

2. Overview CESEE: Overshadowed by war and sanctions

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2.1. COVID-RELATED SLUMP LEFT BEHIND, BUT SCARS STILL VISIBLE

After the COVID-related decline of 2020, last year witnessed a strong rebound in the CESEE economies. On a weighted average basis, the economy of the region expanded by 6.3% last year – 1 percentage point (pp) faster than in the euro area (Table 2.1). This is quite a remarkable achievement and cannot be explained simply by the effect of the statistical base: in 2020, regional GDP contracted by only 2.1%, compared to 6.4% in the euro area. Moreover, the aggregate fiscal and monetary response in CESEE was generally weaker than in the euro area. The strong showing of CESEE economies reflected first and foremost their adaptation to the pandemic and the reluctance of their governments to impose wide-ranging COVID restrictions. Although the numbers of new infections were comparable to those in Western Europe (Figure 2.1), the extent of the restrictions imposed was generally not as great (Figure 2.2), reflecting a more relaxed public attitude towards COVID, lower levels of trust in state institutions, thinner safety nets and tighter fiscal constraints. Under these circumstances, the policy priorities, especially on the southern and eastern peripheries of the CESEE region, typically focused on the economy, rather than public health.

The COVID-related slump has by and large been left behind. Last year, regional GDP exceeded the pre-pandemic level of 2019 by 4.1 pp, with 17 of the 23 countries registering recovery stronger than the decline in 2020 (Figure 2.3). In some cases, the pre-pandemic levels were surpassed by quite some margin: by 13% in Turkey, 6% in Serbia, and more than 5% in Moldova and Estonia. The Turkish economy was the only one in CESEE to avoid economic slump for the full year 2020, and it performed strongly last year on the back of rapid credit expansion and the boost to exports provided by its weaker currency. The Serbian economy has benefited from the generous fiscal stimulus offered in response to the pandemic; meanwhile, an exceptionally good harvest and an investment boom in digital industries played a role in Moldova and Estonia, respectively.

However, COVID-related scarring is still visible in some CESEE countries and sectors. In Czechia and Slovakia, for instance, GDP recovery last year was impeded by a shortage of semiconductor chips in the crucial automotive industry – a legacy of COVID-related disruptions to global value chains. In tourism-dependent Montenegro, the sharp downturn in visitor numbers was not entirely reversed. In North Macedonia, the policy mix adopted in response to the pandemic was arguably too restrictive and acted as a drag on growth. Bulgaria recorded a sharp drop in investment on the back of persistent political instability, while recovery in Ukraine suffered on account of export weakness. In those six CESEE countries, the pre-pandemic levels of economic activity were not reached in 2021.

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Table 2.1 / Indicators 2020-2021 and Outlook 2022-2024 - Baseline Scenario

	GDP					Consumer prices					Unemployment (LFS)				
	real change in % against prev. year					average change in % against prev. year					rate in %, annual average				
	2020	2021	Forecast			2020	2021	Forecast			2020	2021	Forecast		
BG Bulgaria	-4.4	4.2	2.0	3.7	3.5	1.2	2.8	14.0	8.0	5.0	5.1	5.3	5.0	4.5	4.0
CZ Czechia	-5.8	3.3	2.6	3.5	4.2	3.3	3.3	8.7	3.8	2.3	2.6	2.8	2.5	2.5	2.2
EE Estonia	-3.0	8.3	1.8	3.4	3.1	-0.6	4.5	11.0	3.5	2.8	6.8	6.2	8.0	6.0	5.2
HR Croatia	-8.1	10.4	3.5	4.0	3.1	0.0	2.7	6.5	2.9	2.3	7.5	7.7	7.1	6.4	6.5
HU Hungary	-4.7	7.1	2.5	3.9	4.5	3.4	5.2	9.0	5.0	3.5	4.3	4.1	3.9	3.8	3.5
LT Lithuania	-0.1	5.0	1.7	2.8	2.6	1.1	5.5	12.0	6.5	4.0	8.5	7.1	6.8	7.0	6.0
LV Latvia	-3.8	4.7	1.4	2.2	2.3	0.1	3.2	10.0	6.5	3.5	8.1	7.6	7.5	5.8	6.0
PL Poland	-2.5	5.7	4.0	3.5	3.6	3.7	5.2	10.0	6.5	3.5	3.2	3.4	3.0	3.1	3.2
RO Romania	-3.7	5.9	2.0	3.5	4.5	2.3	4.1	9.0	5.0	3.0	5.0	5.6	5.6	5.3	5.0
SI Slovenia	-4.2	8.1	4.1	3.3	2.8	-0.3	2.0	4.8	1.7	1.4	5.0	4.8	4.5	4.3	4.1
SK Slovakia	-4.4	3.0	2.4	3.1	3.0	2.0	2.8	8.0	4.5	2.0	6.7	6.8	6.5	5.9	5.7
<i>EU-CEE11¹⁾²⁾</i>	<i>-3.7</i>	<i>5.6</i>	<i>3.0</i>	<i>3.5</i>	<i>3.8</i>	<i>2.7</i>	<i>4.3</i>	<i>9.5</i>	<i>5.4</i>	<i>3.2</i>	<i>4.4</i>	<i>4.5</i>	<i>4.3</i>	<i>4.1</i>	<i>3.9</i>
<i>EA19³⁾</i>	<i>-6.4</i>	<i>5.3</i>	<i>2.5</i>	<i>2.7</i>	<i>2.1</i>	<i>0.3</i>	<i>2.6</i>	<i>6.0</i>	<i>3.0</i>	<i>2.0</i>	<i>7.9</i>	<i>7.7</i>	<i>7.3</i>	<i>6.9</i>	<i>6.6</i>
<i>EU27³⁾</i>	<i>-5.9</i>	<i>5.3</i>	<i>2.7</i>	<i>2.9</i>	<i>2.3</i>	<i>0.7</i>	<i>2.9</i>	<i>6.2</i>	<i>3.2</i>	<i>2.2</i>	<i>7.1</i>	<i>6.9</i>	<i>6.5</i>	<i>6.1</i>	<i>5.8</i>
AL Albania	-3.5	8.5	3.5	3.7	3.9	1.6	2.0	6.0	3.4	2.5	11.7	11.5	11.2	11.0	10.6
BA Bosnia and Herzegovina	-3.1	7.1	1.8	2.3	2.3	-1.1	2.0	8.0	4.0	3.0	15.9	17.4	16.8	16.3	15.7
ME Montenegro	-15.3	12.4	3.5	3.7	3.3	-0.3	2.4	6.4	3.0	2.0	17.9	16.6	15.3	14.8	14.0
MK North Macedonia	-6.1	4.0	2.5	2.7	2.7	1.2	3.2	8.0	5.0	4.0	16.4	15.7	15.2	14.8	14.5
RS Serbia	-0.9	7.4	3.6	3.4	3.4	1.6	4.1	10.0	6.0	4.0	9.0	11.0	10.5	10.0	9.5
XK Kosovo	-5.3	10.5	3.3	3.7	3.9	0.2	3.4	7.0	4.0	2.0	25.9	24.5	24.3	23.8	23.5
<i>WB6¹⁾²⁾</i>	<i>-3.2</i>	<i>7.6</i>	<i>3.1</i>	<i>3.2</i>	<i>3.3</i>	<i>0.9</i>	<i>3.2</i>	<i>8.5</i>	<i>4.9</i>	<i>3.4</i>	<i>13.0</i>	<i>13.9</i>	<i>13.4</i>	<i>13.0</i>	<i>12.6</i>
TR Turkey	1.8	11.0	2.7	2.8	3.2	12.3	19.6	55.0	20.0	10.0	13.2	12.0	11.5	10.5	9.5
BY Belarus	-0.7	2.3	-3.5	1.6	2.0	5.5	9.5	15.0	12.0	11.0	4.0	3.9	4.1	4.0	4.0
KZ Kazakhstan	-2.5	4.0	1.5	3.2	4.0	6.8	8.0	11.0	8.0	6.0	4.9	4.9	5.0	4.8	4.8
MD Moldova	-7.4	13.9	-3.0	3.0	4.0	3.8	5.1	20.0	10.0	4.0	3.8	3.2	3.5	3.3	3.2
RU Russia	-2.7	4.7	-9.0	-1.5	1.0	3.4	6.7	20.0	14.0	4.0	5.8	4.8	7.5	7.0	6.5
UA Ukraine	-3.8	3.4	-38.0	5.0	13.0	2.7	9.4	15.0	10.0	6.0	9.5	9.9	25.0	15.0	10.0
<i>CIS4+UA¹⁾²⁾</i>	<i>-2.7</i>	<i>4.5</i>	<i>-10.6</i>	<i>-0.3</i>	<i>2.4</i>	<i>3.7</i>	<i>7.1</i>	<i>18.6</i>	<i>13.0</i>	<i>4.6</i>	<i>6.2</i>	<i>5.6</i>	<i>9.5</i>	<i>7.5</i>	<i>6.5</i>
<i>V4¹⁾²⁾</i>	<i>-3.6</i>	<i>5.3</i>	<i>3.4</i>	<i>3.5</i>	<i>3.8</i>	<i>3.4</i>	<i>4.7</i>	<i>9.5</i>	<i>5.6</i>	<i>3.2</i>	<i>3.5</i>	<i>3.7</i>	<i>3.4</i>	<i>3.4</i>	<i>3.3</i>
<i>BALT3¹⁾²⁾</i>	<i>-1.8</i>	<i>5.7</i>	<i>1.6</i>	<i>2.8</i>	<i>2.6</i>	<i>0.4</i>	<i>4.7</i>	<i>11.2</i>	<i>5.8</i>	<i>3.6</i>	<i>8.0</i>	<i>7.0</i>	<i>7.3</i>	<i>6.4</i>	<i>5.8</i>
<i>SEE9¹⁾²⁾</i>	<i>-4.1</i>	<i>6.5</i>	<i>2.4</i>	<i>3.5</i>	<i>3.9</i>	<i>1.6</i>	<i>3.6</i>	<i>9.3</i>	<i>5.2</i>	<i>3.3</i>	<i>8.1</i>	<i>8.7</i>	<i>8.5</i>	<i>8.2</i>	<i>7.8</i>
<i>CIS3+UA¹⁾²⁾</i>	<i>-2.9</i>	<i>3.8</i>	<i>-16.3</i>	<i>3.7</i>	<i>7.6</i>	<i>4.8</i>	<i>8.8</i>	<i>13.6</i>	<i>9.5</i>	<i>6.7</i>	<i>7.2</i>	<i>7.3</i>	<i>15.5</i>	<i>9.9</i>	<i>7.3</i>
<i>non-EU12¹⁾²⁾</i>	<i>-1.4</i>	<i>6.5</i>	<i>-6.2</i>	<i>0.7</i>	<i>2.7</i>	<i>6.1</i>	<i>10.7</i>	<i>28.9</i>	<i>14.8</i>	<i>6.1</i>	<i>8.0</i>	<i>7.4</i>	<i>10.2</i>	<i>8.5</i>	<i>7.5</i>
<i>CESEE23¹⁾²⁾</i>	<i>-2.1</i>	<i>6.3</i>	<i>-3.6</i>	<i>1.5</i>	<i>3.0</i>	<i>5.1</i>	<i>8.8</i>	<i>23.4</i>	<i>12.1</i>	<i>5.3</i>	<i>7.1</i>	<i>6.7</i>	<i>8.8</i>	<i>7.4</i>	<i>6.6</i>

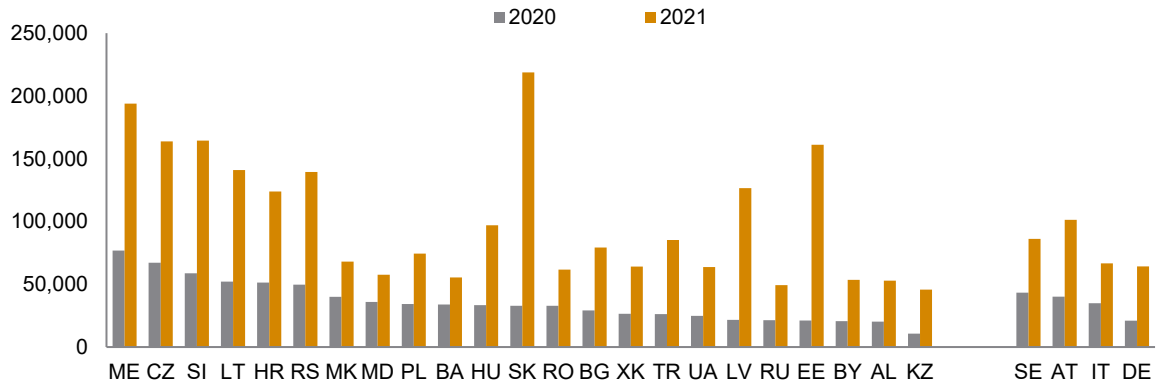
Table 2.1 / (contd.)

