



German Marshall Fund of The United States

Economic Trends and Challenges in Central and Eastern Europe

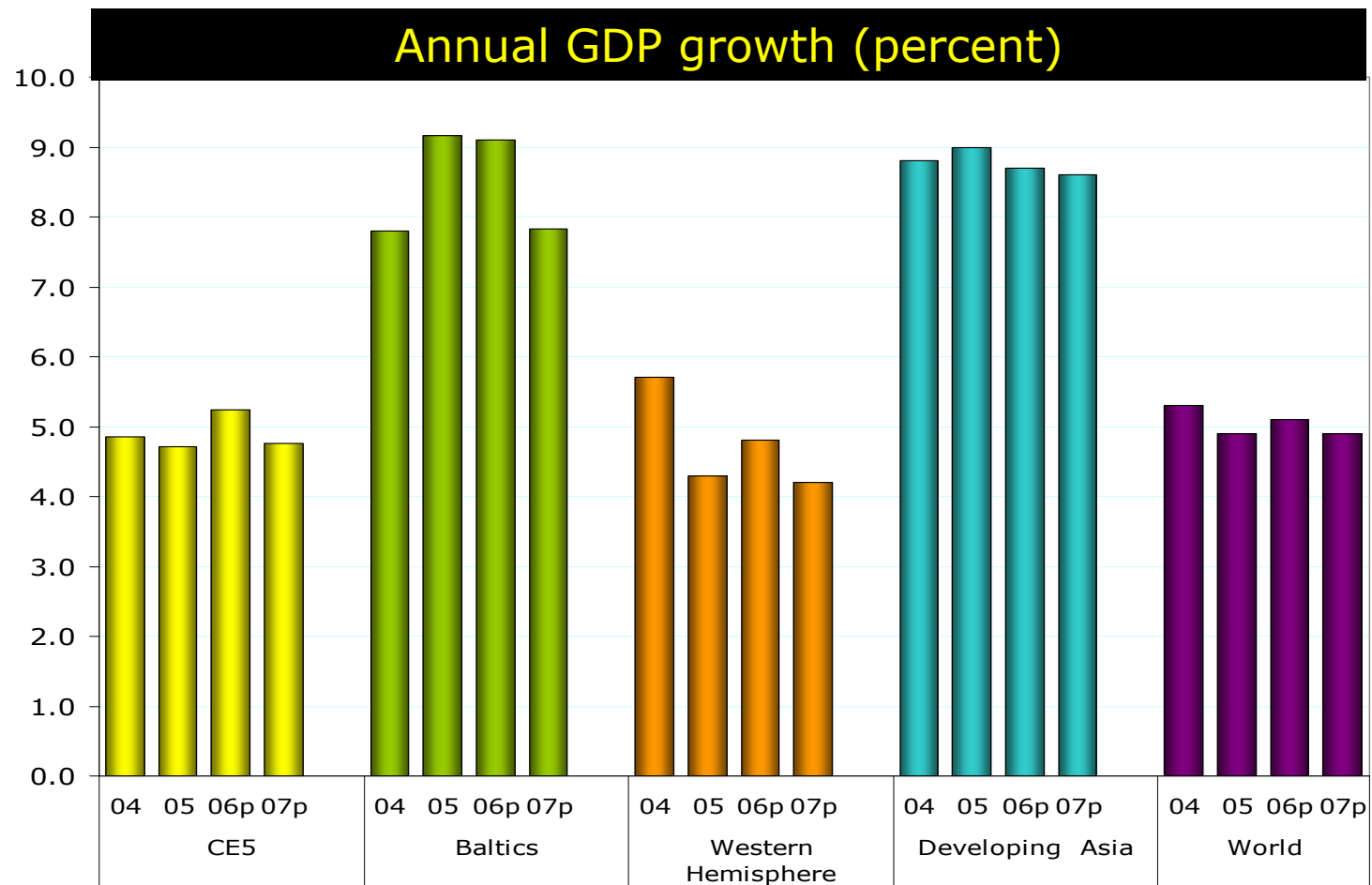
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Warsaw Regional Office
March 2, 2007
Bratislava

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

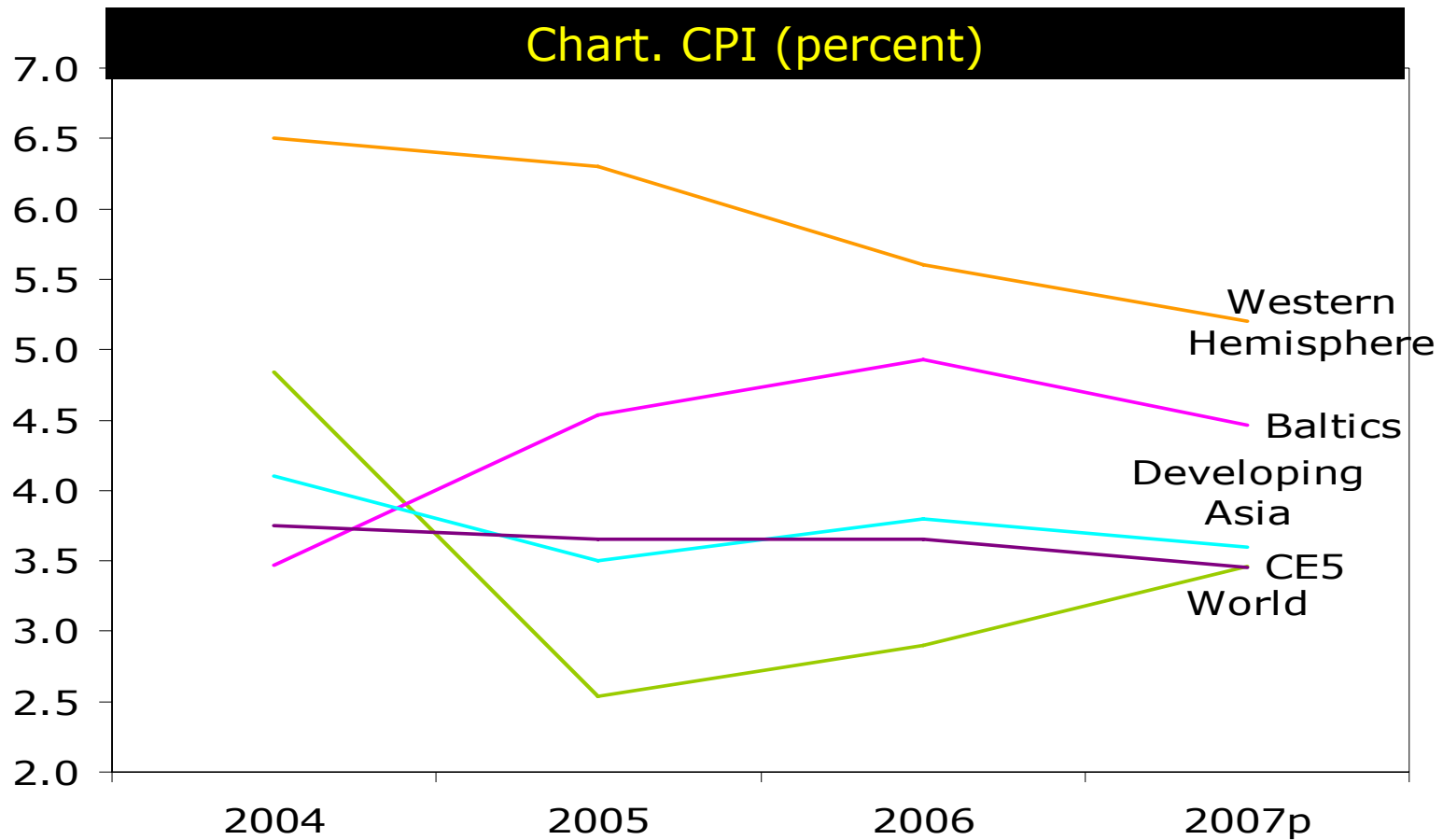
- The overall macro picture: better than ever
- Meanwhile, economists worry about vulnerabilities in the run-up to Euro adoption
 - Lack of fiscal adjustment
 - Credit growth
 - Currency mismatches
 - External imbalances
- Perception gap: how the markets view risks in the CECs
- Policy Conclusions

