

Outlook for selected CESEE countries and Russia

Accelerating inflation and war in Ukraine weigh on growth in the CESEE-6 region; attack on Ukraine severely hits Russia's economy^{1,2}

At 5.5%, the economies of Bulgaria, Croatia, Czechia, Hungary, Poland and Romania (CESEE-6) saw a solid rebound of annual GDP growth in 2021, moderately above our October 2021 forecast of 5.1%. However, growth dynamics started to weaken already in the fourth quarter owing to renewed infection waves and accelerating inflation. Looking ahead, the ongoing war in Ukraine and surging inflation rates in early 2022 lead us to lower our growth forecast for the current year by 1.3 percentage points to 3.2% year on year. For the years 2023 and 2024, we expect GDP to expand by 3.7% and 3.8% year on year. Regarding the composition of growth, all GDP components will weaken in 2022 except for gross fixed capital formation. In particular, export growth will halve. With import growth declining more strongly, the negative contribution of net exports will diminish. Over the entire forecast horizon, the contribution of private consumption growth will remain robust, whereas the contribution of gross fixed capital formation will strengthen notably in 2023 along with the increased disbursement of EU funds. Neither exports nor imports are expected to post a strong recovery in 2023 and 2024. Although the war impact is stronger in the CESEE-6 economies than in the euro area, a positive growth differential of 1 percentage point will reemerge in 2022 based on the severe scenario of the March MPE forecast. In general, this forecast is subject to an exceptionally high degree of uncertainty with political and economic risks tilted to the downside.

Russia's war on Ukraine markedly hurts the Russian economy. In light of uncertainty in Russia, increased Western economic and trade sanctions as well as the country's own countersanctions, we expect Russian GDP to contract by about 10% this year and thereafter remain at levels seen a decade ago, i.e. prior to the annexation of Crimea and initial sanctions on Russia. The ruble's exchange rate has fallen sharply, and Russia's imports are expected to halve to levels reminiscent of the mid-2000s. The volume of Russian exports will decline, particularly as the EU reduces its energy imports from Russia. High inflation will depress household consumption, and fixed investment will suffer. The risks to this forecast are exceptionally large and concern e.g. the war, sanctions, inflation and fixed investment. Government budget spending could grow strongly.

¹ Cutoff date for data underlying the CESEE-6 outlook: March 21, 2022. The projections for the CESEE-6 countries were prepared by the OeNB, those for Russia by the Bank of Finland in cooperation with the OeNB. All projections are based on the assumptions of the March 2022 ECB staff macroeconomic projection exercise (MPE) for the euro area, using the figures from the severe scenario, according to which real annual GDP growth in the euro area is projected to amount to 2.3% in 2022 and 2023, and to 1.9% in 2024. Forecast oil prices are based on the average for oil futures contracts for the ten days preceding March 25, 2022, and yield the following Brent oil prices per barrel: USD 100 in 2022 and USD 89 in 2023.

² Compiled by Julia Wörz with input from Katharina Allinger, Stephan Barisitz, Mathias Lahnsteiner, Anna Raggl, Thomas Reininger, Tomáš Slačik and Zoltan Walko.

Table 1

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

| | Eurostat/ Rosstat | OeNB-BOFIT projections April 2022 | | | IMF WEO forecast April 2022 | | |
|--------------------------|----------------------|--------------------------------------|------------|------------|--------------------------------|------------|------------|
| | | 2021 | 2022 | 2023 | 2024 | 2022 | 2023 |
| Year-on-year growth in % | | | | | | | |
| CESEE-6 | 5.5 | 3.2 | 3.7 | 3.8 | 3.1 | 3.4 | 3.5 |
| Bulgaria | 3.8 | 2.9 | 3.5 | 3.2 | 3.2 | 4.5 | 4.2 |
| Croatia | 10.0 | 2.4 | 3.7 | 3.5 | 2.7 | 4.0 | 3.0 |
| Czechia | 3.3 | 0.7 | 3.5 | 3.7 | 2.3 | 4.2 | 3.6 |
| Hungary | 7.1 | 3.4 | 3.0 | 3.3 | 3.7 | 3.6 | 3.7 |
| Poland | 5.6 | 4.5 | 4.1 | 4.1 | 3.7 | 2.9 | 3.2 |
| Romania | 5.8 | 2.5 | 3.3 | 3.5 | 2.2 | 3.4 | 3.8 |
| Russia | 4.7 | -10.0 | 0.0 | .. | -8.5 | -2.3 | 1.5 |

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

1 CESEE-6: inflation curbs private consumption and external demand weakens in the near term; investments strengthen in the medium term

The year 2021 was characterized by a solid rebound in economic activity. Yet, in the last months of the year, developments were shaped by partly diverging factors: The COVID-19 Delta wave led to renewed restrictions in some cases, which in tandem with accelerating inflation impacted negatively on economic sentiment.³ The Russian invasion of Ukraine on February 24, 2022, substantially worsened the outlook. We base our forecast on the assumption that fighting will abate in the course of this year, but we do not anticipate a stable peace solution to take hold any time soon. Hence, current sanctions against Russia will remain in place throughout the whole projection horizon, as the situation will not improve sufficiently to give rise to a lifting of the sanctions. While we do not presume notable Russian countersanctions – in particular, we do not assume oil and gas deliveries from Russia to be suspended – we expect commodity prices to remain elevated. We further expect war-related supply shortfalls of inputs from Ukraine to cause protracted disturbances in European supply chains, which will only be dissolved rather gradually, even though economic restrictions related to the pandemic should abate further. In the longer term, the CESEE-6 countries will reduce their dependency on oil and gas imports from Russia.⁴

