Central, Eastern and Southeastern Europe (CESEE)

Recovery at risk? - CEE external vulnerability and Poland Article IV preliminary conclusions

CASE, Warsaw - May 27, 2014
James Roaf
Senior Resident Representative
IMF Regional Office for Central and Eastern Europe
Outline

Outlook for the region

External funding patterns and risks

Policy priorities

Poland Article IV
Growth picked up in 2013H2...

CESEE excl. RUS & TUR: Contributions to Real GDP Growth
(Percent)

Euro area - real GDP growth
- Real GDP growth
- Domestic Demand
- Net exports
Drivers of growth different across region...

<table>
<thead>
<tr>
<th>Region</th>
<th>Real GDP growth</th>
<th>Consumption</th>
<th>Investment</th>
<th>Net exports</th>
</tr>
</thead>
<tbody>
<tr>
<td>CEE</td>
<td>-4, 0, 4</td>
<td>-4, 0, 4</td>
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<td>SEE</td>
<td>-4, 0, 4</td>
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<tr>
<td>Russia</td>
<td>-4, 0, 4</td>
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<td>Turkey</td>
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- Real GDP growth
- Consumption
- Investment
- Net exports
... but recovery is mostly “creditless” ...
... while external funding flows became more volatile post-taper talk

CESEE excl. RUS & TUR: Capital Flows
(Billions of US dollars)
Growth is expected to accelerate...

**CESEE excl. RUS & TUR: Contributions to Real GDP Growth**

(Percent)

Euro area - real GDP gro

Real GDP growth

Domestic Demand

Net exports

2009Q1  2010Q1  2011Q1  2012Q1  2013Q1  2013Q4  2014  2015
...but projections have been revised downwards.

Real GDP Growth, 2014
(Percent)

Oct 2013 WEO
...but projections have been revised downwards.

Real GDP Growth, 2014
(Percent)

Apr 2014 WEO
Key Risks

- Protracted weak growth in euro area
- Increasing geopolitical tensions
- Global financial market volatility
Risks from geopolitical tensions: trade linkages with Russia and Ukraine

Exports to Russia and Ukraine
(Percent of trading partner GDP)

- Red: > 10
- Orange: 5 - 10
- Yellow: 2 - 5
- Green: 0 - 2

Map showing the percentage of exports to Russia and Ukraine as a percentage of trading partner GDP.
Risks from geopolitical tensions: Dependence on Russian gas

Imports of gas imports
(Percent of total gas consumption)

- > 75
- 50 - 75
- 25 - 50
- 0 - 25
CESEE External Funding Patterns and Risks

1. External Funding Structures

2. External Funding Conditions
CESEE External Funding Patterns and Risks

1. External Funding Structures

2. External Funding Conditions
High dependence on external funding

Gross External Liabilities
(Percent of GDP)

2008

Baltics
CEE
SEE
East3
RUS
TUR
CESEE

High dependence on external funding
High dependence on external funding

Gross External Liabilities (Percent of GDP)

2012

Average of other EMs
Significant share is FDIs

Gross External Liabilities
(Percent of GDP)

2012

FDI stock
Private sector accounts for most of the external debt

External Debt
(Percent of GDP)

2012

Average of other EMs
Funding structure matters

Private External Debt Structures
(Percent of GDP, 2012)

- Debt securities
- Direct cross-border lending
- Parent bank lending
- Inter-company lending
Taking out funding from affiliated entities gives a different picture.

**Private External Funding from Non-Affiliated Sources**
(Percent of GDP, 2012)

- **Debt securities**
- **Direct cross-border lending**
FX risks arise from external borrowing, but also from FX or FX-linked domestic loans.
Public sector is exposed to foreign funding and exchange rate risks as well…

Public Debt and Foreign Exchange Risks
(Percent of GDP, 2013)
Some countries have both high external and fiscal financing needs.
To sum up: sources of external funding risks

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<th><strong>Stock vulnerabilities</strong></th>
<th><strong>Flow vulnerabilities</strong></th>
<th><strong>External fundamentals</strong></th>
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<tbody>
<tr>
<td>Stock of debt</td>
<td>External financing needs</td>
<td>Exchange rate misalignment</td>
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<td>External funding from non-affiliated sources</td>
<td>Fiscal financing needs</td>
<td>Reserve buffers</td>
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<tr>
<td>Debt denominated or linked to FX</td>
<td>Funding costs</td>
<td></td>
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</table>
Countries susceptible to external funding risks

External Fundamentals

Stock Vulnerability

Flow Vulnerability

EST
SVN
BLR
HRV
HUN
SRB
TUR

Countries: EST, SVN, BLR, HRV, HUN, SRB, TUR
CESEE region has undergone large scale foreign bank funding reduction since the crisis.

**External Position of BIS-Reporting Banks, 2003:Q1-2013:Q3**

(Billions of US dollars, exchange-rate adjusted vis-à-vis all sectors)

- Blue line: CESEE
- Red line: CESEE ex. RUS & TUR

Timeline:
- Oct-08
- Sep-11
- May-13

Years:
- 2003:Q1
- 2006:Q3
- 2010:Q1
- 2013:Q3
Reversal of portfolio inflows since taper talk

Cumulative EPFR Flows into CESEE ETFs and Mutual Funds

(Billions of US dollars)

- Jan-03
- Oct-08
- Jul-07
- Sep-11
- Jan-12
- May-13
- Apr-14

Bond
Equity
... accompanied by a divergence in bond market spreads
While external factors are important, domestic fundamentals also matter.
Near term policy priorities

- Monetary & Exchange Rate Flexibility
- Targeted Liquidity Provision
- Active Debt Management
- International Cooperation
Medium term policy priorities

- Rebuild Fiscal Buffers
- Address Crisis Legacies
- Address Structural Weaknesses
- Diversify Funding Sources
Outline

- Outlook for the region
- External funding patterns and risks
- Policy priorities
- Poland Article IV
Main messages from annual consultation

- Steady recovery from 2012-13 slowdown
- External risks remain, FCL helps
- Inflation low, challenge for monetary policy
- Fiscal consolidation at appropriate pace
- Pension system changes don’t address legacy issues
- Financial sector resilient, but supervisory framework needs further work
- Labor market and business climate reforms needed
Recovery picking up momentum
Real rates rising as inflation falls

Policy rate

y/y inflation rate

(percent)
Calibrated fiscal policy

(percent of GDP)

Structural deficit

Headline deficit

Back
Pension changes

- Improve fiscal aggregates by about 30 percent of GDP in present value terms
- But implicit liabilities rise in turn
- Liquidity in bond and equity markets could fall
- Legacy flaws pose long-term risks
  - fix zero floor in indexation mechanism
  - align disability pension formula with regular benefits
  - address imbalances in special occupational schemes
  - low replacement rates threaten old-age poverty and fiscal pressures
Main messages from annual consultation

- Steady recovery from 2012-13 slowdown
- External risks remain, FCL helps
- Inflation low, challenge for monetary policy
- Fiscal consolidation at appropriate pace
- Pension system changes don’t address legacy issues
- Financial sector resilient, but supervisory framework needs further work
  - fix legal and tax obstacles to NPL resolution
  - restructure credit unions
  - finalize Systemic Risk Board legislation
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