2020 Central and Eastern Europe (CEE) Sovereign Outlook

Subdued growth amid soft external conditions, but improved economic resilience due to domestic demand

Public Finance, Scope Ratings GmbH, 10 December 2019

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

info@scoperatings.com | www.scoperatings.com

| Bloomberg: SCOP

Executive summary

EU CEE economies (CEE 11): Subdued growth in Western Europe and persistent policy uncertainty will affect the CEE 11 in 2020. We project CEE 11 economies to grow next year by an average of 2.9%, less than the 3.6% in 2019. The Federal Reserve's and the ECB's easing biases, combined with a tepid global growth outlook, are likely to prevent most CEE 11 central banks with independent monetary policies from implementing significant rate hikes in 2020 despite ongoing inflationary pressures. Resilient domestic demand in these economies reflects tight labour markets, solid wage growth and public investment driven by EU fund absorption.

Russia: Expectations are for modest growth in Russia in 2020 (of around 1.5%, after 1% in 2019), with fiscal policy set to ease to address domestic challenges. Ongoing sanctions risks, weak governance and a lack of foreign direct investment are challenges. However, we believe Russia's external resilience has improved, reflected in the credit's Positive Outlook.

Turkey: Despite an economic rebound in 2019, which we expect to extend into 2020 (3.0% growth next year), Scope maintains a cautious credit outlook on Turkey entering 2020, as structural and institutional challenges remain largely unaddressed, and geopolitical risks remain.

Key takeaways include:

- **Growth:** Weaknesses in the manufacturing industry of Germany, the largest trading partner of the CEE 11, will considerably affect regional growth in 2020. Ongoing economic resilience in CEE 11 countries reflects a gradual shift in growth – away from export dependence and towards domestic demand, supported by increases in disposable incomes. For Russia, a modest growth pick-up will be abetted by public infrastructure investment using available fiscal space, while for Turkey, annual growth will be higher in 2020 as the country recovers from last year's crisis.
- **Risk:** The risk of a re-escalation of trade conflicts, including possible US tariffs on EU car imports, any new US sanctions against Russia and/or Turkey, and a tightening of external financial conditions represent downside risks for CEE.
- **Reform:** Further enhancements to labour market flexibility, improvements in governance, higher R&D spending and investments into environmental sustainability represent several key drivers for higher long-run growth.
- **EU funds:** The CEE 11, as the largest beneficiaries of EU funds, will concentrate on negotiations around the EU's next multi-annual budget for 2021-27, which is based on the European Commission (EC)'s draft proposal foreseeing significant reductions in fund allocations to CEE. We expect the final budget to be less disadvantageous for the region than that initially proposed.
- **Public debt:** Reductions in debt-to-GDP ratios and falling debt-servicing costs supported our 2019 upgrades of Bulgaria (to BBB+), Slovenia (A), Croatia (BBB-) and Hungary (BBB+) and the Positive Outlook for Lithuania. However, we see higher debt ratios going forward for Romania, Turkey and Russia.
- **Ratings:** Current 'risk-on' market conditions contrast with sluggish global growth, rising non-financial sector debt levels and macro-financial imbalances, which are challenges for sovereign ratings globally next year. Entering 2020, CEE sovereigns with a Negative Outlook are Turkey and Romania, while Russia and Lithuania have a Positive Outlook.

Contents

Scope Public Finance Group

Giacomo Barisone
Managing Director, Head of Public Finance
g.barisone@scoperatings.com

Alvise Lennkh
Director, Public Finance
a.lennkh@scoperatings.com

Dennis Shen
Director, Public Finance
d.shen@scoperatings.com

Bernhard Bartels
Assoc. Director, Public Finance
b.bartels@scoperatings.com

Jakob Suwalski
Assoc. Director, Public Finance
j.suwalski@scoperatings.com

Levon Kameryan
Analyst, Public Finance
l.kameryan@scoperatings.com

Giulia Branz
Assoc. Analyst, Public Finance
g.branz@scoperatings.com

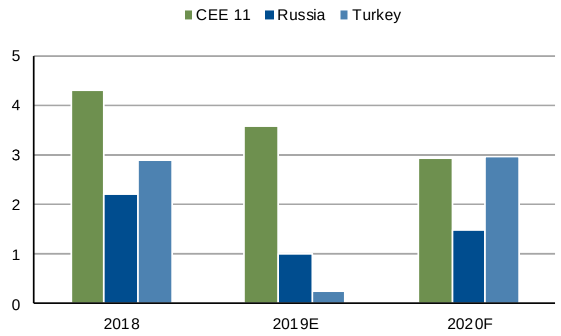
Thibault Vasse
Assoc. Analyst, Public Finance
t.vasse@scoperatings.com

Key themes in CEE for 2020

Domestic demand eases slowdown in CEE 11; recovery in Russia & Turkey

The EU's Central and Eastern European economies (CEE 11) have so far weathered the slowdown in Western Europe comparatively well, reflected in several countries growing above potential and an average projected growth of 3.6% in 2019, after 4.3% in 2018. The ongoing resilience of the CEE 11 mirrors a gradual shift in key growth drivers – away from a reliance on net exports towards greater dependence on domestic demand. Strong domestic demand reflects i) high wage growth and tight labour markets; ii) loose fiscal and monetary policies; and iii) robust public investment supported by EU fund absorption.

