Is the transition countries' reliance on foreign capital a sign of success or failure?

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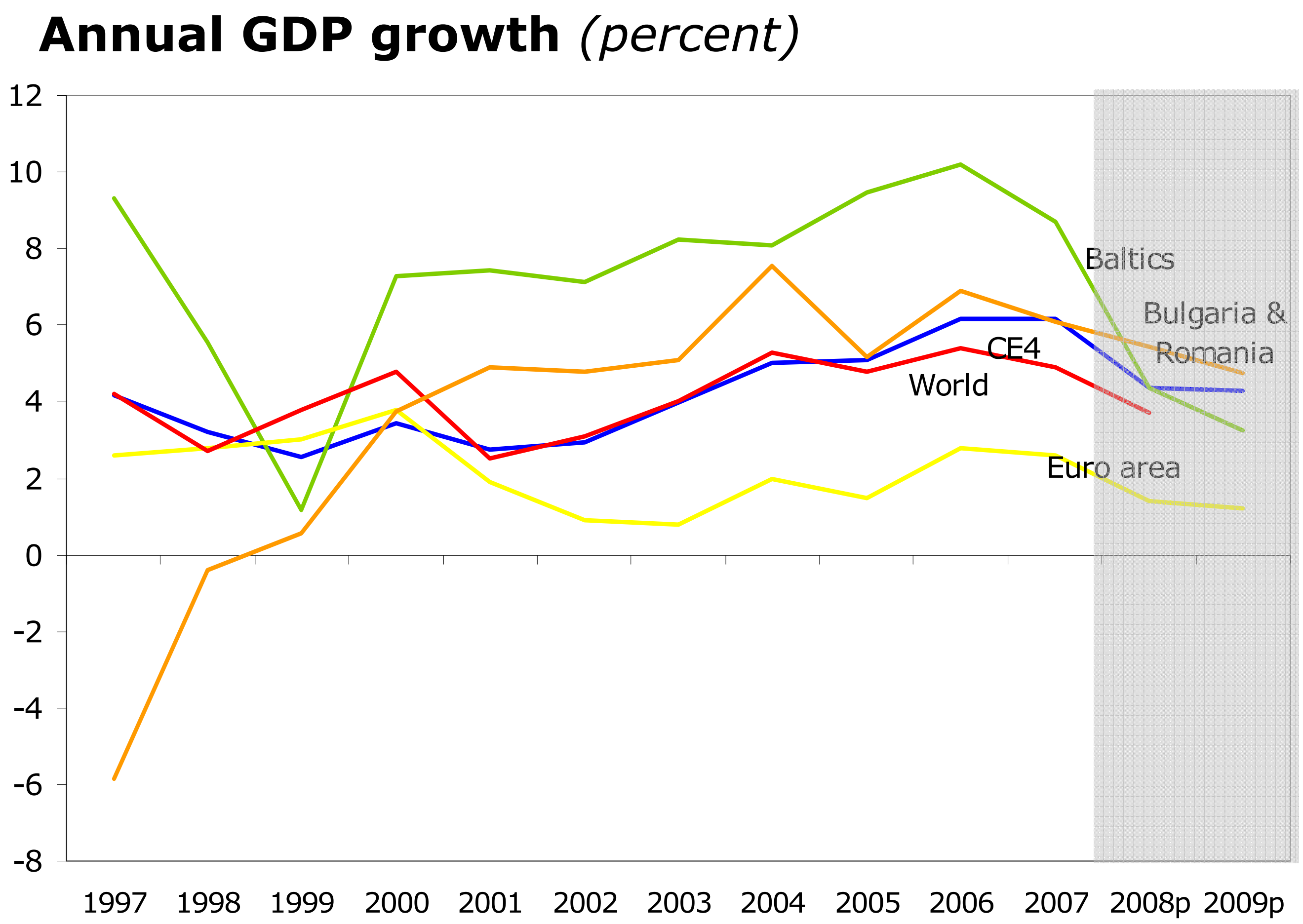
Outline

- Convergence in the CEE countries – the role of foreign capital
- External imbalances: the flip-side of rapid convergence
    - Some reassuring trends
    - Concerns
- Policy Conclusions

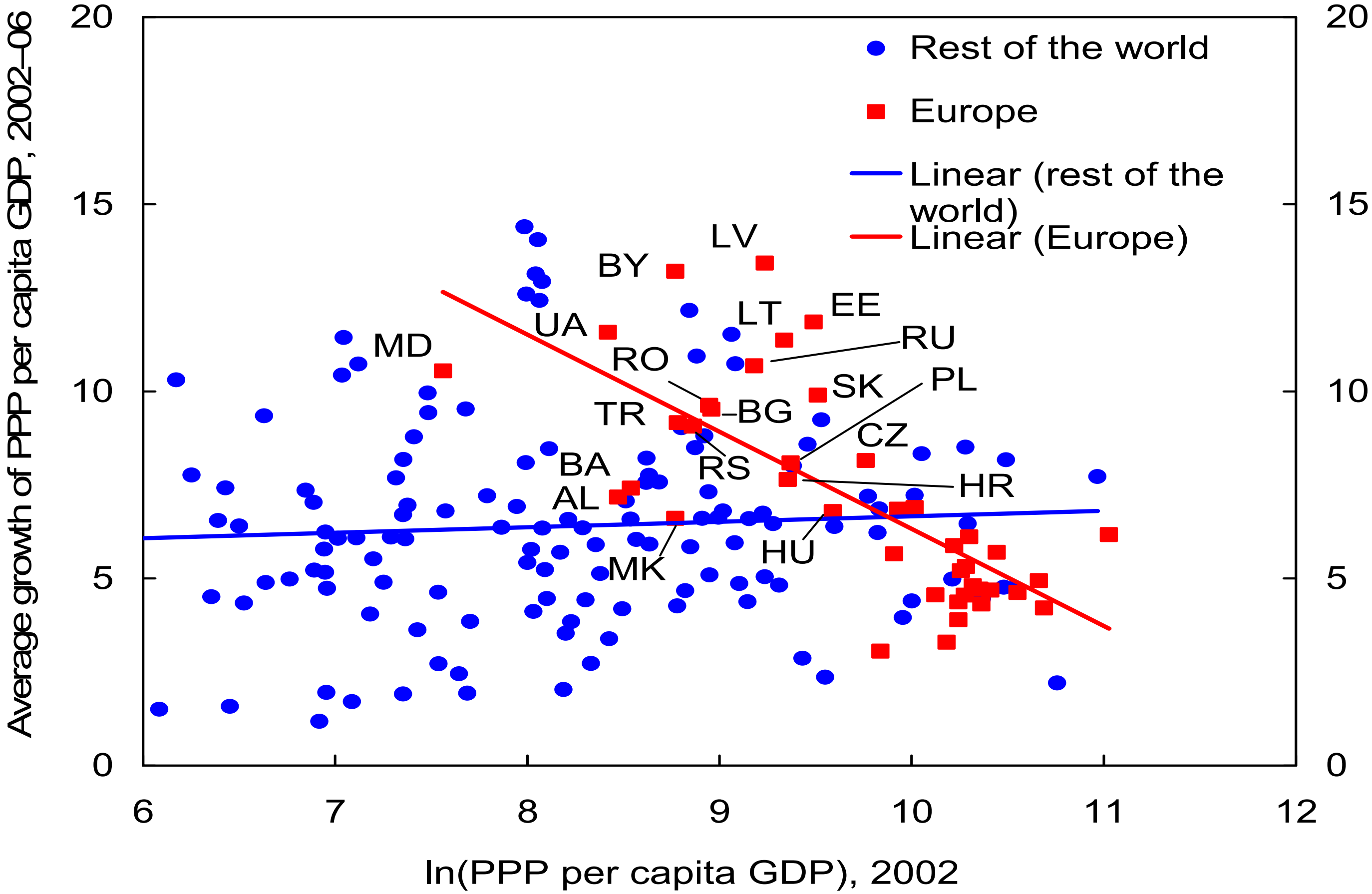
Growth in Emerging Europe is expected to slow in near term, due to global spillovers



Source: WEO April 2008.

