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# Economic Trends and Challenges in Central and Eastern Europe

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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

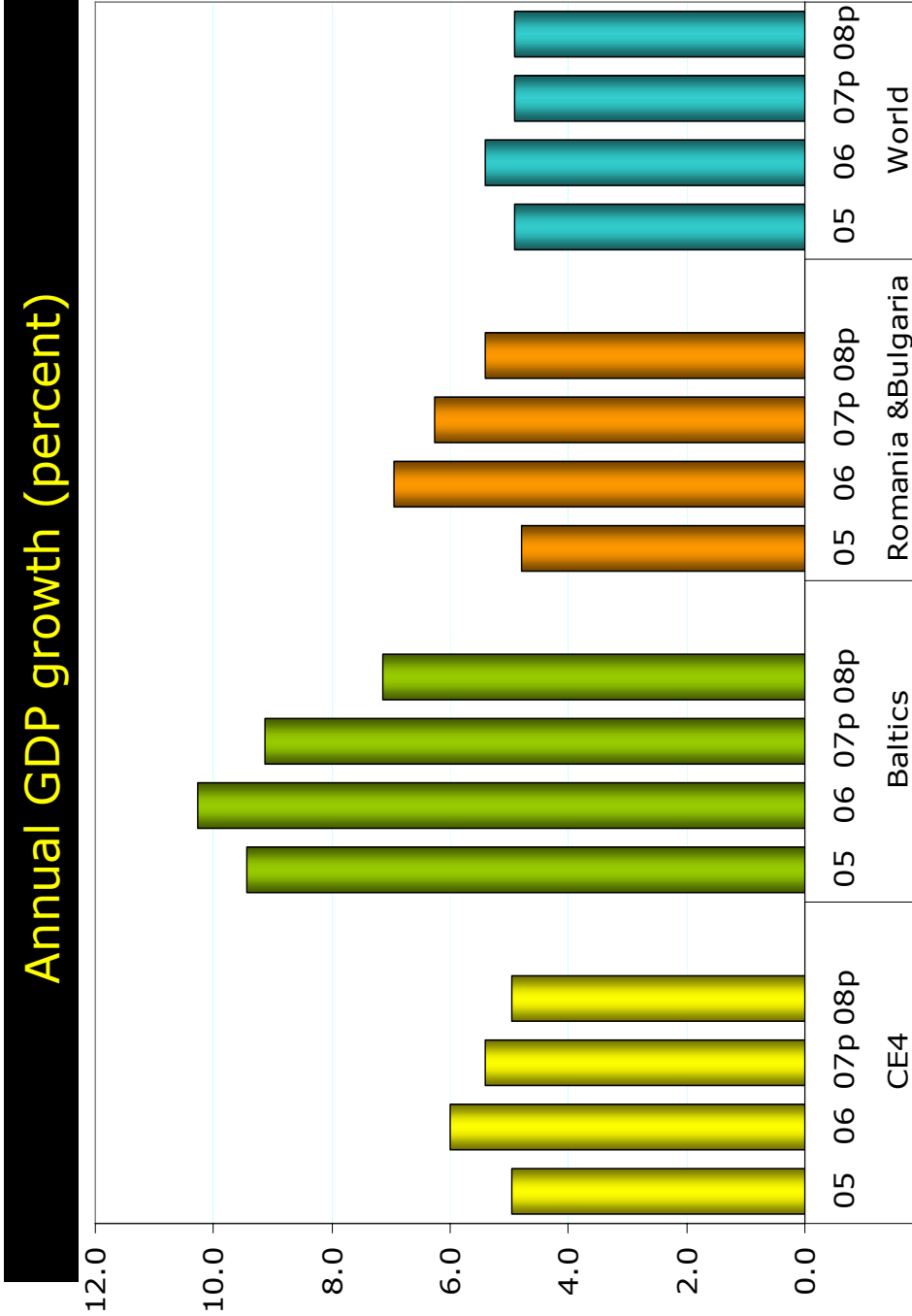
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- The overall macro picture: better than ever
  - But underlying this are vulnerabilities in the run-up to Euro adoption
    - Lack of fiscal adjustment
    - Credit growth
    - Currency mismatches
    - External imbalances
  - Baltics vs. Slovakia (and other CEEs)
  - Policy Conclusions



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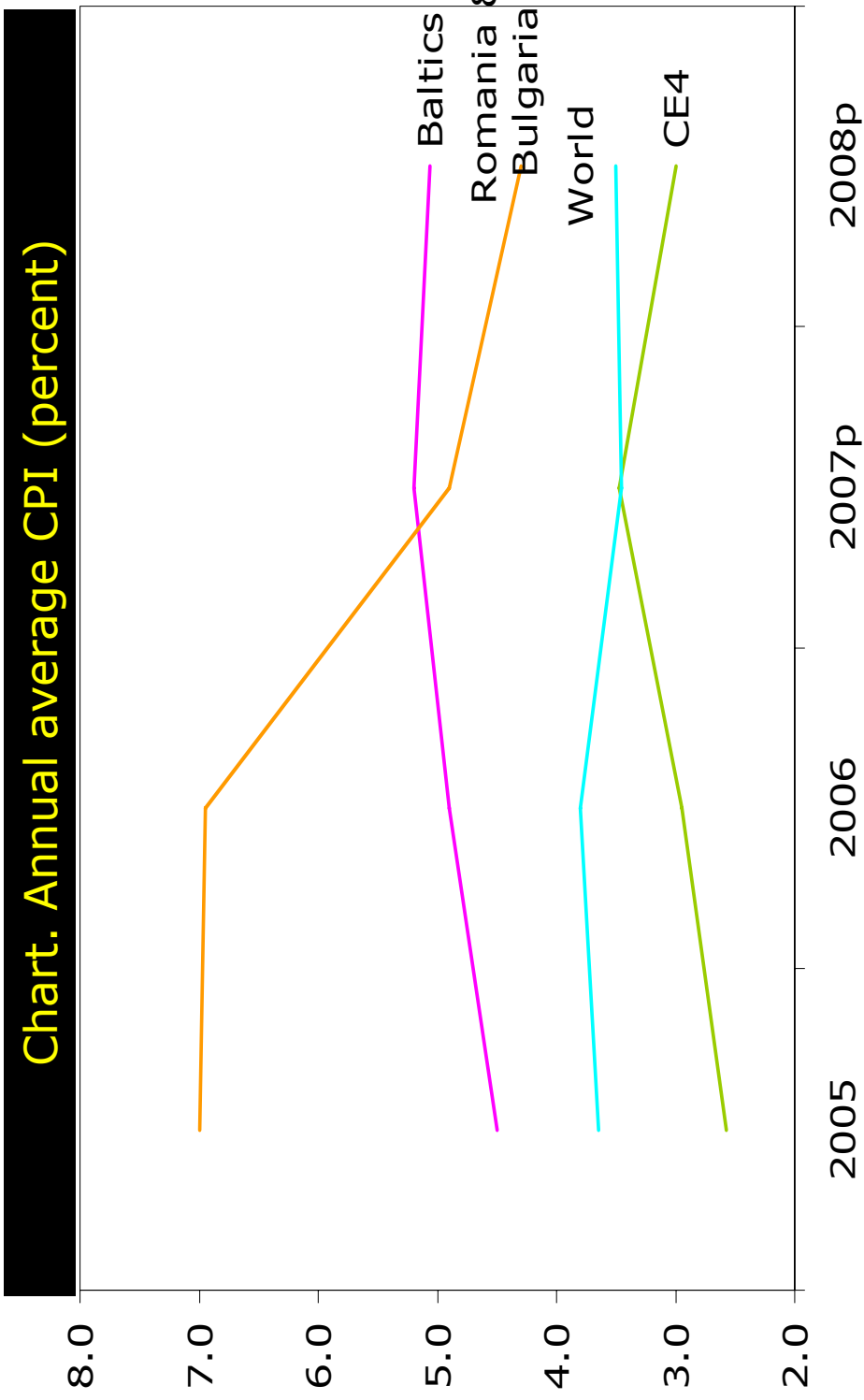
The overall macro  
picture:  
better than ever

