



The New Member States of EU: Trends and Challenges

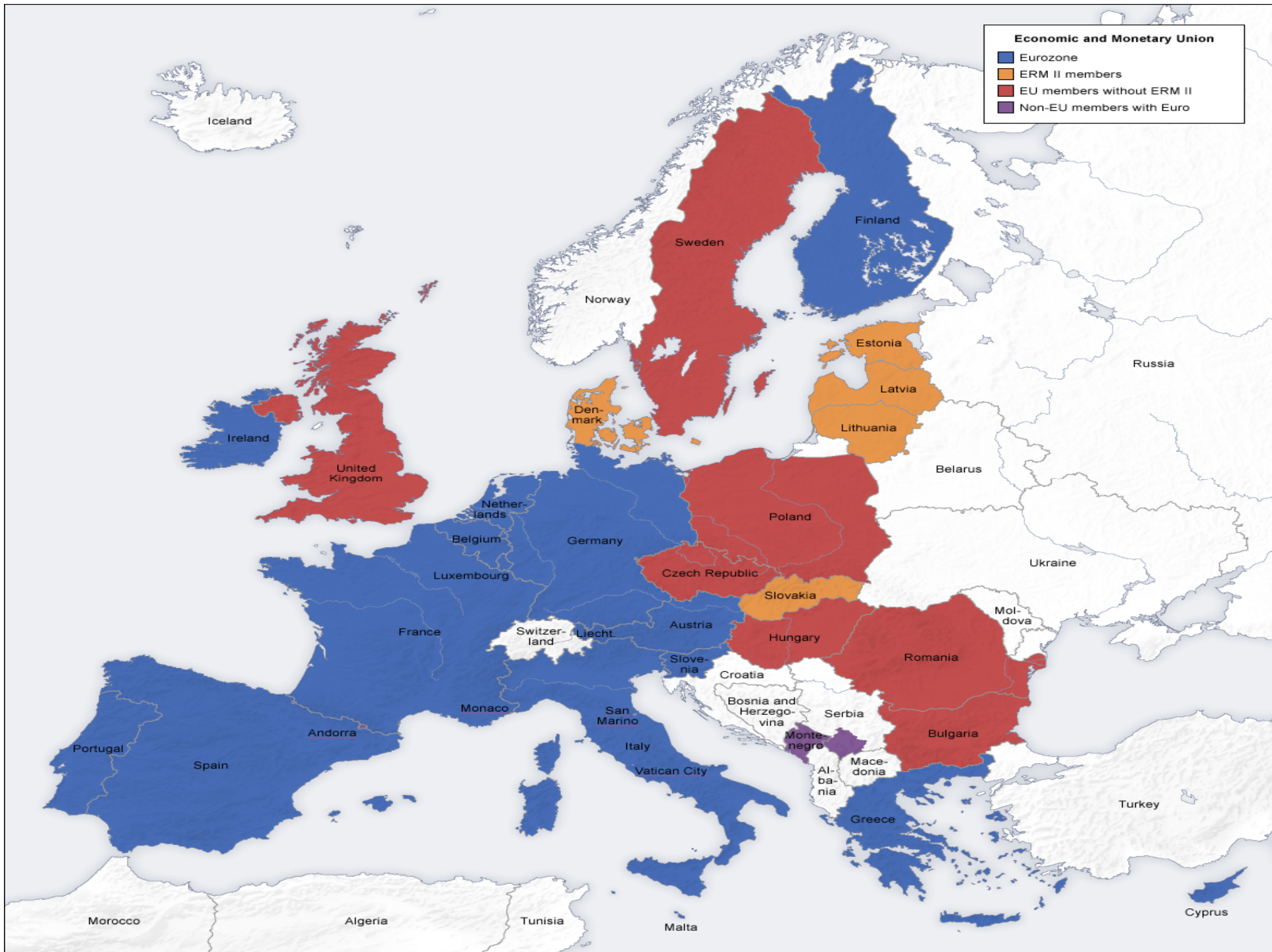
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March 2008

Outline

- The New Member States of the EU (NMS) – some basic facts
- Catching-up with the rest of EU – the secular trend
 - Incomes
 - Prices and Exchange Rates
 - Credit Growth
- Possible bumps on the road – cyclical trends
 - The recent inflation surge and interest rates
 - External Imbalances
 - Fiscal Deficits
 - Fallout from the subprime crisis
- Conclusions

EU Membership

- Free trade
- Free movement of capital
- Free movement of labor (so far restricted to UK, Ireland, Sweden)
- Passport-free travel (Schengen Zone only)
- Common product and service standards
- Euro adoption



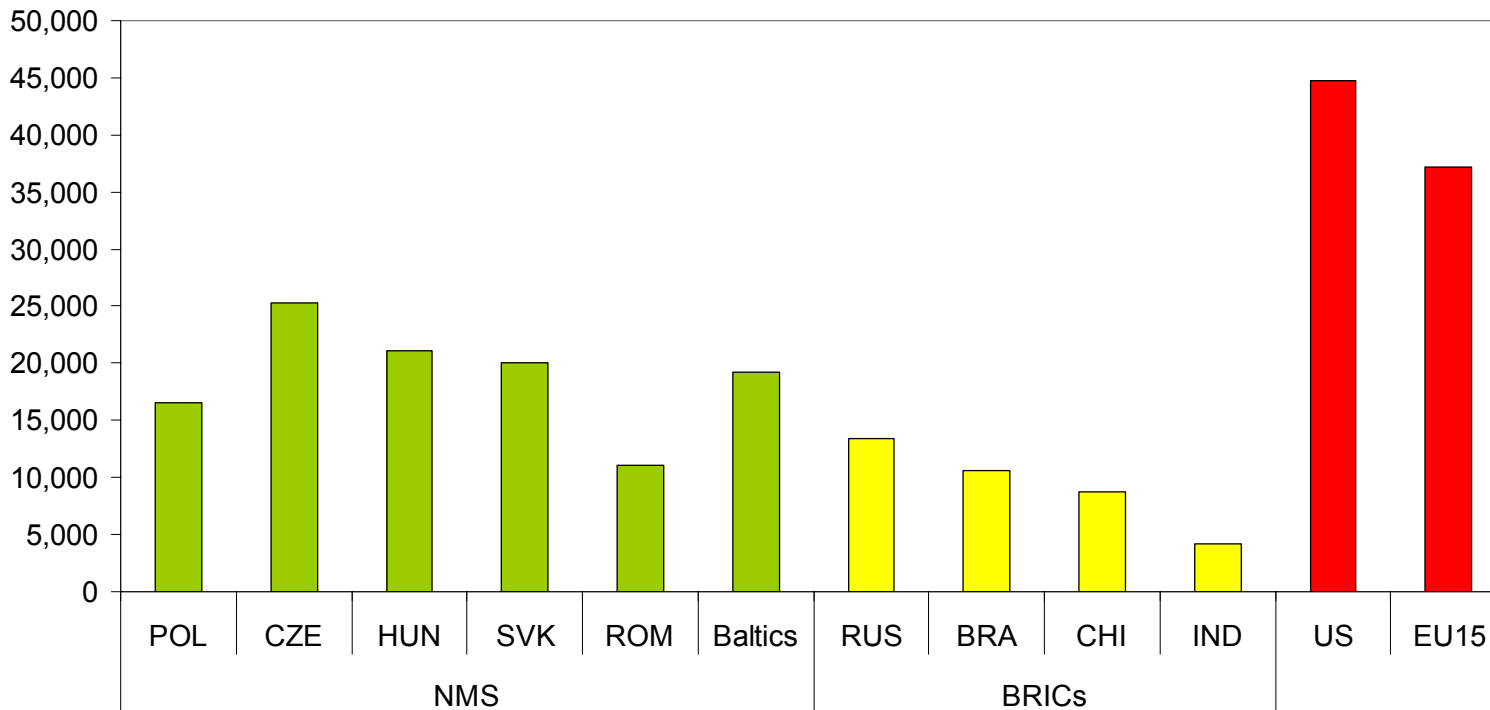
Euro adoption

- Every NMS must adopt Euro
- Need to meet Maastricht criteria
- Malta, Cyprus, Slovenia have already joined, Slovakia is close
- Euro adoption is not likely in the next five years in Poland, Romania, Czech Republic and Hungary

Convergence to the EU

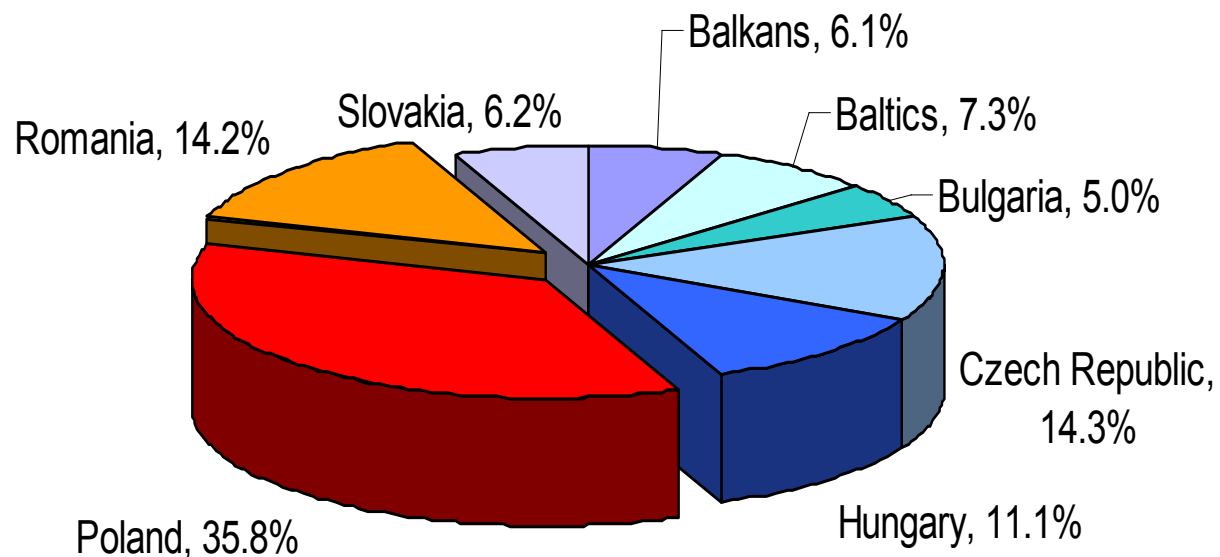
The NMS are generally richer than BRICs, but their catch-up potential is still high

