SCOPE
Scope Ratings

Central and Eastern Europe Sovereign Outlook 2023

Growth falters amid war, higher cost of debt, energy security risk

Sovereign and Public Sector, Scope Ratings GmbH, 15 December 2022

EU CEE-11: Poland I Czech Republic I Hungary I Slovakia I Romania I Bulgaria I Croatia I Slovenia I Lithuania I Latvia I Estonia
Non-EU CEE: Russia I Turkey I Ukraine I Serbia I Georgia

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Executive summary

Our outlook for sovereign ratings in central and eastern Europe (CEE) for 2023 is Negative due to Russia's war in Ukraine and associated adverse economic and financial consequences. Growth of the 11 EU member states of the region (CEE-11) is expected to slow to 1.2% next year, from an estimated 4.6% this year. Outside of the EU, Russia returns to recession in 2023 (-4%), Turkey's growth slows to 3%, Ukraine recovers gradually next year (5.5%), Serbia retains moderate growth (2.7%) as Georgia grows above potential (7% next year).

Key themes for 2023:

Risk of stagnant growth amid high inflation, energy shortages, wider fiscal and external deficits: International sanctions and retaliation by Russia in response to the war in Ukraine, including weaponisation of its energy exports, are downside risks for CEE economies. In brief:

- The CEE region faces an economic slowdown with likelihood of technical recessions during 2022-2023 as energy prices remain high and consumer and business sentiment has worsened in H2 2022.
- Inflation is likely to run higher for longer, curtailing economic growth.
- CEE will have to pay a higher price for its energy security in the future even if current gas reserves are enough to avoid energy shortages this winter.
- Higher borrowing costs are narrowing fiscal room for manoeuvre, mitigated only partially by improved debt profiles. The urgency of large-scale investments in energy infrastructure and defence will strain public finances in the medium term.
- Finally, wider external deficits and the strength of the dollar this year have exerted downside pressures on currencies and foreign-currency reserves, a vulnerability especially for countries outside the euro area.

The consequences of Russia's war in Ukraine require policy adjustments and difficult fiscal and economic trade-offs for CEE countries: CEE governments are absorbing much of the costs facing households and businesses due to higher energy prices, as they also cope with costs from the influx of Ukrainian refugees. The political impact may become increasingly visible as support for populist groups rise in elections. Bulgaria is one country experiencing renewed political instability, which might delay plans for its adoption of the euro. Slovakia also faces growing political uncertainties after the government lost its majority in parliament. Serbia and Georgia face the difficult task of balancing relations with Russia with those with the European Union.

Consolidating public finances will be crucial in determining sovereign ratings trajectories: Greater uncertainties over budgetary discipline and pro-growth structural reform add to risks hanging over outlooks for sovereign debt-to-GDP ratios. The CEE-11 countries remain reliant on EU fund transfers so unresolved disputes over the rule of law in Hungary and Poland cloud their economic and fiscal outlooks and serve as a forewarning to other governments with higher institutional risk, such as Romania and Bulgaria.

Economic imbalances build in Turkey, Russia in deep recession, pace of western aid vital for Ukraine's economic outlook:

- Turkey is entering uncharted waters, pursuing unsustainable economic policies ahead of elections scheduled by June 2023. The country's post-election economic direction is unclear, with risk of international sanctions due to the country's deepening economic cooperation with Russia. Escalation of the conflict in Syria and tensions in the eastern Mediterranean are additional concerns.
- Russia's economy is in recession, partly due to sanctions, offset only in part by closer ties with other middle-income countries. The value of the rouble is likely to come under renewed pressure next year.
- For Ukraine, the speed, scale, and composition of international financial support is crucial for the country's future as Russia increasingly targets Ukraine's economic infrastructure.

CEE-11 geopolitical importance has increased for EU and NATO: The war has led to a concerted and coordinated response from the EU and other European governments supporting Ukraine, except for Hungary. A recent example is EU and US advancement of the so-called "Three Seas Initiative," a group of twelve EU countries (CEE-11 + Austria) centred on developing energy, transport, and digital infrastructure.

Risk for CEE sovereign ratings is negatively skewed for 2023: Six of 15 rated countries of CEE are on Negative Outlook. We hold a Negative Outlook for the ratings of Slovakia (A+), Hungary (BBB+), the Czech Republic (AA) and Poland (A+) due to higher policy uncertainty, energy crisis and supply-chain bottlenecks. The Negative Outlook for Turkey's debt (B- in foreign currency) reflects an unsustainable mix of economic policies. For Ukraine (CC), a Negative Outlook reflects debt-sustainability and balance-of-payment risks from the war and reconstruction.

Meanwhile, Stable Outlooks assigned to the ratings of Slovenia (A), Bulgaria (BBB+), Romania (BBB-), Estonia (AA-), Georgia (BB), and Serbia (BB+) reflect comparatively more limited economic impairments from the war, and in the case of Georgia, some net benefit. *Positive* Outlooks of Latvia (A-) and Lithuania (A) are supported by their modest levels of public debt. Croatia represents an outlier of the region, upgraded from BBB- to BBB+ in July 2022 ahead of the country's entry to the euro area in January 2023.

See **Annex I** for our full macroeconomic forecasts for CEE.

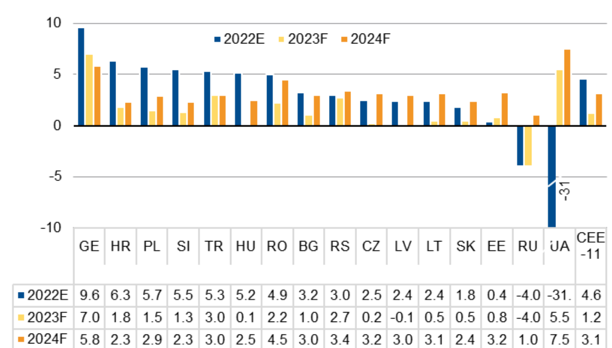
Main economic themes for 2023

Significant slowdown for EU CEE, Russia contracts, Turkey's economic imbalances grow

Output growth in the 11 EU member states of CEE (CEE-11) was above expectations during the first half of this year, benefitting from strong carry-over of growth momentum from 2021. This aligns with economic growth of 4.6% for CEE-11 on aggregate for this year.

With the euro-area economy facing slowdown if not outright output contraction as high inflation hits private demand, a temporary contraction of output in many CEE-11 economies during this winter appears likely. Market surveys signal reductions in industrial production and consumer confidence as prolonged high inflation scales back economic activity. According to preliminary estimates, economic output in the Czech Republic and Hungary contracted during the third quarter compared with the previous three months.

Figure 1: Real GDP growth*, %



	GE	HR	PL	SI	TR	HU	RO	BG	RS	CZ	LV	LT	SK	EE	RU	UA	CEE-11
2022E	9.6	6.3	5.7	5.5	5.3	5.2	4.9	3.2	3.0	2.5	2.4	2.4	1.8	0.4	-4.0	-31.	4.6
2023F	7.0	1.8	1.5	1.3	3.0	0.1	2.2	1.0	2.7	0.2	-0.1	0.5	0.5	0.8	-4.0	5.5	1.2
2024F	5.8	2.3	2.9	2.3	3.0	2.5	4.5	3.0	3.4	3.2	3.0	3.1	2.4	3.2	1.0	7.5	3.1

Source: European Commission, IMF, Scope Ratings forecasts; *sorted by estimated rate of 2022 growth; full forecasts available via **Annex I**

The risk of stagflation next year has increased in parts of the region, particularly as regards energy-intensive, open economies such as that of the Czech Republic and Slovakia (**Figure 1**). Recent acceleration of fiscal consolidation in Hungary comes at the expense of needed investment and raises risk for a full-year recession next year.

However, our baseline view is for annual growth of 1.2% for CEE-11 as an aggregate in 2023. The extent of the euro-area economic downturn, how "sticky" high inflation turns out to be, and the degree of efficiency of EU fund absorption will determine to a large degree the magnitude of the slowdown in the CEE-11.

A prolonged economic slowdown placing greater pressures on economies' balance of payments, exchange rates and foreign-currency reserves, which in turn might materially slow budgetary consolidation, represents a downside risk for sovereign ratings of the region.