**The overall macro picture:
better than ever**

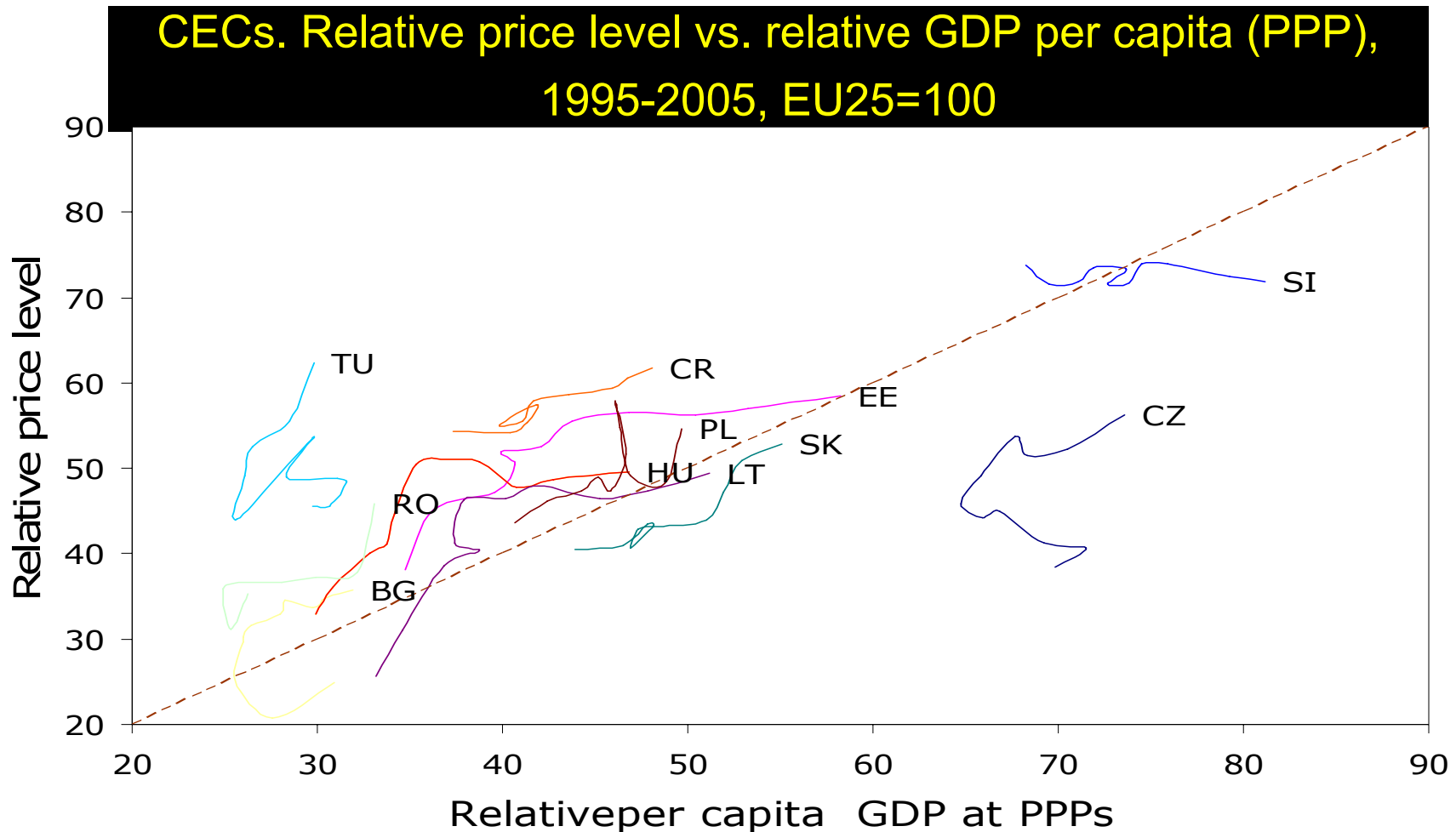
Growth performance is good, albeit mainly cyclical.



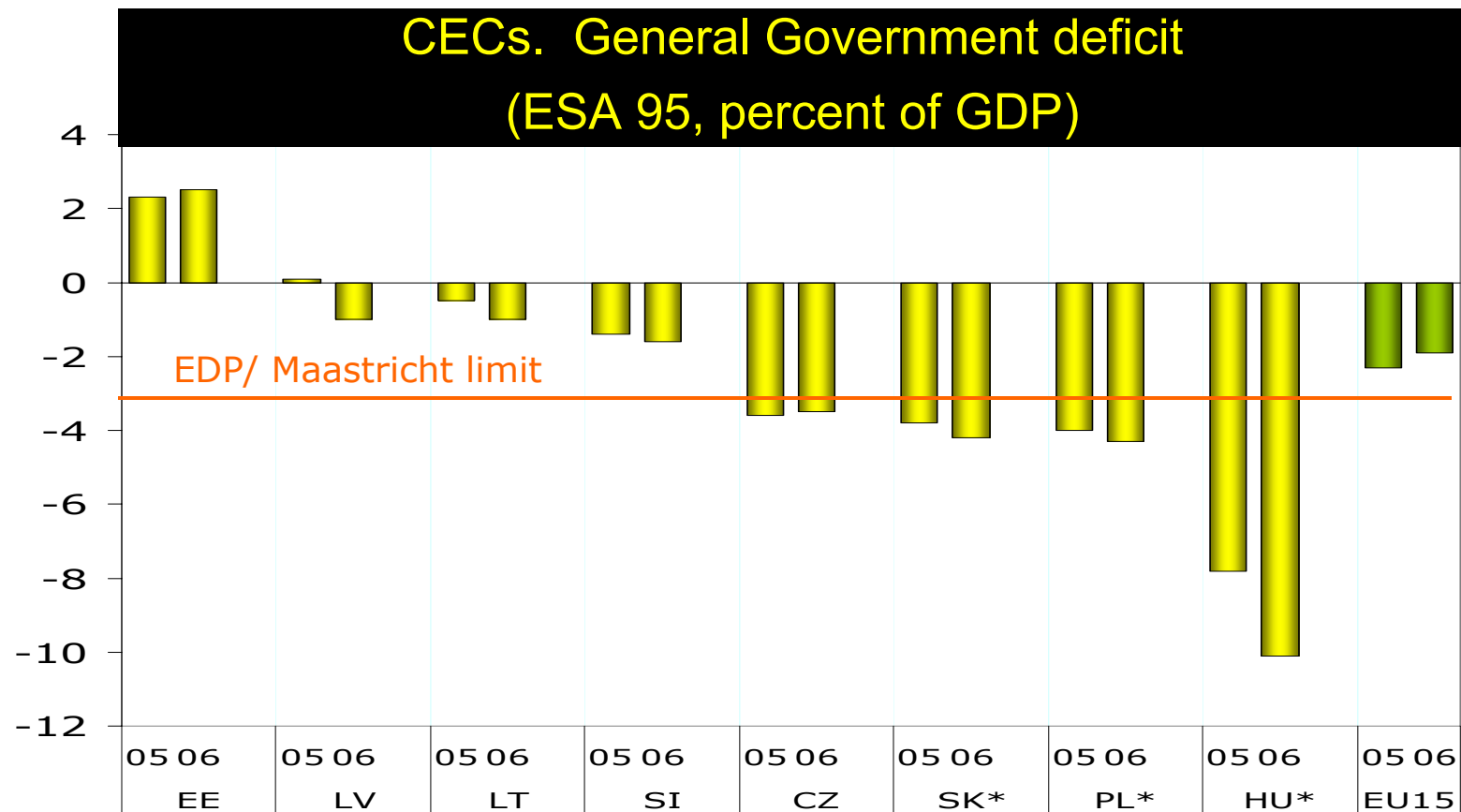
Inflation is relatively subdued



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



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



* incl. pension reform costs

Source: EC General Government Data Autumn 2006

Meanwhile economists worry about
increasing vulnerabilities
in the run-up to euro adoption.

