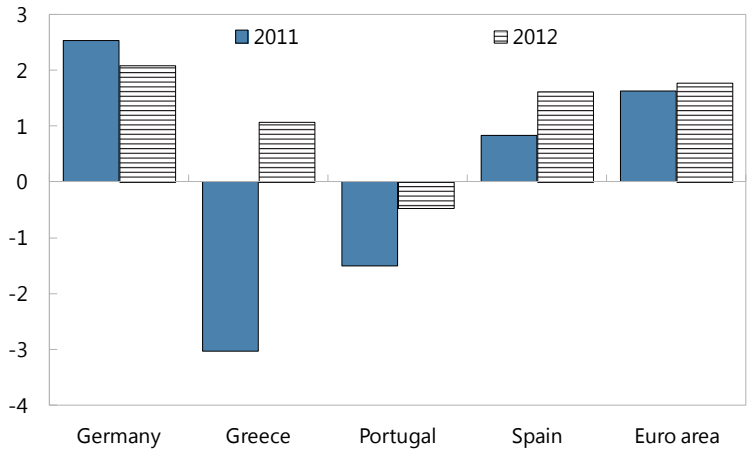
Outlook for Central, Eastern and Southeastern Europe

Bas B. Bakker
European Department, IMF
November 9, 2012

Before Summer 2011 the euro area crisis was contained to periphery, with limited spillovers to emerging Europe

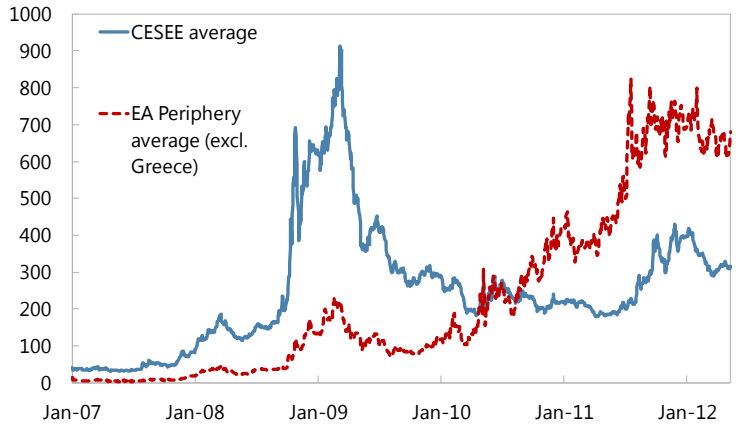
- Outside euro area periphery euro area growth was reasonably strong
- There were concerns about periphery, but they hardly spilled over to emerging Europe
- Spreads in euro area periphery went up, but spreads in emerging Europe were stable or declined

Real GDP Growth Projections, Spring 2011 WEO
(Percent)



Source: IMF, World Economic Outlook database.

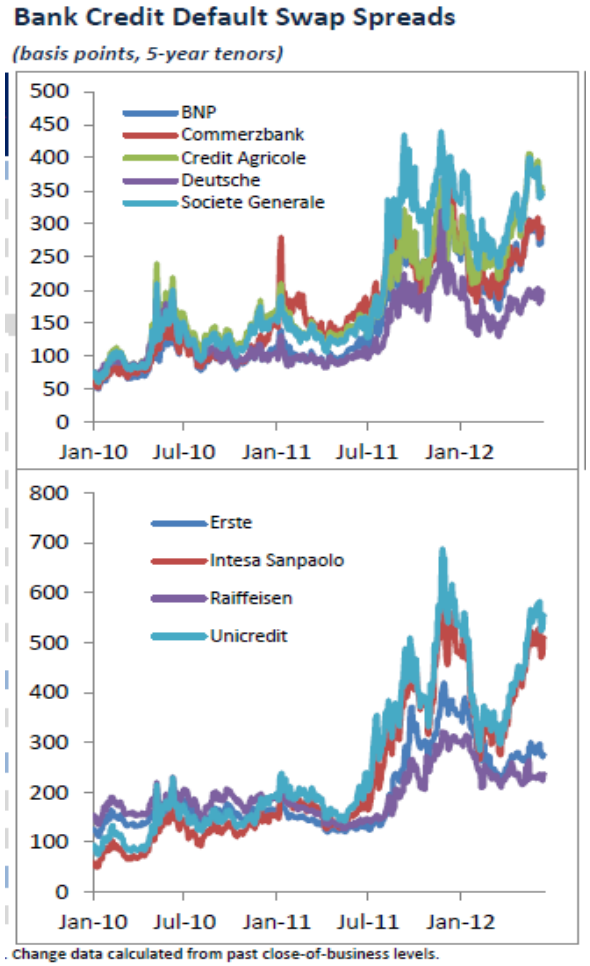
Five-Year Average Sovereign CDS Spreads (in basis points)



Source: Datastream.

In the Summer of 2011, this changed: financial markets in emerging Europe started to be affected by euro area crisis

- Euro area crisis spread to euro area core
- Spreads CDS spreads of large Western Banks in the region widened
- Sovereign CDS spreads in the region increased
- Stock markets dropped

