# Central and Eastern Europe: Public debt concerns and external pressures could rise in 2H 2021

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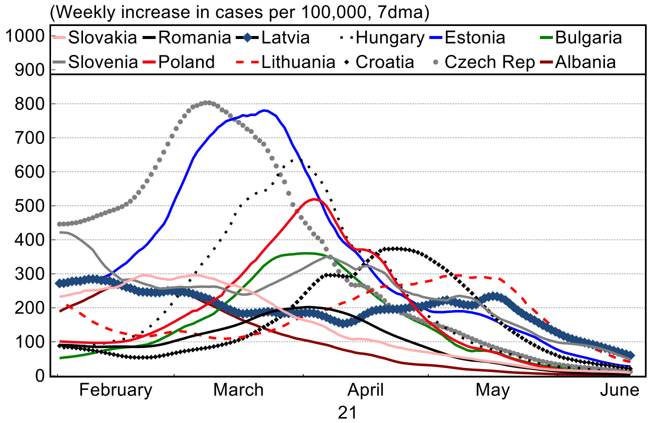
## Attention in Policy Circles May Drift to Future Challenges in 2H 2021

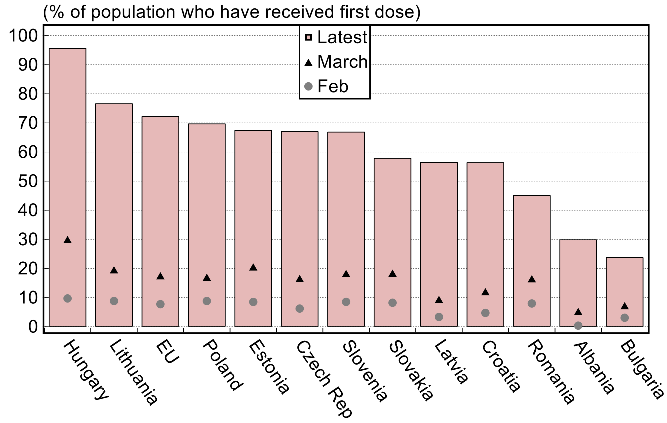
The severity of the COVID-19 shock on public health and output has dominated the economic outlook of Central and Eastern Europe (CEE) since Q1 2020. A third wave of COVID-19 in CEE, which is only now being suppressed, means that containment measures will remain in focus through H1 this year too. The risk of further waves of COVID-19 remains high. Global infection rates have only just started to decline again after another massive wave while the threat of new variants remains. That said, as the roll-out of COVID-19 vaccinations in CEE accelerates this should help to suppress further waves. Attention in policy circles and markets may then drift to challenges facing the region during the recovery phase of the pandemic. These include higher government debt service costs and the prospect for a less benign external backdrop. The US Fed is likely to become more hawkish as 2021 progresses, which will only increase the likelihood of policy rate rises in the countries in CEE that use their own currencies (Poland, Hungary, Czech Republic, Romania, Bulgaria, Croatia and Albania).

COVID-19 Cases




Source: WHO, Macrobond, MUFG Bank Economic Research Office

COVID-19 Vaccination Doses Administered in 2021




Source: Our World in Data, Macrobond, MUFG Bank Economic Research Office

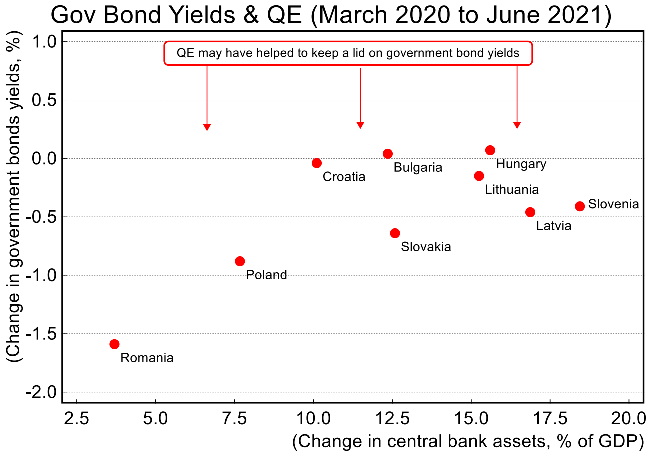
## Fiscal Pressures Contained in Near-Term but Could Rise in 2H 2021