Macro Vulnerabilities

External imbalances are growing, especially in the Baltics

Key Macro Indicators 2005 (in percent of GDP)

	CE5	Baltics	EM countries*
General government deficit	-3.2	0.4	2.2
C/A balance	-3.5	-10.1	1.5
External balance	56.5	81.9	61.2
Public debt	39.0	11.8	45.8
Reserves/ST debt	173.0	54.8	212.4
Credit growth (annual growth)	1.4	7.5	2.9

* EM countries - Argentina, Brazil, Bulgaria, Chile, China, Colombia, Indonesia, Peru, Russia, Singapore, 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.

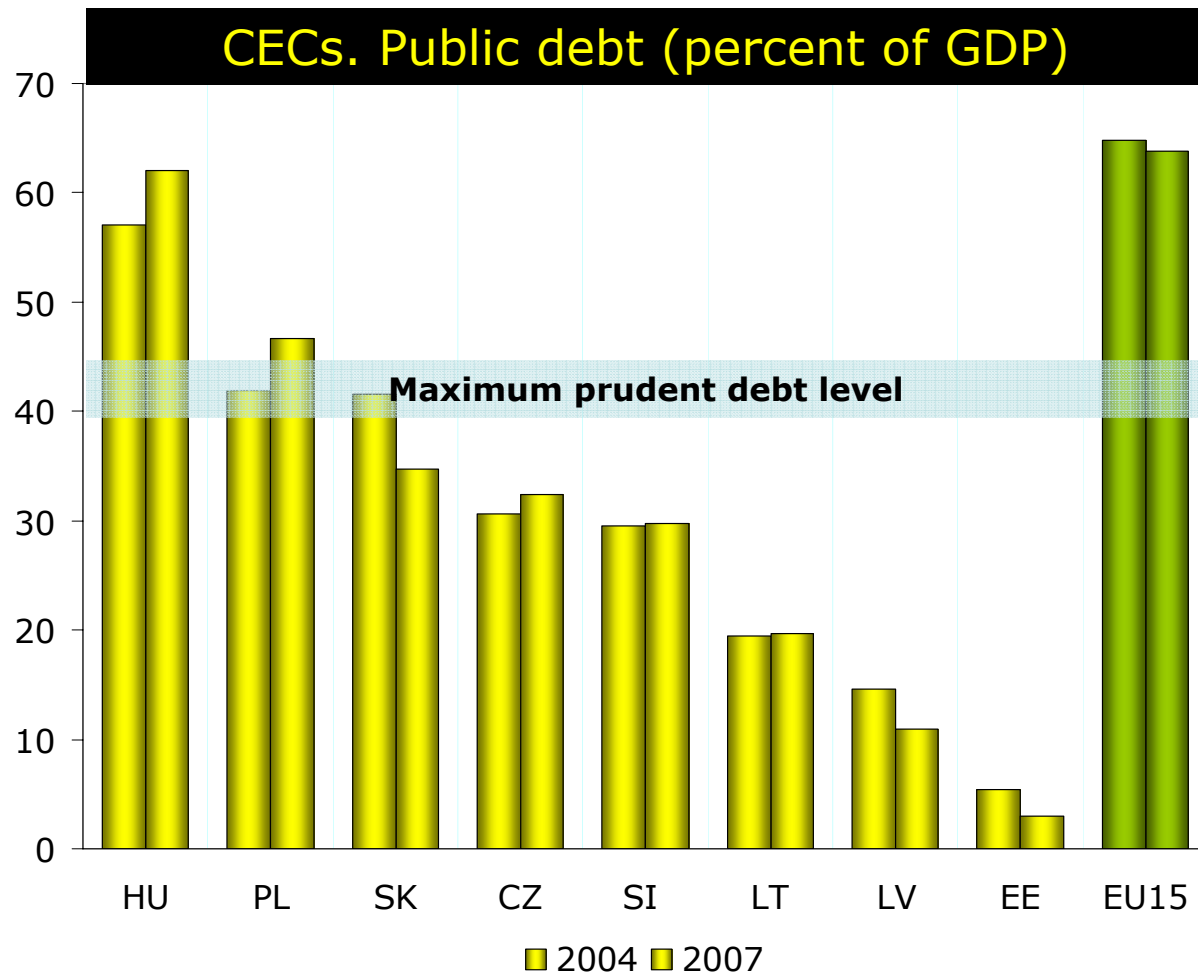
➔ Policy dilemma: how to reduce vulnerabilities without impeding the convergence process?

Main Concerns

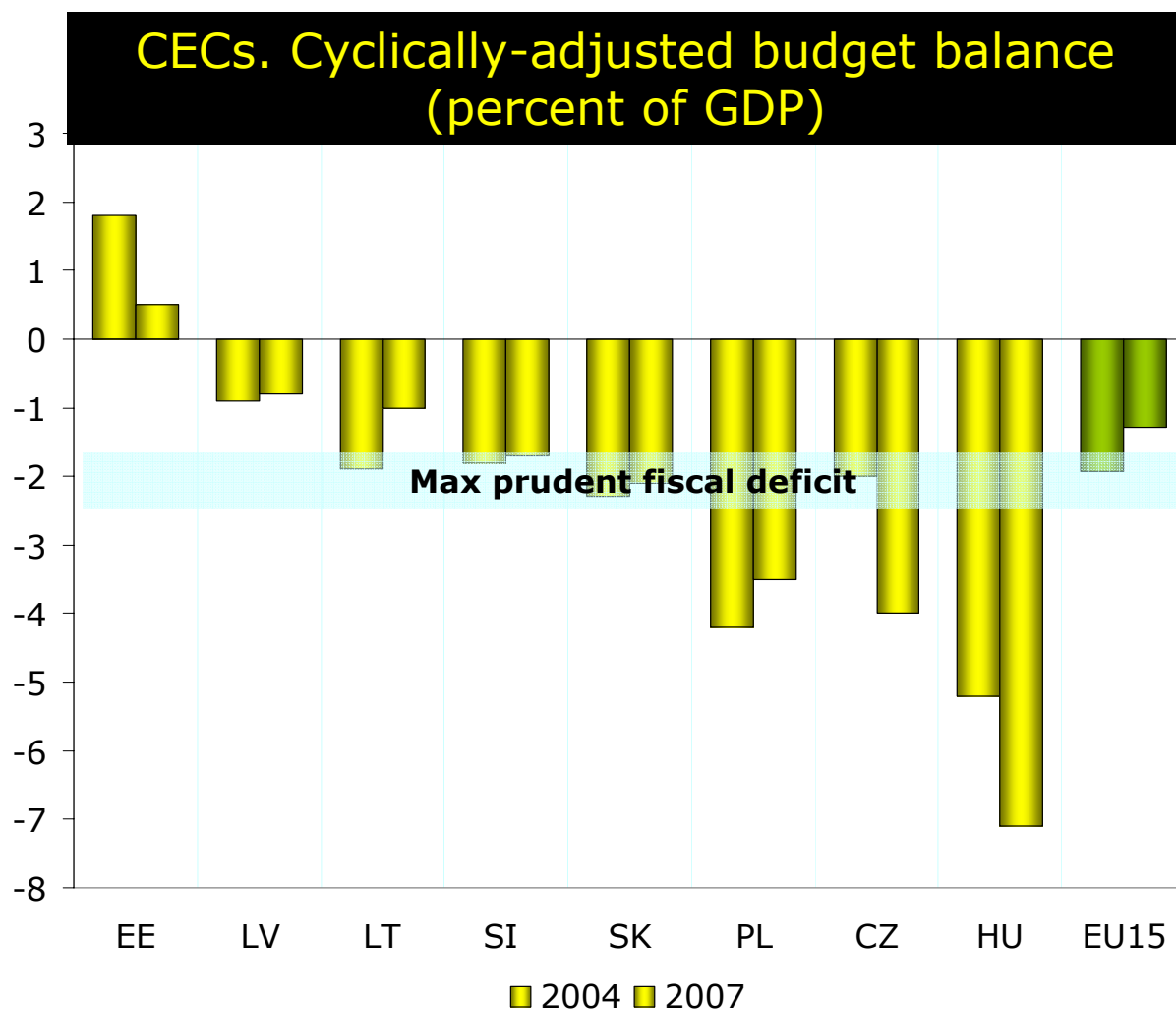
- Lack of fiscal adjustment
- Credit growth
- Currency mismatches
- External imbalances

Lack of fiscal adjustment

Despite healthy growth, public debt ratios are still rising in many CECs.



