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Forecast Report

Beneath the Veneer of Calm

Economic Analysis and Outlook for Central, East and Southeast Europe



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The Vienna Institute for International Economic Studies
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Beneath the Veneer of Calm

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Executive summary

The CESEE region experienced a growth rate of 1.5% in Q2 2023, exceeding that of the EU, which remained stagnant during the same period. However, this seemingly positive result conceals several important nuances.

First, significant variations were observed across individual countries and sub-regions within CESEE. The EU-CEE countries performed at below expectations, mainly due to the recession in Germany. Conversely, the Western Balkan countries exceeded expectations, benefiting from tourism, remittances and foreign direct investment. The CIS countries and Ukraine also did better than anticipated, as they adapted to the new reality.

Secondly, in many of these countries, growth was driven by a decline in imports – primarily on account of the strong base effects resulting from the high level of imports seen the previous year, when energy concerns led to stockpiling. This effect is temporary and will lead to a slowdown in future growth.

Thirdly, despite the overall solid GDP growth in the region, living conditions deteriorated for many, and poverty indicators increased. Real wages remain at significantly below their level of a year and a half ago, and an increasing number of people are struggling to afford to have decent meals.

Inflation generally exceeded expectations, driven not only by global energy and food prices, but also by corporate profits, price increases in other sectors and, in some cases, rising wages. While inflation has started to moderate, the process is slow and it will remain high for some time.

Monetary policy has been restrictive throughout 2023. Although some central banks have ceased their rate hikes, and a few have initiated easing cycles, monetary conditions are expected to remain tight in 2024.

The fiscal authorities in CESEE have faced higher borrowing costs, but have managed to provide some support packages for their citizens and businesses. This has partly been achieved due to inflation's positive impact on public revenue – and, in certain cases, to EU funds. However, as the packages are phased out, so fiscal support is anticipated to decline.

The energy situation has improved since last year, with reduced gas dependence and diversified sources. Nonetheless, the region may face challenges in a severe winter, and there has been only limited progress in reducing fossil fuel dependence and investing in renewable energy for the long term.

Looking ahead, the region appears to be moving toward a new equilibrium, the main features of which will be lower growth and higher inflation. Growth expectations for 2024 and 2025 have been revised downward owing to the global economic slowdown, a weak EU economy, sustained inflation, tight monetary conditions and less fiscal support. Inflation is expected to remain elevated; also, given the complexity of its drivers – which extend beyond global energy prices – there is no prospect of a return to the 2% target any time soon.

COUNTRY SUMMARIES

ALBANIA

Economic growth will accelerate to 3.5% this year, and a similar pace is expected over the medium term, owing to favourable external and domestic demand. A bumper tourist season has greased the wheels of the economy. Strong services exports and buoyant remittance inflows have pushed the current account deficit to unprecedentedly low levels, while FDI inflows have also performed strongly. Consumer prices will surge by a relatively modest 5%, but an inflation rate in double digits for staple foodstuffs is eating into the income of the most vulnerable groups.

BELARUS

In 2023, Belarus's economy has performed considerably better than expected. While this largely reflects recovery from a low base, there have also been signs of adjustment to the effects of Western sanctions. With Russia's assistance, Belarus has remodelled some logistical export chains. The authorities have maintained an accommodative policy stance, combining fiscal stimulus with monetary easing. We expect GDP to grow by 3.0% in 2023, and then to moderate to 2.2% and 2.5% in 2024 and 2025, respectively.

BOSNIA AND HERZEGOVINA

The year started with rather slow economic growth, as a result of a decline in household consumption and net exports. Inflation has been falling, despite the inability of the central bank to influence interest rates under the currency board arrangement. Political tensions are again on the rise, as one part of the country, Republika Srpska, has ceased to heed the decisions of the international official who oversees peace in the country. On a positive note, the country's new government has been making some progress in meeting the conditions set by the EU for progress towards EU accession, and the country's S&P sovereign rating was upgraded in August 2023 in recognition of its economic resilience.

BULGARIA

Economic slowdown became more pronounced over the course of the year, and industry actually plunged into a deep recession. Export performance was dismal against the background of shrinking demand in Western Europe. A new government took office in May, supported by the two main political parties. Its foundations are shaky, however, as the parties have not signed a coalition agreement. Economic weakness will persist: GDP will grow by 1.0% in 2023 and by 1.5% and 2.5% in 2024 and 2025, respectively.

CROATIA

Croatia's accession to the euro area and the EU's border-free Schengen zone boosted tourism in 2023. The country's full EU integration will also provide a fillip to trade and investment in the long term. EU-related funds were already supporting investment activity in the country in 2022, and have continued to do so this year. Nevertheless, persistently high levels of inflation have put real incomes, external demand and investment sentiment under pressure, which is why we have maintained our growth forecast for 2023 of 2.5%.

CZECHIA

There are not too many reasons to be optimistic about the economic performance of Czechia in 2023. The economy will remain stagnant (0.1%) and inflation high (11%). With prices rising steeply, household consumption is dragging growth downward, as are declining inventories. Following a period of surprising

resilience, industry is also losing steam. The dim outlook for Germany is further weakening Czechia's prospects. A mild recovery can be expected in 2024, helped by inflation falling back.

ESTONIA

The Estonian economy performed at below the EU-CEE average in H1, and GDP is now expected to decline by 1.3% in 2023 as a whole, as the aftermath of severe inflation, major supply issues and interest rate hikes unfolds. With shrinking domestic and foreign demand, the outlook for recovery will largely be determined by the country's success in gaining a share of new markets, the resurgence of foreign direct investment and the revival of Estonian firms' competitiveness. Economic growth is expected to gain ground slowly but steadily from next year onwards, with GDP growth forecast to be 1.7% in 2024 and 3.0% in 2025.

HUNGARY

Hungary has slipped into recession, with private consumption and investment contracting in H1 2023. Net exports mitigated the decline. The economy may soon see a slight recovery, but the annual growth rate will remain at below zero. Only a modest recovery is expected in 2024 and 2025. Growth would receive a fillip from EU transfers and a strong recovery of the main export markets, but neither of those things is currently on the horizon. Fiscal consolidation and continued high interest rates may slow the pace of recovery. Inflation will likely fall to below 10% later in 2023 and slowly sink further over the next two years.

KAZAKHSTAN

In H1 2023, the Kazakh economy recorded GDP growth that was among the highest of all CESEE countries – 5.1% – driven by investment and private consumption. We expect economic performance to slow in H2 2023, but growth for the full year will still exceed our previous forecast by 0.2 percentage points (pp), reaching 4.7%. Monetary policy loosening will remain cautious in light of the slow disinflation. Booming imports, fuelled by strong demand and declining exports (amid global oil prices that are lower than in 2022) lead to a higher current account deficit forecast for 2023 and 2024. In 2024-2025 we expect economic growth of around 4%.

KOSOVO

Economic growth for 2023 will be around 3.2% and will be driven by domestic demand. Consumer price inflation has fallen substantially, though there is still upward pressure from food prices and energy costs. The uneasy dialogue with Serbia and the sanctions imposed by the EU are having repercussions for the economy, with a slowing of trade relations and EU investment.

LATVIA

Whereas in 2022 economic activity remained quite lively right up to the end of the year, in 2023 the effects of dwindling external demand and reluctant household consumption are dampening GDP growth. Inflation is declining significantly, so that real incomes are again increasing in H2. While public investment has been expanding this year, enterprises are in the process of running down their stocks. Given the still rather tight labour market, the unemployment rate will fall slightly in 2023 – and even more so in the coming two years. Assuming that the EU economy finds its way back on track next year, we expect a subdued revival in Latvia's GDP growth, to 1.8% in 2024 and 2.3% in 2025.

LITHUANIA

The economy performed worse than expected in H1 2023, and we do not foresee any significant upswing before the end of the year. Since inflation has been declining considerably, real income will pick up again in H2 2023; this will support household consumption – after four consecutive quarters of decline. However, it is only in 2024 that the rise in real incomes will gain momentum. Despite the stagnation, the labour market remains robust. Private investment activity is declining, since external demand is in the doldrums, while the government has considerably raised infrastructure investment. We expect real GDP to decline by 0.1% in 2023; this will be followed by a modest upswing to 1.7% in 2024 and then 2.4% in 2025.

MOLDOVA

After two years of decline, GDP will finally recover in H2 2023. The harvest will be better than last year, and that will have a positive impact on incomes, exports and the food industry. Sharp disinflation will help consumption recover. The future prospects look even brighter, as Moldova has managed to switch its trade flows, including energy supplies, from Russia to the West. The country can rely on multinational institutions to finance its fiscal and current account deficits.

MONTENEGRO

Montenegro's economy performed exceptionally well in H1 2023, growing by 6.5%. The economy is still feeling the positive effects of last year's social reform, which is boosting household consumption. Moreover, there has been a strong tourist season, as well as vibrant investment in hotel facilities and energy infrastructure. The potential formation of a new governing coalition offers hope of a stable political environment. We have upgraded our previous GDP growth forecast for 2023 to 4.5%.

NORTH MACEDONIA

As expected, the economy slowed in Q2, owing to high inflation, restrictive monetary policy and limited foreign direct investment. Driven by company profits, inflation remained very high: the government has reinstated price controls on food products in an effort to tame it (though we do not believe the effects will last long). The GDP forecast for 2023 has been kept unchanged at 1.6%, but our forecast for 2024 has been revised downward to 2%, on account of the cloudier outlook for the EU economy.

POLAND

Restrictive monetary policy has pushed the economy into a minor recession that is directly linked to suppressed real wages and the liquidation of excessive inventories. The recent (6 September) cut in the policy interest rate is expected to prevent further deterioration on the real side. In effect, GDP in 2023 is likely to stay flat – and then to resume its moderate expansion in 2024. At the same time, disinflation will progress naturally. Public deficit spending remains high, but the public debt levels are not a serious threat to fiscal stability.

ROMANIA

Romania will suffer a significant economic growth slowdown to 2.5% in 2023, but – helped along by EU funds and a good harvest – its growth will still be above that of most of its peers. Inflation fell to single digits in August, but real incomes are proving slow to recover. The current account deficit has shrunk due to lower imports of goods and higher exports of services. High fiscal deficits jeopardise the country's access to EU funds, but no harsh stabilisation measures will be necessary to keep most of the funds flowing. The rising political risks moderate our growth expectations for the election year of 2024.

RUSSIA

Low oil prices and a strong rebound of imports have resulted in the rouble depreciating by about 30% since the beginning of the year, prompting drastic monetary policy tightening. Nevertheless, the economy is continuing to recover on the strength of domestic demand, with military procurement boosting industrial production and construction, and a tight labour market pushing up wages and consumption. This year, growth is projected to exceed 2%, to be followed by a mild deceleration in 2024-2025. A growing addiction to fiscal military stimulus and increased technological backwardness together increase the risk of stagnation (or even outright crisis) once the war is over.

SERBIA

The economy grew solidly in Q2, but this is likely to be short lived. Inflation is showing signs of moderating, but is still among the highest in the CESEE region. The central bank is likely to keep interest rates unchanged for the rest of the year, while fiscal policy will probably become less restrictive. We are revising our GDP growth forecast for 2023 upwards to 1.5%, but for 2024 and 2025 downwards, due to the expected lower global growth.

SLOVAKIA

In H1 2023, Slovak GDP grew by 1.3% – far better than expected. On the one hand, the important automotive sector supported export growth; on the other, the persistently high inflation deterred household consumption and dragged down GDP growth. Major uncertainties prevail and could dampen future growth.

SLOVENIA

The reconstruction efforts following the floods in August – the worst in decades – will require several billion euro and will take years to complete, boosting government spending. Growth in 2023 will be subdued, at an estimated 1.3%, as private consumption has slowed significantly. Inflation will be high, but is showing clear signs of decreasing. Industrial output will shrink, as manufacturers face reduced foreign demand. The growth in exports will stall, but imports will fall, leading to a positive current account balance. The labour market is very tight, with the unemployment rate at historically low levels.

TURKEY

In the first half of 2023, Turkey faced a challenge of unbalanced economic growth, fuelled primarily by strong household consumption. While this uptick provided a boost to the economy, it also created a delicate balancing act for the Turkish authorities. If they maintain their dedication to monetary stability, the opportunity exists to gradually rein in inflation over the coming years; however, that would come at the cost of economic slowdown. That said, the possibility of policy reversals in the future, once external financing becomes more stable or the budget deficit levels out, brings an element of uncertainty.

UKRAINE

In Q2 2023, Ukraine's real GDP grew by 19.5% year on year, reflecting both the base effect and the resilience of the economy. Exports of agricultural and food products have been growing, despite Russia's withdrawal from the Black Sea Grain Initiative. Inflation has slowed more than expected, on the back of falling food and fuel prices. Given the greater-than-anticipated resilience of the economy, our GDP growth forecast for 2023 has been revised upwards. However, as the war is likely to be more protracted than we had initially hoped, growth in 2024-2025 will be lower than previously forecast. Most risks to the forecast continue to be on the downside.

Keywords: CESEE, Central and Eastern Europe, economic forecast, Western Balkans, Visegrád group, CIS, Ukraine, Russia, Turkey, euro area, EU, convergence, Russia-Ukraine war, Russia sanctions, commodity prices, inflation, energy crisis, gas, renewable energy, electricity, monetary and fiscal policy, EU funds, purchasing power, poverty, real wages, remittances, FDI, imports, external debt, interest rates, banking sector, credit, impact on Austria, macroeconomic forecasting

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Cut-off date for historical data and forecasts: 21 September 2023. Most data are taken from the wiiw Databases. Direct access is available at: <https://data.wiiw.ac.at/>.

wiiw COUNTRY GROUPS

CESEE23 Central, East and Southeast Europe

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

EU-CEE11 Central and East European EU members

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

V4 Visegrád countries

CZ	Czechia
HU	Hungary
PL	Poland
SK	Slovakia

BALT3

EE	Estonia
LT	Lithuania
LV	Latvia

Baltic countries**SEE9 Southeast Europe**

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

non-EU12 non-European Union CESEE countries

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

WB6 Western Balkans

AL	Albania	MK	North Macedonia
BA	Bosnia and Herzegovina	RS	Serbia
ME	Montenegro	XK	Kosovo

CIS3+UA Commonwealth of Independent States-3 and Ukraine

BY	Belarus	MD	Moldova
KZ	Kazakhstan	UA	Ukraine

CIS4+UA Commonwealth of Independent States-4 and Ukraine

BY	Belarus	RU	Russia
KZ	Kazakhstan	UA	Ukraine
MD	Moldova		

EU27 European Union

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

EA20 Euro area

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

ABBREVIATIONS

ALL	Albanian lek
BAM	convertible mark of Bosnia and Herzegovina
BGN	Bulgarian lev
BYN	Belarusian rouble
CZK	Czech koruna
EUR	euro
HRK	Croatian kuna
HUF	Hungarian forint
KZT	Kazakh tenge
MDL	Moldovan leu
MKD	North Macedonian denar
PLN	Polish złoty
RON	Romanian leu
RSD	Serbian dinar
RUB	Russian rouble
TRY	Turkish lira
UAH	Ukrainian hryvnia
USD	US dollar
BCI	Business Cycle Index (wiiw)
BIS	Bank for International Settlements
BOP	balance of payments
CA	current account
CARE	Cohesion's Action for Refugees in Europe
CB	central bank
CBR	Central Bank of Russia
CIS	Commonwealth of Independent States
CNB	Czech National Bank
CPI	consumer price index/inflation
CSTO	Collective Security Treaty Organisation
EAEU	Eurasian Economic Union
EBRD	European Bank for Reconstruction and Development
EC	European Commission
ECB	European Central Bank
EPPO	European Public Prosecutor's Office
ER	exchange rate
ESA 2010	European system of accounts
EU	European Union
FDI	foreign direct investment
FISIM	Financial Intermediation Services, Indirectly Measured

FOREX	foreign exchange
GDP	gross domestic product
GFCF	gross fixed capital formation
HICP	Harmonised Index of Consumer Prices (EU wide inflation measurement)
IT	information technology
IMF	International Monetary Fund
IPA	Instrument for Pre-accession Assistance
LFS	Labour Force Survey
LNG	liquified natural gas
NACE	Nomenclature statistique des activités économiques dans la Communauté européenne (Statistical classification of economic activities in the European Community)
NATO	North Atlantic Treaty Organisation
NBU	National Bank of Ukraine
NPL	non-performing loan
OECD	Organisation for Economic Cooperation and Development
OPEC+	Organisation of the Petroleum Exporting Countries (OPEC) plus 10 of the biggest non-OPEC oil-exporting countries
PMI	purchasing managers' index
pp	percentage points
PPI	producer price index/inflation
PPP	Purchasing Power Parity
PPS	purchasing power standard
RER	real exchange rate
RIR	real interest rate
RRF	Recovery and Resilience Facility
S&P	Standard & Poor's
SDR	special drawing rights
SDS	Slovenian Democratic Party
SME	small and medium-sized enterprise
SPE	special purpose entity
SPFS	financial messaging system of the Bank of Russia
SWIFT	Society for Worldwide Interbank Financial Telecommunications
TAP	Trans Adriatic Pipeline
UK	United Kingdom
UNHCR	United Nations High Commissioner for Refugees
US	United States

VAR	vector autoregression
VAT	value added tax
wiiw	The Vienna Institute for International Economic Studies
WTO	World Trade Organisation
.	not available (in tables)
bn	billion
m	million
p.a.	per annum
sa	seasonally adjusted
y-o-y	year on year

1. Global overview: German and Chinese weakness weighing on CESEE outlook

BY RICHARD GRIEVESON

- › **The war in Ukraine is likely going to last for much or all of our forecast period. However, the direct economic fallout from the war for most of CESEE will be limited.**
- › **The outlook for Germany in particular and for the euro area economy has deteriorated, and next year's recovery will be weaker than we had previously expected.**
- › **Inflation has peaked in the euro area and will trend downward. The ECB has finished its tightening cycle and will start to cut next year. Some CESEE central banks will cut faster than the ECB, and that will exert downward pressure on regional currencies.**
- › **The global economy is mixed, with China struggling, while the US remains impressively resilient to monetary tightening and external headwinds. For CESEE, the combined negative impact of weakness in the euro area and China is a major headwind for growth.**

1.1. ASSUMPTIONS ABOUT THE WAR

Predicting when and how the war in Ukraine will end is impossible. At times, it has seemed as though Russia was about to take the whole of Ukraine; at others, as though Ukraine was about to fully liberate all of its territory. At the time of writing, the Ukrainian summer offensive has gained some ground, but it is hardly decisive.¹ The Ukrainian army is coming up against manpower and equipment constraints.² Meanwhile, Russia's army has built itself defensive positions and the country's president, Vladimir Putin, appears to believe that time is on his side and that Russia is better placed to handle a war of attrition. Russia's military industry also seems to have been effective at circumventing sanctions.³

The Ukrainians will not give up, even as Russia continues to indiscriminately target civilians. But without more soldiers, equipment and weapons, it will be very hard to win. The US remains the key player, and at least as long as the Biden administration is in office, US support will remain steadfast. However, even the US has not been able to supply Ukraine with everything it needs, and at the speed that it needs it. Our assumption is therefore that the war will last into next year at least; neither side is capable of landing a decisive knock-out blow, but neither is close to giving up either.

A more extensive assessment of the future course of the war is provided in section 2. We see only a 20% chance of a decisive breakthrough by either side. Much more likely are either a stalemate or a more modest advance by Ukraine in the south: to both of those possibilities we assign a 40% probability. The implications of this for the economies of the two countries is important; but for the rest of the region,

¹ <https://www.reuters.com/world/europe/ukraine-retakes-more-territory-east-south-counteroffensive-2023-09-18/>

² <https://www.bbc.com/news/world-europe-66542065>

³ <https://www.nytimes.com/2023/09/13/us/politics/russia-sanctions-missile-production.html>

the future economic impact of the war is likely to be limited. The initial shock of the war, including its impact on energy prices, has been digested by the region's economies. However, the region is now undergoing a major energy transition (see *section 3*) and Europe as a whole faces an end to the peace dividend, which will matter economically.⁴

1.2. ECONOMIC OUTLOOK FOR THE EURO AREA

Table 1.1 / wiiw autumn 2023 global assumptions

	Autumn 2023			Changes since summer		
	2023	2024	2025	2023	2024	2025
Euro area real GDP growth, %	0.5	1.2	1.6	0.0	-0.6	-0.1
Euro area consumer price inflation, %	5.7	3.2	2.5	0.0	0.2	0.2
Euro area unemployment rate, %	6.6	6.6	6.6	0.0	0.0	0.0
Euro area current account, % of GDP	1.0	1.5	2.5	0.0	0.0	0.0
USD/EUR exchange rate, average	1.08	1.08	1.08	0.0	0.0	0.0
ECB refinancing rate, %, end of period	4.50	3.50	2.00	0.5	0.5	0.0
USD per barrel Brent oil, USD, average	82.0	77.0	73.0	2.0	2.0	2.0

Source: forecasts by wiiw. Cut-off date: 21 September 2023.

Our forecasts rest on the following main assumptions:

- › There will be no quick end to the war in Ukraine, but also no major escalation, such as the use of tactical nuclear weapons.
- › The humanitarian tragedy of the war will continue, but the fallout for the rest of Europe's economies will be limited.
- › The European Central Bank (ECB) has finished tightening and the Fed is close to the end. Both will start to cut again next year.
- › The US economy will continue to demonstrate impressive resilience, whereas the Chinese economy will continue to struggle.

We expect the euro area economy to expand by 0.5% this year, unchanged from our previous forecast. However, we have revised downward our projection for 2024 by 0.6 percentage points, to 1.2%; and for 2025 by 0.1 percentage points, to 1.6%. The downgrades reflect the weakness of recent data, indicating that Germany in particular is continuing to struggle, and that the recovery will not be as rapid as we had previously thought. Germany's travails reflect partly structural issues that will not disappear soon. The euro area economy grew by 0.1% quarter on quarter in both Q1 and Q2 2023, after a 0.1% decline in the final three months of 2022; this indicates that the bloc's economy is more or less flatlining. Most worryingly for CESEE, the German economy again failed to grow in Q2, while other key economies – such as those of Italy (-0.4%) and Austria (-0.7%) – contracted.

While the easing of supply bottlenecks and falling energy prices were tailwinds for growth in the first half of the year, this was offset by higher interest rates and the weakness of the global economy, which hit exporters hard. Purchasing managers' indices (PMIs) show that the euro area manufacturing sector in

⁴ <https://www.ft.com/content/93207193-c40d-495c-8b73-0a96a05768e7>

particular is struggling badly, with particular relevance for Germany and large parts of CESEE. Moreover, although the euro is not especially strong by historical standards, it has rallied quite significantly since its lows against the dollar a year ago; that has made goods prices in euros more expensive, and thereby dented demand (Figure 1.1). As inflation moderates and monetary easing begins, economic activity should pick up by 2024.

Figure 1.1 / EUR per USD



Source: Investing.com

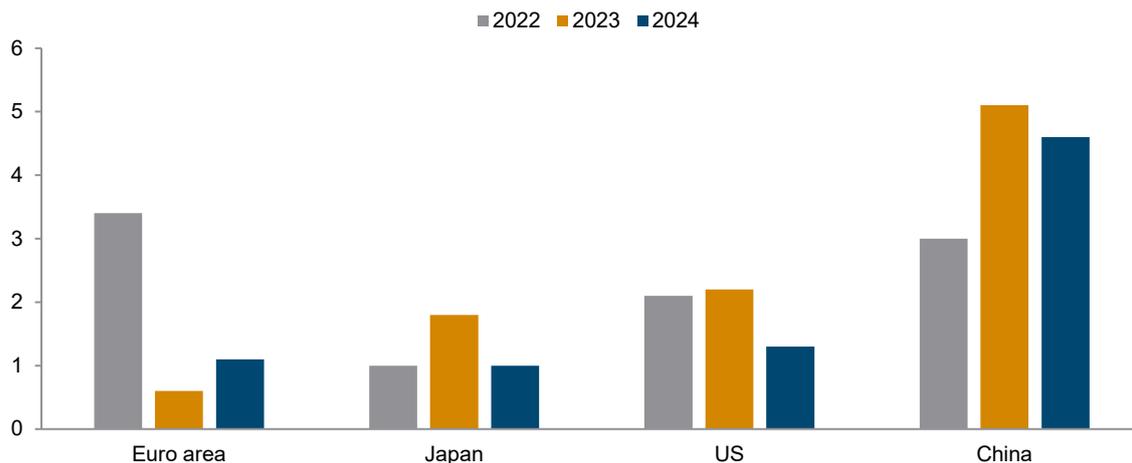
Inflation also seems to have peaked in the euro area, and should continue to trend down. Consumer prices in the euro area rose by 5.2% year on year in August, 0.1 percentage points lower than in July, and down from 9.1% in the same month last year. This is linked to the easing of supply bottlenecks and the pass-through from previous monetary tightening, while the much-feared wage-price spiral has so far failed to materialise. Oil prices have risen markedly recently, but gas storage levels in the EU are high, which bodes well for the winter. We have made small upward revisions to our oil price forecasts for 2023-2025, and now see consumer prices rising by 3.2% next year and by 2.5% in 2025, both 0.2 percentage points higher than our previous forecast. Inflation will therefore take some time to get back to the ECB's target of just below 2% (probably not until the second half of 2025), but will be well below the levels of the last 18 months. We are sticking with our view that the euro will hover at around USD 1.08 throughout the forecast period. The ECB has now finished its tightening cycle, but the Fed will likely also stop soon.

1.3. CONDITIONS IN THE GLOBAL ECONOMY

The story for the global economy as a whole is very mixed. In its most recent projections (released on 19 September), the Organisation for Economic Co-operation and Development (OECD) revised its global GDP forecast up by 0.3 percentage points to 3% for this year, while revising the figure for 2024 down by 0.2 percentage points to 2.7%. It noted that tighter monetary policy, weaker consumer and business confidence, and the fading impact of China's reopening were all weighing on the global economy. Of the main pillars of the global economy, the OECD expects only the euro area to do better in 2024 than this year; but this primarily reflects almost no projected growth in the single currency area for this year.

Otherwise, it expects a slowdown in the US, Japan and China in 2024 (Figure 1.2). The OECD noted that high-frequency indicators from the world's biggest economies generally point to a loss of momentum in the second half of the year, especially in the output and new order components of manufacturing PMIs, while service-sector indicators – although stronger – have also weakened recently.

Figure 1.2 / Real GDP growth, %



Source: OECD projections.

The US is still showing a remarkable degree of resilience, considering the external headwinds and the degree of domestic monetary tightening. In September, the OECD increased its 2023 US real GDP growth projection by 0.6 percentage points to 2.2%, and now expects the economy to expand by 1.3% next year – a 0.3 percentage point upward revision. Despite widespread predictions of a hard landing at the beginning of the year, the Fed seems to have pulled off a ‘no landing’ scenario, getting inflation under control without causing a recession – something that the *New York Times* economist Paul Krugman has called ‘a minor, or maybe not so minor, miracle’.⁵ This resilience reflects a combination of a fairly closed economy, large-scale domestic energy production and loose fiscal policy. However, the nature of the inflation also seems to have been important, with a recent paper finding evidence that inflation in the US was primarily driven by supply bottlenecks linked to Covid, and therefore that the main driver of falling inflation has been supply expansion linked to reopening, rather than the impact of Fed tightening.⁶

By contrast, the Chinese economy is struggling by its own standards, reflecting a nasty combination of a property slump, weak confidence and the fact that there is less fiscal space than in the past to boost the economy. The full reopening of the economy from Covid restrictions has not had the significant positive impact on growth that many had hoped for this year. Meanwhile the attritional grind of years of US sanctions also seems to have adversely impacted foreign investment. The weakness of the Chinese economy has negative implications for the whole global economy, but much more so for Europe than the US.

⁵ <https://www.nytimes.com/2023/09/11/opinion/inflation-unemployment-phillips-recession.html>

⁶ <https://rooseveltinstitute.org/publications/supply-side-expansion-has-driven-the-decline-in-inflation/>

1.4. RISKS TO THE OUTLOOK

There are risks to the outlook in both directions. On the positive side, the prospect of lower inflation and a coordinated global monetary easing cycle will provide a tailwind for growth next year; and if inflation and interest rates fall quicker than is currently expected, economic growth could surprise on the upside. However, the downside risks are currently more prevalent. First, the weakness in Germany and the euro area could intensify, leading to a recession in the bloc, with major negative knock-on effects for CESEE. Some recent high-frequency indicators show very weak sentiment in the euro area, implying that a recession is a possibility. Second, geopolitical factors could damage the economic outlook, such as an escalation of the war in Ukraine following the use of nuclear weapons by Russia, or the onset of a full-blown EU-China trade war. Third, inflation could yet take longer to come down than is currently expected. The sharp increase in global oil prices since June provides one possible sign of this. Fourth, Donald Trump (or a Trump-like candidate) could win next year's presidential election in the US, which could lead to a reduction in, or withdrawal of, US support to Ukraine; an end to the war there on more favourable terms for Russia than currently looks possible; a much larger outflow of refugees to the EU; and a deterioration in investor sentiment towards large parts of CESEE.

2. Political risks in CESEE 2024-2024: Strategic outlook

BY MARCUS HOW*

SUMMARY

- › Over 18 months on from the start of the Russian invasion of Ukraine, its fallout continues to be the key driver of political risks in CESEE.
- › Security aside, the cost to CESEE states of severing their various economic ties with the Russian Federation is proving high – especially for those that are EU members.
- › The Russian and Ukrainian governments remain uncompromising on the possibility of a peace settlement.
- › Military strategies remain attritional, as each of the two sides seeks to degrade the weaponry, logistics, infrastructure and morale of the other. The Ukrainian counteroffensive continues but is grinding along only slowly.
- › It is our assessment that there are four scenarios that could realistically play out over the 12-month outlook period (the likelihood is given in brackets):
 1. A breakthrough by Ukraine in the south (or alternatively east), allowing it to sever the land corridor between Crimea and the Russian Federation (15%);
 2. A modest advance by Ukraine in the south, bringing the land corridor within range of its artillery and increasing attrition among the Russian forces (40%);
 3. Stalemate, with a failure by both sides to make any significant breakthrough (40%);
 4. A breakthrough by Russia in the east, increasing the likelihood that it can consolidate its control of the Donbass region (5%).
- › The war will continue to be influenced by such key variables as manpower, equipment, ongoing Western support for Ukraine and the political outlook in Russia.
- › Overall, the strategic advantages that Russia and Ukraine enjoy are, respectively, numerical and qualitative.
- › Political instability in the US represents a major risk to the Ukrainian war effort, while elections in Slovakia, Poland and Austria may lead the EU consensus surrounding sanctions and aid to begin to unravel.
- › At the same time, the US and the EU have taken major steps to ensure that Ukraine continues to receive military support in the long term; this will sustain its defences, even if it cannot deliver victory.

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- › Russian President Vladimir Putin is unopposed, but his regime is brittle – as the mutiny by the Wagner private mercenary group demonstrated.
- › Another key issue in CESEE is that of EU enlargement: progress will remain uneven in the 12 months ahead, stalling in Serbia, Kosovo and Bosnia and Herzegovina, while tentatively advancing elsewhere.

2.1. MILITARY OUTLOOK IN UKRAINE: THE STATUS QUO

The possible outcome of the war will shape the risk outlook in CESEE politically, economically and in terms of security. Since the Russian Armed Forces (RAF) failed to subjugate Ukraine in the first half of 2022, the administration of Russian President Vladimir Putin has sought to prosecute a war effort that focuses largely on defending its gains. Indeed, the onus has been on the ability of the Armed Forces of Ukraine (AFU) to liberate the 15% of Ukrainian territory that remains occupied by the RAF. Neither side has shown any willingness to compromise on reaching a potential peace settlement, not least because both consider the possible outcome of the war to have existential implications.

The war that is being fought is primarily attritional. Throughout 2023, only very modest amounts of territory were captured by either side. The RAF, following the declaration of partial mobilisation in autumn 2022, sought to grind Ukraine down with bloody attacks on its positions in the Donetsk region, while bombarding the country's infrastructure with missiles and drones. It is also seeking to systematically destroy Ukraine's agricultural sector: by blowing up the Kakhovka dam, in a devastating act of ecocide; by shelling grain silos and ports; and by allowing the expiration of the Black Sea Grain Initiative, which was brokered by the UN to guarantee the safe maritime passage of Ukrainian foodstuffs to developing markets.

The primary objective of the AFU is similarly to wear down RAF positions, with a view to severing the land corridor connecting Crimea with the Russian Federation. The AFU has used Western-supplied long-range artillery and drones to degrade Russian logistics and artillery, especially in the southern regions of Kherson and Zaporizhzhia, but also in Crimea itself. Dozens of hybrid attacks have also been carried out in the Russian Federation, most of which have been low in impact, though they are exhibiting increasing sophistication.

In June 2023, in an attempt to break through down to the Sea of Azov, the AFU launched a major counteroffensive along three axes of advance in the Zaporizhzhia and Donetsk regions. Initially, it attempted a mass mechanised assault through the triple-layered network of trenches, fortifications and minefields known as the Surovikin line. However, it reverted to an attritional approach after losing a fifth of its Western-supplied equipment, amid difficulties in conducting large-scale combined-arms operations.

At the time of writing, the AFU had breached the first, most heavily defended part of the Surovikin line at the villages of Robotyne and Verbove; but it remained to be seen whether it could break out towards the cities of Melitopol and Berdyansk along the coast of the Sea of Azov. It was, however, possible that the AFU could succeed in advancing the 10-15 kilometres necessary to bring the east-west land supply route along the Sea of Azov within range of its artillery, perhaps even capturing the logistical hub of Tokmak.

2.2. MILITARY OUTLOOK IN UKRAINE: SCENARIOS

Strategic momentum in the war shifted to Ukraine in autumn 2022, but defeat of the Russian invasion is unforeseeable within the next 12 months. The most likely scenarios that will play out include (with the likelihood given in brackets):

1. A Ukrainian breakthrough in the south, liberating territory and surrounding Crimea; or alternatively a breakthrough in the east, as the RAF has to redeploy units to stabilise the southern front (15%);
2. A Ukrainian breach of the southern defences, amounting to advances that are gradual, but not strategically decisive, even as the RAF and its positions in Crimea are worn down (40%);
3. Stalemate, with neither side achieving a strategic advantage (40%);
4. A Russian breakthrough in the east later in the winter (5%).

The first scenario would considerably improve the odds of victory on Ukrainian terms within the 12-month outlook and beyond. The second scenario would improve the strategic position of Ukraine in the conflict, but a strategic outcome would remain distant. The same is true of the third scenario, which would increase the likelihood of a frozen conflict. In the fourth scenario, the odds of an overall Russian victory would not increase as such, but it would generate greater pressure for a diplomatic settlement that favours Moscow, especially if Russia manages to consolidate control over the four regions it unilaterally annexed in 2022.

2.3. MILITARY OUTLOOK IN UKRAINE: STRATEGIC VARIABLES

The ability of both Ukraine and Russia to continue to prosecute the war effectively (if at all) is governed by strategic variables that include how well they can sustain their militaries, as well as by their economic resilience.

In the case of Ukraine, the continued provision of Western support is crucial. In the case of Russia, the political consensus surrounding the mobilisation of society and the economy for war needs to be maintained, while at the same time both need to be insulated from the costs of the war.

i. Manpower: Russia

Militarily, the balance of superiority consists in the ability of both sides to generate manpower and equipment. In the case of manpower, it is estimated that the RAF has suffered between 50% and 200% more casualties than the AFU.⁷ Yet Russia retains a numerical advantage, since its population is around five times larger than that of wartime Ukraine. The Putin administration has laid the foundations to leverage this advantage, improving the efficiency of the 2022 decree on mobilisation by raising the maximum draft age by five years, while establishing an electronic system that issues binding summons to eligible recruits. In the 12-month outlook, between 400,000 and 700,000 more recruits could be mobilised.

More generally, the RAF has bolstered its manpower advantage through a combination of coercion, incentivisation and propaganda. On the one hand, blocking units are deployed to shoot recruits who retreat. On the other hand, recruits are paid three times the average salary in Russia; and if they are killed or disabled, their families receive compensation equivalent to between one and four times the

⁷ https://en.wikipedia.org/wiki/Casualties_of_the_Russo-Ukrainian_War#Russian_invasion_of_Ukraine

average annual salary in Russia. The overall quality of the RAF is mixed at best, and anecdotal evidence consistently suggests that morale is low. But Russia's mobilisation of manpower is strategically useful, in that it frees up experienced units to conduct specialised operations.

ii. Manpower: Ukraine

Meanwhile, the AFU is beginning to struggle with manpower. Endemic corruption in the recruitment process has led to tens of thousands of eligible recruits dodging the draft. In August, President Volodymyr Zelensky accordingly fired all the heads of regional recruitment centres nationwide. Concurrent reshuffles at the Ministry of Defence, which saw Oleksii Reznikov replaced by Rustem Umierov as defence minister, will facilitate attempts to resolve organisational issues, as well as corruption. If manpower issues persist, full mobilisation remains an option.

Where the AFU does command an advantage is in the quality of manpower. The existential nature of the conflict has kept morale relatively high. Furthermore, tens of thousands of recruits are being trained by NATO forces. Issues have emerged surrounding the quality of the training, as it is too short for new recruits and focuses too little on operations in a full-scale war. However, it is likely to improve as training programmes adapt.

iii. Equipment: Russia

The effective use of manpower is influenced by the quantity and quality of equipment. Russia and Ukraine share a commonality in this regard, in that they are both at the mercy of external factors in the procurement of high-quality equipment. Ukraine relies on its Western allies, while Russia relies on its ability to circumvent Western sanctions.

After the war began and sanctions were imposed, the Putin administration quietly reactivated illicit Soviet-era procurement networks, thereby facilitating the import of Western technology used in modern weapons systems such as battle tanks and ballistic missiles. While it is not possible to produce such equipment at anywhere near the rate (or cost) as before, it does support strategic planning by providing predictability around production.

For example, Ukrainian military intelligence estimates that the Russian defence complex can produce up to 70 high-precision missiles per month, meaning that its stock, while badly depleted, will never run out. Meanwhile, low-quality missiles – such as the Shahed-136 – may be produced rapidly and at scale, allowing for disruptive barrages.

This is similarly the case with tanks. Visually confirmed equipment losses indicate that two thirds of the RAF's active tank fleet at the beginning of the war has been neutralised, bringing it to numerical parity with the increasingly large and modern Ukrainian fleet. Furthermore, of the approximately 2,300 Russian tanks that have been destroyed, damaged or captured, some 700 were modern battle armour, such as the T-80 and T-90 models.⁸

Yet the RAF has considerable strategic reserves thanks to its Soviet-era stocks, which consist of some 9,000 decommissioned tanks. These are largely dated or otherwise low-quality models, but nevertheless

⁸ <https://www.oryxspioenkop.com/2022/02/attack-on-europe-documenting-equipment.html>

they reduce the need for new production (which is limited to approximately 200 tanks per year),⁹ since they can be quickly deployed after the necessary retrofitting and augmentation. Such reserves are unlikely to provide the RAF with a strategic advantage as regards offensive operations, but they are an important defensive stopgap.

The ability of the Russian wartime economy to generate the equipment necessary to sustain the war is unclear, as the various datasets are contradictory. Although 2023 defence spending targets were tripled to USD 100bn,¹⁰ the ability of the defence complex to absorb the funds is limited, owing to general underinvestment over the past two decades, as well as systemic corruption. Nonetheless, these factors are not likely to be relevant in the 12-month outlook. On the other hand, if Western sanctions were to be enforced more strictly, that would further reduce Russia's ability to reproduce modern weaponry and would significantly undermine its war effort.

iv. Equipment: Ukraine

Ukraine is outnumbered by Russia in most equipment categories, but its capabilities have increased steadily thanks to Western supplies, and even qualitatively outstrip those of Russia. While Ukraine does have domestic production capacity (e.g. of drones), the qualitative expansion of its arsenal depends on the political will of Western states to make different types of modern weaponry available, as well as on their ability to sustain popular consensus on the need to provide Ukraine with military aid. Alongside continuation of this aid, the speed and rate at which equipment is supplied are key variables that directly influence the possible outcome of the war.

The rate of supply has been sufficient to reinforce the strategic momentum that Ukraine seized in 2022. However, it has not been enough to decisively boost the likelihood of outright victory by Ukraine. This is partly because the US and the EU are wary of crossing certain 'red lines' drawn by Russian nuclear doctrine, which permits the use of such weaponry if the existence of the Russian state – as defined by the Kremlin prior to 2022 – is jeopardised.

Since the war began, the AFU has received Western weaponry that includes long-range artillery (US M142 High Mobility Artillery Rocket Systems (HIMARS), US M270 Multiple Launch Rocket Systems (MLRS), UK and French Storm Shadows); air defence systems (US MIM-104 Patriot and German IRIS-T systems); and modern battle tanks (German Leopard-2 tanks, UK Challengers). These have permitted the AFU to devastate Russian supply logistics (which have had to be relocated further away and reorganised), and have greatly improved the efficiency with which Russian missiles and drones can be shot down.

However, the Zelensky administration insists that this is not sufficient, arguing that the AFU requires modern airpower and longer-range missiles to drive home its advantage. The former would greatly improve the air defence necessary to cover ground advances, while the latter would enable Russian targets to be struck hundreds of kilometres behind the front line, including in Crimea and the Russian Federation itself.

Western governments have duly been prevaricating, but the weaponry is likely to trickle through. The Netherlands and Denmark are set to deliver over 60 F-16 fighter jets in 2024, while the UK and France

⁹ <https://www.nytimes.com/2023/09/13/us/politics/russia-sanctions-missile-production.html>

¹⁰ <https://www.reuters.com/world/europe/blood-billions-cost-russias-war-ukraine-2023-08-23/>

have led the way in sending Storm Shadow and SCALP missiles, which have a range of up to 250 kilometres. The next step would be the provision of US Army Tactical Missile Systems (ATACMS) and German TAURUS cruise missiles, which have a range of 300-500 kilometres.

Neither of those weapons systems will be a panacea. A Ukrainian breakthrough – as outlined in scenario 1, for example – would require not only such weapons, but also the ability of the AFU to conduct large-scale combined-arms operations. However, such supplies would increase the likelihood of scenario 2, bringing Crimea (and the supply routes into it via the land corridor and the bridge over the Kerch Strait) under fire control. If scenario 2 transpires, then the likelihood of scenario 1 occurring in the 12-month outlook will also increase.

Nonetheless, the baseline is scenario 3, given that the West is committed to supplying the AFU with ammunition and training on a long-term basis. This hedges against the risk of political instability in Western states, which could destabilise policy on Ukraine. This is discussed in subsections (vi) and (vii).

v. *Political stability: Russia*

The stability of the Putin regime is a key variable that may influence the possible outcome of the war, at the same time as being influenced by that same outcome. Putin has invested political capital in the war, to the extent that the future trajectory of his career will be fundamentally determined by it. In the sense that the war did not achieve its aims quickly, but instead led to the international isolation of Russia, the political position of Putin and his regime was already weakened in 2022.

However, the Putin regime succeeded in stabilising its position by creating a totalitarian culture surrounding the war, systematically neutralising anti-war dissent, while incentivising participation. It also proved adept at weathering the immediate impact of Western sanctions, establishing parallel import routes, cashing in on unprecedented windfalls as it engineered spikes in commodity prices in the first few months after the start of the war and, more recently, diverting the bulk of its oil exports to Asia.

In March 2024, Putin will seek to confirm his political supremacy when presidential elections are held, which he is certain to 'win'. Polling in Russia is mostly state controlled, but independent surveys tentatively indicate that the population would ideally prefer Putin to retire, with two thirds desiring a president who is younger than 70.¹¹ Despite this, Putin commands the necessary support to continue in office, especially given that he will not be challenged by any genuine competitors in the election.

Yet multiple events in 2023 have indicated that the position of the Putin regime, although openly undisputed, is brittle. Since the war began, the regime has not tolerated anti-war sentiment, but it has permitted pro-war commentators to criticise the war effort. Chief among these have been Igor Girkin, a former colonel in the Federal Security Service (FSB) who led the hybrid invasion of Donbass in 2014, and Yevgeniy Prigozhin, founder of the Wagner private mercenary company (PMC).

As the war effort has floundered, so pro-war criticism has increased. It came to a head in June 2023, when Wagner PMC, which had fought a prolonged and bloody battle for the town of Bakhmut in Donetsk region, joined Prigozhin in mutinying against the leadership of the Ministry of Defence. Wagner PMC

¹¹ <https://meduza.io/en/news/2023/09/20/more-than-two-thirds-of-russians-do-not-want-a-president-older-than-70-according-to-independent-survey>

units entered the Russian Federation practically unopposed, capturing the cities of Rostov-on-Don and Voronezh, before driving on towards Moscow. A settlement was brokered within a day, ending the mutiny. Two months later, Prigozhin was killed when his private jet exploded. His motive for the mutiny was probably to strengthen his personal position ahead of the planned dismantling of Wagner PMC by the Ministry of Defence; but the passive response of the military and security services indicated that the Putin regime could be vulnerable in the event of future mutinies or coup attempts.

Consequently, the Putin regime is acting to neutralise dissent altogether, including the 'pro-war' opposition. In July, Girkin was arrested on charges of extremism. Elsewhere, three generals have been dismissed since June for openly criticising the leadership, including Sergei Surovikin, who briefly led the Ukraine campaign before apparently backing the Wagner mutiny. Known ultra-nationalists in mid-ranking positions in the National Guard and Moscow garrison of the RAF have quietly been reshuffled or demoted.

If the morale of the RAF continues to deteriorate, further rebellions and mutinies will become more likely. If the perception takes root that the Putin regime is losing its grip, the likelihood of a coup d'état will increase, even if the chances of success are remote. Nonetheless, political instability in Moscow would very likely create uncertainty on the Ukrainian front.

vi. Political instability: US support

Ukraine remains dependent on the US and the EU for both its military and its financial support. The US has played a pivotal role in regard to the former, providing over USD 46bn since the war began. That is very likely to increase in the next 12 months. In August, the administration of President Joe Biden began negotiations with Congress for the approval of USD 40bn in further aid, nearly USD 15bn of which will be military. According to recent polls, the willingness of the electorate to increase support to Ukraine is peaking, but remains robust.¹²

Policy makers in Washington, as well as in the EU, are increasingly aware that support for Ukraine must be long term, and are acting accordingly, because withdrawal of that support would have global implications, not least regarding the potential invasion of Taiwan by China. On the other hand, it is possible that pressures elsewhere could result in a reshuffling of policy priorities. For example, in October, Hamas carried out mass terrorist attacks in Israel, killing hundreds of people and calling for other Arab states and organisations to join its efforts. If armed hostilities with Israel widen into a regional war, this would have a major impact on the diplomatic and material resources the US may allocate to Ukraine.

Furthermore, the continuation of US support for Ukraine may be threatened by presidential and congressional elections in November 2024. Biden will stand again as the nominee of the Democratic Party, while the most likely nominee of the Republican Party will be the former president, Donald Trump. If Trump is elected, the ability of Ukraine to continue fighting will be compromised. Trump is pledging the rapid negotiation of a peace settlement, which would likely be facilitated by the suspension of support for Ukraine, as a means of exerting pressure. As president, Trump would have considerable power to do that without congressional support. Even then, despite being split on Ukraine policy, the Republican Party has repeatedly shown itself to be subservient to Trump.

¹² <https://www.atlanticcouncil.org/blogs/new-atlanticist/americans-support-for-helping-ukraine-remains-strong-just-look-at-the-polls/>

In the unlikely event that Trump does not receive the Republican nomination, he has very considerable influence – if not control – over policy discourse within the party. In October 2023, amid congressional negotiations over the raising of the federal debt limit, the Speaker of the House of Representatives, Kevin McCarthy, was ousted from his post by fellow Republican representatives opposed to the provision of further aid to Ukraine. His successor is very likely to be sceptical about, if not in opposition to, further aid. If bipartisan consensus around this issue breaks down, US support of Ukraine will become far more difficult to legislate.

Furthermore, Trump's main challengers, such as Florida Governor Ron DeSantis and businessman Vivek Ramaswamy, tend to duplicate his policy positions, rather than contradict them. Nonetheless, polls indicate that it is far from certain that the Republican nominee will win the presidential election.

vii. Political instability: EU support

If the US Republican nominee does win the election, and subsequently curtails support for Ukraine, there are tentative signs that this would matter less than it might once have done. Indeed, Ukraine's dependence on the US is weakening in relative terms. Under a new 'three track' proposal, Ukraine is due to receive crucial military support from the EU via its Act in Support of Ammunition Production (ASAP) – and on a long-term basis.

Under the first track, Ukraine will receive EUR 1.1bn in ammunition that has already been procured. Under the second track, the European Commission is coordinating the provision through the European Peace Facility of EUR 50bn in military aid to Ukraine between 2024 and 2027. This increases the hitherto modest military aid provided by the EU to parity with that provided by the US.

Under the third track, the European defence complex will accelerate and increase production, with a view to supplying Ukraine, or otherwise restocking the depleted arsenals of NATO member states. Already in September, the European Defence Agency concluded eight procurement contracts to produce 155mm artillery shells.

This is a significant development – not only because it reduces the structural dependence on the US, but also because it offsets the provision of bilateral aid by EU member states. As in the US, popular support for Ukraine in the EU is robust. According to Eurobarometer, 70% of respondents support the provision of military aid to Ukraine, while 80% support sanctions on Russian companies and individuals.¹³ However, at the level of individual member states, the outlook is mixed.

The risks posed by political changes in individual member states are increasingly likely to have an impact on support for Ukraine and the continuation of sanctions. In Slovakia, Smer-SD, an illiberal centre-left grouping which led successive governments in 2006-2010 and 2012-2020, emerged in first place in parliamentary elections that were held at the end of September. Its leader, former Prime Minister Robert Fico, is a populist who succeeded in capturing parts of the security apparatus and judiciary while in power. Fico did not previously challenge the geopolitical consensus established after 1998, but since 2018 he has become increasingly Eurosceptic and pro-Russian.

¹³ <https://euneighbourseast.eu/news/latest-news/poll-eu-residents-still-willing-to-support-ukraine-and-its-refugees-and-to-stop-using-russian-energy/>

Slovakia is among the economies most exposed to the fallout from the Russian war in Ukraine. Owing to the cost of subsidising its gas-dependent energy sector, the general government deficit is projected to increase to 6.2% of GDP in 2023, the highest level in the EU. Inflation has steadily fallen from its summer 2022 peak of 15.5%, but remains high at 9%. This offers fertile ground for Fico, who is pledging to veto EU sanctions on Russia, as well as aid to Ukraine. At the time of writing, Smer-SD was negotiating with other parties on the formation of a coalition government.

The challenging economic outlook that Slovakia is facing, combined with its dependence on EU funding, may ultimately temper the incoming government. Yet there will be uncertainty over the provision of military aid to Ukraine, including under the EU plan to manufacture ammunition. President Zuzana Caputova already suspended the provision of military aid pending the formation of the new government. Slovakia has exhausted most of its Soviet-era stocks of arms in supplying Ukraine, but is nevertheless one of the few countries in the EU that is capable of manufacturing large-calibre artillery rounds, with investment and production in 155mm ammunition set to double. Furthermore, Slovakia's Konštrukta-Defence and Ukraine's Kramatorsk Heavy Duty Machine Tool Building Plant are discussing plans to launch the joint production of 155mm artillery systems. Assuming Fico is successful in forming a government, there is a possibility that such contracts will be cancelled or amended. Alternatively, a Fico government will maintain the contracts to assuage its industrialist base and agitate over the provision of aid through the EU instead.

Similarly significant elections are to be held in Poland in October 2023 and in Austria by October 2024 at the latest. Like Slovakia, Austria has been hit hard by the economic fallout from the war – not least because of its stubborn dependence on Russian gas and the relative lack of alternatives. Amid high inflation and wider political disaffection, the far-right Freedom Party (FPÖ) of the former interior minister, Herbert Kickl, is consistently ahead in the polls. It has pledged to veto EU sanctions on Russia, which – in an echo of Fico – it blames for the high inflation. The only realistic coalition partner of the FPÖ is the centre-right People's Party (ÖVP), which heads the incumbent government and has been relatively supportive of Ukraine. However, the regional business clientele of the ÖVP is increasingly sceptical of sanctions, and this may increase its willingness to begin challenging at the EU level if it enters a coalition with the FPÖ.

In Poland, the situation is different. The right-wing Law and Justice Party (PiS) has been embroiled in legal disputes with the European Commission over judicial independence, but has been among the staunchest supporters of sanctions and aid for Ukraine. Yet relations with Ukraine have increasingly come under strain, mainly owing to disagreement over imports of Ukrainian grain. Soon after the war began, the European Commission lifted trade controls on all Ukrainian imports. This was crucial for its agricultural sector, facilitating as it did the rapid export of key foodstuffs (e.g. grain), mostly to countries outside the EU. But logistical bottlenecks and the difficulty of exporting grain via the Black Sea meant that large volumes of Ukrainian grain have built up in storage facilities in Poland, Slovakia, Hungary, Romania and Bulgaria. Some of it is being sold onto the domestic market, prompting PiS to argue that it is undermining the competitiveness of local producers. This prompted the European Commission to impose a temporary ban on Ukrainian grain imports – now lifted after Kyiv pledged to increase controls over its agricultural exports.

Unhappy with this compromise, Poland has said it will impose its own ban, alongside Hungary. This move is partly motivated by the upcoming election, which will be very close. PiS and its right-wing allies

are attempting to prevent the loss of their absolute majority to the centrist and left-wing groupings spearheaded by the Civic Coalition of the former European Council president, Donald Tusk. As such, it is attempting to target the farming constituency, which has traditionally supported PiS, though a large portion of it has become disaffected over the impact of Ukrainian grain. Young farmers, in particular, are being targeted by the far-right Confederation party, which furthermore is opposed to support for Ukraine.

Yet if PiS and its allies lose their majority, the only partner that they could realistically approach to shore it up is Confederation. Although such a scenario is not likely to prompt a major policy shift by a PiS-led government, the provision of support may slow amid domestic opposition. Likewise, if the Civic Coalition ousts PiS, the majority commanded by whatever coalition it manages to negotiate is likely to be slender and could potentially require support from Confederation to be sought in parliament.

The effect of the Slovak, Austrian and Polish elections will be to consolidate a Central European axis opposed to, or at least sceptical of, EU policy on Ukraine and Russia. Hitherto, the only sceptical voice has been that of the Hungarian government of Prime Minister Viktor Orbán and his Fidesz-KDNP alliance. The Orbán government has rhetorically opposed sanctions, but ultimately toed the line on them. It has repeatedly threatened to veto EU aid to Ukraine, albeit mainly as leverage in disputes over the withholding of EU funds earmarked for Hungary. The incidence of such vetoes and the associated threats will increase if Smer-SD, PiS and the FPÖ, in particular, lead the governments of Slovakia, Poland and Austria, respectively.

This will complicate the negotiation of decisions in policy areas where unanimity is required, such as Common Foreign and Security Policy (CFSP). Even where Qualified Majority Voting (QMV) is possible, the EU nonetheless aims for unanimity. One scenario that may result from blockades is that the EU could simply bypass disruptive member states: sanctions and aid could be coordinated by the Commission, but ultimately implemented at the national level. A precedent for this was set when, in 2011, the UK government threatened to veto the EU treaty changes concerning national budgets, prompting all the other member states to circumvent the veto in this way.

It is worth noting that elections to the EU Parliament are also scheduled for June 2024. However, these are not likely to alter EU policy on Russia and Ukraine in any significant way. Although the ruling majority of the European People's Party (EPP), Socialists and Democrats (S&D) and Renew Europe has been eroded somewhat, the broad centre is likely to hold. In any case, the governments of the EU member states rather than the European Parliament are likely to choose to the president of the European Commission, as they did in 2019.

2.4. GEOPOLITICAL OUTLOOK: EU ENLARGEMENT

In June 2022, the EU member states agreed to grant membership candidate status to Ukraine and Moldova. The European Commission estimates that the timeframe for accession will be 10 years, as the Ukrainian and Moldovan governments need to implement certain measures to fulfil the various chapters of the EU acquis. Successful accession will also require solutions to deal with the fact that the territorial integrity of both states is perpetually compromised: that would usually scupper accession, given the risks it would pose to external borders and the single market. Nevertheless, some greater convergence

between Ukraine, Moldova and the EU economy is probable. For example, Moldova is set to participate in the EU Single Market Programme, thereby deepening its trade and investment ties.

Yet strategic drift persists with respect to EU enlargement. This is evident in the Western Balkans, where the process has stalled in key states, despite advancing on paper. In December 2022, the EU member states similarly agreed to grant Bosnia and Herzegovina candidate status. And in February 2023, the EU mediated the Ohrid Agreement, which established the conditions for the normalisation of diplomatic relations between Serbia and Kosovo.

In reality, however, the conditions required for progress in the accession negotiations are unlikely to be met. In Bosnia and Herzegovina, the Serb entity of Republika Srpska maintains a secessionist course, with its parliament rejecting the authority of both the Constitutional Court of the Federation and the internationally appointed high representative for Bosnia and Herzegovina, Christian Schmidt. If the de facto leader of Republika Srpska, Milorad Dodik, cannot be stopped by state prosecutors, further such unilateral steps are very likely, which would increase the probability of a military standoff – or even low-grade civil war.

Similar deadlock persists between the government of Serbian President Aleksandar Vučić and Kosovan Prime Minister Albin Kurti. Although they both signed the Ohrid Agreement, profound disagreements over its implementation have resulted in bilateral relations reaching their nadir. Belgrade even violated one of the terms of the agreement by voting against the admittance of Kosovo as a member of the Council of Europe, while also threatening the territorial integrity of states that voted in favour or abstained, with specific mention being made of Montenegro, Bosnia and Herzegovina and Ukraine.

Meanwhile, the northern part of the Kosovan district of Mitrovica has become a flashpoint, as it is home to an ethnic Serb majority that has undertaken to boycott the political process in Kosovo until such time as Pristina establishes an autonomous institutional structure for Serb municipalities. In September, Serb paramilitaries with high-grade equipment engaged in a shootout with Kosovan police, resulting in four deaths. Belgrade responded by deploying the military to the border with Kosovo, resulting in warnings being issued by the US and EU. Pristina believes that the paramilitaries were sponsored by the Serbian state.

Interstate war between Serbia and Kosovo is very unlikely, given that the latter is a protectorate of NATO, which has a force of some 4,500 troops based there. Yet the situation is tense and further localised violence highly likely. Bilateral relations have reached such a nadir that it will be virtually impossible for the implementation of the Ohrid Agreement to occur. The US and EU may choose to exert pressure on Serbia through sanctions, as it has with Kosovo. The EU has suspended development funding earmarked for Kosovo and has threatened to delay visa liberalisation for Kosovan citizens. However, this coercive approach, which is likely to be maintained in the 12-month outlook, is not having the intended effect on Pristina and is similarly unlikely to sway Belgrade.