Figure 1. Real GDP growth rates, %



Source: EC, Haver Analytics, Scope Ratings GmbH

However, the degree to which CEE 11 economies benefit from domestic sector resilience varies. Scope's study on the level and determinants of income inequality shows that, owing to markedly high levels of inequality, several CEE 11 member countries, in particular Bulgaria, Romania and Croatia, remain vulnerable to social and economic risks in a lower growth environment. Conversely, higher-income CEE 11 economies such as the Czech Republic, Slovakia and Slovenia benefit from broader-based increases in real incomes and will thus benefit more from resilience in domestic demand going forward.

In addition, despite inflation moderately exceeding targets in many economies, owing to continued strong wage growth and tight labour markets, for 2020, most CEE 11 central banks with independent monetary policies are likely to avoid significant rate hikes, inhibited by the continued easing biases of the ECB and the Federal Reserve and the modest growth outlook.

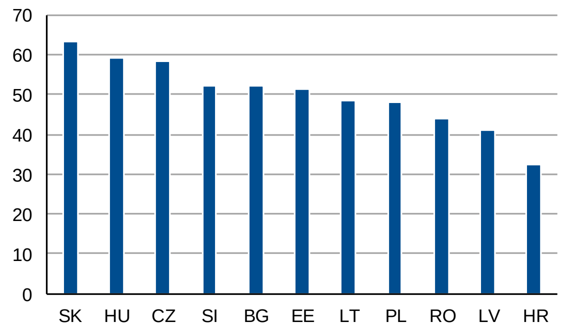
A prolonged period of subdued growth in the euro area (1.1% growth in 2020, after 1.2% in 2019), particularly the slowdown in Germany's manufacturing sector, reflecting current weaknesses in the latter's car industry, will, however, be a significant drag on CEE 11 growth going forward. We project CEE 11 economies in 2020 to slow to 2.9% on average (**Figure 1**).

For Russia, a modest 2020 economic rebound (1.5% growth in 2020, compared to an estimated 1.0% in 2019) will be driven by continued investment into the energy sector supported by Denmark's approval of the construction of Gazprom's Nord Stream 2, as well as easing of fiscal and monetary policies (we expect additional policy rate cuts in Russia in 2020). Turkey's economy started its recovery in 2019 after the 2018 lira crisis, with this recovery expected to continue into 2020 (3% growth next year, after 0.2% in 2019) – supported by fiscal accommodation, more favourable capital inflow conditions and lower domestic borrowing rates after aggressive rate cuts.

Weaknesses in Western Europe, Germany to materially impact CEE 11

The car industry is key for several CEE 11 economies, accounting for 14% of GDP in Slovakia and Romania and almost 10% of GDP in the Czech Republic, Hungary and Slovenia. Germany is the destination for 25% of total exports of goods across the CEE 11. The Czech Republic, Slovakia and Hungary are also the most exposed to global value chains among the CEE 11 (**Figure 2**).

Figure 2. Foreign and domestically produced inputs used in third countries' exports (% of total gross exports), 2015, CEE 11



Source: WTO, Scope Ratings GmbH

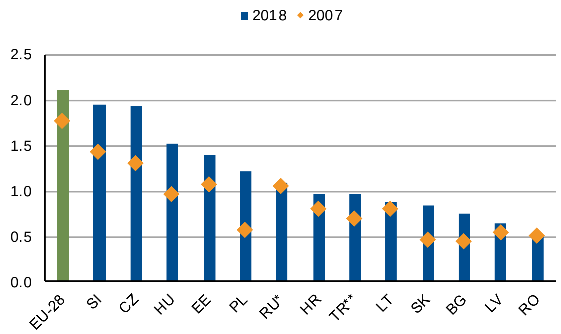
Furthermore, structural changes taking place in the automotive sector, including potential reorganisations of supply chains due to rising demand for electric cars, pose considerable uncertainty for medium-run car production in the region and could present spill-over risks to economic activity. Governments may need to address the changing staffing requirements of companies to ensure their economies continue to enjoy comparative advantages.

Demographics, governance, R&D and the environment are key for growth

Tight labour markets are currently supporting private consumption and improving living standards across the CEE 11. While Scope expects the CEE 11 to continue to attract foreign direct investment in 2020, as they remain cost-competitive compared to Western peer nations, there are considerable differences in institutional quality across countries – key for long-term growth – as captured by the World Bank's Worldwide Governance Indicators. In Russia, weak governance remains a key rating constraint. In Turkey, institutional and governance limitations remain a primary focus after institutional degradation contributed to Scope's 2018 downgrade of Turkey to BB-. At the same time, record-high employment levels in most CEE 11 countries, a shrinking workforce reflecting ageing populations across the region and, in some cases, net emigration, are compelling governments to enhance labour market flexibility, attract foreign talent and raise labour force participation rates.

Furthermore, CEE governments will need to focus on long-term, growth-enhancing investments to ensure average income levels continue to catch up with Western averages. For instance, expenditure on research & development in most CEE countries remains significantly below the EU average of 2.1% of GDP (2018), with frequently inadequate convergence in this area over the past decade despite strong inflows of foreign direct investment.

