



# Central and Eastern Europe: Global spillovers and external vulnerabilities

ICEG Annual Conference

Brussels, May 2008

Christoph Rosenberg  
International Monetary Fund

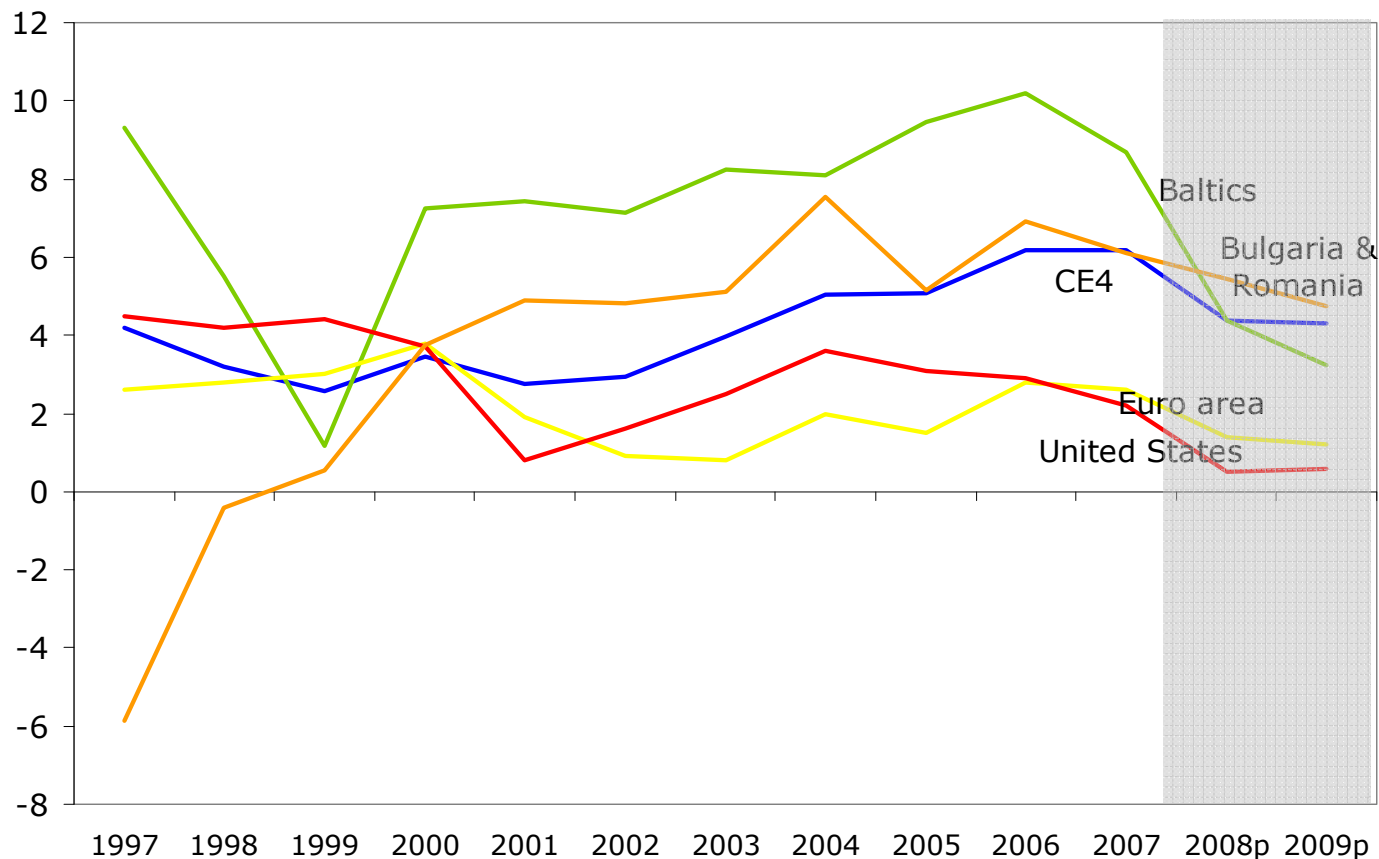
# Overview

- The CEEs' macro picture is still largely unaffected by the global credit crunch
- Large external imbalances in some CEE countries are raising concerns
- Policy agenda

