2. CESEE economic outlook: Braced for fallout from global slowdown

by Vasily Astrov[6]

2.1. STILL A VERY GOOD YEAR FOR MOST CESEE COUNTRIES …

Global economic growth has slowed significantly since 2017, but the countries of Central, East and Southeast Europe (CESEE) are withstanding the deterioration in the external environment fairly well. This applies in particular to the Central and East European EU Member States (EU-CEE). On average, the EU-CEE region has grown by 3.8% this year – nearly 3 percentage points (pp) faster than the euro area, with which it has extensive trade and investment links (Overview Table 2.1). Growth performance in the Western Balkans (WB) and parts of the Commonwealth of Independent States (CIS) and Ukraine remains generally solid as well. Many CESEE countries are now growing faster than the world economy (3% according to the International Monetary Fund[7]), and are thus advancing in relative terms in the global economic context. In six of them – Moldova, Poland, Hungary, Romania, Kosovo and Kazakhstan – real GDP growth should be at least 4% this year.

The main reason for this is strong domestic demand... This applies in particular to private consumption, which continues to benefit from tight labour markets and high wage growth, as well as generous social policies in a number of cases. Investment activity remains by and large robust as well, driven to a large extent by public infrastructure projects, mostly financed by the EU and China. Domestic demand is also supported by credit expansion: in the CIS and Ukraine, it benefits above all household consumption; in the more advanced EU-CEE countries – housing investments. However, the pace of credit growth is generally muted. Only in the CIS countries and Ukraine (and arguably in some Western Balkan countries) is it potentially a cause for concern in the medium term.

… with macroeconomic imbalances being generally held in check. Many CESEE countries have current account surpluses (or only insignificant deficits), with the dynamics improving in many cases (Overview Table 2.1). A weak external position is a problem mostly confined to the Western Balkan countries, Romania and Moldova. However, external deficits are often being financed by foreign direct investment (FDI), which is good news from the sustainability point of view. Despite lax monetary policy, inflationary pressures remain generally contained as well, and have subsided recently – not least thanks to lower energy prices. In the high-inflation countries of Turkey and Ukraine, inflation has recently been falling as well, enabling a relaxation of monetary policy in both countries (Overview Table 2.1).

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6 The author would like to thank Richard Grieveson, Leon Podkaminer and Hermine Vidovic, all wiiw, for the valuable comments and suggestions on the first draft.

7 IMF (2019).

Table 2.1 / OVERVIEW 2017-2018 AND OUTLOOK 2019-2021

		GDP real change in % against prev. year					Consumer prices average change in % against prev. year				
				Forecast					Forecast		
		2017	2018	2019	2020	2021	2017	2018	2019	2020	2021
BG	Bulgaria	3.8	3.1	3.5	2.7	2.4	1.2	2.6	3.0	2.5	2.0
CZ	Czech Republic	4.4	3.0	2.5	2.4	2.6	2.4	2.0	2.5	2.1	2.1
EE	Estonia	5.7	4.8	3.3	2.6	2.4	3.7	3.4	2.6	2.3	2.1
HR	Croatia	2.9	2.6	2.9	2.7	2.7	1.3	1.6	1.0	1.5	1.5
HU	Hungary	4.3	5.1	4.3	3.1	2.6	2.4	2.9	3.5	3.2	3.0
LT	Lithuania	4.2	3.6	3.6	2.4	2.6	3.7	2.5	2.2	1.9	2.0
LV	Latvia	3.8	4.6	2.8	2.2	2.4	2.9	2.6	3.0	2.3	2.4
PL	Poland	4.9	5.1	4.4	3.5	3.3	1.6	1.2	2.0	2.7	2.5
RO	Romania	7.1	4.0	4.2	3.3	3.0	1.1	4.1	4.0	3.5	3.5
SI	Slovenia	4.8	4.1	2.9	2.8	2.8	1.6	1.9	1.8	1.8	2.0
SK	Slovakia	3.0	4.0	2.3	2.2	2.6	1.4	2.5	2.7	2.1	2.0
	EU-CEE11 1)2)	*4.9*	*4.3*	*3.8*	*3.1*	*2.9*	*1.8*	*2.2*	*2.6*	*2.7*	*2.5*
	EA19 3)	*2.5*	*1.9*	*1.1*	*1.2*	*1.4*	*1.5*	*1.8*	*1.2*	*1.3*	*1.5*
	EU28 3)	*2.6*	*2.0*	*1.4*	*1.4*	*1.6*	*1.7*	*1.9*	*1.8*	*1.9*	*1.9*
AL	Albania	3.8	4.1	2.8	3.8	3.4	2.0	2.0	1.7	2.1	2.4
BA	Bosnia and Herzegovina	3.2	3.6	2.6	2.7	2.7	0.8	1.4	1.2	1.6	1.4
ME	Montenegro	4.7	5.1	3.1	3.0	2.1	2.4	2.6	1.5	1.8	1.9
MK	North Macedonia	0.2	2.7	3.3	3.4	3.4	1.4	1.5	1.4	2.4	2.5
RS	Serbia	2.0	4.4	2.9	2.7	2.6	3.0	2.0	1.8	2.2	2.6
XK	Kosovo	4.2	3.8	4.2	4.0	4.3	1.5	1.1	2.7	2.5	2.5
	WB6 1)2)	*2.6*	*4.0*	*3.0*	*3.1*	*2.9*	*2.1*	*1.8*	*1.7*	*2.1*	*2.3*
TR	Turkey	7.5	2.8	-0.7	3.1	3.3	11.1	16.3	16.5	13.0	11.2
BY	Belarus	2.5	3.0	1.3	1.5	1.7	6.0	4.9	6.0	5.5	5.0
KZ	Kazakhstan	4.1	4.1	4.0	3.5	3.5	7.4	6.0	5.3	5.0	5.0
MD	Moldova	4.7	4.0	4.7	3.8	4.0	6.5	2.9	4.5	4.5	4.5
RU	Russia	1.6	2.3	1.1	1.7	1.9	3.6	2.9	4.5	2.9	2.9
UA	Ukraine	2.5	3.3	3.3	3.1	3.3	14.4	10.9	8.0	6.0	5.0
	CIS4+UA 1)2)	*2.0*	*2.6*	*1.6*	*2.0*	*2.2*	*4.9*	*3.9*	*4.9*	*3.4*	*3.4*
	V4 1)2)	*4.6*	*4.6*	*3.8*	*3.1*	*3.0*	*1.9*	*1.7*	*2.4*	*2.6*	*2.4*
	BALT3 1)2)	*4.5*	*4.2*	*3.3*	*2.4*	*2.5*	*3.5*	*2.7*	*2.5*	*2.1*	*2.1*
	SEE9 1)2)	*5.1*	*3.7*	*3.7*	*3.1*	*2.8*	*1.4*	*3.0*	*3.0*	*2.8*	*2.8*
	CIS3+UA 1)2)	*3.3*	*3.6*	*3.3*	*3.0*	*3.1*	*9.6*	*7.5*	*6.3*	*5.4*	*5.0*
	non-EU12 1)2)	*3.7*	*2.7*	*1.0*	*2.3*	*2.5*	*6.7*	*7.5*	*8.2*	*6.2*	*5.7*
	CESEE23 1)2)	*4.1*	*3.2*	*1.8*	*2.6*	*2.7*	*5.3*	*6.0*	*6.6*	*5.2*	*4.7*

