Outlook for selected CESEE countries and Russia

Economic growth slows sharply in the CESEE-5 region despite initial resilience; war and sanctions are triggering a protracted recession in Russia[1,2]

In the first half of 2022, the economies of *Bulgaria, Czechia, Hungary, Poland and Romania (CESEE-5)*[3] weathered the sharply deteriorating external environment caused by the war in Ukraine better than initially anticipated. Compared to our spring projections, we revise our aggregate GDP growth forecast for the CESEE-5 upward by 0.8 percentage points to 4.1% year on year in 2022. Only Poland already recorded weakening economic activity in the second quarter of the year, leading us to revise the country's projected growth down by 0.5 percentage points. Over the remainder of the year, GDP growth will slow considerably in all economies and drop to a meager 1.2% per annum in 2023 for the CESEE-5 aggregate before stabilizing at 3% in 2024. While domestic demand held up well until mid-2022, its contribution will fade, and even turn negative in 2023 in Bulgaria and Hungary. As a result, going forward, import growth will diminish more strongly than export growth, thus rendering the negative contribution of net exports smaller in 2023 and 2024. Like all previous global shocks, this crisis will delay income convergence. The positive growth differential compared to the euro area of 1 percentage point in 2022 will shrink notably in 2023, to only 0.3 percentage points, before

Table 1

OeNB-BOFIT GDP projections for 2022 to 2024 compared with the IMF forecast

	Eurostat/ Rosstat	OeNB-BOFIT projections October 2022			IMF WEO forecast October 2022		
	2021	2022	2023	2024	2022	2023	2024
	Year-on-year growth in %						
CESEE-5	**5.4**	**4.1**	**1.2**	**3.0**	**4.0**	**1.5**	**3.4**
Bulgaria	3.9	3.1	1.9	3.0	3.9	3.0	4.1
Czechia	3.5	1.8	0.8	3.9	1.9	1.5	3.9
Hungary	7.1	5.6	0.9	3.4	5.7	1.8	2.8
Poland	5.8	4.0	1.1	2.0	3.8	0.5	3.1
Romania	5.2	5.5	2.0	4.2	4.8	3.1	3.8
Russia	4.7	–4.0	–4.0	1.0	–3.4	–2.3	1.5

Source: IMF World Economic Outlook (WEO) of October 2022, Rosstat, OeNB-BOFIT projections.

[1] *Cutoff date for data underlying the CESEE-5 outlook: September 28, 2022. The projections for the CESEE-5 countries were prepared by the OeNB, those for Russia by the Bank of Finland in cooperation with the OeNB. CESEE-5 projections are based on the assumptions of the September 2022 ECB staff macroeconomic projection exercise for the euro area, according to which real annual GDP growth in the euro area is projected to amount to 3.1% in 2022, 0.9% in 2023 and 1.9% in 2024.*

[2] *Compiled by Julia Wörz with input from Stephan Barisitz, Mathias Lahnsteiner, Thomas Reininger, Tomáš Slačík, Thomas Scheiber and Zoltan Walko.*

[3] *Since Croatia will join the euro area on January 1, 2023, it will be part of the euro area aggregate for most of the forecast horizon. We therefore decided to switch to the new aggregate of CESEE-5 countries for our semiannual projections. This aggregate includes the EU members in Central and Eastern Europe that have not yet adopted the euro.*

recovering again to 1 percentage point in 2024. Our projections hinge crucially on the external environment and in particular on developments in the euro area. Uncertainty remains exceptionally high, and the balance of risks continues to be tilted to the downside.

Russia's war in Ukraine and severe Western sanctions have caused Russia to plunge into recession. We project that GDP will decline by about 4% in 2022 and by another 4% in 2023, before growth will bounce back to about 1% in 2024. The factors shaping the continuing slide of the Russian economy differ from 2022: In 2023, net exports will likely turn strongly negative because Russia is not likely to find new buyers for the amount of oil deliveries affected by the EU oil embargo; domestic demand drivers will marginally weaken, while imports are expected to recover at least slightly.

