western Europe and CESEE required coordination at various levels for the crisis response to be effective. Western exposure of about US$450 billion corresponded to more than 50 percent of GDP in many countries, and the local affiliates of western banks typically dominated CESEE banking systems. This created the risk of a bank mass exodus with the economic fallout justifying each bank's individual pullout decision, regardless of the fact that collectively banks would actually be better off if they remained engaged. Another risk was that national authorities could limit their financial sector support measures narrowly to the national operations of the cross-border banking groups. And there was the risk that multilateral financial assistance to CESEE would end up fueling additional exposure reductions by western banks rather than cushioning the economic downturn.

The Vienna Initiative was created to coordinate the crisis response of the major public and private stakeholders. Following informal discussions since November 2008, the inaugural Vienna Initiative meeting was held in Vienna, Austria, on January 23, 2009. It brought together the key western parent bank groups, home and host-country authorities (financial supervisors, finance ministries, and central banks), and multilateral organizations (IMF, European Bank for Reconstruction and Development [EBRD], European Commission [EC], European Investment Bank [EIB], and World Bank). The European Bank Coordination Initiative (EBCI) arm of the Vienna Initiative secured so-called private sector involvement for five countries with programs supported by the IMF and the EU. Banks undertook to maintain their exposure to ensure that the external financial assistance would not leak out. Full-forum meetings were also held, providing a platform for policy discussion with representatives across CESEE and their western counterparts. On February 27, 2009, the "Joint IFI Initiative" was launched as the financial assistance arm of the Vienna Initiative. Over the next two years, EBRD, World Bank, and EIB disbursed €33 billion to strengthen banks in the region.



[1] CESEE includes Albania, Bosnia and Herzegovina, Bulgaria, Croatia, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, FYR Macedonia, Montenegro, Poland, Romania, and Serbia.

(*continued*)

BOX 5.2 The Vienna Initiative (*continued*)

Each group of Vienna Initiative participants made critical commitments to ensure a cooperative outcome. Parent banks committed to maintain their exposure to CESEE and recapitalize their local subsidiaries as needed. The international financial institutions (IFIs) pledged financial assistance under the Joint IFI Initiative specifically geared toward the banking sector, in addition to the financing provided under IMF/EU-supported programs. Home-country authorities agreed that any public support for parent banks would not discriminate between the groups' domestic and foreign operations. EU leaders reaffirmed this in their emergency summit on March 1, 2009. Host-country authorities committed likewise not to discriminate between domestic and foreign banks, in addition to implementing adjustment programs as agreed.

The details of the five country-specific agreements differed somewhat. Banks' commitments were stronger in the cases of Romania, Serbia, and Bosnia and Herzegovina, where agreements were an integral part of the negotiations of the adjustment programs, than in the cases of Hungary and Latvia, where agreements were concluded only after the macro-adjustment program had been put in place. Banks formalized their commitments in bilateral letters to host-country central banks in all cases except for Latvia. Commitments were typically revisited and reaffirmed in meetings with banks following each program review. As the financial crisis abated and credit demand fell, exposure limits were lowered beginning in late 2009. By end-2011, the original IMF/EU-supported programs with all five countries were no longer operative and the formal EBCI commitments lapsed accordingly. Vienna Initiative participants remained in contact and continued to discuss issues pertinent to the region, including in occasional full-forum meetings and public-private working groups.

The Vienna Initiative was successful. As a critical supplement to the programs supported by the IMF and the EU, it helped avoid the feared financial meltdown. Banks remained engaged not only in the EBCI countries but in the region as a whole. This may well reflect the demonstration effect of the initiative, which showed that it would be wrong to write off the economies of CESEE and that remaining engaged pays off. Overall exposure of western banks to CESEE declined little and far less than exposure to other regions.

monitored by the central banks of the program countries. Follow-up meetings with IMF staff took place in the context of program review missions. By and large, banks abided by their commitments. Countries also sought, and often received, comfort letters from banks to remain committed outside IMF-supported programs, such as in the case of Bulgaria.

Overall, western banks' exposure to the region shows a modest reduction in the postcrisis period. In mid-2010 it was 2.6 percent of GDP off its peak in the third quarter of 2008 for the average country in emerging Europe. Taking into account the offsetting reduction of emerging Europe's deposits with western banks, net exposure fell by 1.3 percent of GDP over the same period. This is considerably less then was the case in previous crises, when gross and net exposures had declined by an average of 10 and 9 percent of GDP, respectively, seven quarters after their precrisis peaks.

The reduction in exposure to emerging Europe in this crisis varied considerably from country to country (Figure 5.5). Latvia and Ukraine, which respectively suffered a systemic banking crisis and a twin banking-currency crisis, experienced exposure reductions on the same order of magnitude as seen in previous crises. All other countries avoided financial crisis, and western banks'

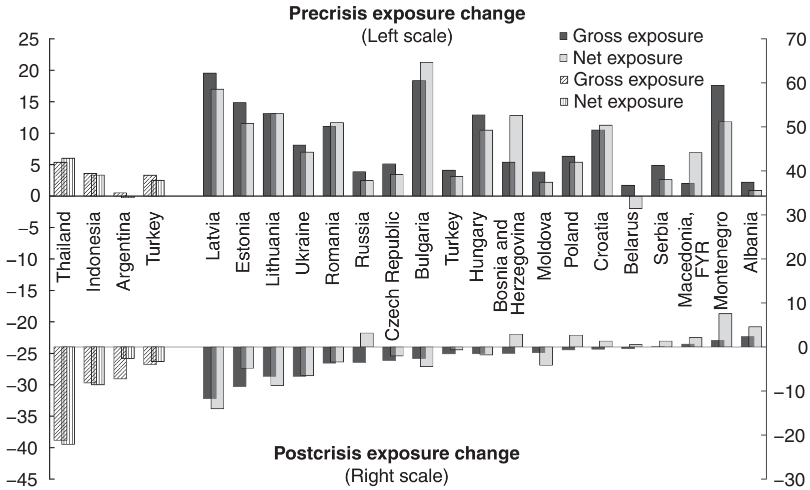


Figure 5.5 Precrisis and Postcrisis Change of Exposure of BIS-Reporting Banks (*Percent of GDP*)

Source: IMF staff calculations based on Bank for International Settlements, *Locational Banking Statistics*, December 2010.
Note: BIS = Bank for International Settlements.

exposure changed little from its peak. The only outliers were Estonia and Lithuania, which both experienced large exposure reduction and yet no financial crisis, as well as Russia, which experienced a currency crisis in the face of modest exposure reduction. Estonia weathered the exposure reduction because it was mainly loans to nonfinancial companies rather than exposure to banks that were cut back. Indeed, net exposure to Estonian banks did not decline at all.

The absence of a financial crisis in Lithuania is harder to explain, since net exposure to banks declined by a considerable 8.7 percent of GDP. Presumably, Lithuania's strong up-front fiscal consolidation and the government's tapping of significant nonprogram external financing played critical roles (see Chapter 19). Exchange rate pressure in Russia, which led to a 30 percent depreciation in January 2009, was primarily due to portfolio investors no longer seeing the exchange rate as consistent with prices fetched by Russia's oil and gas exports in the aftermath of the crisis rather than foreign banks cutting exposure to Russia.

The overall pattern of precrisis and postcrisis bank flows to the region is consistent with deep recessions and the general absence of financial crises. Bank inflows were very large in the precrisis period and came to an abrupt stop at the time of the Lehman Brothers collapse without, however, going much into reverse in most countries. Because bank inflows financed predominantly domestic credit expansion, credit growth and spending growth, including on imports, came to an equally abrupt end. The associated disruptions made deep recessions inescapable, but the collapse of spending forced by the drying up of financing and the recessions also provided relief from balance-of-payments pressures. With bank outflows modest and generous official support available where needed, overall pressures on financial systems and balance of payments remained contained enough to avert financial meltdown.

The experience during earlier crises was very different. Then, comparatively modest bank inflows gave way to very large bank outflows. While the overall swing of bank flows in those crises was comparable to the one in the recent emerging Europe crisis, the fact that flows were sharply negative in the earlier crises meant that many local banks, as well as nonfinancial firms, were pushed into illiquidity and insolvency, while currencies collapsed.

Anecdotal evidence suggests that relatively large buffers in emerging Europe's banking systems also contributed to the region's resilience. Going into 2008, capital ratios in fact stood at a healthy 16 percent, while returns on equity had run at some 17 percent in previous years for the average country of the region. However, such financial soundness indicators are difficult to compare across countries, and they are highly cyclical. Precrisis capital adequacy ratios had also appeared quite reassuring in the run-up to the earlier crises in Thailand, Indonesia, Turkey, and Argentina. Postcrisis performance speaks perhaps more loudly to the strength of emerging Europe's financial systems. Despite the recessions, return on equity remained positive in most countries. Only the banking systems of the Baltic countries, Ukraine, and Montenegro suffered large losses.

PART III

Country Experience in Countries with IMF Arrangements

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CHAPTER 6

Hungary: Placing the First Call to the IMF from Emerging Europe

Hungary was immediately and significantly affected by global deleveraging because of its high external and public debt in conjunction with its close international financial integration. These vulnerabilities had built up over many years, rather than in the context of a precrisis boom of domestic demand, and fiscal consolidation efforts came too late to redress them. Just three weeks after the collapse of Lehman Brothers, Hungary became the first country in emerging Europe to request financial assistance from the IMF when it found its gross financing needs impossible to meet on its own. A strong policy response, together with significant official support from the IMF and the EU, restored financial stability and mitigated the economic downturn. A change of government led to the premature lapse of the program in July 2010 and partial policy reversals. Consequently, Hungary came under renewed pressure as the euro area crisis intensified in the second half of 2011.

BACKGROUND

Hungary embraced the economic transition to a market-based economy but inherited large debts from the pretransition period. Quasi-market elements were introduced from the late 1960s, and legislation on foreign direct investment and the transformation of state enterprises into shareholding companies was put in place in 1988–89. Hungary bolstered this head start with a major austerity, stabilization, and privatization package in the mid-1990s to acquire a leading position as a reformer in the region. The early entry of foreign investors helped build a largely modern and efficient industry and an open economy firmly integrated into Europe's cross-border production chains more generally. The banking system became dominated by subsidiaries of western European banks, but the large former national savings bank, OTP, remained independent and established its own subsidiaries in neighboring countries.

With early success, a degree of complacency set in. The economy began to grow again in 1994 and was particularly vibrant during 1997–2000. Inflation was brought down in the second half of the 1990s under a crawling-peg exchange rate regime. An inflation targeting framework with exchange rate bands was introduced in 2001 (the bands were removed in 2008). However, efforts to reign in government and external debt were never sufficiently decisive. A persistent current account deficit kept external debt high relative to GDP. On the fiscal front,

The main authors of this chapter are Alina Carare, Xavier Debrun, James Morsink, and Johannes Wiegand.

relatively well-off Hungary kept social benefits generous. Fiscal deficits fluctuated with the political cycle but were on average too large to ever bring the debt-to-GDP ratio below 50 percent of GDP.

THE RUN-UP TO THE GLOBAL FINANCIAL CRISIS

The period of 2003-08 was marked by mediocre economic growth and a further buildup of vulnerabilities. At a time when most of emerging Europe went through a domestic-demand-driven boom, Hungary's real GDP expanded by a rate of only 2.9 percent a year. With current account and fiscal deficits persisting and foreign financing readily available, external and public debt kept growing. Foreign investors became important players in the government bond market (Figure 6.1). The entry and subsequent aggressive expansion of foreign banks helped fuel the growth of private debt. In particular, foreign currency denominated lending, especially in Swiss francs, was highly profitable.

The fiscal deficit widened sharply in the run-up to the 2006 election, and the subsequent major fiscal adjustment effort came late. After the fiscal deficit had risen to 9.4 percent of GDP in 2006, the government embarked on fiscal consolidation and focused on cuts to the government wage bill and subsidies, improvements in tax collection, and a pro-growth shift from direct taxation to indirect taxation. In mid-2008, the fiscal deficit for the year was expected to be about 3½ percent of GDP, although gross financing needs (which include maturing debt) remained large at about 17 percent of GDP.

Thus, on the eve of the global financial crisis, Hungary was in a precarious position: (i) despite consolidation efforts, public debt was about 70 percent of

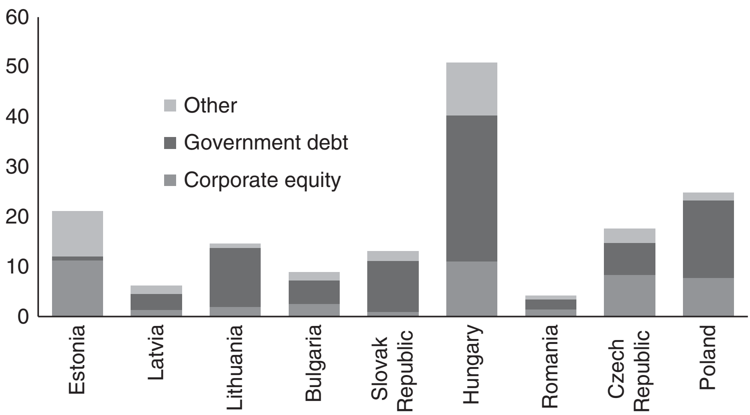

Figure 6.1 New EU Member States: Portfolio Investments by Nonresidents (*Stocks, end-2007, percent of GDP*)

Sources: IMF, Balance of Payments and International Investment Position Statistics Database; and IMF staff calculations.

GDP and its rollover depended on the whim of foreign investors; (ii) banks' loan-to-deposit ratios had risen to 150 percent, exposing them to significant liquidity risk; (iii) almost two-thirds of all bank loans were foreign currency denominated to mostly unhedged borrowers; and (iv) official foreign currency reserves covered little more than half of short-term foreign debt.

IMPACT OF THE GLOBAL FINANCIAL CRISIS

When global liquidity froze in the days after the collapse of Lehman Brothers, funding pressures emerged quickly for Hungary's government and banks:

- *Government funding.* In early October 2008, auctions in the primary government bond market failed. In the secondary market, foreign investors sold more than one quarter (€3.5 billion) of their holdings of domestic-currency denominated government bonds between mid-September and end-November 2008. The sell-off put severe downward pressure on the exchange rate.
- *Bank funding.* Banks hedged their foreign-currency lending in the foreign-exchange swap market, with the typical counterpart being a nonresident who needed domestic currency to purchase high-yielding domestic-currency denominated assets, especially government bonds (Barkbu and Ong, 2010). When global funding markets froze, foreigners' interest in holding domestic currency assets declined, which reduced the supply of swaps. As a result, banks' cost of hedging increased sharply and maturities in the swap market shortened. Moreover, the depreciation of the exchange rate triggered margin calls on swap positions, which caused severe liquidity shortages in some banks. In addition, banks without a foreign parent lost critical direct foreign-currency funding.

POLICY RESPONSES

The Hungarian authorities called the IMF on Thursday, October 9, 2008. It was the central bank governor, who told the IMF, "all hell has broken loose" after an unsuccessful government bond auction in the morning: primary dealers of government securities had stopped quoting prices; the swap spread (an indicator of foreign exchange market pressure) had spiked; the currency was weakening; and the stock market price of OTP was under pressure. Such a rapid and severe impact on Hungary of the global financial market turbulence did not come as a surprise, given Hungary's well-known vulnerabilities. The speed with which the Hungarian authorities asked for assistance was welcome.

The phone call was met by a quick response, leading to IMF Executive Board approval of a stand-by arrangement on November 6, 2008.[1] On October 9, a staff team was organized, IMF management informed the IMF Executive Board that

[1] The program was initially for 17 months. It was subsequently extended by 6 months through October 2010.

it was invoking emergency procedures, and the European Commission was consulted. The next day, a briefing paper was written and approved, and the team left for Budapest on October 11.

The program comprised three main elements: efforts to build fiscal credibility, steps to maintain financial stability, and large front-loaded official financial assistance.

Given high government debt and the low credibility of fiscal policy, it was critical to improve fiscal sustainability and limit government financing needs in the short term. Adjustment focused on the expenditure side because weak spending control had led to a relatively high level of government spending compared to regional peers, leaving ample room for rationalization and restructuring. In contrast, already high tax rates precluded a significant role for revenue measures. While the initial adjustment package announced in October 2008 relied largely on front-loaded spending freezes, entitlement reforms with a durable impact on future spending were subsequently enacted, including an acceleration in the planned increase of the statutory retirement age, incentives to discourage early retirement, a more limited role for wage inflation in pension indexation, and reductions in relatively generous universal transfer programs, such as maternity leave (Figure 6.2). Cuts in the wage bill—mainly through an extension of nominal freezes—were also introduced. To minimize the impact on the poor, safety nets were preserved by expanding means-testing and sheltering the purchasing power of low-income civil servants and retirees. Spending measures were accompanied by a pro-growth, revenue-neutral shift from labor taxation to consumption taxation.

The government's commitment to fiscal sustainability was buttressed by institutional reforms aimed at focusing budget preparation and execution on the need for debt reduction. A fiscal responsibility law (adopted in late 2008) mandated a decline in the budget deficit over the next two years and an annual reduction in debt in real terms thereafter (a requirement that ensures a fall in the debt to GDP ratio as long as real GDP growth is positive). Along with these numerical ceilings, the law sought to enhance the transparency of the budget process through specific disclosure requirements and the creation of a nonpartisan fiscal council to monitor and assess budgetary developments against the objectives of the law. Finally, procedural rules (in particular, the obligation that any new spending or tax initiative be deficit-neutral) were introduced to avoid slippages during the budget year.

As economic activity contracted more sharply than initially expected during the first half of 2009, the fiscal targets were modified to preserve an appropriate balance between the necessity to enhance fiscal credibility and the need to minimize the adverse effect on aggregate demand. The initial consolidation path was adjusted twice (at the first and second reviews of the program) to accommodate roughly half of the expected revenue shortfall. To avoid jeopardizing the medium-term objective of reducing public debt, the government strengthened the initial adjustment measures with structural reductions in future commitments, mainly by rationalizing social transfers (including pensions) and subsidies.

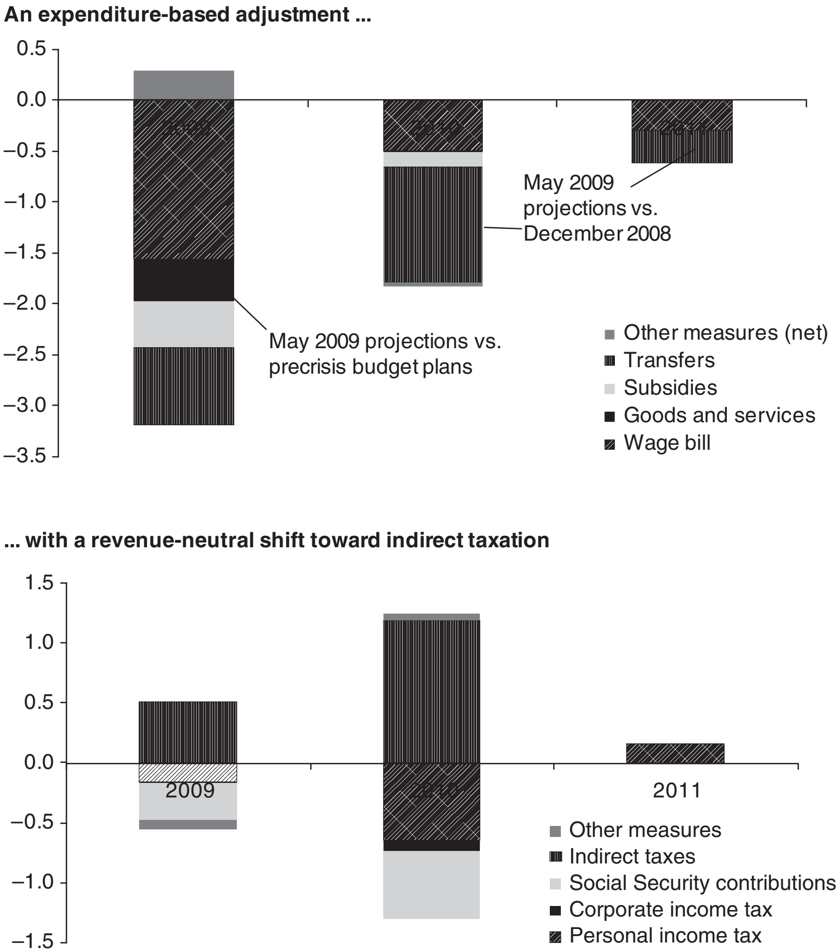

Figure 6.2 Hungary: Composition of Fiscal Adjustment Plans under the IMF-Supported Program (*Announced measures, general government, percent of GDP*)

Source: IMF staff calculations.

The second element of the program—maintaining financial stability—required preventing excessive exchange rate depreciation, assuring bank liquidity and solvency, and strengthening financial supervision and macro-prudential oversight, as follows.

- *Monetary and exchange rate policies*. A sharp currency depreciation would have had significant adverse effects on household and corporate balance sheets. Interest rate policy was the main tool used to defend the exchange rate, with the central bank raising its policy rate by 300 basis points in October 2008. To prevent an intensification of depreciation expectations, the central bank's strategy was to keep its policy interest rate in line with the

European Central Bank's policy rate plus a risk premium (the yield spread on long-term bonds). In addition, the central bank intervened directly in the foreign exchange spot market in February and March 2009.

- *Liquidity*. The central bank quickly established a two-week domestic currency lending facility and an overnight foreign-exchange swap facility. Longer-term (3- and 6-month) swap facilities were added in March 2009. For domestic banks, the government initially granted foreign currency funding guarantees; however, these proved ineffective in light of the government's low credit rating. The government then fell back on extending foreign-currency loans of €2.3 billion directly to three banks without a foreign parent. An interagency group (comprising the central bank, the financial supervisor, and the Ministry of Finance) was established to continuously monitor these banks' financial standing.
- *Bank solvency*. Hungary's banks entered the financial crisis with generally solid capital positions. Nevertheless, as a safeguard against the possible impact of deteriorating economic conditions on bank solvency, a capitalization fund was established. The fund was used only once in a small amount (a temporary injection of €100 million in March 2009 into one bank without a foreign parent). Most banks remained profitable throughout the crisis.
- *Financial supervision*. The authorities put in place a comprehensive program to enhance the quality of financial supervision, with a view to strengthening confidence in the good financial standing of Hungary's financial institutions. In 2009 and early 2010, the Hungarian Financial Supervisory Agency (HFSA) conducted comprehensive on-site inspections of Hungary's eight largest banking groups, and followed up in 2010 with targeted inspections focusing on credit quality. Cooperation between home and host supervisors was strengthened, both in cases where the HFSA is the host supervisor (for subsidiaries of western European parent banks), and where it is the home supervisor (for foreign subsidiaries of OTP).
- *Remedial action and resolution framework*. The remedial action regime was improved, including strengthening legal protection for the supervisory commissioner and establishing an additional mandatory threshold for the appointment of a supervisory commissioner. A legislative proposal to broaden bank resolution tools was developed but not enacted.
- *Macro-prudential oversight*. A Financial Stability Council was established, consisting of the HFSA, the central bank, and the Ministry of Finance, with the task of integrating micro- and macroprudential aspects of financial supervision, thus enhancing the capacity to identify and prevent the build-up of systemic risks within the financial system. The Financial Stability Council and the central bank were granted the right to initiate legislative and regulatory action. However, the HFSA's full regulatory independence was not established, because the government lacked the two-thirds majority in parliament to make the necessary constitutional change.

- *Foreign banks*. Continued commitment of foreign banks to their local subsidiaries was indispensible to the program's success. Disengagement could have easily triggered a large-scale exodus of foreign capital, which in turn would have undermined financial stability and the exchange rate. In October 2008, parent banks provided assurances to the central bank that they would maintain their exposure to subsidiaries and recapitalize them as needed. Indeed, the parent banks of the six largest Hungarian subsidiaries increased their funding by more than a quarter (or €6 billion) in the last quarter of 2008 and the first quarter of 2009. Parent banks formalized their commitments in writing under the European Bank Coordination Initiative (EBCI) arm of the Vienna Initiative in May 2009.

The third element of the program was large and front-loaded financial support from the IMF and the European Union. The economic policies under the program were intended to restore investor confidence in Hungary's external sustainability. However, it was difficult to predict the speed with which investor confidence would return, so sufficiently large and up-front official financial support was essential to convince investors that the country could meet its external obligations for the foreseeable future.

Hungary's external financing need was potentially very large. The gross need was projected to be about €39 billion from 2008:Q4 through end-2009 (it was calculated as the sum of the projected current account deficit, maturing debt obligations, and the needed increase in official reserves to cover about 80 percent of short-term debt). Financial inflows of about €19 billion were expected, including capital transfers from the European Union, foreign direct investment, and other private inflows, leaving a financing gap of about €20 billion. This gap was filled by commitments from the IMF (€12½ billion), the European Commission (€6½ billion), and the World Bank (€1 billion). Of this amount, €7 billion was provided immediately, €4½ billion in 2009:Q1, €1½ billion in 2009:Q2, and €1½ billion in 2009:Q3.

ECONOMIC OUTCOMES IN 2009–11

Financial strains eased and the economy stabilized in less than a year. Financial markets responded positively to the program, as suggested by the behavior of the sovereign credit default swap (CDS) spread (Figure 6.3). The CDS spread fell after the announcement of the program, especially relative to the sovereign CDS spreads of other EU emerging economies. Investor concerns about banking system health in central and eastern Europe led to an increase in financial market pressures in early 2009, but these started to ease after the G20 announced a sharp increase of IMF resources in March 2009. Hungary's CDS spread fell substantially and durably in the late spring of 2009. By July 2009, the central bank began a series of interest rate cuts and the government began to issue bonds at a pace sufficient to meet its financing needs. The successful issuance of a foreign-currency bond in July 2009 strongly signaled that global investor confidence had returned.

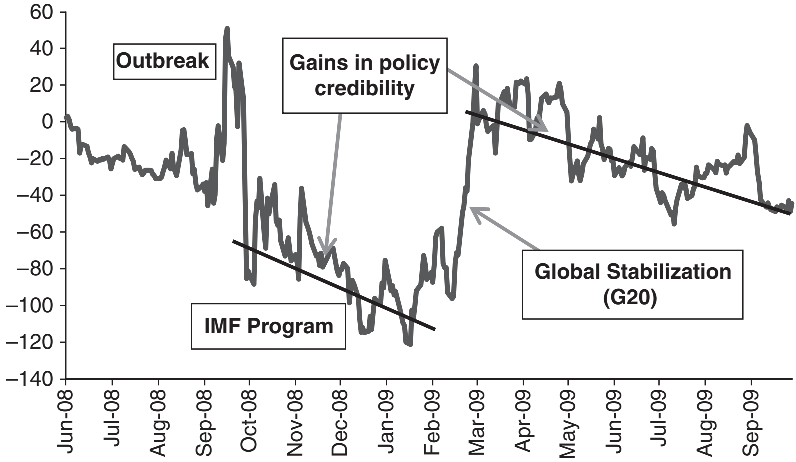

Figure 6.3 CDS Spreads: Hungary Compared with Other New EU Member States, June 2008–October 2009 (*Basis points*)

Sources: Bloomberg L.P., and IMF staff calculations.

Hungary's economic downturn was severe, but it was mostly driven by the shock to global trade. Real GDP contracted by 7¾ percent in seasonally adjusted terms from peak (2008:Q1) to trough (2009:Q4), and the unemployment rate rose by more than 4 percentage points from mid-2008 to early 2010. However, the severity of the downturn was largely due to Hungary's high degree of integration into the global trading system, with exports amounting to about 80 percent of GDP and consisting mostly of machinery and equipment. About two-thirds of Hungary's decline in GDP can be explained by the decline of domestic demand in its advanced-economy trading partners.[2] The depreciation of the nominal exchange rate in Hungary was much less than the depreciation during the Asia crisis. As a result, balance sheet adjustment was more orderly and a banking crisis was avoided.

As global trade rebounded, the economy returned to growth in the third quarter of 2009 on the back of a pickup in exports. The pace of real economic expansion rebounded modestly to about 1½ percent in 2010 and 2011, after an almost 7 percent contraction in 2009. Despite the recession, the fiscal deficit deteriorated by a modest ¾ percent of GDP in 2009, to 4.5 percent of GDP. The external sector has been a particularly bright spot, with the current account swinging into surplus for the first time in more than 15 years. While the slump in domestic demand is partly responsible, exports remain the key driver of the recovery.

[2]This estimate is based on the regression coefficient in Table 2a of Llaudes, Salman, and Chivakul (2010).

Program disbursements stopped in the fourth quarter of 2009. Although the fourth and the fifth program reviews were completed in December 2009 and March 2010, the authorities decided not to draw on IMF or EU resources in light of regained access to market financing. The new government that was formed in mid-2010 took a new direction in economic policies, and the program expired in October 2010 without any additional reviews being completed. Fiscal policy turned sharply expansionary, with the structural deficit widening by 3 percentage points in 2010-11. The de facto nationalization of second-pillar pension funds, institutional changes that weakened economic governance, regressive and complex changes to the tax system, special levies on selected industries, and heavy-handed schemes to convert CHF-denominated mortgages into local currency proved controversial and likely contributed to high risk premiums and low investor and consumer confidence. Although the government subsequently adjusted its fiscal policy stance with the announcement of a program of structural reforms and an ambitious 2012 budget, Hungary came under substantial financial market pressure in the second half of 2011 and requested financial support from the IMF and the European Commission in November.

CHALLENGES AHEAD

Hungary paid a high price for its many vulnerabilities during the global financial crisis, but the worst was avoided through a quick policy reaction and substantial official financial support. Hungary initially made important progress toward improving its resilience, with banks' liquid assets now much higher, international reserves having doubled, and the current account in surplus.

It will take much longer to make substantial inroads into other vulnerabilities. High external and public debt and a large stock of foreign currency loans—along with the accompanying dependency on nonresident holders of government paper and foreign-exchange swaps—can only be corrected by pursuing corrective policies over many years. Fiscal discipline, the development of domestic currency markets, the strengthening of external competitiveness, and structural reform for more growth all need to become permanent features of policymaking in Hungary. The renewed pressures in late 2011 underscore the fact that Hungary has little leeway to deviate from such a reform path, especially in an external environment that is bound to remain volatile for some time.

Hungary: Principal Economic and Financial Indicators, 2003–11									
	2003	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**
					Real Sector Indicators				
GDP (real growth in percent)	3.9	4.8	4.0	3.9	0.1	0.9	–6.8	1.3	1.7
Domestic demand (real growth in percent)	6.0	4.6	1.4	1.6	–1.4	0.7	–10.9	–0.5	–0.6
Net exports (real growth contribution in percent)	–2.1	–0.1	2.5	2.3	1.6	0.2	3.6	1.8	2.2
Exports of goods and services (real growth in percent)	6.2	15.0	11.3	19.1	15.0	5.7	–10.3	14.3	8.4
CPI (end-of-period change in percent)	5.7	5.5	3.3	6.5	7.4	3.5	5.6	4.7	4.1
Employment (growth in percent)	1.2	–0.6	0.1	0.7	–0.2	–1.2	–2.5	0.0	0.8
Unemployment rate (percent)	5.5	6.3	7.3	7.5	7.7	8.0	10.1	11.2	11.0
					Public Finances				
Fiscal balance (percent of GDP)	–7.2	–6.4	–7.8	–9.4	–5.1	–3.7	–4.5	–4.3	4.0
Government revenue (percent of GDP)	42.5	42.7	42.2	42.8	45.6	45.5	46.9	45.2	52.4
Government expenditure (percent of GDP)	49.6	49.1	50.0	52.2	50.6	49.2	51.4	49.5	48.4
Government primary expenditure (percent of GDP)	45.5	44.7	45.9	48.2	46.5	45.1	46.8	45.3	44.5
Government primary expenditure (real growth in percent)	–0.2	2.9	6.9	9.1	–3.4	–2.2	–3.3	–1.9	–0.1
Public debt (percent of GDP)	58.5	59.4	61.7	65.9	67.0	72.9	79.7	81.3	80.4
Of which foreign held	24.0	28.3	26.9	33.8	34.8	29.3	39.3	37.6	...
					External Sector				
Current account balance (percent of GDP)	–8.0	–8.4	–7.5	–7.4	–7.3	–7.4	–0.2	1.1	1.6
Net capital inflows (percent of GDP)[1]	8.2	12.1	13.7	9.7	5.9	10.6	–4.4	1.1	2.9
FDI	0.6	3.1	5.0	2.6	0.2	2.5	0.1	0.7	–0.1
Portfolio	3.7	6.6	3.9	5.7	–1.6	–2.4	–3.9	–0.1	6.5
Other investment	4.0	2.3	4.7	1.4	7.3	10.5	–0.5	0.5	–3.5
Exports (percent of GDP)	62.2	65.3	67.8	77.3	81.0	82.0	77.7	86.3	91.4
Exports (€, growth in percent)	3.3	16.3	12.2	15.4	16.1	6.9	–17.7	18.3	10.2
Global export market share (basis points)	56.5	60.0	60.4	62.7	68.9	67.6	67.3	64.1	...
Remittances (percent of GDP)	0.05	0.04	0.06	0.05	0.04	0.03	0.04	0.04	0.04
Imports (percent of GDP)	66.1	68.0	69.3	78.4	80.3	81.7	73.0	79.9	84.5
Imports (€, growth in percent)	5.9	14.1	10.1	14.6	13.5	7.4	–22.5	16.8	10.0
External debt (percent of GDP)	62.3	67.3	77.1	101.8	111.4	109.0	157.8	141.4	131.3
Gross international reserves (€ billions)	10.1	11.7	15.7	16.3	16.3	24.3	30.6	36.0	41.6
Gross international reserves (percent of GDP)	15.3	15.6	16.8	19.1	17.6	21.9	34.8	37.4	38.3
Reserve coverage (GIR in percent of short-term debt)	84.6	88.8	74.4	76.8	52.0	79.2	105.0	88.6	93.8

Hungary: Principal Economic and Financial Indicators, 2003–11 (*continued*)	2003	2004	2005	2006	2007	2008	2009	2010	2011
Monetary Sector									
Broad money (end of period, growth in percent)	12.0	11.6	14.7	13.7	11.0	7.7	4.4	3.0	5.9
Monetary base (end of period, growth in percent)	18.6	–3.7	19.4	13.8	11.4	19.5	–23.2	14.4	11.3
Private sector credit (end of period, percent of GDP)	43.4	46.8	62.7	57.1	64.7	72.6	72.6	72.6	68.5
Of which foreign currency denominated	11.8	14.9	24.9	25.4	34.4	45.3	45.1	45.5	42.6
Of which foreign currency indexed	...	...	...	...	...	...	...	...	...
Cross-border loans to nonbanks (Q4, percent of GDP)	18.2	19.7	21.4	25.2	27.9	28.6	36.1	24.8	18.6
Private sector credit (end of period, real growth in percent)	26.1	12.6	38.3	–8.0	11.4	15.1	–8.5	-0.3	–4.6
Financial Sector									
Assets (percent of GDP)	66.1	69.7	76.0	87.0	94.8	109.6	115.9	113.0	109.9
ROA (percent)	0.9	1.3	1.4	1.5	1.2	1.2	0.6	0.0	0.1
ROE (percent)	...	...	24.5	23.8	18.4	16.4	8.3	0.4	1.3
CAR (percent of risk-weighted assets)	11.8	12.4	11.6	11.0	10.4	12.3	13.9	13.9	14.2
NPLs (percent of total loans)	...	...	2.3	2.6	2.3	3.0	6.7	9.8	12.3
Loan-to-deposit ratio	1.2	1.2	1.3	1.4	1.6	1.5	1.4	1.4	1.3
Cross-border claims by foreign banks (all sectors, percent of GDP)	34.4	37.3	39.8	51.2	56.8	60.9	73.2	57.2	42.8
Financial Markets									
Interest rates (end of period, one-year government bond, percent)	11.2	8.6	6.4	8.0	7.5	8.8	6.1	6.3	8.0
CDS spreads (sovereign, end of period, basis points)	32	16	27	21	49	430	242	384	623
EMBIG spread (sovereign, end of period, basis points)	28	32	74	58	84	504	186	345	578
Exchange rate (end of period, domestic currency/€)	262.5	246.0	252.9	251.8	253.7	266.7	270.4	278.0	314.6
NEER (index, 2003 = 100)	100.0	102.1	102.9	96.7	102.5	103.9	94.5	94.0	93.2
REER (CPI-based, 2003 = 100)	100.0	106.7	108.9	103.9	115.8	120.0	113.0	115.5	115.6
REER (ULC-based, 2003 = 100)	100.0	105.4	107.5	102.3	112.5	113.3	102.6	99.4	...
Memorandum Items									
GDP (nominal, in billions of domestic currency)	18,738	20,665	22,019	23,676	24,991	26,546	25,623	26,748	28,154
GDP (nominal, in billions of €)	73.9	82.0	88.6	89.6	99.3	104.8	90.9	96.9	105.7

Source: IMF staff.

Note: CAR = capital adequacy ratio; CDS = credit default swap; CPI = consumer price index; EMBIG = Emerging Markets Bond Index Global; FDI = foreign direct investment; GIR = gross international reserves; NEER = nominal effective exchange rate; NPLs = nonperforming loans; REER = real effective exchange rate; ROA = return on assets; ROE = return on equity; ULC = unit labor cost.

[1] Financial and capital account balances excluding EU balance-of-payments support, use of IMF resources, and SDR allocations.

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CHAPTER 7

Ukraine: Weathering the Perfect Storm—Challenges and Opportunities

Ukraine was confronted by a near-perfect storm when the crisis broke in the fall of 2008. Capital flow reversals, collapsing global steel prices, and drastic cuts in energy subsidies from Russia triggered currency and banking crises that quickly engulfed public finances and pushed Ukraine into one of the deepest recessions in the region. With support from the international community for the authorities' adjustment efforts, rising steel prices, and an upswing in key trading partner growth, a cyclical recovery started to take hold in late 2009. However, more than three years after the onset of the crisis, the economy was still vulnerable to the gyrations of global commodity prices and investor sentiment. Strong policies and ambitious institutional and structural reforms remain important for Ukraine to build a more resilient economy and achieve sustainable growth.

BACKGROUND

In the first decade of its independence, Ukraine's economy experienced hyperinflation and a sharp downturn. The demise of the Soviet military-industrial complex hit Ukraine's heavy industries—metallurgy, machine-building, and chemical industries—particularly hard. The cost of transition to a market economy was heightened by slow economic restructuring amid vested bureaucratic and economic interests and weak political consensus regarding market reforms. By late 1999, formal activity had shrunk by 60 percent, more than in most CIS countries.

Under stop-and-go efforts, important first-generation reforms were eventually introduced. These included the successful launch of a new currency (the hryvnia), large-scale privatization, a reduction of chronically high fiscal deficits, financial liberalization, and some progress in improving the business environment. These efforts were rewarded with a resumption of growth from 2000. However, economic activity remained concentrated in the low-value-added segments of the metals and chemical industries, Russia continued to dominate external trade, and the business environment was still riddled with opaque laws and regulations that were inconsistently enforced.

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THE RUN-UP TO THE GLOBAL FINANCIAL CRISIS

Notwithstanding institutional and structural weaknesses, growth gathered speed from 2003 to mid-2008, fueled by domestic and external factors. Private consumption accelerated on the back of fast credit growth, exports expanded, boosted by terms-of-trade gains, and large-scale capital inflows and investment were facilitated by enhanced external integration. By 2008, Ukraine's economy had recovered some of the ground lost in the 1990s and ranked 45th in the world by size, with GDP topping US$180 billion.

The boom sped up convergence but dampened the urgency of reforms. An acrimonious political climate with frequent elections, shifting parliamentary coalitions, and the politicization of government agencies eroded support for change. Hopes that the "Orange Revolution" of 2004 would mark a decisive break with the past quickly dissipated, and limited progress was achieved in improving market efficiency. Excessive regulation, weak institutions, economic informality, and undiversified export structures lingered. The large energy sector remained poorly managed, riddled with inefficiencies and incapable of overcoming inadequate domestic pricing policies and cuts in Russian subsidies.

The boom also generated new vulnerabilities, particularly in the private sector. Household and corporate sector debt grew rapidly, but banks' risk management and lending standards, as well as supervisory oversight over them, did not keep pace. Credit risks rose due to real estate prices surging well above the levels in countries with comparable incomes and to currency mismatches on borrowers' balance sheets caused by pervasive foreign currency lending. Banks' liquidity risk also deepened as their loan-to-deposit ratios exceeded 150 percent, one of the highest levels in emerging Europe.

Macroeconomic policies responded to the unfolding boom in a largely procyclical manner. Rapidly growing domestic demand led to a deterioration in the current account of 13 percent of GDP—falling from a 6 percent of GDP surplus in 2003 to a deficit of 7 percent by 2008, despite considerable terms-of-trade gains—and pushed annual inflation to over 30 percent. However, the central bank continued to focus on maintaining a de facto fixed exchange rate against the U.S. dollar and allowed real interest rates to drift into negative territory. On the fiscal side, buoyant revenues supported a spending expansion as revenue gains were channeled into consumption through rising public sector wages and social transfers. However, rapid GDP growth reduced public debt ratios and masked increasing vulnerabilities in public finances—including an unsustainably high level of spending, proliferating tax loopholes, and rising economic informality.

IMPACT OF THE GLOBAL FINANCIAL CRISIS

The 2008/09 crisis hit Ukraine through a sharp deterioration in the terms of trade, a collapse of exports, and a reversal of capital flows. These events exposed the fragility of the domestic economy and set several negative feedback loops into motion. Banks largely halted new lending, and sources of new funding dried up.

Weakened confidence in the banking sector set off a deposit run that quickly developed into a full-blown banking crisis. As depositors fled from banks they also abandoned the hryvnia, triggering a currency crisis. With banks and the currency under strain, the government found itself shut out from capital markets and unable to finance its rapidly widening budget deficit. Ukraine fell into one of the deepest recessions in emerging Europe, with real GDP contracting by 15 percent in 2009—only Latvia and Lithuania suffered similar declines. Economic pressures exposed fault lines in domestic politics, and in mid-September the government coalition in parliament collapsed. In short, Ukraine was hit by a near-perfect storm (more details in Box 7.1).

BOX 7.1 Ukraine: Key Developments in Late 2008

- Ukraine's external terms of trade suffered a double blow from sharply lower global metals prices and price hikes for gas imports from Russia. Global metals prices, which had increased threefold since 2003, fell by 50 percent in the second half of 2008 and into early 2009 (Figure 7.1). On the import side, import prices for gas increased by about 40 percent as Russia phased out gas subsidies to Ukraine. With steel exports and gas imports accounting for 15 and 6 percent of GDP, respectively, the associated terms-of-trade deterioration was very significant.

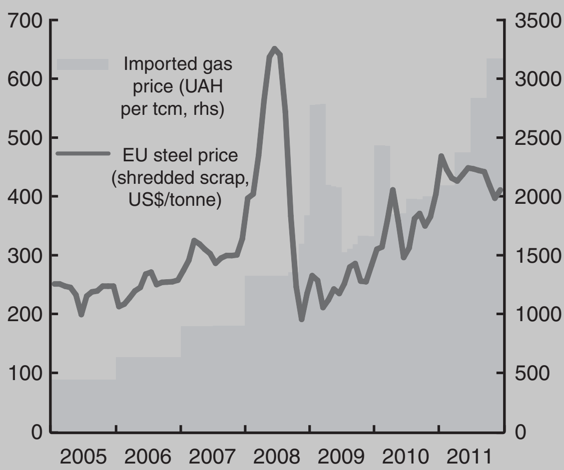

Figure 7.1 Ukraine: Terms of Trade Developments, 2005–11

Sources: Bloomberg L.P.; and country authorities.

- The collapse of global trade further compounded the strain on Ukraine's trade balance. Export volumes fell by almost 40 percent from the third quarter of 2008 to the second quarter of 2009.
- Capital flows turned sharply negative from the third quarter of 2008. Inflows that averaged 7 percent of GDP in the four quarters leading up to the peak of the boom gave way to outflows of 13 percent of GDP in the following four quarters. Western banks cut their exposure to Ukrainian banks and the banking system came under considerable strain.

(*continued*)

BOX 7.1 Ukraine: Key Developments in Late 2008 (*continued*)

- Confidence in the banking system soon buckled. After the sixth-largest bank, Prominvest, was put under receivership, deposits started to be withdrawn on a large scale. In the ensuing months, banks ended up losing some 20 percent of their deposit base. Several systemic banks had to be intervened and many other banks turned out to be capital deficient.
- In November-December 2008, the exchange rate peg collapsed under the combined pressures in the capital and trade accounts. When the peg became unhinged the hryvnia depreciated by some 35 percent even though the National Bank of Ukraine spent about a quarter of its foreign exchange reserves to fight the currency's loss of value.
- Public finances deteriorated rapidly and faced hard financing constraints. The fiscal position had already been moderately in the red at the height of the boom. Revenue underperformance as the crisis unfolded opened a wide gap in the budget. Complicating things further, the government faced huge financing challenges. With sovereign CDS spreads spiking to over 5000 basis points and a four-notch downgrade to CCC+ by Standard & Poor's, the government was essentially shut out of international capital markets. Limited T-bill issuance and drawdown of government deposits at the National Bank of Ukraine became the remaining limited financing options, but these were insufficient to cover the widening fiscal gap.

POLICY RESPONSES

Under these challenging circumstances, Ukraine's immediate priorities were to take measures to contain the crisis and secure international support. The IMF responded to Ukraine's request for support with a US$16 billion exceptional access stand-by arrangement in mid-November 2008. The policy response focused initially on shoring up confidence in the banking system. Key measures included:

- *Bank liquidity support and deposit guarantees*. Faced with the imminent risk of financial meltdown, the National Bank of Ukraine extended large-scale emergency liquidity support to banks, reaching more than 9 percent of GDP at its peak (Figure 7.2). To address the deposit hemorrhage, the government increased deposit guarantees in size and scope to cover nearly all household deposits. It also imposed limits on the early withdrawal of time deposits.
- *Bank recapitalization*. With liquidity problems morphing quickly into solvency concerns, the National Bank of Ukraine conducted diagnostic studies and stress tests for all banks to assess their viability and capital deficiency. Private shareholders ended up injecting some 3 percent of GDP during 2009–10 to correct the identified capital deficiencies. Government recapitalization of state and nationalized banks came to 4 percent of GDP by end-2010.
- *Crisis management and bank resolution.* The authorities strengthened bank crisis management and recapitalization procedures. A Crisis Management Unit was created within the National Bank of Ukraine to deal with bank

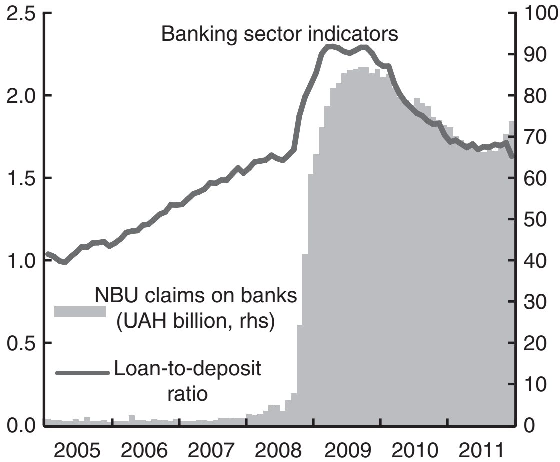

Figure 7.2 Ukraine: Banking Sector Indicators, 2005–11

Source: National Bank of Ukraine.

resolution issues. In addition, a Recapitalization Board composed of senior government officials and headed by the prime minister was established to decide on any government participation in the restructuring of individual systemic banks.

- *Removal of weak banks.* The legal framework to resolve banks was amended to facilitate prompt and cost-effective bank resolution. A total of 27 banks were intervened, with 15 banks being put into liquidation.
- *Administrative measures.* To stem reserve outflows, the National Bank of Ukraine intensified de facto and de jure exchange controls and regulations.

The policy response also involved measured monetary tightening to guard against exchange rate overshooting and inflation in the wake of the depreciation. Interest rates were briefly hiked to positive real levels, but sharp interest spikes were avoided, not least in light of financial sector weaknesses. After several failed attempts to repeg the hryvnia to the dollar at various levels, including through administrative controls and intervention, the hryvnia stabilized with the help of intervention and tighter monetary policy. The IMF-supported program envisaged a flexible exchange rate regime to facilitate adjustment given the economy's openness and trade pattern concentration, discourage dollarization, and achieve greater independence of monetary policy to pursue inflation objectives. However, by mid-2009, with pressures on banks and the currency gradually dissipating, the National Bank reverted to a tightly managed system.

Fiscal policy was initially focused on containing the deterioration of public finances, but it quickly shifted to cushioning the downturn as the severity of the global and domestic economic downturn became clear. Initially, a balanced general government budget was targeted in 2009, in view of the substantial uncertainty about economic and financial prospects, the cost in resolving banking sector problems, and increasingly binding financing constraints. However, as major output and revenue declines emerged, deficit targets were rapidly revised upward. Given the scarcity of both domestic and external market financing, the lion's share of disbursements from the IMF went toward budget financing, including some US$2 billion of the special drawing rights allocation that Ukraine received from the IMF in the third quarter of 2009, so that priority current outlays and social spending could proceed.

Strengthening the energy sector became a key reform objective. The financial position of Naftogaz, the state-owned gas company, deteriorated sharply in 2008 and 2009 when the negotiated price for imported gas from Russia increased by 38 percent and 30 percent, respectively. But with regulated domestic gas prices for end users only partially adjusted, domestic gas subsidies—and Naftogaz's losses—skyrocketed (Figure 7.3). With Naftogaz cut off from market financing, the government assumed responsibility for covering its financing shortfalls out of the budget. But with budgetary pressures particularly severe, Ukraine struggled to make payments for imported gas, and a dispute broke out between Ukraine and Russia in early 2009 that eventually led to disruptions in gas transit to many European countries. Reflecting the heightened importance of the gas sector, (i) the scope of the fiscal program target was broadened to include Naftogaz's deficit; (ii) a schedule of quarterly increases in domestic energy prices was agreed to; and (iii) the energy sector was to be reformed with the support of other international financial institutions with a view to developing a viable and transparent gas market. However, political resistance thwarted the implementation of these measures, including the scheduled price hikes for gas, and Naftogaz's financial condition remained weak.

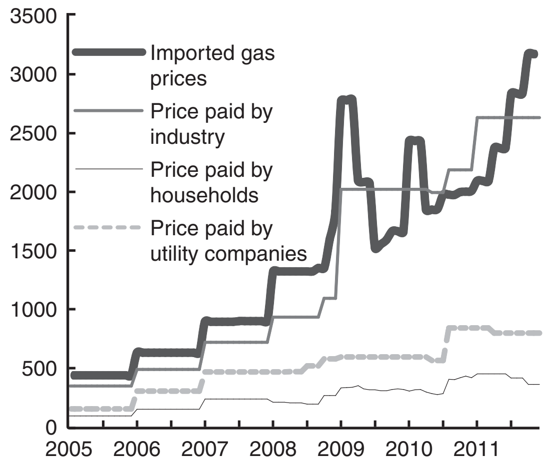

Figure 7.3 Ukraine: Imported and Domestic Gas Prices, 2005–11 (*UAH per tcm, net of taxes and fees*)

Sources: Ukrainian authorities; and IMF staff calculations.

Policies were also aimed at facilitating the restructuring of unsustainable corporate and household debt. With debtors reeling from the weak economy and the increased burden of foreign currency loans, insolvencies and nonperforming loans mushroomed quickly. The program envisaged reform of the regulatory framework aimed at aiding the resolution of private sector debt problems, including through better frameworks for voluntary debt restructuring, a strengthening of the insolvency regime and creditor rights, and the adoption of loan loss classification and provisioning rules in line with best international practices.

In the run-up to the 2010 presidential elections, program implementation deteriorated and the program went off track in the fall of 2009.

Support from the IMF resumed in July 2010 under a new program (a 29-month, US$15 billion exceptional access stand-by arrangement). The new government that took office in March quickly formulated a five-year plan to advance reforms in the areas of: (i) public finance; (ii) financial sector development; (iii) social security, education, and health care; and (iv) infrastructure development and modernization, including in the energy sector. The IMF-supported program sought to promote policy reforms in four key areas:

- The rehabilitation of the banking system, through completion of the capitalization program to increase banks' buffers to absorb the ongoing deterioration in asset quality; strengthened supervision; and a more robust framework for resolution of impaired loans.
- Fiscal sustainability, through a multiyear program of fiscal adjustment aimed at improving structural balances in 2010–12 and bringing debt down to below 35 percent of GDP by 2015. To underpin this adjustment, the program envisages reforms to entitlements, including pension and public administration.
- Modernization of the gas sector, including the phasing out of Naftogaz's deficits, through: (i) near-term measures to improve the pricing policy and to depoliticize the price setting of public utilities; and (ii) medium-term reforms to improve efficiency by unbundling gas production, transit, and distribution to the end-user and by allowing new entrants into the domestic gas market.
- Development of a more robust monetary policy framework through strengthening of central bank independence to enhance its accountability and allow it to focus more squarely on price stability. In addition, foreign exchange liberalization is supported by reforms aimed at facilitating foreign exchange market operations, enhancing exchange rate determination, and strengthening risk management.

ECONOMIC OUTCOMES IN 2010–11

Policy efforts and results were complicated by the size of the imbalances prior to the crisis and the banking crisis (a feature shared only with Latvia among emerging market countries) and currency crisis (a feature shared only with Belarus and

Russia) that ensued. But the initial efforts succeeded in avoiding a financial meltdown, and there were encouraging signs of progress in restoring macroeconomic and financial stability during 2010–11. Economic activity expanded by 4.1 percent in 2010 and by 5.2 percent in 2011, unemployment trended down, bank deposits surpassed their precrisis levels, the exchange rate remained broadly stable, and Ukraine returned to international capital markets.

However, the economic cost of the crisis was very large and has given rise to new challenges and vulnerabilities (IMF, 2011c). Public debt is now significantly higher than before 2008. The financial sector is weaker, strained by high nonperforming loans. Corporates and households have to deal with a much heavier debt burden. Private sector activity is constrained by an excessive regulatory framework, weak institutions, and an unfriendly business environment, which by some metrics deteriorated further during 2011. The economy continues to be overly dependent on a few commodity products, and shifting to a higher value-added mix of production and reducing energy consumption remain important challenges. Notwithstanding some efforts, only limited progress was made on Ukraine's structural reform agenda, with the modernization of the energy sector still pending, the banking system continuing to record losses, and the exchange rate regime reverting back to a de facto fixed arrangement. With global financial market sentiment progressively worsening in the second half of 2011, Ukraine started to encounter difficulties in raising financing from domestic and foreign markets.

CHALLENGES AHEAD

Heading into 2012, Ukraine remains vulnerable, with large external financing requirements in an uncertain external environment, and difficult domestic political choices as it approaches its October parliamentary elections. Balancing these pressures and challenges will require sustained efforts to promote institutional and structural reforms to ensure that Ukraine emerges from this crisis with a stronger economy, one where its citizens can benefit from higher economic growth and improved standards of living.

Ukraine: Principal Economic and Financial Indicators, 2003–11

	2003	2004	2005	2006	2007	2008	2009	2010	2011
Real Sector Indicators									
GDP (real growth in percent)	9.6	12.1	2.7	7.3	7.9	2.3	–14.8	4.1	5.2
Domestic demand (real growth in percent)	12.2	11.3	11.6	13.9	15.9	6.9	–21.4	6.2	10.6
Net exports (real growth contribution in percent)	–3.0	3.9	–12.1	–6.9	–10.7	–5.8	11.0	–3.8	–7.8
Exports of goods and services (real growth in percent)	10.3	21.3	–13.0	–5.3	2.5	5.6	–21.6	3.9	1.7
CPI (end-of-period change in percent)	8.2	12.3	10.3	11.6	16.6	22.3	12.3	9.1	4.6
Employment (growth in percent)	0.4	0.7	1.9	0.2	0.8	0.3	–3.7	0.4	0.3
Unemployment rate (percent)	9.1	8.6	7.2	6.8	6.4	6.4	8.8	8.1	7.9
Public Finances									
Fiscal balance (percent of GDP)	–0.9	–4.4	–2.3	–1.4	–2.0	–3.2	–6.3	–5.8	–2.7
Government revenue (percent of GDP)	38.0	37.1	41.8	43.2	41.8	44.3	42.3	43.3	42.4
Government expenditure (percent of GDP)	38.9	41.5	44.1	44.6	43.8	47.4	48.6	49.0	45.1
Government primary expenditure (percent of GDP)	37.9	40.6	43.3	44.0	43.3	46.9	47.4	47.4	43.2
Government primary expenditure (real growth in percent)	13.6	20.2	9.7	8.8	6.3	10.8	–13.9	2.9	–2.9
Public debt (percent of GDP)	29.4	24.7	17.7	14.8	12.3	20.5	35.4	40.5	36.4
Of which foreign held	17.4	15.5	12.2	10.1	8.3	6.6	9.3	11.7	...
External Sector									
Current account balance (percent of GDP)	5.8	10.6	2.9	–1.5	–3.7	–7.1	–1.5	–2.2	–5.5
Net capital inflows (percent of GDP)[1]	0.7	–6.7	9.4	3.8	10.6	5.1	–11.0	4.7	3.6
FDI	2.8	2.6	8.7	5.3	6.5	5.5	4.0	4.2	4.3
Portfolio	–1.8	3.2	3.2	3.3	4.0	–0.7	–1.3	3.1	0.9
Other investment	–0.3	–12.5	–2.5	–4.9	0.1	0.3	–13.7	–2.6	–1.5
Exports (percent of GDP)	57.8	63.6	51.5	46.6	44.8	47.5	46.3	50.2	53.9
Exports (US$, growth in percent)	24.0	42.6	7.5	13.2	27.4	33.8	–36.6	27.7	28.3
Global export market share (basis points)	32.3	35.7	32.7	31.7	35.5	41.8	32.1	34.5	...
Remittances (percent of GDP)	0.4	0.3	0.3	0.3	1.6	1.2	1.4	1.1	1.1
Imports (percent of GDP)	55.2	56.0	50.7	49.5	50.6	55.5	47.9	53.1	59.3
Imports (US$, growth in percent)	28.7	31.3	20.4	22.0	35.4	38.5	–43.8	30.3	33.5
External debt (percent of GDP)	47.5	47.2	46.0	50.6	56.0	56.4	88.2	85.1	76.5
Gross international reserves (US$ billions)	6.7	9.5	19.0	21.9	31.8	30.8	25.6	34.1	31.6
Gross international reserves (percent of GDP)	13.4	14.7	22.1	20.3	22.3	17.1	21.8	24.7	19.2
Reserve coverage (GIR in percent of short-term debt)	58.5	76.4	93.5	81.7	83.9	67.8	67.4	71.2	55.0

(*continued*)

Ukraine: Principal Economic and Financial Indicators, 2003–11 (*continued*)

	2003	2004	2005	2006	2007	2008	2009	2010	2011
Monetary Sector									
Broad money (end of period, growth in percent)	46.4	31.9	54.4	34.5	51.7	30.2	–5.5	22.7	14.7
Monetary base (end of period, growth in percent)	30.1	34.1	53.9	17.5	46.0	31.6	4.4	15.8	6.3
Private sector credit (end of period, percent of GDP)	24.5	25.1	32.2	44.3	58.1	73.8	73.4	62.4	55.8
Of which foreign currency denominated	15.0	15.0	18.6	22.9	29.8	32.0	38.6	35.6	24.1
Of which foreign currency indexed	10.6	10.9	14.1	22.3	29.6	45.8	40.3	30.9	...
Cross-border loans to nonbanks (Q4, percent of GDP)	2.0	3.7	6.1	6.9	6.4	6.1	7.7	6.4	4.5
Private sector credit (end of period, real growth in percent)	52.1	17.7	48.4	52.2	49.0	36.6	–14.7	–7.6	4.1
Financial Sector									
Assets (percent of GDP)	33.4	35.1	44.2	55.6	71.3	91.2	97.0	88.8	79.9
ROA (percent)	1.0	1.1	1.3	1.6	1.5	1.0	–4.4	–1.5	–0.8
ROE (percent)	7.6	8.4	10.4	13.5	12.7	8.5	–32.5	–10.2	–5.3
CAR (percent of risk-weighted assets)	15.2	16.8	15.0	14.2	13.9	14.0	18.1	20.8	18.9
NPLs (percent of total loans)	...	...	...	4.0	3.0	3.9	13.7	15.3	14.7
Loan-to-deposit ratio	1.1	1.0	1.1	1.4	1.5	2.1	2.2	1.8	1.6
Cross-border claims by foreign banks (all sectors, percent of GDP)	3.5	5.6	9.8	14.2	20.3	20.1	22.4	18.5	12.0
Financial Markets									
Interest rates (end of period, one-year government bond, percent)	...	...	...	...	...	...	...	5.3	10.0
CDS spreads (sovereign, end of period, basis points)	...	253	163	156	242	3,274	1,272	513	848
EMBIG spread (sovereign, end of period, basis points)	258	255	184	172	303	2,771	989	461	925
Exchange rate (end of period, domestic currency/US$)	5.3	5.3	5.1	5.1	5.1	7.7	8.0	8.0	8.0
NEER (index, 2003 = 100)	100.0	94.2	95.9	96.4	89.9	83.5	62.6	60.9	59.8
REER (CPI-based, 2003 = 100)	100.0	97.8	107.5	112.9	113.4	123.8	103.8	106.5	106.9
REER (ULC-based, 2003 = 100)	...	...	...	...	...	...	...	...	...
Memorandum Items									
GDP (nominal, in billions of domestic currency)	267	345	441	544	721	948	913	1,083	1,317
GDP (nominal, in billions of US$)	50.1	64.9	86.2	107.8	142.7	180.1	117.2	137.9	165.0

Source: IMF staff.

Note: CAR = capital adequacy ratio; CDS = credit default swap; CPI = consumer price index; EMBIG = Emerging Markets Bond Index Global; FDI = foreign direct investment; GIR = gross international reserves; NEER = nominal effective exchange rate; NPLs = nonperforming loans; REER = real effective exchange rate; ROA = return on assets; ROE = return on equity; ULC = unit labor cost.

[1] Financial and capital account balances excluding EU balance-of-payments support, use of IMF resources, and SDR allocations.

CHAPTER 8

Latvia: The Domino That Did Not Fall

Latvia went through the most extreme boom-bust cycle in all of emerging Europe. The liquidity freeze following the Lehman Brothers collapse hit very hard an economy that was already slowing after many years of unsustainably rapid growth. Economic activity fell by a quarter and a banking crisis claimed Latvia's second-largest bank. Latvia designed its adjustment program around its fixed exchange rate, made possible by massive financial support from the international community, with an eye on the exit strategy of euro adoption. The peg held, external imbalances corrected quickly, and by the end of 2009 the economy had returned to growth. Unprecedented fiscal austerity measures, wage cuts, and structural reforms were key to keeping the fiscal deficit from spiraling out of control and improving competitiveness without recourse to a nominal devaluation of the currency. Despite these achievements, the fall in output has been substantial. Reducing the high level of unemployment and strengthening the social safety net, redirecting output toward exports and the tradable sector, and continuing with structural reform remain important challenges.