Outside of the European Union, we have revised down growth estimates of Turkey to 3% next year, from our previous estimate of 3.5%, after 5.3% growth estimated for this year (revised down from 5.8% in our July forecasts). The Turkish government will continue to prioritise loose economic policies to charge up near-term growth, including a pre-election spending spree. There is risk Turkey introduces further capital controls if already elevated pressure on lira intensifies further, and further presses domestic banks to purchase more government debt to hold financing costs artificially low.

The Russian economy is expected to shrink about 4% next year after a 4% contraction this year. The war in Ukraine and intensified sanctions represent setbacks to productivity, the size of the available workforce as well as capital accumulation. We do not believe Russia will be able to compensate for its lost access to western technology, export markets, and global financial systems via sought deeper integration with other developing economies, such as with China, India and Turkey, as closer collaboration is restrained by friendly countries' conflicting priorities, recognising risk for secondary sanctions for cooperation with Russia.

Ukraine has suffered unprecedented economic impairment from the full-scale invasion of its sovereign territory, seeing significant disruption to its labour market, as well as to supply and production chains. With the conflict easing in some regions – and liberation of multiple Ukrainian territories, adaptation of businesses to wartime conditions and a period of opening of a "grain corridor", the economy started output recovery from Q3 2022. Nevertheless, persistent logistical challenges, destruction of productive capacity and decline of real household incomes constrain the speed of recovery. We have expected Ukraine's economy to contract by 31% this year but revised down our expectation for 2023 recovery to 5.5% (from 12.5% in our July forecasts), with output remaining next year over 25% below 2021 levels.

High cost of *energy security* remains a risk to economic and fiscal outlooks

Despite CEE's high dependence on Russian energy, the energy situation has improved with low risk of substantive disruptions in economies this winter, due to sufficient gas storage (given current levels covering 25-30% of annual gas consumption).

CEE-11 has accelerated construction of new gas pipelines and liquified natural gas (LNG) infrastructure to secure its supplies. Gas started flowing to Poland from Norway via the Baltic Pipe during October. This will completely substitute Poland's Russian gas imports of 10bcm, or about 50% of aggregate domestic gas use, and also help other CEE-11 economies diversify their energy supplies. Exceptions from this diversification are Hungary and Serbia, who have located limited alternative energy sources to Russian gas.

Most CEE-11 economies reached a 1 November target of filling gas storages to 80% ahead of this winter, with Poland, Romania and the Czech Republic at near full capacity at this stage. Exceptions are Slovenia,

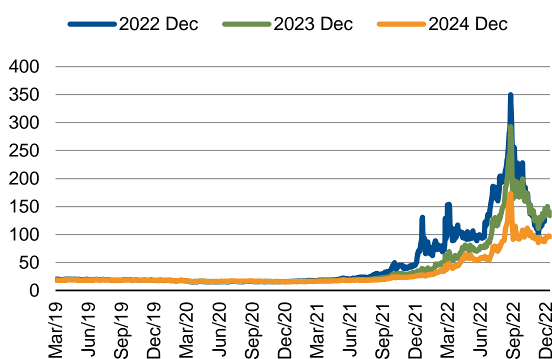
Lithuania and Estonia, which have no storage capacity but managed to establish solidarity agreements with other EU member states. Latvia's current storage is around 50% full, including gas stored for other Baltic states as well as for Finland.

However, there is a significant degree of uncertainty surrounding the next winter (that of 2023–2024) as gas supplies are likely to remain scarce in absence of Russian gas. Gas storage might be depleted by the end of the current winter heating season. In view of uncertainties regarding adequacy of energy supplies, energy security for the region will come at a high cost for the foreseeable future, with risk to fiscal and economic performance.

Europe might face a gas shortfall next winter if Russia halts remaining supplies to Europe and China's demand for imports of LNG recovers. The US Energy Information Administration estimates a demand-supply gap of 30bcm (EU gas consumption in 2021 was 412bcm) during the summer of 2023 for refilling gas storage of Europe. This could once again drive energy prices on the continent higher next year.

Total pipeline gas from Russia to the EU is estimated around 60bcm this year, mostly reflecting gas delivered during the first half of the year before Russia halted most of its supplies. It obviously appears unlikely Russia will provide the EU with as much gas next year. For the 15 CEE countries we rate, Hungary and Serbia are the most vulnerable to further cuts in their imports of Russian gas. Meanwhile, Russia's gas flows to Turkey are unlikely to stop.

Figure 2: Dutch TTF Natural Gas Futures, EUR/MWh



Source: Intercontinental Exchange (ICE), Scope Ratings

At the same time, most CEE-11 governments have announced retail energy price ceilings, among other supportive measures, to shield customers from the full impact of higher energy prices. Poland is set to cap electricity prices next year at this year's levels for households and for small and medium-sized enterprises. Bulgaria, the Czech Republic, Estonia, Hungary, Lithuania, Romania, and Slovakia are further CEE-11 nations that have introduced retail energy price regulations.

Although such measures have eased short-term fallout from high energy prices for domestic economies, the measures have come at sizeable budgetary cost and are unlikely to prove fiscally sustainable long run. They might also reduce incentives to cut energy demand, as has been the case in Hungary operating price caps on fuels, and risk depletion of stored energy.

Although wholesale gas and energy prices have fallen significantly since the peaks in the summer, markets continue to expect wholesale energy prices in the next few years to remain significantly higher than they were during 2019-20 (**Figure 2**). As governments gradually remove energy price caps, this could result temporarily in further inflationary pressures, but hopefully without preventing inflation from returning to levels consistent with central-bank objectives.

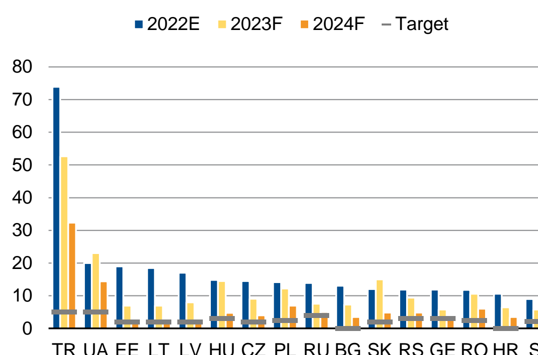
Persistent inflation, currency pressures drive terminal rates higher

The central banks in CEE began raising rates in advance of the ECB and the Federal Reserve, which has partially mitigated currency pressures so far and prevented additional exchange-rate-related inflationary impulse to domestic price rises. However, inflation in the region will only peak by Q4 2022-Q1 2023 and remain above central-bank targets next year, reflecting a challenging environment for businesses as well as for consumers.

Central banks in CEE have a challenging task ahead. They have already embarked on a cycle of a rapid monetary tightening. However, following the aggressive hikes of the Federal Reserve and the ECB, CEE central banks are under pressure to act further such as to discourage capital flight and relieve pressure on exchange rates. At the same time, there is little monetary policy can ultimately do to keep price rises in check when inflation is mainly due to supply-side factors.

Central banks are left contemplating further tightening of monetary conditions to curtail demand and defend currencies, even if this runs the risk of economic recession.

Figure 3: Headline inflation, annual average, %



Source: National central banks, Eurostat, IMF, Scope Ratings forecasts

We expect double-digit averages for headline inflation across CEE this year, except in Slovenia (**Figure 3**).

Core inflation (excluding the prices of food and energy) has furthermore risen, reaching as high as 24% YoY in Hungary by November. Inflation will not drop below central-bank objectives until at least end-2023 for most economies of the region.

Most CEE central banks have slowed if not halted their rate-hike cycles. Central banks of the Czech Republic, Hungary and Poland have signalled that rate hikes have possibly come to a close. Meanwhile, central banks of Romania, Serbia and Georgia might continue hiking at a slower pace through Q1 2023. Conversely, the central banks of Turkey and Russia have cut rates this year.

However, more significant tightening of monetary conditions might be necessary to bridle inflation. For this reason, CEE central banks are likely to also use other quantitative policy tools to manage money supply and support their currencies, such as select macroprudential measures per higher reserve requirements for the banks and selling foreign-currency reserves to withdraw domestic-currency liquidity from the market.

In Turkey, domestic politics continue to drive policymakers' approaches to inflation. A reset of monetary policy is highly unlikely before presidential and parliamentary elections scheduled by June 2023. President Recep Tayyip Erdoğan is behind potential presidential candidates of the main opposition Republican People's Party in opinion polls. This provides an incentive for the President to double down on current ultra-loose monetary policies given potential damage to his credibility that a U-turn from expansionary policy might inflict. This is even with official annual inflation running at 84.4% as of November (although having dropped in November for a first time since May 2021).