The situation in Serbia, Kosovo and Bosnia and Herzegovina is symptomatic of the failure of the US and EU to develop a strategic concept for resolution of the outstanding territorial issues. This partly reflects the fact that the development of such a strategic concept is unrealistic so long as authoritarian, irredentist governments are in power in Belgrade and Banja Luka.

Indeed, these governments have been moving away from EU standards. According to the Worldwide Governance Indicators of the World Bank, since 2012 Serbia has deteriorated markedly on such key measures as 'voice and accountability' and 'control of corruption'.¹⁴ Furthermore, not only does Serbia have a free trade agreement with the Eurasian Economic Union, but it is negotiating one with China, effectively disbaring itself from membership of the EU customs union.

For as long as such deadlock persists, the EU accession process of these states is unlikely to advance beyond formal commitments. The outlook is less bleak in Montenegro, Albania and North Macedonia, the latter two of which began their accession negotiations in July 2022 after nearly three years of delay. Similarly, in Montenegro, which began accession negotiations in 2012, the process may gain momentum following presidential and parliamentary elections that saw its long-time authoritarian leader, Milo Đukanović, step down.

However, political instability still poses a considerable risk to the accession negotiations of these three states. In Montenegro, President Jakov Milatović's Europe Now! party is struggling to form a ruling majority, due to internal disputes. In North Macedonia, the coalition government led by the Social Democratic Union of Macedonia (SDSM) must pass constitutional amendments to address the rights of the Bulgarian minority, but faces widespread opposition. In Albania, accession negotiations are at risk from bilateral disputes with Greece, one longstanding issue being that of maritime jurisdiction. Meanwhile, the Socialist Party (PS) leader Edi Rama has been prime minister for 10 years, with institutional authority becoming increasingly centralised over that time.

¹⁴ <https://info.worldbank.org/governance/wgi/Home/Reports>

3. CESEE overview: Beneath the Veneer of Calm

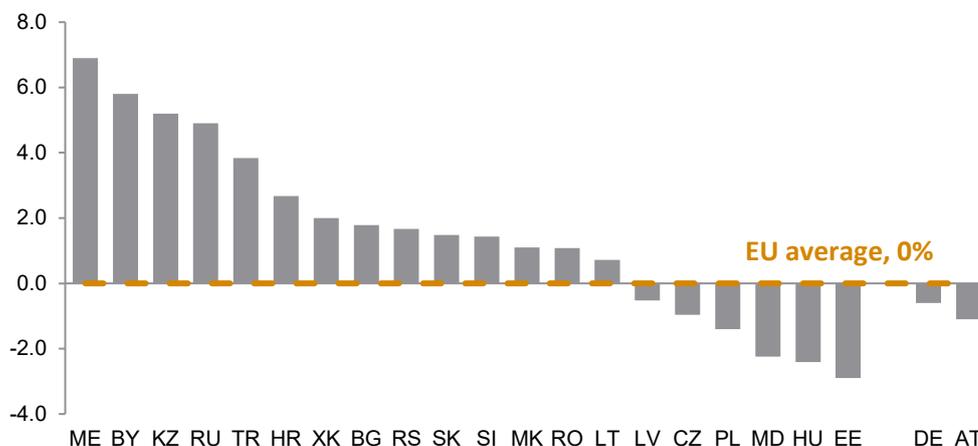
BY BRANIMIR JOVANOVIĆ¹⁵

- › The economy of the CESEE region grew by 1.5% in Q2 2023, outperforming the EU and the euro area. However, this overall benign picture conceals many nuances.
- › There were notable differences between the various regions. The EU-CEE countries performed worse than expected, due to the recession in Germany. The Western Balkan countries performed better than expected, thanks to tourism, remittances and FDI. And the CIS countries and Ukraine also did better than anticipated, as they adapted to the new reality.
- › Inflation is proving far more persistent than previously imagined; it is driven not just by global energy prices, but also by company profits, price rises in other sectors and, most recently, higher wages.
- › The price increases are having a serious adverse effect on people's living standards and poverty, and some indicators have worsened dramatically.
- › Growth in 2024 and 2025 will be lower than previously expected, on account of the global slowdown, the weak EU economy, the more persistent inflation, the tighter monetary conditions and less-supportive fiscal policy.
- › Inflation will also be higher and will not return to 2% any time soon, as its dynamics have become far more complex and are no longer driven just by higher global energy prices.

3.1. SOLID GROWTH OVERALL, BUT WITH MANY QUESTION MARKS

Economic growth in the CESEE region in Q2 2023 was notably resilient. Despite the stagnation of the EU economy, two thirds of CESEE countries saw their economies expand, sometimes quite robustly. Montenegro led the pack, growing by 6.9% on the back of strong tourism and foreign direct investment (FDI); this continues a streak that has already lasted for some time. The CIS countries also grew strongly, owing to a weak base effect from the previous year, increased military production in Russia and the reorientation of the Russian economy towards countries that have not imposed sanctions. On the other hand, the Baltic and Visegrád countries performed relatively poorly, with the former suffering from their geographical proximity to Russia and the latter from the recession in Germany (Figure 3.1).

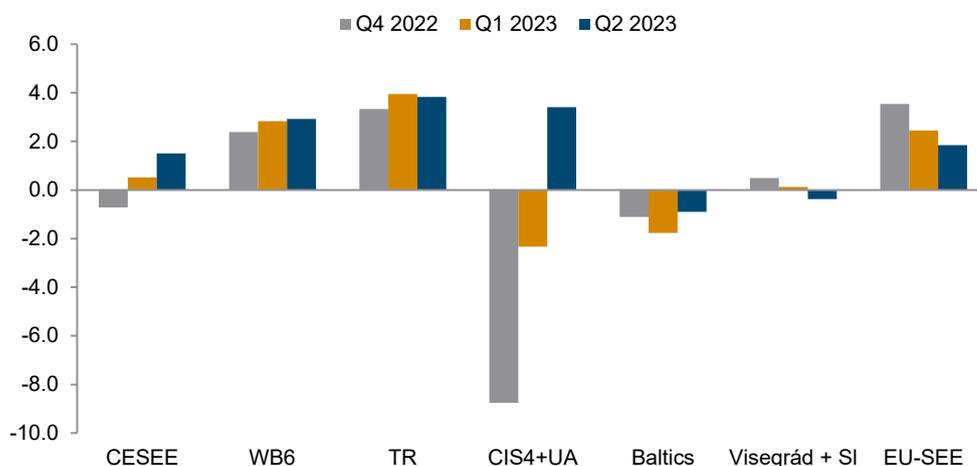
¹⁵ The author would like to thank Alexandra Bykova, Doris Hanzl-Weiss and Gabor Hunya for their valuable comments and suggestions on the first draft.

Figure 3.1 / Real GDP growth in CESEE in Q2 2023, %, year on year

Note: Countries which have not published data on Q2 not shown.

Source: Eurostat and wiiw Monthly Database.

Economic growth in the CESEE region in Q2 2023 was generally better than in the previous two quarters, but there was significant variation across the countries. Overall, in the second quarter the region expanded by 1.5% year on year, a clear improvement over the 0.5% growth of Q1 (simple averages). This was also significantly better than the growth in the EU during this period, which was 0%. The sub-region with the highest rate of growth was the CIS plus Ukraine, which saw an expansion of 3.4% in Q2 (compared to a decline of 2.3% in the previous quarter). The Baltic countries also saw their decline moderate from -1.8% in Q1 to -0.9% in Q2. Growth in Western Balkans and Turkey was almost unchanged, while the EU countries of Southeast Europe (EU-SEE) experienced a major slowdown, from 2.5% to 1.8%. The Visegrád countries and Slovenia saw their economies decline by 0.4% in Q2, after growth of 0.1% in the previous period (Figure 3.2).

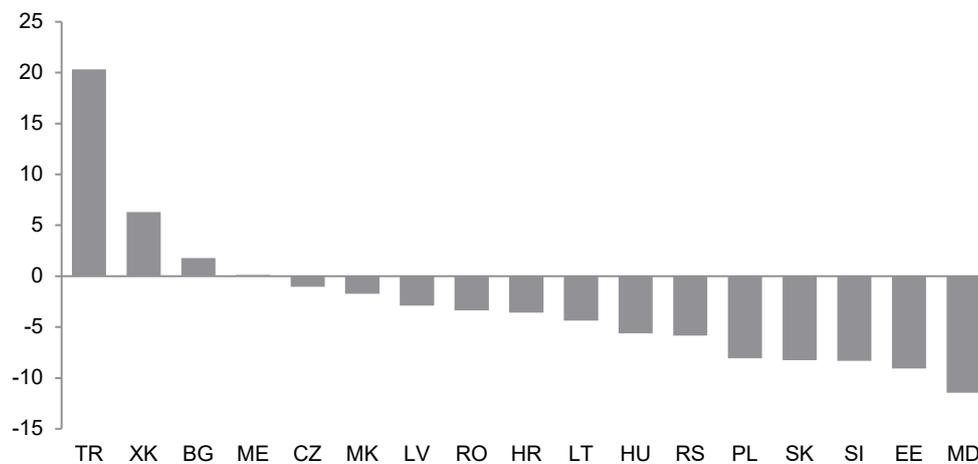
Figure 3.2 / Real GDP growth in the last three quarters, by sub-region of CESEE, %, year on year

Note: Simple averages. No data for Albania, Bosnia and Herzegovina or Ukraine.

Source: Eurostat and wiiw Monthly Database.

The main driver of growth in the CESEE region in Q2 was, perhaps somewhat surprisingly, the decline in imports. Imports declined in 13 of the 17 CESEE countries that published data on this, by an average of 2.7% for the whole region (simple average). This was due primarily to the big imports of energy in Q2 2022, when there was major uncertainty surrounding the availability and price of energy, leading governments and businesses to rush to import energy. A notable exception was Turkey, where imports of goods and services increased by 20% in real terms (Figure 3.3).

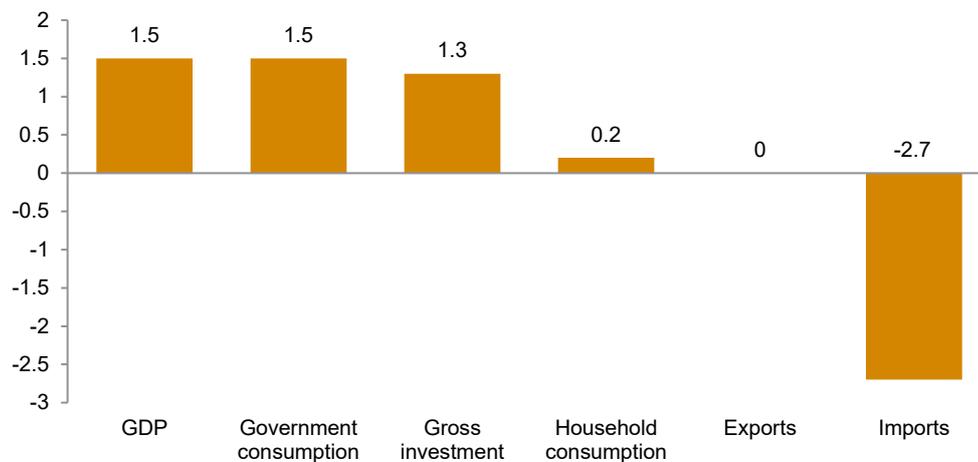
Figure 3.3 / Real growth in imports of goods and services in CESEE in Q2 2023, %, year on year



Note: Countries which have not published data on Q2 not shown.

Source: Eurostat and wiiw Monthly Database.

Figure 3.4 / Real growth of the different GDP components in Q2 2023, %, year on year (simple averages for whole CESEE)



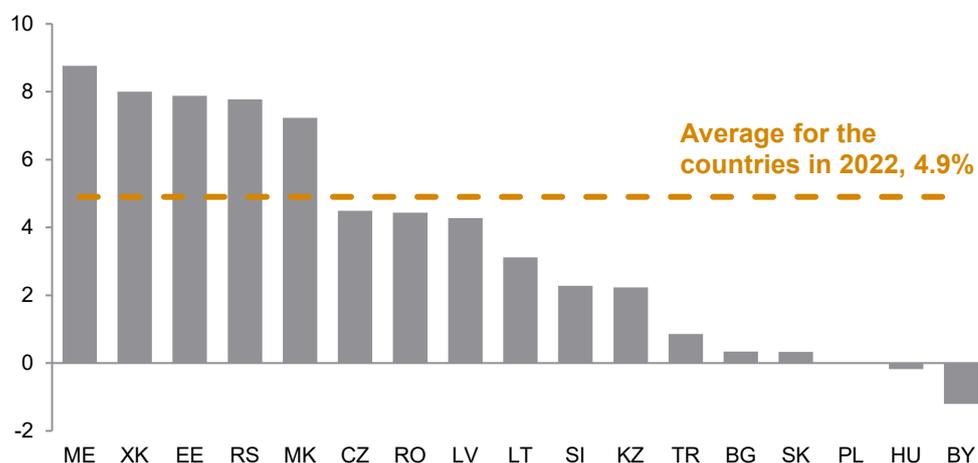
Note: No data on Albania, Bosnia and Herzegovina, Belarus, Kazakhstan, Russia or Ukraine.

Source: Eurostat and wiiw Monthly Database.

Household consumption remained weak in Q2 2023, due to high inflation and the erosion of real incomes. It grew by just 0.2% on average for the whole region (simple average). In 10 of the 17 countries that published data on this, household consumption declined compared to the same period of 2022. Exports were also weak, owing to the recession in Germany and weak activity in China. They stagnated on average for the whole region, declining in nine of the 17 countries for which data are available. Government consumption, on the other hand, was supportive, though only mildly: it grew by 1.5% on average, with 12 of the 17 countries recording a positive change. Gross investment grew similarly, at 1.3% on average for the whole region, with 12 countries seeing an expansion, thanks to strong FDI inflows (Figure 3.4).

FDI inflows remained relatively robust in Q2 2023, although noticeably lower than in 2022. Across the entire region, they averaged 3.6% of GDP – down on both the previous quarter (5.8%) and 2022 (4.9%). This moderation can be attributed to the global economic slowdown, stagnation within the EU and Germany’s recession. Nevertheless, some countries continued to attract substantial FDI inflows, primarily the Western Balkan nations, the Baltic countries and a few select Central European countries, such as Czechia and Romania (Figure 3.5). Conversely, some traditionally attractive destinations for FDI – like Slovakia, Hungary and Poland – underperformed in the second quarter, potentially influenced by the recession in Germany. Belarus stood out as a notable outlier (as has often been the case recently): it experienced negative FDI inflows, implying that international companies have been leaving the country. One also has to bear in mind that FDI inflows can be very volatile and are driven by many factors, so they could change a lot by the end of the year.

Figure 3.5 / FDI inflows into CESEE countries in Q2 2023, % of GDP

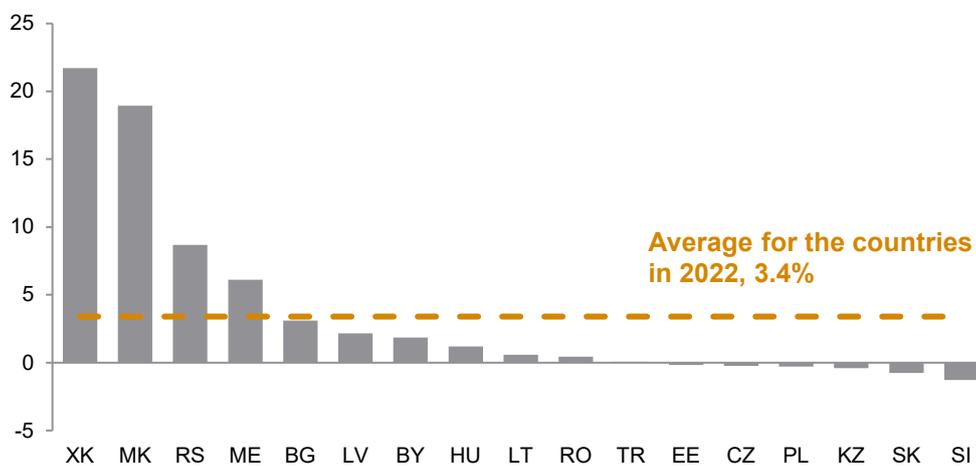


Note: The data refer to FDI inflows (liabilities) from Balance of Payments statistics. Countries which have not published data on Q2 not shown.

Source: Central banks, wiiw calculations.

Remittance inflows, represented by secondary income in the Balance of Payments, remained strong, particularly in countries with significant diasporas. In Q2 they averaged 3.6% of GDP for the entire region – slightly up on the previous year’s inflows of 3.4%. The Western Balkan countries saw the strongest inflows, with Kosovo and North Macedonia receiving transfers of around 20% of GDP, and Serbia and Montenegro around 6-9% of GDP. On the other hand, countries that have attracted workers from abroad in recent years, such as Slovenia, Slovakia, Poland and Czechia, had outflows in the secondary income category (Figure 3.6). Strong remittances explain a significant portion of the resilience that some CESEE countries have been demonstrating during this crisis. Evidence from this and past crises, including the pandemic, suggests that remittances in the region do not decline during economic downturns, implying that they are likely to remain robust in the coming period.

Figure 3.6 / Secondary income inflows into CESEE countries in Q2 2023, % of GDP



Source: Central banks, wiiw calculations.

Table 3.1 / OVERVIEW 2021-2022 AND OUTLOOK 2023-2025

	GDP					Consumer prices					Unemployment (LFS)				
	real change in % against prev. year					average change in % against prev. year					rate in %, annual average				
	2021	2022	Forecast			2021	2022	Forecast			2021	2022	Forecast		
BG Bulgaria	7.6	3.4	1.0	1.5	2.5	2.8	13.0	9.0	7.0	5.0	5.3	4.3	4.2	4.1	4.0
CZ Czechia	3.6	2.4	0.1	2.0	2.7	3.3	14.8	11.0	4.0	2.8	2.8	2.2	2.8	2.6	2.6
EE Estonia	7.2	-0.5	-1.3	1.7	3.0	4.5	19.4	9.5	3.4	2.5	6.2	5.6	6.7	7.0	6.1
HR Croatia	13.1	6.2	2.5	2.9	3.1	2.7	10.7	7.5	4.0	3.0	7.6	7.0	6.8	6.7	6.6
HU Hungary	7.2	4.6	-0.5	1.8	2.4	5.2	15.3	17.5	6.0	4.0	4.1	3.6	4.0	3.8	3.6
LT Lithuania	6.0	1.9	-0.1	1.7	2.4	4.6	18.9	8.0	2.8	2.0	7.1	6.0	7.1	6.5	6.0
LV Latvia	4.3	2.8	0.3	1.8	2.3	3.2	17.2	9.5	3.0	3.2	7.6	6.9	6.6	6.3	6.0
PL Poland	6.9	5.1	0.0	2.8	3.8	5.2	13.2	11.5	5.2	3.6	3.4	2.9	3.0	3.6	3.8
RO Romania	5.8	4.7	2.5	3.2	3.5	4.1	12.0	10.5	7.5	5.0	5.6	5.6	5.7	5.8	5.7
SI Slovenia	8.2	2.5	1.3	2.7	2.5	2.0	9.3	7.2	3.6	2.4	4.8	4.0	3.7	3.7	3.6
SK Slovakia	4.9	1.7	0.8	1.9	2.4	2.8	12.1	11.0	5.0	3.0	6.8	6.1	6.0	6.0	5.8
<i>EU-CEE11 ¹⁾²⁾</i>	<i>6.4</i>	<i>4.2</i>	<i>0.6</i>	<i>2.5</i>	<i>3.2</i>	<i>4.3</i>	<i>13.5</i>	<i>11.2</i>	<i>5.4</i>	<i>3.7</i>	<i>4.5</i>	<i>4.0</i>	<i>4.2</i>	<i>4.4</i>	<i>4.4</i>
<i>EA20 ³⁾</i>	<i>5.6</i>	<i>3.3</i>	<i>0.5</i>	<i>1.2</i>	<i>1.6</i>	<i>2.6</i>	<i>8.4</i>	<i>5.7</i>	<i>3.2</i>	<i>2.5</i>	<i>7.7</i>	<i>6.8</i>	<i>6.6</i>	<i>6.6</i>	<i>6.6</i>
<i>EU27 ³⁾</i>	<i>5.7</i>	<i>3.4</i>	<i>0.7</i>	<i>1.4</i>	<i>1.8</i>	<i>2.9</i>	<i>9.2</i>	<i>5.9</i>	<i>3.4</i>	<i>2.7</i>	<i>7.1</i>	<i>6.2</i>	<i>5.8</i>	<i>5.8</i>	<i>5.8</i>
AL Albania	8.9	4.9	3.5	3.6	3.7	2.0	6.7	4.6	3.0	2.5	11.5	10.9	10.5	10.0	9.5
BA Bosnia and Herzegovina	7.4	3.9	1.7	1.9	2.1	2.0	14.0	7.5	3.0	2.5	17.4	15.4	13.8	13.5	13.2
ME Montenegro	13.0	6.4	4.5	2.9	3.0	2.4	13.0	9.1	5.0	2.8	16.6	14.7	13.8	13.1	12.0
MK North Macedonia	3.9	2.1	1.6	2.0	2.5	3.2	14.2	10.0	5.0	3.0	15.7	14.4	13.0	12.5	12.0
RS Serbia	7.5	2.3	1.5	2.0	2.5	4.1	11.9	12.5	5.5	3.5	11.0	9.4	9.5	9.0	8.5
XK Kosovo	10.7	3.5	3.2	3.3	3.7	3.4	11.6	5.5	4.0	2.5	20.7	12.5	12.4	12.3	12.0
<i>WB6 ¹⁾²⁾</i>	<i>7.8</i>	<i>3.2</i>	<i>2.1</i>	<i>2.4</i>	<i>2.7</i>	<i>3.2</i>	<i>11.8</i>	<i>9.5</i>	<i>4.5</i>	<i>3.0</i>	<i>13.6</i>	<i>11.7</i>	<i>11.3</i>	<i>10.9</i>	<i>10.4</i>
TR Turkey	11.4	5.5	3.2	2.7	3.6	19.6	72.3	54.9	54.0	35.0	12.0	10.5	9.5	10.5	10.0
BY Belarus	2.4	-4.7	3.0	2.2	2.5	9.5	15.2	9.0	8.0	8.0	3.9	3.6	3.4	3.4	3.4
KZ Kazakhstan	4.3	3.2	4.7	4.0	4.2	8.0	15.0	14.5	9.0	6.0	4.9	4.9	4.8	4.8	4.8
MD Moldova	13.9	-5.0	0.0	3.5	3.5	5.1	28.7	14.0	6.0	5.0	3.2	3.1	4.5	4.0	4.0
RU Russia	5.6	-2.1	2.3	1.9	1.7	6.7	13.8	5.6	4.9	3.4	4.8	3.9	3.3	3.2	3.1
UA Ukraine	3.4	-29.1	3.6	4.2	5.3	9.4	20.2	14.0	8.0	6.0	9.9	25.0	20.0	15.0	10.0
<i>CIS4+UA ¹⁾²⁾</i>	<i>5.3</i>	<i>-3.5</i>	<i>2.6</i>	<i>2.3</i>	<i>2.2</i>	<i>7.1</i>	<i>14.4</i>	<i>7.2</i>	<i>5.6</i>	<i>4.0</i>	<i>5.6</i>	<i>7.4</i>	<i>6.0</i>	<i>5.1</i>	<i>4.2</i>
<i>V4 ¹⁾²⁾</i>	<i>6.2</i>	<i>4.3</i>	<i>0.0</i>	<i>2.4</i>	<i>3.3</i>	<i>4.6</i>	<i>13.7</i>	<i>12.2</i>	<i>5.1</i>	<i>3.5</i>	<i>3.7</i>	<i>3.2</i>	<i>3.4</i>	<i>3.7</i>	<i>3.8</i>
<i>BALT3 ¹⁾²⁾</i>	<i>5.8</i>	<i>1.6</i>	<i>-0.2</i>	<i>1.7</i>	<i>2.5</i>	<i>4.2</i>	<i>18.5</i>	<i>8.8</i>	<i>3.0</i>	<i>2.4</i>	<i>7.0</i>	<i>6.1</i>	<i>6.9</i>	<i>6.6</i>	<i>6.0</i>
<i>SEE9 ¹⁾²⁾</i>	<i>7.3</i>	<i>4.3</i>	<i>2.2</i>	<i>2.7</i>	<i>3.1</i>	<i>3.6</i>	<i>12.0</i>	<i>9.8</i>	<i>6.4</i>	<i>4.3</i>	<i>8.7</i>	<i>7.7</i>	<i>7.6</i>	<i>7.5</i>	<i>7.3</i>
<i>CIS3+UA ¹⁾²⁾</i>	<i>3.9</i>	<i>-9.3</i>	<i>3.9</i>	<i>3.8</i>	<i>4.3</i>	<i>8.7</i>	<i>17.2</i>	<i>13.4</i>	<i>8.4</i>	<i>6.3</i>	<i>7.3</i>	<i>15.3</i>	<i>12.5</i>	<i>9.8</i>	<i>7.2</i>
<i>non-EU12 ¹⁾²⁾</i>	<i>7.1</i>	<i>-0.4</i>	<i>2.8</i>	<i>2.4</i>	<i>2.7</i>	<i>10.5</i>	<i>32.4</i>	<i>22.2</i>	<i>20.7</i>	<i>13.6</i>	<i>7.4</i>	<i>8.3</i>	<i>7.1</i>	<i>6.7</i>	<i>5.9</i>
<i>CESEE23 ¹⁾²⁾</i>	<i>6.9</i>	<i>0.9</i>	<i>2.1</i>	<i>2.4</i>	<i>2.8</i>	<i>8.7</i>	<i>26.8</i>	<i>18.9</i>	<i>16.1</i>	<i>10.7</i>	<i>6.7</i>	<i>7.3</i>	<i>6.4</i>	<i>6.1</i>	<i>5.6</i>

Table 3.1 / (contd.)

	Current account					Fiscal balance				
	in % of GDP					in % of GDP				
	2021	2022	Forecast			2021	2022	Forecast		
		2023	2024	2025			2023	2024	2025	
BG Bulgaria	-1.9	-0.7	-0.5	-0.3	0.3	-3.9	-2.8	-5.0	-4.0	-3.0
CZ Czechia	-2.8	-6.1	-1.2	-0.6	-0.1	-5.1	-3.6	-4.2	-1.9	-1.0
EE Estonia	-1.8	-2.9	0.9	1.1	1.7	-2.4	-0.9	-3.5	-3.3	-2.7
HR Croatia	1.8	-1.6	-0.4	0.2	1.7	-2.5	0.4	-2.4	-2.0	-1.8
HU Hungary	-4.1	-8.1	-2.3	-0.6	0.0	-7.1	-6.2	-4.8	-4.2	-3.3
LT Lithuania	1.1	-5.1	-1.1	-0.8	-0.9	-1.2	-0.6	-2.0	-1.8	-1.5
LV Latvia	-4.2	-6.4	-2.1	-2.0	-1.9	-7.1	-4.4	-3.5	-2.8	-2.3
PL Poland	-1.4	-3.0	1.2	0.6	0.7	-1.8	-3.7	-4.8	-4.0	-3.5
RO Romania	-7.2	-9.3	-7.0	-5.6	-5.2	-7.1	-6.2	-5.7	-4.5	-4.0
SI Slovenia	3.3	-1.0	1.3	2.2	2.3	-4.6	-3.1	-4.2	-3.5	-2.1
SK Slovakia	-2.5	-8.2	-1.8	-1.3	-0.4	-5.4	-2.0	-6.0	-4.4	-4.5
<i>EU-CEE11¹⁾²⁾</i>	-2.5	-5.1	-1.3	-0.9	-0.5	-4.1	-3.9	-4.7	-3.6	-3.0
<i>EA20³⁾</i>	4.1	1.2	1.0	1.5	2.5	-5.3	-3.6	-3.7	-2.7	-2.6
<i>EU27³⁾</i>	3.7	1.0	1.0	1.5	2.5	-4.8	-3.4	-3.3	-2.3	-2.2
AL Albania	-7.7	-5.9	-3.6	-3.5	-3.4	-4.6	-3.7	-2.2	-1.5	-1.0
BA Bosnia and Herzegovina	-2.4	-4.5	-3.9	-3.6	-4.0	-0.3	-0.4	-0.5	0.5	0.3
ME Montenegro	-9.2	-12.9	-11.8	-10.8	-10.2	-1.9	-5.1	-4.9	-4.8	-4.5
MK North Macedonia	-3.1	-6.0	-2.2	-2.5	-3.1	-5.4	-4.5	-4.0	-3.0	-2.5
RS Serbia	-4.2	-6.9	-3.5	-4.3	-4.4	-4.1	-3.2	-2.0	-2.0	-1.5
XK Kosovo	-8.7	-10.5	-8.9	-7.9	-7.6	-1.3	-0.5	-0.5	-1.4	-2.0
<i>WB6¹⁾²⁾</i>	-4.8	-6.7	-4.2	-4.4	-4.6	-3.4	-2.8	-2.0	-1.7	-1.4
TR Turkey	-0.9	-5.3	-5.3	-4.1	-3.7	-2.4	-1.1	-4.0	-3.0	-3.0
BY Belarus	3.1	3.5	0.1	-0.1	-0.7	0.2	-1.5	-2.0	-1.0	0.0
KZ Kazakhstan	-1.3	3.5	-3.3	-3.2	-1.7	-3.0	-2.1	-2.7	-2.6	-2.4
MD Moldova	-12.4	-15.7	-10.3	-8.2	-7.1	-1.9	-3.2	-5.0	-4.0	-3.0
RU Russia	6.6	10.5	2.6	3.4	3.7	0.8	-1.4	-2.5	-2.0	-1.5
UA Ukraine	-1.9	5.0	-0.7	-3.1	-4.5	-3.4	-16.3	-27.0	-15.0	-10.0
<i>CIS4+UA¹⁾²⁾</i>	5.0	9.3	1.6	2.0	2.2	0.1	-2.3	-4.2	-3.0	-2.2
<i>V4¹⁾²⁾</i>	-2.2	-4.9	-0.1	0.0	0.4	-3.7	-3.9	-4.8	-3.6	-3.0
<i>BALT3¹⁾²⁾</i>	-1.1	-4.9	-0.9	-0.6	-0.5	-3.1	-1.7	-2.8	-2.5	-2.0
<i>SEE9¹⁾²⁾</i>	-4.8	-6.5	-4.7	-3.9	-3.5	-5.2	-4.1	-4.4	-3.5	-3.0
<i>CIS3+UA¹⁾²⁾</i>	-1.2	3.4	-2.2	-2.9	-2.7	-2.7	-6.9	-10.4	-6.4	-4.6
<i>non-EU12¹⁾²⁾</i>	3.1	5.2	-0.6	-0.1	0.0	-0.7	-2.1	-4.0	-2.9	-2.4
<i>CESEE23¹⁾²⁾</i>	1.0	1.6	-0.9	-0.4	-0.2	-2.0	-2.7	-4.3	-3.2	-2.7

1) wiiw estimates. - 2) Current account data include transactions within the region (sum over individual countries). -

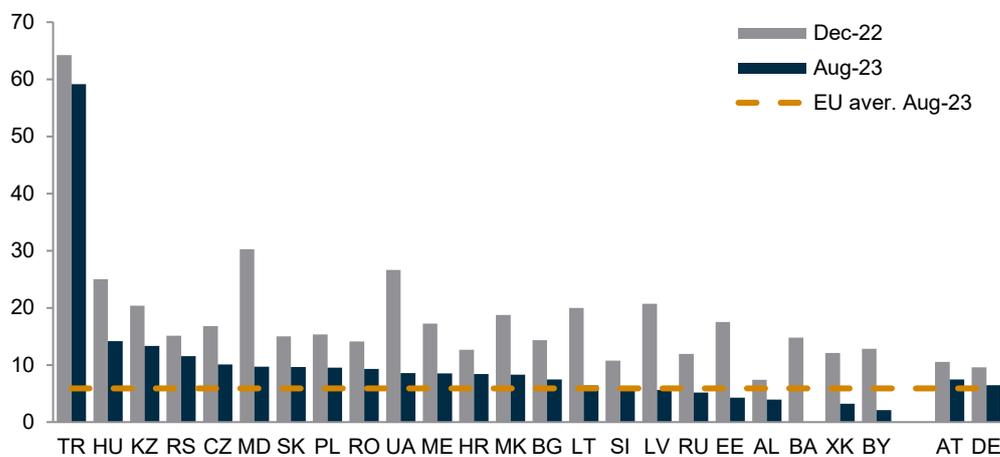
3) Forecasts estimated by wiiw.

Source: wiiw, Eurostat. Forecasts by wiiw. Cut-off date for historical data and forecasts: 21 September 2023.

3.2. INFLATION MODERATING, BUT NOT ABOUT TO REACH TOLERABLE LEVELS

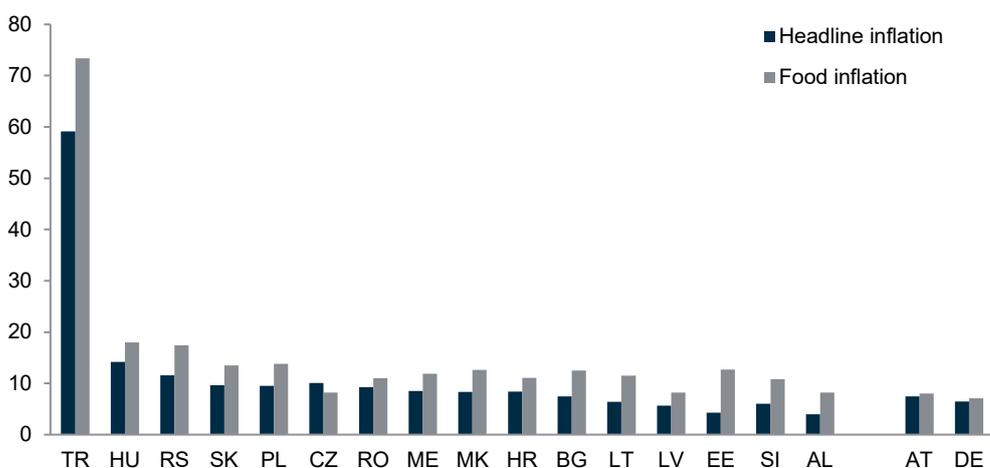
Inflation is moderating everywhere – but only slowly, so that it remains very high. In August 2023, it was below the level at the end of 2022 in all the countries. However, it was under 3% only in Belarus; and it was below the EU average of 5.9% in just six countries. Turkey continues to have the highest inflation – 59% in August – and it has actually increased in recent months, from 38% in June, due to depreciation of the lira. Hungary and Kazakhstan likewise continue to have double-digit inflation rates, again due to the depreciation of their currencies (Figure 3.7).

Figure 3.7 / Headline inflation in CESEE in December 2022 and August 2023, %, year on year



Source: Eurostat and wiiw Monthly Database.

Figure 3.8 / Headline and food inflation in CESEE in August 2023, %, year on year



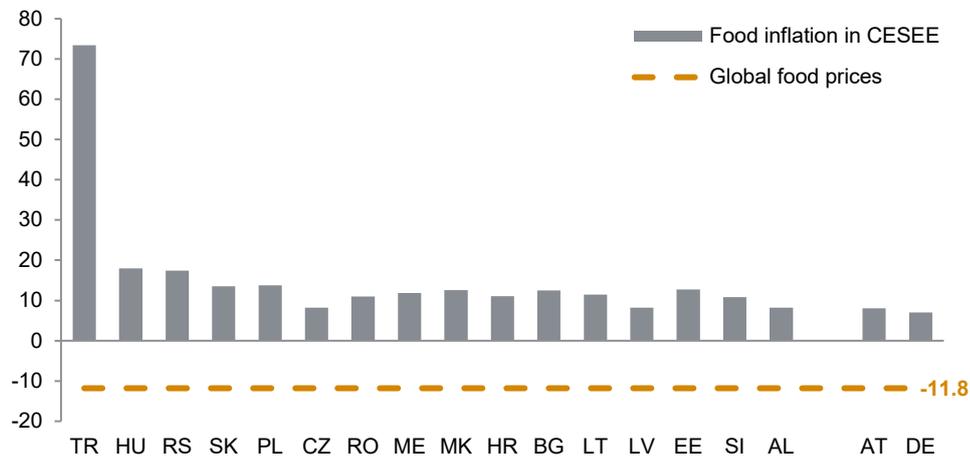
Source: wiiw calculations, using data from Eurostat and wiiw Monthly Database. Some CESEE countries are omitted, due to unavailability of data on inflation by sub-component in the Eurostat database.

Food prices stand out as the main component that has been driving inflation in recent months. In all CESEE countries with data on inflation by component, food inflation exceeds headline inflation, often

by a significant margin. The only exception is Czechia, where food inflation in August was below headline inflation (Figure 3.8), and where energy (housing, water, electricity, gas and other fuels) has been the main component driving inflation. Falling global energy prices have meant that the cost of energy has been stable (or has declined) in most countries, apart from Czechia, Slovakia, Poland, Serbia, North Macedonia and Turkey, where it has increased significantly in 2023.

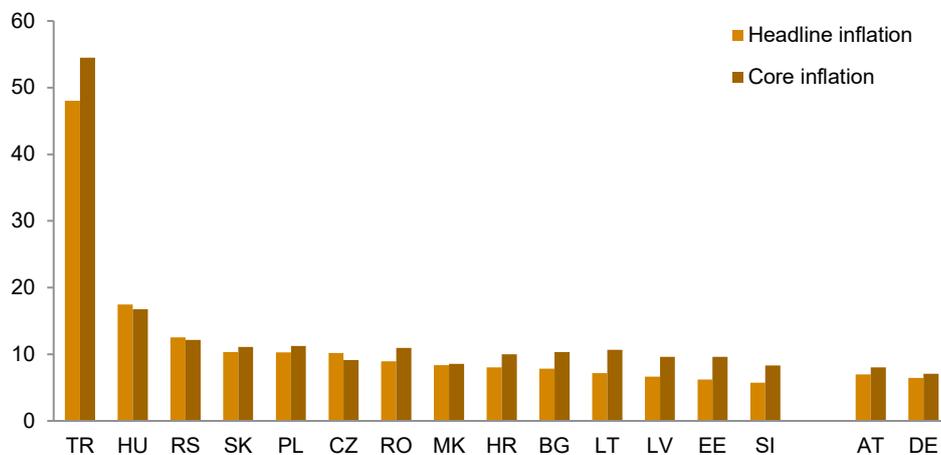
Food inflation in CESEE has been driven mainly by domestic factors, such as firm profits, as global food prices have continued to decline. In August 2023, the food price index of the Food and Agriculture Organization (FAO) was 11.8% lower than in the same period the year before (Figure 3.9). Of the components of the index, almost all – meat, dairy products, cereals and oils – declined year on year (by figures ranging from 5% to 23%). Only sugar increased (by 34%).

Figure 3.9 / Food inflation in CESEE and global food prices in August 2023, %, year on year



Source: Eurostat, wiiw Monthly Database and FAO.

Figure 3.10 / Headline and core inflation in CESEE in August 2023, %, year on year

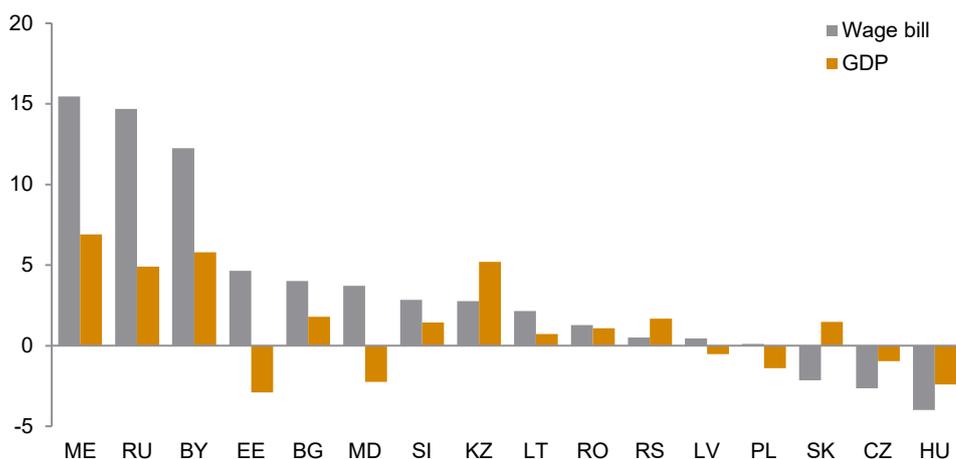


Source: wiiw calculations, using data from Eurostat and wiiw Monthly Database. Some CESEE countries are omitted, due to unavailability of data on inflation by sub-component in the Eurostat database.

Still, it would be wrong to attribute the ongoing inflation solely to food prices, since core inflation has also been increasing everywhere in CESEE. So far this year, core inflation (i.e. inflation excluding food and energy prices) has exceeded headline inflation in all but three countries of the region: Serbia, Czechia and Hungary are the only exceptions (Figure 3.10). This indicates that price pressures have spilled over to other components, making inflation more difficult to tame and likely to stay elevated for some time.

Wages have become more important for the dynamics of inflation in CESEE. In 2022 and Q1 2023, corporate profits grew much faster than wages, and the profit share of income increased in most countries of the region. However, in Q2 2023, the real growth in the wage bill (i.e. the combined growth of real wages and employment) exceeded real GDP growth in most CESEE countries, suggesting that labour may be regaining some of the income share it lost in the previous year (Figure 3.11). This could lead to a fresh bout of inflation, if businesses respond to rising labour costs by raising prices, in order to maintain their profit margins. This would make inflation more persistent and long-lasting than previously thought.

Figure 3.11 / Real growth in the wage bill and real growth in GDP in CESEE in Q2 2023, %, year on year



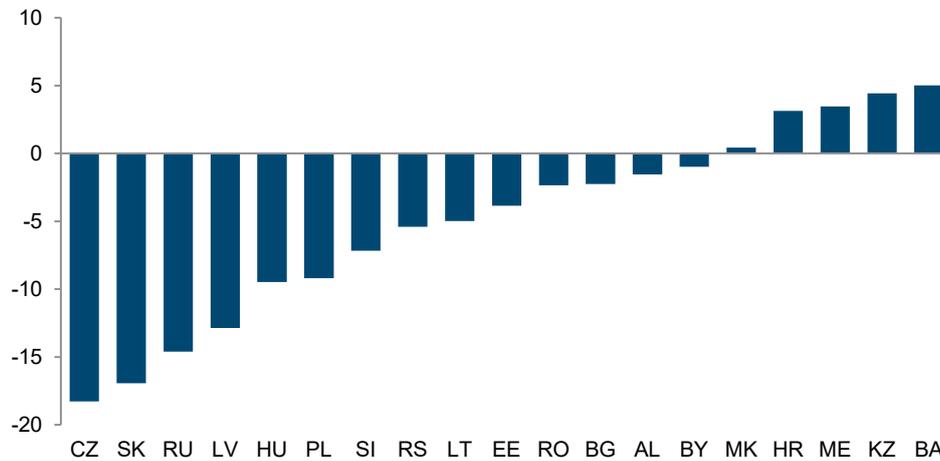
Note: The growth in the wage bill is calculated as combined growth in real wages and the number of employed persons. For countries that have had methodological changes or new censuses, the data used here have been adjusted to take account of these changes.

Source: wiiw calculations, using data from Eurostat and wiiw Monthly Database.

3.3. THE HARROWING SOCIAL IMPACTS OF THE PRICE INCREASES

While there was year-on-year growth in real wages during Q2, this cannot conceal the fact that most of the CESEE region had seen a persistent decline in real wages over the previous year and a half. When comparing Q2 2023 to Q4 2021, one can see that real wages in the second quarter of this year were below the level of a year and a half previously in 14 of the 19 CESEE countries with available data (Figure 3.9). Notably, only Bosnia and Herzegovina, Kazakhstan, Montenegro and Croatia experienced increases of 3% or more in the previous 18 months. Conversely, countries like Czechia, Slovakia, Russia and Latvia witnessed double-digit declines (Figure 3.12). This points to the fact that people's living standards have deteriorated significantly during the cost-of-living crisis, and that real wages have a chasm to bridge if they are to return to pre-crisis levels. This may in turn exert further pressure on prices to rise.

Figure 3.12 / Real gross wages in CESEE economies in Q2 2023, compared to Q4 2021, % change

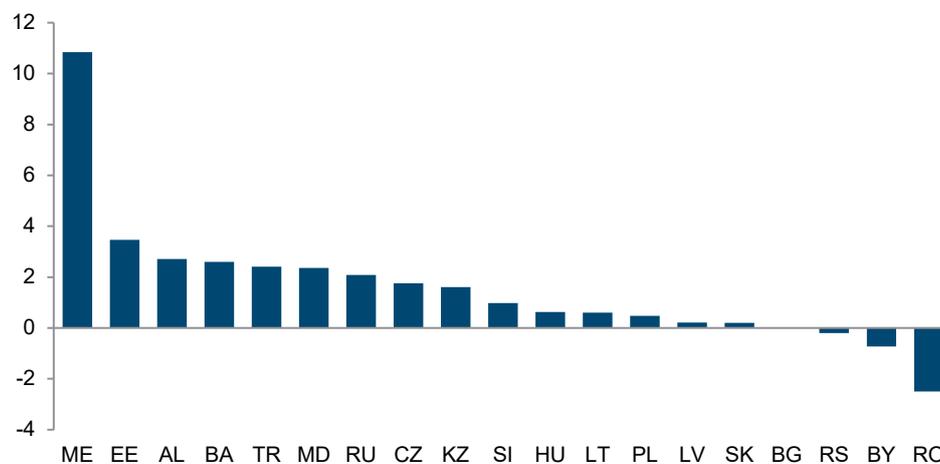


Note: For Czechia, Slovakia, Lithuania and Albania, the latest data point is Q1 of 2023, not Q2.

Source: wiiw Monthly Database.

On the flip side, employment remains remarkably stable, and there are no visible signs of crisis-induced job losses. Only three countries of the region – Romania, Belarus and Serbia – saw a reduction in the number of employed individuals during Q2 2023, compared to the same period the previous year. Montenegro again stands out: it experienced impressive 11% year-on-year growth in the number of employed individuals, mirroring its robust GDP expansion (Figure 3.13). The strong employment trend has been consistent for some time and may be attributed to heightened corporate profits: as many firms continue to reap substantial profits from their price hikes, they find it unnecessary to lay off employees and, in fact, have the capacity to take on more workers.

Figure 3.13 / Change in the number of employed persons in Q2 2023, %, year on year

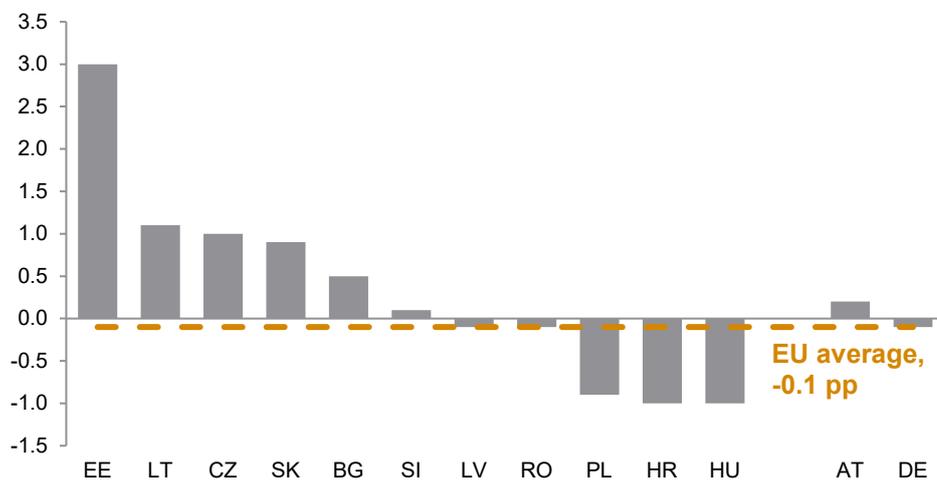


Note: For countries that have had methodological changes or new censuses, the data shown here have been adjusted to take account of these changes. Some countries omitted, due to a lack of data, or methodological breaks.

Source: wiiw Monthly Database.

The crisis has also swelled the number of people at risk of poverty or social exclusion, at least in some CESEE countries. This indicator – which measures how many people are either at risk of poverty, or are severely materially and socially deprived, or are living in a household with very low work intensity – increased in 2022 in six of the 11 CESEE countries that have published such data. Estonia saw the largest increase, of 3 percentage points (pp) in a year, while Lithuania, Czechia and Slovakia witnessed rises of around 1pp. Only Poland, Croatia and Hungary saw sizeable declines in this indicator in 2022, of around 1pp (Figure 3.14). One must also bear in mind that this indicator could underestimate the impact of the crisis, since the risk of poverty is calculated as relative poverty (i.e. as the percentage of people who have income lower than 60% of the median) – thus, if everyone has experienced a same deterioration in real income, the percentage will not change.

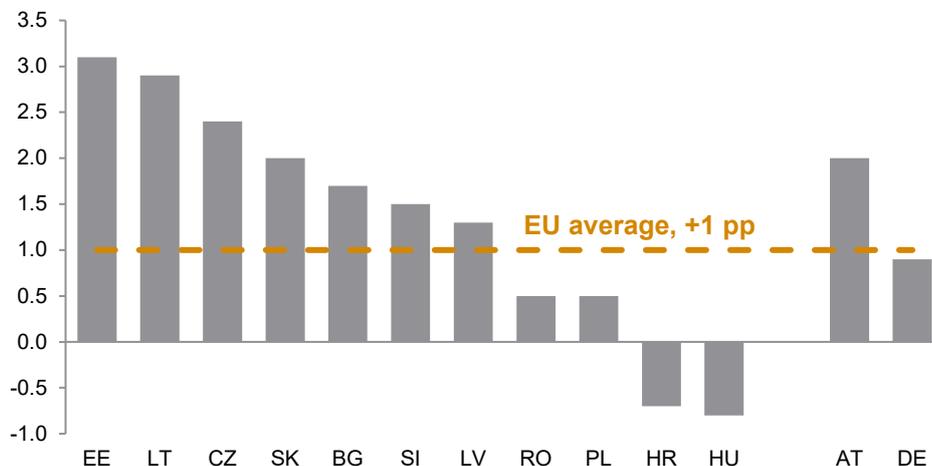
Figure 3.14 / Change in the share of people at risk of poverty or social exclusion in 2022 with respect to 2021, pp, year on year



Source: Eurostat.

The adverse social consequences of inflation become more evident when one looks at some more granular indicators. For example, the share of people who cannot afford a meal with meat, chicken, fish (or vegetarian equivalent) every other day increased in all but two countries of the CESEE region in 2022 (Croatia and Hungary being the exceptions). In some countries the figure rose quite substantially, by almost 3pp (Estonia and Lithuania). The proportion also increased quite a lot in the EU overall, as well as separately in Austria and Germany (though the figure there is still generally lower than in CESEE) (Figure 3.15). One also has to bear in mind that this deterioration in social indicators comes at a time when some CESEE governments have implemented fiscal packages to protect the most vulnerable from the impact of higher prices. These packages are likely to be phased out in the coming years, suggesting that the adverse social impact of price increases is likely to worsen in the coming period.

Figure 3.15 / Change in the share of people who cannot afford a meal with meat, chicken, fish (or vegetarian equivalent) every other day in 2022, pp, year on year



Source: Eurostat.

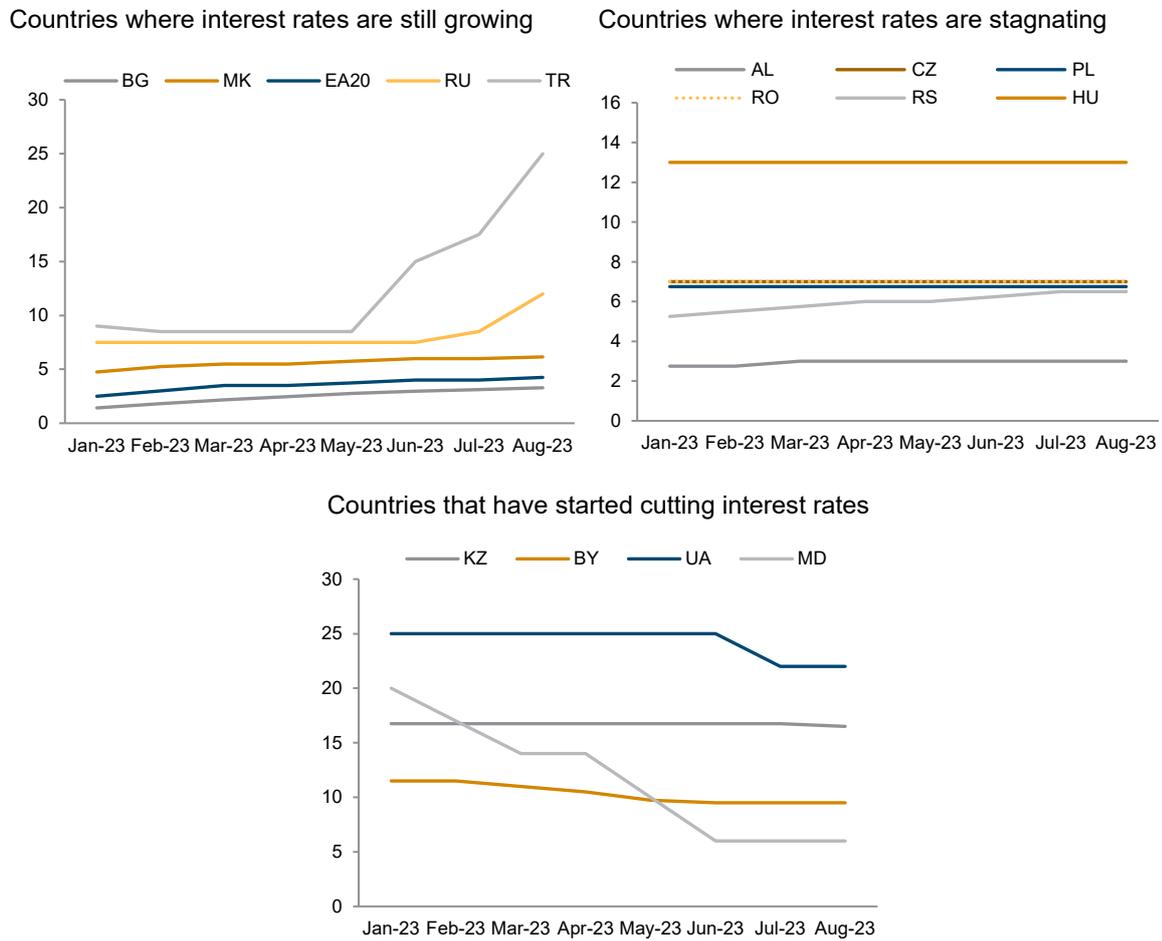
3.4. THE HIKING CYCLE IS COMING TO AN END, FISCAL SUPPORT WILL DECLINE

Monetary policy in CESEE has remained restrictive throughout 2023, though in recent months some central banks have begun easing. As of the end of August, four countries with independent monetary policy – Bulgaria, North Macedonia, Russia and Turkey, plus the euro-area countries – had not yet stopped raising interest rates. Six countries – Albania, Czechia, Poland, Romania, Serbia and Hungary – had probably ended their hiking cycles, as their central banks did not increase their interest rate on their last meeting. Four countries – Kazakhstan, Belarus, Ukraine and Moldova – had even begun an easing cycle, cutting their interest rates at least once in recent months (Figure 3.16). It is likely that more countries will start easing (or at any rate stop hiking) in the coming months, as inflation moderates and economic activity struggles¹⁶. However, drastic interest rate cuts are unlikely, as inflation will probably remain elevated for some time.

Particularly interesting developments have been seen in the base interest rates of the Turkish and Russian central banks. After more than a year of unorthodox monetary policy, the Turkish central bank finally raised its base rate after the election – from 8.5% in May to 25% in August – in an effort to stabilise the exchange rate and cool inflation. The Russian central bank was also forced to raise its rate from 7.5% in July to 12% in August, due to the depreciation of the rouble. On the other hand, Moldova has seen the most aggressive cut to its base rate – from 20% in January to 6% in August – thanks to the rapid moderation of inflation.

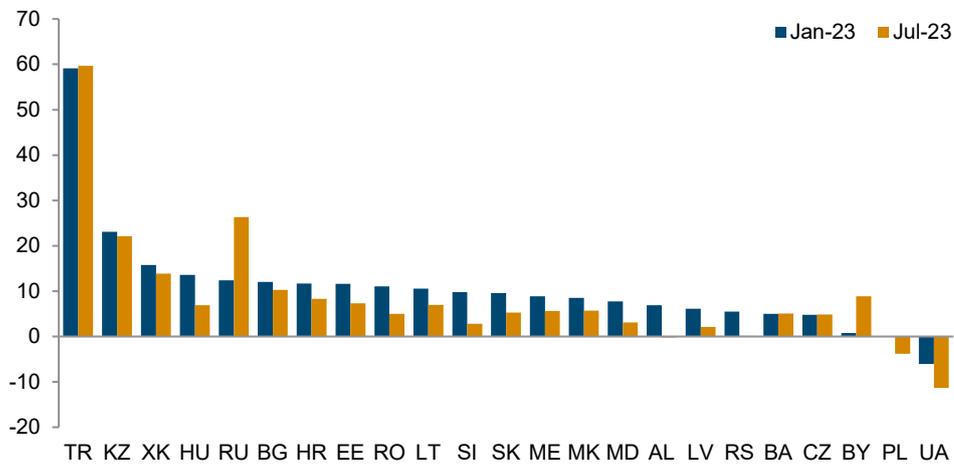
¹⁶ The data presented here ends with August. Developments in September are not reflected. For instance, in September, the Polish central bank reduced its interest rate by 75 basis points.

Figure 3.16 / Central bank policy rate in CESEE countries in 2023, end of period, %



Source: wiiw Monthly Database.

Figure 3.17 / Nominal growth in loans to non-financial private sector in January and July 2023, %, year on year



Source: wiiw Monthly Database.

Although it is still unclear whether monetary tightening has contributed to the slowdown in inflation (given that the inflation does not seem to be caused by higher demand), the tightening has certainly slowed credit activity in the region. In August, credit growth decelerated compared to January in 18 of the 23 CESEE countries (in nominal terms). Only Russia and Belarus saw a significant acceleration in credit growth (Figure 3.17). The slowdown in credit activity has certainly dampened demand in the economy and, through it, economic activity; but on the positive side, it seems that it has not yet had any adverse effect on the banking sectors in the region, as the share of non-performing loans remains low in all countries.

