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KEY POLITICAL RISKS FACING CENTRAL & EASTERN EUROPE IN 2023

Regional political outlook on the CEE region for 2023

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EXECUTIVE SUMMARY

2022 was an incredibly challenging year for Central & Eastern Europe and this year is not expected to be any different, with significant political, economic and security risks looming over the region throughout 2023.

Russia's war against Ukraine will bring the largest set of risks for CEE this year, with severe security, political and economic implications. Governments across the region will continue to mitigate the impacts of the war, including the ongoing energy crisis, the expected economic downturn, spiralling inflation and rising living costs, while businesses face an uncertain economic environment with the risk of unwanted regulatory and budgetary changes.

While the EU is widely expected to remain united in supporting Kyiv, this year could see more tension between Brussels and both Poland and Hungary, both of which have long running disputes with EU institutions and are aiming to unlock €billions in post-pandemic EU recovery funding.

As in 2022, political instability is likely to be among the most pressing issues for international companies present in the CEE region. In the short term, Slovakia and Bulgaria will be the most impacted, with both countries likely heading for snap elections later this year, while Estonia and Poland are also scheduled to held much-anticipated parliamentary elections. Despite the challenges unleashed by the war and the risks arising from the political and economic difficulties, however, the region's underlying stability means that CEE will remain both open for business and a safe destination for investors.

Below, Aretera presents its outlook on CEE for 2023, with a focus on political risks facing the region.

This memo will cover:

- the risks stemming from Russia's continued war against Ukraine,
- political stability prospects for key CEE countries,
- an overview of major upcoming elections in 2023,
- implications for international investors.

1. RUSSIA'S WAR AGAINST UKRAINE

Resulting from its severe consequences for European and global security, Russia's all-out war against Ukraine will constitute the largest political risk for Central & Eastern Europe in 2023, driving fears of a potential military escalation.

With no end to the war in sight, analytical consensus suggests Russia will proceed with its conventional war efforts in Ukraine's south and east, while additionally targeting Ukraine's critical infrastructure. Following up on its first major and ultimately successful counteroffensive during the second half of 2022, Ukraine is likely to be preparing new strategic counterattacks to defend itself. Simultaneously, much will depend on the domestic political situation in Russia; any domestic revolt against the war, although unlikely for now, would almost certainly disrupt the Russian war machine. While Russian threats to Ukraine's staunchest Central European supporters will remain, along with Vladimir Putin's nuclear saber-rattling, our baseline scenario assumes that war will not expand beyond the border of NATO countries.

At the same time, CEE countries, particularly those on NATO's eastern flank, have to actively and continuously calculate with a number of security threats, including the Kremlin's hybrid warfare and efforts to undermine regional support to Ukraine. In this regard, countries to watch include Poland and the Baltic states, Ukraine's staunchest regional supporters, Bulgaria, which, as revealed by a recent landmark investigation by WELT, provided covert support to Kyiv in the early stages of the invasion, as well as Russia-allied Belarus, which might be dragged into the war more actively, and Moldova, which remains exposed to the threats of Russian expansionism, due to its territorial dispute with Moscow over Transnistria.

Additional to conventional security threats, the economic fallout from Russia's war remains a major concern not only to CEE but to the whole of Europe. Over the past 11 months, the war has been the largest contributor to Europe's spiralling inflation, growing budgetary strains, ongoing energy crisis and overall economic downturn, and will continue to highly impact European energy and food markets as well as regional and global supply chains.

2. EU DISUNITY ON UKRAINE & RUSSIA

The countries of the West have reacted decisively to Russia's actions in Ukraine. Adding to pre-existing restrictive measures over Russia's annexation of Crimea in 2014 and involvement in the East Ukrainian War, the European Union – often criticized for its complicated and lengthy decision-making process – has introduced nine sanctions packages against Russia since the start of the invasion on 24 February 2022. These include a series of individual, financial and economic sanctions, export and import restrictions and a gradually introduced oil embargo.