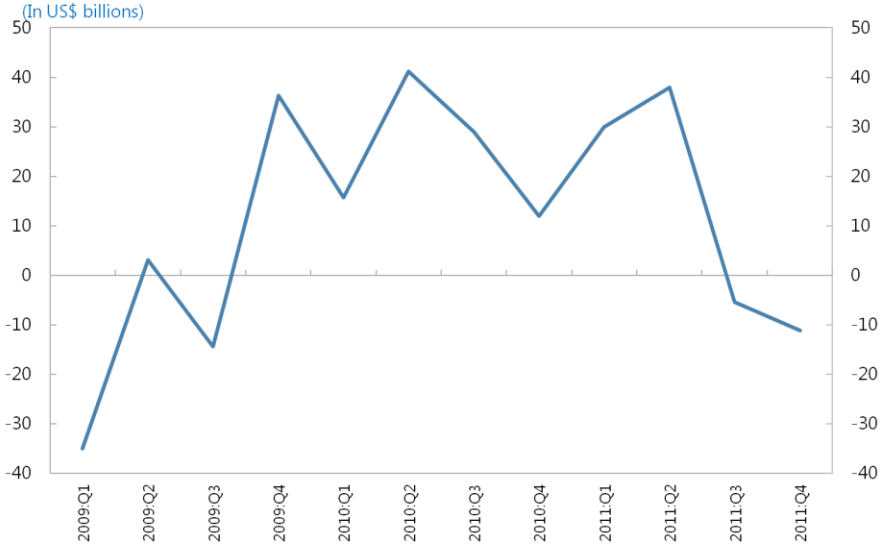


Capital flows dropped, and risk aversion increased

In the second half of 2011, capital flows to the region dropped sharply, exchange rates came under pressure and CDS spreads became elevated, especially in vulnerable countries.

CESEE: Net Capital Inflows, 2009:Q1-2011:Q4

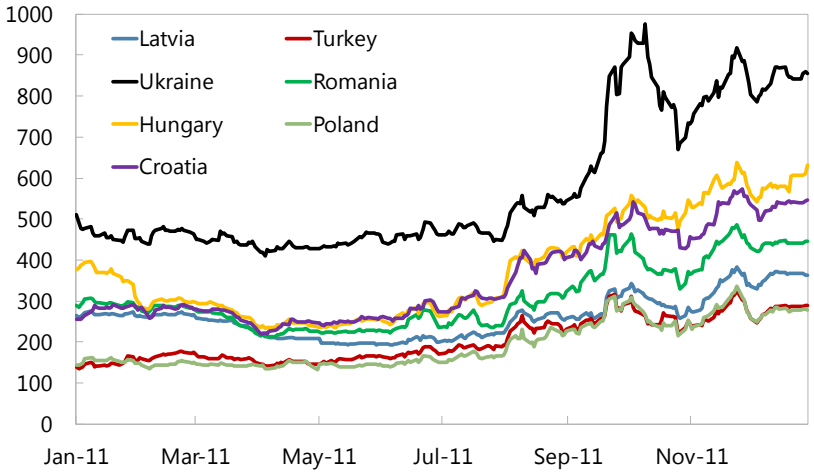
(In US$ billions)



Sources: Haver Analytics; and IMF staff calculations.

5-year Sovereign CDS Spreads

(Basis Points)



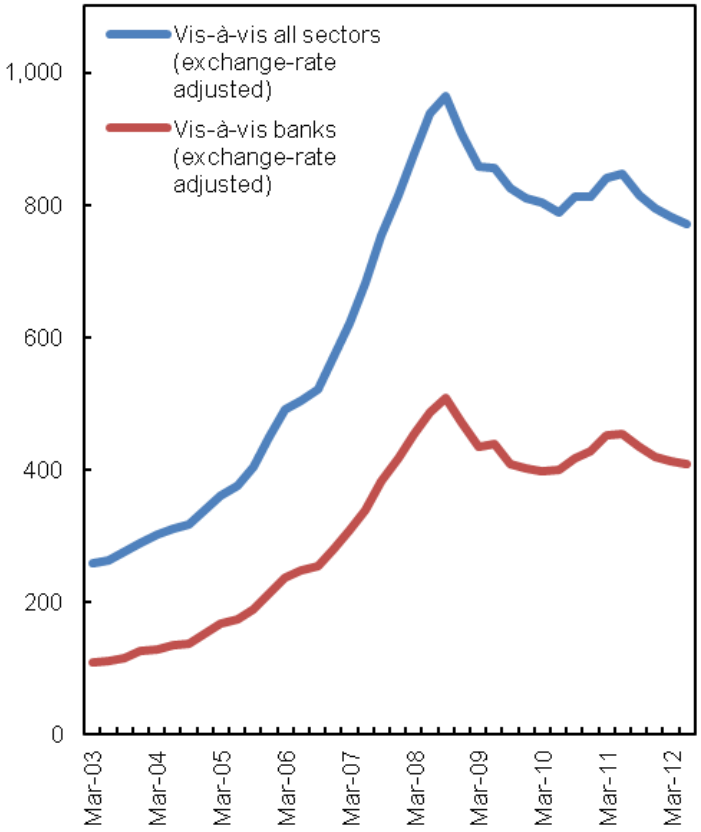
Source: CMA (available through Datastream and Bloomberg Terminal).

Cross-border deleveraging of Western European banks resumed

- First wave after Lehman Brothers collapse
  - Stopped in early 2010 as CESEE crises subsided
- Second wave starting in mid-2011
  - Intensifying strains in funding markets as euro area crisis started to affect core euro area banks
  - Regulatory and market pressures to improve capitalization
  - Weak credit demand in CESEE

CESEE: External Position of BIS-reporting Banks, 2003:Q1-2012:Q2

(Billions of US$)



Sources: BIS, Locational Banking Statistics; and IMF staff calculations.

