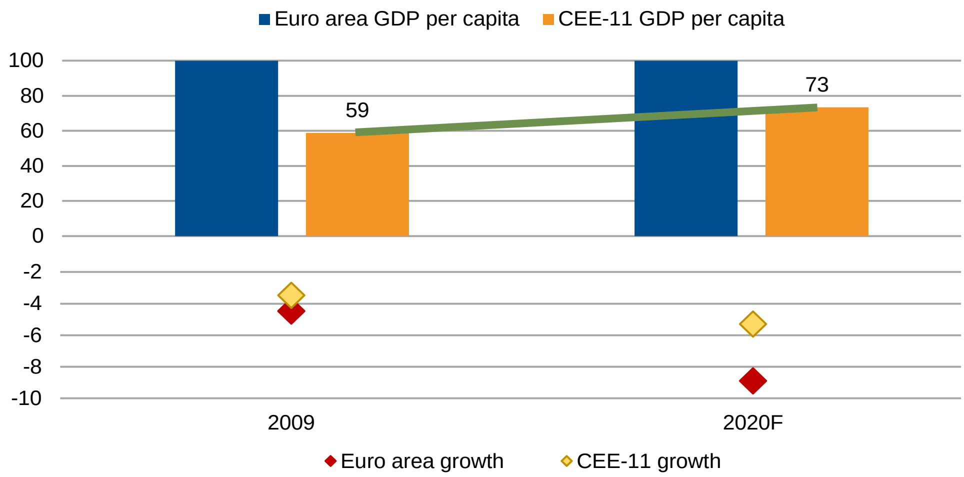
Central and Eastern Europe: safeguarding economic resilience after the pandemic

This time is different for the Central and Eastern European economies of the EU (CEE-11)[1], with the region better positioned to withstand this year's crisis than when the Global Financial Crisis (GFC) hit in 2008. CEE-11 sovereign ratings are supported entering 2021 by i) more diversified growth drivers, with consumption and investment as key growth engines besides net exports; ii) strong and broad-based income convergence over the past years, even if significant income gaps with western European countries exist; iii) strengthened fiscal positions before this crisis, due to marked debt reductions post-GFC, lowered interest payments and lengthened debt maturities; and iv) improved financial stability, with more resilient financial systems, lower net external financial liabilities, and gradual development of local capital markets. Looking forward, sustained income convergence with euro area aggregate levels will require CEE countries to address i) productivity limitations and ageing populations, ii) bottlenecks in domestic capital market development, and iii) environmental, social and governance (ESG)-related risks, such as climate change, including via EU funds.

Figure 1: GDP per capita (%, euro area=100) and real growth for the euro area aggregate versus that of the 11 CEE EU member states (CEE-11)



Source: Eurostat, Macrobond, Scope Ratings GmbH

After early economic rebounds mid-2020, the CEE-11 is experiencing again severe challenges from renewed spread of the coronavirus in the 2H-20. For many countries of the region, we expect full recovery to 2019 pre-crisis output levels only by 2022.

Meanwhile, robust fiscal and monetary support from regional governments and central banks has spared the region of a deeper severity of economic contraction and capital market disruption this year. Government-subsidised short-time work schemes have prevented sharper rises in unemployment.

CEE governments will need to target sustained recovery to ensure incomes continue a catch-up process with that of western European peers. This will rely upon i) improving labour supply and productivity levels; ii) developing capital markets to foster more liquid markets and diversified funding options; and iii) further improving EU fund absorption capacity and addressing ESG deficits to facilitate necessary investment flows.

[1] The CEE-11 are: Poland, Romania, the Czech Republic, Hungary, Slovakia, Bulgaria, Croatia, Lithuania, Slovenia, Latvia and Estonia.

