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Monthly Report

Winter Forecast Update

Strong Growth but Big Downside Risks in 2022

Economic Forecasts for Eastern Europe for 2022-24

The Vienna Institute for International Economic Studies
Wiener Institut für Internationale Wirtschaftsvergleiche

Winter Forecast Update

Strong Growth but Big Downside Risks in 2022

Economic Forecasts for Eastern Europe for 2022-24

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Cut-off date for historical data and forecasts: 19 January 2022. Most data are taken from the wiiw Databases. Direct access is available at: https://data.wiiw.ac.at/.

ABBREVIATIONS

EUR	euro
USD	US dollar
BIS	Bank for International Settlements
CIS	Commonwealth of Independent States
COVID-19	coronavirus disease
CPI	consumer price index
EA	euro area 19 countries
ECB	European Central Bank
EU	European Union
FDI	foreign direct investment
GDP	gross domestic product
HICP	harmonised index of consumer prices
ICT	information and communications technology
IMF	International Monetary Fund
KDNP	Christian Democratic People's Party (Hungary)
LFS	Labour Force Survey
NATO	North Atlantic Treaty Organization
NCU	national currency units
NGEU	NextGenerationEU
OPEC	Organization of the Petroleum Exporting Countries
PMI	purchasing managers' index
pp	percentage points
RRF	Recovery and Resilience Facility
wiiw	The Vienna Institute for International Economic Studies
.	not available (in tables)
bn	billion
eop	end of period
m	million
p.a.	per annum
Q1 2021	first quarter of 2021
y-o-y	year on year

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wiiw COUNTRY GROUPS

CESEE23 Central, East and Southeast Europe

AL	Albania	ME	Montenegro
BA	Bosnia and Herzegovina	MK	North Macedonia
BG	Bulgaria	PL	Poland
BY	Belarus	RO	Romania
CZ	Czechia	RS	Serbia
EE	Estonia	RU	Russia
HR	Croatia	SI	Slovenia
HU	Hungary	SK	Slovakia
KZ	Kazakhstan	TR	Turkey
LT	Lithuania	UA	Ukraine
LV	Latvia	XK	Kosovo
MD	Moldova		

EU-CEE11 Central and East European EU members

BG	Bulgaria	LV	Latvia
CZ	Czechia	PL	Poland
EE	Estonia	RO	Romania
HR	Croatia	SI	Slovenia
HU	Hungary	SK	Slovakia
LT	Lithuania		

V4	**Visegrád countries**	**BALT3**	**Baltic countries**
CZ	Czechia	EE	Estonia
HU	Hungary	LT	Lithuania
PL	Poland	LV	Latvia
SK	Slovakia		

SEE9 Southeast Europe

AL	Albania	MK	North Macedonia
BA	Bosnia and Herzegovina	RO	Romania
BG	Bulgaria	RS	Serbia
HR	Croatia	XK	Kosovo
ME	Montenegro		

non-EU12 Non-European Union CESEE countries

AL	Albania	MK	North Macedonia
BA	Bosnia and Herzegovina	RS	Serbia
BY	Belarus	RU	Russia
KZ	Kazakhstan	TR	Turkey
MD	Moldova	UA	Ukraine
ME	Montenegro	XK	Kosovo

WB6	**Western Balkans**		
AL	Albania	MK	North Macedonia
BA	Bosnia and Herzegovina	RS	Serbia
ME	Montenegro	XK	Kosovo

CIS3+UA	**Commonwealth of Independent States-3 and Ukraine**		
BY	Belarus	MD	Moldova
KZ	Kazakhstan	UA	Ukraine

CIS4+UA	**Commonwealth of Independent States-4 and Ukraine**		
BY	Belarus	RU	Russia
KZ	Kazakhstan	UA	Ukraine
MD	Moldova		

EU27	**European Union**		
AT	Austria	IE	Ireland
BE	Belgium	IT	Italy
BG	Bulgaria	LT	Lithuania
CY	Cyprus	LU	Luxembourg
CZ	Czechia	LV	Latvia
DE	Germany	MT	Malta
DK	Denmark	NL	Netherlands
EE	Estonia	PL	Poland
EL	Greece	PT	Portugal
ES	Spain	RO	Romania
FI	Finland	SE	Sweden
FR	France	SI	Slovenia
HR	Croatia	SK	Slovakia
HU	Hungary		

EA19	**Euro area**		
AT	Austria	IT	Italy
BE	Belgium	LT	Lithuania
CY	Cyprus	LU	Luxembourg
DE	Germany	LV	Latvia
EE	Estonia	MT	Malta
EL	Greece	NL	Netherlands
ES	Spain	PT	Portugal
FI	Finland	SI	Slovenia
FR	France	SK	Slovakia
IE	Ireland		

January 2022 interim forecast update

Table 1 / OVERVIEW 2020-2021 AND OUTLOOK 2022-2024

		GDP real change in % against prev. year					Consumer prices average change in % against prev. year					Unemployment (LFS) rate in %, annual average				
				Forecast					Forecast					Forecast		
		2020	2021 1)	2022	2023	2024	2020	2021	2022	2023	2024	2020	2021 1)	2022	2023	2024
BG	Bulgaria	-4.4	3.5	3.8	3.5	3.5	1.2	2.8	6.0	3.5	2.5	5.1	5.0	4.5	4.0	4.0
CZ	Czechia	-5.8	2.8	4.0	3.6	3.6	3.3	3.3	5.3	2.5	2.2	2.6	2.9	2.5	2.5	2.5
EE	Estonia	-3.0	7.8	3.5	4.0	3.3	-0.6	4.5	5.5	2.8	2.2	6.8	6.5	5.8	4.9	4.7
HR	Croatia	-8.1	8.7	4.7	4.1	3.3	0.0	2.7	3.0	2.0	1.9	7.5	8.0	7.0	6.7	6.6
HU	Hungary	-4.7	6.3	4.5	4.0	3.7	3.4	5.2	5.0	3.7	3.2	4.3	4.2	3.9	3.8	3.7
LT	Lithuania	-0.1	5.0	3.7	3.3	2.9	1.1	4.6	4.4	2.8	2.0	8.5	7.2	6.8	6.2	6.0
LV	Latvia	-3.6	4.5	4.3	3.6	3.0	0.1	3.2	5.2	3.1	2.5	8.1	7.6	6.9	6.5	6.2
PL	Poland	-2.5	5.3	4.9	4.9	4.3	3.7	5.2	5.3	3.6	3.0	3.2	3.2	3.0	2.9	2.9
RO	Romania	-3.7	6.6	4.3	4.5	4.8	2.3	4.1	5.5	3.0	3.5	5.0	4.8	4.5	4.0	3.5
SI	Slovenia	-4.2	6.6	4.1	3.3	3.0	-0.3	2.0	3.2	1.5	1.5	5.0	4.3	4.0	3.9	3.6
SK	Slovakia	-4.4	3.0	3.9	3.7	3.3	2.0	2.8	4.5	2.5	2.0	6.7	6.9	6.5	5.9	5.7
	EU-CEE11 1)2)	*-3.7*	*5.3*	*4.4*	*4.3*	*4.0*	*2.7*	*4.3*	*5.1*	*3.1*	*2.8*	*4.4*	*4.3*	*4.0*	*3.8*	*3.6*
	EA19 3)	*-6.4*	*5.1*	*4.2*	*2.9*	*1.8*	*0.3*	*2.6*	*3.2*	*1.8*	*1.7*	*7.9*	*7.7*	*7.3*	*6.9*	*6.6*
	EU27 3)	*-5.9*	*5.3*	*4.4*	*3.1*	*2.0*	*0.7*	*2.9*	*3.4*	*2.0*	*1.9*	*7.1*	*6.9*	*6.5*	*6.1*	*5.8*
AL	Albania	-4.0	8.2	4.2	4.0	3.8	1.6	2.0	2.9	2.8	2.8	11.7	11.3	11.1	10.8	10.5
BA	Bosnia and Herzegovina	-3.2	4.8	2.5	2.8	2.6	-1.1	1.9	2.6	2.2	1.8	15.9	16.9	16.5	15.9	15.5
ME	Montenegro	-15.3	11.4	4.5	3.0	2.7	-0.3	2.4	3.6	1.1	2.0	17.9	16.9	16.3	15.2	14.0
MK	North Macedonia	-6.1	4.0	3.5	3.2	3.0	1.2	3.2	3.5	2.5	2.0	16.4	15.7	15.2	14.8	14.5
RS	Serbia	-0.9	7.5	4.9	4.5	4.0	1.6	4.1	4.5	2.5	2.0	9.0	10.0	9.0	8.5	8.0
XK	Kosovo	-5.3	8.8	4.3	4.0	4.0	0.2	3.4	3.2	2.5	2.5	25.9	25.4	25.0	24.5	24.0
	WB6 1)2)	*-3.3*	*7.0*	*4.2*	*3.9*	*3.5*	*0.9*	*3.2*	*3.7*	*2.4*	*2.1*	*13.0*	*13.4*	*12.7*	*12.0*	*11.6*
TR	Turkey	1.8	9.5	3.5	3.5	4.0	12.3	19.6	26.2	16.0	12.0	13.2	13.1	12.5	12.0	11.0
BY	Belarus	-0.7	2.3	1.0	2.0	2.0	5.5	9.5	10.0	9.0	8.0	4.0	4.0	3.9	3.8	3.8
KZ	Kazakhstan	-2.5	3.9	4.2	4.4	4.1	6.8	8.0	6.9	6.0	5.5	4.9	4.9	4.8	4.8	4.8
MD	Moldova	-7.4	7.8	4.0	4.5	4.5	3.8	5.1	9.0	4.0	4.0	3.8	3.8	3.5	3.0	3.0
RU	Russia	-2.7	4.5	2.0	1.5	1.5	3.4	6.7	7.1	4.4	3.9	5.8	5.0	4.7	4.5	4.5
UA	Ukraine	-3.8	3.1	3.5	3.5	4.0	2.7	9.4	6.0	5.0	4.5	9.5	9.0	8.0	8.0	7.0
	CIS4+UA 1)2)	*-2.7*	*4.2*	*2.3*	*2.0*	*2.0*	*3.7*	*7.2*	*7.1*	*4.8*	*4.3*	*6.2*	*5.6*	*5.2*	*5.0*	*4.9*
	V4 1)2)	*-3.6*	*4.8*	*4.6*	*4.4*	*4.0*	*3.4*	*4.6*	*5.2*	*3.3*	*2.8*	*3.5*	*3.6*	*3.4*	*3.2*	*3.2*
	BALT3 1)2)	*-1.7*	*5.5*	*3.8*	*3.5*	*3.0*	*0.4*	*4.2*	*4.9*	*2.9*	*2.2*	*8.0*	*7.2*	*6.6*	*6.0*	*5.8*
	SEE9 1)2)	*-4.2*	*6.4*	*4.2*	*4.2*	*4.2*	*1.6*	*3.6*	*4.9*	*2.8*	*2.9*	*8.1*	*8.1*	*7.8*	*7.1*	*6.6*
	CIS3+UA 1)2)	*-2.9*	*3.4*	*3.4*	*3.7*	*3.7*	*4.8*	*8.8*	*7.0*	*6.0*	*5.4*	*7.2*	*6.9*	*6.4*	*6.3*	*5.8*
	non-EU12 1)2)	*-1.4*	*5.9*	*2.7*	*2.5*	*2.7*	*6.1*	*10.6*	*12.5*	*7.9*	*6.4*	*8.0*	*7.6*	*7.2*	*6.9*	*6.5*
	CESEE23 1)2)	*-2.1*	*5.7*	*3.2*	*3.0*	*3.1*	*5.1*	*8.7*	*10.3*	*6.5*	*5.3*	*7.1*	*6.8*	*6.4*	*6.0*	*5.7*

Table 1 / OVERVIEW 2020-2021 AND OUTLOOK 2022-2024 (contd.)

		Current account in % of GDP					Fiscal balance in % of GDP				
				Forecast					Forecast		
		2020	2021 1)	2022	2023	2024	2020	2021 1)	2022	2023	2024
BG	Bulgaria	-0.3	-1.1	-0.6	-0.3	0.0	-4.0	-4.0	-3.0	-2.5	-2.0
CZ	Czechia	3.6	0.4	1.0	0.8	0.7	-5.6	-6.9	-5.0	-4.0	-3.2
EE	Estonia	-0.3	-3.7	-0.5	-0.2	0.3	-5.6	-4.0	-2.0	-1.5	-0.8
HR	Croatia	-0.1	0.6	0.5	0.4	0.6	-7.4	-4.5	-2.9	-2.5	-2.5
HU	Hungary	-1.6	-1.5	-1.0	-0.8	-0.4	-8.0	-7.8	-5.5	-3.7	-3.0
LT	Lithuania	7.3	2.8	1.7	1.5	1.2	-7.2	-6.2	-4.0	-2.5	-1.9
LV	Latvia	2.9	-2.7	-1.9	-1.8	-1.5	-4.5	-8.0	-4.8	-2.3	-1.7
PL	Poland	2.9	1.0	1.5	1.3	1.3	-7.1	-5.5	-4.5	-3.6	-3.0
RO	Romania	-5.0	-7.0	-6.5	-5.5	-4.8	-9.3	-7.0	-6.0	-4.5	-3.0
SI	Slovenia	7.4	5.2	4.6	4.7	5.0	-7.7	-6.7	-2.4	-2.5	-2.1
SK	Slovakia	0.1	-2.1	-2.4	-2.4	-1.9	-5.5	-7.1	-5.1	-4.1	-3.0
	EU-CEE11 1)2)	*1.2*	*-0.8*	*-0.4*	*-0.3*	*-0.1*	*-7.0*	*-6.2*	*-4.7*	*-3.6*	*-2.8*
	EA19 3)	*2.8*	*2.0*	*1.8*	*1.9*	*2.1*	*-7.2*	*-5.9*	*-3.2*	*-2.1*	*-1.8*
	EU27 3)	*2.8*	*2.0*	*1.8*	*1.9*	*2.1*	*-6.9*	*-5.5*	*-2.8*	*-1.7*	*-1.4*
AL	Albania	-8.8	-7.7	-7.1	-6.9	-6.7	-6.8	-5.0	-3.5	-2.5	-2.0
BA	Bosnia and Herzegovina	-3.8	-2.5	-2.9	-3.0	-3.3	-5.3	-2.2	-0.8	-0.5	0.5
ME	Montenegro	-26.1	-13.5	-14.9	-13.0	-12.0	-11.1	-3.4	-6.3	-5.0	-4.0
MK	North Macedonia	-3.4	-2.0	-3.0	-3.5	-3.5	-8.3	-4.3	-3.5	-2.5	-2.0
RS	Serbia	-4.1	-3.0	-3.5	-3.8	-4.0	-8.0	-3.0	-2.5	-2.0	-2.0
XK	Kosovo	-7.0	-7.5	-7.0	-6.8	-6.8	-7.6	0.2	-1.5	-1.5	-1.0
	WB6 1)2)	*-5.7*	*-4.2*	*-4.6*	*-4.6*	*-4.7*	*-7.5*	*-3.1*	*-2.6*	*-2.0*	*-1.6*
TR	Turkey	-5.0	-2.3	-2.0	-2.0	-3.5	-2.8	-2.8	-3.0	-2.5	-2.5
BY	Belarus	-0.4	1.6	0.6	0.4	0.0	-1.7	-2.0	-2.0	-1.0	-1.0
KZ	Kazakhstan	-3.8	-3.2	-2.5	-2.0	-2.5	-4.0	-3.3	-3.2	-2.6	-2.5
MD	Moldova	-7.5	-9.5	-7.5	-7.0	-6.0	-8.5	-6.0	-7.0	-5.0	-5.0
RU	Russia	2.4	7.3	6.5	5.0	5.0	-4.0	1.0	0.8	0.5	0.5
UA	Ukraine	3.4	-0.9	-2.0	-2.5	-3.0	-5.3	-3.0	-2.5	-2.0	-2.0
	CIS4+UA 1)2)	*1.8*	*5.4*	*4.7*	*3.5*	*3.5*	*-4.1*	*0.1*	*0.0*	*-0.1*	*-0.1*
	V4 1)2)	*2.2*	*0.2*	*0.7*	*0.5*	*0.6*	*-6.8*	*-6.3*	*-4.8*	*-3.8*	*-3.0*
	BALT3 1)2)	*4.2*	*-0.4*	*0.1*	*0.1*	*0.2*	*-6.0*	*-6.1*	*-3.7*	*-2.2*	*-1.6*
	SEE9 1)2)	*-3.9*	*-4.6*	*-4.4*	*-3.9*	*-3.5*	*-7.9*	*-5.4*	*-4.4*	*-3.4*	*-2.5*
	CIS3+UA 1)2)	*-0.6*	*-1.8*	*-2.0*	*-2.0*	*-2.4*	*-4.3*	*-3.1*	*-2.9*	*-2.2*	*-2.2*
	non-EU12 1)2)	*-0.3*	*2.9*	*2.5*	*1.7*	*1.2*	*-3.9*	*-0.8*	*-0.9*	*-0.8*	*-0.8*
	CESEE23 1)2)	*0.3*	*1.5*	*1.4*	*0.9*	*0.7*	*-5.1*	*-2.8*	*-2.3*	*-1.9*	*-1.6*

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. Cut-off date for historical data and forecasts: 19 January 2022.