NMS and other EMs:
Per capita GDP 2007 (PPP\$)



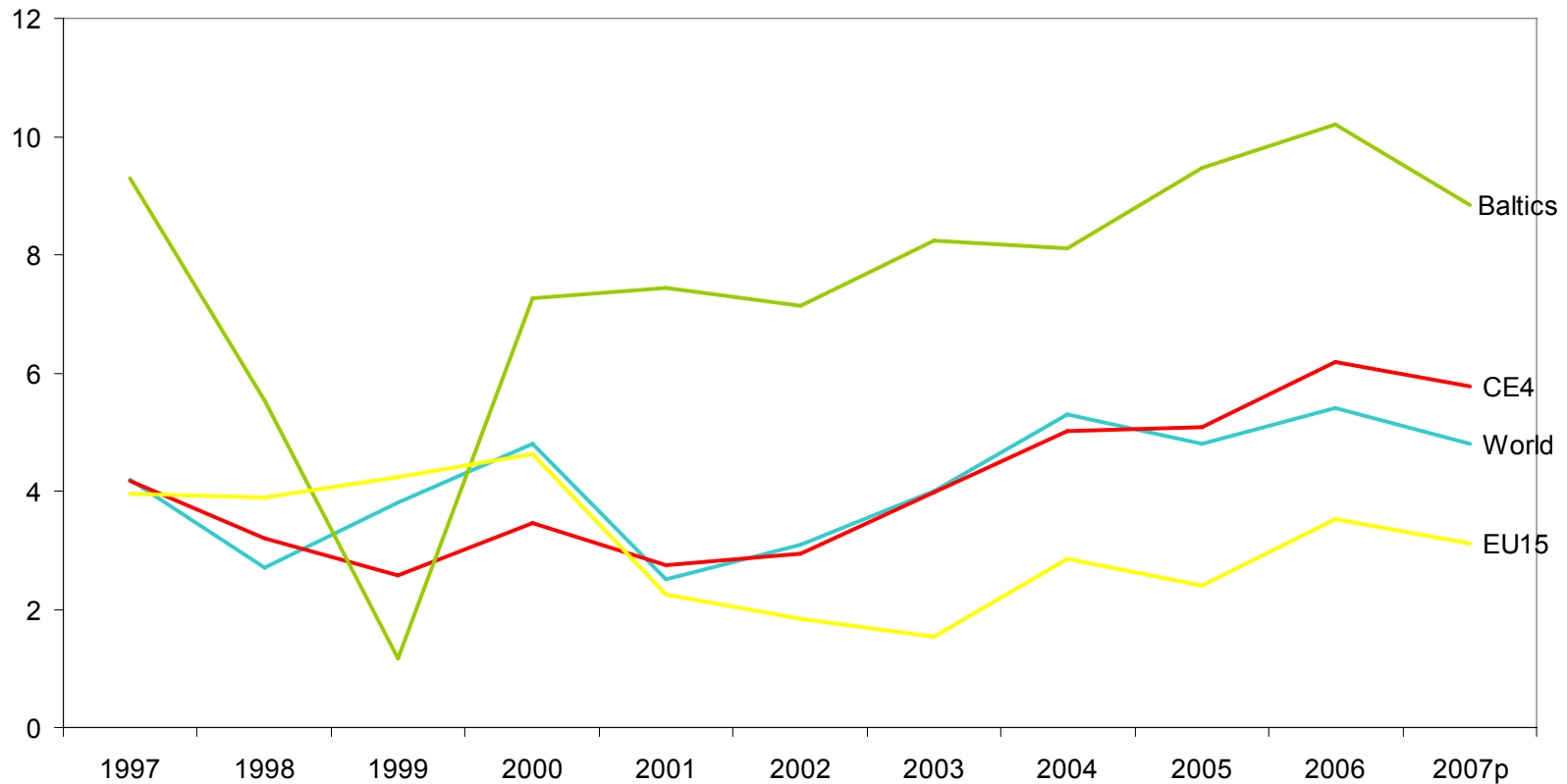
Poland is by far the largest country in the region

GDP distribution
(2007, PPP weights)



The NMS have been growing rapidly, especially after EU membership

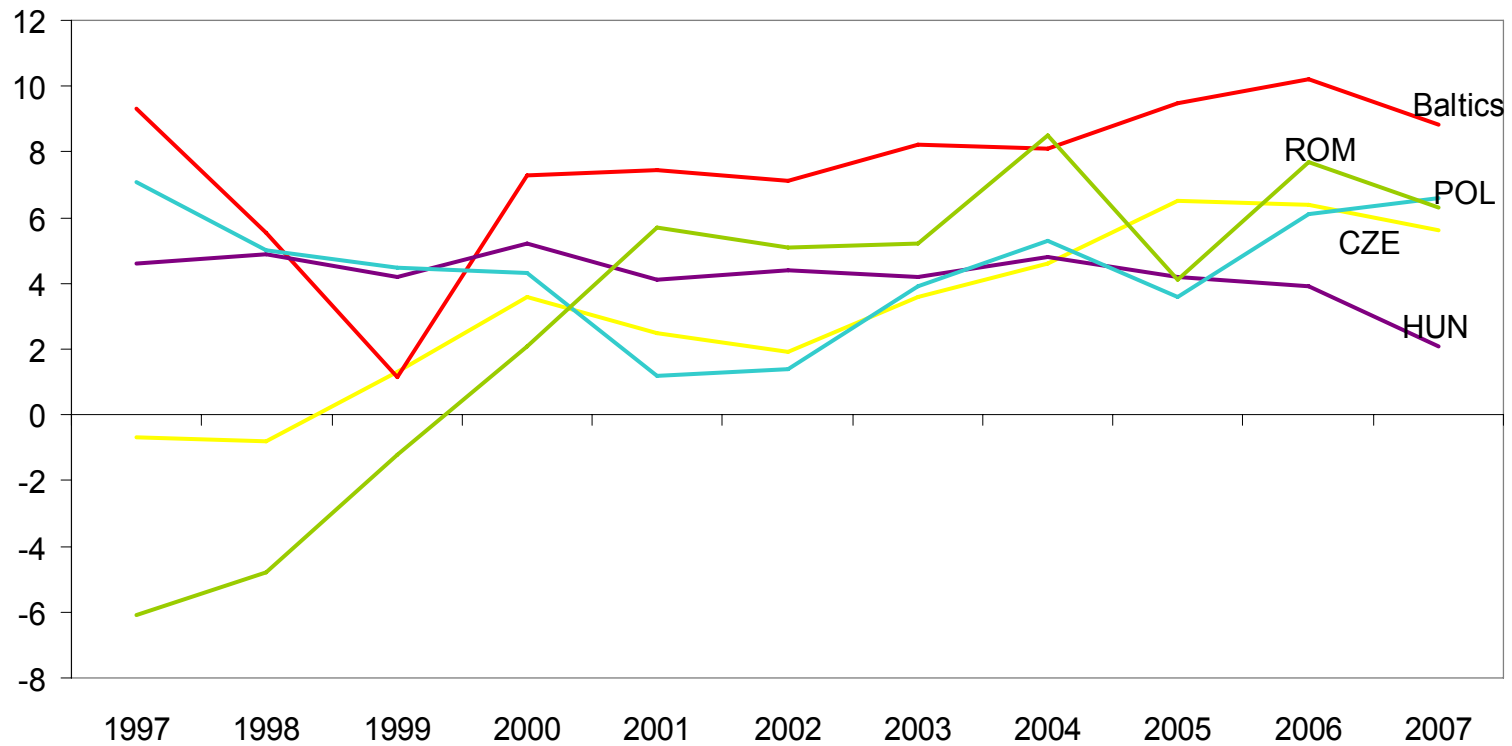
GDP growth (annual)



Source: IMF.