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	4.6	4.5	4.4	3.5	5.4	6.0	4.4	3.2
CZ	Czech Republic	2.9	2.2	2.0	2.0	2.0	1.6	0.3	0.4	0.3	0.2
EE	Estonia	5.8	5.4	5.0	5.2	5.0	2.7	2.0	2.8	2.2	2.1
HR	Croatia	11.2	8.5	6.5	6.0	5.5	3.4	1.9	0.6	0.2	0.1
HU	Hungary	4.2	3.7	3.5	3.5	3.5	2.3	-0.5	-0.1	-0.1	-0.1
LT	Lithuania	7.1	6.2	5.8	5.6	5.5	0.5	0.3	0.8	0.2	0.0
LV	Latvia	8.7	7.4	6.5	6.3	6.0	1.0	-0.7	-0.2	-0.5	-0.6
PL	Poland	4.9	3.9	3.7	3.4	3.4	0.1	-1.0	-1.0	-1.2	-0.9
RO	Romania	4.9	4.2	3.8	3.7	3.7	-3.2	-4.6	-5.2	-5.0	-4.9
SI	Slovenia	6.6	5.1	4.5	4.0	4.0	6.1	5.7	4.8	4.6	4.4
SK	Slovakia	8.1	6.5	5.8	5.8	5.6	-1.9	-2.6	-3.0	-2.8	-2.5
	EU-CEE11 1)2)	*5.3*	*4.3*	*3.9*	*3.8*	*3.7*	*0.5*	*-0.7*	*-0.8*	*-1.0*	*-0.9*
	EA19 3)	*9.1*	*8.2*	*7.7*	*7.5*	*7.4*	*3.6*	*3.5*	*2.8*	*2.7*	*2.5*
	EU28 3)	*7.6*	*6.8*	*6.2*	*6.0*	*6.0*	*2.4*	*2.1*	*1.5*	*1.4*	*1.3*
AL	Albania	13.7	12.3	11.3	11.0	10.5	-7.5	-6.7	-7.3	-6.6	-6.1
BA	Bosnia and Herzegovina	20.5	18.4	15.8	15.0	14.0	-4.3	-3.7	-4.5	-4.3	-4.0
ME	Montenegro	16.1	15.2	14.3	14.0	13.9	-16.1	-17.0	-17.8	-18.0	-14.3
MK	North Macedonia	22.4	20.7	18.5	17.5	17.5	-1.1	-0.1	-1.4	-2.5	-3.1
RS	Serbia	13.5	12.7	11.5	10.8	10.3	-5.2	-5.2	-6.0	-5.5	-5.4
XK	Kosovo	30.5	29.6	25.0	23.5	21.0	-5.4	-7.6	-7.2	-7.5	-7.9
	WB6 1)2)	*16.9*	*15.7*	*13.8*	*13.2*	*12.6*	*-5.4*	*-5.3*	*-6.1*	*-5.8*	*-5.6*
TR	Turkey	10.9	10.9	13.5	13.4	11.5	-5.5	-3.4	-0.2	-1.6	-2.3
BY	Belarus	5.6	4.8	4.4	4.5	4.5	-1.7	-0.1	-0.4	-1.2	-1.4
KZ	Kazakhstan	4.9	4.9	4.8	4.8	4.8	-3.1	-0.2	-2.4	-2.0	-1.9
MD	Moldova	4.1	3.0	6.0	6.0	6.0	-5.7	-10.6	-9.8	-9.2	-8.2
RU	Russia	5.2	4.8	4.6	4.5	4.4	2.1	6.8	5.1	5.9	6.0
UA	Ukraine	9.5	8.8	8.4	8.1	7.8	-2.2	-3.3	-2.6	-3.0	-3.5
	CIS4+UA 1)2)	*5.9*	*5.4*	*5.2*	*5.1*	*5.0*	*1.2*	*5.3*	*3.6*	*4.2*	*4.3*
	V4 1)2)	*4.7*	*3.8*	*3.6*	*3.4*	*3.4*	*0.5*	*-0.8*	*-0.8*	*-0.8*	*-0.7*
	BALT3 1)2)	*7.3*	*6.4*	*5.9*	*5.7*	*5.5*	*1.2*	*0.4*	*1.1*	*0.5*	*0.4*
	SEE9 1)2)	*9.7*	*8.6*	*7.6*	*7.3*	*7.0*	*-1.9*	*-2.5*	*-3.2*	*-3.3*	*-3.3*
	CIS3+UA 1)2)	*7.5*	*6.9*	*6.7*	*6.6*	*6.4*	*-2.6*	*-1.5*	*-2.4*	*-2.4*	*-2.6*
	non-EU12 1)2)	*7.5*	*7.1*	*7.5*	*7.4*	*6.8*	*-1.0*	*2.6*	*2.3*	*2.4*	*2.3*
	CESEE23 1)2)	*7.0*	*6.4*	*6.6*	*6.5*	*6.1*	*-0.5*	*1.4*	*1.2*	*1.2*	*1.1*

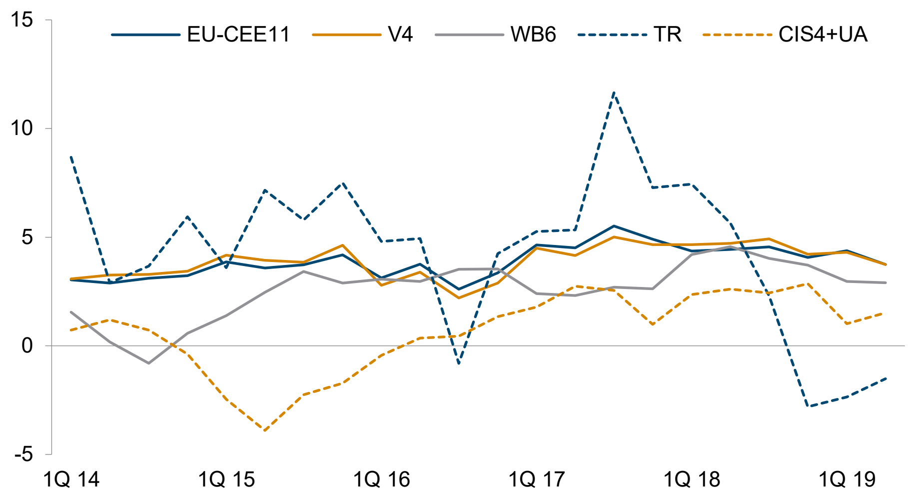
1) wiiw estimates. - 2) Current account data include transactions within the region (sum over individual countries). -
3) Forecasts estimated by wiiw.
Source: wiiw, Eurostat. Forecasts by wiiw (November 2019).

Only Russia, Belarus and Turkey are displaying weak growth performance. In Russia, the policy mix is restrictive and is prioritising stability and resilience to Western sanctions over growth; this is also acting as a drag on the pace of expansion in neighbouring Belarus. Both economies have grown by only about 1% this year, partly also because of the decline in oil prices. Turkey, on the other hand, is recovering from the severe financial crisis that erupted last year. After a slump in the second half of 2018, the Turkish economy has lately been in recovery mode (on a quarterly basis), helped by the high tourist inflows and accommodative global liquidity conditions. However, given the high statistical base (the first half of 2018), the economy will not be able to avoid posting full-year negative growth this year.

2.2. … BUT THE EXTERNAL ENVIRONMENT IS STARTING TO BITE

At the same time, and as predicted earlier by wiiw,[8] the peak of the economic boom has already passed. For the region as a whole, real GDP growth will slow markedly this year, to 1.8% (from 3.2% recorded in 2018). However, this is mostly on account of the sharp deterioration in growth performance in Turkey (Figure 2.1). Outside Turkey, the deceleration has been much milder, and in six countries – Bulgaria, Croatia, Romania, North Macedonia, Kosovo and Moldova – growth has even gained momentum this year.

Figure 2.1 / Real GDP change against preceding year in %



Note: EU-CEE11 = the 11 countries of EU-CEE; V4 = the Visegrád countries of the Czech Republic, Hungary, Poland and Slovakia; WB6 = the six countries of the Western Balkans; CIS4 = the four CESEE countries of the CIS (Russia, Belarus, Kazakhstan and Moldova).
Source: wiiw Monthly Database incorporating national and Eurostat statistics.

In EU-CEE, we estimate that growth will have decelerated on average by 0.5 pp this year on the back of a slowdown in the euro area and the specific problems of the automotive industry, which is crucial for the region. In the Visegrád countries, this has already started weighing on the investment mood, although elsewhere in EU-CEE investments have held up well.

In the Western Balkans and the CIS, growth will have slowed by on average 1 pp this year, mostly on account of developments in Serbia and Russia. In Serbia, this is to a large extent a statistical base

8 wiiw (2019a); wiiw (2019c).

effect, since the record harvest of 2018 will not be repeated this year. Besides, the 100% import tariff imposed on Serbian products by Kosovo last year and the temporary shutdown in the crucial Fiat Chrysler plant have been a drag on the pace of economic expansion in Serbia. In Russia, the deceleration in growth is due to the combined effect of export decline on account of lower oil prices and cyclical investment stagnation.

