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By Grzegorz Sielewicz,
Coface Economist for Central
& Eastern Europe
based in Warsaw, Poland

The singularity of political risk in Central and Eastern Europe

With the ongoing wave of elections in the Central and Eastern Europe region, CEE countries are experiencing a key period of change in a context of political risk and economic acceleration, which currently seem to be the two crucial issues attributed to the region. The region's average GDP growth rate soared to 4.5% in 2017, i.e. the highest level since 2010. However, local politics and national judiciary system changes are creating problems for the region. Worsening relations with the European Union (EU) and a threat of sanctions for Poland have raised additional concerns.

Although the social risk has risen in the last decade – mostly in Hungary, according to results of the Coface risk model –, the CEE region is much less risky than other emerging regional markets. However indicators published by international institutions monitoring freedom and civil liberties within the political system show weakened assessments, with Poland joining Hungary as a cause for concern. Although CEE countries have made huge improvements in terms of corruption, it remains prevalent: Bulgaria, Hungary, and Romania placed last among European countries in Transparency International's corruption index. Despite the numerous benefits that EU membership brings to CEE economies, they are becoming more and more "Eurosceptic": according to the latest Eurobarometer results, the Czech Republic is the third-most Eurosceptic member of the community, despite its integration with Western Europe supply chains and strong EU trade links.

Hard data indicates that these political issues have yet to negatively impact CEE economies and businesses. Fiscal easing supports households, and also businesses in some cases, like in Hungary where the corporate capital gains tax was decreased to the lowest rate in Europe. Opinion polls show that the current ruling parties in Hungary and Poland are likely to extend their terms in office. Admittedly, controversial changes to legal systems have triggered social discontent, and demonstrations have been experienced in a number of countries, but companies, including foreign entities have yet to back out of the CEE region. The inflow of foreign investments remains positive and a number of large investments are conducted in the region. It seems that the advantages of price and quality competitiveness, geographical proximity to Western Europe, and solid economic expansion prevail over political concerns. Any possible further deterioration in terms of political risk could make foreign entities reluctant to remain in CEE countries, especially if it would hurt them directly. If the idea of linking EU funds to the rule of law was implemented, economies would not collapse, but certain businesses would suffer. Due to a significant cooperation with the public sector using EU co-financing, construction and ICT would be the first sectors hit, with their partner sectors second to experience deterioration. Ultimately, a compromise to these clashed relations would be the most reasonable scenario.

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Political risk has increased globally but it differs in CEE

The Coface Political Risk Model[2] **(Chart 1)** takes into consideration various measures grouped into two major parts: security risk, which includes conflict (either State vs State or between factions within a given territory, with the latter often attested to a government's inability to fulfil its sovereign functions) and terrorism, and the risk arising from political and social fragility, which includes populism. Moreover, the political risk of a particular country can be elevated by terrorist attacks, a form of violence that has increased in recent years. Whereas their economic impact is difficult to measure, terrorism in a certain location undoubtedly affects confidence levels of both residents and non-residents (tourists, foreign investors, etc.). Ethnic and linguistic fractionalisation, i.e. the existence of various groups in competition, also impacts the quality of institutions and the ability to create a political consensus. Political risk would be also elevated by rising social frustration, which could trigger social movements. Within this regard, the Coface methodology measures social pressure indicators that could have a negative impact, including inflation, unemployment, GDP per capita, income inequalities, corruption, and crime rates. Instruments facilitating the transforming of pressures into change are also taken into account, i.e. the education rate in tertiary education, the literacy rate, access to the internet, the proportion of young people in the population and the urbanisation rate. In our political risk model, the highest risk is connected mostly to countries in Asia, the Middle East, and Africa – with Afghanistan, Iraq, and Libya making a podium finish.

Since the economic transformation after the fall of the Iron Curtain, the attention was mostly focused on CEE countries' ability to adapt to the new environment of market-oriented economies. Undoubtedly, the political situation and its possible changes remained to be an important factor however the political risk became somehow dormant. CEE governments were open to adapt their laws to standards of developed countries and convince foreign businesses that the region is an attractive destination for their investments. Strong law fundamentals were also supported by the EU accession, with most CEE countries joining the European community in 2004[1].