# Macro Outlook

# Growth is expected to slow, due to spillovers from the US and the Eurozone

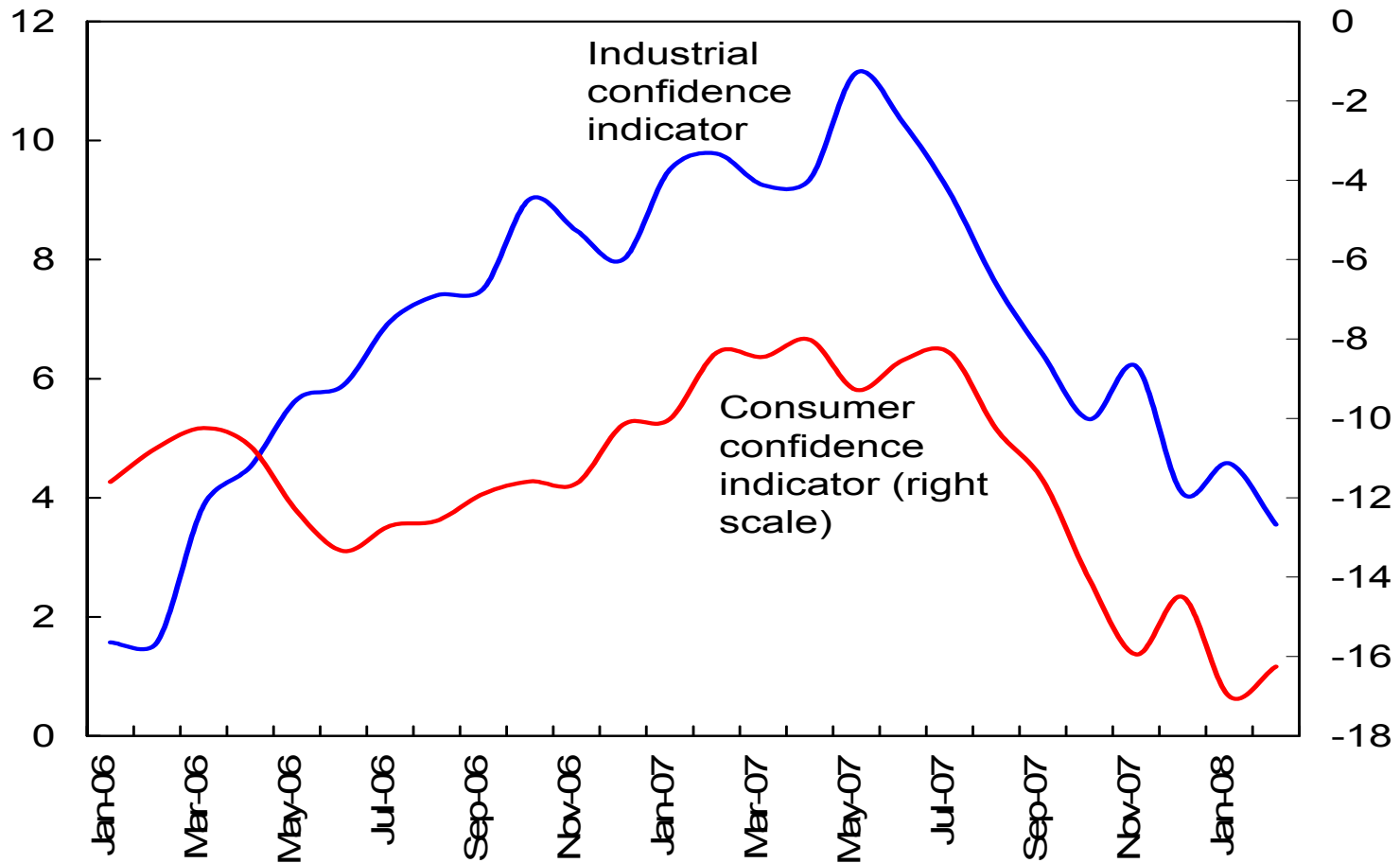
**Annual GDP growth (percent)**



# Emerging Europe is not immune to the deterioration in global sentiment

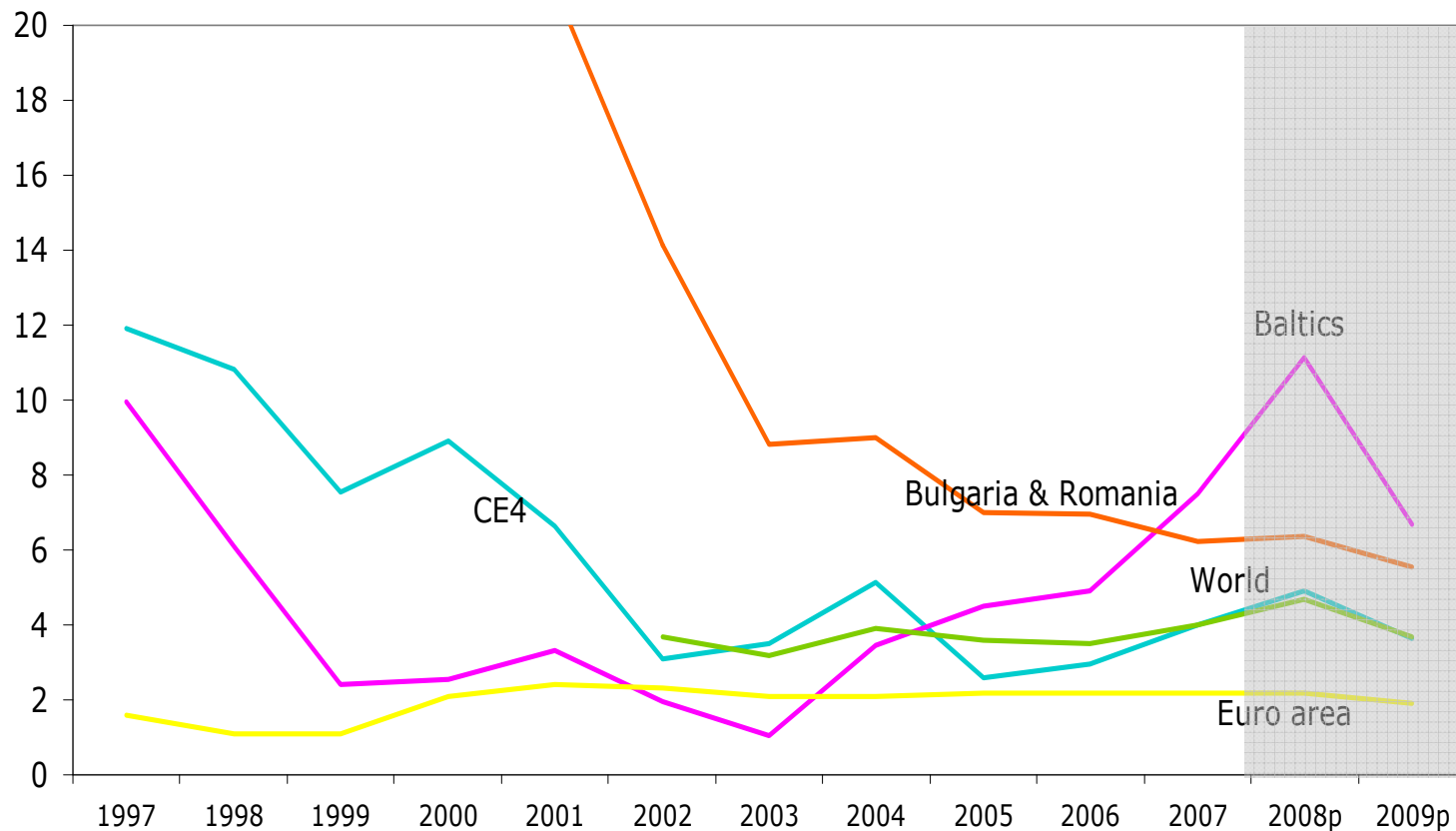
## Emerging Europe: Confidence Indicators, January 2006–February 2008

