Reflections of IIB's Chief Economist on the global economy and the CEE

I. The Global Snapshot – A crisis unlike any before

After the dramatic and unparalleled 11% quarter-on-quarter contraction in EU GDP during the first wave in Q2, and the equally dramatic 12% recovery in Q3, the EU economy will likely contract by up to 2% in Q4 during the second wave. This latest contraction is limited in size namely because policy makers have overall learnt a great deal about how to economically deal with Coronavirus. With the successful development of various vaccines, the economic picture for 2021 looks very encouraging indeed. Current forecasts are for annual GDP in the EU to grow by 4% in 2021 after a contraction of 7% in 2020[1]; in reality, this figure could be even stronger in 2021 if policy makers can continue to use the "whatever it takes" attitude.

This crisis has been incredibly atypical, and not just because of the unique nature of the Covid-19 pandemic, but because of the immediate and powerful response of fiscal and monetary policy makers globally. One area this is most visible is unemployment; today EU unemployment stands at 7.5% only 1% higher than the low seen in January 2020. That compares to the 4% jump from 7% to more than 11% during the Global Financial Crisis and then Euro-Zone Debt Crisis. Statistical comparisons between these crises concerning indicators such as credit spreads or even bankruptcies also show a very different type of crisis. That all is despite the depth of the 2020 contraction being larger than the prior crises. **The fundamental explanation for the different crises outcomes has been "lessons learnt" by global policy makers to the benefit of the containing the economic fall-out of the Covid-19 crisis.**

There are no free lunches – there will be a cost to current Fiscal and Monetary policies

The easiest observation that any economist could make in 2020 is that Covid-19 has led to structurally higher debt burdens. The IIF calculates that Global Debt has reached $272 trillion, equating to around 365% of GDP both records[2]. For the most part, this has occurred due to a sharp increase in fiscal spending – Governments have footed the bill for avoiding a Great Depression 2.0. Global government debt has crossed the 100% to GDP line for the first time since[3].

These depressing statistics give rise to a feeling of an imminent debt crisis (particularly given our last experience of the Euro-zone debt crisis following the Great Financial Crisis). **No such crisis will occur this time around namely because global policy makers are on permanent firefighting mode with essentially unlimited central bank bond purchases, fiscal stimulus and no self-destructive calls for austerity.** Central Banks globally (led by the Fed and the ECB) have embarked on an unparalleled policy

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[1] European Commission 'Autumn 2020 Economic Forecast' November 2020 https://ec.europa.eu/
[2] Institute of International Finance - 'Global Debt Monitor: Attach of the Debt Tsunami' November 2020. https://www.iif.com/
[3] International Monetary Fund – 'A History of World Debt' March 2011 https://www.imf.org

of monetary financing by now holding 20% to 50% of their own government debt stock. In essence, the size of the Covid-19 fiscal deficits have been entirely financed by Central Banks (ie. The governments' themselves). Citigroup for instanced calculated that the ECB will purchase more than Euro-zone governments' issuances in 2021. Other than financing government deficits and supporting demand, this has also in turn ensured that credit markets have been sufficiently liquid in order to avoid a financial crisis.

For better or for worse the role of Central Banks have changed significantly in recent times and while publicly they are unlikely to admit it, Central Banks' have essentially already lost independence. That is a real "cost" of this crisis, which will make future inflation inevitable and harder to subdue.

II. Despite the costs of Covid-19, the future will be bright for CEE countries

Despite a recent flare-up in Coronavirus across Central & Eastern Europe and corresponding restrictions, the region will outperform the EU in 2020 and in the subsequent recovery period. **The key economic theme of Central & Eastern Europe remains a strong integration into the European manufacturing supply chain** (particularly although not limited to the auto sector). Manufacturing as a segment has not suffered as much as services in part driving the outperformance of the region vis-à-vis economies such as Spain and Italy.

Additionally, the close linkage between many of the region's economies to Germany (who also have been an outperformer in Europe) has been a positive supporting factor. Indeed, a key supporting factor despite the second wave has been the unexpectedly strong performance across CEE in Q3, which indicate that the recovery post Second Wave will be equally impressive.

