Central and Eastern Europe: Global spillovers and external vulnerabilities

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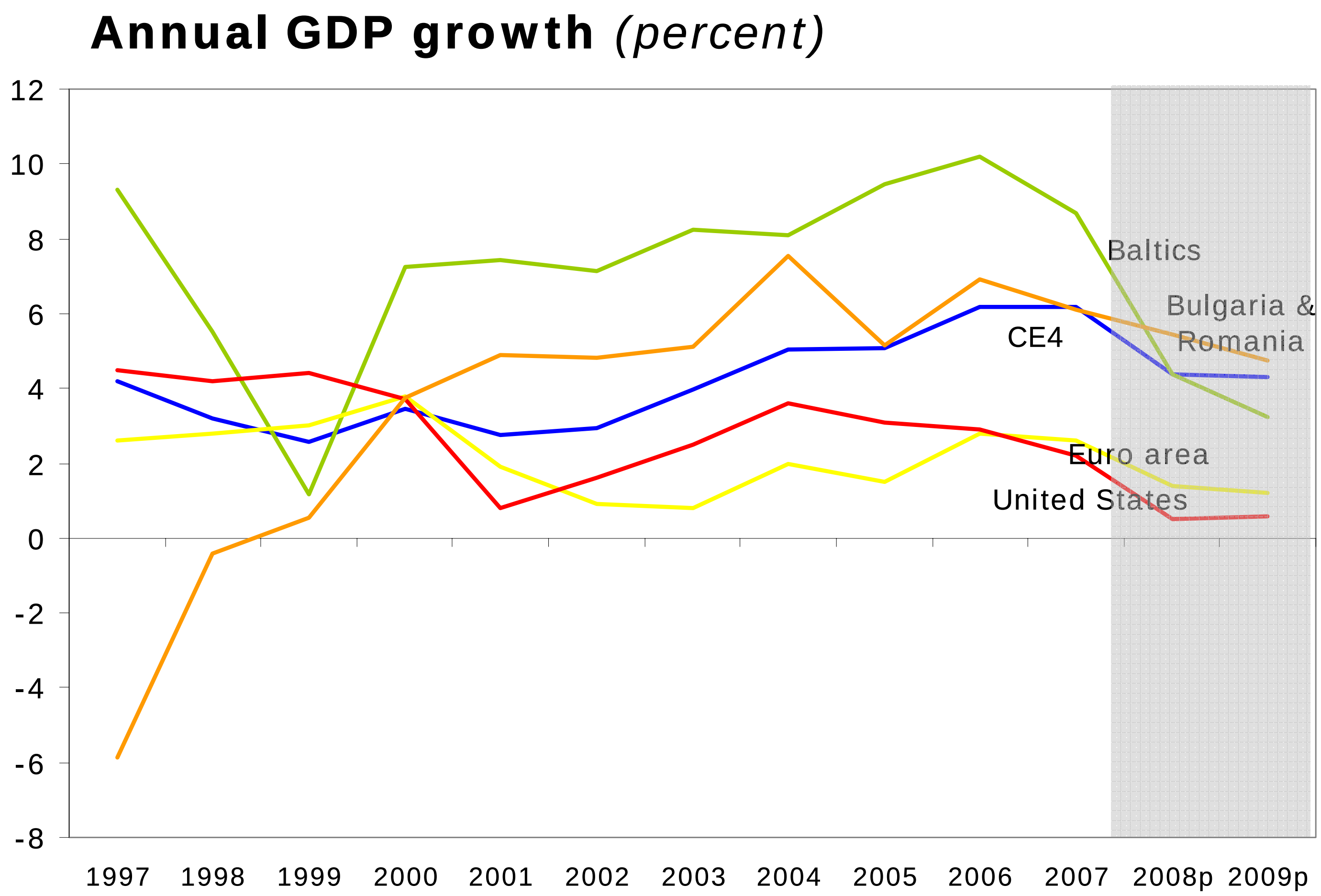
Overview

- The CEEs' macro picture is still largely unaffected by the global credit crunch
- Large external imbalances in some CEE countries are raising concerns
- Policy agenda

Macro Outlook

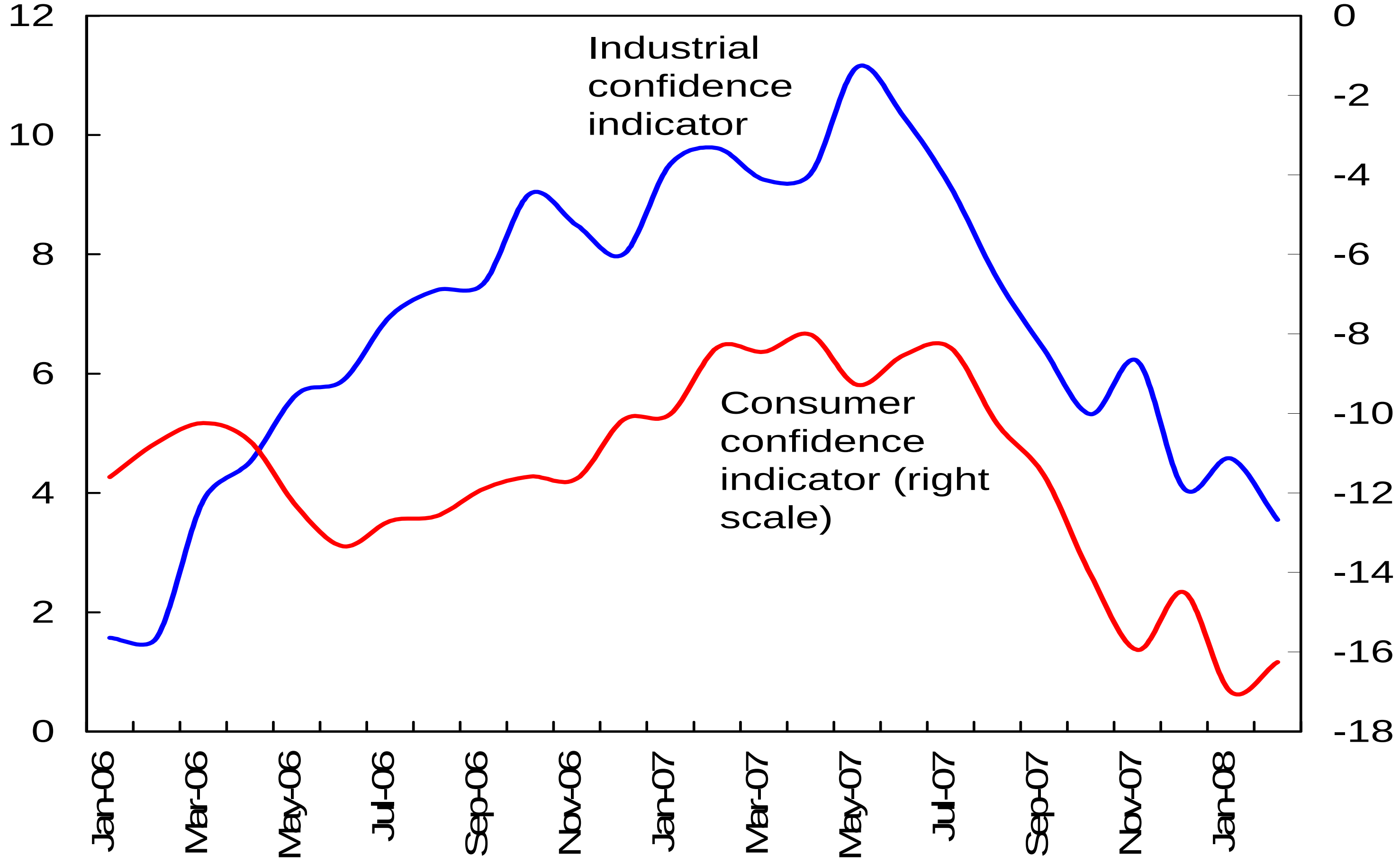
Growth is expected to slow, due to spillovers from the US and the Eurozone