In some countries, cross-border deleveraging has been very large

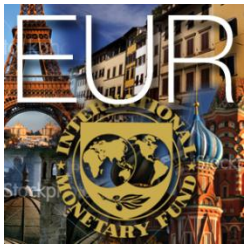
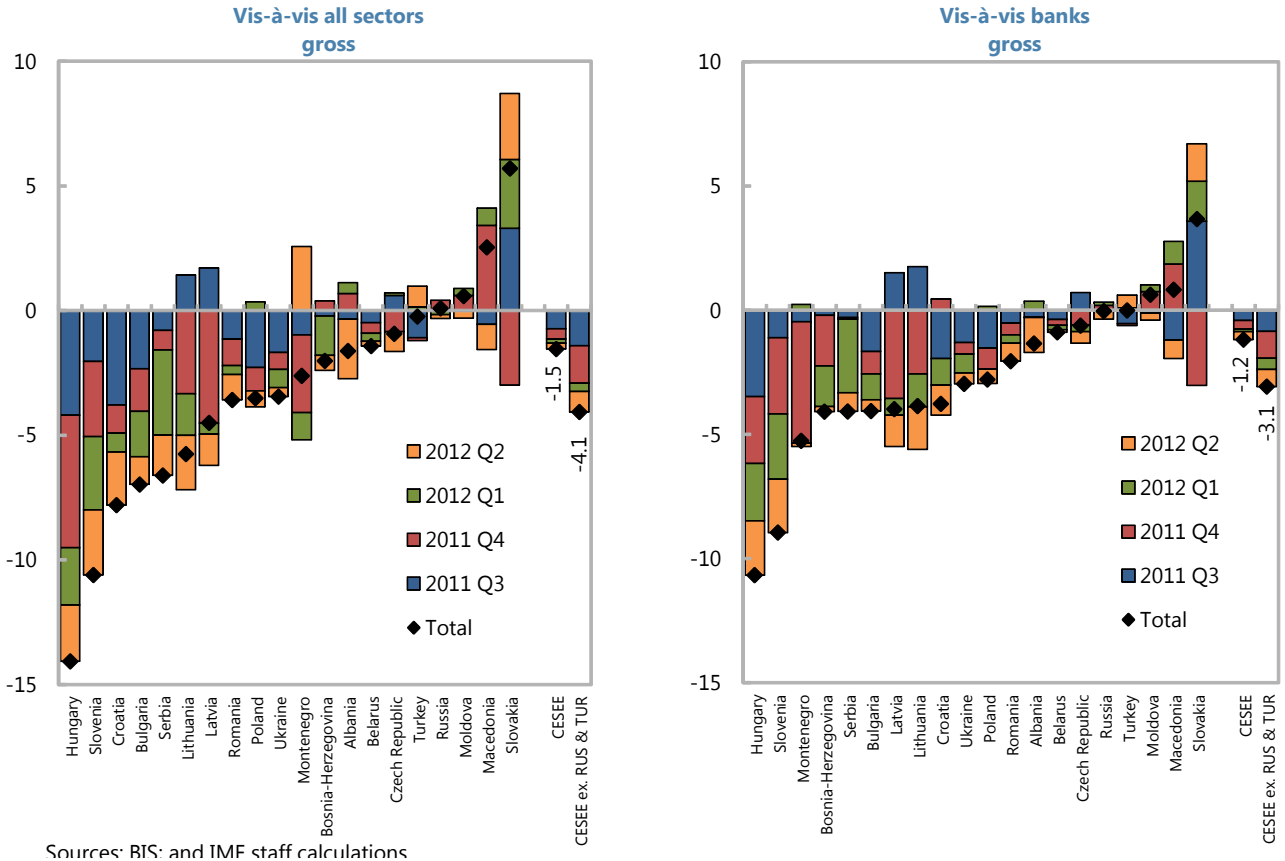


Figure 1. CESEE: External Positions of BIS-reporting Banks, 2011:Q3 - 2012:Q2

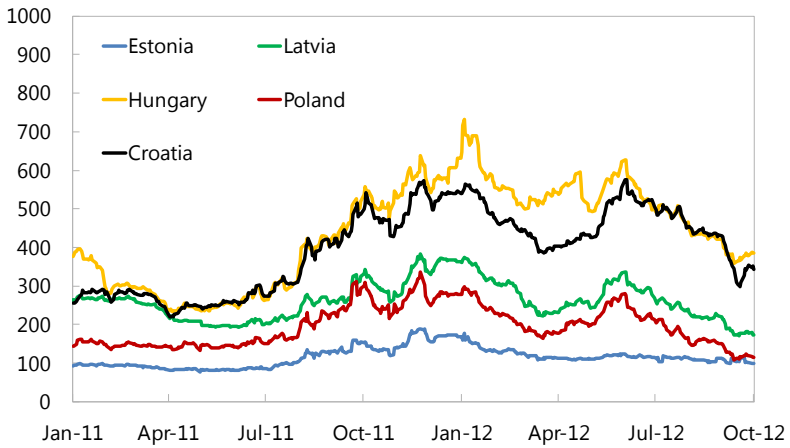


Sources: BIS; and IMF staff calculations

Renewed policy actions by the ECB to contain tail risks have managed to decrease CDS spreads significantly

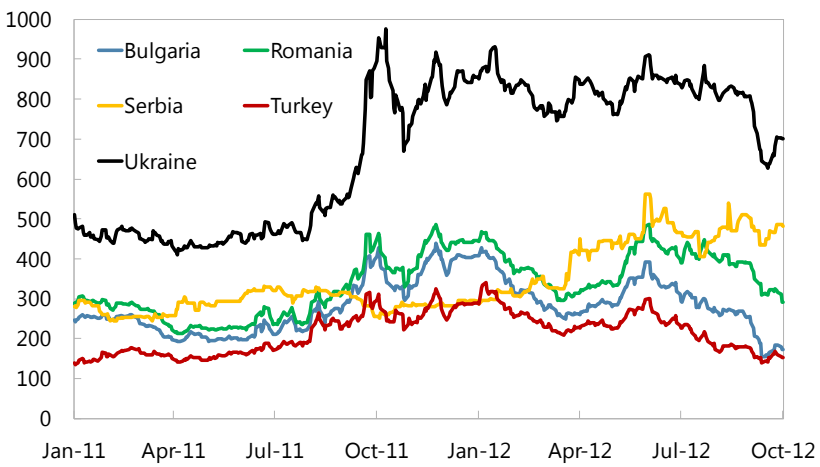
- ECB's LTROs in late 2011 and early 2012 brought relief, but spreads crept up again afterwards
- Draghi's statement that ECB would do "whatever it takes to save euro" led to sharp decline in CDS spreads since August 2012
- OMT further reduced risks of break-up of euro area, which reduced risk aversion vis-à-vis CESE

