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...

- CEE (Percent)
- SEE (Percent)
- Russia (Percent)
- Turkey (Percent)

- Real GDP growth
- Consumption
- Investment
- Net exports
... but recovery is mostly “creditless” ...
... while external funding flows became more volatile post-taper talk.
Growth is expected to accelerate...

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

(Percent)

<table>
<thead>
<tr>
<th>Year</th>
<th>2009Q1</th>
<th>2010Q1</th>
<th>2011Q1</th>
<th>2012Q1</th>
<th>2013Q4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net exports</td>
<td>![Net exports graph]</td>
<td></td>
<td></td>
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</tr>
<tr>
<td>Domestic Demand</td>
<td>![Domestic Demand graph]</td>
<td></td>
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<tr>
<td>Real GDP growth</td>
<td>![Real GDP growth graph]</td>
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</table>

- Euro area - real GDP growth
- Real GDP growth
- Domestic Demand
- Net exports
...but projections have been revised downwards.

Real GDP Growth, 2014
(Percent)

Oct 2013 WEO

BGR  HRV  SVN  CZE  HUN  ROU  ALB  BIH  MNE  POL  MD  LTU  SVK  EST  BLR  UVK  MDA  RUS  RUS  TUR  SRB
...but projections have been revised downwards.
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)

- > 10
- 5 - 10
- 2 - 5
- 0 - 2
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
High dependence on external funding

Gross External Liabilities
(Percent of GDP)

2012

Baltics
CEE
SEE
East3
RUS
TUR
CESEE
Average of other EMs
Significant share is FDIs

Gross External Liabilities
(Percent of GDP)

FDI stock

2012
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.
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)

- **Rest**
- **Public debt exposed to FX risk**
Some countries have both high external and fiscal financing needs.
To sum up: sources of external funding risks

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

- External Fundamentals
  - EST
  - SVN
  - HRV
  - HUN
  - SRB
  - BLR
  - TUR

- Stock Vulnerability
- Flow Vulnerability
CESEE External Funding Patterns and Risks

1. External Funding Structures

2. External Funding Conditions
CESEE region has undergone large scale foreign bank funding reduction since the crisis …


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

Oct-08  Sep-11  May-13

CESEE  CESEE ex. RUS & TUR
Reversal of portfolio inflows since taper talk

Cumulative EPFR Flows into CESEE ETFs and Mutual Funds
(Billions of US dollars)

- Bond
- Equity

Jan-03 | Jul-07 | Oct-08 | Sep-11 | May-13 | Apr-14
... accompanied by a divergence in bond market spreads

EMBIG Spreads Indices, Jan 2013 - Apr 2014
(May 21, 2013 = 100)

BLR RUS TUR & UKR (simple avg.)
Others (simple avg.)

May 22, 2013
Jan 21, 2014
While external factors are important, domestic fundamentals also matter

External and Domestic Drivers
(Percent of variance)

- **External factors**
- **Domestic factors**
- **Residual**

<table>
<thead>
<tr>
<th>Metric</th>
<th>CDS/EMBIG spreads</th>
<th>Local bond yields</th>
<th>Portfolio flows</th>
<th>Cross-border bank flows</th>
</tr>
</thead>
<tbody>
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<td>Percent of variance</td>
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</table>
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
Thank you!