

2. CESEE Overview: Darkest before the dawn?

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2.1. CESEE HAS SACRIFICED PUBLIC HEALTH TO KEEP THE ECONOMY GOING OVER THE WINTER

CESEE economies will continue their recovery from the COVID-19-driven downturn this year, but at an uneven pace and with risks to the downside. The key determinant of the economic performance of CESEE economies this year will be a combination of the development of the virus and its various mutations, the speed at which vaccinations are rolled out, and the way in which governments and populations react to this. Our forecasts are being undertaken at a time of unprecedented uncertainty (Figure 1.3).

CESEE's strong public health performance during the pandemic's first wave has not been repeated in the second, reflecting the actions of both governments and citizens. Whereas during the first wave CESEE's good economic performance was partly *because of* good health management, in the second wave public health appears to have been sacrificed in an attempt to keep the economy going. During late winter and spring 2020, as the pandemic arrived in Europe, CESEE countries by and large got on top of it early. They generally imposed tough restrictions on economic life, despite low numbers of infections (especially compared with Western Europe) (Grieveson et al., 2020a). This limited the spread materially during the first wave, and meant that they could reopen their economies more quickly. However, the second wave has been quite different. Despite a sharp rise in cases in CESEE from October/November 2020, governments have mostly not reacted by imposing stiff restrictive measures, while CESEE residents have failed to adapt their behaviour as much as during the first wave.

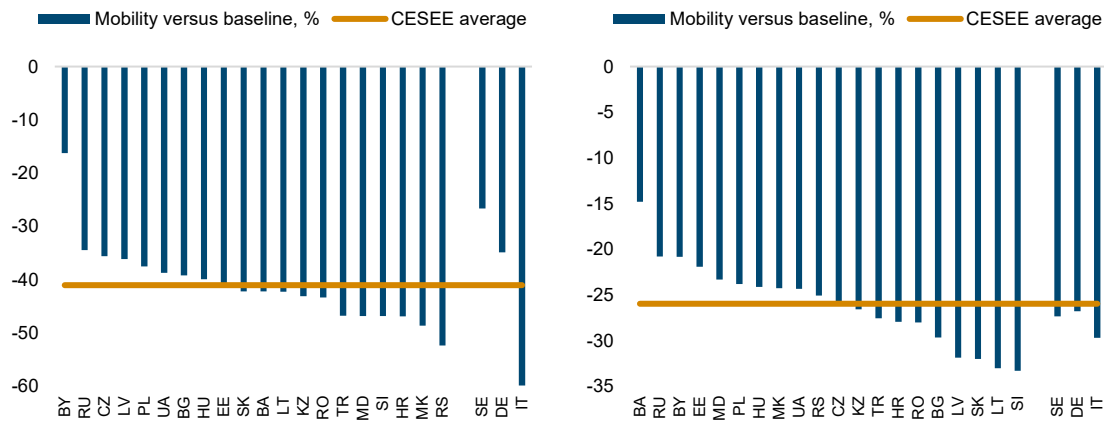
The data show significant differences in terms of both restrictions and mobility, compared with the first wave. Workplace mobility data, for example, show that during the first wave, CESEE residents recorded an average mobility decline of 41% (Figure 2.1, left-hand chart).⁴ During the second wave, however, workplace mobility was down by only 26%.⁵ It is also noticeable that during the first wave, almost all CESEE countries recorded a much more substantial decline in workplace mobility than Sweden (a country that famously took a looser approach) and Germany (a proxy for the Western European average). In the second wave, the CESEE average in terms of workplace mobility decline was less than in both of those countries. From the government side, the data on the extent of the restrictions tell a similar story (Figure 2.2). Whereas in the first wave, CESEE countries on average introduced much stiffer restrictions than European and global benchmarks, over the winter months measures have generally been much looser than in their developed country peers.

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⁴ We use mid-March to mid-May 2020 to represent the first wave.

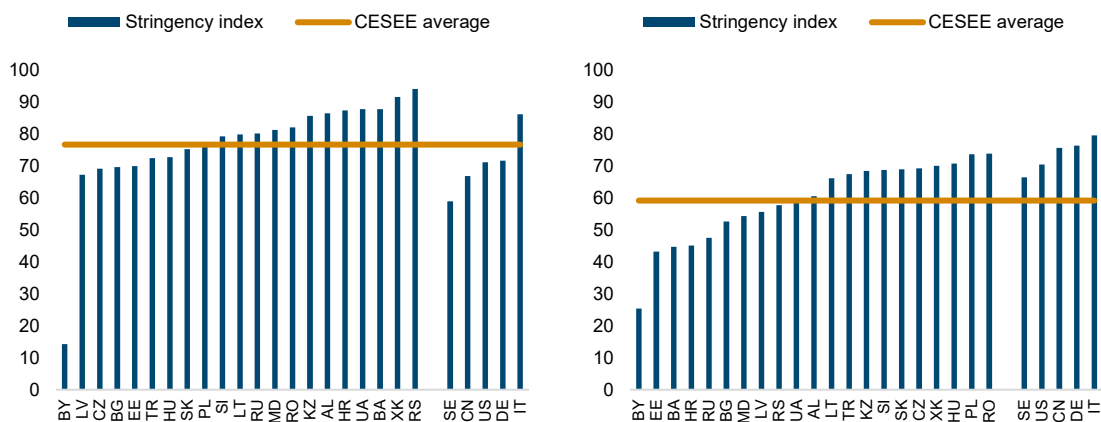
⁵ We use November 2020 to February 2021 to represent the second wave.

Figure 2.1 / Workplace mobility versus baseline: 15 March - 15 May 2020 (left) and November 2020 - February 2021 (right), %



Source: Google.

Figure 2.2 / Stringency index: 15 March – 15 May 2020 (left) and November 2020 - February 2021 (right)



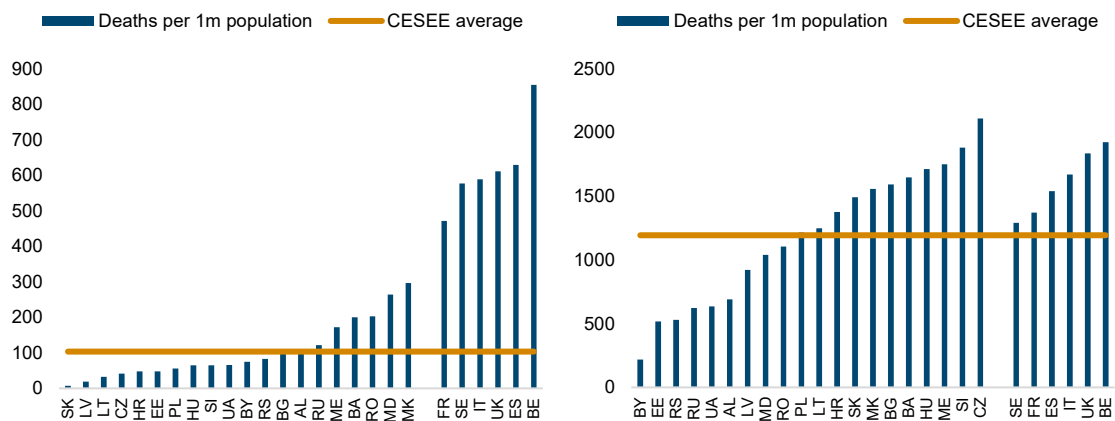
Note: 100 denotes the most restrictive measures; 0 denotes the least restrictive measures.
Source: Oxford Blavatnik School of Government.

The public health implications of this have been disastrous. Whereas during the first wave, CESEE death rates were well below those seen in Western Europe, as of March 2021 the death rates from COVID-19 in many CESEE countries have been worse than the hardest-hit countries of Western Europe (Figure 2.3). Data on ‘excess deaths’ provide perhaps the most accurate picture of the public health situation.⁶ In 2020 as a whole, the number of deaths in many CESEE countries was over 10% higher than the 2015-2019 average (Figure 2.4), with particularly big increases in Kazakhstan and North Macedonia (both around 24%). In mid-March 2021, CESEE countries occupied most of the top places in the

⁶ ‘Excess deaths’ are the difference between the number of deaths recorded in a specific period and those that would be expected to occur in the same period of time, based on historical averages. For COVID-19, a typical measure of excess deaths has been to compare total deaths in 2020 with the average number of deaths per year in 2015-2019.

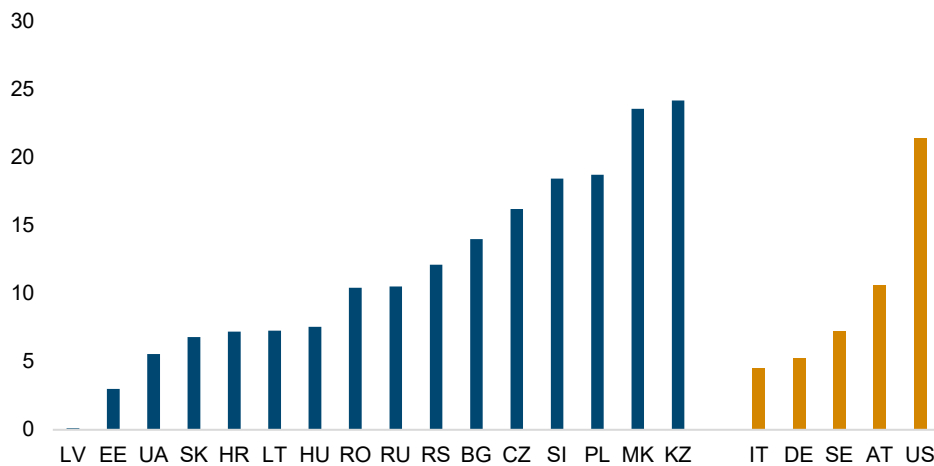
Economist's global excess deaths tracker.⁷ Measured in terms of excess deaths per 100,000 population, Russia, North Macedonia, Bulgaria, Lithuania and Serbia occupied the top places in CESEE (Figure 2.5).

Figure 2.3 / Deaths related to COVID-19 per 1m population, as of September 2020 (left) and March 2021 (right)



Source: Worldometer.

Figure 2.4 / Increase in total number of deaths in 2020 compared with 2015-2019 average, %

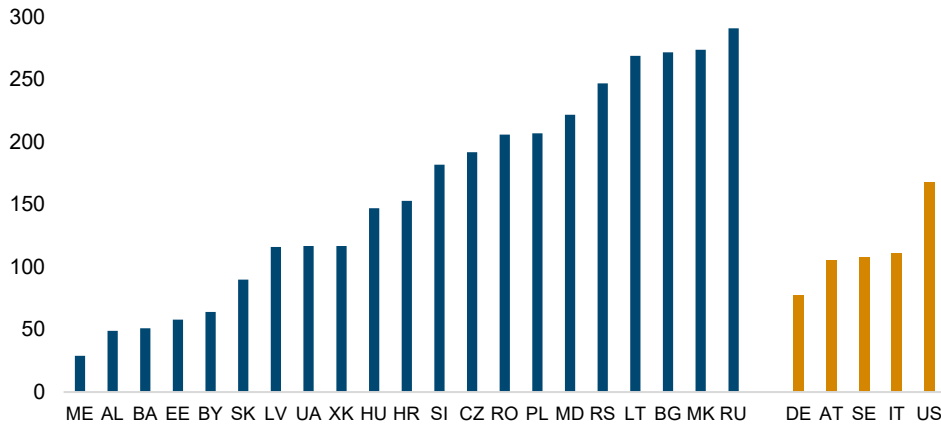


Source: Our World in Data, wiiw calculations.

⁷ *The Economist's* excess deaths tracker monitors excess deaths since the country's first 50 COVID-19 deaths, and adjusts for population size. As of 9 March (the most recent update at the time of writing), Russia, North Macedonia, Bulgaria, Lithuania, Serbia, Moldova, Poland, Romania and Czechia were all in the top 15 in the world.

<https://www.economist.com/graphic-detail/coronavirus-excess-deaths-tracker>

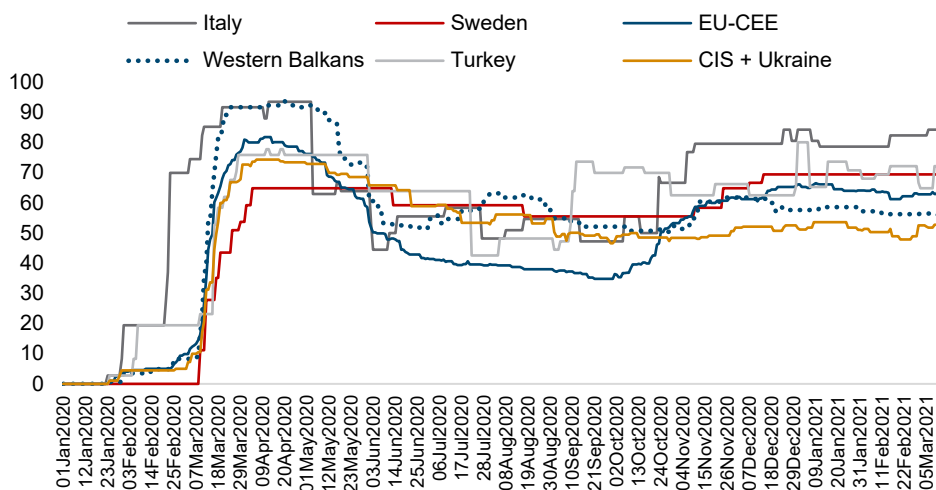
Figure 2.5 / Excess deaths from COVID-19 per 100,000 people, as of mid-March 2021



Source: *The Economist*.

This approach may have kept the economy going in the short term, but the public health implications could necessitate a longer period of restrictions in the spring, with repercussions for economic growth. As a result of the rapid spread of the virus, many CESEE countries are being forced to return to lockdown. In the first half of March, countries including Czechia, Estonia, Poland and Hungary significantly increased the restrictions on economic life. This tightening will certainly weigh on economic activity, even if the impact may not be as damaging to economic activity as during the first wave.

