Executive summary

For the second year in a row, wiiw is publishing its Spring Forecast Report at a time of almost unprecedented global economic uncertainty. Governments around the world are racing to roll out vaccines to get ahead of new, more aggressive mutations of COVID-19. At the time of writing, there is significant divergence in terms of both public health and economic performance. China, the US and some other Western countries are performing well on public health, and are therefore seeing strong economic recovery. However, much of the developing world – including large parts of CESEE – are being buffeted by new mutations, with grave repercussions for economic activity. The euro area, and indeed most of Western Europe, is also currently coming under severe pressure.

In terms of timing and severity, our best guess is that – at least for the major global economies and the developed world generally – the worst is now over, even if a full return to normality will not occur this year. Acquired immunity and vaccines will bring the number of deaths down to a level that societies can tolerate. A ramping-up of vaccination efforts, plus better weather in the northern hemisphere, will allow a substantial easing of restrictions by late spring. In the developed world, a majority of the adult population may well have been vaccinated by the end of the summer. The euro area – CESEE's most important market and the source of foreign demand, tourists, remittances and investment – will recover, but will not boom. It will underperform the US significantly this year. Interest rates in the euro area will remain low, but those countries reliant on dollar funding will face higher borrowing costs. This policy divergence will weaken the euro against the dollar, increasing imported inflation in the euro area and those economies of CESEE that are linked to the single currency.

In economic terms, CESEE performed much better than Western Europe in 2020. On a weighted average basis, CESEE economies contracted by 2.3% last year. This was a milder downturn than the global economy (-3.4%, according to the OECD), and substantially better than the euro area (-6.8%). A large part of this strong performance was due to public health factors, with CESEE countries generally managing the first wave of the pandemic better than Western Europe.

One of the key drivers of differences between CESEE countries has been fiscal policy, reflecting both varying amounts of policy space and also different levels of willingness and capacity to use that space. Every country in CESEE in 2020 ran a fiscal deficit way above its average since 2004 – and for most countries, also considerably greater than in 2009, immediately following the global financial crisis. This reflected a response to the scale and type of emergency, but also a move away from the austerity that characterised the response to the last crisis. The size of the state may have permanently increased in CESEE as a result.

For CESEE as a whole, monetary policy has been less important as a strong crisis-fighting mechanism, given that many countries went into 2020 with low or negative real policy rates. Only in the CIS, Ukraine and Turkey (where the move has now largely been reversed) has there been substantial policy loosening. However, this does not mean that central banks in EU-CEE and the Western Balkans have not responded: rather, they have followed Western central banks in resorting to other monetary tools to stimulate the economy, such as quantitative easing.

Headline labour market data suggest a surprisingly limited impact from the pandemic so far, but the figures almost certainly do not tell the whole story. Many people who lost their jobs because of the pandemic have become inactive, rather than officially unemployed. Meanwhile, those in receipt of government support will rarely be getting their normal salaries, while those in the grey economy have certainly been badly affected. Cross-border seasonal workers from countries such as Ukraine have also been hit by the crisis. In many countries, the burden of the crisis seems to have fallen disproportionately on older workers. It may be the case that younger workers will not suffer as much as after 2008, given their better IT skills and the boost to the digital economy generated by the pandemic.

CESEE countries went into the current crisis with smaller external imbalances and longer maturities on foreign debt than in 2008. External liquidity has also remained plentiful, allowing foreign debt to be refinanced at historically low interest rates. The main exception to this fairly benign picture is Turkey, due to its combination of a large current account deficit, high inflation, lack of policy credibility and low foreign exchange reserves. Two parts of the external accounts that have taken a much more visible hit are tourism and foreign direct investment (FDI). Tourism was engulfed by a perfect storm in 2020, which combined heavy restrictions during most months of the year with heightened uncertainty and fear among many prospective tourists about travelling long distances. Meanwhile, announced greenfield FDI projects fell precipitously across CESEE last year, reflecting a sharp decline in investor sentiment owing to the pandemic.

Currently, CESEE is in the grip of a savage wave of the virus, which has pushed health systems to breaking point and necessitated a series of economically damaging new lockdowns. The region's strong public health performance during the pandemic's first wave has not been repeated in the second, with public health effectively sacrificed in an effort to keep the economy going. As of mid-March 2021, CESEE countries occupied most of the top places in the *Economist*'s global excess deaths tracker. It could take years for parts of the region to get back to truly 'normal' life, and during that time the economic, social and public health costs are likely to be considerable. Escaping the latest tight set of lockdowns will require an increase in the pace of vaccination, but this is proceeding at very different speeds across CESEE. While some countries can hope to reach herd immunity this year, others would appear to have no chance.

