Economic Trends and Challenges in the New Member States

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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

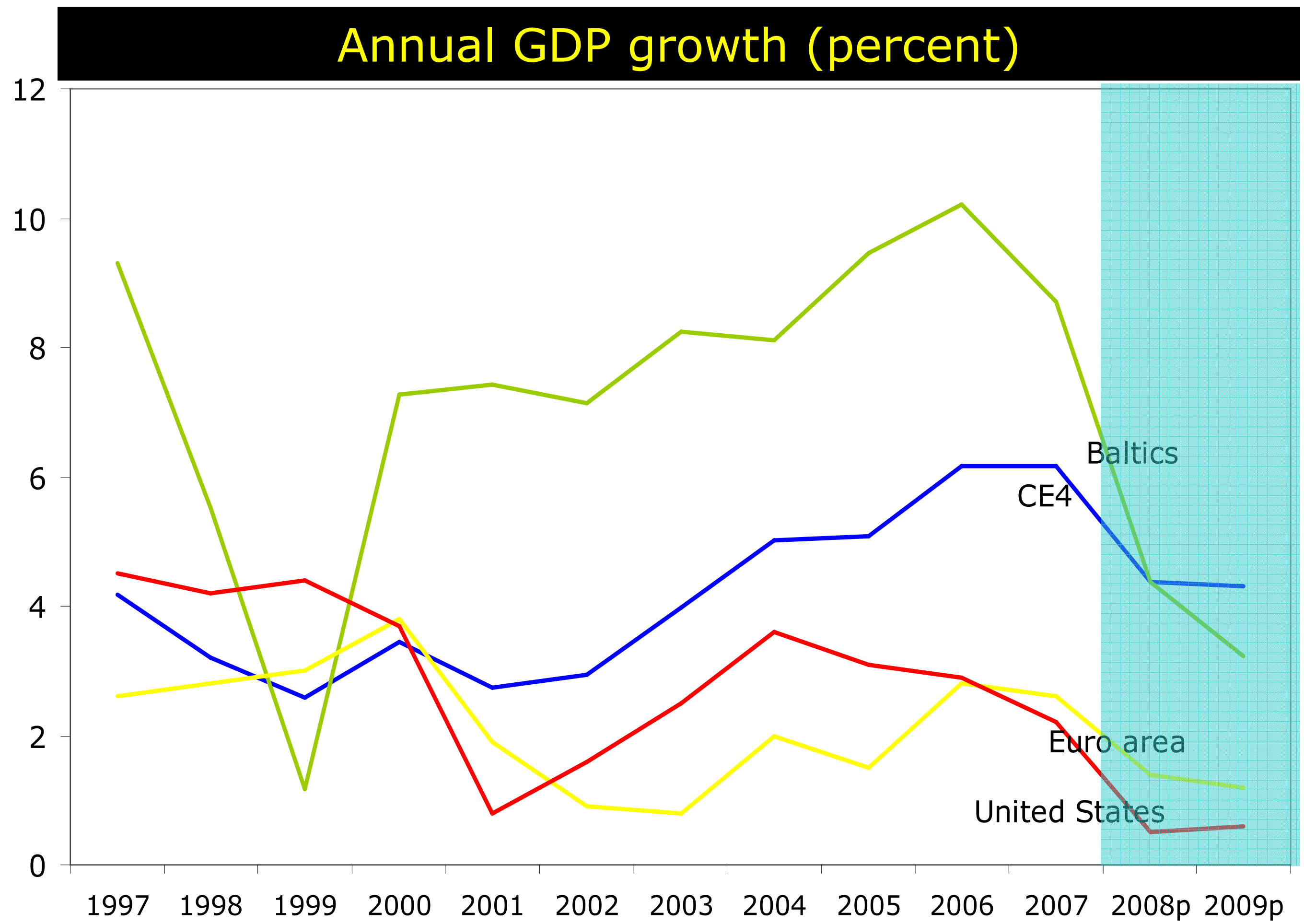
Overview

- The overall macro picture still largely unaffected by the global credit crunch
- 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 Chalenges

The overall macro picture:

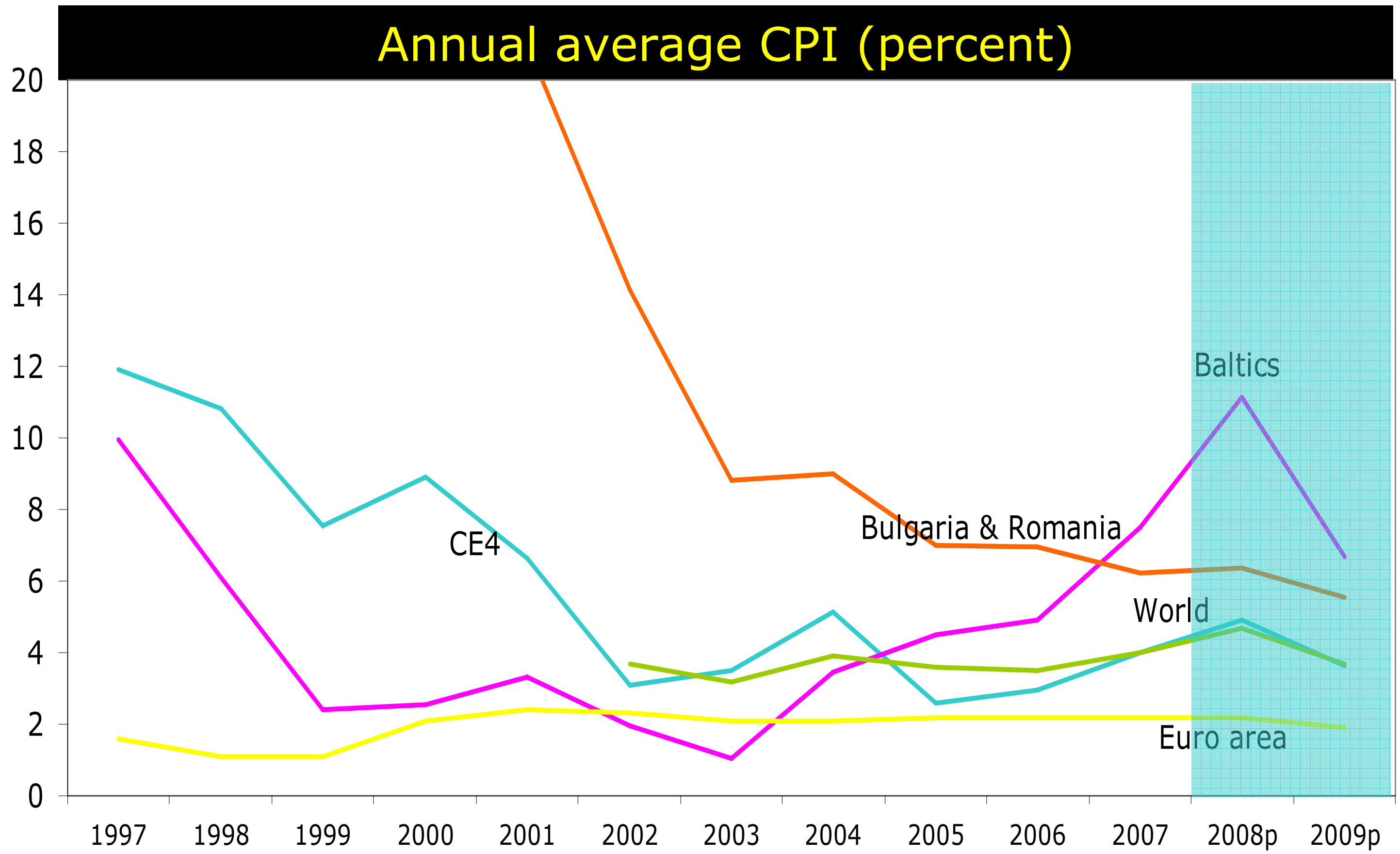
Still fairly good

Growth performance is expected to hold up, despite the global credit crunch.