# Growth performance is good, albeit mainly cyclical.

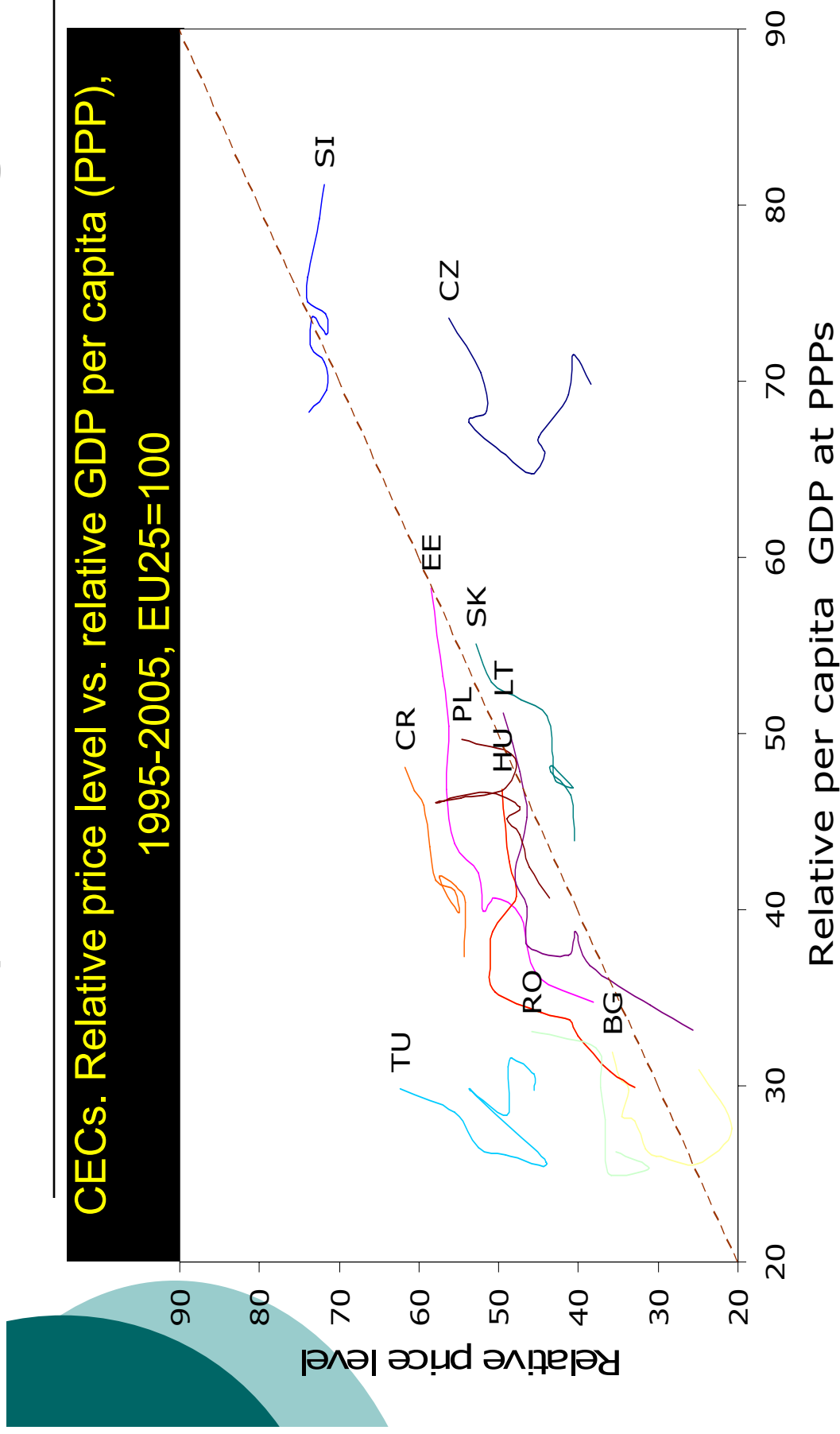


Source: WEO April 2007.

# Inflation is relatively subdued...

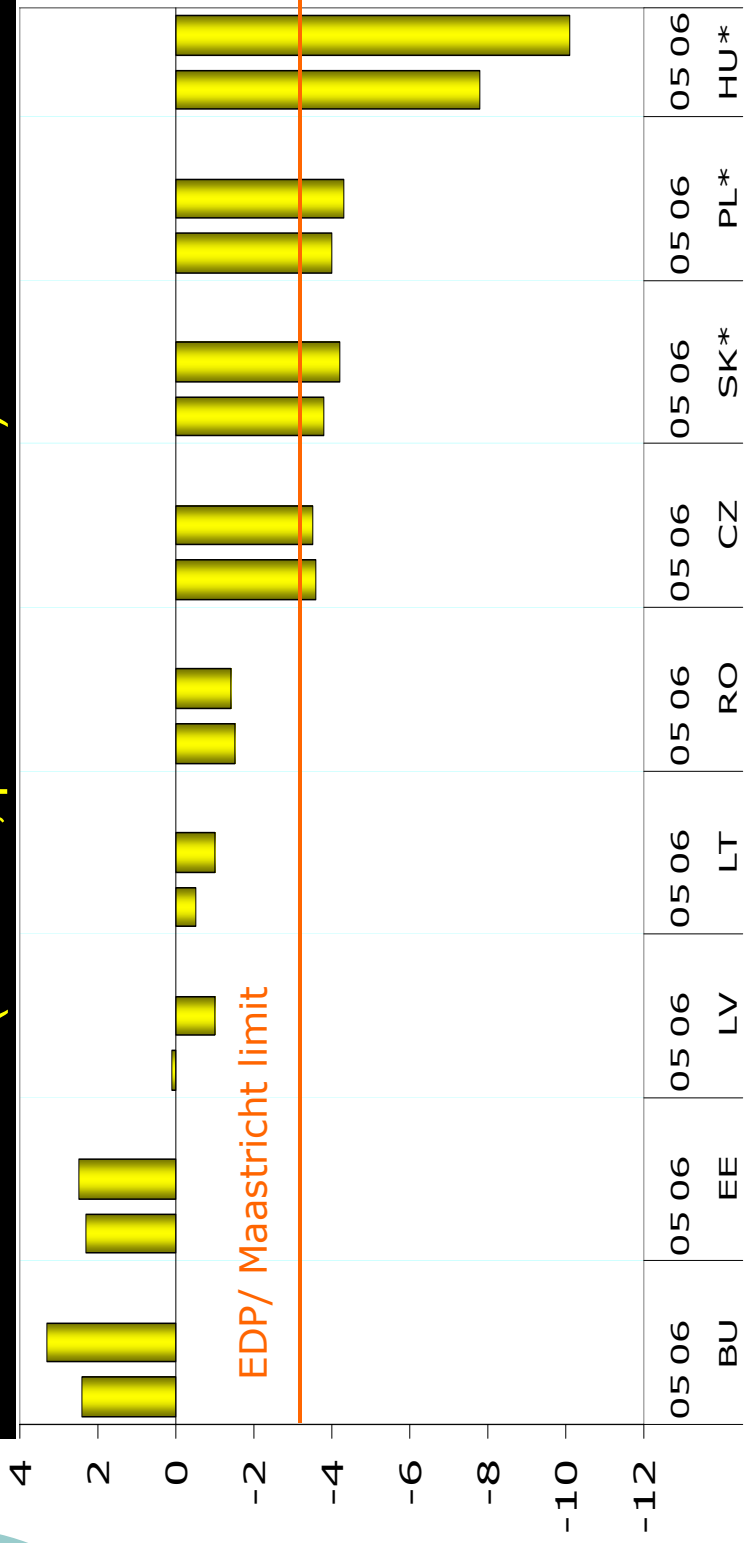


...especially considering that rising price levels are naturally associated with convergence.



