2022 Central and Eastern Europe Sovereign Outlook

Sound albeit uneven growth ahead but risks to the region are mounting

Sovereign and Public Sector, Scope Ratings GmbH, 14 December 2021

EU CEE-11: 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

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Executive summary

The economies of Central and Eastern Europe (CEE) have continued rebounds after last year's pandemic-induced recession, supporting improvement in countries' sovereign credit outlooks. A core constraint remains, however, still-elevated budget deficits preventing any meaningful reduction of government debt ratios and exposing government balance sheets to risk during any tightening in global financial conditions.

Inflation is running above target across CEE markets, limiting the room central banks have to abet recovery via continued monetary accommodation. In this context, quality of economic policies is becoming increasingly critical for growth and credit outlooks in view of diverging political conditions in the region, prolonged fiscal adjustments that are needed, rising labour shortages, as well as evolving environmental and technological challenges.

The access of CEE members of the EU (CEE-11) to substantial EU investment funds provides them with an historic opportunity to raise longer-run potential growth via infrastructure projects in addition to the funding's support for nearer-run economic recovery. Improved economic resilience and reduced external-sector risk contribute to improving credit outlooks of the Baltic States, Bulgaria and Croatia, the latter two nations benefitting from accession to the EU's Exchange Rate Mechanism II and Banking Union. Even so, higher-than-usual policy uncertainty persists in some countries, such as Poland and Hungary, compounded by tensions with the EU over rule of law that could result in further delay of EU funding and adversely impact outlooks for growth and public finances. Those CEE economies most integrated in global supply chains, such as Slovakia and the Czech Republic, face near-term slowdown.

Outside of the CEE-11, Russia is benefitting from recovery in commodity prices. Effective fiscal and monetary management has aided stabilisation of the economy amid lingering impacts of the Covid-19 crisis, while reducing FX volatility. However, the risk for further sanctions is very elevated – such as those potentially affecting banks and the secondary market trade-ability of government securities – weighing on the investment and growth outlooks. The significance of sanctions for the credit ratings of Russia hinges at this stage on whether the government's approach on Ukraine favours a status quo, reducing tensions, or escalating a crisis next year with likelihood under such a scenario of further international sanctions. Nevertheless, factors that have made the Russian economy more resilient *longer term* to sanctions risk, external crisis and volatility in rouble anchored our decision to upgrade Russia's credit rating to BBB+/Stable in October.

In Turkey, overly loose monetary policy has supported strong growth over 2021 at expense of intensifying longer-run macroeconomic imbalances and possibility of a hard economic landing. Turkey's economic policy framework, as President Recep Tayyip Erdoğan consolidates control over levers of governance – including the central bank, remains inconsistent with the economy's long-run sustainability.

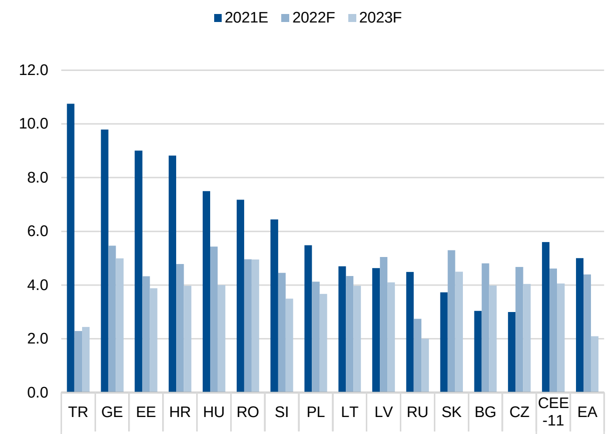
Main economic themes in 2022

Solid but *uneven* growth moving ahead

A recovery from the pandemic recession is underway across the region. Increased household consumption, associated with pent-up demand, as well as with rising wages and levels of employment, has supported stronger-than-anticipated CEE growth in 2021. Expansion has, moreover, been broad based. Investment aided growth, although the contribution from net exports was negative in many economies in Q3. Poland, Hungary and Lithuania grew around 6% in Q3 from the same period a year before. In the same quarter, growth reached 8% in Romania and 9.2% in Estonia. Poland, Romania, Slovenia, Hungary and the Baltic states have achieved pre-pandemic levels of output. The Czech Republic grew only 3.1% in Q3 from the same quarter the previous year, while Slovakia grew 1.3% YoY. Both economies will require longer to return to pre-pandemic levels of output.

Outside the EU, growth remained strong in Turkey (7.4%) and in Georgia (9%) in Q3, supported by strong growth of exports as well as a gradual recovery of tourism. Both economies face considerable external-sector risk. Russia's economy was back at pre-pandemic levels of output in Q2 2021, after growing 8.1% from Q2 of the previous year, supported by increasing mining and oil production.

Figure 1: Real GDP growth rates*, %



	TR	GE	EE	HR	HU	RO	SI	PL	LT	LV	RU	SK	BG	CZ	CEE -11	EA
2021E	10.8	9.8	9.0	8.8	7.5	7.2	6.4	5.5	4.7	4.6	4.5	3.7	3.0	3.0	5.6	5
2022F	2.3	5.5	4.3	4.8	5.4	5.0	4.5	4.1	4.3	5.0	2.7	5.3	4.8	4.7	4.6	4.4
2023F	2.4	5.0	3.9	4.0	4.0	5.0	3.5	3.7	4.0	4.1	2.0	4.5	4.0	4.0	4.1	2.1

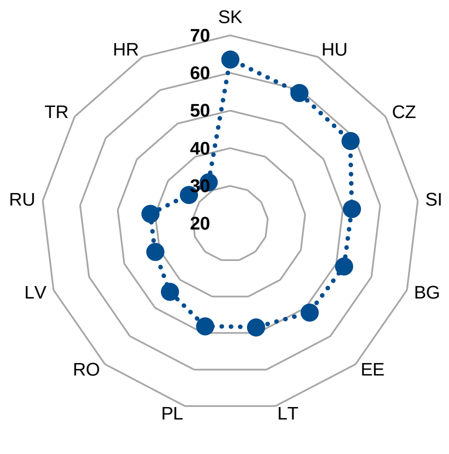
Source: European Commission, IMF, national statistical offices, Scope Ratings GmbH forecasts; *sorted by estimated rate of 2021 growth; full forecasts in **Annex I**

Business and investor sentiment is strong in the region, pointing to sturdy growth moving ahead, but there are nevertheless obstacles. New waves of Covid-19 infection and associated restrictions of economic activity, lingering supply-chain disruptions, elevated gas and electricity prices represent challenges for consumers and producers, on top of structural constraints in form of adverse demographics and transformation challenges.