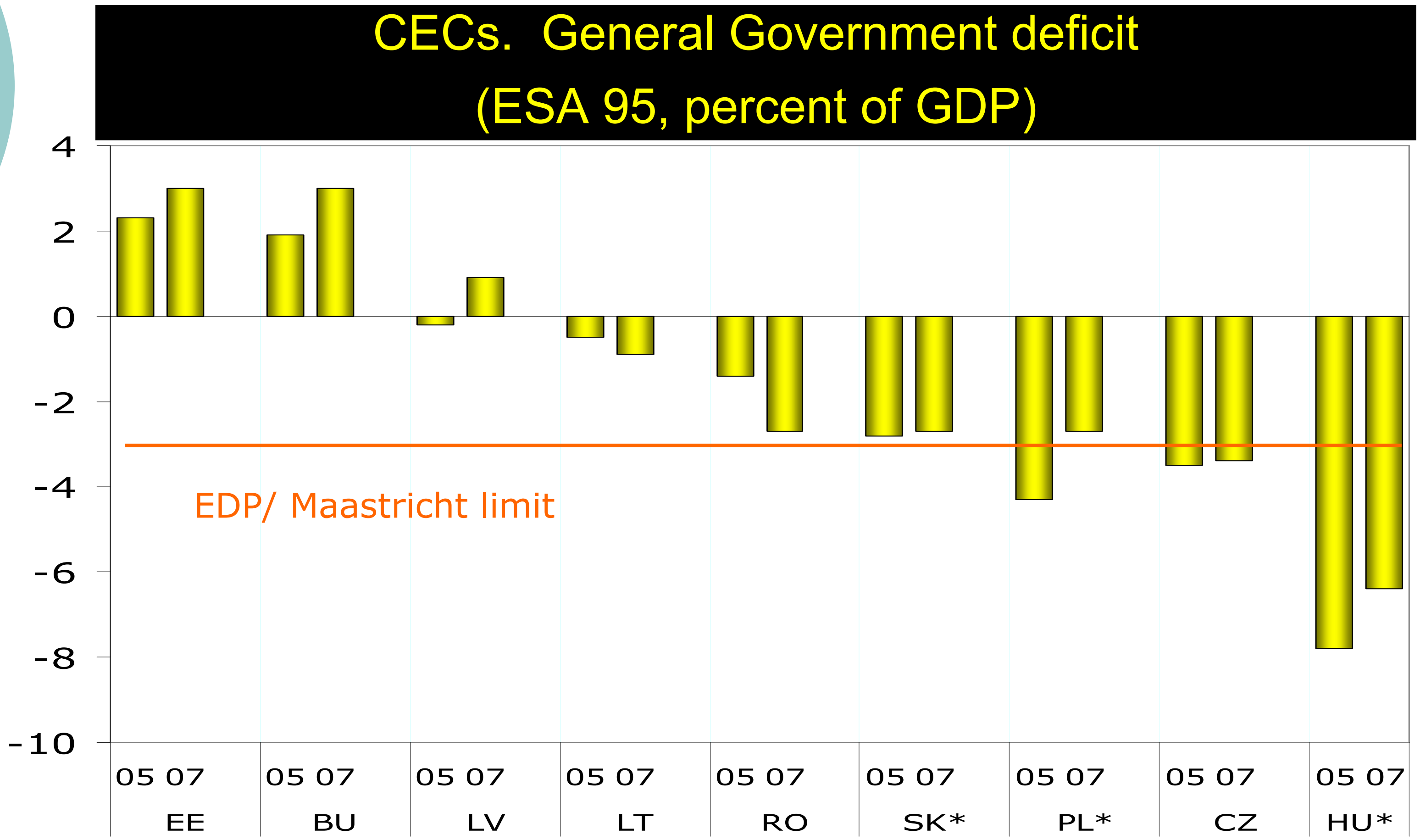
Source: WEO April 2008.

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



Source: WEO April 2008.

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



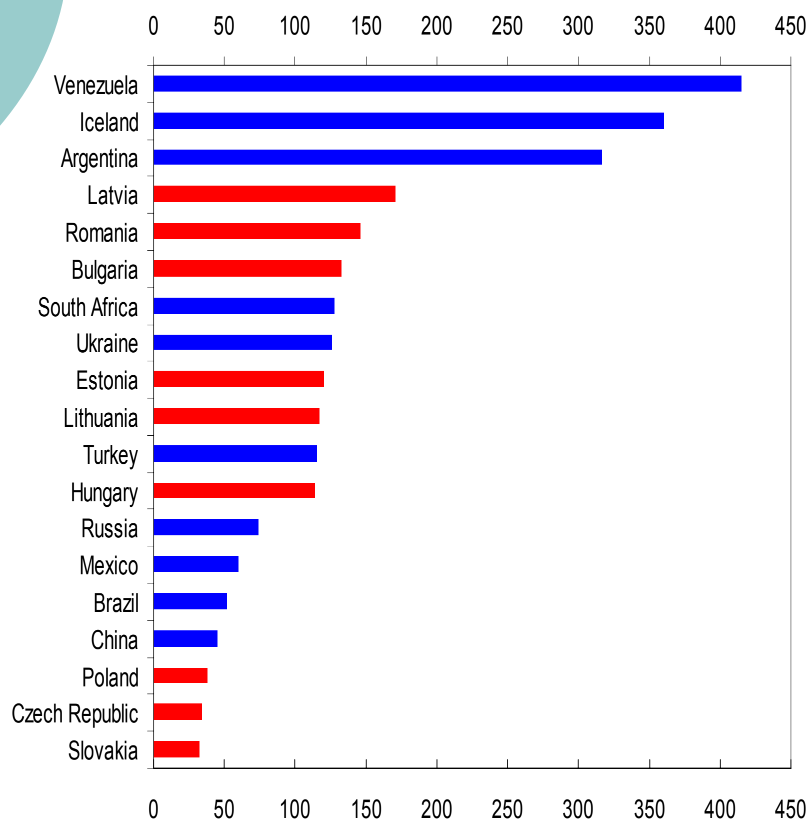
* incl. pension reform costs
Source: Eurostat, EC Autumn Forecast 2007

The baseline outlook is for a soft landing, but downside risks have increased:

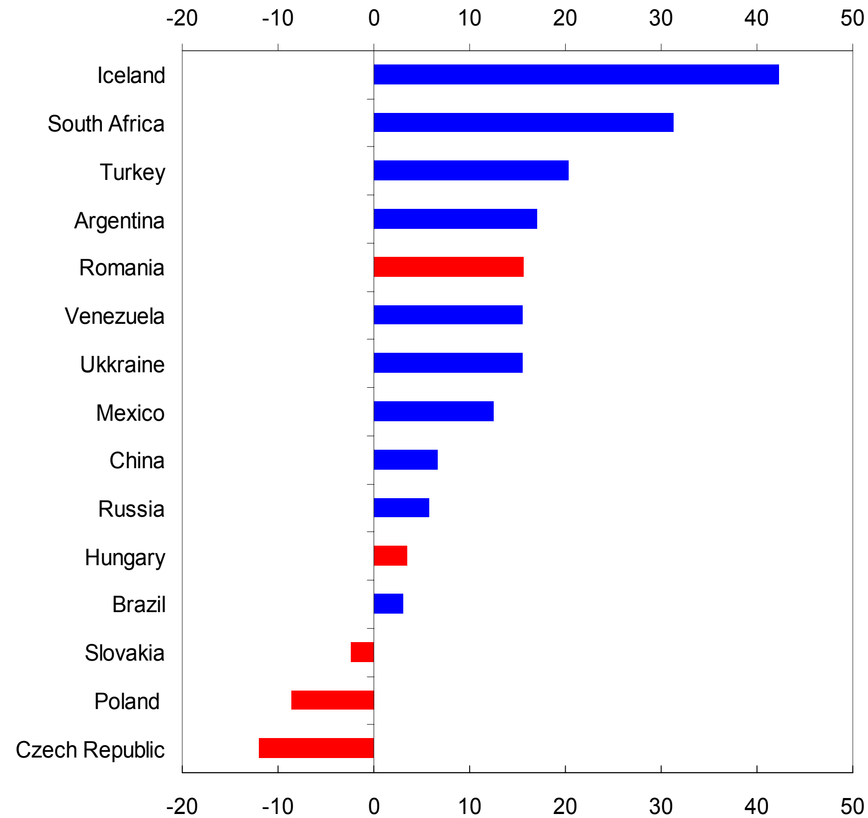
- **Exports:** slowdown in Europe and US could be more protracted than in the baseline
- **Inflation:** global effects
- **Profitability and asset quality:** wage pressures and housing bubbles may make FDI less attractive
- **External funding:** vulnerable to a slow-down of petrodollar flows
- **Financial contagion:** tighter lending standards, increased funding cost

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

Change in CDS
July 17 – April 17 *(bps)*



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



Source: Bloomberg, national statistics.

