# 2. CESEE economic outlook

## 2.1. CESEE OVERVIEW: SLOWER GROWTH IS HERE

**by Richard Grieveson**

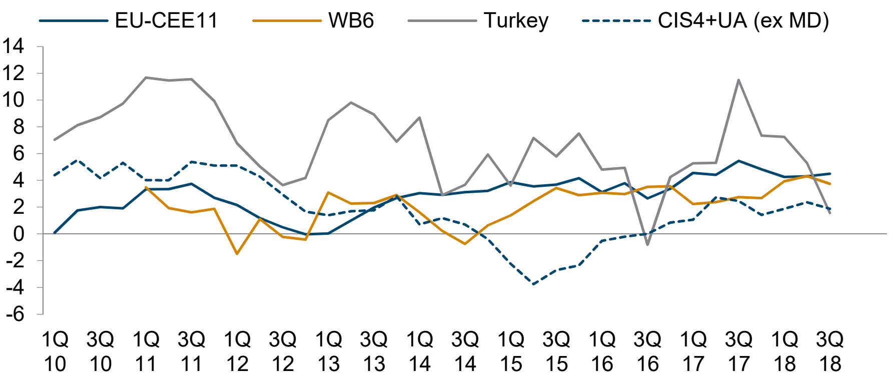
*Growth in much of CESEE is still at or close to its best level since the global financial crisis, and the outlook for 2019-21 is reasonably positive for most. This reflects a combination of strong wage rises, low interest rates, and a generally good outlook for investment. However, growth has now peaked for CESEE, and most of the region's economies will expand more slowly in 2019-21 than in 2016-18. The slowdown in key sources of final demand such as Germany and China will weigh on exports. Regionally, the main challenges are increasingly severe labour shortages, the impact of global developments on confidence, and the potential for lower EU funds inflows. Authoritarianism, state capture and interference in the independence of institutions are all on the rise, creating significant risks for growth in the medium- and long-term.*

### 2.1.1. Review of 2018: Another good year for most in CESEE

**Economic activity in large swathes of the CESEE region remains very robust, despite increasing external risks and a marked slowdown in the eurozone.** Aggregate growth in both EU-CEE11 and WB6 remains at or close to a post-crisis high (Figure 2.1). Activity in the CIS and Ukraine is bumping along at a low level, but has picked up from 2015-2016; and if Russia is taken out of the equation the situation does not look too bad. Last year was therefore, for most countries in the region, another good one in the post-crisis context. For the second year in a row, no country recorded negative growth (a first since 2007). Aside from Russia, the clear negative story is Turkey, where activity dropped off precipitously in the second half of 2018, following a series of external shocks.

**Figure 2.1 / Quarterly real GDP growth**

change in % against preceding year




Source: wiiw Monthly Database incorporating national and Eurostat statistics.

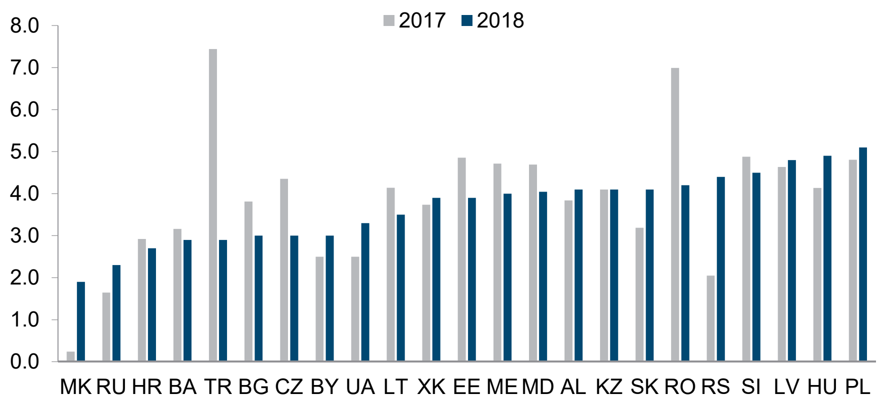
**Turkey's large size and sharp slowdown had a big impact on aggregate growth in CESEE last year.** Aggregate real GDP growth in the CESEE23 was 3.2% in 2018 – rather a significant drop from 4% the previous year. Far and away the largest part of the aggregate CESEE23 slowdown was due to Turkey, with additional minor contributions from Romania and the Czech Republic. We estimate that Turkish real GDP growth was 4.5 percentage points (p.p.) lower in 2018 than in 2017, and that in Romania it declined by 2.8 p.p., both reflecting a slowdown from overheating. Other notable fallers were Estonia (-1 p.p.), the Czech Republic (-1.4 p.p.) and Bulgaria (-0.8 p.p.). In 14 of the 23 countries, growth was slower in 2018 than in 2017 (in the other nine it was more rapid). However, for most countries where a slowdown occurred, the difference was small.

**Aside from Turkey, Romania and the Czech Republic, all the other big countries in the region posted either similar or better growth rates in 2018 than in 2017.** The upswing in Russian growth came as a surprise (although this was not enough to prevent it being the second slowest-growing economy in the CESEE23). Growth in Ukraine also picked up relative to the previous year. The fastest-growing economies in the region – perhaps surprising for readers of political news – were Hungary and Poland.

**The big improvements in 2018 relative to the previous year were largely concentrated in the Western Balkans.** North Macedonian real GDP growth improved by 1.7 p.p., as the country emerged from a political crisis; and in Serbia, output was 2.4 p.p. higher, as the economy bounced back from a drought. Otherwise notable improvements were recorded in Slovakia (+0.9 p.p.), helped by particularly strong investment (notably construction) activity, and Ukraine, where high real wage growth and remittance inflows played an important role in stimulating growth. Incredibly, Hungary recorded its best growth rate since 2004. Growth in both Serbia and Poland also reached a post-crisis high.

**Figure 2.2 / Real GDP growth**

change in % against preceding year




Source: wiiw Annual Database incorporating national and Eurostat statistics.

**Taking a simple average of the CESEE23 countries, private consumption added 2.4 percentage points to growth last year, 0.1 percentage points higher than in 2017.** However, this masked some big differences between countries. In the Baltics and the Balkans, as well as in Belarus, consumers moved up a gear. The main exceptions were the 'overheaters', Turkey and Romania. Although in both countries private consumption still made a positive contribution to growth in 2018, that contribution was 2.7 and 3.1 percentage points, respectively, less than in 2017. In Turkey, we estimate that real private consumption added only 0.9 percentage points to headline growth, by far the weakest contribution since 2009.

**The strength of private consumption in CESEE reflects a combination of low inflation, improved labour market performance, and higher wages and social transfers.** Inflation is at historically low levels pretty much everywhere, except Turkey, and in many cases nominal wage growth is strong, meaning high real wage increases. Several countries have recently raised the minimum wage, in some cases for the first time since before the crisis.

**Real gross fixed capital formation added 1.5 percentage points to growth on average across CESEE countries last year, down marginally from 2017 (1.6 percentage points).** The strongest contributions were recorded in EU-CEE11 and the Western Balkans, and in particular in Hungary, Latvia, Slovenia, Montenegro, Kosovo and Serbia. In EU-CEE11, we attribute at least some of the strong investment growth to labour shortages, while the EU funds cycle also no doubt played a role (especially in Hungary). However, these explanations apply less to the Western Balkan countries, where foreign direct investment and pent-up demand from the bad post-crisis years (for example, in Serbia) were likely more influential. Across the region, very low real interest rates were also supportive of growth. The countries where investment played much less of a role in 2018 than in 2017 were Turkey, Romania, Estonia and Russia. In the first two countries, a response to overheating was probably the reason. In Russia, we attribute the disappointing results to weak investor confidence.

**A key development for regional growth, especially in the second half of last year, was the emergence of external headwinds, which had implications for the export contribution to economic activity.** Overall external trade growth slowed quite markedly for the region as a whole in 2018, after a very strong 2017. In nominal euro terms, we estimate that CESEE23 exports rose by 6.8% in 2018, compared with 14.2% in 2017. Growth was especially weak in EU-CEE11 (0.7%, from 10.9% in 2017), reflecting greater integration with European and global value chains, and the slowdown in key sources of final demand, such as Germany and China. Industrial output trends generally reflected this, with slowdowns in 2018 recorded in much of EU-CEE11 (and Turkey) compared to the previous year. By contrast, industrial output growth increased in 2018 in most of the Western Balkans and (to a lesser extent) in the CIS and Ukraine.

**On average, exports of goods and services added 2.8 percentage points to GDP growth last year in the CESEE countries – down from 4 percentage points in 2017.** Combined with relatively strong import growth on the back of robust private consumption and investment trends, this meant that net trade subtracted on average 0.6 percentage points from headline growth, similar to 2017. The most significant change in 2018 was in Turkey, where we estimate that net exports added 3 p.p. to headline growth (from 0.1 p.p. in 2017), reflecting the collapse of the lira and consequently higher exports and lower imports in the second half of the year. Russia's net export contribution also shifted from a large negative in 2017 to a small positive last year.

