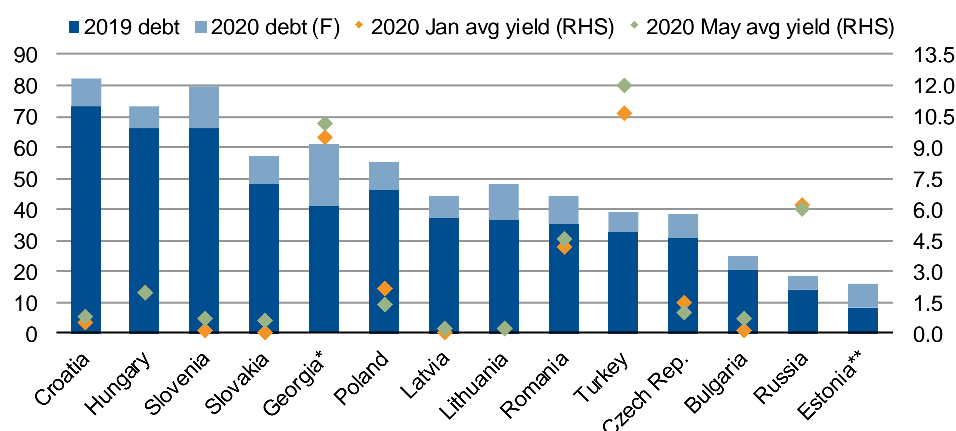
18 May 2020

Central and Eastern Europe: monetary policy is easing Covid-19 capital markets disruption – five charts

Central banks in Central and Eastern Europe (CEE) have, in most cases, contained debt-financing costs for governments, which are spending heavily to counter the economic impact of the pandemic (Chart 1). The capacity to implement bond-buying programmes and interest-rate cuts have, nonetheless, varied considerably across the region while government borrowing rates have risen in some countries as elevated external-sector and public-finance risks have resulted in sizeable portfolio outflows.

CEE economies will contract sharply this year from the direct economic impact of the pandemic as well as from fall-out from deep recessions in western Europe and disruptions to global supply chains. The region's governments have deployed significant direct fiscal support for households, workers and businesses, equivalent to around 6% of GDP (in direct revenue and expenditure measures) in the cases of Poland and Hungary, around 3.5% of GDP in the Czech Republic, and 2.5% in Russia. Extra public spending and reduced output will push public debt ratios up toward 2014 levels for most countries and weaken public finances over the medium term as gross financing needs rise.

Chart 1: Public debt (% of GDP) and bond yields (%, 10-year, local currency), only displayed for CEE countries rated by Scope



Source: IMF, Eurostat, Bloomberg, debt projections Scope Ratings; * Georgia's May average yield corresponds to April average yield, ** Estonia has no outstanding government bonds of corresponding maturity

The main conclusions of this report are:

- For euro area CEE economies, low borrowing rates and investors' relatively sanguine risk assessment reflect ECB actions – notably the large-scale asset-purchase programmes – in addition to the euro's reserve-currency status.
- Among non-euro area EU CEE countries, central bank policy responses of Poland, the Czech Republic and Hungary back the large fiscal stimulus packages and mitigate tightening of financial conditions. Romania, however, has less room for bolder policy response due to elevated exchange-rate risk given a high proportion of foreign-currency public- and private-sector borrowing.
- Outside the EU, Turkey's external risks are further exacerbated by economic mismanagement, with Turkey's real interest rates in negative territory after incremental rate cuts, which has amplified weakness in the exchange rate, increasing the likelihood of an emergency rate hike ultimately being required.
- Additional fiscal measures and rate cuts are expected in Russia given its substantial liquid reserves (National Wealth Fund worth 11.3% of GDP) and policy space, although the country faces the additional impact of lower-for-longer oil prices, given the economy's reliance on energy exports. Direct purchases of government bonds on secondary markets are not expected to be on the central bank's agenda, but longer-term repo funding to banks is likely.