This is even though new waves of Covid-19 infection are expected to prove *less* disruptive to economic activity than earlier ones. Consumers and companies are increasingly adapting manners of conducting business during intermittent restrictions, vaccination has advanced, even though the percentage of fully vaccinated in CEE is lower than that in western Europe, especially in Bulgaria, Georgia (around 25%), and in Russia and Romania (around 40%).

The region remains far from economically homogenous despite broad increases of living standards over the past decade, and the pace of recovery is seen continuing to vary (**Figure 1, previous page**) contingent upon economies' underlying strengths and weaknesses, not least exposures to supply-side shock. While capacity utilisation in industry is back at pre-pandemic levels, services sectors have not bounced back as fully, with this latest wave of coronavirus representing an added setback. Supply-side interruptions particularly affect countries with more open economies (**Figure 2**). Here, component supply shortages in the automotive industry are crimping recovery in nations more reliant upon production and export of cars, such as Slovakia and the Czech Republic.

Figure 2: Global value chain participation rates*



Source: World Trade Organization; *foreign inputs, and domestically produced inputs used in third countries' exports, % of total exports

Despite outstanding headwinds, Scope projects broad-based economic expansion in CEE-11 to continue, marking full-year growth of 4.6% next year and 4.1% in 2023, after an 5.6% estimate this year, allowing for gradual easing of supply-side bottlenecks and stabilising energy prices by H2 2022. Our updated growth forecasts are presented in **Figure 1 (previous page)** with expanded forecasts available via **Annex I**. Overall, rebound of domestic and foreign demand sustain growth. EU CEE countries will increasingly access funding from a 2021-27 EU budget and Next Generation EU recovery fund from 2022 – providing further stimulus buoying investment.

Outside the EU, Russia is seen growing an above-trend rate of 2.7% in 2022, after 4.5% this year. Spending from the National Wealth Fund on domestic infrastructure and higher commodity exports support growth. We expect growth to thereafter return near a more subdued potential rate of around 1.5-2% from 2023, reflecting slow structural reform efforts and high sanctions risk.

Turkey's economy is estimated to expand 10.8% this year even accounting for drop-off near the end of the year as the economy enters currency crisis, before 2.3% in 2022 and 2.4% in 2023. Loose monetary policy, elevated consumer loan growth and strong exports, as a weakening lira supports external competitiveness, have anchored growth. However, fast-rising consumer prices and failure to address significant and increasing macroeconomic and external-sector imbalances risk compromising the longer-run economic outlook.

Georgia ought to record growth of around 5.0-5.5% over 2022-23, after 9.8% this year, supported by government commitment to a credible macroeconomic policy framework with involvement from concessional multilateral creditors such as the IMF and the EU. Prolonged political instability is a downside risk to outlooks for the economy and public finances.

Moderating deficits ease immediate vulnerabilities to fiscal sustainability

In 2020, budget deficits ballooned across the CEE region during severe downturn and as governments spent in helping households and businesses. Debt-to-GDP ratios rose an average 11pps for CEE-11 in 2020 from the year before – in many cases to levels not seen since peaks of the global financial crisis.

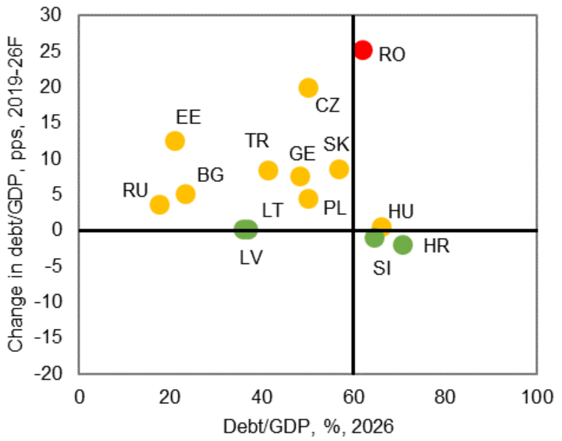
Deficits stayed elevated around 5.5% of GDP on aggregate in CEE-11 this year compared with 7.1% of GDP in 2020 as governments extended discretionary budgetary measures to accelerate recovery. As result, debt ratios are seen peaking in 2021 before stabilising and gradually declining from 2022. Continued recovery and withdrawal of emergency government support from the crisis support budget balances. Altogether, an aggregate budget deficit of CEE-11 is seen shrinking to 3.8% of GDP in 2022 before 3.1% in 2023.

Russia ought to come close to a balanced budget over 2022-23, anchored by higher oil prices. In Turkey, increasingly frequent economic crises have brought repeated requirement for counter-cyclical use of budgetary resources. We see general government deficits of 5.4% of GDP in 2022, further rising to 6.4% in 2023, after a more-modest-than-anticipated 3.2% this year.

A spike in regional debt ratios has increased longer-run budgetary vulnerabilities (**Figure 3**) and represents a risk concerning sovereign credit ratings, especially as regards non-euro-area CEE governments, which do not benefit from asset purchases and loan facilities of the ECB. As such, non-euro-area CEE governments face more tangible risks associated with their public debt burdens. This includes Hungary and Romania, for which gross government financing requirements are expected to remain more than 10% of GDP next year (more than 15% of GDP in case of Hungary).

Under such a context, governments must demonstrate renewed commitment to fiscal consolidation as this Covid-19 crisis eases, especially in those countries with other stress factors or sources of uncertainty such as political instability or forthcoming elections, per in Turkey, Romania, Slovakia, Hungary, Poland and Georgia. Authorities' abilities in consolidating government finances will help determine trajectories of their sovereign credit ratings.

Figure 3: General government debt trends



Source: IMFWEO October 2021 and Scope Ratings GmbH forecasts

Development of domestic capital markets is crucial for many countries of the region, given increased pressure on rolling over higher levels of government debt after this crisis. Relative to GDP, the average size of CEE-11 capital markets remains only around a third of the EU average.

Shifting international capital flows present an opportunity for CEE-11 to attract new forms of investors to domestic capital markets. As an example, CEE-11 is well positioned to become an attractive destination for new environment, social and governance (ESG)-minded investor groups, given an EU strategic focus upon sustainable economic growth and ways to finance this growth. In this evolving area, countries with stable legal systems and strong rule-of-law frameworks are the most likely to benefit.