Some have done better than others

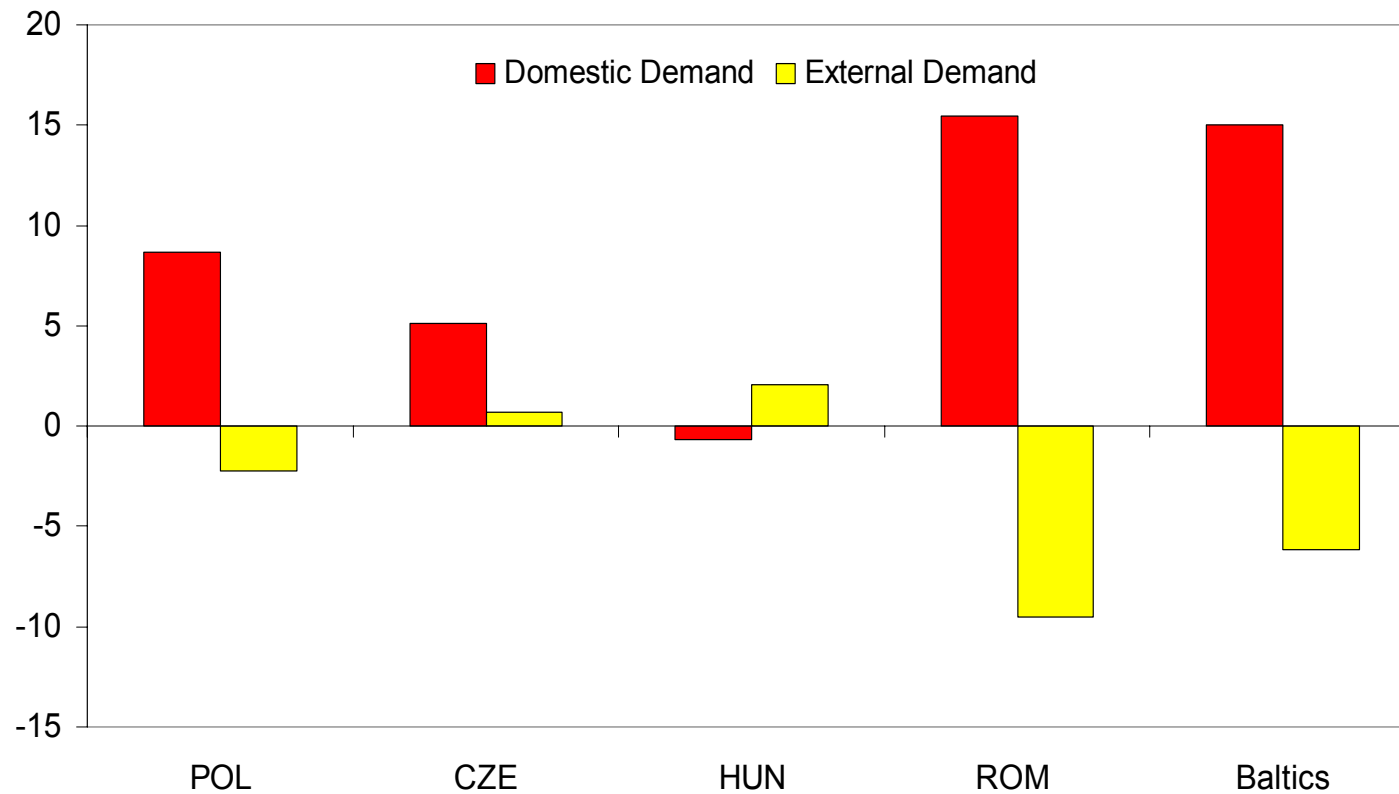
GDP growth (annual)



Source: IMF.

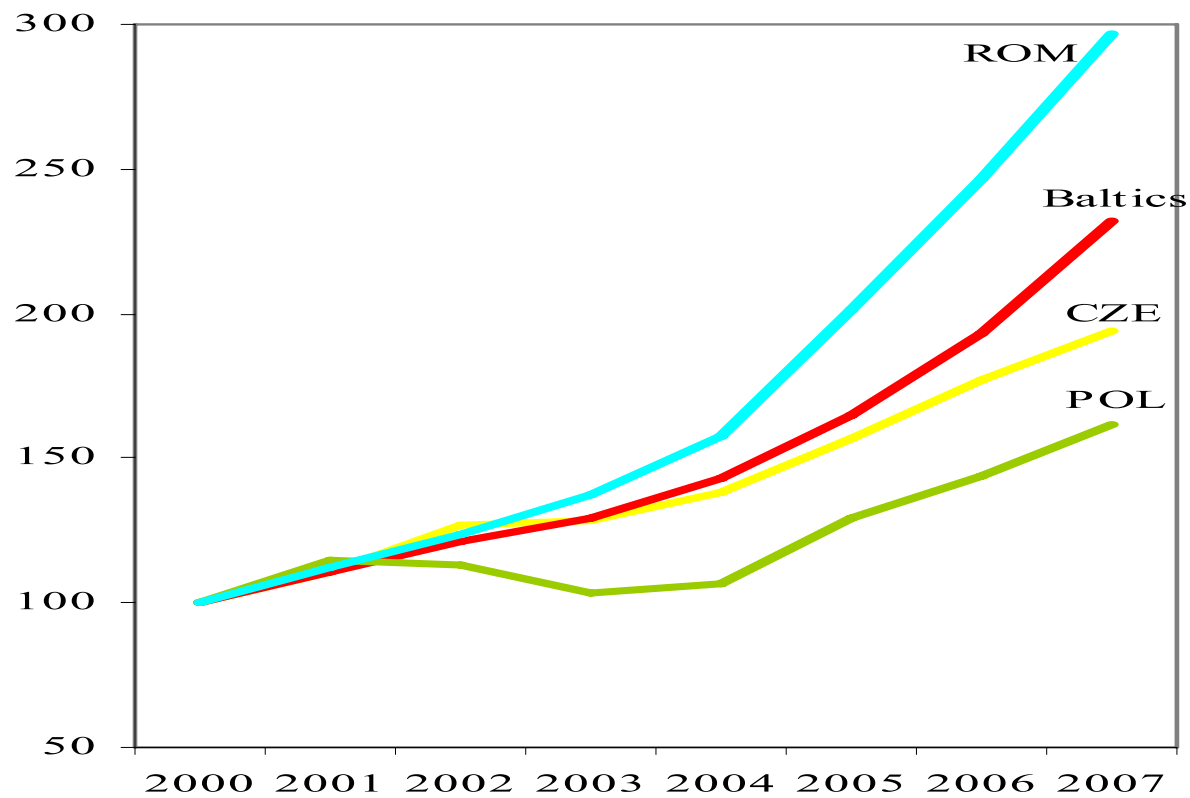
Growth has been driven by domestic demand...

Contribution GDP growth 2007 (annual)



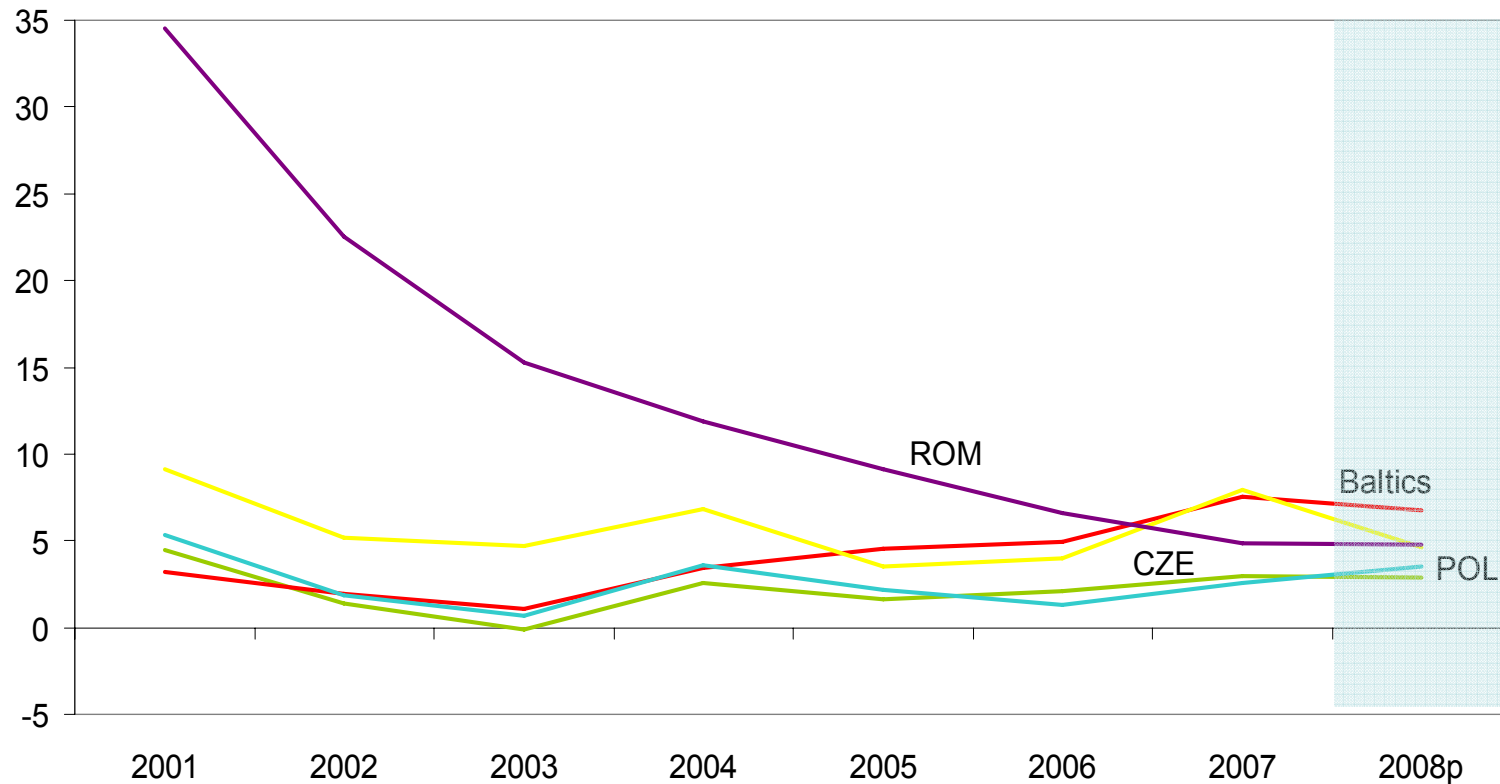
... putting more money in peoples' pockets