5-year Sovereign CDS Spreads
(Basis Points)



Source: CMA (available through Datastream and Bloomberg Terminal).

5-year Sovereign CDS Spreads
(Basis Points)

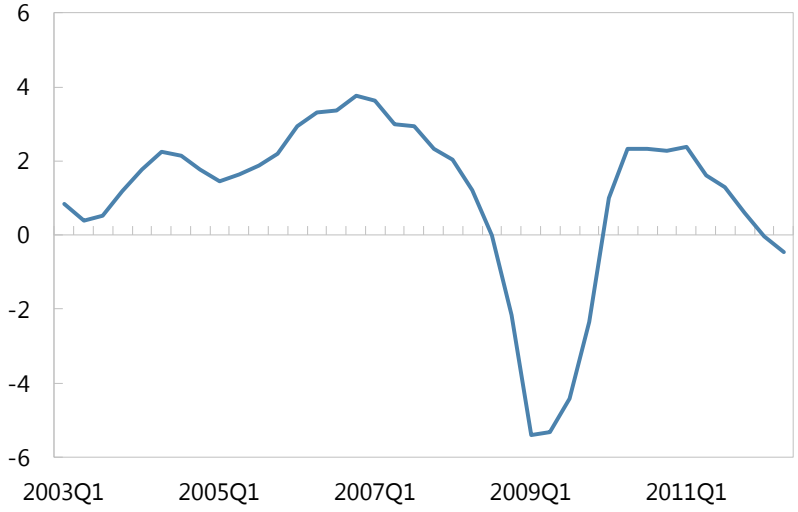


Source: CMA (available through Datastream and Bloomberg Terminal).

Notwithstanding recent improvement in market sentiment, euro area recession has weakened GDP growth in the region

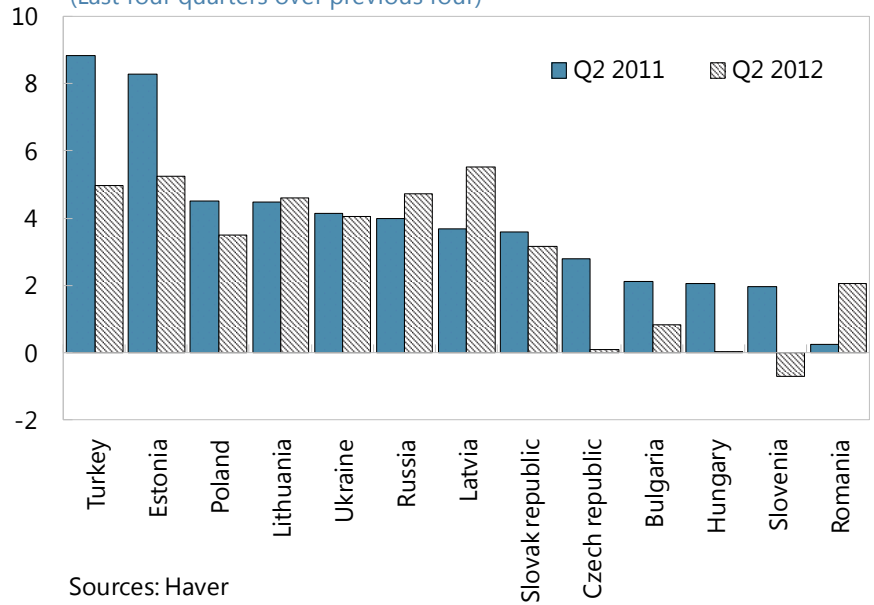
GDP growth is particularly weak in Czech Republic, Bulgaria, Hungary, and Slovenia

Euro area: real GDP
(y/y change, percent)



Sources: Haver

Real GDP Growth
(Last four quarters over previous four)



