Is the transition countries’ reliance on foreign capital a sign of success or failure?

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Outline

- Convergence in the CEE countries – the role of foreign capital
- External imbalances: the flip-side of rapid convergence
  - Some reassuring trends
  - Concerns
- Policy Conclusions
Growth in Emerging Europe is expected to slow in near term, due to global spillovers.

Source: WEO April 2008.
Nevertheless, the region has been converging very fast.
Productivity improvements and capital accumulation (from abroad) have been key.
The flip-side of this are high current account deficits, especially high in the Baltics and South-Eastern Europe...

These are closely related to financial deepening

Sources: National authorities; and IMF staff calculations.
Most of the deterioration of C/A balances is driven by an increase in investment…

Emerging Europe: Contributions to Current Account Deficit, 2003–07
(Percent)
External imbalances: some reassuring trends

... and financed by FDI (and borrowing from foreign parent banks)

C/A minus net FDI, 2002-2006 average
(percent of GDP)
EU transfers (mainly structural and agricultural funds) are an increasingly important part of the balance of payments.

External imbalances: some reassuring trends

**EU Funds, average annual commitments, 2004-6, 2007-13 financial perspectives**

*percent of GDP*
Exchange rate appreciations do not explain high C/A deficits…

Emerging Europe: Change in Current Account Balance and Real Effective Exchange Rate Appreciation, 2003–07

(Percent)
External imbalances: some reassuring trends

...and lack of competitiveness is not a problem
The “EU halo effect”: markets continue to reward EU membership

External imbalances: some reassuring trends
C/A deficits in some countries are much higher than supported by fundamentals.

Current Account Balances and Model Predictions
(Percent of GDP)

- Latvia
- Estonia
- Bulgaria
- Romania
- Lithuania
- Hungary
- Slovak Rep.
- Czech Rep.
- Poland
- Slovenia

Current account model predictions, emerging Europe
Current account balances, emerging Europe, average 2003-07
Current account model predictions, Asia

External imbalances: Concerns
External debt is growing and reserve coverage is insufficient in some countries

External debt to GDP
Change 2002-2007

Short-term debt / reserves, 2007
Although lending to emerging Europe is relatively a small share in the portfolio of banks in advanced Europe…

**Relative Magnitudes of Funding Exposure for Emerging and Western Europe, June 30, 2007 (Percent)**

- Exposure in percent of the country's banking sector assets
- Share in total claims on emerging Europe

Source: BIS, IMF staff calculations.
... it exposes the region to common-lender contagion risk

Concentration of Emerging Europe Exposure to Western Europe, June 30, 2007
(Percent)

Note: Country names are abbreviated according to the ISO standard codes.
1/ Emerging Europe exposure to western European banks is defined as the share of the reporting banks in each western European country in the total outstanding claims on a given emerging European country (both bank and nonbank sectors). For example, about 42 percent of Croatia's exposures to Western European reporting banks is owed to Austrian banks, 38 percent to Italian banks, 13 percent to French banks, etc. For the Baltic countries, 85 percent or more of exposures to the reporting banks is owed to Swedish banks.
Credit, mostly refinanced from abroad, is concentrated on households and nontradables.

Credit to Nonfinancial Corporations, 2000-2007
- Real estate and construction
- Other nontradables
- Tradables

Credit to Households, 2000-2007
- Housing purposes
- Consumer and other

External imbalances: Concerns
Since the onset of the global financial crisis, markets have differentiated between emerging market countries.

Change in CDS
July 17 – May 6 (bps)

Change in the EURO exchange rate July 17 – May 6
(+= depreciation, percent)

Source: Bloomberg, national statistics.
Particularly countries with large external imbalances face higher financing cost.

Emerging Europe: Bond Spreads and Current Account Deficits

- Latvia
- Lithuania
- Romania
- Bulgaria
- Hungary
- Poland
- Slovak Republic
- Czech Republic

Current account deficit in 2007 (percent of GDP)

Source: IMF.
So, 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 “boom-bust” evidence of large capital inflows
- Debt financing is potentially vulnerable to sudden stops and increased cost of refinancing (as is already been felt now)
- Foreign capital mainly goes to the non-tradable sector => questions about countries’ capacity to repay
- In the wake of the global credit crisis, markets are starting to punish countries with large imbalances
Policy Dilemma

Large external imbalances should not surprise in an environment of rapid growth.

- Policy challenge: how to reduce vulnerabilities without impeding the convergence process?

- Analytical challenge: how to distinguish “natural” convergence from overheating.
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 if economy slows down, 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