Nevertheless, the region has been converging very fast

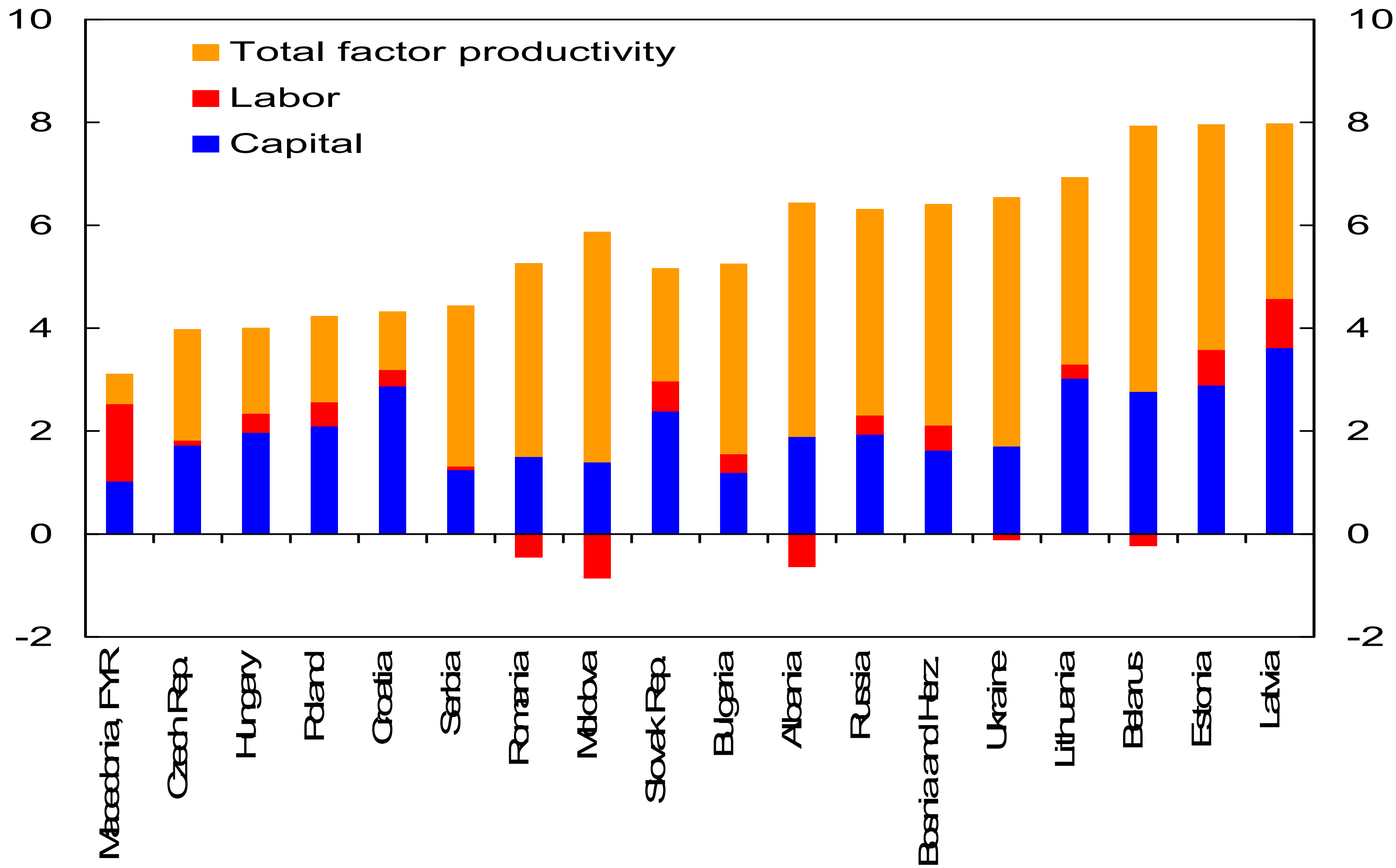
Convergence in Emerging Europe and in the Rest of the World, 2002–06



Productivity improvements and capital accumulation (from abroad) have been key

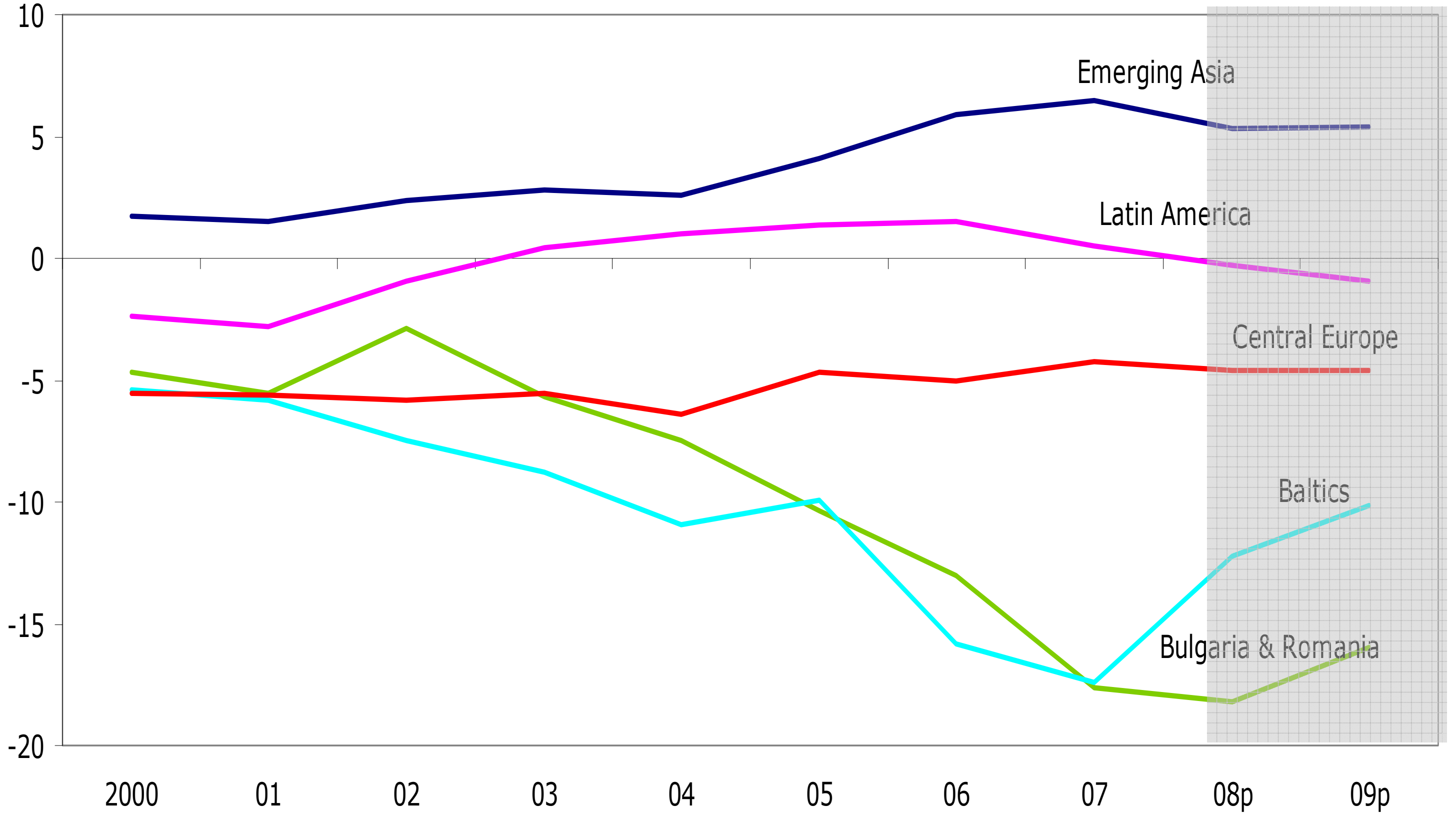
Emerging Europe: Growth Accounting, 2002–06

(Percent per year)



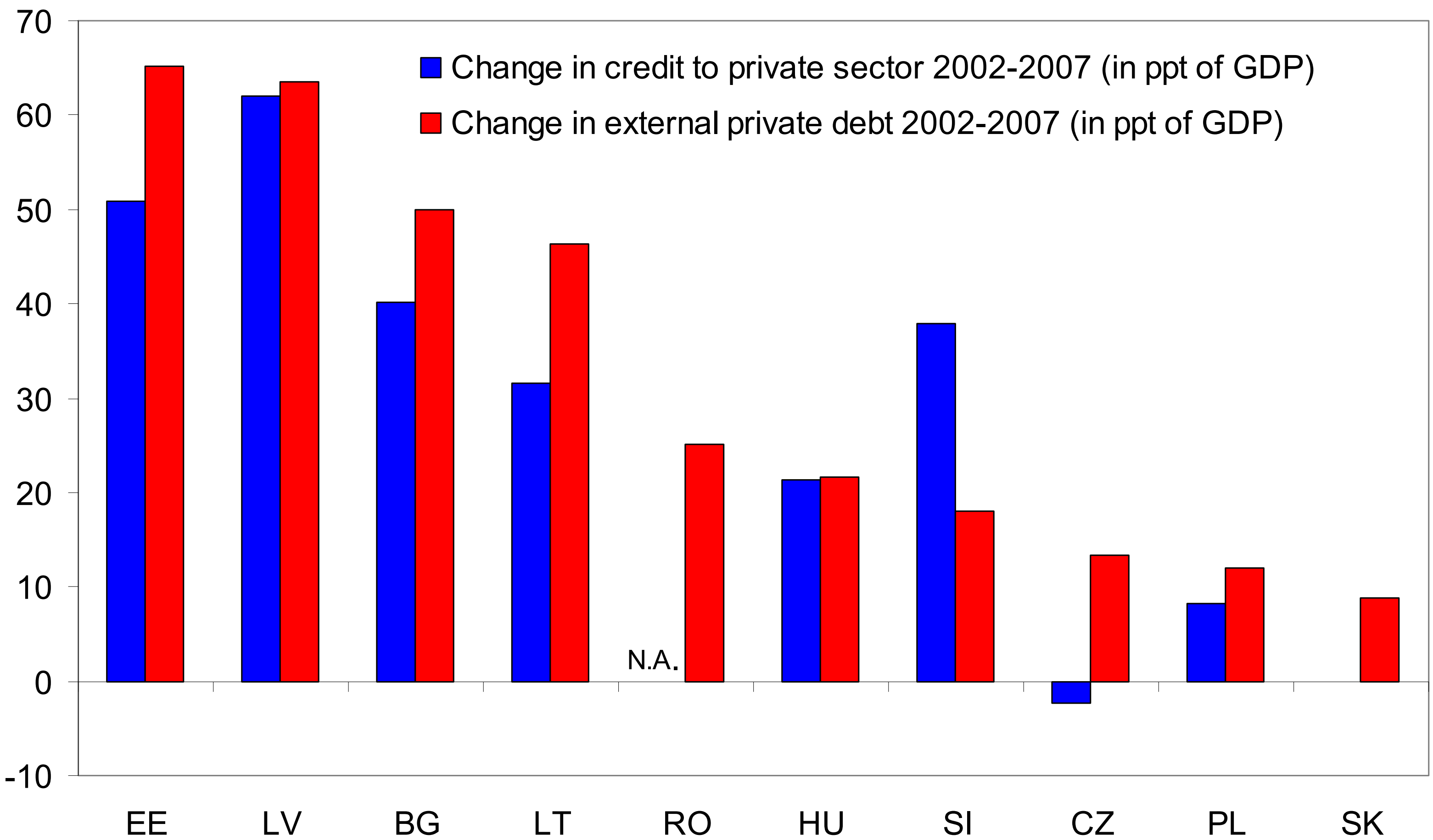
The flip-side of this are high current account deficits, especially high in the Baltics and South-Eastern Europe…