An outlier in terms of support for sanctions has been Hungary, which has expressed criticism towards the bloc's sanctions regime against Moscow over alleged economic fears. The government of Prime Minister Viktor Orbán has also been running a domestic political campaign against EU sanctions, arguing that the economic costs outweigh the expected results. The Hungarian PM has also looked to remove a selected number of Russian figures from the EU's sanctions list, although Hungary has stopped short of vetoing joint EU sanctions against Russia.

As the war continues, Russia's actions in Ukraine will top the political agenda of EU institutions, as well as the Swedish[1] and consecutive presidencies of the Council of the EU. Accordingly, pressure will mount on the European bloc to give a firm response to Russian war crimes, the targeting of Ukrainian civilians and prospective Russian-led escalations, given that a potential weakening of EU support is among the top political concerns facing Ukraine in 2023.

Under our baseline scenario, the EU and the West – despite ongoing debates about the scope of military aid to Kyiv – will remain united in its response to Russia's war and supporting Ukraine militarily, politically and economically. The European bloc has recently disbursed the first, €3billion-worth tranche of its €18billion-worth 2023 financial aid package to Ukraine, aimed at ensuring the country's financial stability. In spite of the political debates over sanctions, Western military aid also remains robust, with the United States, the United Kingdom and Poland among Kyiv's top military providers. At the same time, skirmishes between Hungary and the rest of the EU member states about the details of the bloc's responses are likely to remain.

3. UNSTABLE GOVERNMENTS & UNWANTED ELECTIONS

For a number of CEE countries, politics has become increasingly dominated by often fragile multi-party alliances. Domestic political conflicts, ideological and other divides between political parties, the cost-of-living crisis currently experienced in several countries, and tensions over the political and economic impacts of the war could lead to unstable governments and fractures within governing coalitions.

Domestic political (in)stability is likely to be among the most pressing issues this year for international companies present in the CEE region. Countries likely to be among the most impacted include Slovakia, where 2022 ended with the fall of Prime Minister Eduard Heger's centre-right coalition government[2] following months of political and personal disputes. Slovakia is now heading for early parliamentary elections likely to be held later this year in September. The snap election provides the opposition centre-left parties with an opportunity for a political comeback, and is likely to contribute to the launch of new political formations in an already crowded field of ideologically diverse political parties.

Political instability will also continue in Bulgaria. Last October, the country's fourth snap parliamentary election in just 18 months – which came after the collapse of the reformist government of ex-Prime Minister Kiril Petkov – again produced a hung parliament, with a set of ideologically diverse parties crossing the threshold for admittance to the Bulgarian National Assembly. Since the election, no party has been able to form a functioning governing majority and coalition, with another round of snap elections – likely to be held in the coming months – looming on the horizon.

In 2023, Hungary tops our list of CEE countries with a politically stable outlook. Last April, the ruling Fidesz-KDNP alliance secured its fourth consecutive two-thirds majority in the Hungarian National Assembly. Support for Viktor Orbán's Fidesz has been waning following a series of post-election austerity measures, skyrocketing inflation and Hungary's cost-of-living crisis, but Fidesz is unlikely to be unchallenged in 2023 as the opposition, which suffered a crushing defeat at the polls last April, remains structurally divided, deeply unpopular and lacks a credible leader.

[1] See here for Aretera's overview of the results of the Czech Presidency of the EU and our expectations for the current, Swedish EU Presidency from January 2022
[2] See here for Aretera's overview of the collapse of the Heger Government from December 2022

Neighbouring Romania, also one of the region's largest markets, is preparing for a major government reshuffle later this year. Under a coalition deal from 2021, which provided an unlikely solution to the country's political crisis at the time, the country's grand coalition government – consisting of the centre-right National Liberal Party (PNL), the centre-left Social Democrats (PSD) and the ethnic Hungarian UDMR – will undergo a major restructuring, potentially resulting in the reshuffling of key ministerial portfolios and positions between the major ruling PSD and PNL.