1 CESEE-5: all demand components will continue to weaken well into 2023, EU funds keep supporting investments

The first two quarters of the year 2022 surprised with strong growth in all countries except for Poland, where quarterly GDP growth turned negative in the second quarter of the year. Households continued to profit from savings accumulated during the pandemic, stable labor markets and double-digit nominal wage growth in the first six months of 2022 (except in Czechia), which sustained purchasing power despite rapidly rising inflation rates. Investment activity provided a stable contribution to economic growth. However, high-frequency indicators signal that the economies' resilience in the face of the sharply deteriorating external environment shaped by high inflation and the war in Ukraine is dwindling. Industrial production growth is slowing in all sectors, especially in export-oriented sectors, and expectation surveys reached new lows in August. Purchasing managers' index readings available for Poland and Czechia reached a low last seen at the height of the COVID-19 pandemic in spring 2020. Fewer new orders and increasing delivery times for inputs were cited as factors for these low readings.[4]

We base our forecast on the assumption that the status quo concerning the war in Ukraine will remain more or less unchanged over the projection horizon. While a diplomatic solution is out of sight given the most recent developments, a further escalation may occur any time but does not form part of our baseline. This assumption implies that sanctions will remain in place, with the EU import embargo on Russian oil taking effect at the end of this year. We also assume that gas deliveries from Russia to Europe will remain at their currently negligible levels. Hence, the CESEE-5 economies will be forced to reduce their dependency on oil and gas imports in general, and particularly on those from Russia, much faster than anticipated some months ago.

Outlook depends crucially on future inflation path

The rise in inflation has continued unabated since our last projections. Going forward, two factors in particular may lead to renewed inflation pressures: Further price hikes in wholesale energy markets may occur, and country-specific measures to shield households from the most severe price effects will have to be terminated sooner or later. Clearly, inflation remains one of the decisive factors shaping our

[4] *For further details, see Economic trends in CESEE in this issue of Focus on European Economic Integration.*

forecast. We do not expect inflation to recede notably before mid-2023 for the CESEE-5 aggregate. Yet, despite this extended period of high inflation, strong nominal wage growth and minimum wage rate hikes expected for the beginning of 2023 will compensate households so that we expect real wages to rise again from mid-2023 onward in most countries.

Despite recent employment growth, labor markets will remain tight as firms in the region increasingly cite labor as a factor limiting production. Further, skill mismatches will not dissipate soon.

As mentioned before, energy will remain a decisive factor shaping inflation dynamics even if the impact of different energy sources is currently changing. The focus has clearly shifted from oil to gas: While oil price developments have normalized again, gas prices will remain an important source of inflation and may per se impact on the operation of companies in certain sectors. While we do not expect crucial shortages of supply or gas rationing, record-high gas prices may render business operations economically unviable for some companies, especially smaller and medium-sized firms in branches heavily dependent on gas. On the other hand, high gas prices will also leave their imprint on demand, thus alleviating price pressures to some extent. Overall, high gas prices will leave their mark on economic activity over most of our projection horizon as the situation is unlikely to relax notably anytime soon. Much will depend on how quickly firms can reduce gas demand and/or switch gas suppliers and energy carriers.

No further support from monetary policy, fiscal policy remains overall supportive

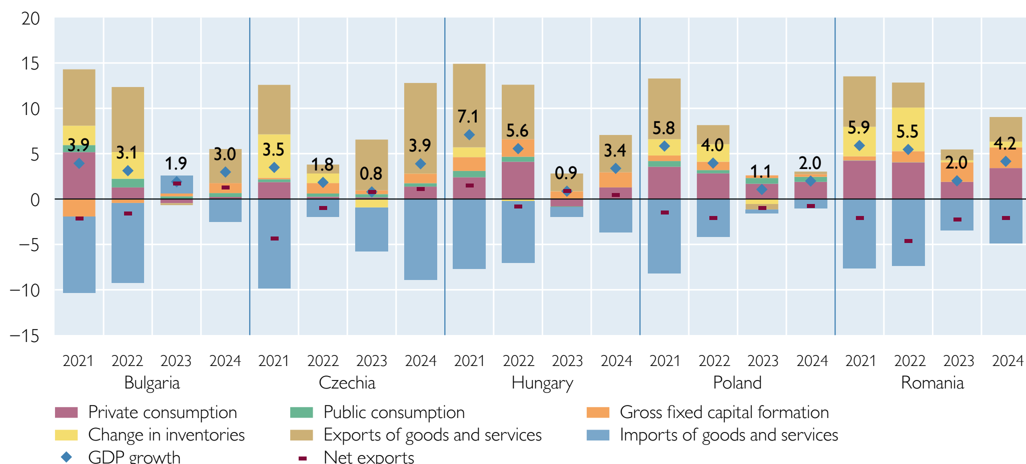
Monetary policy will be challenged to find the right balance between keeping inflation expectations well anchored while not dampening economic activity too much. After pronounced rate hikes throughout the first half of 2022, the monetary policy committees in Romania and Poland have opted for lower rate increases in their recent sittings, and the Czech National Bank (CNB) has kept rates constant in its last two meetings. Yet, high inflation, exchange rate pressures or the expected further tightening by major global central banks such as the Fed and the ECB could necessitate further rate hikes. In contrast, Magyar Nemzeti Bank has further stepped up its rate hikes recently and accompanied the tightening by liquidity measures.