Current account deficit
(in percent of GDP)



Source: IMF WEO April 2007.

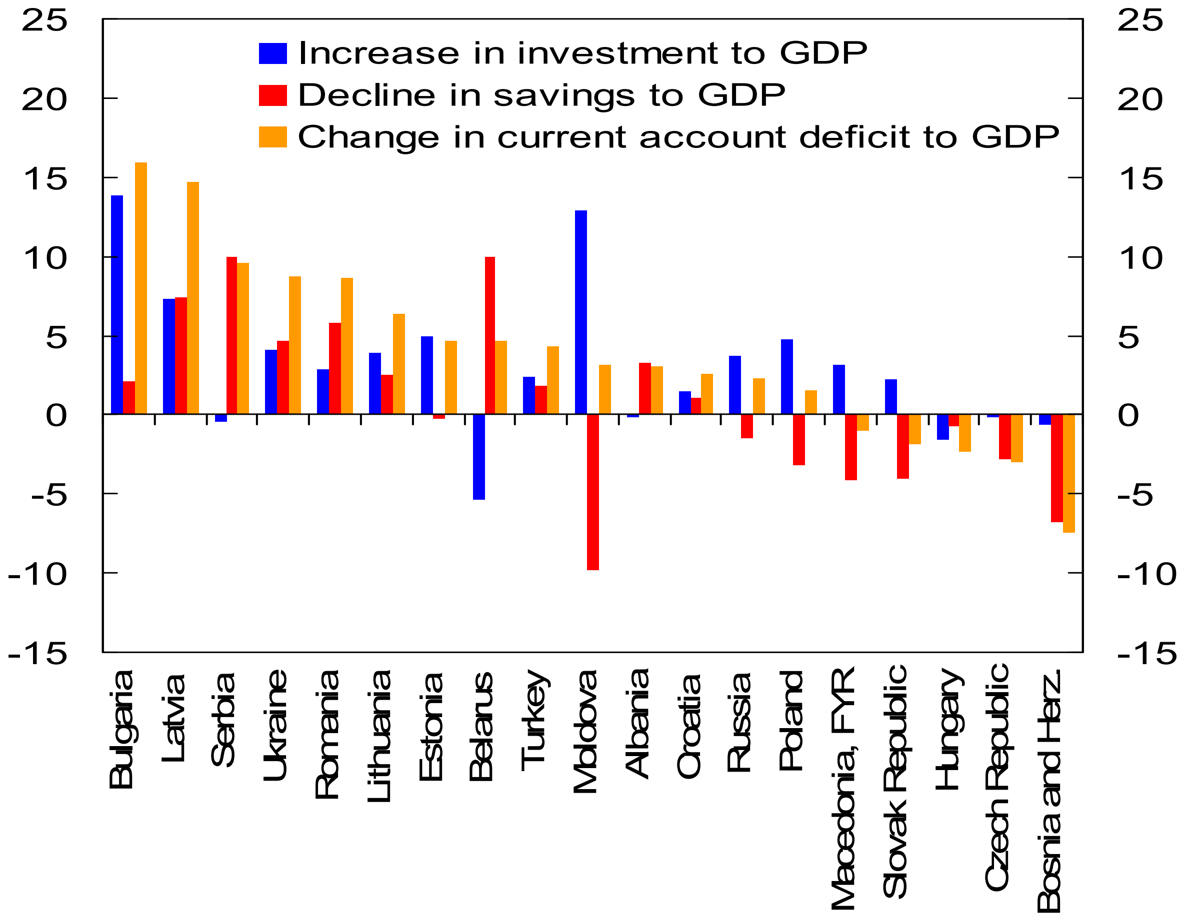
These are closely related to financial deepening



Sources: National authorities; and IMF staff calculations.

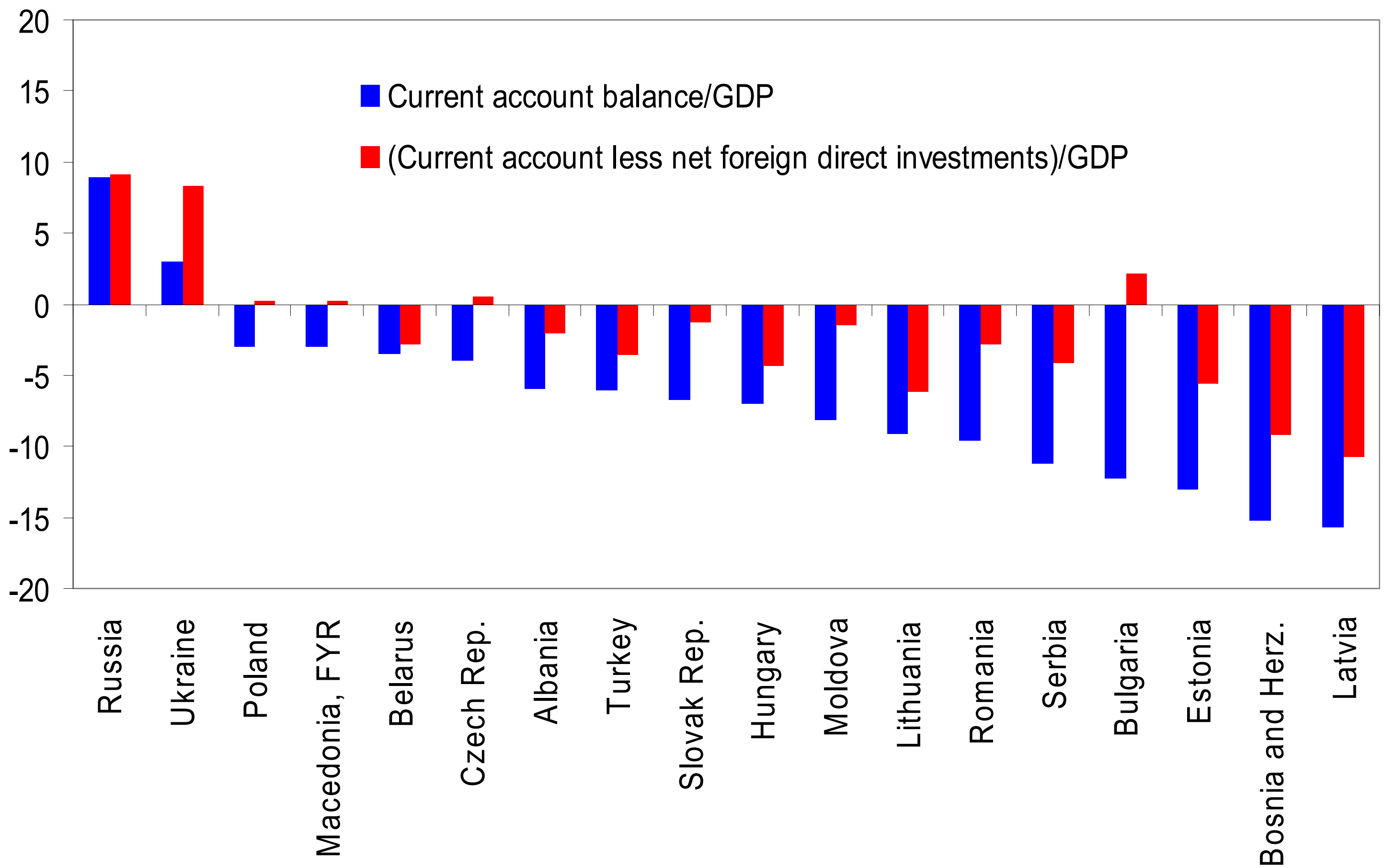
Most of the deterioration of C/A balances is driven by an increase in investment…

Emerging Europe: Contributions to Current Account Deficit, 2003–07
(Percent)



