



Economic Trends and Challenges in New Member States

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Reuters Central European Investment Summit

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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



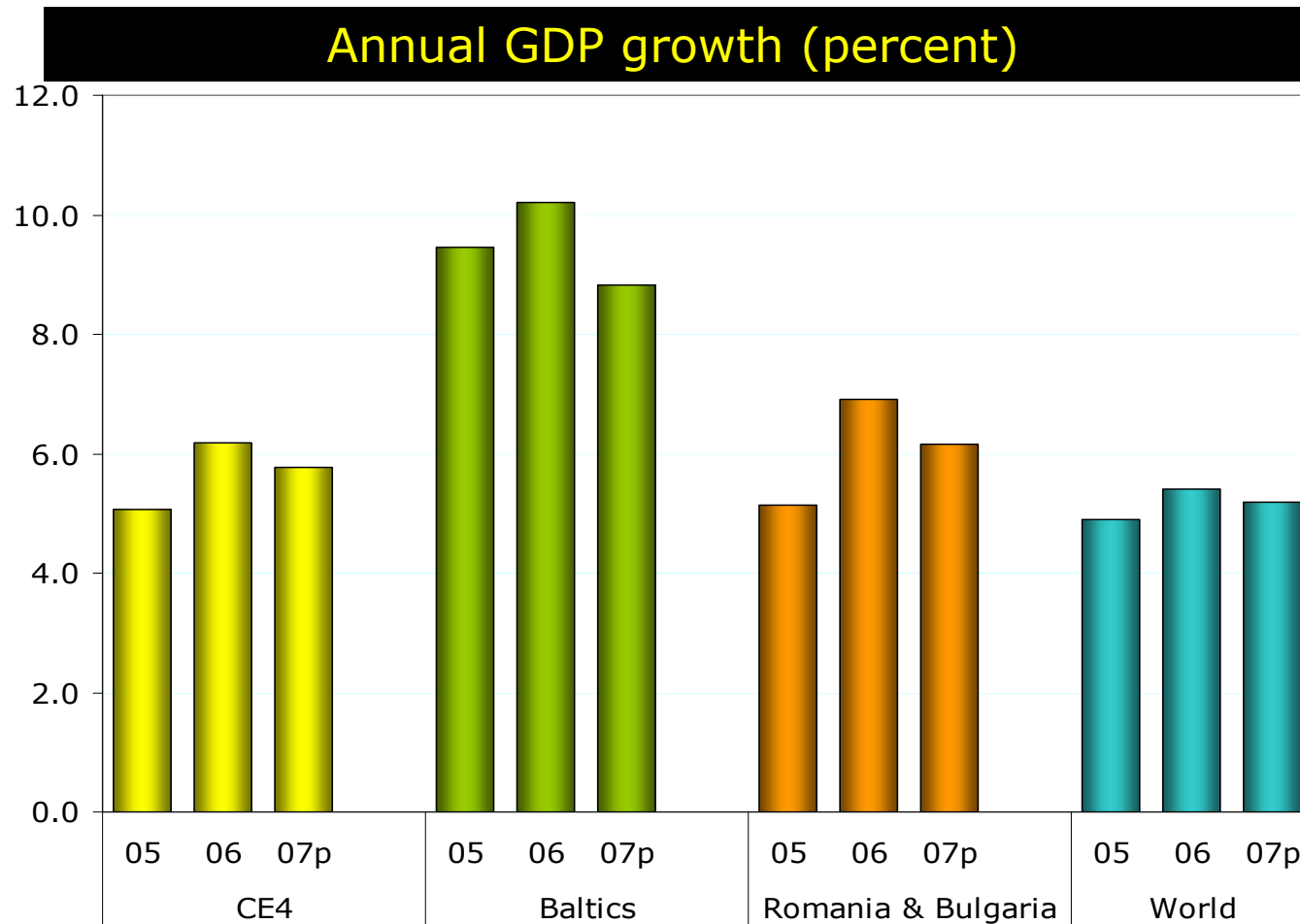
Overview

- 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
- Outlook: The subprime crisis fallout - the dog that didn't bark
- Policy Conclusions



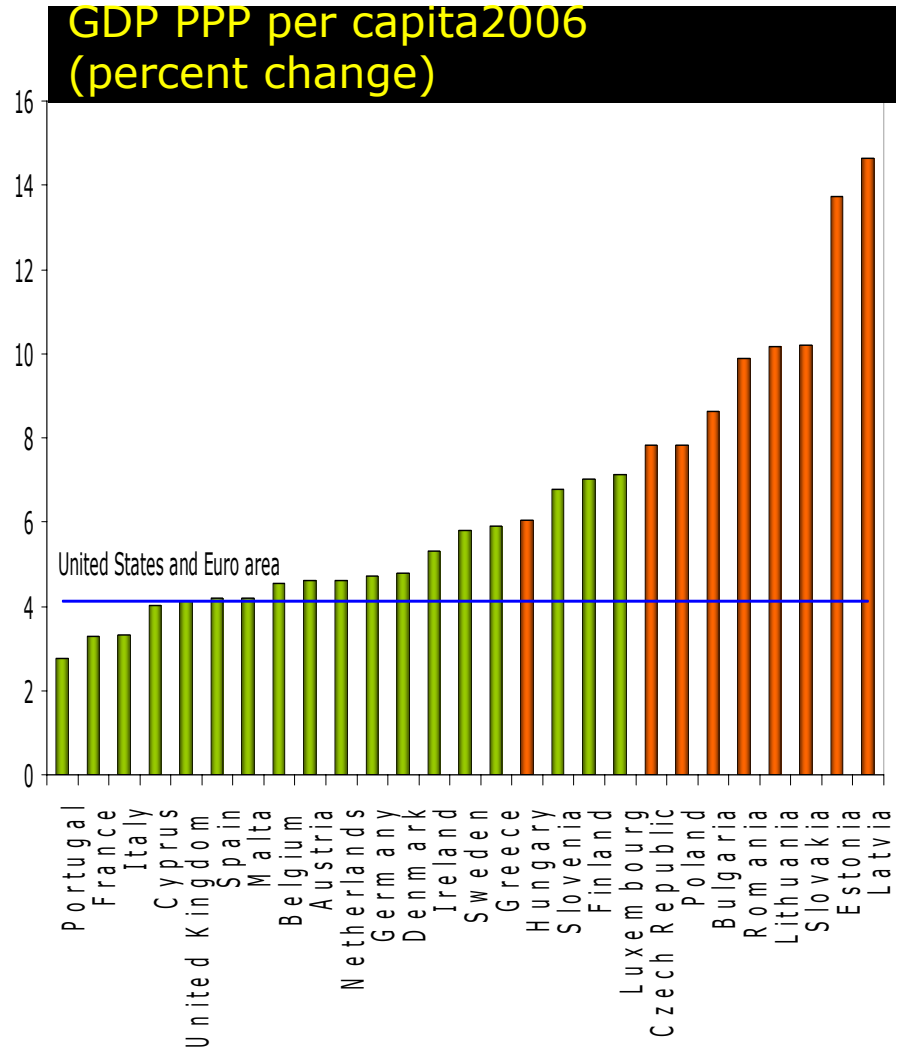
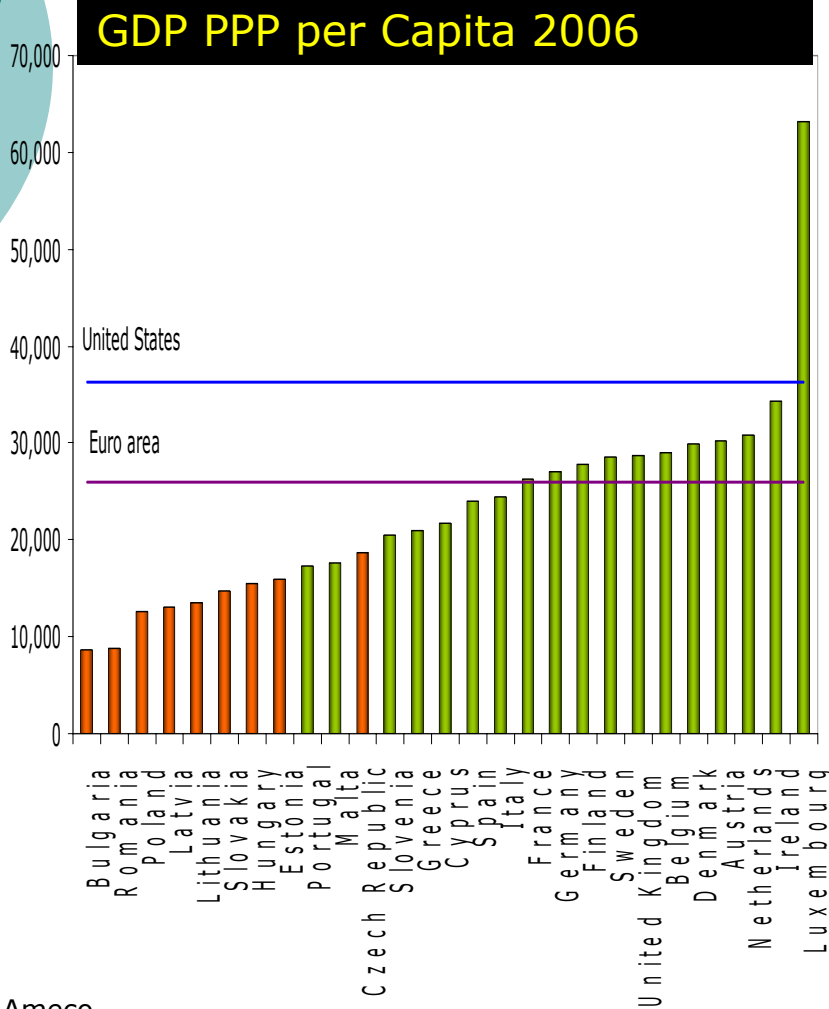
The overall macro
picture:
better than ever