Figure 2.6 / Stringency index



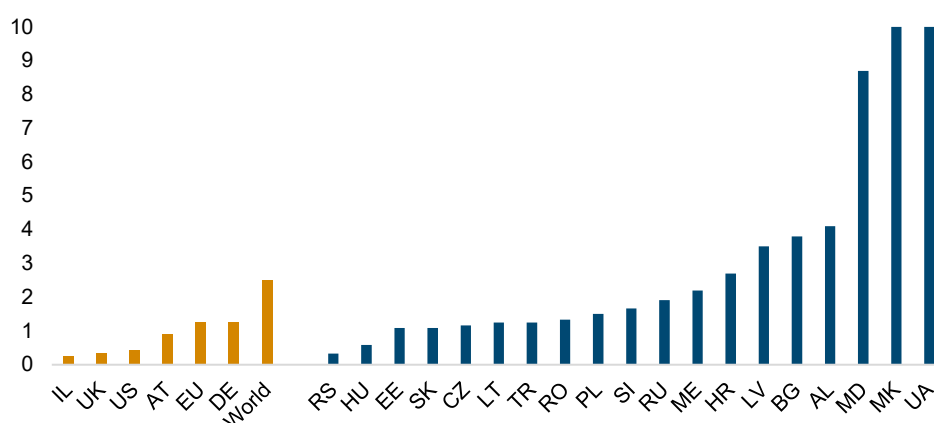
Note: Data are simple averages for each sub-region; 100 denotes the most stringent; 0 denotes the least stringent.
 Source: Oxford Blavatnik School of Government, wiiw calculations.

So far, this renewed tightening of measures has largely been confined to the EU member states of CESEE, with economies in the Western Balkans, CIS and Ukraine apparently striving to avoid increased restrictions (Figure 2.6). At the time of writing, both the Western Balkans and the CIS + Ukraine have, on average, restrictions that are considerably looser than the famously relaxed Sweden

(Figure 2.6). There are various possible reasons for this. It may partly be because these are mainly CESEE's poorer countries, and so they do not have the resources to keep large swathes of the economy shut down, or to provide support for business and workers. Another factor could be the low level of trust in government and institutions, which makes it harder and more politically costly to implement and enforce further lockdowns. Whatever the reasons, the apparent general reluctance of non-EU CESEE countries to introduce further lockdowns may well not last, and these countries may have to increase restrictions during the spring to stop healthcare systems being overwhelmed.

Escaping the latest tight set of lockdowns will require an increase in the pace of vaccination, but this is proceeding at very different speeds across CESEE. While some countries can hope to reach herd immunity this year, others seem to have no chance, and this will affect economic performance. According to Bloomberg's COVID-19 data tracker (as of 26 March), it will take most CESEE countries several years to vaccinate 75% of their population at the current rates of progress (Figure 2.7). These data show that EU-CEE countries generally are in a better position, reflecting their involvement in EU-wide purchase programmes. Some – including Hungary, Czechia and Slovakia – have also turned to Russia. Serbia and Turkey are likewise making reasonable progress, in part owing to vaccines from Russia and China; this is thanks to the generally good relations that Serbia and Turkey have with those two countries. For others, especially Ukraine, North Macedonia and Moldova, unless vaccination rates speed up considerably, their governments will continue to face a choice between very harsh lockdowns and a dire public health situation. Those countries certainly need international help, above all from the World Health Organization's COVAX scheme, which so far has been inadequate. Even a rapid vaccination programme will not be enough; some restrictions on economic life will have to remain in place as well.

Figure 2.7 / Years until 75% of population are vaccinated, based on current vaccination rates



Source: Bloomberg COVID-19 data tracker.

It is likely that, for most CESEE countries, the lingering effects of the pandemic will be more severe than in Western Europe. CESEE will not see a definitive 'end' to the pandemic this year. And many CESEE countries look set to be struggling to vaccinate the necessary share of their populations even by next winter; as a result, looking beyond 2021, it would seem quite possible that the number of cases and deaths as a share of the population will be higher than in Western Europe.

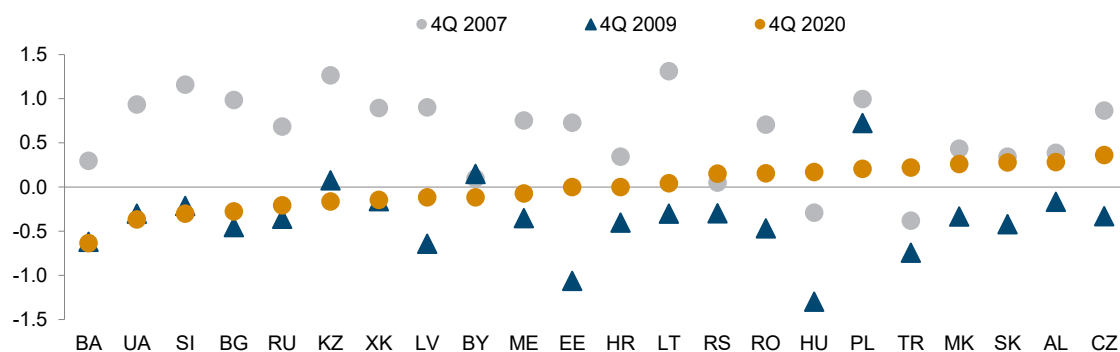
2.2. GDP GROWTH: SPLUTTERING INTO LIFE

In economic terms, CESEE performed much better than Western Europe in 2020. On a weighted average basis, the CESEE economies contracted by 2.3% last year (see Table 2.1). This was a milder downturn than was suffered by the global economy (-3.4% according to the OECD), and substantially better than the euro area (-6.8%). The top performers in the region were Turkey (the only economy in CESEE to grow, by 1.8%), Lithuania (-0.8%), Belarus (-0.9%) and Serbia (-1%). Easily the worst-affected country was Montenegro (-15.2%), followed by Croatia (-8.4%). It is not clear that any sub-region of CESEE was hit especially worse than any other. The weighted average decline in real GDP in CESEE in 2020 was 3.9% in EU-CEE, 3.5% in the Western Balkans and 3.1% in the CIS and Ukraine. However, the range of outcomes between the best and the worst performers in CESEE was the highest for over a decade, reflecting the huge differentiation in terms of impact. The difference between real GDP growth in Turkey and Montenegro was almost 17 percentage points (p.p.).

BOX 2.1 / BUSINESS CYCLE INDEX: MOSTLY NOT AS BAD AS IN 2009

The main story from our Business Cycle Index is that, for most countries, the situation is not as bad as in 2009 – at the nadir of the global financial crisis (Box Figure 2.1). Using a four-quarter trailing average of 11 indicators, we find that Bosnia, Ukraine, Slovenia, Bulgaria, Russia, Kazakhstan, Belarus and Montenegro are all at, or close to, the point they had reached at the end of 2009, at least on average; meanwhile, Poland is at a substantially lower point in the business cycle (Poland did not go into recession after the 2008 crisis). For all other CESEE countries, the average impact across the indicators considered is not as bad as in 2009, with the outperformance versus 2009 particularly strong in Estonia, Hungary and Turkey. The full breakdown (Box Table 2.1) shows that – relative to the historical average – GDP has taken an especially big hit, while fiscal policy is noticeably counter-cyclical almost everywhere. The other important point to note from the breakdown is that the unemployment situation is materially better than the historical average, indicating that – at least on the basis of official data – the labour market has not taken much of a hit so far (see section 2.4 for more analysis).

Box Figure 2.1 / wiiw Business Cycle Index, Q4 2020, headline data



Note: Number of standard deviations from historical mean, average of 11 indicators (see next figure for full list).

Sources: wiiw Monthly Database incorporating national statistics and Eurostat ; BIS; wiiw calculations.

Box Table 2.1 / wiiw Business Cycle Index, Q4 2020, full breakdown

	Domestic economy			External finance			Domestic finance				
	Real GDP	Unemployment	CPI	CA	RER	External debt	RIR	Private credit	Broad money	Fiscal balance	Property prices
BG	-2.59	1.20	-0.71	-0.64	0.55	-1.13	-0.39	-0.42	-0.56	1.70	-0.04
CZ	-2.90	1.63	0.78	-2.04	0.92	1.35	1.75	-0.58	0.64	1.50	0.96
EE	-1.27	0.56	-1.65	-0.52	1.16	0.06	-0.97	-0.45	0.15	3.04	-0.10
HR	-2.91	1.57	-1.34	-0.01	-0.81	-0.03	0.22	-0.06	0.08	1.70	1.60
HU	-2.56	1.21	-0.32	-0.53	-1.19	-0.59	1.92	0.85	1.42	1.81	-0.12
LT	-1.02	0.51	-0.52	-2.04	1.20	0.38	0.27	-0.61	0.90	1.24	0.18
LV	-1.19	0.78	-0.92	-1.09	0.86	0.28	-0.30	-0.54	-0.26	1.15	-0.06
PL	-3.47	1.33	0.59	-2.87	-0.76	0.14	2.07	-0.89	1.60	2.58	1.96
RO	-2.08	0.91	-0.61	-0.09	0.00	0.21	0.85	-0.53	-0.39	2.51	0.96
SI	-2.37	1.03	-1.23	-1.74	-0.63	0.45	-0.65	-0.28	0.47	1.14	0.52
SK	-2.65	1.55	-0.43	-1.13	0.84	2.20	0.84	-0.76	0.24	1.90	0.46
AL	-3.60	1.40	-0.90	-0.15	2.18	1.13	1.50	-0.46	0.06	1.66	
BA	-3.28	1.58	-1.29	-1.22	-2.16	0.47	-0.86	-0.93	-0.50	1.83	
ME	-4.42	0.78	-0.84	0.65	0.58	2.08	-0.20	-0.39	-0.73	1.80	
MK	-2.48	2.23	-0.37	-0.13	-0.67	1.69	0.99	-0.63	-0.61	2.84	0.03
RS	-1.45	1.89	-0.57	-0.59	0.94	0.39	-0.03	-0.26	-0.38	2.37	-0.61
XK	-3.84	1.40	-0.55	-0.67	0.47	1.05	0.84	-0.66	-0.29	0.78	
TR	-0.76	-1.62	-0.24	0.49	-2.38	1.98	0.67	0.11	0.95	0.42	2.83
BY	-1.25	1.55	-0.64	-1.17	-1.41	1.20	-0.27	-0.52	-0.77	2.12	
KZ	-2.32	0.87	-0.50	0.69	-1.27	0.97	-1.16	-0.41	-0.49	2.02	
RU	-1.66	0.55	-1.32	1.10	-0.49	-0.45	0.20	-0.57	-0.65	1.33	-0.29
UA	-1.03	-0.76	-0.94	-0.92	-0.39	0.33	-0.68	-0.84	0.14	1.43	

overheating > 1 SD above historical average underheating > 1 SD below historical average

Notes: CPI: consumer price index; CA: current account; RER: real exchange rate (EUR) CPI deflated, values more than 100 means appreciation and vice versa; RIR: real interest rate CPI deflated. Data for unemployment, current account, real interest rate, fiscal balance are inverted (as for these indicators lower values would indicate overheating). Historical mean calculated for 4Q 2000 - 4Q 2020. Calculations are based on four-quarter trailing averages.

Sources: wiiw Monthly Database incorporating national statistics and Eurostat; BIS; wiiw calculations.

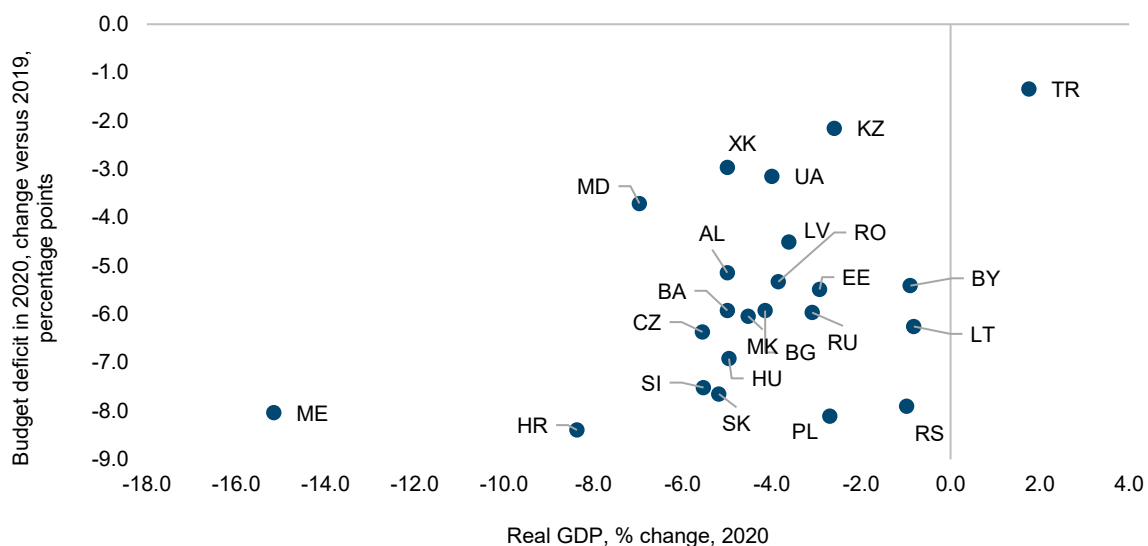
CESEE's overall quite robust performance relative to Western Europe owed a lot to better management of the pandemic during the first wave. As outlined above, most countries in CESEE reacted quickly and decisively, with restrictions on economic life already very high in mid-March 2020, even though at that time CESEE had very few confirmed cases (Grieveson et al., 2020a). As a result, CESEE countries could reopen their economies relatively quickly over the summer. From late May 2020, most countries in CESEE had restrictions on economic life similar to – or looser than – Sweden's, a country considered extremely loose by Western European standards (see Figure 2.6 above). During Q2 and Q3 last year, we find a strong positive correlation between health outcomes and economy performance (Jovanovic, 2021). The outperformance also reflected the generally lower share of services in GDP in CESEE, relative to Western Europe (Astrov et al., 2020).

On the expenditure side of GDP, on average across CESEE private consumption, investment and net exports all made a negative contribution to headline growth. Household consumption contributed negatively to growth in 2020 in all countries except Bulgaria, Kosovo, Turkey and Ukraine. This is hardly surprising, considering the hit to confidence, the supply constraints (i.e. shops and restaurants being closed for long periods) and the general uncertainty. Only Estonia, Romania, Turkey and Kazakhstan recorded positive contributions for gross fixed capital formation (this was especially strong in Estonia; see

country report). Meanwhile net exports were more mixed, adding to growth in 11 countries of CESEE and subtracting from it in the other 12. It seems that trade diversion may have played a part in supporting exports, while in some countries demand from outside the region (e.g. from China) was very supportive, even as core European markets recovered weakly. Net exports were also naturally boosted by the often much deeper decline in imports than exports, owing to weak domestic demand in CESEE and, in some cases, to currency depreciations. However, the biggest negative contributions for net exports came in countries with a particularly heavy reliance on tourism (Croatia and Montenegro) or with an especially large domestic demand (and consequently import) stimulus last year (Turkey). On the flipside, in all but five countries (Hungary, Slovakia, Montenegro, Belarus, Ukraine) government spending added to headline growth.