## 2.1.2. Forecasts for 2019-21: Slower growth is here

**Table 2.1 / Overview 2017-2018 and outlook 2019-2021**

| | | GDP real change in % against prev. year | | | | | Consumer prices change in % against prev. year | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | Forecast | | | | | Forecast | | |
| | | 2017 | 2018 | 2019 | 2020 | 2021 | 2017 | 2018 | 2019 | 2020 | 2021 |
| BG | Bulgaria | 3.8 | 3.0 | 2.8 | 2.5 | 2.5 | 1.2 | 2.6 | 2.5 | 2.5 | 2.5 |
| CZ | Czech Republic | 4.4 | 3.0 | 2.6 | 2.7 | 2.8 | 2.4 | 2.0 | 2.1 | 2.1 | 2.0 |
| EE | Estonia | 4.9 | 3.9 | 2.9 | 2.5 | 2.2 | 3.7 | 3.4 | 2.8 | 2.7 | 2.5 |
| HR | Croatia | 2.9 | 2.7 | 2.6 | 2.5 | 2.5 | 1.3 | 1.6 | 1.8 | 1.8 | 1.5 |
| HU | Hungary | 4.1 | 4.9 | 3.3 | 2.3 | 1.9 | 2.4 | 2.9 | 3.0 | 3.0 | 3.0 |
| LT | Lithuania | 4.1 | 3.5 | 3.0 | 2.6 | 2.3 | 3.7 | 2.5 | 2.4 | 2.4 | 2.3 |
| LV | Latvia | 4.6 | 4.8 | 3.5 | 3.0 | 2.5 | 2.9 | 2.6 | 2.4 | 2.4 | 2.3 |
| PL | Poland | 4.8 | 5.1 | 3.7 | 3.3 | 3.3 | 1.6 | 1.2 | 2.2 | 2.1 | 2.0 |
| RO | Romania | 7.0 | 4.2 | 2.8 | 3.0 | 3.2 | 1.1 | 4.1 | 2.5 | 3.0 | 3.0 |
| SI | Slovenia | 4.9 | 4.5 | 3.2 | 3.0 | 2.9 | 1.6 | 1.9 | 1.8 | 1.8 | 2.0 |
| SK | Slovakia | 3.2 | 4.1 | 3.6 | 3.0 | 2.5 | 1.4 | 2.5 | 2.6 | 2.3 | 2.3 |
| | *EU-CEE11 1)2)* | *4.8* | *4.3* | *3.2* | *3.0* | *2.9* | *1.8* | *2.2* | *2.3* | *2.4* | *2.3* |
| | *EA19 3)* | *2.4* | *1.9* | *1.6* | *1.5* | *1.4* | *1.5* | *1.8* | *1.6* | *1.6* | *1.6* |
| | *EU28 3)* | *2.4* | *1.9* | *1.8* | *1.8* | *1.6* | *1.7* | *1.9* | *1.8* | *1.9* | *1.9* |
| AL | Albania | 3.8 | 4.1 | 3.8 | 3.8 | 3.4 | 2.0 | 2.0 | 2.4 | 2.6 | 2.8 |
| BA | Bosnia and Herzegovina | 3.2 | 2.9 | 2.5 | 2.6 | 2.7 | 0.8 | 1.4 | 1.5 | 1.6 | 1.4 |
| ME | Montenegro | 4.7 | 4.0 | 2.5 | 2.2 | 2.0 | 2.4 | 2.6 | 1.9 | 1.8 | 1.9 |
| MK | North Macedonia | 0.2 | 1.9 | 3.0 | 3.0 | 3.0 | 1.4 | 1.5 | 2.0 | 2.0 | 2.0 |
| RS | Serbia | 2.0 | 4.4 | 3.4 | 2.9 | 2.9 | 3.0 | 2.0 | 2.7 | 2.8 | 2.8 |
| XK | Kosovo | 3.7 | 3.9 | 4.1 | 4.0 | 3.9 | 1.5 | 1.1 | 1.6 | 1.6 | 1.6 |
| | *WB6 1)2)* | *2.5* | *3.8* | *3.3* | *3.0* | *3.0* | *2.1* | *1.8* | *2.2* | *2.3* | *2.3* |
| TR | Turkey | 7.4 | 2.9 | -0.7 | 3.2 | 3.7 | 11.1 | 16.3 | 15.8 | 9.3 | 7.9 |
| BY | Belarus | 2.5 | 3.0 | 2.4 | 2.2 | 2.0 | 6.0 | 4.9 | 7.0 | 8.0 | 8.0 |
| KZ | Kazakhstan | 4.1 | 4.1 | 3.0 | 3.0 | 3.0 | 7.4 | 6.0 | 6.0 | 5.5 | 5.5 |
| MD | Moldova | 4.7 | 4.0 | 3.8 | 3.6 | 3.5 | 6.5 | 2.9 | 4.0 | 4.0 | 5.0 |
| RU | Russia | 1.6 | 2.3 | 1.8 | 1.7 | 1.9 | 3.6 | 2.9 | 5.5 | 4.0 | 4.0 |
| UA | Ukraine | 2.5 | 3.3 | 2.5 | 2.0 | 2.9 | 14.4 | 10.9 | 9.1 | 5.2 | 5.0 |
| | *CIS4+UA 1)2)* | *2.0* | *2.6* | *2.0* | *1.9* | *2.1* | *4.9* | *3.9* | *5.9* | *4.4* | *4.4* |
| | *V4 1)2)* | *4.5* | *4.6* | *3.4* | *3.0* | *2.9* | *1.9* | *1.7* | *2.3* | *2.2* | *2.2* |
| | *BALT3 1)2)* | *4.4* | *4.0* | *3.1* | *2.7* | *2.3* | *3.5* | *2.7* | *2.5* | *2.5* | *2.3* |
| | *SEE9 1)2)* | *5.0* | *3.8* | *2.9* | *2.9* | *3.0* | *1.4* | *3.0* | *2.4* | *2.6* | *2.6* |
| | *CIS3+UA 1)2)* | *3.3* | *3.6* | *2.7* | *2.5* | *2.8* | *9.6* | *7.5* | *7.2* | *5.8* | *5.7* |
| | *non-EU12 1)2)* | *3.7* | *2.7* | *1.2* | *2.3* | *2.6* | *6.7* | *7.6* | *8.8* | *5.8* | *5.4* |
| | *CESEE23 1)2)* | *4.0* | *3.2* | *1.8* | *2.5* | *2.7* | *5.3* | *6.0* | *6.9* | *4.8* | *4.5* |

ctd.