Compared to the wiiw Summer Forecast,[9] **the forecast revisions for 2019 have been largely balanced.** For 10 CESEE countries, the GDP growth forecast has been revised upwards; for eight countries it has been revised downwards; and for five it remains unchanged (Table 2.2). However, in most cases the revisions have not been very significant (apart from Slovakia, Albania and Belarus, where the downward revisions have been of the order of 1 pp or more). Besides, it has to be borne in mind that in summer 2019, wiiw forecasts were mostly revised upwards compared to spring – for many countries, quite substantially. Thus, the current growth estimates for this year are, in many cases, higher than at the beginning of the year, including in such important regional economies as Poland, Hungary, Romania and Ukraine. This demonstrates the surprising resilience of large parts of the CESEE region to external headwinds.

Table 2.2 / Real GDP forecasts and revisions

		Forecast, %				Revisions, pp		
		2018	2019	2020	2021	2019	2020	2021
EU-CEE11	BG	3.1	3.5	2.7	2.4	0.0	-0.7	-0.7
	CZ	3.0	2.5	2.4	2.6	0.0	0.0	0.1
	EE	4.8	3.3	2.6	2.4	0.1	-0.1	0.0
	HR	2.6	2.9	2.7	2.7	0.0	0.0	0.0
	HU	5.1	4.3	3.1	2.6	0.2	0.0	0.0
	LT	3.6	3.6	2.4	2.6	0.4	-0.3	0.2
	LV	4.6	2.8	2.2	2.4	-0.5	-0.9	-0.3
	PL	5.1	4.4	3.5	3.3	-0.2	-0.2	-0.1
	RO	4.0	4.2	3.3	3.0	0.1	-0.3	-0.3
	SI	4.1	2.9	2.8	2.8	-0.4	-0.3	-0.2
	SK	4.0	2.3	2.2	2.6	-1.3	-0.8	0.1
WB6	AL	4.1	2.8	3.8	3.4	-0.9	0.1	-0.1
	BA	3.6	2.6	2.7	2.7	-0.1	-0.1	-0.1
	ME	5.1	3.1	3.0	2.1	0.0	0.0	0.0
	MK	2.7	3.3	3.4	3.4	0.2	0.0	0.0
	RS	4.4	2.9	2.7	2.6	0.0	0.0	0.0
	XK	3.8	4.2	4.0	4.3	0.1	-0.1	0.3
Turkey	TR	2.8	-0.7	3.1	3.3	0.5	0.3	0.2
CIS4+UA	BY	3.0	1.3	1.5	1.7	-1.0	-0.6	-0.3
	KZ	4.1	4.0	3.5	3.5	0.4	0.3	0.3
	MD	4.0	4.7	3.8	4.0	0.7	0.3	0.6
	RU	2.3	1.1	1.7	1.9	-0.2	0.0	0.0
	UA	3.3	3.3	3.1	3.3	0.6	0.1	-0.2

Note: Current forecast and revisions relative to the wiiw Summer Forecast 2019. Colour scale variation from the minimum (red) to the maximum (green).

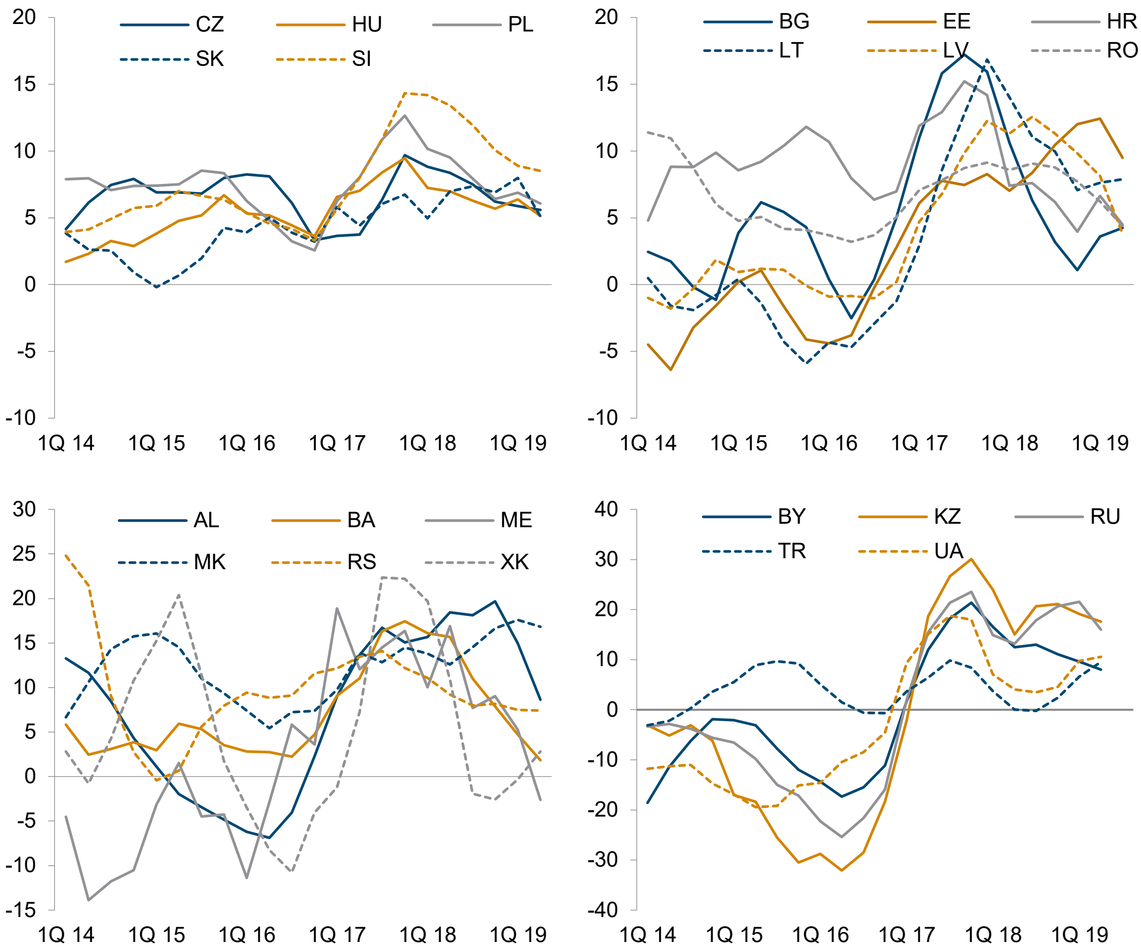
9 wiiw (2019c).

2.3. EXPORTS LOSING MOMENTUM

Stagnation in the German economy has been a drag on the export performance of CESEE countries… As mentioned in the section ‘Global overview’, most CESEE countries are small, open economies. This applies in particular to EU-CEE (and some Western Balkan) countries, which have strong trade links with Germany. The German economy has been struggling of late, shaken by the slump in the demand for cars in China, uncertainties surrounding Brexit, and the difficulties faced by the German car industry in adjusting to new emissions standards. Against this background, a weakening of the export performance of CESEE countries was only a matter of time. In the first quarter of 2019, their exports were still holding up surprisingly well;[10] but in the second quarter, the weakness in Germany started increasingly spilling over (Figures 2.2 and 2.3).

Figure 2.2 / Exports of goods (customs statistics, EUR based), growth in %

4 quarters moving average



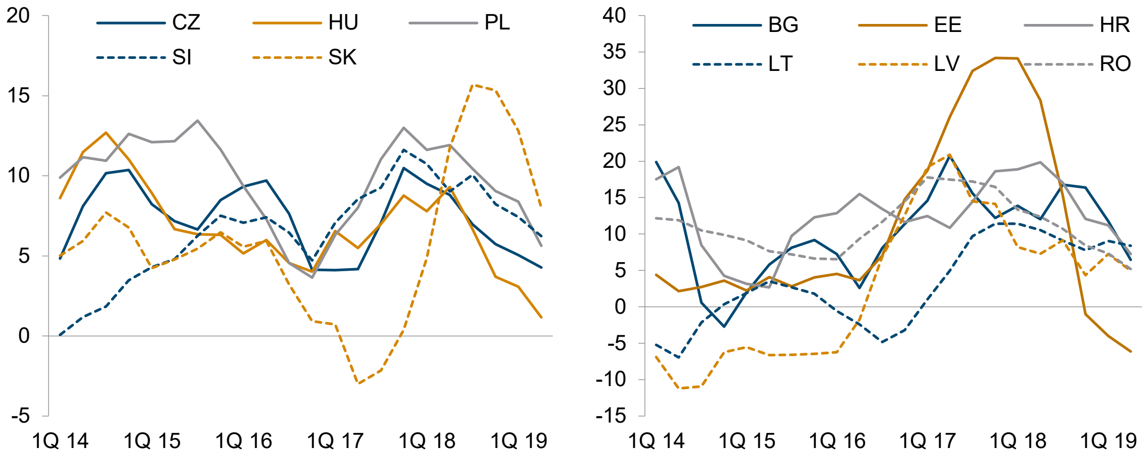
Source: wiiw Monthly Database incorporating national and Eurostat statistics.

