Outlook for selected CESEE countries

CESEE-6: deepest downturn after transformational recession, uncertain recovery; Russia: economy expected to recover gradually[1, 2]

According to our projections, economic growth in the CESEE-6 countries[3] will slump by 5.0% in 2020. We expect a moderate economic recovery of 3.8% in 2021 and of 3.6% in 2022. Croatia and Hungary are expected to be hit strongest by the COVID-19 crisis in 2020 but both economies will rebound somewhat more strongly in 2021. In 2020, private consumption will severely curb GDP growth in all CESEE-6 countries as a result of lockdown measures, income losses and great uncertainty among households. For 2021 and 2022, we expect a gradual recovery. The picture is similar for gross fixed capital formation. In line with our assumptions on euro area imports, exports will take a deep blow in 2020 in all CESEE-6 countries and the subsequent recovery will be somewhat muted. Import growth will turn negative in 2020 due to both lower domestic demand and lower intermediate demand for the production of export goods. In 2021, export and import growth will start to recover. Unlike during the global financial crisis, the contribution of net exports will be negative in all CESEE-6 countries in 2020 apart from Poland, and particularly so in Croatia and Hungary. From 2021 onward, we expect the contribution of net exports to become slightly more favorable in most CESEE-6 countries. The catching-up process will also be affected by the COVID-19 crisis: In our baseline, GDP growth in the CESEE-6 region will surpass euro area growth by 3 percentage points in 2020. However, the growth differential will turn negative in 2021

Table 1

OeNB-BOFIT GDP projections for 2020 to 2022 compared with the IMF forecast

	Eurostat/ Rosstat	OeNB-BOFIT projections October 2020			IMF WEO forecast October 2020		
	2019	2020	2021	2022	2020	2021	2022
	Year-on-year growth in %						
CESEE-6	**3.9**	**–5.0**	**3.8**	**3.6**	**–4.8**	**4.6**	**4.2**
Bulgaria	3.4	–5.3	4.3	3.4	–4.0	4.1	3.7
Croatia	3.0	–8.6	4.9	4.1	–9.0	6.0	4.4
Czech Republic	2.3	–5.3	2.3	3.7	–6.5	5.1	4.3
Hungary	4.9	–6.3	5.2	3.3	–6.1	3.9	4.0
Poland	4.2	–4.2	4.1	3.6	–3.6	4.6	4.5
Romania	4.1	–4.9	3.3	3.6	–4.8	4.6	3.9
Russia	1.3	–4.0	2.4	2.2	–4.1	2.8	2.3

Source: IMF World Economic Outlook (WEO) of October 2020, Eurostat, Rosstat, OeNB-BOFIT projections.

[1] *Cutoff date for data underlying this outlook: September 29, 2020. The projections for the CESEE-6 countries were prepared by the OeNB, those for Russia were prepared by the Bank of Finland in cooperation with the OeNB. In our projections, we assume economic developments in the euro area as set out in the September 2020 ECB staff Macroeconomic Projection Exercise (MPE).*

[2] *Compiled by Antje Hildebrandt, with input from Katharina Allinger, Stephan Barisitz, Markus Eller, Thomas Reininger, Tomáš Slačík and Zoltan Walko.*

[3] *CESEE-6: Bulgaria, Croatia, the Czech Republic, Hungary, Poland, Romania.*

(–1.2 percentage point) and be almost zero in 2022. Our forecast is surrounded by an exceptionally high degree of uncertainty related to the future development of the COVID-19 pandemic, connected economic developments in the euro area and the future EU budget (including the recovery fund). Overall, risks are mainly tilted to the downside.

In Russia, GDP growth[4] is expected to contract by 4% in 2020 but return to a moderate growth rate of 2.4% next year. The Russian economy has had to endure the combined effects of the COVID-19 pandemic and an upheaval in oil markets. The risk of a weaker-than-expected outcome is significant due to the continuing uncertainty related to COVID-19 and commodity market developments.

1 CESEE-6: unprecedented crisis with severe growth impact

Against the background of negative economic growth in the first half of 2020, we expect real GDP growth in the CESEE-6 to amount to a GDP-weighted average of –5.0% in 2020.[5] Annual full-year growth in 2020 will be lower than GDP growth in the first half of 2020 in most CESEE-6 countries. The opposite is the case for the Czech Republic due to already negative growth in the first quarter of 2020 (–1.9% annually). For the third quarter of 2020, we expect a strong rebound in particular in Croatia and the Czech Republic (by 7.5% and 7.9%, respectively, quarter on quarter) that will compensate for some losses recorded in the second quarter of 2020. This development is in line with euro area growth, for which a strong rebound in the third quarter of 2020 is part of our external assumptions. In 2020, growth will be weakest in Croatia (–8.6%) and the economic deterioration will be most contained in Poland (–4.2%).

