Q2 2020 Central and Eastern Europe (CEE) Sovereign Update

Covid-19 impact on CEE economies: significant risk as region enters deep economic recession

Public Finance, Scope Ratings GmbH, 27 April 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

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Executive summary

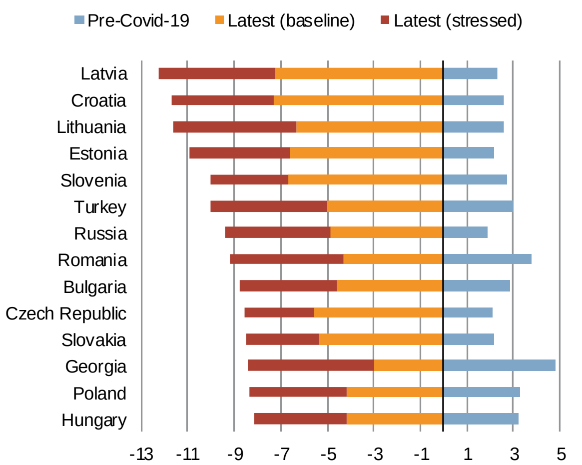
All CEE countries will contract sharply this year due to the Covid-19 shock, which is moreover driving markedly higher public debt and deficit levels. The magnitude of the adverse impact will vary between countries, depending on: i) the duration of lockdowns both domestically and for trading partners; ii) the extent and effectiveness of fiscal and monetary responses; iii) varying economic structures, impacting the speed and sustainability of recovery; and iv) susceptibilities to a deeper crisis in global markets and emerging markets.

The Covid-19 crisis is exceptional for CEE countries on four fronts: i) the unprecedented supply and demand shocks to services sectors; ii) the economic impact of global supply-chain disruptions and the temporary suspension of manufacturing activities, including in critical regional car industries; iii) the renewed volatility in capital and FX markets; and iv) the effects from the oil price collapse, especially on Russia. Cyclical implications relate to risks linked to rising unemployment, corporate defaults, borrowing rates, and FX and banking sector risks. Structural implications correspond to monetary and fiscal policy responses – which raise debt ratios in the longer term and weaken private sector and government balance sheets.

Economic exposure channels to Covid-19 shock

Containment measures as well as CEE economies' high integration in western European value chains will lead to significant output losses in 2020 (**Figure 1**). With the euro area economy forecasted to contract by about -6.5% for 2020 under a baseline scenario (and -11.5% in a severe scenario), we expect EU CEE member countries to similarly slide into a deep recession, albeit at varying magnitudes.

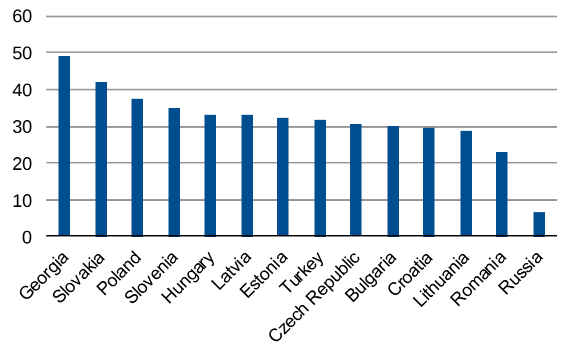
Figure 1. Real GDP growth projection, %



Source: Scope Ratings GmbH

The temporary halt in production by major western European carmakers will adversely affect growth in CEE countries, especially for **Slovakia (A+/Stable), Hungary (BBB+/Stable), Slovenia (A/Stable), the Czech Republic (AA/Stable)** and **Romania (BBB-/Negative)**, whose car industries account for between 10% and 13% of GDP. The consumption shock to the services sector will be more severe on CEE countries with bigger shares of self-employed/micro-enterprises (**Figure 2**) and temporary employment such as **Poland (A+/Stable)**, as these agents usually have limited cash buffers and are thus more exposed in times of economic distress. **Russia (BBB/Stable)** faces the dual impact of lower-for-longer oil prices, with Brent crude prices now at around USD 20 a barrel at the time of writing, alongside the global economic fallout from the Covid-19 pandemic. However, we expect Russia to be comparatively resilient to the crisis. **Turkey (BB-/Negative)**, as the lowest rated issuer in Scope's rated sovereign universe, is vulnerable to the global economic and financial market turmoil. Annex III presents an economic vulnerability matrix and the underlying data for CEE economies.