Unlike monetary policy, fiscal policy will continue its overall supportive stance. Given that inflation is still more elevated in CESEE compared to Western European countries and against the background of a higher share of energy and food in CESEE consumption baskets, all CESEE-5 countries are under pressure to prolong their support to households. Measures to shield the population from the effects of extraordinarily high inflation include income support to vulnerable households, minimum wage hikes, tax reductions, energy subsidies and direct transfers. Since the general escape clause in the Stability and Growth Pact remains activated until end-2023, there is little pressure on the governments to withdraw these various forms of support to households too soon. Hence, we expect that these measures will remain in place for some time and will be financed by dedicated taxes where necessary. In addition to support for households, all countries have increased their military expenses, which has partly resulted in higher public employment supporting output growth. But higher military spending has also led to additional imports, with a consequently negative contribution to GDP growth.

Chart 1

CESEE-5: GDP and GDP components

GDP contributions in percentage points, year-on-year GDP growth in %



Source: Eurostat, OeNB.

Note: Realized data for 2021, projections for 2022 to 2024.

Notable slowdown in private consumption

The second half of 2022 will be marked by a notable weakening in all demand components. Private consumption growth will drop from 4.7% year on year in 2022 to 1.8% in 2023. A combination of factors will cause private consumption growth to be notably lower in 2023 than in 2022: Pent-up demand from the pandemic has mostly been satisfied. In addition, strongly increased uncertainty, rising energy and food bills and hence lower disposable incomes are increasingly translating into lower demand for durables. This has already been observed to some extent since mid-2022 and will continue into mid-2023 as we do not expect inflation pressures to ease much before then. At the country level, the picture is mixed: Private consumption will hold up better in Poland and Romania, the two largest countries in the aggregate. In both countries comprehensive support measures for households play a cushioning role; in Poland, consumption by immigrants and refugees will also play a role in 2023. In contrast, Bulgaria and Hungary will record a decline in private consumption in 2023. In both countries, we expect household support to be scaled back considerably while, in Hungary, also a base effect is playing a role. In Czechia, private consumption will almost stagnate in both, 2022 and 2023, as consumer confidence has reached a record low and inflation is weighing strongly on disposable incomes. In Czechia, and to a lesser degree also in Hungary, we do not expect an overcompensation of inflation by nominal wage growth despite tight labor markets. With inflation pressures fading from mid-2023 onward, we expect private consumption growth to regain ground and accelerate again in all countries. Yet, at 3.3% annually in 2024, aggregate consumption growth will remain below the pre-war level.

Public consumption provides small but steady support to growth

Public consumption will show a constant but small positive contribution (of about 0.3 percentage points) to GDP growth over the entire projection horizon in the

CESEE-5 aggregate. Pre-election spending will have supported growth in Hungary in 2022, with public consumption growth and its contribution turning negative in 2023. In Poland and Romania, we expect to see some pre-election spending in 2023. Due to the ongoing excessive deficit procedure in Romania, this will translate into an increased growth contribution only in Poland.

EU funds back investments

On aggregate, gross fixed capital formation is the demand component that is holding up best against the growth slowdown. For the CESEE-5 on aggregate, growth will weaken from 4.8% in 2022 to 3.4% in 2023 before recovering somewhat to 4.3% year on year in 2024. This is the result of counteracting factors at play for all countries: the sharp slowdown in growth in major advanced economies, coupled with the projected weakness of the Chinese economy, signals a clear deterioration in external demand that will accompany falling domestic demand. Currently high capacity utilization rates will therefore soften in response to overall lower new orders and bleaker expectations. In addition, financing conditions are being significantly tightening in all countries. On the other hand, strong EU fund inflow will counteract these dampening factors. As always, aggregate figures mask greatly diverging developments at the country level: For Bulgaria and Romania, we expect investment growth to accelerate over the entire projection horizon. In Bulgaria, this means that growth in gross fixed capital formation will become positive again after negative growth in 2022. In both countries, EU fund inflows play a particularly strong role despite uncertainty over fund utilization (not least related to the political uncertainty in Bulgaria). Romania may also benefit from firms' relocation plans given the ongoing war in Ukraine. The other three countries will see a sizable decrease in investment growth. Czechia is particularly exposed to ongoing or newly emerging supply interruptions in global value chains. The Czech automotive sector is currently at a crossroads and it remains to be seen if Czechia will embark on the electrification track and thus attract sizable investments in battery production. While gigafactories for battery production have already been established in Poland and Hungary, and plans for new investments have been announced for Hungry and Romania, it is to date unclear if Czechia will follow suit in this direction. Finally, prospects for Hungary are overshadowed by the uncertainty related to its eligibility for Next Generation EU (NGEU) funds.

