

The Crisis is Over, but its Scarring Effects are Hindering Recovery

Economic Analysis and Outlook for Central, East
and Southeast Europe

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The Crisis is Over, but its Scarring Effects are Hindering Recovery

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Executive summary

Last year was a challenging one for the CESEE region, with many economies growing more slowly than in 2022; only the CIS countries and Ukraine witnessed a significant acceleration of economic growth over the previous year. The Baltic and Visegrád countries turned in the worst performance of all the sub-regions, as they were hit disproportionately hard by inflation. Besides, the Baltic countries continued to be worst affected by the repercussions of Russia's war in Ukraine, while the Visegrád countries were dragged down by the recession in their main export market of Germany.

Consumers and industry have maintained a pessimistic outlook; only in the services sector does sentiment appear largely positive, supported by rising demand. There seems to have been some improvement in consumer sentiment in Q4 2023 to Q1 2024, most visibly in the Western Balkans and the Visegrád countries. Sentiment in industry, on the contrary, has shown no sign of recovery, with industry in the Visegrád and Baltic countries having on average far worse expectations than in the rest of the region. The rising bankruptcy rates in industry in many countries point to structural issues exacerbated by the recent economic crisis.

Inflation slowed significantly in all CESEE countries, apart from Turkey and CIS, but core inflation is proving more persistent, backed by rising real wages and tight labour markets. Turkey remains an outlier, with consumer prices having been trending upward since mid-2023, driven by negative real interest rates, national currency depreciation and high import demand. Core inflation is higher than headline inflation everywhere except for Croatia, indicating the continuing pass-through of higher production costs to prices. This is driven primarily by the cost of services, which appear to be slower to respond than food or transport.

Thanks to a strong decline in inflation, real interest rates have moved above zero. Many countries have started to loosen their monetary policy, but national banks have been cutting interest rates more slowly than inflation has been falling, resulting in a tightening of real financing conditions. Turkey, by contrast, has been trying to tighten its monetary policy, but the interest rate hikes in H2 2023 were too small to offset the accelerating inflation; thus that country still has a double-digit negative real interest rate.

In 2024-2026, consumer prices will decline further, as wage growth moderates and global prices remain low. Falling global food and energy prices will allow the relatively painless removal of price controls in many countries, although robust wage growth will stimulate private demand and push prices upwards. Along with Turkey, CIS will continue to see the highest growth of consumer price inflation in CESEE, with prices growing fastest in Belarus and Kazakhstan, where inflation will be driven by high consumer demand, in particular for imports. Russia, by contrast, is expected to have a soft landing, with inflation decelerating rapidly to 3.7% year on year in 2026.

This year, 2024, will bring an acceleration of economic growth for most of the region, apart from CIS, Ukraine and Turkey. The Visegrád and Baltic countries will achieve the most rapid acceleration of annual GDP growth in 2024 – nevertheless, growth there (2.4% and 1.3% year on year, respectively) will be the lowest of all the sub-regions. In CIS, economic growth will moderate to 3.3% year on year in 2024, as the statistical effect of a lower base of comparison in 2022 vanishes. Turkey's economic growth will slow down to 3.4% year on year in 2024, due primarily to monetary tightening.

In 2025-2026, annual GDP growth in CESEE will be about 3%; that will allow economic convergence with the euro area, but at a relatively low speed. Growth will be driven mainly by household consumption, whereas investment will be constrained by limited access to the sources of financing and will be insufficiently high to promote a faster green and digital transition and to ensure the structural changes needed to boost the region's competitiveness. Growth will become more uniform across the sub-regions, as the economies of the Visegrád and Baltic countries will accelerate to grow on a par with other sub-regions. Moderation of the growth in wages and a tightening of fiscal policy will prevent more dynamic economic performance.

Risks to the outlook remain mostly on the downside, with the most significant of these related to geopolitics. Inadequate support from the West could lead to Ukraine losing the war, which would increase the security risks for the whole of Europe. Tensions in the Middle East could cause a significant increase in global energy prices, as well as supply-chain disruptions.

COUNTRY SUMMARIES

ALBANIA

The economy expanded by 3.4% in 2023, driven by increased domestic and external demand. Public finances remain robust, and efforts toward fiscal consolidation will continue. However, imbalances on the labour market are intensifying, posing a risk to growth as emigration rates surge and as labour and skills shortages loom. While inflation is expected to moderate, seasonal challenges persist. The current account deficit has nearly bottomed out and will likely remain low due to sustained external demand. Positive trends in tourism and foreign direct investment are set to continue to fuel the momentum, which is expected to result in growth of 3.5% in the medium term.

BELARUS

In 2023, the economy almost totally recouped the losses incurred the previous year as a result of the Western sanctions. GDP grew by 3.9%, underpinned by a widening of Russia's economic support and accommodative domestic policies. Inflation slowed considerably. However, the indications are that this recovery has come to an end – and the short-term prospects are not propitious. GDP growth is expected to slow to some 2% in 2024 and is likely to remain sluggish in the years to come.

BOSNIA AND HERZEGOVINA

GDP growth in 2023 is estimated to have been 1.7% and to have been largely driven by a rise in consumer spending, spurred by falling inflation and higher real wages. Inflation averaged 6.1% last year; it is expected to continue to fall – to 2.8% in 2024 and 2.5% in 2025. GDP growth is likely to rise to 2.5% in 2024 and 2.9% in 2025, bolstered by increased individual and government spending, alongside a modest improvement in exports. The European Commission's decision in March 2024 to open EU accession negotiations for Bosnia and Herzegovina provides added momentum and impetus for economic growth.

BULGARIA

Bulgarians are being summoned to the polls again in June, in the fifth snap election since 2021. Growth slowed in 2023 and weak performance has continued in the first months of 2024. Inflation has fallen back thanks to a downturn in the non-core component. GDP growth is expected to be around 2% in 2024 and should remain moderate in the coming years. It is anticipated that the external economic environment will remain unfavourable and that growth will predominantly be driven by domestic demand.

CROATIA

Croatia's accession to the euro area and the EU's border-free Schengen zone boosted tourism in 2023, with EU-related funds supporting investment activity. The country's full EU integration will continue to stimulate trade and investment in the period 2024-2026. Improving private consumption and strong services exports will ensure robust growth of 2.9% in 2024; we also expect inflation to decline further to 3.5%. Nevertheless, a lack of skilled workers remains an issue and an obstacle to higher GDP growth.

CZECHIA

Following a minor contraction in 2023, the Czech economy will see a mild recovery this year. As inflation falls sharply and real wages rise, consumption will be the main driver behind this. Uncertainty looms over Czech industry, its trajectory hinging on the pace of growth in certain major economies, particularly Germany. A more dynamic growth path lies ahead in 2025 and 2026, as industry revives and capacity-expanding investment picks up.

ESTONIA

The past year presented significant challenges for the Estonian economy. A constellation of factors, including the disproportionately severe impact of the war in Ukraine, weak domestic and international demand, disruption to supply chains and a shift away from traditional export markets, dealt the economy a heavy blow. However, 2024 will mark a turning point, with stabilising prices, a modest resurgence in external demand and a robust labour market all indicating that the worst may be over. Nevertheless, to enter a new cycle of economic growth, the competitiveness of Estonian firms needs to be revived and new export markets need to be established.

HUNGARY

Runaway inflation was curbed by the end of 2023. The current account closed with a surplus, largely because of a decline in imports due to shrinking consumption, a drop in investment and lower import prices. GDP declined last year and there will be no spectacular recovery of economic growth in 2024 either. A chronic deficit in the general government balance necessitates painful measures, which in turn will put a brake on the pace of economic growth. Inflation continues to be of concern, while the current account will likely remain balanced or in surplus over the forecast horizon.

KAZAKHSTAN

Kazakhstan's economy ended 2023 among CESEE's top-performing economies, with strong private consumption and investment driving economic growth. Despite sluggish exports and skyrocketing imports to meet domestic demand, the economy grew by 5.1%. Private consumption was supported by wage increases, decelerating inflation and credit growth. However, we expect a slight slowdown in private consumption growth this year. By contrast, major investment in transport and logistics infrastructure (resulting from geopolitical shifts) and in modernisation of the energy system and utilities sector is likely to remain an important growth driver in the medium term. We expect the economy to grow by 4.7% in 2024 and by 4.9% in 2025-2026 – one of the fastest rates in CESEE.

KOSOVO

The risks related to external tensions tend toward the upside. Despite the challenges posed by certain external events, the economy has demonstrated remarkable resilience, achieving a growth rate of 3.4% last year. Household consumption and investment both played a pivotal role in bolstering the economy, and these are expected to continue as the primary drivers of growth in the medium term. Moreover, inflation has receded and that trend is likely to continue in the coming years. In addition, there has been a surge in foreign direct investment specifically targeting renewable energy projects.

LATVIA

While 2023 ended with GDP declining slightly (0.3%), this year will see an upswing of 1.6%. We expect external demand to shrink further, but by less than last year. Lower inflation will result in real wages rising – and accordingly in growth in household consumption. The government plans to further increase public investment in 2024, though private business remains reluctant to expand further. Given the still rather tight labour market, the unemployment rate fell slightly in 2023 – and will do so even more in the coming two years. Assuming that Latvia's trading partners also find their way back on track next year, we expect the economy to pick up, with GDP growth of 2.5% in 2025 and 2.7% in 2026.

LITHUANIA

The economy performed worse than expected in 2023, with GDP declining by 0.3%. With the substantial fall in inflation, real incomes had already started to pick up by the end of last year and will continue to do so in 2024; this will support household consumption. Despite the stagnation, the labour market remains robust, and unemployment is likely to decline further. Private investment activity is ailing, since external demand is in the doldrums; meanwhile the government will further raise infrastructure investment. We expect real GDP to increase by 1.6% in 2024; this will be followed by a modest acceleration to 2.2% in 2025 and thereafter to 2.6% in 2026.

MOLDOVA

Economic growth will pick up to 3.5% in 2024, following a very modest showing of 0.7% last year. Inflation will stabilise at a low level, allowing for monetary policy to be loosened. The current account and fiscal deficits will remain relatively high, but multinational institutions will provide a stable source of financing. The Europe-oriented leadership will be challenged in October in a presidential election and a referendum on EU membership. Russia's subversive activities and domestic oligarchic interests support a strong opposition.

MONTENEGRO

Amidst political turmoil, Montenegro managed in 2023 to achieve considerable growth of 6%. This owed much to a record tourist season, the influx of Russian and Ukrainian immigrants and improvements on the labour market. Starting as it does from such a high base, 2024 will likely see a slowing of growth to 4.2%. A range of cross-cutting reforms aimed at increasing salaries and pensions is likely to boost consumption; but it will also place a strain on public finances. EU integration is back on the agenda of both the government and the EU. However, political stability may be tested during the planned government reshuffle in 2024.

NORTH MACEDONIA

The measures adopted by the government ahead of the elections in April and May are breathing life into the economy, with all the indicators now pointing in a positive direction. There is some doubt, though, about the extent to which this can sway the election outcome, and a transfer of power seems likely. If that happens, the biggest question will be how the new government positions itself on the constitutional changes required for EU accession talks to commence. In terms of economic policy, one should expect no great change, as both the main parties support neoliberal agendas. The second half of the year will continue to be exciting, as the current stimulus measures are due to expire, and the new government (whoever leads it) will have to tighten the country's belt.

POLAND

A shallow recession in the first half of 2023 was followed by a moderate recovery in the second, allowing GDP to grow by 0.2% in 2023 as a whole. Inflation and inflationary expectations are falling, while wages are rising apace. If this extra money is saved rather than spent, then the higher household incomes could depress output growth and support disinflation. Though the energy prices are likely to jump by up to 20% in July 2024, this need not provoke a return to high inflation. Nonetheless the move will affect private consumption and limit GDP growth.

ROMANIA

While high fiscal and current account deficits are lasting features of the Romanian economy, they do not pose any imminent danger. Fiscal austerity will not be implemented in the current election year. Economic growth will be about 3% in 2024, fuelled by bullish household demand but hampered by sluggish foreign demand and the slow arrival of EU funds. Fiscal consolidation will dampen growth in 2025, while external demand and private investment will boost it to 3.3% in 2025 and further to 3.8% in 2026.

RUSSIA

Last year, GDP expanded by 3.6%, thanks largely to the boom in military production, which has had positive effects – both direct and indirect – for most of the rest of the economy. With inflation running in excess of 7% and the unemployment rate plunging to below 3%, the economy has clearly been overheating. However, the recent stabilisation of inflation suggests that ‘peak overheating’ has already been reached. Growth is projected to slip below 3% in 2024 and beyond, while inflation will gradually return to closer to the 4% target.

SERBIA

The decline in inflation is boosting real incomes and consumption, while the industrial sector appears to be coming back to life, after two challenging years. Foreign direct investment remains strong, as always, with a notable return of EU investors and the continued strong presence of the Chinese. Public investment is strong, too, lately focused on the upcoming EXPO 2027 in Belgrade. Although the economic conditions in the country have undoubtedly improved, we maintain that numerous structural issues will continue, limiting the potential for higher growth.

SLOVAKIA

While Slovakia’s GDP increased by only 1.1% in 2023, wiiw forecasts a gradual improvement in growth in the coming years. This will mainly be driven by household consumption, bolstered by lower inflation, leading to rising real wages and a favourable labour market. However, the domestic risks are rising due to ongoing political changes.

SLOVENIA

This year will bring higher growth than 2023. Real GDP is expected to grow by 2.5%, thanks to private spending and investment in infrastructure. Exports and industrial production will recover, but will be hampered by sluggish export demand. Inflation will fall to 3.3%. A labour shortage and upward wage pressure are key issues for the labour market. Mid-term growth rates are expected to be lower than pre-pandemic, potentially reflecting the effects of increased energy prices.

TURKEY

In 2023, Turkey’s economy grew by 4.5%, driven by strong domestic demand, but constrained by declining exports. The current account deficit improved modestly in the second half of the year. However, inflation surged to 68.5% year on year in March 2024, prompting a surprise policy rate hike to 50%. The rise in inflation expectations poses a challenge to the effectiveness of monetary policy. The government’s defeat in Turkey’s recent local elections reflects public outrage over inflation and the cost of living, and increases the uncertainty regarding future economic policies.

UKRAINE

GDP growth exceeded 5% in 2023, thanks to the resilience of the economy under war conditions and ample financial and military aid from the West. The establishment of a new shipping route in the Black Sea helped Ukraine partly offset the effects of the border blockade by Poland. However, friction has recently surfaced over the provision of military and financial assistance to Ukraine, and that could hamper further recovery of the economy in 2024. Economic growth will accelerate in 2025-2026, conditional on a reduction in security risks and an expansion of the reconstruction efforts. Downside risks to the forecast have increased: top among these is the risk that Ukraine could lose the war, due to inadequate support from the West.

Keywords: CESEE Central and Eastern Europe, economic forecast, Western Balkans, CIS, Ukraine, Russia, Turkey, EU, business cycle, economic sentiment, euro area, convergence, labour markets, unemployment, Russia-Ukraine war, commodity prices, inflation, price controls, trade disruptions, renewable energy, gas, electricity, monetary policy, fiscal policy, impact on Austria

JEL classification: E20, E21, E22, E24, E27, E31, E32, E5, E62, F21, F31, F51, H56, H60, J20, J30, O47, O52, O57, Q42

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Cut-off date for historical data and forecasts: 10 April 2024. 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 assumptions: US driving recovery amid geopolitical risks

BY RICHARD GRIEVESON

- › The global economy is strengthening, with a nascent recovery in global manufacturing particularly encouraging. The US remains strong, and there have been better data out of China in recent months.
- › The euro area economy is also starting to show some signs of recovery. Inflation is falling more quickly than we previously expected, boosting real incomes, with private consumption set to be the main driver of growth this year.
- › Nevertheless, the euro area manufacturing sector is continuing to suffer from the competitiveness shock of higher energy prices. Tight financial conditions are also weighing on the recovery, with real interest rates now rising sharply as inflation falls. We expect the European Central Bank (ECB) to start loosening policy this year, but the positive impact of this on the economy is likely to be felt only in 2025-2026.
- › The war in Ukraine will not end soon, but the impact on the euro area and global economy will be limited from here.
- › The biggest risk to the recovery at present comes from geopolitics, specifically in the US, where the outcome of the next presidential election will be crucial, and in the Middle East, where heightened tensions involving a number of regional players risk causing a significant and prolonged rise in energy prices. If that happens, it will push global inflation back up, weighing on consumption, and will also delay monetary loosening by the major central banks.
- › We view Donald Trump's possible return as US president as a significant risk in terms of both likelihood and impact. If he wins the election, we expect a negative impact on global trade, increased uncertainty about the US security commitment to Europe (which would be especially damaging for investor sentiment in the Baltic states), higher defence spending in Europe and a greater chance of instability in those areas of CESEE where NATO soldiers are currently stationed.

1.1. GLOBAL OUTLOOK: GLOBAL ECONOMY STRENGTHENING

After two years in which inflation – which reached levels not seen for decades –hammered the global and especially the European economy, early 2024 offers some signs of improvement. The JP Morgan/S&P Global Composite Purchasing Managers' Index (PMI) rose to a nine-month high of 52.3 in March (anything above 50 indicates expansion), marking the fifth consecutive month of growth. Services output remained robust in March, while manufacturing – which has underperformed over most of the last two years – showed encouraging signs of catching up, with output expanding at its fastest rate for 21 months.

The March data also showed encouraging signs that global growth is becoming more balanced, and less reliant on the US. In March, the US (and the UK) continued to expand at a healthy rate; but the survey also noted improvements in Japan, the euro area (especially Spain and Italy), China, India and Russia.

The performance of the US economy in the face of the inflation shock and the sharp interest rate hikes of the past two years has been the latest version of American exceptionalism. While China and the euro area – the other two key pillars of the global economy – have struggled, the US has ploughed on regardless. Such is the strength of the US economy, with inflation recently surprising on the upside, that the Federal Reserve is only likely to make limited rate cuts this year. At the time of writing, market pricing indicated an expectation of only 50 basis points of cuts in 2024, meaning that the Fed is likely to cut less than the ECB. We do not expect this to have a material impact on the exchange rate, but there are downside risks to our forecast of USD 1.08/EUR during the period under consideration.

China, by contrast, faces a multitude of challenges and will not drive global growth as it did pre-COVID; yet there, too, the economic outlook is also improving gradually. Both services and manufacturing posted healthy growth in March, according to PMI surveys. China already saw export growth in January and February, benefiting from the upturn in the global economy.

A strong dollar will be a net negative for other major emerging markets in 2024. The scaling-back of expectations about Fed loosening has seen the dollar strengthen markedly against most emerging market currencies. This will increase imported inflation and may delay (or even reverse) monetary loosening by central banks, as they try to defend their currencies against the dollar. This is likely to weigh somewhat on the global recovery this year.

1.2. EURO AREA OUTLOOK: INFLATION DECLINE DRIVING CONSUMER REVIVAL, BUT INDUSTRY STILL STRUGGLING

The euro area economy is gradually returning to life, after a very difficult two years. The March Composite PMI for the single-currency area moved back above 50 for the first time since May 2023. Most encouragingly, the sub-component for business activity expectations reached its highest level since February 2022, the month in which Russia launched its full-scale invasion of Ukraine.

The March PMI showed services growing robustly in the euro area, with the fall in inflation having a positive impact on consumer purchasing power. Companies reported sales increasing in March for the first time in nine months. Services are being boosted by the sharp decline in inflation, which – in combination with nominal wage rises – is significantly expanding households' real spending power. Euro area inflation slowed to 2.4% year on year in March, compared with 6.9% in the same month a year earlier, its joint-lowest rate since July 2021.

By contrast, manufacturing remains very weak, and the March manufacturing PMI remained in negative territory, caused above all by problems in Germany. German industrial production – which has been struggling for some time – rose in monthly terms in both January and February. However, in February output was still 4.9% lower than a year earlier. Higher energy costs for industry and the

consequent impact on international competitiveness, plus the weakness of Chinese demand (albeit with some recent signs of improvement), are still holding German industry back.

Despite the green shoots, we have made a small downward revision to our euro area growth forecast in 2024, caused by the weaker-than-expected end to last year. We continue to see the recovery gradually firming, led above all by domestic demand as falling inflation boosts real incomes. We also continue to expect the ECB to start cutting interest rates this year, although the positive impact of that on the economy will only be felt later in the forecast period. In 2025-2026 we expect a firmer recovery, with the euro area economy growing by 1.6% in both those years.

Table 1.1 / wiiw spring 2024 global assumptions

	Winter 2024			Change since autumn		
	2024	2025	2026	2024	2025	2026
Euro area real GDP growth, %	0.6	1.6	1.6	-0.2	0.0	0.0
Euro area HICP, %	2.5	2.2	2.0	-0.5	0.0	0.0
Euro area unemployment rate, %	6.7	6.6	6.6	0.1	0.1	0.2
Euro area current account, % of GDP	3.2	3.2	3.1	1.7	1.5	1.4
USD/EUR exchange rate, average	1.08	1.08	1.08	0.0	0.0	0.0
ECB refinancing rate, %, eop	3.50	2.50	2.00	0.0	0.0	0.0
Brent crude oil, USD per barrel, average	80.0	77.0	74.0	0.0	0.0	0.0

Source: wiiw forecasts. Cut-off date: 10 April 2024.

1.3. ASSUMPTIONS ABOUT THE WAR IN UKRAINE

Our assumptions about the future course of the war in Ukraine are broadly unchanged from our January update:

- › The war in Ukraine is likely to last at least into 2025.
- › There will be no major (i.e. nuclear) escalation.
- › The further impact of the war on most European economies will be quite limited.
- › US and EU military and financial support to Ukraine will continue, but with delays in disbursement and with a lot of political noise and uncertainty. Ukraine will get enough to fend off Russia, but not enough to go more decisively on the offensive. The US in particular will remain wary of 'provoking' Russia by delivering more long-range weapons.
- › As long as the war continues, reconstruction cannot start properly, which will hold up Ukraine's economic recovery.
- › The European Parliament elections may well see a rise in support for far-right parties, but this will have no fundamental impact on EU support for Ukraine. The five biggest EU member states all have governments that have expressed unambiguous support for Ukraine. In terms of both the functioning of the Council and EU support for Ukraine, the 2023 election result in Poland is good news.
- › If Trump does win, the outlook is much more uncertain, although even in this scenario we do not regard it as inevitable that the US will stop supporting Ukraine.

1.4. RISKS TO THE OUTLOOK

While the global and euro area outlook is improving, we see three key downside risks that could knock it off course.

First, while it is very difficult to predict what a victory for Donald Trump would mean in the upcoming presidential election,¹ we believe that the net impact on the global economy would be negative, for the following reasons:

- › Trump would likely follow through on at least some of his pledges to impose tariffs on imports from Europe and China, which would hurt growth there and have a knock-on effect for CESEE countries. It is highly likely that Trump would take further steps to reduce the economic integration between the US and China in particular, including by erecting trade barriers and imposing restrictions on flows of investment into China.
- › A victory for Trump would cast doubt on the US commitment to NATO, forcing European governments to spend more on defence – and therefore less on other things, thus accelerating the end of the peace dividend.
- › An uncertain US commitment to NATO could cause serious problems in parts of CESEE, by emboldening revisionist actors in the Western Balkans or damaging investor confidence in other countries that Russia has previously threatened, especially the Baltic states.
- › The US role in the world would be more unpredictable, leading to a security vacuum in global hotspots and increased regional competition and arms races. This could be the case particularly in the Middle East, where the Israel-Hamas war risks spreading into a broader regional conflict involving a number of players. There is a partial vacuum, which others are seeking – and will continue to seek – to fill, increasing the risks of instability. There is a very real chance that, under a second Trump presidency, the coming years will see a series of rolling geopolitical crises, much more frequent than in the past, with repercussions for the global economy and CESEE.

Second, even without a Trump victory, geopolitical and geo-economic tensions, especially between the US and China, pose a downside risk to global economic growth. Treasury Secretary Janet Yellen visited China in April to discuss US concerns about Chinese oversupply. The US is especially worried about China's practice of subsidising its green-tech industry, which is increasing the supply of solar panels, electric vehicles and batteries, and is concerned about the impact this will have on US producers, US workers and ultimately US politics. The Chinese March manufacturing PMI showed that the contraction in output prices deepened, indicating deflationary pressures that will have a knock-on effect globally. Under the current administration, the US has continued to attempt to restrict Chinese access to US inputs, which has been part of the weaker momentum in China (and thereby in the global economy). The general direction of US policy towards China seems set, irrespective of who wins in November.

¹ The former president is currently favourite to win; but there are huge uncertainties, including the array of legal cases against Trump (meaning that he may not be able to stand for office at all); the age of both the main candidates (which makes it unusually likely that one or both will not be around to take office); and the impact of third-party candidates.

Third, inflation could start to rise again; if it does, it will weigh on the current revival in consumer spending and cause interest rates to stay higher for longer. Global commodity prices, including of energy, have risen sharply in recent months. In part, this reflects classic demand/supply fundamentals: the high global demand for oil as the economy recovers and the way OPEC+ is keeping a lid on production are both factors that push up prices. However, the oil price is also rising due to worries about the Middle East. At the time of writing, Israel's attack on the Iranian embassy in Damascus has been followed by Iran firing hundreds of missiles at Israel, most of which were intercepted and so caused no casualties. While the US and key regional players such as Saudi Arabia, Turkey, Iraq and Jordan appear to be very involved in keeping the lines of communication open with all players, given the range of actors involved and the heightened emotions on all sides, the risk of events spiralling out of control and leading to a regional war is non-negligible.

2. CESEE Overview: The crisis is over, but its scarring effects are hindering recovery

BY OLGA PINDYUK

- › Most CESEE economies saw lower growth in 2023 than in 2022, with consumers and industry maintaining a pessimistic outlook. Rising bankruptcy rates in industry in many countries point to structural issues exacerbated by the recent economic crisis. Only in the services sector does sentiment appear largely positive, supported by rising demand.
- › CIS and Ukraine were the only sub-regions where economic growth accelerated in 2023. The Ukrainian economy managed to grow by more than 5% year on year, owing to a significant influx of foreign aid and a remarkable degree of economic resilience; meanwhile Russia's strong result of 3.6% annual GDP growth is credited to its ability to switch the economy to war mode and circumvent Western sanctions.
- › Inflation slowed significantly in all CESEE countries, but core inflation is proving more persistent, backed by rising real wages and tight labour markets. In 2024-2026, consumer prices will decline further, as wage growth moderates and global prices remain low.
- › The use of renewables in electricity generation increased in all CESEE countries in 2023, although it remains at below the levels of Austria or Germany. Financing of the necessary investment in renewable energy in the coming years will be hampered by the narrowing fiscal space and the need to prioritise defence spending.
- › In the next three years, annual GDP growth in CESEE will be about 3%; that will allow economic convergence with the euro area, but at a relatively low speed. Growth will be driven mainly by household consumption, whereas investment will be constrained by limited access to the sources of financing and will be insufficiently high to promote a faster green and digital transition and to ensure the structural changes needed to boost the region's competitiveness.
- › Risks to the outlook remain mostly on the downside, with the most significant of these related to geopolitics. Inadequate support from the West could lead to Ukraine losing the war, which would increase the security risks for the whole of Europe. Tensions in the Middle East could cause a significant increase in global energy prices, as well as supply-chain disruptions.

2.1. CESEE COUNTRIES SAW LITTLE IMPROVEMENT IN THEIR ECONOMIC PERFORMANCE IN Q4 2023

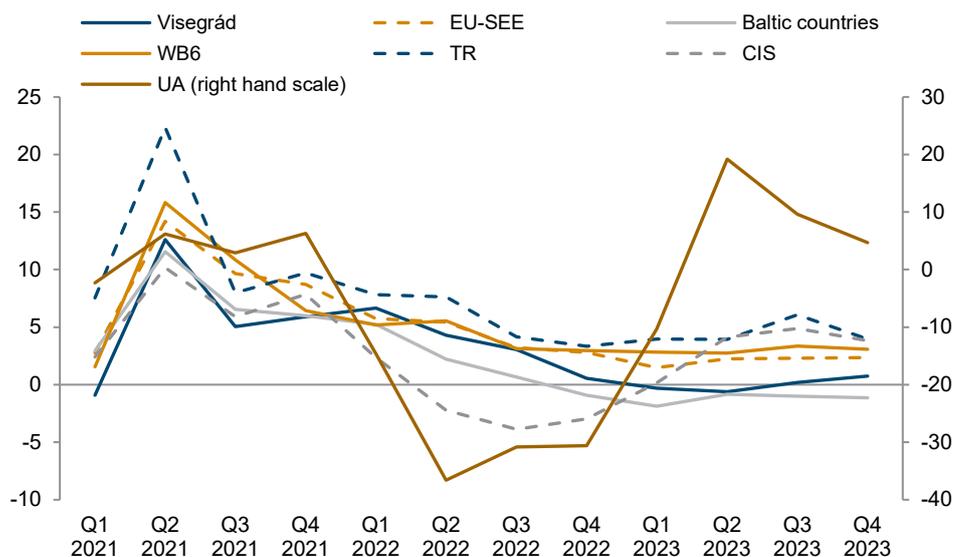
Last year was a challenging one for the CESEE region, with many economies struggling to build up a head of steam. The Baltic countries performed especially poorly (see Figure 2.1): their economies contracted throughout the year, as they continued to be those worst affected by the repercussions of Russia's war in Ukraine. The Visegrád countries, dragged down by the recession in their main export market of Germany (see Global overview), struggled to achieve a growth rate in excess of zero. Both sub-regions were also hit disproportionately hard last year by inflation, which contributed to the

weakening of their economies. Economic growth both in the Western Balkans and EU-SEE was mostly stable throughout 2023, at around 3% and 2% annual real GDP growth, respectively – a marked deceleration for these sub-regions.

Only the CIS countries and Ukraine saw a significant acceleration of economic growth in 2023 compared to the previous year. Ukraine, which lost almost a third of its economy in 2022 (partly on account of the de facto loss of some of its territory and population to Russia), was able to achieve positive economic growth during the second year of the war, thanks to a significant influx of foreign aid and a remarkable degree of economic resilience (see Ukraine report). Although there was a significant slowdown of economic growth in the second half of the year, the 4.7% growth year on year recorded in Q4 2023 was still one of the highest in the region. In the case of CIS, such growth was possible largely on account of Russia's ability to switch its economy to war mode and to circumvent most of the Western sanctions (see Russia report), but it was also helped by a steep rise in investment in Kazakhstan (see Kazakhstan report).

Figure 2.1 / Quarterly real GDP

change against preceding year, %



Note: simple average.

Source: wiiw Monthly Database incorporating national and Eurostat statistics.

In Q4 2023, GDP growth accelerated only in the Visegrád and EU-SEE countries, but then only marginally – by 0.4 and 0.1 percentage points (pp), respectively, year on year. In all other sub-regions, economic growth decelerated, with the Baltic countries being the worst performers: Latvia recorded a year-on-year decline in GDP in Q4 2023. The Western Balkan region, which succeeded in markedly speeding up economic growth in Q3 2023, experienced a deceleration of GDP growth in annual terms of 0.3 pp in the last quarter. In CIS, Moldova, which had been struggling to recover from the effects of Russia's war in Ukraine (see Moldova report), was the laggard in terms of economic growth, achieving only 0.2% year on year in Q4 2023 – a striking 3.1 pp lower than in the previous quarter.

Economic performance in the Western Balkan and EU-SEE sub-regions varied quite substantially from country to country. For EU-SEE, Croatia was something of a sub-regional champion, having seen its GDP growth boosted to 4.3% year on year in Q4 2023; its economy has benefited from a surge in tourism (helped by the country's accession to the EU's border-free Schengen zone) and the increased inflow of EU funds, which supported investment activity (see Croatia report). At the same time, GDP growth in Bulgaria, Romania and Slovenia was noticeably slower in Q4 2023 – between 1% and 2% year on year, as those countries' industries were hit by sluggish demand on their main export markets, and as inventories contracted after the completion of infrastructure projects, signalling a lack of confidence in future demand (see Bulgaria and Romania reports). In the Western Balkans, both Bosnia and Herzegovina and North Macedonia underperformed compared to their peers, achieving only 1.7% and 0.9% year-on-year economic growth in Q4 2023, respectively – versus 4% on average in the rest of the sub-region. Here again, a decline in inventories was among the main reasons for this – likely a result of the stockpiling of gas and oil in 2022 amid the energy crisis (see North Macedonia report).

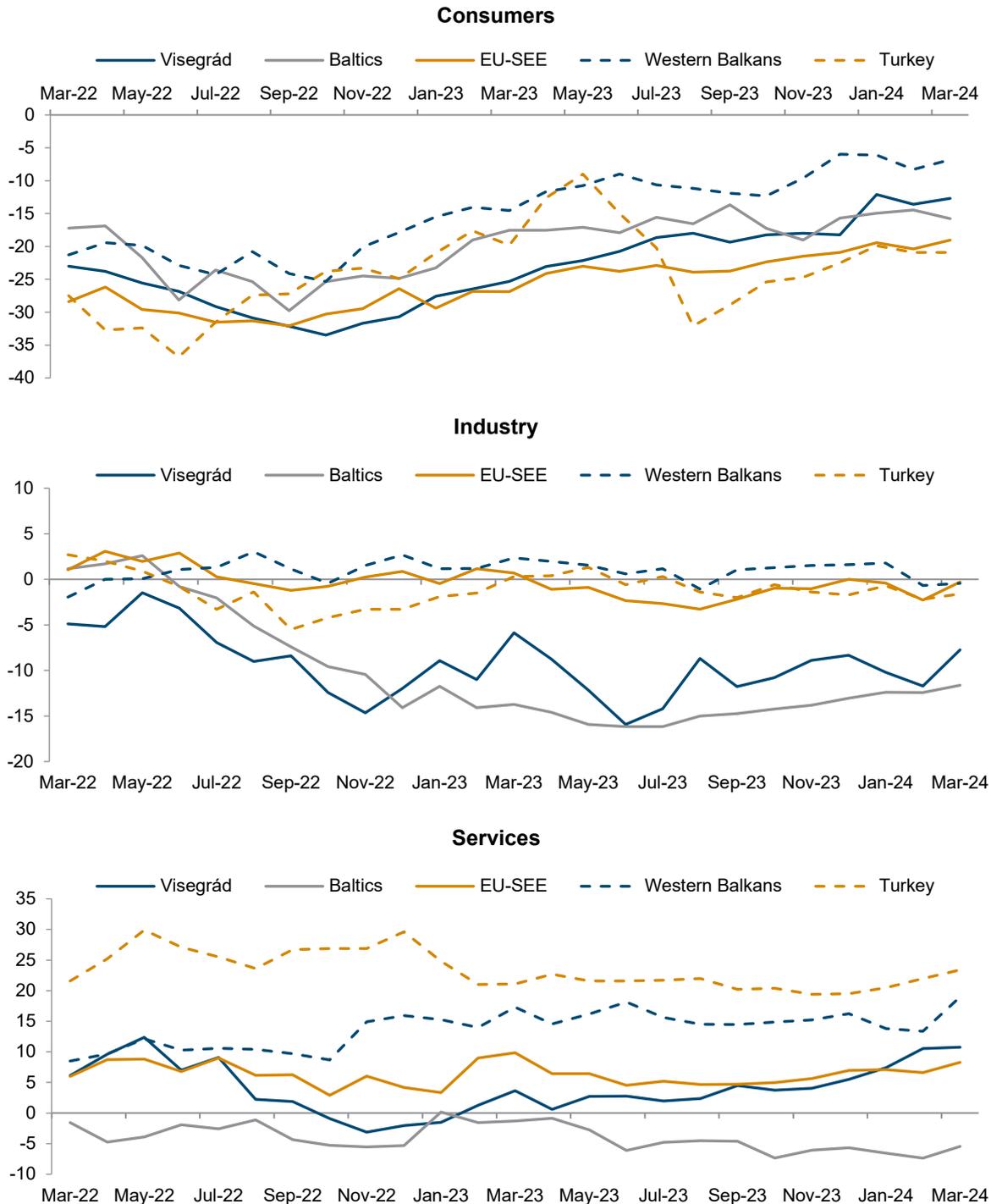
Industry and consumers both remain generally pessimistic, though consumer sentiment has been improving (Figure 2.2). In 2023, the mood of consumers remained subdued in all sub-regions, with the sentiment indicator values staying below zero. Turkey recorded the lowest values – quite likely reflecting the skyrocketing and persistent inflation, which affected the welfare of households (see Turkey report). There appears to have been some improvement in consumer sentiment in Q4 2023 to Q1 2024, most visibly in the Western Balkans and the Visegrád countries. Sentiment in industry, on the contrary, has shown no sign of recovery, with industry in the Visegrád and Baltic countries having on average far worse expectations than in EU-SEE, the Western Balkans and Turkey, where sentiment values have tended to hover around zero. Still, in all sub-regions, the sentiment expressed by industry remains less negative than that voiced by consumers: that dipped significantly deeper in 2022, as households struggled with the cost-of-living crisis, and has not recovered yet.

A striking divergence in economic sentiment developed after the start of the full-scale invasion of Ukraine by Russia, with the Western Balkans having a far more positive (or less negative) sentiment than the Visegrád and Baltic countries in all sectors of the economy. This likely reflects, on the one hand, the greater dependence of the Visegrád countries on the German economy (which was hit particularly hard by the increased energy prices) and, on the other, the greater security risks to the Baltic countries, as perceived by investors. Industry in the countries of EU-SEE maintained a better level of sentiment than the Visegrád countries on the back of robust investment, and to some extent as part of the re-shoring process.

The services sector, by contrast, exhibited overall positive sentiment in all CESEE sub-regions, apart from the Baltic countries (see Figure 2.2). Sentiment indicator values were highest in Turkey and Western Balkan countries, which tend to specialise in tourism services, which have experienced rapidly rising demand since the end of the COVID-19 pandemic. The Visegrád countries experienced a marked improvement in sentiment in the services sector in Q4 2023 to Q1 2024, pointing to a better performance in that part of the economy than in the manufacturing sector. Rising real wages in the region are likely to boost the confidence of service providers in the robustness of domestic demand – in contrast to industry, which remains much more dependent on developments on external markets.

Figure 2.2 / European Commission economic sentiment indicator, seasonally adjusted

Balance of positive over negative survey results²



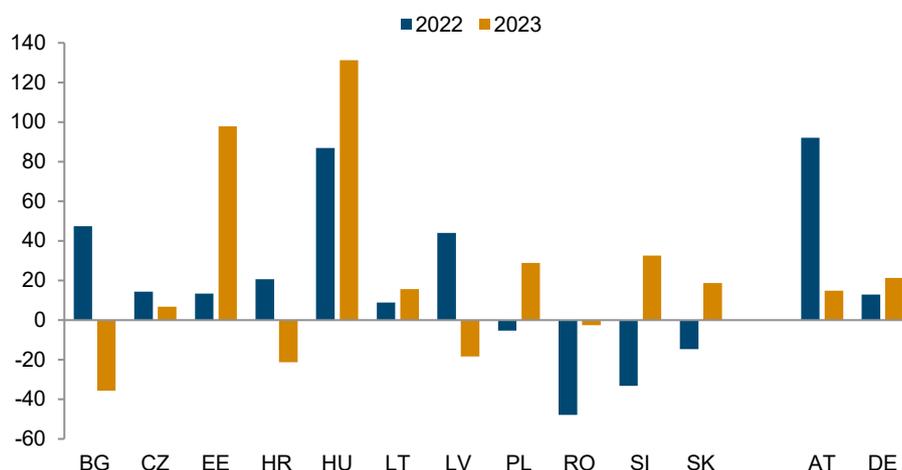
Note: Simple average of each country group. Here Western Balkans refers to just Albania, Montenegro, North Macedonia and Serbia; EU-SEE: Bulgaria, Croatia, Romania, Slovenia.
 Source: Eurostat and national statistics, own calculations.

² Numbers above 0 suggest optimism about future economic performance.

The rising bankruptcy rates in industry in many countries point to structural issues exacerbated by the recent economic crisis. Bankruptcies have been on the rise in all four Visegrád countries – together with Austria and Germany (see Figure 2.3) – driven by tightening of the financing and liquidity conditions amid rising interest rates and supply-chain disruptions. An especially high growth in bankruptcies has been observed in Hungary and Estonia – 131% and 98%, respectively, year on year in 2023. Only Bulgaria, Croatia and Romania saw bankruptcies in industry decline in 2023, which is yet further evidence that their economies are in better shape than the rest of EU-CEE. So far these trends have not caused any deterioration in the non-performing loans (NPL) situation; but in many countries, NPL ratios for corporate loans are noticeably higher than for household loans – by as much as 6.6 pp in Montenegro (where the NPL ratio for corporate loans reached 10% at the end of 2023).

Figure 2.3 / Bankruptcy declarations in industry

Average change against preceding year, %



Source: Eurostat, own calculations.

2.2. INFLATION HAS SLOWED SIGNIFICANTLY, BUT CORE INFLATION IS PROVING MORE PERSISTENT

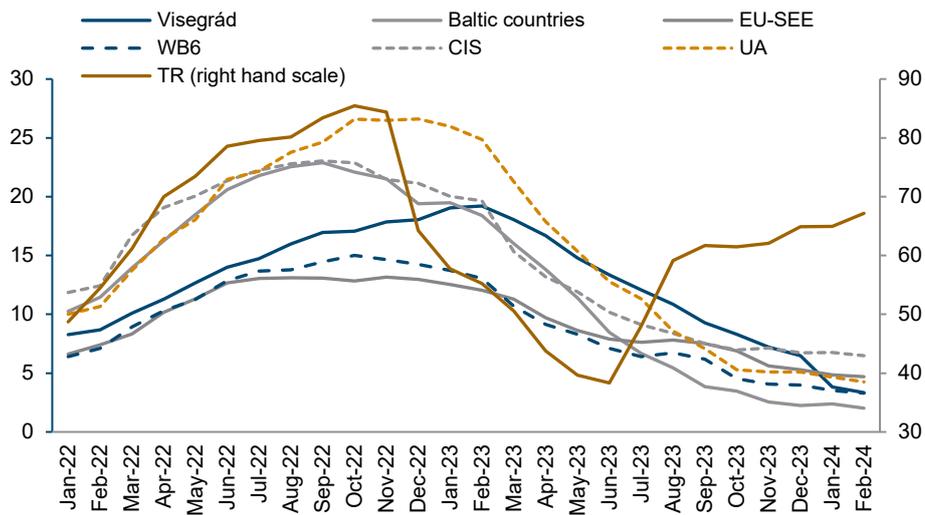
Inflation in CESEE has slowed further over the past few months everywhere, apart from Turkey and CIS (Figure 2.4). Turkey remains an outlier, with consumer prices having been trending upward since mid-2023 to reach 68.5% year on year in March 2024, driven by negative real interest rates, national currency depreciation and high import demand (see Turkey report). In CIS, inflation is highest in Kazakhstan and Russia (9.6% and 7.7%, respectively, year on year in February 2024). Yet in only a handful of countries – namely, Bosnia and Herzegovina, Czechia, Kosovo, Lithuania and Latvia – was inflation at or lower than about 2% in February 2024.

The rise in food and transport prices have decelerated significantly in line with global food and energy price trends (Figure 2.5). In Czechia, Hungary and Latvia, there was even deflation in food prices in February 2024 (partly explicable by the high comparison basis, since in February 2023 food prices in those three countries grew in the range of 18-26%), while transport prices fell in Hungary, Latvia, Poland,

Albania and Bosnia and Herzegovina. Turkey remains the only country in the region incapable of overcoming its problem of high inflation: even war-torn Ukraine has managed to curb its inflation.

Figure 2.4 / Consumer price index

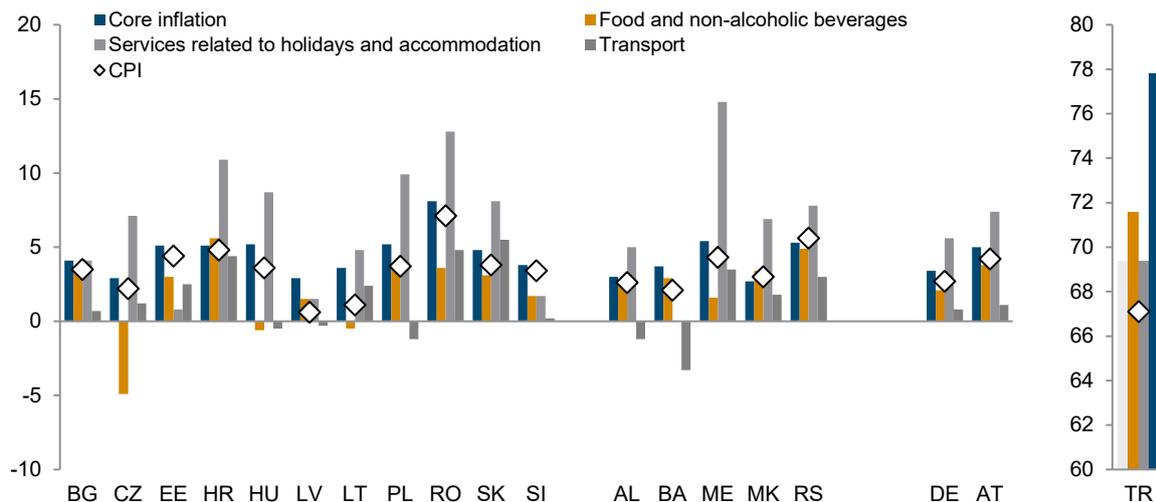
% change year on year, monthly



Note: simple average. Harmonised index of consumer prices (HICP) for EU-CEE.
Source: wiiw Monthly Database incorporating national and Eurostat statistics.

Figure 2.5 / Consumer price inflation sub-components in February 2024

percentage change year on year



Source: National sources, Eurostat, wiiw.

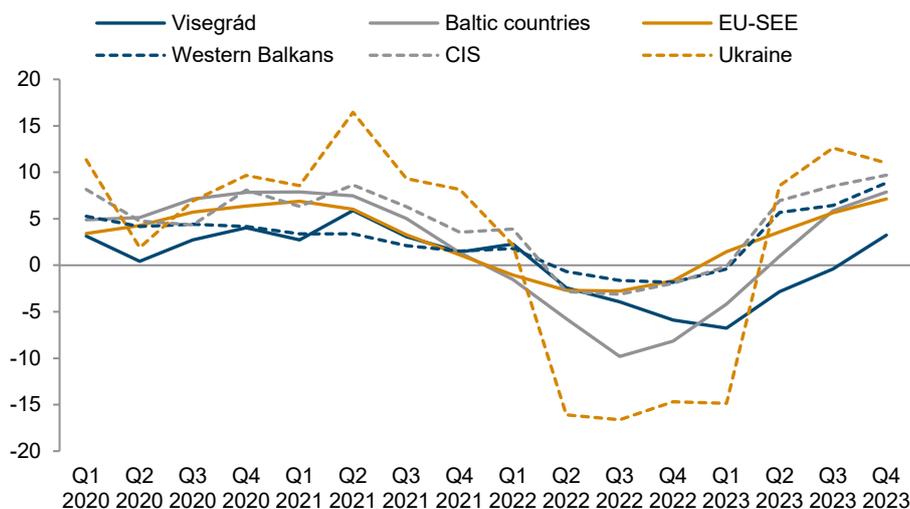
Core inflation is higher than headline inflation everywhere except for Croatia, indicating the continuing pass-through of higher production costs to prices. This is driven primarily by the cost of services, which appear to be slower to respond than food or transport (see Figure 2.5).

Disregarding Turkey as an outlier, the cost of holidays and accommodation services – the fourth biggest component of the harmonised index of consumer prices – have grown fastest in Montenegro, Romania and Croatia: by 14.8%, 12.8% and 10.9%, respectively, year on year in February 2024. This is likely driven both by the rising demand for such services and by strong wage dynamics in the sector amid labour-supply constraints.

The accelerating growth of real wages appears to be one factor behind the steeply rising cost of services. Real wages picked up towards the end of 2023 in all CESEE countries (Figure 2.6) apart from Czechia, where they were still declining in Q4 2023 by 1.9% year on year. The fastest growth has been taking place in Ukraine and CIS, while the Visegrád countries had only a relatively modest increase in real wages of 3.3% year on year in Q4 2023, after six consecutive quarters of decline – likely due to high inflation eating into nominal wage growth, as well as because of the poor performance of their manufacturing sectors. In several countries – Belarus, Latvia, Moldova, North Macedonia and Ukraine – the rate of real wage growth was in double digits, which could indicate that it might take longer for core inflation there to subside.

Figure 2.6 / Real gross wages in 2020-2023, quarterly

percentage change year on year



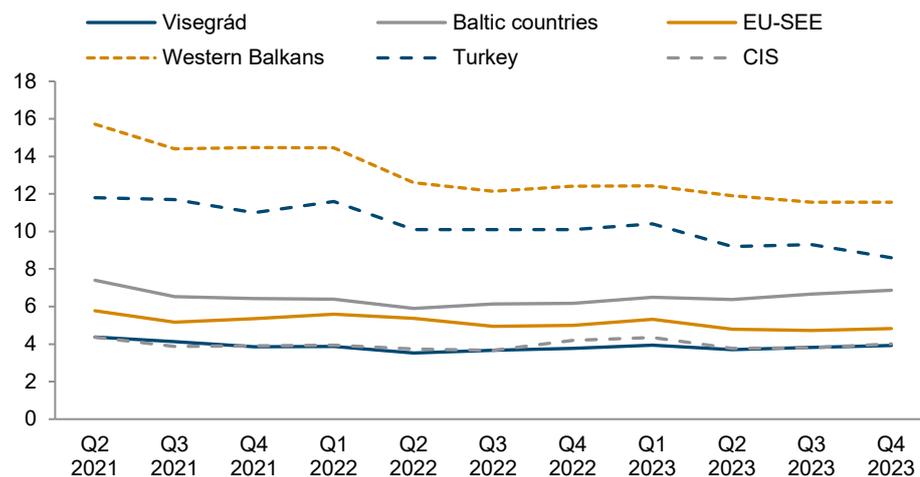
Source: wiiw Monthly Database incorporating national and Eurostat statistics.

Still, for many EU-CEE countries, real wages are much lower than at the end of 2021, and so their growth is quite welcome news for the economy. In Czechia, the decline in real wages has been the most dramatic – in Q4 2023, Czech employees were receiving wages that on average were 40% lower (in real terms) than in Q4 2021. The rate of decline in real wages was cumulatively in double digits during 2022-2023 in Estonia, Latvia, Slovakia and Slovenia, as well as in Moldova and Ukraine.

Wage growth is supported by tight labour markets, which are suffering from chronic labour shortages. The Visegrád and CIS countries appear to have the most acute labour shortages, as reflected in their unemployment data (see Figure 2.7) – for several years now, unemployment rates in those sub-regions have remained at around 4%. Given the difficulty they face in finding employees,

companies tend to ‘hoard labour’ – i.e. to be reluctant to lay off workers even during periods of poor economic performance. In Russia, the unemployment rate has recently declined further to reach 2.9% in Q4 2023 – partly due to war-related demographic shifts: military conscription has been taking men out of the labour force and has caused a lasting decline in the economically active population, since many are killed or rendered disabled in Ukraine. Besides, the threat of conscription has impelled many people, especially young men, to emigrate. On top of everything else, the demand for labour is relatively high, due to the reasonable economic growth. In the Western Balkans, pre-election wage rises in the public sector have played an important role as well. Although unemployment rates remain above 10% in all countries of the sub-region, apart from Serbia, they have been declining steadily, while skill mismatches have become more evident and have led to labour shortages in certain sectors. Only in the Baltic countries has there recently been a gradual uptick in unemployment, due to poor industrial performance; but the average unemployment rate remains relatively low (at just below 7%) and is expected to decline as economic growth is restored.

Figure 2.7 / Unemployment rate, %, quarterly (LFS)



Note: Simple average of each country group.

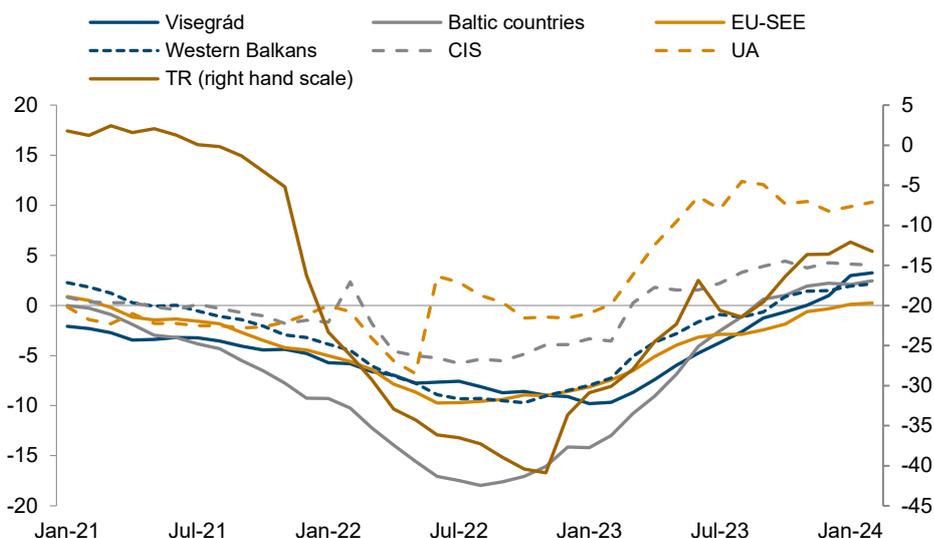
Source: wiiw Monthly Database incorporating national and Eurostat statistics.

