World Economic and Financial Surveys

Regional Economic Outlook

INTERNATIONAL MONETARY FUND

Emerging Europe and the Global Crisis: Lessons from the Boom-Bust

Two years after the collapse of Lehman Brothers…

1. Why was the slump in emerging Europe so deep?

2. Why did the banking and currency crises that many predicted not happen?

3. Why were some countries in the region so much more affected than others?

4. Lessons from a crisis – how to avoid a repeat.

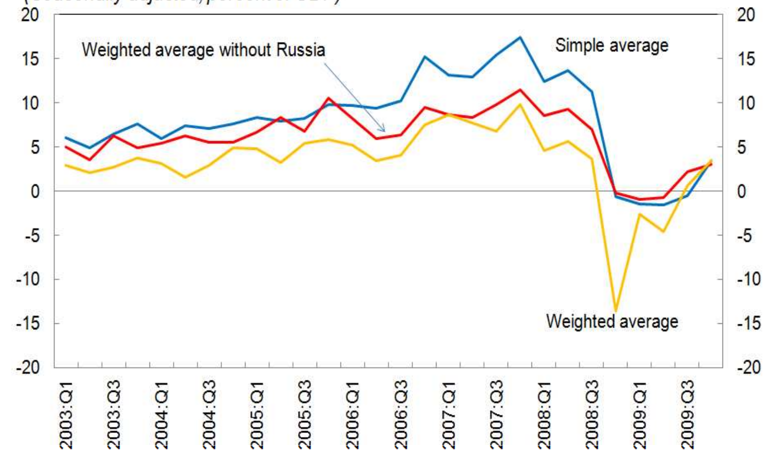
However, the seeds for the crisis were planted in the five years leading up to the crisis

- Buoyant growth in domestic demand led by credit booms
- Overheating of the economy
- Build-up of large imbalances and vulnerabilities

Why was the slump in emerging Europe so deep?

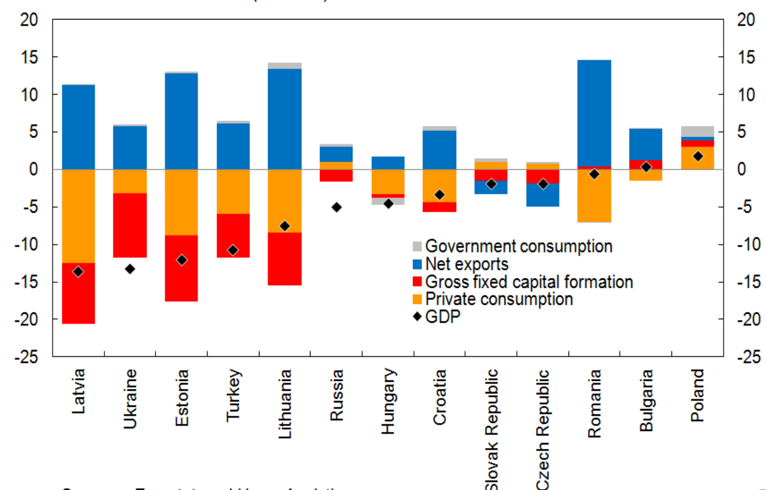
- Crisis trigger – global financial turmoil in the aftermath of Lehman Brothers' collapse
  - ➢ Sudden stop of capital inflows
  - ➢ The collapse of global trade flows

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.

Contributions to Year over Year GDP Growth, End-September 2008–End-March 2009[1] *(Percent)*



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

Why was the slump in emerging Europe so deep?

