2021 Central and Eastern Europe Sovereign Outlook

The region's economic recovery anchored by monetary, fiscal stimulus, but rising debt, external risks are concerns in some countries

Sovereign and Public Sector, Scope Ratings GmbH, 17 December 2020

EU CEE: Poland I Czech Republic I Hungary I Slovakia I Romania I Bulgaria I Croatia I Slovenia I Lithuania I Latvia I Estonia
Non-EU CEE: Russia I Turkey I Georgia

Executive summary

The Covid-19 crisis has been exceptionally challenging for economies of central and eastern Europe (CEE). Fresh pandemic-related economic restrictions in the region will link to negative Q4 2020 quarterly growth in many cases. Going forward, recovery should pick up by the early spring of next year as the winter wave of virus gradually abates – consistent with our global economic outlook for 2021. However, we maintain an expectation of uneven recovery in CEE reaching 2019 output levels by only after 2021 in most countries. **Figure 1** displays growth figures, with full macroeconomic forecasts in **Annex II**.

Key takeaways for 2021 include:

- **EU CEE-11:** Enhanced economic resilience over recent years has made CEE-11 economies better positioned to cope with global crises such as the severe recession of 2020. The new long-term EU budget presents a major opportunity for EU CEE countries to boost investment.
- **Russia:** We expect a sluggish economic rebound in Russia in 2021 following a softer contraction in 2020 than in other major global economies. The Russian economy is supported by greater self-sufficiency, solid external and public-sector balance sheets, and a flexible FX regime.
- **Turkey:** Despite a near-term market-friendly shift in policy frameworks as represented in the central bank's November 2020 rate hike, a restructuring of economic policies will need to not only be maintained but *strengthened*. 2021 is expected to be a bellwether year for Turkey's ratings trajectory.
- **Georgia:** A 2021 ratings focus will be on external-sector and fiscal risks, and structural reform progress.
- **Fiscal vulnerabilities:** Fiscal metrics have worsened, especially for non-euro-area CEE governments. Romania's and Turkey's public debt-to-GDP ratios are expected to continue increasing from about 35% in 2019 to above 60% by 2024. For *most* other CEE countries rated by Scope, however, we see stabilisation and/or declines in debt ratios as policy stimulus is phased out and revenue recovers while spending pressures persist.
- **Accommodative monetary policies:** Central banks are expected to maintain an accommodative stance next year, while some crisis-era policy measures could become structural features of regional central bank toolkits. Turkey's central bank is an exception with tight rates required near term.
- **ESG risks:** CEE governments need to raise labour-force participation rates post-crisis and address shortages of skilled labour. Another growingly important reform priority will be addressing climate risks and associated economic costs, including structural challenges affecting automotive sectors.
- **Ratings:** Entering 2021, of 14 rated CEE sovereigns, those with a Negative Outlook are Turkey, Slovakia, Romania and Georgia, while Lithuania holds a Positive Outlook. Fiscal and monetary support have spared larger economic contractions and mitigated immediate risks of financial market instability. Policy responses have, however, also had a longer-lasting impact on public-sector debt burdens. Policy responses targeting sustained recovery and addressing macro-financial imbalances will be critical for credit assessments of CEE sovereigns next year.

Figure 1. Scope's baseline scenario, as of 17 December 2020

Country/region		Real GDP growth (%)				
		2019	2020E (Dec.)	Diff. from Oct.*	2021F (Dec.)	Diff. from Oct.*
EU CEE-11		3.7	-5.3	↑ 0.1	4.1	↓ 0.7
Euro-area CEE	Slovakia	2.4	-7.8	↑ 0.3	5.2	↓ 1.4
	Slovenia	2.4	-7.0	-	5.0	-
	Estonia	4.3	-4.5	↑ 1.0	4.0	↓ 0.6
	Lithuania	3.9	-1.5	-	3.5	-
	Latvia	2.2	-5.5	-	4.6	-
Non-euro-area EU CEE	Poland	4.1	-3.9	-	3.5	↓ 0.6
	Romania	4.1	-4.8	↑ 0.7	4.2	↓ 0.6
	Czech Republic	2.3	-7.0	-	4.0	↓ 1.2
	Hungary	4.9	-6.0	-	4.6	↓ 0.4
	Bulgaria	3.4	-5.0	-	3.5	↓ 1.0
	Croatia	2.9	-9.1	↓ 0.2	5.9	-
Russia		1.3	-4.5	↑ 1.0	2.5	↓ 1.0
Turkey		0.9	0.7	↑ 2.1	6.2	↓ 1.0
Georgia		5.1	-5.0	-	4.5	↓ 0.3

Source: Scope Ratings GmbH forecasts, Macrobond, IMF.
*Changes compared with October 2020's Q4 CEE Sovereign Update forecasts.

Contents

Scope Sovereign and Public Sector Ratings Group

Giacomo Barisone
Managing Director, Head of Sovereign and Public Sector
g.barisone@scoperatings.com

Alvise Lennkh
Executive Director, Deputy Head
a.lennkh@scoperatings.com

Dennis Shen
Director
d.shen@scoperatings.com

Bernhard Bartels
Director
b.bartels@scoperatings.com

Jakob Suwalski
Director
j.suwalski@scoperatings.com

Levon Kameryan
Analyst
l.kameryan@scoperatings.com

Thibault Vasse
Analyst
t.vasse@scoperatings.com

Giulia Branz
Assoc. Analyst
g.branz@scoperatings.com

Julian Zimmermann
Assoc. Analyst
j.zimmermann@scoperatings.com

Key themes in CEE for 2021

Improved macroeconomic resilience supports recovery prospects

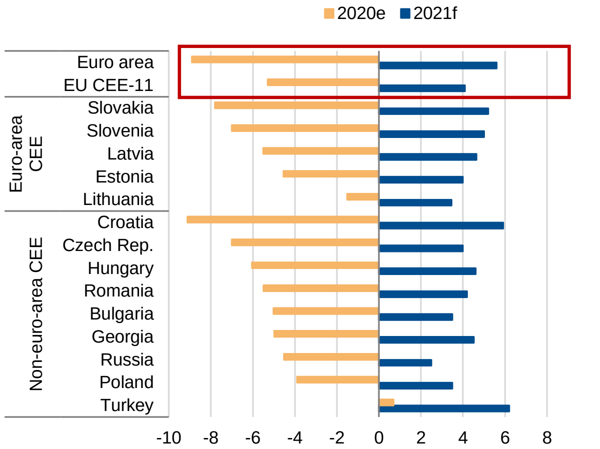
The EU's CEE economies (CEE-11) have enhanced economic resilience over recent years and are better positioned to cope with a crisis such as the severe recession of 2020, compared with preparedness prior to the global financial crisis. We expect annual output in the EU CEE countries to contract around 5.3% in 2020 as a weighted average[1], compared with a decline of 8.9% for the euro area aggregate, followed by recovery of 4.1% in 2021, compared with 5.6% in the euro area.