**Table 2.1 / (ctd.)**

| | | Unemployment (LFS) rate in %, annual average | | | | | Current account in % of GDP | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | Forecast | | | | | Forecast | | |
| | | 2017 | 2018 | 2019 | 2020 | 2021 | 2017 | 2018 | 2019 | 2020 | 2021 |
| BG | Bulgaria | 6.2 | 5.2 | 5.0 | 4.8 | 4.6 | 6.5 | 4.6 | 3.0 | 2.0 | 1.1 |
| CZ | Czech Republic | 2.9 | 2.2 | 2.2 | 2.2 | 2.2 | 1.0 | 0.7 | 0.3 | 0.3 | 0.2 |
| EE | Estonia | 5.8 | 5.5 | 5.7 | 6.0 | 5.8 | 3.2 | 1.2 | 1.3 | 1.3 | 1.2 |
| HR | Croatia | 11.2 | 8.8 | 9.0 | 8.5 | 8.0 | 4.0 | 2.7 | 2.4 | 2.1 | 1.0 |
| HU | Hungary | 4.2 | 3.7 | 3.5 | 3.5 | 3.5 | 3.2 | 1.3 | 1.2 | 0.9 | 1.1 |
| LT | Lithuania | 7.1 | 6.4 | 5.8 | 5.5 | 5.5 | 0.9 | 0.9 | -0.2 | -0.3 | -0.6 |
| LV | Latvia | 8.7 | 7.4 | 7.0 | 6.5 | 6.0 | 0.7 | -0.5 | -0.7 | -1.0 | -1.1 |
| PL | Poland | 4.9 | 3.8 | 3.7 | 3.4 | 3.4 | 0.2 | -0.7 | -1.0 | -1.0 | -1.1 |
| RO | Romania | 4.9 | 4.2 | 4.0 | 4.2 | 4.3 | -3.4 | -4.6 | -4.3 | -4.2 | -4.0 |
| SI | Slovenia | 6.6 | 5.4 | 4.5 | 4.0 | 4.0 | 7.2 | 7.4 | 6.8 | 6.2 | 5.9 |
| SK | Slovakia | 8.1 | 6.5 | 6.2 | 5.8 | 5.6 | -2.0 | -2.5 | -1.6 | -1.3 | -1.0 |
| | *EU-CEE11 1)2)* | *5.3* | *4.4* | *4.2* | *4.0* | *4.0* | *0.6* | *-0.3* | *-0.5* | *-0.6* | *-0.6* |
| | *EA19 3)* | *9.1* | *8.3* | *7.8* | *7.6* | *7.6* | *3.8* | *3.3* | *3.1* | *2.9* | *2.8* |
| | *EU28 3)* | *7.6* | *6.8* | *6.3* | *6.1* | *6.1* | *2.6* | *2.0* | *1.8* | *1.6* | *1.5* |
| AL | Albania | 13.7 | 12.1 | 11.5 | 11.0 | 10.0 | -7.5 | -6.4 | -6.4 | -5.9 | -5.8 |
| BA | Bosnia and Herzegovina | 20.5 | 18.4 | 17.0 | 15.6 | 14.1 | -4.7 | -4.5 | -4.6 | -4.3 | -4.0 |
| ME | Montenegro | 16.1 | 14.8 | 14.3 | 13.8 | 13.6 | -16.1 | -17.2 | -16.9 | -16.8 | -14.0 |
| MK | North Macedonia | 22.4 | 21.0 | 20.0 | 20.0 | 19.0 | -1.0 | -0.8 | -1.1 | -2.4 | -3.0 |
| RS | Serbia | 13.6 | 12.6 | 12.1 | 11.4 | 10.9 | -5.2 | -5.2 | -5.1 | -4.8 | -4.6 |
| XK | Kosovo | 30.5 | 29.0 | 29.5 | 29.0 | 28.0 | -6.1 | -6.5 | -7.3 | -7.8 | -7.7 |
| | *WB6 1)2)* | *16.9* | *15.6* | *14.8* | *14.4* | *13.6* | *-5.5* | *-5.4* | *-5.5* | *-5.4* | *-5.2* |
| TR | Turkey | 10.9 | 10.9 | 11.8 | 11.2 | 10.5 | -5.5 | -3.5 | -0.4 | -1.4 | -1.9 |
| BY | Belarus | 5.6 | 4.8 | 4.6 | 4.5 | 4.5 | -1.6 | -2.0 | -2.5 | -2.6 | -2.7 |
| KZ | Kazakhstan | 4.9 | 4.8 | 5.0 | 5.0 | 5.0 | -3.3 | 0.5 | -3.1 | -3.2 | -2.5 |
| MD | Moldova | 4.1 | 3.0 | 3.0 | 3.0 | 3.0 | -5.8 | -7.2 | -8.3 | -6.8 | -7.4 |
| RU | Russia | 5.2 | 4.8 | 4.9 | 4.9 | 4.7 | 2.1 | 6.9 | 2.7 | 2.8 | 2.7 |
| UA | Ukraine | 9.5 | 8.8 | 8.4 | 8.1 | 7.8 | -2.2 | -3.6 | -3.8 | -5.3 | -6.0 |
| | *CIS4+UA 1)2)* | *5.9* | *5.4* | *5.4* | *5.4* | *5.2* | *1.3* | *5.4* | *1.6* | *1.6* | *1.5* |
| | *V4 1)2)* | *4.7* | *3.7* | *3.6* | *3.4* | *3.4* | *0.6* | *-0.3* | *-0.5* | *-0.5* | *-0.5* |
| | *BALT3 1)2)* | *7.3* | *6.4* | *6.1* | *5.9* | *5.7* | *1.4* | *0.6* | *0.0* | *-0.1* | *-0.3* |
| | *SEE9 1)2)* | *9.7* | *8.6* | *8.3* | *8.2* | *7.9* | *-1.5* | *-2.6* | *-2.8* | *-2.8* | *-3.0* |
| | *CIS3+UA 1)2)* | *7.5* | *6.9* | *6.7* | *6.5* | *6.3* | *-2.7* | *-1.5* | *-3.4* | *-3.9* | *-3.9* |
| | *non-EU12 1)2)* | *7.5* | *7.1* | *7.3* | *7.1* | *6.8* | *-1.0* | *2.6* | *0.8* | *0.6* | *0.3* |
| | *CESEE23 1)2)* | *7.0* | *6.4* | *6.5* | *6.3* | *6.1* | *-0.4* | *1.6* | *0.4* | *0.2* | *0.0* |

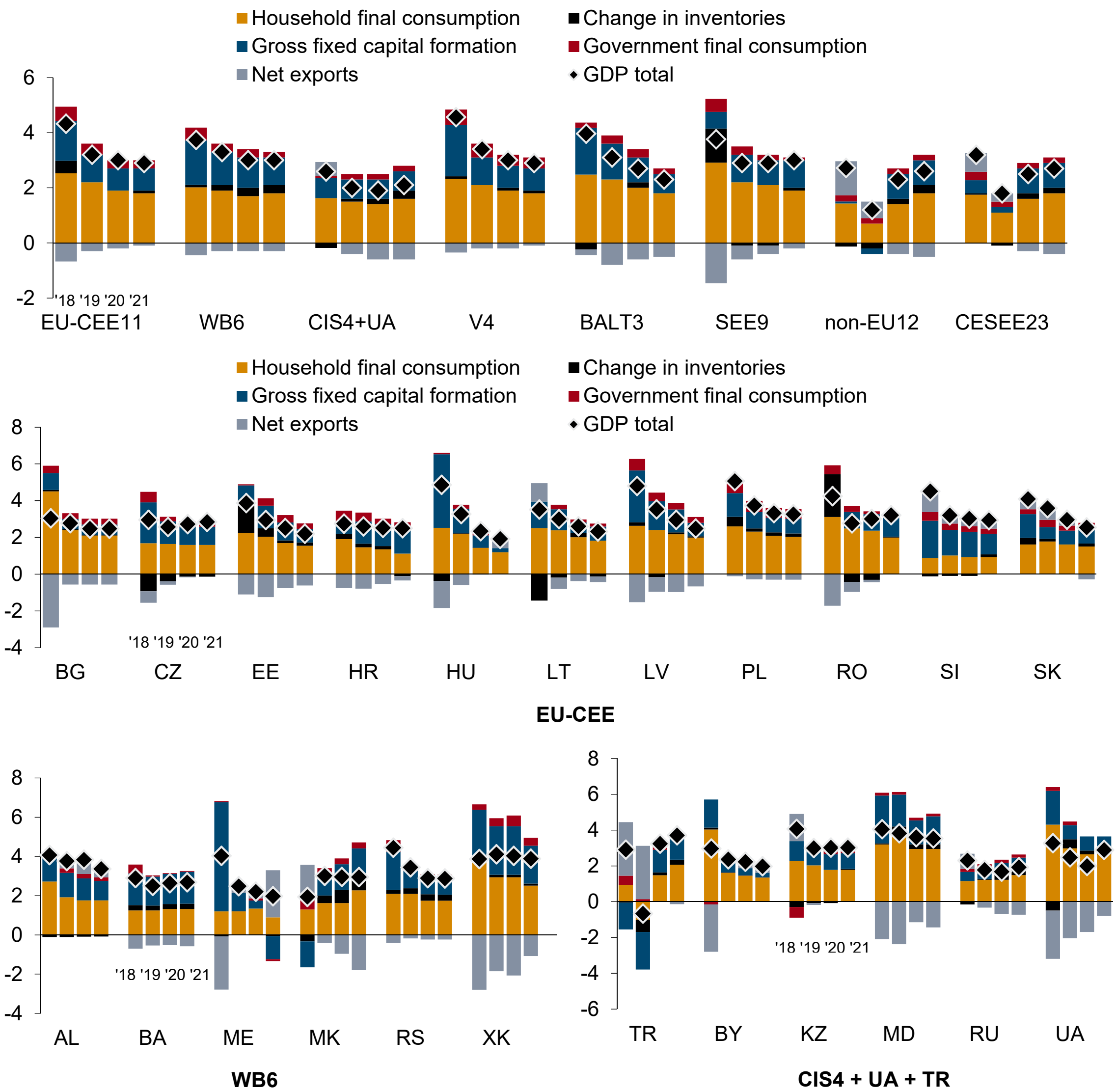
1) wiiw estimates. - 2) Current account data include transactions within the region (sum over individual countries). - 3) Forecasts estimated by wiiw.

Source: wiiw, Eurostat. Forecasts by wiiw (March 2019).

**Growth for the region as a whole peaked in 2017-2018, and will be slower in the next three years than over the previous three.** In 17 of the 23 countries in CESEE, we expect real GDP growth in 2019-2021 to be lower than in 2016-2018. The sharpest slowdowns are, unsurprisingly, in Romania and Turkey (2.4 and 2.3 percentage points, respectively), reflecting previous overheating and the need for tighter policy (or market pressure) to prevent imbalances creating systemic problems for the economy. We also forecast notable slowdowns (1 p.p. or more) in Montenegro, Estonia, Hungary, Slovenia and Bulgaria. Only four countries will have higher growth rates in the forecast period: two in the Balkans (Kosovo and North Macedonia) and two in the CIS (Russia and Belarus). The expected improvement in Belarus and Russia is largely because of a particularly weak 2016, which has dragged down the historical period average. North Macedonia is recovering from a political crisis, which meant basically no growth in 2017. In Kosovo, the improvement will be only by 0.1 p.p.

**Figure 2.3 / GDP growth in 2018-2021**

and contribution of individual demand components in percentage points




Source: wiiw Annual Database incorporating national and Eurostat statistics, own calculation. Forecasts by wiiw.

**Despite the projected slowdown in growth, every country will grow more quickly than the eurozone aggregate during the forecast period, implying convergence with Western Europe.** The fastest growth over the three years will be in Kosovo and Albania. In Kosovo, this will be helped by positive demographic trends (one of only three countries – the others being Turkey and Kazakhstan – where we expect population growth of any significance over the forecast period). Other countries where we expect average growth to be significantly above 3% are Moldova, Poland and Slovakia. No other economy will average growth of above 3.1% per year during the forecast period. The weakest performer will be Russia, with average growth of below 2% over the three years, reflecting deep-seated structural issues, Western sanctions and fairly low oil prices.

### 2.1.2.1. A weaker outlook for external demand

**The drivers of growth during the forecast period vary across the region, but it is clear that support from external factors is likely to be weaker almost everywhere than was the case in the past few years.** With the global economic cycle slowing (if not ending), and weaker growth projected in all major economies, CESEE will be affected. However, the extent to which this matters will differ quite considerably from country to country.