Against this background,
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 2007 (in percent of GDP)

	CE4	Baltics	Romania & Bulgaria	EM countries*	Asia 1997**
General government deficit	-3.8	1.0	0.2	1.2	-1.8
C/A balance	-8.5	-17.4	-15.9	3.6	-3.3
Gross external debt	59.2	105.6	46.9	31.7	66.5
Gross public debt	43.5	10.2	15.9	29.5	18.5
Reserves/ST debt	197.4	52.4	158.4	238.4	20.1
Credit growth (in percent)	22.5	39.1	58.2	2.5***	13.9

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

** Korea, Indonesia, Thailand.

*** - data for 2006

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?

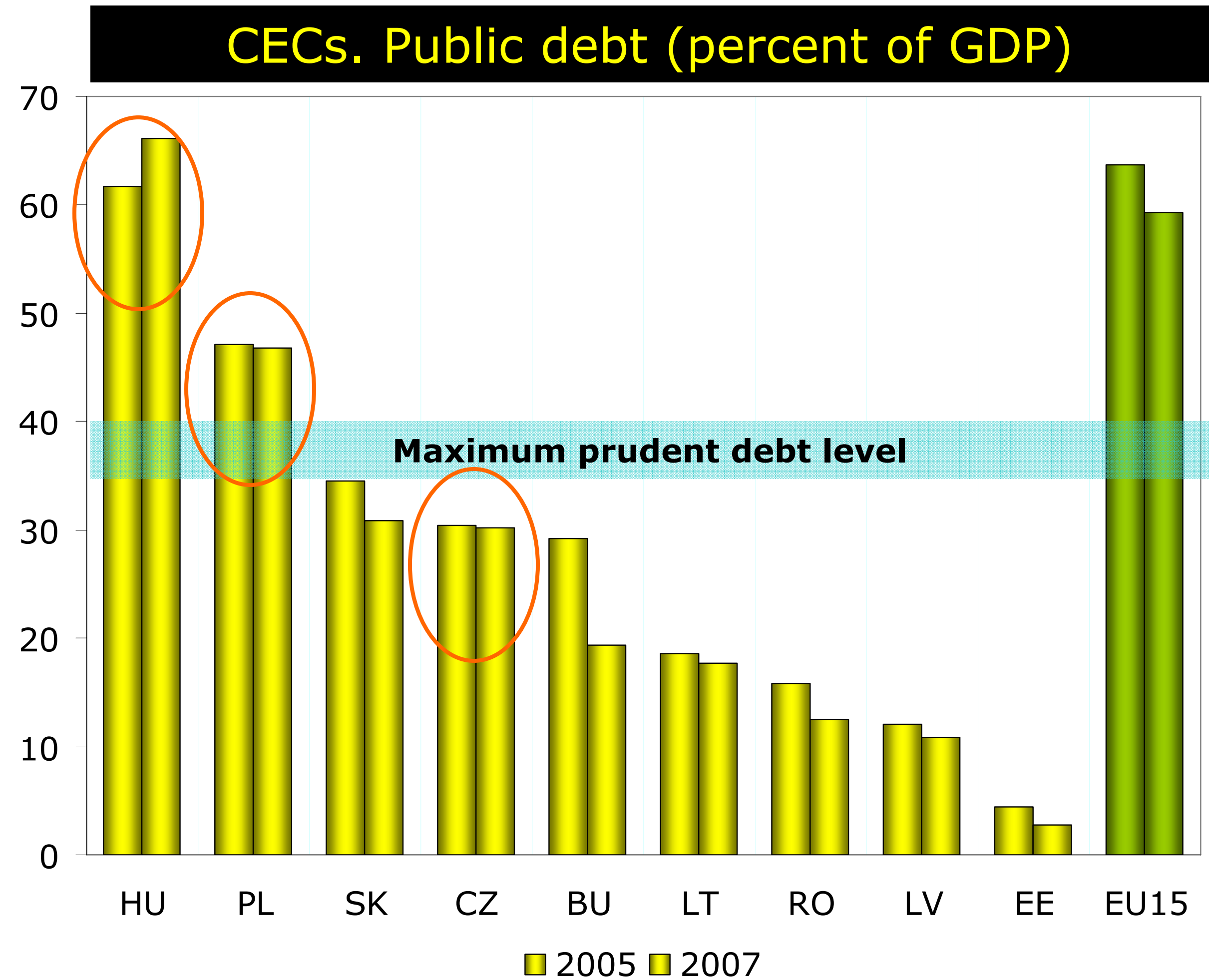
➔ Analytical challenge: how to distinguish "natural" convergence from overheating

Main Concerns

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

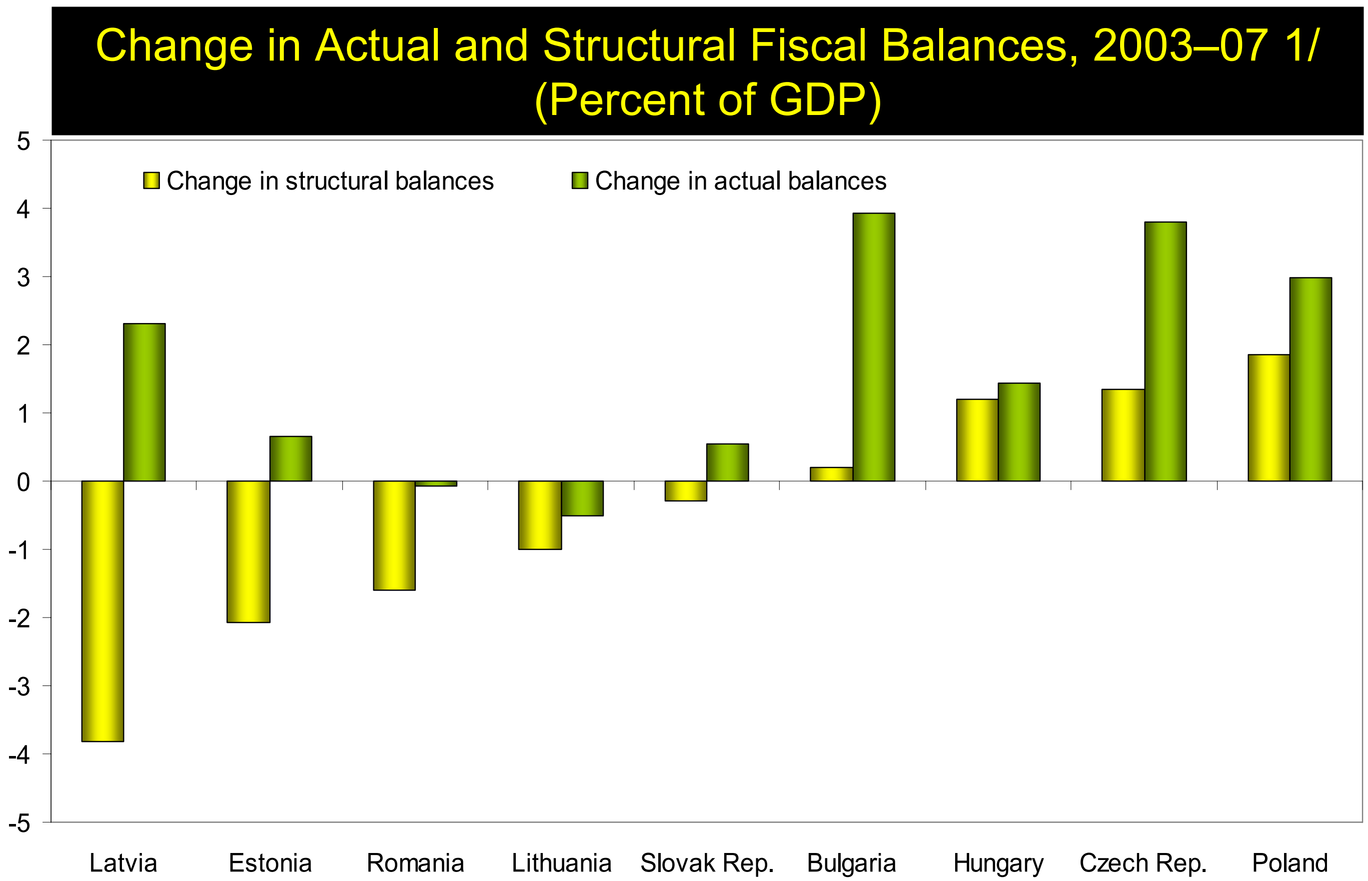
Lack of fiscal adjustment

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.