Higher interest rates have also increased borrowing costs for governments. This has been the case even in developed EU countries like Germany, whose 10-year government bond yield increased from virtually zero in February 2022 (before the European Central Bank started its hiking cycle) to 2.7% in September 2023. CESEE countries have seen a similar increase in yields, but they were already facing higher rates than Germany before the hiking cycle, on account of their country risk premia (Figure 3.18). For example, Bulgaria's yield is now 4.3%, up from 0.5% in February 2022. This significantly raises borrowing costs for CESEE governments and makes it more difficult for them to borrow on international financial markets, limiting in turn the fiscal support they can provide to their economies.

Figure 3.18 / 10-year government bond yields in February 2022 and September 2023, %

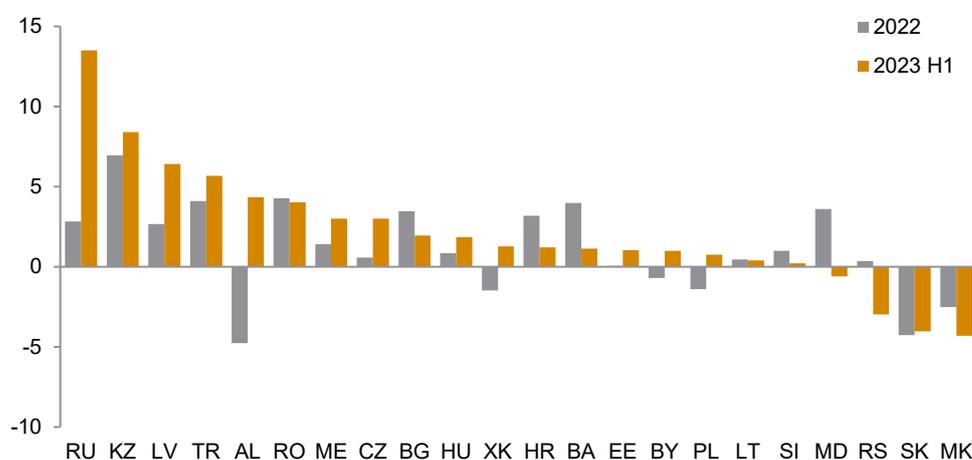


Source: wiiw calculations using data from www.investing.com

Despite the increase in borrowing costs, fiscal policy remained moderately supportive in H1 2023.

Government consumption increased in real terms in 18 of the 22 CESEE countries with available data (Figure 3.19), although in only four of them by more than 5% (Russia, Kazakhstan, Turkey and Latvia). The simple average increase for the region as a whole was 2.1% year on year, which is not particularly strong – but not weak either. In 13 of the 22 countries, fiscal support in H1 2023 exceeded that for the whole of 2022. The still-solid fiscal support in 2023 was primarily due to the support packages that many governments adopted to protect households from the adverse effects of the cost-of-living crisis. From a revenue point of view, such support was possible because of the positive effect that inflation has had on fiscal revenues. To some extent, and especially in some of the EU member states, fiscal support was also made possible by the funds that those countries have received from the EU budget. Looking ahead, though, fiscal policy is likely to be much less supportive, as the support packages will be phased out and the positive impact of higher prices on government revenues will decline.

Figure 3.19 / Real growth in government consumption in CESEE in 2022 and H1 2023, %, year on year



Note: Ukraine omitted due to data unavailability. For Albania, Belarus, Bosnia and Herzegovina, Kazakhstan and Russia, the 2023 data refer only to Q1.

Source: wiiw Monthly Database.

Support for some CESEE EU member states through the NextGenerationEU plan has been significant; for others it has been limited. Poland and Hungary, facing rule-of-law issues, have yet to receive any disbursements. Slovenia, Estonia and Czechia have received only marginal support, amounting to less than 1% of their GDP. Slovakia, Bulgaria, Lithuania and Latvia have obtained support ranging from 1% to 2% of their GDP. Notably, Romania and Croatia have emerged as the front-runners, securing the greatest support, amounting to 2.6% and 3.8% of GDP, respectively (Table 3.2). Disbursements are expected to speed up over time, meaning that most of these countries will benefit from their EU membership and could outperform their CESEE peers. However, for some countries (such as Hungary) there are serious doubts about whether any disbursements will be made at all, meaning that their economies could slow down in the coming period, compared to previous years.

Table 3.2 / Disbursements made under the Recovery and Resilience Facility to EU member states from CESEE by mid-September 2023

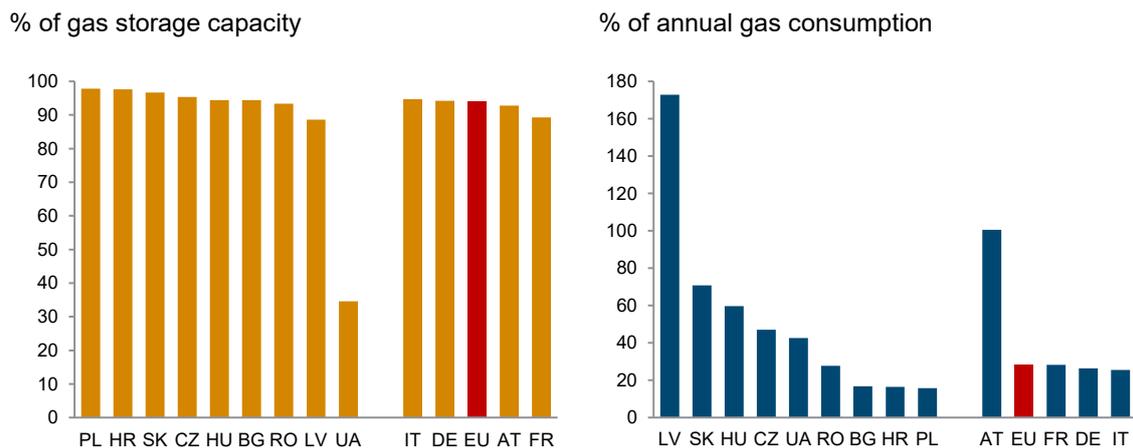
Country	Amount, EUR m	Share in 2021 GDP, %
Romania	6,355.6	2.63
Croatia	2,218.4	3.81
Slovakia	1,930.2	1.92
Czechia	1,842.8	0.77
Bulgaria	1,368.9	1.90
Lithuania	831.5	1.48
Latvia	438.4	1.30
Slovenia	280.6	0.54
Estonia	126.0	0.40
Hungary	n/a	n/a
Poland	n/a	n/a

Source: European Commission.

3.5. THE ENERGY SITUATION IS BETTER THAN LAST YEAR, BUT THERE ARE STILL SOME RISKS

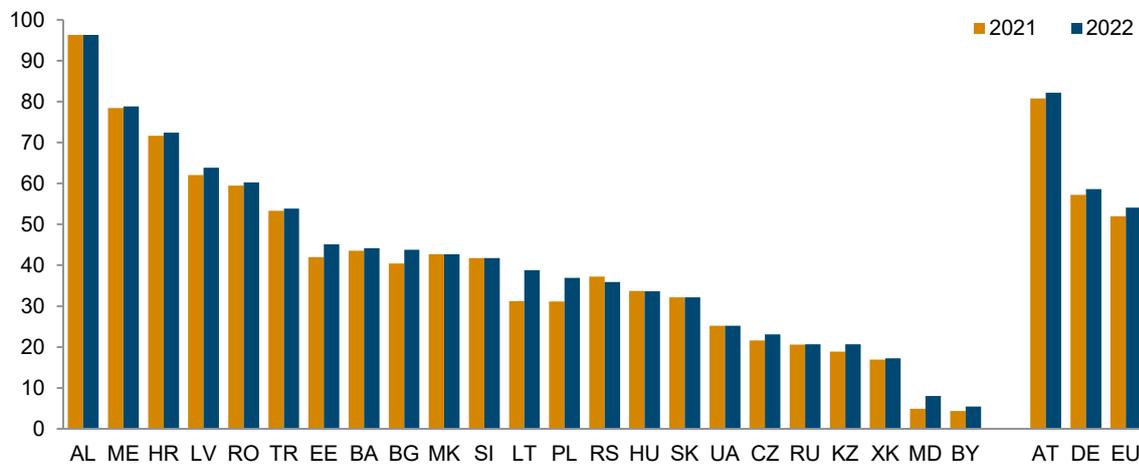
The energy situation in the region this autumn is much more positive than last year, when there were concerns about energy shortages and possible temporary facility closures. All CESEE countries have reduced their use of natural gas, making them less vulnerable to gas-related shocks. Many of them have also diversified their gas sources by replacing Russian pipeline gas with liquefied natural gas (LNG) imports from other countries, reducing the risk of sudden gas supply disruptions. Additionally, in mid-September European gas storage facilities were already almost completely full (Figure 3.20, left panel). However, it is important to note that the stored gas volume is only sufficient for a short period. In the EU as a whole, gas storage covers 28% of annual consumption, though certain CESEE countries have slightly better figures (Figure 3.20, right panel). Although some countries may face challenges in securing enough gas supplies if the winter is severe, the chances of this happening are not very high, considering last year's experience.

Figure 3.20 / Gas stored in storage facilities in CESEE and EU in mid-September 2023, %



Source: Gas Infrastructure Europe website.

On the flip side, the region has made limited progress in addressing its structural energy-sector challenges, particularly the low adoption of renewable energy sources. While there are notable exceptions – like Albania, Montenegro, Croatia and Latvia, where renewable energy capacities account for most of the total installed electricity generation capacity – the majority of the countries in the region still rely heavily on non-renewable sources (Figure 3.21). Moreover, investment in new renewable energy infrastructure has been inadequate, with only a handful of countries significantly increasing their share of renewable energy capacity in 2022: Lithuania increased its share by 8pp, Poland by 6pp, and Bulgaria, Estonia and Moldova by approximately 3pp. For comparison, the EU as a whole saw a 2pp increase in 2022. Some countries – Serbia, Hungary and Slovenia – even witnessed a decline in the share of installed renewable capacities, indicating a greater investment in non-renewable sources.

Figure 3.21 / Renewable energy share of electricity capacity in 2021 and 2022, %

Source: International Renewable Energy Agency.

3.6. LOWER GROWTH AND HIGHER INFLATION OVER THE MEDIUM TERM

Our GDP growth revisions for this year are mixed. For the EU-CEE countries, most of the revisions are on the downside, due to the German recession and weak economic activity in the EU. Slovakia is the only exception within this group: it sees an upward revision, due to the good performance of its automotive industry. In the Western Balkans plus Turkey group, by contrast, most of the revisions are on the upside, thanks to robust tourism, FDI inflows and remittances. Kosovo stands out here as the only economy with a downward revision, on account of the EU sanctions. In the CIS plus Ukraine group, similarly, most of the revisions are on the upside, thanks to stronger growth from the first half of the year, increased military production, the reorientation of the Russian economy towards CIS markets, and the resilience of the Ukrainian economy. Moldova is the only exception here, owing to the poor results from the first half of the year (Table 3.3).

On the contrary, the GDP growth revisions for 2024 and 2025 are on the downside for most of the countries, in all the sub-regions. There are several reasons for this: the global slowdown, the worsening outlook for the EU economy, the more persistent inflation, the tighter monetary conditions, and the less-supportive fiscal policy in coming years. There are some individual exceptions here as well, such as Poland, Ukraine and Russia, for which our expectations over the next two years are more bullish than before (for reasons outlined in the country reports).

Table 3.3 / Real GDP growth forecasts and revisions over previous forecast, October 2023

Region	2023	2024	2025
EU-CEE			
BG Bulgaria	1.0 ▼	1.5 ▼	2.5
CZ Czechia	0.1 ▼	2.0 ▼	2.7
EE Estonia	-1.3 ▼	1.7 ▼	3.0 ▼
HR Croatia	2.5	2.9	3.1
HU Hungary	-0.5	1.8 ▼	2.4 ▼
LT Lithuania	-0.1 ▼	1.7 ▼	2.4 ▼
LV Latvia	0.3 ▼	1.8 ▼	2.3 ▼
PL Poland	0.0 ▼	2.8 ▲	3.8 ▲
RO Romania	2.5 ▼	3.2 ▼	3.5 ▼
SI Slovenia	1.3 ▼	2.7 ▲	2.5 ▼
SK Slovakia	0.8 ▲	1.9 ▼	2.4
Western Balkans			
AL Albania	3.5 ▲	3.6 ▼	3.7 ▼
BA Bosnia and Herzegovina	1.7 ▲	1.9 ▼	2.1 ▼
ME Montenegro	4.5 ▲	2.9	3.0
MK North Macedonia	1.6	2.0 ▼	2.5 ▼
RS Serbia	1.5 ▲	2.0 ▼	2.5 ▼
XK Kosovo	3.2 ▼	3.3 ▼	3.7 ▼
Turkey			
TR Turkey	3.2 ▲	2.7 ▼	3.6 ▼
CIS+UA			
BY Belarus	3.0 ▲	2.2	2.5
KZ Kazakhstan	4.7 ▲	4.0	4.2 ▲
MD Moldova	0.0 ▼	3.5 ▼	3.5 ▼
RU Russia	2.3 ▲	1.9 ▲	1.7 ▲
UA Ukraine	3.6 ▲	4.2 ▲	5.3 ▼

Note: Current forecast and revisions relative to the wiiw Summer Forecast Update (wiiw, 2023). Colour scale variation from the minimum (dark grey) to the maximum (dark orange).

Source: wiiw.

The inflation forecasts for 2023 are again mixed. In the EU-CEE group, most of the forecasts have been revised downwards, as inflation seems to be receding faster than expected. However, some countries in this group – Croatia, Romania, Slovenia and Slovakia – have upward revisions. In the Western Balkans plus Turkey group, most of the revisions are upwards, as inflation there seems to be far more persistent. There are again some exceptions, such as Bosnia and Herzegovina, Montenegro and Kosovo, where inflation has recently slowed more than expected. In the CIS plus Ukraine group,

most of the new forecasts are the same as the old ones; Russia is the only exception, due to the recent depreciation of the rouble.

Table 3.4 / Inflation forecasts and revisions over previous forecast, October 2023

Region	2023	2024	2025
EU-CEE			
BG Bulgaria	9.0 ▼	7.0	5.0
CZ Czechia	11.0	4.0 ▲	2.8
EE Estonia	9.5 ▼	3.4 ▲	2.5 ▲
HR Croatia	7.5 ▲	4.0	3.0
HU Hungary	17.5 ▼	6.0	4.0 ▲
LT Lithuania	8.0 ▼	2.8	2.0
LV Latvia	9.5 ▼	3.0 ▲	3.2 ▲
PL Poland	11.5 ▼	5.2 ▼	3.6 ▼
RO Romania	10.5 ▲	7.5 ▲	5.0 ▲
SI Slovenia	7.2 ▲	3.6	2.4 ▼
SK Slovakia	11.0 ▲	5.0	3.0
Western Balkans			
AL Albania	4.6 ▲	3.0	2.5
BA Bosnia and Herzegovina	7.5 ▼	3.0 ▼	2.5
ME Montenegro	9.1 ▼	5.0 ▲	2.8
MK North Macedonia	10.0 ▲	5.0 ▲	3.0
RS Serbia	12.5 ▲	5.5 ▲	3.5 ▲
XK Kosovo	5.5 ▼	4.0	2.5
Turkey			
TR Turkey	54.9 ▲	54.0 ▲	35.0 ▲
CIS+UA			
BY Belarus	9.0	8.0	8.0
KZ Kazakhstan	14.5	9.0	6.0
MD Moldova	14.0	6.0	5.0
RU Russia	5.6 ▲	4.9 ▲	3.4
UA Ukraine	14.0	8.0 ▼	6.0 ▼

Note: Current forecast and revisions relative to the wiiw Summer Forecast Update (wiiw, 2023). Colour scale variation from the minimum (dark orange) to the maximum (dark grey).

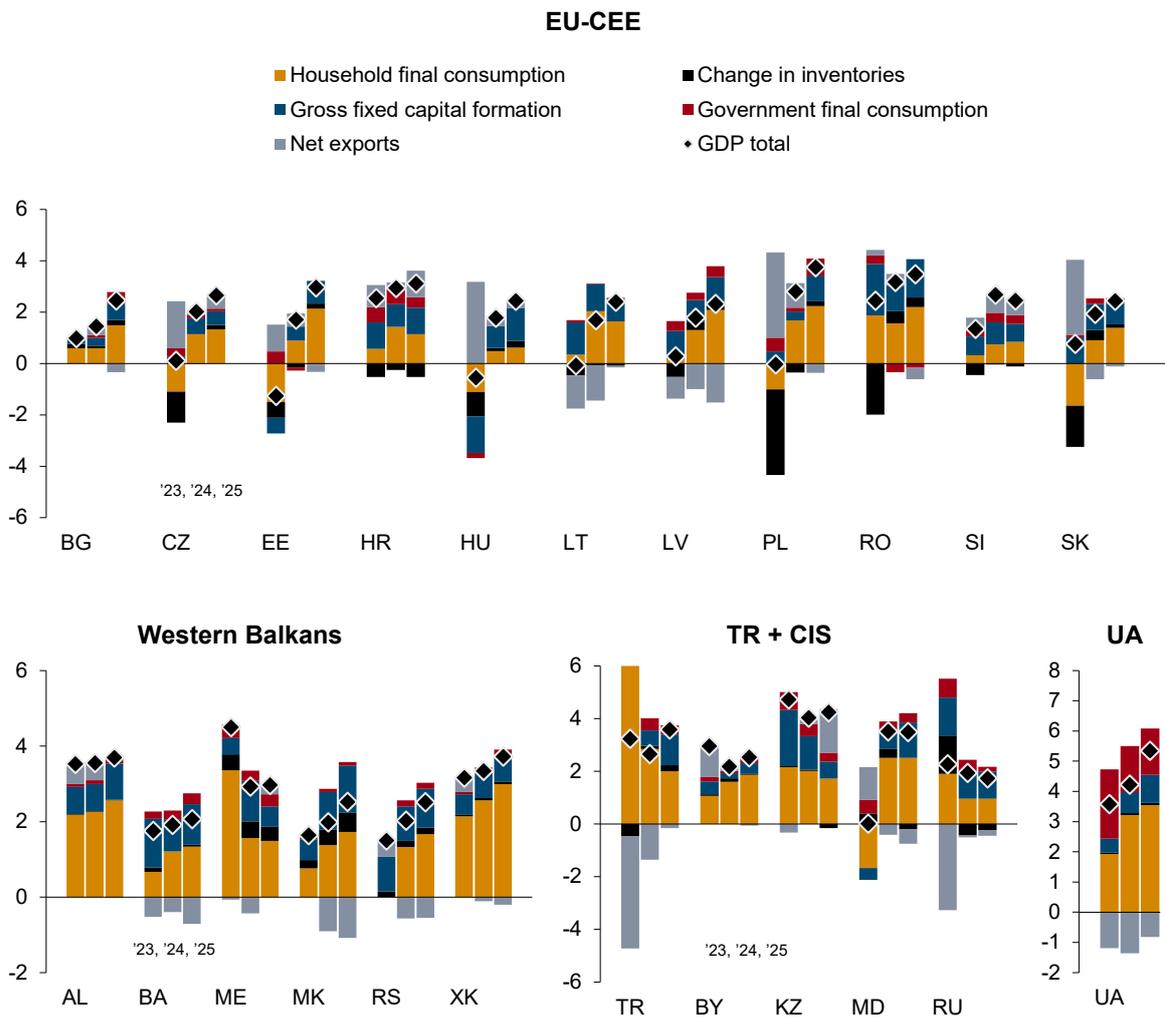
Source: wiiw.

Our inflation forecasts for 2024 and 2025 are now slightly higher than before for most countries, with individual exceptions. This is because price pressures have turned out to be much more persistent and broad based, stemming not just from higher global energy prices, but also from higher company profits, higher prices in other sectors, and – in some cases – higher wages (Table 3.4).

Our new GDP and inflation forecasts suggest that the CESEE region is trending towards a new equilibrium, characterised by lower overall growth and higher inflation. While it is still too early to call the current situation ‘stagflation’, and while there are important differences between the ongoing crisis and that of the 1970s, the region does appear to be entering a new phase that will last for some time and that will have a profound impact on the economic dynamics and people’s living standards.

Figure 3.22 / GDP growth forecast for 2023-2025

and contribution of individual demand components in percentage points



Source: wiiw Annual Database incorporating national and Eurostat statistics, own calculations. Forecasts by wiiw.

3.7. CONCLUSIONS

The CESEE region grew by 1.5% in Q2 2023, outperforming the EU by a significant margin. However, there were notable differences across the various sub-regions of CESEE: EU-CEE countries performed worse than expected (due to the recession in Germany), while Western Balkan countries performed better than expected (thanks to tourism, remittances and FDI). The CIS countries and Ukraine also did better than expected, as they have adapted to the new reality.

Inflation was generally higher than expected, with some exceptions. Its dynamics have also changed, and it is now driven not only by global energy and food prices, but also by company profits, price rises in other sectors and, in some cases, higher wages.

The price increases are having serious repercussions for people's living standards and poverty. Real wages are still well below the level of a year and a half ago, and the number of people who cannot afford to eat the meal they want has increased significantly.

Monetary policy has been restrictive throughout 2023 in all CESEE countries. Some central banks have ended the hiking cycle, and some have even started an easing cycle; but monetary conditions are unlikely to change drastically in 2024 and are likely to remain tight.

Fiscal authorities in CESEE have faced higher borrowing costs, but have still managed to support their economies to some extent. This is partly due to the positive effects of inflation on public revenues – and in some countries also to EU funds.

The energy situation in the region is less worrying than last year, as countries have reduced their dependence on gas, replaced Russian pipeline gas with LNG from different sources and filled up their gas storage facilities. However, a severe winter could pose some problems for certain countries.

On a longer-term horizon, very little has been done to reduce dependence on fossil fuels or to invest in renewable energy.

Over the medium-term, the region seems to be heading towards a new equilibrium, characterised by lower growth and higher inflation.

Growth in 2024 and 2025 will be lower than previously expected, on account of the global slowdown, the weak EU economy, more persistent inflation, tighter monetary conditions and less-supportive fiscal policy.

Inflation will also be higher and will not return to 2% any time soon, as its dynamics have become much more complex and are no longer driven just by higher global energy prices.

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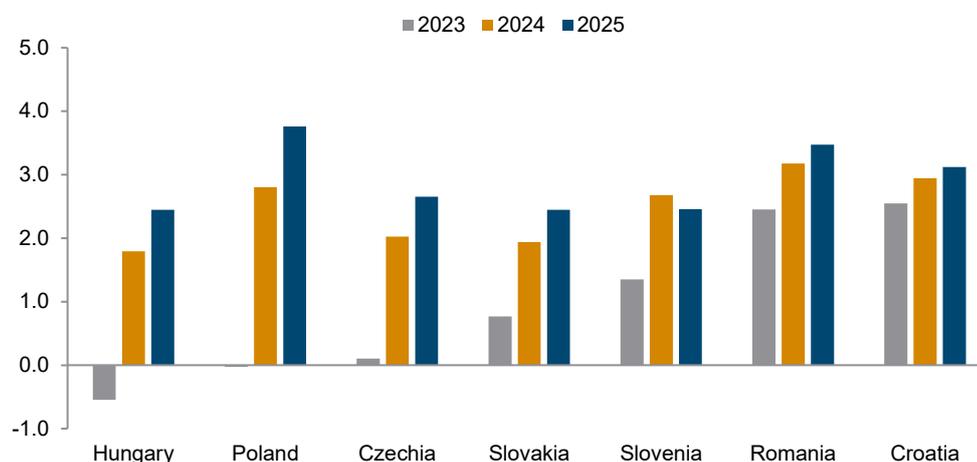
wiiw (2023), Southeast Europe Motors on while Rest of Region Struggles: Economic forecasts for Eastern Europe for 2023-25, Summer Forecast Update, wiiw Monthly Report No. 7-8.

4. Austria and CESEE: Trade affected by a two-speed EU-CEE

BY DORIS HANZL-WEISS

- › The outlook for many of Austria's key trading partners in CESEE has deteriorated since our last forecast.
- › However, despite downward revisions in our forecasts, several of Austria's main trading partners in the group of Central and East European EU members (EU-CEE) – in particular, Slovenia, Croatia and Romania – continue to perform relatively well, and thus still offer some growth impetus for Austria this year.
- › The region will recover in the next two years, but by less than expected. Next year, the countries of Southeast Europe will again be the top performers; but in 2025 Poland will be the star.
- › It was trade with the Western Balkans that grew most strongly in H1 2023; however, Austrian exports to Turkey recorded the biggest absolute increase in euro terms.

Figure 4.1 / Real GDP growth forecasts, percentage change compared to the previous year, ranked by 2023 growth



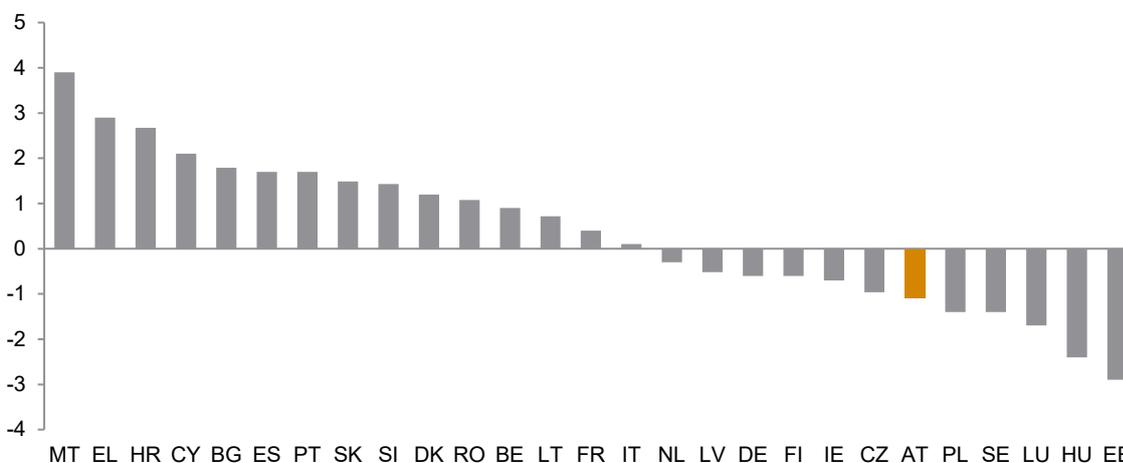
Source: wiiw calculations.

The downward revisions in the GDP forecasts for EU-CEE region will weaken the growth impetus for Austria, given its strong ties with the region. However, the relative resilience of Southeast Europe – a key sub-region for Austria – continues, with Slovenia, Croatia and Romania still doing better than the rest. The weak global external environment, the ongoing Russian war in Ukraine and persistent high inflation all weigh heavily on growth in Europe, and our wiiw forecasts for this year have been revised downwards for several EU-CEE economies, including some of Austria's main trading partners. While its trade and investment ties with Germany predominate, Austria has extended its trading and investment links with the Visegrád countries, Romania, Slovenia and Croatia. Although our forecasts for

Romania and Slovenia have been revised downwards, those countries – along with Croatia – are projected to have the highest growth rates in EU-CEE this year, and thus still offer growth impetus for the Austrian economy.

Austria will see little benefit from its close integration with the Visegrád countries in 2023; it is only in 2025 that Poland will become a beacon of light in the region. Growth expectations for the Visegrád countries are very low for this year, and Hungary is actually in recession. The forecast for Poland has been revised sharply downward and its economy is expected to stagnate in 2023. Overall, the Visegrád countries are suffering on account of their interlinkages with Germany in the so-called German-CEE manufacturing core. The growth rates in Q2 illustrate this divided picture of the region (see Figure 4.2): the Visegrád countries experienced negative year-on-year growth; at -2.4%, the fall was most pronounced in Hungary. Slovakia was unique among the Visegrád countries in having a positive figure. On the other hand, the greatest year-on-year change in EU-CEE was achieved in Croatia, at 2.7%. For 2024 and 2025, wiiw expects a general recovery – although for those years, too, several of its growth forecasts have been revised downwards. Again, Romania and Croatia will perform most strongly. In 2025 Poland will offer the greatest impetus in the region: it is the only country to see an upward revision to its forecast for that year.

Figure 4.2 / Real GDP growth Q2 2023, percentage change against the previous year

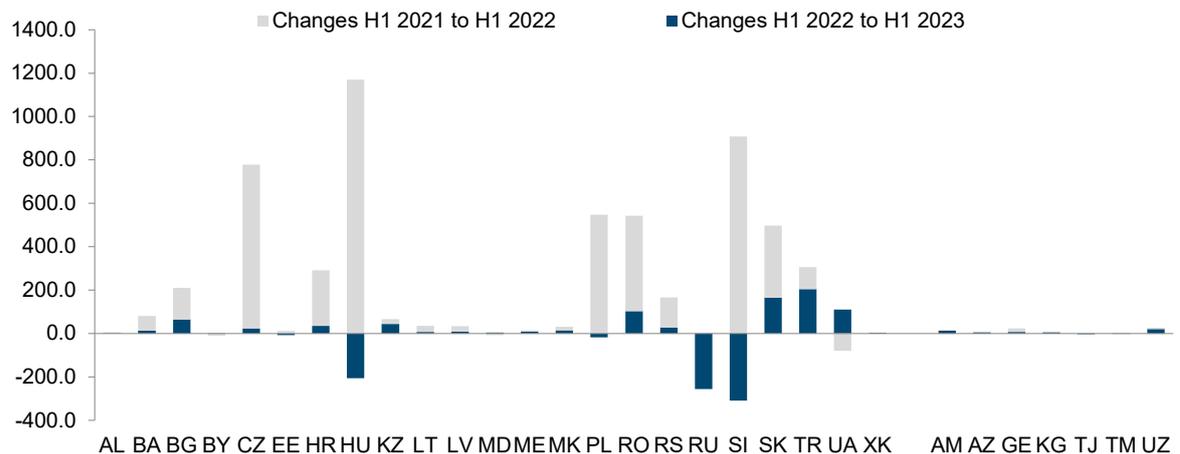


Source: Eurostat.

The growth in exports to CESEE in H1 2023 was disappointing: only to the Western Balkans was there a marked increase. A third of Austria's exports go to Germany, but after that the Visegrád countries are Austria's next-biggest trading partner, accounting in 2022 for 13.3% of its exports. However, as indicated by the GDP trends above, exports to the Visegrád countries fell by 2.2% in H1 2023, compared to the same period of 2022. This decline was less pronounced when we look at the EU-CEE countries as a whole (-0.7%). Otherwise for the CESEE region as a whole, exports grew by 0.2%. Export growth to the Western Balkans was most dynamic, at 7% – even higher than total Austrian export growth (5.7%).

Trade has changed since the Russian invasion of Ukraine on 24 February 2022 and the sanctions on Russia – both directly and indirectly (e.g. apparent trade diversions via other countries, such as Turkey). In order to illustrate Austrian export patterns in more detail, Figure 4.3 shows the changes between H1 2021 and H1 2022, and also between H1 2022 and H1 2023 in millions of euros (including the CIS countries). Austrian exports to Russia fell by EUR 250m (25.8%) between 2021 and 2023: the export of machines dropped significantly, and the main export products are now medical and pharmaceutical products (which are generally unaffected by sanctions). Exports to Ukraine initially fell, but bounced back up again in the second period under consideration; here, too, medical and pharmaceutical products are the main export goods. Overall trade patterns in EUR show large export increases to the Visegrád countries during the first period. During the second, the changes were comparatively small, and the greatest expansion was in exports to Turkey and Slovakia. The increase in exports to the CIS countries and Kazakhstan was small in EUR terms.

Figure 4.3 / Changes to Austrian exports, in EUR million



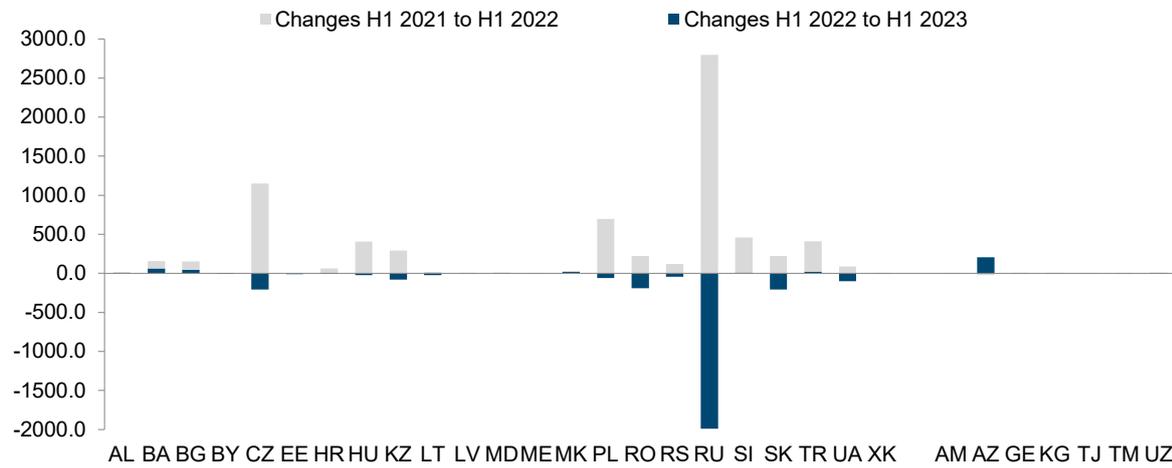
Note: Armenia (AM), Azerbaijan (AZ), Georgia (GE), Kyrgyzstan (KG), Tajikistan (TJ), Turkmenistan (TM), Uzbekistan (UZ).
Source: Statistics Austria.

Imports from the region fell in H1 2023. In terms of imports, Germany is again Austria's main trading partner (similarly accounting for a third of Austrian imports); 12% of Austrian imports came from the Visegrád countries in 2022. In H1 2023, imports from the Visegrád countries declined by 3.4% compared to H1 2022, and from the CESEE region as a whole they fell by 11%. Only imports from the Western Balkans increased – by almost 5%. Overall, total Austrian imports declined by 0.2%.

Russia generally plays a greater role for Austria on the import side than on the export side, on account of Austrian gas imports: whereas Russia was the country's sixth-largest import partner in 2022, in terms of exports it ranked nineteenth. However, recent gas price fluctuations have had a marked influence on import values in EUR and on the changes from year to year: while imports from Russia increased by almost EUR 3bn between H1 2021 and H1 2022, they fell by EUR 2bn between H1 2022 and H1 2023. Although the volume of gas arriving from Russia has been reduced, nevertheless

Austria's dependence on it remains quite high. The proportion of gas imported from Russia fluctuates from month to month: in July 2023 it stood at about 66% (compared to 79% in February 2022).¹⁷

Figure 4.4 / Change in Austrian imports, in EUR million



Note: Armenia (AM), Azerbaijan (AZ), Georgia (GE), Kyrgyzstan (KG), Tajikistan (TJ), Turkmenistan (TM), Uzbekistan (UZ).
Source: Statistics Austria.

¹⁷ <https://energie.gv.at/> based on data from ENTSO-G and E-Control.

5. Convergence Monitor: CESEE again proves its resilience

BY RICHARD GRIEVESON

The years since 2019 have been tumultuous ones for CESEE, with the outbreak of the Covid-19 pandemic in 2020, followed by Russia's full-scale invasion of Ukraine in 2022. While these events affected the whole global economy, they had a particular resonance for CESEE. During the worst of the pandemic in 2020-2021, the region suffered some of the highest rates of 'excess deaths' in the world.¹⁸ Meanwhile the invasion of Ukraine and the ensuing imposition of sanctions on Russia had a major negative impact on the economies of those two countries, but also caused huge disruptions to the region more generally. CESEE economies were impacted by their proximity to the conflict, the severing of important trading relationships with Russia in some cases, and the disruption to energy supplies, which caused inflation rates – especially in the Baltic states – to surge much higher than in most of Western Europe.

In this context, over this period the continued per capita GDP convergence of almost all the CESEE countries with Germany has been remarkable. Figure 5.1 below shows that between 2019 and 2022, 21 of the 23 CESEE countries posted per capita GDP convergence with Germany in purchasing power standard (PPS) terms. The top performers were Turkey, Romania, Poland and Croatia, all of which increased their wealth levels versus Germany by 7 percentage points or more. The best-performing sub-region was EU-CEE, helped by its more active use of fiscal policy – deploying both national budget revenue and also (crucially) EU funds – to counteract external shocks. Although the Western Balkan countries all posted convergence over this period as well, it was generally at a lower rate than EU-CEE, due in part to less fiscal space and limited access to EU funds. For understandable reasons Ukraine was the worst performer, although the massive exodus of people from that country means that its per capita GDP decline versus Germany is much less than for headline GDP. Interestingly, Russia posted convergence over this period, mostly reflecting an increase between 2020 and 2021.

While the positive per capita convergence performance is a welcome sign, it may have been helped by the region's loss of population. While breaks in the series in some cases mean it is hard to make direct population comparisons between 2019 and 2022 for some countries, it does seem clear that the population declined in many CESEE countries over these years.

Our new forecasts suggest that most countries of the region will continue to catch up with Germany, but there are major challenges to future convergence performance. Recent wiiw research has shown that the EU-CEE region is at risk of a functional specialisation trap and urgently needs a new growth model,¹⁹ including a more active industrial policy, to achieve the next stage of economic convergence.²⁰ CESEE's demographic challenges are enormous and will cap growth potential

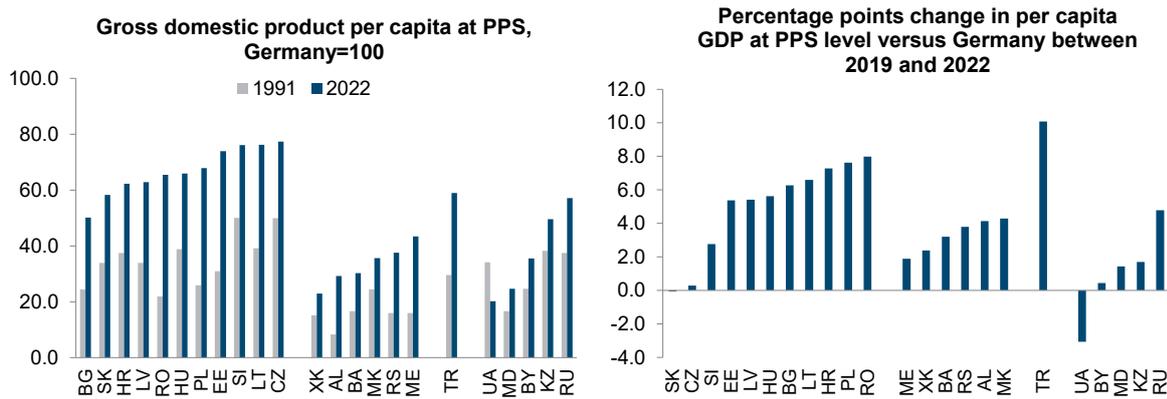
¹⁸ <https://iris.who.int/handle/10665/367758>

¹⁹ <https://wiiw.ac.at/avoiding-a-trap-and-embracing-the-megatrends-proposals-for-a-new-growth-model-in-eu-cee-p-5987.html>

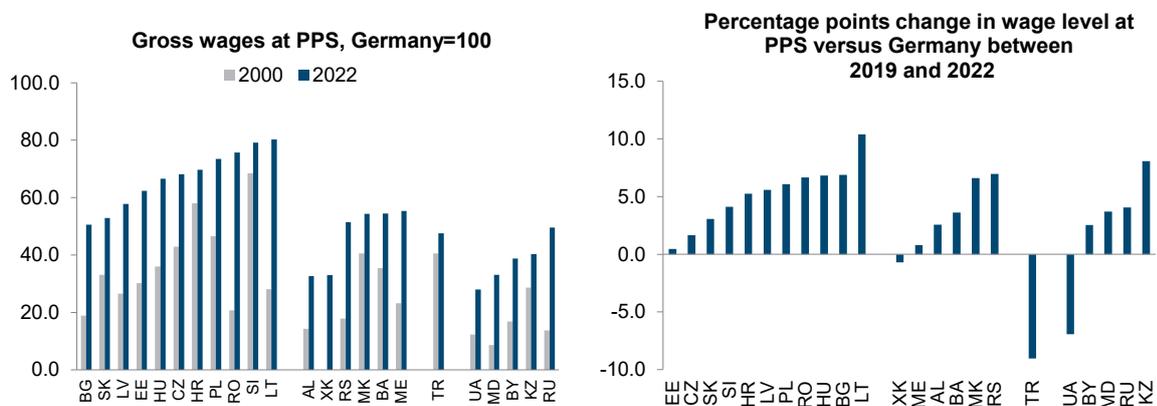
²⁰ <https://wiiw.ac.at/study-eu-cee-countries-need-an-industrial-policy-for-a-new-growth-model-n-604.html>

in the future, albeit not necessarily per capita GDP convergence.²¹ The lasting impact of the war on the region is uncertain, but could adversely affect foreign investor perceptions of CESEE. Finally, the structural problems faced by Germany itself – which remains a major economic partner for almost all CESEE countries, and the centre of the manufacturing network into which many are plugged – also represent a major challenge to future economic growth in the region.

Figure 5.1 / GDP per capita and gross wages per employee at PPS, convergence with Germany



Note: Data 1991 for BA and XK refer to 2000, for ME and RS to 1995.
 Source: wiiw Annual Database incorporating national statistics and Eurostat.



Note: Gross wages are based on administrative data. From 2019 Lithuanian and Romanian wages include employers' social security contributions. Turkey wages: personnel costs, data 2000 refer to 2003.
 Source: wiiw Annual Database incorporating national statistics and Eurostat.

²¹ <https://wiiw.ac.at/eu-faces-a-tough-demographic-reckoning-p-4912.html>

Table 5.1 / CESEE GDP per capita and gross wages per employee at PPS (EU27), 2022

	BG	CZ	EE	HR	HU	LT	LV	PL	RO	SI	SK	EU- CEE
GDP per capita	20,710	31,950	30,530	25,730	27,260	31,480	25,940	28,040	27,070	31,460	24,060	27,980
Gross wages	18,042	24,348	22,286	24,875	23,774	28,666	20,637	26,243	27,027	28,255	18,887	24,828

	AL	BA	BY	KZ	MD	ME	MK	RS	RU	TR	UA	XK	non- EU
GDP per capita	12,080	12,490	14,660	20,470	10,180	17,910	14,730	15,530	23,620	24,360	8,340	9,470	21,020
Gross wages	11,656	19,431	13,858	14,404	11,820	19,769	19,409	18,384	17,706	17,003	10,014	11,781	16,396

Note: Gross wages are based on administrative data. Lithuanian and Romanian wages include employers' social security contributions. Turkey wages: personnel costs.

Source: wiiw Annual Database incorporating national statistics and Eurostat.

Table 5.2 / CESEE GDP per capita and gross wages per employee in EUR, 2022

	BG	CZ	EE	HR	HU	LT	LV	PL	RO	SI	SK	EU- CEE
GDP per capita	12,400	25,850	27,040	17,130	17,580	23,580	20,710	17,370	15,010	27,040	19,930	18,500
Gross wages	10,803	19,694	19,740	16,559	15,333	21,468	16,476	16,251	14,988	24,287	15,648	16,324

	AL	BA	BY	KZ	MD	ME	MK	RS	RU	TR	UA	XK	non- EU
GDP per capita	6,470	6,800	7,470	10,910	5,430	9,600	7,040	8,920	14,430	10,150	4,360	5,030	11,300
Gross wages	6,243	10,571	7,061	7,680	6,300	10,596	9,277	10,555	10,818	7,083	5,243	6,252	9,013

Note: Gross wages are based on administrative data. Lithuanian and Romanian wages include employers' social security contributions. Turkey wages: personnel costs.

Source: wiiw Annual Database incorporating national statistics and Eurostat.

6. Country reports

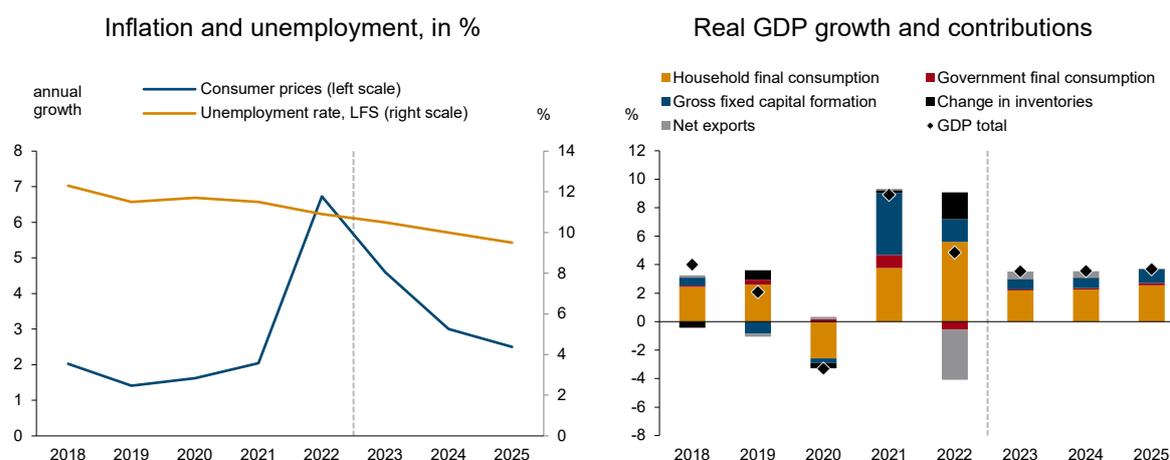


ALBANIA: Economic growth supported by external demand

ISILDA MARA

Economic growth will accelerate to 3.5% this year, and a similar pace is expected over the medium term, owing to favourable external and domestic demand. A bumper tourist season has greased the wheels of the economy. Strong services exports and buoyant remittance inflows have pushed the current account deficit to unprecedentedly low levels, while FDI inflows have also performed strongly. Consumer prices will surge by a relatively modest 5%, but an inflation rate in double digits for staple foodstuffs is eating into the income of the most vulnerable groups.

Figure 6.1 / Albania: Main macroeconomic indicators



Source: wiiw Annual Database incorporating national and Eurostat statistics, own calculation. Forecasts by wiiw.

Economic growth in 2023 is expected to accelerate to 3.5% on the back of favourable external demand. By July 2023, the number of tourists had almost doubled compared to pre-pandemic levels (2017-2019). The economy is expected to perform better than expected in H2 2023 as well. High-frequency data suggest that production activity is being pushed up by the construction sector, the energy sector and retail trade and services. By contrast, manufacturing is not doing too well.

The current account deficit has fallen to a record low, thanks to expanding exports of services and robust remittance inflows. Exports of services kept rising rapidly in H1 – up by 31% – and this positive trend is expected to continue in H2 2023. The government's campaign drive over the last five years, the policy of open doors to tourism during the pandemic and more recently, and high prices in the EU and the surrounding countries have combined to turn Albania into a favourite tourist destination this year (to say nothing of 'ethnic tourism' and the return of migrants for the summer holidays). The number

of foreigners entering the country in January-July exceeded 5.2m – 31% up on the same time last year, while the number of hotel nights spent by residents and non-residents reached 2.9m (46% up).

We have entered good times for the inflow of foreign direct investment (FDI), and this is expected to last. In H1, FDI rose by 7% year on year, and will likely reach EUR 1.4bn for the full year (close to 6% of GDP). There have been several new announcements on solar and wind-power plants. There is also great enthusiasm surrounding the recent tests by Shell in the wake of the discovery of oil at Shpirag (close to Berat, in the central part of the country), which could prove a turning point. The prime minister has announced that Shell could invest EUR 7bn, if the company decides to develop the field. Other officials have announced that if it goes ahead, production could start in 2033. Furthermore, Statkraft – a Norwegian company that has already invested EUR 0.6bn in two hydropower projects in Albania – is considering investing further to expand the installed capacity of those two plants to a total of 1200 MW: this would correspond to 48% of the total hydropower capacity in Albania in 2022. The energy sector will benefit considerably from this investment – which could start in 2025 – since it will boost domestic electricity production and reduce the dependence on imports.

The exchange rate has appreciated this year, owing to a bumper tourist season, remittances and FDI inflows. Between early January and mid-July, the lek appreciated by 15% against the euro. However, the overvaluation of the lek has hit export-oriented firms. Up to July 2023, goods exports contracted by 8% year on year, following the solid momentum built up over the past three years. In June, the government decided that next year such companies will only have to pay profit tax based on their balance; thus, in the event of a loss they will not have to pay.

Inflation is expected to decline to 4.6% in 2023, though the medium-term outlook is hazy. Annual consumer price inflation stood at 4% in August, and in January-August 2023 it averaged 5.2%. However, the rate of consumer inflation on food staples such as meat, cheese, milk, vegetables and other foodstuffs is still in double digits. Almost half of the consumption expenditure of households in Albania – and even more than half for vulnerable groups – goes on food. The government has announced a further rise of 8.6% for pensions as of October 2023, which implies an increase in the average old-age pension from EUR 164 to EUR 178. This will still be inadequate to cover inflation and ensure a decent living for the elderly, who account for a quarter of the population of Albania. It is no coincidence that remittances have surged, as emigration persists and the need to smooth consumption for family members left at home remains elevated. Up to June 2023, remittances grew by 18% year on year, and will reach EUR 1bn this year, or 5% of GDP.

Further fiscal consolidation will be achieved, as the public finances are improving. Up to July 2023, general government revenues (up 12% in nominal terms) grew faster than expenditure (up 4%). Public investments contracted by 4% and accounted for no more than 11% of total spending. The fiscal surplus achieved up to July 2023 will reduce the public debt, although it remains one of the highest in the region. A reform of public-sector wages was announced by the government this year: average wages in the public sector are set to increase from EUR 520 to EUR 900 by 2024, with the rise coming in two tranches – half in H2 2023 and the remainder by the end of June 2024. In H1 2023, nominal wages already grew by 20% year on year in the public sector and by 15% in the private sector – a consequence both of labour and skill shortages due to persistent emigration, and of labour market mismatches. In Q2 2023, the minimum wage rose by 25% year on year, reaching EUR 364. Despite that, average salaries in Albania remain among the lowest in the region. It cannot be ruled out that the

big rise in public wages could lead to a wage-price spiral, unless the move is accompanied by a further increase in labour productivity and more quality jobs in the private sector.

The hike in interest rates has already curbed the demand for credit. The acceleration of inflation to above the target level of 3% prompted the central bank to intervene by raising interest rates, from 0.5% in 2021 to 3% in 2023. That has curbed demand for credit, the volume of which has been stagnant over the past year. In 2023, up until July, demand for credit from the non-financial private sector had declined by almost 4%, while households had continued to expand their demand for credit – up 7%, mainly for the purchase of houses. Still, central bank interest rates are among the lowest in the region and are not expected to rise further. In July 2023, non-performing loans were at a low rate of 5.27% (the same as in July 2022), though that figure is 0.27 percentage points up on the beginning of the year. Though hardly a dramatic change, this still suggests the emergence of some strain, especially for the private sector.

Structural issues that cannot be resolved overnight mean that the labour market is sending mixed messages. Overall, the unemployment rate has declined further to 10.7% in Q2 2023, while the figure for employment has surged further to 57.1%, up 0.6 percentage points. The rise in employment has mainly been driven by the service sector; meanwhile on a yearly basis, in agriculture and industry employment has contracted. Women and people aged 30-64 have been the main beneficiaries of the new jobs. By contrast, youth unemployment has risen further. Moreover, inactivity and employment among those aged 15-29 contracted in Q2 2023, year on year, suggesting that the younger age cohorts are continuing to abandon the country, viewing emigration as a much better option. As a consequence, labour and skill shortages are looming. This is reflected particularly in tourism, but also in other sectors that need highly skilled professionals: curbing the emigration of such individuals is becoming something of an issue. The emigration of doctors, for example, has impelled the government to introduce a kind of 'brain drain' tax for this group: newly qualified graduates from medical school will be granted their diploma only once they have spent five years working in Albania following their graduation.

Overall, we expect GDP growth this year to accelerate to 3.5%, thanks to robust external demand. In the medium term, growth will be solid at above 3%, bolstered by rising domestic and external demand.

Table 6.1 / Albania: Selected economic indicators

	2020	2021	2022 ¹⁾	2022 January-June	2023	2023 Forecast	2024 Forecast	2025
Population, th pers., average	2,838	2,812	2,778	.	.	2,745	2,730	2,715
Gross domestic product, ALL bn, nom.	1,647	1,856	2,138	.	.	2,300	2,500	2,700
annual change in % (real)	-3.3	8.9	4.9	.	.	3.5	3.6	3.7
GDP/capita (EUR at PPP)	9,210	10,300	12,080	.	.	.	.	.
Consumption of households, ALL bn, nom.	1,318	1,411	1,610	.	.	.	.	.
annual change in % (real)	-3.3	4.7	7.4	.	.	2.9	3.0	3.4
Gross fixed capital form., ALL bn, nom.	373	452	512	.	.	.	.	.
annual change in % (real)	-1.4	19.2	6.5	.	.	3.0	3.0	4.0
Gross industrial production								
annual change in % (real)	-6.3	26.2	2.8	0.2	-7.2	3.5	4.0	4.5
Gross agricultural production ²⁾								
annual change in % (real)	1.5	-2.2	2.0	.	.	.	.	.
Construction output total								
annual change in % (real)	9.5	18.0	12.5	7.2	-6.2	.	.	.
Employed persons, LFS, th, average	1,243	1,249	1,298	1,278	1,323	1,325	1,345	1,365
annual change in %	-1.8	0.4	4.0	3.7	3.5	2.1	1.5	1.5
Unemployed persons, LFS, th, average	165	163	160	161	160	160	150	140
Unemployment rate, LFS, in %, average	11.7	11.5	10.9	11.2	10.8	10.5	10.0	9.5
Reg. unemployment rate, in %, eop ³⁾	7.4	7.3	7.0	.	.	.	.	.
Average monthly gross wages, ALL	53,662	57,191	61,898	59,954	67,805	75,100	85,100	91,600
annual change in % (real, gross)	0.8	4.4	1.4	0.7	7.1	16.0	10.0	5.0
Consumer prices, % p.a.	1.6	2.0	6.7	5.6	5.5	4.6	3.0	2.5
Producer prices in industry, % p.a.	-3.3	2.7	19.9	18.8	8.2	4.0	3.5	2.0
General governm. budget, nat. def., % of GDP								
Revenues	25.9	27.5	26.8	.	.	29.0	29.0	29.5
Expenditures	32.6	32.1	30.4	.	.	31.2	30.5	30.5
Deficit (-) / surplus (+)	-6.7	-4.6	-3.7	.	.	-2.2	-1.5	-1.0
General gov. gross debt, nat. def., % of GDP	74.3	74.5	64.5	65.0	58.7	62.0	59.0	56.0
Stock of loans of non-fin. private sector, % p.a.	6.9	9.6	7.0	12.5	1.4	.	.	.
Non-performing loans (NPL), in %, eop	8.1	5.7	5.0	5.3	5.2	.	.	.
Central bank policy rate, % p.a., eop ⁴⁾	0.50	0.50	2.75	1.00	3.00	3.00	3.00	3.00
Current account, EUR m	-1,153	-1,166	-1,063	-445	-323	-750	-810	-830
Current account, % of GDP	-8.7	-7.7	-5.9	-5.2	-3.2	-3.6	-3.5	-3.4
Exports of goods, BOP, EUR m	794	1,265	1,933	992	912	1,860	1,990	2,070
annual change in %	-12.5	59.4	52.8	64.9	-8.0	-4.0	7.0	4.0
Imports of goods, BOP, EUR m	3,776	5,094	6,201	2,806	3,023	6,880	7,350	7,810
annual change in %	-6.8	34.9	21.7	27.0	7.8	11.0	6.9	6.2
Exports of services, BOP, EUR m	2,226	3,486	4,801	2,081	2,721	6,100	6,530	6,860
annual change in %	-34.6	56.6	37.7	45.1	30.7	27.0	7.0	5.0
Imports of services, BOP, EUR m	1,174	1,690	2,400	1,074	1,362	2,830	2,960	3,030
annual change in %	-45.1	43.9	42.0	51.1	26.9	18.0	4.5	2.5
FDI liabilities, EUR m	937	1,032	1,372	640	686	1,400	.	.
FDI assets, EUR m	43	42	182	90	126	100	.	.
Gross reserves of CB excl. gold, EUR m	3,806	4,831	4,786	4,740	5,357	.	.	.
Gross external debt, EUR m	8,549	9,755	9,766	9,863	10,183	10,500	11,000	11,400
Gross external debt, % of GDP	64.2	64.4	54.3	54.9	50.0	50.0	48.0	46.0
Average exchange rate ALL/EUR	123.77	122.46	118.98	121.17	112.87	110.0	109.0	109.0

1) Preliminary. - 2) Based on UN-FAO data, wiiw estimate in 2022. - 3) wiiw estimate from 2021. - 4) One-week repo rate.

Source: wiiw Databases incorporating national statistics. Forecasts by wiiw.

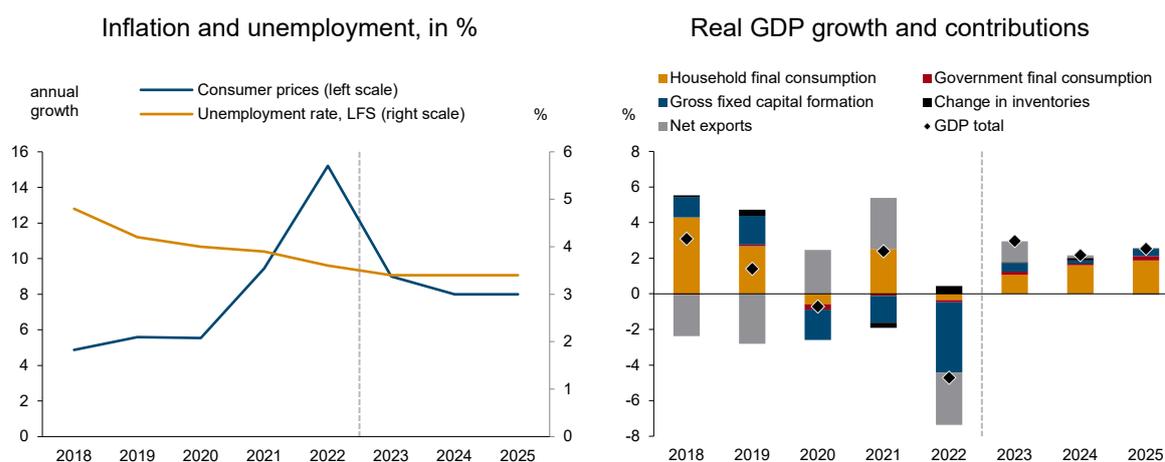


BELARUS: Recovery gathering pace, but the future remains uncertain

RUMEN DOBRINSKY

In 2023, Belarus's economy has performed considerably better than expected. While this largely reflects recovery from a low base, there have also been signs of adjustment to the effects of Western sanctions. With Russia's assistance, Belarus has remodelled some logistical export chains. The authorities have maintained an accommodative policy stance, combining fiscal stimulus with monetary easing. We expect GDP to grow by 3.0% in 2023, and then to moderate to 2.2% and 2.5% in 2024 and 2025, respectively.