**As the external environment deteriorates, so the region's big exporters will struggle.** There will be less support for growth from net external trade for the region's most open economies, including the Baltic states, the Czech Republic and Slovenia (in general the region's economies are very open in terms of exports/GDP, Figure 2.4). In January, the Czech manufacturing purchasing managers' index (PMI) – an important leading indicator of economic activity – fell to a six-year low, emphasising the impact of recent developments in Germany and other key markets on export-dependent economies. By contrast, a big positive change will take place in Turkey, reflecting the large external adjustment there. Net exports will add 3 p.p. to Turkish GDP growth in 2019, according to our forecasts.

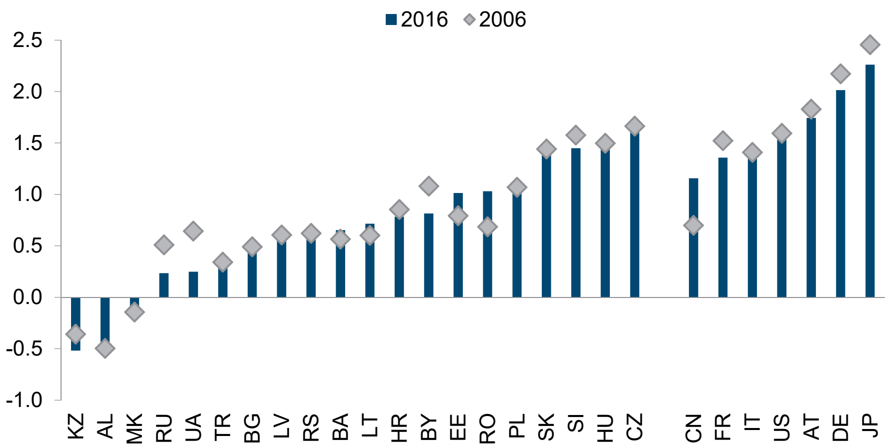
**Figure 2.4 / Exports of goods and services, in % of GDP, 2017**


Source: World Bank.

**The three smaller Visegrád countries, plus Slovenia, are those most exposed to trade tensions at the global level.** The extent to which countries in the CESEE region are affected by trade issues in the global economy depends not only on the degree of their openness, but also on their level of integration into global value chains. As a proxy for global value chain integration, we use the Economic Complexity Index (ECI).[5] As Figure 2.5 shows, the Czech Republic clearly stands out on its own, with a score that is higher than the US's and similar to Austria's (the Czech Republic is ranked seventh in the world). However, three other CESEE countries – Slovenia, Slovakia and Hungary – also score very high (ahead of France, Italy and China, for example). The combination of a higher degree of integration into regional and global value chains and a generally high level of openness (in terms of goods exports/GDP) means that a drop in global trade would affect these countries more.

**Commodity exporters, especially those in the CIS, will also have to adjust to weaker oil price growth, after a big windfall in 2018.** In US dollar terms, the price of front-month Brent crude increased by 31.5% on average in 2018, but this will not be repeated during the forecast period (we expect a drop in 2019, and basically flat oil prices in the next two years). Diversification of the Russian and the Kazakh economies away from oil on a scale that would actually make a difference is not really feasible (even with the fairly strong measures announced recently in Kazakhstan), and certainly not in the next 2–3 years; thus both will have to soldier on one way or another with this model. Belarus is also facing the implications of this (see country report).

**Figure 2.5 / Economic Complexity Index, 2016, CESEE and selected developed countries**




Source: ECI; Observatory of Economic Complexity.

**A final and increasingly important factor for externally driven growth in CESEE is tourism.** Some countries in the region (such as Montenegro and Croatia) are established tourist destinations, and have continued to perform well. However, other countries with less pedigree in this area have in recent years also recorded rapid growth, especially in the Western Balkans, but also in the Baltic states. We attribute the strength of tourism in the region to various factors, including higher security risks in competitor markets, such as Turkey and North Africa.

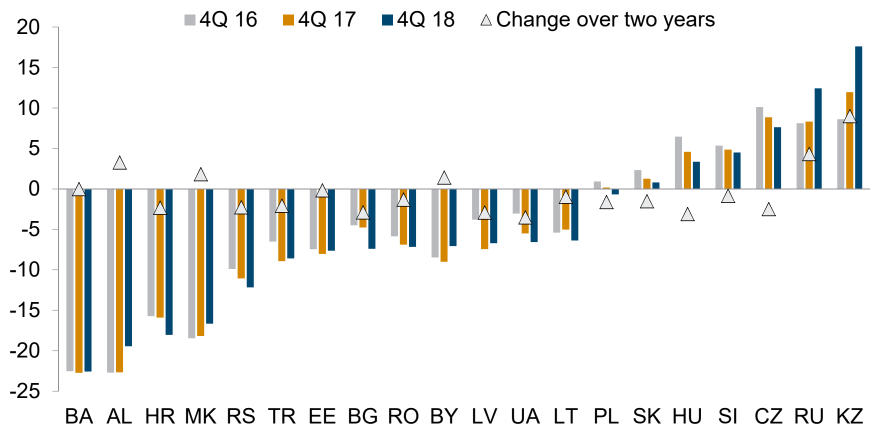
5 The ECI is compiled by the Observatory of Economic Complexity, and measures the knowledge intensity of an economy.

### 2.1.2.2. The challenge of higher wage growth

**Aside from the weakness in external demand, there is also the question of the impact of recently strong wage growth on external competitiveness.** If the region loses external competitiveness at a time of weaker overall external demand, then – considering the heavy export orientation of many economies – it could be particularly problematic. Much of the CESEE region has seen big wage increases recently, reflecting growing labour shortages. There is the further potential problem that this could force firms out of the region (to countries where labour is more plentiful and/or wages are lower), and thereby deliver a more crushing blow to exports (although in general unit labour costs are still low).

**One way to assess this is via the development of trade balances.** Outside the CIS, trade balances have deteriorated in many CESEE countries over the past two years, including in the Visegrád countries, which could suggest some deterioration in external competitiveness (Figure 2.6). However, the Visegrád countries and Slovenia all still run trade surpluses (or only a minor deficit in the case of Poland), indicating little reason to worry. In others parts of EU-CEE11 and the Western Balkans, widening merchandise goods deficits indicate a further deterioration in external competitiveness from an already weak position. In 2018, Romania – which, of the EU-CEE11 countries, has a particular issue with overheating – posted its biggest trade deficit as a share of GDP for almost a decade. Bulgaria and Croatia also recorded a notable widening of their goods trade deficits last year. Generally, across the region, firms not at the frontier in terms of productivity (especially SMEs) will face particular problems from the pressure to pay higher wages in the face of ever-worsening labour shortages.

**Figure 2.6 / Trade balance of goods, in % of GDP, four-quarter average**




Source: wiiw Monthly Database incorporating national and Eurostat statistics.

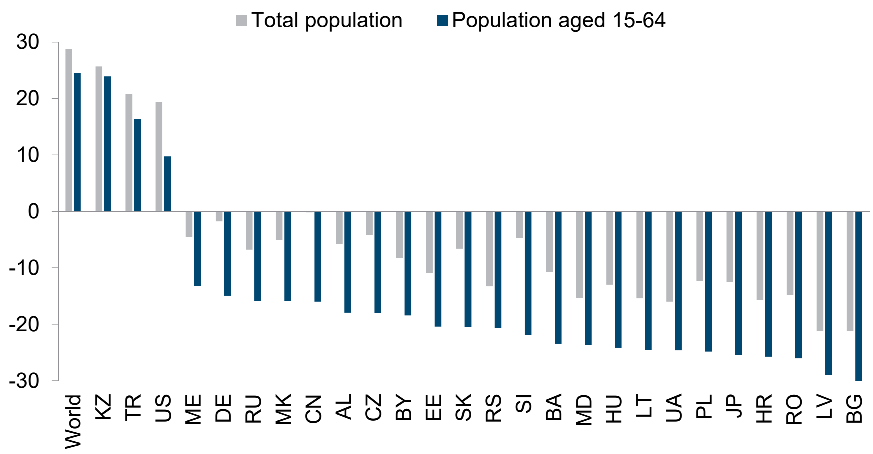
### 2.1.2.3. Can domestic consumption pick up the slack?

**As support from external factors fades, it is possible to make a fairly positive case for private consumption growth in the region during the forecast period.** Oil prices have fallen from 2018 levels, and are set to remain largely flat during the forecast period. Wages in many places are growing very strongly, and this will continue, given that labour shortages will not go away. Labour market trends are generally highly positive, and unemployment is falling quite rapidly, even in the Western Balkans.

**Despite expected strong wage growth, however, in most CESEE countries we expect private consumption to make a smaller contribution to growth in the forecast period than in the last three years** (2016-2018). In 18 out of the 23 countries, this will be the case, according to our forecasts, with only five registering an improvement (Latvia, Russia, North Macedonia, Serbia and Kazakhstan). We expect particularly sharp declines (of at least 1 percentage point) in the contribution of private consumption to growth relative to the last three years in Romania, Montenegro, Ukraine and Turkey. In Romania and Turkey, this will reflect the slowdown after overheating. In Turkey, for example, it will be a result of much higher real interest rates, weaker confidence and higher inflation – all of which will weigh on consumer spending. In Romania, it will also reflect tighter credit conditions.

