Spring 2015 Regional Economic Issues Report on Central, Eastern and Southeastern Europe (CESEE)

MIND THE CREDIT GAP

May, 2015
Growth Divergence in 2014

Quarterly GDP Growth, 2014 (Percent, year-on-year)

Note: The negative trend for Other CIS is mainly driven by Ukraine, which has a weight of close to two-thirds.
3-Speed Growth Outlook: CEE - solid, SEE - sluggish, CIS - recession

2015 Growth Forecast (percent)

October 2014 WEO
3-Speed Growth Outlook:
CEE - solid, SEE - sluggish, CIS - recession

2015 Growth Forecast (percent)

April 2015 WEO
Growth Revision: Oil Price, Euro Area, and Geopolitical Tensions

2015 GDP Revisions – Apr 2015 WEO vs. Oct 2014 WEO *(Percentage points)*

- Lower oil prices
- EU growth outlook
- Russia's slowdown
- Country-specific factors

<table>
<thead>
<tr>
<th>Country</th>
<th>Baltics</th>
<th>CEE</th>
<th>SEE</th>
</tr>
</thead>
<tbody>
<tr>
<td>俄罗斯</td>
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<tr>
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</tbody>
</table>
Inflation Outlook:
Many Sub-Zero Readings in 2014...

CESEE: Headline Inflation, 2014 (Percent, year-over-year)
Inflation Outlook:
...but Started to Turn Positive in 2015

CESEE: Headline Inflation, 2015 (Percent, year-over-year)
Inflation Revision: Oil Price, Euro Area, and Geopolitical Tensions

2015 Inflation Revisions – Apr 2015 WEO vs. Oct 2014 WEO (Percentage points)

- Lower oil prices
- EU inflation outlook
- Russia's slowdown
- Country-specific factors

Baltics

CEE

SEE

Russia

Turkey

Belarus, Moldova

Ukraine
Risks More Balanced but Significant Downside Risks Remain

- Protracted slow growth in euro area
- Surge in financial volatility
- Persistent strength of US dollar
- Geopolitical tensions around Russia/Ukraine

- \( \uparrow \) impact of ECB monetary easing on growth
- \( \uparrow \) impact of low oil prices on growth in oil importers
Downside Risks: Spillovers from Deeper Recession in Russia

GDP Losses from Additional 4 Percent Fall in Russian GDP, 2015
(Relative to Baseline, in Percent)

- Belarus, Moldova
- Ukraine
- Emerging Euro Area
- Bulgaria
- Serbia
- Croatia
- Hungary
- Czech Republic
- Turkey
- Poland
- Romania

Note: Emerging euro area countries are Estonia, Latvia, Lithuania, Slovak Republic and Slovenia.
Downside Risks: Spillovers from Greece

Potential for Greece Spillovers through Real and Financial Channels

**Exports**  
(Percent of GDP)

**Market Share of Greek Subs**  
(Percent of total bank assets)

**Loan-to-Deposit Ratios of Greek Subs**  
(Percent, average)

- **Bulgaria**
- **Macedonia, FYR**
- **Albania**
- **Romania**
- **Serbia**

![Graphs showing data for different countries]
Incomplete Balance Sheet Repair in SEE – Persistently High Debt

Private Sector Debt (Percent of GDP)

- Baltics
  - 2005: 60
  - 2008: 80
  - 2009: 90
  - 2013: 110

- SEE
  - 2005: 100
  - 2008: 110
  - 2009: 120
  - 2013: 130

- Euro area/euro peggers
  - 2005: 70
  - 2008: 80
  - 2009: 90
  - 2013: 100

- Inflation targeters
  - 2005: 50
  - 2008: 60
  - 2009: 70
  - 2013: 80

- CEE
  - 2005: 40
  - 2008: 50
  - 2009: 60
  - 2013: 70
Nonperforming loans (in percent of total loans)

- Baltic countries
- SEE countries
- Euro area/euro peggers
- SEE inflation targeters
- CEE economies

Incomplete Balance Sheet Repair in SEE – Negative Credit Growth

Corporate Bank Credit
(6-month moving average of y-o-y growth rates, percent)

Note: Adjusted for FX valuation effects.
Incomplete Balance Sheet Repair in SEE – No Investment Pick-up

Real Gross Investment
(Index, 2000=100)
Private Sector Balance-Sheet Repair

1. How much deleveraging?
2. Real Impact of Deleveraging
3. Remaining weaknesses and credit gaps
4. Policies to complete repair
1. How Much Deleveraging: Sizable Deleveraging Efforts...

