Executive summary

After the COVID-related decline in 2020, last year saw the CESEE economies rebound sharply. The economy of the region expanded by 6.3%, 1 percentage point (pp) faster than in the euro area, and exceeded the pre-pandemic level of 2019 by 4.1 pp, with 17 of the region's 23 countries registering recovery stronger than the decline seen in 2020. This good showing by the CESEE economies reflected their adaptation to the pandemic and the reluctance of their governments to impose wide-ranging COVID restrictions. In contrast to Western Europe, the policy priority was typically on the economy, rather than public health, especially on the southern and eastern peripheries of the region. However, COVID-related scars are still visible in some CESEE countries and sectors, such as the automotive industry and tourism.

Thanks to the strong recovery, employment in CESEE has attained its pre-pandemic levels, with labour shortages resurfacing in many countries. In general, this attests to the success of government policies adopted during the COVID-19 crisis to stabilise demand and protect jobs. As the labour markets recovered, short-time work schemes and other support measures could be scaled back. At the same time, overall employment growth was accompanied by substantial labour reallocation across sectors, mirroring pandemic-induced changes in the structure of household demand (away from travel and leisure and towards real estate and consumer durables).

These largely positive developments will be knocked back by Russia's war in Ukraine and Western sanctions. The CESEE region is very exposed to the conflict zone: many countries directly border on it, have seen a large influx of Ukrainian refugees and are heavily dependent on it for imports of food and energy (the latter often coming from Russia); some also have extensive trade and investment links with the countries at war. As a result, economic sentiment in CESEE weakened considerably in March, with the Western Balkans being worst affected. Many regional currencies also experienced strong downward pressure in the early weeks of the conflict. However, after the initial 'overshooting', most of them have nearly recovered to pre-war levels, in some cases – such as Russia and Belarus – largely thanks to capital controls.

For the CESEE region, one channel of contagion from the war and the sanctions will be rising commodity prices, which will fuel inflation and depress economic growth. Both Russia and Ukraine are globally important food suppliers, and many CESEE countries are crucially dependent on imports of Russian energy. As a result, in the baseline scenario average inflation in the region is now forecast to accelerate to 23% this year. To counteract commodity price rises, many countries have resorted to regulating prices, cutting taxes and providing subsidies to vulnerable groups. Monetary policy has often been tightened, too. However, with policy rate hikes not keeping pace with the acceleration in inflation, real interest rates have even declined in many countries.

Another channel of contagion is the disruption to trade, which will cost most CESEE economies some 0.5 pp of GDP growth this year. For most of the region – with the exception of the CIS countries and, to a lesser degree, the Baltic states – Russia is not a very significant trading partner, while Ukraine's importance is even lower. However, certain sectors that have extensive cross-border production linkages will be affected much more. For instance, the automotive industry is already suffering on account of a shortage of car components (many of which come from Ukraine) and the large-scale, voluntary withdrawal from Russia of Western car manufacturers.

The massive influx of Ukrainian refugees should not put the regional labour markets under too much pressure, but it will strain public finances. Most of the refugees – women and children – will not immediately enter the labour force of the host countries. Besides, the demand for labour is high in many CESEE countries, and arriving Ukrainians could partly alleviate labour shortages. The chances for their long-term integration within the host countries are generally good – even if past experience strongly suggests that many of them are likely to be overqualified for the jobs available. However, given that an estimated EUR 40bn of EU-wide social spending will be required to accommodate the refugees in the initial stages, the fiscal burden on the most exposed countries – many of them in CESEE – will be substantial.

Largely on account of the war and the sanctions, growth in CESEE (leaving aside the CIS and Ukraine) will decelerate markedly. In the baseline scenario, growth should average around 3% this year – some 1 pp less than was forecast in January. The slowdown will be most pronounced in Turkey, where last year's credit boom has already run into balance-of-payments constraints and is unlikely to continue. For 2023-2024, downward forecast revisions prevail as well, suggesting that the legacy of the current crisis is likely to persist in the medium term. At the same time, energy and food subsidies and increased spending on refugees will support growth this year and possibly next.