Source: WEO April 2008.

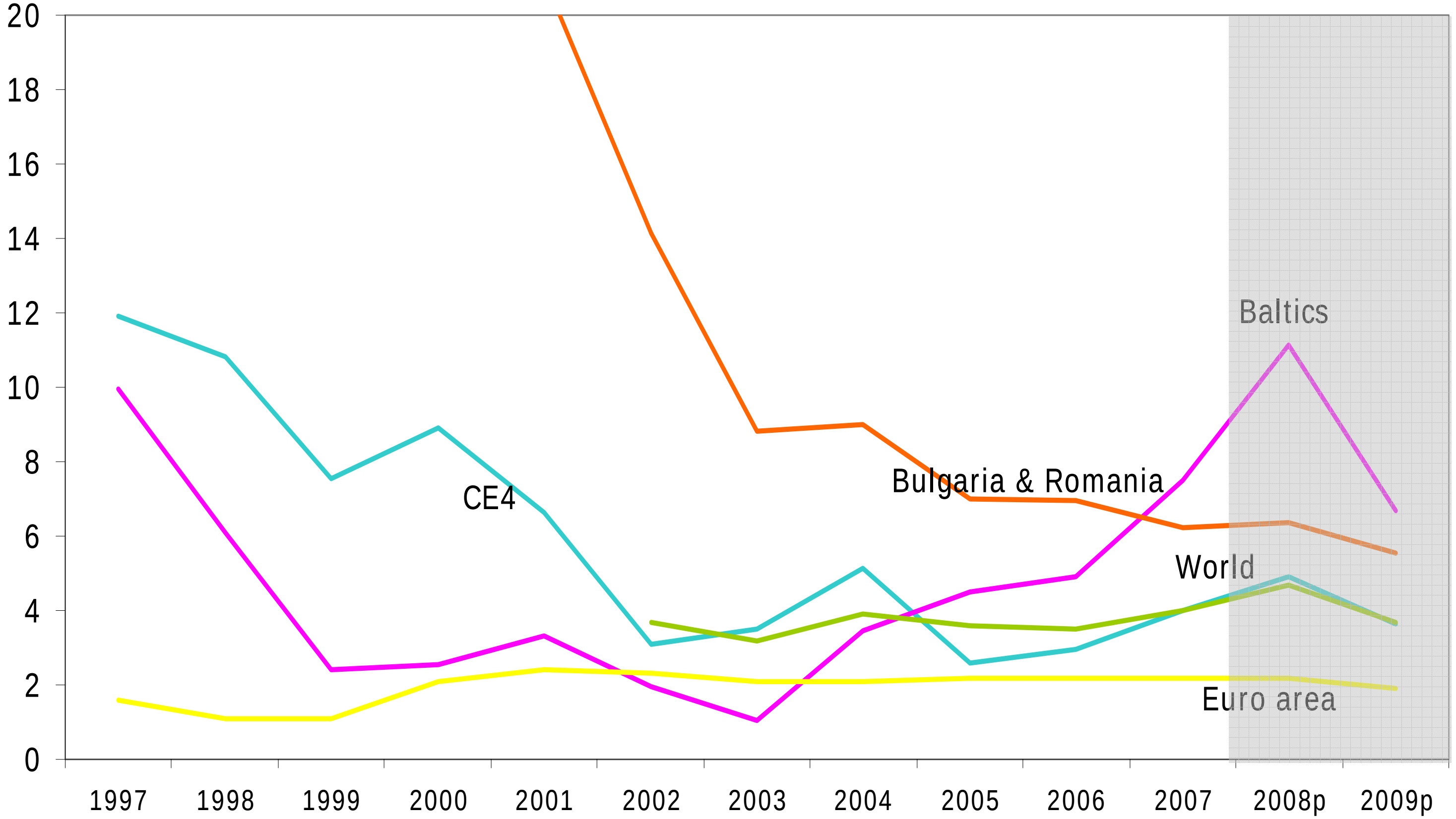
Emerging Europe is not immune to the deterioration in global sentiment

Emerging Europe: Confidence Indicators, January 2006–February 2008
(Percentage balance)



Inflation is picking up, mainly in the fixed exchange rate countries.

