



Economic Trends and Challenges in Central and Eastern Europe

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IMF Seminar for Journalists
Vienna, August 28, 2007

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

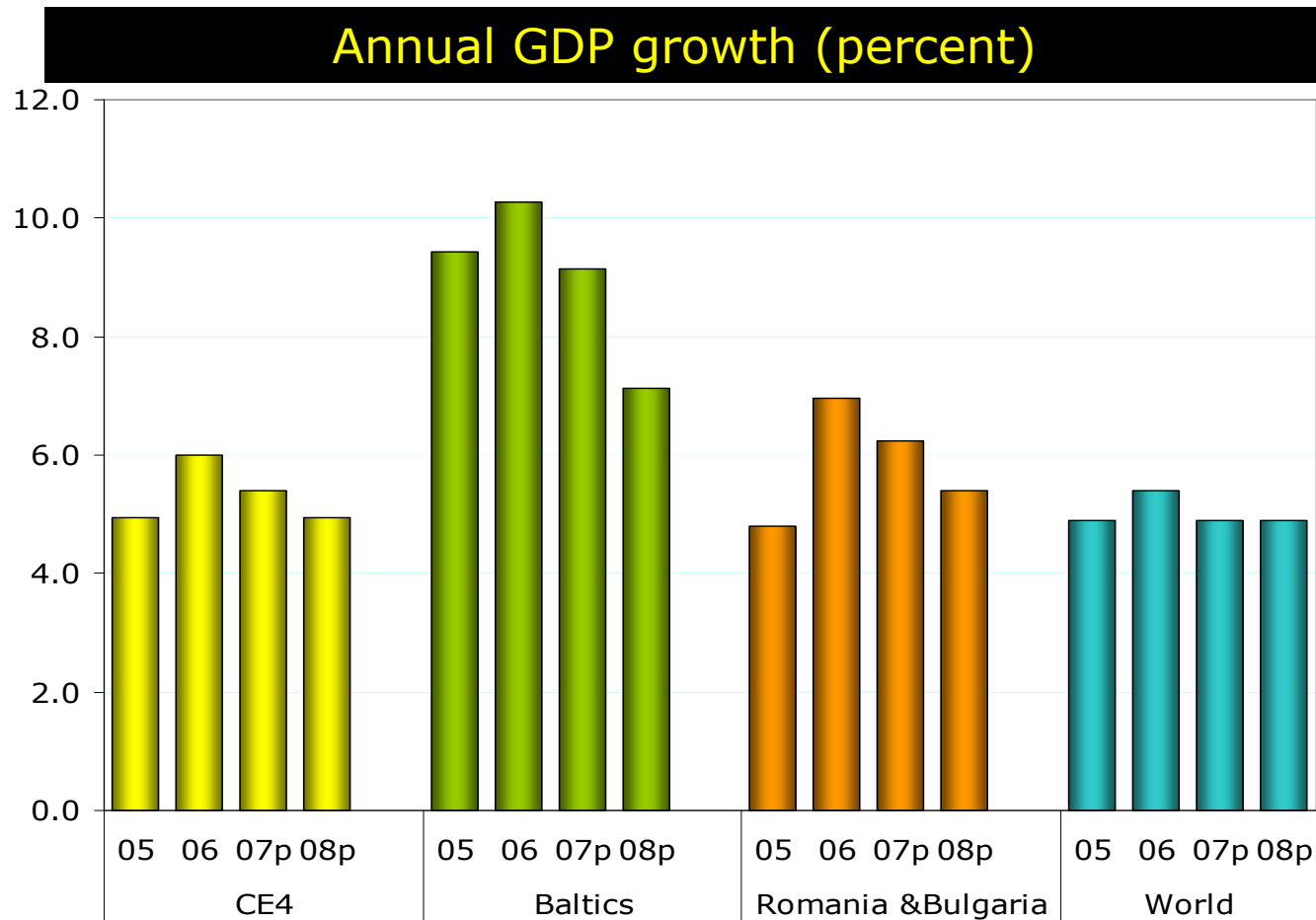


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- The overall macro picture: better than ever
 - But underlying this are challenges in the run-up to Euro adoption
 - Fiscal adjustment
 - Credit growth
 - Currency mismatches
 - External imbalances
 - Financial sector integration
 - Creating flexible economies
 - Policy Conclusions



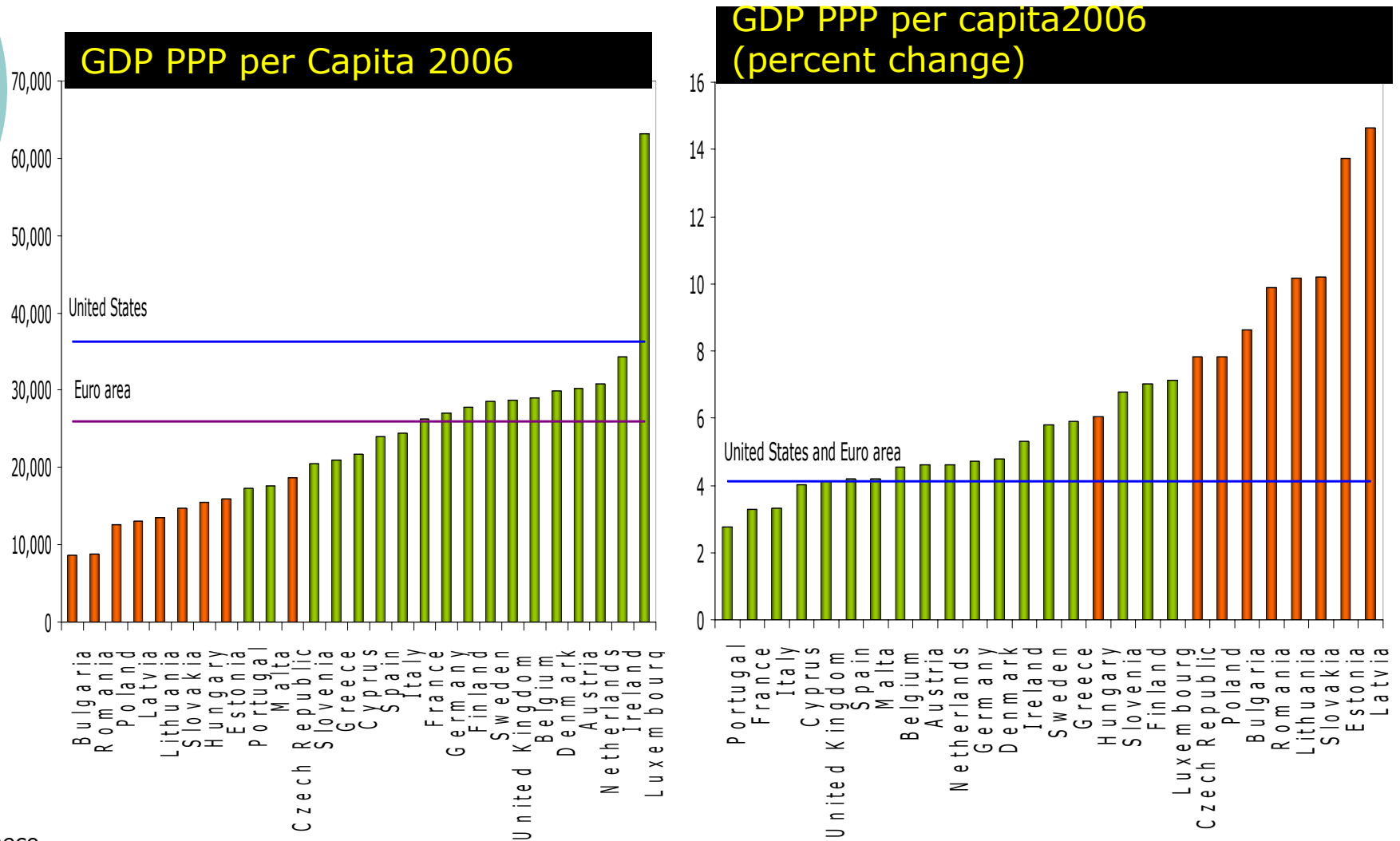
The overall macro
picture:
better than ever

Growth performance is good, driven by EU accession and the global upswing.



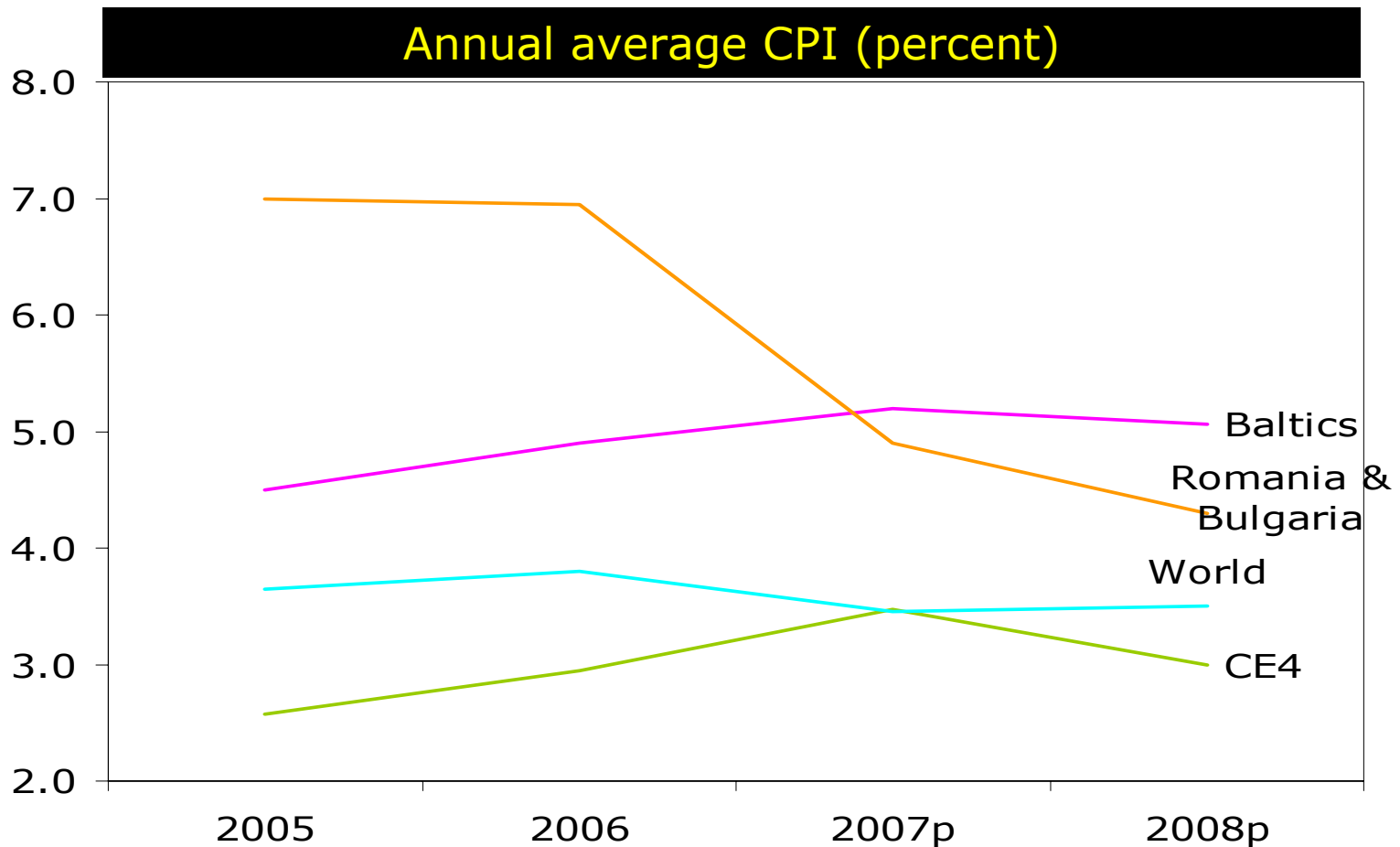
Source: WEO April 2007.

As a result, the CECs are catching up quickly.



Source: Ameco.