2.3. REAL INTEREST RATES HAVE MOVED INTO POSITIVE TERRITORY, BUT SO FAR APPEAR TO HAVE HAD LIMITED EFFECT ON HOUSING PRICES AND CONSUMER LENDING

Thanks to a strong decline in inflation, real interest rates have moved above zero (see Figure 2.8). Many countries have started to loosen their monetary policy, but national banks have been cutting interest rates more slowly than inflation has been falling, resulting in a tightening of real financing conditions. Turkey, by contrast, has been trying to tighten its monetary policy, but the interest rate hikes in H2 2023 were too small to offset the accelerating inflation; thus that country still has a double-digit negative real interest rate. Among EU-CEE countries, real interest rates have increased most in the Visegrád countries, with the average real interest rate in the sub-region exceeding 3% in February 2024. Monetary authorities in the sub-region still appear to be cautious in their approach to monetary loosening: this is due to the sticky core inflation and fast nominal wage growth, as well as to a reluctance to risk any major weakening of the national currency, which could further increase imported inflation. The

countries of EU-SEE have been relatively lax in their monetary policy, with average real interest rates just slightly above zero. Croatia and Romania had real interest rates that were negative in February 2024 – albeit only slightly (-0.3% and -0.1%, respectively). Real interest rates are higher for all EU-CEE countries (bar Latvia and Lithuania) if one deflates nominal interest rates by the annual consumer price inflation (CPI) forecast for 2025 – the difference is greatest for Romania and Croatia. This may be seen as an argument for national banks to be less cautious when deciding on future interest rate cuts.

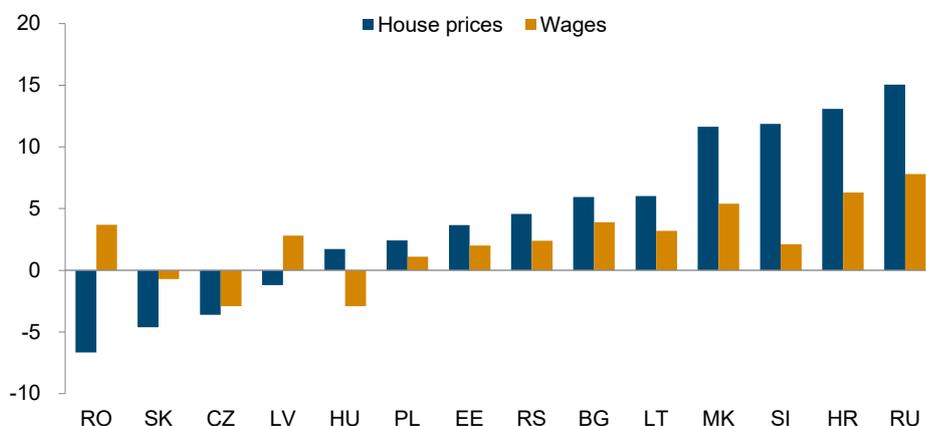
Figure 2.8 / Real interest rate (RIR), CPI deflated, %



Note: Simple averages for country aggregates.
 Source: wiiw Monthly Database incorporating national and Eurostat statistics and Eurostat, Bank for International Settlements.

Figure 2.9 / House prices, deflated by CPI, and real wages in 2023

percentage change year on year



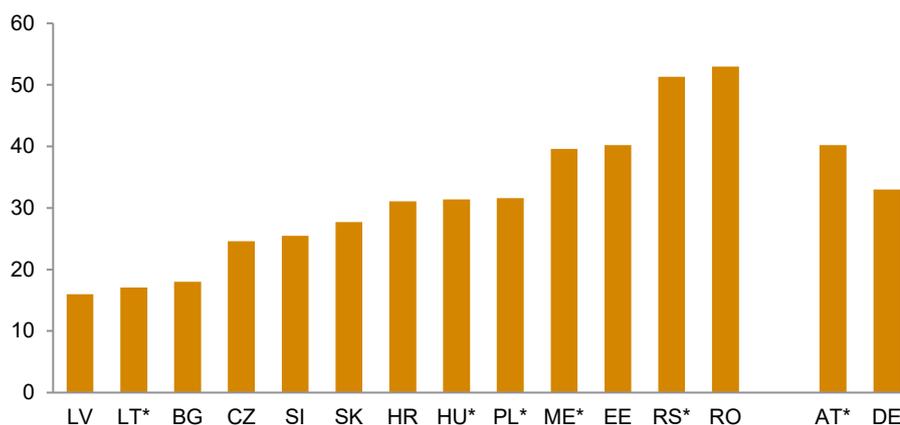
Source: wiiw Monthly Database incorporating national and Eurostat statistics and Eurostat, Bank for International Settlements.

The high demand for housing continued even as interest rates were raised, and house prices in many CESEE countries rose rapidly in real terms in 2023, outpacing real wage growth (see Figure 2.9). An inadequate supply of housing also continues to support the property price growth in many countries. Russia, Croatia, Slovenia and North Macedonia stand out as those countries with double-digit annual growth in real house prices in 2023, while real wages grew much slower. Such developments might point to a possible overheating on the national housing markets.

Lower housing affordability is yet another indicator of the adverse social consequences of inflation. As buying a house becomes increasingly expensive, rapidly rising rents add to the economic hardships faced by households: rent absorbed more than 30% of household income among the poorer households of many CESEE countries (see Figure 2.10); Serbian and Romanian households were particularly badly affected (rents absorbed more than half of household income in those households that fell below 60% of median equalised income).

Figure 2.10 / Rent related to occupied dwelling as a share of disposable household income in 2023, %

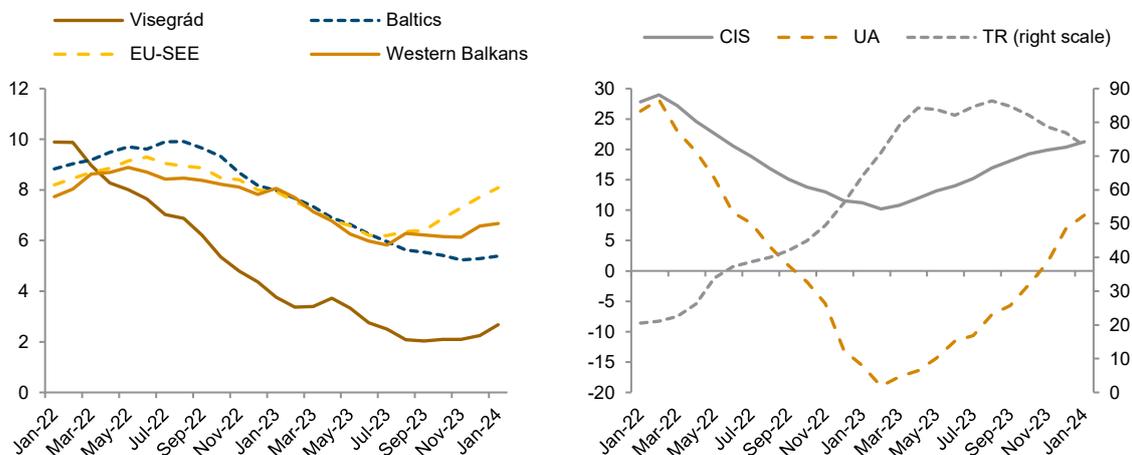
Households below 60% of median equalised income



Note: * the data are for 2022.

Source: Eurostat.

Regardless of rising real interest rates, the growth in loans to households has been accelerating over the past three months in many CESEE countries, though it mostly remains lower than two years ago. CIS countries have recorded double-digit growth in the stock of such loans over the past few years, and this trend shows no sign of abating (see Figure 2.11). As most lending to households in the sub-region is in the form of consumer (short-term) loans, this trend likely points to households financing part of their consumption through borrowing. Within EU-CEE, the countries of Southeast Europe have witnessed the fastest growth in loans to households – 8.1% year on year in January 2024. The four countries concerned vary quite considerably in this respect, though: banks in Bulgaria and Croatia have been rapidly building up their stock of loans to households (at respectively 16.3% and 10.2% year on year in January 2024), whereas in Romania and Slovenia the growth in such loans has been anaemic (1.9% and 3.8%, respectively). Compared to January 2022, the Visegrád countries have seen the greatest slowdown in the growth of household loans, likely as a result of the very high real interest rates in the region.

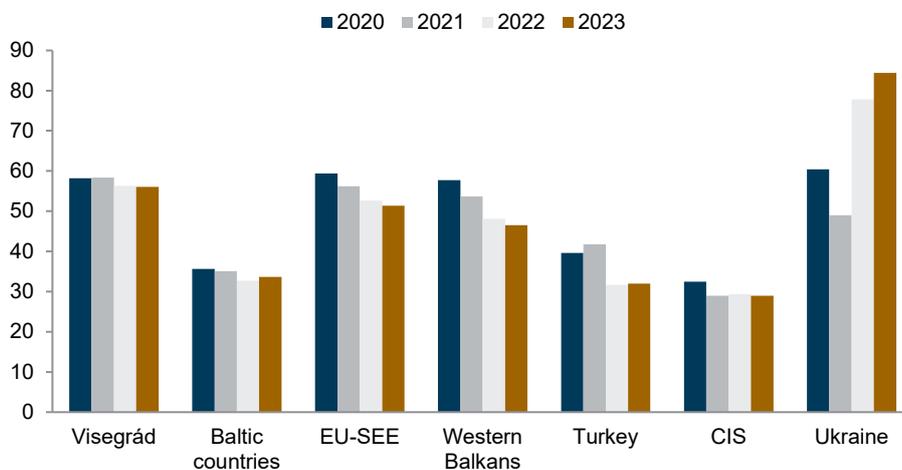
Figure 2.11 / Stock of loans to households, change year on year, %

Note: Simple averages for country aggregates.

Source: wiiw Monthly Database incorporating national and Eurostat statistics and Eurostat.

2.4. TIGHTER FINANCING CONDITIONS STARTING TO LIMIT PUBLIC AND PRIVATE INVESTMENT IN THE REGION

Public debt has been shrinking for several years now across most of the region, primarily due to the effects of high inflation. In 2023, the ratio of public debt to GDP decreased further in all the sub-regions – apart from Ukraine, which received a significant amount of financial support from abroad (see Figure 2.12). As the levels of public debt are relatively low in most countries and as the economic prospects appear positive, investors in sovereign debt will likely show increased interest in the region in the near future. However, the higher cost of borrowing and the need to pursue fiscal consolidation will limit governments' appetite for debt.

Figure 2.12 / Public debt, % of GDP

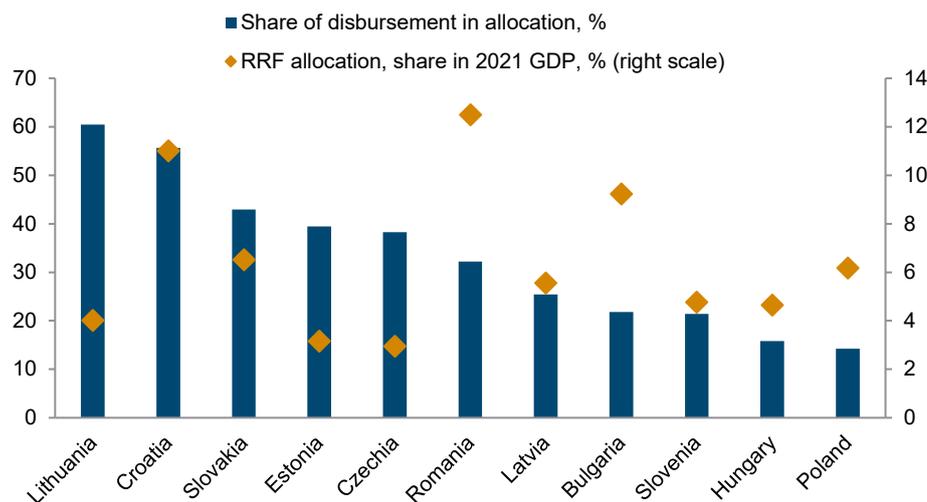
Note: Simple averages for country aggregates.

Source: wiiw Annual Database incorporating national and Eurostat statistics.

Resources from the EU Recovery and Resilience Facility (RRF) have provided relief to the EU-CEE, but disbursement is often too slow (see Figure 2.13). The fund's implementation has been delayed due to disagreements with Brussels over required reforms (primarily in the cases of Hungary, Poland and Slovakia) and over the design of the investment projects to be funded; and internal political bottlenecks have also prevented the agreed milestones being reached. Additionally, disbursements have often been delayed and the size of them effectively eroded by high inflation. By the end of March 2024, only Lithuania and Croatia had managed to secure disbursements of more than 50% of the RRF funds allocated to them in 2021. In March 2024, the European Commission unfroze Poland's funds, which had been blocked due to disagreements about the rule of law; however, it could prove difficult for the country to catch up in terms of the funds' absorption in the time remaining (until the end of 2026). Things look even bleaker for Hungary, where a substantial part of the EU funds continue to be frozen and their disbursement is conditional on the implementation of judicial reforms.

Figure 2.13 / RRF funds allocation and disbursement in 2021-2023

In descending order, by share of disbursement



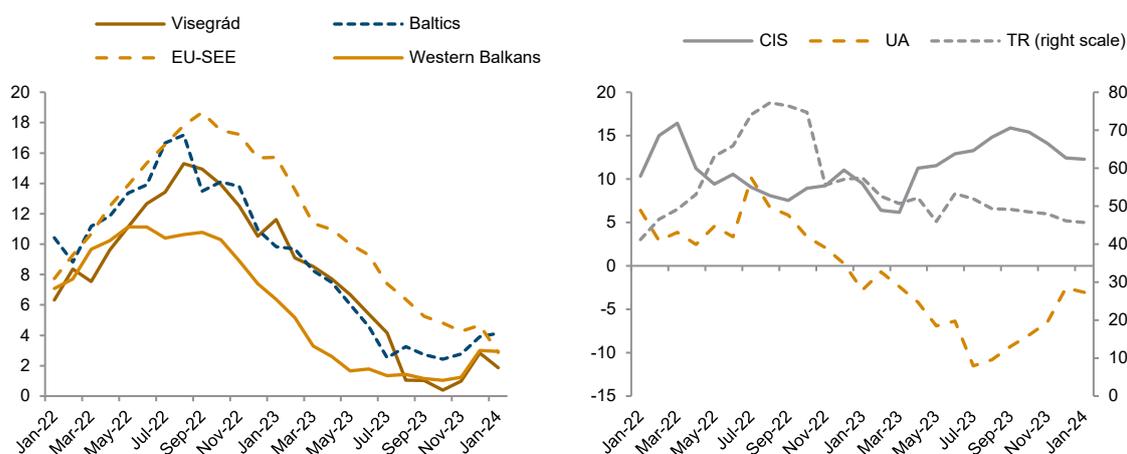
Note: Simple averages for country aggregates. Allocation is for the whole period of RRF operation (2021-2026).
Source: European Commission.

If EU-CEE countries improve their compliance with RRF conditions, they could receive a significant boost to their economies in 2024-2026. So far Croatia and Romania have benefited the most from RRF funds, having received the equivalent of 6.1% and 4.0% of their 2021 GDP. The funds have been crucial to the financing of their digital and renewable energy infrastructure projects. If they are successful in their application for the rest of the available funds, they could generate funds equivalent to as much as 4.9% of 2021 GDP in the case of Croatia, and 8.5% of 2021 GDP in the case of Romania. Bulgaria, Poland and Latvia also have large untapped resources allocated to them, amounting to 4-7% of 2021 GDP.

Private investment is being hampered by higher interest rates, which negatively affect bank lending to companies. Although the banking sector of the CESEE countries remains fairly healthy, with low rates of NPLs and high accumulated profits due to the big differential between deposit rates and loan interest rates, rising interest rates have curbed the growth of credit to non-financial corporations, which has lagged significantly behind the growth of household loans. The euro area bank lending survey

in Q1 2024 showed that net demand for loans by enterprises continued to decline substantially; also rejection rates for loan applications have increased. Signs of a tightened loan supply to companies are visible across most of the region (except for CIS), with the growth rates for loans far below their 2022 levels (see Figure 2.14). Of the EU-CEE countries, the picture regarding loans is poorest in the Visegrád countries, where the stock of loans to non-financial corporations increased by only 1.9% year on year in January 2024. There was even a contraction in the stock of loans in Slovenia, Poland and Latvia – by 7.0%, 4.1% and 0.3% year on year, respectively.

Figure 2.14 / Stock of loans to non-financial corporations, change year on year, %



Note: Simple averages for country aggregates.

Source: wiiw Monthly Database incorporating national and Eurostat statistics and Eurostat.

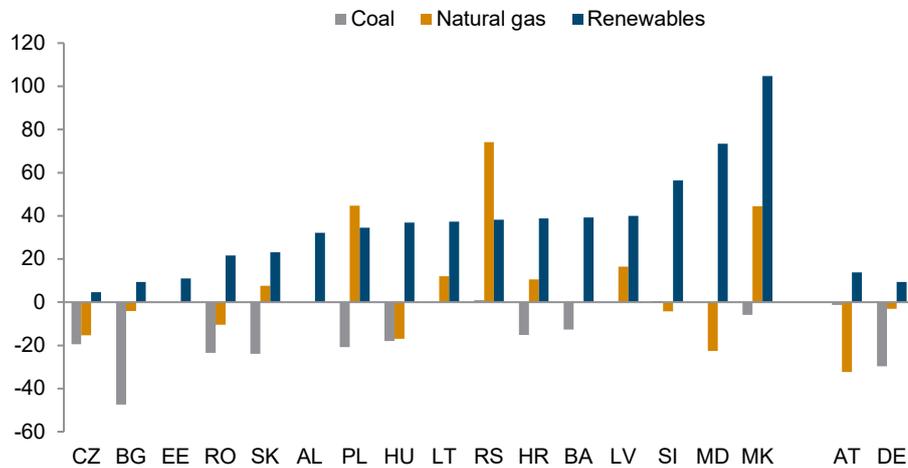
2.5. THE TRANSITION TO RENEWABLE ENERGY HAS BEEN ADVANCING, BUT THE FINANCING OF THE NECESSARY INVESTMENT WILL LIKELY PROVE MORE DIFFICULT IN FUTURE

Many CESEE countries have been investing in various energy infrastructure projects as part of the green transition agenda (and simultaneously with an eye to reducing dependence on Russia as an energy supplier). EU-CEE countries used RRF transfers to finance investment in energy transport networks (setting up connections to liquefied natural gas terminals), energy storage facilities and nuclear projects, as well as solar and wind parks. Outside the EU, the Western Balkans have been investing in solar and wind energy plants. Serbia and Turkey are investing in natural gas connections, in an effort to diversify away from Russian natural gas supplies.

As a result, the use of renewables in electricity generation increased in all CESEE countries in 2023, with Southeast Europe leading the way. All the countries apart from Czechia, Bulgaria and Estonia managed to increase their use of renewables faster than Austria (see Figure 2.15), with the fastest growth achieved in North Macedonia and Moldova; in the case of Moldova, this was motivated by the need to replace gas previously imported from Gazprom with alternative energy sources. Natural gas use increased most in Serbia, Poland and North Macedonia. These developments allowed a reduction in the use of coal everywhere; only in Serbia and Slovenia was there a marginal (below 1%) increase in the use of coal in electricity generation.

Figure 2.15 / Net electricity generation by type of fuel in 2023

percentage change year on year



Note: Renewables consist of solar, wind, hydropower and geothermal energy.

Source: Eurostat, own calculations.

As a result of these developments, the share of renewable energy in electricity generation increased further in CESEE, although the majority of the countries have not yet reached the level of Austria or Germany (Figure 2.16). The biggest increases in the share of renewables in the energy mix in 2023 were achieved in North Macedonia, Estonia, Bosnia and Herzegovina and Slovenia – increases of 19.8 pp, 11.4 pp, 11.1 pp and 10.1 pp, respectively. Now Latvia, Lithuania, Croatia and Romania have more than half of their energy mix generated from renewables.

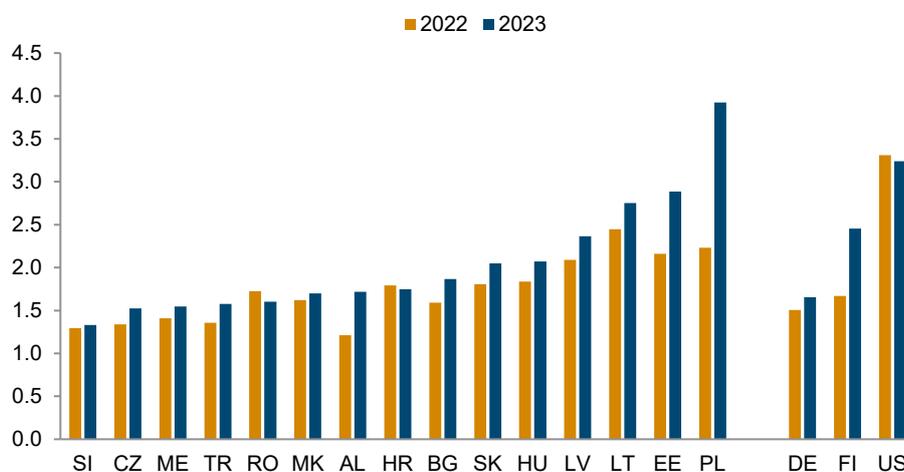
Figure 2.16 / Shares of renewable energy in net electricity generation in 2022 and 2023, %

Note: Renewables consist of solar, wind, hydropower and geothermal energy.

Source: Eurostat, own calculations.

The narrowing fiscal space and the need to prioritise defence spending due to the rising security risks will hinder investment in the green transition over the coming years. As the risk of instability has been increasing in many CESEE countries where a NATO presence is crucial for security (see Global assumptions), they have been raising their defence spending to improve their defence capabilities. Already in 2023, all the NATO members of CESEE (apart from Croatia and Romania) increased the share of defence expenditure in GDP (see Figure 17). Poland and the Baltic states (which feel most threatened by Russia) have been the most resolute in bolstering their military defence – in Poland the share of defence expenditure in GDP reached 4% of GDP in 2023.

Figure 2.17 / Defence expenditure as a share of GDP, %



Note: 2023 values are estimates.

Source: NATO.

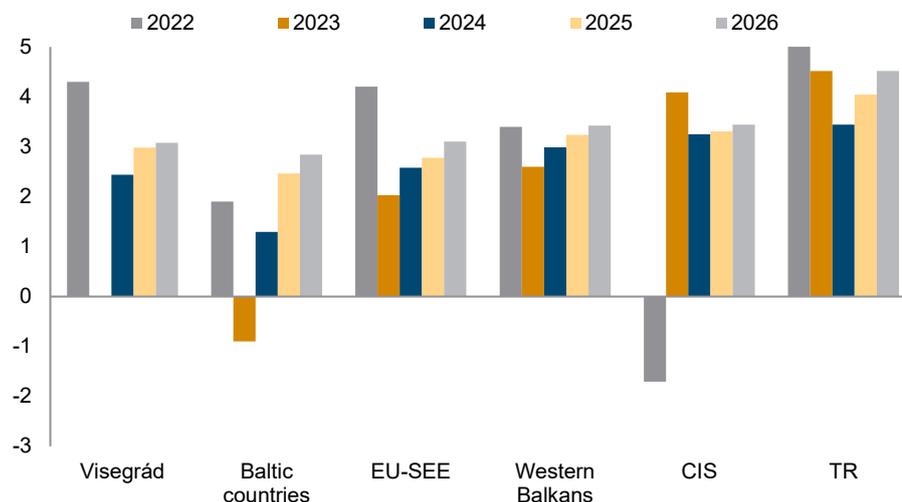
2.6. FORECAST FOR 2024-2026: CAUTIOUS ECONOMIC RECOVERY, WITH CONVERGENCE GRADUALLY SLOWING DOWN

This year, 2024, will bring an acceleration of economic growth for most of the region, apart from CIS, Ukraine and Turkey. The Visegrád sub-region, whose economy stagnated in 2023, will achieve the most rapid acceleration of annual GDP growth in 2024 – by 2.4 pp, after the previous year of economic stagnation (Figure 2.18). The Baltic countries, which went through a recession in 2023, will achieve economic growth of 1.3% this year – a growth differential of 2.2 p.p. Still, regardless of this rapid acceleration, growth in the Baltic and Visegrád countries will be the lowest of all the sub-regions in 2024. EU-SEE will outperform the Visegrád countries again this year, though this time only marginally – by 0.2 pp. In CIS, economic growth will moderate in 2024, as the statistical effect of a lower base of comparison in 2022 vanishes. Turkey's economic growth will slow down in 2024, due primarily to monetary tightening.

In 2025-2026, economic growth will become more uniform at about 3% year on year, as the economies of the Visegrád and Baltic countries accelerate to grow on a par with other sub-regions. Moderation of the growth in wages and a tightening of fiscal policy will prevent more dynamic economic performance. Looking at individual countries (see Tables 6.9, 6.22 and 6.23), Kazakhstan, Turkey and Ukraine will be the leaders in terms of economic growth in the region over the forecast

period. In the case of Ukraine, growth will be driven by both private and government consumption (assuming adequate foreign aid continues to be forthcoming); however, the forecast is subject to large downside risks related primarily to the intensity and duration of Russia's war in Ukraine and the continued willingness on the part of Ukraine's international partners to support it (see Ukraine report). In the Western Balkans, both Bosnia and Herzegovina and North Macedonia will manage to catch up with the other four countries of the sub-region in terms of the speed of growth, with annual GDP growth accelerating in 2026 to 3.4% and 3%, respectively. In the Visegrád region, only Poland will post annual GDP growth of above 3% in 2026; the other three economies will struggle to find stronger drivers of economic growth amidst a weaker global economy. With the exception of Slovenia, members of EU-SEE will perform more strongly than the Visegrád countries; Romania will grow fastest – at 3.8% year on year in 2026, on the back of increased RRF disbursement and mild fiscal stabilisation the previous year.

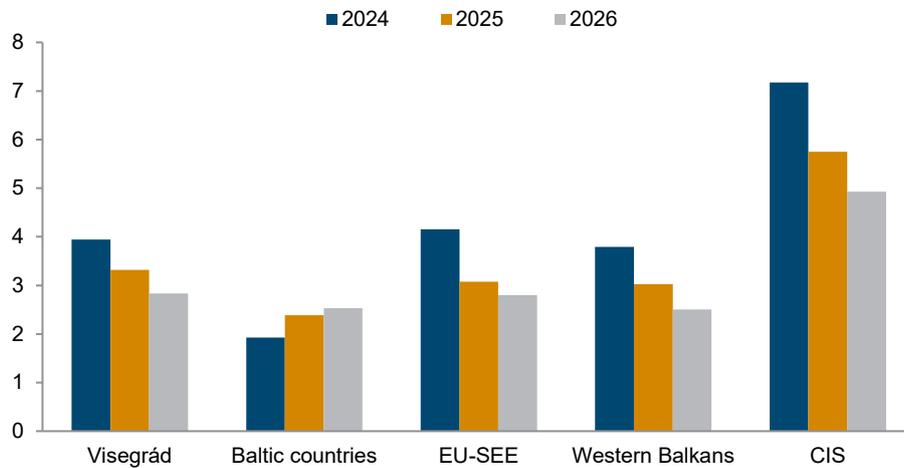
Figure 2.18 / Real GDP, annual change, %



Note: wiiw forecast for 2024-2026.

Source: wiiw annual dataset, wiiw forecast.

Inflation is expected to subside further across the region in 2024-2026, as wage growth moderates and global prices remain low (see Figure 2.19). The Baltic countries present an exception, as their inflation is expected to accelerate somewhat in 2025-2026; but even then it will remain the lowest in the region, at about 2.5% on average in 2026. Falling global food and energy prices will allow the relatively painless removal of price controls in many countries, although robust wage growth will stimulate private demand and push prices upwards. Along with Turkey, CIS will continue to have the highest CPI growth in CESEE, with prices growing fastest in Belarus and Kazakhstan (by 6% year on year in 2026 in both countries) – here inflation will be driven by high consumer demand, in particular for imports. Russia, by contrast, is expected to have a soft landing, with inflation decelerating rapidly to 3.7% year on year in 2026 (see Russia report). Turkey will still have uncomfortably high inflation of above 20% even in 2026, as monetary tightening will remain on the cautious side. In EU-CEE, Hungary, Romania and Slovakia will be the least successful in bringing down inflation, as their central banks tend to be less hawkish, and / or fiscal deficits will remain relatively high over the forecast period.

Figure 2.19 / CPI forecast for 2024-2026, average annual change, %

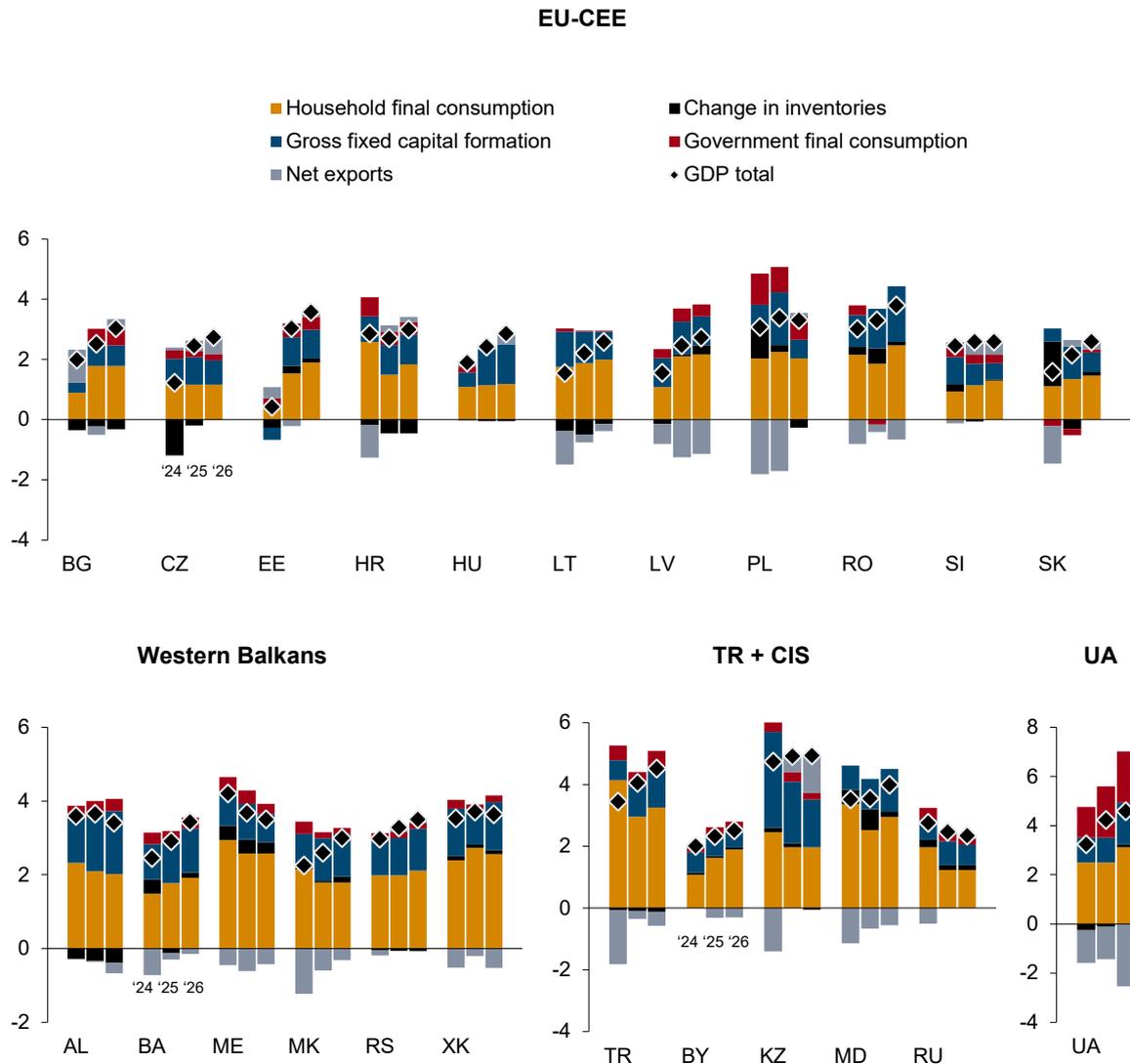
Note: Simple averages for country aggregates.

Source: wiiw forecast.

Economic convergence with the eurozone will speed up in 2024, but then slow down again. In 2024, the euro area's economy is expected to grow by only 0.6% year on year, which will increase the growth differential with CESEE region to 2.3 pp. In 2025-2026, however, it will narrow to 1.5 pp and 1.7 pp, respectively, against the backdrop of accelerated economic growth in the key euro area economies.

Private consumption will continue as the main growth driver during the forecast period, owing to the continued growth of wages and slowdown in inflation (see Figure 2.20). In 2026, it will account for more than 70% of GDP growth in Latvia, Lithuania, Kosovo, Montenegro, Turkey, Belarus and Moldova. Hungary is an outlier in the region, in that its private consumption is expected to contribute less to GDP growth in 2025-2026 than investment – assuming there is some progress in the disbursement of EU RRF and cohesion funds. In Kazakhstan, household consumption is expected to generate the least contribution to GDP growth in 2025-2026 (about 40% each year) in the region – primarily on account of the expanding energy exports.

Figure 2.20 / GDP growth forecast for 2024-2026 and contribution of individual demand components, in percentage points



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

Table 2.1 / OVERVIEW 2022-2023 AND OUTLOOK 2024-2026

	GDP					Consumer prices					Unemployment (LFS)				
	real change in % against prev. year					average change in % against prev. year					rate in %, annual average				
	2022	2023	Forecast			2022	2023	Forecast			2022	2023	Forecast		
BG Bulgaria	3.9	1.8	2.0	2.5	3.0	13.0	8.6	4.0	3.0	3.0	4.3	4.3	4.2	4.1	4.0
CZ Czechia	2.4	-0.3	1.2	2.5	2.7	14.8	12.0	2.0	2.2	2.2	2.2	2.6	3.0	2.6	2.6
EE Estonia	-0.5	-3.0	0.4	3.0	3.6	19.4	9.1	3.5	2.8	2.4	5.6	6.4	7.5	6.2	5.6
HR Croatia	6.3	2.8	2.9	2.7	3.0	10.7	8.4	3.5	2.9	2.5	7.0	6.1	6.1	6.0	6.0
HU Hungary	4.6	-0.9	1.9	2.4	2.9	15.3	17.0	5.2	4.0	3.5	3.6	4.1	4.0	3.8	3.5
LT Lithuania	2.4	-0.3	1.5	2.2	2.6	18.9	8.7	1.5	2.3	2.5	6.0	6.8	6.5	6.3	6.0
LV Latvia	3.0	-0.3	1.6	2.5	2.7	17.2	9.1	1.4	2.2	2.7	6.9	6.5	6.3	6.0	5.8
PL Poland	5.3	0.2	3.1	3.4	3.3	13.2	10.9	4.5	3.5	2.8	2.9	2.8	2.8	3.0	3.1
RO Romania	4.1	2.1	3.0	3.3	3.8	12.0	9.7	5.8	4.0	3.5	5.6	5.6	5.5	5.4	5.2
SI Slovenia	2.5	1.6	2.5	2.6	2.6	9.3	7.2	3.3	2.4	2.2	4.0	3.7	3.7	3.6	3.6
SK Slovakia	1.8	1.1	1.6	2.2	2.6	12.1	11.0	2.2	3.4	3.4	6.1	5.8	5.8	5.6	5.4
<i>EU-CEE11¹⁾²⁾</i>	<i>4.2</i>	<i>0.6</i>	<i>2.5</i>	<i>3.0</i>	<i>3.2</i>	<i>13.5</i>	<i>11.0</i>	<i>4.1</i>	<i>3.3</i>	<i>2.9</i>	<i>4.0</i>	<i>4.1</i>	<i>4.1</i>	<i>4.0</i>	<i>4.0</i>
<i>EA20³⁾</i>	<i>3.4</i>	<i>0.4</i>	<i>0.6</i>	<i>1.6</i>	<i>1.6</i>	<i>8.4</i>	<i>5.4</i>	<i>2.5</i>	<i>2.2</i>	<i>2.0</i>	<i>6.8</i>	<i>6.5</i>	<i>6.7</i>	<i>6.6</i>	<i>6.6</i>
<i>EU27³⁾</i>	<i>3.4</i>	<i>0.4</i>	<i>0.8</i>	<i>1.8</i>	<i>1.8</i>	<i>9.2</i>	<i>6.4</i>	<i>2.7</i>	<i>2.4</i>	<i>2.2</i>	<i>6.2</i>	<i>5.7</i>	<i>5.9</i>	<i>5.8</i>	<i>5.8</i>
AL Albania	4.9	3.4	3.6	3.7	3.4	6.7	4.8	3.0	2.5	2.4	10.9	10.7	10.4	10.0	9.7
BA Bosnia and Herzegovina	4.2	1.7	2.5	2.9	3.4	14.0	6.1	2.8	2.5	2.0	15.4	13.2	12.9	12.7	12.4
ME Montenegro	6.4	6.0	4.2	3.7	3.5	13.0	8.6	4.5	3.0	2.5	14.7	13.1	11.0	10.0	9.0
MK North Macedonia	2.2	1.0	2.2	2.6	3.0	14.2	9.4	3.5	3.0	2.5	14.4	13.1	12.5	11.8	11.0
RS Serbia	2.5	2.5	3.0	3.3	3.5	11.9	12.1	4.5	3.5	2.8	9.4	9.5	9.0	8.5	8.0
XK Kosovo	4.3	3.3	3.5	3.7	3.6	11.6	4.9	3.5	2.5	2.2	12.5	12.4	12.3	12.0	11.5
<i>WB6¹⁾²⁾</i>	<i>3.4</i>	<i>2.6</i>	<i>3.0</i>	<i>3.2</i>	<i>3.4</i>	<i>11.8</i>	<i>9.0</i>	<i>3.8</i>	<i>3.0</i>	<i>2.5</i>	<i>11.7</i>	<i>11.1</i>	<i>10.8</i>	<i>10.0</i>	<i>9.8</i>
TR Turkey	5.5	4.5	3.4	4.0	4.5	72.3	54.0	59.0	31.0	26.0	10.5	9.4	10.0	10.5	10.0
BY Belarus	-4.7	3.9	2.0	2.3	2.5	15.2	5.1	8.0	7.0	6.0	3.6	3.5	3.5	3.4	3.4
KZ Kazakhstan	3.2	5.1	4.7	4.9	4.9	15.0	14.7	8.5	6.5	6.0	4.9	4.7	4.6	4.5	4.4
MD Moldova	-4.6	0.7	3.5	3.5	4.0	28.7	13.4	5.0	5.0	4.0	3.1	4.6	4.0	3.8	3.5
RU Russia	-1.2	3.6	2.8	2.5	2.3	13.8	5.9	7.2	4.5	3.7	4.0	3.2	2.9	2.9	2.9
UA Ukraine	-28.8	5.3	3.2	4.2	4.6	20.2	12.9	8.0	6.0	6.0	25.0	20.0	15.0	10.0	9.0
<i>CIS4+UA¹⁾²⁾</i>	<i>-2.9</i>	<i>3.9</i>	<i>3.0</i>	<i>2.8</i>	<i>2.8</i>	<i>14.5</i>	<i>7.2</i>	<i>7.4</i>	<i>4.9</i>	<i>4.2</i>	<i>7.4</i>	<i>5.9</i>	<i>4.9</i>	<i>4.1</i>	<i>3.9</i>
<i>V4¹⁾²⁾</i>	<i>4.3</i>	<i>0.0</i>	<i>2.4</i>	<i>3.0</i>	<i>3.1</i>	<i>13.7</i>	<i>12.0</i>	<i>3.9</i>	<i>3.3</i>	<i>2.8</i>	<i>3.2</i>	<i>3.3</i>	<i>3.3</i>	<i>3.3</i>	<i>3.3</i>
<i>BALT3¹⁾²⁾</i>	<i>1.9</i>	<i>-0.9</i>	<i>1.3</i>	<i>2.5</i>	<i>2.8</i>	<i>18.6</i>	<i>8.9</i>	<i>1.9</i>	<i>2.4</i>	<i>2.5</i>	<i>6.1</i>	<i>6.6</i>	<i>6.7</i>	<i>6.2</i>	<i>5.8</i>
<i>SEE9¹⁾²⁾</i>	<i>4.2</i>	<i>2.3</i>	<i>2.8</i>	<i>3.1</i>	<i>3.5</i>	<i>12.0</i>	<i>9.2</i>	<i>4.8</i>	<i>3.5</i>	<i>3.1</i>	<i>7.7</i>	<i>7.5</i>	<i>7.3</i>	<i>7.0</i>	<i>6.8</i>
<i>CIS3+UA¹⁾²⁾</i>	<i>-9.4</i>	<i>4.8</i>	<i>3.7</i>	<i>4.2</i>	<i>4.4</i>	<i>17.3</i>	<i>12.5</i>	<i>8.1</i>	<i>6.4</i>	<i>5.9</i>	<i>15.3</i>	<i>12.5</i>	<i>9.8</i>	<i>7.1</i>	<i>6.5</i>
<i>non-EU12¹⁾²⁾</i>	<i>-0.1</i>	<i>4.0</i>	<i>3.1</i>	<i>3.2</i>	<i>3.3</i>	<i>32.3</i>	<i>21.8</i>	<i>23.3</i>	<i>12.9</i>	<i>10.9</i>	<i>8.3</i>	<i>7.0</i>	<i>6.4</i>	<i>5.9</i>	<i>5.7</i>
<i>CESEE23¹⁾²⁾</i>	<i>1.2</i>	<i>3.0</i>	<i>2.9</i>	<i>3.1</i>	<i>3.3</i>	<i>26.6</i>	<i>18.5</i>	<i>17.5</i>	<i>10.0</i>	<i>8.5</i>	<i>7.3</i>	<i>6.3</i>	<i>5.8</i>	<i>5.5</i>	<i>5.3</i>

Contd.

Table 2.1 / Continued

	Current account					Fiscal balance				
	in % of GDP					in % of GDP				
	2022	2023	Forecast			2022	2023	Forecast		
		2024	2025	2026	2024	2025	2026	2024	2025	2026
BG Bulgaria	-1.4	-0.3	-0.2	-0.6	-0.9	-2.9	-3.0	-4.0	-3.0	-3.0
CZ Czechia	-4.9	0.4	0.4	0.8	1.4	-3.2	-3.3	-2.5	-2.0	-1.5
EE Estonia	-3.2	-2.1	-2.0	-1.7	-1.8	-1.0	-3.3	-3.6	-4.5	-3.7
HR Croatia	-2.8	1.1	0.2	1.0	1.3	0.1	-1.0	-2.0	-1.4	-1.2
HU Hungary	-8.4	0.2	0.0	0.2	0.4	-6.3	-6.7	-5.0	-4.0	-3.5
LT Lithuania	-5.5	1.9	2.2	2.8	2.5	-0.7	-1.0	-2.5	-2.5	-2.3
LV Latvia	-4.8	-4.0	-3.1	-4.6	-5.7	-4.7	-3.0	-2.8	-2.3	-2.0
PL Poland	-2.4	1.6	0.5	-1.2	-1.0	-3.7	-5.6	-5.4	-5.3	-5.3
RO Romania	-9.2	-7.0	-6.5	-6.0	-6.0	-6.3	-6.2	-5.7	-4.3	-3.5
SI Slovenia	-1.0	4.5	5.1	4.5	3.8	-3.0	-3.3	-3.5	-2.0	-0.6
SK Slovakia	-7.3	-1.6	-1.3	-0.9	-1.1	-2.0	-6.0	-6.0	-5.0	-4.0
<i>EU-CEE11</i> ¹⁾²⁾	<i>-4.8</i>	<i>-0.4</i>	<i>-0.7</i>	<i>-1.2</i>	<i>-1.1</i>	<i>-3.8</i>	<i>-4.9</i>	<i>-4.6</i>	<i>-4.1</i>	<i>-3.7</i>
<i>EA20</i> ³⁾	<i>1.3</i>	<i>1.8</i>	<i>3.2</i>	<i>3.2</i>	<i>3.1</i>	<i>-3.6</i>	<i>-3.2</i>	<i>-2.6</i>	<i>-2.6</i>	<i>-2.5</i>
<i>EU27</i> ³⁾	<i>1.2</i>	<i>1.8</i>	<i>3.2</i>	<i>3.2</i>	<i>3.1</i>	<i>-3.3</i>	<i>-2.8</i>	<i>-2.2</i>	<i>-2.2</i>	<i>-2.1</i>
AL Albania	-5.9	-0.9	-1.4	-1.3	-1.4	-3.7	-1.4	-1.5	-1.5	-1.0
BA Bosnia and Herzegovina	-4.3	-2.8	-3.6	-3.1	-3.0	-0.4	1.0	-0.5	-0.7	-1.0
ME Montenegro	-12.9	-11.4	-10.7	-10.6	-10.4	-5.1	-5.0	-6.0	-6.0	-6.0
MK North Macedonia	-6.1	0.7	-0.8	-1.9	-2.4	-4.4	-4.9	-4.0	-3.0	-2.5
RS Serbia	-6.9	-2.6	-2.7	-2.9	-2.9	-3.2	-2.2	-2.0	-1.5	-1.0
XK Kosovo	-10.3	-7.6	-8.6	-8.7	-8.5	-0.5	-0.3	-1.0	-1.0	-2.0
<i>WB6</i> ¹⁾²⁾	<i>-6.7</i>	<i>-2.8</i>	<i>-3.2</i>	<i>-3.3</i>	<i>-3.3</i>	<i>-2.8</i>	<i>-1.8</i>	<i>-2.0</i>	<i>-1.7</i>	<i>-1.4</i>
TR Turkey	-5.4	-4.1	-3.1	-2.7	-2.3	-1.1	-5.3	-3.5	-3.0	-3.0
BY Belarus	3.5	-1.4	-2.1	-1.3	-0.9	-1.5	-1.0	-1.5	-1.0	-1.0
KZ Kazakhstan	3.1	-3.3	-2.3	-1.5	-0.5	-2.1	-2.4	-2.3	-2.0	-2.0
MD Moldova	-17.1	-11.9	-9.7	-8.9	-8.1	-3.2	-5.2	-4.0	-3.5	-3.0
RU Russia	10.5	2.5	3.3	3.2	3.0	-1.4	-2.3	-1.7	-1.5	-1.0
UA Ukraine	4.9	-5.2	-4.3	-4.7	-6.4	-16.1	-20.3	-17.0	-15.0	-12.0
<i>CIS4+UA</i> ¹⁾²⁾	<i>9.2</i>	<i>1.2</i>	<i>1.8</i>	<i>1.8</i>	<i>1.7</i>	<i>-2.3</i>	<i>-3.5</i>	<i>-2.9</i>	<i>-2.6</i>	<i>-2.0</i>
<i>V4</i> ¹⁾²⁾	<i>-4.3</i>	<i>0.8</i>	<i>0.3</i>	<i>-0.6</i>	<i>-0.3</i>	<i>-3.8</i>	<i>-5.3</i>	<i>-4.8</i>	<i>-4.4</i>	<i>-4.2</i>
<i>BALT3</i> ¹⁾²⁾	<i>-4.7</i>	<i>-0.7</i>	<i>-0.3</i>	<i>-0.3</i>	<i>-0.8</i>	<i>-1.8</i>	<i>-2.1</i>	<i>-2.9</i>	<i>-3.0</i>	<i>-2.6</i>
<i>SEE9</i> ¹⁾²⁾	<i>-6.7</i>	<i>-4.1</i>	<i>-4.0</i>	<i>-3.8</i>	<i>-3.8</i>	<i>-4.2</i>	<i>-4.1</i>	<i>-4.2</i>	<i>-3.2</i>	<i>-2.7</i>
<i>CIS3+UA</i> ¹⁾²⁾	<i>3.2</i>	<i>-3.9</i>	<i>-3.2</i>	<i>-2.7</i>	<i>-2.7</i>	<i>-6.8</i>	<i>-8.3</i>	<i>-7.1</i>	<i>-6.2</i>	<i>-5.2</i>
<i>non-EU12</i> ¹⁾²⁾	<i>5.1</i>	<i>-0.5</i>	<i>0.1</i>	<i>0.1</i>	<i>0.1</i>	<i>-2.0</i>	<i>-4.0</i>	<i>-3.0</i>	<i>-2.7</i>	<i>-2.3</i>
<i>CESEE23</i> ¹⁾²⁾	<i>1.8</i>	<i>-0.5</i>	<i>-0.2</i>	<i>-0.4</i>	<i>-0.4</i>	<i>-2.6</i>	<i>-4.3</i>	<i>-3.7</i>	<i>-3.2</i>	<i>-2.8</i>

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: 10 April 2024.

Table 2.2 / Real GDP growth forecasts and direction of revisions since wiiw winter forecast 2024

Region	2024	2025	2026
EU-CEE			
BG Bulgaria	2.0 ▲	2.5	3.0
CZ Czechia	1.2 ▼	2.5 ▼	2.7
EE Estonia	0.4 ▲	3.0 ▲	3.6 ▲
HR Croatia	2.9 ▲	2.7	3.0
HU Hungary	1.9 ▼	2.4 ▼	2.9 ▼
LT Lithuania	1.5	2.2 ▲	2.6 ▲
LV Latvia	1.6	2.5 ▲	2.7
PL Poland	3.1 ▲	3.4 ▼	3.3 ▲
RO Romania	3.0	3.3 ▼	3.8 ▲
SI Slovenia	2.5 ▼	2.6 ▲	2.6 ▼
SK Slovakia	1.6	2.2	2.6
Western Balkans			
AL Albania	3.6	3.7	3.4
BA Bosnia and Herzegovina	2.5 ▲	2.9 ▲	3.4 ▲
ME Montenegro	4.2 ▲	3.7 ▲	3.5 ▲
MK North Macedonia	2.2	2.6	3.0
RS Serbia	3.0 ▲	3.3 ▲	3.5 ▲
XK Kosovo	3.5	3.7	3.6
Turkey			
TR Turkey	3.4 ▲	4.0 ▲	4.5 ▲
CIS+UA			
BY Belarus	2.0	2.3 ▼	2.5 ▼
KZ Kazakhstan	4.7 ▲	4.9 ▲	4.9 ▲
MD Moldova	3.5 ▼	3.5 ▲	4.0 ▲
RU Russia	2.8 ▲	2.5 ▲	2.3 ▲
UA Ukraine	3.2 ▲	4.2 ▲	4.6 ▼

Note: Colour scale variation from the minimum (dark grey) to the maximum (dark orange).

Source: wiiw.

Table 2.3 / CPI growth forecasts and direction of revisions since wiiw winter 2024 Forecast Report

Region	2024	2025	2026
EU-CEE			
BG Bulgaria	4.0 ▲	3.0 ▼	3.0 ▼
CZ Czechia	2.0 ▼	2.2	2.2 ▲
EE Estonia	3.5	2.8 ▲	2.4 ▲
HR Croatia	3.5 ▼	2.9 ▼	2.5 ▲
HU Hungary	5.2 ▼	4.0	3.5
LT Lithuania	1.5 ▼	2.3	2.5
LV Latvia	1.4 ▼	2.2 ▼	2.7 ▲
PL Poland	4.5 ▼	3.5 ▼	2.8 ▲
RO Romania	5.8 ▼	4.0	3.5
SI Slovenia	3.3 ▼	2.4 ▼	2.2 ▼
SK Slovakia	2.2 ▼	3.4 ▼	3.4 ▲
Western Balkans			
AL Albania	3.0	2.5	2.4
BA Bosnia and Herzegovina	2.8	2.5	2.0
ME Montenegro	4.5 ▼	3.0	2.5
MK North Macedonia	3.5	3.0	2.5
RS Serbia	4.5	3.5	2.8
XK Kosovo	3.5 ▼	2.5	2.2 ▼
Turkey			
TR Turkey	59.0 ▲	31.0	26.0 ▼
CIS+UA			
BY Belarus	8.0	7.0 ▼	6.0 ▼
KZ Kazakhstan	8.5 ▼	6.5 ▼	6.0
MD Moldova	5.0 ▼	5.0	4.0
RU Russia	7.2 ▲	4.5 ▲	3.7 ▲
UA Ukraine	8.0	6.0 ▼	6.0 ▲

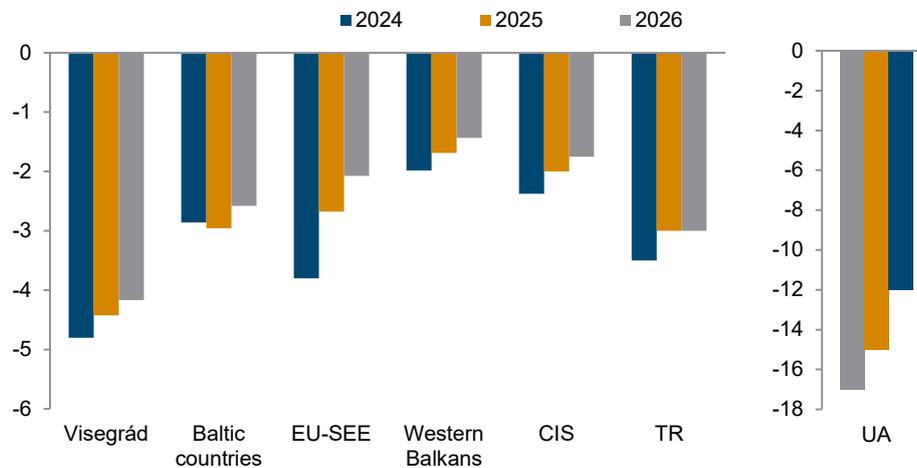
Note: Colour scale variation from the minimum (dark grey) to the maximum (dark orange).

Source: wiiw.

Investment is also expected to recover, but its contribution to economic growth will be too modest to generate the necessary structural changes. On average, investment will play a more important role for economic growth in the Western Balkans than in EU-CEE, even though the latter has access to EU funds. Given that the share in GDP of gross fixed capital formation remains fairly low in most CESEE countries (with the share in Poland as low as 17.5% in 2023), such growth rates will likely be too low to successfully promote the green and digital transition and to ensure the structural changes needed to boost the region's competitiveness.