	Current account					Fiscal balance				
	in % of GDP					in % of GDP				
	2020	2021	Forecast			2020	2021	Forecast		
		2022	2023	2024	2020	2021	2022	2023	2024	
BG Bulgaria	-0.1	-0.4	-1.5	-1.4	-0.7	-4.0	-3.0	-5.0	-4.0	-3.0
CZ Czechia	2.0	-0.9	-2.2	-1.2	0.0	-5.6	-6.8	-5.0	-2.7	-0.5
EE Estonia	-0.3	-1.1	-0.8	-0.5	-0.3	-5.6	-4.0	-3.0	-2.1	-1.2
HR Croatia	-0.1	3.2	1.1	1.8	1.5	-7.4	-3.8	-3.5	-2.7	-2.5
HU Hungary	-1.1	-3.1	-2.9	-1.6	-0.1	-8.0	-7.5	-5.5	-3.5	-3.0
LT Lithuania	7.3	1.4	0.8	0.4	0.5	-7.2	-2.6	-4.0	-3.0	-2.0
LV Latvia	2.9	-2.9	-3.8	-1.9	-2.0	-4.5	-7.3	-5.5	-3.5	-2.0
PL Poland	2.9	-0.6	-0.8	-0.5	-0.4	-7.1	-5.5	-5.0	-4.0	-3.0
RO Romania	-5.0	-7.0	-7.0	-6.2	-5.9	-9.3	-7.0	-7.0	-5.0	-4.0
SI Slovenia	7.4	3.3	1.4	0.3	0.0	-7.7	-5.2	-3.6	-0.4	-0.2
SK Slovakia	0.4	-2.0	-3.9	-3.7	-3.3	-5.5	-7.1	-5.1	-4.1	-3.5
<i>EU-CEE11¹⁾²⁾</i>	<i>1.1</i>	<i>-1.6</i>	<i>-2.2</i>	<i>-1.7</i>	<i>-1.2</i>	<i>-7.0</i>	<i>-5.9</i>	<i>-5.2</i>	<i>-3.7</i>	<i>-2.6</i>
<i>EA19³⁾</i>	<i>2.8</i>	<i>2.0</i>	<i>1.5</i>	<i>1.5</i>	<i>1.5</i>	<i>-7.2</i>	<i>-5.9</i>	<i>-4.0</i>	<i>-2.8</i>	<i>-1.8</i>
<i>EU27³⁾</i>	<i>2.8</i>	<i>2.0</i>	<i>1.5</i>	<i>1.5</i>	<i>1.5</i>	<i>-6.9</i>	<i>-5.5</i>	<i>-3.6</i>	<i>-2.4</i>	<i>-1.4</i>
AL Albania	-8.7	-7.7	-8.1	-7.3	-6.7	-6.7	-4.5	-4.6	-3.0	-2.0
BA Bosnia and Herzegovina	-3.8	-2.1	-3.7	-3.9	-4.1	-5.3	3.5	0.0	0.5	1.0
ME Montenegro	-26.1	-9.2	-12.5	-12.8	-12.3	-11.1	-1.8	-6.0	-4.5	-4.0
MK North Macedonia	-3.4	-3.5	-6.8	-6.7	-6.8	-8.3	-5.4	-4.0	-3.0	-2.0
RS Serbia	-4.1	-4.4	-6.5	-6.8	-7.2	-8.0	-4.1	-3.5	-3.0	-2.5
XK Kosovo	-7.0	-8.8	-9.9	-9.8	-9.4	-7.6	-1.3	-2.0	-2.0	-0.5
<i>WB6¹⁾²⁾</i>	<i>-5.7</i>	<i>-4.9</i>	<i>-6.8</i>	<i>-6.9</i>	<i>-7.0</i>	<i>-7.5</i>	<i>-2.7</i>	<i>-3.1</i>	<i>-2.4</i>	<i>-1.7</i>
TR Turkey	-5.0	-1.8	-6.3	-5.8	-5.5	-2.9	-3.5	-3.2	-2.4	-2.0
BY Belarus	-0.4	2.7	1.3	1.3	0.8	-1.7	-2.0	-4.0	-2.0	-1.0
KZ Kazakhstan	-3.8	-3.0	-0.3	-1.0	-1.2	-4.0	-3.1	-3.5	-2.5	-2.0
MD Moldova	-7.7	-11.6	-12.8	-11.6	-10.9	-5.3	-1.9	-5.0	-3.0	-2.0
RU Russia	2.4	6.9	10.8	7.5	7.0	-4.0	0.8	-3.0	0.0	1.0
UA Ukraine	3.4	-1.3	1.4	1.4	0.2	-5.3	-3.4	-25.0	-15.0	-8.0
<i>CIS4+UA¹⁾²⁾</i>	<i>1.8</i>	<i>5.1</i>	<i>8.7</i>	<i>5.9</i>	<i>5.3</i>	<i>-4.0</i>	<i>0.0</i>	<i>-4.5</i>	<i>-1.3</i>	<i>-0.1</i>
<i>V4¹⁾²⁾</i>	<i>1.9</i>	<i>-1.2</i>	<i>-1.7</i>	<i>-1.1</i>	<i>-0.5</i>	<i>-6.8</i>	<i>-6.2</i>	<i>-5.1</i>	<i>-3.6</i>	<i>-2.5</i>
<i>BALT3¹⁾²⁾</i>	<i>4.2</i>	<i>-0.4</i>	<i>-0.9</i>	<i>-0.4</i>	<i>-0.4</i>	<i>-6.0</i>	<i>-4.1</i>	<i>-4.2</i>	<i>-2.9</i>	<i>-1.8</i>
<i>SEE9¹⁾²⁾</i>	<i>-3.9</i>	<i>-4.3</i>	<i>-5.2</i>	<i>-4.7</i>	<i>-4.5</i>	<i>-7.9</i>	<i>-5.1</i>	<i>-5.4</i>	<i>-4.0</i>	<i>-3.1</i>
<i>CIS3+UA¹⁾²⁾</i>	<i>-0.6</i>	<i>-1.7</i>	<i>0.0</i>	<i>-0.3</i>	<i>-0.8</i>	<i>-4.2</i>	<i>-3.1</i>	<i>-10.7</i>	<i>-6.6</i>	<i>-3.9</i>
<i>non-EU12¹⁾²⁾</i>	<i>-0.3</i>	<i>2.9</i>	<i>4.5</i>	<i>2.4</i>	<i>1.9</i>	<i>-3.9</i>	<i>-1.0</i>	<i>-4.1</i>	<i>-1.6</i>	<i>-0.7</i>
<i>CESEE23¹⁾²⁾</i>	<i>0.2</i>	<i>1.2</i>	<i>1.7</i>	<i>0.7</i>	<i>0.5</i>	<i>-5.1</i>	<i>-2.8</i>	<i>-4.6</i>	<i>-2.5</i>	<i>-1.5</i>

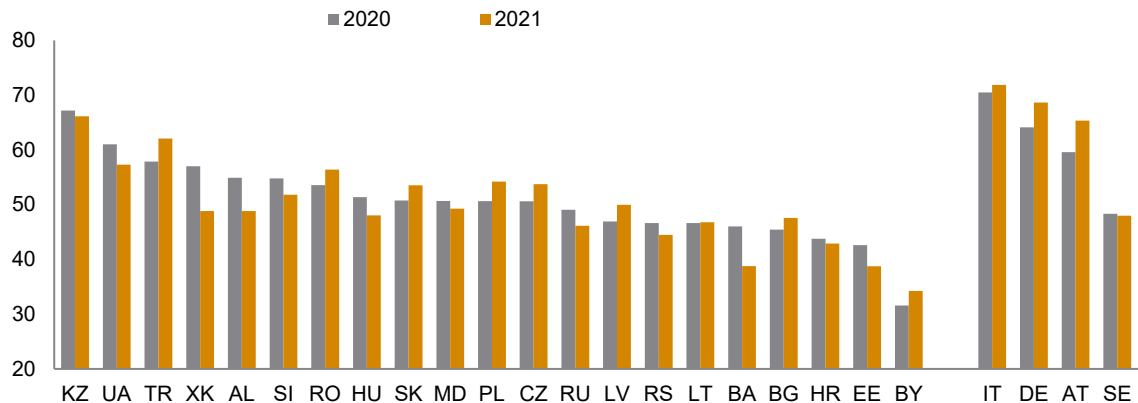
1) wiiw estimates. - 2) Current account data include transactions within the region (sum over individual countries). -

3) Forecasts estimated by wiiw.

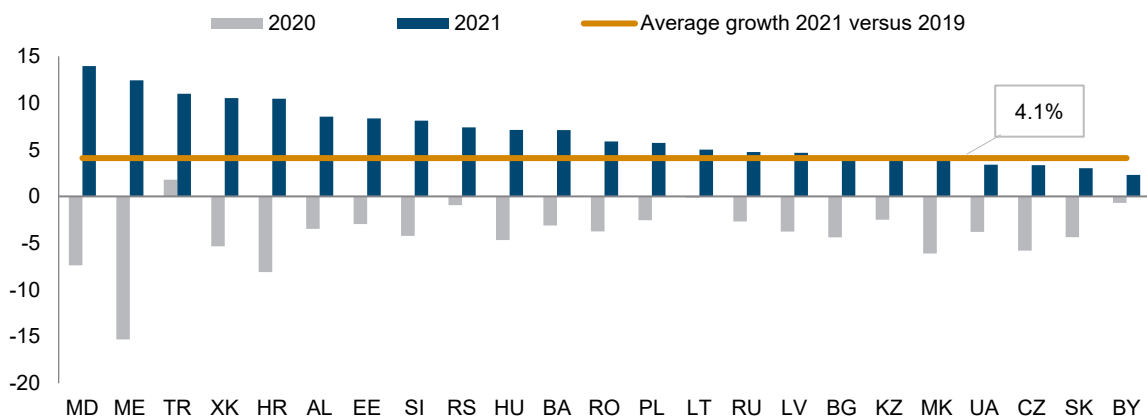
Source: wiiw, Eurostat. Forecasts by wiiw. Cut-off date for historical data and forecasts: 7 April 2022.

Figure 2.1 / Number of new COVID-19 cases (per million population)

Source: Our World in Data, Oxford University, own calculations.

Figure 2.2 / Stringency Index

Source: Blavatnik School of Government, Oxford University, own calculations.

Figure 2.3 / Real GDP growth (% , year on year)

Note: Average growth 2021 versus 2019 is a weighted average over all countries.

Source: wiiw Annual Database incorporating national statistics and Eurostat.

2.2. SWIFT RECOVERY OF LABOUR MARKETS

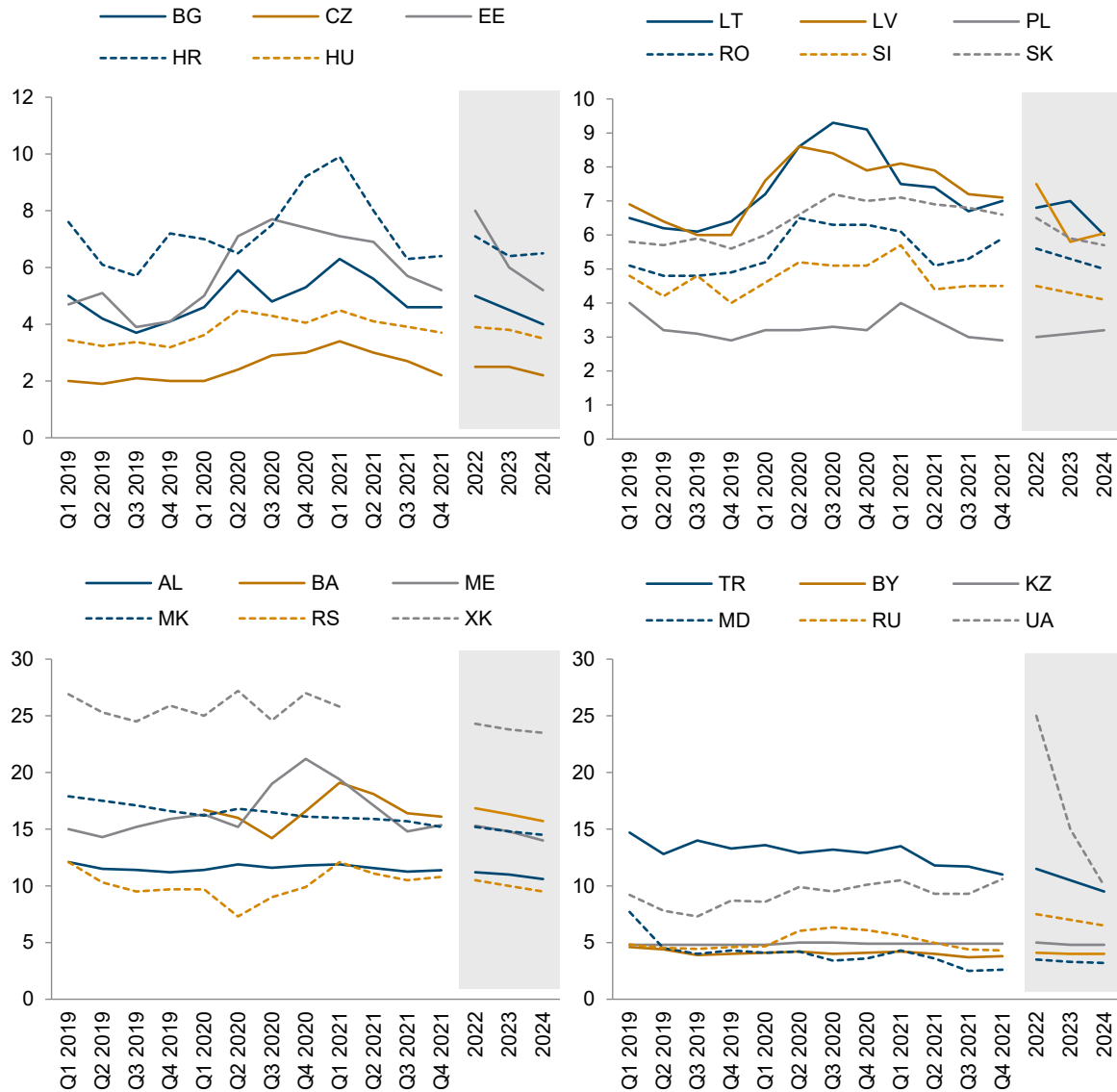
Employment in CESEE has attained pre-pandemic levels, with labour shortages resurfacing in many countries. After the economic slump of 2020, demand for labour recovered swiftly last year, particularly in Hungary, the Baltic states, Slovenia and Croatia. After accounting for the changes in Labour Force Survey (LFS) methodology (see Box 2.1 for details), employment grew nearly everywhere in the region: only in Ukraine, Belarus and Slovakia was there any discernible decline in employment. Simultaneously, unemployment fell gradually (Figure 2.4), and in many EU-CEE countries job vacancy rates approached high pre-crisis levels (Figure 2.5). In general, this attests to the success of policies adopted during the COVID-19 crisis. The uniform commitment of monetary and fiscal policies to demand stabilisation and job protection managed to keep the scarring and hysteresis effects in labour markets to a minimum. This meant that unemployment again declined rapidly and the growth of long-term unemployment could be tamed. As the labour markets recovered, so short-time work schemes and other support measures could be partially withdrawn. In Slovakia, for example, only 137,000 jobs were being subsidised in December 2021, compared to 264,000 a year before.

