Economic Trends and Challenges in New Member States

Christoph Rosenberg
International Monetary Fund

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Note: These are the author's own views, not necessarily those of the IMF. Some of the data presented need to be confirmed with country authorities

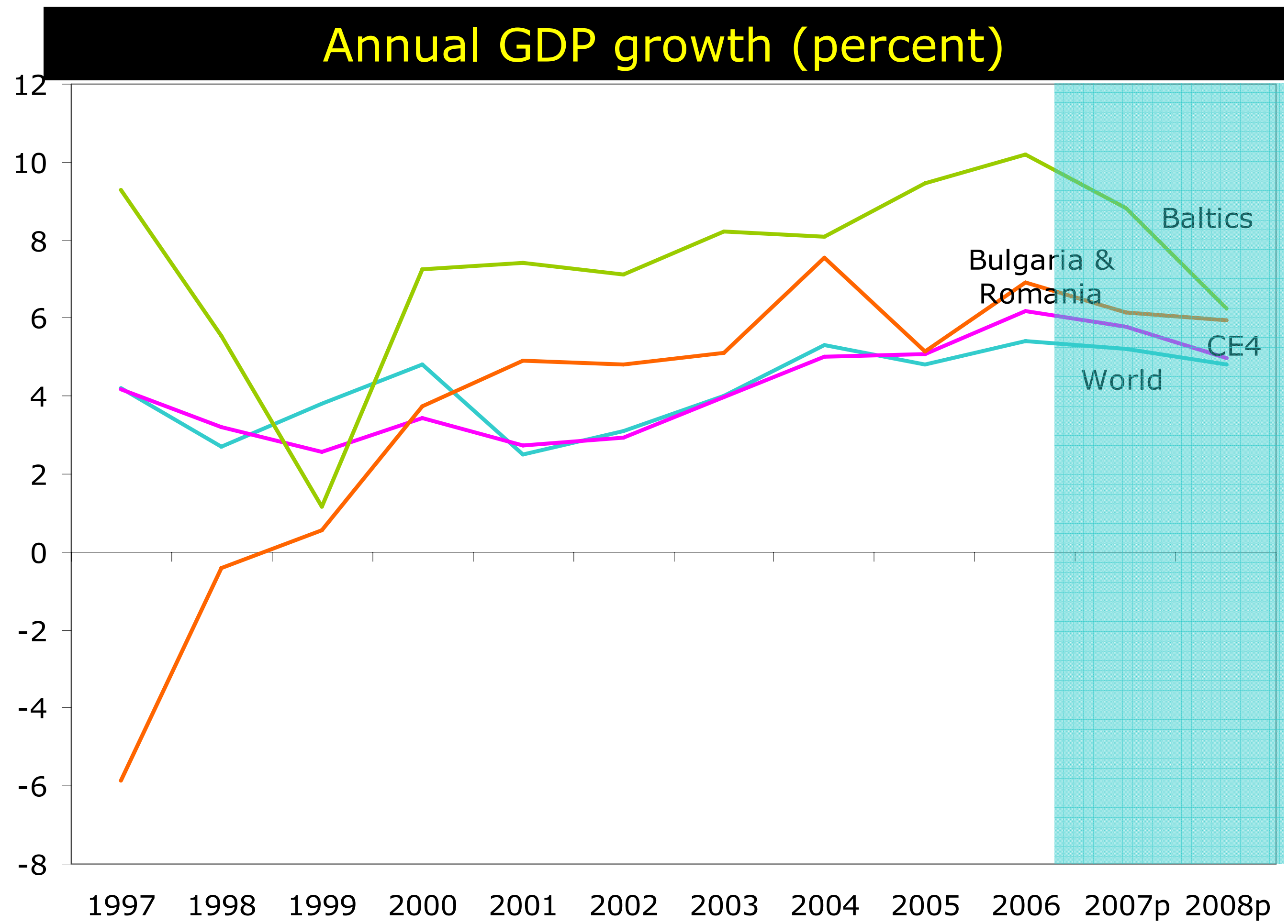
Overview

- The overall macro picture: better than ever
- But underlying this are challenges in the run-up to Euro adoption
  - Fiscal adjustment
  - Credit growth and currency mismatches
  - External imbalances
  - Creating flexible economies
- Policy Conclusions

The overall macro picture:

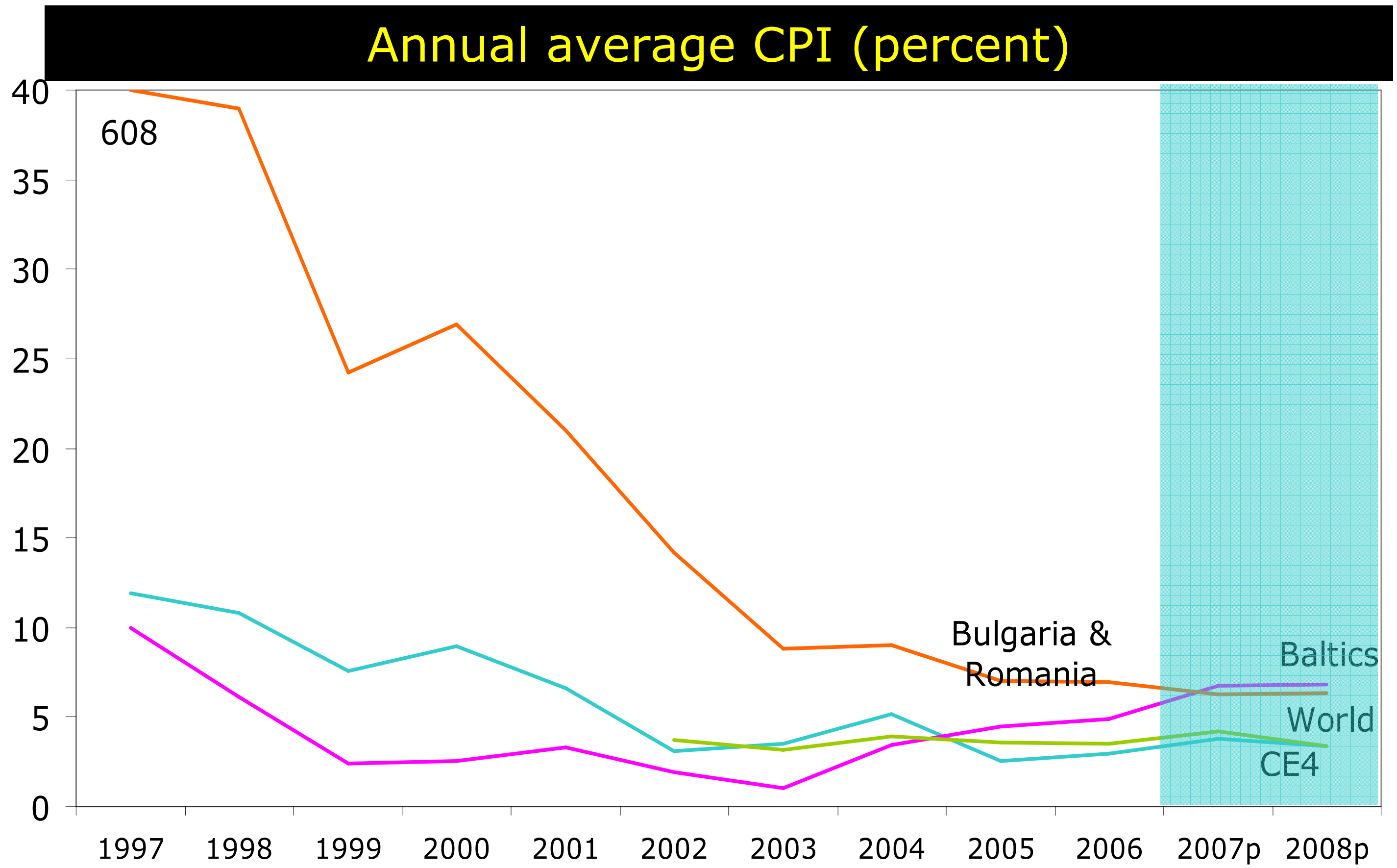
better than ever

Growth performance is still good, driven by EU accession and still solid global growth.