External demand will weaken considerably

The outlook for exports is clearly dim: As mentioned before, external demand will weaken considerably. The number of export markets is diminished by Russia having left the scene already some months ago. The repercussions of the war imply a notable growth slowdown in major Western export markets as well, such as Germany. In addition, China is struggling with a property market crisis and the authorities are not shying away from imposing severe local lockdowns in pursuit of the zero-COVID strategy. This will continue to have global economic implications. While direct exports to China do not feature prominently in overall exports of the CESEE-5, final demand from China constitutes an important factor for European value chains (especially in the automotive industry). Hence, weaker demand from China has severe repercussions on the CESEE-5. Apart from weaker external demand, also supply disruptions will reappear and affect varying production lines at different

stages in the production. Yet, even more than outright shortages, soaring input prices will constitute a growing problem for many exporters. With commodity and energy prices raging high, smaller producers may even be forced to leave the market, which will impair overall exports at the country level. The further weakening of real effective exchange rates can provide a small cushion via rising price competitiveness and lower imports, yet weak external demand will dominate the picture. Overall, CESEE-5 export growth will take a deep dip and fall from 4.4% in 2022 to 1.3% in 2023, before – based on the external assumptions of a recovery in the euro area – regaining ground and expanding by 4% year on year in 2024.

Imports will almost stagnate in 2023

The decline in import growth will be even more pronounced: the expected 7.4% annual growth rate in 2022 already implies a substantial growth slowdown compared to the previous year, yet the 2.5% annual growth rate which we project for 2023 implies that imports will almost stagnate next year. In line with our assumptions on external demand and given still muted domestic demand, import growth will reach 5% year on year in 2024. These weak readings for 2023 and 2024 will reduce the negative contribution of net exports in both years to around half a percentage point (down from −2.3 percentage points in 2022).

CESEE-5 projection risks still tilted to the downside as uncertainty remains high

The extremely high level of uncertainty has not abated since our last projections and geopolitics continue to dominate economics. Hence, the *major risks* are: *developments in major trading partners*, the evolution of the *Russian war in Ukraine* and future *inflation developments* (increasingly including second-round effects arising from a prolonged high-inflation period).

We would like to emphasize that, even more so than in previous rounds, our projections crucially depend on our external assumptions on economic growth in the euro area, in particular in Germany. So far, these assumptions do not imply a recession in the euro area and only a mild recession in Germany. However, a more pronounced or more protracted economic slump in the euro area constitutes a major risk to our forecast. While, in general, this high dependence on the external environment would imply both, up- and downside risks, overall, we think the probability of downside risks materializing is much higher at the moment – especially given the greatly increased uncertainty about the future of Russian gas supplies to Europe in 2023 and beyond.

An intensification of the war in Ukraine or an extension of war or warlike operations beyond Ukraine is a worst-case scenario, forming part of the downside risks to this forecast. At the same time, a pacification of the situation poses a strong upside risk; however, we attach a rather low probability to such a development within our forecast horizon.

Inflation may remain high for longer than anticipated. Especially elevated gas prices could trigger more severe effects on a wider range of firms than envisaged in our projections, thus eliciting more firm failures and ultimately driving nonperforming loans up. This could cause some strain on the banking sector, especially when higher than expected inflation dynamics cause a sharper than expected monetary policy tightening thus further worsening financing conditions for firms. Also, additional energy and food price shocks cannot be ruled out. Such a negative

spiral could, in the worst case, result in financial market turmoil and lead to a financial crisis on top of the current geopolitical and energy crisis. Ultimately, the energy crisis could impair climate policy cooperation and delay policy action against global warming with severe negative medium- to long-run consequences, not least via an intensification of food price inflation.

While renewed large-scale lockdowns appear unlikely from the current perspective, possibly lasting (structural) supply chain disruptions pose a further major risk on top of the currently already extreme level of uncertainty.