In Russia, new American sanctions from earlier this year on the Russian state's primary-market debt issuance have had a limited impact thus far on financial stability, reflecting moderate participation of non-residents in primary treasury bond markets, accounting for (only) around 20% of investors so far in 2021. The Russian state can borrow satisfactorily on domestic capital markets, given low maturing debt of around 1% of GDP a year through 2023. Foreign-currency exposure is limited. Rouble-denominated obligations made up more than 80% of government debt as of December 2021.

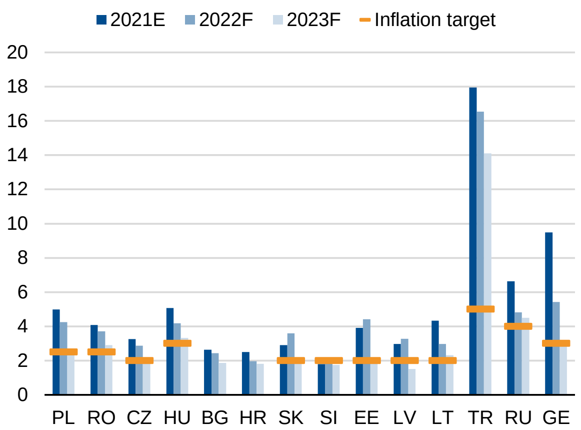
In Turkey, state-owned banks hold adequate liquidity to support financing of government deficits and foreign-currency requirements over the immediate future. However, rising government debt and fast-devaluing lira risk increasingly limiting room for manoeuvre, given compounding effects of lira loss on the sustainability of the foreign-currency-denominated public debt stock.

Higher for longer inflation raises economic uncertainty

Headline inflation has risen sharply (**Figure 4**), to well above central bank objectives and market expectations. Poland and Hungary recorded year-on-year inflation rates of around 7.5% in November. Prices rose well over 8% in Russia and Lithuania in the same month compared with a year before. Core rates of inflation – which excludes volatile food and fuel items – has also increased, albeit to a somewhat lesser extent.

The rapid pick-up of inflation partly reflects pandemic-related mismatch of supply and demand as well as rises of energy prices. The outlook going forward is highly uncertain.

Figure 4: Inflation forecast, year-on-year, %



Source: Central banks, European Commission, IMF and Scope Ratings GmbH forecasts

Inflation will remain above objectives across most CEE markets this year and in early 2022 until supply-side bottlenecks and pandemic-related disruptions moderate.

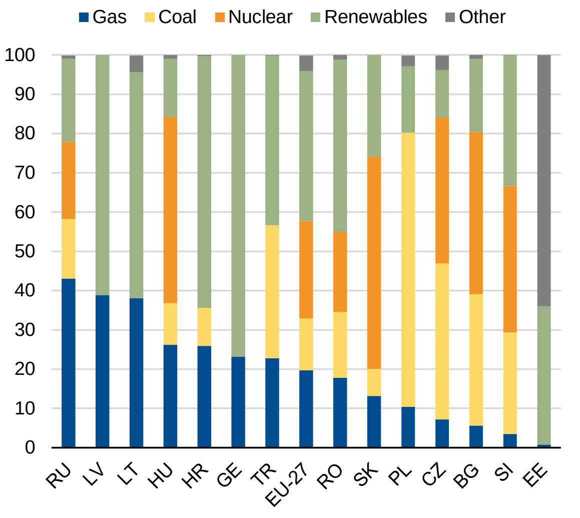
CEE central banks – such as those of the Czech Republic, Hungary and Poland – are seen tightening official rates further in countering inflation pressure. In the Czech Republic, to 3.75% by end-2022, Hungary to 2.7% and Poland 2.5%.

As regards Russia, the central bank's policy framework has underpinned rouble stability. The central bank has hiked its policy rate six times thus far in 2021, bringing cumulative rise to 325bps, with a rate currently of 7.5%. Further hikes are probable. Conversely, in Turkey, a series of recent rate cuts even as peer central banks have tightened have made the economy more vulnerable to lira depreciation, higher inflation and capital outflow – all under a context of significant political interference in monetary policy ahead of elections due by 2023.

Should prolonged supply-side bottlenecks, large swings of commodity prices and increasing wages trigger higher inflation expectations, central banks could face pressure to tighten policy more substantively. Debt servicing costs would then increase materially, at least around the short end of the curve. Rising labour shortages could translate to higher wages and longer-run inflationary pressure.

Many CEE countries depend upon fossil fuels as regards power generation (**Figure 5**). Amid increasing prices, securing *affordable* sources of energy is, furthermore, vital for CEE-11, partly as this is a priority for activation of EU funding, requiring alignment of national policies with EU energy and environmental priorities.

Figure 5: Share of electricity production by source*, %, 2020



Source: Our World in Data, BP Statistical Review of World Energy, Ember, Scope Ratings GmbH. For Estonia, "other" refers mostly to shale oil.

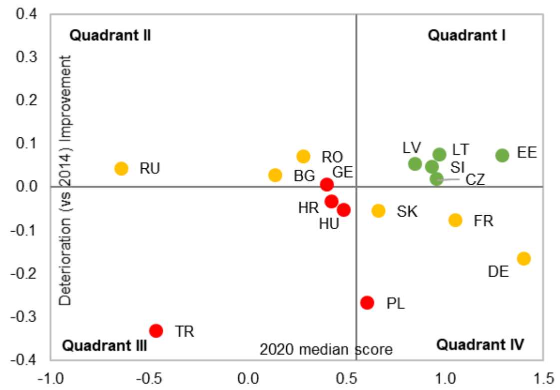
Improvements in institutional quality crucial for credit outlooks

Soundness of political institutions in CEE is becoming increasingly critical in assessments of sovereign credit quality, as poor governance materially undermines growth potential and fiscal prudence. Disputes between the EU and Poland and Hungary over the rule of law have resulted in delays in disbursement of EU recovery funding – impairing growth and reform outlooks.

Decline of institutional quality over past years in Poland and Hungary is reflected via World Bank Worldwide Governance Indicators (WGI) (**Figure 6**). Institutional performance of the two nations has weakened, converging with that of countries such as Romania, and at odds with the institutional performance of other large, more developed and diversified economies.