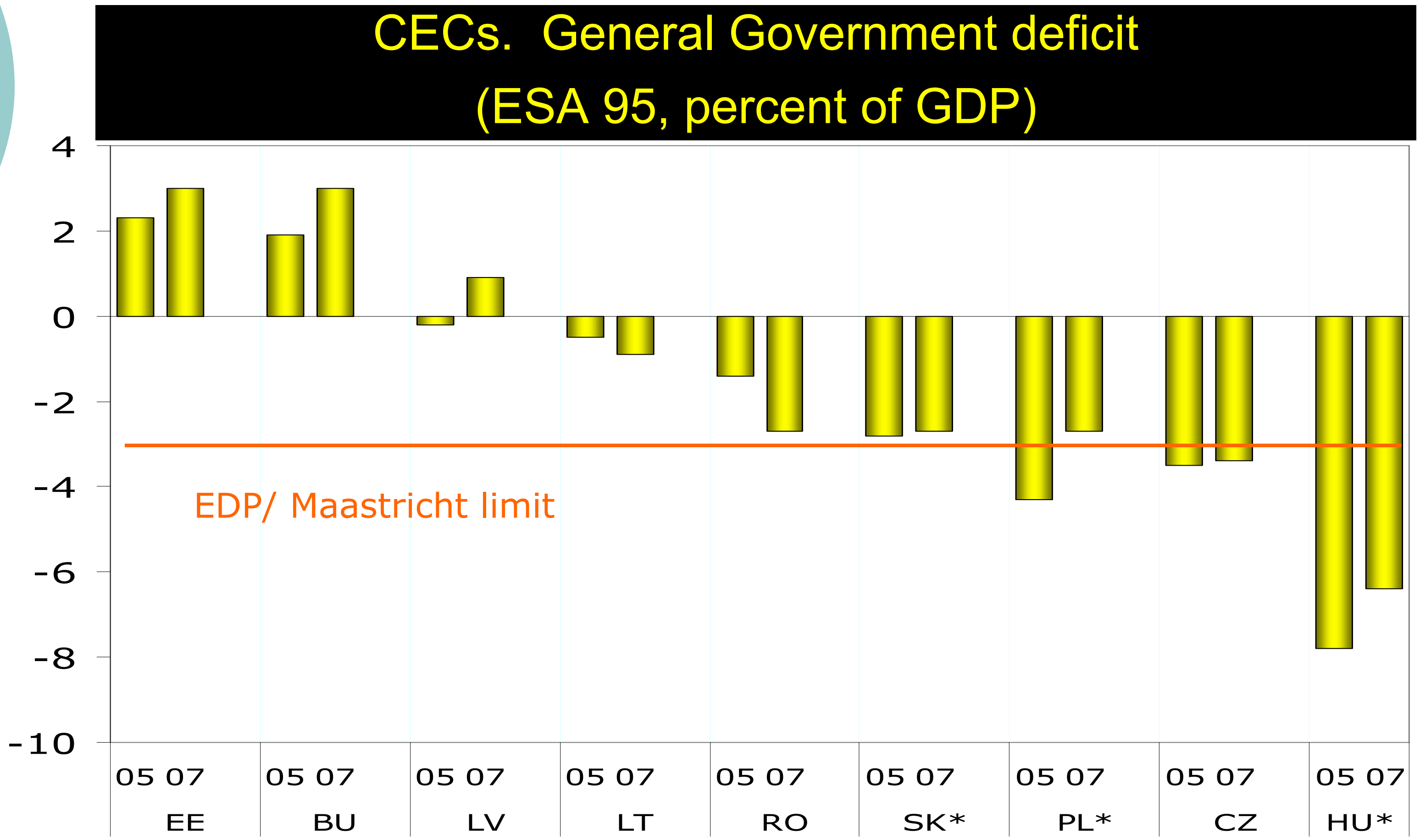
Source: WEO October 2007.

Inflation is relatively subdued, except in the fixed exchange rate countries.



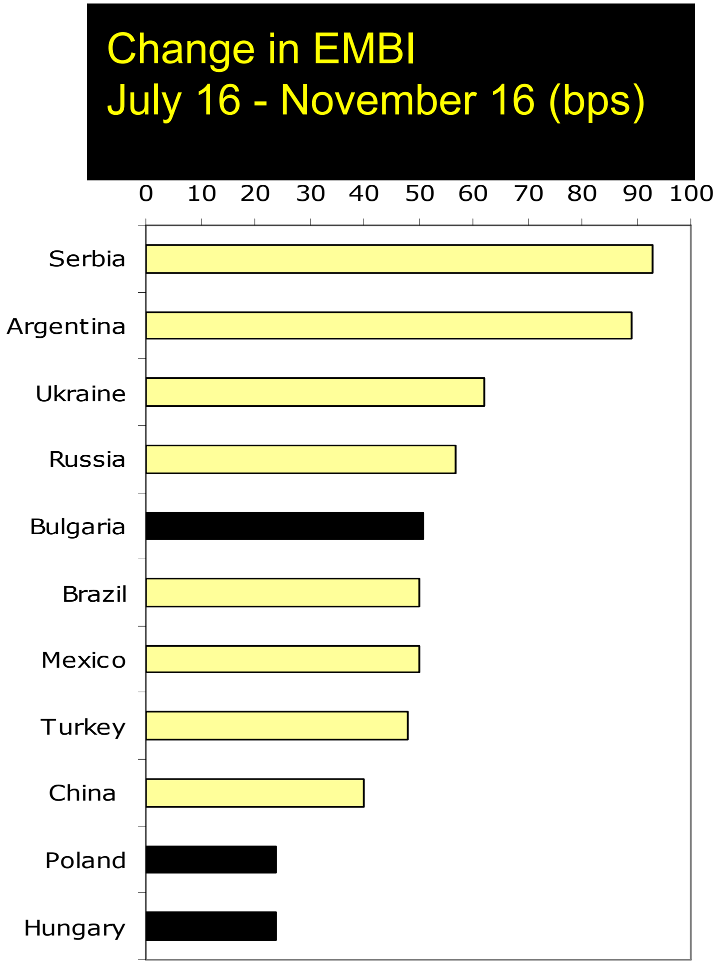
Source: WEO October 2007.

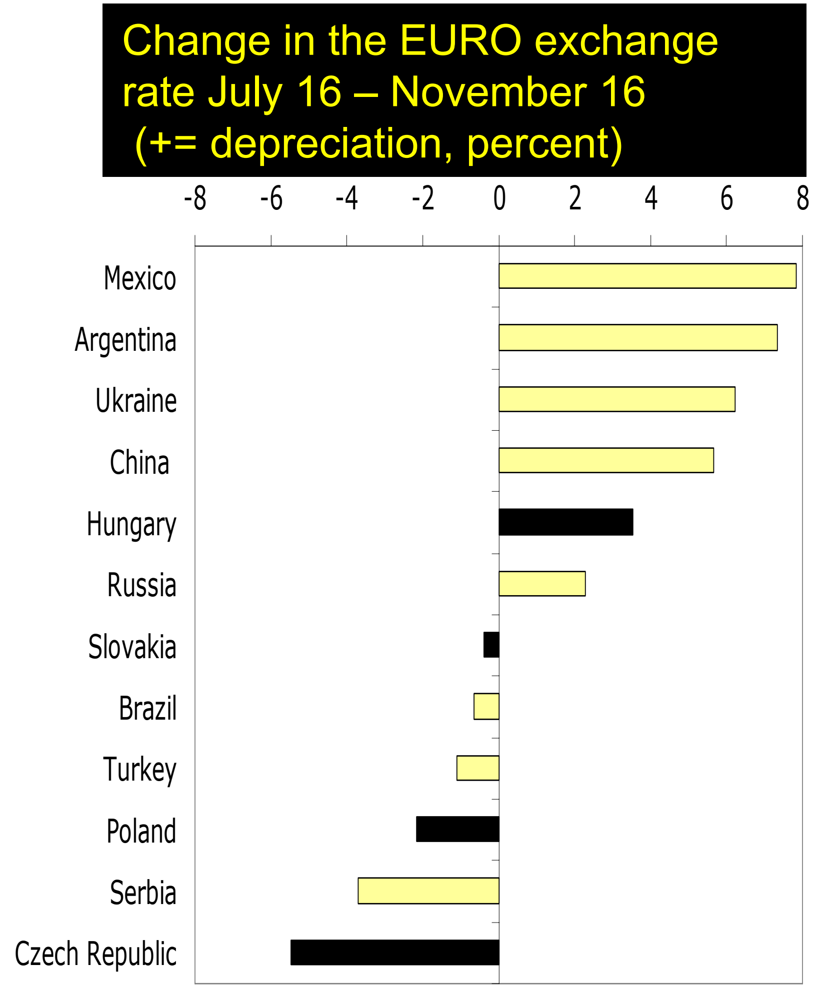
Even headline fiscal deficits are not looking so bad (except Hungary).



* incl. pension reform costs
Source: Eurostat, EC Autumn Forecast 2007

The NMSs have weathered the subprime market fallout better that other EMs





Source: IMF GMM, national statistics.

…although downside risks have increased:

- Sharper than expected squeeze on credit
- Increased risk premia, especially in countries with large imbalances
- Lower FDI from US and Western Europe
- Lower exports to US and Western Europe

Nevertheless we worry
in some countries about
increasing vulnerabilities
in the run-up to euro adoption.