2 Projections for Bulgaria, Czechia, Hungary, Poland and Romania

Bulgaria: prospects for 2023 clouded by weakening external demand, high inflation and political uncertainty

Bulgarian GDP growth surprised on the upside, with 4.5% year on year in the first half of 2022. In spring, we basically expected a stagnation, assuming a slower recovery of private consumption, less government support and a rebound of investments. Actual growth dynamics turned out differently, with private and public expenditures increasing as a reaction to high inflation. Moreover, inventories contributed particularly strongly to real GDP growth, while net exports and gross fixed capital formation had a dampening effect – reflecting a boom in durable goods demand amid heighted (geo)political uncertainty. We expect these growth impulses to fade out in the second half of 2022, and consequently a slowdown of real GDP growth will drag on into 2023.

As a result, we have revised our GDP growth forecast for 2022 up to 3.1% (+0.2 percentage points) and that for 2023 and 2024 down to 1.9% (−1.6 percentage points) and 3.0% (−0.2 percentage points). Headline inflation is expected to stay in double digits at least until the second quarter of 2023, reflecting our assumptions on energy and food prices as well as second-round effects.

Domestic demand will contribute 4.7 percentage points to GDP growth in 2022, which breaks down as follows: inventories will contribute 2.9 percentage points, followed by private and public consumption, which will contribute roughly 1 percentage point each. Net exports will contribute −1.6 percentage points to GDP growth in 2022, because of deteriorating terms-of-trade and stronger import dynamics (by comparison). Furthermore, the number of international tourists remained well below pre-pandemic levels in 2022 again. The war in Ukraine and the rapid increase in the number of COVID-19 cases in July, as well as the situation at airports in Europe with canceled flights, have had an unprecedented impact and will continue to have a negative effect on the travel industry in Bulgaria.

Looking ahead, the contribution of domestic demand to GDP growth is expected to fall to almost zero in 2023, while net exports will improve and will be the key contributor to GDP growth. Although external demand, particularly from the euro area, will slow down substantially, the expected correction of imports will outweigh the effect and contribute to a narrowing of the current account deficit.

We assume that the election outcome of October 2 will prolong the political stalemate in Bulgaria into 2023. This stalemate will add to uncertainty and delay the disbursement of NGEU funds and hence associated investments in the health and education sector and basic infrastructure. As a consequence, gross fixed capital formation is expected to decline again by 2.4% in 2022 (after −9.7% in 2021) and

roughly stagnate in 2023. Moreover, political instability is delaying a comprehensive policy response to mitigate the impact of high inflation on vulnerable groups and industries. Consumer confidence has deteriorated since April 2022. We expect that the steep fall in real wages will translate into a moderate decline of private consumption in 2023. A failure to tame inflation and control the fiscal deficit could endanger Bulgaria's plans to adopt the euro in 2024.

Czechia: inflation is holding back the recovery, frictions caused by the pandemic and the war are becoming more palpable

While foreign demand continued to put a significant drag on economic growth in the first half of 2022, strong household consumption and gross capital formation backed by post-pandemic tailwinds drove a rather robust recovery. However, we expect these drivers of economic growth to start losing steam in the second half of this year amid lingering supply chain frictions, high inflation and elevated uncertainty in the wake of the pandemic and the war in Ukraine. The latter two events have brought about a massive shock, not only cyclical in nature but also structural in many respects, which will slash global growth and demand, further feed surging inflation rates and hamper supply chains over the medium-term horizon. Hence, even under the assumption that the war will not be significantly escalated and/or drawn out, a period of subdued growth and high inflation lies ahead. The economic slack in Czechia is projected to last for most of 2023 before GDP growth regains speed toward the end of the forecasting horizon.

So far, household consumption this year has benefited from a low base in the first half of 2021, remaining pent-up savings and buoyant nominal disposable income amid a tight labor market, rising wages and pensions. Yet, the forced pandemic savings have been depleted and real household income is increasingly suffering from ballooning living costs. In addition, households face rising interest rates and tightening credit conditions. As a result, consumer sentiment indicators have dropped to some of the lowest levels in two decades, which will soon be reflected in cooling private consumption. In fact, household consumption is projected to start shrinking in year-on-year terms in the second half of 2022 and keep contracting well into 2023 before it resumes gradual growth in the medium term on the back of decelerating inflation.

In contrast, public consumption will maintain steadfast growth over the forecast horizon bolstered by increased expenses related to Ukrainian refugees, military equipment, rising public sector wages as well as government compensation for high energy prices.