One of the key drivers of difference between the CESEE countries was fiscal policy, reflecting varying amounts of policy space, but also levels of willingness and capacity to use it. For many countries, sharp GDP contractions occurred in tandem with a hefty fiscal loosening, indicating how much worse it could have been in the absence of fiscal stimulus. For a few, especially Poland and Serbia, decisive fiscal loosening was accompanied by comparatively mild declines in real GDP, suggesting quite a successful counter-cyclical reaction to the downturn. Others (such as Croatia and Montenegro) posted huge fiscal deficits and a sharp decline in GDP. A further group of countries did not have the option to significantly loosen fiscal policy, either because of their inability to finance a large deficit, or because of the difficulty of implementing rapid large-scale emergency fiscal spending (e.g. Bosnia and Herzegovina and Kosovo).

Figure 2.8 / Relationship between real GDP performance and fiscal policy in 2020



Sources: Eurostat, national sources, wiiw estimates and calculations.

Table 2.1 / OVERVIEW 2019-2020 AND OUTLOOK 2021-2023

	GDP					Consumer prices				
	real change in % against prev. year					average change in % against prev. year				
	2019	2020	Forecast			2019	2020	Forecast		
		2021	2022	2023			2021	2022	2023	
BG Bulgaria	3.7	-4.2	2.5	3.1	3.4	2.5	1.2	1.5	1.5	2.0
CZ Czechia	2.3	-5.6	2.9	3.2	3.9	2.6	3.3	2.1	2.0	2.0
EE Estonia	5.0	-2.9	1.2	3.8	4.3	2.3	-0.6	1.3	1.7	2.0
HR Croatia	2.9	-8.4	4.5	4.6	3.7	0.8	0.0	1.0	1.4	1.5
HU Hungary	4.6	-5.0	3.9	4.5	4.0	3.4	3.4	3.9	3.5	3.5
LT Lithuania	4.3	-0.8	2.1	3.8	3.5	2.2	1.1	1.8	2.7	3.3
LV Latvia	2.0	-3.6	2.8	4.2	3.8	2.7	0.1	1.2	2.5	3.5
PL Poland	4.5	-2.7	3.4	3.6	4.4	2.1	3.7	3.0	2.5	2.5
RO Romania	4.1	-3.9	3.8	4.5	4.0	3.9	2.3	3.2	3.5	3.5
SI Slovenia	3.2	-5.5	3.6	4.0	3.3	1.7	-0.3	1.3	1.7	1.6
SK Slovakia	2.3	-5.2	3.6	4.4	3.5	2.8	2.0	1.4	2.0	2.0
<i>EU-CEE11</i> ¹⁾²⁾	3.9	-3.9	3.4	3.9	4.0	2.6	2.7	2.6	2.6	2.6
<i>EA19</i> ³⁾	1.3	-6.6	3.8	3.7	2.0	1.2	0.3	1.1	1.2	1.4
<i>EU27</i> ³⁾	1.6	-6.2	4.2	4.1	2.4	1.4	0.7	1.3	1.4	1.6
AL Albania	2.2	-5.0	4.5	4.4	3.8	1.4	1.6	2.1	2.4	2.6
BA Bosnia and Herzegovina	2.8	-5.0	2.5	2.9	3.3	0.6	-1.1	0.6	0.8	1.0
ME Montenegro	4.1	-15.2	6.5	5.0	3.7	0.4	-0.3	0.9	1.5	1.5
MK North Macedonia	3.2	-4.5	4.1	3.4	3.2	0.8	1.2	1.5	1.8	2.0
RS Serbia	4.2	-1.0	5.0	4.4	4.2	1.7	1.6	2.0	2.4	2.2
XK Kosovo	4.9	-5.0	4.8	4.6	3.9	2.7	0.2	1.5	1.7	2.0
<i>WB6</i> ¹⁾²⁾	3.6	-3.5	4.4	4.0	3.8	1.4	0.9	1.6	2.0	2.0
TR Turkey	0.9	1.8	5.8	3.4	3.5	15.2	12.3	16.0	12.0	10.0
BY Belarus	1.4	-0.9	1.5	1.9	2.2	5.6	5.5	6.5	6.0	6.0
KZ Kazakhstan	4.5	-2.6	3.2	4.1	4.4	5.3	6.7	6.3	5.9	5.5
MD Moldova	3.6	-7.0	4.0	4.5	3.5	4.8	3.8	4.0	4.5	5.0
RU Russia	2.0	-3.1	3.2	2.7	2.3	4.5	3.4	5.0	3.5	3.2
UA Ukraine	3.2	-4.0	3.5	3.2	3.0	7.9	2.7	7.0	6.0	5.0
<i>CIS4+UA</i> ¹⁾²⁾	2.4	-3.1	3.2	2.8	2.6	5.0	3.7	5.4	4.1	3.7
<i>V4</i> ¹⁾²⁾	3.9	-3.8	3.4	3.7	4.2	2.4	3.4	2.8	2.5	2.5
<i>BALT3</i> ¹⁾²⁾	3.9	-2.1	2.1	3.9	3.8	2.4	0.4	1.5	2.4	3.1
<i>SEE9</i> ¹⁾²⁾	3.8	-4.3	3.9	4.2	3.8	2.8	1.6	2.4	2.6	2.7
<i>CIS3+UA</i> ¹⁾²⁾	3.5	-3.1	3.1	3.4	3.5	6.5	4.7	6.6	5.9	5.3
<i>non-EU12</i> ¹⁾²⁾	2.0	-1.7	4.0	3.0	2.9	7.8	6.2	8.4	6.3	5.5
<i>CESEE23</i> ¹⁾²⁾	2.6	-2.3	3.8	3.3	3.2	6.2	5.1	6.7	5.2	4.6

Table 2.1 / (ctd.)

	Unemployment (LFS)					Current account				
	rate in %, annual average					in % of GDP				
	2019	2020	Forecast			2019	2020	Forecast		
			2021	2022	2023			2021	2022	2023
BG Bulgaria	4.2	5.2	5.0	4.5	4.5	3.0	0.1	0.5	0.5	0.1
CZ Czechia	2.0	2.6	3.1	3.2	2.9	-0.3	3.2	2.2	2.8	2.4
EE Estonia	4.4	6.8	7.5	7.0	6.5	2.0	-0.9	-1.0	0.2	1.2
HR Croatia	6.6	7.5	7.0	7.0	7.0	2.7	-4.1	0.2	1.0	1.5
HU Hungary	3.4	4.3	4.2	4.3	4.3	-0.5	0.1	0.0	0.0	0.1
LT Lithuania	6.3	8.5	8.0	7.0	6.5	3.3	8.0	5.1	4.4	4.0
LV Latvia	6.3	8.1	8.0	6.8	6.5	-0.6	3.0	1.6	0.3	-1.2
PL Poland	3.3	3.6	4.0	4.0	3.8	0.5	3.5	2.5	1.7	2.0
RO Romania	3.9	5.5	5.5	4.5	4.0	-4.7	-5.0	-5.0	-4.6	-3.9
SI Slovenia	4.5	5.1	5.5	4.6	4.3	5.6	7.3	6.2	5.8	5.4
SK Slovakia	5.8	6.7	8.2	7.6	7.0	-2.7	-0.3	-0.2	-0.1	-0.5
<i>EU-CEE11</i> ¹⁾²⁾	3.8	4.5	4.9	4.6	4.3	-0.2	1.4	0.9	0.7	0.8
<i>EA19</i> ³⁾	7.6	8.0	8.9	8.4	8.1	3.0	3.0	3.0	3.0	3.0
<i>EU27</i> ³⁾	6.7	7.3	8.2	7.7	7.4	2.9	2.9	2.9	2.9	2.9
AL Albania	11.5	11.7	11.4	11.2	11.0	-8.0	-8.9	-8.5	-7.2	-6.9
BA Bosnia and Herzegovina	15.7	18.0	17.6	16.1	15.3	-3.1	-3.3	-4.5	-4.6	-4.6
ME Montenegro	15.1	17.0	17.0	16.0	16.0	-15.0	-26.0	-20.9	-18.5	-16.1
MK North Macedonia	17.3	16.4	16.0	15.5	15.0	-3.3	-3.5	-3.3	-3.7	-3.7
RS Serbia	10.4	9.0	8.0	7.5	7.0	-6.9	-4.3	-5.6	-6.5	-7.3
XK Kosovo	25.7	26.5	26.0	25.0	24.5	-5.6	-6.3	-6.9	-6.9	-5.7
<i>WB6</i> ¹⁾²⁾	13.4	13.2	12.4	11.8	11.2	-6.3	-5.7	-6.3	-6.5	-6.7
TR Turkey	13.7	13.2	13.4	12.5	11.1	0.9	-5.1	-3.8	-3.6	-3.5
BY Belarus	4.2	4.0	4.1	4.2	4.3	-1.9	-0.4	-0.4	-0.9	-1.1
KZ Kazakhstan	4.8	4.9	4.9	4.8	4.8	-4.0	-3.5	-3.1	-1.9	-0.9
MD Moldova	5.1	3.8	5.0	4.0	3.0	-9.3	-7.1	-9.0	-8.4	-7.0
RU Russia	4.6	5.8	5.5	5.2	5.0	3.8	2.2	3.2	3.6	3.6
UA Ukraine	8.2	9.5	9.0	8.0	8.0	-2.7	4.1	2.0	0.6	-0.2
<i>CIS4+UA</i> ¹⁾²⁾	5.2	6.2	5.9	5.6	5.4	2.4	1.7	2.3	2.6	2.7
<i>V4</i> ¹⁾²⁾	3.3	3.8	4.2	4.2	4.0	-0.1	2.6	1.8	1.6	1.6
<i>BALT3</i> ¹⁾²⁾	5.9	8.0	7.9	6.9	6.5	1.9	4.3	2.6	2.2	1.8
<i>SEE9</i> ¹⁾²⁾	7.4	8.0	7.9	7.2	6.8	-3.1	-4.3	-3.9	-3.7	-3.4
<i>CIS3+UA</i> ¹⁾²⁾	6.6	7.2	7.0	6.4	6.4	-3.3	-0.1	-0.9	-1.0	-0.9
<i>non-EU12</i> ¹⁾²⁾	7.5	8.0	7.9	7.4	7.0	1.7	-0.4	0.3	0.5	0.6
<i>CESEE23</i> ¹⁾²⁾	6.6	7.2	7.2	6.7	6.3	1.0	0.3	0.5	0.6	0.7

1) wiiw estimates. - 2) Current account data include transactions within the region (sum over individual countries). -

3) Forecasts estimated by wiiw.

Source: wiiw, Eurostat. Forecasts by wiiw. Cut-off date for historical data and forecasts: 25 March 2021.

Our core scenario is that the region's economies will emerge gradually from the current wave during the spring, with fairly robust rates of real GDP growth during the second and third quarters of the year. Those countries currently suffering badly will turn the tide via harsh lockdowns, and will gradually reopen as vaccination rates improve.

We expect the strongest growth in 2021 to be posted in Southeast Europe, including Turkey, Croatia and several Western Balkan countries (Table 2.2). Turkey has undergone its customary V-shaped recovery, and although there are increasing risks (see country report), the latest data suggest that a growth rate of close to 6% will be achievable this year. Serbia will also perform strongly, reflecting an advanced vaccination drive and strong policy support. Some of the other countries that we expect to perform best this year will benefit from extremely favourable base effects. These include especially Croatia and Montenegro. Although the outlook for the summer tourist season is highly uncertain, our best guess is that it will be better than last year. Even though arrivals from abroad are likely to be well down on pre-pandemic levels, the improvement over 2020 will generate considerable growth.

Table 2.2 / Real GDP growth forecasts and revisions

		Forecast, %		Revisions, pp	
		2021	2022	2021	2022
EU-CEE	BG	2.5	3.1	↑ 0.8	↑ 0.5
	CZ	2.9	3.2	↓ -1.0	↓ -0.3
	EE	1.2	3.8	↓ -2.7	↑ 0.8
	HR	4.5	4.6	↓ -0.5	↑ 0.6
	HU	3.9	4.5	↑ 0.9	↓ -0.1
	LT	2.1	3.8	↓ -2.4	↑ 0.6
	LV	2.8	4.2	↓ -1.6	↑ 1.4
	PL	3.4	3.6	↓ -0.1	↑ 0.2
	RO	3.8	4.5	↑ 0.1	→ 0.0
	SI	3.6	4.0	↓ -0.9	↑ 1.0
	SK	3.6	4.4	↓ -0.5	↑ 0.5
Western Balkans	AL	4.5	4.4	↓ -0.1	↑ 0.4
	BA	2.5	2.9	↓ -0.7	↓ -0.2
	ME	6.5	5.0	↑ 1.5	↑ 0.9
	MK	4.1	3.4	↓ -0.4	↓ -0.6
	RS	5.0	4.4	↑ 0.5	↑ 0.3
	XK	4.8	4.6	→ 0.0	↑ 0.3
Turkey	TR	5.8	3.4	↑ 1.7	↓ -1.2
CIS+UA	BY	1.5	1.9	↑ 2.7	↑ 0.6
	KZ	3.2	4.1	↑ 0.7	↑ 0.1
	MD	4.0	4.5	→ 0.0	↑ 0.5
	RU	3.2	2.7	↑ 0.7	↑ 0.6
	UA	3.5	3.2	↑ 1.5	↓ -0.4

Note: Current forecast and revisions relative to the wiiw November forecast 2020. Colour scale variation from the minimum (red) to the maximum (green).