Figure 2. Persons employed by micro enterprises (fewer than 10 employees), % of total employment, 2017



Source: Eurostat, World Bank, * for Russia, Turkey and Georgia, data are equal to the self-employed, % of total employment

Output loss depends on economic fundamentals

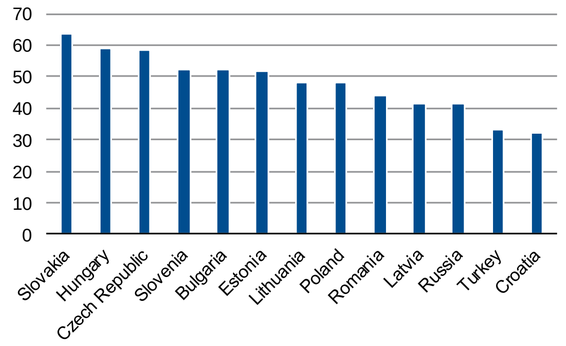
To estimate the impact of widespread shutdowns on growth, we considered a standardised scenario across countries regarding the relative degree of the shock's impact in different economic sectors and the extent and duration of containment measures. We also examined the size and effectiveness of national fiscal stimulus packages announced by governments to date.

Under our baseline scenario, we assume an average capacity utilisation of around 70% in CEE economies between March and June and a gradual recovery starting in Q2 and progressing over the second half of 2020. We assume the hardest-hit sectors to be real estate, trade, travel, arts, entertainment and recreation, with average capacity utilisation reaching only slightly above 50% at crisis peaks compared to 2019 levels. On average, these sectors account for 30% of gross value-added in the CEE region. For industrial production, we assume a baseline capacity utilisation of around 50%-65% relative to 2019 levels at Q2 2020 crisis peaks, including country-specific assumptions with regards to temporary shutdowns of car manufacturing.

Among EU CEE economies, our baseline scenario foresees Poland and Hungary to contract by around 4% in 2020. For Poland, the high share of temporary employment and self-employed workers, each at around 17% of total employment, constitutes an economic vulnerability in times of a prolonged consumption shock. By contrast, Hungary is one of the most exposed to global value chains among CEE countries. Its manufacturing industry, which has been adversely affected by the crisis, accounts for a high 22% of GDP. The Czech and Slovak economies are forecasted to contract by around 5.5% each in 2020, due to reliance on car industries (accounting for 10% and 13% of domestic GDP, respectively), with major carmakers having temporarily halted production in both countries. For Slovenia, the high level of goods trade with Italy (16% of GDP in 2019) will be an additional drag, with real GDP forecasted to shrink by around 7% in 2020.

We have revised Romania's 2020 growth forecast down to -4.3%, from a previous +3.8%, with less room for fiscal stimulus in 2020 given the country's already elevated budget deficits entering the crisis. Bulgaria's economy is projected to contract by around 4.6% this year. Croatia will be heavily hit – with a projected contraction of almost 7.5% in 2020 – because the travel and tourism sector contributes around a quarter of its GDP (with activities indirectly linked to the sector included in this estimate). Lastly, we expect Baltic economies to shrink by over 6% in 2020, reflecting their small, open economic structures and relative sensitivities to the global environment.

Figure 3. Foreign inputs, and domestically produced inputs used in third countries' exports, % of total exports, 2015



Source: WTO, Scope Ratings GmbH

Among non-EU emerging European economies, we have revised our baseline growth projection for **Russia** to around -5% in 2020, which reflects the recent oil price collapse, with the Brent crude price now at around USD 20 a barrel even after OPEC+ announced cuts in its output of 10m barrels a day. Crude prices of around USD 42 a barrel are needed for Russia to achieve a balanced budget.

