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Recovery at risk? Central and Eastern Europe remains vulnerable to external funding threats

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James Roaf, Senior Regional Representative for Central and Eastern Europe at IMF, introduced the key points highlighted by the latest six-month report the IMF has released for Central and Eastern Europe.
He firstly gave an economic outlook of the region, pointing out the fact that Central and Eastern economies are currently experiencing growth, though only at a moderate level. The recovery is mainly led by demand and net export, showing in this a similar pattern to that of the EU, even if at a bigger magnitude. He described the recovery process as an *export led story*, with credit playing little or no role in it (*creditless recovery*). Figures for 2014 predict a moderate 2,3% growth in GDP for the area considered as a whole. He also expressed concerns about *external funding flows*, the warning volatility of which being motivated by the tapering currently implemented by the FED.

Warnings about the risks the area is still facing have led to a downward revision of the projections of some of the countries: particularly, Turkey and Russia have been under the spotlight, the former because of the tightening of the country's monetary policy, the latter because outflows in foreign investments.

The presentation moved then to analyse the main risks Central and Eastern European countries are facing. As far as *geopolitical tensions* are concerned, he pointed out that, while trade linkages between this area and Russia are in fact small, on the other side, there's a warning dependence of these economies on Russian gas. As to the *distresses in the financial markets*, an increase in gross external liabilities was highlighted, mainly due to foreign direct investments and private debt (included the inter-company lending, which tends to have smaller volatility though). Finally, the risk deriving from *foreign exchange markets* was also underlined.

Analysing the issues connected with *public debt*, Dr. Roaf noted that, although the countries of the area have been running low government debts, the effects of the economic crisis are gradually turning them into high debt economies. In addition to this, cost of borrowing is also rising due to the US recovery and the subsequent monetary normalization, which led to an overall increase of short term interest rates on government bonds, particularly in Belarus, Russia and Turkey.

The presentation was concluded by some remarks on possible *policy actions* to be implemented. In the *short term*, Central and Eastern European countries should make use of exchange rate policies (wherever possible, e.g. Poland), targeting of liquidity provision, active debt management (which is already ongoing) and international cooperation. In the *medium term*, convenient policies could be for instance to rebuild a fiscal buffer, to firmly address the crisis legacy, to tackle structural weaknesses and to diversify funding sources.

Zsolt Darvas, Senior Fellow at Bruegel, raised some few issues:
- He claimed a possible contradiction between the many risks these countries are facing, and the relatively good recovery they are experiencing.
- He then asked about the suitability of accounting the liabilities in gross terms.
- After that, he asked about possible implications of the increasing financial integration within Europe on the growth of the area.
- He also raised the problem of a creditless recovery, which he claimed not to be rare in countries with low development levels (for instance, Baltic countries).

- Lastly, he questioned the results of the exercise assessing the effects of a rise in the US bond short term interest rates on the average GDP growth of the countries in the area (claimed to be as much as -1%, following a rise of some 1% - 1,5% in the interest rates).

James Roaf provided the following explanations:
- As to the recovery, he pointed out that managing the effects of the crisis it's easier when governments start from a lower level of public debt.
- He then claimed that the preference for gross data relies in the easiness to find them and in their representativeness.
- He agreed upon the concerns regarding a creditless recovery, arguing that getting credit will be particularly hard for small and medium enterprises.
- Finally, he defended the point of the exercises assessing the relation between US government rates and GDP growth, arguing that some countries could be very sensible to such a variation (particularly, a 1% increase in US rates could lead to some 2,5% increase in government bond rates of some of the countries in the area).

After that, additional issues concerning the current risks the region is facing were raised. First of all, a striking difference between regions within same countries was pointed out. Secondly, the problem of ownership structure of debt was discussed. The matter is also related to the problem of attracting investors from outside, by showing credibility and transparency.

André Sapir, Senior Fellow at Bruegel, asked how much the second lending scheme to Ukraine is likely to be successful, as long as the first one did not appear to be effective.

Guonan Ma, Visiting Fellow at Bruegel, asked additional information about inflation patterns in the area.

Guntram Wolff, Bruegel Director, asked about the impact of ECB's monetary policies on Central and Eastern European countries.

James Roaf replied that operations in Ukraine are still perceived as risky, but there's now a high commitment due to a more stable political scenario. He then moved to assert that low inflation (i.e. below the ECB target) could have in fact a distortionary effect on the area, even if these countries are far away from deflationary pressures for the time being. Lastly, he argued that an action by the ECB could indeed offset the negative effects of the FED tapering, but there are plenty of other factors to be considered.

Zsolt Darvas made some concluding remarks regarding the role of credit in the area, arguing that a creditless recovery could be the results of many factors, including the shift towards sectors less credit-dependent (export led recovery) or the complete bankruptcy of some of the most credit-dependent sectors. He also made the statement that creditless recoveries usually can't last for long.
He concluded inviting to mind also to the inequalities the crisis has unveiled, particularly in the Central and Eastern European countries: above all, he referred to the inequality between young an old people, and between qualified and unqualified workers.

Notes by Giulio Mazzolini