In Russia, partial mobilisation of military reservists could create supply-side restrictions that add to medium-run inflation, adding to challenges for the Bank of Russia. In Ukraine, the National Bank of Ukraine (NBU) has held its policy rate at 25%, after a sharp 15pp hike in June. The current level of the policy rate is seen being retained at least until Q2 2024, although the NBU remains ready to opt for additional hikes if needed.

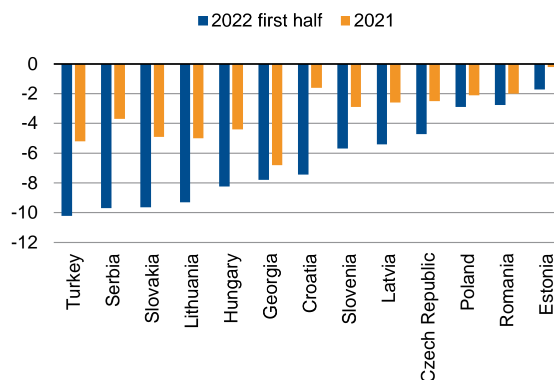
External deficits weaken, adding to pressures on currencies

High energy prices have widened current-account deficits across CEE. Such deficits are expected to remain sizeable next year. All CEE economies, except for Russia, are significant net energy importers (**Figure 4**). Net energy imports could total to 10% of GDP in Turkey, Serbia, Slovakia and Hungary this year, twice their levels from last year.

Current-account deficits may reach around 7% of GDP for Hungary and 3-4% of GDP in the Czech Republic and Slovakia this year, likewise double levels from 2021.

Other global shocks, such as global supply-chain bottlenecks, which impair trade balances, have partially subsided recently but will not have entirely corrected by 2023. Possible further disruptions of global supply chains from China's approach to tackling a renewed rise of Covid-19 infections are a risk.

Figure 4: Energy trade balances*, % of GDP



Source: UN Comtrade, Scope Ratings calculations; *Energy trade is based on HS chapter-27

Prices of metals have fallen to pre-war levels due to reduced Chinese demand and a weakening global economic outlook. Likewise, wheat prices have nearly returned to pre-war levels as deliveries via Ukraine and Russia resumed. Both countries have recently agreed to temporarily renew a grain export arrangement, brokered by the United Nations and Turkey, allowing Ukrainian agricultural products to be shipped through the Black Sea. However, risk of further interruptions to such supplies remains pronounced, due to the difficult logistics of operating in a time of war as well as Russia's strategy of weaponising global food supplies.

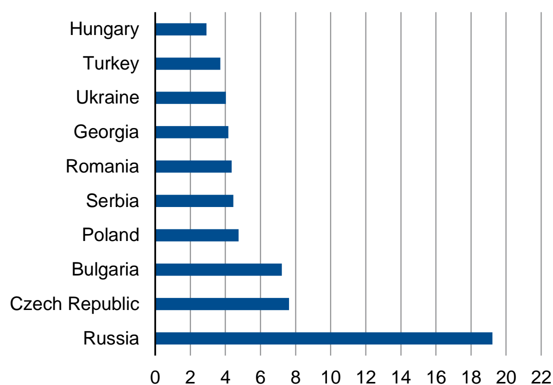
Present external crises alongside deterioration of external balances place further downside pressure on currencies, even as national central banks raised rates. This year, the Polish zloty and Hungarian forint depreciated by over 8% and 15%, respectively, year to date against the dollar, and 2% and 9%, respectively, against euro. Capital outflows from economies of Romania and Hungary have been sizeable since escalation of the war in Ukraine, adding to currency deprecation pressures, although outflows have nevertheless stayed well under peak levels seen at the start of the Covid-19 pandemic crisis.

The size of foreign-exchange reserve stocks helps determine policy responses of non-euro-area governments to high inflation to a relevant degree. Countries with large enough reserves, such as the Czech Republic, have intervened in currency markets such as to control monetary conditions, while relieving some pressures for even more significant rate hikes. By contrast, Hungary, with comparatively low reserves, has needed to tighten monetary policy more aggressively.

On the whole, official reserves of *most* CEE central banks, such as that of the Czech Republic, Poland,

Hungary, Romania and Serbia, are sufficient as to bridge through a current period of excessive market volatility, with reserves in most such cases covering external debt maturing over the next year as well as covering at least three months' of imports (**Figure 5**) – in line with international reserve-adequacy recommendations. Meanwhile, for euro-area CEE economies, external finances are underpinned by the euro's reserve-currency status.

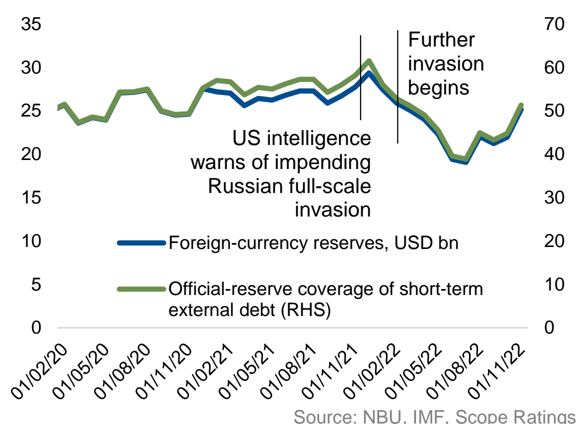
Figure 5: Number of months of imports covered by official reserves



Source: national central banks and statistical offices, Scope Ratings calculations; this ratio shows international reserves expressed in terms of number of months of imports of goods and services they could pay for [Reserves/(Imports(12m average))]

Turkey is likely to continue seeking foreign currency from aligned nations to shore up depleted reserves ahead of elections. Reportedly, Turkey is in talks with friendly nations such as Qatar, Saudi Arabia, and Russia for varying types of funding – in total seeking around USD 20bn. Net central-bank reserves, corrected for short-term forex swap liabilities with domestic banks, were at a record low of negative USD 60.4bn in October 2022 compared with positive USD 18.5bn at end-2019. Inadequate reserves are a core weakness of Turkey's sovereign credit profile.

Figure 6. Ukraine reserves and reserve coverage



Source: NBU, IMF, Scope Ratings

Finally, longer run, US and European policy makers have contemplated co-opting around USD 300bn of frozen Russian reserves to pay or serve as collateral for Ukraine's reconstruction funding. However, there are rightful questions over whether this could undermine due process and whether reserves might be better served as bargaining chips in talks to end the conflict.

In Ukraine, foreign-currency reserves recently increased (**Figure 6**). The expected reduction of NBU financing of the national government and continued receipt of international financial assistance ought to support stemming further reserve losses. The official hryvnia exchange rate was devalued 25% against the US dollar in July 2022, resulting in convergence with the unofficial hryvnia rate although the unofficial rate has since returned to 8% weaker compared with current official dollar-hryvnia rates.

Fiscal vulnerabilities grow, restricting policy making flexibility

CEE-11 governments will undertake limited fiscal adjustments next year as budgetary support for businesses and households continues amid current slower economic growth. We see general government deficits next year ranging from 2.5% of GDP for Croatia to a high of 6.4% of GDP for Slovakia. Weighted-average budget deficits of the CEE-11 bloc should be 4.3% of GDP next year, after 4.4% this year.

Funding allocated by CEE governments against elevated energy prices for societies so far ranges from the 6.6% of GDP of Lithuania to between 2-4% of GDP in Slovakia, the Czech Republic, Romania and Poland.

Some governments are likely to keep in place energy price ceilings and associated budgetary support, maybe after some amendments, until after forthcoming parliamentary or presidential elections, such as for Poland, Romania, and Slovakia. In Bulgaria, the caretaker government decided to extend the 2022 Budget to 2023, keeping introduced measures unchanged.

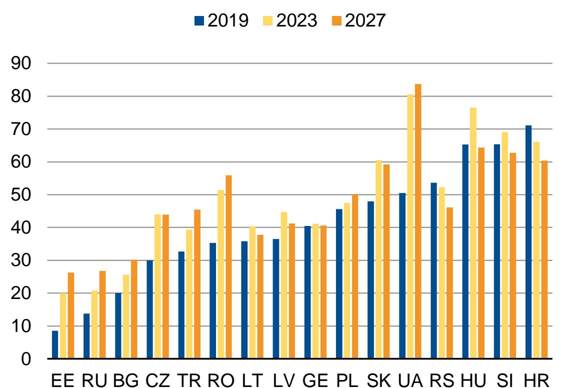
A further source of pressure on public finances medium run is an urgency for CEE governments to invest more heavily in alternative energy infrastructures – from storage facilities to new renewable energies to nuclear generating capacity and natural gas distribution networks. Furthermore, defence spending is a priority in the context of the war in Ukraine. As an example, Poland plans to raise defence spending to above 3% of GDP next year, from a planned 2.2% of GDP for 2022.