High fiscal spending, including higher debts costs, will slow the pace of fiscal consolidation in the region (see Figure 2.21). EU-CEE will benefit from EU funds as an additional source of funding; these are expected to pick up in 2025-2026. The Visegrád countries are forecast to have the highest budget deficits in 2024-2026, at more than 4% of GDP on average. Within EU-CEE, the countries of Southeast Europe will reduce their fiscal balances the fastest, to achieve budget deficits of about 2% of GDP in 2026. Romania – which is facing pressure from Brussels to reduce its fiscal deficit – will go through rapid consolidation, with the deficit falling from 6.2% of GDP in 2023 to 3.5% of GDP in 2026. The countries of the Western Balkans (with the exception of Montenegro) will have to consolidate their public finances much faster than the rest of the region, due to the apparent fiscal space constraints: Albania, Bosnia and Herzegovina and Serbia are expected to reduce their fiscal deficits to a mere 1% of GDP in 2026.

Figure 2.21 / Fiscal balance as % of GDP



Note: simple averages for country aggregates.
Source: wiiw forecasts.

2.7. RISKS TO THE OUTLOOK REMAIN MOSTLY ON THE DOWNSIDE

The most significant downside risk to our forecast is related to a possible deterioration in the security situation of the region. Inadequate support from the West could lead to Ukraine losing the war (see Ukraine report). Mr Trump's (re)election as president in 2024 and the EU's inability to expand its defence sector and provide greater military and financial support to Ukraine could have that very outcome. This could result in an increase in the security risks for the whole of Europe, which would dampen consumer and investor confidence. Former Socialist-bloc countries will be particularly at risk of rising geopolitical instability.

The risk of rising energy prices, increased shipping costs and greater supply-chain disruption due to the tensions in the Middle East remains quite high. As the experience of the COVID-19 pandemic showed, many open economies of the region are highly susceptible to disruption to global trade. This could push inflation up again and reverse the course of the incipient economic recovery in the region.

A delayed German (and Austrian) recovery could have significant repercussions for the region. This risk is especially relevant for the Visegrád countries, for which Germany and Austria offer the most important sources of export demand and foreign direct investment.

Harder lending conditions could cause painful structural adjustments in the economy. As the rising bankruptcy rates in several countries indicate, many sectors are still adjusting to the reality of the new monetary regime, and that adjustment may turn out to be quite painful.

2.8. CONCLUSIONS

After a disappointing economic performance in 2023, things are finally looking up for the CESEE region. Economic growth will accelerate in 2024 in most of the countries, on the back of slower inflation and a recovery in real wages. In 2025-2026, economic growth will become more uniform, at about 3% year on year, as the economies of the Visegrád and Baltic countries speed up to grow on a par with other sub-regions. Private consumption will be the main growth driver, while investment growth will be constrained by higher interest rates.

Risks to the forecast are mainly on the downside. The security situation in the region could deteriorate significantly if Ukraine loses the war due to inadequate support on the part of the West. This could result in an increase in the security risks for the whole of Europe, which would dampen consumer and investor confidence in the region. Rising tensions in the Middle East could lead to increased energy prices and supply-chain disruptions, and could cause inflation to increase once again.

3. Austria and CESEE: Regional growth to continue to provide an important stimulus for Austria

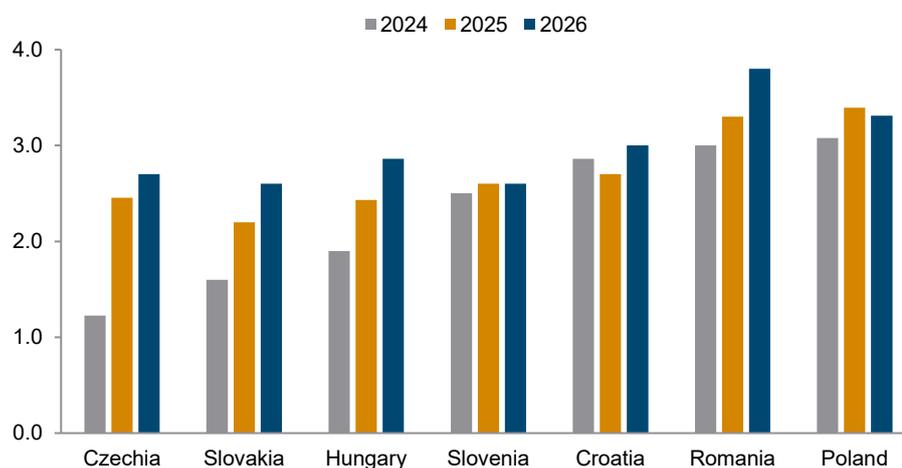
BY DORIS HANZL-WEISS

- › Despite slight downward revisions in our forecasts, growth in CESEE will be higher than in the euro area, providing impetus for the Austrian economy.
- › Austria's goods exports to the region fell by 1.6% in 2023; but exports to the Western Balkans expanded by 7%.
- › Eight countries of the CESEE region featured among Austria's Top 20 export destinations in 2023.
- › Goods imports to Austria from CESEE dropped by 15% last year.
- › Goods imports from Russia have declined due to the falling gas price, causing Russia to drop once again to 11th place among Austria's main import partners.
- › The potential expiration of the gas transit agreement between Gazprom and Ukraine at the end of 2024 presents a challenge for countries along the gas route from Ukraine, through Slovakia to Austria.
- › Different gas diversification strategies have occurred in the region over the years.
- › Neighbouring CESEE countries are again a primary focus for Austrian investors, with Croatia and Hungary the main targets.
- › Austrian companies are largely maintaining their presence and activity in Russia.

Despite some downward forecast revisions, this year Austria's primary trading partners in EU-CEE will provide a positive growth stimulus for the Austrian economy, compared to the euro area. While Germany is its main economic partner, Austria also maintains strong trade and investment ties with the Visegrád nations, Romania, Slovenia and Croatia. Growth forecasts for this year have been revised significantly downward for Czechia and Hungary, whose economies are now expected to grow by 1.2% and 1.9%, respectively (Figure 3.1). Alongside Slovakia (1.6%), growth in those countries will be hampered by the low growth in the euro area, particularly Germany. On a positive note, the forecasts have been adjusted slightly upward for Croatia and Romania: together with Poland, they are expected to grow by 3% this year. Compared to the anticipated growth of 0.6% in the euro area, there will thus be a pronounced growth differential – and thus a notable stimulus originating from the EU-CEE region for the Austrian economy.

The EU-CEE region's growth advantage over the euro area continues to be considerable in 2025 and 2026 (albeit somewhat smaller than in 2024). With an expected acceleration of growth in the euro area in 2025, EU-CEE's prospects will also improve. Although the forecasts for some of Austria's main trading partners in EU-CEE for the years 2025 and 2026 have also been revised slightly downward, the growth differential with the euro area will still amount to 1.1 and 1.4 percentage points (pp). The economies of all Austria's main trading partners in EU-CEE are projected to grow by more than 2%, with Poland and Romania even exceeding 3%. However, leaving aside those two, EU-CEE countries are small, open economies that are heavily reliant on foreign trade. Any disruption to supply chains – such as those occurring on transport routes in the Red Sea – could potentially have repercussions for the region and could pose downside risks to the above forecasts.

Figure 3.1 / Real GDP growth forecasts for Austria's main trading partners in EU-CEE, percentage change compared to last year, ranked by 2024 growth

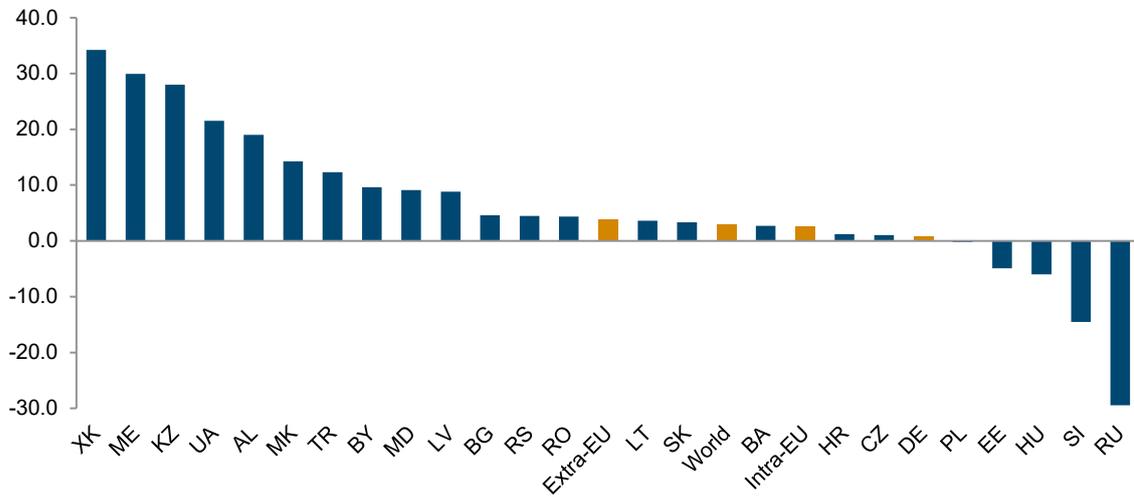


Source: wiiw.

Austrian exports to CESEE fell by 1.6% in 2023, but those to the Western Balkans expanded by 7%. Figure 3.2 illustrates the change in Austrian exports to individual countries within the region: at the upper end, Austrian exports increased by approximately 30% to countries such as Kosovo, Montenegro and Kazakhstan. Additionally, Austrian exports to Ukraine rose by nearly 20%, rebounding from a collapse in 2022 due to Russia's war in Ukraine. At the lower end, exports to Poland, Estonia, Hungary and Slovenia declined. Finally, exports to Russia fell by 29% due to sanctions, including export bans on a wide range of high-tech products, machinery and equipment, and luxury goods, and the withdrawal of some companies from the Russian market. Today, Austria's main exports to Russia are medical and pharmaceutical products, which are not affected by sanctions.

Although some neighbouring countries lost ground, eight CESEE countries figured among Austria's Top 20 export destinations for 2023. In the Top 10 were Poland, Hungary and Czechia (6th, 7th and 9th, respectively): compared to 2022, Poland moved up the rankings, while Hungary slipped down. Slovenia, Slovakia and Romania ranked 12th, 13th and 14th. The strong growth in exports to Turkey (+12%) meant that country moved up three places to occupy 17th spot. Croatia ranked 19th. Russia held 19th place in 2022, but it has now dropped to 26th.

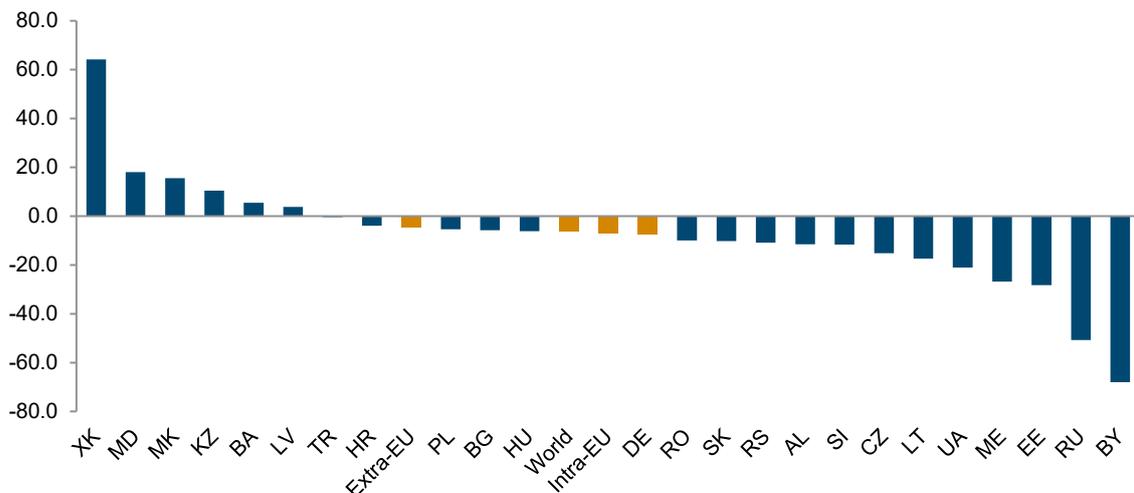
Figure 3.2 / Change in Austrian goods exports to CESEE, in EUR, 2023 compared to 2022 (nominal)



Source: Statistics Austria.

The value of Austrian imports from CESEE fell by 15% in 2023, with imports from all sub-regions recording a decline. Figure 3.3 illustrates the change in Austrian imports from individual countries within the region. Specifically, imports from Russia fell by about 50% and from Belarus by about 70%; imports from EU-CEE dropped by 10%; meanwhile the value of imports from the Western Balkans declined only slightly (-1.3%). Interestingly, imports from six countries increased, particularly those from Kosovo (+60%).

Figure 3.3 / Change in Austrian goods imports from CESEE, in EUR, 2023 compared to 2022 (nominal)



Source: Statistics Austria.

The significant decline in imports from Russia meant that that country fell to 11th place among Austria's main import partners. Overall, of Austria's Top 20 import partners, eight are part of CESEE: Czechia, Poland and Hungary (ranking 5th, 7th and 10th, respectively), as well as Russia, Slovakia, Slovenia, Turkey and Romania (11th, 12th, 14th, 18th and 19th, respectively). The marked decline in energy prices contributed to Russia's fall from 6th place in 2022 to 11th last year. Austria's dependence on Russian gas imports continues to be strong. Although the amount of imported gas decreased, the share of Russian gas is still very high (97% and 87%, respectively, of all imported gas in January and February 2024).³

A potential challenge is looming regarding the termination of gas transit through Ukraine at the end of 2024. Russian gas used to be delivered to Europe via four pipeline corridors: Nord Stream 1, Yamal–Europe (via Poland), Ukraine gas transit and Turkstream. While the first two corridors have been capped, Russian gas still flows to Europe via the latter two routes. In Q1 2024, the volume of EU imports of Russian gas via Ukraine was 3,976 million cubic metres, representing 5.2% of EU gas imports; meanwhile Turkstream gas flows amounted to 3,904 million cubic metres, or 5.3% of EU gas imports.⁴ However, Ukrainian gas transit – which involves gas flowing from Russia, through Ukraine to Slovakia and then Austria – may come to an end, as the transit contract between Ukraine and Russia expires on 31 December 2024. Consequently, the countries involved will need to seek alternative gas supplies. The development is not unexpected, as disputes over the gas transit and gas pricing between Russia and Ukraine have arisen on numerous occasions in the past, and Russia's invasion of Ukraine only served to aggravate the situation.

Various gas diversification strategies have been implemented in the CESEE region over the years. For instance, ever since the 2009 gas crisis Slovakia has invested in its gas transmission infrastructure, enabling reverse gas flows. In addition, in 2015 it launched a Slovak-Hungarian interconnector; this was followed in August 2022 by a Polish-Slovak interconnector. Slovakia also diversified its gas suppliers following the outbreak of Russia's war in Ukraine.⁵ By contrast, Hungary has largely shifted its gas imports from the Ukraine route to Turkstream, receiving gas via Bulgaria and Serbia. Czechia has almost totally decoupled itself from Russian gas: from almost 100% in the first 10 months of 2022 the proportion of Czechia's gas that originated in Russia had fallen to 2% in the first eight months of 2023. This was achieved by stepping up gas imports from Norway, as well as by boosting liquefied natural gas (LNG) imports, with the acquisition of a share in an LNG terminal in the Netherlands.⁶ While the diversification of gas supplies in the event of a halt to Ukrainian gas transit will be inevitable, there are concerns about possible gas price increases as a result, particularly because of the higher transport costs.

Neighbouring EU-CEE countries have once again become a primary focus for Austrian investors, with Croatia and Hungary the main targets. While Turkey was Austria's main investment target in CESEE in 2021 and 2022, there was a noticeable shift towards investing in nearby countries in 2023 (see Figure 3.4). In 2023, the top destinations announced for Austrian investment projects were Croatia

³ <https://energie.gv.at/>

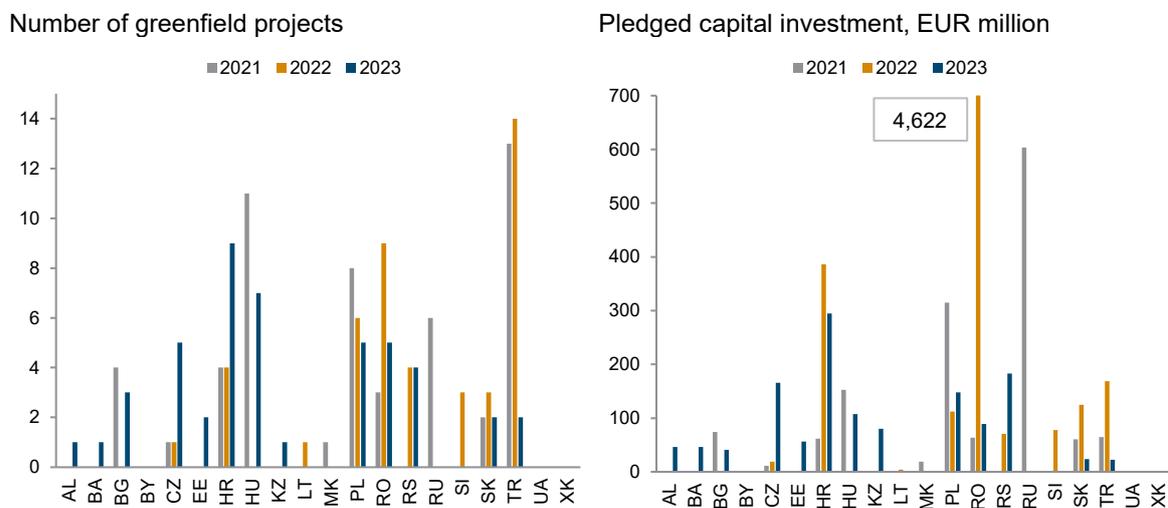
⁴ <https://www.bruegel.org/dataset/european-natural-gas-imports>

⁵ <https://www.euractiv.com/section/politics/news/slovakia-will-survive-winter-even-without-russian-gas-says-economy-minister/>

⁶ https://www.irozhlaz.cz/ekonomika/plyn-rusko-dovoz_2402081822_gut,
<https://www.euractiv.com/section/politics/news/czechia-decreases-russian-gas-dependence-over-eight-months/>

(nine projects), Hungary (seven), Czechia, Poland and Romania (five projects apiece). In terms of capital pledged for investment projects, Croatia led the way with approximately EUR 300m; it was followed by Serbia (EUR 200m), Czechia, Poland and Hungary. The largest investment project was announced in Serbia, where the Austrian company RP Global plans to build a solar park, with a pledged investment of EUR 157m. Last year, the main sectors that attracted Austrian investment were renewable energy (particularly solar power, with five projects), real estate (five projects, mainly in Croatia), industrial equipment (seven projects, especially in Czechia, Hungary and Slovakia) and transportation (10 projects).

Figure 3.4 / Greenfield investment commitments from Austria in selected CESEE countries

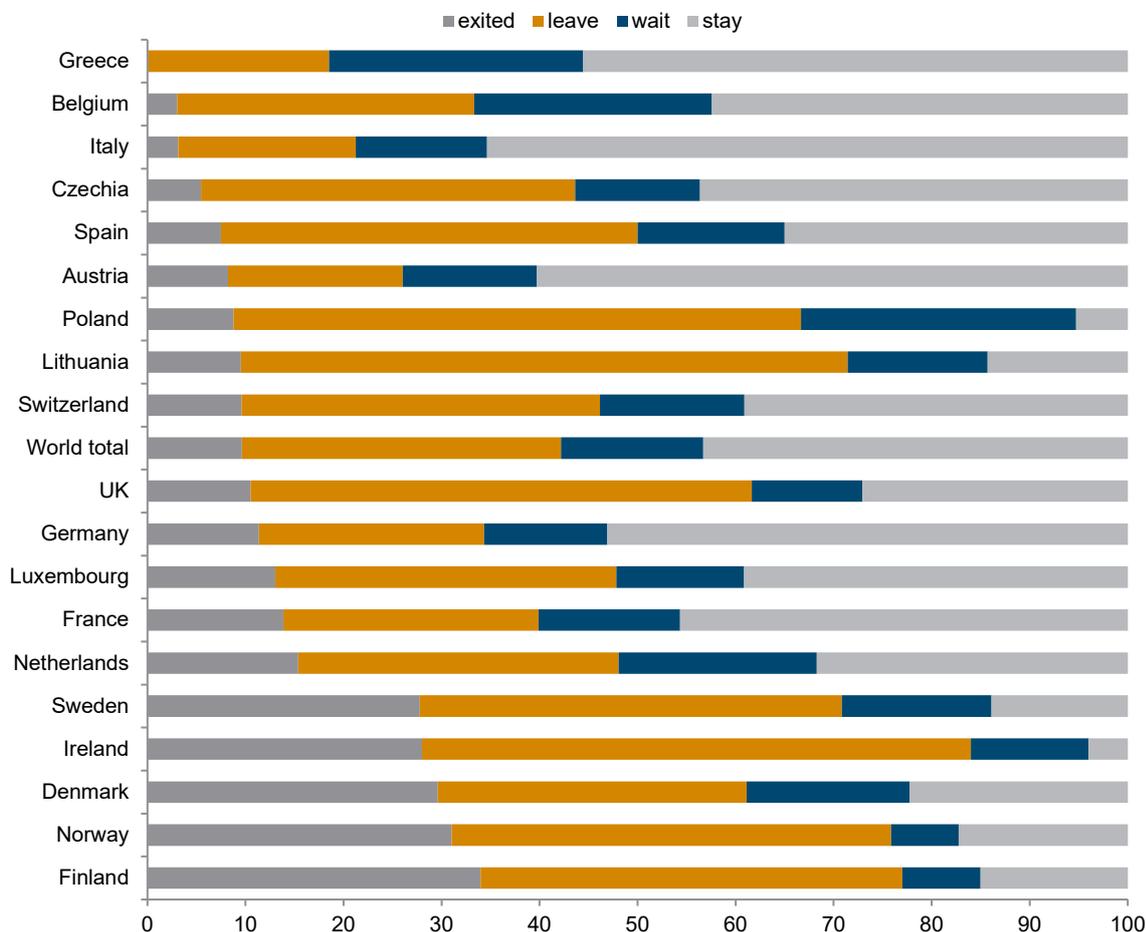


Source: fDi Markets.

Austrian companies are largely maintaining their presence and activity in Russia. Since the outbreak of Russia's war in Ukraine, many foreign companies have either left Russia or announced their intention of doing so. The reasons for this have included concerns about maintaining their public image, sanctions, logistical and payment difficulties, as well as fears of asset nationalisation (see Astrov, 2024). Asset nationalisation, for instance, occurred at the end of 2023, when Austria's OMV had its stake in the Yuzhno-Russkoye gas field seized by the Russian government. Most recently, Wienerberger was reported to be winding up its business in Russia and selling two factories.⁷ However, overall only six Austrian companies have fully exited Russia thus far since the war began, while 13 are in the process of leaving. Taken together, this represents only 26% of all Austrian companies, which is low compared to the world average of 42.2% (Figure 3.5). In some cases, the sale of assets is difficult, complicated as it is by legislative hurdles or unfavourable terms – or even outright prohibited (particularly in the financial, fuel and energy sectors; see Astrov, 2024); in other cases, profit considerations persist. It should be noted, however, that many Austrian companies had already left Russia following the annexation of Crimea in 2014.

⁷ <https://industriemagazin.at/news/wienerberger-verlaesst-russland> (published 28 March 2024).

Figure 3.5 / Status of EU firms in Russia as of 18 February 2024, by country of origin, % of total



Note: Country of origin is defined as the country where the company’s headquarters are located. Status ‘stay’ is assigned to companies which are continuing with their Russian operations; ‘wait’ to companies that have reduced their current operations and are holding off on new investment; ‘leave’ to companies that have curtailed their Russian operations; and ‘exited’ to companies that have completed their withdrawal from Russia. Countries are ranged by the combined share of ‘exited’ and ‘leave’.

Source: wiiw calculations based on data from the Kyiv School of Economics, <https://kse.ua/selfsanctions-kse-institute/>

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Astrov, V. (2024), Austria’s economic relations with the EU Eastern Partnership countries and Russia, *BMF Policy Note*, forthcoming.

4. Wavering consensus? The impact of the 2024 bumper election year on Ukraine and European security

BY MARCUS HOW⁸

- › **The Russian invasion of Ukraine continues to be the main driver of political risks in CESEE.**
- › **These risks are currently elevated, due to the elections to the European Parliament, the US presidency and Congress, as well as to the parliaments of states in the region.**
- › **The European elections are likely to result in a rightward tilt at the EU level, fraying the consensus surrounding those European Commission flagship policies that are pertinent to strategic autonomy.**
- › **The ‘Mitteleuropean’ axis of populist illiberalism may begin to consolidate, with the Austrian elections being of particular importance. This would complicate EU efforts to agree new aid for Ukraine – efforts that are especially significant given the political instability in the US.**
- › **If Donald Trump is elected president in November, the US commitment not only to Ukraine but also to NATO will very likely end, increasing the security risks. The EU and European NATO members would be able to compensate for some (but not all) of the US commitments – if it can muster the political will.**
- › **However, this political will may diminish, given the influence of the aforementioned internal and external factors.**

The year 2024 is a bellwether one for the political outlook of Central, East and Southeast Europe (CESEE) over the coming two years and beyond. This is due to the plethora of elections that are taking place inside and outside the region, the geopolitical stability of which is more volatile than at any time since 1991.

Currently, regional risks are primarily informed by the ongoing Russian war in Ukraine, the fallout from which is having an impact on security, energy supply and economic stability. This spills over into EU policy areas, as well as local politics, with illiberal and populist forces exhibiting ambivalence towards – if not sympathy for – the Russian government.

Meanwhile, the war has descended into stalemate, albeit one in which Ukraine is losing momentum, due to ammunition shortages (a result of political instability in the US) and chronic manpower issues. Russia has leveraged its widening material advantage to increase its attrition of Ukrainian capabilities, thereby managing incremental (if costly) advances in the Donbas region. These dynamics will be directly influenced by political developments in CESEE, the EU and the US over the two-year outlook.

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4.1. OVERVIEW OF THE ELECTORAL CALENDAR

In June, elections will be held to the European Parliament, the results of which will influence the composition and priorities of the next European Commission. Of even greater significance will be the US presidential and congressional elections scheduled for November.

Within CESEE itself, national elections are also taking place this year. In March, presidential elections were held in the Russian Federation, which Vladimir Putin (unsurprisingly) won after ensuring no meaningful opposition. Ukraine was scheduled to hold presidential and parliamentary elections that same month, but these have been postponed indefinitely.

Elsewhere, there will be presidential elections in Lithuania, Moldova and Slovakia; parliamentary elections in Austria, Bulgaria, Croatia, Georgia and North Macedonia; local elections in Hungary, Poland, Serbia and Turkey; and a cocktail of all three in Romania.

While few of these national elections are likely to be of any direct consequence, they will prove formative over the two-year outlook, both domestically and regionally.

4.2. EUROPEAN ELECTIONS

On 6-9 June, the European Parliament will hold elections for its 720 seats. While the European Parliament lacks the power of legislative initiative, it nonetheless commands very considerable influence in shaping the policy agenda of the EU. Since 2019, its core majority has been concentrated in a 'super grand coalition' of the centre-right European People's Party (EPP), the centre-left Socialists & Democrats (S&D) and the liberal Renew Europe (RE).

Average polling indicates that the coalition will retain its nominal majority, but its effectiveness will be compromised by the sharp losses expected to be suffered by parties associated with RE. Meanwhile, parties associated with the far-right Identity and Democracy (ID) and right-wing European Conservatives and Reformists (ECR) groups are forecast to post significant gains, exploiting public disaffection over the high inflation since 2021 and immigration to potentially win third and fourth place, respectively. This will hardly be a landslide, but it will represent a marked rightward tilt.

Although there is a core majority in the European Parliament, its groups may vote freely on policy issues. Thus, a strong showing by the ID and ECR would be significant, since that may facilitate the formation of shifting conservative majorities with the EPP – although these would be far from cohesive. Conversely, the progressive groupings of S&D and RE, as well as the Greens and the Left, are projected to lose out. The composition of the groups will only be finalised after the election, when they negotiate their reconstitution – but the indications are that the Parliament will not be as strongly integrationist as it has been historically.

The president of the European Commission, Ursula von der Leyen (EPP), is likely to be appointed for a second term with the support of the European Council of member states' governments – as well as of the Parliament. The flagship policies of von der Leyen's cabinet include financial and military support for Ukraine; enlargement of the EU to include Ukraine, Moldova, Georgia and the Western Balkan states; addressing deficiencies in the rule of law; and a European Green Deal that seeks to improve energy

independence, while attaining carbon neutrality by 2050. The sum of these policies is to strengthen the cohesion and security of the EU – and with that, its ‘strategic autonomy’.

The ability of the Commission to continue implementing that agenda is likely to be hampered by the composition of the next European Parliament. This will not necessarily entail any policy U-turns, but rather a weakening of existing consensuses, as Eurosceptic and nationalist perspectives become more commonplace. The Green Deal is a likely target, as right-wing groups lobby for greater permissiveness on the issue of phasing out fossil fuels. Most of the legislation underpinning the Green Deal has been adopted under the Fit for 55 package, but future initiatives may struggle. For example, the Commission’s REPowerEU proposal to end reliance on Russian fossil fuels by 2030 still requires additional financing for it to be viable.

The consensus in the Parliament surrounding support for Ukraine is unlikely to change based on its composition alone, as ID is the only group whose members are broadly sceptical of assistance to Ukraine. Nonetheless, there are indications that political changes at the member state level will increase the uncertainty surrounding this consensus.

4.3. NATIONAL ELECTIONS

The success of Eurosceptic and populist parties in national elections will be of particular significance for EU policy areas in which unanimity is required. The most important of these are the Common Foreign and Security Policy (CFSP), EU finances and EU membership. In 2023, the Hungarian government led by Prime Minister Viktor Orbán demonstrated just how disruptive vetoes in this area can be, as decisions concerning the long-term aid committed to Ukraine and its future EU membership were continually delayed.

Orbán was largely isolated in his opposition at the time. However, there is some tentative change ahead, with the formation of a potential axis of allies. After parliamentary elections in Slovakia in October 2023, the Smer party of Robert Fico was able to form a left-right coalition that is opposed to military aid for Ukraine and sceptical of EU sanctions on Russia. In April 2024, its position was confirmed when Fico’s coalition partner and erstwhile protégé, Peter Pellegrini, won the election for the (largely ceremonial) presidency by portraying his opponent, former Foreign Minister Ivan Korčok, as being ‘pro-war’.

The negotiations over EU membership and aid for Ukraine revealed that the Fico government was posturing for the benefit of his domestic audience, as it quickly backed down on the issue. However, future incidents may be more disruptive if the Eurosceptic axis gains a critical mass of like-minded governments. Last November, the far-right Party for Freedom (PVV) of Geert Wilders came first in the Dutch parliamentary elections and is currently attempting to form a coalition, albeit with considerable difficulty.

Another pivotal election will be the one due to be held in Austria in September. Although not formally part of CESEE, Austria has a strategic presence in the region and is closely bound up with it. The far-right Freedom Party (FPÖ) of Herbert Kickl has led the polls for nearly 18 months, during which time the party has garnered up to 30% of the vote. Among other issues, it advocates positions that complement those of the Russian government: these include opposition to EU sanctions on Russia and to EU

investment in defence projects; support for peace negotiations in Ukraine; and the maximisation of gas usage as part of the green transition. It is a natural ally of the Orbán and Fico governments, with which it is likely to form a Central European illiberal axis.

If the FPÖ does win the election, it will attempt to negotiate a coalition government. Its only viable partner is the centre-right People's Party (ÖVP), which leads the current government. The ÖVP has officially pledged not to collaborate with the FPÖ under its current leadership and, under pressure from President Alexander Van der Bellen, may opt for a grand coalition with the Social Democrats (SPÖ) instead. Nonetheless, it is more likely that the ÖVP will abandon its pledge of non-collaboration and instead attempt to extract concessions from the FPÖ on policies regarding the EU, Ukraine and security.

Nevertheless, the FPÖ is more hardline than it has ever been, lacking the pragmatism that belies the performative rhetoric of the Orbán and Fico governments. This is highly likely to complicate policymaking in the European Council, especially when unanimity is required.

Other elections in the region have lower stakes from this perspective. Continuity may be expected in Romania and Croatia, with the incumbent governments remaining in office in one form or another. Meanwhile, Bulgaria – which is experiencing its sixth snap parliamentary election since 2021 – is likely to remain politically deadlocked.

Even if there is increased political instability at the EU level, this will have no impact on the military and financial aid that the EU has already agreed for Ukraine: namely, the tens of billions of euros earmarked for 2024-2027. However, it is likely to complicate negotiations over new aid, as well as over sanctions. If an illiberal axis does decide to place an embargo on new aid, it is likely that the EU will coordinate member states to provide fresh aid through intergovernmental mechanisms. This was done in 2012, when the UK vetoed the EU's fiscal compact, and was mooted in January 2024, when Hungary was blocking long-term aid to Ukraine.

4.4. US ELECTIONS

In November, the US will hold elections for the presidency, as well as for all the seats in the House of Representatives and a third of those in the Senate. The Democrat incumbent, Joe Biden, will (almost certainly) run for a second term against his Republican predecessor, Donald Trump. Currently, the polls indicate that Biden and Trump have an equal chance of victory. The outcome of the contest may have profound consequences not only for Ukraine, but also for European security more generally.

The commitment of the Biden administration to Ukraine has been crucial in maintaining that country's war effort. Since 2022, the US has provided approximately 26% of overall aid.⁹ And that share rises to 38% in the domain of military aid. The US has also been of critical importance in coordinating support packages from its NATO allies, as well as in assisting the Ukrainian security forces with intelligence.

Furthermore, the Biden administration has reinvigorated the US commitment to NATO, which Trump had questioned, citing the failure of European member states to meet defence spending targets. Besides

⁹ <https://www.ifw-kiel.de/topics/war-against-ukraine/ukraine-support-tracker/>

leading on support for Ukraine, the Biden administration has increased armed force deployments to Europe by 40,000, raising the overall number of troops to 100,000.

If Trump is elected president, these policies will be in jeopardy. This is already being felt, with congressional Republicans blocking over six months attempts by the Biden administration to lock in USD 60bn in military aid for Ukraine for 2024-2025. This is even as Ukraine's stocks of air defence missiles and artillery rounds are depleted.

Meanwhile, Trump has pledged to end the war quickly, implying that his administration would force a peace settlement by simply ceasing its support for Ukraine. He has stated that his administration would regard Ukraine's surrender of Crimea and Donbas to Russia as the basis for such an agreement. He has also continued to criticise NATO, suggesting that his administration would tolerate the Russian invasion of member states that do not meet their defence spending targets.

On the one hand, these claims probably do contain some rhetorical exaggeration. In April, Congress finally approved the aid package, a portion of which was redesignated as loans – a proposal that had been made by Trump. Meanwhile, within CESEE, those NATO member states that are failing to meet their spending targets include Albania, Bulgaria, Croatia, Czechia, Montenegro, North Macedonia and Slovenia – none of which is immediately exposed to the threat of invasion.¹⁰ Concerning NATO, the US presidency is not in a position to withdraw unilaterally, as that would require congressional backing.

Yet on the other hand, Trump does harbour genuine antipathy towards Europe in general and NATO in particular. It would be possible for a Trump administration to render US participation in NATO obsolete. For example, Article 5 of the North Atlantic Treaty – which obliges NATO members to aid each other in the event of an attack – may only be invoked collectively; and it anyhow leaves members broad discretion as to the form of assistance they render. Elsewhere, a Trump administration may decide to withdraw US forces from NATO missions, such as in Kosovo, leaving the European partners to provide the necessary security alone.

Outside of security, a Trump administration is also likely to harden its protectionist trade policy towards the EU. Potential measures include extending a broad 10% tariff to the EU (and China), as well as invoking Section 301 of the US Trade Act to respond unilaterally to conduct that it perceives to be undermining US interests.

At the very least, a second Trump administration would reassert a transactional approach to US foreign relations. It is also likely to be more cohesive than the first, unconstrained by Republican Atlanticists and boosted by a more disciplined team.

If the Biden administration is re-elected, continuity may be expected. However, there is a high chance that the Democrats will not win control of both chambers of Congress (or if they do, then by only narrow margins). Thus, if the MAGA faction continues to dominate the Republican party, it is likely that a Biden administration would struggle to get fresh aid for Ukraine through Congress – as the most recent package illustrated.

¹⁰ <https://www.visualcapitalist.com/which-countries-meet-natos-spending-target/>

Both scenarios indicate that the pressure on Europe to develop 'strategic autonomy' is increasing. There are clear continuities between US presidential administrations. Privately, the Biden administration believes that Crimea and Donbas are likely to be bargaining chips in any peace agreement in Ukraine. In the Western Balkans, it has maintained a transactional approach, engaging closely with illiberal governments such as that of Serbia – even as it imposes sanctions on certain politicians and businesspeople throughout the region.

And while the Trump administration was especially aggressive in its trade policy, the Biden administration has broadly adhered to that protectionism. Mass subsidies extended to the renewables sector under the Inflation Reduction Act prompted the European Commission to activate screening mechanisms over competition concerns.

Whatever its complexion, the future US administration will have other strategic priorities elsewhere that are likely to divert considerable resources: not just China and Taiwan, but also the Middle East, which emerged as a wildcard in 2023. The massacre perpetrated by the Hamas terrorist group outside Gaza in October has been highly destabilising, with Israel engaging in direct confrontations with Hamas's ally Iran in April that may be a precursor to wider war in the region. Thus, the US commitment to the security of CESEE is likely to wane over the two-year outlook, regardless of who wins the election.

4.5. BRAVE NEW WORLD

The coming elections herald significant uncertainty for Ukraine and for European security over the two-year outlook. Regardless of whether Biden or Trump is elected, the EU will come under pressure to greatly expand its financial and material support to Ukraine. Landmark measures have already been taken in this regard, and these are building momentum around defence integration.

The mandate of the European Peace Facility (EPF), initially established in 2021 to finance EU peacekeeping missions, has been extended to include the provision of weapons to third countries – namely, Ukraine. Currently, EUR 11.1bn in funds have been earmarked for the EPF, over and above the EUR 22bn in military aid provided bilaterally by EU member states.¹¹ Furthermore, the Act in Support of Ammunition Production (ASAP) is pooling EUR 1.1bn to stimulate the purchase and production of military items, including 155mm artillery shells and devices to intercept hypersonic weapons. Elsewhere, French President Emmanuel Macron has mooted the deployment of French troops to Ukraine to assist with training – in part to underline that country's strategic importance to European security.

Although significant, the volume of this support remains comparatively modest: while the ASAP foresees the annual production of between 1.3 and 1.7 million rounds of artillery ammunition, North Korea provided the Russian armed forces with between 1 and 3 million 152mm rounds in just a matter of months.¹² And given the increasing unpredictability of US supplies, it will be necessary for the EU and its member states to make up as much of the shortfall as possible.

¹¹ <https://www.consilium.europa.eu/en/infographics/eu-solidarity-ukraine/>

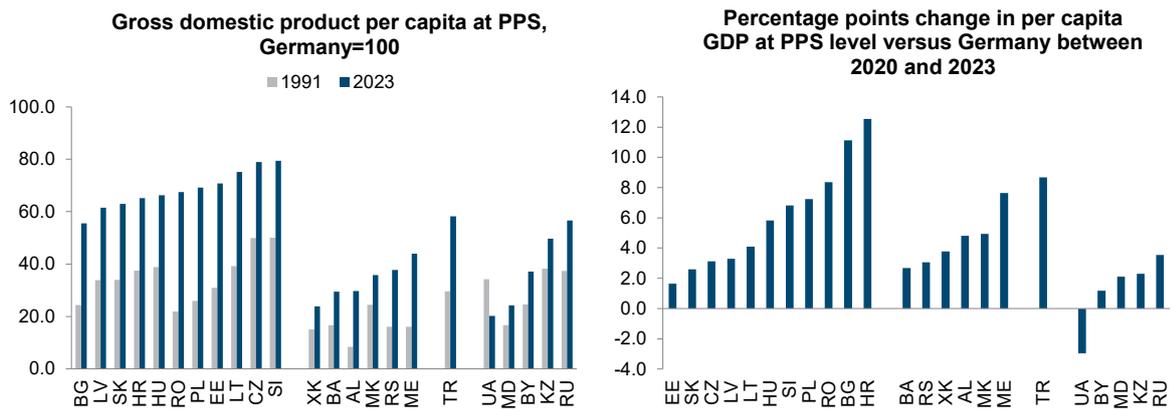
¹² <https://asia.nikkei.com/Politics/Ukraine-war/North-Korea-sent-more-than-3m-artillery-shells-to-Russia-says-Seoul>

The military aid package approved by the US Congress will provide cushioning in the 12-month outlook. Yet if fresh aid cannot be passed beyond 2025, the defence capabilities of Ukraine will be compromised. While the EU could make up some of the shortfall, the US provides Ukraine with advanced weaponry and technology that European states neither possess nor have the capability to produce. The likelihood of Russia expanding its military advantage would thus increase, along with the pressure on Ukraine to agree a peace settlement that would likely involve major territorial concessions.

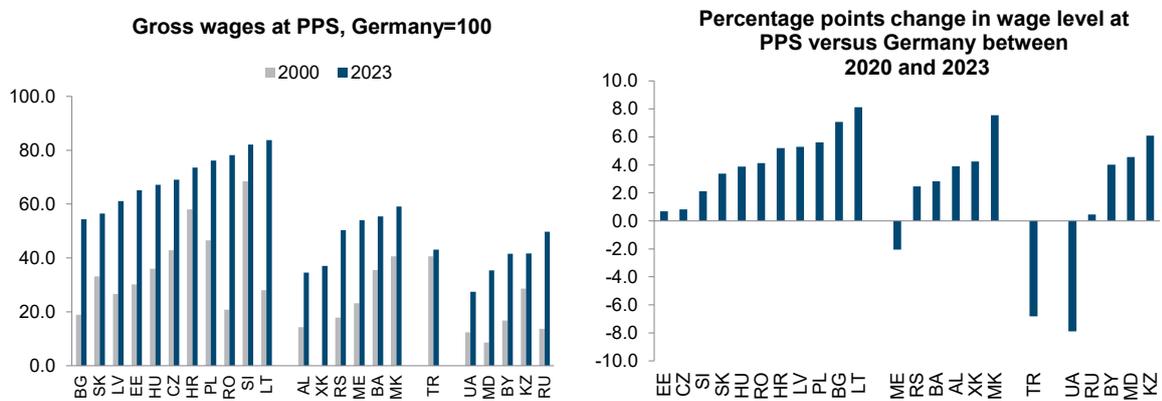
Uncertainty surrounding the European consensus on Ukraine is thus likely to increase. The consensus is unlikely to disintegrate or otherwise change fundamentally, but external and internal factors may weaken it at a time when decisiveness is critical. That will have implications for European security – not least in CESEE, where that security has provided the foundation for economic development since 1989.

5. Convergence monitor

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.

Table 5.1 / CESEE GDP per capita and gross wages per employee at PPS (EU27), 2023

	BG	CZ	EE	HR	HU	LT	LV	PL	RO	SI	SK	EU- CEE
GDP per capita	24,060	34,190	30,670	28,200	28,720	32,560	26,640	29,980	29,220	34,380	27,290	30,030
Gross wages	20,371	25,916	24,437	27,591	25,177	31,396	22,915	28,573	29,325	30,798	21,197	27,044

	AL	BA	BY	KZ	MD	ME	MK	RS	RU	TR	UA	XK	non- EU
GDP per capita	12,880	12,780	16,090	21,530	10,510	19,020	15,510	16,330	24,550	25,200	8,760	10,310	21,810
Gross wages	12,942	20,806	15,597	15,641	13,279	20,233	22,148	18,877	18,666	16,166	10,293	13,874	16,936

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, 2023

	BG	CZ	EE	HR	HU	LT	LV	PL	RO	SI	SK	EU- CEE
GDP per capita	14,580	28,580	27,590	19,430	20,480	25,070	21,440	19,840	16,960	29,750	22,090	20,800
Gross wages	12,347	21,667	21,984	19,008	17,950	24,168	18,444	18,905	17,020	26,651	17,160	18,651

	AL	BA	BY	KZ	MD	ME	MK	RS	RU	TR	UA	XK	non- EU
GDP per capita	7,740	7,340	7,250	12,150	5,930	11,130	7,490	10,500	12,770	11,950	4,500	5,440	11,100
Gross wages	7,779	11,946	7,028	8,823	7,489	11,844	10,705	12,138	9,709	7,668	5,291	7,320	8,713

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

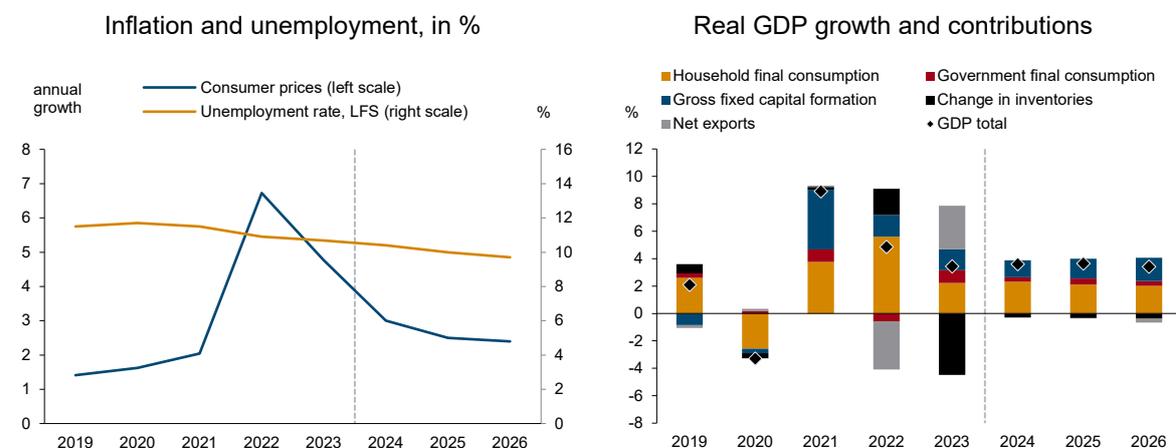


ALBANIA: Tourism to continue as the star of the economy

ISILDA MARA

The economy expanded by 3.4% in 2023, driven by increased domestic and external demand. Public finances remain robust, and efforts toward fiscal consolidation will continue. However, imbalances on the labour market are intensifying, posing a risk to growth as emigration rates surge and as labour and skills shortages loom. While inflation is expected to moderate, seasonal challenges persist. The current account deficit has nearly bottomed out and will likely remain low due to sustained external demand. Positive trends in tourism and foreign direct investment are set to continue to fuel the momentum, which is expected to result in growth of 3.5% in the medium term.

Figure 6.1 / Albania: Main macroeconomic indicators



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

In 2023, the economy expanded by 3.4%, driven by robust domestic and external demand. Key contributors to this were government and household consumption, which rose by 9% and 3%, respectively. Public investment remained high and gross fixed capital formation rose by 6.4%. Exports of services soared, and tourism in particular proved a bright star in the firmament: its growing role in the economy will remain vital in 2024. Despite a 5% contraction in goods exports, they still stood at double their pre-pandemic level. Imports continued to expand, albeit more slowly. Overall, the net effect of trade on growth was noteworthy. Real estate activity and construction continued to experience strong growth, increasing by 11% and 9%, respectively. Information and communication activities and public administration also enjoyed a positive year, growing by 8% and 6%, respectively. However, other sectors such as agriculture and manufacturing – so crucial to the economy and employment – receded by 1% apiece.

Both core and headline inflation have been falling, but a reversal is anticipated during 2024. In 2023, average consumer price inflation dropped to 4.8% – one of the lowest rates in the Western Balkans. Headline inflation was primarily influenced by food prices, which grew by around 9.5%. This year so far, disinflation seems to have continued, and the gap between core and headline inflation is now significantly narrower than in 2023. During January and February 2024, headline inflation stood at 2.6%, below the 3% target set by the central bank. However, we anticipate rising seasonal inflationary pressures as the year progresses, on account of the expected boom in tourism. In addition, wage hikes in both the public and the private sector may contribute to inflationary pressures, preventing inflation from dipping below 3% in 2024.

Public finances are improving, and further fiscal consolidation is expected. In 2023, public finances exhibited a significant improvement, and the trends during Q1 2024 appear promising. Last year, government revenue surged by 12% to reach 27.9% of GDP; this was partly a result of inflation but was mainly due to the increased collection of profit tax, personal income tax and social security contributions – a positive benefit of formalised working arrangements and rising wages. However, the sluggish growth in VAT collection (a rise of a mere 0.5%) suggests that informality and tax evasion continue to pose challenges. Government spending likewise increased: it accounted for 29.3% of GDP and resulted in a budget deficit of 1.4% at the close of 2023. Notably, the government allocated a larger share of the purse to public investments, which grew by an impressive 42% and absorbed 18% of total spending. This prudent fiscal stance helped rein in the public debt, which declined to nearly 60% of GDP. We forecast that the solid growth in revenue (thanks to robust GDP growth) will play a crucial role in furthering fiscal consolidation; public debt is expected to fall to 55% of GDP by 2026.

The banking sector remains solid and well capitalised. In March 2024, the central bank announced that the policy interest rate would remain unchanged at 3.25%, signalling a less restrictive monetary policy for the coming months. Meanwhile, the increased demand for credit continues. Notably, non-performing loans declined further – to 4.9% in 2023, down from 5.1% in 2022. Confidence – both consumer and business – has improved since the beginning of the year, with the exception of one sector: construction. The signals coming from tourism are especially encouraging, and optimism is high for this year.

Despite good growth momentum, labour market weaknesses persist. In 2023, the unemployment rate closed at 10.7%, just 0.1 percentage points (pp) lower than in 2022; meanwhile, the employment rate rose by 0.8 pp to reach 57.1%. Unfortunately, the fall in unemployment and the rise in employment do not translate into better job opportunities, especially for young people. The growth drivers stem primarily from sectors that are susceptible to high seasonal fluctuation, such as services (e.g. tourism), construction and agriculture. As such, any impact on employment is temporary. The labour market prospects facing young people remain bleak: in 2023, the employment rate in the age group 15-29 declined by 1.5 pp, falling from 44.6% in Q4 2022 to 43.1% in Q4 2023. At the same time, this age group also registered a fall in inactivity, in unemployment – and indeed in overall presence within the labour force. All this goes to show that the country is continuing to lose its most vital segment of the population because of emigration.

The spectre of soaring emigration, coupled with the labour and skills shortages, casts a pall over the economy. In response, the government has embarked on reforms related to public-sector wages: in 2023, these increased by 14% in nominal and 8.8% in real terms. This year, the average nominal wage

in the public sector is set to surge to EUR 900 (a 14% nominal jump) from June 2024, which is expected to bolster consumption significantly. After all, the public sector serves as a vital source of employment for approximately a quarter of the workforce (excluding the agricultural sector). Meanwhile, the private sector has also responded to the challenges outlined above by raising nominal wages by 13% in 2024. The pressure is such that nominal wages will continue to rise, especially in the tourist industry.

However, there is a flip side to the emigration phenomenon: remittances. In 2023, remittances reached a staggering EUR 1bn (5% of GDP), marking an 11% increase. These inflows are likely to remain elevated, as emigration waves persist. Yet, despite the remittances, consumption may yet suffer as a consequence of the ongoing decline in the population.

The current account deficit came close to 'ground zero', thanks to robust external demand. In 2023, the current account deficit fell to an unprecedented 1% of GDP. This positive outcome was driven by a significant improvement in the trade balance, a surge in service exports and strong inflows of secondary income, particularly remittances. Notably, service exports enjoyed an exceptional year: their volume doubled compared to pre-pandemic levels and they were 38% up on the previous year. Specifically, tourism-related services experienced a remarkable growth of 50%, fuelled by over 10m tourists visiting in 2023. Looking ahead to 2024, the expectation is that service exports will continue to surge, and the number of tourists is projected to top 14m. However, in contrast, goods exports are contracting: there was a 16% decline for January-February 2024, compared to the same period last year. The reasons for this are twofold: (i) the strong appreciation of the domestic currency against the euro (by almost 9% in 2023), and (ii) the global economic slowdown, which has had an impact on merchandise trade not only within the EU, but also among its main trading partners.

Robust foreign direct investment (FDI) inflows are expected to persist. In 2023, FDI grew by 5% year on year, surpassing EUR 1.4bn, which corresponds to 7% of GDP. Several project announcements and ongoing construction projects (including Vlora airport), as well as investments in renewable energy, oil extraction and railways, all indicate that FDI will continue to thrive. Notably, NATO's investments in Albania have also expanded. Just last month, in March, an airbase in the central part of Albania was reopened following modernisation that involved NATO investment totalling EUR 50m. Furthermore, Standard & Poor's has upgraded the country's rating from B+ to BB- with a stable outlook. This positive signal is likely to attract foreign investors.

Solid economic growth will likely continue this year and beyond. While consumption will remain a key driver, it is expected to grow at a more moderate pace. Government spending will remain generous, providing support to the economy. Strong external demand is expected to sustain and accelerate economic growth in the medium term. Both public and private investments are expected to expand, further contributing to growth. Overall, we project that the economy will maintain a growth rate of 3.6% in 2024 and 3.5% in the medium term.