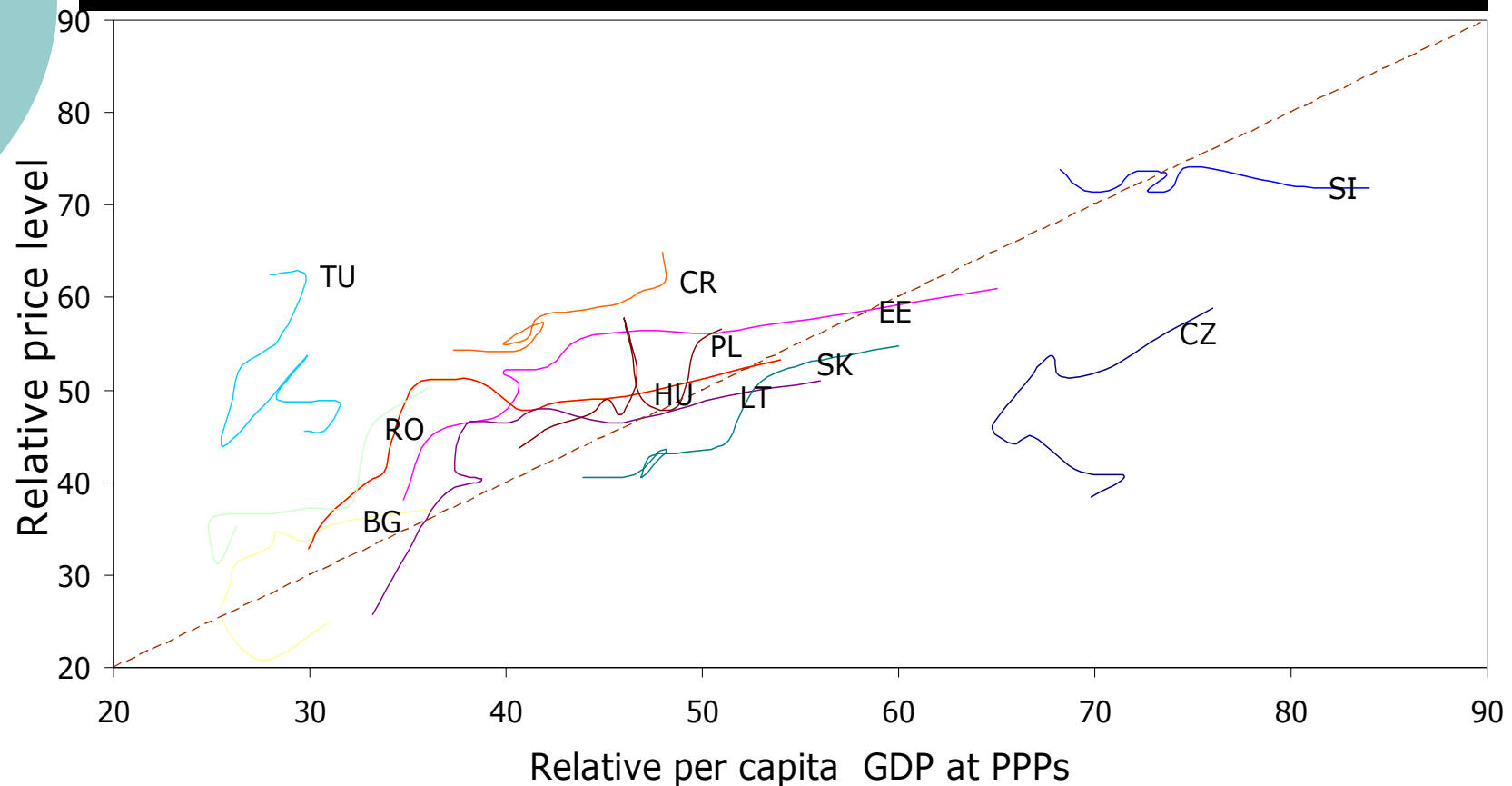
Inflation is relatively subdued...



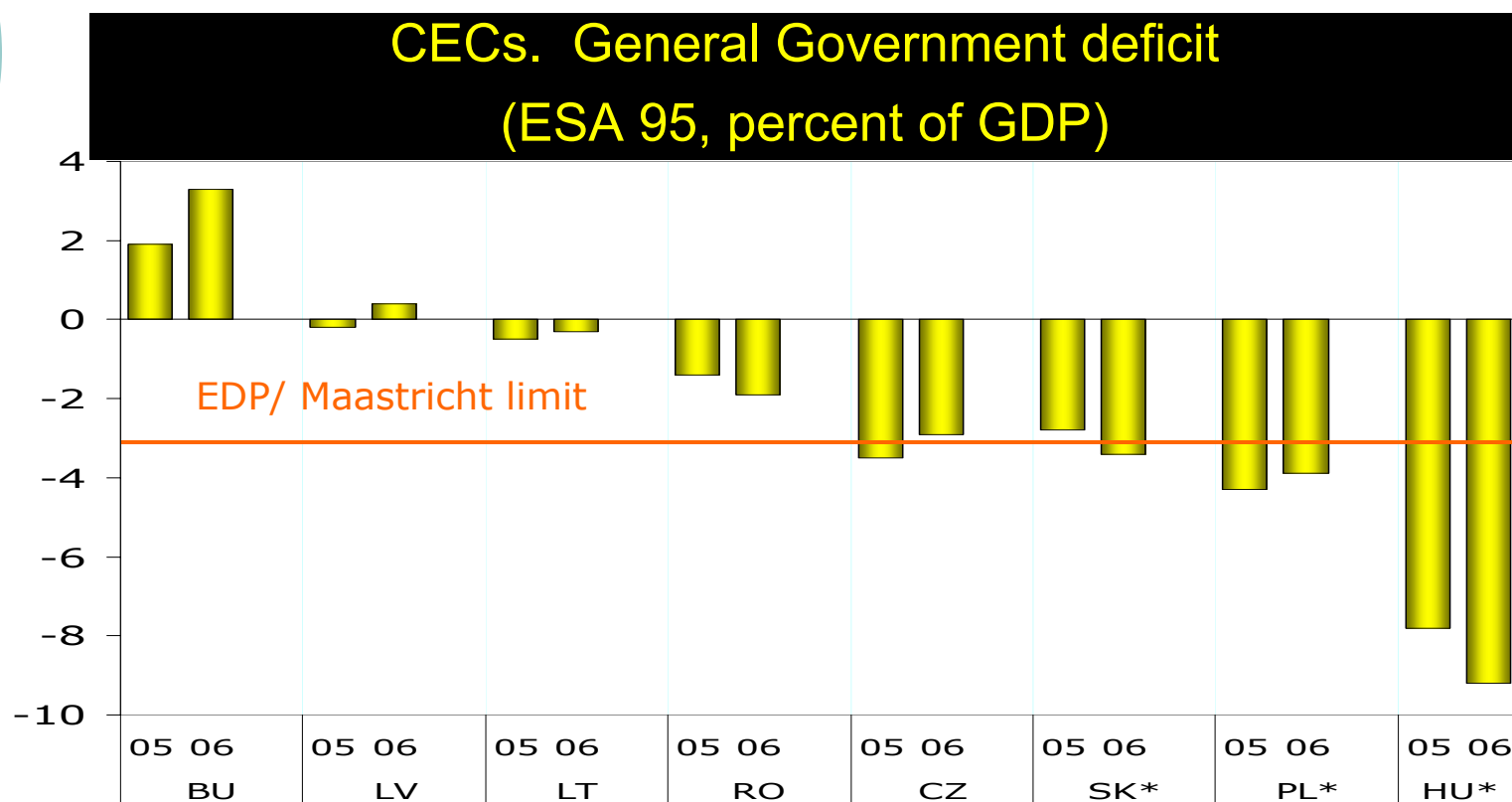
Source: WEO April 2007.

...especially considering that rising price levels are naturally associated with convergence.

CECs. Relative price level vs. relative GDP per capita (PPP), 1995-2006, EU25=100



Even headline fiscal deficits are not looking so bad (except Hungary).

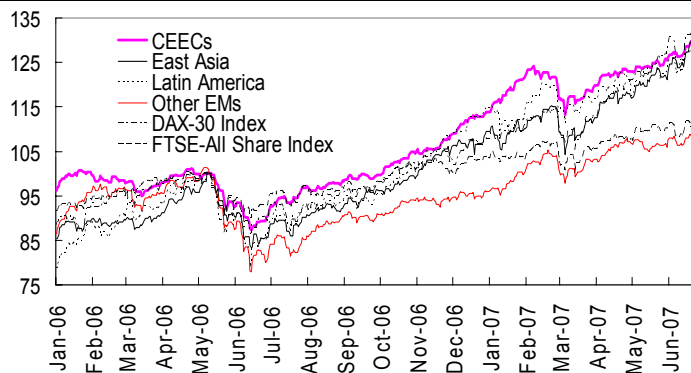


* incl. pension reform costs

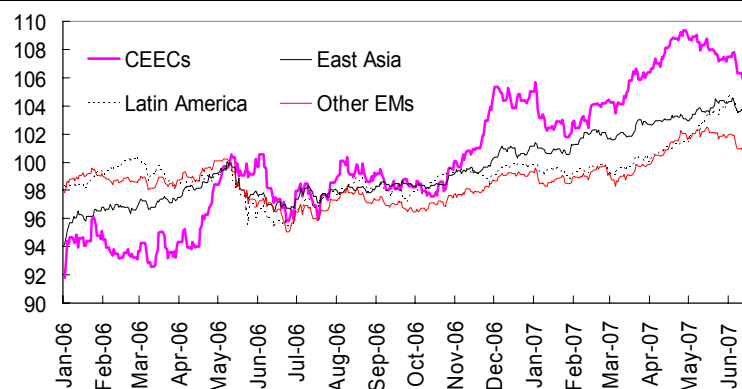
Source: EC Spring Forecast 2007

CEC financial markets have outperformed other EMs...

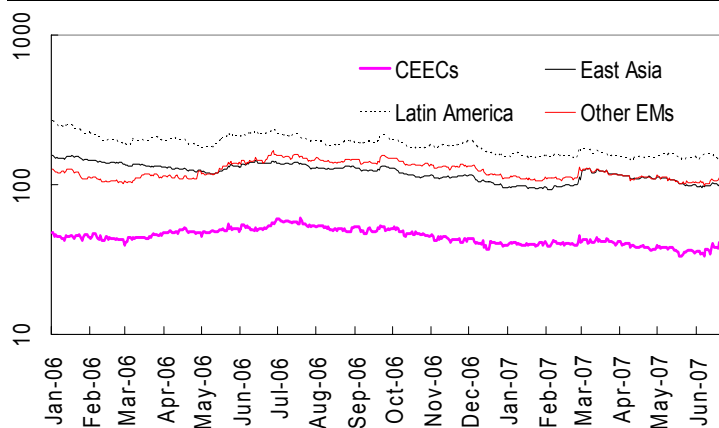
A. Stock Market Indices (May 10, 2006=100)



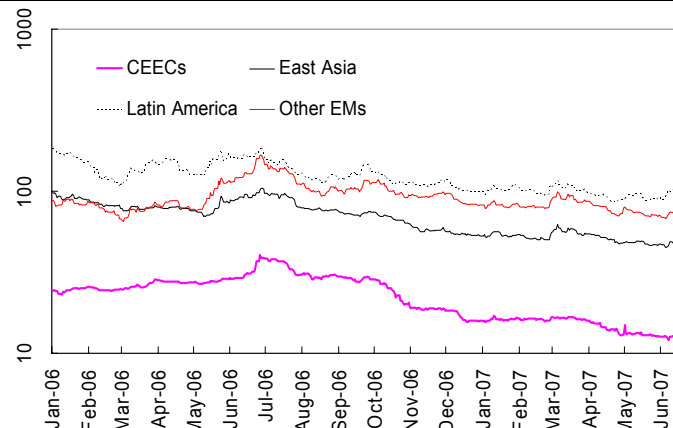
B. Indices of Exchange Rate Against US\$ (May 10, 2006 =100; (+) = appreciation)