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



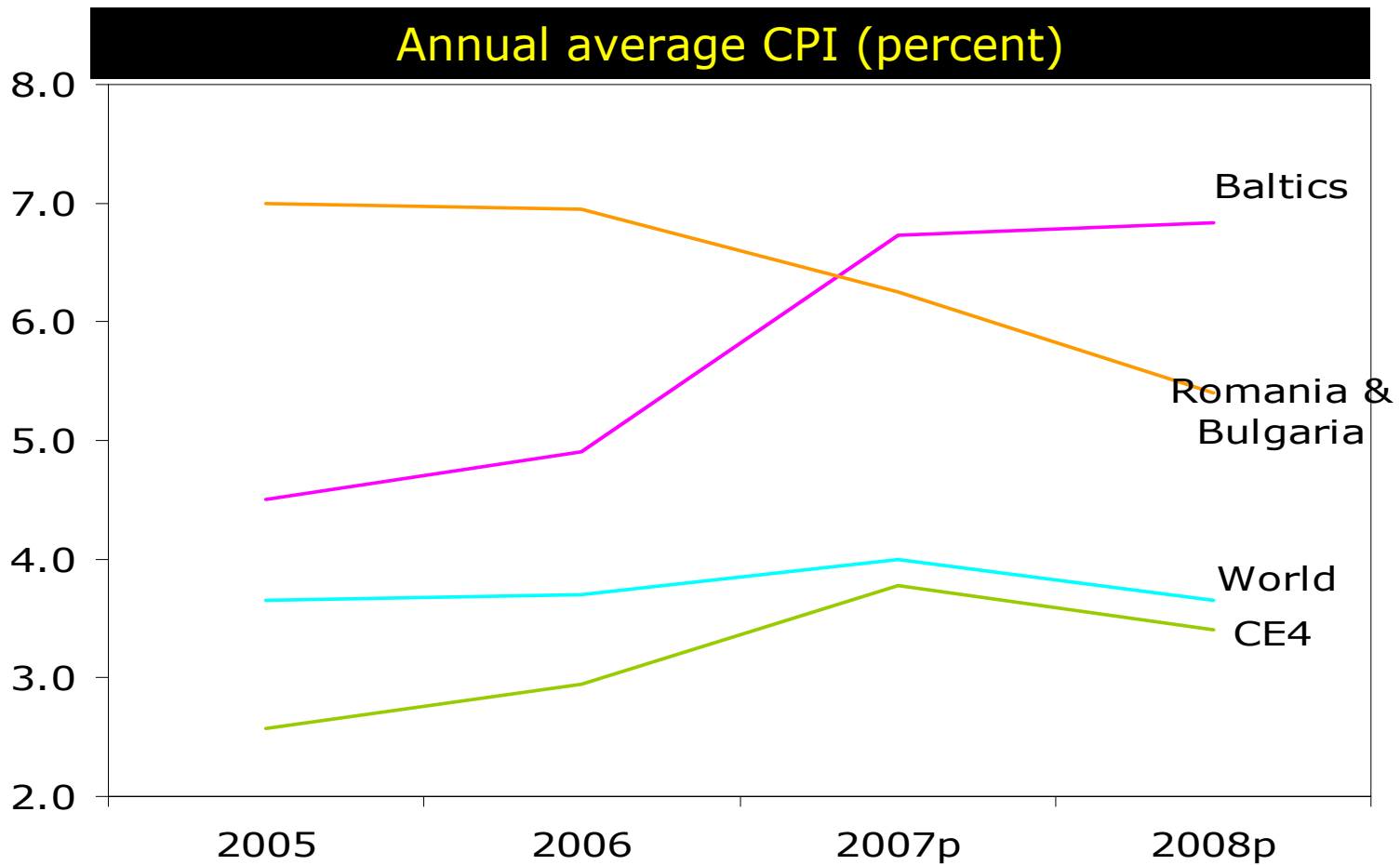
Source: WEO October 2007.

As a result, the new member states (NMS) are catching up quickly.



Source: Ameco.

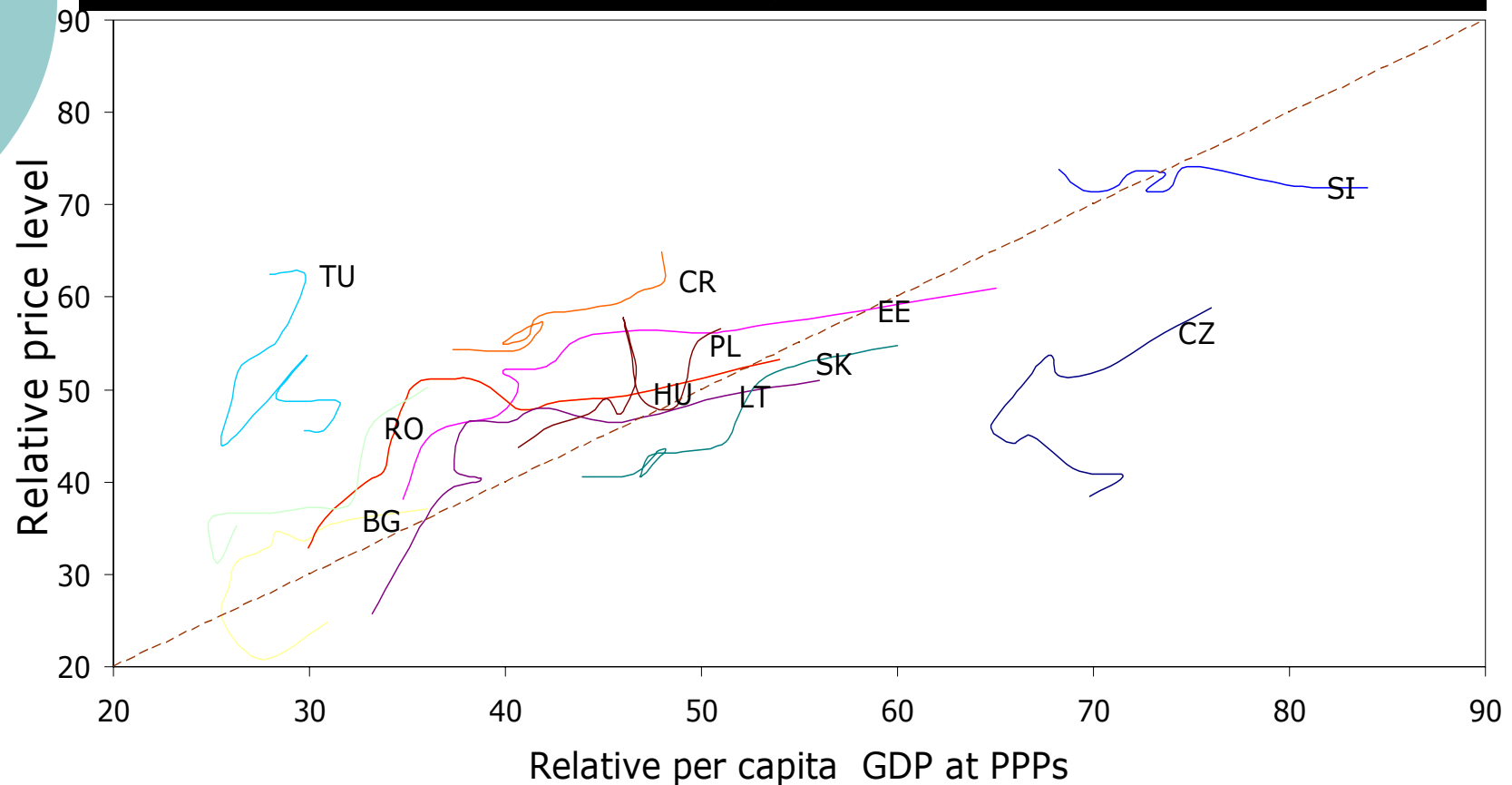
Inflation is relatively subdued...



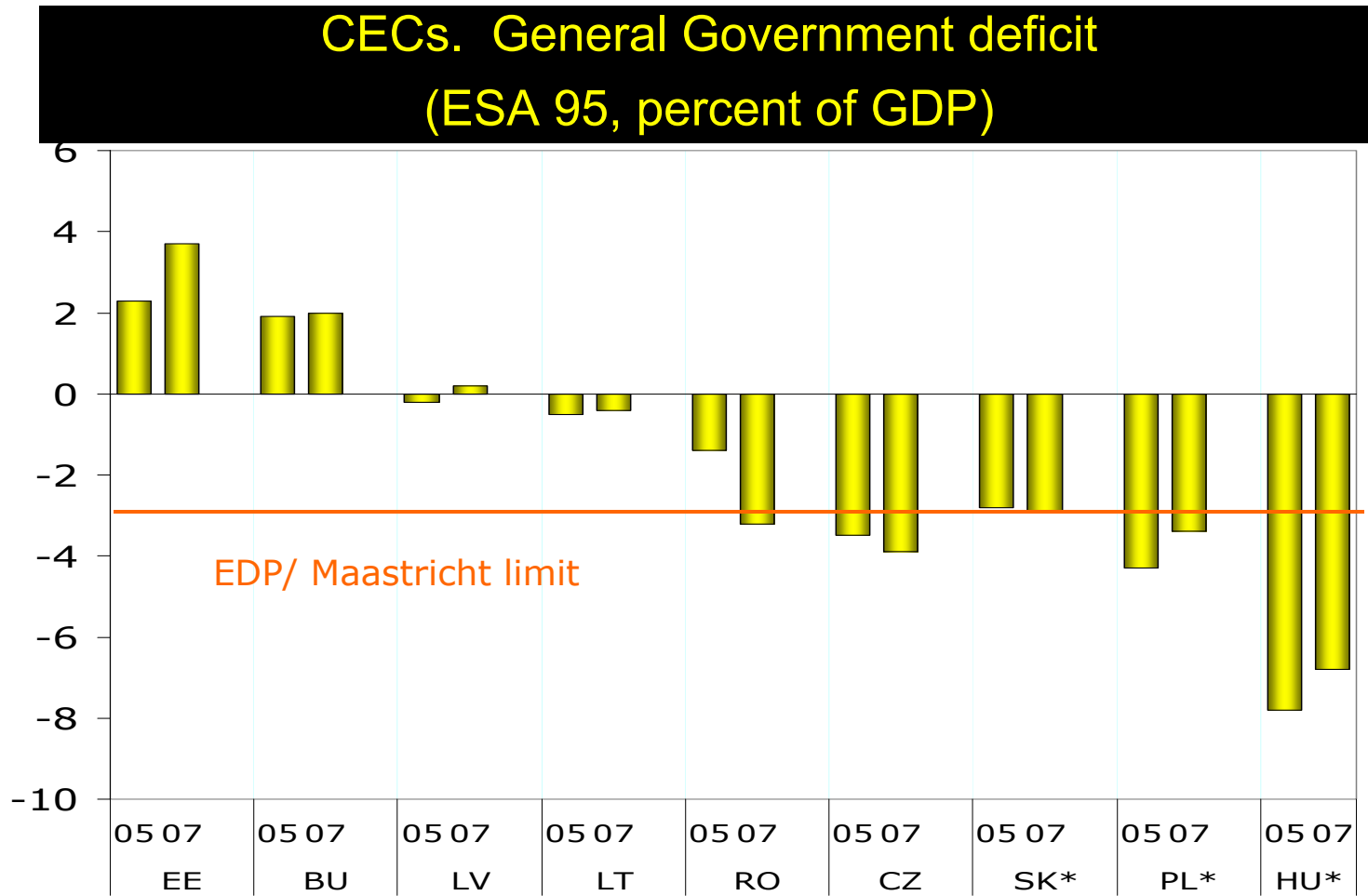
Source: WEO October 2007.

...especially considering that rising price levels are naturally associated with convergence.

CECs. Relative price level vs. relative GDP per capita (PPP), 1995-2006, EU25=100



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

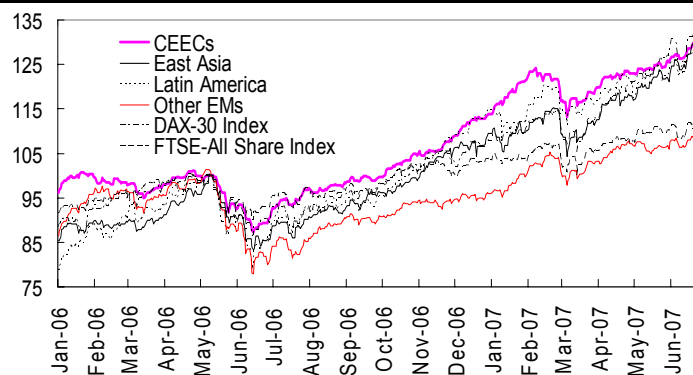


* incl. pension reform costs

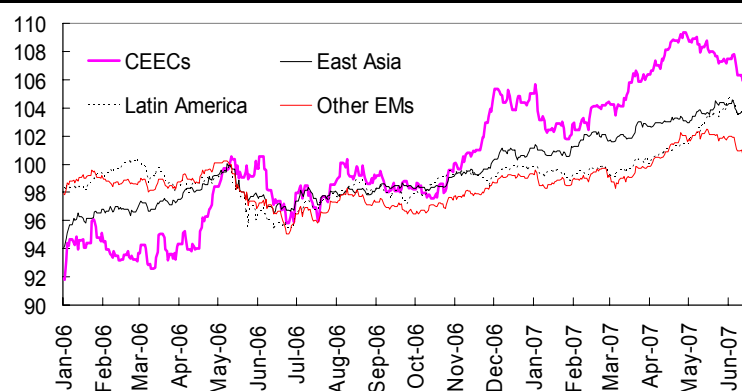
Source: Eurostat, EC Spring Forecast 2007

Until last summer CEC financial markets outperformed other EMs...