Risk is significantly lower in CEE countries, with the region enjoying stable economic activity, which has gained momentum in recent years. Social pressure indicators of macroeconomic performance have improved: GDP per capita has increased, bringing it closer to the Western Europe average, and unemployment rates have contracted significantly, with inflation remaining moderate. At the same time, EU membership shapes similar standards of law framework that are present in Western European countries.

A component of social pressure in Coface political risk model confirms that the social risk in the CEE region is much lower than in other emerging markets, with certain countries across the world having scores double those of CEE countries. Examining large emerging countries' scores, we see 64% in Russia, 61% in Brazil, 52% in China, 48% in South Africa, and 42% in India. CEE countries' scores average at 29%: a low level of social risk. The highest scores in the region belong to Bulgaria (37%), Hungary (36%) and Croatia (33%). Over the last decade, a majority of CEE countries have recorded decreasing risk scores; the exception being Hungary, whose score deteriorated in the same period (from 29% in 2007 to 36% in 2017). This deterioration resulted from wider income equalities as measured by the Gini coefficient[3], worsening of corruption variables, but mostly less favourable assessments concerning the degree of freedom and civil liberties within the political system. Variables measured by Freedom House provide a clear picture of deterioration in this regard for Hungary, as well as more recently for Poland **(see Chart 2)**.

Examining Hungary in particular, concerns began to arise following certain actions by the current government. In April 2010, the conservative Alliance of Young Democrats–Hungarian Civic Union (Fidesz) and its junior partner, the Christian Democratic People's Party won a two-thirds majority in the National Assembly. The resulting government, headed by Fidesz leader Viktor Orbán, passed a series of laws that consolidated its control over the media and other institutions. Moreover, it curtailed the jurisdiction of the Constitutional Court over budgetary matters, after the court attempted to block a retroactive tax law. The government also refused to introduce budget cuts that were a condition of the 2008 emergency loan, resulting in strained relations with the main creditors, i.e. the International Monetary Fund and

CHART 1
Coface Political Risk Model

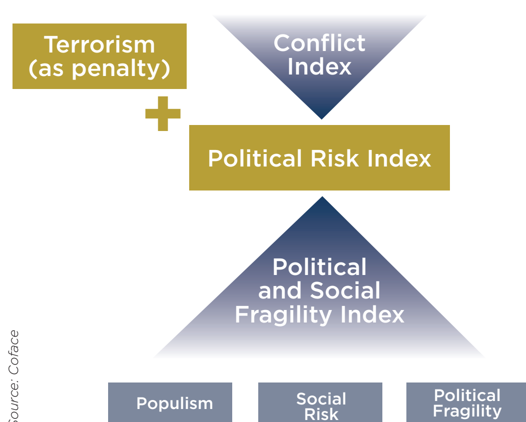
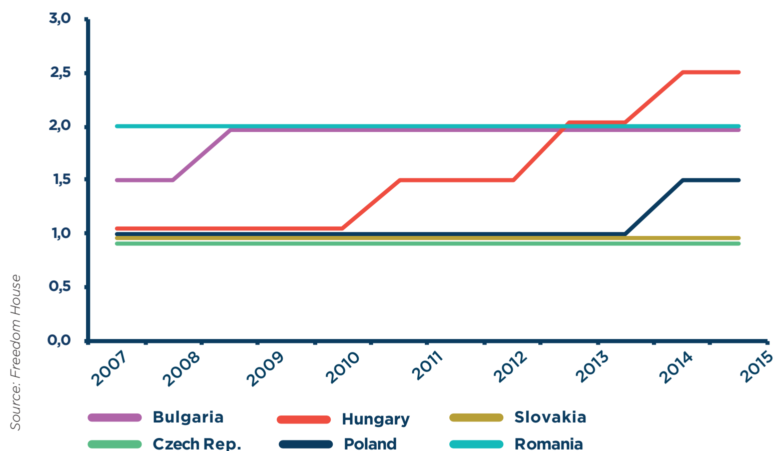


CHART 2
Freedom rating



Note: the rating ranges from 1=most free to 7=least free; calculated from political rights and civil liberties indicators.

