Executive summary

Last year, 2019, was a decent one for most of CESEE, but the slowdown from the peak year of 2017 continued for the region as a whole. Even before coronavirus, an external slowdown was evident, driven by the US-China trade war, weaker global growth in general, and extremely sluggish performance in Germany.

The spread of the coronavirus to Europe has already had negative economic effects, and these could intensify in the coming months. The fallout is already impacting production networks and substantially restricting activity in sectors such as tourism, aviation and energy. The extent of the fallout is, however, highly uncertain. To reflect this uncertainty, in addition to our baseline (or pre-coronavirus) projections for the global economy and CESEE, we have produced GDP forecasts for three coronavirus scenarios: mild, medium and severe.

Under our pre-coronavirus baseline scenario, we had projected that aggregate real GDP growth for CESEE would rise to 2.9% this year, from 2.1% in 2019, largely on account of improvements in Russia and Turkey. In our 'mild' scenario, regional growth rates would be 0.2-0.6 percentage points below this baseline. For the 'severe' scenario, we project that growth would be around 1.1-2.5 percentage points lower. In all cases, the CIS countries and Turkey would be worst affected, with the EU member states and some Western Balkan countries faring relatively better.

The extent of the impact will vary by country, depending on specific areas of vulnerability. Countries with higher levels of trade integration with China (particularly CIS countries) or Italy (especially Albania, Bulgaria, Croatia, Romania and Slovenia) will be worse affected, as will those reliant on energy exports (Russia and Kazakhstan) or tourism (Croatia, Slovenia, Albania and Montenegro). The capacity of healthcare systems to cope is also likely to vary considerably across the region.

We expect the coronavirus to have a notable negative impact on economic activity in the first half of 2020, but that this will then fade in the second half of the year. Overall, we expect much of the GDP lost now to be made up later.We cannot exclude a more 'severe' and longer-lasting demand shock, and a recession in parts of CESEE.

We are likely to see further loosening of fiscal and monetary policies in EU-CEE, in order to counteract the economic slowdown caused by the coronavirus. The Western Balkans, Turkey, and CIS and Ukraine will be limited by considerations of macro-financial stability and will have less fiscal room for manoeuvre.

Beyond 2020, our outlook remains broadly unchanged. Underlying growth in the global economy was already close to its weakest level since the global financial crisis, and this will not change fundamentally during the forecast period. This is despite massive monetary stimulus in the US, Europe and Japan (which we expect to continue).

In 2021-2022, we anticipate economic growth of below 3% in EU-CEE, whereas the Western Balkans are expected to avoid a growth deceleration during that period. Outside EU-CEE and the Western Balkans, pre-coronavirus we had made significant upward revisions to our GDP forecasts for the bigger economies (Turkey, Russia and Ukraine), based on more expansionary fiscal and/or monetary policies. However, without structural reforms there are substantial negative risks to the sustainability of growth.

The coronavirus has temporarily diverted the attention of economists and policy makers from fundamental issues facing CESEE. One of the biggest issues is the shortage of labour, which is likely to become more acute and will subsequently threaten the sustainability of the region's economic model, based as it is on labour-cost advantages and participation in regional production chains.

Digitalisation could help CESEE to increase the productivity of its economies by developing more productive service sectors and increasing the servitisation of their production processes. The region is believed to be well equipped for further digitalisation. However, it is important to develop adequate government policies to ensure reskilling of the labour force and to support investment in new technologies.

COUNTRY SUMMARIES[1]

ALBANIA

Growth is expected to remain moderate in the coming two years. Private consumption on the demand side and services on the production side will continue to support growth, but at a slower pace. A devastating earthquake hit Albania on 26 November 2019. The conference of donors initiated by France raised EUR 1.15 billion, which will likely spur growth in the short term. Since the EU enlargement process is being reformed, the accession process for Albania is likely to get stricter and more rigorous.

BELARUS

The Belarusian economy remained sluggish in 2019, with GDP growing by a meagre 1.2%. Recent performance was adversely affected by a deepening dispute with Russia over the price of imported hydrocarbons, while the domestic economic policy stance has remained relatively tight. The prospects for a favourable oil price deal with Russia are slim and no change in macroeconomic policy is likely in the near future. We therefore expect GDP growth to be around 1% in 2020, and slightly higher in the following two years.