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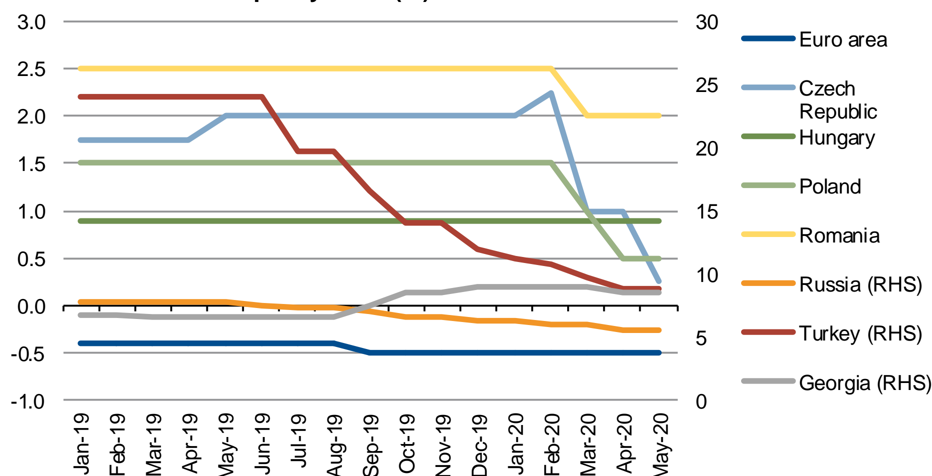
Chart #2: Monetary policy responses in CEE countries support the effectiveness of fiscal response measures

Central banks in EU CEE countries commence QE support programmes

Central banks are providing commercial banks with abundant liquidity, through repo transactions and purchases of government bonds on the secondary market in addition to cuts in interest rates (**Chart 2**).

Chart 2: Central bank policy rates (%)



Source: National central banks, Haver, Scope Ratings

N.B. End-of-month data, as of May 18 for May; overnight deposit facility rate of the ECB shown for the euro area; 2-week repo rate displayed for the Czech Republic; interest rate on minimum reserves shown for Hungary; yield on the 7-day National Bank of Poland money market bills for Poland; 1-week repo rate for Romania, Russia and Turkey, 1-week refinancing rate for Georgia

For CEE countries of the euro area, the ECB's asset purchase programmes of public and private sector securities in 2020, worth over EUR 1trn, are providing ample liquidity.

Among non-euro area EU CEE countries, in Poland and Hungary, quantitative easing by the countries' central banks might amount to as much as 10% of GDP in the case of Poland and 3% of GDP for Hungary. The National Bank of Poland also reduced its reference rate by 50bps twice this year to 0.5% effective from April. The Czech central bank, on the other hand, has not announced quantitative easing so far, but has reduced its benchmark two-week repo rate three times to 0.25% by early May, from 2.25% in February.

Lower policy space for Romania to support the economy

Romania's central bank cut its policy rate by 50bps to 2% in March and started its first-ever QE programme in April, though the size is modest. The central bank is unlikely to make further aggressive interest rate cuts that would risk weakening the value of the Romanian leu, however, a risk given the country's high proportion of foreign-currency public- and private-sector borrowing.

Significant policy easing in Turkey despite elevated financial and external sector risks

Outside of the EU, firstly, the central bank of Turkey has stepped up purchases of government bonds on the secondary market and reduced its policy one-week repo rate by a further 100bps to 8.75% in April, the latest of eight consecutive cuts from 24% as of July 2019, despite very high bank lending growth and double-digit inflation, at 10.9% y-o-y in April. Additional rate cuts are possible in the near-term as the economy loses momentum, although the risk remains that if pressure on the Turkish lira escalates, a significant emergency rate *hike* might ultimately be required.

More rate cuts likely in Russia,

The Central Bank of Russia reduced its policy one-week repo rate by 50bps to 5.5% in April. Additional interest rate cuts are likely, while purchases of government bonds on secondary market seem, however, not to be on the agenda (longer-term repo funding of

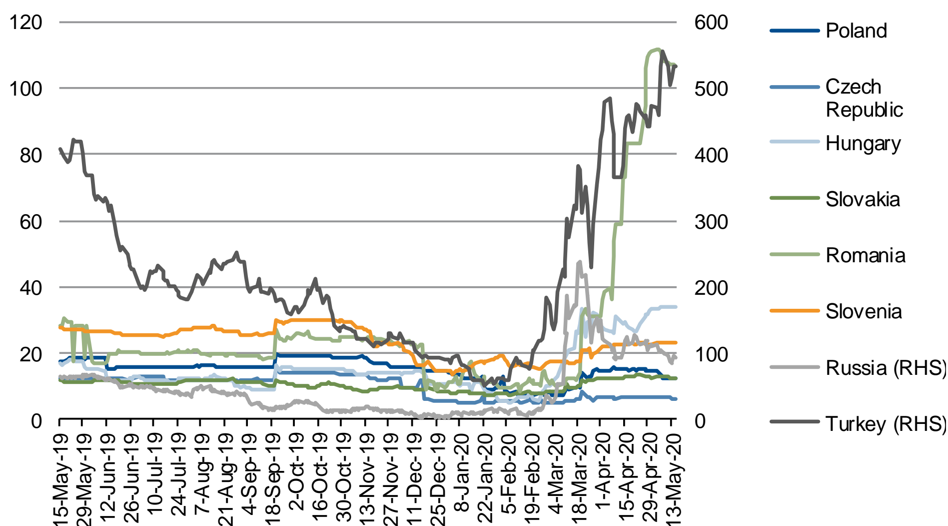
state-controlled lenders to support purchases is possible). Russia's consumer price index rose by 3.1% y-o-y in April, compared with 2.5% in March, nevertheless still running below the central bank target of 4%.