However, CEE-11 countries' ratings benefit from moderate outstanding government debt stocks (**Figure 7, next page**). As an example, for the Baltic states, moderate debt represents a crucial element of resilience against elevated exposures to inflation and to security risk. However, across CEE-11 except in Poland, Slovakia and Croatia, general government debt ratios are expected to continue rising next year.

Medium run, resuming fiscal consolidation will prove crucial to containing further unnecessary rises in debt ratios and lowering funding costs. This is especially relevant for countries with other stress factors or sources of uncertainty such as forthcoming elections

(such as in Turkey, Hungary, Romania, Bulgaria, Poland, Serbia and Georgia). The likelihood of success in the consolidation of public finances will prove a key factor determining ultimate trajectories of sovereign ratings in CEE.

Figure 7: General government debt, % of GDP



Source: IMF World Economic Outlook, Scope Ratings forecasts

In Russia, its Ministry of Finance plans to spend the liquid part of the National Wealth Fund – where a slice of oil and gas revenues have been saved – over the next two years to cover budgetary shortfalls. The full size of the Fund by the end of 2024 will have decreased to 3.7% of GDP, from 10.4% of GDP as of end-2021. We project a budget deficit of 3.5% of GDP next year, after the 1.5% of GDP this year, due to a G7 oil price ceiling, reduced energy revenues, higher expenditure related to the war and support for the economy.

In Ukraine, the 2023 State Budget foresees gradual recovery of tax revenues, especially in VAT and individual income tax collections, although expenditure ought to remain substantively higher than pre-crisis levels and earmarked nearly 50% for army and security deployment. We see the budget deficit having reached 14.9% of GDP this year (revised down from our earlier estimate for 19.7%), before 14.3% of GDP for 2023 and averaging 12.7% during 2024-27.

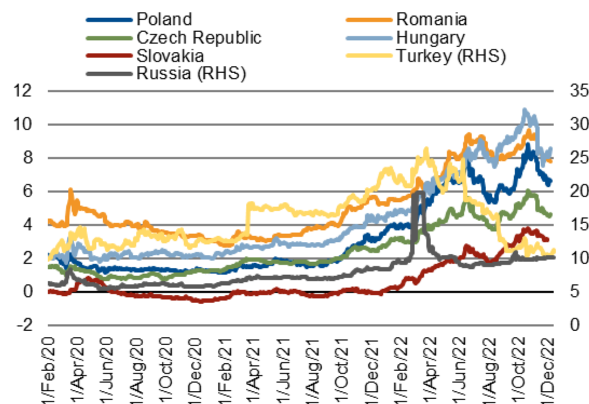
Improved debt structure mitigates consequences of higher interest rates; EU funds disputes linger

Tighter domestic and global monetary conditions have sharply hiked the cost of borrowing across CEE. Yields for 10-year local-currency sovereign securities have risen twofold for CEE-11 compared with where they were as of the end of 2021 (**Figure 8**).

Countries with idiosyncratic pressure points have seen borrowing costs pick up even more significantly. Temporary halt of EU fund disbursements to Hungary has raised pressure on the forint as well as on yields. Romania's borrowing rates have also risen sharply given large external-sector and budget deficits.

Higher borrowing rates will gradually trigger more significant interest payments. The weighted-average maturity of CEE-11 debt portfolios is, however, comparatively long, mitigating such rate risks to a degree. Slovenia presents the region's longest average maturity of debt of 10 years. By contrast, Poland has among the lowest of CEE-11 at 4.9 years.

Figure 8: Government benchmarks, 10-year, yield, %



Source: Macrobond, national central banks and debt management offices, Scope Ratings

Public debt profiles of most CEE-11 sovereigns are more resilient at this stage due to domestic capital market development and a long phase of low yields in advanced economies having pushed foreign investors to purchase higher-yield *local-currency* debt of regional debt markets. As of 2011, about half of Hungarian debt and one-third of Polish debt was owed in a foreign currency. By September 2022, only around a quarter of this debt was in foreign currency.

Borrowing costs will likely stay elevated and remain volatile next year. Borrowing rates of euro-area CEE sovereigns: Slovakia, Slovenia, Croatia (given accession to the euro area by 1 January 2023) and the Baltic states, might remain under pressure due to further ECB tightening but will remain materially below funding rates for non-euro area CEE peers next year.

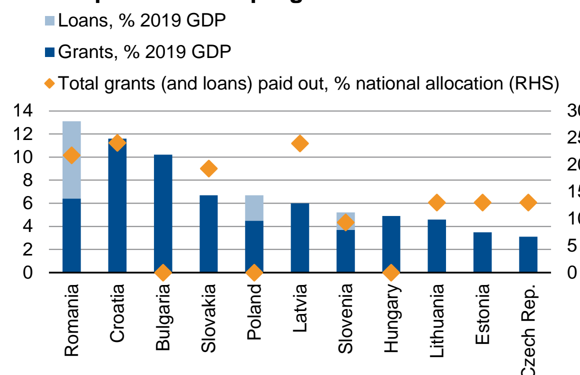
Managing public debt during current adverse economic conditions poses challenges for CEE governments. Avoiding overly much local-currency issuance that raises domestic yields, with knock-on adverse effects for the health of domestic markets and private-sector issuance activities, will have to be balanced against alternative priorities of managing foreign-currency debt issuance and associated foreign-currency risk.

The efficient use of EU funding, as agreed with the European Commission via national Recovery and Resilience Plans (**Figure 9, next page**), is crucial as this represents off-market financing on favourable terms. The introduction of 'rule of law conditionality' in EU development funding has put the EU in a better position to influence its member states by cutting or withholding financial support to economies where policies are deemed by EU institutions as detrimental to democratic values.

In our view, the adoption of the EU rule-of-law conditionality holds important implications for government debt trajectories in the CEE-11. Significant

delays or substantive cuts of EU funds would result in lowered funding for planned investment projects, which would have to be cancelled or funded via own sources.

Figure 9: CEE-11 national Recovery and Resilience Plan implementation progress



Source: European Parliamentary Research Service, Scope Ratings. Data as of 7 December 2022.

Unresolved disputes around the rule of law have clouded economic and fiscal outlooks of Hungary and Poland and served as a harbinger for other CEE countries with comparatively higher institutional risk, such as Romania and Bulgaria, warning of the possible implications of democratic backsliding. The dispute looks more intractable in Hungary where governance standards have deteriorated amid frequent changes of government regulation. Poland has this week offered the EU to amend a law on its Supreme Court to fulfil requirements to receive an initial tranche of EU recovery funds. This amendment awaits parliamentary approval.

In Turkey, domestic banks have been pressed by the central bank to purchase more government debt to ease financing costs for the government. Yields on 10-year lira bonds have dropped artificially to 11% by time of writing from over 25% in March – the former reflecting its lowest levels since January 2020. Any steep hike of interest rates after next year's scheduled elections would damage domestic bank balance sheets.

Russia will step up local borrowing mostly via its state-owned banks as far as market conditions will allow, with rouble staying comparatively strong. In the current quarter, the Finance Ministry raised rouble-denominated debt equivalent to around USD 21bn, over eight times more than a planned USD 2.5bn. Russia's access to foreign capital markets is closed for the present and will remain so for at least as long as the war in Ukraine continues in its current intensity.

CEE sovereign ratings: Negative skew of risk entering 2023

Weaker global growth, prolonged elevated inflation, supply-chain disruptions and rising debt-servicing payments as global central banks complete rate-hike cycles set the stage for sovereign risk next year.

Similar to the skew of our aggregate global sovereign rating outlook for 2023, the outlook for CEE sovereigns is Negative. This reflects 40% of publicly-rated CEE sovereigns (6 of 15: being the Czech Republic, Hungary, Poland, Slovakia, Turkey and Ukraine) presently being evaluated on Negative Outlook, with two on Positive (Latvia, Lithuania). Presently, 11 of Scope's 15 publicly rated CEE sovereigns are investment-grade rated with four rated sub investment-grade (Turkey, Ukraine, Serbia, Georgia).