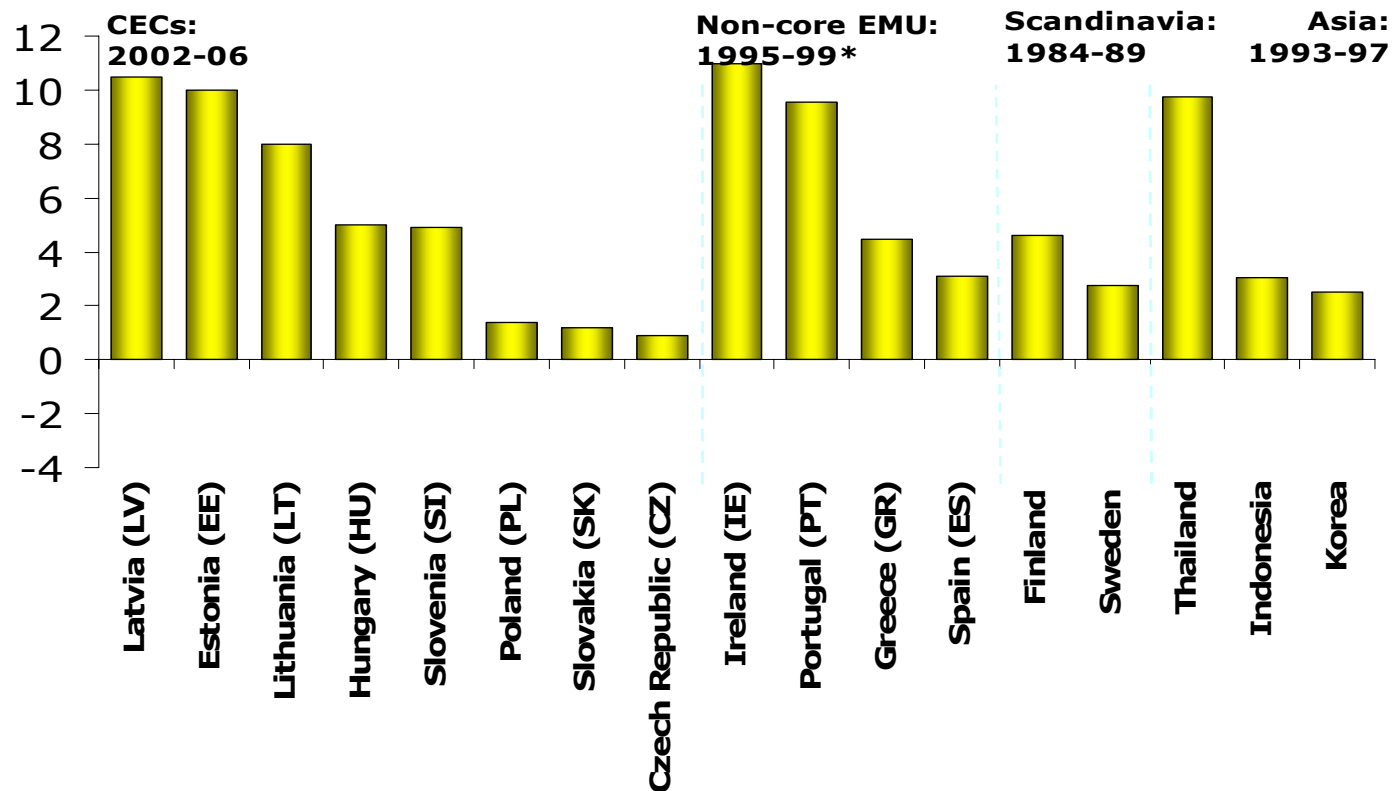
Few countries have used the benign global environment to undertake fiscal adjustment.



**Rapid growth of credit
to the private sector**

Credit growth has been brisk.

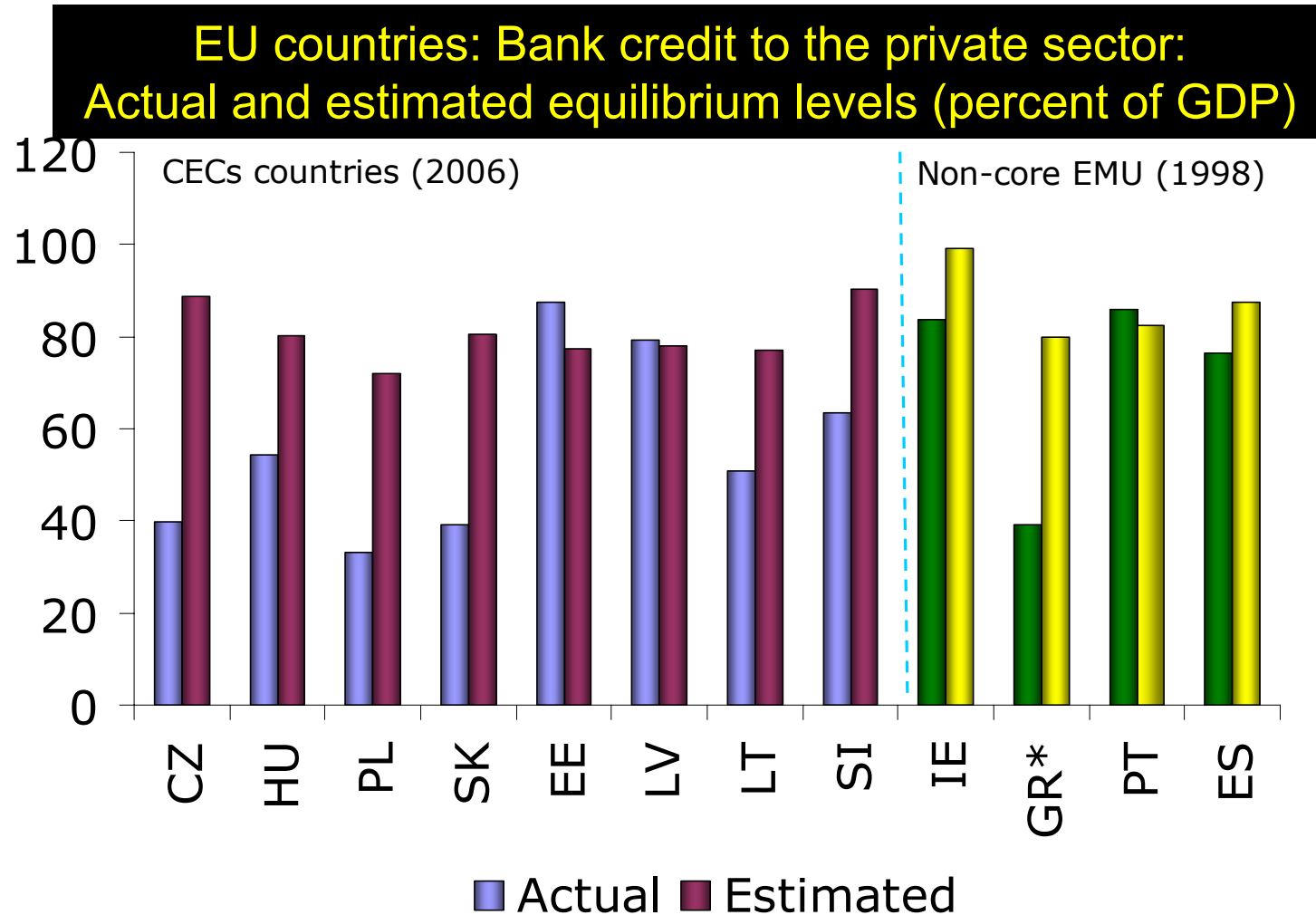
Average growth of credit to the private sector (in percentage points of GDP)



*Greece 1997-2000

Source: IFS, national authorities, IMF staff calculations

Private credit still has some room to grow.