Our core scenario is that the region's economies will emerge gradually from the current wave during the spring. Those countries currently suffering badly will turn the tide via harsh lockdowns, and will gradually reopen as vaccination rates improve. A combination of vaccines and some limited restrictions will keep the health impact at a level that allows for solid economic growth during the rest of the year.

In 2021, CESEE overall is unlikely to continue to outperform the euro area. This reflects a combination of a higher base period (due to CESEE's relatively good performance last year) and the currently high rate of infections in the region, which has necessitated economically damaging lockdowns for many.

Across CESEE in 2021 and beyond, growth will be driven by a combination of exports of goods and services as the global economy recovers, the drawing-down of savings, better domestic sentiment as vaccination rates improve, and more (albeit less than last year) fiscal and monetary support. Private consumption will return as the main driver of growth almost everywhere in 2021 and across the forecast period; but in EU-CEE investment will also make a big contribution on the back of rising inflows of EU funds. Once the latest lockdowns are eased and sentiment picks up, consumer spending could rise sharply. In those countries for which comparable data are available, household savings rates have increased substantially, and it would seem reasonable to expect at least a partial drawdown of these savings in H2.

Although the outlook for the summer tourist season is highly uncertain, our best guess is that it will be better than last year. Even though arrivals from abroad are likely to be well below pre-pandemic levels, the improvement on 2020 will generate considerable growth. By the time the core summer tourism months arrive, vaccination rates will be considerably higher than is currently the case; and like last year, the number of COVID-19 cases should decline with the warmer weather. There are still hopes that policy makers will do even more to help drive tourism flows around Europe over the summer.

The extent to which central banks are able to continue to engage in monetary stimulus will depend on inflation; there are signs that this will rise somewhat this year, but will remain low by historical standards. The recent sharp increase in global commodity prices is a particular issue for CESEE, given that in the region a larger share of the consumer price basket is weighted towards those items than is the case in Western Europe. However, demand-pull pressure on prices is currently extremely weak, and will not re-emerge strongly during the forecast period in our baseline scenario. Without more aggregate demand, firms will struggle to pass on higher input costs to consumers.

Rising US long-term interest rates will push up borrowing costs for those countries weighted towards dollar funding, which could cause external financing difficulties over the forecast period. However, most CESEE economies are in a better position to deal with any repeat of 2013's 'taper tantrum', when a more hawkish-sounding Fed caused a huge outflow of funds from emerging markets. Some countries, including Belarus, Ukraine, Albania and notably Turkey, would likely go into any new tightening of external financing conditions with substantially smaller current account deficits than in 2013. However, Montenegro, Moldova and Romania, in particular, have headline external balances that leave them more exposed to changing foreign investor sentiment than was the case in 2013.

Monetary and fiscal stimuli, supported by robust cross-border banking claims, provided sufficient liquidity in the CESEE region in 2020. However, in most countries this has not translated into strong credit growth. Much of the liquidity has been going into housing market, as signalled by a sharp rise in residential property prices. Risks of a correction in CESEE housing markets are mounting.

Once the acute phase of the crisis passes, attention will quickly turn to the other challenges and opportunities faced by the region – both those that already existed, and some that are new and result from the pandemic. Most of CESEE remains in the grip of the most serious negative demographic decline – excluding wars and famines – ever recorded. The dual shocks of automation and digitalisation, both of which are likely to be accelerated by the pandemic, create challenges, but also significant opportunities for a region that was struggling with a shortage of workers before the pandemic. There are reasons to think that over the medium term CESEE may gain from some 'near-shoring', as Western European firms move outsourced production closer to home. The independence of institutions was under strain long before the pandemic hit, but the unique challenges it has created have thrown up opportunities for unscrupulous leaders to further cement their influence in many parts of the region. Geopolitically, the region is facing a new era without the steadying hand of Angela Merkel in Germany, while the two most important divisions – the US versus China at the global level, and the EU versus Russia more locally – leave many CESEE countries caught in between, with negative implications for political stability and economic development.

COUNTRY SUMMARIES

ALBANIA

Recovery will be slower than expected, as the pandemic is still weighing on economic activity. Domestic demand will support growth, but still at below pre-pandemic levels. External demand has improved somewhat, but will remain weak, as demand in the services and tourism sectors depends heavily on immunisation not only at home, but also in the EU countries. We expect the economy to grow by 4.5% over the medium term.

