

EMERGING EUROPE: THE BALANCE OF RISKS IS TILTED TO THE DOWNSIDE

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MANFRED STAMER

Senior Economist for Emerging Europe
and the Middle East
manfred.stamer@eulerhermes.com

Economic activity in the Emerging Europe region rebounded markedly in Q3 2020, but new lockdowns will send the region into a double-dip recession in Q4. Based on data available for nine economies that account for 70% of regional GDP, we estimate Q3 output to have expanded by +6.3% q/q, with the strongest increases seen in Slovakia (+11.7% q/q, after -8.3% in Q2, see Figure 1) and Hungary (+11.3% after -14.6% in Q2). This follows the substantial easing of lockdowns in May-June, as well as the restoring of supply chains and a recovery in the battered automotive sector. However, amid a very strong second wave of Covid-19, the 11 EU member states in Central and Eastern Europe (CEE-EU-11) have been forced to implement new lockdowns, albeit at varying stringency levels (see Figure 2 in the appendix for details on the seven-day incidence, stringency index and testing scale per country).

The short-term economic cost of these second lockdowns is expected to represent 30-50% of the economic impact that the region experienced in March-May. This is because the new measures are more targeted, mostly towards "Covid-19-vulnerable" services sectors (for example domestic trade, transportation, hotels and restaurants, education, social work, leisure and sports activities) and less restrictive in some countries, while industrial sectors, construction and agriculture will hardly be impacted this time. Moreover, supply-chain disruptions from Asia, which had added to the industrial recession seen in the spring, will be very limited now.¹ However, we expect differences across countries based on (i) the size of the affected services sectors²; (ii) the sanitary situation, which influences the stringency and length of the lockdowns³; (iii) the external trade structure and (iv) the immediate economic policy leeway.

As a result, we forecast the regional GDP to shrink by approximately -4.4% q/q in Q4, taking the full-year 2020 decline to -5.0%. This upward revision from our -5.4% forecast in September is explained by the significantly better-than-expected growth in Q3, which does in the short term more than offset the now expected contraction in Q4 (see Figure 1).

¹ For a similar development in large Western Eurozone economies see our publication [Delayed but not derailed: The Eurozone recovery after 'lockdown-light'](#).

² Figure 3 in the appendix shows that the services sectors are smaller in all Emerging European countries, except for Latvia, than on average in the EU, suggesting that the economies in the East should be somewhat less affected by the second lockdowns than those in the West.

³ Figure 4 in the appendix indicates that the sanitary situation is relatively severe in Czechia, Poland and Slovenia as of mid-November 2020 so that these countries may need a longer lockdown in Q4 than others in order to "flatten the curve" sufficiently. Moreover, Hungary, Croatia and Bulgaria may need more stringent confinement measures than they have currently imposed; otherwise the sanitary situation could deteriorate further.

The bad news is that the outlook for the recovery in 2021 has worsened, resulting in a downward revision of our full-year growth forecast by -1pp to +2.8% for the Emerging Europe region as a whole. The first reason is the negative carry-over from the contraction in Q4 2020. Another reason is that the second reopening after the Q4 lockdowns is likely to be more gradual as governments will aim to learn from the mistakes of summer 2020 in order to avoid a third lockdown and a triple-dip recession. Moreover, we have noticed a sharp decline in FDI inflows into the region in the first eight months of 2020, which will not only affect growth in 2020 but also medium-term perspectives (see Figure 5). Furthermore, monetary policy leeway is largely exhausted in the region, with interest rates being at record lows. Some countries engaged in Quantitative Easing-style policies in 2020 but this should be continued very cautiously in 2021 as this path will otherwise increase debt sustainability and inflationary risks, with adverse effects for medium-term growth.⁴

Regarding fiscal stimulus, the perspectives are diverging across the region. Our **Fiscal Leeway Score**⁵ indicates that Russia, Bulgaria, Slovakia and the three Baltic states still have significant leeway for expansionary fiscal policies. However, Russia is likely to continue its current path of moderate stimulus as it aims to sustain its fiscal reserves against the backdrop of ongoing Western sanctions. Bulgaria is also likely to remain conservative in terms of fiscal policy as it aims to adopt the euro as soon as possible.⁶ Moderate fiscal policy leeway is given in Czechia, Slovenia and Romania, while Hungary, Croatia, Poland and Turkey have less room for fiscal maneuver in 2021 (see Figure 6).