Table 6.1 / Albania: Selected economic indicators

	2020	2021	2022	2023 ¹⁾	2024	2025	2026
					Forecast		
Population, th pers., average	2,838	2,812	2,778	2,745	2,730	2,715	2,700
Gross domestic product, ALL bn, nom.	1,647	1,856	2,138	2,313	2,500	2,700	2,900
annual change in % (real)	-3.3	8.9	4.9	3.4	3.6	3.7	3.4
GDP/capita (EUR at PPP)	9,220	10,260	12,100	12,880	.	.	.
Consumption of households, ALL bn, nom.	1,318	1,411	1,610	1,733	.	.	.
annual change in % (real)	-3.3	4.7	7.4	3.0	3.1	2.8	2.7
Gross fixed capital form., ALL bn, nom.	373	452	511	563	.	.	.
annual change in % (real)	-1.4	19.2	6.5	6.4	5.0	6.0	7.0
Gross industrial production							
annual change in % (real)	-6.3	26.2	2.8	-7.6	3.0	4.5	3.0
Gross agricultural production ²⁾							
annual change in % (real)	1.6	-0.8	0.4	-1.0	.	.	.
Construction output total							
annual change in % (real)	9.6	17.9	12.5	-1.5	.	.	.
Employed persons, LFS, th, average	1,243	1,249	1,298	1,327	1,345	1,365	1,370
annual change in %	-1.8	0.4	4.0	2.2	1.4	1.5	0.4
Unemployed persons, LFS, th, average	165	163	160	159	160	150	150
Unemployment rate, LFS, in %, average	11.7	11.5	10.9	10.7	10.4	10.0	9.7
Reg. unemployment rate, in %, eop ³⁾	7.4	7.3	7.0	6.9	.	.	.
Average monthly gross wages, ALL	53,662	57,191	61,898	70,531	81,400	87,600	92,400
annual change in % (real, gross)	0.8	4.4	1.4	8.8	12.0	5.0	3.0
Consumer prices, % p.a.	1.6	2.0	6.7	4.8	3.0	2.5	2.4
Producer prices in industry, % p.a.	-3.3	2.7	20.0	6.1	1.0	0.5	0.5
General governm. budget, nat. def., % of GDP							
Revenues	25.9	27.5	26.8	27.8	28.5	29.0	29.0
Expenditures	32.6	32.1	30.4	29.2	30.0	30.5	30.0
Deficit (-) / surplus (+)	-6.7	-4.6	-3.7	-1.4	-1.5	-1.5	-1.0
General gov. gross debt, nat. def., % of GDP	74.3	74.5	64.5	59.2	59.0	56.0	55.0
Stock of loans of non-fin. private sector, % p.a.	6.9	9.6	7.0	3.8	.	.	.
Non-performing loans (NPL), in %, eop	8.1	5.7	5.0	4.7	.	.	.
Central bank policy rate, % p.a., eop ⁴⁾	0.50	0.50	2.75	3.25	3.25	3.00	3.00
Current account, EUR m	-1,153	-1,166	-1,063	-191	-330	-350	-390
Current account, % of GDP	-8.7	-7.7	-5.9	-0.9	-1.4	-1.3	-1.4
Exports of goods, BOP, EUR m	794	1,265	1,933	1,836	1,890	1,980	2,070
annual change in %	-12.5	59.4	52.8	-5.0	3.0	5.0	4.5
Imports of goods, BOP, EUR m	3,776	5,094	6,201	6,376	6,580	6,740	6,870
annual change in %	-6.8	34.9	21.7	2.8	3.2	2.5	2.0
Exports of services, BOP, EUR m	2,226	3,486	4,801	6,645	6,910	7,120	7,260
annual change in %	-34.6	56.6	37.7	38.4	4.0	3.0	2.0
Imports of services, BOP, EUR m	1,174	1,690	2,400	3,214	3,350	3,470	3,550
annual change in %	-45.1	43.9	42.0	33.9	4.3	3.5	2.2
FDI liabilities, EUR m	937	1,032	1,372	1,492	.	.	.
FDI assets, EUR m	43	42	182	245	.	.	.
Gross reserves of CB excl. gold, EUR m	3,806	4,831	4,786	5,644	.	.	.
Gross external debt, EUR m	8,549	9,755	9,766	10,147	11,300	12,100	12,700
Gross external debt, % of GDP	64.2	64.4	54.3	47.7	47.0	46.0	45.0
Average exchange rate ALL/EUR	123.77	122.46	118.98	108.80	104.0	103.0	103.0

Note: Introduction of new index 2021=100 (new weights) for construction.

1) Preliminary and wiiw estimates. - 2) Based on UN-FAO data, wiiw estimate in 2023. - 3) wiiw estimate from 2021. - 4) One-week repo rate.

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

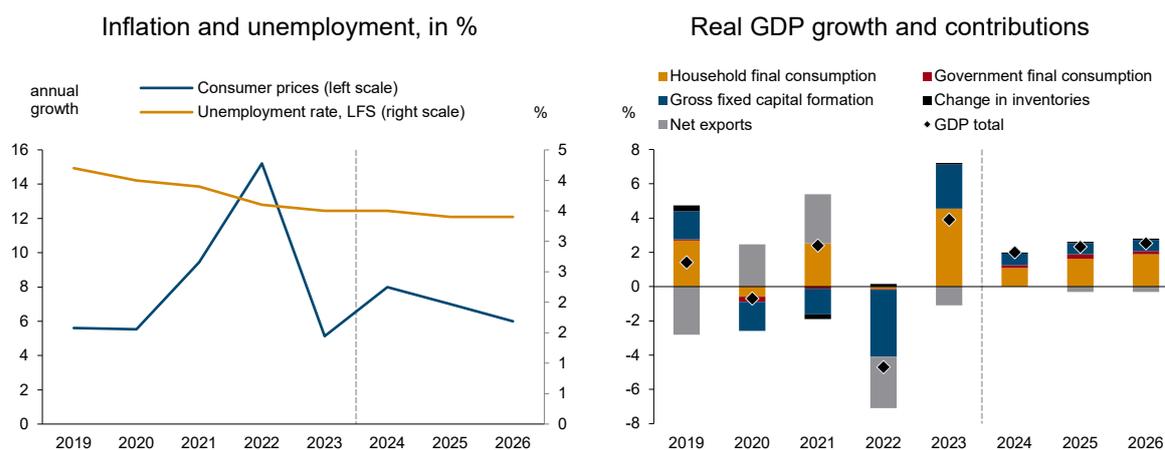


BELARUS: With recovery over, sluggish growth lies ahead

RUMEN DOBRINSKY

In 2023, the economy almost totally recouped the losses incurred the previous year as a result of the Western sanctions. GDP grew by 3.9%, underpinned by a widening of Russia's economic support and accommodative domestic policies. Inflation slowed considerably. However, the indications are that this recovery has come to an end – and the short-term prospects are not propitious. GDP growth is expected to slow to some 2% in 2024 and is likely to remain sluggish in the years to come.

Figure 6.2 / Belarus: Main macroeconomic indicators



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

Last year saw a strong recovery in the Belarusian economy. GDP grew by 3.9%, overshooting even the official growth target of 3.8%. Meanwhile, industrial production surged by 7.7% in annual terms and there was a notable recovery in construction. Exports likewise grew robustly, as Belarus managed to find new markets for a significant share of the exports it had previously shipped to Western countries. Thanks to the strong recovery, the economy almost totally recouped the losses incurred the previous year as a result of the Western sanctions.

The recovery was driven by an upturn in domestic demand. Both private consumption and gross fixed capital formation surged, providing positive contributions to GDP growth. By contrast, net exports contributed negatively, as real imports outstripped exports by a large margin.

This turnaround was underpinned by accommodative domestic policies. The government maintained an interventionist policy stance, providing broad support to both supply and demand. Directed credit by state-owned banks to state-owned firms (an instrument supporting the government's

industrial policy) increased in both size and scope, focusing particularly on supporting the process of export reorientation. The Belarusian Development Bank, which is another arm of the government, also increased its credit exposure (mostly consisting of export and investment support to small and medium-sized businesses) by 23%.

The support from Russia was another key factor behind the recovery of Belarus's industry. One of the important avenues for such support was the facilitation of the re-routing of merchandise through Russian ports after the EU closed its borders to much of Belarus's exports. Rail freight through Russia increased 2.3 times in 2023 compared to the previous year. Thanks to the new export routes, Belarus's oil-processing output recovered almost entirely to its pre-war level. Russia also further reduced the selling price of Russian oil to Belarus: it is estimated that in 2023 alone Belarus benefited from an implicit subsidy of USD 1.9bn thanks to the oil price discount.

The recovery, however, was patchy The downturn in transportation and especially in information and communication technology (ICT) continued for the second year in a row. While some agricultural subsectors fared well, the output of cereals dropped by 9.3% compared to the previous year, due to a bad harvest.

The government preserved many of the price controls introduced back in 2022. The accumulated inertia of this move contributed to notable disinflation: average annual consumer price inflation (CPI) in 2023 was 5.1% – down from 15.2% the previous year. Producer prices followed a similar dynamics. Policy intervention also sought to boost incomes by raising pensions and wages in the public sector. Thanks to the combined effect of these policies, real wages in 2023 surged by almost 11.0%, while real disposable incomes rose by 6.3%. In turn, rising real incomes boosted personal consumption.

The policy stance of the central bank was somewhat ambiguous, as it kept its intervention rate almost unchanged in 2023, at around 10%. Against the background of rapidly falling inflation, this meant that real interest rates gradually changed from negative to positive in the course of the year. However – and somewhat counterintuitively – credit activity was on the rise in 2023, mostly affected by improved business confidence. The central bank's policy stance in this period had little effect on consumer price dynamics either, as the latter was mostly influenced by the administrative price controls.

The geographical composition of Belarus's foreign trade continued its transformation. The exact parameters of this change are not publicly available, since the authorities have imposed an embargo on a significant portion of statistical data, including the composition of trade. However, according to anecdotal evidence, Russia has further expanded its dominant share of Belarus's trade, while China is now firmly ensconced in second position. In particular, Belarus doubled its exports of potash fertilisers to China and significantly increased the export of foodstuffs. In turn, China is gradually becoming Belarus's main supplier of technological equipment.

The make-up of the Belarusian forex market also altered radically after 2022, reflecting the changing composition of foreign trade. Given the restraining effect of the Western sanctions, the share of the US dollar and the euro has been shrinking, while that of the renminbi has been expanding. According to statements by the National Bank of the Republic of Belarus, at the end of 2023 the renminbi accounted for about 10% of all foreign trade transactions – approximately the same as the share of the US

dollar. At the beginning of 2024, transactions on the Belarusian currency exchange were dominated by the Russian rouble (accounting for some 50% of transactions) and the renminbi (some 30%).

There are many indications, however, that the period of benign recovery in Belarus has come to an end. Recent short-term indicators suggest that as from around mid-2023, the growth in industrial output started to slow and that this has continued in the first months of 2024. At present, many Belarusian manufacturers are operating at almost full capacity and are facing supply constraints. In the first place, this concerns labour: given the recent mass exodus of the working-age population, the economy is facing severe labour shortages in many occupation categories. At the same time, a number of production facilities are obsolete, but firms face problems in upgrading them due to the Western sanctions.

The real effective exchange rate depreciated in the first half of 2023, but subsequently this trend was reversed. Of late, the local currency has been appreciating vis-à-vis the Russian rouble at par with the upturn in demand for that currency, and this development has also dominated the dynamics of the real effective exchange rate. At the same time, after declining in the first half of 2023, unit labour costs started to rise thereafter, reflecting the slowdown in output and the continued rise in wages. Overall, these trends point to deteriorating international competitiveness, which is likely to act as a deterrent to the further expansion of exports.

The reliance on domestic demand-driven growth has led to a considerable worsening of the current account balance. If the real exchange rate appreciation continues, it could lead to a further aggravation of the situation with the external balances. At the same time, the possible economic slowdown in Russia could suggest a diminishing external impetus to the Belarusian economy in the short run.

The effect of price controls seems to have run its course. Inflation started gathering pace in the final months of 2023, and this trend has continued in the first months of 2024. The central bank has already signalled that its policy focus in 2024 may shift towards curbing the inflationary pressures. In January, it raised the reserve requirements in an attempt to rein in credit growth. The government, however, has indicated that it intends to continue fiscal support for the economy.

Overall, although the domestic policy stance is expected to remain largely accommodative in the short run, its effect is likely to weaken. With a diminishing external lift, GDP growth will continue to be mostly driven by domestic demand, and is expected to slow to some 2% in 2024. Inflation will rise again and the average annual rate of CPI is likely to be around 8% in 2024.

At present there is no indication that an about-turn towards robust growth is on the cards in the coming years. At the same time, the process of further adjustment to the new geopolitical reality is likely to continue. Belarus may expand its presence in new markets, so exports could also provide some impetus to growth. We expect, therefore, a possible slight strengthening of growth in 2025 and 2026.

Table 6.2 / Belarus: Selected economic indicators

	2020	2021	2022	2023 ¹⁾	2024	2025	2026
					Forecast		
Population, th pers., average	9,380	9,303	9,228	9,178	9,150	9,120	9,100
Gross domestic product, BYN m, nom.	149,721	176,879	193,741	216,100	238,100	260,700	283,300
annual change in % (real)	-0.7	2.4	-4.7	3.9	2.0	2.3	2.5
GDP/capita (EUR at PPP)	13,310	14,540	15,130	16,090	.	.	.
Consumption of households, BYN m, nom.	77,101	88,839	102,227	116,889	.	.	.
annual change in % (real)	-1.1	4.9	-0.3	8.6	2.0	3.0	3.5
Gross fixed capital form., BYN m, nom.	37,977	39,924	37,678	47,222	.	.	.
annual change in % (real)	-6.3	-5.9	-17.3	13.2	3.0	3.0	3.0
Gross industrial production							
annual change in % (real)	-0.7	6.5	-5.4	7.7	4.0	3.0	2.5
Gross agricultural production							
annual change in % (real)	4.4	-4.0	3.6	1.1	.	.	.
Construction industry							
annual change in % (real)	-1.6	-13.3	-10.7	11.4	.	.	.
Employed persons, LFS, th, average	4,885	4,851	4,847	4,801	4,780	4,760	4,740
annual change in %	-0.5	-0.7	-0.1	-0.9	-0.5	-0.5	-0.5
Unemployed persons, LFS, th, average	206	197	180	172	173	168	167
Unemployment rate, LFS, in %, average	4.0	3.9	3.6	3.5	3.5	3.4	3.4
Reg. unemployment rate, in %, eop	0.2	0.1	0.1	0.1	.	.	.
Average monthly gross wages, BYN	1,255	1,444	1,633	1,902	2,160	2,400	2,620
annual change in % (real, gross)	8.8	5.1	-1.8	10.9	5.0	4.0	3.0
Consumer prices, % p.a.	5.5	9.5	15.2	5.1	8.0	7.0	6.0
Producer prices in industry, % p.a. ²⁾	5.6	12.2	15.2	5.8	9.0	8.0	7.0
General governm. budget, nat. def., % of GDP							
Revenues	35.5	35.7	36.0	36.0	36.5	37.0	37.0
Expenditures	37.2	35.6	37.5	37.0	38.0	38.0	38.0
Deficit (-) / surplus (+)	-1.7	0.2	-1.5	-1.0	-1.5	-1.0	-1.0
General gov. gross debt, nat. def., % of GDP ³⁾	47.5	40.3	42.0	41.0	41.0	40.0	39.0
Stock of loans of non-fin. private sector, % p.a.	21.4	3.3	3.2	16.8	.	.	.
Non-performing loans (NPL), in %, eop ⁴⁾	4.8	5.3	4.9	5.0	.	.	.
Central bank policy rate, % p.a., eop ⁵⁾	7.75	9.25	12.00	9.50	10.0	10.0	9.0
Current account, EUR m ⁶⁾	-156	1,830	2,418	-942	-1,400	-900	-700
Current account, % of GDP	-0.3	3.1	3.5	-1.4	-2.1	-1.3	-0.9
Exports of goods, BOP, EUR m ⁶⁾	24,890	33,189	35,838	36,360	36,100	35,200	36,100
annual change in %	-14.0	33.3	8.0	1.5	-0.7	-2.5	2.6
Imports of goods, BOP, EUR m ⁶⁾	26,637	33,755	35,471	38,537	38,400	37,500	38,000
annual change in %	-18.5	26.7	5.1	8.6	-0.4	-2.3	1.3
Exports of services, BOP, EUR m ⁶⁾	7,703	8,749	8,790	7,855	8,100	8,500	8,700
annual change in %	-10.7	13.6	0.5	-10.6	3.1	4.9	2.4
Imports of services, BOP, EUR m ⁶⁾	4,249	4,815	4,789	5,242	5,400	5,600	5,800
annual change in %	-18.9	13.3	-0.5	9.5	3.0	3.7	3.6
FDI liabilities, EUR m ⁶⁾	1,221	1,044	1,536	1,912	.	.	.
FDI assets, EUR m ⁶⁾	72	-67	174	30	.	.	.
Gross reserves of CB excl. gold, EUR m ⁶⁾	3,604	4,687	4,494	4,084	.	.	.
Gross external debt, EUR m ⁶⁾	34,230	37,080	37,349	33,134	34,000	35,000	36,000
Gross external debt, % of GDP	63.8	62.7	53.5	49.8	50.1	49.7	48.3
Average exchange rate BYN/EUR	2.7888	2.9923	2.7755	3.2479	3.50	3.70	3.80

1) Preliminary and wiiw estimates. - 2) Domestic output prices. - 3) Including publicly guaranteed debt. From 2022 wiiw estimate. - 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.

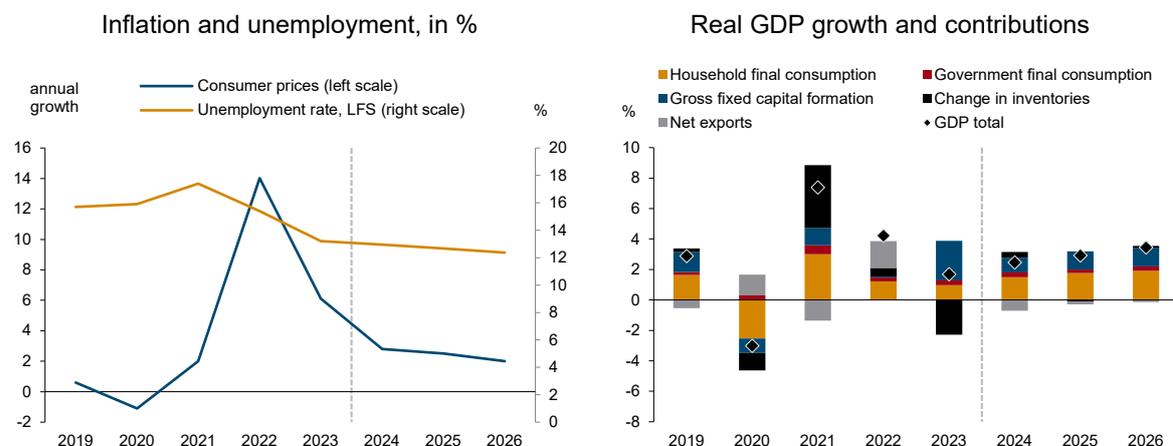


BOSNIA AND HERZEGOVINA: The way to EU accession talks open at last

SELENA DURAKOVIĆ

GDP growth in 2023 is estimated to have been 1.7% and to have been largely driven by a rise in consumer spending, spurred by falling inflation and higher real wages. Inflation averaged 6.1% last year; it is expected to continue to fall – to 2.8% in 2024 and 2.5% in 2025. GDP growth is likely to rise to 2.5% in 2024 and 2.9% in 2025, bolstered by increased individual and government spending, alongside a modest improvement in exports. The European Commission’s decision in March 2024 to open EU accession negotiations for Bosnia and Herzegovina provides added momentum and impetus for economic growth.

Figure 6.3 / Bosnia and Herzegovina: Main macroeconomic indicators



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

GDP growth in 2023 is estimated to have been 1.7%, driven largely by an increase in consumer spending on the back of lower inflation and rising real net wages. Government consumption and investment also increased in 2023, while exports and imports decreased. Remittances, investment income and tourism revenue have also been rising, providing an additional fillip to private consumption and growth; meanwhile, the trade deficit in goods and services stayed at a level similar to the previous year's. Tourist visits increased by 17.3% in 2023 compared to 2022, and there was a notable decline in the primary income deficit, due to a substantial increase in investment income (mostly on the central bank's internationally invested reserve assets) following a significant rise in global interest rates. Secondary income rose as a result of an increase in remittances of 5.6%. All of this resulted in a significant decline in the current account deficit. Foreign direct investment has also been increasing, although its share of GDP was still very low in 2023, at 3.5%.

Inflation in 2023 averaged 6.1%, which was lower than expected, and we anticipate a further fall in 2024 and 2025. In the first two months of 2024 inflation was even lower: just 2% and 2.1% in annual terms. This decline was largely due to the prices of imported goods (primarily energy) increasing more slowly. However, we do expect some rise in the coming period, following a significant jump of 28% in the minimum wage in Republika Srpska in 2024, and an increase in average real net wages and pensions throughout the country. At the same time, the Federation of Bosnia and Herzegovina has announced fiscal reforms for this year that will entail an even more significant rise in the minimum wage, of around 40%, in this part of the country. A decline in the tax wedge should also be a result of these reforms, and that could affect inflation by providing higher disposable income. Taking all this into account, we maintain our previous projection for inflation of 2.8% in 2024 and 2.5% in 2025, despite the low inflation rate in the first months of 2024.

Growth in 2024 is forecast to be 2.5%, primarily as a result of an expected increase in household consumption. Net wages rose at the beginning of 2024 and additional increases are planned for the remainder of the year. Retail trade turnover increased nominally by 13.1% in January and by 18.6% in February 2024, while industrial production fell in January by 6.4% and increased in February by 1%, year on year. Merchandise exports decreased in the first two months of 2024, while imports increased, resulting in a greater trade deficit. The slow growth prospects of the country's main trading partners mean that we have downgraded our forecast for export growth. On the other hand, we anticipate that household consumption will rise by more than previously expected, due to lower prices, an increase in wages and the fiscal reforms announced in the Federation of Bosnia and Herzegovina. Lower investment potentially presents a risk to growth, as there are already delays in foreign-funded infrastructure projects in Republika Srpska, while sanctions have been announced for banks that cooperate with politicians from Republika Srpska who are on the US 'blacklist' for undermining peace, sovereignty and constitutional order in the country.

The banking sector is still very stable, while interest rates have been increasing slowly. Non-performing loans have been decreasing, reaching 4% in 2023. Interest rates have been increasing at a much slower pace than in the countries of the euro area (where most of the banks in Bosnia and Herzegovina originate). Since the central bank of Bosnia and Herzegovina functions as a currency board, it does not have the key rate as a policy instrument, and so there has been no pressure on commercial banks to significantly raise their interest rates (apart from the pressure exerted by rising inflation), and most of the banks' funding comes from local sources, which are relatively cheap. An increasing differential between deposit and lending interest rates resulted in the greater profitability of the banking sector in 2023.

The unemployment rate is currently at a historical low. Unemployment fell to 13.2% in 2023, compared to 15.4% in 2022. The main jobs were created in tourism and the trade sector. An increasing problem is the emigration of the skilled workforce, as this induces labour shortages in certain sectors, such as construction and health care. Moreover, there has been a natural population decline for years, which adds to the problem through an aging population and pension sustainability. Anticipating a modest acceleration in economic activity, coupled with ongoing emigration, we project a continued gradual decline in the unemployment rate through 2024 and 2025.

In March 2024, EU leaders agreed to initiate negotiations with Bosnia and Herzegovina regarding its accession to the bloc. Bosnia and Herzegovina has been an official candidate for EU membership since 2022, but it needed to implement a number of reforms if it was to progress any further. Ursula von der Leyen, president of the European Commission, stated that Bosnia and Herzegovina had made progress in aligning its foreign and security policies with those of the EU and in enacting laws to combat money laundering and the funding of terrorism; this opened the door to negotiations. However, EU leaders have emphasised that Bosnia and Herzegovina must carry out additional reforms before the talks can start. Since the extensive reforms are needed it will take considerable time both to implement them and to reach consensus within the country.

Table 6.3 / Bosnia and Herzegovina: Selected economic indicators

	2020	2021	2022	2023 ¹⁾	2024	2025	2026
					Forecast		
Population, th pers., average	3,475	3,453	3,434	3,410	3,385	3,360	3,340
Gross domestic product, BAM m, nom. ²⁾	34,728	39,145	45,618	48,948	51,600	54,400	57,400
annual change in % (real)	-3.0	7.4	4.2	1.7	2.5	2.9	3.4
GDP/capita (EUR at PPP) ²⁾	9,930	10,990	12,270	12,780	.	.	.
Consumption of households, BAM m, nom. ²⁾	24,659	26,337	30,372	34,724	.	.	.
annual change in % (real)	-3.5	4.2	1.8	1.5	2.1	2.5	2.7
Gross fixed capital form., BAM m, nom. ²⁾	7,685	8,399	10,081	11,686	.	.	.
annual change in % (real)	-4.1	5.1	0.3	11.7	4.0	5.0	5.0
Gross industrial production							
annual change in % (real)	-6.4	9.8	0.9	-3.9	1.0	3.0	4.0
Gross agricultural production ³⁾							
annual change in % (real)	9.1	-16.8	18.2	1.0	.	.	.
Construction output total							
annual change in % (real)	0.2	2.5	-0.5	-0.5	.	.	.
Employed persons, LFS, th, average ⁴⁾	1,173.1	1,151.0	1,162.0	1,195.5	1,210	1,220	1,240
annual change in %	.	.	1.0	2.9	1.0	1.0	1.5
Unemployed persons, LFS, th, average ⁴⁾	221.0	241.8	211.3	181.3	180	177	175
Unemployment rate, LFS, in %, average ⁴⁾	15.9	17.4	15.4	13.2	12.9	12.7	12.4
Reg. unemployment rate, in %, eop	33.7	31.2	29.7	28.7	.	.	.
Average monthly gross wages, BAM	1,476	1,542	1,723	1,947	2,200	2,320	2,460
annual change in % (real, gross)	5.0	2.4	-2.0	6.5	10.0	3.0	4.0
Average monthly net wages, BAM	956	998	1,122	1,263	1,390	1,450	1,510
annual change in % (real, net)	4.9	2.4	-1.4	6.1	7.0	2.0	2.0
Consumer prices, % p.a.	-1.1	2.0	14.0	6.1	2.8	2.5	2.0
Producer prices in industry, % p.a.	-1.2	5.6	19.8	3.6	2.1	2.0	2.0
General governm. budget, nat. def., % of GDP							
Revenues	41.6	41.0	39.9	37.0	40.0	42.3	42.0
Expenditures	46.8	41.3	40.3	36.0	40.5	43.0	43.0
Deficit (-) / surplus (+)	-5.2	-0.3	-0.4	1.0	-0.5	-0.7	-1.0
General gov.gross debt, nat. def., % of GDP	36.1	33.9	29.3	26.9	25.5	24.1	24.4
Stock of loans of non-fin. private sector, % p.a.	-2.5	3.7	5.3	6.8	.	.	.
Non-performing loans (NPL), in %, eop	6.1	5.8	4.5	3.8	.	.	.
Central bank policy rate, % p.a., eop ⁵⁾
Current account, EUR m ⁶⁾	-501	-355	-1,011	-703	-940	-860	-870
Current account, % of GDP	-2.8	-1.8	-4.3	-2.8	-3.6	-3.1	-3.0
Exports of goods, BOP, EUR m ⁶⁾	4,818	6,499	8,369	8,011	8,250	8,890	9,420
annual change in %	-7.4	34.9	28.8	-4.3	3.0	7.7	6.0
Imports of goods, BOP, EUR m ⁶⁾	8,023	10,165	13,575	13,225	13,890	14,860	15,680
annual change in %	-13.5	26.7	33.6	-2.6	5.0	7.0	5.5
Exports of services, BOP, EUR m ⁶⁾	1,324	2,022	2,856	3,033	3,310	3,540	3,860
annual change in %	-37.6	52.7	41.2	6.2	9.0	7.0	9.0
Imports of services, BOP, EUR m ⁶⁾	488	626	859	1,014	1,130	1,220	1,370
annual change in %	-29.4	28.3	37.2	18.1	11.0	8.0	12.0
FDI liabilities, EUR m ⁶⁾	428	610	754	874	.	.	.
FDI assets, EUR m ⁶⁾	71	71	66	43	.	.	.
Gross reserves of CB excl. gold, EUR m ⁶⁾	6,942	8,204	8,133	8,239	.	.	.
Gross external debt, EUR m	11,234	11,449	11,977	12,234	12,660	13,100	13,750
Gross external debt, % of GDP	63.3	57.2	51.4	48.9	48.0	47.1	46.9
Average exchange rate BAM/EUR	1.9558	1.9558	1.9558	1.9558	1.9558	1.9558	1.9558

Note: Introduction of new index 2021=100 (new weights) for gross industrial production.

1) Preliminary and wiiw estimates. - 2) According to ESA'10 (FISIM reallocated to industries). - 3) Based on UN-FAO data, wiiw estimate in 2023. - 4) From 2021 new methodology in line with the Integrated European Social Statistics Regulation (IESS). From 2020 continuous quarterly survey based on census 2013 and according to EU + ILO definition. Growth rates are not comparable. - 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.

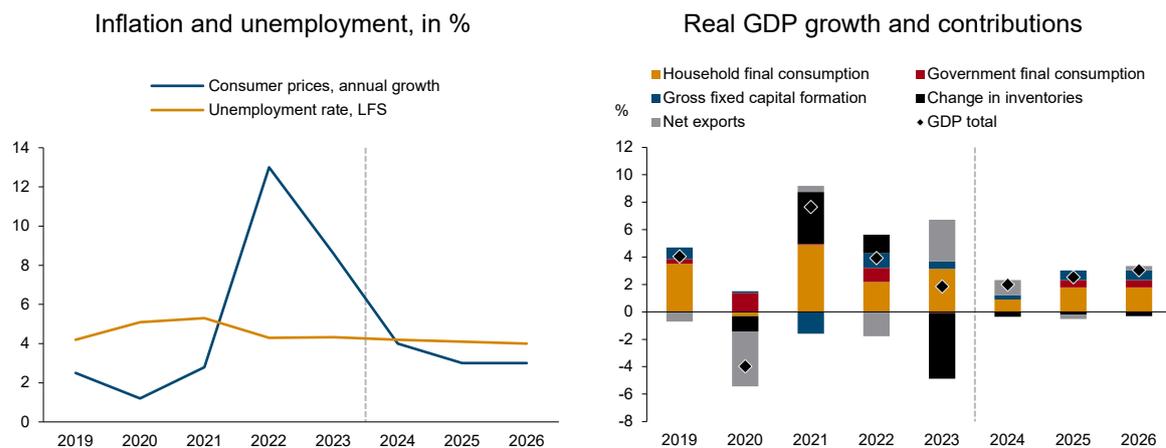


BULGARIA: Prospects not bright, with political stalemate and fresh snap elections

RUMEN DOBRINSKY

Bulgarians are being summoned to the polls again in June, in the fifth snap election since 2021. Growth slowed in 2023 and weak performance has continued in the first months of 2024. Inflation has fallen back thanks to a downturn in the non-core component. GDP growth is expected to be around 2% in 2024 and should remain moderate in the coming years. It is anticipated that the external economic environment will remain unfavourable and that growth will predominantly be driven by domestic demand.

Figure 6.4 / Bulgaria: Main macroeconomic indicators



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

Bulgaria is heading for a fresh snap election just a year after the previous one. The flaky coalition (which called itself a ‘non-coalition’) that has been in power for the past nine months disintegrated just as the previously agreed rotation of the cabinet was about to take place. The divergent stances on many policy issues, as well as the bitter rivalries among the governing parties, made it impossible for them to continue under the previous scheme. The snap election is expected to be held on 9 June, coinciding with the elections to the European parliament.

This will be the fifth snap election since 2021. The situation – which is a result of recurrent fragmented parliaments – reflects, on the one hand, the deep political divide within society and, on the other, society’s inability to generate a political constellation capable of leading it out of the protracted crisis. Regrettably, the new snap election will most likely have a similar outcome. At the same time, the caretaker government that will be in office until the polls does not have the power to shape a new policy course.

The policy stance of the outgoing government was dominated by populist moves and a lack of clear direction, reflecting the heterogeneity of the ruling coalition. In fact, it was just a continuation of the lasting political and policy stalemate that has prevailed in Bulgaria since 2021. Among the most visible repercussions of this persistent mayhem have been the failure of Bulgaria's attempts to join the euro area and, more recently, the critical delay in agreeing a Recovery and Resilience Plan with the European Commission. On the domestic front, the governance limbo has led to a chronic weakening of the country's fiscal position, with long-lasting negative implications.

Last year was marked by a sharp economic slowdown. GDP grew by just 1.8%, down 2.1 percentage points on the previous year. Industry sank into deep recession, reflecting the worse external environment and unfavourable price conditions. Electricity production dropped by more than 20%, as local producers suffered a loss of competitiveness against the background of a plunge in international energy prices. The export of goods dropped off considerably both in nominal and in real terms, mirroring the weakening in the major EU markets.

In statistical terms, all the major components of final demand made a positive contribution to GDP growth. Household consumption continued to grow in 2023, bolstered by the continued rise in real wages and a surge in consumer credit. There was a turnaround in gross fixed capital formation, after a decline in both 2021 and 2022. Despite a fall in real exports, net exports of goods and services contributed positively to GDP growth, thanks to the larger drop in real imports. However, a reduction of inventories made a significant negative contribution to GDP growth, as companies dumped the large stockpiles accumulated over the previous two years.

Disinflation prevailed throughout 2023, but average annual growth in consumer price inflation remained high at 8.6%, due to carryover effects from the previous year. The external factors that had been driving non-core inflation (high international energy and food prices) have gradually subsided, and this effect is reflected in the recent dynamics of CPI. The remaining pro-inflationary factors are mostly of a domestic nature: chronic disproportionate growth in incomes and the resulting demand push.

There were divergent trends on the financial markets. While lending to the corporate sector slowed in 2023 as economic activity weakened, lending to households (both consumer credit and house-purchase loans) accelerated. This latter trend, together with rising real incomes, was one of the factors behind the sharp growth in private consumption and was a source of pro-inflationary pressure. Recently the Bulgarian National Bank took some soft policy steps (such as the recommendations for tightening credit screening) designed to cool the credit expansion.

The labour market tightened further in 2023, and the shortages of manpower in some sectors have intensified. The labour force in Bulgaria continued to shrink – a lasting trend mirroring the population ageing. This has resulted in chronic labour shortages and upward pressure on wages. In 2023, wages kept growing faster than labour productivity, with real wages rising by 3.9%. The unemployment rate remained unchanged from 2022, at 4.3%.

The 2024 budget epitomises the current policy impasse. While lavishly expansionary in terms of spending, it is unrealistically optimistic on the revenue side. Thus, the first months of 2024 indicated that some important revenue items (such as VAT) were significantly off target. On the other hand, the budget incorporates a commitment to a considerable rise in some expenditure items, in particular social

spending. The likely outcome will be a deficit well above the 3% cash target. During a recent visit, an International Monetary Fund (IMF) review team for the first time criticised the rudimentary and simplistic flat tax in Bulgaria (initially introduced in the country in 1997 on the insistence of the IMF), referring to it as outdated and not relevant to the current socioeconomic conditions in the country. However, so far there has not been any debate on possible changes to the system of taxation.

The further delays in the European Commission's approval of the national Recovery and Resilience Plan – inevitable, given the political crisis – will also have fiscal repercussions. The 2024 budget has factored in spending items that are conditional on the Commission's transfers under the Plan. However, in the current situation, it is unlikely that these transfers will materialise in 2024 (so far, Bulgaria has received only a first advance payment under the Plan, back in 2022). The upshot will be that some investment projects contained in the 2024 budget will have to be cancelled or deferred.

The slowdown has continued in the first months of 2024. The downturn in manufacturing deepened in line with the ongoing decline in exports to key EU markets and unfavourable price conditions. The continuing slump in many industries has led to a weakening in labour demand, including in those sectors facing acute labour shortages, such as information and communications technology. There have also been signs of a moderation in lending, as credit conditions become less attractive. Retail sales have also slowed. Recent business confidence indicators offer no hint of optimism in the short run.

Overall, GDP growth is expected to be moderate in 2024, at around 2%. Growth will remain predominantly driven by domestic demand, but the growth push from personal consumption is likely to weaken in view of the expected tightening of credit. The prospects for public fixed investment will depend partly on the implementation of projects under the Recovery and Resilience Plan – something that remains in question. The external economic environment is expected to remain unfavourable for Bulgarian manufacturers. Moreover, given the anticipated low external demand, real exports of goods could decline further in 2024, repeating the 2023 pattern.

Consumer inflation should decelerate further, to some 4% in 2024. This will mainly be a result of changing macroeconomic fundamentals, rather than deliberate policy actions: such a development is consistent with the ongoing decline in producer prices and the almost certain relaxation of the situation on the labour market.

Developments over the coming two years are expected to follow a similar pattern. The political situation will probably remain shaky, and policy will continue to lack clear direction. The chances of more favourable economic performance will depend on the external environment improving.

Table 6.4 / Bulgaria: Selected economic indicators

	2020	2021	2022	2023 ¹⁾	2024	2025	2026
					Forecast		
Population, th pers., average ²⁾	6,934	6,878	6,643	6,400	6,350	6,300	6,250
Gross domestic product, BGN m, nom.	120,492	138,979	167,809	183,743	194,900	205,800	218,400
annual change in % (real)	-4.0	7.7	3.9	1.8	2.0	2.5	3.0
GDP/capita (EUR at PPP)	16,440	18,540	22,020	24,060	.	.	.
Consumption of households, BGN m, nom.	69,748	80,213	96,703	109,068	.	.	.
annual change in % (real)	-0.5	8.4	3.8	5.4	1.5	3.0	3.0
Gross fixed capital form., BGN m, nom.	22,981	22,720	28,627	31,796	.	.	.
annual change in % (real)	0.6	-8.3	6.5	3.3	2.0	4.0	4.0
Gross industrial production ³⁾							
annual change in % (real)	-5.9	9.8	12.7	-8.3	1.0	2.0	3.0
Gross agricultural production							
annual change in % (real)	-11.1	18.7	-8.2	-4.8	.	.	.
Construction industry ⁴⁾							
annual change in % (real)	-5.4	2.7	0.5	-1.4	.	.	.
Employed persons, LFS, th, average ⁵⁾	3,122	3,077	3,151	2,932	2,950	2,960	2,970
annual change in %	-3.4	-0.6	2.4	-0.3	0.5	0.5	0.5
Unemployed persons, LFS, th, average ⁵⁾	169	171	140	132	130	130	120
Unemployment rate, LFS, in %, average ⁵⁾	5.1	5.3	4.3	4.3	4.2	4.1	4.0
Reg. unemployment rate, in %, eop ⁵⁾	6.7	4.8	4.7	5.6	.	.	.
Average monthly gross wages, BGN	1,391	1,561	1,770	2,012	2,160	2,310	2,470
annual change in % (real, gross)	7.9	8.7	-1.7	3.9	3.0	4.0	4.0
Consumer prices (HICP), % p.a.	1.2	2.8	13.0	8.6	4.0	3.0	3.0
Producer prices in industry, % p.a.	-1.9	15.9	40.1	-10.6	-2.0	2.0	3.0
General governm. budget, EU def., % of GDP							
Revenues	37.7	37.7	38.5	38.0	38.0	38.0	38.0
Expenditures	41.5	41.7	41.4	41.0	42.0	41.0	41.0
Net lending (+) / net borrowing (-)	-3.8	-4.0	-2.9	-3.0	-4.0	-3.0	-3.0
General gov. gross debt, EU def., % of GDP	24.6	23.9	22.6	22.5	24.0	25.0	26.0
Stock of loans of non-fin. private sector, % p.a.	4.5	8.3	12.2	11.1	.	.	.
Non-performing loans (NPL), in %, eop	7.5	6.0	4.6	3.6	.	.	.
Central bank policy rate, % p.a., eop ⁶⁾	0.00	0.00	1.30	3.80	3.5	3.0	2.5
Current account, EUR m	24	-1,225	-1,200	-251	-200	-600	-1,000
Current account in % of GDP	0.0	-1.7	-1.4	-0.3	-0.2	-0.6	-0.9
Exports of goods, BOP, EUR m	27,272	34,405	47,146	43,335	43,500	44,000	45,000
annual change in %	-6.3	26.2	37.0	-8.1	0.4	1.1	2.3
Imports of goods, BOP, EUR m	29,213	37,292	52,220	46,963	46,000	47,000	48,000
annual change in %	-8.8	27.7	40.0	-10.1	-2.1	2.2	2.1
Exports of services, BOP, EUR m	7,320	9,231	12,223	14,109	13,200	13,500	14,000
annual change in %	-28.5	26.1	32.4	15.4	-6.4	2.3	3.7
Imports of services, BOP, EUR m	4,171	5,041	6,973	7,420	7,400	7,600	8,000
annual change in %	-21.9	20.8	38.3	6.4	-0.3	2.7	5.3
FDI liabilities, EUR m	3,154	2,029	3,131	4,083	.	.	.
FDI assets, EUR m	395	781	1,032	1,017	.	.	.
Gross reserves of CB excl. gold, EUR m	28,830	32,490	36,198	39,480	.	.	.
Gross external debt, EUR m	38,991	41,317	44,249	45,414	46000	47000	48000
Gross external debt, % of GDP	63.3	58.1	51.6	48.3	46.0	45.0	43.0
Average exchange rate BGN/EUR	1.9558	1.9558	1.9558	1.9558	1.9558	1.9558	1.9558

Note: Introduction of new index 2021=100 (new weights) for gross industrial production, construction and producer prices in industry.

1) Preliminary and wiiw estimates. - 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. From 2021 new LFS methodology 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.

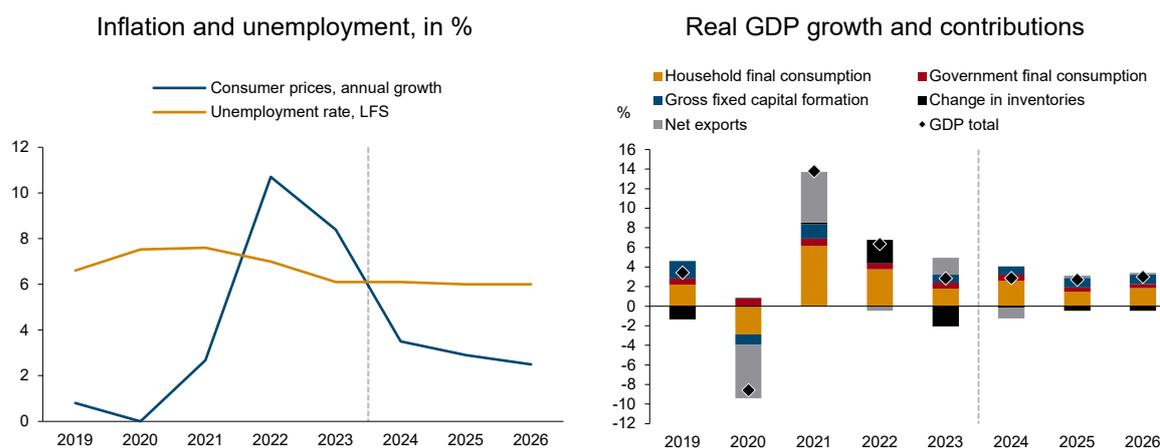


CROATIA: Calm waters ahead

BERND CHRISTOPH STRÖHM

Croatia's accession to the euro area and the EU's border-free Schengen zone boosted tourism in 2023, with EU-related funds supporting investment activity. The country's full EU integration will continue to stimulate trade and investment in the period 2024-2026. Improving private consumption and strong services exports will ensure robust growth of 2.9% in 2024; we also expect inflation to decline further to 3.5%. Nevertheless, a lack of skilled workers remains an issue and an obstacle to higher GDP growth.

Figure 6.5 / Croatia: Main macroeconomic indicators



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

Thanks to robust household consumption and a solid summer tourist season, as well as better-than-expected growth in Q4 2023 (4.3% year on year), Croatia's economy grew by 2.8% in 2023. While exports of goods declined in 2023 due to weak external demand, strong services exports meant that overall net trade contributed positively to growth. Croatia's GDP growth will remain robust, rising by 2.9% in 2024. Nevertheless, external demand will continue to exude uncertainty, owing to the poor outlook for growth in the EU – and particularly Germany. Downside risks also stem from the war in Ukraine and the global political uncertainty. Consequently, GDP growth in both 2024 and 2025 will likely not exceed the 3% mark.

Croatia's accession to the euro area and the EU's border-free Schengen zone boosted tourism in 2023 and will continue to support the sector in 2024. Croatia saw 20.6m arrivals and 108m overnight stays in 2023. That represents a 9% increase in arrivals and a 3% rise in overnight stays compared to 2022. The 2023 figures are on a par with those of 2019. The Croatian National Tourist Board (HTZ) has

announced that in Q1 2024 Croatia had already recorded 1.1m tourist arrivals and over 3m overnight stays, which is an increase of 16% and 15%, respectively, over the same period of 2023. It should be noted, though, that the country's potential for tourism-related growth is not limitless.

Inflation declined from 10.7% in 2022 to 8.4% in 2023. The annual inflation rate for food, beverages and tobacco stood at 4.7% and for services 6.6%, while energy prices grew by 1.4%. Inflation has continued to moderate, and dropped to 4.1% year on year in March 2024. We expect inflation to decline further to 3.5% in 2024, owing to softer pressure on energy and commodity prices.

Real wages in 2023 increased by 6.2%. We expect nominal and real gross wages in Croatia to continue to grow in 2024, albeit more slowly than in 2023, with pronounced wage growth in the public sector. Public-sector unions signed a collective-bargaining agreement in March 2024 which could mean that some 240,000 employees whose pay comes from the state budget will benefit on average from a 13.5% pay increase in 2024 over 2023 pay levels.

In March 2024, the government adopted its sixth anti-inflation aid package: worth some EUR 503m, it is designed to support local households and the economy in managing rising electricity and gas prices. It may also be regarded as part of the government's spending spree, ahead of the parliamentary and presidential elections this year. The package comes on top of the EUR 3.4bn (5% of GDP) in state aid allocated last year to facilitate investment in energy-efficiency measures and to mitigate the cost-of-living crisis in Croatia.

Croatia's unemployment reached pre-COVID-19 levels. The unemployment rate declined to 6.1% in 2023, down from 7% in 2022, and will likely remain at the same level in the period 2024-2025. Nevertheless, the lack of skilled workers – partly due to the emigration of skilled workers to other EU member states – remains an issue for the economy and presents an obstacle to higher GDP growth. According to the Croatian Employers' Association (HUP), Croatia could lose 6.8% of its active working population by 2030. The government is attempting to address the persistent labour shortages by hiring foreign workers. In 2021 it abolished the annual quota for the employment of foreign nationals. Statistics show that in 2023, some 172,500 residence and work permits were issued by Croatia to workers from third countries: nationals from Bosnia and Herzegovina received the most residence permits (124,000), followed by those from Serbia (24,000) and Nepal (23,500). Most foreign workers are employed in construction, tourism and the catering/hospitality sector.

The government is focusing on investment in Croatia's energy security and decarbonisation of the country's power supply. In February 2024, it announced that it was planning to spend EUR 400m on two new natural gas pipelines, and pledged to utilise EUR 580m from EU funds to upgrade the country's power grid. The EU views Croatia's liquefied natural gas terminal in Omišalj as strategically significant, which is why the terminal received a subsidy of EUR 101.4m after being listed as one of the EU's Projects of Common Interest (PCI). The government also announced that it was to put a total of 1,200MW of solar and wind-power capacity into operation in 2024. Croatia plans to cut its CO₂ emissions by 45% by 2030 and to abandon the use of coal by 2033. In 2023, renewable energy accounted for some 32% of the country's total energy mix; Croatia's National Energy and Climate Plan aims at achieving a 36.4% share for renewables by the year 2030, through large-scale investments.

EU budget support will continue to underpin Croatia's economic growth. According to EU estimates, cohesion policy measures will contribute up to 8 percentage points of Croatia's cumulated GDP growth by the end of 2030. In November 2023, the European Commission revised its maximum grant allocation to Croatia from the Recovery and Resilience Facility for the period 2021-2026 down from EUR 6.3bn to EUR 5.5bn, in order to reflect the fact that Croatia's economic outcome is better than was initially forecast in 2020 and 2021.

Croatia will hold parliamentary and presidential elections in 2024. Parliament was dissolved in March 2024 to pave the way for elections in April, before the June elections to the EU parliament. A broad left-liberal coalition, including the SDP and nine other parties, called 'For a Better Croatia' was established to run against the ruling conservative HDZ party. The HDZ, on the other hand, will likely establish a centre-right coalition with four smaller parties. Polls suggest that the ruling HDZ party will win most seats in the new parliament, followed by the SDP. Even though the HDZ may win the election, it will likely have fewer seats than after the 2020 election, when it received 37.3% of the vote. The newly elected government will probably continue with policies aimed at strengthening the country's energy diversification and countering its brain drain. Owing to the government's pre-election spending spree in the form of wage, pension and social benefit hikes, and its anti-inflation aid packages, Croatia's fiscal deficit is projected to surge to 2% in 2024, up from 1% in 2023.

Table 6.5 / Croatia: Selected economic indicators

	2020	2021	2022	2023 ¹⁾	2024	2025	2026
					Forecast		
Population, th pers., average ²⁾	4,047	3,949	3,857	3,853	3,850	3,849	3,850
Gross domestic product, EUR-HRK m, nom.	50,569	58,408	67,993	75,855	81,000	86,000	91,000
annual change in % (real)	-8.6	13.8	6.3	2.8	2.9	2.7	3.0
GDP/capita (EUR at PPP)	19,450	22,840	25,820	28,200	.	.	.
Consumption of households, EUR-HRK m, nom.	29,095	32,911	39,089	43,481	.	.	.
annual change in % (real)	-5.2	10.7	6.7	3.1	4.5	2.6	3.2
Gross fixed capital form., EUR-HRK m, nom.	11,217	12,294	13,350	14,812	.	.	.
annual change in % (real)	-5.0	6.6	0.1	4.2	4.3	5.0	5.0
Gross industrial production ³⁾							
annual change in % (real)	-2.8	6.3	1.2	-0.3	1.3	2.5	2.7
Gross agricultural production							
annual change in % (real)	1.1	-3.4	-4.2	0.1	.	.	.
Construction output ³⁾							
annual change in % (real)	4.3	9.3	4.0	5.2	.	.	.
Employed persons, LFS, th, average ⁴⁾	1,657	1,678	1,707	1,603	1,630	1,660	1,690
annual change in %	-1.3	1.3	1.7	.	1.5	1.7	1.8
Unemployed persons, LFS, th, average ⁴⁾	135	138	128	104	110	110	110
Unemployment rate, LFS, in %, average ⁴⁾	7.5	7.6	7.0	6.1	6.1	6.0	6.0
Reg. unemployment rate, in %, eop	9.3	7.3	6.7	6.4	.	.	.
Average monthly gross wages, EUR-HRK	1,223	1,274	1,380	1,584	1,700	1,800	1,900
annual change in % (real, gross)	2.4	1.6	-2.3	6.3	3.0	2.5	2.6
Average monthly net wages, EUR-HRK	898	946	1,016	1,148	1,200	1,300	1,400
annual change in % (real, net)	2.6	2.7	-3.1	4.6	2.3	2.5	2.6
Consumer prices (HICP), % p.a.	0.0	2.7	10.7	8.4	3.5	2.9	2.5
Producer prices in industry, % p.a.	-3.5	6.6	18.2	3.5	1.0	1.5	2.0
General governm. budget, EU def., % of GDP							
Revenues	46.7	46.1	45.0	48.0	46.6	46.6	47.0
Expenditures	54.0	48.6	44.9	49.0	48.6	48.0	48.2
Net lending (+) / net borrowing (-)	-7.3	-2.5	0.1	-1.0	-2.0	-1.4	-1.2
General gov.gross debt, EU def., % of GDP	86.8	78.1	68.2	63.0	60.0	59.0	57.0
Stock of loans of non-fin. private sector, % p.a.	3.5	2.3	11.2	8.4	.	.	.
Non-performing loans (NPL), in %, eop ⁵⁾	5.4	4.3	3.0	2.6	.	.	.
Central bank policy rate, % p.a., eop ⁶⁾	3.0	3.0	3.0	4.5	.	.	.
Current account, EUR m	-488	572	-1,894	829	190	900	1,190
Current account, % of GDP	-1.0	1.0	-2.8	1.1	0.2	1.0	1.3
Exports of goods, BOP, EUR m	12,029	14,803	20,563	19,196	19,940	21,100	22,490
annual change in %	-6.2	23.1	38.9	-6.6	3.9	5.8	6.6
Imports of goods, BOP, EUR m	20,879	26,206	38,686	36,499	39,800	43,400	47,300
annual change in %	-10.4	25.5	47.6	-5.7	9.0	9.0	9.0
Exports of services, BOP, EUR m	8,927	14,317	19,702	22,328	24,600	27,600	30,700
annual change in %	-41.9	60.4	37.6	13.3	10.0	12.0	11.4
Imports of services, BOP, EUR m	3,621	4,494	5,771	6,565	6,900	7,100	7,300
annual change in %	-28.8	24.1	28.4	13.8	5.0	2.5	2.5
FDI liabilities, EUR m	1,110	3,952	3,408	2,715	.	.	.
FDI assets, EUR m	372	941	-242	1,261	.	.	.
Gross reserves of CB excl. gold, EUR m ⁷⁾	18,945	25,022	27,771	2,880	.	.	.
Gross external debt, EUR m ⁸⁾	41,293	47,260	49,826	63,999	67,200	69,900	71,900
Gross external debt, % of GDP	81.7	80.8	73.3	84.4	83.0	81.3	79.0
Average exchange rate EUR-HRK/EUR	1.0005	0.9992	1.0001	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).

Introduction of new index 2021=100 (new weights) for gross industrial production, construction and producer prices in industry.