Polarised political conditions in Poland and Hungary and outstanding political disputes with the European Union make a longer-run outlook as regards policy making less predictable. Aside from financial penalties, the risk is that said economies face more significant and prolonged suspensions of their EU funding. This could adversely impact outlooks as regards growth and public finances, particularly should governments resort to domestic borrowing to compensate for suspended EU financing. In addition, adversarial relationships with the EU call into question the reliability of lender-of-last-resort financing options from the EU should the economies enter adverse market equilibria.

Figure 6: Average of the six World Bank WGI*, CEE vs Germany, France (and change in score since 2014)



Source: World Bank, Scope Ratings GmbH; *WGI scores range from around -2.5 (weakest) to 2.5 (strongest); dividing line for the x-axis relates to 2020 median score for CEE across the six WGI

In the Czech Republic and Bulgaria, newly-formulated opposition alliances won general elections. These electoral outcomes reflect discontent with the longer-lasting dominance of earlier ruling parties.

In Romania, Bulgaria, Croatia and Slovakia, below-average governance marks – as judged via WGI – have contributed to historically weak absorption rates of EU financing (of under 60% over a previous 2014-20 EU multiannual period as of September 2021), remaining an obstacle to economic growth.

Against this backdrop, introduction of "rule of law conditionality" in EU development funding is a game-changer, enabling suspension of payments to EU member states when violations of the rule of law "affect or seriously risk affecting" management of funding.

Developing the institutional capacity needed for more effective spending of EU funding is vital to boosting longer-run growth in the region. This is especially true as the potential rate of economic growth eases as incomes rise, the number of persons of working age drops and the proportion of elderly increases.

Previously high foreign direct investment (FDI) inflow to the region is under structural decline, reflecting increasingly mature consumer markets, largely exhausted opportunities for privatisation and past completion of large-scale infrastructure assignments. To compensate, CEE governments need to adopt economic and institutional reforms to address outstanding economic bottlenecks.

Turkey is an outlier of the region with weak and deteriorating institutional quality. Authorities' pursuit of unorthodox economic policies in engineering economic growth at expense of high inflation risks pushing the country to a full balance-of-payments crisis before elections due by 2023. Monetary policy has been controversially supplicated to the political agenda.

In Russia, prudent macroeconomic policy has reinforced economic resilience to external crises, but a coherent plan is required that addresses long-term structural challenges, such as the carbon intensity of the economy.

In Georgia, progress on structural reform to raise productivity and address labour-market weaknesses – the unemployment rate was an elevated 19.5% as of Q3 2021 – has slowed, due to immediate urgency of offsetting economic disruptions of the Covid-19 crisis.

Labour shortages have become more pronounced

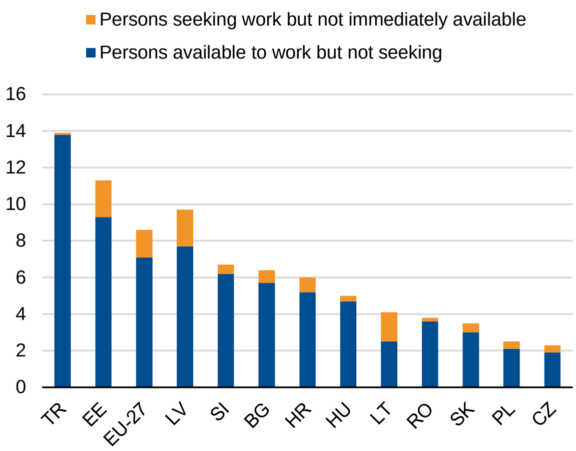
Labour markets are improving in CEE with rising employment. CEE-11 average unemployment declined to 5.3% as of October, slightly above a pre-crisis rate of 4.5%. As services sectors resume recovery, labour markets are expected to strengthen further, with unemployment rates returning to pre-pandemic levels by 2022.

Stronger employment markets are, at the same time, bringing labour shortages, exacerbated by ageing populations. Old-age dependency ratios (representing populations aged 65 years and over to that aged 15-64 years) are expected to increase across Scope-rated CEE countries over the next five years, staying low only in Turkey. This development represents a challenge for sovereign credit ratings. This is despite some improvement as regards immigration flows over recent years. Poland has been registering the highest number of immigrant workers of the EU.

The share of manufacturing firms pointing to labour shortages as a constraint on production has been much higher in CEE-11 than in the EU as an aggregate and has increased substantively over the past five years. Furthermore, most countries have limited spare human capital (**Figure 7**), including in the Czech Republic, Poland, Slovakia and Romania – and below EU averages. Turkey is the only country of the region with abundant labour supply.

If not addressed, declining working-age populations constrain labour market supply and hinder longer-run growth while burdening public spending through higher pensions, health care and social care costs. Reform to improve the efficacy and flexibility of labour markets including via skills training and targeted immigration is required. To this end, improving education, enhancing governance and fine tuning welfare provisions are further priorities.

Figure 7: Potential additional labour force, % of population outside the labour force, Q2 2021



Source: Eurostat; data for Turkey as of Q4 2020

Covid-19 could accelerate structural transitions in regional car industries

For many CEE economies, the automotive industry has been a principal driver of economic convergence with western Europe over the past two decades. This has exposed economies to the automotive sector's global supply chains – see **Figure 2 (page 4)**. The sector accounts for 13% of Slovak output, and around 10% of GDP in the Czech Republic, Hungary and Romania. Component supply shortages since onset of the crisis have taken a toll on automobile production and exports with this potentially persisting until at least mid-2022. The National Bank of Slovakia estimates components shortages might shave off around a percentage point of growth in 2021.

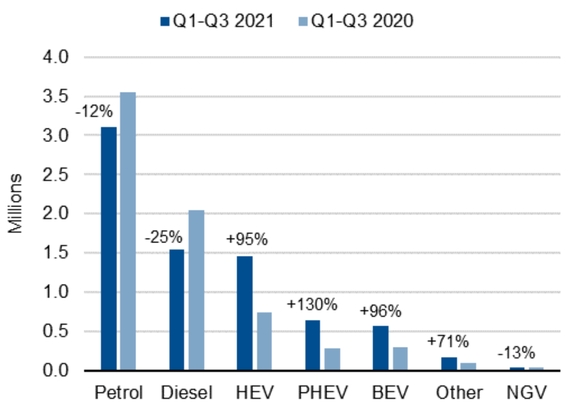
Beyond the Covid-19 crisis, structural change in the automotive sector, including rising demand for electric cars (**Figure 8, next page**), with this transition accelerated by current higher oil prices, poses considerable uncertainty for longer-run automobile production and exports of the region. According to a recent estimate[1], use of electric vehicles is expected to increase significantly over the next two decades and account for more than two thirds of passenger vehicle sales by year 2040. As of 2020, electric cars were a more modest 5% of total CEE car exports, up albeit on

[1] Bloomberg

2% from 2019, helped by an increasing number of assembly lines for electric automobiles in the region.