BOX 2.1 / CHANGES TO LABOUR FORCE SURVEY METHODOLOGY UNDERSTATE EMPLOYMENT GROWTH

Recent changes to the Labour Force Survey (LFS) methodology complicate comparisons, both across countries and over time, and understate the true extent of employment growth in CESEE last year. The most important change is that people who produce agricultural products for their own consumption (subsistence farming) are no longer regarded as employed, but are considered to be out of the labour force. Thus, the figures for employment in agriculture fell substantially in Poland, Bulgaria and Montenegro; and in Romania, they even halved (the unemployment rate in Romania would be about 1 pp lower if we excluded the impact of changes to the statistical methodology). As a result, total employment published from 2021 onwards is lower (based on the new LFS methodology) for many CESEE countries. The changes also had an impact in Bosnia and Herzegovina and in Serbia. In the latter, many who had remained inactive during the COVID-19 restrictions of 2020 again started to search for jobs in 2021, which increased the rate of those statistically registered as unemployed.

By contrast, only in 2021 did Hungary start to classify as employed those people on parental leave who had formerly been in work; this resulted in a statistical increase in employment of 3%.

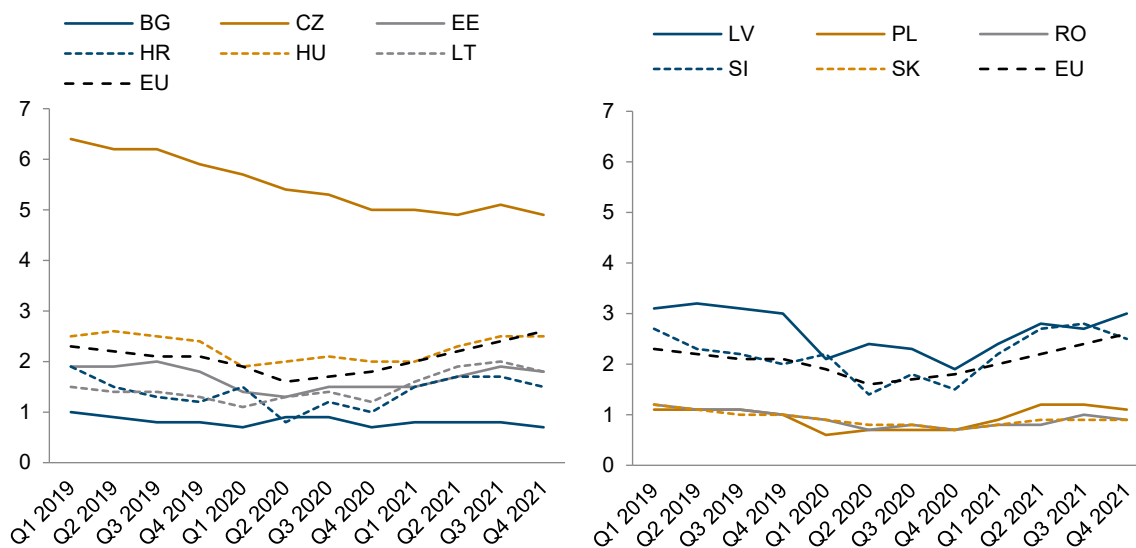
Figure 2.4 / Unemployment rate, in %, quarterly (LFS)



Note: BG, EE, HR, SI, SK, BA, ME, RS, TR: break due to new methodology 2021

Source: wiiw Monthly Database incorporating national statistics. wiiw forecasts for 2022-2024.

At the same time, strong overall employment growth last year was accompanied by a structural change across sectors. While some sectors, such as hospitality, were still ailing somewhat due to COVID-19 restrictions, both industry and business services recruited additional workers. This mirrored the general restructuring of the economies caused by pandemic-induced changes in the structure of household demand. Since, for example, many households could not spend their income on holidays abroad or various other types of leisure activities, they invested in their homes and in consumer durables generally. Those sectors were desperate for additional labour.

Figure 2.5 / Job vacancy rate, in %

Notes: The job vacancy rate measures the number of total posts that are vacant, divided by the sum (number of occupied posts + number of job vacancies), expressed as a percentage.

Data refer to B-S economic activities: Industry, construction and services (except activities of households as employers and extra-territorial organisations and bodies).

Source: Eurostat.

2.3. OUTBREAK OF WAR WEIGHS HEAVILY ON ECONOMIC SENTIMENT

These largely positive developments will be knocked back by Russia's war in Ukraine and by the subsequent sanctions. On 24 February 2022, Russia – partly assisted by Belarus – embarked on the large-scale military invasion of Ukraine. This led to a swift and strong response by the EU, the US and their Western allies, in the form of wide-ranging sanctions imposed on Russia and Belarus. These included financial, trade and personal sanctions against top politicians and oligarchs. In addition, many Western companies have announced their voluntary withdrawal from Russia and Belarus, reflecting their concern about the possibility of being sanctioned indirectly by the US,² fears of nationalisation of their assets and a desire to safeguard their public image.³ In Ukraine itself, economic activity in the war-torn areas contracted sharply as the population fled those areas, logistics were disrupted and infrastructure was damaged. Those Ukrainian regions that have been directly affected by the war account for 53% of GDP, 43% of industrial production, 34% of agricultural production and 50% of goods exports (Table 2.2).

² This happened, for instance, in Iran, after the imposition of US sanctions.

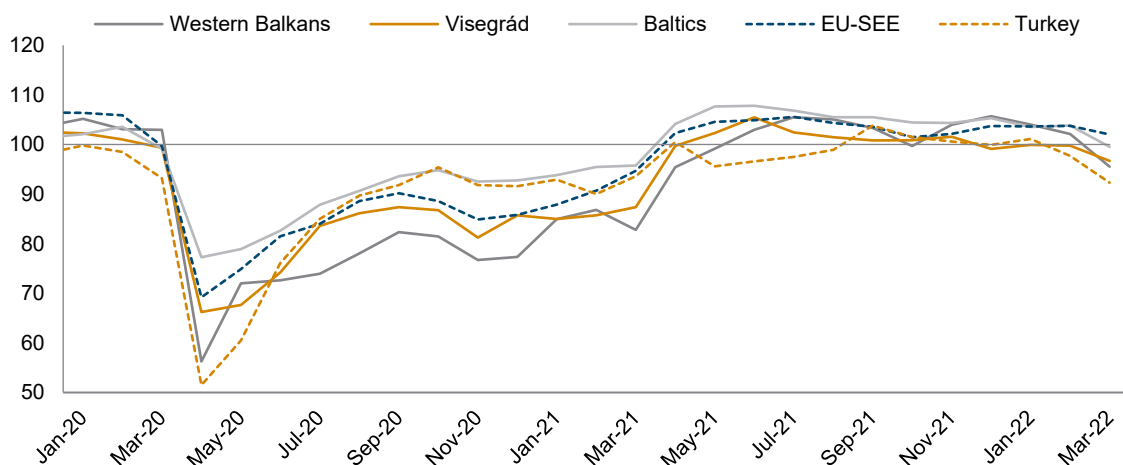
³ At the time of writing, some 600 Western companies have suspended their operations in Russia or announced their withdrawal, while more than 200 have deferred new investment or scaled back their operations. See <https://som.yale.edu/story/2022/over-600-companies-have-curtailed-operations-russia-some-remain> (figures as of 19 April 2022).

Table 2.2 / Main characteristics of the Ukrainian regions on the front line

Regions	Population 2021 million people	GDP 2019	Industrial	Goods	Services	Agricultural	Foreign
			production	exports	exports*	production	direct
			2020	2020	2019	2020	investment
			share of the total for the country, %				
			2020	2020	2019	2020	stock* 2020
Kyiv city	2.95	23.9	11.8	25.3	48.5	-	46.4
Chernihiv	0.96	2.0	1.4	1.8	0.4	6.9	1.1
Kharkiv	2.60	6.2	7.1	3.0	4.6	6.4	2.2
Kherson	1.00	1.6	1.3	0.6	0.4	3.9	0.9
Kyiv	1.80	5.5	5.1	4.0	4.2	5.9	4.4
Mykolayiv	1.09	2.3	2.5	4.6	5.9	3.1	1.5
Donetsk	4.06	5.2	10.3	8.0	1.1	3.3	5.0
Luhansk	2.10	1.0	0.8	0.3	0.4	2.2	0.8
Total for the selected regions	18.91	52.7	43.1	50.3	75.4	34.0	66.0
Total for the selected regions without Kyiv city	15.96	28.8	31.3	25.0	26.9	34.0	19.6

* Excluding unallocated value.

Source: Astrov et al. (2022).

Figure 2.6 / European Commission economic sentiment indicator, long-term average = 100

Note: Simple average of each country group. Western Balkans: Albania, Montenegro, North Macedonia; EU-SEE: Bulgaria, Croatia, Romania, Slovenia.

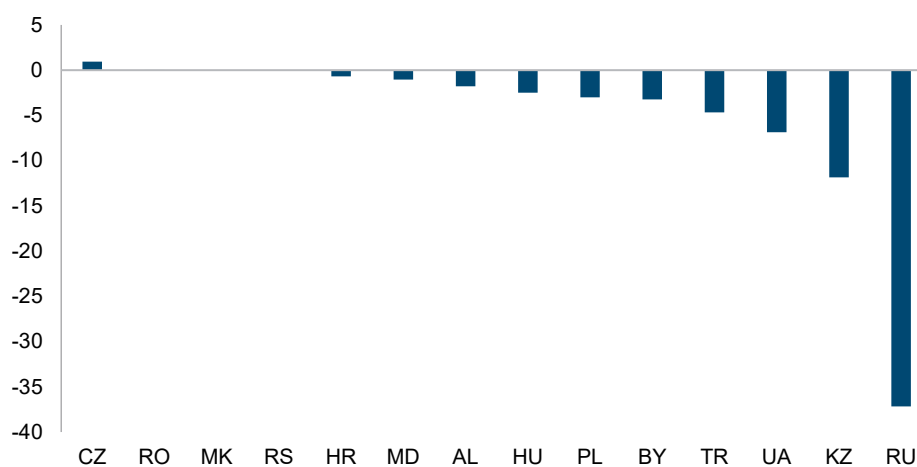
Source: European Commission, Eurostat.

Economic sentiment in CESEE has already suffered as a result. The region is very exposed to the conflict zone: many countries directly border on Russia, Belarus or Ukraine, have seen a large influx of Ukrainian refugees and are heavily dependent on imported food and energy (the latter often coming from Russia); some also have extensive trade and investment links with the countries at war. Therefore, it comes as little surprise that economic sentiment in the CESEE region weakened considerably in March (Figure 2.6). Interestingly, the biggest impact was felt in the Western Balkan countries, despite the fact that many of them do not have very strong direct economic links with Russia and Ukraine. With

the Western Balkans characterised by pronounced political instability in the not-too-distant past, there is an increased perception that the armed conflict could spill over into this region as well.