Macro Vulnerabilities

External imbalances are growing, especially in the Baltics

Key Macro Indicators 2006 (in percent of GDP)

	CE4	Baltics	Romania & Bulgaria	EM countries*	Asia 1997**
General government deficit	-5.3	0.2	1.0	1.1	-1.8
C/A balance	-5.2	-15.6	-13.1	2.7	-3.3
Gross external debt	57.7	89.8	57.4	51.9	66.5
Gross public debt	43.5	11.3	19.8	42.2	18.5
Reserves/ST debt	115.1	54.8	180.6	175.8	20.1
Credit growth (in percent)	8.4	37.6	22.8	2.5	13.9

* EM countries - Argentina,Brazil, Chile, China, Colombia, Indonesia, Peru, Russia, Singapore, Thailand, data for 2005.

** Korea, Indonesia, Thailand.

Source: IMF GFS, IMF IFS, IMF Article IV Consultations

Macro Vulnerabilities

... but this should not surprise in an environment of rapid growth and still-evolving institutions.

➔Policy dilemma: how to reduce vulnerabilities without impeding the convergence process?

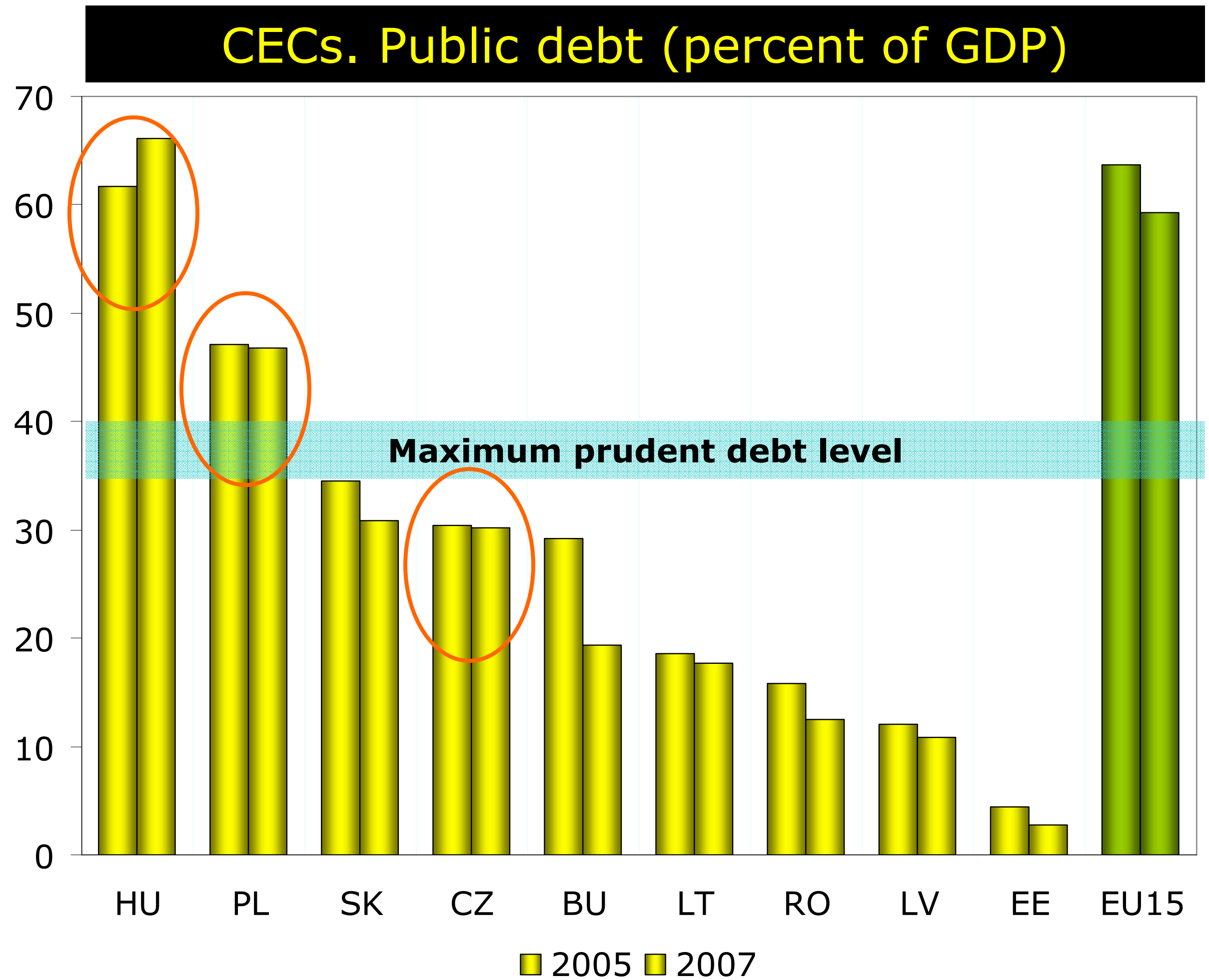
➔Analytical challenge: how to distinguish “natural” convergence from overheating

Main Concerns

- Lack of fiscal adjustment
- Credit growth and currency mismatches
- External imbalances and cross-border contagion risks

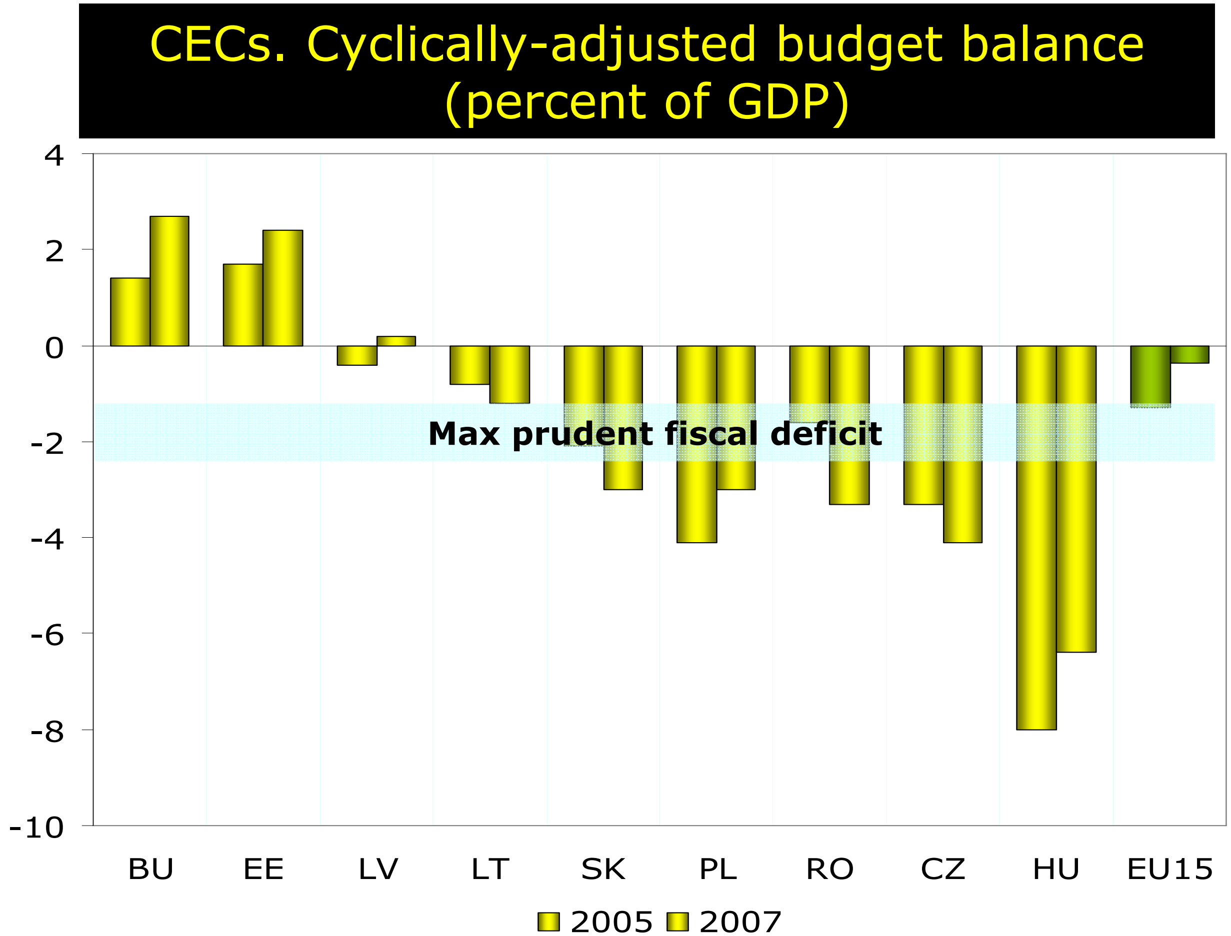
Lack of fiscal adjustment

Despite healthy growth, public debt ratios are not declining in key CECs.