Over the past decade, private consumption and investment have become dominant growth drivers, allowing for more broad-based economic expansion and increased resilience to external shocks. This stands in contrast with 2009-13, during which growth was characterised by stronger export dependency. Today's more sustainable growth architecture, after broad-based increases in incomes, foreign direct investment (FDI) inflows, alongside improvements in the liquidity of domestic capital markets and sizeable pre-crisis declines of public debt ratios and net external financial liabilities support CEE-11's economic and credit rating outlooks entering 2021.

The surge in Covid-19 cases over the autumn period has led to the partial reinstatement of containment policies by CEE authorities, reversing recoveries in many cases. 2021 restarts of recovery will hinge on i) the effectiveness of short-run restrictions in controlling coronavirus transmission and suppression of transmission to more moderate levels; ii) progress in the distribution of vaccine and therapeutics including to developing economies of CEE; iii) monetary and fiscal stimulus; iv) policy actions to address increased insolvency and higher unemployment; and v) underlying economic structures. We expect most economies of the CEE-11 to be growing by the spring of 2021 as the acute winter phase of the pandemic passes.

Currently, we see investment across the CEE-11 recovering over 2021 as uncertainty decreases, supported by improvements in global demand. The long-run EU budget for 2021-27 and the EU Recovery Fund amounting together to EUR 1.8trn will support investment going forward. Expectations for a longer period of accommodative monetary policies of the European Central Bank – after extension of crisis programmes into 2022 – and the US Federal Reserve, which will continue asset purchases of at least USD 120bn per month, combined with monetary support from non-euro CEE central banks and liquid and well-capitalised financial sectors, are expected to keep borrowing costs of CEE governments in check and help mitigate risks to financial-market stability.

Figure 2: Real GDP growth rates, %



Sorted by scale of 2020 economic losses/gains.
Source: Scope Ratings GmbH forecasts

Among Scope's rated CEE countries *outside* of the EU, Russia's *relative* resilience economically in the current crisis, with 2020 growth of an estimated -4.5%, has been anchored by i) the Russian economy's structure, including a smaller role for services sectors and for small and medium-sized enterprises, as well as a more substantive role for the state sector, the latter requiring less policy support; and ii) economic policies of recent years that have led to a higher degree of self-sufficiency entering this crisis and lower exposure to disruption of global supply chains. We predict moderate recovery of 2.5% in 2021. In our view, international sanctions on Russia are likely to remain in place under the forthcoming US administration if not be strengthened.

In Turkey, despite a near-term shift in policy frameworks as represented in the central bank's rate hike last month, a restructuring of economic policies in a more market-friendly and orthodox direction will need to not only be maintained but *strengthened*. Addressing this requires tighter, more sustainable monetary, fiscal and structural economic policies that prioritise lower but more durable economic growth, both in response to and beyond crisis conditions – something that has been lacking in the past. In 2021, Scope expects growth of 6.2% with an uneven recovery subject to setbacks from virus relapse to markets to geopolitics. 2021 growth comes after growth of 0.7% in 2020 (revised up 2.1pp from estimates per the Q4 2020 CEE Sovereign Update).

In Georgia, we estimate growth of -5% in 2020 and 4.5% in 2021. Vulnerability to FX volatility, due to reliance on foreign-currency borrowing as well as on the tourism sector, has been a risk since the crisis. In 2021, a focus in the ongoing ratings assessment will be on

[1] Weighted by purchasing power parity GDP in international dollars.

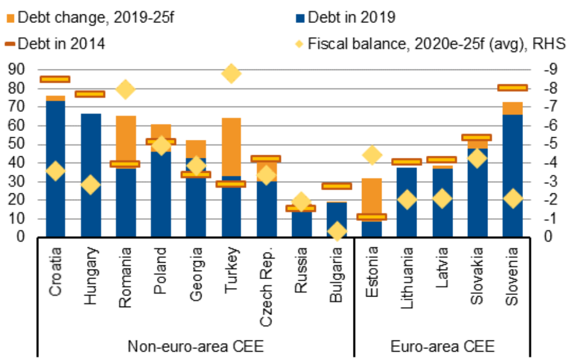
external-sector and fiscal risks, and government progress on structural reform.

Re-emergence of fiscal vulnerabilities due to the pandemic

Fiscal vulnerabilities have increased, especially for non-euro-area CEE governments, which do not benefit from forceful monetary accommodation by the ECB in support of more elevated national-government debt stocks in the crisis and instead face much more tangible risk from foreign-currency-denominated public debt issuance and in which local-currency debt markets might be less advanced. Budget deficits have deteriorated in a synchronised fashion due to measures adopted in support of private sectors to minimise unemployment hikes and provide resources to businesses under duress, and due to cyclical drops in tax revenue. In the 14 CEE countries rated by Scope, deficits of 2020 are estimated between 3.5% of GDP for Bulgaria to a high of 10% in Hungary and Turkey. Next year, deficits across the region will narrow but remain outsized – from about 3% in Bulgaria and Russia to above 8% in Turkey and Romania.

Turkey, Romania, Croatia, Hungary and Poland each face significant increases in public debt ratios of above 10% of GDP this year. Romania's and Turkey's public debt ratios are expected to, in addition, continue increasing from about 35% in 2019 to above 60% over by 2024 (**Figure 3**). Turkey's external-sector weaknesses and structural lira depreciation undermine the public-debt trajectory, exacerbated by over half of central government debt denominated in foreign currency. For *most* other CEE countries rated by Scope, we expect, conversely, stabilisation and/or eventual gradual decline in debt ratios as recoveries advance.

Figure 3: Public debt trends (LHS) and average fiscal balances (RHS), % of GDP



Source: IMFWEO October 2020 and Scope Ratings GmbH forecasts

In Hungary, gross government financing needs are estimated at above 20% of GDP in 2021 – significantly above the IMF threshold of 15%, above which an emerging market issuer is considered as under "high scrutiny". Gross government financing needs of Croatia and Romania are expected to remain under those of Hungary next year, although still significant around 15% of GDP. In the case of Russia, still-modest levels of public debt provide fiscal space in support of recovery, important ahead of 2021 parliamentary elections.

Further advancing domestic capital markets is required to ensure the stable rollover of more elevated debt stocks post-crisis in 2021 and beyond. Encouraging domestic savings and focusing on 'green' finance to attract diverse investors are some possible steps to deepen capital markets. In addition, the Baltic states, together with the European Bank for Reconstruction and Development, are planning to develop Baltic commercial paper markets. The size of capital markets in the CEE-11 relative to GDP remains, nevertheless, (only) around one third that of the EU average as of 2018 (including the UK in the latter).

In Turkey, earlier exits of international investors have cut the share of domestic debt held by the non-resident sector to only 4% as of December from 20% in late 2017 – damaging financing flexibility and debt sustainability. Key to minimising fiscal risk going forward will be the attracting of foreign investors back to Turkish domestic- and hard-currency markets – stabilising the currency, reducing borrowing rates and rebuilding foreign-exchange reserves. In Russia, the federal rouble-denominated (OFZ) bond market continued expanding from RUB 8.9trn at start-2020 to RUB 12.8trn as of November 2020 due to demand from domestic investors.

