Executive summary

Global growth should remain fairly robust by post-crisis standards throughout the forecast period, powered above all by strong activity in the US. Despite downgrades to its forecasts in October, the IMF projects global growth at 3.7% this year and next, which is the same as in 2017. US growth for 2018–2019 will be quite a bit better than for 2016–2017. This will continue to provide a relatively favourable backdrop for CESEE economies.

However, challenges to global growth have increased, and the outlook is less positive than at the time of our Spring Forecast. Tighter US monetary policy, an apparent slowdown in the pace of Chinese growth, trade tensions between the US and various international partners (in particular China) and subdued activity in some parts of the eurozone present increasing challenges for the global economy. Rising US interest rates have significantly increased the chances of an emerging markets crisis (although within CESEE we are only really concerned about Turkey in this respect). As the US Federal Reserve continues to tightening monetary policy, prices across assets classes such as equities and property (which have benefitted from almost a decade of ultra-loose monetary policy) could stagnate or fall.

Despite a less positive outlook than at the time of our Spring Forecast, we expect most economies in CESEE to grow quite strongly by post-crisis standards in 2018-2020. In the short term, tight labour markets will continue to push up wages, and elevated capacity-utilisation levels will support investment. However, backing from external sources for growth is already fading, and we expect this to continue. A loss of momentum in the eurozone and the advanced economies presents a challenge to growth in the CESEE economies, especially in those that are strongly integrated into the regional production chains and rely on exports in their growth models.

Regional growth has already peaked, and will trend downwards for most countries during the forecast period. Only a few Western Balkan economies will keep up their current pace of growth, though that will remain rather moderate and not enough for significant convergence with wealthier parts of EU-CEE or Western Europe. Convergence as a whole will continue, although at an ever-slower pace as the forecast period progresses. Weaker demand from the eurozone will become particularly apparent by the end of our forecast period: we have revised down our forecasts for 2020 for many countries, in particular for the EU-CEE sub-region.

Turkey and Russia – the region's biggest economies – are both currently struggling with low growth, although in the medium run the outlook for the former is much more positive than for the latter. We expect Turkey to undergo a fairly pronounced recession in the coming quarters, but to bounce back from its current difficulties by 2020. By contrast, Russia will remain the CESEE economy facing the biggest challenges, and will continue to post very disappointing growth rates during the forecast period. In part, this will reflect the impact of international sanctions, although the main reasons for Russia's weak growth performance are domestic and structural in nature. Its problems will have negative spill-over effects for the rest of the CIS region as well.

Labour shortages are an increasing concern for growth in the region, especially in EU-CEE, and how firms respond will largely dictate the pace of future growth. Labour shortages are nothing new, but vacancy-rate data indicate that they are becoming increasingly acute, especially in parts of EU-CEE. We are cautiously optimistic that businesses will continue to invest in productivity-enhancing capital upgrading, rather than move production away from the region – although there is a significant risk of that happening. Unlike in much of EU-CEE, labour markets in the Western Balkans are not facing significant labour shortages. In this sub-region, unemployment is generally high, employment rates are low, and most countries have a particularly high share of youth and long-term joblessness. This reflects cultural factors, a reliance on remittances and a high degree of informality.

Despite rising wages, inflation is fairly subdued in most of the region, particularly when the effects of higher oil prices are stripped out. This remains a complex story (and not one unique to CESEE), although we think that an increase in savings rates across much of the region is a key explanation, as higher earnings do not necessarily translate into more demand. Additionally, outflows of remittances from countries with high shares of immigrant workers may also be having an effect. Over the medium term, even in the context of fairly acute labour shortages we expect wage increases to be capped by the legacy of increased labour market flexibility in CESEE, which has reduced labour's bargaining power.

China's Belt and Road Initiative (BRI) is important for the CESEE region, and especially the Western Balkans. It will bring much-needed infrastructure upgrading, but also political influence, increased corruption risks, and the chances of an unsustainable rise in public debt in some countries. We think that the EU should respond with a "Big Push" investment initiative of its own, framed as a complement rather than competitor to the BRI.

Our four new monitors attempt to track and analyse developments in CESEE convergence, the business cycle, credit and FDI. We find that most countries are continuing to converge with Western Europe, but that the outlook is increasingly challenging. Overheating concerns have abated since our Spring Forecast, reflecting strong policy responses in Turkey (monetary) and Romania (fiscal). Across the region, potential overheating is most evident in tight labour markets, higher external debt, elevated property prices and negative real interest rates. The credit cycle is mostly picking up, helped by improved asset quality, although this reflects primarily credits to households; growth of loans to non-financial corporations has remained rather weak. Finally, FDI inflows into CESEE declined quite strongly last year, reflecting capital withdrawals by foreign investors.

