3. CESEE risk outlook

3.1. CESEE RISK MATRIX

Table 3.1 / Summary of risks and changes since spring 2019

New risks:

- 'Significant increase in US tariffs on EU automotive exports' (medium likelihood, high impact);
- 'Collapse in one or more inflated asset markets' (low/high).

Deleted risks:

- 'Global trade war/major Chinese slowdown' (rated in the spring as high likelihood/high impact). Both a global trade war and a fairly substantial slowdown in China have already happened.
- 'European Parliament election leads to big gains for anti-EU forces' (high/low). Anti-EU parties did indeed gain seats, but not as many as feared. The impact was, as expected, quite low.
- 'Faster than expected tightening by the ECB' (low/medium). We now think that any tightening, if at all, by the ECB during the forecast period is almost unthinkable, and so this is no longer even a low risk.

Changed risk assessments:

- 'Renewed outbreak of the crisis in the euro area' goes from high to low likelihood (but remains high impact). This move largely reflects the changed make-up of the Italian government.

		Impact on CESEE countries*		
		High	**Medium**	**Low**
Likelihood	High	Smaller EU budget (only EU countries)	Rule of law and quality/independence of institutions deteriorate further	
	Medium	Labour shortages stimulate higher investment Significant increase in US tariffs on EU automotive exports		
	Low	Formalised core/periphery in EU (only EU countries) Renewed outbreak of EZ crisis Collapse in one or more inflated asset markets German consumption growth roars into life	EM crisis affects more countries in CESEE Hard/no deal Brexit	Improvement in EU-Russia relations

Note: Red = negative risk, green = positive risk. *Impact on all 23 CESEE countries covered by wiiw unless otherwise stated. Risks related to the forecast period, 2019-2021. When measuring likelihood, high = 30-49% chance, medium = 10-30% chance, low = 1-10% chance.

Table 3.2 / Positive risks detail

Risk	Likelihood		Impact on CESEE	
Labour shortages stimulate virtuous cycle of rising wages and investment	Medium	Many countries in CESEE are facing acute labour shortages, including jobs requiring few skills. It remains unclear how this will go in the long run. Foreign firms in the region, faced with less labour and higher wages, may decide to move production east. However, they have many big incentives to stay, including high sunk costs, a better business environment, proximity to Western Europe, and a higher quality of labour and infrastructure. More broadly, a lack of labour could stimulate higher investment in automation, leading to higher productivity in the services sector as well.	High	Higher investment in productivity-enhancing improvements would lift the region's growth potential, and could increase per capita real GDP growth quite significantly. This could also feasibly improve the pace of convergence.
Improved EU-Russia relationship leads to removal of sanctions and increased trade and investment flows between the two	Low	This has become moderately more likely now because of US policy, which has resulted in closer EU ties with countries under pressure from the US, such as Iran and Turkey. However, Russia remains a special case, especially because EU sanctions on it are tied so closely to Minsk II (the terms of which are almost impossible to imagine Russia meeting). Nevertheless, opinion surveys indicate significant positive sentiment towards Russia in many EU countries, including in Germany.	Low	An unwinding of Russia-EU sanctions would matter more for Russia than other countries, but it is unlikely that it would be a game changer for anyone. The reasons that the Russian economy is doing so badly are mostly either structural or because of the weaker oil price of the last few years, not the sanctions. There would be a small positive impact on Russian growth, with spill-overs for other CIS countries. For the rest of CESEE, the impact would be minimal. Most have diverted trade away from Russia since the sanctions were introduced, and would not quickly go back. Many EU investors would remain wary, especially if tensions between Russia and the US remain high.
German consumption growth roars into life	Low	The German economy has slowed significantly recently, leading to major downgrades to growth projections by many leading forecasters. Germany's high level of dependence on external trade means it has been particularly badly affected by the US-China trade war. However, many domestic indicators are positive, including in the labour market and wage growth. There remains a (fairly small) chance that Germans will shrug off negative external news, and that higher spending could trigger a virtuous cycle of rising consumption and investment.	High	This would be very positive from the perspective of CESEE. Germany is an important export market for almost every country in the region, as well as a key source of FDI, tourism and remittances for many.