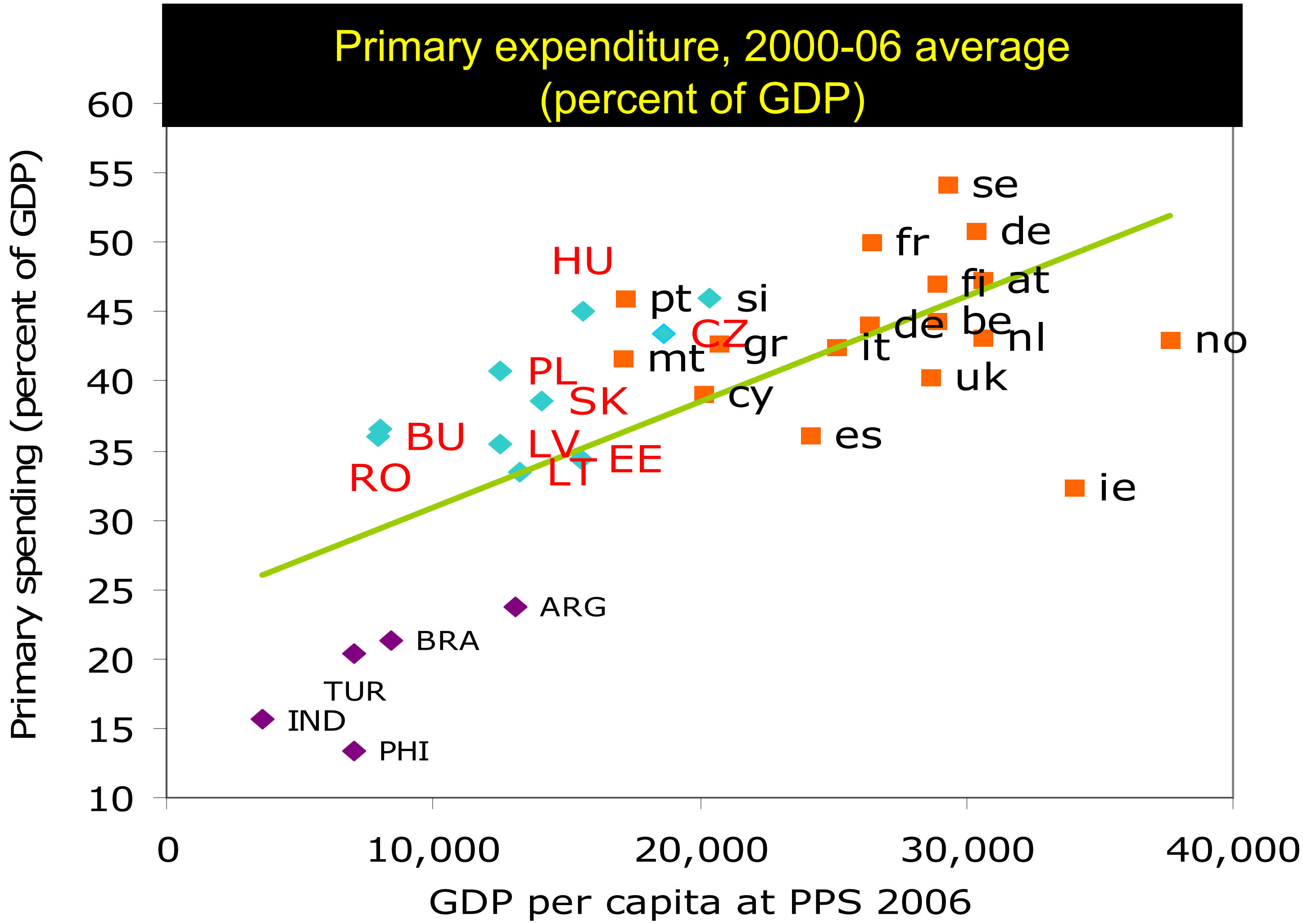
Source: EC Autumn Forecast 2007

Few countries have used the benign global environment and buoyant revenue to reduce deficits to prudent levels.



Source: EC Autumn Forecast 2007

Primary spending in the NMSs is high, suggesting that fiscal adjustments should start at the expenditure side.

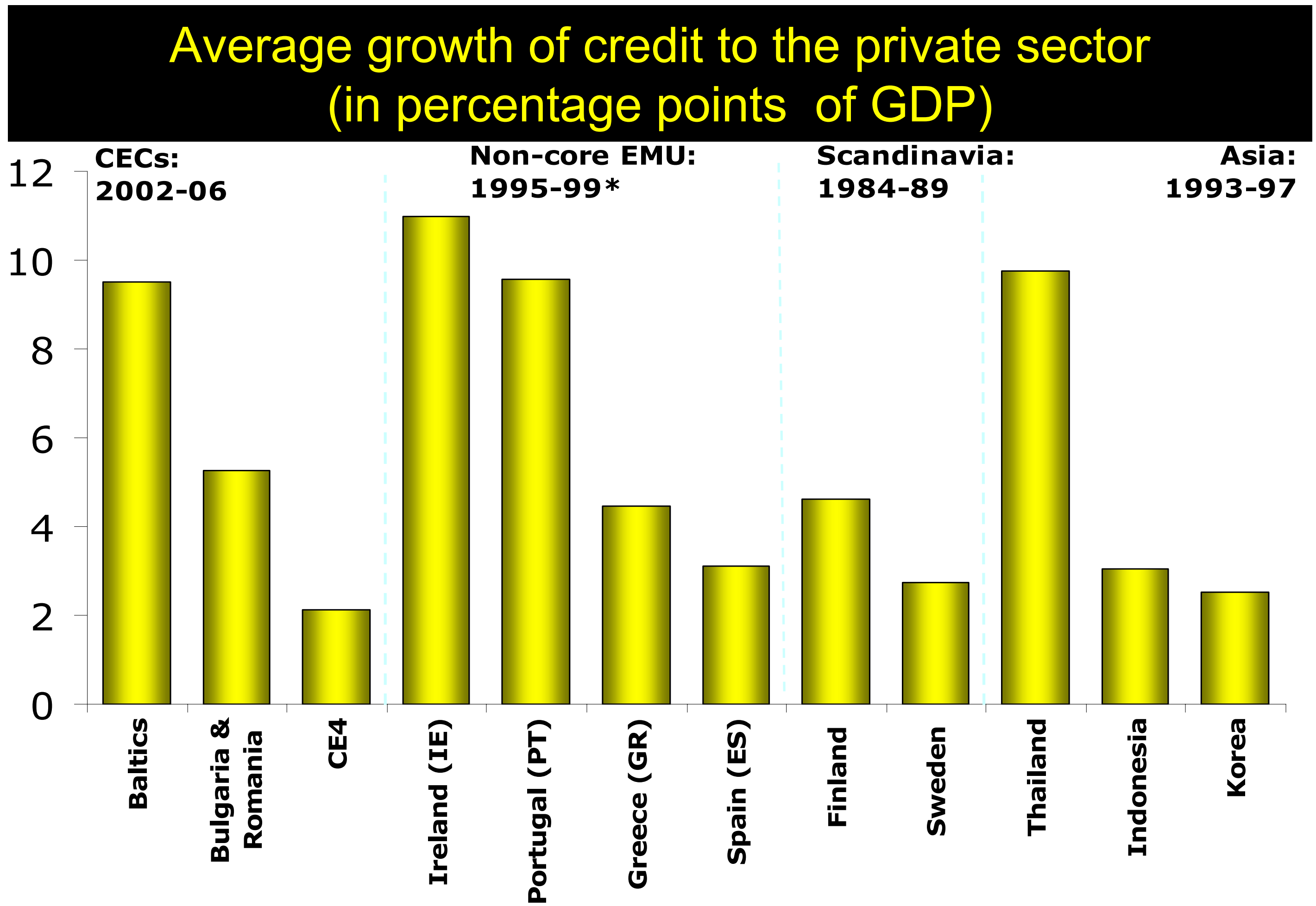


Source: AMECO.
Data for RO & BU for 2005.