**The relative weakness of private consumption growth in 2019-2021 will come as a result of many common factors.** One issue is confidence: people read the news and understand that a trade war between the world's two biggest economies is an issue that could have repercussions for them. Many may also be concerned about domestic or international political developments. This could lead, for example, to higher savings (especially in economies like the Czech Republic and Slovakia, where a greater share of employment is tied directly and indirectly to exports). We also see indications of this in Poland.

**Figure 2.7 / UN population projections, % change between 2015 and 2045**




Source: UN. Medium fertility variant.

**A second issue is demographics: populations are declining in most countries in the region.** The scale of population decline projected across most of CESEE is unprecedented in peacetime (Figure 2.7), and there are only limited options to offset this. Employment rates have already risen considerably in many countries, and so the scope for further impetus from this source is limited (the rates in the Czech Republic and the Baltic states are already among the highest in the EU). In some of the countries where there could be scope for higher employment rates, such as Poland, Romania, Croatia and Hungary, there are political obstacles to this happening. Anyway, in some of those countries – notably Hungary and Romania – significant increases have already been achieved over the past decade, according to Eurostat.[6] The model of importing workers from Ukraine to address labour shortages is not really a long-

[6] Hungary's so-called 'slave law' can be understood as a particularly extreme attempt to fully exploit potential labour reserves. However, the government appears less interested in attempting to lift skills levels or access to work among the less-educated, poorer, rural population. https://wiiw.ac.at/protest-against-slave-law-in-hungary-n-356.html

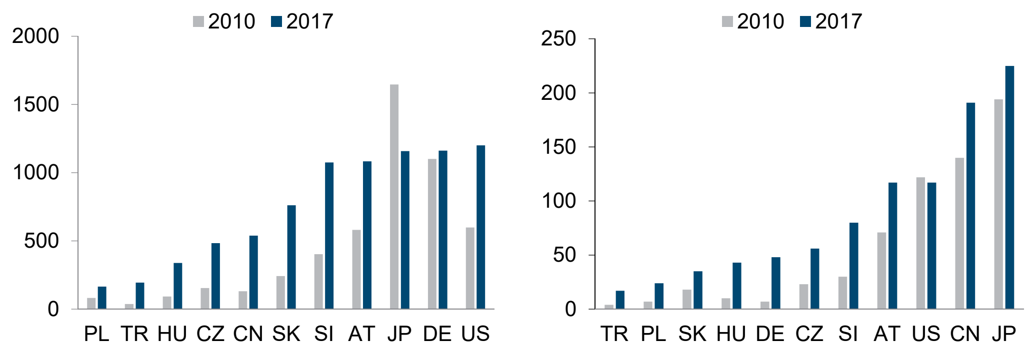
term solution, especially as Ukrainians now find it easier to move to Western Europe (see Ukraine country report). Financially incentivising people to have children will only, at best, bring results in 1–2 decades from now. For the EU-CEE11 countries, there also remains the simple fact that they have free movement with countries in Western Europe, where substantially higher wages are on offer and where labour shortages are also often acute.

### 2.1.2.4. A mixed outlook for investment

**Taking a simple average across the 23 countries, we expect gross fixed capital formation to add 1 p.p. to growth in 2019-2021 (from 1.1 p.p. in the last three years, so not a big change).** Within this, though, there are some interesting country stories. In Montenegro, investment growth will weaken considerably, after several strong years related largely to a Chinese-financed motorway. We also expect a sharp weakening of real investment growth in Hungary, owing to a drop-off in the inflow of EU funds after previous front-loading of disbursements. Meanwhile investment growth will be stronger in the forecast period in Slovakia, Belarus, Poland, Romania and North Macedonia.

**The general backdrop for investment remains quite supportive in most of the region.** Business sentiment in many countries has been affected by external developments, but is still generally at historically high levels. EU funds are playing an important role, and this should continue in most EU-CEE11 countries. The long-hoped-for improvement in absorption capacity in Croatia and Romania has yet to materialise, however. Meanwhile real interest rates remain very low by historical standards almost everywhere (admittedly, with the important exceptions of Russia and Turkey).

**Figure 2.8 / Estimated number of multipurpose industrial robots per 10,000 persons employed in automotive industry (left) and in all other industries (right)**



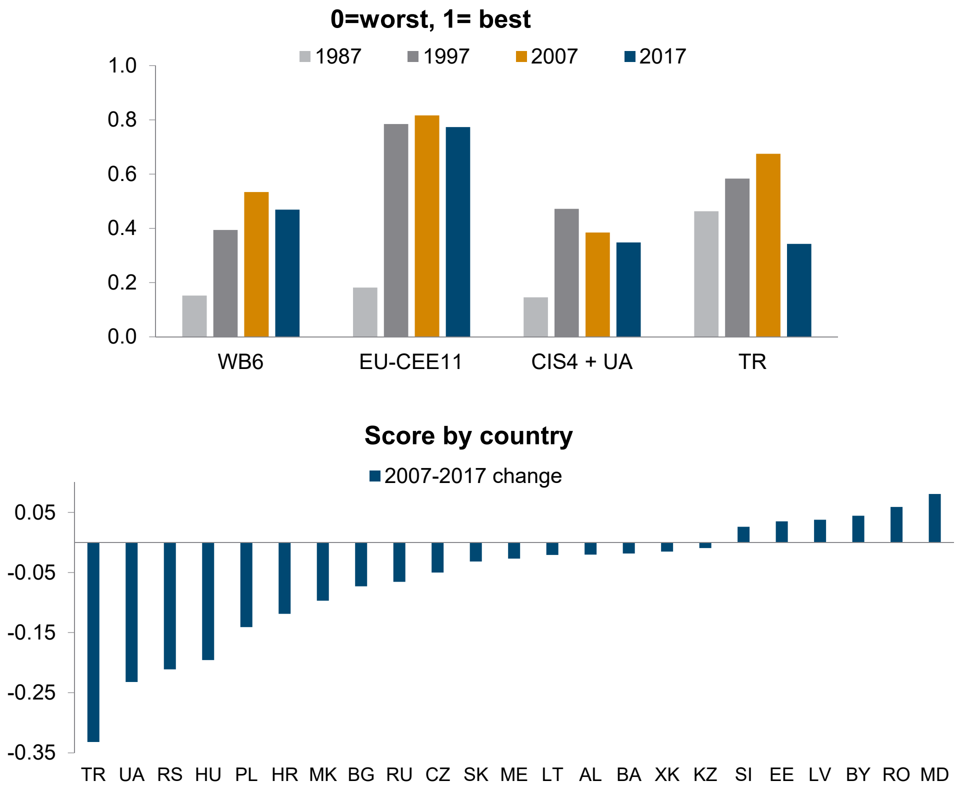

Source: International Federation of Robotics (2018), World Robotics 2018, Tables 2.6 and 2.7.

**Finally, one possible response to increasingly acute labour shortages in the region would be an increase in productivity-enhancing investment.** We have already noted an increase in imports of industrial robots in many parts of EU-CEE11, possibly in response to labour shortages. The country that appears to have gone most strongly in this direction so far is the Czech Republic; that makes sense, considering this is the country with the most extreme labour shortage problem. However, these trends are far from guaranteed to last, and the gap to the frontrunners (measured in terms of robots per worker) is generally quite high (Figure 2.8). It is also clear that for many firms this is not even an option: those with lower productivity will not be able to pay the higher wages and stay in business. Some labour-intensive firms in Romania, for example, have already shut down and moved production to Asia in the face of labour shortages and higher wages (see Romania country report). More generally, the biggest potential for productivity improvements lies in the services sector, including the government. However, such firms (or the government) do not necessarily have the resources to commit to such new investments, unlike, say, a large German carmaker.

**One factor that may discourage firms (including foreign ones) from investing more to offset labour shortages and higher wages is the negative political development in many countries.** The impact of politically driven legal uncertainty on private investment in countries such as Poland and Russia has been clear for some time, and there is reason to think that this could become an issue in other countries as well.

**Increased authoritarianism, state capture and interference in the independence of institutions appear to be on the rise across much of CESEE, including in the EU-CEE11 countries.** According to the Varieties of Democracy Index (V-Dem), democracy is on the back foot almost everywhere in CESEE, and this has been especially the case over the past ten years (Figure 2.9). Negative political trends in many parts of CESEE are already having important implications for institutional quality, capacity and independence, and this in turn could be a problem for economic growth in the future.

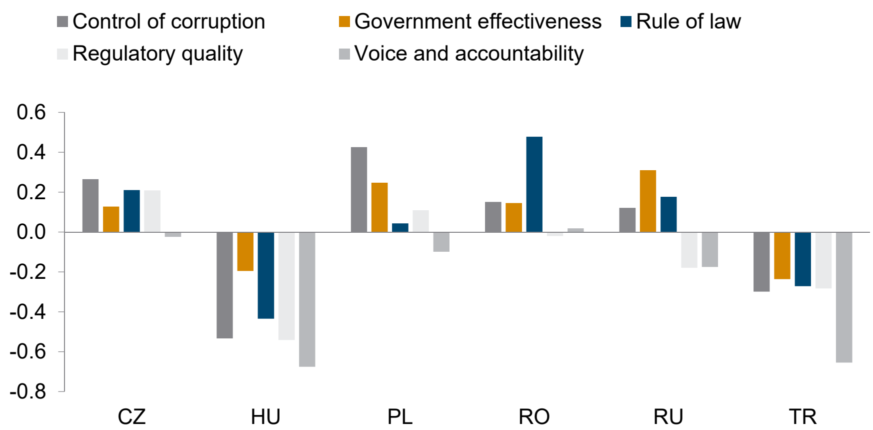
**Figure 2.9 / V-Dem electoral democracy index**




Source: V-Dem.