The balance of risks to our 2021 forecasts is tilted to the downside. The potential reshoring of supply chains as well as the production of final goods from Asia (notably China) to Central and Eastern Europe is a small upside risk. Indeed, the likelihood of it happening on a large scale in 2021 is low as the relocation of production channels usually takes time. The downside risks are much larger, with continued uncertainty over the development of the health situation being a key one. Should the current lockdowns last longer than expected to flatten the second wave or should a third wave of Covid-19 cases occur in Emerging Europe in 2021, requiring a third lockdown, then consumer and investor confidence would take a hit

Another downside risk is policy mistakes, especially in Turkey. The country is currently already suffering because it has kept monetary policy too loose for too long. We do not expect that last week's replacements of the important posts of central bank governor and finance minister will result in a lasting reversal of economic policies. Markets are currently pricing in a significant interest rate hike by the Central Bank of Turkey (CBT) at its scheduled meeting on 19 November, which is likely to come through. However, this will not be a game-changer and is actually included in our scenario. We expect that as soon as the TRY exchange rate has stabilized and inflationary pressures have moderated for a few months, the CBT would return to a monetary easing cycle, most likely too early, as it did in

⁴ For a detailed analysis on this topic see our publication [Quantitative Easing in emerging markets: Playing with fire?](#)

⁵ We derive the Fiscal Leeway Score from a set of five indicators across selected Emerging Markets: discretionary fiscal policy response to Covid-19 (% of GDP), estimated change in fiscal deficit in 2020 (% of GDP), total public debt forecast in 2020 (% of GDP), trajectory of public-debt-to GDP ratio in 2015-2019 (scored on a scale from 1=best to 5=worst), and the long-term government bond yield (%).

⁶ Bulgaria, along with Croatia, was admitted to the ERM-II, the "waiting room" for eventual euro adoption, in July 2020 and could join the Eurozone in 2023 at the earliest.

2019 after the previous severe currency crisis. Continued economic policy mistakes combined with the government's ongoing involvement in a growing number of geopolitical conflicts suggest that financial market turbulence will remain on the agenda, including negative repercussions and downside risks for the real economy.

Over the medium-term, the conditionality of the EU 2021-2027 budget and the Recovery and Resilience Facility (RRF), which was agreed last week by negotiators from the European Parliament and EU governments, provides room for policy mistakes in Poland and Hungary. The deal, which now needs to be formally approved by all EU governments and the European Parliament, will cause tension because it links access to EU funds to the respect for the rule of law – a condition that Poland and Hungary strongly oppose because they are under EU scrutiny for undermining the independence of courts and media. Both countries have already threatened to veto the EU budget. Such a veto would derail money for all EU member states, which would dampen the economic outlook for all of the CEE-EU-11 region, including Hungary and Poland themselves, both of which would continue to be net beneficiaries of EU financial support. Since it appears to be difficult for the EU to circumvent such a veto, it is likely to back down on the severity of the conditionality to allow for a compromise and get the budget deal through. However, there is a tail risk that the European Parliament will not completely give in, forcing Poland and Hungary into a compromise solution that may reduce the funding for them as long as they do not comply with EU laws. Should this relatively unlikely event occur, it would be considered as a policy mistake by the two countries that would reduce their future potential growth, although mostly beyond 2021 because EU funds are not expected to flow before H2 2021.

Appendix

Figure 1 – Expected cost of Q4 lockdowns and real GDP growth forecasts (in % compared to the previous period)

	Cost of Q4 lockdown (in % of Q2 lockdown)	Q3 2020	Q4 2020	2020	Revision from Q3 forecast (pp)	Q1 2021	Q2 2021	Q3 2021	Q4 2020	2021	Revision from Q3 forecast (pp)
Emerging Europe	46%	6.3	-4.4	-5.0	0.4	2.1	3.2	1.7	1.3	2.8	-1.0
Russia	50%	5.2	-4.0	-4.5	0.6	1.8	2.7	1.4	1.1	2.2	-0.7
Turkey	42%	5.8	-4.9	-4.9	-0.2	2.4	3.6	1.9	1.5	2.5	-1.5
CEE-EU-11	45%	7.5	-4.7	-5.5	0.5	2.3	3.5	1.8	1.4	3.4	-1.1
Poland	47%	7.7	-4.3	-3.7	0.8	1.9	2.9	1.5	1.2	3.2	-1.0
Czechia	33%	6.2	-2.9	-7.0	0.2	1.8	3.5	1.4	1.1	3.8	-1.5
Romania	51%	5.6	-6.8	-6.8	-0.4	3.4	5.1	2.7	2.0	3.0	-1.2
Hungary	47%	11.3	-7.1	-7.1	0.7	3.2	4.5	2.6	1.9	4.0	-1.1
Slovakia	38%	11.7	-3.1	-6.0	2.2	1.4	2.1	1.1	0.8	4.7	-1.1
Croatia	49%	11.0	-7.4	-8.3	0.7	3.3	5.0	2.7	2.0	4.3	-0.9
Bulgaria	47%	4.3	-5.0	-5.5	-0.5	2.5	4.2	2.0	1.5	2.5	-1.6
Slovenia	47%	8.0	-4.5	-8.4	0.2	2.7	4.0	2.2	1.6	5.1	-0.9
Lithuania	42%	3.7	-2.5	-2.0	0.5	1.1	1.7	0.9	0.7	1.4	-1.2
Latvia	50%	6.6	-3.6	-4.8	2.0	1.6	2.4	1.3	1.0	2.9	-2.1
Estonia	37%	3.5	-2.1	-4.4	-0.3	1.3	2.5	1.0	0.8	2.5	0.0