BACKGROUND

Following independence from the Soviet Union in 1991, Latvia's economy faced multiple challenges: output initially collapsed; the subsequent recovery gave way to a recession in 1995 and a systemic banking crisis; and the Russian financial crisis in 1998 was another setback. It was not until the 2000s that growth became established, but Latvia's industrial base had become rather narrow, relying on the wood and furniture sector as well as food processing. The banking crisis had been overcome, but credit-to-GDP ratios were low. Foreign banks, mainly from Sweden and other Nordic countries, began buying up local banks and started to dominate the financial system. One major financial institution, Parex Bank, remained in local hands. However, just as the foreign banks relied on parent financing rather than local deposits, Parex's financing relied increasingly on the wholesale market and non-resident deposits. Inflation was brought down to single digits in the late 1990s under a fixed exchange rate regime, which pegged the lat against the SDR, and later the euro, and which was supposed to operate like a currency board.

The main author of this chapter is Mark Griffiths, helped by James John and the IMF's Latvia team. Material is drawn from the IMF Staff Reports for the initial stand-by arrangement, the first through fifth reviews, and especially the 2010 Article IV Consultation. These documents provide more detail and are available at http://www.imf.org/external/country/lva/index.htm.

THE RUN-UP TO THE GLOBAL FINANCIAL CRISIS

Latvia had accumulated substantial and unsustainable economic imbalances long before the crisis. From 2000 to 2004, annual GDP growth had averaged an already very high 7.5 percent, but following EU membership in 2004 growth accelerated to double digits. Low interest rates under the peg and large inflows from Nordic banks fueled rapid credit expansion, largely foreign currency-denominated. Investment in the nontradable sector took off, together with a bubble in real estate prices. Current account deficits exceeded 20 percent of GDP in 2006 and 2007, as Latvia's private sector credit rose rapidly from 40 percent of GDP in 2003 to 90 percent in 2007. With tax revenues growing rapidly, rather than saving these and running surpluses, the government decided to put its "pedal to the metal" and was able to double public spending in real terms during 2001–07 without causing sizable fiscal deficits.

The boom ran out of steam in late 2007. Worried about the rise of inflation, the Bank of Latvia had tightened its regulatory policy at the beginning of the year by restricting mortgage lending and increasing reserve requirements. Foreign parent banks started reducing lending to their Latvian subsidiaries in the summer, amid signs of overheating. The credit boom had peaked, hitting the housing and construction sector. Real estate prices fell from the second quarter of 2007 and real GDP followed suit from the first quarter of 2008.

IMPACT OF THE GLOBAL FINANCIAL CRISIS

The collapse of Lehman Brothers and the subsequent international liquidity freeze catalyzed and compounded the crisis in Latvia. Doubts over the health of Swedish parent banks surfaced, but the Swedish government's September support package restored confidence. Speculation soon turned to Parex Bank and whether it would be able to repay its short-term syndicated loans. In the resulting panic, the bank lost 25 percent of its deposits. To provide liquidity to banks under pressure, the Bank of Latvia cut reserve requirements, but depositors continued to withdraw funds and convert them to foreign exchange. Initial half-hearted attempts to stabilize Parex Bank through partial nationalization proved insufficient, and the authorities had to impose a partial deposit freeze on Parex to stabilize its deposits and conserve liquidity.

Latvia had reached a crossroads. Private sector deposits in the banking system had fallen almost 10 percent between end-August and end-November 2008, with much of the decline due to nonresident accounts. Rumors of imminent lat devaluation were widespread. With banks' loan-to-deposit ratios at 150 percent (and 280 percent if less stable nonresilient deposits are excluded), reserves covering less than a third of short-term external debt, and the future of the quasi-currency board coming into doubt as the reserve cover of base money dropped towards 100 percent, the situation became precarious.

POLICY RESPONSES

In November 2008, the Latvian authorities decided to seek outside financial assistance, primarily from the IMF and the European Union. However, not all of the authorities were fully prepared to recognize the enormity of the challenge, as evidenced by the now famous words of the then finance minister that Latvia's problems were "nothing special." Time was running short. The IMF mission was only invited to Latvia in mid-November when the financial and exchange rate panic was already well underway. Given the depth of the problem, the response needed to be not only quick but also substantial, requiring the pooling of resources from the IMF, the European Union, bilaterals, and other international financial institutions. In any event, as an EU member Latvia had to approach the EU balance of payments facility before seeking IMF support. This in turn required coordination of the various assistance programs, an extra step. However, unless it were resolved quickly and decisively, Latvia's crisis risked spilling over to other European countries with fixed exchange rates, from neighboring Estonia and Lithuania to the currency board in Bulgaria.

A €7.5 billion program was announced on December 19, 2008, with financing from the European Union (€3.1 billion), IMF (€1.7 billion), Nordic countries (€1.8 billion, though as a second line of defense and ultimately not utilized), and the World Bank (€0.4 billion), with the EBRD and other bilateral lenders providing the remainder. An emergency swap line from the central banks of Sweden and Denmark that was already in place provided a bridge to the first disbursement from the IMF. The IMF arrangement was approved by the IMF Board on December 23, under emergency financing procedures. Total program financing corresponded to over 30 percent of Latvia's GDP—a relative size never reached in any previous IMF-supported program.

The program's strategy was centered on maintaining Latvia's exchange rate peg. In light of Latvia's large current account deficit, estimates of overvaluation, and the difficulties in defending an exchange rate peg under an open capital account in the middle of a financial panic, exchange rate policy was hotly debated in the program discussions. The IMF wanted to make sure that all options were considered, including the possibilities of a widening of the exchange rate band to ±15 percent or some form of accelerated euro adoption, potentially at a depreciated rate.[1] However, the EU authorities firmly ruled out immediate euro adoption as inconsistent with the Maastricht Treaty. The Latvian authorities were unequivocally committed to keeping the exchange rate peg, since it had been the linchpin of economic stability since the early days of transition. Moreover, devaluation would have had severe balance sheet effects, since most private sector debt was denominated in euros and rollover of external debt might have become even more difficult. However, the decision to leave the exchange rate unchanged increased demands on the rest of the program.

[1] See Request for Stand-By Arrangement, paragraphs 19–20 and Box 1; 2010 Article IV Consultation Staff Report, paragraphs 4–5.

With the exchange rate peg maintained, domestic policies needed to be radically strengthened to generate the needed real depreciation. In essence, real exchange rate overvaluation would need to be addressed through price and wage adjustment, along with productivity-boosting structural reforms—a process referred to as “internal devaluation.” This price adjustment in turn required tight wage policies and, most likely, a short period of economic recession would be unavoidable. This would be a painful process, and there were doubts whether it would be possible to generate sufficient competitiveness gains this way.

Fiscal policy needed to be tightened for two reasons. First, the worsening recession led to a deep slump in revenues which threatened to raise the fiscal deficit into double digits as a share of GDP. While Latvia’s public debt was extremely low at the outset, such large deficits would have been difficult to finance, would have left no room to support the shaky financial sector, and would not have inspired confidence. Second, given the choice of the fixed exchange rate, fiscal policy needed to contribute to internal devaluation by restraining domestic demand and lowering wages to improve competitiveness. The government would end up implementing measures of some 15 percent of GDP over the next three years—much more than initially envisaged, as the recession proved substantially deeper than expected at the outset. Measures included across-the-board cuts in salaries and bonuses for civil servants.

The program emphasized the need for social safety net protection to cushion the recession’s impact, with an adjuster allowing new safety net spending of up to 1 percent of GDP. Safety net measures, designed with the World Bank, included jobs programs for the unemployed, increases in guaranteed minimum income support, and coverage of health copayments for the poor.[2]

The program’s immediate task was to restore confidence in the financial system and the exchange rate to contain outflows of deposits and reserves. To this end, the government took full control of Parex Bank by increasing its stake to 85 percent and by installing new management in mid-December. In the event, the bank received government capital injections in March and September 2009, the EBRD provided it with loans and acquired a 25 percent stake in September 2009, and the bank was split into a good and bad bank in August 2010, with the former retaining the performing assets and carrying out all regular banking functions and the latter receiving the problem loans for workout. Financial sector reform under the program also involved a focused examination of the banking system and encouragement for recapitalization, monitoring of foreign banks to ensure that they maintained credit lines, and legal changes providing the authorities with better tools to resolve banks. Program funding was calibrated so as to be able to accommodate financial restructuring costs as high as 15–20 percent of GDP—much more than would eventually be needed, but signaling to markets and depositors that the program was well financed. The announcement of substantial assistance was followed by the actual disbursement of €0.6 billion from the IMF

[2] See First Review Letter of Intent, paragraph 14.

in late December and €1 billion from the European Union in early 2009, increasing confidence in the peg by substantially strengthening the outlook for reserves.

Implementing the program proved challenging, especially for the budget. In the program's first months, the economic slump in Latvia intensified as the world economy too fell into recession. The fiscal deficit rose sharply, well beyond program forecasts, and the government's initial program commitment to reduce it to 5 percent of GDP in 2009 became harder to deliver. Demonstrations and protests became more numerous, though largely without violence, and it was unclear whether the Latvian people could tolerate the coming severe recession. Unable to pass a supplementary budget that would include structural reforms to underpin the budget cuts agreed in December, only two months into the program, in February 2009, the government fell.

A new coalition government formed in March. Deepening recession and failure to implement the adjustment agreed to in December threatened to increase the deficit to around 15 percent of GDP unless measures were taken. Without the IMF/EU-supported program, the deficit could not be financed. The new government submitted a supplementary budget, but the first draft included only token measures that were clearly insufficient.

A revised supplementary budget for 2009 was finally passed on June 16, once local elections had been held and following consultations with social partners and with the president's involvement. The supplementary budget included 3.5 percent of GDP in consolidation measures for the remainder of the year (6.5 percent of GDP on a full-year basis).

While the authorities deserve considerable credit for delivering an adjustment of this magnitude, the last-minute rush to pass the budget meant there were many problems with its quality.[3] However, the authorities were not willing to amend the budget to address these issues, lest the agreement with social partners unravel. Given the sheer magnitude of the government's effort (and promises of further adjustment in the future), the European Commission quickly completed its first review of the program. Despite concerns with the quality of the adjustment, the IMF followed soon after.

Preparation and passage of the 2010 budget proved the next major challenge. After much wrangling, and helped both by the interventions of European Commissioner Joaquin Almunia and Swedish Finance Minister Anders Borg and by long negotiations with the IMF and the Commission teams, the government in the end delivered on its First Review Letter of Intent commitment to a further L500 million (4.2 percent of GDP) of adjustment. Increases in personal income tax, real estate tax, car tax, and excises were expected to raise 2.3 percent of GDP, with spending cuts providing the remainder.[4] However, the adjustment was partially unwound, first by December's Constitutional Court ruling reversing the

[3] These included reducing teacher salaries to close to minimum wage, excessive use of across-the-board spending cuts, tax increases that were regressive, and uniform cuts in pensions without protecting the poor (and which were later ruled unconstitutional). See Box 4 of the First Review Staff Report.
[4] Staff Report for the Second Review, paragraphs 25–30.

pension cuts passed in June (1 percent of GDP) and then, with the government falling into minority, by ad hoc spending increases and tax cuts throughout 2010, ahead of October's parliamentary elections.

ECONOMIC OUTCOMES IN 2010–11

Passage of the supplementary budget in June 2009 and completion of the first program review marked the turning point. Disbursements of €1.2 billion from the European Union and €0.2 billion from the IMF increased international reserves to €4.5 billion, or roughly 200 percent of base money, and more than 55 percent of broad money, by end-August 2009. As a result, confidence in the exchange rate gradually returned, overnight interbank interest rates fell from more than 30 percent in June 2009, when the exchange rate was under attack, to the low single digits, and the central bank's foreign exchange sales fell off. Deposit withdrawal restrictions on Parex Bank could largely be lifted in October 2009, as nonresident and resident depositors returned to the banking system.

Contagious currency devaluations and financial meltdown had been successfully averted. The exchange rate peg held, and currency boards elsewhere in emerging Europe also endured. Foreign banks stood by their local subsidiaries, recapitalizing them as needed. The banking crisis was largely contained to Parex Bank, and the fiscal cost of bank restructuring would turn out to be much lower than initially allowed for. Latvia's banking system returned to profitability in 2011. Large-scale international financial support had proved effective, even if it could not convince syndicated lenders to roll over their exposures initially, though only because the Latvian authorities used the time to deliver on substantial fiscal adjustment. The Latvian government returned to the Eurobond market in June 2011 with a US$500 million 10-year issue, the country's first international issue since 2008. In February 2012 a successful US$1 billion issuance followed.

The large precrisis current account deficit corrected much more swiftly than expected. Indeed, external surpluses were recorded in 2009 and 2010. While this reflected the exceptionally deep recession, it also meant that official financing—together with the restoration of confidence, the return of deposits, and the authorities' fiscal adjustment—proved larger than needed. Arresting a capital account crisis and bank run tends to require larger upfront international support packages to restore confidence. If successful in restoring confidence, then these amounts may not actually need to be drawn down, provided program implementation is strong. Accordingly, the Latvian authorities have treated official funding that became available with the fourth and fifth program reviews in May and December 2011 as precautionary. The program ended on December 22, 2011, with €4.1 billion drawn from the financing package of €7.5 billion.

Public finances are improving. Although fiscal policy during the boom had been procyclical, Latvia entered the crisis with public debt of only around 10 percent of GDP. Given this favorable starting point, and with strong fiscal consolidation measures to keep public finances under control, Latvia's fiscal solvency was never really an issue, despite high fiscal deficits in the crisis years. The 2010 deficit (ESA basis, including bank restructuring costs) fell to 8.2 percent of GDP (from 9.7 percent in 2009), below the 8.5 percent revised program target. A huge fiscal effort of some 15 percent of GDP over the program period is likely to have reduced the deficit to less than 4 percent of GDP in 2011. With the government determined to bring the deficit below the Maastricht threshold, euro entry is coming within reach and would mark a major success for the program. And despite having overseen a tough adjustment program, following elections in October 2010 and again in September 2011, Prime Minister Valdis Dombrovskis has kept his office, heading governments committed to implementing the program.

While the program delivered economic and financial stability, it could not prevent a severe recession. Output fell by 18 percent in 2009. The peak-to-trough decline came to a cumulative 25 percent—more than in any other country in emerging Europe. Unemployment increased to 20 percent and, despite the recession in Europe, outward migration increased too. With exchange rate depreciation ruled out, it was difficult to generate sufficient expenditure switching to offset the collapse in domestic demand. Though the output collapse was much worse than initial program projections, these developments also reflected the unanticipated world recession, the collapse in world trade, and the end of Latvia's real estate and financial sector bubble: precrisis output levels were not sustainable.

Latvia's economy has returned to growth. Output started to expand again at the end of 2009 on a quarter-over-quarter basis. The recovery was initially driven by exports, but domestic demand followed suit, with GDP growing by more than 5 percent in 2011.

The experience shows that internal devaluation can work, although it has its limits, even in Latvia where labor markets are considered relatively flexible. Between December 2008, when the program was launched, and December 2010, wages fell by around 8 percent and unit labor costs by much more (around 20 percent), reflecting the effect of labor shedding on productivity. However, prices fell only around 4 percent from the peak in the first quarter of 2009 to the trough in February 2010, and since then both wages and prices have started to increase despite the sizable output gap and high unemployment. Thus, while competitiveness has improved, there are limits to downward wage and (especially) price flexibility.

CHALLENGES AHEAD

The next challenges are to maintain Latvia's stabilization, boost growth, and reduce unemployment.

Macroeconomic stability would be best secured if Latvia could qualify for euro adoption—the exit strategy envisaged under the program. For a small open economy like Latvia, fixed exchange rates have numerous benefits. Euro adoption would not remove all vulnerabilities, but it would have the major advantages of removing currency risk, ending speculative attacks on the exchange rate, and ensuring sufficient international reserves so that the central bank (in this case, the ECB) could act as an effective lender of last resort. With strong fiscal, structural, and financial regulatory policies in place, joining the euro would also reduce the risk of recurrence of financial crisis.

Meeting the Maastricht criteria for euro adoption in the fiscal area will require a final push. The general government deficit needs to be lowered to no more than 3 percent of GDP on a sustainable basis. Much of the adjustment will need to come from spending: spending ratios have increased massively, in part because of the fall in GDP but primarily because government spending increased too rapidly during the precrisis years, on the erroneous assumption that rapid growth was permanent. Across-the-board cuts have been relatively simple to implement but may be difficult to sustain. Durable cuts depend on finding functions that are duplicated or unnecessary or which can be shifted to the private sector. The government's functional analysis working group has made suggestions (although savings are limited), as have IMF technical assistance missions and the World Bank's public expenditure review.

Political decisions to protect pensions have forced a disproportionate adjustment burden on other spending. Pensions make up roughly 20 percent of government spending and increased almost 30 percent between 2005 and 2008. Before the crisis, supplementary pensions, initially awarded only to poor pensioners, were extended to all; price indexation was supplemented with partial indexation to wage growth; and retirees received supernormal pension increases since under the notional defined contribution system their rates of return were linked to (rapid) wage growth, which proved unsustainable. As a result, from 2005 to 2010 pension spending rose from 6 percent to 10 percent of GDP. Although it would be difficult politically, it seems that a case could be made for finding savings in pensions to share the adjustment burden in a way that was fair and which protected the poor. Failure to do this meant that greater spending cuts had to be imposed elsewhere or that social contributions had to rise, which increases the labor tax wedge, raises unemployment, and encourages migration, further undermining the adjustment.

On the surface, tax increases are easier and more tempting to implement, but they do not solve the underlying problem, namely that during boom years a government may have grown ahead of the economy. In Latvia, tax increases in 2012 would also be inconsistent with the authorities' aim of meeting the Maastricht inflation criteria. However, introduction of a progressive personal income tax would have helped share the burden of fiscal adjustment, and increases in residential real estate taxes might have raised revenue in a less distortionary manner. These options remain available for the future.

Sustaining growth will depend on structural reforms and creating a business environment that encourages investment, since Latvia's fixed exchange rate regime prevents competitiveness gains through currency depreciation.[5] These reforms are difficult and will take time. But without growth, the European

[5] Staff Report for the 2010 Article IV Consultation, paragraphs 46–49.

Union's single labor market (and labor mobility facilitated by the Schengen zone) and the gap in living standards between Latvia and the rest of the European Union could lead to renewed emigration. Euro adoption could also help promote growth, by increasing confidence in the exchange rate, reducing interest rates, and encouraging credit growth. To prevent growth from leading to new current account deficits, the economy's structure needs to be redirected away from real estate, construction, and financial services and toward traded goods. This may require new skills and retraining. And boosting demand for Latvian tradable goods may require further improvements in competitiveness. Finally, given the risk that higher unemployment rates are likely to persist, strengthening the social safety net—in a way that does not penalize Latvians for taking job offers—will be an important challenge.

Latvia: Principal Economic and Financial Indicators, 2003–11

	2003	2004	2005	2006	2007	2008	2009	2010	2011
					Real Sector Indicators				
GDP (real growth in percent)	7.2	8.7	10.6	10.5	9.6	–3.3	–17.7	–0.3	5.5
Domestic demand (real growth in percent)	10.7	12.1	9.3	16.6	12.9	–9.1	–27.4	0.1	10.2
Net exports (real growth contribution in percent)	–4.5	–5.1	0.1	–8.9	–6.2	7.6	12.9	–0.2	–4.7
Exports of goods and services (real growth in percent)	5.2	9.4	20.2	6.5	10.0	2.0	–14.1	11.5	12.6
CPI (end-of-period change in percent)	3.5	7.4	7.1	6.8	14.0	10.4	–1.4	2.4	3.9
Employment (growth in percent)	2.0	0.7	1.6	4.4	2.7	0.1	–11.4	–3.6	3.3
Unemployment rate (percent)	10.7	10.6	8.8	7.0	6.2	7.8	17.3	19.0	15.6
					Public Finances				
Fiscal balance (percent of GDP)	–1.7	–1.2	–1.3	–0.5	0.6	–7.5	–7.8	–7.2	–3.4
Government revenue (percent of GDP)	32.9	33.9	35.3	36.2	36.3	35.6	36.2	36.2	35.9
Government expenditure (percent of GDP)	34.6	35.2	36.6	36.7	35.7	43.1	44.1	43.4	39.3
Government primary expenditure (percent of GDP)	33.8	34.4	36.0	36.1	35.3	42.8	42.9	42.0	37.9
Government primary expenditure (real growth in percent)	5.6	10.7	15.6	11.0	7.2	17.0	–17.4	–2.5	–4.8
Public debt (percent of GDP)	14.6	14.4	11.8	9.9	7.8	17.2	32.9	39.9	37.8
Of which foreign held	7.6	8.3	6.0	5.8	5.3	5.8	21.5	25.9	23.8
					External Sector				
Current account balance (percent of GDP)	–8.1	–12.9	–12.5	–22.6	–22.4	–13.2	8.7	3.0	–1.2
Net capital inflows (percent of GDP)[1]	8.2	14.9	16.8	30.3	23.9	9.4	–21.9	–6.2	–5.3
FDI	2.3	3.8	3.6	7.5	6.8	3.0	0.6	1.5	5.1
Portfolio	–2.0	1.6	–0.8	0.2	–2.4	1.1	0.7	–0.9	–2.3
Other investment	7.9	9.5	14.0	22.7	19.4	5.2	–23.2	–6.8	–8.1
Exports (percent of GDP)	41.8	43.6	47.0	44.2	41.6	42.3	43.3	53.4	58.3
Exports (€, growth in percent)	3.2	16.7	25.5	15.3	24.5	10.6	–16.4	20.3	22.5
Global export market share (basis points)	3.8	4.4	4.9	5.1	6.0	6.3	6.2	6.3	...
Remittances (percent of GDP)	0.01	0.01	0.01	0.01	0.01	0.01	0.01	0.00	0.00
Imports (percent of GDP)	54.4	59.5	62.2	66.5	62.2	56.2	44.4	54.3	61.6
Imports (€, growth in percent)	8.0	22.2	21.6	31.3	23.5	–1.7	–35.5	19.4	27.2
External debt (percent of GDP)	76.3	89.2	99.5	120.6	136.5	121.2	164.3	165.0	137.2
Gross international reserves (€ billions)	1.1	1.4	1.9	3.3	3.8	3.6	4.6	5.7	4.9
Gross international reserves (percent of GDP)	12.9	14.0	14.0	22.0	19.4	15.1	25.7	31.7	22.5
Reserve coverage (GIR in percent of short-term debt)	22.9	19.3	22.8	33.4	24.0	29.2	48.6	42.2	35.5

Latvia: Principal Economic and Financial Indicators, 2003–11 (*continued*)									
	2003	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**
					Monetary Sector				
Broad money (end of period, growth in percent)	21.1	27.0	38.9	37.5	12.6	–3.9	–1.9	9.8	1.5
Monetary base (end of period, growth in percent)	6.3	18.4	44.4	65.8	7.4	–15.2	–22.2	10.1	13.2
Private sector credit (end of period, percent of GDP)	41.3	51.7	69.2	88.5	89.5	98.4	109.2	103.7	86.1
Of which foreign currency denominated	22.3	30.9	48.1	68.2	77.6	87.5	100.8	95.8	77.2
Of which foreign currency indexed	...	...	...	...	...	...	...	...	...
Cross-border loans to nonbanks (Q4, percent of GDP)	4.3	5.3	6.1	8.6	15.3	14.4	18.5	15.2	10.8
Private sector credit (end of period, real growth in percent)	33.0	35.6	52.3	47.3	17.3	8.8	–8.6	–9.6	–11.1
					Financial Sector				
Assets (percent of GDP)	83.0	99.3	115.1	134.9	138.5	136.1	155.0	160.6	136.9
ROA (percent)	1.4	1.7	2.1	2.1	2.0	0.3	–3.5	–1.6	–0.9
ROE (percent)	...	...	27.1	25.6	24.3	4.6	–41.6	–20.4	–11.2
CAR (percent of risk-weighted assets)	11.7	11.7	10.1	10.2	11.1	11.8	14.6	14.6	17.4
NPLs (percent of total loans)	...	...	0.7	0.5	0.8	3.6	16.4	19.0	17.5
Loan-to-deposit ratio	...	...	...	1.2	1.3	1.6	1.6	1.2	1.1
Cross-border claims by foreign banks (all sectors, percent of GDP)	16.7	21.8	35.6	58.4	71.6	68.1	77.1	65.2	48.7
					Financial Markets				
Interest rates (end of period, one-year government bond, percent)	...	...	...	...	...	...	...	...	...
CDS spreads (sovereign, end of period, basis points)	...	...	...	7	138	833	551	265	365
EMBIG spread (sovereign, end of period, basis points)	...	...	...	...	...	...	...	...	...
Exchange rate (end of period, domestic currency/€)	0.67	0.70	0.70	0.70	0.70	0.71	0.71	0.71	0.70
NEER (index, 2003 = 100)	100.0	97.9	92.9	92.4	93.8	95.0	98.7	95.4	97.1
REER (CPI-based, 2003 = 100)	100.0	100.9	98.9	102.0	110.1	122.0	128.9	120.4	122.7
REER (ULC-based, 2003 = 100)	100.0	102.3	110.4	126.1	156.2	180.6	164.2	144.9	...
					Memorandum Items				
GDP (nominal, in billions of domestic currency)	6.4	7.4	9.1	11.1	14.7	16.1	13.1	12.7	14.2
GDP (nominal, in billions of €)	9.9	11.1	12.9	15.8	20.9	22.7	18.6	18.1	21.3

Source: IMF staff.

Note: CAR = capital adequacy ratio; CDS = credit default swap; CPI = consumer price index; EMBIG = Emerging Markets Bond Index Global; FDI = foreign direct investment; GIR = gross international reserves; NEER = nominal effective exchange rate; NPLs = nonperforming loans; REER = real effective exchange rate; ROA = return on assets; ROE = return on equity; ULC = unit labor cost.

[1] Financial and capital account balances excluding EU balance-of-payments support, use of IMF resources, and SDR allocations.

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CHAPTER 9

Belarus: A Tale of Missed Opportunities

Throughout the two decades following the breakup of the former Soviet Union, Belarus retained many elements of the central planning system. It reported rapid growth during 2000–08, as capacity utilization at state-owned enterprises increased with the reestablishment of economic linkages with Russia, as ample credit was allocated to investment, and as low-priced energy resources from Russia helped underpin the viability of enterprises and public finances alike. As exports slumped in the wake of the global financial crisis and Russia cut back energy subsidies, a looming balance of payments crisis was averted through a program supported by a $3.5 billion stand-by arrangement with the IMF (January 2009–March 2010). Growth slowed sharply but remained positive in 2009, and inflation was contained. However, significant policy loosening after the end of the program triggered a major currency crisis in 2011 which raged through much of the year.

BACKGROUND

Belarus enjoyed one of the highest living standards in the former Soviet Union. Belarus authorities prevented economic collapse after independence in 1991 by preserving and extensively supporting the system of state-owned enterprises. Their support included the supply of cheap credit from the state-owned banks and the National Bank of the Republic of Belarus (NBRB), resulting in high inflation. Subsequently, tighter monetary policy and liberalization efforts improved the macroeconomic environment. Following the exchange rate unification in 2000, the NBRB effectively started targeting the exchange rate with the U.S. dollar, and the de facto peg to the dollar was maintained until the end of 2008.

However, Belarus retained many elements of the central planning system, and as a result state involvement in the economy remained pervasive. The government still exercises strong control over production through a system of five-year and annual plans specifying quantitative targets at all levels of production and a system of directed credit delivering resources to "priority" sectors. The majority of industrial output still comes from large state-owned or state-controlled enterprises. State-owned banks account for three-quarters of banking assets. In agriculture, state land ownership and government-controlled collectives were preserved. The government retains extensive powers over price formation via state-owned suppliers and control of selected retail prices or profit margins.

The main authors of this chapter are Eliza Lis and Dmitriy Kovtun.

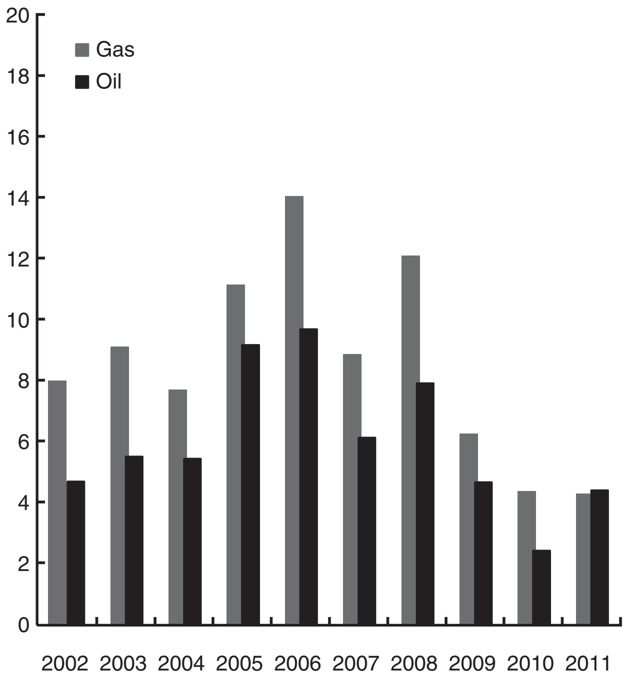

Figure 9.1 Belarus: Implicit Gain from Below-Market Prices for Crude Oil and Natural Gas (*Percent of GDP*)

Source: IMF staff calculations.

Energy subsidies from Russia provided critical support for the economy. Russia supplied Belarus with oil and natural gas at prices that were only a fraction of international or western European levels—an implicit subsidy corresponding to 10 percent of GDP for gas and 6.7 percent of GDP for oil per year during the 2001–08 period (Figure 9.1). Subsidies were largely passed on to companies and households in the form of low energy prices at no budgetary cost. This helped companies remain viable and expand. Refining imported Russian oil into petroleum products to be sold on western markets at international prices became a lucrative business. Belarus also earned significant transit fees from Russian energy exports to western and central Europe that passed through its pipeline system.

THE RUN-UP TO THE GLOBAL FINANCIAL CRISIS

The Belarus economy expanded at a rapid pace of 9½ percent a year during 2003–08, mainly on account of Russia's implicit energy subsidies and rising domestic demand later in that period. In the early years, the implicit energy subsidies increased as the prices of oil and gas imported by Belarus lagged behind rising international prices. This loosened the balance of payments constraint and increased opportunities for high levels of investment. However, when Russia embarked on a policy of gradual withdrawal of subsidies, domestic demand policies failed to adjust, stimulating high investment at the price of increasing the current account deficit. Russia doubled the price of the natural gas it exported to Belarus in 2007—a cut in the implicit subsidy equivalent to some 2½ percent of GDP—but double-digit domestic demand growth continued in 2007 and increased to nearly 18 percent in 2008. The high level of investment stimulated GDP growth: the investment-to-GDP ratio rose from some 23 percent of GDP in 2003 to 33 percent of GDP in 2008.

Loose financial policies and the reduction of energy subsidies under a fixed exchange rate regime led to external imbalances and currency overvaluation. The current account deficit widened to 6.7 and 8.2 percent of GDP in 2007 and 2008, respectively. Inflation, which peaked in August 2008 at 16 percent in year-over-year terms, and rapid wage growth eroded competitiveness under Belarus's fixed exchange rate regime. Lacking integration with international financial markets, Belarus relied mainly on loans from Russia and Russian foreign direct investment into its pipeline network to finance its external deficit. International reserves remained low.

On the eve of the global financial crisis, Belarus was therefore highly vulnerable. Its economy was overheated, and financing its large current account deficit was difficult. In September 2008, international reserves covered 1.6 months of imports of goods and services.

IMPACT OF THE GLOBAL FINANCIAL CRISIS

When the global financial crisis intensified in the fall of 2008, Belarus was faced with a collapse of its exports. Its main trading partner, Russia, fell into deep recession. Moreover, with the depreciation of the Russian ruble and the Belarusian ruble pegged to the U.S. dollar, the real exchange rate appreciated substantially. Export volumes declined by 15 percent in year-over-year terms in the fourth quarter of 2008 and by close to 50 percent in the first quarter of 2009.

Although the crisis was transmitted to Belarus mainly through the trade account, Russia's reduced willingness to provide external financing also played a role. Unlike most of emerging Europe, Belarus had not relied heavily on capital inflows from the west and was therefore not directly affected when western liquidity dried up. However, financing from Russia was on a declining path: Belarus received the equivalent of US$1.5 billion in 2007, US$1 billion in 2008, and only US$0.5 billion in 2009.

Over the course of 2009, Belarus was hit by further adverse developments. The prices of its major commodities exports—refined oil and phosphates—fell sharply, causing a worsening of the terms of trade by 9 percent. In December 2009 Russia announced that it intended to impose an export duty on oil imported by Belarus for refining and re-export, implying a worsening of the oil trade balance by the equivalent of US$2 billion (about 4 percent of GDP).

POLICY RESPONSE

Faced with an acute shortfall in external financing, Belarus approached the IMF in the fall of 2008 for a program to help it adjust to the external shocks and redress its pressing vulnerabilities. A 15-month stand-by arrangement was approved in January 2009—the first arrangement for Belarus with the IMF, apart from a short-lived program in 1995. The 2009 program was seen as setting the stage for further reforms over the medium term, with a successor program being considered from the outset. However, a successor program was not agreed upon. The major planks of the stand-by arrangement were these:

- *Exchange rate adjustment.* Belarus devalued its ruble by 20 percent against the U.S. dollar and introduced an exchange rate band of ±5 percent centered on a basket of U.S. dollars, euros, and the Russian ruble. In response to a further deterioration of the external environment, the band was widened to ±10 percent in May 2009 and recentered at end-2009. After the devaluation, the ruble gradually depreciated by 10 percent against the basket of currencies during the program period.
- *Macroeconomic tightening.* Exchange rate realignment was supported by tight domestic demand policies. The government committed to a balanced budget. A government wage increase of 20 percent, granted just before the end of 2008, was rescinded. The wage freeze was subsequently extended. Other fiscal measures included a cut in traditionally high public investment, various other expenditure reductions, and an increase in the value-added tax. Overall, fiscal measures amounted to about 3 percent of GDP. The government also agreed to eliminate the practice of using government deposits with commercial banks to finance "lending under government programs," a practice that had been widely used for supplying resources to priority sectors through presidential decrees and government resolutions. In August 2009, the government committed to limit such lending, which at that time was financed by credit at below-market rates from the NBRB.
- *Structural reforms to reduce financial sector risks and promote transition.* The legal and institutional framework for privatization was improved by amending the Privatization Law and passing a decree on establishing the National Investment and Privatization Agency (NIPA). An enabling business environment and private sector development was facilitated by a new Presidential Directive ("On development of entrepreneurial initiative and promotion of business activities in the Republic of Belarus"). Advances in price liberalization were made by eliminating the right to introduce mandatory ceilings on price increases, reducing the number of goods and services subject to price regulation, and repealing mandatory justification of price increases. The program also envisaged creation of a Special Financial Agency—eventually to become a development bank—to remove "lending under government programs" from the banking system, but the development bank is still being set up.

- *Large up-front financing from the IMF to boost reserves and avoid excessive contraction.* About one-third of the US$2.5 billion stand-by arrangement was made available upon program approval. In June 2009, in response to the worse-than-projected fall in demand for Belarus's exports, the amount of IMF financing was increased to US$3.5 billion.

ECONOMIC OUTCOMES IN 2009–11

In 2009, real economic activity held up relatively well. Belarus avoided an outright contraction in output except for a few months in early 2009. For the year as a whole, GDP grew by 0.2 percent, followed by a very strong expansion of 7.7 percent in 2010. Official registered unemployment remained low, as state-controlled firms retained workers and the work week was shortened. Twelve-month inflation eased to around 10 percent, despite the devaluation and hikes in administered prices for utilities. This outcome owed much to the fall of economic activity below potential and to the tightening of policies under the program.

However, external adjustment was limited. While the program worked largely as intended on the fiscal and exchange rate fronts, credit growth was only belatedly and partially brought under control (Figure 9.2). Imports fell, but not enough to offset the loss of export earnings, which suffered due to the additional

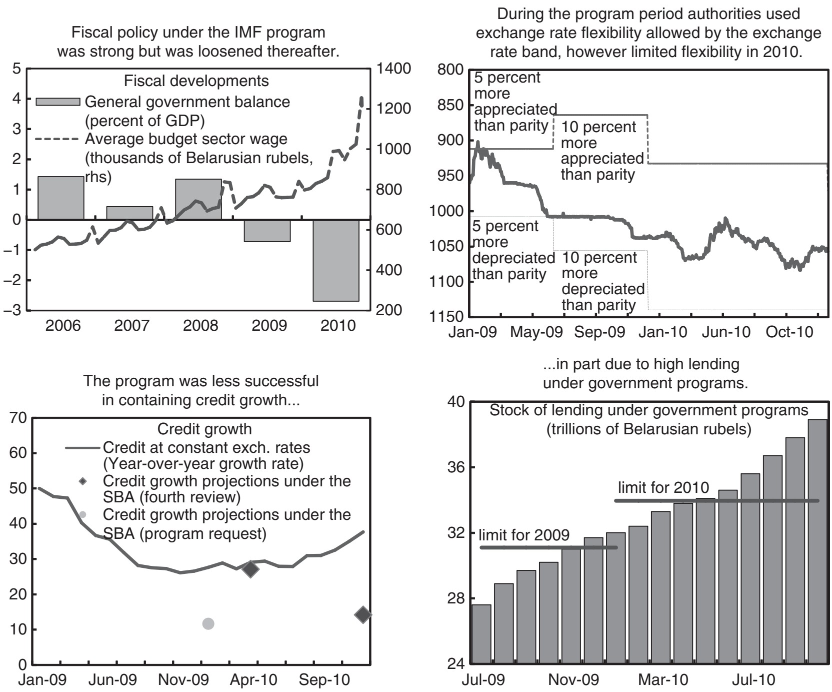

Figure 9.2 Belarus: IMF-Supported Program and Beyond

Sources: Belarusian authorities; and IMF staff calculations.
Note: SBA = stand-by arrangement.

adverse shocks during 2009. Consequently, the current account deficit widened to 12½ percent of GDP in 2009.

When the program ended in March 2010, the government quickly loosened macroeconomic policies instead of proceeding with a successor adjustment program to deepen reform. In the run-up to the presidential election of December 2010, emphasis was placed on support for domestic demand and economic activity in an effort to deliver the macroeconomic objectives set out in the annual plan for 2010. Credit growth accelerated to nearly 40 percent toward end-2010. The "first grade wage," which anchors the wage system in the public sector, was increased by 46 percent between March and December 2010. Fiscal deficit targets for both 2010 and 2011 were loosened to accommodate the wage increases. While 12-month inflation fell to a single-digit level at the end of 2010, it started to pick up again rapidly in the spring of 2011.

Expansionary policies aggravated external vulnerabilities further. Imports rebounded and the current account deficit widened to 15 percent of GDP in 2010. Initially, Belarus was successful in mobilizing external financing. With economic activity seeming to be only temporarily dented by the crisis, Belarus won the confidence of markets and managed to make a debut on the Eurobond market with a US$600 million issue in July 2010, followed by a US$400 million placement in August and a US$800 million placement in January 2011. Russia's decision of December 2010 to restore some of its oil subsidies offered the prospect of an improvement in the oil balance in 2011.

External vulnerabilities came to a head in March 2011, and Belarus went into a foreign exchange crisis. The ever larger current account deficit in the first quarter of 2011 swamped available foreign financing. As expectations of a renewed depreciation took hold, dollarization intensified, putting further pressure on international reserves. A widening of the exchange rate band, hikes of policy interest rates, and administrative measures proved insufficient to arrest the momentum. After reserves had fallen by a quarter to less than one month of imports, the NBRB suspended its foreign exchange intervention and a parallel "street" foreign exchange market emerged. In a failed attempt to unify the exchange rates, the authorities devalued the official exchange rate by 35 percent against the U.S. dollar on May 24. This did not solve the problem, however, as the authorities wished to maintain the fixed exchange rate without intervention. The rate on the street market depreciated rapidly during the summer. With insufficient monetary tightening, inflation surged to triple-digit levels in late 2011. GDP growth, which had been in the double digits in the first half of the year, slowed to 5.3 percent for the year.

The economy began to stabilize only in late 2011 after the authorities undertook necessary stabilization measures. The NBRB unified the exchange rate in October and moved to a flexible exchange rate regime, committing to use intervention sparingly and only for limiting excessive short-term volatility. Monetary policy has been significantly strengthened: the policy rates have been raised and liquidity tightened. Improved relations with Russia helped as well: a new gas contract with Russia nearly halved import prices for natural gas (a benefit of some

5 percent of GDP for 2012) and significant privatization proceeds from selling the government's remaining 50 percent stake in Beltransgas as well as additional financing from Russia and the EurAsEC's Anti-Crisis Fund boosted international reserves to nearly two months of imports of goods and services at the end of 2011.

In retrospect, the latest crisis was the result of missed opportunities. At the conclusion of the IMF-supported program in March 2010, the path needed for adjustment to work was clear. Maintaining tight domestic demand policies, using the flexibility available to the NBRB under the exchange rate band, and accelerating structural reforms would have paved the way to sustainable growth. Instead, the Belarus authorities chose to spur domestic demand by increasing credit growth and raising wages paid by budgetary institutions and preferred to maintain a de facto exchange rate peg against the U.S. dollar. Only recently have the authorities begun to rectify the imbalances by tightening monetary policy and liberalizing the exchange rate.

CHALLENGES AHEAD

Solidifying Belarus's nascent stabilization requires strong policies—the authorities need to implement tight fiscal and monetary policies and tight wage policy while maintaining the flexible exchange rate regime. The lessons from the recent crises suggest that the best insurance against macroeconomic instability is a coherent macroeconomic framework with realistic targets for economic growth and real wages, underpinned by ambitious fiscal adjustment measures, strong monetary policy (including tight control over lending under government programs), and exchange rate flexibility.

More broadly, Belarus needs to adjust its economy to the new conditions. It is difficult to see how a rigid state-controlled system can underwrite sustained improvements of living standards over the longer run, especially if the economy is to overcome its dependence on energy subsidies from Russia. The 2008/09 crisis and the subsequently intensified dialogue with international financial institutions prompted the authorities to accelerate economic liberalization in many areas, including fiscal management, price formation, and financial system reform. However, several reforms were slowed down or even reversed afterwards. The authorities should embark on a course of strong structural reforms and take the opportunity to put the economy on a sustainable development path.

Belarus: Principal Economic and Financial Indicators, 2003–11

	2003	2004	2005	2006	2007	2008	2009	2010	2011
Real Sector Indicators									
GDP (real growth in percent)	7.0	11.4	9.4	10.0	8.6	10.2	0.2	7.7	5.3
Domestic demand (real growth in percent)	8.8	11.4	10.5	15.1	11.6	17.8	–1.1	11.2	2.9
Net exports (real growth contribution in percent)	3.3	7.3	–13.5	–7.9	–1.3	–9.2	1.3	–3.7	3.8
Exports of goods and services (real growth in percent)	10.9	15.3	–15.5	8.2	6.7	1.9	–9.0	7.7	28.4
CPI (end-of-period change in percent)	25.4	14.4	7.9	6.6	12.1	13.3	10.1	9.9	108.7
Employment (growth in percent)	–2.6	0.7	4.0	–4.0	2.0	5.9	–4.1	5.8	–0.5
Unemployment rate (percent)	3.1	1.9	1.5	1.2	1.0	0.8	0.9	0.7	0.6
Public Finances									
Fiscal balance (percent of GDP)	–1.0	0.0	–0.7	1.4	0.4	1.3	–0.7	–1.8	3.1
Government revenue (percent of GDP)	45.9	46.9	47.4	49.1	49.5	50.6	45.7	41.6	42.0
Government expenditure (percent of GDP)	46.0	46.3	47.2	47.4	47.2	47.2	46.1	43.4	38.9
Government primary expenditure (percent of GDP)	45.6	45.8	46.8	47.0	46.8	46.7	45.3	42.7	37.3
Government primary expenditure (real growth in percent)	13.4	12.1	11.9	10.4	8.1	10.0	–2.8	1.7	–8.1
Public debt (percent of GDP)	...	9.7	8.4	13.4	18.3	21.7	34.9	41.0	50.6
Of which foreign held	1.8	1.9	1.9	1.6	4.5	5.9	10.0	10.9	...
External Sector									
Current account balance (percent of GDP)	–2.4	–5.3	1.4	–3.9	–6.7	–8.2	–12.6	–15.0	–10.5
Net capital inflows (percent of GDP)[1]	2.2	5.0	–0.1	4.6	11.6	6.8	9.6	11.0	13.4
FDI	1.0	0.7	1.0	0.9	4.0	3.5	3.6	2.4	7.1
Portfolio	0.0	0.3	–0.1	–0.1	–0.1	0.0	0.0	2.1	1.5
Other investment	1.2	4.1	–1.0	3.7	7.8	3.3	5.9	6.4	4.7
Exports (percent of GDP)	64.9	69.1	60.2	60.2	61.0	61.0	50.5	54.2	84.1
Exports (US$, growth in percent)	24.4	35.5	15.9	22.3	24.2	34.2	–32.9	20.3	56.1
Global export market share (basis points)	13.2	15.1	15.4	16.4	17.5	20.3	17.2	16.9	...
Remittances (percent of GDP)	...	...	...	...	...	...	...	...	...
Imports (percent of GDP)	68.7	75.6	59.1	64.3	67.2	68.6	61.8	67.7	87.1
Imports (US$, growth in percent)	25.0	40.4	3.8	33.2	28.0	37.0	–27.0	22.8	29.3
External debt (percent of GDP)	21.8	20.2	15.8	17.4	26.5	25.0	45.6	51.1	61.1
Gross international reserves (US$ billions)	0.5	0.8	1.3	1.4	4.2	3.1	5.7	5.0	7.9
Gross international reserves (percent of GDP)	2.8	3.4	4.3	3.7	9.2	5.0	11.5	9.1	14.4
Reserve coverage (GIR in percent of short-term debt)[2]	20.2	22.0	39.3	31.6	56.8	40.4	63.2	42.0	57.0

Belarus: Principal Economic and Financial Indicators, 2003–11 (*continued*)

	2003	2004	2005	2006	2007	2008	2009	2010	2011
Monetary Sector									
Broad money (end of period, growth in percent)	54.3	50.0	42.2	39.3	40.0	26.3	23.1	31.9	121.2
Monetary base (end of period, growth in percent)	51.1	41.9	73.7	19.8	38.4	11.7	–11.5	49.5	84.1
Private sector credit (end of period, percent of GDP)	11.7	14.1	15.5	19.5	23.7	27.2	35.3	42.3	41.5
Of which foreign currency denominated	5.3	6.0	5.6	5.9	8.6	8.4	10.1	8.7	15.7
Of which foreign currency indexed	...	...	...	...	...	...	...	...	...
Cross-border loans to nonbanks (Q4, percent of GDP)	0.6	0.8	0.9	1.4	2.0	1.7	1.9	1.9	0.8
Private sector credit (end of period, real growth in percent)	44.5	41.3	34.6	43.9	32.9	35.6	24.9	30.4	–21.2
Financial Sector									
Assets (percent of GDP)	24.3	27.0	29.1	34.4	40.6	46.0	56.7	73.8	90.0
ROA (percent)	0.0	1.5	1.2	1.7	1.7	1.4	1.4	1.7	1.7
ROE (percent)	...	7.8	6.8	9.6	10.7	9.6	8.9	11.8	15.5
CAR (percent of risk-weighted assets)	0.0	25.2	22.7	24.4	19.3	21.8	19.8	20.5	24.7
NPLs (percent of total loans)	...	4.3	3.1	2.8	1.9	1.7	4.2	3.5	4.2
Loan-to-deposit ratio	0.9	1.2	1.2	1.4	1.4	1.7	1.9	2.1	...
Cross-border claims by foreign banks (all sectors, percent of GDP)	2.8	2.7	2.4	3.8	5.7	5.2	5.2	6.3	5.2
Financial Markets									
Interest rates (end of period, one-year government bond, percent)	...	...	...	...	...	...	...	...	...
CDS spreads (sovereign, end of period, basis points)	...	...	...	...	...	...	...	...	...
EMBIG spread (sovereign, end of period, basis points)	...	...	...	...	...	...	...	...	...
Exchange rate (end of period, domestic currency/US$)	2,156	2,170	2,152	2,140	2,150	2,200	2,863	3,000	8,350
NEER (index, 2003 = 100)	100.0	88.9	87.4	85.6	80.4	77.7	69.8	64.4	42.8
REER (CPI-based, 2003 = 100)	100.0	98.0	98.4	97.5	93.7	95.2	90.9	86.3	76.2
REER (ULC-based, 2003 = 100)	...	...	...	...	...	...	...	...	...
Memorandum Items									
GDP (nominal, in billions of domestic currency)	36,565	49,072	65,067	79,267	97,165	129,791	137,442	164,476	274,282
GDP (nominal, in billions of US$)	17.8	22.7	30.2	37.0	45.3	60.8	49.2	55.2	55.5

Source: IMF staff.

Note: CAR = capital adequacy ratio; CDS = credit default swap; CPI = consumer price index; EMBIG = Emerging Markets Bond Index Global; FDI = foreign direct investment; GIR = gross international reserves; NEER = nominal effective exchange rate; NPLs = nonperforming loans; REER = real effective exchange rate; ROA = return on assets; ROE = return on equity; ULC = unit labor cost.

[1] Financial and capital account balances excluding EU balance-of-payments support, use of IMF resources, and SDR allocations.

[2] Short-term debt at original maturity.

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CHAPTER 10

Serbia: Facing Challenges beyond Crisis Management

The growth of the Serbian economy before the global financial crisis was respectable, but external vulnerabilities were allowed to proliferate. When the crisis unfolded, the authorities quickly approached the IMF. A stand-by arrangement and a bail-in agreement with foreign banks helped stave off financial instability. Large, front-loaded fiscal adjustment created room for automatic fiscal stabilizers to operate through the remainder of the crisis period, and a significant real depreciation restored external cost competitiveness. These successes notwithstanding, the crisis exposed deep flaws in Serbia's consumption-based growth model. Politically painful structural reforms will be needed to shift to a more sustainable growth model that keeps wages competitive while raising savings and exports.

BACKGROUND

Serbia has had an unhappy transition experience. In 1990, before eastern Europe's transition began in earnest, Serbia was relatively rich and export oriented. However, by 2000, Serbia's per capita income trailed far behind that of its peers, and the income gap has remained large since then (Figure 10.1). This reflects the many setbacks in the context of the violent disintegration of Yugoslavia, including the Bosnia-Herzegovina and Kosovo conflicts. Under the circumstances, it took longer in Serbia than elsewhere to establish macroeconomic stability. Fundamental reforms, such as price and trade liberalization, fiscal overhaul, and reform of the banking system, have been introduced only since 2000.

Related to this transition experience, Serbia was saddled with three external sector handicaps:

- *A large external deficit*. Income expectations and consumption habits of the population remained conditioned by unrealistic memories of past high incomes and consumption standards. Reflecting this, gross domestic savings rates during the run-up to the crisis were close to zero. But large capital inflows, intermediated by mostly foreign-owned banks, easily bridged the large external gap.
- *An uncompetitive export sector*. In 1990, Serbia's export-to-GDP ratio was about 70 percent. In the early 2000s, the ratio had shrunk to a trough of some 20 percent. A large public enterprise sector and a difficult business climate both stymied formal sector growth, an unfavorable setting for

The main author of this chapter is Albert Jaeger.

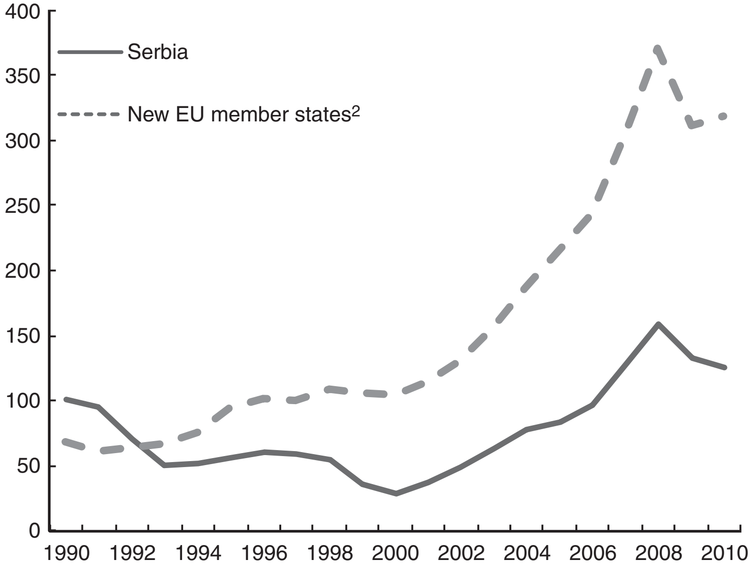

Figure 10.1 Serbia and New EU Member States: Per Capita Income during Transition[1] (*Serbia 1990 = 100*)

Sources: UN statistics; and IMF staff calculations.
[1] Gross national income per capita in current U.S. dollars.
[2] Weighted average of Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, and Slovenia.

exporters. Excessive wage settlements relative to labor productivity growth undermined external cost competitiveness.

- *A lack of trust in the domestic currency*. Fiscal dominance led to bouts of hyperinflation in the 1990s, resulting in entrenched dominance of first the Deutsche Mark, and then the euro. While banks were largely hedged against currency risk, corporates carried large unhedged foreign exchange positions on their balance sheets.

THE RUN-UP TO THE GLOBAL FINANCIAL CRISIS

In the precrisis period, Serbia's economy performed respectably. During 2003–08, real GDP expanded at an annual average rate of 5 percent, on the back of economic reforms and a supportive external environment. On the macroeconomic front, public finances recorded relatively small deficits or small surpluses, although public expenditures remained high at about 45 percent of GDP and the 10-party coalition government that took office in July 2008 made fiscal promises worth an estimated 5 percent of GDP during its election campaign. Progress was made with disinflation, and from 2006 the focus of monetary policy shifted from the exchange rate to inflation, culminating in the adoption of formal inflation targeting in 2008. Real private credit grew briskly. However, the initial level of credit penetration was low. And thanks to strict prudential regulation, bank capitalization was strong and banks' foreign liabilities were mainly long term.

Serbia ran large current account deficits throughout the precrisis period, in the range of 7 to 22 percent of GDP. These external imbalances were structural in nature, reflecting income and consumption habits that were no longer realistic. They escalated toward the end of the 2005–08 period due to falling remittances, partly reflecting measurement problems as the reintermediation of mattress money into the banking system slowed after 2006. In any event, a tide of capital inflows, intermediated by the largely foreign-owned banking system, smoothly financed the large current account deficit and allowed the buildup of a comfortable international reserves buffer. Unlike in most other countries in emerging Europe, however, widening external deficits were not the result of a domestic demand boom. In Serbia, real domestic demand grew by 5.2 percent annually—not significantly faster than real GDP.

IMPACT OF THE GLOBAL FINANCIAL CRISIS

In late 2008, the global financial crisis rapidly spilled over to Serbia through both financial and trade channels. Sovereign bond spreads soared, large capital inflows suddenly gave way to small outflows during October 2008–January 2009, and households withdrew some 15 percent of their foreign currency deposits from the banking system during September–November 2008. The Serbian dinar lost some 20 percent of its value against the euro, despite heavy foreign exchange intervention by the central bank in its defense. On the trade side, exports and imports plunged as both foreign and domestic demand collapsed.

POLICY RESPONSES

Serbian policymakers and the public were unusually open to external support and advice. High political fragmentation and the unhappy transition experience meant the public had limited trust in local political solutions to the crisis. Close involvement by international financial institutions to solve the crisis therefore carried little stigma and was generally welcomed, or at least tolerated, across the political spectrum.

Serbia was accordingly quick to approach the IMF, mainly to facilitate a coordinated policy response. The authorities were not so much concerned about risks to external financing or financial stability, in light of Serbia's strong international reserve position, the absence of significant short-term external exposures, and strong bank capitalization. The worry was more about the capacity to mount coordinated and credible policy responses in an economic environment that had suddenly turned sour. In early October 2008, they requested a low-access, precautionary stand-by arrangement (SBA), partly to distinguish Serbia's approach from the "emergency SBAs" negotiated at the time with Hungary, Latvia, and Ukraine. After protracted negotiations on a partial rollback of the government's precrisis fiscal promises, a €0.4 billion SBA was approved by the IMF Board in January 2009. As the global crisis deepened, it was augmented to €3 billion in May 2009.

The strategy adopted under the SBA combined external financing from the international financial institutions with fiscal adjustment and a bail-in of foreign banks. Fiscal tightening was to facilitate external rebalancing, restore sustainability to public finances, and observe constraints on the financing of budget deficits. An agreement with foreign parent banks was to ensure sufficient liquidity and capitalization of their Serbian affiliates, thereby underwriting financial stability and containing external financing needs. Any remaining external financing gap was to be closed by disbursements from the IMF, other international financial institutions, and the European Union.

Regarding fiscal policy, the main challenge was to stabilize public finances, starting from an unfavorable precrisis position. Serbia's history of fiscal dominance put a high premium on stabilizing public finances early and credibly. But the precrisis fiscal position was a considerable deficit, once cyclical effects were stripped away. Moreover, the forthcoming shifts in the Serbian economy to a more viable growth model were projected to result in a drop of the tax-to-GDP ratio of an estimated 4 percent of GDP. Tax revenues would suffer through three channels as excessive domestic demand and competitiveness problems were corrected: (i) lower-taxed domestic savings would rise sharply at the expense of higher-taxed consumption; (ii) lower-taxed profits would rise at the expense of higher-taxed wages; and (iii) tax collection points would shift from relatively unproblematic collection points (for example, imports) to more difficult collection points (for example, domestic production of goods and services).

To meet these challenges, it was agreed that a large, front-loaded fiscal adjustment was required. The fear was that the slump in activity could prove deeper than projected, triggering a vicious circle of disappointing growth and procyclical fiscal tightening. A large fiscal adjustment package of 3½ percent of GDP was agreed upon in May 2009, with most measures comprising nominal freezes or across-the-board discretionary spending cuts. The understanding was that this strong fiscal effort should allow automatic fiscal stabilizers to operate later in the program if growth continued to disappoint, as indeed would be the case.

The ad hoc nature of the fiscal adjustment triggered a contentious debate on the medium-term fiscal strategy. It was agreed that the stopgap measures would need to be replaced over time by more durable and higher-quality spending or revenue measures. The IMF team advocated an early value-added tax hike combined with back-loaded structural spending reforms. The government's strongly preferred strategy was to eschew significant tax increases, and implement on an accelerated schedule a package of structural spending reforms covering public employment, education, health care, and pensions. In the end, the authorities' preferred approach was adopted, although the IMF team was skeptical as to whether structural spending reforms would materialize on the agreed schedule.

To safeguard the envisaged medium-term deficit reduction, given the authorities' risky adjustment strategy, a fiscal responsibility law was introduced. The lynchpin of the new fiscal framework is a numerical fiscal balance rule, originally proposed by Marin (2002) in the context of the European Union's Stability and Growth Pact. In Serbia, the rule targets a medium-term deficit of 1 percent of GDP, while allowing automatic fiscal stabilizers to operate in response to temporary output growth fluctuations (the rule does not require estimates of the output gap). The fiscal balance rule is supplemented by a temporary "golden threshold rule," whereby until 2015 public investment in excess of 5 percent of GDP would not count toward the targeted fiscal deficit to accommodate the possibility of high-cost, lumpy public investment projects.

Designing a fiscally affordable, economically efficient, and socially acceptable pension system remains one of Serbia's key policy conundrums. Although a pensioner party controlled the balance of votes in the 10-party coalition government, pension reform was high on the SBA agenda. Serbia's pension conundrum has three ingredients: the population is aging rapidly; social expectations of what amounts to a fair pension are high; and the pension contribution base—formal employment—is low. Following a nominal pension freeze during 2009–10, it was agreed to index pensions until the 2012 elections—in tandem with public wages—to the consumer price index plus one-half of real GDP growth in the past year. While there was also agreement on a package of parametric reforms to gradually raise effective retirement ages, further rounds of parametric reforms will almost surely be needed.

Regarding the bail-in of foreign banks, obtaining assurances from them to remain engaged was an early priority under the SBA. Serbia's main financial Achilles' heel was high corporate debt to foreign banks. Experience with private sector involvement in earlier IMF-supported programs suggested that the conditions for a coordinated rollover in Serbia should be propitious: there were only a small number of foreign banks to coordinate; no sovereign debt rollover was involved; and there were no interbank credit lines. At the same time, the incentives for banks to voluntarily agree to a coordinated rollover seemed fairly compelling: failure to do so could have triggered a deleveraging spiral, potentially ending in a currency-cum-banking crisis, leaving the foreign banks as a group much worse off than the coordinated outcome.

A formal bail-in agreement under the SBA was reached in March 2009. Under the European Bank Coordination Initiative arm of the Vienna Initiative, foreign banks pledged to maintain their exposures to Serbia in March 2009 and formal commitment letters to this effect were received by April 2009 from the 10 largest foreign banks (see also Box 5.2). The National Bank of Serbia was able to monitor the exposure commitment closely based on daily bank-by-bank reports.

ECONOMIC OUTCOMES IN 2009–11

Serbia managed to contain the recession in 2009 and returned to growth in 2010. At 3½ percent, the 2009 contraction was smaller than on average in emerging Europe. On the back of exports, the economy returned to growth in the third quarter of 2009 and recorded an expansion of 1 percent for the year 2010. Growth picked up modestly in 2011 to some 2 percent.

Balance-of-payments developments were much more favorable than expected. Not only did the current account balance improve much more than expected, but capital inflows were also substantially higher (Table 10.1). As a result, foreign exchange reserve accumulation was significantly larger than targeted, and the authorities made only two full drawings from the IMF after completing the first and second program reviews. But since EU official financing was conditional on a disbursing IMF-supported program, the authorities continued to make small, largely symbolic drawings.

The exchange rate stabilized soon after program approval but came under renewed pressure in the context of the crisis in Greece. Following the depreciation prior to the program, which helped restore external cost competitiveness, the exchange rate was broadly stable during the remainder of 2009. However, new exchange rate pressure built in the context of the crisis in Greece, leading to another depreciation of around 10 percent against the euro. This also gave rise to a flare-up of inflation. The National Bank of Serbia raised interest rates substantially in response.

Banks largely abided by their commitments to exposure maintenance. The high monitoring capacity of the National Bank of Serbia allowed early detection of free-rider behavior among individual banks. This helped ensure a high degree of compliance, and during 2009–10 only one foreign bank was found to be consistently in breach of its rollover commitments. The exposure floor of banks was lowered in April 2010 as the intense phase of the crisis had long passed and demand for credit remained low.