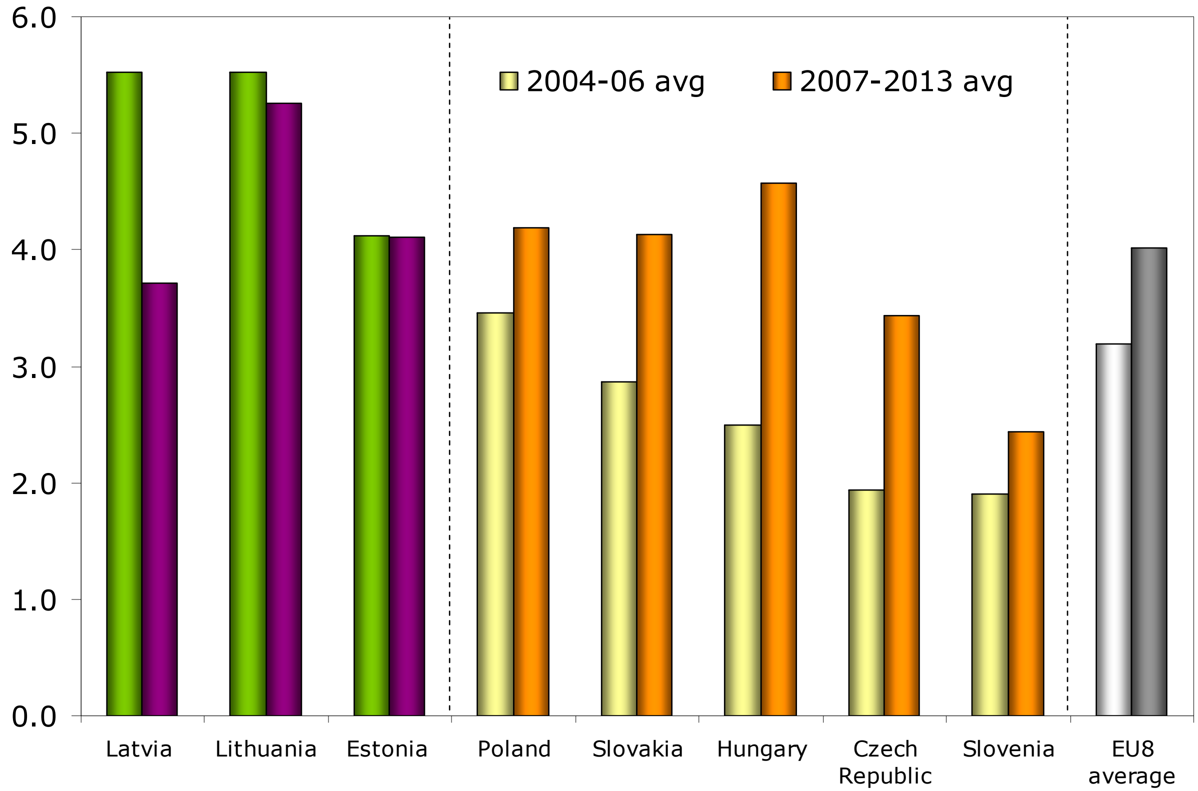
… and financed by FDI (and borrowing from foreign parent banks)

C/A minus net FDI, 2002-2006 average
(percent of GDP)



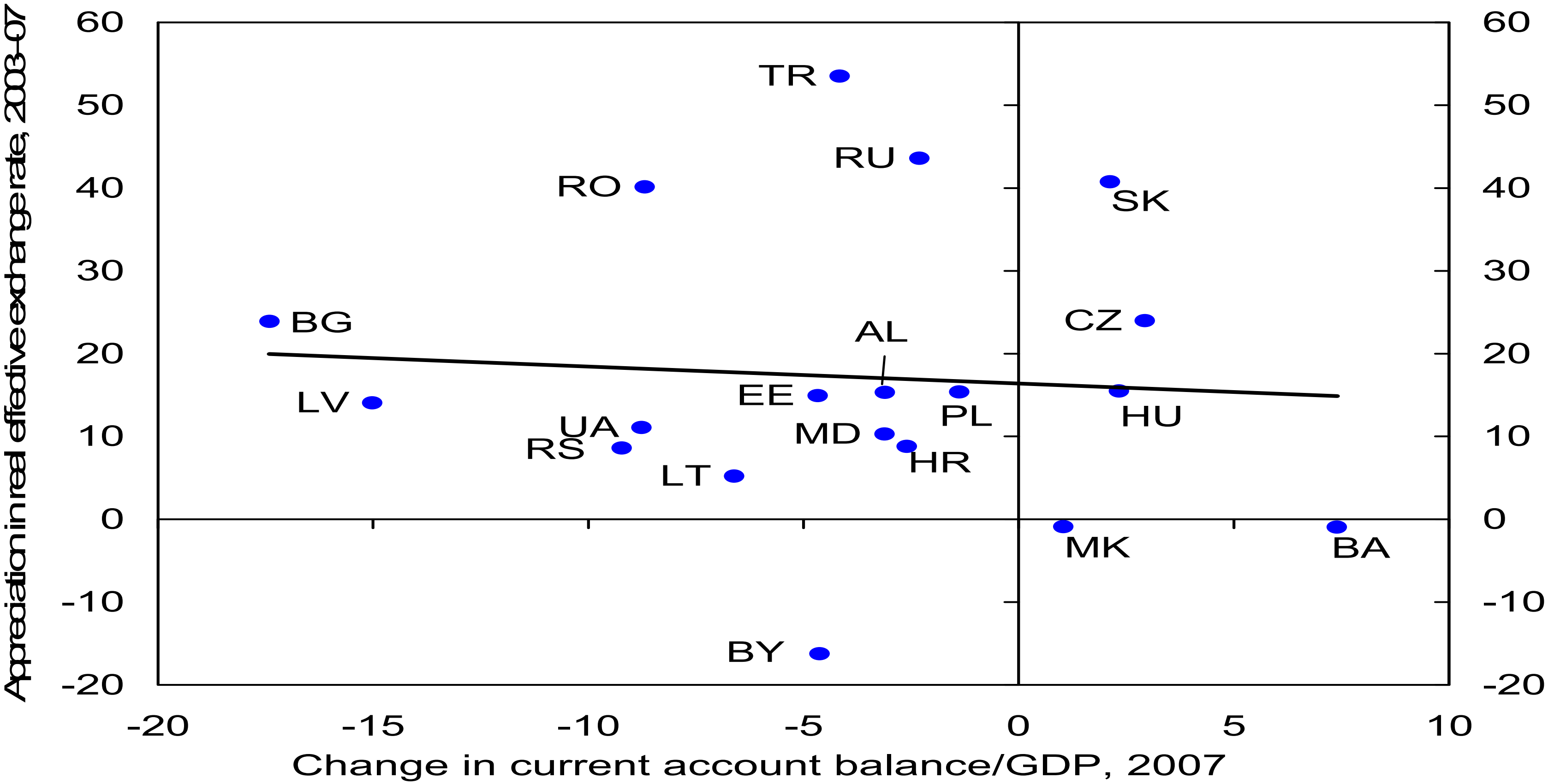
EU transfers (mainly structural and agricultural funds) are an increasingly important part of the balance of payments

EU Funds, average annual commitments, 2004-6, 2007-13 financial perspectives
(percent of GDP)



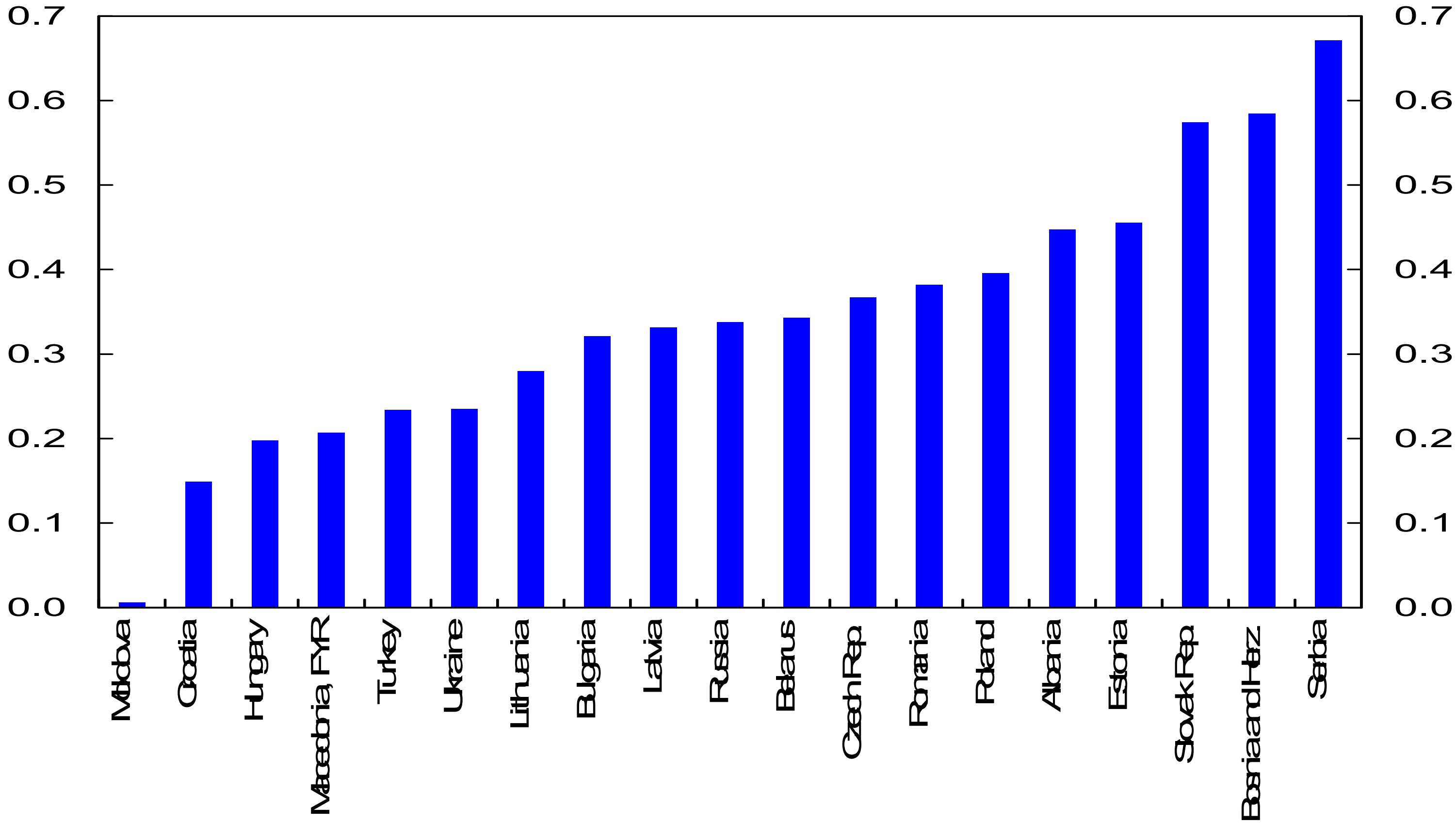
Exchange rate appreciations do not explain high C/A deficits…