C. External Bond Spreads



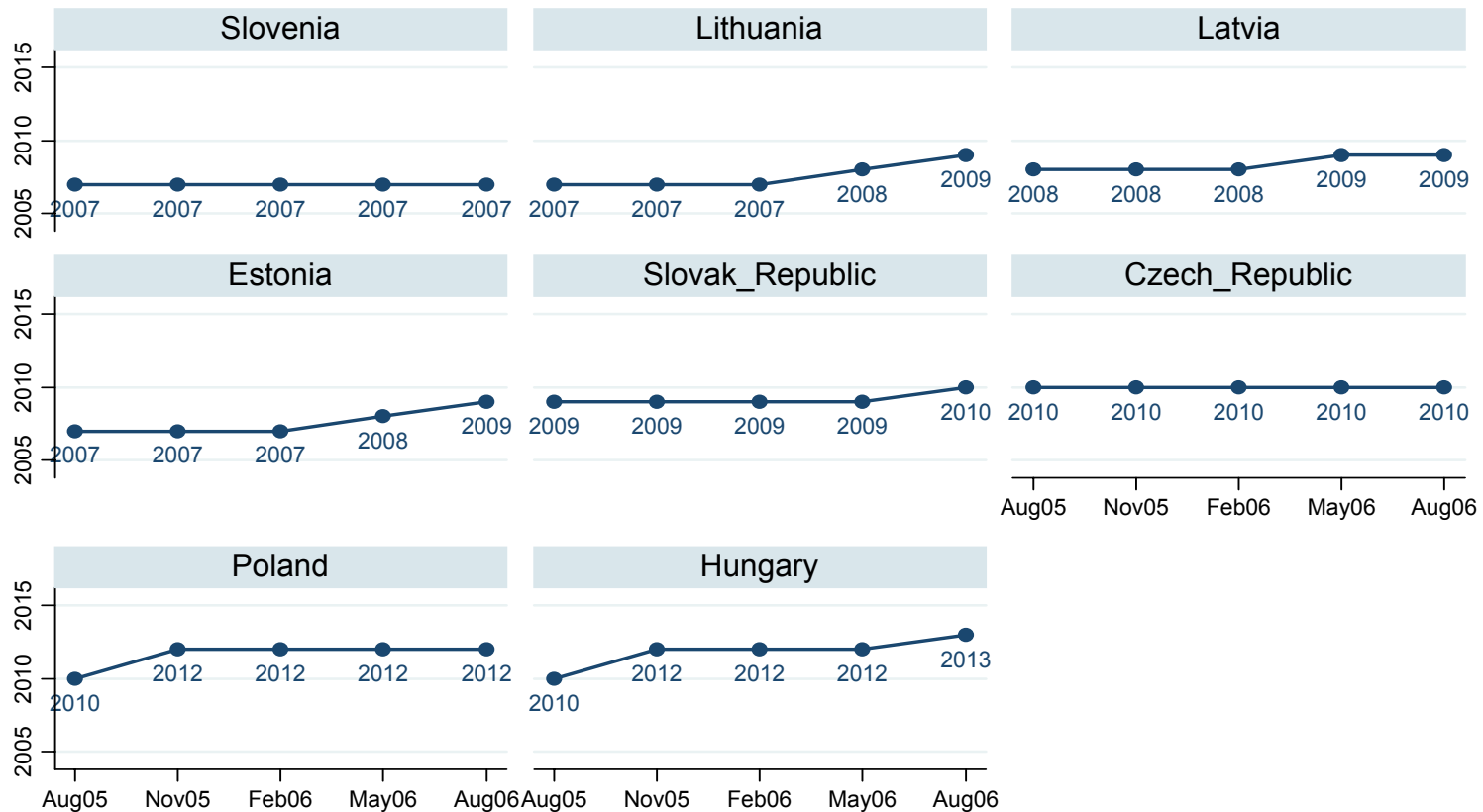
D. 5-year CDS Spreads



Source: Pipat Luengnaruemitchai, Susan Schadler, Do Economists' and Financial Markets' Perspectives on the New Members of the EU differ?, IMF Working Paper 07/65.

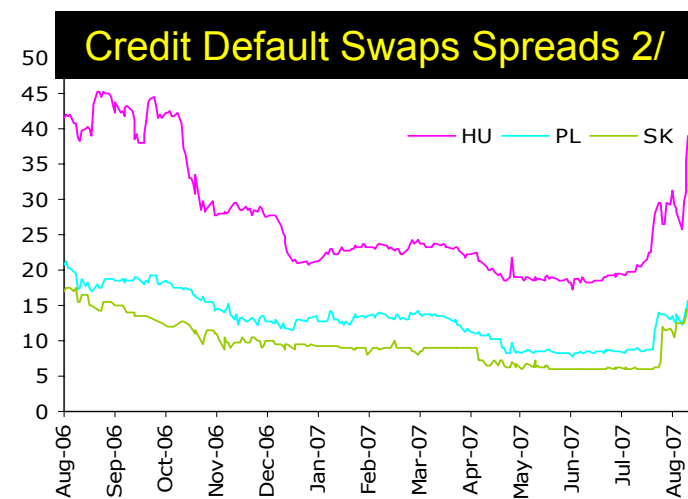
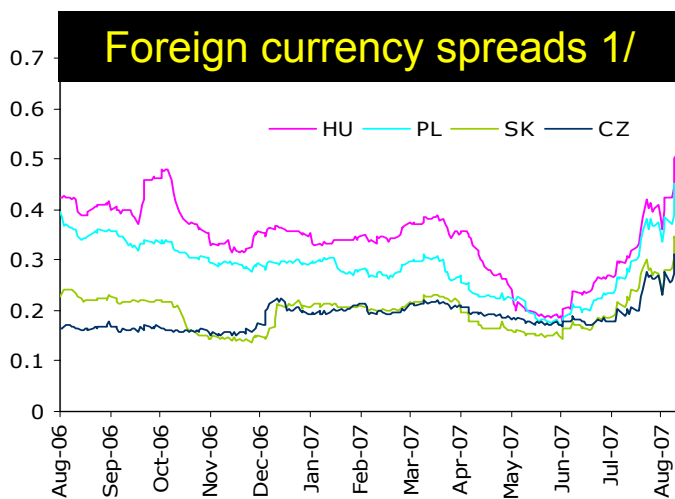
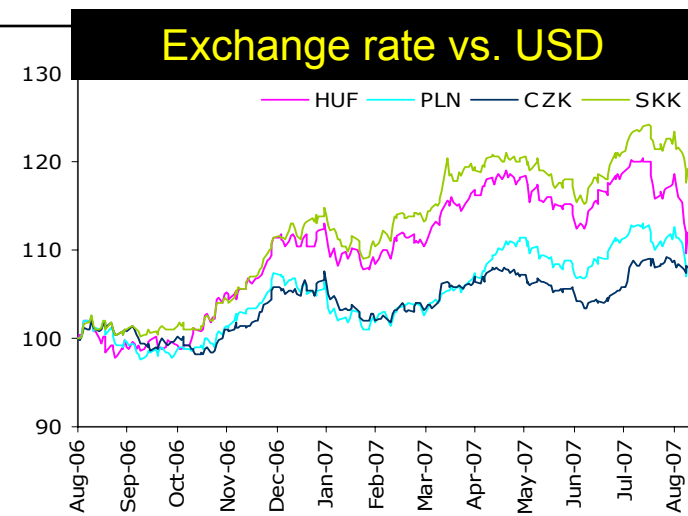
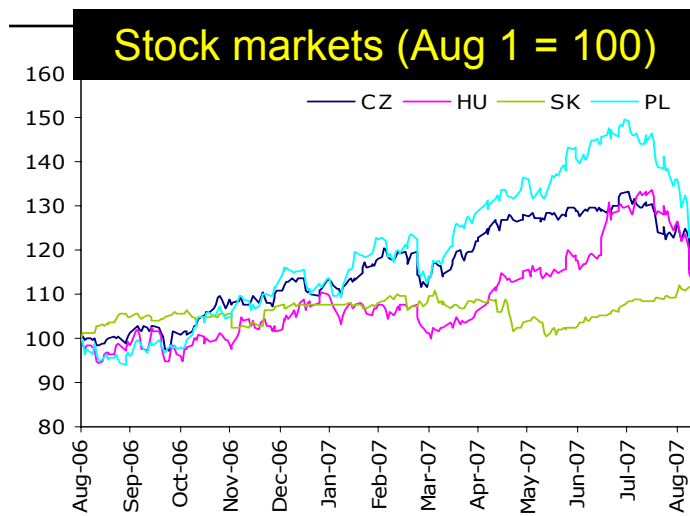
...despite receding euro adoption prospects.

REUTERS Polls on Euro Adoption Date Median Value of the Responses



Source: Reuters

The fallout from the supprime mortgage crisis in the US has had some effects on financial markets.



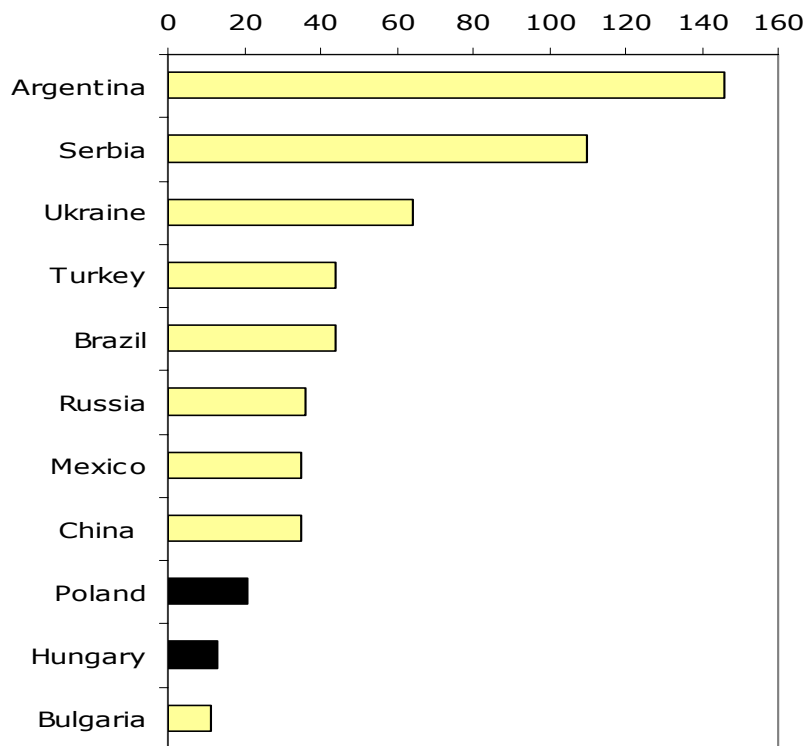
Source: Bloomberg.

1/ Spread of 5-year euro denominated international government bonds versus %-year Bund.

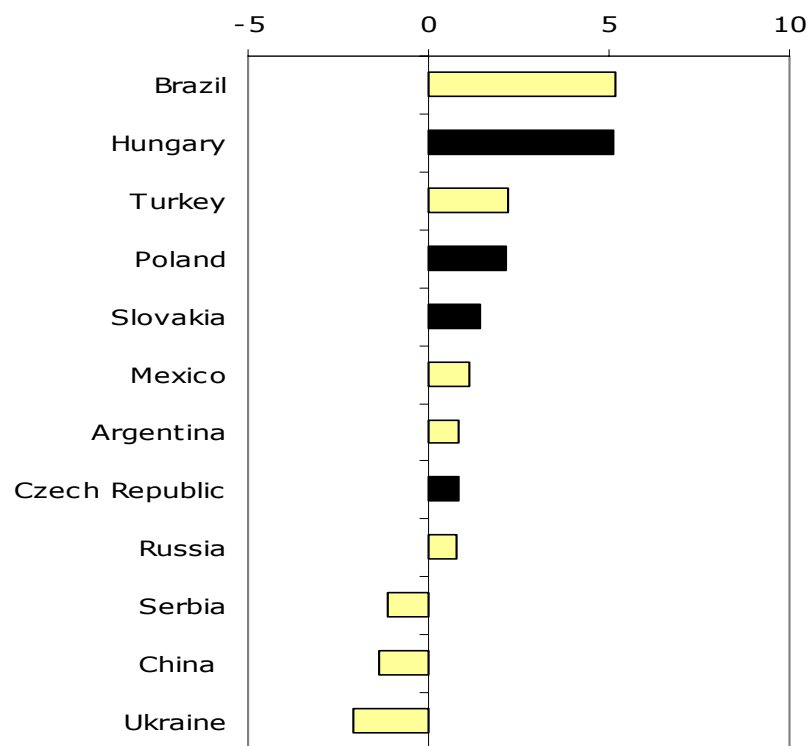
2/ The credit default swap (CDS) is an over-the-counter contract whereby the buyer pays the seller a periodic fee in return for contingent payment by the seller upon default of the issuer of a credit instrument.