Inflation will dampen real disposable income

One of the decisive factors shaping our current forecast is inflation. While the energy component was driving up consumer prices throughout most of 2021, the recent surge in January and February 2022 arose primarily from core inflation. The transition to a new year may have been a welcome moment for many producers to reset their prices and pass on part of the increased cost pressure for inputs to

³ For further details on the most recent developments, see the section on *Developments in selected CESEE countries in this issue*.

⁴ For further information on the economic linkages of the CESEE-6 countries with Russia prior to the invasion, see the section on *Developments in selected CESEE countries in this issue*.

consumers. The increase in the contribution of energy was somewhat contained due to government support measures in recent months aimed at limiting price increases for household energy (and to some extent also for fuel). The measures range from compensation payments, reductions in VAT rates and/or network charges to direct intervention in the form of price reductions or price caps. Going forward, these interventions are increasingly burdening national budgets and/or the balance sheets of energy suppliers and could lead to sudden price surges if energy prices remain elevated for a longer period of time. In January, the Czech economy experienced a sudden pick-up in inflation when the expiration of the temporary VAT exemption on electricity and gas pushed energy prices substantially upward. The prospects for a considerably longer period of high price pressures have increased substantially since the start of the war in Ukraine.

Monetary policy will be challenged to rein in inflation while not suppressing economic activity in the current environment. Sharply accelerating inflation pressures will likely affect the monetary policy stance in Czechia and Hungary, and somewhat less so in Romania, while ERM II requirements reduce the monetary policy space in Bulgaria and Croatia.

Fiscal policy tightening will be somewhat delayed for many reasons. As mentioned above, government support aimed at mitigating rising energy prices will burden public budgets, as will additional expenses for refugees. In most countries, spending on pensions will rise (Bulgaria, Czechia, Hungary and Romania). Also, the green transition will cause fiscal costs in the near term; for instance, Czechia plans to increase subsidies for renewable resources. Further additional social spending is envisaged in Bulgaria and Croatia (i.a. maternity and unemployment benefits).

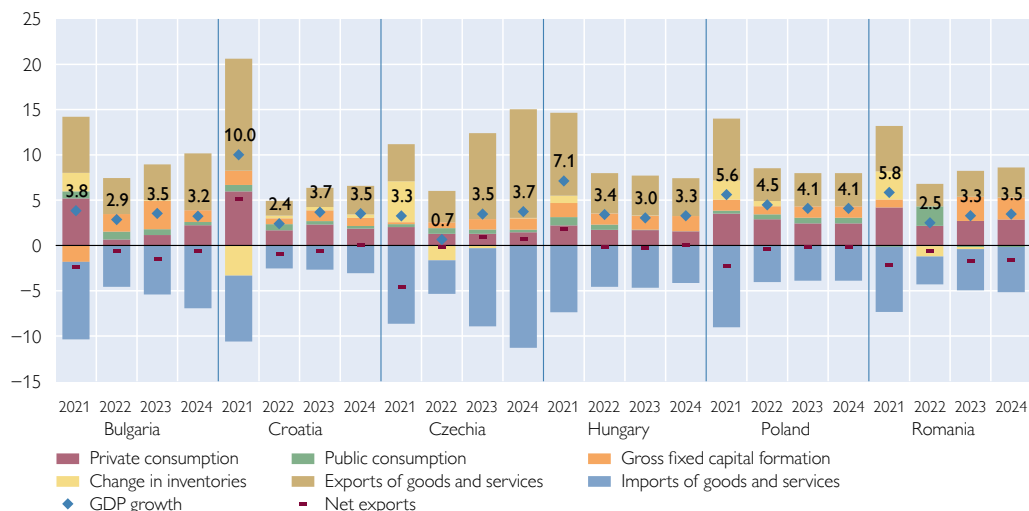
Ukrainian refugees will not immediately support labor supply

Labor markets should develop favorably; employment growth is supported by stimuli in Bulgaria and Croatia. Job retention schemes have kept unemployment low during the pandemic, and the pick-up in domestic demand, supported by increasing EU-funded investments over the forecast horizon, will lead to further demand for labor. While most governments intend to support the swift labor market integration of Ukrainian refugees, it remains to be seen how this influx of people will contribute to the labor supply within our forecast horizon. Mostly women and children were allowed to leave Ukraine, while men fit for work were prohibited from leaving the country. The participation rate for the female population in Ukraine stood at roughly 60% in 2021. The fact that many refugees stayed in neighboring countries is likely related to the hope to be able to return quickly. If these hopes should be disappointed, refugees might relocate to other destinations with an already existing large diaspora, such as Germany, Italy and Spain. Also, skill mismatches are likely to exist. Finally, it remains to be seen whether, and to what extent, the loss in seasonal workers and commuters from Ukraine, induced by the war and general mobilization, can be counterbalanced by the refugees.