*Greece (Q1.1999)

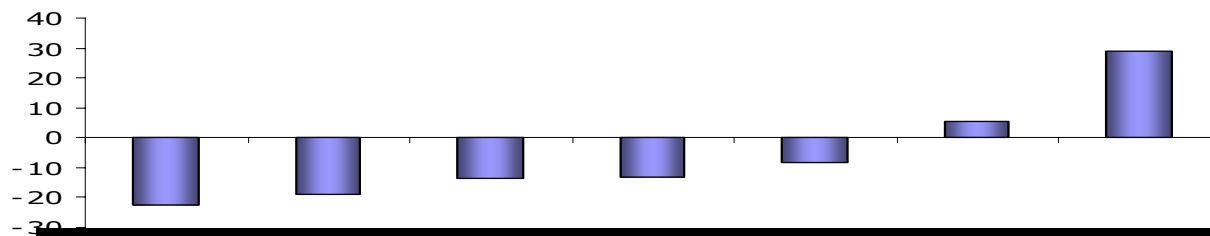
Source: National authorities, calculations based on Schadler et al. (2005)

**Build-up of
currency mismatches
in the
non-financial sector**

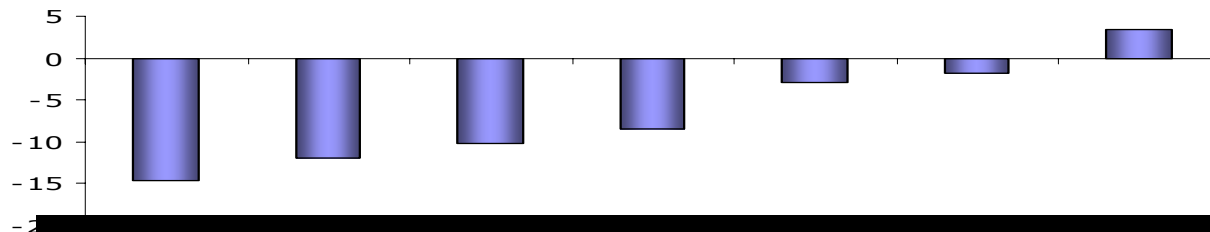
Most CECs are exposed to currency risk emanating in the non-financial private sector

CECs. Economy-wide currency mismatches

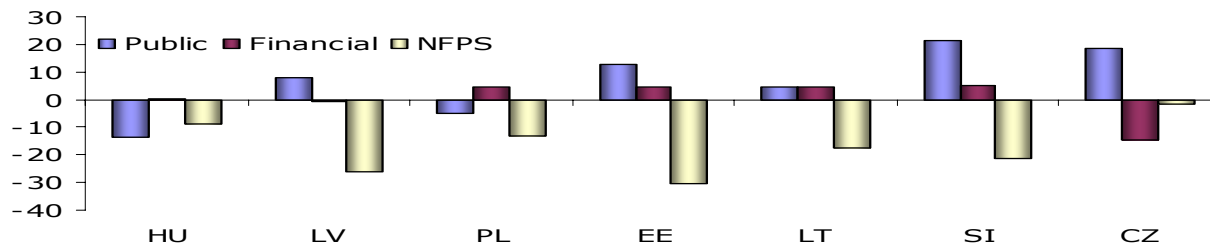
Net FX position, 2005 (in percent of GDP)



Change in net FX position, 2002-05 (in percent of GDP)



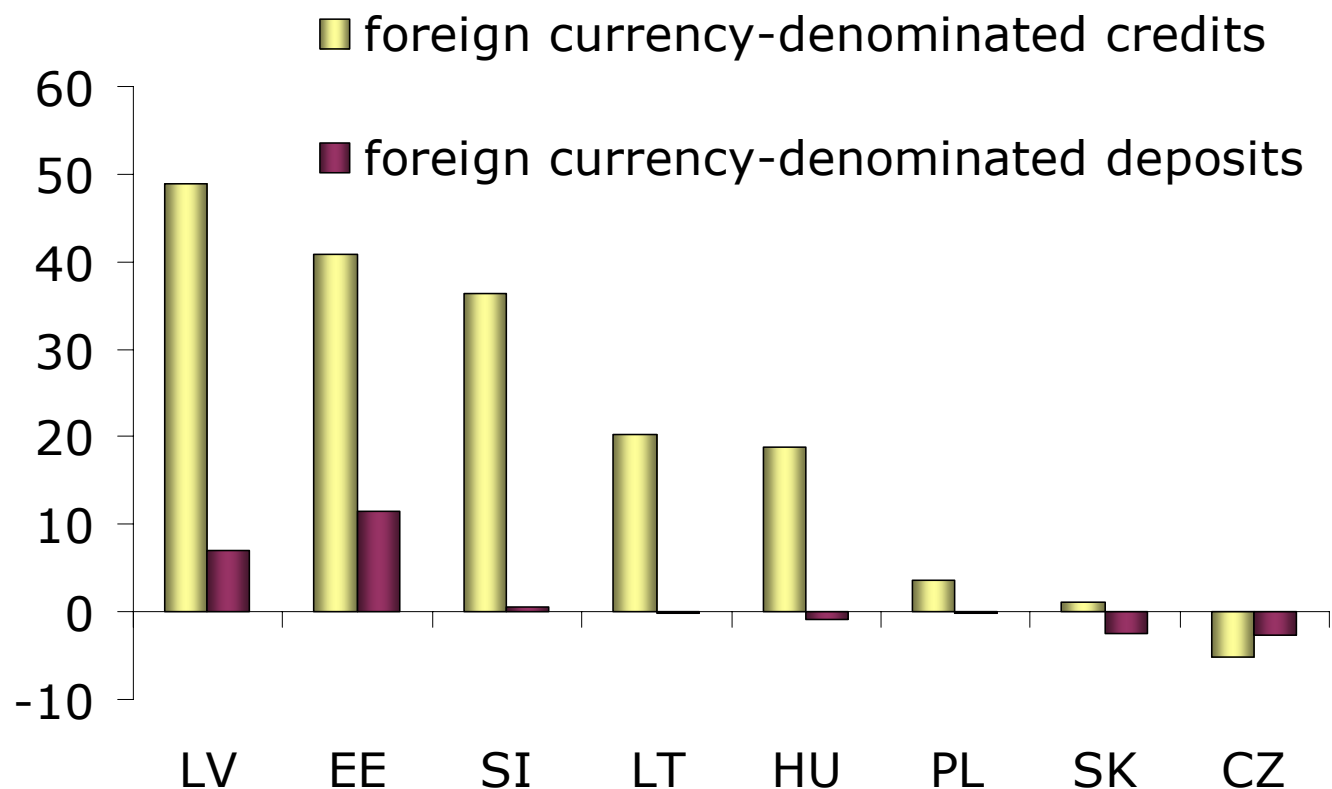
Sectoral net FX position, 2005



Source: National authorities.