Fixed investment recorded rather solid growth in the first half of 2022 despite partially skyrocketing input prices and tightening monetary policy. However, against the background of persistently high prices of energy, raw materials and other inputs, these frictions will become increasingly crippling. In addition, fixed investment growth will be more and more dampened by cooling domestic and external demand and value chain disruptions. Housing investment will cool down noticeably on the back of tightened financing conditions and elevated prices for property, labor and raw materials. In contrast, rising labor costs as well as structural changes (e.g. vehicle electrification) are likely to boost investment in automation and robotization. Overall, despite some slowdown in the remainder of the year, fixed capital formation will remain relatively solid in 2022 but lose more steam next year.

Whereas the notorious shortage of some inputs, particularly semiconductors, has gradually faded, other supply side frictions and bottlenecks have obstructed production. As a result, additions to stocks (of unfinished products waiting for completion) were the single most prominent driver of economic growth in the first six months of this year. Companies will be gradually finishing off the products currently piled up in these forced stocks so that their contribution to growth should turn negative in the months ahead.

Growth of exports will remain subdued over the first half of the forecasting horizon owing to persistent supply chain disturbances and a notable slowdown of foreign demand, particularly in the euro area but also in other markets such as Russia, which was, for instance, the third-biggest sales market for the car producer Skoda. Yet, as growth of imports will slow down too because of cooling domestic demand, the contribution of net exports to growth is forecast to turn positive in the medium term and strengthen thereafter.

Following a change in the composition of the board, the CNB has paused its monetary policy tightening cycle for now. Nonetheless, the policy rate remains at its highest level since 1999 and CNB board members have signaled vigilance and readiness to resume rate hikes if necessary. Despite increased government expenditures on military equipment, support to refugees and measures to offset the impact of high energy prices, the fiscal stance is expected to be slightly restrictive in 2022 due to the earlier termination of pandemic support programs. Continued higher expenditure will turn the fiscal stance slightly supportive in 2023.

Hungary: dynamic start into 2022 but consequences of war started to bite from mid-year on

Hungarian GDP growth in the first half of 2022 amounted to 7.2% year on year, substantially exceeding our expectation of 4.5%. Private consumption grew by nearly 12%, more than twice the growth rate we had expected. Investment growth (9.5%) was also substantially stronger than expected, whereas surprisingly buoyant domestic demand resulted in a worse than expected contribution of net real exports.

Following the strong start into the year, we expect the economy to slow substantially in the second half of 2022, with the weakness extending into 2023. As a result, we have changed our GDP forecasts for 2022 (up from 3.4% to 5.6%) and for 2023 (down from 3.0% to 0.9%). We broadly maintain our expectation for 2024 (3.4%).

Heavy payouts by the government and the nearly 20% rise in minimum wages boosted private consumption during the first half of 2022. We expect private consumption growth to slow markedly in the second half of 2022 and to turn negative in 2023. Accelerating inflation is increasingly eroding strong nominal income growth. Moreover, from August 2022 the government has tangibly scaled back gas and electricity price subsidies for households and tightened the eligibility criteria for its preferential small business tax (equaling a substantial income tax hike). Interest rate hikes by the central bank have translated into markedly rising interest rates on new loans to households. All these factors have contributed to a sharp worsening of consumer confidence. Weak household consumption will likely extend into 2023, as we expect price caps (on fuel and staple foods), the mortgage interest rate cap and the limited debt repayment moratorium to be lifted and real wages to decrease in 2023. We expect a recovery to start in the second half of 2023 or early 2024, with slowing inflation and improving overall economic prospects.

Government consumption was boosted in 2022 by the spending spree ahead of the parliamentary elections in April. However, we expect government consumption to decelerate in the second half of the year as a result of savings measures, such as across-the-board expenditure cuts (or freezes) by ministries, and to contract modestly in 2023 from a comparably high base.

Various factors point to a slowdown of gross fixed capital formation, such as global supply shortages (e.g. microchips), compounded by high gas prices across Europe and dim prospects for Hungary's major trading partners. Windfall profit taxes imposed on eight sectors, rising interest rates and curtailed preferential financing programs will likely additionally restrain companies' propensity to invest. Public sector investments will partially fall victim to budgetary savings, while the inflow of EU funds could resume in the first quarter of 2023 at the earliest. Household investments will likely suffer from households' worsening real income position, rising interest rates and the substantial rise in construction prices. At the same time, the extension of the preferential VAT rate for new home construction beyond 2022 will continue to support building activity.

