Executive summary

The economic recovery in Central, East and Southeast Europe (CESEE) identified in our Spring and Summer Forecasts has strengthened further in recent months. Current momentum across much of the region is buoyant: on average in the region, the pre-crisis level of 2019 was already exceeded in the second quarter. This has resulted in a number of additional upgrades to our forecasts for 2021 and beyond. This year, the economy of CESEE is estimated to grow by 5.4% – 1.4 percentage points faster than was projected in the summer, and faster than in the euro area (4.8%). This is quite a remarkable achievement, and cannot be explained simply by the effect of the statistical base: last year, regional GDP contracted by only 2.3%, compared to 6.3% in the euro area. Moreover, the aggregate fiscal (and indeed monetary) response has generally been weaker in CESEE than in the euro area.

This good performance has been built on two important foundation stones: the adaptation of the CESEE economies to the pandemic and the increasing reluctance of their governments to impose restrictions. As the pandemic unfolded, so people and companies adapted their behaviour and got on with 'business as usual', even during severe waves of the pandemic. Besides, the appetite for restrictions has gradually evaporated, and in nearly all of the countries they are now less stringent than, for instance, in Austria. As a result, the pandemic – which remains prevalent in large parts of CESEE, especially in those countries with low vaccination levels – has not exerted anything like the drag on economic growth this year that it did in 2020.

The main driver of the economic rebound in CESEE has been private consumption. That has benefited from the easing of COVID-19 restrictions, the effect of delayed consumption, rising employment and wages, and the release of savings accumulated during the pandemic – as well as, in some cases, the strong inflow of remittances and rapid credit expansion. Investment growth in the region has also been high, although this is, to a considerable degree, driven by developments in Estonia, which has capitalised hugely on its digital specialisation and has attracted large foreign investments in information and communications, biotechnology and a newly opened factory producing COVID-19 tests.

The exports of CESEE countries have been in recovery mode, helped by improved demand globally (and particularly in the euro area), a strong revival in energy prices and the recovery of cross-border tourism. However, the legacy of pandemic-related disruptions in value chains has not yet been fully overcome (e.g. the shortage of semiconductor chips that is affecting the production of cars and electronics). Nevertheless, the contribution of real net exports to GDP growth is negative in more than half of the CESEE countries, with export growth not keeping pace with the rise in imports.

The strong economic upswing in CESEE has resulted in labour demand reviving swiftly. However, for most CESEE countries, there is still some way to go to overcome last year's slump in employment – most notably in Montenegro, Moldova and Ukraine. Besides, the COVID-19 crisis has left scars in the form of underemployment, which is now everywhere higher than before the pandemic. Unemployment also remains a problem, especially in the Western Balkans. At the same time, paradoxically, the labour markets are becoming tighter again. While, in many countries, workers who were previously employed in the hospitality sectors are still jobless, there are numerous employers in business services, construction, health care and other public services who are again eagerly searching for labour. This ongoing structural change is resulting in a peculiar combination of strong wage growth and still relatively high underemployment.

Inflationary pressures in CESEE have increased markedly, especially in the non-euro countries. Currently, in most countries of the region, consumer price inflation is 3% to 4% higher than at the beginning of the year. In Czechia, Hungary, Poland, Romania, Russia, Ukraine, Belarus, Kazakhstan and Moldova, the policy rate has already been raised in response (in some cases markedly). Despite that, real interest rates have declined and are now nearly everywhere in negative territory. The recent spike in inflation has been supply-side driven (with energy prices featuring particularly prominently) and is likely to prove transitory. Overheating is hardly an issue in most CESEE countries at present, with the exceptions of Turkey and, possibly, Hungary, Serbia and Albania. However, housing prices have been booming, raising concerns about the formation of property-market bubbles.

The pace of economic recovery in CESEE is projected to slide to 3.7% next year and 3.5% in 2023. The effect of the low statistical base of 2020 will gradually fade, and monetary policy tightening will put the brakes on credit expansion. In EU-CEE countries, growth will be crucially helped by disbursements from the EU Recovery and Resilience Facility, which aims at facilitating economic recovery and simultaneously at fostering digital and green transition. However, approval of the Hungarian and Polish recovery and resilience plans is still pending, while Bulgaria has not even yet submitted its plan to the European Commission. Risks to the above forecasts are mostly on the downside, and include notably

(i) particularly unfavourable COVID-19 developments, which are more likely in countries on the eastern and southern periphery of the CESEE region, given their low vaccination rates;

(ii) premature fiscal consolidation, especially in the Western Balkans and the CIS; and

(iii) the upcoming monetary tapering in the US, which may have particularly severe repercussions for Turkey and Romania, but could impact other CESEE countries as well.