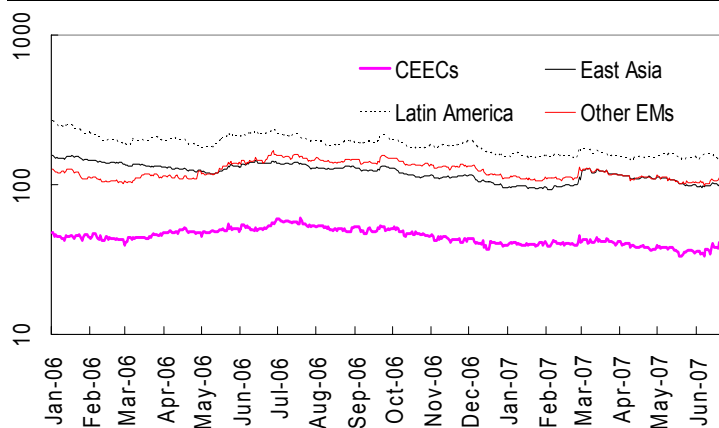
A. Stock Market Indices
(May 10, 2006=100)



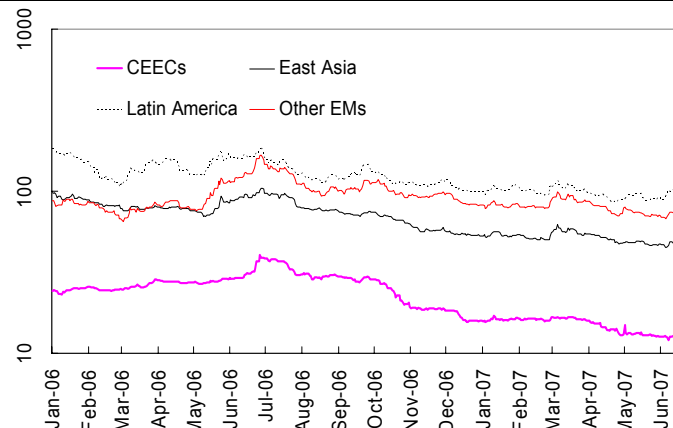
B. Indices of Exchange Rate Against US\$
(May 10, 2006 =100; (+) = appreciation)



C. External Bond Spreads



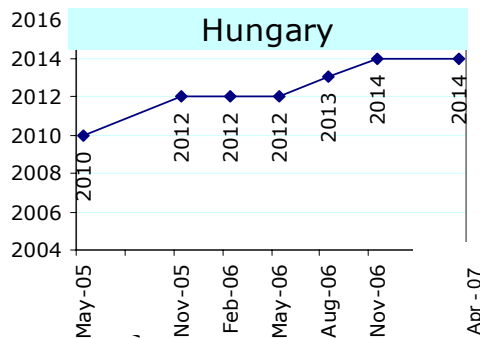
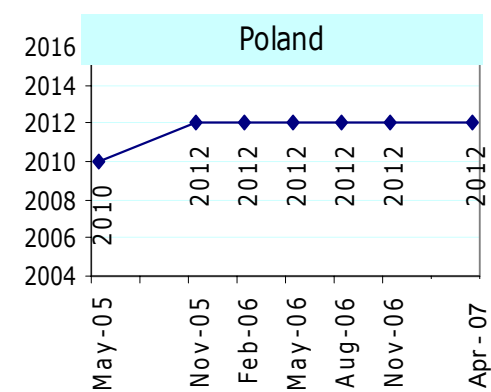
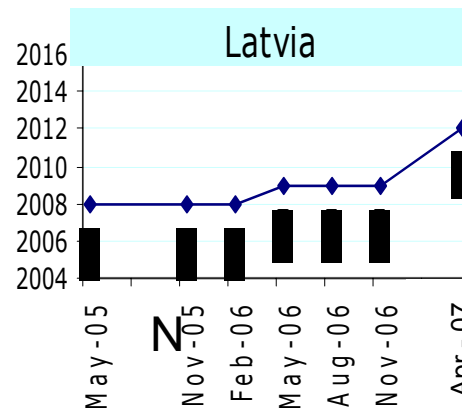
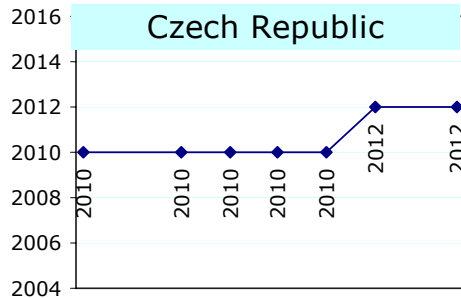
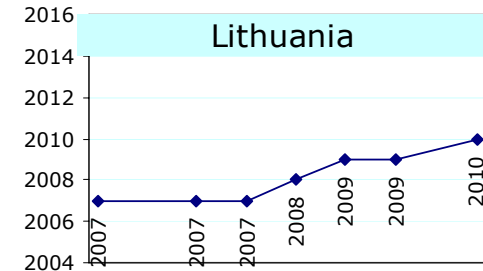
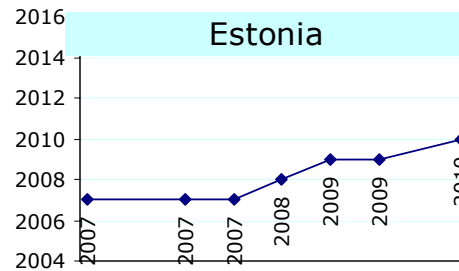
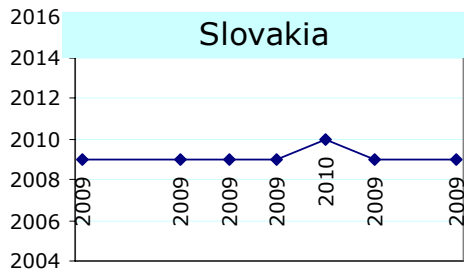
D. 5-year CDS Spreads



Source: Pipat Luengnaruemitchai, Susan Schadler, Do Economists' and Financial Markets' Perspectives on the New Members of the EU differ?, IMF Working Paper 07/65.

...despite receding euro adoption prospects.