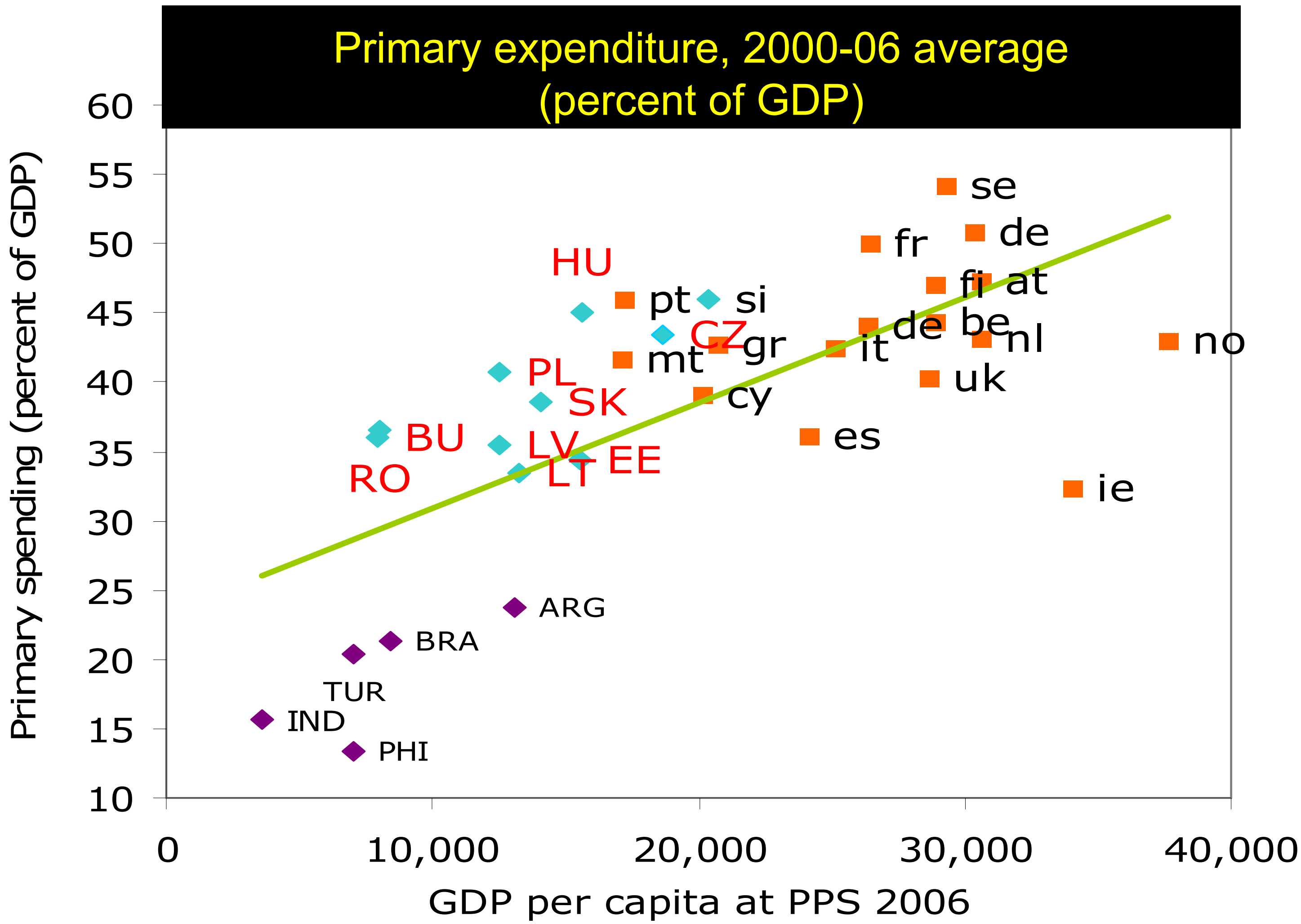


Source: IMF, World Economic Outlook; and IMF staff calculations.

1/ The structural balances do not take into account spending related to pension reform and spending related to EU transfers.

2/ Russia's structural balance is assumed to be equal to the non-oil balance.

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.

Does the global slowdown call for a fiscal stimulus?

The IMF has supported anticyclical easing in US and some other countries

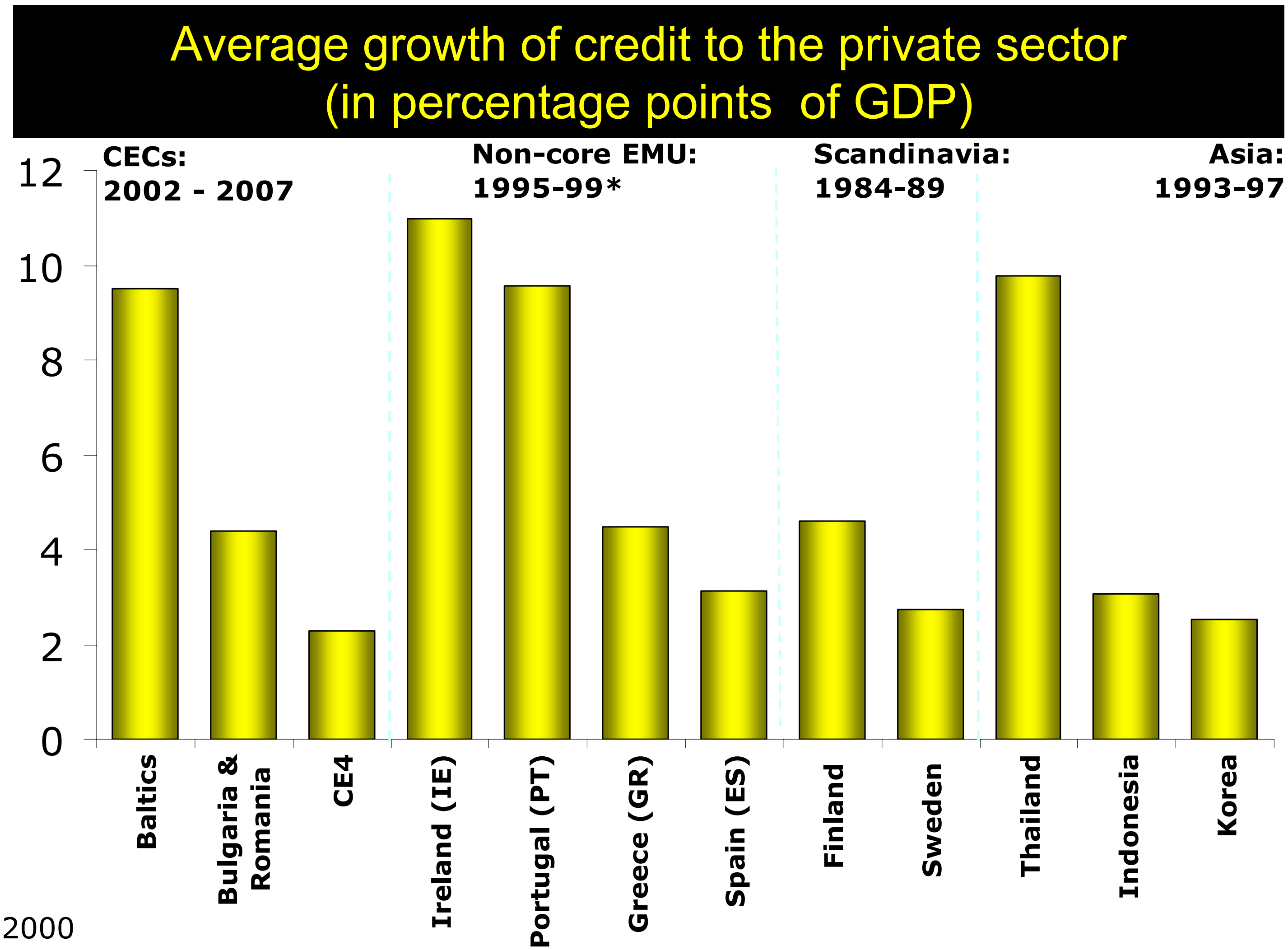
Considerations in Central and Eastern Europe:

- Relatively little fiscal space (deficits are close to EDP / Maastricht limits, public debt is relatively high)
- Growth is not expected to slow down by much (no recession)
- Monetary policy is tightening

=> Letting automatic stabilizers work is for the time being the best course of action