Table 2 / Policy rate and exchange rate for selected CESEE countries: overview 2020-2021 and outlook 2022-2024

		Policy rate eop, p.a.					Exchange rate NCU/EUR average				
				Forecast					Forecast		
		2020	2021	2022	2023	2024	2020	2021	2022	2023	2024
AL	Albania	0.50	0.50	0.50	0.50	0.50	123.8	122.5	122.8	122.5	122.0
BY	Belarus	7.75	9.25	9.50	9.00	8.00	2.789	2.992	3.1	3.2	3.3
CZ	Czechia	0.25	3.75	4.00	3.25	2.75	26.5	25.6	24.6	24.3	24.8
HR	Croatia	3.00	3.00	3.00	3.00	3.00	7.538	7.528	7.52	7.51	7.50
HU	Hungary	0.60	2.40	4.00	4.00	3.50	351.3	358.5	360	350	350
KZ	Kazakhstan	9.00	9.75	9.50	9.00	8.50	471.4	503.9	502	507	513
MD	Moldova	2.65	6.50	7.50	4.00	4.00	19.7	20.9	21.5	21.0	21.0
MK	North Macedonia	1.50	1.25	1.75	2.00	2.25	61.7	61.6	61.7	61.7	61.7
PL	Poland	0.10	1.75	2.50	2.50	2.25	4.443	4.565	4.55	4.55	4.55
RO	Romania	1.50	1.75	3.50	2.50	2.00	4.838	4.922	5.00	5.02	5.05
RS	Serbia	1.00	1.00	1.50	2.00	2.50	117.6	117.6	117.6	117.0	116.5
RU	Russia	4.25	8.50	8.00	6.00	5.50	82.4	87.2	91.0	93.0	95.0
TR	Turkey	17.00	14.00	14.00	14.00	12.00	8.05	10.51	14.2	15.0	15.6
UA	Ukraine	6.00	9.00	7.50	6.50	5.00	30.8	32.3	32.0	33.0	34.0

Source: wiiw, forecasts by wiiw. Cut-off date for historical data and forecasts: 19 January 2021.

1 Strong growth but big downside risks in 2022

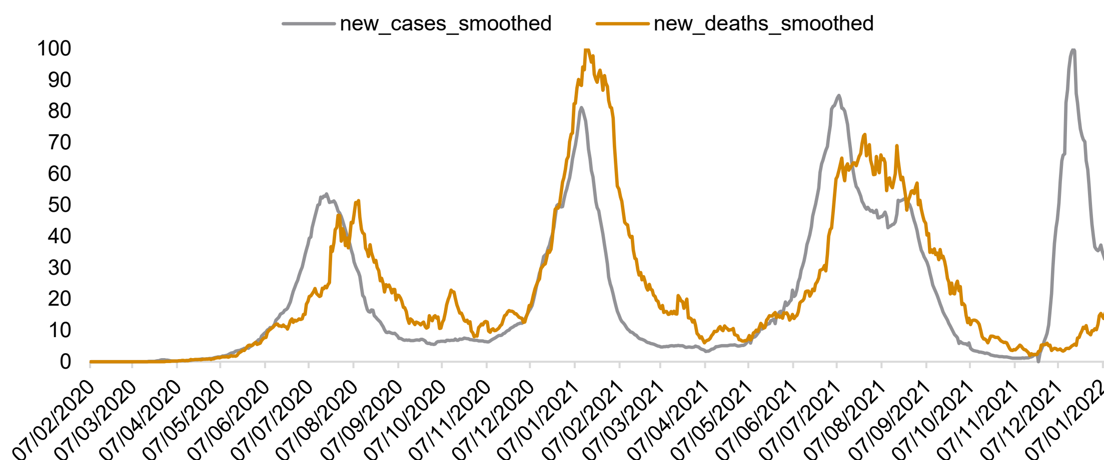
BY RICHARD GRIEVESON

- **The global economy is continuing to recover, but currently high inflation will eat into real incomes and cause a moderate slackening of growth momentum, compared with previous forecasts. Supply-chain disruptions could ease, but will not fully disappear this year.**
- **Interest rates are rising, creating risks in particular for dollar borrowers in emerging markets, but real rates remain firmly negative and overall financial conditions are still quite loose.**
- **In CESEE, both inflation and COVID-19 cases are rising rapidly. Plan A in the region seems to be to hope that both problems largely resolve themselves, with real interest rates set to remain mostly negative and COVID-19 restrictions limited.**
- **Our baseline macroeconomic outlook for the region is relatively upbeat, reflecting adaptability, resilience, and the assumption that the vast majority of COVID-19 cases in the current and any further waves of the pandemic will be very mild.**
- **Although CESEE growth will slow from 5.7% last year to 3.2% in 2022, this reflects the phasing-out of favourable base effects from 2020 and the weak performance of the region's two biggest economies, Russia and Turkey. In both EU-CEE and the Western Balkans, real growth will top 4% this year – a slowdown from 2021, but still a healthy rate of expansion.**
- **However, there are material downside risks to these forecasts. High inflation may well have a much bigger dampening impact on economic growth than we currently expect. And the COVID-19 wave is hitting an often unvaccinated and elderly population.**
- **Meanwhile, political risks are at their highest since 2014 in the former Soviet Union, and highest since the 1990s in the Western Balkans. A Russian invasion of Ukraine would lead to a renewed exchange of sanctions with the West and an even sharper spike in energy prices, damaging the economies of both sides.**

1.1 GLOBAL ASSUMPTIONS: CONTINUED STRONG RECOVERY WITH MAJOR DOWNSIDE RISKS

Despite a surge in cases, the pandemic is not currently a major barrier to global economic activity; that applies also to the euro area, CESEE's most important market and source of capital flows. Vaccination rates in much of Western Europe are high, and the dominant variant of COVID-19 is mostly mild. Any statements about the future path of the pandemic should be couched very tentatively, but data from South Africa – where the current dominant Omicron strain was first detected – suggest that the current wave in Europe will pass quickly (Figure 1). Thanks to both the mildness of Omicron and the increased vaccination rates, the relationship between cases and severe public health outcomes appears to be much weaker than in previous waves. More risk-averse countries will maintain some restrictions, and activity will face disruptions as large numbers of workers contract the virus and have to stay at home; but the impact on economic growth is likely to be limited. Taken together, this implies that 2022 should be a good year for the European economy.

Figure 1 / New COVID-19 cases and deaths in South Africa, peak for each series = 100



Source: Our World in Data. Updated 18 January 2022.

However, beyond that, there are far more difficult questions about the impact of the pandemic on economic life. COVID is on its way to becoming endemic (as has long been clear), and rich countries with high vaccination rates, such as Spain, are already starting to think about the virus in these terms. However, in poor and/or low-vaccination countries, that is much more difficult. For the global economy as a whole, this is a major problem, particularly for as long as China sticks with its zero-COVID policy. Until the developing world is more fully vaccinated (and that is about willingness, not just supply), there will likely be more variants. A variant that is more deadly would see the return of hard lockdowns. Meanwhile, until all countries are willing and able to treat the virus as endemic, there will be more restrictions on trade.

The year 2021 was actually quite a good one for the global economy, with full-year expansion estimated at 5.5% by the World Bank. Based on this, the global economy easily recovered the ground it lost in 2020, when it contracted by 3.4%. This recovery came despite several waves of the pandemic, and again demonstrated the impressive adaptability and resilience of economies, with each wave apparently having a less negative economic effect than the previous one. However, towards the end of last year, the balance of risks tilted decisively to the downside, owing to rising inflation, supply-chain bottlenecks, a potential real-estate crisis in China, and a great deal of important and worrying political noise (see the chapter ‘Political risks in CESEE in 2022’).

The global economy therefore enters 2022 with a good level of underlying growth momentum, but also with a daunting list of challenges facing it. The most recent forecasts by major institutes have tended to see much higher inflation and somewhat lower economic growth for 2022, relative to previous projections (although the growth adjustments have tended to be quite minor). For the euro area, we expect the harmonised index of consumer prices (HICP) to rise by 3.2% this year (on an annual average basis) – a rate that is 1.6 percentage points higher than we anticipated in autumn 2021 (Table 3). However, we expect this to reduce growth by only 0.2 percentage points, relative to our previous projection, with the euro area economy expanding by a historically very strong 4.2% this year.

Table 3 / Global assumptions, wiiw global forecasts Winter 2022

	Euro area				EU			
	2021	2022	2023	2024	2021	2022	2023	2024
Real GDP growth, % per year	5.1	4.2	2.9	1.8	5.3	4.4	3.1	2.0
CPI, % per year	2.6	3.2	1.8	1.7	2.9	3.4	2.0	1.9
Unemployment rate, %	7.7	7.3	6.9	6.6	6.9	6.5	6.1	5.8
Current account, % of GDP	2.0	1.8	1.9	2.1	2.0	1.8	1.9	2.1
Fiscal balance, % of GDP	-5.9	-3.2	-2.1	-1.8	-5.5	-2.8	-1.7	-1.4
EUR/USD	1.18	1.14	1.14	1.14				
Brent crude, US$ per barrel	71.8	78.0	73.0	68.0				

Source: ECB, own forecasts.

Our core scenario for the global economy is that 2022 will be a challenging year, but that ultimately firms, consumers and governments will be resilient enough to mostly overcome it without a dramatic break in growth momentum. Inflation is not going to fall as quickly as key central banks maintained throughout most of 2021, and supply-chain problems will also not be rapidly unwound. Getting through the current Omicron wave will likewise not be easy for every country – especially not for those with older populations and/or low vaccination rates – while China's zero-COVID policy will exert pressure on global trade throughout the year. However, the mildness of the Omicron wave and the speed of its passing, the still-favourable base effects (not least in the euro area), and the now repeatedly demonstrated resilience and adaptability of the global economy in the face of the pandemic will ensure another year of strong growth by post-2008 standards.

The most serious challenge to this outlook, and the greatest area of uncertainty in 2022 and beyond, is the path of inflation and how the major central banks respond to it. US inflation hit a 39-year high of 7%, year on year, in December 2021, with the corresponding rate for the euro area reaching 5%, its most elevated level since the single currency was formed. Energy prices have been an important driver of this. As of 18 January 2022, the front-month gas price at the Dutch TTF hub, Europe's natural gas trading benchmark, was EUR 78.30 per megawatt-hour, compared with an average of EUR 19.80 for the same month last year, an increase of almost 300% (Belyi, 2021).

While commodity costs are a major driver of headline consumer price inflation, it is clear that price pressures are now much broader, and that inflation will not be as transitory as central banks were proclaiming only a few months ago. Along with energy prices, current inflation rates also reflect a basic imbalance between supply and demand, linked to the pandemic. Due to restrictions, consumers stayed at home more, but often replaced spending on services with spending on goods. This led to a surge in demand for consumer durables that caught firms on the hop, and they have struggled to keep up. Fiscal stimulus, especially in the US, has added to the increased demand. That has been compounded by supply dislocations, owing to, for example, blockages at US ports and the impact of China's zero-COVID policy. The 'great resignation' has also caused labour tightness in some places – notably the US, but also parts of the euro area. The Bank for International Settlements (BIS) estimates that these supply dislocations alone increased US inflation by 2.8 percentage points in 2021 (Rees and Rungcharoenkitkul, 2021).

The most likely scenario continues to be that these factors will remain quite important throughout 2022. Supply dislocations will not disappear this year – not least because of China's continued zero-COVID policy, the delay in scaling up production to meet demand, and overreactions to the supply/demand imbalance (the so-called 'bullwhip economy').[1] Easing restrictions as the Omicron wave passes will also lead to higher demand for services, where labour market tightness is also likely to be evident. Meanwhile, energy prices could yet go higher, at least for a short time: various investment bank research departments now expect USD 100 oil at some point this year, due to robust global growth and dwindling spare capacity.[2] The price of oil in dollar terms has recovered spectacularly since the depths of the pandemic in April 2020 (Figure 2).

Figure 2 / Brent crude, USD per barrel

Source: Investing.com.

However, the worst of the supply dislocations are likely to have passed, and a sustained period of high energy prices also seems unlikely, meaning that inflation will not be strong enough or persistent enough to fundamentally knock the recovery off course during our forecast period. A new measure of worldwide supply constraints produced by the Federal Reserve Bank of New York suggests that the peak of supply pressure was in October (Figure 3).[3] And in general, supply chains have actually held up very well. Last year, major economies, including the US and Germany, exceeded the 2019 levels of durable goods consumption. The much-discussed semiconductor shortage has somewhat obscured the fact that both Taiwan and South Korea recorded year-on-year growth in semiconductor exports in both 2020 and 2021 (Rees and Rungcharoenkitkul, 2021). Although world trade volumes dipped a bit in the second half of 2021, they remain very close to their long-term trend (Figure 4). An excess of demand, rather than a shortage of supply, has been the real story in global trade over the past 18 months. This underlines the point that much of the current surge in inflation is also healthy, even if it does cause short-term difficulties. Strong growth and higher inflation reflect a strong

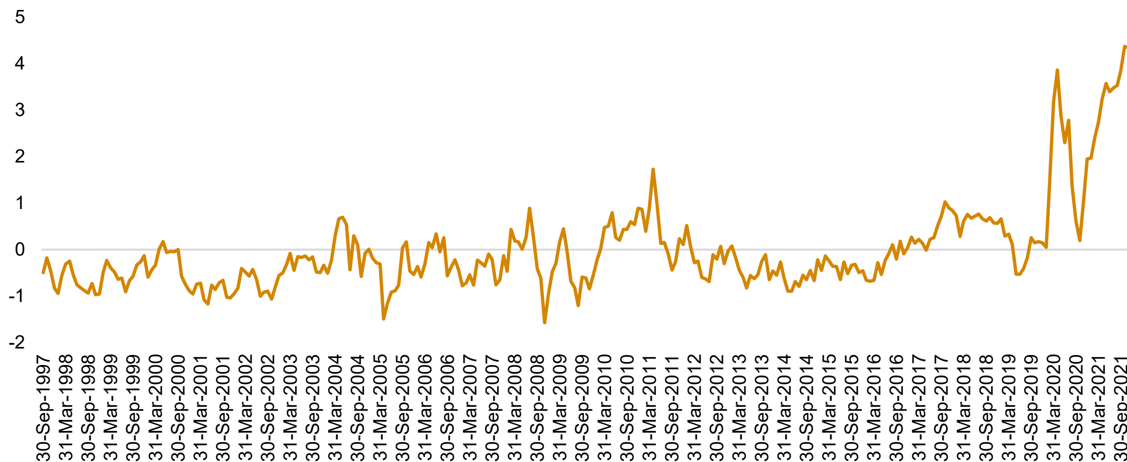
[1] https://www.ft.com/content/9444643e-9d43-4e5f-92d8-78c64c9414db?emailId=61db2df6f94b090004ac6d53&segmentId=1ce3de53-bbd6-f782-fb6e-1124c8f8297f

[2] https://www.ft.com/content/70f58398-8911-45d3-b1b0-cc16c4ac184d?emailId=61e6f420ff04e10004997285&segmentId=488e9a50-190e-700c-cc1c-6a339da99cab

[3] https://libertystreeteconomics.newyorkfed.org/2022/01/a-new-barometer-of-global-supply-chain-pressures/

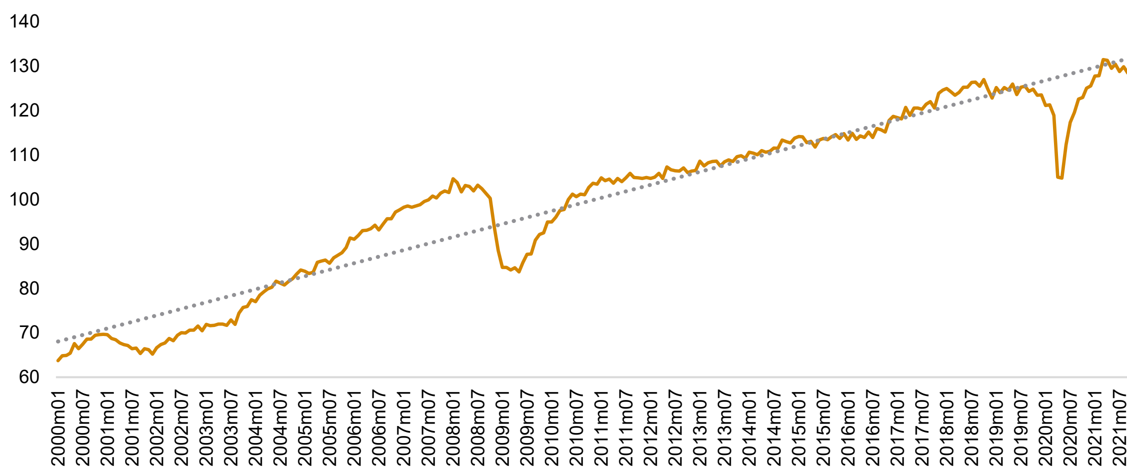
recovery from the pandemic, engineered by a robust policy response that has demonstrated that the key lessons of 2008 and its aftermath have been learned.

Figure 3 / Global supply-chain pressure index



Note: The index is normalised such that a zero indicates that the index is at its average value, with positive values representing how many standard deviations the index is above this average value (and negative values representing the opposite).
Sources: Federal Reserve Bank of New York; Bureau of Labor Statistics; Harper Petersen Holding GmbH; Baltic Exchange; IHS Markit; Institute for Supply Management; Haver Analytics; Bloomberg L.P.; authors' calculations.

Figure 4 / World trade volume, 2010 = 100



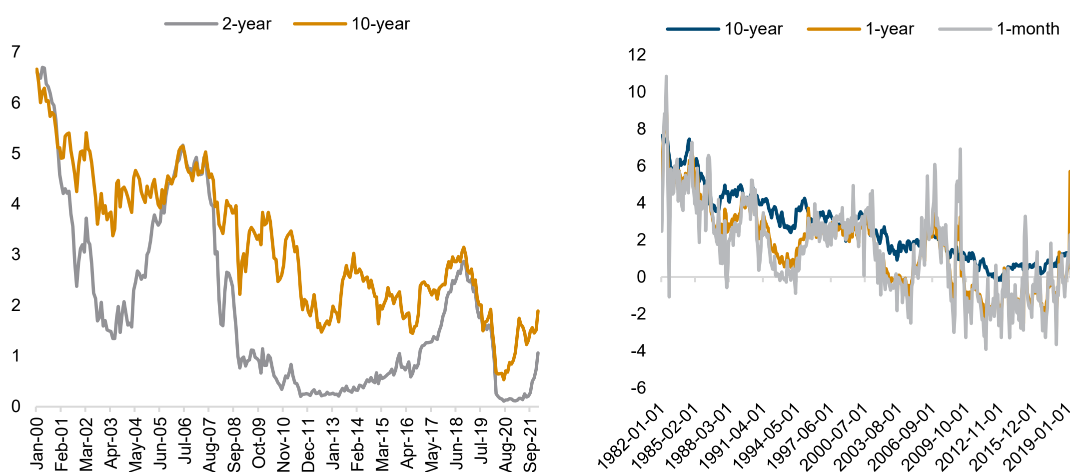
Source: CPB Netherlands Bureau for Economic Policy Analysis.