Borrowing spreads were less affected than in other Ems.

Change in EMBI
July 16-August 22 (bps)



Change in the EURO exchange rate
July 16-August 23
(+= depreciation, percent)



Source: IMF GMM, national statistics.



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

Key Macro Indicators 2006 (in percent of GDP)

	CE4	Baltics	Romania & Bulgaria	EM countries*	Asia 1997**
General government deficit	-5.3	0.2	1.0	1.1	-1.8
C/A balance	-5.2	-15.6	-13.1	2.7	-3.3
External debt	57.7	89.8	57.4	51.9	66.5
Public debt	43.5	11.3	19.8	42.2	18.5
Reserves/ST debt	115.1	54.8	180.6	175.8	20.1
Credit growth (in percent)	8.4	37.6	22.8	2.5	13.9

* 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



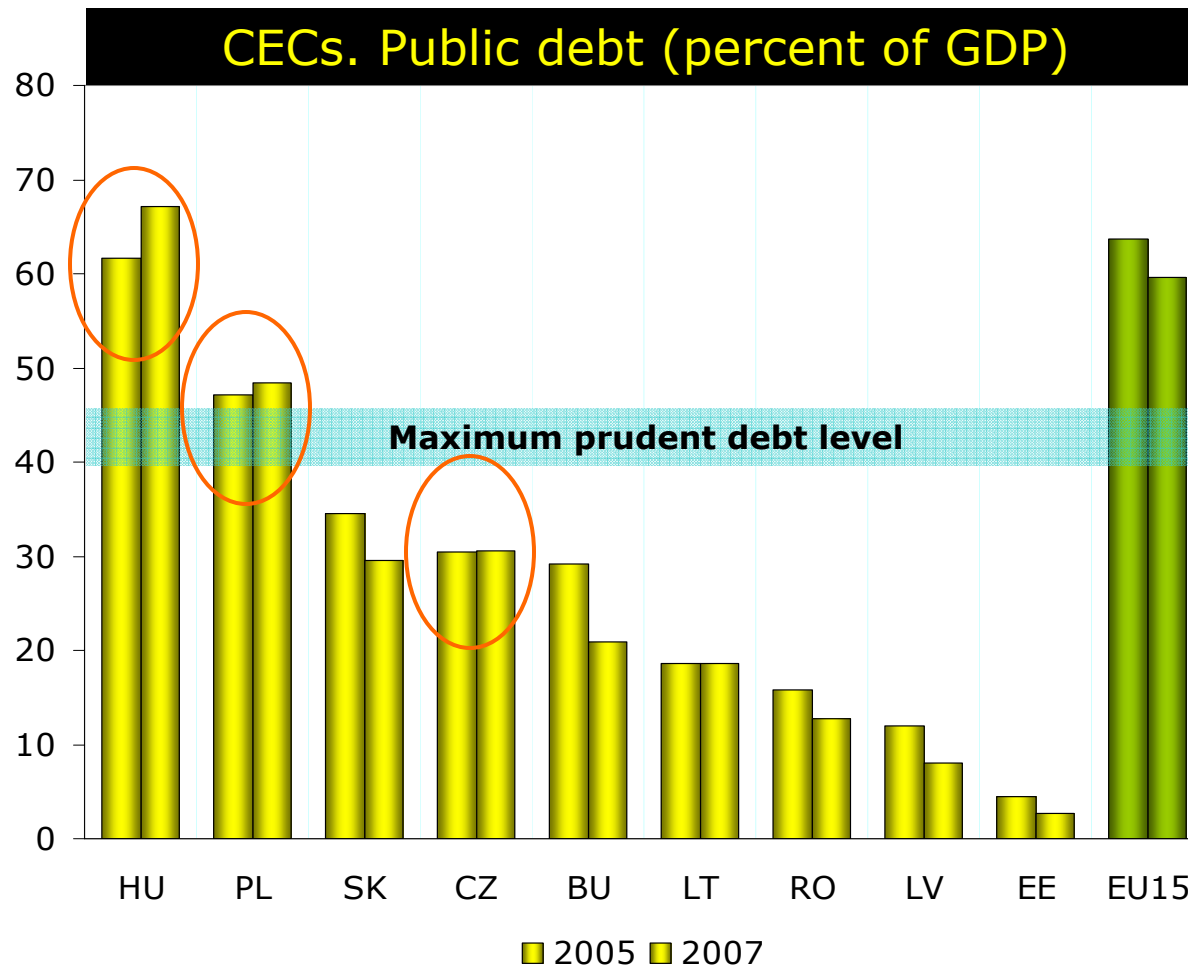
Main Concerns

- Lack of fiscal adjustment
- Credit growth
- Currency mismatches
- External imbalances
- Cross-border contagion risks

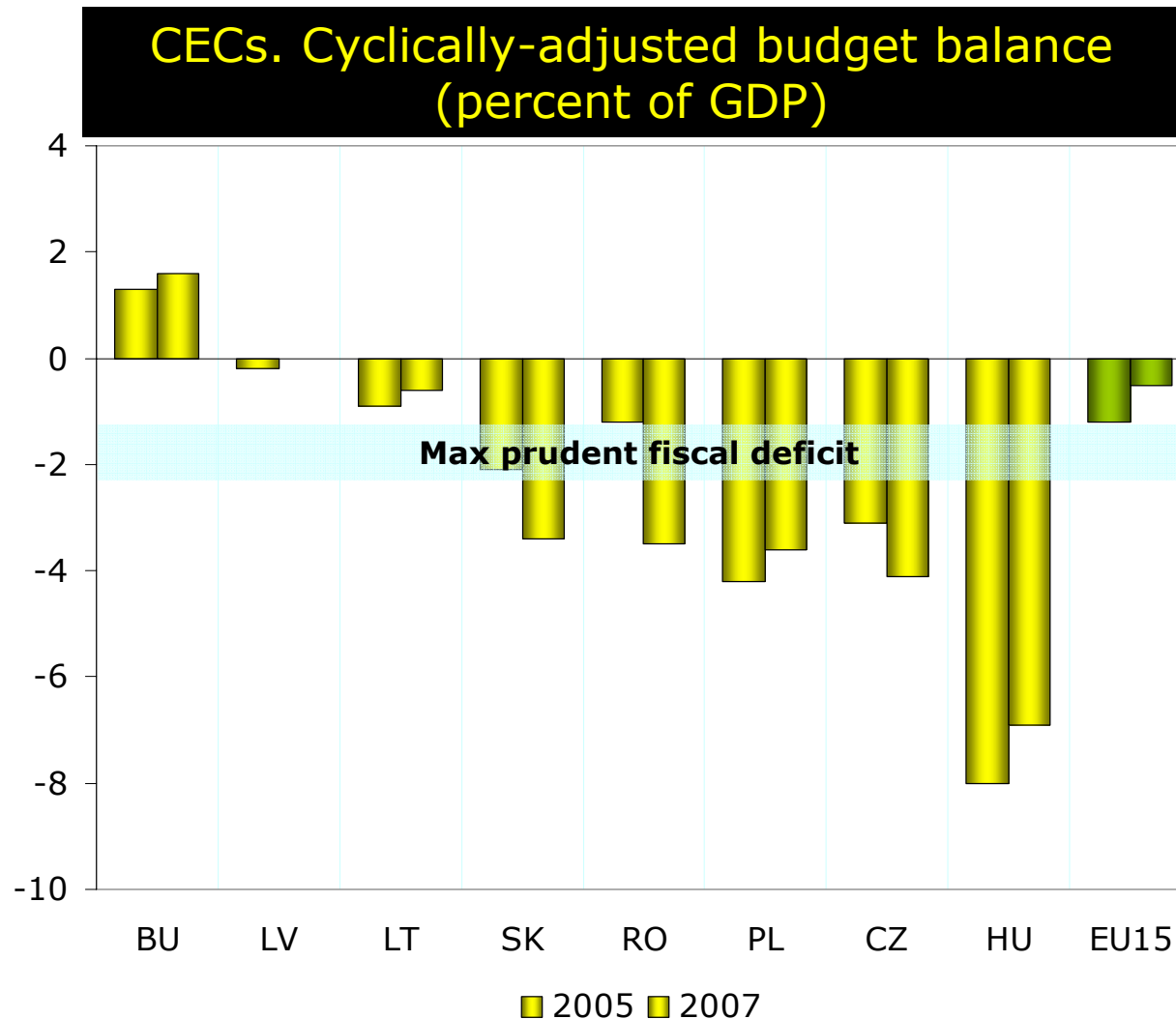


Lack of fiscal adjustment

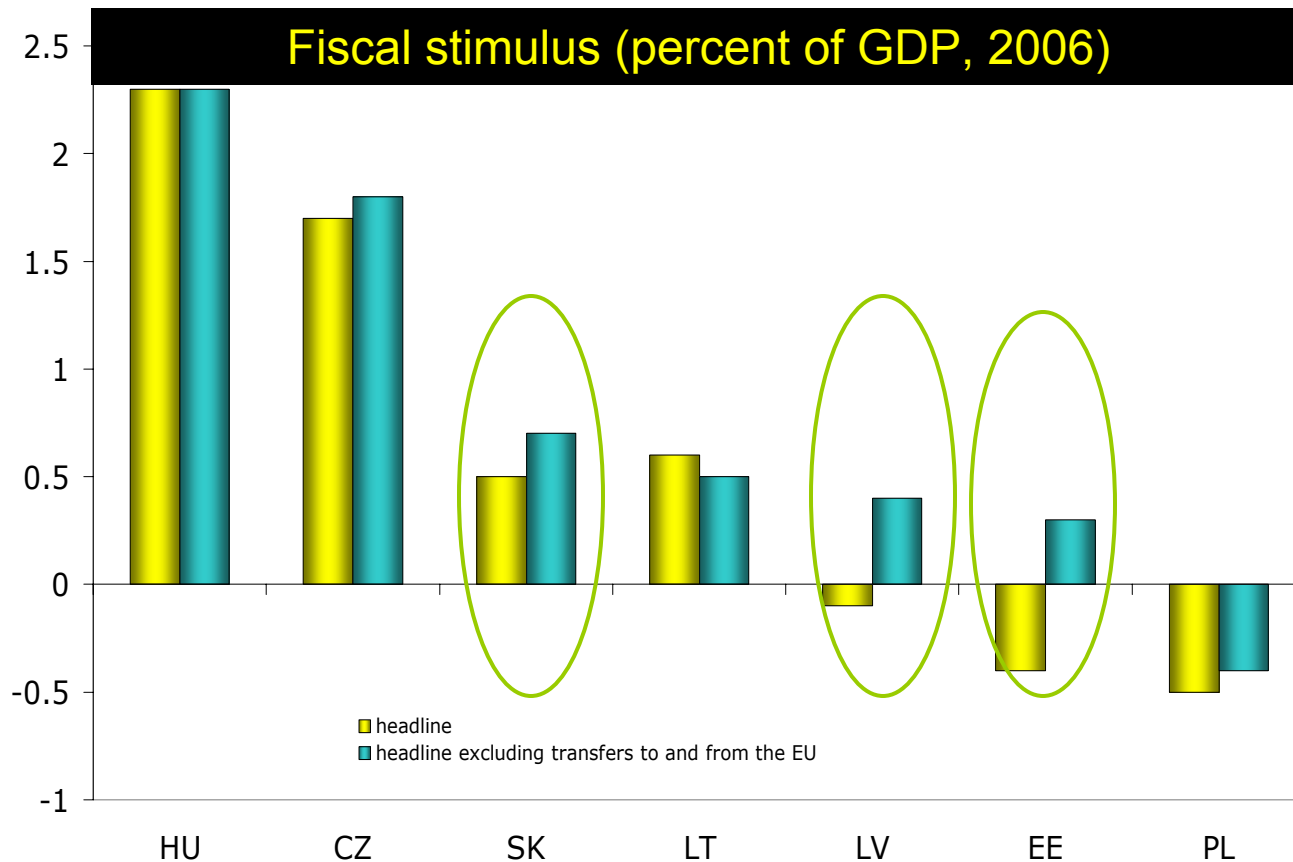
Despite healthy growth, public debt ratios are not declining in key CECs.