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

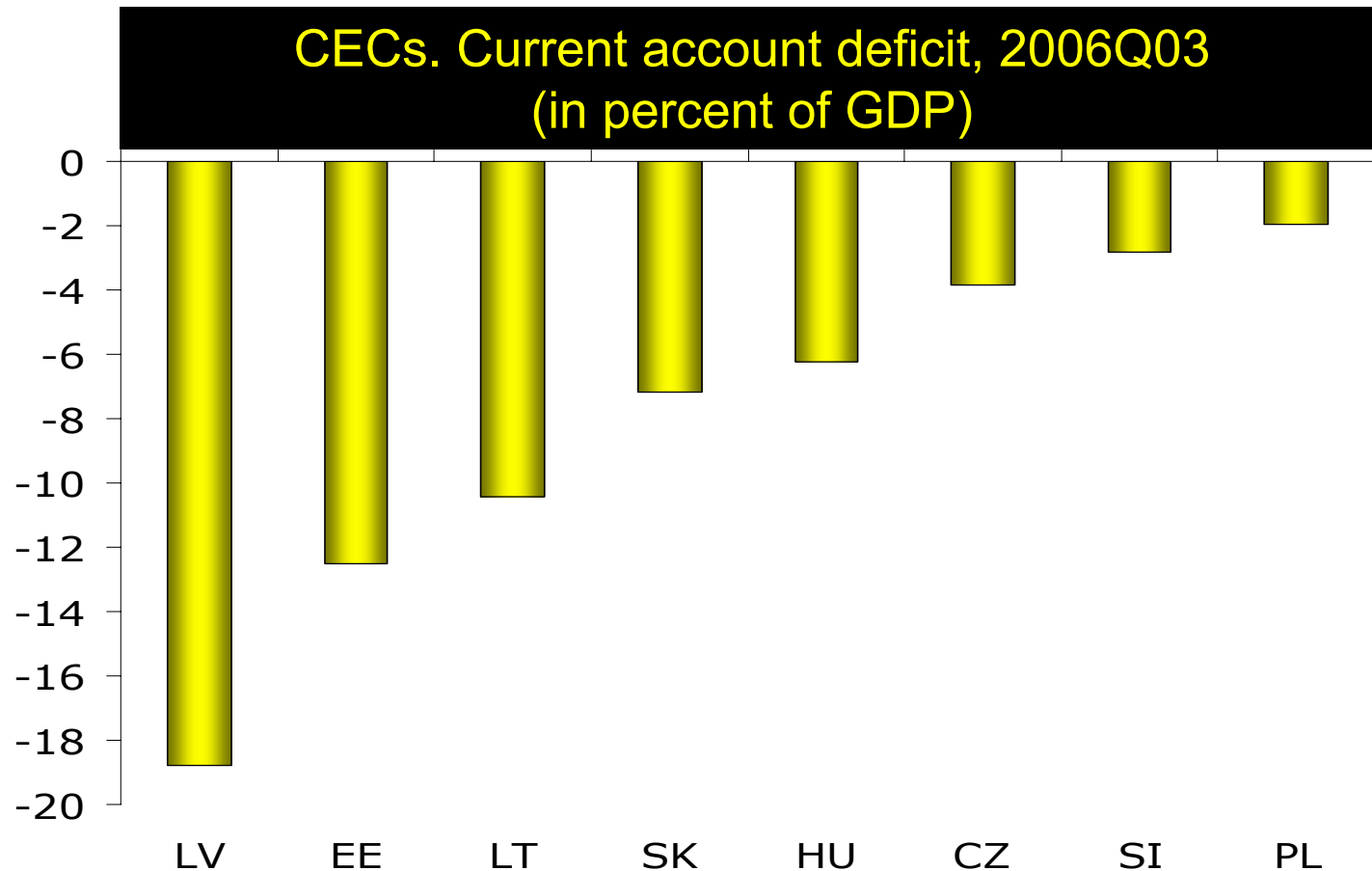
CECs. Change of foreign currency credits and deposits during 2001-05 (in percentage points of GDP)



Source: National authorities, IMF staff estimates

**Large external
stock and flow
imbalances**

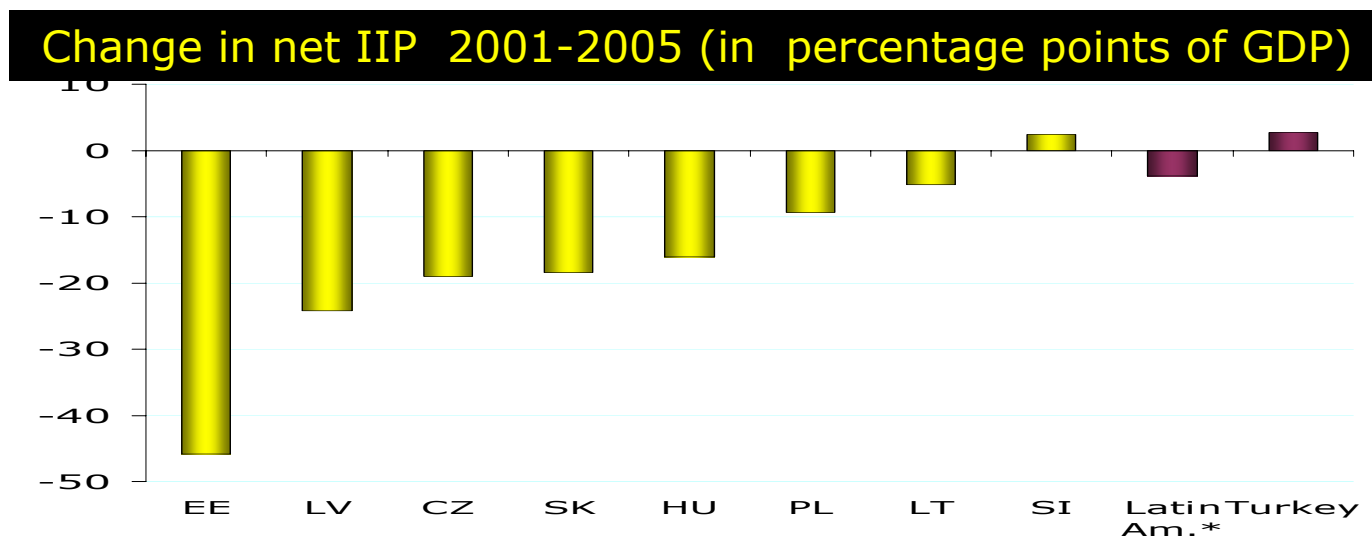
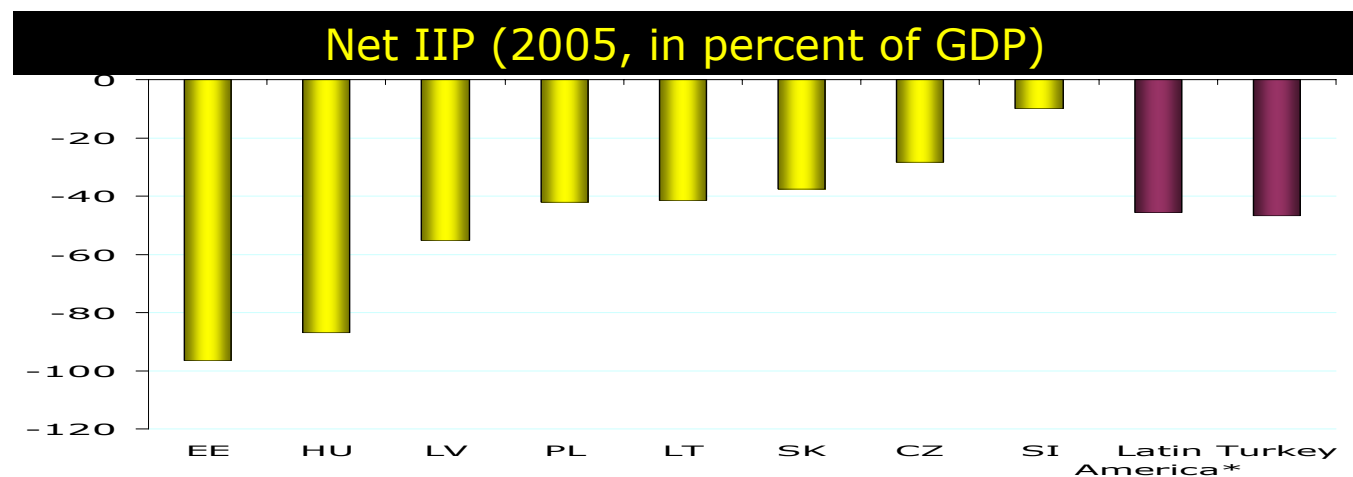
Current account deficits are high in some CECs



Source: Eurostat, National Authorities

As expected, net IIPs are negative, but unlike in other EMs they have lately deteriorated

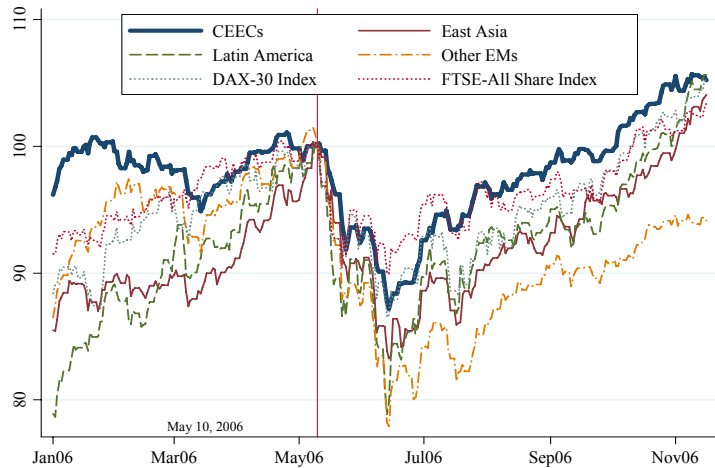
CECs and EMs: International Investment Position