A key factor in determining how much of a problem inflation is for the global economy will be the actions of major central banks, and in particular the Fed. Currently, market commentary is dominated by noise around the scale and pace of rate hikes by the Fed in 2022. Consensus expectations imply total tightening of around 100 basis points this year. Whether the rate goes up by a further 25 basis points, or whether the first hike is in March or in June, is very unlikely to be decisive. More important from the perspective of the global economy is how orderly and well communicated this

tightening is, and what the end point will be. A steady, well-communicated increase in short-end US rates back towards 2% in nominal terms over the next couple of years would certainly cause some problems (for example, among non-investment-grade credit in emerging markets), but is unlikely to knock the global recovery off course.

According to the core scenario, real interest rates will remain negative for some time to come, and thereby – even with nominal tightening – financial conditions will remain extremely accommodative. At present, the expected scale of nominal tightening means less-negative, rather than positive, real rates. It is true that US rates, especially at the short end, have recently gone up rapidly; but the overall levels are still very low in historical terms (Figure 5), at both the short and the long ends. And when inflation is factored in, in real terms policy is still extremely loose, especially at the short end (Figure 5). Although the European Central Bank (ECB) is far behind the Fed in terms of monetary policy tightening, rising global rates and inflation are also lifting yields in the euro area. But also here, real rates remain firmly in negative territory, indicating still very loose financial conditions.

Figure 5 / US treasury yields, % (left) and real interest rates, % (right)



Source: Investing.com.

The key risk is that inflation stays higher for longer than is currently expected, and becomes increasingly driven by expectations, with producers raising prices in anticipation of, rather than in reaction to, increases in their own costs. That would lead to central banks having to tighten more rapidly than is currently expected, which would certainly have more negative economic effects, and could lead to a great deal of turbulence in financial markets – especially in the developing world, but also conceivably among weaker euro area sovereigns. In the euro area, after almost a decade of very low borrowing costs, it is likely that there is a (fairly low) level above which nominal interest rates cannot rise without causing many borrowers serious problems that could have systemic implications. The ECB is unlikely to be able to significantly reduce its dominant position as a holder of euro area debt without a material increase in sovereign credit spreads – something that it will be determined to avoid. That said, the politics of this will become much more challenging in the future.

Assuming that the inflationary impact of energy prices and supply/demand imbalances declines through 2022, it is not clear that the factors that have kept inflation so low over the past decade

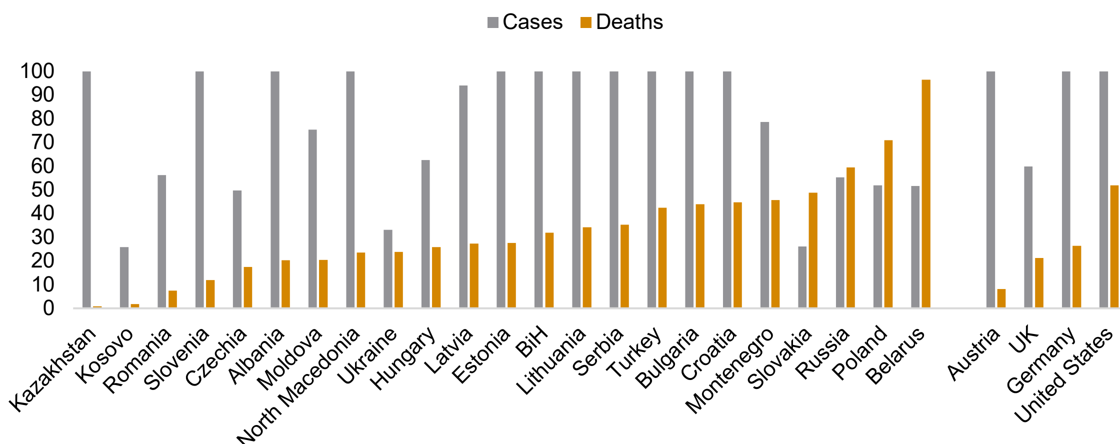
have fundamentally changed. Wages are rising, but at well below inflation in the euro area; and even if wages do continue to rise strongly and move ahead of inflation, if this is happening with a dwindling workforce ('great resignation'), it may not necessarily precipitate a huge amount of demand-pull inflation. Labour bargaining power remains fairly weak, particularly compared to the oft-cited episode of the truly high inflation of the 1970s; and the power of technology to increase competition and keep down prices in online retail has, if anything, been strengthened by the pandemic. Meanwhile, the prevalence of within-country income inequality, which has been shown to be a key driver of weak price growth (Mian et al., 2021), is unlikely to be fundamentally altered by the pandemic.

While inflation and higher interest rates are the biggest economic risk to the outlook, we see several other important downside risks, some of which are political. The political factors are covered in more detail in the chapter entitled 'Political risks in CESEE in 2022'. Apart from inflation and interest rates, we see the biggest risks being a new exchange of sanctions between Russia and the West and a spike in energy prices as a result of a fresh conflict in Ukraine (covered in more detail in section 1.3 below). In addition, a real-estate crisis and economic slowdown in China would have major repercussions for the global economy.

1.2 THE PANDEMIC IN CESEE

In general, for those countries for which data are available, the standard Omicron scenario established in South Africa seems to be playing out: a large number of cases, but relatively few serious ones, and nothing like the previous peaks in terms of impact on the healthcare service. In terms of new, confirmed cases, most of the region is at (or close to) the highest level since the beginning of the pandemic – as indeed is a large part of Western Europe and the US (Figure 6). However, the number of deaths from COVID-19 is well below 50% of the peak in most of the region, with the significant exceptions being Belarus, Poland and Russia.

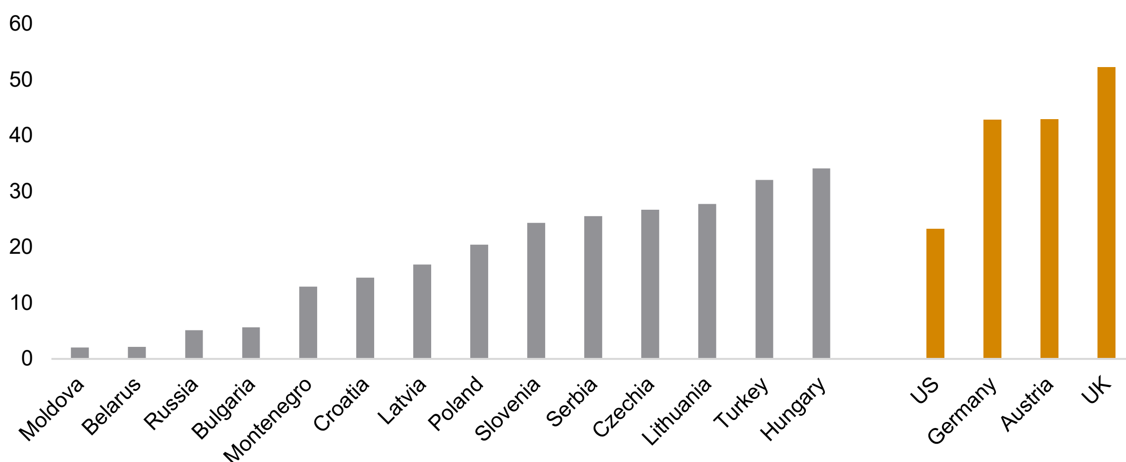
Figure 6 / New COVID-19 cases and deaths per million, 7-day rolling average, % of highest recorded level since March 2020



Note: weekly data on Sunday of each week are taken for comparison
Source: Our World in Data. As of 16 January 2022.

Nevertheless, there is a great deal of uncertainty: the milder Omicron variant could pose more serious risks for parts of CESEE, given that the region is much less vaccinated than Western Europe, and has a mostly much older population than South Africa. This is particularly the case in countries where the roll-out of third shots has been slow (Figure 7) – available studies suggest that the 'booster' shot is the key factor in combating Omicron. As a result, the quite positive picture illustrated in Figure 6 in terms of serious illness may not last in all of CESEE. However, improvements in treatment will also make a difference. Pfizer's new COVID-19 antiviral pill cuts the risk of hospitalisation or death in high-risk patients by 89%.[4] Omicron is also likely to mean that the tricky issue of vaccine hesitancy – a particular problem in much of CESEE – can be kicked down the road for most of 2022, as those refusing to be vaccinated gain temporary immunity via mild illness.

Figure 7 / Booster shots per 100 people



Source: Our World in Data. As of 9 January 2022.

Whatever happens with public health, our best guess is that restrictions are likely to remain quite limited. CESEE has already demonstrated an approach that prioritises the economy over public health, reflecting, among other things, the lower capability that the population has to work remotely (compared to Western Europe) and the fewer resources available to finance long furlough schemes (Astrov et al., 2021). Moreover, as in previous waves, much of the change in mobility is likely to come from individuals themselves, rather than government restrictions (IMF, 2020). As in the rest of the world, firms, workers and consumers in CESEE have found ways of adapting their behaviour in response to the pandemic that minimise economic disruption.

This expected limited economic impact should not, however, take away from the quite dramatic public health impact already evidenced across CESEE. Even if the vast majority of Omicron cases do not result in hospitalisation, they can still lead to absence from work, fairly serious illness and many weeks of recovery, during which cognitive functions are impaired. The mental health impact, both now and even once the pandemic truly becomes endemic, is dramatic and certainly underappreciated. The Economist's excess deaths tracker continues to show CESEE dominating the world rankings (with 15 of

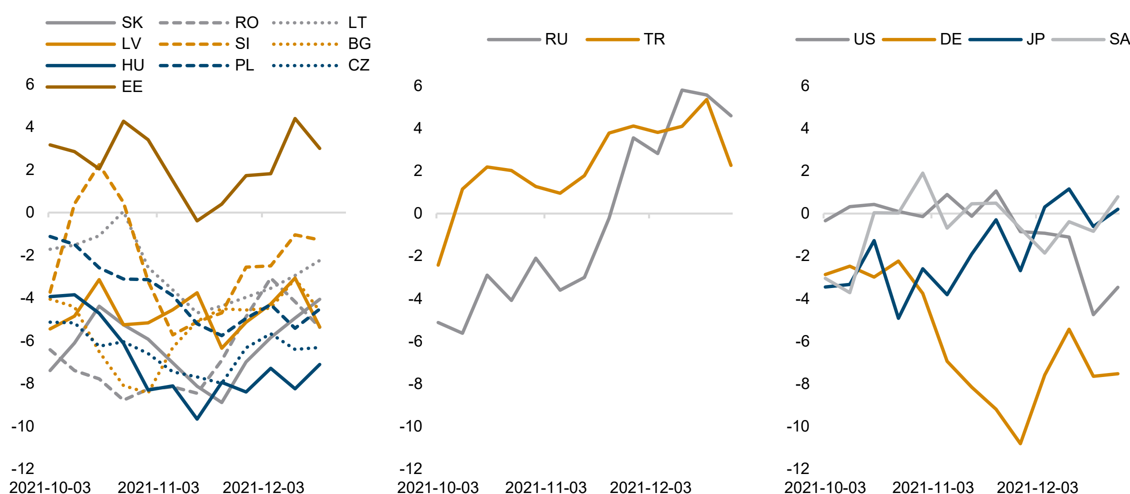
[4] https://www.ft.com/content/16796f92-5845-4b83-8e96-39d5c2fd13ea?emailId=61d4ebc75d4b8c00049b636f&segmentId=38af067e-f67a-09ef-7f9d-cb40b4153a58

the top 20 worst-affected countries, as of 17 January).[5] Whatever the economic performance – and this has been relatively good in CESEE throughout the pandemic, compared to Western Europe and many other parts of the world – the last two years have been an unmitigated public health disaster for the region. Much of the political class has been revealed as at best complacent; institutions have been found wanting; and in terms of both scale and quality, the state apparatus has simply been unable to provide the protection and support that most Western Europeans enjoy. It remains to be seen whether this will have political consequences in the coming years.

1.3 CESEE GDP AND BUSINESS CYCLE TRENDS

So far, the latest wave of the pandemic, the higher inflation and the supply-chain bottlenecks do not seem to have had a major negative impact on economic activity in CESEE. High-frequency data for CESEE countries, available for most of the EU-CEE states, plus Russia and Turkey, show that economic activity either remained steady during the last quarter of the year, or actually improved (relative to the no-pandemic counterfactual) (Figure 8). This stands in stark contrast to global comparators, such as the US and Germany. The impact in South Africa was notably very minor, indicating reasons for optimism in CESEE in the coming months.

Figure 8 / OECD Weekly Tracker of GDP growth, pp difference versus counterfactual*

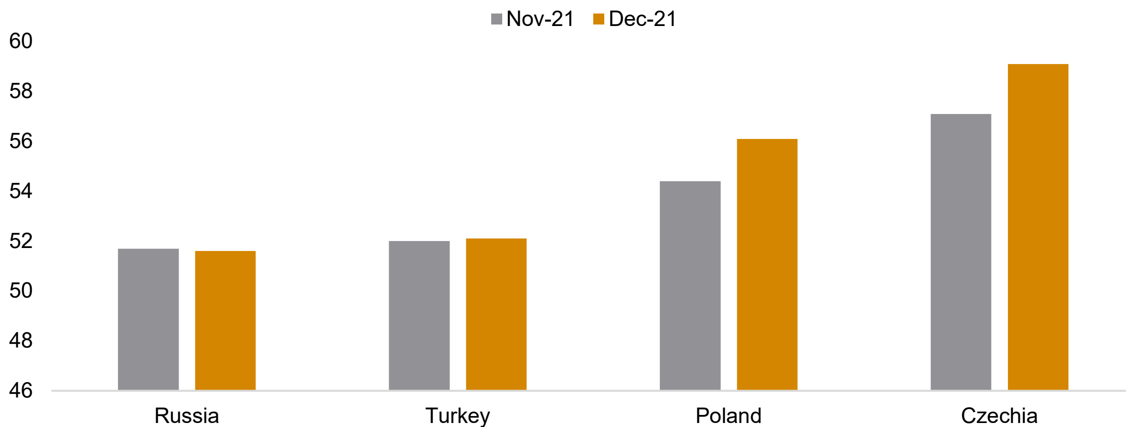


*Counterfactual = growth based on OECD end-2019 forecasts.
Source: OECD.

Manufacturing purchasing managers' indices (PMIs) tell a similar story, suggesting that, at least in the region's major economies, higher input costs and supply-chain bottlenecks are not driving activity into negative territory. Especially in Czechia, one of the region's most industrially advanced economies, with a high degree of integration into European (and therefore indirectly global) value chains, activity ended the year close to an all-time high. In both Czechia and Poland, sentiment improved strongly in December, relative to November. Meanwhile, in Turkey and Russia, although activity was more subdued, sentiment nevertheless remained firmly in positive territory (Figure 9).

5 https://www.economist.com/graphic-detail/coronavirus-excess-deaths-tracker

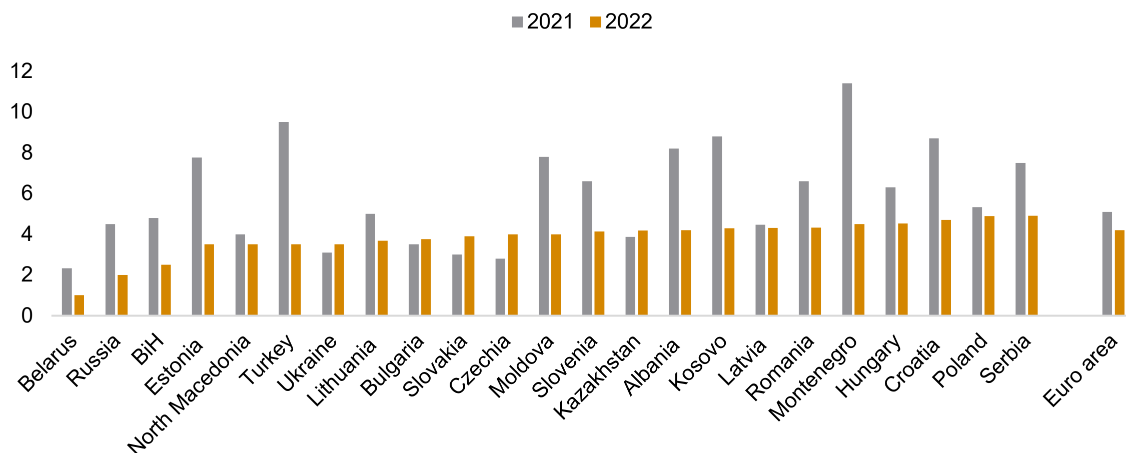
Figure 9 / Manufacturing purchasing managers' index (PMI); 50 = no change



Source: IHS Markit, national sources.

In this context, our forecasts for real GDP growth this year remain mostly quite positive, with several upward revisions from autumn 2021. We expect real GDP growth in the region to range between 1% (Belarus) and 4.9% (Poland and Serbia) in 2022 (Figure 10). After two years of having generally outperformed the euro area, only around a third of CESEE countries will grow faster than the single-currency area this year. Many countries will post lower rates of expansion than in 2021, although this largely reflects the scaling-down of large stimulus measures (as the acute phase of the pandemic has passed) and the phasing-out of extremely favourable base effects for those countries that were hit particularly badly in 2020 (such as Montenegro and Croatia). Underlying growth momentum is likely to remain solid. Moreover, several countries will grow faster in 2022 than in 2021: Ukraine, Bulgaria, Slovakia, Czechia and Kazakhstan.

Figure 10 / Real GDP forecasts, % change versus previous year



Sources: Eurostat, national sources, wiiw.