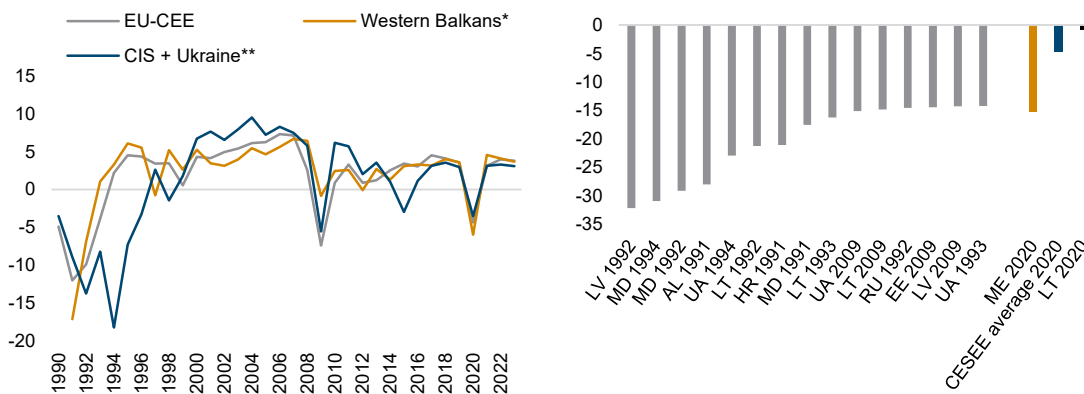
Source: wiiw.

BOX 2.2 / THE CRISIS IN CONTEXT FOR CESEE

While the current downturn is the worst for the global economy since the Second World War, CESEE has actually experienced much worse within living memory (Box Figure 2.2). Only Montenegro suffered a decline in real GDP in 2020 that was in any way comparable to the worst CESEE experiences faced during the early 1990s transition recessions or in the immediate aftermath of the 2008 global financial crisis. Using unweighted averages, we can see that the 2020 downturn was worse than in 2009 for both EU-CEE countries and (especially) the Western Balkans (Box Figure 2.3). However, for Turkey and the CIS and Ukraine, 2020 was a much better year than 2009. Given the weight of Turkey and Russia in the overall average, last year was substantially better for CESEE as a whole than 2009, on a weighted basis.

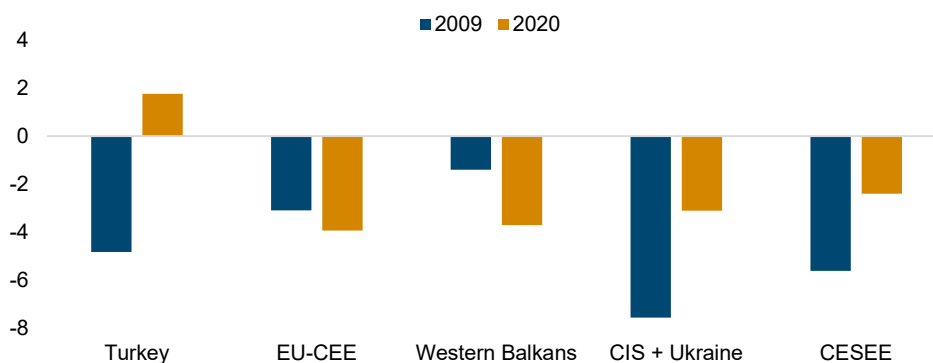
Box Figure 2.2 / Real GDP growth, percentage change per year

regional averages (left) and CESEE's 15 worst post-1989 years compared with the range of outcomes in 2020 (right)



Note: Left-hand chart shows simple averages. Turkey is excluded from these charts, as it did not experience the transition recessions of the early 1990s. *Average includes Albania and North Macedonia from 1991, Serbia from 1996, Bosnia and Herzegovina and Montenegro from 2000, and Kosovo from 2001. **Average includes Russia and Ukraine from 1990, and Belarus, Kazakhstan and Moldova from 1991.
Source: National sources, wiiw.

Box Figure 2.3 / Real GDP growth, %

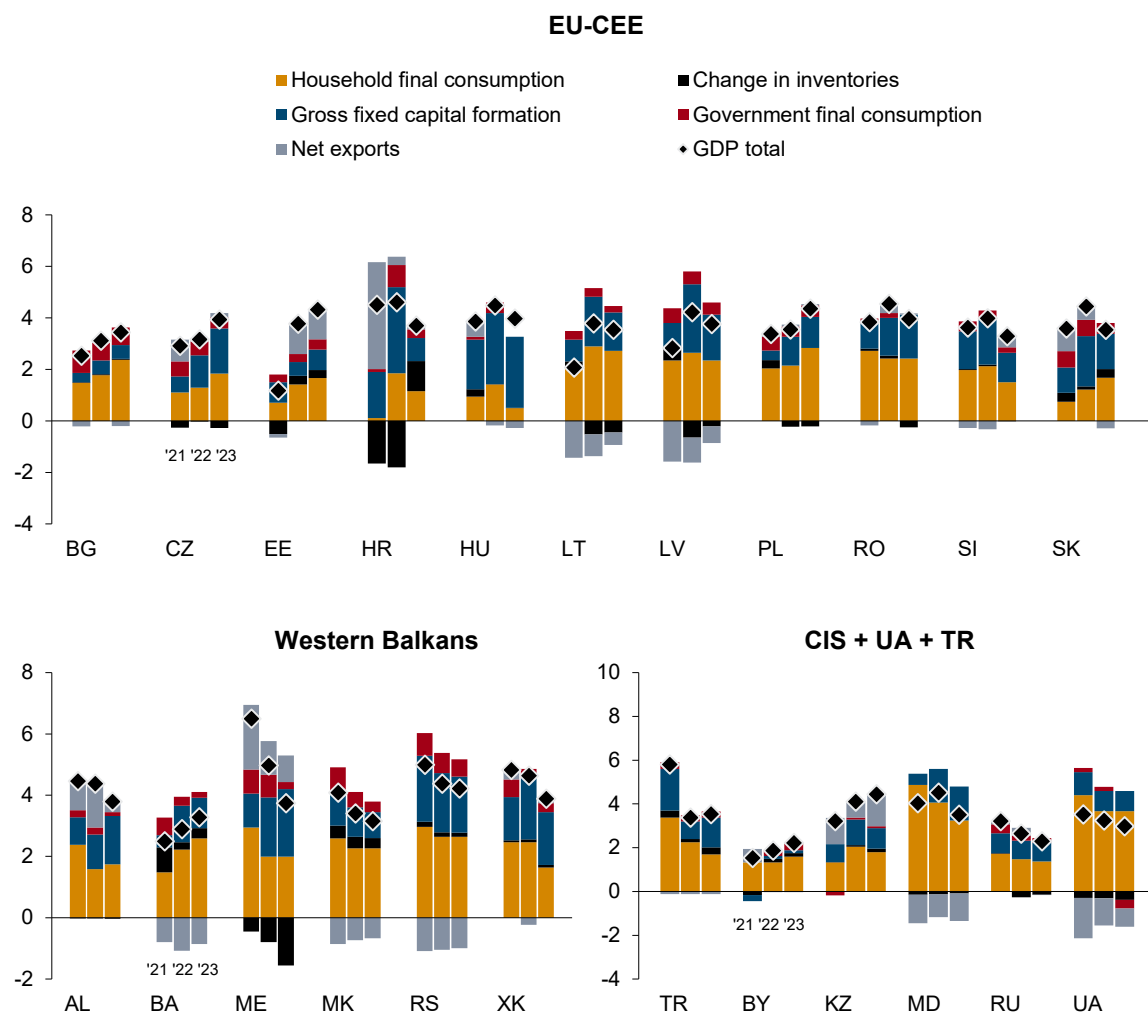


Note: Data are weighted averages.
Source: National sources, wiiw.

Given that last year was better than expected, we have made quite a few downward revisions for 2021, reflecting the combination of a higher base and the reimposition of lockdowns in much of the region (Table 2.2). We expect 2021 growth to be lower than previously forecast in eight EU-CEE and three Western Balkan countries. Our downward revisions are particularly large for the Baltic states, reflecting the fact that they provided among the most positive surprises last year, and will therefore have a higher base than we had previously anticipated. Our most notable upward revisions are for Belarus, Ukraine and Turkey. For Belarus, this reflects greater confidence about external funding coming from Russia, the resumption of oil and gas deliveries from Russia to Belarus, and the rise in oil prices. For Ukraine, our improved forecast reflects higher prices for commodity exports. In Turkey, the upgrade reflects very strong recent high-frequency data, the large credit impulse, robust industrial and export performance, and an expectation that monetary conditions will be loosened during the rest of the year.

Figure 2.9 / GDP growth forecast for 2021-2023

and contribution of individual demand components, in percentage points



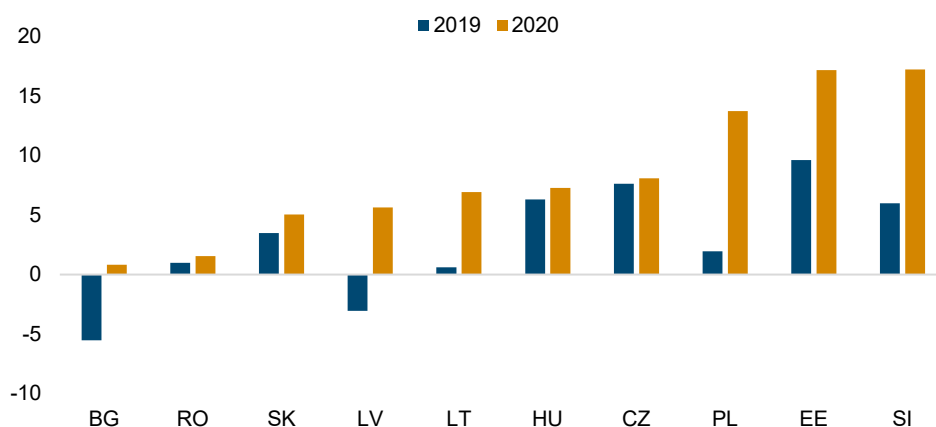
Source: Forecasts by wiiw.

In 2021, CESEE overall is unlikely to continue to outperform the euro area. We expect average (weighted) growth in CESEE in 2021 to be 3.8%, a very similar rate to that of the euro area as a whole. To a large extent, this reflects the fact that CESEE did so much better last year, and so therefore the base is higher relative to the euro area. However, the key reason for the less spectacular performance in 2021 will be the harsh second/third/fourth wave that has hit the region, and the consequent need to impose tighter lockdowns at the start of 2021 to get on top of things. We are also less optimistic than previously about the extent to which restrictions can be loosened this year. The main summer months may well again see very loose restrictions, as in 2020, but the extent to which the region can generate serious economic growth will depend on the much looser restrictions continuing for significantly longer than last year.

Across CESEE in 2021 and beyond, growth will be driven by a combination of exports of goods and services as the global economy recovers, the drawing-down of savings, better domestic sentiment as vaccination rates increase, and more (albeit less than last year) fiscal and monetary support. Private consumption will return as the main driver of growth almost everywhere in 2021 and across the forecast period; but in EU-CEE investment will also make a big contribution on the back of rising inflows of EU funds (Figure 2.9). In countries that were hardest hit by the tourism shock last year – Croatia, Montenegro and Albania – net exports should make a positive contribution this year.

Once the latest lockdowns are eased and sentiment picks up, consumer spending could rise strongly. In those countries for which comparable data are available, household savings rates increased substantially last year, especially in the Baltic states, Poland and Slovenia (Figure 2.10). It seems reasonable to expect at least a partial drawdown of these savings by the second half of the year, which would provide a sizeable boost for purchases of consumer durable goods and overall private consumption growth.

Figure 2.10 / Net saving rates of households and non-profit institutions serving households

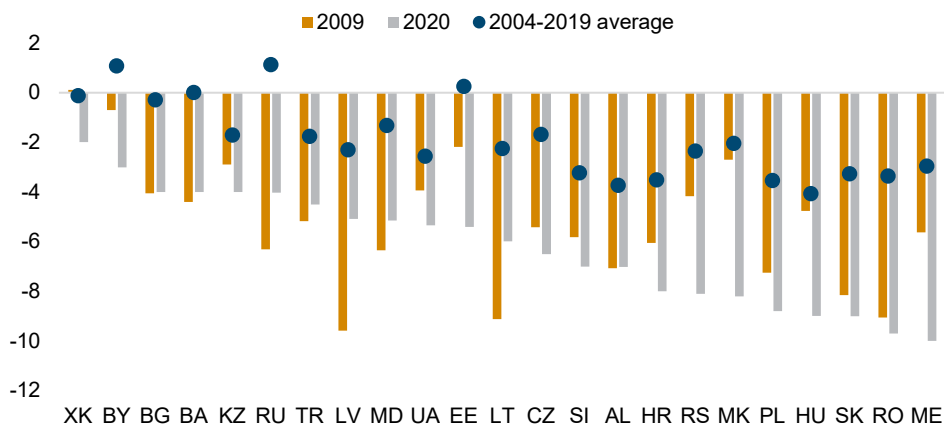


Source: OECD.

2.3. POLICY RESPONSE: MORE OPTIONS THAN AFTER 2008

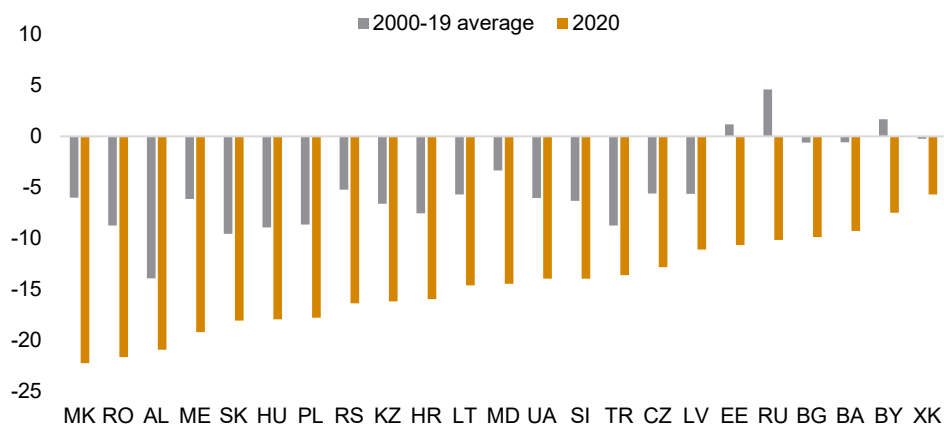
The fiscal response to the current crisis in CESEE has been much more substantial than at any point in recent decades. Every country in CESEE in 2020 ran a fiscal deficit far above its average since 2004 – and for most, considerably bigger even than in 2009, immediately following the global financial crisis (Figure 2.11). Using the ‘budget deficit ratio’ – the budget deficit as a share of total government expenditure – we also identify an unusually big policy response in 2020 (Figure 2.12).⁸ There are two main reasons for this. First, the scale and unusual nature of the pandemic, which forced governments to respond decisively in order to prevent what could have been a much more severe social fallout. Second, a lot of assumptions about fiscal policy have changed since 2009. Then, austerity was the dominant narrative, accompanied by fears of inflation and assumptions that both central banks and finance ministries faced very tight constraints on their actions. After more than a decade of massively increased money supply, with barely a hint of consumer price inflation (real estate and other asset markets are, of course, a different matter), many think differently. Thanks to the glut of global liquidity, the effective interest rate on public debt has collapsed in most countries of CESEE for which data have been available since 2009 (Figure 2.13). We do not know what a ‘safe’ level of public debt is as a share of GDP, but under current conditions it is substantially higher than it was in 2009. This has increased policy makers’ confidence in acting more decisively with fiscal policy this time.

