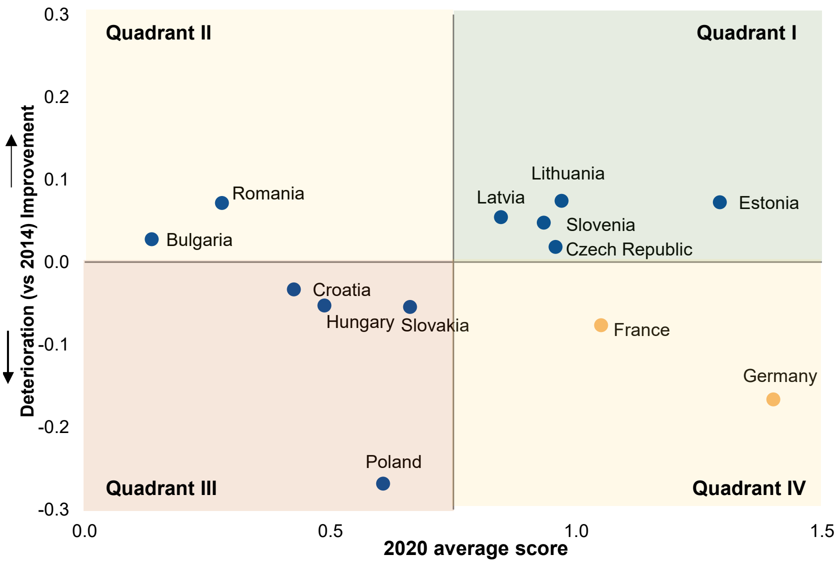
Central & Eastern Europe: improving institutional quality crucial for economic outlook

The economic growth and development of the EU's 11 central and eastern European member states (CEE-11) are a success story but further progress of these maturing economies hinges upon improving the quality of domestic institutions. Such progress is vital for the CEE-11 given declining growth potential and reliance on foreign capital for growth, including on the disbursement of EU funds contingent on governments' respect for the rule of law.

The CEE-11 region's reliance on foreign capital is due in part to moderate savings and less advanced capital markets. Foreign direct investment (FDI) inflows to CEE-11 are, however, in structural decline, reflecting changing FDI flow dynamics to maturing markets of the region. Other structural constraints on growth include relatively low labour productivity and adverse demographics. CEE governments' abilities to develop and execute sound policies leveraging skills bases, improving productivity, maintaining attractiveness for FDI and strengthening the role of capital markets are under scrutiny.

Latest indicators of institutional health in CEE-11 are mixed, judging by the recently updated World Bank Worldwide Governance Indicators (WGI) for 2020. Rule of law has weakened in Poland since 2014, and more recently in Hungary, but has improved in the Baltics. However, regulatory quality, defined as a government's ability to formulate and implement sound policies in support of private-sector development, which also has the highest correlation with level of investment of an economy among WGI, despite some decline, has remained sturdy.

Figure 1: World Bank WGI, average of the six WGI, CEE-11 vs Germany, France



Source: World Bank, Scope Ratings GmbH; WGI scores range from around -2.5 (weakest) to 2.5 (strongest); dividing line for the x-axis relates to 2020 average score for CEE-11 among six WGI; full scores available in Appendix II

Although Scope has not conducted downside ratings changes thus far on CEE-11 sovereigns solely as result of deterioration in governance, diverging institutional trends of the region may become increasingly relevant for ratings outlook of countries such as Poland and Hungary as well as of Romania should soundness of political institutions deviate from countries' fundamentals, materially affecting potential for economic growth and sound governance.

Against this backdrop, the use of Next Generation EU funds will prove essential in determining economic outlooks. The EU Commission has postponed approval of Hungary's and Poland's national recovery plans over rule of law concerns. However, we expect EU authorities to ultimately unlock EU recovery financing to these nations once the countries have addressed rule-of-law concerns identified as part of EU-wide policy coordination.