Nominal wage growth will be strong, but given even stronger inflation dynamics, real wages are likely to remain flat or decrease. Minimum wages are being increased in all countries, bringing them closer to average wages. Bulgaria, Czechia and Hungary will also see strong public wage growth, while Romania has imposed a wage freeze in most public sector areas, except for moderate increases in education and health.

CESEE-6: 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.

Private consumption will remain a stable, albeit smaller, growth factor

Over the projection horizon, private consumption will expand steadily at just below 4% year on year, adding somewhat more than 2 percentage points to overall GDP growth in each year. While high inflation will weigh on real income, these negative effects on private consumption should be countered by positive labor market developments over the projection horizon. Furthermore, the inflow of refugees will immediately support private consumption, even if their integration into CESEE labor markets will take longer as outlined above.

As mentioned before, public spending will increase so as to mitigate price effects for households and corporates, to cushion the effects from the war and related sanctions and to provide assistance for refugees from Ukraine. In 2022, annual public consumption growth will be at 3% in all countries except for Romania, where fiscal space is limited by the ongoing excessive deficit procedure. For the CESEE-6 region in total, the GDP growth contribution of public consumption growth will triple to almost 1 percentage point in the current year, before falling back to around 0.3 percentage points in the subsequent years. Apart from Hungary, where some pre-election spending continued until April 2022, no further elections are scheduled in the CESEE-6 this year.

Investment growth will accelerate in 2023

Gross fixed capital formation is the only demand component to show a growth acceleration from 2021 to 2022, even though developments at the country level are mixed. Due to extremely low base effects, Bulgaria will show the strongest growth rate (+11% year on year), followed by Romania (+7% year on year). Hungary and Poland will post continuous growth in gross fixed capital formation of about 5% year on year, while the rather moderate annual growth rate of 2.5% in Czechia also implies a notable rebound from the previous year. Only in Croatia will investment

growth halve to slightly over 3% year on year. We expect gross fixed capital formation growth to accelerate more notably in 2023 in line with our baseline assumption of fading uncertainty and growing private investments, given the prospect of additional funding through the NextGenerationEU (NGEU) recovery instrument and the EU's multiannual financial framework (MFF) for 2021–2027. Much of the NGEU funds will be used to support the greening of the economy and its digital transformation, while military expenditure (also recorded as investments) may go up as well. Especially in the near term, a more vigorous expansion of investments is impaired by the elevated uncertainty, deteriorating business sentiment, continued supply chain frictions, higher prices for raw and construction materials, uncertain demand prospects (especially concerning export demand) and tighter financing conditions.

External demand is set to weaken

The outlook for exports is rather muted. Not only has Russia become less important as an export market, but the outlook for major export markets in the EU has clouded as well. Russian tourists make up an important share of tourism revenues in many CESEE-6 countries, especially in Bulgaria, Hungary and Poland. Croatia on the other hand is likely to become more attractive as a tourist destination for guests from Central Europe and could well profit from the situation. While Russia has generally not been an important export destination for the CESEE-6 economies (besides having generated not an insignificant amount of tourist revenues in some countries), it has been an important market for cars produced in Czechia (and partly hosts the production of Czech cars).

What is more important, foreign demand will recede in general, as the growth projections for all export markets, in particular in the euro area, have been revised downward. We revised export growth for the CESEE-6 region down by 3.3 percentage points to 5.3% year on year in 2022. At the same time, import growth will decelerate by 3.7 percentage points to 5.8% year on year, due to the strong import-export nexus, rising uncertainty and lower real income (thus also reducing import demand for final goods). Hence, the strong negative growth contribution from net exports will narrow to remain at –0.4 percentage points throughout the forecast horizon. Both export and import dynamics should marginally increase again in 2023 and 2024, as the geopolitical situation should stabilize and delivery bottlenecks and hence supply shortages should soften again.

Risks to CESEE-6 projections are strongly tilted to the downside; uncertainty is exceptionally high

The current environment is characterized by an extremely elevated degree of uncertainty both in political and economic terms. The two major risks affecting the outlook are the future evolution of inflation (and related second-round effects of a prolonged high-inflation scenario) and the developments in Ukraine. Both factors can turn our growth projections to the upside or the downside, whereby we consider the balance of risks to be tilted clearly to the downside at the moment.

A rapid and lasting peace in Ukraine seems unrealistic at the current juncture; hence, the severe and unprecedented sanctions against Russia are more likely to stay in place (as assumed in our baseline) than to be relaxed or lifted. On the contrary, it cannot be ruled out that the sanctions against Russia are intensified or

further countersanctions are imposed by Russia, also restricting oil and gas deliveries to the rest of Europe. This would constitute a major downside risk to our GDP forecasts, as the dependency on energy from Russia is particularly high in the CESEE-6 countries.