Prior to Russia's full-scale invasion of Ukraine on 24 February, we held a more balanced skew of risk for our ratings with Negative Outlooks of three CEE issuers: Ukraine, Turkey and Poland as compared with three borrowers on Positive: Lithuania, Latvia and Croatia. Turkey's foreign-currency ratings have since February been further downgraded to B-, with maintenance of a Negative Outlook. We became the first EU credit rating agency to withdraw Russia's credit ratings in March. A first-time sovereign rating of BB+ was assigned to Serbia in June 2022, with a Stable Outlook.

Ukraine's foreign-currency debt was downgraded to selective default (SD) in August of this year on the consent of foreign investors to defer debt-service payments, before an upgrade to CC with a Negative Outlook assigned after conclusion of the debt restructuring.

Croatia's ratings were upgraded to BBB+ with a Stable Outlook, reflecting forthcoming accession to the euro area. Marked deterioration of economic growth, elevated dependence on Russian energy and higher policy uncertainty informed Negative Outlook revisions for the Czech Republic, Hungary and Slovakia. **Annex II** summarises rating actions in 2022.

Country outlooks

Visegrád countries

Poland (A+/Negative): Governance risks, economic slowdown, high inflation challenge ratings

After a comparatively moderate downturn during 2020, with output growth of -2%, the Polish economy recorded robust recovery, seeing quarterly output reaching 11pps above end-2019 levels by Q1 2022. This recovery momentum weakened by the second quarter of this year, with quarter-on-quarter economic growth of -2.3%, bouncing back by Q3 (1.0% QoQ). We forecast significant slowdown during coming quarters but robust growth for 2022 on the whole, at 5.7%, before economic growth of 1.5% during 2023 and 2.9% in 2024.

General government debt-to-GDP is expected to decline to 47.5% in 2023 (from the 57.1% of 2020 peaks), before resuming a gradual upside trajectory during subsequent years from combined effects of primary fiscal deficits alongside rising interest payments, concluding a forecast horizon to 2027 around 50%. After an average of an estimated 14.2%

this year, headline inflation is expected to average 12.2% next year, before receding to a still-elevated 7% by 2024. The National Bank of Poland surprised markets by leaving rates unchanged at 6.75% since October – although there is a possibility of further hikes being necessary next year.

Recently, Poland agreed with the European Union around legislation that could open up EUR 35.4bn (5.1% of average 2021-26 GDP) of Recovery Funds, reflecting EUR 23.9bn in grant financing. However, finalisation hinges on parliamentary approval. On. 22 December 2021, the European Commission furthermore opened fresh infringement proceedings in association with the breach of the primacy of EU law. Rule-of-law contentions have also evolved during recent months after communication during October that release of European Cohesion Funds for Poland under the 2021-27 EU budget, amounting to a significant EUR 76.5bn (10.7% of average 2021-27 GDP), has been placed on hold.

A longer-standing trend of weakening of governance institutions and disputes around the rule of law between the Polish government and the EU increases uncertainty around predictability of EU funding as well as of contingent European support under adverse economic scenarios. Furthermore, marked deterioration of the inflation outlook, associated rise of borrowing rates, and challenges faced by the National Bank of Poland as far as conduct of monetary policy are ratings concerns. Scope revised Poland's Outlook to Negative during January of this year, ahead of Russia's further invasion of Ukraine.

Czech Republic (AA/Negative): credible macroeconomic policies, but exposure to external risk

A record of robust macroeconomic policy making and strong institutional arraignments underpin AA credit ratings of the Czech Republic, despite revision of the Outlook to Negative this July.

We expect the economy to enter technical recession in the second half of the year and stagnate next year. High inflation and energy scarcity are risks. Despite high gas storage levels and secured LNG deliveries through Netherlands, uncertainty around the adequacy of energy supplies during 2023-2024 remains.

Due to extraordinary spending on energy subsidies, we expect the general government deficit to reach about 4.5% of GDP this year and remain elevated at 3.9% of GDP next year. Public debt is expected to reach around 45% of GDP by 2024 from 42.7% of GDP in 2022. However, the government is likely to maintain fiscal prudence preventing a more significant rise in debt.

The sovereign ratings are supported by credibility of the Czech National Bank's monetary policy and sizeable foreign-currency reserve stocks, which help mitigate negative economic and financial repercussions of the Russia-Ukraine conflict.

Medium-run economic headwinds are compounded by structural economic vulnerabilities, such as dependence on external demand, strong economic linkages with global supply chains and adverse demographics – representing constraints for longer-run economic growth.

Hungary (BBB+/Negative): further delays of EU funding could amplify economic risks

Hungary's growth outlook has materially worsened due to weaker demand from core export markets, elevated inflationary pressures, and currency weakness. This underpinned revision of our Outlook to Negative in September. We anticipate growth for 2023 of just 0.1%. Main economic risks include uncertainties surrounding the inflow of EU funds, effects of significant past monetary tightening and exposure to further cuts of Russian energy supplies. Contrary to most countries in CEE, Hungary has located limited alternative energy sources to replace Russian gas.

The ongoing dispute with the European Union over the rule of law puts at risk a substantial share of EUR 35bn (22.8% of 2021 GDP) in funds Hungary could expect from the 2021-27 long-term budget. The EU is furthermore withholding EUR 7.5bn (5% of 2021 GDP) in pandemic recovery funding requested by Hungary. Further significant delays or substantive cuts in EU funding would negatively affect policy flexibility and fiscal consolidation plans while adding pressure on external finances.

The central bank's indication of it having concluded the rate-hike cycle has increased pressure on HUF. The Hungarian National Bank has a comparatively weaker foreign-currency reserve stockpile compared with regional peers in the Czech Republic and Poland, lowering its capacity to defend HUF in currency markets.

From 2024, we expect Hungary's growth to return towards medium-run potential of about 2.5%-3.0% a year. Hungary's policies towards the Russia-Ukraine conflict and weakening governance indicators could negatively affect foreign investment inflows, key for growth of the economy.

Slovakia (A+/Negative): rising energy-supply risks, weakened growth amid elevated political uncertainty

The Negative Outlook for Slovakia reflects weakened economic prospects because of deterioration in the economic outlook of main European trading partners, extended supply-chain disruptions and higher policy uncertainty as the government lost majority in parliament. Energy security is vulnerable to a complete halt of Russian oil and gas exports, as well as to a sustained phase of commodity-price volatility.

We expect growth of 0.5% in 2023, after 1.8% growth this year, as energy-security concerns and inflation take their toll on private demand. The domestic economy would suffer from any sharper economic slowdown in

the European Union, the latter accounting for 78% of Slovak exports. Reduced growth would adversely impair policy flexibility and fiscal consolidation plans. Average inflation is forecast around 15% next year, the highest rate of the euro area.

Slovakia's budget deficit is projected at 6.4% of GDP next year, after 4.9% of GDP this year, amid higher budget spending. A strong fiscal framework should enable reduction of the deficit to below 3% of GDP medium term. General government debt is forecast to decline from 62.2% of GDP in 2021 to under 60% of GDP by 2025. The sovereign benefits from a favourable debt profile with the ECB holding nearly half of outstanding government securities.

Southeast Europe

Romania (BBB-/Stable): ratings outlook depends on fiscal reform, use of EU funds

We expect the Romanian economy to slow to 2.2% growth next year, after the 4.9% estimated for 2022 – the former being slower than that in most peer economies. Romania's credit rating is anchored by strong economic growth potential medium run, which we estimate at 4% annually. The economy is much less dependent on imported gas than its CEE-11 neighbours. Domestic production of natural gas could cover up to 90% of annual consumption.

Slowdown of growth represents a challenge for a government programme to cut the budget deficit to below 3% of GDP by 2024. We forecast the deficit instead at 6% in 2022, 5.4% in 2023 and 4.6% by 2024, affected by extension of budgetary support in the face of elevated energy prices. A rigid budgetary structure and uncertainty over the pace of future pension hikes constrain the fiscal outlook, with spending on state pensions and wages alone accounting for around 90% of aggregate tax collections. Absent an enlargement of the tax base, the fiscal outlook remains overly contingent upon sustained elevated growth.