Elsewhere in Southeast Europe, Slovenia entered 2023 after holding crucial parliamentary and presidential elections and a referendum last year, resulting in a change of a government and a new, centre-left President, Nataša Pirc Musar. Going forward, the prospects of the country's recently restructured three-party coalition government – led by green-centrist Prime Minister Robert Golob – remain stable, with the government preparing for introducing reforms in various policy areas.

In neighbouring Croatia, the two-party minority government of centre-right Prime Minister Andrej Plenković is credited with the country's long-awaited admittance to the EU's Schengen Area, as well as joining the Eurozone on 1st January. However, despite the promising start to this year, Plenković's minority cabinet will continue to rely on external support in the Croatian parliament.

UPCOMING ELECTIONS

Key National Electoral Races to Watch in Central & Eastern Europe in 2023		
Country	**Type of Election**	**Date**
Czech Republic	Presidential	January
Estonia	Parliamentary	April
Poland	Parliamentary	October/November
Ukraine	Parliamentary	November
Possible Snap Elections in 2023		
Country	**Type of Election**	**(Foreseeable) Date**
Bulgaria	Parliamentary	TBD
Slovakia	Parliamentary	September

Following a tumultuous election season in 2021 and a lower number of (still significant) elections in CEE in 2022, this year will see crucial elections in the Czech Republic, Estonia and Poland. 2023 started with presidential elections in the Czech Republic[3] where retired army general Petr Pavel will face billionaire former Prime Minister Andrej Babiš in the presidential run-off vote in late January to determine the successor to outgoing Czech President Miloš Zeman.

Elsewhere in the region, Estonia is preparing for parliamentary elections, in which Prime Minister Kaja Kallas' centrist Estonian Reform Party stands good chances of leading the country's next governing coalition but will also face a strong challenge from the right-wing populist EKRE party.

[3] See here for Aretera's overview of the first round of the Czech presidential elections from January 2023

In a much-anticipated electoral contest that will decide the political future of Central Europe's largest economy, Polish voters will head to the polls this autumn to elect the country's next parliament. Poland's right-wing governing coalition – led by the major ruling Law and Justice party (PiS) – saw a considerable challenge to keep its voter base in wake of the war-fuelled cost-of-living crisis with the country's multi-party opposition preparing to unseat the PiS-led coalition.

Ukraine was also scheduled to hold parliamentary elections this year, although it remains unlikely whether the election will be held. In addition to scheduled national elections, Slovakia and Bulgaria are both likely to hold snap parliamentary elections following the collapse of government in Bratislava last December and Bulgaria's latest inconclusive snap parliamentary vote. Both snap elections include the possibility of the opening (or continuation) of an unwanted electoral cycle.

4. CONTROVERSIAL REGULATORY & BUDGETARY CHANGES

Russia's war against Ukraine has placed an unprecedented economic burden and budgetary strain on a number of CEE economies, creating social discontent over spiraling consumer prices and forcing governments to implement austerity measures. In general, a wartime period entails a higher level of political and economic uncertainty, which potentially leads to rapid and unexpected regulatory changes at the national level, often without a normal consultation process.In crisis situations, changes in the regulatory environment may also include amended legal orders, as in Hungary where the Orbán Government, having imposed a national emergency due to the war in Ukraine, has essentially been governing by decree ever since. From the perspective of international companies present in the region, this primarily meant rapidly increasing costs in 2022. Last year saw a number of CEE governments – including Bulgaria, Croatia, the Czech Republic, Hungary, Slovakia, Slovenia and Romania – introducing special tax regimes imposed on a number of sectors (particularly banking and energy).

While most of these taxes were imposed with the natural idea of general and proportionate sharing of taxation, some have been strongly criticized. Imposed last May, Hungary's special tax regime, which imposed extra budgetary burdens on eight different industries (significantly more than in other regional economies), was criticized for targeting underperforming international companies in the aviation and other sectors. At the same time, the Hungarian government stressed that the measures are temporary and most of them will be phased out by the end of 2023.