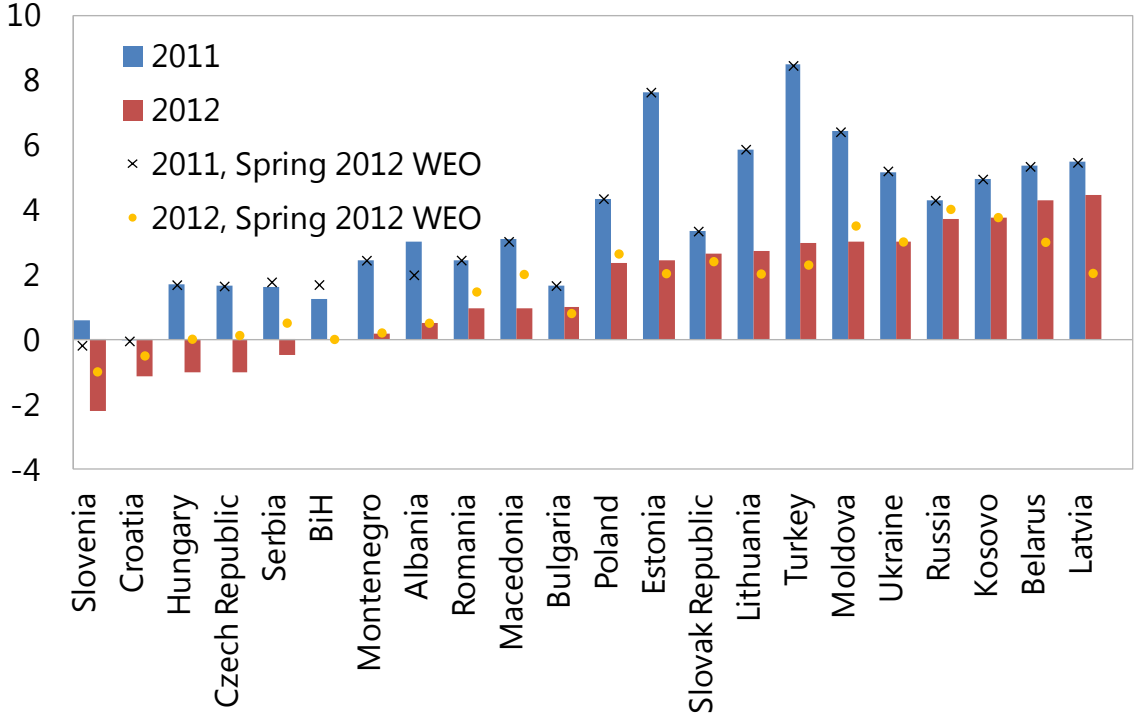
Sources: Haver

Fall WEO projections for 2012 not much different from Spring—notable slowdown from 2011

Emerging Europe's growth for 2012 was revised from 2.9 to 2.8 percent; growth for 2013 from 3.4 to 3.2 percent

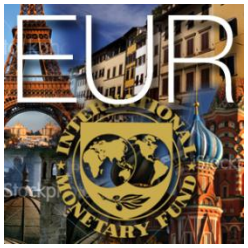
CESEE: Real GDP Growth, 2011 and 2012

(Percent)



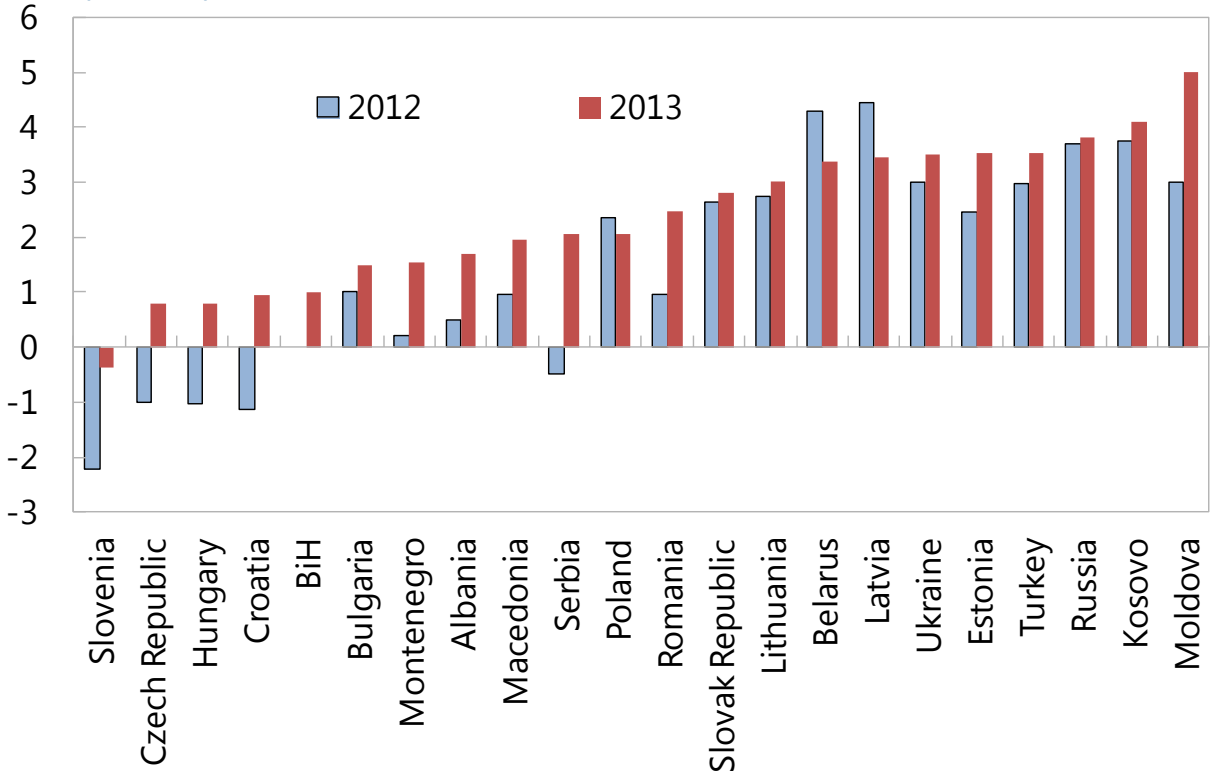
Source: IMF, World Economic Outlook database.

Growth in 2013 is projected to pick up slightly—particularly in the weaker countries



CESEE: Real GDP Growth

(Percent)



Source: IMF, World Economic Outlook database.