Figure 6.2 / Belarus: Main macroeconomic indicators



Source: wiiw Annual Database incorporating national and Eurostat statistics, own calculation. Forecasts by wiiw.

By any measure, Belarus's economy has performed considerably better in 2023 than was expected by most analysts. Economic growth accelerated in Q2, with GDP growing by 4.1% year on year (after a decline of 2.9% in Q1). The recovery in industry began earlier: gross industrial output grew by 2.2% in Q1, to be followed by a 10.0% surge in Q2. After a prolonged plunge, Belarusian exports also started to recover, so that by mid-year their annualised value had almost reached its pre-sanctions level. In another sign of an upturn, investment activity – which had been subdued over the previous couple of years – started to recover in Q2.

In statistical terms, these outcomes largely reflect the effects of the shock to the Belarusian economy in Q2 2022 caused by the Western sanctions imposed after Russia's invasion of Ukraine. But leaving aside the purely statistical effect, the performance in 2023 indicates a considerable degree of adjustment to the new hostile external environment. This has largely been facilitated by Russia's accommodative policies, which have resulted in a further opening-up of Russia's markets to

Belarusian products previously exported to Western markets and the facilitation of new trade corridors for the export of Belarusian products to other markets – on top of the traditional support channels, such as the supply of cheap oil and gas.

Thanks to Russia's assistance, Belarus has been able to remodel some logistical chains for key export products. Thus, it is estimated that in 2023 Belarus will manage to treble its exports to third countries via Russian ports, compared to 2022. In particular, according to a statement by high-level Belarusian officials, the country is now capable of shipping about 1m tonnes of potash fertilisers per month through Russian ports, meaning up to 12m tonnes exported per year. For reference, the average annual export of potash from Belarus in previous years was in the region of 10m tonnes.

Following the imposition of Western sanctions, the Belarusian authorities slapped an embargo on the publication of certain detailed trade statistics, including commodity composition and direction of trade. Therefore, it is not possible to trace precisely the actual reorientation of trade flows that has occurred in the most recent period. Nevertheless, the available data – as well as some mirror statistics – suggest that there has been a considerable further reorientation of exports towards Russia and certain Asian markets. For example, only in H1 2023, China imported from Belarus potash fertilisers worth USD 1bn – almost double the level of the same period in 2022. For comparison, the pre-sanctions value of Belarusian worldwide exports of potash fertilisers amounted to some USD 3.6bn. China has also considerably increased its imports of timber and foodstuffs from Belarus.

Belarus has continued its policy of providing a fiscal stimulus to the business sector. The government has pumped significant equity into the capital base of some key state-owned industrial firms. In addition, substantial new fiscal stimulus for the business sector has been channelled through the Belarusian Development Bank.

The central bank has also considerably eased its monetary stance. The key policy rate was trimmed on five occasions in H1, resulting in a cumulative 2.25 percentage-point reduction since the end of 2022 and bringing its level to 9.5% in July. The central bank also started actively applying policies of quantitative easing, through the massive purchase of government bonds and foreign currencies, effectively injecting significant liquidity into the economy. The expansionary monetary stance resulted in lower interest rates and contributed to increased borrowing by firms and households – which, in turn, supported economic activity.

The central bank's moves were facilitated by the ongoing process of disinflation. H1 2023 was marked by lower imported inflation, especially in the commodity segment, while the residual effects of the price controls introduced in Q4 2022 continued to be felt. Consequently, the pace at which the price of consumer goods rose (both food and non-food) continued to moderate, and it was mainly consumer services that had a pro-inflationary effect. Within the latter group, the main inflation driver was non-regulated consumer services. This suggests a possible build-up of suppressed inflation that could be released if price controls are lifted.

The exchange rate against the dollar and the euro continued to closely track that of the Russian rouble – and the general trend in 2023 has similarly been one of depreciation. However, since the beginning of the year the Belarusian rouble has appreciated against the Russian currency, which is now the main factor affecting the terms of trade and international competitiveness.

Given the continued exodus of qualified personnel, labour shortages have kept mounting, generating upward pressure on wages. Coupled with the soft stance of income policy regarding wages in the public sector and pensions, this has resulted in a considerable rise in real earnings: the real disposable income of the population in the period January-July was 4.5% higher than a year earlier. While this has supported the recovery of private consumption, further unchecked income rises could turn into a pro-inflationary factor.

It should be noted that the recovery has been uneven and has not extended to all sectors. The IT sector has been one of the main casualties of Western sanctions, as many technology firms have quit the country. In the course of 2023, the recession in this sector has been deepening. It is estimated that the value added produced in the IT sector in Q2 2023 dropped by 17% year on year. According to preliminary estimations, the 2023 harvest will also be below expectations, due partly to unfavourable weather conditions.

Compared to the previous two years – and reflecting the upturn in domestic demand – the current account balance has weakened in 2023. Nevertheless, for the year as a whole it may still remain in positive territory.

Belarus continues to service its foreign obligations in Belarusian roubles, claiming that the Western sanctions make it technically impossible for it to do so in USD or euro. In consequence, Moody's has further lowered Belarus's sovereign rating from Ca to C. However, in practice this move will have no tangible effect on the Belarusian economy, since the country has no access to international financial markets anyway.

The current upturn, albeit significant, mostly represents a recovery from a low base, and the current positive economic trends cannot be expected to last long. The period 2021-2022 was characterised by underinvestment, and many production facilities are worn out and underperforming. The opportunities for accelerated growth are limited on account of the existing supply constraints, in terms of both capital and labour. The period of disinflation also seems to have come to an end: it is expected that in the coming months the price dynamics will reverse, due to the loose macroeconomic stance.

Given the recent developments in the real economy, we have raised our GDP growth forecast for 2023 to 3.0% – 1.7 percentage points up on the spring forecast. In view of the impetus received, most components of final demand (both domestic and external) are expected to contribute positively to the overall growth. Average annual consumer price inflation in 2023 is likely to be well below the previous year's level and may move into single digits.

Overall, the downside risks remain high and the current upturn is not likely to translate into a sustained recovery. Growth will continue to be mostly demand driven, as the authorities will maintain the accommodative policy stance. Given the existing constraints, we expect GDP to grow by 2.2% and 2.5% in 2024 and 2025, respectively. Under these circumstances, we also expect the current account in the years ahead to move into the red, but that is not likely to pose a threat to macroeconomic stability. Given the soft policy stance, inflation will remain in high single digits.

Table 6.2 / Belarus: Selected economic indicators

	2020	2021	2022 ¹⁾	2022 January-June	2023	2023 Forecast	2024 Forecast	2025
Population, th pers., average	9,380	9,303	9,228	.	.	9,150	9,100	9,050
Gross domestic product, BYN m, nom.	149,721	176,879	191,374	87,173	97,577	214,800	237,000	262,400
annual change in % (real)	-0.7	2.4	-4.7	-4.4	2.0	3.0	2.2	2.5
GDP/capita (EUR at PPP)	13,310	14,540	14,660	.	.	.	.	.
Consumption of households, BYN m, nom.	77,101	88,839	102,151	.	.	.	.	.
annual change in % (real)	-1.1	4.9	-0.7	.	.	2.0	3.0	3.5
Gross fixed capital form., BYN m, nom.	37,977	39,924	37,167	.	.	.	.	.
annual change in % (real)	-6.3	-5.9	-17.5	.	.	2.5	1.0	2.0
Gross industrial production								
annual change in % (real)	-0.7	6.5	-5.4	-5.2	6.0	4.0	2.0	2.5
Gross agricultural production								
annual change in % (real)	4.4	-4.0	3.6	.	.	.	.	.
Construction industry								
annual change in % (real)	-1.6	-13.3	-10.7	-13.3	12.1	.	.	.
Employed persons, LFS, th, average	4,885	4,851	4,847	4,814	4,773	4,800	4,780	4,780
annual change in %	-0.5	-0.7	-0.1	-0.3	-0.8	-1.0	-0.5	0.0
Unemployed persons, LFS, th, average	206	197	180	185	172	169	168	168
Unemployment rate, LFS, in %, average	4.0	3.9	3.6	3.7	3.5	3.4	3.4	3.4
Reg. unemployment rate, in %, eop	0.2	0.1	0.1	0.2	0.1	.	.	.
Average monthly gross wages, BYN	1,255	1,444	1,633	1,569	1,795	1,870	2,080	2,290
annual change in % (real, gross)	8.8	5.1	-1.8	0.1	7.4	5.0	3.0	2.0
Consumer prices, % p.a.	5.5	9.5	15.2	14.6	6.6	9.0	8.0	8.0
Producer prices in industry, % p.a. ²⁾	5.6	12.2	15.2	15.6	7.8	10.0	9.0	9.0
General governm. budget, nat. def., % of GDP								
Revenues	35.5	35.7	36.5	.	.	36.0	37.0	38.0
Expenditures	37.2	35.6	38.0	.	.	38.0	38.0	38.0
Deficit (-) / surplus (+)	-1.7	0.2	-1.5	.	.	-2.0	-1.0	0.0
General gov. gross debt, nat. def., % of GDP ³⁾	47.5	40.3	42.0	.	.	41.0	40.0	39.0
Stock of loans of non-fin. private sector, % p.a.	21.4	3.3	3.2	8.4	5.4	.	.	.
Non-performing loans (NPL), in %, eop ⁴⁾	4.8	5.3	4.9	.	.	.	.	.
Central bank policy rate, % p.a., eop ⁵⁾	7.75	9.25	12.00	12.0	9.5	9.5	9.0	8.0
Current account, EUR m ⁶⁾	-156	1,830	2,396	343	-1,425	100	-100	-500
Current account, % of GDP	-0.3	3.1	3.5	1.2	-4.5	0.1	-0.1	-0.7
Exports of goods, BOP, EUR m ⁶⁾	24,890	33,189	35,838	15,582	17,667	37,000	37,500	38,000
annual change in %	-14.0	33.3	8.0	8.3	13.4	3.2	1.4	1.3
Imports of goods, BOP, EUR m ⁶⁾	26,637	33,755	35,471	15,346	18,811	38,000	38,900	39,800
annual change in %	-18.5	26.7	5.1	4.3	22.6	7.1	2.4	2.3
Exports of services, BOP, EUR m ⁶⁾	7,703	8,749	8,760	4,066	3,898	8,300	8,800	9,300
annual change in %	-10.7	13.6	0.1	0.7	-4.1	-5.2	6.0	5.7
Imports of services, BOP, EUR m ⁶⁾	4,249	4,815	4,780	2,028	2,599	5,100	5,600	6,000
annual change in %	-18.9	13.3	-0.7	-7.3	28.2	6.7	9.8	7.1
FDI liabilities, EUR m ⁶⁾	1,221	1,044	1,536	1,646	2,012	1,900	.	.
FDI assets, EUR m ⁶⁾	72	-67	174	11	23	100	.	.
Gross reserves of CB excl. gold, EUR m ⁶⁾	3,604	4,687	4,494	4,143	4,105	.	.	.
Gross external debt, EUR m ⁶⁾	34,230	37,080	37,349	41,815	33,746	42,300	43,900	45,900
Gross external debt, % of GDP	63.8	62.7	54.2	60.6	50.3	63.0	63.0	63.0
Average exchange rate BYN/EUR	2.7888	2.9923	2.7755	2.9699	3.0626	3.20	3.40	3.60

1) Preliminary. - 2) Domestic output prices. - 3) Including publicly guaranteed debt. - 4) Doubtful, bad and small part of supervised assets. - 5) Refinancing rate of CB. - 6) Converted from USD.

Source: wiiw Databases incorporating national statistics. Forecasts by wiiw.

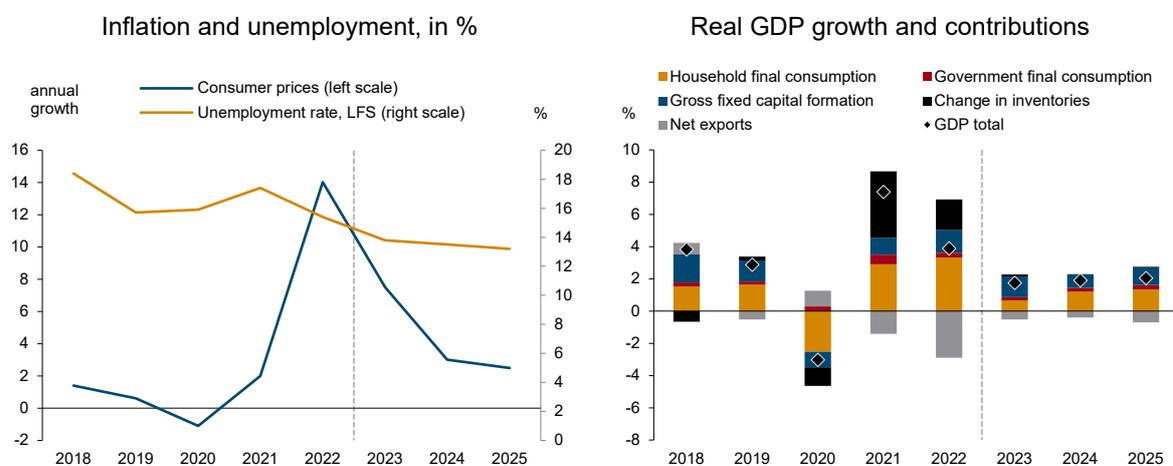


BOSNIA AND HERZEGOVINA: Economy stagnating, as political tensions come to the fore

SELENA DURAKOVIĆ

The year started with rather slow economic growth, as a result of a decline in household consumption and net exports. Inflation has been falling, despite the inability of the central bank to influence interest rates under the currency board arrangement. Political tensions are again on the rise, as one part of the country, Republika Srpska, has ceased to heed the decisions of the international official who oversees peace in the country. On a positive note, the country's new government has been making some progress in meeting the conditions set by the EU for progress towards EU accession, and the country's S&P sovereign rating was upgraded in August 2023 in recognition of its economic resilience.

Figure 6.3 / Bosnia and Herzegovina: Main macroeconomic indicators



Source: wiiw Annual Database incorporating national and Eurostat statistics, own calculation. Forecasts by wiiw.

The data for Q1 2023 suggest slow economic growth, and only a minor improvement is expected for the rest of the year. The GDP growth rate has declined steadily since 2021, reaching 1.1% in Q1 2023. Compared with the same period last year, real increases were recorded in government consumption (+2%) and gross capital formation (+12.4%); meanwhile, real decreases were posted in household final consumption (-0.4%) and net exports (-3%) – consequences of the high rate of inflation at the beginning of the year and weaker demand from EU markets, respectively. However, inflation fell in Q2 and real wages increased in the first six months (by 4.9% on average, compared to the same period last year); thus we can expect to see some improvement in household consumption from Q2 onwards.

On balance, we have left our growth forecasts for 2023 and 2024 unchanged, at 1.7% and 1.9%, respectively. Industrial production fell by 3.9% in the first seven months of 2023, compared to the same period last year, while retail trade turnover increased by 13.1% in real terms for the same period, supported by increased consumer borrowing, tourism and remittances. Remittances rose by 7% in Q1 year on year, and tourist visits in the first seven months were 20.7% up on the same period last year. Although foreign direct investment increased by more than 80% in nominal euro terms in Q1 2023, compared to Q1 2022, it did not reach the level of Q1 2021 and accounted for only around 3% of GDP. We expect a slow increase in the coming period in both household and government consumption, as well as in gross capital formation; however, we also anticipate deteriorating net exports. Accordingly, we have made no revision to the spring forecast for GDP growth for 2023 and 2024 – 1.7% and 1.9%, respectively.

Inflation has plummeted – to 4% in July – while interest rates remain low. The central bank of Bosnia and Herzegovina cannot influence commercial banks' interest rates, as it operates as a currency board. Since banks in Bosnia and Herzegovina currently rely almost entirely on local funding sources that are unconnected to benchmark interest rates on the international market, interest-rate increases have been much lower than in the case of commercial banks in the euro area. Although interest rates have remained quite low, inflation has been falling rapidly – from 14.1% in January to 4% in July, the lowest level for two years, mostly on account of a fall in the cost of transport and electricity. We expect inflation to stay at a similar level until the end of the year, so our inflation forecast for 2023 has been downgraded by 1.5 percentage points (to 7.5% on an average annual basis). We expect a further decline to 3% next year.

Unemployment is falling significantly, but mostly because of high emigration. According to the Labour Force Survey (LFS), the unemployment rate declined significantly in Q1 and Q2 2023 – to 13.3% and 13.1%, respectively, as against 15.5% in 2022. This is largely a result of a high rate of emigration from the country (according to the LFS, the active population continued to fall in the first two quarters) and partly a consequence of increased employment in the service sector (primarily tourism) and the IT sector. The increased emigration of the workforce and skilled people means that the labour shortage is increasing, especially in construction, transportation, catering and tourism. Work permits for foreign workers have been increasing in number – and would probably have increased even more had the application process not been so lengthy. Other persistent problems on the labour market include high long-term unemployment (60.3% of those unemployed have had no work for more than two years) and high youth unemployment (33.5%).

Political tensions are increasing again, with one part of the country – Republika Srpska – ignoring the decisions of the high representative, the international official who oversees implementation of the Dayton Agreement. Republika Srpska has passed two laws, the first preventing the high representative's decisions from being published in Republika Srpska's Official Gazette (so that it does not have to heed them), and the second allowing the constitutional court's rulings to be ignored on the entity's territory. In consequence, the president of Republika Srpska, Milorad Dodik, has been charged by the prosecutor's office in Bosnia and Herzegovina with disobeying the decisions of the high representative and the constitutional court. All of this undermines the country's constitution and the functioning of state institutions. It may also place the economic progress of the country 'on hold', as political issues are again being put before economic growth, while at the same time it projects to the international community and potential investors the image of an unstable country.

On the positive side, the new government is making some progress with the adoption of new laws required by the EU, and S&P has improved Bosnia and Herzegovina's credit rating. The new government is making some progress towards fulfilling the conditions required for EU accession negotiations to commence, by passing new laws (e.g. on freedom of access to information, a human rights ombudsman, etc.) required within the 'European package'. Furthermore, in August 2023, S&P upgraded Bosnia and Herzegovina's credit rating from 'B' to 'B+', with a stable outlook. This reflects the country's economic resilience, in spite of such recent impacts as the Covid-19 pandemic, several instances of political unrest, and weaker external demand. However, the move came before the fresh political tensions, and so S&P may reconsider its decision if those tensions increase.

Table 6.3 / Bosnia and Herzegovina: Selected economic indicators

	2020	2021	2022 ¹⁾	2022 January-June	2023	2023 Forecast	2024 Forecast	2025
Population, th pers., average	3,475	3,453	3,431	.	.	3,385	3,355	3,350
Gross domestic product, BAM m, nom. ²⁾	34,728	39,107	45,605	.	.	49,900	52,400	54,800
annual change in % (real)	-3.0	7.4	3.9	.	.	1.7	1.9	2.1
GDP/capita (EUR at PPP) ²⁾	9,920	11,120	12,490	.	.	.	.	.
Consumption of households, BAM m, nom. ²⁾	24,659	26,300	30,586	.	.	.	.	.
annual change in % (real)	-3.5	4.1	4.9	.	.	1.0	1.8	2.0
Gross fixed capital form., BAM m, nom. ²⁾	7,679	8,367	9,826	.	.	.	.	.
annual change in % (real)	-4.2	4.8	6.6	.	.	6.0	4.0	5.0
Gross industrial production								
annual change in % (real)	-6.4	9.7	0.9	4.0	-4.5	-1.0	2.0	4.0
Gross agricultural production ³⁾								
annual change in % (real)	9.2	-16.9	0.3	.	.	.	.	.
Construction output total								
annual change in % (real)	0.2	2.5	-0.5	-0.6	-0.1	.	.	.
Employed persons, LFS, th, average ⁴⁾	1,173.1	1,151.0	1,162.0	1,156	1,180	1,180	1,190	1,200
annual change in %	.	.	1.0	2.6	2.1	1.5	1.0	1.0
Unemployed persons, LFS, th, average ⁴⁾	221.0	241.8	211.3	223	180	207	203	200
Unemployment rate, LFS, in %, average ⁴⁾	15.9	17.4	15.4	16.2	13.2	13.8	13.5	13.2
Reg. unemployment rate, in %, eop	33.7	31.2	29.7	29.9	29.0	.	.	.
Average monthly gross wages, BAM	1,476	1,542	1,723	1,664	1,916	1,910	1,980	2,050
annual change in % (real, gross)	5.0	2.4	-2.0	-1.8	5.4	3.0	0.5	1.0
Average monthly net wages, BAM	956	998	1,122	1,085	1,244	1,240	1,290	1,340
annual change in % (real, net)	4.9	2.4	-1.4	-0.7	4.9	3.0	1.0	1.5
Consumer prices, % p.a.	-1.1	2.0	14.0	11.5	9.3	7.5	3.0	2.5
Producer prices in industry, % p.a.	-1.2	5.6	19.8	18.5	8.8	8.0	4.0	3.0
General governm. budget, nat. def., % of GDP								
Revenues	41.6	41.1	39.9	.	.	39.5	40.0	42.3
Expenditures	46.8	41.3	40.3	.	.	40.0	39.5	42.0
Deficit (-) / surplus (+)	-5.2	-0.3	-0.4	.	.	-0.5	0.5	0.3
General gov. gross debt, nat. def., % of GDP	36.1	34.0	29.3	.	.	27.3	25.5	24.1
Stock of loans of non-fin. private sector, % p.a.	-2.5	3.7	5.3	4.8	5.0	.	.	.
Non-performing loans (NPL), in %, eop	6.1	5.8	4.5	5.2	4.1	.	.	.
Central bank policy rate, % p.a., eop ⁵⁾
Current account, EUR m ⁶⁾	-575	-472	-1,045	.	.	-990	-960	-1,120
Current account, % of GDP	-3.2	-2.4	-4.5	.	.	-3.9	-3.6	-4.0
Exports of goods, BOP, EUR m ⁶⁾	4,818	6,499	8,249	.	.	8,910	9,890	10,680
annual change in %	-7.4	34.9	26.9	.	.	8.0	11.0	8.0
Imports of goods, BOP, EUR m ⁶⁾	8,023	10,165	13,410	.	.	14,620	16,080	17,210
annual change in %	-13.5	26.7	31.9	.	.	9.0	10.0	7.0
Exports of services, BOP, EUR m ⁶⁾	1,251	1,930	2,719	.	.	3,070	3,610	3,830
annual change in %	-41.0	54.2	40.9	.	.	13.0	17.5	6.0
Imports of services, BOP, EUR m ⁶⁾	488	615	866	.	.	990	1,120	1,210
annual change in %	-29.4	26.2	40.7	.	.	14.0	13.0	8.0
FDI liabilities, EUR m ⁶⁾	384	529	615	.	.	680	.	.
FDI assets, EUR m ⁶⁾	62	69	27	.	.	70	.	.
Gross reserves of CB excl. gold, EUR m ⁶⁾	6,942	8,204	8,133	7,977	7,747	.	.	.
Gross external debt, EUR m	11,339	11,654	11,994	.	.	12,550	12,960	13,100
Gross external debt, % of GDP	63.9	58.3	51.4	.	.	49.2	48.4	46.8
Average exchange rate BAM/EUR	1.9558	1.9558	1.9558	1.9558	1.9558	1.9558	1.9558	1.9558

1) Preliminary. - 2) According to ESA'10 (FISIM reallocated to industries). - 3) Based on UN-FAO data, wiiw estimate in 2022. - 4) From 2021 new methodology in line with the Integrated European Social Statistics Regulation (IESS). - 5) Bosnia and Herzegovina has a currency board. There is no policy rate and even no money market rate available. - 6) Converted from national currency.

Source: wiiw Databases incorporating national statistics. Forecasts by wiiw.

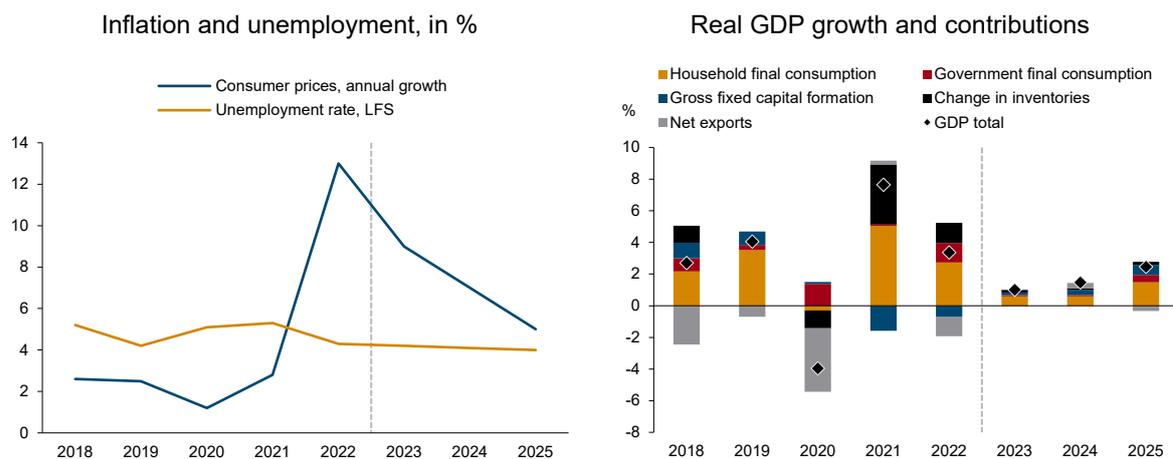


BULGARIA: Economic weakness likely to persist

RUMEN DOBRINSKY

Economic slowdown became more pronounced over the course of the year, and industry actually plunged into a deep recession. Export performance was dismal against the background of shrinking demand in Western Europe. A new government took office in May, supported by the two main political parties. Its foundations are shaky, however, as the parties have not signed a coalition agreement. Economic weakness will persist: GDP will grow by 1.0% in 2023 and by 1.5% and 2.5% in 2024 and 2025, respectively.

Figure 6.4 / Bulgaria: Main macroeconomic indicators



Source: wiiw Annual Database incorporating national and Eurostat statistics, own calculation. Forecasts by wiiw.

Over the course of 2023 there has been a continuous slowdown, provoked by both external and domestic factors. Economic weakening became more perceptible in Q2, with year-on-year GDP growth slowing to 1.8% (after 2.1% in Q1). The industrial sector actually plunged into a deep recession, with gross industrial output down 10.6% year on year in Q2 and manufacturing output dropping by 7.0%. The poor manufacturing and export performance was mostly due to the shrinking of import demand in Western Europe, coupled with falling export prices. In current euro terms, exports of goods and services to the EU in H1 2023 dropped by 6.3%, compared to the same period in 2022, while the year-on-year decline in Q2 alone amounted to 16.0%.

The low growth figures for 2023 also partly reflect the effect of a high base in 2022. Last year – quite aside from the generally favourable external environment – some Bulgarian manufacturers recorded windfall profits, thanks to exceptionally high exports to Ukraine of military equipment, fuel and other war-related products.

On the demand side, both private consumption and gross fixed capital formation increased in H1 and contributed positively to GDP growth. Consumer and investor confidence in that period was underpinned by still low interest rates. At the same time, there was destocking on a massive scale, reflected in the national accounts item 'change in inventories' (probably related to seasonal factors in the production of military equipment), which made a sizeable negative contribution to GDP growth.

The political horse-trading following the April elections produced a government supported by the two main parties – GERB and 'We Continue the Change'. The new majority, however, did not sign a formal coalition agreement. The informal agreement between them amounts to a formula for a 'rotating government', with the parties taking it in turns to nominate the prime minister (and hence the composition of the cabinet) every six months. The first such government – nominated by 'We Continue the Change' – took office on 22 May.

The formation of a regular government put an end to the series of caretaker governments that had been in office over the past couple of years. In principle, this represents a break from the long political stalemate, as only a regular government, backed by a parliamentary majority, is empowered to take key policy decisions with lasting implications. However, the new quasi-coalition government is faced with the need to deal with serious economic problems, and it remains to be seen whether it will cope with the momentous challenges that lie ahead.

Following the endorsement of the government, in July parliament finally adopted a budget for the year 2023 (up until then, public spending had been governed by provisional rules). While this budget envisages a cash deficit of only 3% of GDP for the year, most analysts consider that to be barely achievable on account of the unrealistic assumptions: it is overly optimistic regarding revenue and overlooks some fiscal liabilities. In particular, the new budget envisages full absorption of the EU transfers envisaged for Bulgaria under the Recovery and Resilience Plan for 2023 – even though the country is still a long way off meeting the Commission's conditionalities for disbursement of those funds. Aside from that, the current statistics available suggest that some revenue items in 2023 have fallen significantly behind target. As an example, the nominal revenue from VAT imposed on imports in the period January-July was 14.5% lower than in the same period of 2022.

Furthermore, Bulgaria's main fiscal problem is the structural deficit that has opened up in the last couple of years. Addressing this deficit will require the introduction of some tough and unpopular measures. The 2023 budget fell short of addressing any of the structural fiscal problems, and the ruling quasi-coalition has not yet even hinted that it intends to deal with them.

The uncertainties surrounding the political situation in the country remain, due to the absence of stable and agreed operating principles for the present government. The first major test for the current political constellation will be the important local elections scheduled for 29 October. If the results diverge significantly from those of the last parliamentary election, that could shake the foundations of the current informal agreement between GERB and 'We Continue the Change'.

There has been little change in the labour market, which remains tight. A stagnant (or even shrinking) labour force and chronic labour shortages in many sectors have maintained upward pressure on wages, which has been a persistent feature of recent years. Between 2017 and 2022, average nominal wages in Bulgaria increased by 69.7%, with an annual rate of growth of 11.2%. Wage inflation

continued in 2023 as well. Since it has, by and large, outstripped gains in productivity, the result has been a significant rise in unit labour costs. The deterioration in competitiveness may be another factor behind the dismal export performance this year.

Headline inflation slowed somewhat in H1 2023. However, the annual average rate of consumer price inflation (CPI) this year is likely to remain high, due to carry-over effects from 2022 and such cost-push factors as the persistent surge in nominal wages. By contrast, following the general global trend, producer prices have been on the slide, due to falling energy prices and lower external demand.

The central bank raised the minimum reserve requirements in two steps: to 10% in May (from 5%) and then to 12% in July. This was an attempt to cool the credit expansion of 2022 and early 2023, which was regarded as pro-inflationary. Consequently, starting in June and continuing through September, lending rates have been rising in an effort to curb consumer credit, which was an important driver of private consumption in previous months. Apart from the dampening effect on economic activity and consumer spending, rising interest rates will mean higher costs of financing the fiscal deficit.

At present there is no sign of a reversal in the ongoing deterioration in the domestic and external environment. Under these circumstances, the economic slowdown is likely to continue in the remaining months of 2023. Our current forecast is for GDP to grow by 1.0% in 2023 – 0.7 percentage points down on the spring forecast. The average rate of CPI for the year as a whole will stay high, at close to 10%, under pressure from domestic cost-push factors. The fiscal deficit will remain a headache for the government, especially in view of the absence of agreed measures to tackle the structural fiscal problems.

There are no indications of a possible sustained recovery in the coming years either. We now expect GDP growth of 1.5% in 2024 and 2.5% in 2025 – both below the spring forecast. In the absence of strict containment measures, inflation will remain relatively high in the forecast period. Given the persistent problems with ensuring price stability and sound and sustainable public finances, Bulgaria's declared intention of joining the euro zone may remain just an aspiration in the foreseeable future.

Table 6.4 / Bulgaria: Selected economic indicators

	2020	2021	2022 ¹⁾	2022 January-June	2023	2023 Forecast	2024 Forecast	2025
Population, th pers., average ²⁾	6,934	6,878	6,465	.	.	6,400	6,350	6,300
Gross domestic product, BGN m, nom.	120,553	139,012	165,384	72,995	82,285	182,100	197,700	212,700
annual change in % (real)	-4.0	7.6	3.4	4.1	1.9	1.0	1.5	2.5
GDP/capita (EUR at PPP)	16,570	18,640	20,710	.	.	.	.	.
Consumption of households, BGN m, nom.	69,776	80,454	98,240	42,061	50,036	.	.	.
annual change in % (real)	-0.5	8.7	4.7	3.7	4.9	1.0	1.0	2.5
Gross fixed capital form., BGN m, nom.	22,981	22,720	25,412	10,516	12,937	.	.	.
annual change in % (real)	0.6	-8.3	-4.3	-9.6	8.6	1.0	2.0	4.0
Gross industrial production ³⁾								
annual change in % (real)	-5.9	9.8	12.7	17.2	-7.7	-4.0	1.0	2.0
Gross agricultural production								
annual change in % (real)	-11.1	18.0	-7.8	.	.	.	.	.
Construction industry ⁴⁾								
annual change in % (real)	-5.3	2.6	0.4	1.8	-0.7	.	.	.
Employed persons, LFS, th, average ⁵⁾	3,122	3,077	3,151	3,095	2,921	2,950	2,960	2,970
annual change in %	-3.4	-0.6	2.4	1.6	1.1	0.0	0.5	0.5
Unemployed persons, LFS, th, average ⁵⁾	169	171	140	155	138	130	130	120
Unemployment rate, LFS, in %, average ⁵⁾	5.1	5.3	4.3	4.8	4.5	4.2	4.1	4.0
Reg. unemployment rate, in %, eop ⁵⁾	6.7	4.8	4.7	4.2	5.0	.	.	.
Average monthly gross wages, BGN	1,391	1,561	1,761	1,667	1,920	2,000	2,200	2,360
annual change in % (real, gross)	7.9	8.7	-2.2	-1.3	2.1	4.0	3.0	2.0
Consumer prices (HICP), % p.a.	1.2	2.8	13.0	11.1	11.0	9.0	7.0	5.0
Producer prices in industry, % p.a.	-2.0	15.5	38.1	37.2	0.5	20.0	12.0	10.0
General governm. budget, EU def., % of GDP								
Revenues	37.7	37.7	38.5	.	.	37.0	37.0	38.0
Expenditures	41.5	41.6	41.3	.	.	42.0	41.0	41.0
Net lending (+) / net borrowing (-)	-3.8	-3.9	-2.8	.	.	-5.0	-4.0	-3.0
General gov. gross debt, EU def., % of GDP	24.5	23.9	22.9	.	.	24.0	26.0	27.0
Stock of loans of non-fin. private sector, % p.a.	4.5	8.3	12.2	12.4	10.9	.	.	.
Non-performing loans (NPL), in %, eop	7.5	6.0	4.6	5.2	3.8	.	.	.
Central bank policy rate, % p.a., eop ⁶⁾	0.00	0.00	1.30	0.00	2.96	4.0	3.5	3.0
Current account, EUR m	24	-1,316	-578	190	723	-500	-300	300
Current account in % of GDP	0.0	-1.9	-0.7	0.5	1.7	-0.5	-0.3	0.3
Exports of goods, BOP, EUR m	27,272	34,405	45,927	22,743	22,470	45,000	46,000	47,000
annual change in %	-6.3	26.2	33.5	39.8	-1.2	-2.0	2.2	2.2
Imports of goods, BOP, EUR m	29,213	37,292	50,816	24,515	23,525	49,500	50,500	51,500
annual change in %	-8.8	27.7	36.3	42.0	-4.0	-2.6	2.0	2.0
Exports of services, BOP, EUR m	7,320	9,184	11,886	5,199	5,417	12,000	13,000	14,000
annual change in %	-28.5	25.5	29.4	35.0	4.2	1.0	8.3	7.7
Imports of services, BOP, EUR m	4,171	5,104	6,560	2,978	2,885	7,000	7,500	8,000
annual change in %	-21.9	22.4	28.5	33.1	-3.1	6.7	7.1	6.7
FDI liabilities, EUR m	3,154	2,084	3,014	1,387	2,061	2100	.	.
FDI assets, EUR m	395	781	1,005	717	473	800	.	.
Gross reserves of CB excl. gold, EUR m	28,830	32,490	36,198	31,195	32,940	.	.	.
Gross external debt, EUR m	38,991	41,214	44,431	41,743	44,056	45500	46000	47000
Gross external debt, % of GDP	63.3	58.0	52.5	49.4	47.3	49.0	46.0	43.0
Average exchange rate BGN/EUR	1.9558	1.9558	1.9558	1.9558	1.9558	1.9558	1.9558	1.9558

1) Preliminary. - 2) From 2022 according to census 2021. - 3) Enterprises with 10 and more employees. - 4) Enterprises with 5 and more employees. - 5) From 2023 according to census 2021. Comparable growth rate for employed persons in H1 2023 of 1.1% is based on the H1 2022 value of 2,891 th persons. From 2021 the new LFS methodology is applied in line with the Integrated European Social Statistics Regulation (IESS). - 6) Base interest rate. This is a reference rate based on the average interbank LEONIA rate of previous month (Bulgaria has a currency board).

Source: wiiw Databases incorporating Eurostat and national statistics. Forecasts by wiiw.

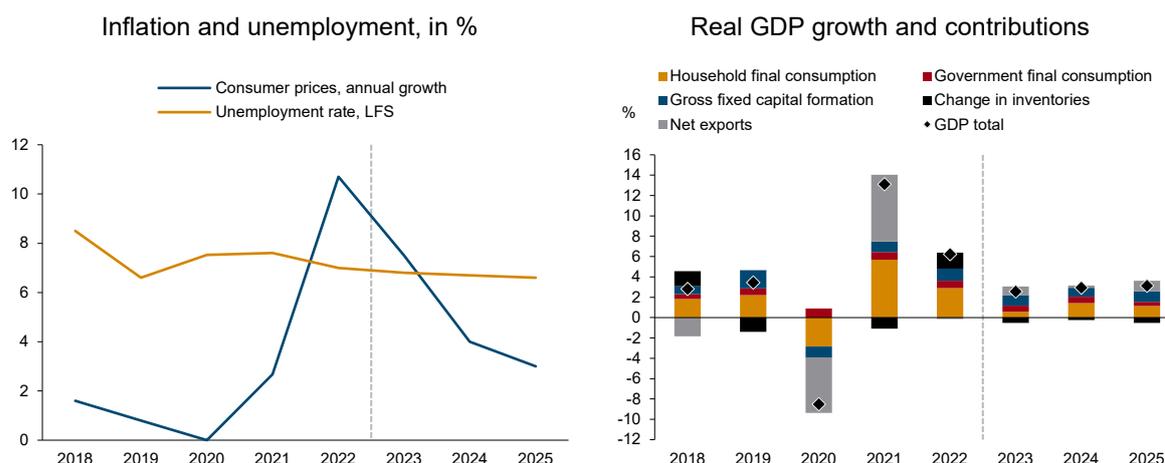


CROATIA: Tourism to keep economy afloat

BERND CHRISTOPH STRÖHM

Croatia's accession to the euro area and the EU's border-free Schengen zone boosted tourism in 2023. The country's full EU integration will also provide a fillip to trade and investment in the long term. EU-related funds were already supporting investment activity in the country in 2022, and have continued to do so this year. Nevertheless, persistently high levels of inflation have put real incomes, external demand and investment sentiment under pressure, which is why we have maintained our growth forecast for 2023 of 2.5%.

Figure 6.5 / Croatia: Main macroeconomic indicators



Source: wiiw Annual Database incorporating national and Eurostat statistics, own calculation. Forecasts by wiiw.

Croatia's economy displayed stable performance in H1 2023, despite the ongoing cost-of-living crisis. GDP expanded by 2.7% year on year in Q2 2023, following a 2.8% surge the previous quarter. Economic growth was driven by strong investments and public consumption. In addition, private consumption supported domestic demand by accelerating to 2.3% year on year in Q2 2023; investment activity also grew at a similar pace in Q2, surging to 3.2% year on year. Lastly, net exports likewise made a positive contribution to growth – exports of goods and services fell by only 1.6% year on year in Q2, compared to imports, which saw a 3.6% decline year on year.

The country's accession to the euro area and the EU's border-free Schengen zone boosted tourism in 2023. Despite the current circumstances – not least the impact of global inflation and the ongoing conflict in Ukraine – Croatia's tourist season performed very well, thanks to the introduction of the euro as the country's currency and its accession to the Schengen area in January 2023 (about 80% of tourists come from the Schengen area and some 60% from the euro area). From January to the end

of August 2023, Croatia saw 16.2m arrivals and 88.5m overnight stays – up 8% and 2%, respectively, against the same period of 2022. According to the Croatian Tourism Ministry, tourist numbers this year will likely surpass the record set in 2019.

The declining trend in inflation, observed since the November 2022 peak of 13.5%, went into reverse in August, as inflation surged to 7.8%. The main drivers of inflation in August were still food, beverages and tobacco (+10.1% year on year). In addition, the introduction of the euro in January led to an immediate surge in the price of certain goods (in particular coffee and baked goods) during the two-week transition period when both the kuna and the euro were in circulation. Alongside some supply-chain normalisation, the government support package helped ease the pressure of prices for housing and utilities in H1 2023. Nevertheless, food prices continued to rise, even though the government reduced the VAT on certain food products to 5% and is actively monitoring movements in the price of foodstuffs (to little significant effect). Given the August figure, we have revised our average inflation forecast for this year upward, from 6.5% to 7.5%. As for the coming years, we forecast that inflation will gradually fall – to 4% in 2024 and 3% in 2025.

Overall, the government is planning to allocate EUR 3.4bn (5% of GDP) in 2023 to investments in energy-efficiency measures and to mitigating the cost-of-living crisis. This includes the fifth state aid package presented in September (worth EUR 1.7bn). We have thus maintained our previous forecast that the budget deficit in 2023 will remain at 2.4% of GDP and will continue at around 2% in 2024. The high level of inflation meant that the public debt declined to 68.8% of GDP in 2022 (from 79.3% in 2021). We project that this downward trend will continue in the coming period, and that public debt will fall to 63% in 2023.

Croatia's unemployment rate will decline to pre-Covid-19 levels. According to the national statistical office, there were 103,774 unemployed persons registered with the Employment Service in July 2023 – 5.3% lower than in the same month of 2022. We expect the unemployment rate to fall to 6.8% on average this year, thus reaching its pre-Covid-19 levels. Despite this relatively high rate of unemployment, the country is still facing labour shortages in certain professions and sectors, due to mass emigration to other EU countries. Croatia also faces a declining demography – the country's population contracted by some 10% (roughly 400,000 people) from 2011 to 2021. According to an estimate by the Croatian State Bureau of Statistics, the population of the country in mid-2022 was 3,855,641.

The inflow of funds from the EU's Recovery and Resilience Facility (RRF) is supporting growth dynamics in 2023. In 2021, the European Commission approved a grant of EUR 6.3bn (12.8% of Croatia's 2020 GDP) from the RRF for the period 2021-2026. In June 2023, Croatia managed to fully absorb allocations from the EU Solidarity Fund to deal with the aftermath of the Zagreb and Petrinja earthquakes to the tune of EUR1.03bn. Total EU funding for 2023 is capped at some EUR 4bn. Implementation of the RRF-financed projects, including the reconstruction of earthquake-damaged infrastructure in the Zagreb, Krapina-Zagorje, Sisak-Moslavina and Karlovac counties, will contribute 1.5 percentage points to headline GDP growth in 2023 and 2.5 percentage points in 2024 and 2025 (according to the European Commission). In September, the government asked the European Commission to alter the country's RRF and add EUR 4.4bn in loans to reflect the fact that Croatia's economic performance in 2020 and 2021 had been better than originally envisaged by the government.

Croatia's economy is projected to grow by 2.5% in 2023, unchanged from our previous forecast.

The high inflation, coupled with the deteriorating funding conditions and uncertainty, will depress real wages and hamper investor sentiment. Household consumption will also remain subdued for the remainder of 2023. The allocation of EU funds means that public investment will act as the main driver of this year's economic growth, while tourism will likely fall by the wayside in Q4. In 2024, external demand will bring more uncertainty, due to the poor outlook for growth in the EU and particularly Germany. There are also downside risks from the war in Ukraine dragging on. This will result in a slowdown in the global economy, which could have an unfavourable effect on the Croatian tourism sector. Consequently, GDP growth in both 2024 and 2025 will likely stay at the 3% mark.

Table 6.5 / Croatia: Selected economic indicators

	2020	2021	2022 ¹⁾	2022 January-June	2023	2023 Forecast	2024 Forecast	2025
Population, th pers., average ²⁾	4,047	3,949	3,857	.	.	3,853	3,850	3,849
Gross domestic product, EUR-HRK m, nom.	50,477	58,244	66,943	31,283	35,511	74,000	79,000	84,000
annual change in % (real)	-8.5	13.1	6.2	8.2	2.7	2.5	2.9	3.1
GDP/capita (EUR at PPP)	19,460	22,570	25,730	.	.	.	.	.
Consumption of households, EUR-HRK m, nom.	29,092	32,726	38,128	18,133	20,263	.	.	.
annual change in % (real)	-5.1	9.9	5.2	7.1	1.9	1.0	2.5	2.0
Gross fixed capital form., EUR-HRK m, nom.	11,217	12,068	13,839	6,803.3	7,783	.	.	.
annual change in % (real)	-5.0	4.7	5.8	3.0	3.5	5.0	4.3	5.0
Gross industrial production ³⁾								
annual change in % (real)	-2.7	6.3	1.2	2.8	-0.8	-0.5	2.3	2.5
Gross agricultural production								
annual change in % (real)	1.1	-3.4	-6.5	.	.	.	.	.
Construction output ³⁾								
annual change in % (real)	4.4	9.3	4.0	4.5	3.2	.	.	.
Employed persons, LFS, th, average ⁴⁾	1,657	1,678	1,707	1,700	1,596	1,710	1,740	1,770
annual change in %	-1.3	1.3	1.7	2.5	.	1.9	1.5	1.5
Unemployed persons, LFS, th, average ⁴⁾	135	138	128	132	110	120	120	130
Unemployment rate, LFS, in %, average ⁴⁾	7.5	7.6	7.0	7.3	6.5	6.8	6.7	6.6
Reg. unemployment rate, in %, eop	9.3	7.3	6.7	6.1	5.6	.	.	.
Average monthly gross wages, EUR-HRK	1,223	1,274	1,380	1,363	1,546	1,500	1,600	1,700
annual change in % (real, gross)	2.4	1.6	-2.3	-0.9	3.3	3.0	2.5	2.3
Average monthly net wages, EUR-HRK	898	946	1,016	1,004	1,123	1,100	1,200	1,300
annual change in % (real, net)	2.6	2.7	-3.1	-1.7	1.8	2.0	2.3	2.5
Consumer prices (HICP), % p.a.	0.0	2.7	10.7	8.6	10.0	7.5	4.0	3.0
Producer prices in industry, % p.a.	-3.2	11.6	25.5	28.8	4.0	10.0	4.0	2.2
General governm. budget, EU def., % of GDP								
Revenues	46.8	46.2	45.5	.	.	47.0	46.3	47.0
Expenditures	54.1	48.7	45.1	.	.	49.4	48.3	48.8
Net lending (+) / net borrowing (-)	-7.3	-2.5	0.4	.	.	-2.4	-2.0	-1.8
General gov. gross debt, EU def., % of GDP	86.9	78.3	68.8	.	.	63.0	62.0	60.0
Stock of loans of non-fin. private sector, % p.a.	3.5	2.3	11.2	8.0	9.2	.	.	.
Non-performing loans (NPL), in %, eop ⁵⁾	5.4	4.3	3.0	3.8	3.0	.	.	.
Central bank policy rate, % p.a., eop ⁶⁾	3.0	3.0	3.0	3.0	4.0	.	.	.
Current account, EUR m	-267	1,022	-1,061	.	.	-330	130	1,420
Current account, % of GDP	-0.5	1.8	-1.6	.	.	-0.4	0.2	1.7
Exports of goods, BOP, EUR m	12,028	14,803	20,439	.	.	22,070	23,680	25,220
annual change in %	-6.2	23.1	38.1	.	.	8.0	7.3	6.5
Imports of goods, BOP, EUR m	20,882	26,205	38,419	.	.	43,100	47,000	51,200
annual change in %	-10.4	25.5	46.6	.	.	12.2	9.0	9.0
Exports of services, BOP, EUR m	8,928	14,315	19,871	.	.	24,500	27,300	31,200
annual change in %	-41.9	60.3	38.8	.	.	23.5	11.5	14.3
Imports of services, BOP, EUR m	3,622	4,494	5,692	.	.	6,000	6,200	6,400
annual change in %	-28.8	24.1	26.7	.	.	4.9	2.5	2.5
FDI liabilities, EUR m	1,111	3,903	3,488	.	.	3,590	.	.
FDI assets, EUR m	406	1,105	-260	.	.	1,200	.	.
Gross reserves of CB excl. gold, EUR m ⁷⁾	18,943	25,022	27,771	25,243	2,890	.	.	.
Gross external debt, EUR m	41,285	47,213	49,554	.	.	57,700	58,500	61,300
Gross external debt, % of GDP	81.8	81.0	74.0	.	.	78.0	74.0	73.0
Average exchange rate EUR-HRK/EUR	1.0005	0.9992	1.0001	1.0009	1.0000	1.0	1.0	1.0

Note: Croatia has introduced the Euro from 1 January 2023. Up to and including 2022 all time series in HRK as well as the exchange rates have been divided for statistical purposes by the conversion factor 7.5345 (HRK per EUR) to achieve euro-fixed series (EUR-HRK).

1) Preliminary. - 2) From 2021 based on census 2021. - 3) Enterprises with 20 and more employees. - 4) From 2023 according to census 2021. From 2021 the new LFS methodology is applied in line with the Integrated European Social Statistics Regulation (IESS). - 5) Loans more than 90 days overdue and those unlikely to be paid. - 6) Discount rate of CB. - 7) From January 2023 (Euro introduction) only foreign currency reserves denominated in non-euro currencies.

Source: wiiw Databases incorporating Eurostat and national statistics. Forecasts by wiiw.

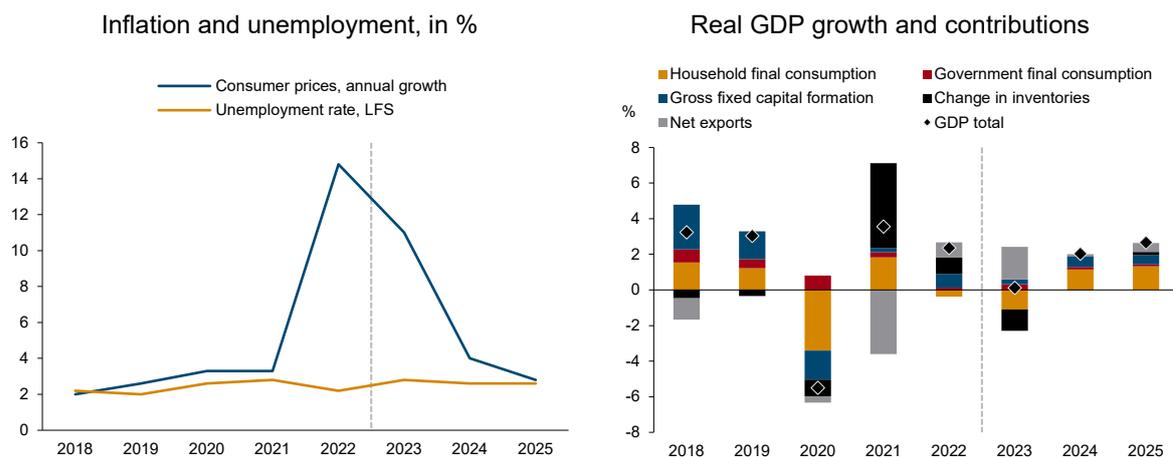


CZECHIA: In the slow lane

ZUZANA ZAVARSKÁ

There are not too many reasons to be optimistic about the economic performance of Czechia in 2023. The economy will remain stagnant (0.1%) and inflation high (11%). With prices rising steeply, household consumption is dragging growth downward, as are declining inventories. Following a period of surprising resilience, industry is also losing steam. The dim outlook for Germany is further weakening Czechia's prospects. A mild recovery can be expected in 2024, helped by inflation falling back.

Figure 6.6 / Czechia: Main macroeconomic indicators



Source: wiiw Annual Database incorporating national and Eurostat statistics, own calculation. Forecasts by wiiw.

The Czech economy contracted slightly in Q2 2023 (-0.4%) year on year, the same as in the previous quarter. The factors driving and hindering growth also remained largely unchanged, as the economy is dealing with the same headwinds. On the positive side, net exports (+2.5pp), fixed investments (+0.8pp) and government consumption (+0.7pp) all contributed to growth. On the negative side, household consumption (-1.9pp) and inventory reduction (-2.5pp) proved a drag on growth. Quarter-on-quarter GDP growth was negligible (0.1%); however, the dynamics of household consumption turned positive for the first time since Q3 2021.

Following a period of surprising resilience in 2022 and early 2023, industry has been losing steam. Much of the resilience seen hitherto can be attributed to the automotive sector, which has been offsetting the otherwise weak industrial performance and propping up the country's export position. Combined with a sluggish growth of imports, the trade balance has witnessed a significant improvement since last year. Yet, with the backlog being fulfilled through the release of inventories and with new

orders consistently declining, recent data suggest that the worst is yet to come. Unfavourable global conditions, particularly the underperformance of Czechia's most important trading partner Germany, further add to the bleak prospects for the country's export-oriented industry.

Despite clear disinflationary trends over recent months, inflation still topped 10% in August²² – the nineteenth consecutive month of double-digit HICP growth for Czechia. Electricity, gas and other fuels are pushing up the inflation figures most strongly. On the other hand, food prices contracted slightly in monthly terms, reflecting the decline in agricultural producer prices. While the pace of growth in consumer prices will keep slowing (helped by the base effect), it will temporarily pick up at the end of the year, due to the absence of the energy price cap put in place by the government last August. The measure was adopted to shield consumers from the cost of energy last winter, but the cap was abolished for this year. Nevertheless, inflation is forecast to moderate significantly in 2024 (to 4%) and to reach the central bank's 2-3% target range by 2025 (2.8%), down from this year's 11.0%.

Inflation is eating into the incomes of Czech workers, as real wages declined (by 3.1%) for the seventh quarter in a row in Q2 2023. While wages grew relatively strongly in nominal terms, that was not yet sufficient to compensate for the high inflation. Hence, it is hardly surprising that consumption is acting as a major drag on growth, as households continue to put off purchasing big-ticket items until their financial situation improves. A study conducted by the Czech National Bank using 2022 national accounts data reveals that the steepest decline in real incomes was experienced by employees, whereas self-employed persons saw an improvement in their real incomes.²³ Pensioners witnessed only a slight fall in their income in real terms, despite facing higher inflation rates. In terms of income quintiles, the middle class was the worst hit.

There are no major developments on the labour market, with shortages of labour continuing to be the main issue. The employment rate has not seen much of a change this year. However, the average number of registered employees in industry has been on a declining trend in recent months, reflecting the deteriorating climate in the sector. The unemployment rate is expected to increase slightly to 2.8% this year and to stay at 2.6% in the coming years, which still represents a significantly lower rate than the EU overall.

As of September 2023, there were over 366,000 Ukrainian refugees registered under the temporary protection scheme in Czechia, a large proportion of them employed. However, qualification mismatches remain an issue for the integration of refugees onto the labour market. The humanitarian aid available to Ukrainian refugees has been markedly reduced since July of this year, following amendments to the Lex Ukraine law package, which came into force in March 2022 to support Ukrainian refugees.

The Czech National Bank (CNB) is expected to be more patient than other non-euro central banks in the region when it comes to monetary easing. As anticipated, the CNB again kept the policy rate unchanged in August at 7% and has voiced caution about lowering the rate prematurely. Considering the bank was a first mover – raising interest rates as early as 2021 – its firm commitment to tackling inflation is evident. Given its conservative stance, the bank will likely hold off cutting the policy rate until

²² Harmonised Index of Consumer Prices (HICP) values. The Czech Consumer Price Index and the HICP differ due to methodological differences related to imputed rents.

²³ Martin Kábrt, 'Nerovný dopad inflace na české domácnosti: poznatky z národních účtů', Czech National Bank, 10 May 2023, https://www.cnb.cz/cs/o_cnb/cnblog/Nerovny-dopad-inflace-na-ceske-domacnosti-poznatky-z-narodnich-uctu/

the end of 2023 (and then only with a modest reduction of around 0.25pp), after which it is expected to gradually reduce the policy rate to the natural rate of 3% by 2025.

The koruna was deliberately strengthened in order to combat imported inflation, but the CNB announced in August that it would be phasing out its foreign exchange interventions. As import prices have been declining steeply this year, the move does not really come as a surprise. Following the announcement, the koruna has depreciated, but it is still significantly stronger against the euro than its historical average.

The government is in the process of passing an austerity package, due to come into force in 2024. The fiscal balance turned negative in 2020 following a period of surplus years, and has remained in the red ever since. Following months of negotiations, the consolidation package is now in the final stages of approval by the cabinet. The package will consist primarily of tax reforms, introducing changes to excise duties, property taxes and value added tax, among others. A pension reform was introduced earlier this summer, which has also sparked heated public debate. With the incumbent government intent on improving the public finance situation through austerity measures, the fiscal balance and the public debt are forecast to shrink over the coming years.

All in all, there are not too many reasons to be optimistic about the prospects for Czechia in 2023: the economy will remain stagnant (0.1%) and inflation high (11%). With prices still rising steeply, household consumption will drag down growth, as will declining inventories. Net exports will be the main growth driver, helped by the so far resilient automotive industry and weak imports. Moderate growth of 2% in 2024 is expected to follow, as consumption and investment regain some of their dynamism. However, a high level of uncertainty surrounding future developments in industry is clouding the outlook for 2024 and 2025, with risks mainly on the downside.