Rapid growth of foreign exchange credit

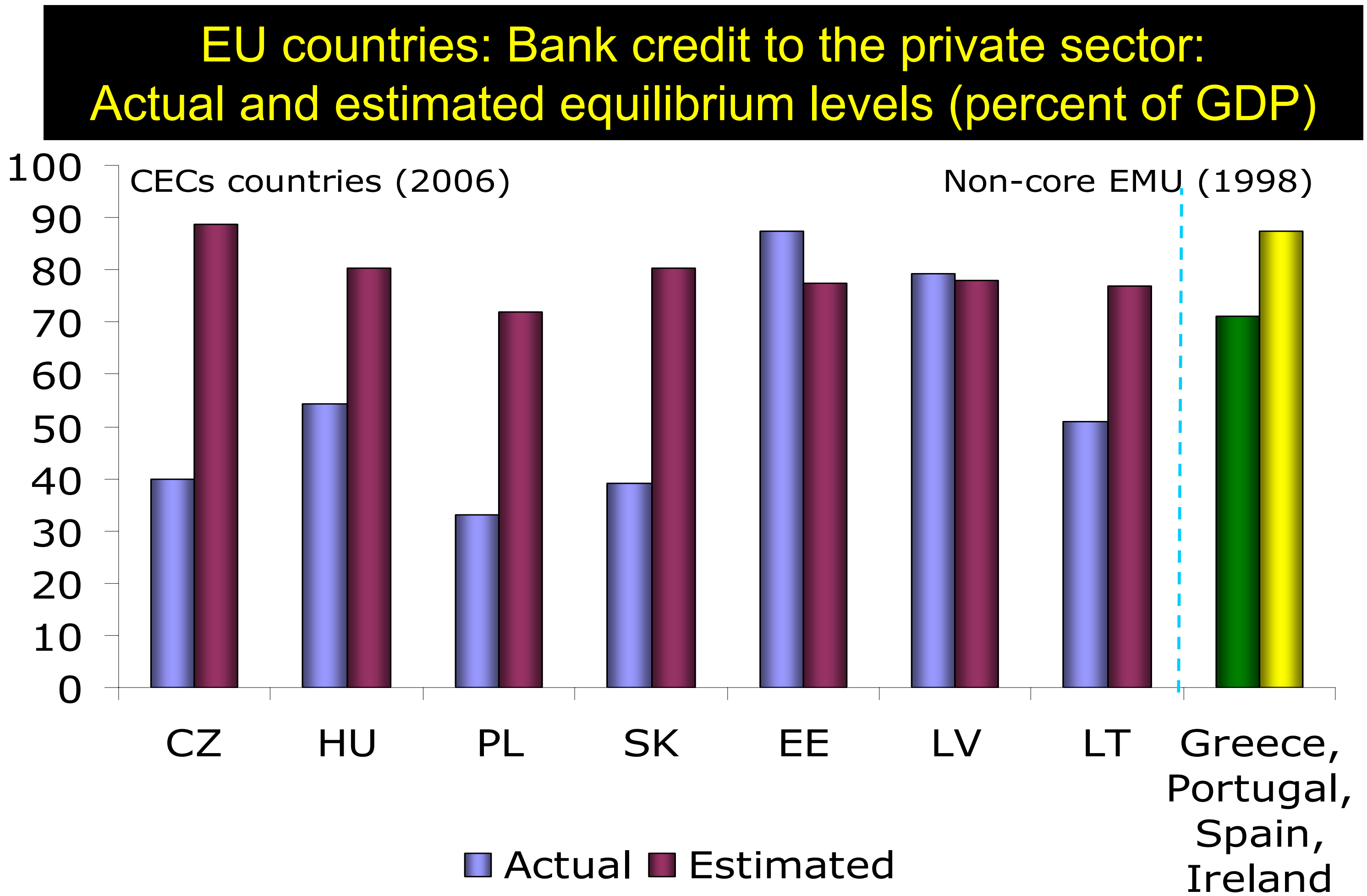
to the private sector

Credit growth has been brisk.



*Greece 1997-2000
Source: IFS, national authorities, IMF staff calculations

Private credit still has some room to grow, at least in Central Europe.

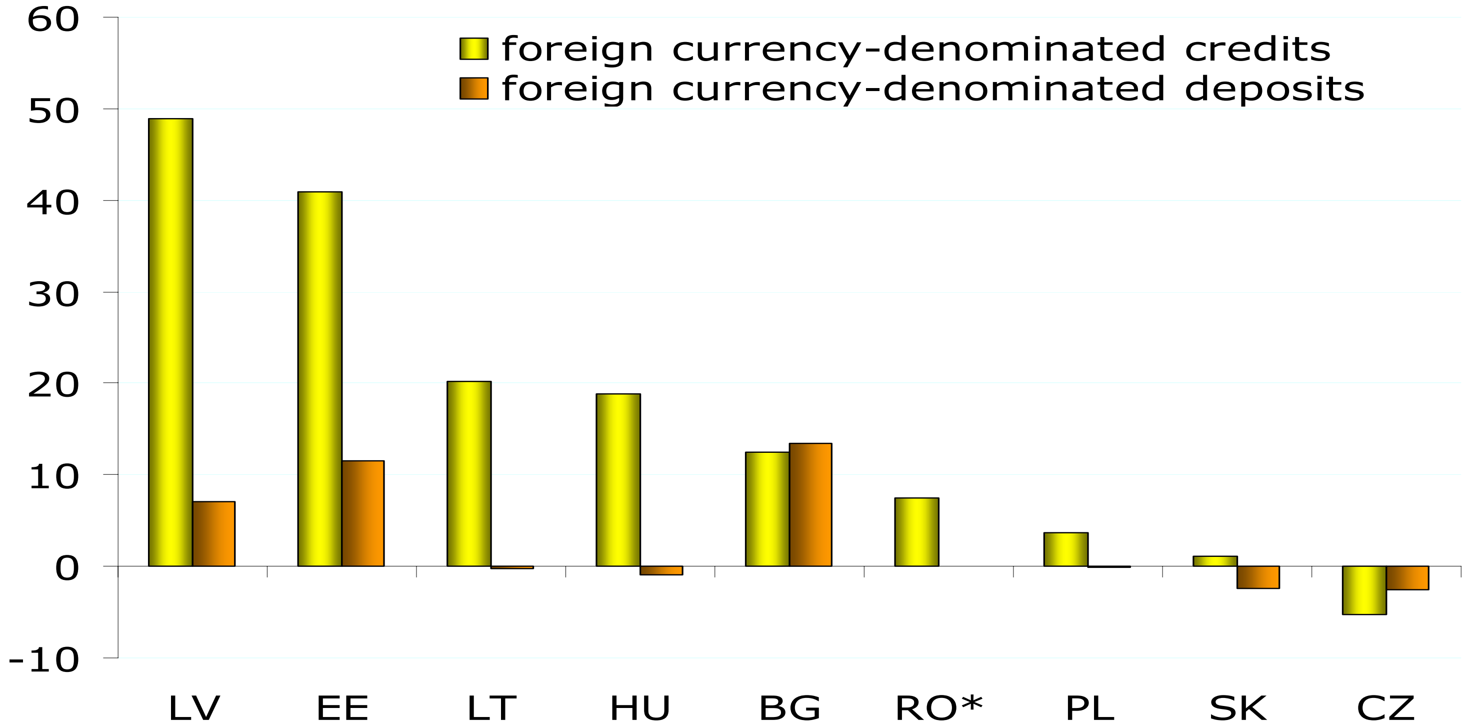


*Greece (Q1.1999)

Source: National authorities, calculations based on Schadler et al. (2005)

