# Executive summary

**Global economic growth is at its weakest level since the end of the global financial crisis.** US protectionism (in general, but especially that directed towards China) is weighing heavily on global trade. The uncertainty surrounding Brexit and the latent risk of a repeat of 2018's emerging markets crisis are also keeping businesses and investors cautious. Meanwhile the key central banks, including the ECB, are largely out of ammunition.

**Despite the clear negative signals, we are wary of becoming too pessimistic on the global economy at this stage.** Some recent high-frequency indicators suggest a rebound in business sentiment in key economies. As the US election approaches, President Donald Trump will be keen to keep the economy running at a decent speed, and may well continue to dial down his trade war. At least for the euro area, some kind of moderate bounce-back in economic activity in 2020 is quite realistic.

**Considering the scale of the external slowdown, the resilience of CESEE has so far been impressive.** EU-CEE countries will grow by 3.8% on average this year, almost 3 percentage points higher than the euro area. Growth performance in the Western Balkans and parts of the CIS and Ukraine remains generally solid as well.

**The main factor of resilience remains stubbornly strong domestic demand, reflecting a combination of labour shortage-induced wage increases, loose fiscal policy, rapid credit growth and robust public investment.** Real income is also being supported by weak price growth. Inflation remains at generally subdued levels, despite around half of the countries in the region running negative real interest rates. This reflects lower energy prices, as well as structural factors such as negative demographic trends and the impact of online retail. Even in countries with extremely high inflation rates, such as Ukraine and Turkey, monetary policy is being loosened.

**Our business cycle monitor index has declined compared with the spring, largely owing to negative growth in Turkey.** Across CESEE, the clearest signs of potential overheating are in the labour market, (negative) real interest rates, and property prices. On the other hand, we identify current accounts and fiscal balances as the clearest instances of potential under-heating. In the historical context, no country is really showing strong signs of overheating, but the countries with the most potential for this are Hungary, the Czech Republic and Romania.

**The acute labour shortages of recent years appear to have eased somewhat in many countries.** Job vacancy rates, which indicate unmet labour demand, have recently fallen. This reflects a combination of structural labour market adjustment, stabilisation (or reduction) of labour demand and increased immigration. Despite significant political opposition in most parts of the region, a large number of non-European immigrants have arrived in many CESEE labour markets to fill gaps.

**The increasingly prevalent role of the public sector in investment projects could be an issue further down the line.** Russia, Turkey, Bulgaria and some Visegrád countries have recently witnessed a marked weakening of private investment activity in productive capacity. The investment ratios of around 20% of GDP across most of CESEE are arguably too low to lay the supply-side foundations of sustained long-term catching-up. Particularly problematic are low levels of investment in machinery and equipment. In per capita terms (at PPP), these are far below the levels of advanced countries.

**Some non-EU CESEE countries remain highly successful in attracting large-scale FDI inflows, which is an important pillar of growth for them.** 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 region increased by 28% last year, and this trend largely continued into 2019. 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, FDI has mainly gone into real estate.

**Despite the impressive degree of resilience to negative external trends thus far, we do not think that CESEE can remain unaffected.** The region’s economies are generally quite export reliant, and many are heavily plugged into the German manufacturing core. Countries with particularly high degrees of exposure to Germany and/or where the automotive sector plays a large role in manufacturing – including the Visegrád countries, Romania, North Macedonia and Serbia – are particularly vulnerable. This over-specialisation in automotive production represents a risk for the future.

**We continue to think that the peak of growth in CESEE has passed, and that the outlook is more subdued.** For our Autumn Forecast, we have made several quite substantial downgrades to our growth forecasts, especially for EU-CEE countries in 2020. We expect the effects of a weaker euro area and slower global growth to continue to ripple out through the region in the coming quarters.

**EU-CEE countries will in particular be affected by negative external trends, albeit there may be some moderate relief next year.** Private consumption in EU-CEE will continue to benefit from solid wage growth and generous social policies. Inflows of EU transfers should stay intact at least until the end of the forecasting period.

**In the Western Balkans, the outlook remains decent but underwhelming, and growth will not deliver a particularly high degree of convergence over the forecast period.** 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 of late. The delay to EU accession in particular may stall the fragile reform momentum in the region.

**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 year, making Russia the worst performer in the CESEE region. The rest of the CIS region will do better, but its strong economic integration with Russia will cap the growth potential of countries like Belarus.

**The Turkish economy will continue to rebound from the recent crisis, but downside risks remain substantial.** Quarterly growth rates have been positive since the start of 2019, helped by the typically quick adjustment of the economy following the external shock of 2018. We expect real GDP growth to be above 3% in both 2020 and 2021. However, external debt rollover needs remain substantial, making Turkey highly dependent on the mood in global financial markets, and also on good relations with the US. The military operation in northern Syria in October 2019 has introduced a particularly high degree of uncertainty to our forecasts.