Ukraine and the CIS countries (apart from Kazakhstan) will not be able to sidestep recession this year. In the baseline scenario, recession in Russia will reach 9% in 2022 and will persist into next year as well, while the country's long-term growth potential will be undermined by Western sanctions and the large-scale exodus of foreign firms. Ukraine is poised for imminent economic collapse, with its economy projected to shrink by 38% this year in the baseline scenario (which assumes a ceasefire from the middle of the year and the start of reconstruction). A large-scale Western assistance package akin to the Marshall Plan would provide a welcome boost to its economy, but the full effect is unlikely to be felt before 2024.

The forecast risks are clearly tilted to the downside. In the more adverse scenario – assuming a further major escalation of the war and an immediate EU embargo on Russian oil and gas – many CESEE countries will slide into recession this year, while inflation will soar into double figures nearly everywhere, on account of sharply rising energy costs. In this scenario, the Russian economy may contract by 15% or more this year, but those economies that are heavily dependent on Russian gas – e.g. Hungary, Slovakia and Turkey – will also be badly affected. In 2023-2024, the energy shock will subside, but growth will remain lower than in the baseline scenario.

Austria's overall exposure to the countries at war is limited, but an EU embargo on Russian gas would push its economy into recession. Russia accounts for only 1% of Austrian exports and 2% of its outward direct investments (although that share is higher in the banking sector), while Ukraine's importance is even lower. However, of all the EU countries, Austria is the third most dependent on Russian gas, which makes that a crucial area of vulnerability in the event of an embargo on gas imports. On a more positive note, the war in Ukraine will likely result in improved EU accession prospects for the countries of the Western Balkans – a traditionally important region for Austrian investment.

COUNTRY SUMMARIES

ALBANIA

Albania has a low volume of trade with Russia and Ukraine, but it will experience negative spill-overs from the war in Ukraine, on account of its strong trade relations with the EU. Monetary policy has shifted towards higher interest rates, and the government's fiscal stimulus measures will go some way to support consumption. Exports of minerals and fuel have gained momentum; however the country's current account balance will deteriorate. According to the baseline scenario, inflation this year will be 6% and growth 3.5%. In the medium term, inflation will fall to 3% and growth will rise to 3.9%.

BELARUS

Lukashenko's support for Russia's invasion of Ukraine triggered fresh economic sanctions by major Western countries. Subsequently there has been a rapid deterioration in the economic situation and havoc on the financial markets. Being cut off from the West, Belarus sought aid from, and further economic integration with, Russia. However, the latter has limited resources to support its ally. Recession seems inevitable in 2022, and economic weakness will prevail in the following years as well.

BOSNIA AND HERZEGOVINA

The economy grew more strongly than expected in 2021, due to a significant rise in industrial production, private consumption and exports. However, growth in 2022 is expected to be much weaker, given the threats of high inflation brought about by the war in Ukraine and the rise in local political tensions. The entity governments have failed to reach agreement on decisions that are important to the country's progress, and this is undermining its prospects for European integration, while also rendering it less attractive to both foreign investors and its own citizens, who are leaving the country in droves.

BULGARIA

Bulgaria is facing numerous challenges, on account of its chronic economic problems and the shocks resulting from the war in Ukraine. The diversity of the new government is in itself a source of weakness and is constraining its policy course. The recovery that was under way before the Russian invasion of Ukraine has come to a halt. The delays over approval of the National Recovery and Resilience Plan will mean a reduction in the transfer of EU funds in 2022. GDP is expected to grow by some 2% in 2022, and a moderate upturn is expected in 2023.

CROATIA

The Croatian economy has made a full recovery from the COVID-19 pandemic, with GDP increasing by 10.4% year on year in 2021. However, Russia's invasion of Ukraine has generated much uncertainty regarding Croatia's growth prospects for 2022. The surging energy costs, which are serving to boost inflation, will put pressure on government spending plans and will slow private consumption in 2022. The spill-over effects of the war will also adversely affect Croatia's summer tourist season, which is why we have adjusted the forecast for this year's GDP growth downward to 3.5%.