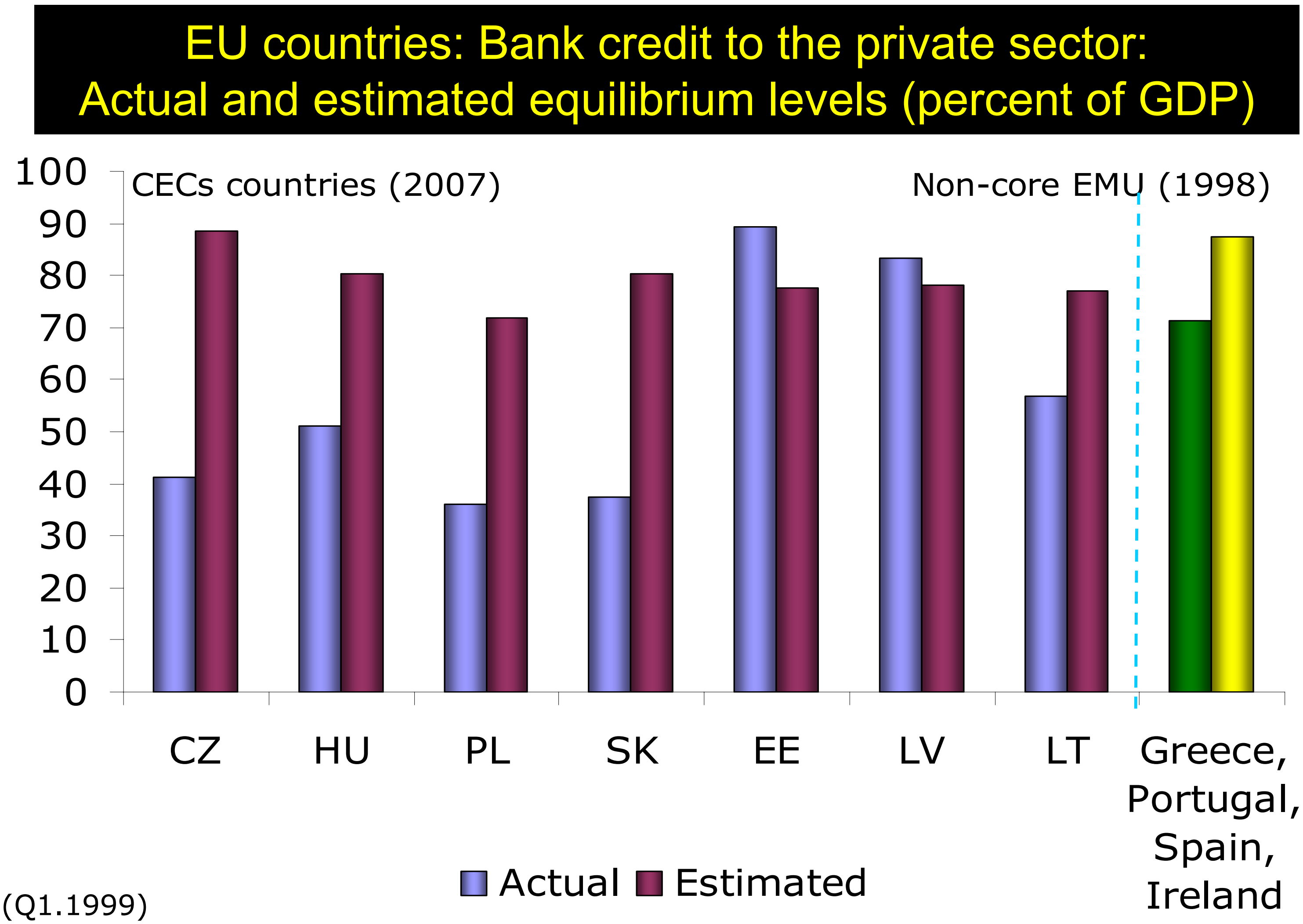
Rapid growth of foreign exchange credit to the private sector

Credit growth has been brisk.



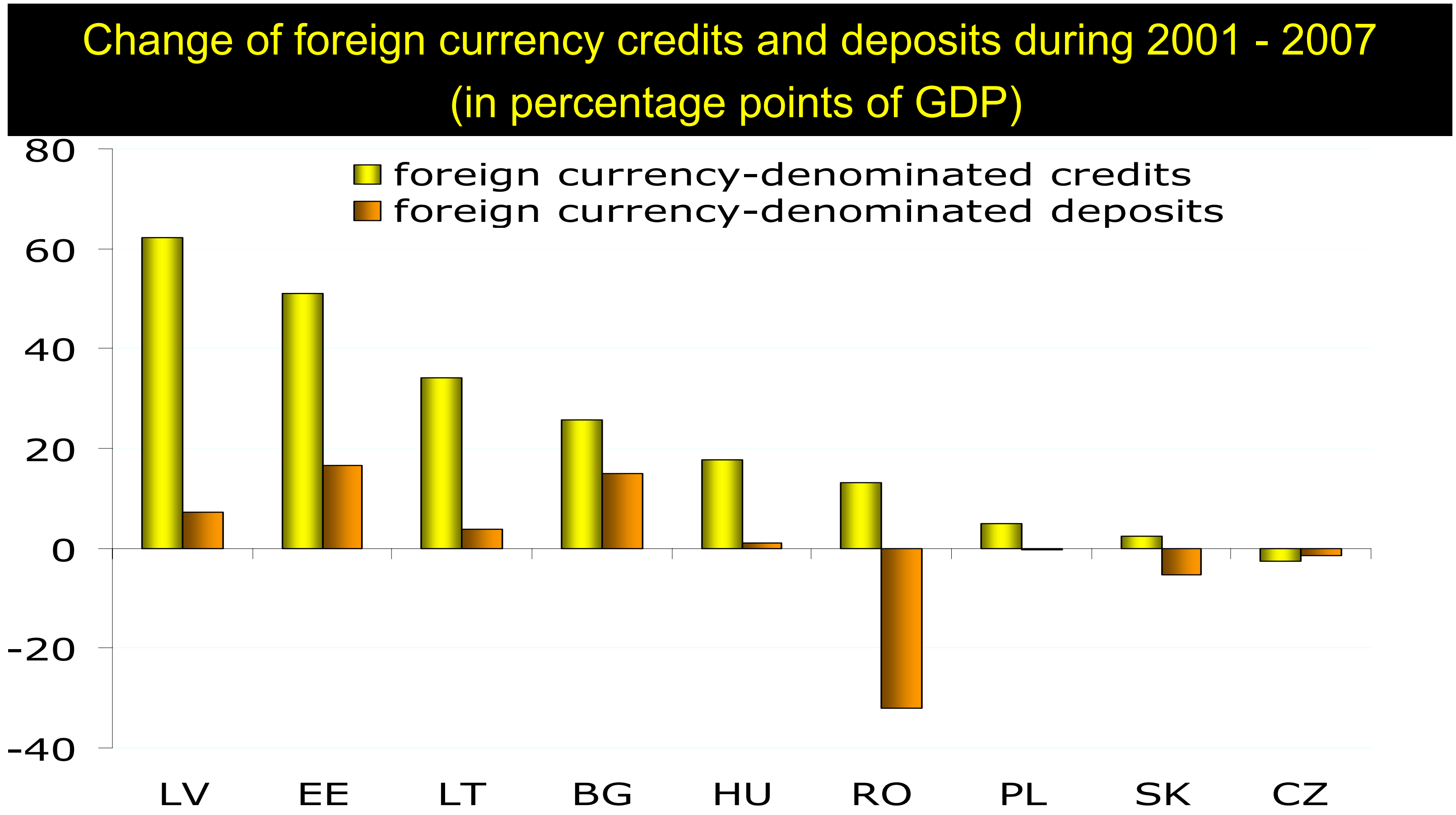
*Greece 1997-2000
Source: IFS, national authorities, IMF staff calculations