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

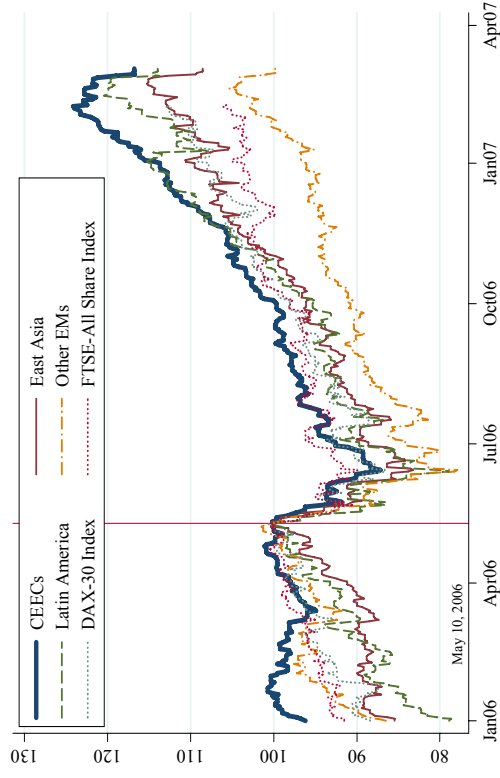
**CECs. General Government deficit (ESA 95, percent of GDP)**



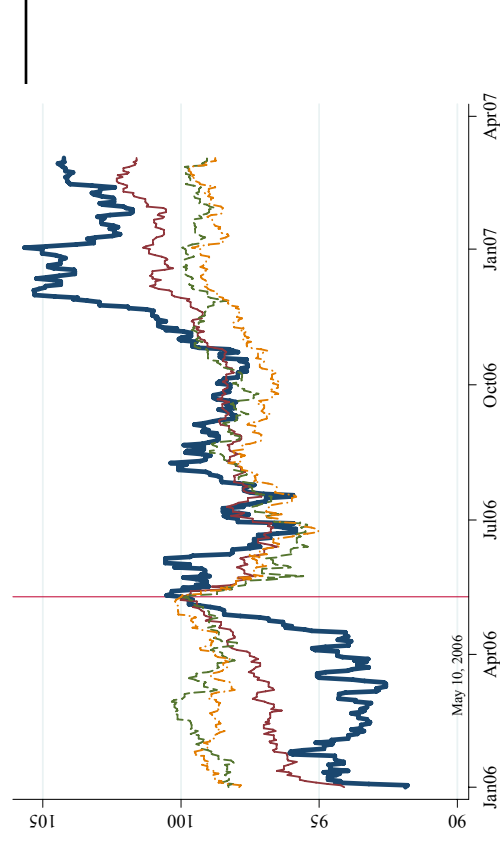
\* incl. pension reform costs  
 Source: EC General Government Data Autumn 2006

# CEC financial markets outperform other EMs

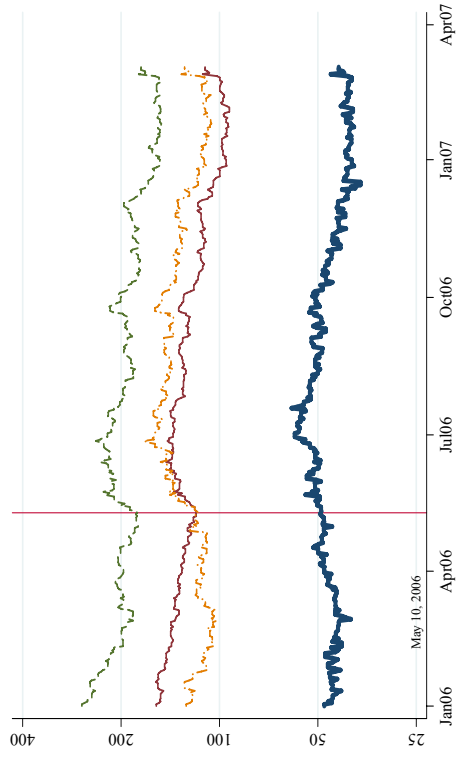
**A. Stock Market Indices  
(May 10, 2006=100)**



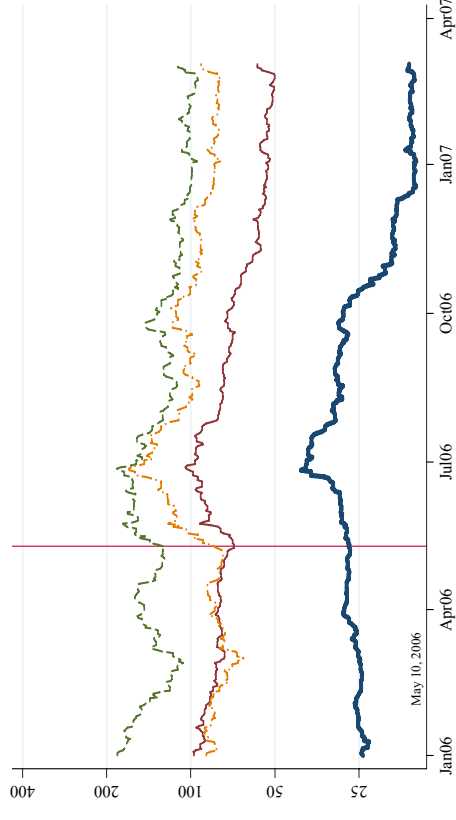
**B. Indices of Exchange Rate Against US\$  
(May 10, 2006 =100; (+) = appreciation)**



**C. External Bond Spreads**



**D. 5-year CDS Spreads**

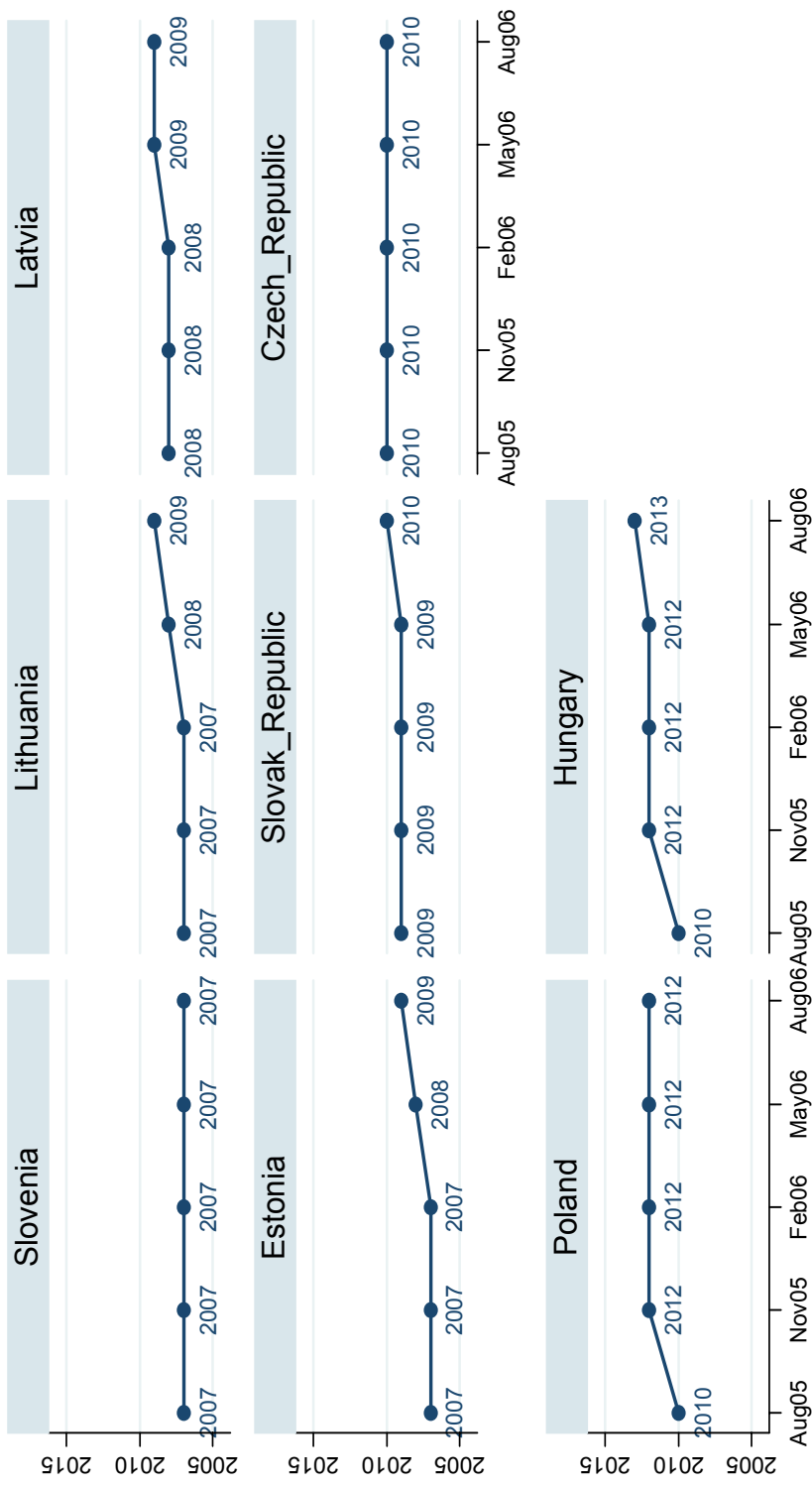


Source: Pipat Luengnaruemitchai, Susan Schadler, Do Economists' and Financial Markets' Perspectives on the New Members of the EU differ?, IMF Working Paper 07/65.