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Reliance on foreign capital raises the importance of institutional quality to sustain robust growth

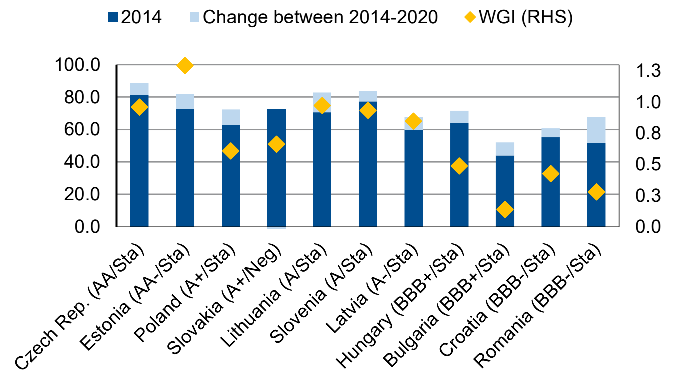
Robust growth of the past ensured income convergence

The CEE-11 region has recorded robust overall economic growth and greater macroeconomic stability since 2014, underpinned by improvements in employment rates and solid wage growth, which have narrowed income gaps with Western Europe (**Figure 2**). We expect all economies of the region to return to pre-crisis levels of output by early 2022, with some already fully recovered, helped by renewed export growth and pent-up domestic demand.

Improved external positions supporting economic resilience

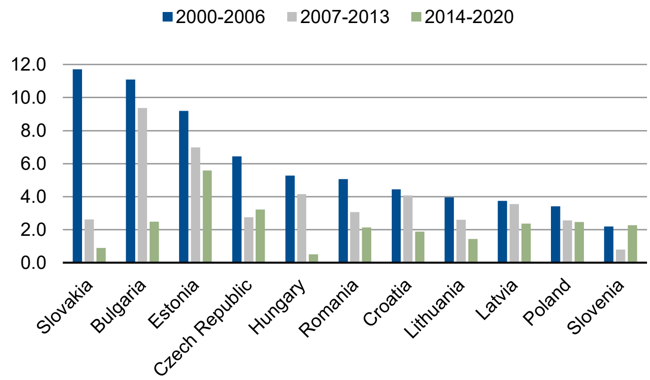
Structural improvements in the economic diversification and increasing production capacities supported a reduction in the deficits in traded goods. The CEE-11 economies have largely maintained price competitiveness relative to euro area economies. Unit labour costs in relative terms increased moderately for many countries, including Poland, Czech Republic and Hungary, up on average by 10% since 2014. Another critical development contributing to the region's economic strength are rising services exports, reflecting the region's improving competitiveness in commercial services and the rise of the services sector across economies globally. The growth of the services sector's output has led to strong employment growth in the CEE-11 region.

Figure 2: GDP per capita (%, euro area=100) purchasing power standard and WGI scores (averages)



Source: European Commission AMECO, Scope Ratings GmbH

Figure 3: *Inward* FDI flows, % of GDP, yearly averages



Source: UNCTAD, Scope Ratings GmbH

Still high reliance on foreign capital & structurally lower FDI

At the same time, previously high FDI inflows to the CEE-11 region are now in structural decline (**Figure 3**), suggesting maturing consumer markets, largely exhausted privatisation opportunities alongside the completion of large-scale physical infrastructure projects. Despite economic convergence with Western Europe, the CEE-11 region will likely remain reliant on foreign capital and investment over time, which is due to relatively low domestic savings in many countries of the region as well as less developed domestic capital markets. The size of capital markets in the CEE-11 relative to GDP remains (only) around one third that of the EU average. The moderate savings rate (close to or below 20% of GDP in Poland, Romania, Slovakia and Lithuania, below a euro area average of 25%) mirrors the low investment rate of the regional non-financial corporate sector, which is dominated by labour-intensive, rather than capital-intensive, small- and medium-sized enterprises. This weighs on the region's economic potential and makes economies reliant on investment from abroad.

Institutional quality important for foreign direct investments

Against this backdrop and given a greater competition from other developing countries and European institutional investors growing focus on environmental, social and governance (ESG) policies, maintaining institutional soundness will be key for future FDI inflows. As the empirical evidence suggests, institutional quality, government effectiveness and control of corruption have a significant effect on foreign investors' investment decisions in the host countries. Good institutional quality also enhances the positive impact of FDI in the capital market development. The CEE-11 region needs to put further emphasis on attracting foreign investment to bolster industrial competitiveness, and to improve domestic capital markets to help maintain the level of investment required to ensure high growth rates over the longer run while making the most of today's low interest rates.