When the SBA with Serbia expired in April 2011, much had been achieved, but the transition to a more sustainable growth model remained incomplete and fragile. Serbia was still reliant on sizable capital inflows that could dry up quickly in an external downside scenario.

TABLE 10.1

Serbia: External Financing 2009–10
(*Cumulative, billions of euros*)

	Program	Actual	Difference
Financing requirement	16.3	12.7	–3.6
Current account deficit	7.1	4.1	–3.0
Amortization	9.2	8.6	–0.6
Available financing	16.2	13.5	–2.7
Private capital inflows	12.7	11.8	–0.9
Official financing	3.5	1.6	–1.9
IMF	3.0	1.5	–1.5
World Bank	0.2	0.2	–0.1
European Union	0.3	0.0	–0.3
Use of foreign exchange reserves[1]	0.1	–0.7	–0.8

Sources: National Bank of Serbia; and IMF staff estimates.
[1] Negative amounts signal net accumulation.

Soon after the program ended, the new fiscal framework was challenged by a populist fiscal decentralization law that transferred significant tax revenue to local governments. Long-standing structural bottlenecks, such as uncertain property rights, an oversized public sector, and a dysfunctional labor market, had not been sufficiently addressed. Against this background a successor 18-month precautionary SBA was approved in September 2011 to insure against external risks and to provide a policy anchor.

CHALLENGES AHEAD

The slow pace of structural fiscal reforms under the SBA was a disappointment. The government's preferred medium-term fiscal strategy relied on structural cuts in recurrent spending, but little headway has been made under the SBA to reduce public employment through reforms in health care, education, and public administration. The proximate reasons for this slow progress remain unclear: some argue that it is difficult to implement structural reforms in the middle of a crisis, some note that the skilled personnel to spearhead such reforms are not available at present levels of public sector pay, while others argue that implementing structural reforms is impossible given Serbia's high political fragmentation.

Progress on growth-oriented structural reforms was similarly slow. The crisis could have been used as an opportunity for far-reaching progrowth reforms. But restructuring the still large and inefficient public enterprise sector has been hampered by the heavy influence of political parties. Attempts to improve the business climate often faltered because of coordination problems among ministries controlled by different members of the governing coalition. And special interests opposed or stymied the upgrading of legal frameworks, such as in the areas of competition and procurement.

Nevertheless, the main lesson Serbia will likely take away from the crisis experience is a consensus on the need to shift to a more sustainable growth model. The main structural policy prescriptions to achieve more-balanced growth are well known, and Slovakia has often been advertised as a real-world example of a successful transition effort from a difficult initial starting point (IMF, 2010d). The much less favorable alternative will be to return to the precrisis growth paradigm of consumption-based growth, which would almost certainly lead to the reemergence of high external stability risks.

Serbia: Principal Economic and Financial Indicators, 2003–11

	2003	2004	2005	2006	2007	2008	2009	2010	2011
					Real Sector Indicators				
GDP (real growth in percent)	2.5	9.3	5.4	3.6	5.4	3.8	–3.5	1.0	1.8
Domestic demand (real growth in percent)	1.7	14.4	–3.9	4.8	10.2	4.8	–8.9	–2.0	1.5
Net exports (real growth contribution in percent)	0.5	–7.5	10.3	–2.4	–8.2	–2.2	8.6	3.7	0.0
Exports of goods and services (real growth in percent)	31.6	5.7	14.4	4.9	17.2	4.2	–15.2	19.1	5.3
CPI (end-of-period change in percent)	4.1	14.2	15.8	5.7	11.0	8.6	6.6	10.3	7.0
Employment (growth in percent)	6.6	–2.6	–0.8	–3.4	–2.1	9.3	–9.9	–5.2	–2.4
Unemployment rate (percent)	14.6	19.5	21.8	21.6	18.8	14.7	17.4	20.1	23.7
					Public Finances				
Fiscal balance (percent of GDP)	–2.9	0.1	0.8	–1.6	–1.9	–2.7	–4.5	–4.6	–4.8
Government revenue (percent of GDP)	42.5	43.0	43.0	44.2	44.0	42.8	42.3	41.0	39.4
Government expenditure (percent of GDP)	45.4	42.9	41.9	45.2	45.3	44.8	46.0	44.6	43.5
Government primary expenditure (percent of GDP)	44.4	41.6	40.4	43.7	44.6	44.2	45.2	43.5	42.2
Government primary expenditure (real growth in percent)	1.4	2.5	2.3	12.1	7.4	2.9	–1.3	–2.9	–1.2
Public debt (percent of GDP)	77.8	65.4	56.3	43.0	35.6	34.2	38.2	44.8	47.9
Of which foreign held	...	...	...	...	...	18.7	21.8	24.6	...
					External Sector				
Current account balance (percent of GDP)	–7.3	–12.1	–8.7	–10.2	–16.1	–21.6	–7.1	–7.2	–9.1
Net capital inflows (percent of GDP)[1]	...	...	...	...	19.7	16.8	5.8	0.6	14.5
FDI	...	...	...	...	6.4	5.6	4.7	3.1	6.0
Portfolio	...	...	...	...	2.4	–0.3	–0.2	0.3	5.0
Other investment	...	...	...	...	10.9	11.5	1.3	–2.8	3.6
Exports (percent of GDP)	22.3	23.5	26.2	29.9	30.6	31.3	29.4	35.1	36.1
Exports (€, growth in percent)	22.9	16.0	18.6	31.6	24.5	16.9	–16.5	18.8	16.2
Global export market share (basis points)	...	...	1.0	5.2	5.5	5.7	5.6	5.9	...
Remittances (percent of GDP)	...	...	...	...	7.5	5.3	9.3	8.4	...
Imports (percent of GDP)	41.8	50.1	47.2	51.4	54.8	58.1	47.1	51.8	52.6
Imports (€, growth in percent)	12.7	31.8	0.2	25.7	29.7	20.8	–28.0	9.4	14.9
External debt (percent of GDP)	69.5	59.6	61.3	66.8	67.3	64.4	81.6	83.1	78.8
Gross international reserves (€ billions)	2.7	3.0	4.8	8.9	9.5	8.0	10.3	9.8	11.8
Gross international reserves (percent of GDP)	17.5	17.4	22.4	39.8	35.7	23.4	36.9	34.5	34.0
Reserve coverage (GIR in percent of short-term debt)	198.7	425.0	230.8	284.0	262.7	170.6	249.8	170.7	149.1

Serbia: Principal Economic and Financial Indicators, 2003–11 (*continued*)

	2003	2004	2005	2006	2007	2008	2009	2010	2011
Monetary Sector									
Broad money (end of period, growth in percent)	27.8	31.9	42.1	38.3	42.5	9.8	21.5	12.9	10.3
Monetary base (end of period, growth in percent)	13.9	28.2	67.3	60.6	10.2	17.5	3.9	1.1	14.0
Private sector credit (end of period, percent of GDP)	19.2	22.9	29.0	29.1	35.2	40.2	45.1	51.3	48.9
Of which foreign currency denominated	8.7	10.6	13.4	10.2	7.8	6.3	6.7	6.5	1.8
Of which foreign currency indexed	3.6	8.8	15.3	19.0	22.6	24.0	30.3	33.0	32.6
Cross-border loans to nonbanks (Q4, percent of GDP)	...	...	...	7.1	14.4	14.0	16.0	13.1	11.4
Private sector credit (end of period, real growth in percent)	24.0	28.0	32.8	10.9	26.3	23.0	7.3	13.8	–1.7
Financial Sector									
Assets (percent of GDP)	33.3	37.7	47.9	57.9	66.6	65.9	79.3	85.3	82.1
ROA (percent)	–0.3	–1.2	1.1	1.7	1.7	2.1	1.3	1.1	1.3
ROE (percent)	...	...	6.5	9.7	8.5	9.3	5.7	5.4	6.5
CAR (percent of risk-weighted assets)	31.1	27.9	26.0	24.7	27.9	21.9	21.4	19.9	19.7
NPLs (percent of total loans)	...	...	...	...	8.4	11.3	15.5	16.9	18.8
Loan-to-deposit ratio	1.2	1.2	1.0	1.0	1.2	1.1	1.2	1.2	1.2
Cross-border claims by foreign banks (all sectors, percent of GDP)	...	...	...	18.7	24.1	24.4	31.6	29.4	25.1
Financial Markets									
Interest rates (end of period, one-year government bond, percent)	...	...	...	...	...	...	10.4	14.7	10.9
CDS spreads (sovereign, end of period, basis points)	...	...	...	135	221	380	358	348	348
EMBIG spread (sovereign, end of period, basis points)	...	...	238	186	304	1224	333	418	601
Exchange rate (end of period, domestic currency/€)	69.0	78.9	85.2	79.0	79.1	87.5	96.1	105.9	104.6
NEER (index, 2003 = 100)	100.0	91.0	78.5	77.4	82.2	81.8	72.4	64.4	65.4
REER (CPI-based, 2003 = 100)	100.0	96.1	93.7	101.2	110.9	118.1	110.2	101.4	112.6
REER (ULC-based, 2003 = 100)	...	...	...	...	...	...	...	...	...
Memorandum Items									
GDP (nominal, in billions of domestic currency)	1,126	1,381	1,683	1,962	2,277	2,661	2,713	2,988	3,303
GDP (nominal, in billions of €)	17.3	19.0	20.3	23.4	28.4	32.4	28.8	28.7	34.0

Source: IMF staff.

Note: CAR = capital adequacy ratio; CDS = credit default swap; CPI = consumer price index; EMBIG = Emerging Markets Bond Index Global; FDI = foreign direct investment; GIR = gross international reserves; NEER = nominal effective exchange rate; NPLs = nonperforming loans; REER = real effective exchange rate; ROA = return on assets; ROE = return on equity; ULC = unit labor cost.

[1] Financial and capital account balances excluding EU balance-of-payments support, use of IMF resources, and SDR allocations.

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CHAPTER 11

Romania: Reanchoring Growth in More Solid Ground

After tardy reform efforts in the first decade of transition, Romania's growth took off in the early 2000s as a critical mass of reforms combined with firm EU membership prospects. But these fundamentals were overlaid with a domestic demand and credit bubble, readily financed by foreign parent banks flush with liquidity. Fiscal and public wage policies only added to the problem, while countercyclical efforts in the monetary and macroprudential areas had little effect. The resulting large current account deficits and banking sector vulnerabilities set Romania up for a hard landing as the global financial crisis unfolded. Difficulties in financing the rapidly widening fiscal deficit ultimately prompted the authorities to request and receive large-scale financial assistance from the IMF and the European Union. The €20 billion program of May 2009 was successful in restoring macroeconomic stability, forestalling a banking crisis, and correcting external imbalances. Following the 2009 recession, recovery was slower to take hold than elsewhere, but Romania's economy expanded by 2½ percent in 2011. These achievements and ongoing reforms, especially in the structural area, hold the promise of convergence with living standards in the rest of the European Union better grounded in fundamentals.

BACKGROUND

Romania's transition has been protracted and painful, reflecting difficult initial conditions and hesitant reforms efforts (IMF, 2004; Demekas and Khan, 1991). The Ceausescu regime, which ended in 1989, left a legacy of extreme centralization, no experience with partial reforms, and a very large, highly energy-intensive and bloated state enterprise sector, along with vast collective farms. Efforts to repay foreign debt in the 1980s had come at the expense of low consumption and investment, resulting in an eroded capital stock and pent-up consumer demand. The absence of foreign debt, following repayments in the 1980s, along with available domestic energy supplies, reinforced the view by many that Romania could take a gradual approach to transition. Structural reform and macroeconomic stabilization efforts by successive governments were accordingly piecemeal for most of the 1990s. In particular, quasi-fiscal support for ailing state-owned enterprises periodically undermined stabilization efforts. Inflation still exceeded 40 percent at the turn of the century, and none of the five IMF-supported programs during 1991–99 remained on track.

The main authors of this chapter are Jeffrey Franks and Anita Tuladhar.

Key reforms from the late 1990s and prospects of European Union and NATO membership set off a stretch of fast growth from 2001. In 1999, directed lending was terminated, the biggest state-owned bank was closed, and other banks were recapitalized, amid stricter financial supervision. Liberalization of the exchange and trade regimes had already taken place in 1997. Tighter macroeconomic policies helped preserve the competitiveness gains from the 1999 devaluation (IMF, 2004). An end to the long tradition of depressed energy prices would follow, together with accelerated privatization and employment reductions in state-owned enterprises. The December 1999 Helsinki European Council decided to commence EU integration talks with Romania and other eastern European countries, providing a strong anchor for reform, along with IMF-supported programs through mid-2006. GDP started to expand rapidly, though from a low base, with Romania's per capita GDP less than half that of Hungary in 2000.

THE RUN-UP TO THE GLOBAL FINANCIAL CRISIS

Romania's economy experienced an economic boom during 2003–08, with annual GDP growth averaging 6½ percent. Much of this was catch-up, reward for economic reforms, and anticipation of EU accession in 2007. However, there also was a strong element of overheating and, ultimately, unsustainable imbalances built up. Foreign direct investment and capital inflows channeled through the banking sector fueled high investment and consumption growth. But these inflows produced imbalances: domestic demand—further stoked by highly procyclical fiscal policy—grew at a much faster pace than exports during 2006–07. Consequently, the current account deficit rose relentlessly toward a clearly unsustainable 13½ percent of GDP in 2007, despite strong remittances equivalent to 4 percent of GDP. Disinflation became difficult to sustain and prices started to accelerate again from 2007 on the back of generous public sector wage increases and demand pressures. The real exchange rate appreciated by around 50 percent between mid-2004 and mid-2007. Buoyant capital inflows and the expansionary fiscal policy stance undermined the effects of monetary tightening. The central bank missed the targets under its inflation targeting regime, which had been introduced in August 2005.

Rapid credit growth, financed by capital inflows, also led to a successive build-up of vulnerabilities in the banking sector. Private sector credit grew at an average annual rate of 50 percent. Much of it took the form of foreign currency-denominated loans extended to unhedged household and corporate borrowers by the local subsidiaries of western banks, which had ample access to parent bank financing. The banking system had no open foreign currency position, yet it was exposed to significant indirect currency risk and depended on continued liquidity provision from abroad. Soaring real estate prices encouraged credit growth further. Macroprudential measures aimed at curtailing rapid credit growth proved toothless as banking groups circumvented local restrictions by switching to direct cross-border lending.

Loose fiscal policy exacerbated overheating and added to the vulnerabilities. Despite rapid growth and consequently buoyant revenues, the fiscal deficit increased from 2 percent of GDP in 2003 to 5 percent of GDP in 2008—spending doubled in nominal terms between 2005 and 2008 alone. Public employment rose by 24 percent between 2004 and 2008. Wages in the public sector grew even faster than in the private sector, increasing the wage bill by 2 percentage points of GDP over this period and lifting wage levels in the public sector above those in the private sector. Pensions were also increased several times, culminating in a 20 percent hike in late 2008 that pushed the public pension bill up by 2½ percentage points of GDP compared to 2006. Furthermore, as economic activity already began to trail off in late 2008, when market access to financing became more difficult, politically motivated expenditure increases in the run-up to the November elections were financed by risky borrowing at short maturities.

IMPACT OF THE GLOBAL FINANCIAL CRISIS

The global financial crisis hit Romania hard in late 2008. Real GDP declined by 13 percent (quarter-over-quarter, annualized) in the fourth quarter of 2008, compared to positive growth averaging 9 percent during the first three quarters of the year—one of the sharper reversals in the European Union. Following the global collapse of trade, exports slid. But imports contracted at almost double that rate in 2009 as domestic demand imploded, leading to a sharp external adjustment between 2007 and 2009 equivalent to 9 percentage points of GDP.

In the wake of the Lehman Brothers collapse in October 2008, Romania suffered a sudden stop of capital inflows and a serious liquidity crunch. As private capital inflows dried up, the banking system, which was so heavily dependent on foreign financing, was severely affected. The interbank market ground to a halt amid rising risk aversion and fears of counterparty risk when one commercial bank experienced a short-lived deposit run. The country risk premium rose dramatically, and the currency fell by 15 percent between October 2008 and early 2009. This further exposed banks to risks from businesses and households with unhedged foreign currency risk as nonperforming loan ratios started a long ascent. Bank lending contracted due to both demand and supply factors as households began to deleverage and banks tightened lending standards in the face of difficult liquidity conditions and greater capital needs. Romania's international credit rating was cut to below investment grade, based on concerns about the sustainability of its current account and the financial health of its banking sector. This led to substantially higher borrowing costs.

POLICY RESPONSES

Politics complicated Romania's crisis response (Åslund, 2010). The government lacked a parliamentary majority, and its strained relations with the presidency precluded proactive policies as the crisis built. Large pre-electoral spending in the run-up to elections in November 2008 contributed to precrisis vulnerabilities. The elections produced a grand coalition with an ample majority to push through reforms, but it fell apart after less than a year in the run-up to the presidential elections. After the presidential elections were completed in December 2009, a narrow but ultimately more stable coalition was formed in January 2010 under the same prime minister.

The government that took office in December 2008 was elected with a mandate to address the worsening economic situation. While they were not fully convinced at first that a deep and prolonged downturn would hit Romania, inadequate market access to finance Romania's rapidly widening fiscal deficit and roll over its limited public debt prompted the authorities to request a program with the IMF and the European Union, supplemented by additional funding from the World Bank and other multilateral institutions. Following preliminary discussions with the authorities at IMF headquarters in Washington, a mission to Bucharest reached staff-level agreement on a program on March 25, 2009. The IMF's Executive Board approved a two-year stand-by arrangement (SBA) for €12.9 billion on May 4, 2009. The total finance package was in the amount of €20 billion. The program was designed to cushion the effects of the sharp drop in capital inflows while addressing Romania's external and fiscal imbalances and strengthening its financial sector. Key program objectives included: (i) fiscal consolidation by addressing both short- and longer-term sources of budget imbalance; (ii) strengthening of the financial sector and avoidance of a banking crisis; (iii) prudent monetary policy to reduce inflation; and (iv) securing of adequate external financing and improvement in confidence. Each is discussed in turn in the following pages.

Fiscal Consolidation

While Romania's debt-to-GDP ratio was among the lowest in Europe, lack of market financing together with the unsustainable increase in government spending and the need to restore market confidence meant that there was little room for fiscal stimulus. Under the program, the new government aimed for a fiscal consolidation of 3 percentage points of GDP in 2009—without corrective measures the deficit would have ballooned to 9 percent of GDP. Key budget measures included: (i) an increase in social contributions; (ii) hikes in excise taxes on alcohol and tobacco; (iii) an increase in property taxes due to revaluation; (iv) cuts in the public wage bill through reductions of bonuses and other benefits and the elimination of vacancies (previously used to grant higher salaries to existing staff); and (v) substantial reductions in goods and services spending as well as in subsidies. With these measures, the deficit was expected to be reduced to 4.6 percent of GDP in 2009, down slightly from 4.8 percent of GDP in 2008, despite the anticipated recession.

However, it soon became clear that the economic downturn would be much deeper than initially foreseen (a contraction of 7 to 8 percent, compared to the 4 percent originally programmed) and fiscal policy needed recalibration. Tax collections underperformed, while current spending experienced overruns. The key challenge was to strike a balance between providing cyclical support and the medium-term fiscal objective to return to a deficit target of 3 percent of GDP. A compromise was struck between the IMF, European Union, and the government to accommodate more than half of the effect of the deterioration—allowing the deficit to rise above 7 percent of GDP—while implementing an additional adjustment of 2 percentage points of GDP. Direct budget financing was provided by both the European Union and the IMF to help meet the higher fiscal financing needs. The program also envisaged comprehensive structural measures that would ensure fiscal sustainability over the medium term through permanent reductions in government spending, such as rationalization of public sector institutions, structural reform commitments on wages and pensions, and new reforms to strengthen spending controls both within the central government and for units outside central government that posed significant fiscal risks (local governments, self-financed institutions, and state-owned enterprises). The latter set of measures was also intended to address the problem of significant payments arrears that had started to emerge.

The composition of fiscal adjustment also needed review. While it was true that an unsustainable rise in current spending was behind the precrisis increase in the fiscal deficit, legal and political challenges made it hard to reverse past spending increases, particularly in wages and social entitlements. The program thus sought to rely on short-term revenue measures, including some broad-based measures with less severe distributional impact than social spending cuts. In 2010, however, the slower-than-anticipated economic recovery and strains from the crisis in Greece necessitated further action, and in July the authorities boldly reduced public sector wages by 25 percent and hiked the value-added tax by 5 percentage points. These measures, while highly procyclical, helped to firmly anchor the credibility of the fiscal adjustment plans and secured a sharp reduction in the deficit from 6½ percent of GDP in 2010 to 4 percent of GDP in 2011.

Fiscal institutional reform was aimed at improving medium-term fiscal performance. A Fiscal Responsibility Law was approved which included (i) a framework for improved multiyear budgeting; (ii) limits on intrayear budget revisions; (iii) fiscal rules on expenditures, public debt, and the primary deficit; (iv) the creation of an independent fiscal council; and (v) a framework for managing guarantees and other contingent liabilities. The Local Public Finance Law was amended to improve the financial controls of local governments. Major pension reform legislation was passed which, while contributing little to short-term fiscal consolidation, would reduce the long-term imbalances in the system by nearly 5 percentage points of GDP. Legislation overhauling the public pay system removed distortions and inequities and significantly reduced bonus payments.

Strengthening the Financial Sector

Although banks generally entered the crisis well capitalized, they were confronted with evaporating interbank market liquidity, limited access to external funding sources, and rising nonperforming loans. Program measures focused on safeguarding the system against crisis risks while enhancing the authorities' ability to address bank problems should a crisis occur. The National Bank of Romania proactively requested banks to increase their capital through conservative profit retention to bolster cushions against further deterioration in asset quality. At the system level, the average capital adequacy ratio rose to 14.7 percent at end-2009, from 13.8 percent at end-2008. All banks were asked to maintain capital ratios of at least 10 percent, above the statutory 8 percent minimum. Romania was also the first country to reach agreement with foreign-owned banks under the Vienna Initiative (see Box 5.2). Early on, the principal western banking groups operating in Romania had publically committed to maintain their exposure to Romania and fortify the capital of their local subsidiaries as needed.[1] The agreement was largely respected during its two years of operation.

The National Bank of Romania strengthened its liquidity operations framework. It enhanced its liquidity monitoring through stricter reporting requirements on the maturity and currency breakdown of banks' assets and liabilities positions. The central bank also reviewed emergency lending arrangements, which it makes available to all banks, foreign and domestic owned. In addition, it took steps to broaden the range of acceptable collateral for its refinancing operations. Like other European central banks, it established contingency plans to address episodes of financial distress.

To strengthen bank resolution capabilities, amendments to the legal framework fortified the Deposit Guarantee Fund by improving its governance and enhancing its funding regime. Actual and targeted coverage ratios were increased, banks' contingent credit lines were eliminated, and banks' ex ante contribution rates were hiked. The coverage of deposit insurance had already been raised to €50,000 per eligible account in 2008. Banking resolution legislation was modified to give the authorities purchase and assumption powers and to strengthen the legal status of bank special administrators.

Prudent Monetary Policy

Despite the large negative output gap, inflation remained stubbornly high, reducing the scope for a more accommodative monetary policy. While core inflation declined, headline inflation lagged, partly due to supply side shocks such as excise tax hikes, the pass-through from the exchange rate depreciation of October 2008, and administrative price increases. As a result, the central bank missed inflation targets for three years in a row. As inflationary and exchange rate pressures abated, the National Bank of Romania was able to ease monetary policy in support of economic recovery, reducing the policy rate by a cumulative 400 basis points from February 2009 and lowering reserve requirements significantly (in particular on foreign currency liabilities).

[1] IMF Press Release No. 09/86, March 25, 2009.

ECONOMIC OUTCOMES IN 2009–11

The program remained on track during most of its duration from May 2009 through early 2011, despite temporary uncertainties due to political instability, which delayed completion of the second review from 2009 to February 2010. Despite the political complexities, the commitment to the program remained strong throughout, and quarterly targets were consistently met (with the exception of difficulties in bringing payments arrears down as quickly as agreed). By March 2011, the authorities had regained sufficient market access to forego the final disbursement under the SBA, end the program a month ahead of time, and replace it with a new two-year precautionary arrangement.

Following agreement on the SBA in May 2009, financial market stress eased considerably—pressures on the exchange rate subsided, reserves grew, CDS spreads came down, and domestic interest rates fell steadily. This created room for a cautious reduction in the central bank policy rate and enabled the treasury to extend maturities and lower its borrowing costs in the domestic market. Spreads increased temporarily in late 2009 due to the political uncertainties and the delay in concluding program reviews, but that was reversed after the elections in December. Net capital inflows did better than anticipated under the program, with rollover rates of 90 percent and 75 percent in the banking and corporate sectors, respectively, in 2009, despite foreign direct investment flows that nearly halved. In the banking sector, adequate liquidity was available, which helped bring down deposit rates. Lending rates declined less as banks increased spreads to finance their provisioning against rising nonperforming loans, which reflected the lagged effects of the economic downturn. More importantly, no banks failed, despite mounting external pressures on subsidiaries of Greek banks in 2010.

The sharp economic decline halted in 2010, but the recovery was weak and often more protracted than anticipated. The first half of 2010 saw a mild recovery, but it suffered a setback in the second half of the year due to the fiscal austerity measures, the impact of severe floods on agricultural production, and a plunge in consumer confidence and economic sentiment. Domestic demand was generally slow to pick up, reflecting the combined impact of rising unemployment, deleveraging by households and corporates, and tight credit conditions.

On the external side, as a result of the deeper recession, the current account adjusted faster than expected. The current account deficit improved from 11½ percent of GDP in 2008 to less than 4¼ percent of GDP in 2009 (compared to 7½ percent of GDP envisaged under the program). In 2010, it remained at a level similar to 2009, as booming exports balanced the incipient recovery of imports.

Inflationary pressures eased owing to the decline in domestic demand, but supply shocks led to an elevated headline inflation rate, which was among the highest in the European Union. In 2009, headline inflation in Romania declined to 4.7 percent from 6.3 percent in 2008. After dropping early in the year, inflation edged up slightly at year end due to excise tax increases on alcohol and tobacco. In the second half of 2010, inflation jumped owing to the value-added tax hike, reaching around 8 percent. Nonetheless, second-round effects from this tax increase were contained, obviating the need for a rise in policy rates.

In 2011, Romania's economy made further headway and GDP expanded by 2½ percent, on account of a recovery in domestic demand. Fiscal consolidation reduced the deficit to 4.1 percent of GDP, and further planned adjustment should bring it well below the 3-percent-of-GDP threshold in 2012—a one-year delay relative to the objective of the 2009 SBA. Meanwhile, inflation has returned within the target range as tax and administrative price increases have run their course. While the lofty growth rates of the 2003–08 period are a long way off, Romania is on track to anchor its future development in firmer ground.

CHALLENGES AHEAD

Significant progress has been made under the 2009 SBA in achieving fiscal consolidation and safeguarding the financial sector. These policies, together with financing assurances, restored macroeconomic stability and corrected external imbalances. The focus has now shifted toward boosting potential growth by deepening structural reform while fiscal adjustment is being completed and financial sector policies are being strengthened further.

The precautionary successor SBA is designed to assist Romania in carrying these reforms forward and providing cover for possible future shocks. It includes comprehensive reform of state-owned enterprises, particularly in the energy and transport sectors, and improvement in regulators' effectiveness, while protecting vulnerable members of society. The authorities will also reform the health care system and continue with fiscal adjustment in line with their commitments to Europe to achieve sustainable public finances. Improving the absorption of EU funds to help build critical infrastructure is another priority.

Potential spillovers from the euro area crisis remain a risk for the financial sector, along with the challenges from still deteriorating asset quality. Subsidiaries of euro area banks account for the bulk of the Romanian banking system, with Greek-owned banks constituting a relatively high share—roughly 16 percent of system assets. The National Bank of Romania has intensified liquidity monitoring of all banks in the system and continues to strengthen supervision and resolution capabilities. Nonperforming loan ratios continue to increase, reaching 14 percent in December 2011. The associated new provisioning led to a loss for the banking sector as a whole for the year.

Romania: Principal Economic and Financial Indicators, 2003–11

	2003	2004	2005	2006	2007	2008	2009	2010	2011
Real Sector Indicators									
GDP (real growth in percent)	5.2	8.5	4.2	7.9	6.3	7.3	–6.6	–1.6	2.5
Domestic demand (real growth in percent)	8.3	12.0	7.9	12.9	14.2	7.3	–12.0	–1.5	3.1
Net exports (real growth contribution in percent)	–3.5	–4.4	-4.5	–6.3	–9.6	–1.0	7.0	0.0	–0.8
Exports of goods and services (real growth in percent)	9.3	14.1	7.6	10.4	7.8	8.3	–6.4	14.0	9.9
CPI (end-of-period change in percent)	14.1	9.2	8.8	5.0	6.7	6.4	4.9	8.0	3.1
Employment (growth in percent)	–4.5	–0.6	0.1	1.9	0.7	0.2	–1.3	0.0	–1.1
Unemployment rate (percent)	7.0	8.1	7.2	7.3	6.4	5.8	6.9	7.3	7.2
Public Finances									
Fiscal balance (percent of GDP)	–2.2	–3.4	–0.7	–1.4	–3.1	–4.8	–7.3	–6.4	–4.1
Government revenue (percent of GDP)	28.7	29.9	31.4	32.3	32.3	32.2	31.2	32.3	31.4
Government expenditure (percent of GDP)	30.9	33.3	32.1	33.7	35.4	37.0	38.5	38.7	35.5
Government primary expenditure (percent of GDP)	28.9	32.0	30.9	32.9	34.6	36.3	37.3	37.3	34.0
Government primary expenditure (real growth in percent)	4.3	20.3	0.5	14.8	12.0	12.4	–4.0	–1.5	–6.7
Public debt (percent of GDP)	...	21.1	17.6	12.6	12.7	13.6	23.8	31.2	33.0
Of which foreign held	16.8	16.0	12.0	10.5	8.2	7.0	10.5	12.0	12.6
External Sector									
Current account balance (percent of GDP)	–5.8	–8.4	-8.6	–10.4	–13.4	–11.6	–4.2	–4.5	–4.2
Net capital inflows (percent of GDP)[1]	8.0	14.2	14.4	15.3	17.3	12.5	–2.4	2.0	3.6
FDI	3.6	8.4	6.6	8.9	5.7	6.7	3.0	1.8	1.4
Portfolio	1.0	–0.7	1.0	–0.2	0.4	–0.4	0.4	0.7	1.3
Other investment	3.3	6.5	6.8	6.6	11.2	6.2	–5.9	–0.5	0.9
Exports (percent of GDP)	34.8	35.8	33.1	32.2	29.3	30.6	30.6	35.5	38.3
Exports (€, growth in percent)	6.7	19.4	20.7	19.3	15.9	16.6	–14.9	21.7	18.9
Global export market share (basis points)	23.4	25.7	26.6	27.0	29.2	31.1	32.9	32.5	...
Remittances (percent of GDP)	...	...	3.8	4.5	4.0	3.7	2.6	2.0	1.6
Imports (percent of GDP)	42.2	44.9	43.3	44.2	43.3	43.9	36.7	41.3	43.5
Imports (€, growth in percent)	11.5	23.4	26.1	25.2	24.7	13.2	–28.9	18.2	16.0
External debt (percent of GDP)	36.8	38.0	37.0	44.4	50.1	48.2	72.1	74.3	68.5
Gross international reserves (€ billions)	6.5	10.9	17.0	21.4	25.4	26.6	28.4	34.1	36.2
Gross international reserves (percent of GDP)	13.8	19.5	20.2	23.0	21.9	18.1	24.9	27.7	24.7
Reserve coverage (GIR in percent of short-term debt)	145.9	183.9	141.6	107.9	95.8	86.9	124.2	115.9	109.8

(*continued*)

Romania: Principal Economic and Financial Indicators, 2003–11 (*continued*)

	2003	2004	2005	2006	2007	2008	2009	2010	2011
					Monetary Sector				
Broad money (end of period, growth in percent)	23.3	37.6	36.5	28.1	33.7	17.5	9.0	6.9	6.6
Monetary base (end of period, growth in percent)	22.7	39.3	62.1	55.7	41.0	3.5	2.4	6.7	11.9
Private sector credit (end of period, percent of GDP)	...	16.6	20.7	26.8	35.6	38.5	39.9	40.1	38.6
Of which foreign currency denominated	7.6	9.6	10.9	12.2	18.9	21.8	23.6	25.1	24.2
Of which foreign currency indexed	...	...	...	...	...	...	...	...	...
Cross-border loans to nonbanks (Q4, percent of GDP)	5.7	7.0	6.8	9.3	11.5	13.1	16.6	14.0	10.6
Private sector credit (end of period, real growth in percent)	...	...	34.0	47.1	50.3	25.6	–3.8	–3.1	–3.4
					Financial Sector				
Assets (percent of GDP)	27.2	32.7	40.9	46.0	56.1	58.5	64.2	65.6	62.5
ROA (percent)	2.7	2.5	1.6	1.3	1.2	1.6	0.2	–0.2	–0.3
ROE (percent)	...	...	15.4	10.2	10.5	17.0	2.9	–1.7	–3.4
CAR (percent of risk-weighted assets)	21.1	20.6	21.1	18.1	13.8	13.8	14.7	15.0	13.4
NPLs (percent of total loans)	...	...	2.6	1.8	2.6	2.8	7.9	11.9	14.0
Loan-to-deposit ratio	0.7	0.8	0.9	1.1	1.3	1.2	1.2	1.2	1.2
Cross-border claims by foreign banks (all sectors, percent of GDP)	8.0	11.4	13.1	23.3	32.9	34.8	37.9	35.1	27.8
					Financial Markets				
Interest rates (end of period, one-year government bond, percent)	...	...	...	...	...	...	...	...	...
CDS spreads (sovereign, end of period, basis points)	161	56	38	20	82	645	286	293	447
EMBIG spread (sovereign, end of period, basis points)[2]	161	58	49	38	90	854	267	323	543
Exchange rate (end of period, domestic currency/€)	4.1	3.9	3.7	3.4	3.6	4.0	4.2	4.3	4.3
NEER (index, 2003 = 100)	100.0	93.6	103.6	107.0	113.9	104.6	92.4	90.8	91.0
REER (CPI-based, 2003 = 100)	100.0	102.3	120.5	129.3	140.1	133.1	123.1	125.5	129.0
REER (ULC-based, 2003 = 100)	100.0	95.1	127.0	136.0	162.7	175.6	145.5	145.7	...
					Memorandum Items				
GDP (nominal, in billions of domestic currency)	197	247	289	345	416	515	501	523	579
GDP (nominal, in billions of €)	52.6	61.0	79.6	97.7	124.5	138.8	118.0	123.9	143.0

Source: IMF staff.

Note: CAR = capital adequacy ratio; CDS = credit default swap; CPI = consumer price index; EMBIG = Emerging Markets Bond Index Global; FDI = foreign direct investment; GIR = gross international reserves; NEER = nominal effective exchange rate; NPLs = nonperforming loans; REER = real effective exchange rate; ROA = return on assets; ROE = return on equity; ULC = unit labor cost.

[1] Financial and capital account balances excluding EU balance-of-payments support, use of IMF resources, and SDR allocations.

[2] Euro bond.

CHAPTER 12

Poland: A Beacon of Resilience in Europe

Poland fared far better than most of its emerging European neighbors during the global financial crisis. It is the only EU economy to have escaped outright recession, helped by resilient domestic demand and more limited exposure to the decline in world trade. Perhaps most importantly, Poland entered the crisis with relatively low imbalances, and it had space to implement countercyclical policies to cushion the downturn. Early adoption of a Flexible Credit Line (FCL) arrangement with the IMF provided further cover, lifted investor confidence, and helped maintain access to international capital markets.

BACKGROUND

Poland was the first country in the region to embark on economic transition from central planning. As it blasted a trail for others with rapid price liberalization, deregulation, and privatization, Poland went through a deep recession, hyperinflation, external debt restructuring, and soaring unemployment in the late 1980s and early 1990s. The consumer-oriented manufacturing sector suffered with the collapse of its traditional markets, but Poland was able to retain its traditional role as an exporter of raw materials and semiprocessed products.

The strong and early push for reform paid off, with Poland becoming in 1996 the first transition economy to regain its pretransition output level. The manufacturing sector restructured quickly, developing strong automotive and furniture sectors, for example. Heavy industry, such as the steel sector and Poland's large coal sector, found it harder to adapt. Poland reintegrated rapidly into the world trading system, oriented exports toward the west, and with its EU accession in 2004 became increasingly enmeshed in the production network of western firms. However, as the largest economy in central Europe, Poland's export-to-GDP ratio remained materially lower than those of its smaller regional peers. Inflation was decisively brought down to low levels in the early 2000s—Poland adopted a floating exchange rate regime in 2000 and introduced inflation targeting four years later.

Despite all this progress, unemployment remained high throughout and reached 20 percent in the wake of the economic slowdown in the early 2000s. Similarly, strengthening public finances remained an uphill battle well into the 2000s.

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THE RUN-UP TO THE GLOBAL FINANCIAL CRISIS

Poland's macroeconomic performance was strong in the precrisis period but, unlike elsewhere, the buildup of significant imbalances was avoided. Real GDP growth averaged some 5¼ percent during 2003–08, as EU accession boosted business confidence and spurred investment. Private consumption growth was also robust, driven by rapidly rising real wages, increasing employment, and high albeit comparatively contained credit growth. Still, overall growth was less buoyant than elsewhere, which some observers found disappointing at the time. In retrospect, however, it became clear that such growth comparisons mainly reflected the overheating in comparator economies rather than any policy shortcomings on the part of Poland. Poland's GDP evolved largely in line with the steady increase of potential output, which benefited from strong investment and robust labor productivity growth (IMF, 2008b; Epstein and Macchiarelli, 2010). Current account deficits and inflation remained contained.

The avoidance of imbalances owes much to Poland's appropriately restrictive macroeconomic policies. With the painful memories of hyperinflation still fresh, the central bank charted a determined anti-inflationary course throughout. This not only cooled demand, it also built lasting confidence in monetary institutions and helped anchor inflation expectations, thus increasing the monetary policymakers' room to maneuver in the subsequent downturn. The floating exchange rate regime was another plus: it meant that capital inflows were accompanied by substantial appreciation—the zloty gained almost 50 percent in value against the euro between its trough in early 2004 and its peak in the summer of 2008—which likewise helped mitigate overheating pressures. On the fiscal front, Poland finally made important strides in addressing its traditionally weak public finances when it brought the deficit down to below 2 percent of GDP in 2007 from over 6 percent of GDP in 2003. Again, this had the dual benefit of leaning against overheating in the upswing and building cushions for the more meager years to come.

Disciplined macroeconomic policies were supplemented by macroprudential measures. In particular, in 2006, as foreign currency mortgage lending gained pace throughout the region, the Polish financial supervisors responded with measures that in effect placed constraints on such lending (known as "Recommendation S"). As a result, foreign currency lending was one of the lowest in the region, accounting for around one-third of total loans in 2008. In early 2008, the institutional framework for financial stability was buttressed by the unification of financial supervision under the aegis of the Polish Financial Supervision Authority.

IMPACT OF THE GLOBAL FINANCIAL CRISIS

Immediately following the collapse of Lehman Brothers, activity decelerated sharply, reflecting spillovers through real and financial channels. With Poland's key export markets in recession, exports contracted by about 20 percent year-over-year in the fourth quarter of 2008. While the share of exports in GDP—about 40 percent—was relatively low compared to that of its neighbors, the significant compression in exports nonetheless had a considerable impact on domestic activity, especially on industrial production, which fell by 10 percent year-over-year at the trough of the crisis. Still, private consumption held up well; although growth in retail sales declined sharply, it remained in positive territory.

Poland's relatively large and internationally integrated financial markets were more exposed. As in other countries in the region, local asset markets suffered large price declines amid a sharp slowdown of capital inflows. Although western banks reduced their exposure to Poland only slightly even in the most intense phase of the crisis, the sudden lack of new inflows was strongly felt. Exchange rate pressures were higher there than elsewhere, with the zloty depreciating by 30 percent against the euro through February 2009. In addition, the interbank market froze in late October 2008, reflecting increased uncertainty, and a number of banks had difficulty obtaining foreign exchange liquidity to fund the mortgages that were denominated in Swiss francs and other foreign currencies.

POLICY RESPONSES

Because Poland entered the crisis with relatively healthy economic fundamentals, policymakers had room to implement countercyclical policies. These, in turn, cushioned the downturn and were instrumental in avoiding a recession.

On the fiscal side, significant tax cuts fortuitously enacted before the crisis provided a strong stimulus to the economy. In light of the substantial deficit reduction through 2007, the government had approved cuts in the personal income tax and disability contribution rates that were to be phased in gradually. As it turned out, these measures came into effect just as the crisis hit, providing a significant and ex post "perfectly timed" stimulus of a cumulative 2½ percent of GDP just when the economy slowed. Earlier plans to offset the revenue loss through other fiscal measures were eventually dropped, notwithstanding the European Commission's invocation of the Excessive Deficit Procedure against Poland.[1] In addition, in late 2008 the authorities implemented several direct crisis-related measures, including employment subsidies and mortgage support for the unemployed, although these were rather limited (estimated at less than 0.1 percent of GDP). These fiscal policy changes, together with cyclical revenue losses, widened the fiscal deficit to 7.3 percent of GDP in 2009. This used up most of the fiscal space generated in the precrisis period, but it was instrumental in supporting domestic demand through the downturn.

Monetary policies were also supportive. Starting in November 2008, the National Bank of Poland embarked on a loosening cycle. Policy rates were lowered from 6.0 to 3.5 percent through June 2009. They were kept at this level for

[1] The Excessive Deficit Procedure for Poland was formally approved by EU finance ministers on July 8, 2009, requiring Poland to reduce its fiscal deficit to below 3 percent of GDP by 2012.

the remainder of the year and all of 2010. In addition, reserve requirements were cut by 50 basis points to 3.0 percent. The authorities also introduced a number of measures to support liquidity and credit provision in the financial sector. Specifically, to address foreign currency funding risks and broader liquidity shortfalls, the central bank introduced dollar, Swiss franc, and euro swaps, expanded the list of eligible collateral for discount window lending, and extended the tenor of repo transactions to up to six months. Moreover, to boost confidence in the financial system, the Bank Guarantee Fund Law was amended to increase the deposit insurance limit from €22,500 to €50,000 while eliminating coinsurance. Finally, to ease the credit crunch, the authorities introduced a credit-guarantee program offered by the state-owned Bank Gospodartstwa Krajowego (BGK), although the uptake remained limited. Despite these monetary loosening measures, inflation and inflation expectations both stayed low, underscoring the price stability credentials built up by the National Bank of Poland over the years.

Safeguarding financial stability was a top priority for policymakers in the acute phase of the global crisis. A Financial Stability Committee was established in the fall of 2008, comprising representatives from the central bank, the Ministry of Finance, and the Polish Financial Supervision Authority, with the aim of improving information sharing and bolstering crisis preparedness. The Polish Financial Supervision Authority proactively sought to address potential falls in capital buffers by recommending to banks that they retain their 2008 profits—advice that was generally heeded. It also intensified its financial sector surveillance by increasing the frequency of stress testing and on-site inspections and requesting banks to review their lending policy and contingency plans as well as submit daily reports on new exposures to foreign entities. The Polish Financial Supervision Authority stepped up individual measures for some banks, including by issuing early warnings to stop mortgage lending in foreign currency and issuing recommendations to increase their capital base, as needed.

On April 14, 2009, Poland expressed interest in a one-year FCL. The IMF had just established the new instrument in the context of a major overhaul of its lending facilities to be able to respond better to the global financial crisis. It was meant as a crisis prevention instrument to provide high, front-loaded credit lines to members with very strong fundamentals and policies. During the global financial crisis, three countries—Colombia, Mexico, and Poland—officially requested the FCL, with a view to benefiting from its reserve-like characteristics and positive market signaling. For Poland, the FCL was intended to reassure markets in the context of rapid exchange rate depreciation, providing additional cover for its countercyclical policies and improving access to market financing.

The FCL in the amount of €15.5 billion was approved by the IMF's Executive Board on May 6, 2009, upon a successful assessment of the relevant qualification criteria. The Board recognized Poland's important strides in the decade leading up to the global crisis, with robust and well-balanced growth underpinned by a sustained track record of sound policies and continued commitment to macroeconomic stability. Key elements supporting Poland's economic performance and its resilience during the crisis were identified in its disciplined and transparent inflation targeting framework, the shock-absorbing role of its floating exchange rate regime, and its strong commitment to the budgetary policy framework of the European Union's Stability and Growth Pact, as well as strengthened public debt sustainability rules, and proactive macroprudential supervision to preserve the stability of the financial sector.

Upon the announcement of the FCL request, Poland's bond spreads declined, local equity prices rose, and the zloty began to steadily appreciate. True, assessing the impact of the FCL on Poland's financial markets is complicated by the contemporaneous and sustained improvements in overall emerging market asset prices that followed the March 24 reforms to the IMF's lending instruments and also by the April 1 announcement by the G-20 of a sizable increase in IMF resources. Nonetheless, the Polish authorities believe that the FCL helped secure continued market access—with significant bond placements at favorable yields—creating room for needed countercyclical policies. Bond spreads continued to decline despite the announcement of much larger fiscal deficit figures in April 2009. Between April and October 2009, the Polish authorities tapped bond markets in the euro (€2.4 billion), U.S. dollar ($3.5 billion), and Swiss franc (CHF 750 million) with 5- to 15-year papers that were significantly oversubscribed. Other successful debt issuances in international capital markets have followed since, with foreign investors also returning to the domestic Treasury market.

ECONOMIC OUTCOMES IN 2009–11

With these policies during the crisis and, perhaps even more importantly, prior to the crisis, Poland fared relatively well. Its economy experienced only a single quarter of contraction—growth for 2009 as a whole came to 1.6 percent and picked up to around 4 percent in 2010 and 2011. The banking system was able to withstand the crisis, from which it emerged liquid, profitable, and well capitalized. In contrast to most of its regional peers, in Poland real credit growth remained positive in real terms during 2009–11. As intended, the FCL was not used but kept as a precautionary measure. The positive experience with the FCL as an insurance mechanism prompted Poland to first renew it (July 2, 2010) and then augment it to €21.9 billion and extend it for another two years (January 21, 2011).

CHALLENGES AHEAD

The most obvious challenge relates to public finances. While substantial fiscal consolidation reduced the fiscal deficit from almost 8 percent of GDP in 2010 to 5.1 percent of GDP in 2011, public debt remains relatively high at around 55 percent of GDP (ESA95 basis). Polish policymakers recognize this challenge and are committed to further consolidation in order to achieve their medium-term objective of a deficit of 1 percent of GDP, which is necessary to put debt firmly on a downward path.

More generally, Poland needs to deal with the consequences of its success. In particular, Poland will need to manage the risks associated with a potential surge in capital inflows once external financial strains are alleviated. Its good track record of economic performance has elevated Poland's attractiveness to foreign investors searching for yield in a low-interest global environment. Indeed, in 2010 and the first half of 2011, together with Turkey, Poland was one of the main magnets for foreign capital in emerging Europe, with inflows approaching precrisis magnitudes.

Poland: Principal Economic and Financial Indicators, 2003–11

	2003	2004	2005	2006	2007	2008	2009	2010	2011
					Real Sector Indicators				
GDP (real growth in percent)	3.9	5.3	3.6	6.2	6.8	5.1	1.6	3.9	4.3
Domestic demand (real growth in percent)	2.8	6.2	2.5	7.3	8.7	5.6	–1.1	4.6	3.8
Net exports (real growth contribution in percent)	1.0	–1.0	1.1	–1.1	–2.1	–0.6	2.7	–0.7	0.5
Exports of goods and services (real growth in percent)	14.2	14.0	8.0	14.6	9.1	7.1	–6.8	12.1	7.3
CPI (end-of-period change in percent)	1.7	4.4	0.7	1.4	4.0	3.3	3.5	3.1	4.6
Employment (growth in percent)	0.6	1.3	2.3	3.4	4.4	3.7	0.4	0.6	1.1
Unemployment rate (percent)	19.6	19.0	17.7	13.8	9.6	7.1	8.2	9.6	9.6
					Public Finances				
Fiscal balance (percent of GDP)	–6.2	–5.4	–4.1	–3.6	–1.9	–3.7	–7.3	–7.8	–5.1
Government revenue (percent of GDP)	38.5	37.2	39.4	40.2	40.3	39.5	37.2	37.5	39.4
Government expenditure (percent of GDP)	44.7	42.6	43.4	43.9	42.2	43.2	44.5	45.4	44.5
Government primary expenditure (percent of GDP)	41.7	39.9	40.6	41.2	39.9	41.0	41.9	42.7	41.8
Government primary expenditure (real growth in percent)	4.7	0.7	5.6	7.7	3.3	8.0	3.8	6.0	2.1
Public debt (percent of GDP)	47.1	45.7	47.1	47.7	45.0	47.1	50.9	54.9	55.4
Of which foreign held	19.1	18.2	19.3	18.6	16.4	15.8	19.0	23.7	27.3
					External Sector				
Current account balance (percent of GDP)	–2.5	–5.2	–2.4	–3.8	–6.2	–6.6	–4.0	–4.7	–4.3
Net capital inflows (percent of GDP)[1]	4.4	3.1	4.9	4.1	9.5	7.6	8.0	8.2	5.4
FDI	2.0	4.6	2.3	3.1	4.2	1.9	2.0	0.8	1.7
Portfolio	1.1	3.7	4.1	–0.9	–1.5	–0.5	3.4	5.4	3.1
Other investment	1.3	–5.1	–1.5	1.9	6.7	6.2	2.6	2.0	0.5
Exports (percent of GDP)	33.3	37.7	37.1	40.4	41.0	40.4	39.7	42.3	44.9
Exports (€, growth in percent)	6.2	20.1	17.9	21.6	15.6	14.4	–15.5	21.8	11.0
Global export market share (basis points)	71.3	80.8	85.9	92.3	101.3	107.0	110.7	103.8	...
Remittances (percent of GDP)	0.3	0.4	0.6	0.9	1.0	0.9	0.8	0.8	0.7
Imports (percent of GDP)	35.8	40.0	37.8	42.3	44.3	45.3	40.4	44.1	46.5
Imports (€, growth in percent)	2.5	18.5	13.4	24.8	19.4	18.4	–23.3	25.0	10.0
External debt (percent of GDP)	49.5	51.4	43.7	49.7	54.9	46.2	65.1	67.2	64.9
Gross international reserves (€ billions)	25.9	26.1	34.8	35.3	42.9	42.7	52.8	68.3	75.4
Gross international reserves (percent of GDP)	15.1	14.0	13.5	13.6	14.8	11.2	17.7	19.4	19.0
Reserve coverage (GIR in percent of short-term debt)	106.3	101.8	97.3	103.1	72.4	79.1	82.7	98.8	76.8

(continued)

Poland: Principal Economic and Financial Indicators, 2003–11 (*continued*)

	2003	2004	2005	2006	2007	2008	2009	2010	2011
Monetary Sector									
Broad money (end of period, growth in percent)	5.8	9.4	13.1	16.0	13.4	18.6	8.1	8.8	12.5
Monetary base (end of period, growth in percent)	...	...	1.9	23.1	18.2	23.1	8.8	1.6	–1.1
Private sector credit (end of period, percent of GDP)	...	30.1	30.8	35.2	41.0	51.0	52.9	54.8	58.3
Of which foreign currency denominated	...	6.6	7.4	8.9	9.3	16.3	15.7	16.6	18.5
Of which foreign currency indexed	...	...	...	...	...	...	...	...	...
Cross-border loans to nonbanks (Q4, percent of GDP)	8.9	9.3	11.9	13.4	13.9	11.1	14.1	12.0	10.3
Private sector credit (end of period, real growth in percent)	4.9	12.7	8.2	21.2	24.5	30.6	5.4	5.9	9.5
Financial Sector									
Assets (percent of GDP)	...	52.0	53.7	57.6	59.8	72.0	74.5	78.3	81.2
ROA (percent)	0.5	1.4	1.6	1.7	1.7	1.5	0.8	1.0	1.3
ROE (percent)	...	...	20.6	22.5	22.4	20.7	11.2	13.2	16.6
CAR (percent of risk-weighted assets)	13.8	15.4	14.5	13.2	12.0	11.2	13.3	13.9	13.1
NPLs (percent of total loans)	...	...	11.0	7.4	5.2	4.4	7.9	8.8	8.3
Loan-to-deposit ratio	0.8	0.8	0.8	1.0	1.1	1.1	1.1	1.1	1.1
Cross-border claims by foreign banks (all sectors, percent of GDP)	15.6	16.7	18.3	21.0	25.6	21.8	28.2	26.0	22.9
Financial Markets									
Interest rates (end of period, one-year government bond, percent)	5.9	6.4	4.5	4.3	6.2	5.4	4.2	4.1	4.5
CDS spreads (sovereign, end of period, basis points)	42	15	16	13	24	256	132	142	280
EMBIG spread (sovereign, end of period, basis points)	76	69	62	47	67	314	124	151	315
Exchange rate (end of period, domestic currency/€)	4.7	4.1	3.9	3.8	3.6	4.2	4.1	4.0	4.5
NEER (index, 2003 = 100)	100.0	98.4	110.0	113.7	118.3	129.5	106.9	113.0	110.0
REER (CPI-based, 2003 = 100)	100.0	99.7	111.2	113.5	117.5	128.9	109.5	116.4	114.7
REER (ULC-based, 2003 = 100)	100.0	94.9	105.4	106.8	111.2	125.3	101.2	110.6	...
Memorandum Items									
GDP (nominal, in billions of domestic currency)	843	925	983	1,060	1,177	1,275	1,343	1,415	1,523
GDP (nominal, in billions of €)	191.7	203.5	244.0	272.1	310.3	359.7	309.1	353.8	387.2

Source: IMF staff.

Note: CAR = capital adequacy ratio; CDS = credit default swap; CPI = consumer price index; EMBIG = Emerging Markets Bond Index Global; FDI = foreign direct investment; GIR = gross international reserves; NEER = nominal effective exchange rate; NPLs = nonperforming loans; REER = real effective exchange rate; ROA = return on assets; ROE = return on equity; ULC = unit labor cost.

[1] Financial and capital account balances excluding EU balance-of-payments support, use of IMF resources, and SDR allocations.

CHAPTER 13

Bosnia and Herzegovina: Containing the Fallout with International Assistance

The global crisis exposed the fragility of Bosnia and Herzegovina's growth, which relied on ample foreign-financed credit, inward remittances, and donor-financed reconstruction of the war-torn economy. The sudden stop of financial inflows from abroad zapped domestic demand and, together with contracting exports, opened sizable external and fiscal financing gaps. The authorities' stabilization program supported under a stand-by arrangement (SBA) with the IMF stabilized public finances and shored up confidence in the currency board and the domestic banking system, thereby limiting the output loss. Looking beyond the past crisis, establishing strong sustainable growth and improving resilience against external shocks requires the implementation of ambitious structural reforms.

BACKGROUND

Bosnia and Herzegovina (BiH) lived through a traumatic transformation in the 1990s. Prior to the dissolution of Yugoslavia, its economy had been heavily industrialized and dominated by large-scale, export-oriented enterprises in the energy, raw materials, and military sectors. The 1992–95 war caused immense human suffering, destruction of physical infrastructure, and a decline in GDP by almost 80 percent. The 1995 Dayton Peace Agreement, which ended the war, created a complex political system designed to protect the interests of the different ethnic groups. BiH consists of two largely autonomous entities: the Republika Srpska and the Federation of BiH (hereafter the Federation), the latter divided into 10 cantons, each with substantial autonomy. The nation also has an overarching state government (referred to as the Institutions of BiH) with a limited mandate. In addition, there is the Brcko District, which is also a self-governing unit.

Growth in the period immediately following the war primarily reflected reconstruction financed by exceptionally large donor assistance. By 2003, progress had been remarkable. Real GDP tripled and exports grew 10-fold, although industry never recovered the breadth and dominance it once had. Inflation stabilized at low rates thanks to the introduction of a currency board arrangement that pegged the newly created convertible marka (KM) first to the Deutsche Mark and later to the euro. The banking system was privatized, recapitalized, and better regulated. Foreign banks would eventually account for close to 90 percent of system

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assets. The fiscal situation improved to the point where, after years of deficits, BiH recorded a small surplus. International reserves rose to three months of imports. On the downside, however, large external assistance allowed BiH to develop with less urgency to implement fundamental reforms than in other transition economies.

THE RUN-UP TO THE GLOBAL FINANCIAL CRISIS

In the years preceding the crisis, BiH enjoyed robust but increasingly unsustainable growth. During 2003–08, GDP grew on average by over 5¼ percent per year. Domestic demand—supported by rapid credit growth, remittances from abroad on the order of 10–15 percent of GDP, hefty wage increases, and a sizable fiscal impulse—exceeded GDP by a substantial margin throughout. Much of the private sector credit growth, which averaged 19 percent in real terms, was funded by foreign parent banks that provided their local subsidiaries with loans and capital.

Public spending took off to unsustainable levels—increasing by 56 percent during 2005–08, well in excess of the 44 percent increase of nominal GDP. The increased spending was financed by the successful introduction of the value-added tax in 2006 and went mostly into nonproductive uses: boosting public wages by 54 percent and war-related benefits by 76 percent. In addition, the Republika Srpska used large privatization proceeds in 2007 to undertake an ambitious multiyear public investment program. This weakened public finances, with the consolidated general government balance deteriorating from a surplus of 2.2 percent of GDP in 2006 to a deficit of 3.7 percent of GDP in 2008.

By 2008, external and internal stability came under threat. The current account deficit hit 14 percent of GDP, well outside the sustainable range. However, given easy access to external financing, the large deficit failed to appreciably dent foreign reserves. Indeed, between 2003 and 2007, the import coverage ratio rose from 3 to 4.7 months, and the reserve buildup continued through the third quarter of 2008. The sharp increases in government spending on wages and social transfers in 2008 magnified the impact of booming food and energy prices on domestic inflation, which peaked at 10 percent in July 2008.

The robust growth performance in the precrisis years masked the economy's structural weaknesses. BiH has consistently trailed its central and eastern European peers on most structural indicators. Following the 2000–01 voucher privatization, the sale of strategic enterprises moved forward only in 2007 in the Republika Srpska and is effectively stalled in the Federation. Official unemployment remained stubbornly high at well over 20 percent of the labor force, with employment generation held back by sizable skill gaps, an outdated collective bargaining system, widespread informality, and low labor force participation. On a positive note, the establishment of the Fiscal Council in August 2008 was an important step toward better fiscal coordination, and the signing of the Stabilization and Association Agreement with the European Union in June 2008 raised expectations for faster progress in critical structural areas.

IMPACT OF THE GLOBAL FINANCIAL CRISIS

The crisis arrived in BiH in the fourth quarter of 2008—at a time when overheating concerns had already taken root. As the financial health of foreign parent banks with subsidiaries in BiH was called into question, a mini–deposit run ensued in October 2008. The outflow of household deposits was covered by emergency loans from parent banks and freed-up liquidity from the lowering of reserve requirements. Official foreign exchange reserves experienced the largest one-month decline in years, raising red flags with foreign investors. In addition, exports started to let up and private investment collapsed. Private consumption softened to a lesser extent, as the impact of rising unemployment was partly offset by moderate growth in wages and social benefits. Inflation decelerated sharply amid the economic malaise and falling international commodity prices. Faced with the worsening financial health of enterprises and households, banks cut back their loan portfolios. Financial soundness indicators started to deteriorate, reinforcing the downturn in private sector credit. The stock market slumped.

Balance-of-payments and fiscal pressures escalated in the first half of 2009. The leakage of official foreign exchange reserves continued because the improvement in the trade balance brought on by the weakness of domestic demand was overcompensated for by the decline of remittances and the sudden unwillingness of foreign banks and investors to provide the customary funding. On the fiscal front, cumulative indirect tax revenue reached a trough in July 2009, off by 15 percent relative to the same period in 2008, before recovering somewhat to finish the year 12 percent below the 2008 outcome. In the Republika Srpska, privatization proceeds helped soften the blow to public finances and ensured continued financing of the public investment program and subsidized lending through the Investment and Development Bank. The Federation, on the other hand, faced the full brunt of the fiscal crisis, accumulating expenditure arrears of 1.4 percent of national GDP at end-2008.

POLICY RESPONSES

Faced with increasing financing pressures in early 2009, the authorities turned to the IMF and requested financial support for their economic adjustment program. The idea of approaching the IMF was first raised by the Federation government, which was under tremendous financial strain; it was quickly endorsed by the Fiscal Council. An IMF negotiating mission was dispatched very quickly, and staff-level agreement was reached on May 5, 2009. Given BiH's political structure, discussions were held with members of the Presidency, the Chairman of the Institutions of BiH, 12 prime ministers, 13 finance ministers, and the central bank. The original and subsequent letters of intent carried no less than seven signatures.

A three-year SBA in the amount of SDR 1.01 billion (US$1.57 billion) was approved in July 2009 by the IMF's Executive Board. A US$111 million Development Policy Loan from the World Bank, to be followed by two additional such World Bank loans and a €100 million macroeconomic support loan from the European Union, completed the envisaged financing package. The program was designed to safeguard the currency board in a deteriorating external environment while redressing fiscal imbalances, strengthening the financial sector, and securing commitments from foreign parent banks to maintain exposure and keep subsidiaries adequately capitalized. In particular:

- Roughly two-thirds of the resources made available under the SBA were envisaged for strengthening the reserves of the central bank should a need arise.[1] The currency board had been the linchpin of macroeconomic stability for one and a half decades, the central bank and commercial banks had built sizable liquidity buffers to support the viability of the monetary regime, and the exchange rate was not significantly misaligned. However, depreciations in the exchange rate of regional trading partners were a distinct possibility, so continued external competitiveness needed underpinning from wage flexibility, fiscal restraint, prudent financial sector policy, and progress in structural reforms.
- Fiscal policy tried to strike a balance between softening the economic downturn and achieving the necessary fiscal consolidation. Given the unsustainable fiscal starting position, applying a discretionary fiscal stimulus was out of the question. But there was room to allow automatic stabilizers to play out, primarily on the revenue side. The disbursements under the SBA, as well as the SDR allocation to the IMF membership, helped the authorities broadly maintain the provision of public services while initiating structural fiscal reforms. All levels of government were expected to contribute to the adjustment, but the burden fell disproportionately on the Federation, reflecting its tight financing constraints and larger contribution to the structural fiscal deficit. The Institutions of BiH, Republika Srpska, the Federation, and the Brcko District all committed to reducing the wage bill and rationalizing other expenses, including war-related benefits. Reforms, supported by the World Bank's Development Policy Loan, aimed at better and more-targeted protection of the poor, through eligibility audits and conditioning on recipients' income and ability to work.
- Financial sector policies focused on enhancing the capacity to monitor financial stability, strengthening the health of the banking sector, and shoring up confidence. A Standing Committee for Financial Stability was established. Stress testing of individual banks was introduced with technical assistance from the IMF. To help reassure the public, the individual deposit insurance limit was raised from KM 7,500 to KM 35,000 (€17,000) and extended to all banks. In this context, BiH signed an agreement with the EBRD that enabled the Deposit Insurance Agency to access emergency credit of up to €50 million in case its funds turned out to be insufficient to

[1] As of end-2011, these funds remained undrawn, as public and foreign investors' confidence in the financial system was quickly restored.

cover a payment event. To support credit growth in a tightening credit environment, the authorities temporarily relaxed the prudential rules on restructuring. Moreover, reserve requirements, which had already been lowered from 18 to 14 percent in October 2008, were further cut from 10 percent to 7 percent for long-term bank liabilities.