# ...despite receding euro adoption prospects.

## REUTERS Polls on Euro Adoption Date Median Value of the Responses



Source: Reuters



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**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*
<b>General government deficit</b>	-5.3	0.2	1.0	2.1
<b>C/A balance</b>	-5.2	-15.6	-13.1	1.8
<b>External debt</b>	57.7	89.8	57.4	61.4
<b>Public debt</b>	43.5	11.3	19.8	45.9
<b>Reserves/ST debt</b>	115.1	54.8	180.6	215.2
<b>Credit growth (in percent)</b>	8.4	21.0	22.8	2.8

\* EM countries - Argentina, Brazil, Chile, China, Colombia, Indonesia, Peru, Russia, Singapore, Thailand, data for 2005.

Source: IMF GFS, IMF IFS, IMF Article IV Consultations



## Macro Vulnerabilities

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... 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

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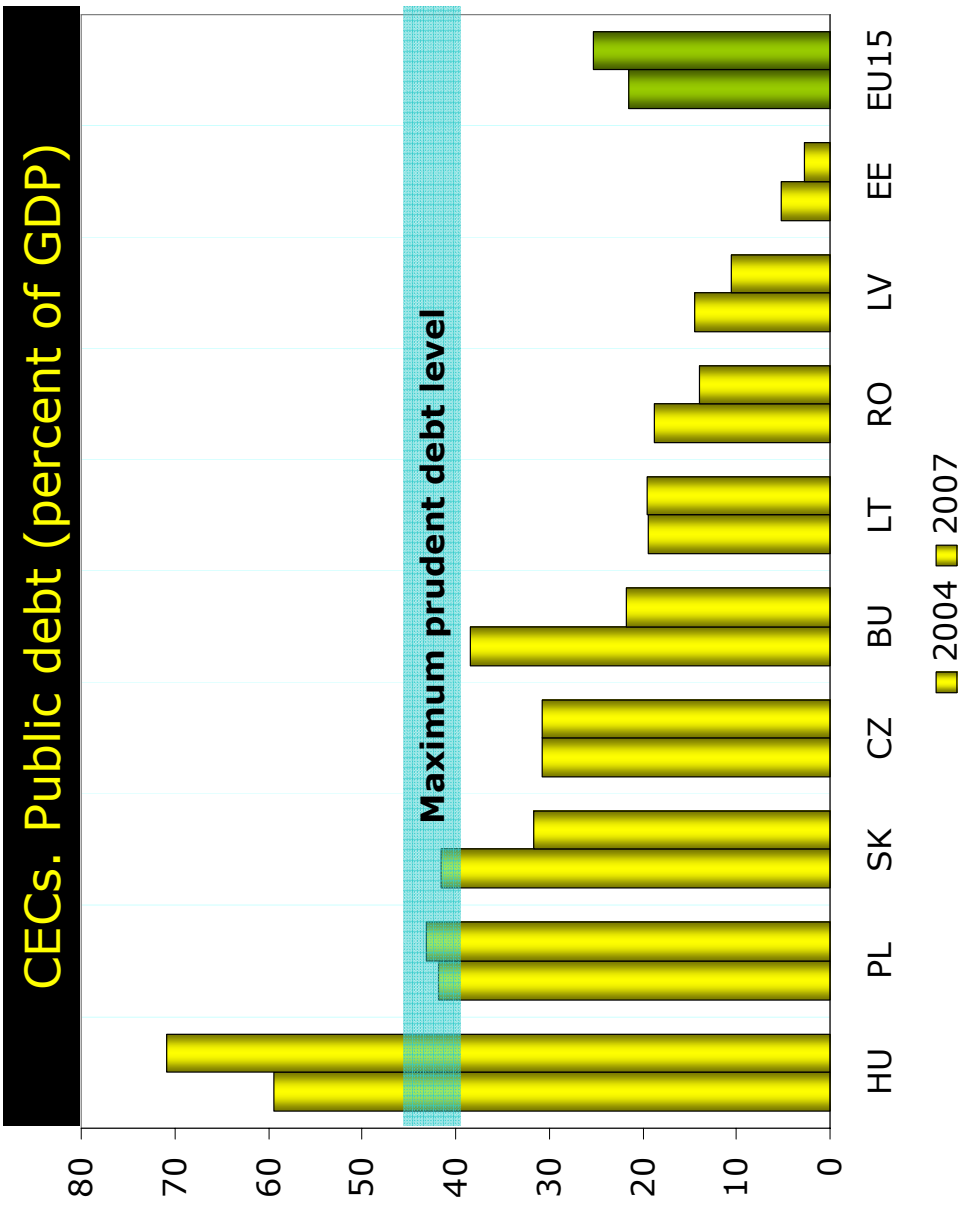
- Lack of fiscal adjustment
- Credit growth
- Currency mismatches
- External imbalances



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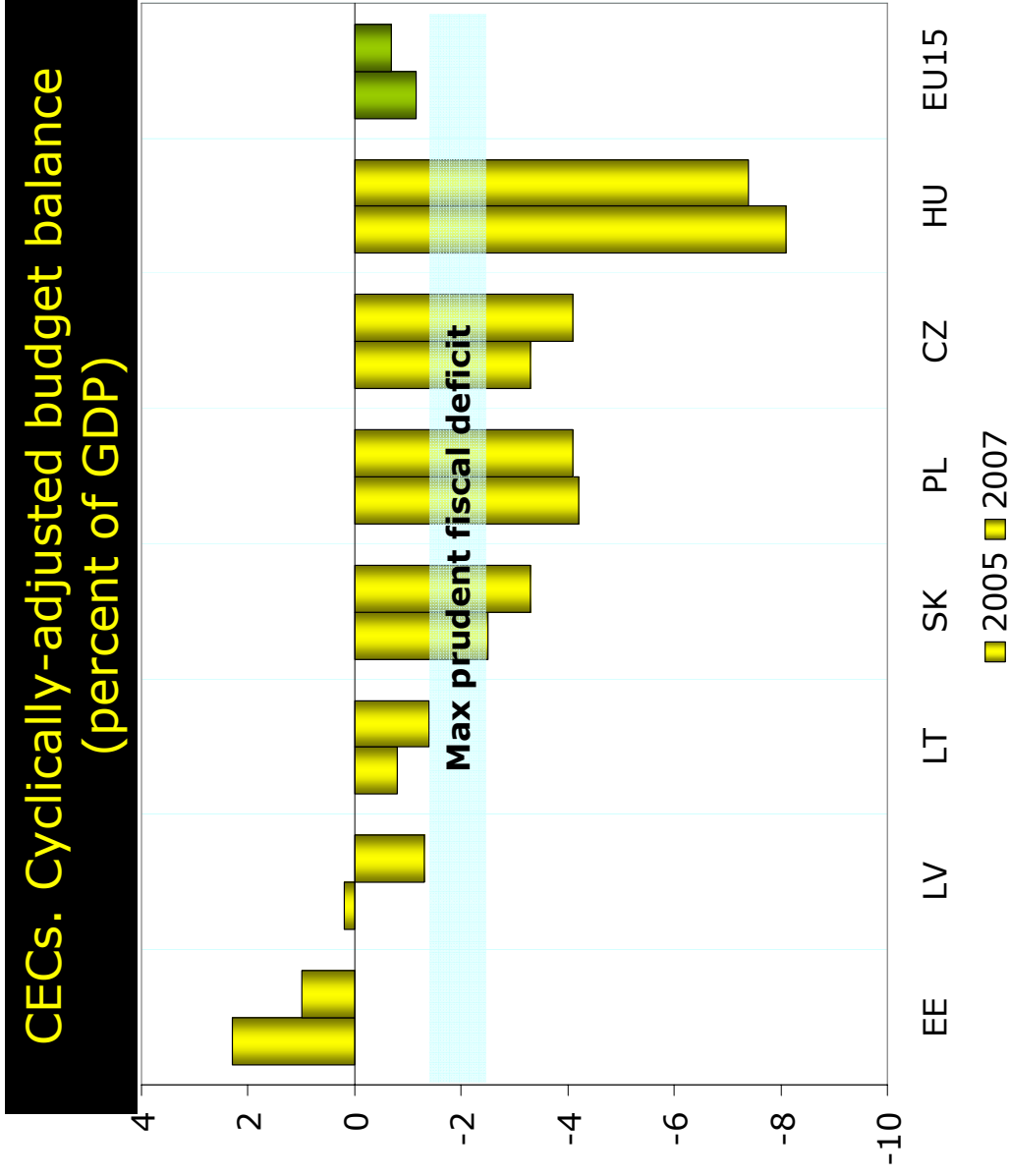
# Lack of fiscal adjustment