1 - *The Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia, and Slovenia joined the EU in 2004; Bulgaria and Romania did in 2007, and Croatia did in 2013.*
2 - *Coface Panorama: The rise and rise of political risks, March 2017 (http://coface.com/content/download/150827/2487577/file/Panorama-03-2017-GB-V07.pdf)*

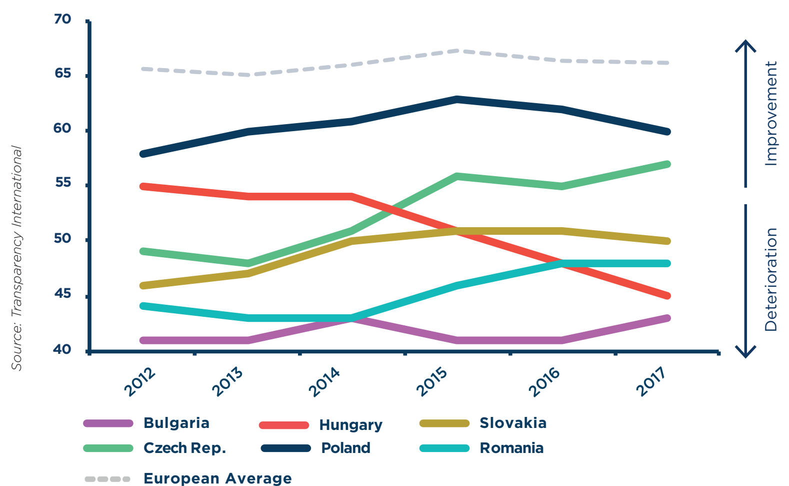
the EU. The following years saw the nationalisation of the assets of compulsory private pension funds, and the passing of the Constitution Act, whose rapid process and limited input from civil society was criticized by the Venice Commission of the Council of Europe. Some actions of the Fidesz government have hurt businesses via various additional fiscal burdens, including an advertising tax on media, a progressive retail tax depending on companies' turnover, additional taxes on energy sector entities if they do not invest in Hungary, and plans of implementing an internet tax. Some of these measures were abandoned due to the European Commission's objections or demonstrations. On the political side, international transparency watchdogs and the Organization for Security and Co-operation in Europe (OSCE) pointed to strong government influence over the media, and unequal financial resources for parties.

More recently, Poland has been home to speculations regarding an increase of populism and elevated political risk. This started after the May 2015 presidential elections, won by Andrzej Duda of the Law and Justice Party (PiS), followed by PiS obtaining a parliamentary majority in the Autumn 2015 general elections. Since then, a number of reforms have been introduced, with similarities to those seen in Hungary. In late 2015, the Polish law concerning the Constitutional Tribunal was changed, and thereafter other judiciary changes followed, including changes to the National Judiciary Council, Supreme Court, and the merging of the posts of Justice Minister and the formerly independent Prosecutor General. In December 2017, the European Commission concluded that "there is a clear risk of a serious breach of the rule of law in Poland" and recommended member states to trigger Article 7[4] of the EU treaty, which is considered to be "a nuclear option". This mechanism has never been used, although its use against Hungary was considered. The final decision on triggering Article 7 is made by a supermajority of four fifths at the meeting of the European Council. However, imposing sanctions requires unanimity.

Although Coface's social risk model indicates low risk, CEE society polarisation can be seen in the number of civilian demonstrations. Various changes affecting inhabitants' situations or the political landscape have led to a number of demonstrations across the countries, including Hungarians protesting against the idea of implementation of an internet tax, Poles showing their discontent on changes in judiciary system, Romanians protesting against weakening of anti-corruption powers, Czechs demonstrating against President Milos Zeman and Finance Minister Andrej Babis (the current Prime Minister), with the latter being suspected of tax evasion and abuse of media, and Slovakians conducting the biggest protests since communism as a response to the killing of Jan Kuciak, a young journalist who was investigating government corruption.