IIB CEE economies will return to 2019 levels faster than the rest of the EU

GDP growth	2019	2020	2021	2022	GDP returns to 2019 levels
Bulgaria	3.7%	-4.5%	3.4%	3.6%	Q2 2022
Czechia	2.3%	-7.0%	3.2%	4.5%	Q4 2022
Hungary	4.6%	-6.5%	4.3%	4.7%	Q3 2022
Romania	4.2%	-5.0%	3.5%	4.1%	Q2 2022
Slovakia	2.3%	-7.0%	4.7%	4.5%	Q3 2022
EU[4]	2.1%	-7.4%	4.1%	3.0%	Q2 2023

[4] European Commission 'Autumn 2020 Economic Forecast' November 2020 https://ec.europa.eu/

In 2020, CEE economies will fare off better than the EU by 1.5% on average, compared to being worse than the EU by 1% in 2009. In part, this reflects years of successful policy implementation in the region such as building up a strong domestic financial system with local and regional banks. **Overall, one can note that the CEE has entered this economic crisis with more fiscal and monetary tools than it has ever had before and policy makers should be applauded for their quick and decisive response.**

CEE governments have saved thousands of businesses and hundreds of thousands of jobs

Taking Czech Republic as an example, the government has used tax policy (Liberation packages; delaying of tax return payments etc.), employment policy (Antivirus support programme – contributing to employers salaries), monetary policy (easing restrictions on open market transactions, cutting central bank rates), banking policy (introduction of moratoriums) and a raft of sector specific policies (such as compensating lost income for the hotel sector or for self-employed persons legally permitting rent deferrals, debt relief for hospitals etc.) to name but a few. **It is absolutely certain that without these support packages the region would have faced a dramatic increase in bankruptcies and mass unemployment. The current 3.7% unemployment rate in Czech Republic compared to 8% rate seen during the Euro-zone debt crisis is one of the clearest indicators of the success of these policies.**

Czech Republic's headline covid fiscal stimulus package has been the largest among IIB member states at around 14% of GDP, compared to 12% in Hungary, 6% in Slovakia, 5% in Bulgaria and 4% Romania. However, it is also worth noting that the **Hungarian and Romanian Central Banks have also undertaken quantitative easing programs – such programs coupled with other liquidity measures have strongly averted any risk of a financial crisis (through staving off the potential threat of frozen debt markets and a seizure of bank lending).**

In Romania's case, the actions of the Central Bank have been extremely important during a year of political gridlock, which alongside a weaker fiscal position entering 2020 has prevented a comprehensive fiscal response program. **The incoming government though must ensure that a pro-growth fiscal stimulus package is swiftly implemented**, as monetary policy cannot be the only instrument to dealing with the aftermath of Covid-19. In particular, the Romanian government could look to borrow some ideas from the packages implemented in Czech Republic and Hungary – particularly increasing the use of loans, equity injections and public guarantees in order to generate maximum economic effect with a minimal impact on the 2021 fiscal deficit.

Slovakia's actual fiscal stimulus has been larger than the aforementioned 6% covid response figure playing a very important stabilising role for the economy. The fiscal deficit has swung from 0% last year to approximately 9% (of GDP) this year, thus helping the economy show an impressive recovery in the 3rd quarter – **in an economic crisis all spending matters**. Projected deficits of 6% in the coming years have led to some discussions regarding fiscal consolidation in order to meet legal brake rules. However,

Slovakia's position as one of the few countries in the CEE region, which uses the Euro, has an additional safety net in the form of the ECB (which currently own 33% of Slovakian Treasury Bills). Recent bond market developments in Slovakia's government curve (which is at record negative yields) are sending a very clear signal – **Slovakia has ample room to finance its debt load (it is after all one of the lowest in the Euro-zone).** In particular, **the government has a perfect opportunity to increase public investment** (which at 3.9% of GDP is below that of Czech Republic's 4.8% and Hungary's 6.3%) and **thus boost long-term economic growth.** As such**, Slovakia should look to apply a new set of fiscal rules (focusing on increasing investment) in order to take account for the new economic realities thus avoiding economically painful (and self-defeating) fiscal consolidation.**

Of course, Governments have to be wary about increasing debt burdens too much, and in this regard, **the decision to increase the capitalization of state development agencies is extremely necessary** (for instance in Czech Republic the approval of CZK 4 billion capital increase of the Export Guarantee and Insurance Company). **National Development agencies like EGAP, CMZRB, and for that matter MDBs like IIB and EIB, can play a vital role in maximising the volume of economic support on a sustainable basis** (financial institutions are able to leverage capital multiple fold) as well as ensuring a very targeted application of funds given the close relationship between financial institutions and their clients.

Furthermore, **institutions like EGAP, EXIMBanka Slovakia, Magyar Eximbank and IIB are critical for supporting the extremely heavy export orientated economies of the CEE**. While it is clear that the national governments have successfully protected domestic economies through all the aforementioned policies, exporters are left facing strong competition in foreign markets (where local governments are also supporting domestic companies). In many ways, the world's regulators of free trade have been forced to close their eyes on state support during this crisis and **without increasing the role of export focused development institutions, the CEE's vitally important export sector may be crowded out of an already shrinking export market.**

Central & Eastern European governments continue to have one of the best balance sheets globally which coupled with their ability to tap EU funds has meant that fiscal support has and will continue to be a very strong supporting factor in growth dynamics. On average, Government debt to GDP in IIB's CEE economies will increase from 42% in 2019 to 50% in 2020, substantially better than the increase from 79% to 94% respectively in the European Union as a whole. As such, governments in the region will have a far freer hand to develop new investment programmes to stimulate growth in the coming decades.