Few countries have used the benign global environment and buoyant revenue to reduce deficits to prudent levels.

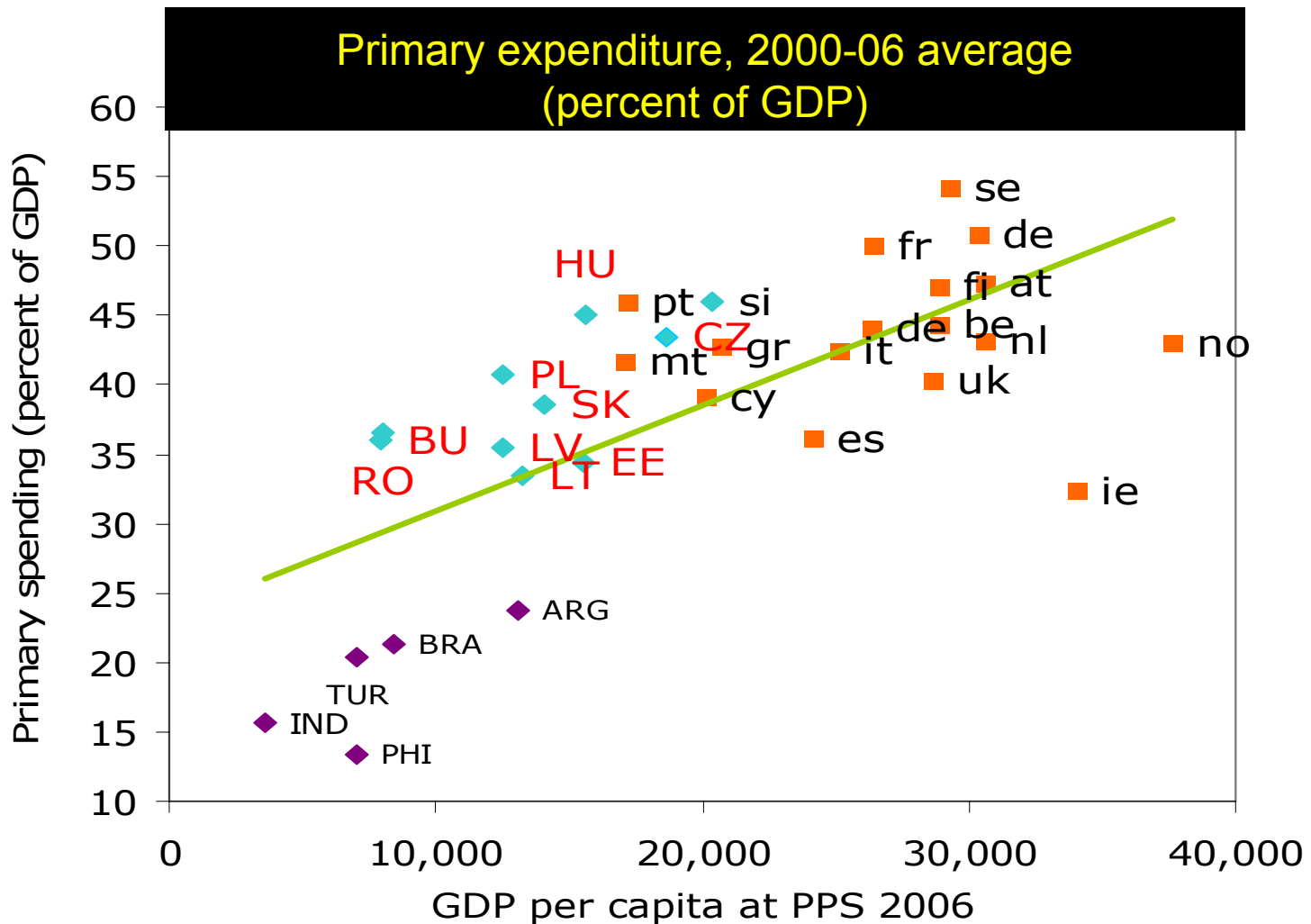


Fiscal policy is even more procyclical if one accounts for EU funds.



Source: Christoph B. Rosenberg and Robert Sierhej, Interpreting EU Funds Data for Macro Analysis in the New Member States, IMF Working Paper 07/77

Primary spending in Central Europe is high, suggesting that fiscal adjustments should start at the expenditure side.

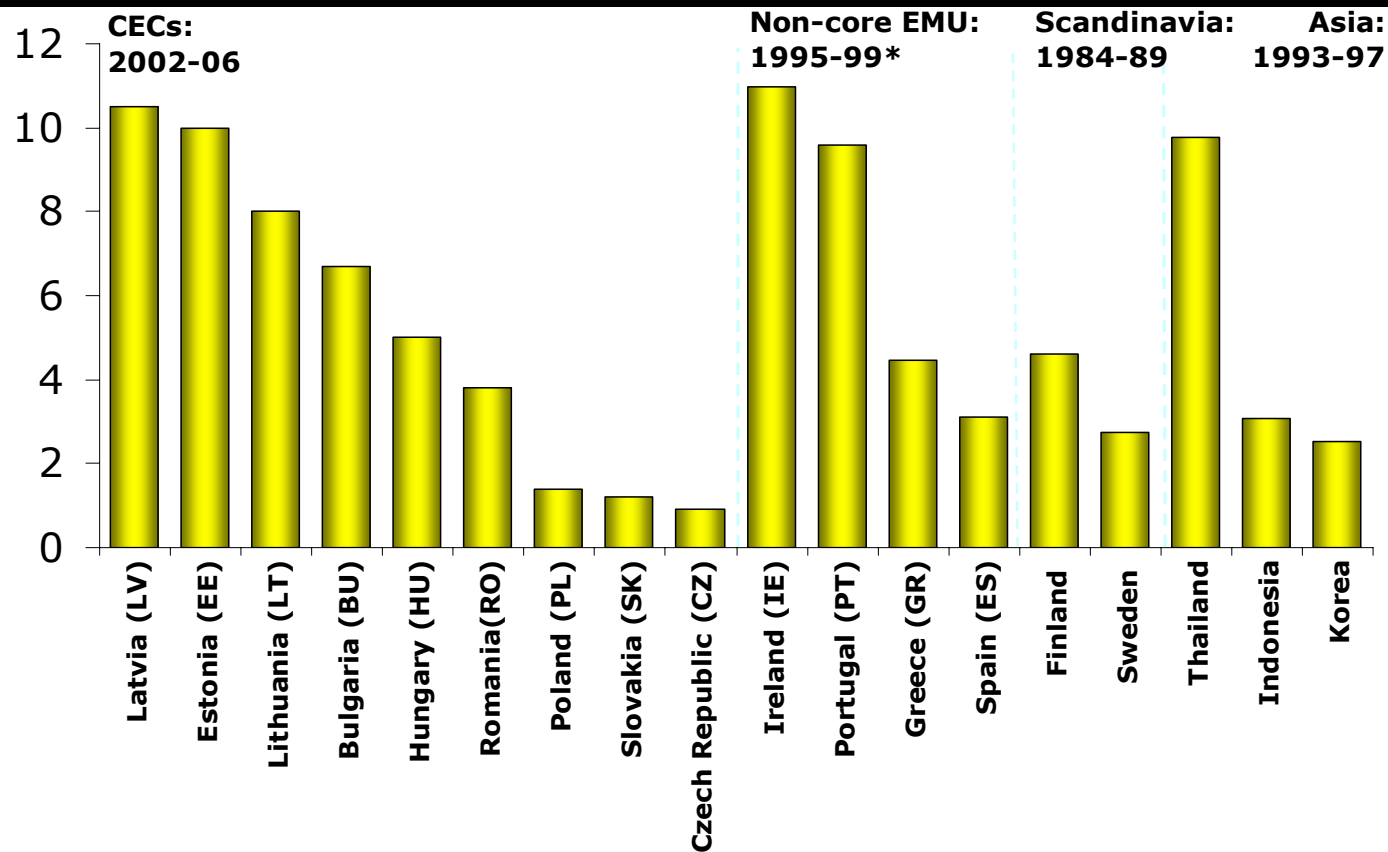




Rapid growth of credit to the private sector

Credit growth has been brisk.

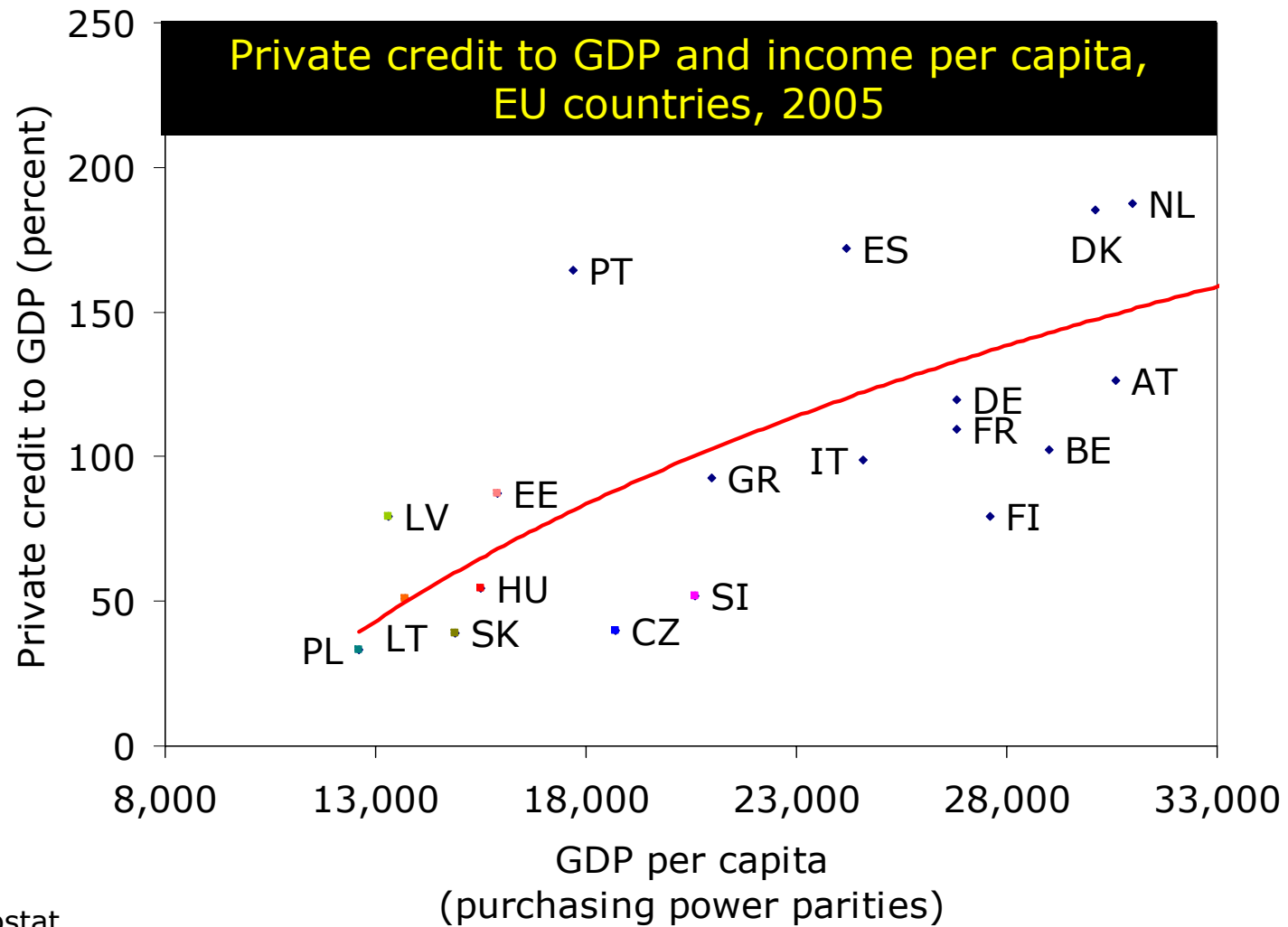
Average growth of credit to the private sector (in percentage points of GDP)



