Executive summary

Economic activity in large swathes of the CESEE region remains very robust, despite increasing external risks and a marked slowdown in the eurozone. Aggregate growth in both EU-CEE11 and WB6 is at or close to a post-crisis high. Activity in the CIS and Ukraine is bumping along at a low level, but has picked up from 2015-2016; and if Russia is taken out of the equation the situation does not look too bad. Last year was, for most countries in the region, another good one in the post-crisis context. For the second year in a row, no country recorded negative growth (a first since 2007).

The fastest-growing economies in the region – perhaps surprising for readers of political news – were Hungary and Poland. Hungary's growth rate was its best since 2004, while Poland also achieved a post-crisis high. The biggest improvements relative to 2017 were largely concentrated in the Western Balkans, and especially in Serbia and North Macedonia. Ukraine and Slovakia also had a good year, compared to the previous 12 months. Aside from Russia, the clear negative story was Turkey, where activity dropped off precipitously in the second half of 2018, following a series of external shocks. Romania also recorded significantly lower growth last year. In both Turkey and Romania, this reflected a slowdown after a period of overheating.

Strong external headwinds to growth emerged in the second half of last year, and these had important implications for the export contribution to economic activity. Export growth was especially weak in EU-CEE11, reflecting greater integration with European and global value chains, and the slowdown in key sources of final demand, such as Germany and China.

Growth for CESEE as a whole peaked in 2017-2018, and will be slower in the next three years than over the previous three. The sharpest slowdowns are expected in Romania and Turkey. We also forecast notably weaker growth in Montenegro, Estonia, Hungary, Slovenia and Bulgaria. Despite the projected slowdown, however, every country will grow more quickly than the eurozone aggregate during the forecast period, implying convergence with Western Europe.

Overheating is not a concern at the aggregate level, and growth in the two countries where potential overheating was previously most visible – Turkey and Romania – has slowed. In CESEE as a whole, we see the greatest potential signs of overheating in labour markets and property prices, especially in EU-CEE countries. By contrast, signs of under-heating are visible in current account and fiscal balances. On the credit front, loans to households are growing rapidly in Russia, Ukraine and Belarus; this trend could become a concern if it continues. We also note very negative real interest rates in the Baltic states, Hungary, Slovakia and Slovenia. However, asset quality continues to improve in most places, providing an important source of stability.

The drivers of growth during the forecast period vary across the region, but it is clear that support from external factors is likely to be weaker almost everywhere than was the case in the past few years. With the global economic cycle slowing (if not ending), and weaker growth projected in all major economies, CESEE will be affected.

The three smaller Visegrád countries, plus Slovenia, are those most exposed to trade tensions at the global level. This reflects not only their high degree of openness (measured in terms of exports/GDP), but also their high degree of integration into regional and global value chains. Commodity exporters, especially those in the CIS, will also have to adjust to weaker oil price growth, after a big windfall in 2018. Some support will be provided by tourism, which has become an increasingly important driver of growth in many countries.

Despite recently very strong wage growth, we see little threat to external competitiveness for most countries. The exceptions are Bulgaria, Romania and Croatia, where merchandise trade balances have deteriorated quite significantly. Generally, across the region, firms not at the frontier in terms of productivity (especially SMEs) will face particular problems from the pressure to pay higher wages in the face of ever-worsening labour shortages.

Despite expected strong wage growth, in most CESEE countries we expect private consumption to make a smaller contribution to growth in the forecast period than in the last three years. One issue is confidence: people read the news and understand that a trade war between the world's two biggest economies is an issue that could have repercussions for them. This could in turn lead to higher savings. A second issue is demographics: populations are declining in most countries in the region. The scale of population decline projected across most of CESEE is unprecedented in peacetime, and there are only limited options to offset this. Employment rates have already risen considerably in many countries, and so the scope for further impetus from this source is limited. The model of importing workers from Ukraine to address labour shortages is not really a long-term solution. Financially incentivising people to have children will only, at best, bring results in 1–2 decades from now.