Analyst

Levon Kameryan
+49 696677389 21
l.kameryan@scoperatings.com

Team leader

Dr Giacomo Barisone
+49 69 6677389 22
g.barisone@scoperatings.com

Media

Matthew Curtin
+49 30 27891 147
m.curtin@scopegroup.com

Related Research

Sovereign Outlook 2021: global growth recovers amid high debt; changing fiscal, monetary frameworks – 9 December 2020

Central & Eastern Europe Q4 Sovereign Update: full economic recovery to be gradual and uneven – 19 October 2020

Central, Eastern Europe: monetary policy is easing Covid-19 capital market disruption – 18 May 2020

Scope Ratings GmbH

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

Phone +49 69 66 77 389 0

Headquarters

Lennéstraße 5
10785 Berlin

Phone +49 30 27891 0
Fax +49 30 27891 100

info@scoperatings.com
www.scoperatings.com

Bloomberg: RESP SCOP

More balanced CEE-11 growth enhances economic resilience while activating EU funds key to raising long-term growth…

Reduced reliance on net exports

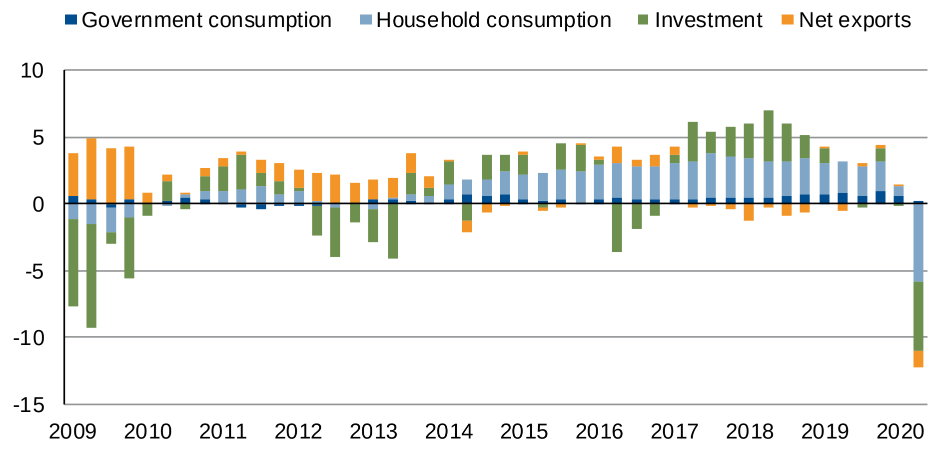
Since the GFC, the CEE-11 has increasingly narrowed income gaps with western Europe (**Figure 1, cover page**). Here, private demand and investment are contributing significantly more to economic growth (**Figure 2**), making growth more broad based and resilient to external economic shocks. These factors had helped shield CEE economies to an extent against a slowdown in the euro area between Q2 2018 and 2019. This does stand in contrast to the period 2009-13, during which the main contributor to growth was net exports.

Labour markets drive robust domestic demand

Growth in CEE income levels has reflected i) improvements in employment rates pre-crisis – tightening labour markets; ii) solid wage growth; and iii) foreign direct investment (FDI) inflows. Over the last decade, investment to GDP reached an average of nearly 23% annually in CEE-11, compared with below 21% in the euro area aggregate.

Figure 2: Contributions to CEE-11 growth

Percentage points, year-on-year, quarterly



Source: Eurostat, Scope Ratings GmbH; CEE-11 displays changes in aggregate GDP as well as GDP components of the CEE-11 countries

External sector developments support regional economic resilience

Another critical development contributing to the region's resilience is a rising share of services exports in regional GDP alongside simultaneous reduction in goods trade deficits, reflecting improvements in the economic diversification and production capacities of countries, supported by foreign direct investment. A higher share of services exports relative to goods exports could lower an economy's external vulnerabilities, as services typically rely less upon global value chains than industrial products do.

Going forward, the EU's 2021-27 budget (which totals EUR 1.8trn, including the Recovery Fund of EUR 390bn in grants and EUR 360bn in loans) will present a major opportunity for CEE EU members. The funds will allow countries to raise their investment, reduce infrastructure deficits, and support inclusive economic growth exiting this current crisis. EU funds finance more than half of all public investment of many CEE economies. The IMF calculates that one additional percent of GDP spent on infrastructure has the potential to raise output by up to 2-2.5% over the long run in central, eastern and southeastern Europe[2].

[2] Kammer, A., L. Papi, and P. Topalova. (2020), Central, Eastern, and Southeastern Europe After COVID-19: Securing the Recovery Through Wise Public Investment.