The 2020 financial crisis particularly impacts sovereign issuers at the lower end of Scope's ratings scale. Here, **Turkey** will see significant economic risks from the global economic and financial market turmoil, with Scope now anticipating GDP contraction of 5% in 2020, revised from a 2020 contraction of around 1% in an earlier 2020 estimate (with even bigger declines under more adverse scenarios). Turkey's external sector weakness, including a significant FX debt exposure and high external debt outstanding, makes it more sensitive to extended periods of global economic weakness and/or 'risk-off' market conditions.

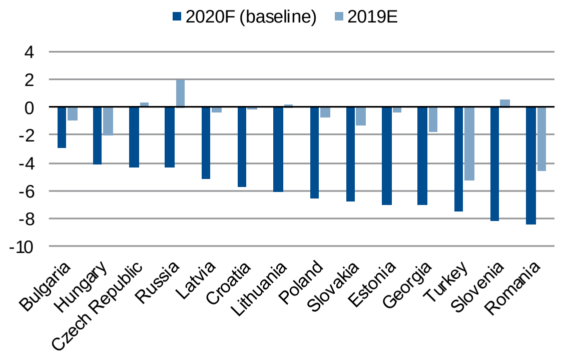
Lastly, among our rated emerging Europe universe, we project **Georgia**'s real GDP to contract by at least 3% in 2020 (after +5% in 2019), due to its dependence on tourism and travel, which account for around 30% of GDP.

Risks to baseline assumptions are skewed to the downside as growth could weaken further if the Covid-19-related shock endures longer. An alternative stressed scenario capturing this downside risk is presented in **Figure 1 (previous page)** as well as in **Annex II**.

Significant fiscal & monetary stimulus

CEE countries are using fiscal space to mitigate the contraction in output prompted by the crisis. This will, however, result in a sharp increase in fiscal deficits, pushing debt levels back towards those existing in 2014 for most countries (**Annex II**). That said, the budgetary outcomes of the fiscal shock will vary, depending on starting fiscal positions (**Figure 4**), the scale of cyclical deterioration and budgetary impacts from 2020 fiscal support measures.

Figure 4. General government balances, % GDP



Source: IMF, projections Scope Ratings GmbH

In an adverse scenario, which assumes stricter lockdown measures extended into the second half of 2020, CEE budgetary deficits would be even wider. As a result, downside risks for CEE sovereign ratings are rising, especially for the countries with weak public finances that limit authorities' room for fiscal support to stabilise the economy during the crisis.

Anti-crisis measures across the CEE region are being supported by monetary policy responses. Along with interest rate cuts, central banks are providing banks with abundant liquidity through repo transactions and by purchasing treasury bonds on the secondary market as part of structural operations. Moreover, borrowing rates of euro area CEE countries are benefitting from the ECB's asset purchase programmes for public and private sector securities in 2020, worth over EUR 1trn.

The fiscal measures announced by **EU CEE** governments are sizeable and include wage subsidies, temporary tax deferrals or cancellations, delays to loan and utility bill instalments, in addition to interest-free credit lines and loan guarantees. The Polish government announced a fiscal stimulus worth 2.9% of GDP in addition to loans and guarantees to the private sector equating to 7.7% of GDP. Czech authorities are planning a fiscal stimulus worth up to 18% of GDP, with a direct fiscal cost of 1.8% of GDP in addition to 16% of GDP in loan guarantees. Hungary plans to create a new fund to support the economy worth 2.9% of GDP, in addition to 1.4% of GDP allocated for disease control and 1% of GDP to support investment. Fiscal stimulus enacted by Slovakia's new government amounts to 1% of GDP *monthly*, alongside an additional 0.5% in loan guarantees monthly.

Among non-EU countries in the region, Russia announced a fiscal stimulus package amounting to 2.1% of GDP. However, given Russia's sizeable fiscal space with substantial cash reserves – the Russian National Wealth Fund has liquid assets worth 7.3% of GDP as of 1 March – we expect new and substantial fiscal stimulus measures to be forthcoming. Last week the Bank of Russia cut the key rate by 50 bps to 5.5%.