1) Preliminary and wiiw estimates. - 2) From 2021 based on census 2021. - 3) Enterprises with 20 and more employees. - 4) From 2023 according to census 2021. From 2021 new LFS methodology in line with the Integrated European Social Statistics Regulation (IESS). - 5) Loans more than 90 days overdue and those unlikely to be paid. - 6) From 2023 official refinancing operation rate for euro area (ECB), discount rate of CB before. - 7) From January 2023 only foreign currency reserves denominated in non-euro currencies. - 8) From 2023 increase of gross external debt due to euro introduction.

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

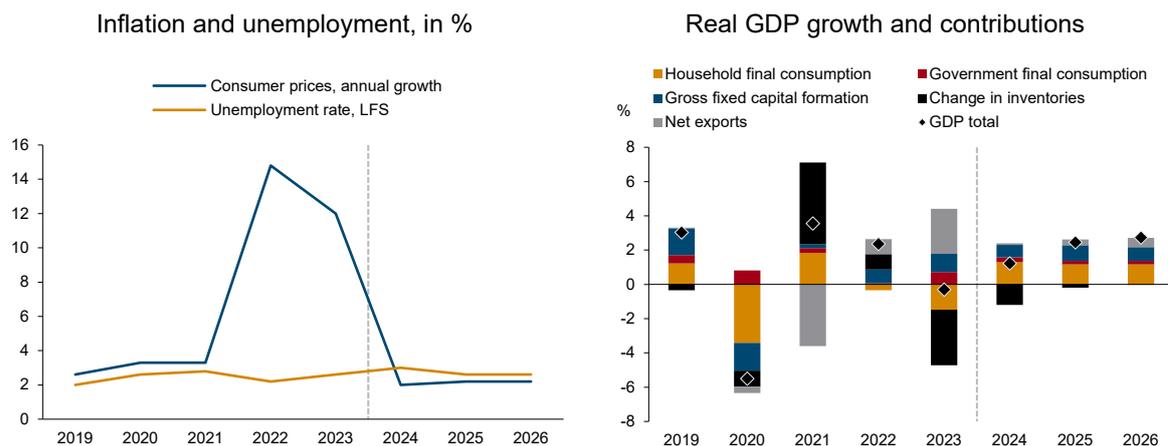


CZECHIA: A consumption-driven recovery

ZUZANA ZAVARSKÁ

Following a minor contraction in 2023, the Czech economy will see a mild recovery this year. As inflation falls sharply and real wages rise, consumption will be the main driver behind this. Uncertainty looms over Czech industry, its trajectory hinging on the pace of growth in certain major economies, particularly Germany. A more dynamic growth path lies ahead in 2025 and 2026, as industry revives and capacity-expanding investment picks up.

Figure 6.6 / Czechia: Main macroeconomic indicators



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

The Czech economy experienced a slight contraction of 0.3% in 2023, falling below the EU's growth rate and coming into line with that of Germany. Household consumption (-1.2 percentage points (pp)) and inventory depletion (-3.1 pp) contributed to the GDP decline, while government consumption (+0.6 pp), gross fixed capital formation (+1.1 pp) and net exports (+2.2 pp) contributed positively.

Following a period of stiflingly high inflation, a steep decline is expected in 2024. Inflation reached 14.8% in 2022 and was still 12.0% in 2023, which implies a 28.6% growth in price levels in just two years. Together with the Baltic countries and Hungary, this makes Czechia one of the EU countries worst hit by inflation. The most recent figures suggest that inflation is stabilising. February saw a steep fall in the Harmonised Index of Consumer Prices to 2.2%, helped primarily by the high base of last year. The exact same figure was maintained in March. Still, a number of pro-inflationary factors remain, including the weaker Czech koruna against the euro and the dollar, the relatively high inflation in certain services, the abolition of energy price controls and the stretched labour market. Therefore, inflation is expected to hover at around its current level, without decreasing much further.

Real wages will finally rise, which will motivate Czech consumers to increase their spending.

After two consecutive years of declining wages – which resulted in two consecutive years of declining household consumption – the purchasing power of Czech households will begin to recover. The tight labour market adds further to the pressure on employers to increase wages. Economic sentiment indicators already show recovering consumer confidence in the first months of 2024. Therefore, consumption is expected to rebound and become the main growth driver this year. The momentum is expected to be sustained throughout the forecast period.

The Czech National Bank (CNB) is advancing with its careful interest-rate cutting. The CNB began its monetary policy loosening in December of last year, when it first trimmed the two-week repo rate by 25 basis points. Another two cuts followed in February and March. At the time of writing, the policy rate stands at 5.75% – down from its peak of 7%. Despite the hawkish stance of the CNB, loosening is expected to continue, as inflation falls significantly and real interest rates turn positive. Our forecast sees the policy rate dropping by another 150 basis points this year to reach 4.25%, before stabilising at around 3% by the end of 2025. Reflecting the rate cuts, the Czech koruna has been depreciating in recent months, hitting a two-year low against the euro in April. Having reached its historically strongest point in 2023, the koruna will be somewhat weaker in the period ahead, though some appreciation is to be expected once the European Central Bank embarks on rate cuts of its own.

Industry continues to grapple with headwinds, particularly with the weak (albeit recovering)

German economy. Industrial production declined modestly (by 1.3%) in 2023, cushioned primarily by the surprisingly strong automotive sector – the manufacture of motor vehicles grew by over 16% last year. As Czechia's most important trading partner and third largest foreign direct investor, Germany's bleak economic outlook limits the potential for dynamic industrial production in Czechia, at least in the first half of 2024. Industrial production figures in the first two months of 2024 painted a mixed picture: January saw stagnation year on year and a 2.3% decline month on month. February's growth figures were more optimistic (partly on account of a lower comparison basis from February 2023): 0.7% year on year and 1.9% month on month. The automotive sector is weaker than last year, but is still strong, growing by 7.9% in the first two months of 2024. The most recent trade figures hint at recovering exports, as well as imports, though uncertainty remains high. The trade balance is expected to be slightly positive this year, with exports picking up more strongly than imports in the period to follow, as external demand accelerates.

A new gigafactory project appears to be on the horizon. The Czech government recently revealed that a foreign investor will be setting up a production plant for batteries near the town of Karviná, close to the border with both Poland and Slovakia. While the government has not yet disclosed the name of the investor, it claims the plant will produce batteries for electric vehicles and that the investment will total around EUR 7.8bn. After the Volkswagen gigafactory plans fell through at the end of last year, reportedly due to the low demand for batteries in Europe,¹³ the current announcement puts Czechia back in the game of electric vehicle battery manufacturing.

¹³ <https://www.euractiv.com/section/politics/news/volkswagen-rejects-czech-gigafactory-location-citing-low-demand-for-ev-batteries/>

The labour market remains stable, with the shortage of workers persisting as the primary concern.

The labour market was largely shielded from the impacts of the economic contraction last year, seeing only a marginal increase in the unemployment rate. A small and temporary uptick in unemployment is to be expected this year, due to the struggles of industry. At 2.6% in 2023, unemployment is still lower than in any other EU member state. Czechia introduced the so-called 'Highly qualified worker programme' in 2021, a scheme that tries to simplify and accelerate the administrative process for immigrants in crucial sectors that face a shortage. In addition to the highly qualified worker scheme, there are visa programmes – aimed primarily at low-skilled workers – that will be augmented by 20,000 applications in 2024. These specifically target less-developed countries in Southeast Europe and Asia, including the Philippines, Mongolia and the Balkan countries, as well as Ukraine.¹⁴

The government's fiscal consolidation package came into force in January and imposes various austerity measures.

Prime Minister Fiala's 'recovery package' – which sparked massive protests last year – brings reductions in state aid programmes, increases in several taxes and contributions, and cuts to public-sector wages. With inflation moderating, the government has also abolished a number of support measures related to the energy crisis, including revisions to regulated energy prices, the discontinuation of one-off payments to families with children and the reintroduction of fees for supported renewable energy sources. Some smaller, targeted support packages remain in place, such as housing support for low-income households.

EU finances will boost investment activity over the medium term, as fresh tranches from the Recovery and Resilience Facility (RRF) are unlocked and new cohesion policy funds spent.

In the programming period 2021-2027, Czechia has EUR 21.4bn in EU cohesion policy funds at its disposal. In addition, the RRF totals over EUR 9.3bn, much of it dedicated to green and digital investment. Once combined, these funds represent over 10% of Czechia's 2023 GDP. While implementation of the country's recovery and resilience plan got off to a slow start, Czechia appears to have expedited progress in recent months, requesting the disbursement of the second and third tranches of RRF funds in December of last year. The second tranche – worth over EUR 700m – has just been transferred to Czechia (in April).

The Czech economy will see only a modest recovery (1.2%) in 2024, supported by domestic factors but constrained by external ones.

This represents a downgrading (of 0.5 pp) from our previous forecast, reflecting the weak outlook for Germany and other major global actors. More dynamic growth is to be expected in 2025 (2.5%) and 2026 (2.7%), as industry recovers fully and capacity-expanding investment activity picks up. Inflation will fall more sharply than previously expected (a downward revision of 0.8 pp against our Winter forecast), plateauing at around 2% already this year. The fragile geopolitical landscape brings major downside risks to the outlook, however, as further supply-chain issues and spikes in energy prices will inevitably take their toll on the economy. In addition, Czechia faces a number of structural challenges that hamper its growth prospects over the long run, including major labour shortages, sluggish progress with the green transition and a slow transition from an economic model dependent on foreign direct investment.

¹⁴ https://www.exporthmag.cz/mezinarodni-obchod/programy-pracovni-migrace-letos-prinesou-novinky/?utm_source=businessinfo&utm_medium=web&utm_campaign=portal_selfpromo

Table 6.6 / Czechia: Selected economic indicators

	2020	2021	2022	2023 ¹⁾	2024	2025	2026
					Forecast		
Population, th pers., average ²⁾	10,698	10,506	10,672	10,850	10,880	10,900	10,900
Gross domestic product, CZK bn, nom.	5,709	6,109	6,787	7,344	7,620	7,990	8,400
annual change in % (real)	-5.5	3.6	2.4	-0.3	1.2	2.5	2.7
GDP/capita (EUR at PPP)	28,050	29,990	32,040	34,190	.	.	.
Consumption of households, CZK bn, nom.	2,536	2,716	3,107	3,286	.	.	.
annual change in % (real)	-7.4	4.1	-0.8	-3.2	2.9	2.6	2.6
Gross fixed capital form., CZK bn, nom.	1,516	1,589	1,819	1,980	.	.	.
annual change in % (real)	-6.0	0.8	3.0	4.0	2.7	3.4	3.0
Gross industrial production							
annual change in % (real)	-7.1	6.8	2.1	-1.3	2.0	3.2	3.4
Gross agricultural production							
annual change in % (real)	5.2	1.5	-1.6	-1.6	.	.	.
Construction industry							
annual change in % (real)	-7.1	2.7	3.2	-2.7	.	.	.
Employed persons, LFS, th, average ³⁾	5,235	5,213	5,174	5,061	5,070	5,070	5,090
annual change in %	-1.3	-0.5	-0.8	1.4	0.2	0.0	0.4
Unemployed persons, LFS, th, average ³⁾	137	151	118	134	160	140	140
Unemployment rate, LFS, in %, average ³⁾	2.6	2.8	2.2	2.6	3.0	2.6	2.6
Reg. unemployment rate, in %, eop	4.0	3.5	3.7	3.7	.	.	.
Average monthly gross wages, CZK	36,176	38,277	40,317	43,341	46,000	48,600	50,900
annual change in % (real, gross)	1.4	1.9	-8.5	-2.9	4.0	3.3	2.5
Consumer prices (HICP), % p.a.	3.3	3.3	14.8	12.0	2.0	2.2	2.2
Producer prices in industry, % p.a.	0.5	6.2	18.4	4.4	2.8	2.6	2.5
General governm. budget, EU def., % of GDP							
Revenues	41.5	41.4	41.4	42.5	42.2	42.0	42.3
Expenditures	47.2	46.5	44.6	45.8	44.7	44.0	43.8
Net lending (+) / net borrowing (-)	-5.8	-5.1	-3.2	-3.3	-2.5	-2.0	-1.5
General gov. gross debt, EU def., % of GDP	37.7	42.0	44.2	44.4	44.8	44.6	44.4
Stock of loans of non-fin. private sector, % p.a.	4.1	8.4	4.5	6.5	.	.	.
Non-performing loans (NPL), in %, eop	2.8	2.4	1.9	1.7	.	.	.
Central bank policy rate, % p.a., eop ⁴⁾	0.25	3.75	7.00	6.75	4.25	3.00	3.00
Current account, EUR m	4,393	-6,639	-13,555	1,205	1,300	2,400	4,600
Current account, % of GDP	2.0	-2.8	-4.9	0.4	0.4	0.8	1.4
Exports of goods, BOP, EUR m	128,226	148,552	175,612	182,185	185,800	196,000	208,700
annual change in %	-8.0	15.9	18.2	3.7	2.0	5.5	6.5
Imports of goods, BOP, EUR m	117,611	145,936	176,533	170,081	173,800	182,700	193,300
annual change in %	-9.6	24.1	21.0	-3.7	2.2	5.1	5.8
Exports of services, BOP, EUR m	22,842	25,275	33,055	36,720	39,100	41,700	43,900
annual change in %	-16.0	10.7	30.8	11.1	6.4	6.7	5.2
Imports of services, BOP, EUR m	18,912	21,180	29,094	32,821	35,100	37,600	39,700
annual change in %	-18.1	12.0	37.4	12.8	7.0	7.0	5.7
FDI liabilities, EUR m	7,367	10,953	8,729	7,620	.	.	.
FDI assets, EUR m	1,788	9,818	5,312	6,923	.	.	.
Gross reserves of CB excl. gold, EUR m	134,905	152,755	130,626	132,442	.	.	.
Gross external debt, EUR m	164,648	181,763	186,324	186,944	187,500	199,800	210,000
Gross external debt, % of GDP	76.3	76.3	67.4	61.1	62.0	62.5	62.5
Average exchange rate CZK/EUR	26.46	25.64	24.57	24.00	25.2	25.0	25.0

Note: Introduction of new index 2021=100 (new weights) for gross industrial production, construction and producer prices in industry.

1) Preliminary and wiiw estimates. - 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 (I ESS), excluding persons on parental leave from employed persons. - 4) Two-week repo rate.

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

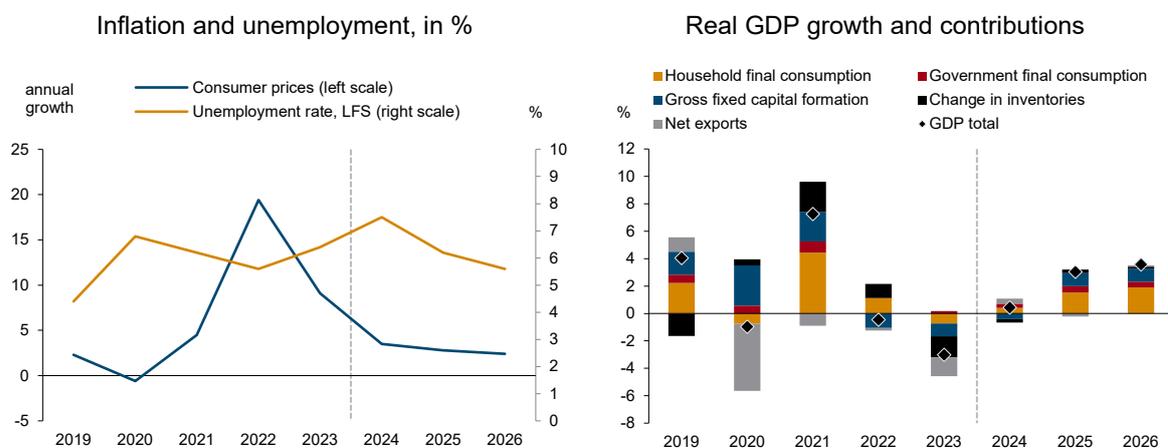


ESTONIA: Over the worst

MARYNA TVERDOSTUP

The past year presented significant challenges for the Estonian economy. A constellation of factors, including the disproportionately severe impact of the war in Ukraine, weak domestic and international demand, disruption to supply chains and a shift away from traditional export markets, dealt the economy a heavy blow. However, 2024 will mark a turning point, with stabilising prices, a modest resurgence in external demand and a robust labour market all indicating that the worst may be over. Nevertheless, to enter a new cycle of economic growth, the competitiveness of Estonian firms needs to be revived and new export markets need to be established.

Figure 6.7 / Estonia: Main macroeconomic indicators



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

Last year, Estonia experienced the most significant economic decline of all European Union countries, with a 3% decrease in GDP. Although value added fell in most sectors, the recession was driven primarily by the energy and mining, manufacturing, transportation, and storage sectors, which collectively accounted for nearly a quarter of Estonia's GDP in 2021. Those sectors have been disproportionately affected by the war in Ukraine and by the weak economic performance of key export markets, including the Nordic countries, Latvia and Lithuania.

GDP will start gradually to recover in 2024, but all-out growth will only be seen in 2025. As major supply-side issues are being resolved, and as demand – both domestic and on the country's primary export markets – is gradually improving, no further economic downturn is foreseen. Factors contributing to economic stabilisation include a decrease in commodity and production input costs, lower energy

prices, reduced interest rates, a stabilisation of prices and improved purchasing power. However, the economy will gain momentum very slowly, with GDP growth forecast to be 0.4% in 2024. With ample production capacities standing idle, there is abundant potential for firms to undertake a rapid revival of industrial production as the economy recovers and companies venture into new markets. This will result in more confident GDP growth of 3% in 2025 and 3.6% in 2026.

An increase in VAT led to a rise in year-on-year consumer price inflation (CPI) to 3.9% in March; however, without the impact of this tax hike, inflation would have stood at 2.4%. Throughout 2024, prices for energy, agricultural products and manufactured goods are expected to continue to fall, indicating that overall inflation will likely hover at around 3.5%. The CPI is projected to decline further to 2.8% in 2025 and 2.4% in 2026. However, such a fall could be offset by several new planned tax increases, including a car tax.

Household consumption contracted by 1.5% in 2023, as the full-scale distorting effect of inflation materialised (while savings had already been depleted the year before). Consumers remain cautious about future economic developments, and this is resulting in weaker consumption and investment activity. Although consumption probably reached its nadir in 2023, the combination of higher VAT (up from 20% to 22%) and sluggish real wage growth is expected to restrain private consumption through 2024, resulting in meagre growth of 0.8%. However, certain factors that are on the cards – such as a recovery in the purchasing power of wages, an interest rate decline, a strong labour market and a higher tax-free income threshold due to come into force in 2025 – are projected to drive consumption growth back up to 3% in 2025 and 3.7% in 2026.

Gross industrial production fell by approximately 10% year on year in 2023. The most pronounced decline in industrial output over the past two years was observed in the wood and metal production sectors. This was driven by the disruption to the supply of cheap raw materials from Russia and Belarus, diminishing competitiveness and modest demand. Companies are gradually adjusting and seeking out new markets and substitutes for the disrupted supply chains; however, demand-side factors will continue to restrain growth in 2024.

The foreign trade turnover declined by 5% in 2023, largely on account of exports and imports of goods. Both were down by 16% compared to 2022, owing to a significant decline in manufacturing exports across all exporting branches. The depreciation of the currencies of countries outside the euro area, including Sweden and Norway, further undermined the competitiveness of Estonian products. This added to the ongoing detrimental effects of an upsurge in input prices and supply-chain distortions. Despite these challenges, trade in services picked up in 2023. There was 5% year-on-year growth in service exports, largely due to ICT, processing and tourism services, and a 7% growth in service imports.

No significant revival in foreign trade is anticipated in 2024, as heavy competition pressure remains and the assessments by business continue to be gloomy. There will be a further real decrease of 1.3% in exports and 1.8% in imports in 2024. However, the steady weakening of energy and input price pressures, as well as the more favourable exchange rates for Swedish krona and Norwegian krone anticipated for later this year, should give a boost to exports. Consequently, a gradual but steady recovery in foreign trade is projected to commence in 2025, driven by strengthening foreign demand and improved domestic economic conditions.

The labour market proved resilient throughout 2023, and the impact on it of the ongoing stagnation in business activity is expected to be minimal this year. Companies, anticipating an economic revival and a resurgence of labour shortages, are inclined to hang onto employees even during challenging times and in the face of rising costs. A generally weak economic outlook, coupled with a rise in minimum and public-sector wages, is expected to push the unemployment rate up to 7.5% in 2024. However, this surge in joblessness is likely to be temporary. Unemployment is forecast to fall to below 6% in the subsequent years, as labour demand strengthens rapidly and labour shortages re-emerge as the primary factor constraining economic growth.

Real wages grew steadily throughout 2023, but the reduced capacity of companies to keep up with higher labour costs will retard wage growth this year. Despite high inflation, real wage growth in 2023 was positive, and the average nominal wage growth of 11% marginally outstripped inflation. In 2024, nominal wages are set to rise by 6%, thanks to a 10% increase in public-sector wages and a 13.1% boost to the minimum wage.

Budget expenditure rose steeply in 2023, driven by an increase in public-sector wages and in social and defence spending. Revenue was restrained by an overall economic slump, resulting in a budget gap of around 3.3% of GDP in 2023. Despite tax increases, slower real wage growth and a temporary spike in unemployment are expected to lead to lower tax receipts this year. On the expenditure side, the growth in public-sector wages and social transfers will decelerate. Although the government is aiming for a 3% budget deficit this year, persistently high government consumption will likely result in a wider budget gap of 3.6% of GDP. The effective reduction in personal income tax is likely to result in a short-lived expansion of the budget deficit to around 4.5% in 2025, though it should subsequently narrow to 3.7% in 2026.

Table 6.7 / Estonia: Selected economic indicators

	2020	2021	2022	2023 ¹⁾	2024	2025	2026
					Forecast		
Population, th pers., average	1,330	1,331	1,349	1,366	1,360	1,355	1,350
Gross domestic product, EUR m, nom.	27,430	31,169	36,011	37,682	39,200	41,500	44,000
annual change in % (real)	-1.0	7.2	-0.5	-3.0	0.4	3.0	3.6
GDP/capita (EUR at PPP)	25,590	28,180	30,140	30,670	.	.	.
Consumption of households, EUR m, nom.	13,168	14,991	17,933	19,306	.	.	.
annual change in % (real)	-1.5	9.3	2.3	-1.5	0.8	3.0	3.7
Gross fixed capital form., EUR m, nom.	8,174	9,090	9,910	10,016	.	.	.
annual change in % (real)	10.8	7.3	-3.7	-3.4	-1.5	3.6	3.6
Gross industrial production							
annual change in % (real)	-3.0	13.3	1.8	-11.4	2.7	4.5	5.6
Gross agricultural production							
annual change in % (real)	0.0	-4.9	7.2	-7.1	.	.	.
Construction industry							
annual change in % (real)	-6.1	9.4	-1.2	-5.8	.	.	.
Employed persons, LFS, th, average ²⁾	656.6	654.2	680.8	700.0	690	710	730
annual change in %	-2.2	-0.5	4.1	2.8	-1.2	3.0	2.4
Unemployed persons, LFS, th, average ²⁾	47.9	43.1	40.2	47.7	56	47	43
Unemployment rate, LFS, in %, average ²⁾	6.8	6.2	5.6	6.4	7.5	6.2	5.6
Reg. unemployment rate, in %, eop ³⁾	8.3	6.8	7.7	7.7	.	.	.
Average monthly gross wages, EUR ⁴⁾	1,448	1,548	1,645	1,832	1,950	2,070	2,200
annual change in % (real, gross)	3.4	2.1	-6.5	2.0	3.0	3.3	4.0
Consumer prices (HICP), % p.a.	-0.6	4.5	19.4	9.1	3.5	2.8	2.4
Producer prices in industry, % p.a.	-2.2	11.9	25.3	-0.3	3.5	2.8	2.4
General governm. budget, EU def., % of GDP							
Revenues	39.4	39.4	38.8	41.5	41.8	41.5	42.3
Expenditures	44.9	41.9	39.8	44.8	45.4	46.0	46.0
Net lending (+) / net borrowing (-)	-5.4	-2.5	-1.0	-3.3	-3.6	-4.5	-3.7
General gov. gross debt, EU def., % of GDP	18.6	17.8	18.5	21.0	22.0	22.4	21.5
Stock of loans of non-fin. private sector, % p.a.	4.8	7.5	11.7	6.1	.	.	.
Non-performing loans (NPL), in %, eop	0.4	0.2	0.2	0.2	.	.	.
Central bank policy rate, % p.a., eop ⁵⁾	0.00	0.00	2.50	4.50	.	.	.
Current account, EUR m	-521	-808	-1,163	-781	-780	-710	-780
Current account, % of GDP	-1.9	-2.6	-3.2	-2.1	-2.0	-1.7	-1.8
Exports of goods, BOP, EUR m	13,269	16,414	20,143	17,872	17,150	17,540	17,980
annual change in %	-0.4	23.7	22.7	-11.3	-4.0	2.3	2.5
Imports of goods, BOP, EUR m	13,542	17,674	22,715	20,255	19,600	20,230	21,020
annual change in %	-4.9	30.5	28.5	-10.8	-3.2	3.2	3.9
Exports of services, BOP, EUR m	5,716	8,606	10,748	11,667	12,110	12,500	13,020
annual change in %	-20.5	50.6	24.9	8.6	3.8	3.2	4.2
Imports of services, BOP, EUR m	5,594	7,658	8,367	9,062	9,420	9,760	10,200
annual change in %	9.2	36.9	9.3	8.3	4.0	3.6	4.5
FDI liabilities, EUR m	3,243	6,322	1,696	4,878	.	.	.
FDI assets, EUR m	315	5,561	1,628	2,035	.	.	.
Gross reserves of CB excl. gold, EUR m	1,615	2,081	2,068	2,335	.	.	.
Gross external debt, EUR m	24,333	26,523	30,519	33,993	35,700	36,600	38,200
Gross external debt, % of GDP	88.7	85.1	84.7	90.2	91.1	88.2	86.8

Note: Introduction of new index 2021=100 (new weights) for gross industrial production and producer prices in industry.

1) Preliminary and wiiw estimates. - 2) From 2021 new LFS methodology 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.

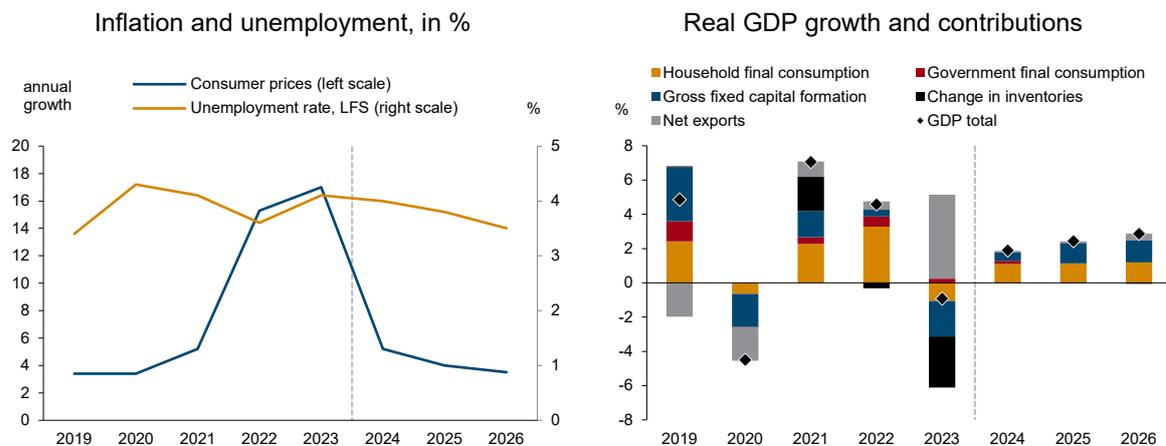


HUNGARY: Fiscal consolidation ahead

SÁNDOR RICHTER

Runaway inflation was curbed by the end of 2023. The current account closed with a surplus, largely because of a decline in imports due to shrinking consumption, a drop in investment and lower import prices. GDP declined last year and there will be no spectacular recovery of economic growth in 2024 either. A chronic deficit in the general government balance necessitates painful measures, which in turn will put a brake on the pace of economic growth. Inflation continues to be of concern, while the current account will likely remain balanced or in surplus over the forecast horizon.

Figure 6.8 / Hungary: Main macroeconomic indicators



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

The Hungarian economy suffered a hard landing in 2023. Contrary to the government's initial GDP growth target of over 4%, the sad reality turned out to be a 0.9% decline. The doling out of 'helicopter money' prior to the spring 2022 general election was followed by an inflation shock in late 2022 and early 2023. Though slowing, the still very high average rate of inflation (17%) last year meant that household consumption fell considerably (by 2.5%). Especially hard hit were low-income households, which had to cope with the runaway food price rises (annual average: 25.9%). Better-earning households also consumed less, became more cautious and boosted their rate of saving through the purchase of government securities offered with enticing yields. Government consumption dropped, too. Investment recorded a poor result, as well, with a decline of over 7%. Aside from the falling inflation, the only good news came from foreign trade: a considerable improvement was reported in the trade balance. The explanation for this was stagnating goods exports, coupled with a sharp contraction of imports on account of lower imported energy prices and reduced demand for imports generally, due to

the recession. The current account booked a small surplus in 2023 – a big improvement after the deficit of over 8% of GDP the previous year. On the production side of GDP, agriculture had an excellent year, contributing 2.2 percentage points to the GDP change. All the other main segments of the economy reported negative growth rates last year: industry -5.2%, construction -5.6% and services -1.6%.

Late 2023 and early 2024 witnessed sharp consumer price disinflation – from 25.7% in January 2023 to 3.6% in March 2024. This was the combined outcome of reduced domestic demand and a monetary policy that had turned strongly restrictive. Lower imported inflation helped curb inflation as well. Shrinking consumption led to falling government revenue from consumption-related taxes, primarily VAT. Government expenditure also surpassed the planned level: the payment of interest on the public debt and the purchase of property played the main role here. The general government deficit amounted to 6.7% of GDP, higher than in 2022 and much higher than originally planned.

The government has stated that while 2023 was the year of disinflation, 2024 will bring a revival of growth, with GDP expansion of about 4%. However, the first two months of the year belied this optimism. Although Q3 2023 did show early signs of a recovery, Q4 heralded stagnation, while the economic indicators in the first months of 2024 were frankly disappointing. Industrial output declined in January and the order books showed substantially lower stock than a year previously. Retail trade reported only a marginal upturn. The worst news has come from the Ministry of Finance: in Q1 2024, the general government deficit amounted to 92% of the sum originally planned for the whole year. After just the first two months of the year, the official GDP growth target for 2024 was halved and the fiscal deficit target was revised substantially upwards.

Economic policy faces a dilemma now: should it focus on kick-starting growth, thereby risking a combination of resurgence of inflation and a worryingly high fiscal deficit, with the danger of the forint weakening considerably? Or should it prioritise consolidation of the budget and a cautious easing of monetary policy (with an eye on exchange rate stability), and just accept that GDP growth will pick up only slowly over the entire forecast period? All this must be seen in the political context, bearing in mind the forthcoming municipal and European Parliament elections and the declining popularity of the ruling Fidesz party in the wake of recent political scandals. Any economic policy option will have to take into consideration the fact that inflation has been successfully tamed, but not vanquished. Risks abound. One is that nominal wage rises may be too high if the high inflation rate of the recent past is used as a reference point in the bargaining process. A further risk is that the forint exchange rate could weaken – either as a result of a too-early and too-radical cut in the policy rate, or else triggered by the faltering trust of international investors in the government's economic policy. Should fiscal consolidation rely primarily on raising taxes, that may also push up inflation. The current level of the fiscal deficit cannot be sustained: the only question is to what extent and by what means will consolidation be initiated? High interest payments on public debt have been a critical issue: last year they already attained 4.5% of GDP. This component of fiscal expenditure can be reduced only gradually. An improvement in the primary fiscal balance is therefore imperative; but irrespective of whether that is achieved by increasing budget revenue or by reducing public expenditure, the consequences will be painful.

While macroeconomic dilemmas and the expected rate of GDP growth are the focus of attention, the economy's structural problems have recently become more visible. The domination of the domestic market by a handful of companies is greater in Hungary than in any other OECD country.¹⁵ A

¹⁵ OECD Economic Surveys: Hungary 06 March 2024, p. 64. https://www.oecd-ilibrary.org/economics/oecd-economic-surveys-hungary-2024_795451e5-en

study of the top 50 high-tech companies in Central and Eastern Europe, ranked in terms of their revenue growth over the years 2019-2022, reveals that Czechia and Poland can boast 18 firms apiece, while Croatia has 5, Slovakia has 4, Romania has 3, and Serbia and Bulgaria have 1 firm apiece: not a single Hungarian enterprise was found to be in the top 50.¹⁶ This finding seems closely correlated with the political circumstances in Hungary, where in an increasingly large section of the economy competition has been significantly weakened over the past decade and a half.

The confrontation between the government and the EU gained momentum last year, while the government's anti-EU propaganda inside Hungary shifted into a higher gear. The government's strategy of negotiating with the EU on the basis of blackmail and obstruction of decision-making procedures has become standard. Although over EUR 10bn of the EU funds potentially available to Hungary has recently been released, further tranches are hedged around with a considerable number of conditions. Even the disbursement of recently released transfers is far from certain. The European Parliament is threatening to sue the Commission, as it perceives no guarantee that the resolutions approved by the Hungarian government to restore the rule of law in Hungary will actually be implemented. Currently either extreme scenario – the disbursement of all EU funds earmarked for Hungary and the near-total suspension of further payments – is possible. wiiw considers the most probable scenario (at least over the forecast horizon) to be a partial mobilisation of the EU funds; but transfers disbursed will fall short of the sum that would be available were the country to have unfettered access to the funds earmarked for it.

As for the outlook, wiiw reckons on no clear victory for either of the currently competing economic policy strategies. Up until the June elections, the government's growth-promoting rhetoric will remain strident; thereafter, steps may be taken to improve the fiscal stance. Should a forced easing of monetary policy and a less strict management of the fiscal deficit be pushed through by the main protagonist of this approach – Mr Márton Nagy, the minister of economy and (more importantly) Mr Orbán's currently most influential advisor and confidant on economic questions – then the likely major devaluation of the forint, flare-up of inflation and unfavourable reception from international investors would make short shrift of that particular adventure. Nevertheless, any fiscal consolidation will be cautious, and it will probably take the next three years to produce any convincing results. Inflation will remain of concern: by the end of the year and in 2025 it will be higher than it was in the first months of 2024. The current account position is expected to be roughly in balance this year and slightly positive in the following two years. Industrial production will expand moderately, closely related to the absorption capacity of the main export markets in Western Europe. Agriculture is unlikely to come close to the exceptionally good performance of last year. The labour market remains tight and one of the obstacles to more dynamic growth. The required workforce for the new plants being built with foreign direct investment to produce batteries for electric vehicles will partly come from abroad – in direct contradiction to the anti-migration rhetoric of the government. The weak start to 2024 and the unavoidable fiscal consolidation will enable only moderate GDP growth of about 1.9% this year. That may be followed by a somewhat better growth performance in both 2025 and 2026.

¹⁶ Deloitte Technology Fast 50 Central Europe 2023. <https://www2.deloitte.com/ce/en/pages/about-deloitte/topics/technology-fast-50.html>

Table 6.8 / Hungary: Selected economic indicators

	2020	2021	2022	2023 ¹⁾	2024	2025	2026
					Forecast		
Population, th pers., average ²⁾	9,750	9,710	9,644	9,600	9,570	9,530	9,500
Gross domestic product, HUF bn, nom.	48,444	55,205	65,952	74,992	79,700	84,900	90,400
annual change in % (real)	-4.5	7.1	4.6	-0.9	1.9	2.4	2.9
GDP/capita (EUR at PPP)	22,380	24,370	26,930	28,720	.	.	.
Consumption of households, HUF bn, nom.	22,946	25,528	31,471	35,572	.	.	.
annual change in % (real)	-1.3	4.8	7.1	-2.2	2.3	2.4	2.5
Gross fixed capital form., HUF bn, nom.	12,845	15,036	18,391	19,759	.	.	.
annual change in % (real)	-7.1	5.7	1.4	-7.4	1.8	4.5	5.0
Gross industrial production							
annual change in % (real)	-6.1	9.6	6.1	-5.6	4.0	5.0	6.5
Gross agricultural production							
annual change in % (real)	-2.4	-1.1	-16.5	25.0	.	.	.
Construction industry							
annual change in % (real)	-9.8	11.9	1.9	-5.0	.	.	.
Employed persons, LFS, th, average ³⁾	4,461	4,642	4,709	4,738	4,750	4,760	4,760
annual change in %	-1.1	0.7	1.4	0.6	0.3	0.2	0.1
Unemployed persons, LFS, th, average ³⁾	198	196	176	203	200	190	170
Unemployment rate, LFS, in %, average ³⁾	4.3	4.1	3.6	4.1	4.0	3.8	3.5
Reg. unemployment rate, in %, eop ⁴⁾	6.2	5.1	4.8	4.6	.	.	.
Average monthly gross wages, HUF	391,194	425,915	499,980	571,182	621,900	661,000	701,900
annual change in % (real, gross)	6.3	3.6	2.5	-2.9	3.5	2.2	2.6
Average monthly net wages, HUF	260,144	283,234	332,487	379,836	413,600	439,600	466,800
annual change in % (real, net)	6.3	3.6	2.5	-2.9	3.5	2.2	2.6
Consumer prices (HICP), % p.a.	3.4	5.2	15.3	17.0	5.2	4.0	3.5
Producer prices in industry, % p.a.	4.3	13.6	33.7	5.8	4.0	4.0	3.5
General governm. budget, EU def., % of GDP							
Revenues	43.8	41.2	42.7	42.3	42.5	42.5	42.5
Expenditures	51.4	48.4	48.9	49.0	47.5	46.5	46.0
Net lending (+) / net borrowing (-)	-7.6	-7.2	-6.3	-6.7	-5.0	-4.0	-3.5
General gov. gross debt, EU def., % of GDP	79.2	76.7	74.0	73.0	72.8	71.0	69.8
Stock of loans of non-fin. private sector, % p.a.	13.4	12.8	11.6	3.3	.	.	.
Non-performing loans (NPL), in %, eop ⁵⁾	3.6	3.2	3.2	2.6	.	.	.
Central bank policy rate, % p.a., eop ⁶⁾	0.60	2.40	13.00	10.75	6.00	4.50	4.00
Current account, EUR m ⁷⁾	-1,571	-6,553	-14,096	431	0	500	900
Current account, % of GDP ⁷⁾	-1.1	-4.3	-8.4	0.2	0.0	0.2	0.4
Exports of goods, BOP, EUR m ⁷⁾	88,655	100,269	122,214	126,131	128,300	134,100	141,500
annual change in %	-4.2	13.1	21.9	3.2	1.7	4.5	5.5
Imports of goods, BOP, EUR m ⁷⁾	89,990	104,712	137,450	125,852	128,100	134,100	142,100
annual change in %	-6.5	16.4	31.3	-8.4	1.8	4.7	6.0
Exports of services, BOP, EUR m ⁷⁾	19,889	22,800	29,920	33,377	36,000	40,700	46,400
annual change in %	-26.1	14.6	31.2	11.6	8.0	13.0	14.0
Imports of services, BOP, EUR m ⁷⁾	15,885	18,043	22,067	23,550	25,200	28,200	32,900
annual change in %	-19.9	13.6	22.3	6.7	7.0	12.0	16.5
FDI liabilities, EUR m ⁷⁾	3,037	8,776	14,064	3,194	.	.	.
FDI assets, EUR m ⁷⁾	826	5,024	9,061	646	.	.	.
Gross reserves of CB excl. gold, EUR m	32,115	33,501	33,533	35,725	.	.	.
Gross external debt, EUR m ⁷⁾	112,135	133,991	154,903	167,937	165,000	165,000	150,000
Gross external debt, % of GDP ⁷⁾	81.3	87.0	91.9	85.5	82.4	79.7	68.9
Average exchange rate HUF/EUR	351.25	358.52	391.29	381.85	398	410	415

Note: Introduction of new index 2021=100 (new weights) for gross industrial production and producer prices in industry.

1) Preliminary and wiiw estimates. - 2) From 2022 according to census 2022. - 3) From 2021 new LFS methodology 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) Base rate. - 7) Excluding SPE.

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

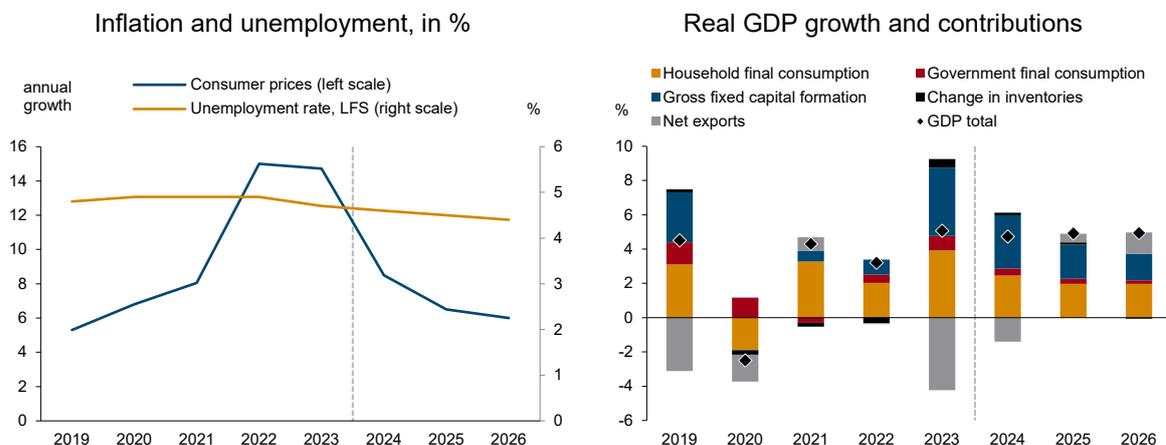


KAZAKHSTAN: One of CESEE's top performers, thanks to strong investment

ALEXANDRA BYKOVA

Kazakhstan's economy ended 2023 among CESEE's top-performing economies, with strong private consumption and investment driving economic growth. Despite sluggish exports and skyrocketing imports to meet domestic demand, the economy grew by 5.1%. Private consumption was supported by wage increases, decelerating inflation and credit growth. However, we expect a slight slowdown in private consumption growth this year. By contrast, major investment in transport and logistics infrastructure (resulting from geopolitical shifts) and in modernisation of the energy system and utilities sector is likely to remain an important growth driver in the medium term. We expect the economy to grow by 4.7% in 2024 and by 4.9% in 2025-2026 – one of the fastest rates in CESEE.

Figure 6.9 / Kazakhstan: Main macroeconomic indicators



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

Kazakhstan turned in one of CESEE's best economic performances in 2023, with 5.1% real GDP growth, driven by domestic factors. Although full-year data for GDP using the expenditure approach have not yet been published, it is evident that the main drivers of the robust economic performance were household consumption and investment. By contrast, the contribution of net exports to GDP growth was negative, as imports surged in real terms to meet rapidly increasing domestic demand.

With inflation steadily easing throughout the year, private consumption ended on a strong note, supported by growth in real incomes and consumer credit. Retail trade grew by 7.7% in real terms over the previous year. A rise in both the minimum and public-sector wages at the beginning of the year and decelerating consumer inflation (from 21.4% in February to 10.1% in December) resulted in a 2.1% annual increase in real wages. New loans to private households (75% of them long term) increased by 41% over the previous year,¹⁷ and this provided a strong boost to private consumption.

We expect private consumption growth to be slightly weaker this year than last. The consumer confidence index in the first three months of this year is tending slight downward. The share of respondents who consider current conditions to be favourable for making large purchases has decreased, and those who envisage an improvement in their own financial position during the year has fallen. Q1 retail sales growth of 4.7% year on year was lower than the overall figure for 2023. However, in view of a 21.4% hike in the minimum wage in January 2024 and a further slowing of inflation, private consumption is likely to continue to drive economic growth, albeit at a lower rate.

Public and private investment significantly boosted economic performance in 2023 and will continue to drive growth in the medium term. The need to restructure transport corridors and logistics amid geopolitical shifts resulted in annual investment growth in this sector of 40% in real terms in 2023 and of 47% in the first two months of 2024 (the share of this sector in total investment in 2023 amounted to 14%). This restructuring includes mainly new transport corridors to avoid goods having to cross the territory of Russia – especially transport connections between China and Europe (the so-called Middle Corridor). Apart from the modernisation of ports in the Caspian Sea and of airports, a recently announced project worth mentioning is a new airport in the special economic zone of Khorgos, on the border with China, to be constructed by 2027 with German co-investment (USD 0.5bn). The modernisation of obsolescent infrastructure in the utilities sector will continue. Annual real growth of investment in this sector (6.6% of total investment in the economy), reached 38.9% in 2023 and 31.6% in January-February 2024. In the oil sector – which still accounts for the largest share of investment – a fresh delay in the expansion of the Tengiz oil field has been announced: it is being postponed until mid-2025, with overall project investments set to increase by USD 1.5bn. However, due to the base effect, we expect a gradual slowdown in the still strong investment growth over the medium term.

After only sluggish growth in oil production in 2024, we expect an increase of around 10% by the end of 2026, which will provide an additional boost to economic growth. In 2023, the oil sector suffered from the decline in global oil prices (of around 18%), which was partly offset by a 6.9% increase in output. According to official estimates, oil production in 2024 will remain at almost the same level as last year, owing to the commitment by OPEC+ to maintain the reduced production until June 2024. We expect the expansion of oil production capacity in the Tengiz oil field to have an impact from 2025.

In view of the current robust performance by construction, trade and manufacturing, and in light of an improvement in business sentiment, we have revised upwards our real GDP growth forecast for 2024. Manufacturing posted growth of 7.4% year on year in the first two months of 2024, driven by the chemical industry (25.3%), metallurgy (10.6%), metal products except machinery and equipment (24.3%), machinery (23.4%) and other finished products (76.3%). The short-term economic indicator reflecting performance in the main economic sectors increased by 5.2% over the first two

¹⁷ Stock of loans to households grew by 28.9% year on year in 2023.

months relative to 2023, and accelerated in February. Both manufacturing and services business sentiment improved in March.

We expect a pause in further monetary easing, as rising utility tariffs hamper the slowdown of inflation. The deceleration of consumer price inflation and lower inflation expectations led to a series of policy rate cuts, most recently to 14.75% at the end of February 2024. However, monthly inflation was higher than expected in February and March, as the utility tariffs component rose when price controls were lifted and in view of the high costs of power-grid modernisation. Inflation expectations have also rebounded slightly. In response, the national bank signalled a possible break in its easing cycle in April, although further easing is expected by the end of the year. Future decisions depend on the development of utility tariffs, the impact of fiscal measures and imported inflation, especially from Russia. Besides, given the anticipated negative trade balance, we expect the tenge to depreciate in 2024, which may also fuel inflation. (Last year, the tenge appreciated by 1%, supported by large transfers from the National Oil Fund converted into tenge – despite a deterioration in the trade balance.)

A tightening of fiscal policy is expected in the medium term, although this could be halted by fiscal support measures, to quell the increased risk of social discontent. Despite the official goal of fiscal consolidation, its scale is likely to be limited. Government's support for 'high added-value' sectors associated with oil and gas production (refining, chemical production), as well as domestic military production, is likely to persist. The change of government at the beginning of February, which further strengthened President Tokayev, was apparently partly a reaction to signs of social dissatisfaction with the pace of the promised reforms. Catastrophic flooding in northern Kazakhstan in April, caused by melting snow and a dam failure in Russia, fuelled social discontent over the apparent mismanagement by the local authorities of preventive measures. While there is still uncertainty about the amount required to compensate for the damage, it is unlikely to have a large impact on the budget.

External geopolitical risks will test Kazakhstan's diplomatic manoeuvring abilities. Amid reports of sanctions-evasion schemes and trade statistics that hint at the re-export of sanctioned goods from Europe to Russia, the risk of secondary sanctions being imposed by the US and the EU – at least on certain firms – is looming large. To minimise the risk of disruption at the Novorossiysk terminal of the Caspian Pipeline Consortium's oil pipeline (the main oil transport route to Europe), at the end of March Kazakhstan held consultations with Russia and Ukraine to ensure safe operation, following a series of drone attacks on Russian oil refineries.

Table 6.9 / Kazakhstan: Selected economic indicators

	2020	2021	2022	2023 ¹⁾	2024	2025	2026
					Forecast		
Population, th pers., average ²⁾	18,756	19,001	19,635	19,900	20,200	20,500	20,800
Gross domestic product, KZT bn, nom.	70,649	83,952	103,766	119,251	132,400	145,900	159,200
annual change in % (real)	-2.5	4.3	3.2	5.1	4.7	4.9	4.9
GDP/capita (EUR at PPP)	17,540	19,100	20,420	21,530	.	.	.
Consumption of households, KZT bn, nom.	36,661	42,419	50,952	63,100	.	.	.
annual change in % (real)	-3.7	6.3	4.0	8.0	5.0	4.0	4.0
Gross fixed capital form., KZT bn, nom.	17,463	19,342	22,959	30,200	.	.	.
annual change in % (real)	-0.2	2.6	3.8	18.0	14.0	9.0	7.0
Gross industrial production							
annual change in % (real)	-0.5	3.6	1.2	4.3	4.0	5.0	5.0
Gross agricultural production							
annual change in % (real)	5.7	-2.3	9.1	-7.7	.	.	.
Construction industry							
annual change in % (real)	11.6	8.3	10.2	13.3	.	.	.
Employed persons, LFS, th, average ²⁾	8,732	8,807	8,972	9,080	9,200	9,320	9,440
annual change in %	-0.6	0.9	0.2	1.2	1.3	1.3	1.3
Unemployed persons, LFS, th, average ²⁾	449	450	458	450	440	440	430
Unemployment rate, LFS, in %, average ²⁾	4.9	4.9	4.9	4.7	4.6	4.5	4.4
Reg. unemployment rate, in %, eop	1.5	1.1	1.4	1.8	.	.	.
Average monthly gross wages, KZT ³⁾	213,003	250,311	309,697	362,710	410,100	453,800	499,300
annual change in % (real, gross)	6.8	8.8	7.7	2.1	4.2	3.9	3.8
Consumer prices, % p.a.	6.8	8.0	15.0	14.7	8.5	6.5	6.0
Producer prices in industry, % p.a.	-8.0	32.5	27.1	-2.1	3.0	3.0	3.0
General governm. budget, nat. def., % of GDP							
Revenues	20.6	18.9	19.5	20.9	19.5	19.5	19.5
Expenditures	24.5	21.9	21.6	23.3	21.8	21.5	21.5
Deficit (-) / surplus (+)	-4.0	-3.0	-2.1	-2.4	-2.3	-2.0	-2.0
General gov. gross debt, nat. def., % of GDP	30.5	27.6	25.7	24.0	24.0	24.0	24.0
Stock of loans of non-fin. private sector, % p.a.	5.5	26.5	23.3	22.4	.	.	.
Non-performing loans (NPL), in %, eop	6.9	3.3	3.4	2.9	.	.	.
Central bank policy rate, % p.a., eop ⁴⁾	9.00	9.75	16.75	15.75	13.50	10.00	9.00
Current account, EUR m ⁵⁾	-9,601	-2,260	6,709	-8,009	-6,100	-4,100	-1,400
Current account in % of GDP	-6.4	-1.4	3.1	-3.3	-2.3	-1.5	-0.5
Exports of goods, BOP, EUR m ⁵⁾	38,598	55,626	81,432	73,885	75,400	81,500	88,000
annual change in %	-27.4	44.1	46.4	-9.3	2.1	8.1	8.0
Imports of goods, BOP, EUR m ⁵⁾	33,335	35,141	48,151	55,230	59,100	63,300	67,800
annual change in %	-9.2	5.4	37.0	14.7	7.0	7.1	7.1
Exports of services, BOP, EUR m ⁵⁾	4,562	5,018	7,577	9,516	10,000	10,300	10,600
annual change in %	-34.1	10.0	51.0	25.6	5.1	3.0	2.9
Imports of services, BOP, EUR m ⁵⁾	7,398	6,793	9,051	11,192	11,800	12,500	13,200
annual change in %	-28.2	-8.2	33.2	23.7	5.4	5.9	5.6
FDI liabilities, EUR m ⁵⁾	6,312	3,861	4,819	4,906	.	.	.
FDI assets, EUR m ⁵⁾	1,165	2,253	-2,862	2,769	.	.	.
Gross reserves of CB excl. gold, EUR m ⁵⁾	9,827	9,586	13,691	14,893	.	.	.
Gross external debt, EUR m ⁵⁾	133,664	145,248	150,834	147,252	155,000	157,000	157,000
Gross external debt, % of GDP	89.2	87.2	70.4	60.9	59.0	56.0	52.0
Average exchange rate KZT/EUR	471.44	503.88	484.22	493.33	508	518	529

1) Preliminary and wiiw estimates. - 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.

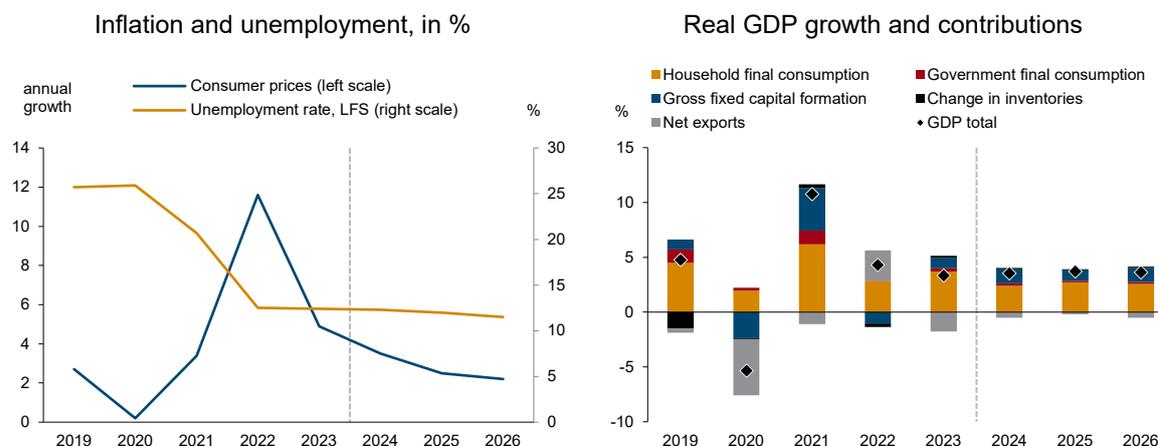


KOSOVO: Economy remaining resilient in the face of heightened regional tension

ISILDA MARA

The risks related to external tensions tend toward the upside. Despite the challenges posed by certain external events, the economy has demonstrated remarkable resilience, achieving a growth rate of 3.4% last year. Household consumption and investment both played a pivotal role in bolstering the economy, and these are expected to continue as the primary drivers of growth in the medium term. Moreover, inflation has receded and that trend is likely to continue in the coming years. In addition, there has been a surge in foreign direct investment specifically targeting renewable energy projects.