POLICY ISSUES

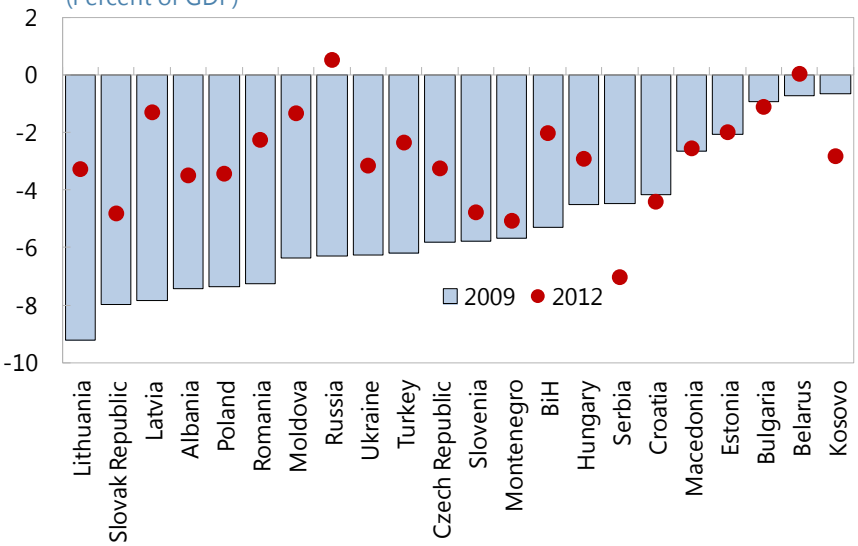
There are a number of important policy challenges, mainly legacies from 2008/09 crisis

A) Repair of public finances
B) Decrease of external vulnerabilities
C) NPL resolution

A) Deficits remain too high in number of countries and should be reduced further

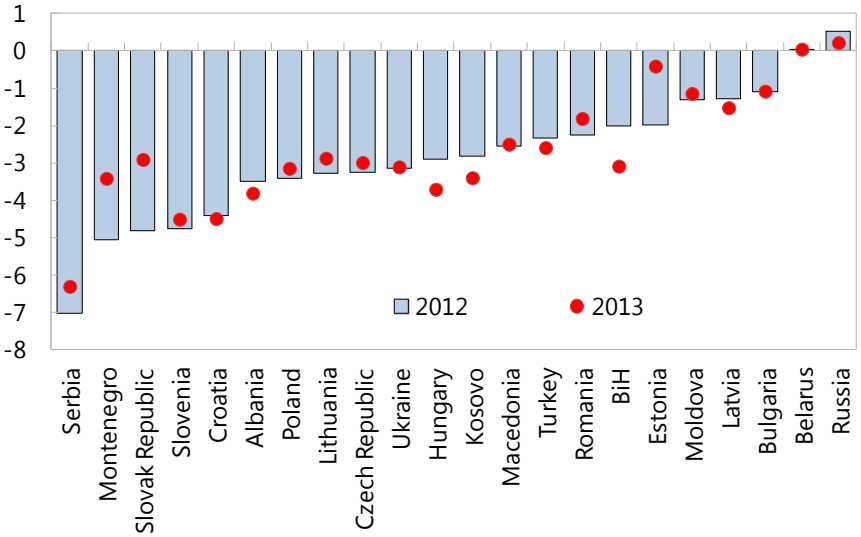
- Fiscal deficit has improved markedly since 2009
- But remains above 3 percent of GDP in 9 countries
- Particularly high in Serbia, Slovenia, Croatia, Albania
- Not much further reduction in 2013

CESEE: Fiscal Balance
(Percent of GDP)



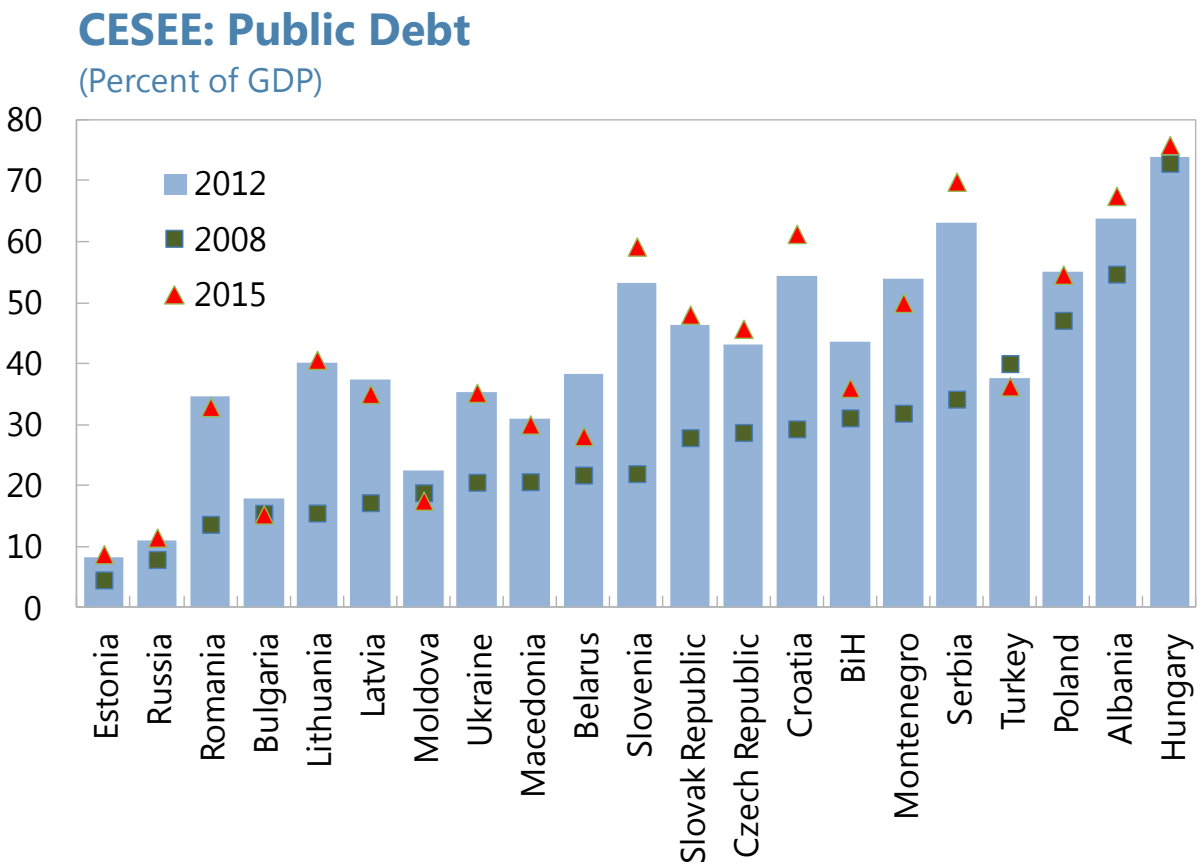
Source: IMF, World Economic Outlook database.