In **Turkey**, the policy one-week repo rate was reduced further by 100bps to 8.75% last week (incrementally in eight consecutive cuts from 24% as of July 2019), with additional rate cuts likely. This has amplified lira lending to the domestic economy to +19.1% YoY as of March. These macro-economic imbalances along with long-standing questions around the quality of Turkey's macro-economic management have been sapping foreign investor confidence, especially when global sentiment is weak like it is currently. The government announced in March USD 15.4bn (1.9% of GDP) in economic stimulus, introducing tax cuts, payment deferrals and increased pension payouts, with significant additional fiscal support having been announced since.

Annex II presents a summary of fiscal support measures taken by CEE governments to date.

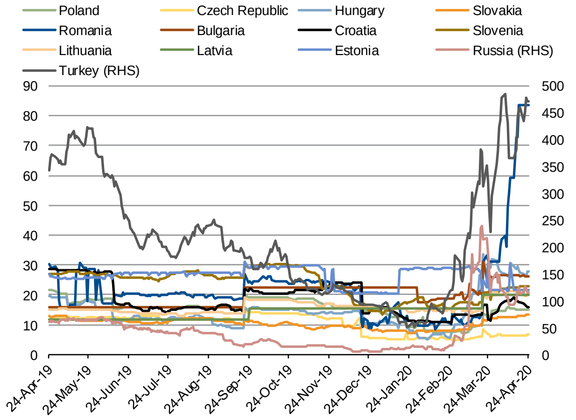
Higher borrowing rates and FX market volatility in 2020

Volatility is high in non-euro CEE exchange rates as well as in bond markets (**Figure 5**) and is likely to remain over the duration of the Covid-19 lockdown and global health crisis, reflecting the crisis' impact on global risk aversion.

Since March, the Polish zloty, the Czech koruna and the Hungarian forint have each weakened by around 5% against the euro. The tightly managed Romanian leu and Croatian kuna have been less volatile owing to continued interventions by central banks. Central bank reserves of non-euro EU CEE economies are sufficient to address this economic crisis, remaining above the IMF threshold of 100% coverage of short-term external debt, though Romania's level is somewhat lower (85%).

The one-year euro CDS spreads of CEE governments widened in mid-March, although movements have varied in magnitude and spreads for some countries have reversed lower since March peaks. Russia's spreads increased from around 15bps in January to over 200bps in mid-March but is back now to just over 100bps. Turkey's increased sharply, from 80bps in January to around 465bps now. Romania's spread is now at 85bps, up from 15bps in January. CDS spreads of other CEE sovereigns have increased more moderately.

Figure 5. CDS spread (1-year, euro denominated)



Source: Reuters, Scope Ratings GmbH

Outside of the EU, the Russian rouble has lost around 10% of its value against the US dollar and the euro since March. Russia's floating exchange rate has, however, cushioned the country's international reserves from the full impact of the collapse in oil prices. Official reserve assets amounted to USD 563bn in March, down from USD 570bn in February, covering nonetheless almost five times the outstanding short-term external debt balance.

For Turkey, the lira is 27% weaker against an August 2019 peak against the dollar (trading around 7 per dollar at the time of writing), with further depreciation representing a ratings concern given 53% of central government debt denominated in foreign currency alongside a significant private sector net FX debt position, which, while curtailed from February 2018 peaks of USD 223bn, totalled USD 175bn as of January 2020. The weak lira puts companies saddled with FX debts in a challenging position. 10-year lira government borrowing rates have increased sharply in 2020 despite significant easing of short-term monetary policy rates.

Moreover, Georgia is highly vulnerable to exchange rate changes, with 55% of loans, 62% of deposits, and around 80% of public debt (mostly multilateral concessional loans) denominated in foreign currency, predominately in euros and dollars, with the Georgian lari having depreciated by 12% and 14% against the two currencies since March.

Q2 Update country focus: Romania

Macro-economic environment

After a long period of economic expansion, with real growth of 4.2% in 2019, Romania is expected to contract in 2020 (baseline: -4.3% YoY). Short-term macroeconomic risks are partially mitigated by the concerted actions of the national government, central bank and the EU, while the economy is set to face adjustment costs to its manufacturing sector over the medium term, especially in the machinery and transport equipment sector. In addition, growth in domestic consumption is likely to slow owing to lower social expenditures and softening industrial production.