Further improving absorption of EU funds is key to continued income convergence

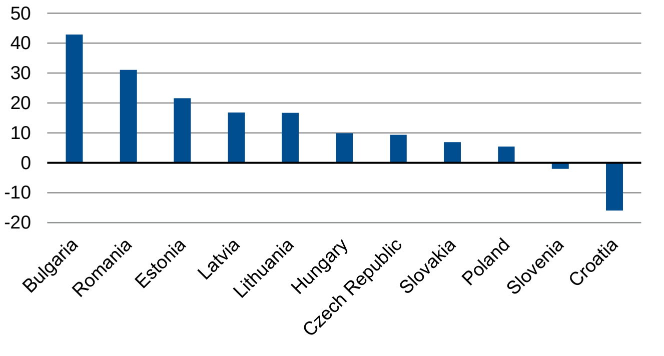
The ability of CEE economies to deploy forthcoming extra EU funding will prove critical to recoveries and long-term growth. We expect a strong political support and commitment to enhancing management and implementation of EU funds from CEE governments, which could have a positive impact on fund absorption.

CEE-11 governments need to secure long-term growth-enhancing investments to ensure sustained catch-up with income levels of western European peers, and without jeopardising price competitiveness. This is important as wage growth in many CEE countries has consistently outpaced productivity growth over this last decade. In addition, CEE labour productivity levels still remain well below euro area averages, although this gap has narrowed over the last five years: the highest productivity economies of the region, the Czech Republic and Slovenia, have reached around 75% of euro area productivity (**Figure 5, next page**).

Still low wage levels secure CEE's competitiveness despite strong wage growth

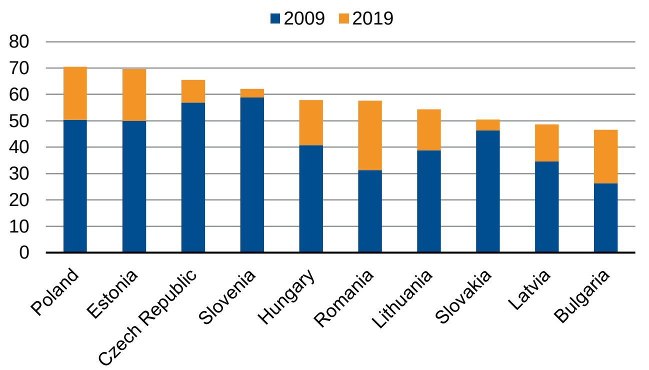
The CEE-11 has largely maintained economies' price competitiveness relative to euro area economies in the period following the GFC, as unit labour costs in relative terms increased only moderately for many countries (**Figure 3**). External competitiveness was supported in some cases as well by sizeable exchange rate depreciations against the euro (such as in the case of the Hungarian forint). Overall, wage levels in CEE, despite sizeable growth over the last decade, remain significantly below those of the euro area (**Figure 4**), supporting nonetheless the region's external competitiveness.

Figure 3: Unit labour costs relative to the euro area average (% change 2019 vs 2009)



Source: Eurostat

Figure 4: Net earnings, pps, relative to the euro area average



Source: Eurostat; net earnings refer to single persons without children earning 100% of average earnings

… but more investment in labour markets needed to ensure sustained income catch-up.

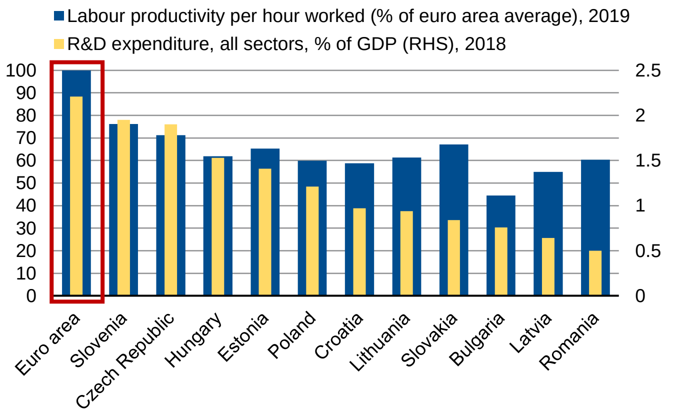
Productivity growth and skilled-labour shortages remain bottlenecks to faster income convergence

Nonetheless, productivity growth in many CEE-11 countries remains only moderate – and improvements could anchor continued income convergence while preserving competitiveness. One restraint on productivity growth is limited expenditure on research and development, at levels well below an euro area average of 2.2% of GDP (**Figure 5**). Another reason is the high share of small firms in some countries, the former which tend to spend less on research and development and do not benefit from economies of scale.

