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
• Meanwhile, economists worry about vulnerabilities in the run-up to Euro adoption
  - Lack of fiscal adjustment
  - Credit growth
  - Currency mismatches
  - External imbalances
• Perception gap: how the markets view risks in the CECs
• Policy Conclusions
The overall macro picture: better than ever
Growth performance is good, albeit mainly cyclical.

Source: WEO Sep 2006
Inflation is relatively subdued

Chart. CPI (percent)

Source: WEO Sep 2006
...especially considering that rising price levels are naturally associated with convergence.

Source: Eurostat
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
Meanwhile economists worry 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 2005 (in percent of GDP)</th>
<th>CE5</th>
<th>Baltics</th>
<th>EM countries*</th>
</tr>
</thead>
<tbody>
<tr>
<td>General government deficit</td>
<td>-3.2</td>
<td>0.4</td>
<td>2.2</td>
</tr>
<tr>
<td>C/A balance</td>
<td>-3.5</td>
<td>-10.1</td>
<td>1.5</td>
</tr>
<tr>
<td>External balance</td>
<td>56.5</td>
<td>81.9</td>
<td>61.2</td>
</tr>
<tr>
<td>Public debt</td>
<td>39.0</td>
<td>11.8</td>
<td>45.8</td>
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<tr>
<td>Reserves/ST debt</td>
<td>173.0</td>
<td>54.8</td>
<td>212.4</td>
</tr>
<tr>
<td>Credit growth (annual growth)</td>
<td>1.4</td>
<td>7.5</td>
<td>2.9</td>
</tr>
</tbody>
</table>

* EM countries - Argentina, Brazil, Bulgaria, Chile, China, Colombia, Indonesia, Peru, Russia, Singapore, 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?
Main Concerns

- Lack of fiscal adjustment
- Credit growth
- Currency mismatches
- External imbalances
Lack of fiscal adjustment
Despite healthy growth, public debt ratios are still rising in many CECs.

Source: EC Spring Forecast 2006
Few countries have used the benign global environment to undertake fiscal adjustment.

Source: EC Spring Forecast 2006
Rapid growth of 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.

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, 2005 (in percent of GDP)

Change in net FX position, 2002-05 (in percent of GDP)

Sectoral net FX position, 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 2001-05 (in percentage points of GDP)

- yellow bars: foreign currency-denominated credits
- purple bars: foreign currency-denominated deposits

Source: National authorities, IMF staff estimates
Large external stock and flow imbalances
Current account deficits are high in some CECs

Source: Eurostat, National Authorities
As expected, net IIPs are negative, but unlike in other EMs they have lately deteriorated. 

CECs and EMs: International Investment Position

Perception gap: how the markets view risks in the CECs
CECs 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

Do markets differentiate CECs because of “fundamentals”? What are “fundamentals”?

<table>
<thead>
<tr>
<th>Economic Risk</th>
<th>Political Risk</th>
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</thead>
<tbody>
<tr>
<td>• GDP per capita</td>
<td>Index based on 12 political and socio-economic conditions</td>
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<tr>
<td>• Real GDP Growth</td>
<td></td>
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<tr>
<td>• Inflation</td>
<td></td>
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<tr>
<td>• Budget Balance</td>
<td></td>
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<tr>
<td>• Current Account Deficits</td>
<td></td>
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</tbody>
</table>

<table>
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<tr>
<th>Financial Risk</th>
<th>Global Financial Conditions</th>
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</thead>
<tbody>
<tr>
<td>• External debt/GDP</td>
<td>• Implied volatility index</td>
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<tr>
<td>• External debt service ratio</td>
<td>• 30-day Fed Fund futures rate</td>
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<tr>
<td>• Current account/exports</td>
<td>• Volatility of Fed Fund futures</td>
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<tr>
<td>•Official reserves/imports</td>
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<tr>
<td>• Exchange rate stability</td>
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</tbody>
</table>
Econometric analysis shows that markets differentiate CECs beyond what “fundamentals” warrant.

Source: Pipat Luengnaruemitchai, Susan Schadler, Do Economists’ and Financial Markets’ Perspectives on the New Members of the EU differ?, IMF Working Paper (forthcoming)
All CECs enjoy a regional advantage ("halo effect") which seems to have stabilized at about 100 bps…

Source: Luengnaruemitchai and Schadler.
...and so far seem not to be influenced by receding euro adoption prospects.

Source: Reuters
Conclusions

• Headline numbers look good, but vulnerabilities are growing, especially in the Baltics
• Rather than using the favorable environment to reduce risks, most governments are pouring oil into the fire by pursuing procyclical fiscal policies
• Policy challenges:
  ➢ Tightening fiscal policies
  ➢ Create flexible economies and sound institutions
  ➢ Euro adoption