Table 6.6 / Czechia: Selected economic indicators

	2020	2021	2022 ¹⁾	2022 January-June	2023	2023 Forecast	2024 Forecast	2025
Population, th pers., average ²⁾	10,698	10,506	10,672	.	.	10,850	10,800	10,800
Gross domestic product, CZK bn, nom.	5,709	6,109	6,786	3,238	3,565	7,340	7,750	8,160
annual change in % (real)	-5.5	3.6	2.4	4.2	-0.6	0.1	2.0	2.7
GDP/capita (EUR at PPP)	28,050	29,710	31,950	.	.	.	.	.
Consumption of households, CZK bn, nom.	2,536	2,716	3,104	1,506	1,604	.	.	.
annual change in % (real)	-7.4	4.1	-0.8	3.7	-5.1	-2.4	2.5	2.9
Gross fixed capital form., CZK bn, nom.	1,516	1,589	1,817	839	891	.	.	.
annual change in % (real)	-6.0	0.8	3.0	5.4	-0.1	1.0	2.3	2.0
Gross industrial production								
annual change in % (real)	-7.2	6.9	2.5	1.0	0.6	0.3	2.0	3.3
Gross agricultural production								
annual change in % (real)	5.2	1.5	-1.3	.	.	.	.	.
Construction industry								
annual change in % (real)	-6.3	2.7	2.6	7.1	-2.7	.	.	.
Employed persons, LFS, th, average ³⁾	5,235	5,213	5,174	5,152	5,038	5,010	5,050	5,090
annual change in %	-1.3	-0.5	-0.8	-0.3	1.5	0.6	0.8	0.8
Unemployed persons, LFS, th, average ³⁾	137	151	118	118	134	140	130	140
Unemployment rate, LFS, in %, average ³⁾	2.6	2.8	2.2	2.3	2.6	2.8	2.6	2.6
Reg. unemployment rate, in %, eop	4.0	3.5	3.7	3.1	3.4	.	.	.
Average monthly gross wages, CZK	36,176	37,903	40,317	39,046	42,246	43,700	46,800	49,200
annual change in % (real, gross)	1.4	0.9	-7.6	-6.8	-4.8	-2.4	2.9	2.2
Consumer prices (HICP), % p.a.	3.3	3.3	14.8	12.6	15.2	11.0	4.0	2.8
Producer prices in industry, % p.a.	0.6	6.2	18.6	18.9	6.3	5.0	3.5	2.5
General governm. budget, EU def., % of GDP								
Revenues	41.5	41.4	41.0	.	.	42.2	42.8	42.3
Expenditures	47.2	46.5	44.7	.	.	46.4	44.7	43.3
Net lending (+) / net borrowing (-)	-5.8	-5.1	-3.6	.	.	-4.2	-1.9	-1.0
General gov. gross debt, EU def., % of GDP	37.7	42.0	44.2	.	.	45.0	44.3	43.0
Stock of loans of non-fin. private sector, % p.a.	4.1	8.4	4.5	8.1	5.4	.	.	.
Non-performing loans (NPL), in %, eop	2.8	2.4	1.9	2.1	1.8	.	.	.
Central bank policy rate, % p.a., eop ⁴⁾	0.25	3.75	7.00	7.00	7.00	6.75	4.50	3.00
Current account, EUR m	4,393	-6,639	-16,911	-4,239	-57	-3,800	-2,000	-200
Current account, % of GDP	2.0	-2.8	-6.1	-3.2	0.0	-1.2	-0.6	-0.1
Exports of goods, BOP, EUR m	128,226	148,552	174,999	85,818	94,424	183,400	190,700	200,200
annual change in %	-8.0	15.9	17.8	13.5	10.0	4.8	4.0	5.0
Imports of goods, BOP, EUR m	117,611	145,936	179,041	87,114	87,313	178,700	185,700	193,700
annual change in %	-9.6	24.1	22.7	23.5	0.2	-0.2	3.9	4.3
Exports of services, BOP, EUR m	22,842	25,275	31,985	14,725	17,121	34,500	37,000	39,600
annual change in %	-16.0	10.7	26.5	25.8	16.3	7.9	7.3	7.0
Imports of services, BOP, EUR m	18,912	21,180	28,333	12,477	15,217	30,900	33,100	35,400
annual change in %	-18.1	12.0	33.8	29.8	22.0	9.2	7.0	7.0
FDI liabilities, EUR m	7,367	10,953	10,045	4,362	5,746	10,000	.	.
FDI assets, EUR m	1,788	9,818	3,009	2,390	463	2,500	.	.
Gross reserves of CB excl. gold, EUR m	134,905	152,755	130,626	148,258	129,054	.	.	.
Gross external debt, EUR m	164,648	181,763	184,682	.	.	201,900	208,000	217,300
Gross external debt, % of GDP	76.3	76.3	66.9	.	.	66.0	65.5	65.5
Average exchange rate CZK/EUR	26.46	25.64	24.57	24.64	23.68	24.0	24.4	24.6

1) Preliminary. - 2) From 2022 including persons granted temporary protection. From 2021 according to census March 2021. - 3) From 2023 a new methodology in the LFS survey is applied. From 2021 new methodology in line with the Integrated European Social Statistics Regulation (IESS), excluding persons on parental leave from employed persons. - 4) Two-week repo rate.

Source: wiiw Databases incorporating Eurostat and national statistics. Forecasts by wiiw.

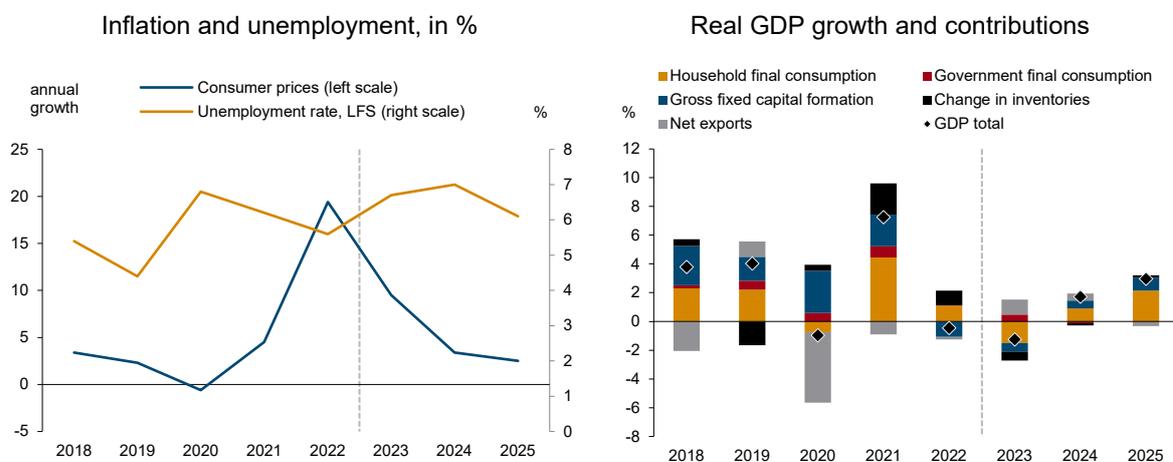


ESTONIA: No swift economic recovery on the cards

MARYNA TVERDOSTUP

The Estonian economy performed at below the EU-CEE average in H1, and GDP is now expected to decline by 1.3% in 2023 as a whole, as the aftermath of severe inflation, major supply issues and interest rate hikes unfolds. With shrinking domestic and foreign demand, the outlook for recovery will largely be determined by the country's success in gaining a share of new markets, the resurgence of foreign direct investment and the revival of Estonian firms' competitiveness. Economic growth is expected to gain ground slowly but steadily from next year onwards, with GDP growth forecast to be 1.7% in 2024 and 3.0% in 2025.

Figure 6.7 / Estonia: Main macroeconomic indicators



Source: wiiw Annual Database incorporating national and Eurostat statistics, own calculation. Forecasts by wiiw.

The economic downturn is likely to ease in H2 2023, but still the economy is expected to shrink by 1.3% for the full year; this will be followed by a recovery of 1.7% in 2024 and growth of 3.0% in 2025. Estonian GDP in Q2 2023 was 0.2% lower than in Q1 – the sixth consecutive quarter of decline. The economic outlook appeared fairly optimistic at the beginning of the year, but the results from H1 2023 clearly indicate the effects of high inflation, fragmented supply chains and sluggish external demand: economic performance has ended up in the doldrums. The usual driving forces of economic resilience – steady investment inflow, good business performance and sound private consumption – have all seen a decline since the beginning of the year.

The government has largely got to grips with inflation, but there are still economic consequences to be faced. Persistent economic sluggishness over the past year, interest rate hikes and deteriorating private consumption have all served to reduce the pressure on prices, so that inflation slowed from 20% in early 2023 to 4.6% in August. Yet huge sectoral differences have emerged: the cost of energy and durable goods has fallen, while food prices have been rising steadily. Inflation is forecast to average around 9.5% in 2023, to be followed by a major slowdown to around 3.4% in 2024 and 2.5% in 2025.

The record low business sentiment is blamed on interest rate rises, steadily high input prices, a lack of state support, and declining domestic and foreign demand. Industrial production has been stuck in steady decline over 2023, and production capacities have increasingly been underutilised. Electricity production, mining (other than oil shale) and manufacturing appear to have been the worst affected, while the oil shale sector is among the few to have posted persistent growth. However, the major increase in pollution charges envisaged for next year is likely to hit the oil shale sector's performance from 2024 onwards.

The deteriorating outlook for foreign trade has dealt Estonia's open economy a powerful blow. Weakening demand for Estonian products, especially in the Scandinavian countries, is undermining the prospects for recovery. Given that approximately 40% of the value created by Estonian firms is intended for exports, the economic decline experienced by Estonia's major trading partners (including Finland, Sweden and Germany) is depriving Estonian firms of an important source of revenue.

Partly because of high inflation, the competitiveness of Estonian firms on foreign markets has been eroded, and exports are likely to decline by a further 2.4% in 2023. Likewise, imports are projected to fall by 3.6% in 2023, largely on account of slackening domestic demand. Foreign trade will start to pick up in 2024, with exports and imports growing by 2.3% and 1.7%, respectively. However, we will see the pronounced revival of exports only in 2025, since gaining a share of the new markets will take time; and to regain their competitiveness, Estonian firms first need to get their input supply and production efficiency issues sorted out. IT technologies and services will remain a cornerstone of export activity through the turbulent years ahead.

Purchasing power has weakened, as the effects of the interest rate hike bite. Challenged by extremely high inflation since mid-2022, private consumption has been losing momentum. The steady rise in food prices, the higher cost of borrowing and larger payments on outstanding loans will all lead private consumption to contract in 2023. As real wage growth is eroded by inflation, and as the private savings used to finance the rising cost of living are depleted, consumption will fall in H2: for 2023 as a whole, the decline will be around 3%. However, it will bounce back in the coming years (with 1.8% growth in 2024 and 4.3% in 2025), fuelled largely by decelerating inflation and improving economic performance.

The labour market's resilience started to flag in mid-2023, with unemployment rising gradually and layoffs reaching even the most resistant IT sector. Unemployment is expected to surge to 6.7% on average in 2023, as companies struggle to cope with the consequences of inflation, interest rate hikes, investment decline, reduced demand and rising nominal wages. As the prospects of making a profit are crucial in securing funds, it will be challenging to attract new investment – even in the IT sector, so that companies will be forced to lay off IT specialists. Unemployment will peak at 7% in 2024, and the government is considering making 2,000 public employees redundant, in an attempt to curb public

spending and minimise the bureaucracy. Any revival of employment is only likely from 2025, and even then it will be fairly gradual. Moreover, the Estonian labour force will be swollen by the influx of Ukrainian refugees, and that will inflate the unemployment figures over the coming years.

Real wage growth has so far been reined in by inflation, and the declining demand for labour will impose further limits on wage rises. In nominal terms, gross monthly wages rose 12.4% year on year in Q2 2023, driven largely by an increase in public-sector wages. The private sector posted a steady increase in nominal gross wages over the year, but further developments will rely heavily on a revival of business activity, the resurgence of foreign direct investment (FDI) and a recovery in the competitiveness of Estonian firms on foreign markets.

The budget gap will not narrow within the forecast horizon, but the government is aiming at fiscal consolidation. Budget revenues are expected to surge in 2023, despite the economic downturn. This year, the government got the ball rolling on tax reform: several major changes are already under way (an increase in VAT; the elimination of tax exemptions) and several other reforms are in the pipeline (higher income tax; pollution charges). However, these have limited scope to narrow the budget deficit, which will be around 3.5% of GDP in 2023, declining to 2.7% by 2025. Government spending remains high, and further support activity is needed to stimulate economic recovery, boost the competitiveness of Estonian firms and safeguard internal security. Thus, the government has limited room for manoeuvre in reducing public spending: laying off public employees and capping wage growth in the public sector are among a few budget cuts currently being discussed.

The long-term model of Estonian economic success will probably require a rethink. Even though the current economic decline is, in all likelihood, only a temporary blip, if the country is to drag itself out of the mire and get the economy back on the track of steady growth, then a new longer-term strategy is required. The current economic outlook clearly indicates that re-establishing the competitiveness of the Estonian economy, reviving economic activity and boosting the flow of FDI are all contingent on strategic action on the part of the government and business. The new longer-term economic growth strategy should embrace several aspects: from implementing new, more efficient technologies in manufacturing, adopting green energy solutions and increasing labour productivity at all levels of business, to continuing with the reform of taxes.

Table 6.7 / Estonia: Selected economic indicators

	2020	2021	2022 ¹⁾	2022 January-June	2023	2023 Forecast	2024 Forecast	2025
Population, th pers., average	1,330	1,331	1,349	1,332	1,366	1,350	1,349	1,347
Gross domestic product, EUR m, nom.	27,430	31,169	36,011	17,070	18,244	38,900	40,900	43,200
annual change in % (real)	-1.0	7.2	-0.5	1.6	-3.3	-1.3	1.7	3.0
GDP/capita (EUR at PPP)	25,820	28,590	30,530	.	.	.	.	.
Consumption of households, EUR m, nom.	13,168	14,991	17,933	8,444	9,349	.	.	.
annual change in % (real)	-1.5	9.3	2.3	5.8	-2.2	-3.0	1.8	4.3
Gross fixed capital form., EUR m, nom.	8,175	9,090	9,910	4,597	4,153	.	.	.
annual change in % (real)	10.8	7.3	-3.7	-13.8	-13.5	-2.2	2.0	3.2
Gross industrial production								
annual change in % (real)	-3.0	13.3	-2.0	3.8	-11.7	-2.5	5.5	3.2
Gross agricultural production								
annual change in % (real)	0.0	-4.9	5.0	.	.	.	.	.
Construction industry								
annual change in % (real)	-6.1	9.4	-1.2	4.7	-11.5	.	.	.
Employed persons, LFS, th, average ²⁾	656.6	654.2	680.8	676.8	701.7	690	690	700
annual change in %	-2.2	-0.5	4.1	4.8	3.7	1.2	-0.6	1.1
Unemployed persons, LFS, th, average ²⁾	47.9	43.1	40.2	40.7	44.7	50	52	46
Unemployment rate, LFS, in %, average ²⁾	6.8	6.2	5.6	5.7	6.0	6.7	7.0	6.1
Reg. unemployment rate, in %, eop ³⁾	8.3	6.8	7.7	6.8	7.4	.	.	.
Average monthly gross wages, EUR ⁴⁾	1,448	1,548	1,645	1,602	1,807	1,770	1,890	2,010
annual change in % (real, gross)	3.4	2.1	-6.5	-4.7	-1.1	-1.5	3.0	4.0
Average monthly net wages, EUR ⁴⁾	1,185	1,269	1,349	1,314	1,482	1,450	1,540	1,640
annual change in % (real, net)	3.5	2.3	-6.5	-4.6	-1.1	-1.7	2.9	4.0
Consumer prices (HICP), % p.a.	-0.6	4.5	19.4	16.5	14.1	9.5	3.4	2.5
Producer prices in industry, % p.a.	-3.5	17.2	36.0	40.0	2.5	9.0	3.4	2.5
General governm. budget, EU def., % of GDP								
Revenues	39.5	39.4	38.7	.	.	41.0	42.3	42.6
Expenditures	44.9	41.8	39.6	.	.	44.5	45.6	45.3
Net lending (+) / net borrowing (-)	-5.5	-2.4	-0.9	.	.	-3.5	-3.3	-2.7
General gov. gross debt, EU def., % of GDP	18.6	17.8	18.5	.	.	21.6	20.7	19.5
Stock of loans of non-fin. private sector, % p.a.	4.8	7.5	11.7	10.6	8.1	.	.	.
Non-performing loans (NPL), in %, eop	0.4	0.2	0.2	0.2	0.2	.	.	.
Central bank policy rate, % p.a., eop ⁵⁾	0.00	0.00	2.50	0.00	4.00	.	.	.
Current account, EUR m	-272	-568	-1,042	-687	91	340	470	750
Current account, % of GDP	-1.0	-1.8	-2.9	-4.0	0.5	0.9	1.1	1.7
Exports of goods, BOP, EUR m	13,290	16,367	20,091	9,662	9,237	19,100	19,620	20,930
annual change in %	-0.2	23.2	22.8	29.1	-4.4	-4.9	2.7	6.7
Imports of goods, BOP, EUR m	13,533	17,662	22,749	10,998	10,001	21,300	22,080	23,400
annual change in %	-5.0	30.5	28.8	34.9	-9.1	-6.4	3.7	6.0
Exports of services, BOP, EUR m	5,736	8,254	10,817	5,080	5,362	11,500	12,600	13,650
annual change in %	-20.3	43.9	31.1	44.2	5.6	6.3	9.6	8.3
Imports of services, BOP, EUR m	5,470	7,073	8,386	4,022	4,204	8,950	9,400	10,050
annual change in %	6.1	29.3	18.6	9.6	4.5	6.7	5.0	6.9
FDI liabilities, EUR m	3,122	6,169	1,583	-1,837	1,543	1590	.	.
FDI assets, EUR m	253	5,558	1,560	-1,072	360	1220	.	.
Gross reserves of CB excl. gold, EUR m	1,615	2,081	2,068	2,237	2,244	.	.	.
Gross external debt, EUR m	24,333	26,523	30,519	29,896	32,018	33,100	34,200	35,600
Gross external debt, % of GDP	88.7	85.1	84.7	83.0	81.5	85.0	83.5	82.4

1) Preliminary. - 2) From 2021 the new LFS methodology is applied in line with the Integrated European Social Statistics Regulation (IESS). - 3) In % of labour force (LFS). - 4) From 2022 based on tax administration data, survey data before. - 5) Official refinancing operation rate for euro area (ECB).

Source: wiiw Databases incorporating Eurostat and national statistics. Forecasts by wiiw.

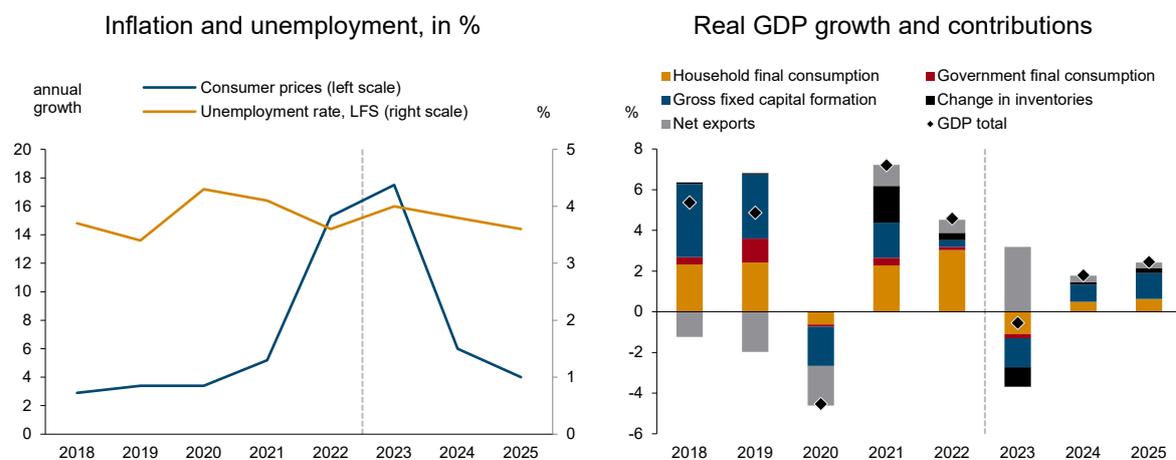


HUNGARY: A bumpy road to recovery from the recession

SÁNDOR RICHTER

Hungary has slipped into recession, with private consumption and investment contracting in H1 2023. Net exports mitigated the decline. The economy may soon see a slight recovery, but the annual growth rate will remain at below zero. Only a modest recovery is expected in 2024 and 2025. Growth would receive a fillip from EU transfers and a strong recovery of the main export markets, but neither of those things is currently on the horizon. Fiscal consolidation and continued high interest rates may slow the pace of recovery. Inflation will likely fall to below 10% later in 2023 and slowly sink further over the next two years.

Figure 6.8 / Hungary: Main macroeconomic indicators



Source: wiiw Annual Database incorporating national and Eurostat statistics, own calculation. Forecasts by wiiw.

The Hungarian economy has slipped into recession, with GDP declining for four quarters in a row. Very high inflation ate up the extraordinary revenues pumped into the economy last year in the run-up to the general election in April. Back in H1 2022 there was an expansion of over 10% in household consumption, in sharp contrast to the 3.6% decline reported for the corresponding period this year; retail trade data painted an even worse picture, with a 10.3% contraction. Investments have been dropping steeply as well. EU transfers remain suspended, which is handicapping public investment. Business-sector investment has been discouraged by the high interest rates. Nor have the country's main export markets been in very good shape: Hungarian exports barely grew. Nevertheless, net exports contributed positively to GDP growth in H1 2023, thanks to a sharp decline in imports. Summarising the sectors: industry declined, as did construction, as did services. Agriculture rode to the rescue, thanks to a record harvest this year.

Inflation has gradually declined since the beginning of the year, with headline inflation amounting to 14.2% in August. The reason for this is twofold: first, a very high basis last year; and second, decreasing private consumption, with real wages down 8.1% in H1. Inflation in Hungary has been considerably higher than the EU average, and also substantially in excess of the country's regional peers. An exceptionally painful feature of the inflation has been that food prices have risen much faster than the average, hitting people on low incomes hard. One might expect public uproar in such circumstances, but so far that has failed to materialise: the popularity of the Orbán government has barely been dented – as yet. Government propaganda has successfully conveyed the message that this is 'war inflation' caused by 'Brussels' and the collective West, which support Ukraine with weapons, rather than trying to achieve 'peace' (i.e. the surrender of Ukraine to Russia). It is hard to fathom why the public does not ask how it is that all the peer countries, which have been just as badly affected by the war as Hungary, have managed to curb inflation much more successfully.

The GDP slump is likely to end in H2 2023. The pace of quarter-on-quarter GDP decline has diminished over the last four quarters, and the final two quarters of 2023 will see a return to growth – albeit marginal, due partly to the low statistical basis. With lower inflation, the rate of decline in real incomes will also diminish. Nevertheless, households were spoilt by a formidable increase in real wages over the previous ten years, and the shock suffered this year has been extreme. Households have become cautious and now consume less, while high interest rates make credit very expensive. All in all, a rapid upward turn in household consumption is not on the cards.

Nor are there any grounds for optimism in the field of investment. There is no sign of de-escalation in the conflict between the Hungarian government and the EU over the 'rule of law' issues. This implies that no EU transfers will be forthcoming soon and therefore public-sector investments will likely be minimal. The business sector is none too eager to invest either, as the interest on credit is high, the domestic market is depressed, and the export markets are weak. The only exception to all this is the special raft of large foreign direct investment (FDI) projects in the production of batteries for electric vehicles. This has become a flagship project for the reindustrialisation efforts of the government. With substantial (mostly non-transparent) support from the government, this sector is booming, bringing in badly needed foreign currency. However, the intensely unfavourable environmental impact, the inadequate water supply, the labour shortage (on account of inauspicious demographic trends and outward migration) and the lack of public consultation on controversial issues render the initiative highly problematic. The order of importance of countries behind inward FDI has shifted: the previously dominant Western countries have been losing ground, while China and South Korea, the main players in the battery-production projects in Hungary, are gaining in importance.

Net exports – the only positive component of GDP in H1 2023 – will also contribute to growth in 2024 and 2025, but to much lesser extent than this year. In 2023, imports have been developing in a favourable direction, due to lower imported energy prices and shrinking domestic demand because of the recession. This latter effect will disappear as growth returns.

The budget deficit this year will be much larger than planned. The government is addressing the deficit in a half-hearted fashion: on the one hand, several initiatives have been curtailed or suspended; on the other, huge outlays are in the pipeline – e.g. the planned purchase of Budapest airport, which has a price tag of billions of euros. The interest burden on public debt is high and increasing: it could reach 4% of GDP next year. All the uncertainty over the pace of recovery and the suspension of EU transfers means

that a return to a fiscal deficit of below 3% of GDP is not very likely in 2024. The resumption by the EU of the excessive deficit procedure is, therefore, a real danger. In the current circumstances, there is no scope for fiscal support for recovery over the forecast horizon. Nor is a growth-friendly monetary policy on the cards. Even if cuts in the effective policy rate have started, the fragile HUF/euro exchange rate means that interest rates will remain too high for the business sector en masse to resume the expansion of production and to step up investment. Economic policy must choose between rapidly reining in inflation or spurring economic growth; currently moderating inflation seems to be the preferred option.

This year GDP will shrink slightly (0.5%), while 2024 and 2025 will likely see a modest recovery (1.8% and 2.4%) from the very low basis, with downside risks. A fillip to growth could come from EU transfers and a strong recovery of the main export markets, but there is no sign of either at the moment. The tight fiscal and monetary policy, as well as the imprudence and chaotic decision making shown at the highest level, could result in slower-than-expected growth. Inflation will likely dip below 10% later in 2023, and slowly sink further in 2024 and 2025 to approach the EU average.

Table 6.8 / Hungary: Selected economic indicators

	2020	2021	2022 ¹⁾	2022 January-June	2023	2023	2024 Forecast	2025
Population, th pers., average ²⁾	9,750	9,710	9,643	.	.	9,600	9,600	9,590
Gross domestic product, HUF bn, nom.	48,425	55,255	66,616	29,974	33,990	72,200	77,900	83,000
annual change in % (real)	-4.5	7.2	4.6	7.3	-1.7	-0.5	1.8	2.4
GDP/capita (EUR at PPP)	22,380	24,380	27,260	.	.	.	.	.
Consumption of households, HUF bn, nom.	22,947	25,538	31,941	14,923	17,636	.	.	.
annual change in % (real)	-1.3	4.8	6.5	10.1	-3.6	-2.3	1.0	1.3
Gross fixed capital form., HUF bn, nom.	12,841	15,139	18,909	7,957	8,378	.	.	.
annual change in % (real)	-7.1	6.5	1.2	8.0	-11.8	-5.0	3.0	4.5
Gross industrial production								
annual change in % (real)	-6.0	9.6	6.1	5.5	-4.8	-3.0	4.0	5.0
Gross agricultural production								
annual change in % (real)	-2.4	-0.7	-18.2	.	.	.	.	.
Construction industry								
annual change in % (real)	-9.8	11.9	1.9	6.0	-7.1	.	.	.
Employed persons, LFS, th, average ³⁾	4,461	4,642	4,709	4,697	4,721	4,730	4,740	4,750
annual change in %	-1.1	0.7	1.4	2.1	0.5	0.5	0.3	0.2
Unemployed persons, LFS, th, average ³⁾	198	196	176	169	196	200	190	180
Unemployment rate, LFS, in %, average ³⁾	4.3	4.1	3.6	3.5	4.0	4.0	3.8	3.6
Reg. unemployment rate, in %, eop ⁴⁾	6.2	5.1	4.8	4.8	4.6	.	.	.
Average monthly gross wages, HUF ⁵⁾	391,194	425,915	499,980	489,932	556,673	575,700	616,300	651,800
annual change in % (real, gross)	6.3	3.6	2.5	7.7	-8.1	-2.0	1.0	1.7
Average monthly net wages, HUF ⁵⁾	260,144	283,234	332,487	325,804	370,187	382,900	409,900	433,500
annual change in % (real, net)	6.3	3.6	2.5	7.7	-8.1	-2.0	1.0	1.7
Consumer prices (HICP), % p.a.	3.4	5.2	15.3	9.7	23.9	17.5	6.0	4.0
Producer prices in industry, % p.a.	4.3	13.6	33.6	27.8	18.2	12.0	4.0	4.0
General governm. budget, EU def., % of GDP								
Revenues	43.6	41.2	41.6	.	.	44.5	44.0	44.0
Expenditures	51.1	48.3	47.8	.	.	49.3	48.2	47.3
Net lending (+) / net borrowing (-)	-7.5	-7.1	-6.2	.	.	-4.8	-4.2	-3.3
General gov. gross debt, EU def., % of GDP	79.3	76.6	73.3	.	.	73.0	72.0	70.0
Stock of loans of non-fin. private sector, % p.a.	13.4	12.8	11.6	13.4	7.0	.	.	.
Non-performing loans (NPL), in %, eop ⁶⁾	3.6	3.2	3.2	3.5	3.0	.	.	.
Central bank policy rate, % p.a., eop ⁷⁾	0.60	2.40	13.00	7.75	13.00	11.00	7.00	4.00
Current account, EUR m ⁸⁾	-1,570	-6,252	-13,730	-4,824	166	-4,300	-1,200	100
Current account, % of GDP ⁸⁾	-1.1	-4.1	-8.1	-6.0	0.2	-2.3	-0.6	0.0
Exports of goods, BOP, EUR m ⁸⁾	88,655	100,885	124,340	60,274	66,303	128,100	134,500	141,200
annual change in %	-4.2	13.8	23.2	19.6	10.0	3.0	5.0	5.0
Imports of goods, BOP, EUR m ⁸⁾	89,990	105,311	139,246	65,949	66,211	139,200	144,800	152,000
annual change in %	-6.5	17.0	32.2	31.7	0.4	0.0	4.0	5.0
Exports of services, BOP, EUR m ⁸⁾	19,889	22,777	29,265	13,743	15,258	32,500	36,400	40,000
annual change in %	-26.1	14.5	28.5	38.2	11.0	11.0	12.0	10.0
Imports of services, BOP, EUR m ⁸⁾	15,885	17,863	21,245	10,070	10,544	22,700	24,700	26,700
annual change in %	-19.9	12.5	18.9	27.9	4.7	7.0	9.0	8.0
FDI liabilities, EUR m ⁸⁾	3,153	7,304	11,404	3,330	-66	4,000	.	.
FDI assets, EUR m ⁸⁾	803	4,345	7,218	3,750	2,293	2,000	.	.
Gross reserves of CB excl. gold, EUR m	32,115	33,501	33,533	32,195	34,539	.	.	.
Gross external debt, EUR m ⁸⁾	111,754	130,525	150,115	.	.	143,000	144,000	145,000
Gross external debt, % of GDP ⁸⁾	81.1	84.7	88.2	.	.	77.2	73.9	71.6
Average exchange rate HUF/EUR	351.25	358.52	391.29	374.71	380.71	390	400	410

1) Preliminary - 2) From 2022 according to census 2022. - 3) From 2021 the new LFS methodology is applied in line with the Integrated European Social Statistics Regulation (IESS). - 4) In % of labour force (LFS). - 5) Based on tax administration data. - 6) Loans more than 90 days overdue and those unlikely to be paid. - 7) Base rate. - 8) Excluding SPE.

Source: wiiw Databases incorporating Eurostat and national statistics. Forecasts by wiiw.

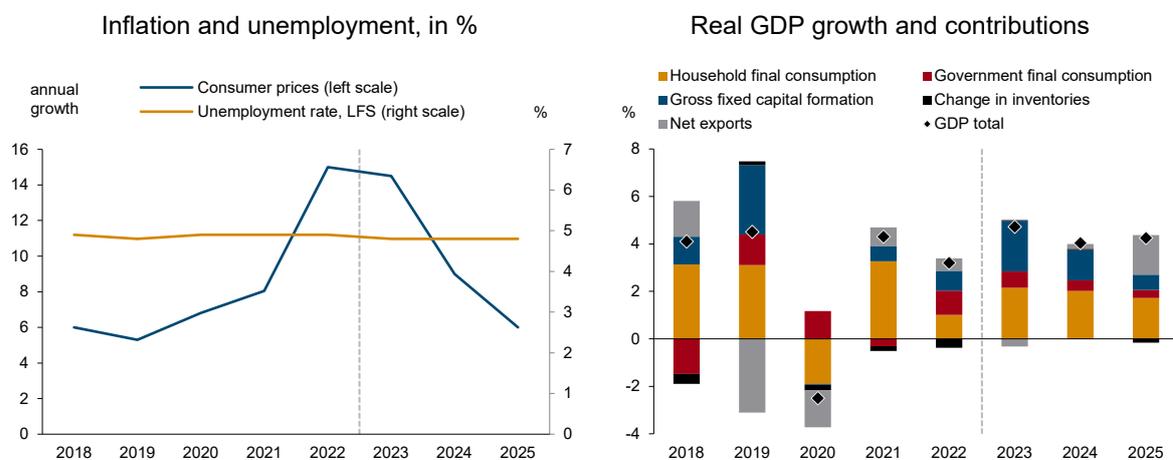


KAZAKHSTAN: Robust economic growth weakens slightly

ALEXANDRA BYKOVA

In H1 2023, the Kazakh economy recorded GDP growth that was among the highest of all CESEE countries – 5.1% – driven by investment and private consumption. We expect economic performance to slow in H2 2023, but growth for the full year will still exceed our previous forecast by 0.2 percentage points (pp), reaching 4.7%. Monetary policy loosening will remain cautious in light of the slow disinflation. Booming imports, fuelled by strong demand and declining exports (amid global oil prices that are lower than in 2022) lead to a higher current account deficit forecast for 2023 and 2024. In 2024-2025 we expect economic growth of around 4%.

Figure 6.9 / Kazakhstan: Main macroeconomic indicators



Source: wiiw Annual Database incorporating national and Eurostat statistics, own calculation. Forecasts by wiiw.

The economy is among the fastest growing in the CESEE region, but is losing momentum in the face of a looming slowdown in domestic demand. Real annual GDP growth peaked at 5.1% in H1 2023, before slowing: the figure for January-August was 4.9%, according to estimates by the Ministry of National Economy. The largest contributions to this strong performance were made by trade, construction and the oil sector, with growth rates of 11% (wholesale trade), 11.4% and 6.6%, respectively, year on year for the first eight months. By contrast, manufacturing grew by only 3.1%. Looking ahead, the leading indicators point to a moderate cooling of demand not only in manufacturing, but also in services. Given the robust H1 growth, we have revised our GDP forecast for 2023 up 0.2pp, to 4.7%.

Wage hikes and extensive consumer lending are supporting private consumption. An increase in the minimum wage and in public-sector wages in January 2023 partly cushioned the erosion of real incomes caused by high inflation: real incomes declined by only 1.4% year on year over the first seven months, while small year-on-year growth was already visible in June and July. Retail trade turnover expanded by 7.7% year on year over the first eight months, with slower growth posted in Q2. A 7.4% decline in the sale of foodstuffs was offset by a 15.6% increase in non-food sales, driven mainly by consumer lending. The volume of new consumer loans issued by banks in January-July 2023 was 42.9% greater than in the same period of 2022, and reached 5.6% of annual GDP. However, as those loans are mostly long term, credit growth so far has not had any adverse impact on the banking sector and the quality of assets. The expected moderation in inflation and the new 21.4% hike in the minimum wage from January 2024 (surprisingly announced by President Tokayev in his Address to the Nation in September) are likely to boost consumption next year. Although the labour market remains stable, persistent regional income and consumption disparities and the increasing burden of consumer loan repayments may potentially fuel social discontent.

Public and private investment in the oil and transport sectors and the modernisation of infrastructure are likely to boost economic growth in the medium term. Oil-sector investment (around a third of all investment) grew more slowly than overall investment in the first eight months of 2023 (by 5.7% and 12.2% year on year, respectively). By contrast, investment in the transport sector expanded by 50% year on year. In view of the geopolitical shifts under way, Kazakhstan is seeking to take advantage of its geographical location by prioritising the development of new transport corridors and the necessary infrastructure in both an east-west (Middle Corridor) and a north-south direction. Electricity, water and utilities (whose modernisation is long overdue) also posted investment growth of above 50% year on year, supported by the state and regional budget funding. We expect all those investments to persist in the medium term.

Policies to attract foreign direct investment (FDI) to develop priority manufacturing industries remain on the government agenda. After around USD 4.9bn of FDI inflows last year, the figure for H1 alone reached USD 4.3bn.²⁴ Although the oil sector continues to attract the bulk of this investment, the government hopes to intensify FDI in those priority industries with high value added.²⁵ However, state efforts to attract further FDI have been overshadowed by an international lawsuit brought by Kazakhstan over its share of revenue from old oil production-sharing agreements.²⁶

The current account turned from surplus in 2022 to deficit in 2023, due to rapidly rising imports and declining exports – a situation that is likely to persist next year. High demand for non-food and capital goods led to merchandise imports exploding by 35% in USD terms (year on year) in January-July, mostly on account of the increase in physical volumes (30.5%). Exports declined by 8.8%, mostly on the back of the fall in the price of oil. Both factors are likely to persist next year, and we have revised our forecast for the current account balance downwards. We expect exports to grow strongly in 2025, thanks to a substantial increase in oil production and exports following expansion of the Tengiz oil field.

²⁴ The data refer to FDI inflows (liabilities) from Balance of Payments statistics.

²⁵ Advanced metal processing; oil, gas and coal chemical industry; heavy machinery; uranium conversion and enrichment; automotive component manufacturing; fertiliser production.

²⁶ Kazakhstan is suing the Kashagan and Karachaganak operators – international consortia – for around USD 16bn, claiming that the operators should not have deducted those costs over the period 2010-2019.

However, any forecast of oil export revenues is fraught with uncertainty. The growth in oil production this year is mainly explained by the low statistical base, following last year's disruptions. The OPEC+ production cuts from May 2023 until the end of 2024 will constrain growth in Kazakhstan's oil output. Power outages in the main oil fields following major accidents in the energy system in July and August have also disrupted oil production. It has been announced that the increase in production volumes in the Tengiz oil field – previously expected to occur this year – has been delayed to the very end of 2024. On a positive note, the recently announced additional voluntary production cuts by Saudi Arabia and Russia are likely to support global oil prices. The priority assigned by the state to the development of domestic production in the chemical industry may boost domestic demand for oil and gas, which in turn is likely to limit export revenues.

The cautious monetary policy easing is explained by the slow disinflation, coming on the back of country-specific domestic factors. After peaking in February at 21.3%, annual inflation slowed to 13.1% in August. Food price disinflation has been faster than for other sub-components. The growth of non-food prices is being driven by strong consumption and the resulting pass-through inflation on imported goods. July's hike in tariffs and regulated fuel prices (which had previously been frozen) was responsible for an increase in this sub-component of inflation. Those country-specific factors explain the cautious monetary policy easing, with an interest rate cut in August of only 25 basis points to 16.5%. Further policy rate cuts are expected. However, the central bank has communicated various risks that could slow the pace of monetary loosening: new fiscal stimuli, the possible acceleration of inflation in Russia, a possible rise in global food prices, a further increase in domestic fuel prices, elevated inflation expectations.

The tenge's depreciation against the US dollar is likely to accelerate amid expanding imports. The tenge position against the US dollar has weakened by 2.3% since the start of the year. Aside from the global strengthening of the US dollar and rising imports, suspension of the mandatory sale of foreign currency earnings by quasi-public-sector entities caused tenge depreciation to accelerate in August (by 3%). The dynamics of global oil prices and imports will determine the speed of further tenge weakening. By contrast, an increase in exports (33.6%) to Russia, mostly machinery and chemical products – allegedly partly re-exports from Western countries – and a decline in imports (6.6%) in the country's trade with Russia in January-July added to the tenge's strength against the Russian rouble: it has appreciated by 23.8% against the Russian currency since the beginning of the year.

Fiscal policy is expected to remain loose next year, and new fiscal measures will push the budget deficit up to 2.6% of GDP in 2024. In addition to the increase in the minimum wage, new support measures are planned to develop the priority manufacturing industries and to boost domestic military production. Over the medium term, it has been announced that there will be a gradual reduction in the budget deficit, accompanied by reform of the tax code and a possible increase in VAT from 12% to 16%. Privatisation of some state-owned enterprises is expected as well. Fiscal federalism is likely to be further strengthened by devolving more tax collection and investment to the regions, as well as by holding direct elections at the regional level.

In 2024-2025, the economy will grow by around 4% year on year. The main growth drivers in the next two years will continue to be domestic demand backed by fiscal stimuli, as well as public and private investment in oil extraction, the transport sector and infrastructure.

Table 6.9 / Kazakhstan: Selected economic indicators

	2020	2021	2022 ¹⁾	2022 January-June	2023	2023 Forecast	2024 Forecast	2025
Population, th pers., average ²⁾	18,756	19,001	19,635	19,563	19,833	19,900	20,200	20,500
Gross domestic product, KZT bn, nom.	70,649	83,952	103,766	40,034	46,728	121,700	134,200	146,900
annual change in % (real)	-2.5	4.3	3.2	3.6	5.1	4.7	4.0	4.2
GDP/capita (EUR at PPP)	17,540	19,100	20,470	.	.	.	.	.
Consumption of households, KZT bn, nom.	36,661	42,419	49,725	.	.	.	.	.
annual change in % (real)	-3.7	6.3	2.0	.	.	4.5	4.2	3.6
Gross fixed capital form., KZT bn, nom.	17,463	19,342	22,164	.	.	.	.	.
annual change in % (real)	-0.2	2.6	3.6	.	.	10.0	6.0	3.0
Gross industrial production								
annual change in % (real)	-0.5	3.6	1.1	3.5	3.8	3.7	3.8	3.9
Gross agricultural production								
annual change in % (real)	5.7	-2.3	9.1	0.8	3.2	.	.	.
Construction industry								
annual change in % (real)	11.6	8.3	9.4	9.2	12.3	.	.	.
Employed persons, LFS, th, average ²⁾	8,732	8,807	8,972	8,965	9,073	9,080	9,200	9,320
annual change in %	-0.6	0.9	0.2	0.3	1.2	1.2	1.3	1.3
Unemployed persons, LFS, th, average ²⁾	449	450	458	460	453	460	460	470
Unemployment rate, LFS, in %, average ²⁾	4.9	4.9	4.9	4.9	4.8	4.8	4.8	4.8
Reg. unemployment rate, in %, eop	1.5	1.1	1.4	2.2	3.0	.	.	.
Average monthly gross wages, KZT ³⁾	213,003	250,311	309,885	298,722	353,069	361,900	408,300	447,900
annual change in % (real, gross)	6.8	8.8	7.7	10.6	0.2	2.0	3.5	3.5
Consumer prices, % p.a.	6.8	8.0	15.0	11.9	17.9	14.5	9.0	6.0
Producer prices in industry, % p.a.	-8.0	32.5	27.1	37.0	-2.9	-3.0	3.0	3.0
General governm. budget, nat. def., % of GDP								
Revenues	20.6	18.9	19.5	24.8	24.4	19.7	19.5	19.5
Expenditures	24.5	21.9	21.6	25.1	27.8	22.4	22.1	21.9
Deficit (-) / surplus (+)	-4.0	-3.0	-2.1	-0.3	-3.5	-2.7	-2.6	-2.4
General gov. gross debt, nat. def., % of GDP	30.5	27.6	25.7	22.1	24.6	25.0	26.0	26.0
Stock of loans of non-fin. private sector, % p.a.	5.5	26.5	23.3	27.5	21.7	.	.	.
Non-performing loans (NPL), in %, eop	6.9	3.3	3.4	3.6	3.3	.	.	.
Central bank policy rate, % p.a., eop ⁴⁾	9.00	9.75	16.75	14.00	16.75	16.00	12.00	8.00
Current account, EUR m ⁵⁾	-9,602	-2,163	7,433	6,005	-3,349	-8,100	-8,400	-4,700
Current account in % of GDP	-6.4	-1.3	3.5	7.4	-3.5	-3.3	-3.2	-1.7
Exports of goods, BOP, EUR m ⁵⁾	38,598	55,626	81,230	39,281	35,597	71,200	74,100	80,000
annual change in %	-27.4	44.1	46.0	56.6	-9.4	-12.3	4.1	8.0
Imports of goods, BOP, EUR m ⁵⁾	33,335	35,140	47,318	19,879	26,609	57,600	61,100	63,500
annual change in %	-9.2	5.4	34.7	28.3	33.9	21.7	6.1	3.9
Exports of services, BOP, EUR m ⁵⁾	4,562	4,977	7,534	3,046	3,706	8,800	9,300	9,500
annual change in %	-34.1	9.1	51.4	34.6	21.6	16.8	5.7	2.2
Imports of services, BOP, EUR m ⁵⁾	7,398	6,685	8,954	3,732	4,179	9,600	10,100	10,700
annual change in %	-28.2	-9.6	33.9	26.4	12.0	7.2	5.2	5.9
FDI liabilities, EUR m ⁵⁾	6,312	3,846	4,667	3,291	3,958	6,500	.	.
FDI assets, EUR m ⁵⁾	1,165	2,243	-2,861	1,378	1,003	1,400	.	.
Gross reserves of CB excl. gold, EUR m ⁵⁾	9,827	9,586	13,691	9,110	13,989	.	.	.
Gross external debt, EUR m ⁵⁾	133,664	145,234	150,654	.	.	150,000	155,000	157,000
Gross external debt, % of GDP	89.2	87.2	70.3	.	.	61.0	60.0	58.0
Average exchange rate KZT/EUR	471.44	503.88	484.22	491.33	488.24	497	518	540

1) Preliminary. - 2) From 2022 according to census 2021. - 3) Excluding small enterprises, engaged in entrepreneurial activity. - 4) Base rate (overnight repo rate as a target). - 5) Converted from USD.

Source: wiiw Databases incorporating national statistics. Forecasts by wiiw.

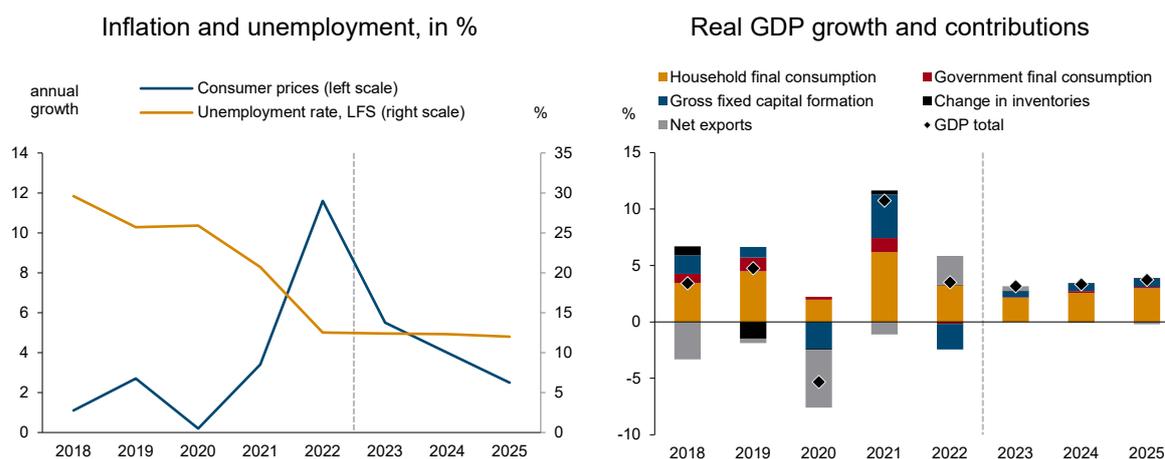


KOSOVO: Renewed tensions with Serbia jeopardising economic prospects

ISILDA MARA

Economic growth for 2023 will be around 3.2% and will be driven by domestic demand. Consumer price inflation has fallen substantially, though there is still upward pressure from food prices and energy costs. The uneasy dialogue with Serbia and the sanctions imposed by the EU are having repercussions for the economy, with a slowing of trade relations and EU investment.

Figure 6.10 / Kosovo: Main macroeconomic indicators



Source: wiiw Annual Database incorporating national and Eurostat statistics, own calculation. Forecasts by wiiw.

Economic growth in the first half of the year was 3%, with the main driver being domestic demand. However, this growth is showing signs of losing its vigour, and will be weaker than projected in our previous forecast. Both government and household consumption rose by less than 3% in H1 2023, while gross fixed capital formation remained subdued and did not exceed 2% of growth. Exports of goods lost steam, contracting by 6% in January-July 2023, year on year, in a reversal of the positive trend witnessed over the past three years. By contrast, exports of services maintained their positive trajectory. Overall, however, net exports have been a drag on economic growth and are expected to be so for the remainder of the year. The main sectors of the economy that supported growth were the information and communication sector, wholesale and retail trade, and scientific activities. On the flip side, other sectors such as manufacturing, the extraction industry and public administration made a negative contribution to economic activity, especially in Q2 2023.

Inflationary pressure has eased considerably this year. In August, annual consumer price inflation was 3.2%, and on average for January-August 2023 it still stood at 6%. For 2023 as a whole, the figure is expected to decline to 5.5%. Nevertheless, the upward pressure on inflation from food prices and energy costs continues: in the case of foodstuffs, inflation remained high – at above 10% – in the period

January-August. The expectation is that inflation will pick up again at the start of 2024 and will be driven by food and energy costs. Turning to energy, in real terms imports of electricity have risen further this year – up 8% in H1 2023 – due to higher demand from business and industry (though less so from households). At the same time, exports declined by 18%, resulting in the country again being a net importer of electricity.

The public finances have been doing well: revenues have been rising faster than government spending (at least up until July 2023). Public investment (mainly on the road network) grew strongly – by 80% for the period January-July 2023. That said, such investment has absorbed only 10% of public spending and is far below the budgetary plan. Government support for more vulnerable groups of the population has proved rather a failure: social transfers and subsidies – planned to expand by 5% for the year as a whole – actually contracted by 2% in the period January-July. All this will help keep the public debt relatively low, at 20% of GDP (one of the lowest figures in the region), but it will do nothing to assist the economy.

The signals from the banking sector are more positive. It has remained resilient, and demand for credit has been rising. Especially enterprises continued to seek loans in Q2, though at a slower pace than in Q1. Non-performing loans stood at a record low of 2% in Q2. However, the banks have recently tightened up on their conditions for loans and – together with the raising of interest rates – this could contribute to reduced credit demand from the corporate sector. With respect to households, however, the credit conditions have been tightened only marginally, and the expectation is that demand for credit from households will rise further, mainly to cover consumer spending.

After a relatively calm summer, political tensions in northern Kosovo flared up again recently, and there is deadlock in the dialogue with Serbia. In May 2023, the situation almost escalated after Albanian mayors took office in the wake of the April local elections in northern Kosovo. The elections had been held on the advice of the country's international partners; however, they were boycotted by ethnic Serbs, who then refused to accept the election results. Protests followed and emotions ran high, although the tension was relieved somewhat over the summer, thanks to the intervention of international partners and the protection and presence of the NATO-led international peace-keeping force KFOR. The Kurti government has agreed to fresh elections being held, and the formation of Association of Serb-majority Municipalities should undergo in line with the Kosovo constitution. The meeting of Kosovo's Prime Minister Albin Kurti and Serbia's President Alexander Vučić on 14 September, under the auspices of the EU and the US, was the latest in a round of meetings, but produced no tangible outcome. Ten days after the meeting, tensions flared again. Four people were killed – a Kosovar policeman and three ethnic Serb gunmen – and six other ethnic Serb gunmen were injured after a shootout in Banjska (northern Kosovo). It is difficult to see how the situation will resolve itself, given that the dialogue with Serbia is frozen and it is only with the assistance of the international community that further dangerous escalations can be avoided.

The uneasy dialogue with Serbia and the EU sanctions are already having a deleterious effect on the economy. The EU seems to blame mainly Kosovo for the stalemate in its dialogue with Serbia, and has announced a raft of sanctions against Kosovo, depriving the country of at least EUR 500m in EU funding. Trade relations and EU investment seem to have suffered somewhat. Although the inflows of foreign direct investment (FDI) rose by 14% in H1 2023, this was driven largely by Turkish investment. Kosovo's other major partners – such as the EU and the US – cut their FDI inflows. In particular, the

main investing partners – Germany and Switzerland – have reduced their FDI inflows to Kosovo by 7% and 4%, respectively, while FDI from the US almost halved. Turning to exports, those to the EU, Kosovo's main trading partner, recorded a decline of 7% in January-July – although (exceptionally) exports to Germany continued to expand by 12%. Trading relations have also mutated: Kosovo's exports to the countries covered by the Central European Free Trade Agreement (CEFTA) rose 6% in January-July – apart from to Serbia, where exports dropped by 15% (imports from that country shrank by almost 30% over the same period).

That economic activity is running at below its potential is shown by the meagre growth in employment. High-frequency data suggest that employment in manufacturing has remained almost unchanged, whereas it has contracted in retail trade. What new jobs there are have mainly been created in the service sector. Overall, the labour market situation remains dire, with an unemployment rate that remains among the highest in the region (12.5% as of 2022) and persistently high youth unemployment (age 15-24) of 19%. On top of that, a third of young people aged 15-24 are not in education, employment or training (NEET). The labour market mismatch and the low wages (average nominal wages of EUR 521, as of 2022) are a source of frustration on both the supply and the demand side of the labour market: employers struggle to find workers with the proper skills, and so turn their attention to workers from abroad; meanwhile, job seekers fail to find a decent job. Potential emigration from Kosovo is one of the highest in the region: according to the Balkan Barometer, 57% of Kosovars would consider moving and working abroad (against an average of 44% for the Western Balkan region as a whole). It is no coincidence that remittances have continued to rise and constitute an important source of income for many Kosovo households, helping to smooth their consumption: remittances soared by 12% in the period January-July 2023 and will most likely exceed 10% of GDP again this year.

Overall, we expect real growth this year to be 3.2% and to be driven by domestic demand, mainly household consumption. In the medium term, we expect weaker external demand as a consequence of the EU sanctions against Kosovo and other side effects of the uneasy dialogue with Serbia. Accordingly, growth will be around 3.3% in 2024 and 3.7% in 2025, 0.4 percentage points down on our previous forecast.

Table 6.10 / Kosovo: Selected economic indicators

	2020	2021	2022 ¹⁾	2022 January-June	2023	2023 Forecast	2024 Forecast	2025
Population, th pers., average	1,790	1,786	1,782	.	.	1,778	1,774	1,770
Gross domestic product, EUR m, nom.	6,772	7,958	8,955	3,955	4,266	9,700	10,500	11,300
annual change in % (real)	-5.3	10.7	3.5	3.7	2.9	3.2	3.3	3.7
GDP/capita (EUR at PPP)	7400	8660	9170	.	.	.	.	.
Consumption of households, EUR m, nom.	5,718	6,572	7,656	3,648	3,836	.	.	.
annual change in % (real)	2.5	7.3	3.9	6.1	2.3	2.5	3.0	3.5
Gross fixed capital form., EUR m, nom.	2,012	2,617	2,848	.	.	.	.	.
annual change in % (real)	-7.6	13.0	-6.8	.	.	1.7	2.0	2.3
Gross industrial production ²⁾								
annual change in % (real)	0.8	0.3	0.2	0.2	-0.1	0.5	2.0	3.0
Gross agricultural production								
annual change in % (real)	2.7	-2.0	4.5	.	.	.	.	.
Construction output ³⁾								
annual change in % (real)	-9.0	8.8	-3.0	.	.	.	.	.
Employed persons, LFS, th, average ⁴⁾	347.1	383.3	403.8	.	.	410	420	430
annual change in %	-4.4	10.4	5.4	.	.	1.0	2.0	2.0
Unemployed persons, LFS, th, average ⁴⁾	121.4	100.2	58.1	.	.	60	60	60
Unemployment rate, LFS, in %, average ⁴⁾	25.9	20.7	12.5	.	.	12.4	12.3	12.0
Reg. unemployment rate, in %, eop	.	.	.	.	.	.	.	.
Average monthly gross wages, EUR	466	484	521	608.0	693.3	620	680	720
annual change in % (real, gross)	-2.5	0.4	-3.5	-12.1	6.6	12.0	6.0	4.0
Average monthly net wages, EUR	416	432	446	538.7	612.8	480	510	530
annual change in % (real, net)	-3.4	0.4	-7.5	-12.0	6.4	1.0	2.0	2.0
Consumer prices (HICP), % p.a.	0.2	3.4	11.6	7.0	7.0	5.5	4.0	2.5
Producer prices, % p.a.	-0.6	4.9	9.3	9.8	-0.5	-0.5	1.0	2.5
General governm. budget, nat. def., % of GDP								
Revenues	25.4	27.4	27.7	28.6	31.5	28.0	28.2	28.5
Expenditures	33.0	28.8	28.3	24.6	26.5	28.5	29.6	30.5
Deficit (-) / surplus (+)	-7.6	-1.3	-0.5	3.9	4.9	-0.5	-1.4	-2.0
General gov. gross debt, nat. def., % of GDP	22.0	21.1	19.6	20.8	17.3	20.0	20.5	21.0
Stock of loans of non-fin. private sector, % p.a.	7.1	15.4	16.0	17.3	14.3	.	.	.
Non-performing loans (NPL), in %, eop	2.7	2.3	2.0	2.1	2.0	.	.	.
Central bank policy rate, % p.a., eop ⁵⁾	6.01	5.80	6.29	6.0	6.5	6.5	6.5	6.0
Current account, EUR m	-472	-695	-940	-639	-554	-860	-830	-860
Current account, % of GDP	-7.0	-8.7	-10.5	-16.2	-13.0	-8.9	-7.9	-7.6
Exports of goods, BOP, EUR m	475	753	932	451	427	860	890	910
annual change in %	20.8	58.4	23.8	31.0	-5.4	-8.0	3.0	2.5
Imports of goods, BOP, EUR m	3,048	4,320	5,219	2,436	2,528	5,380	5,570	5,680
annual change in %	-5.7	41.7	20.8	27.4	3.8	3.0	3.5	2.0
Exports of services, BOP, EUR m	995	1,906	2,503	867	1,089	2,850	3,020	3,140
annual change in %	-40.6	91.6	31.3	50.7	25.7	14.0	6.0	4.0
Imports of services, BOP, EUR m	603	871	1,127	459	536	1,260	1,300	1,400
annual change in %	-19.5	44.4	29.4	36.3	16.8	12.0	3.0	8.0
FDI liabilities, EUR mn	346	421	778	327	374	790	.	.
FDI assets, EUR mn	59	100	176	82	102	130	.	.
Gross reserves of CB excl. gold, EUR m	901	1,100	1,176	1,280	1,266	.	.	.
Gross external debt, EUR m	2,502	2,956	3,424	.	.	3,500	3,700	3,800
Gross external debt, % of GDP	37.0	37.1	38.2	.	.	36.0	35.0	34.0

1) Preliminary. - 2) Turnover in manufacturing industry (NACE C), covering 95% of enterprises. - 3) Based on gross value added data. -

4) Population 15-64. - 5) Average weighted effective lending interest rate of commercial banks (Kosovo uses the euro as national currency).

Source: wiiw Databases incorporating national statistics. Forecasts by wiiw.