# Despite healthy growth, public debt ratios are still high in some CECs.



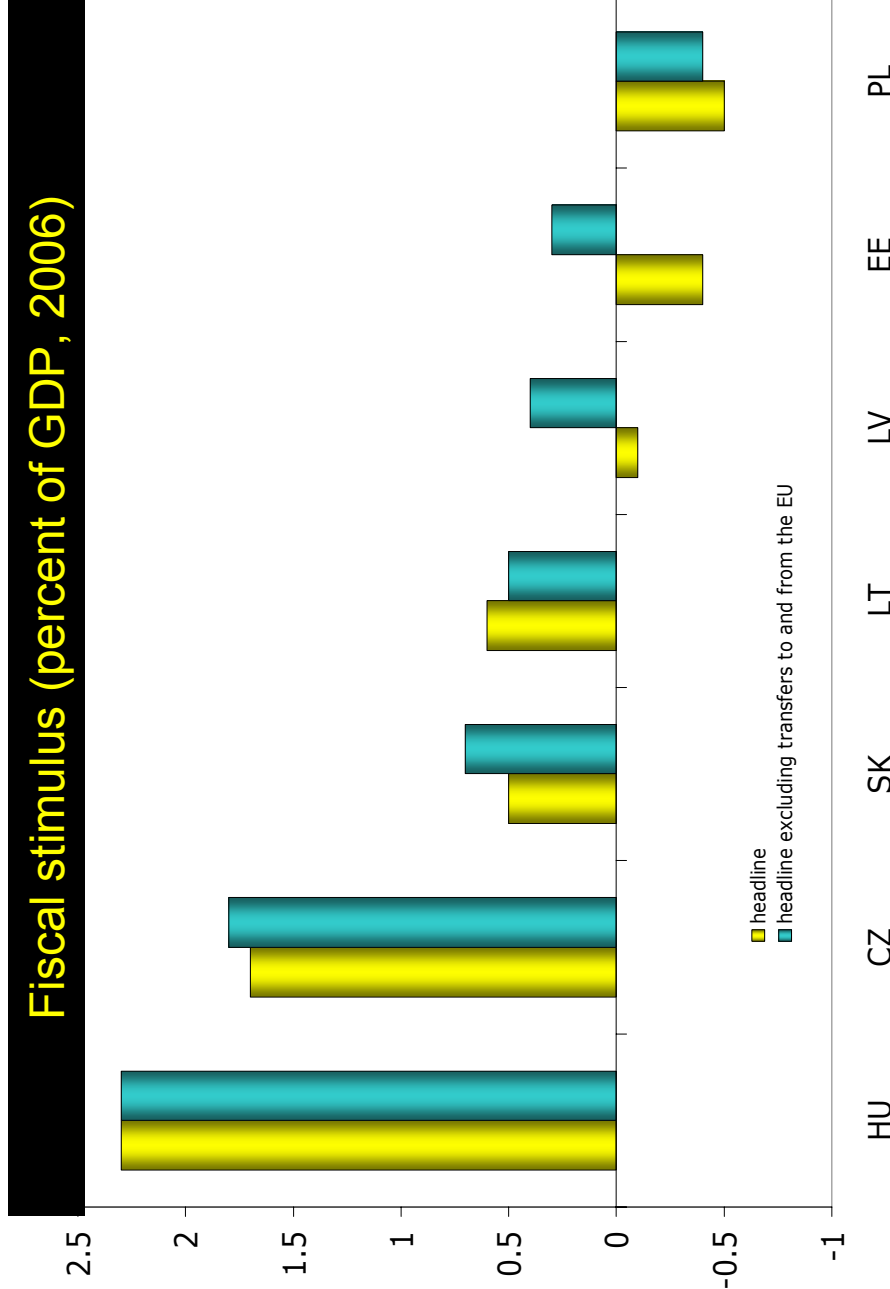
Source: EC Autumn Forecast 2006

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

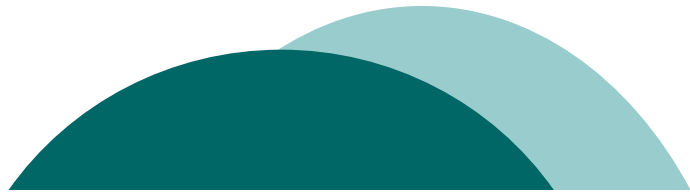




# Fiscal policy is even more procyclical if one accounts for EU funds

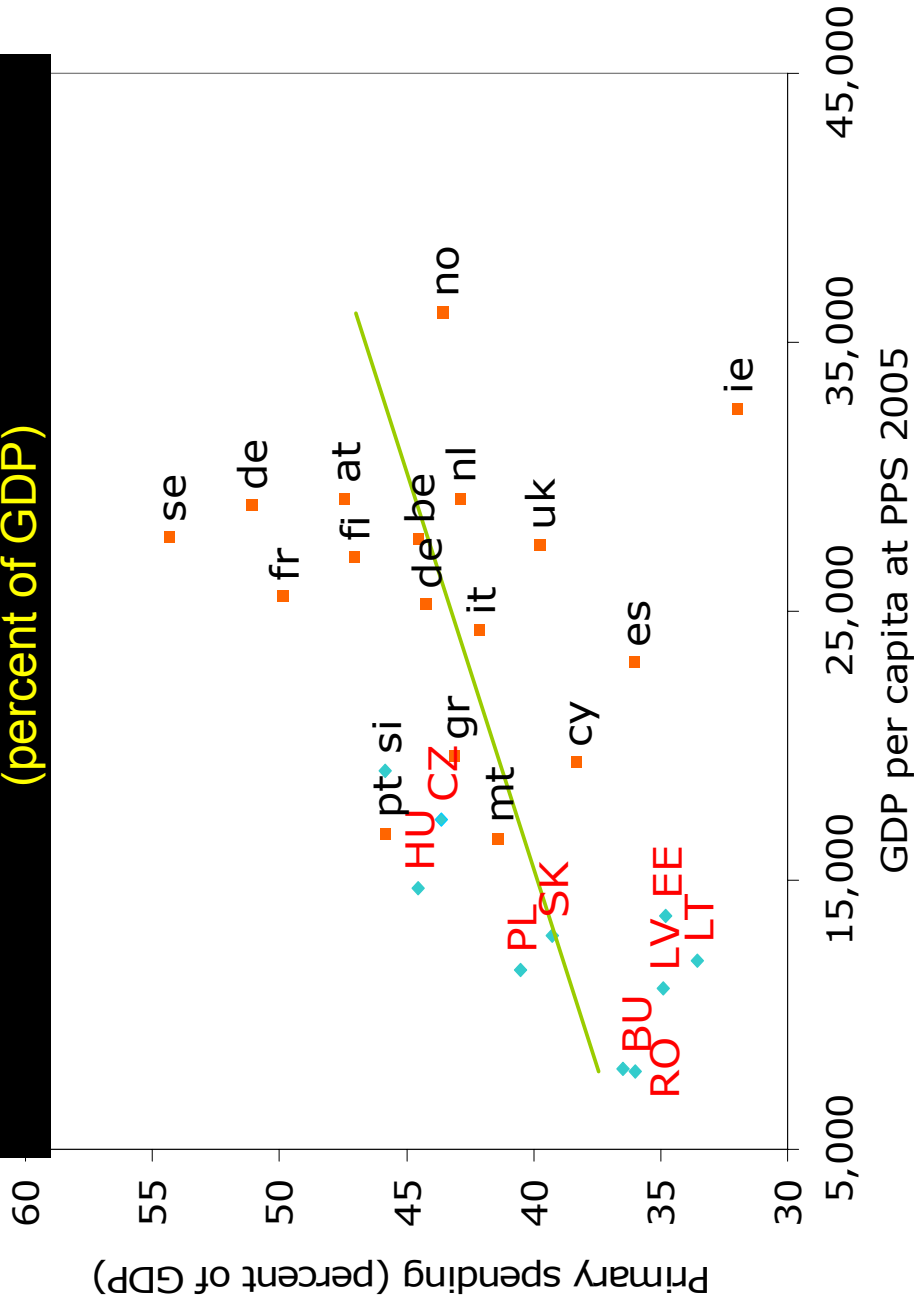


Source: Christoph B. Rosenberg and Robert Sierhej, Interpreting EU Funds Data for Macro Analysis in the New Member States, IMF Working Paper (forthcoming)



Primary spending in Central Europe is high, suggesting that fiscal adjustments should start on the expenditure side.