Social, energy transition poses a challenge for CEE governments

ESG risks key for long-term credit outlooks of the CEE-11

ESG factors are a growing area of concern and increasingly relevant for sovereign ratings, accentuated further by the pandemic crisis. According to Scope's recent research, the CEE-11 are significantly exposed to ESG-risks. This places a greater importance on the ability of CEE governments to develop and execute sound policies to enhance labour force participation and productivity and support longer-term transition away from carbon intensive economic activities, given the prevailing economic importance of coal-based power generation in the region.

Demographic declines necessitate more investment in labour markets

The CEE-11's potential growth rate is set to decline with higher income levels and with declining contribution of labour input to growth in view of rapidly changing demographics, which has intensified challenges to labour supply and income developments. The share of the working age population (20-64 years) in the total population is projected to continue declining across all CEE countries over the next five years. This is due to demographic ageing, and net emigration in some cases such as Bulgaria, Croatia and Romania. Low effective retirement ages in the region are placing spending pressures on public finances. Policy measures aimed at further improving physical and social infrastructure, education and health-care systems are important for raising the attractiveness of the labour markets and a reversal of migration flows, given rising skill shortages which adverse demographic trends could make worse.

Mixed progress on energy transition and digitalization

Additionally, securing sustainable and affordable energy and exploiting digital technology to enhance productivity and innovation are vital for CEE countries, in terms of deploying EU funds and matching the strategic focus of EU policies. The progress on energy transition varies considerably across CEE, reflecting below-average expenditure and investment in environmental protection in several countries of the region and an energy sector with a typically dominant share of electricity generated in conventional power plants, partially using hard coal. Fossil fuels also play a large role in household energy consumption in the region, especially in heating, while the energy efficiency of buildings in many cases remains poor compared with the Western Europe.

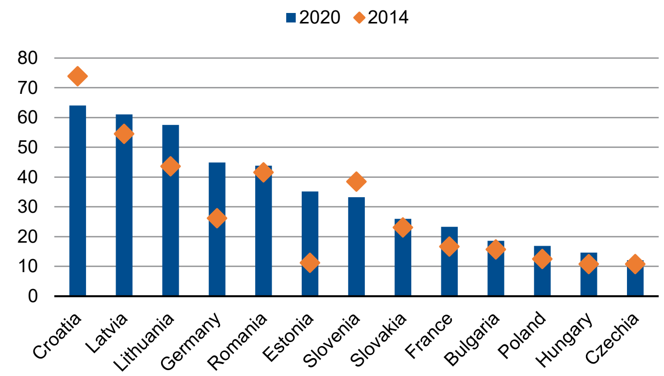
Environmental issues growing in importance

Environmental challenges include a surge in passenger and freight traffic in the region over the recent decades with emissions from the transport sector growing rapidly. The Energy Transition Index from the World Economic Forum, which captures the performance and readiness of energy systems across countries for transition, reveals that the Baltic states lead the ranking in the region, reflecting the progress on energy security, diversified energy mix, and the regulatory framework, while Poland ranks the last among the CEE-11. In Poland, Hungary and Czech Republic, for example, the share of renewables in energy production remains very low, at around 15% (**Figure 4**), reflecting the still-high reliance on coal for energy production in cases of Poland and Czech Republic, and nuclear energy generation in Hungary.

Going forward, the ability of CEE countries to adapt to structural changes in the automotive sector will be important for maintaining comparative advantages, given the importance of this sector for the economic development (car industry currently produces 13% of GDP in Slovakia and Romania, and around 10% in the Czech Republic and Slovenia) and the possible reorganisation of international supply chains due to changing staffing needs.