Figure 2.11 / Budget balance, % of GDP



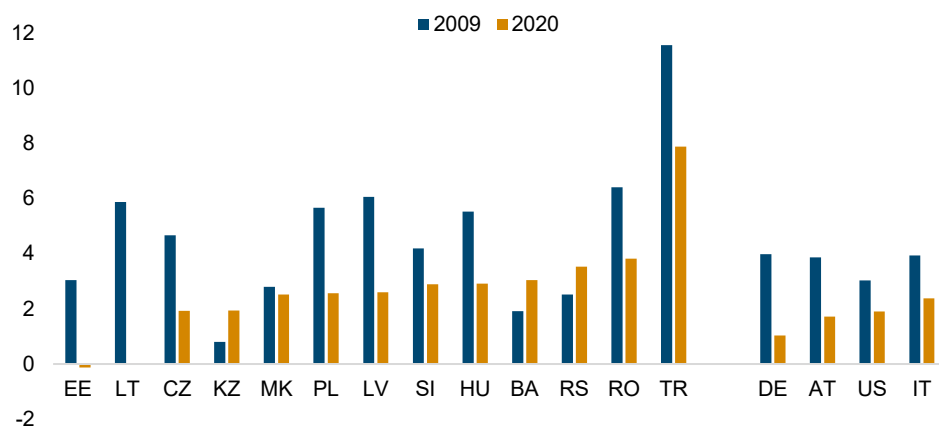
Source: wiiw Annual Database incorporating national statistics and Eurostat.

⁸ The ‘budget deficit ratio’ is used by economic historians to understand previous periods of high inflation. Historically, a budget deficit ratio above 20% has been found to be an explanatory variable for subsequent periods of high inflation.

Figure 2.12 / Budget deficit ratio, %

Note: Budget deficit ratio = budget deficit divided by government expenditure.

Source: wiiw Annual Database incorporating national statistics and Eurostat, wiiw calculations.

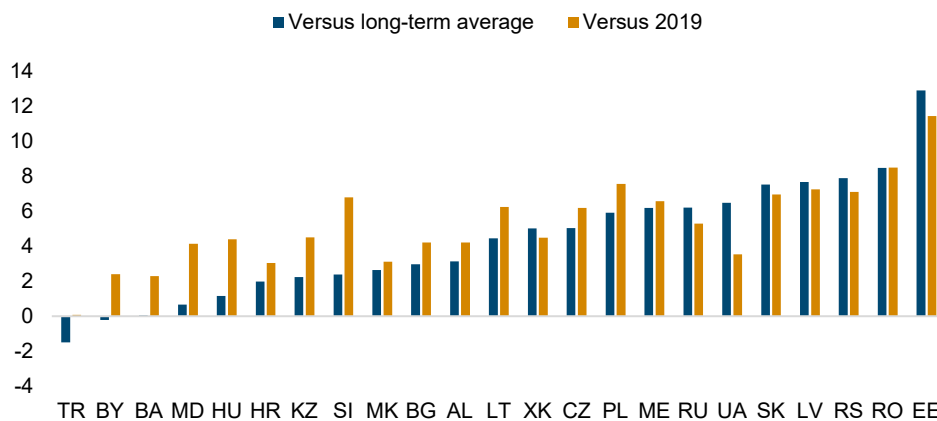
Figure 2.13 / Effective interest rate on public debt, %

Note: Effective interest rate on public debt calculated as interest payments (primary budget balance - overall budget balance) divided by net public debt.

Sources: IMF, wiiw calculations.

Fiscal policy will not be able to repeat its heroics of 2020 in most of the region, and the long road to fiscal consolidation will begin this year. However, the lingering effects of the pandemic, combined with the continued very favourable financing conditions, mean that in a lot of countries the pace of consolidation is likely to be very slow. Public expenditure as a share of GDP rose to multi-year highs last year (Figure 2.14). On average, general government outlays as a share of GDP were 4.1 p.p. higher than the long-term average (2000-2019) and 5 p.p. higher than in the previous year. In most cases, the fiscal deficit for 2021 should not be dramatically smaller than in 2020 (and even then, mostly on account of a cyclical increase in tax revenues, rather than a change in the fiscal policy stance), and we do not expect this to be fully unwound during the forecast period; the size of the state in CESEE may well have been increased permanently by this crisis.

Figure 2.14 / General government expenditure as a percentage of GDP – 2020 versus long-term average and 2019, p.p.

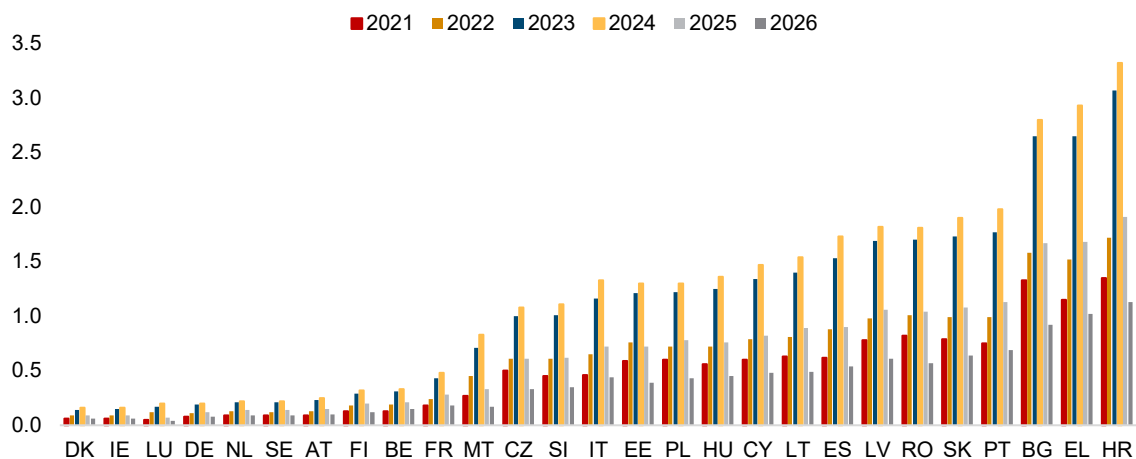


Note: Long-term average = 2000-2019.

Source: wiiw Annual Database incorporating national statistics and Eurostat, wiiw calculations.

EU-CEE countries are going to get a lot of money from the EU to boost fiscal space in the coming years. The EU has been criticised for lacking a fiscal response comparable to that of the US or other developed countries; but the various funds are a huge step forward and potentially represent something of a game-changer for countries in EU-CEE. Funds include both the existing EU budget (Multiannual Financial Framework – MFF) from which EU-CEE countries have historically benefited (and continue to do so) and the Next Generation EU (NGEU) funds – a temporary instrument set up in response to the current pandemic. The NGEU has several components, but the most important is the Recovery and Resilience Facility (RRF). The MFF for 2021-2027 totals EUR 1.074trn, while the NGEU is worth an additional EUR 750bn. Together they therefore amount to around EUR 1.8trn. Importantly, around 70% of NGEU funds are planned for 2021-2022. Allocations to member states will be based on population size, wealth levels and the unemployment rate in recent years relative to the EU average.

Figure 2.15 / Estimated allocations under the NGEU programme, % of GNI



Source: Zsolt Darvas, Bruegel.

Much remains uncertain about the EU funds, but it seems that some of EU-CEE's hardest-hit countries are in line for fairly sizeable inflows. Estimates by Zsolt Darvas of the Bruegel think tank show that Croatia will be the single biggest recipient of NGEU loans and grants as a share of gross national income (GNI) in coming years (Figure 2.15). Both Croatia and Bulgaria are entitled to 1% of GNI this year, 2% in 2022 and 3% in 2023. Along with some Southern European countries, all the major recipients of NGEU funds will be EU-CEE countries.

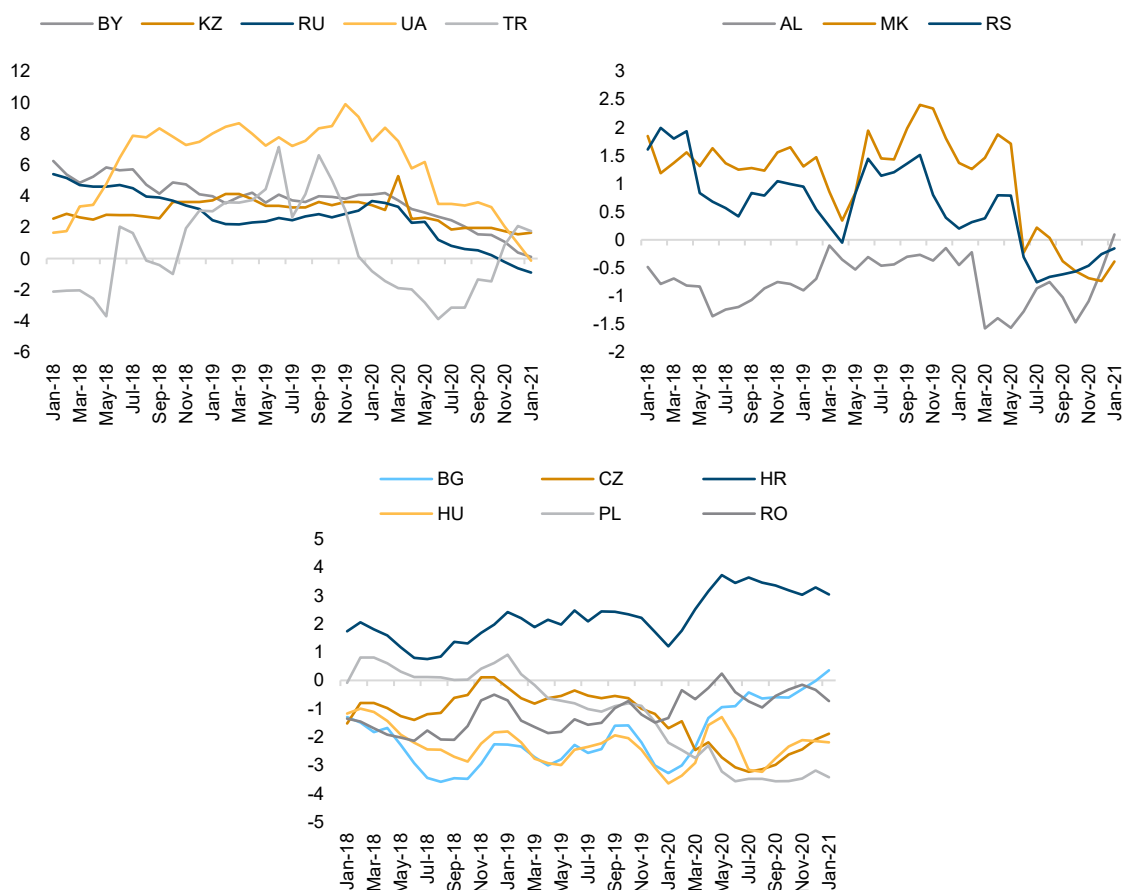
However, as the last 15 years in EU-CEE have shown, the challenges surrounding absorption capacity mean that entitlement to EU funding does not necessarily translate into actual receipt of it. It remains to be seen whether EU-CEE countries can convert these large allocations into concrete public investment and other productive forms of spending. Countries must also prepare plans and get approval from the Commission, and the deadline for submission of these plans is the end of April 2021. At least for 2021, we are quite cautious about the possible impact of NGEU plans on headline growth; however, we believe that from 2022 the impact could be more significant.

The second key question is the extent to which the EU will manage to concretely tie fund disbursement to rule-of-law abuses, and the extent to which this will limit allocations for at least some EU-CEE countries. The last decade or so seems to indicate that while Brussels is certainly upset about the undermining of institutional independence in parts of EU-CEE – especially, but not exclusively, Hungary – its ability to take concrete action is very limited. Over the past few years, Hungary has been among the largest recipients of EU funds as a share of its GDP. However, two things create the possibility that this time things could be different. First, the sheer size of the additional NGEU funds on top of the existing EU budget has raised the stakes. Such a disbursement of money has brought an increased desire in several northwestern EU member states to see that it is spent properly. Second, and linked to this, at the end of 2020 the EU – in the teeth of Hungarian and Polish opposition – did push through a mechanism to restrict EU funds to any member state where corruption in the use of such funds has been established (the Rule of Law Conditionality Mechanism). This may not yet affect the core issue of the undermining of independent institutions; but it could well be that a Rubicon has been crossed that will allow the EU to go much further than in the past in restricting EU funds for countries such as Hungary (see the Hungary country report for a further discussion of this). In a recent interview, Commission Vice President Věra Jourová used tough language in suggesting that the EU will not shy away from taking concrete steps as early as this year (Bodoni and Simon, 2021).

For the rest of CESEE, there will be much less outside help, and so fiscal policy is unlikely to be much of a growth driver. Some non-EU countries, such as Kazakhstan and Russia, certainly have policy space to use, should they so wish; but particularly the latter is likely to use only a fraction of what it could. The options for countries such as Belarus and Ukraine are much more limited. In the Western Balkans, some external financing options exist, but so far only Serbia has sought to maximise them. Its success in managing the downturn well using fiscal policy may inspire others to use currently favourable financing options to do the same this year (although this will be easier for some than for others). Bosnia and Herzegovina is a particularly difficult case: limited financing options and a complicated constitutional set-up that hampers effective policy implementation will prevent a major role for fiscal policy in managing the recovery. For the Western Balkans as a whole, more involvement in EU financing mechanisms would be a game-changer, while having barely any impact on the budget of the EU itself (Grievson et al., 2020b). However, the chances of this happening seem close to zero.