Table 3.3 / Negative risks detail

Risk	Likelihood		Impact on CESEE	
Renewed outbreak of the euro area crisis	Low	Progress on reforms of the euro area to better insulate it from the next downturn in growth remains painfully slow. In Germany, such reforms tend to be seen as the German taxpayer subsidising profligate Southern Europeans. Some insurance is provided by the expanded role of the ECB in recent years, but over the medium term this may not be enough on its own to prevent a new crisis.	High	In the long run, the euro area needs a banking union and some kind of fiscal sharing to be able to ward off speculative market attacks during downturns. Any break-up of the euro area would badly affect the economies of CESEE, due to high levels of trade, investment and financial integration.
Significant increase in US tariffs on EU automotive exports	Medium	This is probably a low likelihood before the next US election, but becomes a higher likelihood thereafter if Donald Trump wins (and so we put it at 'medium' for the whole forecast period). US President Donald Trump has made this specific threat on several occasions.	High	This is a key risk for growth in our region during the forecast period. Most economies in our region are very open in terms of exports/GDP, and many deliver inputs into the German supply chain that go direct to the US. Some of the economies of the region (CZ, HU, SK, RO, MK, RS) are especially reliant on the automotive sector.
Rule of law and institutional quality deteriorate further in CESEE countries	High	This is already happening to an extent. In recent years, indicators of institutional and governance quality have declined for some CESEE countries, such as Turkey, Poland and Hungary. Governments in these countries look quite well entrenched, and are popular in most cases, meaning that current trends may well continue. For the EU countries, Brussels has so far shown itself largely unable to take any action.	Medium	Governments can get away with it for a while, but as the example of Turkey shows, an undermining of institutional independence can contribute to a crisis. In the case of Poland and Hungary, there are already signs that it has affected domestic private investment. Lower-quality institutions also threaten long-term growth.
EU budget is cut and EU-CEE countries receive significantly less money in the new financing period	High	A smaller post-Brexit EU budget is highly likely. Funding priorities may also change, including a linking of future EU funding to certain benchmarks. There is a growing feeling in some Western European capitals that funding should be tied more closely to indicators such as compliance with EU law.	High	EU-CEE countries receive 2-5 percentage points of GDP per year from the EU, so cuts to the budget would be important for them.
'Rings' of EU integration are formalised and most of EU-CEE is left out	Low	Irritation in some Western European capital with parts of EU-CEE has been growing for some time. This is for three main reasons: a lack of 'solidarity' on the sharing of refugees, threats to institutional independence and the rule of law, and corruption in the use of EU funds. Recent French proposals have suggested 'rings' of integration, which could lead to a more formalised 'core' and 'periphery' in the EU.	High	Any formalisation of 'core' and 'periphery' could have important political and economic consequences, particularly if it affects things like Schengen. Many EU-CEE countries could end up in the outer ring.

ctd.

Table 3.3 / ctd.

Risk	Likelihood		Impact on CESEE	
Hard/no-deal Brexit	Low	The likelihood of some kind of deal between the EU-27 and the UK remains quite high. There are major incentives for both sides to avoid a 'hard' Brexit. Moreover, the UK parliament has put in place various measures that make a 'no-deal' Brexit almost impossible.	Medium	The UK and EU-27 economies are heavily intertwined, and London has huge importance for euro area finance. A breakdown of talks and a 'hard' Brexit would likely have quite serious economic and political consequences. The most direct effects would be felt in Western Europe, but the strong linkages between the German economy and CESEE would provide a channel of contagion to our region as well.
Emerging markets crisis moves beyond Turkey to affect more countries in the CESEE region	Low	After a decade of ultra-loose monetary policy, levels of global liquidity are at extremely high levels. Investors need yield, and as such there are still lots of dollars and euros willing to finance even high-risk debts in CESEE. In addition, most countries have reduced private debt/GDP since the crisis, including in foreign currency, and generally external vulnerabilities are lower (current account deficits have mostly been cut or have disappeared over the past decade). Turkey seems like a big outlier in our region.	Medium	The impact of the crisis in 2018 on Turkey's currency and bond markets, and then as a follow-through on inflation and the economy, is a big warning sign to the rest of the region. However, the much lower external vulnerability of almost all other CESEE countries provides a lot of insulation. The most exposed are probably those which also tend to borrow in US dollars, specifically Ukraine and Kazakhstan.
Collapse in one or more inflated asset markets	Low	Real estate, bond and equity markets across the world, including in much of CESEE, are inflated by historical standards. This reflects a decade of ultra-loose monetary policy. So long as central banks remain in ultra-loose mode (which seems overwhelmingly likely), it is hard to see what will deflate these asset markets. Nevertheless, as 2008-2009 showed, the financial community can be blind to certain risks in the system, which then explode without warning.	High	As the 2008-2009 financial crisis showed, the emergence of stress in the financial system can have wide-ranging effects and can quickly spill over into the real economy. It is true that the role of global central banks has increased markedly since then, which could cushion the impact somewhat, but it is hard to see how a big fall in, for example, house prices would not have a sizeable negative impact on growth.