In the same vein, supply disruptions are likely to prevail longer than assumed in our baseline. In particular, the war has extended the range of products affected by supply shortages to more inputs, including neon from Ukraine, palladium from Russia and, most importantly, steel with a strong impact on almost all industrial sectors, including construction. Building on the flexibility observed for global value chains during previous crisis events (such as the earthquake in Japan in 2011), we assume that shortfalls of inputs from Russia and Ukraine will, to a large extent, be substituted with other sources. Yet, this process may take longer than expected or remain incomplete, given its magnitude and suddenness, which would pose a serious threat to industrial production, not least in the important automotive sector.

While we do not expect widespread restrictive measures to be re-imposed in the region in response to new surges in COVID-19 infection rates, renewed supply chain disruptions arising from the pandemic cannot be ruled out. In particular, China's zero-COVID strategy represents a risk, as closures of production sites and ports in China have the potential to shake supply chains worldwide – especially given concurrent interruptions on land routes from China due to the war in Ukraine.

While financial market reactions to the military attack have been contained so far, negative confidence effects could intensify and worsen risk sentiment further, leading to higher financial market volatility beyond the current level and to a strong rise in risk premia, which would match badly with burdened public budgets in the region.

Inflation may stay high for a longer period of time than currently anticipated by policymakers. This would bring central banks increasingly under pressure and could – if not sufficiently addressed in time – also trigger turbulences on financial markets, worsen financial conditions beyond expectations and negatively impact on financial market stability.

Apart from geopolitics, political uncertainty in the region itself prevails. It remains to be seen how the dispute with the EU about the conformity of Hungarian and Polish national regulations with EU law develops against the background of a more united EU against an external aggressor. Thus, uncertainty about the disbursement of EU funds, including NGEU funds, to Hungary and Poland remains high for the moment.

Finally, climate risks are no longer relevant in the long term only. Recent extreme events, such as floodings and droughts, have exposed the vulnerability to natural disasters of economies in moderate climate zones. In combination with imminent food shortages caused by the war raging in Ukraine, such events would yield stronger effects on food supplies and prices than under normal circumstances. More generally, the green transition coupled with currently high levels of uncertainty and depressed consumer sentiment may also affect consumer behavior and curb demand for automobiles in the near term and in the longer term alike, with a detrimental impact on this dominant sector in many CESEE-6 economies, unless structural reforms reduce dependency on the sector.

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

Bulgaria: consumption depressed by inflation; investment will lead growth in the medium term

Growth in 2021 remained below expectations in Bulgaria, and political uncertainty throughout the year and soaring COVID-19 infection cases slowed the recovery. In light of current developments, we revised our forecast for 2022 down and expect a growth rate of 2.9% in 2022, followed by 3.5% and 3.2% growth in the subsequent two years.

We expect that domestic demand will be the key contributor to growth over the next years. Private consumption, entering with a high base from 2021, will support growth over the forecast horizon, although only to a limited extent in 2022. The government adopted increases in minimum wages, pensions and social benefits, but these are likely to barely offset the increases in price levels that are expected to continue through 2022. Labor market participation rates and employment rates have been rising recently, but they are not yet back to pre-pandemic levels. The uncertainty related to the war in Ukraine, including its consequences for tourism and trade, can hinder a swift progression and constitute an obstacle for strong consumption growth.

Gross fixed capital formation is expected to be a key driver of Bulgaria's growth over the next years. This is in part due to a low base effect resulting from a sharp decline in investment in 2021 which was related to ongoing political and pandemic-induced uncertainty throughout the year. More substantially, we expect a boost to investments from the accommodative budget, effective as of April 1, 2022. The budget focuses on increasing public investment to strengthen the recovery after the pandemic. Apart from raising social spending, the government plans to bolster the education and health sector and make sizable capital investments, in particular to update infrastructure. The budget will be revised in mid-2022, and the revised budget should provide buffers to address accelerating inflation and spending related to refugees from Ukraine.

The political instability in 2021 led to a postponed submission of the country's Recovery and Resilience Plan, the approval of which is a precondition for accessing NGEU funds. Bulgaria submitted its plan in mid-October 2021, requesting a total of EUR 6.6 billion in grants under the Recovery and Resilience Facility. At the time of writing, Bulgaria's Recovery and Resilience Plan is still under review by the European Commission. Funds are not expected to flow before the second half of 2022, but we expect them to promote further investment growth in 2023.

The number of international tourists remained well below pre-pandemic levels in 2021. A shortfall in Russian and Ukrainian tourists and the geographical proximity to the war raging in Ukraine combined with the very low and stagnating level of COVID-19 vaccination rates are likely to severely hamper a recovery of the tourism industry in 2022. Subdued growth in other EU countries, the ongoing disruptions in global value chains and the high degree of uncertainty, now fueled by the war in Ukraine, will be a further drag on exports. For 2022, we expect a moderately negative contribution of net exports to growth, due to moderate growth in imports. For 2023, however, we expect imports to pick up, triggered by investment activities. Overall, net exports are expected to slow down GDP growth over the forecast horizon.

Croatia: accelerating inflation and geopolitical crisis weigh on outlook

GDP growth surprised on the upside in 2021, reaching 10% year on year. In recent months, though, the growth momentum slowed down, amidst the spread of the COVID-19 Omicron variant, accelerating inflation and Russia's invasion of Ukraine. The latter two factors have led us to revise our forecast for Croatia downward to 2.4% year on year in 2022. Growth is expected to pick up to 3.7% and 3.4% year on year in 2023 and 2024, respectively.