In 2021, average economic growth in the CESEE-6 region will come to 3.8%, and for 2022, we expect some leveling off to 3.6%. Countries with the strongest slump in 2020 (namely Croatia and Hungary) will see the strongest recovery next year, with growth rates reaching around 5%. For the Czech Republic, however, we foresee a rather subdued recovery for country-specific reasons. For the CESEE-6 average, GDP losses are expected to be compensated only in the course of 2022.

Accommodative monetary policy to continue but challenges ahead

So far, monetary policy has been accommodative in the CESEE-6, also in reaction to needs related to the COVID-19 crisis. However, inflation rates have started to accelerate recently, which might challenge the central banks of inflation-targeting countries (i.e. the Czech Republic, Hungary, Poland). Furthermore, the growth of credit to the private sector has weakened since the beginning of the COVID-19 crisis both for households and corporates, and therefore is expected to provide limited support for economic activity at the moment.

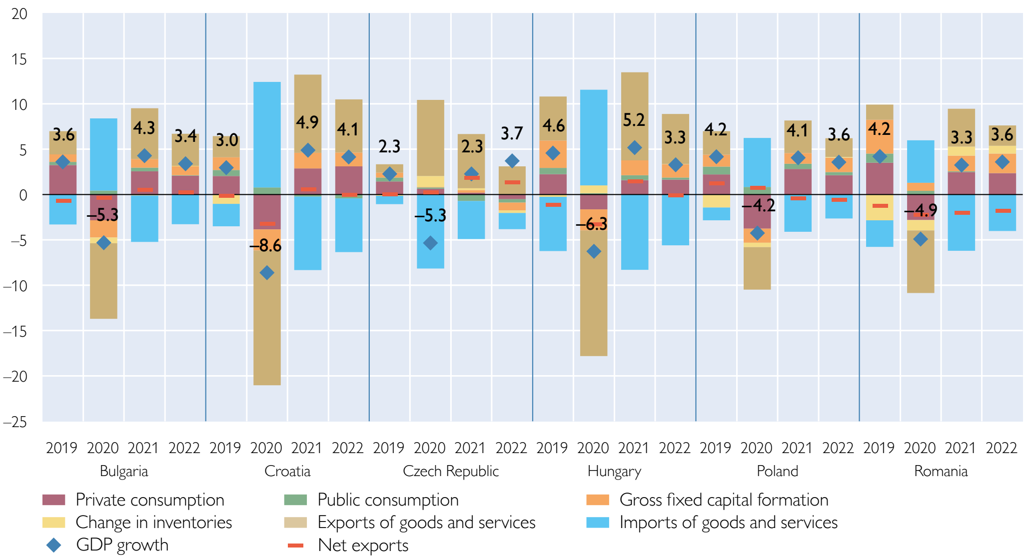
[4] *Forecast oil prices based on the average for oil futures contracts for the ten days preceding September 14, 2020, yield the following oil prices per barrel: USD 42 in 2020, USD 45 in 2021 and USD 48 in 2022.*

[5] *In our baseline, we assume that the COVID-19 pandemic will be contained or that there will be some form of treatment (e.g. vaccination) around mid-2021. Furthermore, we assume that no full lockdown will be enacted in the CESEE-6 over our projection horizon. Regarding EU funds, the EU multiannual financial framework (MFF) for the period from 2021 to 2027 will be in place while the Next Generation EU (NGEU) framework for the period from 2021 to 2026 is not part of our baseline.*

Chart 1

CESEE-6: GDP and GDP components

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



Source: Eurostat, OeNB.

Note: Realized data for 2019, projections for 2020 to 2022.

Tighter fiscal stance from 2021 onward

With regard to fiscal policy, we still assume a positive impetus for the economy, in particular until the end of 2020. Measures in reaction to the crisis have been implemented in all CESEE-6 countries (even so, they varied in size relative to GDP) and have put severe strain on public finances. Therefore, we assume a tighter fiscal stance from 2021 onward. Against this backdrop, the first round of policy measures taken to dampen the economic fallout from the COVID-19 crisis is unlikely to serve as a blueprint for a second round of policy measures if needed.

