Executive summary

The CESEE region has so far coped relatively well with the economic and financial fallout from the Russian invasion of Ukraine. The economic results for the first half of 2022 were generally better than expected, owing mainly to the release of pent-up consumption as COVID restrictions were relaxed. Rising incomes from the beginning of the year and supportive credit activity also contributed, as did the fact that people brought forward purchases in anticipation of higher prices in the future.

Still, the surge in the global prices of food and energy caused by the war has generated runaway inflation everywhere in the region. Inflation has already reached double-digit levels in all CESEE countries, except Albania, and there are no signs of it slowing down. The most recent data available suggest that it continued to accelerate during Q3, and that it has not yet peaked.

The economic damage from the higher and more persistent inflation will become evident only as time progresses. Real incomes are in freefall almost everywhere in CESEE – their year-on-year growth rates turned negative in most of the countries back in June, when inflation was much lower than it was in August or September. Consumer confidence is lower than in the early days of the pandemic, and business sentiment is also deteriorating, though not yet to the same extent.

Central banks are hiking their rates, which will have only a limited effect on inflation, but will certainly take its toll on the economy. To some extent, the rises are understandable – the central banks have a legal mandate to fight inflation, and many countries are trying to prevent capital outflow and currency depreciation, following hikes by the Fed and the European Central Bank. But they will inevitably slow credit activity, and in turn the economy, and may magnify existing risks to the financial systems and property markets.

The higher interest rates will further limit the scope for CESEE governments to support their economies during the cost-of-living crisis. Fiscal policy was not very supportive during the first half of the year: government consumption was much weaker than at the start of the pandemic. And that trend will only intensify in the coming period, as governments experience increased difficulty in finding money, on account of the rising borrowing costs everywhere in the region.

On top of all this comes the cut in the supply of Russian gas to Europe. Different countries will be affected differently by this, but we see three main challenges for the region. The first arises from gas dependence. Some CESEE countries are heavy users of gas – half of the countries depend on gas more than Germany does. So they could well suffer from lack of the fuel. To some extent, the gas already set aside in storage facilities will help; but the volumes there are enough to cover only a fraction of annual consumption.

The second challenge arises from the high import of electricity among some of the countries. Because of the currently high electricity prices, these countries will have trouble finding affordable electricity, which could eventually lead to stoppages at some big industrial plants, at least for a while. The Baltic countries, North Macedonia and Hungary are particularly vulnerable to this risk.

The third challenge arises from high exposure to the German economy, which will almost certainly enter recession over the winter. For the Visegrád countries, North Macedonia and Slovenia, exports to Germany exceed 15% of GDP. If there is energy rationing in Germany and the temporary closure of some plants, those countries will be severely hit.

The better-than-expected first half of 2022 means that we are revising our growth forecasts for this year upwards for most of the CESEE countries. For 14 of the region's 23 countries, we now expect higher GDP growth; for four countries we keep the forecast unchanged; and for five we revise our projection downwards. Most notably, we raise the growth forecast for Ukraine by 5 percentage points (pp), because of the way the economy had adapted to war conditions, and because of the country's success on the battlefield. At the same time, we also upgrade our growth forecast for Russia by 3.5 pp, as the country's economic situation is obviously better than anybody expected, at least for the time being.

The higher and more persistent inflation over the first eight months means that we are also revising our inflation forecasts for 2022 upwards for almost all the countries. Russia is a notable exception – we revise its forecast for this year downwards (by 1.7 pp), due to the appreciation of the rouble in recent months. Turkey will have the highest inflation in 2022, of around 71% for the year as a whole. The only three countries that will have single-digit inflation are Albania (7%), Croatia and Slovenia (both around 9.5%).

Our forecasts for 2023 are far more pessimistic than three months ago. In a way, they are similar to our adverse scenario from spring, in which we assumed that the EU would ban Russian energy imports. The difference is that it was not the EU that banned Russian energy imports, but rather Russia that decided to cut its gas supply to the EU. The overall effect is similar, though: the unavailability of gas has led to its price increasing, fuelling inflation and crippling growth.