For CESEE as a whole, monetary policy has been less important as a strong crisis-fighting mechanism, given that many countries went into 2020 with low or negative real policy rates. Only in the CIS, Ukraine and Turkey (where the move has now largely been reversed) has there been substantial policy loosening (measured as a decline in real interest rates) since the start of 2020 (Figure 2.16). On the same basis, there has only been much more moderate loosening in parts of the Western Balkans and EU-CEE. However, this does not mean that central banks in EU-CEE and the Western Balkans have not responded: rather, they have followed Western central banks in resorting to other monetary tools to stimulate the economy, such as quantitative easing. Central banks – including those of Hungary, Croatia, Poland, Romania, Turkey and Serbia – have bought government bonds since the pandemic started.

Figure 2.16 / Real policy rates, consumer price index adjusted, %



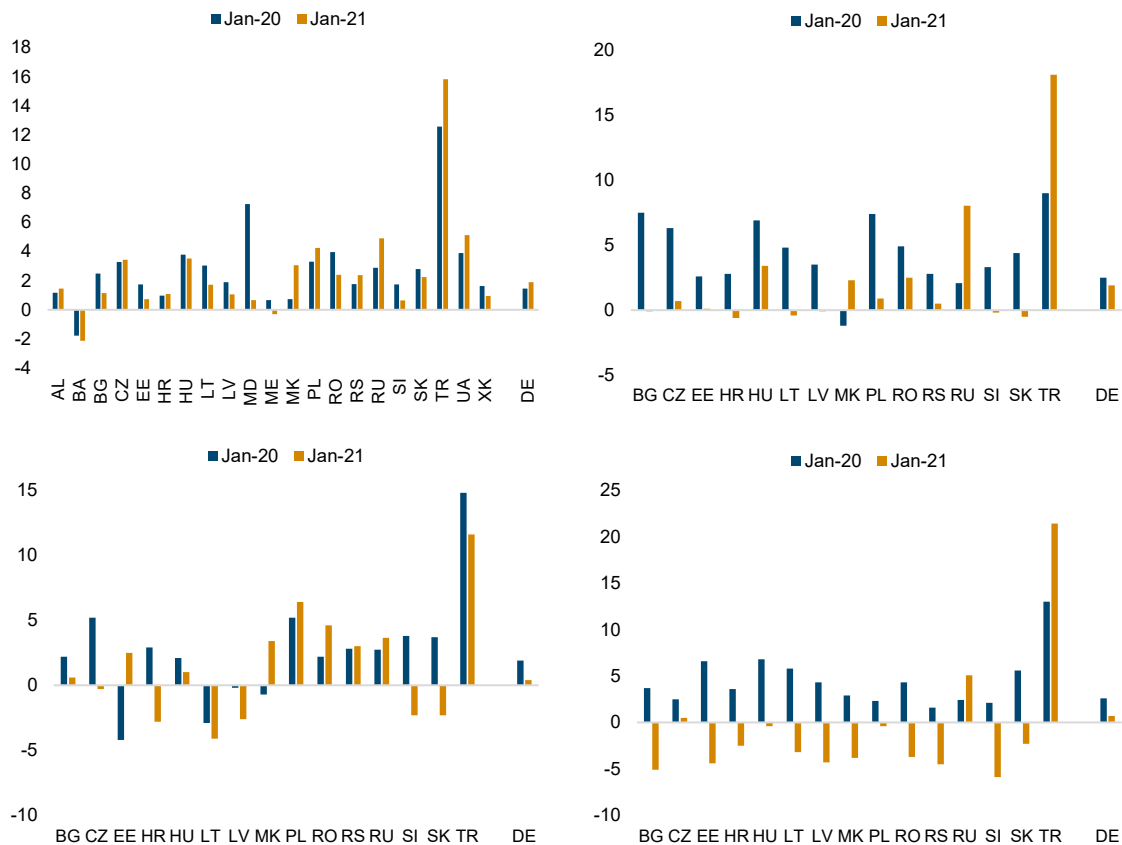
Source: wiiw Monthly Database incorporating national statistics and Eurostat.

The extent to which central banks are able to continue to engage in monetary stimulus will depend on inflation: there are signs that it will rise somewhat this year, but will remain low by historical standards. The recent sharp increase in global commodity prices (see chapter 1) is a particular issue for CESEE, given that in the region a larger share of the consumer price basket is weighted towards those items than is the case in Western Europe. Although, for much of CESEE, the effect of this has been absorbed somewhat by the stronger euro, cost-push pressure on inflation has certainly risen, as evidenced by recent Purchasing Managers' Index (PMI) surveys for the region's

bigger economies. However, this is offset by sizeable output gaps for most countries, which in most cases will be far from closed this year. As a result, demand-pull pressure on prices is currently extremely weak, and will not re-emerge strongly during the forecast period in our baseline scenario. This is hinted at by core inflation (excluding energy and unprocessed food), which has fallen in most countries since the start of the pandemic (Figure 2.17). Without more aggregate demand, firms will struggle to pass on higher input costs to consumers. So far, they certainly do seem to be struggling. Despite the rise in global energy and food prices, inflation in these categories in CESEE countries is very limited, if not actually negative (Figure 2.17). Although there is some inflation in the housing, water, gas, electricity and other fuels component of the consumer price index (CPI), this reflects domestic increases in electricity prices (see country reports for more details). Some change in these domestic price dynamics is very likely: global energy prices collapsed in the early months of the COVID-19 pandemic, and so this much lower base period will ‘kick in’ with the March inflation data. However, while CESEE is in partial lockdown, rising international commodity prices will probably lead to a squeezing of margins, while commodity prices will probably fall back over the medium term. It is, however, possible that when vaccination rates are higher and economies reopen, residents of CESEE will draw down their savings in a way that generates at least a few months of substantially higher inflation in the middle of this year.

Figure 2.17 / Consumer price inflation sub-components, percentage change year on year

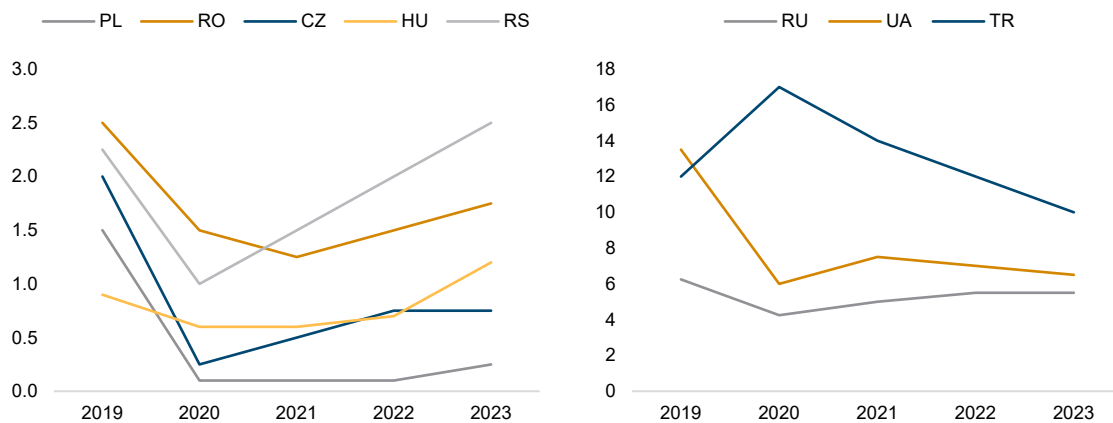
Core (top left); food and non-alcoholic beverages (top right); housing, water, gas, electricity and other fuels (bottom left); transport (bottom right)



Note: Core = headline minus energy and unprocessed food.
Source: National sources, Eurostat, wiiw.

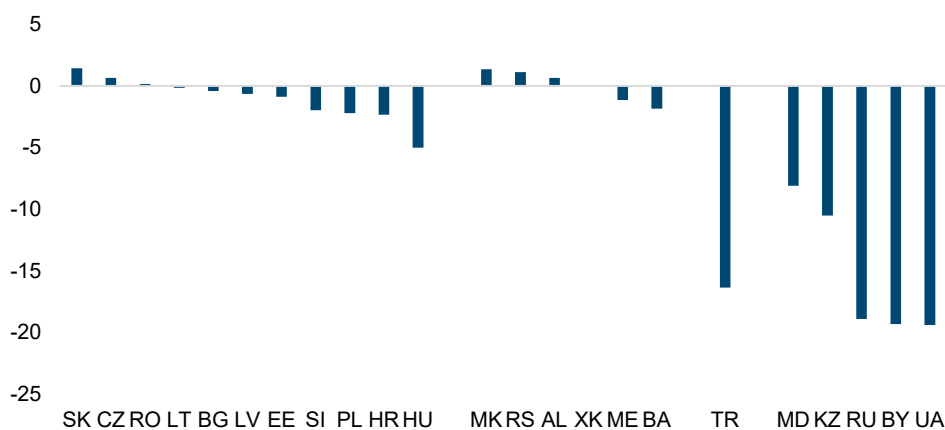
Although the risks of sustained inflation seem quite limited, some of the region's central banks are keen to get ahead of the curve. Reflecting higher inflation, the Ukrainian and Russian central banks have already started to tighten policy: in March, the Russian Central Bank raised its benchmark rate by 25 basis points to 4.5%, and did not rule out further hikes in the coming months, citing rising inflation and geopolitical factors. Meanwhile, communication from the Czech National Bank in the same month suggested tightening will start from Q4, owing to higher price pressures and an expectation that the pandemic situation will be markedly better by then. We expect tightening in Czechia, Ukraine, Serbia and Russia this year (Figure 2.18). By contrast, following its March meeting, the Hungarian National Bank appeared willing to accept what it expects to be a temporary spell of inflation above its 2-4% target band in the coming months, despite further weakness in the forint. We expect the central banks in Romania and Poland also to remain on hold this year. Turkey looks almost certain to cut rates, however damaging that will be. Thereafter, we expect some moderate tightening in most of the region. Turkey is an exception, although there is a substantial risk that the central bank will have to reverse its course in order to react to inflation, a weakening lira and capital outflows.

Figure 2.18 / Central bank nominal policy rates, end of year, %



Source: wiiw Annual Database incorporating national statistics, forecasts by wiiw.

The impact of the pandemic on exchange rates across the region has been very diverse, but sharp real depreciations have been recorded in Turkey, the CIS, Ukraine and, to a lesser extent, Hungary (Figure 2.19). This reflects low or negative real policy rates in some cases (and weaker oil prices in the case of Russia and Kazakhstan), but more broadly the perceptions of risk at a time of heightened uncertainty and volatility on the financial markets. Although this will have knock-on effects on inflation, and has already prompted the central banks in Russia and Turkey to tighten policy, it has also delivered a potential competitiveness boost to those countries. In Turkey, the benefits of a weaker lira for exporters can be seen in the robust recovery of industrial output in H2 2020.

Figure 2.19 / Real exchange rates against the euro, percentage change since December 2019

Note: Data are as of January 2021 or latest available.

Source: wiiw Monthly Database incorporating national statistics and Eurostat, wiiw calculations.

2.4. LABOUR MARKETS: HARD TO GAUGE THE TRUE IMPACT

Headline labour market data suggest a surprisingly limited impact from the pandemic so far.

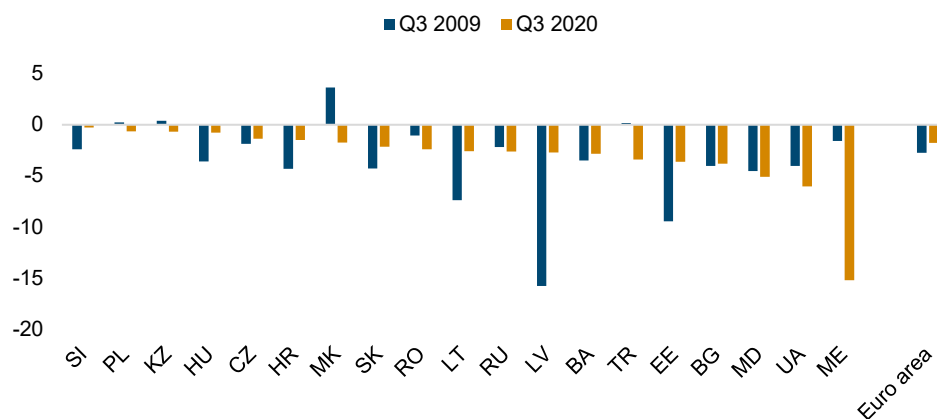
Labour Force Survey (LFS) data show that most countries recorded a rise in the rate of unemployment between Q3 2019 and Q3 2020, but in most cases this was around 2 p.p. or less (Figure 2.20), which is relatively minor in the context of the global economy's worst recession for 75 years. Only Russia, Ukraine, the Baltic states, Croatia and Montenegro – the last two badly affected by the collapse in tourism – saw more significant hits to their labour market in the first year of the pandemic. Yet even for these countries, the early impact of the pandemic on the unemployment rate has been considerably smaller than that caused by the 2008 global financial crisis and its aftermath.

Figure 2.20 / Change in LFS unemployment rate, p.p., Q3 2019 - Q3 2020

Source: wiiw Monthly Database incorporating national statistics and Eurostat, wiiw calculations.

Part of the key to this puzzlingly benign picture is the fact that people who lost their jobs because of the pandemic became inactive, rather than unemployed. In the third quarter of 2020, employment fell in year-on-year terms in every CESEE country, by an average of around 3% overall (Figure 2.21). Despite various short-time and furlough schemes designed to keep people in work, many countries recorded considerably larger drops in employment in Q3 2020 than in the same period of 2009, immediately after the global financial crisis. It is also likely that the headline figures fail to reflect a lot of the reality of this crisis, as experienced by many workers. Those receiving government support will rarely have been getting their normal salary, while those in the grey economy have certainly been badly affected. Cross-border seasonal workers from countries such as Ukraine have also been hit by the crisis. In many countries, the burden also seems to have fallen disproportionately on older workers. It may be the case that younger workers will not suffer as much as after 2008, given their better IT skills and the boost to the digital economy generated by the pandemic.