Primary expenditure, 2000-05 average (percent of GDP)



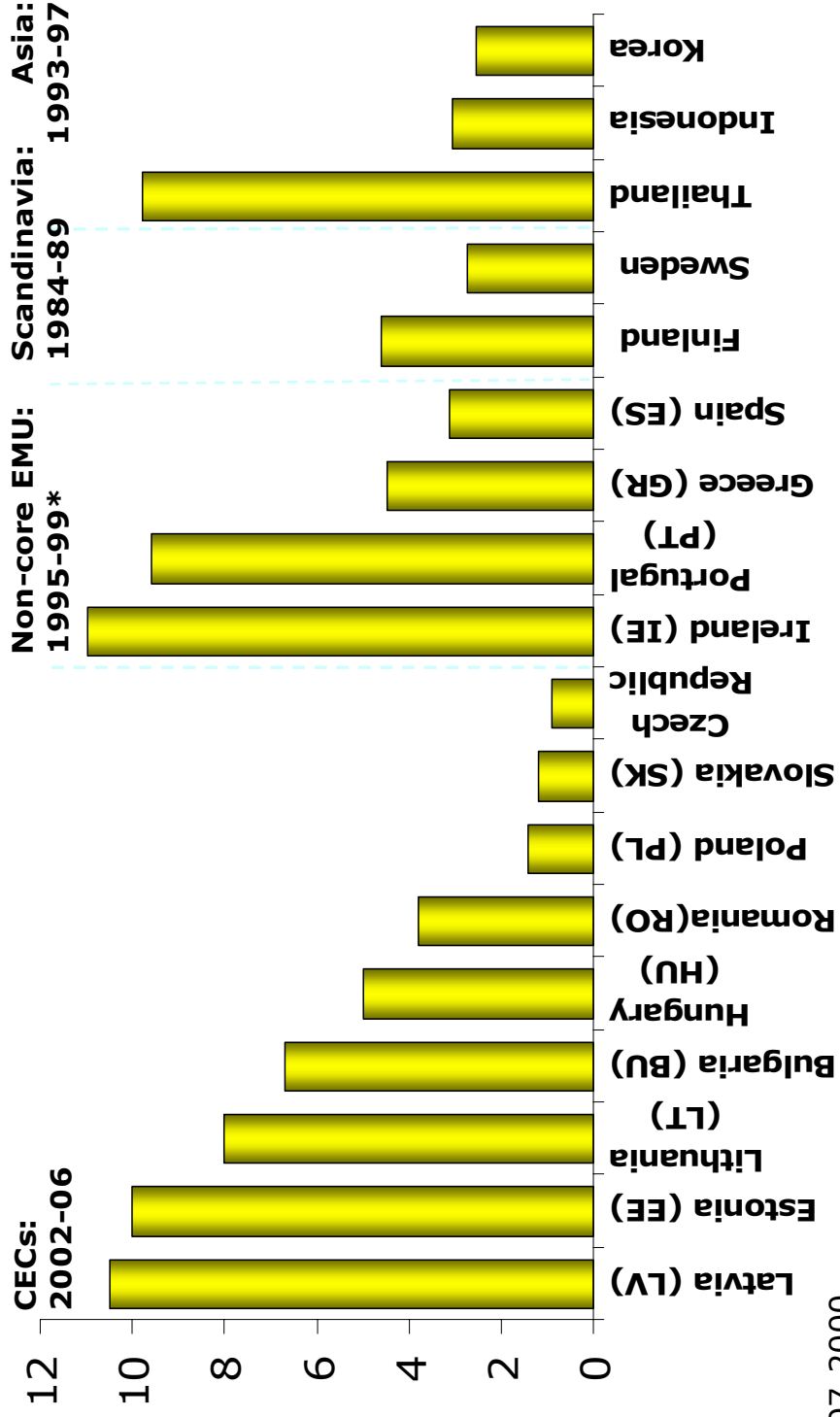


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# Rapid growth of credit to the private sector

# Credit growth has been brisk.

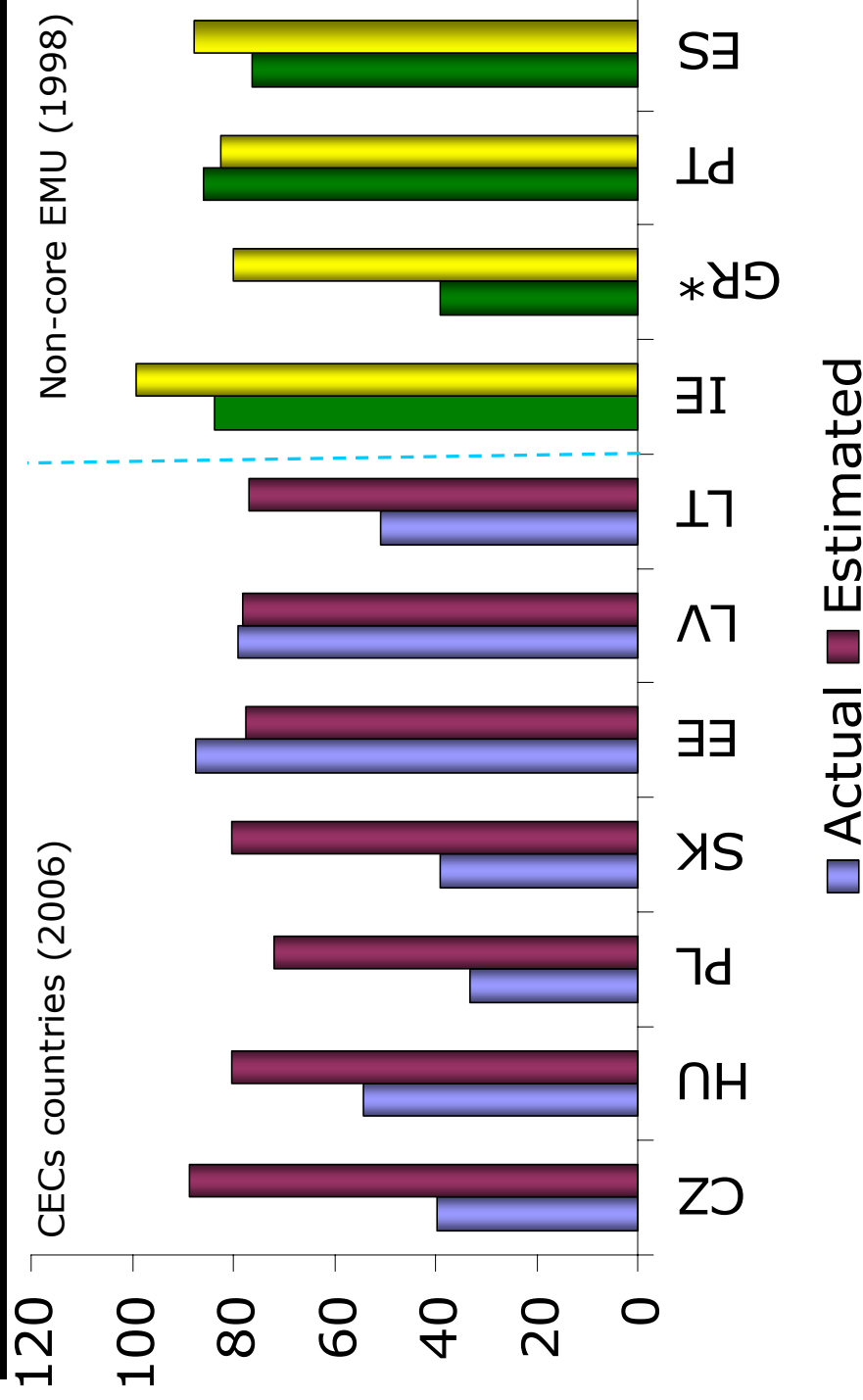
**Average growth of credit to the private sector  
(in percentage points of GDP)**