Romania has been allocated EUR 29.2bn (10% of 2022 GDP) via the EU Recovery and Resilience Facility (RRF), alongside EU structural funds of around EUR 50bn (17.5% of GDP). Implementing pensions reform by 2023 and raising tax revenue by at least 2.5pps of GDP by 2025 – as agreed with the European Commission under the RRF – will prove important to guaranteeing steady inflow of EU financing and preserving fiscal stability under a context of an ageing population. However, weak historical absorption of EU funds (only 58% of 2014-20 funds were spent by June 2022) remains a bottleneck. Failure to maintain a stable government that implements credible fiscal and economic reforms would present downside risks to Romania's investment-grade credit ratings.

Bulgaria (BBB+/Stable): stable government, institutional reform key for euro adoption

The early election in October, the fourth such election in under two years, resulted in a fragmented parliament with a low chance of forming a stable new coalition government. There is a likelihood of another early election being required next year, which could extend political instability, hindering passage of reforms and risking a delay of Bulgaria's euro adoption date beyond a sought 1 January 2024 entrance.

High inflation is the main risk factor to progress around convergence criteria for adoption of euro. In the past 12 months, Bulgaria's inflation rate has been substantially higher than that of the three EU member states with the lowest inflation rates, and we expect inflation to stay elevated next year, averaging above 7%. The convergence criteria concerning public finances, interest rates and exchange-rate stability should be less challenging to meet.

We believe the ability of Bulgaria to form a stable coalition government with a clear mandate for euro adoption would boost political backing of euro-area authorities for Bulgaria's future membership of the currency union and potentially provide a degree of flexibility around their evaluation of convergence criteria, as authorities applied for Croatia's accession. Adopting the euro will support Bulgaria's credit ratings, as it would provide the economy with reserve-currency status and enhance monetary flexibility.

Growth potential medium run is estimated around 2.5%-3% annually, held back by a declining working-age population (projected at a 1% decline annually this decade). The risk of energy shortages remains, as Bulgaria holds comparatively low gas-storage capacity of 0.5bcm compared with annual consumption of around 3bcm, formerly largely met via gas imports from Russia. A long-term agreement with Azerbaijan for a delivery of 1bcm, with a possible extension to 2bcm, and EU solidarity mechanisms should help avoid strict energy rationing over the winter.

Croatia (BBB+/Stable): 2023 euro-area entry underscored July rating upgrade

The upgrade of Croatia's ratings to BBB+/Stable in July 2022 reflected formalisation of entrance to the euro area on 1 January 2023 and coming adoption of euro as local currency, which will significantly curtail foreign-currency risk in the economy, banking system and public debt, among other credit-positive aspects.

The Stable Outlook for the sovereign reflects an expectation the economy will perform comparatively robustly despite an ongoing energy crisis and trade disruptions. This is due to low direct energy and trade exposures to Russia and Ukraine, sizeable inflows of EU funding and strong tourism-export receipts. At the same time, due to a marked slowdown of core trading partners within the EU, such as Germany and Italy, we expect economic growth of Croatia to slow to 1.8% in 2023, from an expected 6.3% growth this year.

Core credit challenges remain: i) an elevated debt burden, although trending lower from an expected 70% of GDP in 2022 to 65% by 2024; and ii) comparatively

modest economic growth potential of 3% a year despite moderate wealth levels given a GDP per capita of around half the euro-area average.

Slovenia (A/Stable): solid medium-run growth prospects, but fiscal challenges remain

The Stable Outlook of Slovenia reflects downside risks resulting from the Russia-Ukraine shock balanced against solid medium-run growth prospects.

We foresee growth slowing to 1.3% next year (from 5.5% in 2022) given higher consumer as well as producer prices, tighter financial conditions, and curtailed external demand. Still-high inflation (5.8% on average for next year) and reduced real wages should dampen consumption, while growth in private investment is expected to decelerate due to greater economic uncertainties. However, dependence on Russian gas and oil imports has been trimmed. Prolonged supply-chain disruptions and economic slowdown among EU trading partners is likely to present further challenges for its small, open economy. Still, public investment ought to stay strong thanks to RRF financing.

The budget deficit is seen remaining elevated at 5.2% of GDP in 2023, as fiscal policy remains supportive of mitigating the impact of high energy prices. Medium run, the fiscal deficit should narrow to below 3% by 2025. Our conservative fiscal projections assume gradual phasing out of energy price mitigation measures, a degree of uncertainty around the fiscal stance in the coming legislative period, among which is a planned tax reform, and rising age-related expenditure. Nevertheless, Slovenia holds a significant cash cushion and public debt is seen declining to 63% of GDP by 2027, although nevertheless remaining among the highest in CEE.

Baltic states

Lithuania (A/Positive): improved economic resilience amid high inflation

The Lithuanian economy has proven resilient to the Covid-19 crisis with no meaningful contraction during 2020 followed by a 6% rebound of growth last year. The economy has so far navigated comparatively well economic ramifications of the Russia-Ukraine war. Annual growth should be 2.4% this year, 0.5% next year before 3.1% in 2024.

We estimate growth potential of Lithuania at 2.5% medium run, supported by steady access to EU funding and a favourable business environment. We do not expect the Russia-Ukraine conflict to cause permanent damage to the macroeconomic outlook, due to continued improvements in energy security, enabling steady substitution of Russian energy imports. At the same time, we recognise Lithuania's, along with the other Baltic states', elevated exposures to inflation risk. Annual average inflation of 7% is expected for 2023, after 18.5% for 2022.

Moderate debt and prudent fiscal policies underpin fiscal flexibility. While this year's budgetary outcomes should be somewhat more favourable than initially expected, with a projected deficit of 2% of GDP for 2022, sizeable spending increases in the 2023 Budget should widen the deficit to 4.5% of GDP next year. We envision gradual convergence of the budget deficit to 1% of GDP medium run. The public debt ratio should stabilise around 40% of GDP over 2022-25 before gradual decline to 38% by 2027.

Latvia (A-/Positive): solid medium-run growth, but the energy crisis requires policy trade-offs

The Latvian economy is seen stagnating next year, after a projected growth of 2.4% for this year. The escalation of the war in Ukraine significantly affects near-term growth, given material, albeit declining, trade linkages with Russia and associated shocks to energy and commodity prices this year due to the war.

Inflationary pressures remain elevated: we expect annual average inflation of a still-high 8% next year, after 17% for 2022. Nevertheless, medium-run growth should remain solid, thanks to access to EU funding totalling about 28% of GDP via the RRF as well as the Cohesion Policy and Common Agricultural Policy of the 2021-27 EU Budget.

On the fiscal end, the new government needs to strike a careful balance between providing fiscal support against an ongoing cost-of-living crisis and strengthening defence capabilities, while ensuring gradual fiscal consolidation. Here, a record of prudent fiscal policies and moderate debt, the latter expected to remain just above 40% of GDP over the coming years, underpin budgetary flexibility. Adverse demographics add to medium-run fiscal pressures.

Estonia (AA-/Stable): solid public finances, but labour shortages and green transition challenge growth

Estonia's economic convergence with the rest of the euro area has been steady, with GDP per capita currently of around 80% of the euro-area average under purchasing power parity standards. Rapid development of high-value-added economic sectors, such as information and communication technology, is strengthening resilience to economic crises. The current account was in surplus during the first half of 2022 despite high energy and commodity prices.

We expect moderate annual growth of 0.8% next year, after 0.4% growth this year. 2024 growth is seen at 3.2%. This outlook reflects our view that the war in Ukraine will have a significant but temporary effect on the Estonian economy. Medium run, we estimate growth potential of 2.2%, supported by access to EU funding, but challenged by adverse demographics and labour shortages. Inflation is projected at 7% in 2023, after 19% for 2022. While Estonia has expanded its renewable energy production capacity in recent years,

its economy remains one of the most carbon-intensive of the EU, reflecting elevated reliance on oil shale.

Government finances are solid, as reflected in the lowest debt-to-GDP ratio of the euro area, of below 18% as of end-2021. However, planned wider budget deficits over coming years, driven by support measures against the energy crisis and investments in safeguarding security, will likely keep debt on an increasing trajectory, reaching about 26% of GDP by 2027.

Eastern Europe and the Caucasus

Russia (WD): uphill battle to offset sanctions' consequences via closer BRICS+ financial, trading linkages

We estimate the Russian economy will be around 8% smaller by end-2023 compared with where it was in 2021 whereas before the war's escalation, we projected that Russia's economy would grow around 5% over 2022-23. In other words, Russia's economy would have been around 14% larger in 2023 were it not for the war.