Sources: National statistics, IMF, IHS Markit, Allianz Research

Figure 2 – Seven-day incidence, stringency index and testing activity for selected countries

	7-day incidence*		Stringency index		Tests per 1mn population
	30 Sep.	mid-Nov.	30 Sep.	mid-Nov.	
Russia	37	97	41	45	452,872
Turkey	13	20	70	68	182,120
Poland	26	455	19	71	142,544
Czechia	143	621	39	73	245,248
Romania	58	291	44	55	185,402
Hungary	62	328	41	41	130,495
Slovakia	53	261	29	75	169,576
Croatia	31	396	29	32	142,132
Bulgaria	22	322	35	48	117,664
Slovenia	48	451	46	69	201,105
Lithuania	27	330	34	63	418,174
Latvia	13	100	37	50	273,994
Estonia	25	91	22	22	215,497

* The number of new infections per 100,000 inhabitants over the past seven days.

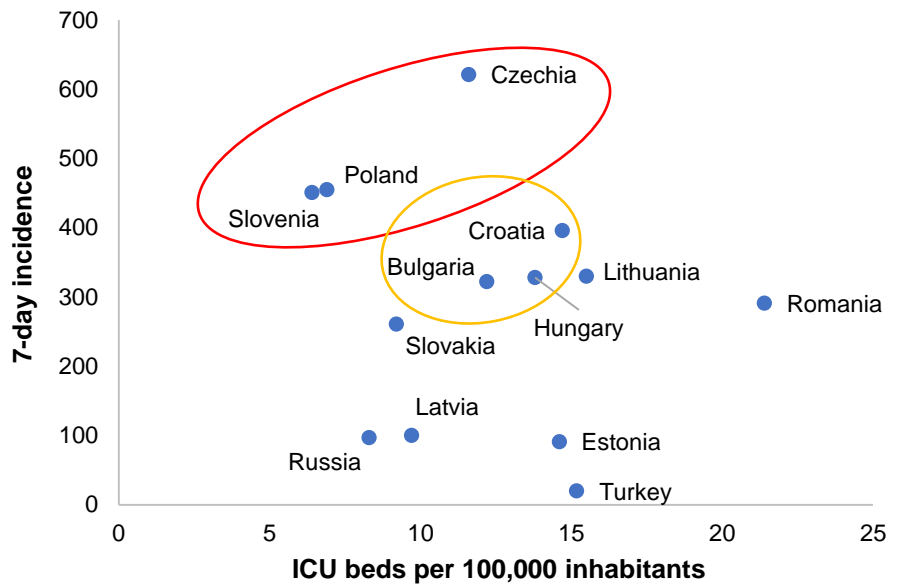
Sources: Various, Oxford Economics, Worldometer, Allianz Research calculations

Figure 3 – Shares of main sectors in gross value added

	Agriculture	Industry	Construction	Services
Turkey	7.1%	24.2%	6.0%	62.7%
Czechia	2.1%	29.2%	5.6%	63.0%
Romania	4.5%	24.1%	7.1%	64.3%
Slovenia	2.3%	27.0%	6.0%	64.7%
Slovakia	2.8%	24.5%	7.6%	65.1%
Poland	2.7%	24.7%	7.2%	65.5%
EU-CEE-11	3.1%	24.5%	6.6%	65.8%
Hungary	4.0%	23.8%	5.6%	66.6%
Lithuania	3.6%	20.8%	7.3%	68.3%
Germany	0.8%	24.3%	5.4%	69.5%
Bulgaria	3.7%	20.6%	4.5%	71.2%
Croatia	3.6%	19.1%	5.7%	71.7%
Estonia	2.9%	19.0%	6.4%	71.8%
EU-27	1.8%	19.7%	5.5%	73.0%
Eurozone	1.7%	19.3%	5.3%	73.7%
Italy	2.1%	19.6%	4.3%	74.0%
Latvia	4.3%	14.9%	6.5%	74.4%
Spain	2.9%	16.1%	6.4%	74.5%
France	1.8%	13.5%	5.8%	78.9%
UK	0.7%	13.4%	6.6%	79.4%