Consequently, our new inflation forecasts for 2023 are higher than before for almost all the countries. On a weighted average basis, we now expect inflation in CESEE in 2023 to be 11.6%, which is far higher than in the euro area (6%). This figure is greatly influenced by Turkey, which will have the highest inflation in 2023, of around 27%. Still, all the CESEE countries will have elevated inflation, and in only two (Albania and Slovenia) will it be lower than in the euro area.

GDP forecasts for 2023 are being revised downwards for almost all the CESEE economies. The biggest revisions are for Moldova (3 pp downwards), due to its dire energy situation, and Hungary (2.7 pp lower), on account of its twin deficits and the suspension of the EU transfers that it was supposed to receive. Despite the deteriorating outlook, we still anticipate that only two countries will see their GDP decline for the whole year – Russia (by 3%) and Hungary (by 1.2%). Ukraine will have the strongest growth (of 5.5%), although that forecast is subject to big downside risks related to the course of the war. On a weighted average basis, we forecast that the CESEE region will grow by 0.3% next year – close to the euro area growth of 0.2%. However, this forecast is heavily influenced by Russia, the biggest economy in the region, which is expected to suffer a 3% decline next year. On a simple average basis, the CESEE region will grow by 1.5% next year, which is clearly better than the euro area.

There are various reasons why many CESEE countries will outperform the euro area in terms of economic growth next year, regardless of having higher inflation. The first is convergence: less-developed countries tend to have higher average growth than more-developed countries. A second reason is that some of the countries are in a better position than the euro area in terms of energy: some CESEE countries do not depend on gas at all, while others export large quantities of electricity. A third reason is that those CESEE countries that are members of the EU should receive sizeable amounts of money from the Recovery and Resilience Facility, which will help keep their economies afloat.

COUNTRY SUMMARIES

ALBANIA

GDP in 2022 will be 3.5%, backed by private consumption and, to a lesser extent, by investments. It will likely stay at above 3% over the forecast horizon. Inflation has been picking up very rapidly, but is still among the lowest in the region. Whether enough energy can be secured for the winter will depend on rainfall and on the volatile import prices, and is among the key risks to our growth forecast for this year and next.

BELARUS

The economy is in recession, as the impact of the war in Ukraine has been amplified by the new Western sanctions. The authorities have adopted some policy measures aimed at damping the shocks and have negotiated new support agreements with Russia. Public finances have been under considerable strain, inflation has kept rising, and problems have also emerged over the servicing of the external debt. GDP is expected to fall by 4.5% in 2022, and the prospects for the coming years remain bleak.

BOSNIA AND HERZEGOVINA

Growth in the first half of the year was better than expected, due to a sustained rise in industrial production and retail trade. But high inflation and the continued political risks will slow it down in the second half of the year, and also in 2023. A general election was held on 2 October and revealed the people’s desire for something different: two of the three elected Presidency members are from non-nationalist parties. However, no great changes are expected: according to preliminary results, the nationalist parties won the majority of the vote at both state and entity level. This will continue to slow the country’s progress generally and towards European integration.

BULGARIA

The outcome of the early election held on 2 October offers no ready solutions to the political stalemate in Bulgaria. Despite the political turmoil and the war-related shocks, GDP grew by 4.5% in the first half of the year, thanks to robust exports and strong industrial output. However, surging inflation and a large fiscal imbalance remained a serious concern. By mid-year the economic environment had worsened and output had weakened. We expect GDP to grow by 3% in 2022, with a weaker performance of 1.5% in 2023.

CROATIA

Croatia’s economy grew strongly in the first half of 2022, thanks to robust household consumption. In addition, the summer tourist season was very solid. As a result, we have revised this year’s GDP forecast up from 3.3% to 5%. Despite record levels of inflation, the European Commission has also confirmed that Croatia is set to join the euro area next year. Nevertheless, the high inflation and the war in Ukraine still promise much uncertainty for 2023.