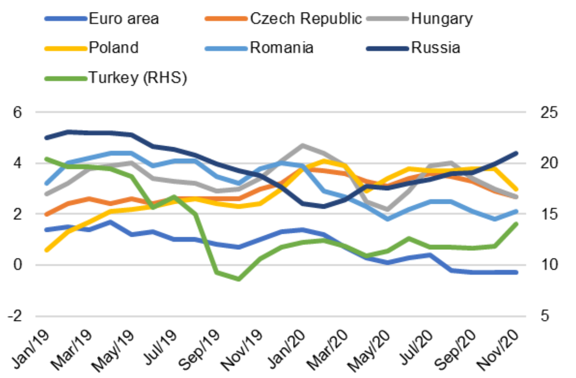
Accommodative monetary policies to support low-cost financing; lower FX volatility expected but risks linger

Next to the ECB's large-scale asset purchases, several non-euro-area CEE central banks introduced quantitative easing programmes during this crisis, including the central banks of Poland, Hungary, Romania, Croatia and Turkey. Quantitative easing is likely to remain a mainstay in monetary policy toolkits moving ahead. While QE might lower domestic-currency borrowing costs short term, it could also put at risk FX devaluation and higher inflation.

Nonetheless, we expect central banks to mostly maintain an accommodative stance next year. Turkey's central bank is an exception, having delivered a 475bp rate increase last month to alleviate currency pressures. While this move aligned the central bank's policy rate with the prevailing weighted average cost of central bank financing (at 15%), Turkish rates will need to remain elevated for a more prolonged time period to assuage markets of prudent policy-setting and the central bank's commitment to price stability. Meanwhile, additional rate *cuts* from the Central Bank of Russia are not precluded, given space for easing amid a benign inflation outlook. In non-euro-area EU CEE countries, inflation should stabilise to close to targeted levels, with labour markets showing spare capacity due to crisis effects. This ought to anchor continued accommodative central bank stances in 2021. Lastly, in regard to CEE member states in the euro area, the European Central

Bank is supplying ample liquidity – likely ensuring financing costs for euro-area government borrowers remain low next year.

Figure 4: Inflation, annual rate of change



As of November 2020. Source: Eurostat, Rosstat, Macrobond; HICP inflation displayed for the euro area, Czech Republic, Hungary, Poland and Romania.

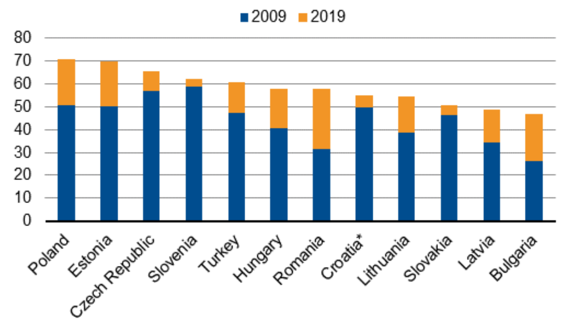
A year of recoveries in 2021, progress in the distribution of coronavirus vaccine, and more predictable US foreign policies should support greater stability in regional FX developments next year. However, with risks lingering, volatility could as well easily return in an idiosyncratic or synchronised manner. Under this context, the foreign-exchange reserves of CEE central banks are cushions against future stresses in exchange-rate markets, with reserve levels close to or exceeding an IMF adequacy threshold of 100% of short-term external debt in most economies of the region. However, Romania's reserves cover 74%, and Turkey's cover only around 66%. Lesser reserve coverage informs in part the Negative ratings Outlooks on Romania and Turkey. Russia's reserves, on the other hand, cover almost five times outstanding short-term external debt, providing an abundant buffer to absorb external shock.

ESG-related credit risks: labour markets remain prime rating constraint

Beyond Covid-19, CEE governments need to raise labour-force participation rates and address shortages of skilled workers, given tight labour markets before the crisis, ageing populations as well as, in many cases, net emigration.

Lower-income economies of the region such as Bulgaria and Romania have continued catch-up growth over the last decade entering the crisis, almost doubling earnings levels *relative* to that of the euro-area average. High growth has also supported Poland and Estonia to reach the highest net earnings of CEE economies, amounting to about 70% of euro-area levels in 2019 under purchasing power parity terms. Conversely, earnings growth in several high-income CEE countries (Slovakia, Slovenia and the Czech Republic) nearly halted over 2009-19 even while incomes remained under western European peers' (**Figure 5**).

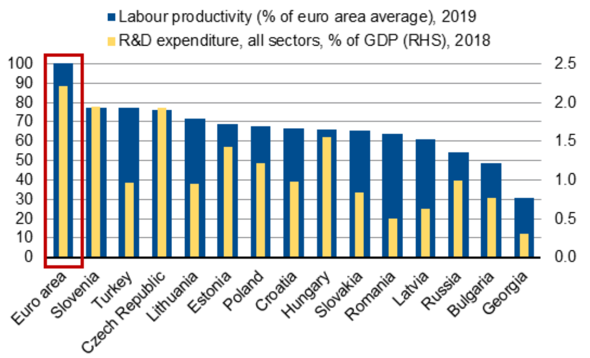
Figure 5: Net earnings, purchasing power standard, relative to the euro area average



Source: Eurostat; net earnings refer to single persons without children earning 100% of average earnings; *Croatia's 2009 data refer to 2013 data; no data on Russia, Georgia

Meanwhile, labour productivity in CEE lags behind euro area averages, although the gap has narrowed. The highest-productivity countries of the region, the Czech Republic and Slovenia, *have* raised productivity to around 75% of the euro area average (**Figure 6**), while Russia's productivity is around half the euro area average. Further building upon progress in increasing labour markets' attractiveness for skilled workers could strengthen sovereigns' creditworthiness longer term.

Figure 6: Labour productivity and R&D expenditure



Source: World Bank, Eurostat, Macrobond; labour productivity refers to GDP per person employed (PPP $)

Next to enhancing labour markets, another growingly important reform priority will be addressing the causes of climate change and associated economic costs, including adapting economies to structural change in automotive sectors and alterations in staffing requirements. The automotive industry produces 13% of GDP in Slovakia and Romania, and around 10% of output in the Czech Republic, Hungary and Slovenia – making assurance of comparative advantages of the sector key to the long-term viability of said economies. CEE economies do hold potential to accelerate green transitions, moreover, given greater scope than western European peers in improving their energy efficiencies of production, supported by affordable labour forces. Here, EU CEE economies could benefit from an increasing EU budgetary focus on the low-carbon transition.

Sovereign ratings: rating actions in 2020 crisis, and 2021 rating outlook

An uneven recovery in global growth, rising government debt and significant transformations in international fiscal policy as well as in international monetary paradigms set the stage for sovereign risk entering 2021.

As of end-February 2020, when the corona crisis was transitioning from a China-centric crisis to a global one, Scope held a Positive Outlook for one issuer in CEE: Lithuania, compared with Negative Outlooks on two issuers: Romania and Turkey. Rating actions taken since the crisis escalated have been Negative Outlooks assigned to Georgia and Slovakia, while Turkey has been the only sovereign issuer (of 36 sovereigns rated by Scope globally) downgraded thus far by the agency in the crisis (see **Annex I** in regard to rating actions in 2020). As such, entering 2021, CEE sovereigns with Negative Outlooks are Turkey, Slovakia, Romania, and Georgia, while Lithuania holds a Positive Outlook.