The hit to GDP in 2020 from the COVID-19 shock and subsequent lockdown restrictions have led to a sharp increase of government debt across the region. Fiscal deficits ballooned as a result of fiscal support packages. The fall in economic activity caused tax revenues to fall and mechanistically led to higher government debt to GDP ratios due to a denominator effect. As a result, the GDP weighted average government debt level in CEE increased by 11.9 percentage points last year to 58.2% of GDP – nearly twice the 6.5pp increase that occurred in the aftermath of the Global Financial Crisis (GFC).

In turn, central banks had to resort to unprecedented measures to prevent a sharper rise of government bond yields, which would have been more detrimental for public finances. For example, the ECB extended its bond buying program, while Poland introduced its first QE program and Hungary restarted its previous program. Altogether, this helped to keep government bond yields and borrowing costs low in 2020.

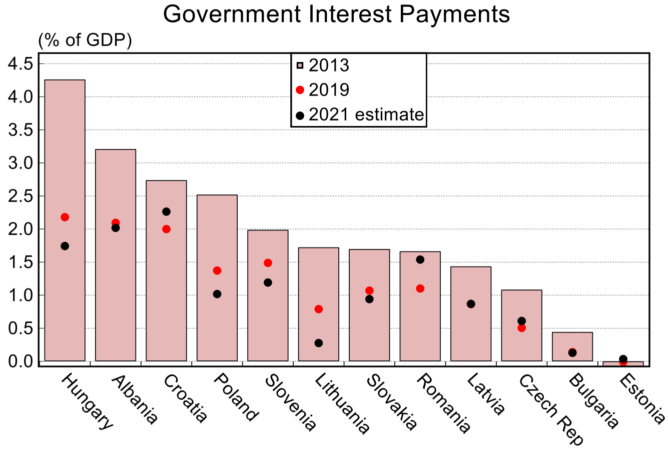
This said fiscal pressures could rise in 2H 2021. Inflationary pressures have been picking-up recently as economies have started to open up again while commodity prices have also led to price rises. As a result, this could necessitate higher domestic policy rates further ahead. The global policy rate environment may be less favourable for the same reason. By end-2021, the US Fed could turn increasingly hawkish as it will have further evidence on the strength of the US recovery. In turn, this could increase the likelihood of tapering on the horizon, which could increase pressures on EM currencies and negatively impact financial indicators in CEE. (Typically a rising interest rate environment deters investors from searching for yield abroad in emerging markets in favour of developed markets). Government bond yields might also rise, and there would be further pressures on central banks in CEE to raise policy rates, both of which could affect government borrowing costs further ahead. The likely effects of this would be felt differently, but on the whole fiscal pressures across the CEE would probably rise.  There could also be some volatility and some countries may be more vulnerable than others – especially those with already-high government debt loads and high interest payments. Indeed, those countries with the highest interest payments as a percent of GDP in 2013 generally have higher government debt servicing costs now as well.

Gov Bond Yields & QE (March 2020 to June 2021)