BELARUS

Although Belarus experienced only a mild recession in 2020, the country is going through a period of political and economic turmoil. The disputed presidential election triggered mass protests and isolation from the international financial markets. Russia remains the only source of external funding; however, new lending may be conditional on tough political concessions. Given the growing financial constraints and the deep-seated structural problems, the economic outlook is rather bleak.

BOSNIA AND HERZEGOVINA

The COVID-19 pandemic caused the worst recession in Bosnia and Herzegovina since the Bosnian war, with an estimated GDP decline in 2020 of 5%. With the third wave of the pandemic, vaccine delays and the introduction of new restrictions, economic recovery will be delayed. Additional obstacles to growth include an inefficient fiscal structure and political disputes, which are preventing structural reform of the country and delaying its progress towards EU and NATO integration.

BULGARIA

After a year of protests and social turmoil, Bulgaria is entering a new electoral cycle with uncertain outcomes. The negative macroeconomic impact of the pandemic in 2020 was moderate. The shocks were partly mitigated by the policy support measures launched by the authorities. The post-COVID recovery is also expected to be moderate, with GDP growth of 2.5% in 2021 and slightly higher in the following two years.

CROATIA

After 2015, Croatia witnessed an economic recovery; however, the COVID-19 pandemic stopped it in its tracks. GDP contracted by 8.4% in 2020, due largely to the pandemic's devastating impact on the tourism sector, but also because the country was rocked by two earthquakes in March and December. EU aid will likely mitigate the earthquakes' adverse effects on Croatia's economic recovery, which is why we expect solid growth of 4.5% in 2021.

CZECHIA

GDP fell by 5.6% in 2020, a smaller decline than had been expected. Although the intensity of the recession was still evident in the fourth quarter of 2020, manufacturing is recovering. A moderate decline in employment is still under way. Czechia's economic fundamentals remain strong: the level of public debt is low, foreign-exchange reserves are very high and the trade balance is in surplus. Positive growth will return in 2021, although the rebound will not be particularly strong.

ESTONIA

The rebound in economic activity in the second half of 2020 suggested that the Estonian economy would bounce back once the virus was contained and restrictions were removed. However, an upswing of infections at the beginning of 2021 has turned out much worse than expected and is jeopardising economic recovery. We have downgraded our GDP growth forecast to 1.2% in 2021. The economy is expected to return to its pre-crisis path only in 2022, with a 3.8% growth rate, followed by 4.3% in 2023.

HUNGARY

Hungary's GDP dropped by 5% in 2020, due mostly to declining net exports, but also, to a smaller extent, to shrinking investment and household consumption. The key issues for a recovery are the early revitalisation of international value chains in the automotive industry, resilience of the small and medium-sized enterprise (SME) sector and restoration of the pre-crisis spending propensity of households. The political stakes are high in the wake of the government's growing confrontation with the EU and the approaching elections, scheduled for early 2022.

KAZAKHSTAN

After a relatively moderate real GDP decline of 2.6% in 2020 (thanks to a large anti-crisis fiscal package), economic recovery of 3.2% is expected for 2021. Although the high price of oil could suggest a more robust economic revival, the remaining pandemic-related restrictions on economic activity and the slow vaccination rate will impede a full recovery in consumption this year. Economic growth is likely to accelerate to above 4% in 2022-2023, driven by consumption, exports and investment.

KOSOVO

The economy contracted by 5% in 2020, but growth will return to 4.5% in the medium term, supported by domestic and external demand. However, the downside risks remain high, with the current pandemic still raging and vaccines far off on the horizon. The triumphant return of a Kurti government ('Kurti 2') represents a new opportunity for Kosovo to gain political stability. In March 2021, the European Parliament reaffirmed its call to the EU council to adopt visa liberalisation for Kosovo.

LATVIA

With GDP declining by 3.6% the Latvian economy has experienced a milder recession than expected; however, the subsequent revival of 2021 will be restrained. Last year household consumption slumped by more than 10%, while capital investments remained afloat. For this year we see a continuation of the revival in household consumption, but also external demand. Similarly, gross fixed capital investment will gain momentum, also boosted by public expenditures. In 2021 we expect GDP to increase by 2.8%; this will be followed by strong growth of 4.2% in 2022 and a somewhat slower upswing of 3.8% in 2023.