Fiscal and monetary support by regional governments and central banks have spared larger economic contractions and mitigated near-term risks to financial stability. This support has, however, had a longer-lasting impact on public-sector debt burdens, meaning CEE governments will need to advance domestic capital markets to ensure the stable rollover of more-elevated debt stocks. Policy responses targeting sustained recovery from the crisis and addressing macro-financial imbalances will prove critical for credit assessments of CEE sovereigns in 2021.

Country views

Visegrád countries

Poland (A+/Stable): capacity limits temper economic resilience

We project a gradual but solid recovery of 3.5% for Poland next year, following a contraction of 3.9% this year. While the second wave of coronavirus cases has stalled recovery, recent announcements about vaccines support the outlook and reduce risks of stricter lockdowns in 2021.

Poland's more-moderate GDP decline during the crisis derives from fiscal and monetary responses both nationally and from the EU level. At the same time, capacity constraints due to the country's high reliance on foreign capital, deterioration in governance, and Poland's adverse demographics are rating-relevant limitations on medium-run growth potential.

Poland's sturdy public finances provide space for fiscal intervention. We expect the general government deficit to widen this year to 9% of GDP due to budgetary support for the health-care sector, businesses and households. Budget deficits are seen gradually declining from 2021 on. We project general-government gross debt to increase to 59% of GDP in 2020 and to stabilise around this level medium term, with higher debt financed by favourable access to capital markets amid ample liquidity in the Polish banking system and the central bank's sovereign bond purchase programme. Fiscal challenges include inflexible social spending programmes along with an ageing population.

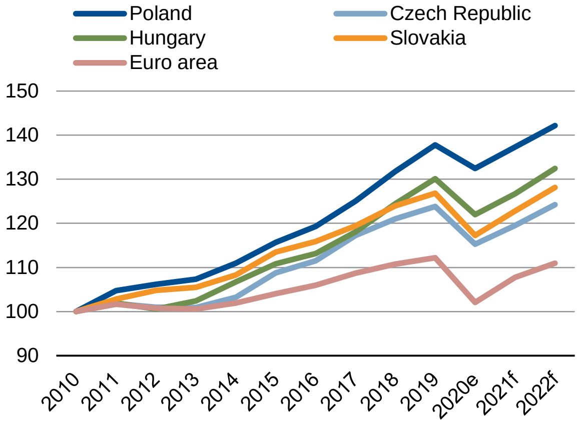
Czech Republic (AA/Stable): ageing demographics constrain medium-run outlook

We expect recovery of around 4% growth in 2021 after the corona crisis hit the small, open and supply-chain-dependent industrial sector of the Czech economy this year, with an expected 2020 output decline of 7%. This year's output shock has been mitigated, however, by solid public finances entering the crisis that have provided fiscal room to cushion the economy.

The most important risk entering 2021 and for the medium-run outlook relates to an ageing population. Economic repercussions of the Covid crisis will reduce labour-market shortages short term but increasing labour force participation rates and reducing skills mismatches remain, nonetheless, paramount to ensuring adequate supply of labour long term. Rising ageing-related expenditure pressure has been compounded by policy: the government decided not to link the statutory retirement age with projected gains in life expectancy and made the pension-indexation formula more generous.

Longer-term structural changes in the automotive industry link to revised CO_2 standards, increasing demand for electric cars and automation. These present further challenges.

Figure 7: Real GDP level, 2010=100



Source: European Commission and Scope Ratings GmbH forecasts

Hungary (BBB+/Stable): re-emergence of fiscal risks in the post-pandemic outlook

We expect recovery of 4-5% growth in 2021, in line with recovery rates of peer economies. This is after contraction in Hungary's economy of an estimated 6% in 2020.

The budget response to the pandemic has increased the deficit to an estimated 10% of GDP in 2020. Fiscal support for the economy has been accompanied by monetary support from the Magyar Nemzeti Bank (MNB), including government securities and mortgage-bonds purchases. Monetary policy is seen remaining loose in 2021.

Debt is estimated to have reverted back to 2011 levels of around 80% of GDP this year, to be followed by a gradual return to a downward debt trajectory from 2021 onward, reaching about 72% of GDP by 2025. Hungary's private- and public-debt profiles improved before the crisis, with the share of FX debts more than halved, from 49% in 2011 to 19% in 2019, strengthening resilience to periods of stress in forint trading.

Moving ahead, the corporate lending programmes of the MNB and investment support from the EU Recovery Fund are key factors supporting growth medium term. Progress has, however, been limited on the side of reforms of industrial policies in the protections of low-productivity Hungarian corporates. In addition, Hungary's tax system remains among the most complex in Europe, characterised by many sector-specific taxes and tax exemptions, resulting in elevated compliance costs for companies.

Slovakia (A+/Negative): deterioration in near-term fiscal dynamics although strong fundamentals anchor recovery

We expect 5.2% growth in 2021 in the Slovak economy, after contraction of 7.8% this year – a comparatively sharp drop in 2020 relative to those of Visegrád peer economies. Slovakia's economy has been exposed in the crisis due to high exposure to global value chains (see **Annex III**) and a high dependence on the car industry, which produces around 13% of GDP. These factors contributed to revision of Slovakia's rating Outlook to Negative in April 2020.

Nonetheless, Slovakia's strong underlying macroeconomic fundamentals, competitive industrial base and improved production capacity, anchored by FDI inflows, will support recovery.

We expect deterioration in near-term fiscal dynamics, with the budget deficit widening over 2020 and 2021 to 9% and 7.2% of GDP respectively, from 1.3% in 2019. In result, general government debt is seen increasing about 17pp compared with pre-crisis levels to 65% of GDP by 2021. Slovakia's debt trajectory should stabilise medium term, however, as recovery progresses.

A credible constitutional budgetary framework that anchors fiscal corrective measures when debt increases above set thresholds supports fiscal discipline over future years. Solid market access, reflected in a negative yield on 10-year government securities and access to European Central Bank facilities, anchors financing of spending needs at accommodative borrowing rates.

Southeast Europe

Romania (BBB-/Negative): fragmented political landscape challenges fiscal consolidation

Scope expects growth of 4.2% in 2021, but not before a steep contraction of 4.8% this year, representing a marked decline after robust growth of previous years. Machinery and equipment, the automotive sector and the furniture sector were the hardest hit by the 2020 crisis with output declines of 15-30% year-over-year.

Tax revenue losses of 2020 and increased fiscal expenditure in prevention of large-scale job loss and bankruptcy align with expectation of a deficit of around 9% of GDP this year, followed by one of about 8% in 2021 (**Figure 8, next page**). Scope projects public debt to rise to over 60% of GDP by 2024, from 35% in 2019.

Deteriorating public finances and limited official reserves covering foreign-currency denominated debt were drivers behind our decision in June to maintain a Negative Outlook on Romania's BBB- ratings.