Figure 6.10 / Kosovo: Main macroeconomic indicators



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

The economy has successfully weathered the pressure that has arisen in the wake of certain external disagreements. In Q4 2023, GDP growth picked up further to 4% year on year, and 2023 as a whole saw real GDP growth of 3.4%, exceeding our expectations by 0.2 percentage points (pp). That growth was particularly supported by household consumption (which increased by 4%) and by public and private investment (which rose by 3% during the same period).

Household consumption made a significant contribution to GDP growth. Overall, it accounted for 4 pp of real GDP growth, due primarily to buoyant remittances, which surged by 10% to reach EUR 1.3bn (equivalent to 14% of GDP). However, the balance of trade in goods and services was negative, as exports of goods lost momentum while imports continued to rise. The overall net effect of trade on growth was -1.8 pp. Looking ahead to the medium term, we anticipate that growth will accelerate further to 3.5% in 2024 and 3.7% in 2025. Factors that will contribute to this include the easing of inflationary

pressures, improvements in the labour market, rising real wages and the continued support of generous remittances that will cushion consumption.

Apart from public administration, all sectors of the economy made a positive contribution to growth. Notably, the manufacturing, financial, and information and communication technology (ICT) sectors have been driving economic activity. It is particularly relevant to highlight the steady rise in Kosovo of the ICT sector, which is becoming a significant source of employment. According to the Oxford University Online Labour Index (OLI), the number of remote workers per capita is rapidly increasing in Kosovo. In fact, it has outstripped the figures for other Western Balkan and Central and Eastern European countries, such as Albania, Croatia, Slovenia and Slovakia.

Public finances have been further consolidated, although in the medium term public debt is expected to rise once again. Public investment surged significantly in 2023 and is projected to remain at a substantial level this year. Capital expenditure rose by 27%, while 12% of total government expenditure was allocated to public investment. Additionally, wage-related expenses increased by over 15%, suggesting that public-sector wages responded reasonably well to the marked surge in inflation. Overall, the general government budget balance was negative, at -0.3% of GDP, while public debt declined to 17.2% of GDP to rank among the lowest in Europe. However, the government has approved an ambitious budget for 2024, with expenditure due to rise by 14% over 2023. It may prove challenging to achieve a positive budget balance under such circumstances, and public debt could rise again this year and in the medium term.

Further disinflation will continue to be a priority for the government. The great inflationary pressure caused by soaring energy prices posed a challenge for households and businesses in 2023. While electricity imports outstripped exports (resulting in the country remaining a net importer), the energy crisis was managed effectively. In 2024, we anticipate that headline inflation will average 2.5% and will once again be mainly driven by energy and food prices. This judgement is based on the lower core inflation observed during the initial months of the year.

The banking sector performed reasonably well. Lending to households and firms increased by 13% in 2023, while non-performing loans remained at 2%. An emerging issue surrounds the Kosovo Central Bank's decision to introduce a new regulation in December 2023. This aims to define the conditions for cash payment transactions, as well as to establish rules, procedures and obligations for importing and exporting euro banknotes and coins, as well as other currencies. The move has generated significant concern among the authorities in Belgrade and ethnic Serbs in Kosovo. Initially due to have been implemented in February 2024, it has faced stiff opposition from the Serbian authorities: they view it as a move that will have an adverse impact on ethnic Serbs in Kosovo, particularly those who receive financial support from Serbia in Serbian dinars. It is noteworthy that Kosovo did not expressly ban the Serbian dinar: rather, it defined payment methods in euros within Kosovo (given that the euro is the official currency). The new regulation will apply to all foreign currencies, including the Swiss franc, which serves as an essential income source for many Kosovar households (thanks to remittances from family members residing in Switzerland). Kosovo's international partners noted that the decision had not been properly communicated and that more time was needed to allow the affected population to adjust. Accordingly, on 12 February the Central Bank of Kosovo granted a three-month extension, during which time other currencies may continue to be offered in payment.

The economy faces challenges related to low labour market participation and slow labour

productivity growth. Emigration is expected to rise, due to the free visa regime, which came into effect on 1 January 2024 and under which citizens of Kosovo can travel to the EU Schengen area without a visa. This move – which is generally being viewed positively – will have various implications: not only will it encourage Kosovars to travel to the EU, but it will also facilitate their temporary or short-term emigration to the EU (where a large diaspora already resides). Unfortunately, this is likely to have repercussions for the labour market: the emigration of health professionals remains of significant concern, despite government efforts to curb it (by offering higher wages, for example). Moreover, the labour market participation rates of women and young people are among the lowest in the Western Balkans and the EU. To address these challenges, active labour market policies are essential to promote inclusiveness and to meet the needs of vulnerable sections of the population. Remittances continue to play a crucial role as an income source for households. However, this reliance on remittances may inadvertently discourage labour market participation and lead to something akin to ‘Dutch disease’.

The current account has shown some improvement, largely due to better performance in

secondary income and services exports. In 2023, the current account deficit improved to -7.6% of GDP, primarily thanks to a more balanced combination of primary and secondary income. Notably, service exports – particularly those related to tourism – experienced growth. However, it is essential to recognise that trade in goods – especially goods imports – has a significantly negative influence on the current account balance, since Kosovo relies heavily on imports. On the other hand, foreign direct investment (FDI) remained robust. During the second half of 2023, FDI inflows exhibited a promising increase, so that for the year as a whole they expanded by 11%. Notably, new capital flowed in from Austria, Albania, Turkey, Slovenia and Switzerland. Meanwhile German investments saw only modest growth of 2% and US investments declined by 32%. Those sectors that attracted the new foreign capital were primarily financial and insurance activities, manufacturing and energy. The last of these is expected to continue to attract sizeable amounts of FDI, in light of the country’s substantial potential in terms of renewable energy and the government’s strategic initiatives to foster such investments.

Risks related to external tensions tend toward the upside. The relief surrounding the positive news about the resolution of the car-numberplates dispute with Serbia was short lived. The issue surrounding the dinar currency now resembles a nest of Matryoshka dolls, further fuelling the ongoing political tensions between Serbia and Kosovo. This impasse perpetuates the status quo in the Serbia-Kosovo dialogue, which remains deadlocked. There is another significant issue on which there has recently been some development: the row over the four ethnically Albanian mayors who were elected last year in North Kosovo, a region inhabited predominantly by ethnic Serbs. The latter contested the election of the mayors, and the issue became a source of tension that rumbled on throughout 2023. Now 21 April 2024 has been set as the date for referendums on the question of the dismissal of the Albanian mayors. On a positive note, Kosovo has made substantial strides toward its membership of the Council of Europe. In March 2024, the Committee on Political Affairs and Democracy of the Parliamentary Assembly of the Council of Europe (PACE) voted to endorse Kosovo’s application. The next step will involve a vote on a draft opinion regarding Kosovo’s membership, to be taken at a meeting in Strasbourg scheduled for 15-19 April 2024.

Overall, we expect the economy to grow at a rate of 3.7% this year and over the medium term. This growth will be propelled by household consumption, as remittances will remain robust, while real wages will experience an upswing. Additionally, public and private investments are both poised to expand.

Table 6.10 / Kosovo: Selected economic indicators

	2020	2021	2022	2023 ¹⁾	2024	2025	2026
					Forecast		
Population, th pers., average	1,790	1,786	1,768	1,775	1,774	1,772	1,770
Gross domestic product, EUR m, nom.	6,772	7,958	8,896	9,653	10,300	10,900	11,500
annual change in % (real)	-5.3	10.7	4.3	3.3	3.5	3.7	3.6
GDP/capita (EUR at PPP)	7410	8690	9840	10310	.	.	.
Consumption of households, EUR m, nom.	5,718	6,573	7,593	8,072	.	.	.
annual change in % (real)	2.5	7.3	3.4	4.4	2.8	3.2	3.0
Gross fixed capital form., EUR m, nom.	2,012	2,617	2,892	3,049	.	.	.
annual change in % (real)	-7.6	13.0	-3.2	3.0	4.0	3.0	4.0
Gross industrial production ²⁾							
annual change in % (real)	0.8	0.3	0.2	2.5	2.0	3.0	3.0
Gross agricultural production ³⁾							
annual change in % (real)	5.2	-7.7	0.3	2.5	.	.	.
Construction output ⁴⁾							
annual change in % (real)	-9.0	8.8	-3.1	2.0	.	.	.
Employed persons, LFS, th, average ⁵⁾	347.1	383.3	403.8	410.0	430	450	460
annual change in %	-4.4	10.4	5.4	1.5	4.0	4.0	3.0
Unemployed persons, LFS, th, average ⁵⁾	121.4	100.2	58.1	60.0	60	60	60
Unemployment rate, LFS, in %, average ⁵⁾	25.9	20.7	12.5	12.4	12.3	12.0	11.5
Unemployed rate, reg, th, eop ⁶⁾	.	16.1	15.7	8.8	.	.	.
Average monthly gross wages, EUR	466	484	521	610	670	710	750
annual change in % (real, gross)	-2.5	0.4	-3.5	12.0	6.0	4.0	4.0
Average monthly net wages, EUR	416	432	446	520	550	570	590
annual change in % (real, net)	-3.4	0.4	-7.5	11.0	3.0	1.5	1.5
Consumer prices (HICP), % p.a.	0.2	3.4	11.6	4.9	3.5	2.5	2.2
Producer prices, % p.a.	-0.6	4.9	9.3	-3.1	1.0	2.5	2.0
General governm. budget, nat. def., % of GDP							
Revenues	25.4	27.4	27.9	29.4	29.5	29.0	29.0
Expenditures	33.0	28.8	28.4	29.7	30.5	30.0	31.0
Deficit (-) / surplus (+)	-7.6	-1.3	-0.5	-0.3	-1.0	-1.0	-2.0
General gov. gross debt, nat. def., % of GDP	22.0	21.1	19.7	17.2	19.0	19.0	20.0
Stock of loans of non-fin. private sector, % p.a.	7.1	15.4	16.0	12.6	.	.	.
Non-performing loans (NPL), in %, eop	2.7	2.3	2.0	2.0	.	.	.
Central bank policy rate, % p.a., eop ⁷⁾	6.01	5.80	6.29	6.35	6.2	6.0	6.0
Current account, EUR m	-472	-695	-917	-738	-890	-950	-980
Current account, % of GDP	-7.0	-8.7	-10.3	-7.6	-8.6	-8.7	-8.5
Exports of goods, BOP, EUR m	475	753	932	871	880	900	930
annual change in %	20.8	58.4	23.8	-6.5	1.0	2.5	3.0
Imports of goods, BOP, EUR m	3,048	4,320	5,219	5,469	5,630	5,740	5,880
annual change in %	-5.7	41.7	20.8	4.8	3.0	2.0	2.5
Exports of services, BOP, EUR m	995	1,906	2,505	2,966	3,090	3,210	3,310
annual change in %	-40.6	91.6	31.4	18.4	4.3	3.8	3.0
Imports of services, BOP, EUR m	603	871	1,132	1,337	1,380	1,490	1,580
annual change in %	-19.5	44.4	29.9	18.2	3.0	8.0	6.0
FDI liabilities, EUR mn	346	421	732	844	.	.	.
FDI assets, EUR mn	59	100	175	189	.	.	.
Gross reserves of CB excl. gold, EUR m	901	1,100	1,176	1,131	.	.	.
Gross external debt, EUR m	2,502	2,956	3,437	3,848	3,600	3,700	3,900
Gross external debt, % of GDP	37.0	37.1	38.6	39.9	35.0	34.0	34.0

1) Preliminary and wiiw estimates. - 2) Turnover in manufacturing industry (NACE C), wiiw estimate in 2023. - 3) According to Economic Accounts for Agriculture (EAA). - 4) Value added. - 5) Population 15-64. - 6) From 2023 new definition of data collection for unemployed persons. - 7) 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.

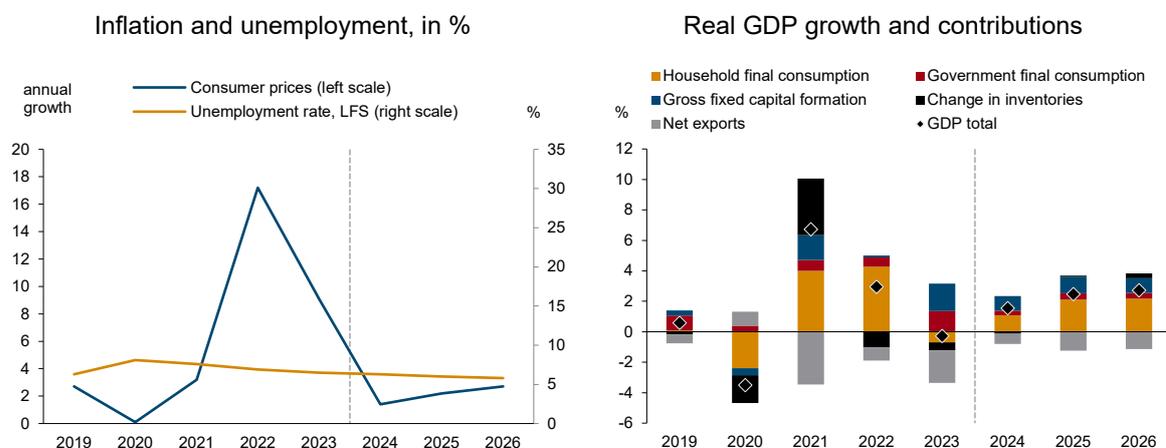


LATVIA: Slight upswing expected, backed by domestic demand

SEBASTIAN LEITNER

While 2023 ended with GDP declining slightly (0.3%), this year will see an upswing of 1.6%. We expect external demand to shrink further, but by less than last year. Lower inflation will result in real wages rising – and accordingly in growth in household consumption. The government plans to further increase public investment in 2024, though private business remains reluctant to expand further. Given the still rather tight labour market, the unemployment rate fell slightly in 2023 – and will do so even more in the coming two years. Assuming that Latvia's trading partners also find their way back on track next year, we expect the economy to pick up, with GDP growth of 2.5% in 2025 and 2.7% in 2026.

Figure 6.11 / Latvia: Main macroeconomic indicators



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

Latvian goods exports are expected to continue to decline for another year – by 0.2% in real terms, following the slump of almost 6% in 2023. The Northern European economies, Latvia's main trading partners, are expected to grow only slowly in 2024. Exports of wood products and building materials generally will continue to falter, since the volume of housing construction in the Scandinavian countries will be much reduced over the coming two years. Moreover, the export of electrical machinery and mineral fuels – two of the country's most important export goods – is on the wane. The transport sector reports declining cargo volumes. Latvian producers are further disentangling themselves from inputs originating in Russia and Belarus: over the course of 2023, imports from those two countries almost halved. Exports to Russia are also declining; however, re-exporting to that country and to Belarus is still an important business. Given the anticipated upswing in household consumption, goods and services imports are expected to increase again this year in real terms. Since import prices are likely to

drop more sharply this year, we expect the current account deficit to continue to fall from the 4% of GDP seen last year to slightly above 3% in 2024.

Latvia was among the EU countries worst affected by inflation over the past two years, due to escalating energy and commodity prices; however, now prices are stagnating. In February 2024, consumer price inflation (CPI) increased by only 0.4% year on year. While our central scenario is that CPI will fall to 1.4% in 2024 on average, there are downside risks of consumer price deflation, since producer and import prices are sliding.

The substantial drop in inflation will result in a revival of household incomes, and we expect real wages to increase by 6.5% in 2024. In January 2024, the government increased the statutory minimum wage by a further 13% (to EUR 700 a month), following a hike of 24% in 2023. This will help lower-income groups maintain their consumption levels. Retail trade, which declined in 2023, had stabilised by the beginning of 2024. With increased purchasing power, we expect households to boost their consumption again gradually this year – and even more so in 2025.

Although economic growth will revive this year, employment is still likely to stagnate in 2024. The decline in industrial production has resulted in the number of manufacturing jobs falling slightly. Bigger falls are reported for both wholesale and retail trade. In business services, however, the steady growth in jobs is continuing. Job vacancy rates are continuing to decrease – though only slightly in recent months. We expect the unemployment rate to rise by only a little in 2024, and then to fall again gradually next year.

Public investment will further push growth in 2024, while private entrepreneurs remain reluctant to expand capacity. The budget envisages a rise in public investment from 4.8% to 6.3% of GDP this year: alongside rail and road infrastructure, the Recovery and Resilience Facility funds are being used to develop electricity grids, undertake additional energy projects and digitalise the economy. Moreover, defence and security are government functions that have been allocated far more resources in the wake of Russia's war in Ukraine. Loan statistics show that the increase in interest rates by the European Central Bank (ECB) has resulted in Latvian entrepreneurs reducing their stock of debt. Following substantial growth in construction output in 2023, recent figures on the number of building permits granted and construction started suggest that investment in real estate will grow much less in the medium term – and may even decline.

The government deficit is likely to attain 3.2% of GDP in 2024, slightly higher than last year. Apart from substantially greater public investment and increased defence spending (to as much as 3% of GDP in 2025), the government will considerably raise the salaries of teachers (in particular). Should the economic upswing materialise, a decline in the fiscal deficit to close to 2.3% of GDP is likely towards 2026. In general, the government envisages higher expenditure in the medium term, and thus also increased government revenue – to close to 40% of GDP. This should allow welfare expenditure to be maintained, while at the same time covering the cost of the war in the neighbourhood.

All in all, we have kept our forecast for GDP growth for 2024 unchanged at 1.6%. According to the baseline scenario, GDP growth will pick up to 2.5% in 2025 and 2.7% in 2026. This scenario assumes that the ECB will realise the potential danger if inflation should fall further, and lowers its interest rates accordingly. That would stimulate private investment and could boost employment and household consumption.

Table 6.11 / Latvia: Selected economic indicators

	2020	2021	2022	2023 ¹⁾	2024	2025	2026
					Forecast		
Population, th pers., average	1,900	1,884	1,879	1,880	1,885	1,880	1,875
Gross domestic product, EUR m, nom.	30,110	33,349	38,386	40,348	41,500	43,500	45,900
annual change in % (real)	-3.5	6.7	3.0	-0.3	1.6	2.5	2.7
GDP/capita (EUR at PPP)	21,540	23,210	25,420	26,640	.	.	.
Consumption of households, EUR m, nom.	16,805	18,645	22,741	24,269	.	.	.
annual change in % (real)	-4.2	7.2	7.7	-1.2	1.8	3.5	3.6
Gross fixed capital form., EUR m, nom.	6,752	7,461	8,453	9,730	.	.	.
annual change in % (real)	-2.2	7.2	0.6	8.2	4.0	4.5	4.0
Gross industrial production ²⁾							
annual change in % (real)	-1.4	6.6	0.9	-5.9	-1.0	4.0	4.0
Gross agricultural production							
annual change in % (real)	4.9	-10.2	2.1	-6.3	.	.	.
Construction industry							
annual change in % (real)	2.7	-6.1	-11.4	19.0	.	.	.
Employed persons, LFS, th, average ³⁾	893.0	869.5	891.2	889.9	892	895	898
annual change in %	-1.9	-3.0	2.5	-0.1	0.2	0.3	0.3
Unemployed persons, LFS, th, average ³⁾	78.7	70.6	65.2	61.5	60	57	55
Unemployment rate, LFS, in %, average ³⁾	8.1	7.6	6.9	6.5	6.3	6.0	5.8
Reg. unemployment rate, in %, eop ⁴⁾	7.7	6.7	6.1	5.7	.	.	.
Average monthly gross wages, EUR	1,143	1,277	1,373	1,537	1,670	1,810	1,930
annual change in % (real, gross)	6.0	8.2	-8.3	2.8	7.0	6.0	4.0
Average monthly net wages, EUR	841	939	1,006	1,119	1,210	1,300	1,380
annual change in % (real, net)	5.8	8.1	-8.7	2.2	6.5	5.5	3.5
Consumer prices (HICP), % p.a.	0.1	3.2	17.2	9.1	1.4	2.2	2.7
Producer prices in industry, % p.a.	-2.0	13.3	32.9	-0.5	-2.0	2.0	4.0
General governm. budget, EU def., % of GDP							
Revenues	38.0	37.5	36.3	39.0	38.0	37.5	37.3
Expenditures	42.5	44.7	40.9	42.0	40.8	39.8	39.3
Net lending (+) / net borrowing (-)	-4.5	-7.2	-4.7	-3.0	-2.8	-2.3	-2.0
General gov. gross debt, EU def., % of GDP	42.2	44.0	41.5	41.0	41.5	41.0	40.0
Stock of loans of non-fin. private sector, % p.a.	-3.8	3.2	7.1	0.7	.	.	.
Non-performing loans (NPL), in %, eop ⁵⁾	3.1	2.5	2.3	2.4	.	.	.
Central bank policy rate, % p.a., eop ⁶⁾	0.00	0.00	2.50	4.50	.	.	.
Current account, EUR m	875	-1,312	-1,833	-1,618	-1,300	-2,000	-2,600
Current account, % of GDP	2.9	-3.9	-4.8	-4.0	-3.1	-4.6	-5.7
Exports of goods, BOP, EUR m	13,448	16,213	20,740	18,332	18,100	18,600	19,300
annual change in %	5.4	20.6	27.9	-11.6	-1.3	2.8	3.8
Imports of goods, BOP, EUR m	14,994	18,970	24,833	22,069	21,700	23,000	24,800
annual change in %	-2.6	26.5	30.9	-11.1	-1.7	6.0	7.8
Exports of services, BOP, EUR m	4,842	5,326	7,241	7,513	7,400	7,600	8,300
annual change in %	-13.3	10.0	36.0	3.8	-1.5	2.7	9.2
Imports of services, BOP, EUR m	2,905	3,621	4,908	5,332	5,200	5,400	5,800
annual change in %	-7.9	24.6	35.5	8.6	-2.5	3.8	7.4
FDI liabilities, EUR m	826	3,166	1,120	1,386	.	.	.
FDI assets, EUR m	171	2,338	-105	804	.	.	.
Gross reserves of CB excl. gold, EUR m	3,982	4,504	3,819	4,088	.	.	.
Gross external debt, EUR m	36,763	36,854	39,270	39,728	39,000	39,600	40,400
Gross external debt, % of GDP	122.1	110.5	102.3	98.5	94.0	91.0	88.0

Note: Introduction of new index 2021=100 (new weights) for gross industrial production and producer prices in industry.

1) Preliminary and wiiw estimates. - 2) Enterprises with 20 and more employees. - 3) From 2021 new LFS methodology 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.

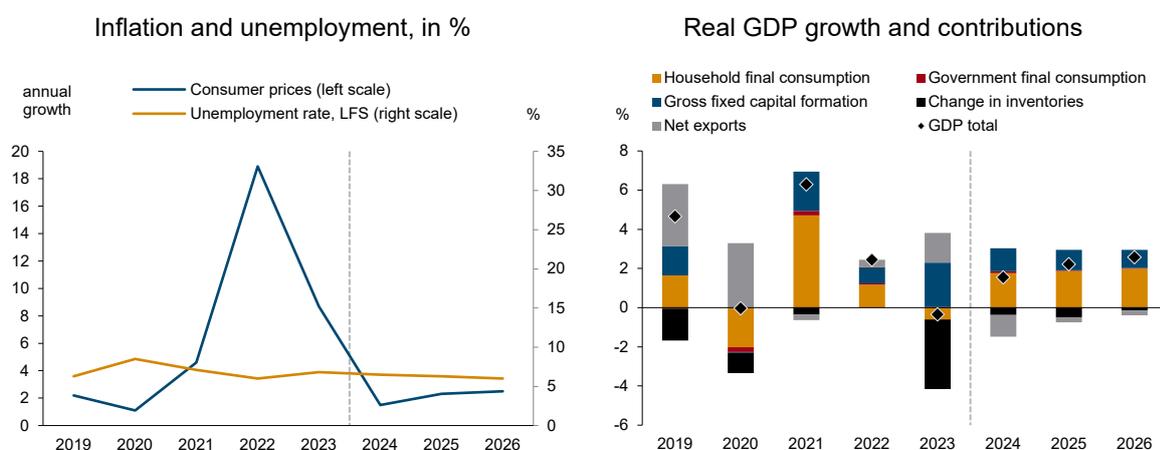


LITHUANIA: End of stagnation, but only a restrained upswing in sight

SEBASTIAN LEITNER

The economy performed worse than expected in 2023, with GDP declining by 0.3%. With the substantial fall in inflation, real incomes had already started to pick up by the end of last year and will continue to do so in 2024; this will support household consumption. Despite the stagnation, the labour market remains robust, and unemployment is likely to decline further. Private investment activity is ailing, since external demand is in the doldrums; meanwhile the government will further raise infrastructure investment. We expect real GDP to increase by 1.6% in 2024; this will be followed by a modest acceleration to 2.2% in 2025 and thereafter to 2.6% in 2026.

Figure 6.12 / Lithuania: Main macroeconomic indicators



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

Exports declined substantially last year, and we can foresee no substantial upswing in 2024. In particular, exporters of chemicals, plastics, furniture and mineral products are suffering at the moment, and those industries have already cut back on staff. The still sluggish EU-wide economic growth is likely to result in an almost stagnant Lithuanian manufacturing sector this year. Lithuania is continuing to disentangle itself economically from Russia, but still that neighbouring country is Lithuania's fourth most important trade partner in terms of exports (imports from Russia have become negligible). 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 faster than expected, which will support the growth in household income and consumption towards H2 2024. In 2023, an inflation rate of close to 9% resulted in real net incomes growing by no more than 2.3%. However, by March 2024 the inflation rate had declined to 0.3% year on year. At the moment, we see the cost of housing and energy plummeting; the price of foodstuffs stagnating; and the cost of hospitality and other services rising sharply. Overall, in 2024 consumer price inflation (CPI) is expected to average 1.5%, resulting in a 6.5% growth in real net incomes. This will bolster household consumption in the second half of the year. In order to maintain the purchasing power of low earners, the government has introduced a 10% rise in the minimum wage from January 2024. In addition, public pensions and the wages of public-sector employees are to rise steeply this year. Moreover, the net income of low-wage earners has been bolstered by a 20% rise in the non-taxable income threshold. Given the anticipated upswing in GDP growth in 2025, we expect the CPI to rise again next year, but to remain close to the European Central Bank (ECB) target of 2%.

Investment in public infrastructure will again be a strong driver of GDP growth in 2024. Using EU funds (including the NextGenerationEU recovery package), the largest chunk of public investment will be devoted to the green transformation, which comprises renewable energy projects including power plants and the renovation of old multi-apartment buildings. Furthermore, greater outlays are planned for rail and road building and maintenance, as well as for research and innovation, health care and digital transformation.

Business sentiment has not yet recovered, which suggests that an upswing in private investment will take longer than expected, particularly in industry. Disappointing developments in the main export destinations within the EU are placing a strain on confidence in all sectors, apart from retail trade. Businesses are running down their stocks and investment plans are being revised downwards. Until the ECB also starts to cut its interest rates, households will refrain from greater investment in dwellings. The rise in interest rates has brought about an additional burden on households, but the rate of non-performing loans has not increased. The figures for construction permits granted suggest that fewer residential and commercial buildings will be erected in the medium term. We expect only a slow revival of private investment towards the end of this year and in 2025.

High inflation brought extra revenue into the government budget in 2023, resulting in a budget deficit of a mere 0.8% of GDP – despite the economic stagnation. Since the government plans to increase both investment and social benefits, and since inflation is falling (and with it the tax revenue), the budget deficit will be somewhat higher in 2024, at 2.5%.

Despite the economic stagnation, employment increased in 2023 by 1.4%. And it is expected to continue to grow this year, albeit at a lower rate. The substantial influx of Ukrainian refugees (12,000 in 2023) offers a considerable additional supply of well-educated workers. More than two thirds of the Ukrainian population in Lithuania are reported to be in employment. Looking at overall employment by sector, jobs in manufacturing are stagnating, while the service sector is still seeking additional personnel. Although the economy is projected to grow only slowly this year, the unemployment rate will likely even decrease slightly, to 6.5% on average. In the following two years we expect unemployment to fall back to 6%.

Considering the continued low external demand and the weakness of private-sector investment, we have kept our growth forecast for 2024 almost unchanged at 1.6%. Otherwise, we have slightly altered our baseline scenario for the coming two years, in expectation of a more rapid upswing. GDP growth will pick up in 2025 to 2.2%, and then to 2.6% in 2025. Nevertheless, much will depend on the dynamics of the war in Ukraine and on how economic activity evolves in Western Europe – and in the Scandinavian countries, in particular. The latter will also be influenced by the coming decision of the ECB on interest rate cuts.

Table 6.12 / Lithuania: Selected economic indicators

	2020	2021	2022	2023 ¹⁾	2024	2025	2026
					Forecast		
Population, th pers., average	2,795	2,801	2,832	2,887	2,915	2,920	2,920
Gross domestic product, EUR m, nom.	49,873	56,478	67,437	71,986	74,200	77,600	81,600
annual change in % (real)	0.0	6.3	2.4	-0.3	1.5	2.2	2.6
GDP/capita (EUR at PPP)	26,300	29,190	31,650	32,560	.	.	.
Consumption of households, EUR m, nom.	28,626	32,410	39,227	42,168	.	.	.
annual change in % (real)	-3.4	8.2	2.0	-1.0	3.0	3.2	3.4
Gross fixed capital form., EUR m, nom.	10,664	12,259	14,432	16,768	.	.	.
annual change in % (real)	-0.2	9.4	3.6	10.6	5.0	4.5	4.0
Gross industrial production (sales)							
annual change in % (real)	0.2	20.5	9.1	-6.4	1.0	5.0	5.0
Gross agricultural production							
annual change in % (real)	10.3	-4.5	8.1	-2.4	.	.	.
Construction industry							
annual change in % (real)	-1.6	4.6	4.6	12.6	.	.	.
Employed persons, LFS, th, average ²⁾	1,358	1,369	1,421	1,441	1,450	1,460	1,470
annual change in %	-1.5	0.8	3.8	1.4	0.8	1.0	1.0
Unemployed persons, LFS, th, average ²⁾	126	105	90	106	101	98	94
Unemployment rate, LFS, in %, average ²⁾	8.5	7.1	6.0	6.8	6.5	6.3	6.0
Reg. unemployment rate, in %, eop ³⁾	16.1	10.2	8.9	9.1	.	.	.
Average monthly gross wages, EUR ⁴⁾	1,429	1,579	1,789	2,014	2,180	2,360	2,580
annual change in % (real, gross)	8.9	5.6	-5.4	3.2	6.8	6.0	6.5
Average monthly net wages, EUR ⁴⁾	913	1,002	1,121	1,249	1,350	1,460	1,590
annual change in % (real, net)	9.8	4.8	-6.5	2.1	6.5	5.8	6.0
Consumer prices (HICP), % p.a.	1.1	4.6	18.9	8.7	1.5	2.3	2.5
Producer prices in industry, % p.a.	-8.9	9.5	26.1	-2.4	-1.5	1.0	3.0
General governm. budget, EUdef., % of GDP							
Revenues	36.2	36.3	35.7	37.0	36.0	36.0	36.0
Expenditures	42.7	37.4	36.3	38.0	38.5	38.5	38.3
Net lending (+) / net borrowing (-)	-6.5	-1.1	-0.7	-1.0	-2.5	-2.5	-2.3
General gov. gross debt, EU def., % of GDP	46.2	43.4	38.1	39.0	39.5	39.0	38.0
Stock of loans of non-fin. private sector, % p.a.	-1.6	13.2	14.0	5.4	.	.	.
Non-performing loans (NPL), in %, eop	1.3	0.7	0.5	0.6	.	.	.
Central bank policy rate, % p.a., eop ⁵⁾	0.00	0.00	2.50	4.50	.	.	.
Current account, EUR m	3,633	641	-3,687	1,397	1,600	2,200	2,000
Current account, % of GDP	7.3	1.1	-5.5	1.9	2.2	2.8	2.5
Exports of goods, BOP, EUR m	25,536	31,648	41,126	36,343	36,200	38,300	41,000
annual change in %	-1.6	23.9	29.9	-11.6	-0.4	5.8	7.0
Imports of goods, BOP, EUR m	25,940	34,544	48,469	41,165	41,000	43,000	45,500
annual change in %	-8.3	33.2	40.3	-15.1	-0.4	4.9	5.8
Exports of services, BOP, EUR m	10,921	13,571	17,408	20,162	20,000	21,000	22,300
annual change in %	-8.0	24.3	28.3	15.8	-0.8	5.0	6.2
Imports of services, BOP, EUR m	5,886	8,137	11,419	12,575	12,300	12,800	14,300
annual change in %	-14.9	38.2	40.3	10.1	-2.2	4.1	11.7
FDI liabilities, EUR m	4,002	2,534	634	2,940	.	.	.
FDI assets, EUR m	3,438	1,286	-1,072	2,141	.	.	.
Gross reserves of CB excl. gold, EUR m	3,662	4,626	4,715	5,252	.	.	.
Gross external debt, EUR m	40,233	44,565	45,565	49,233	47,500	48,100	50,600
Gross external debt, % of GDP	80.7	78.9	67.6	68.4	64.0	62.0	62.0

Note: Introduction of new index 2021=100 (new weights) for gross industrial production and producer prices in industry.

1) Preliminary and wiiw estimates. - 2) From 2021 new LFS methodology 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.

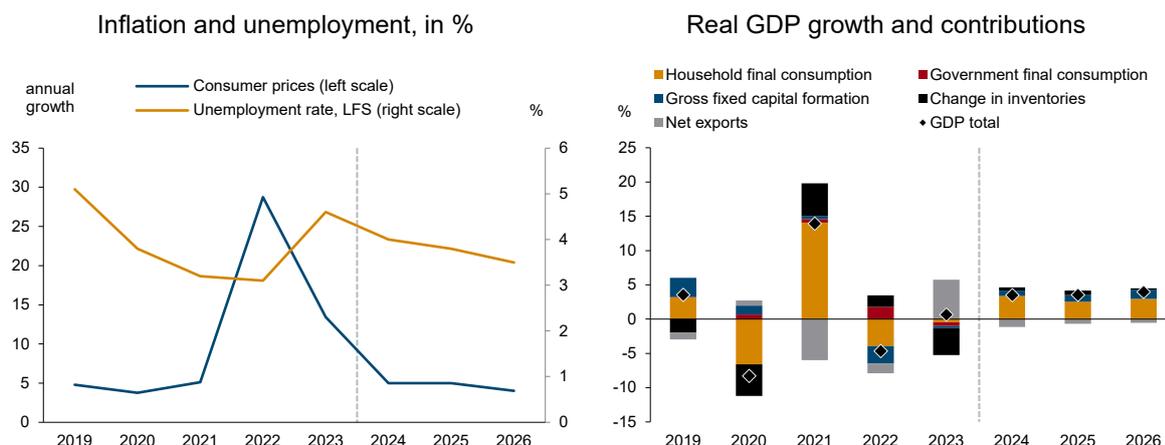


MOLDOVA: Prospects improving amidst considerable political risk

GÁBOR HUNYA

Economic growth will pick up to 3.5% in 2024, following a very modest showing of 0.7% last year. Inflation will stabilise at a low level, allowing for monetary policy to be loosened. The current account and fiscal deficits will remain relatively high, but multinational institutions will provide a stable source of financing. The Europe-oriented leadership will be challenged in October in a presidential election and a referendum on EU membership. Russia’s subversive activities and domestic oligarchic interests support a strong opposition.

Figure 6.13 / Moldova: Main macroeconomic indicators



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

GDP grew by only 0.7% in 2023, following a sharp decline the previous year. This weak growth highlighted the country’s inability to fully digest the shocks inflicted by the war in neighbouring Ukraine, the high inflation and trade reorientation. Consumption – both private and public – fell for the second year in a row, as did investment. Net exports constituted the only positive component of GDP growth, although both nominal exports and imports were lower than the previous year.

There have been signs of a recovery since mid-2023. After negative year-on-year growth in the first two quarters, Q3 2023 brought a remarkable upswing, thanks to a good harvest. But the Q4 results were disappointing, with only 0.2% growth, mainly due to contracting public consumption. At the same time, inflation subsided, allowing household consumption and investments to recover, while exports grew ahead of imports. Private investment was still weak and housing construction did not pick up. But

corporate investment in machinery and equipment took off and the credit market recovered, benefiting from lower interest rates.

Industrial production was down 4.2% in 2023, though it did start to recover in Q4. The production of machinery, electrical equipment and pharmaceuticals grew strongly, indicating a structural shift to higher-skilled products. Still, the bulk of the output and of exports could be chalked up to the food industry, as well as to unprocessed agricultural products. Moldova's products benefit from free access to EU markets, and no quantitative restrictions apply to any of its agricultural products. The extent to which the country is able to benefit from these concessions depends greatly on weather conditions.

A contraction in demand and aggressive monetary tightening brought inflation down in 2023. The annual rate fell from 34.6% in January to 4.3% in December – where it remained for the first two months of the current year. This is below the national bank target and is almost on a par with the policy rate of 4.25%. There is no inflationary threat on the horizon, and so monetary policy can remain loose. Further disinflation is not likely, however, as demand picks up and agricultural input prices stay high.

Disposable real income has still not reached the level it stood at in 2021. But there has been some movement in the right direction, as real wages increased rapidly in Q4 2023 on the back of falling inflation and rising nominal wages. Real wage growth will remain modest in the future, given the abundant supply of labour.

Since the outbreak of the war in Ukraine, there has been a rise in the number of both employed and unemployed people. Some who had been working in either neighbouring Ukraine or in Russia returned home, while others arrived as refugees and entered the labour market. Still, Moldova has remained a country of strong net emigration. According to the World Bank, it receives remittances that total 14% of GDP. In a new development, remittances are now also sent abroad from Moldova in an amount equivalent to 3% of GDP.

The twin deficit of the current account and the general budget has been something of feature of Moldova's economy. The current account deficit shrank to about 8% of GDP in 2023 (from 11% the previous year), while the fiscal deficit widened to 5.2% of GDP (from 3.2%). The inflow of funds from multinational and bilateral institutional donors has allowed for smooth financing of the public sector. The International Monetary Fund is not putting any pressure on the country to introduce an immediate stabilisation policy. Donors also back investment in energy efficiency, infrastructure development and the modernisation of agriculture. Further support is provided to strengthen public institutions and the rule of law. Donors have reported progress in most areas.

The positive trends that emerged in the final months of 2023 will continue in 2024. A revival in consumption and investment on the back of low inflation will support economic growth. International financial institutions will keep the country afloat, just as in the past. But transfers will not be so lavish as to provide a serious boost to economic performance. Nor will the country's absorption capacity and institutional readiness facilitate a jump-start. Under the present circumstances, GDP will grow by about 3.5% in 2024, assuming flat agricultural output under average weather conditions. It should be noted, however, that the weather can affect GDP – either to its benefit or its detriment – by as much as 2 percentage points.

As a country that is catching up from a very low level, Moldova should be in a position to achieve stronger growth in the future; however, the catch-up has been hampered by unfavourable political conditions, both external and internal. Russia has intensified its hybrid-war activities, and the conflict with the breakaway region of Transnistria heats up from time to time. The government has taken steps to shield the population against misinformation and has closed several channels of Russian influence. There are also powerful domestic oligarchs and organisations challenging the European orientation of the country. A popular slogan of the opposition contends that neutrality should mean maintaining equidistance from East and West.

The president and the government do not have the overwhelming majority of the population on their side. A presidential election is scheduled for October of this year, together with a referendum on joining the European Union.¹⁸ Had the presidential election been held in mid-March, the presidential incumbent, Maia Sandu, would have gained only about a third of the votes cast in the first round. According to current polls, only a slim majority of electors is in favour of the country's European orientation, but President Sandu will be hoping to pick up their votes in the second round of the election. Should she fail to do so, the country will in all likelihood renounce its European ambitions. In that case, Moldova would receive less Western support, while Russia's backing may not prove adequate. That would translate into slower economic growth in the coming years.

¹⁸ Moldova was granted EU candidate status in 2022; in November 2023, the EU Commission recommended that the European Council open accession negotiations.

Table 6.13 / Moldova: Selected economic indicators

	2020	2021	2022	2023 ¹⁾	2024	2025	2026
					Forecast		
Population, th pers., average	2,635	2,596	2,539	2,580	2,560	2,530	2,500
Gross domestic product, MDL bn, nom.	199.7	242.1	274.5	300.4	327	349	377
annual change in % (real)	-8.3	13.9	-4.6	0.7	3.5	3.5	4.0
GDP/capita (EUR at PPP)	8,200	10,020	10,430	10,510	.	.	.
Consumption of households, MDL bn, nom.	162.2	199.6	230.3	252.7	.	.	.
annual change in % (real)	-7.9	17.3	-4.8	-0.5	4.0	3.0	3.5
Gross fixed capital form., MDL bn, nom.	49.8	58.3	60.7	59.0	.	.	.
annual change in % (real)	5.6	1.9	-10.5	-1.3	4.0	5.0	7.0
Gross industrial production							
annual change in % (real)	-5.5	12.1	-5.1	-3.6	3.0	5.0	5.0
Gross agricultural production							
annual change in % (real)	-27.2	57.9	-29.2	23.6	.	.	.
Construction industry							
annual change in % (real)	11.8	4.7	-15.1	-2.5	.	.	.
Employed persons, LFS, th, average ²⁾	834.2	843.4	862.3	886.9	900	910	920
annual change in %	-4.4	1.1	2.2	2.8	2.0	1.0	1.0
Unemployed persons, LFS, th, average ²⁾	33.1	28.2	27.7	42.6	40	40	30
Unemployment rate, LFS, in %, average ²⁾	3.8	3.2	3.1	4.6	4.0	3.8	3.5
Reg. unemployment rate, in %, eop	2.9	2.3	2.4	1.0	.	.	.
Average monthly gross wages, MDL	7,943	8,980	10,447	12,259	13,400	14,500	15,500
annual change in % (real, gross)	5.8	7.6	-9.6	3.5	4.0	3.0	3.0
Average monthly net wages, MDL	6,617	7,635	8,900	10,200	11,100	12,000	12,900
annual change in % (real, net)	6.1	9.8	-9.5	1.0	4.0	3.0	3.0
Consumer prices, % p.a.	3.8	5.1	28.7	13.4	5.0	5.0	4.0
Producer prices in industry, % p.a.	2.6	8.5	26.7	12.6	3.0	3.0	3.0
General governm. budget, nat. def., % of GDP							
Revenues	31.4	32.0	33.3	34.1	35.0	35.0	35.0
Expenditures	36.7	33.9	36.6	39.2	39.0	38.5	38.0
Deficit (-) / surplus (+)	-5.3	-1.9	-3.2	-5.2	-4.0	-3.5	-3.0
General gov. gross debt, nat. def., % of GDP	34.2	32.6	35.0	36.0	36.0	35.0	35.0
Stock of loans of non-fin. private sector, % p.a.	13.2	22.6	8.5	3.0	.	.	.
Non-performing loans (NPL), in %, eop ³⁾	7.4	6.1	6.4	5.6	.	.	.
Central bank policy rate, %, p.a., eop ⁴⁾	2.65	6.50	20.00	4.75	4.50	4.00	4.00
Current account, EUR m ⁵⁾	-778	-1436	-2358	-1825	-1,590	-1,550	-1,460
Current account, % of GDP	-7.7	-12.4	-17.1	-11.9	-9.7	-8.9	-8.1
Exports of goods, BOP, EUR m ⁵⁾	1,706	2,165	3,516	3,167	3,330	3,560	3,760
annual change in %	-9.8	26.9	62.4	-9.9	5.1	6.9	5.6
Imports of goods, BOP, EUR m ⁵⁾	4,420	5,706	8,449	7,686	7,920	8,330	8,620
annual change in %	-8.9	29.1	48.1	-9.0	3.0	5.2	3.5
Exports of services, BOP, EUR m ⁵⁾	1,121	1,381	2,165	2,256	2,480	2,810	3,070
annual change in %	-18.7	23.2	56.7	4.2	9.9	13.3	9.3
Imports of services, BOP, EUR m ⁵⁾	772	982	1,302	1,437	1,520	1,650	1,750
annual change in %	-26.7	27.3	32.6	10.3	5.8	8.6	6.1
FDI liabilities, EUR m ⁵⁾	137	326	557	386	.	.	.
FDI assets, EUR m ⁵⁾	3	12	43	1	.	.	.
Gross reserves of CB excl. gold, EUR m ⁵⁾	3,079	3,442	4,202	4,899	.	.	.
Gross external debt, EUR m ⁵⁾	6,591	7,719	9,018	9,411	10,100	11,000	11,500
Gross external debt, % of GDP	65.1	66.7	65.4	61.5	62.0	63.0	64.0
Average exchange rate MDL/EUR	19.74	20.93	19.90	19.64	20.0	20.0	21.0

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

1) Preliminary and wiiw estimates. - 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.

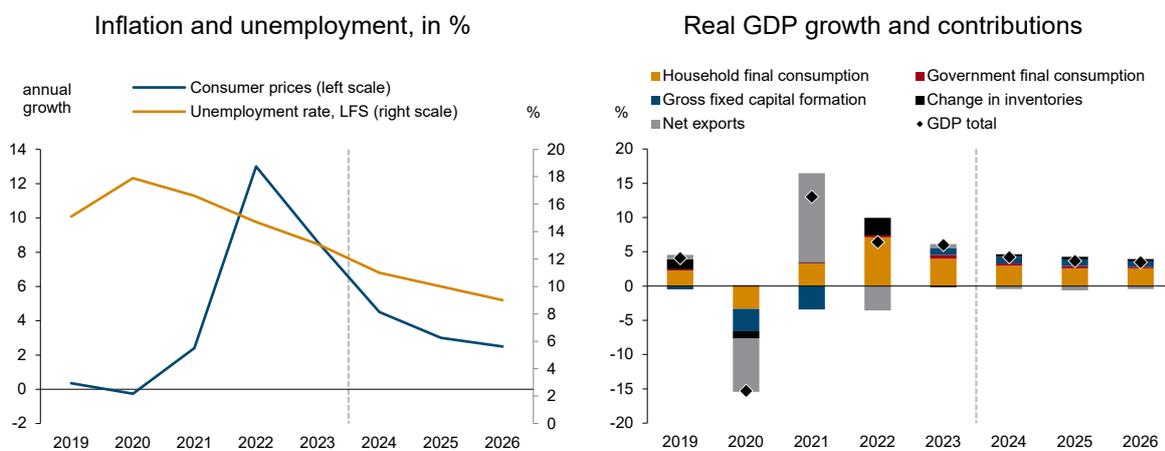


MONTENEGRO: EU integration hopes at an all-time high

MARKO SOŠIĆ

Amidst political turmoil, Montenegro managed in 2023 to achieve considerable growth of 6%. This owed much to a record tourist season, the influx of Russian and Ukrainian immigrants and improvements on the labour market. Starting as it does from such a high base, 2024 will likely see a slowing of growth to 4.2%. A range of cross-cutting reforms aimed at increasing salaries and pensions is likely to boost consumption; but it will also place a strain on public finances. EU integration is back on the agenda of both the government and the EU. However, political stability may be tested during the planned government reshuffle in 2024.

Figure 6.14 / Montenegro: Main macroeconomic indicators



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

Montenegro's economy grew by 6% in 2023 – the highest growth rate in CESEE for the second year in a row. This owed much to the strong (and extended) tourist season, the large influx of immigrants (mostly from Ukraine and Russia), the increase in public-sector wages and record employment rates. Growth is expected to moderate to 4.2% in 2024; it will be driven by private consumption and service exports, along with investment in tourism and the energy sector.

The outlook for 2024 is rather overshadowed by the 'Europe Now 2' programme, which has been announced. The new government swept to power on a promise to implement an ambitious agenda in 2024, with an increase in pensions and in the minimum and average salary, and with full employment – all while reducing working hours. However, the programme has been controversial both because of its overly ambitious promises and because no detailed analysis or roadmap for its implementation exists,

beyond the public statements of officials. Not even the International Monetary Fund Article IV mission was given sight of the programme as a coherent document. One way to achieve the promises could involve cutting the obligatory pension contributions, with the state taking over funding of the pension fund; but that would come at significant fiscal cost. Even though Q2 2024 is already under way, the government has yet to publish its annual agenda or fiscal strategy.

Average real net wages rose by 2.4% in 2023. The growth in wages generally is expected to continue in 2024, assuming the electoral promises of the Europe Now! party are fulfilled. At the same time, the government is hoping to tame the rapid growth in public-sector wages (35% higher in 2024 than in 2020) and their impact on public finances. Over the last four years, frequent changes to legislation and hastily signed new collective-bargaining agreements with the civil service trade unions have led public-sector wages to grow rapidly and haphazardly; 2024 should be the year when the government responds to this issue.

The unemployment rate reached a historic low of 13.1% in 2023 and is expected to fall further during 2024. This was a result of implementation of the 'Europe Now 1' programme and such measures as abolishing the mandatory health contribution and raising the non-taxable wage threshold; these steps have boosted employment. The extended tourist season also helped, as did the country's demographic decline. We expect these trends to continue in 2024 and unemployment to decline further to 11%.

Public investment is likewise expected to support growth in 2024. This includes the continuation of the Bar-Boljare highway with the support of the European Bank for Reconstruction and Development and the Western Balkans Investment Framework, as well as a range of other infrastructure projects. All this will be coupled with structural reforms in the way public infrastructure projects are managed.

Foreign direct investment (FDI), the dominant identifiable source of financing of the current account, saw a significant decline in 2023. After a very successful 2022, when FDI accounted for 14% of GDP, in 2023 the figure was almost half that – just 7.1% of GDP. Notably, EU FDI fell by more than a half. Despite the decline, FDI in Montenegro relative to GDP remains among the highest in the whole of Europe.

Average inflation fell to 8.6% in 2023, from its 2022 peak of 17.2%, and is expected to continue to decline in 2024. The latest available data show that inflation had dropped to 4.3% in February but rose back to 5.5% in March. In an effort to rein it in even further, in March 2024 the government imposed limits on the profit margins of over 500 consumer products (although the impact of these and similar measures implemented in the past has been restricted). Factors such as strong consumer spending, low domestic food production, and the significant market power of food and trade businesses are likely to exert upward pressure on prices. Consequently, our forecast for 2024 sees inflation likely to average around 4.5%.

The minimum pension has been increased by over 50% from January 2024, as part of the new government's welfare programme. This has raised pensions for more than a third of pension beneficiaries. Further reforms are planned for later in the year to boost other pensions. While this is likely to support consumption and economic activity, it will place a further strain on the pension fund and require the establishment of new sources of funding.

The management of public debt could become challenging in 2024. Total government debt (without deposits) at the end of 2023 amounted to 59% of GDP. During the fourth quarter of the year, there was an increase in the debt: new bonds were issued and credit arrangements were concluded with domestic commercial banks to finance the budget deficit. In early 2024, the government raised USD 750m (around 10% of GDP) from its first US dollar bond issue. The seven-year bond will refinance some of Montenegro's previous bonds and debts that mature in 2024 and 2025, and which amount to over EUR 1.2bn. Especially in the area of public-sector wages and welfare, the increase in public spending that stems both from previous decisions and from undertakings that have been announced for later in the year will increase the government's reliance on loans to finance current spending.

EU integration is back on the agenda in the country. In just a short period of time, several important issues that were blocking the integration process have been resolved, mainly concerning appointments to the judiciary. Intensive efforts are being made to secure a positive Interim Benchmark Assessment Report (IBAR) from the European Commission regarding the *acquis* fundamentals cluster. Success in this would provide an opportunity to start closing off other chapters, and the EU membership perspective would be greatly invigorated if the Council of the EU were to approve the next stage in the accession process in June 2024, after the expected intergovernmental conference. However, a government reshuffle that has been announced (with the goal of including more parties) and that is due to take place after the IBAR decision, could give rise to another period of political instability.

The favourable economic trends of 2023 were, in part, fuelled by a large influx of immigrants and foreigners to Montenegro, which had a major effect on private consumption, tourism, the real estate sector, banking parameters and employment. According to the Ministry of Interior, around 96,000 foreigners were residing in Montenegro at the end of 2023 – equivalent to 15% of the country's population. The number is heavily dependent on the geopolitical situation, but is expected to decline in 2024; meanwhile, the effect of the foreigners on the economy may already be waning, if the early 2024 indicators (such as the stabilisation of prices in the real estate sector) are to be trusted.

A population census was held in December 2023, after much political wrangling about its transparency and accuracy. The preliminary results indicate a 2.5% increase in the population since 2011. The final results (with a distinction drawn between actual citizens and foreigners or non-residents) will be published by June 2024.