*(Percentage balance)*



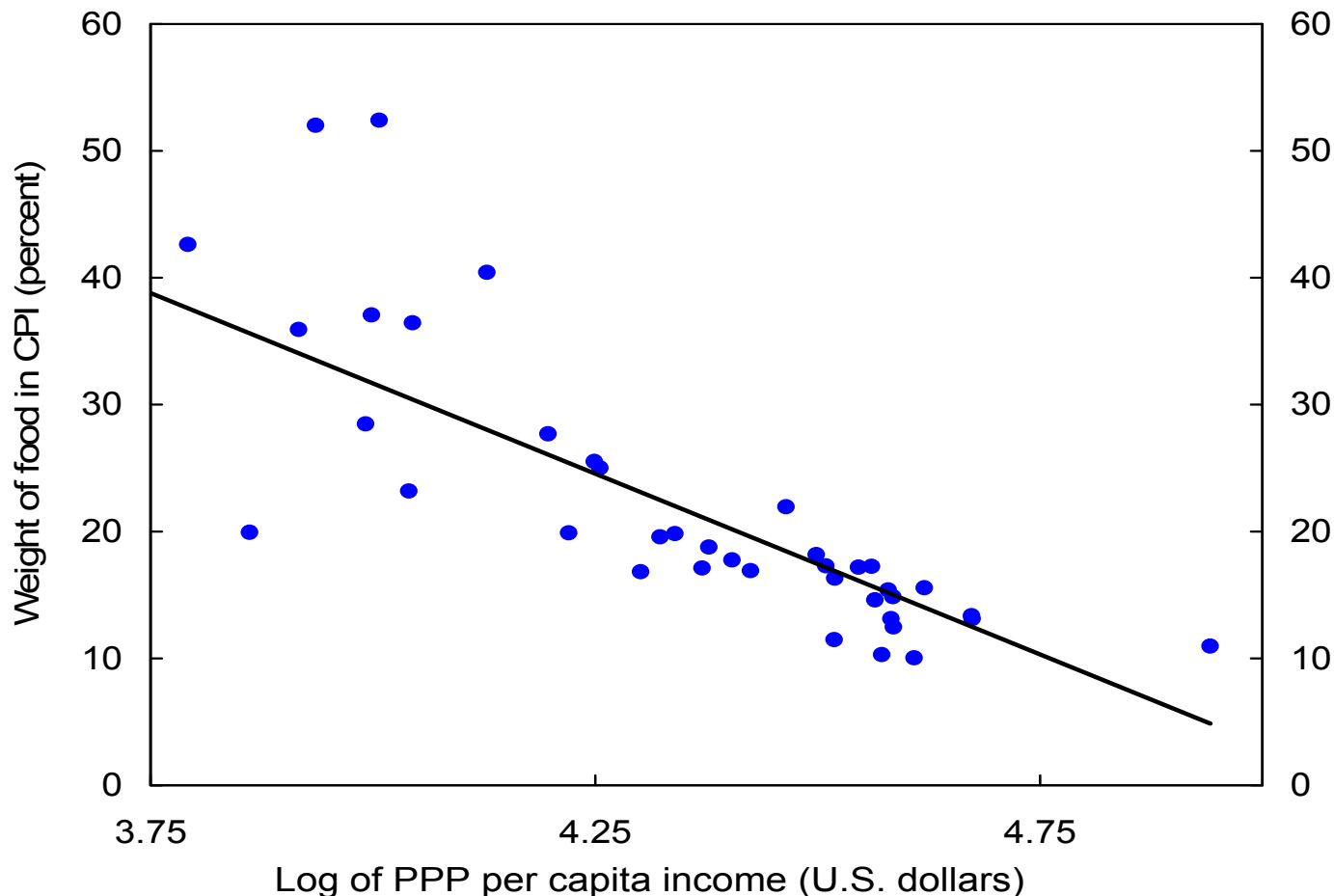
# Inflation is picking up, mainly in the fixed exchange rate countries.

**Annual average CPI (percent)**



# This is partly due to the high share of food in the CPI basket

**Share of Food Expenditures and Per Capita Income in European Countries, 2007**



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

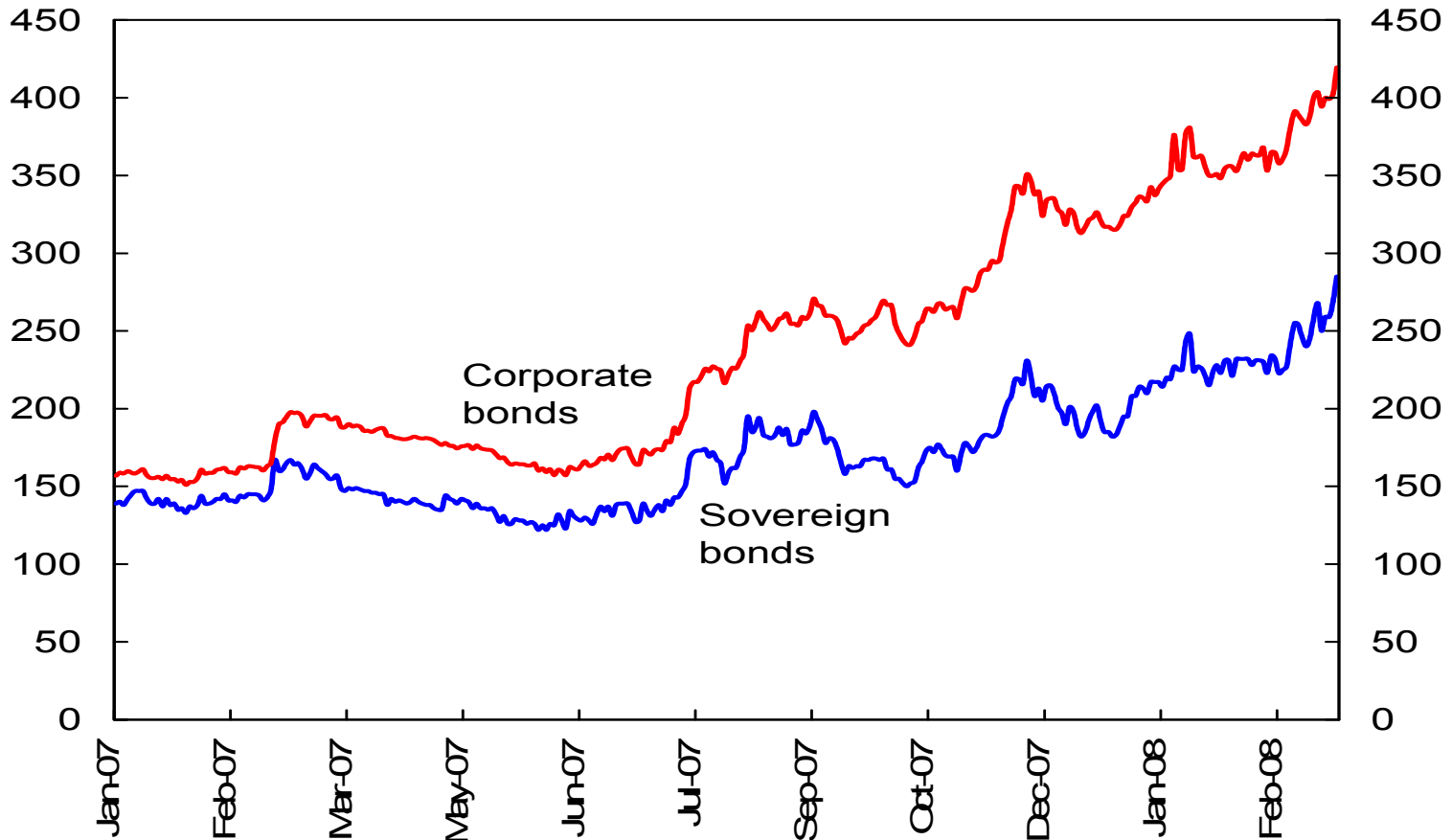
- **Exports:** slowdown in Europe and US could be more protracted than in the baseline
- **Inflation:** global commodity price boom, domestic wage pressures
- **Profitability and asset quality:** wage pressures and housing bubbles may make FDI less attractive
- **External funding:** vulnerable to a slow-down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