CEE governments will need also to further enhance labour force participation rates and address shortages of skilled workers, given ageing populations (**Figure 6, next page**) and, in some cases, net emigration. In case not addressed, declining working-age populations growingly constrain labour market supply and hinder long-run growth potential whilst burdening public spending via higher costs for pensions, healthcare and social care. Further building upon progress of the past in improving the competitiveness of policies and institutions will be important to increasing a labour market's attractiveness for retention of skilled labour. This can be achieved by means of advancing education, governance as well as infrastructure.

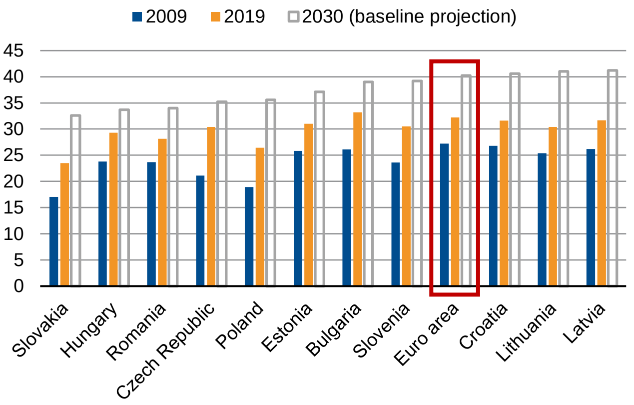
The successful implementation of institutional and economic reforms addressing labour markets in CEE economies could strengthen countries' creditworthiness longer term.

Figure 5: Labour productivity and R&D expenditure



Source: Eurostat

Figure 6: Old-age dependency ratio (population aged 65 years and above versus population aged 15-64 years)



Source: Eurostat

Diverging trends on income inequality

Furthermore, the degree to which CEE-11 economies benefit from domestic sectors' resilience varies. In a study on income inequality in CEE, we concluded that lower-income CEE-11 countries (particularly, Bulgaria, Romania and Croatia) show markedly higher levels of income inequality, exposing them to heightened social and economic risks especially under a low-growth environment. Conversely, higher-income CEE-11 economies (e.g. the Czech Republic and Slovenia) benefit from broader-based increases in real incomes, increasing their economic resiliencies to shock.

Here, three factors named – labour force participation rates, income inequality and old-age dependency – are central to Scope's assessment of sovereign credit risk, captured under social factors embedded in a ESG-credit risk pillar introduced in the agency's sovereign ratings methodology this October.

CEE economies need to accelerate green transitions

CEE needs to adapt to climate change challenges and push forward energy transitions

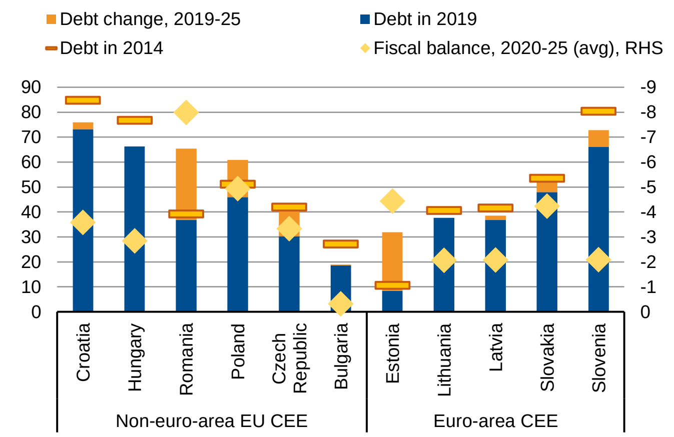
In addition, there is growing consensus on the need to address climate change and its economic consequences. CEE countries will have to adopt structural changes to their automotive sectors. This comes partly due to the EU's growing focus on transitions to a low-carbon society and possible reorganisations of international automotive supply chains. Electric cars accounted for less than 2% of CEE car exports in 2019, although the number of assembly lines for electric cars in the region has been increasing lately.