Figure 3. Expenditure on R&D, % of GDP



Data for Georgia not available. *As of 2015. **As of 2017. Source: Eurostat

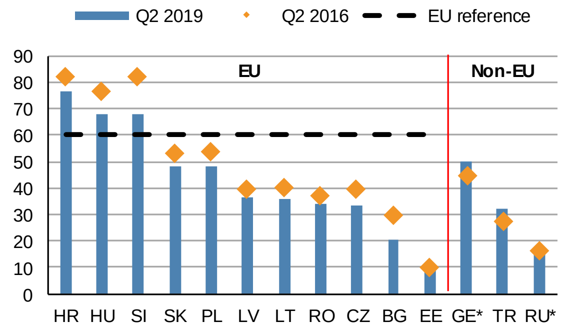
Moreover, a wide consensus is emerging on the need to address climate change and its economic costs. Poland became the first sovereign green bond issuer in 2016 and Russia formally joined the Paris climate agreement this September, to foster a long-term development strategy around low greenhouse gas emissions by 2050. Indeed, CEE economies could accelerate green transitions, also at a low cost, given their scope for higher energy-efficiency in production and consumption relative to European peers.

Declining public debt in many countries despite budget expansion

The creditworthiness of CEE 11 governments remains supported by reductions in public debt ratios and falling interest expenditure (**Figure 4**), providing a degree of fiscal space for stimulus against economic contingencies arising in 2020 and beyond. Meanwhile, Russian public debt remains low despite an upward trajectory expected in coming years as the government invests in 'National Projects'. For Turkey, debt has risen to 32.2% of GDP as of Q2 2019, from 27.1% as of Q22016 – exacerbated by lira devaluation and its effects on the value of foreign-currency-denominated debt.

The fiscal stance of the CEE region has been expansionary overall over 2018-19, which, as such, does not reflect a *full* use of a continued global growth phase to consolidate fiscal books before the cycle turns. A large share of additional fiscal expenditures in the CEE 11 has moreover been spent on public sector wages and pensions to keep pace with the strong growth in private sector salaries. Public debt-to-GDP ratios in Croatia, Hungary and Slovenia are still higher than the EU's reference value of 60% (**Figure 4**). In 2020, among the CEE 11, we project an *increase* in the debt-to-GDP ratio only for Romania, however, reflecting the large pension increase adopted in 2019.

Figure 4. General government debt (% of GDP)



*Reflects annual data corresponding to 2019 and 2016 end-year estimates. Source: Eurostat, IMFWEO, national statistics.

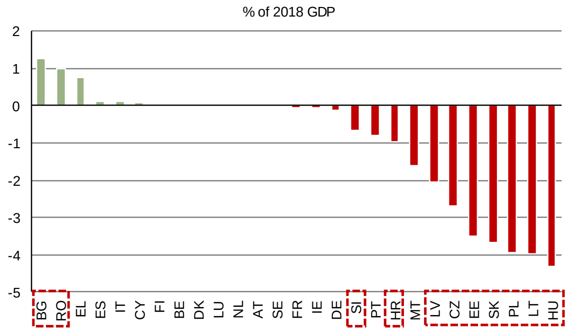
For Hungary, Croatia and Romania, gross financing needs will remain high in 2020 at an average of around 13% of GDP. For the remaining eight CEE 11 economies, gross financing needs will stay low at between 1% and 6% of GDP in 2020. Russia's gross financing needs in 2020 are very limited at under 1% of GDP, while those of Turkey and Georgia are moderate at about 8% and 7% of GDP respectively.

Negotiations on EU's long-term budget matter for CEE outlook

CEE 11 economies are the largest beneficiaries of EU funds, which are key for the investment and growth outlooks of the region. EU funds finance a large share of overall public investment on key infrastructure projects and research and development: as a share of 2018 GDP, EU fund allocations for 2014-20 range from 9% for Slovenia to up to 21% for Croatia. In 2020, Scope expects CEE 11 governments to focus on EU negotiations regarding the next long-term budget for 2021-27. Based on the EC's original draft proposal, the budget foresees significant reductions in fund allocations to the CEE 11 region (**Figure 5, next page**).

This proposal accounts for the UK's planned EU exit, the CEE 11 region's ongoing income convergence process with EU averages and proposed new criteria for EU fund allocations, including on youth unemployment, reception of migrants, and measures taken on climate change and education.

Figure 5. Cohesion policy* funding change, 2021-27 vs 2014-20 under the EC draft proposal



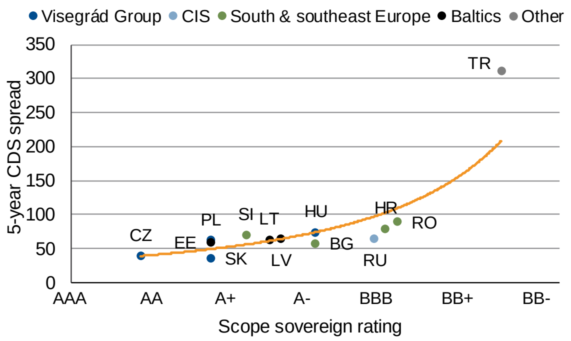
Source: European Court of Auditors, Scope Ratings GmbH; CEE 11 economies in boxes; cohesion policy accounts for on average around 80% of EU funds allocated to CEE countries for 2014-20.

However, given the CEE 11 region's economic importance, as well as the role of its leaders in helping to install Ursula von der Leyen as EC President, we ultimately expect a meaningful upward adjustment in EU funding to the CEE 11 for 2021-27 in the final multi-annual financing framework.