Corruption issues continue to play a role in the CEE region's political risk, despite countries adopting to EU standards and making crucial improvements in this field, including setting up anti-bribery watchdogs in many countries. In 2017, Transparency International expressed that "bias and corruption have become fundamental traits of the system in Hungary", and that "corruption also disrupts economic development in Hungary". Indeed, recent data from Transparency International's Corruption Perceptions Index[5] show that the score of Hungary has been gradually weakening since 2014 **(see Chart 3)**. Currently: the country is assessed at the lowest levels in the EU, along with Bulgaria and Romania. Globally, Bulgaria ranks 71st on the Index (the same as South Africa), and Hungary ranks 66th (the same as Senegal).
The level of political risk in the CEE region can also

CHART 3
Corruption Perceptions Index (scores)



Note: the index uses a scale of 0 to 100 (where 0 is highly corrupt and 100 is very trustworthy), and then ranks the results from scores.

be assessed by the attitude to the EU. The CEE region enjoys a significant inflow of foreign direct investments, and individuals gained gradually-opened access to better-paid labour markets in Western Europe. Nevertheless, developments in Hungary and Poland suggest that the EU is treated as a partner whose imposed conditions and recommendations could be considered as meddling and interfering with national matters. The level of risk can also be assessed by the CEE's resistance to the mandatory migration quota. Indeed, the latest European Commission's Eurobarometer[6] confirms that immigration is seen as the most important issue facing the EU, especially in Estonia (mentioned by 62% of respondents), the Czech Republic, and Hungary (both 58%). The EU average put it also as the main concern, but this was only mentioned only by the calculated average of 39% of respondents.
The latest Eurobarometer results (**Chart 4)** also provide interesting insights into the Czech Republic, which is the third-most EU sceptic member of the Community. 30% of respondents declared that the EU conjures up a negative image for them. The only countries with a more negative response were Greece and the UK.

The Czech Euro-scepticism frightened businesses in the country when Prime Minister Andrej Babis's ANO party held talks on introducing a new referendum law, with a far-right leader who has been openly calling to leave the EU. Although the Prime Minister stated that he did not intend to hold a referendum on EU membership, the evoked principle of "Czexit" shook investor company sentiment. Indeed, Czech exports and the economy as a consequence strongly dependent on exports to other EU countries, as a result of close trade links and an inclusion in Western European (mostly German) supply chains. The EU received 84% of Czech total exports last year. On the other hand, lots of other CEE countries have a positive view on the EU, including Lithuania, Estonia, Latvia, Poland, Romania, Bulgaria, and Hungary.

3 - The Gini coefficient is a measure of the deviation of the distribution of income among individuals or households within a country from a perfectly equal distribution.
4 - Never before used, Article 7 is a law that suspends voting rights for a nation that has violated EU core principles and values.
5 - Source: https://www.transparency.org/news/feature/corruption_perceptions_index_2017

Has political risk hurt CEE businesses?

CEE companies enjoy a supportive macroeconomic environment, with the average GDP growth rate soaring to its highest level in the last eight years in 2017 (4.5%), and Coface forecasts indicating that this will remain at a solid 3.9% in 2018. Households benefit from a tremendous improvement of the labour market, with unemployment rates hitting new lows and fair wage growth. Part of this economic improvement success could be attributed to governments, as authorities have introduced measures that aim to increase the wealth of inhabitants. For example, Hungary introduced measures supporting families, including child support, family housing incentives, and support for household modernisation. Foreign currency mortgage borrowers benefitted from converting their loans into domestic currency, which contributed to the near-disappearance of foreign currency home loans from the Hungarian market. Businesses have benefited from the reduction of the corporate capital gains tax from 19% to 9%, i.e. the lowest tax rate in Europe. Poland implemented a wide coverage child support programme and decreased the retirement age ; although this ran contradictory to demographic projections, the move was an election campaign promise. Investors' attitudes and the risk connected with particular economies are often linked to trends in capital markets. Although government bond yields and foreign exchange quotes belong to such measures, they are also subject to the current monetary policy and its expected developments. In this case, the more accurate measure is the most widely used type of credit derivative: credit default swaps (CDS)[7].