10 wiiw (2019c).

… especially those specialising in the automotive industry. Car exports have generally performed badly, and have been a major drag on the overall export performance of countries that specialise heavily in the automotive industry, such as the Visegrád countries (but also e.g. North Macedonia). Only in those countries that have recently expanded their car production capacity markedly – such as Slovakia (Land Rover) or Serbia (Fiat Chrysler) – has the downturn in export dynamics been smoothed. All in all, these developments expose the dangers of excessive specialisation in car production – even if such specialisation has served the EU-CEE countries rather well to date. So far as the expansion – and potentially even relocation – of automotive production capacities is concerned, EU-CEE will also face increased competition from other countries, such as Turkey.[11]

Figure 2.3 / Exports of goods to Germany (customs statistics, EUR based) growth in %

4 quarters moving average



Source: Comext, own calculations.

Elsewhere, exports have generally held up better. In Slovenia, the downward trend in export dynamics has also been pronounced, but the pace of expansion remains higher thanks to pharmaceuticals. In Bulgaria, Lithuania, Kosovo, Turkey and Ukraine, the export momentum has picked up pace recently, albeit for different reasons. In Turkey, exports have been quick to take advantage of the weak lira. Ukraine has increasingly been benefiting from improved access to the EU market. However, in Russia and Kazakhstan, exports have declined on account of lower oil prices, as well as supply constraints in the framework of the OPEC+ deal (Russia) and production disruptions (Kazakhstan). In Belarus, exports have suffered on the back of weak import demand from Russia and interruptions in Russian energy supplies, partly due to pricing disputes. In Albania, they have been constrained by currency appreciation, as well as by weather conditions: a severe drought has affected hydropower generation and exports.

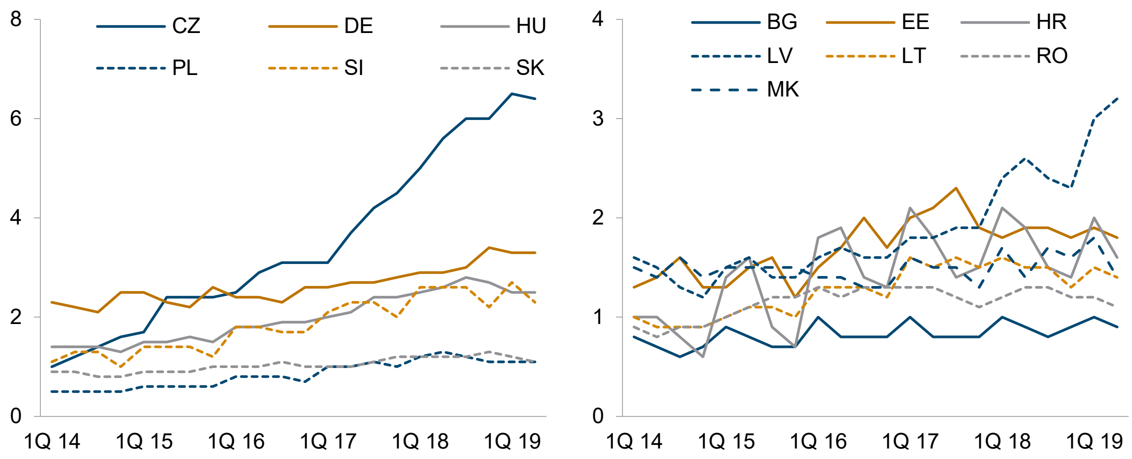
11 For instance, VW is reportedly planning a big investment in Turkey, with production of some 300,000 cars per year, starting from 2022. However, the final decision has been put on hold for the time being, because of the situation in northern Syria. See https://europe.autonews.com/automakers/vw-postpones-final-decision-turkey-plant

2.4. LABOUR SHORTAGES EASE SOMEWHAT

Over the past few years, large parts of the CESEE region have been characterised by deepening labour shortages. The main reason for this has been demographic: the long-term trend of secular decline in the working-age population – even in countries where the total population has been on the rise, such as the Czech Republic and Slovenia. This is a combined outcome of low birth rates and, in many cases, outward migration. Rising participation rates and longer working hours could only partly mitigate this trend, resulting in a sharp decline in unemployment in the vast majority of CESEE countries over the past few years (Overview Table 2.1) – albeit starting from a high level in the case of the Western Balkans, where the unemployment rate is still generally in double digits.

This trend has recently levelled off and has even gone into reverse in some cases, as can be seen from the recent downturn in job vacancies – more pronounced than mere seasonal dynamics would suggest (Figure 2.4). This can be explained by a combination of factors, such as the structural labour market adjustment, the stabilisation (or reduction) in labour demand, and increased immigration.

Figure 2.4 / Job vacancy rate in %



Source: Eurostat.

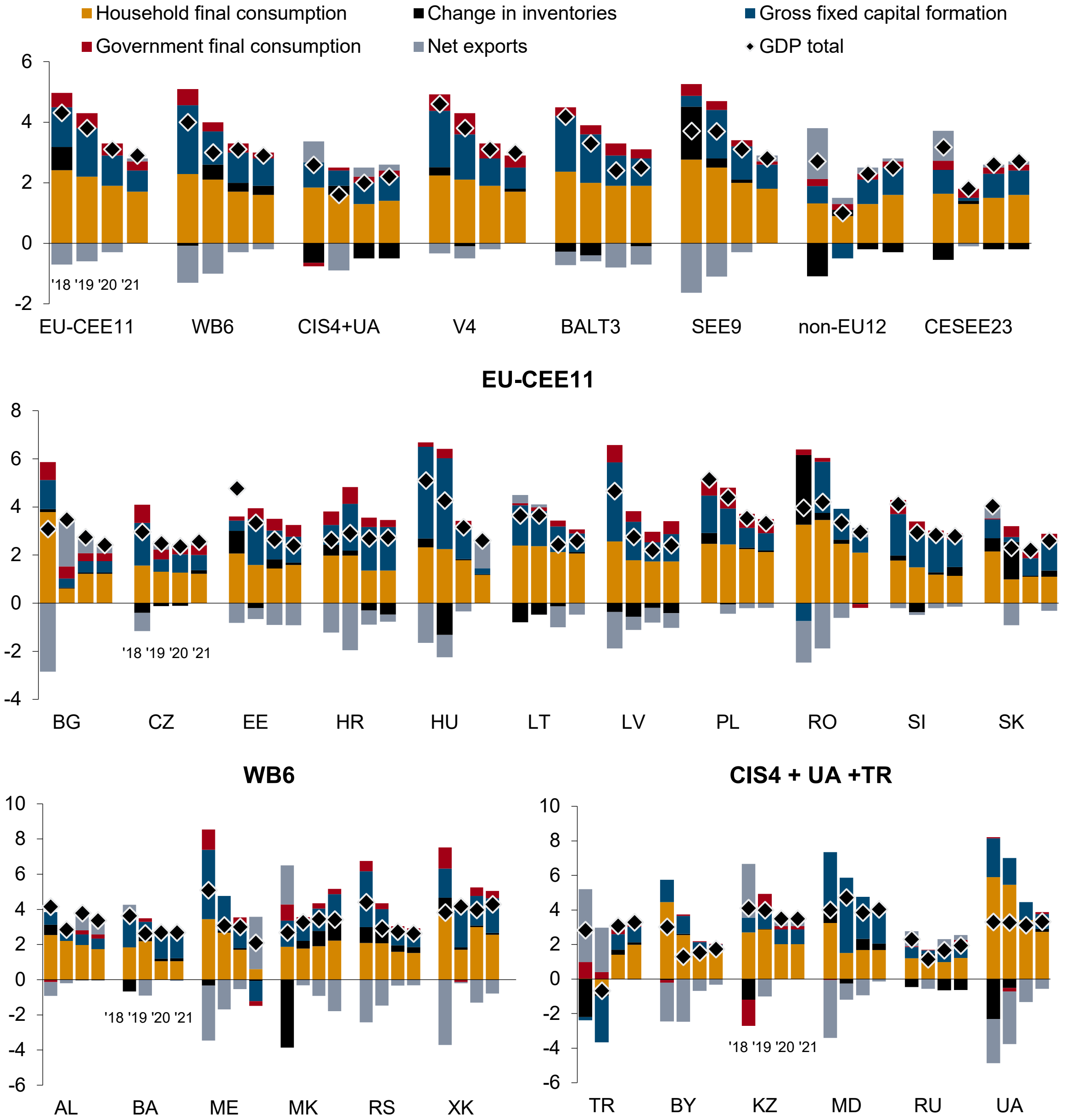
The easing of labour shortages is, to some extent, a natural outcome of the process of matching supply and demand in the labour market, which takes time to play out. To the extent that labour shortages for certain occupations have been driven by the inadequate supply of certain skills, one would expect the idle labour force to adjust to that by undertaking (re)training. On the other hand, the labour demand for certain occupations may have declined, as some investment projects for which labour shortages have represented a crucial bottleneck have been abandoned (a case in point is the Czech Republic). The deterioration in the external environment and the expectations of growth slowdown have also reportedly curtailed the demand for labour recently.