**Risks to the forecast for CESEE are significant and are largely tilted to the downside** (see our risk assessment matrix, chapter 3, for full details). Two of the key risks we identified in the Spring Forecast – a major slowdown in the euro area and an intensification of the global trade war – have already materialised. In the high-risk/high-impact cell of the matrix, we now only have the smaller EU budget (which would primarily affect EU-CEE countries, although potentially also the Western Balkans). Otherwise, we are most concerned about the threat of higher US tariffs on EU car exports (medium likelihood, high impact) and a further decline in the quality/independence of institutions (high risk, medium impact).

**We see two key risks emanating from the financial sector for sub-regions of CESEE: rapid consumer credit growth in the CIS and Ukraine, and strong property price increases in EU-CEE.** First, our credit monitor continues to highlight sustained double-digit consumer lending growth in the CIS and Ukraine, at the same time as a deterioration in asset quality across the region, most significantly in Kazakhstan. Meanwhile, years of ultra-loose monetary policy have pushed down mortgage rates across much of the region, leading to the creation of potential bubbles in many EU-CEE property markets. In Hungary, housing 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%.

## COUNTRY SUMMARIES

### ALBANIA

Growth has been held back by uneven energy supply. Although it will pick up in the next two years, it will remain below its potential. Private and government consumption will continue to support growth, the former underpinned by positive labour market trends, while investment will remain subdued. Outward migration of the young and highly skilled remains a drag on growth potential. Further delays to the start of EU accession negotiations create the risk of backsliding on reforms.

### BELARUS

The Belarusian economy has weakened owing to disruption in gas and oil supplies from Russia. Economic performance in the first half of 2019 was only supported by domestic demand while exports and manufacturing output dropped. The combination of a negative external environment and policy restraint are expected to dominate in the near future as well. The short-term prospects for Belarus have deteriorated and we expect GDP growth to be around 1% in 2019 and slightly higher in the next two years.

### BOSNIA AND HERZEGOVINA

Prospects for growth are more or less where they almost always are; below 3% this year and around that level in the medium run. The political crisis is not all that consequential for the economy, but does represent a barrier to improving international relations. The key sticking point is NATO integration. It is seen as an instrument of stability (as in Montenegro and North Macedonia), but it is opposed by the majority among the Bosnian Serbs. The EU for its part has run out of ideas when it comes to this country.

### BULGARIA

After a strong first quarter, GDP growth slowed down reflecting a worsening domestic and external environment. Cost-push inflationary pressures were partly offset by the weaker domestic demand and inflation stopped rising. Domestic and external demand are expected to weaken further and this will be coupled with continued labour shortages The rate of GDP growth for 2019 as a whole will still be decent, at some 3.5%, but it is expected to slow down in the following years.

### CROATIA

The economy will grow by 2.9% in 2019, an improvement the last year, mainly due to the strengthening of domestic demand (both consumption and investment). Assuming a deterioration of the external environment, domestic demand should remain the main driver of growth in 2020-21. The goal of adopting the euro will be an incentive to continue fiscal consolidation.

### CZECH REPUBLIC

GDP growth has been losing momentum gradually as productive investment starts to decline. Labour resources are nearing depletion, but labour shortages have failed to prompt intensified capital formation. A high dependence on the car industry may become a problem. Signs of recession in Germany are spilling over into Czech manufacturing. Consumption remains the backbone of a subdued output growth. We forecast average growth of around 2.5% in the medium run.

## ESTONIA

Investment activity revived in 2019, following last year's slowdown. Furthermore, 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 3.4% in 2019, followed by a slowdown to 2.7% in 2020 and further to 2.4% in 2021.

## HUNGARY

Hungarian economic growth was strong in the first half of 2019, but the signs of a deceleration are already discernible. In Q2 compared to Q1, investment growth slowed notably, while the external environment deteriorated. From next year, EU transfers will drop by a substantial degree, further weighing on investment. Labour shortages will remain problematic, and put further upward pressure on wages. We expect a significant slowdown of economic growth over the forecast horizon, from 4.3% this year to 3.2% in 2020 and to 2.6% in 2021.

## KAZAKHSTAN

GDP growth will remain robust at 4% in 2019, driven mainly by private consumption, but will slow to around 3.5% in 2020 and 2021, as the stimulating effect of fiscal packages dies out. The current account balance will deteriorate as imports rise on the back of stronger demand for consumer and capital goods. Export growth could decelerate amid an expected economic slowdown in Kazakhstan's main trading partners.

## KOSOVO

Kosovo has been one of the fastest growing economies in the region and is likely to remain so. Growth will be supported by consumption and gross fixed capital formation. The 100% tariff imposed on imports from Serbia and Bosnia and Herzegovina in 2019 is likely to remain in place, and will continue to push up prices. The new government could deliver important domestic reforms, and is also likely to shake up international relations in the Western Balkans region.