Chart #3: Investor assessment of country risk varies throughout the CEE region

Sharp widening of CDS spreads in Turkey; higher spreads in Russia, Romania

While all CEE countries are being hit hard by the knock-on effects of the Covid-19 crisis, capital markets perceptions of credit implications of the crisis differ between countries. For Turkey, the spread on the euro- and dollar-denominated one-year credit default swap (CDS) – designating the cost of protecting against a credit event – has increased sharply this year to 590bps in USD terms and 530bps in EUR at the time of the writing (**Chart 3**), from around 100bps in January for both, reflecting in part significant external-sector weaknesses. Meanwhile, Russia's dollar and euro CDS spreads dipped to 65bps and 95bps respectively, after March peaks at 220-240bps – when Brent crude oil prices fell below USD 30 a barrel – although CDS spreads remain significantly higher than January levels at 15bps. Romania's CDS spreads have increased to 110-120bps since the beginning of May, compared with January levels of 15bps, reflecting the country's weak public finances, exacerbated by higher spending triggered by the coronavirus crisis.

Chart 3: CDS spread (bps, 1-year, euro denominated)



Source: Reuters, Scope Ratings

Marked increase in Hungary's CDS spreads, more moderate rises in the rest of EU CEE economies ex-Romania

Hungary's CDS spreads have also increased noticeably, from 10-15bps at the beginning of the year to 35-40bps currently, while those for Poland and the Czech Republic are currently only modestly higher, at 12bps and 6bps respectively in euro terms. Similarly, the EUR CDS spreads of euro area CEE economies have increased moderately, currently at around 20bps in the cases of Slovenia and the Baltic states and somewhat lower in the case of Slovakia.

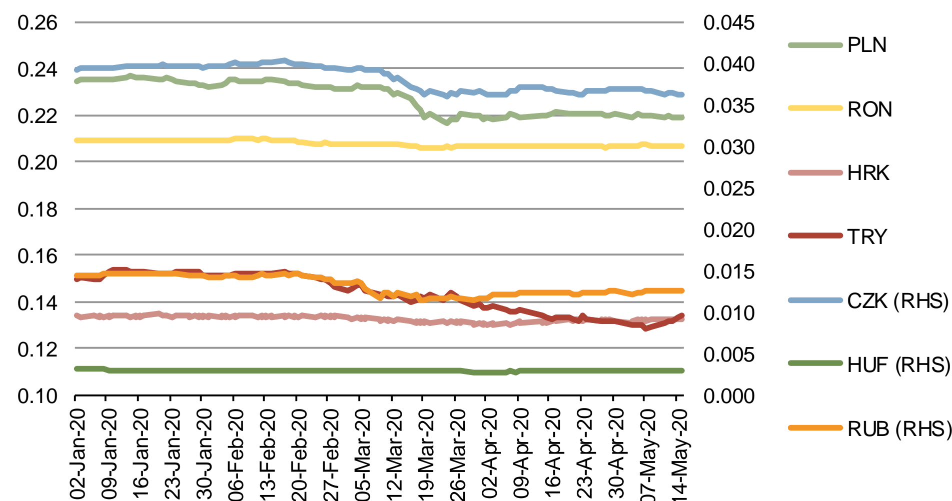
Chart #4: Exchange-rate volatility has increased in non-euro CEE countries and is likely to remain elevated over the duration of the crisis

Central bank interventions mitigate exchange rate volatility in non-euro area EU CEE countries

Since the beginning of March, the Polish zloty and the Hungarian forint have each weakened by around 5% against the euro, while the Czech koruna weakened by 7% (**Chart 4, next page**). The tightly managed Romanian leu and Croatian kuna have been less volatile due to continued central bank interventions. Central bank reserves of non-euro EU CEE economies are adequate to address the current economic crisis, remaining

above an IMF threshold of 100% coverage of short-term external debt, with the exception of Romania's level being somewhat lower (85%).

