Executive summary

Economic growth has weakened in most CESEE countries, hit as they have been by both financial tightening and soaring inflation, which has undermined real incomes and depressed confidence. The threat of a serious energy crisis has not materialised, as the CESEE countries have managed to drastically scale back their natural gas consumption and wean themselves off their dependence on Russian fossil fuels. However, many of them have slipped back into increased coal use as an emergency solution.

Although inflation has mostly slowed in recent months, as global energy prices declined, it remains uncomfortably high and continues to weigh on real incomes. Core inflation is still in double digits in all the CESEE countries, apart from Albania and Slovenia. As real wages have fallen, so households have had to use other sources to finance their consumption. Many CESEE governments have implemented fiscal packages to cushion the blow of higher prices for vulnerable households. Those EU-CEE members that could take advantage of access to the EU Recovery and Resilience Facility have been able to offer more generous support, through the pace of drawdown has varied considerably.

We expect inflation to take longer to subside than we previously thought and have revised our 2023 forecast upwards for most CESEE countries. However, the region will largely avoid recession – apart from Hungary, which is struggling with rampant inflation and difficulties in accessing EU funds. Overall, the Western Balkans will have the strongest economic growth in the region in 2023, with average GDP growth of 2%. In EU-CEE, economic performance will be very uneven: Romania and Croatia are expected to grow by 3.0% and 2.5%, respectively, while the Baltic states, Czechia and Slovakia will expand at below 1%. We have revised downwards our GDP forecast for Ukraine to 1.6%, as the damage caused to the country’s energy infrastructure by Russian missile attacks has raised costs for the economy and aggravated supply-chain issues.

In 2024-2025 we anticipate an overall acceleration of economic growth across the region, primarily on the back of a recovery in private consumption. Investment is also expected to recover, but its contribution to economic growth will generally be quite modest, apart from in Croatia, Romania and North Macedonia: in those countries it will grow on a par with household final consumption, supported to a large extent by FDI inflows and (in the case of the first two countries) by EU funds.

Overall, Southeast Europe, including EU and non-EU members, showed the greatest resilience in the region last year and will continue to perform better than the Visegrád group over the forecast period. The Central European manufacturing core has been particularly affected by the high energy prices for industry and by low growth in Germany, its main export market. During the forecast period, Central European economies will be further constrained by the limitations of their economic model, based as it is on labour-cost advantages.

One of the major downside risks to the forecast is that the persistently high inflation will lead to the economies making a harder landing. A sharp tightening of financial conditions could exacerbate potential structural vulnerabilities in the banking sector, which must undergo a major adjustment of its balance sheets. Those CESEE countries with high debt levels are particularly vulnerable to the rising costs of debt servicing and capital outflows. There could be a deterioration in the security situation of the region if Ukraine encounters problems in securing support from its allies following the US presidential election in November 2024. In turn, that could have a negative impact on investor sentiment towards parts of the CESEE region.

COUNTRY SUMMARIES

ALBANIA

The Albanian economy displayed remarkable resilience in 2022, with a growth rate of 4.8%, driven by a bumper tourist season, robust FDI inflows and strong household consumption on the back of rising real incomes. Inflation was the lowest in the whole CESEE region, averaging 6.7%, but is still high by the country's own standards. This year will be similar to 2022, with expected growth of 3.3% and inflation of 4%.

BELARUS

Throughout 2022, Belarus underwent a painful adjustment to the external shocks it faced. Despite massive policy support measures and Russia's continued economic backing, GDP shrank by 4.7%. That year also witnessed a sweeping reorientation of trade flows, and China became Belarus's second-largest trade partner. Despite all the measures, Belarus's crippled economy will continue to be dominated by persistent weakness. GDP growth in the coming years will remain in the range 1-2%.

BOSNIA AND HERZEGOVINA

Growth in 2022 was 3.9%. This was better than expected, thanks to a rise in private consumption and gross capital formation. However, the continuing high inflation and increasing interest rates are likely to drag growth in 2023 down to 1.7%. The formation of governments after the October 2022 elections is not yet quite complete, but the shape of most of the structures is clear and reveals a slight move away from nationalist parties. The country gained EU candidate status in December 2022, even though the conditions required had not been met. This could provide a fillip to the country's progress in the coming period.