Headline CESEE growth will slow from 5.7% in 2021 to 3.2%, but this will primarily be driven by much weaker performance in the region's two dominant economies, Russia and Turkey. Russian economic growth will slow from 4.5% in 2021 to 2% this year, owing to political risk, probable new sanctions and the traditional reasons for weak trend growth that have long been evident, especially since 2014. In Turkey, the boom that was seen through most of 2021 is now over, following the currency collapse late last year, and rocketing inflation is set to limit the real rate of expansion this year.

Relative to the autumn, our forecast revisions for both 2022 and 2023 are quite limited, with no clear trend in either direction. For 2022, we are more optimistic about growth in Bulgaria, Czechia, Serbia and North Macedonia, and more pessimistic for (in particular) Russia, Belarus, Bosnia and Slovakia (Table 4). For 2023, the most notable change is a 1.3 percentage point downgrade for Russia.

Table 4 / Real GDP growth forecasts and revisions

		Forecast, %		Revisions, pp	
		2022	2023	2022	2023
EU-CEE	BG	3.8	3.5	↑ 0.5	↑ 0.3
	CZ	4.0	3.6	↑ 0.3	→ 0.0
	EE	3.5	4.0	↓ -0.1	↑ 1.0
	HR	4.7	4.1	↓ -0.3	↓ -0.4
	HU	4.5	4.0	→ 0.0	→ 0.0
	LT	3.7	3.3	→ 0.0	↓ -0.2
	LV	4.3	3.6	→ 0.0	↑ 0.2
	PL	4.9	4.9	→ 0.0	→ 0.0
	RO	4.3	4.5	→ 0.0	↑ 0.3
	SI	4.1	3.3	→ 0.0	→ 0.0
	SK	3.9	3.7	↓ -0.5	↓ -0.2
Western Balkans	AL	4.2	4.0	↓ -0.3	↓ -0.2
	BA	2.5	2.8	↓ -0.6	↓ -0.7
	ME	4.5	3.0	↓ -0.3	↑ 0.6
	MK	3.5	3.2	↑ 0.1	→ 0.0
	RS	4.9	4.5	↑ 0.3	→ 0.0
	XK	4.3	4.0	↓ -0.5	→ 0.0
Turkey	TR	3.5	3.5	↓ -0.3	↓ -0.3
CIS+UA	BY	1.0	2.0	↓ -1.0	↓ -0.3
	KZ	4.2	4.4	→ 0.0	→ 0.0
	MD	4.0	4.5	↓ -0.5	↑ 0.5
	RU	2.0	1.5	↓ -1.0	↓ -1.3
	UA	3.5	3.5	↓ -0.1	→ 0.0

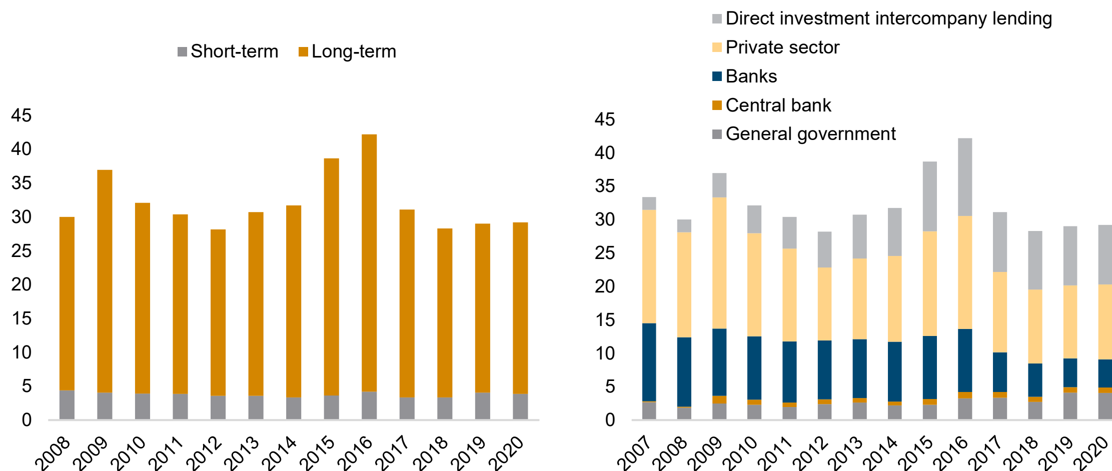
Note: Current forecast and revisions relative to the wiiw November forecast 2021. Colour scale variation from the minimum (red) to the maximum (green).
Source: wiiw.

Some kind of escalation in the Russia-Ukraine conflict, but short of a full invasion, is now our core scenario, and is a key factor behind our low growth forecast for Russia this year; but at present we do not think the tensions will fundamentally knock the CESEE recovery off course. In a climate of great uncertainty, all projections are difficult; but some new Western sanctions against Russia do seem quite likely. US President Joe Biden has said that Russia will pay a 'heavy price' if its troops cross into Ukraine. While some of the more drastic measures, such as cutting Russia off from the

SWIFT financial transaction system, have been played down by the US, many other options are on the table. Sanctions could include blocking Russian access to high-tech Western goods (such as microchips), targeting the Russian banking sector and further restricting access to Russian government bonds.

While Russia would suffer from any new Western sanctions, it is also clear that the country has made itself at least partly 'sanctions proof' in the period since the 2014 Ukraine conflict, and this will also provide a certain degree of insulation this time. Restrictions imposed by the West since 2014 have already severely curtailed the participation of foreigners in Russia's bond market. Conservative monetary and fiscal policy has allowed the build-up of substantial foreign reserves, totalling around USD 630bn, with gross foreign reserves including gold equivalent to around 40% of Russian GDP as of November 2021. Russia has very low levels of external debt and a current account surplus, limiting external exposure. As of 2020, gross external debt stood at 29% of GDP, with short-term debt (i.e. coming due within the next 12 months) at less than 4% of GDP. Moreover, within Russia's total external debt, 8.9 percentage points were accounted for by more stable direct investment intercompany lending. Total private-sector external debt was equivalent to 11.2% of GDP in 2020, little more than a quarter of total foreign reserves (Figure 11).

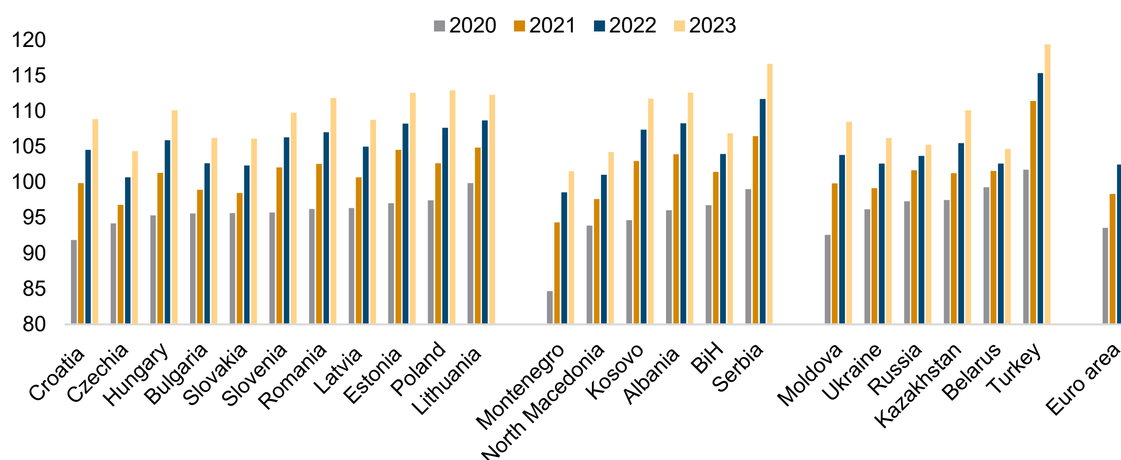
Figure 11 / Russian gross external debt by maturity (left) and by sector (right), % of GDP



Sources: Central Bank of Russia, wiiw.

The permanent scarring from the pandemic will be evident across CESEE, but different sectoral structures and policy responses mean that the recouping of what was lost in economic terms has occurred much more quickly in some countries than in others. Turkey already surpassed its 2019 GDP in 2020, being the only CESEE country to post growth that year. Most other countries of the region exceeded their 2019 levels of economic output last year (Figure 12). Based on our new projections, almost all of the rest will do so this year, but Montenegro – the worst affected country in the region, due to its reliance on tourism – will only return to 2019 GDP levels in 2023. By 2023, we expect the Turkish economy to be 19% bigger than in 2019, compared to just 2% for Montenegro, indicating the very divergent lasting impact of the pandemic on the region.

Figure 12 / Real GDP, 2019 = 100



Sources: Eurostat, national sources, wiiw January 2022 projections.

The NextGenerationEU (NGEU) fund is the latest demonstration of the huge advantage of EU membership for CESEE countries. There are certainly important caveats to this, not least the weak absorption capacity and questions about whether there is sufficient institutional capacity to deal with this wall of money; but both the amounts (conceivably several percentage points of GDP) and the focus (a large share must go towards digital and green investments) represent a potentially very significant boost to growth for EU-CEE countries.

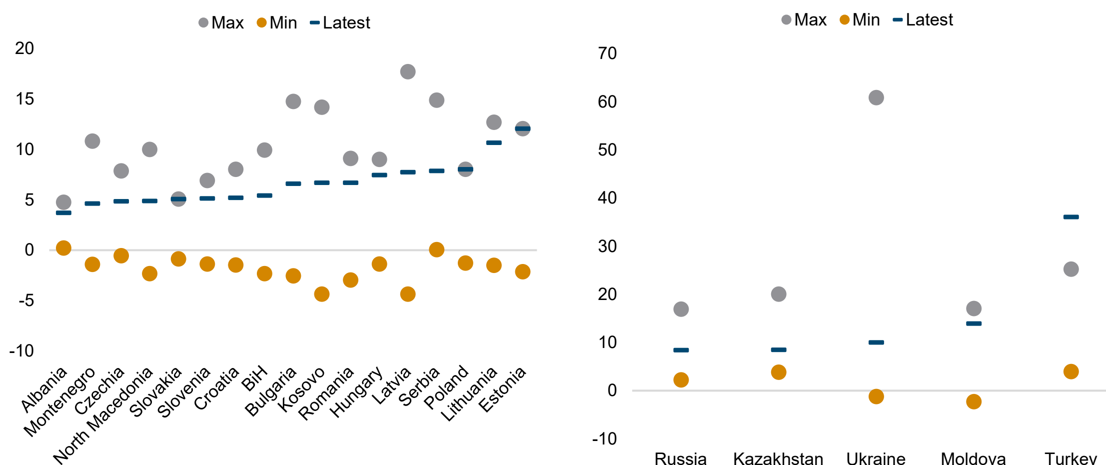
As the recovery continues in the region, so the labour markets will pick up. In all 23 CESEE countries, we forecast the unemployment rate in 2022 to be lower than in 2021. However, it is clear that parts of the labour market have been seriously and negatively affected by the pandemic, and here the recovery may be much slower to arrive. The information and communications technology (ICT) and the professional and scientific activities sectors have remained unaffected by the crisis – or have even benefited from it. However, manufacturing, transportation, accommodation and food services have been much worse affected (Tverdostup and Bykova, 2021). While job retention schemes helped to cushion the shocks in several EU-CEE countries, dramatic discrepancies between badly hit sectors and those that benefited could result in long-lasting structural shifts in the labour market.

Sectoral differentiation was also apparent in the pandemic, and is also likely to leave a strong legacy, with some sectors driving the recovery and others continuing to lag behind. The pandemic moved large parts of the economy online, supporting real growth in the ICT sector in almost all CESEE countries (Bykova, 2021). Meanwhile, the health sector performed exceptionally well (relatively speaking) in the majority of CESEE economies. By contrast, accommodation, the arts and the transportation sectors performed worst, owing to pandemic-related restrictions and increased caution among the populations of CESEE.

1.4 INFLATION, MONETARY AND FISCAL POLICY

As at the global level, the main risk to the outlook for CESEE is persistently higher-than-expected inflation and sharply higher interest rates. However, while December 2021's inflation was at an all-time high in the euro area, this was the case in relatively few countries of CESEE, even if we only look as far back as 2007 (Figure 13). Inflation is at (or close to) its highest level since 2007 in Albania, Slovakia, Hungary, Estonia and Moldova – and has topped that level in Turkey (albeit chiefly owing to the impact of the currency collapse on import prices). But in the rest of the region, inflation has been clearly higher at some other point since 2007; and in certain countries of the region – such as Montenegro, Bulgaria, Kosovo, Latvia, Serbia and most of the CIS and Ukraine – the current rates of inflation are considerably lower than their post-2007 highs.

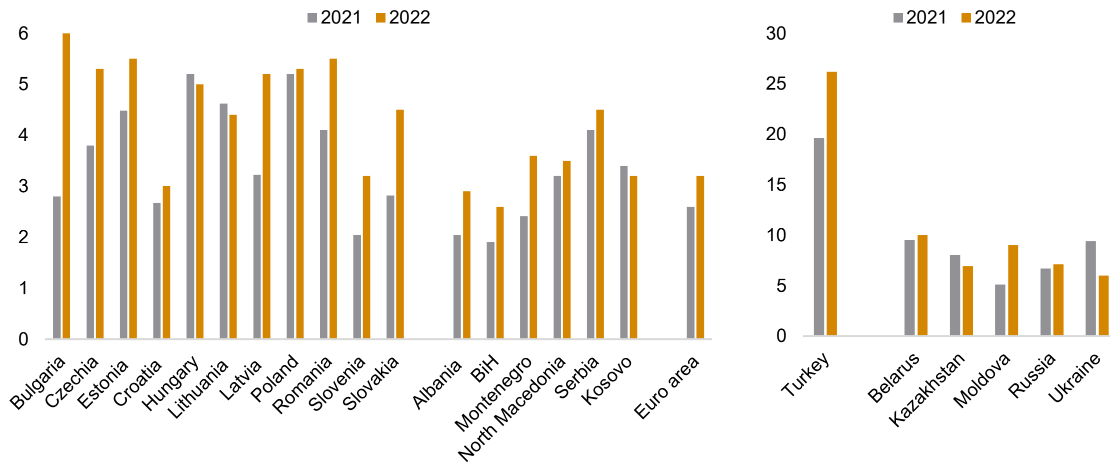
Figure 13 / Consumer price index, % change year on year, December 2021 (or latest available) and maximum and minimum since January 2007



Sources: Eurostat, national sources, wiiw.

Our 2022 inflation forecasts have been revised upwards, quite significantly in many cases. Previously, we expected inflation to be lower in 2022 than 2021 in most of the region; but that will be the case in only very few countries (Figure 14). Inflation is going to stay high for at least another few months. Firms across CESEE are facing major increases in their input costs, and are passing at least some of that on to consumers. The most important question is whether this will lead to a sustained increase in wages. If it does, then we are in for a prolonged period of inflation that will be considerably higher than most countries have experienced since 2008. But the most likely scenario is that, for the reasons outlined in section 1.1 above, price growth will slow by the middle of the year.

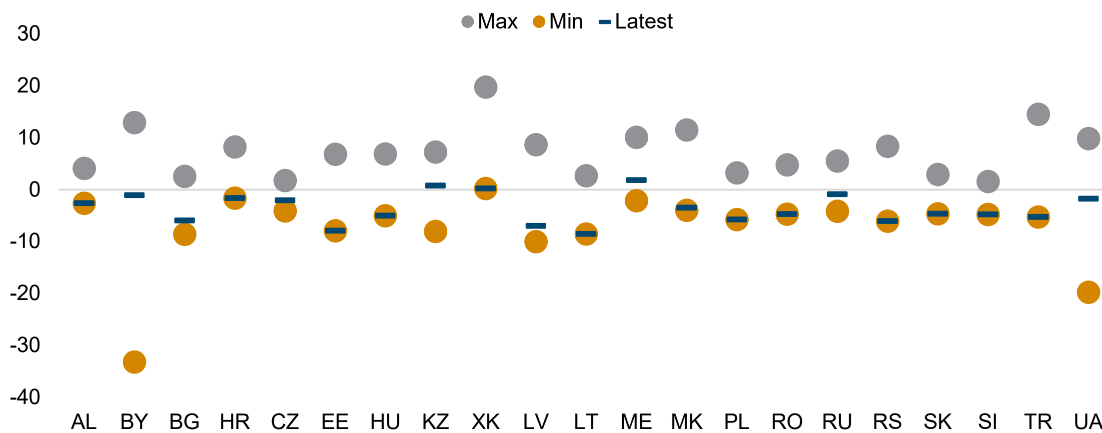
Figure 14 / Average consumer price inflation, % per year



Sources: Eurostat, national sources, wiiw January 2022 projections.

There are no good options for CESEE central banks: with inflation so far above target, they cannot stand back and do nothing; and yet they know that monetary policy is not very useful against inflation driven by supply bottlenecks, and that higher rates will weaken the recovery. This dilemma is reflected in the current policy stance. Nominal rates are rising, but real rates adjusted for inflation are negative. In real terms, monetary policy is as loose as it has been at any point since 2007 in most countries of the region (Figure 15). Current real rates are particularly low in the Baltic states: both Estonia and Lithuania have double-digit year-on-year inflation, according to the latest available data, and Latvia's inflation rate stands at 7.7%. As euro members, the Baltic states do not have a monetary lever, and – at the time of writing – the ECB looks unlikely to increase interest rates this year.