COVID-19 crisis weighs strongly on private consumption

For the CESEE-6 average, private consumption will decline by more than 5% in 2020, with the strongest slumps by more than 6% projected for Croatia and Poland. As private consumption is an important growth contributor, this reduction will significantly burden CESEE-6 GDP growth. For 2021 and 2022, we expect private consumption growth to recover and to contribute positively to growth. Importantly, the base effect will help lift private consumption growth into positive territory in 2021, with growth being strongest in countries that experienced the strongest decline. However, there will also be negative carry-over effects from 2020 that will weigh on private consumption, in addition to income losses and the uncertainty of households. In the Czech Republic, private consumption growth will be particularly low compared to other CESEE-6 countries in 2021 for various reasons, such as very little support from fiscal or regulatory policy from 2021 onward.

Public consumption growth is expected to contribute positively to GDP growth in all CESEE-6 countries in 2020. However, despite support packages for households and corporates, public consumption growth will weaken, compared to previous years, in all countries with the exception of Croatia and the Czech Republic, both of which have introduced relatively sizable support packages. In 2021 and 2022, public consumption growth in the CESEE-6 countries will slow down further compared to 2020, possibly due to limited fiscal space. Only in Hungary will growth gain speed because of carry-over effects from 2020 and the upcoming parliamentary elections.

Gross fixed capital formation will be negative in 2020 in all CESEE-6 countries with the notable exception of Romania. The drop will be strongest in Poland (–7.6% in 2020, following a growth rate of above 7% in 2019). In Romania, gross fixed capital formation accelerated by 16% in 2019 and is expected to come to 3.5% in 2020 due to a good first half of the year. The lockdown in spring 2020 meant a temporary standstill for many projects in the CESEE-6. Furthermore, an uncertain future, financial constraints or shortage of labor from abroad due to travel restrictions (particularly in the construction sector) will reduce investment activity visibly in 2020. For 2021, we foresee a recovery, which will also be based on EU funds. The recovery will be muted, though, by tightening financing conditions, a rising number of bankruptcies and idle capacities.

Our export growth projections are in line with the MPE assumption on euro area imports. Accordingly, export growth will collapse in 2020 in all CESEE-6 countries, with growth figures ranging between –30.5% in Croatia (here, the service sector including tourism exports weighs on growth) and around –14% in Hungary and Romania. Importantly, due to weaker global demand, export growth had already lost some steam in a number of CESEE-6 countries prior to the COVID-19 crisis. Most CESEE-6 countries are strongly integrated in supply chains, especially of the automotive sector, which has been particularly strongly hit by the crisis. For 2021 and 2022, we expect a rather modest recovery in line with assumptions on euro area imports. Import growth in the CESEE-6 will turn negative in 2020 due to both weaker domestic demand and lower export growth, given the high import content of traded goods. In 2021, both imports and exports will recover. In sharp contrast to the global financial crisis ten years ago, the contribution of net exports in 2020 will be clearly negative in all CESEE-6 countries, particularly in Croatia and Hungary (reaching –3.2 and –3.3 percentage points, respectively). Only for Poland do we expect a positive contribution of net exports in the current year. From 2021 onward, we expect the contribution of net exports to become slightly more favorable in most CESEE-6 countries.

Risks to CESEE-6 projections point downward

Currently, the most striking risk to our forecast – namely an increased spreading of the coronavirus in the CESEE-6, accompanied by renewed lockdown measures – is materializing in more and more instances. The Czech Republic e.g. already returned to a state of emergency in early October 2020, after the number of cases of COVID-19 infections had accelerated strongly. However, we do not expect such broad-based lockdown measures as in spring 2020. Still, the so-called second wave presents a severe downside risk to our forecast for the last quarter of 2020 and early 2021. Measures to support the economy will cushion some of the negative impacts but we do not foresee any far-reaching support comparable to what we saw during the first wave, given diminishing fiscal and monetary policy space. On the upside, a containment of the spreading of the coronavirus, new ways of reducing the dangers of COVID-19 infections, e.g. by some new treatment, or the availability of vaccination earlier than in mid-2021 (as assumed in our baseline) would improve our outlook for 2021 and 2022.

Economic growth in the CESEE-6 countries depends largely on economic growth in their trading partners. Therefore, higher (lower) growth of the world economy or of the euro area, in particular, than assumed in our baseline scenario would translate into higher (lower) growth prospects for the CESEE-6. However, we see downside risks to external growth due to the negative impacts of an emerging second wave of COVID-19 infections in the CESEE-6 trading partners. In all euro area countries, COVID-19 infection rates have recently increased strongly, with some hotspots emerging, such as France and Spain. Infection rates are now on the rise also in Germany, one of the most important trading partners of the CESEE-6.