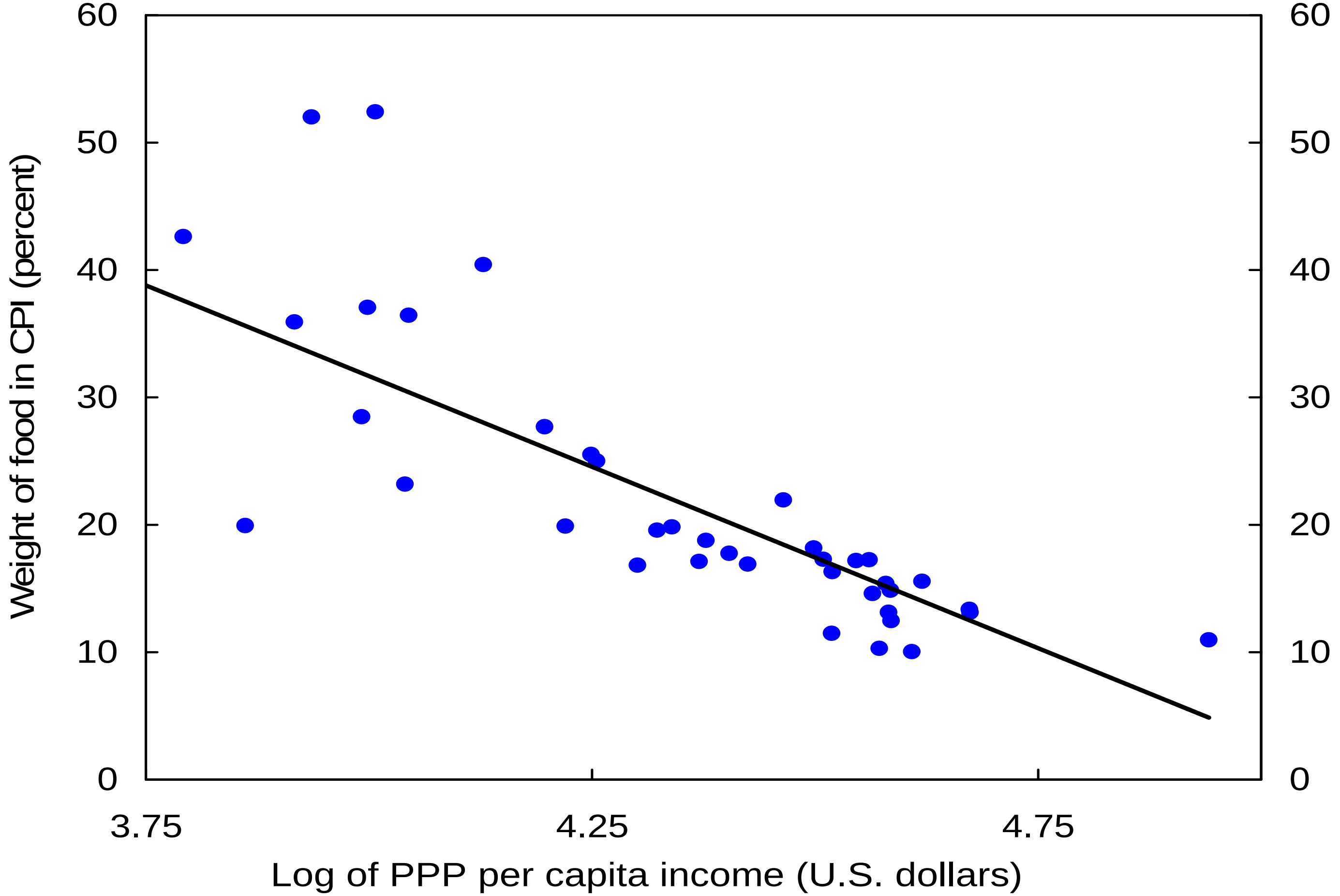
Annual average CPI *(percent)*



Source: WEO April 2008.

This is partly due to the high share of food in the CPI basket

Share of Food Expenditures and Per Capita Income in European Countries, 2007



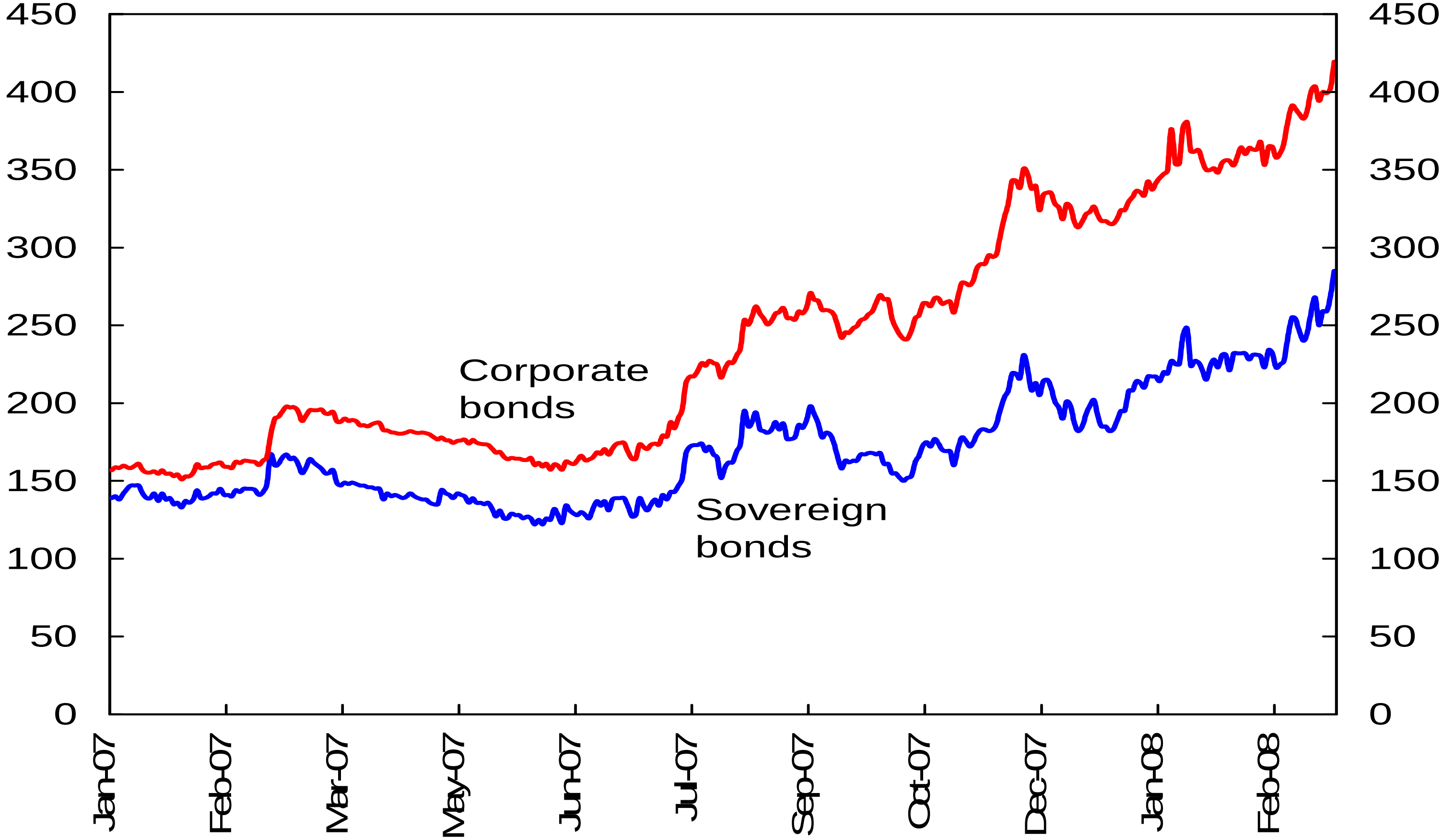
The baseline outlook is for a soft landing, but downside risks have increased:

- **Exports:** slowdown in Europe and US could be more protracted than in the baseline
- **Inflation:** global commodity price boom, domestic wage pressures
- **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

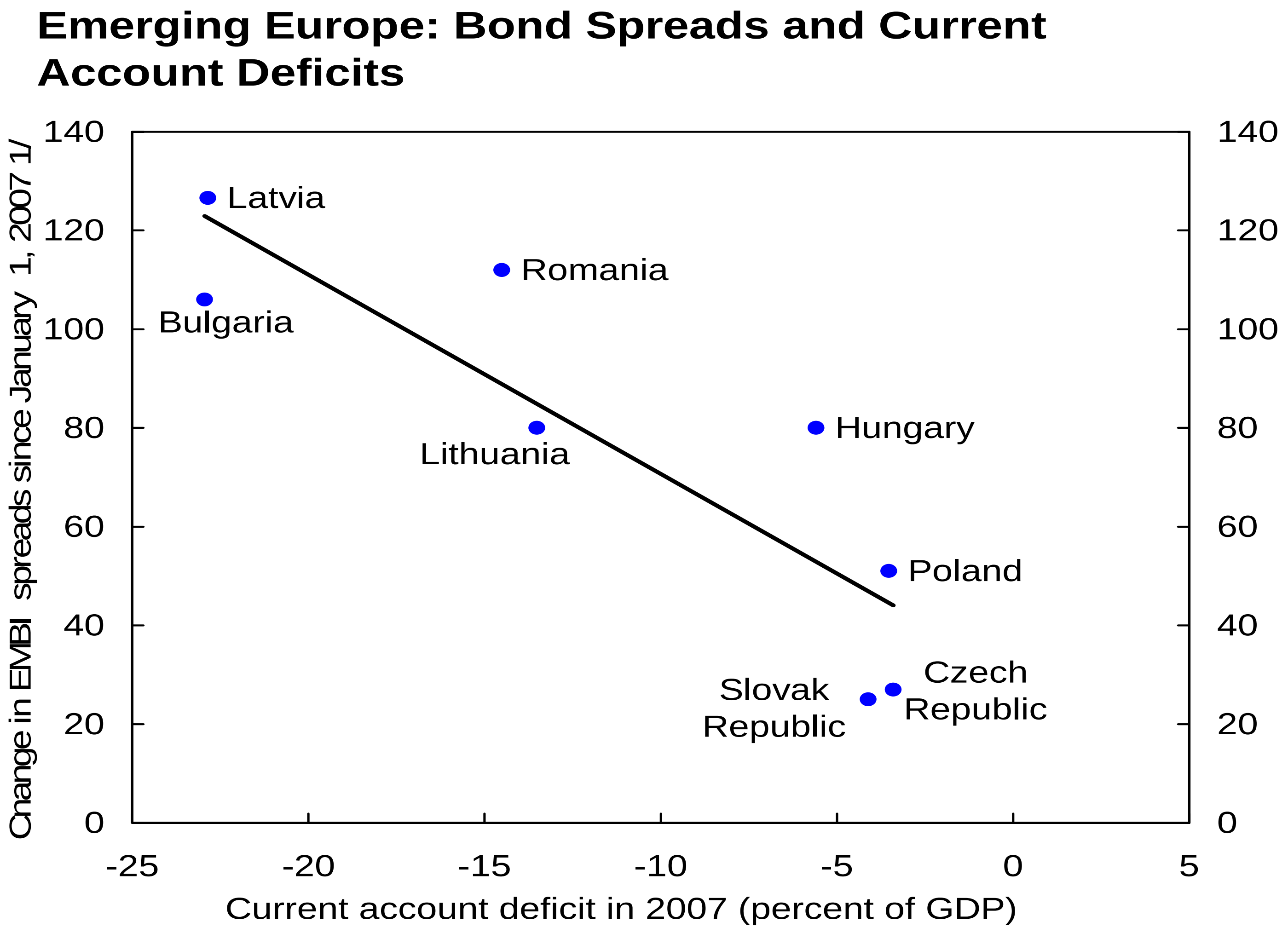
Financial Markets
and
External Imbalances

Borrowing costs have increased…

Emerging Europe: Sovereign and Corporate Bond Spreads,
January 2007–March 2008 *(Basis points)*