Indeed, CEE economies have the potential to accelerate their green transitions, and at an affordable cost, given their greater comparative scope than western European peers in improving energy efficiency in production and consumption, supported by competitiveness of labour forces. Climate-friendly policies among governments could be helped by EU funds. In addition, EU funds could enhance energy market integration and the security of energy supplies to CEE, supporting economic stability, as exemplified, for instance, in the connection of the Baltic states' and continental Europe's electricity and gas networks, co-financed by the EU.

Developing domestic capital markets is key post-crisis amid re-emergence of fiscal vulnerabilities

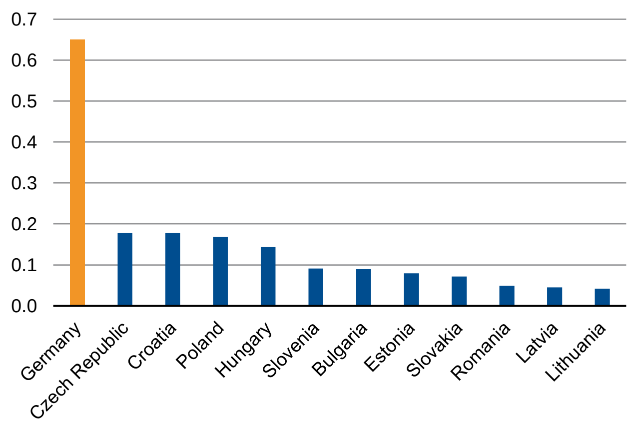
CEE-11 economies' exposures to external shocks have decreased over the previous six years, reflected via significant improvements to net international investment positions. The enhanced debt management strategies of CEE-11 governments are supporting debt issuance at longer-dated maturities and in local currency, in turn helping countries' respective creditworthiness.

Figure 7: Public debt trends (LHS) and average fiscal balances (RHS), % of GDP



Source: IMF October 2020 forecasts, Scope Ratings GmbH

Figure 8: IMF Financial Markets Depth Index, 2018



Source: IMF; 1=highest depth, 0=lowest depth; Financial Markets Depth Index compiles data on stock market capitalisation to GDP, stocks traded to GDP, government international debt securities to GDP, and debt securities of financial and non-financial corporations to GDP.

Increasing fiscal risks due to pandemic

However, fiscal risks have similarly materially increased in CEE due to 2020's crisis. Non-euro-area CEE governments have been especially exposed relative to their euro area peers: in the former, monetary support for national borrowing has been less buoyant and capital markets are less developed. CEE euro area members, by contrast, are receiving ample liquidity via the European Central Bank, underpinned by the euro's status as a global reserve currency, which ensures low government borrowing costs.

Depth of CEE capital markets remains low

For the CEE region as a whole, future rollover of more elevated amounts of public debt accrued during this crisis will require the further development of domestic capital markets (**Figure 8**). Relative to GDP, the average size of CEE capital markets is about a third of the EU average (the latter including the UK as of 2018 data). Furthermore, the market capitalisation to GDP of the most developed CEE capital market, in Poland's, is only about half the EU average's. National savings as a ratio to GDP in Poland, Romania and Slovakia remain low, at close to 20% of GDP (the EU average is 25%), which impedes capital market development and the potential for higher growth.

Some key steps in improving capital market depth include further increasing domestic savings, progressing on financial system integration within the EU in line with objectives of the EU's Capital Markets Union, and focusing on sustainable finance to attract foreign investors. Several CEE countries are planning 'green' financial products. Meanwhile, Poland and Hungary have issued green bonds on international markets.

With CEE governments seeking to maximise the long-term economic impact of EU co-financed projects, a focus on innovation investment and sustainable finance, backed by robust capital market development, is essential. This could enhance long-term market opportunities and encourage private-sector investment.

Central and Eastern Europe: safeguarding economic resilience after the pandemic

Scope Ratings GmbH

Headquarters Berlin
Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0

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

Phone +49 69 66 77 389 0

Paris
23 Boulevard des Capucines
F-75002 Paris

Phone +33 1 8288 5557

London
111 Buckingham Palace Road
UK-London SW1W 0SR

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

Phone +34 914 186 973

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

Phone +39 02 30315 814

Oslo
Karenslyst allé 53
N-0279 Oslo

Phone +47 21 62 31 42

info@scoperatings.com
www.scoperatings.com