- However, the seeds for the crisis were planted during the five years before the crisis

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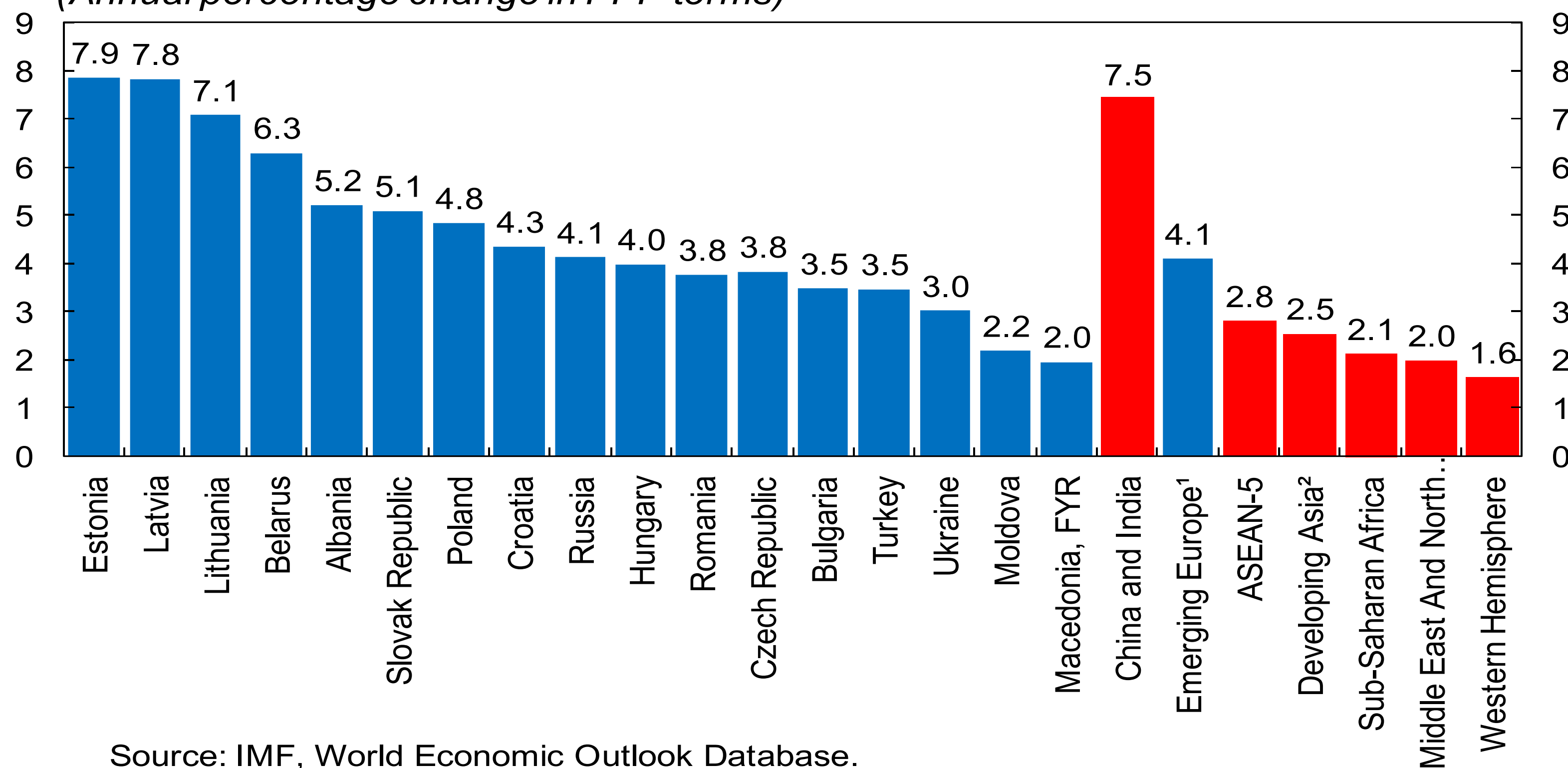
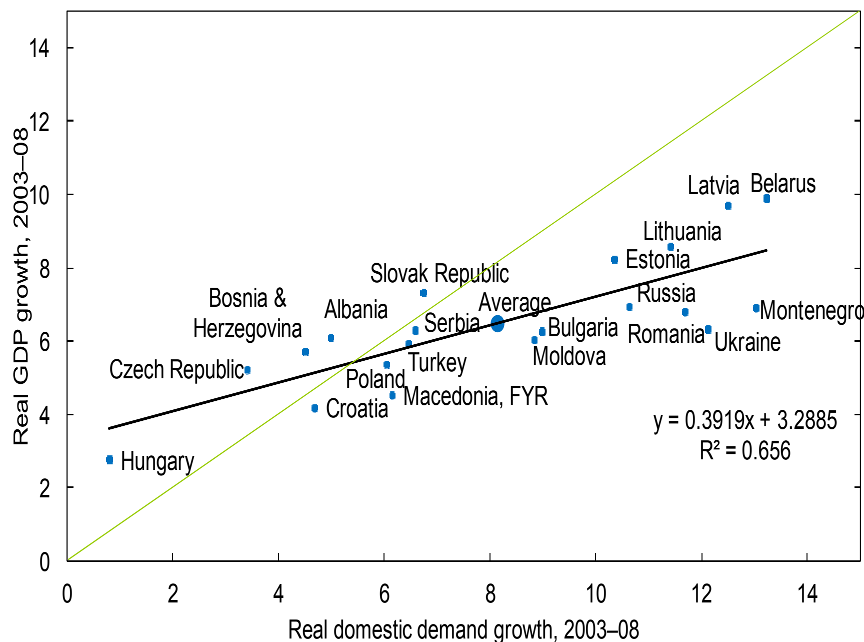
Emerging Europe grew very rapidly before the crisis…