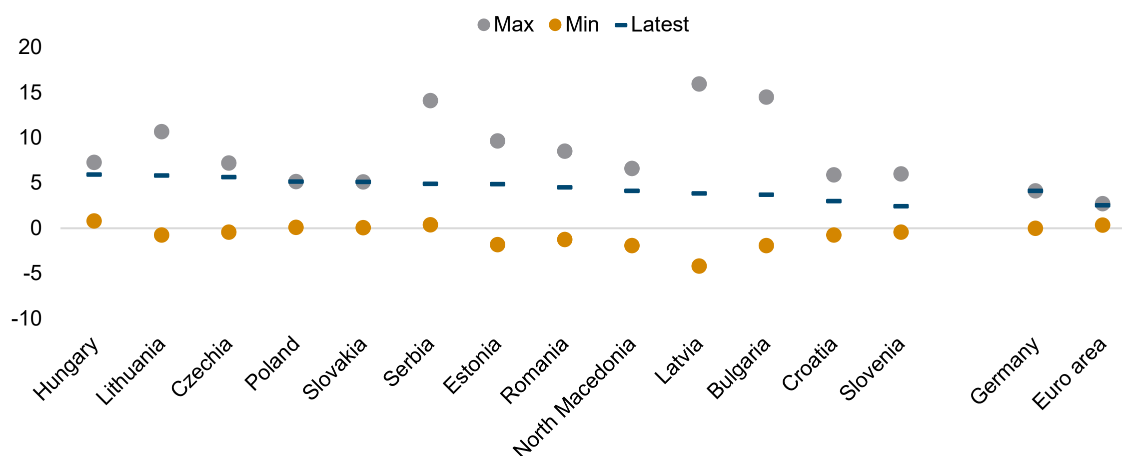
Figure 15 / Real policy rates, consumer price index-adjusted, January 2007 – November 2021



Sources: Eurostat, national sources, wiiw.

High inflation, particularly for commodities such as energy and food, will cause serious difficulties for households in CESEE this year, especially in poorer parts of the region. As a result, governments across CESEE are resorting to price controls,[6] not least for reasons of domestic political stability. People in CESEE also do not have the same levels of savings to draw on as many people in Western Europe. Therefore, it seems likely that the relative impact of higher prices on real economic growth in CESEE will be more significant this year than in Western Europe. Nevertheless, for now it seems that demand can take it. The Polish January manufacturing PMI noted that output costs rose 'rapidly', while the Czech equivalent gave out a similar message, indicating that firms can pass on higher energy and raw material costs to consumers. However, while headline inflation is at historically elevated levels in the region, this is not the case with core inflation in many places. Whereas in both Germany and the euro area, the most recent core inflation reading is at its highest point since 2007, among those CESEE countries for which comparable data exist only Hungary, Czechia, Poland and Slovakia are close to this point or have already reached it (Figure 16).

Figure 16 / Core inflation, in % year on year, November 2021 (or latest available)



Note: Max and min values are for the period between January 2007 and November 2021.
Sources: Eurostat, national sources, wiiw.

With monetary tools of limited use even to those parts of CESEE that have them, there is more attention being devoted to fiscal policy as a means of dampening inflation, although this is also unlikely to make a fundamental difference to price dynamics. On average, we expect fiscal deficits in CESEE to be 0.9 percentage points smaller in 2022 than in 2021. Shortfalls will narrow, in particular, in many EU-CEE member states, but this will be partly due to a boost in revenues. With a couple of exceptions, the largest deficits will continue to be posted in EU-CEE in 2022, however, reflecting the fact that these countries face less market pressure to tighten fiscal policy than do non-EU countries in the region.

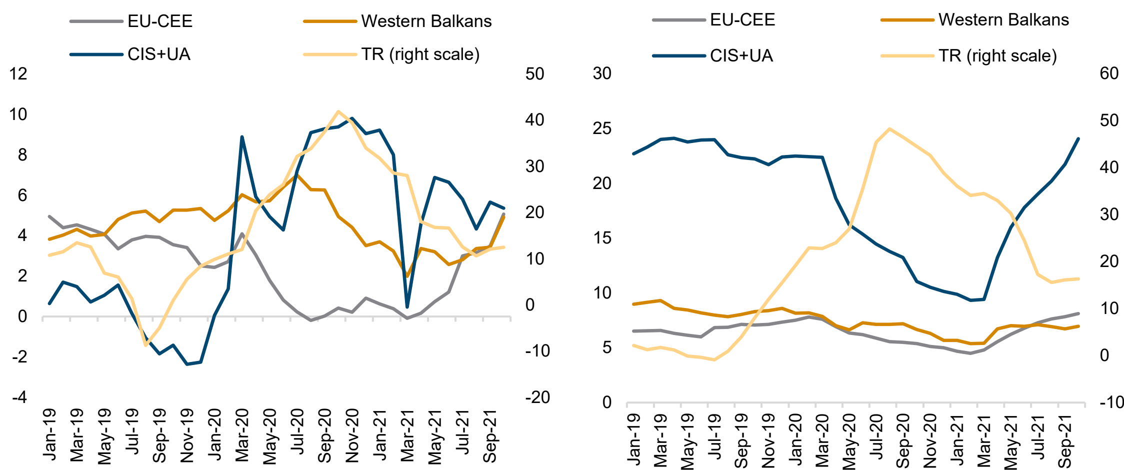
Sharp fiscal tightening is unlikely in most places, not least as NGEU funds start to flow more strongly into EU-CEE. The expansionary fiscal response to the COVID-19 pandemic across the world was much bigger than after 2008, and this was also the case in CESEE. That reflected not only the

[6] https://www.politico.eu/article/food-price-inflation-eastern-europe-poland-romania/

urgency of the situation in 2020 and the way in which the austerity mistake post-2008 changed the debate in policy circles, but also the freedom offered by massive monetary expansion and consequently the much lower borrowing costs for governments. As highlighted in section 1.1 above, a dramatic shift upwards in global rates seems unlikely; but it is nevertheless already clear that dollar and euro rates – both important for borrowers in CESEE – have risen and are likely to continue to rise in the future. This alone will stimulate tighter fiscal policy, particularly in those countries of the region with weaker sovereign credit ratings (largely, but not exclusively, the non-EU member states).

Credit growth has been an important pillar of economic resilience across much of CESEE over the past two years, but the positive credit impulse for growth will be reduced as interest rates rise. During the second half of last year, credit growth remained strongest in CESEE – even increasing, especially among corporates in EU-CEE and the Western Balkans, and most strikingly among households in the CIS and Ukraine. In Turkey, credit growth for both corporations and households slowed significantly from the second half of 2020; but in both cases it remains high, and is likely to continue so, given that the current real policy rate is around -22%. Although credit growth may slow from its present levels across the region, unless the current increase in nominal rates is mirrored in real borrowing costs (which does not look likely at present), credit will be able to continue to grow quite robustly during the forecast period.

Figure 17 / Nominal credit growth, % change year on year; non-financial corporations (left) and households (right)



Sources: National sources, wiiw.

1.5 STRUCTURAL CHANGE ACCELERATED BY THE PANDEMIC

It would be strange if an event as big as the pandemic did not drive structural change, and there are plenty of reasons to think that it will in CESEE. We see four important areas of structural change for the region. In all of these, the pandemic has acted as a catalyst and a trigger for certain aspects; but change was under way in all four areas even before the pandemic. First, a fundamental reassessment of the size of the state and its role in economic life. Second, structural change in industry, accelerated by the pandemic. Third, stronger conditionality in the disbursement of EU funds. And fourth, geo-economic shifts, and altered roles for the EU, US, China and Russia in the region.

The pandemic, like the 2008 financial crisis, has delivered a decisive blow to some core tenets of neoliberal ideology, demonstrating the central importance of the state in crisis management and economic life at times of stress. Neoliberal ideology had little to offer in its responses to either the 2008 or the 2020 crises, both of which required massive state intervention to prevent a much more serious and negative impact on the lives of ordinary people. It is very unlikely that we will return to the pre-2007 consensus of fiscal conservatism, low public debt, deregulation, a small state and ever-freer trade. Even the International Monetary Fund (IMF), perhaps the most important upholder of this consensus, has quite radically shifted its policy prescriptions.

However, greater state capacity is necessarily problematic from the perspective of much of CESEE, given institutional weakness and the growing authoritarianism in some countries. We made a first attempt to grapple with this when assessing the new growth model in EU-CEE (Bykova et al., 2021), where we found that, in order to drive the next phase of economic development, a greater role for the state is largely inevitable. While accepting the challenges, we believe that with strong EU conditionality, a positive trajectory is possible. The crucial upcoming election in Hungary will be a very important barometer. Naturally, further east and south in CESEE, where institutions are generally weaker and the EU anchor is largely absent, a greater role for the state is even more problematic.

The second key structural change under way in CESEE is in industry, and here again the pandemic is less a cause than an accelerator of what was already happening. The vulnerability created by the reliance of much of the region on the automotive industry has been exposed by the damage caused to supply chains during the pandemic, while the speeding-up of the green transition has added a further element of pressure. This is augmented by the return of labour shortages, which create difficulties in labour-intensive manufacturing, as well as simmering dissatisfaction over the dominance of large foreign-owned firms and the emergence of profit repatriation by these firms as a hot political topic. We find that while the current growth model has delivered a great deal, it is now reaching its limits, with not enough expansion in specialisation away from production and towards more lucrative parts of the value chain.

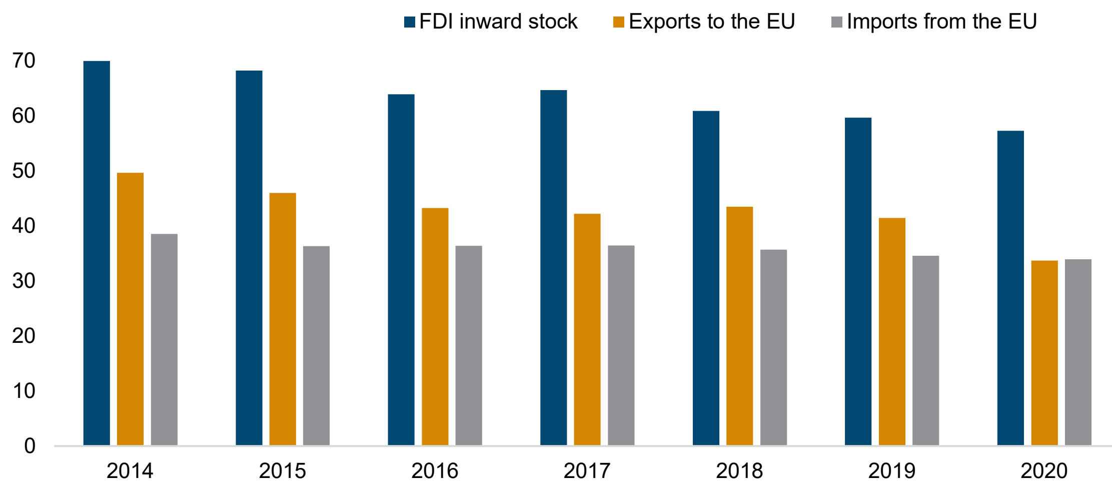
As a result, a major industrial transition is under way, which will entail major structural adjustments and potentially significant social costs. This is particularly the case for countries like Poland, where coal continues to play an important role in both energy supply and the labour market. Although the green transition is an opportunity for the region, there are clear concerns across CESEE about the transition costs. For EU-CEE, it should be possible to manage this transition with the support of EU funds, and in particular with the money devoted to green and digital projects as part of NGEU; but it will require careful policy.

This is not to say, of course, that industry will disappear from the region: it is highly likely that manufacturing activity driven by foreign direct investment (FDI) will remain a core part of the region's growth model for many years to come. The latest available data suggest that foreign investors have not turned away from the region, and indeed may actually see it as more attractive, in light of the pandemic and the increased caution about extended supply chains. Delayed investments appear to have mostly resumed. Meanwhile near-shoring may not be a game changer for the bigger economies, or for those with existing large FDI stocks, but for some countries in Southeast Europe it has great potential (Jovanović et al., 2021). Inflows of FDI to the Western Balkans, for example, rose by 20% year on year in H1 2021, and were higher than in the corresponding period of 2019 (Hunya and Jovanović, 2021). In the Western Balkans, per capita FDI inflows are generally much lower than in EU-CEE, and so the upside potential is much greater from an economic development perspective. Although FDI patterns across CESEE as a whole have been uneven during the pandemic, overall FDI inflows to the region largely returned to H1 2019 levels in the first half of last year, suggesting no permanent negative impact from the pandemic (Hunya and Jovanović, 2021).

The third key structural change is the potential for the EU to be stronger in penalises member states for rule of law infringements. For more than a decade, the EU has appeared quite powerless in the face of illiberalism within the bloc – most obviously in the case of Hungary. But there are clear signs that this could change. The massive expansion of the EU budget in response to the pandemic appears to have made some of the large net contributors to the budget more determined to enforce conditionality. The European Court of Justice is due to rule soon on an enforced conditionality mechanism. And if it is found to be legal, this new mechanism could be applied against Hungary and Poland in February 2022. Poland is already accumulating daily fines from Brussels for refusing to close a coal mine near the Czech border and for not suspending the controversial disciplinary chamber of judges of its Supreme Court: the two fines combined amount to EUR 1.5m per day. Intensified conflict with Brussels probes the weak spot of the current governments of Hungary and Poland, since the populations of both countries are quite strongly pro-EU.

The fourth structural change relates to geopolitics, and the further strengthening of the divide between the West and Russia, and the West and China, that plays out in parts of CESEE. The growing possibility of a Russian invasion of Ukraine underlines the hard divide between Russia and the West, which has been clear since 2007. Russian President Vladimir Putin's speech at the Munich Security Conference in 2007 set the tone, and the willingness of the country to use military means to stop the formal expansion of euro-Atlantic institutions into former Soviet countries was made particularly clear in Georgia in 2008 and Ukraine in 2014. A full-scale war in Ukraine in 2022 would be an intensification of this divide, but not a change in its fundamental direction. The economic consequences of this are evident, most clearly in Ukraine, where economic development has been repeatedly hamstrung by political conflict and uncertainty (among other issues). The exchange of sanctions between Russia and the EU from 2014, in particular, has driven a deep financial and economic wedge between them. Since 2014, Russia's inward FDI stock from the EU and the country's trade with the EU have both fallen substantially as a share of the total (Figure 18).

Figure 18 / Russia's foreign direct investment from and trade with the EU, % of total



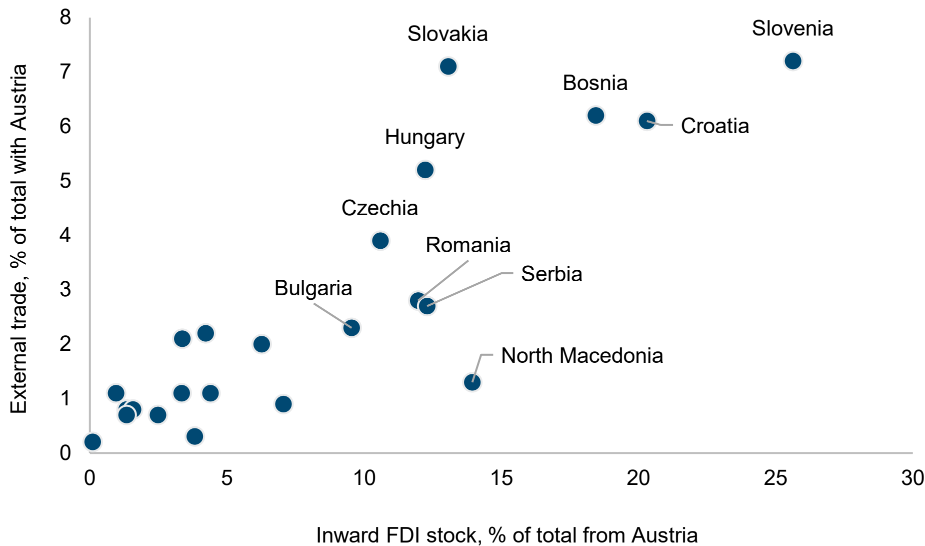
Source: Central Bank of Russia, Russian Federal State Statistics Service, wiiw.

An interesting new development in parts of CESEE is the growing scepticism about China. Various moves in recent years – most famously the '16+1' initiative – have pointed towards a growing economic and financial relationship between China and the countries of CESEE. Initially, this was met with a large degree of enthusiasm in at least parts of the region. However, the limited concrete achievements of this cooperation, growing cautiousness about Chinese investments in strategic sectors (mirroring that of the EU), the bad PR generated by the debt debacle in Montenegro, and the recent spat between Lithuania and China over Taiwan have brought the negative aspects of economic engagement with China more sharply into focus. Especially for EU-CEE countries, it is clear that China cannot offer anything remotely comparable to Brussels in economic and financial terms, especially in light of NGEU. The hardening geopolitical divide will also increasingly force countries to take sides, and for much of CESEE, especially EU-CEE, the incentive to be in the Western camp is quite clear. This is particularly the case for those countries in CESEE for which the US security role in the region is most important, not least Lithuania. Southeast Europe is a more complex case, given the weaker EU influence and the far lower level of EU funding. That would seem to offer a greater role for China. Serbia seems especially keen to continue to develop economic and financial ties with Beijing, along with a strong political relationship. If the EU does not manage to fundamentally change the dynamics of its approach in the Western Balkans, Chinese influence could well become even stronger there (Weiss et al., 2020).

1.6 IMPLICATIONS FOR AUSTRIA

The relatively strong recovery from the pandemic in CESEE, and our expectation that this will continue, is good news for Austria, given the strong trade and investment links. Austria is an important trading and investment partner for most of CESEE – and particularly for large parts of EU-CEE and the Western Balkans (Figure 19). The fact that most of the region outperformed the euro area in both 2020 and 2021 has been advantageous for those Austrian firms with a strong presence in CESEE.