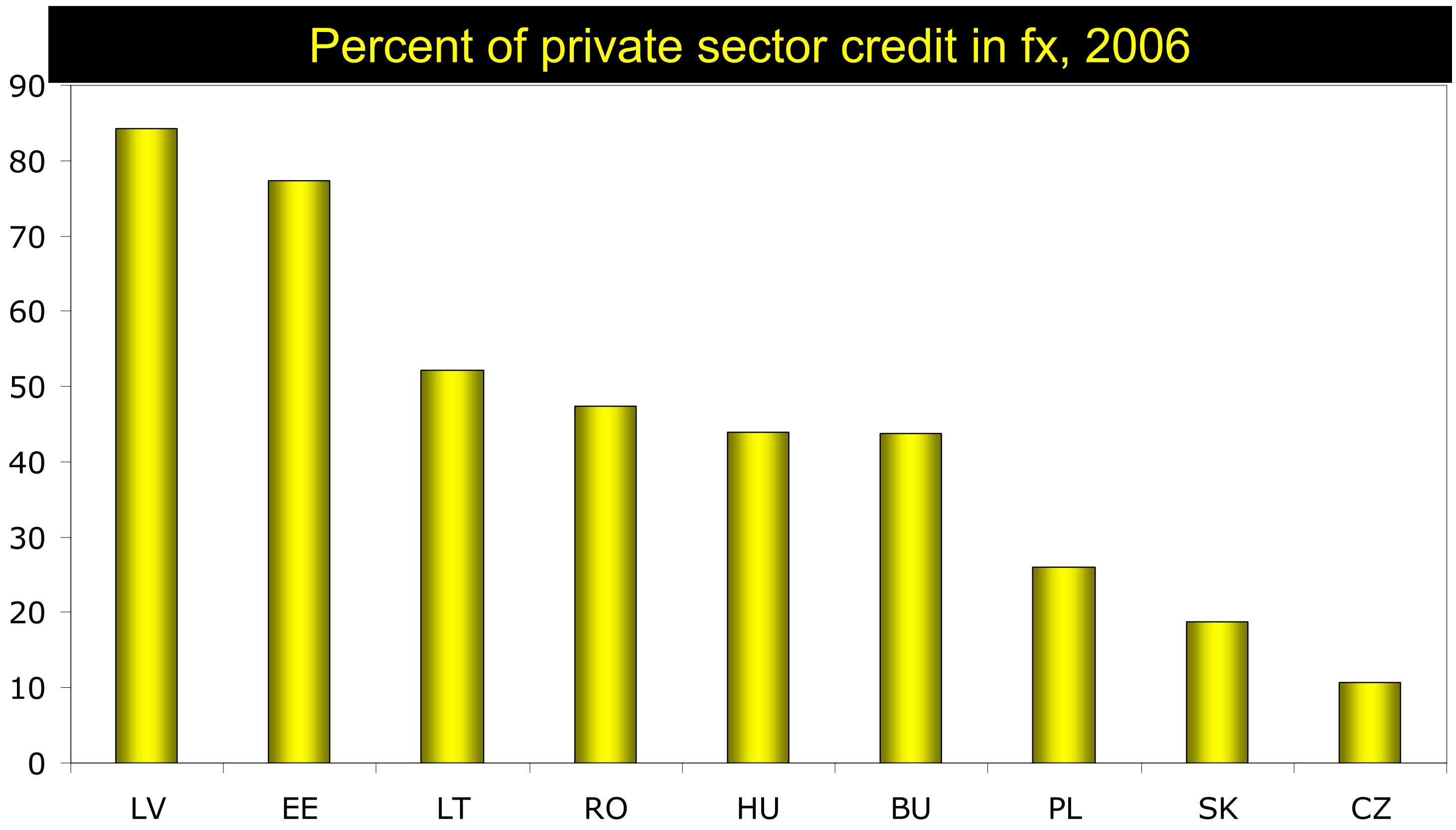
Banks' balanced position masks important shifts in the size and funding of their fx lending.

Change of foreign currency credits and deposits during 2001-06
(in percentage points of GDP)



Source: National authorities, IMF staff estimates
* Deposit data for Romania are not available.

Fx borrowing has become popular, especially in countries witch fixed exchange rates

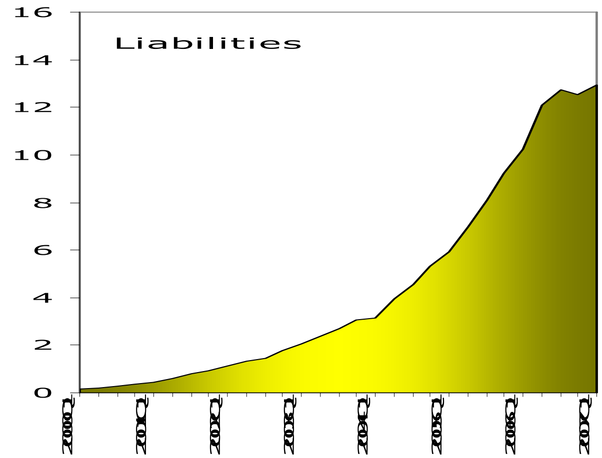


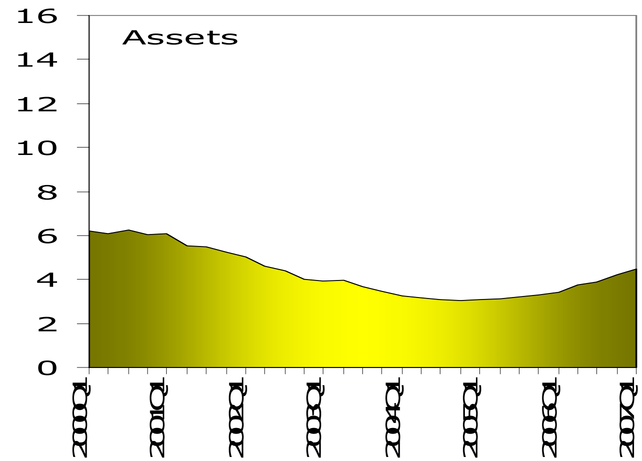
Source: National authorities.

Households in some countries are particularly exposed.

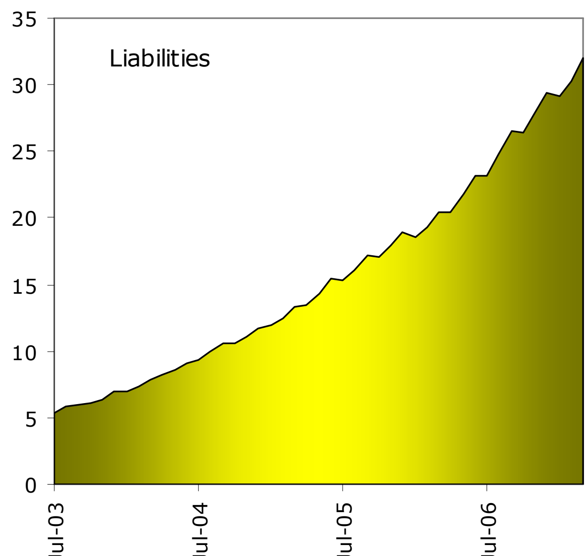
Households' net open fx position (percent of GDP)

