IMF Spring 2014 "Regional Economic Issues" Report for CESEE Recommends:

Safeguarding the Recovery as the Global Liquidity Tide Recedes

Summarized by Christina Lerner

The recent recovery of the euro area economies has also fueled growth in most Central, Eastern and Southeastern European countries. As outlined in the IMF's Spring 2014 Regional Economic Issues[1] report for CESEE,[2] the region – excluding the two largest economies, Russia and Turkey[3] – is projected to grow by 2.3% in 2014 (compared with 1.2% in 2013). Growth in the CESEE countries will, however, be weaker than previously expected.

While recovery is underway, it is strongly dependent on exports and on external demand. At the same time, improvements in domestic conditions have been uneven, and growth is threatened by an unusual constellation of risks:

External funding conditions have become more volatile since mid-2013. Foreign bank funding has continuously been reduced. In the third quarter of 2013, portfolio flows to CESEE (excluding Russia and Turkey) turned negative for the first time since 2009. Further downside risks comprise increasing geopolitical tensions, protracted weak growth in the euro area and global financial market volatility. The escalation of the crisis in Ukraine has introduced new risks for the region.

Funding Structures and Vulnerabilities

The increased volatility of external financial conditions represents a threat to the CESEE economies as they are highly reliant on external funding and hence strongly susceptible to external funding shocks, given above all their high stocks of external debt and sizable refinancing needs as well as their strong reliance on relatively few common creditors. In addition, a significant degree of financial euroization in the region further increases the risks stemming from large foreign currency exposures. Moreover, the outlook is clouded by increased foreign investor participation in local bond markets and the extended role of foreign institutional investors in these markets.

Both public and private sectors in CESEE countries rely on external borrowing. The main foreign creditors are EU Member States, with the relative importance of Western creditors being linked to geographic proximity. The REI report finds higher bond market rates in advanced economies, higher investor risk aversion and tighter global liquidity conditions to contribute to increasing spreads and lower funding flows to CESEE countries.

[1] *Regional Economic Issues (REI) reports, published biannually by the IMF, cover analytical issues of interest to policymakers, academics and the broader public in the relevant region. The CESEE REI Spring 2014 has a special focus on funding structures and risks.*

[2] *CESEE refers to Albania, Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, the Czech Republic, Estonia, Hungary, Kosovo, Latvia, Lithuania, FYR Macedonia, Moldova, Montenegro, Poland, Romania, Russia, Serbia, the Slovak Republic, Slovenia, Turkey, and Ukraine.*

[3] *The two largest economies – Russia and Turkey – have shown divergent growth patterns from the rest of CESEE: In Russia, growth decelerated sharply to 1.3% in 2013 and seems to mirror a considerable slowdown in growth potential. In Turkey, recovery gained momentum in 2013, but large exchange rate adjustments, recent monetary tightening and macroprudential measures will contain domestic demand and hence GDP growth going forward.*

Policy Priorities

As regards the policies to be pursued, the CESEE REI report states that many countries in the region lack policy space: fixed exchange rate regimes, elevated fiscal deficits and above-target inflation impede policy flexibility. Furthermore, there are still crisis legacies to be addressed, such as high levels of nonperforming loans.

The REI report recommends that, as growth becomes more robust, most countries should:

- Diversify funding sources and deepen the local investor base, in order to reduce the countries' susceptibility to external funding shocks.
- Strengthen fiscal positions: Rebuilding fiscal space contributes to lowering vulnerabilities and provides room for policy support. Stronger policies and buffers would help mitigate external shocks and also unlock higher growth potential.
- Boost growth through structural reforms: Enhancing competitiveness in the tradable sector and reducing labor market rigidities would help CESEE countries to better cope with external shocks, particularly in light of low exchange rate flexibility.