CZECHIA

The resilience of the Czech economy is fading, and it is anticipated that the coming months will bring recessionary pressures. The reasons for pessimism are piling up: inflation will remain high, real wages will continue to decline, and industry will struggle with supply-chain issues. As a result, after 2% in 2022, growth will slow to a modest 1% in 2023.

ESTONIA

As the economic effects of the war in Ukraine gradually reveal themselves, the Estonian economy is heading for a difficult phase: inflation is extremely high; the foreign trade outlook is getting grimmer; and private consumption is being undermined by rocketing prices and shrinking savings. Yet, we expect the economic decline to be more of a dip, as energy prices are reined in, while purchasing power will be backed by state support and steady wage growth.

HUNGARY

After strong first half-year growth, the Hungarian economy is heading downhill. Inflation is accelerating, consumer demand is shrinking, public investment projects are being cancelled and private investments postponed. The fragile fiscal position renders unfeasible any substantial government intervention to counterbalance shrinking domestic demand. The foreign trade deficit has been growing rapidly. Unfreezing EU transfers could ease the problems; but that money will not reach Hungary any time soon – if at all.

KAZAKHSTAN

Amid all the geopolitical shocks, Kazakhstan’s balancing act has helped it limit the economic damage. Nevertheless, the economy has been weakening, having been hit by all the disruptions, and is expected to grow by 2.8% this year. Although infrastructure investments, import substitution policies and fiscal stimulus to consumption should all go some way to supporting growth, in view of the lower oil prices, the further recession in Russia and the unfavourable external environment we have revised our real GDP forecast for 2023-2024 slightly downwards.

KOSOVO

The economy will grow by around 3% in 2022 and 2023, despite the war-related inflationary pressures and the energy crunch. Inflation is expected to soar to 10% this year, a casualty of rising food and energy prices. The country’s trade deficit has deteriorated further, despite the big rise in exports. The positive trend in foreign direct investment has been maintained. The dire state of the labour market and high unemployment suggests that there will be a weakening in consumption, although support from the Kosovo diaspora has increased.

LATVIA

Although the boom continued in the first half of 2022, the Russian war in Ukraine will drag growth in Latvia down in the coming months. Almost all sectors will be affected by a substantial fall in demand growth and by escalating prices. Firms will largely refrain from investing, preferring to deplete their stocks. Moreover, the decline in the purchasing power of households will curb growth in consumption. However, the labour market will remain tight next year. For 2022, we still expect GDP growth to reach 2.9%, but it will then fall back to 0.6% in 2023. We expect a revival of GDP growth in Latvia to 2.3% in 2024 in line with the recovery in the EU.

LITHUANIA

The economy has had to deal with the blow caused by Russia's invasion of Ukraine. Steep rises in the cost of energy and other imported inputs will push the inflation rate close to 20% this year. A decline in household and business sentiment alike means that consumption and investment activity will lose momentum in the second half of this year, and particularly in 2023. The government is trying to counter the loss of households' purchasing power and to assist enterprises with energy support measures. It should also manage to keep economic activity afloat with its planned public investments. We expect real GDP to grow by 2.1% in 2022, to be followed by a slump to 0.9% in 2023 and then an upswing to 2.6% in 2024.

MOLDOVA

The effects of the prolonged Russian invasion of Ukraine, skyrocketing food and energy prices, trade disruptions, the influx of refugees and declining public confidence have all worsened Moldova's economic prospects. GDP is certain to decline in 2022 and to stagnate in 2023. Increased funding by international donors and creditors is necessary for the country to cope with the economic challenges and to keep the current Western-oriented leadership in power.

MONTENEGRO

Montenegro continued with its impressive growth in 2022, thanks to rising private consumption. This was a result of a tax reform that increased people's incomes, but which poses a serious threat to the state and the healthcare budget. The future will bring more inflation, which will act as a drag on consumption. Although not yet at pre-pandemic levels, tourism is on a solid path to recovery. The lack of political will to unblock the judiciary is extending the already lengthy road towards EU integration. Fresh parliamentary elections may be on the horizon.