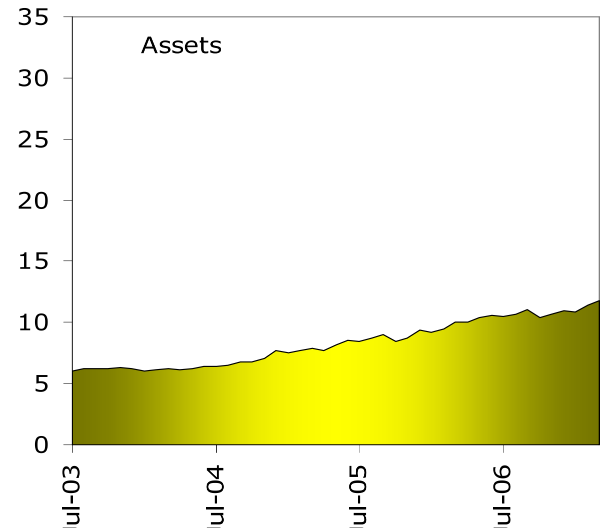
Hungary





Latvia

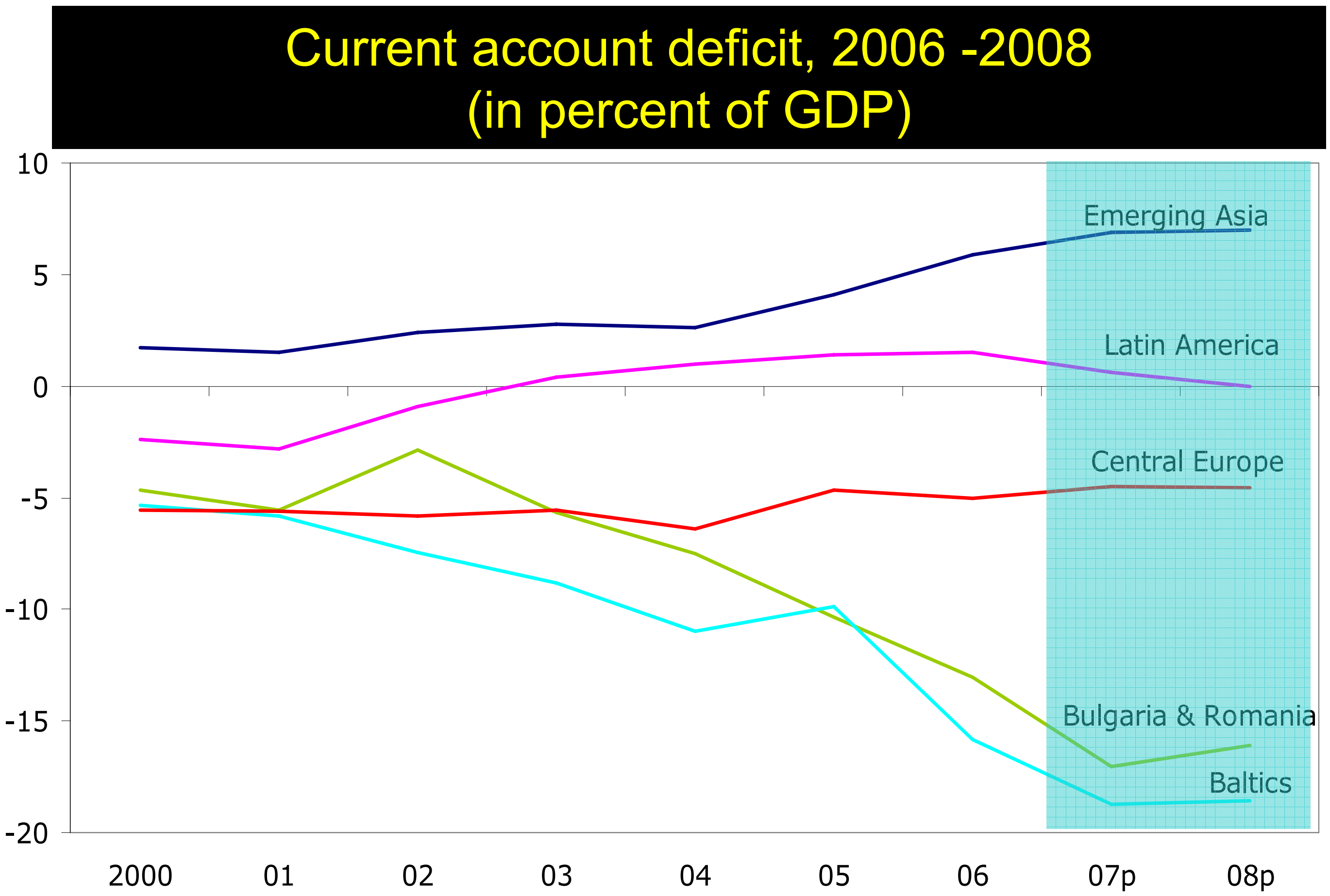




Source: MNB

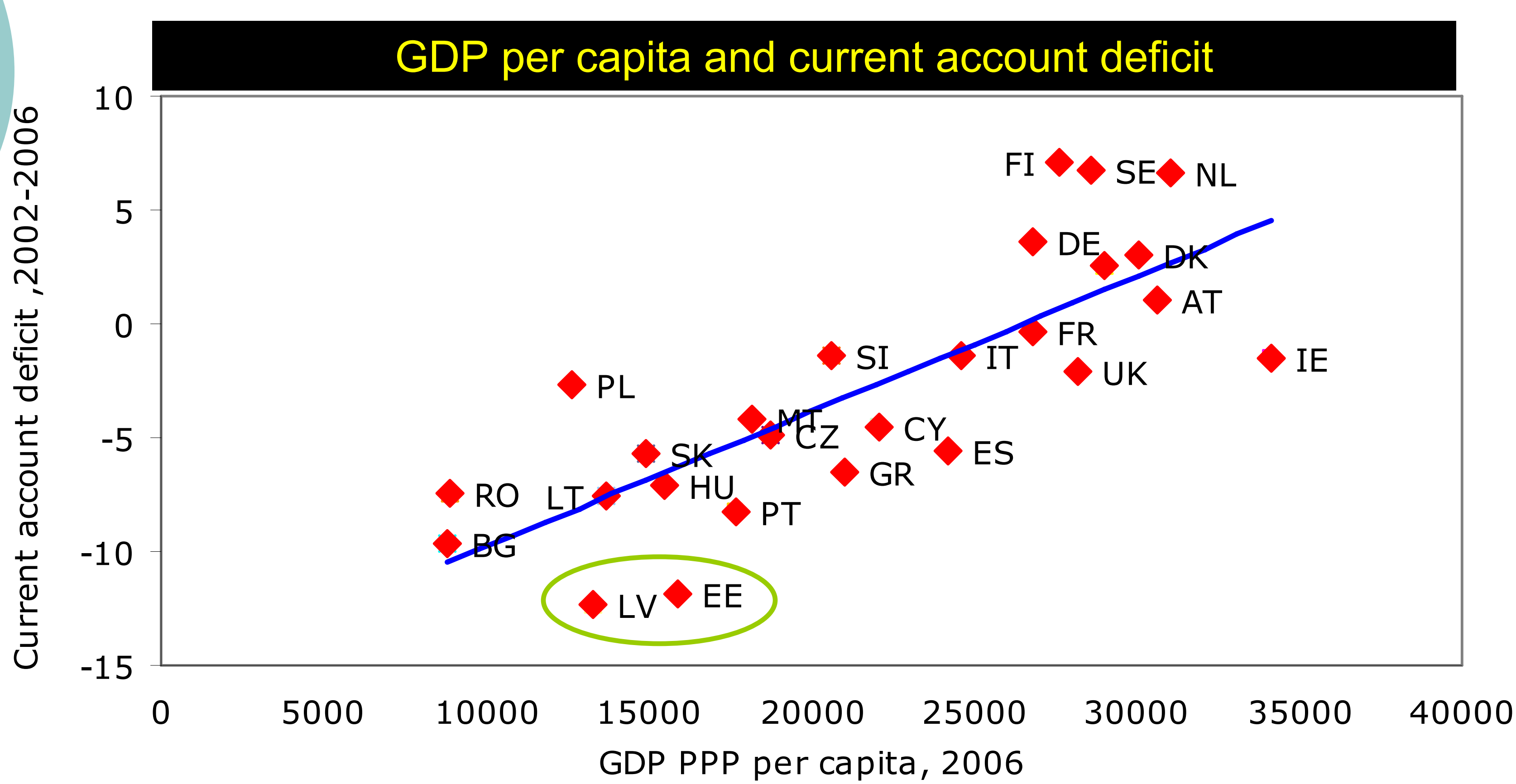
Large external stock and flow imbalances

Current account deficits are high, especially in the Baltics and South-Eastern Europe…



Source: IMF WEO October 2007.

… largely reflecting the convergence process.



Source: Eurostat, IFS and staff calculations.

Are large external imbalances a risk?

Optimists:

- The EU's "halo" effect
- Favorable structure of financing (EU funds, remittances, FDI, low portfolio inflows)
- Presence of large EU banks

Pessimists:

- Historical evidence of large capital inflows (October 2007 WEO)
- EU accession does not provide enough protection
- Debt financing is potentially vulnerable to sudden stops
- Foreign capital mainly goes to the non-tradable sector => capacity to repay
- Foreign banks create new vulnerabilities

Balance sheet exposures between banking systems warrant a cross-country perspective.

Bank's exposure in EM countries, 2007Q02
(as percent of total exposure)

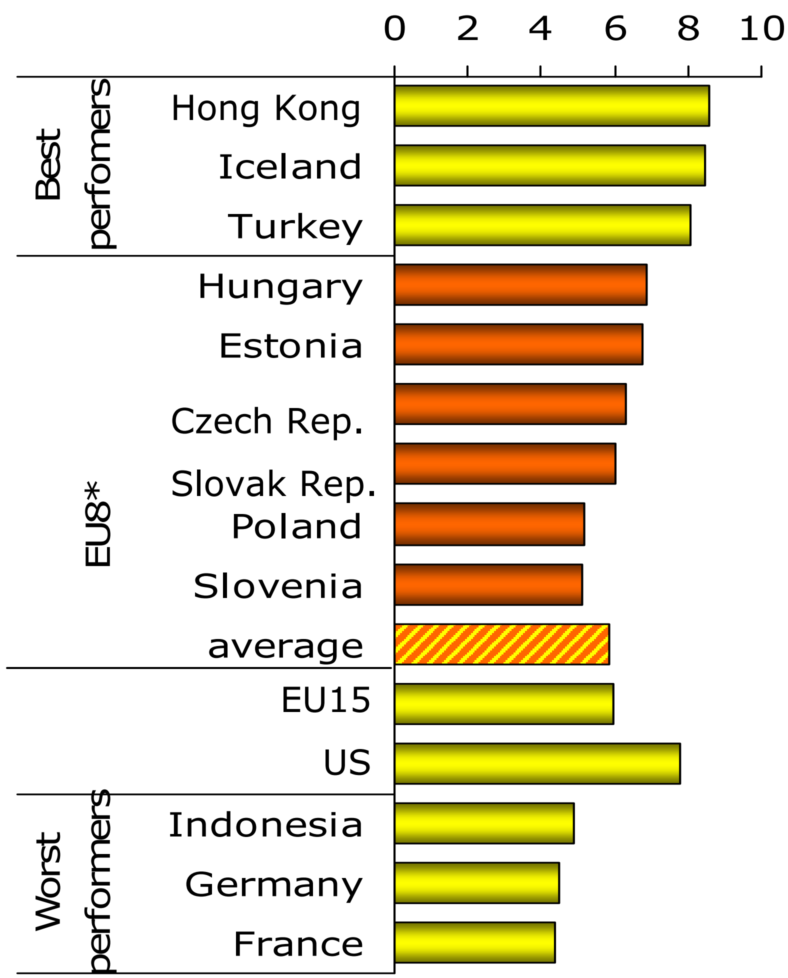
	Austria	Belgium	Sweden	Germany	France	Italy	Portugal	Finland
EU10	**34.7**	**5.6**	**10.3**	**2.6**	**1.9**	**11.4**	**6.6**	**9.9**
Bulgaria	0.9					0.5		
Czech Republic	**8.9**	**2.6**		0.2	**1.0**	0.6	0.1	
Estonia	0.1		**3.6**					**3.9**
Hungary	**6.2**	**1.2**	0.0	0.7	0.2	**2.6**	0.3	
Latvia	0.1		**3.3**	0.1				**2.6**
Lithuania	0.1		**2.9**	0.1				**3.2**
Poland	**2.8**	**1.0**	0.5	0.8	0.2	**4.8**	**6.2**	0.1
Romania	**8.7**			0.5	0.4	0.8		
Slovakia	**5.6**	0.6		0.1		**2.5**		
Slovenia	**2.2**	0.2		0.1	0.1	0.1		
Other EM Europe	14.6	1.0	0.4	1.7	1.2	7.0	1.0	0.5
Other EM	1.0	0.6	0.5	1.6	1.6	1.0	4.1	0.4
ROW	49.6	92.8	88.7	94.1	95.3	80.5	88.3	89.2