REUTERS Polls on Euro Adoption Date Median Value of Responses



Source: Reuters



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



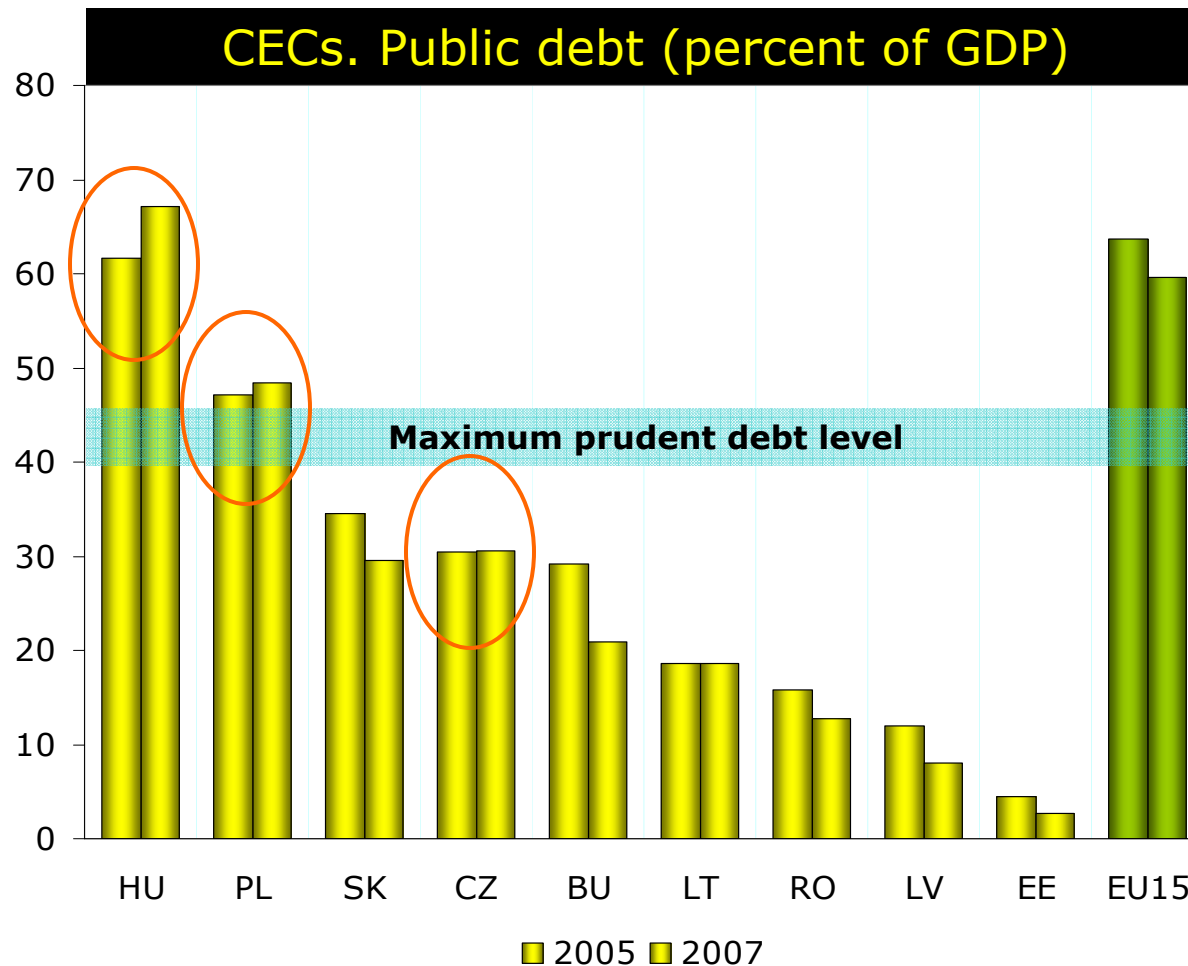
Main Concerns

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

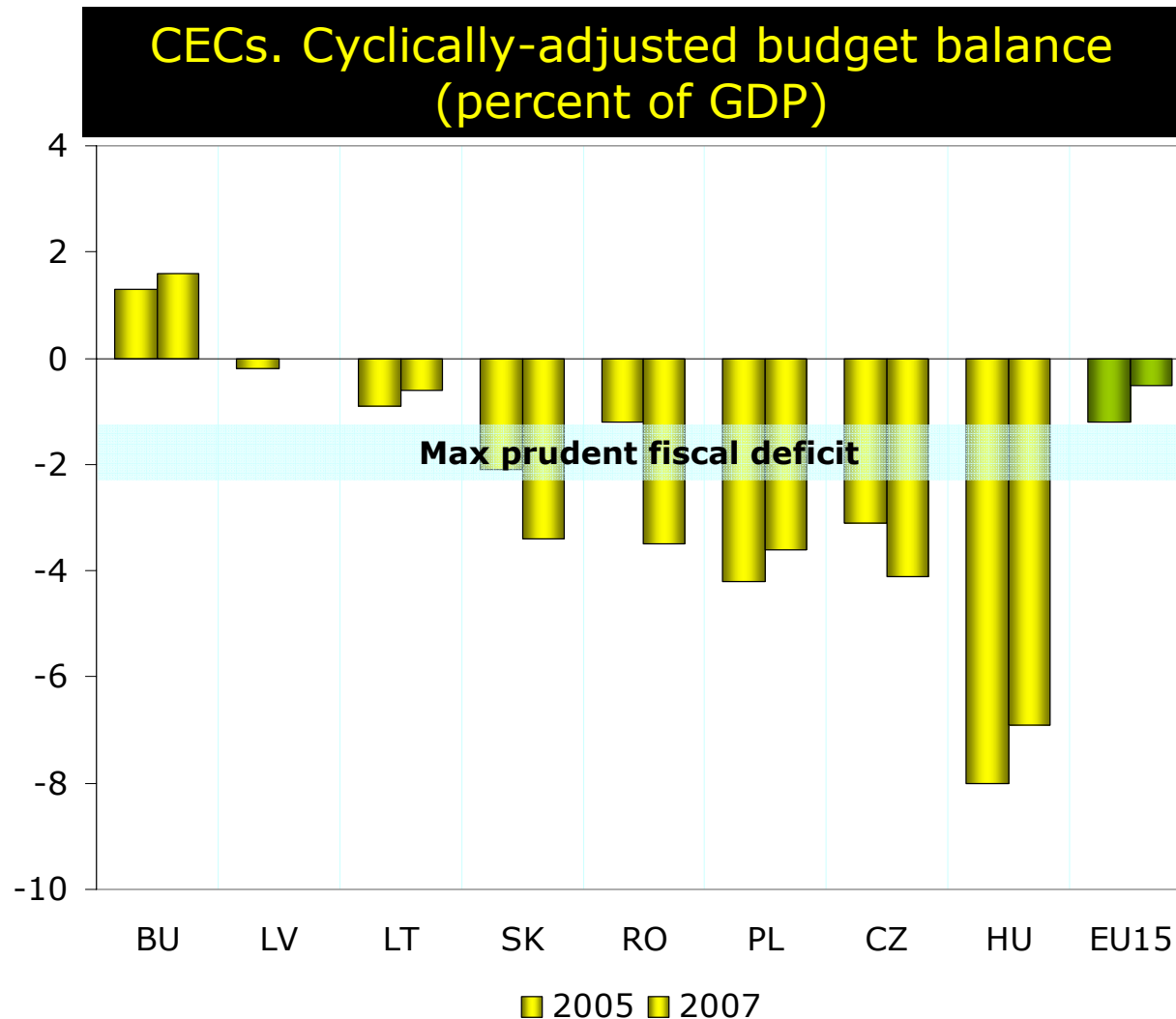


Lack of fiscal adjustment

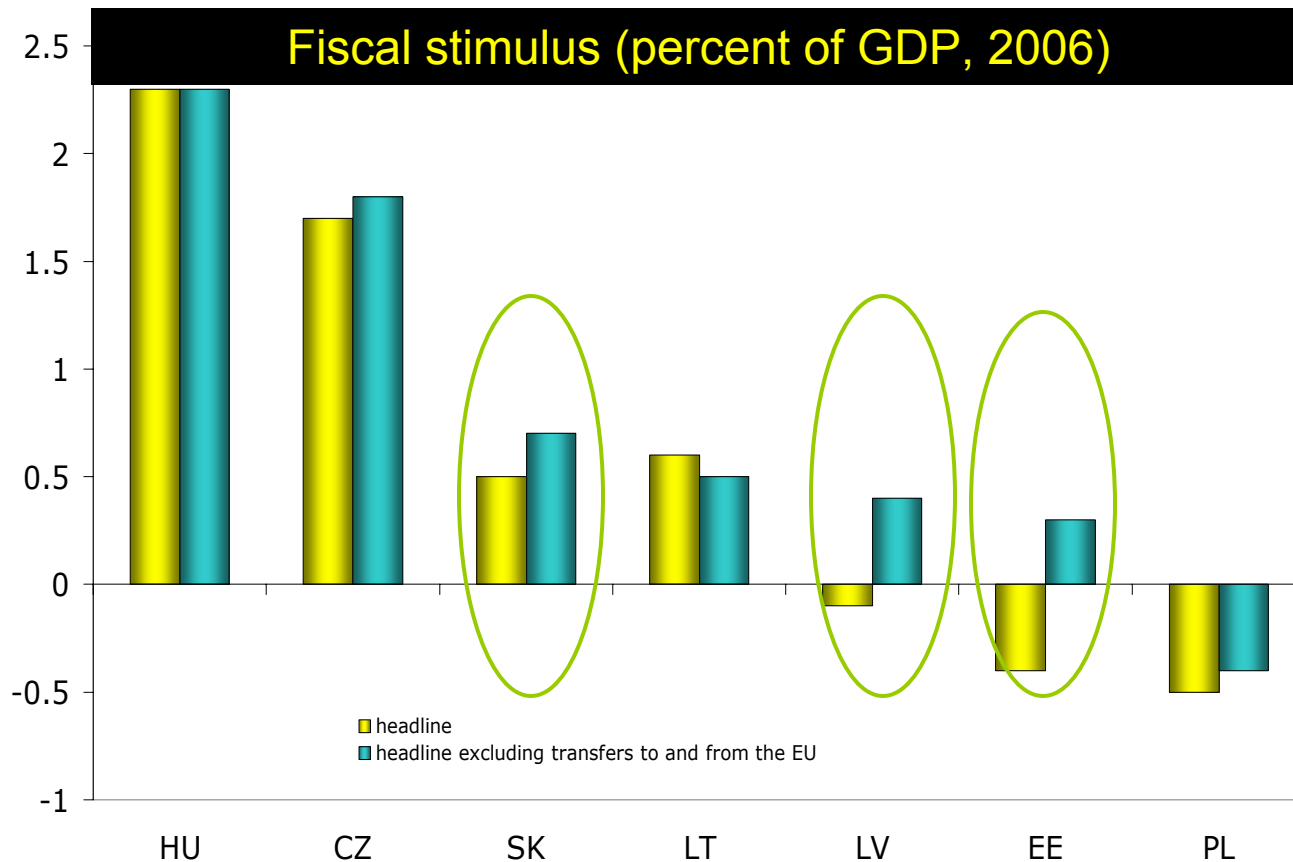
Despite healthy growth, public debt ratios are not declining in key CECs.



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

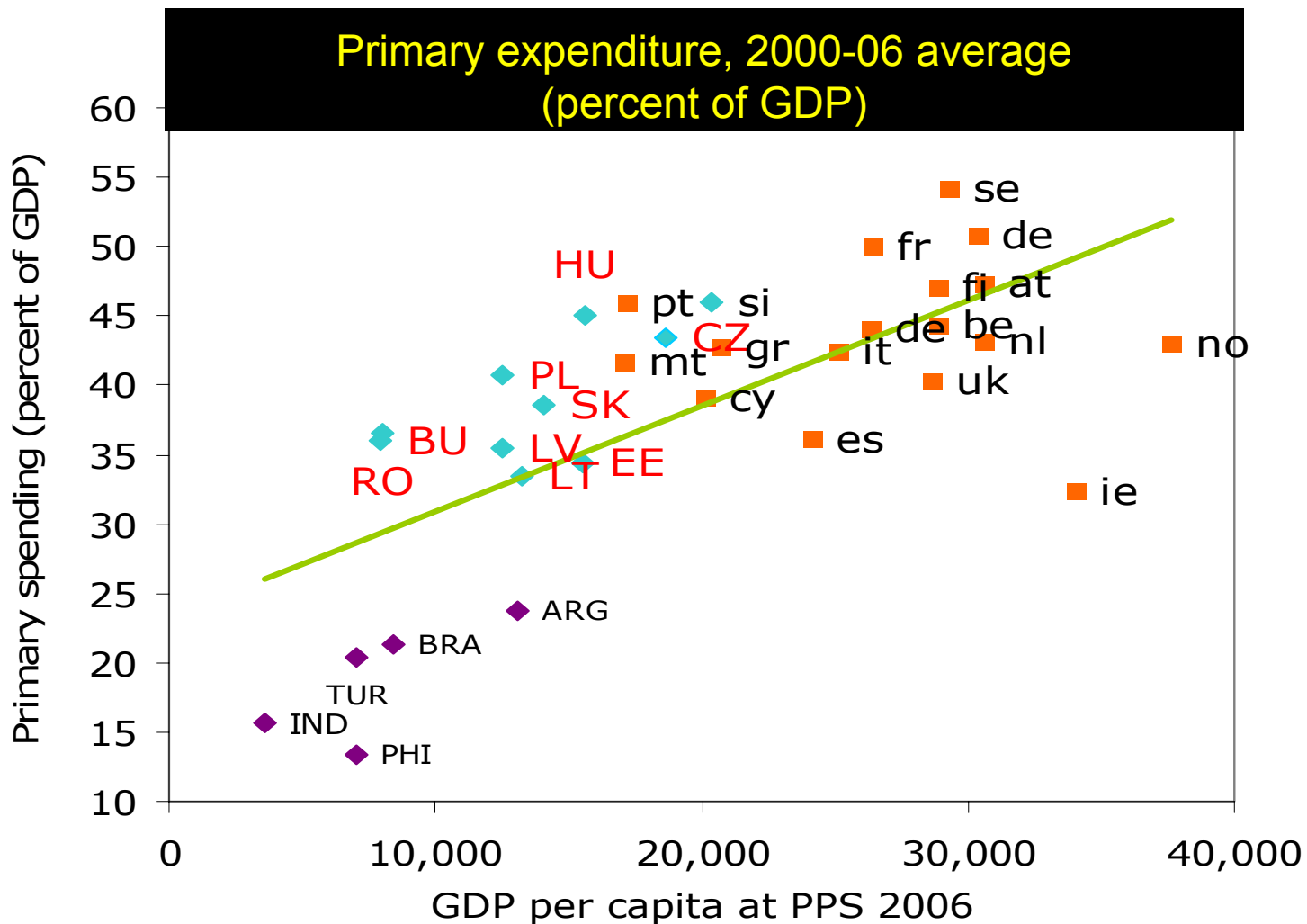


Fiscal policy is even more procyclical if one accounts for EU funds.



Source: Christoph B. Rosenberg and Robert Sierhej, Interpreting EU Funds Data for Macro Analysis in the New Member States, IMF Working Paper 07/77