Nominal Disposable Income (2000=100)



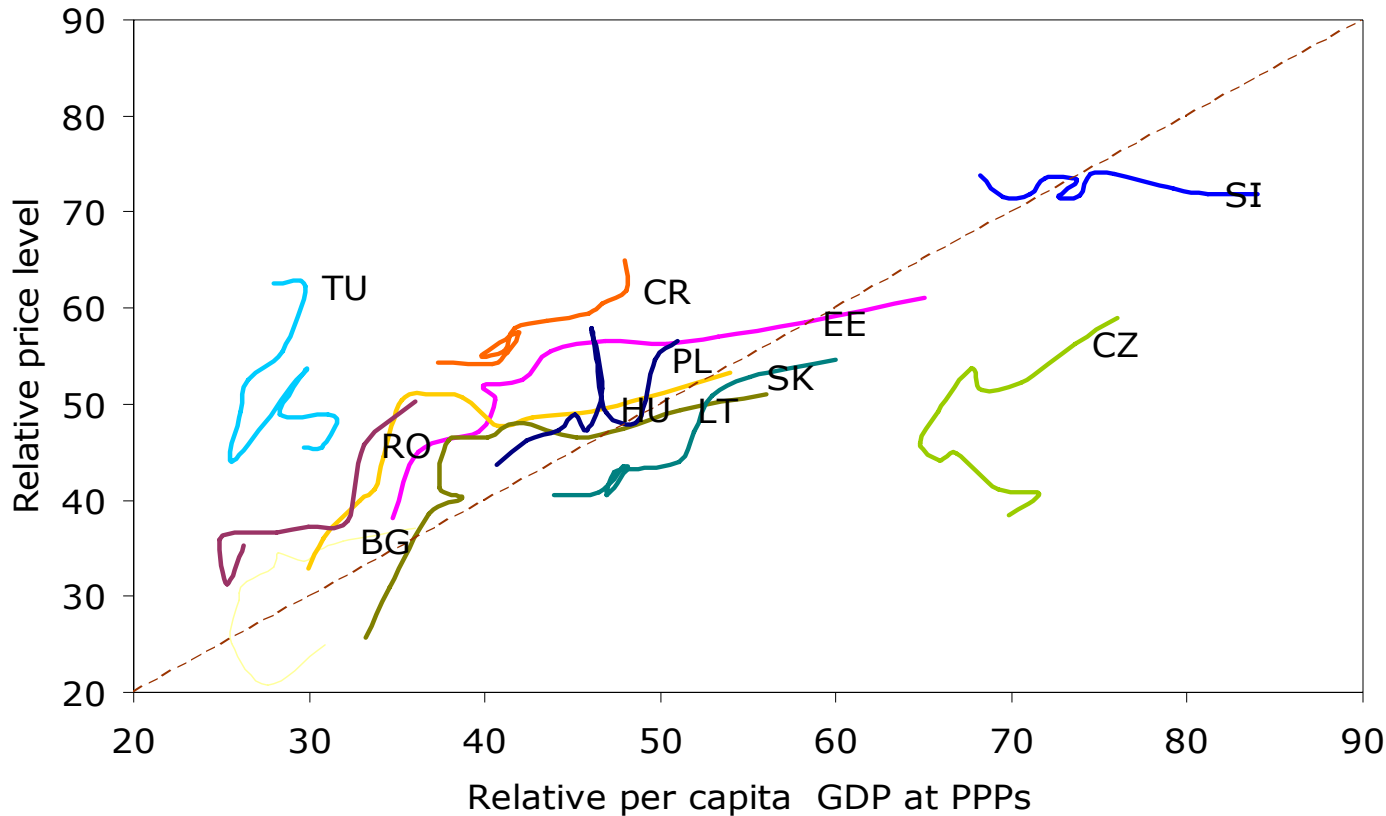
Inflation has been picking up lately, especially in the Baltics...

Average annual inflation



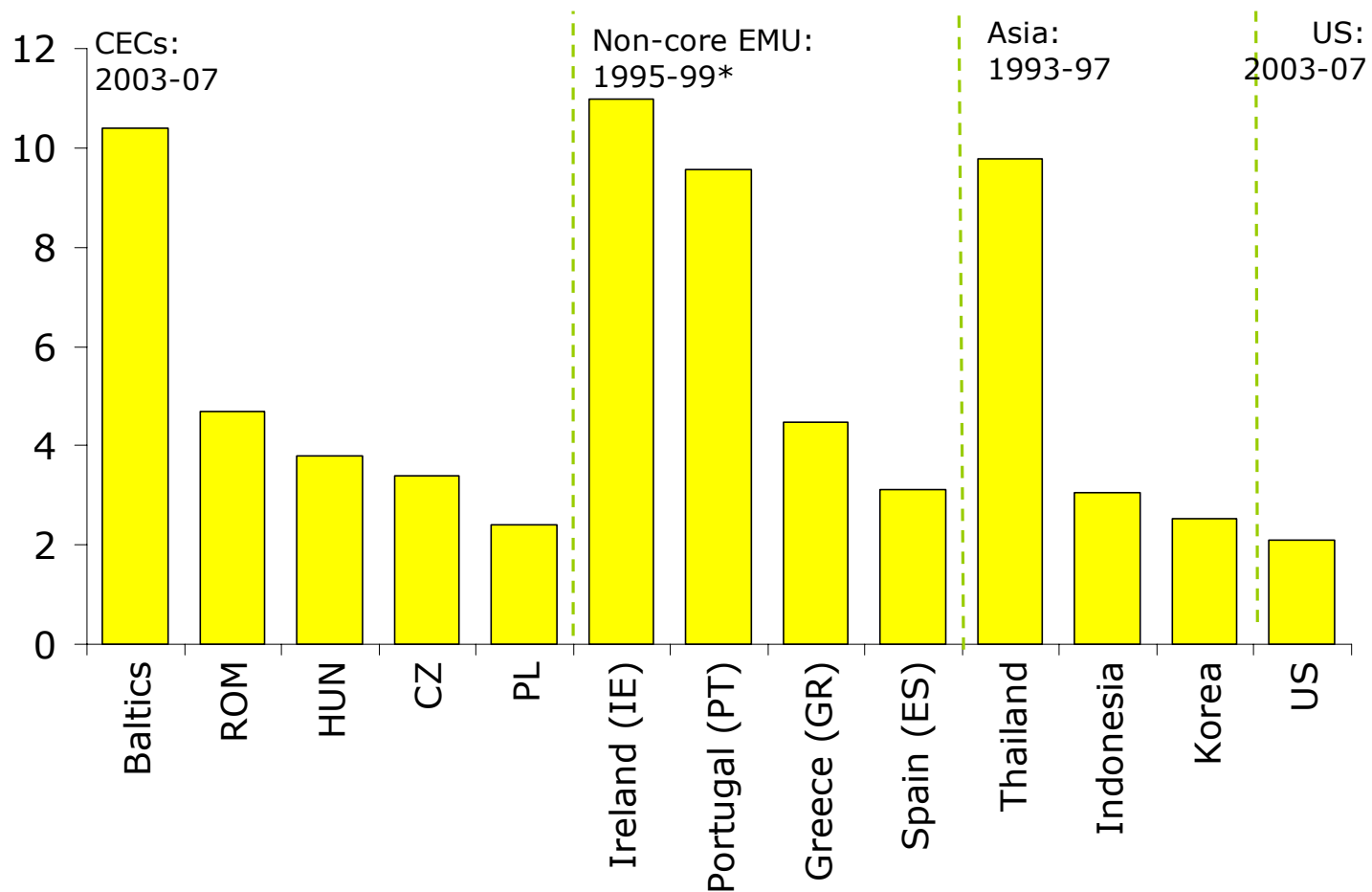
Higher inflation is partly a natural side-effect of convergence (real appreciation)