The ability of CEE-11 countries to adapt to structural change in the automotive sector will prove important for maintenance of comparative advantages post-crisis, given increasing EU budgetary and regulatory focus upon the low-carbon economy, rising intrinsic demand for electric cars and possible reorganisation of international supply chains due to changing staffing needs.

Figure 8: New passenger car registrations in the EU-27 by fuel type



Source: European Automobile Manufacturers' Association (ACEA); hybrid electric vehicles (HEV), plug-in hybrid electric vehicles (PHEV), battery electric vehicles (BEV), natural gas vehicles (NGV)

Sovereign ratings: rating actions in 2021, and 2022 rating outlook

An uneven but robust recovery in global growth amid the pandemic and associated supply-chain disruption, elevated inflation and risk reversal as central banks normalise as well as the transition of international fiscal policies as governments seek more elevated deficits after this crisis set a stage for sovereign credit risk in entering 2022.

As of the end of 2020, we held a Negative Outlook on four issuers of CEE: Romania (BBB-), Georgia (BB), Slovakia (A+) and Turkey (B), compared with one borrower on Positive (Outlook): Lithuania. Most Outlooks entering 2021 were "*resolved*" over the course of the year at outstanding credit rating levels, with Negative Outlooks revised to Stable in cases of Romania, Georgia and Slovakia. Lithuania was upgraded to A in January, while a Positive Outlook was re-assigned for Lithuania in December (see **Annex II** as regards rating actions over 2021). Entering 2021, one CEE sovereign remains on Negative Outlook: Turkey. Currently, 12 of Scope's 14 publicly rated sovereigns of CEE are investment-grade rated with two rated sub-investment-grade (Georgia and Turkey).

Policy responses targeting sustained recovery from the crisis while addressing macro-financial imbalances and institutional limitations will prove critical for credit assessments of CEE sovereigns over 2022.

Country outlooks

Visegrád countries

Poland (A+/Stable): political row with the EU compromises economic, fiscal flexibility

Poland's credit ratings benefit from a large, diversified economy, with less exposure to the Covid-19 crisis' disruptions to global supply chains compared with the rest of the Visegrád Group. We see 2022 growth of 4.1% before 3.7% in 2023, after 5.5% this year. Sizeable EU funding via grant monies and a good track record of EU fund absorption enhance medium-run economic potential and support further decline of external debt. We see public debt moderating slightly to 53% of GDP by 2023, from a 57% peak in 2020. However, the economy's low savings rate and shortages of skilled workers raise reliance upon external resources, raising risk to sustainability of growth. Inflation remains a bottleneck, having jumped to 7.7% YoY in November, with rates raised to 1.75% in December as a response, as expected, and with further rate hikes anticipated over 2022 as real rates remain deeply negative.

Poland's ongoing dispute with the European Union over the rule of law is increasingly relevant for the credit-rating outlook should escalating financial sanctions and delays of EU funding adversely impact economic growth, the trajectory of public finances as well as the reliability of contingent EU support under adverse market scenarios. Checks and balances restricting speed of institutional backsliding, such as opposition control of the Senate and the government's loss of a slim majority in the lower house (Sejm), support ratings.

Czech Republic (AA/Stable): robust economic policies; debt rise to be contained

A record of robust macroeconomic policies underpins the Czech Republic's AA credit ratings. This record has aided a competitive and industrialised economic base as well as high levels of employment, which, alongside expectation of resumed FDI inflow to the economy, support medium-run growth. The automotive industry, however, will need longer to recover to pre-crisis levels of exports. Despite looser-than-foreseen fiscal policies near term, we expect government to contain rises in the government debt ratio over the medium run. The new government will likely focus on how to enhance EU and NATO integration processes and rebuilding fiscal cushions without otherwise undertaking major changes of economic policies.

Hungary (BBB+/Stable): more prolonged cut in EU funding risks ratings outlook

Hungary's sizeable budget stimulus is expected to hold the fiscal deficit around an elevated 7.1% of GDP in 2021 and public debt at 77% of GDP at year-end. The debt ratio is among the highest of CEE-11 and reduces space for future discretionary spending obligations. Fiscal risks are, however, partially mitigated by improved liquidity in domestic capital markets and an enhanced government debt profile. We project robust economic recovery over years ahead supported by strong underlying economic potential, which ought to facilitate gradual decrease in the public debt ratio medium run. Strained relations with the EU, however, risk further delays in disbursement of EU funding vital to supporting strong, durable recovery without resorting to additional borrowing. Should there be a more significant, prolonged cut in EU financing, this could lower Hungary's growth outlook and damage fiscal and external balances, challenging the credit rating. At the same time, tensions with the EU could ease after 2022 parliamentary elections, should a new government be more conciliatory towards the EU.

Slovakia (A+/Stable): structural reforms instrumental for improving fiscal outlook

Slovakia's budget fundamentals have been significantly impacted by the crisis, exacerbated by lack of pre-crisis correction of structural budgetary deficits. Envisaged fiscal and pension reforms of the government, including introduction of multiannual expenditure ceilings and re-linking of the retirement age to average life expectancy, could strengthen public finances and ease pro-cyclicality of fiscal policies. This supported our decision to revise Slovakia's credit rating Outlook to Stable in December. Debt refinancing risks are mitigated by favourable funding conditions, with the ECB holding almost half of outstanding Slovak government securities. Resumed inflow of FDI to Slovakia ought to underpin recovery, reflected in planned investment by automaker Volkswagen of around EUR 1bn – equivalent to around 1% of 2020 GDP – over the next five years. These credit strengths mitigate risk associated with concentration of economic activity in automobile manufacturing and the industry's shift towards electrification – a longer-run challenge as regards the Slovak economy.