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

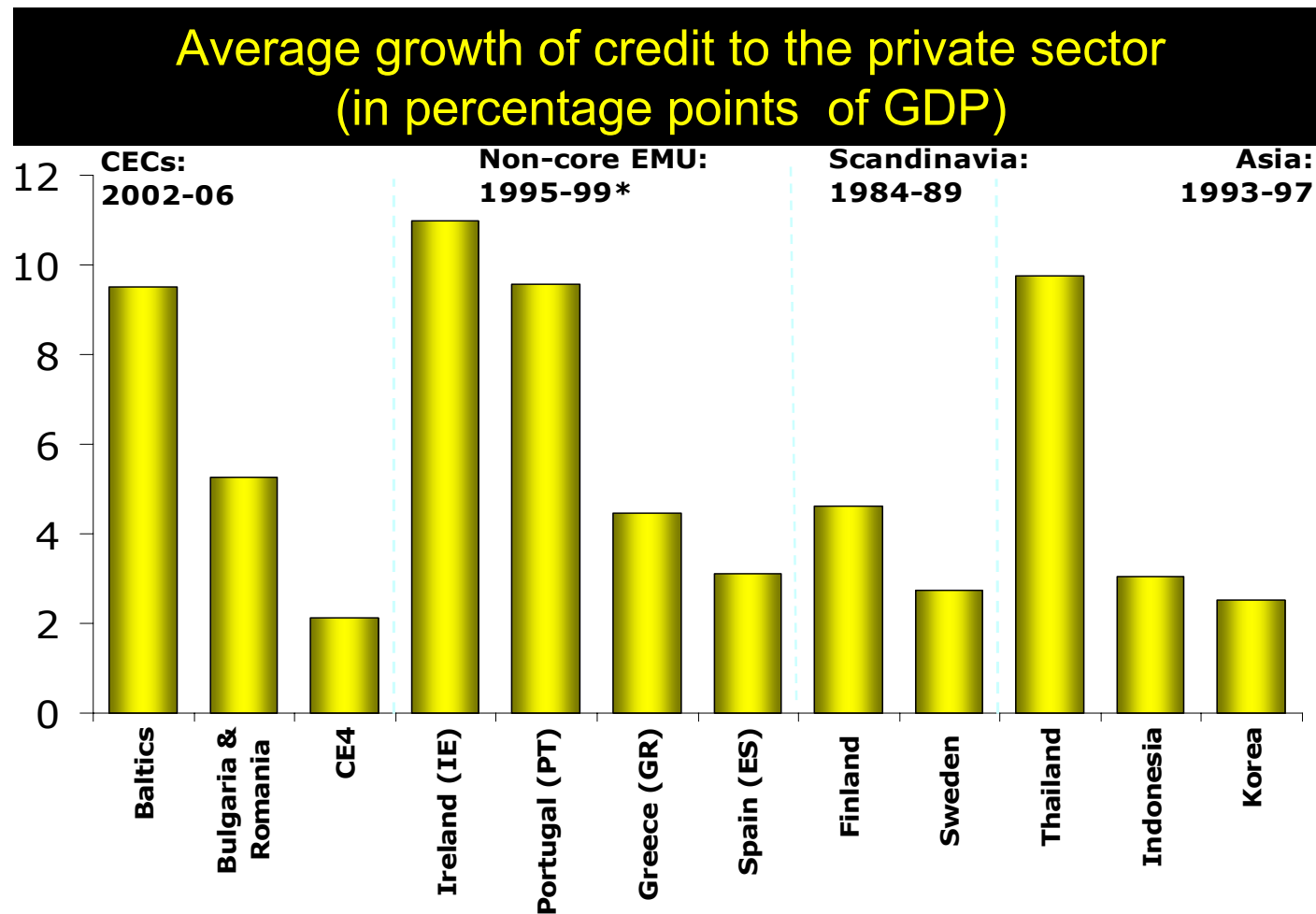


Source: AMECO.
Data for RO & BU for 2005.



Rapid growth of foreign exchange credit to the private sector

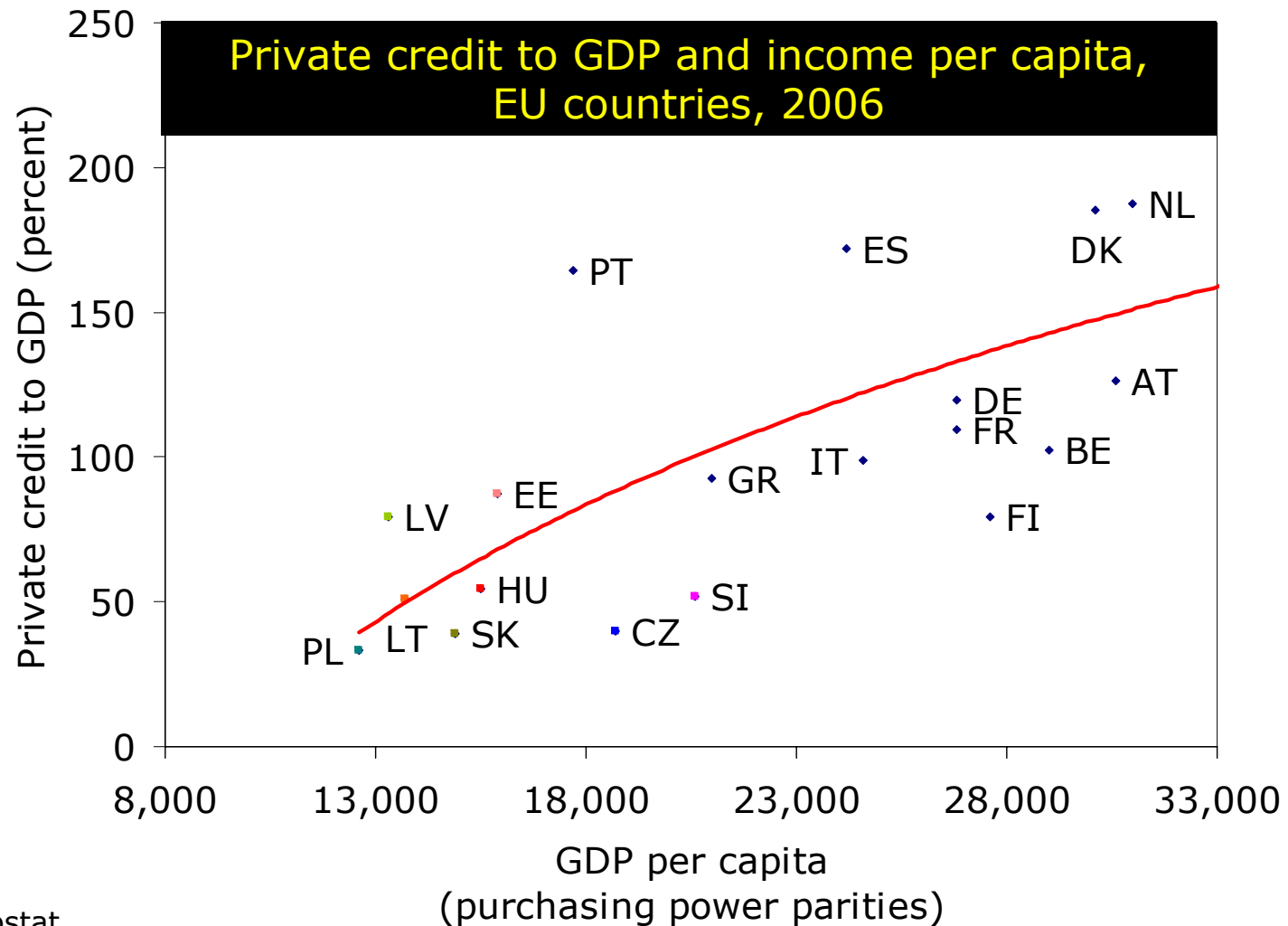
Credit growth has been brisk.



*Greece 1997-2000

Source: IFS, national authorities, IMF staff calculations

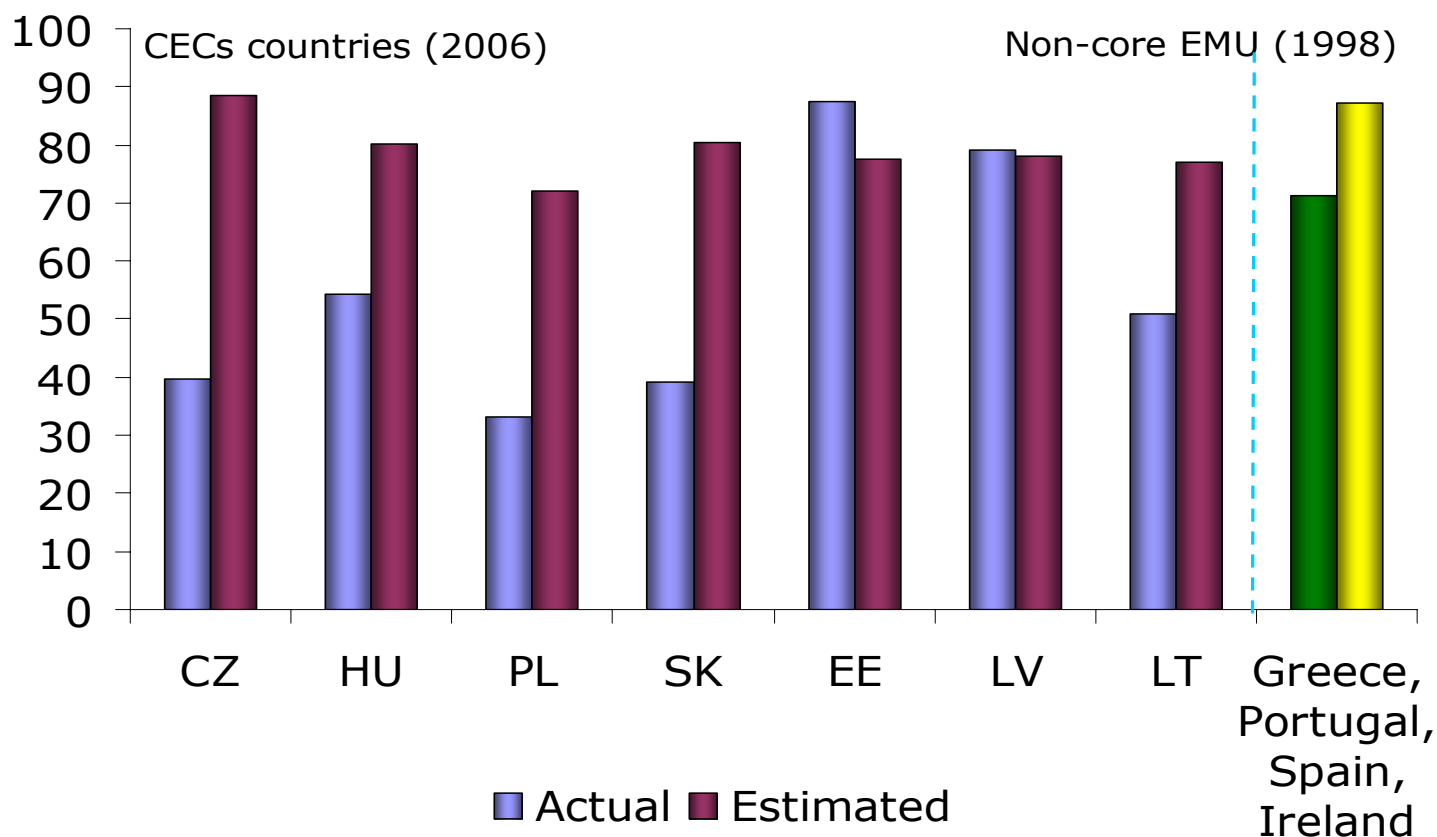
Indebtedness corresponds to income levels.



Source: IFS, Eurostat

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

EU countries: Bank credit to the private sector: Actual and estimated equilibrium levels (percent of GDP)

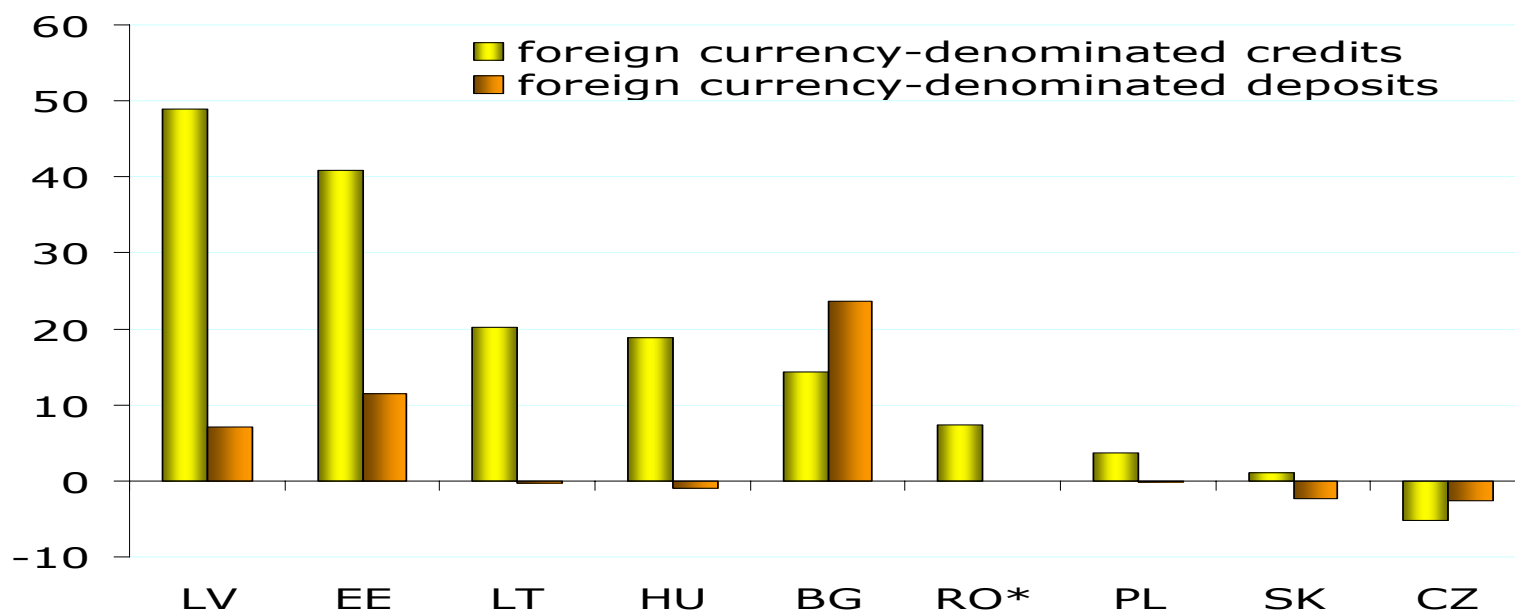


*Greece (Q1.1999)

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.