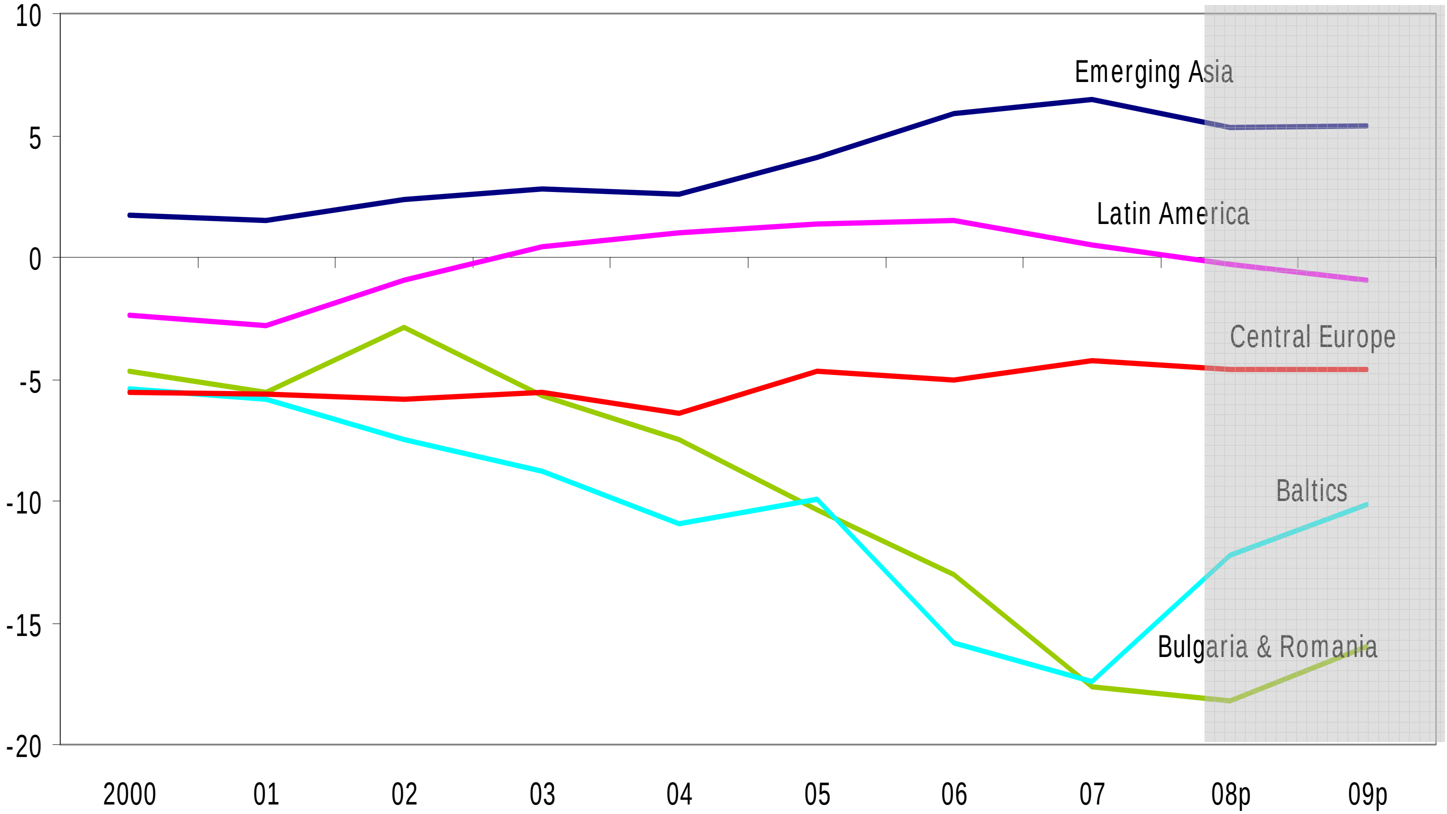
…particularly in countries with large external imbalances.



Source: IMF.

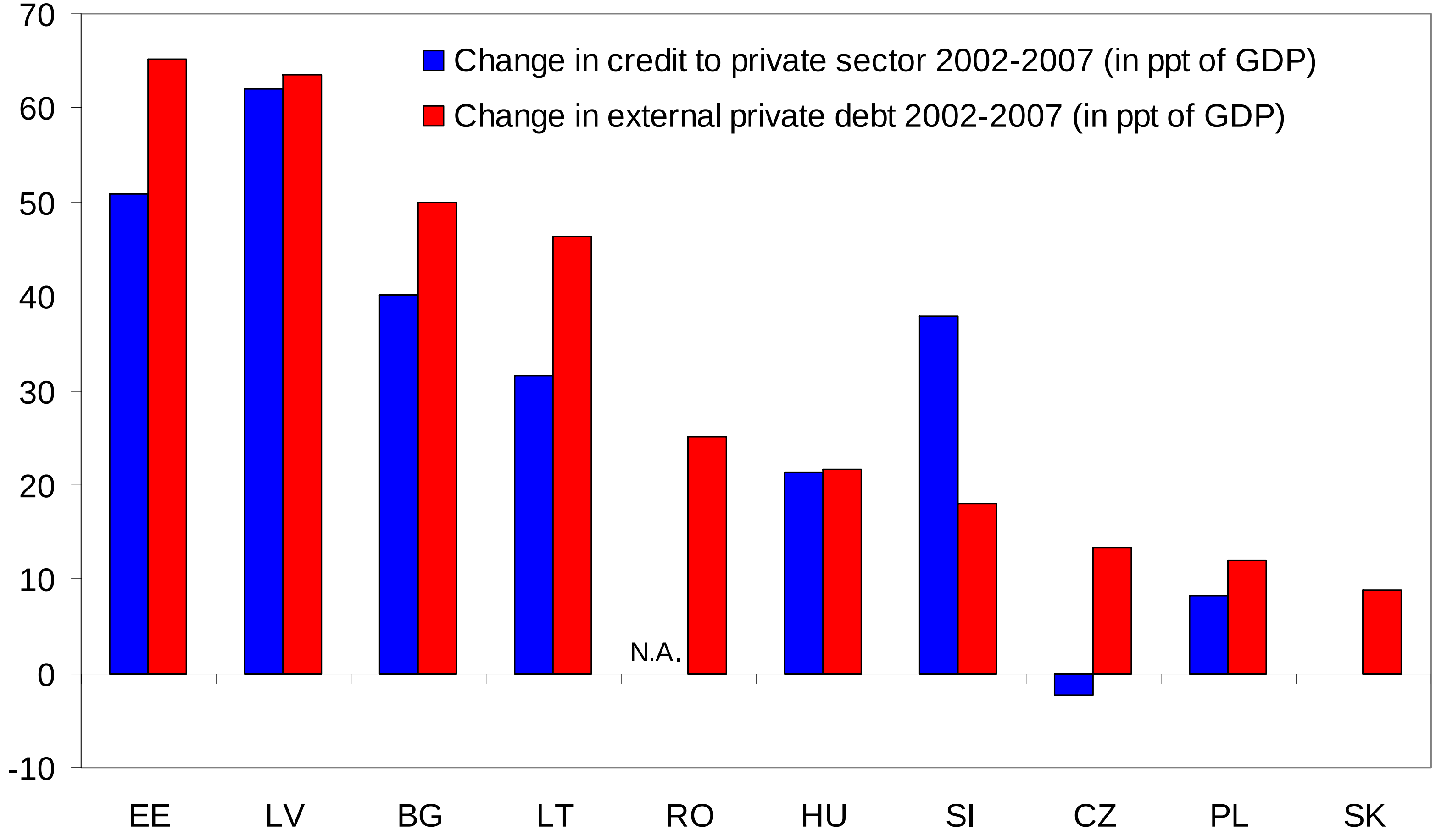
Current account deficits are especially high in the Baltics and South-Eastern Europe...