Fiscal stimulus

Despite a manageable public debt ratio of around 35% of GDP, the present caretaker government has limited fiscal space to mitigate the crisis' impact, after years of strongly pro-cyclical budgets. The expected economic contraction in 2020 will lead to a fiscal deficit of 6.7% of GDP in 2020 under government estimates (our baseline 2020 fiscal expectations are more pessimistic at -8.5% of GDP), including the effects of lower-than-expected tax revenues and increasing unemployment benefits. Fiscal measures could also be tailored via support from international organisations including the EU, the EBRD and, possibly, the IMF.

Monetary stimulus

Romania's EUR 34bn in foreign exchange reserves cover 86% of its foreign-currency-denominated public debt and 235% of total short-term foreign-currency-denominated economy-wide debt. Accordingly, the central bank has sufficient capacity to address the crisis in the domestic economy whilst ensuring a stable RON exchange rate. After a policy rate cut of 50bps to 2% in March, the central bank is unlikely to pursue further aggressive interest rate cuts in order to safeguard the exchange rate. At the same time, quantitative easing could play a greater role in central bank efforts to stimulate the domestic economy going forward.

Rating outlook

The weak fiscal management of Romania's previous government is reflected in Scope's Negative Outlook on the country's BBB- ratings. The current caretaker government has taken decisive actions towards mitigating September's pension hike while structural adjustments to the tax system and overly rigid expenditure items have so far not been enacted. We consider the current counter-cyclical fiscal measures to be important in safeguarding the economy against a more pronounced GDP contraction. At the same time, timely and credible policy actions toward a more prudent fiscal framework in the medium term could support the country's BBB- ratings.

Additional research

Turkey: Covid-19 crisis, significant external vulnerabilities present major challenges in 2020, 23 April

2020 External Vulnerability and Resilience rankings for 63 countries: Covid-19 Crisis update, 21 April

ECB & Eurogroup: sovereign liquidity risks reduced but real political test still to come, 17 April

Transparent framework for potential sovereign rating actions during the Covid-19 crisis, 9 April

Oil price war and Covid-19: three factors supporting Russia's resilience amid the crisis, 8 April

Q2 2020 Sovereign Update, 2 April

Covid-19: Matrix for assessment of economic vulnerability and healthcare capacity, 25 March

Exceptional circumstances demand exceptional action: Scope on Europe's Covid-19 crisis response, 19 March

Covid-19 pandemic's economic impact: significant risk as the world economy falls into recession, 18 March

Special Comment: Covid-19 Risks and Impact on the 2020 Global Outlook, 13 March

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

Figure 6. Scope's CEE long-term, foreign-currency issuer ratings, as of 24 April 2020

Central and Eastern European 11 (CEE 11)				Other 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	BB-/Negative
Slovakia	A+/Stable	Hungary	BBB+/Stable		
Slovenia	A/Stable	Poland	A+/Stable		
		Romania	BBB-/Negative		

Figure 7. Scope's CEE sovereign rating actions in 2020, as of 24 April 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