On the upside, the CESEE-6 countries would benefit particularly strongly, compared to other EU countries in relation to their GDP, from the July European Council agreement on the EU recovery instrument Next Generation EU (NGEU) for the period from 2021 to 2026 and the multiannual financial framework (MFF) for the period from 2021 to 2027 – even though it is currently not clear (1) whether the agreed package will remain the same after the adoption of the EU budget later this year, (2) when the concrete pay-outs can start in 2021 and (3) to which extent the available funds can be absorbed domestically. Better-than-assumed usage of the MFF could lift our projections. In any case, the likely overlap of projects in 2021 and 2022 stemming from the current and the future MFF period could stimulate investment more strongly than expected in some, but not all, countries.

However, different points of view in several political areas, such as migration or climate policy, open and deepen trenches between the EU and some CESEE-6 countries. Furthermore, some CESEE-6 countries' deficiencies in aligning with the EU's democratic standards are challenging these countries' relations with other EU members and present a downside risk for the countries concerned if the EU were to condition the pay-out of EU funds on respecting the rule of law. This could also pose a more general downside risk to all CESEE-6 countries if potentially affected countries vetoed the NGEU.

Regarding Brexit, it is still unclear how the agreement between the EU and Great Britain will be designed after transitional regulations will expire in mid-2021. A hard Brexit cannot be ruled out and could likely impact our growth projections negatively, especially via trade disruptions.

In the context of international trade, disruptions in supply chains could last longer and leave deeper traces than assumed. On the other hand, a relocation of production to European countries in the process of shortening supply chains could also give a positive impetus to trade in the CESEE-6 region. Concerning the automotive sector, a slower-than-assumed recovery resulting from a combination of the COVID-19 crisis-related containment measures and climate-related policies would impact several CESEE-6 countries more strongly than expected.

On the national level, there are political risks, e.g. in Bulgaria, where strong opposition against political elites has been on the rise. More generally, demonstrations against potential new lockdown measures cannot be ruled out, either.

Second-round effects of the COVID-19 crisis are difficult to assess and present a downside risk to our forecast. In our view, additional risks to our baseline projections – namely risks arising from the phasing-out of loan moratoria, wage support, short-time work schemes, tax deferrals or other measures implemented to protect households and companies from the immediate consequences of the coronavirus-induced slump – seem contained overall. In our baseline, we assume a gradual and well-communicated phasing-out of these support measures as is suggested by recent extensions and a more stringent targeting of moratoria and support schemes in many countries. However, an unexpected or too early phasing-out could result in a stronger-than-expected increase in nonperforming loans, lower credit activity or a stronger rise in unemployment. Furthermore, a high degree of uncertainty may prevail among economic agents, both for households and corporates, which might result in higher-than-assumed precautionary saving or in lower-than-assumed investment activity.

We also see moderate downside risks to our growth projections coming from a potentially less accommodative monetary policy in light of modestly accelerating inflation rates in the CESEE-6 countries, in particular in the inflation-targeting countries. In the Czech Republic, for example, the inflation rate is already above the inflation target and thus somewhat limits the space for more accommodative monetary policy measures.

2 Projections for Bulgaria, Croatia, the Czech Republic, Hungary, Poland and Romania

Bulgaria: severe GDP contraction this year and increased political uncertainty

The COVID-19 pandemic-induced recession in Bulgaria – especially the decline in private consumption – was not as severe in the first half of the year as expected at the time of our spring forecast. Therefore, we revise our 2020 real GDP growth projections somewhat upward, expecting a decline of a bit more than 5%. In quarter-on-quarter terms, there will be a rebound of economic activity in the third quarter of 2020 while in year-on-year terms, there will still be a considerable decline. In 2021, there will be a considerable rebound helped by favorable base effects. In 2022, growth will decelerate to pre-crisis dynamics. On balance, the economy will not return to pre-crisis GDP levels before mid-2022. Private consumption remains the main driving force for the slump this year and the recovery thereafter. Net exports will contribute negatively this year before returning to making a positive contribution next year. This positive contribution will diminish somewhat in 2022 in line with external assumptions.

This baseline forecast is subject to several country-specific uncertainties. First, on the downside, the economic outcome of the summer season is, at the time of writing, still not fully visible. On the back of an intensified spread of the coronavirus in the middle of the summer of 2020, preliminary data indicate that the number of foreign tourists in the summer season amounted to only about 80% of the number recorded in 2019 and, as a result, hotels did either not open or had to shut ahead of schedule. Moreover, the recovery of several high-frequency indicators, especially of retail sales, was more restrained during the summer months than for the country's regional peers. Second, it is currently not clear when the economic policy measures adopted to mitigate the impact of the recession will terminate. The main wage support scheme – the so-called 60:40 scheme – terminated already at the end of September 2020, but there are discussions on its prolongation, whereas a second scheme with a far smaller dotation targeting tourism, transportation companies and self-employed persons should last until end-2020. Loan repayment moratoria are scheduled to remain active until end-March 2021. Amid continuing mass anti-government protests, several government support measures might remain in place until the next parliamentary election, which will either be a snap poll or take place at the scheduled date in March 2021. Political instability could also continue after the elections as traditional parties have lost support and new populist movements are on the rise, potentially hampering coalition building and thus the timely response to the crisis-induced economic shortfall.