# Financial Markets and External Imbalances

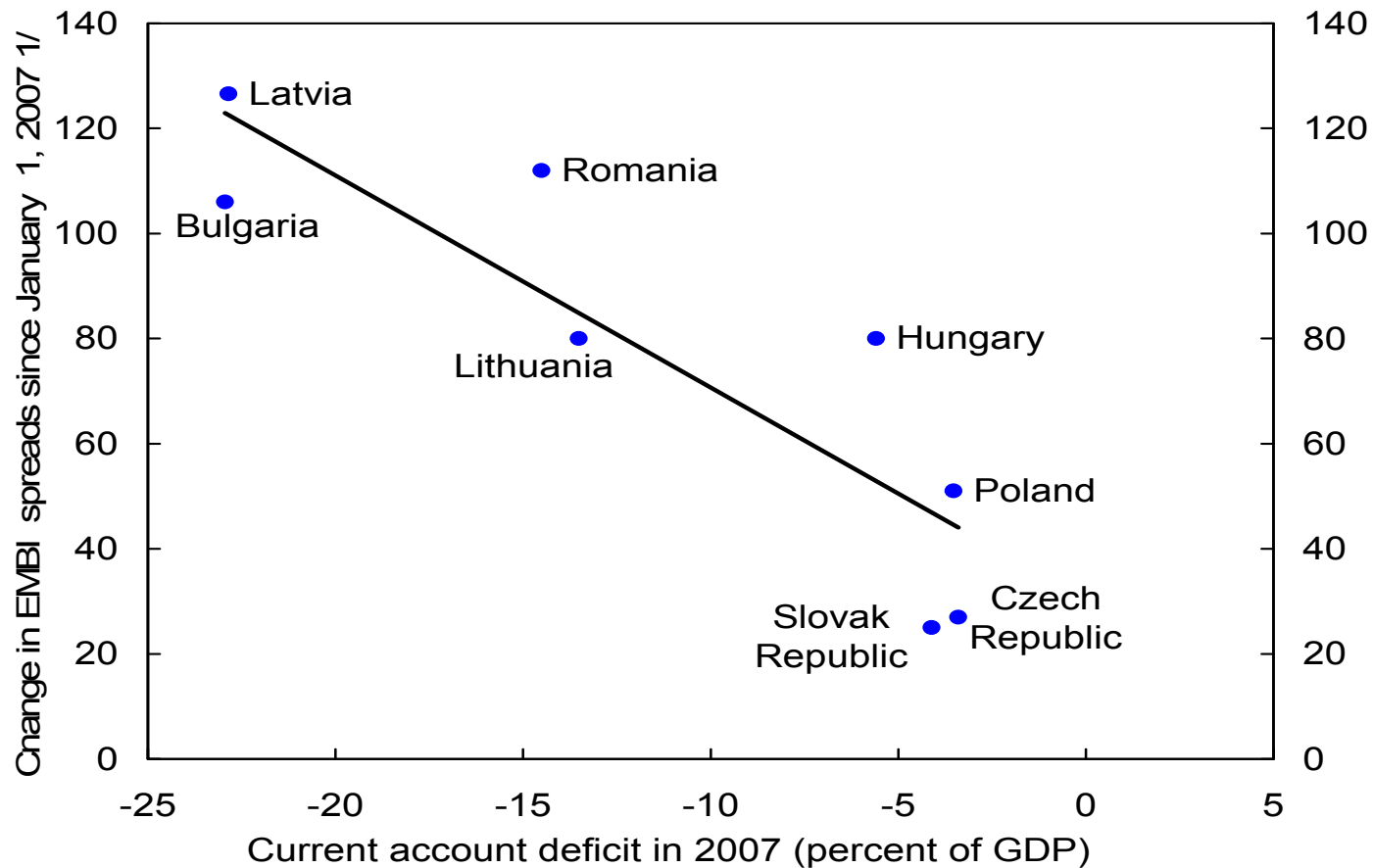
# Borrowing costs have increased...