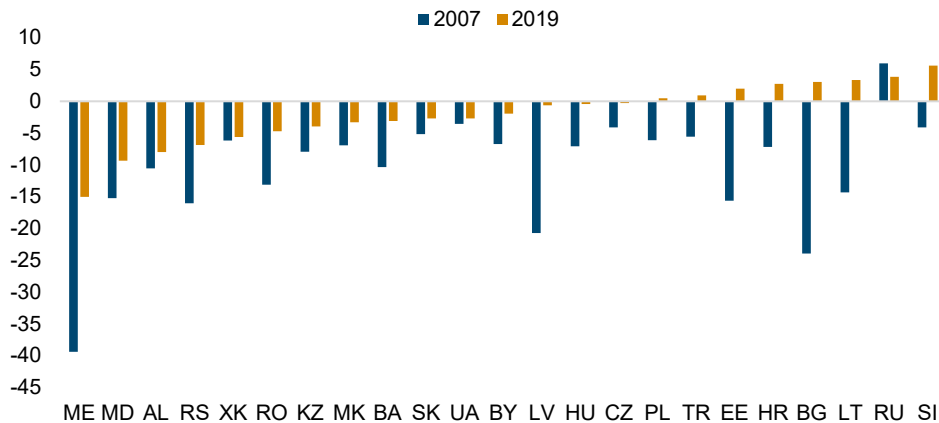
Figure 2.21 / Employment, percentage change year on year



Source: wiiw Monthly Database incorporating national statistics and Eurostat, wiiw calculations.

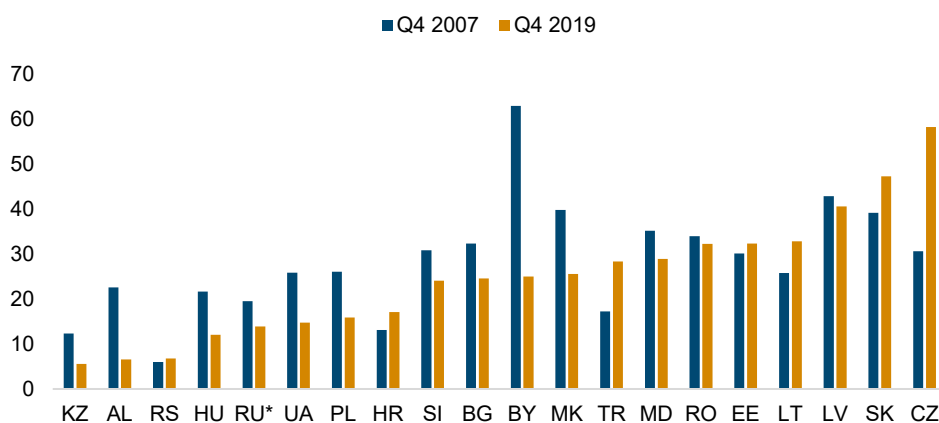
2.5. EXTERNAL ACCOUNTS: SO FAR (MOSTLY) SO GOOD

External imbalances have not dominated the discussion around the region to anything like the extent they did after 2008. Then, the sudden halt to external financing created grave difficulties for many CESEE countries running large external deficits, and contributed to depression-like contractions in Ukraine and the Baltic states. Most countries in CESEE did not have big current account deficits coming into the current crisis. The average current account deficit in CESEE in 2007 was 10.6% of GDP, compared with just 2% in 2019 (Figure 2.22). Those countries that still do run big deficits often fund these with a large share of fairly stable financing from international organisations, with low interest rates and long repayment terms. Meanwhile, the extraordinarily loose policy of the major central banks has created a glut of global liquidity, which has been reinforced over the past 12 months (see global overview). In addition, for the poorest parts of the region, such as Kosovo, remittances last year acted as a counter-cyclical buffer to help finance the deficit, preventing a greater slowdown in economic activity. As a result, this time around the risk of external financing suddenly drying up and producing sharp economic contractions is greatly diminished.

Figure 2.22 / Current account, % of GDP; 2007 versus 2019

Source: wiiw Annual Database incorporating national statistics and Eurostat, wiiw calculations.

A further factor of stability this time is that most CESEE countries went into the COVID crisis with much less short-term debt (maturing in the next 12 months) as a share of the total than was the case at the end of 2007 (Figure 2.23). This indicates that countries have sensibly used those years of very favourable financing conditions to extend the average maturity on their external debt. Mostly, the exceptions to this are euro area or 'euroised' countries with strong fundamentals and high credit ratings. However, they also include Turkey, where short-term external debt was almost 30% of the total at the end of 2019, compared with 17% at the end of 2007. We continue to see Turkey as something of outlier in CESEE, due to its combination of a large current account deficit, high inflation, lack of policy credibility and low foreign exchange reserves.

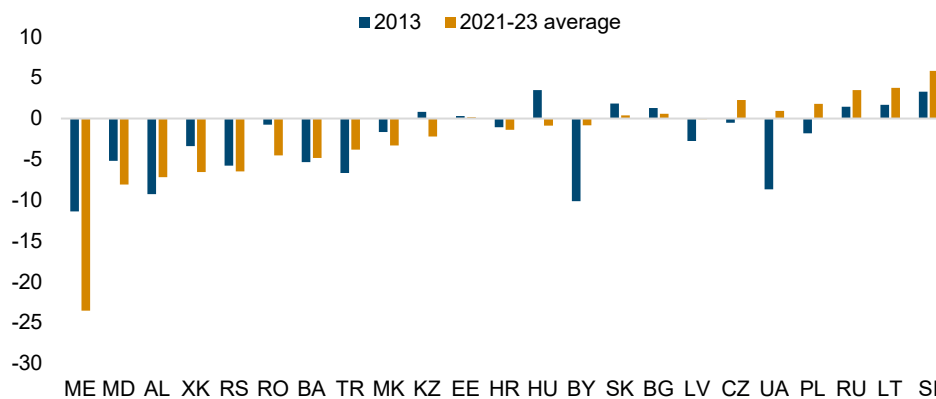
Figure 2.23 / Short-term gross external debt, % of total

Note: *Q4 2007 data for Russia unavailable; data shown are from Q1 2008.

Source: wiiw Annual Database incorporating national statistics, wiiw calculations.

Rising US long-term interest rates (see chapter 1) will push up borrowing costs for those countries weighted towards dollar funding, which could cause external financing difficulties over the forecast period. However, most CESEE economies are in a better position to deal with any repeat of the 2013 'taper tantrum', when a more hawkish-sounding Fed caused a huge outflow of funds from emerging markets. Some countries, including Belarus, Ukraine, Albania and notably Turkey, would likely go into any new tightening of external financing conditions with substantially smaller current accounts deficits than in 2013 (Figure 2.24). However, Montenegro, Moldova and Romania, in particular, have headline external balances that leave them more exposed to changing foreign investor sentiment than was the case in 2013.

Figure 2.24 / Current account, % of GDP; 2013 versus forecast period



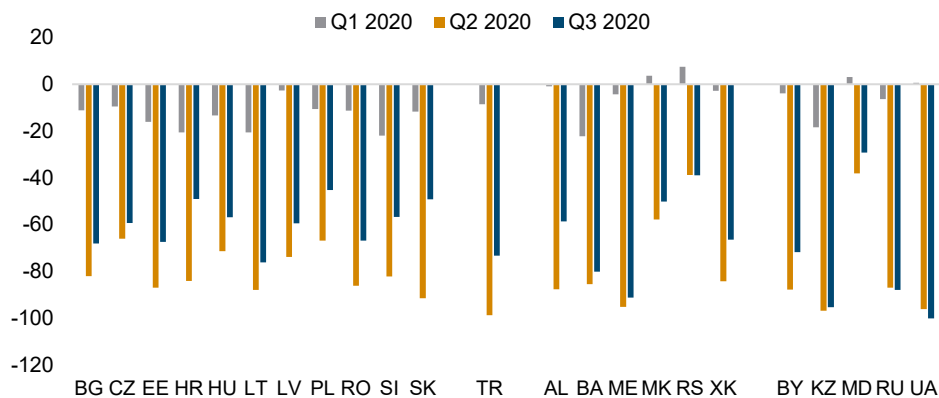
Source: wiiw Annual Database incorporating national statistics and Eurostat, forecasts by wiiw.

One key area of external vulnerability in this crisis has been tourism, and those countries that rely on it suffered badly in 2020. Tourism was hit by a perfect storm in 2020, combining heavy restrictions during most months of the year with heightened uncertainty and fear among many prospective tourists about travelling long distances. All countries suffered from this, with travel credit on the balance of payments (BOP) down by between 38% and 99% year on year in Q2 (Figure 2.25). Although declines were mostly not as bad in Q3 (since restrictions on international travel were eased), travel credits still fell by at least 23% year on year everywhere. Of those countries most reliant on tourism, Croatia suffered least in Q3 (-49%), reflecting a partial recovery as the lifting of restrictions allowed more arrivals from countries such as Germany. Montenegro, which is further away from big Western European tourism sources, suffered much more in Q2 (-91%).

The outlook for tourism this year is extremely uncertain, but it is likely that overall inflows for those CESEE countries most dependent on international arrivals will be up on 2020. The first reason for this is that the base is so low: especially in the second quarter of 2021, almost any amount of tourism will represent growth compared with last year. Meanwhile, by the time the core summer tourism months arrive, vaccination rates will be considerably higher than is currently the case; and like last year, the number of COVID cases should decline in the warmer weather. Croatia will continue to benefit from being a relatively easy car journey away from Germany, Austria and other core tourism sources. Meanwhile, Montenegro should benefit from the particularly high vaccination rates in Serbia, a big source of tourism. There are still hopes that policy makers will do even more to help drive tourism flows around Europe over the summer. Greece and other Southern EU countries have been pushing hard for

vaccination passports. On 17 March, Commission President Ursula von der Leyen announced proposals for a Digital Green Certificate, to include information on the holder's a) vaccination, b) tests and c) medical certificates in case of recovery from COVID-19. Margaritis Schinas, European Commission vice-president in charge of 'promoting our European way of life', has said that the passport scheme will be ready by 1 June.

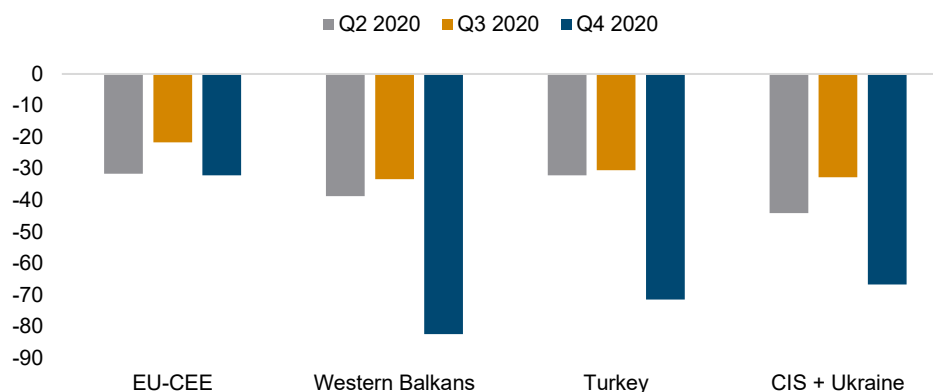
Figure 2.25 / Travel services, credit (BOP), percentage change year on year, euro based



Source: wiiw Monthly Database incorporating national statistics and Eurostat, wiiw calculations.

Inflows of foreign direct investment (FDI) into CESEE dropped sharply last year, but this is a notoriously difficult indicator to read on a short-term basis, and the medium-term prospects for FDI in the region may not be negative. Announced greenfield FDI projects fell precipitously across CESEE last year (Figure 2.26), reflecting a sharp decline in investor sentiment owing to the pandemic. The number of projects announced fell in all sub-regions in Q2, Q3 and Q4, but the sharpest decline was clearly in Q4, especially for the Western Balkans, Turkey and the CIS and Ukraine. While this is patently bad news, and suggests that the worrying trend may continue in 2021, there are reasons to think that over the medium term CESEE may gain from some 'near-shoring', as Western European firms move outsourced production closer to home (Adarov and Hunya, 2020).

Figure 2.26 / Announced greenfield FDI projects, percentage change year on year

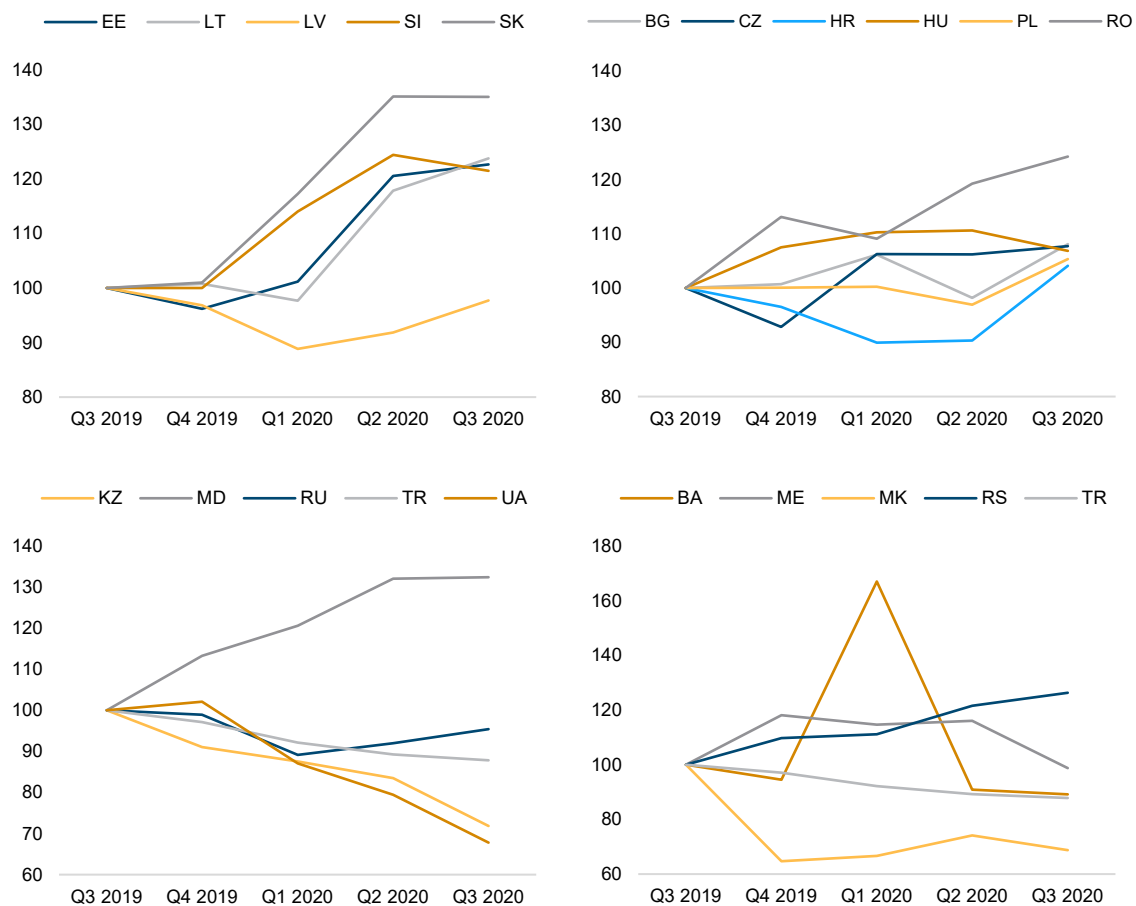


Source: fDi Markets, wiiw calculations.