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

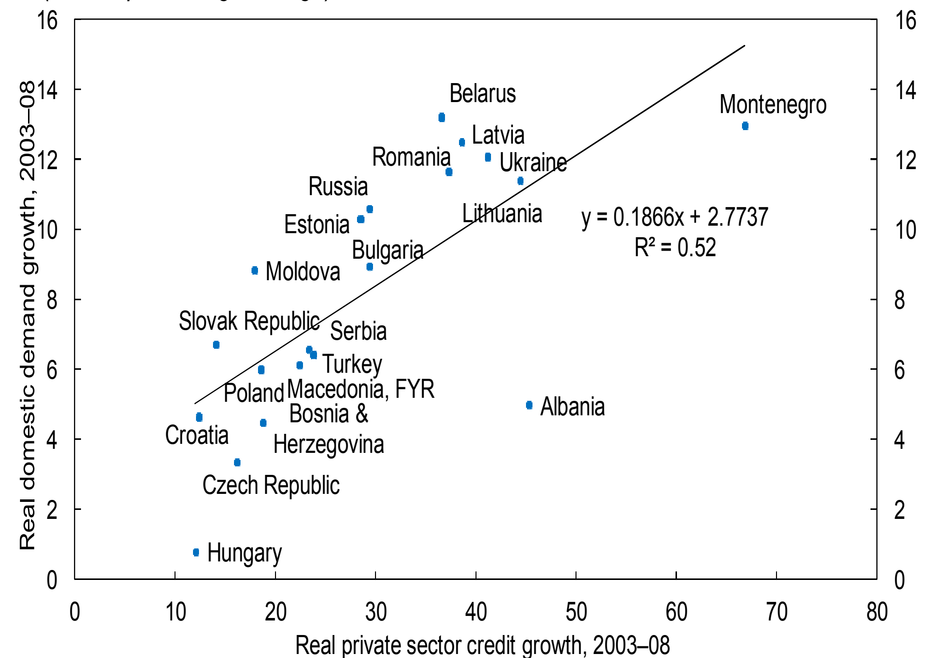
…as credit booms fueled a domestic demand boom.