Increased labour immigration appears to have played a role as well. Despite the strong anti-migrant sentiments prevalent, especially in EU-CEE countries, many of them have recently increased quotas for third-country nationals, and especially for temporary labour migrants. Apart from traditional sources of imported labour, such as Ukraine, the Western Balkans and Belarus (in the Baltic countries), non-European immigration has gained momentum as well: from places such as India (to Hungary and

Croatia, for example), Vietnam and Mongolia (to Hungary), Nepal (to Croatia) and Bangladesh (to Slovenia).

Figure 2.5 / GDP growth in 2018-2021

and contribution of individual demand components in percentage points



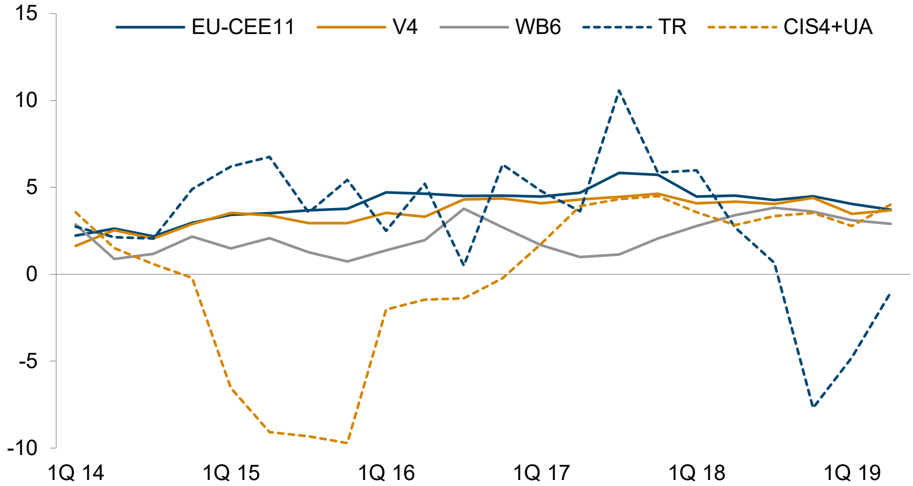
Note: see Figure 2.1 for abbreviations; BALT3 = the three Baltic countries (Estonia, Latvia, Lithuania); SEE9 = the nine countries of Southeast Europe: WB6, Bulgaria, Croatia and Romania; non-EU12 = non-European Union CESEE countries: WB6, CIS4+UA and Turkey.
Source: wiiw Annual Database incorporating national and Eurostat statistics, own calculation. Forecasts by wiiw.

2.5. HOUSEHOLD CONSUMPTION HOLDS UP WELL

Household consumption continues to be the main driver of growth in the CESEE region. In 15 countries of the region, we expect it to have been the main growth driver this year (Figure 2.5). The data for the first half of 2019 demonstrate that its dynamics has remained practically unchanged in the Western Balkans, the CIS and Ukraine, and has subsided only slightly in EU-CEE. In these three sub-regions, household consumption continues to grow on average at 3-4% per year (Figure 2.6). Only in crisis-hit Turkey has the dynamics of household consumption been negative since the fourth quarter of last year, albeit with an improving trend recently, as inflation has subsided. However, there is some variation across individual countries. For instance, private consumption has gained momentum in Romania, Kazakhstan and Bosnia and Herzegovina, but has subsided markedly in Bulgaria, Slovakia, Moldova and Kosovo. In those latter countries, growth is primarily driven by components of final demand other than private consumption.

Figure 2.6 / Household consumption expenditure

real change against preceding year in %



Source: wiiw Monthly Database incorporating national and Eurostat statistics.

Private consumption is fuelled by rising wages… Real wages continue to post solid growth, benefiting from the tight labour market situation and the hikes in the minimum wage in many countries of the region. The latter typically result in disproportionate wage growth in the low-wage segment, thus raising the overall household propensity to consume. Besides, the real purchasing power of households has been strengthened by the recent stabilisation of inflationary pressures, in cases where nominal wage agreements had been concluded in anticipation of higher inflation.

…and employment. Employment growth has been helping the rise in private consumption, too. However, in the face of labour shortages, especially in the more advanced EU-CEE countries, the newly created jobs have increasingly been taken up by foreigners. The latter typically have a lower propensity to consume, sending part of their income back home in the form of remittances – and thus supporting consumption growth in e.g. Western Balkans, Moldova and Ukraine. Thus, a greater reliance on foreign workers may be one of the reasons behind the moderate growth in private consumption in countries such as the Czech Republic and Slovakia – despite solid real wage growth.

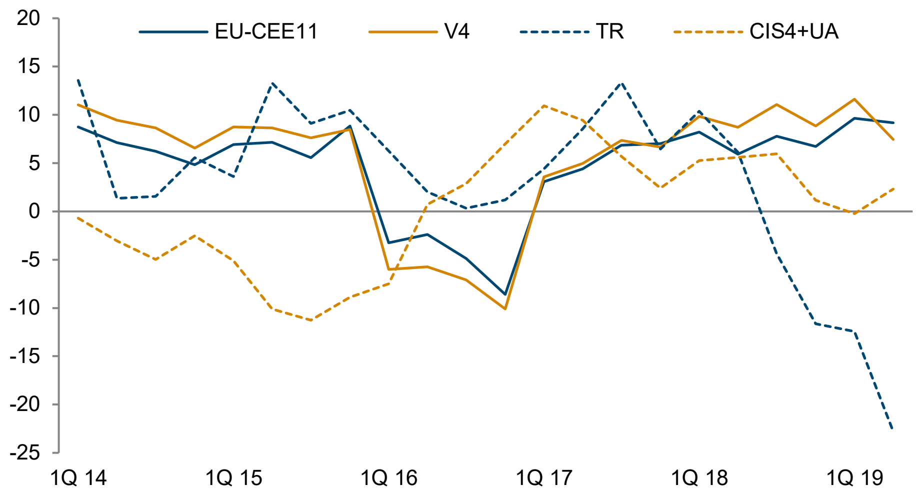
Consumer credit is an important pillar of private consumption, above all in the CIS, Ukraine and some Western Balkan countries. In the CIS and Ukraine, consumer credits have been expanding at close to, or in excess of, 20% annually (see section 'Credit monitor'). Although the levels of household indebtedness in these countries are not very high (10-15% of GDP), rapid credit expansion at high interest rates, if sustained over a protracted period, is potentially a cause for concern. This applies, in particular, to Russia, where the real disposable incomes of households are stagnant (not least because of the high burden of debt service), which fuels more credit demand and creates a vicious cycle of rising indebtedness and falling incomes. These concerns have prompted the authorities in Russia, as well as Kazakhstan, to tighten restrictions on household lending over the past few months.