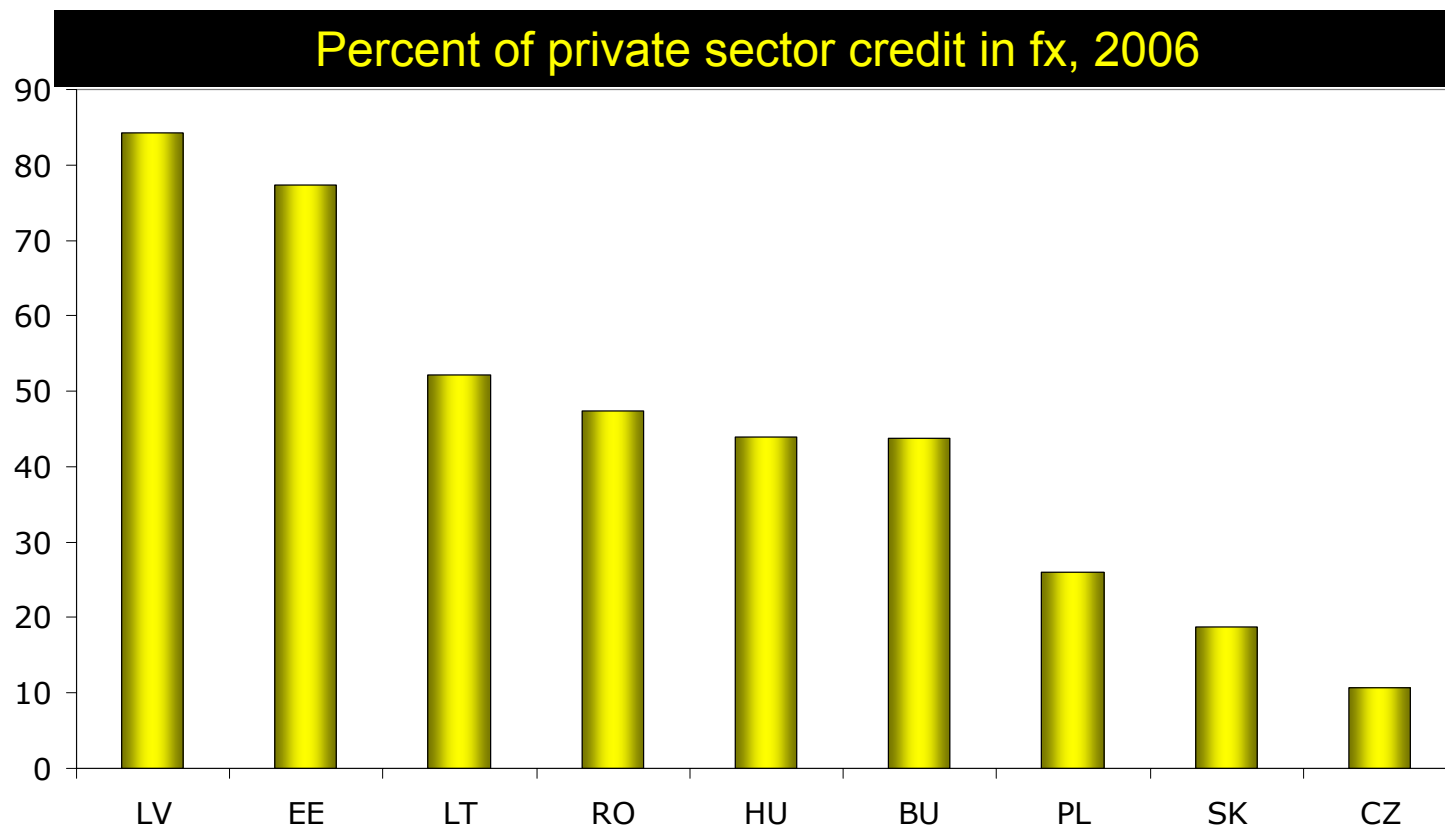
Change of foreign currency credits and deposits during 2001-06 (in percentage points of GDP)



Source: National authorities, IMF staff estimates

* Deposit data for Romania are not available.

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

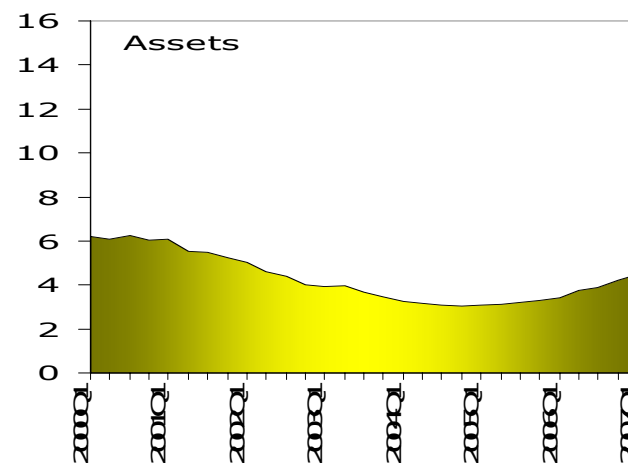
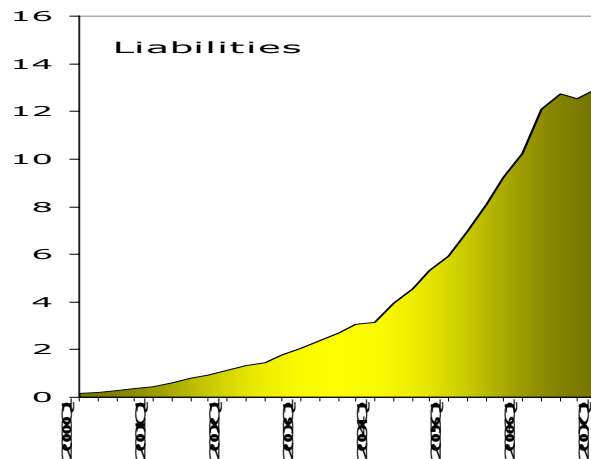


Source: National authorities.

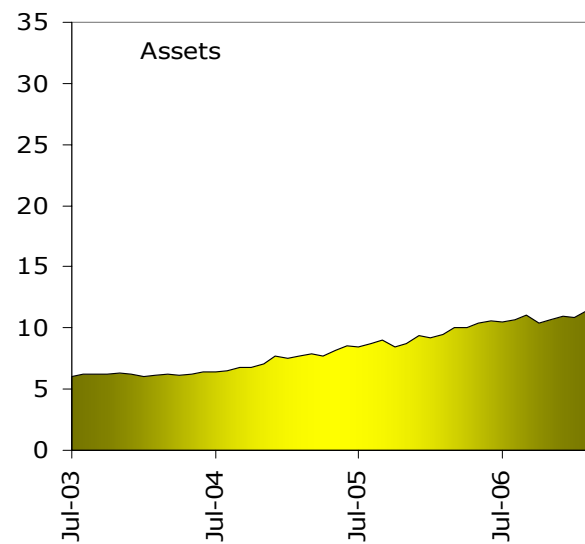
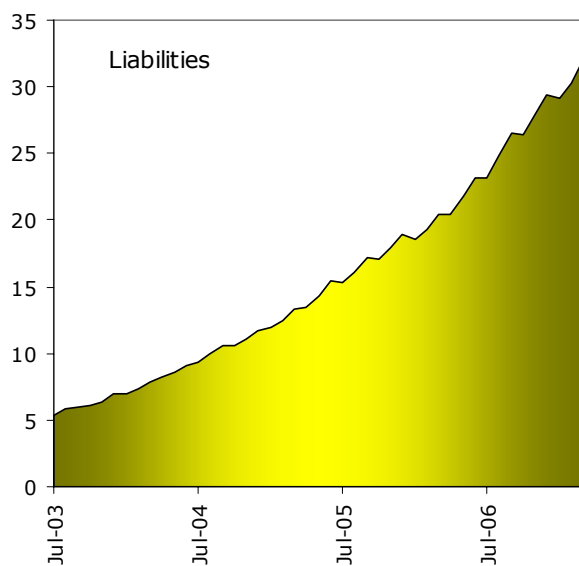
Households in some countries are particularly exposed.

Households' net open fx position (percent of GDP)