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



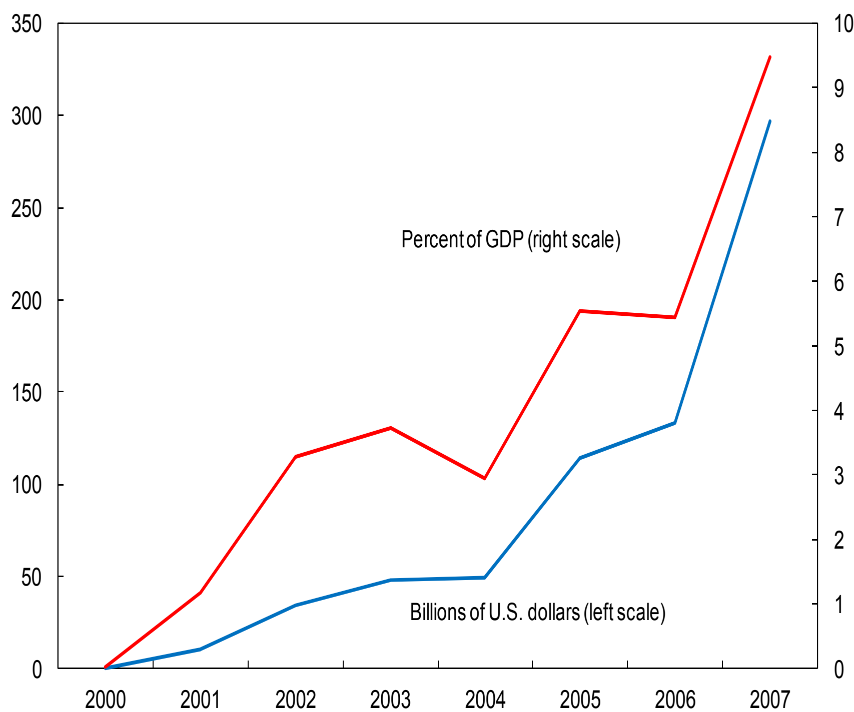
Sources: IMF, *International Financial Statistics* and World Economic Outlook Database.
[1]As the boom in the Baltic states ended in 2007, data for the Baltics refer to 2002–07.

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

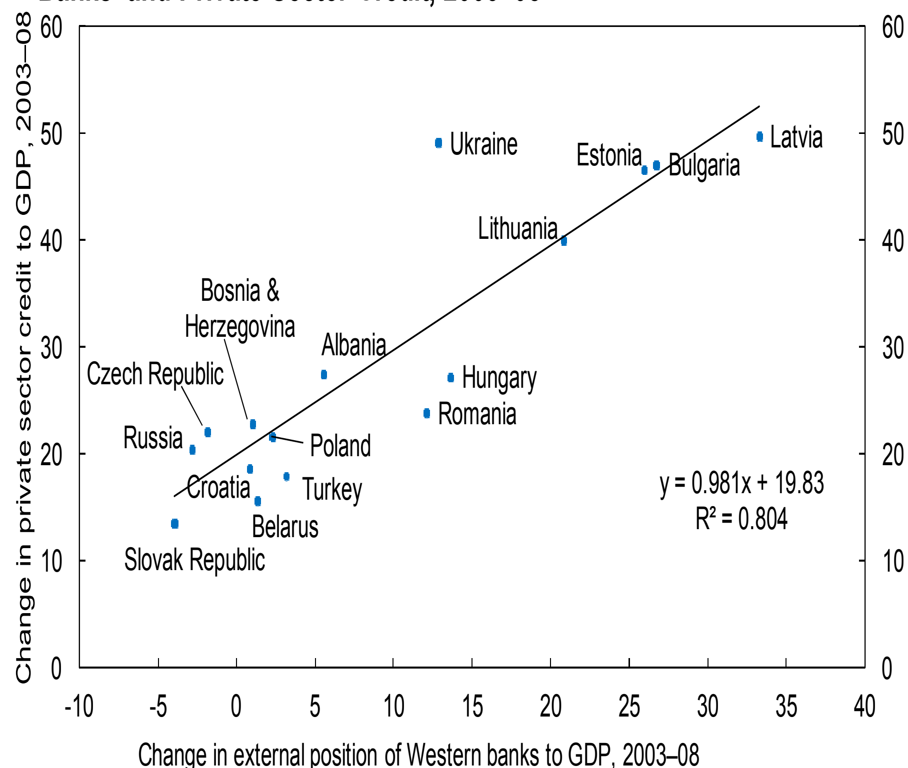


Sources: IMF, *International Financial Statistics* and World Economic Outlook Database.
[1]As the boom in the Baltic states ended in 2007, data for the Baltics refer to 2002–07.