Emerging Europe: Change in Current Account Balance and Real Effective Exchange Rate Appreciation, 2003–07
(Percent)

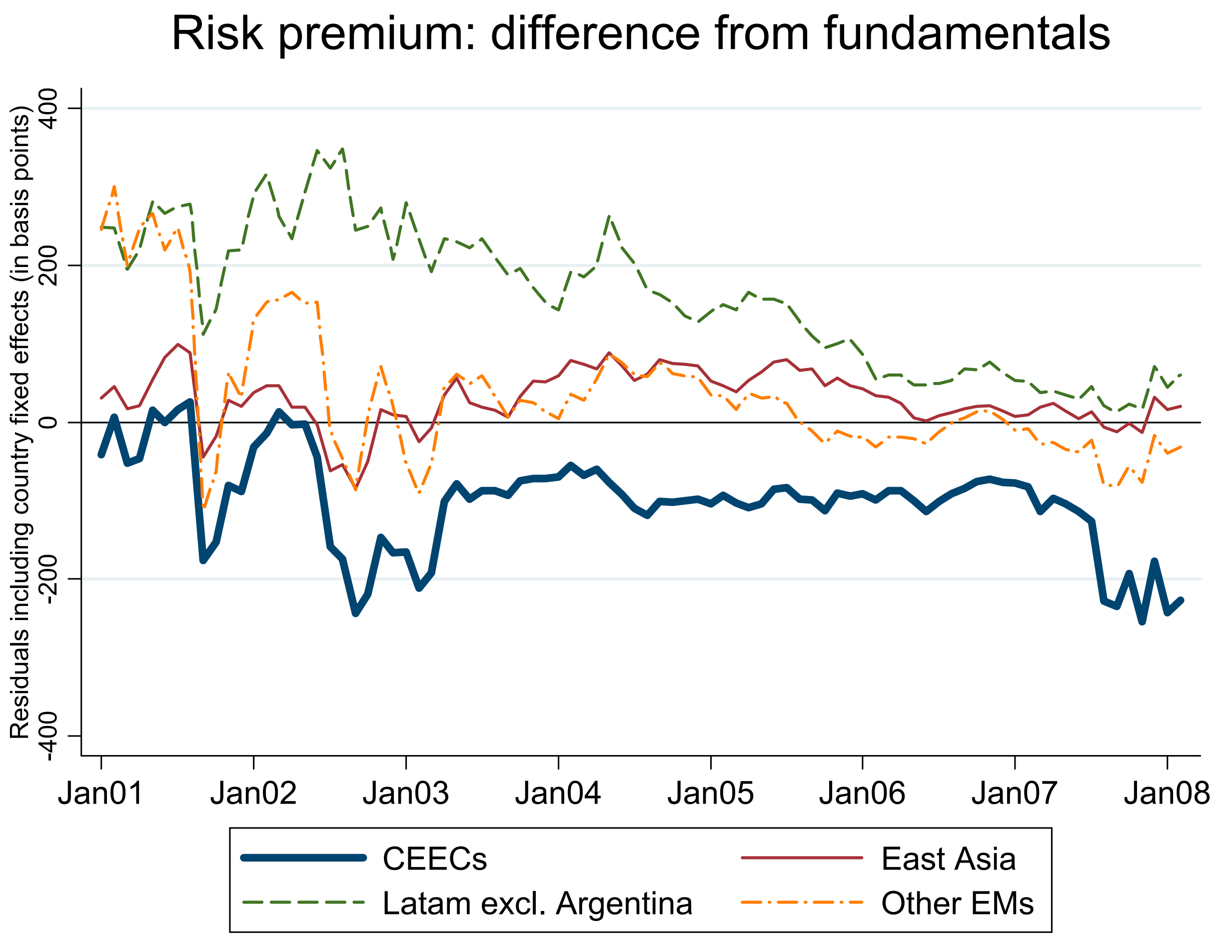


…and lack of competitiveness is not a problem

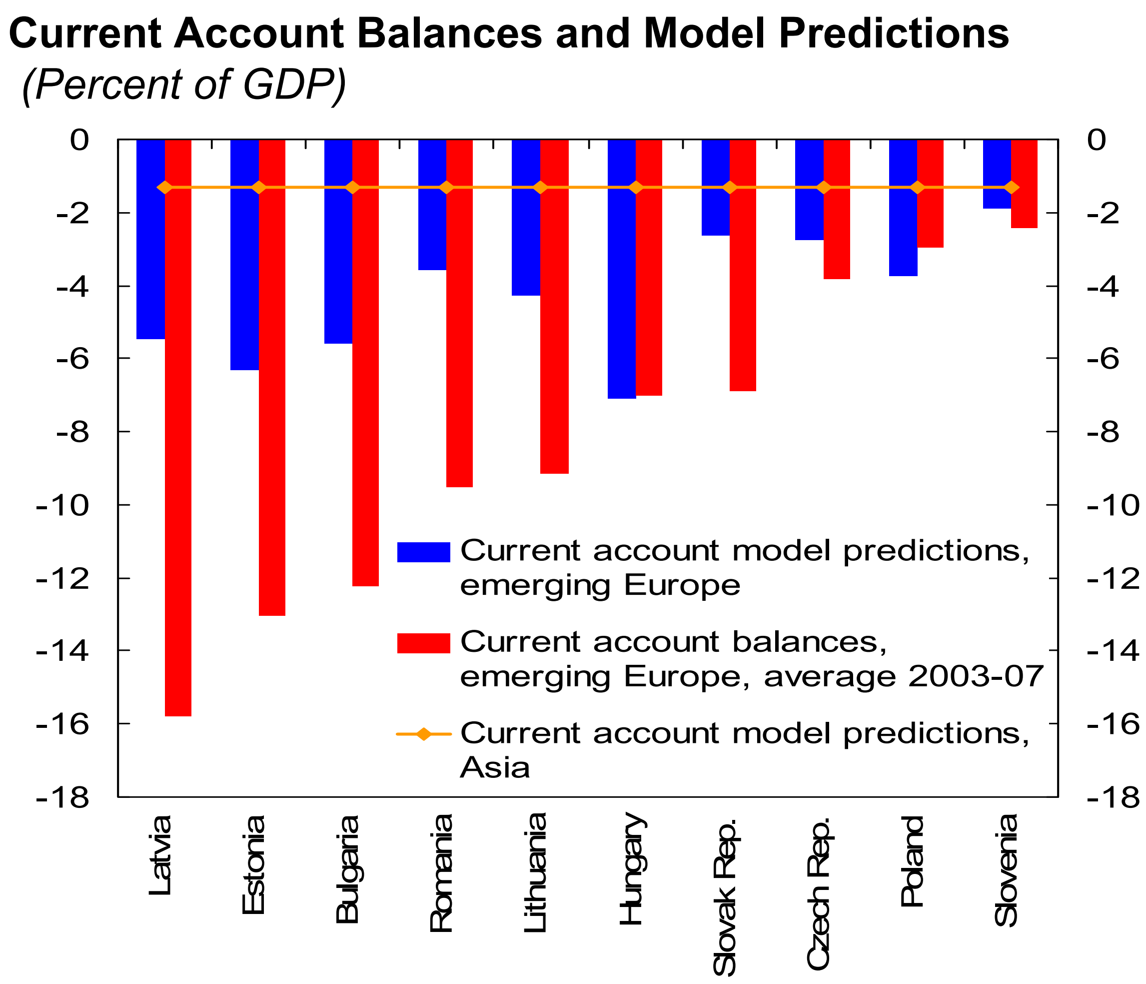
Emerging Europe: Percentage Change in Export Market Shares in the World Economy, 2002–06 1/