Source: National Sources, Macrobond, MUFG Bank Economic Research Office

Government Interest Payments




Source: IMF, Macrobond, MUFG Bank Economic Research Office

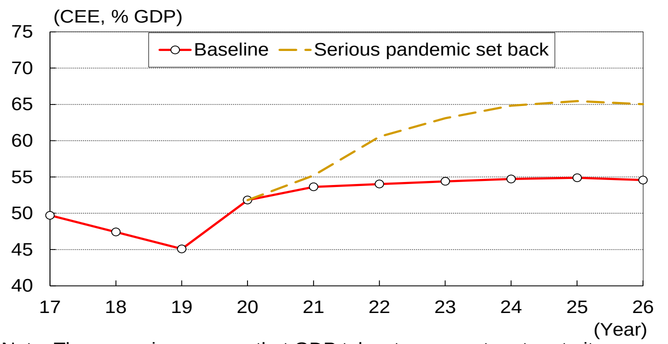
## Region Vulnerable to Further Shocks

The region also looks vulnerable to further shocks, both in the near and longer-term. The outlook for public finances will hinge on the economic recovery and the extent to which both existing and newer vaccines prove effective against new strains of COVID-19 (and corresponding lockdown measures if needed). The IMF is forecasting a fairly buoyant recovery across the region with average real GDP growth of 3.8% YoY over the next 5-years which should go some way to reducing government debt. Nevertheless, government debt is still forecast to rise to 60.5% of GDP in 2025, a 2.3ppts increase over the next 5 years.

We note, if there was a major virus related setback similar to 2020, and real GDP took longer to reach back to pre-pandemic levels, CEE government debt could rise by an extra 10 percentage points of GDP by 2024, versus the current GDP weighted aggregate of IMF forecasts of individual countries. There would be both the impact of lower real GDP (denominator effect) on government debt ratios, as well as higher government fiscal deficits. At the same time, there would also be a number of other government debt related risks that go beyond the dynamics of our simplified model, such as the risk from higher interest rates.

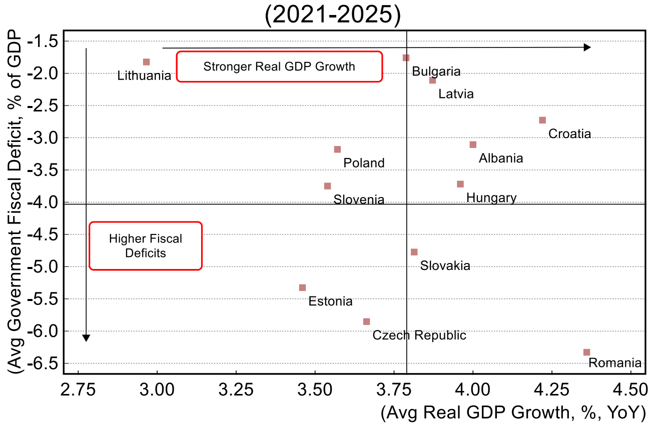
At any rate, the track record of government debt rises after previous crises has not been great. For example, after the initial GFC shock, government debt increased by some 18.1 percentage points of GDP over the course of 2009 to 2013 (real GDP averaged 1.8% over this period). So the outlook for public finances will remain dependent on strong real GDP growth and manageable government debt service costs.

Government Debt Scenarios




Note: The scenario assumes that GDP takes two years to return to its pre-pandemic level, and growth remains below trend at 3% YoY thereafter, while the primary deficit remains unchanged until 2023 before following the IMF's expected path with a 2-year lag. The baseline is a GDP-weighted aggregate of IMF forecasts of individual CEE countries.
Sources: IMF, European Commission, MUFG Economic Research Office

Average Real GDP Growth Vs Government Fiscal Deficits (2021-2025)