The credit booms were fueled and financed by large capital flows from western European banks



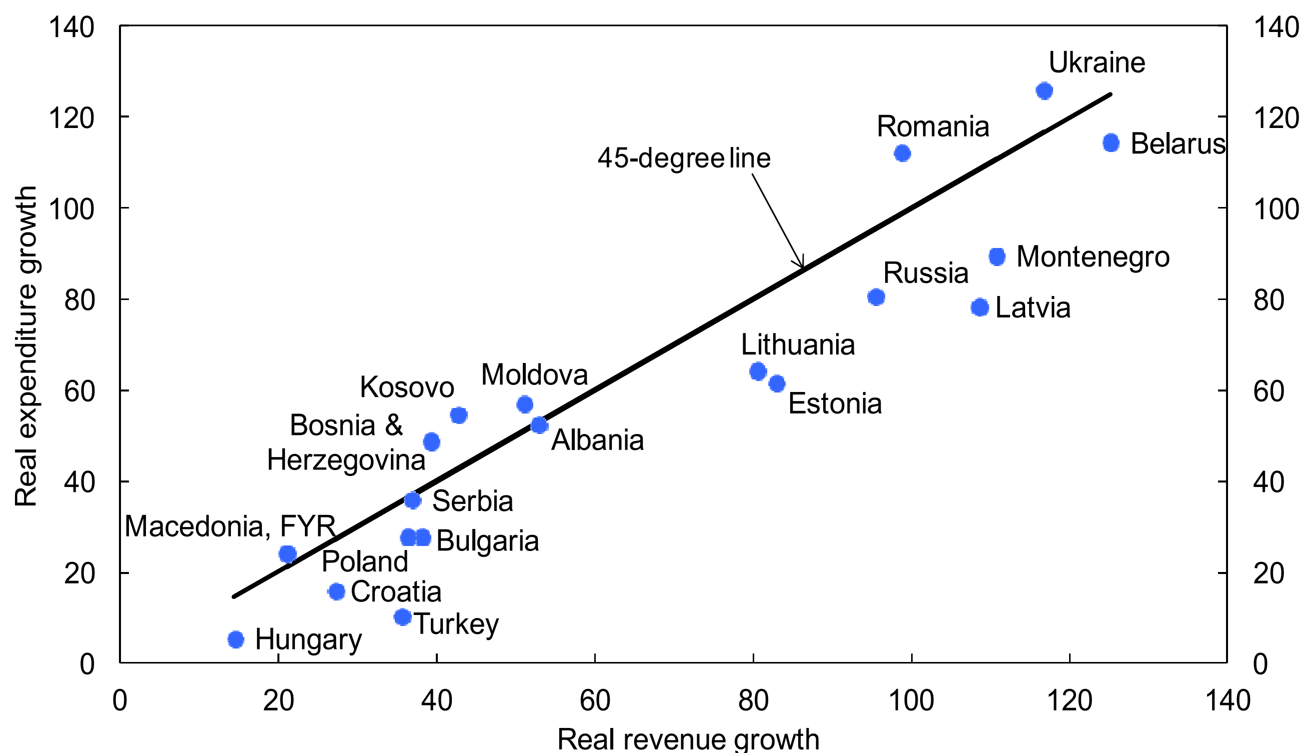
Source: IMF, *International Financial Statistics*.



Sources: IMF, World Economic Outlook Database and *International Financial Statistics*; and BIS locational banking statistics (Table 6A).

[1]As the boom in the Baltic states ended in 2007, data for the Baltics refer to 2002–07.

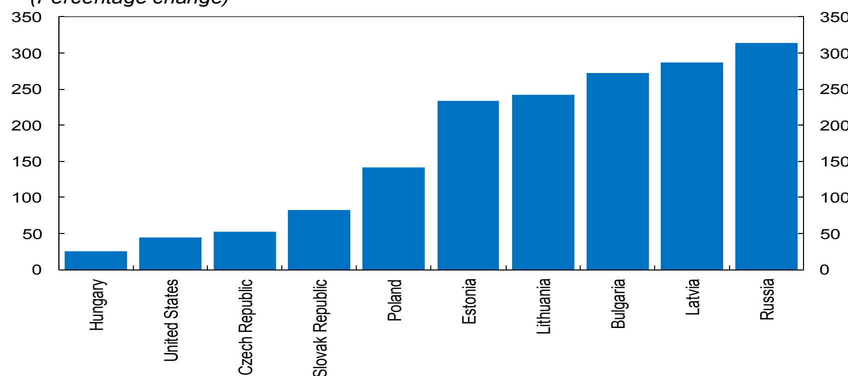
It was not just private demand that grew rapidly—buoyant fiscal revenues were used to increase public expenditure…



