Economic Trends and Challenges in 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.
The overall macro picture: better than ever

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 Conclusions
The overall macro picture: better than ever
Growth performance is still good, driven by EU accession and still solid global growth.

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

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: Eurostat, EC Autumn Forecast 2007
The NMSs have weathered the subprime market fallout better than other EMs.

Change in EMBI
July 16 - November 16 (bps)

Source: IMF GMM, national statistics.

Change in the EURO exchange rate July 16 – November 16
(+= depreciation, percent)
...although downside risks have increased:

- Sharper than expected squeeze on credit
- Increased risk premia, especially in countries with large imbalances
- Lower FDI from US and Western Europe
- Lower exports to US and Western Europe
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

<table>
<thead>
<tr>
<th>Key Macro Indicators 2006 (in percent of GDP)</th>
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</thead>
<tbody>
<tr>
<td></td>
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<tr>
<td>General government deficit</td>
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<tr>
<td>CE4</td>
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<tr>
<td>-5.3</td>
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<tr>
<td>C/A balance</td>
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<tr>
<td>-5.2</td>
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<tr>
<td>Gross external debt</td>
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<tr>
<td>57.7</td>
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<tr>
<td>Gross public debt</td>
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<tr>
<td>43.5</td>
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<tr>
<td>Reserves/ST debt</td>
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<tr>
<td>115.1</td>
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<tr>
<td>Credit growth (in percent)</td>
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<tr>
<td>8.4</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 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: EC Autumn Forecast 2007
Primary spending in the NMSs is high, suggesting that fiscal adjustments should start at the expenditure side.

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**Primary expenditure, 2000-06 average (percent of GDP)**

- **Source:** AMECO.
- **Data for RO & BU for 2005.**

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**GDP per capita at PPS 2006**
Rapid growth of foreign exchange credit to the private sector
Credit growth has been brisk.

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

- **CECs:** 2002-06
- **Bulgaria & Romania**
- **CE4**
- **Ireland (IE)**
- **Portugal (PT)**
- **Greece (GR)**
- **Spain (ES)**
- **Finland**
- **Sweden**
- **Thailand**
- **Indonesia**
- **Korea**

*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.

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.
Fx borrowing has become popular, especially in countries with fixed exchange rates.

Source: National authorities.
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, especially in the Baltics and South-Eastern Europe...

... 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 => capacity to repay
- Foreign banks create new vulnerabilities
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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<tr>
<td></td>
<td>34.7</td>
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<td>1.9</td>
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<td>0.6</td>
<td>0.1</td>
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<td></td>
<td></td>
<td>3.9</td>
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<td>ROW</td>
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<td>94.1</td>
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<td>89.2</td>
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Source: BIS
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)**

<table>
<thead>
<tr>
<th>EU8*</th>
<th>Best performers</th>
<th>Iceland</th>
<th>Turkey</th>
<th>Hungary</th>
<th>Estonia</th>
<th>Czech Rep.</th>
<th>Slovak Rep.</th>
<th>Poland</th>
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<td></td>
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<tr>
<td>Worst performers</td>
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<td>Indonesia</td>
<td>Germany</td>
<td>France</td>
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</tr>
</tbody>
</table>

**Adaptability of companies (0-10)**

<table>
<thead>
<tr>
<th>EU8*</th>
<th>Best performers</th>
<th>Hong Kong</th>
<th>Taiwan</th>
<th>Iceland</th>
<th>Czech Rep.</th>
<th>Hungary</th>
<th>Estonia</th>
<th>Slovak Rep.</th>
<th>Poland</th>
<th>Slovenia</th>
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<td>EU15</td>
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<td>US</td>
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<tr>
<td>Worst performers</td>
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<td>China</td>
<td>Indonesia</td>
<td>Portugal</td>
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</tbody>
</table>

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 look good
- NMS have so far weathered the subprime market fallout well

But:

- Vulnerabilities are growing, especially in the Baltics
- Governments have made little use of the favorable environment
Policy challenges

- Cool off economies during a surge in capital inflows and rapid credit growth => tightening fiscal policies is often the only available tool
- In countries with flexible exchange rates, do not resist nominal appreciation (October 2007 WEO)
- 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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Senior Regional Representative

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