*Greece 1997-2000

Source: IFS, national authorities, IMF staff calculations

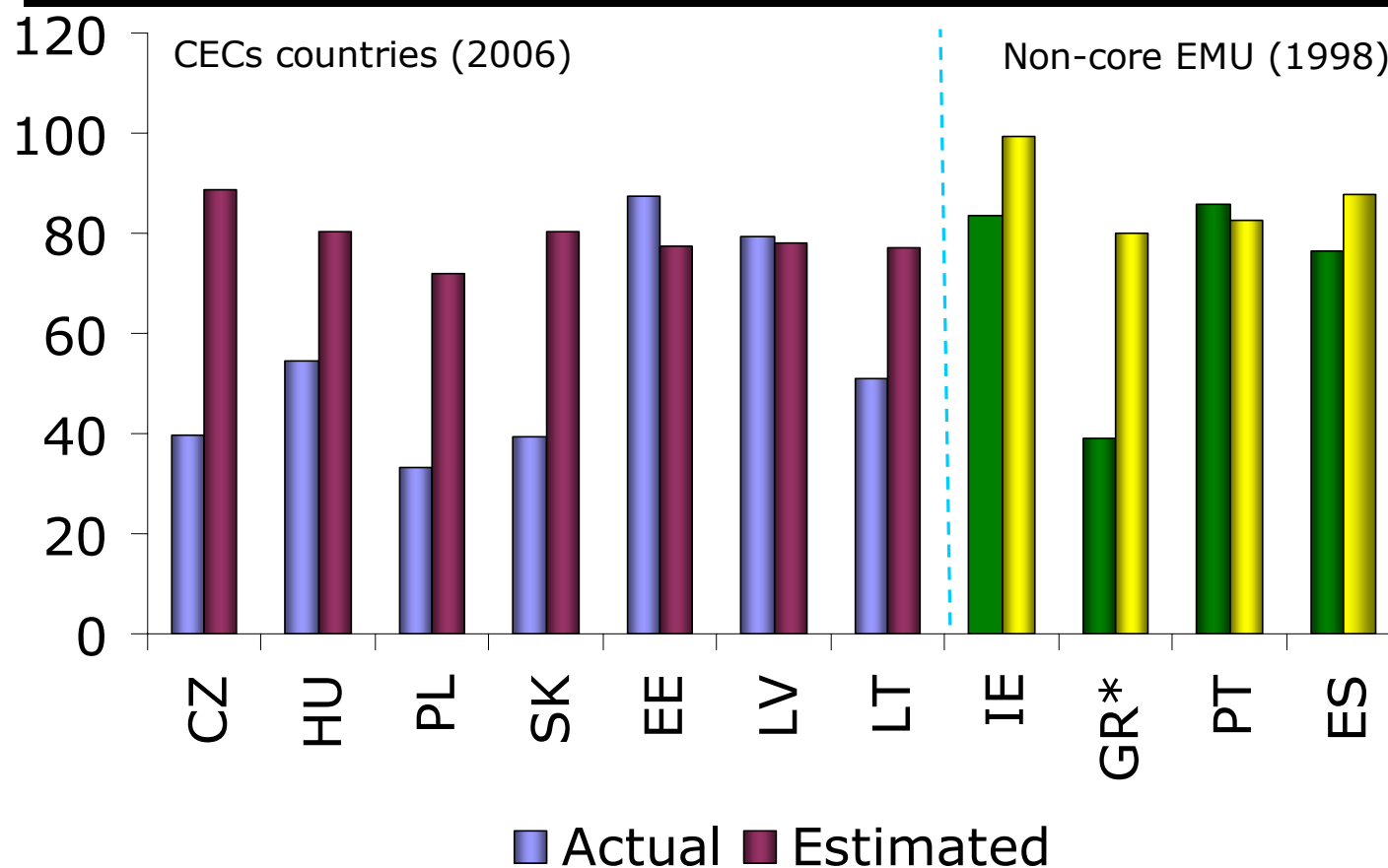
Indebtedness corresponds to income levels.



Source: IFS, Eurostat

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)

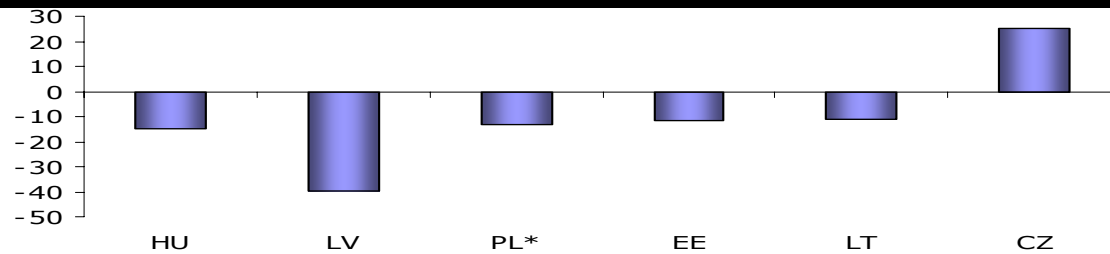


**Build-up of
currency mismatches
in the
non-financial sector**

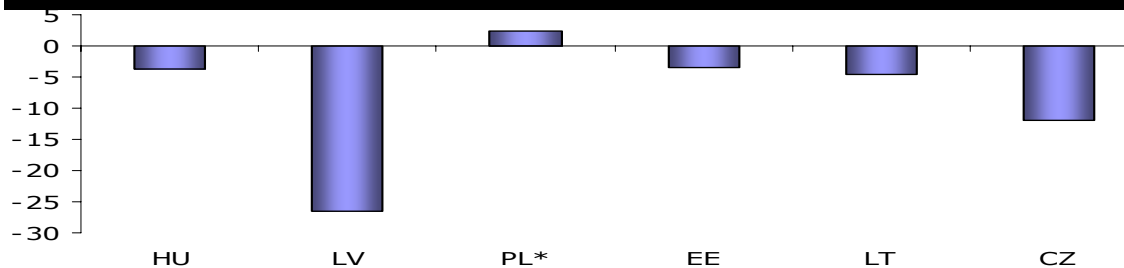
Most CECs are exposed to currency risk emanating in the non-financial private sector.

CECs. Economy-wide currency mismatches

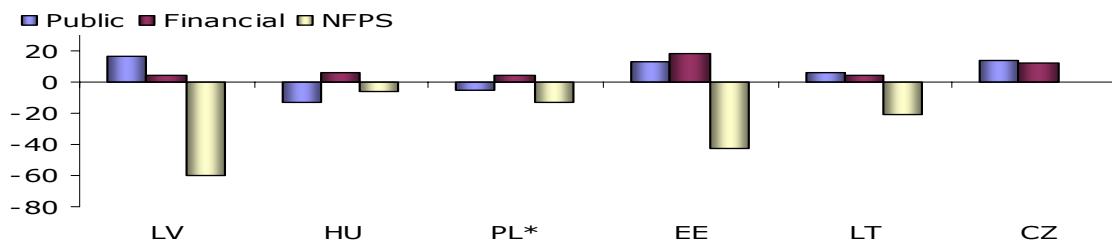
Net FX position, 2006 (in percent of GDP)



Change in net FX position, 2003-06 (in percent of GDP)



Sectoral net FX position, 2006

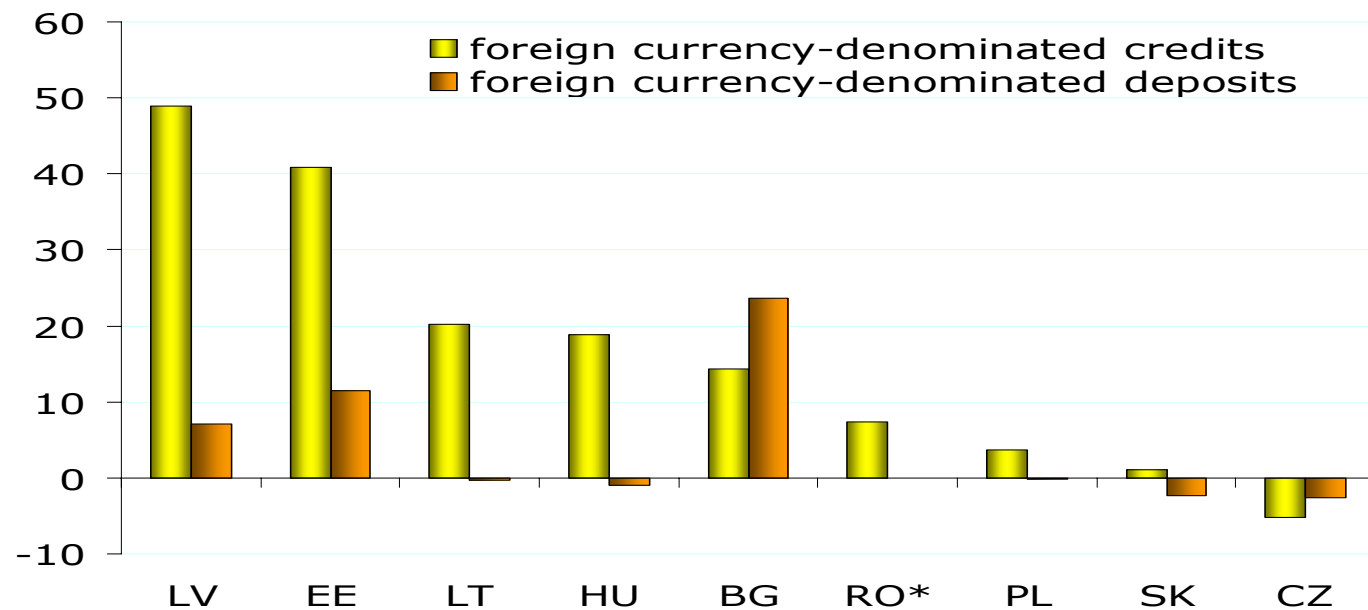


* Data for 2005.

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)



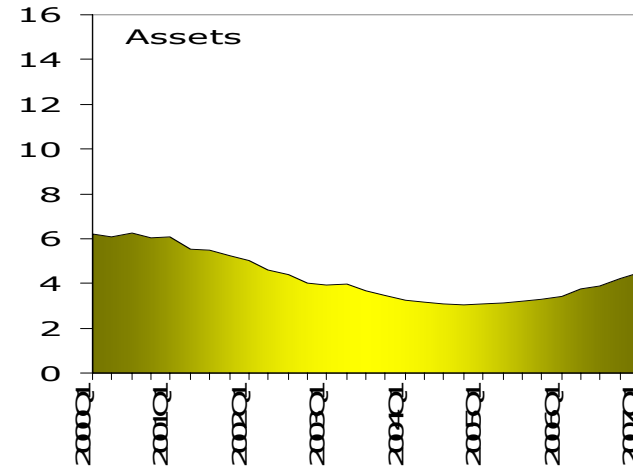
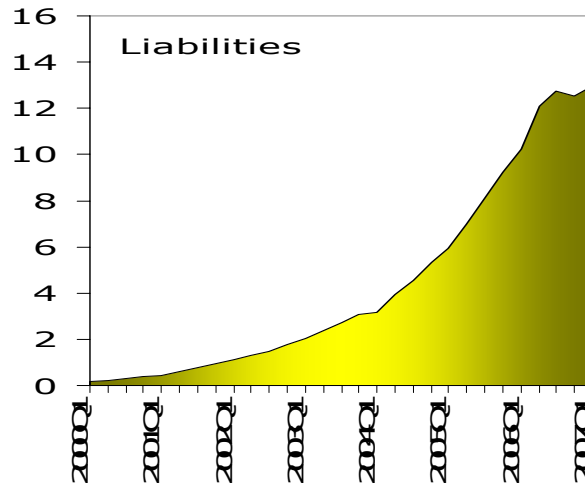
Source: National authorities, IMF staff estimates

* Deposit data for Romania are not available.