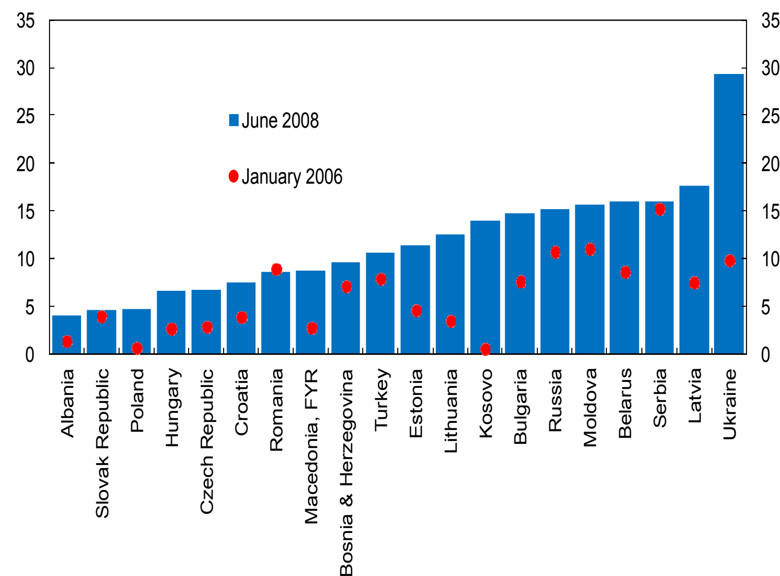
Source: IMF, World Economic Outlook database.

[1]As the boom in the Baltic states ended in 2007, data for the Baltics refer to 2002–07.

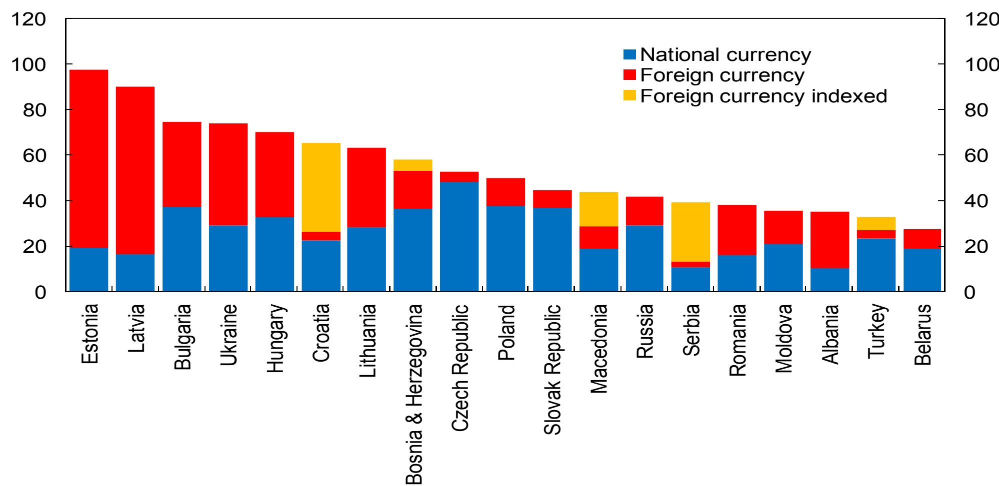
Asset prices and inflation surged and vulnerabilities increased sharply…



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



Source: Haver Analytics.



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

Why was a meltdown avoided?

- Decisive domestic policy
- Large-scale international financial support (IMF, EC, World Bank, EBRD, EIB etc.)
- Western European banks' presence – foreign banks remained in the region during the crisis
- Countercyclical policy in Western Europe – policy rate cuts, liquidity provisions from the ECB, accommodating fiscal policy
- Self-correction of external imbalances

Large-scale and timely international financial support helped.