COUNTRY SUMMARIES

ALBANIA

The V-shaped recovery that we see suggests that the economy is back on track and will remain sound. GDP growth will accelerate to 6.4% in 2021 and will hover at above 4.5% in the medium term. The tourism sector has had an impressive year and is getting closer to its pre-pandemic level. Growth will be led by investment and by optimistic external and domestic demand, but downside risks stemming from the international markets and the pandemic call for vigilance.

BELARUS

The restoration of economic relations with Russia has outweighed the negative effect of the Western economic sanctions. Economic growth has been higher than expected, but the upturn has been accompanied by a surge in inflation. Belarus has taken an important step towards closer economic integration with Russia by signing 28 integration programmes. The figures for 2021 have improved slightly, and GDP is expected to grow by some 2.5% for the year as a whole. However, the prospects for the coming years remain bleak.

BOSNIA AND HERZEGOVINA

The economy has bounced back since restrictions were eased in Q2 2021, growing by 11.6% (and thus more than recouping last year's decline). Mass vaccination has started, but the public's interest in getting inoculated has been far lower than expected; this poses an additional risk to the health sector, as the fourth wave of the pandemic is already upon the country. The introduction of a law proscribing genocide denial has led to fresh political tensions in the country and disruption to the work of government institutions by politicians from Republika Srpska; this could have economic repercussions.

BULGARIA

Bulgaria goes to the polls in November for the third time in 2021, after two failed attempts in parliament to form a government. Despite the political impasse, a moderate recovery has been under way, mostly driven by domestic demand. In early autumn, the country was hit by a new and powerful wave of COVID-19 – in large part a consequence of the very low vaccination rate. The short-term outlook has improved slightly and GDP is expected to grow by 3.5% in 2021 as a whole. Growth is expected to remain moderate in the coming years.

CROATIA

In 2021, Croatia's GDP will grow more strongly than that of most EU-CEE member states, after the government succeeded in maintaining COVID-19 infections at a relatively low level during the summer season, which allowed tourism to do better than expected. With the economy further bolstered by a solid recovery in private consumption and by the influx of EU funds, we expect Croatia's GDP to rebound by 7.2% in 2021.

CZECHIA

Pandemic concerns have been fading. GDP has started to recover, and a rising wage bill is supporting a strong rise in consumption. Growth in gross fixed capital formation is still inadequate, but industrial production is performing very well. An upturn in inflation has led to a tightening of monetary policy. The interest rate hike may have negative consequences for growth, but fiscal policy will continue to be supportive. The prospects, though fairly good, remain unimpressive.

ESTONIA

The first half of 2021 showed Estonia to be another post-pandemic success story. Record high investment flooded into the ICT sector, while strong purchasing power and a rapid revival in foreign trade are the pillars of economic growth. We expect the economy to grow by 7.8% in 2021. Even by the middle of the year, the country's pre-pandemic level of output had been exceeded. Future growth will be driven by production expansion, steady consumer demand, rising investment, a strengthening position on the foreign market and further digital transformation.

HUNGARY

By summer 2021, Hungary's economy had regained its pre-pandemic level. Recovery was helped by dynamic growth in industry and a remarkable contribution by net exports. The economy is overheating, however, and inflation has climbed to around 5%. While the central bank has begun tightening monetary policy, the government has stepped up its expansionary fiscal policy, with an eye to the elections early next year. After the elections, the overheating will have to be tackled. The current dynamic growth cannot be maintained for the duration of the forecast.

KAZAKHSTAN

Economic revival is accelerating, with a full rebound to pre-pandemic performance in sight for this year. Rising consumer demand and new fiscal stimuli will support strong performance in the coming years, but inflationary pressure is re-emerging and is likely to persist next year. The forecasts for 2021 and 2022 have been revised upwards to 3.9% and 4.2%.

KOSOVO

The economy has recovered quickly to pre-pandemic levels, and this year GDP growth will accelerate to 6%. The momentum is likely to persist and will be backed by strong domestic and external demand. Both consumption and investment will continue to benefit, as remittances flood in. Foreign investors are turning their gaze towards Kosovo: foreign direct investment has kept pace with the positive developments of 2020 and will continue on this path. Exports of goods will maintain their positive trend.

LATVIA

Following a relatively mild recession in 2020, the Latvian economy is experiencing a remarkably strong revival in 2021. Household consumption has recouped most of the 10% loss it experienced last year, while enterprises are replenishing their depleted stocks. Public consumption and investment are acting as a growth driver, and external demand has similarly rebounded. In 2021, we expect GDP growth to increase to 4.5% and to remain strong in 2022 (4.3%). That will be followed by a somewhat gentler increase of 3.4% in 2023.

LITHUANIA

The Lithuanian economy recovered strongly in Q2 2021. Better-than-expected export performance and swiftly rebounding household consumption were coupled with an upswing in capital investment and a substantial accumulation of stocks. Sharply rising infection statistics may force the government to reintroduce stricter containment measures, but we do not expect that to choke off the ongoing revival. The government is continuing to deliver substantial fiscal stimuli, and the public investments announced will support recovery over the next two years. For 2021, we expect real GDP to grow by 4.4%, followed by a strong, steady increase of 3.7% in 2022 and 3.5% in 2023.