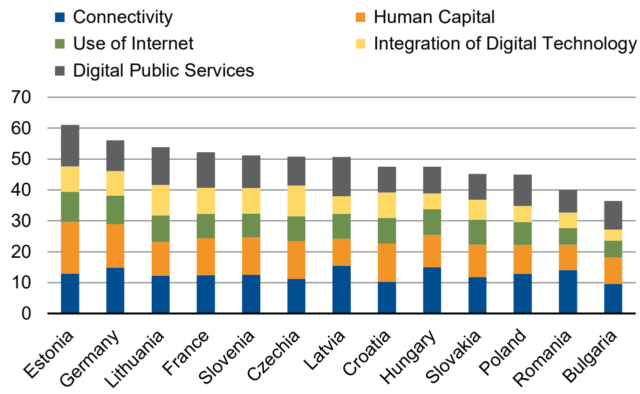
The degree of digitalization reveals a similar picture. Since the start of the pandemic, consumers and producers have relied more on digital technologies. There seems to be a negative correlation between the impact of the pandemic on the economy and labour market, and the level of technology adoption. Take-up of digital technologies can be supported by policy decisions, which, among others, affect the availability of skilled workers. The highest level of digital adoption (**Figure 5**) among CEE-11 is in Estonia and Lithuania. Poland, Romania and Bulgaria show low levels of digital adoption. Poland and Romania, for example, are among the least innovative economies of the region[1].

Figure 4: Share of electricity production from renewables, %



Source: Our World in Data, Scope Ratings GmbH; Renewables includes electricity production from hydropower, solar, wind, biomass. and waste, geothermal, wave and tidal sources.

Figure 5: Digital Economy and Society Index



Source: European Commission, Scope Ratings GmbH; The Digital Economy and Society Index (DESI) is a weighted score (0 to 100) that summarises relevant indicators on five main dimensions: Connectivity, Human Capital, Use of Internet, Integration of Digital Technology, Digital Public Services.

Importance of safeguarding rule of law increasing for EU funding, credit outlooks

EU moneys key for growth outlooks of the CEE-11

The CEE-11 region has benefitted from a transfer of external savings in the form of FDI and EU funds in the last decades, supporting solid economic growth in the region. The long-term EU budget 2021-27 boosted by the Recovery and Resilience Facility provides the region not only with opportunities to mitigate the long-run economic and social impacts of the coronavirus crisis, but also ensure large-scale financial support for investment.

Institutional quality important for effective EU fund absorption

EU fund absorption is an important driver for the growth prospects in the CEE-11 countries, as it accounts for a crucial share of public investments for infrastructure and innovation. It also supports governments' long-term planning, policy transparency and efficiency, and administrative capacity to use public funds effectively. Institutional factors alongside countries' co-financing capabilities are key to determining the capacity of EU members in deploying EU funds (**Figure 6**). Even so, absorption capacity can improve through the strengthening of institutions, by improving transparency of public procurement procedures, enhancing administrative capacity, reducing fragmentation of public administration, and bolstering rule of law. While EU fund absorption data doesn't necessarily reflect the countries' institutional quality, a poor record in putting EU funds to work may signal broader difficulties in investing public funds efficiently.

The recently introduced 'Rule of Law Conditionality Regulation' enables the suspension of payments to Member States where violations of the rule of law "affect or seriously risk affecting" the management of EU funds. In principle, the approval of EU Covid-funding is

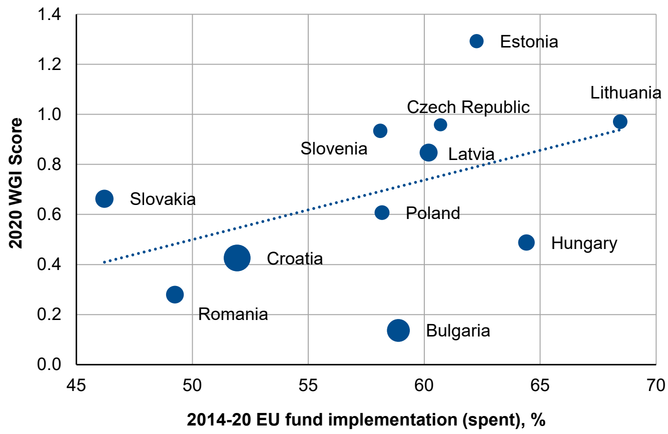
[1] World Intellectual Property Organization, Global Innovation Index 2021

conditional upon Member States showing that their National Recovery and Resilience Plans comply with various economic and environmental benchmarks, including country-specific recommendations adopted in the context of the European Semester, thereby placing more importance on rule of law considerations when disbursing EU funds.