Current account deficit
(in percent of GDP)



Source: IMF WEO April 2007.

…and closely related to financial deepening



Sources: National authorities; and IMF staff calculations.

Are large external imbalances a risk?

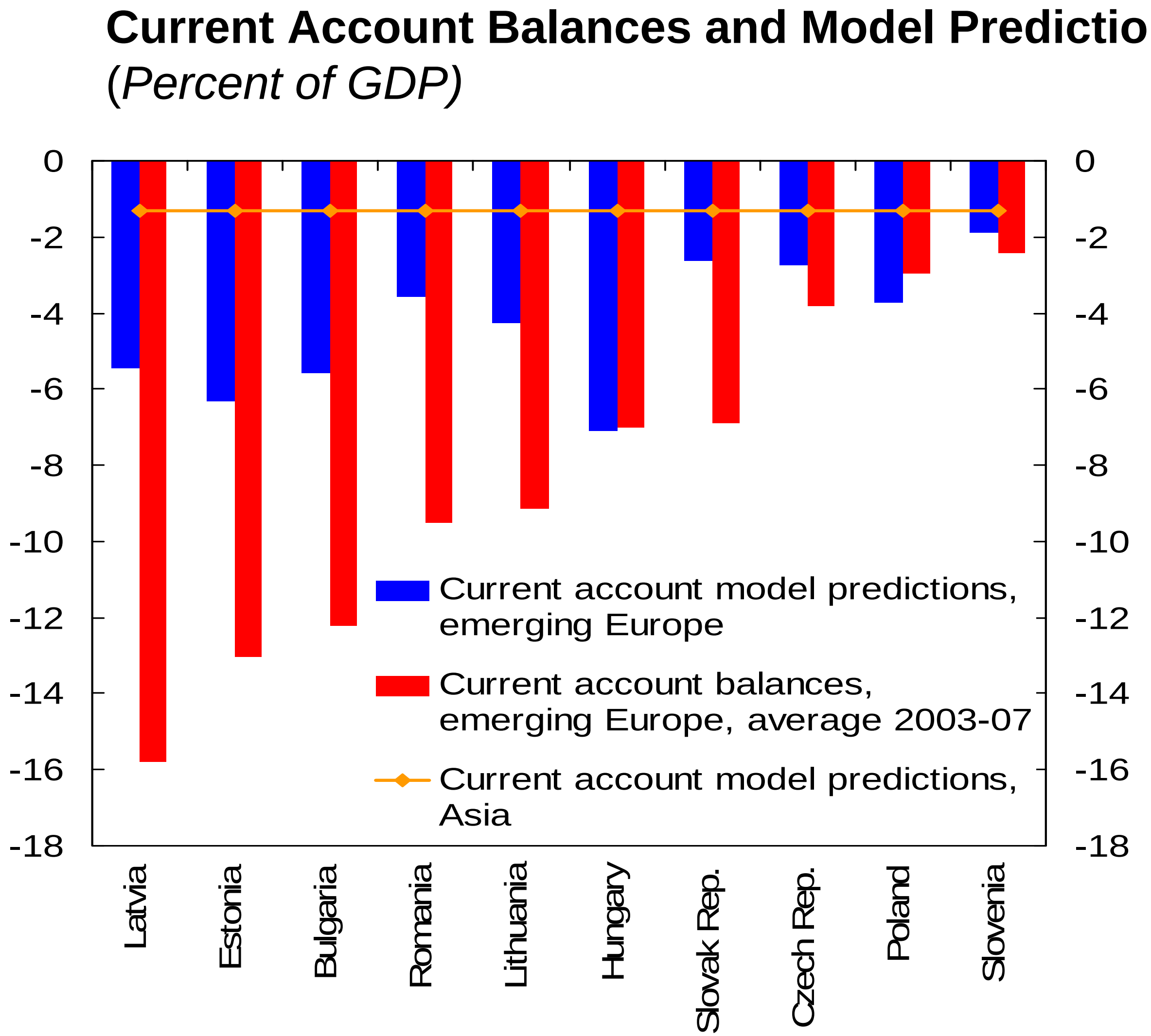
Optimists:

- 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:

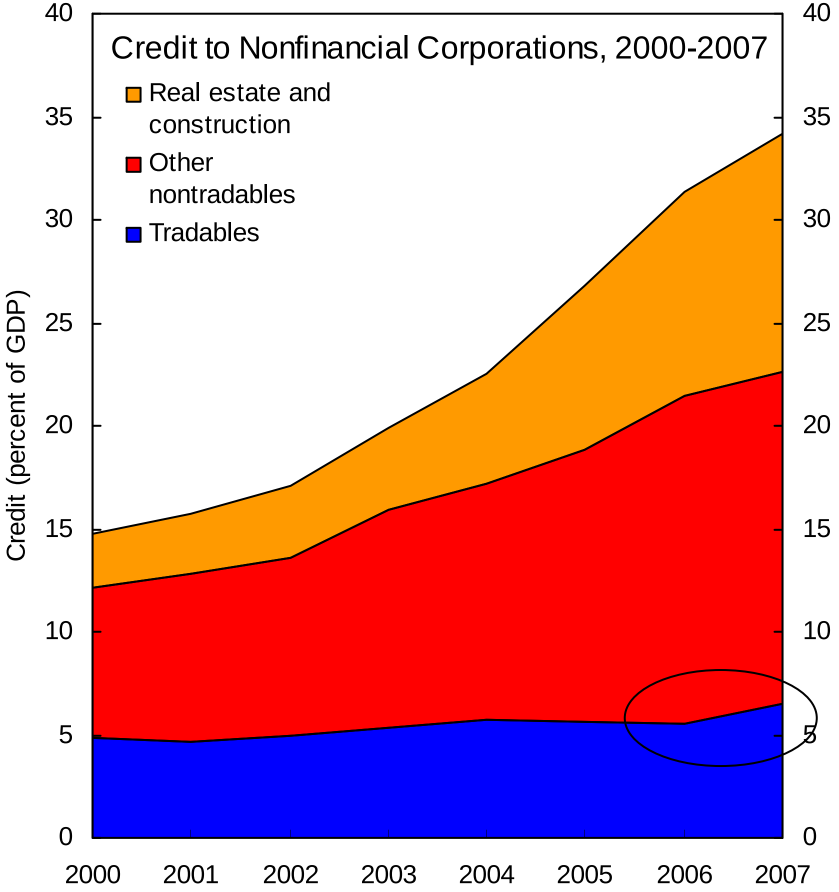
- Historical evidence of large capital inflows and sudden stops
- EU accession does not provide enough assurance of good policies and protection against financing shortfalls
- Foreign capital mainly goes to the non-tradable sector => questions about countries’ long-term capacity to repay
- Markets are punishing countries with large imbalances

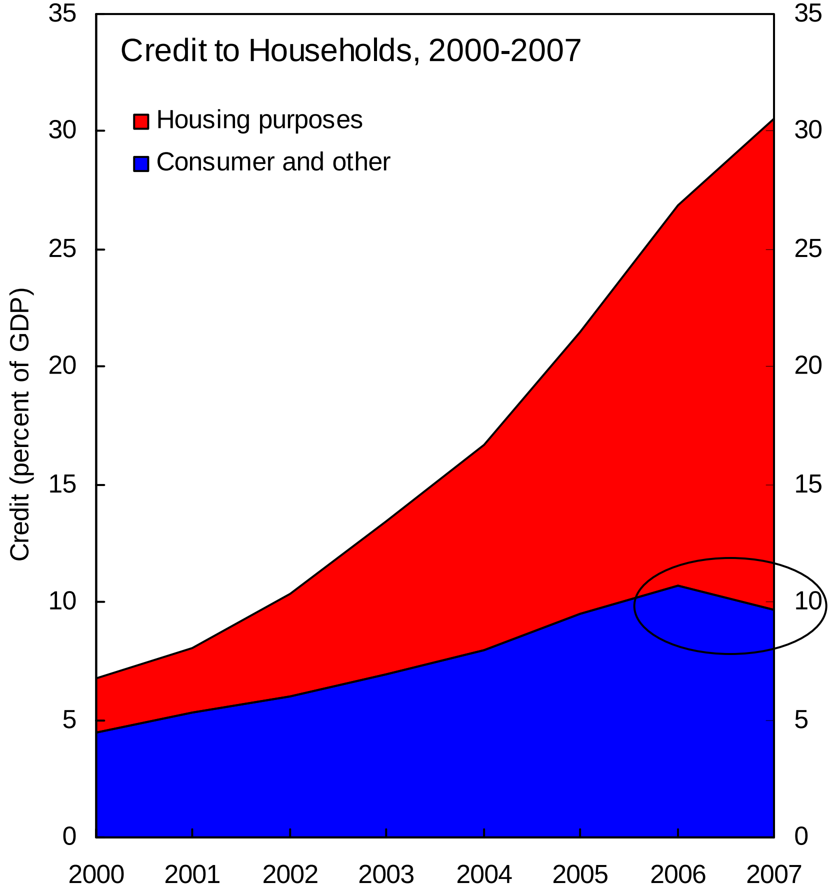
C/A deficits in some countries are much higher than supported by fundamentals



Sources: IMF, World Economic Outlook; and IMF staff calculations.