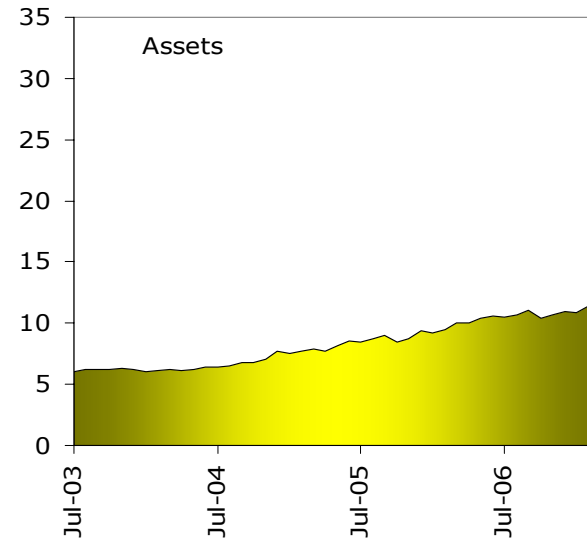
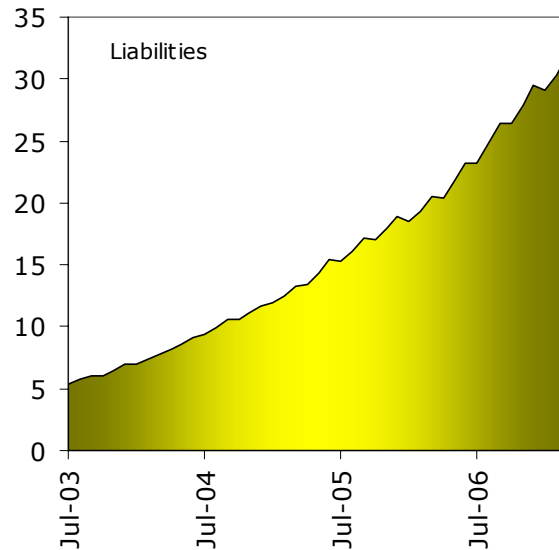
Households in some countries are particularly exposed.

Households' net open fx position (percent of GDP)

Hungary



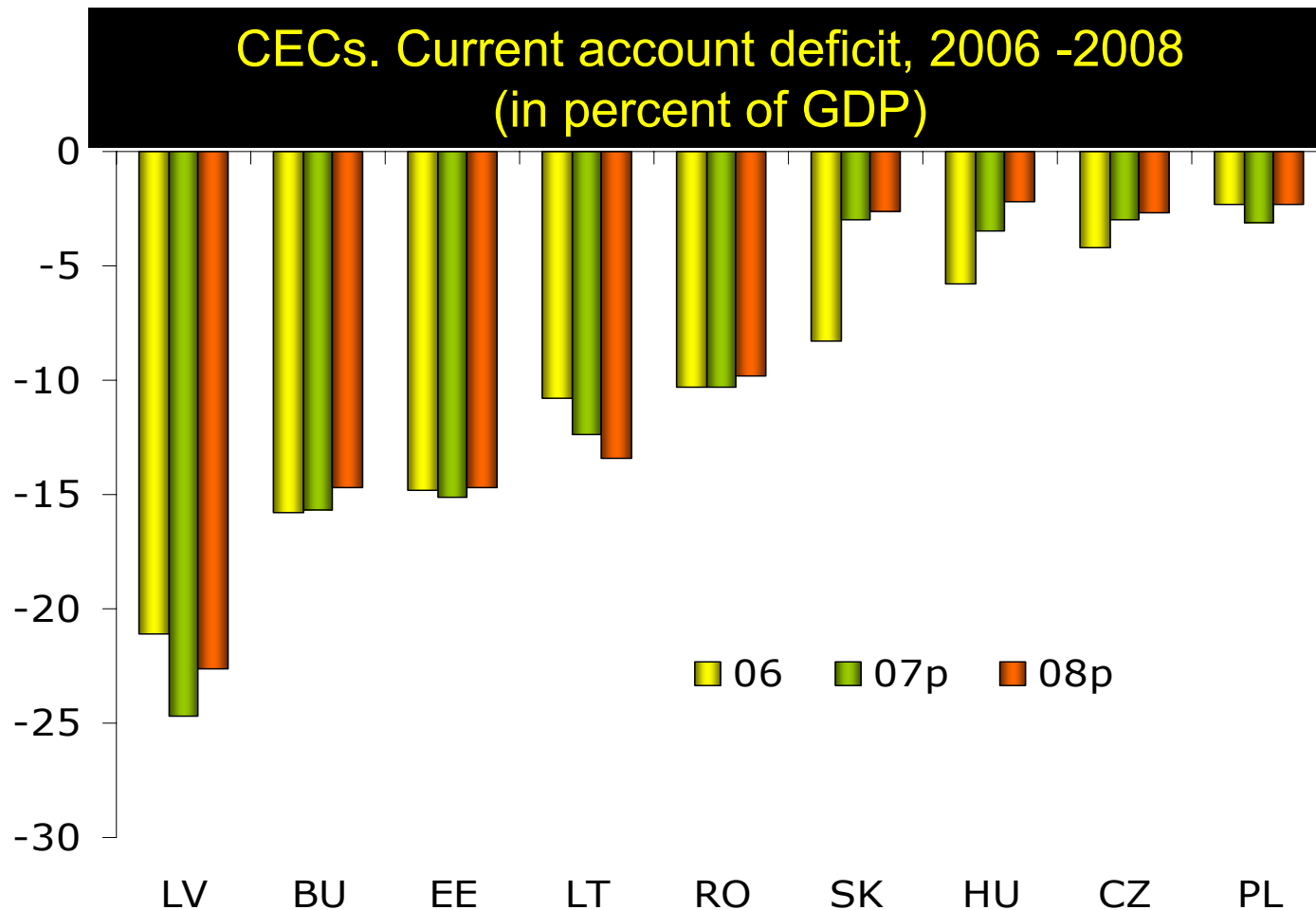
Latvia





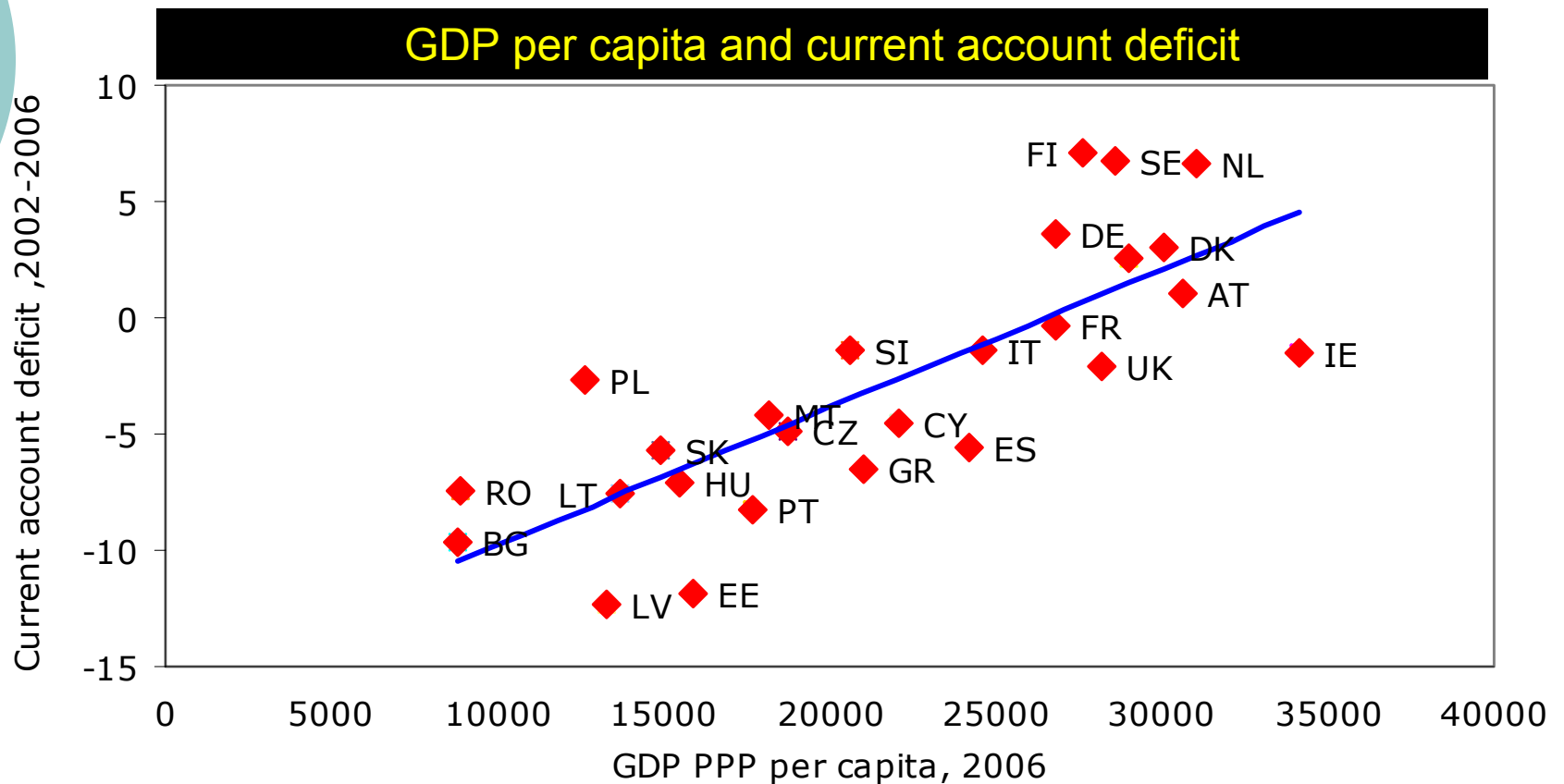
Large external stock and flow imbalances

Current account deficits are high, except in Central Europe...



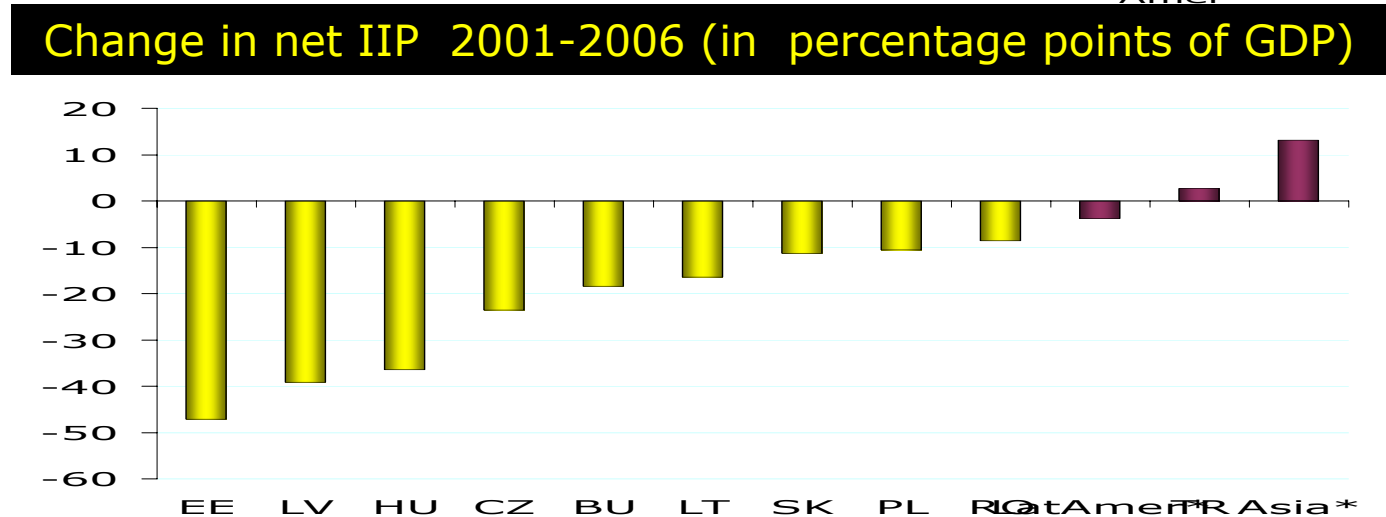
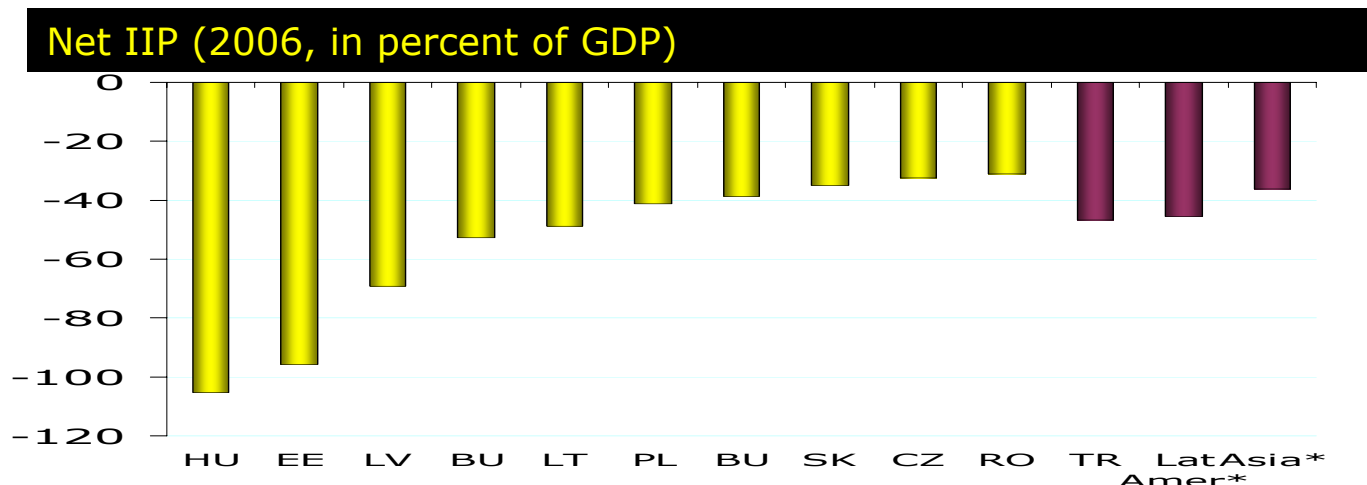
Source: IMF WEO April 2007.