Regulatory quality key for investment activity

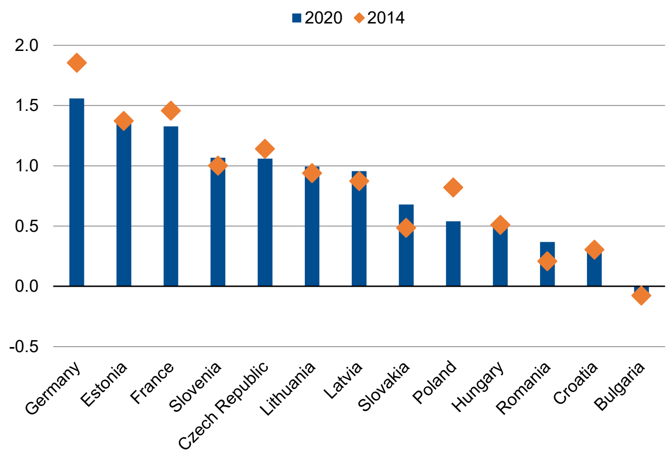
The decline in the rule of law over the past years in Poland and weak rule of law in Hungary are reflected in the World Bank data (**Figure 7, and Appendix III**), with these indicators now around the level of countries like Romania. Furthermore, most of the countries in the region failed to meaningfully improve rule of law since 2014. Based on a simple correlation analysis, however, regulatory quality, as a component of the WGI, has the highest correlation with the investment made into the economy. The CEE-11 perform relatively strongly on this dimension of governance. Some countries are close to or even stronger than France on this dimension, including the Baltics and the Czech Republic, while Poland is not far behind. As regards the political stability the CEE-11 have average scores, nonetheless, around the level of EA-11 averages (Appendix II).

Figure 6: Institutional quality & EU fund implementation



Source: World Bank, European Commission, Scope Ratings GmbH; EU fund implementation as of 30/06/2021; WGI scores range from around -2.5 (weakest) to 2.5 (strongest); bubble size relative to RRF grants & loans, % of 2020 GDP

Figure 7: Rule of law



Source: World Bank, Scope Ratings GmbH; scores range from around -2.5 (weakest) to 2.5 (strongest)

Delayed approval of Hungary's and Poland's pandemic plans over rule-of-law concerns

The EU Commission has delayed the approval of the national recovery and resilience plans submitted by Hungary (BBB+/Stable) and Poland (A+/Stable), which are both currently subject to the Article 7(1) TEU procedure. Poland is also subject to the monitoring procedure of the Council of Europe over functioning of its democratic institutions and the rule of law. In our view, the Polish government's recent loss of a former slim majority in the lower house (Sejm), together with a more difficult-than-expected electoral challenge, are consequences of the institutional erosion of recent years. However, checks and balances restricting the pace of institutional backsliding still hold, including opposition control of the Senate. Together, this might result in somewhat more moderate policymaking over the coming period, which could help ease tensions with the EU.

In Hungary, the government's strong presence in the corporate and financial sectors, its increasing intervention in the judiciary and the media as well as its asylum policies have led to ongoing legal disputes with the European Commission. Due to the delayed release of the EU's Covid recovery fund, high financing needs and growing budgetary pressures in view of adverse demographic developments and a weak social infrastructure, the Hungarian government modified its 2021 financing plan to establish the possibility for the issuance of benchmark sized international foreign currency denominated bonds to raise up to EUR 4.5bn. This would allow Budapest to finance discretionary government expenditure in 2021 and pre-finance some 2022 budgetary expenditures, should there be further delays in transfers from the EU's Recovery and Resilience Facility. In our view, the polarised political environment in Hungary and political headwinds with the EU limit long-term policy predictability, which could weigh on future foreign investment inflows and on macroeconomic sustainability given Hungary's high reliance on foreign funding and external demand. This, alongside a significant delay in the availability of EU funds could notably lower Hungary's growth potential and weigh on debt sustainability, thus leading to a negative rating action.