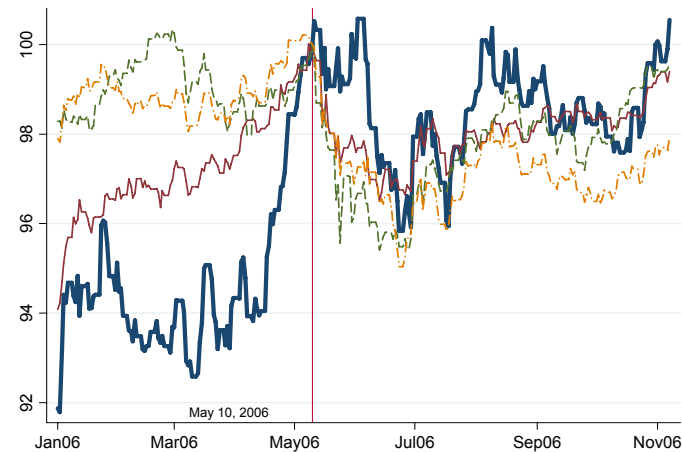
**Perception gap:
how the markets view risks
in the CECs**

CECs outperform other EMs

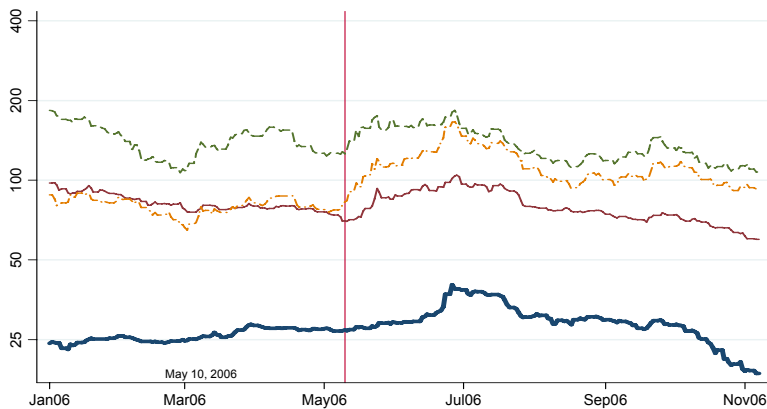
A. Stock Market Indices
(May 10, 2006=100)



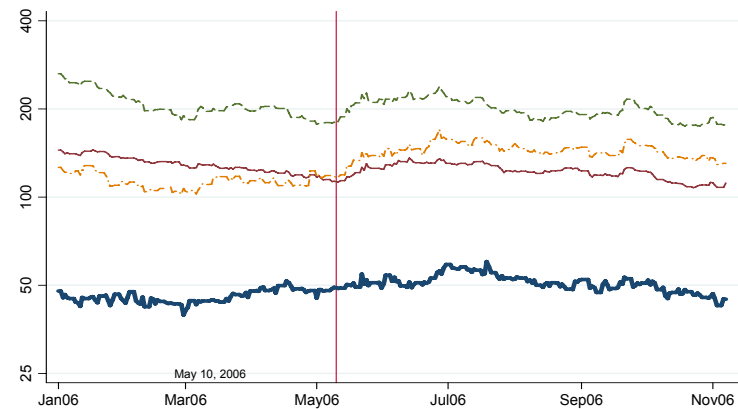
B. Indices of Exchange Rate Against US\$
(May 10, 2006 =100; (+) = appreciation)



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 (forthcoming)

Do markets differentiate CECs because of “fundamentals”? What are “fundamentals”?

Economic Risk

- GDP per capita
- Real GDP Growth
- Inflation
- Budget Balance
- Current Account Deficits

Financial Risk

- External debt/GDP
- External debt service ratio
- Current account/ exports
- Official reserves/ imports
- Exchange rate stability