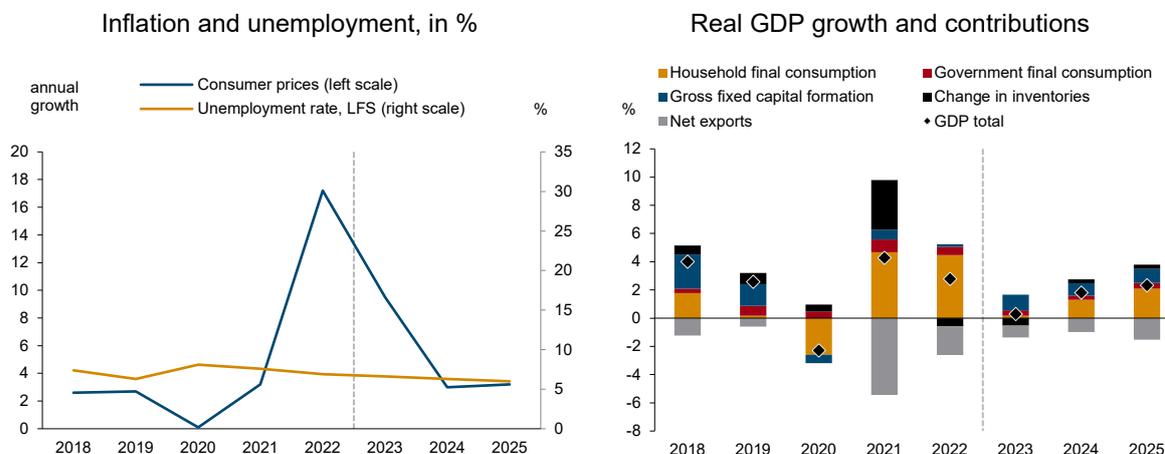


LATVIA: Waiting for the tide to float the boats

SEBASTIAN LEITNER

Whereas in 2022 economic activity remained quite lively right up to the end of the year, in 2023 the effects of dwindling external demand and reluctant household consumption are dampening GDP growth. Inflation is declining significantly, so that real incomes are again increasing in H2. While public investment has been expanding this year, enterprises are in the process of running down their stocks. Given the still rather tight labour market, the unemployment rate will fall slightly in 2023 – and even more so in the coming two years. Assuming that the EU economy finds its way back on track next year, we expect a subdued revival in Latvia's GDP growth, to 1.8% in 2024 and 2.3% in 2025.

Figure 6.11 / Latvia: Main macroeconomic indicators



Source: wiiw Annual Database incorporating national and Eurostat statistics, own calculation. Forecasts by wiiw.

Latvian goods exports declined in the first half of 2023 in real terms, and will continue to shrink throughout the year. The economies of the country's main trading partners are in the doldrums – or even in recession. An important factor is that housing construction in the Scandinavian countries is declining, which is putting pressure on Latvia's exports of building materials and of services. Also, the transport sector – relatively important in the country – is ailing in this context. Exports to Russia are on the decline, but at a slower pace than expected. In parallel, we see a big increase in exports to Kazakhstan, Kyrgyzstan, Armenia and other CIS countries – most likely a large proportion of those goods are then re-exported to Russia and Belarus. At the same time, Latvian producers are further disentangling themselves from Russian and Belarussian commodities and inputs. In general, and

despite weakening exports, we expect the current account deficit to decline from more than 6% of GDP last year to slightly below 3% in 2023.

In common with the other Baltic states, Latvia was among the EU countries worst affected by the energy and commodity price rises of 2022, but inflation is again declining. By August 2023 it had already fallen to 5.4%. Nevertheless, food and beverages – important items in the consumer basket of low-income households – are still subject to quite rapid price rises, as are services. In the coming winter, we expect the prices of goods and services related to housing to increase again somewhat, since we have already seen a slight rise in wholesale energy prices. We expect consumer price inflation to fall to 3% in 2024.

Following the slump in real incomes in 2022, the declining inflation rate will bring about a revival of the purchasing power of households and private consumption as early as in the second half of 2023. Not only did the government raise the statutory minimum wage in January 2023 by 24% (to EUR 620 a month), but it has also scheduled another increase of 13% in 2024. This will help lower-income groups sustain their consumption levels. We thus expect that household expenditure will also experience an upswing in the second half of this year, and even more so in 2024.

Although the economy is stagnating at the moment, employment is projected to increase slightly in 2023. The decline in industrial production has resulted in the number of manufacturing jobs falling slightly. Bigger declines are reported for transport and both wholesale and retail trade. In business services, however, there is steady growth in jobs. Job vacancy rates are still high and have declined only slightly in recent months. We expect the unemployment rate to rise by only a little in 2023 and then to fall again gradually next year. By the end of July 2023, about 42,000 Ukraine refugees – more than 2% of the Latvian population – were benefiting from temporary protection and residing in the country. Thanks to the favourable labour market conditions at the moment, about 20% of those refugees have found a job in Latvia.

Following anaemic developments last year, 2023 has shown an upswing in investment activity, particularly by public institutions. However, the raising of interest rates by the European Central Bank (ECB) to curb inflationary developments has meant that Latvian entrepreneurs remain cautious in planning their investments. Following growth in construction output in the first half of 2023, recent figures on the number of building permits granted suggest that investment in real estate will again decline in the medium term. Having taken advantage throughout 2022 of the (still relatively) cheap inputs to build up their inventories, businesses had already started to run down those stocks in Q2 2023. However, the budget envisages a rise in public investment in infrastructure this year, in order to use the allocations from EU funds, particularly the Recovery and Resilience Facility.

The government deficit is likely to attain 3.5% of GDP in 2023, on account of government support for households and enterprises to deal with the burden of high energy bills. Should the economic upswing materialise, a return of the fiscal deficit to close to 2% of GDP is likely towards 2025. The government will move forward in increasing defence spending over the medium term to 2.5% of GDP in 2025.

Since Prime Minister Kariņš lost the support of his coalition partners – his notion of bringing the Progressive party into government was rejected – he stepped down in August. On 15 September, Evika Siliņa, also from the conservative people's party New Unity, took over as prime minister, making Latvia now the third Baltic country to be ruled by a woman. The other partners in the coalition government remain the same: the far-right National Alliance (which has been part of all coalition governments since 2011) and the United List, a party with a focus on the regions. Thus, the new government's economic policy will likely remain more or less unchanged. Prime Minister Siliņa, who served as Minister of Welfare under Mr Kariņš, has recently spoken in favour of an increase in the level of pensions, in order to sustain their purchasing power.

All in all, we have revised our forecast for GDP growth in 2023 downwards – from 0.8% in the summer to 0.3% now. According to the baseline scenario, however, GDP growth will pick up to 1.8% in 2024 and 2.3% in 2025. This scenario assumes a determined willingness on the part of EU actors to refrain from becoming too austerity oriented in the face of the ongoing stagnation. And that includes the ECB refraining from being too hawkish with its interest rate rises in the coming months.

Table 6.11 / Latvia: Selected economic indicators

	2020	2021	2022 ¹⁾	2022 January-June	2023	2023 Forecast	2024 Forecast	2025
Population, th pers., average	1,900	1,884	1,879	1,870	1,885	1,885	1,885	1,880
Gross domestic product, EUR m, nom.	30,265	33,617	39,063	17,945	19,321	42,900	45,000	47,500
annual change in % (real)	-2.3	4.3	2.8	4.9	0.1	0.3	1.8	2.3
GDP/capita (EUR at PPP)	21,600	23,250	25,940	.	.	.	.	.
Consumption of households, EUR m, nom.	16,822	18,868	23,247	10,706	12,012	.	.	.
annual change in % (real)	-4.5	8.4	8.0	11.9	-0.5	0.3	2.2	3.5
Gross fixed capital form., EUR m, nom.	7,003	7,500	8,508	3,506	4,094	.	.	.
annual change in % (real)	-2.6	2.9	0.7	1.4	7.8	5.0	4.0	4.5
Gross industrial production ²⁾								
annual change in % (real)	-1.5	6.7	0.9	4.2	-6.4	-4.0	2.0	4.0
Gross agricultural production								
annual change in % (real)	4.9	-8.1	1.9	.	.	.	.	.
Construction industry								
annual change in % (real)	2.7	-6.1	-11.4	-11.6	16.1	.	.	.
Employed persons, LFS, th, average ³⁾	893.0	869.5	891.2	882.3	889.2	900	905	910
annual change in %	-1.9	-3.0	2.5	2.3	0.8	1.0	0.5	0.5
Unemployed persons, LFS, th, average ³⁾	78.7	70.6	65.2	65.4	60.2	64	61	58
Unemployment rate, LFS, in %, average ³⁾	8.1	7.6	6.9	7.0	6.4	6.6	6.3	6.0
Reg. unemployment rate, in %, eop ⁴⁾	7.7	6.7	6.1	5.9	5.5	.	.	.
Average monthly gross wages, EUR	1,143	1,277	1,373	1,332	1,494	1,500	1,580	1,680
annual change in % (real, gross)	6.0	8.2	-8.3	-4.5	-2.9	0.0	2.5	3.0
Average monthly net wages, EUR	841	939	1,006	975	1,092	1,100	1,160	1,230
annual change in % (real, net)	5.8	8.1	-8.7	-5.2	-3.0	0.0	2.5	3.0
Consumer prices (HICP), % p.a.	0.1	3.2	17.2	12.8	15.5	9.5	3.0	3.2
Producer prices in industry, % p.a.	-2.2	13.4	34.6	31.0	12.7	13.0	2.0	1.0
General governm. budget, EU def., % of GDP								
Revenues	37.9	37.0	35.8	.	.	38.0	37.0	38.0
Expenditures	42.3	44.2	40.2	.	.	41.5	39.8	40.3
Net lending (+) / net borrowing (-)	-4.4	-7.1	-4.4	.	.	-3.5	-2.8	-2.3
General gov. gross debt, EU def., % of GDP	42.0	43.7	40.8	.	.	41.0	41.5	41.0
Stock of loans of non-fin. private sector, % p.a.	-3.8	3.2	7.1	5.6	3.4	.	.	.
Non-performing loans (NPL), in %, eop ⁵⁾	3.1	2.5	1.8	2.3	1.6	.	.	.
Central bank policy rate, % p.a., eop ⁶⁾	0.00	0.00	2.50	0.00	4.00	.	.	.
Current account, EUR m	788	-1,414	-2,494	-1,554	-883	-900	-900	-900
Current account, % of GDP	2.6	-4.2	-6.4	-8.7	-4.6	-2.1	-2.0	-1.9
Exports of goods, BOP, EUR m	13,440	16,195	20,491	9,588	9,331	20,700	21,500	22,300
annual change in %	5.3	20.5	26.5	32.6	-2.7	1.0	3.9	3.7
Imports of goods, BOP, EUR m	14,992	18,969	24,967	11,749	11,115	24,200	25,200	26,300
annual change in %	-2.6	26.5	31.6	36.5	-5.4	-3.1	4.1	4.4
Exports of services, BOP, EUR m	4,707	5,192	7,000	3,095	3,616	7,100	7,400	7,700
annual change in %	-15.8	10.3	34.8	35.3	16.8	1.4	4.2	4.1
Imports of services, BOP, EUR m	2,862	3,574	4,796	2,126	2,614	4,700	4,700	4,700
annual change in %	-9.2	24.9	34.2	37.5	23.0	-2.0	0.0	0.0
FDI liabilities, EUR m	816	3,185	1,174	479	649	2000	.	.
FDI assets, EUR m	168	2,338	-119	-392	213	-300	.	.
Gross reserves of CB excl. gold, EUR m	3,982	4,504	3,819	4,285	4,006	.	.	.
Gross external debt, EUR m	36,763	36,854	39,270	38,152	39,950	39,500	39,600	39,000
Gross external debt, % of GDP	121.5	109.6	100.5	97.7	93.1	92.0	88.0	82.0

1) Preliminary. - 2) Enterprises with 20 and more employees. - 3) From 2021 the new LFS methodology is applied in line with the Integrated European Social Statistics Regulation (IESS). - 4) In % of labour force (LFS). - 5) Loans more than 90 days overdue and those unlikely to be paid. - 6) Official refinancing operation rates for euro area (ECB).

Source: wiiw Databases incorporating Eurostat and national statistics. Forecasts by wiiw.

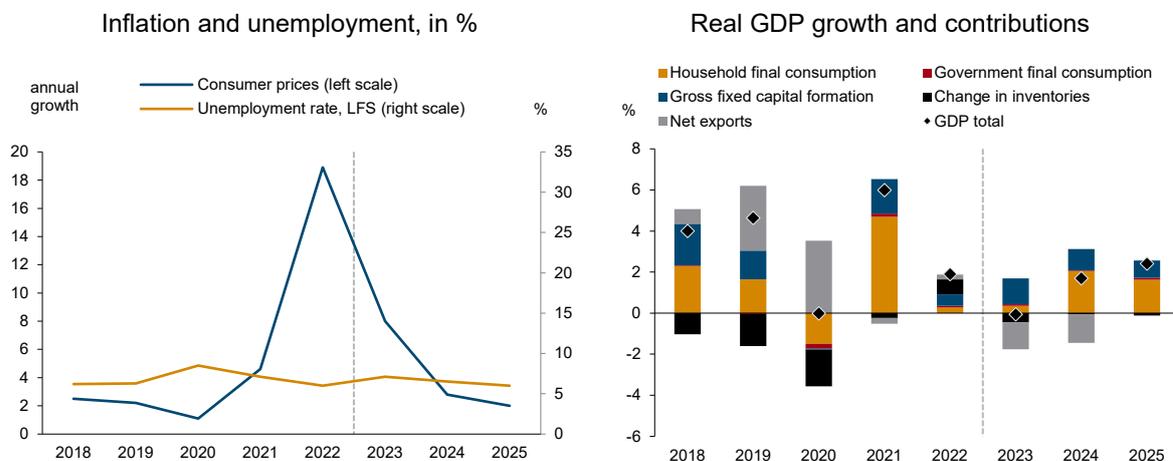


LITHUANIA: Stagnation to last longer than expected

SEBASTIAN LEITNER

The economy performed worse than expected in H1 2023, and we do not foresee any significant upswing before the end of the year. Since inflation has been declining considerably, real income will pick up again in H2 2023; this will support household consumption – after four consecutive quarters of decline. However, it is only in 2024 that the rise in real incomes will gain momentum. Despite the stagnation, the labour market remains robust. Private investment activity is declining, since external demand is in the doldrums, while the government has considerably raised infrastructure investment. We expect real GDP to decline by 0.1% in 2023; this will be followed by a modest upswing to 1.7% in 2024 and then 2.4% in 2025.

Figure 6.12 / Lithuania: Main macroeconomic indicators



Source: wiiw Annual Database incorporating national and Eurostat statistics, own calculation. Forecasts by wiiw.

Exports declined substantially in the first seven months of 2023, and we do not foresee any upswing before the end of the year. The fall in oil prices up to July depressed the profits of the refining sector; but exporters in the chemical, plastics and furniture industries are also ailing and have started to cut back on staff. The sluggish EU-wide economic development is likely to result in a stagnating Lithuanian manufacturing sector in the coming months. Lithuania is continuing to disentangle its economic ties with Russia, but still that neighbouring country is Lithuania's fourth most important trade partner in terms of exports (imports from Russia have become negligible). We anticipate a gradual revival of export activity only in 2024; however, this will depend on the monetary and fiscal policy stance of the European Central Bank (ECB) and the EU, respectively, in the coming months. At the moment, however, the signs do not suggest that a speedy economic recovery is imminent. Given the reduction in

transit trade, the transport sector – which used to profit from shipments between Lithuanian ports and the country's eastern neighbours of Russia and Belarus – is facing a permanent diminution in importance. Nevertheless, overall service exports are still developing well, thanks to tourism, IT, etc.

Inflation has recently been falling continuously and considerably, which will support the growth of household income and consumption in H2 2023. In August 2023, the inflation rate was still 6.4% year on year, and overall, in 2023 consumer price inflation (CPI) is expected to be 8%. At the moment, we see the costs of housing and energy in general dropping, while the prices of foodstuffs, hospitality and recreation are still rising inexorably. Given the recent upsurge in core inflation, we do not expect the CPI to fall much below 3% in 2024. In H1 2023, the substantial price hikes resulted in a stagnation of real incomes, following a substantial decline in 2022. However, for H2 we expect real net wages to grow again significantly. After four consecutive quarters of decline, this will bolster household consumption in the second half of the year. In order to maintain the purchasing power of low earners, the government introduced a 15% rise in the minimum wage from January 2023; and another 10% hike has been agreed for next year. Moreover, the net income of low-wage earners will be bolstered by a 20% rise in the non-taxable income threshold. Still, we do not expect household consumption to regain its previous momentum before 2024.

Investment in public infrastructure will be the strongest driver of GDP growth in 2023. EU funds (including the NextGenerationEU recovery package) have to be used now for planned and approved projects. Thus, construction activity is under way on roads and energy grids. For Lithuania, the biggest single investment project is Rail Baltica, the high-speed rail service linking Tallinn, the capital of Estonia, with Latvia, Lithuania and Poland. The main construction work on the Lithuanian section of the railway began in mid-2022. Rail Baltica is due to commence operations in 2026.

The decline in business sentiment suggests that a gradual upswing in private investment will take longer than expected. Disappointing developments in the main export destinations in the EU are putting a strain on confidence in all sectors, apart from retail trade. Businesses are running down their stocks and investment plans are being revised downwards. The ongoing ECB interest-rate hikes have resulted in households scaling back investment in their dwellings. As yet, there has been no fall in house prices; however, there is stagnation. The rise in interest rates is clearly a burden on households, but we do not expect the rate of non-performing loans to increase markedly. The labour market is not expected to deteriorate, and households are not as overburdened as they were in 2008, on the cusp of the financial crisis. The figures for construction permits granted suggest that fewer residential and commercial buildings will be erected next year. We expect only a slow revival of private investment in 2024.

High inflation brought extra revenue into the government budget even in H1. Thus, following an almost balanced budget last year (with a deficit of just 0.6% of GDP), in 2023 the deficit will remain quite low (2% of GDP), bearing in mind the ongoing stagnation. The specific circumstances associated with inflation, however, are going to fade in the coming months. The anti-inflationary measures to help households and enterprises are being phased out this year. On the other hand, 2024 will bring another rise in the non-taxable minimum income, as well as increased benefits for families and pensioners, and additional public investment in renewable energy sources and energy-saving buildings – just a few of the measures that will result in higher government expenditure levels.

Employment increased in H1 2023 and is expected to continue to grow, despite the stagnation in the second half of the year (albeit at a lower rate). The substantial influx of Ukrainian refugees offers a considerable additional supply of well-educated workers. More than 20,000 of the 80,000 Ukrainians in the country have already found a job. Looking at sectoral developments of employment growth, we see that private services have substantially increased the number of jobs. Meanwhile employment in manufacturing is stagnating, and agriculture is gradually shedding workers. Although the economy is projected to stagnate this year, the unemployment rate will likely increase by only 1 percentage point, to 7.1% on average in 2023. In the following two years we expect unemployment to fall back to 6%.

Considering the lower-than-expected external demand and private investment, we have revised our GDP forecast for 2023 downwards, to -0.1%. Moreover, we have changed our baseline scenario for the coming two years, in expectation of a slower upswing. GDP growth will pick up in 2024 to 1.7%, and then to 2.4% in 2025. Nevertheless, much will depend on the war in Ukraine and on how economic activity evolves in Western Europe and the Scandinavian countries, in particular.

Table 6.12 / Lithuania: Selected economic indicators

	2020	2021	2022 ¹⁾	2022 January-June	2023	2023 Forecast	2024 Forecast	2025
Population, th pers., average	2,795	2,801	2,832	2,828	2,863	2,870	2,900	2,890
Gross domestic product, EUR m, nom.	49,829	56,154	66,791	30,789	33,781	72,100	75,400	78,800
annual change in % (real)	0.0	6.0	1.9	3.2	-0.8	-0.1	1.7	2.4
GDP/capita (EUR at PPP)	26,320	28,950	31,480	.	.	.	.	.
Consumption of households, EUR m, nom.	28,867	32,637	38,979	18,090	20,261	.	.	.
annual change in % (real)	-2.5	8.1	0.5	3.5	-1.7	0.6	3.5	2.8
Gross fixed capital form., EUR m, nom.	10,616	12,017	14,006	6,236	7,446	.	.	.
annual change in % (real)	-0.2	7.8	2.6	1.8	10.4	6.0	5.0	4.0
Gross industrial production (sales)								
annual change in % (real)	-1.3	19.5	9.6	16.7	-5.5	-1.0	4.0	5.0
Gross agricultural production								
annual change in % (real)	10.3	-4.5	6.2	.	.	.	.	.
Construction industry								
annual change in % (real)	-1.6	4.6	4.6	7.1	11.1	.	.	.
Employed persons, LFS, th, average ²⁾	1,358	1,369	1,421	1,408	1,420	1,440	1,450	1,460
annual change in %	-1.5	0.8	3.8	3.9	0.8	1.0	0.8	1.0
Unemployed persons, LFS, th, average ²⁾	126	105	90	86	105	110	101	93
Unemployment rate, LFS, in %, average ²⁾	8.5	7.1	6.0	5.9	6.9	7.1	6.5	6.0
Reg. unemployment rate, in %, eop ³⁾	16.1	10.2	8.9	8.6	8.1	.	.	.
Average monthly gross wages, EUR ⁴⁾	1,429	1,579	1,789	1,743	1,968	1,970	2,090	2,210
annual change in % (real, gross)	8.9	5.6	-5.6	-2.2	-1.8	2.0	3.0	3.5
Average monthly net wages, EUR ⁴⁾	913	1,002	1,121	1,095	1,223	1,240	1,310	1,380
annual change in % (real, net)	9.8	4.8	-6.7	-3.5	-2.9	2.0	3.0	3.5
Consumer prices (HICP), % p.a.	1.1	4.6	18.9	16.3	13.7	8.0	2.8	2.0
Producer prices in industry, % p.a.	-9.0	9.5	26.1	25.5	3.4	-1.0	2.0	0.0
General governm. budget, EUdef., % of GDP								
Revenues	36.1	36.4	35.8	.	.	37.0	36.0	36.0
Expenditures	42.6	37.5	36.5	.	.	39.0	37.8	37.5
Net lending (+) / net borrowing (-)	-6.5	-1.2	-0.6	.	.	-2.0	-1.8	-1.5
General gov. gross debt, EU def., % of GDP	46.3	43.7	38.4	.	.	39.0	39.0	38.0
Stock of loans of non-fin. private sector, % p.a.	-1.6	13.2	14.0	16.8	7.6	.	.	.
Non-performing loans (NPL), in %, eop	1.3	0.7	0.5	.	.	.	.	.
Central bank policy rate, % p.a., eop ⁵⁾	0.00	0.00	2.50	0.00	4.00	.	.	.
Current account, EUR m	3,633	641	-3,396	-1,908	641	-800	-600	-700
Current account, % of GDP	7.3	1.1	-5.1	-6.2	1.9	-1.1	-0.8	-0.9
Exports of goods, BOP, EUR m	25,536	31,648	41,086	18,948	18,349	41,500	43,200	44,900
annual change in %	-1.6	23.9	29.8	32.3	-3.2	1.0	4.1	3.9
Imports of goods, BOP, EUR m	25,940	34,544	48,428	22,249	20,720	48,200	50,100	52,100
annual change in %	-8.3	33.2	40.2	42.9	-6.9	-0.5	3.9	4.0
Exports of services, BOP, EUR m	10,921	13,571	17,397	7,875	8,816	17,600	18,300	19,000
annual change in %	-8.0	24.3	28.2	24.5	12.0	1.2	4.0	3.8
Imports of services, BOP, EUR m	5,886	8,137	11,378	5,188	5,386	11,300	12,000	12,500
annual change in %	-14.9	38.2	39.8	47.6	3.8	-0.7	6.2	4.2
FDI liabilities, EUR m	4,002	2,534	580	-171	1,098	1,000	.	.
FDI assets, EUR m	3,438	1,286	-1,073	-929	704	1,000	.	.
Gross reserves of CB excl. gold, EUR m	3,662	4,626	4,715	4,846	5,079	.	.	.
Gross external debt, EUR m	40,233	44,565	45,565	43,567	48,963	43,300	43,700	44,900
Gross external debt, % of GDP	80.7	79.4	68.2	65.2	67.3	60.0	58.0	57.0

1) Preliminary. - 2) From 2021 the new LFS methodology is applied in line with the Integrated European Social Statistics Regulation (IESS). - 3) In % of working age population. - 4) Including the employers' social security contribution and earnings of sole proprietors. - 5) Official refinancing operation rate for euro area (ECB).

Source: wiiw Databases incorporating Eurostat and national statistics. Forecasts by wiiw.

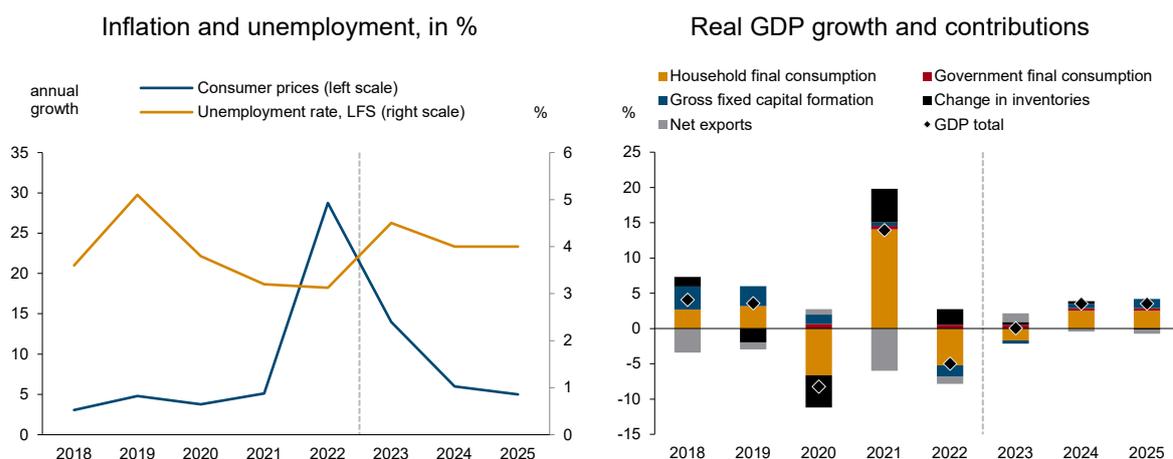


MOLDOVA: Emerging from depression

GÁBOR HUNYA

After two years of decline, GDP will finally recover in H2 2023. The harvest will be better than last year, and that will have a positive impact on incomes, exports and the food industry. Sharp disinflation will help consumption recover. The future prospects look even brighter, as Moldova has managed to switch its trade flows, including energy supplies, from Russia to the West. The country can rely on multinational institutions to finance its fiscal and current account deficits.

Figure 6.13 / Moldova: Main macroeconomic indicators



Source: wiiw Annual Database incorporating national and Eurostat statistics, own calculation. Forecasts by wiiw.

Moldova has managed to absorb two fundamental shocks over the past two years. It has decoupled from the Russian energy supply, though this did cause temporary shortages and significant price hikes, which increased the relative cost of energy. And it has also coped with last year's very poor harvest that was triggered by extreme weather conditions, which came on top of skyrocketing international food prices. Economic depression and declining living standards were the result. Energy and fuel subsidies to the poor and to farmers have helped the country deal with these shocks. Generous financial and political support from the West has also been indispensable for the country's survival.

The economic slump continued in H1 2023, with GDP down by 2.3%. Household consumption fell by 5.6% year on year, and public consumption suffered a minor contraction. Gross capital formation was positive as rising stocks outpaced the 5.8% contraction in fixed capital formation. Investments in machinery and equipment picked up, but housing construction fell sharply. Net exports made a positive contribution to growth, based on marginally higher exports and smaller imports than a year before. The

GDP decline decelerated only marginally in Q2 from the previous quarter. Q2 was worse than Q1 in respect of final consumption and investments, but net exports compensated for this thanks to a rapid contraction in imports.

Manufacturing production fell by close to 10% in H1. This was mainly due to food production (which was short of raw materials in the wake of the bad 2022 harvest) and to low domestic demand (in the face of elevated retail prices). But the production of machinery and equipment increased, thanks to deepening integration in international value chains and growing Ukrainian demand. The slump and structural change in manufacturing were reflected in falling exports and a shift in their structure to more sophisticated products.

The labour supply expanded in H1 2023. The participation rate increased, but it still accounted for only 45% of the working-age population. The unemployment rate also increased – to 3.8% in H1 2023, from 2.2% a year before. Part of this change may be statistical, as the Labour Force Survey achieved better coverage of the unemployed.

Having fallen steadily for a year and a half, in Q2 real incomes recovered by 1.3% year on year. Declining inflation and recovering agricultural incomes could be the main reasons for this. The harvest of summer grains was much better than last year, and so farmers saw an improvement in their incomes.

Moldova has undergone sharp disinflation since the end of 2022. The annual rate of consumer price inflation (CPI) fell from 30% in December 2022 to 10% in August 2023. The high inflation in 2022 was a result of the energy price adjustments and food price shocks, which had trickled down through the whole economy. Contracting domestic demand, falling energy prices and recovering food production have all put the brakes on inflation in 2023. As a result, the central bank has switched from a very restrictive to an accommodative stance. The policy rate has stood at 6% since June 2023, down from 20% in December 2022. Real interest rates on new loans have come down to low positive levels, though the volume of new loans has picked up only modestly. The local currency has appreciated against the euro, and that has also contributed to disinflation.

The shrinking foreign trade deficit indicates that the current account gap must also be contracting (though at the time of writing there are no data available for Q2). The central bank's foreign exchange reserves reached more than six months' worth of imports at the end of July, up from five months' worth a year before.

The geographical structure of foreign trade has undergone important changes. Romania is Moldova's most important partner, while Ukraine has become its second most important in terms of exports, and its third most important in terms of imports (after China). Russia's share in imports fell to 4% in H1 2023 – from 14% the year previously. Gas imports have by and large been switched away from Russia to other suppliers. Diversification of sources and subsidies on the cost of imported energy have improved economic stability in general. Integration with the Romanian gas and electricity networks is helping to avoid any serious shortages. Investments are in hand to increase the capacity of the interconnections, which is necessary to increase the stability of supply. Management of the gas transmission network was recently removed from the Gazprom-controlled Moldovagaz and given to Vestmoldtransgaz, a company owned by the Romanian gas transport system operator Transgaz and the European Bank for Reconstruction and Development. Russian gas is, however, still being supplied to

Transnistria, which is the heavy-industry and energy-generation hub of Moldova. Gazprom charges the central government for these deliveries. Unpaid bills are a disputed issue and could result in disruption to gas deliveries.

Fiscal policy has been more expansionary than last year. The deficit may reach 5% of GDP in 2023, but there is no pressure to stabilise. The country is under an International Monetary Fund (IMF) programme, the conditions of which focus on disinflation and institutional reform, rather than on fiscal prudence. The government has limited access to the international financial markets, but generous foreign aid and loans from multinational and bilateral donors provide advantageous financing. The IMF estimates that the total external financing gap will be USD 803m in 2023, to be covered by disbursements from the IMF, World Bank and the EU, together with aid and credit lines from individual governments. Nevertheless, government debt will amount to only a modest 36% of GDP by the end of the year.

H2 2023 will see an upturn in the economy, and it is likely that 2023 will end with around 0% GDP growth for the year as a whole. Household consumption will recover due to declining inflation and improving rural income. The harvest will be better than last year, and that will have a positive impact on exports and on the food industry, thus generating further income. The energy crisis of last winter may not recur: most of the necessary gas has already been purchased and is being stored in Ukraine and Romania. Moldova's future prospects look even brighter, as the country has digested the structural shocks related to the shift in its trade linkages from Russia to the West. The benefits of deepening EU integration in return for institutional reforms are starting to be felt. As one element of these reforms, anti-corruption bodies have started their activities.

Political stability is not in any imminent danger, despite serious menaces. Russia's efforts at disruption are serious, but the Moldovan government has taken steps to curtail the Russian presence in the country by restricting access to media that spreads Russian propaganda and by reducing the Russian embassy staff. Pro-Russian political parties are also restricted in their operations, although one of them could win the local election in the province of Gagauzia, which is populated by a Russian-speaking minority of Turkic origin. Tensions with Transnistria have not escalated recently, as the separatist region has no long-term alternative to economic integration with the rest of the country. As a first step, the Moldova Steel Works in Transnistria has started to pay the environmental pollution tax to the central government, in exchange for getting a certificate allowing it to export to the EU. NATO considers it unlikely that Russia would intervene militarily in Transnistria. The pro-Western Moldovan government is maintaining its neutrality and has no intention of joining NATO. However, poor living conditions and increased poverty make it vulnerable to popular unrest. The government has announced that social and military stability will attract greater political attention and fiscal support. The results of the local elections on 5 November will be the first test of public support.

Table 6.13 / Moldova: Selected economic indicators

	2020	2021	2022 ¹⁾	2022 January-June	2023	2023 Forecast	2024 Forecast	2025
Population, th pers., average	2,635	2,596	2,539	.	.	2,580	2,560	2,530
Gross domestic product, MDL bn, nom.	199.7	242.1	274.2	120.3	133.9	296	322	343
annual change in % (real)	-8.3	13.9	-5.0	0.5	-2.3	0.0	3.5	3.5
GDP/capita (EUR at PPP)	8,200	10,020	10,180	.	.	.	.	.
Consumption of households, MDL bn, nom.	162.2	199.6	229.4	96.8	110.3	.	.	.
annual change in % (real)	-7.9	17.3	-6.3	-3.1	-5.6	-2.0	3.0	3.0
Gross fixed capital form., MDL bn, nom.	49.8	58.3	61.8	27.3	27.4	.	.	.
annual change in % (real)	5.6	1.9	-6.8	-7.7	-3.4	-2.0	3.0	6.0
Gross industrial production								
annual change in % (real)	-5.5	12.1	-5.1	0.7	-7.8	-4.0	5.0	5.0
Gross agricultural production								
annual change in % (real)	-27.2	57.9	-29.8	.	.	.	.	.
Construction industry								
annual change in % (real)	11.8	-0.3	-13.9	-11.6	-8.0	.	.	.
Employed persons, LFS, th, average ²⁾	834.2	843.4	862.3	853.7	882.5	880	890	900
annual change in %	-4.4	1.1	2.2	4.1	3.4	2.0	1.0	1.0
Unemployed persons, LFS, th, average ²⁾	33.1	28.2	27.7	23.6	43.2	40	40	40
Unemployment rate, LFS, in %, average ²⁾	3.8	3.2	3.1	2.7	4.7	4.5	4.0	4.0
Reg. unemployment rate, in %, eop	2.9	2.3	2.4	1.5	1.4	.	.	.
Average monthly gross wages, MDL	7,943	8,980	10,447	9,969	11,831	12,000	13,200	14,600
annual change in % (real, gross)	5.8	7.6	-9.6	-8.4	-1.2	1.0	4.0	5.0
Average monthly net wages, MDL	6,617	7,635	8,900	.	.	10,200	11,400	12,700
annual change in % (real, net)	6.1	9.8	-9.5	.	.	1.0	5.0	6.0
Consumer prices, % p.a.	3.8	5.1	28.7	24.3	20.2	14.0	6.0	5.0
Producer prices in industry, % p.a.	2.6	8.4	26.5	23.0	19.3	12.0	5.0	4.0
General governm. budget, nat. def., % of GDP								
Revenues	31.4	32.0	33.4	34.7	35.1	35.0	35.0	34.0
Expenditures	36.7	33.9	36.6	37.5	40.5	40.0	39.0	37.0
Deficit (-) / surplus (+)	-5.3	-1.9	-3.2	-2.8	-5.3	-5.0	-4.0	-3.0
General gov. gross debt, nat. def., % of GDP	34.2	32.6	35.0	29.2	.	36.0	36.0	35.0
Stock of loans of non-fin. private sector, % p.a.	13.2	22.6	8.5	19.1	2.7	.	.	.
Non-performing loans (NPL), in %, eop ³⁾	7.4	6.1	6.4	6.7	7.1	.	.	.
Central bank policy rate, %, p.a., eop ⁴⁾	2.65	6.50	20.00	18.50	6.00	6.00	5.00	4.00
Current account, EUR m ⁵⁾	-778	-1436	-2161	.	.	-1,610	-1,390	-1,280
Current account, % of GDP	-7.7	-12.4	-15.7	.	.	-10.3	-8.2	-7.1
Exports of goods, BOP, EUR m ⁵⁾	1,706	2,165	3,517	.	.	3,610	3,790	3,980
annual change in %	-9.8	26.9	62.4	.	.	2.6	5.0	5.0
Imports of goods, BOP, EUR m ⁵⁾	4,420	5,706	8,251	.	.	8,230	8,480	8,900
annual change in %	-8.9	29.1	44.6	.	.	-0.3	3.0	5.0
Exports of services, BOP, EUR m ⁵⁾	1,121	1,381	2,161	.	.	2,370	2,610	2,820
annual change in %	-18.7	23.2	56.4	.	.	9.7	10.1	8.0
Imports of services, BOP, EUR m ⁵⁾	772	982	1,302	.	.	1,350	1,400	1,460
annual change in %	-26.7	27.3	32.6	.	.	3.7	3.7	4.3
FDI liabilities, EUR m ⁵⁾	138	331	562	.	.	470	.	.
FDI assets, EUR m ⁵⁾	5	8	53	.	.	0	.	.
Gross reserves of CB excl. gold, EUR m ⁵⁾	3,079	3,442	4,202	3,434	4,483	.	.	.
Gross external debt, EUR m ⁵⁾	6,620	7,735	8,891	.	.	10,300	11,400	12,300
Gross external debt, % of GDP	65.4	66.9	64.5	.	.	66.0	67.0	68.0
Average exchange rate MDL/EUR	19.74	20.93	19.90	20.20	19.89	19.0	19.0	19.0

Note: All series excluding data on districts from the left side of the river Nistru and municipality Bender.

1) Preliminary. - 2) Methodology in line with the Integrated European Social Statistics Regulation (IESS). - 3) Substandard, doubtful and loss credit portfolio. - 4) Overnight (refinancing) operations rate. - 5) Converted from USD.

Source: wiiw Databases incorporating national statistics. Forecasts by wiiw.

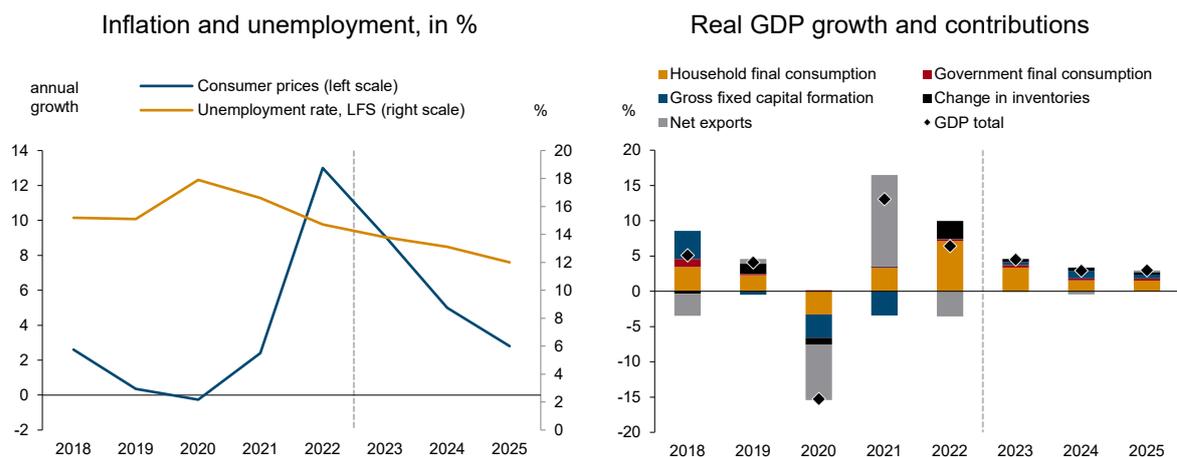


MONTENEGRO: Election results could offer fresh hope

BERND CHRISTOPH STRÖHM

Montenegro's economy performed exceptionally well in H1 2023, growing by 6.5%. The economy is still feeling the positive effects of last year's social reform, which is boosting household consumption. Moreover, there has been a strong tourist season, as well as vibrant investment in hotel facilities and energy infrastructure. The potential formation of a new governing coalition offers hope of a stable political environment. We have upgraded our previous GDP growth forecast for 2023 to 4.5%.

Figure 6.14 / Montenegro: Main macroeconomic indicators



Source: wiiw Annual Database incorporating national and Eurostat statistics, own calculation. Forecasts by wiiw.

Thanks to strong household consumption, a bountiful tourist season and robust inflows of foreign direct investment (FDI), Montenegro will again enjoy very healthy growth in 2023. GDP increased by 6.9% year on year in Q2 2023 (following growth of 6.1% in Q1). The 2022 social reform – when the government shifted the tax burden from low-income to high-income individuals, and at the same time significantly raised the minimum wage – is continuing to stimulate household consumption. FDI has also contributed to the country's solid performance this year: in the period January-July, the inflow of FDI amounted to EUR 516m, of which 61% was in the form of equity investments. All this leads us to revise our GDP growth forecast for 2023 upward to 4.5% (from 3.5%). Nevertheless, high inflation and elevated interest rates will rein in household spending after a while. The deteriorating growth prospects in the EU may have an adverse effect on Montenegro's own growth prospects next year, given the country's reliance on its vital tourism sector. Accordingly, we are projecting restrained GDP growth of 2.9% in 2024.

Having surged to 17.5% in November 2022, inflation then fell for eight months in a row (to 6.9% in July), before picking up again in August (8.6%). The main drivers of August's inflation were food and non-alcoholic beverages (+10.5%). Additional inflationary pressure came from demand-side factors, such as the strong recovery in tourism, favourable developments on the labour market and the government's minimum wage hike of 80% at the beginning of 2022. Despite the recent slowdown, inflation will remain high this year, averaging 9.1% (0.6 percentage points down on our previous forecast).

Tourist arrivals will generate solid revenue in 2023, helped along by new airline connections.

Montenegro's service sector is managing the effects of the war in Ukraine better than expected. The number of tourists from abroad in July increased by 10.4% year on year, following a 37.8% surge in June. Last year, the number of tourists reached 85% of pre-pandemic levels (up from 68% in 2021), and this year we expect a full rebound. However, part of the recorded increase may be attributed to Ukrainian and Russian citizens who have fled the war and the draft, and who are registered as tourists in Montenegro. If we look at the structure of overnight stays in 2022, we find that most were undertaken by tourists from Serbia (25.5%), Russia (16.4%), Bosnia and Herzegovina (9.9%), Germany (5.9%) and Ukraine (4.9%).

Unemployment in 2022 fell to an all-time low of 14.7%, from 16.6% the previous year. According to the Montenegrin employment agency, the number of jobless people in Montenegro at the end of August (38,108) was 12.8% lower than a year previously. Supported by economic growth and policy measures (such as abolishing mandatory health contributions and introducing a non-taxable part of wages), the unemployment rate for 2023 should hit a new record low of 13.8%.

The energy sector remains an important driver of the Montenegrin economy. Montenegro enjoyed the largest share of wind power in domestic electricity production anywhere in Europe in December 2022, and was one of the biggest net exporters of electricity in 2022. This year, electricity production and exports will see a further rise, thanks to the solid rainfall season, which boosted hydropower electricity generation. Higher energy prices are also supporting Montenegro's electricity exports. All this, together with exports of tourism and transport services and solid remittances, is projected to support a modest reduction in the current account deficit to 11% of GDP by 2024.

Investments in the energy industry promise further stimulus. Montenegro has great potential in the renewable energy sector – a potential that has by no means been fully exploited. The government managed in March to approve the construction of solar power plants in Cetinje and Nikšić. The Montenegrin grid operator CGES is also planning to invest some EUR 200m over the next few years to prepare the country's power grid for the additional solar energy. Next to renewables, the country also wants to focus on gas as a source of energy in the future. That is why the government decided in May 2023 to construct a EUR 1bn liquefied natural gas (LNG) terminal at the port of Bar; it is due to commence operations by the end of 2025. The Serbian government was quick to voice interest in purchasing liquefied gas from the planned terminal. It could supply LNG not only to Montenegro and Serbia, but also to other neighbouring countries, most notably Bosnia and Herzegovina, Kosovo and Albania.

Montenegro is in the process of becoming an electricity transport hub serving the Western Balkans and Italy. In 2019, the governments of Italy and Montenegro started operating an underwater power cable, worth some EUR 1.15bn, between the Italian port city of Pescara and the Montenegrin city of Bar. The cable, which stretches for 423 kilometres along the Adriatic seabed, at a depth of over 1,000

metres, represents an important energy transit route, connecting the electricity systems of Italy, Montenegro, Serbia, Bosnia and Herzegovina and Romania.

Following the June parliamentary elections, the recently formed pro-European Europe Now! party will be central to the new government coalition. Montenegro had been embroiled in political and institutional deadlock since August 2022, when the previous government fell after a vote of no confidence, but the results of the June elections are encouraging. Following the victory of Europe Now! in the elections, President Jakov Milatović nominated its head Milojko Spajić, as prime minister designate. The latter then announced that he had reached an agreement with several parties to form a new governing coalition, giving him the support of 44 MPs in the 81-seat parliament. He has until 10 November to receive approval from parliament for the formation of his new government. A new, stable government in Montenegro would help attract capital investment to the country and would bode well for its overall prospects.

Table 6.14 / Montenegro: Selected economic indicators

	2020	2021	2022 ¹⁾	2022 January-June	2023	2023 Forecast	2024 Forecast	2025
Population, th pers., average	621	619	617	.	.	619	618	618
Gross domestic product, EUR m, nom.	4,186	4,955	5,924	2,469	2,922	6,800	7,300	7,700
annual change in % (real)	-15.3	13.0	6.4	10.5	6.6	4.5	2.9	3.0
GDP/capita (EUR at PPP)	13,440	15,540	17,910	.	.	.	.	.
Consumption of households, EUR m, nom. ²⁾	3,400	3,617	4,424	2,002	2,339	.	.	.
annual change in % (real)	-4.6	4.0	9.7	12.8	10.6	4.5	2.1	2.0
Gross fixed capital form., EUR m, nom.	1,166	1,096	1,274	610	634	.	.	.
annual change in % (real)	-12.0	-12.3	0.1	2.1	10.6	2.0	5.0	2.5
Gross industrial production ³⁾
annual change in % (real)	-0.9	4.9	-3.2	-2.3	4.5	7.0	4.0	3.0
Net agricultural production ⁴⁾
annual change in % (real)	1.1	-0.5	-2.9	.	.	.	.	.
Construction output	.	.	.	.	.	.	.	.
annual change in % (real)	-5.5	-4.8	-4.4	-1.8	-9.5	.	.	.
Employed persons, LFS, th, average ⁵⁾	219.4	212.6	251.2	243.6	269.6	257	265	273
annual change in %	-10.0	-3.1	18.2	26.0	10.7	2.5	3.0	3.0
Unemployed persons, LFS, th, average ⁵⁾	47.8	42.2	43.2	45.2	44.5	40	40	40
Unemployment rate, LFS, in %, average ⁵⁾	17.9	16.6	14.7	15.7	14.2	13.8	13.1	12.0
Reg. unemployment rate, in %, eop	20.1	24.7	20.1	19.8	18.1	.	.	.
Average monthly gross wages, EUR	783	793	883	876	971	950	1,020	1,070
annual change in % (real, gross)	1.6	-1.1	-1.5	1.0	-0.2	-1.0	2.0	2.5
Average monthly net wages, EUR ⁶⁾	524	532	712	704	781	770	820	860
annual change in % (real, net)	2.1	-0.9	18.4	21.1	0.0	-1.0	1.5	2.5
Consumer prices, % p.a.	-0.3	2.4	13.0	9.8	11.0	9.1	5.0	2.8
Producer prices in industry, % p.a. ⁷⁾	-0.1	1.3	11.2	8.8	8.3	6.0	4.0	2.6
General governm. budget, nat. def., % of GDP	.	.	.	.	.	.	.	.
Revenues	44.6	44.3	38.8	.	.	39.3	39.0	38.9
Expenditures	55.7	46.2	43.9	.	.	44.2	43.8	43.4
Deficit (-) / surplus (+)	-11.1	-1.9	-5.1	.	.	-4.9	-4.8	-4.5
General gov. gross debt, nat. def., % of GDP	105.3	84.0	69.2	.	.	70.5	70.0	69.0
Stock of loans of non-fin. private sector, % p.a.	2.9	3.4	8.8	9.1	4.8	.	.	.
Non-performing loans (NPL), in %, eop	5.5	6.2	5.7	6.3	5.2	.	.	.
Central bank policy rate, % p.a., eop ⁸⁾	5.33	5.16	5.45	5.06	5.82	5.8	5.5	5.4
Current account, EUR m	-1,090	-456	-766	-551	-539	-800	-790	-782
Current account, % of GDP	-26.1	-9.2	-12.9	-22.3	-18.4	-11.8	-10.8	-10.2
Exports of goods, BOP, EUR m	409	526	763	413	397	990	1,070	1,120
annual change in %	-12.2	28.6	45.2	70.9	-3.8	30.0	8.4	5.0
Imports of goods, BOP, EUR m	2,051	2,441	3,434	1,566	1,758	3,850	4,100	4,270
annual change in %	-19.0	19.0	40.7	47.4	12.3	12.2	6.6	4.1
Exports of services, BOP, EUR m	679	1,597	2,289	734	1,056	2,580	2,780	2,960
annual change in %	-60.2	135.2	43.3	71.9	43.9	12.9	7.8	6.4
Imports of services, BOP, EUR m	503	641	972	421	530	1,070	1,140	1,210
annual change in %	-26.8	27.5	51.6	72.7	25.9	10.5	7.0	6.5
FDI liabilities, EUR m	466	591	833	375	278	700	.	.
FDI assets, EUR m	-5	9	50	12	11	45	.	.
Gross reserves of CB excl. gold, EUR m ⁹⁾	1,739	1,749	1,915	1,657	1,616	.	.	.
Gross external debt, EUR m	9,275	9,501	9,396	.	.	10,880	11,610	12,170
Gross external debt, % of GDP	221.6	191.7	158.6	.	.	160.0	159.0	158.0

1) Preliminary. - 2) Including expenditures of NPISHs. - 3) Enterprises with 5 and more employees. - 4) Based on gross value added data. - 5) From 2021 the new LFS methodology is applied in line with the Integrated European Social Statistics Regulation (IESS). - 6) From 2022 net wages excluding health insurance contributions and including an impact of personal income tax reform. - 7) Domestic output prices. - 8) Average weighted lending interest rate of commercial banks (Montenegro uses the euro as national currency). - 9) Data refer to reserve requirements of the Central Bank.

Source: wiiw Databases incorporating national statistics. Forecasts by wiiw.

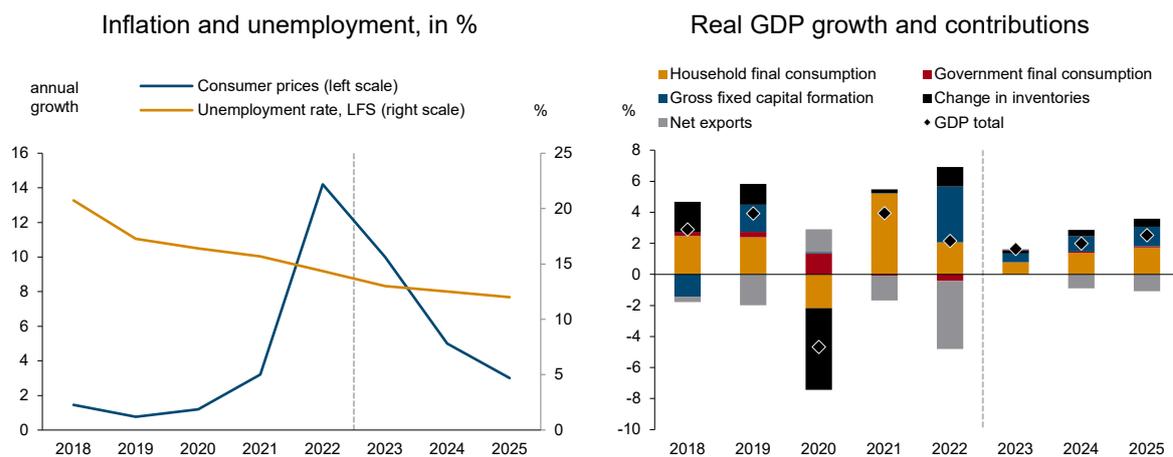


NORTH MACEDONIA: Same Old Story

BRANIMIR JOVANOVIĆ

As expected, the economy slowed in Q2, owing to high inflation, restrictive monetary policy and limited foreign direct investment. Driven by company profits, inflation remained very high: the government has reinstated price controls on food products in an effort to tame it (though we do not believe the effects will last long). The GDP forecast for 2023 has been kept unchanged at 1.6%, but our forecast for 2024 has been revised downward to 2%, on account of the cloudier outlook for the EU economy.

Figure 6.15 / North Macedonia: Main macroeconomic indicators



Source: wiiw Annual Database incorporating national and Eurostat statistics, own calculation. Forecasts by wiiw.

The assessment in our previous report – that the robust growth of Q1 could be short lived – has proved accurate. Economic growth in Q2 was lacklustre, with GDP expanding by a mere 1.1% year on year (0.2% quarter on quarter). The slowdown is evident across all GDP components, as each experienced a decline in Q2 – with the sole exception of household consumption, which saw a 1.6% year-on-year increase in Q2 (though that was also weaker than the growth observed over the preceding three quarters). This sluggish economic performance can be attributed to a combination of factors, including high inflation, a restrictive monetary policy stance and limited inflows of foreign direct investment (FDI).

Inflation has shown some sign of moderating in recent months, but it remains very high, eroding people's incomes and exerting downward pressure on economic growth. It fell to 8.3% in August, but over the past three months – when observed on a month-to-month seasonally adjusted basis – the rate at which prices have risen has actually accelerated, since the government repealed the price

controls that it introduced at the beginning of the year. Notably, food prices continue to be the primary driver of inflation, registering an approximately 11% increase in August, compared to the same period the previous year. At the same time, the producer price index in July recorded a decline compared to the previous year, while real wages remained stagnant in H1 2023, underscoring the fact that inflation was propelled primarily by company profits, rather than wages.

The high inflation has compelled the government to reintroduce price controls. In mid-September, it imposed price caps on approximately 25 categories of food products, effective until the end of November. While this measure is expected to bring down the prices of those specific products while it is in operation, it should be noted that the list of regulated items is fairly limited and that the measure is intended to run for just two months. Past experience of the two previous episodes of price controls over the last year and a half indicates that once the caps are lifted, companies often significantly increase their prices in order to compensate for their reduced profits during the price-control period. Therefore, it is our belief that the measure is likely to have only a minor impact on inflation and the overall standard of living, unless the government opts to extend it.

Monetary policy has maintained a restrictive stance throughout the year, and while the pace of interest rate hikes has slowed somewhat, the rises have not yet come to a halt. The central bank has consistently raised its policy rate at every meeting this year, bringing it to 6.3% as of September. Notably, the two most recent rate hikes – in August and September – were, at 0.15 percentage points, smaller than earlier increases (of 0.25 percentage points). It is likely, though, that the September hike will be the last this year, as the National Bank of North Macedonia closely follows the European Central Bank (ECB), and in our core scenario we assume that the ECB will not increase its rate before the end of 2023.

Fiscal policy has also fallen short in supporting the economy, despite a notably large deficit in H1 of around 6% of GDP. This deficit is primarily on account of the ongoing construction of a motorway in the western part of the country, which the government has started to pay for but which has faced sluggish progress and has been plagued by numerous scandals. Aside from the motorway project, public spending has remained relatively low in most other areas. Government consumption saw a decline of approximately 4% year on year in H1, and the rises in public-sector wages and social transfers were only marginal.

The labour market situation cannot be analysed in any great detail, as the Labour Force Survey methodology changed at the beginning of the year, and revised data for the period prior to the change have not been made available. According to the new methodology, the unemployment rate for Q2 was reported at 13.1%, which is lower than the previous figure. Although the labour market may face some challenges in 2023 due to the sluggish economy, over the medium term population decline and emigration are expected to result in an inevitable further reduction in unemployment.

Following the robust FDI figures from the previous year, foreign investment declined in H1 2023. During this period it accounted for 4.2% of GDP; while not alarming when compared to the country's long-term trends, this is still approximately 20% lower in real terms than the inflows observed in the corresponding period of last year. This may be attributed to the exceptionally strong inflows of 2022, which, as discussed in our previous reports, were driven primarily by intracompany loans, and were not expected to be sustained.

Remittances remained a strong support for the economy in H1 2023. Secondary income from the balance of payments (a proxy for remittance flows) accounted for 19% of GDP – some 5% up on the same period last year (in real terms). Despite the slowdown in the EU, remittances have proved very stable and are unlikely to be affected by the weaker recovery in the euro area; thus they should continue to support the economy in the coming period.

Despite the country's significant exposure to the German economy, there has been no significant indication of a German recession adversely affecting the North Macedonian economy. Exports to Germany during the first five months of the year increased by approximately 8% year on year in nominal USD terms, while German FDI in the country for the first half year surged by 62% in nominal EUR terms. Even the automotive industry, dominated as it is by German-owned companies, witnessed a substantial 10% expansion in production during the initial seven months, when assessed in real terms. While adverse effects may yet materialise after a time lag, there remains the possibility that German companies could expand their operations in North Macedonia in order to minimise production costs. That would have a positive impact on the local economy.

There have been no major changes in the country's EU integration process. It must still amend its constitution to include Bulgarians in its preamble before accession talks can begin. The opposition continues to be against this, and the ruling majority still does not have the two-thirds majority required to change the constitution. Rumours have been circulating that the ruling majority is attempting to persuade some opposition MPs to support it (in a move not unlike the strategy it used in 2019, when the country's name was changed). However, at the time of writing, there is no clear indication that this will be possible.

In light of all that has been said, we are keeping our GDP forecast for 2023 unchanged at 1.6%. Due to the cloudier outlook for the EU economy in 2024, we are revising our GDP forecast for that year down to 2% (from 2.5%). As for inflation, the steep price rises of recent months have led us to revise our forecast slightly upwards – to 10% in 2023 and 5% in 2024 (up 1 percentage point).