Political crisis in Romania makes passage of reform difficult

More recently, the collapse of the government in Romania (BBB-/Stable) following the no-confidence vote increases the risk of fiscal slippage and could delay implementation of important reforms, including, as regards the justice system and anti-corruption framework aimed at restoring investor confidence and raising institutional credibility. The prolonged political instability also makes the passing of important reforms such as those required for critical EU funding more difficult, which is crucial given Romania's reliance on EU fund inflows (Appendix I). In our view, the credibility of authorities' fiscal consolidation and reform agenda is a key driver for Romania's ratings. Should Romania fail to form a stable coalition government near-term which will reinstate confidence that the fiscal consolidation agenda and reforms as outlined in the country's recovery plan, which was recently endorsed by the EC, will see a lengthier period of implementation, this could undermine growth and public finance outlooks and lead to a negative rating action.

The rule of law conditionality could prevent further institutional erosion

In our view, the rule of law conditionality attached to EU funds ought to continue curtailing the scope of institutional erosion in countries such as Hungary, Poland and Romania given how economically important EU funding is for these nations as well as in cases of other EU member states. As an example, Poland's dependence on EUR 58.7bn in EU monies (grants and loans made available (although Poland does not plan on accessing all loans made available), Appendix I) as part of the RRF, equivalent to more than 10% of 2020 GDP, constrains the government's room for manoeuvre should EU financing continue to be withheld. At the same time, we see room for compromise as it is in the interest of the EU to distribute funding to these nations, given their strategic importance in the region and given pressure to accelerate sustainability-related funding in transport and energy sectors.

Appendix I. Estimated and requested grants & loans from Recovery and Resilience Facility, EUR bn

	Estimated grants	Grants requested	Maximum loans	Loans requested	Estimated grants and maximum loans, % of 2020 GDP*
Bulgaria**	6.3	-	4.2	-	17.3
Croatia	6.3	6.4	3.7	0.0	20.3
Czech Republic	7.1	7.1	14.3	0.0	10.0
Estonia	1.0	1.0	1.9	0.0	10.7
Hungary	7.2	7.2	9.7	0.0	12.4
Latvia	2.0	1.8	2.0	0.0	13.6
Lithuania	2.2	2.2	3.2	0.0	11.0
Poland	23.9	23.9	34.8	12.1	11.2
Romania	14.2	14.3	15.0	15.0	13.4
Slovakia	6.3	6.6	6.3	0.0	13.8
Slovenia	1.8	1.8	3.2	0.7	10.8

Source: European Commission, Economic Governance Support Unit, Bruegel, * Loans can be requested for up to 6.8% of the 2019 Gross National Income at current euro prices; ** Bulgaria has not yet submitted the National Recovery and Resilience Plan.

Appendix II. World Bank Worldwide Governance Indicators (WGI)

	Rule of Law	Voice and Accountability	Political Stability and Absence of Violence/Terrorism	Government Effectiveness	Regulatory Quality	Control of Corruption
Bulgaria	-0.1	0.3	0.5	-0.1	0.5	-0.3
Croatia	0.3	0.6	0.6	0.4	0.4	0.2
Czech Republic	1.1	1.0	0.9	1.0	1.2	0.6
Estonia	1.4	1.2	0.7	1.3	1.5	1.6
Hungary	0.5	0.4	0.9	0.6	0.5	0.1
Latvia	1.0	0.9	0.5	0.9	1.2	0.7
Lithuania	1.0	1.0	0.9	1.1	1.1	0.8
Poland	0.5	0.6	0.6	0.4	0.9	0.7
Romania	0.4	0.6	0.6	-0.2	0.4	0.0
Slovakia	0.7	0.9	0.6	0.5	0.8	0.4
Slovenia	1.1	0.9	0.7	1.2	0.9	0.8
EA-11	1.4	1.3	0.8	1.3	1.3	1.4

Source: World Bank, Scope Ratings GmbH; WGI data refers to estimates; EA-11 is calculated as the average of WGI for Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain; scores range from around -2.5 (weakest) to 2.5 (strongest).