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



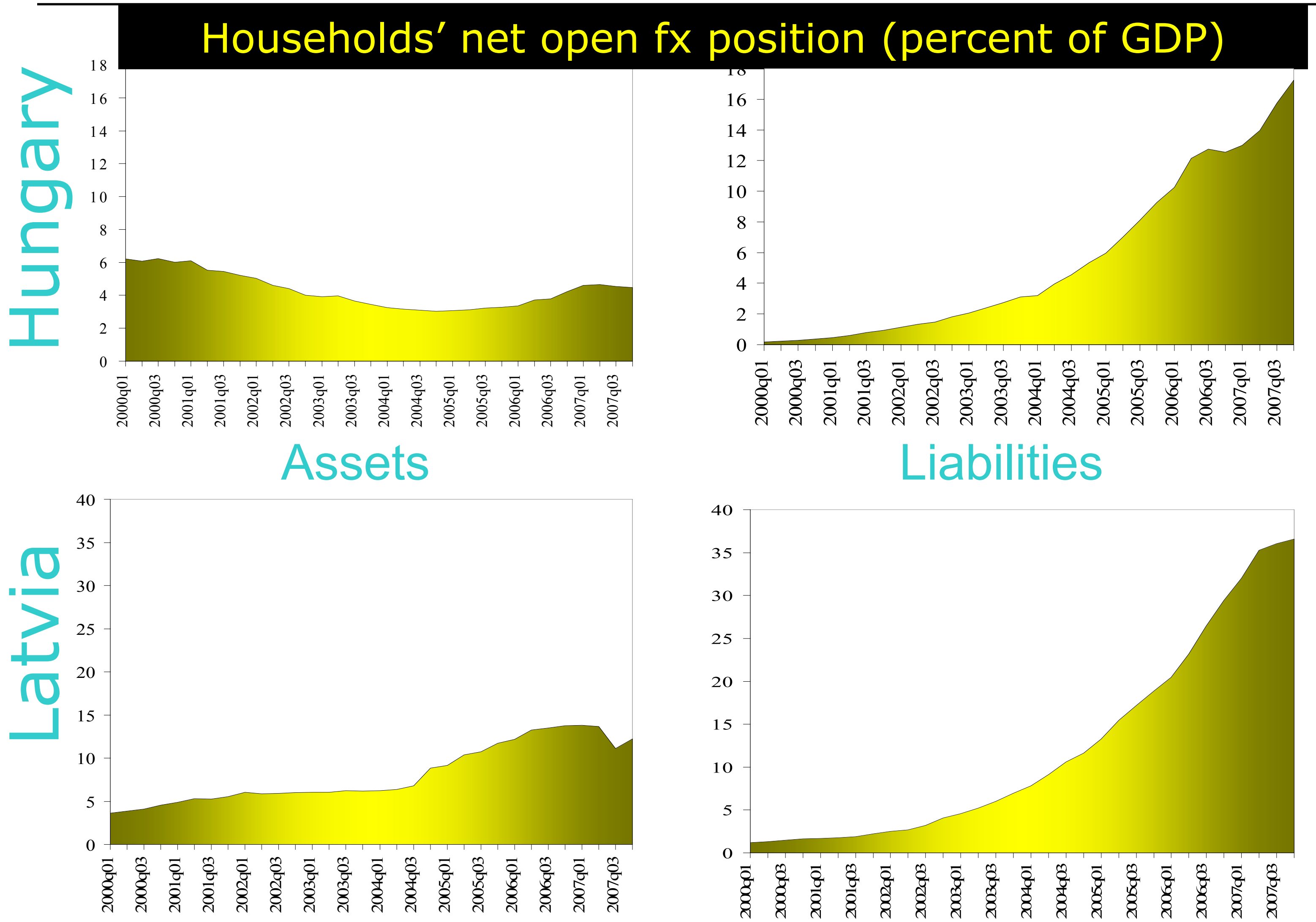
*Greece (Q1.1999)
Source: National authorities, calculations based on Schadler et al. (2005)

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



Source: National authorities, IMF staff estimates

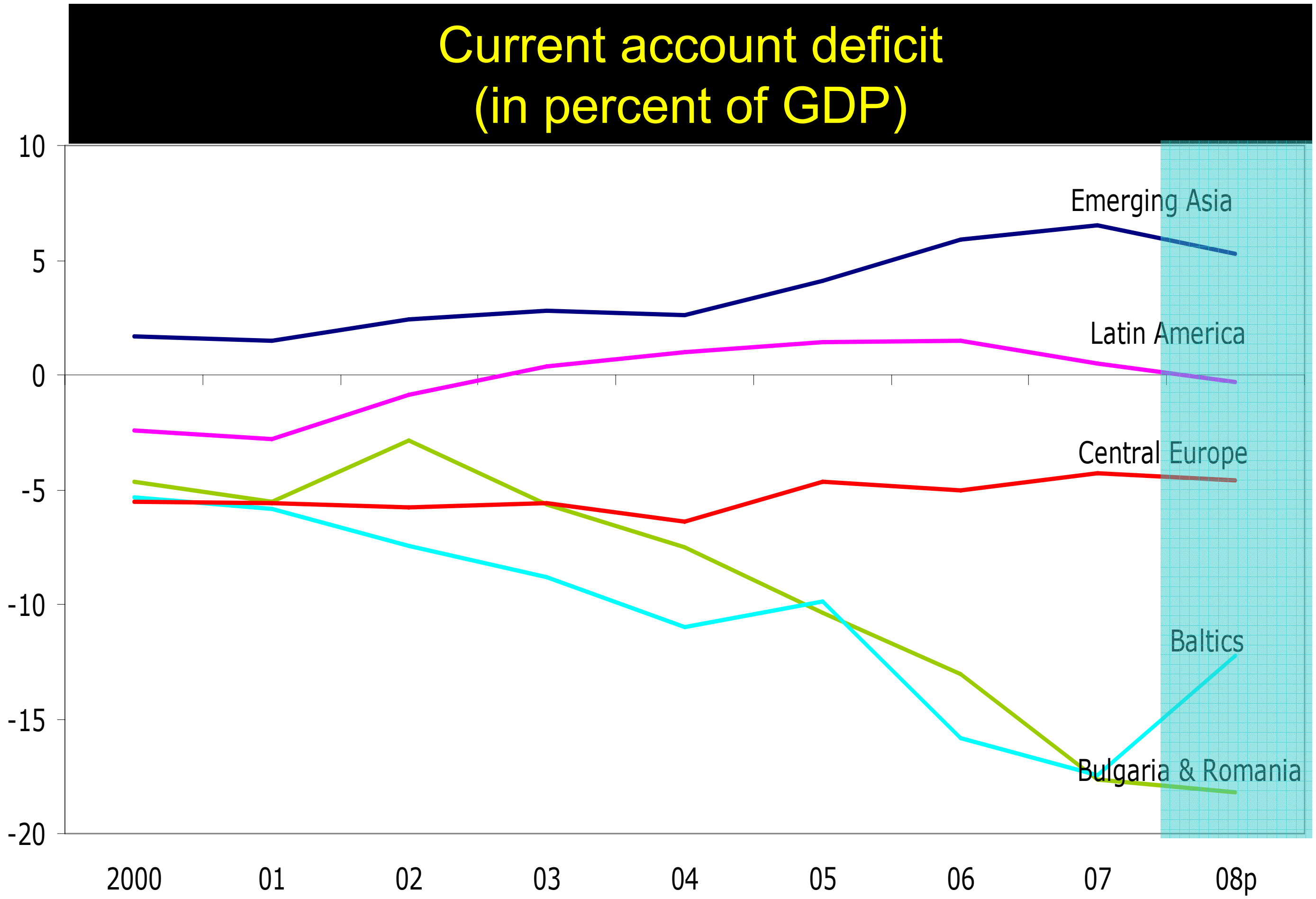
Households in some countries are particularly exposed.



