3. CESEE risk outlook

3.1. CESEE RISK MATRIX: TRADE WAR, LACK OF EUROZONE REFORM AND NEXT EU BUDGET POSE BIGGEST RISKS

Downside risks to the economic outlook in CESEE have risen over the past year, reflecting a potentially volatile mixture of regional and global factors. For the region as a whole, we are most worried about the chances of a global trade war, and the spill-overs from a re-emergence of the eurozone crisis.

Table 3 / Summary of risks

		Impact on CESEE countries*		
		High	**Medium**	**Low**
Likelihood	**High**	Global trade war Smaller EU budget (only EU countries) No eurozone reform	Rule of law and institutions deteriorate further	
	Medium	Labour shortages stimulate higher investment		
	Low	Formalised core/periphery in EU (only EU countries)	EM crisis affects more countries in CESEE Faster-than-expected ECB tightening Hard/no deal Brexit	Improvement in EU-Russia relations

Note: Red = negative risk, green = positive risk. *Impact on all 22 CESEE countries covered by wiiw unless otherwise stated. Risks related to the forecast period, 2018-20.

Table 4 / 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 by 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, and the next Chancellor in Berlin could take a different line to Angela Merkel.	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 Russia 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.

Table 5 / Negative risks detail

Risk	Likelihood		Impact on CESEE	
No progress is made to reform the eurozone, such as further steps towards a banking and/or fiscal union.	High	Looking at the politics of Germany and Italy in particular, this appears more and more likely. In Germany, such reforms tend to be seen as the German taxpayer subsidising profligate Southern Europeans. The new government in Italy and its current budget plans makes this an ever harder sell in Germany.	High	This matters a lot, because the eurozone is not in great shape for the next downturn. In long run it 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 eurozone (which is highly unlikely, although no longer unthinkable with the current Italian government in particular) would badly affect the economies of CESEE.
Global trade war involving exchange of sanctions between US and China and visible impact on global trade volumes.	High	This is already to an extent underway. Trade restrictions on imports into both the US and China have increased significantly over the past decade, and global trade relative to GDP has been flat since the crisis. However, several exchanges of sanctions between the US and China would have a significant additional impact on global growth and trade. Neither side appears willing to back down, so this appears to be becoming more likely.	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 directly to China or the US.
Rule of law and institutional quality deteriorates further in CESEE countries.	High	This is already happening to an extent. Indicators of institutional and governance quality have declined for some CESEE countries in recent years, 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 is 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 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 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.

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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 on both sides to avoid a "hard" Brexit, and major concessions may be made in the final round of negotiations. A much more tricky issue is what happens when that deal is then put to the UK parliament. The main opposition Labour Party is desperate for a general election, and may use the opportunity to bring the government down. Meanwhile many on the right of the ruling Conservative Party may rebel against any deal that they feel keeps the UK too close to the EU.	Medium	The UK and EU-27 economies are heavily intertwined, and London has huge importance for eurozone finance. A breakdown of talks and "hard" Brexit in March 2019 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	So far, most countries in our region have been relatively unaffected. Countries in our region tend to be much more exposed to the euro interest rate than the dollar, and the ECB is (and will remain) at a very different point in the tightening cycle to the Fed. 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 disappeared over the past decade). Turkey seems like a big outlier in our region.	Medium	The impact in recent months on Turkey's currency and bond markets, and then as a follow-through on inflation and the economy, are a big warning sign to the rest of the region. However, the much lower external vulnerabilities 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.
Faster-than-expected monetary tightening by the ECB causes financing difficulties for countries in CESEE.	Low	The ECB is currently expected to begin cautiously tightening monetary policy by end-2019, but even this is subject to risks of further delay. Core inflation trends in much of the eurozone remain very weak, reflecting major slack in many labour markets. Meanwhile economic growth outside of Germany has slowed quite significantly this year, and is unlikely to pick up again soon.	Medium	Most countries in CESEE are more exposed to euro interest rates rather than dollars, and as such have been relatively insulated from the recent market turmoil. If the ECB did start a fairly quick tightening cycle, this would change, and other countries in CESEE could run into trouble. However, few would find themselves in the position of Turkey under this scenario. Turkey has much bigger external imbalances and financing needs than other countries in CESEE.