BULGARIA

The early general election held in April 2023 – the fifth in two years – has delivered no clear winner. The absence of a stable government over the past couple of years has resulted in fiscal destabilisation and delays to the country's planned accession to the euro area. While GDP growth in 2022 was above expectations (thanks to a surge in exports), in 2023 it will slow to 1.7%. Rebalancing the public finances requires a radical shift in fiscal policies – something that may be problematic given the current political environment.

CROATIA

Thanks to robust household consumption and a stellar summer tourist season, as well as better-than-expected growth in Q4 2022, Croatia's economy grew by 6.3% in 2022. In January 2023, the country adopted the euro and joined the EU's border-free Schengen Area, which will likely boost trade, tourism and investment in the long term. Nevertheless, given the high rate of inflation, the deteriorating funding conditions and the uncertainty (which will act as a drag on private consumption and investment), we expect the economy to grow by only 2.5% in 2023.

CZECHIA

With persistently high inflation, cooling internal and external demand, tight monetary conditions and a deteriorating fiscal position, the macroeconomic challenges facing Czechia are mounting. The Czech economy will manage to keep its head just above water and will avoid a recession, but it will be stagnant this year. The slowdown is expected to be temporary, and the economy should be in a position to see renewed growth from 2024 onwards.

ESTONIA

The anticipated economic decline – driven by severe inflation and weakening foreign demand – did indeed materialise in Q4 2022. However, economic prospects are not that grim, as inflation is slowing and consumption is gradually recovering. Moreover, economic activity in those sectors that are less reliant on imports of raw materials remains strong. Yet two major risk factors overshadow the outlook – the reduced export competitiveness of Estonian firms and a deepening systemic imbalance between budget revenue and expenditure.

HUNGARY

In early 2023, Hungarian inflation was the highest in the EU. Measures to rein in inflation have been unavoidable, but do little to encourage growth. Both consumption and investment will fall this year, and the only positive contribution to GDP change will come from foreign trade, where deficits are expected to shrink substantially. This year will be split between recession in the first half and moderate recovery in the second. EU transfers continue in limbo. A new industrial policy aimed at facilitating the FDI-based mass production of batteries for electric cars has the potential to turn into a costly fiasco.

KAZAKHSTAN

Despite the anticipated decline in oil prices, which will have an adverse impact on exports, economic growth is expected to accelerate over the forecast period due to domestic demand factors. Investments in infrastructure, in particular transport and logistics, will contribute positively to growth in the coming years. Consumption is likely to start recovering in 2023, although inflation is expected to take longer to contain, amid fiscal stimulus and the recent increase in regulated fuel prices.

KOSOVO

Despite the challenges of 2022, Kosovo's economy remained resilient, thanks to its robust export performance in both goods and services, as well as strong household consumption, encouraged by remittances. These factors are expected to continue to drive economic growth in 2023, supported by an accelerated trend in capital investment.

LATVIA

After a boom in 2022, the effects of dwindling external demand and escalating prices will bring the economy close to stagnation this year (0.3%). Enterprises are largely refraining from investment, preferring to deplete their stocks. Moreover, the ongoing decline in the purchasing power of households will curb growth in consumption. Given the tight labour market, the unemployment rate will rise only slightly in 2023, then decline again next year. Assuming that the EU economy finds its way back on track by the end of 2023, we expect a revival in Latvia's GDP growth to 2.5% in 2024.

LITHUANIA

The economy dealt better than expected last year with the blow caused by Russia's invasion of Ukraine, although inflation reached almost 20%. The economy will shrink in the first half of 2023, but the evident stabilisation in household and business sentiment suggests that consumption and investment activity should pick up thereafter. The government is trying to counter the loss of households' purchasing power, and public investments should also go some way to supporting economic activity. We expect real GDP to grow by 0.9% in 2023; this will be followed by an upswing to 2.7% in 2024 and then 2.5% in 2025.

MOLDOVA

The energy crisis, soaring inflation and extreme drought were the main reasons for the economic contraction in 2022 (GDP down by 5.9%). There should be an improvement across the board in 2023, thanks to elevated external assistance, rapid structural adjustment and better weather conditions (GDP to rise by 3.5%). In the absence of negative external shocks, and with determined efforts to foster EU integration, the economy will grow by about 4% in the coming years.

MONTENEGRO

Private consumption flourished in 2022, following a tax reform that resulted in very high GDP growth of 6.1%. Against all the odds, fiscal policy is still expansionary and fiscal risks are thus rising. A further rebound in tourism and expansion of the energy sector will be the main drivers of economic growth in 2023, which is projected to be 2.9%. The recent presidential election witnessed the triumph of the new 'Europe Now' party, which will likely win a significant share in the June parliamentary election, too, and could be a game changer in contemporary Montenegrin (geo)politics.

