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.
The overall macro picture: better than ever
But underlying this are challenges in the run-up to Euro adoption
- Fiscal adjustment
- Credit growth
- Currency mismatches
- External imbalances
- Financial sector integration
- Creating flexible economies

Policy Conclusions
The overall macro picture: better than ever
Growth performance is good, driven by EU accession and the global upswing.

As a result, the CECs are catching up quickly.
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 Spring Forecast 2007
CEC financial markets have outperformed 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

...despite receding euro adoption prospects.

Source: Reuters
The fallout from the suprime mortgage crisis in the US has had some effects on financial markets.

**Stock markets (Aug 1 = 100)**

**Exchange rate vs. USD**

**Foreign currency spreads 1/**

**Credit Default Swaps Spreads 2/**

Source: Bloomberg.

1/ Spread of 5-year euro denominated international government bonds versus %-year Bund.

2/ The credit default swap (CDS) is an over-the-counter contract whereby the buyer pays the seller a periodic fee in return for contingent payment by the seller upon default of the issuer of a credit instrument.
Borrowing spreads were less affected than in other Ems.

Change in EMBI
July 16-August 22 (bps)

Change in the EURO exchange rate July 16-August 23
(+= depreciation, percent)

Source: IMF GMM, national statistics.
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)

<table>
<thead>
<tr>
<th></th>
<th>CE4</th>
<th>Baltics</th>
<th>Romania &amp; Bulgaria</th>
<th>EM countries*</th>
<th>Asia 1997**</th>
</tr>
</thead>
<tbody>
<tr>
<td>General government deficit</td>
<td>-5.3</td>
<td>0.2</td>
<td>1.0</td>
<td>1.1</td>
<td>-1.8</td>
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<tr>
<td>C/A balance</td>
<td>-5.2</td>
<td>-15.6</td>
<td>-13.1</td>
<td>2.7</td>
<td>-3.3</td>
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<tr>
<td>External debt</td>
<td>57.7</td>
<td>89.8</td>
<td>57.4</td>
<td>51.9</td>
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<tr>
<td>Public debt</td>
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<td>11.3</td>
<td>19.8</td>
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<td>Reserves/ST debt</td>
<td>115.1</td>
<td>54.8</td>
<td>180.6</td>
<td>175.8</td>
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<tr>
<td>Credit growth (in percent)</td>
<td>8.4</td>
<td>37.6</td>
<td>22.8</td>
<td>2.5</td>
<td>13.9</td>
</tr>
</tbody>
</table>

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

** Korea, Indonesia, 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?

 Analytical challenge: how to distinguish “natural” convergence from overheating
Main Concerns

- Lack of fiscal adjustment
- Credit growth
- Currency mismatches
- External imbalances
- Cross-border contagion risks
Lack of fiscal adjustment
Despite healthy growth, public debt ratios are not declining in key CECs.

Source: EC Spring Forecast 2007
Few countries have used the benign global environment and buoyant revenue to reduce deficits to prudent levels.

![CECs. Cyclically-adjusted budget balance (percent of GDP)](chart)

Max prudent fiscal deficit

Source: EC Spring Forecast 2007
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 07/77
Primary spending in Central Europe is high, suggesting that fiscal adjustments should start at the expenditure side.

Source: AMECO.
Data for RO & BU for 2005.
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
Indebtedness corresponds to income levels.

Private credit to GDP and income per capita, EU countries, 2005

Source: IFS, Eurostat
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)
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**

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)

Source: National authorities, IMF staff estimates
* Deposit data for Romania are not available.
Households in some countries are particularly exposed.

Households’ net open fx position (percent of GDP)

Source: MNB
Large external stock and flow imbalances
Current account deficits are high, except in Central Europe...

... largely reflecting the convergence process.
As expected, net IIPs are negative, but unlike in other EMs they have lately deteriorated.

CECs and EMs: International Investment Position

Source: National authorities, Milesi-Ferretti and Lane, “External Wealth of Nations” database.
* Data for 2005.
Balance sheet exposures between banking systems warrant a cross-country perspective.

<table>
<thead>
<tr>
<th>EU10</th>
<th>Austria</th>
<th>Belgium</th>
<th>Sweden</th>
<th>Germany</th>
<th>France</th>
<th>Italy</th>
<th>Portugal</th>
<th>Finland</th>
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<td>Bulgaria</td>
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</table>

Source: BIS
Creating flexible economies
Labor markets seem relatively flexible, but are untested.

Source: OECD.
1\ The scale of indicators is from 1-10 from most to least regulated.
A flexible business environment is essential for sustaining convergence and eventually doing well in the euro zone.

Flexibility and adaptability (0-10)

<table>
<thead>
<tr>
<th>Best performers</th>
<th>Average</th>
<th>EU8*</th>
<th>EU15</th>
<th>US</th>
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<table>
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<th>Worst performers</th>
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Adaptability of companies (0-10)

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Source: IMD World Competitiveness
* Excluding Lithuania and Latvia
Conclusions

- Headline numbers look good, but vulnerabilities are growing, especially in the Baltics (“Running with your shoelaces open”)

- So far, CECs have weathered market turmoil surprisingly well

- Rather than using the favorable environment to reduce risks, some governments are pouring oil into the fire by pursuing procyclical fiscal policies

- Preparation for euro adoption is overly focused on meeting Maastricht criteria
Policy challenges

- Cool off economies during a surge in capital inflows and rapid credit growth => tightening fiscal policies is often the only available tool
- Financial sector supervision, including of cross-border exposures
- Prepare for euro adoption by creating flexible economies and sound institutions