

FOUR POLITICAL RISKS FACING CENTRAL & EASTERN EUROPE IN 2022

Key political developments to watch & implications for international investors

January 2022

Issues & Sectors	Political Stability, Coalition Fractures, Parliamentary Elections, EU-Russia Relations
Stakeholders	Governments, Parliaments, Prime Ministers, Heads of State

For Central & Eastern Europe, 2021 was a year of political instability and this year is expected to bring similarly pressing challenges. The majority of the region is now governed by experimental and/or ideologically diverse coalitions, with many facing major question marks over their potential to remain in power throughout 2022 as the region hopes to continue its recovery from the COVID-19 crisis. After a tumultuous election season last year, the region is also braced for much-anticipated electoral contests in Serbia, Slovenia, Hungary and Latvia, as well as troubled Bosnia and Herzegovina, with Hungary set to hold its most open general election in more than a decade. At the same time, the region's political stability depends not only on domestic political factors but also international affairs, most crucially the impasse between Russia and the West over Ukraine.

Below, Aretera highlights four key political developments for international investors to watch in 2022 which we consider have the potential to shape the political and economic life of the region for this year and beyond.

This memo will cover:

1. Unstable Governments Across CEE	2
2. A Post-Election/Constitutional Crisis In Hungary	3
3. Strained Ties Between CEE Countries and the EU	4
4. Escalating Tensions Between Russia & the West	5
Conclusions	5

1. UNSTABLE GOVERNMENTS ACROSS CEE

Politics in the CEE region has become increasingly dominated by often fragile multi-party alliances. Combined with political conflicts, the mishandling of the COVID-19 crisis, social tensions over the economic impacts of the pandemic and inter-party struggles for power, this has led to some coalitions falling apart, as well as collapsing governments across the region.

- Slovakia's centre-right coalition was the first to collapse in the region last March over a politically controversial purchase of COVID-19 vaccines from Russia. The unilateral action of now former PM Igor Matovič brought under-the-surface tensions within the country's four-party ruling bloc to light. The turmoil almost led to the collapse of the four-party coalition; eventually it was only averted by Matovič's resignation. The government is now led by Prime Minister Eduard Heger, a former Finance Minister, however tensions within the coalition remain.
- 2021 marked an unprecedented election cycle for Bulgaria, as neither the country's parliamentary elections in April nor a subsequent snap parliamentary vote produced a functioning majority in the country's legislature. With a hung parliament, the country was governed by the Caretaker Government of Stefan Yanev to avoid a crisis of governance throughout 2021. The deadlock was eventually broken by a third general election in November, which produced an experimental four-party government led by Kiril Petkov as PM.
- Divisions inside the ruling United Right coalition behind the Polish government of Prime Minister Mateusz Morawiecki culminated last August over a number of issues, including the country's troubled relations with the EU, as well as Morawiecki's controversial economic and media reform plans. The crisis resulted in MPs of the junior ruling Accord party leaving the coalition, although the United Right eventually managed to maintain its majority in the Sejm, the Polish lower house.
- Romania's three-party government led by former PM Florin Cîțu was toppled by a no-confidence vote following a power struggle between the senior ruling centre-right PNL and the liberal USR-PLUS parties. Cîțu's fall was followed by two months of unsuccessful attempts to form the country's next government. As Romania faced a crisis on multiple fronts, the crisis ended with an unlikely coalition government between PNL, the social democratic PSD and the ethnic Hungarian UDMR.

Looking back on the events of 2021 and the political implications for this year and beyond, political instability is likely to be among the most pressing issues for international companies, not only in those countries listed above, but across the entire region. Poland, the largest market of the region, faces a tense political year as the ruling United Right bloc will be challenged by a range of political players, including the often unpredictable cast of its junior coalition partners, as well as Donald Tusk, the country's former PM and new-old leader of the main opposition party Civic Coalition.

The recently installed governments in Bulgaria and Romania constitute experimental alliances between former political rivals, as well as parties without prior experience in government. In Bulgaria, the coalition members supporting Prime Minister Petkov could clash over ideological and policy issues, while a coalition crisis in Romania could become increasingly possible as Romania heads

towards 2024, the next election year, in which the PNL and the PSD will stand as the main competitors. The same concerns hold for the Government of Petr Fiala, the new Prime Minister of the Czech Republic, who is supported by the country's first, ideologically diverse five-party coalition.

Instability will also continue to overshadow the Western Balkans, where the possibility of a return to conflict has escalated since the leadership of Republika Srpska, the Serbian entity of the federal state of Bosnia and Herzegovina (BiH), has increasingly signalled its intention towards secession. Most recently, the parliament of the Bosnian Serb entity passed a series of laws enabling Republika Srpska to establish its own parastatal institutions and military by May. Given the history of war and ethnic tensions in the country and its neighbours, a breakaway attempt from BiH – led by the region's secessionist leader Milorad Dodik – could ultimately trigger a conflict that would resonate across the whole of Southeast Europe.