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



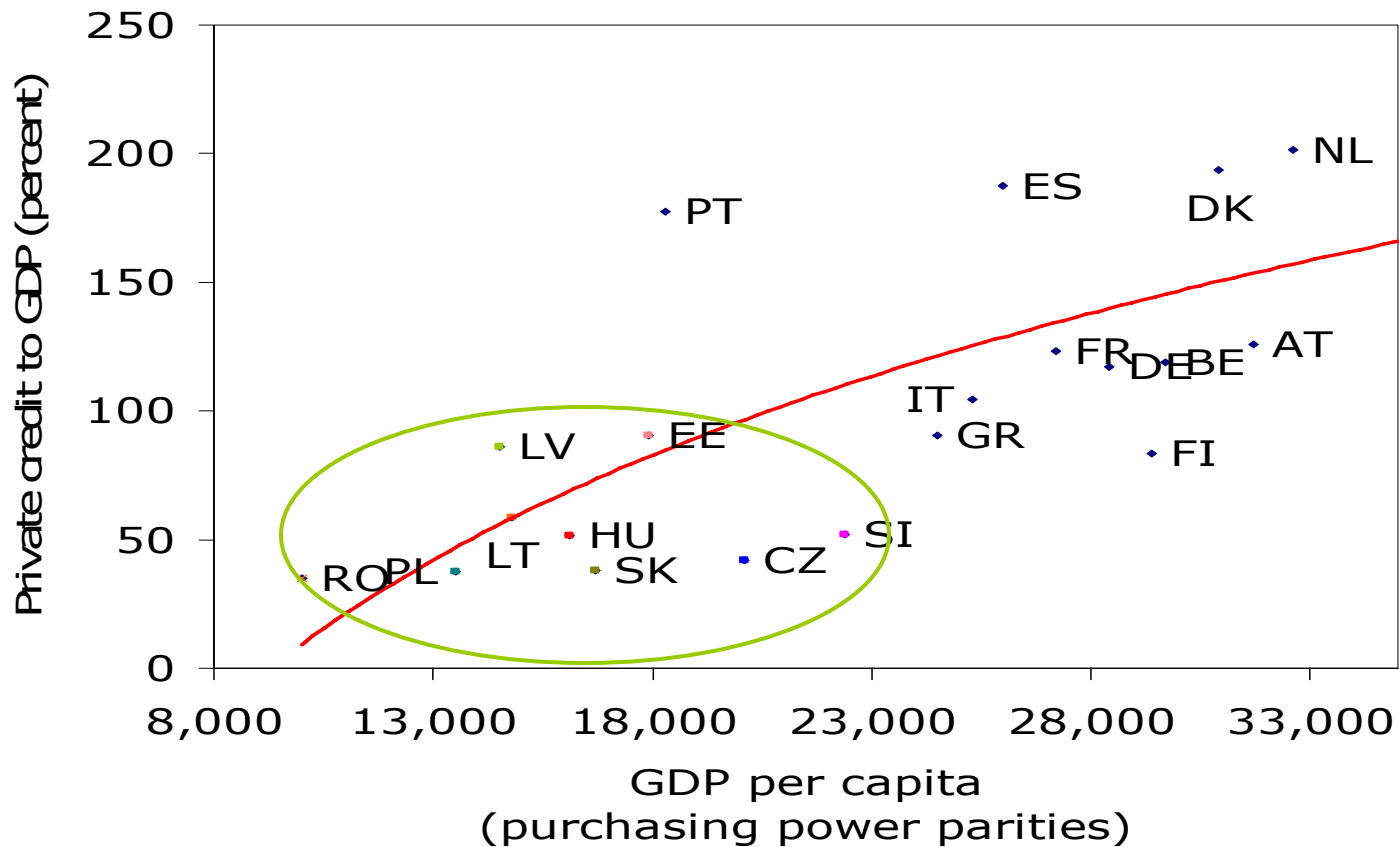
Credit growth has been brisk

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



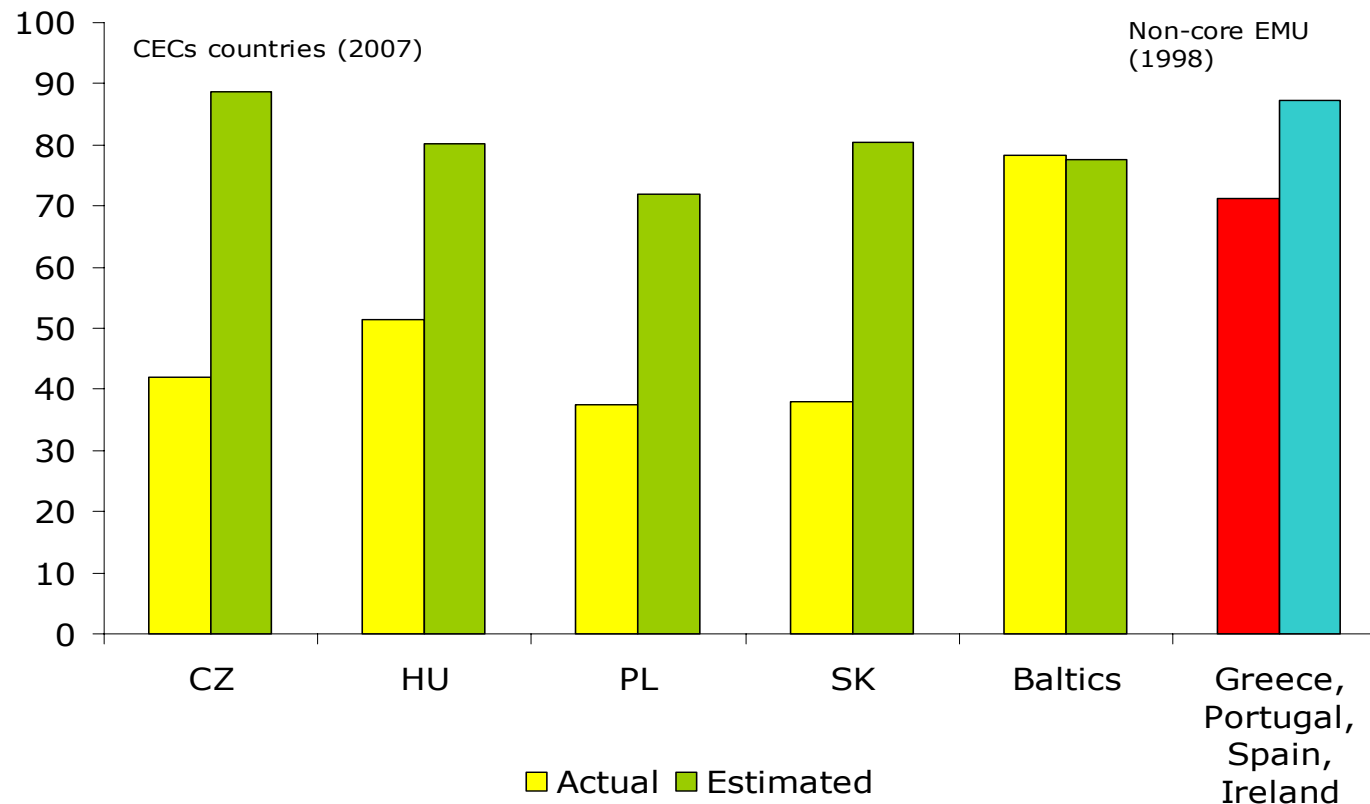
Indebtedness corresponds to income levels

Private credit to GDP and income per capita, EU countries, 2007



Private credit still has much 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)

Some NMS have developed an attractive business environment

World Bank: Doing Business 2008

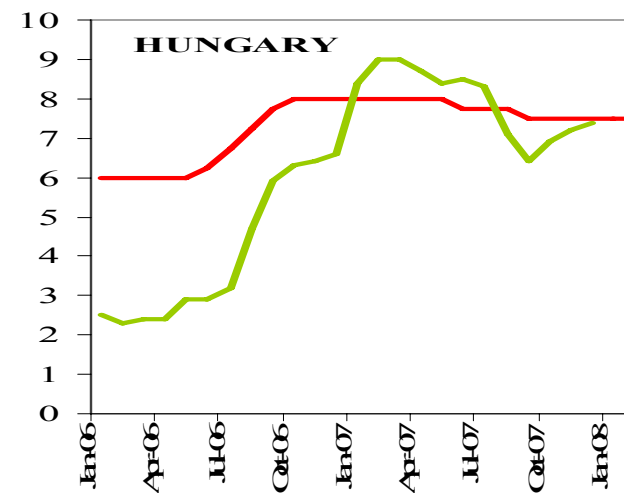
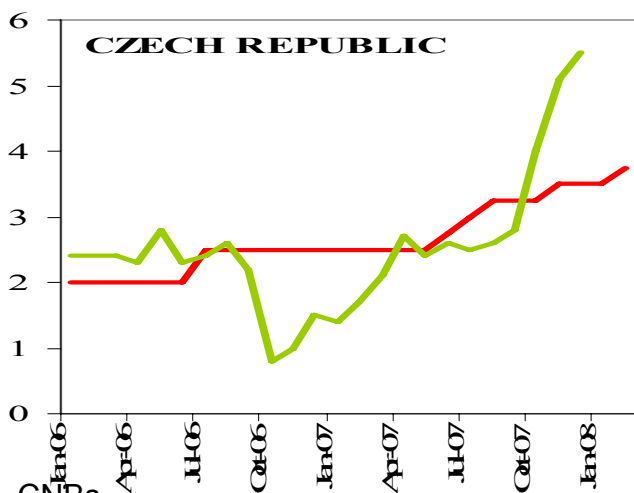
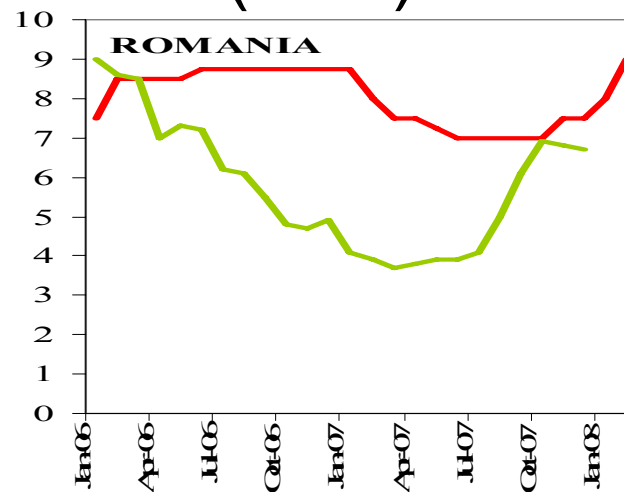
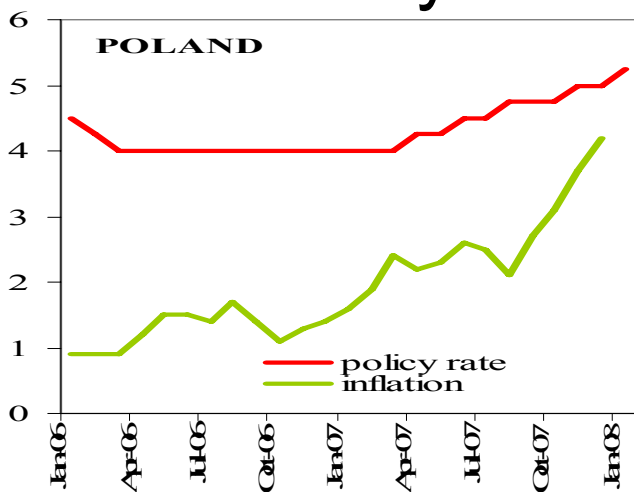
Country	Rank	Country	Rank
Singapore	1	Spain	38
New Zealand	2	Luxemburg	42
United States	3	Hungary	45
Denmark	5	Romania	48
United Kingdom	6	Italy	53
Finland	13	Slovenia	55
Sweden	14	Czech Republic	56
Estonia	17	Poland	74
Belgium	19	China	83
Germany	20	Greece	100
Netherlands	21	Russia	106
Latvia	22	India	120
Austria	25	Brazil	122
Lithuania	26	Guinea-Bissau	176
France	30	Central African Republic	177
Slovakia	31	Congo, Dem. Rep	178
Portugal	37		

Source: WB.