Southeast Europe

Romania (BBB-/Stable): credible fiscal reform agenda crucial for ratings outlook

Near-term budget risks have been reduced after the government froze state pensions and wages during 2021. An EU programme to support long-run economic growth ensuring Romania's access to significant inflow of EU funding also abets fiscal consolidation, reflected in our decision to revise the Outlook of Romania's credit ratings to Stable, from Negative, in May 2021. A prolonged phase of political instability has elevated risk of fiscal slippage and economic instability, however. Romania's credit outlook hinges moving ahead on the credibility of authorities' reform agenda. Should lawmakers in Romania fail to maintain a stable government implementing credible fiscal and economic reform as envisioned under the Recovery and Resilience Plan, this could undermine growth and public finances outlooks, challenging the credit rating.

Bulgaria (BBB+/Stable): institutional reform vital for speedy euro area accession

Policy choices and stability of the new coalition government in Bulgaria are crucial for medium-run growth and fiscal outlooks as well as meeting a sought 1 January 2024 target date for accession to the euro area. November's third elections held only in 2021 have resulted in an opportunity to advance a four-party, centrist reformist coalition. Critical factors to watch moving ahead include strengthening of the rule of law, tackling of corruption and judicial independence, and developing the institutional capacity required for more effective spending of EU funding, vital for boosting Bulgaria's growth potential to more than a current (estimated) 2.75% a year. In addition, the government's success in meeting euro-area convergence requirements during this Exchange Rate Mechanism II trial phase is critical. We estimate growth of 4.8% in 2022 and 4.0% in 2023, after a tepid 3% in 2021. The country's low level of government debt and prudent fiscal policies remain credit strengths, underpinning BBB+ investment-grade credit ratings.

Croatia (BBB-/Stable): progress on euro entry amid high debt, modest growth potential

We estimate growth of 4.8% in 2022 and 4% in 2023, following an estimated 2021 growth of 8.8%, after better-than-anticipated economic performance and revival of intra-EU travel. This ought to allow Croatia to return to pre-pandemic output levels by Q1 of 2022. Croatia's credit outlook benefits from an ongoing process towards euro adoption, including progress under commitments of the EU's Exchange Rate Mechanism II, assisting an upgraded accession objective of authorities of 1 January 2023. However, significant credit challenges remain, including the need to consolidate the budget to reduce an elevated government debt burden, projected around 84% of GDP in 2021. Other challenges include raising weak medium-run growth potential, estimated around 2.5-3.0% – given insufficient economic reform and, resultingly, tepid productivity growth, limited economic diversification and labour-market shortages.

Slovenia (A/Stable): crisis impairment but otherwise favourable economic outlook

The Stable Outlook assigned with respect to Slovenia's credit ratings reflects a trade-off between adverse effects of the pandemic on external and financial sectors counterbalanced by an otherwise favourable economic growth outlook and anticipated post-crisis improvements of public finances. Fiscal consolidation is expected to resume over the medium run, leading to stabilisation and then gradual decrease of a high public debt ratio. Pre-crisis reform of the labour market, financial-sector privatisation and advancements of external-sector competitiveness – Slovenia's share of world exports has improved by 20% since 2015 – have cushioned the economy over this crisis. Slovenia is seen running current account surpluses medium run. An important challenge is raising labour productivity, given adverse demographics constraining fiscal flexibility.

Baltic states

Lithuania (A/Positive): enhanced external resilience supports ratings Outlook

The Positive Outlook assigned earlier this month on Lithuania's ratings is supported by strengthened resilience against external shocks, fostered by prudent and predictable economic and fiscal policies and effective absorption of EU financing. Medium-run economic growth potential benefits from strategic public-infrastructure investment projects co-financed with the EU, including connection of the Baltic states with continental Europe's rail, gas and electricity networks planned by 2026, 2022 and 2025 respectively. Lithuania's track record in consolidation of public finances ought to support stabilisation of government debt around 45% of GDP in 2022, under a 60% Maastricht threshold. However, improving tax collections is crucial for underlying fiscal dynamics, considering a comparatively small tax base. An ageing population and rising pensions obligations remain constraints on outlooks for growth and public finances.

Latvia (A-/Stable): solid growth, reduction of financial-sector risk support outlook

Latvia's ratings benefit from institutional strengths underpinned by memberships of the EU and the euro area, in addition to a solid and balanced economic growth outlook over the medium run. EU co-funded infrastructure projects support growth. Latvia's record of effective fiscal policy making and prudent debt management ought to ensure budget deficits remain manageable over 2022-23 and public debt gradually converges towards pre-crisis levels medium run. Financial sector risk has subsided with a diminishing reliance of Latvian banks upon non-resident depositing, achieved absent materially impacting banking system liquidity and helped by authorities' effective reform based around Council of Europe recommendations. Despite political fragmentation, we expect comparative policy continuity under a new government after elections in 2022, including commitment to maintaining fiscal cushions. However, moderate productivity growth and net emigration, albeit diminishing, remain constraints on long-run growth.

Estonia (AA-/Stable): solid public finances, but demographics and green transition are challenges

Estonia's sturdy institutions, coherent policy making and sound budget management have ensured public debt remains low. General government debt of an estimated 19% of GDP in 2021 is still the lowest of the CEE-11. A favourable investment environment and digital transformation of the economy – exemplified via recent investment of Volkswagen in automotive software development – demonstrate economic resilience. Public infrastructure projects in the Baltics contribute to healthy medium-run growth potential.

Risks to the credit ratings associate with unfavourable demographics, constraining labour market supply and burdening the pensions system, exacerbated by current low levels of pension payments, which may not be socially viable. By contrast, Estonia has benefitted from net *immigration* since 2015, mitigating labour-sector shortages in some sectors. The transition required to meet EU carbon-neutrality objectives appears challenging, given importance of the country's oil shale sector. The sector accounted for 40% of electricity production in 2020, although down from 76% in 2018.

Non-EU: Russia, Turkey and Georgia

Russia (BBB+/Stable): elevated geopolitical and sanctions risks, although enhanced economic & external resilience

We upgraded Russia's credit rating to BBB+ in October on basis of strengthened macroeconomic resilience, including in the face of *anticipated* geopolitical and sanctions-related risks over 2022 and longer term. Effective fiscal, monetary and exchange-rate management have abetted economic capacity to weather such external shock. General government debt is expected to stabilise near 20% of GDP by 2024 after balanced budgets. Russia's medium-run draft budget is built around a conservative assumption of decline in the Urals oil price to USD 62.2/barrel in 2022 from USD 66/barrel this year, followed by further drop-off reaching USD 58.4/barrel and USD 55.7/barrel by 2023 and 2024 respectively. The average price of Urals oil was USD 79.7/barrel as of November 2021.