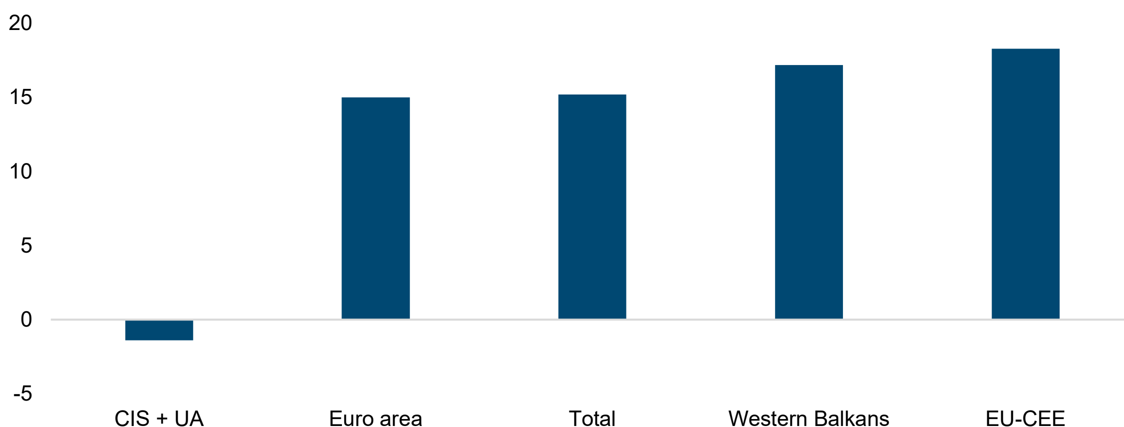
Figure 19 / Austria's trade and investment links with CESEE countries



Note: Data for 2020 or latest available.
Sources: Eurostat, national sources, wiiw.

This advantage was noticeable in 2021, as Austrian exports to CESEE grew strongly, with sales to CESEE countries mostly outperforming both total exports and sales to the euro area. In January-October 2021, Austrian nominal euro-denominated exports increased by a substantial 15.2% in total and by 15% to the euro area. However, sales to EU-CEE rose by 18.3%, and exports to the Western Balkans by 17.2%, reflecting the relatively good performance of these economies last year – and consequently the stronger demand for imports (Figure 20). Last year, the CIS and Ukraine was the only weak spot in CESEE from the perspective of Austrian exporters: euro-denominated exports to it declined by 1.4% relative to the first 10 months of 2020. This entirely reflected weak demand from Russia: Austrian exports to that country declined by 9.1% over this period, whereas those to Kazakhstan, Ukraine, Belarus and Moldova increased.

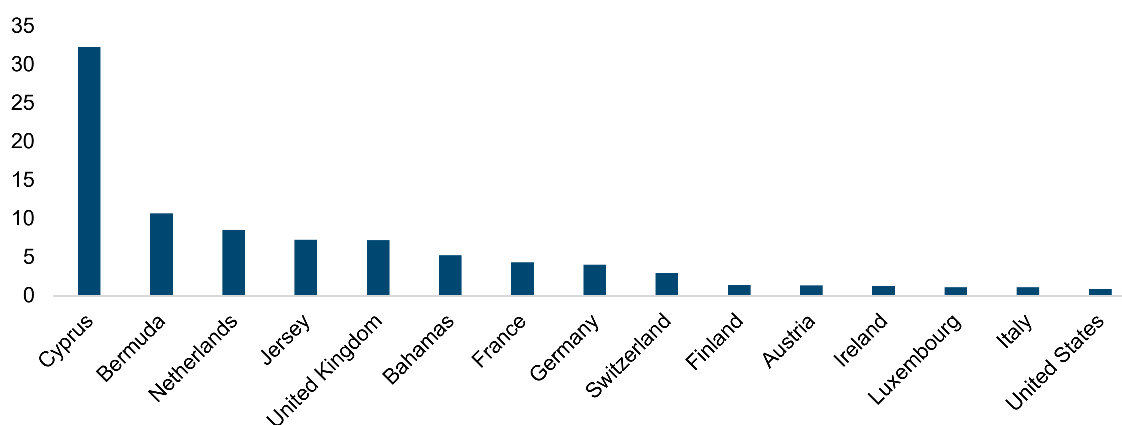
Figure 20 / Austrian exports by destination, January-October 2021, % change year on year



Source: Statistik Austria.

The weakness of Austrian exports to the CIS could continue this year and next, given the continuing uncertainty over Russia's potential intervention in Ukraine and the possibility of an exchange of sanctions between Russia and the West. We have revised downwards our real GDP growth forecasts for Russia by at least 1 percentage point for both this year and next, indicating that demand will remain subdued for some time. Austria runs a large trade deficit with Russia, totalling EUR 1.8bn in January-October 2021. This is Austria's second-largest bilateral shortfall (after that with Germany), indicating that, from the Austrian perspective, imports from Russia are much more significant than exports to it. This hints at Austria's heavy reliance on Russia for energy, and indicates vulnerability to any exchange of sanctions and potential supply disruptions or further price spikes. Austria is meanwhile the eleventh-biggest foreign investor in Russia, accounting for 1.3% of the total inward stock in 2020 (Figure 21).

Figure 21 / Russian inward FDI stock by source, % of total, 2020



Note: Jersey data estimated based on June 2020 data.
Sources: Central Bank of Russia, wiiw.

On the investment side, the available data also suggest a continuation – and even a strengthening – of economic links between Austria and CESEE in the post-pandemic period. Although inward FDI to CESEE fell sharply in 2020, the decline from Austria (-21% year on year) was less than the total (-34%). The sharpest decline in Austrian investment in 2020 was in Serbia and Russia; by contrast, Austrian FDI inflows into Bulgaria and Poland increased (Hunya and Jovanović, 2021). Notably, in the first three quarters of last year, Austrian greenfield FDI in CESEE totalled 35 projects, identical to the same period of both 2019 and 2020, indicating continued interest in the region from Austrian investors, despite the huge impact of the pandemic on the regional economy. In both 2020 and 2021, Austria's biggest greenfield investment project commitments lay in Hungary, followed in 2021 by Poland, Russia and Turkey. This implies that investors have so far remained relatively unconcerned by political noise and potential political risks to the business environment in these countries. Nevertheless, the largest stock of Austrian FDI in CESEE is still in Czechia, followed by Romania, Hungary and Poland.

The strong recovery in CESEE and the continuing convergence process may, however, reduce Austria's ability to attract workers from the region to fill labour market gaps in the future. Labour shortages were already an important theme before the pandemic, and they have already returned in

CESEE, limiting the available pool of workers who could potentially move west. Moreover, economic convergence is narrowing the income gap, especially when adjusted for purchasing power parity, thus reducing the incentive to move to countries like Austria, at least from the most developed parts of CESEE. One sector that has felt this impact very clearly is the tourism sector. The digital transition, for which the pandemic has been a catalyst, has also made remote working easier, and could contribute to nascent signs of a brain gain (rather than a brain drain) for the region (Leitner, 2021).

The structural change under way in CESEE economies will also have important implications for Austria, as one of the main foreign capital owners in the region. Should the CESEE region transition towards a growth model built more on innovation and higher productivity and wages, it would change the nature of the economic interdependence between those countries and Austria (and Germany as well). For firms that have so far outsourced labour-intensive production to the Visegrád countries, this may mean moving these investments to markets further east or south, for example the Western Balkans and Turkey. However, as the CESEE countries – and especially those of EU-CEE – become richer, they will become an ever-more important source of demand for Austrian firms. As demonstrated above, this was already evidenced in 2021.

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2 Political risks in CESEE in 2022

BY MARCUS HOW*

- **At the beginning of 2022, political risks in CESEE were regionally at their highest since the 1990s.**
- **Global economic trends such as high inflation are impacting on the prices of basic goods and utilities, increasing the potential for political and social instability.**
- **Domestic developments in individual states in CESEE are having increasing spill-over effects inside the region, reflecting its geopolitical interconnectedness.**
- **This is partly due to competition in the region between major stakeholders such as the US, Russia, China and the EU, but also growth in the relative strategic autonomy of other states, such as Hungary, Serbia and Turkey.**
- **In 2022, political risks in CESEE will be shaped by, but not limited to, three strategic trends:**
  - **First, the high probability of targeted military action by Russia in Ukraine, as Moscow seeks to coercively constrain the security apparatus of its neighbour, while consolidating its strategic influence vis-à-vis NATO and China.**
  - **Second, the greater likelihood of institutional failure (and possibly armed conflict) in Bosnia and Herzegovina, reflecting the failure of the US and EU to respond adequately to strategic challenges in the Western Balkans, which is hosting an increasing number of competing interests.**
  - **Third, the increased chance that 'illiberal' incumbents will be defeated in elections in Hungary and Slovenia, fundamentally altering the balance of power in the EU, even as their multiparty successors struggle to govern effectively.**
- **Other strategic trends not included in this analysis include the politically inflicted crash of the Turkish lira; the deterioration in relations between China and Central and Eastern European states such as Lithuania and Czechia; and the limited impact of liquefied natural gas in reducing energy dependence.**

2.1 WAR RISKS: RUSSIAN WARGAMING IN UKRAINE AND THE CIS

War risks in CESEE are at their highest since 2014, as Russian President Vladimir Putin seeks formal guarantees as to the geopolitical contours of the former Soviet space and Eastern Europe more generally. First, Moscow wishes to force the implementation of the Minsk peace agreements on Ukraine, which, under the presidency of Volodymyr Zelensky, it believes is becoming a permanently hostile neighbour.

Over the past year, the Zelensky administration has taken considerable steps to develop Ukraine's relative strength vis-à-vis Russia, further modernising its military capabilities through the acquisition of

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weaponry from NATO members, such as the US, UK and Turkey. Moscow fears that this may facilitate a Ukrainian offensive against separatist forces in the breakaway territories of Donetsk and Luhansk, and also that Kyiv may acquire military capabilities with which it can target Russian cities.

Second, Moscow seeks a wider renegotiation of security arrangements within Central and Eastern Europe, demanding that NATO commit to curtailing its deployments within the territories of its easternmost members, while expanding no further.

Moscow has employed coercive diplomacy to this end, signalling its willingness to use force as a last resort by amassing at least 100,000 troops along the Russian border with Ukraine. Multiple battalions have also assembled to conduct wargames in Belarus: this previously neutral territory has emerged as a possible northern front from which direct attacks on the Ukrainian capital, Kyiv, could be launched.

Many of the items tabled by Moscow in the negotiations with NATO in Geneva can be traded away. NATO expansion itself is a distraction, as the neighbouring states of Russia that are not in NATO – including Ukraine – are not going to join in the foreseeable future. Precluding Ukrainian membership also changes little for NATO in substantive terms. Yet while Washington may admit this privately, it cannot do so publicly without losing face – just as Moscow cannot walk away with assurances that it cannot sell to an audience, be it domestic or international.

Regardless, the short timeframe that Moscow has imposed on NATO to reach an agreement indicates that a grand security bargain is unlikely. The rush is to force concessions that will stunt Ukraine's security apparatus in the medium to long term. The longer Moscow waits, the stronger Kyiv may become, with the Kremlin expressing particular concern that it will ultimately acquire the capability to launch long-range missiles that could reach Russian cities.

If Moscow cannot secure credible guarantees, it may decide to resort to force, striking first to prevent such a scenario – as well as to forestall the prospect of a stronger Ukrainian offensive in Donbas. A full-scale land invasion of Ukraine is unlikely because, even if Russian forces could achieve a swift victory, the cost of containing a deeply hostile population over a vast territory would be very high in the medium and long term. That could increase the risks of civil unrest and political instability in Russia, where polls suggest that the public, weary of stagnating living standards and dysfunctional local services, is divided on the prospect of war.[1]

Targeted, limited action is more likely, designed to inflict significant damage on Ukrainian defence capabilities, increase Moscow's negotiating leverage vis-à-vis Kyiv and destabilise the Zelensky administration. This could be accomplished through a variety of means, such as the use of Russia's superior long-range artillery capabilities and/or the launching of a ground offensive in the direction of Kyiv. Moscow will not necessarily act immediately: it could potentially wait until spring for the Omicron wave of the COVID-19 pandemic and the Beijing Winter Olympics to pass.

1 https://www.levada.ru/en/2021/04/16/ukraine-and-donbas/

Fresh rounds of sanctions from the US, UK and EU are very likely to follow, while the rouble is expected to depreciate by as much as 20%. Nonetheless, the Russian economy has considerable cushioning, with the central bank having accrued some USD 630bn in foreign reserves, up to USD 175bn more than in 2014.[2]

Furthermore, the EU remains unwilling to match its sanctions regime with that of the US. Both have discounted the possibility of removing Russia from the SWIFT payments system in the event of an escalation in Ukraine, which would be the severest of options. The Biden administration has even gone so far as to distinguish between different types of military action (‘minor incursions’), suggesting that there would be a spectrum of options for sanctions. But while the US would very likely target major Russian banks, EU member states such as Germany are hoping to soften any such action by exempting certain banks and transactions (such as payments for oil and gas).

It is therefore questionable whether sanctions would inflict the necessary damage on Russia to disincentivise military action. This extends to project risks, specifically around the Nord Stream 2 gas pipeline. The willingness of Germany’s new ‘traffic light’ coalition to suspend Nord Stream 2 (which is awaiting regulatory approval) indefinitely is as unclear as it was under the previous government. If it finds itself obliged to proceed with the suspension, natural gas prices in Europe will spike further.

The real risks to the Russian economy will more likely manifest themselves in the medium to long term, as its competitiveness and diversification stagnates further in the deepening absence of foreign direct investment. This trend of stagnation has been under way since at least 2014, perpetuated by international sanctions, restrictive monetary and fiscal policy, and institutional weakness. Nonetheless, Moscow is currently in as strong a position as it is ever likely to be with respect to extracting concessions over Ukraine and NATO, whether diplomatically or militarily.

Yet its wider strategy is not limited to merely pacifying Kyiv. The formalisation of its geopolitical influence provides a foundation from which Russia may emerge as a strategic wedge between the West and China, shifting between alliances of convenience. This has partly informed Moscow’s interventions to prevent the overthrow – whether by popular protest or palace intrigue – of the administrations of Alexander Lukashenko in Belarus and Kassym-Jomart Tokayev in Kazakhstan. It is not just about preventing ‘colour’ revolutions: there is also geopolitical value in maximising strategic leverage.

There are many differences between Belarus and Kazakhstan – not least in relation to the events that prompted Moscow to intervene. But where the two countries are similar is that both have conducted their external relations since 1991 on an increasingly multi-vectoral basis, despite being important allies of Russia. This reflected the strategic autonomy that Alexander Lukashenko and Nursultan Nazarbayev (Tokayev’s predecessor as president) cultivated.

In the wake of Moscow’s intervention, Belarus has effectively become a vassal state, sustained by rationed financial support. This has already paid dividends as far as Moscow is concerned, with Lukashenko reversing his erstwhile refusal to recognise the annexation of Crimea and to permit Russian military bases (and even the deployment of nuclear weapons) in Belarus. Indeed, the country has ended up informing the security strategy of Moscow in Europe to such an extent that the trajectory of domestic events in Belarus has become largely dependent on external actors.

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[2] https://www.cbr.ru/eng/hd_base/mrrf/mrrf_7d/?UniDbQuery.Posted=True&UniDbQuery.From=01.2012&UniDbQuery.To=01.2022

Kazakhstan is not in the same situation, but Moscow did help Tokayev consolidate his tenuous hold on power at the expense of the faction of interests surrounding Nazarbayev. The stability of the Tokayev administration is not necessarily dependent on Moscow; but the latter proved itself a powerful ally, should it ever be needed. In this sense, the Tokayev administration is likely to coordinate with Moscow more closely on foreign policy, potentially facilitating greater interdependence. This, as opposed to creeping annexation, is a cost-effective means by which Moscow can consolidate a strategic bloc.

2.2 GEOPOLITICAL RISKS: PARALYSIS IN THE WESTERN BALKANS

The Western response to a Russian escalation in Ukraine could be hamstrung by political instability in the Western Balkans. This might be violent in nature, with Bosnia and Herzegovina experiencing armed conflict for the first time since the 1990s as Republika Srpska – one of its two autonomous entities – threatens to initiate secession from state institutions.

The current standoff was triggered in 2021 by the outgoing High Representative for Bosnia and Herzegovina, Valentin Inzko, imposing legal changes to ban genocide denial. In response, the long-time leader of Republika Srpska, Milorad Dodik, ordered a boycott of state institutions by Republika Srpska officials, at the same time taking steps to create separate judicial, regulatory, tax and military bodies.

The West was slow to respond to these acts, with the Biden administration only announcing sanctions against Dodik and his close associates in January 2022; meanwhile, the EU has so far failed to agree on sanctions, due to the opposition of Hungary. The Republika Srpska leadership in Banja Luka is evincing a willingness to discuss an end to the boycott; but whether this will actually materialise is uncertain.

Even if the boycott is lifted, it will remain a symptom of a deeper institutional paralysis in Bosnia and Herzegovina – one that is eroding the functionality of the state in its current form. The representatives of the Bosniaks, Serbs and Croats who make up the country have repeatedly failed to pass electoral reforms. These are technically necessary ahead of the national elections that are scheduled for 2 October, but they are being delayed by Croat politicians, who are demanding that Bosniaks should be barred from voting for Croat candidates; in this they are supported by Banja Luka.

If electoral reforms are agreed, it will be a positive indicator; but they will likely reflect the entrenchment of ethnic divisions. If the reforms fail to materialise, voting could technically still proceed on the basis of by-laws, which was the case in the 2018 election – but the participation of Croat and Serb representatives could not be guaranteed. An alternative would be for the ruling parties to continue to govern on a technical mandate. There is a precedent for this at the local level: elections were not held in Mostar for 12 years.

Yet in the absence of a consensus, the risks of institutional failure – and even violent secession – will remain elevated. Armed conflict would be different to 1992, when the Serb minority actively seized territory to carve out its enclave, using heavy armour and other weaponry that it no longer possesses. However, the situation could escalate quickly, as the Republika Srpska police are relatively militarised and the Bosnian army is divided into ethnically homogeneous battalions. A likely flashpoint would be Brčko District, an autonomous unit that disrupts the territorial continuity of Republika Srpska.

Something that could increase the likelihood of armed conflict would be a military escalation in Ukraine. Moscow actively supports Banja Luka and could encourage unilateral action, concurrently precipitating a second security crisis for the West.

But Russian influence is just one factor among multiple competing interests in the Western Balkans. The geopolitical – and therefore economic – trajectory of the region is unclear, given that the EU accession process has stalled. There are three reasons for this. First, the unanimity required by EU member states on the enlargement process belies a deeper ambivalence over whether it should continue at all. After French President Emmanuel Macron demanded reforms to the process, in order to effectively increase conditionality, domestic political considerations in Bulgaria prompted Sofia to block the formal launch of EU accession negotiations with North Macedonia, whose membership application is coupled with that of Albania.