On the upside, we must consider that Bulgaria belongs to the EU countries that would benefit most from the NGEU (with an average share of 2.7% of its 2019 GDP expected annually during the period from 2021 to 2026, according to the July European Council agreement). This could stimulate more gross fixed capital formation than assumed in our forecast. Last but not least, Bulgaria's participation in ERM II since July 2020 and in the EU banking union as of October 2020 as well as the country's gradual process toward euro adoption in the next few years will help anchor macrofinancial stability.

Croatia: downward revision due to abrupt end of tourist summer season

We revise our 2020 GDP forecast for Croatia downward to –8.6% year on year (from –7.6% year on year in the previous forecast). A key reason behind this downward revision is the resurge of COVID-19 infections in Croatia and in important tourist home countries since mid-August and related containment measures, in particular travel warnings. Our view on the remainder of the tourist season and the recovery in Croatia has therefore become more pessimistic.

We also revise the composition of growth drivers in Croatia. Private consumption is now expected to drop by less than envisaged in April, namely by 6.6% year on year. After a strong contraction related to lockdown measures in the second quarter of 2020, we are expecting a substantial rebound in the third quarter and subsequently a gradual further recovery of consumption, supported by government measures. In September 2020, the Croatian government announced, for instance, the prolongation of the wage support scheme until end-2020 (with tightened eligibility criteria) and planned income tax cuts effective from January 1, 2021. The prolonged uncertainty and slack in the labor market will likely lead to a lag in the recovery of durable goods consumption.

Gross fixed capital formation is expected to shrink by 10% year on year in 2020. Investments already contracted sharply in the first half of 2020 and we do not expect a noteworthy recovery in the second half of the year given high economic uncertainty. Loan repayment moratoria were still in place at the time of writing and used by many firms, likely masking the solvency issues of some firms. Bankruptcies and lingering uncertainty will likely subdue private investments in the coming years. However, EU funds play an important role for investments in Croatia and will support the recovery as Croatia is likely to be allocated substantial funds in the EU budget negotiations.

The realized contraction in exports and imports in the first half of 2020 has led us to revise downward our forecast for both components. Given the realized dynamics in the first half of 2020 and the fact that the tourist season was cut short in August, we now expect a strong negative contribution of net exports to GDP growth in 2020. We expect a rebound in tourism in 2021, but not to pre-crisis levels, due to several factors. In our baseline, a medical solution to the COVID-19 pandemic will not be widely available before mid-2021. Moreover, the severe economic downturn could dampen tourists' ability and willingness to spend and leave scars on the supply side if tourism-related enterprises go out of business.

Overall, we continue to expect a moderate recovery of the Croatian economy, with growth rates of 4.9% and 4.1% year on year in 2021 and 2022. Croatia will therefore need some years to recover the GDP losses of the current crisis. The substantial allocation of EU funds is one of the few upside risks, amidst a highly uncertain outlook with many downside risks related to the evolution of the COVID-19 pandemic and macroeconomic imbalances. It also remains to be seen how the Croatian government will balance fiscal stimulus and fiscal consolidation needs in the light of its targeted adoption date for the euro.

Czech Republic: despite strongly accommodative economic policies, recovery from this year's deep dive will be difficult

In spite of some relaxation in the second half of this year, economic activity in the Czech Republic is heading for a deep plunge in 2020 which will likely dwarf even the recession seen in 2009. We expect the economy to recover only very gradually over the forecast horizon as a result of long-tailed repercussions of the COVID-19 crisis as well as possible structural factors.