The immediate impact of the war and the sanctions was strong, albeit short-lived, downward pressure on many CESEE currencies. Unsurprisingly, the Russian rouble suffered the most:⁴ during the first few weeks of the war, it lost nearly half of its value. The pressure on other CESEE currencies was far more limited, with the extent largely reflecting a country's proximity to, and its trade dependence on, Russia. Thus, the Belarusian rouble and the Kazakh tenge broadly followed the fluctuations in the exchange rate of the Russian rouble, losing 30% and 20% versus the US dollar, respectively, during the first few weeks of the war. Among those non-CIS currencies worst affected were the Hungarian forint and the Polish zloty, which depreciated by close to 10% initially. The Czech koruna was affected less (as has usually been the case in times of crisis), while in Serbia (which is relatively close to Russia economically and otherwise) and Romania (which has rather shaky fiscal and external fundamentals) the currencies remained largely stable, thanks to heavy forex interventions (Figure 2.7). However, after the initial 'overshooting', most CESEE currencies recovered (or nearly recovered) to their pre-war levels. In Russia and Belarus, the recovery has been facilitated by capital controls.

Figure 2.7 / Percentage change in the value of the national currency versus EUR, December 2021 to March 2022



Notes: Based on monthly averages. Data for Belarus refer to February 2022.

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

In what follows, we analyse the likely main channels by which the war and the sanctions will have an impact on CESEE economies: (i) rising commodity prices and monetary policy response, (ii) trade disruptions and (iii) the influx of Ukrainian refugees.

⁴ By contrast, the exchange rate of the Ukrainian hryvnia was frozen at its pre-war level, in line with martial law.

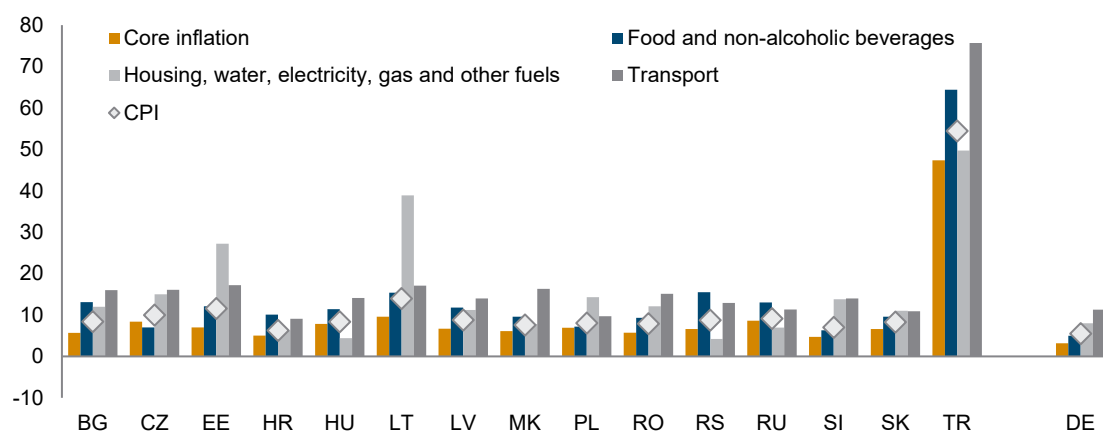
2.4. RISING COMMODITY PRICES AND MONETARY POLICY TIGHTENING

CESEE countries were already facing significant inflationary pressures well before the war.

Defying early predictions that the post-COVID spike in prices was transitory, inflation has been on the rise in CESEE (and elsewhere) over the past year or so. By February 2022, annual inflation had reached double-digit levels in Czechia, Estonia and Lithuania, and was approaching the 10% mark in most other countries. The wiiw Autumn 2021 Forecast Report⁵ came to the conclusion at the time that inflation was primarily being driven by supply bottlenecks and the rising cost of energy and transportation, rather than broad-based demand-side pressures: the rise in core inflation was relatively limited (with the dramatic exception of Turkey). In February 2022, those conclusions still broadly held, although the role of food prices was more pronounced than last autumn (Figure 2.8).

The war in Ukraine and the sanctions on Russia have pushed up energy prices still further, reflecting concerns over Russian energy supplies and transit via Ukraine in wartime conditions. And some of those concerns have actually materialised. The EU has slapped an embargo on imports of Russian coal (with a four-month grace period); the US is banning the import of Russian oil, liquefied natural gas (LNG) and coal; and the UK is stopping imports of Russian oil and coal (by the end of 2022). Furthermore, although an oil embargo has not yet (at the time of writing) been enacted by the EU, oil imports from Russia are already effectively hampered by the disruption to payments and by the fact that some Russian oil majors feature on the sanctions list.⁶ On top of everything else, Russia has demanded a switch to payment in roubles for its gas deliveries to the EU. This demand has not been accepted by the EU, and that has resulted in a further rise in concerns over supply.

Figure 2.8 / Consumer price inflation sub-components in February 2022, percentage change year on year



Source: National sources, Eurostat, wiiw.

Food prices have risen sharply as well. Russia and Ukraine together account for 53% of global trade in sunflower seed and 27% in wheat. In Ukraine, the war-related disruption to agricultural production is amplified by logistical challenges, with seaports – traditionally an important export route – either blockaded

⁵ wiiw (2021).

⁶ As a result of these sanctions, the Urals oil blend is now traded at a considerable discount of up to USD 30 per barrel compared to the benchmark Brent.

(such as Odesa) or at the epicentre of fighting (such as Mariupol). In turn, Russia and some other countries have introduced export bans on wheat and certain other commodities. Finally, metals prices have been on the rise, fuelled in part by bans on imports from Russia. In many CESEE countries, the impact of these developments was already being felt in March, when inflation climbed to new heights.

On account of sharply rising commodity prices, wiiw inflation projections for 2022 have been revised upwards. On average in the region, consumer price inflation is forecast to accelerate to 23% – from 8.8% last year (Table 2.1). Although this is partly driven by Turkey, where inflation will probably average 55% this year, it will pick up elsewhere in the region as well, doubling (or more) in many cases. With increased expenditure on essential items, such as food and energy, households in the region will be increasingly constrained in their purchases of other items, which will hamper the growth of private consumption and GDP. Besides, sharply rising energy prices will affect the performance of energy-intensive industries, possibly resulting in some business closures.

Table 2.3 / Policies to offset the impact of energy price rises on consumers

	Reduced energy tax/VAT	Retail price regulation	Transfers to vulnerable groups	Windfall profits tax/regulation
Albania		x		
Bosnia and Herzegovina	x	x		
Bulgaria		x		x
Croatia	x	x	x	
Czechia	x	x	x	
Estonia	x	x	x	
Hungary		x		
Kosovo			x	
Latvia	x		x	
Lithuania		x	x	
North Macedonia	x		x	
Poland	x	x	x	
Romania	x	x	x	x
Serbia	x	x		
Slovakia		x		
Ukraine	x			

Notes: Includes measures both announced and already approved. Fuel price regulation in Croatia ended at the end of March 2022. In Hungary, price regulation of gas and electricity has been in place since 2015.

Sources: Sgaravatti et al. (2022), Raiffeisen Research (2022), wiiw research.

To counteract price increases, many CESEE countries have resorted to fiscal support measures.

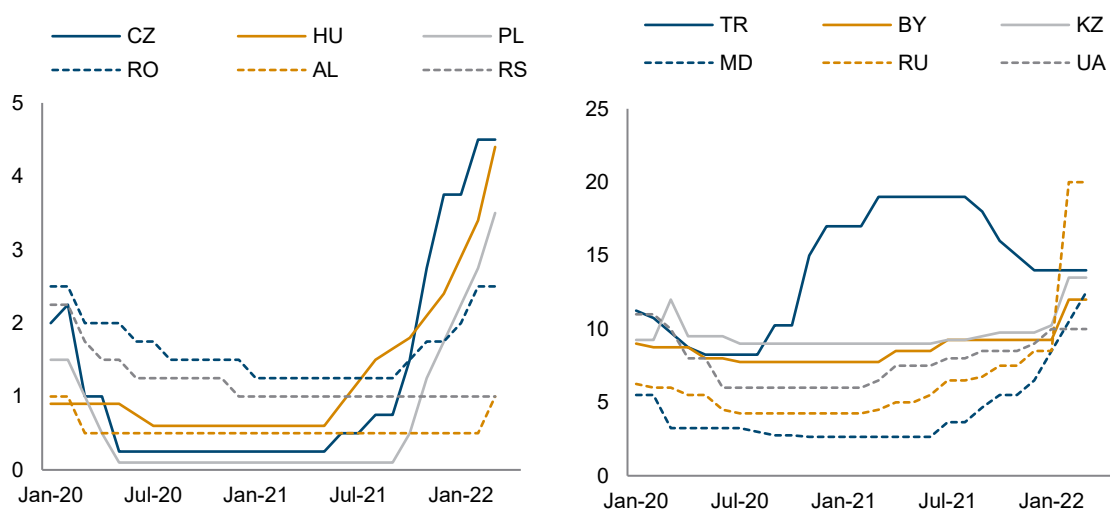
When it comes to energy, the most common measures have been the direct price regulation of fuel and electricity, while Poland and Albania have delayed the liberalisation of gas prices for households and small and medium-sized businesses. Cuts in taxes on energy and cash transfers to vulnerable social groups have also been common, while Bulgaria and Romania have imposed windfall profit taxes on domestic energy companies (Table 2.3). Also, a number of countries have introduced price caps on key foodstuffs (Hungary, Serbia, Russia, Ukraine, North Macedonia); tax cuts on food (Poland, Croatia, Bosnia and Herzegovina, North Macedonia) and fertilisers (Poland, Serbia, Croatia); and agricultural subsidies (Poland, Kosovo, Croatia).⁷ Russia, Belarus, Kazakhstan and Serbia have all imposed export

⁷ Raiffeisen Research (2022).

bans on certain essential food items, in order to boost domestic supply and tame price growth. Nevertheless, all these measures are likely to mitigate the increases in the price of commodities only partly, while resulting in widening budget deficits.

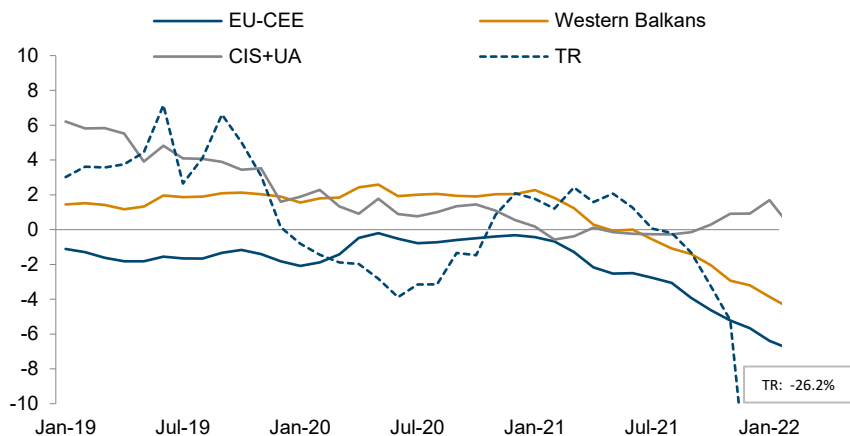
With inflation increasingly deviating from the official targets, many central banks in the region have continued the tightening cycle (Figure 2.9). Of those countries with flexible exchange rate regimes (and therefore with at least a degree of monetary policy autonomy), only Ukraine and Turkey refrained from interest rate hikes after the war started. In Turkey, the policy rate was cut last autumn and has stayed flat over the past few months. In Russia, the policy rate was initially more than doubled – to 20% – as part of the financial stabilisation package in response to Western sanctions.

Figure 2.9 / Central bank nominal policy rate, end of month, %



Source: wiiw Monthly Database incorporating national statistics.

Figure 2.10 / Real policy rate, CPI deflated, %



Note: Simple averages for country aggregates.

Source: wiiw Monthly Database incorporating national statistics.

Nevertheless, real interest rates are firmly in negative territory. The policy rate hikes, by and large, have not kept pace with the acceleration in inflation, so that real interest rates have even declined in many countries (Figure 2.10). Only in the CIS and Ukraine were real policy rates (adjusted for past inflation) in February marginally positive (and even those turn negative once adjusted for future inflation). Thus, there are good reasons to believe that it is primarily commodity price rises per se – rather than the restrictive monetary response to them – that will affect CESEE countries' growth prospects.

2.5. TRADE DISRUPTIONS

Russia is not a very important trading partner for most CESEE countries, and so that will limit the direct trade effects of the sharp recession there on most of the rest of the region. However, Russia is of much more importance to Belarus, where it accounts for around half of total exports and imports, and to Kazakhstan, where over 40% of imports come from Russia. The Baltic states and Moldova are also relatively dependent on trade with Russia, while that is not the case with many Western Balkan countries (Figure 2.11). However, Russian tourists have historically been an important source of revenue for Croatia and Montenegro, as well as for Turkey.