The prolonged uncertainty resulted in the resignation of Zoran Zaev as North Macedonia's prime minister, after his party was defeated in local elections in October. Three parliamentary elections in Bulgaria in 2021 ultimately resulted in a reformist government committed to finding an agreement with Skopje over the cultural issues that provided the basis for the veto. The applications of North Macedonia and Albania are likely to proceed, but nonetheless it is all rather symbolic, as the institutional reforms necessary for EU membership will take at least a decade – assuming they are enacted at all.

This informs the second reason for the stalled accession process: namely, that candidate states are instituting reforms that, while notionally adequate on paper, are largely hollow and vulnerable to abuse by powerful informal interests. The most problematic candidate in this respect is Serbia, where institutional power has been captured by President Aleksandar Vučić and his proxies in the intelligence services.

The third reason is that the territorial status of Serbia and Kosovo (and effectively that of Bosnia and Herzegovina) remains unresolved. In Kosovo, the formation of a majority government by Albin Kurti's Self-Determination Movement in 2021 prompted a change in approach that has widened the bilateral differences. For as long as the stalemate persists, it will be virtually impossible for either Serbia or Kosovo to join the EU. Moreover, the deadlock will prevent the formation of the Western Balkans as a unified economic bloc in its own right.

This status quo is creating a vacuum may be exploited by competing interests. Besides Russia, China has emerged as a strategic actor, even if the scale and success of its engagement is overstated. Meanwhile, Hungarian Prime Minister Viktor Orbán's hard-right government is blocking EU sanctions against the Republika Srpska leadership, and it has pledged EUR 100m in funding for the Republika Srpska entity. The influence of Budapest is modest in absolute terms, but in recent years it has exploited the delicate balance to bolster its own interests, both politically and economically.

The absence of progress in the accession process has also enabled Belgrade to position itself as a regional leader, emerging as a hub for foreign investments that are facilitating its integration into EU value chains, while simultaneously deepening its diplomatic and economic relations with China, Russia and the Arab states. Belgrade is now pioneering its own regional initiatives, such as the Open Balkan initiative, which aims to create, together with Albania and North Macedonia, a 'mini-Schengen' area, in which labour and capital may move freely – but outside the Berlin Process driven by the EU, thus excluding Kosovo, Bosnia and Herzegovina and Montenegro, as well as the customs union that it envisages.

In this sense, armed conflict is not in the interests of Belgrade, despite its willingness to exploit the political divisions of its neighbours, while its corporate interests acquire stakes in their multimedia and telecoms sectors.

2.3 POLITICAL INSTABILITY: ELECTIONS IN CESEE

Five national elections are scheduled to be held in CESEE in 2022: in Hungary, Serbia, Slovenia, Latvia and Bosnia and Herzegovina. The results will be of great significance to the balance of geopolitical power within the EU, as there is a possibility that the 'illiberal' bloc could face defeat in Hungary and Slovenia. Serbia is holding presidential, parliamentary and local elections concurrently on 3 April; regime change is unlikely, but the opposition forces will potentially be able to score symbolic victories, such as in the Belgrade mayoral election. Poland and Turkey also face an increased likelihood of snap elections in 2022, owing to the political instability that is undermining their respective illiberal governments.

On 3 April, Viktor Orbán's alliance of Fidesz and the Christian Democratic People's Party (KDNP) will compete for its fourth consecutive term in office. Over much of the past decade, Fidesz-KDNP has commanded a two-thirds majority, enabling wholesale structuring of the constitution to reflect its illiberal nationalism. In practice, this has centralised power with the Prime Minister's Office, be it directly or indirectly. International indices show that institutional checks and balances have been systematically undermined, including judicial independence, democratic oversight and media discourse. Corruption has also increased considerably, with the public-private divide blurred by an oligarchic class that has privileged access to public resources, such as contracts.

Despite the hegemony that Fidesz-KDNP has established, the upcoming election will be the most hotly contested since 2010. The reason is that six opposition parties – ranging from the centre-left Democratic Coalition to the right-wing Jobbik – have set aside years of feuding to form a single national list and to field single candidates for an alliance called United for Hungary. Such cooperation proved successful in the 2019 local elections, when opposition pacts secured victories in multiple cities across Hungary, including Budapest. United for Hungary is also fielding a single prime ministerial candidate, Péter Márki-Zay, a centre-right political outsider who was elected in open primaries. The opposition will focus on themes such as the mismanagement of the COVID-19 pandemic and the high levels of corruption.

In order to win an absolute majority in parliament, United for Hungary will need to secure 5% more of the vote than Fidesz-KDNP, which has a structural advantage owing to distortions in the electoral system. Average opinion polling currently indicates that United for Hungary has lost the momentum it accumulated after the autumn primaries.[3] The challenge is compounded by the capture of nearly all the major media by Fidesz-KDNP, as well as by the propensity of the opposition parties to engage in infighting.

Nonetheless, it is very likely that Fidesz-KDNP will lose its two-thirds majority in parliament. If United for Hungary should win, the result would be of major symbolic significance both within Hungary and in the EU. For example, suspending the voting rights of member states that violate the rule of law – such as Poland – would become considerably easier.

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[3] https://www.politico.eu/europe-poll-of-polls/hungary/

However, political instability in Hungary would increase, since the opposition alliance would immediately be hamstrung by the fact that Fidesz-KDNP has embedded many policy areas in the constitution. Meanwhile, annual budgets must be approved by the National Fiscal Council, whose three members were appointed indirectly by Orbán for nine-year terms and cannot be dismissed. If it rejects the annual budget, a snap election may be triggered automatically.

Given these obstacles, United for Hungary is still not in agreement on whether to enact changes in the modest number of areas that are outside the purview of the constitution; rewrite the constitution and submit it to a referendum; or simply override it. This will create considerable legal uncertainty, even as United for Hungary struggles to reconcile its pledge not to increase taxes with the need to reduce a structural budget deficit worth 8% of GDP.

The case of Hungary illustrates the challenge that broad alliances have in governing if they can win elections in illiberal, semi-authoritarian systems. This is partly due to institutional obstacles erected by incumbent interests; but it is equally attributable to the diverse nature of the alliances themselves, which are formed on the basis of a lowest common denominator, and which draw together a plethora of ideologies and vested interests, as well as personal rivalries.

In Montenegro and Slovakia, where multiparty opposition alliances succeeded in defeating entrenched incumbents in 2020, progress in implementing reforms has been slow, with the newly victorious majorities descending into destabilising squabbling almost immediately. In Romania, where a reformist coalition was formed in 2021, the protracted disputes between the coalition partners became so bitter that the National Liberal Party instead opted to form a grand coalition with the Social Democratic Party – the very institutional force it was seeking to dislodge.

Such paralysis perpetuates voter disaffection and increases the risk of populism and backsliding. In Slovenia, Janez Janša’s Slovenian Democratic Party is likely to emerge without partners following the parliamentary election on 24 April; but the four-party centrist alliance that is seeking to replace it has a record of instability, raising doubts as to whether it can govern effectively. In Czechia, the new five-party centre-right coalition, which comprises mostly establishment parties, will risk its popularity as it attempts deep fiscal consolidation. Yet the populist vote is large and it only failed to carry the 2021 election because of its fragmentation across parties.

Governments such as these are like minority administrations, in that they must painstakingly negotiate each policy item. There are few states in CESEE where the opposition appears in the form of a unified political movement. And even where it does – namely in Kosovo and Moldova – any new government will find its freedom of action constrained by external factors, not least larger neighbours.

Slovakia also demonstrates that within the EU, the risk of sanctions is not neutralised by regime change: the government there has struggled to introduce those changes on which its full receipt of EU recovery funds depends, such as reforms to its courts and universities. Thus, the current opposition forces in those member states that are deemed by the EU to be institutionally compromised – such as Hungary and Poland – would, if they came to power, have to contend with conditionality just as much as the current illiberal incumbents, who are facing delays in the payment of EU stimulus funds.

Yet payment risks are only a short- to medium-term factor stemming from political paralysis, populism and suboptimal governance. In EU-CEE, economic models based on foreign direct investment and the export of finished and intermediate goods to higher-value markets are reaching their limits. In order to compete on the global market in the long term, governments will need to develop industrial policies that facilitate innovation, in the process reforming education systems to upskill the labour force and facilitating research and development.[4] This impacts EU-CEE most immediately; but other emerging markets – from Russia to the Western Balkans – face similar challenges.

This all ties in with another strategic challenge: namely, the ability to halt the demographic decline, which recent censuses in Bulgaria and Croatia have shown is deeper than was thought. This does not necessarily entail a future of low growth, as structural trends such as automation are strong mitigating factors.[5] But institutional stagnation and backsliding – and the concomitant populism and political instability – are unlikely to be meaningfully reversed until the exodus of labour and skills is adequately tackled.

[4] https://wiiw.ac.at/avoiding-a-trap-and-embracing-the-megatrends-proposals-for-a-new-growth-model-in-eu-cee-dlp-5987.pdf

[5] https://www.oenb.at/dam/jcr:02851c10-fcbb-4d1f-b056-5095d246e2dc/11_Demographic_decline_feei_2018_q3.pdf

3 Country updates

ALBANIA: STRONG REBOUND IN INVESTMENT AND CONSUMPTION BOOSTS GROWTH

by Isilda Mara

The economy is expected to have accelerated to above 8% in 2021 supported by buoyant household, government and investment spending (the latter thanks to a construction boom and post-earthquake reconstruction). The expansion in economic activity benefited from rising services exports and tourism, although the levels of both remained at below those of pre-pandemic times. Merchandise exports rose sharply – especially of minerals, fuel and electricity. In December 2021, inflation rose to 3.7% and will stabilise at 3% in 2022. The fourth wave of the COVID-19 pandemic at the start of 2022 brought unprecedented numbers of daily infections. Meanwhile, 40% of the population has been fully vaccinated. Skyrocketing international energy prices suggest that 2022 could be a bumper year for the extraction industry and its exports. In 2022, growth will hover at 4.2%; this will be driven by domestic and external demand – though the pace of growth will be slower than before, since the base effect is already a thing of the past.

BELARUS: ECONOMIC PROSPECTS REMAIN GLOOMY

by Rumen Dobrinsky

According to preliminary estimates, GDP growth in 2021 as a whole was 2.3%, slightly below our last forecast, in October. In 2021, Belarus benefited from the restoration of full-fledged trade relations with Russia, rising world market prices for hydrocarbons and an upswing in the global demand for a number of commodities. However, this positive external fillip was short-lived. Economic activity in the coming years will remain sluggish, curbed by chronic structural problems and the negative effect of Western sanctions. GDP growth in 2022 and 2023 will probably be in the range of 1-2%. Imported inflationary pressures and a loose policy stance triggered a return to high levels of inflation in 2021: the average annual CPI rate for the year as a whole came close to 10%. Given the anticipated weak economic activity, the Belarusian authorities will likely prolong the accommodating policy course and, consequently, inflation in 2022-2023 may be expected to remain quite high.

BOSNIA AND HERZEGOVINA: POLITICAL TENSIONS REACH THE HIGHEST LEVEL SINCE THE 1990S

by Selena Duraković

The economy grew by an estimated 4.8% in 2021, thereby exceeding the pre-pandemic level of 2019. Industrial production, private consumption, exports and FDI inflows all increased significantly, while COVID-related mobility restrictions were fairly soft. Inflation rose strongly towards the end of 2021, due to sharp rises in food and energy prices; but it was still below 2% for the year as a whole. With further increases in energy prices, inflation is expected to climb to 2.6% in 2022 – an upward revision of 1.6 percentage points from our autumn forecast. The economy of Bosnia and Herzegovina is expected to grow by only 2.5% in 2022 – a downward revision of 0.6 percentage points from our autumn forecast. The projected growth rate is among the lowest in the CESEE region. This is largely a reflection of the increased political risks, which will likely cause public infrastructure projects and private-sector investments to be put on hold, while consumer spending and exports will grow only slowly. Political tensions have been on the rise since the second half of 2021, as one part of the country, Republika Srpska, has taken steps to create its own army, tax authority and judiciary – thus increasing the risk that it will secede. This jeopardises the country's political stability, economic progress and support from the EU, and potentially opens up the possibility of renewed inter-ethnic violence.

BULGARIA: NEW GOVERNMENT, BUT MAJOR ECONOMIC POLICY CHANGES UNLIKELY

by Rumen Dobrinsky

After prolonged political stalemate and three rounds of parliamentary elections, a new regular government finally took office in December. It is backed by a broad and diverse coalition, drawing together four parties from the left, the right and the centre. Given the heterogeneous nature of the government, major changes to the course of economic policy seem unlikely. GDP for 2021 as a whole is expected to come in at around 3.5% – at the upper end of our last (October) forecast, mainly supported by private consumption. Growth in the short run will be predominantly driven by domestic demand and will stay in the range of 3-4%. Gross fixed capital formation should pick up, thanks to the expected transfers from the EU Recovery and Resilience Facility. The current account balance in coming years will likely stay in negative territory, while rising inflation could provide a cause for concern.

CROATIA: SOLID GROWTH FOLLOWING STELLAR RECOVERY

by Bernd Christoph Ströhm

In 2021, Croatia's economy grew faster than most EU-CEE countries, with real GDP rebounding by an estimated 8.7%, in the wake of stellar 15.8% year-on-year GDP growth in Q3 2021. In 2022, we expect the economy to grow by 4.7%, with the inflow of EU Recovery and Resilience Facility (RRF) funds further supporting Croatia's growth dynamics. According to government estimates, implementation of the RRF-financed projects – including the reconstruction of earthquake-damaged infrastructure in the Zagreb, Krapina-Zagorje, Sisak-Moslavina and Karlovac counties – will contribute 1.4 percentage points to headline GDP growth in both 2022 and 2023. As the government steps up fiscal consolidation with a view to introducing the euro in January 2023, this year's budget deficit will decline to below the 3% Maastricht requirement, and the public debt-to-GDP ratio will fall to around 80%. Supported by economic recovery across the EU and the normalisation of tourist activity, Croatia's current account surplus is projected to rise to 0.5% of GDP, though the unemployment rate will remain at some 7% – above pre-COVID levels. Persistent global supply-chain disruptions and higher energy prices will continue to exert upward pressure on inflation, which should average 3% in 2022.

CZECHIA: RESILIENT GROWTH DESPITE BUMPS IN THE ROAD

by Zuzana Zavarská

The economy continued to post solid growth in the second half of 2021, despite mounting challenges to the country's export-reliant industrial core. Household consumption remained a key growth driver, but gross capital formation also contributed positively through increased inventory stocks, resulting from bottlenecks. However, shortages of components dragged down industrial production and put a damper on exports – even as imports were rising dynamically. Consumer prices surged in the final months of the year, and it is anticipated that they will continue on an upward path well into 2022. As a result, the Czech National Bank became ever more hawkish, bringing the nominal policy rate to a 13-year high in December 2021, with more hikes likely to follow in 2022. While the policy rate remains very negative in real terms, rising rates could nevertheless hamper the post-pandemic recovery. Despite these headwinds, we have revised our forecasts for real GDP growth in 2022 upward to 4% (from 3.7%). This reflects an impressive degree of resilience, alongside an expectation on our part that the bottlenecks will ease later in the year, releasing pent-up exports. It is also anticipated that fixed capital formation will stimulate growth, as investment regains its dynamism. Nevertheless, challenges remain. We expect inflation to stay high in 2022, reflecting continued supply pressures, and the labour market to become stretched. Given the roll-out of support measures in response to rising energy prices, and the potential for virus mutations to limit business activity, there may not be much room for fiscal consolidation, despite the new government's commitment to maintaining tighter budgets.

ESTONIA: GROWTH APPROACHING THE LIMITS

by Maryna Tverdostup

The economic growth that commenced in the first half of 2021 lasted through the second half of the year, largely based on three pillars – thriving private consumption, rapid utilisation of resources (which had been standing idle since the outbreak of the pandemic) and a sharp rise in hours worked. A recovering external environment, thriving domestic production and improved purchasing power fuelled foreign trade. Inflation has exceeded all expectations, reaching 12.2%, year on year, in December; this was driven mainly by exceptionally high energy prices and, to a lesser extent, by food and durables. After estimated growth of 7.8% in 2021, we have revised our projection downward to 3.5% for 2022, followed by 4.0% for 2023. The pace of economic recovery will gradually wane in 2022 due to high inflation, a slump in private consumption in response to increased prices, and supply-side limitations, including mounting shortages of labour and production resources. There will be further strong price pressure in the first half of 2022, with extreme energy prices, a steady increase in food prices and rising wage costs; this will result in 5.5% inflation in 2022. The budget will remain in deficit within the forecast horizon, since the increased public-sector expenditure – including on defence and pensions – is barely covered by rising tax revenues.

HUNGARY: TIME TO STEP ON THE BRAKES

by Sándor Richter

In 2021, the Hungarian economy grew by an estimated 6.3%, virtually recouping the losses from the previous year's strong COVID-19-related recession. Demand management fostered growth on both the investment and the consumption sides, albeit at the cost of a deterioration in the fiscal and external balances and accelerating inflation. CPI inflation had jumped to 7.4% by the end of the year, and in December the exchange rate came close to its historical lowest value. The central bank started with a cycle of policy rate hikes as early as June, while the government carried on injecting additional demand into the economy via various election campaign lollipops. Increased deficit spending, combined with the effect of partially suspended EU transfers, may have pushed the public debt/GDP ratio above 80% again towards the end of last year, with a general government deficit of close to8% of GDP. There will be no major alteration to economic policy until after the April elections. Irrespective of whether Prime Minister Orbán remains in office or the united opposition comes to power, the government will have to start with consolidation of the fiscal stance, in order to stop overheating. The easy part of this would be to suspend several unnecessary and/or overpriced investment projects; however, unpopular measures involving household incomes are also likely to be unavoidable. One crucial issue will be whether the partial suspension of EU transfers is lifted: such a move would relieve the expenditure side of the budget and improve the external equilibrium as well. Consolidation measures are expected to slow economic growth to around 4.5% this year. Nevertheless, both the curbing of inflation and consolidation of the budget require economic policy to be more restrictive and monetary policy tighter than is currently the situation, with repercussions extending beyond 2022.