LITHUANIA

The Lithuanian economy experienced a short-lived recession in the second quarter of 2020, recovering quickly and experiencing just a small GDP decline of 0.8% for the full year 2020. Better-than-expected export performance and swiftly rebounding household consumption were coupled with a slump in imports. In 2021 the ongoing restrictions due to the second and third wave of infections will keep the economic revival subdued. The government continues to deliver substantial fiscal stimulus, and the announced public investments will support recovery over the next two years. For 2021 we expect real GDP to grow by 2.1%, followed by a faster upswing of 3.8% in 2022 and 3.1% in 2023.

MOLDOVA

The 7% drop in GDP in 2020 was mainly the result of contracting household demand and an extremely bad harvest. Official employment and unemployment both declined, as people were forced into irregular work. Economic growth will resume in 2021 (+4%), but slow progress in vaccination will delay a full recovery to the pre-crisis level. Surprisingly low inflation will not be sustainable once the economy starts growing.

MONTENEGRO

Montenegro suffered comfortable CESEE's deepest contraction in economic activity in 2020, with GDP shrinking by 15.2% on the back of a steep decline in tourism revenue and the country's limited fiscal cushion. In 2021, we expect economic recovery to be somewhat inhibited, with the government's COVID-19 restrictions from 2020 radiating well into 2021. We still expect GDP to grow by 6.5%, boosted by tourism and remittances.

NORTH MACEDONIA

After a large initial decline, North Macedonia's economy improved in the second half of 2020, ending the year with a minus of 4.5%. The improvement came as a result of government fiscal support. 2021 will be a year when the damage created by the pandemic will be slowly repaired, with real GDP growing by 4.1%. The pre-crisis level of activity will be reached at the beginning of 2022, and then, when ground zero is reached after two lost years, old structural challenges will come to the fore.

POLAND

The decline in GDP in 2020 turned out to be quite shallow. Trade made a positive contribution to growth, and industry is recovering. Inadequate demand remains the chief problem for the corporate sector, while shortages of labour have ceased to be a serious problem. During the forecast period, expansive monetary and fiscal policies are likely to continue, but the recovery in investment will be muted at best. Improvements in 2021 and beyond are possible, but not guaranteed.

ROMANIA

The Romanian economy weathered the 2020 COVID-19 storm better than many others in the EU. Restrictions were less severe than elsewhere during the winter, and so the full-year contraction of GDP remained below 4%. The recovery in 2021 will not be fast (+3.8%), owing to protracted lockdowns and austerity measures in the government budget. Huge inflows of EU funds could boost investment in the coming years.

RUSSIA

Few restrictions in response to the second wave of the pandemic have resulted in a sharp rise in infections and deaths, but have also mitigated the extent of economic downturn. GDP declined by only 3.1% last year, of which 1 pp was due to oil production cuts. In the baseline scenario, we project a recovery of 3.2% this year, while growth should gradually revert to the long-term average of around 2% in the years thereafter.

SERBIA

Serbia finished 2020 as one of the best-performing European economies, and started 2021 in a similar manner. Real GDP fell by just 1% in 2020, fuelled by strong public spending. Thanks to an excellent vaccine roll-out and growth in high-frequency indicators, we project 5% growth for 2021. The main risks lie with the ongoing pandemic wave, which might stall the economy for a while, and the announced fiscal consolidation, which could hamper growth if undertaken too soon.

SLOVAKIA

Slovakia's GDP dropped by 5.2% in 2020. This year the economy is expected to recover by 3.6%; in the following years the inflow of EU funds should foster gross fixed capital formation. However, the pandemic plus internal and external uncertainties pose several downside risks.

SLOVENIA

The economy remained robust during the strong second wave of the pandemic, which got under way in October. Exports, manufacturing and construction covered the losses in services and retail incurred by a prolonged lockdown. Government support measures continue to shield domestic firms and the labour market from shocks. In 2021 the ongoing pandemic will dampen the recovery and restrict the projected growth rate to 3.6%, underpinned by a strong current-account surplus and European recovery funds.

TURKEY

Uniquely in CESEE, the Turkish economy posted positive full-year economic growth in 2020, reflecting credit expansion in response to the pandemic. A period of higher nominal interest rates stabilised the lira, but is likely now at an end thanks to yet another change at the top of the central bank. Growth will be strong this year but slow by 2022, either due to high real interest rates to get inflation under control, or a lira collapse and balance of payments crisis.

UKRAINE

Ukraine's GDP contracted in 2020 by only 4%, largely because of favourable conditions in key export markets and resilient household incomes. In 2021 the economy will return to growth, supported by a rebound in private consumption and a revival in investment. Negative risks to the forecast have been growing, due to the suspension of the IMF loan programme and a slow vaccine roll-out.

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