Divergence between Scope's and the market's sovereign risk assessment

Modest global growth, rising global debt levels and macro-financial imbalances – in a context of the limited efficacy of additional central bank easing and varying capacities of governments to implement counter-cyclical fiscal stimulus – are setting the stage for global sovereign risk in 2020. Here, we note some divergence between our CEE sovereign ratings and market risk perception via five-year CDS spreads (**Figure 6**).

Figure 6. Five-year US dollar CDS spreads vs Scope ratings, bps, as of 10 December 2019

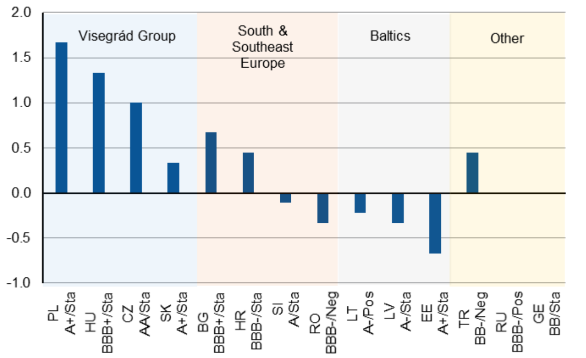


Source: Bloomberg, Scope Ratings GmbH

First, even though Turkey's credit ratings are the lowest in Scope's rated sovereign universe, the market appears even more pessimistic. Second, the market considers sovereign risk in Russia, Croatia and Romania to be less than Scope's ratings might imply; this holds true even following Scope's *upside* rating actions on Russia and Croatia in 2019.

Compared with US rating agency peers (**Figure 7**), Scope's rating assessments are, on average, higher with regards to the four Visegrád Group nations, but lower for the Baltic countries. Scope's view on Turkey is now more favourable than the average assessment of the US agencies after downgrades of the sovereign by peer rating agencies.

Figure 7. Scope's ratings vs US rating agency average, notches, as of 6 December 2019



Source: Reuters Eikon, Scope Ratings GmbH;

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.

Finally, looking at the market's perception of the credit risk on Ukraine (not rated by Scope), we note positively that CDS spreads have fallen markedly from above 700bps in January to around 460bps currently. This reflects the ongoing stabilisation of Ukraine's macroeconomic conditions, supported by the recent staff-level agreement on a 3-year, USD 5.5bn programme with the IMF to continue addressing monetary, fiscal, and financial sector governance reforms as well as to enhance the judiciary and strengthen the rule of law. In addition, Scope views constructively Ukraine's long-run deepening of relations with the EU, a priority of the current government.

Country views

Visegrád countries

Poland (A+/Stable): robust growth tempered by capacity constraints

For Poland, we project slow but robust growth at 3.3% in 2020, below its potential rate of 3.9% and this year's level of around 4%. Private consumption will still be key for growth. This will be underpinned by a buoyant labour market, with a record-high employment rate (people aged 15-64) of 68% as of Q2 2019, and by planned fiscal stimulus including increased social benefits. The slower growth will reflect capacity constraints as well as the weaker demand from main trading partners, which is only slowly filtering into the Polish economy.

Risks associated with the portfolio of foreign-currency mortgage loans (6.8% of banks' assets in June 2019) are abating, in our view, given the heterogeneity of contract types. At the same time, the potential costs to bank balance sheets, including those related to loan conversions to zloty, will be spread out over time.

We anticipate a budget deficit of around 2% of GDP in 2020 after an estimated 1.5% in 2019. Uncertainties regarding one-off revenues, such as sales of licenses, and increasing expenditure pressures will constitute budgetary challenges. We also expect the government to remain committed to EU and national fiscal rules. The recent electoral setback of the incumbent party, Law and Justice, could result in more moderate policies in 2020. This could defuse additional tensions with the EU, although those related to disagreements over the rule of law are unlikely to disappear.

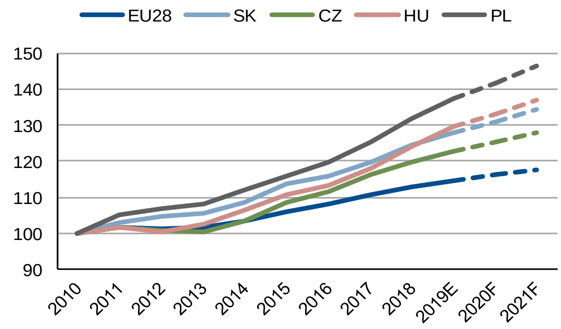
Czech Republic (AA/Stable): ageing constrains medium-term outlook

The weaker external environment impacted the Czech economy, causing growth for 2019 to be revised from 2.9% to 2.5%. In 2020, we expect domestic demand to be the key growth driver, supported by fiscal stimulus to boost public investment and wages. Our growth projection for the Czech Republic remains unchanged at 2.5% for 2020 despite the expected impact of the German industrial downturn on Czech manufacturers.

The most important risk for public finances stems from the high projected pension obligations. We expect this to result in higher public debt over the medium term unless the government implements counter-balancing measures. Increasing retirement rates and a lack of inward migration are placing further constraints on the labour force, as shown by an unemployment rate of just 2.2%, the lowest ratio among the EU-28.

Politics in the country remains fragile. Public protests are continuing against the government after revelations that EU funds were funnelled to the prime minister's company and subsequent judicial reforms were enacted to protect him from trial.