Source: BIS

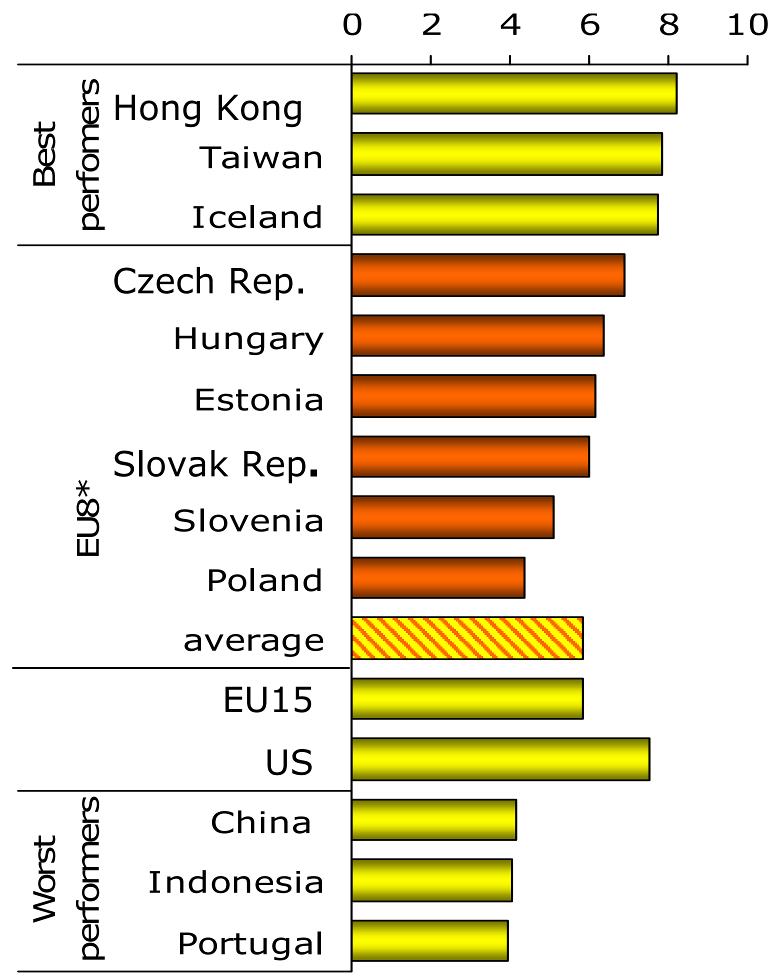
Creating flexible economies

A flexible business environment is essential for sustaining convergence and eventually doing well in the euro zone.

Flexibility and adaptability (0-10)

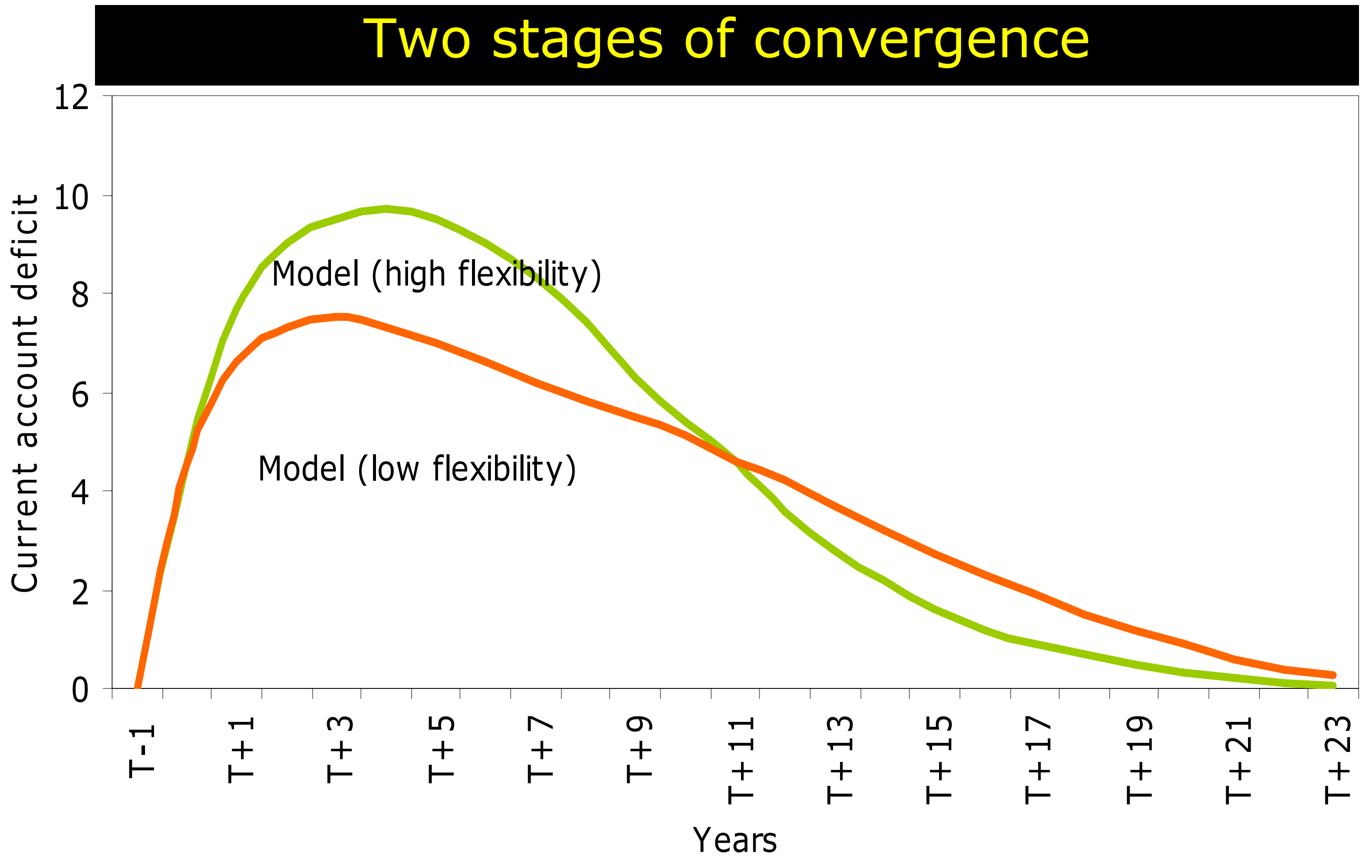


Adaptability of companies (0-10)



Source: IMD World Competitiveness
* Excluding Lithuania and Latvia

A flexible economy is key to increase the speed limit and to eventually reverse current account deficits



Source: IMF staff simulations.
For simulation details see R. Bems and P. Schellekens, Finance and Convergence: What's Ahead for Emerging Europe?, IMF WP 07/244.

Conclusion:
"Running with your shoelaces open"

- Headline numbers look good
- NMS have so far weathered the subprime market fallout well

But:

- Vulnerabilities are growing, especially in the Baltics
- Governments have made little use of the favorable environment

Policy challenges

- Cool off economies during a surge in capital inflows and rapid credit growth => tightening fiscal policies is often the only available tool
- In countries with flexible exchange rates, do not resist nominal appreciation (October 2007 WEO)
- Financial sector supervision, including of cross-border exposures
- Prepare for euro adoption by creating flexible economies and sound institutions

Thank you!

Christoph B. Rosenberg
Senior Regional Representative

International Monetary Fund
Regional Office for Central Europe and Baltics

Ul. Zielna 37C
0-108 Warszawa
Tel.: + 48 22 338 67 00
E-mail: cee-office@imf.org
Visit our website at: www.imf.org/cee