**Institutional de-convergence over the past ten years is particularly apparent in Hungary and Turkey**, according to the World Bank Governance Indicators (Figure 2.10 shows comparisons with the other big CESEE countries). In Turkey, there has been a clear deterioration across all the selected indicators during the past decade (and particularly strongly for 'voice and accountability'). Political developments have undermined both the capacity and the independent functioning of many institutions. Hungary also tells a very negative story: on all five of the indicators used here, Hungary recorded the largest (or the joint-largest) deterioration among CESEE countries in its score between 2007 and 2017. The comparison with Hungary's Visegrád peers is stark. For example, in 2007 Hungary was equal with, or better than, the Czech Republic on four out of the five indicators. As of 2017, by contrast, it scored clearly worse on all five. It is notable that the same trends are not visible in Poland. However, the Law and Justice (PiS) party has only been in power since the end of 2015. Interestingly, the biggest improvements over the period 2007-2017 were recorded in the CIS, and specifically in Belarus and Kazakhstan, albeit from a low base.

**Figure 2.10 / World Bank Governance Indicators for major CESSE economies, change 2007-17**




Source: World Bank.

### 2.1.2.5. Fiscal policy unlikely to save the day

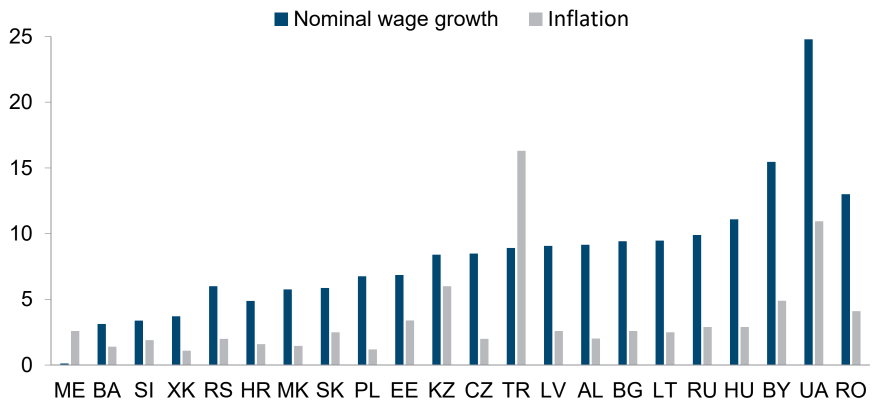
**It is not likely that fiscal policy will make a significant contribution to growth on aggregate in the region during the forecast period.** It may well be the case that, as external conditions deteriorate (with implications in some cases for private consumption and investment), so fiscal policy could pick up some of the slack in certain countries. Strong fiscal positions and still very attractive financing conditions certainly create room for this in many CESEE countries. However, we are not convinced that most will use this opportunity, and certainly not in a decisive way from the perspective of headline real GDP growth. On average, we expect government spending to add around 0.3 percentage points to headline growth in CESEE countries in 2019-2021, similar to the historical period. In only two countries – North Macedonia and Kosovo – do we expect a significantly bigger contribution in the forecast period than over the past three years. Meanwhile, in many countries the contribution will be smaller – most significantly in Turkey (0.6 percentage points less per year on average), reflecting the much tighter policy stance.

### 2.1.2.6. Where is the inflation and will it rise again?

**Inflation in most countries of the region is surprisingly weak, particularly in the context of last year's sharp increase in oil prices and the very strong wage rises in some countries.** Much of the region at least flirted with deflation in 2014-2016, but this episode now seems to be decisively over, with price growth back in positive territory everywhere. However, particularly in EU-CEE11 and parts of the CIS and Ukraine, real wage growth is running well ahead of inflation (Figure 2.11). In 2018, only a few countries saw significantly higher (i.e. more than a couple of tenths of a percentage point) inflation than in the previous year, and in almost all of them it was due to overheating/idiosyncratic factors (Bulgaria, Romania, Slovakia, Hungary and Turkey). The rest recorded either negligible increases or declines.

**Figure 2.11 / Nominal gross monthly wages and inflation in 2018**

change in % against preceding year




Note: Data based on wage or earning surveys. Romanian wages include employers' social security contributions.
Source: wiiw Annual Database incorporating national and Eurostat statistics.

**Several countries stand out in the region for having recently had particularly high nominal wage growth in relation to inflation: Romania, Ukraine, Belarus, Hungary, Russia, Albania, Lithuania, Bulgaria, Czech Republic, Latvia and Poland.** For these countries, nominal wage growth was at least 5 percentage points higher than headline inflation in 2018. In all cases, this was well above the post-crisis average. Only two countries – Turkey and Montenegro – posted wage growth below inflation last year.

**At first glance, the general lack (so far) of pass-through from very strong and sustained wage growth to headline inflation presents something of a mystery.** In all likelihood, a confluence of factors is keeping price growth low by historical standards in most of CESEE, and it is probable that the balance of these factors differs between countries:

› First, inflation is **going nowhere in most of the eurozone**. Given the very high degree of trade integration between most of CESEE and the single currency area, this is likely playing a role (and possibly the decisive one).

- Second, there remains substantial **slack** in some parts of the economy, partly as a legacy of the crisis, and this is now being eaten up by productivity gains (as opposed to strong growth at a time of high capacity utilisation, which should then translate into higher inflation).
- Third, it may be that, after years of subdued price growth, **inflation expectations have de-anchored**, leading to a more permanent state of ultra-low inflation/deflation.[7]
- Fourth, looking at inflation breakdowns, there appears to be a fairly standard consistency in **consumer-focused products** (such as furniture or household equipment) falling in price. In addition to this, retail trade value and retail trade volume are growing at similar rates in most countries. All of this suggests that firms selling consumer goods are struggling to increase prices, indicating either that competition is playing a much greater role (see below), or that consumer demand is not as strong as it appears.
- Fifth, and linked to the previous point, it may be that **consumer goods are predominantly being produced abroad**, and that therefore exchange rates could be playing a role. It is true that after fairly sustained and significant post-crisis appreciation, since the start of 2015 the Chinese yuan has steadily depreciated against the euro.
- Sixth, it may just be that the **collapse in the cost of Brent crude in 2014** has had broad knock-on effects for producer (and therefore consumer) prices over a multi-year time horizon.
- Seventh, **low international food prices** are likely to be playing a role. Food prices tend to be the biggest component of the consumer price index (CPI). According to the Food and Agriculture Organization of the United Nations (FAO), global food prices have fallen for six of the last seven years. Between 2011 and 2018, the FAO's global food price index fell by almost 27%.[8]
- Eighth, higher household **savings rates** may be playing a role. We find evidence for this in some countries for which full comparable data are available, but by no means in all (Figure 2.12).
- Ninth, there appears to be evidence that the **rise of online retailers** has had a disinflationary impact on the overall price level.[9]
- Tenth, it is possible that the fact that the **labour income share is at a historically low level** in many countries means that wage developments do not matter as much for inflation as in, say, the 1970s.
- Finally, several of the wealthier parts of CESEE (such as Poland and the Czech Republic) now host a lot more immigrants (often from other parts of the region), meaning that a greater share of the money earned in those countries is not spent there, but rather flows out in the form of **remittances**.[10]

---

7 Recent data show that this may have happened in Germany, for example.

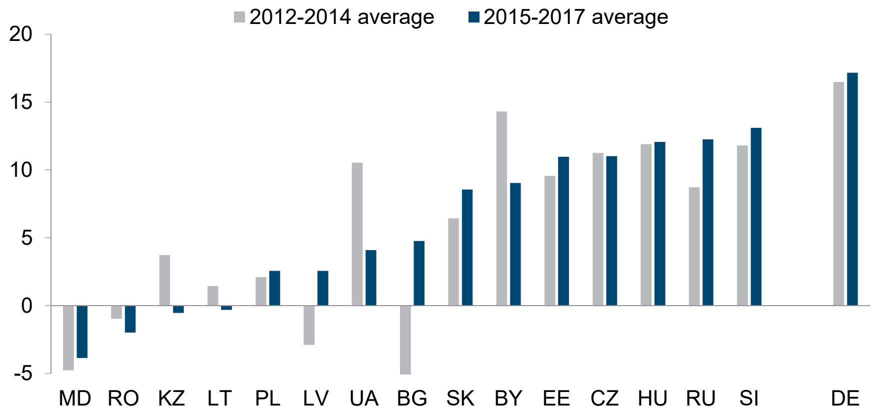
8 http://www.fao.org/worldfoodsituation/foodpricesindex/en/

9 https://www.reuters.com/article/us-usa-fed-inflation/amazon-effect-could-have-impact-on-inflation-dynamics-paper-idUSKCN1LA0IO

10 https://wiiw.ac.at/ukrainian-workers-in-poland-demand-by-far-exceeds-supply-n-308.html