## LATVIA

Economic growth has almost halved in comparison to the last two boom years. Investment growth has slowed, although household consumption remains robust. Although abating slightly, exports have grown more strongly than expected so far in 2019. Despite the economic slowdown, the labour market is tightening further with the unemployment rate falling towards 6.5% in 2019. This year, we expect GDP growth to decline to 2.7%, followed by a further slowdown to 2.2% in 2020 and amelioration to 2.4% in 2021.

## LITHUANIA

Growth accelerated again in 2019, underpinned in particular by public and private investment. A further decline in unemployment, a minimum wage hike and a reduction of the effective income tax rate have resulted in rapid increases in the purchasing power of households. External demand has been stronger than expected in 2019 but is likely to abate in the coming two years. For 2019, we estimate real GDP growth of 3.6%, followed by a projected slowdown to 2.4% in 2020 and 2.6% in 2021.

### MOLDOVA

Economic growth should accelerate to about 5% in 2019 on account of booming investments. After correcting for the current overheating, growth is expected to hover at around 4% in the coming years. A resumption of transfers from the IMF and EU will stabilise external financing. The current government coalition of pro-EU and pro-Russian parties has strong external support but may clash on domestic reforms.

### MONTENEGRO

Growth will slow to around 3% in the short run but may accelerate somewhat beyond that, depending primarily on the resumptions of ambitious government investments. Politically, the opposition is yet to find a way to challenge the governing coalition, though the democratic deficit is taking its toll on internal and external credibility. Montenegro is a front-runner in EU integration, though the prospects of accession are not rosy as the EU does not appear to be interested in enlargement any time soon.

### NORTH MACEDONIA

The economy is recovering after its growth came to a halt during the political crisis two years ago. The potential growth rate is around 4%, at least as long as there is large slack in the labour market. Growth should be above 3% this year, and increase further in the medium run. The delayed start to EU accession negotiations could yet have negative repercussions for domestic politics.

### POLAND

Broad-based economic growth has continued. German economic stagnation is not yet affecting foreign trade, but industrial output has started to underperform. A strong rise in gross fixed capital formation primarily reflects larger infrastructural and public sector investments. Household consumption is driven by strongly rising wages and social transfers. Labour shortages have become less acute while moderate inflation is back. The next government may feel obliged to continue the lavish social policies.

### ROMANIA

Economic growth is even stronger than last year, and could reach 4.2% in 2019, driven by household consumption and investment. Monetary and fiscal policy remains loose. Expanding deficits can be easily financed due to abundant international liquidity, albeit at a relatively high cost, constituting a burden for the future. Weaker external demand is already feeding through to industrial production, and will act as a barrier to growth in the future. We expect the interim government to take steps to curtail the fiscal deficit in 2020.

### RUSSIA

Growth in the first half of the year decelerated sharply, largely on account of weaker investment activity and declining net exports. Private consumption remains weak, constrained not least by the tight fiscal policy, although monetary policy has been softened in response to recent disinflation. Even with the planned start of infrastructure projects and increased social spending, it is difficult to see the Russian economy growing above 2% p.a. in the medium term.

### SERBIA

After posting comfortably its strongest real GDP increase for a decade in 2018, the Serbian economy has adjusted back to a more muted growth path, and should expand by just under 3% this year. Growth of 2.5-3% is likely during the rest of the forecast period, with the government set to remain focussed on

FDI-driven investment. Political tensions in the region are rising, but would have to get much worse to constitute a significant downside risk to the economy.

### SLOVAKIA

Slovakia's growth decelerated sharply in the second quarter of 2019 due to declining exports and investments. Growth in the key automotive industry turned negative in June. Growth will slow down in the coming years, with forecasts for this and next year amounting to 2.3% and 2.2%.

### SLOVENIA

After a strong increase in 2018, economic activity slowed in the course of 2019 due to weakening foreign demand. However, thanks to a continued rise in consumption and investments, GDP growth will end up at a fairly robust 2.9% for the year as a whole, with unemployment reaching record lows. In the coming years we expect GDP growth to remain subdued, driven mostly by domestic demand. Banking privatisation has been finally completed after a long lasting process.

### TURKEY

The economy is expanding in quarterly terms, but overall growth is still likely to be negative in 2019. From next year the recovery will firm; we expect the economy to expand by a bit more than 3% in 2020-21. However, while external vulnerabilities are much reduced, the possibility of serious sanctions and volatility in the exchange rate related to the military operation in Northern Syria pose material downside risks to our forecasts.

### UKRAINE

Progress in the peace negotiations with Russia and the reform agenda of the new government sent strong positive signals to investors. If the reforms are implemented the economy will receive a significant boost, though it will likely only be felt in the medium run. During 2019-2021, GDP growth will remain rather moderate at around 3% per annum. The major negative risk to the forecast is inability of the government to shake off the influence of oligarchs.

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