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 Challenges
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).

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

* 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)
  - Source: Bloomberg, national statistics.

- **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)

<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>-3.8</td>
<td>1.0</td>
<td>0.2</td>
<td>1.2</td>
<td>-1.8</td>
</tr>
<tr>
<td>C/A balance</td>
<td>-8.5</td>
<td>-17.4</td>
<td>-15.9</td>
<td>3.6</td>
<td>-3.3</td>
</tr>
<tr>
<td>Gross external debt</td>
<td>59.2</td>
<td>105.6</td>
<td>46.9</td>
<td>31.7</td>
<td>66.5</td>
</tr>
<tr>
<td>Gross public debt</td>
<td>43.5</td>
<td>10.2</td>
<td>15.9</td>
<td>29.5</td>
<td>18.5</td>
</tr>
<tr>
<td>Reserves/ST debt</td>
<td>197.4</td>
<td>52.4</td>
<td>158.4</td>
<td>238.4</td>
<td>20.1</td>
</tr>
<tr>
<td>Credit growth (in percent)</td>
<td>22.5</td>
<td>39.1</td>
<td>58.2</td>
<td>2.5***</td>
<td>13.9</td>
</tr>
</tbody>
</table>

* 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.

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

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.

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

Change of foreign currency credits and deposits during 2001 - 2007
(in percentage points of GDP)

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...

... 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)

<table>
<thead>
<tr>
<th>EU8</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>
</tr>
</thead>
<tbody>
<tr>
<td>Bulgaria</td>
<td>0.9</td>
<td>0.1</td>
<td>0.5</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Czech Republic</td>
<td>8.9</td>
<td>3.0</td>
<td>0.2</td>
<td>0.8</td>
<td>1.4</td>
<td>0.1</td>
<td></td>
<td></td>
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<tr>
<td>Estonia</td>
<td>0.1</td>
<td>4.0</td>
<td>3.9</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Hungary</td>
<td>6.2</td>
<td>1.1</td>
<td>0.7</td>
<td>0.2</td>
<td>2.0</td>
<td>0.3</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Latvia</td>
<td>0.1</td>
<td>3.1</td>
<td>0.1</td>
<td>0.1</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Lithuania</td>
<td>0.1</td>
<td>3.4</td>
<td>0.1</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Poland</td>
<td>2.8</td>
<td>1.3</td>
<td>0.7</td>
<td>0.9</td>
<td>0.4</td>
<td>4.2</td>
<td>7.6</td>
<td>3.2</td>
</tr>
<tr>
<td>Romania</td>
<td>8.7</td>
<td>0.1</td>
<td>0.5</td>
<td>0.5</td>
<td>0.8</td>
<td>0.1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Slovakia</td>
<td>5.6</td>
<td>0.5</td>
<td>0.1</td>
<td></td>
<td></td>
<td>1.5</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Slovenia</td>
<td>2.2</td>
<td>0.2</td>
<td>0.1</td>
<td>0.1</td>
<td>0.2</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other EM Europe</td>
<td>14.6</td>
<td>1.9</td>
<td>1.1</td>
<td>2.0</td>
<td>1.9</td>
<td>5.2</td>
<td>1.6</td>
<td>0.5</td>
</tr>
<tr>
<td>Other EM</td>
<td>1.0</td>
<td>1.1</td>
<td>0.8</td>
<td>2.3</td>
<td>3.0</td>
<td>1.0</td>
<td>5.2</td>
<td>0.4</td>
</tr>
<tr>
<td>ROW</td>
<td>49.7</td>
<td>90.8</td>
<td>87.0</td>
<td>93.1</td>
<td>93.1</td>
<td>83.7</td>
<td>85.2</td>
<td>89.3</td>
</tr>
</tbody>
</table>

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)**

- **Best performers**
  - Hong Kong
  - Iceland
  - Turkey
  - Hungary
  - Estonia
  - Czech Rep.
  - Slovak Rep.
  - Poland
  - Slovenia
  - Average

- **Worst performers**
  - Indonesia
  - Germany
  - France

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

- **Best performers**
  - Hong Kong
  - Taiwan
  - Iceland
  - Czech Rep.
  - Hungary
  - China
  - Poland
  - Average

- **Worst performers**
  - Indonesia
  - Portugal

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 adoption 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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