Table 6.14 / Montenegro: Selected economic indicators

	2020	2021	2022	2023 ¹⁾	2024	2025	2026
					Forecast		
Population, th pers., average	621	619	617	615	613	611	609
Gross domestic product, EUR m, nom.	4,186	4,955	5,924	6,847	7,500	8,000	8,500
annual change in % (real)	-15.3	13.0	6.4	6.0	4.2	3.7	3.5
GDP/capita (EUR at PPP)	13,420	15,460	17,580	19,020	.	.	.
Consumption of households, EUR m, nom. ²⁾	3,400	3,617	4,424	5,037	.	.	.
annual change in % (real)	-4.6	4.1	9.7	5.4	4.0	3.5	3.5
Gross fixed capital form., EUR m, nom.	1,166	1,096	1,275	1,318	.	.	.
annual change in % (real)	-11.9	-12.3	0.1	4.8	5.0	5.0	4.0
Gross industrial production ³⁾							
annual change in % (real)	-0.9	4.9	-3.3	6.4	4.0	3.0	2.0
Gross agricultural production ⁴⁾							
annual change in % (real)	3.8	-1.5	-0.7	-2.0	.	.	.
Construction output							
annual change in % (real)	-5.5	-4.8	-4.4	-3.0	.	.	.
Employed persons, LFS, th, average ⁵⁾	219.4	212.6	251.2	278.3	287	296	305
annual change in %	-10.0	-3.1	18.2	10.8	3.0	3.0	3.0
Unemployed persons, LFS, th, average ⁵⁾	47.8	42.2	43.2	41.8	40	30	30
Unemployment rate, LFS, in %, average ⁵⁾	17.9	16.6	14.7	13.1	11.0	10.0	9.0
Reg. unemployment rate, in %, eop	20.1	24.7	17.0	14.0	.	.	.
Average monthly gross wages, EUR	783	793	883	987	1,050	1,100	1,150
annual change in % (real, gross)	1.6	-1.1	-1.5	2.9	2.0	2.0	2.0
Average monthly net wages, EUR ⁶⁾	524	532	712	792	850	930	960
annual change in % (real, net)	2.1	-0.9	18.4	2.4	3.0	6.0	1.0
Consumer prices, % p.a.	-0.3	2.4	13.0	8.6	4.5	3.0	2.5
Producer prices in industry, % p.a. ⁷⁾	-0.1	1.3	11.2	6.2	3.0	2.5	2.0
General governm. budget, nat. def., % of GDP							
Revenues	44.6	44.3	38.8	39.0	38.0	38.0	38.0
Expenditures	55.7	46.2	43.9	44.0	44.0	44.0	44.0
Deficit (-) / surplus (+)	-11.1	-1.9	-5.1	-5.0	-6.0	-6.0	-6.0
General gov.gross debt, nat.def., % of GDP	105.3	84.0	69.2	70.5	72.0	74.0	76.0
Stock of loans of non-fin. private sector, % p.a.	2.9	3.4	8.8	6.5	.	.	.
Non-performing loans (NPL), in %, eop	5.5	6.2	5.7	5.0	.	.	.
Central bank policy rate, % p.a., eop ⁸⁾	5.33	5.16	5.45	6.11	5.0	4.5	4.0
Current account, EUR m	-1,090	-456	-766	-782	-800	-850	-880
Current account, % of GDP	-26.1	-9.2	-12.9	-11.4	-10.7	-10.6	-10.4
Exports of goods, BOP, EUR m	409	526	763	716	790	860	920
annual change in %	-12.2	28.6	45.2	-6.2	10.0	9.0	7.5
Imports of goods, BOP, EUR m	2,051	2,441	3,434	3,699	4,070	4,420	4,730
annual change in %	-19.0	19.0	40.7	7.7	10.0	8.5	7.0
Exports of services, BOP, EUR m	679	1,597	2,289	2,769	3,120	3,450	3,760
annual change in %	-60.2	135.2	43.3	21.0	12.5	10.5	9.0
Imports of services, BOP, EUR m	503	641	972	1,074	1,190	1,290	1,380
annual change in %	-26.8	27.5	51.6	10.5	10.5	8.0	7.0
FDI liabilities, EUR m	466	591	833	487	.	.	.
FDI assets, EUR m	-5	9	50	58	.	.	.
Gross reserves of CB excl. gold, EUR m ⁹⁾	1,739	1,749	1,915	1,425	.	.	.
Gross external debt, EUR m	9,275	9,501	9,381	9,002	9,000	9,200	9,350
Gross external debt, % of GDP	221.6	191.7	158.4	131.5	120.0	115.0	110.0

Note: Introduction of new index 2021=100 (new weights) for gross industrial production.

1) Preliminary and wiiw estimates. - 2) Including expenditures of NPISHs. - 3) Enterprises with 5 and more employees. - 4) Based on UN-FAO data, wiiw estimate in 2023. - 5) From 2021 new LFS methodology in line with the Integrated European Social Statistics Regulation (I ESS). - 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.

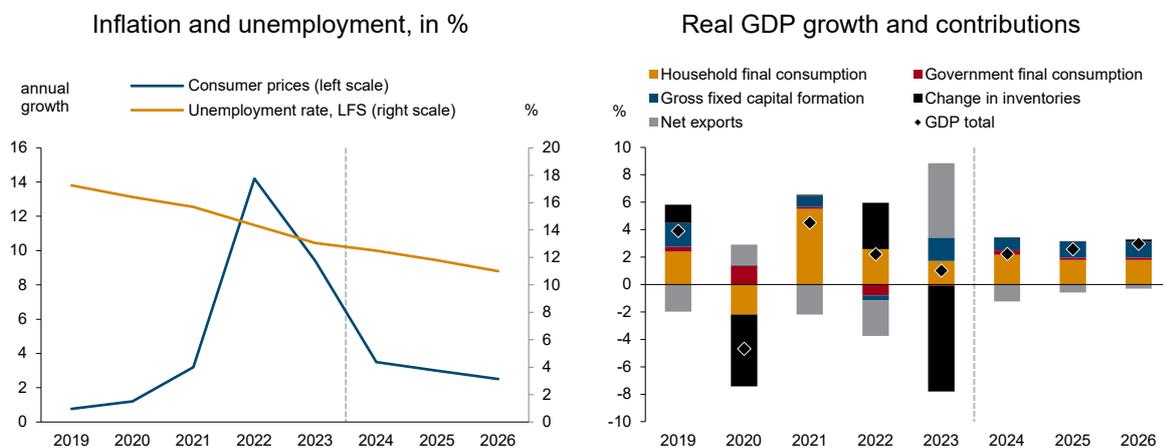


NORTH MACEDONIA: Pre-election calm, post-election storm

BRANIMIR JOVANOVIĆ

The measures adopted by the government ahead of the elections in April and May are breathing life into the economy, with all the indicators now pointing in a positive direction. There is some doubt, though, about the extent to which this can sway the election outcome, and a transfer of power seems likely. If that happens, the biggest question will be how the new government positions itself on the constitutional changes required for EU accession talks to commence. In terms of economic policy, one should expect no great change, as both the main parties support neoliberal agendas. The second half of the year will continue to be exciting, as the current stimulus measures are due to expire, and the new government (whoever leads it) will have to tighten the country's belt.

Figure 6.15 / North Macedonia: Main macroeconomic indicators



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

After a gloomy 2023, economic activity seems to be coming back to life at the start of 2024. The growth in GDP of just 1% in 2023 was the lowest in the Western Balkans. Although household consumption increased by 2.5%, all other GDP components saw a decline. The most significant of these was in gross investment, which plummeted by a whopping 17%, due primarily to the depletion of inventories (likely a result of the stockpiling of gas and oil in 2022 amid the energy crisis). The start of 2024 appears slightly rosier. Industrial production in January and February increased by 1.5%, and retail trade (excluding fuels) saw a 3.3% improvement, both measured in real terms on a year-on-year basis.

One of the reasons for the improvement is the generous fiscal support provided by the government ahead of the presidential and parliamentary elections scheduled for April and May.

The package, which was adopted in November, envisages higher public-sector wages, bigger pensions, increased social assistance transfers, cash transfers to pupils and students, direct financial subsidies to firms that undertake to raise wages, and favourable loans for small and medium-sized enterprises. Most of the measures are designed as short-term stimuli, though, and are set to expire by May.

After spending most of 2022 and 2023 in decline, real wages have returned to positive growth.

This may be attributed to a combination of factors: the government's fiscal stimulus, the increase in the minimum wage and, most significantly, the fact that inflation has slowed sooner than anticipated. As a result, real wages ended 2023 some 5% up on the previous year, which more than made up for the 3% drop experienced in 2022. In January 2024, real wages were 13% above their level the year before, signalling robust consumer spending in the coming months.

After several months of slowing down, inflation again rose in March to 4%. This increase is attributable to the government's decision that from March onwards, the price controls that were introduced in October 2023 will no longer be in place. That pushed the average inflation rate for the first three months to 3.4%. The uptick could be further exacerbated by the double-digit growth in real wages, which may prompt firms to raise their prices in order to maintain profit margins. Therefore, we are maintaining our initial forecast of a 3.5% inflation rate for the entire year.

Despite the slowdown in inflation, the central bank has yet to adjust its policy interest rate. It has kept this at 6.3% since September, and we forecast that it will maintain that rate until the European Central Bank cuts its own rate. Following this, we anticipate four cuts in the latter half of the year, which we expect will bring the base interest rate down to around 5.5%.

The rosy start to the year comes at a price, though – the elevated budget deficit. This reached 6% of GDP in Q4 2023 and averaged close to 5% for the whole year. The first two months of 2024 saw it range between 8% and 9% of GDP. Public debt will certainly exceed 60% of GDP in 2024, though fiscal stability will not be undermined. The government's fiscal package, which is due to expire after the elections, suggests that the deficit will shrink in the second half of the year. However, this also implies that the economic momentum supplied by the fiscal policies will wane as the year progresses. This slowdown will be further compounded by an anticipated moderation in real wages. Consequently, the economic outlook for the second half of the year would appear to be significantly less optimistic. Hence, we maintain our previous forecast for GDP growth in 2024 at 2.2%.

The upcoming elections in April and May are set to be the most significant since Gruevski's fall in 2017. The parliamentary and the presidential elections are to be held together, with 8 May as the decisive day when both results become known. The polls consistently show the ruling social democratic SDSM party heading for defeat, as it pays the price of unfulfilled domestic promises and lack of progress in its EU accession efforts. The conservative VMRO party is poised for a comeback, though there are questions about the potential coalition partners in the upcoming government. As is customary in the country, the new government will need to include some ethnic Albanian party – something that has traditionally been challenging for the VMRO, due to its nationalistic tendencies. This does not seem to be a problem at the moment, as the VMRO is indeed cooperating with some Albanian parties at the local level. However, the formation of a new government may necessitate an alliance with smaller ethnic-

Macedonian parties, which could have agendas and demands that conflict with those of the Albanian party. Thus, even if the VMRO succeeds in winning the election and forming a government, the new coalition could be unstable.

Whoever wins the elections, there will be hardly any change in terms of economic policies. The two main parties have historically embraced neoliberal principles, a stance that is clearly mirrored in their current electoral platforms. The only difference in this respect is that the VMRO is not so keen on wages rising, which may put a spoke in one of the engines of growth over the past few years. On the other hand, it is again promising tax cuts for businesses (although how that could be achieved is none too clear, as taxes are already very low).

However, the two parties do diverge significantly on cultural and social issues. A government led by the VMRO is likely to adopt a more conservative and authoritarian stance, and past experience raises concerns regarding respect for democratic standards and civil liberties.

The biggest uncertainty revolves around the constitutional amendments needed to initiate EU accession negotiations. The VMRO, while in opposition, has stoutly resisted the inclusion of Bulgarians in the constitution's preamble. However, that stance would prove quite challenging to maintain if the party did gain power. It would come under considerable international pressure (with responsibility for the stalemate in the accession talks falling squarely on its shoulders), and would also be under pressure from whatever Albanian party became its coalition partner. But on the other hand, if it accepted an amendment to the constitution, it would alienate its nationalist supporters, who may then feel bound to gravitate towards smaller parties. Consequently, the VMRO finds itself on the horns of a dilemma, whereby any decision could have an unfavourable outcome. This suggests that a win in the elections could ultimately be something of a pyrrhic victory for the party.

The presidential race, on the other hand, offers a less predictable scenario. It is likely to culminate in a second-round showdown between the incumbent, Stevo Pendarovski, backed by the ruling SDSM, and the VMRO candidate, Gordana Siljanovska-Davkova. The final outcome will depend on the support of voters from other parties; and while Siljanovska-Davkova is marginally the favourite, Pendarovski may well cling on. This raises the possibility of a divided government after the elections, with the president and the prime minister coming from opposing parties. While not unprecedented in the country's political history, such an outcome would undoubtedly introduce a fresh dynamics into the political landscape of the country.

Table 6.15 / North Macedonia: Selected economic indicators

	2020	2021	2022	2023 ¹⁾	2024	2025	2026
					Forecast		
Population, th pers., average ²⁾	2,073	1,837	1,832	1,822	1,812	1,802	1,792
Gross domestic product, MKD bn, nom.	669.3	729.4	803.1	840.6	890	940	992
annual change in % (real)	-4.7	4.5	2.2	1.0	2.2	2.6	3.0
GDP/capita (EUR at PPP)	11,420	14,110	15,010	15,510	.	.	.
Consumption of households, MKD bn, nom.	436.4	487.4	550.2	603.7	.	.	.
annual change in % (real)	-3.4	8.5	3.9	2.5	3.0	2.5	2.5
Gross fixed capital form., MKD bn, nom.	144.5	171.1	189.0	194.5	.	.	.
annual change in % (real)	0.4	3.8	-1.5	7.2	4.0	5.0	5.0
Gross industrial production ³⁾							
annual change in % (real)	-9.5	1.4	-0.2	0.6	2.0	3.0	3.5
Gross agricultural production ⁴⁾							
annual change in % (real)	1.7	-7.6	2.0	-4.0	.	.	.
Construction industry							
annual change in % (real)	1.3	-11.4	-11.9	-2.2	.	.	.
Employed persons, LFS, th, average ⁵⁾	794.9	795.1	692.0	688.3	700	710	720
annual change in %	-0.3	0.0	-0.2	0.0	1.0	1.0	1.0
Unemployed persons, LFS, th, average ⁵⁾	155.9	147.9	116.0	103.4	100	90	90
Unemployment rate, LFS, in %, average ⁵⁾	16.4	15.7	14.4	13.1	12.5	11.8	11.0
Reg. unemployment rate, in %, eop ⁵⁾⁶⁾	25.8	19.7	19.8	19.3	.	.	.
Average monthly gross wages, MKD	40,566	42,887	47,637	54,916	58,500	61,500	63,700
annual change in % (real, gross)	7.0	2.4	-2.7	5.4	3.0	2.0	1.0
Average monthly net wages, MKD	27,182	28,718	31,859	36,614	39,000	41,000	42,400
annual change in % (real, net)	6.5	2.3	-2.9	5.1	3.0	2.0	1.0
Consumer prices, % p.a.	1.2	3.2	14.2	9.4	3.5	3.0	2.5
Producer prices in industry, % p.a.	0.6	11.1	17.3	1.2	1.0	2.0	2.0
General governm. budget, nat. def., % of GDP							
Revenues	29.9	32.0	32.1	33.0	32.5	32.0	32.0
Expenditures	38.1	37.4	36.5	37.9	36.5	35.0	34.5
Deficit (-) / surplus (+)	-8.2	-5.4	-4.4	-4.9	-4.0	-3.0	-2.5
General gov.gross debt, nat. def., % of GDP	50.8	51.4	50.4	53.1	55.0	56.0	57.0
Stock of loans of non-fin. private sector, % p.a.	4.6	8.2	9.4	5.0	.	.	.
Non-performing loans (NPL), in %, eop	3.3	3.2	2.8	2.7	.	.	.
Central bank policy rate, %, p.a., eop ⁷⁾	1.50	1.25	4.75	6.30	5.50	5.00	4.50
Current account, EUR m	-318	-329	-797	95	-110	-290	-380
Current account, % of GDP	-2.9	-2.8	-6.1	0.7	-0.8	-1.9	-2.4
Exports of goods, BOP, EUR m	4,820	6,041	7,320	7,292	7,660	8,080	8,560
annual change in %	-9.9	25.3	21.2	-0.4	5.0	5.5	6.0
Imports of goods, BOP, EUR m	6,623	8,378	10,801	9,868	10,460	11,140	11,860
annual change in %	-9.2	26.5	28.9	-8.6	6.0	6.5	6.5
Exports of services, BOP, EUR m	1,445	1,746	2,320	2,648	2,890	3,180	3,530
annual change in %	-11.1	20.8	32.9	14.2	9.0	10.0	11.0
Imports of services, BOP, EUR m	1,021	1,248	1,568	1,915	2,200	2,460	2,710
annual change in %	-20.8	22.2	25.6	22.1	15.0	12.0	10.0
FDI liabilities, EUR m	28	575	788	650	.	.	.
FDI assets, EUR m	-127	187	134	127	.	.	.
Gross reserves of CB excl. gold, EUR m	3,019	3,288	3,486	4,125	.	.	.
Gross external debt, EUR m	8,536	9,577	10,790	11,463	12,400	13,400	14,500
Gross external debt, % of GDP	78.7	80.9	82.8	83.9	86.0	88.0	90.0
Average exchange rate MKD/EUR	61.67	61.63	61.62	61.56	61.6	61.6	61.6

Note: Introduction of new index 2021=100 (new weights) for gross industrial production.

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

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

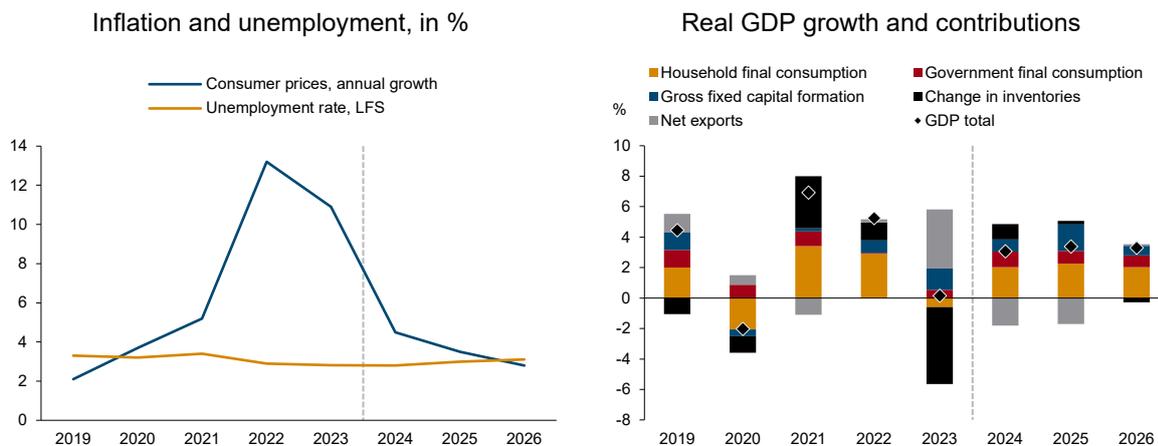


POLAND: Leaving stagnation (and inflation) behind?

ADAM ŻURAWSKI

A shallow recession in the first half of 2023 was followed by a moderate recovery in the second, allowing GDP to grow by 0.2% in 2023 as a whole. Inflation and inflationary expectations are falling, while wages are rising apace. If this extra money is saved rather than spent, then the higher household incomes could depress output growth and support disinflation. Though the energy prices are likely to jump by up to 20% in July 2024, this need not provoke a return to high inflation. Nonetheless the move will affect private consumption and limit GDP growth.

Figure 6.16 / Poland: Main macroeconomic indicators



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

Moderate GDP growth in the second half of 2023 helped to make up for the output losses suffered during the recessionary first half of the year. The turnaround – due to quite a strong recovery in public consumption and a continuing expansion of gross fixed investment (mostly by the public sector) – finally allowed GDP to grow by a (symbolic) 0.2% in 2023 as a whole.

Household consumption stagnated throughout 2023, while the trade balance contributed strongly to growth (+3.9 percentage points (pp)). The positive contribution made by the trade balance was, however, overshadowed by the negative contribution of the change in inventories (-5.0 pp).

Growth has accelerated markedly in the first months of 2024. According to our provisional calculations, GDP may have risen by over 2% year on year in the first quarter of 2024, with private consumption up by over 3% and with a much-reduced negative contribution from changing inventories.

Inflation and inflationary expectations have been falling spectacularly. In February 2024 consumer price inflation (CPI) reached 2.8% (year on year), down from the peak of 18.4% recorded a year ago. Provisional estimates (by the Central Statistical Office) suggest that CPI may even have been lower in March (1.9%), less than the inflation target of 2.5%. Core inflation, though still elevated, is witnessing the same declining trend. Clearly, the effects of the earlier supply-side and cost perturbations are fading. At the same time, the falling inflation indicates that excess demand was not the primary source of the inflation. Weak demand and easing cost pressures have manifested themselves in a strong and protracted (since May 2023) fall in producer prices in manufacturing. The fact that CPI is mainly driven by the rising cost of services suggests that the current inflation is a vehicle of structural change in consumer preferences, rather than simply a sign of a general excess demand. Services in Poland – as elsewhere in less affluent countries – are still relatively cheap, and growing affluence should result in inflation for services rising faster than for goods.

Nominal wages have been rising briskly, not least on account of a hike in the statutory minimum wage and a 20% across-the-board rise in public-sector wages (30% for teachers). Both changes came into force on 1 January 2024. In fact, there has been an impressive improvement in real wages also in the private corporate sector. Stable labour market conditions (and fairly low unemployment), combined with continuing disinflation, mean that this translates into growing purchasing power for households' current incomes.

The growing prosperity of the household sector need not translate into a corresponding rise in private consumption, however, given the increased propensity to save. Rising household incomes ought – according to a widely held view – to lead to more rapid growth in private consumption. This would seem to justify the expectations of much faster GDP growth in 2024 (and beyond) – but it could also herald higher inflation. Household income is quite likely also to rise on account of additional social benefits and a lower tax burden on the smallest businesses. On the other hand, household deposits (and other financial assets) are continuing to grow quite strongly – and much faster than households' credit liabilities. It may be that the increased household income is being channelled into savings more than might normally be expected (rather than being spent on rising consumption). The high inflation of 2022-2023 eroded the real value of savings and investments of the household sector. It may now be high time to save more, so as to restore the real value of financial assets. In that case, output growth fed by additional income gains may prove less robust than is generally assumed.

As of 1 April, 5% VAT on foodstuffs has been reintroduced. This is unlikely to have any meaningful impact on overall CPI. The fierce price wars currently being waged by the biggest retail organisations will mitigate the scale of any possible food price rises.

Other uncertainties over inflation in 2024 persist. Apart from unpredictable movements in the price of imported raw materials (above all energy carriers), the country is facing a potential shock linked to the possible complete lifting of the temporary controls on internal energy prices. The decision on the scale and scope of the move (from July 2024) has not yet been announced. However, if the government did decide to unfreeze the energy prices completely, energy costs could jump by 20% in the second half of 2024 – and average inflation for the year as a whole would likely leap to nearly 6% (from the 3% expected if the current arrangements were to remain unchanged), eroding household real incomes and private consumption once again (if only temporarily). It is therefore reasonable to assume that the

energy price controls will not be completely lifted; in all likelihood, such a scenario would result in inflation close to 4.5% in 2024 (and then falling further in 2025-2026).

Public-sector fiscal deficits will remain high in 2024 and beyond. Fulfilment of some of the electoral promises made last autumn is going to cost the public finances quite dear. In addition, the country is set to maintain high spending on defence (approximately 3.5% of GDP). Disinflation (and fairly weak growth in 2023) is also proving quite costly for the government, on account of lower tax revenue. Hiking the energy prices may be of some use – albeit limited: that would reduce the fiscal deficit by at most about 1% of GDP in 2024 (from about 6% to 5%). The fiscal gains of higher energy prices in 2025-2026 would be even lower.

Public debt is still not a serious problem. At about 49.6% of GDP, public debt was still relatively low in 2023 (the public sector's foreign currency debt is about 12.7% of GDP). Although these indicators are going to rise, even if energy prices are fully deregulated, the 60% limit for the public debt/GDP ratio required under EU regulations will not be exceeded.

Servicing the public debt is fairly costly. In 2022, the interest on public debt was about 1.5% of GDP; in 2023 it was about 2.2%. The high interest rates maintained by the National Bank of Poland (NBP) (the average reference rate in 2023 was 6.44% vs. 5.35% in 2022) are part of the fiscal problem. Also, in the context of the pretty anaemic expansion of credit to the economy, the government would now like to see a much more relaxed monetary policy that would facilitate economic recovery. But the NBP seems determined to keep its rates unchanged (since October 2023, the reference rate has been 5.75%).

The tug of war between the NBP and the new government has not (yet) affected the economy. The outcome of the legal battle over the tenure of the present governor (which will take time) is not easy to predict. In the meantime, the conflict does not seem to have affected the Polish currency (which is very strong), financial markets or capital inflows. The remarkable strength of the PLN is partly due to the high interest rates. Besides, foreign exchange inflows are quite large, also due to current account surpluses.

The new government has taken over the agenda of the old administration, but hopes to unlock the EU funds. Having won the parliamentary elections in October 2023, the broad coalition of centrist parties led by Mr Tusk assumed power in mid-December. Naturally, the new government's current actions have to be consistent with the budget law for 2024 that was drawn up by the previous government controlled by Mr Kaczyński's Law and Justice Party (PiS). As concerns fiscal (and social) policies, no major changes are likely in 2025-2026 either. But the new government has managed to unlock the first (limited) portion of the EU recovery funds, which under the PiS government had been blocked because of rule-of-law disputes with Brussels. Making good use of these funds will help to promote improvements in infrastructure, the healthcare and education systems.

Table 6.16 / Poland: Selected economic indicators

	2020	2021	2022	2023 ¹⁾	2024	2025	2026
					Forecast		
Population, th pers., average ²⁾	37,899	37,747	37,204	36,700	36,700	36,700	36,700
Gross domestic product, PLN bn, nom.	2,338	2,631	3,067	3,396	3,680	3,940	4,190
annual change in % (real)	-2.0	6.9	5.3	0.2	3.1	3.4	3.3
GDP/capita (EUR at PPP)	22,930	25,240	28,160	29,980	.	.	.
Consumption of households, PLN bn, nom.	1,300	1,455	1,745	1,915	.	.	.
annual change in % (real)	-3.6	6.2	5.2	-1.0	3.6	4.0	3.6
Gross fixed capital form., PLN bn, nom.	428	442	516	593	.	.	.
annual change in % (real)	-2.3	1.2	4.9	8.4	4.5	10.0	3.6
Gross industrial production (sales) ³⁾							
annual change in % (real)	-1.2	14.5	10.3	-1.2	2.0	4.6	4.6
Gross agricultural production							
annual change in % (real)	7.8	-1.7	-0.6	0.5	.	.	.
Construction industry ³⁾							
annual change in % (real)	-3.5	1.5	7.6	4.9	.	.	.
Employed persons, LFS, th, average ²⁾⁴⁾	16,441	16,656	17,251	17,307	17,360	17,360	17,360
annual change in %	-0.1	2.6	0.5	0.3	0.3	0.0	0.0
Unemployed persons, LFS, th, average ²⁾⁴⁾	537	580	511	502	500	540	560
Unemployment rate, LFS, in %, average ²⁾⁴⁾	3.2	3.4	2.9	2.8	2.8	3.0	3.1
Reg. unemployment rate, in %, eop	6.8	5.8	5.2	5.1	.	.	.
Average monthly gross wages, PLN ⁵⁾	5,226	5,683	6,363	7,155	8,000	8,610	9,160
annual change in % (real, gross)	2.9	3.3	-1.8	1.1	7.0	4.0	3.5
Consumer prices (HICP), % p.a.	3.7	5.2	13.2	10.9	4.5	3.5	2.8
Producer prices in industry, % p.a.	-0.5	7.9	23.7	3.9	3.0	4.0	2.5
General governm. budget, EU def., % of GDP							
Revenues	41.3	42.3	40.2	40.3	41.3	41.6	41.7
Expenditures	48.2	44.1	43.9	45.9	45.5	46.9	47.0
Net lending (+) / net borrowing (-)	-6.9	-1.8	-3.7	-5.6	-5.4	-5.3	-5.3
General gov. gross debt, EU def., % of GDP	57.2	53.6	49.3	49.3	51.0	53.0	55.0
Stock of loans of non-fin. private sector, % p.a.	0.4	4.6	0.2	-2.5	.	.	.
Non-performing loans (NPL), in %, eop	7.0	5.8	5.6	5.4	.	.	.
Central bank policy rate, % p.a., eop ⁶⁾	0.10	1.75	6.75	5.75	5.25	4.50	4.00
Current account, EUR m ⁷⁾	12,820	-7,404	-15,722	11,775	4,400	-10,500	-9,600
Current account, % of GDP ⁷⁾	2.4	-1.3	-2.4	1.6	0.5	-1.2	-1.0
Exports of goods, BOP, EUR m ⁷⁾	220,604	263,723	322,119	334,387	374,500	408,200	428,600
annual change in %	0.1	19.5	22.1	3.8	12.0	9.0	5.0
Imports of goods, BOP, EUR m ⁷⁾	213,625	271,406	346,398	328,180	372,500	424,700	450,200
annual change in %	-4.9	27.0	27.6	-5.3	13.5	14.0	6.0
Exports of services, BOP, EUR m ⁷⁾	58,308	68,731	90,884	99,959	105,500	115,000	121,900
annual change in %	-7.4	17.9	32.2	10.0	5.5	9.0	6.0
Imports of services, BOP, EUR m ⁷⁾	35,329	41,939	54,385	60,303	63,300	72,200	75,100
annual change in %	-9.1	18.7	29.7	10.9	5.0	14.0	4.0
FDI liabilities, EUR m ⁷⁾	16,646	30,568	34,608	27,880	.	.	.
FDI assets, EUR m ⁷⁾	4,132	8,583	10,685	11,227	.	.	.
Gross reserves of CB excl. gold, EUR m	114,299	134,652	143,949	153,878	.	.	.
Gross external debt, EUR m ⁷⁾	307,412	323,335	347,584	386,353	397,600	411,900	423,700
Gross external debt, % of GDP ⁷⁾	58.4	56.1	53.1	51.7	47.0	46.0	45.0
Average exchange rate PLN/EUR	4.4430	4.5652	4.6861	4.5420	4.35	4.40	4.45

Note: Introduction of new index 2021=100 (new weights) for gross industrial production and producer prices in industry.

1) Preliminary and wiiw estimates. - 2) From 2022 according to census 2021. - 3) Enterprises with 10 and more employees. - 4) From 2021 new LFS methodology 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.

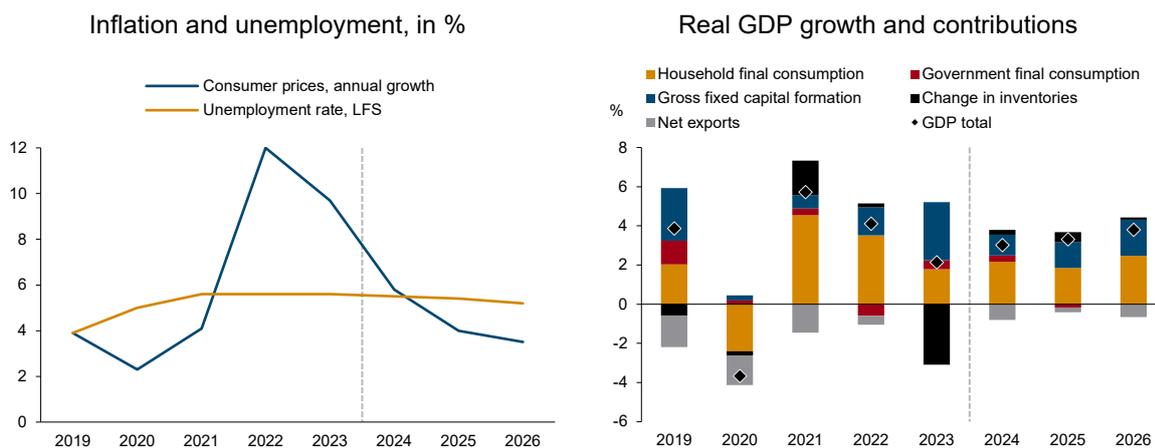


ROMANIA: Moderate growth despite loose fiscal policy

GÁBOR HUNYA

While high fiscal and current account deficits are lasting features of the Romanian economy, they do not pose any imminent danger. Fiscal austerity will not be implemented in the current election year. Economic growth will be about 3% in 2024, fuelled by bullish household demand but hampered by sluggish foreign demand and the slow arrival of EU funds. Fiscal consolidation will dampen growth in 2025, while external demand and private investment will boost it to 3.3% in 2025 and further to 3.8% in 2026.

Figure 6.17 / Romania: Main macroeconomic indicators



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

Growth in the Romanian economy slowed to 2.1% in 2023, about half the rate achieved the previous year. Household consumption was up 2.9%, contributing 2 percentage points (pp) to growth. Gross fixed capital formation was buoyant, increasing by 12% and contributing 2.9 pp. Public consumption also had a positive effect, while that of the foreign trade balance was neutral. Thus, the decline in inventories was the only component on the negative side: this reflected the completion of infrastructure projects and the lack of confidence in future demand. Economic activities with rising value added included agriculture, construction, and information and communication technology. Industrial value added contracted by 2.3% and manufacturing production fell by 4.6%, most prominently in the export-oriented branches, reflecting sluggish demand on Romania's main export markets.

After a bullish start to the first half of 2023, growth decelerated well into 2024. Growth was especially modest in Q4 2023 at only 1% year on year, while GDP was 0.5% lower than in the previous quarter. But the March 2024 business surveys indicate an improvement in the expectations of managers

across all major economic activities. Domestic demand will boost the economy, as indicated by rising retail sales backed by growing real incomes.

Real wages increased in 2023, especially in the final quarter of the year. Recent nominal wage claims have sought to recoup the losses caused by the elevated inflation of the previous year. These claims have not been fully met, but the awards have been generous enough to encourage consumption to lift off. A major reform of the pension system will provide a further boost to consumption from September 2024, with the effects being felt well into 2025.

Inflation subsided slowly in 2023, from 15% in January to 7% in December. It remained almost constant in the first two months of 2024, due mainly to indirect tax hikes. Price increases were reported for non-food items and services, but the cost of several foodstuffs fell. Disinflation will resume for the rest of the year, but will be mitigated by growing household demand, resulting in annual average inflation of 5.8%.

The National Bank of Romania (NBR) will be cautious about relaxing the policy rate in 2024, in view of the stubborn inflation and loose fiscal policy. It did not rely much on the policy rate to counter inflationary pressure in 2023, when it correctly assessed that the major part of the inflation was imported and could not be suppressed by that particular monetary instrument. After a series of small hikes, the policy rate ended up at 7% in December, when the domestic component of inflation became dominant. Rate cuts will also follow in small steps during 2024 and 2025 until inflation drops below 3.5%, which is on the upper side of the inflation target band. Over the past two years, the main anti-inflationary tool of the NBR has been to keep the exchange rate for the local currency against the euro almost stable. The NBR may reduce its activity on the currency market in the future and allow for some modest nominal depreciation.

The current account deficit remained elevated, although its ratio to GDP eased from 9.2% in 2022 to 7% in 2023. This change was mainly brought about by a contraction in the import of goods – mainly fuels and raw materials (reflecting the lower prices for oil and gas). The deficit will stay relatively high in the coming years, partly on account of the import needs generated by rising consumption. Another important component of the current account deficit has been the income of foreign investors: the deficit on primary income almost matched the deficit on goods and services in 2023. Companies achieved large windfall profits, but only part of those was tapped by fiscal measures. Foreign banks and energy companies have also recently reported high earnings on their activities, which means that foreign direct investment (FDI) income may not subside before 2025. Unfortunately, only 45% of FDI earnings were reinvested in Romania in 2023, although one cannot exclude the possibility that some of the profits returned via the portfolio channel. Relatively high yields and an almost stable exchange rate have attracted large volumes of portfolio investments. Such inflows amounted to 5.7% of GDP, compared to the FDI and capital account balances, which were both in the order of 2% of GDP.

The excessive fiscal deficit (about 6% of GDP over the past two years) has been the weak point of Romania's economic policy. In 2023, it was obvious from the outset that the country would not meet its deficit target of 4.4% of GDP. Following a warning from the European Commission, a fiscal consolidation package was introduced from 1 October. Revenue started to be generated by an extra tax on the turnover of large companies and banks, while some tax allowances and extra benefits for certain groups of the population were abolished. These measures can reduce the fiscal deficit by only 0.6 pp per annum. However, in Q4 2023, the main short-term policy tool was a curb on current expenditure, mainly by the

military. As for 2024, the government has again stipulated low deficits – unrealistic in an election year, especially as the governing parties are losing popularity. When it became aware of this problem in March, the European Commission again sent Romania notification, urging the country to rein in its budget deficit, otherwise a portion of the funds it is due will be suspended. But the deadline for action has been set as the end of the current year, and so it will be the task of the government following the general election in December to implement the necessary austerity measures – and that will be no easy matter.

A pension reform to take effect in September 2024 will cost the budget some 1.3% of GDP; as yet there is no counterpart to this on the revenue side. Both pension reform and a reform of the system of public-sector wages were among the targets of the National Recovery and Resilience Plan (NRRP), and both imply higher fiscal expenditure in the years to come. Thus, the EU programmes will place Romania under fiscal pressure on both the expenditure and the deficit side simultaneously. An overhaul of the revenue side of the budget – which currently operates with low flat tax rates – will have to be put on the agenda.

Accessing EU funds is a fundamental target of the government. Nevertheless, Romania found the disbursement of funds delayed in 2023 – partly on account of poor institutional capacity and partly through having to renegotiate some of the NRRP targets. There was only one disbursement of EUR 2.76bn from the Recovery and Resilience Facility (RRF) in 2023; meanwhile EUR 4.5bn came as the final instalment under the Multiannual Financial Framework (MFF) 2014-2020 (altogether 2.2% of GDP). This year, EU funds will be thin on the ground, as most of the projects that are to be financed from the MFF 2021-2027 have not started yet and no more than one instalment of funds will be disbursed under the RRF. Consequently, the expansion of investment will slow temporarily.

Relatively large future current account and fiscal deficits may constrain the country's capacity to withstand adverse shocks. Of all the EU-CEE countries, Romania has attracted the worst foreign currency credit rating from all the major rating agencies; it also has the highest government bond yields. Given both the relatively high perceived risk and the high cost of financing, the country really needs to follow a more prudent policy in the future. Fortunately, the risk premiums on German federal government bonds have fallen internationally in the past 12 months – for Romania, from 3.3 to 2.1 basis points between January 2023 and January 2024 – thus financing costs have eased somewhat. The large international reserves of the NBR – 35% of the relatively low external debt (52% of GDP) – provide an ample buffer.

Medium-term economic growth will depend on success in securing the disbursement of EU funds, while implementing fiscal consolidation. For the baseline scenario, we expect a compromise with the European Commission and no shocks on the financial markets. Major fiscal stress could be avoided by increasing certain tax rates in 2025 without excessively damaging domestic demand. Also in 2025, there could be a recovery in demand on the main export markets, so that net exports would neutralise the effects of fiscal austerity. The result should be solid GDP growth of 3% in 2024, 3.3% in 2025 and 3.8% in 2026.

However, it is also worth considering a negative scenario. The general election scheduled for December 2024 may yield inconclusive results. A fragile government coalition may prove incapable of managing the fiscal deficit and related social issues. This could result in more limited access to EU funds and lower FDI inflows, to be followed by more severe austerity later. In this case, the economic growth rate could be 1 pp lower than the baseline forecast.

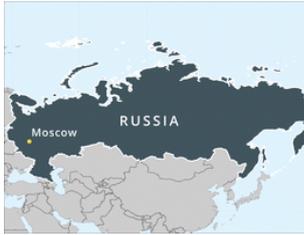
Table 6.17 / Romania: Selected economic indicators

	2020	2021	2022	2023 ¹⁾	2024	2025	2026
					Forecast		
Population, th pers., average	19,265	19,122	19,049	18,900	18,800	18,700	18,500
Gross domestic product, RON bn, nom.	1,066.8	1,189.1	1,401.3	1,598.6	1,750	1,890	2,030
annual change in % (real)	-3.7	5.7	4.1	2.1	3.0	3.3	3.8
GDP/capita (EUR at PPP)	21,870	23,940	26,670	29,220	.	.	.
Consumption of households, RON bn, nom.	642.1	722.6	875.6	987.8	.	.	.
annual change in % (real)	-3.9	7.5	5.8	2.9	3.5	3.0	4.0
Gross fixed capital form., RON bn, nom.	251.0	288.4	346.5	421.9	.	.	.
annual change in % (real)	1.1	2.9	5.9	12.0	4.0	5.0	7.0
Gross industrial production ²⁾							
annual change in % (real)	-9.2	7.1	0.5	-3.0	2.0	4.0	4.0
Gross agricultural production							
annual change in % (real)	-15.4	14.3	-15.9	6.1	.	.	.
Construction industry ²⁾							
annual change in % (real)	15.9	-0.6	12.3	16.1	.	.	.
Employed persons, LFS, th, average ³⁾	8,521	7,756	7,807	7,696	7,710	7,750	7,790
annual change in %	-1.8	0.7	0.7	-1.4	0.2	0.5	0.5
Unemployed persons, LFS, th, average ³⁾	452	459	464	456	450	440	430
Unemployment rate, LFS, in %, average ³⁾	5.0	5.6	5.6	5.6	5.5	5.4	5.2
Reg. unemployment rate, in %, eop	3.4	3.0	3.0	2.9	.	.	.
Average monthly gross wages, RON ⁴⁾	5,213	5,535	6,126	7,016	7,700	8,300	8,900
annual change in % (real, gross)	4.7	1.1	-2.7	3.7	4.0	3.5	3.5
Average monthly net wages, RON	3,217	3,416	3,801	4,384	4,800	5,200	5,600
annual change in % (real, net)	4.9	1.1	-2.2	4.5	4.2	3.7	3.7
Consumer prices (HICP), % p.a.	2.3	4.1	12.0	9.7	5.8	4.0	3.5
Producer prices in industry, % p.a.	0.0	14.4	43.8	4.6	1.0	2.0	2.0
General governm. budget, EU def., % of GDP							
Revenues	32.5	32.9	33.9	34.0	34.8	36.0	35.5
Expenditures	41.8	40.0	40.2	40.2	40.5	40.3	39.0
Net lending (+) / net borrowing (-)	-9.3	-7.2	-6.3	-6.2	-5.7	-4.3	-3.5
General gov. gross debt, EU def., % of GDP	46.8	48.5	47.5	50.0	51.0	52.0	52.0
Stock of loans of non-fin. private sector, % p.a.	5.0	14.3	11.2	5.9	.	.	.
Non-performing loans (NPL), in %, eop	3.8	3.4	2.7	2.3	.	.	.
Central bank policy rate, % p.a., eop ⁵⁾	1.50	1.75	6.25	7.00	6.00	4.00	3.00
Current account, EUR m	-10,893	-17,471	-26,052	-22,634	-22,600	-22,300	-23,700
Current account, % of GDP	-4.9	-7.2	-9.2	-7.0	-6.5	-6.0	-6.0
Exports of goods, BOP, EUR m	57,532	70,170	86,046	86,537	89,100	94,400	101,000
annual change in %	-8.8	22.0	22.6	0.6	3.0	6.0	7.0
Imports of goods, BOP, EUR m	76,476	93,286	118,110	115,540	119,000	125,500	135,500
annual change in %	-5.5	22.0	26.6	-2.2	3.0	5.5	8.0
Exports of services, BOP, EUR m	23,764	27,881	36,938	40,455	43,300	47,600	53,300
annual change in %	-12.2	17.3	32.5	9.5	7.0	10.0	12.0
Imports of services, BOP, EUR m	14,321	18,462	23,865	26,961	28,800	31,400	35,200
annual change in %	-22.2	28.9	29.3	13.0	7.0	9.0	12.0
FDI liabilities, EUR m	3,056	9,933	10,902	7,796	.	.	.
FDI assets, EUR m	112	1,117	2,095	1,240	.	.	.
Gross reserves of CB excl. gold, EUR m	37,379	40,475	46,636	59,770	.	.	.
Gross external debt, EUR m	126,750	136,585	143,887	168,812	190,000	206,000	220,000
Gross external debt, % of GDP	57.5	56.5	50.6	52.2	54.3	55.0	55.5
Average exchange rate RON/EUR	4.8383	4.9215	4.9313	4.9467	5.00	5.05	5.12

Note: Introduction of new index 2021=100 (new weights) for gross industrial production, construction and producer prices in industry.

1) Preliminary and wiiw estimates. - 2) Enterprises with 4 and more employees. - 3) From 2021 new LFS methodology 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.

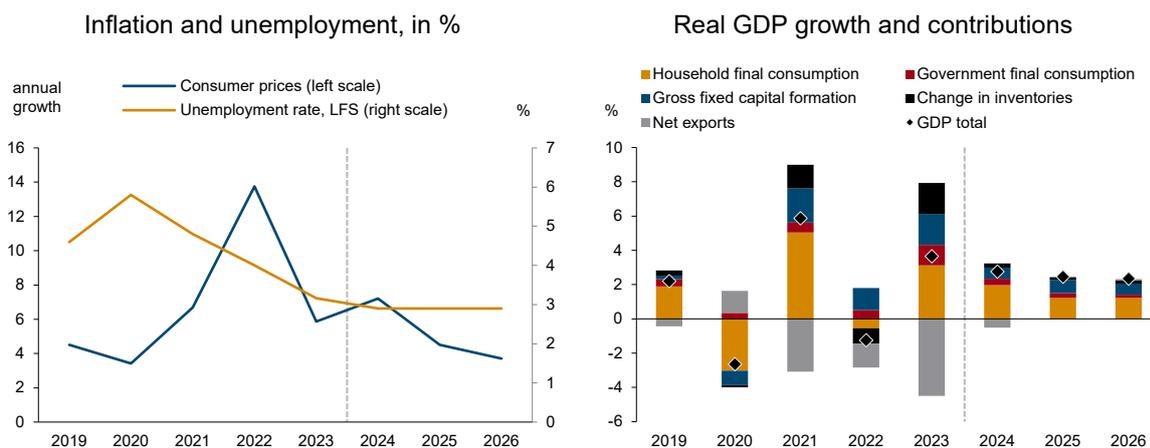


RUSSIA: 'Peak overheating' has likely been reached

VASILY ASTROV

Last year, GDP expanded by 3.6%, thanks largely to the boom in military production, which has had positive effects – both direct and indirect – for most of the rest of the economy. With inflation running in excess of 7% and the unemployment rate plunging to below 3%, the economy has clearly been overheating. However, the recent stabilisation of inflation suggests that 'peak overheating' has already been reached. Growth is projected to slip below 3% in 2024 and beyond, while inflation will gradually return to closer to the 4% target.

Figure 6.18 / Russia: Main macroeconomic indicators



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

In 2023, the Russian economy grew by 3.6% – faster than had generally been expected. Across economic sectors, the highest growth in value added was reported in hospitality and catering (+10%), information and communication technology (+9.8%), the financial sector (+8.7%), administrative and support service activities (+8%) and manufacturing (+6.9%), as well as in construction and trade (+6.6% apiece). Manufacturing industries with a large share of military output recorded above-average growth rates. For instance, value added in computers, electronic and optical products soared by 31.1%; in finished metal products except machinery and equipment – by 26%; in other transport vehicles and equipment – by 22.7%; and in electrical equipment – by 17.4%. The strong performance of many market services went hand in hand with the boom in private consumption (+6.5%), while construction benefited from the solid expansion of gross fixed capital formation (+8.8%). Government consumption grew by 7%, while the contribution of net exports to GDP growth was negative (-4.5 percentage points (pp)). Across the broad economic sectors, value added declined only in mining (-2%) and water supply (-3%).

The decline in mining was due primarily to falling natural gas production (-5.5%),¹⁹ whereas oil production remained virtually stable, as the bulk of shipments to Europe were reoriented towards Asia, particularly China and India.

The boom in private consumption has been fuelled by high wage growth on the back of labour shortages. By February 2024, the unemployment rate (Labour Force Survey) had plunged to an all-time low of 2.8% – not least on account of military mobilisation and the emigration of around 1m people since the beginning of the war, which has led to a reduction in the size of the labour force (though it should also be pointed out that employment rate is also up). Moreover, the sharp wage hikes enacted in the defence sector have led to competition for labour from other sectors. As a result, in 2023 average wages soared by 14.1% in nominal and by 7.8% in real terms, leading to a 1.8 pp rise in the wage share of GDP. Nevertheless, at 40.3%, the latter was still rather low in international terms. This suggests that strong wage growth – and the redistribution of national income from capital to labour – may continue for some years to come without unduly affecting price competitiveness, just so long as rising production costs are (at least partly) absorbed by squeezing profits. In poor regions (which have been the main source of contract soldiers and mobilised reservists for the war), household incomes have also been boosted by hefty government payments to soldiers and their families in the event of serious injury or death. All in all, the real disposable income of households picked up by 5.4% last year, with a marked acceleration to 6.8% year on year in Q4.²⁰

Investment growth has been facilitated by military infrastructure projects, by the restructuring of transportation and logistics infrastructure in response to sanctions, and by the reorientation of foreign trade towards Asia, as well as by high business confidence and import substitution in some sectors following the withdrawal of foreign firms. For instance, the domestic market share of imported capital goods (equipment) has fallen from a figure of 80-85% before the war to just about 50% today. Another example is domestic tourism, which has benefited from the stricter visa regulations for Russian citizens in the EU and the huge increase in the cost of flights to Europe. Industries such as automotive production and the production of beverages – which were dominated by foreign owners and experienced a collapse in investment during the first year of the war – have witnessed a sharp rebound in terms of investment as well. However, the capacity of domestic companies to undertake import substitution depends enormously on each particular sector. For instance, despite the ambitious plans (the government intends to build around 1,000 new aircraft by 2030) and generous state funding, the aircraft manufacturing industry is reportedly facing major challenges in expanding its domestic production.

Last year closed with a current account surplus of a mere USD 50bn – less than a quarter of the 2022 value. Relative to GDP, this corresponds to a decline from 10.5% to 2.5%. The main reason for this was the unfavourable trends in foreign trade. In US dollar terms, goods exports fell by 28%, while goods imports, by contrast, picked up by 10%; in services trade, the trends were broadly similar. Exports suffered primarily on account of the much-lower oil prices, not least due to Western energy sanctions: the price discount on Russian oil versus the benchmark Brent widened sharply in Q1 2023, before narrowing gradually over time; but it widened again in Q4, largely because of increased scrutiny from the US as it sought to enforce secondary sanctions on companies from third countries that were found to be violating the USD 60 per barrel price cap. This demonstrates that energy sanctions, when they are supported by

¹⁹ In particular, natural gas production by the state-owned Gazprom declined by around 9%, and pipeline gas exports by around a quarter last year – a direct consequence of the sharply curtailed exports to the EU.

²⁰ That said, real disposable household incomes in 2023 were still 1.4% below the all-time peak registered in 2013.

effective enforcement of secondary sanctions, have the potential to seriously undermine Russia's energy (and fiscal) revenues.

Recent high-frequency data suggest a further strengthening of growth momentum. According to Ministry of Economy estimates, real GDP picked up by 4.6% year on year in January and by 7.7% year on year in February. The growth in gross industrial production in those two months reached 4.6% year on year and 8.5% year on year, respectively, while retail trade turnover expanded by 10.7% year on year in the first two months. Apart from the ongoing major rise in household income, private consumption has also been fuelled by a renewed uptick in consumer lending, following a dip at the end of last year in response to sharp monetary policy tightening. So far, the main transmission mechanism of policy tightening has been the strong growth in household deposits, while the response of credit dynamics has been far more muted. On balance, the net saving propensity of households has risen; but this has not been sufficient to offset the positive effect of rapidly rising incomes on private consumption, which has continued to boom. In February, the consumer sentiment index climbed to another all-time high.

After picking up speed throughout most of last year, inflationary pressures have finally stabilised, albeit at a rather high level. By 8 April 2024, annual consumer price inflation had reached 7.8% – far above the 4% inflation target. Apart from the strong wage growth, inflationary pressures last year were fuelled by a pronounced exchange-rate depreciation of around 30% between January and October, mirroring above all the unfavourable trends in foreign trade. In response, on 16 October the authorities imposed a surrender requirement on export proceeds – something that has proved extremely successful in stabilising the foreign exchange market. Parallel to that, the policy interest rate was hiked sharply, by a combined 8.5 pp between July and December 2023, bringing it to 16%. In real terms, the policy rate now exceeds 8%. This is one of the highest levels in Russia's recent history, and yet so far it has had little success in cooling the economy. Nevertheless, given the recent stabilisation of inflation, the central bank reckons that 'peak overheating' will already have been reached in Q2 2024. A gradual cooling of the economy over the remainder of the year will enable progressive disinflation. Inflation is projected to decline to 5-6% by the end of 2024, which should allow a moderate relaxation of monetary policy.

Despite high military spending and a big drop in energy revenue, last year the consolidated budget deficit reached a relatively modest 2.3% of GDP, the bulk of which was financed by tapping the sovereign National Welfare Fund (NWF). The fiscal outlook has improved greatly this year, with the energy and non-energy tax revenues of the federal government in Q1 2024 soaring by 79% and 43% year on year, respectively, far outstripping the 20% rise in expenditure. On current trends, it is unlikely that the government will run out of funds for warfare any time soon. Despite high military spending (which is officially projected to peak at 6% of GDP this year), the budget deficit is expected to remain at below 2% of GDP over the forecast horizon. Government revenues should be helped by the planned fiscal reforms – a more progressive taxation of personal income and a hike in corporate income tax²¹ – as well as by the ambitious privatisation plans (not least involving the sale of the nationalised assets of foreign companies). With the liquid part of the NWF (which can be used to cover budget deficits) now standing at a mere 3.3% of GDP, that may be depleted as early as the end of next year. However, the government will still have the option to borrow from domestic banks: at 15% of GDP, Russia's public debt is still very low. However, the yields on government bonds have risen recently to

²¹ The government draft proposal reportedly envisages the introduction of progressive income taxation, with tax rates ranging from 13% to 20% (instead of 13-15% currently), as well as a hike in the corporate tax rate from 20% to 25%.

more than 14% p.a. on ten-year maturity bonds at the beginning of April (although this is still below the policy rate of the central bank).