Parliamentary elections on 6 December brought political fragmentation with significant support for smaller political groupings, elevating their roles in coalition talks with the conservative liberals – the latter likely to retain responsibility in leading the next government. The incoming government, including a new Prime Minister after the resignation of Ludovic Orban, faces the challenge of amending a deteriorating fiscal outlook after a 40% pension hike in September 2020. This challenge will be made the more daunting by fragmented coalition politics.

Bulgaria (BBB+/Stable): reform momentum to be maintained after entry to ERM-II and Banking Union

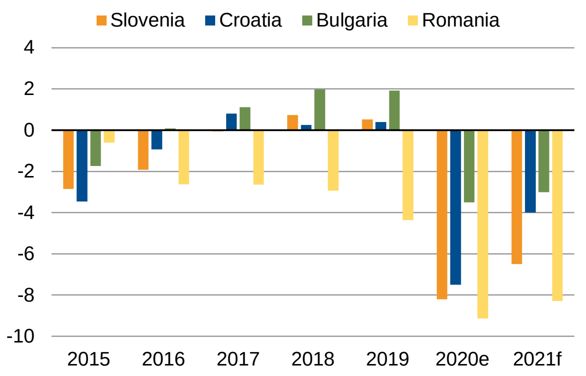
We see Bulgaria's economy growing 3.5% in 2021, after contraction of an estimated 5% this year, close to the estimated 2020 output losses of the CEE-11 average. After 2021, we expect gradual reversion towards Bulgaria's medium-term underlying yearly growth rate of 2.5%.

The entry of Bulgaria and Croatia in July to the Exchange Rate Mechanism II (ERM II) and EU Banking Union helps to reduce financial, external-sector and foreign-exchange-related risks with reform momentum across areas from banking-system governance to raising growth potential to be sustained ahead of entrance to the euro area. Scope considers 2020's entry to the ERM II to be credit positive. However, strengthening central bank independence, addressing corruption and government efficiency, as well as resolving deviations in inflation rates from euro area countries' are required areas for continued economic and institutional convergence.

Bulgaria's BBB+ investment-grade credit ratings recognise the government's strong commitment to fiscal discipline and record of balanced budgets pre-crisis. The crisis has pushed public debt modestly higher to around 26% of GDP in 2020 from 20% in 2019, but this ratio remains comparatively moderate, providing the government with room for a gradual fiscal consolidation post-crisis. The fiscal balance is expected to turn a deficit of 3% of GDP in 2021 after 3.5% in 2020, milder than deficits of CEE peer economies, before returning to a balanced position by 2023.

We expect the next government after 2021 elections to maintain a commitment to reform in view of euro area entrance requirements (with such entry at earliest only feasible by January 2023). However, Bulgaria's history of unstable governments is a rating constraint as it restricts continuity in reform drives.

Figure 8: Fiscal balance, % GDP



Source: European Commission, Scope Ratings GmbH forecasts

Croatia (BBB-/Stable): high debt, low growth potential are challenges to tackle amid euro-entrance process

For 2021, we expect output to recover 5.9% in Croatia. This comes after a projected output decline of 9.1% this year, the latter representing the largest such drop among CEE countries we rate, reflecting Croatia's high dependence on travel and tourism sectors, which together account for a quarter of GDP (including indirect impacts on other sectors).

Croatia joining ERM II should enforce a degree of credit-positive prudence in policy making and help further reduce financial, external-sector and foreign-exchange-linked risks. However, any progress over future years towards joining the euro will, similar to in the example of Bulgaria, hinge on the government's commitment to reform aimed at sustainable convergence with the euro area. This will include necessitating i) sustained reductions in elevated public debt, which is expected to increase to above 85% of GDP this year, from 73% in 2019, due to deterioration in the fiscal balance (to -7.5% of GDP from 0.4% of GDP in 2019); and ii) improvements in Croatia's modest growth potential, which stands at 2-2.3% over the medium term, weighing upon convergence prospects. Reform priorities include addressing the business environment, regulatory quality and high private debt.

Croatia has improved its fiscal framework in line with EU and IMF recommendations – supporting prudent policy making and the sovereign's creditworthiness. Fully integrating improved fiscal rules and better monitoring of the contingent liabilities of state-owned companies are keys to sustaining fiscal consolidation.

Slovenia (A/Stable): fiscal stimulus, structural reforms support 2021 recovery

We expect a rebound in the Slovenian economy of 5% in 2021 with significant fiscal stimulus continuing over 2021 and 2022 as announced by the Ministry of Finance. This follows a severe economic contraction of around 7% this year.

Structural improvements to potential growth, via reforms of the labour market and successful privatisations in the financial system, will support next year's recovery. Risks to the recovery stem from the external sector's dependence on mature European markets, an ageing population alongside persistent productivity gaps in the corporate sector.

The fiscal deficit will be pushed to above 8% of GDP this year, from a surplus of 0.5% in 2019. The government will likely allow the deficit to remain wide at nearly 6.5% of GDP in 2021 before 5% in 2022 as gradual consolidation is undertaken. Public debt is seen increasing to around 80% of GDP this year from 66% in 2019, followed by stabilisation and gradual decrease medium term. High comparative levels of public debt constrain Slovenia's fiscal flexibility. However, Slovenia can finance itself in markets for 10 years at a yield of -0.2% currently – supporting resilience.

The most important medium-term reform challenge is providing a framework for higher labour productivity growth, given regressing demographics. Building on the capital stock – for example via better information & communications technology-infrastructure – could be an important channel in raising long-run growth.

Baltic states

Lithuania (A-/Positive): enhanced economic resilience, prudent fiscal management support Positive Outlook

We expect recovery of 3.5% growth in 2021, after expectation of a comparatively soft output decline of 1.5% in 2020 – among the most modest in the EU this year, supported by the economy's enhanced resilience via progress in enhancing external and fiscal metrics pre-crisis. This enhanced resilience supports the Positive Outlook on Lithuania's ratings.

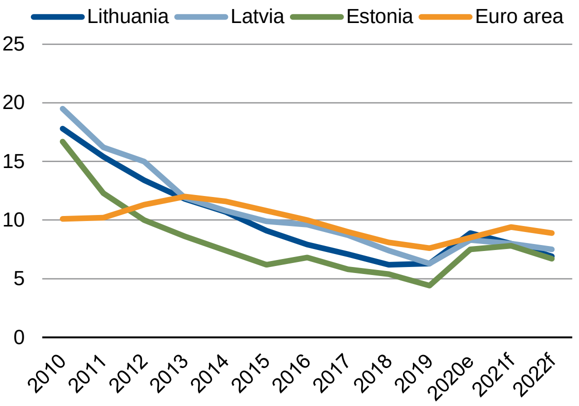
The government has used available fiscal space to support recovery, adopting a public investment programme to end-2021 of EUR 6.3bn or 13% of 2019 GDP focused on spending on infrastructure, human capital, R&D and meeting climate change commitments. Spending is anchored by a high absorption rate of EU funds.

The general government deficit is seen at 8% of GDP this year prior to 5% in 2021.