- The successful negotiation of the SBA allowed the authorities to secure commitments from nine foreign parent banks to maintain their exposure to BiH and recapitalize their subsidiaries under the European Bank Coordination Initiative arm of the Vienna Initiative (see Box 5.2). Follow-up meetings would be held in the context of program reviews.

ECONOMIC OUTCOMES IN 2009–11

BiH's stabilization program was successful in mitigating the impact of the global financial crisis on the economy. The IMF and World Bank external financial support helped minimize the impact of revenue shortfalls on government spending, thus limiting output losses. The economy bottomed out in 2009 and has since stabilized, paving the way for a gradual rebound in 2010–11. The multilateral support package has also helped stem the loss of official foreign exchange reserves, shoring up investor confidence (Figure 13.1).

The economy turned the corner in 2010 on the back of recovering export demand. Real GDP growth reached 0.7 percent in 2010 and 1.7 percent in 2011.

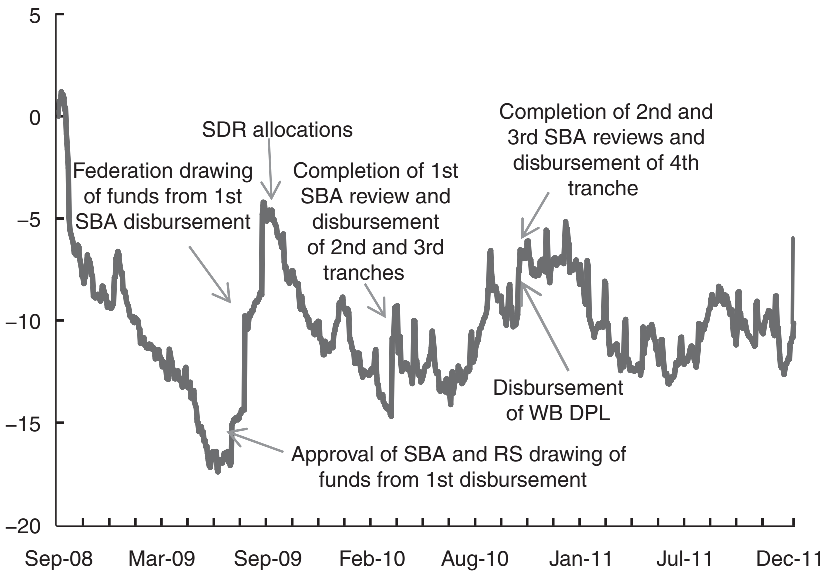

Figure 13.1 Bosnia and Herzegovina: Central Bank's Foreign Assets (*Percent change since end-September 2008*)

Sources: Central Bank of Bosnia and Herzegovina; and IMF staff calculations.
Note: DPL = Development Policy Loan; RS = Republica Sprska; SBA = stand-by arrangement; SDR = special drawing right; WB = World Bank.

However, the expansion has failed to spread to domestic demand amid rising unemployment, falling real wages, weak foreign direct investment inflows, and stalled bank lending. The strength of external demand, in conjunction with a slow recovery of imports, further narrowed the current account deficit, while official foreign exchange reserves increased. Core inflation is low, while headline inflation is driven by higher oil prices and tobacco excises.

Fiscal performance has so far been broadly in line with the program. Despite expenditure reduction measures initiated under the SBA, revenue shortfalls in 2009 led to a breach of the deficit ceiling by 1 percentage point of GDP and necessitated an easing of the deficit target for 2010 from 4 to 4.5 percent of GDP in the context of the first review. The revised 2010 target was comfortably met. Stopgap measures kept the 2011 fiscal deficit in line with the target of 3 percent of GDP. However, while overall spending stayed within the program envelope, its composition is a source of growing concern. The consolidated general government wage bill grew in 2009–11 despite programmed moderation, and savings from war-related benefits have fallen short of expectations amid stalled reforms. The overruns on wages and transfers have been offset by strict control over other current spending and by underperformance of the capital budget. Fiscal structural reforms have advanced very slowly. Both entities have approved legislation to reform war-related benefits, but implementation has been slow.

The banking sector has stabilized. Household deposits have fully recovered and are now above the levels reached prior to the October 2008 deposit run. But bank credit to the private sector has stabilized below its precrisis peak amid tightened lending standards. Nonperforming loans reached 11.8 percent of total loans at end-2011. As a result of the higher provisioning against nonperforming loans and the slump in lending activity, the banking sector recorded an overall loss in 2010, but it returned to profitability in 2011.

The first three program reviews were completed through October 2010, but the inability to form a new state government following the October 2010 elections has not allowed (as of end-2011) the resumption of program discussions.

CHALLENGES AHEAD

Going forward, BiH needs to see through the quantitative fiscal consolidation envisaged under the program. Lasting medium-term macroeconomic stability also requires structural fiscal reform to free up resources for much-needed infrastructure investment. This in turn requires persevering with the reforms of war-related benefits to improve their efficiency, reining in the public wage bill, and putting the pension systems on a sustainable footing.

With the government deficit and current account on track to return to sustainability and inflation in check, attention should increasingly be paid to addressing long-standing labor market rigidities and impediments to entrepreneurship. Chief among the labor market reform priorities are the need for: better alignment of the systems of collective bargaining and wage determination with the principles of a market economy; restraint in public sector hiring and benefits; and a refocusing of the work of employment agencies from providing welfare to active job placement policies. Speeding up the pace of technological change would require increasing the efficiency of the regulatory framework to allow quicker business startups, fewer authorizations for business operations, and a reduction in the number of different tax payments. Corporate sector performance could be boosted by privatization of the large strategic enterprises in the Federation and of the remaining medium-sized public companies in both entities. Legislative and institutional reforms aimed at creating a single economic space within the country will be needed to attract foreign direct investment and promote further integration of the local economy in the larger European marketplace.

Bosnia and Herzegovina: Principal Economic and Financial Indicators, 2003–11	2003	2004	2005	2006	2007	2008	2009	2010	2011
Real Sector Indicators									
GDP (real growth in percent)	3.9	6.3	3.9	6.0	6.2	5.7	–2.9	0.7	1.7
Domestic demand (real growth in percent)	3.9	2.9	1.8	–1.5	7.8	4.1	–6.4	–1.7	1.2
Net exports (real growth contribution in percent)	–2.0	1.6	1.1	8.0	–3.8	0.3	5.6	2.4	0.2
Exports of goods and services (real growth in percent)	18.3	12.2	6.1	15.1	11.6	8.2	–5.6	7.0	4.6
CPI (end-of-period change in percent)	0.5	0.6	4.3	4.5	4.9	3.8	0.0	3.1	2.7
Employment (growth in percent)	–0.6	0.2	0.9	1.2	4.8	4.7	–3.5	–1.9	–3.2
Unemployment rate (percent)	31.1	31.1	31.1	31.1	29.0	23.4	24.1	27.2	27.6
Public Finances									
Fiscal balance (percent of GDP)	–0.2	0.1	0.8	2.2	0.2	–3.7	–5.5	–4.2	–2.6
Government revenue (percent of GDP)	47.0	45.6	46.6	48.2	47.0	46.0	44.9	46.3	46.3
Government expenditure (percent of GDP)	47.2	45.5	45.8	46.0	46.8	50.0	50.6	50.7	49.4
Government primary expenditure (percent of GDP)	46.5	44.9	45.2	45.3	46.2	49.4	50.1	50.1	48.7
Government primary expenditure (real growth in percent)	3.8	2.6	4.7	6.2	8.2	13.2	–1.7	0.8	–1.2
Public debt (percent of GDP)	27.6	25.6	25.6	21.4	32.9	31.2	36.1	39.6	40.6
Of which foreign held	27.3	25.3	25.3	21.1	18.2	17.2	21.8	25.7	26.1
External Sector									
Current account balance (percent of GDP)	–19.2	–16.2	–17.1	–8.0	–10.7	–14.1	–6.3	–6.1	–8.3
Net capital inflows (percent of GDP)[1]	12.5	14.0	17.5	11.3	14.8	10.7	1.2	3.4	6.8
FDI	4.5	6.9	5.6	6.2	13.5	5.3	1.4	1.1	2.3
Portfolio	0.0	0.0	0.0	0.0	0.0	0.0	–1.1	–0.5	0.1
Other investment	8.0	7.1	11.9	5.2	1.3	5.4	0.9	2.8	4.3
Exports (percent of GDP)	25.9	29.1	32.6	36.5	37.4	37.0	32.3	37.6	41.1
Exports (€, growth in percent)	12.7	22.4	20.4	25.7	15.6	12.1	–15.0	18.9	12.9
Global export market share (basis points)	1.5	1.6	2.1	2.3	2.3	2.2	2.2	2.2	...
Remittances (percent of GDP)	13.5	14.6	13.5	12.9	12.8	10.3	8.4	8.1	8.0
Imports (percent of GDP)	70.9	70.1	72.8	65.6	68.9	70.1	55.5	59.4	64.7
Imports (€, growth in percent)	6.0	7.3	11.8	1.4	18.5	15.1	–22.9	9.3	12.5
External debt (percent of GDP)	54.4	52.2	49.6	49.3	51.6	47.7	55.9	52.5	46.6
Gross international reserves (€ billions)	1.4	1.8	2.1	2.8	3.4	3.2	3.2	3.3	3.3
Gross international reserves (percent of GDP)	18.9	21.7	24.5	28.0	30.8	25.5	25.9	26.4	25.4
Reserve coverage (GIR in percent of short-term debt)	304.2	550.4	351.7	395.7	276.6	175.1	195.1	168.7	182.4

Bosnia and Herzegovina: Principal Economic and Financial Indicators, 2003–11 (*continued*)	2003	2004	2005	2006	2007	2008	2009	2010	2011
Monetary Sector									
Broad money (end of period, growth in percent)	9.9	24.3	18.2	22.6	20.7	4.1	2.2	7.2	5.8
Monetary base (end of period, growth in percent)	...	...	...	...	...	...	...	...	...
Private sector credit (end of period, percent of GDP)	34.3	36.5	43.3	44.3	51.0	54.8	54.5	54.7	55.1
Of which foreign currency denominated	...	...	...	...	...	...	...	...	...
Of which foreign currency indexed	...	...	...	...	...	...	...	...	...
Cross-border loans to nonbanks (Q4, percent of GDP)	5.3	6.3	5.9	5.0	6.5	6.2	8.5	6.9	8.1
Private sector credit (end of period, real growth in percent)	19.5	14.9	22.3	9.9	24.0	17.6	–3.4	–0.8	1.3
Financial Sector									
Assets (percent of GDP)	52.2	58.9	69.2	76.5	90.0	85.4	87.5	86.5	86.6
ROA (percent)	0.4	0.7	0.7	0.9	0.8	0.4	0.1	–0.6	0.7
ROE (percent)	...	...	6.2	8.5	9.0	4.3	0.8	–5.5	5.9
CAR (percent of risk-weighted assets)	20.3	18.7	17.8	17.7	17.1	16.3	16.1	16.2	17.2
NPLs (percent of total loans)	...	...	5.3	4.0	3.0	3.1	5.9	11.4	11.8
Loan-to-deposit ratio	1.3	1.2	1.2	1.1	1.1	1.3	1.2	1.2	1.2
Cross-border claims by foreign banks (all sectors, percent of GDP)	8.7	10.7	20.8	22.8	28.6	25.4	29.1	24.1	21.2
Financial Markets									
Interest rates (end of period, one-year government bond, percent)	...	...	...	...	...	...	...	...	...
CDS spreads (sovereign, end of period, basis points)	...	...	...	...	...	...	...	...	...
EMBIG spread (sovereign, end of period, basis points)	...	...	...	...	...	...	...	...	...
Exchange rate (end of period, domestic currency/€)	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
NEER (index, 2003 = 100)	100.0	101.3	101.2	101.0	101.8	102.9	104.8	102.3	102.9
REER (CPI-based, 2003 = 100)	100.0	98.8	98.1	100.9	100.1	103.9	104.0	101.5	102.0
REER (ULC-based, 2003 = 100)	...	...	...	...	...	...	...	...	...
Memorandum Items									
GDP (nominal, in billions of domestic currency)	15	16	17	19	22	25	24	24	25
GDP (nominal, in billions of €)	7.5	8.1	8.8	9.8	11.1	12.6	12.2	12.5	13.5

Source: IMF staff.

Note: CAR = capital adequacy ratio; CDS = credit default swap; CPI = consumer price index; EMBIG = Emerging Markets Bond Index Global; FDI = foreign direct investment; GIR = gross international reserves; NEER = nominal effective exchange rate; NPLs = nonperforming loans; REER = real effective exchange rate; ROA = return on assets; ROE = return on equity; ULC = unit labor cost.

[1] Financial and capital account balances excluding EU balance-of-payments support, use of IMF resources, and SDR allocations.

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CHAPTER 14

Moldova: Rebounding on Improved Policies

Following a difficult early transition period, Moldova's economy had been expanding strongly since 2000 from low income levels. Growth became increasingly domestic demand driven, fueled by ever-increasing inflows of remittances and capital. The current account deficit ballooned. Initial hopes that the global financial crisis would bypass Moldova because of the limited international integration of its financial system proved misplaced. A sharp drop of inflows as well as exports forced a severe contraction and rebalancing of the economy, and expansionary fiscal policies soon reached their limits as public finances were exposed as much weaker than presumed during the boom years. Since January 2010, a stabilization program, supported by a three-year arrangement with the IMF, has been restoring viable public finances and competitiveness. The economy rebounded strongly in 2010 and 2011.

BACKGROUND

Moldova is the least prosperous country of emerging Europe. The first decade after independence in 1991 was marked by sharp economic contraction and high unemployment. This fostered strong outward labor migration, with an estimated 10–15 percent of the population living and working abroad. Migrants' remittances and worker compensation, equivalent to 10–20 percent of GDP, are considerable, bridging much of the traditionally large shortfall of exports over imports. Moldova benefited from subsidized gas imports from Russia for some time after independence, although less so than other former Soviet Republics for lack of significant heavy industry. Agriculture remains a key sector of the economy, while food processing accounts for more than one-third of the industrial sector. Light industry, such as textiles and clothing, has gained importance over the years.

Following the Russian financial crisis in 1998, Moldova made important headway in achieving and maintaining macroeconomic stability. Inflation was significantly reduced, although it was never brought decisively into the single digits. The National Bank of Moldova's mandate had traditionally been focused on ensuring nominal currency stability, but from 2007 it shifted to a more active anti-inflationary policy. The fiscal position was roughly in balance. Moldova made much progress shifting to a viable free-market economy, and its private sector now accounts for four-fifths of GDP. Prices were liberalized early on and widespread consumer subsidies were phased out. The relatively small, mainly

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domestically owned banking system makes for a relatively low credit penetration. The economy returned to economic growth in the year 2000.

THE RUN-UP TO THE GLOBAL FINANCIAL CRISIS

Rapid domestic demand growth of some 10 percent propelled GDP growth to over 6 percent annually during 2003–08. Remittances and capital inflows fueled the boom, and so did fiscal policy. The current account balance deteriorated progressively to peak at over 16 percent of GDP in 2008. The seeds for a sharp correction were sown.

Record inflows of remittances and capital widened economic imbalances in 2006–08. True, much of the capital inflows took the form of foreign direct investment and trade credit—normally considered "good" inflows—but they financed mostly imports and investment in the nontradable sector rather than contributing to Moldova's export potential. Meanwhile, major exports—wine and agricultural products—were hurt by a Russian embargo during 2006–07 and a drought in the summer of 2007. Moreover, Russia announced the phasing out of gas subsidies and sharply raised gas prices over the course of 2006. The real exchange rate appreciated by as much as 46 percent from mid-2007 to early 2009, indicating a serious loss of competitiveness.

On the fiscal front, policy gradually turned procyclical. As buoyant consumption-based taxes lifted revenues by as much as 5 percentage points of GDP during 2004–08, spending was allowed to grow even faster. While the headline budget balance did not deteriorate by much, underlying public finances worsened significantly due to the cyclical nature of the revenue gains. Key fiscal reforms were delayed, such as consolidating the education sector in the face of a rapidly declining student population and putting the pension system on a socially and financially sound footing.

Monetary policy was slow to react to mounting demand and inflationary pressures. In response to the foreign exchange inflows, the National Bank of Moldova accumulated a large stock of international reserves (US$1.8 billion, or five months' worth of imports, by September 2008). The central bank eventually raised policy interest rates and reserve requirements, but these measures largely played catch-up with inflation developments and failed to mop up enough of the liquidity injections from reserve accumulation. With real interest rates low and the economy booming, credit growth remained high and inflation stubbornly stayed in the double digits.

The financial sector appeared robust in the boom years. Rapidly increasing credit penetration, though from a low base, market-determined interest rates, and a favorable regulatory regime made for highly profitable banks. All of them maintained high capital adequacy and liquidity ratios. Nonperforming loans accounted for a modest 4.6 percent of total loans in September 2008.

A three-year IMF-supported program under the Poverty Reduction and Growth Facility came into effect in May 2006. Initially it helped Moldova maintain macroeconomic stability and promote growth. It also secured a restructuring of Paris Club debt. However, escalating policy slippages in the run-up to the April 2009 general elections put the program off track—no review after June 2008 would be completed.

IMPACT OF THE GLOBAL FINANCIAL CRISIS

Moldova felt the first signs of the global financial crisis in late 2008, when external demand and inflows started contracting. However, the authorities only belatedly recognized the full economic implications. The limited foreign exposure of Moldova's financial system made them believe that the crisis would largely bypass their economy. Amid two rounds of parliamentary elections in April and July 2009, it would take until late 2009 for a coherent anticrisis policy response to take shape.

The global financial crisis indeed did not hit Moldova's financial sector directly. However, a deep recession would soon lead to a surge of nonperforming loans, which eroded profitability. Still, all banks remained liquid and well capitalized, except for one medium-sized institution that became insolvent in June 2009 on account of unfavorable exposure concentration and risk management irregularities.

The crisis was instead transmitted to Moldova through a sharp contraction of inward remittances, capital inflows, and exports. In 2009, remittances fell by more than 5 percent of GDP, capital inflows corresponding to more than 20 percent of GDP came to a sudden stop, and exports plunged by 20 percent. The overall balance of payments, which had recorded a large surplus up until the third quarter of 2008, came under acute pressure. Robbed of its financing sources, domestic demand took a tumble and the economy fell into recession.

POLICY RESPONSES

Fiscal policy was highly expansionary through much of 2009. Public expenditure soared by 13 percent in real terms in the first three quarters of 2009 relative to 2008, reflecting large increases in public sector wages and pensions in the run-up to the elections. With revenues meanwhile falling by some 10 percent as a result of the recession, the budget deficit widened rapidly to 6¼ percent of GDP. While this politically motivated fiscal policy stance might have helped prop up weak domestic demand, it had several drawbacks. First, it soon ran into financing constraints. Heavy domestic borrowing sent interest rates in the shallow domestic T-bill market to 15–25 percent and exacerbated the credit crunch for the private sector. Only the special SDR allocation to all IMF members saved the government from recourse to the printing press or large-scale arrears. Second, spending hikes were neither temporary nor well targeted, leaving a legacy of sharply deteriorated public finances that would take many years to correct.

Monetary policy went from tight to accommodative. Initially the National Bank of Moldova resisted sustained exchange rate depreciation pressures, selling about one-third of its international reserves in the process. This led to a gradual depreciation of a cumulative 8 percent between end-August 2008 and end-April 2009. The central bank also sharply curtailed liquidity. Signs of deflation started to emerge. In response, the National Bank of Moldova changed course in mid-2009 and eased monetary policy through large reductions in its policy interest rates and by cutting reserve requirements in half. The exchange rate did not respond much. The policy changes also did little to ease the credit crunch, since apprehensive banks preferred to park the extra liquidity at the central bank or in the T-bill market.

A more coherent crisis response emerged in late 2009. The elections of July 2009 had brought a four-party center-right coalition to power, sending the communist party, which had dominated politics since the early 2000s, into opposition. Some correction of the current account deficit notwithstanding, the external financing gap was still large and international reserves had suffered. Public finances were on an unsustainable path and the recession showed no sign of abating. This prompted the new government to embark on an adjustment course and to seek financial assistance from the IMF.

Thus, the authorities postponed pre-election plans to increase public sector wages further in late 2009 and 2010, and revised the 2009 budget to bring the deficit in line with available financing. The National Bank of Moldova intervened in the foreign exchange market to replenish its stock of foreign reserves, allowing the exchange rate to depreciate by some 10 percent. The government also scrapped a number of export and import restrictions and simplified customs controls, licensing requirements, and procedures for business registration and liquidation.

In January 2010, the IMF approved a three-year arrangement with financial assistance of US$574 million to support the government's stabilization and recovery program.[1] The program rested on four pillars: (i) fiscal policies to restore sustainability while safeguarding public investment and social spending priorities; (ii) flexible monetary and exchange rate policies to keep inflation under control and facilitate adjustment to shocks; (iii) policies to ensure financial stability; and (iv) structural reforms to raise the economy's potential.

Fiscal policy aimed to correct the structural imbalances at a pace matching the speed of the economic recovery, relying mainly on reform-based cuts in current expenditure. Key challenges included containing the wage bill—public sector wages were among the highest in the region relative to the economy's ability to finance them—through consolidation in the public sector and deep structural reforms in the oversized education sector. On the other hand, the program included increased growth-supporting capital expenditure and an expanded social safety net to help mitigate the impact of the recession. On balance, the program envisaged a fiscal tightening of 7 percent of GDP in 2010 relative to the deficit that would have resulted from unchanged policies as of mid-2009.

[1]The program is a fifty-fifty blend of arrangements under the Extended Credit Facility and the Extended Fund Facility.

Monetary policy faced the immediate challenges of breaking the credit crunch and preserving financial stability. Weak monetary transmission channels and the economy's relatively high degree of dollarization limited the influence of policy measures at first. Despite large policy rate cuts, bank loan rates lingered at high levels, and credit growth remained sluggish until mid-2010. In an effort to buttress the impact of its policies, the National Bank of Moldova accelerated the transition to a monetary policy framework focused on inflation targets and a flexible exchange rate. Proactive supervision and regulation ensured that the commercial banks maintained sufficient capital and liquidity buffers. The program also sought to strengthen financial stability by enhancing the tools for early detection of bank difficulties and strengthening the legal framework for bank rehabilitation and resolution.

Structural reforms were aimed at supporting the fiscal effort, improving the business environment, and liberalizing markets to promote private enterprise and competition. A far-reaching tax administration reform focused on raising compliance and expanding the tax net to the informal sector. Early retirement would be phased out to ensure the sustainability of the social insurance system, and substantial reforms were planned to raise efficiency in public administration and the education system. Energy sector reforms sought to end losses among public enterprises in the regulated energy sector, mainly by depoliticizing tariff setting and entrenching cost recovery.

ECONOMIC OUTCOMES IN 2009–11

A difficult international economic environment and the incoherent policy response made for poor economic performance in 2009. Real GDP fell by 6 percent while domestic demand suffered a much larger contraction of more than 18 percent. Credit declined by 7 percent. Prices remained flat over the course of the year. On the bright side, Moldova avoided a financial crisis—exchange rate depreciation remained contained and the banking system stayed stable.

From late 2009, growth returned sooner and with much more vigor than was expected when the adjustment package was put together. The credibility of the policy program and the improved international environment both contributed to this favorable outcome. A strong pickup in industrial production and external trade in late 2009 continued throughout 2010, supported by the rebuilding of business inventories, a recovery among the main trading partners, and the removal of many trade restrictions. A good harvest and rising international agricultural prices helped the export expansion as well. Consumer demand recovered robustly, as capital started flowing back into the country and inward remittances rose. All told, GDP growth reached an impressive 7.1 percent in 2010 and is estimated to have reached 6.4 percent in 2011.

Fiscal policy performed better than programmed. The budget deficits in both 2009 and 2010 were substantially lower than envisaged under the program on account of a robust revenue intake and expenditure restraint. By 2011 the fiscal deficit had been reduced below 2½ percent of GDP. At the same time, vulnerable households benefited from a large increase of funds for social assistance, allowing their guaranteed minimum income to rise by 23 percent in 2010. Enrollment in the new targeted social assistance program expanded steadily as well.

In January 2010, the National Bank of Moldova announced an inflation target of 5 percent with a narrow ±1 percent tolerance band. However, the revival of domestic demand and the pass-through from international energy and food price shocks kept headline inflation around 8 percent during 2010 and pushed it close to 9 percent in the second half of 2011. The National Bank of Moldova responded with interest rate hikes and tighter reserve requirements. This led to a stabilization of inflation in the autumn of 2011, paving the way for a gradual interest rate relaxation toward end-2011 in light of the subdued global economic outlook.

The exchange rate remained broadly flat in 2010, but fluctuations in foreign exchange inflows to the thin domestic market led to increased exchange rate volatility and required the occasional intervention of the central bank. Overall, however, the flexible exchange regime pursued by the National Bank of Moldova has allowed it to replenish its international reserves without compromising its inflation objective.

Banks' financial standing has been steadily improving as well. Profits began to rise early in 2010. Nonperforming loans peaked at 18 percent of total loans in July 2010 but then fell to less than 11 percent at end-2011 as banks cleaned their balance sheets and new lending resumed. Credit growth reached some 20 percent in 2011 in nominal terms (and corrected for write-offs and valuation effects from exchange rate changes).

Through end-2011, the IMF-supported program remained broadly on track. It is set to expire in January 2013.

CHALLENGES AHEAD

The crisis has highlighted the limitations of Moldova's growth model and its vulnerability to a boom-bust cycle rooted in its dependence on remittances and capital inflows. Remittances may well have peaked in 2007–08, since the earlier high rates of migration cannot be sustained going forward and migrants' ties with their home country tend to weaken over time. Capital inflows are prone to sudden stops. The outflow of labor and the relatively subdued outlook for private investment limit medium-term potential GDP growth to an estimated 4½–5 percent under Moldova's current policies, a modest rate relative to Moldova's vast development needs and poverty reduction objectives.

To boost its long-term growth prospects, Moldova is well advised to develop a "second engine" of growth based on exports. For this purpose, it will be essential to:

- Maintain macroeconomic stability centered on a sustainable fiscal policy and a flexible monetary policy focused on price stability. This will require significant consolidation and rationalization of the public sector, strengthening of the monetary framework, and deepening of financial markets.

- Maintain external price competitiveness by keeping real wage growth in line with productivity gains and avoiding policies that could lead to large overvaluation.
- Seek export expansion opportunities in EU markets in the context of the Association Agreement with the European Union, not least by striving to meet the European Union's food safety requirements.
- Lower the costs of doing business by cutting red tape, continuing market liberalization, and strengthening governance to attract private investment in the sectors producing tradable goods.
- Upgrade the country's long-neglected infrastructure. In this regard, Moldova has a golden opportunity to make substantial progress in light of the significant amount of international assistance that accompanies the IMF-supported program.

Moldova: Principal Economic and Financial Indicators, 2003–11

	2003	2004	2005	2006	2007	2008	2009	2010	2011
Real Sector Indicators									
GDP (real growth in percent)	6.6	7.4	7.5	4.8	3.0	7.8	−6.0	7.1	6.4
Domestic demand (real growth in percent)	17.1	2.6	16.8	10.4	9.4	5.5	−18.6	9.7	6.0
Net exports (real growth contribution in percent)	−12.2	2.7	−11.6	−7.8	−8.6	−1.3	17.2	−5.4	−3.9
Exports of goods and services (real growth in percent)	19.2	11.0	14.7	1.1	10.5	3.4	−12.1	13.7	28.6
CPI (end-of-period change in percent)	15.7	12.5	10.0	14.1	13.1	7.3	0.4	8.1	7.8
Employment (growth in percent)	−9.9	−3.0	0.2	−4.7	−0.8	0.3	−5.3	−3.5	−1.5
Unemployment rate (percent)	7.9	8.1	7.3	7.4	5.1	4.0	6.4	7.4	6.7
Public Finances									
Fiscal balance (percent of GDP)	0.7	0.7	1.5	0.0	−0.2	−1.0	−6.3	−2.5	−2.4
Government revenue (percent of GDP)	34.0	35.4	38.6	39.9	41.7	40.6	38.9	38.3	36.7
Government expenditure (percent of GDP)	33.3	34.6	37.0	39.8	42.0	41.6	45.2	40.8	39.1
Government primary expenditure (percent of GDP)	31.2	32.7	35.8	38.6	40.8	40.4	43.9	40.0	38.3
Government primary expenditure (real growth in percent)	17.9	12.5	17.5	13.1	8.7	6.8	2.1	−2.3	1.8
Public debt (percent of GDP)	54.6	42.8	34.8	31.0	24.6	19.3	29.1	26.5	23.4
Of which foreign held	37.3	26.1	20.8	21.1	17.4	12.9	14.2	14.0	...
External Sector									
Current account balance (percent of GDP)	−6.6	−1.8	−7.6	−11.3	−15.2	−16.2	−8.6	−8.3	−10.6
Net capital inflows (percent of GDP)[1]	7.0	2.5	6.8	12.5	24.8	22.5	1.2	9.8	14.6
FDI	3.7	3.3	6.4	7.6	11.9	11.5	2.5	3.3	3.6
Portfolio	−1.2	−0.4	−0.2	−0.1	−0.1	0.1	−0.1	0.1	0.1
Other investment	4.4	−0.4	0.6	5.0	13.0	10.9	−1.2	6.4	10.9
Exports (percent of GDP)	53.3	51.0	50.3	44.8	45.5	41.1	36.8	39.4	45.0
Exports (US$, growth in percent)	20.4	25.7	13.4	1.6	31.0	24.4	−19.7	14.6	37.4
Global export market share (basis points)	1.05	1.08	1.05	0.87	0.96	0.99	1.04	1.03	...
Remittances (percent of GDP)	7.7	8.5	13.2	17.7	19.1	17.3	11.7	10.5	10.0
Imports (percent of GDP)	87.0	80.9	90.9	91.9	98.2	94.2	73.4	78.8	85.5
Imports (US$, growth in percent)	33.1	22.0	29.2	15.3	38.0	32.0	−30.1	14.8	30.7
External debt (percent of GDP)	86.6	65.1	60.9	63.6	63.3	55.2	65.5	67.3	67.0
Gross international reserves (US$ billions)	0.3	0.5	0.6	0.8	1.3	1.7	1.5	1.7	2.0
Gross international reserves (percent of GDP)	15.3	18.1	20.0	22.8	30.3	27.6	27.2	30.5	29.5
Reserve coverage (GIR in percent of short-term debt)	...	...	...	...	...	...	...	...	...

Moldova: Principal Economic and Financial Indicators, 2003–11 (*continued*)

	2003	2004	2005	2006	2007	2008	2009	2010	2011
Monetary Sector									
Broad money (end of period, growth in percent)	30.7	37.7	35.0	23.6	39.8	15.9	3.2	13.4	10.6
Monetary base (end of period, growth in percent)	16.6	39.8	41.3	–1.7	59.3	25.6	–12.5	8.9	21.8
Private sector credit (end of period, percent of GDP)	20.3	21.2	23.6	27.5	36.8	36.4	36.0	33.3	33.6
Of which foreign currency denominated	...	...	9.3	10.9	16.2	15.0	16.2	14.1	14.9
Of which foreign currency indexed	...	...	...	...	...	...	...	...	...
Cross-border loans to nonbanks (Q4, percent of GDP)	1.8	1.0	1.2	1.5	1.6	1.8	1.7	2.2	1.4
Private sector credit (end of period, real growth in percent)	25.3	7.8	18.8	21.3	41.6	8.5	–5.6	1.7	7.2
Financial Sector									
Assets (percent of GDP)	33.9	38.5	45.1	48.8	57.1	59.3	66.2	58.9	57.2
ROA (percent)	...	...	3.2	3.4	3.9	3.5	–0.5	0.5	2.0
ROE (percent)	...	...	15.4	20.5	24.0	19.9	–2.5	2.6	11.5
CAR (percent of risk-weighted assets)	...	...	27.2	27.8	29.1	32.2	32.1	30.1	30.4
NPLs (percent of total loans)	...	...	5.3	4.4	3.7	5.2	16.4	13.3	10.7
Loan-to-deposit ratio	...	...	...	...	...	...	...	...	...
Cross-border claims by foreign banks (all sectors, percent of GDP)	3.9	3.2	2.5	8.5	10.9	11.0	10.4	8.2	5.2
Financial Markets									
Interest rates (end of period, one-year government bond, percent)	...	...	...	...	...	...	...	...	...
CDS spreads (sovereign, end of period, basis points)	...	...	...	...	...	...	...	...	...
EMBIG spread (sovereign, end of period, basis points)	...	...	...	...	...	...	...	...	...
Exchange rate (end of period, domestic currency/US$)	13.2	12.5	12.8	12.9	11.3	10.4	12.3	12.2	11.7
NEER (index, 2003 = 100)	100.0	106.5	102.2	97.1	97.8	110.5	116.3	105.4	108.7
REER (CPI-based, 2003 = 100)	100.0	114.5	117.2	120.5	130.7	155.7	158.7	149.1	157.9
REER (ULC-based, 2003 = 100)	...	...	...	...	...	...	...	...	...
Memorandum Items									
GDP (nominal, in billions of domestic currency)	28	32	38	45	53	63	60	72	82
GDP (nominal, in billions of US$)	2.0	2.6	3.0	3.4	4.4	6.1	5.4	5.8	7.0

Source: IMF staff.

Note: CAR = capital adequacy ratio; CDS = credit default swap; CPI = consumer price index; EMBIG = Emerging Markets Bond Index Global; FDI = foreign direct investment; GIR = gross international reserves; NEER = nominal effective exchange rate; NPLs = nonperforming loans; REER = real effective exchange rate; ROA = return on assets; ROE = return on equity; ULC = unit labor cost.

[1] Financial and capital account balances excluding EU balance-of-payments support, use of IMF resources, and SDR allocations.

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CHAPTER 15

Kosovo: Watching the Global Crisis from the Sidelines

Kosovo's financial and economic integration with the global economy is limited. Since the end of the Kosovo war in 1999, the emphasis has been on rebuilding the country with international assistance and establishing government institutions—since 2001 under interim United Nations administration and Provisional Institutions of Self-Government and since its declaration of independence in 2008 under its own government. Due to the insularity of Kosovo's economy, the global financial crisis merely dented growth in 2009. Nonetheless, Kosovo faces formidable development challenges. The IMF supported Kosovo through a stand-by arrangement (SBA) and a staff-monitored program.

BACKGROUND

Kosovo's separation from Serbia turned into an armed conflict between the Kosovo Liberation Army and Federal Yugoslav forces during 1998–99. Following NATO's successful military campaign to halt the violence, the United Nations Interim Administration Mission in Kosovo was established. In 2001, the UN mission promulgated a constitutional framework for the establishment of Provisional Institutions of Self-Government. In February 2008, Kosovo declared independence. It joined the IMF and the World Bank in June 2009.

This painful path to still-fresh independence also shaped Kosovo's economic developments. Years of conflict and disruption led to a neglect of education and investment. Low human capital and infrastructure bottlenecks, such as frequent power outages, traffic logjams, and inadequate regional connectivity in the transport and energy systems, depress its competitiveness and living standards. Economic activity is dominated by services, including retail trade and construction, and although there are some green shoots in the manufacturing sector, job opportunities are insufficient, with official unemployment hovering around 40 percent. Exports are very low and per capita income remains one of the lowest in the region. Import dependence is high. Kosovo's large current trade deficit is financed by remittances and foreign direct investment from Kosovo citizens working abroad as well as official international assistance.

Nonetheless, much progress has been made in building institutions and adopting a market-based economy. Most of the state-owned enterprises have been privatized, including the largest exporter, and the private sector now accounts for the bulk of economic activity. The banking sector is dominated by foreign banks,

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which account for 90 percent of assets, without, however, relying much on foreign financing. Inflation is low thanks to the unilateral adoption of the euro. Public finances have tended to be in surplus, reflecting efficient value-added tax collection at the border, frequent underexecution of the budget, and an absence of borrowing opportunities. But the fiscal balance turned negative after independence, especially owing to the scaling-up of the investment program.

THE RUN-UP TO THE GLOBAL FINANCIAL CRISIS

Economic growth was relatively robust before the global crisis, averaging close to 5 percent during 2003–08. The following main factors explain this performance. First, remittances were a significant and reliable income source of 12 to 15 percent of GDP per year. Second, Kosovo boasts one of Europe's youngest populations, with around half of the population below the age of 25; population growth hovers around an estimated 1.5 percent per year. Third, large-scale international support helped spur growth shortly after the end of the armed conflict. Fourth, fiscal policy provided for rapid expenditure growth, underpinning brisk domestic demand growth.

Following the initial reconstruction boom, the growth momentum began to shift from the international public sector to the private sector, partially financed by credit. Private sector credit grew by 60 percent in real terms during 2003–08, albeit from a very low base. Moreover, Kosovo's banking sector had the distinct advantage of a stable funding base. The financial sector was set up from scratch, and despite the closure of one small domestic bank in 2006, the sector was quick to gain the population's confidence. As a result, substantial holdings of mattress money and remittances bolstered deposit growth, which exceeded 20 percent per year during 2003–08. Foreign liabilities, therefore, were minor on the eve of the global financial crisis—just 2 percent of GDP in September 2008—and the loan-to-deposit ratio stood at a comparatively low 82 percent in 2008. In addition, the Central Bank of the Republic of Kosovo (CBK) successfully dampened credit growth by tightening supervision and exercising moral suasion to convince banks to keep loan-to-deposit ratios below the 80 percent mark.

IMPACT OF THE GLOBAL FINANCIAL CRISIS

Given the limited dependence on foreign lending, the global financial crisis only had a moderate impact on Kosovo's economy. The primary transmission channels included exports, remittances, and foreign direct investment. Although exports of goods dipped during 2009, their low base shielded the real economy from major disturbances. Workers' remittances experienced a moderate peak-to-trough decline of 12 percent, reflecting the resilience of labor markets in Germany and Switzerland, the primary hosts of Kosovo's migrants. Given that a substantial share of foreign direct investment reflects migrants' real estate purchases, its decline was also moderate.

Bank lending decelerated significantly but remained in positive territory. Because banks were not dependent on foreign financing and domestic deposits

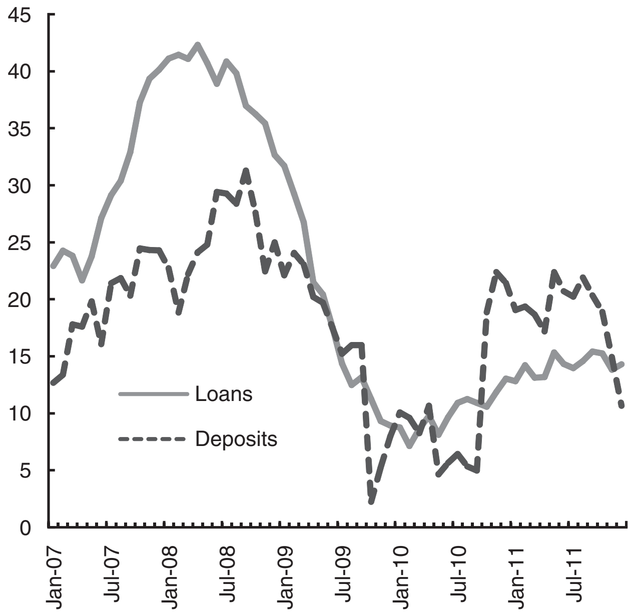

Figure 15.1 Kosovo: Bank Deposits and Loans, 2007–11 (*Year-over-year percent change*)

Source: Central Bank of Kosovo.

held up well, banks had no reason to deleverage sharply. Liquidity strains did not arise, since the decline of deposit growth was less pronounced than the decline of lending growth (Figure 15.1).

POLICY RESPONSES

Since the global financial crisis largely bypassed Kosovo, a specific policy response was not necessary. However, fiscal policy turned more expansionary in 2008 upon independence due to escalating demands for social spending, transfers to the loss-making energy sector, and infrastructure investments. By 2009, the general government budget deficit had reached nearly 6 percent of GDP (not counting the large one-time dividend payment from the publicly owned telecom company of 5 percent of GDP). In 2010, the government decided to begin constructing the first highway that will provide direct access to the port of Durres in Albania. The World Bank estimates that this project will cost about 24 percent of 2010 GDP over a period of four years. While the fiscal surpluses of previous years had accumulated substantial government balances at the CBK, which could now be drawn down, such large-scale investment projects required a broader fiscal strategy with substantial consolidation in other areas (Figure 15.2). It is in this context, rather than in response to imminent pressures from the global financial crisis, that the authorities turned to the IMF for the July 2010 SBA (Box 15.1).

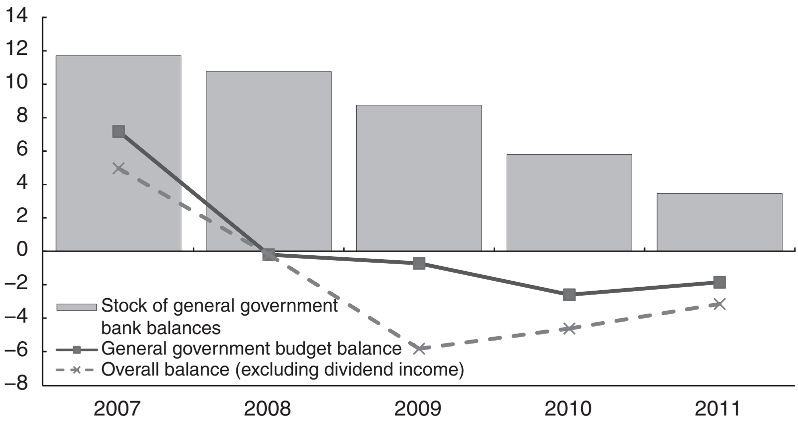

Figure 15.2 Kosovo: General Government Bank Balances and Budget Balance (*Percent of GDP*)

Sources: Kosovo authorities; and IMF staff calculations.

BOX 15.1 The IMF-Supported Program of July 2010

An 18-month stand-by arrangement was approved by the IMF Executive Board on July 21, 2010, in the amount of SDR 92.5 million (about €108.9 million). The program was built around (i) restraint on current spending, higher revenues, and privatization proceeds to contain the impact of the investment program on the overall deficit, and (ii) bolstering of the government's deposits with the central bank to build buffers for fiscal and financial contingencies. In particular:

- The authorities committed to a combination of revenue and spending measures to limit budget deficits to 3.4 percent of GDP in 2010 and 5.5 percent of GDP in 2011, amid accelerating highway-related spending in 2011. To this end, excise taxes were raised and capital spending (other than for the highway) was reduced as part of an amendment to the 2010 budget. The Law on Public and Financial Management and Accountability was amended in order to improve fiscal discipline and to ensure that any spending initiatives would be budget-neutral at future midyear budget reviews. Moreover, the authorities undertook to limit current spending, to refrain from commercial borrowing in 2011, and to upgrade the quality of expenditure and public financial management.
- To buttress financial sector stability, the Assembly adopted a new central bank law that meets international standards and establishes a limited lender-of-last-resort function for the Central Bank of the Republic of Kosovo (CBK). However, given euroization, the scope for the CBK to engage in lender-of-last-resort activities is narrow. The CBK's international reserves mainly comprise the counterpart of the government's deposits held at the CBK and liquid assets linked to the CBK's equity capital. Hence, the authorities pledged to maintain their central bank deposits at prudent levels.

The 2011 budget adopted by the newly constituted Assembly deviated from program commitments, notably by increasing public sector wages by between 30 and 50 percent in the context of an early parliamentary election. Unfunded social spending initiatives with unclear budgetary implications posed additional fiscal risks. As a result, no review under the program could be completed.

ECONOMIC OUTCOMES IN 2009–11

Real GDP growth decelerated from its 6.9 percent peak in 2008 to 2.9 percent in 2009. It rebounded to about 4 percent in 2010 and 5 percent in 2011 on account of reviving exports and a pickup in foreign direct investment. The current account deficit remained large, although it may have been overstated due to underreported cash transfers, but it continues to be financed through foreign direct investment and other non-debt-creating flows for now.

Throughout the period of the global financial crisis, Kosovo's banking sector remained adequately capitalized and very profitable. True, the loan portfolios started showing signs of strain, but the rise of nonperforming loans to a peak of 6 percent of total loans in mid-2011 from a precrisis low of 3.3 percent was modest compared to developments elsewhere in emerging Europe.

The Kosovo Pension Savings Fund initially took a hard hit. This fund is charged with investing the contributions collected by the second and third pillars of the private pension system. Absent domestic securities, the vast majority of this pension fund's assets are invested abroad. The fund thus suffered an investment loss of 32 percent in 2008. However, by end-2010, it had recovered about four-fifths of this loss.

CHALLENGES AHEAD

Developing Kosovo's economic potential requires, foremost, a reorientation of its growth model and a strategic rethinking of its fiscal priorities. So far, growth has relied mostly on exceptionally high remittances and foreign direct investment, but longer-term prospects for these flows will be subdued as diaspora Kosovars integrate more closely into their host countries. A key challenge is therefore to develop a vibrant tradable sector, which in turn requires upgrading public infrastructure and education while keeping wages competitive. In the fiscal area, large infrastructure projects require careful evaluation, and other spending initiatives will need to take a back seat to ensure sustainability of public debt and adequate buffers for liquidity management.

Since July 2011, Kosovo's reform efforts, especially in the fiscal area, have been supported by a staff-monitored program with the IMF. While this program involves neither endorsement by the IMF Executive Board nor financial assistance, such informal agreements with IMF staff help monitor the implementation of the authorities' economic program, with a view to establishing a track record of strong economic performance. The staff-monitored program was successfully completed at the end of 2011, with substantial progress in fiscal structural adjustment, improvements in budgetary planning and execution, better revenue collection, and steps to strengthen the financial system's resilience.

Kosovo: Principal Economic and Financial Indicators, 2003–11

	2003	2004	2005	2006	2007	2008	2009	2010	2011
Real Sector Indicators									
GDP (real growth in percent)	5.4	2.6	3.8	3.4	6.3	6.9	2.9	3.9	5.0
Domestic demand (real growth in percent)	10.6	7.8	4.3	3.1	8.6	8.4	4.2	5.3	4.6
Net exports (real growth contribution in percent)	0.7	1.0	–0.8	1.2	–2.7	–1.9	–1.1	–1.5	–0.1
Exports of goods and services (real growth in percent)	–19.0	103.4	8.1	32.0	13.4	4.7	7.8	24.2	13.6
CPI (end-of-period change in percent)	0.5	–3.7	0.7	1.1	10.5	0.5	0.1	6.6	3.6
Employment (growth in percent)	...	...	...	...	...	...	...	...	...
Unemployment rate (percent)	...	...	...	...	...	47.5	45.4	45.1	...
Public Finances									
Fiscal balance (percent of GDP)	1.6	–4.6	–3.1	2.7	7.2	–0.2	–0.6	–2.6	–1.9
Government revenue (percent of GDP)	19.9	21.1	20.9	23.1	26.5	24.5	29.3	27.6	28.1
Government expenditure (percent of GDP)	18.3	25.7	24.0	20.3	19.3	24.7	29.9	30.2	30.0
Government primary expenditure (percent of GDP)	18.3	25.7	24.0	20.3	19.3	24.7	29.9	30.0	29.8
Government primary expenditure (real growth in percent)	-9.1	–1.7	–8.5	–6.6	–6.2	13.9	11.8	3.6	4.7
Public debt (percent of GDP)	...	...	...	...	...	...	17.6	16.7	15.0
Of which foreign held	...	...	...	...	...	...	17.6	16.7	15.0
External Sector									
Current account balance (percent of GDP)	–8.1	–8.4	–7.4	–6.7	–8.3	–15.3	–15.4	–17.4	–20.3
Net capital inflows (percent of GDP)[1]	...	–1.9	0.7	1.3	10.7	12.3	–1.0	7.6	8.5
FDI	...	1.5	3.6	9.3	12.7	8.8	7.2	8.1	8.4
Portfolio	...	–1.1	–0.6	–2.1	–1.1	0.4	–1.6	–0.7	–1.3
Other investment	...	–2.3	–2.3	–5.8	–0.9	3.0	-6.7	0.2	1.5
Exports (percent of GDP)	5.4	10.6	11.1	14.1	15.1	14.8	15.5	18.5	20.0
Exports (€, growth in percent)	–20.4	94.5	7.4	32.7	16.0	11.1	6.4	28.8	19.1
Global export market share (basis points)	...	...	...	...	...	...	...	...	...
Remittances (percent of GDP)	11.6	12.2	13.9	15.0	15.2	13.8	15.0	13.6	12.6
Imports (percent of GDP)	38.6	45.1	47.3	50.8	53.7	56.0	55.2	59.1	61.1
Imports (€, growth in percent)	–3.2	14.6	8.2	11.7	14.9	18.4	0.1	15.4	13.7
External debt (percent of GDP)	...	...	...	...	...	...	17.6	16.7	15.0
Gross international reserves (€ billions)	0.4	0.3	0.3	0.4	0.6	0.7	0.6	0.7	0.6
Gross international reserves (percent of GDP)	14.3	10.7	9.3	11.4	19.1	17.4	16.0	16.4	13.5
Reserve coverage (GIR in percent of short-term debt)	...	...	...	...	...	...	...	...	...

Kosovo: Principal Economic and Financial Indicators, 2003–11 (*continued*)

	2003	2004	2005	2006	2007	2008	2009	2010	2011
					Monetary Sector				
Broad money (end of period, growth in percent)	20.3	29.9	23.1	7.7	23.8	11.7	41.6	15.5	10.7
Monetary base (end of period, growth in percent)	22.7	19.8	34.9	–3.2	18.3	17.7	81.0	–32.0	0.0
Private sector credit (end of period, percent of GDP)	7.8	12.8	17.1	20.4	26.3	30.7	32.9	34.4	34.4
Of which foreign currency denominated	...	...	...	...	...	...	...	...	...
Of which foreign currency indexed	...	...	...	...	...	...	...	...	...
Cross-border loans to nonbanks (Q4, percent of GDP)	...	...	...	...	...	...	...	...	...
Private sector credit (end of period, real growth in percent)	167.6	66.9	36.5	22.5	26.8	32.0	8.7	5.4	10.6
					Financial Sector				
Assets (percent of GDP)	19.0	26.9	31.4	35.9	40.3	44.7	53.8	56.2	55.2
ROA (percent)	...	...	...	2.3	2.9	2.6	1.4	1.8	1.5
ROE (percent)	...	...	...	60.4	54.8	60.3	55.3	55.6	57.0
CAR (percent of risk-weighted assets)	...	...	...	16.8	17.4	16.5	17.9	18.8	17.6
NPLs (percent of total loans)	...	...	...	4.1	4.1	3.3	4.3	5.2	5.7
Loan-to-deposit ratio	...	...	...	0.7	0.8	0.8	0.7	0.8	0.8
Cross-border claims by foreign banks (all sectors, percent of GDP)	...	...	...	...	...	...	...	...	...
					Financial Markets				
Interest rates (end of period, one-year government bond, percent)	...	...	...	...	...	...	...	...	...
CDS spreads (sovereign, end of period, basis points)	...	...	...	...	...	...	...	...	...
EMBIG spread (sovereign, end of period, basis points)	...	...	...	...	...	...	...	...	...
Exchange rate (end of period, domestic currency/€)	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
NEER (index, 2003 = 100)	100.0	102.7	103.1	103.6	103.2	104.1	107.7	106.8	107.8
REER (CPI-based, 2003 = 100)	100.0	97.9	92.7	89.4	89.3	92.2	91.2	90.6	93.0
REER (ULC-based, 2003 = 100)	...	...	...	...	...	...	...	...	...
					Memorandum Items				
GDP (nominal, in billions of domestic currency)	3.0	2.9	3.0	3.1	3.4	3.9	3.9	4.2	4.6
GDP (nominal, in billions of €)	3.0	2.9	3.0	3.1	3.4	3.9	3.9	4.2	4.6

Source: IMF staff.

Note: CAR = capital adequacy ratio; CDS = credit default swap; CPI = consumer price index; EMBIG = Emerging Markets Bond Index Global; FDI = foreign direct investment; GIR = gross international reserves; NEER = nominal effective exchange rate; NPLs = nonperforming loans; REER = real effective exchange rate; ROA = return on assets; ROE = return on equity; ULC = unit labor cost.

[1] Financial and capital account balances excluding EU balance-of-payments support, use of IMF resources, and SDR allocations.

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PART IV

Country Experience in Other Countries

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CHAPTER 16

Russia: Rising and Falling with the Price of Oil

Given the importance of the oil and gas sector in its economy, Russia's changing fortunes are closely linked to international oil prices. In the precrisis years, procyclical economic policies amid ever-increasing oil prices and capital inflows overheated the economy. Domestic demand expanded rapidly and inflation rose to 15 percent, although the current account stayed in surplus thanks to improving terms of trade. By the same token, the Russian economy was hard hit when global oil prices collapsed and capital flows reversed in the wake of the Lehman Brothers bankruptcy. The peak-to-trough contraction, at some 11 percent, was larger than in any other G-20 country. In response, the government forcefully deployed its large fiscal and reserve buffers built up during the precrisis years, forestalling an even bigger slump. While the government eventually allowed a large depreciation of the hitherto tightly managed exchange rate, a financial crisis was avoided. Russia's postcrisis recovery has been unimpressive, laying bare a slew of long-standing fundamental shortcomings, including weak policy frameworks, lack of structural reforms, and governance issues.

BACKGROUND

The postcommunist governments that took over in 1991 inherited an economic catastrophe. It was characterized by collapsing output, depleted international reserves, desolate public finances, and an economic structure that had lost its captive markets and was internationally uncompetitive. While successive governments took Russia down the path of price liberalization, macroeconomic stabilization, and integration with the world economy, they tended to shy away from other structural reforms. This left the economy dominated by large enterprises that often depended on government subsidies, with an uninviting business climate, and beset by governance issues.

The economy was ill-placed to weather the repercussions of the Asian crisis in 1997/98. The result was a forced revaluation of the ruble and a default on domestic government debt in August 1998. Thereafter, more solid growth took hold—initially as the depreciation stoked import substitution and increasingly from soaring international oil prices, which over the coming decade would increase more than sevenfold. This was enough to keep the economy afloat without the need to tackle deep and difficult reforms.

Russia is by far the largest economy in emerging Europe. Still, the importance of the oil and gas sector, which accounts for two-thirds of exports, one-fifth of

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The main authors of this chapter are David Hofman, Julie Kozack, and Daria Zakharova.

GDP, and one-quarter of government revenue, means that the Russian economy is strongly exposed to global developments.

Russia's financial sector is dominated by a handful of domestic state-controlled banks and, in addition, there are a large number of small banks that often function primarily as treasuries for big enterprises. The financial sector is developing from a low base, with credit-to-GDP ratios around 20 percent in the early 2000s, rising to around 45 percent at present. Access to credit for households and small and medium-sized enterprises is traditionally difficult, while large enterprises often fall back on direct cross-border borrowing.

THE RUN-UP TO THE GLOBAL FINANCIAL CRISIS

Real GDP growth picked up further from the already strong rates following the 1998 crisis to average 7½ percent during 2003–07. Domestic demand boomed as oil wealth rose and large capital inflows transmitted easy global financial conditions to the domestic economy. Given Russia's initially low modern capital stock and financial leverage, investment and credit grew particularly fast. Investment and financial deepening lifted productivity and wages, lending further impetus to domestic demand.

Monetary and financial policies were lax. The efforts of the Central Bank of Russia (CBR) to limit exchange rate appreciation resulted in large unsterilized foreign exchange market intervention and rapid growth of domestic liquidity. Moreover, the resulting "controlled ruble appreciation" turned ruble-denominated investments into an apparent one-way bet, which only egged on speculative inflows further. Rising inflation eroded real interest rates and domestic savings, compounding the dependency on foreign financing.

Inflows were typically intermediated by the weakly regulated domestic financial system. Large unhedged foreign exchange exposures built up, and banks' underlying asset quality was set to deteriorate amid weak internal risk management practices and poor supervision. Real credit growth averaged higher than 30 percent during 2003–07. In addition, large state-owned companies, which enjoyed implicit sovereign guarantees, borrowed cross-border or tapped international capital markets at low spreads, also taking on foreign exchange risk in the process.

With monetary policy hemmed in by exchange rate considerations, the task of maintaining macroeconomic stability fell mainly on fiscal policy. In the early years of the boom, the authorities were successful in taxing and saving a large share of the oil windfall as the economy was running increasingly close to full capacity. Two institutional arrangements were critical: (i) the practice of using conservative macroeconomic assumptions—a prudent oil price forecast in particular—in preparing the government budget, and (ii) the introduction of an Oil Stabilization Fund in 2004. Later, the fund was split into a Reserve Fund, intended as a medium-term fiscal stabilization fund, and a National Welfare Fund, an investment fund with a longer-term horizon aimed at preserving part of the oil wealth to backstop the pension system.

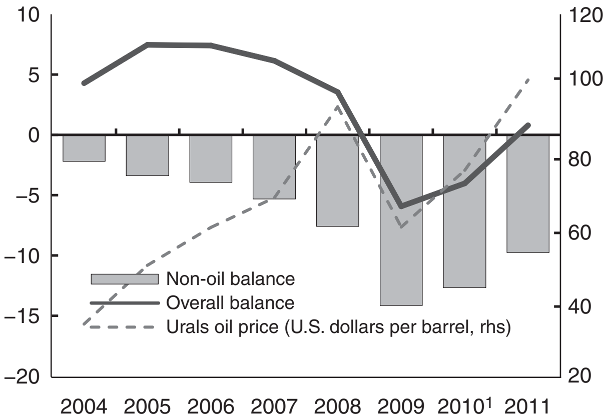

Figure 16.1 Russia: Federal Government Finances (*Percent of GDP*)

Sources: Bloomberg L.P.; Russian Ministry of Finance; and IMF staff calculations.
[1] Excludes Yukos receipts.

However, fiscal discipline gradually slipped (Figure 16.1). As oil prices kept rising and strong economic growth continued, political pressures to spend more of the oil wealth mounted. In this environment, fiscal policy became increasingly procyclical—with higher government spending fueling consumption at a time when private demand was already buoyant—even as headline fiscal balances remained in surplus. The absence of a credible fiscal policy framework, manifested in routine supplementary budgets that increased spending beyond original budget targets, gradually eroded fiscal discipline.

By 2007, real GDP was growing at an annual rate of 8½ percent, a pace that would be sustained in the first half of 2008. The economy showed clear signs of overheating. Domestic demand growth had risen to an annual rate of almost 14 percent in real terms. Labor utilization rates reached record highs, and real wage growth—which had already outpaced productivity for most of the decade—peaked at an annual rate of over 16 percent. Tightening domestic resource constraints were increasingly reflected in higher prices and rapidly increasing imports relative to GDP. Headline inflation more than doubled, rising from 7.4 percent in March 2007 to 15.2 percent in June 2008.

On the eve of the Lehman Brothers collapse, the Russian economy had built up many vulnerabilities, although it had sizable buffers as well. While Russia ran current account surpluses, its domestic demand still depended on foreign financing. The financial system had churned out loans at a hasty rate. The banking and corporate sector were exposed to large-scale foreign currency risk. The health of public finances depended more than ever on favorable international oil prices. In general, little had been done to attenuate the economy's overall dependence on oil. On the positive side, exchange rate policy and fiscal policy had formidable buffers at their disposal: in August 2008, international reserves stood at a massive

US$600 billion (43 percent of GDP), of which the combined Reserve and National Welfare Funds accounted for US$225 billion (16 percent of GDP). At less than 8 percent of GDP, public debt was negligible.

IMPACT OF THE GLOBAL FINANCIAL CRISIS

With the global financial crisis accelerating in the fall of 2008, the two main engines of Russia's precrisis growth went into reverse. International oil prices fell from a peak of US$133 per barrel in July 2008 to a low of US$42 per barrel in December 2008. And the international liquidity freeze, together with quickly reversed exchange rate expectations, gave rise to large capital outflows. Capital outflows reached US$130 billion (8 percent of annual GDP) in the fourth quarter of 2008 on account of large portfolio withdrawals, a flight into foreign currency cash holdings, rising bank net asset positions, and net loan repayments by the corporate sector. The massive capital outflows put severe pressure on the ruble, which depreciated by about 30 percent against the euro-dollar currency basket (and by 15 percent in real effective terms) from December 2008 through January 2009.

The abrupt loss of foreign financing and a sharp deterioration of credit quality put severe strain on bank balance sheets, and the early stages of the crisis saw domestic deposit withdrawals and some bank failures. As the macroeconomic situation deteriorated, the level of nonperforming loans quadrupled, peaking at 10 percent in early 2010 according to official statistics (the actual rate was likely much higher), despite regulatory forbearance and substantial evergreening of loans. In this environment of high uncertainty, Russian banks exhibited a strong preference for liquidity, causing a collapse in credit growth and a decline in the overall stock of credit.

As a result, domestic demand contracted sharply. In particular, fixed investment plummeted, shattering the nexus of high growth in investment, productivity, and wages that had powered consumption and the economic expansion.

POLICY RESPONSES

The key immediate challenges for the Russian authorities were to preserve stability in the financial sector and cushion the overall impact of the external shock on the Russian economy. Early on, particular priorities included alleviating the acute funding constraints of banks and limiting the adverse balance sheet effects of abrupt changes in exchange rates on the banking sector, households, and corporates. To this end, the CBR drew on its sizable reserve buffer to prevent an abrupt depreciation of the ruble. However, as reserve losses mounted and capital outflows surged, the ruble was allowed to sharply depreciate and monetary policy was tightened. In addition, a massive fiscal stimulus was deployed to support domestic demand.

Monetary Policy

The monetary policy response went through three distinct phases—accommodation, devaluation and tightening, and gradual easing.