CESEE: Fiscal Balance
(Percent of GDP)



Source: IMF, World Economic Outlook database.

Given also the sharp increase in debt that has taken place in many countries



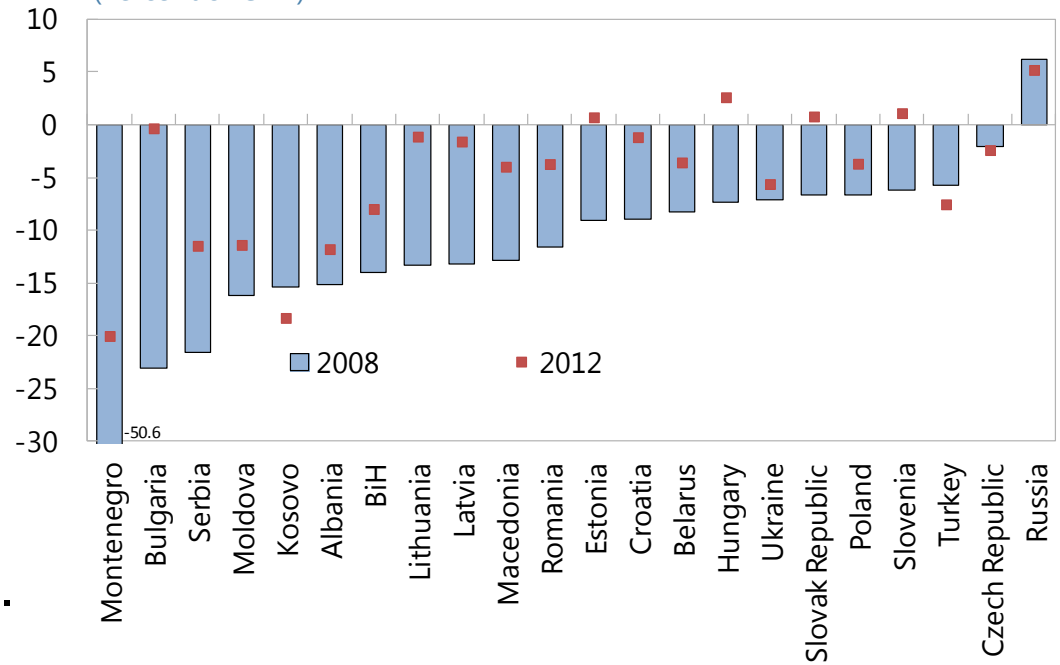
Source: IMF, World Economic Outlook database.

B) External flow vulnerabilities have eased but stock vulnerabilities remain

- Pre-crisis external imbalances have largely corrected
- However, large current account deficits in Turkey, as well as several Balkan countries, a cause for concern
- External debt projected to still exceeds 75 percent of GDP in 8 countries in 2012. Gross external financing needs accordingly high

CESEE: Current Account Balance

(Percent of GDP)