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

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

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

Western European banks contributed to financial stability during the crisis

- Foreign banks played an important role in the build-up of vulnerabilities *prior* to the crisis

- However, foreign banks remained in the region during the crisis

Countercyclical policy of western Europe helped cushion the impact of the crisis.

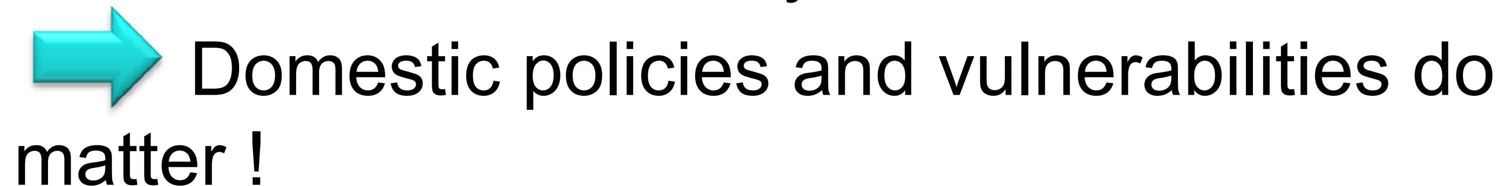
- Rapid cuts in policy rates
- Ample liquidity provision was provided to western European banks by the ECB
- Accommodative fiscal policy had positive spillovers to EE

Imbalances were of self-correcting nature

- Decline in capital inflows led to decline in domestic demand, imports and current account deficits
- As lower capital inflows were offset by lower current account deficits, impact on reserves was limited

Why were some countries more affected than others?

The common trigger of the crisis (external) yet different outcomes. Why?



Domestic policies and vulnerabilities do matter !

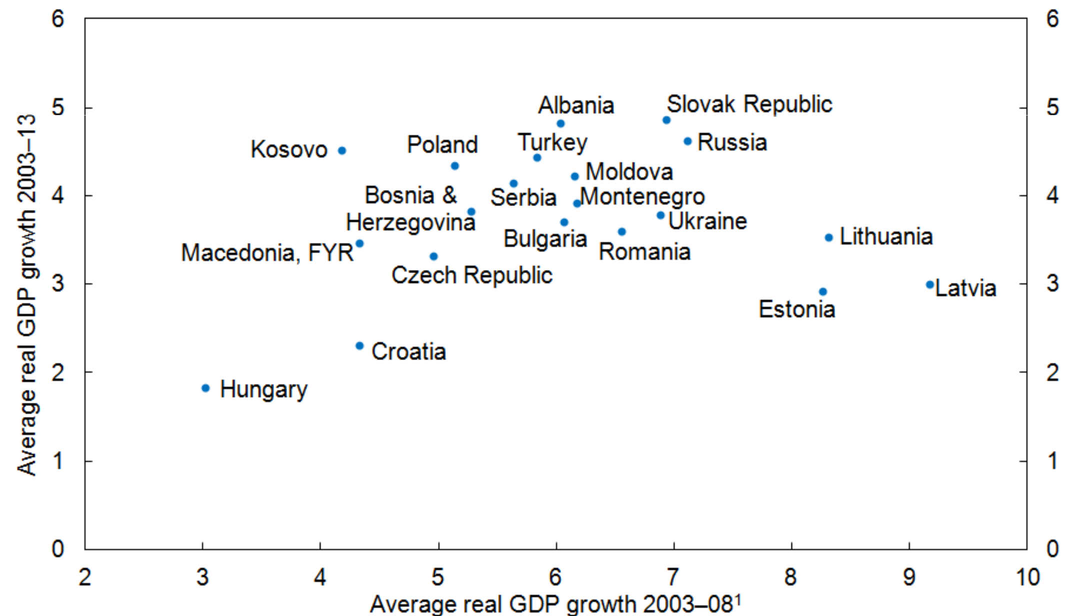
- Countries that had the largest imbalances and the strongest credit booms have seen the deepest recessions

- Countries that managed to avoid the excesses have seen much shallower recessions or avoided them altogether

Lessons from the crisis—how to avoid a repeat

Lesson #1. Credit booms can be costly

Seen over a longer time period, countries with credit booms have not only seen higher *volatility*; in many cases they have also seen lower *average* growth.