We expect net real exports to have a negative impact on the overall GDP growth rate in full-year 2022 despite an improving outcome in the second half of the year. For 2023, we expect export growth to slow substantially along with weakening external demand, while the stagnation of domestic demand will cause an import slowdown, resulting in a positive contribution of net real exports, which will likely get somewhat smaller in 2024.

Poland: sharp growth slowdown in 2023 but recession unlikely

In Poland, annual GDP growth is forecast to decelerate from an expected rate of 4.0% in 2022 to 1.1% in 2023 and 2.0% in 2024. Foreign demand growth will not render a positive contribution to total final demand and GDP growth in 2023. With a weight of almost 40% in total final demand, exports are of particular interest: Exports are forecast to decline by about 1% in 2023, following a projected expansion of 3.5% in 2022. Russia's war against Ukraine will continue to have both direct and indirect negative effects on Polish exports, with Russian and Ukrainian demand for Polish goods shrinking sharply and euro area growth slowing. GDP and import growth of Germany, a particularly important trading partner, is even more affected than overall euro area GDP growth and growth of euro area imports from outside the euro area. On top of this, there is also the slowdown of imports by the world excluding the euro area. Domestic demand is expected to grow by about 2.1% in 2023, substantially less than the 6% expected for 2022.

As a result, in 2023, the slowdown of foreign and domestic demand growth will decelerate import growth sharply toward near-stagnation, following projected growth of 7% in 2022. Hence, real import growth will remain marginally positive while real exports will marginally contract in 2023. Despite starting from a sizable external surplus, the growth differential will be sufficiently large to keep the contribution of net exports to GDP growth in negative territory but not as deep as in 2022.

Private consumption is expected to grow at close to 3% in 2023, a moderate slowdown from the expected 5% in 2022. On the one hand, this results from a substantial deterioration of consumer confidence, driven by the ongoing war and the rise of inflation. Moreover, employment growth will slow or even turn negative in response to slowing foreign demand and the postponement of domestic investment

projects. On the other hand, wage increases are likely to more than offset inflation, even more so as inflation will likely decline substantially in the course of 2023, due to the favorable base effect and weaker demand. The hikes in minimum wages agreed for 2023 will support poorer households' consumption. The outflow of Ukrainian migrant workers will contribute to a tight labor market and substantial nominal wage increases. At the same time, Ukrainian refugees fleeing from the war will provide additional private consumption demand, financed by personal savings and public transfers received in Poland. More generally, public support measures will bolster consumption through cuts in indirect tax rates (prolonged "anti-inflationary shield") and direct tax rates (Polish deal) as well as through energy subsidies (coal) and higher family transfers. Public consumption growth will accelerate given measures related to incoming refugees and national defense and probably also in view of elections in 2023.

Fixed investment is expected to grow at about 1.5% in 2023, after an expansion of about 5% in 2022. On the one hand, weaker foreign demand and war-driven uncertainty will considerably weaken corporate and residential fixed investment. Moreover, supply chain bottlenecks will likely remain a limiting factor. On the other hand, both public and corporate sector fixed investment will benefit from additional EU funds under the Recovery and Resilience Facility and from higher national defense efforts. Besides, the forecast incorporates a negative growth contribution from inventory change in 2023, as the buildup will be far smaller than in 2022 when it increased substantially compared to 2021.

Romania: economic growth surprisingly robust in the first half of 2022, notable weakening in 2023

As economic growth turned out markedly higher than expected in the first half of 2022, we revise our GDP forecast for 2022 upward to 5.5%. Yet, economic activity will begin to lose steam in the second half of 2022, hampered by high inflation, high energy prices and weakening external demand. As economic weakness will drag on into next year, we revise our GDP forecast for 2023 downward to 2%. With inflation expected to come down in the course of 2023 and in line with our external assumptions, we expect growth to accelerate to above 4% in 2024.

In the next few quarters, private consumption will be dampened by negative real wage growth, low consumer loan growth and tightening financial conditions. Real wage growth might turn positive again in the course of 2023 due to falling inflation rates, the renegotiation of private sector wages and likely also due to a further minimum wage hike (a minimum wage hike of 18% is being discussed). Regarding pensions, an increase of 10% in 2023 is currently being considered by government officials. Natural gas and electricity price caps were extended until August 2023, and further social measures targeted at vulnerable households were introduced in the first half of 2022. As 2023 is a pre-election year, the government might be inclined to renew or introduce further social support measures. However, public consumption is not expected to act as a distinct growth driver due to the ongoing excessive deficit procedure.