**Emerging Europe: Sovereign and Corporate Bond Spreads,**  
**January 2007–March 2008** (*Basis points*)



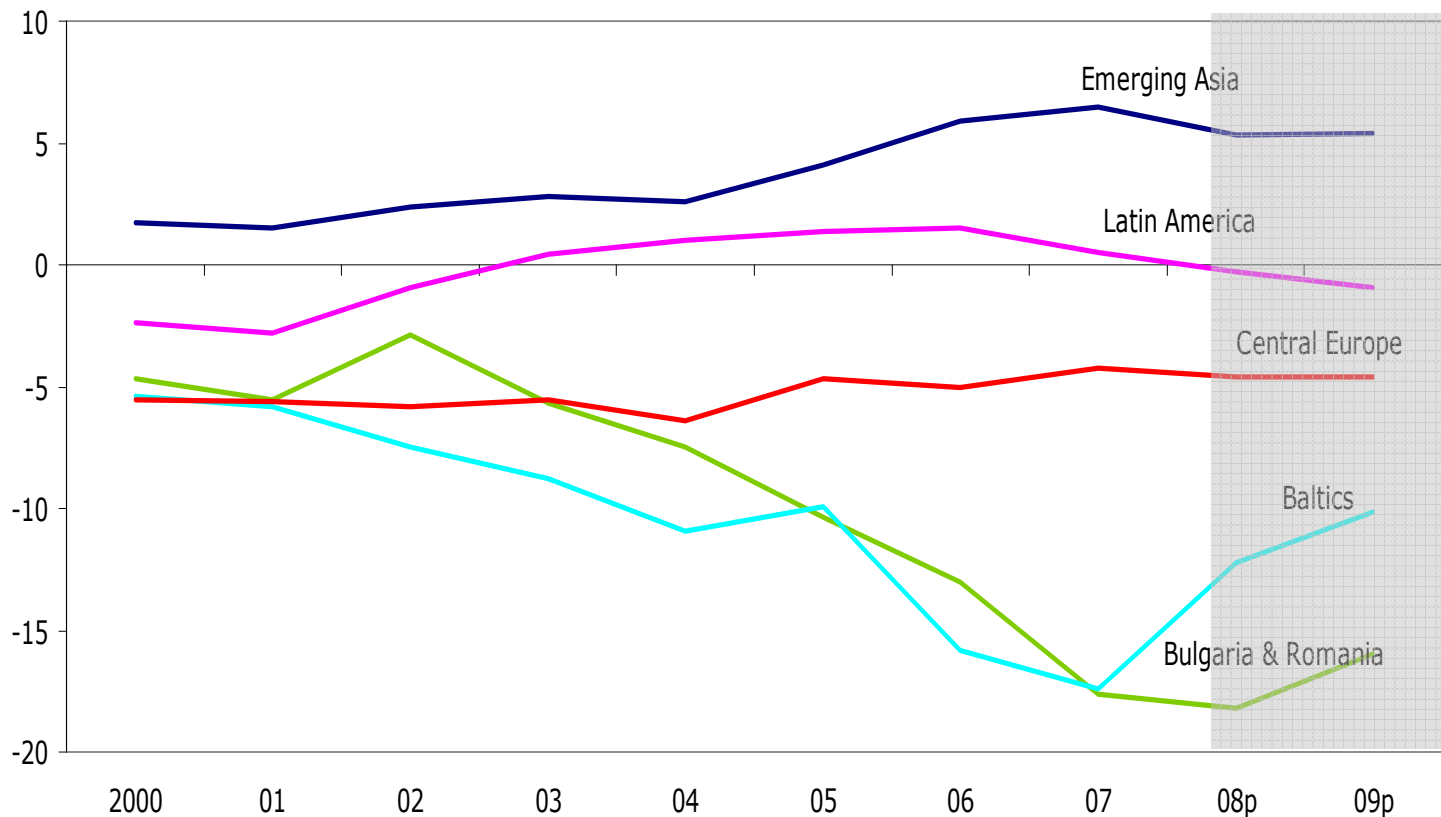
...particularly in countries with large external imbalances.