The general backdrop for investment remains quite supportive in most of the region. Business sentiment in many countries has been affected by external developments, but is still generally at historically high levels. EU funds are playing an important role, and this should continue in most EU-CEE11 countries. Meanwhile real interest rates remain very low by historical standards almost everywhere (admittedly, with the important exceptions of Russia and Turkey). FDI inflows into EU-CEE11 and the Western Balkans rose last year, but Russia and Turkey experienced declines. Labour shortages and strong wage growth could present barriers to FDI growth during the forecast period.

One possible response to increasingly acute labour shortages in the region would be an increase in productivity-enhancing investment. We see an increase in imports of industrial robots in many parts of EU-CEE11, possibly in response to labour shortages. However, these trends are by no means guaranteed to continue, and the gap between CESEE and the frontrunners in Western Europe, North America and ASia (measured in terms of robots per worker) is still generally quite high.

A factor that may discourage firms from investing more to offset labour shortages and higher wages is the negative political development in many countries. The impact of politically driven legal uncertainty on private investment in countries such as Poland and Russia has been clear for some time, and there is reason to think that this could become an issue in other countries as well. Increased authoritarianism, state capture and interference in the independence of institutions appear to be on the rise across much of CESEE, including in the EU-CEE11 countries. Institutional de-convergence over the past ten years is particularly apparent in Hungary and Turkey.

Inflation in most countries of the region is surprisingly weak, particularly in the context of last year’s sharp increase in oil prices and the very strong wage rises in some countries. The disparity between wage growth and inflation is particularly apparent in Romania, Ukraine, Belarus, Hungary, Russia, Albania, Lithuania, Bulgaria, the Czech Republic, Latvia and Poland. In all likelihood, a confluence of factors is keeping price growth low relative to wages in most of CESEE. These factors include weak inflation in the eurozone, slack in parts of the economy, a de-anchoring of inflation expectations, increased competition from online retailers, lower international food prices, higher savings rates, a relatively low labour income share, and remittance outflows. With the exception of some CIS countries (where inflation fell quite sharply last year, and will bounce back), we do not expect current inflation dynamics in CESEE to change significantly during the forecast period.

Russia and Turkey are easily the biggest economies in CESEE – and currently also the worst performing. However, while this looks like being a long-term issue for the former, we do see a somewhat brighter (albeit volatile) future for the latter. Russia is bumping along at a bit below 2%; and without major institutional and other reforms (the latter impossible to imagine any time soon), this will not change. By contrast, Turkey is in recession and has a tough near-term outlook; but by 2021, it could again be one of the fastest-growing economies in the region.

The dovish tone of our recent reports (often going against consensus expectations) has turned out to be correct. Except for in Hungary (where core inflation has risen above 3%), central banks in EU-CEE appear reluctant to tighten monetary policy, reflecting the continued weakness of inflation. The other three major EU-CEE central banks (Czech Republic, Romania and Poland) appear relaxed about inflation, with real interest rates either around zero or negative. This stance is reinforced by an increasingly dovish ECB (it would be difficult to overstate the impact of years of ultra-low policy rates by the major global central banks, and particularly the ECB, on interest rates in CESEE). The exceptions among the major CESEE central banks are Russia, Ukraine and Turkey, where policy is much tighter.

The risks to the growth outlook in our region are fairly significant, and overwhelmingly tilted to the downside. Our main concerns are unchanged from the autumn: a global trade war and sharp slowdown in the Chinese economy, a smaller EU budget from 2021, and a renewed outbreak of the eurozone crisis.

COUNTRY SUMMARIES

ALBANIA

Economic growth, supported both by domestic and external demand, will continue, but at a slower pace. Remittances – close to 6% of GDP – will boost consumption, and will also contribute to a lower current account deficit. Fiscal consolidation is expected to continue, via a cut in expenditures. Intensification of investments in renewable energy is expected to boost alternate sources of energy production. Uncertainty about FDI inflows is expected. Political unrest and massive protests threaten macroeconomic stability and the process of EU integration.

BELARUS

Economic activity slowed down abruptly in the second half of 2018 due to a combination of domestic and external factors. These include changes in Russia's energy taxation system which affect Belarus. Private consumption remained the main growth driver thanks to rising income and a boom in consumer credit. There are no imminent threats to macroeconomic stability but the short-term prospects have deteriorated and the Belarusian economy is expected to slow down in the coming years.