Annex II: Macro-economic outlook 2019E-2020F

	Country/region	Real GDP growth (%)			General government balance (% of GDP)		Public debt (% of GDP)		Fiscal stimulus (% of 2019 GDP), as of April 13, 2020**		Yield, local currency, 10-year (%)	CDS spread EUR 1-year (bps)	Policy rate (%)****	Exchange rate vis-à-vis euro (%)	Reserve (% ST external debt)*****
		2019E	2020 (baseline)	2020 (stressed)	2019E	2020 (baseline)	2019E	2020 (baseline)	Direct fiscal support	Credit guarantees and/or subsidised loans	As of April 27			Feb 3 - Apr 23	2019
Euro area CEE	Slovakia	2.3	-5.3	-8.5	-1.3	-6.8	48.2	57.4	1.0***	0.5***	0.7	13	-0.5	-	-
	Slovenia	2.4	-6.7	-10.0	0.5	-8.2	66.8	79.6	8.3		0.8	23	-0.5	-	-
	Estonia	4.3	-6.6	-10.9	-0.4	-7.0	8.4	16.3	7.1		-	22	-0.5	-	-
	Lithuania	3.9	-6.3	-11.6	0.2	-6.1	37.7	48.2	2.3	2.7	0.2	20	-0.5	-	-
	Latvia	2.2	-7.2	-12.2	-0.4	-5.1	36.8	44.1	1.6	4.9	0.3	20	-0.5	-	-
Non-euro area EU CEE	Poland	4.1	-4.2	-8.3	-0.7	-6.6	46.7	55.2	2.9	7.7	1.3	15	0.5	-5.3	112.2
	Romania	4.1	-4.3	-9.2	-4.6	-8.5	37.3	44.2	2.0	0.9	4.6	84	2.0	-1.3	85.1
	Czech Republic	2.6	-5.6	-8.6	0.3	-4.3	30.8	38.2	1.8	15.9	1.2	7	1.0	-8.6	124.4
	Hungary	4.9	-4.2	-8.2	-2.0	-4.1	66.3	73.5	5.3	5.3	2.4	29	0.9	-4.9	156.5
	Bulgaria	3.4	-4.6	-8.8	-1.0	-3.0	20.6*	24.9	2.2	0.6	0.1	26	0.0	0.0	189.6
	Croatia	2.9	-7.3	-11.7	0.0	-5.8	72.0	82.0	7.5		0.9	16	2.5	-1.6	151.8
Non-EU emerging Europe	Russia	1.3	-4.9	-9.4	1.9	-4.4	14.0	18.6	2.1	0.5	6.0	116	5.5	-15.1	428.3
	Turkey	0.9	-5.0	-10.0	-5.3	-7.5	33.1	39.3	1.9	0.6	11.6	466	8.75	-12.8	60.7
	Georgia	5.1	-3.0	-8.4	-1.8	-7.0	41.4	50.0	4.0		10.2	-	9.0	-7.5	84.7

Source: Scope Ratings GmbH, IMF, OECD, Eurostat, Bloomberg, national central banks, Haver Analytics; * as of Q3 2019, ** in some cases, direct fiscal support, credit guarantees and subsidised loans are shown together, *** per month, **** deposit facility rate of the ECB for euro area CEE economies; ***** coverage of short-term external debt (based on original maturity) plus long-term external debt maturing in one year or less, an IMF adequacy threshold for this ratio is 100%.

Annex III: Economic vulnerability to the Covid-19 shock

	Country/region	External			Internal	
		Global value chain participation rate, % of total gross exports, 2015*	Manufacturing, % of gross value added, 2019 or latest available data	Travel and tourism total contribution to GDP, % of GDP, 2018	Temporary employment, % total employment (15-64 year), 2019 Q3 or latest available data	Persons employed by micro enterprises (fewer than 10 persons), % of total employment, 2017**
Euro area CEE	Slovakia	63.6	21.2	6.4	6.5	42.0
	Slovenia	52.4	23.2	12.3	10.9	34.9
	Estonia	51.6	14.9	15.5	3.1	32.1
	Lithuania	48.4	18.0	4.9	1.5	28.9
	Latvia	41.3	11.7	9.4	2.6	33.0
Non-euro area EU CEE	Poland	48.1	19.1	4.5	17.1	37.7
	Romania	44.2	18.9	5.4	1.2	22.9
	Czech Republic	58.6	24.9	7.6	6.4	30.5
	Hungary	59.2	21.7	8.0	6.0	33.0
	Bulgaria	52.2	16.5	11.3	3.9	30.0
	Croatia	32.4	14.7	25.1	15.7	29.7
Non-EU CEE	Russia	41.3	14.6	4.9	7.8	6.8
	Turkey	33.4	21.1	11.7	12.6	32.0
	Georgia	N/A	10.1	31.3	N/A	49.2

Source: WTO, Eurostat, World Bank, OECD, World Travel & Tourism Council, Rosstat, Turkstat, Geostat; * foreign inputs, and domestically produced inputs used in third countries' exports, % of total exports; ** for Russia, Turkey and Georgia, data are equal to the self-employed, % of total employment in 2018.

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