MOLDOVA

The economy will grow by 8% in 2021, against the 7% contraction of the previous year, bringing real GDP back to the pre-crisis level of 2019. The new western-oriented and reform-minded government enjoys overwhelming support in parliament and is able to attract ample foreign funds to finance the expansion of the fiscal and current account deficits.

MONTENEGRO

From Q2 2021, the economy has been enjoying a big increase in industrial production, retail sales, exports of goods and tourism. Accordingly, a high rate of GDP growth is expected in 2021. All the same, the huge contraction in 2020 means that the pre-crisis level will not be reached this year. Public debt and the budget deficit are falling but are still high, limiting fiscal space in the coming years. Despite improvements in economic activity, the unemployment rate remains high.

NORTH MACEDONIA

Weak government support, deep-seated structural problems and global issues in the automotive sector all combined to slow economic recovery in North Macedonia in the first half of 2021. We are downgrading our forecast for GDP growth in 2021 from 4.1% to 3.5%. Developments in the years to follow will depend on whether the government starts to undertake structural reforms and invests in green and digital transformation.

POLAND

The ‘fourth wave’ of the pandemic currently presents little cause for concern. From a mild decline in GDP, Poland has seen a shift towards recovery. The rising wage bill supports a strong recovery in consumption without jeopardising corporate profitability. Growth in gross fixed capital formation is still inadequate, but industrial production is performing very well. An upturn in inflation has not unduly affected the central bank’s monetary policy. However, the course of fiscal policy remains uncertain. Overall, Poland’s prospects are good, but conflicts with the European Commission need to be resolved.

ROMANIA

With expected growth of 6.8% in 2021, the Romanian economy will surpass the pre-crisis level of 2019. The high twin deficits on the fiscal balance and the current account could become a problem only in the event of negative external shocks. The short-term prospects are dimmed by three simultaneous crises in the areas of the pandemic, gas supply and government.

RUSSIA

Despite the persistently unfavourable COVID-19 situation, the economy has rebounded strongly and exceeded the pre-pandemic level in Q2 2021. But inflation has also accelerated markedly. In response, the policy interest rate has been hiked sharply, and more rises are likely to follow. Real GDP is projected to grow by 4% this year and by around 3% per year in 2022-23.

SERBIA

Firm government support and effective vaccine roll-out in the first half of the year have helped the Serbian economy offset the losses brought about by the pandemic. We are upgrading our GDP forecast for 2021 to 6.6%, from 6%. There are three issues that could potentially slow growth down in the coming period: the global problems in the automotive industry, the fiscal consolidation announced by the government and the recent political tensions in the region.

SLOVAKIA

Slovakia's GDP recovered by 9.6% in Q2 2021. Manufacturing – especially the automotive industry – is driving growth, but the shortage of semiconductors is of increasing concern. Slovakia's GDP is expected to rise by 4% this year, while the influx of EU money will drive up investment in coming years.

SLOVENIA

GDP has almost recovered to its pre-crisis levels. Strong economic performance has led our forecast for economic growth to be revised upwards to 5.2%. Q2 2021 saw an increase in private expenditure, a renewed growth in services and strong private investment activity. Exports and trade-oriented industrial sectors have already grown beyond 2019 levels. Inflation has stabilised and is not likely to exceed 2% in 2021. With a surge in infections, the slow progress of vaccination is a risk factor for the winter.

TURKEY

The economy is currently booming, underpinned by strong credit growth, robust domestic consumption, and the impact of the global recovery on export demand and tourism. Ultra-loose monetary policy by the major economies is supporting capital inflows; but as the US, in particular, starts to taper its asset purchases, the risks for Turkey's external financing will rise. While the short-term outlook is good, the usual vulnerabilities remain – not least high inflation and uncertainty over the direction of monetary policy.

UKRAINE

Economic recovery in 2021 will be slower than expected, with GDP growing by 3.8% in annual terms. Private consumption will remain the main driver of growth throughout the forecast period. The recent acceleration in inflation is only temporary: it will slow down in 2022-2023. Any further delays to IMF funding disbursements would constitute a major risk to growth.

Keywords: CESEE, economic forecast, Central and Eastern Europe, Western Balkans, EU, euro area, CIS, Turkey, US, convergence, business cycle, coronavirus, coronavirus restrictions, coronavirus vaccination, Recovery and Resilience Facility, private consumption, credit, investment, exports, labour markets, unemployment, short-time work schemes, monetary policy, fiscal policy

JEL classification: E20, E21, E22, E24, E32, E5, E62, F21, F31, H60, I18, J20, J30, O47, O52, O57, P24, P27, P33, P52