Heightened geopolitical risk linked to the conflict with Ukraine and threat of more punitive Western sanctions weigh on an outlook for economic and financial-market stability. The significance of sanctions for the credit ratings of Russia hinges in significant part on whether the state's approach to Ukraine favours a status quo, easing tensions and a diplomatic method given western alignment against Russia, or escalating the crisis with risk of advancing sanctions – such as affecting the banking system and/or rouble convertibility.

A scenario in which Russia were cut from the SWIFT payments system could entail substantive adverse implications for investment conditions and the exporting sector, and, as such, would be negative for Russia's credit ratings. However, US and European action on Russia's participation in SWIFT – discussed as a countermeasure over the years – appears unlikely at current stage.

De-dollarisation has strengthened Russia's sovereign balance sheet against sanctions risk associated with transaction in dollar. Russia has fully de-dollarised the National Wealth Fund since July, now comprising of a basket of euro (40%), renminbi (30%), gold (20%) as well as sterling and yen (5% each).

The Russian government can borrow satisfactorily on domestic debt capital markets mostly via lending from state-owned banks, given low levels of maturing debt equivalent to around 1% of GDP a year through 2023. Rouble-denominated obligations made up more than 80% of aggregate government debt as of December 2021, with USD denominated debt accounting for most of the remainder (around 15%). Likewise, the share of foreign investors among holders of Russia's OFZ treasury bonds accounted for a moderate 21.2% as of October.

Any scenario of US sanctioning of the secondary trading of Russian government bonds would be negative for foreign investment inflow and the value of the rouble. This would curtail foreign demand for rouble-denominated assets, entailing a more tangible impact on Moscow's room for financial manoeuvre above and beyond April American sanctions on primary market debt issuance of the state.

Wide-ranging sanctions on the Russian energy sector seem not to be very likely. However, Russian exports to the EU may be materially affected by an EU proposed carbon levy. Assessment of the potential costs from such a levy is of around EUR 5.5-6bn a year (roughly 0.5% of 2020 GDP). This impact is modest but may increase should the EU expand the mechanism to include oil and gas. From an international vantage point, much rests at this stage upon how Moscow cooperates with Brussels on environmental policies to limit impact of EU measures such as the carbon border adjustment mechanism. Financial consequences for Russia of the world's gradual shift away from fossil fuels, moreover, hinges on whether Moscow decides to address environmental issues in domestic policy making on a more fundamental level.

Turkey (B/Negative): 2022 may prove a flash-point year for Turkey's ratings

We downgraded Turkey (B/Negative) in late 2020. The Turkish central bank's policies are likely only to deepen Turkey's economic difficulties and increase likelihood of full balance of payment crisis. In addition, rate cuts raise possibility of another sudden reversal of monetary policy if the lira continues to decline in value. We have seen that in the past, as in 2018 and late 2020: if a lira crisis gets "bad enough", rates are raised in the end. The question is how much further lira would need to fall before we reach such a watershed moment. The currency has lost around half its value since February.

However, high political stakes involved in Turkey's interest-rate setting next year ahead of elections due in 2023 makes such a short-run pivot of monetary policy harder to foresee. Turkish President Erdoğan and his AKP have fallen behind in opinion polling over the run of 2021. As for prospects that higher growth aided by lowered rates might engineer Erdoğan's sought electoral comeback, recent evidence suggests there is less correlation between growth and the president's political fortunes than expected. We estimate growth of a very high 10.8% over 2021 accounting for an economic reversal expected at the end of this year as the currency crisis has evolved (before moderating sharply to 2.3% in 2022 and 2.4% in 2023), still voters appear preoccupied with more pressing economic crises such as loss of purchasing power and rising poverty. The government's attention on raising economic growth via easing rates, including possibility for further rate cuts, is damaging the country and economic stability – impairing the ratings outlook.

As lira devalues, we see entering 2022 the government falling back to a degree on past strategies of tightening capital controls, engaging in forex swap arrangements with domestic banks and foreign allies, and using forex reserves in defence of the currency – to allow for loose monetary policy settings while slowing down losses of the exchange rate. The problem with this policy combination is its cost: of over USD 100bn of reserves during 2018-20: net reserves ex-swaps stood at negative USD 42.3bn as of October.

Should Erdoğan refuse to change course ahead of the elections and faces defeat, 2022 and 2023 may prove flash-point years for Turkey in the case the president seeks alternative avenues to remain in power, with an opposition otherwise in pole position to oust him.

Georgia (BB/Stable): strong growth outlook amid prolonged political uncertainty

We revised the Outlook on Georgia's credit ratings to Stable, from Negative, in September, on stronger-than-anticipated recovery near term anchored by pent-up household demand, growth of remittances and recovering exports. The economy holds potential to grow around 5% a year medium run, especially with resumption of FDI inflows encouraged by authorities' credible macroeconomic management and favourable investment conditions. The government remains committed to sound institutional engagement with the IMF, EU and other international donor organisations, enhancing a credit-positive prudence in policy making. Georgia has access to donor financing on concessional terms, anchoring foreign-currency reserve stocks. This is despite prolonged political instability – an obstacle to economic reform. Improvements in the labour market, enhancing productivity and capital market development are priorities in reducing structural external deficits and curtailing reliance on foreign financing over time.