Source: MNB

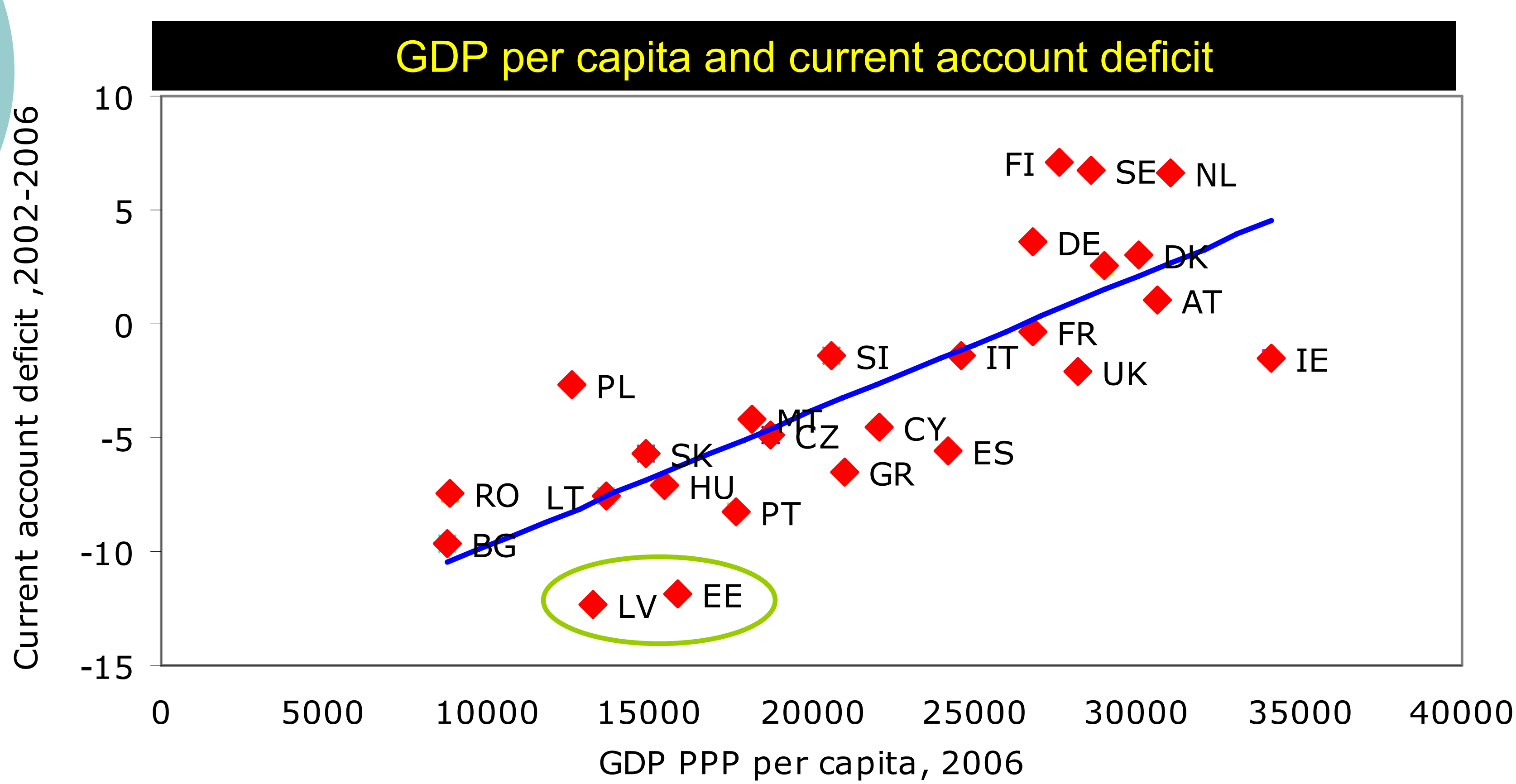
Large external stock and flow imbalances

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



Source: IMF WEO April 2007.

… largely reflecting the convergence process.



Source: Eurostat, IFS and staff calculations.

Are large external imbalances a risk?

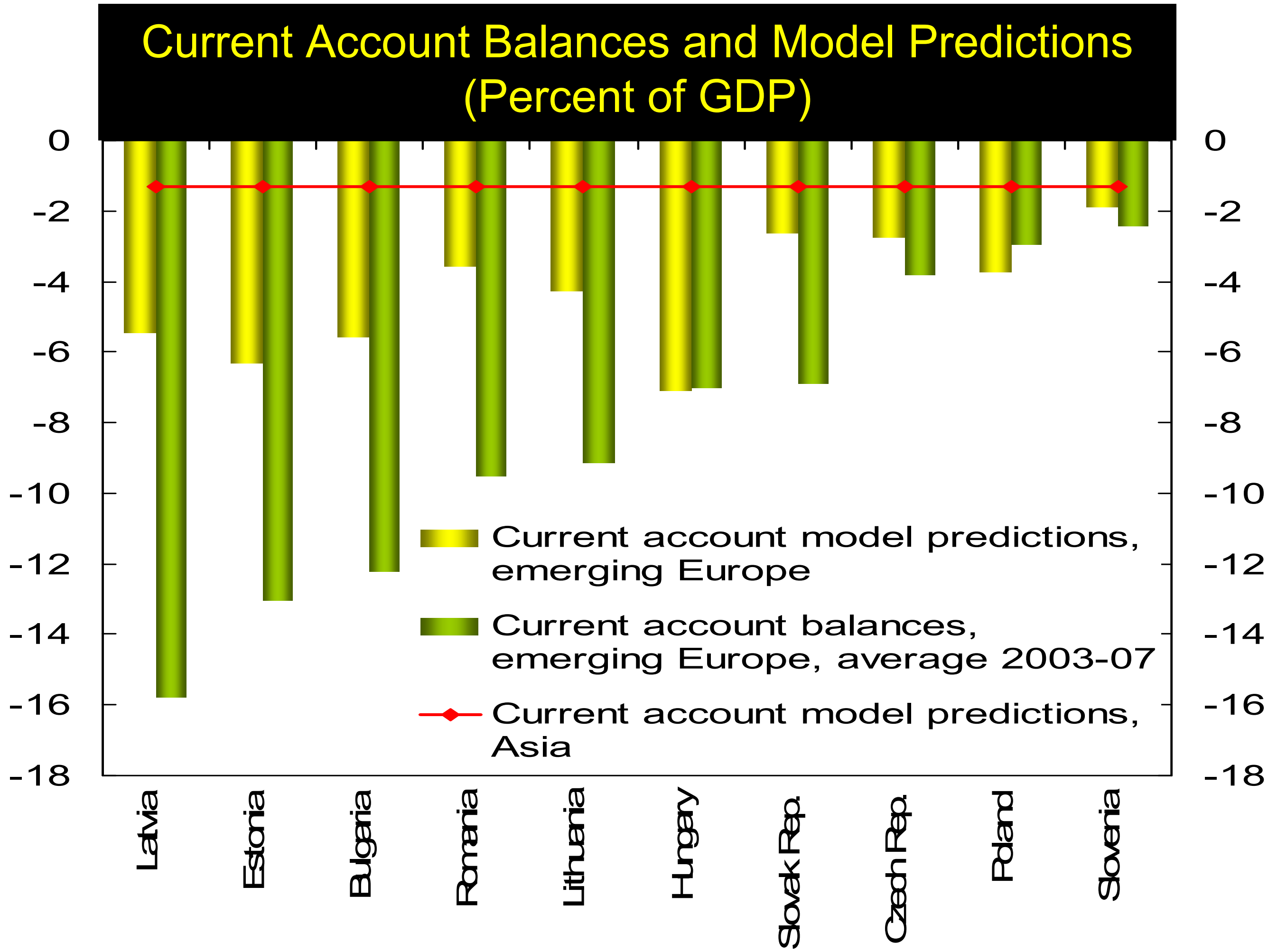
Optimists:

- 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 => questions about countries’ capacity to repay
- Foreign banks create new vulnerabilities

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



Sources: IMF, World Economic Outlook; and IMF staff calculations.

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

Banks' exposure in EM countries 2007Q03

(as percent of total exposure)

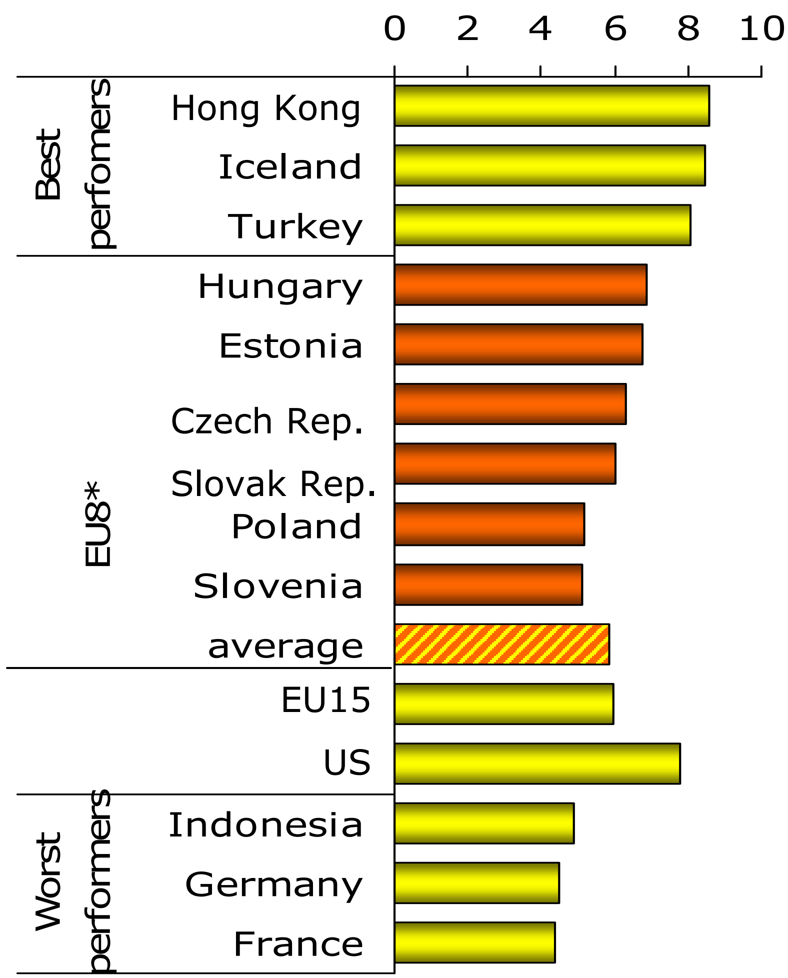
	Austria*	Belgium	Sweden	Germany	France	Italy	Portugal	Finland*
EU8	**34.7**	**6.2**	**11.1**	**2.6**	**2.0**	**10.2**	**7.9**	**9.8**
Bulgaria	0.9				0.1	0.5		
Czech Republic	**8.9**	**3.0**		0.2	0.8	**1.4**	0.1	
Estonia	0.1		**4.0**					**3.9**
Hungary	**6.2**	**1.1**		0.7	0.2	**2.0**	0.3	
Latvia	0.1		**3.1**	0.1		0.1		
Lithuania	0.1		**3.4**	0.1				**2.6**
Poland	**2.8**	**1.3**	**0.7**	0.9	0.4	**4.2**	**7.6**	**3.2**
Romania	**8.7**	0.1		0.5	0.5	0.8		0.1
Slovakia	**5.6**	0.5		0.1		**1.5**		
Slovenia	**2.2**	0.2		0.1	0.1	0.2		
Other EM Europe	14.6	1.9	1.1	2.0	1.9	5.2	1.6	0.5
Other EM	1.0	1.1	0.8	2.3	3.0	1.0	5.2	0.4
ROW	49.7	90.8	87.0	93.1	93.1	83.7	85.2	89.3