- *Accommodation*. Initial efforts were aimed at keeping the exchange rate stable while providing liquidity to banks at low interest rates to offset the abrupt loss of foreign financing and the tightening effect of interventions to support the ruble. The CBR used its sizable reserves to support a gradual and predictable depreciation of the ruble. This allowed the private sector to hedge its foreign exchange exposures and probably also prevented deposit runs by easing concerns over a disorderly ruble depreciation akin to the one that took place during the 1998 crisis. In addition, the government auctioned excess budgetary funds to banks, while the CBR provided ample liquidity, including through the use of uncollateralized loans (Figure 16.2). However, the sizable liquidity provisions—which at their peak amounted to two-thirds of base money—fueled further capital outflows, as expectations of ruble devaluation grew stronger. By mid-January 2009, the pace of reserve loss had reached more than US$50 billion a month and the total reserve loss since August amounted to over US$200 billion.
- *Devaluation and tightening*. Confronted with surging reserve losses, in January 2009 the ruble was allowed to depreciate sharply and monetary policy was tightened (Figures 16.3 and 16.4). After a depreciation of the ruble by a cumulative 20 percent during December and the first half of January, the CBR allowed a sharp one-off 10 percent devaluation of the exchange rate at the end of January and declared that it would defend the ruble at this new, more credible level. In addition, it started to curtail its

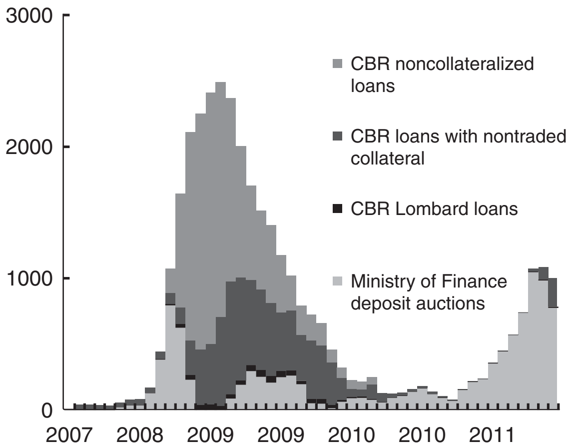

Figure 16.2 Russia: Crisis Liquidity Injections (*Stock outstanding, billions of Russian rubles*)

Sources: Central Bank of Russia (CBR); and IMF staff calculations.

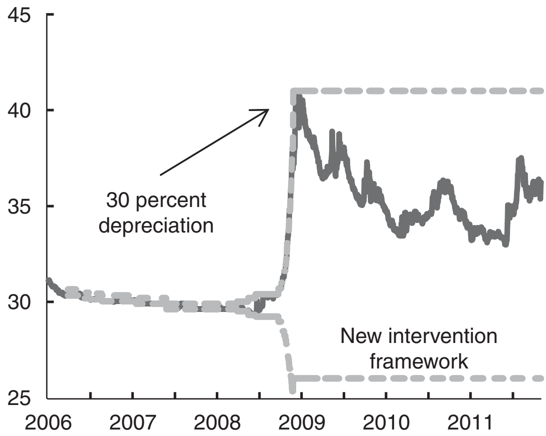

Figure 16.3 Russia: Euro-Dollar Basket Value of the Ruble (*Percent*)

Sources: Central Bank of Russia; and IMF staff calculations.

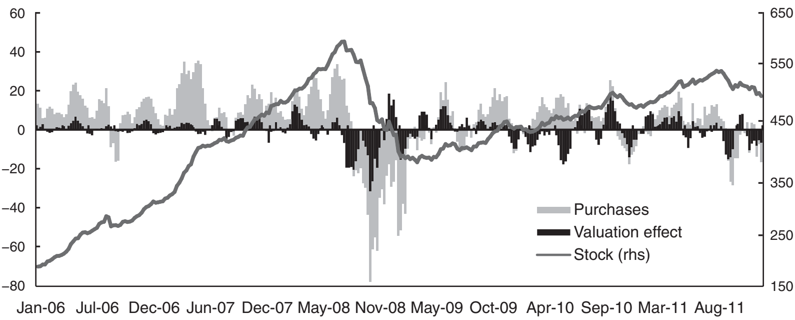

Figure 16.4 Russia: Monthly Change in Reserves (*Billions of U.S. dollars*)

Sources: Central Bank of Russia; and IMF staff calculations.

liquidity support, allowing interest rates to rise significantly—at their peak, overnight interbank rates reached 28 percent. Pressure on the exchange rate eased almost immediately, and reserves stabilized at around US$380 billion.

- *Gradual easing*. In the context of a more stable ruble and recovering oil prices, monetary policy was gradually eased during April 2009–June 2010. In total, policy interest rates were cut by 525 basis points, from 13 percent in April 2009 to 7.75 percent in June 2010, before the CBR paused the easing cycle. For most of this period, interbank rates hovered around the CBR's standing deposit facility rate, reflecting banks' preference for liquidity over new lending. Over the course of 2009 and into 2010, the ruble appreciated in nominal terms against the dollar-euro basket on the back of rising oil prices. This allowed for a steady rebuilding of reserves, as the CBR intervened to reduce appreciation pressures on the ruble. By end-December 2010, reserves stood at about US$480 billion.

Financial Sector Policies

With the banking system under added pressure on account of deposit outflows and some bank failures, the public sector injected capital into banks. The Russian government shored up capital in several government-owned banks, including VTB (the second-largest state-owned bank), mortgage and leasing companies, and VEB, the state development agency. These capital injections amounted to Rub 505 billion (1.3 percent of GDP). Additional capital was provided to state and private banks (including Sberbank and VTB) through either VEB or the CBR in the form of subordinated loans. These loans totaled Rub 904 billion (2.2 percent of GDP). The CBR also offered guarantees for interbank lending to qualifying banks, covering losses in the event that the license of a counterparty was withdrawn. To bolster confidence in the banking system, the deposit insurance limit was raised and the deposit insurance agency was allocated additional resources to deal with bank failures.

Regulatory forbearance for banks was introduced, temporarily easing loan classification and provisioning requirements in 2009. Although this created some breathing room for banks, it also masked the full extent of the deterioration in their loan portfolios. The use of nonstandard definitions for nonperforming and restructured loans further obscured the state of banks' loan books, particularly because evergreened loans were not reported as delinquent.[1] The CBR also took steps to loosen accounting standards to limit banks' mark-to-market losses and to expand access to its unsecured loan auctions. Although a number of small- and medium-sized banks were taken into receivership, the combination of CBR liquidity support and regulatory forbearance allowed the banking system to weather the early stages of the crisis relatively well.

Most of the crisis-related support to banks has been withdrawn. By mid-2010, the CBR had largely exited from the extraordinary liquidity support extended during the crisis. With banks increasingly liquid, they used excess funds to repay their uncollateralized loans ahead of schedule. Also, Sberbank made an early repayment of Rub 200 billion (out of Rub 500 billion) in subordinated credits that it had received during the crisis. Beginning in July 2010, regulatory forbearance, in the form of easier loan-provisioning requirements, was gradually brought back to precrisis norms. Lending limits for uncollateralized loans were reduced in February 2010 and interbank market guarantees were being unwound.

Fiscal Policy

In April 2009, as the economy continued to contract, the government passed a large supplementary budget to support flagging domestic demand. The budget

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[1] International best practice requires that loans 90 days past due be reported as nonperforming and placed on (interest) nonaccrual status. By contrast, CBR regulations require only that loans classified in categories IV and V be placed on nonaccrual status—a less rigorous standard. Transparency is also reduced because banks are not required to report as overdue the entire principal outstanding of an overdue loan but rather may choose to report only the amount of the overdue payment.

included large discretionary spending along with a package of anticrisis measures aimed at stimulating economic activity by reducing taxes, extending support to strategic sectors—auto industry, defense, agriculture, and airlines—and enhancing social assistance.

The package of measures implied a dramatic fiscal relaxation in the second half of 2009. The overall general government balance swung from a surplus of 5 percent of GDP in 2008 to a deficit of 6¼ percent of GDP in 2009, while the underlying non-oil deficit—overall balance excluding oil revenue—increased from 8¼ percent of GDP in 2008 to 15 percent of GDP in 2009, mostly on account of higher spending. However, the effectiveness of the stimulus was partially undermined by political pressures to support vested interests, and as a result much of the expansion was targeted at areas not supportive of growth, such as strategic sectors and defense and security. Moreover, most of the stimulus was implemented in the second half of the year—too late to prevent the deep recession. The deficit was largely financed by drawing down the oil funds held at the CBR without significant risks to external stability.

As the economy recovered, the stimulus was only partially withdrawn, calling into question the authorities' commitment to fiscal sustainability. By the end of 2010, the underlying federal government non-oil balance was still some 8 percent of GDP above both its precrisis level and the government's own medium-term target of 4.7 percent of GDP. Crucially, much of the cumulative fiscal expansion of some 9 percent of GDP during 2007–10—as measured by the change in the non-oil balance of the general government—took the form of permanent measures, including large pension increases. This caused the structure of budget spending to become increasingly inflexible, heightening concerns that the large fiscal stimulus would not be reversed and raising the risk that fiscal policy would become procyclical, fueling inflation and real exchange rate appreciation and undermining competitiveness.

ECONOMIC OUTCOMES IN 2009–11

Despite Russia's resolute policy response, a large drop in economic activity was not prevented. Real GDP contracted by 7.8 percent in 2009, more than the emerging Europe average. In response, labor market conditions eased appreciably, dampening growth in real wages, and inflation started to descend as a large output gap opened up. The current account remained in surplus as lower import demand compensated for lost export earnings. The economy returned to growth in the third quarter of 2009 on the back of fiscal stimulus, recovering exports, and rebounding oil prices. A better-targeted and more timely fiscal stimulus might have yielded better results.

Fiscal and reserve positions deteriorated markedly, but given their comfortable precrisis starting points this did not pose any immediate problems. Fiscal deficits could be financed from the oil funds and without recourse to issuing public debt. Nonetheless, fiscal policy was knocked off a sustainable path to which it has yet to return. Coverage ratios of international reserves remained comfortable throughout.

A financial crisis was successfully avoided. Banking problems remained mostly confined to a number of smaller banks. However, large-scale across-the-board financial sector support might have distracted from decisively and proactively dealing with the problems in the banking system, thereby contributing to the prolonged period of stagnant credit growth.

Perhaps most telling is the tepid recovery from the deep recession, with annual growth of 4.3 percent in 2010 and 2011. With international oil prices recovering quickly to average just under US$80 a barrel in 2010 and above US$100 in 2011, and with fiscal stimulus still in full swing, one might have expected a better performance. Investors appear reserved toward Russia as well. Capital continued to leave the country in 2010 and 2011 even as many other emerging markets saw strong renewed capital inflows. This points to deeper flaws in the Russian economy that the crisis has laid bare.

CHALLENGES AHEAD

Going forward, the overarching policy challenge for Russia is to put growth on a sustained higher trajectory. Doing so will require breaking with the procyclical policies of the past and renewed commitment to reforms.

Reducing fiscal risks and promoting balanced growth require a more ambitious, credible, and growth-friendly fiscal consolidation than planned. By end-2011, at close to 10 percent of GDP, the federal government non-oil deficit—which should be the anchor for fiscal policy in oil-exporting countries, given the volatility of oil prices and the nonrenewable nature of oil wealth—remains at double the authorities' sustainable long-term target of 4.7 percent of GDP. The latter target would need to be reached in the next three to four years for government finances to return to a sustainable path. However, the 2012–14 medium-term budget plans envisage fiscal retrenchment of only about ½ percent of GDP and increases in defense spending at the expense of health, education, and infrastructure programs.

Fiscal consolidation should also be underpinned by a credible fiscal framework. This would require avoiding excessive use of supplementary budgets—which tend to increase spending when the economy is already operating above potential, thus amplifying overheating—while anchoring fiscal policy on the non-oil balance to reduce expenditure volatility in response to oil price fluctuations and to ensure that the wealth from oil is preserved for future generations. The oil reserve fund—which served Russia well during the crisis—should be replenished to cushion government finances against large swings in oil prices.

Monetary policy should focus squarely on reducing inflation, in the context of a flexible exchange rate. While inflation declined sharply from more than 15 percent before the crisis to a low of 5½ percent in July 2010, it was allowed to rise to almost 10 percent in the first half of 2011 before dropping back to 6.1 percent at year end. And although the exchange rate has become more flexible following the crisis, monetary policy has appeared to remain circumscribed by considerations other than inflation control. However, low and stable inflation is crucial for mobilizing long-term funding for productive investment that would boost growth.

While the banking system has stabilized, considerable risks remain and strengthening the regulatory framework is vital. By end-2011, banks remained burdened by a large stock of problem loans, constraining the sustainable expansion of credit. Key policy actions would include the strengthening of loan classification and provisioning and the speedy implementation of legislation on consolidated supervision and connected lending.

Tackling the long-standing micro-level structural shortcomings is equally critical to achieve economic diversification and more vibrant growth. This includes governance reform to strengthen property rights and the rule of law as well as an overhaul of the judiciary system and the civil service. The business climate would also benefit from reducing state dominance in economic decision making, advancing privatization, and reducing the subsidies to connected enterprises. Russia's recent accession to the World Trade Organization and the President's 10-point plan to improve the investment climate could support such reforms.

Russia: Principal Economic and Financial Indicators, 2003–11

	2003	2004	2005	2006	2007	2008	2009	2010	2011
					Real Sector Indicators				
GDP (real growth in percent)	7.3	7.2	6.4	8.2	8.5	5.2	–7.8	4.3	4.3
Domestic demand (real growth in percent)	7.9	9.9	8.9	11.5	13.9	9.1	–14.2	8.2	8.8
Net exports (real growth contribution in percent)	0.2	–1.4	–1.4	–2.0	–3.4	–3.0	5.3	–3.4	–4.3
Exports of goods and services (real growth in percent)	12.6	11.8	6.5	7.3	6.3	0.6	–4.7	7.0	1.0
CPI (end-of-period change in percent)	12.0	11.7	10.9	9.0	11.9	13.3	8.8	8.8	6.1
Employment (growth in percent)	–0.3	1.4	1.3	0.7	2.5	0.6	–1.4	1.8	1.9
Unemployment rate (percent)	8.6	8.2	7.6	7.2	6.1	6.4	8.4	7.5	6.5
					Public Finances				
Fiscal balance (percent of GDP)	1.4	4.9	8.2	8.3	6.8	4.9	–6.3	–3.5	1.6
Government revenue (percent of GDP)	36.4	36.6	41.0	39.5	39.9	39.2	35.0	35.5	38.4
Government expenditure (percent of GDP)	34.9	31.7	32.8	31.1	33.1	34.3	41.4	39.0	36.8
Government primary expenditure (percent of GDP)	33.2	30.5	31.8	30.4	32.5	33.8	40.7	38.4	36.2
Government primary expenditure (real growth in percent)	4.3	–1.5	10.9	3.3	16.1	9.5	11.0	–1.6	–1.8
Public debt (percent of GDP)	30.4	22.3	14.2	9.0	8.5	7.9	11.0	11.7	9.6
Of which foreign held	20.3	15.7	9.1	4.7	3.1	1.6	2.8	2.6	...
					External Sector				
Current account balance (percent of GDP)	8.2	10.1	11.1	9.5	5.9	6.2	4.0	4.7	5.5
Net capital inflows (percent of GDP)[1]	0.6	–0.8	0.2	0.3	7.3	–7.8	–3.0	–1.6	–4.0
FDI	–0.4	0.3	0.0	0.7	0.7	1.2	–0.6	–0.6	–0.8
Portfolio	–1.0	0.1	–1.5	1.6	0.4	–2.1	–0.2	–0.1	–1.0
Other investment	2.0	–1.2	1.6	–1.9	6.1	–6.9	–2.3	–0.9	–2.3
Exports (percent of GDP)	35.4	34.5	35.2	33.8	30.3	31.5	28.2	29.9	31.1
Exports (US$, growth in percent)	25.8	33.9	31.9	24.5	17.7	32.7	–34.0	29.0	29.4
Global export market share (basis points)	174.9	182.3	230.2	242.9	254.3	287.0	230.7	250.7	...
Remittances (percent of GDP)	0.07	0.16	0.08	0.08	0.07	0.05	0.06	0.05	0.06
Imports (percent of GDP)	24.0	22.1	21.5	21.1	21.7	22.1	20.7	21.7	22.4
Imports (US$, growth in percent)	22.2	26.6	25.7	27.3	35.1	30.0	–31.0	27.4	28.6
External debt (percent of GDP)	43.2	36.1	33.7	31.6	36.2	28.9	38.2	32.9	25.0
Gross international reserves (US$ billions)	73.8	121.5	176.5	296.2	467.6	412.7	417.8	454.5	473.4
Gross international reserves (percent of GDP)	17.2	20.5	23.1	29.9	36.0	24.8	34.2	30.6	25.6
Reserve coverage (GIR in percent of short-term debt)	116.0	141.4	148.0	216.8	216.3	277.1	283.9	291.6	316.7

(*continued*)

Russia: Principal Economic and Financial Indicators, 2003–11 (*continued*)

	2003	2004	2005	2006	2007	2008	2009	2010	2011
Monetary Sector									
Broad money (end of period, growth in percent)	39.4	33.7	36.3	40.5	40.2	14.3	17.3	24.6	21.1
Monetary base (end of period, growth in percent)	55.3	24.3	22.4	41.5	33.7	1.2	15.9	26.6	5.5
Private sector credit (end of period, percent of GDP)	21.2	24.3	25.9	30.9	37.8	41.6	45.3	43.9	46.1
Of which foreign currency denominated	6.3	6.8	6.7	6.8	8.8	10.7	13.1	11.5	...
Of which foreign currency indexed	...	...	...	...	...	...	...	...	...
Cross-border loans to nonbanks (Q4, percent of GDP)	6.5	6.1	6.9	5.5	7.1	5.5	6.3	4.4	4.0
Private sector credit (end of period, real growth in percent)	28.7	32.1	22.0	36.4	34.8	20.5	–5.9	3.8	19.0
Financial Sector									
Assets (percent of GDP)	38.8	39.3	39.6	46.5	54.3	63.0	69.8	68.5	70.7
ROA (percent)	2.6	2.9	3.2	3.3	3.0	1.8	0.7	1.9	2.4
ROE (percent)	...	...	24.2	26.3	22.7	13.3	4.9	12.5	17.6
CAR (percent of risk-weighted assets)	19.1	17.0	16.0	14.9	15.5	16.8	20.9	18.1	14.7
NPLs (percent of total loans)	...	...	2.6	2.4	2.5	3.8	9.5	8.2	6.6
Loan-to-deposit ratio	1.1	1.1	1.1	1.2	1.4	1.2	1.1	1.1	1.1
Cross-border claims by foreign banks (all sectors, percent of GDP)	11.5	10.6	11.9	11.1	14.2	10.9	11.6	9.4	8.4
Financial Markets									
Interest rates (end of period, one-year government bond, percent)	...	4.7	5.6	5.9	6.0	9.4	6.6	5.0	6.4
CDS spreads (sovereign, end of period, basis points)	201	139	68	44	88	741	186	146	275
EMBIG spread (sovereign, end of period, basis points)	257	213	118	99	157	805	203	224	364
Exchange rate (end of period, domestic currency/US$)	29.5	27.7	28.8	26.3	24.5	29.4	30.2	30.5	32.2
NEER (index, 2003 = 100)	100.0	101.3	102.0	105.2	105.5	104.3	88.7	93.4	95.0
REER (CPI-based, 2003 = 100)	100.0	107.8	118.0	129.6	136.7	146.0	135.9	148.6	155.7
REER (ULC-based, 2003 = 100)	...	...	...	...	...	...	...	...	...
Memorandum Items									
GDP (nominal, in billions of domestic currency)	13,208	17,027	21,610	26,917	33,248	41,277	38,809	45,166	54,369
GDP (nominal, in billions of US$)	430	591	764	990	1,300	1,661	1,223	1,487	1,850

Source: IMF staff.

Note: CAR = capital adequacy ratio; CDS = credit default swap; CPI = consumer price index; EMBIG = Emerging Markets Bond Index Global; FDI = foreign direct investment; GIR = gross international reserves; NEER = nominal effective exchange rate; NPLs = nonperforming loans; REER = real effective exchange rate; ROA = return on assets; ROE = return on equity; ULC = unit labor cost.

[1] Financial and capital account balances excluding EU balance-of-payments support, use of IMF resources, and SDR allocations.w

CHAPTER 17

Turkey: Managing a Forceful Rebound

Far-reaching reforms and solid macroeconomic policies instituted in the aftermath of Turkey's 2001 crisis paid important dividends during the global financial crisis. They not only mitigated overheating in the precrisis years but also created policy room for a countercyclical crisis response. As a result, the crisis was primarily felt as a short-lived but sharp real-sector downturn. Accommodative policies have largely been unwound. The challenges have now shifted to managing this economic success, engineering a soft landing after two years of very high growth, and adjusting to risks in the external environment. A large current account deficit financed by short-term capital inflows needs to be contained, saving rates should be raised, and an unfinished structural reform agenda awaits completion.

BACKGROUND

Turkey was well placed to weather the global crisis relative to earlier periods of global macroeconomic turbulence. Greater political stability and the initiation of EU accession negotiations brightened Turkey's prospects. In addition, far-reaching policy reforms in the context of IMF-supported programs improved confidence in economic management and strengthened Turkey's fundamentals.

The strong economic and financial policies, in particular, were a break from the past. Turkey had long known macroeconomic instability, punctuated by economic and financial crises. The 2001 crisis was particularly acute. In its wake policies were considerably strengthened by setting tighter public finance targets, restructuring the financial system, overhauling banking supervision, floating the exchange rate, and introducing inflation targeting.

THE RUN-UP TO THE GLOBAL FINANCIAL CRISIS

As a result, macroeconomic outcomes improved considerably. In a setting of strong world growth and bounce-back from the 2001 crisis, real GDP growth averaged 6¾ percent during 2002–07, although unemployment remained stuck at around 10 percent. Inflation fell from 55 percent at the beginning of the decade to single digits. In addition, rapid growth, exchange rate appreciation, and prudent fiscal policies that targeted large primary surpluses for many years reduced public debt from close to 80 percent of GDP in 2000 to less than

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40 percent of GDP by 2007. The cleanup of the financial system, buttressed by the enhanced supervisory and regulatory framework, led to a significant strengthening of the sector's capital and asset quality. Throughout this period, IMF financial support in the context of two stand-by arrangements (SBAs) played an important role in buttressing the authorities' reform efforts.

The setting of strong growth, amid abundant global liquidity and low domestic savings, attracted strong capital inflows that fueled the economic expansion but also widened the current account deficit. Capital inflows—direct private external borrowing, large amounts of foreign direct investment, and portfolio flows—spurred private investment which, in turn, supported rapid GDP growth. But while public savings improved, private sector savings fell due to the greater financing available to banks and declining real borrowing costs. As a result, growth was heavily dependent on external savings. Thus, alongside a cumulative 40 percent appreciation of the CPI-based real exchange rate from 2002 to 2007, imports consistently grew faster than exports, and the current account moved from balance in 2002 into a deficit of around 6 percent of GDP in 2007.

Bank lending to the private sector was more contained in Turkey than elsewhere in emerging Europe. Credit growth of some 20 percent a year during 2003–08 in real terms was likely dampened by several factors. Many banks had to rebuild their balance sheets in the wake of the 2001 crisis; household borrowing in foreign currency was prohibited; and foreign banks with their ready excess to funding from parents accounted for a relatively small share of the Turkish banking system (17 percent). Moreover, private sector credit started to grow from a low base—a legacy of Turkey's long history of macroeconomic instability. As a result, the credit-to-GDP ratio was a low 33 percent in 2008, even after a run of strong credit growth in the preceding years.

Just prior to the global crisis, a series of adverse domestic and external shocks weakened macroeconomic performance. Jumps in the prices of energy and food, reflecting global developments, a local drought, and new cost recovery pricing for electricity, pushed up inflation from mid-2007 to the low double digits by the second half of 2008. Weakened competitiveness from higher inflation and the strengthening lira caused imports to expand faster than exports in volume terms in 2007, slowing GDP growth to 4½ percent even as domestic demand remained robust. Subsequently, a legal challenge to close down the governing party, and thus bring down the government, introduced more political uncertainty, undermined confidence, and caused domestic demand and growth to slow sharply in the first half of 2008. Notwithstanding these depressing effects on import growth, the current account deficit remained close to 6 percent of GDP on account of spiking oil prices, even as the non-oil current account deficit improved.

Nonetheless, despite the emergence of new vulnerabilities, Turkey entered the global crisis in a stronger position than many other countries in emerging Europe. Standard indicators suggest that Turkey's fundamentals were not as strong as those typical of emerging Asia and Latin America, but its vulnerabilities (particularly external debt, the cyclically adjusted primary fiscal deficit, and the current account deficit) were generally well below levels seen elsewhere in emerging

Europe. This reflects the more restrained size of the foreign-credit-induced boom in Turkey, better focus of macroeconomic policies leaning against the cyclical upswing, and a more restrictive regulatory environment for credit. Moreover, Turkey's real sector was less exposed to overheating pressures relative to other countries. Real GDP had been growing rapidly but from a low base following the 2001 crisis, and the economy had already started to slow by the time Lehman Brothers collapsed.

IMPACT OF THE GLOBAL FINANCIAL CRISIS

Turkey was initially hit hard by the global financial crisis. Despite its reasonably strong fundamentals, Turkey's long history of economic crises and its vulnerability to shocks initially induced very strong risk aversion. Confidence eroded quickly, with a collapse in domestic demand. Investment fell dramatically. In addition, limited capital flight, an abrupt pullback in bank lending, and the collapse of external demand all deepened the shock to confidence.

As a result, the global crisis was primarily felt in Turkey as a real-sector crisis. Seasonally adjusted output plummeted 12 percent during the fourth quarter of 2008 and the first quarter of 2009. Unemployment spiked, rising by more than 5 percentage points in early 2009 relative to the same period in 2008. In this setting, inflation fell rapidly, down to about 5 percent by mid-2009. While exports declined in the face of weak external demand (notably in Europe), the drop in imports was more dramatic, and the current account deficit narrowed to 2¼ percent of GDP in 2009. The nominal effective exchange rate depreciated by more than 20 percent between late 2008 and early 2009 before recovering.

Public finance and financial sector weaknesses—the origin of crises in the past—were much less of a concern this time. Cyclical factors and a structural loosening weakened the fiscal balance from mid-2008 to mid-2009. Cyclical revenue losses accounted for the bulk of the deterioration in the nonfinancial public sector primary balance. However, an across-the-board discretionary loosening (including a long-planned 5 percentage point cut in social security premiums, a sizable increase in the real wage bill, and increased investment spending), unrelated to the downturn, was already underway when the crisis hit in late 2008. Likewise, the financial sector remained resilient to the crisis, reflecting the restructuring of the system and enhanced regulatory and supervisory practices put in place in the wake of the 2001 crisis as well as its low loan-to-deposit ratios and strong capitalization.

POLICY RESPONSES

Given the strides made since the 2001 crisis, for the first time policymakers could respond to the challenges in a countercyclical way. On the fiscal front, there was room not only to let the automatic stabilizers work but also to put in place discretionary stimulus. Monetary policy could afford a lowering of interest rates. And there was no need to support the financial sector.

A package of targeted stimulus measures was adopted in early 2009. These measures included expanded short-term unemployment benefits and temporary tax cuts on purchases of cars and other consumer durables. Reflecting also the playing out of automatic stabilizers, public sector balance sheets deteriorated, with the nonfinancial public sector primary balance declining by 4 percentage points during 2007–09 to reach a deficit of 1 percent of GDP. The debt-to-GDP ratio rose by 6 percentage points to 46 percent. The central bank relaxed monetary policy considerably in light of the collapse in domestic demand. It lowered its policy rate by 10¼ percentage points between late 2008 and end-2009 and expanded lira and foreign exchange liquidity through various operations, including reductions in reserve requirements and extension of repo maturities. Nonetheless, in the face of generally tighter external financing conditions and weak domestic demand, private sector credit remained relatively flat until the second half of 2009.

The financial sector benefitted from the relaxation of the reserve requirement and of some other regulatory requirements. However, stronger measures, such as emergency liquidity or capital support, were not necessary.

ECONOMIC OUTCOMES IN 2009–11

Turkey's recovery was V-shaped. Domestic demand revived strongly from the second quarter of 2009 on improving global sentiment and the consequent reflow of capital, combined with the looser fiscal and monetary policies. Inventory restocking abroad also helped buoy Turkish exports. The sharp recovery cushioned the GDP decline to 4¾ percent for 2009 as a whole and was more than made up for by expansions of 9 percent and 8½ percent in 2010 and 2011, respectively. Consistent with a rapidly closing output gap, capacity utilization picked up in tandem with the very strong rebound in industrial production. Seasonally adjusted unemployment moderated from a peak of 15 percent in early 2009 to below 10 percent at end 2011—a floor that had not been breached in the preceding decade.

The current account deficit again widened greatly from late 2009 on account of surging imports, while export growth remained more moderate. Reflecting Turkey's dependence on imported energy and the high energy intensity of its GDP relative to the European Union, the energy trade deficit proved stable at around 4–5 percent of GDP, in contrast to nonenergy imports, which remained highly cyclical. In addition, abundant low-cost external savings relaxed residents' borrowing constraints and, together with weak competitiveness due to structural factors, pushed up imports and suppressed exports. As a result, the current account deficit surged to about 10 percent of GDP in 2011, mostly financed by short-term inflows. Indeed, the quality of Turkey's external financing has deteriorated significantly since the crisis, with foreign direct investment and longer-term debt only representing about one-third of the current account deficit.

Starting in mid-2009, fiscal policy focused on exiting from the stimulus, making Turkey one of the first G-20 countries to do so. The widening spread between the cost of government borrowing and the policy rate raised concerns that the rapidly growing deficit was weakening confidence and crowding out the nascent private sector credit recovery. In July 2009, excises on tobacco and petroleum were raised, yielding about 0.5 percent of GDP on a full-year basis, although this further skewed the tax burden toward indirect taxes. A medium-term fiscal program announced by the government in September 2009, and updated in subsequent years, targets gradual fiscal consolidation over the medium term.

Headline fiscal balances recovered strongly in 2010 and 2011, but the underlying fiscal stance remained relaxed. The 2010 primary balance outturn in the nonfinancial public sector of 0.4 percent of GDP exceeded the target by more than ½ percent of GDP. This outturn was supported by a strong cyclical rebound in revenues, further hikes in already-high excises on petroleum, alcohol, and tobacco, increased health care copayments, reduced payments to drug suppliers, and lower than envisaged capital spending. However, an ad hoc increase in low pensions (costing 0.3 percent of GDP per annum) was granted at the beginning of 2010, and expenditure growth generally remained buoyant. On the back of the extraordinarily strong economy in 2010 and 2011, the overall deficit of the nonfinancial public sector fell to under 1 percent of GDP in 2011 from over 6 percent of GDP in 2009. However, much of this improvement was driven by strong cyclical revenue performance and one-off factors, thereby adding further to the economic boom.

The Central Bank of Turkey (CBT) kept the policy interest rate low in the postcrisis years. Initially, relaxed monetary policy was designed to support the recovery. When it took hold and the economy started to expand strongly, fueled by foreign-financed credit growth, the concern shifted to excessive capital inflows and financial stability. So as not to attract further capital inflows, the CBT cut interest rates further while at the same time trying to contain credit growth through tighter reserve requirements and a host of other measures. While this arrested the appreciation pressures on the Turkish lira, credit growth was slow to respond and strong economic growth continued. When global economic sentiment deteriorated in the second half of 2011, the Turkish lira depreciated by some 15 percent against the U.S. dollar. The pass-through to domestic prices conspired with buoyant domestic demand and administered price changes to push inflation to over 10 percent by end-2011. The CBT responded by intervening in the foreign exchange market in support of the lira and tightening liquidity, although the headline policy rate was left unchanged.

The banking sector displayed considerable resilience to the crisis, helped by a supportive policy environment. Strong capitalization, minimal foreign exchange exposure, primarily deposit-based funding, and adequate liquidity allowed banks to weather the financial and output shocks. The policy responses to the crisis helped boost profits and capital ratios through wider interest margins and dampened the rise in nonperforming loans. They also led to a shift in bank assets toward zero-risk-weighted government bonds, which were expected to gain value in the wake of future declines in interest rates. As a result, Turkish banks' profits rose substantially in 2009 and the average capital adequacy ratio increased to about 20 percent. In addition, initial concerns about capital outflows receded. Because the crisis originated in the United States and Europe, the Turkish financial system became in part a "safe haven" for Turkish residents, with the result that there was some repatriation of previous capital outflows.

CHALLENGES AHEAD

Having come through the crisis well relative to many other countries in emerging Europe, Turkey now needs to manage the consequences of this success. The V-shaped recovery from the 2008/09 crisis quickly gave way to economic overheating. Ironically, Turkey's postcrisis boom resembled in many ways the precrisis boom in the rest of emerging Europe. In particular, credit growth became very strong and was largely financed by capital inflows. The challenge is now to engineer a soft landing and cope with capital inflows that can be very strong but, at the same time, remain volatile. In devising its policy response, Turkey should draw on the lessons learned from the boom-bust cycle in emerging Europe (see Chapter 25).

Turkey may again soon face the challenge of coping with strong short-term capital inflows. Push and pull factors—many of them legacies of the global crisis—are expected to continue to drive short-term capital inflows. This will likely keep domestic demand strong, inflation above its target, and the current account deficit elevated, deferring the needed adjustment. Private savings remain low relative to peer countries. Low interest rates in advanced economies, combined with the Turkish government's and banks' favorable near-term growth prospects and healthy balance sheets as well as Turkey's less-leveraged (than in much of Europe) households, will continue to attract inflows.

Looking further ahead, a strong set of structural reforms would enable Turkey to boost potential growth, reduce unemployment, further strengthen the country's resilience to shocks, and enhance Turkish firms' ability to adapt to capital inflows. In the wake of the global crisis, competitiveness remains a concern in a setting of weak external demand. In particular, labor market reforms remain critical to better align productivity-adjusted formal sector employment costs with those of regional peers. In the energy sector, sustained uniform application of cost recovery energy pricing to promote conservation and more efficient generation capacity will support more efficient use of imported energy. In addition, a reduction in taxes on labor and business, supported by a permanent improvement in tax compliance (through improved audit procedures and avoidance of tax amnesties) will be an important component of structural reforms. All of these measures would help raise the domestic content of production and allow Turkey to better compete in global product markets.

Turkey: Principal Economic and Financial Indicators, 2003–11

	2003	2004	2005	2006	2007	2008	2009	2010	2011
					Real Sector Indicators				
GDP (real growth in percent)	5.3	9.4	8.4	6.9	4.7	0.7	–4.8	9.0	8.5
Domestic demand (real growth in percent)	8.8	11.7	9.5	7.0	5.7	–1.2	–7.4	13.4	10.2
Net exports (real growth contribution in percent)	–3.8	–2.4	–1.3	–0.3	–1.3	1.7	2.8	–4.3	–2.1
Exports of goods and services (real growth in percent)	6.9	11.2	7.9	6.6	7.3	2.7	–5.0	3.4	6.0
CPI (end-of-period change in percent)	18.4	9.4	7.7	9.7	8.4	10.1	6.5	6.4	10.4
Employment (growth in percent)	–0.8	2.0	–7.4	1.7	1.6	2.1	0.4	6.2	6.6
Unemployment rate (percent)	10.5	10.3	10.6	10.2	10.2	10.9	14.0	11.9	9.9
					Public Finances				
Fiscal balance (percent of GDP)	–10.5	–4.4	–0.8	–0.7	–2.1	–2.9	–6.2	–3.5	–0.7
Government revenue (percent of GDP)	31.0	31.2	32.4	32.8	31.7	31.4	32.1	32.7	33.9
Government expenditure (percent of GDP)	41.0	35.1	32.6	32.8	33.3	33.8	37.7	35.4	34.2
Government primary expenditure (percent of GDP)	25.8	24.8	25.5	26.6	27.4	28.4	32.0	30.9	30.8
Government primary expenditure (real growth in percent)	7.9	5.1	11.3	11.8	7.8	4.2	7.2	5.4	8.1
Public debt (percent of GDP)	67.7	59.6	52.7	46.5	39.9	40.0	46.1	42.2	39.4
Of which foreign held	14.0	13.1	12.2	13.5	12.2	9.7	11.3	11.5	...
					External Sector				
Current account balance (percent of GDP)	–2.5	–3.7	–4.6	–6.1	–5.9	–5.7	–2.2	–6.3	–9.9
Net capital inflows (percent of GDP)[1]	2.4	4.5	8.8	8.1	7.6	4.8	1.4	8.0	8.5
FDI	0.4	0.5	1.9	3.6	3.1	2.3	1.1	1.0	1.7
Portfolio	0.8	2.0	2.8	1.4	0.1	–0.7	0.0	2.2	2.9
Other investment	1.1	2.0	4.2	3.0	4.4	3.1	0.2	4.8	3.9
Exports (percent of GDP)	23.2	23.3	21.8	22.5	22.2	24.1	23.4	21.2	23.5
Exports (US$, growth in percent)	28.5	30.0	15.1	13.2	21.1	22.2	–18.6	8.4	17.3
Global export market share (basis points)	62.9	69.1	70.8	71.2	77.4	82.6	82.8	76.4	...
Remittances (percent of GDP)	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.1	0.1
Imports (percent of GDP)	24.2	25.9	25.5	27.7	27.4	29.0	24.6	26.8	32.6
Imports (US$, growth in percent)	37.7	38.3	21.5	19.1	21.3	19.0	–28.6	30.1	29.0
External debt (percent of GDP)	47.5	41.0	35.2	39.3	38.4	38.4	43.7	39.5	41.7
Gross international reserves (US$ billions)	34.2	35.9	50.8	61.1	73.6	70.6	71.1	83.9	82.1
Gross international reserves (percent of GDP)	11.3	9.1	10.5	11.5	11.3	9.7	11.6	11.4	10.5
Reserve coverage (GIR in percent of short-term debt)	76.5	62.7	76.0	78.5	90.5	73.6	77.0	73.0	69.8

(*continued*)

Turkey: Principal Economic and Financial Indicators, 2003–11 (*continued*)

	2003	2004	2005	2006	2007	2008	2009	2010	2011
Monetary Sector									
Broad money (end of period, growth in percent)	16.2	21.6	31.0	22.2	15.3	24.7	13.0	18.6	15.2
Monetary base (end of period, growth in percent)	18.2	32.0	40.7	28.3	9.0	27.8	0.9	22.5	39.6
Private sector credit (end of period, percent of GDP)	14.5	17.3	22.2	25.9	29.5	32.6	36.5	44.0	49.7
Of which foreign currency denominated	4.6	4.1	3.7	3.6	3.2	4.0	5.0	8.7	11.8
Of which foreign currency indexed	0.5	0.7	1.4	1.7	2.1	2.5	2.2	2.3	2.5
Cross-border loans to nonbanks (Q4, percent of GDP)	10.5	9.9	9.8	13.3	14.8	13.7	14.9	11.6	11.3
Private sector credit (end of period, real growth in percent)	9.8	33.5	38.8	24.3	16.6	13.2	5.3	31.4	20.9
Financial Sector									
Assets (percent of GDP)	50.0	49.8	57.8	60.1	62.5	70.0	80.5	82.7	85.0
ROA (percent)	2.2	2.1	1.5	3.2	3.3	2.5	3.3	3.0	2.2
ROE (percent)	15.8	14.0	10.9	27.1	26.6	20.1	26.4	23.9	18.9
CAR (percent of risk-weighted assets)	30.9	28.2	23.7	21.9	18.9	18.0	20.6	19.0	16.5
NPLs (percent of total loans)	13.0	6.4	5.0	3.9	3.6	3.4	5.0	3.5	2.7
Loan-to-deposit ratio	0.4	0.5	0.6	0.7	0.8	0.8	0.8	0.9	1.0
Cross-border claims by foreign banks (all sectors, percent of GDP)	14.8	14.1	15.6	19.6	21.1	19.5	21.6	21.2	20.8
Financial Markets									
Interest rates (end of period, one-year government bond, percent)	46.4	24.7	16.4	17.8	18.3	19.3	11.7	8.4	11.2
CDS spreads (sovereign, end of period, basis points)	323	232	156	161	167	409	183	141	304
EMBIG spread (sovereign, end of period, basis points)	309	264	223	207	239	534	197	177	390
Exchange rate (end of period, domestic currency/US$)	1.4	1.3	1.3	1.4	1.2	1.5	1.5	1.5	2.4
NEER (index, 2003 = 100)	100.0	96.5	102.2	95.4	97.6	94.0	84.2	88.2	75.9
REER (CPI-based, 2003 = 100)	100.0	104.1	118.5	118.9	128.6	130.4	122.3	135.7	120.0
REER (ULC-based, 2003 = 100)	100.0	104.1	115.5	113.4	124.5	127.5	115.8	132.7	128.1
Memorandum Items									
GDP (nominal, in billions of domestic currency)	455	559	649	758	843	951	953	1,104	1,304
GDP (nominal, in billions of US$)	303	392	483	529	649	730	614	735	778

Source: IMF staff.

Note: CAR = capital adequacy ratio; CDS = credit default swap; CPI = consumer price index; EMBIG = Emerging Markets Bond Index Global; FDI = foreign direct investment; GIR = gross international reserves; NEER = nominal effective exchange rate; NPLs = nonperforming loans; REER = real effective exchange rate; ROA = return on assets; ROE = return on equity; ULC = unit labor cost.

[1] Financial and capital account balances excluding EU balance-of-payments support, use of IMF resources, and SDR allocations.

CHAPTER 18

Estonia: Making a Run for the Euro

Severe precrisis overheating meant that Estonia could not escape a sharp subsequent economic contraction. However, policy buffers, contingency planning, early policy action, and a flexible economy allowed Estonia to weather the crisis without recourse to financial support from the international community. Pressure on the exchange rate, which was fixed under a currency board arrangement, was minimal, deposit withdrawals from the banking system were small and short lived, and strong fiscal consolidation measures contained the deterioration of public finances. Indeed, Estonia was one of only a handful of EU countries to keep its fiscal deficit below the Maastricht ceiling throughout the crisis period. This allowed it to adopt the euro in January 2011—a remarkable feat against the backdrop of an economic peak-to-trough contraction by one-fifth. The economy recovered strongly, with growth surging to 7½ percent in 2011.

BACKGROUND

Estonia has been an early and avid reformer ever since gaining independence in 1991. Early on, it set about creating the most open free-market economy of all the former Soviet Union countries. Trade was quickly reoriented away from Russia toward Finland and other western countries. The manufacturing sector refocused on light industry, while many of the heavy industries wound down. Over the years, the importance of its high-value-added products has increased, and Estonia has become increasingly integrated into the Nordic-Baltic chain of production.

In June 1992, Estonia introduced its own currency, the kroon, which was pegged by law (first to the Deutsche Mark and later to the euro) and operated as a currency board. Following EU accession in January 2004, Estonia joined the European Exchange Rate Mechanism II in June of the same year. With the currency board providing a strong policy anchor, fiscal policy remained conservative throughout Estonia's rapid transition to a market economy: the general government was only briefly in deficit (during the Russian financial crisis of 1998) and it accumulated a sizable fiscal reserve and almost no debt.

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THE RUN-UP TO THE GLOBAL FINANCIAL CRISIS

Following EU membership in 2004, Estonia entered a boom phase. As in other fixed exchange rate countries, domestic demand was fueled by relatively cheap euro-denominated credit, which was largely channeled to real estate. On the supply side, this was facilitated by the banking system, almost entirely foreign (mainly Swedish) owned. The economy eventually overheated, with annual real credit growth exceeding 35 percent in 2006, housing prices more than doubling between 2005 and 2007, year-over-year inflation rising to exceed 10 percent in the first half of 2008, and unemployment dropping to 4 percent at the same time.

The turning point came well before the collapse of Lehman Brothers would plunge the global financial system into disarray. Consumer and investor confidence in Estonia was dented as early as May 2007 by political tensions with Russia, following the removal of a Soviet war memorial. This was compounded by sporadic regional (February 2007) and global (August 2007) market jitters. At the same time, Swedish parent banks, recognizing the vulnerabilities associated with their rapidly increasing exposure, sought to engineer a controlled deceleration of credit growth. By 2008, Estonia seemed to be headed for a drawn-out postbubble slowdown.

In early 2008 it dawned on the authorities that the situation might become much graver. Senior officials point to two eye-openers: First, tax revenues in early 2008 came in much weaker than anticipated. Secondly, at a seminar jointly organized by the IMF and the Bank of Estonia in January, academics, market participants, and policymakers concluded that the Baltics might be headed for a hard landing. Much of the discussion at the time was about avoiding the "Portuguese trap"—low competitiveness amid persistent high external and fiscal imbalances.

Policymakers first and foremost had to decide how to react to emerging fiscal pressures. Should they let automatic stabilizers work and allow the fiscal deficit to widen? Or should they cut spending in the face of an already slowing economy? In the event, the authorities fell back on their fiscally conservative instincts. After a short but lively debate, it was decided to tighten fiscal policy—an approach motivated by a desire to avoid having to rely on market financing or on drawing down fiscal reserves and to ensure fiscal sustainability. A supplementary budget in mid-2008 curtailed spending. Subsequently, pension hikes planned for 2009 were scaled back (from 14 to 5 percent).

IMPACT OF THE GLOBAL FINANCIAL CRISIS

The downturn accelerated dramatically in the period following the collapse of Lehman Brothers. Estonia was affected through a variety of channels.

- *Financial stability concerns*. These were particularly acute in late 2008, when one of the larger foreign-owned banks experienced a temporary outflow of deposits. Concerns about banks' loan portfolios (in light of the property bust) and the health of their foreign parents (due to the global funding freeze) were further aggravated by events in neighboring Latvia, which needed international financial support to avoid a default and to beef up reserves in support of its currency peg. While financial market tensions in Estonia never reached the levels seen in other Baltic countries, CDS spreads and the forward exchange rate remained elevated through mid-2009. Confidence would only return in late 2009, when the prospect of euro adoption became tangible.

- *Domestic demand*. As foreign financing dried up, credit growth quickly ground to a halt and even turned slightly negative. This, together with a loss of confidence, led to a severe retrenchment of private consumption and investment. Government demand also declined as a result of the authorities' fiscal austerity strategy, although the procyclical effect of budgetary belt-tightening was mitigated by the increased use of EU funds. A sharp rise in unemployment, nominal wage cuts in both the public and private sectors, and a high private debt-servicing burden further dented domestic demand.
- *Exports*. Estonia's primary export markets—Sweden, Finland, Russia, Latvia, and Germany—were particularly hard hit by the global crisis. Moreover, the real effective exchange rate appreciated in early 2009 as some trading partners saw their currencies weaken against the euro. While the cumulative decline of exports was sizable (some 20 percent between 2008:Q4 and 2010:Q1), it was comparable to the declines in its Nordic neighbors, and its overall contribution to the decline of GDP was less than that of domestic demand. In 2010, exports would rebound along with the recovery in trading partners, helping pull the economy out of its deep recession.

POLICY RESPONSES

As the crisis worsened in 2008–09, the pillars of the recovery strategy going beyond fiscal austerity were put into place. The key element was a strong determination to achieve the necessary adjustment and regain lost competitiveness through an adjustment in goods and services prices and factor prices, along with structural reforms, rather than through altering the peg to the euro—a process referred to as "internal devaluation." This necessitated not only tight budget policies but also a lowering of nominal wage costs, including in the private sector. The task was facilitated by Estonia's traditionally high labor market flexibility, further boosted by a new labor law passed in mid-2009. As a result, labor shedding and the modification of work contracts were relatively easy, certainly compared to countries in western Europe.

Other elements of the authorities' strategy for responding to the crisis included: (i) regulatory and legislative reforms aimed at strengthening banking supervision and crisis response capacity, (ii) efforts to improve the legal framework for private debt restructuring, and—later in the crisis—(iii) active labor markets policies and (iv) targeting of EU-funded projects to the tradable sector and research investments.

Meanwhile, preserving financial stability continued to be on authorities' minds. Contingency plans were developed to prepare for the possibility of liquidity runs or exchange rate pressures in the event that Latvia should be forced to devalue. In fact, the authorities actively contributed to international efforts to avoid such an event by pledging €100 million in support of the Latvia program. At the same time, they strengthened the deposit insurance system, improved the framework for providing emergency liquidity, and negotiated a memorandum of understanding with other Nordic and Baltic governments on crisis management and burden-sharing principles. As an additional insurance element, the Estonian Central Bank in February 2009 also established a precautionary swap agreement with the Swedish Riksbank to complement the liquidity buffers of Swedish banks operating in Estonia.

The overriding element in Estonia's crisis response was an unwavering determination to adopt the euro as soon as possible. Joining the euro area had been a long-standing aspiration, widely shared by the population at large. It was not only rooted in the economic logic of eliminating residual currency and liquidity risks from an exchange rate regime that had already been fixed for two decades. For Estonians, euro adoption was yet another step toward closer integration with the developed nations of western Europe, in a vein similar to joining the European Union, the North Atlantic Treaty Organization, the Organisation for Economic Co-operation and Development, and the Schengen zone. The euro was seen as key to securing financial and political stability, a paramount objective after a tumultuous history.

Estonia had therefore been assiduously pursuing euro adoption ever since EU accession. But while it easily met the Maastricht criteria in the fiscal area, early efforts to join the euro area were foiled by relatively high headline inflation, due first to its domestic demand boom (2005–07) and then to the global commodity boom (2008). Domestic policy instruments proved largely insufficient to address the surge in credit growth and consumer prices.

As inflation tumbled in the wake of the crisis, meeting the inflation criterion was suddenly within reach. In early 2009, it became clear that by year end the 12-month inflation rate could be below the reference level for the first time in five years. This further focused policymakers' minds on keeping the fiscal deficit below the limit of 3 percent of GDP in 2009 and beyond—a seemingly daunting task in the middle of a deepening recession. Nevertheless, there was political consensus across party lines that quickly joining the euro area at the present parity was more important than seeking to mitigate the current slump in economic activity. Even in this period of financial turmoil, euro adoption was seen less as an exit from vulnerabilities—which the authorities believed to be low—than as a way to boost long-term investment and growth.

The debate therefore centered not on whether to pursue fiscal adjustment but on how. A series of adjustments was made to the budget in the first months of 2009, mainly spending cuts. An IMF mission, which visited Tallinn in May, advised the authorities to also consider revenue measures—an idea initially resisted by the authorities. The issue of revenue measures was also hotly debated within the government and contributed to the departure of the Socialist Party from the ruling coalition. Soon after, however, the government introduced a second supplementary budget that did include hikes in value-added and excise taxes. Altogether, the authorities took gross adjustment measures of almost 9 percent of GDP in 2009, one-third on the revenue side and one-third structural in nature (see Box 18.1).

BOX 18.1 Explaining Estonia's Astonishing Fiscal Performance

Among Estonia's achievements during the crisis, the one that has attracted the most attention is its astonishing fiscal performance in 2009. Specifically, how could a country that experienced one of the largest output declines in the region (14.3 percent) in the same year record the lowest public deficit (2 percent of GDP)? The contrast is particularly stark with respect to its Baltic neighbors Latvia and Lithuania, which faced the same challenges under seemingly similar circumstances, but recorded much higher public deficits.

Table 18.1, which compares the 2009 fiscal position across all three Baltics, helps explain the differences in fiscal performance. These include:

- *An already low 2008 deficit*, in part due to fiscal tightening measures that year. The authorities arguably moved more quickly than others to adjust their policies.
- *Lower spending rigidities*. Expenditures as a share of GDP increased in all countries due to a spending overhang built up during the boom, when public sector salaries and benefits increased sharply. In Estonia, however, the automatic change in expenditures was about 3 percent of GDP lower than in its neighbors. This was in part due to the rolling back of promised wage and benefit increases in the fall of 2008, generating full–year savings in 2009.
- *Less additional spending on social assistance.* The increase in social benefits due to the crisis was lower than in Latvia (but not as low as in Lithuania), primarily reflecting lower replacement rates for unemployment benefits.
- *Better revenue performance.* In contrast to other countries, revenue collection in Estonia moved broadly in line with GDP. This may be explained by a relatively stronger (and stepped-up) tax administration and a culture of tax compliance. Unlike in Latvia and Lithuania, there was also no large stock of unclaimed value-added tax (VAT) refunds.
- *No additional interest spending.* With a small fiscal deficit and very low net debt, Estonia did not experience an increase in debt-servicing costs.
- *Offsetting measures.* The total package of measures—while smaller than in Latvia—was sufficient to compensate for the automatic deterioration of the fiscal position due to the crisis. Under unchanged policies the public deficit would have exceeded 10 percent of GDP.

(*continued*)

BOX 18.1 Explaining Estonia's Astonishing Fiscal Performance (*continued*)

TABLE 18.1

Comparison of the 2009 Fiscal Positions across the Baltic Countries
(*Percent of GDP, unless indicated otherwise*)

	–/+ deficit-increasing/deficit-reducing factors	Estonia	Latvia	Lithuania
I.	**2008 fiscal balance**[1]	**–2.9**	**–3.3**	**–3.3**
II.	**2009 fiscal balance**	**–2.0**	**–7.8**	**–9.2**
	2009 measures (net)	7.1	11.2	7.2
	Deficit-reducing measures	8.8	13.9	**8.2**
	Deficit-increasing measures	–1.7	–2.7	–1.0
	2009 deficit before measures[2]	–9.1	–19.1	–16.3
III.	**Fiscal deterioration in 2009 (I – II)**	**0.8**	**–4.6**	**–5.8**
IV.	**Automatic effects**	**–8.6**	**–16.2**	**–11.6**
	Automatic change in expenditure due to change in GDP	–6.4	–9.5	–9.1
	Additional spending on social assistance	–1.2	–2.1	–0.3
	Change in revenue due to macroeconomic factors and compliance[3]	–0.9	–4.0	–1.9
	Additional interest spending	–0.1	–0.7	–0.4
V.	**Deterioration (–)/improvement (+) net of automatic effects (III – IV)**	**9.4**	**11.6**	**5.8**
	Possible explanatory factors (VII + VIII)	7.4	10.7	6.0
VI.	2009 measures (net)	7.1	11.2	7.2
	Deficit-reducing measures	8.8	13.9	8.2
	Deficit-increasing measures	–1.7	–2.7	–1.0
VII.	Full-year effect of 2008 measures[4]	0.3	–0.5	–1.2
VIII.	**Unexplained residual**[5]	**1.9**	**0.9**	**–0.2**

Source: IMF staff estimates.
[1] Excludes bank restructuring costs of 4.2 percent of GDP in the case of Latvia.
[2] Passive 2009 deficit-to-GDP ratio is derived implicitly as the sum of measures and 2009 deficit outturn.
[3] Nongrant revenue projections are based on econometric regressions, the relevant bases, and net of 2009 tax measures.
[4] In Lithuania, increase in base pensions on August 1, 2008, and extension of maternity leave by one more year at an 85 percent replacement rate.
[5] Residuals reflect possible underestimation of the full-year effect of the 2008 expansionary measures, the gap between estimated 2009 yield of measures and actual outturns, and the impact of arrears.

Table 18.2 takes a closer look at the size and composition of fiscal adjustment relative to the other Baltics. Like elsewhere, Estonia's fiscal adjustment was expenditure–led, although only a relatively small part of the spending cuts were structural in nature. On the revenue side, the key permanent measure was the hike of VAT and excise rates. In addition, the authorities found a number of temporary revenue sources, such as one–off dividends from state–owned enterprises, asset sales, and a two–year diversion of second–pillar pension contributions to the budget.

BOX 18.1 Explaining Estonia's Astonishing Fiscal Performance (*continued*)

TABLE 18.2

Size and Composition of Fiscal Adjustment across the Baltics, 2009
(*Percent of GDP*)[1]

	Estonia	Latvia	Lithuania
Gross adjustment[2]	8.8	13.9	8.0
Net adjustment	7.1	11.2	7.0
Net revenue measures	3.8	5.0	1.7
Durable net revenue rate and base increases (net of tax cuts)	1.3	2.5	0.7
Of which VAT and excise increases	0.5	2.4	1.5
One-off and reversible revenue measures[3]	2.5	2.5	1.0
Net spending measures	3.3	6.1	5.3
Structural spending reductions	1.7	2.0	1.9
Of which structural reform (e.g., pension, benefits)[3]	1.1	0.7	0.6
Of which wage measures[4]	n.a.	1.3	1.4
Of which benefit-increasing measures[5]	0.0	0.0	0.0
Current spending and investment reductions and other temporary measures	3.8	5.6	3.4
Spending-increasing measures	–2.2	–1.5	0.0
Memorandum items			
Adjustment reversible or subject to renewed approval	6.3	8.1	4.4
Share of adjustment potentially reversible or unsustainable	88.5	72.4	62.5
Share of spending-based adjustment	46.4	54.3	76.1

Sources: IMF staff reports; and IMF staff estimates based on country authorities' budgets.
[1] Yields in year of implementation; thus if measures are implemented midyear, the full-year yield is larger than shown.
[2] Gross excludes impact of deficit-increasing measures such tax cuts and noninterest spending increases.
[3] Includes diversion of Pillar II contributions to Pillar I: worth annually 0.6 percent of GDP in Estonia, 1.2 percent of GDP in Latvia, and 0.5 percent of GDP in Lithuania.
[4] 2009 reduction in pension benefits in Estonia of 0.6 percent of GDP and 0.5 percent of GDP in sickness benefits were permanent. In Latvia, reductions in pensions of 0.7 percent were subsequently ruled unconstitutional and need to be repaid in 2010–12. In Lithuania, 2009 reductions in sickness benefits and other schemes like school lunches of 0.4 percent of GDP were permanent. The 2010 reductions in maternity, child benefit, and pensions were worth 1.7 percent of GDP and require parliamentary approval to extend beyond 2012.
[5] Wage reductions in Latvia subject to parliamentary approval every six months. In Lithuania, reductions in place until end–2010.

ECONOMIC OUTCOMES IN 2009–11

The initial impact of the crisis on economic activity in Estonia was massive. Reflecting the very large precrisis imbalances and vulnerabilities, GDP contracted by about one-fifth cumulatively during 2008–09—one of the largest output declines in the world.

By the fall of 2009, the authorities' stabilization efforts were starting to bear fruit: both the financial situation and the economic situation turned the corner. Economic activity started to expand again in the fourth quarter of 2009. Exports provided the initial impulse, and domestic demand recovered with a lag. At about 2¼ percent, growth was positive for the year 2010 and increased sharply to

7½ percent in 2011. The current account swung into surplus in 2009 and has remained in surplus through the recovery. The banking system proved to be considerably more robust than in other countries that experienced credit booms, thanks largely to higher capital and liquidity requirements and exceptionally close integration with foreign banks (which were backstopped by their home governments). It returned to profitability in the third quarter of 2010, and the asset quality deterioration was less than elsewhere in the region. The exchange rate peg held—the need to actively defend it through currency intervention never arose and the foreign exchange swap line with the Swedish Riksbank was never tapped. Moreover, residual exchange rate risks were eliminated when the euro was adopted in 2011, and while access to ECB liquidity facilities has therefore become available, these facilities have not been tapped.

Tight fiscal policies preserved the health of public finances and paved the way for euro adoption. Public sector deficits and debt remained negligible throughout the recession years. As the fiscal situation stabilized, the IMF's Article IV consultation mission in October 2009 stated that "as a result of present and past efforts, euro adoption in 2011 appears within reach"—making the IMF the first international institution to publicly do so. Senior European Commission officials also issued supportive statements, and financial markets became increasingly convinced that Estonia was indeed heading for the euro. But skeptics expressed concern that low inflation rates could be short-lived and that a boom-bust cycle might return. The IMF argued that this was unlikely as price convergence was already far advanced while high debt and unemployment would likely suppress domestic demand for years to come. At the end of the day, what convinced other EU member states was not only Estonia's handling of the crisis and the fact that it met the Maastricht criteria, but its strong institutions as well as its tradition of fiscal prudence and stability-oriented policies. In June 2010, the European Council welcomed Estonia to join the euro zone in January 2011.

CHALLENGES AHEAD

The boom-bust cycle saddled the economy with severe legacies, including a loss of competitiveness, weakened public finances, sharply increased indebtedness of households and corporates, and persistently high unemployment that reflects not only cyclical factors but also structural factors such as skill mismatches.

Against this background, euro adoption was a remarkable feat—but it is no panacea. It has strengthened stability and confidence, but overcoming the aforementioned legacies will take time and continued determination. Competitiveness has improved and productivity and corporate profits have rebounded from cyclical lows. However, looking forward, increasing sustainable long-term growth will require safeguarding competitiveness while moving up the value-added chain, addressing long-term unemployment, and enhancing human capital.

In the fiscal area, temporary measures taken during the crisis are being replaced by permanent ones, including excise tax increases. Tight current expenditure controls, while improving the fiscal position, have increased social pressures and will need to be balanced against the funding needs for education and health. As to the financial sector, deleveraging is underway, with substantial reductions in private sector debt ratios. However, further improvements in Estonia's bankruptcy laws and restructuring framework could facilitate workouts, and enhanced supervision of the cross-border banking sector could bolster financial stability further.

Estonia: Principal Economic and Financial Indicators, 2003–11[1]

	2003	2004	2005	2006	2007	2008	2009	2010	2011
Real Sector Indicators									
GDP (real growth in percent)	7.8	6.3	8.9	10.1	7.5	–3.7	–14.3	2.3	7.6
Domestic demand (real growth in percent)	10.3	7.0	9.7	16.1	9.2	–9.5	–22.3	0.3	11.0
Net exports (real growth contribution in percent)	–3.3	–1.2	–1.5	–7.0	–2.6	5.3	11.1	2.5	0.1
Exports of goods and services (real growth in percent)	7.7	14.5	18.6	6.1	3.7	0.6	–18.6	22.5	24.9
CPI (end-of-period change in percent)	1.1	5.0	3.6	5.1	9.6	7.0	–1.7	5.4	4.1
Employment (growth in percent)	1.5	0.2	2.0	6.4	1.4	0.2	–9.3	–4.2	6.7
Unemployment rate (percent)	10.0	9.7	7.9	5.9	4.7	5.5	13.8	17.3	12.5
Public Finances[2]									
Fiscal balance (percent of GDP)	1.7	1.6	1.6	2.5	2.4	–2.9	–2.0	0.3	1.0
Government revenue (percent of GDP)	36.5	35.6	35.2	36.1	36.4	36.5	43.2	40.9	39.2
Government expenditure (percent of GDP)	34.8	34.0	33.6	33.6	34.0	39.5	45.2	40.6	38.2
Government primary expenditure (percent of GDP)	34.6	33.8	33.4	33.4	33.8	39.3	45.0	40.5	38.1
Government primary expenditure (real growth in percent)	4.5	2.2	5.0	7.3	15.2	19.1	–3.7	–9.1	3.8
Public debt (percent of GDP)	5.6	5.0	4.6	4.4	3.7	4.5	7.2	6.6	6.0
Of which foreign held	3.2	2.9	2.1	2.4	1.5	1.6	3.4	2.5	2.0
External Sector									
Current account balance (percent of GDP)	–11.3	–11.3	–10.0	–15.3	–15.9	–9.7	3.7	3.6	3.2
Net capital inflows (percent of GDP)[3]	13.1	14.2	11.0	18.0	15.7	10.8	–7.2	–12.9	–5.8
FDI	7.7	5.8	16.5	4.0	4.5	2.6	1.0	6.4	7.4
Portfolio	2.0	6.0	–16.3	–7.6	–2.2	3.0	–10.7	–2.9	0.2
Other investment	3.4	2.4	10.8	21.6	13.5	5.3	2.5	–16.3	–13.4
Exports (percent of GDP)	69.0	72.9	80.1	79.5	71.1	74.1	70.3	85.3	100.4
Exports (€, growth in percent)	9.4	17.4	26.8	19.0	7.2	5.4	–19.3	25.5	31.7
Global export market share (basis points)	7.5	6.5	7.4	8.1	7.9	7.8	7.3	7.2	...
Remittances (percent of GDP)	0.1	0.1	0.1	0.1	0.1	0.3	0.3	0.3	0.3
Imports (percent of GDP)	76.4	79.9	86.5	90.1	81.0	79.5	64.5	77.9	93.6
Imports (€, growth in percent)	10.2	16.3	24.9	24.9	7.9	–0.8	–31.0	24.9	34.5
External debt (percent of GDP)	64.4	77.2	86.6	96.9	108.5	117.1	125.0	115.8	98.5
Gross international reserves (€ billions)	1.1	1.3	1.6	2.1	2.2	2.8	2.8	2.1	2.2
Gross international reserves (percent of GDP)	14.0	14.9	14.0	16.6	14.8	16.6	20.7	15.2	14.0
Reserve coverage (GIR in percent of short-term debt)	41.6	42.8	36.3	33.6	29.0	29.0	28.8	36.8	...