Unemployment is seen rising to around 9% in 2020 and remaining elevated short term but will gradually decline as the economy recovers (**Figure 9**). Lithuania's ageing population and moderate productivity growth remain challenges. However, constructively, net migration turned positive for the first time in 2019, which should help offset some growth effects of demographic decline.

The new coalition government after parliamentary elections of October 2020 is expected to pursue continuity in foreign policies, including closer integration with the other Baltic states, the EU and NATO. On the domestic policy end, we expect the government to focus on further improving the investment environment whilst committing to fiscal discipline.

Figure 9: Unemployment rate, %



Source: European Commission and Scope Ratings GmbH forecasts

Latvia (A-/Stable): enhancing productivity, addressing declining labour force are keys to growth

For 2021, we expect a growth rebound of 4.6%, with recoveries in private consumption and investment. Latvia's output is forecast to contract 5.5% in 2020, the largest drop among the Baltic states, although still below that of the euro area aggregate.

Latvia's economic outlook is supported by public infrastructure investment co-financed by the EU, including construction of Rail Baltica connecting the Baltic region with the European rail network via Poland (envisioned by mid-2026), which has been started.

The government's fiscal support has eased the crisis' impact on the labour market. Unemployment fell to 8.0% in October from a peak at 8.8% in July but remains above a 5.8% low of October 2019.

General government debt is seen increasing around 10pp in 2020 to 48.5% of GDP, before the trajectory stabilises by next year. We expect Latvia's five-party coalition government to remain committed to fiscal discipline after the crisis, which should anchor gradual declines in the debt ratio medium term.

Latvian banks have decreased reliance on non-resident short-term deposits: the share of non-resident deposits in total deposits has been trimmed from 46.8% in October 2017 to 19.6% in October 2020, supported by authorities' commitment to strengthening the anti-money-laundering framework. Going forward, enhancing productivity and addressing a declining labour force are keys for the growth outlook.

Estonia (AA-/Stable): low debt, prudent fiscal policies support outlook

We forecast Estonian GDP to rebound 4% next year. Recovery in investment from 2021 on will be helped by the EU's 2021-27 Budget, with Estonia's absorption rate of EU funds among the highest of CEE recipients. We expect the government to use EU funding to prioritise investments in green infrastructure and digitalisation in coming years.

In 2020, we estimate Estonia's annual output to have dropped 4.5%, which is a significant decline but 1pp less than anticipated in our October forecasts. Government stimulus measures have supported the economy and are set to be extended into 2021. Estonia's record of prudent fiscal management and significant declines in the economy's net external financial liabilities before the crisis have enabled a robust policy response this crisis.

Under a recent reform, the mandatory second pillar of the pension system will become voluntary from 2021 onward. Positively, this change could enhance private consumption short term, support recovery and increase individual investment choices. However, allowing persons to exit the system and withdraw savings could present budgetary bottlenecks longer term, in view of an ageing population.

Despite increases in general government deficits and debt over 2020-21, Estonia's public debt ratio is set to remain the lowest of the EU (at 22% of GDP by 2021). In June 2020, Estonia re-entered debt capital markets, issuing for the first time since 2002 a long-term bond: a EUR 1.5bn security with a maturity of 10 years and coupon of 0.125%. Estonia's low debt supports AA- credit ratings.

Non-EU: Russia, Turkey and Georgia

Russia (BBB/Stable): sluggish recovery but strengthened external-sector resilience

Reigniting growth remains a major challenge for Russia. In 2021, we anticipate growth of 2.5%, supported by recovery in oil prices. Further monetary easing could also abet recovery, given a benign inflation outlook – with consumer price growth currently near a 4% target.

This year, we project the economy to contract 4.5%, somewhat softer than that in many other major countries. This owes to i) the Russian economy's structure, including a smaller role for services sectors and small and medium-sized enterprises, as well as a more substantive role for the state sector, the latter requiring less policy support; alongside ii) the country's reorientation over the past six years towards greater self-reliance, building up on substantive fiscal buffers and lowering (still-high) economic sensitivities to oil price changes. Macroeconomic stability is supported, moreover, by a flexible exchange-rate regime and an improved fiscal framework in recent years, which strengthen budgetary flexibility and foreign-exchange reserve adequacy.

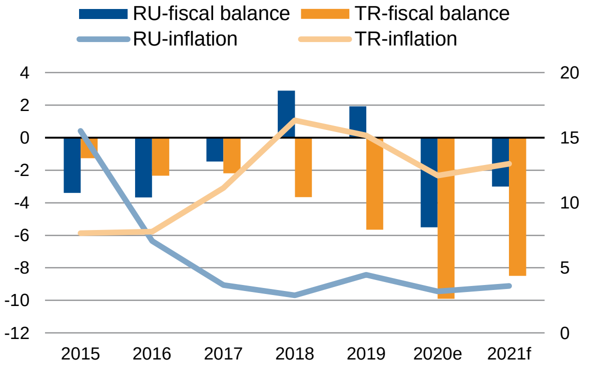
These factors have enhanced the economy's capacity to withstand external shocks, including mitigating the impact of some tightening of US sanctions under the forthcoming Joe Biden administration. At the same time, geopolitical risks related to the Ukraine conflicts, exposure to political instability in Belarus, and possible intensified sanctions weigh upon external financing flexibility, investment inflows and growth prospects.

In our view, more profound structural reform to raise weak medium-run growth potential (estimated at 1.5%) is unlikely to arrive soon. Growth remains structurally curtailed by adverse demographic trends and a weak business climate, with difficulties present in achieving diversification away from the dominant role of the oil and gas sector in the economy.

The postponement of the ambitious National Development Plan including key infrastructure projects, as one consequence of this year's crisis, will further weigh on growth potential. In addition, a significant winter wave of the virus and associated impacts on global oil demand, and an expansion in oil production as agreed by the OPEC+ from January 2021 onward amid structural oversupply of oil, will weigh on crude prices, Russia's budgetary revenue and longer-term investment into its energy sector.

We expect, however, fiscal consolidation in Russia from 2021 going forward to accommodate for lower-for-longer oil prices. Policy continuity with regards to prudent fiscal, monetary and foreign-exchange policies is anticipated, which supports macroeconomic stability. As a result, the general government's debt-to-GDP ratio is set to increase modestly in 2020 to around 20%, but stabilise thereafter medium term, supported by sizeable government cash deposits and low foreign-exchange risk in sovereign debt obligations.

Figure 10: Fiscal balance (LHS), % GDP and inflation rate (RHS), %



Source: IMF, Rosstat, Turkstat, Scope Ratings GmbH

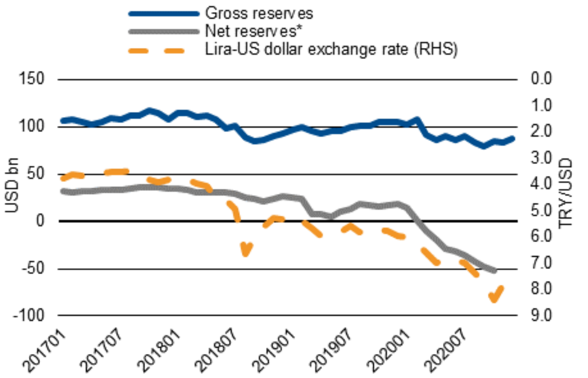
Turkey (B/Negative): 2021 to be a bellwether year for Turkey's ratings trajectory

Turkey (B/Negative) has been the only sovereign issuer downgraded by Scope thus far during the 2020 crisis (with foreign-currency ratings downgraded two notches and local-currency ratings one notch). Changes in economic governance were announced last month and the central bank under new governance raised the key repo rate 475bps to 15% from 10.25% – by and large aligning the policy rate with the weighted-average cost of central-bank funding.

