Economic Trends and Challenges in Central and Eastern Europe

Christoph Rosenberg
International Monetary Fund
Warsaw Regional Office
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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 vulnerabilities in the run-up to Euro adoption

- Lack of fiscal adjustment
- Credit growth
- Currency mismatches
- External imbalances

Baltics vs. Slovakia (and other CEEs)

Policy Conclusions
The overall macro picture: better than ever
Growth performance is good, albeit mainly cyclical.

Inflation is relatively subdued...

Chart. Annual average CPI (percent)

...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
CEC financial markets 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

...despite receding euro adoption prospects.

Source: Reuters
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>
<th>CE4</th>
<th>Baltics</th>
<th>Romania &amp; Bulgaria</th>
<th>EM countries*</th>
</tr>
</thead>
<tbody>
<tr>
<td>General government deficit</td>
<td>-5.3</td>
<td>0.2</td>
<td>1.0</td>
<td>2.1</td>
</tr>
<tr>
<td>C/A balance</td>
<td>-5.2</td>
<td>-15.6</td>
<td>-13.1</td>
<td>1.8</td>
</tr>
<tr>
<td>External debt</td>
<td>57.7</td>
<td>89.8</td>
<td>57.4</td>
<td>61.4</td>
</tr>
<tr>
<td>Public debt</td>
<td>43.5</td>
<td>11.3</td>
<td>19.8</td>
<td>45.9</td>
</tr>
<tr>
<td>Reserves/ST debt</td>
<td>115.1</td>
<td>54.8</td>
<td>180.6</td>
<td>215.2</td>
</tr>
<tr>
<td>Credit growth (in percent)</td>
<td>8.4</td>
<td>21.0</td>
<td>22.8</td>
<td>2.8</td>
</tr>
</tbody>
</table>

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

Source: EC Autumn Forecast 2006
Few countries have used the benign global environment and buoyant revenue to undertake fiscal adjustment.

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

Source: EC Autumn Forecast 2006
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 (forthcoming)
Primary spending in Central Europe is high, suggesting that fiscal adjustments should start on the expenditure side.

Source: AMECO.
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)

- **CECs: 2002-06**
- **Non-core EMU: 1995-99**
- **Scandinavia: 1984-89**
- **Asia: 1993-97**

*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)

Czech Republic (CZ), Hungary (HU), Poland (PL), Slovakia (SK), Estonia (EE), Latvia (LV), Lithuania (LT), Ireland (IE), Greece (GR*), Portugal (PT), Spain (ES)

*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. 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**

* Data for 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 2001-06
(in percentage points of GDP)

- foreign currency-denominated credits
- foreign currency-denominated deposits

Source: National authorities, IMF staff estimates
Large external stock and flow imbalances
Current account deficits are high, especially in the Baltics and Bulgaria.

CECs. Current account deficit, 2006 (in percent of GDP)

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

Source: National authorities, Milesi-Ferretti and Lane, “External Wealth of Nations” database.
* Data for 2005.
Why are the Baltics overheating and Slovakia (and other CECs) are not?
Why are the Baltics overheating and Slovakia (and other CECs) not?

<table>
<thead>
<tr>
<th>Macroeconomic indicators (annual growth, in percent)</th>
<th>Slovakia</th>
<th>Baltics</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real GDP</td>
<td>6.0</td>
<td>8.3</td>
</tr>
<tr>
<td>Domestic Demand</td>
<td>8.6</td>
<td>6.2</td>
</tr>
<tr>
<td>CA balance (% of GDP)</td>
<td>-8.6</td>
<td>-8.0</td>
</tr>
<tr>
<td>CPI (average)</td>
<td>2.8</td>
<td>4.4</td>
</tr>
<tr>
<td>Credit to private sector</td>
<td>28.3</td>
<td>24.8</td>
</tr>
<tr>
<td>Real wage</td>
<td>6.2</td>
<td>4.0</td>
</tr>
<tr>
<td>Population (millions, 2005)</td>
<td>5.4</td>
<td></td>
</tr>
<tr>
<td>GDP Per capita (PPP, % of EU15)</td>
<td>53.0</td>
<td>56.0</td>
</tr>
</tbody>
</table>

* Baltics is a simple average of EE, LV and LT figures.

Why are the Baltics overheating and Slovakia (and other CECs) not?

Differences in macro fundamental:

- Monetary framework: fixed vs. flexible exchange rates
- Fiscal policy and EU funds utilization
- Labor markets and migration
- Allocation of investment: Export-oriented and productive sectors vs. real estate and domestic services
Conclusions

- The general maro outlook is positive, and is largely well deserved due to good policies in the run-up to EU membership.

- But vulnerabilities are growing, especially in the Baltics (“Running with your shoelaces open”). Governments are making insufficient use of the supportive environment.

- Policy challenges:
  - Anti-cyclical fiscal policies
  - Financial sector supervision
  - Creating flexible economies and sound institutions
  - Euro adoption