We expect GDP growth to be mostly driven by domestic demand, which is however difficult to predict, given the multitude of growth-retarding and -enhancing factors currently at work. Uncertainties relating to the pandemic and the geopolitical crisis, elevated and accelerating inflation and potentially also some monetary and macroprudential tightening⁵ will likely dampen domestic demand. However, the Croatian government has already undertaken measures to limit the impact of higher inflation on the private sector: It passed a substantial package that includes VAT cuts, energy price regulations and subsidies for vulnerable households and sectors. Private consumption will also be supported by another increase in minimum wages and a renewal of the housing subsidy program. On the investment side, the absorption of funds and start of projects related to the EU's MFF and the Recovery and Resilience Facility are expected to outweigh the negative effects on private investments from the factors mentioned above. Anticipating growth-retarding factors to abate over time, we see growth of private consumption accelerating from 2.8% year on year in 2022 to 3.8% year on year in 2023, and investment growth rising from 3.2% year on year in 2022 to 5.7% year on year in 2023.

Public consumption growth will make mildly positive and declining contributions to growth over the forecast horizon. Croatia must balance the need for fiscal support with the need for fiscal prudence, given high public debt levels.

We expect another successful tourist season in 2022, as the geographic proximity and perceived predictability and safety of a holiday in Croatia will likely continue to be important factors drawing (mostly) Central European tourists to the Croatian coast. This will not only support growth of exports but also feed back positively to domestic demand, given the high share of the tourism sector in gross value added and employment. We are more pessimistic about goods exports in 2022, given likely disruptions to supply chains and fluctuations of prices of raw materials. Export growth is expected to accelerate over the forecast horizon. Net exports make a negative contribution to growth in 2022 and 2023.

While there is some upside risk to our forecast, on the whole, we still consider that the risks are mostly on the downside. Upside risks would arise from a quicker-than-expected softening of inflation, an even better-than-expected tourist season and stronger investments. Downside risks largely stem from spillovers from the external environment related e.g. to the war and the pandemic, and are exacerbated by high domestic public and private debt levels.

Czechia: pandemic- and war-induced frictions turn recovery into stagflation

The relatively modest pace of economic recovery recorded in 2021 was expected to gain some momentum in the medium term. Nonetheless, owing to protracted supply chain frictions in the wake of the pandemic and elevated inflation with

⁵ The European Systemic Risk Board warned of risks in residential real estate markets in late 2021.

resultant monetary policy tightening, no exuberant economic growth was in the cards even before February 24. The war in Ukraine will curb global growth and demand, further accelerate the already surging inflation rates and hamper the still battered supply chains for much longer than expected in our last projections. As a result, apart from higher public expenditures e.g. on refugee support and military equipment, all demand-side components will face noticeable cuts. From the current perspective which is, obviously, subject to an exceptional level of uncertainty and risks, there is no chance for the long-wished-for robust economic recovery of the Czech economy to resume before the second half of the forecasting horizon.

Apart from the impact of demand related to a significant number of Ukrainian refugees, private consumption growth in 2022 will benefit from a low base in the first half of 2021 and pent-up savings. However, the buoyant nominal disposable income growth on the back of a tight labor market, rising wages and pensions will be more than offset by very high and rising inflation. Moreover, owing to the war-induced supply disruptions and other factors, including domestic ones, inflation rates will not only peak at higher levels than previously expected but will also stay high noticeably longer. Hence, in the months ahead, real wages are set to experience a plunge unseen since the beginning of transition. This will put a significant drag on household consumption growth in 2022 and beyond as is also echoed in still subdued consumer confidence. Even before the war, frictions in raw material and component supplies, particularly the shortage of semi-conductors, were expected to continue – despite some easing – in the short to medium term. Large stocks of unfinished products waiting for completion upon arrival of missing components have been driven down significantly. Nonetheless, supply chain bottlenecks translated, i.a., into reduced production in the first quarter of this year. The war in Ukraine has exacerbated the situation, as the supplies of some key components from Russia and Ukraine, particularly in the automotive industry, have been interrupted and will lead to outright production reductions at least until provisions can be recovered or substituted. As a result, supply chain disturbances and dearth of inputs in combination with impaired foreign demand not only in the EU but also in Russia – which is, for instance, the third biggest sales market for the car producer Škoda – will significantly hamper net exports and fixed investment.

To contain domestic inflationary forces and prevent inflation expectations from unanchoring, the Czech National Bank has repeatedly signaled that it will continue its monetary policy tightening, and with more vigor in light of the impact of the war on prices. Dearer credits and stricter lending conditions will thus pose an additional damper on private consumption and especially on fixed investment in the short to medium term before strengthening. While the fiscal stance was expected to be broadly neutral over the forecast horizon, with unexpected expenditures triggered by the war and the massive migration wave, it is likely to turn significantly accommodative.