CHART 4
Eurobarometer: share of respondents with a negative image of the EU

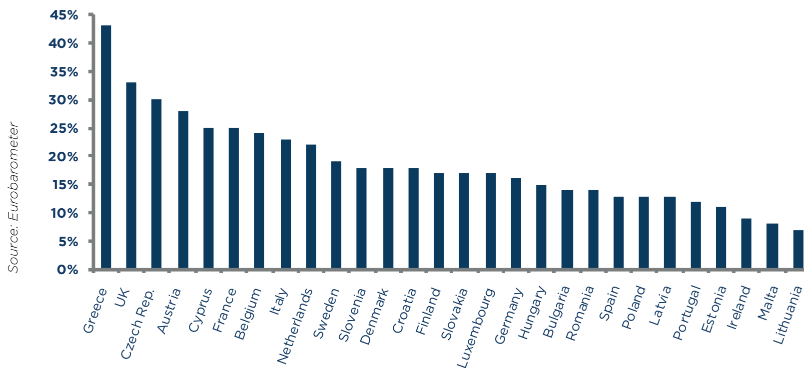
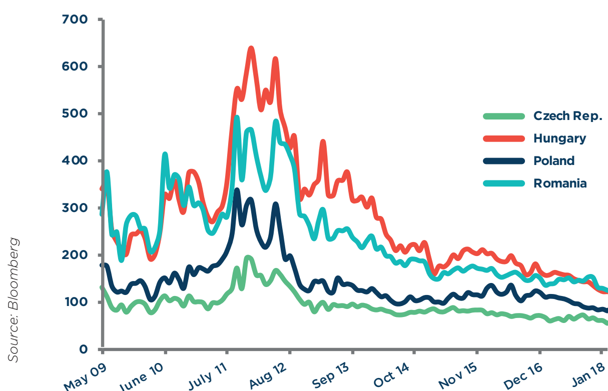


CHART 5
Credit Default Swaps (CDS)



CDS rates show that the risk connected with CEE countries has lowered in last years. **Chart 5** shows that the CDS of CEE countries reached its lowest level in last nine years. In 2011, Hungary's CDS were elevated by political issues, but also fuelled by external developments. Similar trends were observed in other countries. Political concerns have been also seen in Poland's CDS prices, which fluctuated moderately after PiS took office in autumn 2015 – however, it decreased to pre-crisis levels over recent quarters.

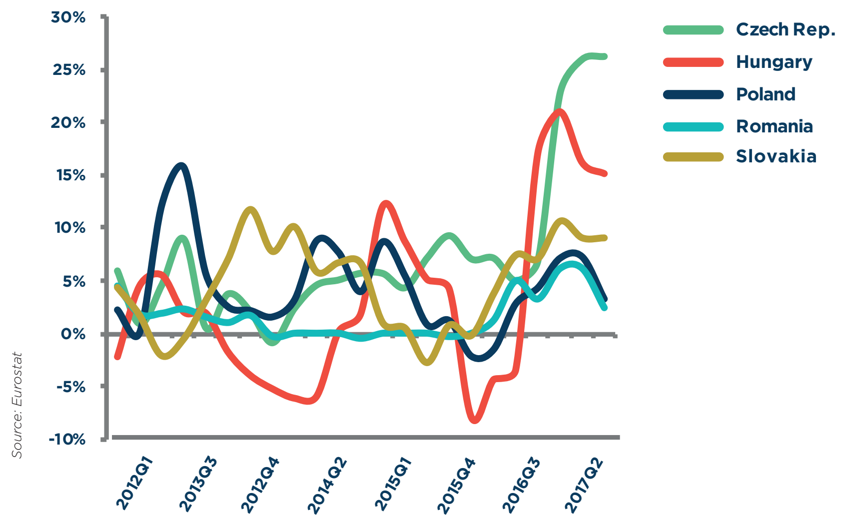
Foreign investors' willingness to invest in the CEE region has not yet deteriorated as a result of political issues. Their sentiment would more likely be shaken by concerns regarding the rule of law, CEE countries' access to EU co-financing, or tougher relations with EU institutions. Nevertheless, the CEE region remains an attractive destination for expansion, as investors seek to make the most of the region's cost and quality competitiveness. In the middle of the Fidesz party's second consecutive term as leader of the country, Mercedes announced a EUR 1 billion investment into its Hungary site. It also appears that investors are not targeting low-value textile and food-processing sectors anymore, but are moving to premium cars (Mercedes in Hungary, Jaguar Land Rover in Slovakia), renewable energy, and technology. Poland has managed to attract a number of international banks in recent years, and both Goldman Sachs and JP Morgan have set up Polish operations centres, in 2017 and 2018, with the latter creating 3,000 jobs. Companies in other sectors have also enjoyed an inflow of foreign investors to Poland, including LG Chem, who is building the biggest electrical vehicle battery factory in Europe. A number of such important investors have received local grants. Foreign Direct Investment (FDI) dynamics data shows that CEE countries have enjoyed a positive inflow of direct investments in the last few quarters, and most of them even across the last several years **(Chart 6).** Nevertheless, a long and steady deterioration of the business environment could lead to a decline in investment flows, as has been seen in Russia and Turkey.