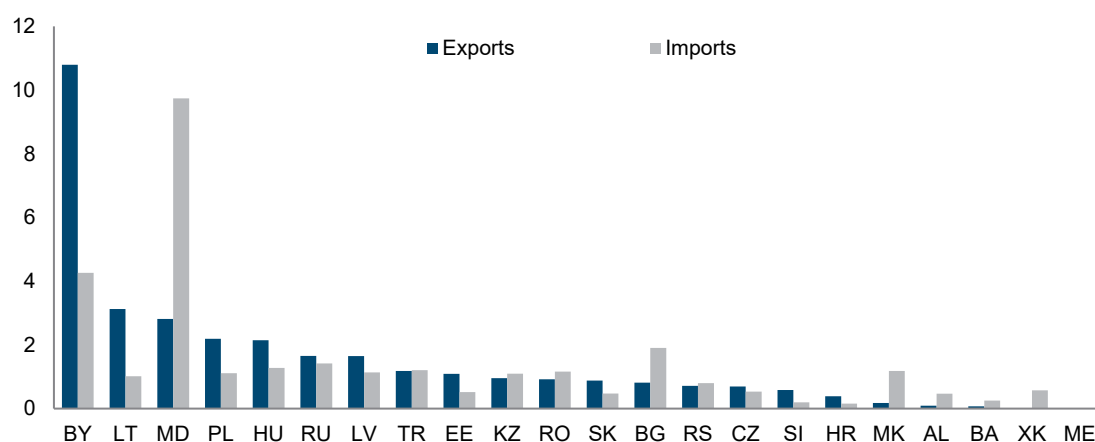
Figure 2.11 / Merchandise trade with Russia, as % of total



Note: Data refer to last available year.

Source: wiiw Annual Database incorporating national statistics and Eurostat.

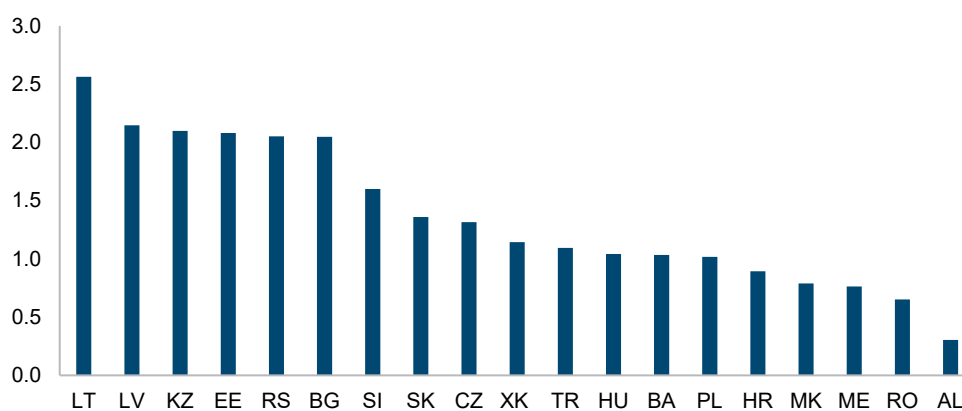
The role of Ukraine as a trading partner is even lower – less than 2% in most cases. Again, notable exceptions are Belarus, where around 10% of exports go to Ukraine, and Moldova, which has around 10% of imports coming from there (Figure 2.12).

Figure 2.12 / Merchandise trade with Ukraine, as % of total

Note: Data refer to last available year.

Source: wiiw Annual Database incorporating national statistics and Eurostat.

Value-added exports to Russia account for only around 1% of GDP for most CESEE countries, limiting the negative effects of the downturn in Russia on regional economies (see Figure 2.13, which shows value added directly and indirectly involved in exports linked to Russian final domestic and imported demand). Accordingly, the impact on the CESEE economies of the looming Russian recession should be relatively small. Figure 2.14 shows these effects modelled according to two scenarios, which differ in terms of their underlying assumptions (see Box 2.2 for details). In the first scenario, the greatest negative effect should be on Bulgaria (-0.45 pp of GDP growth), while in the second scenario the negative impact on CESEE economies is even smaller, as they adjust to changes in sourcing structures. The economy of Kazakhstan might actually be boosted as a result, with domestic production benefiting from the reduction in (up until now very large) imports from Russia.

Figure 2.13 / Value-added in exports to Russia in 2018, share of GDP in %

Note: Western Balkan countries based on wiiw MC-IOT.

Source: OECD TIVA database, Release 2021, own calculations.

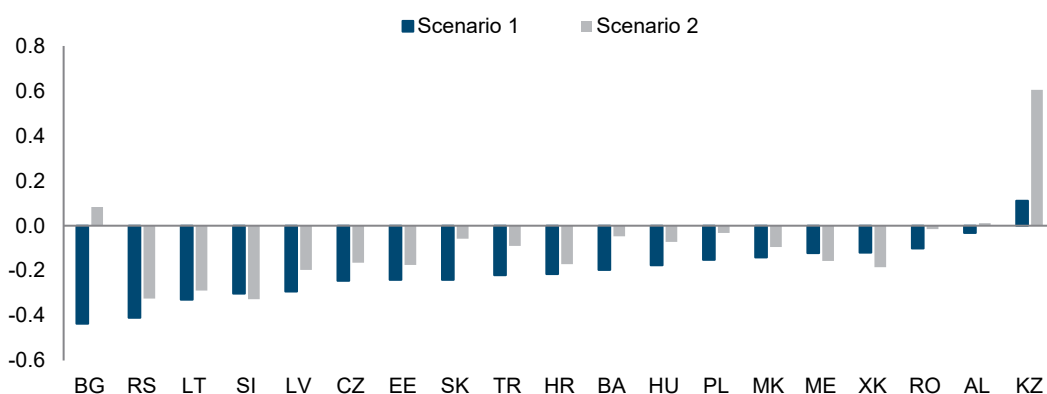
BOX 2.2 / SCENARIOS OF RUSSIAN RECESSION AFFECTING CESEE VIA THE TRADE CHANNEL

In the first scenario, we assume economic recession in Russia of 10%, and a reduction of 30% in Russian imports of final goods and of 13% in Russian exports of final goods. This is roughly in line with the current wiiw forecasts for Russia. These declines can be substituted by CESEE countries with domestic production or imports from other countries. Technically, for the sake of simplicity, we assume a proportional change in the sourcing structures of final goods. There is no change in the sourcing structures for intermediate inputs.

In the second scenario, as well as the trade decline in final goods outlined in scenario 1, we also assume a trade decline of the same magnitude in intermediate products. We assume that the decline in Russian exports of intermediate products can be countered by CESEE countries using substitutes from other countries (proportionally, according to the current sourcing structures of intermediate inputs), and that Russia is able to counter the decline in imports of intermediate products domestically. We allow for changes in the sourcing structures by applying the ‘partial global extraction method’. Such a scenario might be interpreted as the global economy responding to this shock by implementing longer-term structural changes to sourcing structures.

It should be stressed that these scenarios indicate only the direct effects of the recession in Russia via trade and production linkages. They do not take into account potential adverse effects on growth and demand in other countries, e.g. due to the rising cost of energy and raw materials, supply-chain disruptions, or dependence on critical inputs (like gas or oil), on specific commodities (like palladium or nickel) or on inputs like neon.

Figure 2.14 / Estimated GDP effects of projected recession in Russia in 2022 via the trade channel, in pp



Notes: For the assumptions underlying scenarios 1 and 2, see Box 2. For the Western Balkan countries simulations are based on the wiiw MC-IOT.

Source: OECD TiVA database, Release 2021, own calculations.

Overall, disruptions to trade with Russia and Ukraine should cost most CESEE economies some 0.5 pp of GDP growth this year.⁸ However, sectors with a high degree of production fragmentation and extensive cross-border value-chain linkages will be affected much more. A case in point is the important automotive industry. Already weakened by the COVID-related shortages of semiconductor chips,⁹ it now faces a fresh challenge, as the war has disrupted the production and shipment of cable looms produced in Western Ukraine. This has already resulted in production being halted in many car factories across the region (see Box 2.3).

BOX 2.3 / IMPACT ON THE AUTOMOTIVE INDUSTRY OF THE WAR AND SANCTIONS

The automotive industry has been hit by shortages and by the rising cost of inputs from Ukraine and Russia. Ukraine is a major supplier of cable looms. Following the Russian invasion, supply-chain disruptions have hit the big car manufacturers in Europe, and some have had to stop production for lack of cable looms from Ukraine. Also, Ukraine is a major producer of neon gas, which is used in the production of semiconductors. Thus, the chip shortage that has been plaguing the automotive industry since 2021 will be further aggravated. For its part, Russia is a major exporter of metals, including the palladium used in catalytic converters and the nickel used in batteries: it accounts for 25% and 14% of world exports of these metals, respectively.¹⁰ Already, the price of these metals has soared as a result of the war and sanctions.

However, the direct impact of the fall-off in demand from Russia should be more limited. On the export side, the exposure of the EU-CEE automotive industry to Russia is generally quite small. In terms of motor vehicle exports,¹¹ the figure is highest for Slovakia (3.4% in 2019), followed by Poland (2%); other countries have shares of below 1%.¹² In terms of the export of car parts,¹³ the figure is somewhat larger for Czechia and Romania (around 4%), followed by Slovakia (2.5%) and Poland (1.7%). Trade links, for example, exist between Romania's Dacia and the Renault factories in Russia.

The greatest impact of the war and the sanctions is being felt by Russia itself, with car production currently running at 50% of the level a year ago.¹⁴ Apart from supply-chain disruptions, it is exposed to the additional shock of foreign car manufacturers leaving the country en masse. Among those foreign producers that have halted production in Russia are BMW, Ford, Toyota, Nissan and Mitsubishi, while Renault has announced its intention of selling its stake in the joint venture with Russia's Avtovaz. Failure of the ongoing negotiations between these companies and the Russian government would open up the possibility of their assets being nationalised.

⁸ The assumption here is that the much deeper recession in Ukraine (-38% projected for 2022) compared to Russia (-9%) will be offset by the much lower dependence of CESEE countries on trade with it.

⁹ For more on this, see Hanzl-Weiss and Reiter (2022).

¹⁰ OECD (2022).

¹¹ NACE rev. 2, 29.1.

¹² For some individual producers, this share is much higher: e.g. Kia in Slovakia exports around 12% of its cars to Russia; Suzuki in Hungary around 10%.

¹³ NACE rev. 2, 29.3.

¹⁴ 'Russia looks to shore up automotive market amid sanctions', 13 April 2022, <https://www.wardsauto.com/industry-news/russia-looks-shore-automotive-market-amid-sanctions>

2.6. INFLUX OF UKRAINIAN REFUGEES STRAINING GOVERNMENT BUDGETS

The massive influx of Ukrainian refugees fleeing the war should not place too much strain on CESEE labour markets. About half of all the refugees arriving in CESEE countries are children, while a large proportion of the adults are women with care responsibilities; they will not join the labour force of the host countries immediately. Besides, the demand for labour in many CESEE countries is high. In Poland, where more than 2m Ukrainian refugees have ended up, the unemployment rate stands at only 3.4%; meanwhile, in Czechia, where more than 300,000 people have arrived, it is as low as 2.8%. Also in other CESEE countries that are today hosting a large number of Ukrainians (Hungary, Romania and even Moldova), the unemployment rate hovers around 5%.

It is primarily the public spending of host countries that will come under strain. With activation of the EU Temporary Protection Directive on 8 March,¹⁵ Ukrainian refugees will be entitled to full access to housing, health care, child care, education and social welfare assistance for the next 12 months. In order to finance this increased expenditure, the EU Council adopted the regulation on Cohesion's Action for Refugees in Europe (CARE) on 4 April; this allows countries to spend an additional EUR 17bn in total from cohesion and other EU funds.¹⁶ Rough estimates, based on the 2015/2016 wave of refugees, suggest overall annual EU-wide expenditure of EUR 15,000 per refugee, or EUR 40bn in total. Since the majority of refugees are hosted in only a few EU countries, discussion is in progress on whether the EU might introduce additional funds or allocation mechanisms to distribute the costs more equitably.¹⁷ Moldova – which is hosting more Ukrainian refugees per capita than any other CESEE country – will also get EU financial assistance.¹⁸

The chances are good that those Ukrainian refugees who are willing (and permitted) to stay in the EU long term will integrate quite quickly. The Ukrainian population is, in general, well educated.¹⁹ This does not guarantee that they will easily find a job: highly skilled jobs require a good level of competence in the host country's language, and the transferability of skills is generally a problem for migrants. Experience shows that low-educated refugees are likely to find jobs more quickly. On the other hand, the incoming refugees will encounter existing migrant networks of fellow Ukrainians in the host countries: in 2020, 500,000 Ukrainians already had a temporary residence permit for Poland and 165,000 for Czechia – double the figure for Germany. The host countries' governments should, in any case, invest in language courses and other measures to raise the skills of the newcomers. That should allow them to integrate better into the labour market and society.