Hungary: GDP bounced back in 2021, but growth outlook deteriorates

GDP grew by 7.1% year on year in 2021, sharply rebounding from the nearly 5% recession in 2020. However, dynamics slowed in the second half of the year. Prior to the war in Ukraine, we would have expected fiscal impulses to start dissipating, following the start of monetary tightening in the second half of 2021. We are

substantially revising our forecasts for 2022–2024 compared to the no-war baseline. Given the inflationary impact and heightened financial market uncertainties, monetary policy will pursue further tightening for a longer period than previously expected until inflation risks become evenly balanced. By contrast, fiscal policy tightening may be delayed if fiscal compensation becomes necessary to cushion the negative economic and social effects of the war and accommodate additional costs of care for refugees.

As for 2022, we expect negative repercussions both for private consumption and business investments to dominate. Consumer sentiment, export expectations and overall business sentiment will likely be dented by the war, while supply chains will likely be disrupted both upstream (e.g. deliveries from Russia, shortage of raw materials and semi-products) and downstream (e.g. production disturbances in major export markets/industries, export sanctions, loss of Russian tourists). Rising prices for raw materials, transport costs and potential supply shortages will burden both producers and consumers with higher costs.

As far as not consumed by higher inflation, households will likely use additional income from tax rebates/cuts, wage and pension hikes to increase their savings rate, but in 2022 private consumption will still be supported by various price and interest rate caps. Housing investments will likely remain supported by home construction subsidies, but the substantial rise in financing costs will deter credit financing.

We expect government consumption to accelerate in 2022 on the back of increased transfer payments, public sector wage hikes and operating costs (e.g. energy prices, election costs, costs of care for refugees). Thereafter, we expect government consumption to reverse owing to the need to tighten the fiscal stance (less favorable financing conditions, need to cover the expected annual losses of the central bank).

The outlook for investments remains good but less favorable than at the time of the last forecast. On the one hand, interest rates on corporate loans have started to rise in reaction to higher central bank interest rates and the end to the central bank's preferential facilities. Also, in late 2021, the government postponed investment projects worth nearly 2% of GDP, and public investments will increasingly hinge on the inflow of EU funds, notwithstanding unresolved issues concerning the release of Recovery and Resilience Facility funds by the EU. Business investments will likely be put on hold, given major uncertainties about short- to medium-term domestic and global demand conditions, deteriorating corporate earnings and high financing costs. On the other hand, the corporate sector's net financial asset position improved during 2021. Also, the economic recovery pushed capacity utilization in industry again beyond its long-term average.

We expect the contribution of net real exports to worsen in 2022, as the deteriorated global environment hampers the outlook for exports more than for imports, which will be supported by domestic demand. Overall, net exports should have a slightly negative or neutral impact on the GDP growth rate over the forecast horizon.

Poland: growth slows in 2022 as most demand components weaken

In Poland, GDP growth is forecast to decelerate year on year to 4.5% in 2022 and 4.1% in 2023, after a rebound of 5.6% in 2021 from the contraction by 2.5% in 2020. In 2022, foreign demand growth will contribute significantly less than domestic demand to total final demand (and hence GDP growth) and moderately less so in 2023. Exports, having a weight of almost 40% in total final demand, will expand by about 6% annually in 2022 and 2023, substantially less than in 2021 when their growth stood at 12%. The war in Ukraine will have both a direct and indirect negative effect on Polish exports, with Russian and Ukrainian demand for Polish goods shrinking and euro area growth slowing. Domestic demand is expected to grow by about 5.3% in 2022, substantially less than in 2021 when it expanded by as much as 8.2%. Domestic demand growth will be smaller than that of exports but render a relatively larger growth contribution given its larger weight. In 2023, domestic demand growth is expected to slow further to 4.4% in annual terms.

As a result, in both 2022 and 2023, the slowdown of foreign and domestic demand growth will decelerate import growth sharply, after imports ballooned by more than 17% annually in 2021. Likely, supply chain problems will further contribute to the weakening of real import growth, while higher import prices may somewhat uphold imports in nominal terms. In both years, real import growth is forecast to exceed real export growth, albeit to a lesser extent than in 2021. Despite starting from a sizable external surplus, the growth differential will be sufficiently large to continue rendering a negative contribution of net exports to GDP growth, but a much smaller one than in the previous year.

Private consumption is expected to grow year on year at about 5% in 2022 and 4.2% in 2023, after growing by 6.1% in 2021 when it benefited from the partially favorable base effect and from anti-COVID-19 crisis measures. Post-pandemic pent-up demand on the back of accumulated extra savings together with hikes in minimum wages will constitute supportive factors. Moreover, refugees fleeing from the war in Ukraine will provide additional private consumption demand, using both own private savings and transfers received in Poland. At the same time, the rise of inflation and the expectation of a somewhat prolonged period of higher inflation (given supply bottlenecks) will dampen private consumption, as wage increases are unlikely to reflect this acceleration of inflation to the full extent. Moreover, employment growth will slow in the wake of shrinking foreign demand, and consumer sentiment is bound to deteriorate. Public consumption growth will accelerate, given measures related to infrastructure for incoming refugees in 2022 and likely also in view of upcoming elections in 2023.