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

# Private credit still has some room to grow, 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)



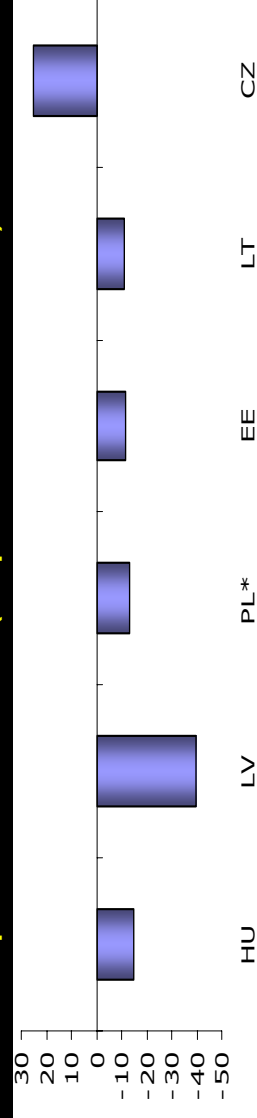
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# Build-up of currency mismatches in the non-financial sector

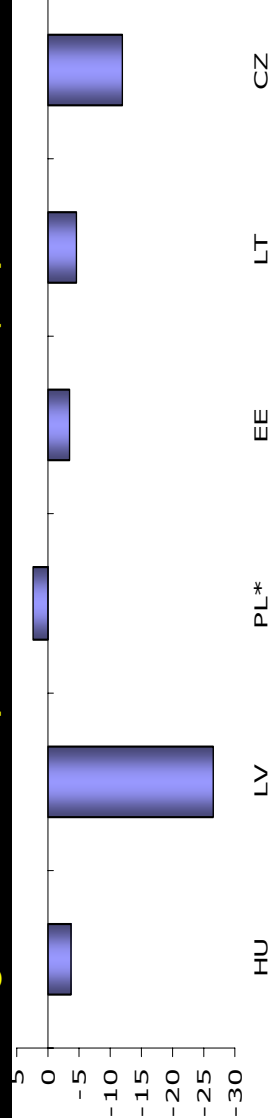
# Most CECs are exposed to currency risk emanating in the non-financial private sector

CECs. Economy-wide currency mismatches

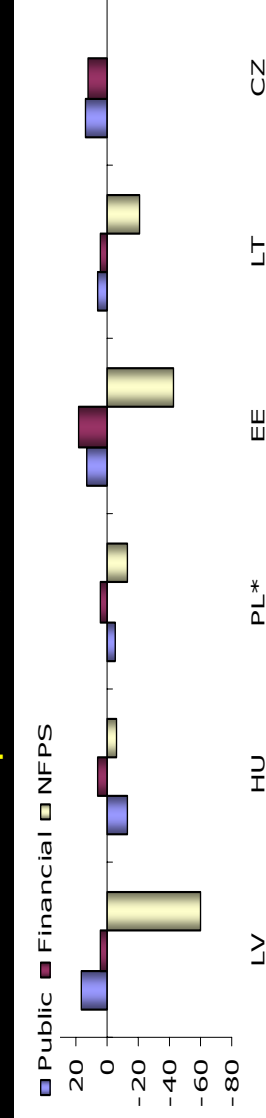
**Net FX position, 2006 (in percent of GDP)**



**Change in net FX position, 2003-06 (in percent of GDP)**



**Sectoral net FX position, 2006**

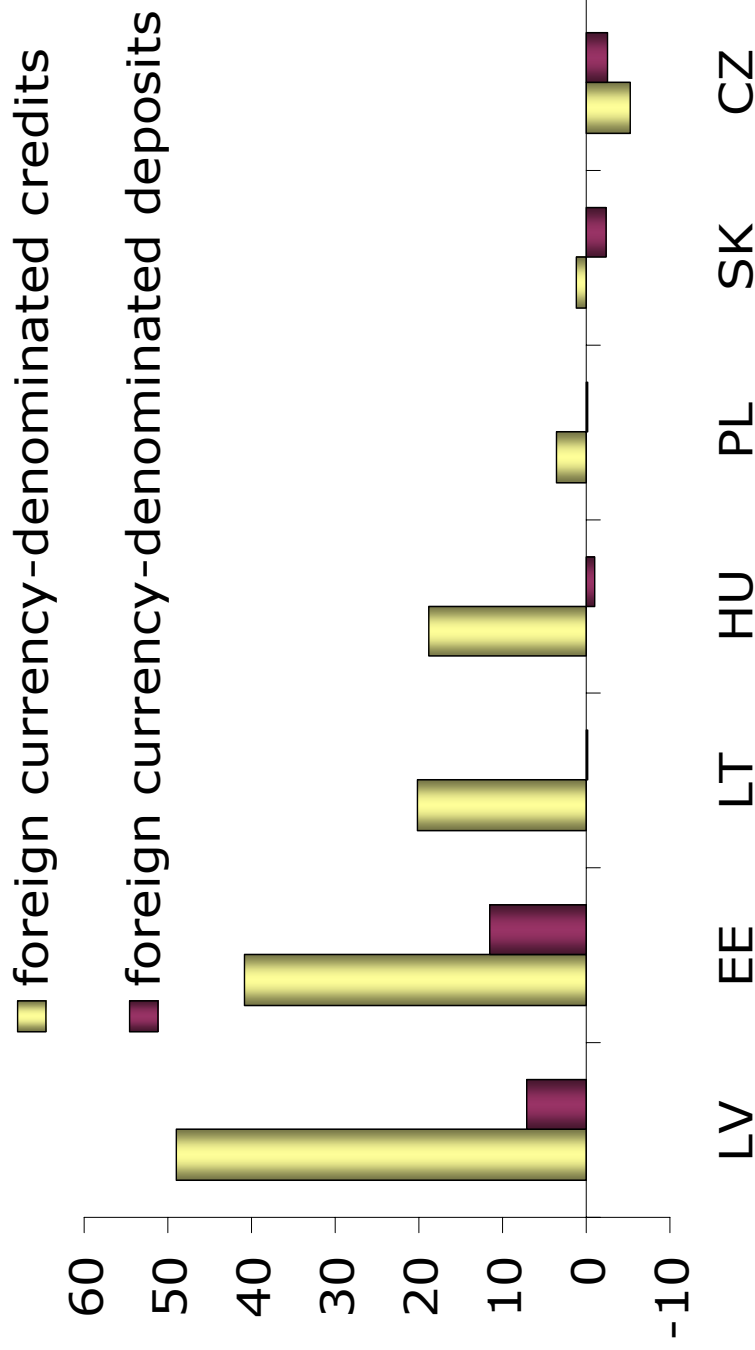


\* Data for 2005.

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 2001-06 (in percentage points of GDP)**