### Emerging Europe: Bond Spreads and Current Account Deficits

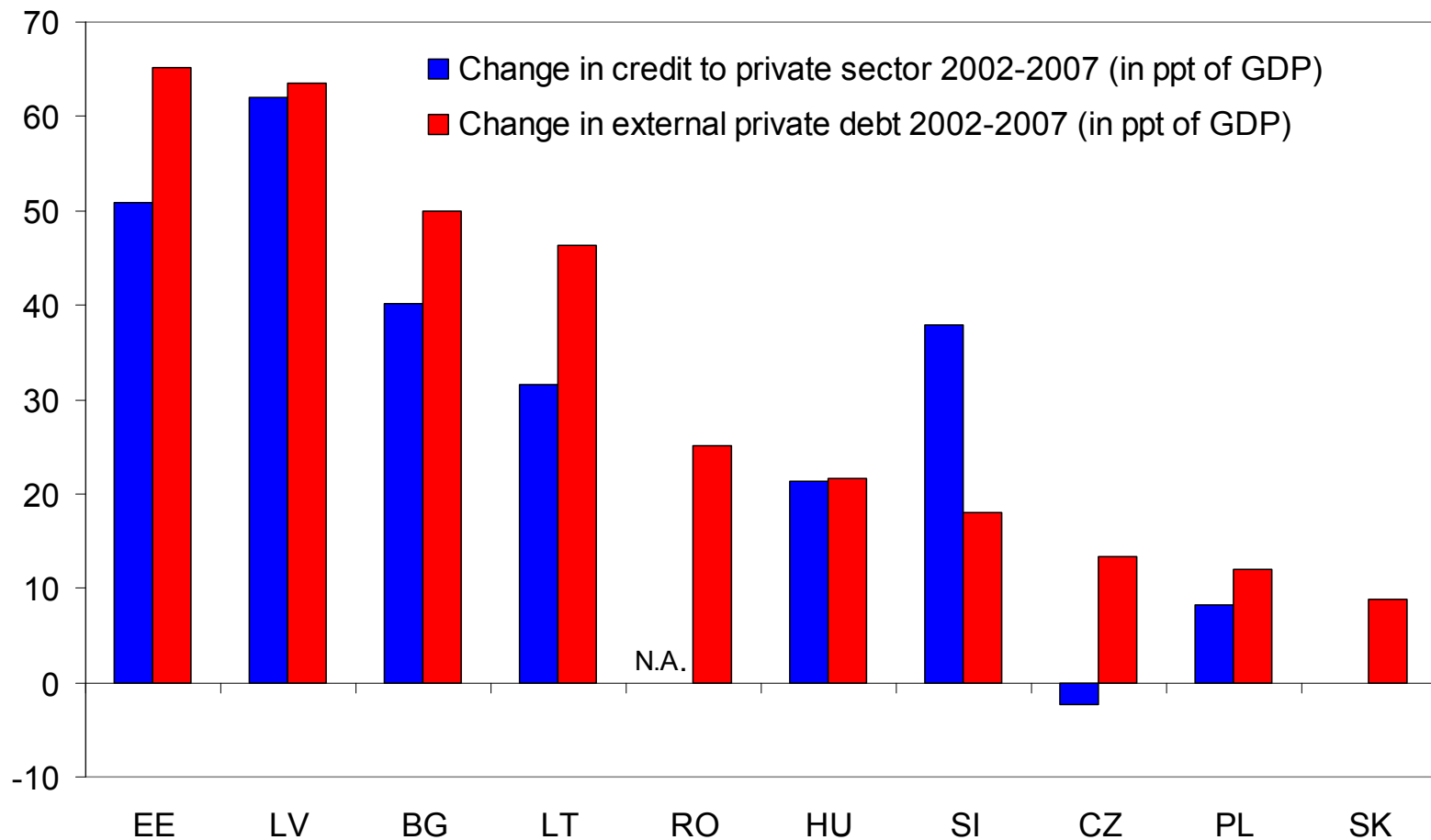


# Current account deficits are especially high in the Baltics and South-Eastern Europe...

**Current account deficit**  
*(in percent of GDP)*



# ...and closely related to financial deepening



# Are large external imbalances a risk?

## Optimists:

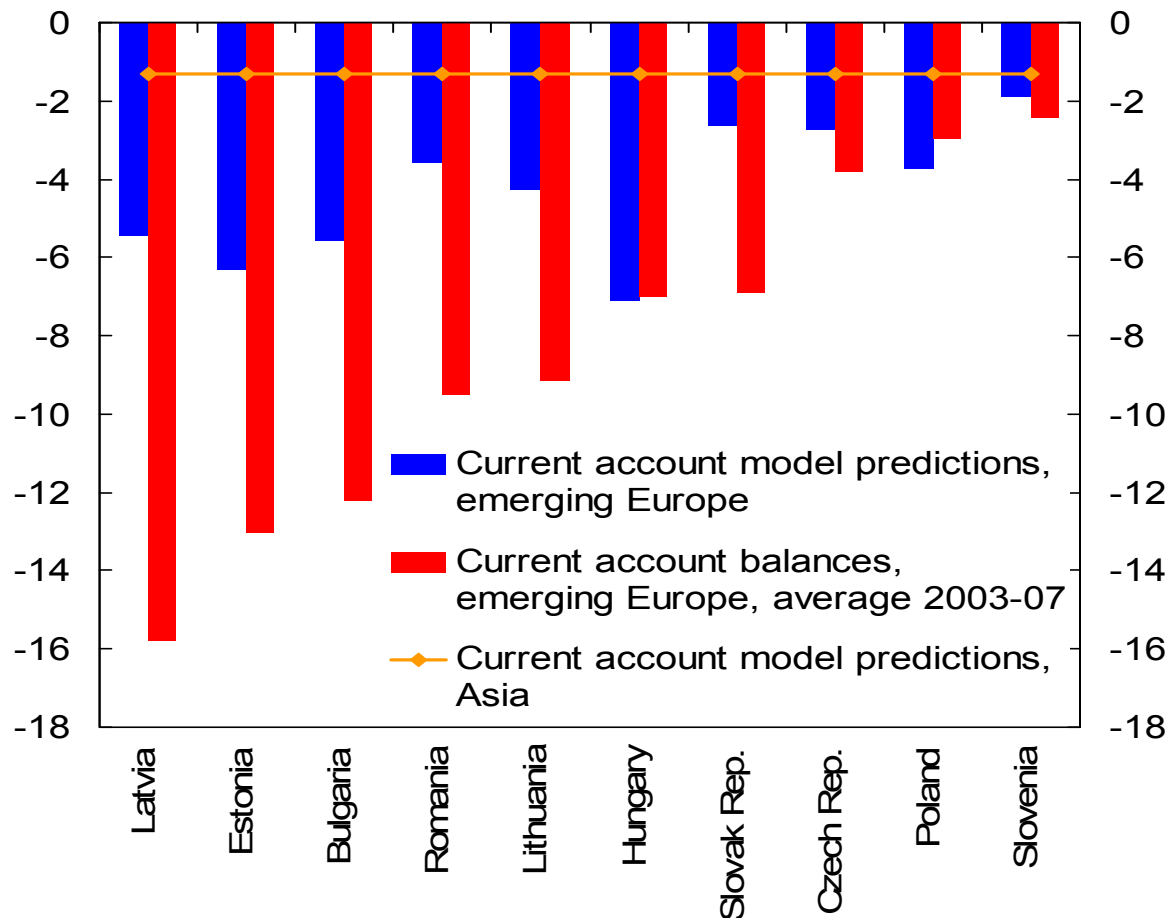
- The EU's "halo" effect (about 100 bp)
- Favorable structure of financing (EU funds, remittances, FDI, low portfolio inflows)
- Presence of large EU banks