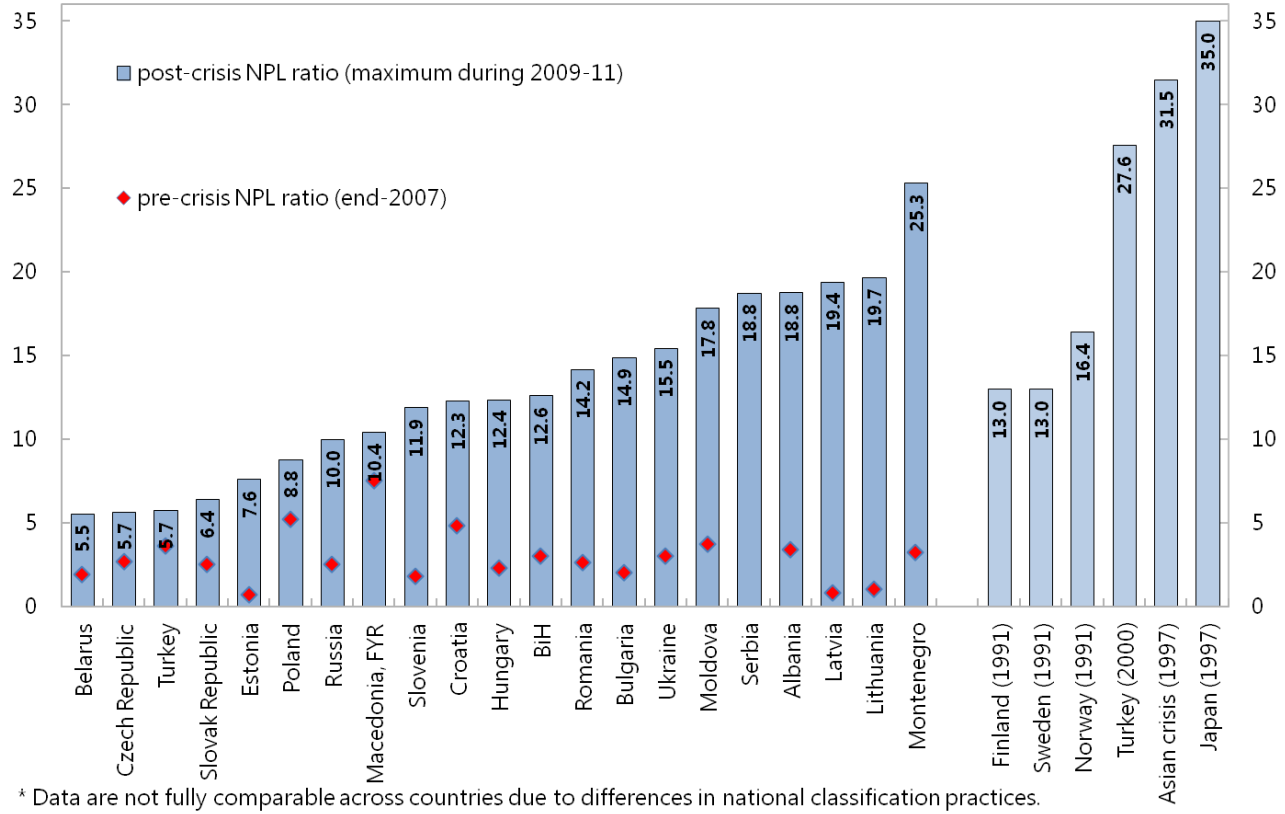


Source: IMF, World Economic Outlook database.

C) NPLs. The crisis of 2008/09 and the preceding credit boom have left a legacy of high NPLs.

CESEE and Previous Crises Countries: Peak NPL Ratios*

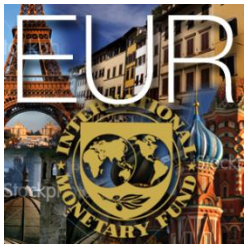
(Percent of total loans)



* Data are not fully comparable across countries due to differences in national classification practices.

Sources: Country authorities; IMF country desks; IMF Statistics Department; and Laeven and Valencia (2008).

High NPLs are problem, faster NPL resolution could lead to a virtuous circle



- Large unresolved NPLs have constrained credit supply
- Unresolved NPLs leave assets in unproductive uses
- Banks have little incentive to rapidly clean up their books and incur losses
  - Collateral execution is not attractive given current prices
  - Some banks lack sufficient capital to recognize adequate provisions and losses
- NPL resolution could set off a virtuous circle of improving economic performance and lower NPLs/higher collateral values
- Virtuous circle unlikely to materialize by itself because of collective action problems

IMF ARRANGEMENTS

Current arrangements with the IMF in CESEE

- Eight arrangements in place in CESEE
  - Bosnia and Herzegovina, Kosovo, Macedonia, Moldova, Poland, Romania, Serbia, and Ukraine
- Three post-Lehman arrangements expired without successor
  - Belarus (Mar. 10), Hungary (Jun. 10/Oct. 10), and Latvia (Dec. 11)
- Three new arrangements requested
  - Belarus (May 11), Hungary (Nov. 11), and Kosovo (Approved by IMF Executive Board on Apr. 12)

Arrangements with the IMF

Poland	FCL US$30 billion Jan.11 - Jan.13	Insurance against downside risks and external uncertainty	Kept precautionary; last review Jan. 12
Romania	SBA €3.5 billion plus €1.4 billion from EU and €0.4 billion from World Bank Mar. 11 - Mar. 13	Designed as precautionary; focus on promoting growth and employment and maintaining financial and macroeconomic stability	Kept precautionary; 6th review completed Sept. 12; €3.2 billion (US$4.1) available
Moldova	ECF/EFF US$569.4 million, Jan. 10 – Jan. 13	Support Moldova's program aimed at restoring fiscal and external sustainability, preserving financial stability, reducing poverty, and raising growth	Disbursing; 5th review completed on Oct. 12

Arrangements with the IMF (continued)

Kosovo	SBA US$140.8 million Apr. 12 - Nov. 13 20 months	Aimed at restoring a sustainable fiscal position and sufficient government cash buffers, anchor fiscal policy through the introduction of a fiscal rule, and enhance the resilience of the financial system.	Disbursing, 1st review completed July 12
Serbia	SBA US$1.5 billion Sep. 11 - Mar. 13	Designed as precautionary; insure against external shocks, anchor fiscal responsibility framework, and address bottlenecks in the investment climate to promote employment creation	1st review faces delay on 2012 fiscal policy

Arrangements with the IMF (concluded)

Ukraine	SBA US$15.2 billion Jul.10 - Dec.12	Restore confidence and fiscal sustainability; modernize gas sector; safeguard banks' soundness; develop robust monetary policy framework	1st review completed Dec. 10, bringing total disbursements to US$3.4 billion; completion of 2nd review remains pending
Bosnia and Herzegovina	SBA US$520.6 million Sept. 12 – Sept. 14	Safeguard the currency board through determined fiscal, income, and financial sector policies	Initial disbursement of US$78.1 is available under the new program

Arrangements with the IMF (concluded)

Macedonia	PLL US$640 million Jan. 11 - Jan. 13	Supporting market confidence by signaling Macedonia's commitment to prudent policies and strengthening its reserve buffers	US$310 million drawn in Mar. 11; 1st review completed Sep. 11 The authorities did not pursue the completion of the 2nd review and decided to allow the agreement to expire in January 2013.

Thank you!