¹⁵ https://ec.europa.eu/commission/presscorner/detail/en/ip_22_1469

¹⁶ <https://www.consilium.europa.eu/en/press/press-releases/2022/04/04/ukraine-council-unlocks-17-billion-of-eu-funds-to-help-refugees/>

¹⁷ Darvas (2022).

¹⁸ https://ec.europa.eu/commission/presscorner/detail/en/ip_22_2272

¹⁹ Astrov et al. (2022).

2.7. GROWTH SLOWDOWN AHEAD, BUT RECESSION ONLY IN THE CIS AND UKRAINE

Due to the adverse impact of the war and sanctions, wiiw growth forecasts for the region have been revised downwards, compared to January,²⁰ in some cases sharply (Table 2.4). The growth forecast for 2022 has not been revised upwards for a single CESEE country; for Slovenia it has been left unchanged.²¹ The extent of the revision varies considerably by country, with Ukraine and Russia obviously being the worst affected, followed by their CIS neighbours. In most other countries, growth is now projected to be around 1 pp lower than was forecast in January; that said, the downward revisions are bigger in Romania, Bulgaria and the Baltic states, which are more vulnerable both to disruption in trade with Russia and to geopolitical risks. For 2023-2024, the pattern is more mixed, but downward revisions still prevail, suggesting that the current crisis is likely to leave its legacy over the medium term as well.

Table 2.4 / Real GDP growth forecasts and revisions – Baseline Scenario

		Forecast, %			Revisions, pp		
		2022	2023	2024	2022	2023	2024
EU-CEE	BG	2.0	3.7	3.5	↓ -1.8	↑ 0.2	→ 0.0
	CZ	2.6	3.5	4.2	↓ -1.4	↓ -0.1	↑ 0.6
	EE	1.8	3.4	3.1	↓ -1.7	↓ -0.6	↓ -0.2
	HR	3.5	4.0	3.1	↓ -1.2	↓ -0.1	↓ -0.2
	HU	2.5	3.9	4.5	↓ -2.0	↓ -0.1	↑ 0.8
	LT	1.7	2.8	2.6	↓ -2.0	↓ -0.5	↓ -0.3
	LV	1.4	2.2	2.3	↓ -2.9	↓ -1.4	↓ -0.7
	PL	4.0	3.5	3.6	↓ -0.9	↓ -1.4	↓ -0.7
	RO	2.0	3.5	4.5	↓ -2.3	↓ -1.0	↓ -0.3
	SI	4.1	3.3	2.8	→ 0.0	→ 0.0	↓ -0.2
Western Balkans	SK	2.4	3.1	3.0	↓ -1.5	↓ -0.6	↓ -0.3
	AL	3.5	3.7	3.9	↓ -0.7	↓ -0.3	↑ 0.1
	BA	1.8	2.3	2.3	↓ -0.7	↓ -0.5	↓ -0.3
	ME	3.5	3.7	3.3	↓ -1.0	↑ 0.7	↑ 0.6
	MK	2.5	2.7	2.7	↓ -1.0	↓ -0.5	↓ -0.3
	RS	3.6	3.4	3.4	↓ -1.3	↓ -1.1	↓ -0.6
Turkey	XK	3.3	3.7	3.9	↓ -1.0	↓ -0.3	↓ -0.1
	TR	2.7	2.8	3.2	↓ -0.8	↓ -0.7	↓ -0.8
CIS+UA	BY	-3.5	1.6	2.0	↓ -4.5	↓ -0.4	→ 0.0
	KZ	1.5	3.2	4.0	↓ -2.7	↓ -1.2	↓ -0.1
	MD	-3.0	3.0	4.0	↓ -7.0	↓ -1.5	↓ -0.5
	RU	-9.0	-1.5	1.0	↓ -11.0	↓ -3.0	↓ -0.5
	UA	-38.0	5.0	13.0	↓ -41.5	↑ 1.5	↑ 9.0

Note: Current forecast and revisions relative to the wiiw Winter forecast 2022. Colour scale variation from the minimum (red) to the maximum (green).

Source: wiiw.

²⁰ wiiw (2022).

²¹ Slovenia is arguably the least exposed to these shocks and showed unexpectedly strong growth performance in the first quarter.

Most CIS countries covered in this report will not be able to avoid recession this year (Table 2.1).

This will be determined by several factors: Western sanctions (Russia and Belarus), high trade exposure to Russia (Belarus and Moldova) and a steep rise in energy prices (Moldova). In Russia, recession is likely to persist into next year as well, reflecting economic stagnation under sanctions and this year's relatively high statistical basis, on account of the country's still strong performance in the first quarter. Only the economy of Kazakhstan will stay afloat and register positive growth this year on the back of high energy prices.

Ukraine is poised for imminent economic collapse. In the baseline scenario, which assumes that a ceasefire is signed by the middle of the year and reconstruction can get under way, its economy is projected to shrink by 38%, though it will return to growth next year. Needless to say, this forecast is subject to enormous risks, most of which are on the downside. Economic dynamics this year and next will obviously depend on the duration and intensity of the war, but also on the reconstruction effort once the war is over. A large-scale Western package akin to the Marshall Plan (currently under discussion) would provide a welcome boost to the economy, but its effect is unlikely to be fully felt before next year. Besides, private-sector investment will take much longer to return. Finally, there is a lot of uncertainty over the country's future borders, which will obviously affect economic dynamics as well.

Elsewhere in CESEE, recovery will decelerate markedly this year, before picking up slightly in 2023-2024. In EU-CEE, the recovery is expected to slow by 2.6 pp, which is roughly in line with the euro area; but the slowdown will be more pronounced in the Western Balkans (4.5 pp) and especially Turkey (8.3 pp), where the credit boom had already run into balance-of-payments constraints at the end of last year and is unlikely to carry on. In many countries, the slowdown can be directly attributed to the war and sanctions. It is indicative that in nearly all of them (except Romania, Turkey and Albania), net exports are likely to act as a drag on growth this year, reflecting war-related trade disruptions (Figure 2.15). In some cases, the war also has negative repercussions for domestic demand: in Estonia, for example, the investment boom observed last year is now falling flat and many projects are being cancelled in the face of dramatically increased risk perceptions.²² In other countries, it is idiosyncratic factors that will come to the fore: in Hungary and Serbia, for instance, runaway public spending before the April 2022 elections will yield to budget consolidation.

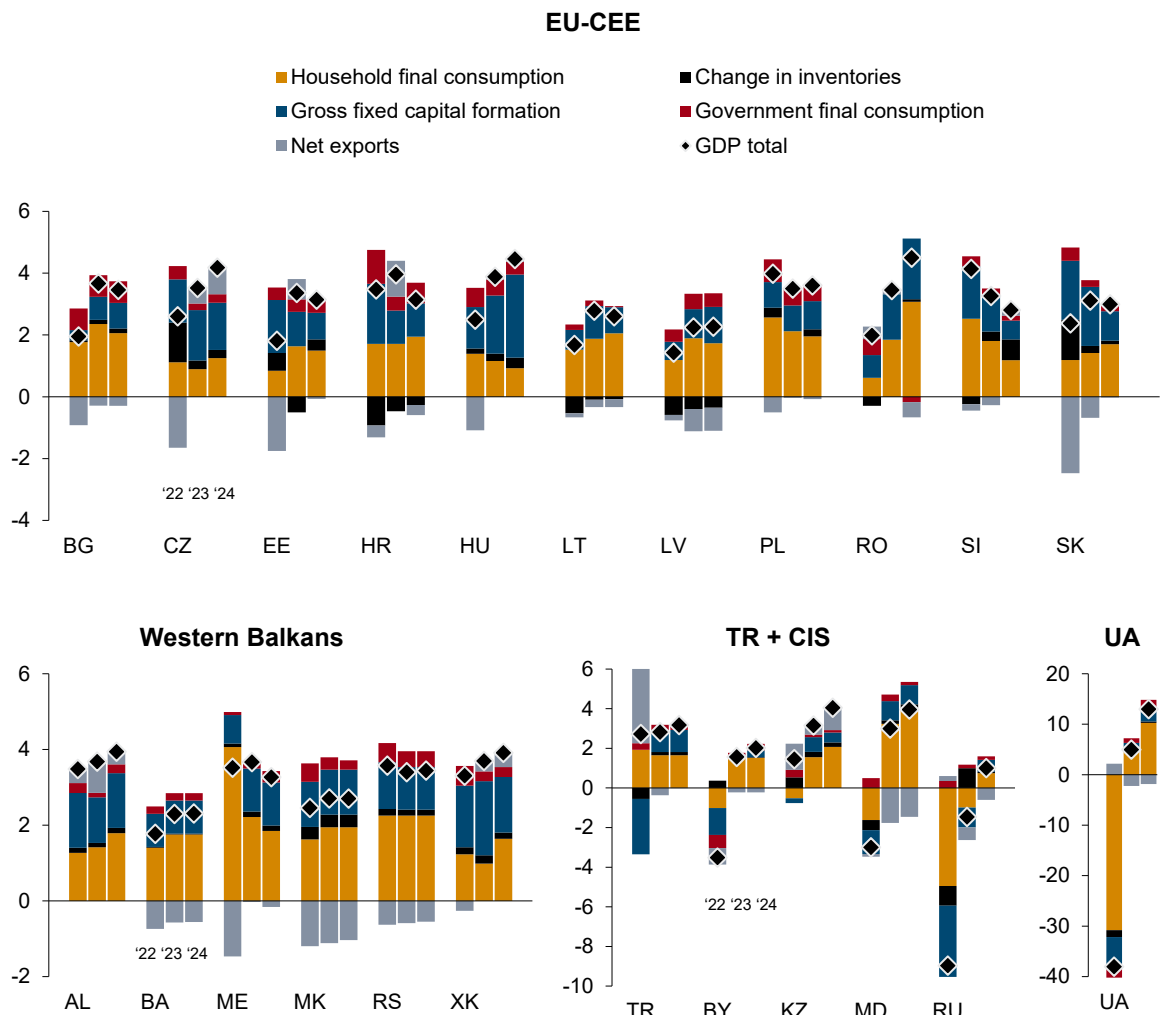
The negative effects of the projected slowdown in growth on CESEE labour markets should be limited. Although the previously observed rapid labour market revival will run out of steam, unemployment rates in the region will still show a slight downward trend in years to come (Figure 2.4 above). Only in Estonia, Russia and Ukraine do we expect an increase in unemployment; in Ukraine this increase will obviously be enormous. As of mid-April, the number of Ukrainian refugees who left Ukraine after 24 February 2022 had reached 4.6m. Moreover, in Ukraine itself an additional 7.1m are internally displaced.²³ In most other CESEE countries, the remarkable pre-pandemic situation on the labour market is likely to be attained again in 2024.

²² Estonia and the other Baltic states are located close to Russia. Despite their NATO membership, some people believe their security is in jeopardy.

²³ These figures are as of 11 April 2022 and originate from the UNHCR data portal (<https://data2.unhcr.org/en/situations/ukraine>) or most recent press reports.

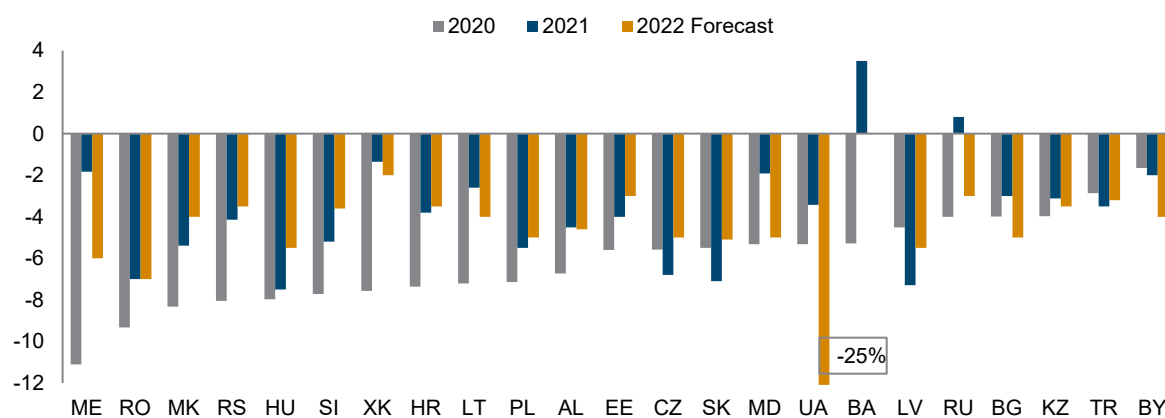
Figure 2.15 / GDP growth forecast for 2022-2024

and contribution of individual demand components in percentage points



Source: wiiw forecasts.