2.6. INVESTMENTS INCREASINGLY DRIVEN BY THE PUBLIC SECTOR

Large parts of the CESEE region – Russia, Turkey, Bulgaria and some Visegrád countries – have witnessed a marked weakening of investment activity recently (Figure 2.7). This primarily reflects weakening private sector investments, especially in productive capacities. In Turkey, gross fixed capital formation (GFCF) contracted by 18% in the first half of 2019 – a predictable development in times of recession. In Russia, private investments have stagnated, due to the low levels of capacity utilisation and the generally overcast outlook, while the implementation of infrastructure projects has been delayed. In most Visegrád countries (except Hungary) and Bulgaria, pessimistic expectations have weighed heavily on private sector investments as well. Besides, labour shortages have resulted in some of the investment projects being cancelled.

Figure 2.7 / Gross fixed capital formation

real change against preceding year in %

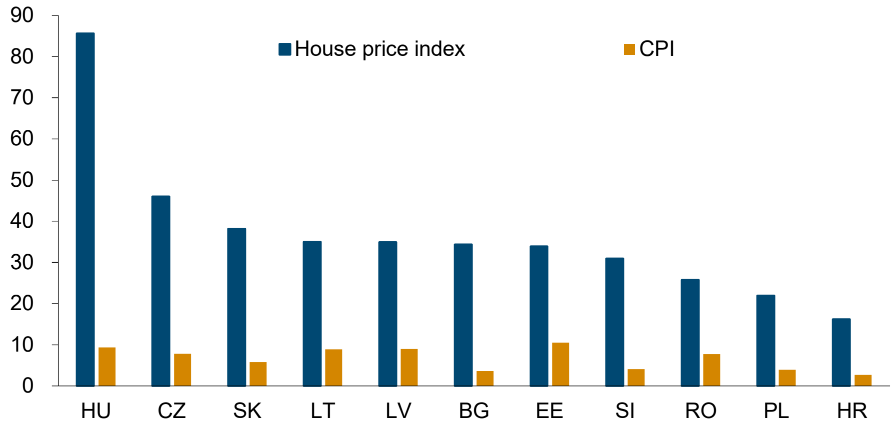


Source: wiiw Monthly Database incorporating national and Eurostat statistics.

The weakness of investment in productive assets may not bode well for growth and convergence prospects. The investment ratios of around 20% of GDP typically recorded by most CESEE countries[12] may not be particularly low in international comparison (that is similar to the level in Western Europe). However, unless accompanied by higher productivity (which cannot be taken for granted), they are arguably too low to lay the supply-side foundations of sustained long-term catching-up: for that, much higher investment ratios would be needed.[13] Particularly problematic are low investments in productive capacities such as machinery and equipment: in per capita terms (at Purchasing Power Parity – PPP), these are far below the levels observed in advanced countries.[14] The recent weakening of investment dynamics, if sustained over a prolonged period, may further exacerbate these flaws.

A large part of private sector investment in CESEE has been channelled to real estate, fuelled by low interest rates on mortgages. As a result, the construction sector in many countries has been expanding strongly and housing prices have been rising rapidly – much faster than consumer prices (see Figure 2.8 for EU-CEE countries). Many EU-CEE countries have been among the front-runners in the EU when it comes to house price inflation, suggesting the possibility of housing 'bubbles' in some cases. In Hungary, house prices have increased by 86% over the past five years; in the Czech Republic by 46%; and in most other EU-CEE countries by between 30% and 40%. For comparison, the strongest Consumer Price Index (CPI) increase in the region over the same period (in Estonia) has been only 10.5%.

Figure 2.8 / House price index and CPI, cumulative % change, 2Q 2014 - 2Q 2019



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

Elsewhere, investment activity has remained strong, not least thanks to robust FDI inflows. In four CESEE countries – Estonia, Hungary, Moldova and Kosovo – gross fixed capital formation will be the main growth driver this year (Figure 2.5). Moldova and several Western Balkan countries (notably Serbia and North Macedonia) have increasingly been establishing themselves as a cheaper alternative to EU-CEE countries, especially when it comes to car production. FDI inflows to the Western Balkan

12 Across CESEE, only Turkey and Montenegro recorded much higher investment ratios in 2018, exceeding 30% of GDP in both countries.

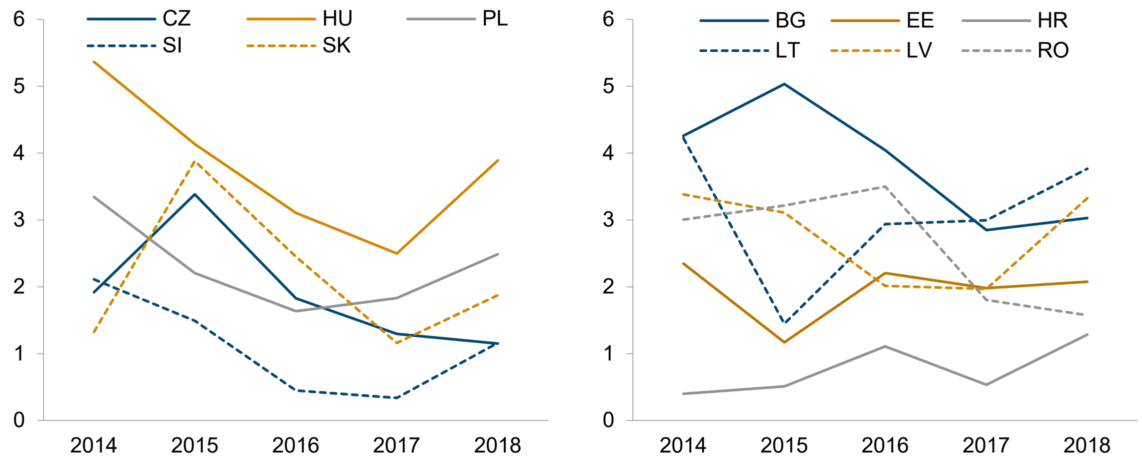
13 Japan and South Korea used to record investment ratios in excess of 30% of GDP, China over 40%, West European countries around 25% over prolonged periods of catching-up.

14 Podkaminer (2019).

region increased by 28% last year, and this trend largely continued into 2019 (wiiw, 2019b). In Moldova, GFCF surged by 20% in the first half of 2019, as the production of car components has been partly relocated to that country from neighbouring Romania for reasons of cost. Despite that, Romania remained an overall attractive destination for FDI – albeit labour-intensive industries, such as textiles and leather recorded divestment because of the wage pressures. In several countries, FDI has primarily been targeting the energy sector, such as the ongoing construction of the Trans-Adriatic gas Pipeline (TAP) and hydropower station in Albania, or the expansion of oil fields in Kazakhstan. In Kosovo, it mainly went into real estate.

Infrastructure investments performed well, and in Visegrád countries partly offset private investment weakness. In general, public sector investments in EU-CEE countries have historically strongly correlated with the inflows of EU transfers. The current Multiannual Financial Framework (MFF) for 2014-2020 is now at an advanced stage. This means that, after the usual teething problems, the inflow of EU funds into the EU-CEE countries is now in full swing. Figure 2.9 demonstrates that net inflows of EU funds picked up markedly last year, in some cases – such as in the Czech Republic, Slovakia or Slovenia – after a protracted decline during the preceding years. Those countries were joined by 'slow starters' such as Croatia, which joined the EU only in 2013, and thus could not draw on the previous EU MFF for 2007-2013. Anecdotal evidence suggests that public investments driven by EU transfers have also been strong this year. Among the big infrastructure projects that started this year and that are co-financed by the EU is, for instance, Rail Baltica, a high-speed train project connecting the Baltic countries with the Central European network.