BOSNIA AND HERZEGOVINA

Following the general elections in October 2018, the process of government formation at the country level and in the Federation of Bosnia and Herzegovina is lengthy. Along with slightly deteriorating external conditions over the whole forecasting period, the political factors will negatively affect growth in 2019, with an estimated growth rate of 2.5%. Under the assumption that the political stalemate is resolved soon, we expect growth in 2020 and 2021 to mildly increase.

BULGARIA

The 3% increase in GDP in 2018 was below the rates of growth in the preceding years. The slowdown mirrors a weakening of exports which became a drag on economic activity. The tight labour market was adding supply constraints to growth. By contrast, private consumption surged, providing an impetus to economic activity in 2018. We expect further moderation of GDP growth in the period 2019-2011. In the absence of external shocks, the macroeconomic situation will remain stable and under control.

CROATIA

Croatia's GDP growth will continue to moderate to 2.5% in the 2019-2021 period. The main support to growth will come from private consumption and tourism. A more effective use of EU funds would be key to stimulating investments and growth. Continued emigration of young people together with the ageing of the population is becoming a growth limiting factor. Joining the euro area is high on the political agenda.

CZECH REPUBLIC

The strong rise in public investment in 2018 is to moderate in 2019 thus reducing overall growth accordingly. Tight labour markets and the ongoing wage push support private consumption. Despite this, higher inflation is not on the horizon while rising unit labour costs are responsible for falling corporate profitability and may weaken foreign trade performance. Monetary policy may become too restrictive. Fiscal policy targeting surpluses does little to support growth.

ESTONIA

Investment activity will revive in 2019-2020, induced by inflows of EU funds and increased capital spending for machinery by enterprises. Household consumption, backed by a considerable rise in employment and incomes, continues to be a strong driver of growth. However, given the weakened outlook for external demand, exports will develop at a declining pace in the coming years. We project GDP to grow at lower rates of 2.9% in 2019 and 2.5% in 2020, while even diminishing to 2.2% in 2021.

HUNGARY

Economic growth has been driven by domestic demand. Beside strong investment growth also household consumption expanded more rapidly than the GDP. In trade of goods the expansion of imports exceeded to a large extent that of the exports. The strong dependence on EU transfers, a characteristic feature of the current growth path, makes it likely that the expected huge drop in EU supported investments in 2019-2022 will significantly deteriorate Hungary's growth prospects.

KAZAKHSTAN

GDP growth reached 4% year on year in 2018, mainly owing to high oil prices and expansion of production in the oil sector. In 2019, the negative effect of the drop in oil prices on the economy will be somewhat offset by government stimulus measures directed primarily at stimulating private consumption. Nevertheless, economic growth will slow down to about 3% p.a. during the forecast period.

KOSOVO

The pace of growth will pick up to above 4% in the medium term. Consumption as well as public and private investment will provide a new impetus to growth. The external sector will be characterised by a further widening of the trade deficit. The 100% tariff on imports from Serbia is unlikely to have a strong impact on the economy. 2019 is expected to be a decisive year for the Kosovo-Serbia dialogue and their future place in the EU.

LATVIA

Both public and private investment keep the economy growing at a high pace in 2019, whereas export activity is further abating this year. Household consumption will continue to rise rapidly in 2019. While employment increases, skill shortage results in strong wage growth. The incoming coalition government may pursue a more lax fiscal policy. In 2019 we expect GDP to grow still considerably, by 3.5% in real terms, followed by a further slowdown to 3% in 2020 and 2.5% in 2021.

LITHUANIA

External demand dynamic cooled off last year and is expected to continue abating in 2019 and the coming two years. Public and private investment will drive growth for another year. Thereafter we expect private investment activity to subside gradually. A further decline in unemployment is driving rapid wage increases. In addition, the implemented income tax reform will foster growth in household consumption. For 2019, we expect real GDP to grow by 3%, followed by 2.6% in 2020 and 2.3% in 2021.

MOLDOVA

Economic growth of 4% or more for the third consecutive year in 2018 has corrected for the setbacks suffered during the bank-fraud related crisis in 2015. Inflation has come down and the local currency stabilised. Economic prospects are positive but cumbersome coalition building following inconclusive recent elections can delay necessary reforms.