Economic growth in the Czech Republic had been gradually losing steam even before the COVID-19 shock hit in mid-March 2020, and the remainder of the year will continue to be heavily clouded by the COVID-19 pandemic. Nonetheless, we expect the latter to have a less detrimental effect than in the first six months to June 2020 as, inter alia, the profoundly dented but improving business sentiment indicators suggest. This is because most of the anti-coronavirus restrictions that are significant in economic terms have been wound down or largely relaxed. It currently seems that their re-introduction on a large scale would be met with a somewhat fiercer political, legal and social opposition than in spring 2020 despite rising numbers of COVID-19 infections. Moreover, the economic impact on private consumption and investment in the second half of 2020 will be mitigated by highly accommodative fiscal and monetary policy. Overall, we expect real GDP in the Czech Republic to plummet by 5.3% this year (while growth declined by 6.4% year on year in the first six months of 2020). The negative contributions of all expenditure-side GDP components will be counteracted only by accelerated growth in government consumption due to, inter alia, higher COVID-19-related expenditures (not only in healthcare).

Looking further ahead – even if the acute COVID-19 pandemic threat were to abate relatively soon (which does not seem very likely from the current perspective) – we expect economic recovery in the Czech Republic to remain rather moderate next year and to strengthen gradually toward the end of the forecast horizon. This is because private consumption, which is generally recovering, investment and export demand will be held back by several factors. On the one hand, the current fiscal and regulatory support measures for households and corporates will most likely terminate during the next months. As a result, a growing number of firms will be forced into bankruptcy, and unemployment will rise. On the other hand, several economic sectors are quite likely to suffer from long-lasting damage as a result of residual fear and prevalent uncertainty before demand and investment will return to their pre-pandemic behavioral patterns. In addition, the automobile industry, the heart of the Czech economy, was facing significant cyclical and structural demand- and supply-side challenges which will be compounded in the wake of the COVID-19 pandemic and ever-stricter EU-wide regulation. In sum, we expect domestic demand to be the main driver of relatively moderate but strengthening economic growth over the next two years. The contribution of net exports will be broadly neutral in 2021 and turn more significantly positive only toward the end of the forecast horizon.

The risks to our forecast are clearly tilted to the downside. In particular, the (structural) damage to the economy described above will be all the more pronounced the longer the COVID-19 pandemic and the ensuing restrictions and uncertainty will last.

Hungary: COVID-19 crisis causes bigger drop in GDP than expected

During the first half of 2020, GDP in Hungary performed worse than we had anticipated in March, and we now also expect a later and slower rebound than previously forecast. Therefore, we revise our forecast for 2020 downward to a GDP contraction by 6.2% year on year. For 2021 we expect a rebound by 5.2%, but at the same time we lower our forecast for 2022 to 3.3%. With inflation running near the upper bound of the central bank's target range and the Ministry of Finance expecting the 2020 budget deficit to almost double compared to its spring forecast and state debt to swell to 75% to 80% of GDP by end-2020 (from 66% at end-2019), economic policy will have hardly any room to fuel economic growth over the forecast horizon in any way similar to what it was doing over the past several years.

Following the lifting of the lockdown in May and June 2020, private consumption in Hungary will likely start to recover in the third quarter of 2020. Until end-2020, it will continue to benefit from a number of supporting policy measures taken in response to the COVID-19 pandemic. Also, the availability of various preferential loan facilities, together with central bank efforts to ensure smooth lending activity to households, should support consumption. Nevertheless, the contraction in employment, the increase in the share of part-time workers and the slowing of real average wage growth (not least due to elevated inflation) will put a brake on the recovery.

Public consumption in Hungary decreased only modestly in the first half of 2020, and we expect it to expand during the second half of the year as a result of various fiscal measures taken in response to the COVID-19 pandemic. We expect public consumption to remain strong in 2021 as a whole, due to both the carry-over effects from late 2020 and increased spending in the second half of 2021 in line with the electoral cycle (parliamentary elections are due in spring 2022).

Gross fixed capital formation in Hungary was heavily hit by the COVID-19 crisis in the first half of 2020, and we expect a notable recovery of investment activity only from the second half of 2021. EU fund inflow under the 2021–2027 MFF should aid this recovery. On the other hand, capacity utilization in manufacturing fell sharply during the crisis, the outstanding stock of credit to the corporate sector declined sharply between March and July 2020 despite the beneficial effect of the debt service moratorium and the expansion of the Hungarian central bank's various funding schemes, while corporate profitability was likely adversely affected by the COVID-19 crisis, reducing the availability of internal funds for investment as well.

External trade volumes contracted sharply during the second quarter of 2020. We expect trade volumes to start recovering in the second half of 2020, but given carry-over effects from the first half of 2020 and a strong base in the third quarter of 2019, both export and import volumes are expected to decline substantially in full-year 2020, resulting in a negative contribution of net real exports by almost

3 percentage points. Exports and imports should recover sharply in 2021, with net real exports again contributing positively to the overall GDP growth rate. With import growth overtaking export growth in 2022 in line with the further recovery of domestic demand, the growth contribution of net real exports is expected to become broadly neutral.