Estonia: Principal Economic and Financial Indicators, 2003–11[1] (*continued*)

	2003	2004	2005	2006	2007	2008	2009	2010	2011
Monetary Sector									
Broad money (end of period, growth in percent)	10.9	15.8	40.7	26.3	13.0	3.0	0.1	3.0	6.8
Monetary base (end of period, growth in percent)[4]	14.6	24.0	33.1	30.7	1.5	28.7	–5.1	–39.5	–7.4
Private sector credit (end of period, percent of GDP)	52.3	62.3	71.1	83.9	93.8	98.5	109.1	99.3	85.3
Of which foreign currency denominated	...	44.9	53.6	64.4	72.8	82.9	94.7	88.9	...
Of which foreign currency indexed	...	...	...	...	...	...	...	...	...
Cross-border loans to nonbanks (Q4, percent of GDP)	6.7	7.6	9.6	15.9	14.9	12.9	13.0	12.0	10.4
Private sector credit (end of period, real growth in percent)	25.4	26.1	27.2	34.5	20.6	–0.1	–3.1	–9.7	–9.2
Financial Sector									
Assets (percent of GDP)	65.2	81.5	97.5	104.9	119.5	123.5	138.5	129.6	...
ROA (percent)	...	...	2.0	1.7	2.7	1.2	–2.8	0.3	3.5
ROE (percent)	...	...	21.0	19.2	30.2	13.4	–24.6	2.1	33.3
CAR (percent of risk-weighted assets)	...	...	11.7	13.2	14.8	18.9	22.3	22.1	18.6
NPLs (percent of total loans)	...	...	0.2	0.2	0.5	1.9	5.2	5.4	4.0
Loan-to-deposit ratio[5]	1.6	1.8	1.6	1.8	2.1	2.1	1.9	1.7	1.3
Cross-border claims by foreign banks (all sectors, percent of GDP)	27.6	38.7	58.8	73.2	83.7	80.0	91.9	76.7	50.2
Financial Markets									
Interest rates (end of period, one-year government bond, percent)	...	...	...	...	...	...	...	...	...
CDS spreads (sovereign, end of period, basis points)	...	...	...	...	...	...	...	...	...
EMBIG spread (sovereign, end of period, basis points)	...	...	...	...	...	...	...	...	...
Exchange rate (end of period, domestic currency/€)	15.6	15.6	15.6	15.6	15.6	15.6	15.6	15.6	1.0
NEER (index, 2003 = 100)	100.0	101.4	101.2	101.1	102.1	103.3	105.5	102.3	102.1
REER (CPI-based, 2003 = 100)	100.0	102.4	103.9	105.8	110.6	118.1	119.4	117.1	118.6
REER (ULC-based, 2003 = 100)	100.0	105.8	107.5	115.3	132.0	144.6	144.9	134.8	...
Memorandum Items									
GDP (nominal, in billions of domestic currency)	136	152	175	210	251	255	217	224	16.0
GDP (nominal, in billions of €)	8.7	9.7	11.2	13.4	16.1	16.3	13.8	14.3	16.0

Source: IMF staff.

Note: CAR = capital adequacy ratio; CDS = credit default swap; CPI = consumer price index; EMBIG = Emerging Markets Bond Index Global; FDI = foreign direct investment; GIR = gross international reserves; NEER = nominal effective exchange rate; NPLs = nonperforming loans; REER = real effective exchange rate; ROA = return on assets; ROE = return on equity; ULC = unit labor cost.

[1] Estonia adopted the euro in 2011.

[2] ESA95-based.

[3] Financial and capital account balances excluding EU balance-of-payments support, use of IMF resources, and SDR allocations.

[4] Decline in 2010 is related to reserve requirement harmonization upon euro adoption.

[5] Data for 2011 are based on euro area classifications and are not necessarily comparable with data for prior years.

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CHAPTER 19

Lithuania: Earning Market Confidence

Lithuania's economic developments bear all the hallmarks of the region's boom-bust cycle: a credit-fueled domestic demand boom largely financed by foreign banks, overheating the economy and sharply widening the external deficit in the boom phase; and the drying up of financing after the Lehman Brothers collapse, sending domestic demand and asset prices into a tailspin in the bust phase. The ensuing recession was the fourth largest in the region after Latvia's, Estonia's, and Ukraine's. A strong policy response and sheer grit on the part of the population helped restore external balance and quickly rebuild the confidence needed for access to international capital markets. Lithuania's exchange rate peg under its long-standing currency board arrangement was preserved without recourse to financing from the IMF. The economy staged one of the strongest recoveries in Europe with growth of some 6 percent in 2011, but formidable challenges remain, requiring continued efforts on the fiscal, financial, and structural fronts to entrench strong medium-term growth and to create jobs.

BACKGROUND

Soon after gaining independence, Lithuania restored macroeconomic stability in a strategy built around a fixed exchange rate under a currency board arrangement. From 1994 the litas was pegged, first to the U.S. dollar and then, from 2002, to the euro. Lithuania inherited a large industrial complex from the Soviet Union, including a Chernobyl-type nuclear power plant and one of the largest refineries in the world. Unlike other former Soviet republics, Lithuania was cut off from Russian energy subsidies upon independence; its manufacturing sector successfully restructured to produce more-sophisticated products over the ensuing decades. A banking crisis in 1995 and the ruble crisis in 1998 gave further impetus to restructuring. Western banks, especially those headquartered in Sweden, came to dominate the domestic banking system, accounting for around 85 percent of bank assets a decade later. In 2004, Lithuania's reorientation toward the west culminated in European Union and NATO membership. Expectations ran high that income would quickly converge to EU levels and that the euro would soon be adopted. However, Lithuania narrowly missed the criteria for euro adoption in 2007 and was denied entry into the currency union. Also, despite its westward orientation, Lithuania's largest trading partner remains Russia, followed by Latvia and Germany.

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THE RUN-UP TO THE GLOBAL FINANCIAL CRISIS

With Lithuania's prospects bright, global interest rates low, and the exchange rate fixed, capital readily flowed into the country. Between 2003 and 2008, Lithuania received cumulative inflows of 63 percent of GDP, the bulk of which came as loans from Scandinavian parent banks to their Lithuanian subsidiaries.

Capital inflows funded a rapid expansion in bank credit on easy terms, fueling a consumption and property boom. Credit grew at an average annual real rate of 40 percent, and private sector credit as a share of GDP nearly quadrupled. Much of this credit was directed toward real estate, and housing prices rose steeply. However, this rapid expansion of bank lending left Lithuania highly vulnerable to a sudden reversal in capital inflows. On the eve of the crisis, the loan-to-deposit ratio in the banking system was just shy of 200 percent, foreign banks' exposures corresponded to almost 50 percent of Lithuania's GDP, and household and corporate debt—almost two-thirds of which was denominated in foreign currency, mainly the euro—scaled new heights.

Unsurprisingly, the economy was overheating. During 2003–08, real GDP grew at an average annual rate of 7½ percent as private consumption and gross fixed investment surged ahead at rates in excess of 10 percent a year. With domestic demand this buoyant, the current account deficit widened, peaking at almost 16 percent of GDP in the first quarter of 2008, while inflation was pushed up to reach 12 percent in mid-2008. Competitiveness suffered as the average wage rose by about 18 percent a year, and outward migration added further to the tightness of the labor market.

Fiscal policy further encouraged the boom. Buoyed by rapid consumption and asset price growth, tax receipts soared, and so did government spending, particularly in the areas of wages and entitlements. Social benefit spending rose by 44 percent in real terms between 2006 and 2008, reflecting a 60 percent real increase in sickness benefits, a 40 percent real increase in pension spending, and a doubling of outlays for maternity benefits, making them among the most generous in the world (with two years' fully paid leave). At the same time, the government successively lowered the flat personal income tax rate from 33 to 21 percent during 2006–09. Thus, while the headline fiscal deficit remained well below the Maastricht ceiling, the underlying deficit deteriorated to an estimated 6 percent of GDP in 2008.

Despite these clear signs of overheating, developments were less extreme than in the other Baltic economies. First, Lithuania's boom started relatively late. Inflation first crept into the double digits only toward end-2007, and growth remained positive right up to the collapse of Lehman Brothers. The current account peaked at a deficit not as large as in Estonia and Latvia. Second, the banking sector was dominated by foreign-owned banks, and nonresident deposits were small, leaving the banking system less exposed to the freeze in wholesale funding markets and withdrawals of nonresident deposits. Third, the private sector was less indebted, mostly reflecting the low starting point (Herzberg, 2010). Fourth, wages rose less quickly in the export-oriented manufacturing sector than in other sectors, leaving manufacturing unit labor costs below those in Estonia and Latvia (IMF, 2010a). Even in the boom, exports were growing strongly and Lithuania was gaining market share.

IMPACT OF THE GLOBAL FINANCIAL CRISIS

The global financial crisis in the wake of the Lehman Brothers collapse turned a slowdown that had started in 2008 into free fall. Large capital inflows were no longer forthcoming, and large amounts of capital started leaving the country.

The boom unraveled with the implosion of domestic demand. In the final quarter of 2008, as banks sought to quickly deleverage in response to the global liquidity crunch, credit expansion—the engine of private demand during the boom—suddenly stopped. Foreign-owned banks experienced varying degrees of loss of depositor confidence, and the banking system lost 6½ percent of its deposit base in October. Consumer and investor confidence plummeted, fueled by concerns about the stability of banks and the exchange rate peg and about the impact of the global recession. Retail sales for durable goods such as cars came to a virtual halt and investment projects were abandoned.

The collapse of global trade compounded the domestic-demand-led contraction. Lithuania's key trading partners—Latvia, Russia, and the Nordic countries—were hit disproportionally hard by the crisis. Exports fell sharply, by some 22 percent between the third quarter of 2008 and the second quarter of 2009.

The closure of the Ignalina Nuclear Power Plant at the end of 2009 compounded the shock, prolonging the contraction in headline GDP in year-over-year terms through the first quarter of 2010. The closure of the second and final block of the plant was part of a long-standing agreement with the European Union, but it had supplied Lithuania with more than 70 percent of its electricity needs at a very low cost.

POLICY RESPONSES

Lithuania's strategy to address the crisis centered on maintaining macroeconomic stability, including safeguarding the currency peg. The anchor of the strategy was to maintain the currency board until it was feasible to adopt the euro and thus to exit from residual currency risk and lessen liquidity risks. As the lynchpin of macroeconomic stability for almost 20 years, the currency board commanded broad support. Changing it was seen as seriously undermining confidence and macroeconomic stability. Moreover, with such a large share of bank loans denominated in euros, a weaker exchange rate would have dramatically reduced private sector net worth, potentially triggering a large increase in insolvencies and nonperforming loans, with negative knock-on effects for the financial system. An internal devaluation would instead be orchestrated, underpinned by policies to safeguard financial stability, reduce the fiscal deficit, lower wage costs, and secure budget financing.

The first order of business was preserving financial stability. Responding to pressures on deposits, particularly in Swedish subsidiaries, at the height of the global crisis, the Bank of Lithuania reduced its reserve requirements from 6 percent to 4 percent to boost liquidity. In an emergency session of parliament, the level of coverage under the deposit insurance scheme was increased to €100,000, ahead of the European Union's recommended deadline. A key difference from the Asian Crisis of 1997/98 was the fact that parent banks helped maintain financial stability by initially providing their subsidiaries with the liquidity, and then the capital, needed to support their local operations. However, in the context of low credit demand and need to deleverage their balance sheets, the rollover of external liabilities by the parent banks was less than 100 percent. To ensure the deleveraging process was orderly, the government sought more formal letters of commitment from the parent banks. Even before the onset of the crisis, the Bank of Lithuania had already requested that banks retain their profits. In the context of the annual on-site inspections, banks were advised to build provisions and inject capital to raise capital adequacy ratios to at least 10 percent, above the required 8 percent minimum. Concerns about the exchange rate peg were also alleviated by the joint EU and IMF program with Latvia that helped preserve the currency-board-like arrangement there.

Sizable fiscal adjustment was necessary to align government financing needs with available resources. Without policy action, Lithuania's fiscal deficit would have risen to 16½ percent of GDP in 2009. Record spending was set to rise further with the full-year effect of the pay and pension increases that had been granted in the fall 2008 general elections now in the pipeline, while government revenues were falling rapidly as the windfall tax receipts of the boom dissipated.

As veterans of the 1998 ruble crisis, the newly elected government of Prime Minister Andrius Kubilius, which took office at end-2008, was quick to recognize the risks. Within a week, it put together a budget for 2009 containing an array of measures to reduce spending and raise taxes (see IMF, 2009c). As the depth of the downturn became apparent, supplementary budgets with new savings were passed in May and July. Overall, the net adjustment implemented in 2009 amounted to about 7 percent of GDP (Table 19.1). This limited the headline deficit to about 9.2 percent of GDP.

The adjustment was, appropriately, focused on the expenditure side.[1] Given the need to realize quick cash savings and limit financing needs, the 2009 budget relied on across-the-board reductions in current and non-EU-financed capital outlays. However, this gave way to more permanent and structurally based reforms in the subsequent supplementary and 2010 budgets. To curb the wage bill, civil servant wages were first reduced in May 2009 through cuts in base and bonus pay, increases in unpaid leave, and reductions in staffing levels. These policies were extended to workers in education, health, law enforcement, and the judiciary in July 2009. The reductions, included as part of a national agreement

[1] The details of the measures are discussed in greater detail in Purfield and Rosenberg (2010).

TABLE 19.1

Lithuania: Size and Composition of Fiscal Adjustment, 2009[1] (*Percent of GDP*)	
Gross adjustment[2]	8.0
Net adjustment	7.0
Net revenue measures	1.7
Durable net revenue rate and base increases (net of tax cuts)	0.7
Of which VAT and excise increases	1.5
Other revenue measures (e.g., reversible, one-off dividends, Pillar II diversion to Pillar I, etc.)[3]	1.0
Net spending measures	5.3
Structural spending reductions	1.9
Of which structural reform (e.g., health, education, benefits)[3, 4]	0.6
Of which wage measures[5]	1.4
Of which benefit-increasing measures[5]	0.0
Reductions in current spending or investment plus other temporary measures	3.4
Spending-increasing measures	0.0
Memorandum items	
Adjustment reversible (i.e., no underpinning structural reform, or measure is legislated to lapse, e.g., Pillar II diversions that are legislated to be reinstated)	4.4
Share of adjustment potentially reversible[5]	62.5
Total revenue in percent of adjustment	
Share of spending-based adjustment	76.1

Sources: IMF staff reports; and IMF staff estimates based on country authorities budgets.

[1] Yields in year of implementation; thus if measures are implemented midyear, the full-year yield is larger than shown. Estimates may over- or understate yields to the extent that issues, e.g., changes in tax compliance, may have also impacted the actual outturn.

[2] Gross excludes impact of deficit-increasing measures such tax cuts and noninterest spending increases.

[3] Includes diversion of Pillar II contributions to Pillar I worth annually 0.5 percent of GDP in Lithuania. Also includes the 5 percentage point 2009 increase in the corporate tax rate that was then reversed from January 1, 2010.

[4] The 2009 reduction in sickness benefits was made permanent in July 2010. The 2010 budget reductions in maternity and child benefits and pensions were worth 1.7 percent of GDP and require parliamentary approval to extend beyond 2012. In Lithuania, the constitutional court ruled in mid-2010 that there needed to be compensation for the cut in pensions but left the government discretion as to the timing and amount of compensation. The government has determined that compensation will only be made once the deficit is bought back to sustainable levels and the economy recovers, and the compensation will be partial.

[5] Reductions in place until end-2010, but in July 2010 parliament approved the extension of these cuts through 2012. Assumed not reversible in calculating share of adjustment that is reversible because de facto the cuts have to be kept in place for three years given the extension through 2012.

with social partners, were progressive, with the highest-paid workers bearing the largest reductions, often in excess of 20 percent.

The government also undertook various structural reforms to bring entitlement spending to more affordable levels. Sickness, disability, maternity, and pension benefits were all reduced, often in a progressive manner to safeguard the most vulnerable, and eligibility requirements were tightened. In mid-2010, these cuts in wages and benefits were extended through end-2012. However, a 2010 constitutional court ruling required the government to provide some compensation for pension cuts once financial conditions allowed.

Tax measures played an important supplementary role in the adjustment. The standard value-added tax rate was raised by 3 percentage points to 21 percent in 2009, and its base was broadened by eliminating preferential rates and exemptions. Various excises were also raised. To alleviate pressures on the national security fund, part of the social security contribution earmarked for the second pension pillar was diverted back to the first pillar (and has yet to be restored). However, a reduction in personal income tax rates by 2 percentage points at the start of 2009 eroded part of these gains, while the 5 percentage point increase in the corporate income tax rate implemented in 2009 was reversed in the 2010 budget amid fears that it deterred investment.

With international financial markets closed to most emerging markets at the height of the crisis, Lithuania's government creatively tapped alternative funding sources. In November 2008, the European Union modified its cohesion policy, allowing members to draw additional advances on structural and cohesion funds. Lithuania sharply stepped up its absorption of EU funds from around €1.2 billion in 2008 to €1.75 billion in 2009, including by making sizable drawdowns from the previous EU disbursements. This helped to preserve capital spending and to support sectors badly hit by the crisis. Early in 2009, the government also secured some €1 billion in a multiyear funding arrangement from the European Investment Bank and a smaller amount of funding from other Nordic-country agencies. Finally, it sold its remaining stake in the Mazeikiu refinery for €245 million.

Flexible labor markets facilitated the downward adjustment in nominal wages required to bolster competitiveness. Reforms to the Labor Law in July 2009 removed restrictions on flexible work arrangements (part-time, temporary, overtime, and night work). The costs of labor shedding, such as redundancy, furloughs, and severance pay, were also reduced. Unemployment insurance and employment support laws were revised to permit greater access to public sector work and to provide retraining grants equivalent to 70 percent of the minimum wage. In 2010, a job support program worth about 7 percent of GDP was established using EU funds. Through end-2009, economy-wide labor earnings fell by almost 9 percent from their peak—about 12 percent in working-day-adjusted terms (Figure 19.1). Labor costs declined not only in the nontradable sector, where wage pressures had been the greatest in the boom years, but also in the export-oriented manufacturing sector. Consequently, the CPI-based real effective exchange rate receded from its peak, despite substantial depreciations in competitor countries, thus unwinding about one-quarter of the appreciation that had occurred in the years leading up to the crisis.

ECONOMIC OUTCOMES IN 2009–11

These efforts helped avert outright banking and currency crises. Although Bank Snoras, the country's fifth-largest bank, was found to be insolvent and was placed in bankruptcy in late 2011, the banking system remained stable. Bank deposits had long returned to precrisis levels. Nonperforming loans rose steeply to peak at almost 20 percent of total loans in late 2010, but have since stabilized and come down somewhat. With the need for new provisioning accordingly receding, the banking sector returned to profitability in 2011 after two years of losses. The exchange rate peg was preserved.

The government managed to restore access to the capital market relatively quickly. Building on the momentum from passage of the May 2009

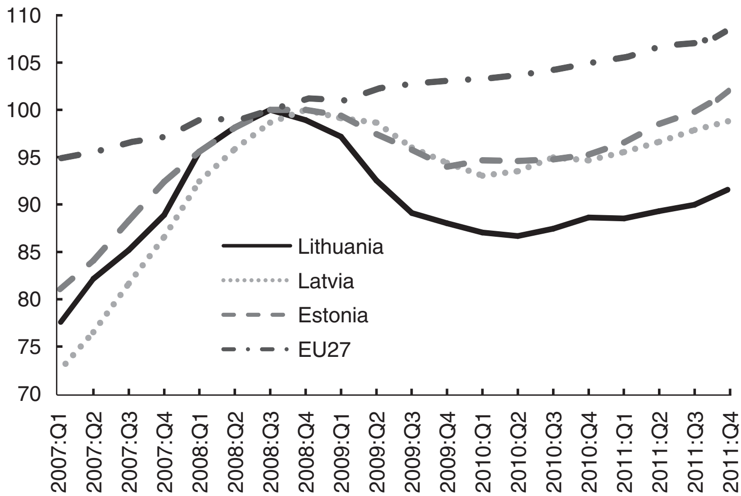

Figure 19.1 Lithuania and Selected Countries: Hourly Labor Costs (*Peak = 100*)[1]

Source: Eurostat.
[1]EU27 has not peaked. Indexed to Lithuania peak.

supplementary budget, Lithuania issued its first Eurobond since the crisis erupted. The bond, which raised €500 million for five years at a yield of over 9 percent, was relatively small and expensive. However, given the turbulence, the fact that an issue could be made at all signaled that markets were tentatively willing to support the internal devaluation strategy. As the government continued to show its resolve to push ahead with reforms, subsequent bond issues won increased volumes, longer maturities, and falling yields. All in all, the Eurobond issues played a crucial role not only in helping finance about two-thirds of the budget deficit in 2009 and 2010, but also in increasing international reserves to boost confidence in the currency board.

External imbalances corrected quickly. For 2009 as a whole, the current account showed a surplus of 4.7 percent of GDP—a truly radical turnaround from the deficit of 14.6 percent of GDP only two years earlier. The sharp contraction of imports was the chief contributor, although exports also held up much better than developments in trading partner imports would have suggested. With strong growth returning in 2011, the current account balance swung into a modest deficit.

Despite the government's best efforts, the recession that followed the boom years was very deep by any measure. From its peak in the second quarter of 2008 to its trough in the fourth quarter of 2009, GDP fell by 18 percent in seasonally adjusted terms. This set incomes back to the levels of 2005/06. At the same time, unemployment rose sharply as labor was set free in the bloated nontradable sector. The unemployment rate rose from just over 4 percent to more than 15 percent in the first half of 2010. The economy started to recover from early 2010 on the back of exports that had revived from mid-2009. Over time, the recovery broadened to include domestic demand. At 1.4 percent, annual real GDP growth was still modest in 2010, but it picked up sharply to some 6 percent in 2011. Meanwhile, the unemployment rate came down to a still-high 15½ percent in 2011. While these developments are encouraging, normalcy is still a long way off.

CHALLENGES AHEAD

The crisis has left formidable legacies. The fiscal deficit remains high despite the massive adjustment already undertaken. Given its reliance on markets to fund this deficit, Lithuania is vulnerable to shifts in market sentiment and potential spill-overs from the sovereign debt crisis in the euro area. More work lies ahead in dealing with the high level of nonperforming loans in the banking sector. The social dimension of the crisis is also a critical concern, given the large share of the labor force out of work.

Generating strong and more stable growth in the future will depend on steadfast policy implementation and continued flexibility. Efforts to reduce the fiscal deficit must continue as growth returns. This is necessary not only to arrest the buildup of debt and the associated interest burden, but also to maintain the credibility of euro adoption as a policy anchor. To this end, the government is rightly targeting to reduce its fiscal deficit from 5¼ percent of GDP in 2011 to below 3 percent of GDP in 2012. Continued flexibility in the private sector and structural reforms in product and labor markets are needed to foster the export sector as a key growth driver and entrench a solid recovery.

Lithuania: Principal Economic and Financial Indicators, 2003–11

	2003	2004	2005	2006	2007	2008	2009	2010	2011
Real Sector Indicators									
GDP (real growth in percent)	10.3	7.4	7.8	7.8	9.8	2.9	–14.8	1.4	5.9
Domestic demand (real growth in percent)	10.5	13.4	8.3	9.0	14.0	3.1	–24.9	1.3	5.1
Net exports (real growth contribution in percent)	–0.7	–6.6	–1.1	–1.8	–5.5	–0.7	12.8	–0.2	0.5
Exports of goods and services (real growth in percent)	8.4	4.1	17.0	12.2	3.1	11.4	–12.5	17.4	13.7
CPI (end-of-period change in percent)	–1.3	2.8	3.0	4.5	8.2	8.5	1.2	3.6	3.5
Employment (growth in percent)	2.3	–0.1	2.6	1.7	2.3	–0.9	–6.8	–5.1	2.3
Unemployment rate (percent)	12.4	11.4	8.3	5.6	4.3	5.8	13.7	17.8	15.5
Public Finances									
Fiscal balance (percent of GDP)	–1.3	–1.5	–0.5	–0.4	–1.0	–3.3	–9.2	–7.1	–5.2
Government revenue (percent of GDP)	31.0	31.7	33.0	33.3	33.8	34.0	34.7	35.0	34.1
Government expenditure (percent of GDP)	32.2	33.2	33.5	33.7	34.8	37.3	43.9	42.1	39.3
Government primary expenditure (percent of GDP)	31.0	32.2	32.6	33.0	34.1	36.6	42.6	40.1	37.2
Government primary expenditure (real growth in percent)	7.2	11.6	9.3	8.8	13.6	10.5	–0.8	–4.6	–1.7
Public debt (percent of GDP)	21.0	19.3	18.4	17.9	16.8	15.5	29.4	38.0	39.0
Of which foreign held	12.8	11.8	11.0	12.3	11.3	10.0	20.7	28.3	29.2
External Sector									
Current account balance (percent of GDP)	–6.8	–7.6	–7.0	–10.6	–14.5	–13.3	4.7	1.5	–1.7
Net capital inflows (percent of GDP)[1]	9.0	5.1	8.7	15.3	15.8	8.6	–8.7	–2.0	3.5
FDI	0.8	2.3	2.6	5.0	3.6	3.4	–0.4	1.8	2.5
Portfolio	1.5	0.9	–1.0	–0.8	–0.7	–0.5	2.9	5.1	3.8
Other investment	6.7	1.9	7.1	11.0	12.9	5.7	–11.2	–8.9	–2.8
Exports (percent of GDP)	51.0	51.9	57.0	58.8	53.9	60.0	54.5	68.0	76.7
Exports (€, growth in percent)	6.1	12.1	26.4	18.5	9.2	25.4	–25.2	29.2	25.8
Global export market share (basis points)	9.5	10.2	11.3	11.8	12.4	14.8	13.4	13.6	...
Remittances (percent of GDP)	0.2	0.7	1.2	2.5	3.0	2.7	2.6	3.5	3.8
Imports (percent of GDP)	56.8	58.8	64.2	69.1	67.2	71.9	55.7	69.1	78.5
Imports (€, growth in percent)	6.9	14.0	25.5	23.8	15.8	20.5	–36.2	28.3	26.7
External debt (percent of GDP)	44.6	46.2	48.1	62.7	76.5	68.2	91.5	85.8	75.1
Gross international reserves (€ billions)	2.7	2.6	3.2	4.4	5.3	4.6	4.6	5.1	5.9
Gross international reserves (percent of GDP)	18.1	15.5	14.3	18.3	18.5	14.2	17.3	18.5	18.3
Reserve coverage (GIR in percent of short-term debt)	69.9	60.1	58.9	67.3	65.7	44.2	41.9	56.4	48.8

(*continued*)

Lithuania: Principal Economic and Financial Indicators, 2003–11 *(continued)*

	2003	2004	2005	2006	2007	2008	2009	2010	2011
Monetary Sector									
Broad money (end of period, growth in percent)	19.4	22.3	32.4	21.8	21.7	–0.4	–4.4	14.3	11.5
Monetary base (end of period, growth in percent)	26.6	7.1	27.6	19.3	20.9	–1.2	–17.8	14.2	42.9
Private sector credit (end of period, percent of GDP)	20.3	25.9	35.2	46.3	56.4	58.9	66.8	59.7	50.5
Of which foreign currency denominated	...	17.1	26.2	26.5	33.1	41.1	52.3	49.3	42.1
Of which foreign currency indexed	...	...	...	...	...	...	...	...	...
Cross-border loans to nonbanks (Q4, percent of GDP)	5.7	7.0	7.9	15.2	17.0	14.5	16.6	12.3	9.0
Private sector credit (end of period, real growth in percent)	67.9	36.6	51.9	44.4	34.4	8.7	–8.0	–10.7	–9.0
Financial Sector									
Assets (percent of GDP)	35.8	44.1	59.8	69.6	80.1	79.4	94.6	89.2	77.8
ROA (percent)	1.3	1.2	1.0	1.3	1.7	1.1	–4.5	–0.4	1.4
ROE (percent)	13.4	13.5	13.6	20.3	25.9	13.5	–48.4	–4.7	15.3
CAR (percent of risk-weighted assets)	13.3	12.4	10.3	10.8	10.9	12.9	14.2	15.6	14.0
NPLs (percent of total loans)	...	...	0.6	1.0	1.0	4.6	19.3	19.7	16.4
Loan-to-deposit ratio	1.1	1.3	1.0	1.3	1.5	1.9	1.5	1.3	1.2
Cross-border claims by foreign banks (all sectors, percent of GDP)	14.5	17.5	21.1	38.0	48.8	46.4	53.6	40.0	32.3
Financial Markets									
Interest rates (end of period, one-year government bond, percent)	...	...	...	...	...	...	...	...	...
CDS spreads (sovereign, end of period, basis points)	...	...	...	6	7	605	314	251	367
EMBIG spread (sovereign, end of period, basis points)	...	...	...	...	...	...	332	267	457
Exchange rate (end of period, domestic currency/€)	3.5	3.5	3.5	3.5	3.5	3.5	3.5	3.5	3.5
NEER (index, 2003 = 100)	100.0	101.9	100.8	100.3	101.6	103.5	107.8	104.3	106.1
REER (CPI-based, 2003 = 100)	100.0	99.7	97.9	98.1	101.4	108.6	115.9	110.8	112.4
REER (ULC-based, 2003 = 100)	100.0	103.5	106.8	115.3	118.9	125.2	123.0	112.5	...
Memorandum Items									
GDP (nominal, in billions of domestic currency)	57	63	72	83	99	112	92	95	106
GDP (nominal, in billions of €)	16.5	18.2	21.0	24.1	28.7	32.3	26.6	27.5	32.2

Source: IMF staff.

Note: CAR = capital adequacy ratio; CDS = credit default swap; CPI = consumer price index; EMBIG = Emerging Markets Bond Index Global; FDI = foreign direct investment; GIR = gross international reserves; NEER = nominal effective exchange rate; NPLs = nonperforming loans; REER = real effective exchange rate; ROA = return on assets; ROE = return on equity; ULC = unit labor cost.

[1] Financial and capital account balances excluding EU balance-of-payments support, use of IMF resources, and SDR allocations.

CHAPTER 20

Bulgaria: Surviving the Crisis on Its Own

Bulgaria entered the crisis with the largest current account deficit in emerging Europe and significant currency mismatches on balance sheets. Nonetheless, it managed to avoid a banking and currency crisis without external support, largely reflecting its substantial fiscal and financial sector buffers. The main impact of the crisis was one of the sharpest deteriorations of public finances in emerging Europe. While the large swing in the fiscal balance is likely to have helped mitigate the downturn, it also forced the government to withdraw its application for the European Exchange Rate Mechanism II and postponed entry into the European Economic and Monetary Union.

BACKGROUND

Bulgaria's transition from central planning to a market-based economy had a difficult start. Output declined by 47 percent between 1989 and 1997 as reforms were only slowly implemented and macroeconomic stability remained elusive. Macroeconomic instability culminated in a banking and currency crisis in 1996–97, in which inflation surpassed 2000 percent, reserves were nearly depleted, and much of the banking system became insolvent.

Growth took off after the introduction of a currency board on July 1, 1997 (IMF, 1999). The currency board not only restored private sector confidence, it also became an anchor for economic policies. Despite the country's never having re-elected the same government since transition, Bulgaria's economic policies have remained centered on the preservation of the currency board, including in the context of a series of successfully completed IMF-supported programs, which ended in 2007. Cautious fiscal policy was key to achieving this goal, starting with the elimination of deficits and movement toward successive surpluses, with gross public debt falling from 77 percent of GDP in 2000 to 15 percent in 2008. Growth was further boosted by privatization, the acceptance of the *acquis communautaire*[1] in preparation for EU accession, and extensive reforms. Effective in 2008, Bulgaria introduced a flat income tax with a 10 percent rate—the lowest of all new EU member states.

The main authors of this chapter are Bas B. Bakker and Pritha Mitra.

[1]The *acquis communautaire* is the accumulated legislation, legal acts, and court decisions which constitute the body of European Union law.

THE RUN-UP TO THE GLOBAL FINANCIAL CRISIS

As a late reformer on its way to join the European Union, Bulgaria received the highest capital inflows among all the emerging European countries in the five years preceding the crisis. Capital inflows took off in 2004, when agreement was reached on Bulgaria becoming an EU member in 2007, and they continued to increase, peaking at 45 percent of GDP in 2007. The largest components of capital inflows were foreign direct investment in the nonfinancial sector—such as real estate (including vacation homes), construction, services, and manufacturing—followed by capital flows into the banking sector. Capital inflows fueled and financed a credit boom, with private sector credit rising from 26 percent of GDP in 2003 to 72 percent of GDP in 2008. This made Bulgaria's credit growth one of the highest in the region. Administrative measures by the Bulgarian National Bank to slow credit growth proved effective only in the short run, since banks soon circumvented them by booking loans abroad.

Despite the large capital inflows, Bulgaria's GDP growth only slightly exceeded the region's average, as much of the demand boom leaked out to higher imports. High imports partly reflected the particular form of Bulgaria's domestic demand boom, which was an investment boom rather than a consumption boom, since investment tends to have a higher import content than consumption.

Nevertheless, by the summer of 2008 the economy was seriously overheating. Inflation had reached 15 percent, wages were growing at a rate of 25 percent, and the current account deficit had swollen to 25 percent of GDP. The credit boom and capital inflows had boosted growth in the nontradable sector—in particular, construction, financial intermediation, and real estate—and much more so than in many other countries in the region (Figures 20.1 and 20.2). Moreover, large private sector balance sheet vulnerabilities had emerged. External debt had risen to

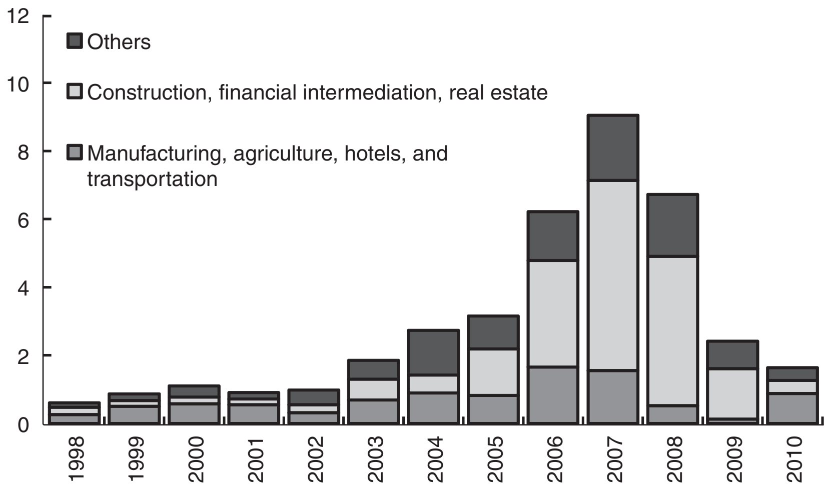

Figure 20.1 Bulgaria: Foreign Direct Investment by Sector, 1998–2010 (*Billions of euros*)

Source: National Statistical Institute.

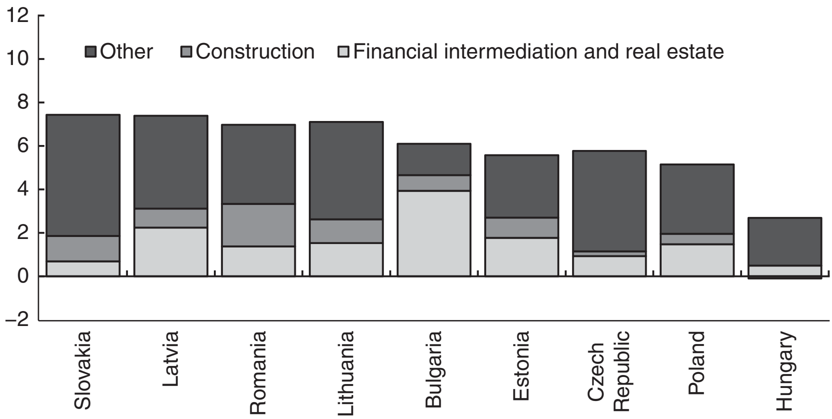

Figure 20.2 Selected Countries: Contribution to Average Real Gross Value Added Growth, 2003–08 (*Percentage points*)

Source: Haver Analytics.

98 percent of GDP at end-2008 and foreign currency-denominated debt of the private sector amounted to 72 percent of GDP. However, about half of the nonfinancial private sector exposure was intercompany debt, carrying more limited risks.

These private sector vulnerabilities were partly offset by strong public sector balance sheets. The central bank had sizable reserves, equivalent to 39 percent of GDP at end-2007. With the budget in surplus and public debt low, the government was not dependent on favorable conditions in financial markets. Moreover, the presence of foreigners in bond and equity markets was low, limiting the risk from a sudden pullout.

IMPACT OF THE GLOBAL FINANCIAL CRISIS

The global turmoil that followed the collapse of Lehman Brothers soon led to a sharp drop in capital inflows. Overall capital inflows declined from 33 percent of GDP in 2008 to 1.4 percent of GDP in 2009. Bank flows fell the most, swinging from inflows of 10 percent of GDP in 2008 to outflows of 2½ percent of GDP in 2009. The decline in foreign bank funding led to intense competition for deposits, rising interest rates, and a near standstill of credit growth. Foreign direct investment declined as well, though it remained positive, falling from 18 percent of GDP in 2008 to 7 percent of GDP in 2009. The sharpest drop occurred in the real estate sector, where inflows plummeted 75 percent.

The sudden stop of capital inflows and the abrupt end of the credit boom had a significant impact on the economy. Housing prices declined by 17 percent during the fourth quarter of 2008 and the first quarter of 2009, and by late 2010 had fallen to one-third of their peak level, with construction following suit. Domestic demand contracted by 13 percent in 2009.

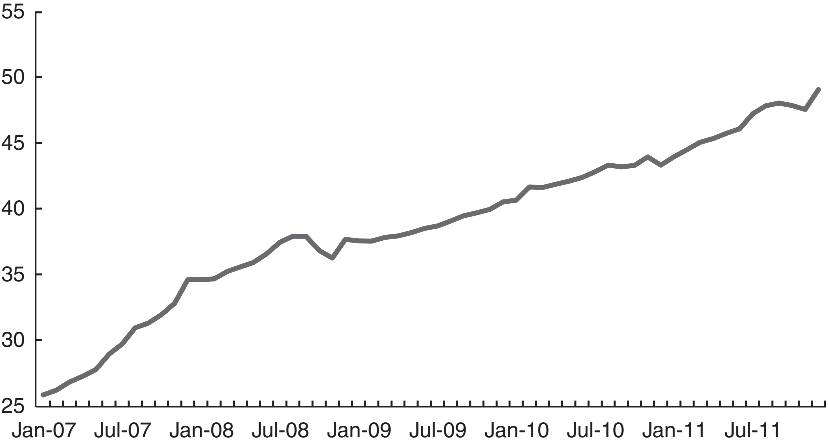

Figure 20.3 Bulgaria: Total Bank Deposits, 2007–11 (*Billions of lev*)

Source: Haver Analytics.

The recession was further exacerbated by falling exports. Exports declined strongly in the fourth quarter of 2008 and the first quarter of 2009, hit by the recession in Bulgaria's trading partners, and stabilized thereafter. For 2009 as a whole, exports declined by some 19 percent in value terms and 11 percent in volume terms.

POLICY RESPONSES

One of the first challenges for policymakers was to ensure the stability of the financial system. In the uncertainty that followed the collapse of Lehman Brothers, banks were confronted with withdrawals of domestic deposits. Residential deposits declined by 4.3 percent (cumulatively) during October and November, largely driven by enterprises—a major shock considering that in the summer of 2008, deposits had still been growing by 30 percent year-over-year (Figure 20.3). This was a potentially explosive situation, since a run on the banking system could potentially put the survival of the currency board at risk.[2] To stem these risks, the deposit insurance coverage was increased, first from €25,000 to €50,000 and then in mid-2010 to €100,000. A reduction in reserve requirements helped stabilize the banking system by boosting liquidity. It also allowed local affiliates of foreign banks to repay the liquidity support that had temporarily been provided by their parents. By December 2008, most of the deposit decline had been reversed. The Bulgarian National Bank base rate peaked at 5.8 percent in December, and then started to decline rapidly to 0.6 percent by end-2009.

[2]The health of the currency board and the banking system were intertwined: a strong and resilient financial system was needed to sustain the currency board, while the stability of the increasingly euroized banking system hinged critically on maintaining the currency board arrangement.

The Bulgarian National Bank eased some of the measures taken to contain credit growth during the boom period, and it also took steps to further increase banking system buffers. In early 2009, provisioning rules were adjusted, and in 2010 the risk weights were reduced to EU-required levels. The Bulgarian National Bank requested that bank owners add their 2008 profits to their capital rather than pay out dividends, and encouraged them to do the same with their 2009 profits. It also sought and obtained comfort letters from parent banks pledging adequate liquidity and capital support for their Bulgarian subsidiaries. The large buffers ensured that the banking system would remain liquid and well-capitalized, even in the face of increasing nonperforming loans in 2009 and 2010. At end-2010, the aggregate capital adequacy ratio stood at 17½ percent, well above the minimum mandatory ratios of 12 percent in Bulgaria and 8 percent in the EU. Most banks had been able to cover impairment costs associated with deteriorating asset quality out of operating profits.

On the fiscal front, Bulgaria experienced one of the largest fiscal balance deteriorations in emerging Europe. In accrual terms (the concept used by the European Union), Bulgaria's fiscal balance went from a surplus of 1¾ percent of GDP in 2008 to a deficit of almost 5 percent in 2009. While this large swing in the fiscal balance is likely to have helped mitigate the downturn, it also forced the government to withdraw its application for participating in the European Exchange Rate Mechanism II and thus postpone entry into the European Economic and Monetary Union.

The fiscal balance deteriorated so much because rapid spending growth continued until mid-2009. Bulgaria entered the downturn with large fiscal surpluses of around 3 percent of GDP in both 2007 and 2008—and the 2009 budget assumed this would continue. By December of 2008, however, it became clear that the 20 percent spending growth in the 2009 budget was far too high to reach this target. Rather than adjusting the budget, which carried the risk that parliament might increase spending, Finance Minister Plamen Oresharski instructed ministries to limit spending to 90 percent of budget allocations—the so-called 90 percent rule. The remainder would only be released if budgetary developments turned out favorably. However, the new targets were not adhered to. With the July elections approaching, the expenditure surge that began in the last quarter of 2008 continued even though revenue had dropped 11 percent. Pensions were increased in January and July by a total of 17 percent. Capital expenditure was also increased by two-thirds. Revenue shortfalls were exacerbated by a reduction in social security contribution rates by 2 percentage points. All told, the cumulative fiscal deficit for the first seven months of 2009 came to 0.6 percent of GDP, down from a surplus of 6.3 percent in the same period of 2008.

This changed after the elections in mid-July, when a new government came into office. Prime Minister Sergey Stanishev, who had led a center-left coalition of the Bulgarian Socialist Party, the National Movement for Stability and Progress, and the Movement for Rights and Freedom, was replaced by Boiko Borisov, the leader of the center-right Citizens for European Development of

Bulgaria,[3] who was elected on a platform of cracking down on organized crime and corruption and reducing the role of the government. He formed a minority government, controlling 116 out of 240 seats in the National Assembly.

The new government aimed for balanced budgets (on a cash basis) in both 2009 and 2010 through expenditure reductions and improvements in tax administration. Spending was curtailed by across-the-board cuts—in particular for maintenance and capital spending—and most end-year and other bonus payments in the public sector were scrapped. The authorities hoped that by balancing its budgets, Bulgaria could make a convincing case for its application to enter the European Exchange Rate Mechanism II, which was going to be submitted in early 2010.

On a cash basis, the full-year deficit came to 0.9 percent of GDP. Tax revenues fell short of targets as the economic downturn devastated tax revenues, and measures to improve tax administration yielded less than anticipated, but expenditure was close to plan. However, the cash outturn substantially understated actual government outlays.

In early 2010, the 2009 accrual deficit (the measure used by the European Union) was revised up from 1.9 to 4.9 percent of GDP.[4] The upward revision mainly followed the discovery of large arrears, primarily in the construction and defense sectors, that had been accumulated in the first half of 2009. After the revision, the government dropped its application for the European Exchange Rate Mechanism II, while the European Commission initiated an Excessive Deficit Procedure.[5] Market reactions were, nevertheless, muted. CDS spreads and the stock market showed little reaction and ratings agencies did not change their outlook for Bulgaria.

Tight fiscal policy managed to reduce the fiscal deficit below the Maastricht ceiling, but only in 2011. After the discovery of arrears, it became clear that the 2010 cash deficit target of ¾ percent of GDP was no longer attainable. Confronted with further disappointing tax revenues, the government raised the target to 4.8 percent of GDP. To contain the deficit, the government froze pensions and wages, streamlined public administration (including through reducing the civil service by some 9,000 workers), increased excise duties (cigarettes, electricity), and hiked taxes on gambling and real estate. This ultimately resulted in a cash deficit of 3.9 percent of GDP. In light of difficult market conditions and the government's decision not to seek financing from international financial institutions, the government financed the deficit by drawing down its fiscal reserve buffers, by around 3 percent of GDP. Further consolidation efforts in 2011 reduced the deficit to 2.1 percent of GDP, below the Maastricht deficit ceiling.

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[3]The former King Simeon Saxe-Coburg's party.

[4]The accrual-based 2009 deficit was initially revised up to 3.9 percent of GDP in April 2010. Eurostat revised the deficit further in October 2010 to 4.7 percent of GDP reflecting more complete data and inclusion of the state-owned railway company.

[5]http://ec.europa.eu/economy_finance/sgp/deficit/index_en.htm.

ECONOMIC OUTCOMES IN 2009–11

Bulgaria suffered a severe recession in 2009. GDP growth went flat in the fourth quarter of 2008, the economy shrank through 2009 by nearly 9 percent, and a recovery took hold from the first quarter of 2010. Given the strong growth momentum of the economy in 2008 and the publication lag in growth statistics, the severity of the recession became fully apparent only around May 2009. This, together with the election timetable, may explain the relatively late fiscal policy response. For 2010 as a whole, real GDP grew by 0.4 percent, and GDP picked up moderately to 1.7 percent in 2011. Bulgaria's recovery, like that of most other countries in the region, was export-led. Year-over-year growth in exports turned positive in the first quarter of 2010, and for 2010 as a whole it grew by 15 percent. In contrast, real domestic demand remained a drag on growth and declined in 2009, 2010, and 2011. Domestic demand in 2011 was some 18 percent lower than in 2008; investment was particularly hard hit.

The recession brought about a sharp correction of external and internal imbalances. The current account deficit declined from a peak of 25 percent of GDP in 2007 to 1 percent in 2010 and then turned into a surplus of 2 percent of GDP in 2011, as a sharp drop in investment led to a decline in imports. Inflation declined from a peak of 15 percent in mid-2008 to some 2 percent by end-2011. Wage growth has also adjusted from a peak of 25 percent in 2008 to 9 percent in 2011, although it remains elevated.

While the decline in GDP was large, it was less than what could have been expected given the size of the precrisis imbalances. In Latvia, which had a similar current account deficit during the boom, GDP declined by a quarter peak-to-trough, compared to 9 percent in Bulgaria. The difference likely reflects both luck—Latvia was already in recession when the global financial crisis fully erupted while Bulgaria was still growing strongly—and different growth patterns in the boom years. Just as the investment boom had leaked out through higher imports during the upswing, during the downturn the reverse was happening, with much of the adjustment reflected in lower imports rather than lower GDP.

CHALLENGES AHEAD

Although concerns that the global financial crisis might trigger a balance-of-payments or banking crisis in Bulgaria have fortunately not materialized, challenges remain. High private debt, currency mismatches on balance sheets, and exposure to euro area banks weakened by the crisis have not disappeared. Bulgaria remains strongly exposed to the vagaries of international financial markets in general and to the euro area crisis in particular.

The main challenge for Bulgaria will be eventual euro adoption. This would eliminate the residual exchange rate risk and the associated balance sheet vulnerabilities—although, as problems in euro area countries demonstrate, it would not be a panacea.

Eventual euro adoption will require public finances to continue to comply with Maastricht criteria, among other policy measures. Prudent fiscal policy is necessary, in any event, to rebuild public sector buffers as a counterbalance to Bulgaria's high private sector external debt and in support of the currency board.

The private sector will also need to be sufficiently flexible. It will not only need to shift from a growth pattern driven by capital inflows and domestic demand to a more-balanced one with a bigger role for the tradable sector. It will also need to ensure that as the economy recovers, price pressures remain contained. While nominal wage growth has slowed, it continues to be more elevated than in many other countries of the region.

Bulgaria: Principal Economic and Financial Indicators, 2003–11

	2003	2004	2005	2006	2007	2008	2009	2010	2011
					Real Sector Indicators				
GDP (real growth in percent)	5.5	6.7	6.4	6.5	6.4	6.2	–5.5	0.4	1.7
Domestic demand (real growth in percent)	8.9	8.3	9.5	10.8	8.7	6.4	–12.8	–5.1	–0.3
Net exports (real growth contribution in percent)	–4.2	–2.4	–4.3	–6.0	–3.8	–1.5	10.0	5.6	2.3
Exports of goods and services (real growth in percent)	10.6	11.9	–17.5	50.7	6.1	3.0	–11.2	14.7	12.8
CPI (end-of-period change in percent)	5.6	4.0	7.4	6.1	11.6	7.2	1.6	4.4	2.0
Employment (growth in percent)	6.9	3.3	2.4	4.3	4.5	3.0	–3.1	–6.1	–3.4
Unemployment rate (percent)	15.2	13.4	11.1	10.1	8.1	7.1	8.2	11.5	12.5
					Public Finances				
Fiscal balance (percent of GDP)	0.0	1.6	2.3	3.3	3.3	2.9	–0.9	–3.9	–2.1
Government revenue (percent of GDP)	36.6	37.5	37.4	37.0	38.2	38.0	35.3	32.7	32.5
Government expenditure (percent of GDP)	36.6	35.8	35.2	33.6	34.9	35.2	36.2	36.6	34.6
Government primary expenditure (percent of GDP)	34.6	34.1	33.7	32.4	33.9	34.3	35.4	36.0	33.8
Government primary expenditure (real growth in percent)	7.7	5.2	5.2	2.5	11.3	7.6	–2.5	1.9	–4.3
Public debt (percent of GDP)	46.5	39.1	29.4	23.4	18.6	15.5	15.6	16.7	17.0
Of which foreign held	34.8	26.7	15.9	13.7	10.8	6.9	8.3	8.0	...
					External Sector				
Current account balance (percent of GDP)	–5.3	–6.4	–11.7	–17.6	–25.2	–23.2	–8.9	–1.3	1.9
Net capital inflows (percent of GDP)[1]	13.6	12.2	18.0	27.2	44.6	32.5	1.4	–1.9	–2.9
FDI	10.0	11.1	13.9	23.0	28.7	17.5	7.2	2.9	3.1
Portfolio	–1.0	–2.1	–4.5	1.1	–1.7	–2.1	–1.8	–1.8	–0.9
Other investment	4.6	3.2	8.5	3.1	17.6	17.0	–4.0	–2.9	–5.1
Exports (percent of GDP)	51.4	55.3	56.2	61.2	59.5	58.4	47.6	57.6	66.3
Exports (€, growth in percent)	10.3	19.7	15.9	24.3	12.8	12.6	–19.3	24.7	23.0
Global export market share (basis points)	9.8	10.8	11.3	12.6	13.4	14.1	13.3	13.5	...
Remittances (percent of GDP)	3.3	1.7	1.6	1.3	2.1	2.0	2.1	2.1	...
Imports (percent of GDP)	61.7	66.6	71.7	78.8	79.2	79.1	55.9	59.7	64.8
Imports (€, growth in percent)	13.9	20.2	22.7	25.4	16.8	14.4	–30.0	10.2	16.1
External debt (percent of GDP)	63.3	67.1	63.6	82.3	100.3	97.7	113.4	101.6	86.2
Gross international reserves (€ billions)	5.0	6.5	6.9	8.4	11.2	12.1	11.9	12.5	13.1
Gross international reserves (percent of GDP)	30.8	35.0	28.0	33.2	39.3	32.6	35.4	35.0	31.6
Reserve coverage (GIR in percent of short-term debt)	176.0	113.9	112.0	92.1	93.1	71.3	80.7	90.8	96.3

(*continued*)

Bulgaria: Principal Economic and Financial Indicators, 2003–11 (*continued*)

	2003	2004	2005	2006	2007	2008	2009	2010	2011
Monetary Sector									
Broad money (end of period, growth in percent)	19.6	23.1	23.9	26.9	31.2	8.8	4.2	6.4	12.2
Monetary base (end of period, growth in percent)	23.2	24.4	10.6	19.1	34.9	–0.3	–4.9	3.2	8.5
Private sector credit (end of period, percent of GDP)	26.4	35.3	41.0	45.0	63.0	71.9	75.8	74.5	72.5
Of which foreign currency denominated	11.2	16.8	19.3	20.2	31.3	40.5	44.0	45.4	46.1
Of which foreign currency indexed	...	...	...	...	...	...	...	...	...
Cross-border loans to nonbanks (Q4, percent of GDP)	4.8	8.0	8.7	16.6	19.6	21.5	23.0	21.4	16.2
Private sector credit (end of period, real growth in percent)	41.0	43.2	23.6	17.8	45.8	22.7	2.1	–2.9	1.8
Financial Sector									
Assets (percent of GDP)	44.3	58.2	65.3	74.5	92.4	96.1	100.1	100.5	99.6
ROA (percent)	2.4	2.1	2.0	2.2	2.4	2.1	1.1	0.9	0.8
ROE (percent)	...	...	21.4	25.0	24.8	23.1	10.2	7.9	7.1
CAR (percent of risk-weighted assets)	22.0	16.6	15.3	14.5	13.8	14.9	17.0	17.5	17.5
NPLs (percent of total loans)	...	...	2.2	2.2	2.1	2.5	6.4	11.9	14.9
Loan-to-deposit ratio	0.8	0.9	0.9	0.9	1.1	1.3	1.3	1.2	1.1
Cross-border claims by foreign banks (all sectors, percent of GDP)	9.7	14.9	16.1	24.8	40.5	47.0	48.9	44.9	33.5
Financial Markets									
Interest rates (end of period, three-year government bond, percent)	...	...	4.0	3.6	4.1	3.4	3.2	3.7	3.6
CDS spreads (sovereign, end of period, basis points)	128	32	34	17	72	514	232	247	414
EMBIG spread (sovereign, end of period, basis points)	177	77	90	66	153	674	179	195	362
Exchange rate (end of period, domestic currency/€)	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
NEER (index, 2003 = 100)	100.0	101.8	100.3	101.0	102.1	104.2	107.6	104.1	106.3
REER (CPI-based, 2003 = 100)	100.0	105.0	105.0	109.6	115.9	126.8	132.3	127.1	130.6
REER (ULC-based, 2003 = 100)	100.0	101.7	103.1	106.7	113.0	123.5	137.5	142.3	...
Memorandum Items									
GDP (nominal, in billions of domestic currency)	36	40	45	52	60	69	68	71	75
GDP (nominal, in billions of €)	18.3	20.3	23.2	26.4	30.7	35.2	34.9	36.0	40.3

Source: IMF staff.

Note: CAR = capital adequacy ratio; CDS = credit default swap; CPI = consumer price index; EMBIG = Emerging Markets Bond Index Global; FDI = foreign direct investment; GIR = gross international reserves; NEER = nominal effective exchange rate; NPLs = nonperforming loans; REER = real effective exchange rate; ROA = return on assets; ROE = return on equity; ULC = unit labor cost.

[1] Financial and capital account balances excluding EU balance-of-payments support, use of IMF resources, and SDR allocations.

CHAPTER 21

Croatia: Averting Financial Crisis but Struggling to Become Competitive

Croatia entered the global financial crisis with an unsustainable growth model characterized by strong domestic demand and current account deficits, financed by credit growth and capital inflows. External competitiveness was low. These underlying problems were exposed when capital flows seized with the onset of the crisis. Economic activity contracted sharply and public finances deteriorated. Strong, proactive financial sector policies and foreign parent banks' willingness to maintain exposure helped avert a full-blown financial crisis. Nonetheless, a stable exchange rate regime, overstretched balance sheets, and long-standing rigidities make it difficult to return to positive growth.

BACKGROUND

Croatia's economy suffered a large setback during the war of 1991–94. The war destroyed much of Croatia's industry directly and severed critical trade linkages with the rest of the former Yugoslavia. Growth resumed in 1995, driven by large reconstruction needs and sizable government expenditure programs, such as the upgrading of the road network. During 1995–2002, real GDP growth averaged some 4 percent and the current account deficit exceeded 6 percent of GDP. Progress in liberalizing the economy was more limited than elsewhere in emerging Europe. The budget continued to support a number of large loss-making companies, notably in shipbuilding, railways, and steel. The public sector also remained large by European standards.

THE RUN-UP TO THE GLOBAL FINANCIAL CRISIS

Croatia's precrisis growth was dependent on capital inflows that financed domestic absorption. During 2003–08, private consumption and investment, mostly in the construction sector, were the main drivers of economic growth. Abundant foreign capital inflows, predominantly in the form of debt, were channeled through the foreign-owned banking system or directly provided to domestic corporates by the foreign parent banks. This fueled strong private sector credit growth. Most of the loans were denominated in, or indexed to, foreign currency

The main authors of this chapter are Jesmin Rahman and Zuzana Murgasova.

(Atoyan, 2010). Credit predominantly financed activities in the nontradable sector, while the relative importance of exports declined. Trade deficits were high even by regional standards, with net exports contributing negatively to growth each year during 2003–08. On the whole, easy financing conditions allowed Croatia to continue to grow at a fast clip and run large current account deficits, resulting in a rapid buildup of external debt.

The lagging export performance reflected, among other things, underlying competiveness problems. Wages had been historically high and unit labor costs also appeared uncompetitive when compared to Croatia's overall income level (Figure 21.1). Meanwhile, limited progress in key structural reforms saddled the economy with pervasive rigidities. Almost two decades after the beginning of transition, Croatia lags behind its European peers in large-scale privatization, enterprise restructuring, and competition policy. Strict labor regulations severely constrain labor market flexibility, while generous social benefits reduce labor force participation and burden those employed in the formal sector. The combination of relatively high wage levels and an inflexible economy meant that Croatia did not succeed in attracting substantial greenfield foreign direct investment to expand its export sector. Exports remained below their potential during the pre-crisis years, and Croatia continues to be a relatively closed economy.

Macroeconomic policies had only limited success in dampening credit growth and may even have contributed to the buildup of vulnerabilities. While the headline fiscal deficit was brought down to 1¼ percent of GDP by 2008, the

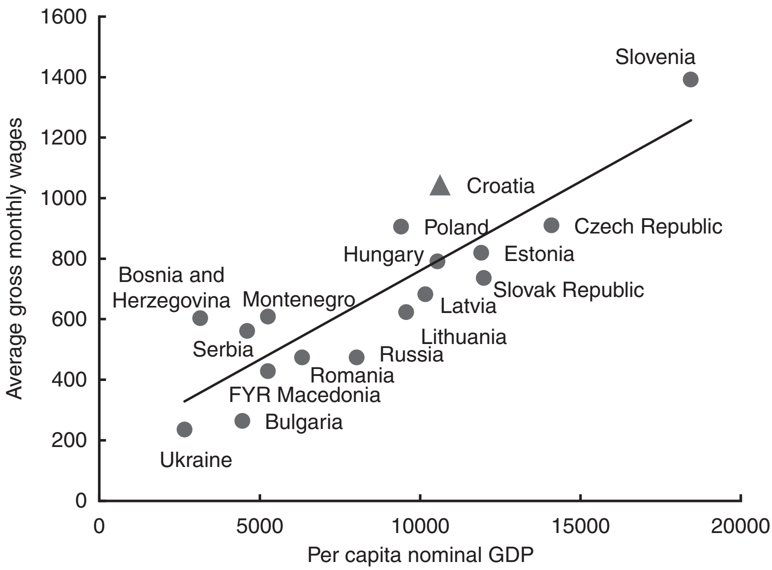

Figure 21.1 Selected European Countries: Average Gross Monthly Wages versus Per Capita GDP, 2008 (*Euros*)

Sources: Haver Analytics; and IMF staff calculations.

cyclically adjusted fiscal balance remained large during the boom years. Similarly, public debt, including the guaranteed stock, remained elevated, leaving little room for fiscal maneuver during the crisis (Rahman, 2010). Challenging reform needs in the public sector were left unaddressed, creating ossified spending structures with high mandatory expenditure. Monetary policy during the precrisis years was largely geared toward maintaining exchange rate stability. While the stable exchange rate regime kept inflation and inflation expectations low, it also reduced the perceived exchange rate risk and therefore may have contributed to excessive foreign currency borrowing, including direct cross-border borrowing by nonfinancials.

Financial sector policies were mainly concerned with ensuring the stability of the banking system in the face of large capital inflows. Since 2003, the Croatian National Bank had used a variety of measures to lean against the wind in an attempt to slow the pace of credit growth. These included conventional measures, such as higher reserve requirements and higher risk weights for unhedged foreign currency loans, as well as unconventional measures, such as ceilings on credit growth, marginal reserve requirements on foreign borrowing, and foreign currency liquidity requirements. These measures had some success in reducing credit growth, though foreign parent banks substituted capital injections for lending to Croatian subsidiaries to finance credit expansion and they increasingly resorted to extending credit directly to Croatian corporates. Nonetheless, these measures helped build up liquidity and capital buffers in the local banking sector, which proved useful during the crisis.