BOSNIA AND HERZEGOVINA

After previous setbacks following the global financial crisis, the Bosnian economy is expanding steadily, with an expected growth rate of around 2.7% in 2020 and 3% p.a. in the period 2021-2022. The official unemployment rate is expected to decline further, from 30% in 2020 to around 28.5% in 2022; however, this will partly be a result of the great 'brain drain' and the withdrawal of workers from the labour market. Even though growth continues to be stable, the newly formed central government may yet be challenged by the emergence of a potential migration crisis in spring/summer 2020.

BULGARIA

After an upturn in the first half of 2019, economic activity subsided in the second semester. The slowdown was triggered by a weakening of external demand, while private consumption remained relatively strong. The labour market tightened further and continued to exert pressure on wages. The short-term prospects have deteriorated, and GDP growth is expected to decelerate to below 3% in 2020 – and may slow further in the coming years.

CROATIA

Croatia's economy performed well in 2019. GDP growth will slow somewhat over the forecast period, but will remain at a relatively high level (2.7% p.a.) thanks to the country's strong tourism sector. Private consumption and investments supported by EU transfers will remain the main drivers of growth. In its quest to adopt the euro as soon as possible, the Croatian government will seek to keep the budget in balance or in surplus, and to further reduce public debt.

CZECH REPUBLIC

GDP growth has gradually been losing momentum, as productive investment starts to decline. Labour resources are nearing depletion, but labour shortages are failing to spark intensified capital formation. Interest rates on loans are no longer as low as they used to be, and the exchange rate is becoming less

[1] These country summaries were written before the full extent of the coronavirus became clear, and therefore reflect our pre-coronavirus assumptions. Country-specific updates following the spread of coronavirus to Europe are included in chapter 3 of this report.

stable. The recessionary tendencies in Germany are spilling over into Czech manufacturing. Consumption remains the backbone of a subdued growth in output.

ESTONIA

Investment activity is expected to slow in 2020, following last year's strong increase. Furthermore, growth in external demand will continue to decline both this year and in 2021. Household consumption, backed by an ongoing rise in employment and real wages, continues to be a strong driver of economic activity. We project a decline in GDP growth to 2.7% in 2020, followed by a further slowdown to 2.5% in 2021 and a slight upswing to 2.7% in 2022.

HUNGARY

With GDP growing last year by 4.9%, the Hungarian economy turned in one of the best performances in the EU. This expansion was driven by domestic demand, primarily investments. But sustainability is the critical issue highlighted here: the economy faces reduced EU transfers, uncertainties and fragile growth in the export markets, labour shortages, rapidly rising wages and a weakening of the national currency.

KAZAKHSTAN

Economic growth will decelerate to below 4% over the forecast period, having peaked at 4.5% in 2019 on the back of extensive fiscal stimuli. Domestic demand will remain robust, but low exports, along with strong import demand for capital goods, will negatively impact economic performance. A decline in commodity prices and the slowdown in China are downside risks to export dynamics.

KOSOVO

Great things are expected of the new government, but it faces some big challenges in consolidating the rule of law and energising the economy. Its ambitious programme is expected to stimulate private and public investment. Kosovo-Serbia dialogue is likely to be resumed, thanks to the active and leading role of the USA. In the medium term, growth will remain robust at above 4%, backed by consumption and investment, and Kosovo is likely to remain among the fastest-growing economies in CESEE.

LATVIA

The Latvian economy experienced a soft landing in 2019. Growth in gross fixed capital investment and foreign trade has declined substantially and will remain subdued in 2020-2021. A tight labour market will keep wages rising fairly swiftly, which will lead to lively household consumption over the next two years. Export activity is likely to revive slightly this year. Despite the economic slowdown, the labour market is tightening further, with the unemployment rate set to fall to 6.3% this year and in 2021. In 2020, we expect GDP growth to decline further to 2.0%, to be followed by a slight upswing (to 2.4%) in 2021 and on to 2.6% in 2022.

LITHUANIA

A better-than-expected export performance and still swiftly rising gross fixed capital investment propelled growth in the Lithuanian economy in 2019 to 3.9% in real terms year on year. A further minimum wage hike and a reduction in the effective income tax rate for low earners will maintain the country's remarkable increase in the purchasing power of households. Thus, private consumption will continue to encourage the rapid growth of economic activity. External demand was strong in 2019, but is likely to abate in the next two years. For 2020, we expect real GDP to grow by 2.8%, followed by a small decline to 2.6% in 2021 and then 2.7% in 2022.

MOLDOVA

Economic growth accelerated to about 4.8% in 2019 on the back of booming investments and household consumption. In the wake of sluggish external demand and declining investment, growth is expected to hover at around 4% in the coming years. The resumption of transfers from the IMF and the EU has stabilised external financing.