2. A POST-ELECTION/CONSTITUTIONAL CRISIS IN HUNGARY

After a heavily crowded election season last year, 2022 will be limited in terms of general elections in CEE, with votes scheduled in Serbia, Hungary, Slovenia, Latvia, as well as Bosnia and Herzegovina. Of the upcoming general elections, Hungary's parliamentary vote – scheduled for early April – is expected to be the most anticipated electoral contest of the region.

The high anticipation comes as Viktor Orbán, Hungary's right-wing Prime Minister, is facing his toughest electoral challenge since he rose to power in 2010 as – for the first time in nearly 12 years – Hungary's ideologically diverse multi-party opposition, which consists of six previous electoral rivals, is now running on a joint ticket to defeat the country's ruling Fidesz-KDNP alliance.

Following two failed attempts to unseat Orbán in 2014 and 2018, the country's main opposition parties agreed to run as part of an electoral alliance which they hope to transform into a rainbow coalition of social democratic, green, conservative and liberal political forces. This agreement was followed by the first-ever national (opposition) primaries last October, in which more than 800,000 Hungarians voted to choose the opposition's candidate for Prime Minister and its single-district candidates in 106 constituencies. Beating all expectations, Péter Márki-Zay, an independent, conservative-minded small-town mayor, emerged as the unlikely winner of the two-round primary race, defeating Klára Dobrev, an MEP from the centre-left and strongest opposition Democratic Coalition party in the runoffs.

Polls show Fidesz and the opposition – now running as United for Hungary (UfH) – are running neck-and-neck in terms of popular support, indicating the most open electoral race in more than a decade. Despite visible cracks between Márki-Zay and the leaders of the opposition parties, this represents a major challenge for Fidesz, even with the ruling party still enjoying far greater electoral experience, financial resources and media support than the opposition.

In the face of such a concerted effort to unseat him, Orbán has announced a sweeping pre-election welfare program, including tax cuts for families, entrepreneurs and young people, extra money for pensioners and salary increases in a number of sectors. Introduced in January, the program is likely to shift the public mood towards Fidesz, however it will have to be seen whether it will be enough for the party to maintain its majority.

With less than three months to go, the election is taking on seismic importance. Some of Orbán's critics argue that – similarly to his ideological ally, former US President Donald Trump, who endorsed Orbán for PM – he could even refuse to accept the election results if he loses. Pro-government media and ruling party politicians have repeatedly spoke of potential foreign interference into the elections in favour of the opposition and from the United States. While the latter certainly plays into the hands of such fears, Orbán remains unlikely to follow in Trump's footsteps.

Recent events suggest that Orbán is heavily preparing for at least the possibility of an election loss. Over recent months, the Fidesz-KDNP supermajority in the Hungarian National Assembly has taken a number of steps which critics consider are designed to keep Fidesz-friendly government officials in power if Márki-Zay forms a government. These include outsourcing state-owned wealth assets to private foundations in the education and other sectors, exempting the country's nuclear energy authority (OAH) from government control and preventing any non-two-thirds parliamentary majority from removing Hungary's top prosecutor or appointing a new one.

While the possibility of Orbán contesting the results remains unlikely, the post-election period is expected to be very heated irrespective of the result. Some members of the opposition have already spoken of possible attempts from Fidesz to rig the vote through a recent amendment to the country's election law that critics say would allow voting from fictitious addresses. With polarization in Hungarian society running high, a Fidesz win could be followed by post-election mass protests – as it was in 2018.

However, an opposition win could also bring political risks as Márki-Zay, the opposition candidate for PM, has signalled that he might change the Hungarian Constitution even without a two-thirds majority in parliament – a move that could easily trigger a constitutional crisis. Furthermore, a Márki-Zay win would mean an experimental coalition at the helm of Hungary's government. With an unprecedented, six-party coalition and a non-affiliated PM, political instability could easily return in the form of coalition fractures.

3. STRAINED TIES BETWEEN CEE COUNTRIES AND THE EU

Last year marked a new low in the European Union's already troubled relations with the Polish and Hungarian governments over their alleged breaches of the rule of law and the possibility of losing EU funding as the two countries hope to continue their post-pandemic economic recovery.

Responding to the COVID-fuelled economic downturn, the EU in late 2020 agreed on a landmark economic stimulus package aimed at driving the post-pandemic recovery for the next decade. Under the Next Generation EU (NGEU) facility, the EU has started providing €750 billion in grants and loans for its member states that is expected to inject momentum into economic growth across European markets.