Figure 2.9 / Net EU transfers, as % of GDP



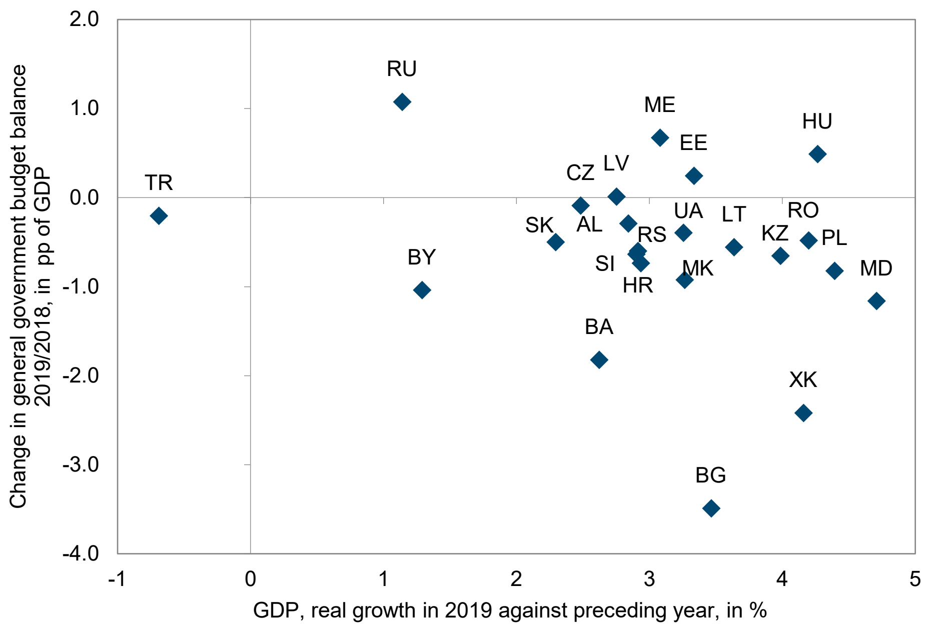
Source: wiiw Annual Database incorporating national and Eurostat statistics, EU Commission.

In the Western Balkans, infrastructure investments are driven partly by funds from the EU, but especially by the Chinese Belt and Road Initiative (BRI), as China sees the region as an important transit route. More than half of all BRI funds allocated to the CESEE region (in the form of loans) go to the Western Balkans. However, in Montenegro infrastructure spending has been scaled down this year on the back of fiscal consolidation.

2.7. EXPANSIONARY POLICY MIX

The strength of domestic demand in many CESEE countries is partly due to their pro-growth fiscal policy. The fiscal stance of a country can be roughly derived by juxtaposing the change in the government budget balance and the country's growth performance (for the reasoning behind this, please see Box 2.1). Using this method, in 18 out of 23 CESEE countries, fiscal policy this year can be classified as clearly expansionary. In many cases, fiscal stimulus takes the form of generous social policy. One example is Poland, which has adopted a large range of social benefits that target various social groups. Another example is Kazakhstan, which hiked the minimum wage by 50% in January, and then the salaries of low-paid public officials by 30% in July of this year.

Figure 2.10 / Fiscal stance in 2019



Source: wiiw forecasts.

Even applicants for accession to the euro area – Croatia and Bulgaria – hardly see a need for fiscal austerity in the current circumstances. Both countries have ambitions to enter the European Exchange Rate Mechanism 2 (ERM2) soon, possibly even next year, which should pave the way for them to join the euro area two years later. For that, they will need, among other things, to satisfy the formal Maastricht criteria – including the criterion of public debt, which in the case of Croatia is still rather high, at above 70% of GDP (compared to the Maastricht 'threshold' of 60%), though it is gradually declining. In Bulgaria, which has a track record of fiscal prudence, this is less of a problem.[15] However, Bulgaria's current inflation rate of around 3% may potentially violate another Maastricht criterion, which requires that CPI inflation should not exceed the average of the three euro area countries with the lowest

[15] The expected strong deterioration in Bulgaria's fiscal balance this year by 3.5 pp of GDP is due to the one-off effect of a single transaction (acquisition of jet fighters) and may not be indicative of the overall fiscal stance.

inflation rates by more than 1.5 pp. A more restrictive fiscal course would be one way of bringing inflation down (whether that would be wise is another question).[16]

BOX 2.1 / ASSESSING THE FISCAL STANCE IN CESEE COUNTRIES

A proper assessment of the fiscal stance requires the headline budget balance to be adjusted on account of the 'cyclical' component. For instance, a reduction in the budget deficit accompanied by economic growth may be entirely due to the impact of automatic stabilisers (such as higher tax revenues and reduced spending on unemployment benefits), and is not necessarily a reflection of laxer fiscal policy. For the same reason, the widening of the budget deficit during a recession need not necessarily be indicative of fiscal policy easing, but may be on account of the cyclical downturn in revenues.

Estimating the cyclically adjusted budget balance is no trivial task; it calls for knowledge of the corresponding elasticities of state revenues and expenditures with respect to GDP and an estimate of 'potential GDP'. Those are generally country specific and depend on the particular tax and social welfare system of a country. However, as a first approximation, one can identify two clear-cut cases that correspond to two quadrants in Figure 2.10. A change in the fiscal stance is clearly expansionary if the budget balance deteriorates (or remains unchanged) despite a burgeoning economy (south-east quadrant). Conversely, a change in the fiscal stance is clearly restrictive if the budget balance improves (or remains unchanged) despite a recession (north-west quadrant). In the remaining two quadrants, no unambiguous conclusion can be drawn with respect to the fiscal stance, without entering into deeper analysis. However, the position of a country far from the origin and close to the horizontal axis would strongly suggest that in qualitative terms the fiscal stance is the same as the one observed on the other side of the axis.

CESEE countries can afford lax fiscal policy, so long as underlying growth fundamentals are reasonably solid and borrowing costs are low. In most countries, the yields on government bonds have been on a downward trend since the third quarter of 2018, and even turned negative in Slovakia and Slovenia (Figure 2.11). Nearly everywhere, they have been below the nominal growth rates of GDP for a number of years, allowing the economies to 'grow out' of public debt – without a need to resort to painful austerity measures. A case in point is Serbia, which has succeeded in bringing down its public debt since 2015 by about 20 pp of GDP. Declines on a smaller scale could also be observed in other countries where the levels of public debt have been historically high and at times a cause for concern, such as Hungary and Croatia.

Low borrowing costs are partly due to abundant global liquidity, but also to dovish monetary policy. This applies not only to the euro area, of which five EU-CEE countries are formally part,[17] but also to CESEE countries which retain some degree of monetary policy autonomy – even if, in practice, they cannot deviate very much from the stance of the European Central Bank (ECB). The policy rates of