**Post-Crisis Change in Private Savings Rate (Percent of GDP)**

- Bulgaria
- Montenegro
- Lithuania
- Latvia
- Macedonia, FYR
- Serbia
- Russia
- Estonia
- Croatia
- Belarus
- Hungary
- Slovenia
- Poland
- Slovak Republic
- Romania
- Moldova
- Czech Republic
- Bosnia
- Turkey
- Ukraine
- Albania

**Post-Crisis Change in Private Investment Rate (Percentage points of GDP)**

- Latvia
- Estonia
- Montenegro
- Romania
- Slovenia
- Lithuania
- Moldova
- Albania
- Bulgaria
- Ukraine
- Bosnia
- Slovak Republic
- Croatia
- Serbia
- Hungary
- Turkey
- Poland
- Czech Republic
- Kosovo
- Macedonia, FYR
- Russia
- Belarus
1. How Much Deleveraging: ...but Modest Results

Growth of Private Debt-to-GDP Ratio over 2008–13 (Percent)

Contributions to Growth of Private Debt-to-GDP Ratio over 2008–13 (Percent)
2. Real Impact of Deleveraging: Reduces Absorption of Leveraged Sectors

**Employment and Leverage**

(Percent)

**Investment and Leverage**

(Percent)

Corporate debt to GDP

Employment fall in response to 10 percent decline in sales

Investment fall in response to 10 percent decline in sales
2. Real Impact of Deleveraging: ...but Needed for Investment Recovery

**CEE: Profitability and Investment**
*(12-month growth rate, percent)*

Note: Data points are quarterly, weighted-averages for CEE EU countries.
3. Remaining Weaknesses and Credit Gaps: Corporate Debt Risk Exposures

**Liquidity Risk – Debt-to-Income**  
*(Percent, aggregate sectoral accounts data)*

- Slovenia
- Bulgaria
- Estonia
- Hungary
- Latvia
- Romania
- Slovak Republic
- Czech Republic
- Poland
- Lithuania

**Solvency Risk – Debt-to-Equity**  
*(Percent, aggregate sectoral accounts data)*

- Latvia
- Croatia
- Bulgaria
- Slovenia
- Hungary
- Slovak Republic
- Romania
- Poland
- Estonia
- Czech Republic
- Lithuania

Note: Data are net of intercompany loans and cross-equity holdings among domestic firms. Thresholds are the cut-off points of the top quartile of the EU-wide distribution of the indicators over 1995-2007.
3. Remaining Weaknesses and Credit Gaps: Corporate Debt Risk Exposures (2)

**Liquidity Risk** – Debt-to-Income (Percent, weighted-average of firm-level data)

- Croatia
- Ukraine
- Slovenia
- Serbia
- Estonia
- Latvia
- Slovak Republic
- Russia
- Lithuania
- Turkey
- Romania
- Bulgaria
- Poland
- Hungary
- Czech Republic

**Solvency Risk** – Debt-to-Equity (Percent, weighted-average of firm-level data)

- Latvia
- Croatia
- Ukraine
- Slovenia
- Russia
- Estonia
- Turkey
- Bulgaria
- Lithuania
- Romania
- Slovak Republic
- Poland
- Serbia
- Hungary
- Czech Republic

Note: Data includes intercompany loans and cross-equity holdings among domestic firms. Thresholds are the average values of indicators across sample countries in 2013.
3. Remaining Weaknesses and Credit Gaps: Corporate Debt Risk Exposures (3)

Note: (*) based fully or in part on firm-level data.
3. Remaining Weaknesses and Credit Gaps: Corporate Debt-at-Risk