Figure 8. Real GDP level, 2010 = 100



Source: EC, Scope Ratings GmbH

Hungary (BBB+/Stable): economic resilience despite political polarisation

Scope upgraded Hungary by one notch to BBB+ in October 2019 together with the assignment of a Stable Outlook, following the country's sustained debt reduction, increased resilience against external shocks and strong investment dynamics. In 2020, we expect growth to moderate towards 2.8% from 4.6% in 2019. Growth in 2020 will be backed by fiscal spending and the ongoing absorption of EU funds, but with a slightly tighter fiscal stance, reflecting weak external demand.

The government budget for 2020, including a 1% of GDP headline deficit target, is more ambitious than in the past. However, budget figures are subject to a 4% growth projection for 2020, which seems optimistic given soft global conditions. Going forward, we anticipate a gradual improvement in Hungary's structural deficit towards 2% of GDP over the medium term, while further debt reduction will hinge on economic performance.

Political polarisation remains high under Prime Minister Viktor Orbán, especially regarding migration and social policies, the latter which tend to favour native Hungarian families at the expense of minority groups and low-income households. We expect the government's strong presence in corporate and financial sectors, increasing intervention in the judiciary and the media, and asylum policies to continue to divide public opinion.

Slovakia (A+/Stable): growth slowdown due to weak external demand

As a very open economy specialised in the automotive industry, Slovakia's export performance weakened notably in 2019, driven by the deterioration in the manufacturing industry of Germany, its largest trading partner. We expect foreign demand for Slovakian goods to grow only moderately in 2020, projecting real growth of 2.7% in both 2019 and 2020, lower than our estimated medium-term growth potential of around 3%. The potential for US tariffs on European cars and car parts constitutes a key downside risk to the outlook.

Increased political fragmentation in Slovakia could hinder government formation following elections to take place in February 2020. The new government would need to focus on improving productivity and institutional quality, which are key to maintaining the external competitiveness of Slovakia's industrial sector.

We project a slightly higher fiscal deficit in 2020 compared to this year's, at 1.2% of GDP, reflecting planned tax relief measures, partly in the context of upcoming elections. EU and national fiscal requirements, however, will keep expenditure increases in check. In our view, the new retirement age cap at 64 years of age, effective from 2019, will weigh on the budget over the longer term amid population ageing.

South and southeast Europe

Romania (BBB-/Negative): interim government to stabilise budget

Romania's strong growth record continued in 2019, with an expected rate of around 4% YoY, but is expected to gradually revert to potential rates of around 3% in 2020 and 2021. At the same time, Romania's twin fiscal and current account deficits pose material risks to its economic outlook. This was the key driver behind our decision in October 2018 to downgrade Romania to BBB- with a Negative Outlook.

The biggest task for the current interim minority government is to reduce the deficit in next year's budget. This is particularly challenging given a new law stipulating a 40% increase in pensions from next year onwards, projected to lead to a general government deficit of around 4.4% of GDP unless the government can enact counter-balancing measures.

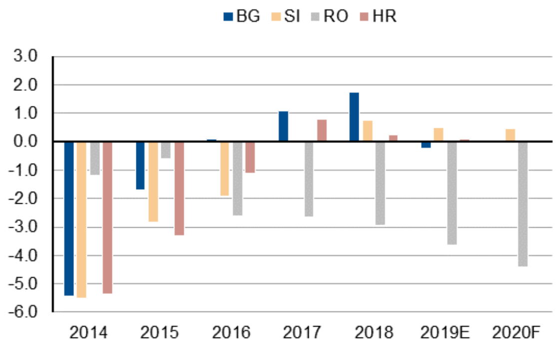
The main political event in 2020 is the parliamentary election scheduled for the end of the year. Pre-election campaigning is likely to postpone the necessary fiscal and structural economic adjustments. On the other hand, recently approved judicial reforms and the successful indictment on corruption of the former Social Democratic Party leader, Liviu Dragnea, have helped to rebuild trust in Romania's political and legal institutions.

Bulgaria (BBB+/Stable): 2020 ERM II entry would be credit-positive

We upgraded Bulgaria to BBB+/Stable in February 2019. In 2020, we will monitor closely Bulgaria's progress in entering both the Exchange Rate Mechanism II (ERM II) and the European Banking Union. Bulgaria's government has now set a target date of April 2020. We would consider a successful entry in ERM II to be credit-positive for the country, but post-entry reforms must be aimed at sustainable economic and institutional convergence with the rest of the EU. With at least two years required in ERM II before euro area admission, Bulgaria's ongoing process towards adopting the euro would enforce a degree of credit-positive prudence in policymaking.

In 2020, we expect growth of around 3.5%, after an estimated 3.7% in 2019, in part driven by a significant current account surplus (8.5% of GDP in the year to September 2019, from just 0.1% in 2015). Scope expects the 2019 budget to conclude the year at about -0.25% of GDP in accrual terms (compared with a wider deficit in cash terms). However, Bulgaria has set forward its aim for a balanced budget in 2020, and Scope expects similarly a balanced 2020 budget. Finally, foreign-exchange reserves remain sturdy at about 2.6 times short-term external debt.

Figure 9. Fiscal balance, % GDP (accrual basis)



Source: EC, Scope Ratings GmbH

Croatia (BBB-/Stable): making progress towards ERM II

We upgraded Croatia to investment grade in June 2019, reflecting improvements in its fiscal framework and financial stability, and the declining external liabilities. Collectively, these factors support the country's progress towards entry into ERM II.