MONTENEGRO

Montenegro's economy continues to benefit from strong tourism, a rise in investments and an increase in industrial production. Economic growth will continue in 2020 at 3.3%, the same as in 2019. A fall in private and public consumption, however, will restrain growth in 2021-2022. Public debt remains the greatest medium-term risk to the economy, especially the huge investment in the Bar–Boljare motorway project. The country is still struggling with domestic problems: deindustrialisation, demographics, an inflated government apparatus and a still rigid labour market.

NORTH MACEDONIA

After a long period of stagnation and negative development, rising investments and a boost in consumption will ensure stable GDP growth for North Macedonia in the period 2020-2022 of about 3.3% p.a. The construction industry has started to expand and recorded solid growth rates in 2019. In addition, unemployment will fall to a historical low in 2020. Despite stable projections, North Macedonia still suffers from various socioeconomic issues. Moreover, the delay to the start of EU accession talks has dampened the country's growth potential.

POLAND

Economic growth has been losing momentum as industry starts to underperform. Household consumption is driven by sharply rising wages and social transfers. Labour shortages are becoming less acute, while moderate inflation is back, driven by a supply-side shock to agriculture. The next government may feel obliged to discontinue the country's lavish social policies.

ROMANIA

The Romanian economy is emerging from a period of overheating and has to tackle high fiscal and current account deficits. Economic growth will cool from 4.1% in 2019 to 3.2% in 2020, and then 2.8% in 2021. Abundant financial inflows will allow a slow reduction of the twin deficits, but with increased vulnerability to financial turbulence. Political instability is expected to continue until general elections, expected to take place in mid-2020, ahead of schedule.

RUSSIA

Last year, growth slowed to a mere 1.3% on the back of weakening private consumption and export decline. However, following a recent shift to a more expansionary fiscal and monetary policy, GDP growth is expected to pick up to above 2% in 2020-2022. The constitutional changes recently proposed by President Putin suggest that he will not seek another re-election in 2024, although he will likely retain his political influence in a different capacity.

SERBIA

The Serbian economy is performing strongly, and after a robust 2019 outturn we have made an upward revision to our 2020 forecast. Growth is being driven above all by strong private consumption and investment, the latter supported by the construction of the TurkStream gas pipeline and FDI inflows. The outlook for regional stability is more positive after intensive US mediation, but the upcoming parliamentary election could mean somewhat higher domestic political risk.

SLOVAKIA

Slovakia's growth halved in 2019, reaching only 2.4%. In 2020, it is forecast to increase by 2%, and by around 2.5% in the years thereafter. Overall, growth is backed by stable household consumption, while the effect of net exports is unclear. Domestic and external risks are rising.

SLOVENIA

GDP growth will remain unchanged at 2.6% in 2020, due to sluggish external demand, but will increase slightly thereafter. Domestic consumption will remain the main driver of growth, but could be dampened by the recently adopted consumer loans restrictions. Downside risks arise from changes in global conditions and adverse demographics.

TURKEY

Turkey has again confirmed its status as the most high-beta economy in CESEE, with a host of indicators suggesting that a 'V-shaped' recovery is in progress. The currency crisis and sharp economic downturn of 2018–2019 now seem a long time ago, following a sharp bounce-back in the second half of last year. Growth could be around 4% this year, but that will mean a return to reliance on credit growth and external imbalances, and the old familiar vulnerabilities of the Turkish economy.

UKRAINE

Rapid macroeconomic stabilisation in 2019 allowed for a marked loosening of monetary policy. Exports showed robust growth on the back of agricultural products and services – notwithstanding hryvnia appreciation. We have revised our forecast of GDP growth upwards in the light of the positive trends. In 2020, GDP will grow by 3.6%, and in 2021-2022 growth will accelerate to 4.2% and 4.5%, respectively. A major risk to the forecast remains the inability of the government to break the oligarchs' grip on the country.

Keywords: CESEE, economic forecast, Europe, Central and Eastern Europe, Southeast Europe, Western Balkans, new EU Member States, CIS, Russia, Ukraine, Romania, Czech Republic, Hungary, Turkey, Serbia, convergence, business cycle, coronavirus, external risks, trade war, EU funds, private consumption, credit, investment, digitalisation, servitisation, exports, FDI, labour markets, unemployment, employment, wage growth, migration, inflation, central banks

JEL classification: E20, E31, E32, F15, F21, F22, F32, F51, G21, H60, J20, J30, J61, O47, O52, O57, P24, P27, P33, P52