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

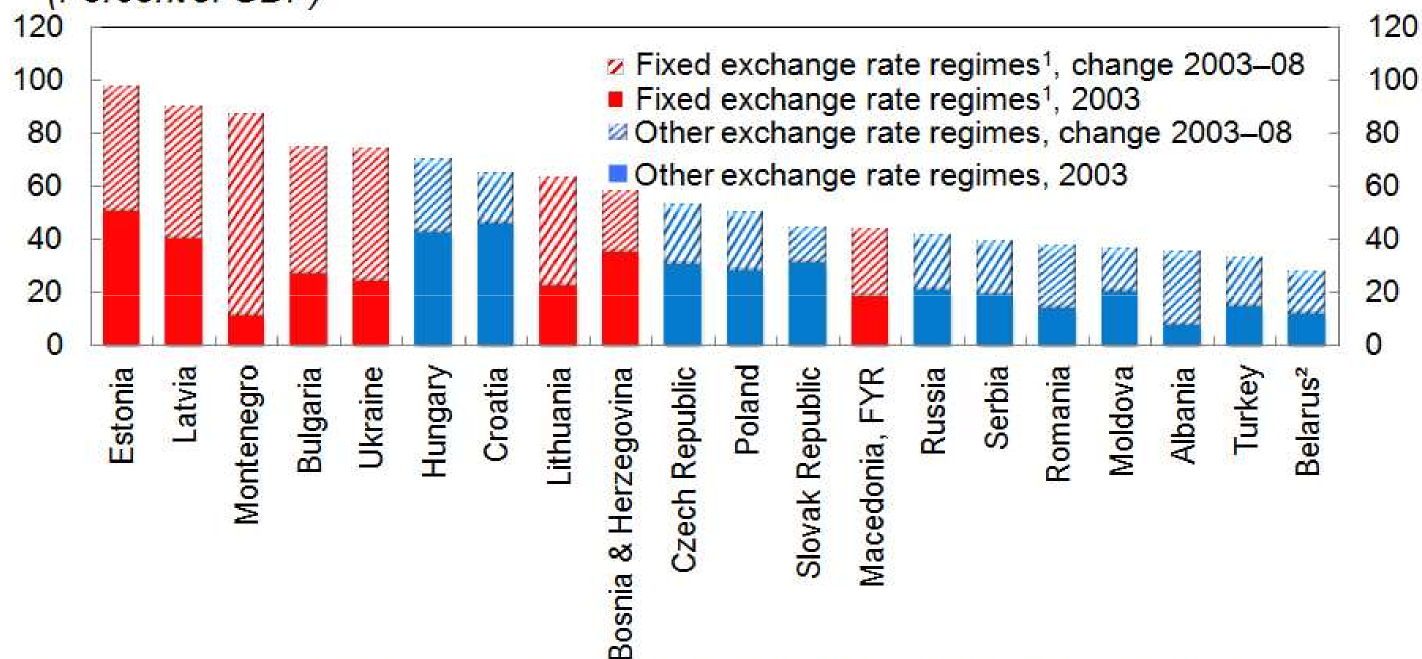
Lesson #2: Slowing credit growth through prudential measures is challenging

- Most host country measures can be easily circumvented, especially in banking systems dominated by foreign affiliates
- Cross-border supervisory coordination key
- That is not to say prudential measures don't work: stronger discouragement of foreign-currency loans would have cooled credit growth and prevented build-up of balance sheet risks

Lesson #3: Credit booms especially hard to stop under fixed exchange rate regimes

Private Sector Credit, 2003 and 2008

(Percent of GDP)



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

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

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

Lesson #4: More active fiscal policy needed

- Boom flattered public finances
- Larger surpluses in boom years to lean against overheating and build buffers for countercyclical policies in the downturn

Most important!

Be wary of "this time is different" stories in the next boom

Thank you

Comments and Questions