**Figure 2.12 / Household savings rates**

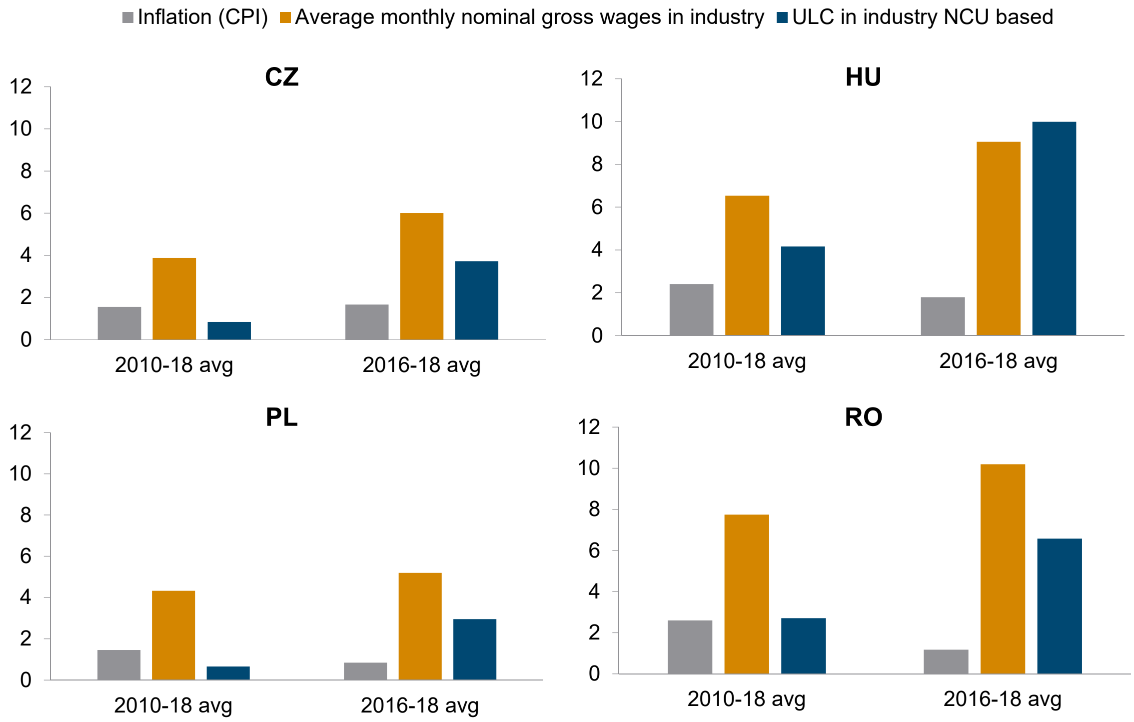
gross saving in % of gross disposable income




Source: AMECO.

**Figure 2.13 / Inflation, wages and unit labour costs**

change in % against preceding year



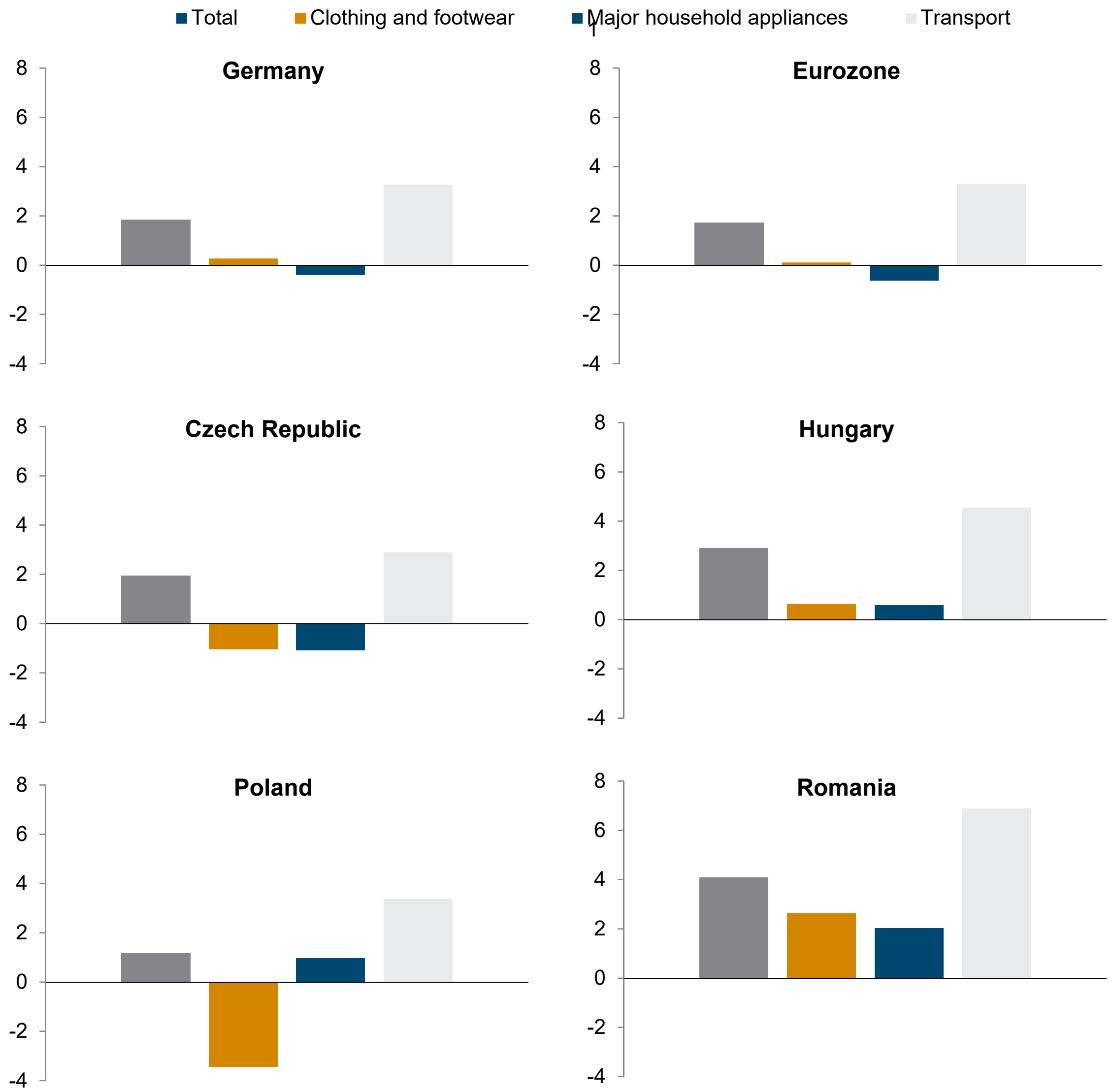

Source: Source: wiiw Monthly Database incorporating national and Eurostat statistics.

**The argument about improved productivity offsetting nominal wage rises also remains quite persuasive for CESEE, and finds some support in the data.** In most countries for which data are available, we find that unit labour costs are rising much more slowly than nominal wages (implying productivity gains), and this is mirrored in low inflation (we use data for industry as the sector generally most exposed to international competition). This is certainly the case in the Czech Republic, the country with the most acute labour shortages, for example; but it also applies to most other countries in the region. Our conclusions overall are unchanged from a similar analysis conducted in 2016 (Astrov et al. 2016). Wage increases are being offset by improved labour productivity or improved non-price competitiveness of products (e.g. quality).

**However, rather different developments can be observed in Hungary (and to an extent in Slovakia).** At least over the past couple of years, unit labour costs have risen more quickly than wages in industry in these two countries, implying that productivity is declining marginally (Figure 2.13). This could indicate that problems may emerge for Hungary, in particular. Hungarian core inflation is now running at around 3%, which is high by EU-CEE standards. More generally, it is clear that in most countries unit labour costs have risen much more quickly in the last couple of years.

**Figure 2.14 / HICP growth in 2018**

% change against preceding year, selected components




Source: Eurostat.

**Delving deeper into the inflation dynamics of those countries that generally operate with inflation-targeting monetary regimes,[11] two things become noteworthy.** First, the role of energy prices (demonstrated by the 'transport' component of the EU-harmonised index of consumer prices) has recently had a big impact on overall price growth, reflecting the sharp rise in Brent crude prices last year. And second, there appears to be a clear weakness of price growth in sectors that are reliant on domestic demand. Of these countries, only in Romania is there any sign of price growth edging toward 2% in consumer demand-focused segments, such as clothing/footwear or major household appliances (Figure 2.14). This suggests still rather 'soft' consumer demand conditions, implying that consumers are not allocating all of their higher wages to increased spending (or that higher competition or online retail are depressing price growth in these sectors). Moreover, high frequency data indicate that retail trade growth is trending down in these countries, albeit from high levels in at least some of them.

**With the exception of some CIS countries (where inflation fell quite sharply last year, and will bounce back), we do not expect current inflation dynamics in CESEE to change significantly during the forecast period.** Looking at the scale of labour shortages and the wage response, one might conclude that a spike in inflation is imminent. However, as demonstrated, these conditions have been around for several years, without any apparent inflationary response. In the absence of a sharp increase in international commodities prices, it appears likely that a combination of the factors listed above will keep inflation at historically low levels in most of CESEE during the forecast period. We expect oil prices to be generally flat during the forecast period, meaning that the large positive contribution to headline inflation from transport costs last year will not be repeated.