Chart 4: Exchange rates, EUR per local currency



Source: ECB, Haver, Scope Ratings

TRY, RUB have fallen significantly against USD, EUR

Outside of the EU, Russia's rouble has lost around 9% of its value against the dollar and more than 6% against the euro since March, while the Turkish lira is currently trading around 10% lower against the dollar and 7% weaker against euro compared with end-February. Russia's reserves cover almost five times outstanding short-term external debt and support the external resilience of the Russian economy. On the other hand, Turkey's official reserves cover only about 70% of short-term external debt, which poses a significant risk of a deeper balance-of-payment crisis if lira depreciation gets worse. Portfolio outflows from emerging Europe moderated in April, however, following March peaks.

Chart #5: Government bond yields in CEE countries increased in mid-March before reversing lower in April

The Covid-19 global shock and its impact on public finances as governments have responded with large increases in public spending to support the economy are visible across the CEE region, where government bond yields rose steeply in March before falling in recent weeks, although moves have varied by country in magnitude.

Increase in Romania's borrowing rates despite a rate cut; pre-Covid-19 borrowing rates in many other EU CEE countries

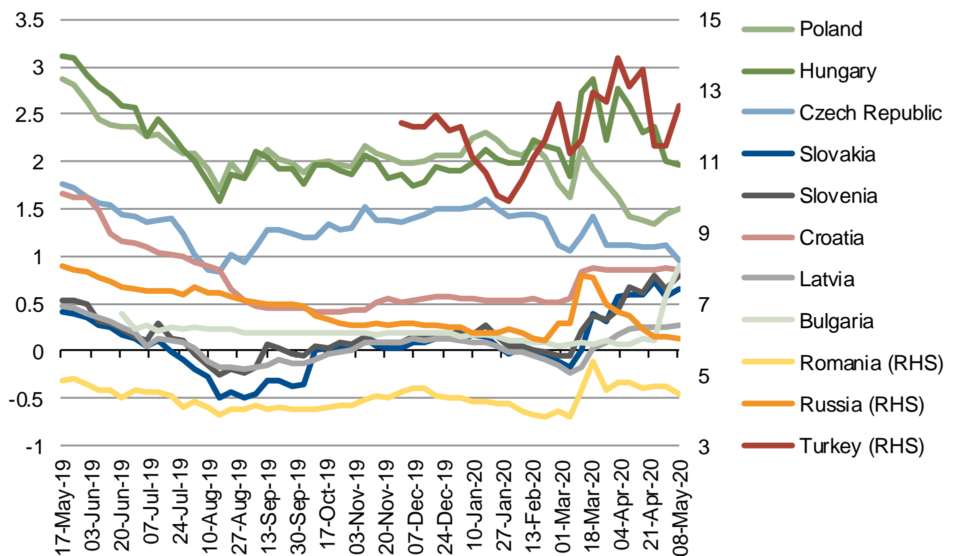
Romania's local currency 10-year government bond yield had increased to 4.4% at the time of the writing, from 4.1% as of January lows (**Chart 5, next page**) despite a 50bp rate cut. Hungary's 10-year yield has reverted to January levels of 1.9%, after picking up to 3.3% mid-March. On the other hand, Czech and Polish yields of 0.8% and 1.3% respectively are currently somewhat lower than they were in January pre-crisis.

Yields for euro area CEE governments increased only modestly in 2020 at currently around 0.6% for Slovakia and Slovenia, and below 0.3% in the case of the Baltic states. The yield on the local currency 10-year bond of Bulgaria, which has a currency board regime with the euro, increased to over 1% currently, from under 0.3% in January. In Croatia, which de facto pegs the kuna to the euro, the 10-year yield has increased to around 0.9% from 0.55% at the beginning of this year.

Higher borrowing rates for Turkey despite significant policy easing, Russia's borrowing rates at January levels

Outside of the EU, Russia's 10-year yield fell to 5.4% supported by monetary easing, after picking up to over 8% mid-March. On the contrary, Turkey's 10-year lira government borrowing rates have increased sharply in 2020, to 13.3% at time of writing, from January lows of under 10%, despite cuts of 250bps in central bank policy rates over the same time period.

Chart 5: Sovereign bond yields (%, 10-year, local currency)



Source: Bloomberg, Scope Ratings

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