The incumbent government is likely to maintain the structural reforms needed to ensure euro area member countries continue to support its ERM II admission process. This is despite the government's small majority in Parliament, which often makes it reliant on ad-hoc support from smaller political parties and independent representatives. A successful entry by Croatia into ERM II, potentially late in 2020, would be credit-positive, curtailing risks from the country's high foreign-currency exposure to the euro as it moves towards adopting the currency.

The key challenge for Croatia's government (elections are scheduled for December 2020) is to enhance the economy's weak growth potential, estimated at only 2.5% for 2020 by the European Commission. This is attributed to Croatia's low growth in productivity and investment as well as shortages of skilled labour.

Slovenia (A/Stable): minority government using available fiscal space

We upgraded Slovenia to A/Stable in June 2019, driven by the country's sustained public debt reduction and structural improvements in potential growth via gradual reforms of the labour market and the financial sector. We expect its debt-to-GDP ratio to reach the EU's reference value of 60% by 2021, supported by recent improvements in the country's fiscal framework.

Our growth projection for 2020 of 2.7% in 2020, unchanged from the growth estimate for 2019, considers resilient domestic demand, while the contribution from net trade is set to remain negative.

Although Slovenia's centre-left minority government holds only 43 out of 90 seats in Parliament, we expect the current government to be able to implement its reform-oriented fiscal policies, which are increasingly expansionary but remain prudent overall. The government recently proposed legislative changes regarding taxation, pensions and the labour market, though these still need parliamentary approval.

In line with the closing of a positive output gap, we anticipate a slower pace of fiscal consolidation going forward. We believe the government will further reduce the size of contingent liabilities via privatisation – currently these are having a material impact on both its balance sheet and productivity growth.

Baltic states

Lithuania (A-/Positive): robust economic growth despite euro area slowdown

We revised the Outlook on Lithuania's A- rating to Positive in October 2019. This is driven by sustained robust economic performance, reflecting solid private demand and a high absorption of EU structural funds. We project Lithuania's real GDP growth at 3.8% in 2019 to moderate to around 2.5% in 2020, dampened by weak external demand and labour shortages. Strong growth has increased employment rates, which at 73% in Q2 2019 are significantly higher than the EU average.

The current government has initiated structural reforms to improve education, healthcare, and R&D as well as to strengthen national fiscal rules, which is credit positive. Parliamentary elections are scheduled for October 2020, and Scope expects the next government to remain committed to this reform agenda. However, a key challenge is to increase productivity growth, which is below real wage growth, potentially damaging the international competitiveness of domestic producers.

We expect a balanced budget in 2019 and 2020. The increase in the debt-to-GDP ratio, to an estimated 36% in 2019, is due to plans to pre-finance borrowing needs for 2020-21 at very low interest rates. We expect the gradual reduction in the ratio to resume going forward.

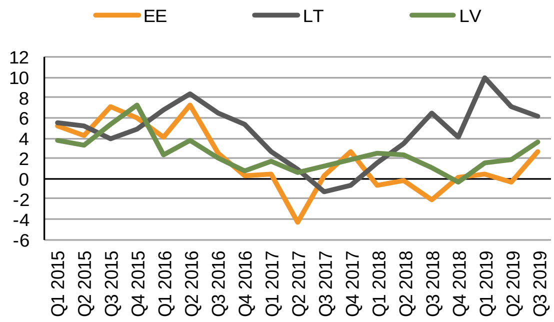
Latvia (A-/Stable): deeper-than-expected slowdown

The slowdown in Latvia's economy in 2019 was deeper than expected, reflecting subdued growth in private investment and weakening exports. By contrast, public investment was strong, amounting to 5.6% of GDP in 2019, due to a high absorption of EU funds. We expect real growth of around 2.5% both in 2019 and in 2020. Private consumption will be the main growth driver, supported by tax cuts and a strong labour market, although both employment growth and wage increases are set to slow due to weaker economic growth.

We expect the current five-party coalition government to focus on fiscal discipline and further improve the business environment, including its anti-money-laundering framework based on EU recommendations. While the share of non-resident deposits halved since 2017 to 25% as of October 2019, it remains far above the levels in Lithuania (3%) and Estonia (9.5%). Furthermore, to improve its economic growth potential, Latvia needs to increase R&D expenditure, the second lowest in the EU-28 as a share of GDP after Romania's.

We expect a continued moderate budget deficit in 2019 and 2020. The slowing decline in debt-to-GDP ratio during 2019 is set to continue into 2020, given planned issuances to pre-finance debt redemptions in 2020-21 by making use of the very low current interest rates.

Figure 10. Real wage growth minus real productivity growth, percentage points



Source: National statistical offices, Scope Ratings GmbH

Estonia (A+/Stable): slowing growth mitigated by a strong labour market

Estonia's real GDP growth remained well above the EU average, estimated at 3.2% in 2019, helped by high employment rates (for the 15-64 age group) at 75% as of Q2 2019, and strong investment growth. Estonia's absorption rate of EU structural funds is the highest among the CEE 11, supporting strategic infrastructure projects, among other areas. Moreover, the labour market benefits from rising immigration, but significant demographic challenges remain. Growth is expected to moderate to around 2% in 2020, driven by weaker external demand. Employment growth is also set to slow, reflecting labour supply shortages.