5. STRAINED RELATIONS BETWEEN CEE & THE EU

Following months of political disputes at the EU level over alleged breaches of the rule of law in Poland and Hungary, 2022 ended with what many view as a possible step towards the reconciliation of ties in the relations of Budapest and Warsaw with EU institutions.

Last December, EU member states – under a deal[4] brokered by the Czech Presidency of the EU – unlocked Hungary's €5.8 billion in EU recovery funding under the bloc's post-pandemic economic recovery program. In turn, the Hungarian government vowed to undertake a series of judicial and transparency reforms needed to disburse the funds, dropped its longstanding opposition to joint EU financial aid to Ukraine for 2023 and approved the lengthily debated 15% global corporate minimum tax within the EU (albeit in exchange for a national exemption).

[4] See here for Aretera's overview of the Czech-brokered EU-Hungary agreement on Ukraine aid, global taxation and EU funds from December 2022

While the EU also moved to temporarily suspend nearly €22 billion in cohesion funds to Hungary, the bloc's approval of Hungary's recovery funding has been seen as extremely significant, since it can play a crucial role in adding to economic growth. Ongoing access to these funds, however, remains subject to the implementation of judicial reforms demanded by the EU. Our baseline scenario assumes that the Hungarian government, despite ongoing political disputes with Brussels, will aim to undertake all reforms needed to receive all cohesion and recovery funds.

The European Commission, the EU's top executive body, approved Poland's post-pandemic recovery funds worth more than €35 billion in grants and preferential loans last June, conditioning the disbursement of the funds to "rule-of-law milestones." For the months that followed, the Polish government, citing political pressure from Brussels, was reluctant to undertake the reforms needed to unlock the much-needed recovery funds. However, Poland's ruling PiS backtracked and moved to push new legislation aimed at rolling back controversial judicial changes through parliament. While the bill was approved by the lower house of parliament (Sejm) on 13th January, it subsequently divided both the governing coalition and the Polish opposition parties, with the eventual law now subject to potential amendments in the opposition-led upper house (Senate) and the signature of PiS-allied Polish President Andrzej Duda, who has also expressed reservations about the bill, leaving the potential outcome uncertain at the time of writing.

LOOKING AHEAD

2022 was an undoubtedly challenging year for CEE and this year is expected to bring further political, economic and security risks for the region. At the same time, 2023 will also bring considerable opportunities, while some takeaways from last year also give reason for optimism.

While Bulgaria and Romania are yet to achieve this goal, Croatia became the latest CEE country to join the EU's Schengen Area, also introducing the Euro this year. Despite domestic challenges, both Bucharest and Sofia remain committed to join the Schengen Zone, with Bulgaria also aiming to adopt the Euro in 2024.

Away from the challenges unleashed by Russia's war, the region's underlying stability means that CEE remains both open for business and a safe destination for investors. Several multinational companies in all sectors have committed further to the region and to supporting Ukraine as the war continues.

For Europe, Ukraine's recovery and reconstruction will be the theme of the year in 2023. In addition to continued Western military, financial and humanitarian aid to Kyiv, the G7 and the European Union, along with CEE governments, are making preparations to support Ukraine's recovery as part of what is expected to be one of the largest economic reconstruction efforts in history, with CEE countries and corporations in the region well-positioned to support this historic reconstruction.

Among the key takeaways from 2022 is that interest in investing in CEE countries is also growing. Foreign investments into Poland, the region's largest economy, totalled €3.7 billion last year, €200 million more than in 2021 and €1 billion more than in 2020, with Germany the main source of FDI. Hungary saw a record-breaking, €6.5 billion-worth of foreign investment last year, with South Korea topping the value of investments and Germany bringing the largest number of new jobs. FDI into Romania reached nearly €10.3 billion during the first nine months of 2022, €2.3 billion more than in the corresponding period of 2021, while Bulgaria's FDI grew by 4.7% in the same period.

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If you would like to schedule a discussion of this paper, please contact:
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