Hungary



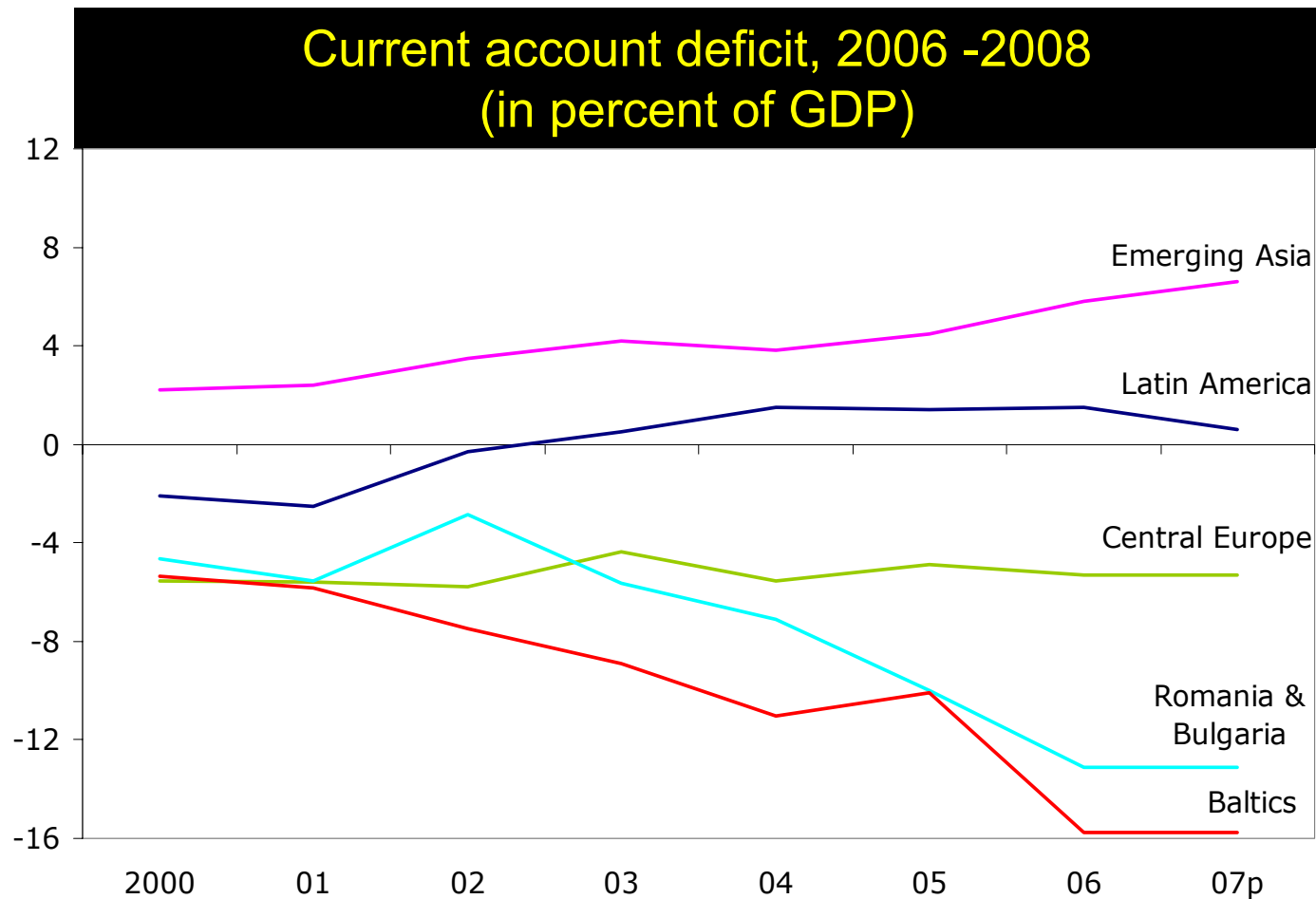
Latvia





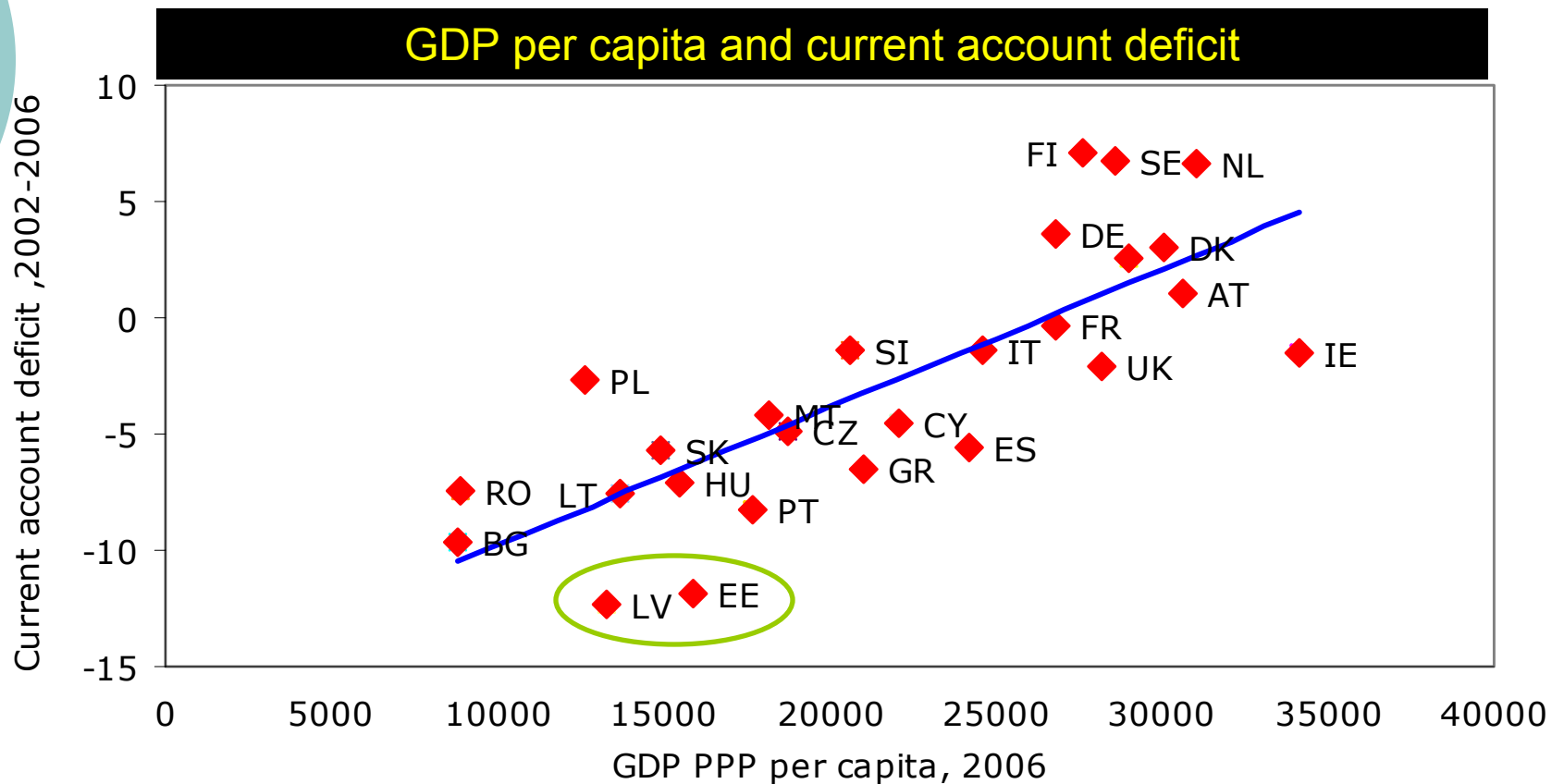
Large external stock and flow imbalances

Current account deficits are high, except in Central Europe...



Source: IMF WEO October 2007.

... largely reflecting the convergence process.





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 stop
- 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

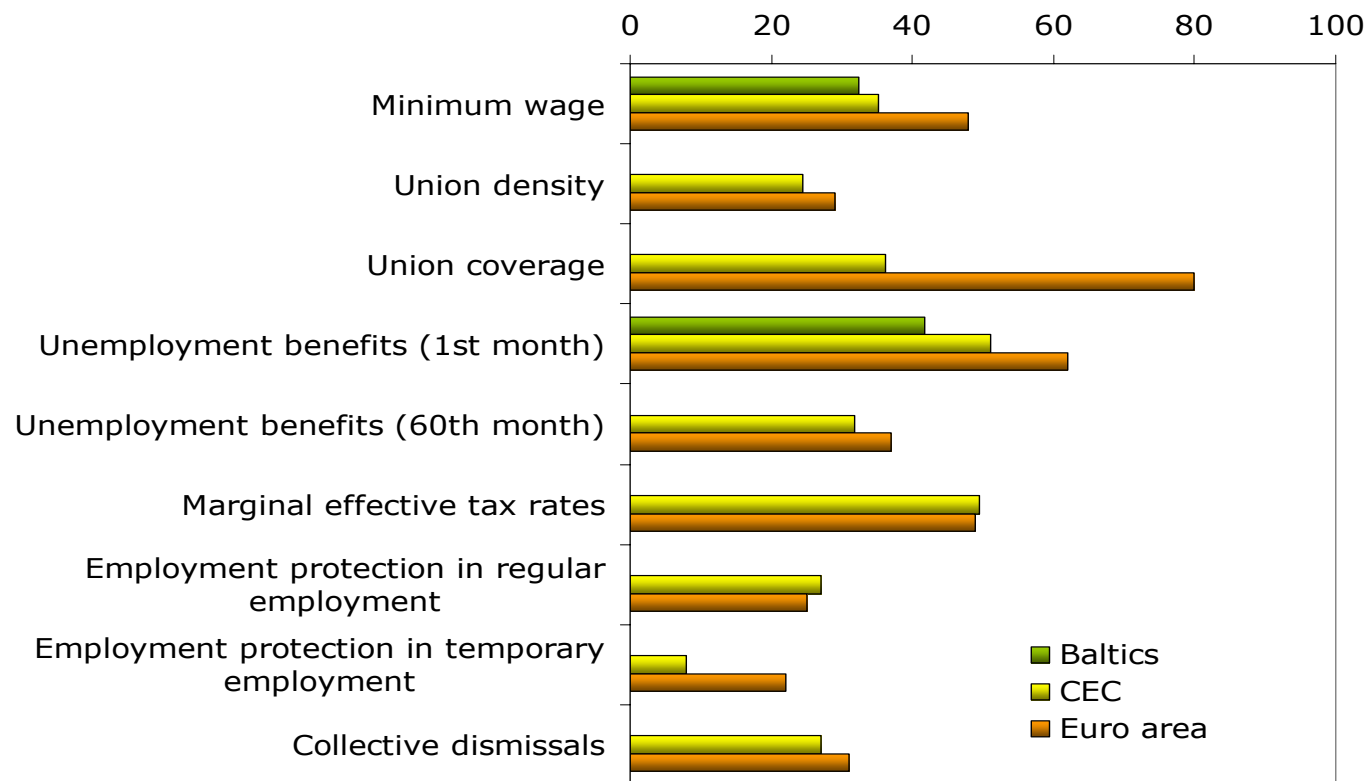
Source: BIS



Creating flexible economies

Labor markets seem relatively flexible, but are untested.

Labor market rigidities



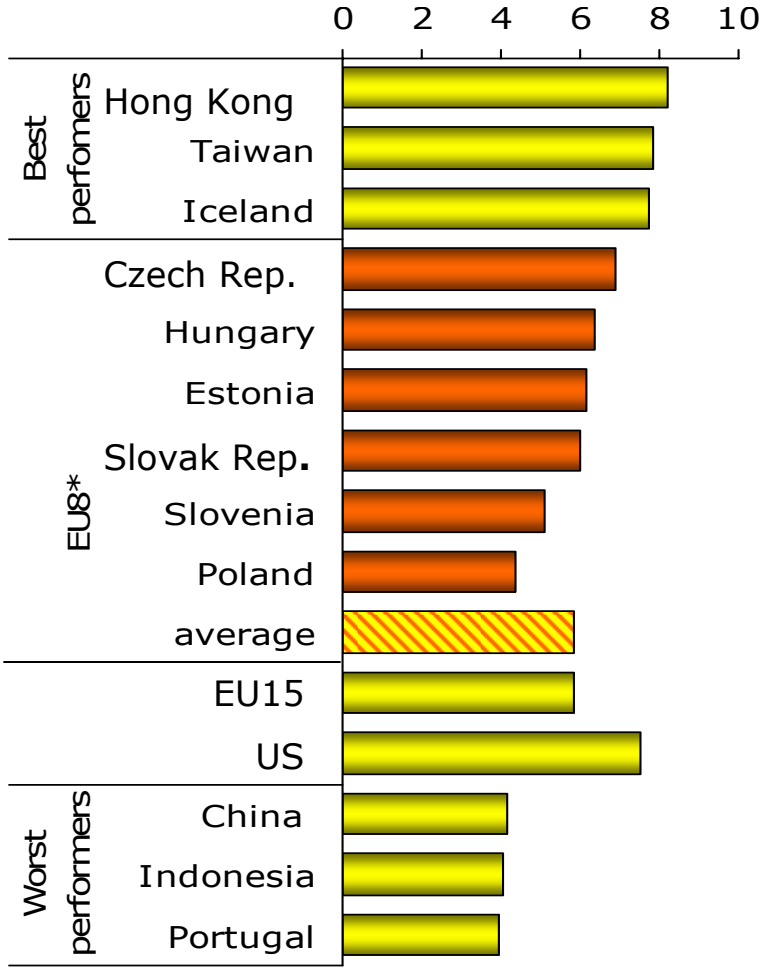
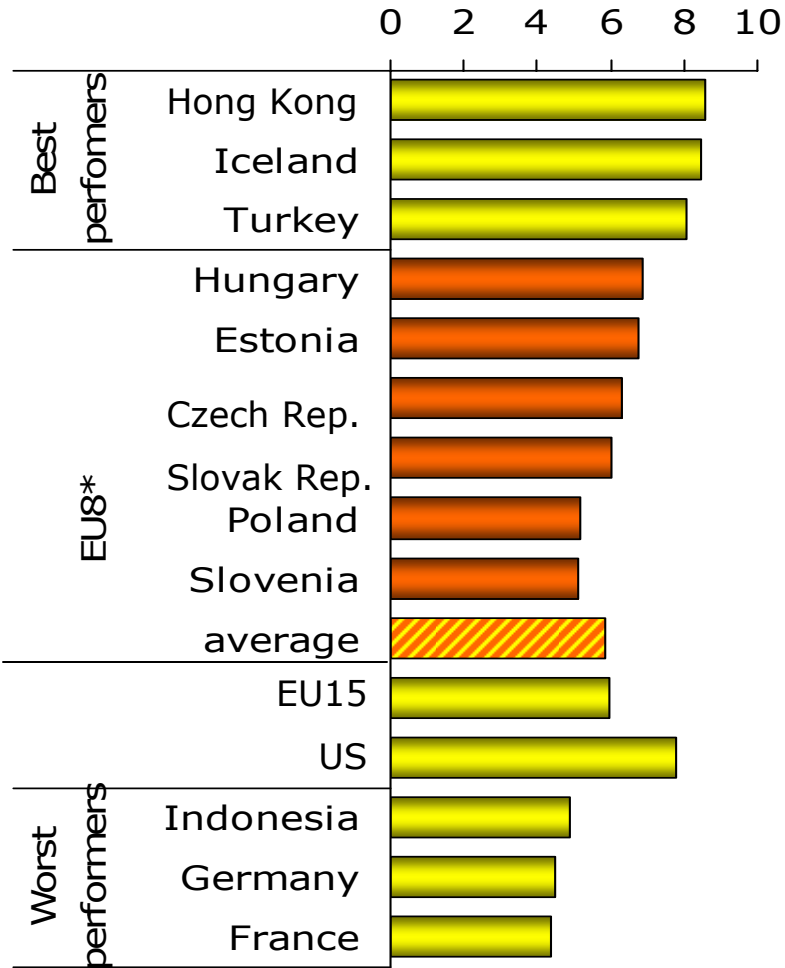
Source: OECD.