The ratio of the working-age (15-64) population to the old-age (65 and over) population has steadily worsened over the last decade, reaching a ratio of 4.1-to-1 by early 2022, from 5.6-to-1 in 2011. So, the number of people retiring has been outpacing those entering the labour market. This ratio is projected to further decline to 3.4-to-1 by 2030, according to UN projections from July. The war and an acceleration of workforce outflows – with estimates of several hundreds of thousands of persons leaving since 24 February, most of them educated and highly-skilled – further worsen demographic decline, reducing output and productivity growth – underpinning our estimate of an increasingly restricted rate of potential economic growth (of 1%-1.5% annually) medium run.

Russia is seeking further economic integration with the BRICS group of developing economies as well as with countries aspiring to join the group such as Egypt, Turkey, Algeria and, more recently, Saudi Arabia, to try to replace trade and investment lost due to Western sanctions. However, we do not expect Russia to compensate for the lost technology, export markets, and access to global financial systems through such BRICS+ participation.

Firstly, not all BRICS countries share Russia's urgency as far as diversifying their trade away from the United States and the EU or integrating in one another's financial systems. Secondly, Russia's de-dollarisation strategy will inevitably result in greater reliance on Chinese yuan – which is already being perceived as a proxy for the US dollar in Russian markets despite lacking the international fungibility of the US currency – and on Chinese economic policies, which presents its own risks. Finally, Russia's use of more costly and poorer quality imported components will constrain productivity growth, crucially in its oil and gas industry, as the country develops more complex alternative supply networks with such nations.

Ukraine (CC/Negative): rising reserves, gradual recovery, reduced monetary financing supporting ratings

On 22 August, Scope Ratings upgraded foreign-currency long-term ratings of **Ukraine** to CC after completion of an anticipated foreign debt-service suspension, while assigning a Negative Outlook on basis of a probability for further debt relief being presented over forthcoming years, potentially requiring additional private-sector involvement, in ensuring Ukraine's debt sustainability as well as adequate liquidity during war and reconstruction. Based upon this year's debt restructuring, around USD 6bn of foreign-currency debt service has been deferred two years, with the first Eurobond maturity after a suspension phase coming due on 1 September 2024. Scope was the only credit rating agency to assign Ukraine a Negative Outlook ahead of the 24 February full-scale invasion, and assess significant likelihood of such military steps being taken by Russia. Domestic-currency ratings are one step above foreign-currency, rated CCC/Negative.

In our July 2022 global outlook, we revised up expectations for Ukraine's economy for this year to a contraction of 31%. For 2023, recovery of 5.5% (revised down from 12.5%) is foreseen, with output remaining next year over 25% under 2021 levels. Our forecasts assume protracted conflict with Russia. Inflation is seen averaging 23% in 2023 and 14.4% in 2024, after 20% this year, with the National Bank of Ukraine expecting its current level of the policy rate (25%) to be maintained until at least Q2 2024.

The severe 2022 drop of economic output has placed substantive pressures on debt sustainability: Ukraine's debt-to-GDP ratio is expected to gain from 47.6% of GDP as of end-2021 to 81.8% of GDP in 2022, dropping to 80.6% during 2023 recovery, before concluding a forecast horizon to 2027 around 84% of GDP – held up by the significant costs of long-run reconstruction.

Foreign-currency reserves rose to USD 25.2bn in November 2022, from USD 19.1bn in July (see **Figure 6, page 8**). Official reserve (including gold) coverage of short-term external debt (by remaining maturity) has risen, reaching 51.3% in November, although still well under a 62% level as of end-2021. Expectation of further reductions of NBU monetary financing and continued receipt of international financial assistance support reserve levels and the ratings outlook.

Georgia (BB/Stable): strong growth outlook despite elevated policy uncertainty

Georgia's credit ratings are supported by credible institutional arrangements and steady access to donor financing and inward foreign direct investment (FDI), helping finance moderate budget as well as wide external deficits at an affordable cost.

Georgia could grow nearly 10% this year, boosted by the elevated tourism-services and remittances revenues associated with significant inflow of Russian businesses and migrants since the full-scale Ukraine

war. We expect growth to remain an above-potential 7% next year.

Rising current-account inflows have supported appreciation of lari of 16% against dollar this year and a pick-up in official reserves of more than USD 600mn since February to USD 4.6bn by November. This will act as a cushion against wide current-account deficits. Lari appreciation has cut inflationary pressure from imported energy and food prices (CPI was 10.4% YoY as of November, down from 13.9% in January) and has enabled the central bank to maintain rates unchanged at 11% since March.

We expect the government to stay committed to favourable investment conditions and fiscal discipline, supported by steady institutional engagement with the IMF, the EU and other supranational organisations. However, elevated political polarisation between ruling party Georgian Dream and the largest opposition group, United National Movement, raises political risk ahead of 2024 elections.

While Ukraine and Moldova were granted candidate status for long-run EU accession in June, Georgia was granted a “European perspective” – candidacy only upon meeting specified institutional and governance targets. We consider Georgia to be highly exposed to geopolitical risk – related to unresolved conflicts in South Ossetia and Abkhazia with Russia. However, we do not expect a material escalation of the dispute in the foreseeable future, given Georgia’s nuanced approach to sanctions against Russia and ongoing material economic relations between Russia and Georgia.

Rest of Emerging Europe

Turkey (B-/Negative): ongoing credit deterioration, uncertainty around policy and institutional environment after elections

Ahead of scheduled elections by June 2023, we expect the Turkish government to continue prioritising near-term growth through increasingly loose monetary and fiscal policies. This unorthodox economic policy mix raises risk to its external and public finances, while failing to restore currency stability or rebuild foreign-exchange buffers.

We do not see any likelihood of a reset in monetary policy, at least before the elections. This will keep the currency under constant pressure. The lira has lost nearly 30% of its value against dollar this year.

We estimate Turkey running a current-account deficit of around USD 40bn, or 4.5% of GDP, over the next 12 months, up from a deficit of USD 7.3bn (0.9% of GDP) last year. Alongside using capital controls more freely, Turkey is likely to leverage potential USD-denominated Islamic bond issuances, currency swap deals with friendly central banks and closer cooperation with Russia – all of which involve varying degrees of geopolitical, economic and financial trade-offs – to help address external deficits.

We have revised down output growth for Turkey to 3% (from 3.5% under our July forecasts) for next year, after 5.3% (revised down from 5.8%) in 2022, as economic imbalances widen. Despite ultra-loose monetary policy in stark contrast with the rapid tightening behaviours of most other G20 central banks, aggregate supply in Turkey has been well behind aggregate demand. The negative contribution of inventories to growth reached around -10pps in Q2 2022. This results in high inflation and risks a disorderly adjustment in aggregate demand. We project headline inflation to average around 50% in 2023, after 74% this year.

Pressure on lira could ease if economic policies change following scheduled elections to centre more on price stability and addressing macroeconomic imbalances. This would support Turkey’s credit ratings. Conversely, possible political unrest related to elections, heightened geopolitical concerns, such as sanctions risks from the US over deepening cooperation of Turkey with Russia, the nation’s engagement in conflicts in Syria and Libya, as well as tensions around gas exploration in the eastern Mediterranean pose risks to the ratings.

Serbia (BB+/Stable): policy discipline, IMF engagement reduce risk of macro instability

We have revised down growth expectations for 2023, to 2.7% from 4% in our July forecasts, after keeping growth for 2022 unchanged at 3%. For the first time since 2015, FDI might not entirely finance the current-account deficit, with the latter projected to widen to around 9% of GDP this year and next, from 4.4% of GDP in 2021, due to higher-cost energy imports.

Serbia is likely to use upcoming IMF financing (a 24-month Stand-By Arrangement of EUR 2.4bn or 4% of 2022 GDP has been agreed) and a low-interest loan received from the UAE (EUR 1bn) to cover high external financing requirements of the next two years. This could help prevent further rises of funding costs on international markets. As 60% of external liabilities comprise of stable FDI, this reduces risk of outsized capital outflows during crises.

Expected adoption of a new fiscal rule next year and oversight from the IMF ought to help rebuild fiscal cushions and keep the budget deficit contained around 2% of GDP in 2023. The National Bank of Serbia has adequate forex reserves for preserving a stable exchange rate. Gross FX reserves of EUR 16.9bn at end-October, the highest level to date, cover almost five months’ import and over twice short-term external debt, well above international reserve-adequacy guidelines.