We consider Estonia to have significant fiscal space, with the debt-to-GDP ratio and annual gross financing needs at very low levels. This fiscal space can be prudently directed towards increased spending on infrastructure, R&D and education, which would boost the economy's longer-run growth potential while staying well within EU and national fiscal rules. However, government plans to make the second pension pillar voluntary from 2020 onwards, while supporting short-term growth through higher private consumption, could create budgetary pressures in the longer term due to low pension savings.

Non-EU: Russia, Turkey and Georgia

Russia (BBB-/Positive): policies bolster external resilience

Russia's BBB-/Positive rating reflects the government's robust budgetary position, which results from a fiscal policy focused on rebuilding fiscal buffers over the past few years, as well as the improved external sector resilience underpinned by a strong external-creditor position and flexible exchange rates. These factors improve the Russian economy's capacity to cope with external shocks, including mitigating the economic impact of a recent tightening in US sanctions.

However, re-igniting growth remains a major challenge. In 2020, we expect growth of around 1.5%, up from 1% in 2019 driven by continued investment into the energy sector, supported by Denmark's approval of the construction of Gazprom's Nord Stream 2, as well as fiscal and monetary policy easing. After delays in the envisaged public investment programme, fiscal policy is set to ease in order to address domestic economic challenges, via a public investment strategy comprising 'National Projects', with EUR 360bn of investment estimated for 2019-24, primarily focused on transport infrastructure. As a result, the government's debt-to-GDP ratio is set to moderately increase but remain below the government's 20% of GDP debt ceiling.

In addition, given the moderation in Russia's inflation outlook – with inflation falling to 3.5% in November and set to average 3.7% in 2020 – the Russian central bank cut the key rate from 7% to 6.5% in October, with further easing possible in 2020. In our view, growth remains structurally curtailed by the low involvement of the private sector, a lack of foreign direct investment, and weak consumer confidence. In addition, ongoing sanctions-related risks and projections for a moderate decline in oil prices (to USD 57 per barrel in 2020 from currently USD 64) are set to weigh on growth in 2020.

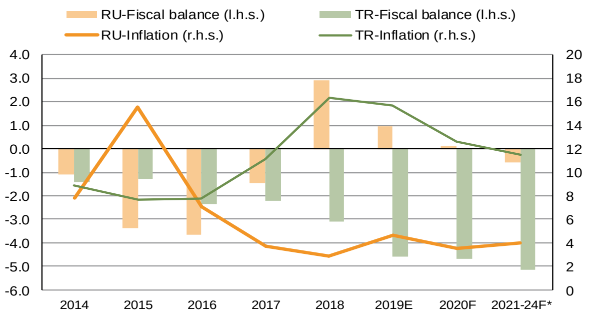
Turkey (BB-/Negative): cautious outlook despite economic recovery

In 2020, Turkey's Negative Outlook on its BB- rating could be stabilised if: i) credible fiscal, monetary and economic policies are adopted; ii) the country's external vulnerabilities are reduced; and/or iii) the deterioration in Turkey's governance framework is reversed. Conversely, Turkey's ratings could be downgraded to a single-b category if: i) macroeconomic instability is further heightened; ii) fiscal, central bank and structural economic policies remain inconsistent with long-run sustainability; and/or iii) further institutional deterioration or geopolitical tensions arise.

Recent economic developments have been mostly positive: inflation increased to 10.6% YoY in November 2019 (well above the 5% target), but remains well off a peak of 25.2% in October 2018; lira sentiment has stabilised; the current account balance reversed to a *surplus* of 0.8% of GDP in the year to September 2019, from a peak deficit of 6.6% of GDP in the year to May 2018, albeit mainly driven by import contraction; and official reserves picked up to USD 104.8bn as of November 2019, from USD 84bn last October.

Still, we remain cautious despite these improvements. The central bank has cut its one-week repo policy rate since July to 14%, from a peak of 24%. In 2020, a key challenge will be whether aggressive rate cuts resume beyond the extent called for by fundamentals. If rate cuts are too aggressive, they could undermine Turkey's central banking framework and raise the likelihood for renewed macro-economic instability. In addition, monetary easing is taking place at the same time as significant fiscal easing, which has seen the general government deficit increase to an estimated 4.6% of GDP in 2019, from 2.2% of GDP in 2017 (**Figure 11**).

Figure 11. Fiscal and inflation trajectories, % of GDP (l.h.s.); % (r.h.s.)



Source: IMFWEO, Scope Ratings GmbH; *refers to average.

Georgia (BB/Stable): steady growth, but heightened political uncertainty

Georgia's three-year economic reform programme with the IMF remains on track: we anticipate growth at around 4.5-5.0% in 2020, similar to 2017-19 levels. We also expect Georgia to continue to comply with programme targets, which will support its fiscal sustainability and the development of its capital markets. Growth will be driven by i) a small fiscal stimulus, with the budget deficit set to widen to around 2% of GDP in 2019 and 2020, reflecting higher spending on education and welfare; ii) the continued implementation of reforms, including infrastructure improvements and export sector diversification; and iii) a stable macro-economic environment, with the central bank accumulating foreign-currency reserves whilst targeting exchange rate flexibility.

Still, political uncertainty is adding to downside risks. Anti-government demonstrations are intensifying and led to the resignation of Georgia's prime minister in September 2019. We expect this uncertainty to persist at least until the parliamentary elections scheduled for October 2020. In addition, we expect geopolitical risks related to unresolved conflicts in South Ossetia and Abkhazia with Russia to persist, resulting in a limited likelihood for a re-opening of trade corridors with Russia – the second largest destination for Georgian exports – before the next parliamentary elections.