Table 6.15 / North Macedonia: Selected economic indicators

	2020	2021	2022 ¹⁾	2022 January-June	2023	2023 Forecast	2024 Forecast	2025
Population, th pers., average ²⁾	2,073	1,837	1,832	.	.	1,817	1,807	1,797
Gross domestic product, MKD bn, nom.	669.3	720.4	794.8	361	406	889	952	1,005
annual change in % (real)	-4.7	3.9	2.1	3.1	1.6	1.6	2.0	2.5
GDP/capita (EUR at PPP)	11,350	13,670	14,730	.	.	.	.	.
Consumption of households, MKD bn, nom.	436.4	480.7	549.9	259	290	.	.	.
annual change in % (real)	-3.4	8.0	3.1	2.0	2.1	1.1	2.0	2.5
Gross fixed capital form., MKD bn, nom.	144.5	162.4	197.6	.	.	.	.	.
annual change in % (real)	0.4	0.1	16.0	.	.	2.2	4.0	5.0
Gross industrial production ³⁾								
annual change in % (real)	-9.5	1.5	-0.3	2.3	1.5	1.0	2.0	3.0
Gross agricultural production ⁴⁾								
annual change in % (real)	1.7	-7.6	2.0	.	.	.	.	.
Construction industry								
annual change in % (real)	1.3	-11.4	-11.9	-5.4	-6.4	.	.	.
Employed persons, LFS, th, average ⁵⁾	794.9	795.1	692.0	693	686	700	710	720
annual change in %	-0.3	0.0	-0.2	-0.1	.	0.5	1.0	1.0
Unemployed persons, LFS, th, average ⁵⁾	155.9	147.9	116.0	118	104	100	100	100
Unemployment rate, LFS, in %, average ⁵⁾	16.4	15.7	14.4	14.6	13.2	13.0	12.5	12.0
Reg. unemployment rate, in %, eop ⁵⁾⁶⁾	25.8	19.7	19.8	20.5	18.8	.	.	.
Average monthly gross wages, MKD	40,566	42,887	47,637	46,237	52,869	52,400	55,600	58,400
annual change in % (real, gross)	7.0	2.4	-2.7	-0.8	0.7	0.0	1.0	2.0
Average monthly net wages, MKD	27,182	28,718	31,859	30,950	35,286	35,000	37,100	39,000
annual change in % (real, net)	6.5	2.3	-2.9	-0.9	0.4	0.0	1.0	2.0
Consumer prices, % p.a.	1.2	3.2	14.2	10.0	13.6	10.0	5.0	3.0
Producer prices in industry, % p.a.	0.6	11.1	17.3	19.5	4.8	6.0	3.0	2.5
General governm. budget, nat. def., % of GDP								
Revenues	29.9	32.4	32.4	32.2	32.3	32.0	32.5	32.5
Expenditures	38.1	37.8	36.9	35.1	38.2	36.0	35.5	35.0
Deficit (-) / surplus (+)	-8.2	-5.4	-4.5	-2.9	-5.8	-4.0	-3.0	-2.5
General gov. gross debt, nat. def., % of GDP	50.8	52.0	50.9	47.3	50.3	51.0	52.0	53.0
Stock of loans of non-fin. private sector, % p.a.	4.6	8.2	9.4	9.9	6.5	.	.	.
Non-performing loans (NPL), in %, eop	3.3	3.2	2.8	3.2	2.8	.	.	.
Central bank policy rate, %, p.a., eop ⁷⁾	1.50	1.25	4.75	2.00	6.00	6.30	6.00	5.50
Current account, EUR m	-318	-366	-772	-623	-12	-320	-380	-510
Current account, % of GDP	-2.9	-3.1	-6.0	-10.6	-0.2	-2.2	-2.5	-3.1
Exports of goods, BOP, EUR m	4,820	6,000	7,346	3,554	3,706	8,300	9,010	9,710
annual change in %	-9.9	24.5	22.4	21.5	4.3	13.0	8.5	7.8
Imports of goods, BOP, EUR m	6,623	8,371	10,799	5,304	4,898	11,720	12,600	13,550
annual change in %	-9.2	26.4	29.0	32.8	-7.7	8.5	7.5	7.5
Exports of services, BOP, EUR m	1,445	1,743	2,318	1,005	1,213	2,630	2,950	3,300
annual change in %	-11.1	20.7	32.9	29.1	20.6	13.5	12.0	12.0
Imports of services, BOP, EUR m	1,021	1,248	1,577	673	945	1,730	1,940	2,170
annual change in %	-20.8	22.2	26.4	47.1	40.4	10.0	12.0	12.0
FDI liabilities, EUR m	28	575	803	643	588	800	.	.
FDI assets, EUR m	-127	187	133	394	351	150	.	.
Gross reserves of CB excl. gold, EUR m	3,019	3,288	3,486	2,734	3,804	.	.	.
Gross external debt, EUR m	8,536	9,577	10,856	.	.	12,300	13,300	14,200
Gross external debt, % of GDP	78.7	81.9	84.2	.	.	85.0	86.0	87.0
Average exchange rate MKD/EUR	61.67	61.63	61.62	61.7	61.6	61.6	61.6	61.6

1) Preliminary. - 2) From 2021 according to census September 2021. - 3) Enterprises with 10 and more employees. - 4) wiiw estimate in 2022. - 5) From 2023 the new LFS methodology is applied in line with the Integrated European Social Statistics Regulation (IESS), from 2022 based on census September 2021. - 6) In % of labour force (LFS). - 7) Central Bank bills (28-days).

Source: wiiw Databases incorporating national statistics. Forecasts by wiiw.

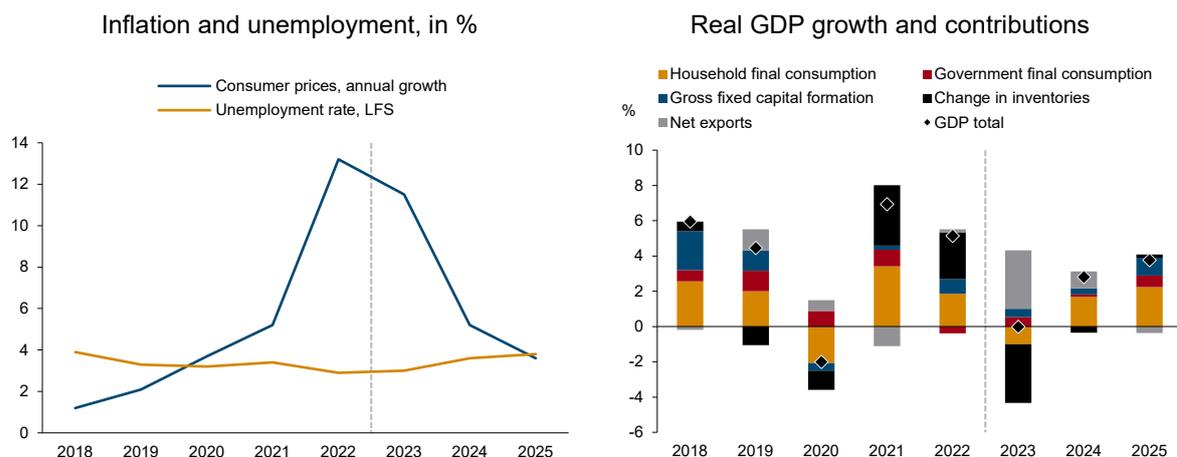


POLAND: Technically in recession

ADAM ŻURAWSKI

Restrictive monetary policy has pushed the economy into a minor recession that is directly linked to suppressed real wages and the liquidation of excessive inventories. The recent (6 September) cut in the policy interest rate is expected to prevent further deterioration on the real side. In effect, GDP in 2023 is likely to stay flat – and then to resume its moderate expansion in 2024. At the same time, disinflation will progress naturally. Public deficit spending remains high, but the public debt levels are not a serious threat to fiscal stability.

Figure 6.16 / Poland: Main macroeconomic indicators



Source: wiiw Annual Database incorporating national and Eurostat statistics, own calculation. Forecasts by wiiw.

GDP fell by 0.6% in Q2 2023 (year on year), following the 0.3% decline of Q1. This was due to a further fall in inventories, whose contribution to overall GDP growth reached -3.8 percentage points (pp). Household consumption fell by 2.7%, but public consumption rose by 2.6%. Gross fixed capital formation increased by 7.9%. With the volume of imports falling much more steeply than that of exports, the contribution made to GDP growth by foreign trade in goods and services turned markedly positive: 3.1pp (following a rise of 4.3pp in Q1 2023). Gross value added is continuing to contract in manufacturing, and particularly noticeably in the domestic retail trade and transportation/storage sectors.

The data available for Q3 2023 paint a rather unpromising picture. On the one hand, in July industrial production fell for the sixth consecutive month. Sales of manufactured durable consumer goods, intermediate goods and energy have continued to decline. However, sales of capital goods have kept on rising sharply (in July by over 10%, year on year). The growth in output of the export-oriented branches of industry is now slowing down, and the production of those industrial branches that supply

mainly the domestic market has tended to stagnate or decline. To cap everything, retail sales have continued to perform quite badly. Finally, the business climate indicators in August were negative, with entrepreneurs remaining pessimistic, and the consumer confidence indicators similarly remained profoundly negative. The good news is that construction output rose by over 10% (January-July 2023) and the corporate sector's investment outlays have expanded quite considerably (over 10% in H1 2023).

There are signs of excess supply, reflecting inadequate demand. Firms supplying consumer durables and intermediate goods report the highest levels of excess supply. The excess supply conditions are reflected in inventories, whose levels are now considered by a large proportion of businesses to be too high. Excessive inventories of finished goods, now being scaled down, are adversely affecting the prospects for growth in production. Also, firms are finding it more difficult to pass their costs on to buyers in the shape of higher prices. Slight deflationary tendencies are already being captured by the statistics: the growth in producer price indices (PPIs) for industry and construction has been slowing, and in a number of manufacturing branches the price of articles sold has been declining. (In July and August, the PPI for manufacturing actually declined, year on year.)

The profitability of the entire corporate non-financial sector remains quite high, despite some recent deterioration. After a few quarters of corporate revenues rising much faster than their costs, the situation has reversed. Firms are now being induced to cut their markups somewhat. In effect, the net turnover profitability of the whole corporate sector declined to 5.1% in H1 2023 (from 6.1% the year before).

The labour market is in pretty good shape, though this is unlikely to last. The unemployment rate is low: 2.6% according to the Eurostat methodology (Labour Force Survey) and 5% by registration. However, the demand for labour has stopped rising, and business surveys suggest some decline in employment over the coming months. This is consistent with signs of weakening demand and sales.

Foreign workers remain important. Over 700,000 Ukrainians (predominantly female) have been registered as regular employees. In total, over 1m working foreigners currently contribute to the social security system. The unregistered employment of Ukrainians (as well as of other foreigners) is bound to be quite high, too. Quite likely their presence is reducing the bargaining power of regular employees and keeping a lid on wage hikes.

Wages have trailed slightly behind inflation, implying a gentle erosion of the real income of wage-earning households. On the other hand, the income of retired people has risen very sharply: in effect, the real monthly gross retirement pension has risen by over 6% year on year, and over 12% in the case of retired farmers. No doubt the generosity of the public pension system has much to do with the upcoming parliamentary elections (due 15 October).

Massive social transfers in the form of higher pensions and other extraordinary subsidies are helping to support private consumption and GDP growth (as well as to fuel inflation, at least partly). On the other hand, these transfers are increasing the size of the public-sector fiscal deficit (expected to reach about 5% of GDP) and the level of public debt. At about 50% of GDP, the latter is not going to be a serious menace to fiscal stability in 2023, though.

High inflation is still perceived to be a problem, although it has been declining consistently since February. In August, the consumer price index (CPI) stood at 10.1%. Part of that reflects the effects of hikes in administered prices. The CPI level has been constant for four consecutive months now. As it is becoming clear that the present inflation cannot be blamed on excessive consumer demand, price-wage spirals or some ill-defined 'inflationary expectations', there is fairly little that conventional restrictive monetary and fiscal policies can achieve. Further disinflation will follow naturally, as the price and cost effects of the initial negative shocks to the prices of imported energy carriers gradually fizzle out.

Monetary policy has been eased. Up until September, the key policy interest rate had been maintained at 6.75% (since September 2022). In the meantime, falling inflation had in effect tightened monetary policy, as in real terms the interest rate kept increasing. Since the recessionary effects of the monetary policy had become obvious, the central bank decided to cut its rates by 75 basis points (September 2023). Further, perhaps more moderate, cuts may follow in the coming months. This may be expected to affect the prevailing high (nominal) interest rates charged by the commercial banks, and thus strengthen private demand for consumer and investment credit. Thus far, the volume of household debt owed to banks has been falling (and that held by non-financial corporations has been increasing very slowly), while the volume of household and corporate bank deposits has been rising. Lower interest rates are expected to prevent entrenchment of the recessionary tendencies.

The exchange rate has temporarily depreciated in response to the interest rate cuts. For much of 2022 and 2023, the PLN/euro exchange rate fluctuated – often quite unexpectedly – at around 4.64. Those fluctuations did not reflect any obvious interest-rate movements. More recently, though (since April 2023), the exchange rate strengthened for a couple of months to stand close to 4.4. That development was hard to square with the fact that in the meantime, the European Central Bank kept increasing its policy rates. The interest rate cut in September immediately provoked a sharp weakening of the zloty which has returned to the values consistent with the longer-term means. That may positively affect the foreign trade balance, but it could also slow disinflation.

The disagreements with the European Commission are not yet of vital concern. The conflicts over a number of constitutional issues, which are unlikely to be resolved before the parliamentary elections, have already cost the country a large amount of money in the form of withdrawn EU funds. But given the country's strong forex reserves, the Polish government is not yet ready to follow the 'diktat of Brussels'. Possible delays (assumed in our forecast for 2023) in the transfer of EU funds to Poland are not yet a particularly grave problem – at least not in the medium term. Things may not be that easy in 2024 and beyond.

The elections (due on 15 October) may not affect the economy (at least not in the medium term). The opposition parties appear unable to form a 'united front', so that the ruling coalition led by Mr Kaczyński's Law and Justice (PiS) party may well stay in power. Despite high inflation, PiS enjoys popularity – especially among the less prosperous population strata that still relish the various social security transfers made over the past eight years. The last-minute 'sweeties' that the government is distributing quite lavishly are helping as well. It is fairly obvious that, if victorious, PiS will continue the economic policy pursued so far. A victorious opposition would have to follow this overall successful (at least so far) economic policy as well, at least for a year.

Table 6.16 / Poland: Selected economic indicators

	2020	2021	2022 ¹⁾	2022 January-June	2023	2023 Forecast	2024 Forecast	2025
Population, th pers., average ²⁾	37,899	37,747	36,822	.	.	38,360	38,370	38,380
Gross domestic product, PLN bn, nom.	2,338	2,631	3,078	1,420	1,607	3,390	3,660	3,950
annual change in % (real)	-2.0	6.9	5.1	8.0	-0.8	0.0	2.8	3.8
GDP/capita (EUR at PPP)	22,860	25,070	28,040	.	.	.	.	.
Consumption of households, PLN bn, nom.	1,300	1,455	1,721	840	936	.	.	.
annual change in % (real)	-3.6	6.2	3.3	6.8	-2.8	-1.8	3.0	4.0
Gross fixed capital form., PLN bn, nom.	428	442	513	199	232	.	.	.
annual change in % (real)	-2.3	1.2	5.0	8.7	7.2	2.8	2.1	6.0
Gross industrial production (sales) ³⁾								
annual change in % (real)	-1.2	14.5	10.6	14.7	-2.1	-2.0	4.0	5.0
Gross agricultural production								
annual change in % (real)	8.0	-1.7	2.2	.	.	.	.	.
Construction industry ²⁾								
annual change in % (real)	-3.5	1.5	7.6	15.0	1.2	.	.	.
Employed persons, LFS, th, average ⁴⁾	16,441	16,656	16,742	16,742	16,851	16,780	16,680	16,630
annual change in %	-0.1	2.6	0.5	1.4	0.7	0.2	-0.6	-0.3
Unemployed persons, LFS, th, average ⁴⁾	537	580	498	495	474	520	620	660
Unemployment rate, LFS, in %, average ⁴⁾	3.2	3.4	2.9	2.9	2.8	3.0	3.6	3.8
Reg. unemployment rate, in %, eop	6.8	5.8	5.2	5.2	5.0	.	.	.
Average monthly gross wages, PLN ⁵⁾	5,226	5,683	6,346	6,422	7,234	7,120	7,750	8,270
annual change in % (real, gross)	2.9	3.3	-2.1	0.9	-1.8	0.6	3.5	3.0
Consumer prices (HICP), % p.a.	3.7	5.2	13.2	10.9	14.2	11.5	5.2	3.6
Producer prices in industry, % p.a.	-0.5	8.1	23.8	22.0	11.6	12.0	8.0	4.0
General governm. budget, EU def., % of GDP								
Revenues	41.3	42.3	39.8	.	.	40.3	40.1	40.5
Expenditures	48.2	44.1	43.5	.	.	45.1	45.5	44.0
Net lending (+) / net borrowing (-)	-6.9	-1.8	-3.7	.	.	-4.8	-4.0	-3.5
General gov. gross debt, EU def., % of GDP	57.2	53.6	49.1	.	.	48.2	51.0	52.5
Stock of loans of non-fin. private sector, % p.a.	0.4	4.6	0.2	5.7	-3.1	.	.	.
Non-performing loans (NPL), in %, eop	7.0	5.8	5.6	5.6	5.6	.	.	.
Central bank policy rate, % p.a., eop ⁶⁾	0.10	1.75	6.75	6.00	6.75	5.75	5.00	4.00
Current account, EUR m ⁷⁾	12,820	-8,268	-19,618	-10,724	9,915	8,500	4,400	6,000
Current account, % of GDP ⁷⁾	2.4	-1.4	-3.0	-3.5	2.9	1.2	0.6	0.7
Exports of goods, BOP, EUR m ⁷⁾	220,604	263,740	320,361	154,633	168,675	345,000	379,500	413,700
annual change in %	0.1	19.6	21.5	20.8	9.1	7.7	10.0	9.0
Imports of goods, BOP, EUR m ⁷⁾	213,625	271,363	344,614	166,569	162,816	350,800	378,900	420,600
annual change in %	-4.9	27.0	27.0	32.3	-2.3	1.8	8.0	11.0
Exports of services, BOP, EUR m ⁷⁾	58,308	68,731	91,154	42,490	47,396	99,800	105,300	114,800
annual change in %	-7.4	17.9	32.6	34.5	11.5	9.5	5.5	9.0
Imports of services, BOP, EUR m ⁷⁾	35,329	41,934	54,694	24,501	27,649	58,500	61,400	65,400
annual change in %	-9.1	18.7	30.4	34.5	12.9	7.0	5.0	6.5
FDI liabilities, EUR m ⁷⁾	16,646	31,371	33,085	19,509	8,913	24,000	.	.
FDI assets, EUR m ⁷⁾	4,132	7,964	6,974	3,151	1,766	6,000	.	.
Gross reserves of CB excl. gold, EUR m	114,299	134,654	143,949	134,943	151,155	.	.	.
Gross external debt, EUR m ⁷⁾	307,412	322,710	348,068	.	.	360,900	373,800	395,800
Gross external debt, % of GDP ⁷⁾	58.4	56.0	53.0	.	.	49.4	47.7	47.1
Average exchange rate PLN/EUR	4.4430	4.5652	4.6861	4.6329	4.6259	4.64	4.67	4.70

1) Preliminary. - 2) From 2022 according to census 2021. - 3) Enterprises with 10 and more employees. - 4) From 2021 the new LFS methodology is applied in line with the Integrated European Social Statistics Regulation (IESS). - 5) Excluding employees in national defence and public safety. - 6) Reference rate (7-day open market operation rate). - 7) Including SPE.

Source: wiiw Databases incorporating Eurostat and national statistics. Forecasts by wiiw.

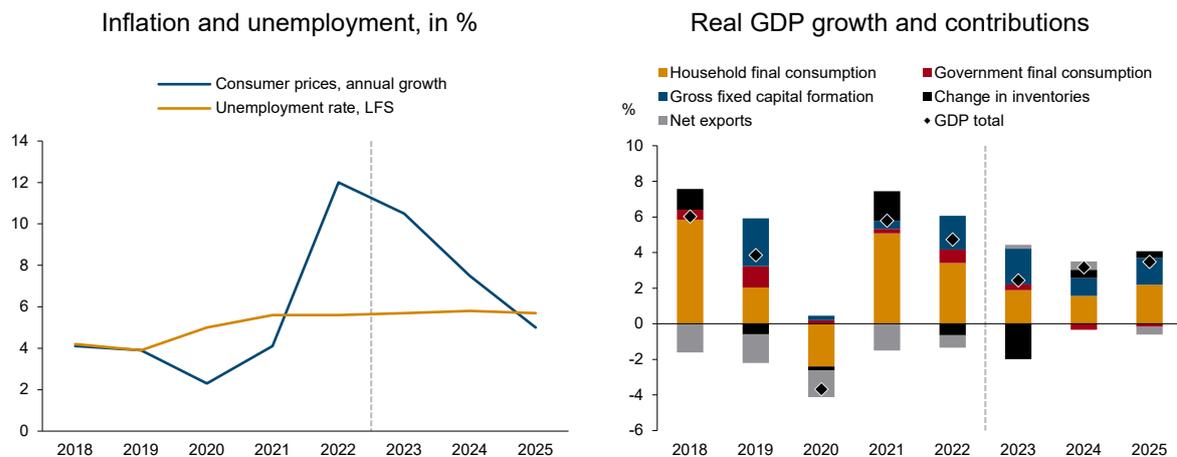


ROMANIA: How much fiscal consolidation?

GÁBOR HUNYA

Romania will suffer a significant economic growth slowdown to 2.5% in 2023, but – helped along by EU funds and a good harvest – its growth will still be above that of most of its peers. Inflation fell to single digits in August, but real incomes are proving slow to recover. The current account deficit has shrunk due to lower imports of goods and higher exports of services. High fiscal deficits jeopardise the country's access to EU funds, but no harsh stabilisation measures will be necessary to keep most of the funds flowing. The rising political risks moderate our growth expectations for the election year of 2024.

Figure 6.17 / Romania: Main macroeconomic indicators



Source: wiiw Annual Database incorporating national and Eurostat statistics, own calculation. Forecasts by wiiw.

The Romanian economy suffered a severe slowdown in Q2 2023. GDP increased by only 1.1%, compared to the same period of last year – considerably less than the 2.4% of Q1. Household consumption weakened significantly, as inflation gobbled up much of the wage rise that came into effect at the beginning of the year. Government consumption increased, reflecting a widening fiscal gap. Gross fixed capital formation surged, mainly in infrastructure projects and machinery, while residential construction fell. The rapid depletion of stocks led to negative gross capital formation, which was the primary cause of economic deceleration. Net exports contributed positively to growth, as exports of goods and services fell less than the corresponding imports.

Industrial production decreased by 4.8% in the first 6 months, compared to the same period last year. With a similar fall for the year as a whole, Romanian industry will be back where it was in 2017 – worse off than in most other EU-CEE countries. Prohibitive energy costs meant that companies engaged

in energy-intensive industries (which have a major presence in Romania) had to stand idle for months, at the same time as international demand for their products was shrinking. Food producers were also running at reduced capacity after last year's poor harvest. There were just a few industrial activities that enjoyed increased production, albeit these were the more sophisticated ones: pharmaceuticals, computers and electronics, machinery and transport equipment. A similar structural shift could be observed in the country's exports, 45% of which were accounted for by machinery and transport equipment – more than before.

Marginally declining employment and a stable rate of unemployment characterised the labour market in H1. The contracting economic activity in some parts of the economy had no major negative effects on unemployment, as it was mainly the capital-intensive sectors that were affected, while labour-intensive activities did relatively well. Employment may decline and unemployment may increase if the government's fiscal adjustment plans come to fruition.

Inflation fell to 9.4% in July 2023 from a peak of 16.8% in November 2022. Services were the main driver of inflation. Food prices also rose faster than average in the first half of the year, but began to decline in June. The government took active steps to rein in inflation, prescribing tight trade margins on food products. But it also changed regulation of the pharmaceutical trade, which triggered a jump in prices. The national bank (BNR) has not been very active in adjusting the policy rate: it reached a high point of 7% in January 2023 and remained stable through August. A small cut may follow later in the year, depending on how sticky inflation remains. The BNR has been active on the currency market, achieving remarkable exchange-rate stability. While this was a useful measure to combat inflation, exporters have suffered.

The current account gap narrowed to EUR 9.8bn in H1 2023, from EUR 12bn the year before. Imports of goods contracted on account of lower fuel prices and subdued economic activity, while export growth was sluggish due to weak external demand and the strong domestic currency. More than half of the deficit in the trade in goods was balanced by the surplus in the trade in services. Romanian hauliers benefited from the increased need to transport goods across the country to and from Ukraine and Moldova. Exports of telecom and computer services also boomed.

The high primary income deficit is the blot on the current account. It amounted to more than 90% of the current account deficit in H1 2023. Investors' income was mostly booked in Q2, thus the primary deficit will have a lower share of the current account deficit in the remainder of the year. Reinvested foreign direct investment (FDI) earnings compensated for half of the primary income deficit. Portfolio investments, especially in government securities, not only financed a major part of the current account deficit, but also increased the level of foreign exchange reserves. These covered 5 months of imports in July 2023, as against 4 months the year before.

In view of the increasing fiscal strains, the government issued bonds in excess of its financing plans, which boosted reserves. This increased the external debt of the general government by 23% in H1 2023. Total external debt has also grown, but will still be among the lowest in the EU, at about 53% of GDP by the end of the year. The interest rate on 10-year government bonds was 6.2% in July – the second highest in EU-CEE, after Hungary. Debt service obligations, still relatively low, will be a growing item of fiscal expenditure and will increase the country's vulnerability to external shocks in the future.

In June, the European Commission sent Romania notification for the country to curb its budget deficit, otherwise part of the cohesion funds would be suspended. Romania was under the Excessive Deficit Procedure prior to the Covid-19 crisis (when the regulation was temporarily suspended) and that has now been reactivated. In view of the mid-year results, the country is unlikely to meet the deficit target of 4.4% of GDP this year. The fiscal deficit has expanded, following generous pay rises in the public sector and lower-than-planned revenue due to sluggish consumption. As of mid-September, the government agreed on a fiscal consolidation package to be introduced as of 1 October and put it up for discussion. The government would like to cut only 1 percentage point from the projected deficit of 6.5% of GDP for this year. The main part of the higher revenues is expected to come from a 1% extra tax on the turnover of companies and banks. Tax allowances and extra benefits for various groups of the population will be abolished. An extra tax on valuable real estate and cars would also be imposed. More radical measures – such as switching the flat 10% rate of personal income tax to a progressive system – were abandoned as they divided the two coalition partners. The planned consolidation measures will reduce the fiscal deficit by about 0.6 percentage points per annum for five years. This is less than the cut expected by the Commission, thus further measures cannot be excluded. Somewhat more inflation, higher unemployment and less economic growth seem to be the likely macroeconomic effects of the fiscal tightening, and these have been factored into our forecast.

In view of the results for the first 6 months and the upcoming fiscal consolidation, it is justified to revise our GDP forecast downward – to 2.5% for 2023 and 3.2% for 2024. However, in H2 2023 growth looks better than in H1. Household consumption has picked up recently on the back of a better harvest than last year and an exceptional rise in the minimum wage. Net exports may grow more rapidly if external conditions improve. Inflows from the Multiannual Financial Framework and Next Generation EU may amount to 4.0% of GDP in 2023 and 2024, which would maintain the growth of gross fixed capital formation. The prerequisite is that Romania meets its milestone conditions; thus delays are likely, as the government is hesitant about the size of the fiscal adjustment.

Fiscal restrictions in exchange for EU funds will be a fundamental economic policy issue over the coming years. Moderate fiscal consolidation is the most likely trajectory to be agreed with the Commission, meaning that the deficit will not dip below 3% of GDP before 2026. In its negotiations with the EU, Romania will be able to rely on its improved international standing as a supporter of Western political and military efforts in Ukraine. Government stability is a precondition for both the success of the negotiations and the smooth implementation of any fiscal reform. There is some risk that the governing coalition may split over the reform agenda if further tightening becomes necessary. Slippages in the country's fiscal stance could delay or even lead to some loss of EU funds and put the brakes on economic growth. The assumption underlying our forecast is that EU funding will continue to flow, even if there are delays and cuts.

In 2024, Romania will have four rounds of elections. First, the EU elections in June, followed by the local elections. Towards the end of the year, presidential and parliamentary elections will be held. The ruling coalition of the two largest moderate parties (PSD and PNL) could lose votes to the right-wing populist party (AUR), which currently heads the polls. The latter opposes fiscal reform and the fulfilment of EU conditionalities, and is active in stirring up an ideological dispute between sovereignty and globalism. The risk of political instability acts as a drag on the economic growth forecast even for 2025, when the international environment may allow some acceleration.

Table 6.17 / Romania: Selected economic indicators

	2020	2021	2022 ¹⁾	2022 January-June	2023	2023 Forecast	2024 Forecast	2025
Population, th pers., average	19,265	19,122	19,047	.	.	18,900	18,800	18,700
Gross domestic product, RON bn, nom.	1,066.8	1,187.4	1,409.8	601.9	690.0	1,600	1,770	1,890
annual change in % (real)	-3.7	5.8	4.7	5.6	1.7	2.5	3.2	3.5
GDP/capita (EUR at PPP)	21,830	24,040	27,070	.	.	.	.	.
Consumption of households, RON bn, nom.	642.1	732.6	883.6	382.5	443.5	.	.	.
annual change in % (real)	-3.9	8.4	5.5	7.5	4.1	3.0	2.5	3.5
Gross fixed capital form., RON bn, nom.	251.0	281.9	351.6	134.5	161.7	.	.	.
annual change in % (real)	1.1	1.9	8.0	2.2	11.1	8.0	4.0	6.0
Gross industrial production ²⁾								
annual change in % (real)	-9.2	7.1	-1.8	-0.9	-4.8	-3.0	3.0	4.0
Gross agricultural production								
annual change in % (real)	-15.4	14.3	-15.8	.	.	.	.	.
Construction industry ²⁾								
annual change in % (real)	15.9	-0.6	12.9	4.4	11.8	.	.	.
Employed persons, LFS, th, average ³⁾	8,521	7,756	7,807	7,815	7,683	7,730	7,690	7,690
annual change in %	-1.8	0.7	0.7	1.0	-1.7	-1.0	-0.5	0.0
Unemployed persons, LFS, th, average ³⁾	452	459	464	467	455	470	470	460
Unemployment rate, LFS, in %, average ³⁾	5.0	5.6	5.6	5.7	5.6	5.7	5.8	5.7
Reg. unemployment rate, in %, eop	3.4	3.0	3.1	2.8	2.9	.	.	.
Average monthly gross wages, RON ⁴⁾	5,213	5,535	6,159	6,284	7,145	6,900	7,600	8,200
annual change in % (real, gross)	4.7	1.1	-2.2	-1.1	0.8	1.0	3.0	3.0
Average monthly net wages, RON	3,217	3,416	3,832	3,871	4,464	4,300	4,700	5,100
annual change in % (real, net)	4.9	1.1	-1.4	-0.5	2.2	2.0	2.5	3.5
Consumer prices (HICP), % p.a.	2.3	4.1	12.0	10.3	11.3	10.5	7.5	5.0
Producer prices in industry, % p.a.	0.0	14.9	44.7	46.7	13.2	8.0	4.0	4.0
General governm. budget, EU def., % of GDP								
Revenues	32.3	32.7	33.5	.	.	33.5	34.0	34.0
Expenditures	41.5	39.8	39.7	.	.	38.7	37.5	37.5
Net lending (+) / net borrowing (-)	-9.2	-7.1	-6.2	.	.	-5.7	-4.5	-4.0
General gov. gross debt, EU def., % of GDP	46.9	48.6	47.3	.	.	50.0	49.0	48.0
Stock of loans of non-fin. private sector, % p.a.	5.0	14.3	11.2	16.6	5.8	.	.	.
Non-performing loans (NPL), in %, eop	3.8	3.4	2.7	3.0	2.7	.	.	.
Central bank policy rate, % p.a., eop ⁵⁾	1.50	1.75	6.25	3.75	7.00	6.75	5.00	4.00
Current account, EUR m	-10,893	-17,471	-26,706	-11,996	-10,804	-22,800	-20,000	-19,600
Current account, % of GDP	-4.9	-7.2	-9.3	-9.9	-7.7	-7.0	-5.6	-5.2
Exports of goods, BOP, EUR m	57,532	70,170	85,862	41,670	44,185	89,300	94,700	102,300
annual change in %	-8.8	22.0	22.4	22.4	6.0	4.0	6.0	8.0
Imports of goods, BOP, EUR m	76,476	93,286	118,222	56,121	57,191	120,600	126,600	136,700
annual change in %	-5.5	22.0	26.7	26.7	1.9	2.0	5.0	8.0
Exports of services, BOP, EUR m	23,764	27,881	37,002	16,926	19,489	41,400	46,400	51,000
annual change in %	-12.2	17.3	32.7	35.4	15.1	12.0	12.0	10.0
Imports of services, BOP, EUR m	14,321	18,462	24,290	11,359	12,142	25,500	28,100	29,800
annual change in %	-22.2	28.9	31.6	36.8	6.9	5.0	10.0	6.0
FDI liabilities, EUR m	3,056	9,933	11,295	4,741	6,841	11,000	.	.
FDI assets, EUR m	112	1,117	1,663	331	2,598	4,000	.	.
Gross reserves of CB excl. gold, EUR m	37,379	40,475	46,636	42,033	53,418	.	.	.
Gross external debt, EUR m	126,750	136,585	144,561	136,512	159,233	170,000	190,000	205,000
Gross external debt, % of GDP	57.5	56.6	50.6	47.8	49.6	52.4	53.1	54.2
Average exchange rate RON/EUR	4.8383	4.9215	4.9313	4.9457	4.9339	4.93	4.95	5.00

1) Preliminary. - 2) Enterprises with 4 and more employees. - 3) From 2021 the new LFS methodology is applied in line with the Integrated European Social Statistics Regulation (IESS). - 4) Including the employers' social security contribution. - 5) One-week repo rate.

Source: wiiw Databases incorporating Eurostat and national statistics. Forecasts by wiiw.

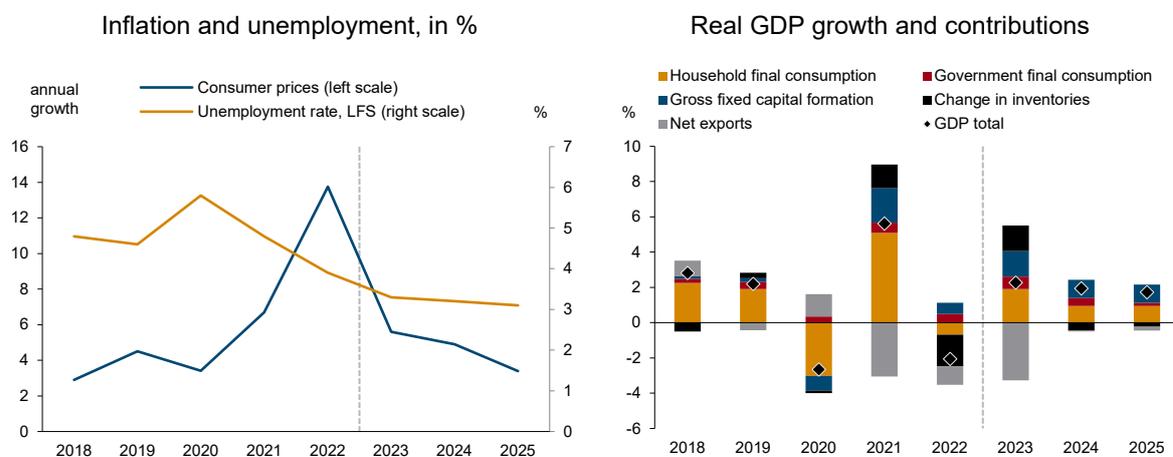


RUSSIA: Resisting depreciation pressures

VASILY ASTROV

Low oil prices and a strong rebound of imports have resulted in the rouble depreciating by about 30% since the beginning of the year, prompting drastic monetary policy tightening. Nevertheless, the economy is continuing to recover on the strength of domestic demand, with military procurement boosting industrial production and construction, and a tight labour market pushing up wages and consumption. This year, growth is projected to exceed 2%, to be followed by a mild deceleration in 2024-2025. A growing addiction to fiscal military stimulus and increased technological backwardness together increase the risk of stagnation (or even outright crisis) once the war is over.

Figure 6.18 / Russia: Main macroeconomic indicators



Source: wiiw Annual Database incorporating national and Eurostat statistics, own calculation. Forecasts by wiiw.

The Russian economy is continuing its recovery from last year's slump, thanks in large part to the heavy military spending. In Q2 2023, real GDP grew by 4.9% year on year, bringing growth in the first half year to 1.6%. This means that the economic crisis has now essentially been left behind, at least at the aggregate level (which masks great heterogeneity across sectors and industries). Industrial production growth in H1 2023 averaged 2.6%, with those industries that enjoy a large share of military production leading the way. Accordingly, the production of computers, electronic and optical products soared by 30.4%; 'finished metal products except machinery and equipment' by 29.7%; other transport vehicles and equipment by 22.1%; and electric equipment by 22%. Crucially, the military production boom is being assisted by the fact that Russia reportedly imports most of the products it requires, including badly needed semiconductor chips, via third countries – the Western trade sanctions notwithstanding. Other sectors that recorded above-average growth included construction (9.8%) and

hospitality and catering (12.3%, both in value-added terms). Construction benefited in large part from the creation of military infrastructure in regions bordering Ukraine, as well as of transport and logistics infrastructure in the Far East, along the Trans-Siberian Railway (in the wake of the foreign trade reorientation towards Asia); meanwhile, the upsurge in hospitality and catering partly reflects the boom in domestic tourism, since travelling abroad has become so much more difficult.²⁷ By contrast, mining value added declined by 2.1%, largely reflecting the 14.9% drop in natural gas production.

On a negative note, the exchange rate has depreciated by around 30% since the beginning of the year, mirroring the unfavourable trends in foreign trade. Whereas last year the rouble was supported by high energy prices and the initial collapse of imports (in the face of Western trade sanctions and the withdrawal of many foreign companies), in 2023 those trends have largely gone into reverse. Global oil prices have generally declined; moreover, the price spread between Brent and the Russian oil widened (at least initially) following the imposition of the EU import embargo (in December 2022 for crude oil and in February 2023 for oil products), although Russia then successfully reoriented the bulk of its oil exports to Asia.²⁸ (It was not until July 2023 that oil prices started to rise again, in large part due to voluntary production cuts by Russia and Saudi Arabia, while the Brent-Urals spread has narrowed recently.)²⁹ Russia's exports of natural gas have also struggled: since the beginning of the war, the country has lost a large slice of its main gas market – the EU – and the limitations of the existing infrastructure mean that it will take some time to reorient exports to Asia. All in all, Russian goods exports declined by 32% in January-August 2023 (in US dollar terms); by contrast, imports surged by 17%, as economic recovery gained momentum and new ways were found to circumvent the trade sanctions. The current account surplus in the first eight months of the year shrank by more than 85% year on year, putting pressure on the exchange rate.

The rouble depreciation has fuelled inflation and prompted drastic monetary policy tightening. After the low of 2.3% in April 2023, consumer price inflation has been on the rise, reaching 4.3% in July and 5.2% in August – thus above the 4% inflation target, and with annualised inflation (based on the most recent trends) even higher. Exchange rate depreciation apart, the steep rise in the price of petrol and diesel fuel following the recent cuts to the subsidies has played a role as well (leading the government to impose a ban on exports of these products as of 21 September). Under these circumstances, the Central Bank of Russia (CBR) has resorted to drastic policy tightening: it has hiked the key rate in three steps since July, by a combined 5.5pp (to 13%) and has stepped up foreign exchange interventions.³⁰ These measures, coupled with the increased 'voluntary' conversion by exporters of their foreign currency earnings, have been successful in stabilising the exchange rate for now. Such fundamental factors as recovering oil prices should provide support for the rouble in the coming months as well. However, as the pass-through from the previous depreciation into consumer prices is not yet over, inflationary pressures may not subside very rapidly. Besides, the CBR is

²⁷ Direct flights between the EU and Russia were cancelled immediately after the start of the war, and most land borders were effectively closed during the subsequent months as well. Besides, EU visa procedures for Russians have become much more restrictive.

²⁸ China and India now absorb more than half of Russia's oil exports.

²⁹ The price cap, set by the G-7 at USD 60 per barrel for Russian oil shipments to third countries, has arguably played little part (if any) in these developments: the price of Russian oil shipped to Asia, such as ESPO (Eastern Siberia-Pacific Ocean), has invariably been higher than the cap.

³⁰ Another move in this vein has been the tightening, as of September 2023, of regulations on subsidised mortgages, which had been an important driver of credit growth. The minimum downpayment required has been raised from 15% to 20%, and the interest rate subsidy on mortgages has been cut by 0.5pp.

concerned about 'overheating' of the economy, whereby strong domestic demand is increasingly facing capacity bottlenecks, with potentially adverse inflationary consequences.

The presence of capacity bottlenecks is suggested by the widespread labour and skill shortages.

By July 2023, the unemployment rate (Labour Force Survey) had plunged to a mere 3% – an all-time low. On the one hand, after near-stagnation last year, employment growth has gained momentum, reaching 2.6% year on year in July 2023. On the other hand, labour supply has been shrinking for many years now on account of long-term demographic decline. The 'partial' military mobilisation announced in September 2022 (of up to 500,000 men) and the recent emigration (mostly to other CIS countries, Serbia, Israel and Turkey) of some 800,000-900,000 people fleeing mobilisation and the increasingly repressive political regime have only served to aggravate this trend. Even if the real labour market may not be as tight as is suggested by the official statistics,³¹ the labour and skill shortages are widespread, especially in the IT sector. The structural mismatch also plays a role: workers laid off in sectors that are affected by sanctions and by the withdrawal of foreign firms often cannot be absorbed by those industries that are booming, such as arms industry. Labour and skills shortages are typically identified as likely to be among the key constraints on Russia's growth performance in years to come. However, there is a welcome demand-side effect: with employers forced to compete for labour, real wages are being pushed up – in H1 2023, earnings soared by 6.8% to become an important driver of recovering private consumption.

Another manifestation of capacity bottlenecks is the high level of capacity utilisation –

something that bodes well for investment. According to various surveys, by mid-2023 capacity utilisation had reached its highest level in Russia's recent history. Coupled with labour shortages, this suggests that the potential for economic recovery based on idle production capacities may now be largely exhausted. Under these circumstances, the continuation of economic growth will crucially hinge on new (labour-saving) investments and their productivity. Indeed, there is evidence of vibrant investment activity currently under way in Russia: investment was up 7.6% in H1 2023, partly on account of the above-mentioned construction boom, but also in the wake of the realignment of production and logistic value chains by private businesses in response to the recent shocks. However, there are question marks over the productivity of investments, given Russia's reduced access to Western technology. Unsurprisingly, the main beneficiaries of Western sanctions appear to be third countries. For instance, one recent survey (conducted in August) found that 77% of Russian industrial companies are planning to purchase equipment from such countries as China, India and Turkey (compared to 59% a year ago), while the success of Russia's import substitution strategy when it comes to investment goods appears questionable at best.

Against all the odds, the budget deficit target for this year is likely to be broadly met, and the overall fiscal outlook has brightened.

Low energy exports this year have affected the government's energy revenues, which historically used to account for around 40% of the federal budget. Although the recent upturn in oil prices and the rouble depreciation have brought some relief, on average in January-August 2023 these revenues were still down by 38%. However, non-energy tax revenues picked up by 24%, thanks to the economic recovery under way. Moreover, the growth in budget expenditure – which

³¹ The results of macroeconomic modelling carried out at wiiw suggest that the earlier trend of declining unemployment went into reverse at the start of the war and sanctions, with a moderate rebound in the unemployment rate (Labour Force Survey) to around 4.5-5%. One reason for the discrepancy with the official statistics is that workers in the ailing automotive industry are reportedly often not registered as unemployed, but rather are sent on unpaid leave or are still on the company payroll.

was very high at the beginning of the year – has moderated and averaged a mere 12% in the period January-August. While the budget deficit reached RUB 2.4 trillion in the first eight months, the whole-year target of RUB 2.9 trillion now appears broadly realistic. Thanks to all this, the fiscal outlook for the next few years has also brightened. This is all the more important, as Russia no longer has access to international financial markets, while domestic borrowing remains quite expensive, at 11-12% in nominal terms.

On the strength of recent growth performance, our forecast for 2023 has been revised upwards to 2.3%, to be followed by a modest slowdown in the next two years. With no end to the war in sight, the current growth trajectory – based as it is in large part on military fiscal stimulus – will likely continue for some time, despite the economy suffering increased labour shortages and falling behind on the technological front, due to the Western sanctions. However, the longer the war lasts, the more addicted the economy will become to military spending, raising the risk of stagnation (or even outright crisis) once the conflict is over. Moreover, should the war culminate in Russia's defeat, that would likely have major repercussions for domestic political stability, potentially leading to a collapse of the current regime and stoking the (by no means negligible) chances of even more nationalistic (and anti-market) political forces coming to power.

Table 6.18 / Russia: Selected economic indicators

	2020	2021	2022 ¹⁾	2022 January-June	2023	2023 Forecast	2024 Forecast	2025
Population, th pers., average ²⁾	146,460	145,864	146,714	146,745	146,374	146,330	145,800	145,400
Gross domestic product, RUB bn, nom.	107,658	135,295	153,435	72,939	75,392	160,100	171,400	181,300
annual change in % (real)	-2.7	5.6	-2.1	-0.9	1.6	2.3	1.9	1.7
GDP/capita (EUR at PPP)	19,660	22,570	23,620	.	.	.	.	.
Consumption of households, RUB bn, nom.	54,752	65,811	73,260	.	.	.	.	.
annual change in % (real)	-5.9	10.0	-1.4	.	.	4.0	2.0	2.0
Gross fixed capital form., RUB bn, nom.	23,211	26,623	31,784	.	.	.	.	.
annual change in % (real)	-4.0	9.1	3.3	.	.	7.0	5.0	5.0
Gross industrial production ³⁾								
annual change in % (real)	-2.1	6.4	0.6	2.3	2.2	3.0	2.5	2.5
Gross agricultural production								
annual change in % (real)	1.3	-0.4	10.2	7.3	2.9	.	.	.
Construction output								
annual change in % (real)	2.1	7.0	5.2	3.7	9.2	.	.	.
Employed persons, LFS, th, average	70,601	71,719	71,974	71,733	73,167	73,410	74,140	74,510
annual change in %	-1.9	1.6	0.4	0.8	2.0	2.0	1.0	0.5
Unemployed persons, LFS, th, average	4,321	3,631	2,951	3,074	2,533	2,400	2,400	2,300
Unemployment rate, LFS, in %, average	5.8	4.8	3.9	4.1	3.4	3.3	3.2	3.1
Reg. unemployment rate, in %, eop ⁴⁾	3.7	1.0	0.8	0.9	0.7	.	.	.
Average monthly gross wages, RUB	51,344	57,244	65,338	61,853	70,058	73,800	80,500	85,700
annual change in % (real, gross)	3.8	4.5	0.3	-0.8	7.3	7.0	4.0	3.0
Consumer prices, % p.a.	3.4	6.7	13.8	14.3	5.5	5.6	4.9	3.4
Producer prices in industry, % p.a. ⁵⁾	-3.8	24.5	11.4	23.4	-6.3	-5.0	5.0	5.0
General governm. budget, nat. def., % of GDP								
Revenues	35.5	35.6	34.6	36.1	33.7	35.0	35.0	35.0
Expenditures	39.5	34.8	36.0	32.2	36.9	37.5	37.0	36.5
Deficit (-) / surplus (+)	-4.0	0.8	-1.4	3.9	-3.3	-2.5	-2.0	-1.5
General gov. gross debt, nat. def., % of GDP	17.6	15.5	14.9	12.8	15.7	17.0	18.7	20.0
Stock of loans of non-fin. private sector, % p.a.	12.4	19.8	13.6	7.5	26.9	.	.	.
Non-performing loans (NPL), in %, eop ⁶⁾	6.1	5.1	4.7	.	.	.	.	.
Central bank policy rate, % p.a., eop ⁷⁾	4.25	8.50	7.50	9.50	7.50	13.00	10.00	8.00
Current account, EUR m ⁸⁾	30,957	103,142	223,066	134,807	21,624	46,600	58,800	63,300
Current account, % of GDP	2.4	6.6	10.5	15.4	2.4	2.6	3.4	3.7
Exports of goods, BOP, EUR m ⁸⁾	291,895	417,548	558,271	279,789	191,197	404,800	433,200	454,800
annual change in %	-22.1	43.0	33.7	62.0	-31.7	-27.5	7.0	5.0
Imports of goods, BOP, EUR m ⁸⁾	210,118	256,781	261,460	115,599	138,430	289,500	304,000	319,200
annual change in %	-7.3	22.2	1.8	-0.9	19.8	10.7	5.0	5.0
Exports of services, BOP, EUR m ⁸⁾	41,973	46,920	45,854	22,750	17,835	36,800	38,700	40,600
annual change in %	-24.1	11.8	-2.3	11.9	-21.6	-19.7	5.2	4.9
Imports of services, BOP, EUR m ⁸⁾	56,666	64,136	67,168	29,371	32,990	73,100	76,700	80,500
annual change in %	-35.5	13.2	4.7	11.9	12.3	8.8	4.9	5.0
FDI liabilities, EUR m ⁸⁾	8,296	34,166	-37,836	.	.	-25,000	.	.
FDI assets, EUR m ⁸⁾	5,117	55,647	-12,393	.	.	0	.	.
Gross reserves of CB excl. gold, EUR m ⁸⁾⁹⁾	372,318	439,693	414,569	554,838	532,991	.	.	.
Gross external debt, EUR m ⁸⁾	380,941	426,299	353,872	451,995	318,192	281,500	240,000	224,500
Gross external debt, % of GDP	29.2	27.5	16.7	21.4	18.1	16.0	14.0	13.0
Average exchange rate RUB/EUR	82.39	87.20	72.48	83.31	83.19	91.0	100.0	105.0

Note: Including Crimean Federal District.

1) Preliminary. - 2) From 2022 according to census 2021. - 3) Excluding small enterprises. - 4) In % of labour force (LFS). - 5) Domestic output prices. - 6) According to Russian Accounting Standards overdue debt is defined as debt service overdue, therefore the data are not fully comparable with other countries. - 7) One-week repo rate. - 8) Converted from USD. - 9) Including part of resources of the National Wealth Fund of the Russian Federation.

Source: wiiw Databases incorporating national statistics. Forecasts by wiiw.

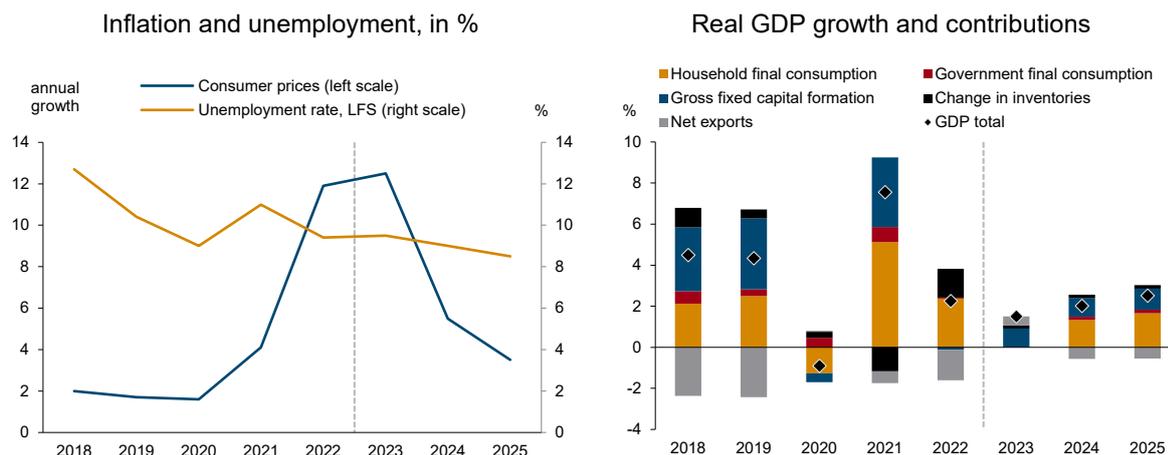


SERBIA: A lighter shade of grey

BRANIMIR JOVANOVIĆ

The economy grew solidly in Q2, but this is likely to be short lived. Inflation is showing signs of moderating, but is still among the highest in the CESEE region. The central bank is likely to keep interest rates unchanged for the rest of the year, while fiscal policy will probably become less restrictive. We are revising our GDP growth forecast for 2023 upwards to 1.5%, but for 2024 and 2025 downwards, due to the expected lower global growth.

Figure 6.19 / Serbia: Main macroeconomic indicators



Source: wiiw Annual Database incorporating national and Eurostat statistics, own calculation. Forecasts by wiiw.

The economy in Q2 outperformed expectations. GDP grew by 1.7% year on year, which, on an annualised quarter-on-quarter basis, exceeded 5%. This was accompanied by an upward revision of Q1 growth by the statistical office to 0.9% (from the previous 0.7%). The relatively good results for Q2 are likely to be short lived, though. Household and government consumption both declined by around 1%, while investment and exports grew only marginally, by around 4% and 2%, respectively (all in real terms). In such a situation, the primary driver of the growth in Q2 was the approximately 6% decline in imports. This drop is probably a consequence of reduced energy imports compared to the previous year, and is unlikely to be sustained.

Inflation is showing signs of moderating, but it still ranks among the highest in the CESEE region. In August, it stood at 11.5%, down from its peak of 16.2% in March. The high inflation is partly due to the government's decision to increase the price of electricity and gas at the start of the year, and to remove the price controls on basic foodstuffs that it introduced at the end of 2021. Recognising that the decision to lift these price controls was a mistake, the government agreed with several supermarket chains in September to reduce the prices of around 30 essential food and hygiene products for the

remainder of the year. While this measure is expected to provide some relief for the public, its impact on the overall price level will be limited, since it applies to only a handful of products.

Not only is high inflation acting as a brake on the economy, but it is also damaging people's standard of living. While there are no official data on poverty trends after 2021, real wages stagnated in the first six months of 2023, while the unemployment rate increased in Q2 by 0.7 percentage points year on year, to reach 9.6%. The number of persons employed declined marginally, although the employment rate increased by 0.5 percentage points, due to a decline in the working-age population. The stagnation of real wages and the decline in employment at a time when real GDP is growing (even if only modestly) suggest that the labour share of income is shrinking while the profit share is rising. This also implies that inflation in the country is currently being driven by company profits, not wages.

The combination of monetary and fiscal policies in the first nine months of the year has been quite restrictive and has held back economic growth. Monetary policy took the lead (with the central bank steadily raising its interest rate) while fiscal policy followed (as the government kept spending low). The policy mix is likely to be less restrictive in the coming months, which will somewhat favour economic activity.

The cycle of interest-rate hikes appears to be over. The central bank has kept its rate unchanged for two months in a row (August and September), having raised it 15 times in the 16 months between April 2022 and July 2023. The base interest rate remains relatively high, though, at 6.5% as of September, significantly higher than the European Central Bank (ECB). While we believe the central bank is unlikely to raise rates again this year, much will depend on the actions of the major central banks, especially the ECB. If it continues to raise rates in the coming months, the Serbian central bank may do the same.

Fiscal policy has also been restrictive so far this year, but this is likely to change. The general government budget recorded a surplus of around 1% of GDP in the first six months, due to relatively weak expenditure. Spending was especially low on capital investment, which fell to around 5% of GDP in the first half of the year – some 15% below its level for the same period last year (in real terms). Public spending is likely to improve in the last few months of the year, as the government has announced higher pensions, an increase in public-sector salaries, and even one-off payments to certain groups of people. This will probably push the budget balance back into negative territory. The move will likely support economic activity somewhat, although over the medium term, fiscal policy will probably be much less supportive than in previous years, owing to higher interest rates.

Foreign direct investment (FDI), which has been the cornerstone of the country's economic model in recent years, remained solid in H1 2023. It grew by around 20% in real terms year on year, reaching 6.3% of GDP. There were also some interesting developments in the structure of the investments, which may indicate the direction in which the country is moving: in Q1 (the latest available data), 63% of inflows came from EU countries – almost double the share of the year before; at the same time, investment from China amounted to 15% of total inflows – around half its share in 2022. While it may be too early to draw any firm conclusions (since the data are for only one quarter and FDI data are notoriously volatile), these trends may indicate that Western investors are regaining confidence in the country.

The general impression is that the country is improving its relations with the West – something that is likely to be positive for FDI inflows and overall economic developments. In recent months, President Vučić has twice met Ukrainian President Zelensky, once in June in Moldova and once in August in Greece. There have also been media reports that weapons produced in Serbia are being used by the Ukrainian army. While President Vučić has denied that Serbia is selling weapons direct to Ukraine, he has acknowledged that Serbian weapons may be reaching the country through intermediaries. The West has also been quite supportive of Serbia in its recent squabbles with Kosovo. However, it is highly unlikely that Serbia will introduce sanctions against Russia or sever its economic relations with the country: more likely it will try to maintain good political and economic relations with both the West and Russia, in an effort to benefit from both sides. After all, Russian FDI in Serbia in the Q1 2023 was also significant, amounting to 6% of total FDI – equal to the German share. Several hundred thousand Russians have arrived in Serbia over the past year or so (although many have also left), and around 7,000 Russian companies have opened up, mainly in the IT and services sectors.

Considering all this, we are revising our GDP forecast for 2023 upwards to 1.5% (up 0.2 percentage points). We have taken this step for several reasons: the strong performance in Q2, the upward revision of growth in Q1, the announcements of greater fiscal support in the remainder of the year, and the country's improved relations with the West. However, on a longer-term horizon, it is clear that the economy is on a slower track than previously, due to both domestic and global factors, and that it is unlikely to return to growth rates of 3-4% any time soon. Accordingly, we are revising our forecasts for 2024 and 2025 downwards by 0.5 percentage points (to 2% and 2.5%, respectively).

As for inflation, we are revising our forecast upwards for both 2023 and 2024, on account of the price hikes over the past few months. For 2023, we now expect it to average 12.5%; for 2024, we now forecast 5.5% (both figures 0.5 percentage points up on the previous forecast).