The “EU halo effect”: markets continue to reward EU membership

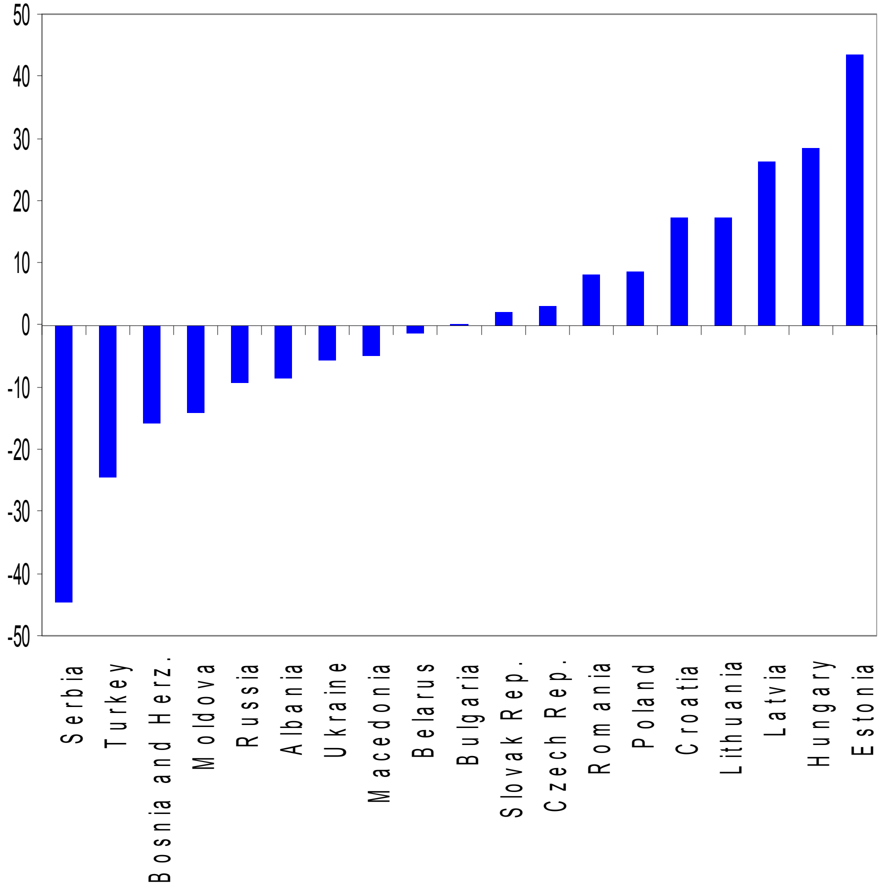


C/A deficits in some countries are much higher than supported by fundamentals

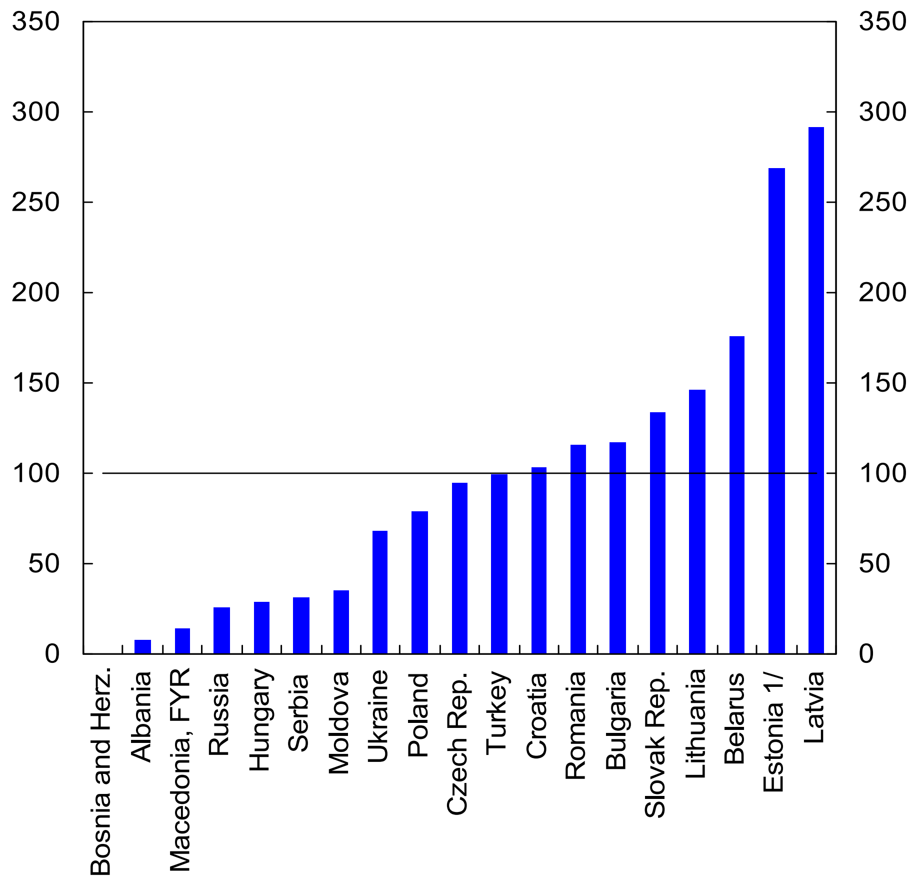


External debt is growing and reserve coverage is insufficient in some countries

External debt to GDP
Change 2002-2007

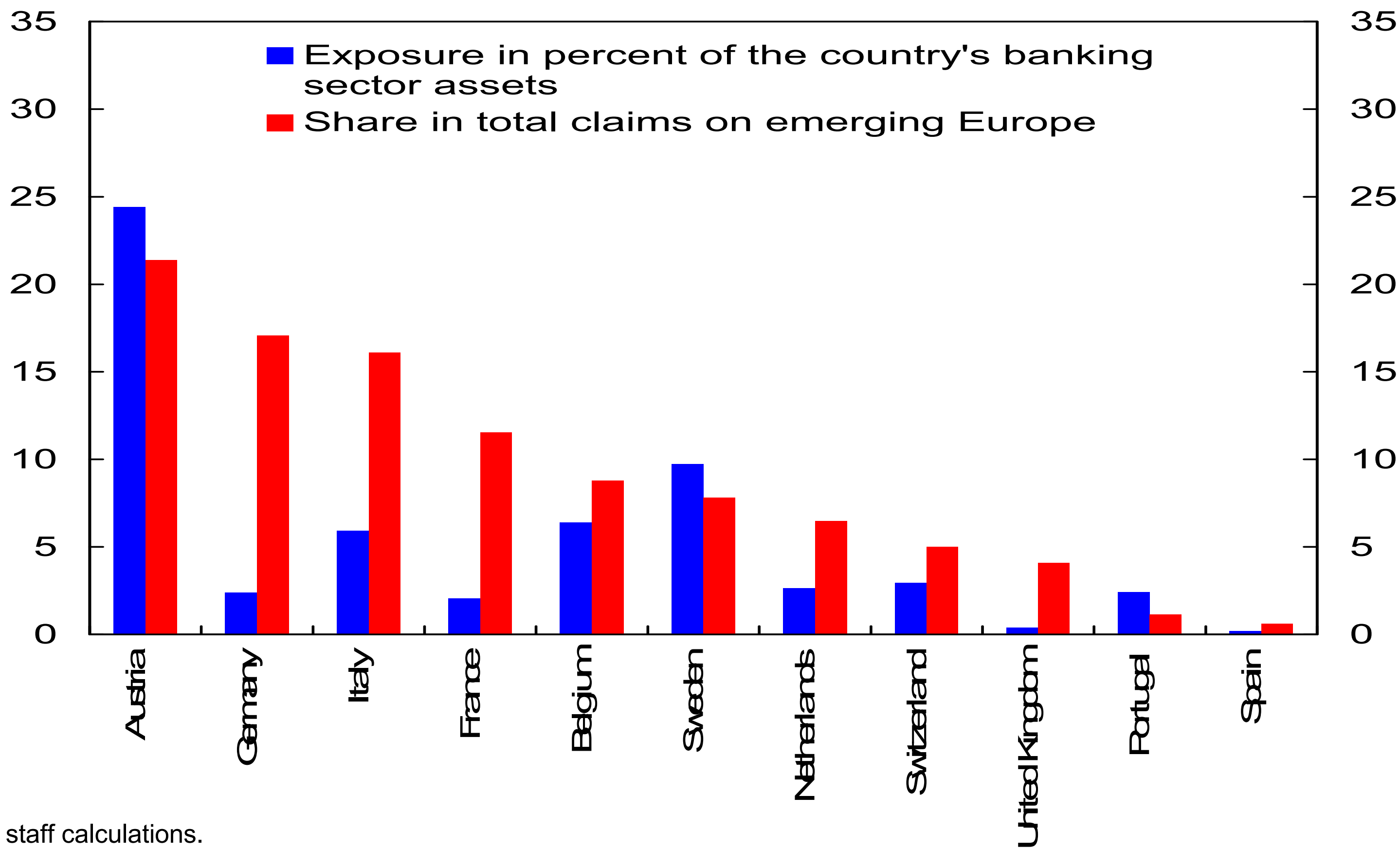


Short-term debt / reserves, 2007



Although lending to emerging Europe is relatively a small share in the portfolio of banks in advanced Europe…