## Pessimists:

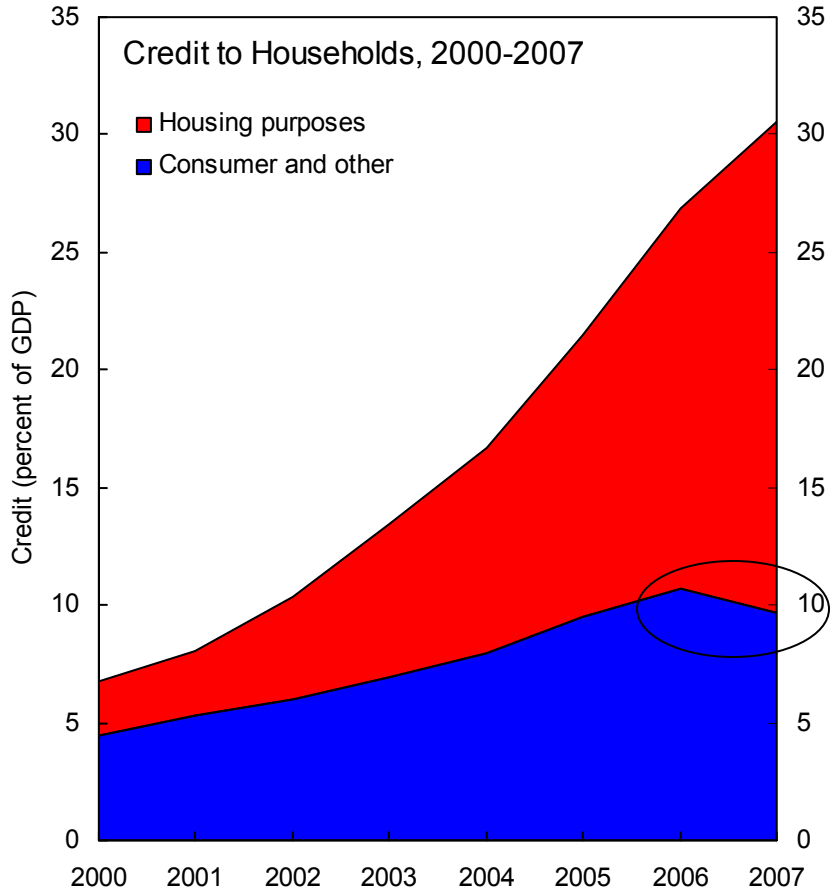
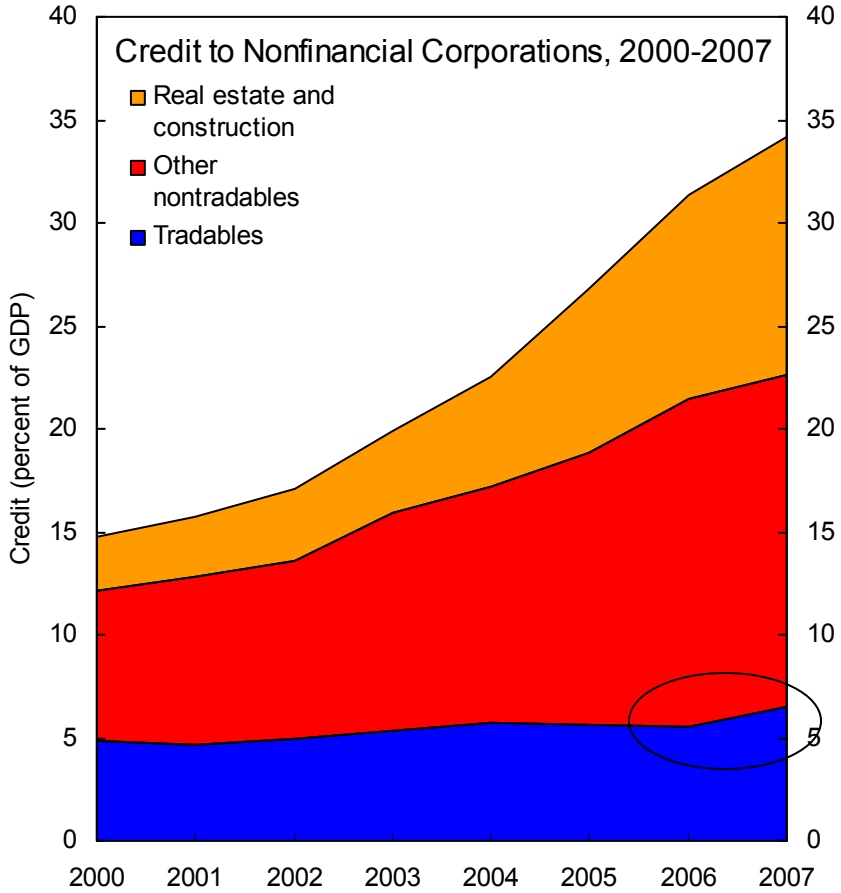
- Historical evidence of large capital inflows and sudden stops
- EU accession does not provide enough assurance of good policies and protection against financing shortfalls
- Foreign capital mainly goes to the non-tradable sector => questions about countries' long-term capacity to repay
- Markets are punishing countries with large imbalances