Bumps on the Road

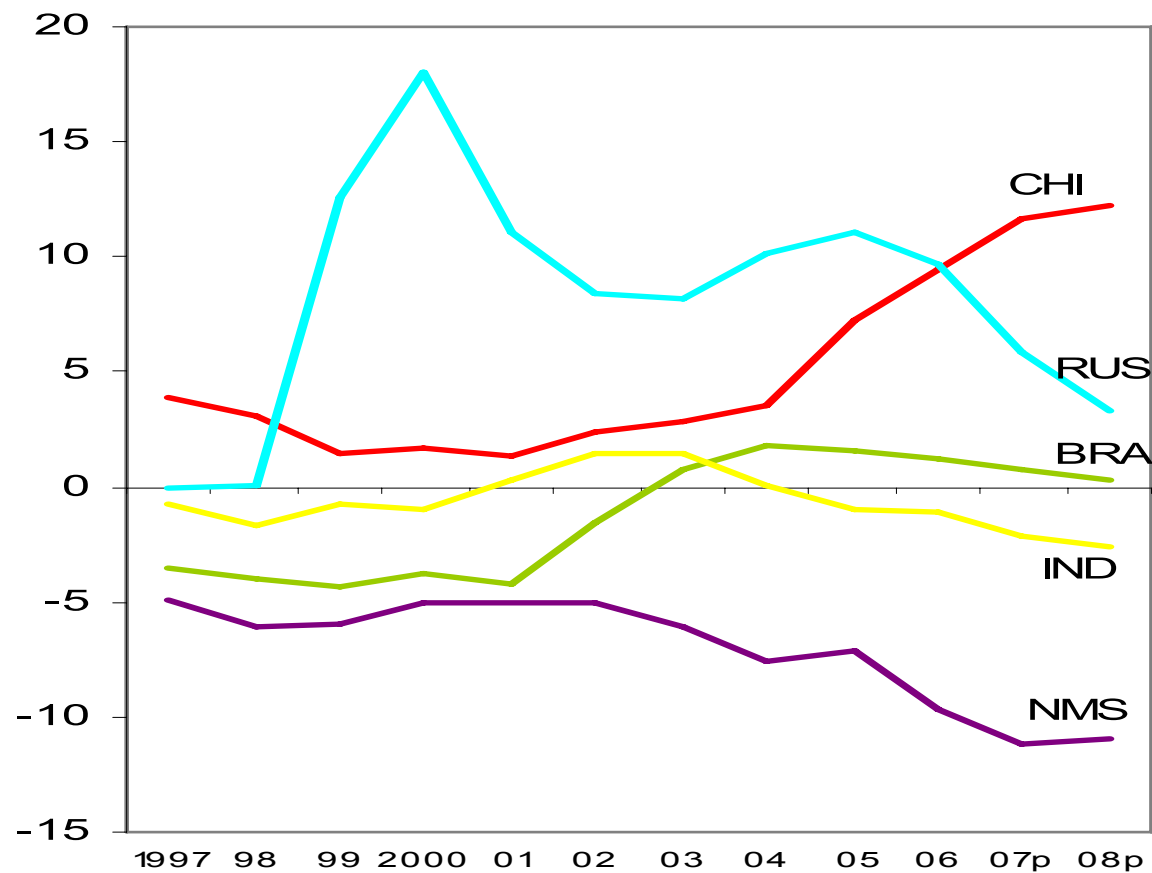
Higher inflation is forcing central banks to hike interest rates

Policy rates, inflation (YoY)



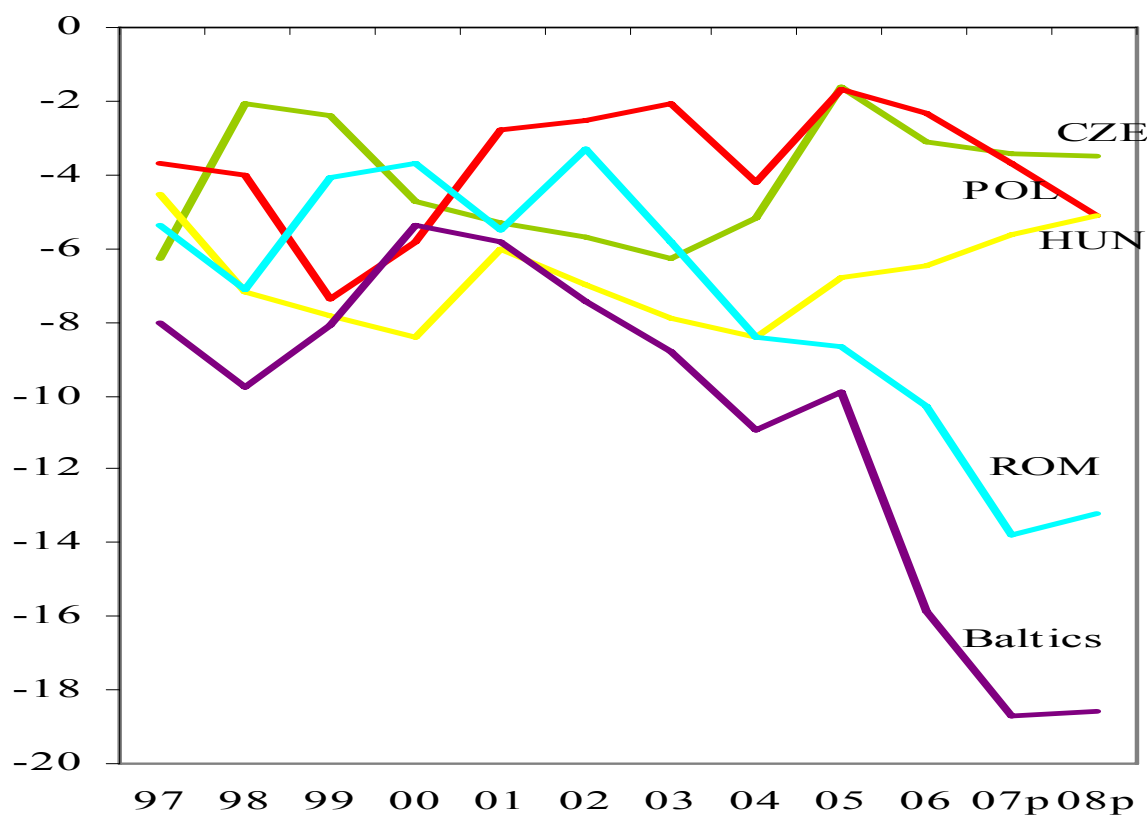
Unlike in other EMs, external imbalances have been growing in the NMS...

Current account balance (percent of GDP)