Appendix III. Rule of law in the CEE-11

Many of the institutional challenges that the economies in the CEE-11 region are facing with respect to the rule of law are long-standing issues. Addressing them within a short period of time will be challenging given slowly evolving nature of political institutions. The table below discusses the rule of law situation in the CEE-11.

Rule of law	Countries	Overview
Below average	Bulgaria (~)	Judicial reform has progressed gradually in Bulgaria. Challenges remain as regards the judicial independence and good functioning of the judicial system. The level of perceived corruption in the public sector remains high. For example, the lack of results in the fight against corruption is one of the key aspects raised throughout the 2020 protests in Bulgaria. The government introduced some measures to address the challenges on the checks and balances. However, risks remain as regards the practice of adoption of legislative amendments.
	Croatia (~)	Considerable challenges remain as regards the efficiency and quality of the justice system, and the appointment procedure of judges. The level of perceived judicial independence remains low. Corruption risks remain high in the public procurement procedures. Efforts have been put in place to improve the institutional framework to fight corruption, but the resource limits remain a challenge.
	Romania (↑)	The government gradually enacted reforms of the justice system and anti-corruption framework, partially addressing deficits in institutional quality. However, some past amendments of justice laws risk harming the independence and functioning of the judiciary, while the efficiency of the justice system is impacted by the human resource deficits. Despite a comprehensive anti-corruption framework, difficulties over its good functioning remain.
	Hungary (~)	Despite relatively good performance as related to the efficiently and quality of the justice system, the judicial independence has been further influenced by the new rules enabling choice of members of the Constitutional Court to the Supreme Court beyond the ordinary process. Concerns persist as regards the independence and pluralism of the media due to the trend of economic take-over of independent media outlets by pro-government businesses. The predictability of the regulatory environment and the quality of checks and balances are affected by frequent pace of changes of the legislation.
	Poland (↓)	The reforms carried out in the Polish justice system since 2015 intensified the influence of executive and legislative authorities over the justice system, harming judicial independence. This led to the launching of an ongoing procedure under Article 7(1) TEU by the European Commission. Despite presence of anti-corruption legal and institutional frameworks, there are risks as relates to effectiveness of the fight against high-level corruption. In regard to media freedoms, the legal framework aims at strengthening the independence of the media regulator. However, actions of the present government have curtailed media freedoms.
Average	Slovakia (↑)	The government adopted important reform since 2020 aimed at improving the independence and functioning of the justice system and improving capacity and effectiveness of the anti-corruption framework, areas where Slovakia made a limited progress previously. The recent reforms of the legislation aim to improve the transparency of the media ownership. However, concerns over effective functioning of checks and balances remain.
Above average	Latvia (↑)	The application of the new reform as regards the selection of judges could be beneficial for the judicial impendence. A new judicial reform strategy has been adopted adequately targeting further improvements in judicial independence. Latvia's anti-money laundering framework has been strengthened as reflected in Council of Europe's assessment. Public perception of level of corruption, however, remains relatively high and the legislative changes to anti-corruption framework are yet to be fully applied.
	Lithuania (↑)	The efficiency of the justice system is relatively high, supported by high levels of digitalization and improved competences of the Judicial Council. A new comprehensive anti-corruption strategy has been adopted, focusing on reducing corruption risks both in the private and public sectors. Free access to information is gradually improving with amendments to the legislation.
	Czech Republic (↓)	The recent reforms of the appointment process for judges and ongoing digitalization of justice could improve the independence and quality of the judiciary system. However, the public perception of judicial independence remains average. There is a lack of progress in the implementation of the government's anti-corruption strategy.
	Slovenia (↑)	Recent efforts have improved the judicial independence and disciplinary proceedings regarding judges. Anti-corruption framework has been strengthened, and the implementation of anti-corruption strategy has been largely good. Challenges remain over the appointment process of judges and financial crime proceedings
	Estonia (~)	The public perception of judicial independence is relatively high, and the efficiency of judicial system is underpinned by advanced digitalization and electronic communication system. The application of anti-corruption legislation has been largely effective. Estonia benefits from functioning system of check and balances.

Source: European Commission, OECD, World Bank, Scope Ratings GmbH; arrows indicate improvement / deterioration / mostly unchangingness since 2014 based on World Bank data.

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