While most EU member states in CEE have already received the first tranches of funding from Brussels, the European Commission has not yet endorsed the so-called National Recovery and Resilience Plans (NRRPs, needed to unlock the funds) submitted by Poland and Hungary, essentially their blocking NGEU funding. Under the NGEU agreement, Poland is entitled to €36 billion in loans and grants, while Hungary expects to receive €7.2 billion in grants.

Besides a long-running dispute between Brussels and Warsaw over Poland's controversial judicial reforms, which critics say undermine the independence of judges, the current standoff is the result of a battle over the legitimacy of Polish national law over EU legislation and court rulings, after the Polish Constitutional Tribunal in October declared parts of the EU's founding treaties incompatible with Polish law. This was preceded and followed by multiple court rulings from the European Court of Justice (ECJ) against Polish judicial reforms, as well as an infringement procedure initiated by the European Commission against Poland for violating EU law in December.

The rejection of Hungary's NRRP comes amid ongoing EU concerns of institutional corruption. So far, the Orbán Government has refused to meet EU demands for judicial reform and accused the Commission of withholding the funds over Hungary's recent introduction of a controversial law involving the LGBT+ community. Furthermore, both Poland and Hungary await a crucial verdict from the ECJ – expected for early this year – that could allow the European Commission to withhold funds under the EU's 2021-2027 budget from countries abusing the rule of law.

The continued withholding of EU funds poses a considerable risk for both Poland and Hungary as the EU's support could become a significant contributor to economic growth in 2022. While both governments are widely expected to agree with Brussels, the timing is still unclear.

4. ESCALATING TENSIONS BETWEEN RUSSIA & THE WEST

2021 has been the toughest year in terms of relations between the Western community and Russia since the beginning of the war in Ukraine's east eight years ago, after Russia mobilized tens of thousands of troops along the Ukrainian border last April, as well as at the end of last year. Kyiv and its international partners now fear a large-scale Russian invasion of Ukraine (which the Kremlin denies), while Moscow is increasingly concerned over neighbouring countries that aspire for NATO membership, particularly Ukraine.

With tensions between the two sides culminating, Russia has agreed to take part in currently ongoing high-level security talks in Geneva with the United States, NATO and the OSCE – an unprecedented series of summits focused on Ukraine. The opposing sides have put forward differing demands: the US wants guarantees for Ukraine's territorial integrity and to prevent a Russian offensive against Ukraine, while Moscow is aiming for no further NATO expansion in former Soviet countries and reducing US missile capabilities near Russia.

While the Geneva talks offer the promise of de-escalation, any major escalation in Ukraine could not only impact the country but the whole CEE region, particularly Poland, Romania and the Baltic states, which constitute NATO's eastern flank. Any intensification of the war in Ukraine could and will likely discourage international investors with an eye on the whole CEE region. As the past eight years brought deteriorating relations, including sanctions and counter-sanctions as part of an economic response to a political conflict, a new escalation could trigger further sanctions against Russia from the West, primarily the US and the European Union.

CONCLUSIONS

Political instability largely overshadowed Central and Eastern Europe last year. Under our baseline scenario, the situation is not expected to be different in 2022 as a number of CEE governments are supported by politically fragile coalitions, many of which are experimental and/or ideologically diverse. This year, investors are advised to pay special attention to political stability factors in a

number of countries, including Bosnia and Herzegovina, Poland, Romania, Bulgaria, the Czech Republic and Slovakia.

Of the upcoming electoral contests in CEE, the Hungarian general elections are expected to be the most anticipated parliamentary vote in 2022. With the Hungarian opposition running on a joint ticket for the first time in 12 years, Prime Minister Viktor Orbán faces his toughest electoral challenge since he came to power in 2010. Post-election turmoil is possible whatever the result.

While last year marked a new low in the EU's relations with Budapest and Warsaw, 2022 could bring further tensions between the EU institutions, as well as the Polish and Hungarian governments. The stakes are high as both Poland and Hungary hopes to receive post-pandemic recovery funding from the EU that could be an impetus for economic growth in the coming years.

With high-level security talks between Russia and the West taking place in Geneva, this year offers hopes of de-escalation between the two sides and their differences on Ukraine. While it is yet to be seen if the talks are successful, any major military escalation in Ukraine will negatively impact the short-term investment potential of the whole CEE region.

###

*If you would like to schedule a discussion of this paper, please contact:
Chris Dobson, Executive Partner at c.dobson@areterapa.com*



Aretera is a leading independent public affairs advisory firm operating across Central & Eastern Europe, Turkey, Ukraine, Central Asia and a growing number of global emerging markets. We advise a wide range of leading multi-national corporations, providing counsel on all aspects of public policy, public affairs and reputation management.

Aretera works to the highest international standards of transparency and compliance, partnering with global and local client teams, lawyers and global agencies, to serve our clients' needs in our regions.

www.areterapa.com