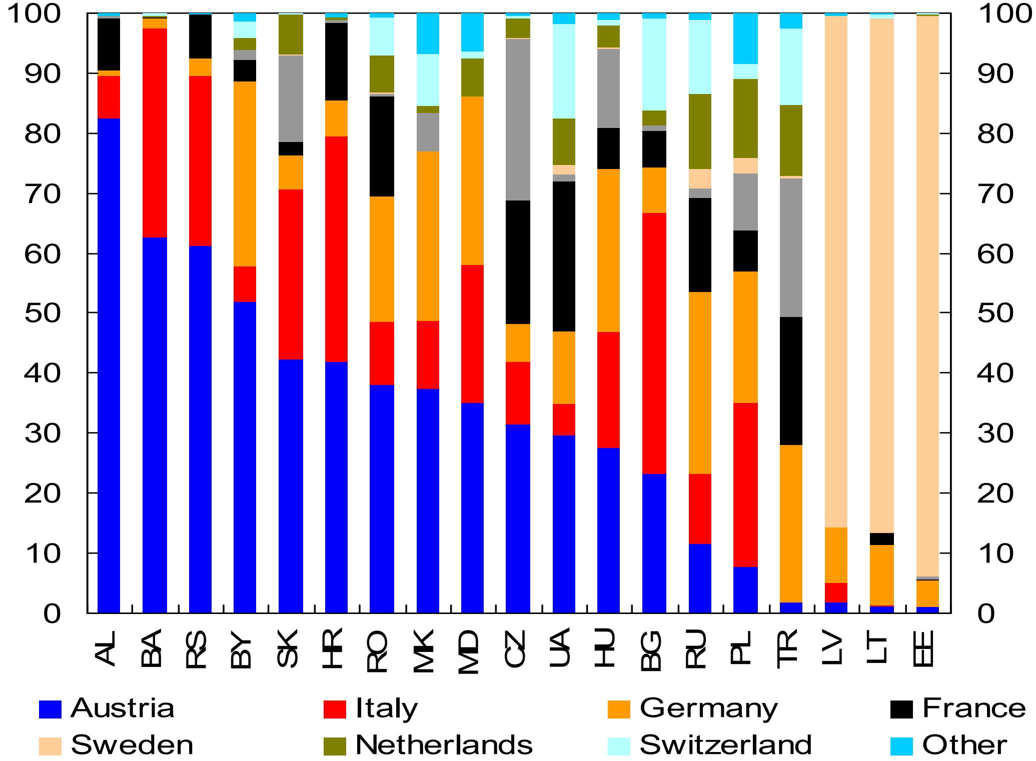
Relative Magnitudes of Funding Exposure for Emerging and Western Europe, June 30, 2007 *(Percent)*



Source: BIS, IMF staff calculations.

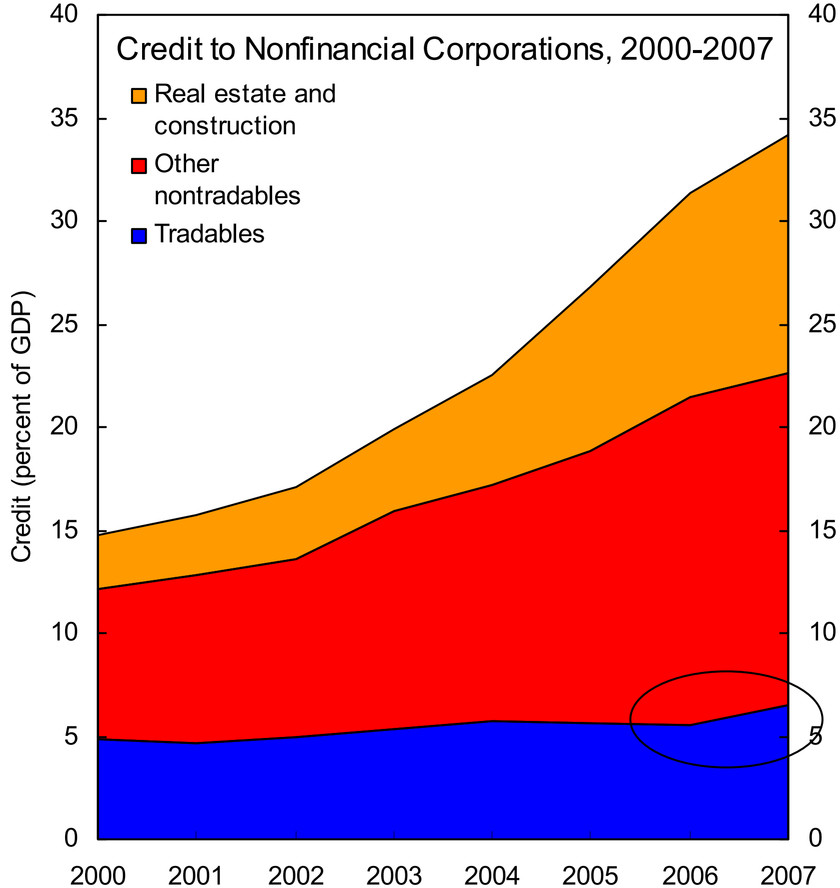
… it exposes the region to common-lender contagion risk

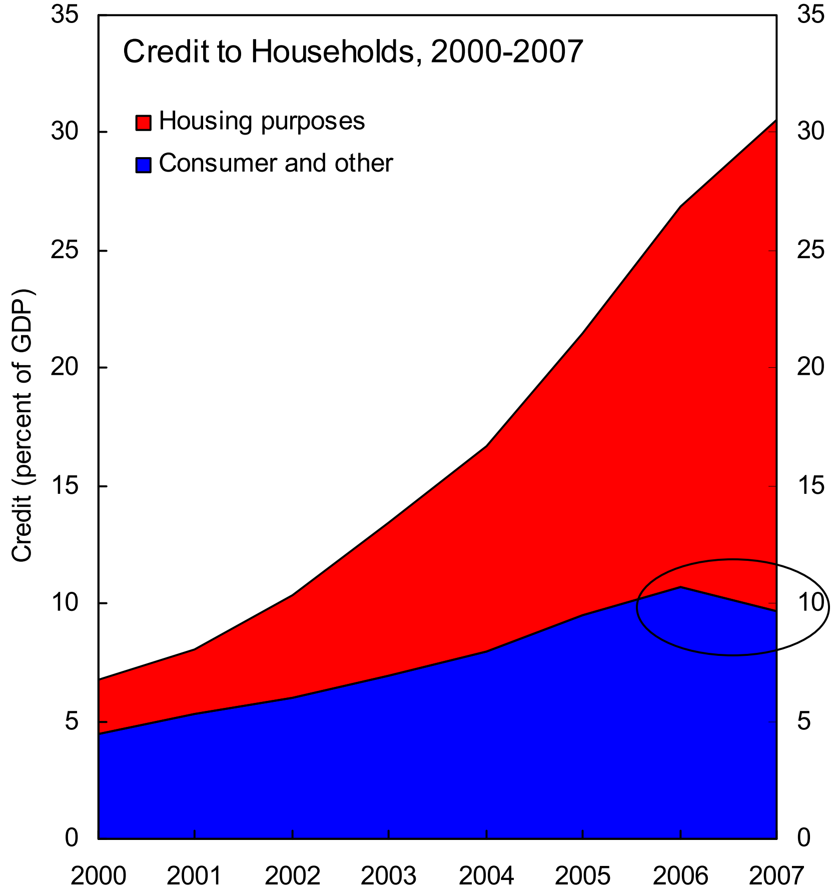
Concentration of Emerging Europe Exposure to Western Europe, June 30, 2007
(Percent)



Source: Bank for International Settlements, Quarterly Review, December 2007.
Note: Country names are abbreviated according to the ISO standard codes.
1/ Emerging Europe exposure to western European banks is defined as the share of the reporting banks in each western European country in the total outstanding claims on a given emerging European country (both bank and nonbank sectors). For example, about 42 percent of Croatia's exposures to Western European reporting banks is owed to Austrian banks, 38 percent to Italian banks, 13 percent to French banks, etc. For the Baltic countries, 85 percent or more of exposures to the reporting banks is owed to Swedish banks.