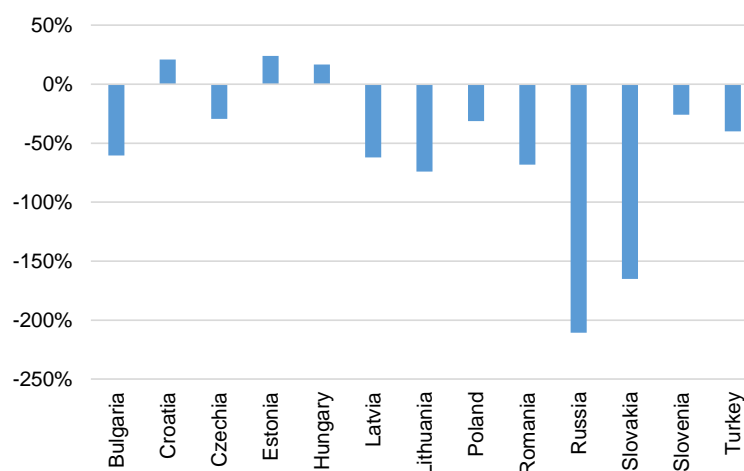
Sources: Eurostat, Allianz Research

Figure 4 – Sanitary situation in Emerging Europe



Sources: Various, Allianz Research calculations

Figure 5 – Net FDI inflows (% y/y change in January-August 2020)



Sources: Macrobond, Allianz Research

Figure 6 – Fiscal Leeway Score

Economy	Fiscal Leeway Score	Discretionary fiscal response to Covid-19 crisis (% of GDP, announced as of September)	Estimated change in fiscal deficit in 2020 (% of GDP)	Total public debt forecast in 2020 (% of GDP)	Trajectory of public debt-to-GDP ratio in 2015-2019*	LT government bond yield (% , latest month available)
Bulgaria	-1.60	6.7	-3.7	24.0	1	0.85
Russia	-1.30	3.4	-5.4	18.9	1	6.31
Estonia	-1.27	7.9	-4.8	18.7	1	2.88
Mexico	-0.89	1.1	-3.2	65.5	2	6.21
Nigeria	-0.73	1.5	-2.1	35.0	4	11.76
South Korea	-0.64	13.8	-2.2	48.4	2	1.19
Lithuania	-0.64	8.3	-3.7	48.3	3	0.16
Slovakia	-0.64	7.0	-4.6	61.8	2	-0.27
Latvia	-0.60	11.2	-3.2	44.1	3	-0.20
Saudi Arabia	-0.57	3.1	-3.9	33.4	5	3.38
Indonesia	-0.33	3.8	-4.5	38.5	4	7.25
Romania	-0.29	5.4	-6.1	44.8	3	3.49
Slovenia	-0.29	14.6	-2.7	81.0	1	-0.08
Egypt	-0.28	1.7	-0.5	86.6	3	13.82
Czechia	-0.22	19.8	-4.2	39.1	1	0.98
Thailand	-0.20	12.5	-5.0	50.4	2	1.53
UAE	-0.19	2.1	-7.1	36.9	5	0.78
Morocco	-0.04	3.3	-4.5	76.9	4	2.62
Hungary	0.04	8.5	-6.7	77.4	1	2.43
Croatia	0.05	5.2	-7.9	87.7	1	0.79
Israel	0.05	9.7	-7.0	76.5	1	0.70
Poland	0.16	11.7	-7.9	60.0	1	1.35
Chile	0.45	10.7	-6.6	32.8	5	2.59
China	0.50	5.9	-5.6	61.7	5	4.90
Turkey	0.67	13.8	-3.2	41.7	4	13.73
Colombia	0.91	5.3	-8.6	68.2	4	5.93
India	0.94	7.0	-5.9	89.3	4	6.45
South Africa	1.73	9.6	-7.3	78.8	5	10.65
Argentina	2.27	6.0	-3.3	100.0	5	29.89
Brazil	2.94	18.0	-9.8	101.4	5	6.29

* 1 = declining; 2 = stable; 3 = up and down; 4 = rising; 5 = rapidly rising

Sources: National statistics, IMF, Eurostat, IHS Markit, Allianz Research

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