However, market prices and FDI inflows do not mean that there are no risks related to political developments in the CEE region. European institutions are concerned about breaching the rule of law. Koen Lenaerts, President of the European Court of Justice, declared that independent courts are a fundamental value of the European Union that should be respected on the national level. Whereas in a case of Poland the way to a sanctioning mechanism resulting from the aforementioned Article 7 would be difficult to implement, given that several CEE countries have already claimed that they would vote against sanctions, other measures could hurt the Polish economy, such as the European Commission's recent initiative to link budget transfers to the rule of law. Poland is the single largest recipient of the EU budget, with an allocation of EUR 82.5 billion in the 2014-2020 financial framework, equivalent to roughly 20% of the total EU budget, or about 2% of country's GDP per year. Hungary receives around 2.5% of its annual GDP from EU structural and cohesion funds. According to Oxford Economics' estimations[8], Poland's GDP would have been about 1% lower in 2016 without EU funds, and 1.9% lower in 2014 – the year of peak absorption. In terms of GDP, Hungary is an even bigger beneficiary, with its GDP enhanced by 2.7% in the peak year of absorption. Given the solid economic expansion of these countries (GDP growth reached 4.6% in Poland and 4.0% in Hungary in 2017), such measures would have a limited impact in the short-term. However, their impact would be felt during the next EU budget (2021-2027), when growth

6 - European Commission, Standard Eurobarometer 88, Autumn 2017
7 - The contract is similar to insurance because it provides the buyer of the contract, who often owns the underlying credit (municipal bonds, emerging market bonds, mortgage-backed securities, or corporate debt), with protection against default, a credit rating downgrade, or other negative credit events. An annual protection fee is expressed in basis points, i.e. CDS quotes. The contract can be used as a hedge or a separate instrument about the credit quality of a particular reference entity. Source: https://www.investopedia.com/articles/optioninvestor/08/cds.asp.

in CEE countries is likely to stabilise at lower levels if supply constraints are not improved. The current rebound of fixed asset investments experienced in the region is fuelled in large part by projects co-financed by the EU budget. This applies to lots of public investments, which have also elevated in the election year[9]. Moreover, particular sectors could suffer from the limiting of EU funds. Any possible squeezing of co-financing from EU funds would be harmful for the construction and ICT sectors (the sectors in which the most companies are dependent on public orders). Indirect negative consequences could be experienced by local transport companies, or businesses cooperating with the construction sector (producers of building materials, steel manufacturers and distributors, machine producers etc.). On the other hand, worsening relations would disadvantage the EU as much as Poland: Poland is not only the biggest beneficiary of EU funds, but also supplies most of its exports (79.7% of total exports in 2017), and will be the fifth-largest EU nation after the UK leaves the EU. It is therefore likely that the current Poland-EU stand-off will end in a compromise: both parties have too much to lose in a case of worsening relations.

CHART 6
Dynamics of foreign direct investments inflow transactions (year-on-year changes)



8 - Oxford Economics, "Poland: A problem the EU is unlikely to solve", 7th March 2018.
9 - Parliamentary elections scheduled for April 2018 in Hungary; municipal elections scheduled for autumn 2018 in Poland.

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COFACE SA
1, place Costes et Bellonte
92270 Bois-Colombes
France

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