Annex I: 2022-23 macroeconomic outlook

	Country/ region	Real GDP growth (annual average, %)			General government balance (% of GDP)			General government debt (end of period, % of GDP)			Inflation, year-on-year (annual average, %)*			Policy rate (%), end of period**				Yield, local currency, 10-year (%)	CDS spread, EUR, 1-year (bps)	Δ in EUR per local currency (%)	International reserves (% of short-term external debt)***
		2021 (E)	2022 (F)	2023 (F)	2021 (E)	2022 (F)	2023 (F)	2021 (E)	2022 (F)	2023 (F)	2021 (E)	2022 (F)	2023 (F)	As of 13.12	2021 (F)	2022 (F)	2023 (F)	As of 13.12		Since start-2021	2021 (E)
	EU CEE-11	5.6	4.6	4.1	-5.5	-3.8	-3.1				4.2	3.7	2.6								
Euro-area CEE	**Slovakia**	3.7	5.3	4.5	-7.5	-4.4	-3.2	62	61	60	2.9	3.6	2.2	-0.50	-0.50	-0.50	-0.50	-0.1	9	-	-
	Slovenia	6.4	4.5	3.5	-7.2	-4.9	-3.6	78	77	75	1.8	2.0	1.7	-0.50	-0.50	-0.50	-0.50	0.2	13	-	-
	Lithuania	4.7	4.3	4.0	-4.3	-3.0	-1.0	46	45	44	4.3	3.0	2.3	-0.50	-0.50	-0.50	-0.50	0.2	9	-	-
	Latvia	4.6	5.0	4.1	-9.0	-4.1	-2.0	49	49	47	3.0	3.3	1.5	-0.50	-0.50	-0.50	-0.50	0.2	13	-	-
	Estonia	9.0	4.3	3.9	-3.1	-2.5	-2.0	19	20	21	3.9	4.4	2.1	-0.50	-0.50	-0.50	-0.50	0.1	19	-	-
Non-euro-area EU CEE	**Poland**	5.5	4.1	3.7	-3.7	-2.2	-2.2	55	54	53	5.0	4.3	2.7	1.75	1.75	2.50	3.00	3.2	13	-1.1	102
	Romania	7.2	5.0	5.0	-7.0	-6.0	-5.3	52	54	55	4.1	3.7	2.9	1.75	1.75	2.75	2.75	5.3	21	-1.6	106
	Czech Republic	3.0	4.7	4.0	-7.5	-4.7	-4.0	44	46	47	3.3	2.9	2.2	2.75	3.00	3.75	3.75	2.4	12	3.5	178*****
	Hungary	7.5	5.4	4.0	-7.1	-5.3	-3.4	77	76	74	5.1	4.2	3.3	2.10	2.10	2.70	2.70	4.3	14	-0.5	207
	Bulgaria	3.0	4.8	4.0	-3.6	-2.5	-1.8	26	27	27	2.6	2.4	1.9	0.00	0.00	0.00	0.00	0.6	19	0.0	229
	Croatia	8.8	4.8	4.0	-4.1	-2.7	-1.8	84	81	79	2.5	2.0	1.8	0.05	0.05	0.05	0.05	0.5	26	0.4	118
Non-EU emerging Europe	**Russia**	4.5	2.7	2.0	-0.5	0.0	0.0	18	19	19	6.6	4.8	4.5	7.50	8.50	7.75	6.75	8.5	45	10.5	444
	Turkey	10.8	2.3	2.4	-3.2	-5.4	-6.4	36	39	44	18.0	16.5	14.1	15.00	14.50	14.50	17.50	20.6	425	-41.9	63
	Georgia	9.8	5.5	5.0	-6.5	-4.2	-3.0	55	53	52	9.5	5.4	3.0	10.50	10.00	9.00	8.00	9.2****	-	15.2	108

Source: Scope Ratings GmbH, Macrobond, IMF, Eurostat, OECD, Bloomberg, national central banks and statistical offices; *Scope Ratings estimates for 2021; IMF and European Commission forecasts for 2022, 2023; **deposit facility rate of the ECB for euro area CEE economies; Poland: yield on the 7-day National Bank of Poland money market bills; 2-week repo rate displayed as regards the Czech Republic; interest rate on minimum reserves displayed for Hungary; 1-week repo rate as regards Romania, Russia and Turkey; base rate of Bulgaria; rate on regular operations regarding 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 one of above 100%; data from IMF Assessing Reserve Adequacy; ****as of 19 October (primary market); *****Scope estimate.

Annex II: Scope's CEE sovereign ratings & 2021 rating actions

Figure 5. CEE long-term foreign-currency issuer ratings, as of 14 December 2021

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

Figure 6. Scope's CEE sovereign rating actions in 2021, through 14 December 2021

Date	Sovereign	Rating action	Rating & Outlook*
29 January	Lithuania	Upgrade/Outlook change	A/Stable
14 May	Romania	Outlook change	BBB-/Stable
18 June	Bulgaria	Affirmation	BBB+/Stable
3 September	Georgia	Outlook change	BB/Stable
29 October	Russia	Upgrade	BBB+/Stable
3 December	Slovakia	Outlook change	A+/Stable
10 December	Lithuania	Outlook change	A/Positive

*Foreign-currency long-term issuer ratings only.

Annex III: Additional relevant research

2022 Sovereign Outlook: An uneven global recovery amid Covid-19, inflation and monetary tightening challenges sovereign outlook, 7 Dec

Bulgaria: breaking the political deadlock, reforms vital for credit outlook, 16 Nov

Country external risk ranking 2021, 8 Nov

Poland: row with the EU could have negative impact on outlook for growth, public finances, 2 Nov

Central & Eastern Europe: improving institutional quality crucial for economic outlook, 7 Oct

The prolonged political crisis in Romania endangers fiscal consolidation and reform agenda, 6 Oct

Sovereign ESG risk: opportunities beckon for Africa; dangers for Middle East, CEE, 31 Aug

Russia: near-term economic stabilisation contrasts with slow reform momentum, climate challenges, 31 Aug

Poland: minority PiS government restricts capacity for reform, raises early election risk, 24 Aug

Bulgaria: formation of a stable and reform-driven government critical for credit outlook, 4 Aug

June 2021 Sovereign Interim Outlook: A robust yet uneven global recovery continues, with diverging sovereign ratings implications, 17 Jun

Turkey: political interference at central bank, weak lira risk policy mistakes ahead of elections, 2 Jun

Romania: government reduces near-term fiscal risk; longer-term sustainability, reform are challenges, 19 May

Poland: EU funds could help shift the economy towards a more sustainable growth path, 5 May

Sovereign ESG risk: Eastern Europe, CIS, Middle East most exposed to transition risks, 21 Apr

Russia: US sanctions on sovereign debt signal rising risk surrounding geopolitical tensions, 16 Apr

Covid-19 sovereign impact: lasting on debt, mixed for growth and mostly transitory on unemployment, 9 Apr

Turkey: persistent challenges in monetary governance increase risk to macroeconomic stability, 22 Mar

Greening central banks' mandates: Hungary leads Czech Republic, Poland in tackling climate challenge, 4 Mar

Romania: political stability bodes well for fiscal discipline; rising debt limits policy flexibility, 18 Feb

Baltic states: economic resilience improves; addressing structural bottlenecks vital for recovery, 12 Feb

Country Abbreviations

Slovakia (SK), Slovenia (SI), Estonia (EE), Latvia (LV), Lithuania (LT), Poland (PL), Romania (RO), Czech Republic (CZ), Hungary (HU), Bulgaria (BG), Croatia (HR), Russia (RU), Turkey (TR), Georgia (GE).

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