Croatia entered the crisis with a strong financial sector but an uncompetitive and highly vulnerable economy and with little room for policy maneuver. The many years of large current account deficits had pushed Croatia's external debt to over 80 percent of GDP by 2008. The associated high rollover needs, together with sizable current account deficits, posed substantial external financing risks. The fiscal position was highly susceptible to any economic downturn and, with sizable structural deficits and public debt, it left little or no policy room. Meanwhile, extensive euroization in the banking system—where three-quarters of assets were denominated in foreign currency—accentuated balance sheet risks and constrained the authorities' monetary and exchange rate policy options. Although the banking sector itself was profitable and sound, the high indebtedness of households and corporates meant that any downturn would affect banks' asset quality.

IMPACT OF THE GLOBAL FINANCIAL CRISIS

Financing conditions for Croatia deteriorated sharply in late 2008. Conditions in the financial markets, both external and domestic, worsened in the fourth quarter of 2008 as capital inflows experienced a marked slowdown, although they remained positive, and foreign bank exposure held up. Bond and CDS spreads shot up, the Zagreb stock market plunged, and pressures on the kuna exchange rate intensified.

The mere slowdown of capital inflows was enough to push the Croatian economy into a severe recession. Tight credit conditions and diminished confidence caused domestic demand to contract. With trading partners' imports also contracting and poor competitiveness, exports plunged. After experiencing a slowdown since the second quarter of 2008, real GDP growth halted in the fourth quarter and dropped sharply by 6¾ percent year-over-year during the first half of 2009.

POLICY RESPONSES

Croatia's initial policy actions focused on supporting financial and exchange rate stability. Given the extent of the economy's euroization and the adverse balance sheet effects associated with any sharp depreciation, the Croatian National Bank adopted a three-pronged approach: support for the kuna, liquidity maintenance in the interbank market, and alleviation of capital outflow pressures. In addition to tightly managing kuna liquidity in the interbank market, the central bank intervened intermittently in the foreign exchange market to contain depreciation pressures. It also reduced the overall reserve requirements, relaxed regulatory requirements for repo auctions, and simplified rules for access to liquidity assistance in order to address liquidity shortages in the interbank market. To counter capital outflow pressures, the Croatian National Bank eliminated the marginal reserve requirement on banks' foreign borrowing, quadrupled the insurance coverage of deposits, and impressed upon the banks the need to keep their profits in Croatia. The commitment of foreign parent banks to maintain their share in the market also shielded the Croatian subsidiaries.

Considering the large financing needs and the uncertain market outlook, fiscal policy focused on containing the budget deficit. As economic activity dropped sharply in the first quarter of 2009, Croatia faced a difficult trade-off between supporting growth by allowing the fiscal deficit to widen, on the one hand, and keeping public financing needs at a manageable level, on the other. The rapid deterioration in revenues, particularly from indirect taxes, and the lack of fiscal space made it difficult to implement any fiscal stimulus to support growth. In the course of 2009, the authorities adopted three supplementary budgets to contain the overall deficit. The measures in these budgets, amounting to 2¼ percent of GDP, were mostly on the spending side. They included cuts in discretionary expenditure, wage and pension freezes, a value-added tax rate increase, and the introduction of a temporary surtax on high incomes and pensions. These measures contained the 2009 fiscal deficit to some 4 percent of GDP.

This policy mix succeeded in improving market sentiment. As 2009 progressed, the kuna recouped its losses, official reserves were rebuilt, and bond spreads came down considerably. Liquidity pressures in the banking system eased, with parent banks maintaining credit lines to their domestic subsidiaries and domestic deposits stabilizing. Although credit quality worsened significantly and profitability declined during 2009, the banking sector came out of the crisis still well capitalized. The Croatian government was also able to tap international capital markets twice in 2009.

In 2010, following others in the region, Croatia put in place credit support schemes to spur growth. With tight credit conditions amid risk-averse banks and a reluctant, highly leveraged private sector, Croatia introduced multiple credit schemes to stimulate bank lending. In the context of low inflationary pressures and a sizable output gap, these schemes, whose combined size was less than 3 percent of GDP, were thought to provide a needed boost. The schemes released liquidity through a conditional reduction in reserve requirements to boost credit for both working capital and new investment, with the government providing guarantees for the latter. But while credit recovered somewhat, growth did not pick up.

ECONOMIC OUTCOMES IN 2009–11

The policy response was successful in staving off financial meltdown, but a protracted recession could not be avoided. Economic activity contracted by 6 percent in 2009—a rate close to the regional average. The current account deficit also improved substantially, as imports fell in the wake of weak domestic demand. However, Croatia was one of the few countries in the region still mired in recession in 2010, and the only one failing to post positive growth in 2011. The credit schemes, which were slow to take off, had a limited impact in restoring credit growth, particularly for new investment, as uncertainties lingered and demand for credit remained feeble. Compromised competitiveness is still very much an issue and stands in the way of shifting to a new growth model that relies more on a vibrant tradable sector.

CHALLENGES AHEAD

Croatia's key challenge is to achieve durable growth. Croatia's growth has relied on domestic demand, foreign financing, and the nontradable sector for many years. With new foreign financing now in short supply and indebtedness already at high levels, Croatia needs to change track. Going forward, growth will have to come more from the tradable sector. This in turn requires addressing Croatia's external competitiveness problems, which are manifested in large and persistent trade deficits, and a relatively narrow and undiversified export base. While the underlying reasons are complex, there are some obvious deficiencies. Wages are set rigidly, and nominal wages appear too high relative to most of Croatia's peers, particularly in the skill-intensive manufacturing subsectors. A poorly rated business environment compared to regional peers points to room for improvement on the structural front.

Improving price competitiveness involves difficult policy choices. The high degree of financial euroization and a large external debt burden reinforce the authorities' preference for sticking with the stable exchange rate regime. Competitiveness gains would then need to come from reducing income and wages to bring them down to more competitive levels. There would be a cost in terms of foregone growth during the adjustment period.

Structural reform should also be brought into play to help improve growth prospects. According to the World Bank (2009), Croatia's largest growth dividend could come from increased labor force participation. With population projected to decline at an accelerated pace through 2050, increasing labor force participation needs to be achieved by changing the social benefits parameters so as to strengthen incentives to work and by making labor contracts more flexible so as to facilitate hiring. Croatia also needs to improve its business environment through a reduction of the regulatory burden and completion of pending privatization. Recent reforms to harmonize the retirement age between men and women, increase the penalty for early retirement, introduce incentives to delay retirement, and reduce the duration and amount of unemployment benefits constitute notable progress. However, challenging reforms to allow for more flexible wage setting and to reduce the size of the public sector are yet to be tackled.

In addition, Croatia will also need to increase its fiscal policy space. As a small open economy, Croatia is highly susceptible to external shocks. Under its stable exchange rate policy, fiscal policy becomes the main demand management tool. But fiscal policy can only fill this role once consolidation has generated sufficient room to maneuver. This would require implementing strong fiscal consolidation to balance the overall budget over the medium term and lower public debt to safer levels. That in turn would facilitate maintaining a cyclically adjusted balanced fiscal position over the long term.

Recognizing these challenges, the government adopted a comprehensive reform package in the first half of 2011, known as the Economic Recovery Program. The goal of this 10-year plan, which includes 131 measures in 10 key areas, is to generate economic recovery in the short term and create a more competitive economy in the longer term. As such, it aims to ensure fiscal sustainability through a reduction in pension and health expenditures, better targeting of social spending, and implementation of a Fiscal Responsibility Law. It intends to reduce government interference in economic activities through privatization, civil service retrenchment, and better management of public enterprises. It also includes complementary reforms in the labor market, education, and the judiciary to strengthen the role of the private sector. Although initially greeted with strong enthusiasm, the program faces implementation challenges. Progress has been made in reducing unemployment benefits, adjusting pension parameters, and reducing health expenditures. However, advancing the macro-critical reforms, such as privatization, public administration reform, and labor market flexibility, will be up to the new government, which took office in December 2011.

Croatia: Principal Economic and Financial Indicators, 2003–11

	2003	2004	2005	2006	2007	2008	2009	2010	2011
					Real Sector Indicators				
GDP (real growth in percent)	5.4	4.1	4.3	4.9	5.1	2.2	–6.0	–1.2	0.0
Domestic demand (real growth in percent)	6.2	4.0	4.5	6.3	6.2	2.7	–9.0	–3.8	–0.4
Net exports (real growth contribution in percent)	–1.2	–0.2	–0.5	–1.6	–1.5	–0.7	3.0	2.6	0.4
Exports of goods and services (real growth in percent)	11.6	5.4	3.5	5.8	3.7	2.2	–17.3	6.0	2.2
CPI (end-of-period change in percent)	1.7	2.7	3.7	2.1	5.8	2.8	1.9	1.9	2.0
Employment (growth in percent)	0.6	1.7	0.7	0.8	2.0	1.1	–2.0	–4.5	–3.3
Unemployment rate (percent)	14.3	13.8	12.7	11.1	9.4	8.3	9.1	12.2	13.2
					Public Finances				
Fiscal balance (percent of GDP)	–4.7	–3.4	–2.8	–2.6	–2.1	–1.3	–4.1	–4.9	–5.5
Government revenue (percent of GDP)	39.1	39.0	38.6	38.6	39.8	39.1	38.2	37.0	35.9
Government expenditure (percent of GDP)	43.8	42.4	41.4	41.2	41.9	40.4	42.3	41.9	41.4
Government primary expenditure (percent of GDP)	42.1	40.6	39.5	39.3	40.2	38.9	40.6	39.9	39.0
Government primary expenditure (real growth in percent)	2.6	0.5	1.4	4.4	7.5	–1.1	–1.9	–2.8	–2.4
Public debt (percent of GDP)	35.4	37.6	38.2	35.4	32.9	29.2	35.1	41.2	45.6
Of which foreign held	21.8	21.7	16.2	15.7	14.9	9.6	12.6	13.4	...
					External Sector				
Current account balance (percent of GDP)	–6.0	–4.1	–5.3	–6.7	–7.3	–8.9	–5.0	–1.0	0.9
Net capital inflows (percent of GDP)[1]	13.8	7.6	10.8	13.7	11.7	11.4	8.7	3.5	3.9
FDI	5.6	1.8	3.5	6.4	7.9	6.7	3.3	0.9	2.3
Portfolio	2.9	0.7	–3.4	–0.5	0.7	–1.4	1.1	0.9	1.4
Other investment	5.3	5.1	10.7	7.8	3.1	6.1	4.3	1.6	0.3
Exports (percent of GDP)	43.4	43.1	42.4	42.7	42.1	41.5	35.7	38.6	39.3
Exports (€, growth in percent)	18.2	8.5	7.1	11.2	7.6	8.2	–17.5	8.7	1.9
Global export market share (basis points)	8.2	8.8	8.4	8.6	9.1	8.9	8.4	7.8	...
Remittances (percent of GDP)	0.7	0.7	0.7	0.6	0.6	0.5	0.5	0.6	0.6
Imports (percent of GDP)	50.0	48.9	48.3	49.2	49.3	49.5	39.1	38.6	37.3
Imports (€, growth in percent)	10.1	6.8	7.7	12.5	9.1	10.1	–24.2	–0.6	–3.2
External debt (percent of GDP)	73.4	76.3	68.6	78.5	82.4	82.0	102.7	102.1	93.8
Gross international reserves (€ billions)	6.5	6.4	7.5	8.7	9.3	9.3	10.3	11.2	12.0
Gross international reserves (percent of GDP)	24.0	21.4	19.6	23.0	23.0	18.5	23.5	24.7	24.4
Reserve coverage (GIR in percent of short-term debt)	159.5	119.4	80.6	86.6	112.7	70.3	99.5	67.2	72.2

(*continued*)

Croatia: Principal Economic and Financial Indicators, 2003–11 (*continued*)

	2003	2004	2005	2006	2007	2008	2009	2010	2011
Monetary Sector									
Broad money (end of period, growth in percent)	11.0	8.6	10.5	18.0	18.3	4.3	–0.9	4.4	3.5
Monetary base (end of period, growth in percent)	23.9	19.9	20.6	16.7	5.2	–12.7	5.9	–0.3	11.3
Private sector credit (end of period, percent of GDP)	45.7	48.5	52.6	59.2	62.3	64.4	65.9	70.1	72.2
Of which foreign currency denominated	3.7	3.4	3.8	3.6	3.2	3.5	13.3	5.5	5.8
Of which foreign currency indexed	...	...	...	38.8	35.1	38.7	43.3	46.7	...
Cross-border loans to nonbanks (Q4, percent of GDP)	13.8	14.2	21.0	25.9	34.2	33.9	37.2	34.1	28.4
Private sector credit (end of period, real growth in percent)	13.2	11.5	12.7	20.4	8.8	9.0	–2.4	4.2	3.0
Financial Sector									
Assets (percent of GDP)	87.5	91.8	96.4	103.6	106.5	105.6	111.7	117.7	121.1
ROA (percent)	1.6	1.7	1.6	1.6	1.6	1.7	1.2	1.2	1.2
ROE (percent)	14.1	16.1	15.1	17.4	14.0	12.8	8.8	8.3	8.8
CAR (percent of risk-weighted assets)	16.5	16.0	15.2	14.0	16.3	15.1	16.4	18.8	19.2
NPLs (percent of total loans)	8.9	7.5	6.2	5.2	4.8	4.9	7.7	11.1	12.3
Loan-to-deposit ratio	0.9	1.0	1.0	1.0	1.1	1.1	1.1	1.1	1.1
Cross-border claims by foreign banks (all sectors, percent of GDP)	33.5	33.3	44.6	56.9	71.8	62.3	71.2	65.2	59.3
Financial Markets									
Interest rates (end of period, one-year government bond, percent)	6.0	5.9	4.4	3.9	5.0	8.0	6.1	3.8	5.5
CDS spreads (sovereign, end of period, basis points)	102	35	38	20	66	443	236	258	547
EMBIG spread (sovereign, end of period, basis points)	...	...	...	...	...	...	195	298	663
Exchange rate (end of period, domestic currency/€)	7.6	7.7	7.4	7.4	7.3	7.4	7.3	7.4	7.5
NEER (index, 2003 = 100)	100.0	102.2	102.8	104.1	104.7	107.4	106.7	105.1	103.6
REER (CPI-based, 2003 = 100)	100.0	101.9	103.4	105.6	106.3	111.2	112.3	109.6	107.2
REER (ULC-based, 2003 = 100)	...	...	...	...	...	...	...	...	...
Memorandum Items									
GDP (nominal, in billions of domestic currency)	229	247	267	291	318	345	335	335	341
GDP (nominal, in billions of €)	30.2	33.0	36.0	39.7	43.3	47.5	45.5	45.8	48.1

Source: IMF staff.

Note: CAR = capital adequacy ratio; CDS = credit default swap; CPI = consumer price index; EMBIG = Emerging Markets Bond Index Global; FDI = foreign direct investment; GIR = gross international reserves; NEER = nominal effective exchange rate; NPLs = nonperforming loans; REER = real effective exchange rate; ROA = return on assets; ROE = return on equity; ULC = unit labor cost.

[1] Financial and capital account balances excluding EU balance-of-payments support, use of IMF resources, and SDR allocations.

CHAPTER 22

Albania: Building Resilience Just in Time

Albania experienced two crises in little more than a decade that could not have panned out more differently: collapsing pyramid schemes in 1997 triggered widespread chaos and economic decline, but Albania was among the very few European economies that escaped the 2008/09 crisis largely unscathed. These divergent experiences are not a matter of chance, but the result of more than a decade of sound macroeconomic policymaking and structural reforms following the 1997 crisis. These actions built up considerable policy buffers that Albania could draw on to mitigate the fallout from the global crisis. However, three years on, policy space is heavily depleted. Repairing public finances is the foremost challenge, while maintaining financial stability and accelerating structural reform are also critical.

BACKGROUND

Since emerging from one of the harshest communist regimes and self-imposed isolation in 1991, Albania has come a long way in transitioning to a market economy and securing macroeconomic stability. In 2008 it attained middle-income country status, although it remains one of the poorest countries in the region.

The first years after the collapse of the communist regime in 1990 were hard, even by regional standards. Old and inefficient state enterprises shut down, GDP contracted by one-third, inflation spiraled to three-digit levels, the current account deficit surged to 40 percent of GDP, and foreign reserves ran out. Under successive IMF programs, Albania eliminated price controls, liberalized trade and exchange systems, and engaged in massive privatization of small and medium-sized enterprises. The ensuing rebound in 1993–95 was exceptional, with GDP growing by an average of 9 percent, inflation falling to single digits, and the current account deficit narrowing to 6.5 percent of GDP.

However, the rebound gave way to overheating as unregulated investment schemes (pyramids) pushed the economy into overdrive. These schemes reached the end of the line in 1997 after having amassed liabilities equivalent to 50 percent of GDP. Their collapse, compounded by an earlier disputed election, triggered large-scale social unrest, and the government's authority crumbled. With the country teetering on the brink of anarchy, GDP fell by 10 percent, inflation surged to 42 percent, and the lek depreciated by 40 percent, as critical remittances from the many Albanians working abroad dried up.

The main authors of this chapter are Gerwin Bell, Chuling Chen, and Linda Spahia.

The 1996–97 crisis ushered in a decade of policies that placed priority on achieving and maintaining macroeconomic stability, again supported by successive programs with the IMF, from May 1998 to January 2009. The central bank proved extraordinarily successful in bringing inflation down to its target range of 3±1 percent, and during the ensuing decade growth averaged 7 percent. Reviving remittances added further to the significant improvement of social conditions.

THE RUN-UP TO THE GLOBAL FINANCIAL CRISIS

During the seven years leading up to the global financial crisis, Albania's economy grew at an average annual rate of 6 percent—slightly below the pace of emerging Europe as a whole. As was the case elsewhere in the region, in the years prior to the crisis credit was made amply available to the private sector: annual average real growth of 45 percent took the credit-to-GDP ratio from 8 percent in 2003 to 35 percent in 2008. However, unlike in many other countries the credit expansion was mainly financed by domestic deposits rather than by loans from foreign parent banks, and the loan-to-deposit ratio stayed well below 100 percent throughout.

It should also be mentioned that the initial depth of the financial system in Albania was lower than anywhere else in the region. Arguably, the lion's share of credit growth reflected genuine financial deepening rather than a credit bubble. That said, the authorities rightly grew increasingly concerned as the credit boom unfolded. Under the Banking Act of 2006 they implemented a number of macroprudential measures to dampen credit growth and bolster banks' buffers (Box 22.1). Credit indeed started to decelerate. At the eve of the global financial crisis, standard indicators of banks' financial soundness looked strong by regional standards.

By 2007–08, the economy showed signs of overheating. Inflation drifted upward although it rarely exceeded the upper limit of the target band at 4 percent, as the central bank tightened monetary policy and the exchange rate held stable against the euro. Instead, the current account became the primary vent for excess demand. The deficit ratio turned double digit in these two years, compared to 4–6 percent of GDP in the earlier years—a level that was largely financeable by non-debt-creating inflows. While imports grew strongly, Albania's exports never really took off. The ratio of goods exports to GDP hovered around just 10 percent. To some extent, the widening of the current account deficit reflected the initiation of large-scale public road projects. However, declining private savings and increasing private investment remained the dominant forces at work. External debt remained low as large-scale recourse to external debt financing of the current account was confined to only a few years.

IMPACT OF THE GLOBAL FINANCIAL CRISIS

Albania's still-limited economic and financial integration with the rest of the world largely insulated its economy from the global financial crisis that reached fever pitch from mid-September 2008. Albania's export dependence was small. Its

BOX 22.1 Albania: A Case Study of Effective Macro-prudential Measures

Using powers under the Banking Act of 2006, the Bank of Albania undertook decisive measures to restrain high credit growth. To improve credit risk management, stricter requirements were placed on individual banks based on their (i) rate of credit growth and (ii) levels of nonperforming loans. For example,

- the Bank of Albania imposed higher capital adequacy ratios (12½–13 percent) on two banks than the minimum of 12 percent;
- non-euro-denominated foreign currency lending was banned;
- the maximum risk weights were raised to 150 percent, and banks were required to slow their credit growth by reducing acceptable levels of customers' debt service-to-income ratios to below 25 percent;
- maintenance of foreign bank exposure was helped by strong moral suasion, and if needed, by suspending dividend distribution; and
- in a few cases, managers of banks were also removed or banks were asked to suspend expansion of branch networks.

The Bank of Albania took a proactive approach to increase awareness of loan quality through open forums, meetings, and official letters. This approach included:

- requiring prudent loan-to-value ratios;
- encouraging tighter internal loan classification rules;
- promoting prudence in foreign currency lending; and
- establishing a credit registry. (In particular: Banks submit daily (i) detailed information on the borrower and terms of all new loans; (ii) information on related persons; and (iii) information on collateral. Banks report quarterly the status and internal classification for each loan. They are required to obtain a credit report from the registry for each new credit. During on-site examinations, Bank of Albania inspectors check the files to assure adherence to this requirement.)

banks, though mostly foreign-owned, were not very dependent on foreign funding, and external debt was relatively low. There was no direct exposure of the financial sector to toxic assets in the west.

Nonetheless, the global financial crisis had serious repercussions for Albania. It was transmitted to the domestic economy through three main channels: a confidence channel, exchange rate pressures, and remittances.

In the wake of news about global financial turmoil and about emergency measures to guarantee deposits in Greece, confidence in Albania's banking system fell. Depositors, possibly still burned by experiences with Albania's earlier financial crises, were quick to withdraw, and Albanian banks saw some 10 percent of their deposit base evaporate. It would take until the second half of 2009 for deposits to recover (Figure 22.1).

In early 2009, when the global financial crisis showed little sign of abating, pressures on the lek mounted and it depreciated by almost 10 percent against the euro. These pressures reflected the financing needs associated with the large current account deficit that would come in at 13½ percent of GDP in 2009, only a marginal improvement over the record deficit in 2008. Nonetheless, these

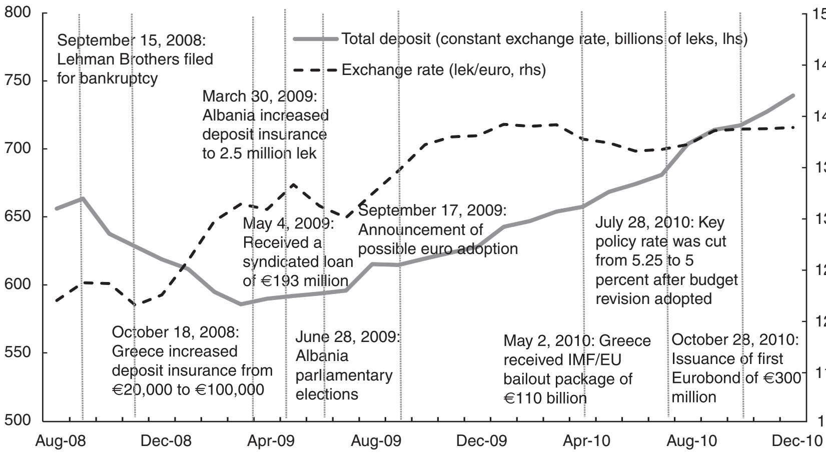

Figure 22.1 Albania: Deposits and Exchange Rate Movements, August 2008–December 2010

Sources: Bank of Albania; and IMF staff calculations.

exchange rate pressures were relatively contained compared to those experienced by many other countries in the region, reflecting Albania's more-limited gross external financing needs.

Finally, remittances are estimated to have fallen drastically. Albanians working in Greece, Italy, and other foreign countries typically remit amounts equivalent to more than 10 percent of GDP back home every year, although precise estimates are difficult to come by. In any event, remittances fell as Albanian expatriates lost their jobs or delayed transfers until it became clearer how the crisis would pan out back home. This would have dampened domestic demand and added to exchange rate pressures.

POLICY RESPONSES

In contrast to the 1997 crisis, the 2008 global crisis found authorities able to draw on policy buffers to counter the impact. They had the policy space to allow expansion of fiscal and monetary policies, as well as to support the banking system without risking undue exchange rate deprecation, inflationary pressures, or financing difficulties. The buffers built up in the banking system were another advantage.

Considerable fiscal stimulus was provided—partly by design and partly by coincidence—and financed to a substantial degree by remaining privatization income. On the revenue side, in addition to the full play given to automatic stabilizers, social security contributions had been cut. On the expenditure side, a large-scale road project was already underway and strong fiscal relaxation occurred prior to the mid-2009 parliamentary election. Overall, the deficit rose to 7½ percent of GDP in 2009—up from 3¼ percent in 2007.

The monetary policy framework—an inflation target range combined with a flexible exchange rate—proved its value during the crisis. Within this framework, monetary policy was loosened by the Bank of Albania, with two interest rate cuts of 50 basis points each in January and October 2009. From late 2008, the Bank of Albania also provided liquidity injections to banks to help them cope with the wave of deposit withdrawals. When the exchange rate came under pressure, the Bank of Albania supported the lek through foreign exchange market interventions, drawing on its considerable foreign exchange reserves. Exchange rate pressure was also eased through the inflows related to privatization proceeds and a syndicated loan.

In addition, and thanks to earlier preventive macro-prudential rules, banks were able to use ample liquidity buffers to meet withdrawals of deposits. Furthermore, their foreign parents increased exposure—also by complying with a temporary ban on distributing dividends. To further boost confidence, deposit insurance limits were quintupled.

ECONOMIC OUTCOMES IN 2009–11

Albania's limited exposure to the global financial crisis, together with its policy strategy before and after the crisis, meant that its economy fared rather well. In fact, GDP expanded by around 3½ percent in both 2009 and 2010, with the 2009 fiscal stimulus handing off to a strong revival of exports in 2010, a weather-related surge in hydroelectric power production, and generally resilient developments in the services sector. The only sector that took a substantial hit in the wake of the crisis was construction, after the large-scale road project came to a close and residential real estate construction rapidly cooled. However, growth slowed in 2011 with the return to more normal rainfalls and the budget's on-and-off efforts at consolidation.

The pass-through from the 2009 lek depreciation was limited, inflation remained mostly within the 3±1 percent target band, and inflation expectations stayed well anchored. By end-2011 inflation had fallen back to below 2 percent, allowing the central bank to reduce policy rates. Confidence in the banking sector has returned and monetization is moving back toward precrisis levels. With the end of the large-scale road project, the fiscal deficit declined to 4.2 percent of GDP in 2010 and further to 3.5 percent in 2011. However, it required significant midyear budget reviews in both 2010 and 2011 to limit the budget deficit and keep public debt below 60 percent of GDP. The associated reduction in domestic demand, together with the increase of exports, helped narrow the current account deficit, but at over 13 percent of GDP in 2011, external imbalances remain elevated.

These macroeconomic outcomes and fiscal consolidation efforts in 2010 opened a window of opportunity for Albania to successfully place its first-ever Eurobond, in the amount of €300 million, in October 2010 with an annual coupon of 7½ percent.

CHALLENGES AHEAD

While successful, the crisis mitigation strategy has left policy space exhausted—it now needs urgent rebuilding.

In particular, public debt has been ratcheted up to close to 60 percent of GDP—the legal limit in Albania. That is also a debt level associated with considerable vulnerability in an emerging economy increasingly subjected to market scrutiny and positioned in a still-fragile regional and global environment. Moreover, some two-thirds of public debt is short term, exposing the government to rollover risk. The government is rightly targeting debt reduction through consolidation, but concrete underpinning measures remain to be fully identified.

The banking sector is recovering only slowly. Slow remonetization and rising nonperforming loans have lowered profitability significantly. Capital ratios are less comfortable than they were before the crisis. Concerns about the health of parent banks, some of them based in Greece, complicate matters further.

Despite the improvement in the current account, the deficit remains large. This challenge should preferably be addressed by boosting Albania's still very low exports rather than reducing imports through a squeeze of private domestic demand. The need to promote exports puts a premium on structural reform, efforts to improve Albania's business climate, and attracting foreign direct investment. Infrastructure bottlenecks, a deeply inefficient electricity sector, and unresolved ownership issues remain major hindrances.

Albania: Principal Economic and Financial Indicators, 2003–11

	2003	2004	2005	2006	2007	2008	2009	2010	2011
					Real Sector Indicators				
GDP (real growth in percent)	5.8	5.7	5.8	5.4	5.9	7.5	3.3	3.5	2.0
Domestic demand (real growth in percent)	6.6	6.5	9.2	0.1	4.8	4.8	2.1	–3.2	2.0
Net exports (real growth contribution in percent)	–2.3	–2.1	–4.2	3.5	–0.4	0.5	0.4	5.2	–0.5
Exports of goods and services (real growth in percent)	9.0	16.3	8.8	13.7	18.9	16.3	1.4	9.7	4.3
CPI (end-of-period change in percent)	3.3	2.2	2.0	2.5	3.1	2.2	3.7	3.4	1.7
Employment (growth in percent)	0.7	0.5	0.1	0.3	0.5	0.9	–0.8	0.7	0.7
Unemployment rate (percent)	15.5	15.0	14.5	13.8	13.5	12.5	13.1	12.5	11.5
					Public Finances				
Fiscal balance (percent of GDP)[1]	–4.6	–5.0	–3.5	–3.3	–3.3	–5.1	–7.4	–4.2	–3.5
Government revenue (percent of GDP)	24.1	24.6	25.1	26.0	26.0	26.7	26.0	25.8	25.3
Government expenditure (percent of GDP)	28.7	29.6	28.5	29.4	29.3	31.8	33.4	30.0	28.8
Government primary expenditure (percent of GDP)	24.4	25.8	25.3	26.5	26.6	29.0	30.2	26.7	25.7
Government primary expenditure (real growth in percent)	–4.2	11.8	3.8	10.4	6.4	16.9	7.9	–8.7	–1.9
Public debt (percent of GDP)	60.7	57.7	58.2	56.7	53.8	55.1	59.8	58.3	58.9
Of which foreign held	...	...	...	...	15.7	18.3	23.7	25.4	25.7
					External Sector				
Current account balance (percent of GDP)	–5.0	–4.0	–6.1	–5.6	–10.4	–15.1	–13.5	–11.6	–13.2
Net capital inflows (percent of GDP)[2]	3.5	5.2	5.2	5.9	8.5	16.6	11.2	12.9	9.8
FDI	3.1	4.4	3.2	3.5	6.0	6.7	7.6	9.2	7.5
Portfolio	–0.4	0.0	–0.1	0.4	0.2	–0.3	0.2	2.6	3.1
Other investment	0.8	0.8	2.1	2.0	2.3	10.2	3.4	1.1	–0.8
Exports (percent of GDP)	20.3	22.0	22.9	25.5	28.2	29.3	28.7	32.1	33.6
Exports (€, growth in percent)	7.2	25.4	15.8	21.9	20.6	17.8	–3.4	14.8	8.8
Global export market share (basis points)	0.6	0.7	0.6	0.6	0.7	0.8	0.8	1.0	...
Remittances (percent of GDP)	13.5	14.1	14.2	13.1	12.2	9.4	9.0	7.8	7.3
Imports (percent of GDP)	44.8	44.2	47.6	49.9	55.0	55.9	53.2	53.3	56.2
Imports (€, growth in percent)	4.7	14.1	19.8	14.9	20.0	15.1	–5.9	2.7	9.4
External debt (percent of GDP)	24.3	22.8	20.4	25.0	24.8	27.5	33.4	37.0	37.8
Gross international reserves (€ billions)	0.8	1.0	1.2	1.3	1.4	1.7	1.6	1.9	1.6
Gross international reserves (percent of GDP)	17.6	18.6	17.3	19.7	19.7	17.9	19.0	22.9	20.7
Reserve coverage (GIR in percent of short-term debt)	...	...	...	740.1	481.2	277.9	206.5	346.7	331.1

(*continued*)

Albania: Principal Economic and Financial Indicators, 2003–11 (*continued*)

	2003	2004	2005	2006	2007	2008	2009	2010	2011
Monetary Sector									
Broad money (end of period, growth in percent)	8.7	13.5	13.9	16.3	13.7	7.7	6.8	12.5	9.1
Monetary base (end of period, growth in percent)	–2.0	11.2	11.0	9.8	4.9	19.1	4.8	–0.5	2.2
Private sector credit (end of period, percent of GDP)	7.5	9.5	15.2	22.1	29.9	35.1	36.6	37.4	39.1
Of which foreign currency denominated	6.0	7.5	11.1	15.5	21.2	25.1	25.1	25.5	25.8
Of which foreign currency indexed	...	...	...	...	...	...	...	...	...
Cross-border loans to nonbanks (Q4, percent of GDP)	1.5	1.6	7.4	1.5	1.5	5.0	7.9	5.9	6.0
Private sector credit (end of period, real growth in percent)	27.1	34.0	70.5	53.6	44.0	29.4	6.3	6.5	8.6
Financial Sector									
Assets (percent of GDP)	52.5	55.2	59.3	69.3	75.0	75.2	76.0	79.7	86.3
ROA (percent)	1.2	1.3	1.4	1.4	1.6	0.9	0.4	0.7	0.1
ROE (percent)	19.5	21.1	22.2	20.2	20.7	11.4	4.6	7.6	0.8
CAR (percent of risk-weighted assets)	28.5	21.6	18.6	18.1	17.1	17.2	16.2	15.4	15.6
NPLs (percent of total loans)	4.6	4.2	2.3	3.1	3.4	6.6	10.5	14.0	18.8
Loan-to-deposit ratio	0.2	0.3	0.4	0.5	0.6	0.6	0.7	0.6	0.6
Cross-border claims by foreign banks (all sectors, percent of GDP)	2.5	2.6	13.0	2.8	5.9	7.5	11.2	9.7	10.7
Financial Markets									
Interest rates (end of period, one-year government bond, percent)	9.6	8.1	6.8	7.7	8.3	8.6	9.1	7.1	6.9
CDS spreads (sovereign, end of period, basis points)	...	...	...	...	...	...	...	...	...
EMBIG spread (sovereign, end of period, basis points)	...	...	...	...	...	...	...	...	...
Exchange rate (end of period, domestic currency/€)	133.8	125.9	122.4	123.6	121.6	123.5	138.0	138.8	139.1
NEER (index, 2003 = 100)	100.0	108.7	111.3	112.7	112.5	114.1	106.7	101.5	100.5
REER (CPI-based, 2003 = 100)	100.0	108.0	110.0	110.6	110.5	111.1	105.2	100.3	99.4
REER (ULC-based, 2003 = 100)	...	...	...	...	...	...	...	...	...
Memorandum Items									
GDP (nominal, in billions of domestic currency)	694	751	815	882	968	1,089	1,151	1,237	1,306
GDP (nominal, in billions of €)	5.1	5.9	6.5	7.2	7.8	8.8	8.7	9.0	9.7

Source: IMF staff.

Note: CAR = capital adequacy ratio; CDS = credit default swap; CPI = consumer price index; EMBIG = Emerging Markets Bond Index Global; FDI = foreign direct investment; GIR = gross international reserves; NEER = nominal effective exchange rate; NPLs = nonperforming loans; REER = real effective exchange rate; ROA = return on assets; ROE = return on equity; ULC = unit labor cost.

[1] The data may differ from those in other published sources owing to a conversion to *Government Finance Statistics Manual 2001* (GFSM 2001).

[2] Financial and capital account balances excluding EU balance-of-payments support, use of IMF resources, and SDR allocations.

CHAPTER 23

Former Yugoslav Republic of Macedonia: Weathering the Storm Rather Well

Macedonia came through the global economic crisis better than most countries in the region. Precrisis excesses were largely avoided, reflecting limited international financial integration, prudent fiscal policy, and monetary policy that kept inflation low. Banks financed brisk lending growth predominantly from domestic deposits and were comfortably capitalized. Macedonia's main vulnerability was a wide current account deficit in the context of an exchange rate peg. However, foreign direct investment provided most of the financing, international reserve buffers were substantial, and the real exchange rate was not overvalued. Hence, Macedonia experienced only a mild recession in 2009, although the recovery in 2010 was likewise modest. The prospect of accession to the European Union currently provides incentives for furthering the structural reform agenda, which would raise growth over the medium term.

BACKGROUND

As was the case elsewhere in the former Yugoslavia, transition in Macedonia was slowed down by noneconomic factors. Although Macedonia separated from Yugoslavia without violent conflict, it was severely affected by the 1992 international trade embargo against neighboring Serbia and Montenegro, the trade embargo and border blockade by Greece in the dispute over Macedonia's name and national symbols during 1994 and 1995, an influx of refugees during the Kosovo conflict in 1999, and ethnic tension between its Slav majority and its Albanian minority in 2001 that took the country to the brink of civil war.

On the economic front, it took until the mid-1990s to establish macroeconomic stability. The authorities adopted a de facto peg to the Deutsche Mark/euro in 1994 and started controlling monetary expansion. The system of soft budget constrains was also ended, tightening fiscal policy. As a result, inflation declined into the single digits and growth turned positive in 1996.

Key structural reforms were implemented in the second half of the 1990s. A majority of state-owned and socially-owned enterprises were privatized, various labor market restrictions were abolished, and trade barriers were dismantled. Nonetheless, Macedonia's industrial sector had a hard time coping with the disruptions of its traditional trade linkages and the intermittent blockage of transportation routes vital to the landlocked country. In the financial sector, it took until 2000 to privatize the two largest banks. Credit penetration of the economy was very low,

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not least as a result of the high interest margins of a banking system recouping the losses incurred in the era of macroeconomic instability. Moreover, the private sector tended to hold large amounts of cash, mostly in the form of foreign exchange, outside the banking system. More recently, a conversion of holdings into local currency has contributed to large private current transfers in the balance of payments.

Throughout its transition, Macedonia engaged with the IMF (as well as the World Bank and the European Bank for Reconstruction and Development) through various facilities, which helped stabilize the economy and promote structural reforms.

THE RUN-UP TO THE GLOBAL FINANCIAL CRISIS

Between 2003 and 2008, GDP growth averaged some 4½ percent as Macedonia reaped the fruits of macroeconomic stability and earlier restructuring. Brisk credit growth of some 20 percent annually in real terms helped underpin the economic expansion. However, it largely avoided overheating and any buildup of large vulnerabilities.

Inflation stayed low under the exchange rate peg and in the face of Macedonia's chronically high unemployment. This also meant that a loss of competitiveness through real exchange rate appreciation did not take place. The current account was in deficit throughout the period, but truly large imbalances were recorded only in 2007 and especially in 2008. Moreover, foreign direct investment typically financed the bulk of the deficit. As a result, external debt as a percentage of GDP stayed roughly constant, and the National Bank of the Republic of Macedonia could bolster its reserves.

Banks financed the new credit mostly from domestic deposits and repatriation of their foreign assets rather than from less stable sources, such as wholesale funding or credit lines from foreign banks. The loan-to-deposit ratio thus stayed well below 100 percent. Moreover, credit growth had taken off only in the mid-2000s and from a low base, leaving private credit at a still-low 42 percent of GDP in 2008. The mortgage market was still in its infancy, accounting for a mere 18 percent of banking sector assets at end-2008, and loan-to-value ratios were low. In addition, banks had strong capital buffers. At end-2008, the capital adequacy ratio stood at 16 percent, 14 percentage points of which was tier 1 capital. Great strides had been made over the years in bringing down nonperforming loan ratios.

Public finances were also in good shape leading up to the crisis. Unlike elsewhere in emerging Europe, primary spending growth remained very contained, and it was not out of line with a reasonably conservative estimate of trend GDP growth. The ratio of public debt to GDP fell by half during 2003–08 to reach a modest 21 percent of GDP. Moreover, most debt was long-term and carried low interest rates.

IMPACT OF THE GLOBAL FINANCIAL CRISIS

When the crisis reached its apex in September 2008, Macedonia was well on track to rack up another year of good economic growth, but global developments quickly intruded. Exporters, especially in the metals industries, were among the first to be confronted. Exports would contract by some 20 percent year-over-year in late 2008. Meanwhile, imports continued to increase throughout 2008, helping to swell the current account deficit to 13 percent of GDP. A fall-off in foreign direct investment and a sharp drop in private transfer inflows took hold in late 2008, adding to balance of payments pressures. At the same time, economic sentiment soured and investment took a tumble.

POLICY RESPONSES

The authorities' response was multipronged. The central bank raised its policy interest rate to 9 percent (even as inflation turned negative), increased reserve requirements for foreign exchange deposits, and provided regulatory incentives for banks to hold their foreign assets at the central bank rather than abroad. It intervened in the foreign exchange market to defend the peg, selling 32 percent of its reserves in the process. The government switched from issuing local currency-denominated debt instruments to foreign exchange-linked T-bills, which helped satisfy banks' demand for foreign assets and reduce outflows. In the summer of 2009 it managed to issue a Eurobond, boosting reserves by €175 million. Meanwhile, the government rebalanced the budget twice during the year, curbing expenditures when revenues fell short of projections, in order to meet its fiscal deficit target of 2.8 percent of GDP.

ECONOMIC OUTCOMES IN 2009–11

These measures, together with a slowing economy and the onset of adjustment in imports, helped reverse the decline in central bank reserves and restore confidence. As confidence improved, private transfers rebounded. By late 2009, reserves had largely recouped their earlier losses, allowing the central bank to embark on a cycle of interest rate cuts. Despite the successful defense of macroeconomic stability, the economy took a hit, contracting 0.9 percent in 2009. While this was a good performance relative to its regional peers, the recession still hit hard in a country with an official unemployment rate of over 32 percent and widespread poverty. In 2010, growth resumed at a below-potential pace of 1.8 percent. As Macedonia's trading partners recovered, and supported by lower interest rates and ample liquidity in the banking system, growth strengthened to 3 percent in 2011.

A financial crisis was avoided, and the exchange rate peg was preserved. The banking system held up well, benefiting from its limited reliance on foreign financing and large capital buffers. While nonperforming loans rose from 6.8 percent to peak at 10.4 percent of total loans in the third quarter of 2010, banks were able to provision against these potential losses from operating income, preserving capital ratios at over 16 percent on average. Meanwhile, the current account deficit fell to 2.2 percent of GDP in 2010 and 2.8 percent of GDP in 2011. It is predominantly financed by foreign direct investment.

CHALLENGES AHEAD

With recovery well underway by 2010, downside risks came from the potential for the euro area crisis to spill over to Macedonia. To mitigate this risk, Macedonia requested from the IMF a two-year Precautionary Credit Line (PCL) in the amount of SDR 413 million (some €475 million), which was approved in January 2011 (IMF, 2011a). The PCL was designed for IMF members that had sound policies and fundamentals but faced remaining vulnerabilities, thereby providing insurance against the possibility of an unexpected change in financing circumstances.[1] In the event, Macedonia drew upon the PCL in March 2011 when unexpected early elections clouded the prospects for a planned Eurobond issue. The first program review was completed in September 2011.

Over the longer term, the exchange rate peg and the banking system's high degree of euroization call for extra caution in macroeconomic and financial policies. This includes preserving low fiscal deficits and public debt to minimize the risk of financing pressures and provide policy with room for maneuver in the event of future shocks. The government should avoid excessive reliance on external sovereign debt markets for fiscal financing by reducing fiscal deficits as growth resumes and gradually developing domestic financing alternatives as financial deepening takes hold. It will be important to maintain strong buffers in the form of international reserves and ample banking system capital and liquidity. Over the longer term, the envisaged EU accession and eventual euro adoption would offer an opportunity to reduce macroeconomic and financial risks.

In the area of structural reform, the key challenge will be to reduce unemployment, raise labor force participation, and increase growth rates. This will take time and will require sustained investment in education and infrastructure as well as continued improvements in the business climate to boost private investment. With its relatively low GDP per capita, low wage rates, and a track record of macroeconomic stability, Macedonia has the potential for rapid growth and improved living standards in the years ahead.

[1] The IMF replaced the PCL instrument with the Precautionary and Liquidity Line (PLL) instrument in November 2011.

Macedonia: Principal Economic and Financial Indicators, 2003–11	2003	2004	2005	2006	2007	2008	2009	2010	2011
Real Sector Indicators									
GDP (real growth in percent)	2.8	4.6	4.4	5.0	6.1	5.0	–0.9	1.8	3.0
Domestic demand (real growth in percent)	–3.2	7.2	3.1	6.7	9.2	6.7	–3.3	–0.1	5.7
Net exports (real growth contribution in percent)	6.6	–4.1	0.6	–3.0	–4.9	–3.7	3.5	2.5	–4.2
Exports of goods and services (real growth in percent)	–5.9	13.1	11.0	8.3	12.0	–7.0	–16.0	24.1	10.5
CPI (end-of-period change in percent)	2.7	–2.2	1.6	3.1	6.7	4.1	–1.6	3.0	2.8
Employment (growth in percent)	–2.9	–4.1	4.4	4.4	3.5	3.2	3.4	1.3	1.1
Unemployment rate (percent)	36.7	37.2	37.3	36.0	34.9	33.8	32.2	32.1	31.4
Public Finances									
Fiscal balance (percent of GDP)	–0.1	0.4	0.2	–0.5	0.6	–0.9	–2.7	–2.5	–2.6
Government revenue (percent of GDP)	37.4	35.5	34.2	32.0	32.2	32.5	30.5	30.2	29.6
Government expenditure (percent of GDP)	37.4	35.2	34.0	32.5	31.6	33.4	33.2	32.7	32.1
Government primary expenditure (percent of GDP)	36.4	34.3	33.1	31.5	30.8	32.8	32.6	32.0	31.3
Government primary expenditure (real growth in percent)	–4.2	–1.4	0.7	0.0	3.8	11.6	–1.5	–0.1	1.0
Public debt (percent of GDP)	37.9	35.6	39.5	32.0	24.0	20.6	23.8	24.8	28.1
Of which foreign held	26.9	25.0	25.2	21.4	16.1	12.9	16.2	16.1	...
External Sector									
Current account balance (percent of GDP)	–4.0	–8.1	–2.5	–0.4	–7.1	–12.8	–6.8	–2.2	–2.8
Net capital inflows (percent of GDP)[1]	5.9	8.5	9.6	6.2	10.3	12.2	6.2	3.3	6.8
FDI	2.5	5.8	1.6	6.5	8.6	6.1	2.0	3.2	3.9
Portfolio	0.1	0.2	4.0	1.4	1.9	–0.7	1.6	–0.9	–0.6
Other investment	3.3	2.4	4.1	–1.6	–0.2	6.8	2.7	1.0	3.4
Exports (percent of GDP)	36.5	38.5	42.8	45.8	51.5	50.4	38.0	46.1	54.4
Exports (€, growth in percent)	6.8	11.0	20.5	16.2	28.3	10.3	–24.7	25.0	26.8
Global export market share (basis points)	1.8	1.8	2.0	1.5	2.4	2.5	2.2	2.2	...
Remittances (percent of GDP)	13.2	12.9	16.6	17.6	16.6	13.9	16.4	19.2	19.4
Imports (percent of GDP)	54.6	60.1	61.2	64.6	70.8	76.5	61.1	66.7	76.1
Imports (€, growth in percent)	–0.5	16.0	10.4	14.6	25.0	21.7	–20.3	12.5	22.7
External debt (percent of GDP)	48.6	50.5	50.0	50.4	50.7	45.5	59.1	59.6	63.5
Gross international reserves (€ billions)	0.7	0.7	1.1	1.3	1.4	1.4	1.4	1.6	2.0
Gross international reserves (percent of GDP)	18.9	16.6	20.7	26.8	25.6	19.5	22.1	23.4	25.6
Reserve coverage (GIR in percent of short-term debt)	104.8	99.7	77.0	100.0	115.7	111.3	106.3	109.0	140.7

(*continued*)

Macedonia: Principal Economic and Financial Indicators, 2003–11 (*continued*)

	2003	2004	2005	2006	2007	2008	2009	2010	2011
Monetary Sector									
Broad money (end of period, growth in percent)	17.3	16.5	15.0	25.0	29.3	11.2	6.0	12.2	9.7
Monetary base (end of period, growth in percent)	0.6	1.5	25.1	19.9	21.9	15.8	8.0	3.9	9.2
Private sector credit (end of period, percent of GDP)	18.3	21.5	24.0	29.0	35.3	42.1	43.5	45.2	46.3
Of which foreign currency denominated	2.9	4.3	6.2	7.9	8.8	9.7	9.9	11.7	13.1
Of which foreign currency indexed	4.0	4.4	5.8	8.0	10.7	14.5	15.7	14.9	14.3
Cross-border loans to nonbanks (Q4, percent of GDP)	1.4	1.9	1.9	1.9	3.1	4.8	5.5	5.2	6.7
Private sector credit (end of period, real growth in percent)	6.6	27.0	19.1	26.9	30.4	29.0	4.9	4.3	5.5
Financial Sector									
Assets (percent of GDP)	38.2	42.4	46.5	53.5	60.7	60.6	65.5	71.6	73.4
ROA (percent)	0.5	0.5	1.2	1.8	1.8	1.4	0.6	0.8	0.4
ROE (percent)	2.3	3.1	7.5	12.3	15.0	12.5	5.6	7.3	3.4
CAR (percent of risk-weighted assets)	25.8	23.0	21.3	18.3	17.0	16.2	16.4	16.1	16.8
NPLs (percent of total loans)	22.4	17.0	15.0	11.2	7.5	6.7	8.9	9.0	9.5
Loan-to-deposit ratio	0.6	0.7	0.7	0.7	0.8	0.9	0.9	0.9	0.9
Cross-border claims by foreign banks (all sectors, percent of GDP)	3.1	3.0	3.0	3.0	4.9	6.2	7.8	11.6	14.3
Financial Markets									
Interest rates (end of period, one-year government bond, percent)[2]	6.2	10.0	8.5	5.7	4.8	7.0	8.5	4.0	4.0
CDS spreads (sovereign, end of period, basis points)	...	...	...	...	...	...	...	...	...
EMBIG spread (sovereign, end of period, basis points)	...	...	...	...	...	...	...	...	...
Exchange rate (end of period, domestic currency/€)	61.3	61.3	61.2	61.2	61.2	61.4	61.2	61.5	61.5
NEER (index, 2003 = 100)	100.0	102.6	103.6	103.7	104.5	105.6	107.6	105.9	107.4
REER (CPI-based, 2003 = 100)	100.0	98.6	95.3	95.2	95.2	98.2	98.1	95.6	97.4
REER (ULC-based, 2003 = 100)	100.0	90.9	84.1	82.7	70.6	66.1	...	...	...
Memorandum Items									
GDP (nominal, in billions of domestic currency)	258	272	295	320	365	412	411	425	450
GDP (nominal, in billions of €)	4.2	4.4	4.8	5.2	6.0	6.7	6.7	6.9	7.8

Source: IMF staff.

Note: CAR = capital adequacy ratio; CDS = credit default swap; CPI = consumer price index; EMBIG = Emerging Markets Bond Index Global; FDI = foreign direct investment; GIR = gross international reserves; NEER = nominal effective exchange rate; NPLs = nonperforming loans; REER = real effective exchange rate; ROA = return on assets; ROE = return on equity; ULC = unit labor cost.

[1] Financial and capital account balances excluding EU balance-of-payments support, use of IMF resources, and SDR allocations.

[2] Refers to the yield on the 28-day bill issued by the Macedonian Central Bank. The domestic government bond market is still in an early stage of development, and the current three- and six-months maturities price off the central bank rate.

CHAPTER 24

Montenegro: Riding the Capital Flow Roller Coaster

In its brief history since independence in 2006, Montenegro has been buffeted by strong, and sequentially opposing, external shocks. The postindependence boom, on the back of bold reforms and lofty assessments of the economy's potential, lacked a broad base, and it aggravated underlying vulnerabilities with unparalleled credit growth and external imbalances. That left this small country of 600,000 fully exposed to the sharp deterioration of the global environment in the fall of 2008. Mitigating domestic policies were largely unavailable in the face of full euroization and depleted buffers in both public finances and the banking system. The economic contraction in 2009 was sharp and on the same order of magnitude as for emerging Europe on average. The legacy of the boom years and an unfinished structural reform agenda make for a weak recovery.

BACKGROUND

In the final years of the last century, and on the heels of the increasing international isolation of what was then Serbia and Montenegro, Montenegro experienced a dramatic reduction in economic activity: a drop in the standard of living, the evaporation of financial wealth through hyperinflation, large-scale degradation of physical and human capital, loss of traditional markets, and expansion of the underground economy accompanied by a rise in crime and corruption. In 1998, Montenegro started distancing itself from beleaguered Serbia with a bold reform program, focused on economic stabilization through the unilateral adoption of the Deutsche Mark, and later the euro, and through significant fiscal adjustment (Fabris and others, 2004). Structural reform and privatization were also set in motion. International integration was pursued as a political priority, culminating in declaration of independence in June 2006 (Vukotic, 2004).

THE RUN-UP TO THE GLOBAL FINANCIAL CRISIS

Because of its considerable potential, which had largely lain dormant in the Yugoslav years, Montenegro quickly found itself in the crosshairs of international investors searching for yield. The shift toward a market-based economy, capital account liberalization, and large-scale privatization encouraged massive capital inflows, especially in real estate, tourism, and financial services. The inflows led to rapid economic gains—the country became the world's fastest-growing

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The main author of this chapter is Gerwin Bell.

international tourist destination in 2007—but overall these gains were not absorbed in a sustainable fashion.

Given the magnitude of the inflows, Montenegro's small size, and its economic openness, macroeconomic policy anchors would have had a difficult time in avoiding overheating under the best of circumstances. Making matters worse, domestic policy levers were either not available or insufficiently deployed by the authorities.

Through much of the boom, monetary policy in the euro area had been overly loose for Montenegro's cyclical position. Lacking an independent monetary policy, the Central Bank of Montenegro could only affect credit conditions by raising reserve requirements or mandating tighter supervisory and prudential standards, thus effectively raising the cost of credit. While the Central Bank of Montenegro undertook these measures, credit growth on aggregate was hardly dented.

This placed the burden of cooling the economy on fiscal policy; however, it was not tightened enough. While surpluses were initially built up, to a large extent they reflected unsustainable tax collections resulting from temporarily high imports (Gagales, 2008). And in any event, accumulated surpluses were placed in the domestic banking system rather than invested abroad, thereby facilitating further procyclical credit extension. Moreover, toward the end of the boom period, buoyant revenues were increasingly used to fund permanent fiscal relaxation, such as tax cuts and public sector wage increases of 30 percent in early 2008. The fiscal stance thus became outright expansionary, further boosting demand.

On the structural side, reforms did occur, but some of them took too long to bear fruit in time. Significant employment protection and a centralized collective bargaining system with little firm-level flexibility did their part in keeping wage growth and the unemployment rate high, thereby limiting the supply-side response of the corporate sector.[1] A new labor law, passed in mid-2008, reduced some of the rigidities but still contained substantial employment protection, discouraging job creation and longer-term employment contracts. The otherwise successful privatization program also occurred late compared to the rest of emerging Europe. This limited the interest of the more-experienced multinational companies that had already invested elsewhere. The large industrial sector legacy enterprises, in particular, were sold to investors that were themselves headquartered in emerging markets and would experience a loss of financing when the global crisis escalated.

Accordingly, imbalances built rapidly, largely led by soaring consumption—the share of investment in GDP remained at average levels despite very large foreign investment. The decline in savings was facilitated by wealth effects from booming real estate and other asset prices and extremely rapid credit growth, which topped 100 percent annually in 2006 and 2007. A gaping hole emerged in the current account, which hit a deficit of a stunning 50 percent

[1] Reflecting these rigidities, the tourism industry's seasonal surges in labor demand were typically met by large inflows of foreign workers despite high unemployment.

of GDP in 2008 and was increasingly debt financed. Excessive wage growth—following the public sector pay increase it peaked at 25 percent in August 2008—and the pickup of inflation to 9 percent in 2008 were further evidence of acute overheating.

IMPACT OF THE GLOBAL FINANCIAL CRISIS

With these large imbalances and dependence on continued capital inflows, Montenegro was highly exposed to the global financial dislocations that unfolded in the fall of 2008. They were transmitted to the domestic economy through three principal channels:

- *A drastic and severe credit crunch on the heels of contagion and concerns about the robustness of the banking system* (Figure 24.1). The initial driving force was massive and broad-based deposit withdrawals, much larger and more persistent than in neighboring countries, that drained liquidity and tested the resilience of the banking system. Important foreign parent banks were also severely stressed, and one (Hypo Alpe Adria) was even nationalized by its home authorities. The owners of domestic banks were often unable to provide sufficient funding to address liquidity and solvency needs. New credit dried up, and banks shrank their loan portfolios for lack of financing and mounting nonperforming loans.
- *Depressed external and domestic demand with strong negative effects on economic activity*. Weaker interest by foreign investors in real estate in Montenegro and negative wealth effects—dropping asset prices, weaker balance sheets, and reassessment of growth prospects—triggered a sharp decline in construction activity. Tourism was also affected as the global fallout of the crisis led to a decline in overnight visits.
- *Large negative terms-of-trade shocks*. Tumbling international commodity prices undermined the viability of much of the metals-focused industrial sector, such as the large aluminum complex and the steel mill. The drop of the aluminum price below the company's break-even level prompted severe production cuts and a buildup of arrears and nonperforming loans.

POLICY RESPONSES

Initial plans for fiscal stimulus were abandoned. In the fall of 2008, a stimulus package was launched, consisting of bank support and increased public investment, but as the full extent of the global crisis became evident and revenues plummeted, the government reversed course in order to contain budget financing requirements. A midyear revision of the state budget and similar adjustments at the local level ordered large cuts in capital expenditure, goods and services outlays, and the wage bill, all of which were extended into 2010. However, these efforts were met by implementation difficulties, triggering widespread arrears accumulation. Including those, the 2009 deficit came to 6½ percent of GDP,

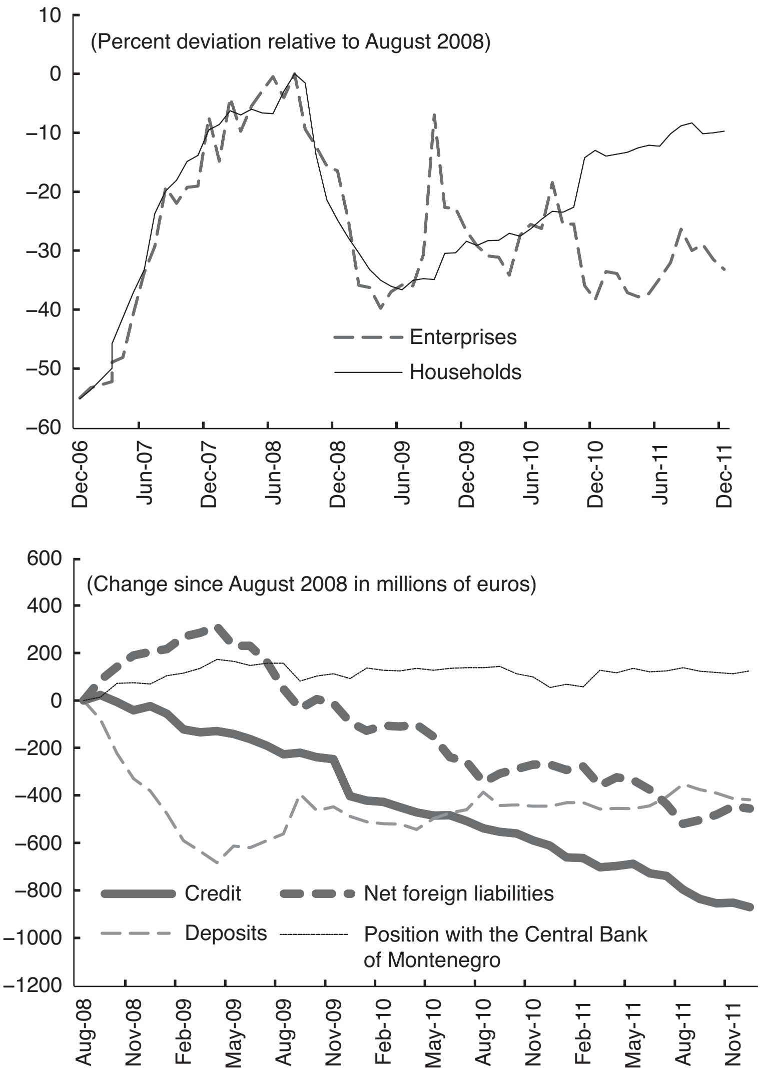

Figure 24.1 Montenegro: Development of Bank Deposits and Other Balance Sheet Items

Sources: Central Bank of Montenegro; and IMF staff calculations.

a level at which it has hovered since, partly also driven by the financing of new subsidies and transfers benefiting the industrial sector.[2] In addition, the government assumed some state enterprise debt and extended significant loan

[2] While there is a considerable range of uncertainty surrounding the calculation of structural fiscal balances in Montenegro (Kapsoli, 2010), this deterioration is nevertheless consistent with some fiscal consolidation from 2008.

guarantees to the aluminum and steel plants in order to advance their restructuring and to provide critical working capital. As a result, public and publicly guaranteed debt leapt to some 55 percent of GDP (from 27 percent in 2007).

Despite early, strong, and proactive measures, restoring health to the banking sector proved challenging. Starting in the fall of 2008, the following actions were taken:

- The government guaranteed all bank private deposits and, on a case-by-case basis, interbank lending until end-2009—a contingent liability of 48 percent of GDP. It used its deposits outside domestic commercial banks for early repayment of bank loans, and it offered to provide banks with loans for up to one year against collateral of shares of at least equal nominal value, to help boost liquidity. In this context, a collateralized loan of €44 million was provided to the largest domestic bank in December 2008.
- Moreover, the government pledged up to €100 million for bank recapitalization on a case-by-case basis at the request of banks or, in the case of systemically important banks, at the central bank's request. Loan guarantees to the industrial sector also helped mobilize inflows, while large parts of the 2009 proceeds from the privatization of the electricity company and of the fall 2010 Eurobond proceeds, which were not needed for budget financing, were placed with the banking system.
- The Central Bank of Montenegro for its part created a small short-term liquidity support facility, enabling solvent banks to borrow against prime collateral for up to 30 days, renewable up to three times. It also allowed banks to borrow up to 50 percent of their required reserves for periods not exceeding seven days in each month and cut required reserves to 10 percent.
- The Central Bank of Montenegro also engaged in countercyclical regulation, bringing previously more-demanding loan classification requirements back in line with international standards. In a large domestic bank, where the problems were diagnosed to run deeper, the central bank prohibited new lending, demanded the installation of new management, and commissioned an independent external audit.

These measures helped slow deposit withdrawals. In addition, all foreign parent banks supported their subsidiaries with additional funding, thus helping to partially offset the decline in deposits. They also met central bank requests for large recapitalizations to restore solvency. The domestically owned banking sector had a harder time, and central bank sanctions remained in place into 2011.

Faced with the potential shutdown of the industrial sector in the face of the new owners' financial difficulties, past privatization contracts were reopened to grant more breathing space and incentives for additional investments in exchange for government loan guarantees. The owners of the aluminum complex also returned a significant part of their shares to the government. Still, the success of this strategy remains uncertain, since financial difficulties and poor labor relations persist, both holding up the needed restructuring.

ECONOMIC OUTCOMES 2009–11

Montenegro's very fast precrisis growth gave way to a severe recession in 2009 and a tepid recovery in 2010–11, reflecting the economy's many vulnerabilities, its exposure to external developments, and the limited room for countervailing policies.