Fixed investment is expected to grow at about 5% annually in 2022, after growing by about 7% in 2021. After all, both public and corporate sector fixed investment benefit from the new MFF funding cycle and the post-pandemic National Reconstruction Plan, and corporate investment receives further support from substantial corporate savings. Yet, supply chain bottlenecks will be a partially limiting factor. Moreover, weaker foreign demand and war-related uncertainty

will prevent fixed investment growth from accelerating at high rates. For 2023, no substantial acceleration is expected either in view of these factors. Besides, the forecast incorporates a moderate growth contribution from inventory increases in 2022, albeit a far smaller one than in 2021 when increases contributed almost 3 percentage points to annual GDP growth.

Romania: moderate growth expected with EU fund inflows playing a key role

Following weakening economic dynamics in the second half of 2021, we expect GDP growth to be muted at 2.5% year on year in 2022, before slightly accelerating to 3.3% in 2023 and 3.5% in 2024. In particular in 2022, economic growth will be negatively affected by the economic ramifications related to Russia's war against Ukraine through higher inflation, supply chain disruptions and adverse confidence effects. Romania's fiscal room for maneuver seems limited against the background of the commitments made under the excessive deficit procedure. Though COVID-19 restrictions were lifted in March 2022, pandemic-related uncertainties continue to be a factor. As vaccination progress has remained subdued, further COVID-19 waves could entail the reintroduction of some restrictions.

Gross fixed capital formation will be an important growth driver over the forecast horizon due to sizable EU fund inflows (from the EU's multiannual budget frameworks and the NGEU recovery instrument). Yet, there is quite some 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 domestic credit growth (largely on the back of state guarantee programs) will support private investments. While Russia's war on Ukraine will entail negative confidence effects, Romania could benefit from foreign direct investments related to production reallocations from Ukraine and Russia.

We expect rather moderate private consumption growth figures in the coming years. The lifting of COVID-19 restrictions should underpin private consumption particularly in the first half of 2022. The minimum wage hike as well as the increase of pensions and other social security benefits effective from the beginning of 2022 will also support private consumption. High inflation rates will erode real disposable income, but high inflation expectations will likely also result in higher renegotiated wages in sectors facing labor shortages. Moreover, the extension of the energy price cap until end-March 2023 increases the leeway for consumption spending. Yet, the continued public sector wage freeze (with exceptions for state employees working in social assistance, healthcare and education) will clearly have a dampening effect on private consumption growth.

Based on the assumption of continued positive growth in the euro area, Romanian exports are projected to rise over the forecast horizon. However, their growth will be restrained by supply chain disruptions in particular in the automotive industry. Moreover, unit labor costs in the manufacturing sector started to rise markedly again in the second half of 2021, while the nominal exchange rate vis-à-vis the euro weakened only a little. Domestic demand growth will keep up import growth so that the contribution of net exports will remain negative.

3 Attack on Ukraine severely hits Russia's economy

Russia's war on Ukraine is strongly hurting the Russian economy. The most significant immediate economic effects were a roughly 40% drop in the ruble's exchange rate after the attack and a spike in inflation to record heights. Russian economic output and imports are contracting. EU countries and many others have imposed unprecedented economic and trade sanctions on Russia. The punitive measures i.a. restrict exports of selected goods to Russia, further restrict access to finance for Russian banks, firms and the government, ban certain Russian banks from using SWIFT messaging services for international payments and prohibit transactions with the central bank as well as various companies. The EU recently also set a goal of phasing out energy imports from Russia in the next few years. Russia's counter-sanctions tend to focus on imported and exported goods. Russia has also e.g. restricted outbound payments by foreign firms operating in Russia. Russian firms are now required to convert 80% of their export earnings to rubles.

We expect the Russian economy to contract in 2022 even with higher prices for oil and other key export commodities produced in Russia. Markets expect energy prices to fall especially next year, and international sanctions and Russia's countersanctions to remain in place throughout the forecast period. The EU's fresh energy goal means that EU energy imports from Russia are to decline steadily. Moreover, the pandemic is expected to subside during this year. Facing very large uncertainty, we estimate that Russian GDP will contract by about 10% this year, to the level seen in 2011–2012. The economy is not seen to turn to recovery next year, being strained by instability, sanctions and Russia's own restrictive measures. The long-term growth outlook, tepid already earlier at around 1%–1.5% a year, has now weakened further, as it is increasingly unlikely that Russia moves ahead with needed economic reforms. Russian imports are foreseen to decline by about half this year, and to remain at that lower level for the remaining forecast period. It may be possible to substitute some imports with domestic products, but unlike in earlier recessions, Russia's domestic production will, this time, suffer from import disruptions due to export bans imposed by foreign countries.

Private consumption should fall this year to levels seen a decade ago, as inflation, already relatively high at 9% before the invasion, erodes purchasing power and depresses real household income. With the ruble's collapse, inflation has accelerated and is anticipated to accelerate further with supply and production disruptions as well as higher world market prices. Russian inflation could reach as much as 20% or more this year. Distress in corporations will, like in earlier recessions in Russia, probably lead to larger cuts in real wages than in employment. Nevertheless, unemployment is expected to rise. Real wages in the government sector are also foreseen to decrease. Under the Russian constitution, pensions need to be adjusted to keep up with inflation, while other social supports have already been scheduled to increase. Consumer credit turned to rise after the 2020 recession, but is now likely to come to a halt.