CZECHIA

The Czech economy grew in line with expectations in 2021, driven by household consumption as pandemic concerns faded into the background and savings started to be spent. Despite persistent supply-side troubles and sharply rising prices in the first two months of 2022, the pre-war outlook for growth over the forecast period was relatively favourable. The supply-chain pressures limiting exports showed signs of easing, and – boosted by the inflow of EU funds – investment activity was expected to accelerate. The war in Ukraine now limits these prospects. Great uncertainty, disruption and surging prices will dampen most channels of growth this year. We expect real GDP to grow modestly, by 2.6% in 2022, gradually picking up in 2023 and 2024.

ESTONIA

Economic performance in 2021 exceeded all expectations, with 8.3% GDP growth. This was steered by strong consumption, massive production expansion and a strengthening position on the global market. Yet the war has been a turning point. Because the Estonian economy started the year in excellent shape, economic recession will likely be avoided. However, real economic growth will fall to 1.8% in 2022, due mainly to rapid price rises, supply-side issues, disruptions to exports and a lack of major one-off investment – all magnified by the immense geopolitical uncertainty.

HUNGARY

Since mid-2021, the Hungarian economy has undergone a period of overheating that was intimately bound up with the extended campaign leading up to the parliamentary elections on 3 April. The excessive deployment of ‘election goodies’ by the government has resulted in large current account and fiscal deficits, rising inflation and a weak forint. Now that the election has been won, Prime Minister Orbán will have to deal with the unpopular task of economic consolidation. A relatively soft landing would require the country to gain access to the EU transfers from the Recovery and Resilience Facility, but the ongoing conflict with the EU over the ‘rule of law’ (primarily corruption related) renders this doubtful. Economic growth is expected to slow this year, to the range of 2-3%.

KAZAKHSTAN

Recession in Russia will drag down Kazakhstan’s economic performance in 2022. Inflation will accelerate on the back of high global food and energy prices, as well as high imported inflation from Russia. At the same time, elevated global commodity prices will have a beneficial impact on exports and tax revenues, and we expect net exports to make a positive contribution to economic growth. We have revised our real GDP growth forecast in the baseline scenario down to 1.5% for 2022 and 3.2% for 2023.

KOSOVO

Kosovo’s economic growth is likely to lose steam, owing to its high exposure to external shocks and certain domestic bottlenecks surrounding energy supplies. Consumption will spur growth, but at a slower pace. The restructuring of international trade will have negative spill-over effects, but there is also likely to be a silver lining in the shape of a surge in lignite exports. According to the baseline scenario – and on the assumption that the war in Ukraine will be over this year – inflation will climb to 7% and the growth rate will be 3.3%. In the medium term, inflationary pressure will slacken and growth will accelerate to 3.9%.

LATVIA

The Russian war in Ukraine will substantially drag down growth in the small, open economy of Latvia. Almost all sectors will be affected by a fall-off in demand and escalating prices. The influx of Ukrainian refugees (accounting for 0.5% of the Latvian population) may even induce additional consumption in the short run. In these uncertain times, enterprises will largely refrain from investment, preferring to deplete their stocks and wait for the price rises to stabilise. In 2022, we expect GDP growth to fall to 1.4%, but then to recover somewhat, to 2.2% in 2023. Our main scenario assumes no substantial intensification of economic sanctions. Later, we would expect a stabilisation of GDP growth in Latvia at 2.3% in 2024.

LITHUANIA

Following a strong recovery last year, economic growth in Lithuania has been dealt a blow by Russia's invasion of Ukraine. Big rises in the price of energy and other imported inputs for industrial production are hitting economies worldwide. In addition, the trade linkages with Russia, Belarus and Ukraine are obviously more intensive in the Baltics than in other parts of the EU. A decline in household and business sentiment alike means that consumption and investment activity will lose momentum in 2022. The government is trying to counter the loss of households' purchasing power with an anti-inflationary package, and it should manage to keep economic activity afloat with its planned public investments. In our main scenario, we expect real GDP to grow by 1.7% in 2022, followed by an upswing of 2.8% in 2023 and 2.6% in 2024.

MOLDOVA

After the boom fuelled by a bumper harvest in 2021, Moldova is facing negative growth in 2022. Soaring inflation – and especially the energy price shock – is hitting both consumption and production. The disruption to trade links with Russia and Ukraine is affecting production and causing a temporary shortage of basic goods. The country is providing refuge for many people who have fled Ukraine, which adds to demand. Generous Western aid and political support are crucial for the necessary economic adjustments.