The overall effect of the second wave will delay the return to economic normalisation by approximately 1 year. The outlook for 2021 though is a positive with the caveat that the first quarter will continue to be affected by Coronavirus restrictions as well as facing tougher Year-on-Year

comparisons. From Q2 2021 onwards, the region should start to benefit from a new and continuous growth cycle fuelled by fiscal and monetary stimulus with the add on of additional EU support funds.

CEE has a large growth potential but needs continued investment

Looking forward the whole region has a unique opportunity to further consolidate its position as a manufacturing hub in the European Union. As well as to focus on the key business sectors of the 21st Century (electric vehicles, fin tech, online retail etc.). For instance, this requires increased investment into digitalisation which unfortunately still remains below (on a proportional basis) than other areas of Europe[5].

Without new investment into high technology areas, the region will struggle to further close the wage gap to Western European levels. Such investments typically go hand-in-hand with enticing multinational organizations to invest into region bringing their know-how and large investment budgets (a recent example of this is IBM's decision to build a new IT centre not far from Budapest backed by Hungarian Government grants). **This is also something which IIB has focused on since relocating to the CEE; the Bank has financed multinational corporations from Germany, Spain, France and Sweden for the specific purpose of enhancing FDI into the region.** An example of this is our partnership with Schaeffler, who are a leader in innovative technologies concerning CO2 efficient drives, electric mobility, Industry 4.0 and digitalization where we have financed their expansion into Czech Republic, Slovakia, Romania and Hungary[6].

Other areas of improvement can easily be located in the World Bank's "doing business" rankings[7], the region ranks at an acceptable level globally; Czechia (41st), Slovakia (45th), Hungary (52nd), Romania (55th) and Bulgaria (61st) out of the 190 countries ranked. But if the region is to achieve complete economic convergence with the rest of the European Union these rankings will need to be improved. **The three key areas, which let the region down, are "starting a business", "dealing with construction permits" and "getting electricity".**

Two of these areas "starting a business" and "getting electricity" can thrive with the support of development institutes; for instance**, IIB partners with the European Investment Fund as well as government agencies from Austria, Czech Republic, Slovakia, Hungary and Slovenia to boost equity investment into small and medium-size businesses in the EUR 97 million Central Europe Fund of Funds**[8]. Elsewhere, IIB has been a very active backer of supporting the key energy development in the region such as supporting Hungarian Magyar Villamos Muvek Zrt (MVM Group) with a EUR 100 million

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[5] PwC Central and Eastern Europe Private Business Survey 2019
[6] https://iib.int/en/articles/iib-supports-strategic-cee-automotive-industry-the-bank-will-provide-a-loan-to-schaeffler-ag-a-leadi
[7] https://www.doingbusiness.org/en/rankings
[8] https://www.eif.org/what_we_do/resources/CEFoF/index.htm

credit facility[9], as well as a EUR 90 million facility to Slovakian Slovenske Elektrarne and a EUR 50 million with Bulgarian Energy Holding Group.

Structurally the whole CEE has to stick together if it will look to move to the next level of economic development with a continued focus on national and regional champions. The IIB CEE member states have a combined population of 52 million, which when added with some of the other countries in the region such as Poland, Slovenia, Serbia and Croatia add up to nearly 100 million. Governments in the region should look to enhance M&A between corporations in order to create these regional champions who will be able to compete with multinationals from outside the region. IIB has also financed such CEE institutions who having growing international presence such as Energo Pro, CPI Property Group, Home Credit Group, Banca Transilvania, MOL Group, PPF Group and Huvepharma.

Finally, the region must focus on green investment as regulatory bodies and even investors increasingly penalize environmentally unfriendly production processes. **This is an opportunity to seize the types of investments that have been emboldened in the EU's 2021-2027 budget with the Green Deal and plan to achieve climate neutrality by 2050**[10] - particular with the large size of EU grant facilities related to the green transition up for grabs. This is another area where IIB has been particularly active, for instance financing the transition away from coal to biomass in line with EU regulations in Slovakia[11] as well as supporting the development of Green Bonds across the CEE region[12].

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[9] https://iib.int/en/articles/iib-will-provide-eur-100-mln-credit-facility-to-mvm-group-for-the-development-of-the-hungarian-energ

[10] https://ec.europa.eu/clima/policies/budget/mainstreaming_en

[11] https://iib.int/en/articles/iib-provides-financing-for-a-new-green-energy-project-in-the-slovak-republic

[12] https://iib.int/en/articles/iib-acts-as-an-investor-in-the-debut-placement-of-the-hungarian-green-sovereign-bonds and https://iib.int/en/articles/iib-makes-another-important-step-to-support-financial-markets-development-of-its-member-states-the-b