Credit is concentrated on households and nontradables

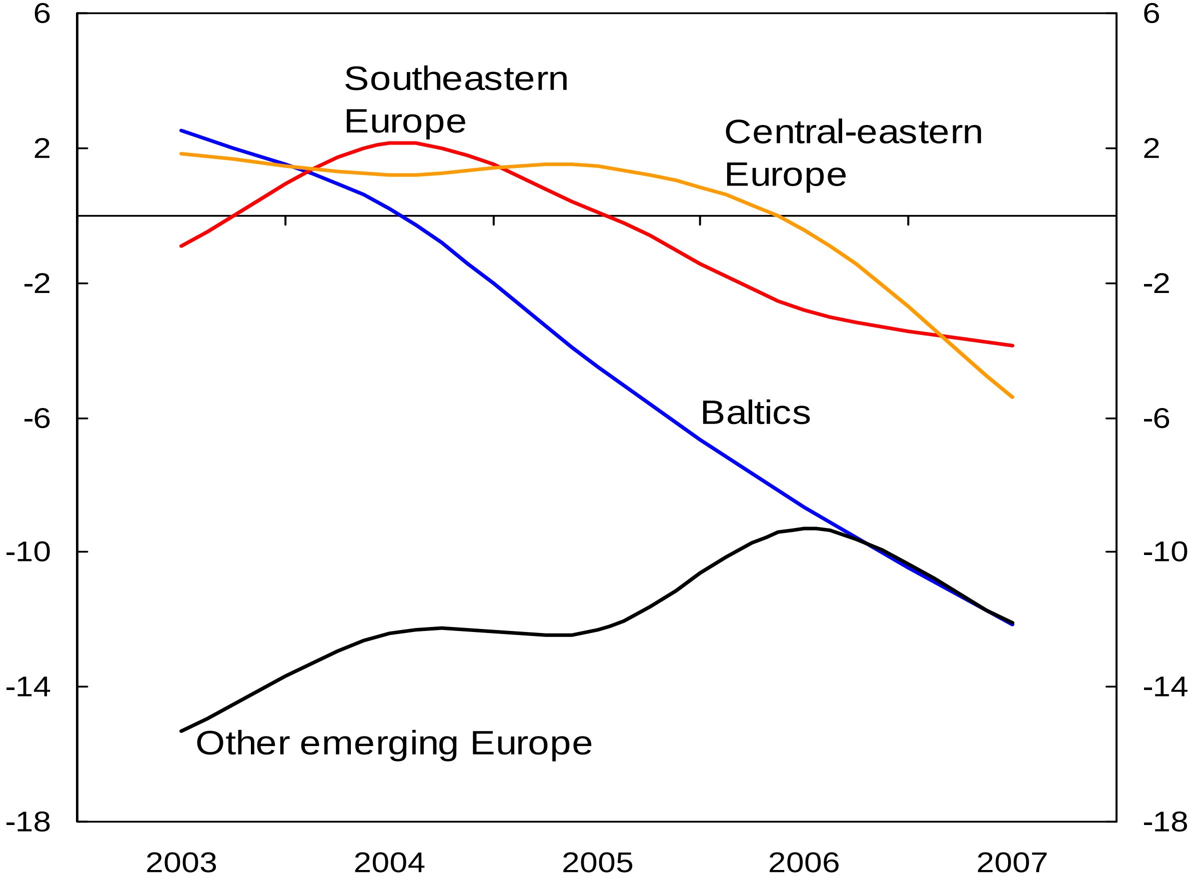




Macro Policies

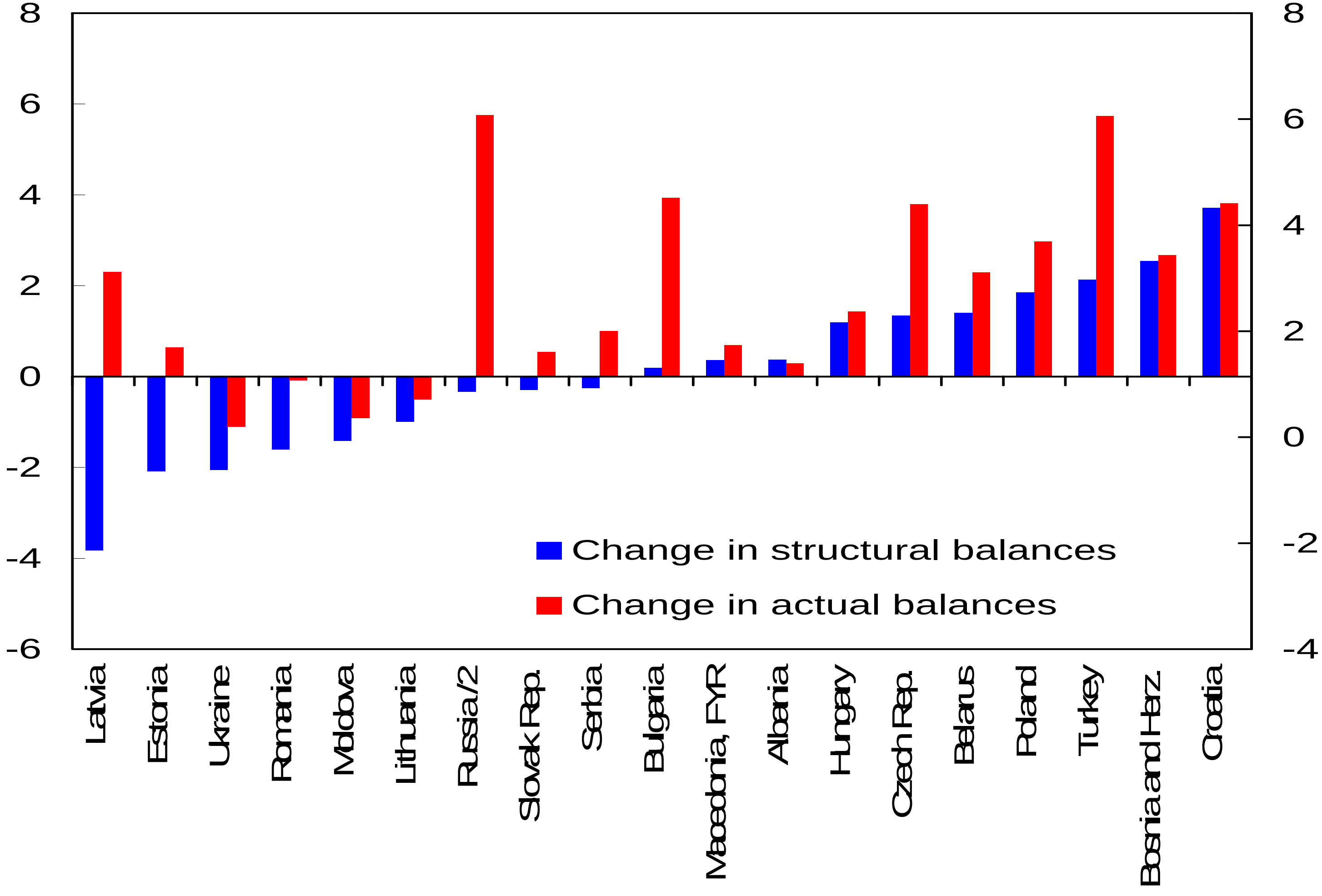
Monetary conditions are loose

Emerging Europe: Lending Interest Rate–Taylor Rule Interest Rate, 2003–07



There is room for more fiscal consolidation

Change in Actual and Structural Fiscal Balances, 2003–07 1/
(Percent of GDP)



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

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, 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