Despite high uncertainty, rising interest rates in Romania and tightening global financial conditions, we still expect gross fixed capital formation to gain importance in the growth structure, mainly due to Romania's access to sizable EU fund inflows (from the multiannual budget frameworks and NGEU). Yet, there is considerable

uncertainty about effective EU fund absorption and the implementation of the national recovery and resilience plan as a requirement for disbursements from the Recovery and Resilience Facility. Robust corporate credit growth (partly on the back of state guarantee programs) is supportive of private investments, but a tightening of credit standards can be expected. While Russia's war on Ukraine entails negative confidence effects, gross fixed capital formation in Romania could benefit from foreign direct investments related to production reallocations, from energy efficiency investments and from investments into the transport infrastructure aimed at facilitating the reconfiguration of Ukraine's export routes. Ongoing investments (and investment plans) in the automotive and battery sectors are a further positive factor for gross fixed capital formation and will also lead to an increase of Romania's export capacities.

In the short term, however, the outlook for exports is clouded by faltering external demand, remaining supply chain bottlenecks and possible production cuts related to high energy prices. Moreover, noticeable increases of unit labor costs in the manufacturing sector combined with a largely stable exchange rate vis-à-vis the euro do not bode well for Romania's external price competitiveness. While import growth will be dampened by weakening domestic demand, exchange rate developments seen so far will not entail an additional effect. Hence, we expect the growth contribution of net exports to remain negative over the forecast horizon.

3 Russia: war and sanctions are triggering a protracted recession

Russia's invasion of Ukraine and severe Western sanctions have caused Russia to plunge into recession. However, this downswing has so far been milder than originally expected because of the Russian authorities' quite effective macroeconomic response. Policy actions have included capital controls that have helped block large capital outflows and prevent massive bank runs. The resulting restabilization of the ruble in turn has contributed to reining in inflation. Other forces that cushioned the downswing were still sizable revenue inflows stemming from high oil prices and the fact that Russia redirected some energy (particularly oil and coal) deliveries to nonsanctioning countries.

GDP is projected to shrink by about 4% in 2022 and by another 4% in 2023, before growth will return to positive territory at about 1% in 2024. Private consumption will decrease markedly, in line with retail trade, destabilized by the swelling of inflation and uncertainty. Indeed, private consumption is seen as the major factor pulling the Russian economy into recession in 2022. Gross capital formation is also expected to contract sharply, largely on account of a massive drawdown of inventories following Western trade restrictions covering various sectors. On the other hand, net exports are expected to skyrocket in 2022, given a combination of a sharp sanctions-triggered drop of imports and a mild decline of exports (notably of natural gas, coal, wood and steel, while oil exports largely remain on 2021 levels). Meanwhile the fiscal stimulus delivered in 2022 promises to remain modest. Different forces from those seen in 2022 are expected to drive the continuing slide of the Russian economy in 2023: Specifically, net exports will likely plunge deep into negative territory, assuming that the planned EU embargo on Russian tanker-transported oil is implemented from late 2022, because Russia is not likely to find new buyers for the entire amount of oil deliveries in question. Moreover, Russian imports are expected to recover at least slightly. Private consumption will marginally

weaken or stagnate on its new-found lower level; the same goes for public consumption and gross capital formation. In 2024, the Russian economy is projected to revert to – very low – growth of 1% again.

Risks for this forecast are tilted downward. Uncertainty is huge and possible major defeats in the ongoing war in Ukraine may have destabilizing political and economic effects. An escalation of the war and/or the economic conflict with the West (including a threatened Russian oil embargo in response to the imposition of a unilateral price cap on Russian oil envisaged by the G7) could exacerbate Russia's recession in 2023 and further weaken the global economy with spillbacks on Russia. Given these various imponderables, the Urals export prices for 2023 and 2024 are very difficult to predict. In any case, the oil price ranges Russia can fetch are likely to be lower than in 2022, so probably no additional growth boost can be expected from oil.

Table 2

Russian GDP and components (realized and forecast)

	2019	2020	2021	2022	2023	2024
	Year-on-year growth in %					
GDP	**2.2**	**–2.7**	**4.7**	**–4**	**–4**	**1**
Private consumption	4	–7	10	–9	–1	–
Public consumption	2	2	2	2	0	–
Gross capital formation	2	–4	9	–15	1	–
Exports	1	–4	4	–5	–10	–
Imports	3	–12	17	–25	5	–

Source: BOFIT-OeNB October 2022 projections, Rosstat.