Table 6.19 / Serbia: Selected economic indicators

	2020	2021	2022 ¹⁾	2022 January-June	2023	2023 Forecast	2024 Forecast	2025
Population, th. pers., mid-year ²⁾	6,899	6,834	6,664	.	.	6,614	6,564	6,514
Gross domestic product, RSD bn, nom.	5,504	6,270	7,091	3,280	3,734	8,100	8,700	9,200
annual change in % (real)	-0.9	7.5	2.3	3.9	1.3	1.5	2.0	2.5
GDP/capita (EUR at PPP)	12,810	14,350	15,530	.	.	.	.	.
Consumption of households, RSD bn, nom.	3,606	4,067	4,719	2,180	2,493	.	.	.
annual change in % (real)	-1.9	7.8	3.7	5.2	-0.4	0.0	2.0	2.5
Gross fixed capital form., RSD bn, nom.	1,180	1,448	1,620	725	784	.	.	.
annual change in % (real)	-1.9	15.9	-0.6	1.7	3.1	4.0	4.0	4.5
Gross industrial production ³⁾								
annual change in % (real)	0.5	6.4	1.6	3.3	1.5	2.0	2.5	3.0
Gross agricultural production								
annual change in % (real)	2.0	-5.6	-8.0	.	.	.	.	.
Construction output								
annual change in % (real)	-2.5	17.0	-11.5	-6.9	9.5	.	.	.
Employed persons, LFS, th, average ⁴⁾	2,895	2,849	2,913	2,912	2,857	2,900	2,930	2,960
annual change in %	-0.2	2.6	2.3	4.9	0.5	-0.5	1.0	1.0
Unemployed persons, LFS, th, average ⁴⁾	287	352	302	314	312	300	290	270
Unemployment rate, LFS, in %, average ⁴⁾	9.0	11.0	9.4	9.8	9.9	9.5	9.0	8.5
Reg. unemployment rate, in %, eop	17.9	17.4	15.4	.	.	.	.	.
Average monthly gross wages, RSD	82,984	90,784	103,316	100,622	116,126	117,400	126,300	134,600
annual change in % (real, gross)	7.8	5.2	1.7	3.5	0.1	1.0	2.0	3.0
Average monthly net wages, RSD	60,073	65,864	74,933	72,945	84,197	85,100	91,600	97,700
annual change in % (real, net)	7.7	5.4	1.7	3.4	0.1	1.0	2.0	3.0
Consumer prices, % p.a.	1.6	4.1	11.9	9.7	15.3	12.5	5.5	3.5
Producer prices in industry, % p.a.	-1.3	8.7	14.9	14.8	5.6	4.0	3.0	2.5
General governm. budget, nat. def., % of GDP								
Revenues	41.0	43.3	43.8	45.5	44.9	44.0	44.0	44.0
Expenditures	49.0	47.4	46.9	46.2	43.7	46.0	46.0	45.5
Deficit (-) / surplus (+)	-8.0	-4.1	-3.2	-0.6	1.2	-2.0	-2.0	-1.5
General gov. gross debt, nat. def., % of GDP	57.8	57.1	55.6	52.4	52.1	55.0	56.5	58.0
Stock of loans of non-fin. private sector, % p.a.	11.1	10.2	6.5	12.8	0.3	.	.	.
Non-performing loans (NPL), in %, eop	3.7	3.5	3.0	3.3	3.0	.	.	.
Central bank policy rate, % p.a., eop ⁵⁾	1.0	1.0	5.0	2.5	6.3	6.5	5.8	5.0
Current account, EUR m	-1,929	-2,266	-4,139	-2,898	-527	-2,400	-3,200	-3,500
Current account, % of GDP	-4.1	-4.2	-6.9	-10.4	-1.7	-3.5	-4.3	-4.4
Exports of goods, BOP, EUR m	16,079	21,018	26,913	12,971	14,183	30,400	33,600	36,900
annual change in %	-2.0	30.7	28.0	33.2	9.3	13.0	10.5	9.8
Imports of goods, BOP, EUR m	21,280	27,038	36,266	18,289	17,374	38,800	42,900	46,800
annual change in %	-3.4	27.1	34.1	48.7	-5.0	7.0	10.5	9.0
Exports of services, BOP, EUR m	6,191	7,800	11,087	4,717	6,031	12,500	13,800	15,200
annual change in %	-10.7	26.0	42.1	37.0	27.9	13.0	10.5	10.0
Imports of services, BOP, EUR m	5,090	6,402	8,771	3,820	4,516	9,400	10,400	11,400
annual change in %	-14.1	25.8	37.0	41.9	18.2	7.0	10.5	9.5
FDI liabilities, EUR m	3,039	3,886	4,416	1,612	2,147	4,450	.	.
FDI assets, EUR m	100	229	110	115	130	150	.	.
Gross reserves of CB, excl. gold, EUR m	11,732	14,523	17,311	12,642	20,410	.	.	.
Gross external debt, EUR m	30,787	36,488	41,885	.	.	48,500	52,900	56,900
Gross external debt, % of GDP	65.8	68.4	69.4	.	.	70.0	71.0	72.0
Average exchange rate RSD/EUR	117.58	117.57	117.46	117.59	117.31	117.0	116.8	116.5

1) Preliminary. - 2) From 2022 according to census 2022. - 3) Excluding arms industry. - 4) From 2023 according to census 2022. From 2021 the new LFS methodology is applied in line with the Integrated European Social Statistics Regulation (IESS). - 5) Key policy rate.

Source: wiiw Databases incorporating national statistics. Forecasts by wiiw.

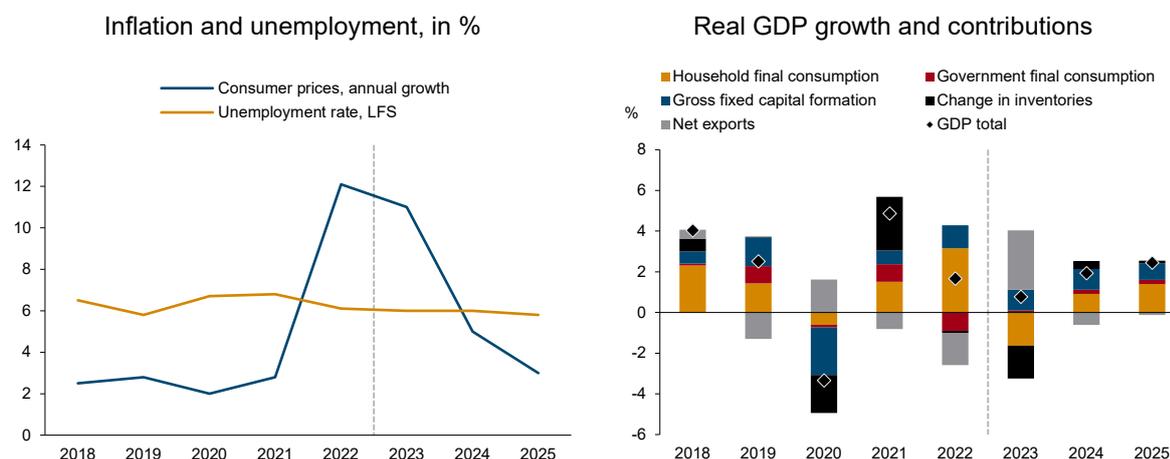


SLOVAKIA: Automotive industry propping up growth, but for how long?

DORIS HANZL-WEISS

In H1 2023, Slovak GDP grew by 1.3% – far better than expected. On the one hand, the important automotive sector supported export growth; on the other, the persistently high inflation deterred household consumption and dragged down GDP growth. Major uncertainties prevail and could dampen future growth.

Figure 6.20 / Slovakia: Main macroeconomic indicators



Source: wiiw Annual Database incorporating national and Eurostat statistics, own calculation. Forecasts by wiiw.

Slovak GDP grew in H1 2023 by 1.3% – slightly less than in 2022 – and remains strongly influenced by the persistently high inflation. While GDP increased by 1.0% year on year in Q1 2023, it actually grew by 1.5% year on year in Q2 – far better than expected. Growth was based first and foremost on positive net foreign trade: imports declined sharply, while exports picked up in Q2. Investment also increased. On the other hand, growth was dragged down by falling household consumption – a casualty of the persistently high inflation and depletion of the household savings used last year. Gross capital formation (declining inventories) fell by 30% in Q1 and by almost 20% in Q2. If we look at trends in the various sectors, those that contribute most to value-added growth were industry (automotive sector); wholesale and retail trade; transportation and storage; accommodation and food services; and construction.

The automotive sector propped up growth in H1 2023, but for how long can that continue? Over the first seven months of 2023, industrial production declined by 2%, with negative contributions from the rubber and plastic sector; computer, electronic and optical products; and wood and paper products. However, the all-important Slovak automotive sector grew by 4% during this time, as it recovered from last year's shortage of components and as EU car registrations surged by 18% in H1 2023 (in Spain and Italy by 20%; in France and Germany by 17%). Preparation of the site for the new Volvo plant is

ongoing, with construction due to start in November 2023 and production planned to commence in 2026. Volvo will become the fifth car producer in Slovakia, joining Volkswagen, Kia, Stellantis and Jaguar Land Rover. Together those firms produced about 1m cars in 2022, making Slovakia again the largest per capita car producer in the world. Volvo will manufacture electric cars, with an annual production capacity of 250,000. A planned expansion was announced recently: in the next phase, an additional 250,000 cars will be produced. This would make the Volvo plant the largest car producer in Slovakia (Volkswagen produced about 400,000 cars annually at its peak in 2018; Stellantis and Kia about 300,000). Direct government support has been given to Volvo to the tune of EUR 250m, while indirect support comes through financing of the Valaliky industrial park.³²

While the labour market remains resilient, the still high inflation and declining real wages have deterred household consumption in 2023. The positive developments on the labour market in 2022 continued into H1 2023, but at a slower pace: the growth in employment has moderated to just 0.2%. More people were employed in services, which are still recovering from the pandemic, and fewer in manufacturing. The rate of unemployment increased slightly in Q1 (compared to Q4 2022), but dropped to an all-time low level of 5.7% in Q2. There are major regional disparities: whereas the unemployment rate in Bratislava was about 2% in Q2, in the east of the country it was in the region of 10%. Real wages declined in H1 2023 by 3.4% on account of the still high inflation, which peaked in February 2023 (15.4% year on year) and has since been falling only slowly. In fact, Slovakia recorded the highest inflation in the euro area in recent months. In August, the rate at long last dipped into single digits (9.6%). This may be attributed to the high proportion of food and beverages in Slovakia's Harmonised Index of Consumer Prices (HICP) basket (at 26.3%, it is the largest share of all the Visegrád countries): comestibles still reflected the largest increase of all the basket's components (16.5% in July). For the whole year 2023, the HICP forecast has been revised upwards, to around 11%. Also for 2024, inflation will remain at a higher level than previously expected. Households are, however, helped by electricity and gas price caps, as well as by a government support package.

The current account improved significantly in H1 2023, but will remain in negative territory in the short term. In 2022, Slovakia posted a record-high current account deficit of 8.2% of GDP, due to rising energy prices. With the fall in energy costs, the current account improved significantly in H1 2023 and was in deficit by only 0.8% of GDP. This was due to a positive trade and services balance: exports of goods and services rose, while goods and services imports fell. Goods exports increased by 8.9% year on year in the first seven months of 2023, while imports grew by only 1%. Exports to the country's main partners – Germany and Czechia – were up 11.5% and 0.9%, respectively. Exports of machinery and transport equipment increased by 20.2%, driven by growth in motor vehicle exports. Trade with Russia halved in terms of both exports and imports, but the trade deficit with Russia is high. Looking at trade with Ukraine, imports declined by 20%, while exports increased by 72%, so that Slovakia runs a trade surplus with Ukraine.

A high public deficit will prevail this year, and the pace of consolidation in the coming years will depend on the complexion of the next government. In 2022, the budget deficit was quite low compared to the crisis years of 2020-2021, making up 2% of GDP, while the public debt level stood at 57.8% of GDP. For this year, a higher deficit is expected, as government measures to help households, businesses and municipalities counter the high energy prices kick in. As such, the budget deficit is

³² <https://www.economy.gov.sk/top/volvo-sa-rozhodlo-pre-sr-preinvestuju-vyse-miliardu-a-vzniknu-tisice-novych-pracovnych-miest>

expected to climb to 6% of GDP this year. For the coming years, the deficit should fall again. However, the pace of fiscal consolidation will depend on the outcome of the upcoming parliamentary elections. Disbursements from the EU funding period 2014-2020 (for which Slovakia was allocated EUR 14.5bn) will come to an end this year, while the 2021-2027 Multiannual Financial Framework will take over from next year. Slovakia's absorption rate lags behind that of its peers: as of August, about 76% of the EU funds had been drawn. For the EU's Recovery and Resilience Facility (RRF) – from which an overall EUR 6.3bn has been allocated to Slovakia – anecdotal evidence suggests a better performance.

Our growth forecasts for 2023 and 2025 have been revised slightly upwards, and that for 2024 downwards; but a high level of uncertainty prevails. For this year, the wiiw growth forecast has been revised slightly upwards due to the country's better performance in the first half year; nevertheless, the forecast remains cautious, as we expect growth to falter in the second half of the year. Overall, growth will be based on positive net trade and investment, while household consumption will act as a drag on it. The growth forecast has been revised slightly downwards for 2024, but upwards for 2025. With inflation falling significantly in 2024 and 2025, household consumption will also recover and will make a positive contribution to growth. In addition, investment will be supported by the inflow of EU funds. The effects of net exports will be neutral in the coming years. Overall, negative downside risks remain, and uncertainty is high on the external side, as well as domestically. The weak global environment, the recession in Germany – Slovakia's main export market – and the Russian war in Ukraine are all adverse factors. The outcome of the parliamentary elections on 30 September will add to the uncertainty as well. The Slovak political parties have fragmented over time, making the 5% threshold for entering parliament a decisive factor in terms of the number of parties that make it into the legislature – and then making it difficult for any would-be party of government to find an adequate number of coalition partners. With the Russian war in neighbouring Ukraine rumbling on, the diversification of energy supplies remains on the agenda and greening of the economy generally presents a major challenge for the country.

Table 6.20 / Slovakia: Selected economic indicators

	2020	2021	2022 ¹⁾	2022 January-June	2023	2023	2024	2025
							Forecast	
Population, th pers., average ²⁾	5,459	5,447	5,432	.	.	5,426	5,414	5,399
Gross domestic product, EUR m, nom.	93,442	100,324	109,652	51,802	58,069	122,600	131,200	138,400
annual change in % (real)	-3.3	4.9	1.7	2.1	1.3	0.8	1.9	2.4
GDP/capita (EUR at PPP)	21,560	22,920	24,060	.	.	.	.	.
Consumption of households, EUR m, nom.	52,871	56,042	66,452	31,784	35,088	.	.	.
annual change in % (real)	-1.1	2.7	5.7	7.1	-2.9	-2.7	1.5	2.3
Gross fixed capital form., EUR m, nom.	18,210	19,255	22,332	9,250	11,011	.	.	.
annual change in % (real)	-10.9	3.5	5.9	2.2	5.4	5.0	5.0	4.0
Gross industrial production								
annual change in % (real)	-8.3	10.2	-4.0	-2.7	-1.5	-2.5	4.0	4.0
Gross agricultural production								
annual change in % (real)	3.4	-3.4	-10.3	.	.	.	.	.
Construction industry								
annual change in % (real)	-11.3	-2.0	0.0	-0.1	0.1	.	.	.
Employed persons, LFS, th, average ³⁾	2,531	2,561	2,604	2,588	2,594	2610	2620	2630
annual change in %	-2.0	-1.7	1.7	2.8	0.2	0.2	0.3	0.5
Unemployed persons, LFS, th, average ³⁾	181	188	170	172	164	170	170	160
Unemployment rate, LFS, in %, average ³⁾	6.7	6.8	6.1	6.3	6.0	6.0	6.0	5.8
Reg. unemployment rate, in %, eop	7.6	6.8	5.9	6.3	5.1	.	.	.
Average monthly gross wages, EUR	1,133	1,211	1,304	1,252	1,373	1420	1510	1590
annual change in % (real, gross)	1.9	4.5	-4.5	-3.0	-3.4	-2.0	1.5	2.5
Consumer prices (HICP), % p.a.	2.0	2.8	12.1	10.1	13.8	11.0	5.0	3.0
Producer prices in industry, % p.a.	-0.6	6.8	27.8	27.6	14.5	9.5	4.0	2.3
General governm. budget, EU def., % of GDP								
Revenues	39.4	40.1	40.2	.	.	40.0	39.5	39.3
Expenditures	44.7	45.6	42.3	.	.	46.0	43.9	43.8
Net lending (+) / net borrowing (-)	-5.4	-5.4	-2.0	.	.	-6.0	-4.4	-4.5
General gov. gross debt, EU def., % of GDP	58.9	61.0	57.8	.	.	60.0	59.4	60.1
Stock of loans of non-fin. private sector, % p.a.	5.0	7.2	10.8	11.3	6.2	.	.	.
Non-performing loans (NPL), in %, eop	2.3	1.9	1.7	1.9	1.7	.	.	.
Central bank policy rate, % p.a., eop ⁴⁾	0.00	0.00	2.50	0.00	4.00	.	.	.
Current account, EUR m	526	-2,465	-8,938	-3,933	-447	-2,200	-1,700	-500
Current account, % of GDP	0.6	-2.5	-8.2	-7.6	-0.8	-1.8	-1.3	-0.4
Exports of goods, BOP, EUR m	70,011	81,303	96,534	47,764	51,752	101,800	106,900	113,300
annual change in %	-7.3	16.1	18.7	18.7	8.3	5.5	5.0	6.0
Imports of goods, BOP, EUR m	68,996	81,815	103,163	50,517	50,659	102,100	107,700	113,100
annual change in %	-10.0	18.6	26.1	27.3	0.3	-1.0	5.5	5.0
Exports of services, BOP, EUR m	9,048	9,580	11,931	5,333	5,433	12,100	13,000	14,000
annual change in %	-17.6	5.9	24.5	25.8	1.9	1.0	7.5	8.0
Imports of services, BOP, EUR m	8,085	9,034	11,552	5,184	4,991	11,000	11,600	12,100
annual change in %	-17.2	11.7	27.9	27.7	-3.7	-5.0	5.0	4.0
FDI liabilities, EUR m	-934	818	3,876	1,341	-251	700	.	.
FDI assets, EUR m	1,475	1,097	1,528	341	71	500	.	.
Gross reserves of CB excl. gold, EUR m	6,050	6,850	7,915	8,094	7,708	.	.	.
Gross external debt, EUR m	111,746	133,051	113,065	.	.	110,000	105,000	100,000
Gross external debt, % of GDP	119.6	132.6	103.1	.	.	89.7	80.0	72.3

1) Preliminary. - 2) From 2021 according to census 2021. - 3) From 2021 the new LFS methodology is applied in line with the Integrated European Social Statistics Regulation (IESS). - 4) Official refinancing operation rates for euro area (ECB).

Source: wiiw Databases incorporating Eurostat and national statistics. Forecasts by wiiw.

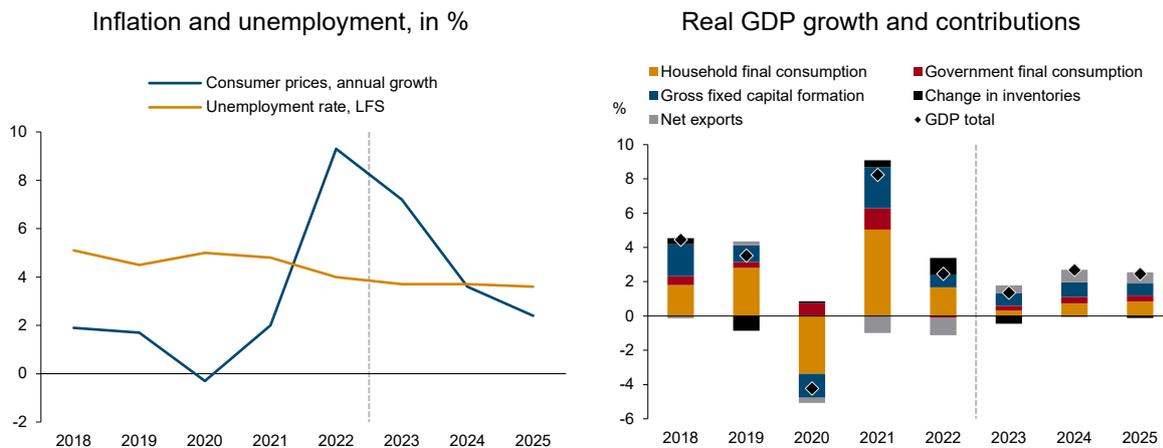


SLOVENIA: Worst flooding in decades is the defining moment of the year

NIKO KORPAR

The reconstruction efforts following the floods in August – the worst in decades – will require several billion euro and will take years to complete, boosting government spending. Growth in 2023 will be subdued, at an estimated 1.3%, as private consumption has slowed significantly. Inflation will be high, but is showing clear signs of decreasing. Industrial output will shrink, as manufacturers face reduced foreign demand. The growth in exports will stall, but imports will fall, leading to a positive current account balance. The labour market is very tight, with the unemployment rate at historically low levels.

Figure 6.21 / Slovenia: Main macroeconomic indicators



Source: wiiw Annual Database incorporating national and Eurostat statistics, own calculation. Forecasts by wiiw.

On 8 August, Slovenia was hit by the worst environmental disaster since independence.

Torrential rain caused several rivers to flood, most severely in parts of Gorenjska and Koroška. Seven people died, 120 houses were completely destroyed and hundreds more were damaged. Some companies will face disruption to their operations for months to come. Immediately after the disaster, a work-free day, known as a 'day of solidarity' was announced to encourage the population to help in the clean-up efforts. To date, tens of thousands of people have provided some form of help.

The first estimates of direct damage, announced by PM Robert Golob, were EUR 4.7bn; it is expected that the final figure will be in the region of EUR 7bn. The first official estimate of direct damage to publicly owned buildings and infrastructure reached EUR 2.7 bn. The government has passed legislation aimed at offering direct financial assistance to afflicted households, companies and infrastructure. Measures in the Emergency Law range from direct financial help to a moratorium on bank

credit repayments. EUR 520m has been secured through a rapid reallocation of the 2023 government budget. New ways to finance the reconstruction work are being considered, including a special tax of 0.3% on income, a nationwide workday on a chosen Saturday and a tax on bank balance sheets. The EU has promised significant funds for reconstruction, including EUR 400m from the Solidarity Fund. Reconstruction is expected to take years to complete. Water infrastructure (and water management practices) will have to be significantly upgraded and anti-flood measures implemented. The disaster has also sparked public debate on the need to invest in climate adaptation measures and to rethink the current practice of building in areas that are at risk of flooding.

We forecast real GDP to grow by 1.3% in 2023. In Q2 2023, real GDP grew by only 1.4%, and further weakening is expected in the second half of the year. In an unexpected announcement, the official growth figure for 2022 was revised significantly downwards, from 5.4% to 2.5%. The official explanation for this focuses on the extraordinary circumstances in 2022 related to inflation and post-Covid recovery, which affected the reliability of the quarterly data used to provide the first official estimate. More worryingly, it also shows that the post-Covid recovery was less robust than previously thought. We have reduced our previous forecast for real GDP growth in 2023 by 0.1pp because of a drop in industrial activity, and to a lesser extent because of the disruption to economic activity due to the floods. Although the damage to infrastructure, residential buildings and companies was disastrous, in macroeconomic terms the floods are not expected to make a significant dent in GDP growth in 2023, since only a small part of the economy was (and still is) disrupted. However, private consumption will grow by only 0.8%, as households face higher prices, and consumer confidence is at a two-year low. Growth will be driven primarily by investment – mostly in infrastructure and buildings – as well by net exports, despite a cooling of foreign demand.

Inflation in 2023 will be above the EU average, but it is expected to fall back in 2024. In the first 8 months of 2023, inflation averaged 8.2%. Annual inflation has been decreasing steadily since April 2023, and this trend is expected to continue into 2024. The gradual decline in inflation is due primarily to stabilisation in the growth of food and energy prices. Core inflation, which excludes the costs of energy and food, remains high and is driven primarily by the increased cost of services. For these reasons, inflation in 2023 will be high, at 7.2%. In 2024, we expect this figure to drop to 3.6%.

In the H2 2023 and throughout 2024, exports will be hampered by high inflation and weaker foreign demand. Exports are expected to grow by only 0.1% this year. Industrial production is forecast to drop by 1.7%, as exporting companies reduce their output because of high energy prices and a technical recession in Germany – the main export market. Companies producing energy-intensive basic materials have been disproportionately affected. Imports will shrink by 0.4%, as household consumption is growing only slowly. After the current account balance went into the red in 2022, foreign trade will once again contribute positively to growth this year, and the current account is projected to improve to 1.3% of GDP. In part, this is due to a successful tourist season. In 2024, we expect exports to recover somewhat (by 3.8%), while imports will grow by 3.5%.

Unemployment in 2023 and 2024 will reach a new record low of 3.7%. The labour shortage is continuing to pose a problem for the economy, particularly in construction, manufacturing and hospitality. New employments have been gradually slowing in H2 2023. The vast majority – 90% or so – of new employments involve foreign workers. We expect this situation to become the ‘new norm’. The emptiness of the labour pool means that unemployment is not expected to rise in 2024, unless the Euro area slips into a recession.

Nominal wages will grow by 7.6% this year, but by only 1.1% in real terms. The largest wage increases have been seen in sectors with a significant labour shortage. The rises in public-sector salaries and in the minimum wage that were implemented in H1 2023 have also contributed to the overall wage growth. In 2024 wages are projected to rise by 5.5%.

The reconstruction after the recent flooding will push government spending above its planned levels. The budget for 2023 and 2024 will have to be renegotiated, and disaster relief efforts will likely increase the deficit in 2023 (to 4.2% of GDP) and 2024 (3.5% of GDP). The final mix of sources of funds to finance the reconstruction has yet to be determined; however, it is likely that additional debt will need to be taken on, which will somewhat hamper the steady downward trajectory of government debt reduction. In 2024, government debt is expected to reach 68.5% of GDP.

The floods represented a rare moment of political unity, and have overshadowed other political events. The coalition of Robert Golob has thus far failed to deliver the promised healthcare reform, and has announced delays to other reforms (such as the public salary system), citing the floods. While healthcare reform will remain the government's priority, the coalition's ability to deliver reforms, many of which come with promises of increased spending, remains to be seen.

In 2024, we expect GDP growth to rebound to 2.7%, as inflation recedes. Private consumption will grow by 1.4% and the current account surplus will rise further, to a projected 2.2% of GDP. Increased government spending (of 1.9%) on flood reconstruction will also drive growth. Industrial production will return to growth (of 2.2%). However, as the outlook for the euro area deteriorates, so the possibility of a plunge in foreign demand could endanger Slovenia's growth performance in 2024 (and 2025).

Flood reconstruction will continue to be an important factor as we move into 2024. Since some transfers from the Cohesion Fund and the Recovery and Resilience Facility are expected to be redirected to support flood recovery, their contribution to growth is harder to estimate. It is likely that the short-term effect on growth will be higher, since the projects will have to be prepared and implemented quickly, and will help the construction and civil engineering sector. However, if funds are diverted from long-range investments, that could have repercussions for Slovenia's long-term ability to improve productivity.

Table 6.21 / Slovenia: Selected economic indicators

	2020	2021	2022 ¹⁾	2022 January-June	2023	2023 Forecast	2024 Forecast	2025
Population, th pers., average	2,102	2,108	2,112	.	.	2,115	2,119	2,125
Gross domestic product, EUR m, nom. ²⁾	47,045	52,279	57,038	28,330	31,783	62,000	66,000	69,200
annual change in % (real)	-4.2	8.2	2.5	9.3	1.1	1.3	2.7	2.5
GDP/capita (EUR at PPP)	26,780	29,190	31,460	.	.	.	.	.
Consumption of households, EUR m, nom. ²⁾	23,293	26,530	30,157	14,833	16,389	.	.	.
annual change in % (real)	-6.5	10.2	3.3	16.6	0.9	0.6	1.4	1.6
Gross fixed capital form., EUR m, nom. ²⁾	8,893	10,582	12,330	6,138	7,155	.	.	.
annual change in % (real)	-7.2	12.6	3.5	8.3	9.7	3.4	4.0	3.2
Gross industrial production								
annual change in % (real)	-5.3	10.3	1.2	4.6	-3.8	-1.7	2.5	3.0
Gross agricultural production								
annual change in % (real)	5.0	-13.3	-0.8	.	.	.	.	.
Construction industry								
annual change in % (real)	-0.7	-0.5	22.1	18.8	24.4	.	.	.
Employed persons, LFS, th, average ³⁾	978.0	971.6	986.1	983.5	984.2	1,000	1,010	1,020
annual change in %	-0.5	0.3	1.5	3.2	0.1	1.2	0.9	0.6
Unemployed persons, LFS, th, average ³⁾	51.2	48.4	41.2	43.9	37.5	40	40	40
Unemployment rate, LFS, in %, average ³⁾	5.0	4.8	4.0	4.3	3.7	3.7	3.7	3.6
Reg. unemployment rate, in %, eop	8.9	6.7	5.4	5.5	4.7	.	.	.
Average monthly gross wages, EUR ⁴⁾	1,856	1,970	2,024	1,976	2,177	2,330	2,550	2,730
annual change in % (real, gross)	5.9	4.1	-5.5	-7.0	1.0	7.2	5.5	4.6
Average monthly net wages, EUR ⁴⁾	1,209	1,270	1,319	1,282	1,416	1,430	1,510	1,580
annual change in % (real, net)	6.6	3.1	-4.6	-6.1	1.3	1.1	2.0	2.5
Consumer prices (HICP), % p.a.	-0.3	2.0	9.3	7.7	8.9	7.2	3.6	2.4
Producer prices in industry, % p.a.	-0.3	5.5	19.7	18.7	11.1	10.2	4.0	2.8
General governm. budget, EU def., % of GDP								
Revenues	43.7	44.9	43.9	.	.	45.1	46.9	47.4
Expenditures	51.4	49.5	47.0	.	.	49.3	50.4	49.5
Net lending (+) / net borrowing (-)	-7.6	-4.6	-3.1	.	.	-4.2	-3.5	-2.1
General gov.gross debt, EU def., % of GDP	79.6	74.4	72.3	.	.	71.0	68.5	68.1
Stock of loans of non-fin. private sector, % p.a.	0.0	5.9	10.2	10.4	4.1	.	.	.
Non-performing loans (NPL), in %, eop ⁵⁾	2.6	1.6	1.5	1.6	1.4	.	.	.
Central bank policy rate, % p.a., eop ⁶⁾	0.00	0.00	2.50	0.00	4.00	.	.	.
Current account, EUR m	3,398	1,732	-578	-378	1,925	810	1,480	1,580
Current account, % of GDP	7.2	3.3	-1.0	-1.3	6.1	1.3	2.2	2.3
Exports of goods, BOP, EUR m	29,622	35,255	42,628	21,045	21,884	47,230	51,290	54,680
annual change in %	-7.4	19.0	20.9	23.2	4.0	10.8	8.6	6.6
Imports of goods, BOP, EUR m	27,289	34,373	44,802	22,074	21,008	49,370	53,120	56,570
annual change in %	-11.1	26.0	30.3	37.1	-4.8	10.2	7.6	6.5
Exports of services, BOP, EUR m	6,985	8,471	11,133	4,916	5,379	13,030	14,060	15,170
annual change in %	-19.3	21.3	31.4	40.3	9.4	17.0	7.9	7.9
Imports of services, BOP, EUR m	5,072	6,273	7,651	3,404	3,609	9,030	9,480	10,050
annual change in %	-11.8	23.7	22.0	32.5	6.0	18.0	5.0	6.0
FDI liabilities, EUR m	446	1,856	2,051	1,362	931	1,500	.	.
FDI assets, EUR m	708	1,442	763	795	330	810	.	.
Gross reserves of CB excl. gold, EUR m	913	1,838	1,962	1,965	1,992	.	.	.
Gross external debt, EUR m	48,049	50,923	51,825	51,769	55,708	53,300	56,200	58,500
Gross external debt, % of GDP	102.1	97.4	90.9	90.8	90.4	86.0	85.2	84.6

1) Preliminary. - 2) Half-year GDP data 2022 unrevised. - 3) From 2021 the new LFS methodology is applied in line with the Integrated European Social Statistics Regulation (IESS). - 4) Wage increase in 2020 due to COVID emergency relief compensations. - 5) Loans more than 90 days overdue and those unlikely to be paid. - 6) Official refinancing operation rates for euro area (ECB).

Source: wiiw Databases incorporating Eurostat and national statistics. Forecasts by wiiw.

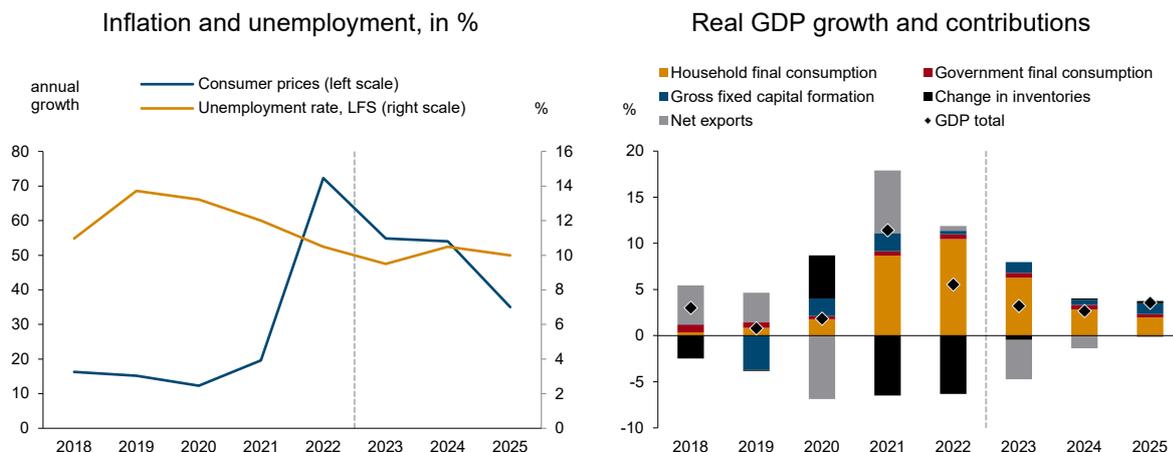


TURKEY: A balancing act between growth and disinflation

MERYEM GÖKTEN

In the first half of 2023, Turkey faced a challenge of unbalanced economic growth, fuelled primarily by strong household consumption. While this uptick provided a boost to the economy, it also created a delicate balancing act for the Turkish authorities. If they maintain their dedication to monetary stability, the opportunity exists to gradually rein in inflation over the coming years; however, that would come at the cost of economic slowdown. That said, the possibility of policy reversals in the future, once external financing becomes more stable or the budget deficit levels out, brings an element of uncertainty.

Figure 6.22 / Turkey: Main macroeconomic indicators



Source: wiiw Annual Database incorporating national and Eurostat statistics, own calculation. Forecasts by wiiw.

In Q2 2023, Turkey's economy outperformed expectations, achieving a growth rate of 3.8% year on year. This performance can be attributed mainly to: (i) a significant surge in household consumption (of 15.6%), driven by high inflationary expectations and negative real interest rates, as people believe that durable goods will not only become more expensive, but will also serve as a reliable store of value; and (ii) expansion in the construction industry and increased investment activity, spurred on by the rebuilding work following the February earthquakes. However, the industrial sector experienced a contraction of 2.6%, and exports declined by 9% year on year due to weakened external demand, underscoring the persistent economic imbalances. By contrast, imports of goods and services grew by 20.3% in Q2, further indicating robust domestic demand.

Despite the strong growth in Q2, high-frequency indicators suggest a slowdown in the latter half of the year. Indices measuring both sectoral and consumer confidence experienced significant declines in July and August. Furthermore, the manufacturing purchasing managers' index (PMI), which had stayed above the 50% threshold in the first half of the year, dipped below that figure in July and August, signalling a loss of momentum in the manufacturing sector in Q3. Declining business and consumer confidence, coupled with increased inflation and interest rates, herald a slowdown in the second half of the year.

The country's persistently high inflation rate – once again far and away the highest in the CESEE region – remains a fundamental challenge for Turkey's economy. After seven consecutive months of decline, inflation briefly dropped to 38%, only to see an unexpected surge in July and August, when it reached 47.8% and 58.9%, respectively. The new central bank governor, Hafize Gaye Erkan, revealed an upward revision of the year-end inflation projection to 63% and a 2024 forecast of 33%. While the depreciation in the exchange rate is often pointed to as a primary factor, several factors contributed to this upsurge in inflation: rigidity in services inflation, sustained upward pressure on food prices, shifts in tax and pricing policies, and rising fuel and car prices. However, the significant growth in household consumption and imports poses the biggest challenge in the fight against inflation. The persistently negative real interest rates and the high inflation have prompted consumers to indulge in a spending spree, with the aim of preserving their wealth in the face of erosion in the value of their money. This consumer behaviour in turn exacerbates inflationary pressures, leading to a continuous uptick in prices.

Despite the central bank's reiteration of its commitment to price stability, doubts persist about the efficacy of the measures taken thus far. The central bank remains hesitant about adopting a more aggressive approach to interest rate hikes and instead continues to favour selective credit policies and quantitative tightening. Although the central bank adopted a more restrictive monetary policy after the May election, the initial rate hikes remained relatively modest. The unexpected 650-basis-point increase in August and the 500-basis-point increase in September raised the policy rate to 30%. Nonetheless, real interest rates remain deeply negative. Furthermore, recent measures – including the macroprudential rule adjustments introduced over the summer to curb consumer demand – have so far yielded limited results, especially regarding credit cards and lira-denominated consumer loans. The lira's substantial depreciation, coupled with external imbalances and volatile capital flows since the May elections, continues to cloud over the economic outlook.

Despite the decline in energy costs, the ongoing deficit in merchandise trade continues to be the primary factor driving the deterioration in the current account. After a brief improvement in June, Turkey's current account reverted to negative territory in July, registering a deficit of USD 5.5bn. This pushed the 12-month rolling deficit to a hefty USD 58bn (around 6.5% of forecast GDP). The widening goods deficit played a pivotal role in this swing, as it expanded from USD 3.76bn in June to USD 10.48bn in July. However, the services sector showed a net surplus of USD 6bn, with travel services contributing a net inflow of USD 4.8bn as the tourist season resumed. It is noteworthy that the current account deficit has been financed solely by central bank reserves. The depletion of these reserves underscores yet again the desperate need to balance the current account deficit and secure external financing, if economic stability is to be ensured.

The upcoming municipal elections in Turkey appear to carry a relatively low political cost for President Erdoğan, who is able to take advantage of the ongoing failure of the opposition to unite behind a single candidate. This situation may work to his advantage, potentially facilitating his victory in key cities like Istanbul and Ankara. Meanwhile diplomatic relations with the EU show some sign of improvement. However, Erdoğan's conflicting statements about EU cooperation could hinder immediate progress. Turkey's pursuit of strategic autonomy – by maintaining pragmatic relations with the EU, Russia and the Gulf countries alike – may place the country at odds with the EU. With migration and customs union upgrades remaining key points for discussion, little substantial progress in EU-Turkey relations is likely without democratic reforms.

Overall, recent economic developments reflect a growing sense of unease in Turkey's economic landscape. President Erdoğan's commitment to maintaining stringent monetary policies, a notable departure from his previous stance on the 'inflation lobby', underscores his appreciation of the seriousness of the situation, at least for now. President Erdoğan and his governments has prioritised two key objectives over the past two decades: keeping the budget deficit under control and stimulating economic growth. In the last five years, this approach has evolved into an ongoing juggling act, rather than an effective strategy to address underlying structural challenges. Balancing the trade-off between exports and imports, growth and inflation, and maintaining a stable current account has become increasingly difficult. As a result, the Turkish economy has been overheating for some time, as is evident from the rising inflation, increased consumer demand and heightened imports. The elevated household spending has led to an upward revision of our 2023 growth forecast to 3.2%. Consequently, the substantial surge in the July and August inflation figures requires an adjustment to our inflation forecast too, which now stands at 55% for 2023. To combat these inflationary pressures, the government is considering further measures, such as linking wage rises to the target inflation rate (currently set at 5%), rather than the actual inflation rate, and gradual interest rate hikes. Thus, we have revised our policy rate forecast for 2023 and 2024, respectively, to 40% and 25% (end of period), and our GDP growth rate forecast for 2024 downward to 2.7%.

Table 6.22 / Turkey: Selected economic indicators

	2020	2021	2022 ¹⁾	2022 January-June	2023	2023 Forecast	2024 Forecast	2025
Population, th pers., average	83,385	84,147	84,980	.	.	86,179	87,213	88,260
Gross domestic product, TRY bn, nom.	5,049	7,256	15,012	5,944	10,145	24,000	37,900	53,000
annual change in % (real)	1.9	11.4	5.5	7.7	3.9	3.2	2.7	3.6
GDP/capita (EUR at PPP)	18,330	20,360	24,360	.	.	.	.	.
Consumption of households, TRY bn, nom.	2,847	3,983	8,564	3,390	6,176	.	.	.
annual change in % (real)	3.2	15.4	19.0	20.8	16.4	11.0	5.0	3.5
Gross fixed capital form., TRY bn, nom.	1,389	2,044	4,378	1,798	3,250	.	.	.
annual change in % (real)	7.3	7.2	1.3	3.4	4.4	4.0	2.0	4.0
Gross industrial production ²⁾								
annual change in % (real)	2.2	16.5	6.2	11.3	-2.0	-0.5	1.0	3.5
Gross agricultural production ³⁾								
annual change in % (real)	4.1	0.5	10.0	.	.	.	.	.
Construction industry ²⁾								
annual change in % (real)	-3.0	3.0	5.0	.	.	.	.	.
Employed persons, LFS, th, average ⁴⁾	26,808	28,827	30,725	30,092	31,182	31,700	32,500	33,300
annual change in %	-4.5	8.0	6.6	7.8	3.6	3.3	2.5	2.5
Unemployed persons, LFS, th, average ⁴⁾	4,063	3,916	3,592	3,666	3,399	3,330	3,810	3,700
Unemployment rate, LFS, in %, average ⁴⁾	13.2	12.0	10.5	10.9	9.8	9.5	10.5	10.0
Reg. unemployment rate, in %, eop	.	.	.	.	.	.	.	.
Average monthly gross wages, TRY ⁵⁾	4,594	5,846	10,276	.	.	16240	25010	34440
annual change in % (real, gross)	-8.5	6.4	2.0	.	.	2.0	0.0	2.0
Consumer prices (HICP), % p.a.	12.3	19.6	72.3	64.6	46.9	54.9	54.0	35.0
Producer prices in industry, % p.a. ⁶⁾	12.1	43.9	128.5	118.6	57.6	56.0	55.0	35.0
General governm. budget, nat. def., % of GDP								
Revenues	29.6	27.9	25.3	.	.	25.5	26.0	27.0
Expenditures	32.5	30.3	26.4	.	.	29.5	29.0	30.0
Deficit (-) / surplus (+)	-2.9	-2.4	-1.1	.	.	-4.0	-3.0	-3.0
General gov. gross debt, nat. def., % of GDP	39.6	41.8	31.7	.	.	46.4	48.0	48.0
Stock of loans of non-fin. private sector, % p.a.	35.3	32.4	56.9	58.1	60.1	.	.	.
Non-performing loans (NPL), in %, eop	4.1	3.1	2.1	2.5	1.6	.	.	.
Central bank policy rate, % p.a., eop ⁷⁾	17.00	14.00	9.00	14.0	15.0	40.00	25.00	10.00
Current account, EUR m	-28,126	-5,958	-45,522	-26,130	-34,199	-50,000	-41,000	-40,000
Current account, % of GDP	-4.5	-0.9	-5.3	-7.1	-7.3	-5.3	-4.1	-3.7
Exports of goods, BOP, EUR m	147,045	190,365	241,130	115,279	112,620	258,000	273,000	287,000
annual change in %	-9.7	29.5	26.7	33.8	-2.3	7.0	6.0	5.0
Imports of goods, BOP, EUR m	180,244	215,210	326,508	152,680	159,515	353,000	364,000	382,000
annual change in %	1.4	19.4	51.7	56.9	4.5	8.0	3.2	5.0
Exports of services, BOP, EUR m	33,370	52,206	86,836	33,707	40,124	94,000	102,000	110,000
annual change in %	-44.5	56.4	66.3	98.6	19.0	8.0	8.0	8.0
Imports of services, BOP, EUR m	20,893	25,102	38,537	17,211	21,981	41,000	44,000	47,000
annual change in %	-18.4	20.1	53.5	59.1	27.7	7.0	7.0	7.0
FDI liabilities, EUR m	6,706	11,319	12,735	6,476	4,446	14,008	.	.
FDI assets, EUR m	2,804	5,493	4,673	2,301.2	2,446.8	5,140	.	.
Gross reserves of CB excl. gold, EUR m ⁸⁾	40,776	64,182	77,714	55,069	61,796	.	.	.
Gross external debt, EUR m ⁸⁾	349,749	386,086	430,057	.	.	487,500	498,700	524,600
Gross external debt, % of GDP	55.8	55.9	49.9	.	.	52.0	50.0	49.0
Average exchange rate TRY/EUR	8.0547	10.5124	17.4088	16.2330	21.5444	25.60	38.00	49.50

1) Preliminary. - 2) Enterprises with 20 and more employees; for construction wiiw estimate. - 3) Based on UN-FAO data, wiiw estimate in 2022. - 4) From 2021 new methodology in line with the Integrated European Social Statistics Regulation (IESS). - 5) Personnel costs. Data based on Annual Industry and Service Statistics excluding NACE activities agriculture and fishing, finance and insurance, public administration, defence and social security. - 6) Domestic output prices. - 7) One-week repo rate. - 8) Converted from USD.

Source: wiiw Databases incorporating national statistics. Forecasts by wiiw.

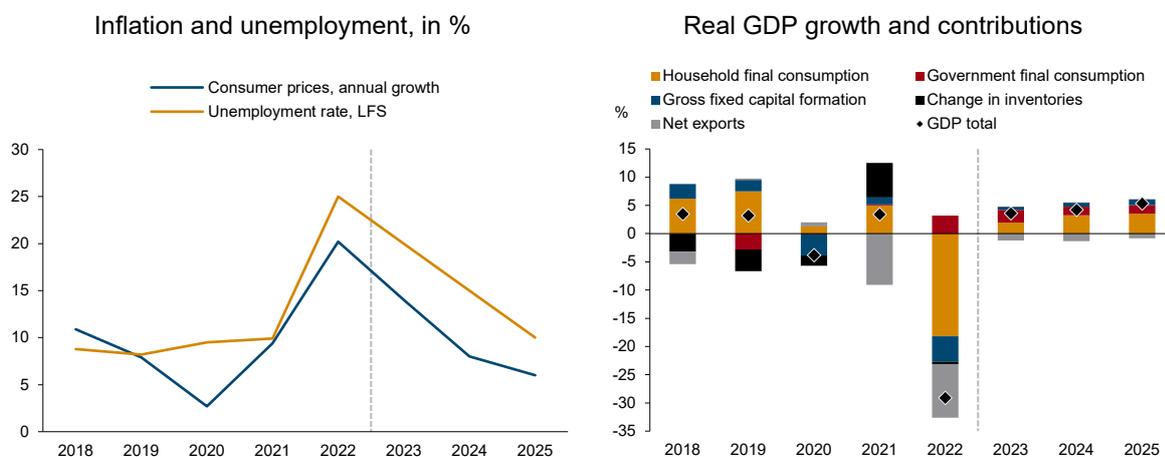


UKRAINE: Economy showing resilience in wartime

OLGA PINDYUK

In Q2 2023, Ukraine's real GDP grew by 19.5% year on year, reflecting both the base effect and the resilience of the economy. Exports of agricultural and food products have been growing, despite Russia's withdrawal from the Black Sea Grain Initiative. Inflation has slowed more than expected, on the back of falling food and fuel prices. Given the greater-than-anticipated resilience of the economy, our GDP growth forecast for 2023 has been revised upwards. However, as the war is likely to be more protracted than we had initially hoped, growth in 2024-2025 will be lower than previously forecast. Most risks to the forecast continue to be on the downside.

Figure 6.23 / Ukraine: Main macroeconomic indicators



Source: wiiw Annual Database incorporating national and Eurostat statistics, own calculation. Forecasts by wiiw.

In Q2 2023, Ukraine's real GDP grew by 19.5% year on year – the first quarter of positive growth since Russia's full-scale invasion in February 2022. To a large extent, the double-digit growth can be explained by the statistical effect of the low base of comparison – the economy experienced its deepest slump in Q2 2022 (-36.9% year on year). Still, the country's economy has been recovering more rapidly than previously expected, supported by final consumption growth and resilient manufacturing and agriculture. The recovery in household demand is evidenced by the retail trade dynamics (+7.3% year on year in H1 2023), growing sales of new passenger cars (according to data from UkrAutoprom, sales of passenger cars rose by 3.4% year on year in Q2 2023, and in August the figure accelerated to 9.0%

year on year),³³ steadily rising occupancy of shopping malls,³⁴ and the booming domestic tourism sector.³⁵

Government consumption grew primarily to finance defence-related expenditure. During January-July 2023, it increased by 235% year on year to account for about half of all fiscal spending. This was financed by tax revenues, while most of the rest of the fiscal spending was financed via foreign financial aid, which reached USD 30.6bn in the first eight months of 2023. Ukraine's budget deficit financing needs in 2023 are anticipated to be USD 59.3bn. However, only USD 42.1bn of foreign financing has been pledged so far, and the government has issued USD 10bn worth of domestic bonds. This leaves a financing gap of USD 7.2bn, which will likely be covered by additional issues of domestic bonds and additional pledges by foreign partners.

The war has led to structural shifts in the economy. The damage to the country's infrastructure and housing stock caused by Russia's missiles has led to an upsurge in construction activity, as well as in demand for metals and machinery and equipment. Ukraine's armed forces have also been generating demand for the production of military equipment, such as drones. The limited opportunities available for the export of non-agricultural products, and the destruction by Russia of many production facilities, mean that Ukraine's export structure has become dominated by agricultural commodities, which accounted for about 60% of total merchandise exports in the period January-July 2023, 20 percentage points (pp) higher than in 2021, the year before the war began.

Agricultural performance in 2023 has been bolstered by a good harvest. The Ministry of Agriculture forecasts that the gross harvest of grain and oilseeds this year will be slightly up on last year, because of the good weather (76.7m tonnes in 2023 vs 76.1m tonnes in 2022). The Ukrainian Grain Association's forecast is even higher – 80.5m tonnes.

Exports of agricultural and food products have been growing, despite Russia pulling out of the Black Sea Grain Initiative on 17 July. According to data provided by the Ukrainian Agribusiness Club association, Ukrainian agricultural exports rose by 16% between July and August to reach 4.3m tonnes. (Data from the State Statistics Service of Ukraine show that in January-July 2023, exports of grain increased by 24% and of food products by 29%, both year on year.) In August, a bigger than before share of exports passed through the Danube ports of Ukraine and by rail via the western border crossings. In addition to the land and river routes, Ukraine has been developing an alternative Black Sea corridor, in an attempt to break the sea blockade; this has been successfully tested by several ships.

However, negative risks to the export performance have been increasing. The constant missile attacks on Danube ports by Russia and the unilateral ban on imports of Ukrainian grain imposed by Poland and Hungary (in violation of the European Commission's decision on 14 September to lift the temporary ban on Ukrainian grain imports) have created additional complications for Ukrainian exporters.³⁶

³³ <https://ukrautoprom.com.ua/en/category/statistics>

³⁴ <https://www.ucsc.org.ua/galuz-prodovzhuye-vidnovlennya-shho-chekaye-ukrayinski-trcz-u-drugij-polovyni-2023-go/>

³⁵ <https://forbes.ua/war-in-ukraine/trivozhnyy-vidpochinok-popit-na-turistichni-mistsya-vsередini-kraini-zris-u-devyat-raziv-viruchka-goteliv-na-zakhodi-ukraini-na-50-chomu-i-yak-ukraintsi-podorozhuyut-pid-chas-viyeni-31082023-15301>

³⁶ Initially Slovakia also defied the EU and restricted imports from Ukraine, but later it reached an agreement with Ukraine and lifted the ban.

Inflation has slowed more than expected (8.6% year on year in August 2023), primarily on the back of falling food and fuel prices. On 28 July, the National Bank of Ukraine (NBU) reduced its policy rate by 3pp – the first reduction since the rate was hiked to 25% in June 2022. This was followed by a second cut of 2pp on 15 September. Inflation is expected to continue to slow down in the coming years, to reach an annual figure of 6% in 2025, as the reduced security risks help cut business costs and increase the supply of consumer goods.

The hryvnia exchange rate on the cash market remained stable throughout the summer, at an average level of below 38 UAH/USD. It has been supported by the reduced inflationary pressures and the NBU's interventions to the tune of USD 1.5-2bn per month (the official exchange rate has remained fixed at 36.57 UAH/USD). Despite the interventions, the NBU's forex reserves remain at a record high of USD 40.4bn (equivalent to about seven months' worth of imports), thanks to the influx of foreign financial aid and the robust dynamics of personal remittances. The latter decreased only slightly (about 8%) during January-July 2023, compared to the same period of 2022, to USD 6.7bn, and remittances remain an important source of foreign currency in the country (equivalent to more than 20% of total exports).

In view of the greater-than-expected resilience of the economy, our real GDP growth forecast for 2023 has been revised upwards, to 3.6% year on year. However, as the war is likely to prove more protracted than we had initially hoped, growth in 2024-2025 will likely be lower than previously forecast – since no major investment in reconstruction of the country is likely to occur until the security risks become less significant. The mass return of refugees is unlikely to come about until there is more certainty about the outcome of the war. Foreign financial aid will be crucial if the economy is to stay afloat during this period.

Most of the risks to the forecast continue to be on the downside. The election of Donald Trump in the US presidential elections in November 2024 remains one of the biggest risks, as that could lead to a significant decline in US support for Ukraine (see section 2). Signs of a rift beginning to open up in the EU with respect to support for Ukraine also give cause for concern. The illegal bans on the import of agricultural products from Ukraine imposed by Poland and Hungary could undermine not only EU solidarity in support of Ukraine, but also fundamental principles of the EU single market.

Table 6.23 / Ukraine: Selected economic indicators

	2020	2021	2022 ¹⁾	2022 January-June	2023	2023 Forecast	2024 Forecast	2025
Population, th pers., average	41,745	41,378	35,000	.	.	34,300	34,000	35,500
Gross domestic product, UAH bn, nom.	4,222	5,451	5,191	.	.	6,100	6,900	7,700
annual change in % (real)	-3.8	3.4	-29.1	.	.	3.6	4.2	5.3
GDP/capita (EUR at PPP)	8,580	9,470	8,340	.	.	.	.	.
Consumption of households, UAH bn, nom.	3,054	3,718	3,342	.	.	.	.	.
annual change in % (real)	1.7	6.9	-26.7	.	.	3.0	5.0	5.5
Gross fixed capital form., UAH bn, nom.	564	720	603	.	.	.	.	.
annual change in % (real)	-21.3	9.3	-34.3	.	.	4.0	6.0	8.0
Gross industrial production								
annual change in % (real)	-4.5	1.9	-36.7	.	.	2.0	4.0	6.0
Gross agricultural production								
annual change in % (real)	-10.1	16.4	-25.0	.	.	.	.	.
Construction output								
annual change in % (real)	5.6	6.8	-64.8	.	.	.	.	.
Employed persons, LFS, th, average	15,915	15,610	13,000	.	.	13,500	14,000	14,500
annual change in %	-4.0	-1.9	-16.7	.	.	3.8	3.7	3.6
Unemployed persons, LFS, th, average	1,674	1,712	4,330	.	.	3,380	2,470	1,610
Unemployment rate, LFS, in %, average	9.5	9.9	25.0	.	.	20	15	10
Reg. unemployment rate, in %, eop ²⁾	1.6	1.1	.	.	.	.	.	.
Average monthly gross wages, UAH ³⁾	11,591	14,014	14,847	.	.	17,600	20,100	23,400
annual change in % (real, gross)	7.5	10.5	-11.9	.	.	4.0	6.0	10.0
Consumer prices, % p.a.	2.7	9.4	20.2	15.1	19.4	14.0	8.0	6.0
Producer prices in industry, % p.a.	-1.6	40.8	26.0	.	.	10.0	9.0	5.0
General governm. budget, nat. def., % of GDP								
Revenues	32.6	30.5	42.3	.	.	40.0	40.0	40.0
Expenditures	37.9	33.9	58.6	.	.	67.0	55.0	50.0
Deficit (-) / surplus (+)	-5.3	-3.4	-16.3	.	.	-27.0	-15.0	-10.0
General gov. gross debt, nat. def., % of GDP	60.4	49.0	78.5	59.4	77.3	88.0	90.0	93.0
Stock of loans of non-fin. private sector, % p.a.	-2.8	8.2	-3.1	4.8	-7.6	.	.	.
Non-performing loans (NPL), in %, eop	41.0	30.0	38.1	29.7	38.9	.	.	.
Central bank policy rate, % p.a., eop ⁴⁾	6.00	9.00	25.00	25.00	25.00	20.0	15.0	10.0
Current account, EUR m ⁵⁾	4,612	-3,278	7,587	2,567	-1,831	-1,100	-5,100	-7,800
Current account, % of GDP	3.4	-1.9	5.0	3.8	-2.4	-0.7	-3.1	-4.5
Exports of goods, BOP, EUR m ⁵⁾	39,527	53,301	38,926	18,857	17,081	33,300	36,000	38,900
annual change in %	-3.9	34.8	-27.0	-17.2	-9.4	-14.5	8.1	8.1
Imports of goods, BOP, EUR m ⁵⁾	45,462	58,911	52,871	22,948	28,160	58,100	62,800	69,000
annual change in %	-15.6	29.6	-10.3	-6.2	22.7	9.9	8.1	9.9
Exports of services, BOP, EUR m ⁵⁾	13,628	15,532	15,816	7,626	7,483	16,100	17,000	18,300
annual change in %	-12.6	14.0	1.8	12.8	-1.9	1.8	5.6	7.6
Imports of services, BOP, EUR m ⁵⁾	9,775	12,178	26,366	11,111	12,375	24,300	24,900	25,600
annual change in %	-30.3	24.6	116.5	112.8	11.4	-7.8	2.5	2.8
FDI liabilities, EUR m ⁵⁾	266	6,717	235	-146	2,401	3,700	.	.
FDI assets, EUR m ⁵⁾	317	368	32	119	135	300	.	.
Gross reserves of CB excl. gold, EUR m ⁵⁾	22,422	25,920	25,282	20,172	34,165	.	.	.
Gross external debt, EUR m ⁵⁾	102,293	114,426	122,949	120,236	135,830	148,000	153,000	148,000
Gross external debt, % of GDP	74.6	67.8	80.5	78.7	89.0	97.0	93.0	85.0
Average exchange rate UAH/EUR	30.79	32.31	33.98	31.74	39.52	40.0	42.1	44.3

Note: Excluding the territories occupied by the Russian Federation from 2014 to 2022, and territories where the military actions are/were conducted in 2022 and 2023. Due to the war, most of the usual statistical data are not being collected or published. This means that all Ukraine forecasts are subject to an unusually high degree of uncertainty.

1) Preliminary. - 2) In % of working age population, wiiw estimate. - 3) Enterprises with 10 and more employees. - 4) Discount rate of CB. - 5) Converted from USD.

Source: wiiw Databases incorporating national statistics. Forecasts by wiiw.

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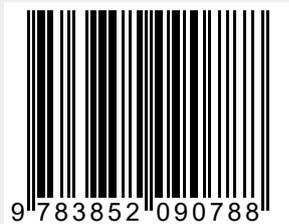
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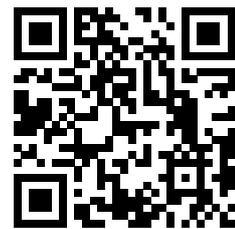
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