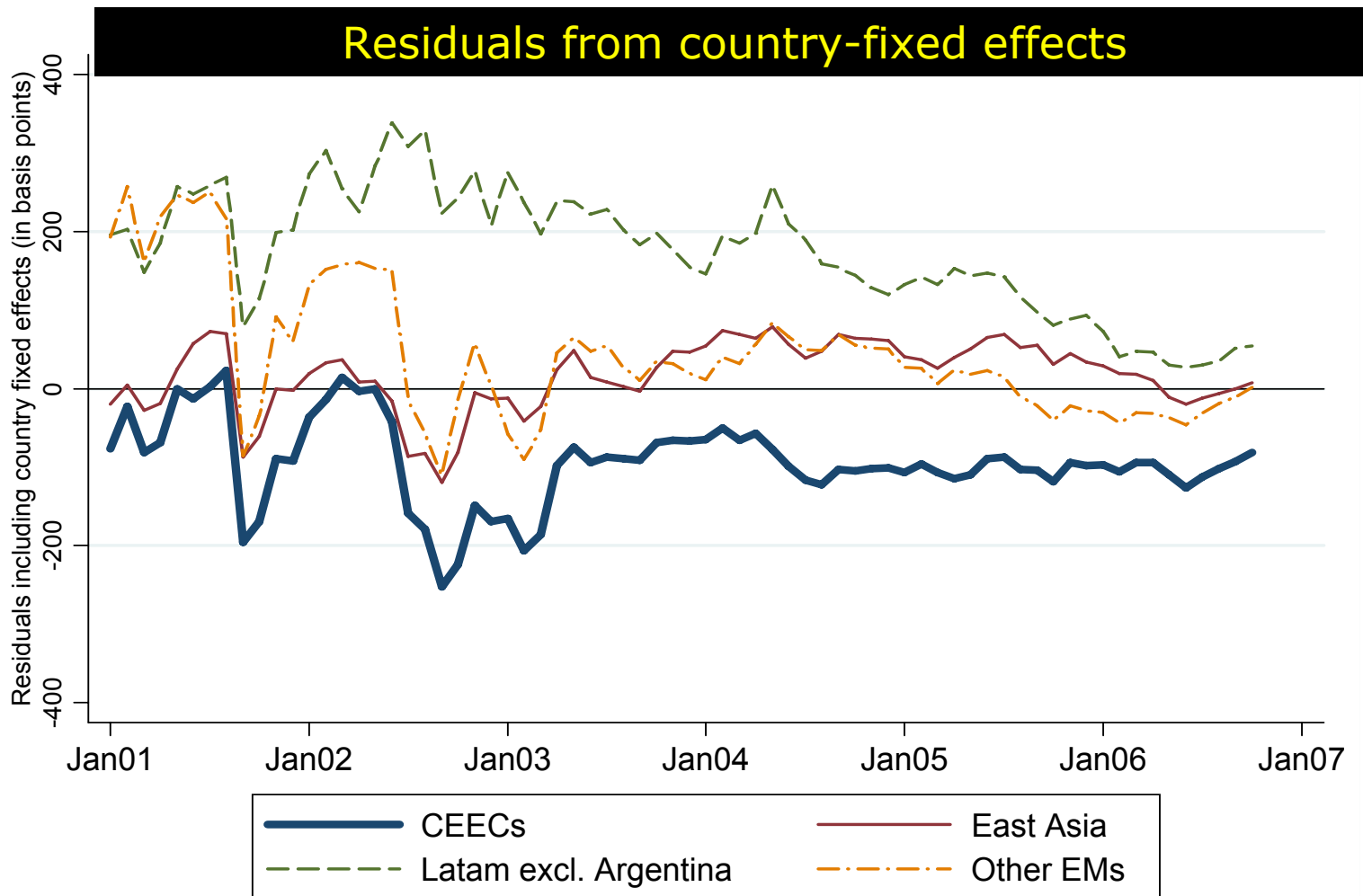
Political Risk

Index based on 12 political and socio-economic conditions

Global Financial Conditions

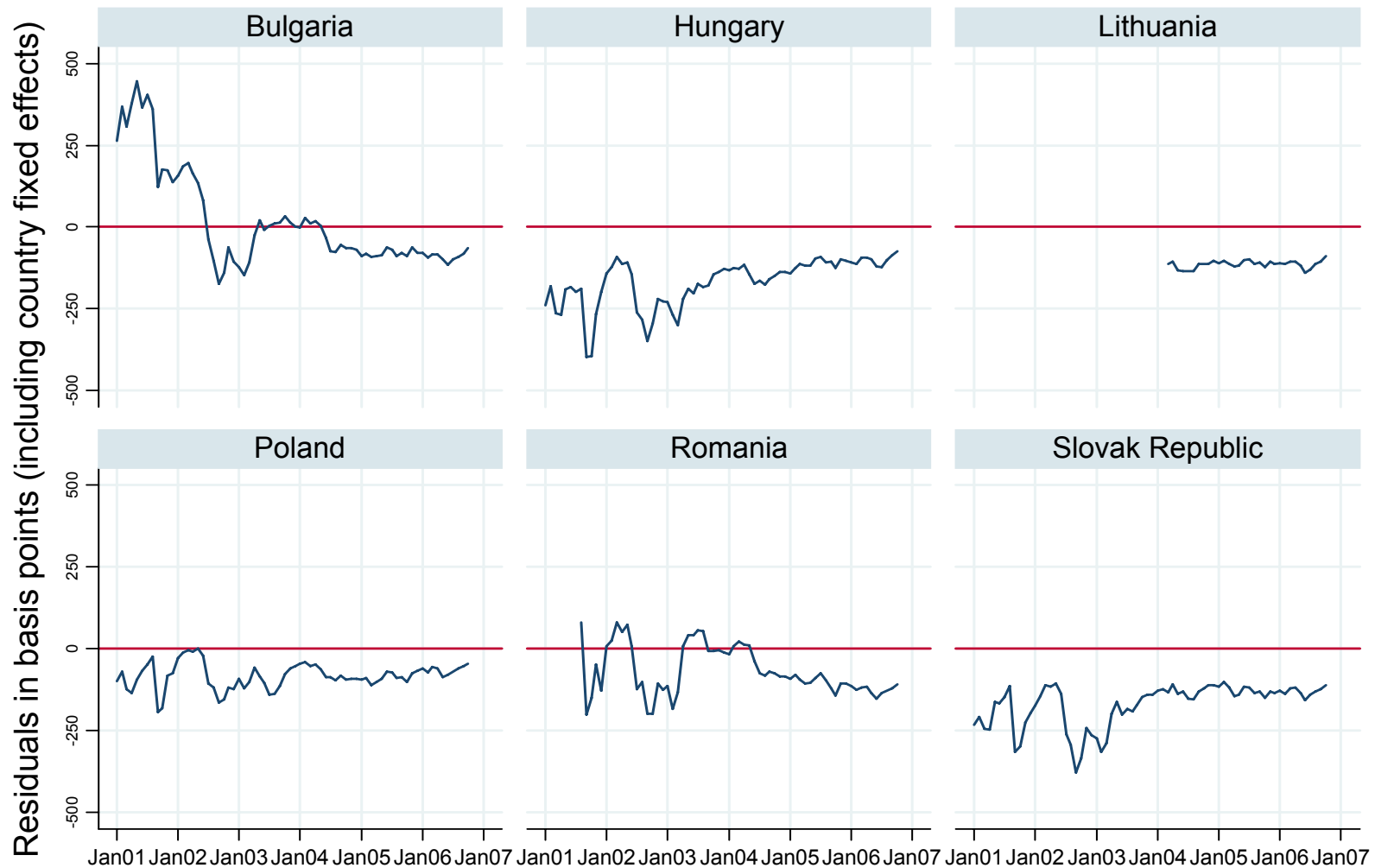
- Implied volatility index
- 30-day Fed Fund futures rate
- Volatility of Fed Fund futures

Econometric analysis shows that markets differentiate CECs beyond what “fundamentals” warrant



Source: Pipat Luengnaruemitchai, Susan Schadler, Do Economists' and Financial Markets' Perspectives on the New Members of the EU differ?, IMF Working Paper (forthcoming)

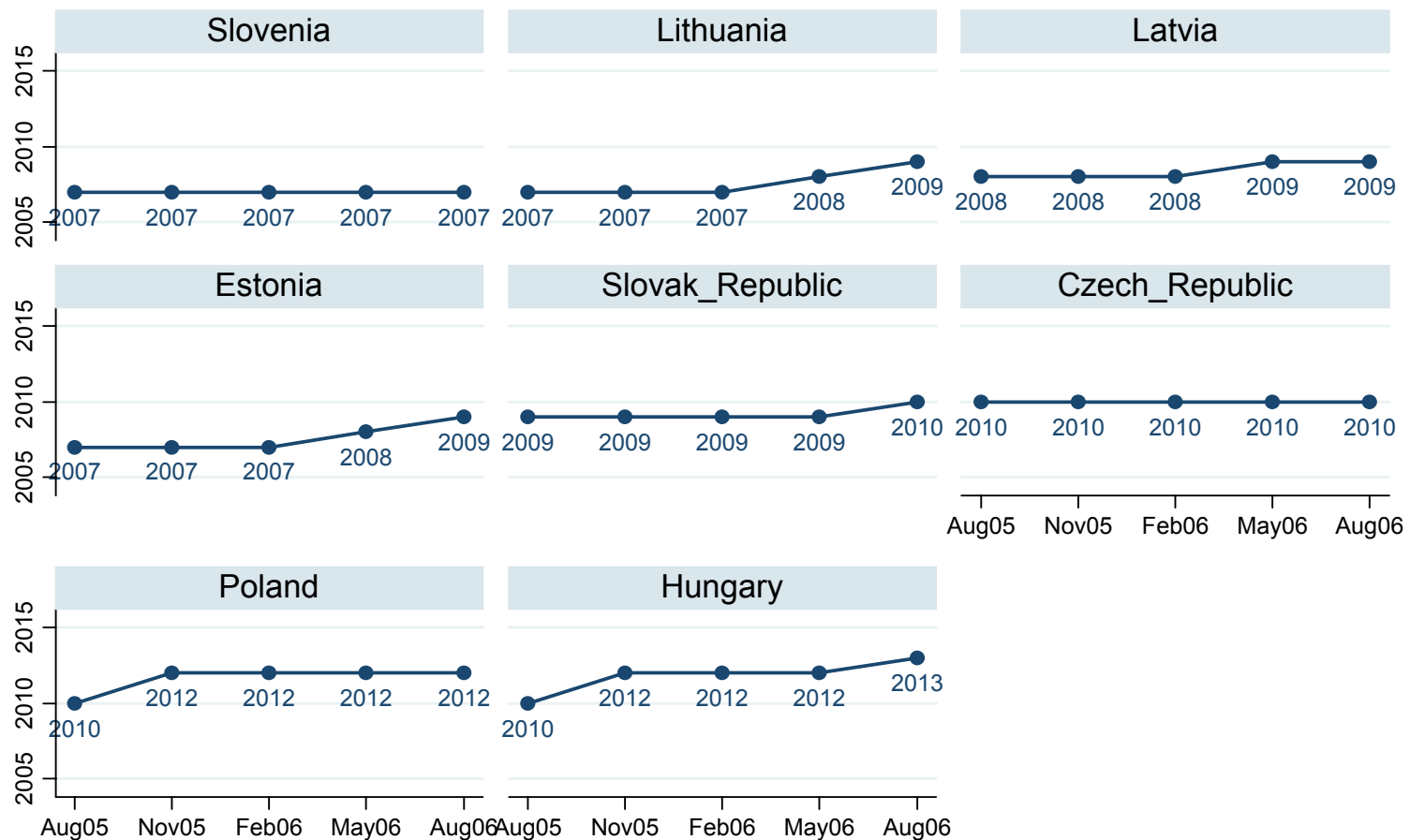
All CECs enjoy a regional advantage (“halo effect”) which seems to have stabilized at about 100 bps...



Source: Luengnaruemitchai and Schadler.

...and so far seem not to be influenced by receding euro adoption prospects.

REUTERS Polls on Euro Adoption Date Median Value of the Responses



Source: Reuters

Conclusions

- Headline numbers look good, but vulnerabilities are growing, especially in the Baltics
- Rather than using the favorable environment to reduce risks, most governments are pouring oil into the fire by pursuing procyclical fiscal policies
- Policy challenges:
 - Tightening fiscal policies
 - Create flexible economies and sound institutions
 - Euro adoption



Central Europe