NORTH MACEDONIA

The mild winter helped keep the pessimistic scenarios touted at the end of 2022 at bay, and as a result the economy performed better than anticipated. This was partly due to strong foreign direct investment inflows (although the sustainability of these inflows is uncertain). The government's decision to reinstate price controls on essential foodstuffs has succeeded in bringing down inflation, but it is unclear how long these controls will remain in place. Overall, the economic situation in the country seems more positive than it did three months ago, though many challenges remain.

POLAND

The Polish economy has proved surprisingly resilient so far. But growth is already slowing. High interest rates are having a major effect on private consumption and investment, while inflation is eroding the real value of current wage incomes. Symptoms of excess supply abound. However, falling inflation and a recovery in household incomes will gradually restore demand and sales, thereby paving the way for an acceleration in growth. But these positive developments will set in only towards the end of 2023.

ROMANIA

Economic growth will slow to 3% in 2023, from close to 5% the previous year. Domestic demand will be eroded by high inflation and sluggish wage growth. The dynamic expansion of investments financed mainly by EU programmes and FDI will continue. Fiscal and current account deficits will contract, but will remain elevated – which will constitute a moderate risk. The improved international position of Romania in economic, political and military aspects supports its long-term economic development.

RUSSIA

After a sharp downturn in Q2 2022, the economy stabilised in the second half of the year and is projected to broadly stagnate in 2023. The overall picture masks the very uneven impact of the war and the sanctions across sectors: while domestic trade and industries that depend heavily on cross-border linkages have suffered, military production and certain import-substituting sectors have flourished. The recently imposed energy sanctions have dealt government revenue a heavy blow and will contribute to budget deficits being much higher in the years ahead.

SERBIA

Weak investment meant that the economy grew by less than expected in 2022, but there are signs of a recovery in early 2023. Inflation has been on the rise since the government started to lift the price controls it had introduced, and this poses some additional challenges. A major deal has been struck on the normalisation of relations with Kosovo; this could mark a turning point for the country, but questions remain about the implementation of the deal.

SLOVAKIA

In 2022, Slovakia's GDP growth reached just 1.7%. This year, too, high inflation will continue to prevent stronger economic growth, which is forecast to be 0.6%. Declining household consumption and poor prospects for Germany – the country's main export market – will drag down growth, while the influx of EU funds will provide some growth momentum. The situation should improve in 2024, but domestic political instability resulting from party fragmentation might threaten future prospects in the long run.

SLOVENIA

Slovenia continues to perform well in crisis times. In 2023, real GDP will grow by 1.4%, supported by government spending on infrastructure and solid export performance. At 5.5%, inflation will remain high, but lower than the EU average. Unemployment will be at an all-time low for the second year in a row, while real wages will increase despite high inflation. The government has announced reforms in healthcare, pensions, public salaries and taxes, all of which come with long-term fiscal implications and will be a hot topic in 2023.

TURKEY

Despite the various challenges, economic momentum was strong in the first half of 2022, but began to slow in Q4. In 2023, Turkey has been grappling with the fallout from February's devastating earthquakes and the political uncertainty surrounding the upcoming May elections. Growth will slow this year, due to a combination of external vulnerabilities and internal structural challenges. The easing of political instability and increased reconstruction investment are likely to stimulate growth in 2024-2025.

UKRAINE

Ukraine's economy has been performing relatively well, considering the wartime conditions and the targeted destruction of its energy infrastructure by Russia. International financial aid will remain crucial for the economy's functioning in the short term. We expect economic growth to resume in 2023 and to accelerate in 2024-2025. But this forecast is subject to major downside risks related primarily to the intensity and duration of Russia's war in Ukraine and the continued willingness of international partners to support Ukraine.

Keywords: CESEE, Central and Eastern Europe, economic forecast, Western Balkans, Visegrad group, CIS, Ukraine, Russia, Turkey, euro area, EU, convergence, Russia-Ukraine war, Russia sanctions, commodity prices, inflation, energy crisis, gas, coal, renewable energy, electricity, monetary and fiscal policy, EU funds, purchasing power, remittances, external debt, interest rates, banking sector, financial liabilities, credit, impact on Austria, macroeconomic forecasting

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