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Ms. Susan Schadler, Deputy Director of the IMF's European department and Mr. Christoph Rosenberg, the IMF's senior regional representative to Central Europe and the Baltics presented on Friday in Budapest, Hungary, at a seminar organized together with ICEG European Center, the highlights of the IMF's *World Economic Outlook*—a review of global economic developments and near-term projections which was released in late-September—focusing on the implications for the economies of Central Europe and the Baltics.

Ms. Schadler painted a generally favorable picture of near term prospects for the global economy: growth is expected to return to its trend of just over 4 percent annually in 2005-06; inflation is subdued, especially in industrial countries; and financial conditions remain benign, with long-term interest rates unusually low. But downside risks are rising.

Favorable global projections are reflected in the Fund's forecast for the euro area. "The domestic demand based recovery in 2004 hit a soft spot in early 2005", she said. But the Fund's projections envisaged that several influences—rising employment, low long-term interest rates, strong profits, and rising exports—should produce a recovery in the second half. The recent strengthening of exports and industrial production, were promising signs. The Fund projections therefore saw GDP growth of 1.2 percent in 2005 and 1.8 percent in 2006, supported by a pick-up in both consumption and investment growth. Core inflation remained low, and though oil prices are now having an effect on headline rates, it should be temporary.

In Central Europe and Baltics, Schadler said, growth is set to continue to exceed the euro area average. But the range of performances is sizable, with the Baltics outperforming the Central European countries and the average for emerging markets. Schadler identified two factors that will be important for growth in the near term: Euro area GDP and export growth, which are rather closely correlated with growth in several of the countries in the region and raising employment levels. Inflation was projected to remain low in most countries: in inflation targeters owing to the growing credibility of the policy framework and, in most of the ERM2 countries, because fiscal policies were tight..

Current account deficits will continue to vary widely across the region. Financing conditions have been benign, and most countries have sizable backing from foreign direct investment. But increases in external debt in some countries could point to problems if unchecked.

On the recent oil price increases, Schadler said that the effects—globally, in the euro area, and in the region—had so far been contained. "For the region, we estimate that a 10 percent increase in oil prices adds about a quarter percentage point to headline inflation," she said. "But with inflation expectations well-anchored, effects could be less." The effect on growth should also not be of large proportions. The IMF estimates that recent increases in oil prices would slow cumulative growth in 2005-06 by about ½ percent, with the energy-intensive Baltic countries affected somewhat more.

Schadler then turned to global imbalances as the key downside risk for the region. The IMF is concerned about historically low levels of savings and investment, widening current account imbalances and possible disruptions to unusually low real long-term interest rates. "These imbalances cannot continue. How they unwind may have profound implications for the Baltics and Central Europe," Schadler said. In a disruptive scenario, where foreigners abruptly stop absorbing US assets, interest rates, exchange rates, interest rates, and growth could change sharply.

This, she said, underscored the importance of reducing vulnerabilities and improving countries' resilience to shocks. "High debt countries need to ensure that well-designed fiscal adjustment is undertaken quickly." Moreover, strong financial sector supervision needed to ensure that rapid credit growth does not weaken the banking sector. She turned the floor over to Mr. Rosenberg to discuss vulnerabilities from these sources.

Rosenberg noted that rapid growth of bank credit to the private sector was driven by low global interest rates and inevitable financial deepening. Nevertheless, the pace of change within the region varied widely, probably reflecting differences in creditor rights, private and foreign bank ownership, public sector crowding out and proximity to Euro adoption. Yet IMF calculations indicate that credit to GDP ratios in most of the new member states are well below levels commensurate with their income levels and economic structures. Rosenberg concluded that credit growth is likely to rise in countries where it has thus far been comparatively slow and to remain rapid in others.

Rosenberg also noted the sizable and in some cases growing shares of foreign currency denominated lending in total bank lending. While credit risks from such lending are low when borrowers hedge or have natural hedges, foreign currency lending to households is likely to be unhedged.

A related development, Rosenberg said, is bank financing of foreign exchange lending by drawing on foreign credit lines. This increases the linkages between banks and opens new channels of contagion. Particularly in high current account deficit countries this could increase vulnerabilities to possible abrupt increases in world interest rates, sudden stops of capital inflows and exchange rate depreciation.

Rosenberg proposed several measures to prevent the build-up of vulnerabilities. First , supervision needed to be kept in top form. He noted that banks in the region are well capitalized and provisioned and banking supervision is generally strong. "Nevertheless, supervisors need to be on high alert to ensure that rapid lending growth does not lead to slips in credit standards." Also, bank supervisors, needed to work closely with counterparts in other countries when cross-border bank exposures are large. And borrowers, especially households, needed to be better informed about the potential risks of foreign currency exposures.

From a macroeconomic viewpoint, rapid credit growth can feed overheating of the economy. Rosenberg noted that in the Baltics, real estate prices and stock market capitalization have

grown by double-digits, driven by strong domestic demand. “In these circumstances, fiscal tightening is a critical tool for containing demand,” he said.

On fiscal policy, Rosenberg painted a mixed picture. Some countries, notably in the Baltics, had low debt and fiscal deficits. But in some Central European countries where debt to GDP ratios were high and rising, fiscal policy was a concern. He argued that debt ratios in the region will need to be lower than in existing Euro-area countries because revenues and debt service are more volatile, adding uncertainty to fiscal outcomes. “Particularly in countries without good fiscal track records, the risk of sudden financing stops is greater”, he added..

IMF analyses suggest that 40-45 percent of GDP is a safe range for public debt ratios in the new member states. This level would ensure that countries can absorb negative shocks without pushing debt to excessive levels. “This implies running fiscal deficits of 2-2½ percent of GDP over the cycle, given recent average growth rates in the region”, Rosenberg added. And for some countries reducing debt to prudent levels in the medium term would require lower deficits during the adjustment.

Several countries have moved away from this target, despite high growth rates, appreciating real exchange rates, and benign global liquidity conditions that lower debt servicing cost. “But the still positive global outlook offers a good environment for undertaking adjustment,” Rosenberg added. In the Baltics, the level of public debt was no constraint on fiscal policy. Nevertheless, fiscal policy had to be tailored to constraining rapid domestic demand growth. “These countries are growing rapidly and fiscal restraint helps avoid overheating,” he said.

Rosenberg argued that sustainable fiscal adjustment needs to start on the expenditure side, by reforming ill-targeted social programs, excessive staffing in government administration, and inefficiencies in education. “Primary expenditure relative to GDP in Central Europe is high by international standards,” Rosenberg said. The Baltics had much leaner public sectors.

Rosenberg pointed to the successful fiscal consolidation in Slovakia. “While its flat tax has been touted as a symbol of pro-business fiscal policy, at least as important was the drop in primary expenditure relative to GDP by 10 percentage points in just four years.” And its tax reform went far beyond flat taxes. “Slovakia’s success lies in the coherence of its reforms.”

On the case for flat taxes, Rosenberg noted that the jury is still out. If properly designed, flat taxes could help improve the business environment, simplify tax administration, fight corruption and avoid tax arbitrage. But there was not convincing evidence that by expanding the tax base the introduction of flat taxes paid for itself. Indeed a recent IMF study of Russia’s experience found that after controlling for factors such as wage growth and simultaneous reforms in tax administration, tax compliance and labor supply were unaffected by the introduction of a flat tax.