1\ The scale of indicators is from 1-10 from most to least regulated.

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)



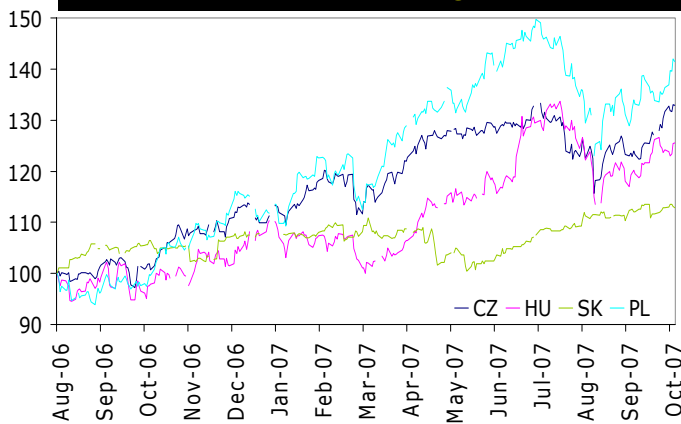
Source: IMD World Competitiveness
 * Excluding Lithuania and Latvia



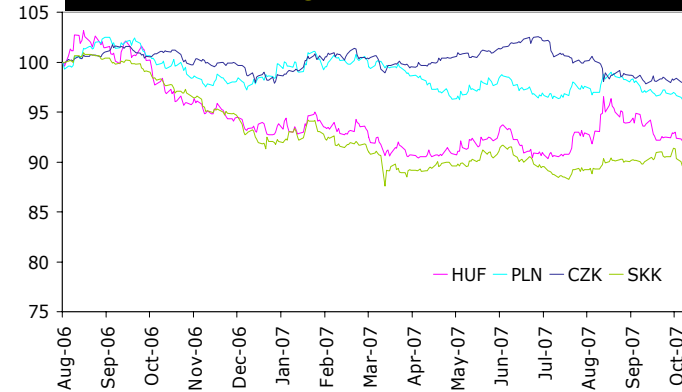
Outlook

The fallout from the supprime mortgage crisis in the US has had some effects on financial markets.

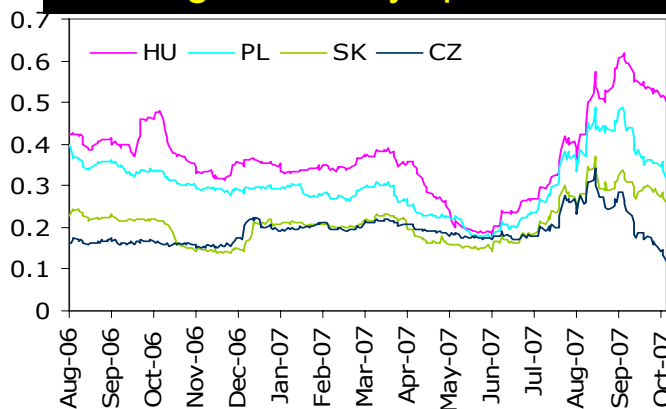
Stock markets (Aug 1 = 100)



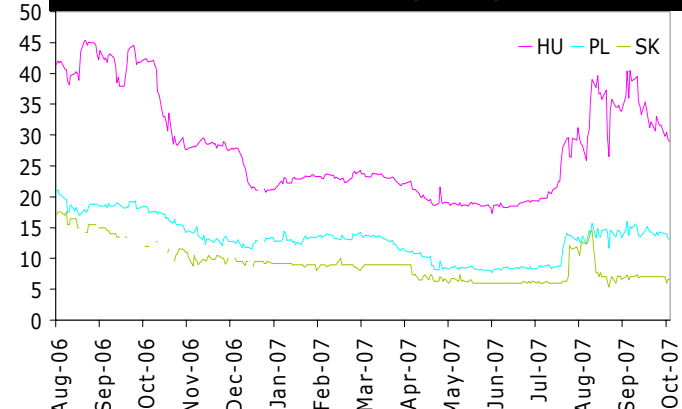
Exchange rate vs. EUR



Foreign currency spreads 1/



Credit Default Swaps Spreads 2/



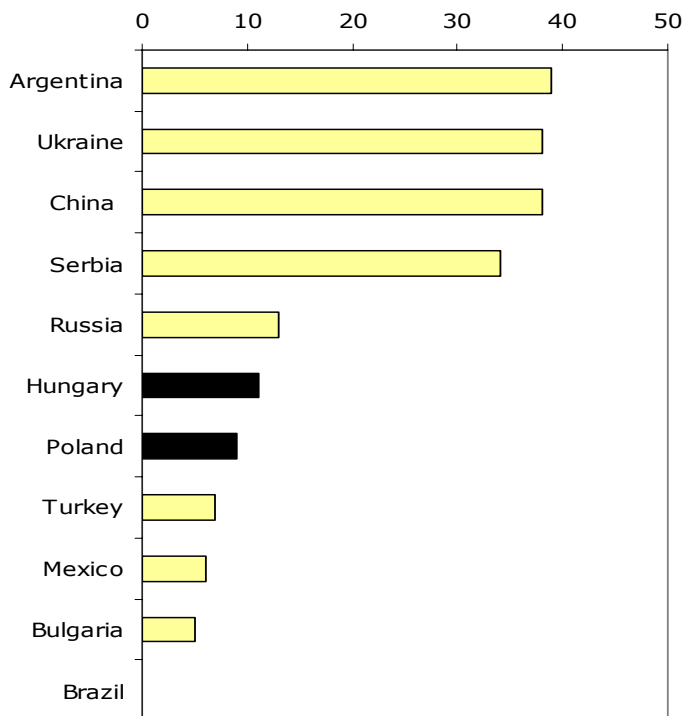
Source: Bloomberg.

1/ Spread of 5-year euro denominated international government bonds versus %-year Bund.

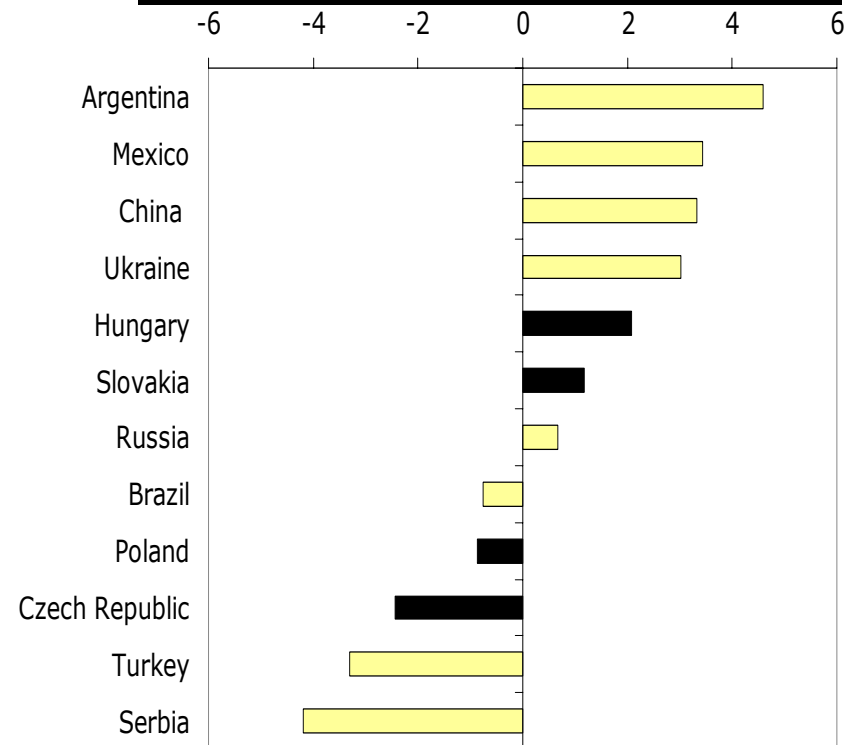
2/ The credit default swap (CDS) is an over-the-counter contract whereby the buyer pays the seller a periodic fee in return for contingent payment by the seller upon default of the issuer of a credit instrument.

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

Change in EMBI
July 16-October 12 (bps)



Change in the EURO exchange rate
July 16- October 12
(+= depreciation, percent)



Source: IMF GMM, national statistics.

IMF growth forecast for the NMS have marginally been revised downward...

Real GDP growth

	October WEO		Revision from July forecast
	2007	2008	2008
Emerging Europe (excl. Turkey)	6.1	5.2	-0.1
Baltics	8.8	6.3	-0.2
Estonia	8.0	6.0	-0.9
Latvia	10.5	6.2	-0.1
Lithuania	8.0	6.5	---
Central Europe	5.8	4.9	-0.2
Czech Republic	5.6	4.6	-0.3
Hungary	2.1	2.7	-0.3
Poland	6.6	5.3	-0.1
Slovak Republic	8.8	7.3	-0.2
Southern and south-eastern Europe	6.0	5.7	-0.8
Bulgaria	6.0	5.9	-0.1
Romania	5.6	4.8	---
Eurozone	2.5	2.1	-0.4
United States	1.9	1.9	-0.9
World	5.2	4.8	-0.4



...while 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 Europe



Conclusions

- Headline numbers still look good, but vulnerabilities are growing, especially in the Baltics (“Running with your shoelaces open”)
- So far, the NMSs have weathered market turmoil surprisingly well
- Rather than using the favorable environment to reduce risks, some governments have been pouring oil into the fire by pursuing procyclical fiscal policies
- Flexible labor and capital markets are key to support the unencumbered flow of resources from non-tradables to tradables
- Preparation for euro adoption is overly focused on meeting Maastricht criteria



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!

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