MONTENEGRO

In 2018, GDP is estimated to have grown by 4% and was mostly driven by surging investment and growing exports. Employment increased considerably, but unemployment still remains high. The high government debt burden represents the largest challenge for policy-makers, which pursue an ambitious fiscal consolidation plan. During 2019-2021, economic growth will gradually slow down with an average rate of around 2.2%. In 2019, the government started the Montenegro Citizenship by Investment Programme.

NORTH MACEDONIA

The North Macedonian economy grew by 2.3% year on year in 2018 on the back of strong export growth and a pick-up in private consumption. The approval by the Greek Parliament of the new official name of North Macedonia was a major positive political development. Improved political stability will boost investor confidence and promote robust investment growth. Overall GDP will grow by about 3% p.a. during 2019-2021.

POLAND

Despite lower profits the corporate sector's financial standing and financing conditions are good. But private domestic firms are still reluctant to expand investment. Ongoing political changes are destabilising 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

Economic growth turned out at 4.2% in 2018, above wiiw expectation, and the decline to or below 3% p.a. in 2019-2021 will be below earlier forecasts. Beyond deteriorating external conditions and weak investments, new unorthodox fiscal policy measures will drag on the economy. Raising fiscal revenues by taxing turnover in the banking, telecom and energy sectors will suppress economic activity.

RUSSIA

GDP growth for 2018 surprised everybody. Net exports and investments were the main drivers, the record current account surplus and a low inflation among the cheerful passengers. But neither the pace of growth nor the size of the current account surplus is sustainable and will be maintained. Still, the accumulated reserves and cautious economic policies will serve as a buffer mitigating external risks. Stability and weak growth will thus characterise Russian developments in the coming years.

SERBIA

After a desperately weak post-crisis performance even by CESEE standards, the Serbian economy finally had a good year in 2018. Growth will weaken a bit in 2019, but remain fairly robust in the context of the last decade. A bigger slowdown is likely in 2020-2021. Domestic and international political risks have risen, which is an issue for an economy that relies so much on FDI. The EU reform process will continue to provide an important policy anchor, but accession is still many years away.

SLOVAKIA

Slovakia saw high growth in 2018, thanks to increasing household consumption and gross capital formation. However, our forecasts for this and next year have been revised downwards and amount to 3.6% in 2019 and about 3% thereafter. Domestic and external risks are on the rise.

SLOVENIA

After another successful year, GDP growth is expected to moderate to 3% or even less between 2019 and 2021. Investments spurred by EU funding and consumption backed by rising wages will continue to be important drivers of economic activity. The contribution of net exports is likely to turn negative in the forecast period given a weakening of external demand. In the medium term the shrinking of the working-age population and increasing labour shortages may become growth-limiting factors.

TURKEY

The worst of the crisis may have passed, assuming that the government does not attempt any radical measures and that relations with the US do not deteriorate. However, the economy will have a difficult year in 2019. Things should improve by 2020, with the economy bouncing back to reasonable growth. External risks remain, but the current account deficit has shrunk considerably, reducing vulnerabilities, and a more dovish US Federal Reserve provides important support.

UKRAINE

In 2018, Ukraine's economy recorded its highest growth since 2011 thanks to robustly rising wages and remittances, currency stability, and a record grain harvest. However, growth is projected to lose steam this year on the back of monetary tightening and a lower harvest, and owing to reduced gas transit revenues next year. The forthcoming presidential elections may result in more populist economic policies, but will not change the country's current EU and NATO integration efforts.

Keywords: CESEE, economic forecast, Europe, Central and Eastern Europe, Southeast Europe, Western Balkans, new EU Member States, CIS, Russia, Ukraine, Romania, Czech Republic, Hungary, Turkey, Serbia, convergence, business cycle, overheating, external risks, trade war, EU funds, private consumption, credit, investment, exports, FDI, labour markets, unemployment, employment, wage growth, unit labour costs, migration, inflation, savings rate, financial crisis, financial markets, direct lending, leverage, central banks

JEL classification: E20, E31, E32, F15, F21, F22, F32, F51, G21, H60, J20, J30, J61, O47, O52, O57, P24, P27, P33, P52