**Liquidity Risk – Debt-to-Income (Percent)**

Corporate debt-to-GDP, of which
- Weak firms (debt-to-earnings > 8 or negative)
- Viable firms
- No firm-level data available

**Solvency Risk – Debt-to-Equity (Percent)**

Corporate debt-to-GDP, of which
- Weak firms (debt-to-equity > 5 or negative)
- Viable firms
- No firm-level data available
3. Remaining Weaknesses and Credit Gaps: Credit Gaps in 2013

Estimated Credit Gaps, 2013

- Level: below model benchmark
  Growth: higher than model benchmark

- Level: above model benchmark
  Growth: higher than model benchmark

2013 gap between actual and long-run fundamentals-consistent values of private debt (% of GDP)
3. Remaining Weaknesses and Credit Gaps:
Credit Gaps in 2020

2013 Credit Gap as Ratio to GDP in 2020 (Percent)
4. Policies to Complete Repair: Fiscal Accommodation but Reduced Space

2008-13 Change in Public Debt
(Percentage points of GDP)

<table>
<thead>
<tr>
<th>Country</th>
<th>2008</th>
<th>2011</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>Belarus</td>
<td>-4.8</td>
<td>-4</td>
<td>0.1</td>
</tr>
<tr>
<td>Bosnia</td>
<td>-1.7</td>
<td>1.1</td>
<td>-0.5</td>
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<td>Bulgaria</td>
<td>-4.6</td>
<td>3.9</td>
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<tr>
<td>Croatia</td>
<td>-1.1</td>
<td>3.5</td>
<td>2.8</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>-0.8</td>
<td>2.2</td>
<td>-0.5</td>
</tr>
<tr>
<td>Croatia</td>
<td>-1</td>
<td>2.1</td>
<td>-0.8</td>
</tr>
<tr>
<td>Latvia</td>
<td>4.1</td>
<td>1.1</td>
<td>-0.5</td>
</tr>
<tr>
<td>Lithuania</td>
<td>2.7</td>
<td>3.1</td>
<td>-0.3</td>
</tr>
<tr>
<td>Macedonia</td>
<td>0.1</td>
<td>1.3</td>
<td>1.7</td>
</tr>
<tr>
<td>Poland</td>
<td>0.6</td>
<td>1.4</td>
<td>0.8</td>
</tr>
<tr>
<td>Romania</td>
<td>2.5</td>
<td>2</td>
<td>-0.3</td>
</tr>
<tr>
<td>Russia</td>
<td>-0.2</td>
<td>-0.5</td>
<td>1</td>
</tr>
<tr>
<td>Serbia</td>
<td>0.3</td>
<td>1.5</td>
<td>3.8</td>
</tr>
<tr>
<td>Slovak Republic</td>
<td>1.2</td>
<td>2.3</td>
<td>0.3</td>
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<td>Slovenia</td>
<td>-1.3</td>
<td>4.7</td>
<td>3.5</td>
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<tr>
<td>Turkey</td>
<td>-1.5</td>
<td>-2.2</td>
<td>-1.1</td>
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<tr>
<td>Ukraine</td>
<td>1.5</td>
<td>1.4</td>
<td>-1</td>
</tr>
</tbody>
</table>

Gap between Debt-Stabilizing and Actual Primary Balance
(Percent of GDP)
4. Policies to Complete Repair: Monetary Policy Key, but Options Limited

CESEE Exchange Rate Regimes

<table>
<thead>
<tr>
<th>Euro peggers</th>
<th>Euro area members</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bosnia and Herzegovina</td>
<td>Latvia</td>
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<tr>
<td>Bulgaria</td>
<td>Lithuania</td>
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<td>Croatia</td>
<td>Estonia</td>
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<tr>
<td>Kosovo</td>
<td>Slovak Republic</td>
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<tr>
<td>Macedonia, FYR</td>
<td>Slovenia</td>
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<tr>
<td>Montenegro, Rep. of</td>
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</tbody>
</table>