Annex I: Scope's CEE sovereign ratings & 2019 rating actions

Figure 12. Scope's CEE long-term, foreign-currency issuer ratings, as of 10 December 2019

Central and Eastern European 11 (CEE 11)				Other CEE	
Euro area		*Non-euro area*			
Estonia	A+/Stable	Bulgaria	BBB+/Stable	Georgia	BB/Stable
Latvia	A-/Stable	Croatia	BBB-/Stable	Russia	BBB-/Positive
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 13. Scope's CEE sovereign rating actions in 2019, as of 10 December 2019

Date	Sovereign	Rating Action	Rating & Outlook
22 February	Bulgaria	Upgrade/Outlook change	BBB+/Stable
5 April	Estonia	Affirmation	A+/Stable
14 June	Turkey	Affirmation	BB-/Negative
21 June	Slovenia	Upgrade	A/Stable
28 June	Croatia	Upgrade	BBB-/Stable
26 July	Russia	Affirmation/Outlook change	BBB-/Positive
4 October	Lithuania	Affirmation/Outlook change	A-/Positive
18 October	Hungary	Upgrade/Outlook change	BBB+/Stable
1 November	Poland	Affirmation	A+/Stable
15 November	Slovakia	Affirmation	A+/Stable

Annex II: Macro-economic outlook 2018-2020F

Region	Real GDP growth (%)			Inflation				Unemployment rate, %			General government balance (% of GDP)			General government debt (% of GDP)			Current account (% of GDP)		
	2018	2019E	2020F	Target	2018	2019E	2020F	2018	2019E	2020F	2018	2019E	2020F	2018	2019E	2020F	2018	2019E	2020F
CEE 11 euro area																			
Estonia	4.8	3.2	2.0	<2.0	3.4	2.4	2.1	5.4	5.1	5.4	-0.6	-0.2	-0.2	8.4	8.7	8.4	2.0	1.4	1.6
Latvia	4.6	2.5	2.5	<2.0	2.6	3.1	2.5	7.4	6.6	6.4	-0.7	-0.6	-0.6	36.4	36.0	35.2	-0.7	-0.8	-1.4
Lithuania	3.6	3.8	2.5	<2.0	2.5	2.4	2.2	6.2	6.2	6.2	0.6	0.0	0.0	34.1	36.3	35.1	0.3	1.2	1.5
Slovakia	4.0	2.7	2.7	<2.0	2.5	2.7	2.5	6.5	5.8	5.7	-1.1	-0.9	-1.2	49.4	48.1	47.3	-2.6	-3.4	-3.7
Slovenia	4.1	2.7	2.7	<2.0	1.9	1.8	1.9	5.1	4.4	4.2	0.8	0.5	0.5	70.4	66.7	63.1	5.7	5.7	5.4
CEE 11 non-euro area																			
Bulgaria	3.1	3.7	3.5	-	2.6	2.4	1.6	5.2	4.4	4.1	1.8	-0.25	0.0	22.3	21.1	19.9	5.4	8.5	6.5
Croatia	2.6	2.9	2.6	-	1.6	1.1	1.4	8.4	6.9	5.8	0.3	0.1	0.0	74.8	71.2	67.7	2.6	1.3	0.3
Czech Republic	3.0	2.5	2.5	2.0	2.0	2.6	2.3	2.2	2.1	2.2	1.1	0.2	-0.1	32.6	31.5	30.7	0.3	0.5	0.9
Hungary	5.1	4.6	2.8	3.0	2.9	3.4	3.1	3.7	3.4	3.4	-2.3	-1.8	-1.0	70.2	68.2	66.7	-0.5	-1.4	-1.0
Poland	5.1	4.0	3.3	2.5	1.2	2.2	2.6	3.9	3.5	3.6	-0.2	-1.5	-2.0	48.9	47.8	47.3	-1.0	-0.9	-0.9
Romania	4.0	4.0	3.0	2.5	4.1	3.9	3.5	4.2	3.9	4.2	-3.0	-3.6	-4.4	35.0	35.5	37.2	-4.6	-5.3	-5.5
Non-EU																			
Turkey	2.8	0.2	3.0	5.0	16.3	15.7	12.6	11.0	13.8	13.7	-3.1	-4.6	-4.7	30.2	30.1	30.8	-3.5	0.4	-1.0
Russia	2.3	1.0	1.5	4.0	2.9	4.5	3.7	5.0	5.1	4.9	2.9	2.1	1.5	14.3	15.3	15.7	6.9	5.2	4.6
Georgia	4.7	4.6	4.6	3.0	2.6	4.3	3.8	12.7	12.3	12.0	-0.9	-1.9	-2.0	44.9	50.0	52.0	-7.7	-5.9	-5.8

Source: Scope Ratings GmbH, European Commission, IMF, Haver Analytics

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
1 Cour du Havre
F-75008 Paris

Phone + 33 1 8288 5557

London
Suite 301
2 Angel Square
London EC1V 1NY

Phone +44 20 3457 0444

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

Phone +34 914 186 973

Milan
Via Paleocapa 7
IT-20121 Milan

Phone +39 02 30315 814

Oslo
Haakon VII's gate 6
N-0161 Oslo

Phone +47 21 62 31 42

info@scoperatings.com
www.scoperatings.com

Disclaimer