Aside from visible challenges, additional downside risks to the global economic outlook have also increased. From the perspective of CESEE – and taking account of both likelihood and impact – we are most concerned about the structural deficiencies in the eurozone (which make a renewed crisis more likely when the next downturn hits) and a full-scale trade war between the US and China. In terms of risks emanating from the CESEE region specifically, we view a smaller post-Brexit EU budget as the biggest issue (for EU-CEE at least), and are also concerned about a further decline in the rule of law and quality of institutions. A further spike in oil prices (the subject of much recent speculation in the media) would also be a big headwind for growth in most countries in CESEE, although we regard this development as much less likely.

More fundamentally, the post-Second World War international and political economic order is showing increasing signs of strain, and the chances of coordinated action at the global level to restore stability are low. The peaceful political, military and economic rise of China is in no way guaranteed, particularly considering the current occupant of the White House. Globalisation appears to have stalled, and is under attack from politicians in many countries. The EU is likely to remain focused primarily on internal issues.

Political trends in the eurozone remain concerning, and could have big negative economic implications, including for CESEE. Hard- and far-right parties are gaining in the polls, and parliamentary representation in general is becoming more fragmented (with centrist parties losing vote share). The most problematic country is Italy, which now has an anti-establishment government with a far-right presence. This matters for three reasons: Italy is a systemically important member of the eurozone; the Italian economy is already struggling with very high public debt and decades of negligible growth; and serious eurozone reform is now much less likely.

Brexit will not be an economic catastrophe for the EU, but the political fallout will be significant. Although Brexit has been a powerful unifying force for the remaining 27 members (as we expected), this will not last. It is almost impossible to imagine that the high degree of consensus among the EU-27 on Brexit will be repeated on more systemically important issues like migration, reform of the eurozone and the future budget.

COUNTRY SUMMARIES

ALBANIA

Our forecasts are largely unchanged from the spring, and we continue to expect the economy to remain strong and grow above 4% in the medium term. Both domestic and external demand will support growth. Higher international oil prices should mean higher investments and exports in this sector. Public private partnership projects must be transparent and well monitored in order to avoid rises in public debt. Tangible progress of judicial system reform is critical for the start of EU membership talks.

BELARUS

The economy has rebounded thanks to an improving external environment and a policy stimulus engineered through wage rises. Real disposable income rose sharply supporting an upturn in private consumption. GDP growth was entirely driven by domestic demand while net exports made a negative contribution. Recent indicators suggest that growth has passed its peak and will decelerate. In 2018 as a whole GDP could rise by 3.7%, but thereafter will likely slow down to around 3% in the following years.

BOSNIA AND HERZEGOVINA

Political risk is unusually high following the recent election, and in particular the potential for a constitutional crisis in the Federation. This will have an impact on reforms and policy-making, but shouldn't impact growth too much. We think that growth will remain in the range of 3-3.5% during the forecast period, with external factors such as remittances, exports and tourism likely to remain important. Inflation will stay low, while the labour market will improve slowly.

BULGARIA

GDP grew by 3.3% in the first half of 2018 which was below the rates of growth in the three preceding years. The moderation in output growth coincided with a slowdown in exports. The labour market tightened further and labour costs continued to rise. CPI accelerated due to rising energy prices and growing cost-push inflationary pressure. We expect GDP growth for 2018 as a whole of around 3.3%, and it should stay at a similar level in the coming years.

CROATIA

Croatia's economy will continue its path of moderate growth, with annual GDP growth of slightly below 3% in the period 2018-2020; increasing the absorption of EU funds will be an important precondition for achieving this growth rate. Demographic changes, coupled with continued emigration of young and educated people and rising labour shortages in crucial sectors, will become a major challenge in the future.

CZECH REPUBLIC

The Czech economy may face a period of slowing growth. Tight labour markets and the wage push which have supported growth recently may produce second-round effects such as rising unit labour costs, falling corporate profitability and weakened foreign trade performance. These effects may actually depress growth especially if monetary policy becomes too restrictive, foreign demand for Czech goods proves insufficient and productivity advances are less impressive than generally assumed.

ESTONIA

Investment activity has abated so far in 2018, following last year's peak growth induced by fresh inflows of EU funds. However, external demand continued growing at a higher pace than expected. Household consumption, backed by a considerable rise in employment and real wages, continues to be a strong driver of economic activity. We project GDP to grow at a rate of 3.5% in 2018 and 3.1% in 2019, while declining somewhat to 2.7% in 2020.

HUNGARY

The Hungarian economy expanded by 4.8% in Q2 of 2018, reaching the zenith of the current business cycle. Growth has been driven by the extraordinarily rapid utilisation of EU cohesion policy resources. This high growth rate cannot be sustained in the next three years. A sharp decrease in EU transfers from next year on will remove an important driver of growth and there is no comparable substitute for that in sight.