... largely reflecting the convergence process.



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.



Cross-border financial integration

Balance sheet exposures between banking systems warrant a cross-country perspective.

Bank's exposure in EM countries, 2006 (as percent of total exposure)

	Austria	Belgium	Sweden	Germany	France	Italy	Portugal	Finland
EU10	34.7	5.6	10.3	2.6	1.9	11.4	6.6	9.9
Bulgaria	0.9					0.5		
Czech Republic	8.9	2.6		0.2	1.0	0.6	0.1	
Estonia	0.1		3.6					3.9
Hungary	6.2	1.2	0.0	0.7	0.2	2.6	0.3	
Latvia	0.1		3.3	0.1				2.6
Lithuania	0.1		2.9	0.1				3.2
Poland	2.8	1.0	0.5	0.8	0.2	4.8	6.2	0.1
Romania	8.7			0.5	0.4	0.8		
Slovakia	5.6	0.6		0.1		2.5		
Slovenia	2.2	0.2		0.1	0.1	0.1		
Other EM Europe	14.6	1.0	0.4	1.7	1.2	7.0	1.0	0.5
Other EM	1.0	0.6	0.5	1.6	1.6	1.0	4.1	0.4
ROW	49.6	92.8	88.7	94.1	95.3	80.5	88.3	89.2

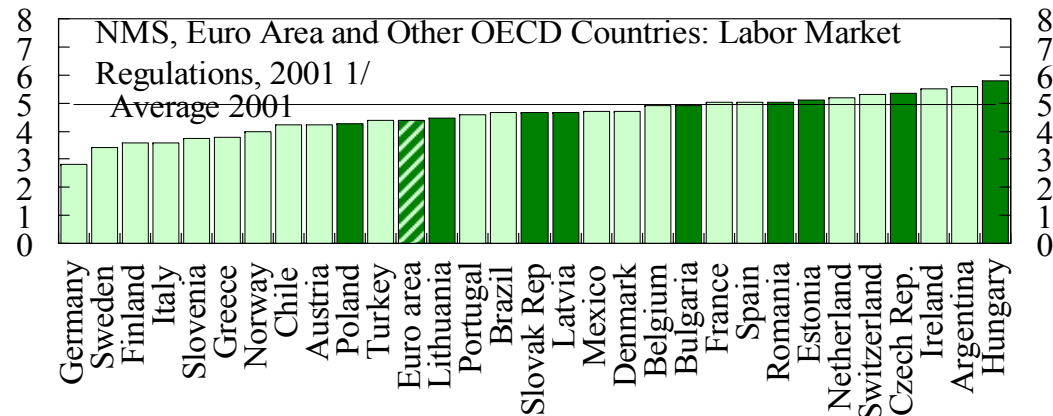
Source: BIS



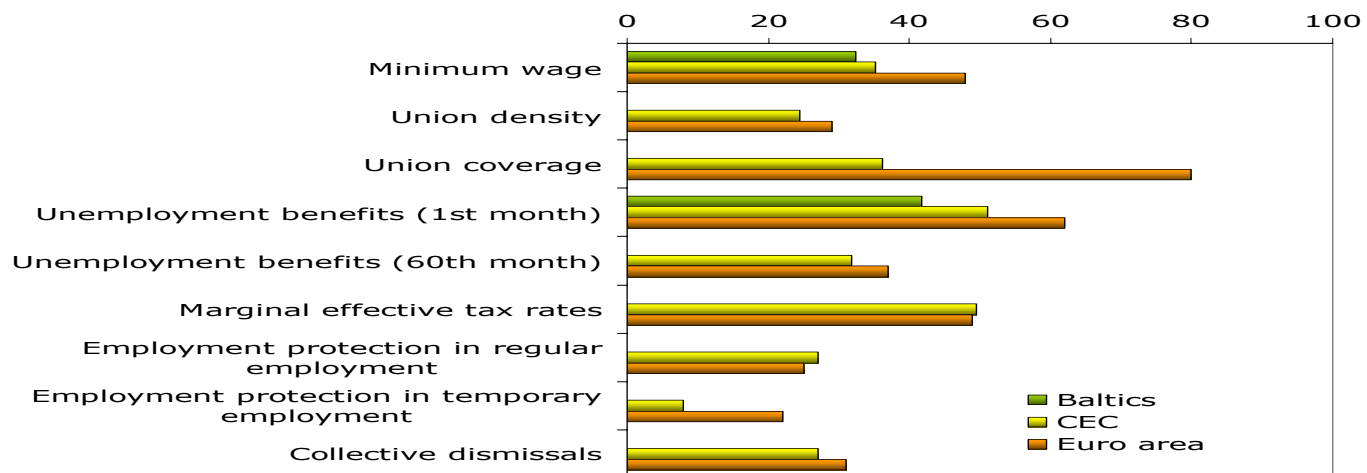
Creating flexible economies

Labor markets seem relatively flexible, but are untested.

Labor market regulations



Labor market rigidities



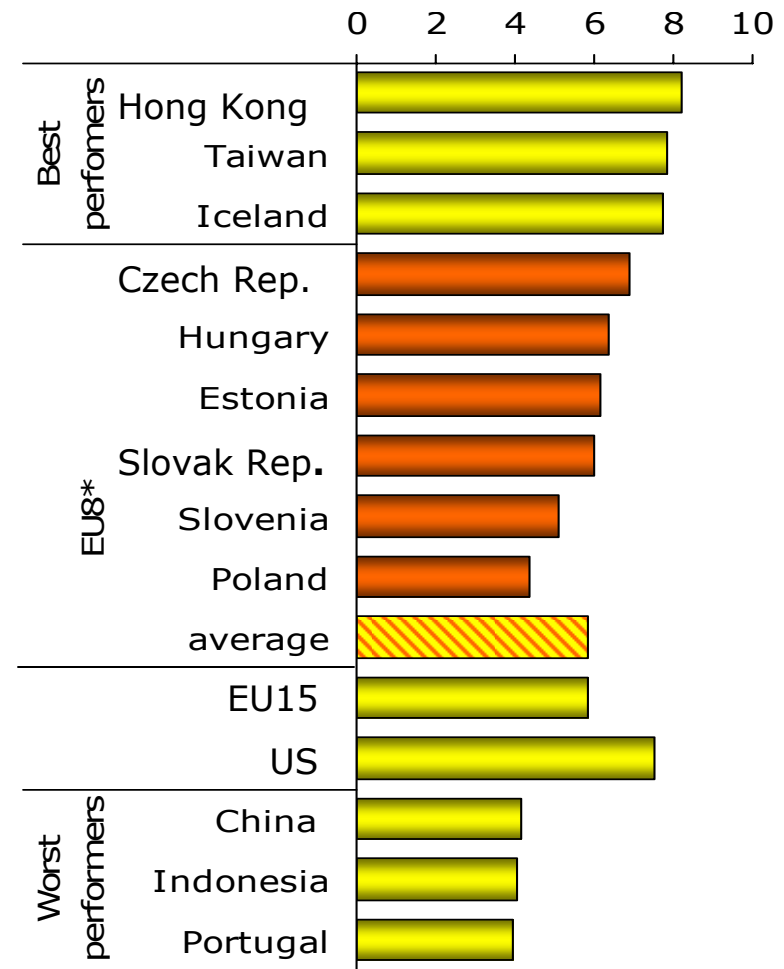
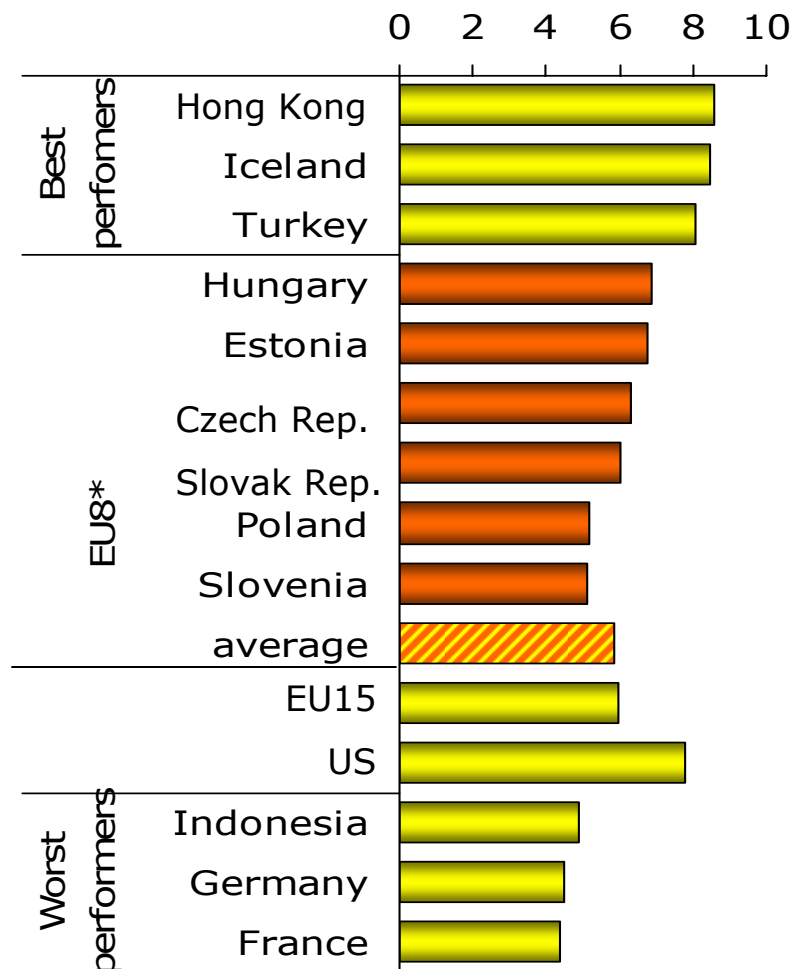
Source: OECD.

1\ The scale of indicators is from 1-10 from most to least regulated.

A flexible business environment is essential for sustaining convergence and eventually doing well in the euro zone.

Flexibility and adaptability (0-10)

Adaptability of companies (0-10)



Source: IMD World Competitiveness
 * Excluding Lithuania and Latvia



Conclusions

- Headline numbers look good, but vulnerabilities are growing, especially in the Baltics (“Running with your shoelaces open”)
- So far, CECs have weathered market turmoil surprisingly well
- Rather than using the favorable environment to reduce risks, some governments are pouring oil into the fire by pursuing procyclical fiscal policies
- Preparation for euro adoption is overly focused on meeting Maastricht criteria



Policy challenges

- Cool off economies during a surge in capital inflows and rapid credit growth => tightening fiscal policies is often the only available tool
- Financial sector supervision, including of cross-border exposures
- Prepare for euro adoption by creating flexible economies and sound institutions