Broader normalisation of Serbia’s relations with Kosovo, and substantive reform around the rule of law – crucial preconditions for EU accession – are likely to stay longer-run challenges. We believe Serbia will continue its balancing act with regard to Russia’s war in Ukraine. Given that Serbia has, to date, not aligned itself with EU measures against Russia, this might further complicate EU accession talks. We therefore expect a target year for accession by 2025 to be delayed considerably.

Annex I: 2022-24 macroeconomic outlook

	Country/region	Real GDP growth (annual average, %)			General government balance (% of GDP)			General government debt (EOP, % of GDP)			Headline inflation (annual average, %)			Policy rate (EOP, %)*			Yield, local currency, 10-year (%)	CDS spread, USD, 1-year (bps)	EUR per local currency (% change)	Reserves (% of short-term external debt)**
		2022 (E)	2023 (F)	2024 (F)	2022 (E)	2023 (F)	2024 (F)	2022 (E)	2023 (F)	2024 (F)	2022 (E)	2023 (F)	2024 (F)	2022 (E)	2023 (F)	2024 (F)	Current		Since start-2022	2022 (EOP, %)
	EU CEE-11	4.6	1.2	3.1	-4.4	-4.3	-3.5				13.7	11.0	5.5							
Euro-area CEE	Slovakia	1.8	0.5	2.4	-4.9	-6.4	-4.4	61	61	60	12.0	15.0	4.8	2.00	3.00	2.50	3.0	16	-	-
	Slovenia	5.5	1.3	2.3	-4.0	-5.2	-3.1	69	69	68	9.0	5.8	3.4	2.00	3.00	2.50	3.1	18	-	-
	Lithuania	2.4	0.5	3.1	-2.0	-4.5	-2.0	39	40	40	18.5	7.0	2.5	2.00	3.00	2.50	3.4	70	-	-
	Latvia	2.4	-0.1	3.0	-6.1	-4.1	-2.0	43	45	44	17.0	8.0	2.5	2.00	3.00	2.50	3.4	60	-	-
	Estonia	0.4	0.8	3.2	-2.0	-3.5	-2.7	17	20	22	19.0	7.0	2.5	2.00	3.00	2.50	3.4	48	-	-
Non-euro-area EU CEE	Poland	5.7	1.5	2.9	-3.9	-3.9	-3.5	49	47	48	14.2	12.2	7.0	6.75	7.50	6.00	6.4	70	-1.8	91
	Romania	4.9	2.2	4.5	-6.0	-5.4	-4.6	49	51	53	11.8	10.6	6.0	6.75	6.75	5.75	7.9	106	0.5	85
	Czech Republic	2.5	0.2	3.2	-4.5	-3.9	-2.9	43	44	45	14.5	9.1	4.0	7.00	6.00	4.50	4.5	23	2.4	120****
	Hungary	5.2	0.1	2.5	-6.0	-4.7	-3.5	76	77	74	14.8	14.5	4.8	13.00	11.50	6.50	8.6	89	-9.2	154
	Bulgaria	3.2	1.0	3.0	-3.9	-3.7	-3.1	23	26	27	13.1	7.3	3.5	1.30	1.00	0.50	5.7	99	0.0	307
	Croatia	6.3	1.8	2.3	-1.4	-2.5	-2.9	70	66	65	10.6	6.5	3.5	3.00	3.00	2.50	3.4	36	-0.3	113
Non-EU emerging Europe	Russia	-4.0	-4.0	1.0	-1.5	-3.5	-2.9	17	21	23	13.9	7.5	5.0	7.50	7.00	6.00	10.1	-	24.6	351
	Turkey	5.3	3.0	3.0	-3.8	-4.5	-4.4	38	39	41	73.8	52.6	32.3	9.00	7.00	10.00	11.0	375	-23.3	61
	Ukraine	-31.0	5.5	7.5	-13.5	-13.0	-12.5	82	81	77	20.0	23.0	14.4	25.00	25.00	20.00	-	-	-19.8	52
	Serbia	3.0	2.7	3.4	-3.0	-2.0	-1.5	55	52	50	11.9	9.4	4.9	5.00	5.00	4.00	7.3	108	0.2	290
	Georgia	9.6	7.0	5.8	-3.0	-2.5	-2.2	39	41	41	11.9	5.8	3.8	11.00	9.00	10.00	9.0***	-	24.1	124

Source: Scope Ratings, Macrobond, IMF, Eurostat, OECD, Bloomberg, Refinitiv Eikon, national central banks and statistical offices; *deposit facility rate of the ECB for euro-area CEE economies; yield on the 7-day National Bank of Poland money market bills for Poland; 2-week repo rate displayed for the Czech Republic; interest rate on minimum reserves shown for Hungary; 1-week repo rate for Romania, Russia and Turkey; base rate for Bulgaria; discount rate for 2022 and ECB rate for 2023 and 2024 for Croatia; 1-week refinancing rate for Georgia; key policy rate for Ukraine, Serbia; **coverage of short-term external debt plus long-term external debt maturing in one year or less: an IMF adequacy threshold for this ratio is above 100%; data from IMF Assessing Reserve Adequacy dataset; Russia's data include sanctioned reserves ***as of 15 November (primary market); ****Scope estimate.

Annex II: Scope's CEE sovereign ratings & 2022 rating actions

Figure 10. CEE long-term foreign-currency issuer ratings, as of 15 December 2022

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

Figure 11. Scope's CEE sovereign rating actions in 2022, through 15 December 2022

Date	Sovereign	Rating action	Rating & Outlook*
25 November	Estonia	Affirmation	AA-/Stable
28 October	Slovakia	Affirmation/Outlook change	A+/Negative
5 September	Hungary	Affirmation/Outlook change	BBB+/Negative
22 August	Ukraine	Upgrade/Outlook assigned	CC/Negative
19 August	Slovenia	Affirmation	A/Stable
16 August	Ukraine	Downgrade	SD
22 July	Ukraine	Downgrade/Under review	C/Developing
15 July	Croatia	Upgrade/Outlook change	BBB+/Stable
8 July	Czech Republic	Affirmation/Outlook change	AA/Negative
17 June	Ukraine	Confirmation/Outlook assignment	CCC/Negative
3 June	Serbia	First-time rating	BB+/Stable
17 March	Russia	Withdrawal	WD
11 March	Turkey	Downgrade	B-/Negative
10 March	Russia	Downgrade/Under review	C/Developing
4 March	Russia	Downgrade/Under review	CCC/Review for downgrade
1 March	Russia	Downgrade/Under review	BB+/Review for downgrade
1 March	Ukraine	Downgrade/Under review	CCC/Developing
28 January	Croatia	Affirmation/Outlook change	BBB-/Positive
28 January	Ukraine	First-time rating	B/Negative
21 January	Czech Republic	Affirmation	AA/Stable
14 January	Poland	Affirmation/Outlook change	A+/Negative
14 January	Latvia	Affirmation/Outlook change	A-/Positive

*Foreign-currency long-term issuer ratings only.

Annex III: Additional research of CEE (since July 2022 Mid-Year Outlook)

Sovereign Outlook 2023: Sharp economic slowdown, challenging fiscal dynamics, high inflation and rising rates underpin divergence in sovereign ratings, 12 Dec

Creating a BRICS reserve currency: a long-term project despite Russia's de-dollarisation strategy, 7 Dec

Ukraine: European multilateral banks need guarantees to play key role in funding reconstruction, 16 Nov

Turkey: current economic model stores up imbalances, increases cost of disorderly adjustment, 9 Nov

Russia faces uphill task to offset sanctions with closer BRICS+ financial, trading links, 31 Oct

Europe and Ukraine: how much financial support can the EU offer for rebuilding the country?, 18 Oct

Bulgaria: forming new coalition government to test political stability, euro progress, 10 Oct

Russia: Western sanctions, war in Ukraine exacerbate structural economic weaknesses, 19 Sep

Baltics: small, open economies face highest European inflation; underlying credit resilience intact, 15 Sep

Hungary: policy uncertainty, EU dispute test fiscal flexibility, effective response to energy crisis, 9 Sep

Turkey: balance-of-payments tension rises; stopgap efforts to stabilise lira increase risks, 8 Sep

Country abbreviations

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

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