International Monetary Fund

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2014 Spring REI for Central, Eastern and Southeastern Europe: Safeguarding the Recovery as the Global Liquidity Tide Recedes

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The International Monetary Fund (IMF) launched today in Istanbul, Turkey, its Spring 2014 Regional Economic Issues (REI) for **Central, Eastern and Southeastern Europe** (CESEE). The REI, which was first introduced by the IMF's European Department in April 2013, covers analytical issues of interest to policy makers, academics, and the broader public in the region. The focus of the Spring 2014 REI is on CESEE external funding patterns and risks.

Growth is picking up in most of the region in the wake of the recovery in the euro area. CESEE as a whole excluding the largest economies—Russia and Turkey—is projected to grow by 2.3 percent in 2014, almost twice last year's pace.

But an unusual constellation of risks clouds the outlook. External funding conditions have become more volatile since mid-2013. In addition to the ongoing reduction in foreign bank funding, portfolio flows to CESEE excluding Russia and Turkey turned negative in 2013Q3 for the first time since 2009. While flows rebounded in 2013Q4, pressures may re-emerge if risks stemming from further escalation of geopolitical tensions in the region, further bouts of financial volatility along the path towards monetary policy normalization in advanced economies, and the possibility of protracted weak growth in the euro area were to materialize.

Many CESEE countries are susceptible to external funding shocks due to relatively high stocks of external debt, large financing needs, sizable foreign currency exposures and reliance on relatively few common creditors. While many CESEE countries have greatly improved their current account positions in recent years, vulnerabilities to external shocks persist because of their relatively high stock of external debt and the associated large refinancing needs. CESEE countries' sensitivity to changes in global financial conditions stems from their high degree of foreign currency exposure, increased foreign investor participation in local bond markets, increased role of foreign institutional investors in those markets, and reliance on relatively few common creditors.

Tighter and more volatile external financial conditions would have a net negative—but likely manageable—effect on CESEE. While faster U.S. economic recovery would boost CESEE growth, for most countries that could be more than offset by the contractionary impact of tighter global monetary conditions and financial market volatility that could accompany faster-than-anticipated monetary policy normalization in the U.S. Some CESEE countries may also face further reductions in bank flows if the euro area asset quality review (AQR) and stress tests add to deleveraging pressures on parent banks with significant exposures to the region.

Strong policies and buffers will help safeguard against external shocks and unlock higher growth potential. More specifically,

- Countries with **exchange rate and monetary policy flexibility** should continue to use it as the principal line of defense during episodes of market volatility. Securing external credit lines and targeted liquidity provision could be helpful as well.
- **Diversifying funding sources** and **deepening the local investor base** would help reduce countries' vulnerability to idiosyncratic shocks and contagion through common lenders.
- All countries, especially those with weaker macroeconomic fundamentals, can increase their resilience to shocks by **rebuilding fiscal space** and **addressing the legacies and problems exposed by the crisis**—structural weaknesses that are holding back growth and keeping unemployment unacceptably high; and high levels of nonperforming loans that are hamstringing credit.
- **Implementing structural reforms** that boost growth potential will also attract more stable foreign investment.

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