NORTH MACEDONIA

Inflation is out of control and is eating into real incomes. Soaring global electricity prices are taking an additional toll, as some big industrial plants may be forced to close over the winter. Monetary and fiscal policies are becoming more and more restrictive, further crippling the economy. On top of that comes a possible recession in Germany, which takes half of all Macedonian exports.

POLAND

The Polish economy has proved surprisingly resilient so far. But growth will slow in the second half of 2022 and beyond. Rising interest rates are affecting consumption and investment, while inflation is eroding the real value of current wages. If the full disbursement of EU recovery funds continues to be delayed, public spending may become less lavish than before. To cap it all, essential imports such as energy and metals may be in short supply, or else become prohibitively expensive.

ROMANIA

Economic growth in Romania was among the most rapid in the EU in 2022, driven by household consumption and accumulation of inventories. However, future prospects are overshadowed by declining real wages and tightening fiscal policy. Still, with 2.2% growth in 2023, Romania will grow faster than most regional peers. The inflow of foreign direct investment (FDI) and EU funds will strengthen Romania's chances of balancing the fiscal and current account deficits and will maintain its ability to invest. The country's relatively modest dependence on energy imports from Russia also limits its vulnerability.

RUSSIA

So far, the effects of Western sanctions on the economy have been generally milder than expected. By Q3 2022, the economy had partly adjusted to the 'new normal', thanks to high energy prices, trade reorientation towards Asia and increased military spending. However, with the newly announced partial mobilisation, another wave of the crisis looks to be on the cards. After an estimated decline of 3.5% in 2022, the economy is heading for another recession next year.

SERBIA

Despite the hard times brought about by the Russian invasion of Ukraine, Serbia is doing relatively well in an economic sense, mainly because of supportive government measures. The country should be able to see the winter through without major problems, but its medium-term economic prospects remain uncertain, depending as they do essentially on how the country positions itself vis-à-vis Russia.

SLOVAKIA

The adverse impact of the Russian war in Ukraine, high inflation and the energy crisis are all taking their toll on the Slovak economy. We estimate real GDP growth of 1.8% in 2022, driven by private consumption. While household consumption will fall back in the face of soaring inflation, the inflow of EU funds could provide some growth impetus in 2023 and beyond.

SLOVENIA

In 2022, we estimate that Slovenia's real GDP will have expanded by 5.7%, mostly due to very high growth in the first half of the year. However, next year it will decline to 1.9%, as consumption and investments start to shrink due to inflation, and as manufacturing begins to feel the full extent of the energy crisis. To counter inflation, the government has introduced various support mechanisms and is trying to secure enough gas to last the winter; however, uncertainty over the energy supply and prices has contributed to falling business confidence.

TURKEY

After a strong first half year, driven by reopening effects and a boom in tourism, the economy looks set for a much bleaker winter. The boosts to external competitiveness that resulted from the weak lira were short lived and soon erased by inflation, while the main benefits of the rebound in tourism have already been reaped. The extremely high inflation is sharply reducing purchasing power and is putting pressure on industry. Risks are weighted to the downside, including the potential for domestic political noise ahead of the election, rising US interest rates and the geopolitical backdrop.

UKRAINE

The Russian invasion is causing significant human loss and physical capital destruction in Ukraine. However, after a sharp contraction, Ukraine's economy has started to show signs of adjusting to the war conditions. External financial assistance is crucial both to keep the economy functioning and to achieve military victory. An accelerated recovery in the post-war period will depend on the establishment of a Marshall Plan-style international agency capable of providing adequate financing for the reconstruction of Ukraine's economy.

Keywords: CESEE Central and Eastern Europe, economic forecast, Western Balkans, CIS, Ukraine, Russia, Turkey, EU, euro area, convergence, business cycle, coronavirus, COVID, labour markets, unemployment, Russia-Ukraine war, Russia sanctions, commodity prices, inflation, price controls, trade disruptions, Ukrainian refugees, energy crisis, gas, electricity, monetary policy, fiscal policy, impact on Austria

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