2.6. FINANCIAL SECTOR: ABUNDANT LIQUIDITY, BUT LIMITED INVESTMENT OPTIONS

In 2020, central banks around the world responded to the pandemic with sweeping stimuli to provide relief to the disrupted economies. The latest European Investment Bank (EIB) Bank Lending Survey (BLS)⁹ shows that the monetary and fiscal stimulus to offset the negative economic effects of the COVID-19 pandemic in the euro area kept the credit channel partially open in 2020, and the balance sheets of banks in Europe have surged. After a massive exodus from the emerging markets at the start of the coronavirus crisis, foreign investors embarked on a vigorous return to many of the CESEE countries' stocks and debt markets in the second half of 2020, further boosting the liquidity situation there.¹⁰

Figure 2.27 / Indices of cross-border consolidated bank claims on an ultimate risk basis by counterparty, USD terms, Q3 2019=100



Source: BIS.

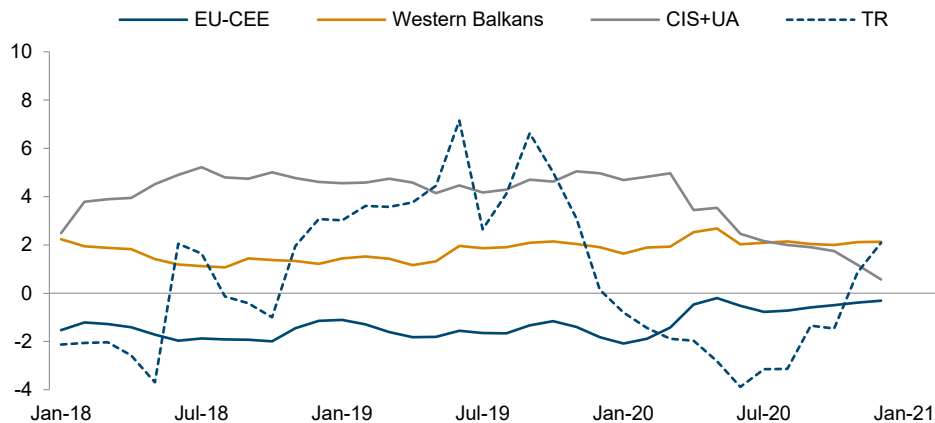
⁹ https://www.ecb.europa.eu/stats/ecb_surveys/bank_lending_survey/html/index.en.html

¹⁰ In our analysis, we use data from the Bank for International Settlements (BIS), and specifically its consolidated banking statistics on an ultimate risk basis and its real property prices time series. The consolidated banking statistics (CBS) measure international banking activity from a nationality perspective, focusing on the country where the banking group's parent is headquartered. The country of ultimate risk is defined as the country in which the guarantor of a financial claim resides or the country in which the head office of a legally dependent branch is located.

Cross-border bank claims in most of CESEE did not experience as dramatic a decline in 2020 as following the global financial crisis. According to the latest BLS, parent banks in the CESEE countries reported an overall positive approach in terms of their operations, commitment and profitability in the region. Around 60% of parent bank groups indicated their intention of maintaining the same level of operations, while 40% planned a selective expansion of operations in the region. Some 85% of groups expect the region to be profitable in the near future. Figure 2.27 shows that among EU member states in the region there was even an increase in cross-border bank claims in Q2-Q3 2020, most pronounced in the euroised countries. When it comes to the non-EU countries, the trends are quite different, especially in Ukraine, Kazakhstan and Turkey, where cross-border bank claims steadily declined throughout the period, largely due to depreciation of the local currencies. In the Western Balkans, Serbia appears to have outperformed the other countries in terms of positive cross-border bank claims.

Liquidity conditions were ample in the region in 2020, as reflected in the low real interest rates (Figure 2.28). In the second half of 2020 there was a slight monetary tightening in EU-CEE and – particularly – in Turkey; however, in EU-CEE the real policy interest rate remained negative on average. In CIS+UA, higher inflation and accommodative monetary policy shifted the real policy rate in the opposite direction, with Ukraine reducing its real policy rate in H2 2020 the most – by 2.5 points. Though many central banks in Western Balkans cut their policy rates, real interest rates stayed mostly unchanged, due to the low inflation, and oscillated around 2% throughout the year.

Figure 2.28 / Real interest rate, CPI adjusted, %



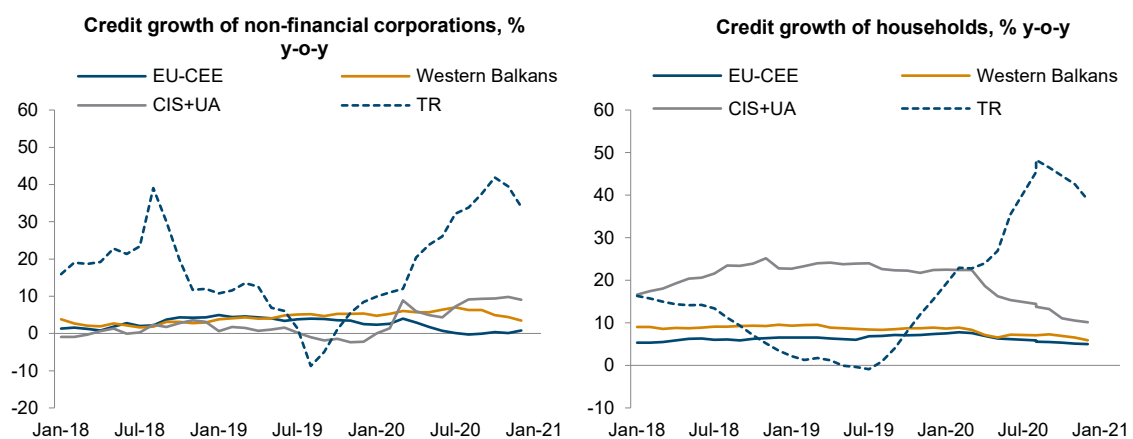
Note: Simple averages for country aggregates.

Source: wiiw Monthly Database incorporating national statistics.

Non-performing loans (NPLs) have been declining until now – partly owing to moratoria on bankruptcies introduced in many countries. However, banks expect them to rise in the near future, as many borrowers become insolvent. This is supported by a decline in the quality of loan applications in 2020 (BLS 2021). Moreover, the moratoria will serve to increase the future debt service, as they prolong the lending period over which interest is calculated. This implies a higher debt burden for households and firms, and may also contribute to higher default rates.

Credit activity has not reflected the favourable liquidity situation in CESEE: there has been some slowing in the growth of loans both to households and to the corporate sector (see Figure 2.29). In part, this is due to a tightening of the credit standards on loans, in line with the banks' heightened perception of risk and greater uncertainty about economic recovery. On the other hand, there has been a sharp fall in demand for loans by both firms and households (in the case of households, the fall in demand has mostly been for consumer loans) (BLS 2021). Loan rejection rates have also increased, particularly for consumer loans. A broad trend, evident since the global financial crisis, has been for the structure of banks' balance sheets to shift from credit to debt securities, fuelled by increased government borrowing.

Figure 2.29 / Credit growth among companies and households, %



Note: Simple averages for country aggregates.

Source: wiiw Monthly Database incorporating national statistics.

Demand for housing loans, by contrast, has been rising, as have real residential property prices.¹¹ This appears to be where much of the liquidity is (see Figure 2.30). In Q1-Q3 2020, real residential property prices increased most sharply in Turkey, Russia, Lithuania and Croatia.¹² In the countries of the euro area, this has been a continuous trend in recent years, but in 2020 growth accelerated – presumably because the European Central Bank (ECB) started boosting liquidity earlier than the central banks of CESEE countries. Net demand for housing loans has been growing, supported by the low general level of interest rates. Mortgage lending has also been facilitated by the fact that the reduced creditworthiness of borrowers is less important for housing loans than it is for consumer credit (BLS 2021).

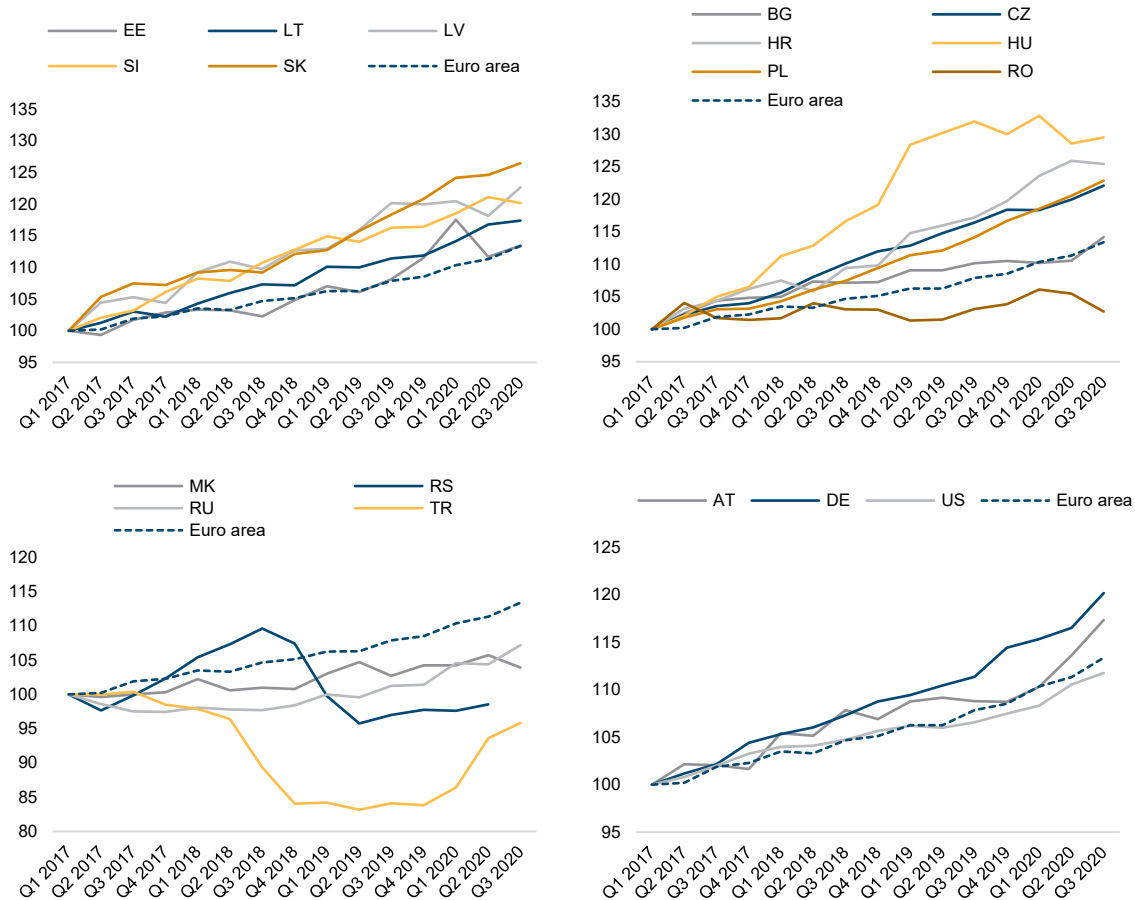
The recent developments point to an increased risk of correction on the housing markets of CESEE countries. Ample liquidity, a concentration of investment in the residential real estate sector and the rising risk of insolvency facing many firms and households create all but ideal conditions for the development of a financial crisis. That said, the banks are now arguably much better prepared for such an eventuality than they were on the eve of the global financial crisis (they have higher capital adequacy ratios). Low interest rates appear to be insufficient to revive business investment in the high-uncertainty

¹¹ Calculated by deflating the nominal residential property price series with the consumer price index.

¹² In Russia, the programme of subsidised mortgages was the decisive factor behind the rapid growth in residential property prices.

environment caused by the pandemic, which again indicates the need for increased public investment (as argued by Creel et al., 2020). Moreover, skyrocketing house prices have made homeownership increasingly unaffordable for a large section of households, while also driving up rents and causing gentrification in many cities.¹³ This all requires government policy to promote affordable housing. Whether the housing bubble actually bursts will depend, to a large extent, on how far unemployment rises and how far future household income drops when support schemes are scaled back.¹⁴ The likely tightening of mortgage lending standards by banks could also foster a slowdown in the housing cycle.

Figure 2.30 / Index of real residential property prices, Q1 2017=100



Source: BIS.

¹³ <https://eurocities.eu/latest/housing-affordability-a-european-crisis/>

¹⁴ <https://www.ecb.europa.eu/pub/financial-stability/fsr/html/ecb.fsr202011~b7be9ae1f1.en.html#toc4>

2.7. CONCLUSIONS: AFTER THE PANDEMIC

CESEE has clearly been hit hard by the pandemic and its fallout, and although the worst may be over, it is a long road back to normality. Truly normal life may take years to resume in parts of the region, and during that time the economic, social and public health costs are likely to be considerable. Nevertheless, after last year's negative shock and the renewed lockdowns of early 2021, the most likely scenario is that a combination of vaccines and some limited restrictions will keep the health impact at a level that allows for solid economic growth during the rest of the year.

Once the acute phase of the crisis passes, attention will quickly turn to the other challenges and opportunities faced by the region – both those that already existed, and some that are new and result from the pandemic. Most of CESEE remains in the grip of the most serious negative demographic decline – excluding wars and famines – ever recorded. The dual shocks of automation and digitalisation, both of which are likely to be accelerated by the pandemic, create challenges, but also significant opportunities for a region that was struggling with a shortage of workers before the pandemic. The independence of institutions was under strain long before the pandemic hit, but the unique challenges it has created have thrown up opportunities for unscrupulous leaders to further cement their influence in many parts of the region. Geopolitically, the region is facing a new era without the steadying hand of Angela Merkel in Germany, while the two most important divisions – the US versus China at the global level, and the EU versus Russia more locally – leave many CESEE countries caught in between, with negative implications for political stability and economic development.

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