Energy and food subsidies and increased social spending on refugees will hamper fiscal consolidation across CESEE. Last year, economic recovery and the partial withdrawal of COVID-related income support resulted in a marked improvement in fiscal balances (Figure 2.16). However, in 2022 this trend will be partly reversed, with increased public spending (and falling tax revenues in CIS countries as they enter recession) resulting in a renewed widening of the budget deficit in Bulgaria, Lithuania, Kazakhstan, Montenegro, Albania and Kosovo. In Ukraine, the war will wreck the government budget: the fiscal deficit is projected to balloon to 25% of GDP this year, and will have to be largely covered by Western official assistance.

Figure 2.16 / Fiscal balance, as % of GDP

Note: 2021 data are partly wiiw estimates.

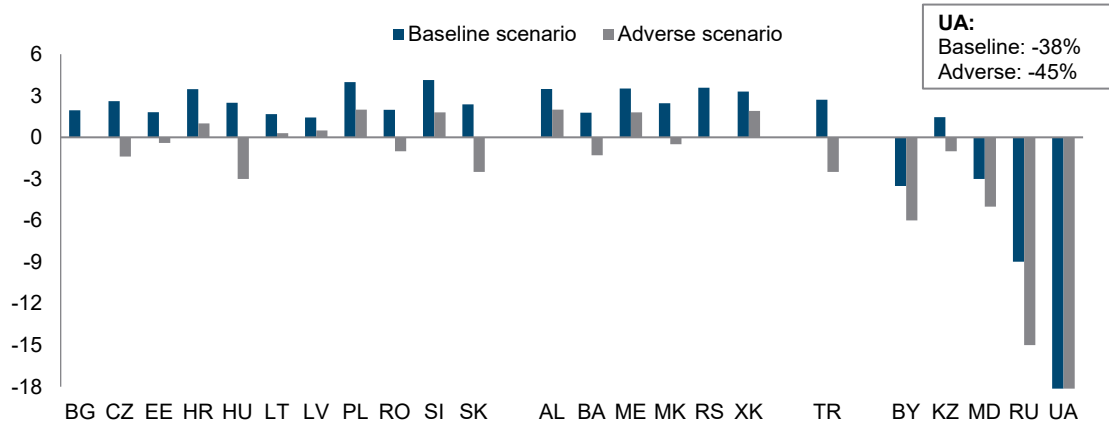
Source: wiiw Annual Database incorporating national statistics and Eurostat; wiiw forecasts.

In the more adverse scenario – assuming a further major escalation of the war and an immediate EU embargo on Russian oil and gas – many CESEE countries will slide into recession this year, while inflation will soar into double figures nearly everywhere. In this scenario, the Russian economy may contract by 15% this year (or more), primarily because the EU is the main export market for its gas, while export diversification towards Asia is hampered by infrastructure bottlenecks. Outside the CIS and Ukraine, recessions are likely to be deepest in Hungary, Slovakia and Turkey (Figure 2.17a), reflecting their heavy dependence on Russian gas and the limited short-term possibilities for its substitution. In other cases, where reliance on Russian gas is lower (Poland, Czechia, Romania), where it is technically feasible to replace it with alternative supplies, such as LNG (the Baltic states), or where the import embargo will not apply (the Western Balkans), the negative growth impact should be less pronounced. However, soaring energy prices will be felt everywhere in the region,²⁴ pushing inflation into double-digit territory (Figure 2.17b). In 2023-2024, the shock should subside, with alternative energy supplies becoming more readily available and CESEE economies gradually adjusting to the ‘new normal’. However, growth will remain lower than in the baseline scenario, marred by scars left by the energy shock (Table 2.5).

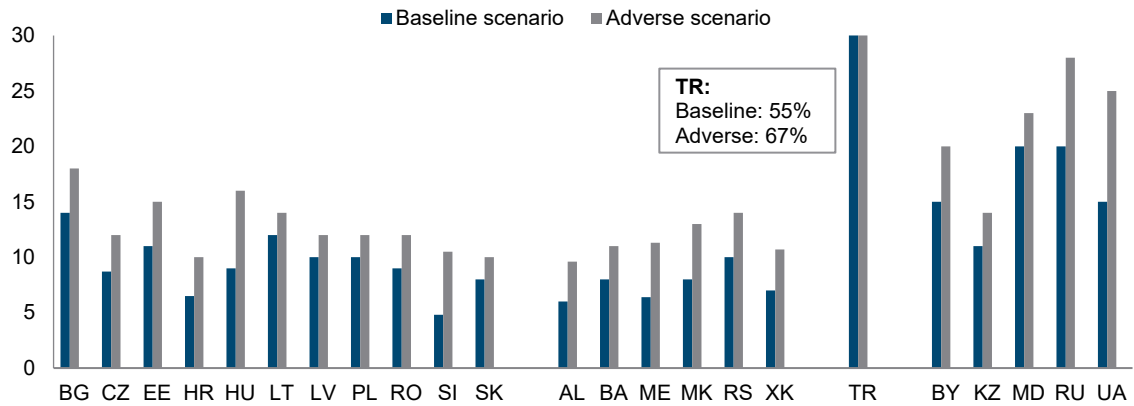
²⁴ Technically, we assume that an EU import embargo on Russian energy will result in a doubling of global energy prices this year, to around USD 200 per barrel on an average annual basis, based on the available consensus expert forecast.

Figure 2.17 / wiiw forecasts for the baseline and adverse scenarios compared

(a) Real GDP, % change year on year, 2022



(b) Average consumer price inflation, % change year on year, 2022



Source: wiiw forecasts as of 7 April for basis scenario and as of 20 April 2022 for adverse scenario.

Table 2.5 / Indicators 2020-2021 and Outlook 2022-2024 - adverse scenario

		GDP					Consumer prices				
		real change in % against prev. year					average change in % against prev. year				
		2020	2021	Forecast			2020	2021	Forecast		
				2022	2023	2024			2022	2023	2024
BG	Bulgaria	-4.4	4.2	0.0	2.0	2.5	1.2	2.8	18.0	10.0	6.0
CZ	Czechia	-5.8	3.3	-1.4	1.5	3.5	3.3	3.3	12.0	6.5	3.2
EE	Estonia	-3.0	8.3	-0.4	2.0	3.4	-0.6	4.5	15.0	6.5	4.0
HR	Croatia	-8.1	10.4	1.0	2.5	3.0	0.0	2.7	10.0	6.0	5.0
HU	Hungary	-4.7	7.1	-3.0	0.5	2.5	3.4	5.2	16.0	8.0	5.0
LT	Lithuania	-0.1	5.0	0.3	1.4	1.8	1.1	5.5	14.0	7.0	4.0
LV	Latvia	-3.8	4.7	0.5	1.5	1.7	0.1	3.2	12.0	7.5	4.0
PL	Poland	-2.5	5.7	2.0	2.5	2.5	3.7	5.2	12.0	7.0	5.0
RO	Romania	-3.7	5.9	-1.0	3.0	4.0	2.3	4.1	12.0	7.0	4.0
SI	Slovenia	-4.2	8.1	1.8	2.7	3.1	-0.3	2.0	10.5	6.5	3.7
SK	Slovakia	-4.4	3.0	-2.5	1.0	2.5	2.0	2.8	10.0	7.5	3.0
	<i>EA19¹⁾</i>	-6.4	5.3	-0.9	1.8	1.4	0.3	2.6	9.5	4.0	2.7
AL	Albania	-3.5	8.5	2.0	2.2	2.6	1.6	2.0	9.6	5.0	3.6
BA	Bosnia and Herzegovina	-3.1	7.1	-1.3	1.1	1.8	-1.1	2.0	11.0	6.0	4.0
ME	Montenegro	-15.3	12.4	1.8	2.2	2.8	-0.3	2.4	11.3	6.0	3.2
MK	North Macedonia	-6.1	4.0	-0.5	1.5	2.0	1.2	3.2	13.0	9.0	5.0
RS	Serbia	-0.9	7.4	0.0	2.0	2.5	1.6	4.1	14.0	10.0	6.0
XK	Kosovo	-5.3	10.5	1.9	2.4	2.7	0.2	3.4	10.7	5.5	3.2
TR	Turkey	1.8	11.0	-2.5	1.5	3.5	12.3	19.6	67.0	26.0	15.0
BY	Belarus	-0.7	2.3	-6.0	0.0	1.5	5.5	9.5	20.0	15.0	12.0
KZ	Kazakhstan	-2.5	4.0	-1.0	2.7	4.0	6.8	8.0	14.0	10.0	7.0
MD	Moldova	-7.4	13.9	-5.0	3.0	4.0	3.8	5.1	23.0	12.0	6.0
RU	Russia	-2.7	4.7	-15.0	0.0	1.5	3.4	6.7	28.0	19.0	4.0
UA	Ukraine	-3.8	3.4	-45.0	4.0	12.0	2.7	9.4	25.0	15.0	7.0

1) wiiw estimates.

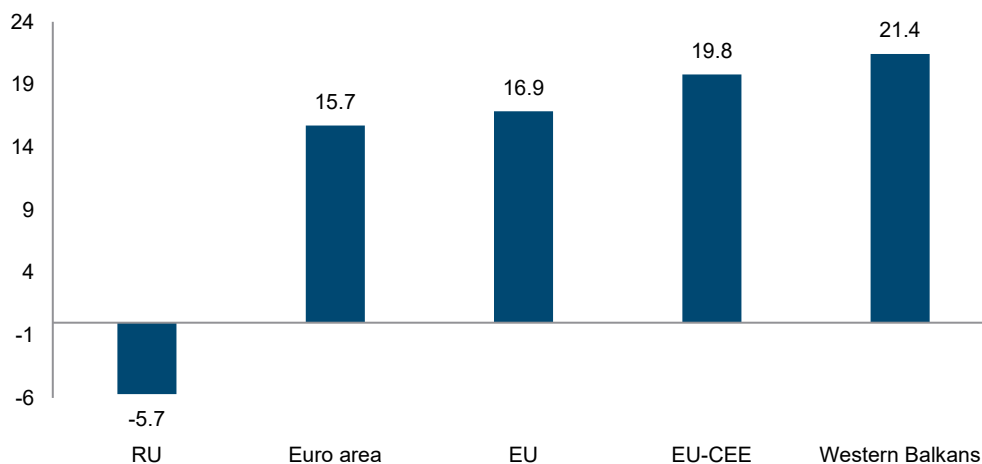
Source: wiiw, Eurostat. Forecasts by wiiw. Cut-off date for historical data: 7 April 2022, for forecasts: 20 April 2022.

2.8. IMPLICATIONS FOR AUSTRIA

Austria's direct trade exposure to the CESEE economies most affected by the war in Ukraine is limited. Austria's merchandise exports are traditionally dominated by Germany: in 2021, it accounted for 30.1% of all Austria's exports. By contrast, Austria's exports to Belarus, Russia and Ukraine combined accounted for less than 2% (1.2% to Russia and 0.3% to Ukraine). If the Visegrád region were a country, it would be Austria's second-biggest trading partner, accounting for 13.3% of Austrian exports in 2021.

Exports to Russia were already declining in 2021, but this was of limited significance, given the strong growth in sales to more important markets in the EU and CESEE. In the whole CESEE region, only Russia and Montenegro experienced a drop-off in Austrian exports last year. Austria's exports to the EU as a whole increased by 16.9%, to EU-CEE countries by 19.8%, and to the Western Balkans by 21.4% (Figure 2.18). Exports to EU-CEE contributed decisively to Austria's swift economic recovery after the COVID shock: with that region accounting for 28% of Austria's exports in 2021, 32 percentage points of the overall increase in Austrian exports to the EU can be attributed to EU-CEE countries.

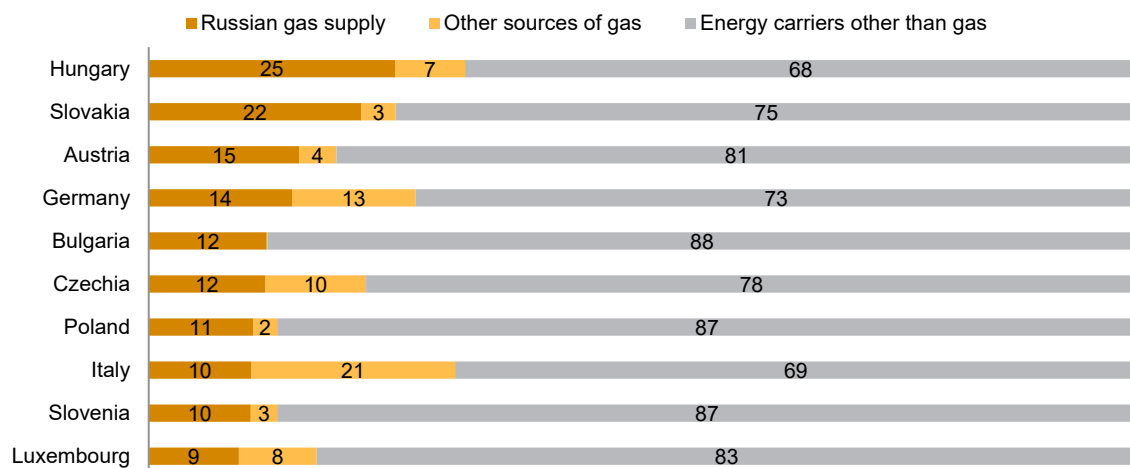
Figure 2.18 / Austrian merchandise exports by destination in 2021, % change year on year



Source: Statistik Austria.