Source: BIS
* Data for 2007Q2

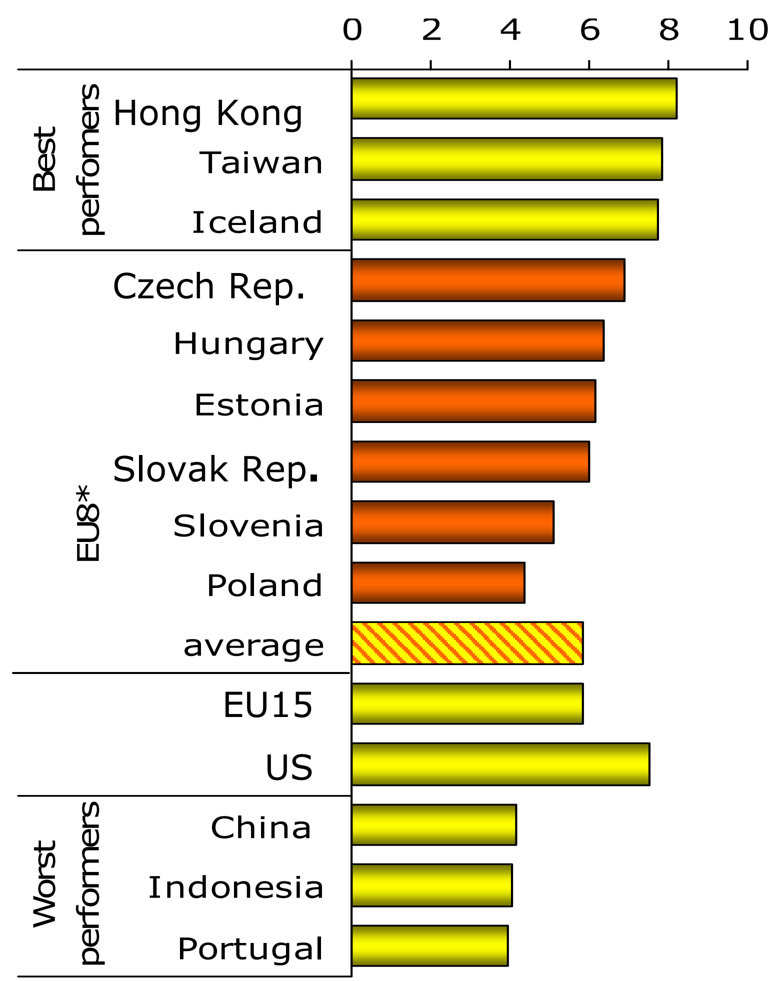
Creating flexible economies

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

Flexibility and adaptability (0-10)

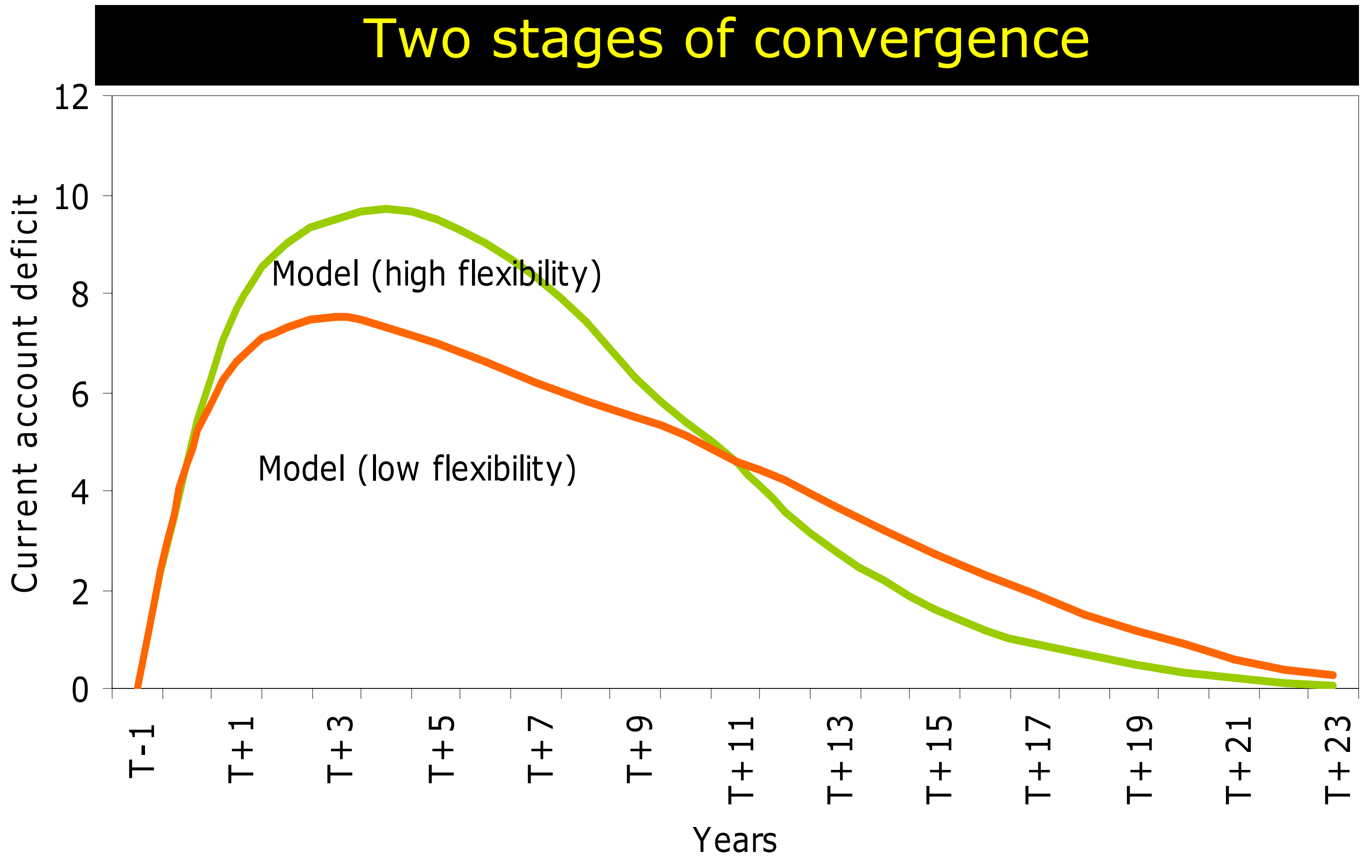


Adaptability of companies (0-10)



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 still look fairly good
- NMS have so far weathered the subprime crisis fallout well

But:

- Vulnerabilities are growing, especially in the Baltics and South-East Europe
- Governments have made little use of the favorable environment
- A more volatile macro environment makes meeting the Maastricht criteria for euro adopton more difficult

Policy challenges

- Monetary policy: address inflationary pressures, but keep an eye on interest differentials
- Fiscal policy: let automatic stabilizers work, but no room for additional stimulus
- 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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