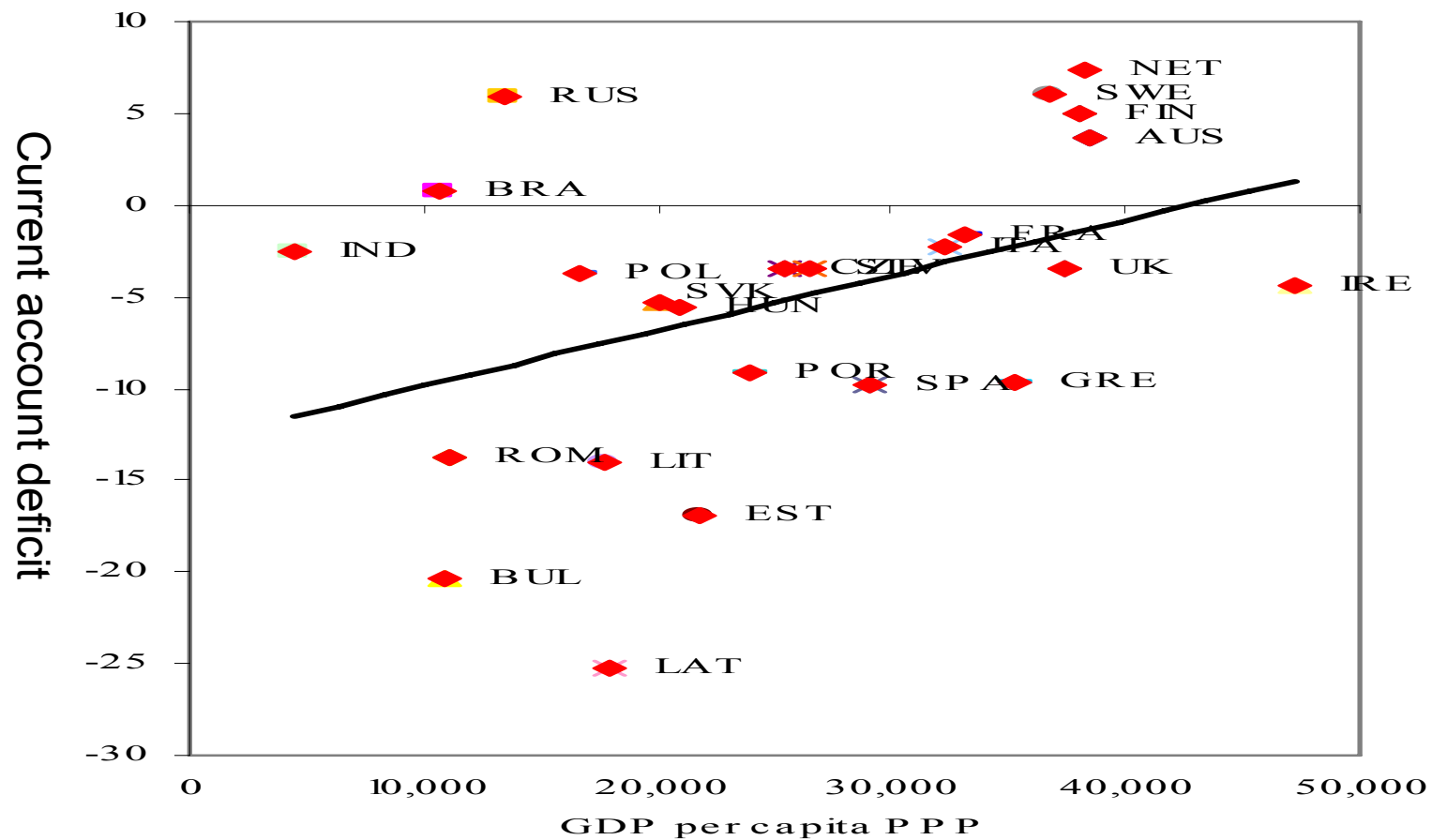
...especially in the Baltics and South Eastern Europe.

Current account balance (percent of GDP)



This largely reflects the convergence process

Current account deficit and GDP PPP per capita



Source: IMF.

Risks associated with large external deficits

Large foreign borrowing needs expose the NMS to the risk of sudden stop

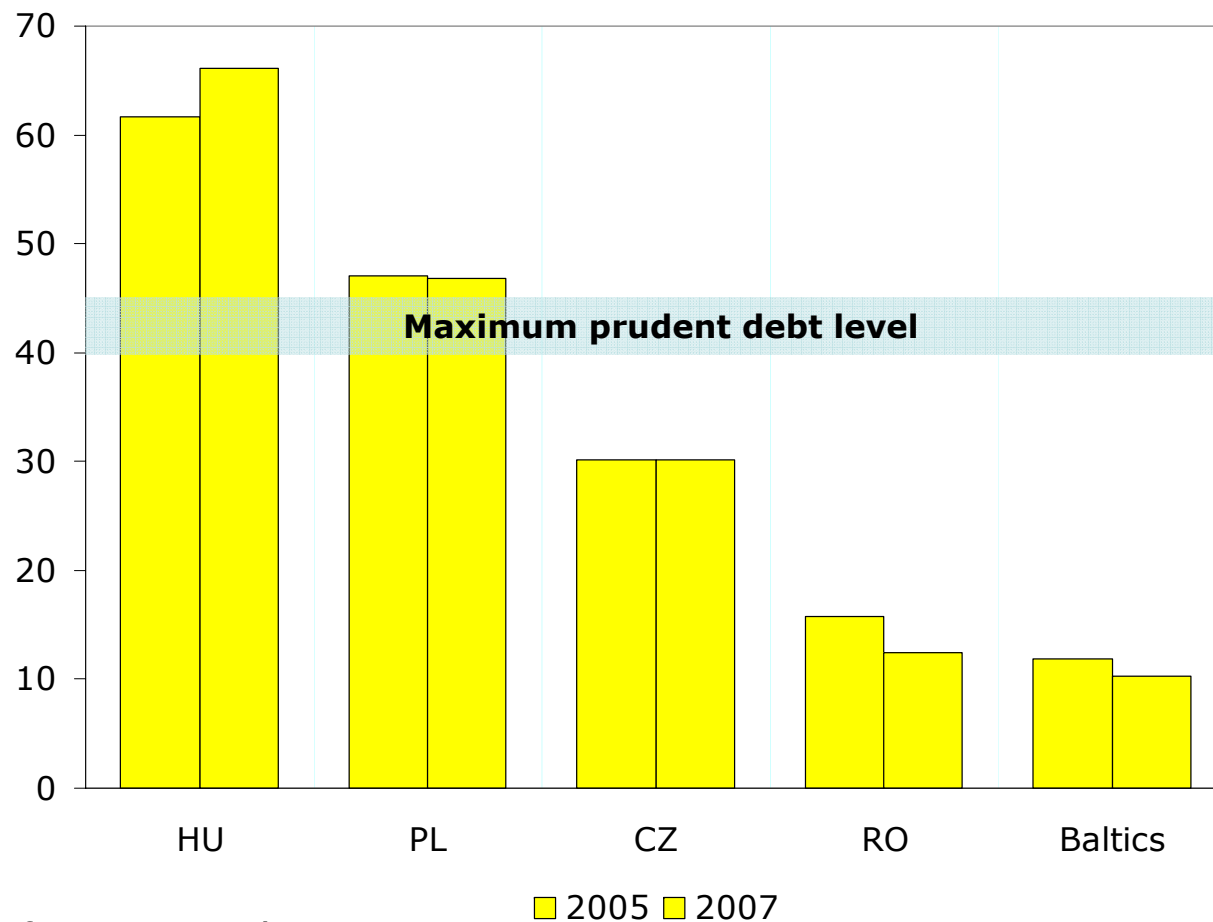
Mitigating factors:

- Equity financing, mainly FDI
- Borrowing from (less footloose) parent banks
- Foreigners are not necessarily more prone to capital flight than residents
- High standards of transparency and governance
(Unlike Asia 1997)

But: Imbalances in the Baltics are clearly out of line with fundamentals

Despite buoyant growth, public debt has not been declining much...

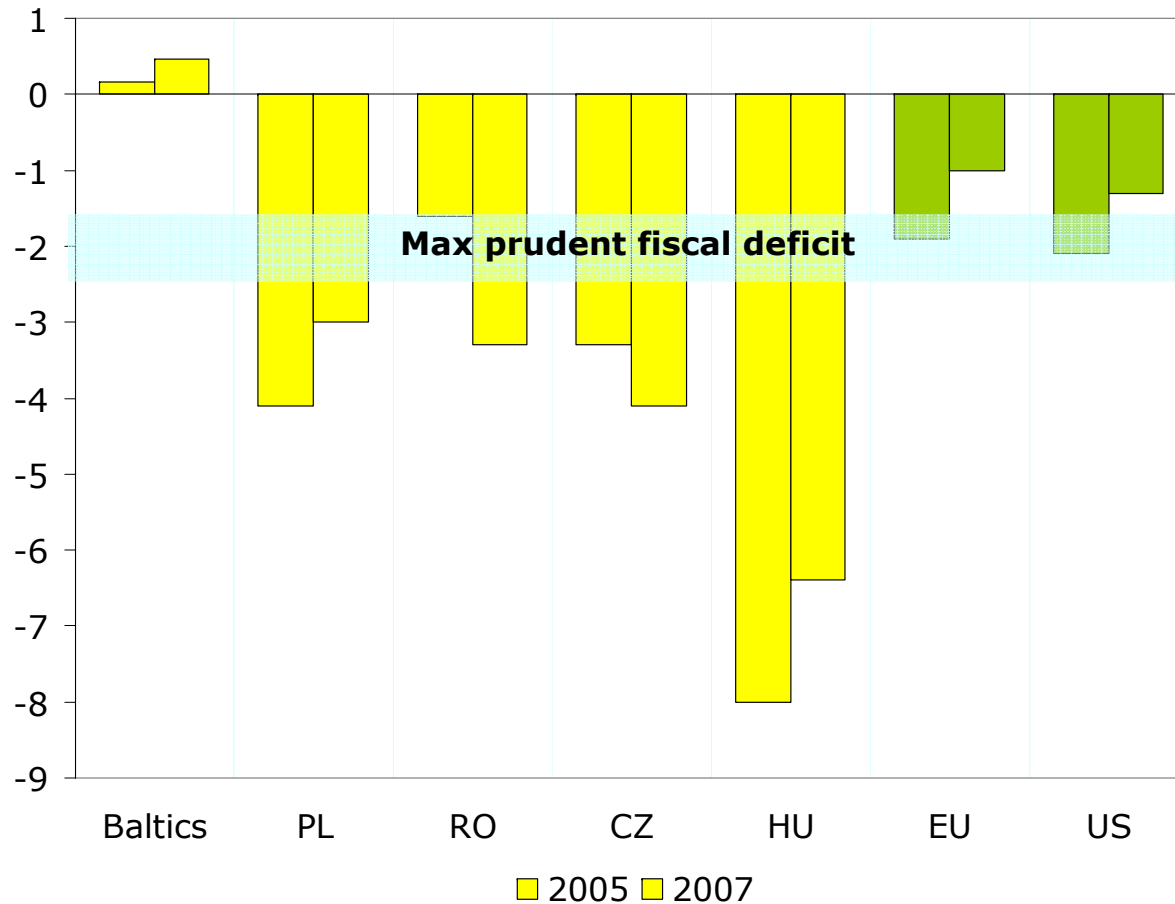
Public debt (percent of GDP)