Poland: partial recovery in 2021 albeit still marked by COVID-19 effects

In Poland, GDP is forecast to contract by 4.2% in 2020. Growth in 2020 reflects a sharp fall of both gross exports and domestic demand. Exports will shrink by close to 9% in line with the decline in imports by the euro area, Poland's main trading partner, with no other trading partners offering substantial offset. Domestic demand, albeit severely hit by lockdown measures like in other countries, will shrink by about 5% and hence by considerably less than exports. However, the weight of domestic demand in total final demand is about 65%, i.e. almost twice the weight of exports. Thus, both exports and domestic demand render a contribution of roughly the same size to overall GDP contraction.

In 2021, the Polish economy is expected to grow by about 4.1%. While growth will be supported by a beneficial base effect, it will not be larger in absolute terms than the previous decline, as economic hysteresis effects and the number of bankruptcies postponed to 2021 will have dampening effects. Exports will start expanding again, driven by the recovery of demand in both the euro area and other parts of the world. However, foreign demand will recover substantially less strongly than it previously shrank. Moreover, some Polish export companies might go bankrupt while others will find it difficult to enter the export business in the current circumstances. Hence, export growth in 2021 is expected to come in at about 7%, only partially offsetting the previous decline. Domestic demand will show a similar pattern, with growth predicted to reach about 4.5%. Thus, both exports and domestic demand will render a large contribution to overall GDP growth in 2021.

As a result of the combined strong contraction of both export and domestic demand, imports will fall by about 11% in 2020, even more strongly than exports. Thus, there will be a positive contribution of net exports to GDP growth of more than half a percentage point. By contrast, in 2021, import growth is forecast to outpace export growth, as pent-up domestic demand will compound the effect of restarting foreign demand growth. This will imply a swing of the contribution of net exports to GDP growth into negative territory, to reach about –0.5 percentage points.

Both private consumption and gross fixed capital formation will register severe year-on-year contraction in the second half of 2020, albeit less severe than in the second quarter of 2020, especially in the case of private consumption. In the full year of 2020, private consumption is foreseen to contract by 6.5%, reflecting the comparatively low level and short duration of unemployment benefits and the high uncertainty among consumers, who likely spend only a fraction of the income support received in various forms (including partial exemptions of social security payments and banks' moratoria) out of precautionary motives. Public consumption will rise strongly countercyclically but it has a limited weight in overall GDP growth. Gross fixed capital formation is forecast to contract by 7.6% in the wake of lacking demand. A deeper contraction will likely be avoided thanks to fiscal support for companies, a more optimistic outlook for 2021 and larger public investment, which should offset the impact of the fading-out EU funding cycle on local governments and (publicly owned) companies. In 2021, domestic demand components will grow again, although the route toward normalization is not likely to be straightforward. Private consumption will benefit from pent-up demand while being held back by adverse effects from bankruptcies and the deteriorated labor market situation. Public consumption growth will moderate, but not fully reverse. Gross fixed capital formation will benefit from restarting foreign and consumer demand and from continuously stronger public investment, underpinned by the overlapping of old and new MFF funding cycles.

Romania: recovery subject to fiscal policy uncertainty

After the COVID-19-related lockdown and disruptions in global supply chains caused a deep economic plunge in the second quarter of 2020, the easing of containment measures and the resumption of production in important industries will result in a partial recovery of earlier GDP losses starting from the third quarter of 2020. After a rebound in the third quarter, recovery in Romania will likely be gradual as uncertainties will keep economic sentiment subdued and fiscal correction is imminent. According to our current projection, seasonally adjusted GDP will only in the course of 2022 reach the level recorded in the first quarter of 2020. Downside risks to our forecast for 2020 stem from this year's drought that started in spring and might cause agricultural output to be substantially lower this year than in 2019.

Turning to individual demand components, retail sales suggest that the recovery in private consumption has proceeded well. Moratoria increased households' room for maneuver while government-supported furlough schemes, in particular, averted a steep rise in unemployment. Income losses under furlough schemes and short-time work, precautionary savings as long as uncertainties remain elevated as well as gradually rising unemployment will restrict private consumption growth, however. Given the strained fiscal situation, hardly any support from fiscal policy can be expected in the coming years. In this respect, uncertainties are very high as a fiscal strategy will only be available after the parliamentary election scheduled for early December 2020. It is still unclear, moreover, whether and when the parliamentary decision to stick to a 40% pension expenditure hike, as opposed to the 14% hike envisaged by the minority government, will be enforced. If it will be enforced, this step will probably go hand in hand with counterbalancing budgetary measures.