KAZAKHSTAN

GDP will grow by 4% in 2018, mainly owing to high oil prices and expansion of production in the oil sector. In 2019-2020, the economy will continue benefiting from the favourable commodity price environment and grow by about 3% annually. The main risks to the forecast are a sharp decline in global oil prices and intensifying geopolitical tensions around Russia and China.

KOSOVO

We forecast that growth will strengthen further to above 4%. Imminent risks due to political tensions surrounding the consultations about territorial swapping with Serbia remain high. Infrastructure investments will be a major driver of growth in the medium term boosted by private and public investments. The banking sector remains solid and well capitalised and credit growth is expected to continue on its upward trend. The fiscal stance and monetary policy remain supportive of growth.

LATVIA

Both public and private investment have kept the economy growing at a high pace in 2018 and exports evolved more strongly than expected. Household consumption is also rising rapidly; a tightening labour market and the 2018 income tax reform will provide further stimulus. While public spending is likely to expand quickly, we assume external demand growth to abate gradually. In 2018 we expect another year with high GDP growth of 4.1%, followed by a slight slowdown to 3.3% in 2019 and 2.7% in 2020.

LITHUANIA

Public and private investment have driven growth in the Lithuanian economy for another year. A further decline in unemployment has resulted in rapid wage increases. Furthermore, the enacted income tax reform will foster steady, strong growth in household consumption. The increase in external demand has been stronger than expected in 2018, but is likely to abate slightly in the coming two years. For 2018, we expect real GDP to grow by 3.5%, followed by 3% in 2019 and 2.6% in 2020.

MACEDONIA

The Macedonian economy started to recover in 2018 owing to a strong revival of industry and solid export performance. Real GDP is projected to grow by about 3% per year in the medium term, although the chances of political instability suggest significant downside risks. The failed referendum on the country's 'name issue' on 30 September will prolong the political crisis and may destabilise the country again with adverse economic consequences, regardless of the new name's endorsement by the parliament in October.

MONTENEGRO

In 2018, GDP will grow by 4.2% – better than previously expected. The main driving forces behind the dynamic growth are fast growing investment and exports. High growth has brought about job creation, but unemployment remains high. The costs of the Bar-Boljare highway project have risen, which exacerbated the government debt burden. During 2019-2020, economic growth will slow down to about 3%.

POLAND

Despite lower profits the corporate sector's financial standing and financing conditions are good. But the private domestic firms are reluctant to expand investment. The ongoing political changes destabilise the country's legal framework undermining trust in the rule of law. The conflict between the European Commission and the Polish government may lead to substantial cuts in the funds available to Poland which would also undermine public investment and reduce medium-term growth prospects.

ROMANIA

The Romanian economy is experiencing an unavoidable slowdown, following a boom based on fiscal stimulus of household consumption in the past two years. Economic growth is sustainable at rates somewhat below 4% over the forecast period. Business sector investment is supporting economic growth, while public investments are falling victim to fiscal rebalancing.

RUSSIA

The Russian economy continues to grow at a slow pace. The unimpressive performance is forecast to last even in the medium term since no improvements in either domestic or external conditions for development are expected. High oil prices currently mitigate the adverse impacts of geopolitical tensions, though both investments and economic restructuring suffer. Chinese-Russian relations are likely to strengthen further.

SERBIA

Current economic growth and the near-term outlook are as good as has been the case at any time since the global financial crisis a decade ago. A combination of FDI inflows and private consumption are likely to remain the key growth drivers. The economy continues to face challenges, although efforts to bring down public debt and clean up the banking sector have been partly successful. Over the medium term, growth will trend down towards 3%, implying very slow convergence with Western Europe.

SLOVAKIA

Slovakia's growth accelerated in the first half of 2018 on a broad base. Forecasts for this and next year amount to 3.8% and about 4% respectively, thanks to the new Jaguar Land Rover plant. Main internal risks are growing wages and labour shortages.

SLOVENIA

GDP growth is expected to reach 4.5% in 2018, but will slow due to lower export growth in the forecast period. Domestic demand, investments fuelled by EU funding and steady consumption growth will remain the main drivers of GDP growth. The shrinking of the working-age population and increasing labour shortages will put an upward pressure on wages.

TURKEY

Turkey's economy is heading for recession, and is set to face at least several difficult quarters. US monetary tightening, and domestic and international political risk factors, have combined with an unbalanced and debt-reliant growth model to create a perfect storm for Turkey. The policy response by the authorities, including monetary tightening and an attempt to calm international tensions, have significantly reduced the chances of a full-blown crisis. Our core scenario is that the economy will start to recover by end-2019.

UKRAINE

Thanks to the booming domestic demand, economic growth should exceed 3% this year but will likely decelerate somewhat in 2019 due to recent monetary policy tightening. In the face of a less supportive global environment, Ukraine has agreed on a new IMF loan, which should ensure macroeconomic stability at least in the short term. However, the social impact of the related recent hike in gas tariffs may prove politically costly for the authorities ahead of the March 2019 presidential elections.

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