MONTENEGRO

After the fall of the government at the beginning of the year, there is still no clear political solution in sight. Despite a growth rate of 12.4% in 2021, the pre-pandemic GDP level has not yet been reached, leaving further room for growth in 2022. There will be a decline in foreign direct investment, as a result of the sanctions against Russia. Despite rising inflation, household consumption will support growth in 2022, since the 'Europe Now' reform programme has led to an unprecedented increase in net earnings. The economy is expected to grow at a rate of 3.5% in 2022, 1 percentage point lower than initially expected.

NORTH MACEDONIA

The country has not yet recovered from the pandemic shock, and now the energy crisis and the war in Ukraine are rubbing salt into its wounds. The economic prospects appear gloomy, with weak growth and elevated inflation. We are revising our GDP projection for 2022 downwards, to 2.5% (from 3.5%); meanwhile, we expect inflation to be higher, at around 8% (from 3.5%).

POLAND

The Polish economy has proved surprisingly resilient so far. Industry has performed strongly in the first months of 2022, despite the unfavourable conditions. But growth will slow in 2022 and beyond. Rising interest rates are affecting consumption and investment, and inflation is eroding the real value of current incomes. In addition, the export prospects look less promising than before the war. To cap it all, essential imports (e.g. energy, metals) may be in short supply, or else become prohibitively expensive.

ROMANIA

Romania's energy and trade dependence on Russia and Ukraine is relatively modest, but still the energy price shocks and supply-chain disruptions have set back its economic performance. GDP will grow by no more than 2% in 2022, despite the generous inflows of EU funds. Inflation will rise to 9% on average, which will depress household demand. Currency devaluation will be modest, due to the central bank's interventions on the currency market.

RUSSIA

Tough Western sanctions in response to the Russian invasion of Ukraine will push the economy into deep recession this year and possibly next. Thanks to wide-ranging capital controls and monetary policy tightening, financial stability has been restored, and the rouble has recovered to nearly pre-war levels. However, the full effect of trade sanctions has yet to unfold and, along with the withdrawal of many foreign firms, this will hamper long-term growth prospects.

SERBIA

The war in Ukraine will be costly for Serbia, due to its close relations with Russia. In the short term, the country will face slower economic growth and higher prices: we are revising our GDP forecast for 2022 downwards to 3.6% (from 4.9%) and our inflation forecast upwards to 10% (from 4.5%). But the real challenges facing Serbia stem from its policy of attempting a balancing act between the EU and Russia, which will be hard to maintain in the coming years.

SLOVAKIA

By the end of 2021, Slovakia's GDP had still not fully recovered from the COVID-19 pandemic, showing annual growth of only 3%. Growth forecasts have been revised substantially downwards, reflecting the negative impact of the Russian war in Ukraine. Still, the inflow of EU funds should provide some growth impetus at a time of rising risk.

SLOVENIA

For 2022, we project real GDP to grow by 4.1% – unchanged from our previous forecast. Growth will be affected positively by strong private spending and investment, and negatively by the war in Ukraine, which will impact the economy through higher inflation and lower demand for exports. Inflation will reach 4.8%, and will spill over from energy into food and services. Due to the geopolitical situation, public finance is becoming a matter of some concern, following a period of high spending. The parliamentary elections in April will likely result in a new coalition.

TURKEY

Even before Russia invaded Ukraine, Turkey was in big trouble, with inflation at eye-watering levels, a currency that had halved in value in just a few months, a rapidly expanding current account deficit and rising pressure on external financing due to aggressive Fed tightening. Now the situation is even more difficult, owing to Turkey's strong economic ties with Russia and its heavy reliance on commodity imports. The best-case scenario is a sharp slowdown in growth; meanwhile, the risk of a renewed period of macroeconomic and financial instability has increased.

UKRAINE

The war has caused Ukraine significant economic and humanitarian losses. Economic activity has practically ceased in those regions where military operations are under way, and more than a quarter of the population has been displaced. We expect a gradual recovery of Ukraine's economy in 2023, but there is practically no chance of the recovery being even remotely V-shaped. GDP growth will accelerate in 2024, provided financial support is forthcoming from the West in the shape of a Marshall Plan-type reconstruction fund.

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

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