After gross fixed capital formation (supported by vivid construction activity) showed positive year-on-year growth in the first half of 2020, the investment growth outlook for Romania appears encouraging. Gross fixed capital formation will benefit from EU funds allocated to Romania via the EU's multiannual budget for the period from 2021 to 2027 and remaining funds flowing from the 2014 to 2020 multiannual budget. Plans for new motorways and for the modernization of railway lines (both partially EU funded) have already been announced. On top of this, a substantial upside risk stems from the EU's economic recovery instrument NGEU. Moreover, state-guaranteed loans for corporates (under the IMM Invest Romania Program, which was introduced in response to the COVID-19 crisis) continue to positively affect investment activity. In the medium term, Romania could also benefit from a reallocation of production capacities as multinational European companies might try to increase capacities in Europe to make production chains less vulnerable to global disruptions.

The resumption of production of the two major car producers Dacia and Ford in May 2020 bodes well for a recovery in exports in quarter-on-quarter terms in the third quarter of 2020. With year-on-year growth in industrial production still clearly negative in July 2020, export recovery might turn out to be sluggish, however. The recovery in external demand, as predicted in our external assumptions, will result in positive export growth in 2021 (on top of the base effect) and 2022. The growth contribution of net exports will remain negative, however, as the projected pick-up in domestic demand will entail a marked rise in imports.

3 Russian economy expected to recover gradually

Russia's GDP is expected to contract by 4% this year and to return to moderate growth rates of 2.4% in 2021 and 2.2% in 2022. The Russian economy has had to endure the combined effects of the COVID-19 pandemic and an upheaval in oil markets. Preliminary figures suggest that Russian GDP contracted by 8% year on year in the second quarter of 2020 and by 3.4% year on year in the first half of 2020. As the COVID-19 pandemic has eased in Russia and other countries since spring and the situation in commodity markets has stabilized, we expect the Russian economy to recover gradually. Yet, with renewed high infection rates in late September and early October in Russia, the recovery may be subdued in the months ahead.

Private consumption has been a major factor behind Russia's sharp GDP contraction. The lockdown and other restrictions implemented to deal with the spread of the coronavirus have cut consumption substantially. Consumption is also restricted by a strong decline in real disposable income and by increased unemployment. Since the lifting of most COVID-19 restrictions, a brisk recovery in private consumption appears to be underway. The recovery in consumption is expected to continue through the end of this year, but slowly and gradually.

Preliminary data show that fixed investment declined by 6% year on year in the first half of 2020. Uncertainty about the future makes firms reluctant to invest in new capital projects. Despite monetary policy easing, the sharp drop in corporate profits in the first half of this year has made the financing of investment more difficult for firms. Public-sector investment is constrained as some spending for investment is being redirected to social issues to relieve the economic impact of the COVID-19 pandemic on households.

The volume of Russian exports shrank in the first half of this year as the COVID-19 pandemic chewed through the global economy. In the second quarter of 2020, the volume of exports, however, already posted a slight growth even in annual terms. The improvement in goods exports has been supported by the brisk recovery of the Chinese economy. Russian exports should come back gradually and grow modestly next year as global commodity demand slowly revives. Russian imports are expected to fall substantially this year on the back of a contraction in domestic demand. In particular, the COVID-19 pandemic has caused a spectacular collapse in tourism abroad. In addition, the depreciation of the Russian ruble has dampened import developments. Imports should return to modest growth next year.

The three-year budget framework for the period from 2020 to 2022, which was approved by the Russian cabinet prior to the COVID-19 pandemic, anticipated increases in government spending. As the pandemic grinds on, budget spending is to be raised further this year to support the economy. With a substantial decline in budget income, government finances should finish 2020 deeply in the red. The government will cover some of the deficit with money set aside from oil earnings in the National Welfare Fund and by increasing domestic debt. From the start of next year, however, fiscal policy is planned to moderate again, reducing the supportive effect of public spending on the economy.

Oil market and COVID-19 infection rates mark crucial risks to our Russia forecast

Also, our forecast for Russia is subject to large downside risks. If the COVID-19 pandemic or the oil market situation worsen significantly, Russia's economic outlook may deteriorate substantially. On the other hand, the recovery of the Russian economy could be slightly stronger if consumption resumes faster or if fixed investment falls more slowly than expected as households' and companies' perceptions of the economic outlook improve. Longer-term growth remains limited by the Russian economy's structural challenges. As yet, there is no evidence that the Russian authorities intend to move ahead with major reforms which would be needed to tackle the country's structural economic issues such as inadequate property protection, corruption and the state's oversized footprint in the economy.