Inflation will also depress public consumption. In order to mitigate harms in the current downturn, the country's leadership may also focus on easily implementable transfers of funds, i.e. social supports that will feed into private consumption and corporate subsidies that keep the economy going.

Fixed investment should contract to levels last seen a decade and a half ago. The business environment for private firms has become exceptionally unstable and lacks perspective. The decline in foreign corporate investment to a necessary minimum will be felt, as investment by foreign-owned firms has represented almost 15% of total investment. The leadership will likely seek to stave off a deeper collapse in fixed investment by increasing orders from oligarch and other private companies and commanding state-owned enterprises. While government sector investment may increase, the effects are likely to be relatively limited, as it represents no more than about 20% of total fixed investment. We expect to see an exceptionally large drop in inventories that significantly exacerbates the declines in GDP and imports.

The paradigm that growth of the world economy fuels Russian exports is changing, as the EU pursues its goal of reducing energy imports from Russia and some non-EU countries and large corporations have decided to stop importing Russian oil. While Russia may be able to shift a tangible part of its oil exports to other markets, a particularly large part of its gas exports is tied to pipeline transmission. Russia's own export bans will reduce exports further. In the worst previous recessions, the drops in GDP and the ruble's exchange rate have knocked down Russian imports by 30%. In addition to these two factors, imports will now also be reduced by bans on exports, payment restrictions and voluntary decisions by foreign firms to cease exporting to Russia. The expectation that imports fall by half this year means a decline to a level last seen in the mid-2000s.

The ruble's exchange rate is expected to remain at its current level during the forecast period. The central bank is unable to support the exchange rate through purchasing rubles on the market, as the EU and the US have prohibited transactions with the central bank. On the other hand, the fresh requirement for Russian firms to convert 80% of their foreign exchange export earnings to rubles will provide coverage for payments going abroad, especially as imports have fallen sharply. High export prices and falling imports will push up Russia's current account surplus, which already reached nearly 7% of GDP last year. Nevertheless, the surplus should shrink considerably during our forecast period, as export prices are expected to come down and EU countries cut back on their energy imports from Russia.

Russia's shrinking economy will undermine the fiscal balance following an episode in which a rapid expansion of budget revenues after the 2020 recession had turned the deficit into surplus last year. Although the economy is now shrinking, budget revenues stand to increase markedly faster than inflation in 2021, but not beyond, as dollar-based proceeds from exports by and production taxes on the oil and gas sectors rise sharply in rubles due to the collapse of the ruble's exchange rate. Markets also expect oil and gas prices this year to remain higher on average than in 2021. Other budget revenues will shrink this year due to the severe economic slump. In the next few years, total government revenues will decline in real terms, as changes in oil prices and the ruble's exchange rate no longer support revenues, while inflation probably remains rather brisk. Government spending increases scheduled so far do not look very large, so that high government revenues this year should keep the government budget in surplus. Russia could afford further increases in government spending, as revenues are up this year, but not over a longer term. The National Welfare Fund, the state's reserve fund, appears to be

Table 2

Russian GDP growth and oil prices

| | 2019 | 2020 | 2021 | 2022 | 2023 |
|--------------------------------|--------------------------|-------|------|------|------|
| | Year-on-year growth in % | | | | |
| GDP | 2.2 | -2.7 | 4.7 | -10 | 0 |
| Private and public consumption | 3.4 | -4.9 | 7.1 | -14 | .. |
| Fixed investments | 1.0 | -4.4 | 7.0 | -20 | .. |
| Exports | 0.7 | -4.1 | 3.2 | -2 | .. |
| Imports | 3.1 | -12.1 | 16.7 | -50 | .. |
| Brent oil price (bbl) in USD | 64.0 | 42.0 | 70.4 | 100 | 89 |

Source: BOFIT.

Note: Realized data for 2019 to 2021, projections for 2022 and 2023. Forecast oil prices are based on the average for oil futures contracts for the ten days preceding March 25, 2022.

largely blocked due to the central bank transaction ban imposed by the EU and the US, unless the state and/or the central bank handle the conversion of the Fund's foreign exchange assets into rubles in a way that does not violate the ban.

Soon after Russia's invasion, the central bank raised its key rate to 20%, which staved off a run on household bank deposits. At the same time, the central bank increased the liquidity supply to banks as much as needed and granted a variety of regulatory relaxations. State banks dominate Russia's banking sector, and various funds are available to keep other banks afloat. Nevertheless, banks may face some difficulties, as falling household and corporate income hurts the deposit intake and the weak economic outlook depresses bank lending.

Forecast risks are exceptionally large

Most of the many large risks surrounding this forecast for the Russian economy are tilted to the downside. The growth of the global economy and changes in oil prices could diverge from their expected paths. The war Russia started may take unexpected turns. International economic and trade sanctions on Russia, as well as Russia's own countersanctions, could escalate and further hurt Russian exports and imports. The impacts of interruptions in supply and logistics on Russian production and imports could be surprisingly large. Russian inflation could accelerate more than expected and continue longer than anticipated, which would further erode private consumption in particular. Fixed investment by private firms could contract sharply if, for example, large firms are unable to meet their orders.

Government budget spending could increase significantly during the forecast period, including the possibility of reliance on central bank funding to cover spending.