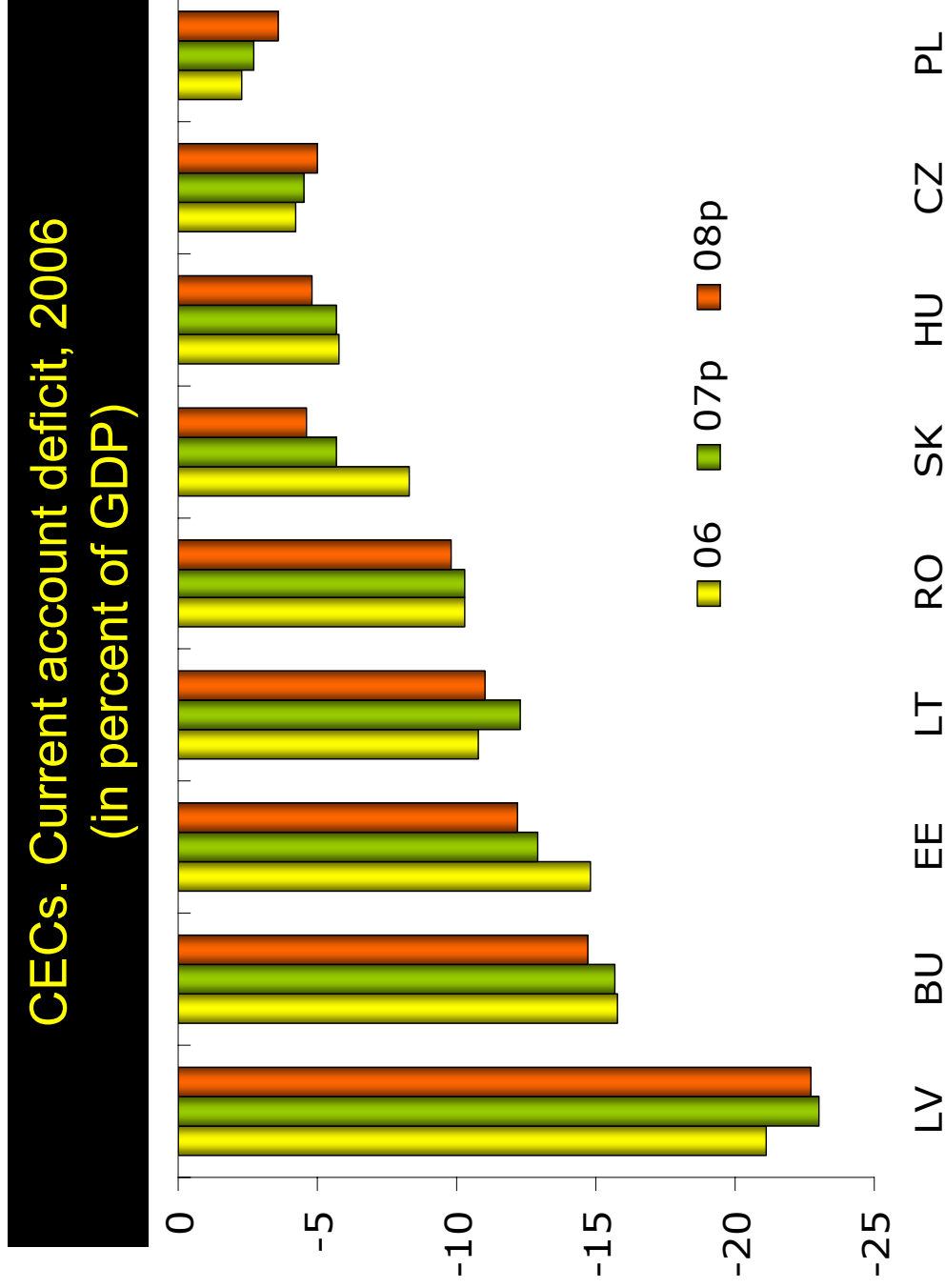




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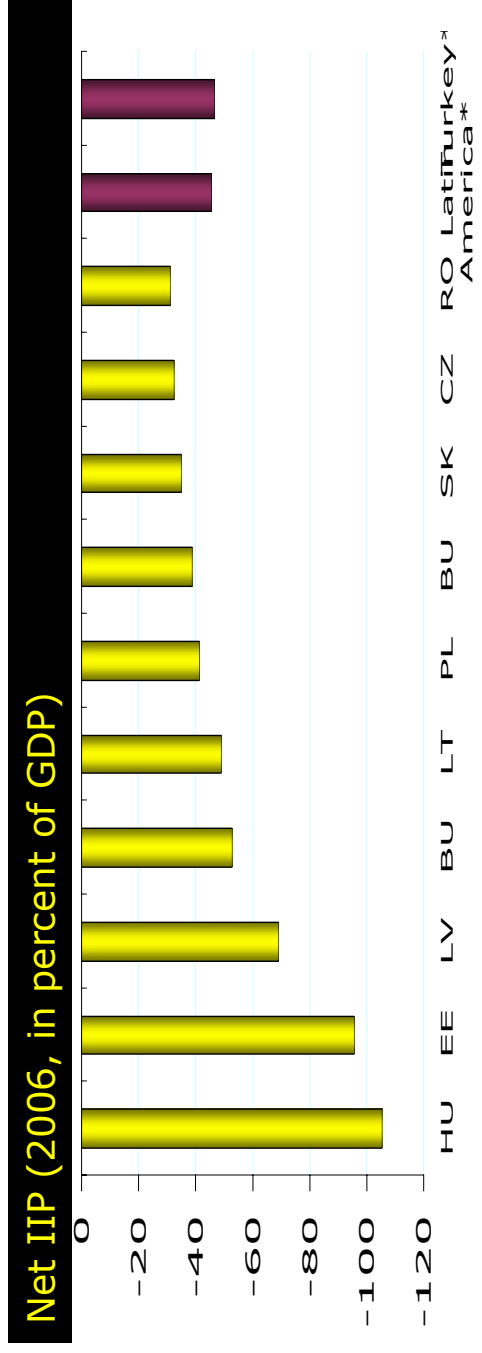
# Large external stock and flow imbalances

# Current account deficits are high, especially in the Baltics and Bulgaria

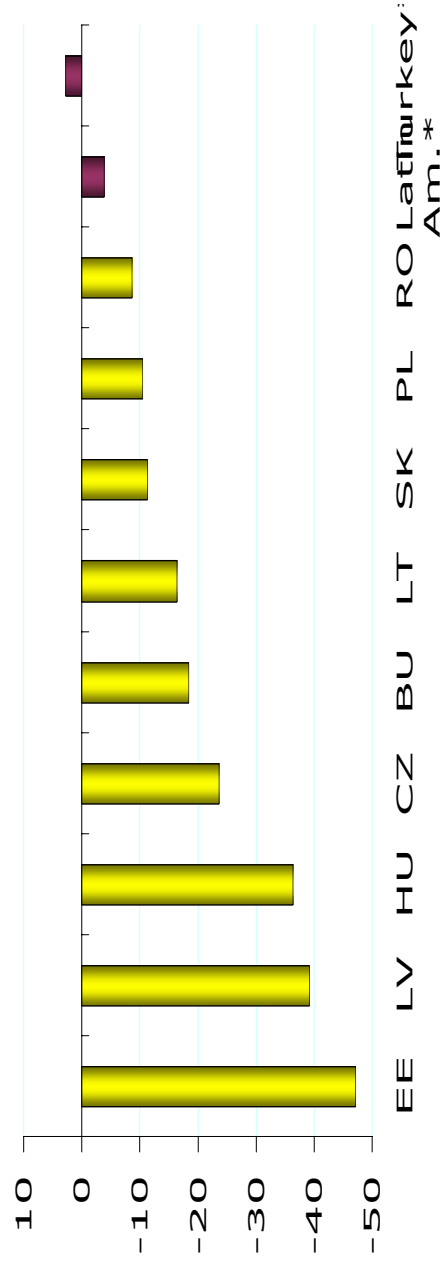


As expected, net IIPs are negative, but unlike in other EMs they have lately deteriorated

## CECs and EMs: International Investment Position



## Change in net IIP 2001-2006 (in percentage points of GDP)



Source: National authorities, Milesi-Ferretti and Lane, "External Wealth of Nations" database. \* Data for 2005.



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**Why are the Baltics  
overheating and Slovakia  
(and other CECs) are not?**

# Why are the Baltics overheating and Slovakia (and other CECs) not?

Macroeconomic indicators (annual growth, in percent)

	Slovakia				Baltics		
	2005	2006e	2007p	2007p	2005	2006e	2007p
Real GDP	6.0	8.3	8.2	8.2	9.5	10.3	9.1
<i>Domestic Demand</i>	8.6	6.2	...	...	8.2	11.4	...
CA balance (% of GDP)	-8.6	-8.0	-5.7	-5.7	-10.1	-15.8	-16.1
CPI (average)	2.8	4.4	2.4	2.4	4.5	4.9	5.2
Credit to private sector	28.3	24.8	...	...	61.4	51.8	...
Real wage	6.2	4.0	...	...	8.5	14.2	...
<i>Population (millions, 2005)</i>		5.4				7.1	
GDP Per capita (PPP, % of EU15)	53.0	56.0	59.0	59.0	49.0	54.0	57.0

\* Baltics is a simple average of EE, LV and LT figures.

Source: Eurostat, national authorities WEO April 2007.

# Why are the Baltics overheating and Slovakia (and other CECs) not?

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## Differences in macro fundamental:

- Monetary framework: fixed vs. flexible exchange rates
- Fiscal policy and EU funds utilization
- Labor markets and migration
- Allocation of investment: Export-oriented and productive sectors vs. real estate and domestic services



# Conclusions

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- The general macro outlook is positive, and is largely well deserved due to good policies in the run-up to EU membership
- But vulnerabilities are growing, especially in the Baltics (“Running with your shoelaces open”). Governments are making insufficient use of the supportive environment.
- Policy challenges:
  - Anti-cyclical fiscal policies
  - Financial sector supervision
  - Creating flexible economies and sound institutions
  - Euro adoption