KAZAKHSTAN: STABLE OUTLOOK DESPITE RECENT TURMOIL

by Alexandra Bykova

Following the protests that rocked Kazakhstan in early January, a reshuffle of the political elite and the managers of large state-owned enterprises has got under way, as President Tokayev consolidates his political power. Despite uncertainty over the extent of the political changes and their economic impact, we expect economic growth to exceed 4% over the next three years and to be in line with long-term averages. The high global oil price favours the growth of exports; domestic demand is recovering; and the increase in the minimum wage of around 40% from January 2022 will further boost consumption this year. Industrial output is likely to remain robust, supported by a strong performance in the manufacturing sector and a recovery in the mining sector, which is gaining momentum in the wake of relaxed OPEC+ oil production restrictions. However, the spread of the Omicron variant of the coronavirus poses a downside risk to the revival of economic activity in 2022. A mild slowdown in consumer price inflation was observed at the end of 2021. Moreover, temporary price regulation of the main motor fuels (until mid-2022) and of socially important food products has been introduced following protests. However, both inflation and depreciation of the tenge remain negative risks to the forecast, given the high global food and energy prices. These risks are reinforced by those that may carry over to Kazakhstan from developments in Russia, due to the two countries' strong trade relations.

KOSOVO: GROWTH MOMENTUM HAMPERED BY ENERGY CRISIS

by Isilda Mara

The economy grew by 16.8% in Q2 and by 14.5% in Q3 2021, year on year; overall growth in 2021 is expected to be 8.8%. The main drivers were strong growth in household and government consumption, as well as in investments. The current account deteriorated, despite a doubling of goods and services exports, while remittances surged to 15% of GDP. Because of the heavy dependence on imports, the current turmoil on the international energy markets is reflected in a sharp hike in consumer prices – up 6.7% in December 2021 (and 3.4% for 2021 as a whole). On 29 December 2021, the government declared a state of emergency: a number of restrictions (including power cuts) will be in force for 60 days. Higher energy prices will lead to greater production costs; but disruption to the power supply will have an effect on production and will impact business investment and employment decisions. At the start of 2022, the daily number of COVID-19 infections again soared, as migrants returned for the new year holidays and as the new Omicron variant of COVID-19 took hold. We expect growth to lose its momentum and hover around the 4.3% mark in 2022.

LATVIA: FURTHER RESTRICTIONS SLOW DOWN RECOVERY

by Sebastian Leitner

Following a remarkable economic rebound during much of 2021, growth again decelerated as the year drew to a close. In October 2021, the government imposed another hard lockdown to curb the rising tide of infections; this included the closure of schools and non-essential shops. Epidemiological safety measures are likely to result in slower economic development in the first months of 2022, as well – a trend that is reflected in lower business confidence. Investment, particularly in public infrastructure, will be an important driver of growth in 2022, and will also be financed by the NextGenerationEU programme. The surging inflation, induced by increasing energy prices, will continue throughout this year and will only decline in 2023. A tightening labour market will result in double-digit net wage increases. We expect GDP to have increased by 4.5% in 2021 and forecast economic activity to continue to recover by 4.3% this year. While investment should pick up in 2022, we expect growth in consumption and exports to slow somewhat. The government plans to reduce the general budget deficit from more than 9% of GDP last year to below 5% of GDP in 2022.

LITHUANIA: ECONOMIC CATCH-UP CONTINUES AMIDST THE PANDEMIC

by Sebastian Leitner

The country's economic recovery remained solid throughout 2021, supported by a revival of investment activity and a rapid growth in household consumption. The latter will continue in 2022, given the roughly 14% increase in the national minimum wage (which rose to EUR 730 in January) and the reduction in the tax burden on employees. In addition, employment this year will exceed the 2019 level. Consumer price inflation will remain high and will abate only in 2023. Given the good revenue picture, the government plans to increase investment in real terms in 2022, while at the same time reducing the budget deficit to about 3% of GDP. We expect GDP to have increased by 5% in 2021 and forecast that GDP growth will moderate to 3.7% this year. In the two years to follow, a slowdown to a trend growth rate of 3% is expected.

MOLDOVA: HIT BY RUSSIAN GAS PRICE HIKES

by Gábor Hunya

The economy rebounded by close to 8% in 2021 (largely on account of a bumper harvest), which compensated for the losses inflicted the previous year by COVID-related lockdowns and disruptions. Gas and energy shortages and price hikes triggered an economic slowdown and surging inflation in Q4 2021, setting the trend for 2022. Our forecast has been corrected downward and anticipates a halving of the GDP growth rate, compared with last year, in addition to surging inflation and expanding budget deficits. As of January 2022, the price that Moldova pays Gazprom for gas has more than quadrupled, compared to a year ago; this will necessitate some cumbersome adjustments in the economy. Inflation will barely fall from the 14% high of December 2021 before the middle of 2022, even if the central bank continues to raise the policy rate beyond the 6.5% mark valid as of mid-January. Household consumption and investments, the main drivers of economic growth, will suffer a blow. Compensation for the cost of energy and other social spending will boost the fiscal deficit to 6% of GDP. The pro-European government in office since mid-2021 enjoys the support of the West. Multinational institutions, such as the IMF and the EU, will provide a stable financing environment through loans and grants, and this will also catalyse inflows of private investment.

MONTENEGRO: AMBITIOUS ECONOMIC REFORM INCREASES BOTH OPTIMISM AND THE FISCAL RISKS

by Nina Vujanović

Montenegro posted one of the highest GDP growth rates in Europe in 2021 (11.4%), as the tourist sector flourished, boosting consumption and services exports. The fiscal economy, although still characterised by a high degree of risk, has stabilised considerably. The impressive economic recovery in 2021 was, however, overshadowed by unstable government, ethnic divisions and a weakening of the judiciary – all of which contributed to a slowdown in progress toward EU accession. Consumption and savings may be significantly boosted in 2022 by the tax and labour market reform programme 'Europe now!', which abolishes health insurance contributions, introduces progressive income taxation and almost doubles the minimum wage. It could significantly reduce income inequality, shrink the grey economy and counter the negative effects of inflation. But it may also reduce government revenues substantially, leading to calls for cuts to public spending and a rise in public debt. The uncertainty with respect to the new government coalition may dampen growth potential in 2022. By the end of Q1 2022, it is expected that the economy will have bounced back to pre-pandemic levels; meanwhile, in the absence of political turmoil, foreign direct investment and increased consumption may support further growth.

NORTH MACEDONIA: CAN THE NEW GOVERNMENT STIMULATE THE ECONOMY?

by Branimir Jovanović

North Macedonia ended 2021 with GDP still lagging some 2% below the pre-pandemic level, thus making it one of the poorest-performing Western Balkan economies. Inadequate government support, the absence of structural reforms and global supply-chain problems proved a drag on the economy throughout the year, and more recently these issues have been joined by the energy crisis. The government has found ways to prevent power cuts, but from 2022 it has had to increase the charges for both electricity and district heating. Inflation, which averaged 3.2% in 2021, will therefore rise further, and we expect it to be around 3.5% in 2022. Price freezes on some basic products have been introduced: these are likely to protect the most vulnerable groups, but it is uncertain how long they will remain in place. A new government has just been formed (January 2022): though still led by the social democrats, there is a new prime minister and cabinet. It is likely to bring fresh energy to the socio-economic sphere, but the political risks remain high, on account of its wafer-thin parliamentary majority. With a new government in Bulgaria as well, hopes are high that the EU accession process will be unlocked. All in all, we expect the economy to perform neither outstandingly well nor terribly badly in 2022, expanding at around 3.5%.

POLAND: PERSONAL INCOME TAX REFORM OFF TO A BAD START

by Adam Żurawski

GDP expanded by 5.5% year on year in Q3 2021, with household consumption (which rose by 4.5%) remaining the core driver of growth. Consumer prices surged in the final months of last year, with inflation coming in at 5.1% for the year as a whole. Along with global factors such as rising energy prices, the elevated inflation in Poland also reflects pricing decisions by the state-owned energy cartels. In order to counteract rising prices, the government is now experimenting with 'temporary' cuts to VAT and excise duties, while the central bank has started to increase nominal interest rates. The reform of personal income tax that came into force on 1 January has led to chaos and to targets being missed. The profitability of the corporate sector is at a record high, which holds out the promise of higher investment. GDP growth in 2022 is expected to top 5%, while inflation will remain a problem.

ROMANIA: STABLE GOVERNMENT HELPS MEET CONDITIONS FOR EU ASSISTANCE

by Gábor Hunya

The economic recovery of about 6.6% in 2021 was the result of elevated growth in the first half of the year and lower growth rates in the latter two quarters. Sluggish international demand, coupled with continuing supply-chain disruption and high energy prices, will keep growth down at 4.3% in 2022. This forecast reiterates our autumn forecast, despite the worsening economic environment, as it reflects improved political conditions. A grand coalition government, endorsed last November, has agreed on a compromise between the deficit-spending attitude of the Social Democratic Party and the austerity goals of the National Liberal Party. The fiscal rules for 2022, which have a deficit of 6.8% of GDP as the target, are in line with the conditions set out in the EU Recovery and Resilience Plan – which ensures the disbursement of EU funds. As for monetary policy, the central bank has been more concerned about the economic slowdown than about surging inflation, which hit 8.2% in December, year on year. Inflation may persist and external financing will expand, all of which makes future rate hikes very likely. The current account deficit widened to about 7% of GDP in 2021 (5% in 2020) due to increasing trade deficits and foreign investors' earnings. FDI inflows of more than EUR 7bn in 2021 – a figure that surpassed the levels of the pre-COVID years – recouped half of the current account deficits. The deficit will narrow to 6.5% in 2022, as a result of decelerating consumption growth, while foreign investors' commitments are expected to remain in place. The downside risk to the growth forecast consists in sustained high inflation, which will curtail household demand, and in a slowdown on the main European markets. On the upside, the inflow of EU funds will boost investments and enable rapid adjustment to the post-COVID situation.

RUSSIA: GEOPOLITICAL ESCALATION ON THE CARDS

by Vasily Astrov

After a showing of 10.5% in Q2 and 4.3% in Q3 2021 (year on year), economic recovery almost certainly picked up pace again in Q4, bringing growth for the year as a whole to an estimated 4.5%. The rebound was entirely driven by domestic demand, which is largely unaffected by the persistently adverse pandemic situation, and was accompanied by very high import growth. However, thanks to strongly rising energy prices, the current account surplus probably exceeded 7% of GDP. Despite a series of aggressive policy rate hikes (of 4.25 percentage points overall in 2021) to 8.5%, annual consumer price inflation reached 8.4% in December. This is far above the official 4% target, and makes the case for further policy tightening in coming months. Although inflationary pressures are likely to subside in 2022 (including on account of 'voluntary' price caps by retailers), inflation will probably climb further in annual average terms, due to carry-over effects from the present levels. In the baseline scenario, GDP growth is projected to slow considerably, to 2% this year and 1.5% in 2023-2024. On the one hand, economic activity should be supported by high energy prices and reduced sensitivity to the pandemic (despite the rather low vaccination rates). On the other hand, however, following the failed negotiations in mid-January on mutual security guarantees, we expect an escalation of the geopolitical conflict between Russia and the West over Ukraine (and beyond). This could lead to further US (and possibly EU) sanctions, which would weigh heavily on the rouble and – in the worst-case scenario – could push the economy into yet another recession.

SERBIA: PUBLIC SPENDING LIFTS THE ECONOMY

by Branimir Jovanović

Serbia’s economy continued its good performance in 2021 – the flash estimate is that GDP grew by 7.5%, which is among the highest figures in Europe. A supportive fiscal policy was one of the main drivers – government capital expenditure increased by over 50% in 2021. Foreign direct investment was also strong, reaching 7.4% of GDP. The strength of the economy, together with high global energy and food prices, caused inflation to reach 7.9% in December, and pushed the average for the year as a whole to 4%. The central bank has not yet raised its policy rate, but the government has decided to freeze the price of certain basic products, which should prevent inflation from escalating further. Still, due to the carry-over effects from 2021, we anticipate average inflation of 4.5% in 2022. The economy is expected to remain robust in 2022. The government will keep fiscal policy expansionary ahead of the presidential and parliamentary elections in April, and it has already embarked on some transfer programmes, such as the EUR 100 stimulus for people aged between 16 and 29. The transfers may be criticised for their timing, but they will have a positive effect on consumption and economic activity. Foreign direct investment is likely to remain strong, and so we forecast GDP growth of 4.9% in 2022. One downside risk might arise from the ongoing problems in the global supply chains, which could hit the output of foreign-owned factories in the country. Another risk might stem from ongoing protests against a proposed lithium mine, which could gather pace as the elections approach.

SLOVAKIA: SEMICONDUCTOR SHORTAGE STILL CONSTRAINS FUTURE GROWTH

by Doris Hanzl-Weiss

Slovak GDP recovered in the first half of 2021, but growth slowed in the second half of the year, with available data (e.g. Q3 GDP) suggesting that the loss of momentum was, in particular, due to net exports. Exports of the important automotive industry were down, hit by supply-chain disruptions and the shortage of semiconductors. Industrial production in this sector declined during much of the second half of last year, but seemed to bottom out in September, with monthly declines after that less severe, year on year. The delta variant led to a short hard lockdown before Christmas, while the new Omicron variant took over from the beginning of 2022. With its low vaccination rate of only 50%, Slovakia faces a higher risk than Western countries of hospital overcrowding, although the government is keen to avoid further lockdowns. GDP growth should strengthen this year relative to last, helped by two main factors: first, stronger household consumption should be backed by growing wages and pent-up demand (high rate of savings). Second, the inflow of EU money should foster investment, which declined in 2021. For this and the next two years, a strong growth impetus should come from the structural funds and the Recovery and Resilience Facility. However, there are heightened risks: lower drawing of funds may jeopardise the positive effect this year and shift it into the future. Meanwhile, the pandemic is far from over: lockdowns cannot be excluded, which would again deter household consumption. In addition, inflation will be particularly high this year (above 4%), thus reducing real wage increases. Also, supply-chain shortages of semiconductors will continue in 2022, putting the brakes on the positive growth effects of net exports.

SLOVENIA: STABLE ECONOMIC OUTLOOK TO SHAPE KEY ELECTION YEAR

by Niko Korpar

Slovenia is in the throes of the fifth wave of the pandemic, with only 57% of the total population double-vaccinated. Nevertheless, the people have, by and large, adapted to the new reality, as shown by a projected 8.8% rise in private spending in 2021. After a year in which the country's economic growth exceeded expectations – with a growth rate of 6.6% – the figure will slow in 2022 to 4.1%. Private spending will grow by 4.5% and investment activity should stay strong at 7.8%. While GDP and exports exceeded pre-crisis levels some months before the end of 2021, two important economic sectors – tourism and automotive – are still operating at below the pre-crisis levels of output: the former due to the pandemic and the latter due to supply-side issues. Whether they will recover fully in 2022 is unclear. Compared to previous years, inflation will stay high through most of 2022. The consumer price index will grow by 3.2% and export prices by 2.8%, indicating that exporters will attempt to take on some of the cost increases. Rising energy prices are also of concern to energy-intensive sectors, which play a prominent role in the economy. With a rapidly rising structural deficit, the sustainability of public finances is also under discussion; that said, the public deficit will decrease substantially year on year (to 2.4% of GDP), due to the reduction in COVID-related expenditure, and public debt will hover at around 80% of GDP. With parliamentary elections scheduled for April, no tightening of fiscal policy is to be expected, and any major reforms will likely be pushed into 2023. The elections will serve as a vote of confidence in the government of the current prime minister, Janez Janša, who has openly feuded with the media and several public institutions, such as the constitutional court. In early 2022, the likely division of parliamentary seats is far from clear, as new players are expected to enter the highly fractured political arena.

TURKEY: WEAKER GROWTH AFTER CURRENCY COLLAPSE

by Richard Grieveson

The economy performed exceptionally well by CESEE standards in 2020 and most of 2021 – it likely grew by almost 10% last year. However, cuts to the nominal policy rate at a time of rising inflation led to a currency collapse in late 2021, resulting in a further sharp surge in the price growth, which in December attained a level not seen for almost two decades. The elevated inflation is eating rapidly into real incomes: the upshot will be a dampening effect on consumption throughout 2022. With the government apparently unwilling to change course, the currency remains prone to further bouts of weakness, particularly in the context of rising interest rates in the developed world and the likely consequent outflow of capital from the emerging markets. Economic growth will be considerably more sluggish in 2022, given the inflation rate of well over 20% and the likelihood of persistent uncertainty regarding economic policy.

UKRAINE: THREAT OF MILITARY INVASION BY RUSSIA

by Olga Pindyuk

Ukraine's economy lost steam in the second half of 2021, as industrial growth and retail sales slowed. As a result, economic growth in 2021 achieved an underwhelming 3% in annual terms. Inflation, fuelled by both global factors and robust domestic consumer demand, peaked in September 2021 at 11% year on year, before starting to decline gradually. At the beginning of January 2022, only 33% of the population were double-vaccinated against COVID-19; thus the emerging Omicron wave is likely to impose a major burden on the country's healthcare system and lead to significant disruption to the economy in the first half of 2022. There are mounting negative risks to economic growth in 2022-2023. The biggest danger comes from a possible military escalation by Russia, which has massed about 100,000 troops on the border with Ukraine. Even if an invasion does not materialise, it will create a high level of uncertainty and will hinder a revival of investment. Declining world commodity prices will dampen export performance. On a positive note, inflation is expected to slow to 6% in annual terms in 2022, and further to 5% and 4.5% in 2023 and 2024, respectively. Household consumption, supported by wage growth and remittances, will remain the main driver of growth in the forecast period. GDP will increase by 3.5% in 2022-2023; we expect an acceleration of growth to 4% in 2024.

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