However, in our view, Turkey's underlying preference for looser monetary policy has not dissipated nor has frequent interference in central bank independence under an executive presidency since 2018, changed. In this respect, a key test will be whether this near-term, market-friendly reorientation in policies can be maintained and *strengthened* over 2021. Tighter, more sustainable monetary, fiscal and structural economic policies over a longer period that prioritise lower but more sustainable economic growth could support a stabilisation of Turkey's credit Outlook in 2021. Conversely, a regression to the unsustainable policies that have wrought multiple crises over recent years could support additional ratings downgrades.

Turkey's official reserves stood at USD 88.2 as of 13 December, compared with USD 105.7 at year-end 2019 and USD 134.6bn at a 2013 peak. Net reserves excluding short-run swaps with domestic banks stood at all-time lows of negative USD 52.3bn in October (**Figure 11, next page**), cut sharply from USD 18.5bn at end-2019.

Figure 11. Turkey: net reserves, lira exchange rate



*Central bank net foreign assets minus short-term swap liabilities. Lira-USD exchange rate as of 17 Dec. 2020; source: Macrobond, Central Bank of the Republic of Turkey, Scope Ratings GmbH

We expect growth recovery of 6.2% in 2021, after depressed growth of 0.7% in 2020 (the latter revised up nonetheless 2.1pp from October forecasts after a strong third quarter GDP). Turkey's traditional credit strength – its public finances – has weakened substantively with the budget balance expected at about -8.5% in 2021 (after -10% of GDP in 2020) – see **Figure 10 (previous page)**, with general government debt seen reaching 69% of GDP by 2025, compared with 45% of GDP at end-2020 and 33% in 2019.

Georgia (BB/Negative): 2021 assessment to centre on external, fiscal risk and structural reform progress

The Georgian economy is projected to recover 4.5% in 2021, supported by recovery in external demand, higher investment and employment-sector gains. This follows contraction of an estimated 5% this year.

The Negative Outlook on Georgia's BB ratings reflects the significant negative impact of the crisis on the economy and public finances, made worse by high dependencies on tourism and travel sectors, which indirectly account for around 30% of GDP, alongside elevated exchange rate pressures and external-sector vulnerabilities. In 2021, a focus in the ongoing ratings assessment will be on external-sector and fiscal risks, and government progress on structural reforms.

After October 2020 parliamentary elections, we expect the government to remain committed to IMF-coordinated reforms, macroeconomic discipline and closer economic and political integration with the European Union, supporting inward FDI flows. Structural reforms to improve productivity and broaden a narrow tax base whilst addressing labour market and demographic weaknesses are keys to ensuring sustained growth. The National Bank of Georgia has reduced inflation, which stood at 3.8% year-on-year in November (against a target of 3%).

We expect Georgia to meet elevated 2021 financing needs and expected repayment of a USD 500m Eurobond coming due in April 2021 would be credit positive – significantly curtailing thereafter the stock of debt outstanding to the private sector. However, Georgia's dependence on foreign-currency financing due to low liquidity of lari capital markets exposes public- and private-debt trajectories to significant exchange-rate risk in 2021 and beyond.

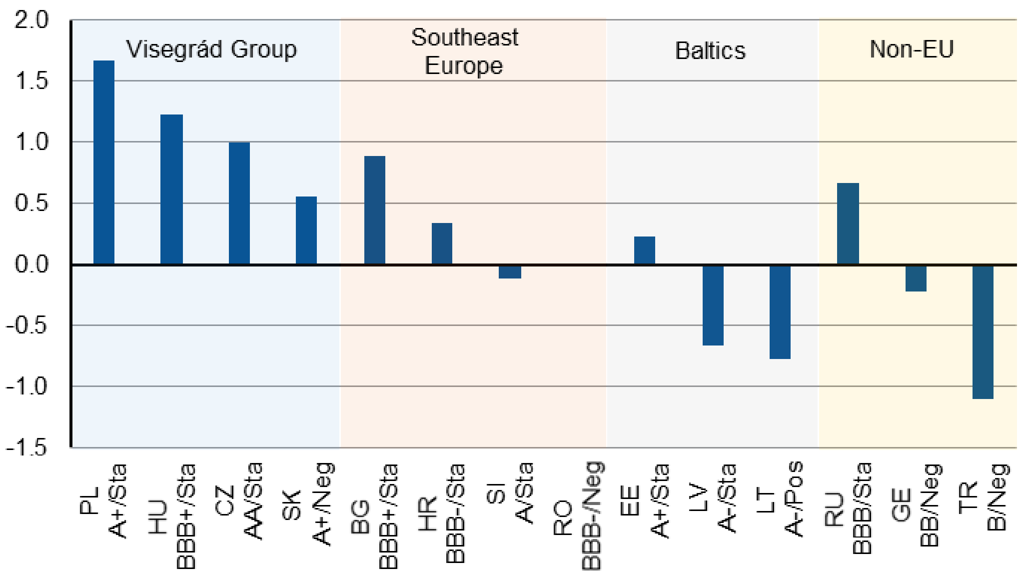
In addition, we expect geopolitical risk to persist in relation to unresolved conflicts in South Ossetia and Abkhazia with Russia, although some progress towards re-opening transport communications is possible.

Annex I: Scope's CEE sovereign ratings & 2020 rating actions

Figure 12. CEE long-term foreign-currency issuer ratings, as of 17 December 2020

Central and Eastern European 11 (CEE 11)				Non-EU CEE	
Euro area		*Non-euro-area EU*			
Estonia	AA-/Stable	Bulgaria	BBB+/Stable	Georgia	BB/Negative
Latvia	A-/Stable	Croatia	BBB-/Stable	Russia	BBB/Stable
Lithuania	A-/Positive	Czech Rep.	AA/Stable	Turkey	B/Negative
Slovakia	A+/Negative	Hungary	BBB+/Stable		
Slovenia	A/Stable	Poland	A+/Stable		
		Romania	BBB-/Negative		

Figure 13: Scope's ratings vs US rating agency average, notches, as of 17 December 2020



Source: Reuters Eikon, Scope Ratings GmbH.

Displayed are long-term foreign-currency issuer ratings differentials. Based on an alpha-numeric conversion on a 20-point scale from AAA (20) to D (1). Positive/Negative Outlooks are treated with a +/-0.33 adjustment. Credit Watch positive/negative with a +/-0.67 adjustment.