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

**Current Account Balances and Model Predictions**  
*(Percent of GDP)*



# Credit is concentrated on households and nontradables

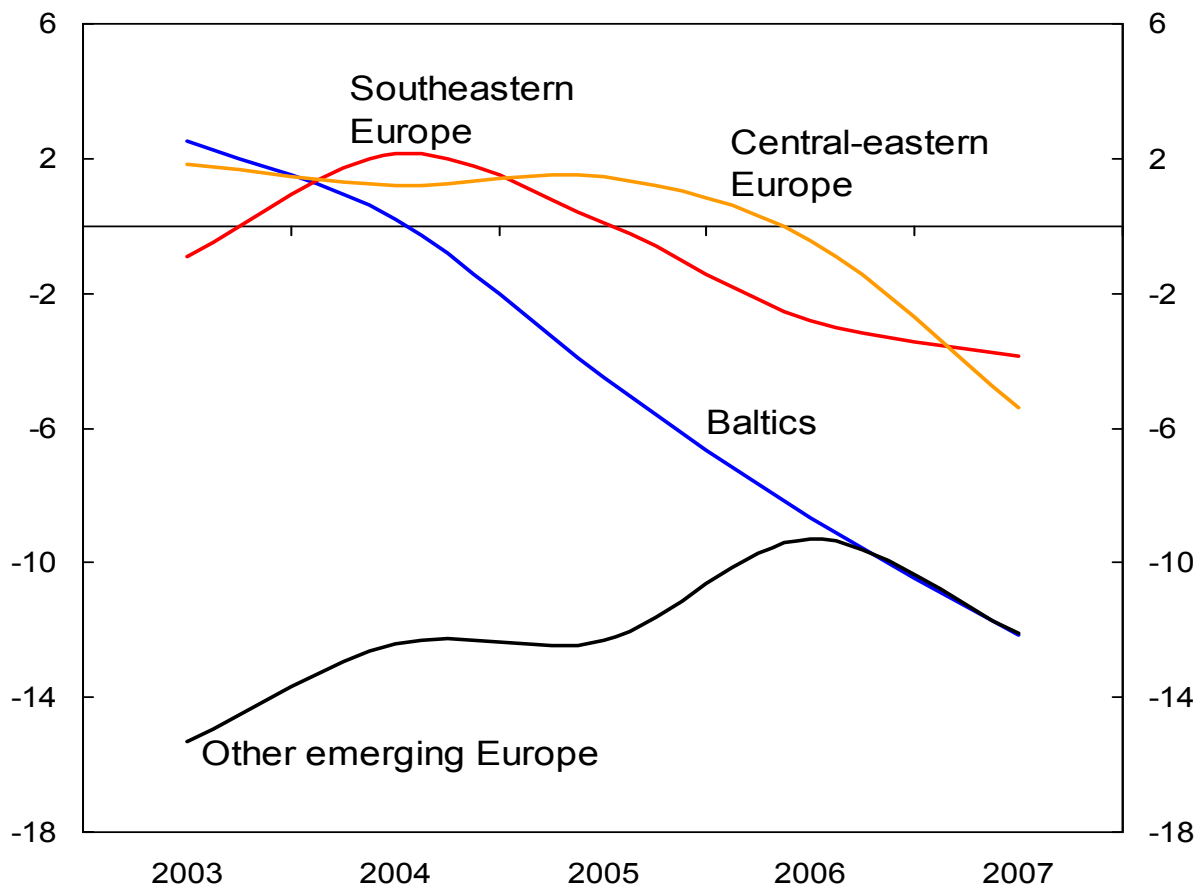




# Macro Policies

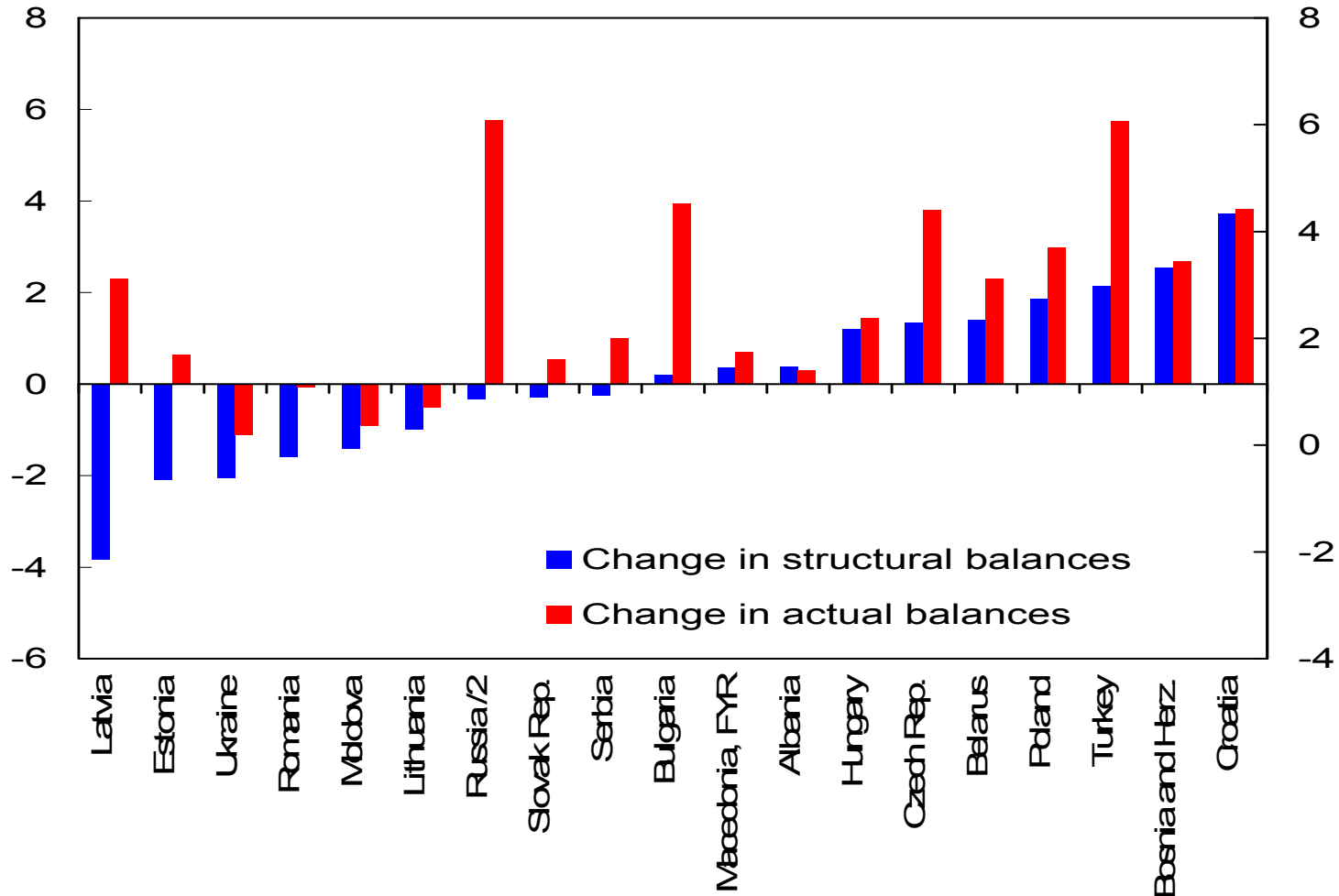
# Monetary conditions are loose

Emerging Europe: Lending Interest Rate–Taylor Rule Interest Rate, 2003–07



# There is room for more fiscal consolidation

**Change in Actual and Structural Fiscal Balances, 2003–07 1/**  
(Percent of GDP)



# 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

# 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, 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