On the import side, Austria's dependence on Russia, Ukraine and Belarus is not very great either, but Austria is highly dependent on Russian gas imports. In terms of the proportion of Russian gas in overall energy consumption, Austria ranks third among EU member states (Figure 2.19). Moreover, of the remaining nine top-ranked states, all but one (Luxembourg) feature among Austria's most important trading partners: these include Germany, the Visegrád countries and Italy. It should be noted that Austria's heavy reliance on Russian gas is a consequence of previous policy decisions. In recent years, some states have undertaken considerable efforts to diversify their gas supply: with EU support, Poland has built an LNG terminal that can now cover approximately a quarter of the country's demand for gas; and the Gas Interconnector Greece-Bulgaria pipeline is expected to be commissioned this year. Overall, Austria has failed to take similar steps.

Figure 2.19 / Dependence on Russian gas supplies as a share of overall final energy consumption, top 10 EU countries



Source: McWilliams et al. (2022).

Austria's heavy reliance on Russian gas is reflected in its current objection to the expansion of EU sanctions on Russian gas and oil. On 8 March, the European Commission set out a plan to cut Russian gas imports by two thirds this year,²⁵ and to stop importing Russian gas well before 2030.²⁶ This plan is already very challenging and would be associated with high costs. Should the EU, however, decide to go further and impose a full import embargo on Russian oil and gas (e.g. because of additional atrocities committed by Russian armed forces in Ukraine), the Austrian economy would be badly hit – albeit not as strongly as the Russian economy. The outcome in this scenario would likely be a recession in the euro area as a whole (see Table 2.5), including in Austria.

Austria's direct investment exposure to Russia, Ukraine and Belarus is limited. In 2021, 35% of its foreign direct investment (FDI) stocks were in CESEE (Figure 2.20), with Poland, Czechia and Romania accounting for half of that. Russia ranked sixth, with 2.3% of Austria's stocks, while Ukraine's share was just 0.3%. By way of comparison, Austrian FDI stocks in Germany amounted to more than 17% of the total. As regards Russia's investments in Austria, Vienna should step up its preparations for an expansion of EU sanctions or for asset freezes. As an example of what may need to be done, only recently the German authorities took over control of Gazprom Germania.

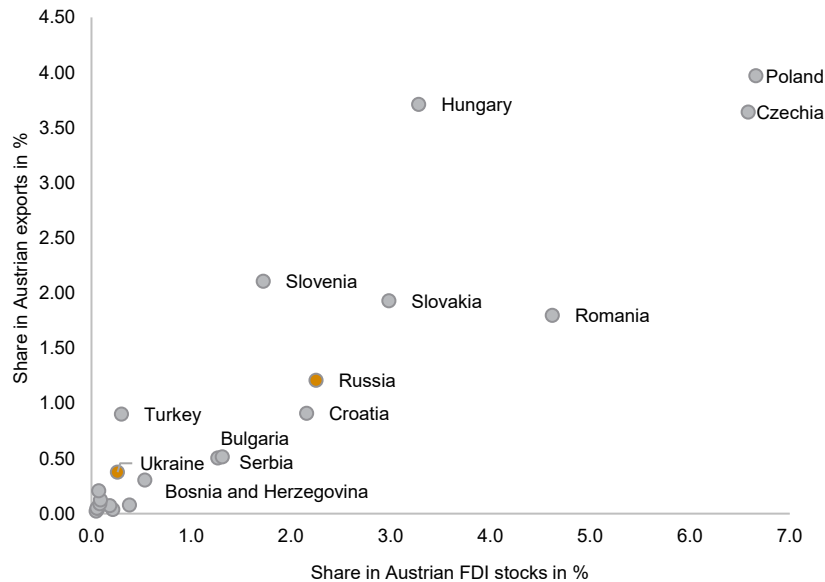
For Austria, the main channels of contagion from the war and sanctions will be via indirect effects: supply-chain disruptions and soaring energy prices. These negative effects apply both to Austria and to its key trading partners – and that fact could magnify the impact. In March, inflation already stood at 6.7% in Austria on an annual basis, with energy and food prices being the dominant drivers. The Austrian Purchasing Managers' Index (PMI) for manufacturing in March reached 59.3 – up from 58.4 in February and well above the 50 level that separates expansion from contraction. However, that is below the January level, as well as the levels observed between April and October last year, when it averaged 63.9. This

²⁵ <https://www.euractiv.com/section/energy/news/eu-rolls-out-plan-to-slash-russian-gas-imports-by-two-thirds-before-year-end/>

²⁶ This was part of the updated 'REPowerEU: Joint European action for more affordable, secure and sustainable energy' initiative, see https://ec.europa.eu/commission/presscorner/detail/en/IP_22_1511

suggests that supply-chain disruptions and elevated commodity prices are already having some impact on Austrian industry, and that impact could become bigger in the coming months.

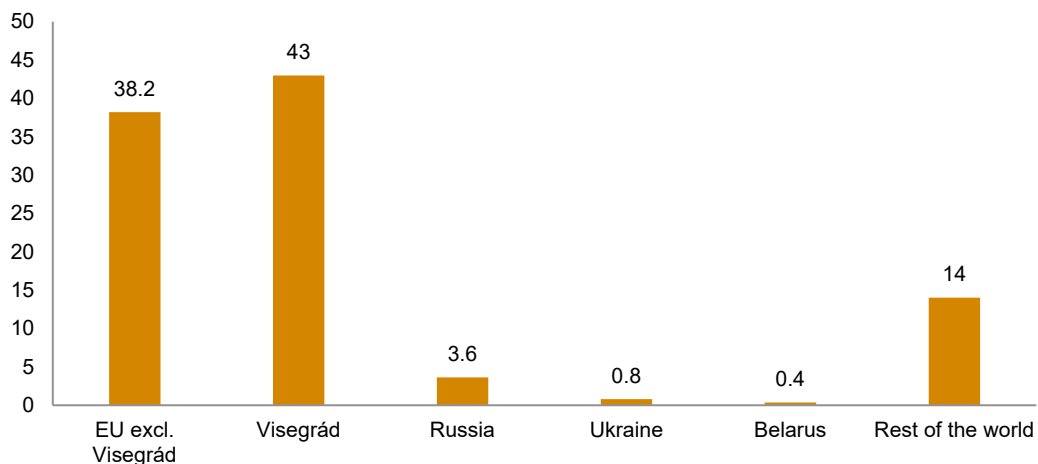
Figure 2.20 / Austrian trade and investment links with CESEE in 2021



Source: Statistik Austria 2022, wiiw.

A further area of possible contagion is via the banking sector, where Austrian lenders have built up a strong position in CESEE, including in Russia and Ukraine. Here again, the Austrian banking sector's exposure lies predominantly within the EU, which accounts for 81% of its foreign assets. Indeed, in Q3 2021, 43% of all its foreign assets were in just the four Visegrád countries (Figure 2.21), while Russia accounted for 3.6%. This is considerably above Russia's share of Austrian external trade or outward FDI.

Figure 2.21 / Foreign claims of Austrian banks, % share of total in Q3 2021

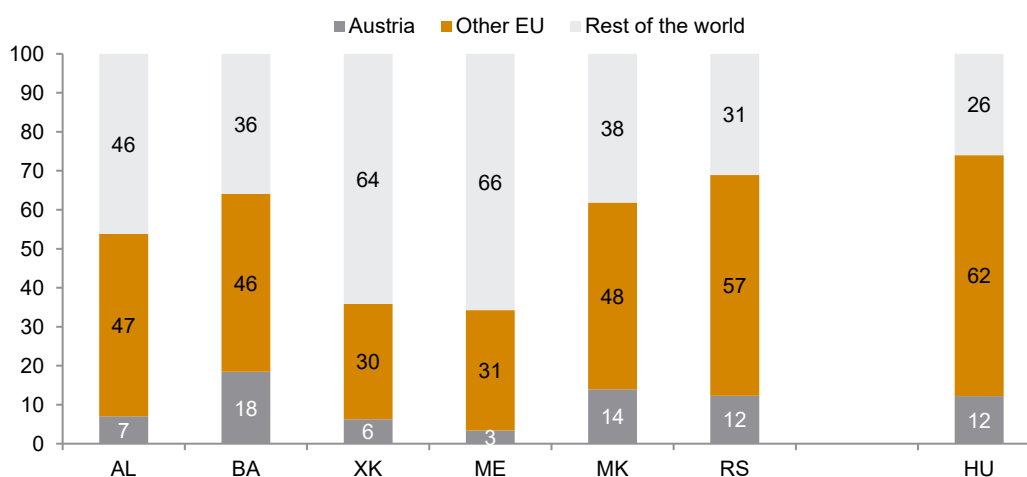


Source: BIS, wiiw.

In light of the war in Ukraine, there is an increased likelihood of political instability in the Western Balkans, a region of major importance to Austria. Russia could step up its efforts to destabilise the area. Serbia, which has so far avoided joining European sanctions against Russia, is expected to continue this policy, following President Vučić's re-election. Also, efforts to destabilise Bosnia and Herzegovina, particularly by the leadership of Republika Srpska, are expected to continue and intensify. China has also attracted recent public attention both for its arms deliveries to Serbia and for its investment in infrastructure, such as the construction of motorways in Croatia and Montenegro. Chinese geopolitical ambitions are increasingly coming to be regarded as critical – both by its European partners and by the EU itself. The EU has been gradually responding and has been focusing on its own supply chains: such as by monitoring its dependence on critical raw materials, or by starting to implement new investment screening policies in 2020 that involve eight member states, including Austria).²⁷

Austria is one of the most important foreign investors in the Western Balkans, and any speeding up of the EU enlargement process would be good news for it. Austria is the biggest investor in both Bosnia and Herzegovina and North Macedonia; and in Serbia, it is the second biggest. European integration and stability in the region are in Austria's vital interests both politically and economically. Its strong presence in the region also gives it considerable leverage on domestic policy actors, and it should make good use of that. The recent focus on Ukraine, Moldova and Georgia and on their ambitions to join the EU could present an opportunity for the Western Balkan region, since the current war shines a spotlight on the geopolitical dimension of EU enlargement and on the ambitions of non-Western players in the region, such as Russia and China. This could help overcome the current anti-enlargement wariness among certain EU member states.

Figure 2.22 / FDI inward stock in 2020, selected countries, as % of total



Source: wiiw FDI Database incorporating national statistics.

The conflict between Hungary and the European Commission is expected to continue, and that could have negative spill-over effects for Austria. After Prime Minister Orbán won the Hungarian parliamentary election in April, the European Commission was quick to announce that it intended to apply the rule-of-law mechanism to withhold Recovery and Resilience Facility (RRF) funds earmarked

²⁷ Oberhofer et al. (2022); Zavorská (2022).

for Hungary. This move is expected to emphasise Hungary's economic weakness and could also have a negative impact on Austrian trade and investment: Austria is Hungary's third-largest investor, and 12% of its outward FDI stocks are there. It might have expected to benefit from spill-overs from the RRF transfers that Hungary was due to receive.²⁸

Finally, uncertainty about the continuation of the COVID-19 pandemic is also rife in the region.

Vaccination rates are still lower than in Austria, and challenges remain in the various countries' healthcare sectors. Given that a war is raging, the COVID-19 pandemic is not expected to be the main economic peril to confront Austria's economy from the direction of CESEE; but it could continue to contribute to the melange of trade-related challenges.

2.9. CONCLUSIONS

The Russian invasion of Ukraine and the Western sanctions on Russia represent a monumental shock to the economy of the entire CESEE region – and not only of countries directly involved in the military conflict. This shock has come just as the region was recovering strongly from the COVID-related slump, and it will be a drag on further growth prospects. Via the rising prices of energy, food and other commodities, it adds to the existing inflation challenge in CESEE economies. Higher inflation will eat into real incomes and depress economic growth in the region. In the months ahead, this will be the most important mechanism by which the war and the sanctions impact on the region's economies.

Most CESEE economies will be able to take this shock in their stride – at least to some extent.

This is largely because, leaving aside commodity trade, Russia is not a very important economic or financial partner for the region; furthermore, much of the unwinding of economic links had already taken place in the years since the annexation of Crimea. Therefore, our core prediction for the bulk of the CESEE region over the forecast horizon 2022-2024 is for weaker but still positive momentum, with the CIS and Ukraine being the main exceptions. Arriving Ukrainian refugees will not jeopardise the regional labour market – indeed, in many cases they may alleviate labour shortages. However, they will strain government budgets, as will the fiscal measures to contain rising energy and food prices.

The forecast risks are largely tilted to the downside. In the more adverse scenario –assuming a further escalation of the war and an immediate EU embargo on Russian oil and gas – many CESEE countries will slide into recession this year, while inflation will soar into double figures nearly everywhere.

²⁸ Astrov, Stehrer and Zavorská (2022).

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