### 2.1.2.7. The curious cases of Russia and Turkey

**Russia and Turkey are easily the biggest economies in CESEE – and currently also the worst performing. However, while this looks like being a long-term issue for the former, we do see a somewhat brighter (albeit volatile) future for the latter.** In the end, Russia reported a better-than-expected 2018, but we are not 100% convinced by the numbers; and even if one accepts them, Russia was still CESEE's weakest economy last year. High frequency indicators suggest a bad start to 2019 for Russia. Meanwhile, although the Turkish economy grew by around 3% overall in 2018, this hides a deep downturn in the final quarter of the year, which looks set to continue during at least the first half of this year.

**For Russia and Turkey, our average growth forecasts for 2019-2021 are 1.9% and 2.2%, respectively, making them two of the three slowest growers in CESEE in the period (the other being Belarus, which is, of course, highly integrated with Russia).** However, the two are facing very different challenges, and as such the medium-term outlook is quite different. Russia is bumping along at a bit below 2%; and without major institutional and other reforms (the latter impossible to imagine any time soon), this will not change. By contrast, Turkey is in recession and has a tough near-term outlook; but by 2021, it will again be one of the fastest-growing economies in the region.

**Under pressure from much weaker oil prices, high rouble volatility, and never-ending rounds of US and EU sanctions, the Russian authorities have made a clear decision to sacrifice growth for**

[11] Here we mean the Czech Republic, Poland, Hungary and Romania. We exclude Turkey and Russia, as the conditions there are quite different.

**macroeconomic stability.** This has worked, and has certainly reduced the vulnerability to (especially) US influence. Fiscal and monetary policies have been very tight, and the current account surplus last year reached over 7% of GDP. External debt (public and private) is being repaid early, and the central bank is reducing the share of FX reserves held in US dollars. Import substitution has been actively pursued (with mixed results), and trade is being reoriented east (especially to China). In short, Russia has settled into a 'new normal' of Western sanctions. Nobody expects these sanctions to go away, and indeed they may get worse (elections in Ukraine and for the European Parliament could have implications here).

**Combined with the likelihood that the oil price will not rise, and the low chances of any reforms to address Russia's inherent structural weaknesses, this makes Russia's growth outlook the worst in CESEE.** Back in 2008, then-presidential candidate Dmitry Medvedev argued that Russia needed to make progress on the 'four I's' – infrastructure, institutions, investment and innovation – to diversify away from its reliance on oil and gas, increase its growth potential and reduce energy dependence vulnerabilities. More than a decade on, nothing has changed, and these issues continue to hamstring the economy. Moreover, even with the big macroeconomic defences that have been put up over the past few years, external factors – such as politics in Ukraine, the escalating global trade war, potential new sanctions and a further collapse in the oil price – remain a threat. There is also a small chance of more serious political instability; but President Vladimir Putin's promises in February to focus on social spending and protection suggest that the government is worried enough to decisively address this. Still, Russia is doomed to fall behind and will be overstretched by its external ambitions.

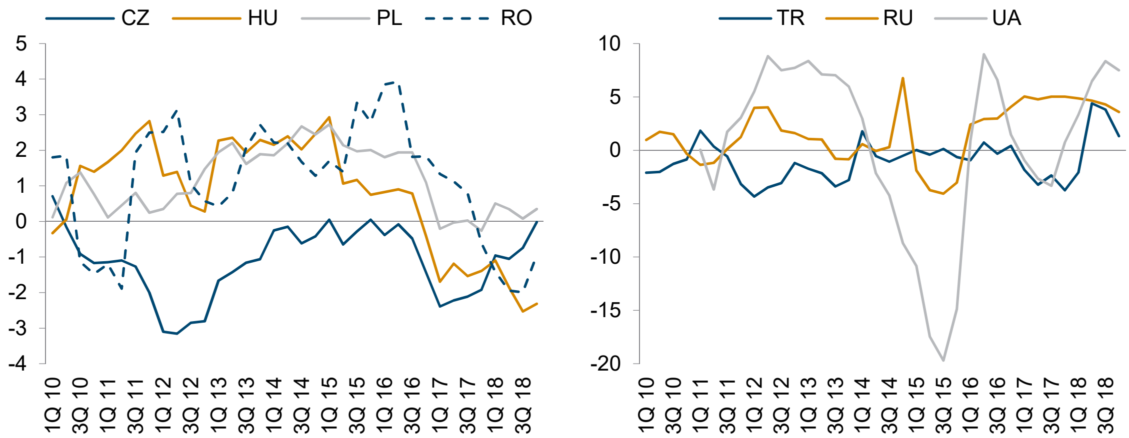
**Turkey is hardly in great shape either, but it is very likely to grow significantly more quickly than Russia over the forecast period and beyond.** The economic model of Turkey leaves it highly exposed to changes in global dollar liquidity and investor sentiment, and volatility in the future is almost assured. However, Turkey compares well with Russia on most, if not all, of the 'four I's', and has a young, growing population. As a result, Turkey's fortunes are likely to depend heavily on global investor sentiment and dollar liquidity. If the US Federal Reserve retains its currently dovish stance, Turkey could well return to its current account deficit-driven growth model of the recent past.

### 2.1.2.8. Monetary policy will stay supportive of growth in most places

**As the above discussion on inflation shows, the dovish tone of our recent reports (often going against consensus expectations) has turned out to be correct.** Except for in Hungary (where core inflation looks set to rise above the 3% target), central banks in EU-CEE do not appear keen to quickly tighten monetary policy, reflecting the continued weakness of inflation. The other three major EU-CEE central banks (Czech Republic, Romania and Poland) appear relaxed about inflation, with real interest rates either around zero or negative (Figure 2.15). Czech rate hike expectations have been pushed back, and the Polish central bank looks set to keep interest rates at their current low levels for an extended period. This stance is reinforced by an increasingly dovish ECB (it would be difficult to overstate the impact of years of ultra-low policy rates by the major global central banks, and particularly the ECB, on interest rates in CESEE). In Hungary, political factors will mean that the central bank will likely tighten policy as slowly as possible.

**The exceptions among the major CESEE central banks are Russia, Ukraine and Turkey, where policy is much tighter.** All three countries have strongly positive real interest rates, indicating restrictive monetary policy. In Russia, this reflects primarily a desire to shield the economy and support the currency against US sanctions, as well as a prioritisation of macroeconomic stability over growth. Similarly, in Ukraine, high real interest rates represent an attempt to tame persistently high inflation, even at the expense of growth. In Turkey, high real policy rates were introduced in 2018 in response to the collapse of the lira, but only reluctantly and with a significant delay.

**Figure 2.15 / Real interest rates, CPI-adjusted, in %**




Source: wiiw Monthly Database incorporating national and Eurostat statistics.

### 2.1.2.9. Political risk still fairly high

**Election wise, 2019 is a busy year for CESEE; and some of the elections will have important implications for the region's economies.** Parliamentary elections were held in Moldova in February (inconclusive), and will take place in Estonia in March, Ukraine in October and Poland in November. Meanwhile, presidential elections were be held in Slovakia and Ukraine in March, North Macedonia in April, Lithuania in May and Croatia in December-January 2020.

**The votes in Ukraine and Poland could be of most consequence.** In Poland, another victory for Law and Justice (PiS) would keep the country on its confrontational course with the EU, and would herald further reforms that are probably not conducive to long-term growth (we put the chances of a PiS victory at 50%). Meanwhile in Ukraine, the outcome of the presidential election is highly uncertain (see country report for full details). All of the main contenders suffer from high disapproval ratings, suggesting a general lack of faith in the country's political class (admittedly, this is hardly unique to Ukraine in the region). Whoever wins, the country's decisive pro-Western political alignment will not change; but policy could move to the left and could bring more conflict with outside sponsors, such as the IMF. Backsliding in some reform areas has already been observed (such as anti-corruption laws). A further 'heating up' of the conflict with Russia, meanwhile, certainly cannot be ruled out and would have devastating consequences.

### 2.1.2.10. Sovereign risk contained by wall of global liquidity

**The sovereign ratings backdrop is positive, and generally mirrors trends in the macro economy across most of the region.** Robust growth and a lot of fiscal austerity have combined to significantly improve many of the ratios used by ratings agencies to assess sovereign creditworthiness. Countries where public and/or external debt ratios appeared only a few years ago to be in danger of spiralling out of control – such as Croatia, Serbia and Hungary – now find themselves on consistent, positive upward ratings trajectories.

**This may change as growth slows; but the likelihood is that, rather than witnessing the onset of downgrades, we will see upgrades peter out.** The unwinding of macro imbalances – both fiscal and external – has been significant and fairly broad-based across CESEE in the past few years. In addition, a major source of stability for CESEE sovereigns is the persistent weakness of inflation in most of the developed world, especially now that the Fed has paused in its interest rate hikes. With so much global liquidity chasing such little yield, and with many of the big money managers struggling to meet liabilities, demand for CESEE sovereign debt is likely to remain very healthy over the medium term. If, however, inflation in the eurozone and the US suddenly shoots higher (not inconceivable, at least in the latter), then the situation could change quite quickly, and in a nasty way for CESEE.

## References

Astrov, V., M. Holzner, M. Landesmann, I. Mara, O. Reiter, S. Richter and R. Stehrer (2016), ‘Labour shortages driving economic growth?’, wiiw Forecast Report, Autumn, Vienna.

Bobeica, E., M. Ciccarelli and I. Vansteenkiste (2019), ‘The link between labor cost and price inflation in the euro area’, February, Working Paper Series, No. 2235, ECB.