GDP dropped sharply in 2009, by almost 6 percent, with the contraction particularly pronounced in industry, construction, and financial services. In the industrial sector, the situation deteriorated further, with work stoppages adding to already large output losses. The tourism sector, in contrast, proved much more resilient. In 2010–11, the economy returned to positive growth, albeit at a slow rate of only 2½ percent, below the regional average.

Employment declined substantially, although the true extent of the deterioration was masked by special factors. Throughout much of 2009, headline employment and unemployment statistics depicted a strong labor market. However, this masked underemployment (especially in the metals sector), rising part-time employment, and the substitution of domestic for foreign labor. In effective terms, employment is estimated to have dropped by 14 percent on an annual average basis.

Pressure on inflation and wages eased. Inflation quickly fell below the euro area average, and nominal wages moderated and even declined during 2009—especially in sectors most affected by the downturn—helped by the 2008 tax cuts, which mitigated the effect on net wages. Subsequently, net wages also declined in 2010.

Despite severe pressure on the banking system and the absence of a lender-of-last-resort function, a systemic financial sector crisis was avoided. This owes much to the commitment of foreign parent banks to stand by their subsidiaries in Montenegro. In September 2010, Montenegro returned to international capital markets with a well-received Eurobond issue. Another issue followed in April 2011, although spreads have widened significantly since, reflecting both a more-discerning investor attitude toward sovereigns in general and the very rapid and large take-up of external debt in Montenegro as well.

CHALLENGES AHEAD

Montenegro's economic and financial roller-coaster experience since independence underscores its need to build a more robust economy, one that raises income levels in a sustainable and steady fashion over time. Action is needed on several fronts.

The still-fragile recovery must be strengthened and a relapse into recession avoided. In addition, the needed rebalancing of the economy still has some way to go. Anchoring potential growth on a sustainable path calls for a strategy centered on enabling private sector-led growth, a smaller government, and deregulation, which would all serve to improve competitiveness. In this context, it is critical that further structural reforms get under way.

It is also essential to revitalize the financial sector. The crisis has taught that regulations and buffers must exceed those elsewhere. To the extent the problem areas of the past have not been worked out, that needs to happen urgently. The ultimate challenge will be to right-size the banking system without imperiling new credit flow.

With use of the euro, a highly open economy, and free capital movement, there is only so much that macroeconomic management can achieve. Buffers are therefore needed so that shocks do not knock the economy too far off track. The lack of fiscal space, in particular at the onset of the crisis, severely restricted the authorities' room for maneuver in dealing with the challenges. The subsequent rapid and large take-up of external public debt has further eroded essential room for maneuver and raised significant new vulnerabilities. Thus, further fiscal consolidation is urgently needed, and the budget should target significant surpluses for a considerable amount of time in order to build up liquid public assets. This challenge could be even greater if large fiscal contingent claims were triggered, for example if some of the extended loan guarantees were to be called.

Montenegro: Principal Economic and Financial Indicators, 2003–11

	2003	2004	2005	2006	2007	2008	2009	2010	2011
Real Sector Indicators									
GDP (real growth in percent)	2.5	4.4	4.2	8.6	10.7	6.9	–5.7	2.5	2.5
Domestic demand (real growth in percent)	–1.7	2.9	4.3	27.4	24.1	15.5	–16.7	–1.9	–1.1
Net exports (real growth contribution in percent)	5.4	–0.5	–1.0	–23.3	–20.5	–14.2	19.4	4.4	3.5
Exports of goods and services (real growth in percent)	–0.3	50.2	8.1	11.3	12.0	–2.2	–22.7	7.4	16.5
CPI (end-of-period change in percent)	6.2	4.2	1.8	2.0	6.3	7.2	1.7	0.7	2.8
Employment (growth in percent)	...	...	...	...	...	...	...	...	...
Unemployment rate (percent)	...	...	...	...	...	...	...	...	...
Public Finances									
Fiscal balance (percent of GDP)[1]	–2.5	–1.6	–0.8	3.1	6.3	–1.4	–6.5	–4.7	–6.2
Government revenue (percent of GDP)	37.5	37.0	36.6	43.4	47.6	48.3	42.3	41.1	37.7
Government expenditure (percent of GDP)	41.1	39.0	37.5	40.3	41.4	49.8	49.2	46.0	44.2
Government primary expenditure (percent of GDP)	41.6	38.3	37.1	39.3	39.9	47.9	46.8	44.9	42.7
Government primary expenditure (real growth in percent)	18.4	–3.9	0.8	15.3	12.2	28.3	–7.8	–1.6	–2.6
Public debt (percent of GDP)	40.3	45.3	38.6	32.6	27.5	31.9	40.7	42.4	46.9
Of which foreign held	...	...	...	...	...	...	...	...	...
External Sector									
Current account balance (percent of GDP)	–6.7	–7.2	–8.5	–31.3	–39.5	–50.6	–29.6	–24.6	–19.4
Net capital inflows (percent of GDP)[2]	...	2.2	15.5	31.7	44.9	37.7	19.5	12.5	5.2
FDI	...	3.0	21.9	21.8	21.2	18.9	35.8	17.8	11.9
Portfolio	...	0.3	0.3	–0.5	0.2	–0.5	–1.4	–0.4	–0.5
Other investment	...	–1.2	–6.7	10.3	23.6	19.5	–14.8	–4.9	–6.2
Exports (percent of GDP)	30.6	42.0	43.5	41.0	43.1	38.9	32.8	35.6	40.6
Exports (€, growth in percent)	...	51.8	12.6	17.5	31.4	3.9	–18.7	13.0	19.9
Global export market share (basis points)	...	...	0.09	0.31	0.32	0.24	0.17	0.18	...
Remittances (percent of GDP)	...	...	...	...	2.4	2.0	2.1	2.2	3.4
Imports (percent of GDP)	47.0	58.1	61.1	78.2	86.0	93.4	65.4	63.2	64.4
Imports (€, growth in percent)	...	36.7	14.3	57.9	37.2	24.9	–32.3	0.6	7.1
External debt (percent of GDP)	37.9	39.9	43.9	47.5	74.1	90.8	93.5	96.4	99.9
Gross international reserves (€ billions)	0.1	0.1	0.2	0.3	0.5	0.3	0.4	0.4	0.3
Gross international reserves (percent of GDP)	3.7	3.9	9.0	14.4	17.5	10.1	13.3	13.4	9.3
Reserve coverage (GIR in percent of short-term debt)	...	...	...	...	...	...	...	...	...

Montenegro: Principal Economic and Financial Indicators, 2003–11 (*continued*)

	2003	2004	2005	2006	2007	2008	2009	2010	2011
Monetary Sector									
Broad money (end of period, growth in percent)	...	...	...	...	...	...	...	...	...
Monetary base (end of period, growth in percent)	...	...	...	...	...	...	...	...	...
Private sector credit (end of period, percent of GDP)	11.3	14.6	17.9	36.3	80.3	87.4	76.4	66.9	55.5
Of which foreign currency denominated	...	...	...	...	...	...	...	...	...
Of which foreign currency indexed	...	...	...	...	...	...	...	...	...
Cross-border loans to nonbanks (Q4, percent of GDP)	...	...	...	3.9	8.9	12.0	18.4	18.6	20.0
Private sector credit (end of period, real growth in percent)	48.2	37.5	31.1	134.7	159.5	18.1	–17.3	–9.5	–15.4
Financial Sector									
Assets (percent of GDP)	18.4	22.0	30.7	53.6	96.7	98.6	93.4	85.5	77.3
ROA (percent)	...	...	0.9	1.2	0.8	–0.6	–0.6	–2.7	–0.1
ROE (percent)	...	...	4.2	...	10.6	–6.6	–6.9	–27.0	–0.6
CAR (percent of risk-weighted assets)	...	...	27.9	21.3	17.1	15.0	15.8	15.9	16.5
NPLs (percent of total loans)	...	...	5.3	2.9	3.2	7.2	13.5	21.0	15.5
Loan-to-deposit ratio	...	...	...	...	...	...	...	...	...
Cross-border claims by foreign banks (all sectors, percent of GDP)	...	...	...	6.6	26.1	32.8	41.5	38.5	29.7
Financial Markets									
Interest rates (end of period, one-year government bond, percent)	...	...	...	...	...	...	...	...	...
CDS spreads (sovereign, end of period, basis points)	...	...	...	...	...	...	...	...	...
EMBIG spread (sovereign, end of period, basis points)	...	...	...	...	...	...	...	...	...
Exchange rate (end of period, domestic currency/€)	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
NEER (index, 2003 = 100)	100.0	104.3	109.5	110.2	108.3	109.0	115.5	119.1	118.4
REER (CPI-based, 2003 = 100)	100.0	102.2	103.0	99.5	97.2	98.7	105.0	105.1	101.7
REER (ULC-based, 2003 = 100)	...	...	...	...	...	...	...	...	...
Memorandum Items									
GDP (nominal, in billions of domestic currency)	1.5	1.7	1.8	2.1	2.7	3.1	3.0	3.1	3.3
GDP (nominal, in billions of €)	1.5	1.7	1.8	2.1	2.7	3.1	3.0	3.1	3.3

Source: IMF staff.

Note: CAR = capital adequacy ratio; CDS = credit default swap; CPI = consumer price index; EMBIG = Emerging Markets Bond Index Global; FDI = foreign direct investment; GIR = gross international reserves; NEER = nominal effective exchange rate; NPLs = nonperforming loans; REER = real effective exchange rate; ROA = return on assets; ROE = return on equity; ULC = unit labor cost.

[1] The data may differ from those in other published sources owing to conversion to *Government Finance Statistics Manual 2001* (GFSM 2001).

[2] Financial and capital account balances excluding EU balance-of-payments support, use of IMF resources, and SDR allocations.

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PART V

Toward Renewed and Sustainable Growth: A Policy Agenda

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CHAPTER 25

Lessons and Renewed Challenges

This chapter tries to summarize lessons learned from the 2008/09 crisis and the subsequent recovery, not least with a view to ascertaining to what extent corrective policies have fortified emerging Europe's resilience. The region's ability to cope with the pressures from the euro area crisis, which was ongoing at the time of writing, is an early "real live test" in this regard.

Looking further ahead, the chapter wonders what the crisis-induced changes in the global and European economies mean for the process of economic integration and convergence. While the deepening of economic ties will no doubt continue, it argues that the integration process must become safer and that, realistically, it may also be slower than previously expected.

INITIAL POLICY LESSONS FROM THE CRISIS

Four important and interrelated lessons can be distilled from the pronounced boom-bust cycle emerging Europe has experienced in the past decade.

Lesson 1: Strive for More-Balanced Growth

During the boom years, growth in many countries of the region was driven by capital inflows that fueled domestic demand and inflated the nontradable sector. Only a few countries retained a focus on exports. The crisis proved that this growth pattern created a series of vulnerabilities.[1] First, it led to rising current account deficits and the buildup of external debt. Second, the boom caused significant real exchange rate appreciation. As the profitability of the nontradable sector surged, exports became less competitive and less attractive. In many of the countries with large capital inflows, the export-to-GDP ratio stagnated—or even declined. Third, growth became addicted to a continuation of strong capital inflows. During the crisis, the mere slowdown of foreign financing was enough to disrupt credit and with it demand in the nontradable sector, which had become the sole engine of growth.

Cross-country differences demonstrate the benefits of seeking more balanced growth. In contrast to most, a few central European countries (notably the Czech Republic, the Slovak Republic, and Poland) had preserved a balanced and trade-oriented growth pattern, which provided a cushion during the crisis.

The main authors of this chapter are Bas B. Bakker and Anne-Marie Gulde-Wolf.

[1] Other authors have also pointed to the unsustainability of the precrisis growth model in many parts of emerging Europe. For instance, Anastasakis and Watson (2011, p. 5).

What will it take for all of emerging Europe to follow suit? In the short term, "staying the course" will now be important. Following the crisis, demand remains weak, since only exports have been recovering, and domestic demand is still hampered by consumers reining in spending to pay off debt. But once a more favorable external environment returns, vigilance and effective policy frameworks will be needed to avoid renewed bubbles. To this end, emerging Europe needs to strive for a new growth model, one that relies more on the tradable sector.

Growth models cannot be mandated, yet policies in a number of areas will be able to influence the eventual outcomes.

Adequate macroeconomic policies, notably keeping in check fiscal expenditure growth—in particular, public sector wage growth—can help prevent the overheating that pulls resources from the tradable to the nontradable sector. Preventing overheating is important, because emerging European economies lost manufacturing competitiveness during the boom. For example, according to EU data, Latvia's unit labor costs in manufacturing rose 90 percent relative to those of its trading partners between 2003 and 2008. Some other countries—for example, Bulgaria, Estonia, and Romania—also suffered sharp appreciations of their real exchange rates.

Tighter fiscal policy will help moderate wage growth. While wages, over time, will catch up with those in western Europe, this catch-up should go hand in hand with productivity increases in manufacturing. Only then will wage growth neither impede competitiveness nor discourage investors.

The credit booms revealed the need for better supervisory policies and more effective coordination of home and host supervisors. In the future, more effective supervisory intervention will be needed so that risks associated with credit growth and sectoral loan concentration can be addressed by higher capital and liquidity ratios. Cooperation of home authorities that supervise cross-border banking groups is essential to give such measures teeth. Reducing lending in foreign currency to unhedged households will also be an important measure to safeguard financial stability and avoid real estate bubbles.

Good macroeconomic and regulatory policies need to be supported by structural measures to promote countries' move "up the value chain." In the longer run, emerging Europe should not compete on low wages alone—and will find it increasingly difficult to do so in any case. Other emerging markets have even lower wages and, as workers migrate to western Europe, wages cannot fall below certain thresholds. The region should therefore aim to produce increasingly sophisticated products. A host of structural reforms could help, including reforms in education and training and measures that bolster the investment and business climate; in some nations, more efforts to fight corruption would help as well.

Attracting the right kind of foreign capital inflows—especially those that benefit the trade-oriented sector—can also play an important role. Such investment would support growth and technology transfer and help contribute to an improvement of labor force skills. However, in attracting foreign funds, countries

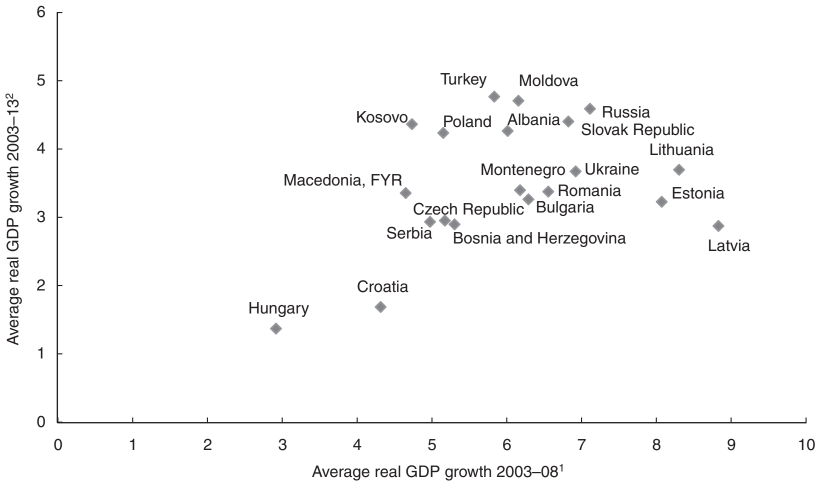

Figure 25.1 Emerging Europe: Average Real GDP Growth (*Percent*)

Sources: IMF, World Economic Outlook database; and IMF staff calculations.
[1] Data for the Baltic countries refer to 2002–07, as their boom ended in 2007.
[2] For 2013, IMF projections.

should steer clear of excessive tax competition and unsustainable subsidies, given negative spillovers and high fiscal costs.

Some countries in the region are already largely following this model. In the Czech and Slovak republics, growth during the boom was much more balanced, credit growth more restrained, and current account deficits small—and exports have been playing an important role. Although growth in those two economies had been more muted than in some of their neighbors before the crisis, their recessions were also much less deep. As a result, over a longer horizon, they have grown faster than countries that had a domestic demand boom (once their higher initial income is controlled for).

Lesson 2: Keep Credit Growth in Check

The crisis in emerging Europe has highlighted the fact that speed matters; in periods of rapid credit growth, credit quality will suffer. During the crisis, countries with the highest credit growth experienced the largest increase in nonperforming loans.[2] In countries with very rapid credit growth, deep recessions during the crisis years were not offset by the benefit of higher growth during the boom phase, often leaving long-term growth lower (Figure 25.1).

[2] Countries with very rapid credit growth experienced a much deeper recession than countries where credit growth remained more moderate. Bakker and Gulde (2010) and EBRD (2009) find that the size of the precrisis credit boom explains the depth of recessions better than any other variable.

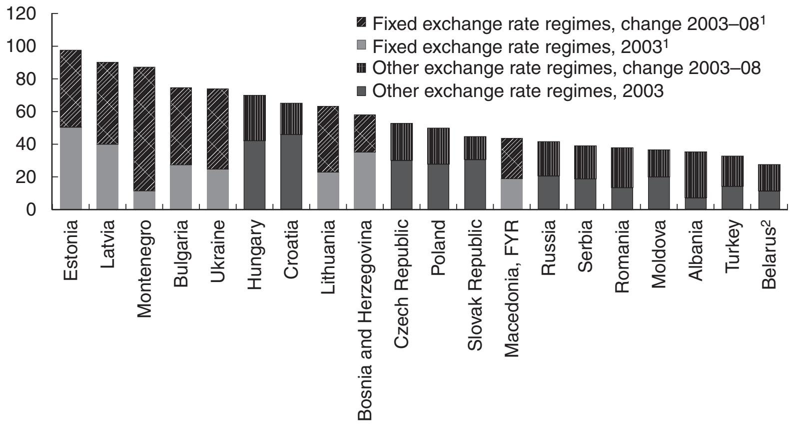

Figure 25.2 Emerging Europe: Private Sector Credit, 2003 and 2008 (*Percent of GDP*)

Sources: IMF, *International Financial Statistics*; IMF, *Annual Report on Exchange Arrangements and Exchange Restrictions* (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.

Building safeguards against excessive credit growth requires a combination of macroeconomic and supervisory measures. The relative emphasis between these policies will have to differ across countries, not least because of different exchange rate regime choices:

- In countries with *fixed exchange rates*, credit booms are hardest to stop, because as the economy heats up and inflation rises, real interest rates decline, further stoking demand. It is striking that the strongest credit growth during the boom years took place in countries with fixed exchange rate regimes (Figure 25.2); the Baltic countries, Bulgaria, Montenegro, and Ukraine all had annual credit growth of at least 10 percent of GDP. However, fixed exchange rates are not the cause of credit booms, since credit growth in the economy is the sum of microeconomic lending decisions. It is noteworthy that there were also some countries with fixed exchange rate regimes that did not experience particularly strong credit booms (Bosnia and Herzegovina and Macedonia). Yet fixed exchange rates do make it harder to stop credit booms driven by large capital inflows.
- 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. Many of the countries that avoided a credit boom (the Czech Republic, Poland, the Slovak Republic) had flexible exchange rate regimes and saw a substantial appreciation of their nominal exchange rates during the boom years.

- Beyond the exchange rate regime, monetary policy often lacks effective control of credit growth. Systems that are dominated by foreign-owned banks are not very responsive to domestic liquidity conditions, as funding can be provided by the foreign parent from abroad.

Another line of defense is the use of prudential measures to control credit expansion—although in practice limiting credit growth in this way has been challenging.[3] A problem with prudential measures is that externally funded credit growth has proven particularly hard to control. Foreign-owned banks can often evade regulatory measures imposed in host countries, 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). Often, these banks are systemically important in the host country, although only a small part of the overall bank group.

Better cooperation between home and host supervisors would likely bring greater success in controlling credit growth through prudential measures. Such cooperation should include adequate mechanisms for effective communication, information sharing, and joint analysis of common and host country concerns, as well as the formulation of effective responses. Taking host country concerns into account, even where the impact on the home country is not a major issue, will need to become a feature of supervisory cooperation if outcomes for both are to improve. The recent advances in integrating national frameworks within the European Union aim to address the challenge of containing the buildup of financial risks, which is particularly complex in countries with an extensive foreign bank presence, but the effectiveness of these advances remains to be tested in practice.

Lesson 3: Discourage Lending in Foreign Currency

In most countries, the credit boom was associated with a surge in foreign currency loans, but the associated risks were underestimated.[4] A number of factors favored the use of foreign currencies. On the demand side, foreign currency borrowing was boosted by the interest rate differential. Foreign currency loans were seemingly cheaper—particularly in credible fixed exchange rate regimes and when the exchange rate risk was ignored. Foreign currency loans were not confined to euro loans; in some countries there was substantial carry trade, and loans were denominated in currencies with even lower interest rates, such as the yen and the Swiss franc. On the supply side, foreign currency lending conveniently matched

[3] Indeed, the effectiveness of the flurry of domestic prudential measures to stem overall credit growth has, at best, been mixed (IMF, 2010b; Enoch and Ötker-Robe, 2007). In emerging Europe, only Albania seems to have had good results from such measures (see Chapter 22).

[4] Unhedged foreign exchange exposure of enterprises was a key contributor to the Asian crisis of the late 1990s. In emerging Europe, it was mainly households that were affected, but the underlying risks should have been known.

banks' funding structure: as local subsidiaries obtained funding from their parent bank in euros, they were keen to on-lend in euros rather than in local currency. While this nominally closed their open foreign exchange positions, it increased credit risk, as borrowers typically lack a natural hedge.

In addition to creating credit risk for banks, foreign currency lending also limited macroeconomic policy space. With a large part of lending denominated in foreign currency, many borrowers would suffer adverse balance sheet effects in case of an exchange rate depreciation. This did not apply only to fixed exchange rate countries. Countries with flexible exchange rate regimes also needed to avoid deep parity changes, given the potential consequences for the financial sector, since many of the foreign currency loans would become nonperforming. Hedging could not eliminate these risks.

Countries where banks' foreign currency lending exceeded their foreign currency funding faced liquidity risks. In Hungary and Poland, banks closed their open foreign currency positions through the swap market. However, when the crisis hit, counterparts for the foreign exchange swaps were difficult to come by, and in Hungary liquidity in the swap market dried up. To avoid a crisis caused by the unavailability of counterparties to roll over maturing foreign currency swaps, the central banks needed to step in and offer a swap window.[5] The large foreign currency exposures thus severely limited the extent to which the exchange rate could be used to respond to the crisis.

In prudential circles, foreign currency risk is generally well understood. Why then did the situation in emerging Europe, in most supervisors' minds, justify a more-relaxed view? The now obvious failure of prudential policies was caused by a combination of factors. With exchange rates either fixed or appreciating as a result of EU convergence, the risk of foreign currency lending was mostly perceived as theoretical. In addition, some of the home countries of foreign banks —most notably Austria and, to some extent, Italy—had their own tradition of foreign currency lending, making it natural to bring the practice to new markets. As a result, only a few countries were serious about limiting foreign currency risks and successful in doing so. Interestingly, and probably reflecting the strength of the "convergence play," those that were successful in this were mostly outside of the European Union.[6]

Lesson 4: Fiscal Policy Needs to Limit Expenditure Growth

Headline fiscal numbers can look very good during boom years—as long as domestic demand booms are fueling fiscal revenues. This often creates the illusion

[5] See Chapter 6 for more details on the developments in the swap market.

[6] For example, Belarus, Moldova, and Turkey effectively restricted household borrowing in foreign currencies through longstanding prudential regulations, while Poland relied on supervisory guidelines to stem such practices.

of fiscal space, at a time when fiscal policy might 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, even where the overall balance showed a fiscal surplus. With booming revenues, the large increases in fiscal spending in the context of fast-growing economies further fueled overheating. Given that most expenditure increases were permanent (such as higher wages and pensions), they also set the stage for large deficits when part of the revenue surge turned out to be temporary. Indeed, countries with better-managed fiscal positions fared better during the crisis. They generally had higher foreign reserves as well as larger fiscal buffers. But most countries lacked foresight, and many needed to undergo significant fiscal adjustment, some in the context of external support programs.

A fiscal policy more oriented to the long term could play an active and key stabilizing role—saving money when revenues are growing instead of increasing spending and boosting public wages.[7] This may mean that during boom times, small fiscal surpluses are not sufficient—that large surpluses are needed. In a political economy context, this is a difficult undertaking. It would require adhering to the overall objective of medium- and long-term fiscal sustainability while limiting short-term spending pressures even for otherwise worthy causes. Policymakers may prefer to spend in boom times, but the payoff from a longer-term-oriented spending policy is that fiscal buffers can be accumulated, which reduces the more politically damaging need to cut expenditure sharply during a recession, as several countries had to do during this crisis.

HAS EMERGING EUROPE MADE PROGRESS TOWARD REDUCING VULNERABILITIES?

Earlier developments had contributed to the buildup of large stock vulnerabilities in the form of domestic and foreign currency debt of households and governments. Do those continue to pose a threat? Are upgraded frameworks, notably in the prudential and fiscal areas, sufficient to prevent the re-emergence of vulnerabilities?

Many Vulnerabilities Are Now Lower . . .

Many of the imbalances that characterized much of emerging Europe prior to the crisis have indeed largely disappeared.

[7] Anastasakis and Watson (2011, p. 8) argue that economic policies, and fiscal policy in particular, need to be more risk averse, given that “convergence with open capital accounts has proved a riskier business than expected.”

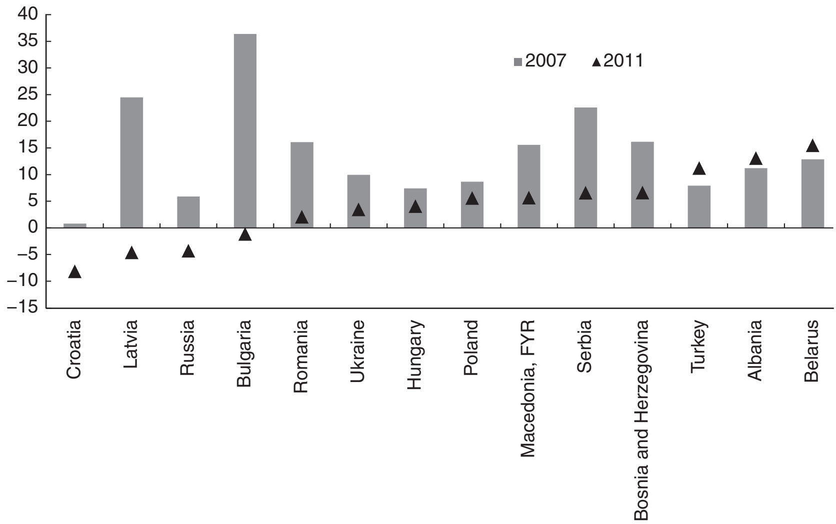

Figure 25.3 Emerging Europe: Net Private Capital Inflows, 2007 and 2011 (*Percent of GDP*)

Sources: National authorities; and IMF staff estimates.

Current Account Deficits in Most of Emerging Europe Have Come Down

In 2007, the last full year before the crisis, capital inflows averaged (unweighted) 15.2 percent of GDP (Figure 25.3)—with a few countries receiving far higher inflows. By 2011, current account imbalances had largely corrected (Figure 25.4), domestic demand booms were no longer an issue, and some of the countries that had previously faced the largest inflows (Bulgaria, Latvia) were seeing current account surpluses and capital outflows. Average net capital inflows in 2011 were only 3.4 percent of GDP. Turkey is an exception. Its current account deficit widened from 2.2 percent of GDP in 2009 to 9.9 percent of GDP in 2011.[8]

Inflation Has Receded

In mid-2008, overheating, together with a rise in global oil and food prices, had contributed to a surge in inflation, which in many countries increased to double digits. The rise in inflation was particularly pronounced in the Baltic countries, Bulgaria, Montenegro, and the European CIS countries. By 2011, inflation had come down significantly, despite renewed increases in energy prices. Inflation remained above 5 percent only in Moldova, Russia, Serbia, and Turkey.

Excessive Credit Growth Has Given Way to Flat or Declining Credit

In the context of weak economic activity, credit demand has been low. At the same time, foreign parent banks reviewed their regional strategies and tightened

[8]The current account deficit in Belarus also remained very high, which contributed to a currency crisis in 2011.

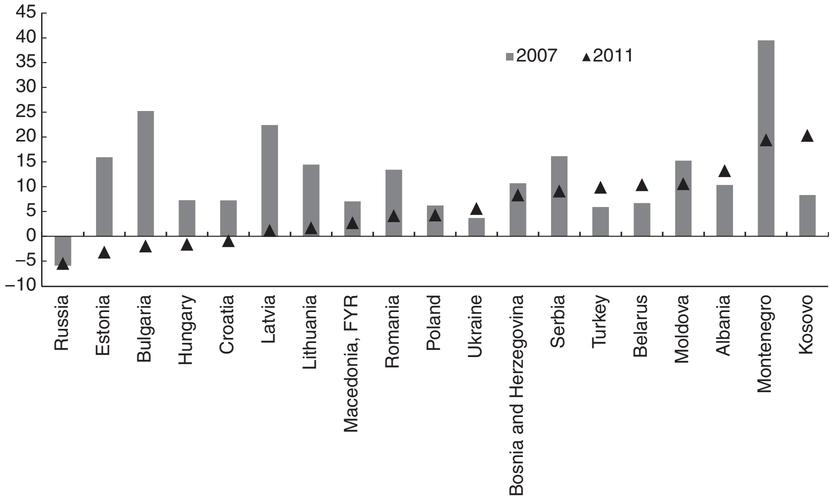

Figure 25.4 Emerging Europe: Current Account Deficits (*Percent of GDP*)

Source: IMF, World Economic Outlook database.

credit supply. While it is difficult to disentangle the relative contribution of supply and demand factors, overall credit in most countries that were hit hard by the crisis has remained flat at best (Figure 25.5).[9]

The adjustment of flow vulnerabilities is a combination of crisis-related import compression and early success in gaining competitiveness and achieving more balanced growth. During the crisis, emerging Europe's imports fell sharply (Figure 25.6) and this was the main driver of current account adjustment. Over time there has also been success in increasing exports (Figure 25.7). Interestingly, exports have increased rapidly in some of the countries with fixed exchange rates (Baltic countries, Bulgaria, Bosnia and Herzegovina). In the Baltic countries this was helped by significant internal adjustment, which contributed to improvements in competitiveness.[10]

…but Other Vulnerabilities Remain High or Increased Further…

Gross Financing Requirements in Many Countries Remain Important, as External Debt in Many Countries Is High

As a result of the crisis, external financing needs increased as public external debt went up and debt maturities shortened (Figure 25.8). Thus, even with much lower current account deficits compared to 2008, financing requirements in 2011 were as high as 60 percent of GDP in Latvia, and between 30 and 40 percent of GDP in Belarus, Bulgaria, Croatia, Lithuania, and Ukraine.

[9] By contrast, credit growth has been strong in some of the countries less affected by the crisis—including Turkey and Poland.
[10] See the chapters on Estonia (18), Latvia (8), and Lithuania (19) for more details.

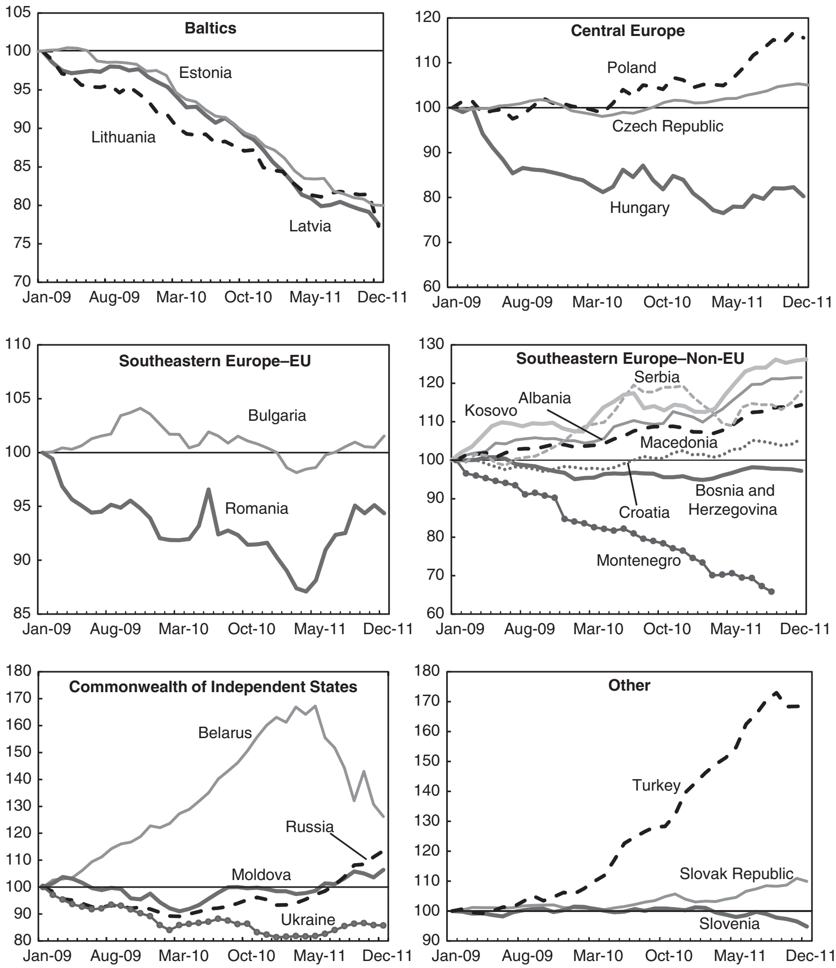

Figure 25.5 Emerging Europe: Real Private Credit, January 2009 to December 2011 (*Index January 2009 = 100*)

Sources: Haver Analytics; IMF, Information Notice System; and IMF, *International Financial Statistics*.

Throughout the Region, the Share of Foreign Currency Loans Remains Close to Peak Levels, Making the Broader Economy Vulnerable to Exchange Rate Pressures and Exposing Banks to Indirect Foreign Currency Risk

In countries with flexible exchange rate regimes, such as Hungary, Romania, and Serbia, balance sheet effects from foreign currency denomination of loans

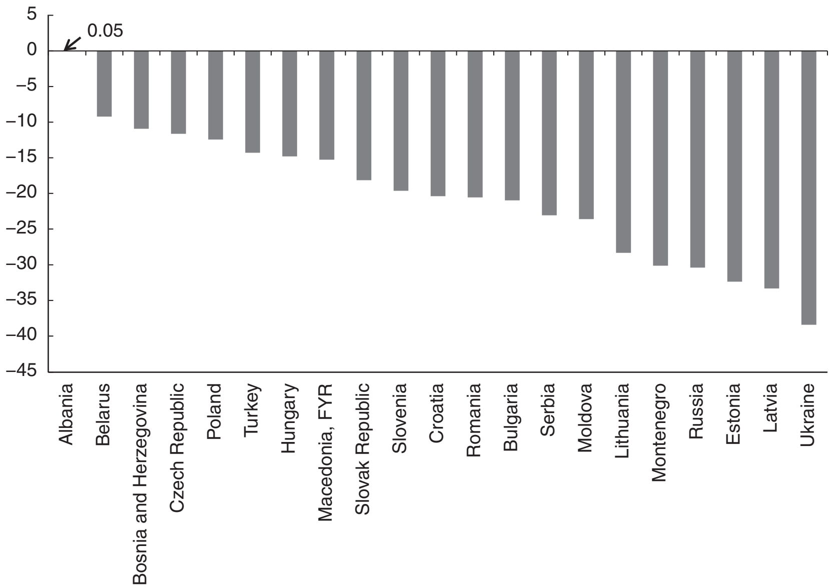

Figure 25.6 Selected CESEE Countries: Change in Real Imports, 2009 (*Percent*)

Source: IMF, World Economic Outlook database.

(Figure 25.9) continues to limit monetary policy's room to maneuver, including in response to the euro area crisis (see Box 25.1).[11]

Rollover Risk in the Domestic Debt Markets Continues

Significant fiscal financing needs, still-relatively-short maturities in domestic debt markets, and the lack of a deep base of domestic institutional investors mean that countries with foreign participation in their local debt markets face significant risk from changes in foreign investor sentiment. This could culminate in significant capital outflows, along with acute pressure on government finance, as happened in Hungary in 2008. Concretely, at end-2011, about 40 percent of domestically issued government bonds in Hungary were held by nonresidents, compared with 34 percent in 2008. In Poland, the share of nonresident holdings of government debt rose from 17 percent in mid-2008 to 30 percent by end-2011—although the Flexible Credit Line (FCL) with the IMF is an important buffer in the event of an exodus by foreign investors.

[11] Hungary implemented several programs to deal with troubled mortgages denominated in Swiss francs. Some schemes were problematic, as they imposed large costs on banks, were poorly targeted, and retroactively altered the terms of private contracts by government fiat.

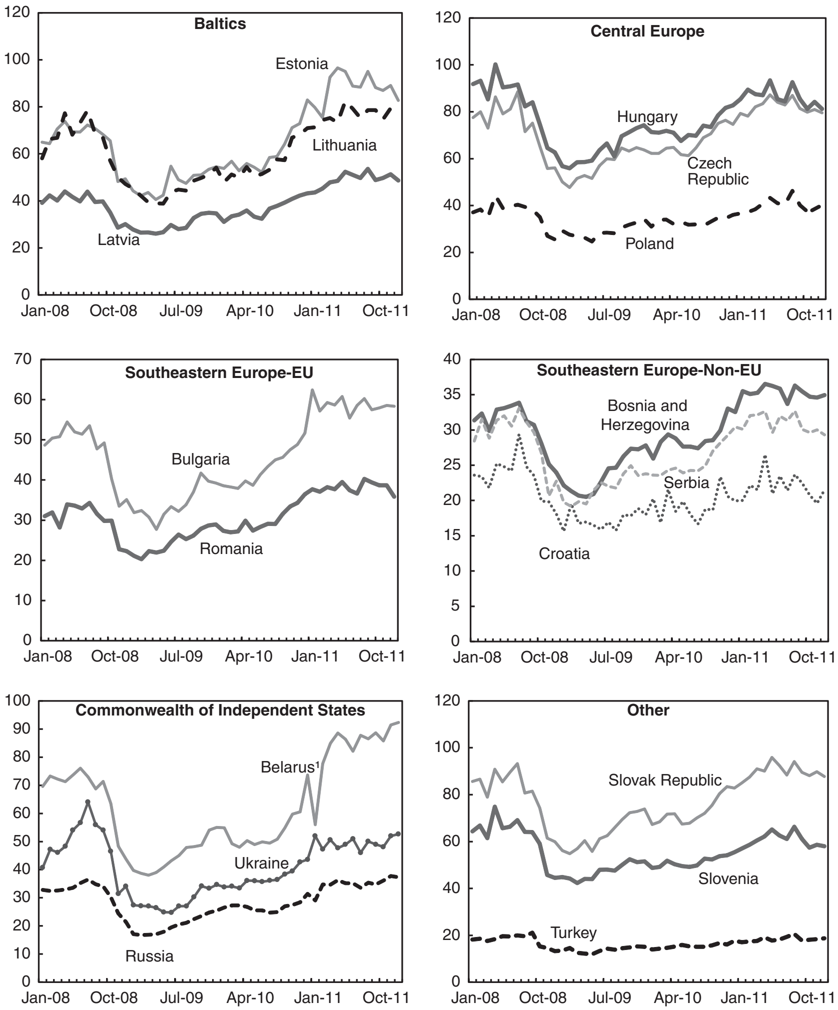

Figure 25.7 Emerging Europe: Exports, January 2008 to December 2011 (*Seasonally adjusted, annualized, in percent of 2010 GDP*)

Sources: Haver Analytics; and IMF, World Economic Outlook database.
[1]Goods and services.

Russia and Ukraine Remain Vulnerable to a Sharp Drop in Commodity Prices

In Ukraine, the economy continues to depend on favorable prices for its steel exports. In addition, the reluctance of the authorities to allow more exchange rate flexibility would make it harder to absorb adverse terms-of-trade shocks.

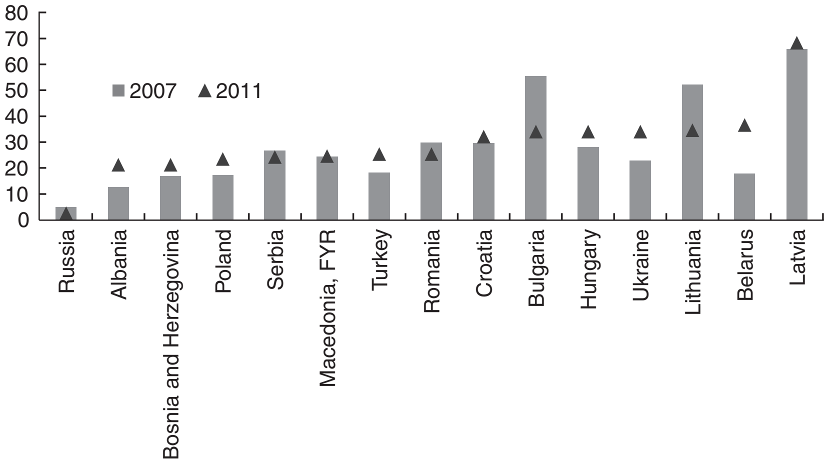

Figure 25.8 Emerging Europe: External Financing Needs (*Percent of GDP*)

Sources: National authorities; and IMF staff estimates.

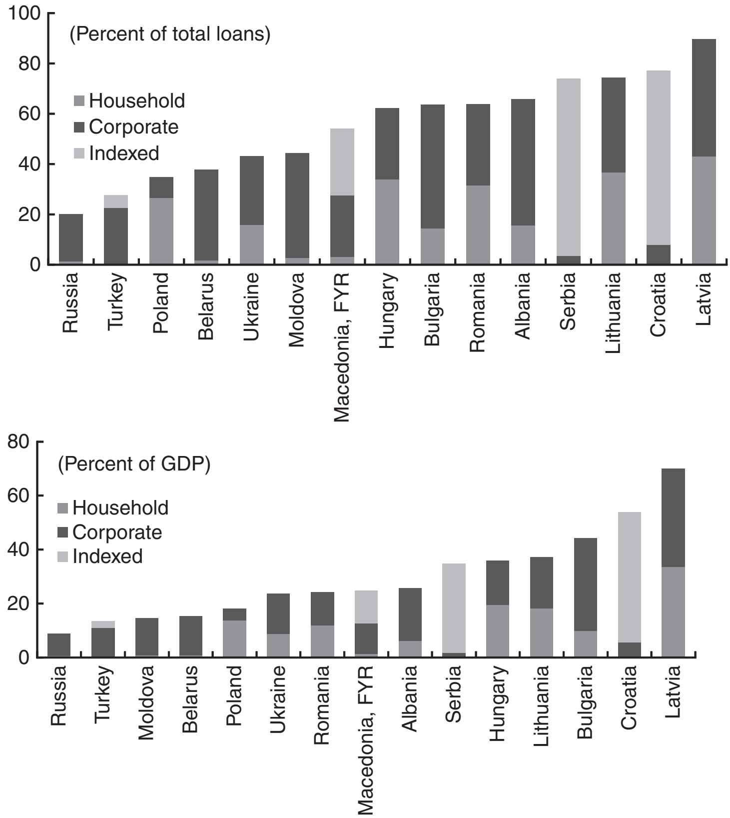

Figure 25.9 Emerging Europe: Stock of Foreign Currency Loans, December 2011

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

BOX 25.1 More Stable or Not? The Euro Area Crisis and Its Impact on Emerging Europe

The euro area crisis surfaced as the countries in emerging Europe had started to address the fallout from their own downturn in 2008/09. The impact of the pressures provides a "real life test" to see to what extent the earlier corrective policies have helped strengthen the region's resilience to spillovers.

Initial indications are that emerging Europe has become significantly less susceptible. Indeed, until the summer of 2011, the euro area crisis had had little impact on financial markets in emerging Europe. While spreads in peripheral advanced Europe went up steadily, spreads in emerging Europe remained flat or continued to edge down as the region was recovering from the 2008/09 crisis. This trend was at times interrupted, but the interruptions reflected spikes in global risk aversion and not specific concerns about emerging Europe.

Contagion to emerging Europe surfaced in mid-2011, when the sovereign debt crisis in the European periphery spilled over to Europe's banking system more generally and, with it, to the principal western parent banks operating in the region. Emerging Europe started to suffer from contagion through bank funding and exchange rate channels.

- Credit default swap (CDS) spreads of large advanced European banks, many of which have a significant presence in emerging Europe, increased sharply. French, Italian, and Greek banks' five-year CDS spreads reached unprecedented levels, while those of Austrian and Swedish banks were close to the levels of January 2009.
- Sovereign CDS spreads rose across the region (Figure 25.10). But this increase was not uniform, as the increase in countries with higher vulnerabilities was larger, while countries that had undergone significant adjustment (notably Latvia) suffered less. Moreover, several emerging European economies are now deemed safer than some "core" euro area countries according to the metric of CDS markets.
- Currencies in the region came under pressure, and foreign currency funding costs on local markets increased.[1] The Hungarian forint, the Polish zloty, the Russian ruble, the Ukrainian hryvnia, and the Croatian kuna all depreciated.[2] The one-year euro-zloty and euro-forint basis swap spreads widened sharply in August and September.

Better euro area sentiment and reduced funding pressures on western European parent banks helped stage a recovery in financial sentiment from mid-December. Prior to the introduction of the European Central Bank's three-year Long-Term Refinancing Operation in mid-December, euro area banks had been under significant funding pressure, which triggered significant deleveraging from emerging Europe. Bank for International Settlements locational statistics show that the external position of western banks vis-à-vis the region declined by 8 percent in the second half of 2011, the biggest decline since the height of the 2008/09 crisis.

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[1] An indirect effect of the euro area sovereign crisis is the continued strength of the Swiss currency, which has increased credit risk in Croatia, Poland, and especially Hungary. During the boom years, borrowing in Swiss francs became popular, because of much lower interest rates. The appreciation of the Swiss franc—now contained because of the franc/euro limit implemented by the Swiss National Bank—has led to a sharp increase in the local currency costs of these loans.

[2] The Belarusian ruble and the Turkish lira had been under depreciation pressure for longer, reflecting mostly country-specific factors.

BOX 25.1 More Stable or Not? The Euro Area Crisis and Its Impact on Emerging Europe (*continued*)

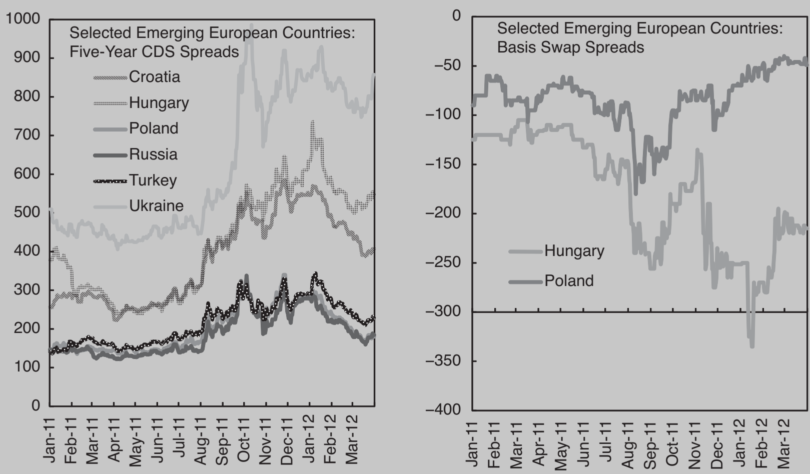

Figure 25.10 Emerging Europe: Selected Financial Indicators, January 2011 to March 2012 (*Basis points*)

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

With the region's close links to western Europe, further spillovers from the euro area crisis are a significant risk, and if tensions in the euro area were to escalate further, emerging Europe would be severely affected through both trade and financial channels. Exports would suffer if euro area growth declined rapidly, financial market strains would intensify, parent bank funding would likely be scaled back, and capital inflows would drop, further weighing on domestic demand.

However, unlike in 2008, absent major homegrown imbalances, emerging Europe is hardly an independent source of a potential new crisis—it is rather a very close bystander to the unfolding events in the euro area. For the most part it has not been a separate cause of concern, and the worries that investors have expressed about peripheral advanced Europe have generally not spread to emerging Europe.

…and with the Crisis, Some Vulnerabilities Are Now Significantly Higher than in 2008

Public Finances Are Significantly Weaker

Prior to the crisis of 2008/09, public finances in emerging Europe seemed to be generally fine, as headline balances were contained, and public debt in most countries was low. With the crisis, the fragility of the situation became apparent: underlying fiscal positions were much weaker as revenue booms had entrenched high expenditures (including on wages and pensions). The sharp drop in revenues that came with the crisis led to initially high deficits and a rapid buildup of debt (Bakker and Christiansen, 2011). At this stage, despite fiscal consolidation, fiscal

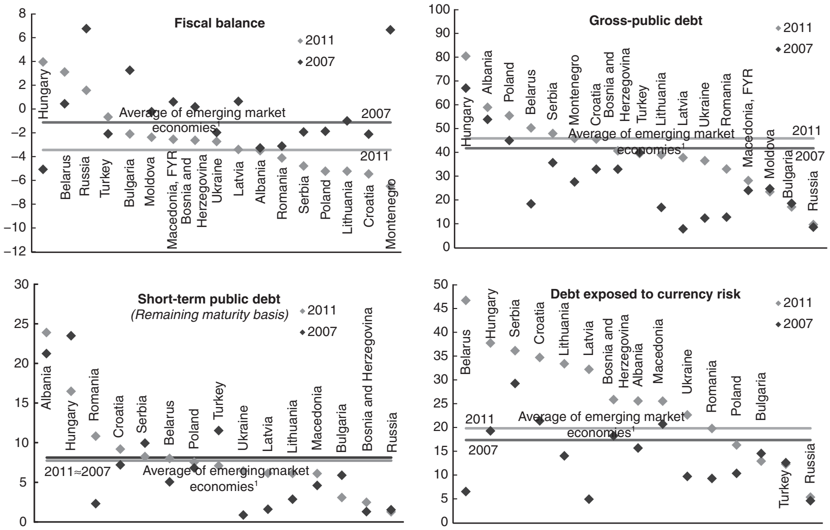

Figure 25.11 Emerging Europe: Fiscal Vulnerability Indicators in Perspective (*Percent of GDP*)

Sources: IMF, World Economic Outlook database; and IMF staff calculations.
[1] Covers 50 major emerging market economies worldwide.

vulnerabilities remain high in a number of emerging European economies (Figure 25.11). Fiscal deficits in 2011 were above 4 percent of GDP in Croatia, Kosovo, Latvia, Lithuania, Poland, Romania, and Serbia. Public debt exceeded 50 percent of GDP in Albania, Hungary, and Poland. Albania and Hungary have relatively high shares of short-term debt that account for more than 20 percent of GDP. Furthermore, a significant share of public debt in a number of countries is denominated in foreign currency, exposing public finances to currency risk.

Financial Sector Balance Sheets are Weaker

Nonperforming loans have increased in all countries, and stand in many cases at uncomfortably high levels. The average reported nonperforming loan ratio in emerging Europe has increased from 3½ percent at end-2007 to over 11 percent at end-2011, reflecting the deep recession of 2009 and the preceding credit and asset price booms. Several countries, including Latvia, Lithuania, Montenegro, Serbia, and Ukraine, reported nonperforming loan ratios in excess of 15 percent (Table 25.1). Nonperforming loan ratios are particularly high in countries that went through a pronounced boom-bust cycle, with rapid credit growth and housing price appreciation fueling the upswing and deep recessions and housing price slumps when the credit cycle turned (Figure 25.12). High capital adequacy ratios and substantial provisions provide important buffers.[12] However, the level of

[12] On average, 66 percent of nonperforming loans are already provisioned for, and the capital adequacy ratio stands at a strong 17 percent—about the same as prior to the 2008/09 crisis. However, provisioning levels vary widely across countries.

TABLE 25.1

Emerging Europe: Selected Financial Soundness Indicators, 2007–11[1]
(*Percent*)

	Capital Adequacy					Return on Assets					Nonperforming Loans to Total Loans				
Country	**2007**	**2008**	**2009**	**2010**	**2011**	**2007**	**2008**	**2009**	**2010**	**2011**	**2007**	**2008**	**2009**	**2010**	**2011**
Albania	17.1	17.2	16.2	15.4	15.6	1.6	0.9	0.4	0.7	0.1	3.4	6.6	10.5	14.0	18.8
Belarus	19.3	21.8	19.8	20.5	24.7	1.7	1.4	1.4	1.7	1.7	1.9	1.7	4.2	3.5	4.2
Bosnia and Herzegovina	17.1	16.3	16.1	16.2	17.2	0.8	0.4	0.1	–0.6	0.7	3.0	3.1	5.9	11.4	11.8
Bulgaria	13.8	14.9	17.0	17.5	17.5	2.4	2.1	1.1	0.9	0.8	2.1	2.5	6.4	11.9	14.9
Croatia	16.3	15.1	16.4	18.8	19.2	1.6	1.7	1.2	1.2	1.2	4.8	4.9	7.7	11.1	12.3
Estonia	14.8	18.9	22.3	22.1	18.6	2.7	1.2	–2.8	0.3	3.5	0.5	1.9	5.2	5.4	4.0
Hungary	10.4	12.3	13.9	13.9	14.2	1.2	1.2	0.6	0.1	–0.4	2.3	3.0	6.7	9.8	12.3
Latvia	11.1	11.8	14.6	14.6	17.4	2.0	0.3	–3.5	–1.6	–0.9	0.8	3.6	16.4	19.0	17.5
Lithuania	10.9	12.9	14.2	15.6	13.9	1.7	1.1	–4.5	–0.4	1.4	1.0	4.6	19.3	19.7	16.3
Macedonia, FYR	17.0	16.2	16.4	16.1	16.8	1.8	1.4	0.6	0.8	0.4	7.5	6.7	8.9	9.0	9.5
Moldova	29.1	32.2	32.1	30.1	30.4	3.9	3.5	–0.5	0.5	2.0	3.7	5.2	16.4	13.3	10.7
Montenegro	17.1	15.0	15.8	15.9	16.5	0.8	–0.6	–0.6	–2.7	–0.1	3.2	7.2	13.5	21.0	15.5
Poland	12.0	11.2	13.3	13.9	13.1	1.9	1.5	0.8	1.0	1.3	5.2	4.5	8.0	8.8	8.3
Romania	13.8	13.8	14.7	15.0	13.4	1.2	1.6	0.2	–0.2	–0.3	2.6	2.8	7.9	11.9	14.0
Russia	15.5	16.8	20.9	18.1	14.7	3.0	1.8	0.7	1.9	2.4	2.5	3.8	9.5	8.2	6.8
Serbia	27.9	21.9	21.4	19.9	19.7	1.7	2.1	1.3	1.1	1.3	8.4	11.3	15.5	16.9	18.8
Turkey	18.9	18.0	20.6	19.0	16.5	3.3	2.5	3.3	3.0	2.2	3.6	3.4	5.0	3.5	2.8
Ukraine	13.9	14.0	18.1	20.8	18.9	1.5	1.0	–4.4	–1.5	–0.8	3.0	3.9	13.7	15.3	14.7
Memorandum items															
Middle East[2]	14.8	13.9	16.1	16.5	16.5	1.6	1.4	1.4	1.3	1.4	5.6	4.4	5.0	5.1	5.2
Latin America[3]	15.9	15.7	17.2	16.7	15.8	2.5	1.9	2.2	2.6	2.1	2.4	2.7	3.4	2.5	2.3
Asia[4]	14.2	14.5	15.3	15.6	15.3	1.2	1.3	1.3	1.5	1.6	5.5	3.8	3.4	2.9	2.4

Sources: IMF, Statistics Department; and IMF country desks.
[1] Please refer to http://fsi.imf.org/fsitables.aspx for detailed notes on cross-country variations in the definitions of the variables.
[2] Average of data for Jordan, Lebanon, Morocco, Oman, and United Arab Emirates.
[3] Average of data for Argentina, Brazil, Chile, Colombia, and Mexico.
[4] Average of data for China, India, Indonesia, Malaysia, the Philippines, and Thailand.

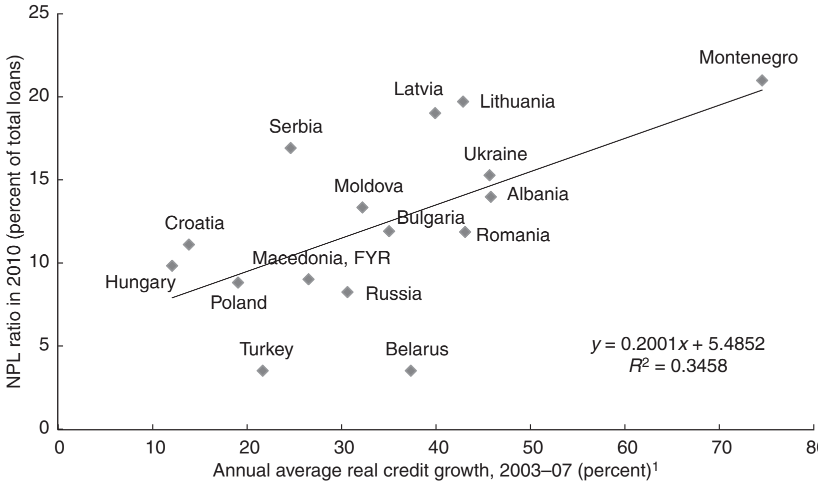

Figure 25.12 Emerging Europe: NPL Levels and Past Credit Growth

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

nonperforming loans raises several concerns, above all, impediments to new lending and a more general drag on economic activity.

But Lessons Have Been Learned, and Policy Measures Are Moving in the Right Direction

In addition to macroeconomic adjustment, most countries have taken steps toward strengthening policy regimes. In the first place, policy measures have addressed areas where risks were most evident.

Regulatory and Supervisory Changes

While banking regulation was generally adequate, weak supervisory practices contributed to the emergence of rapid credit growth and the earlier discussed vulnerabilities. A number of national and international efforts in the region have since been launched to strengthen the supervision of financial systems and improve cooperation between home and host supervisors.[13] The EU has strengthened cross-border supervision, including through the establishment of the European Banking Authority and the European Systemic Risk Management Board. The Vienna Initiative is working toward improving supervisory

[13] The Nordic-Baltic Agreement on crisis resolution is an important example. The agreement enhances cooperation by establishing routines and procedures for information sharing and coordination. The aim is to reduce the risk of a financial crisis spreading across borders and to enhance possibilities for efficient crisis management. See http://www.fi.se/Folder-EN/Startpage/Publications/Miscellaneous/Listan/Nordic-Baltic-Agreement-on-Financial-Stability/.

cooperation and use of macro-prudential tools under "Vienna 2."[14] While these efforts are likely to take time to come to full fruition, the shift in emphasis toward increased responsibilities for both home and host supervisors and more research on good practices in addressing the challenges in the region should bear fruit going forward.

Fiscal Policy

Like the rest of Europe, the region is learning the lessons from the crisis for the formulation of fiscal policy. With the need for fiscal policy to be more prudent during economic expansions, several countries have formulated fiscal rules and debt limits to improve longer-term fiscal sustainability. For example, Latvia and Lithuania are planning fiscal responsibility laws and new deficit rules; the revised Public Finance Act in Poland has defined corrective measures to be taken in case the thresholds under the debt rule are breached; and in 2011, Bulgaria adopted a Financial Stability Pact, which caps government expenditures and the general government budget deficit. However, independent fiscal councils should also be on agendas across the region, since such councils can strengthen transparency and guard against overly rosy government forecasts.[15] In the end, however, political commitment to fiscal discipline is essential for successful fiscal consolidation and adherence to rules.

Structural Adjustment

During the crisis, structural bottlenecks to more-balanced growth became evident. In the context of the crisis response, many countries started to review and address the most important structural impediments to diversification. The focus of these efforts has been on education and job training, as well as critical infrastructure projects. Examples include "Estonia 2020," which sets policy priorities and structural reforms in the areas of research and development, education, infrastructure, and public finances; Romania's planned reforms of the energy and transport sectors; and Moldova's education reforms.

THE ROAD AHEAD: A BROADER VISION FOR RESILIENT CONVERGENCE?

The process of integration and convergence between emerging and advanced Europe will no doubt continue. Most countries in emerging Europe have also reaffirmed a strong desire to progress with further economic and political integration. But more than before, there is a realization that "as fast as possible" may not always be the best policy. Similarly, for those countries that are already EU mem-

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[14] See IMF Press Release No. 12/80.

[15] Such a council was established in Hungary as part of the program supported by the IMF and the EU. However, it was subsequently dismantled, as the new government changed the course of economic policy.

bers, the euro area crisis may have a bearing on the speed of full monetary integration.

Against this backdrop, policymakers need to contemplate the best way of achieving convergence. The lessons reviewed in this chapter suggest that a holistic approach is called for, one in which policies in a broad range of areas may need to be adjusted to achieve the desired goal. When implemented together, a set of revised policies will create a framework that should foster stable convergence; monetary integration should follow once sufficient real convergence has been achieved.

The agenda toward such deep and resilient convergence will include at least three priority areas:

- *Policies to contain domestic consumption and strengthen domestic savings.* Higher domestic savings in emerging Europe will increase the resources available to invest in the domestic economy without creating vulnerabilities from foreign exposure. A wide range of policies can come into play to boost private and public savings. Without claiming comprehensiveness, relevant measures would include tax policy, pension plans, and not least, fiscal savings, especially in cases in which the change in private savings behavior is difficult to achieve. Supporting measures would include the creation of domestic debt markets, which would both encourage private savings and eventually allow the emergence of domestic institutional investors for an efficient allocation of savings.
- *Policies to discourage excessive foreign debt in favor of foreign direct investment.* Capital should continue to flow "downstream" (from richer to poorer countries). However, the reliance on foreign debt, often in the form of bank loans, has led to a broad set of vulnerabilities such as rollover risk, exposure to sudden stops, foreign currency denomination of loans, and insufficient attention to domestic savings and market depth. In the absence of capital controls, a combination of other policies will be needed to foster different and non-debt-creating types of capital inflows, such as foreign direct and longer-term portfolio investment. Relevant measures include all structural efforts to increase the attractiveness of the countries for investment. Those should be supported by regulatory and prudential measures to discourage excessive foreign borrowing by banks, including from parent banks. To ensure their full effectiveness, financial stability will have to be a shared responsibility between home and host authorities, with effective coordination measures put in place to avoid gaps that allowed the earlier imbalances to escalate.
- *Measures to support broader-based growth.* The shift of resources into the booming property and financial sectors in the precrisis years has led to a skills mismatch in many economies in emerging Europe that now prevents a rapid reallocation of resources. Increasing the flexibility of the workforce through appropriate schooling and professional training would increase the resilience of these economies and allow for a smoother shift between sectors. Similarly,

measures to prevent the unbalanced growth of a narrow range of sectors—including, for example, through strict adherence to sectoral exposure limits in lending—would also help avoid the re-emergence of bubbles in narrow parts of the economy, especially in housing. Finally, an open and competitive environment, through deregulation of product and service markets, would support the overall economic environment and facilitate the efficient reallocation of resources in response to changing economic opportunities.

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