Other exchange rate regimes

| Albania                          | Romania          |
| Belus                            | Serbia           |
| Czech Republic                   | Ukraine          |
| Hungary                          | Russia           |
| Moldova                          | Turkey           |
| Poland                           |                  |

4. Policies to Complete Repair: Need Flexible Adjustment Mechanisms

Post-Crisis Deleveraging and Labor Market Flexibility

Post-crisis change in average private saving-investment balance (Percentage points of GDP)

Labor Market Regulations, 2012 (Index, 10 = least restrictive)
4. Policies to Complete Repair: Need to Clean up Bank Loan Portfolios

NPLs and Investment (Percent)

Private investment, 2014 (Percent of GDP)

Share of non-performing in total bank loans, 2013 (Percent)
4. Policies to Complete Repair: Need Effective Legal Frameworks

Country Ranks on Enforcing Contracts and Resolving Insolvency

Country Rank on Enforcing Contracts (1 = best practice)

Country Rank on Resolving Insolvency, 2015
(1 = best practice)
## 4. Policies to Support Repair and Growth

Unfinished Structural Reform Agenda

### CESEE: Structural Reforms Relative to OECD Countries

<table>
<thead>
<tr>
<th>Category</th>
<th>Baltics</th>
<th>CEE</th>
<th>SEE</th>
<th>CIS</th>
<th>Turkey</th>
<th>EU15</th>
</tr>
</thead>
<tbody>
<tr>
<td>Institutions and contracts</td>
<td></td>
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<td></td>
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<tr>
<td>Infrastructure</td>
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<tr>
<td>Human capital</td>
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<td>Labor market efficiency</td>
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<tr>
<td>Business regulation</td>
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<tr>
<td>Openness to trade and FDI</td>
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<tr>
<td>Credit market rigidity</td>
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<tr>
<td>Innovation</td>
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</tbody>
</table>

Note: Red - value in the 25th percentile; Yellow - value in the 50th and 75th percentile. The sample includes all OECD and CESEE countries.
Conclusions and Policy Messages

Growth disparities across CESEE due to

- Differential impact of external shocks
- Incomplete balance-sheet repair and structural weaknesses (in some SEE and CIS)

Policy response

- Mind the credit gaps and use monetary and fiscal space to support recovery and balance sheet repair
- Institutional reforms
  - Address high NPLs
  - Upgrade legal frameworks
  - Complete structural reform agenda
THANK YOU!
Growth divergent across the region

### CESEE: Outlook for Real GDP Growth

<table>
<thead>
<tr>
<th>Region</th>
<th>Projection</th>
<th>2014</th>
<th>2015</th>
<th>2016</th>
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</thead>
<tbody>
<tr>
<td>CESEE&lt;sup&gt;1&lt;/sup&gt;</td>
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<td>1.4</td>
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<td>Baltics&lt;sup&gt;1,2&lt;/sup&gt;</td>
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<td>2.6</td>
<td>3.3</td>
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<tr>
<td>Central and Eastern Europe&lt;sup&gt;1,3&lt;/sup&gt;</td>
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<td>1.7</td>
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<td>Other CIS&lt;sup&gt;1,5&lt;/sup&gt;</td>
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<td>Russia</td>
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<td>2.9</td>
<td>3.1</td>
<td>3.6</td>
</tr>
</tbody>
</table>

Note: 1 Weighted average. Weighted by GDP valued at purchasing power parity. 2 Estonia, Latvia, and Lithuania; 3 Czech Republic, Hungary, Poland, Slovak Republic, and Slovenia; 4 Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Kosovo, Macedonia FYR, Montenegro, Romania, and Serbia; 5 Belarus, Moldova, and Ukraine. Source: IMF World Economic Outlook database.
In 2014, investment made significant positive contribution to growth only in CEE

**CESEE: Contributions to Real GDP Growth in 2014**

*(Percent)*

**Sources:** Haver Analytics; and IMF staff calculations.
Credit Gaps in 2013

2013 gap between actual and fundamentals-consistent values of private debt (% of GDP)

Notes: Data for Bulgaria and Poland are for the 2012 gap and for Romania—for 2011, due to missing data.