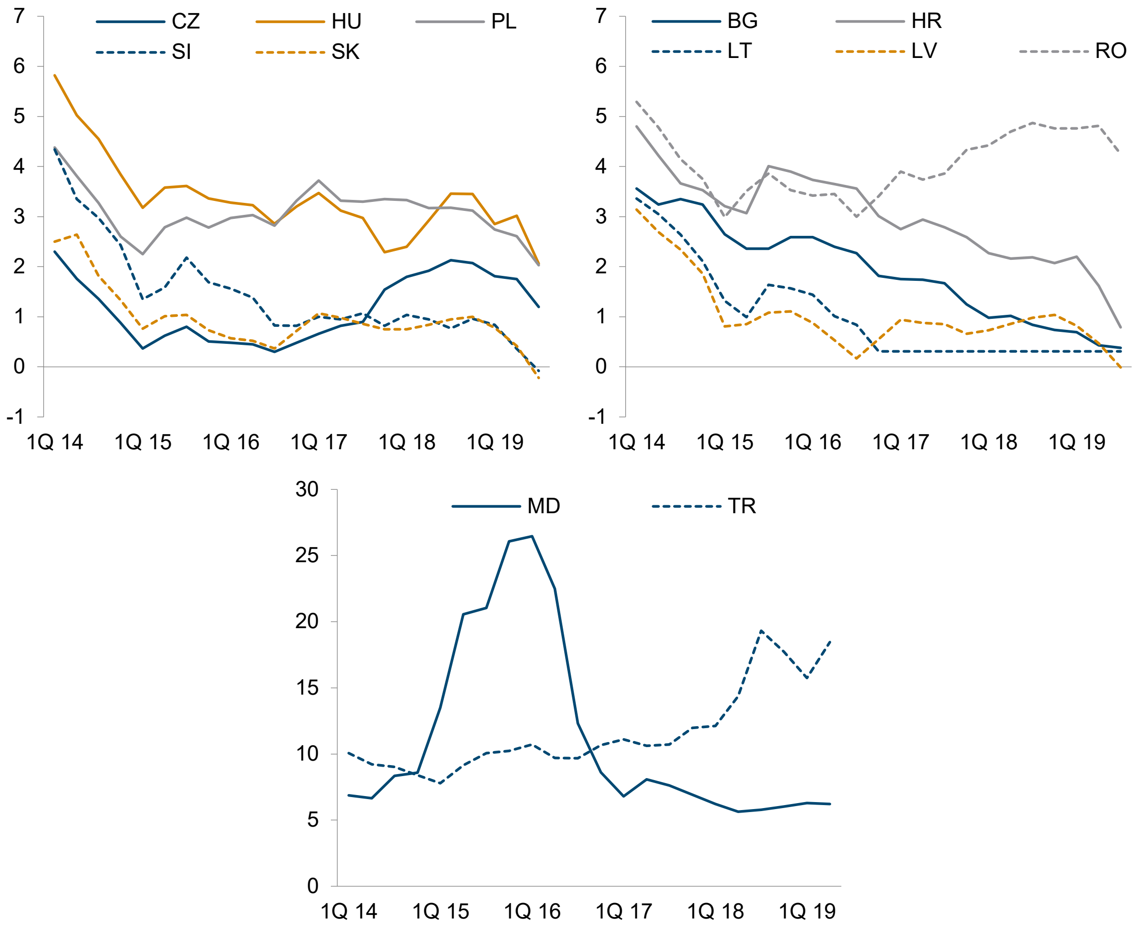
[16] Accession to the euro area requires more than the mere fulfilment of the formal Maastricht criteria on inflation, long-term interest rates, budget deficit, public debt and exchange rate stability; it is also dependent on progress in banking supervision and the institutional environment in general, as well as political factors.

[17] The ultra-loose monetary policy of the ECB has repercussions far beyond the euro area. Montenegro and Kosovo unilaterally use the euro as legal tender, while Bulgaria, Croatia, North Macedonia and Bosnia and Herzegovina peg their currencies to the euro in one way or another.

national central banks are negative in many cases. Even in countries with visible signs of 'overheating', such as Romania and Hungary, national banks have been in no hurry to hike interest rates, clearly prioritising growth over price stability. In any case, the CPI inflation of 3-4% (and subsiding) observed in these countries hardly gives reason for concern.[18] However, in Romania ongoing fiscal expansion runs the risk of the budget deficit surpassing the 'threshold' of 3% of GDP, potentially triggering an EU Excessive Deficit Procedure. In Moldova, fiscal policy should become more restrictive as well under IMF pressure.

Figure 2.11 / Government bond yields, 10-year maturity

in domestic currency, % per annum



Source: Eurostat, Investing.com, International Financial Statistics - IFS (IMF).

Only in Turkey, Russia and Montenegro can the fiscal stance arguably be classified as restrictive. In Turkey, the budget deficit is projected to widen only marginally this year – despite the cyclical downturn in revenues and suggesting some consolidation effort. In Russia, fiscal surplus will grow further, with the aim of making the economy less vulnerable to Western financial sanctions. Apart from fiscal surpluses, Russia has been accumulating part of the 'windfall' gains from energy exports in its sovereign wealth fund, suggesting that the overall fiscal stance is even more restrictive than implied

18 The only exceptions are Kazakhstan and Moldova, where the acceleration of inflation has prompted monetary policy tightening in recent months.

by Figure 2.10. In Montenegro, concerns over high public indebtedness play a role: since it has no currency of its own, it cannot rely on monetary mechanisms for the purpose of debt service, and its stock of public debt is effectively foreign debt. Spending cuts in Montenegro are falling mostly on public infrastructure projects.

2.8. OUTLOOK

Growth in the CESEE region as a whole is expected to pick up by nearly 1 pp in 2020-2021 (Table 2.1). However, this is entirely due to the anticipated 'return to normality' in Turkey, and to a lesser extent in Russia. In EU-CEE, a 'soft landing' will likely take place, while in the Western Balkans, CIS and Ukraine growth should remain broadly stable.

In EU-CEE, the external environment will likely be a drag on growth... Growth in the euro area is projected to pick up somewhat from the current dip, and will cease to be a drag on EU-CEE exports. At the same time, there are still risks of the US imposing prohibitive import duties on European cars, in which case Hungary and Slovakia (which are particularly dependent on car exports to the US, both directly and indirectly via value-added chains) will be affected the most. A 'hard Brexit' (and especially a 'no-deal Brexit') may present another negative trade shock for the EU-CEE region – most notably Poland, which has a large trade surplus with the UK.

… while domestic demand will continue to thrive. Private consumption in EU-CEE will continue to benefit from solid wage growth and generous social policies. Even Romania, where overheating has long been a feature, should be able to sustain fiscal expansion, so long as financial conditions remain supportive. Inflows of EU transfers should remain intact, at least until the end of the forecasting period. The current MFF formally expires in 2020, and countries should still be able to absorb EU funds for two years after that. Under the next MFF (for 2021-2027), many EU-CEE countries will likely face painful cuts in EU transfers on account of Brexit and the likely shift in EU spending priorities: from EU-CEE towards Southern Europe, and from agriculture towards 'clean energy'. Besides, the non-compliance with the 'rule of law' by some EU-CEE countries, notably Hungary and Poland, may play a role as well. However, the impact of any cuts in EU funding will only be felt from 2023 onwards. Only in Hungary do we expect an abrupt reduction in EU transfers next year, since most of the envisaged funds have already been absorbed.

In the Western Balkans, growth is expected to settle at around 3% per annum in the coming years. The current drivers of rising consumption and investment will likely stay in place, while increased FDI inflows should boost further export capacities. However, geopolitical developments in and surrounding the Western Balkans have not been very encouraging recently. The parliamentary victory of hardliners in Kosovo will further complicate the already difficult dialogue with Serbia, and the prohibitive 100% import tariff on goods from Serbia and Bosnia and Herzegovina imposed by Kosovo last year will almost certainly stay in place. North Macedonia has witnessed a major breakthrough recently, when it finally signed an agreement with Greece on the new name for the country. But EU accession talks for this country remain some way off, mainly because of strong opposition from France, which insists on reforming the entire EU enlargement policy. Things look even bleaker for Albania: opposition to the opening of EU accession negotiations with that country is much broader and includes Denmark and the

Netherlands (mostly on security grounds). Taken together, these developments may stall the fragile reform momentum in the region, resulting in EU accession prospects moving even further away.

In Russia, after a dip this year, growth will pick up somewhat in 2020-2021, due to moderate fiscal relaxation, including increased spending on health care, education and infrastructure projects. However, even with the extra fiscal stimulus, growth will not exceed 2% per annum, making Russia the worst performer in the CESEE region. Russia's economic prospects are strongly dependent on the geopolitical environment. The recent signs of détente with Ukraine following the change in the Ukrainian leadership earlier this year have been encouraging. However, implementation of the Minsk Agreement – a crucial precondition for easing EU sanctions against Russia – will not be an easy process, mostly because of the strong opposition to it in large parts of Ukrainian society.

In the CIS countries and Ukraine, the economic dynamics should be broadly stable. In Belarus, economic activity should revive in line with the rebound in Russia, given the strong – and growing – ties between the two economies. In Kazakhstan and Moldova, fiscal stimulus will continue to play a major role, although in Moldova growth will likely slow from the current very high pace. In both Moldova and Ukraine, the external vulnerabilities remain high, and economic prospects depend on access to IMF funding.

The Turkish economy is projected to rebound from the recent crisis, although political risks remain high. On a positive note, the weak lira has restored competitiveness, and the current account is now largely balanced. However, the existing external debt stock still needs to be refinanced, making Turkey highly dependent on the mood of global financial markets – and also on good relations with the US. The latter may be particularly tricky after Turkey started a military operation in northern Syria in October 2019. The baseline scenario at the time of finalising this report is that serious economic sanctions by the US against Turkey will be avoided over the forecasting period – especially if US President Donald Trump is re-elected next year. Nevertheless, the forecast risks for Turkey are by far the highest at the moment in the CESEE region.

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