Source: EC, 'Public finance in EMU', 2007; IMF

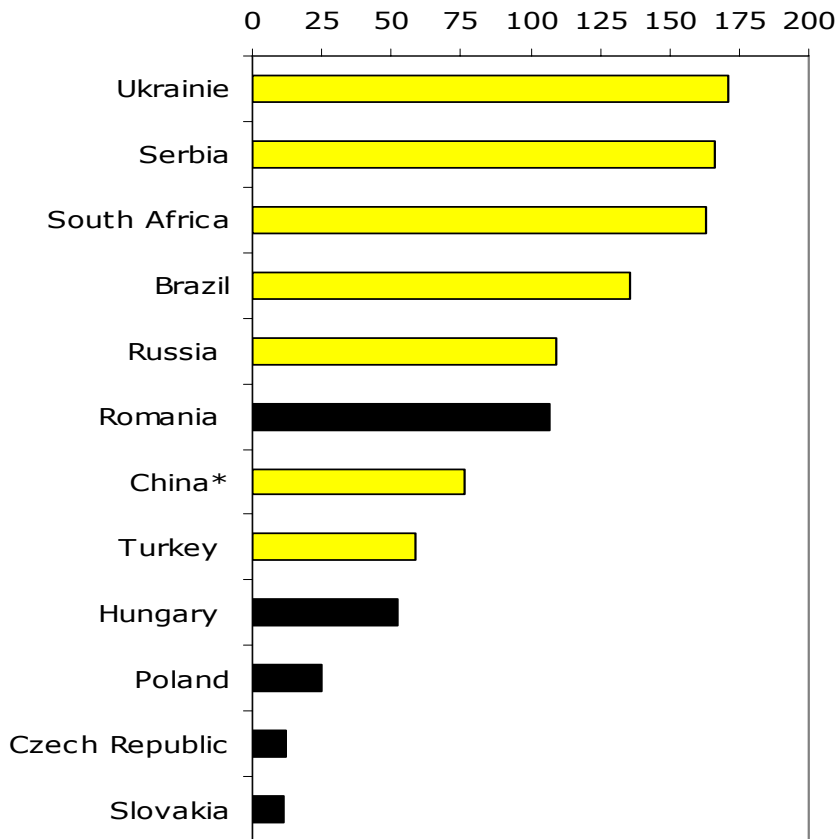
...and structural fiscal balances do not show much improvement

Cyclically-adjusted budget balance (percent of GDP)

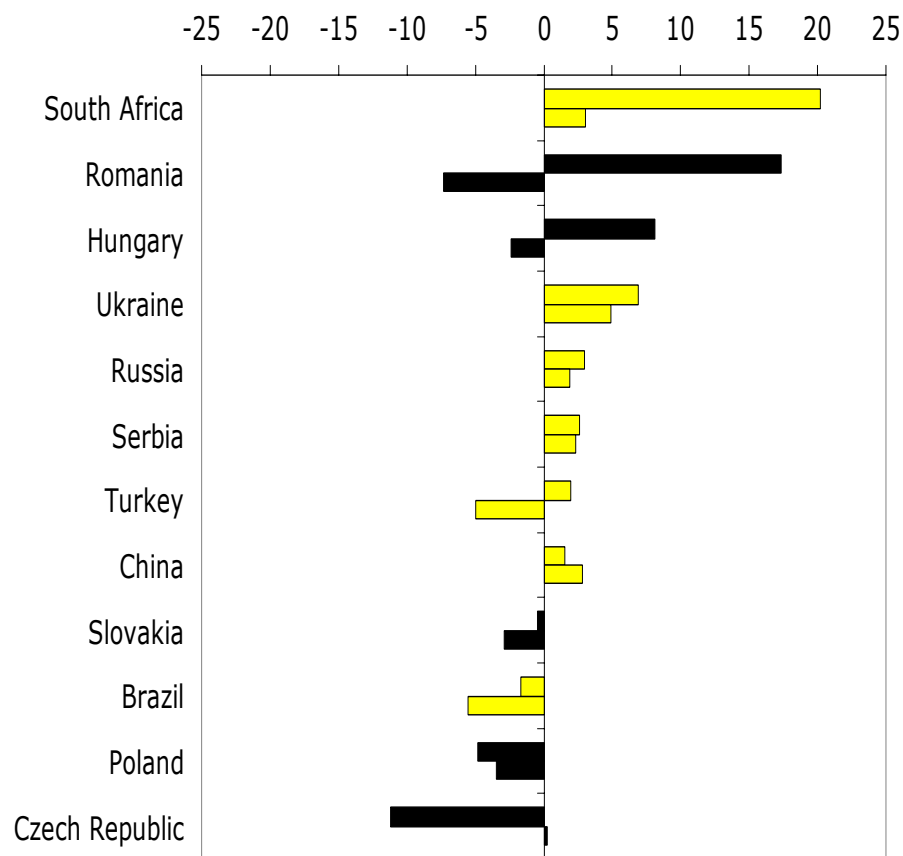


Most NMSs have weathered the subprime market fallout better than other EMs

Change in borrowing spreads (EMBI)
July 16 – February 22 (bps)



Change in the EUR exchange rate
(+= depreciation, percent)
since July 16 vs. 6 months earlier

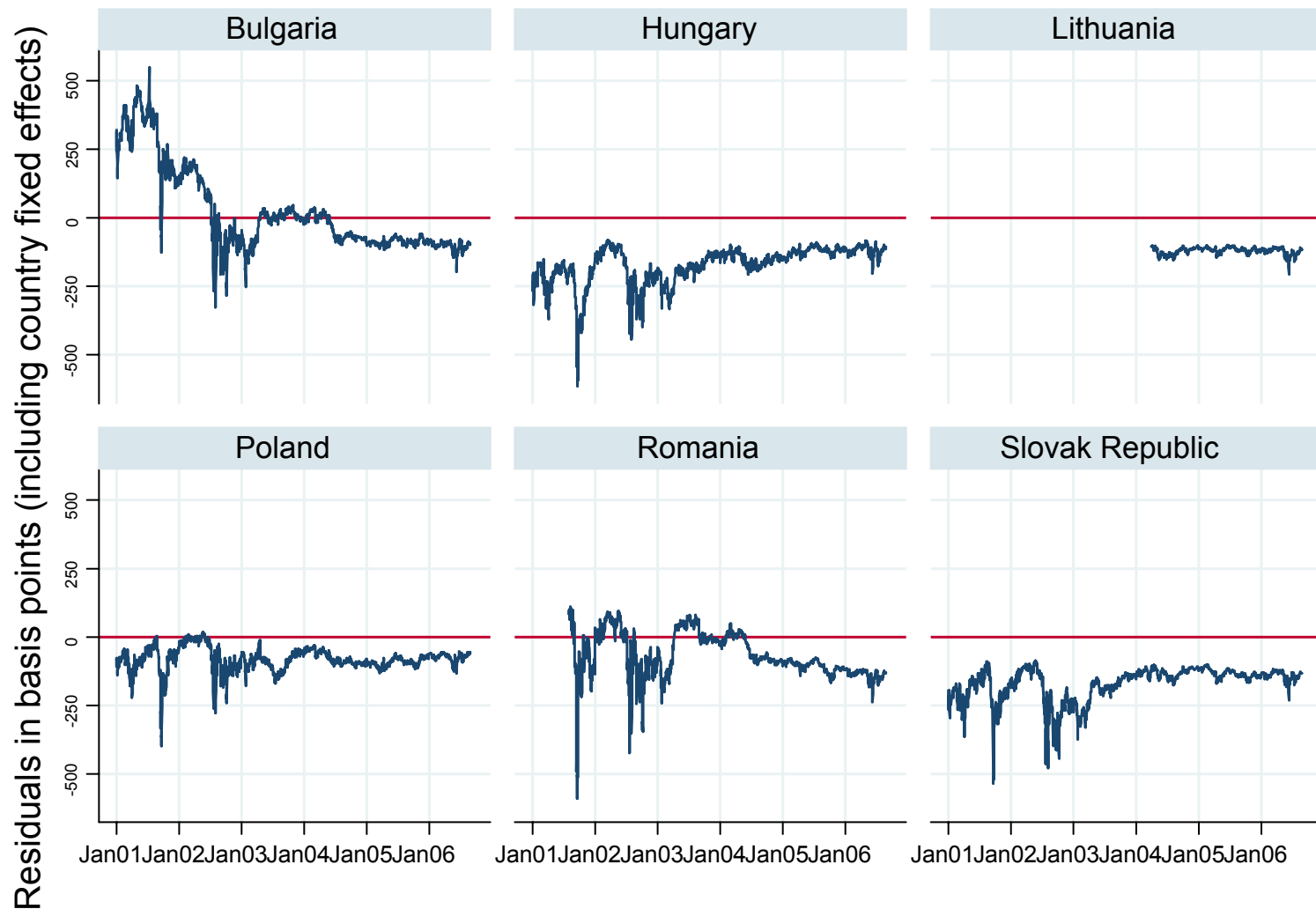


Source: Bloomberg, national statistics.

* FMBI from JPMorgan

This partially reflects the EU “halo effect” which has afforded a 100bp borrowing advantage

Residuals in basis points



Conclusions

- The NMS are in a historic catching-up process, accelerated by joining the EU and prospective euro adoption
- Rapid convergence naturally generates vulnerabilities (“running with your shoelaces open”), but these are mitigated by EU membership
- Fallout to date from the subprime crisis suggests that bumps in the road are manageable in most countries

Thank you!

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