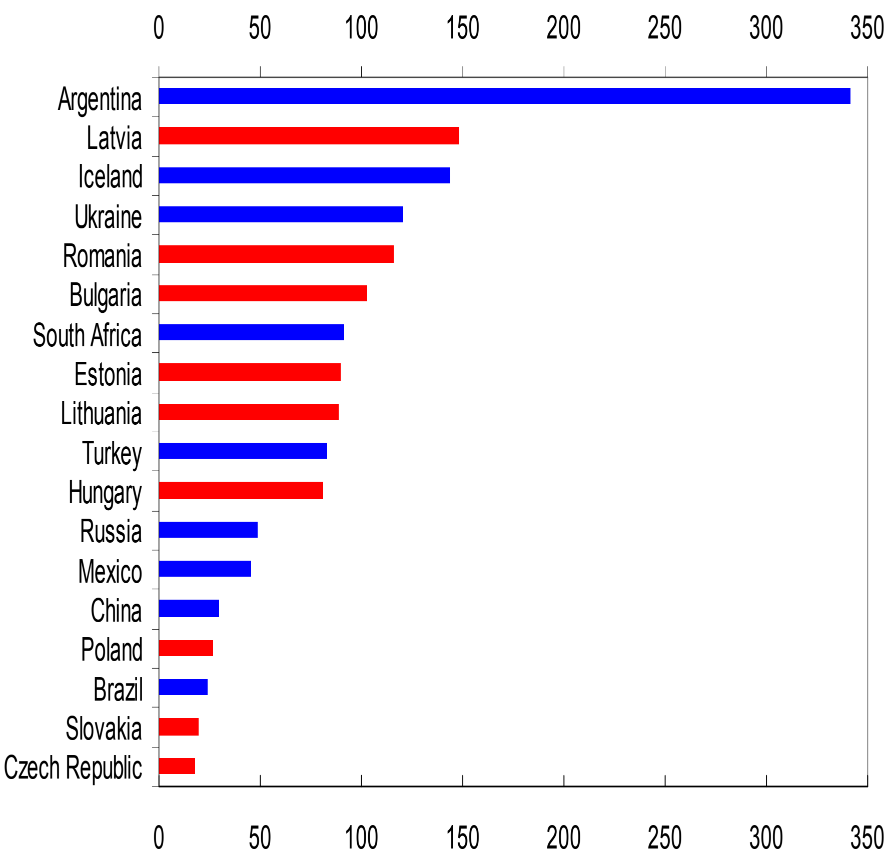
Credit, mostly refinanced from abroad, is concentrated on households and nontradables



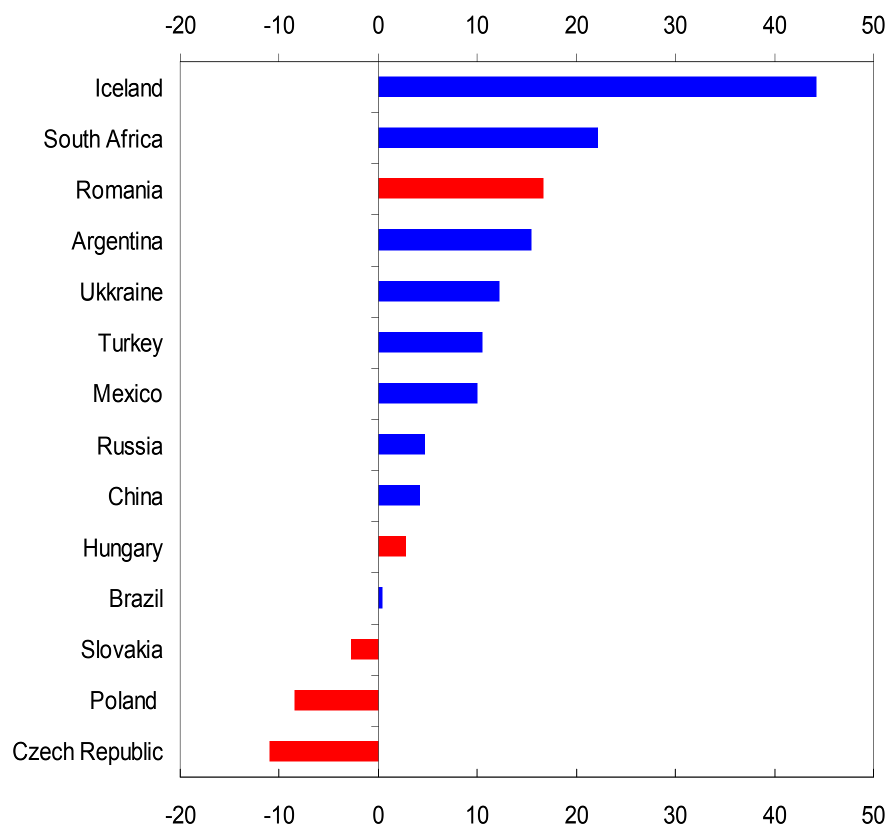


Since the onset of the global financial crisis, markets have differentiated between emerging market countries

Change in CDS July 17 – May 6 *(bps)*

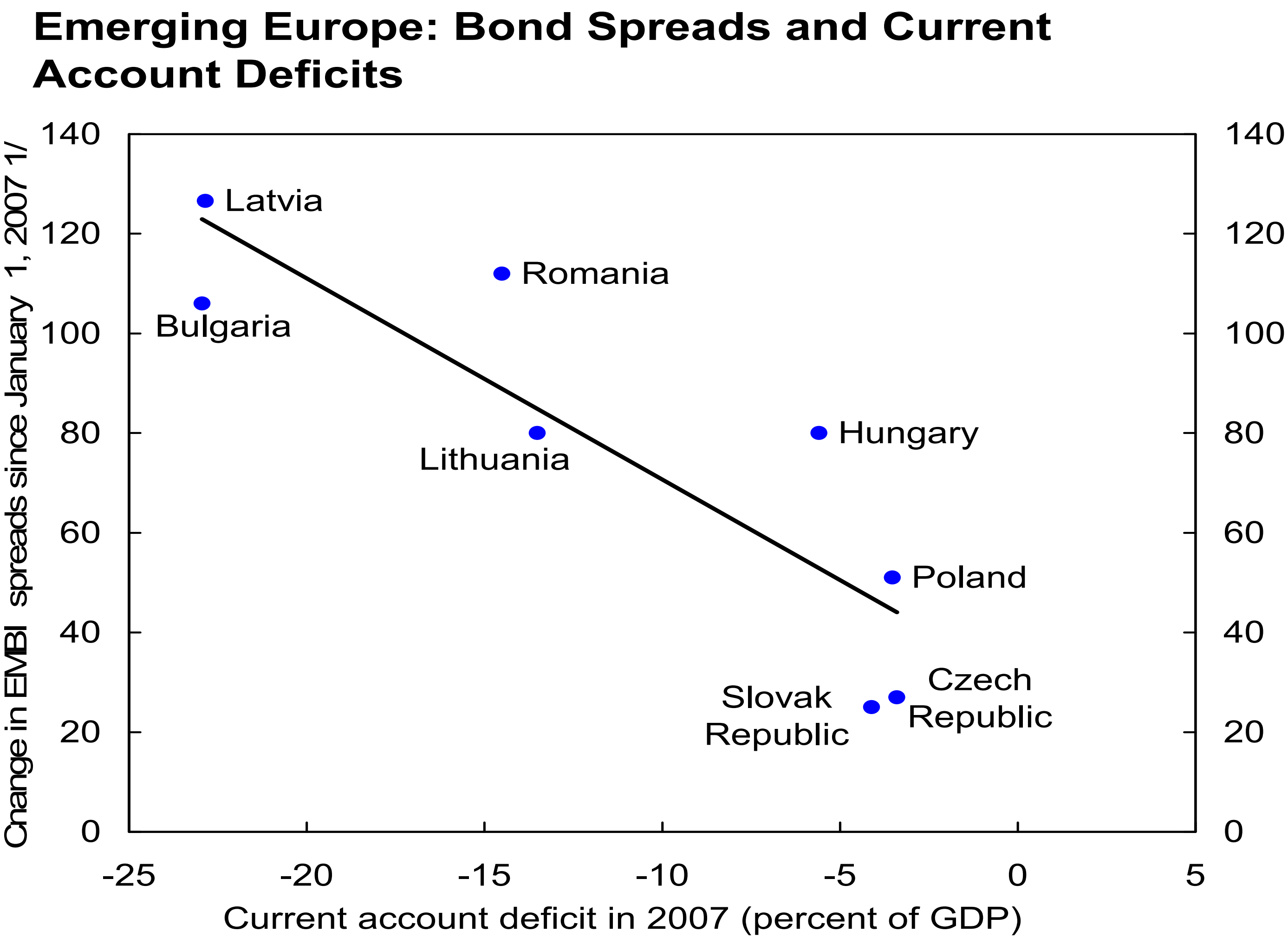


Change in the EURO exchange rate July 17 – May 6 *(+= depreciation, percent)*



Source: Bloomberg, national statistics.

Particularly countries with large external imbalances face higher financing cost



Source: IMF.

So, are large external imbalances a risk?

Optimists:

- The EU's "halo" effect (about 100 bp)
- Favorable structure of financing (EU funds, remittances, FDI, low portfolio inflows)
- Presence of large EU banks

Pessimists:

- Historical "boom-bust" evidence of large capital inflows
- Debt financing is potentially vulnerable to sudden stops and increased cost of refinancing (as is already been felt now)
- Foreign capital mainly goes to the non-tradable sector => questions about countries' capacity to repay
- In the wake of the global credit crisis, markets are starting to punish countries with large imbalances

Policy Dilemma

Large external imbalances should not surprise in an environment of rapid growth

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

➔ Analytical challenge: how to distinguish "natural" convergence from overheating

Policy agenda

- **Monetary policy**: address inflationary pressures, but keep an eye on interest differentials which could induce short-term capital inflows
- **Fiscal policy**: let automatic stabilizers work if economy slows down, but no room for additional stimulus
- **Financial sector supervision**: watch cross-border exposures, encourage the build-up of capital buffers
- Prepare for **euro adoption** by creating flexible economies and sound institutions