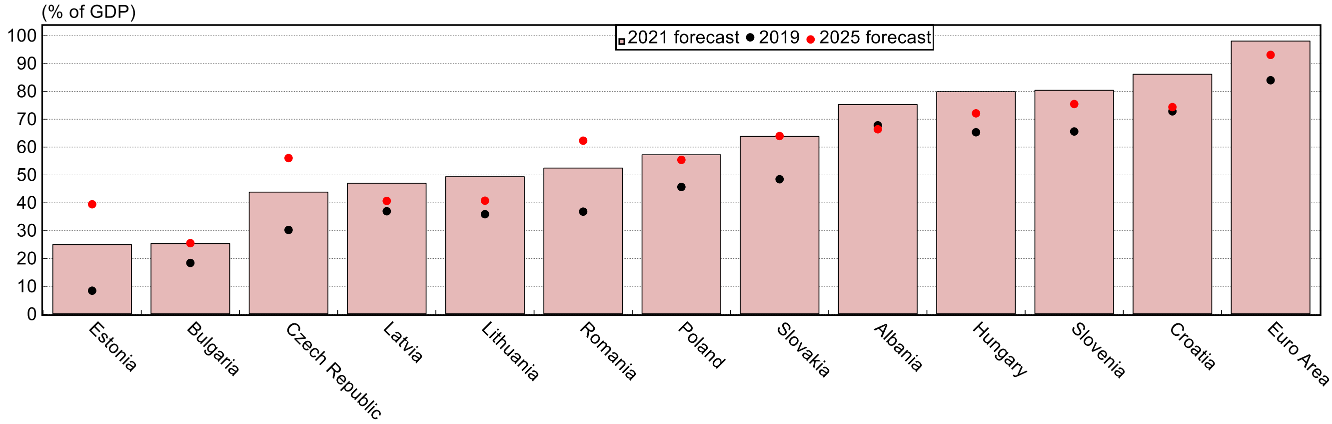

Source: IMF, Macrobond, MUFG Bank Economic Research Office

Under the scenario of weaker real GDP growth, the likelihood of a more fragmented recovery would also increase. National economies would be affected to varying extents owing to contrasting government debt positions prior to the onset of COVID-19, different levels of COVID-19 infection rates, as well as varying use of fiscal policy levers. For example, by 2025 government debt in Slovenia, Croatia and Hungary will remain the highest in the region, after entering the crisis with higher government debt versus the CEE average.

At the same time, those countries which have suffered some of the largest rates of COVID-19 infections and have entered the crisis with lower than average levels of government debt are set to use fiscal policy levers to support the economic recovery. In these countries, however, government debt could increase the most. Czech Republic and Estonia could see some of the most pronounced increases of government debt over the next 5 years, despite some of the lowest government debt ratios in the region before the crisis. Overall the region will be more susceptible to weaker than expected real GDP versus the period before the onset of COVID-19.

A few countries like Lithuania and Latvia might see government debt fall back to 2019 levels but this will not make up for the wider increase.

Gross Government Debt




Source: IMF, Macrobond, MUFG Bank Economic Research Office

## Some Reasons for Optimism

That said there are some good reasons for optimism. CEE economies are generally more resilient this time around due to lower government debt maturities (as a percent of GDP), reduced foreign currency debt and lower interest rates. According to our own estimates, government debt maturities fell to an average of 6.7% of GDP in 2020 from a 5-year average of 6.9% of GDP from 2015 to 2019, even as GDP declined, while government foreign currency debt as a percent of total government debt was only 27.2% of total government debt in 2020, below its 5-year average of 31.2% from 2015 to 2019.

In addition, EU funds should also help to bolster the economic recovery of the CEE region and, in turn, help to provide a greater buffer against any market volatility over 2H 2021. EU funds comprise both the Multiannual Financial Framework budget (MFF) of EUR 1.075 trillion and the 'Next-Generation-EU' recovery fund of EUR 750 billion, both of which will run over 2021 to 2027. The CEE will be a big recipient of the MFF and the recovery fund over the medium-term as the support largely benefits countries with lower GDP per capita. These funds will act as a long-term source of investment that will have positive multiplier effects on real GDP and labour productivity, as well as reducing any real GDP volatility. As a result, economic activity should be broader based and more stable, and the programme is likely to result in greater confidence in the ability of the CEE region to withstand increased external pressures.

We also note, previously when US government bond yields have surprised to the upside this has had a knock-on effect on the region. Most notably, the Taper Tantrum of 2013, which saw a significant sell-off of emerging market assets in the wake of a sudden rise of US yields, should act as a reminder of the pressures the region could come under. This said, the risk of a taper tantrum this time around is much lower as the Fed's communication around the prospect of any policy normalisation is likely to be very gradual.

These three factors should help the region to remain more resilient, nonetheless, the region will clearly remain vulnerable to any new major virus related setbacks, external backdrop changes or any longer-term shocks to real GDP growth.