Figure 14. Scope's CEE sovereign rating actions in 2020, as of 17 December 2020

Date	Sovereign	Rating action	Rating & Outlook
17 January	Russia	Upgrade/Outlook change	BBB/Stable
21 February	Estonia	Upgrade	AA-/Stable
17 April	Georgia	Affirmation/Outlook change	BB/Negative
1 May	Slovakia	Affirmation/Outlook change	A+/Negative
12 June	Romania	Affirmation	BBB-/Negative
10 July	Turkey	Downgrade/Outlook change	B+/Stable
2 October	Czech Republic	Affirmation	AA/Stable
6 November	Turkey	Downgrade/Outlook change*	B/Negative

*Downgrade and new rating level refer to foreign-currency long-term ratings only.

Annex II: 2021 macroeconomic outlook

	Country/region	Real GDP growth (%)			General government balance (% of GDP)			General government debt (% of GDP)			Yield, local currency, 10-year (%)	CDS spread, EUR, 1-year (bps)	Policy rate (%)*	EUR per local currency (%)	Reserves (% of short-term external debt)**
		2019	2020E	2021F	2019	2020E	2021F	2019	2020E	2021F	As of December 14, 2020			Oct. 1 - Dec. 14, 2020	2020 (F)
	EU CEE-11	3.7	-5.3	4.1											
Euro-area CEE	Slovakia	2.4	-7.8	5.2	-1.3	-9.0	-7.2	48.0	62	65	-0.5	14	-0.50	-	-
	Slovenia	2.4	-7.0	5.0	0.5	-8.2	-6.5	66.1	81	80	-0.2	26	-0.50	-	-
	Estonia	4.3	-4.5	4.0	-0.3	-7.0	-5.5	8.4	19	22	-0.2	21	-0.50	-	-
	Lithuania	3.9	-1.5	3.5	0.3	-8.0	-5.0	36.3	46	49	0.0	26	-0.50	-	-
	Latvia	2.2	-5.5	4.6	-0.2	-8.0	-4.0	36.9	49	48	0.5	25	-0.50	-	-
Non-euro-area EU CEE	Poland	4.1	-3.9	3.5	-0.7	-9.0	-5.0	46.0	59	59	1.3	12	0.10	1.3	93.2
	Romania	4.1	-4.8	4.2	-4.3	-9.1	-8.3	35.2	45	54	3.3	64	1.50	0.1	81.8
	Czech Republic	2.3	-7.0	4.0	0.3	-7.0	-4.2	30.8	39	41	1.3	8	0.25	2.3	124.4****
	Hungary	4.9	-6.0	4.6	-2.0	-10.0	-5.5	66.3	80	79	2.2	20	0.60	1.8	188.9
	Bulgaria	3.4	-5.0	3.5	2.1	-3.5	-3.0	20.4	26	27	0.3	23	0.00	0.0	202.1
	Croatia	2.9	-9.1	5.9	0.4	-7.5	-4.0	73.2	88	83	0.7	26	0.05	0.5	109.8
Non-EU emerging Europe	Russia	1.3	-4.5	2.5	1.9	-5.5	-3.0	14.0	20	21	5.8	11	4.25	2.0	502.0
	Turkey	0.9	0.7	6.2	-5.6	-9.9	-8.5	33.0	45	51	13.3	241	15.00	-5.4	45.0
	Georgia	5.1	-5.0	4.5	-2.0	-8.5	-5.0	42.7	62	62	8.8***	-	8.00	-5.8	125.2

Source: Scope Ratings GmbH, IMF, OECD, Eurostat, Bloomberg, national central banks and statistical offices, Macrobond; *deposit facility rate of the ECB for euro area CEE economies; yield on 7-day National Bank of Poland money market bills for Poland; 2-week repo rate displayed for the Czech Republic; interest rate on minimum reserves shown for Hungary; 1-week repo rate for Romania, Russia and Turkey; base rate for Bulgaria; rate on regular operations for Croatia; 1-week refinancing rate for Georgia; **coverage of short-term external debt plus long-term external debt maturing in one year or less, an IMF adequacy threshold for this ratio is above 100%, data from IMF Assessing Reserve Adequacy October 2020; ***as of 20 October; ****IMF Article IV June 2019: Czech Republic.

Annex III: Economic vulnerability to Covid-19 shock (link to research)

	Country/region	External			Internal	
		Global value chain participation rate, % of total gross exports, 2015*	Manufacturing, % of gross value added, 2019	Travel and tourism total contribution, % of GDP, 2018	Temporary employment, % of total employment, 2020 Q3 or latest available data	Self-employed, % of total employment, 2020 Q3 or latest available data
Euro-area CEE	Slovakia	63.6	20.7	6.4	5.5	14.9
	Slovenia	52.4	23.2	12.3	8.7	11.6
	Estonia	51.6	14.9	15.5	2.1	11.5
	Lithuania	48.4	18.0	4.9	1.1	11.4
	Latvia	41.3	11.7	9.4	1.9	10.8
Non-euro-area EU CEE	Poland	48.1	19.1	4.5	15.0	17.9
	Romania	44.2	18.8	5.4	1.0	15.0
	Czech Republic	58.6	24.9	7.6	5.7	15.9
	Hungary	59.2	21.7	8.0	5.0	11.3
	Bulgaria	52.2	16.5	11.3	2.8	10.4
	Croatia	32.4	14.7	25.1	12.2	11.2
Non-EU CEE	Russia	41.3	14.6	4.9	8.0	6.7
	Turkey	33.4	21.1	11.7	6.5	31.5
	Georgia	N/A	10.1	31.3	N/A	51.3

Source: WTO, Eurostat, World Bank, OECD, World Travel & Tourism Council, Rosstat, Turkstat, Geostat; *foreign inputs and domestically-produced inputs used in third countries' exports, percentage of total exports.

Annex IV: Additional relevant research (since Q4 2020 CEE Update)

Sovereign Outlook 2021: Recovery at last, with monetary and fiscal frameworks in transition, and diverging sovereign rating implications, 9 Dec

Turkey: central bank decision calms investor nerves, but a sustained policy reorientation needed, 23 Nov

EU sovereign environmental risk mitigation: Netherlands, Slovenia, Italy rank highly in new study, 12 Nov

Georgia’s incoming government faces longer-term economic challenges beyond Covid-19, 3 Nov

CDS spreads reflect diverging implications of Covid-19 crisis on CEE countries, 27 Oct

Scope Ratings GmbH

Headquarters Berlin
Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0

Frankfurt am Main
Neue Mainzer Straße 66-68
D-60311 Frankfurt am Main

Phone +49 69 66 77 389 0

Paris
23 Boulevard des Capucines
F-75002 Paris

Phone + 33 1 82 88 55 57

London
111 Buckingham Palace Road
London SW1W 0SR

Madrid
Edificio Torre Europa
Paseo de la Castellana 95
E-28046 Madrid

Phone +34 914 186 973

Milan
Regus Porta Venezia
Via Nino Bixio, 31
20129 Milano MI

Phone +39 02 30315 814

Oslo
Karenslyst allé 53
N-0279 Oslo

Phone +47 21 62 31 42

info@scoperatings.com
www.scoperatings.com

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