Economic recovery is expected gradually to run out steam, with growth declining to below 3% this year and approaching 2% by the end of the forecast horizon. Despite a strong start to 2024, tight monetary conditions and the high statistical basis will increasingly weigh on the economic dynamics across the remainder of the year, resulting in GDP growth slowing to 2.8% for the year as a whole and slipping further in 2025 and 2026. Overall, the current growth path of the economy could be sustained over a prolonged period. Against this backdrop, the question is not so much how long the economy can continue to support the war, but rather what will happen when the war is over. The economy has now become accustomed to the war-related fiscal stimulus and could face a demand-side shock once armaments are no longer needed to the same extent.

The main risk to the forecast is on the downside and is related to the impact of secondary sanctions on third countries trading with Russia. For instance, the recently increased US pressure has resulted in several Turkish banks refusing to accept import payments from Russia; this has meant Turkish exports to Russia plunging by around a third year on year in the first two months of 2024. Problems with payments to Chinese banks have recently been mounting as well; even payments in Chinese yuan – widely believed to be sanction-proof – have reportedly been affected. Should these problems persist, the Russian economy may be essentially cut off from the imports of critical parts and components that it needs to sustain domestic (including military) production, resulting in GDP growth being much lower than forecast in the baseline scenario.

Table 6.18 / Russia: Selected economic indicators

	2020	2021	2022	2023 ¹⁾	2024	2025	2026
					Forecast		
Population, th pers., average ²⁾	146,460	145,864	146,714	146,326	145,800	145,400	145,000
Gross domestic product, RUB bn, nom.	107,658	135,774	155,189	172,148	189,300	203,700	216,800
annual change in % (real)	-2.7	5.9	-1.2	3.6	2.8	2.5	2.3
GDP/capita (EUR at PPP)	19,660	22,180	23,220	24,550	.	.	.
Consumption of households, RUB bn, nom.	54,752	67,029	74,453	84,724	.	.	.
annual change in % (real)	-5.9	9.9	-1.1	6.5	4.0	2.5	2.5
Gross fixed capital form., RUB bn, nom.	23,211	26,073	31,661	37,636	.	.	.
annual change in % (real)	-4.0	9.3	6.7	8.8	3.0	3.5	3.0
Gross industrial production ³⁾							
annual change in % (real)	-2.1	6.3	0.7	3.5	2.5	2.0	1.7
Gross agricultural production							
annual change in % (real)	1.3	-0.7	11.3	-0.3	.	.	.
Construction output							
annual change in % (real)	2.1	7.0	7.5	7.9	.	.	.
Employed persons, LFS, th, average ²⁾	70,601	71,719	72,644	73,636	74,370	74,740	74,740
annual change in %	-1.9	1.6	0.5	1.4	1.0	0.5	0.0
Unemployed persons, LFS, th, average ²⁾	4,321	3,631	2,988	2,401	2,200	2,200	2,200
Unemployment rate, LFS, in %, average ²⁾	5.8	4.8	4.0	3.2	2.9	2.9	2.9
Reg. unemployment rate, in %, eop ²⁾⁴⁾	3.7	1.0	0.8	0.6	.	.	.
Average monthly gross wages, RUB	51,344	57,244	65,338	74,550	83,900	91,200	97,900
annual change in % (real, gross)	3.8	4.5	0.3	7.8	5.0	4.0	3.5
Consumer prices, % p.a.	3.4	6.7	13.8	5.9	7.2	4.5	3.7
Producer prices in industry, % p.a. ⁵⁾	-3.8	24.5	11.4	4.0	10.0	5.0	4.0
General governm. budget, nat. def., % of GDP							
Revenues	35.5	35.4	34.2	34.3	35.0	35.5	35.5
Expenditures	39.5	34.7	35.6	36.6	36.7	37.0	36.5
Deficit (-) / surplus (+)	-4.0	0.8	-1.4	-2.3	-1.7	-1.5	-1.0
General gov. gross debt, nat. def., % of GDP	17.6	15.4	14.7	14.9	15.0	15.5	16.0
Stock of loans of non-fin. private sector, % p.a.	12.4	19.8	13.6	23.2	.	.	.
Non-performing loans (NPL), in %, eop ⁶⁾	6.1	5.1	4.7	3.7	.	.	.
Central bank policy rate, % p.a., eop ⁷⁾	4.25	8.50	7.50	16.00	13.50	10.00	8.00
Current account, EUR m ⁸⁾	30,957	105,540	224,578	46,420	59,100	59,100	59,800
Current account, % of GDP	2.4	6.8	10.5	2.5	3.3	3.2	3.0
Exports of goods, BOP, EUR m ⁸⁾	291,895	417,389	559,444	392,085	404,600	412,700	425,100
annual change in %	-22.1	43.0	34.0	-29.9	3.2	2.0	3.0
Imports of goods, BOP, EUR m ⁸⁾	210,118	254,276	261,270	280,320	286,400	295,000	306,800
annual change in %	-7.3	21.0	2.8	7.3	2.2	3.0	4.0
Exports of services, BOP, EUR m ⁸⁾	41,973	46,924	45,952	38,087	38,200	38,900	40,100
annual change in %	-24.1	11.8	-2.1	-17.1	0.3	1.8	3.1
Imports of services, BOP, EUR m ⁸⁾	56,666	64,088	66,968	69,611	73,200	76,200	79,200
annual change in %	-35.5	13.1	4.5	3.9	5.2	4.1	3.9
FDI liabilities, EUR m ⁸⁾	8,296	34,166	-37,607	-10,333	.	.	.
FDI assets, EUR m ⁸⁾	5,117	55,647	-12,365	8,842	.	.	.
Gross reserves of CB excl. gold, EUR m ⁸⁾⁹⁾	372,318	439,693	414,569	400,316	.	.	.
Gross external debt, EUR m ⁸⁾	380,941	431,614	358,013	286,490	252,400	250,000	256,200
Gross external debt, % of GDP	29.2	27.7	16.7	15.3	14.0	13.5	13.0
Average exchange rate RUB/EUR	82.39	87.20	72.48	92.14	105.0	110.0	110.0

Note: Including Crimean Federal District.

1) Preliminary and wiiw estimate. - 2) From 2022 according to census 2020. - 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.

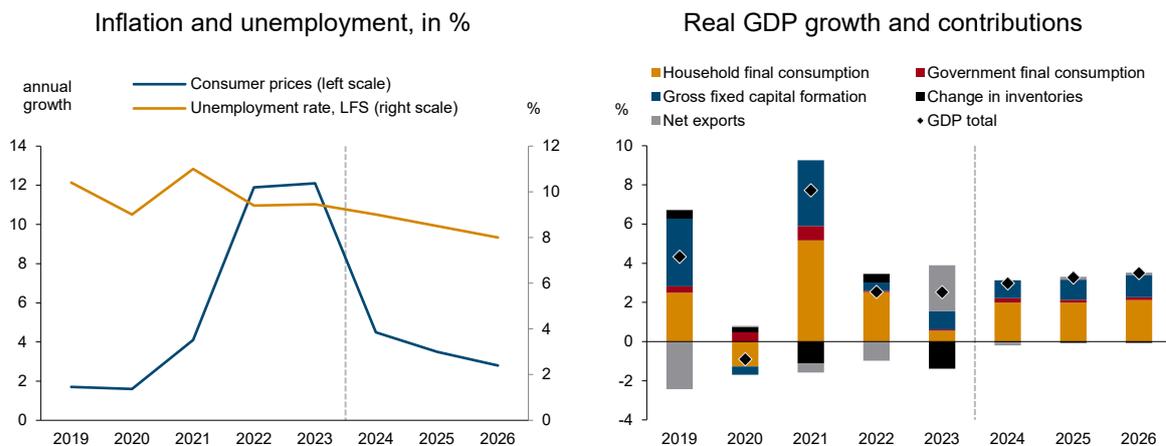


SERBIA: Improved outlook, but structural issues remain

BRANIMIR JOVANOVIĆ

The decline in inflation is boosting real incomes and consumption, while the industrial sector appears to be coming back to life, after two challenging years. Foreign direct investment remains strong, as always, with a notable return of EU investors and the continued strong presence of the Chinese. Public investment is strong, too, lately focused on the upcoming EXPO 2027 in Belgrade. Although the economic conditions in the country have undoubtedly improved, we maintain that numerous structural issues will continue, limiting the potential for higher growth.

Figure 6.19 / Serbia: Main macroeconomic indicators



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

Serbia's economy saw an upturn in the final quarter of 2023, with GDP expanding by 3.8% year on year. This owed primarily to the resurgence in private consumption, which rose by 2.5% as inflation began to slow down and real incomes started to recover. Government consumption also contributed, growing by 5.8%, largely influenced by the December elections. Investment remained robust, as throughout the year, increasing by 5.2%. Exports edged up by a mere 0.3%, a reflection of the global economic slowdown and the recession in Germany. In contrast, imports gained momentum, rising by 4.2%, propelled by strengthened domestic demand.

The start of 2024 looks promising, as the industrial sector, Serbia's traditional powerhouse, shows signs of reviving. Following two years of modest performance, with growth rates hovering at around 2-3%, industrial production in January and February surged by 7.9% year on year. The improvement is broad based, with three quarters of industrial sectors registering expansion, signalling a

general improvement in economic conditions. Notably, the metal and automotive sectors, critical to Serbia's industrial backbone, have witnessed robust double-digit growth, suggesting a rebound in external demand for these Serbian products. Beyond industry, the retail sector is also on a solid trajectory, posting a 6.4% increase in real terms during the first two months, driven by uniform growth across various consumption segments, including food, motor fuels and other goods.

On a less positive note, the country continues to grapple with persistent inflation, which remains among the highest in Europe. Although there has been a steady decline from a peak of 16.2% in March 2023 to 5.6% in February 2024, the rate is still significantly above the central bank's target of $3\% \pm 1.5\%$, and is almost double that seen in the neighbouring countries. Although the persistence of inflation can partly be attributed to robust domestic demand, the primary factor is the frequent adjustment in regulated prices by the government. It has incrementally increased the price of electricity, central heating, tobacco and motor fuels on several occasions, and these adjustments have directly spurred price hikes and led companies to raise their prices further to maintain their profit margins. Measures like the price controls introduced in October 2023, which target a limited range of products, were implemented too late and have proved ineffective in curbing the inflationary trend this time.

A shift towards easing the monetary cycle is expected, but it is unclear when this will start. The central bank has kept its key interest rate at 6.5% since July 2023, and we expect it to stay at that level for at least another two months. Once inflation falls below the upper range of the target (4.5%), and once the European Central Bank lowers its rate, we expect that National Bank of Serbia to start its easing cycle, which should bring the base interest rate to 5.5% by the end of the year.

The fall in inflation has led to a rise in real wages, which is expected to stimulate consumption and economic activity. Throughout 2023, nominal wage growth hovered at around 14-15%; but with inflation reaching similar (or even higher) levels for much of the year, real wages either fell or remained flat. The recent dip in inflation has reversed this trend, resulting in a positive real wage growth of 8.8% in January. This growth is consistent across both public and private sectors. Notably, the rise in lower wages has outpaced that in higher wages, with the median wage experiencing real growth of 10%.

Foreign direct investment (FDI) has remained robust, with a significant resurgence of European investors. FDI inflows hit EUR 4.5bn in 2023, equating to 6.5% of GDP. This represents a slight drop from the previous year's 7.3% of GDP, but still ranks among the highest in Eastern Europe. Investments from EU countries surged by 55% over the previous year, accounting for about half of the country's total FDI inflows. This increase is a strong indicator of Western investors' renewed confidence in Serbia and its geopolitical trajectory. Chinese investment has remained steady, contributing around a third of Serbia's total FDI. Data from January 2024 suggest that these trends are continuing, with inflows in a single month amounting to EUR 560m.

Public investment remains robust, the new focus being EXPO 2027. In 2023, it reached 7% of GDP, slightly down on the 7.4% of 2022, yet still the highest in Europe. This trend is expected to persist, especially with the upcoming specialised EXPO 2027. This is set to take place in Belgrade between May and August 2027, and is expected to attract more than a hundred countries wishing to showcase their cultural heritage and achievements in sport and music. The government has estimated the cost at around EUR 18bn, which includes also investments in infrastructure related to the EXPO, such as highways and public transportation systems. Over a four-year span, this equates to an annual

investment of 5-6% of GDP, aligning with public investment levels from recent years. Although the project is expected to boost economic activity during its execution and potentially to yield positive medium-term economic benefits through infrastructure development, it has faced criticism for its lack of transparency and the risk of corruption.

Despite the robust public investment and the elections toward the end of 2023, the fiscal landscape shows a trend towards consolidation. The deficit shrank to 2.2% of GDP in 2023, outperforming the initial target of 3.3% and falling from 3.2% the year before. This marks a steady reduction from 8% in 2020. The 2024 budget projects a deficit of 2.2%, which appears achievable. Early data for 2024 indicate a budget surplus in January, although this is likely to shift to a deficit in the subsequent months. On the debt front, public debt declined to 52% of GDP at the end of 2023, down from 57% at the end of 2020, helped by the high inflation. As inflation eases, so this trend is likely to be reversed, and public debt is expected either to hover at the current level or to increase gradually, though not to exceed 60% any time soon.

Given the overall positive outlook for the economy, we are adjusting our GDP growth projections upwards. For 2024, we now anticipate a growth rate of 3%, gradually increasing to 3.5% by 2026. Despite the recent improvements, we still think that the numerous structural issues related to the neglect of domestic private investment, the lack of rule of law, problems with corruption and democratic backsliding will be a burden that will prevent the country from achieving sustainable growth in the longer run. Our inflation predictions remain unchanged – 4.5% for 2024, with a gradual decline to 2.8% by 2026.

The improved economic situation has prompted Serbian officials to assert their optimism about receiving an investment-grade rating from credit-rating agencies this year. Notably, S&P recently upgraded Serbia's outlook to positive, affirming its rating at BB+, while Fitch confirmed the country's rating at BB+, with a stable outlook. Our view is that if the economic results this year exceed our current expectations, and if the political situation remains stable, then there could be an upgrade to the rating towards the end of the year. But if growth hovers at around 3% and inflation is above 4%, this is unlikely to happen.

Political uncertainties, particularly regarding the status of Kosovo, remain a key downside risk. The dialogue between Belgrade and Prishtina has been stalled for some time, and tensions have flared up from time to time, most recently over the decision by the Kosovo authorities to ban the Serbian dinar. While such sporadic disputes are conceivable and likely, we believe that any major incident is highly unlikely – not only because of the presence of NATO troops in Kosovo, but also because Serbia does not have any real interest in escalating the situation. Serbia's focus in recent years has been on the economy. The strategy of the current Serbian government has been to 'Make Serbia Great Again' – but in the economic sense: any escalation in northern Kosovo would only undermine this. That does not mean that things may not get out of control, though; and because of that, the only sustainable way forward is through the full implementation of the Brussels and Ohrid agreements on the normalisation of relations between Serbia and Kosovo – and most immediately through the establishment of an Association of Serb-Majority Municipalities in Kosovo.

The upcoming local elections in June could turn out to be very important for Serbia's political dynamics. Despite the convincing victory of the ruling conservative SNS party in the December 2023 parliamentary elections, a rerun of the Belgrade local elections is scheduled, following fraud allegations

by the opposition and a critical report from the Office for Democratic Institutions and Human Rights. An opposition victory in these elections would be a serious blow to the ruling party, potentially indicating a shift in political momentum. Conversely, a win for the ruling party would cement its grip on power and knock down the opposition. Both outcomes seem equally likely. The ruling party has gained strength since December, buoyed by its parliamentary success and an improved economic climate. But Belgrade traditionally resists nationalistic and authoritarian tendencies; if the elections proceed without significant irregularities, and if the opposition manages to get its act together, it could well emerge as the winner. Despite the political importance of these elections, they are unlikely to bring any changes in terms of economic or social policies, as the ruling party will maintain power at the national level and will continue to implement its programmes.

Table 6.19 / Serbia: Selected economic indicators

	2020	2021	2022	2023 ¹⁾	2024	2025	2026
					Forecast		
Population, th. pers., mid-year ²⁾	6,899	6,834	6,664	6,614	6,564	6,514	6,464
Gross domestic product, RSD bn, nom.	5,504	6,272	7,098	8,150	8,800	9,400	10,000
annual change in % (real)	-0.9	7.7	2.5	2.5	3.0	3.3	3.5
GDP/capita (EUR at PPP)	12,820	14,240	15,560	16,330	.	.	.
Consumption of households, RSD bn, nom.	3,606	4,071	4,761	5,385	.	.	.
annual change in % (real)	-1.9	7.9	3.9	0.8	3.0	3.0	3.2
Gross fixed capital form., RSD bn, nom.	1,180	1,459	1,714	1,850	.	.	.
annual change in % (real)	-1.9	15.7	1.9	3.9	4.0	4.5	5.0
Gross industrial production							
annual change in % (real)	-0.1	6.6	1.9	2.6	3.0	3.0	3.0
Gross agricultural production							
annual change in % (real)	2.2	-6.8	-8.9	8.0	.	.	.
Construction output							
annual change in % (real)	-2.5	17.0	-10.4	11.6	.	.	.
Employed persons, LFS, th, average ³⁾	2,895	2,849	2,913	2,868	2,900	2,930	2,960
annual change in %	-0.2	3.0	2.3	0.7	1.0	1.0	1.0
Unemployed persons, LFS, th, average ³⁾	287	352	302	299	290	270	260
Unemployment rate, LFS, in %, average ³⁾	9.0	11.0	9.4	9.5	9.0	8.5	8.0
Reg. unemployment rate, in %, eop	17.9	17.4	15.4	14.1	.	.	.
Average monthly gross wages, RSD	82,984	90,784	103,316	118,599	126,400	134,700	142,600
annual change in % (real, gross)	7.8	5.2	1.7	2.4	2.0	3.0	3.0
Average monthly net wages, RSD	60,073	65,864	74,933	86,007	91,700	97,800	103,600
annual change in % (real, net)	7.7	5.4	1.7	2.4	2.0	3.0	3.0
Consumer prices, % p.a.	1.6	4.1	11.9	12.1	4.5	3.5	2.8
Producer prices in industry, % p.a.	-1.3	8.7	14.9	3.3	1.0	1.5	2.0
General governm. budget, nat. def., % of GDP							
Revenues	41.0	43.2	43.7	42.6	44.0	44.0	44.0
Expenditures	49.0	47.4	46.9	44.8	46.0	45.5	45.0
Deficit (-) / surplus (+)	-8.0	-4.1	-3.2	-2.2	-2.0	-1.5	-1.0
General gov. gross debt, nat. def., % of GDP	57.8	57.1	55.6	52.3	52.0	52.0	52.0
Stock of loans of non-fin. private sector, % p.a.	11.1	10.2	6.5	1.0	.	.	.
Non-performing loans (NPL), in %, eop	3.7	3.5	3.0	3.0	.	.	.
Central bank policy rate, % p.a., eop ⁴⁾	1.0	1.0	5.0	6.5	5.50	5.0	4.5
Current account, EUR m	-1,929	-2,266	-4,162	-1,810	-2,000	-2,300	-2,500
Current account, % of GDP	-4.1	-4.2	-6.9	-2.6	-2.7	-2.9	-2.9
Exports of goods, BOP, EUR m	16,079	21,018	26,928	27,930	29,600	31,200	32,800
annual change in %	-2.0	30.7	28.1	3.7	6.0	5.5	5.0
Imports of goods, BOP, EUR m	21,280	27,038	36,292	34,534	36,400	38,400	40,500
annual change in %	-3.4	27.1	34.2	-4.8	5.5	5.5	5.5
Exports of services, BOP, EUR m	6,191	7,800	11,076	13,079	14,400	15,800	17,400
annual change in %	-10.7	26.0	42.0	18.1	10.0	10.0	10.0
Imports of services, BOP, EUR m	5,090	6,402	8,761	10,062	11,400	12,800	14,200
annual change in %	-14.1	25.8	36.9	14.8	13.0	12.0	11.0
FDI liabilities, EUR m	3,039	3,886	4,432	4,522	.	.	.
FDI assets, EUR m	100	229	104	302	.	.	.
Gross reserves of CB, excl. gold, EUR m	11,732	14,523	17,311	22,516	.	.	.
Gross external debt, EUR m	30,787	36,488	41,895	45,378	50,400	54,900	59,500
Gross external debt, % of GDP	65.8	68.4	69.3	65.3	67.0	68.0	69.0
Average exchange rate RSD/EUR	117.58	117.57	117.46	117.25	117.0	116.5	116.0

Note: Introduction of new index 2021=100 (new weights) for gross industrial production.

1) Preliminary and wiiw estimates. - 2) From 2022 according to census 2022. - 3) From 2023 according to census 2022. From 2021 new LFS methodology in line with the Integrated European Social Statistics Regulation (IESS). - 4) Key policy rate.

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

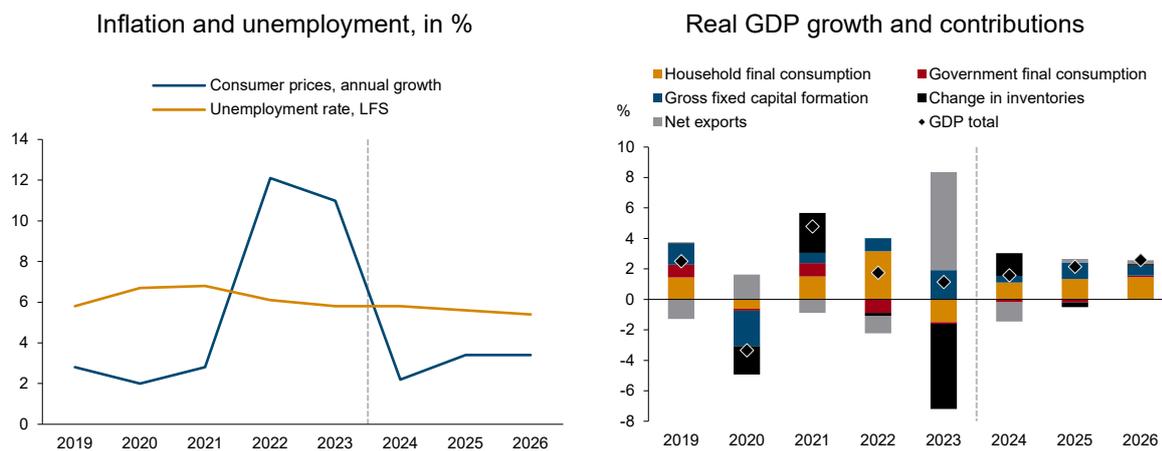


SLOVAKIA: Navigating the political challenges

DORIS HANZL-WEISS

While Slovakia's GDP increased by only 1.1% in 2023, wiiw forecasts a gradual improvement in growth in the coming years. This will mainly be driven by household consumption, bolstered by lower inflation, leading to rising real wages and a favourable labour market. However, the domestic risks are rising due to ongoing political changes.

Figure 6.20 / Slovakia: Main macroeconomic indicators



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

Slovakia's GDP increased by a mere 1.1% in 2023, marking a low point on its growth trajectory of recent years. Since its accession to the EU in 2004, only in 2013 has growth been lower than last year (excluding the crisis years of 2009 and 2020). Nonetheless, up against the other Visegrád countries, Slovakia's performance was the best in the region. The primary driver of growth was net foreign trade, with imports declining more significantly than exports (by 7.4% compared to 1.3%, in real terms). Moreover, increased investment played a significant role, surging by almost 10%. This may be attributed to the end of the financing cycle of EU funds, which (as is often the case) was associated with an upswing in investment activity towards the end of the year. However, a substantial 16% decrease in inventories prevented even higher growth. On the downside, household consumption experienced a decline of 2.5%. This was largely due to Slovakia's very high inflation rate, which at 11% was the highest in the euro area; this resulted in a fall in real wages and household income. Additionally, savings had already been depleted the previous year.

The automotive industry has experienced a sluggish start to the new year. The all-important automotive industry was a key driver of 2023 industrial growth, thanks to its recovery from previous supply-chain disruptions and the shortage of chips, and the subsequent processing of backlog orders. Alongside

the pharmaceutical industry and the basic metals and fabricated metals sector, which also showed growth (both up 9%), the automotive industry (at 12%) pushed overall growth of industrial production into positive territory (+1.5%). In 2023, the four major car companies in Slovakia – VW, Kia, Stellantis and Jaguar Land Rover – increased car production by 10%, to an almost record 1.08m cars; this maintained Slovakia's position as the largest car manufacturer per capita globally. While the Slovak Automotive Industry Association (ZAP) expects that output level to be exceeded this year, there are grounds for caution. In fact, in January, automotive sector production declined by approximately 5% year on year, and industrial orders are down across nearly all manufacturing sectors. Although electric car models are gradually being introduced, last year Volkswagen ceased production of its small VW e-up! cars, which were launched in 2011. The ramping-up of electric car production is expected in 2026, coinciding with the completion and commencement of production at Volvo's new electric car production plant.

The current account improved considerably in 2023, but the export trend went into reverse in the first months of 2024. The current account deficit narrowed in 2023 to 1.6% of GDP. This was due to the trade balance again turning positive: goods exports increased by almost 4%, thanks to exports of machinery and transport equipment, including cars (+15%), while imports declined by 4%, due to falling energy prices. Services exports and imports both fell last year, though the services balance remained positive. If we look in more detail at trade developments (based on trade statistics), exports to the country's main trade partners – Germany and Czechia – were up 5%. Trade with Russia has fallen since the invasion of Ukraine and exports were down 35%, while imports nearly halved (due to much lower energy prices). Still, Slovakia has a trade deficit with Russia of EUR 4bn, due to imports of mineral fuels. When we look at trade with Ukraine, exports increased by almost 30%, while imports fell by about 20%. During the first two months of 2024, goods exports declined slightly, also due to a big drop in machinery and transport equipment exports in February, while imports fell by almost 9%.

Positive developments on the labour market and a decrease in inflation are expected to bolster household consumption in 2024. Last year there was a slight increase in the number of employed persons. However, while the service sector experienced a positive trend (up 2.1%), employment in manufacturing declined (by 2.8%). The unemployment rate continued falling in 2023, dropping below 6% for the first time ever (5.8%). However, further reductions may prove challenging due to significant regional disparities and low labour mobility. For instance, while the unemployment rate stood at 2.2% in Bratislava, it reached 10.7% in the eastern part of Slovakia (Prešov region, Q4 2023 data). Positive trends in the labour market persisted in the first months of 2024. A shortage of labour, especially in the automotive and the transport industry (bus and lorry drivers), has led to a plan to increase the number of so-called 'national visas' (from a maximum of 2,000 to 10,000). Inflation peaked in February 2023 at 15.4%, since when it has fallen (to 2.5% in March 2024). With administered energy prices expected to remain low this year, the inflation forecast for 2024 is close to 2%; that said, inflation may rise in subsequent years when subsidies are lifted. Consequently, following a two-year decline, real wages are expected to increase, further stimulating household consumption. Retail trade showed an increase of 2% year on year in January.

The new government is continuing to subsidise energy prices this year, putting off fiscal consolidation. In 2023, government measures aimed at mitigating the impact of high energy prices for households, businesses and municipalities pushed the budget deficit to about 6% of GDP. In the 2024 budget, Prime Minister Robert Fico's new government is maintaining its energy price subsidies, freezing them for households. Expenditure will also increase due to the support for pensioners and mortgage

borrowers. On the revenue side, new taxes (such as a bank levy) and higher taxes (such as those on tobacco and alcohol in restaurants) will generate more revenue, but the deficit is still projected to reach 6% this year. While deficits are forecast to decline gradually over the coming years, they will likely remain high. The Multiannual Financial Framework of the EU for 2013-2020 ended in 2023, leading to increased investment toward the end of the year, particularly in transport infrastructure. EU funds may now flow in more slowly, since the new political cycle entails personnel changes and a reassessment of programmes. Moreover, the funds may be at risk not only on account of rule-of-law issues related to changes to the Penal Code and the possibility of a standoff between Brussels and Slovakia's new (populist) government, but also because of a failure to meet milestones of the EU's Recovery and Resilience Facility (such as not approving spending limits and delays to pension reform).

For the upcoming years, wiiw forecasts a gradual improvement in growth, which is expected to reach 1.6% in 2024, 2.2% in 2025 and 2.6% in 2026. With inflation finally coming down and real wages seeing growth this year, household consumption is likely to recover and to become the primary growth driver in this and subsequent years. Conversely, net exports are projected to suffer this year, due to sluggish performance in the euro area, and particularly in Slovakia's main trade partner of Germany. However, net exports are expected to improve in subsequent years, contributing once again to overall growth. All in all, however, the risks remain elevated, and especially the domestic risks are growing. Recent political developments are worrying: the change of government has brought instability (e.g. change in top posts in institutions); the abolition of the special prosecutor's office and amendment of the Penal Code pose risks to EU funds; some downgrades by rating institutions have already occurred; and the risk premium is rising (up since the Russian invasion of Ukraine). Additionally, investor uncertainty is increasing, potentially dampening long-run growth. The victory in the 6 April presidential election of Peter Pellegrini, an ally of the populist Prime Minister Robert Fico, will aggravate the political challenges. Protests are ongoing. Various domestic challenges lie ahead, including the transition of the automotive sector towards electric vehicles electric mobility, diversification of energy supplies and greening of the economy, as well as global challenges such as the ongoing Russian war in the neighbouring Ukraine.

Table 6.20 / Slovakia: Selected economic indicators

	2020	2021	2022	2023 ¹⁾	2024	2025	2026
					Forecast		
Population, th pers., average ²⁾	5,459	5,447	5,432	5,427	5,414	5,399	5,389
Gross domestic product, EUR m, nom.	93,444	100,256	109,645	122,156	126,800	133,900	142,000
annual change in % (real)	-3.3	4.8	1.8	1.1	1.6	2.2	2.6
GDP/capita (EUR at PPP)	22,350	23,860	25,190	27,290	.	.	.
Consumption of households, EUR m, nom.	52,871	56,042	66,452	71,467	.	.	.
annual change in % (real)	-1.1	2.7	5.7	-2.5	1.9	2.3	2.5
Gross fixed capital form., EUR m, nom.	18,210	19,255	22,020	26,321	.	.	.
annual change in % (real)	-10.9	3.5	4.5	9.6	2.0	5.0	3.0
Gross industrial production							
annual change in % (real)	-8.9	10.7	-4.5	1.5	2.3	3.1	3.5
Gross agricultural production							
annual change in % (real)	3.4	-2.8	-9.5	11.3	.	.	.
Construction industry							
annual change in % (real)	-11.3	-2.0	0.0	0.5	.	.	.
Employed persons, LFS, th, average ³⁾	2,531	2,561	2,604	2,610	2610	2620	2630
annual change in %	-2.0	-1.7	1.7	0.2	0.0	0.3	0.4
Unemployed persons, LFS, th, average ³⁾	181	188	170	162	160	160	150
Unemployment rate, LFS, in %, average ³⁾	6.7	6.8	6.1	5.8	5.8	5.6	5.4
Reg. unemployment rate, in %, eop	7.6	6.8	5.9	5.1	.	.	.
Average monthly gross wages, EUR	1,133	1,211	1,304	1,430	1520	1600	1680
annual change in % (real, gross)	1.8	3.6	-4.5	-0.7	4.0	1.5	1.5
Consumer prices (HICP), % p.a.	2.0	2.8	12.1	11.0	2.2	3.4	3.4
Producer prices in industry, % p.a.	-0.6	6.7	26.3	8.0	-3.0	2.3	2.3
General governm. budget, EU def., % of GDP							
Revenues	39.4	40.2	40.2	41.0	40.5	40.2	39.8
Expenditures	44.7	45.3	42.3	47.0	46.5	45.2	43.8
Net lending (+) / net borrowing (-)	-5.4	-5.2	-2.0	-6.0	-6.0	-5.0	-4.0
General gov. gross debt, EU def., % of GDP	58.9	61.1	57.8	57.4	59.9	62.0	63.4
Stock of loans of non-fin. private sector, % p.a.	5.0	7.2	10.8	3.0	.	.	.
Non-performing loans (NPL), in %, eop	2.3	1.9	1.7	1.7	.	.	.
Central bank policy rate, % p.a., eop ⁴⁾	0.00	0.00	2.50	4.50	.	.	.
Current account, EUR m	526	-3,970	-8,046	-1,942	-1,700	-1,200	-1,500
Current account, % of GDP	0.6	-4.0	-7.3	-1.6	-1.3	-0.9	-1.1
Exports of goods, BOP, EUR m	70,011	83,106	96,945	100,513	103,000	108,900	116,000
annual change in %	-7.3	18.7	16.7	3.7	2.5	5.7	6.5
Imports of goods, BOP, EUR m	68,996	83,429	103,006	98,926	100,900	105,900	112,800
annual change in %	-10.0	20.9	23.5	-4.0	2.0	5.0	6.5
Exports of services, BOP, EUR m	9,048	9,580	12,017	11,619	12,000	12,500	13,000
annual change in %	-17.6	5.9	25.4	-3.3	3.0	4.0	4.0
Imports of services, BOP, EUR m	8,085	9,034	11,615	11,026	11,800	12,700	13,700
annual change in %	-17.2	11.7	28.6	-5.1	7.0	8.0	8.0
FDI liabilities, EUR m	-934	2,299	3,873	-303	.	.	.
FDI assets, EUR m	1,475	1,011	1,528	-387	.	.	.
Gross reserves of CB excl. gold, EUR m	6,050	6,850	7,915	8,319	.	.	.
Gross external debt, EUR m	111,746	134,511	113,029	117,863	110,000	105,000	100,000
Gross external debt, % of GDP	119.6	134.2	103.1	96.5	86.8	78.4	0.0

Note: Introduction of new index 2021=100 (new weights) for gross industrial production and producer prices in industry.

1) Preliminary and wiiw estimates. - 2) From 2021 according to census 2021. - 3) From 2021 new LFS methodology 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.

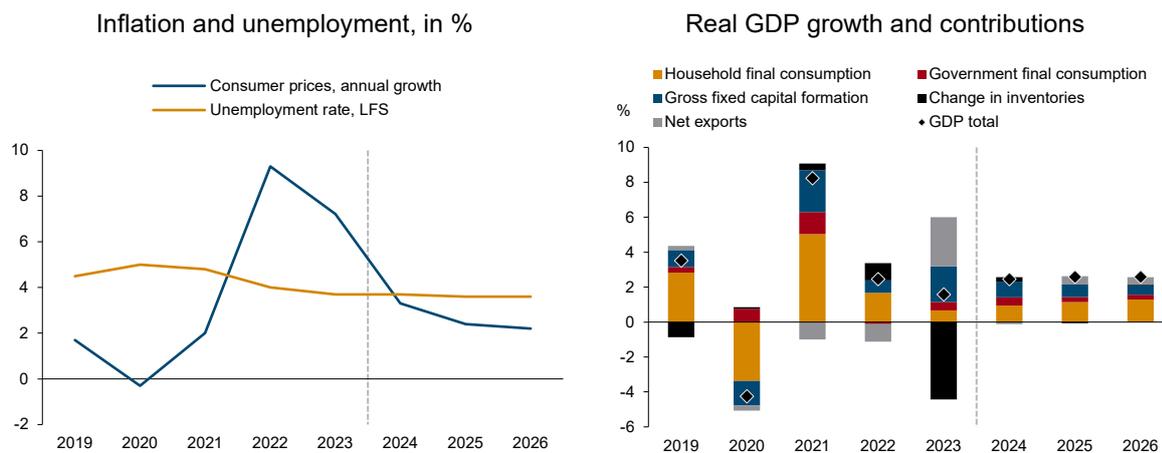


SLOVENIA: Post-inflation recovery to be hampered by the long-term effects of past crises

NIKO KORPAR

This year will bring higher growth than 2023. Real GDP is expected to grow by 2.5%, thanks to private spending and investment in infrastructure. Exports and industrial production will recover, but will be hampered by sluggish export demand. Inflation will fall to 3.3%. A labour shortage and upward wage pressure are key issues for the labour market. Mid-term growth rates are expected to be lower than pre-pandemic, potentially reflecting the effects of increased energy prices.

Figure 6.21 / Slovenia: Main macroeconomic indicators



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

The Slovenian economy entered 2024 relatively unscathed, despite a tumultuous 2023. The period starting with the outbreak of the war in Ukraine and ending with the catastrophic floods of August 2023 impacted on the economy's growth performance, leading households to spend less and forcing the government to spend more. Perhaps most critically, this placed a heavy strain on the energy-intensive and export-focused industry, which was forced to cut output by 1.7% in 2023 as export demand shrivelled across Europe and high energy prices damaged its competitiveness. Still, the signs point to (yet another) recovery being under way since Q4 2023: this has seen real GDP grow by 2.2% year on year, mostly through increased private spending. Growth will thus be higher in 2024 than in 2023 (1.6%).

In 2024, real GDP is expected to grow by 2.5%, fuelled by household spending and investment. Private spending and consumer confidence have both improved as the inflation rate has fallen and wage increases have given households more scope to loosen the purse-strings, following a lacklustre 2023. Year on year, household consumption is expected to grow by 1.8% in 2024. However, high interest rates

(and high prices) have exerted downward pressure on the demand for housing. The gap will be filled by government spending, which is expected to grow by 2.5%, due primarily to investment in the railways and roads, but also to the reconstruction of riverbeds and riverbanks, and of houses that were damaged in the flooding. Government spending will also rise as a consequence of increased healthcare spending, following changes in the collection of supplementary healthcare insurance from citizens. Companies have also to an extent resumed their investment activity on the basis of reduced inflation and the small recovery in export demand. Investment in fixed capital is expected to increase by 4.8% this year.

Inflation is projected to fall to 3.3% in 2024, yet still be somewhat higher than the EU average.

The inflation rate has been declining steadily since peaking in mid-2022, and energy and food prices have ceased to be its main drivers. In 2024, the cost of services and upward wage pressure will contribute to rising prices. Export prices are also expected to continue to recover. Inflation is likely to keep on falling through 2024, although it could see an uptick in the second half of the year as government measures aimed at reducing inflation run out. In 2025, it should finally drop below 3% (2.4%) and hover around the EU average.

Exports are expected to grow by only 1.6% this year as foreign demand recovers slowly; the long-term loss of competitiveness is a cause for concern. Exporting sectors are continuing to reel, having been forced to bump up their prices considerably; meanwhile the forecast for the German economy – Slovenia's main export market – continues to worsen. Exports from high-technology industries, especially pharmaceuticals, will contribute most to export growth, as will the trade in services (mainly tourism). Imports, having fallen by 5.1% in 2023, are projected to grow by 1.9 p.p. more than exports. Still, Slovenia will run a high current account surplus, amounting to 5.5% of GDP.

An increased minimum wage and an upward pressure on wage growth have contributed to a significant rise in nominal wages since 2022, but wage growth will slow in 2024. Still, wages are expected to grow by 5.8% in nominal terms and by around 2.2% in real terms. Wage growth is likely to slow further in 2025 and 2026. The wave of strikes has thus far mostly been limited to various public-sector employees, all of whom anticipate significant pay rises following the announcement of reforms to the public salary rules and healthcare reform.

Growth in employment will continue to slow, and there is no sign of the labour shortage easing any time soon. Employment growth will average 0.9% in 2024 (after 1.2% in 2023). Unemployment will remain at 3.7% in 2024 and will fall to 3.6% in 2025. Demographic decline and a chronic high demand for low-skilled workers will be the key trends in the years to come. The labour shortage is not only affecting construction and manufacturing, but also services, especially hospitality and care work. With the pool of labour in the Western Balkans starting to dry up, it remains to be seen if the government (and public opinion) will allow immigration regulations to be streamlined to the extent that the trend can be reversed.

Despite the unforeseen circumstances of last year's floods and in spite of anti-inflation measures, public finances seem to be under control. Last year saw a lower public deficit than expected (3.3% of GDP), due to better-than-anticipated revenue collection. In 2024 and 2025, the public deficit will be affected by greater structural spending (due to an increase in public-sector wages), greater expenditure on healthcare and spending on the reconstruction of damaged infrastructure, but also by lower discretionary spending, with anti-inflation measures running out by Q3 2024. This year will still see a high public deficit of 3.1% of GDP. In 2025, that should drop to 2.4% of GDP.

The government of Dr Robert Golob experienced a big fall-off in public support in 2023. The reasons for this include a corruption scandal among the minority coalition partners, a wave of prolonged strikes and an overall sense of underperformance in light of the announced wave of healthcare reforms. Still, and despite the turmoil, the government has managed to reform the national television and radio station, introduce a new system of long-term healthcare for the elderly, eliminate the 'voluntary' supplementary healthcare insurance model and take some small steps toward reforming healthcare. A new system for financing public housing is in development, and housing remains a critical issue for the young and low-earning population. Key decisions on the future of energy supply could hinge on a public referendum on building a new block of the Krško nuclear power plant, expected in autumn 2024.

Real GDP is expected to grow in 2025 (and 2026) at a rate similar to 2024 (2.6%), raising the question of whether annual GDP growth of below 3% is the new norm. In 2025, international trade and consumption will make up for decreased government spending after years of discretionary measures to combat the pandemic and inflation, although public funds will continue to be channelled into infrastructure. Despite changed conditions on export markets, we expect export growth to pick up and to exceed 3.5%. However, Slovenia will face lower growth rates than before the pandemic: the relatively successful years between 2014 and 2019 saw average annual growth of 3.5%. This raises the question of how far the permanently higher energy prices, the chronic shortage of lower-skilled workers and the sluggish growth among key export partners will depress Slovenia's growth potential in the medium term.

Table 6.21 / Slovenia: Selected economic indicators

	2020	2021	2022	2023 ¹⁾	2024	2025	2026
					Forecast		
Population, th pers., average	2,102	2,108	2,112	2,120	2,126	2,130	2,134
Gross domestic product, EUR m, nom.	47,045	52,279	57,038	63,090	66,800	70,200	73,600
annual change in % (real)	-4.2	8.2	2.5	1.6	2.5	2.6	2.6
GDP/capita (EUR at PPP)	26,850	29,330	31,880	34,380	.	.	.
Consumption of households, EUR m, nom.	23,293	26,530	30,157	32,765	.	.	.
annual change in % (real)	-6.5	10.2	3.3	1.3	1.8	2.2	2.5
Gross fixed capital form., EUR m, nom.	8,893	10,582	12,330	14,194	.	.	.
annual change in % (real)	-7.2	12.6	3.5	9.5	4.0	3.2	2.4
Gross industrial production							
annual change in % (real)	-5.2	10.1	1.2	-5.5	2.4	3.2	3.0
Gross agricultural production							
annual change in % (real)	4.9	-13.2	-0.9	-0.2	.	.	.
Construction industry							
annual change in % (real)	-0.7	-0.5	22.1	19.2	.	.	.
Employed persons, LFS, th, average ²⁾	978.0	971.6	986.1	989.4	1,000	1,010	1,010
annual change in %	-0.5	0.3	1.5	0.3	0.9	0.6	0.4
Unemployed persons, LFS, th, average ²⁾	51.2	48.4	41.2	37.5	40	40	40
Unemployment rate, LFS, in %, average ²⁾	5.0	4.8	4.0	3.7	3.7	3.6	3.6
Reg. unemployment rate, in %, eop	8.9	6.7	5.4	4.9	.	.	.
Average monthly gross wages, EUR	1,856	1,970	2,024	2,221	2,390	2,520	2,650
annual change in % (real, gross)	5.9	4.1	-5.5	2.1	4.2	3.0	2.8
Average monthly net wages, EUR	1,209	1,270	1,319	1,445	1,510	1,570	1,640
annual change in % (real, net)	6.6	3.1	-4.6	2.0	1.4	1.8	2.2
Consumer prices (HICP), % p.a.	-0.3	2.0	9.3	7.2	3.3	2.4	2.2
Producer prices in industry, % p.a.	-0.3	5.5	19.7	6.0	4.0	2.3	2.1
General governm. budget, EU def., % of GDP							
Revenues	43.7	44.9	44.1	45.1	46.9	47.4	48.5
Expenditures	51.4	49.5	47.2	48.4	50.4	49.4	49.1
Net lending (+) / net borrowing (-)	-7.6	-4.6	-3.0	-3.3	-3.5	-2.0	-0.6
General gov.gross debt, EU def., % of GDP	79.6	74.4	72.3	70.0	68.5	67.2	64.8
Stock of loans of non-fin. private sector, % p.a.	0.0	5.9	10.2	-0.6	.	.	.
Non-performing loans (NPL), in %, eop ³⁾	2.6	1.6	1.5	1.4	.	.	.
Central bank policy rate, % p.a., eop ⁴⁾	0.00	0.00	2.50	4.50	.	.	.
Current account, EUR m	3,398	1,732	-578	2,824	3,440	3,150	2,800
Current account, % of GDP	7.2	3.3	-1.0	4.5	5.1	4.5	3.8
Exports of goods, BOP, EUR m	29,622	35,255	42,628	41,317	42,020	42,900	44,870
annual change in %	-7.4	19.0	20.9	-3.1	1.7	2.1	4.6
Imports of goods, BOP, EUR m	27,289	34,373	44,802	40,854	40,730	41,500	43,490
annual change in %	-11.1	26.0	30.3	-8.8	-0.3	1.9	4.8
Exports of services, BOP, EUR m	6,985	8,471	11,133	11,850	12,550	13,430	14,850
annual change in %	-19.3	21.3	31.4	6.4	5.9	7.0	10.6
Imports of services, BOP, EUR m	5,072	6,273	7,651	8,004	8,230	8,810	9,430
annual change in %	-11.8	23.7	22.0	4.6	2.8	7.0	7.0
FDI liabilities, EUR m	446	1,856	2,051	1,056	.	.	.
FDI assets, EUR m	708	1,442	763	536	.	.	.
Gross reserves of CB excl. gold, EUR m	913	1,838	1,962	1,964	.	.	.
Gross external debt, EUR m	48,049	50,923	51,825	57,940	56,900	59,400	61,900
Gross external debt, % of GDP	102.1	97.4	90.9	91.8	85.2	84.6	84.1

Note: Introduction of new index 2021=100 (new weights) for gross industrial production and producer prices in industry.

1) Preliminary and wiiw estimates. - 2) From 2021 new LFS methodology in line with the Integrated European Social Statistics Regulation (IESS). - 3) Loans more than 90 days overdue and those unlikely to be paid. - 4) Official refinancing operation rates for euro area (ECB).

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

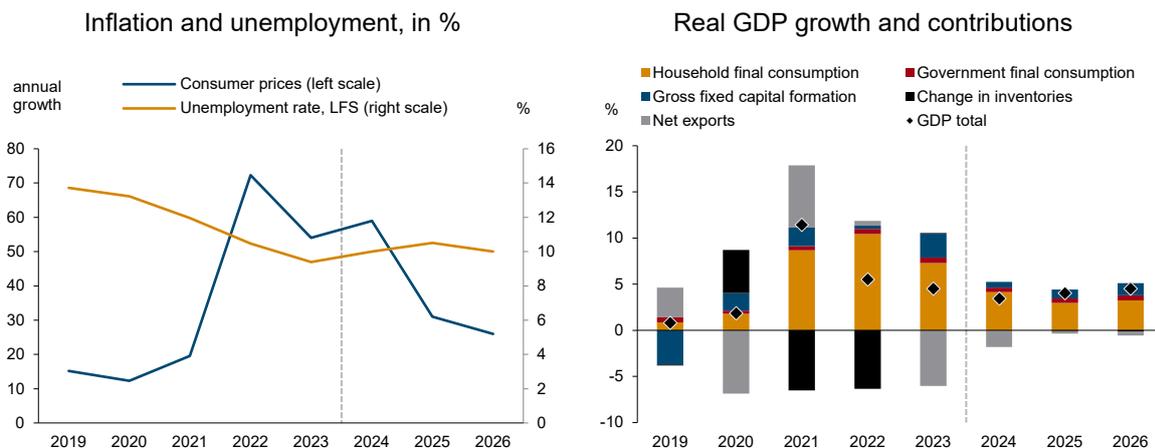


TURKEY: Monetary policy struggling to contain inflation

MERYEM GÖKTEN

In 2023, Turkey's economy grew by 4.5%, driven by strong domestic demand, but constrained by declining exports. The current account deficit improved modestly in the second half of the year. However, inflation surged to 68.5% year on year in March 2024, prompting a surprise policy rate hike to 50%. The rise in inflation expectations poses a challenge to the effectiveness of monetary policy. The government's defeat in Turkey's recent local elections reflects public outrage over inflation and the cost of living, and increases the uncertainty regarding future economic policies.

Figure 6.22 / Turkey: Main macroeconomic indicators



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

Turkey's economic growth exceeded market expectations in 2023. GDP growth reached 4% (year on year) in the last quarter of the year, and 4.5% for the entire year. Domestic demand emerged as the primary driver of the growth, fuelled mainly by an increase of 12.7% in household consumption, 7.5% in investment and 5.2% in government spending. However, real exports contracted by 2.7%. Consequently, while domestic demand contributed 10.5 percentage points to the overall growth in 2023, net exports exerted a downward pressure of 6 percentage points. Monetary expansion in the first half of the year and pre-election spending ahead of the May 2023 general election played a significant part in driving the growth. Post-earthquake reconstruction activities also contributed positively, with construction experiencing a growth rate of 7.8%, second only to the 9% growth recorded in financial and insurance activities.

Exports suffered from low demand in 2023 and may struggle in 2024 due to continued low demand and sanctions on trade with Russia. Last year was a challenging one for exports, leading to a significant trade deficit that exceeded USD 100bn for the second year in a row. Turkey's exports to its major trade partners (such as the EU, US and Iraq) declined on account of weaker external demand. Meanwhile, the country has seen significant export growth to Russia since the start of the war in Ukraine; this has led to sanctions against certain Turkish companies that have provided technology, goods and services to Russia. The impact of sanctions intensified in 2024 following the secondary sanctions announced by the US on foreign banks suspected of supporting Russia's actions in Ukraine. As a result, Turkish banks reportedly severed their ties with their Russian counterparts. The adverse effects of the sanctions have been especially noticeable in exports (rather than imports from Russia), with Turkish exports to Russia dropping by 37% in January-February 2024, compared to the same period of 2023.

While some progress has been made, there is still a long way to go to rebalance the economy away from the credit and current account deficit-fuelled growth model. The government remains committed to prioritising a 'soft-landing' approach, hoping to reduce inflation without sacrificing too much growth. Despite a gradual decline in the retail sales dynamics from August onwards, retail activity rebounded in December 2023. Notwithstanding the persistent high inflation and negative real interest rates, private consumption is likely to have stayed strong in Q1 2024, as households and firms continued to abandon the domestic currency. Although a slowdown is anticipated from Q2, domestic demand will maintain its positive contribution to overall annual growth this year. Despite the possibility that tighter financing conditions could dampen private investment, it is anticipated that earthquake reconstruction efforts will keep the total investment level up. As a result, we are revising our growth forecast from 2.9% to 3.4% for 2024. We expect growth to accelerate to 4% and 4.5% in 2025 and 2026, respectively, driven by easing financial conditions and increased net exports.

In 2023, the current account deficit experienced a modest improvement, declining from 5.4% of GDP in 2022 to 4.1%. This narrowing was driven by a strong performance by tourism, declining energy prices and reduced gold imports in the second half of the year. Additionally, the increased influx of portfolio investments made financing of the current account deficit easier. We anticipate that the current account deficit will narrow further to 3.1% of GDP in 2024. Stable energy prices, a slowdown in imports and a steady inflow of portfolio investments are expected to sustain this improvement and facilitate financing over the next three years. Furthermore, a recovery in demand from Europe in the coming years could boost Turkey's exports and help stabilise the current account deficit.

Despite the tighter monetary policy stance, the outlook for inflation is getting worse. Q1 2024 saw inflation rates exceed all expectations, leading to an annual inflation rate of 68.5% in March. Therefore, despite earlier signals from the Central Bank of the Republic of Turkey (CBRT) and Finance Minister Mehmet Şimşek indicating an end to rate hikes, the CBRT surprised the markets in March by raising the policy rate by 500 basis points to 50%. This move brought the real policy rate to -17.4%; though still substantially negative, this is a significant advance on the record level of -75.4% in November 2022. Furthermore, the CBRT has pledged additional macro-prudential measures, potentially focusing on controlling credit expansion (particularly credit card growth) and counteracting the downward pressure on deposit rates. We anticipate rate cuts starting in Q4 2024, as inflation will likely fall from July onwards, driven by base effects, thereby offering scope for a rate cut. However, we are adjusting our year-end forecast for the policy rate from 35% to 40%.

Monetary policy is struggling to contain inflation, largely due to the increase in inflation

expectations. The surge in inflation in 2024 can be attributed to various factors, including inadequate tightening measures, consistently negative real interest rates, the impact of wage hikes, tax increases and significant hikes in the price of goods and services controlled by public authorities. These factors have collectively worsened inflation expectations, resulting in a widening gap between the CBRT's target and market expectations, also known as the 'credibility gap'. Inflation expectations for the year end, based on a CBRT survey, increased from 41.2% in January to 44.2% in March, surpassing the CBRT's year-end target of 36%. Anchoring inflation expectations is crucial if the CBRT is to ensure the effectiveness of its monetary policy, since expectations strongly influence pricing, spending and investment behaviour. With the CBRT struggling to align inflation expectations with its targets, it will become increasingly challenging to hit those targets, which will necessitate a tighter monetary stance. Therefore, we expect the average annual inflation rate for 2024 to remain rather high at 59%, with the end-of-year inflation projected to be 42%. Additionally, we forecast inflation to persist in the coming years, with average annual rates of 31 % in 2025 and 26% in 2026.

After 22 years of dominance, the governing Justice and Development Party (AKP) suffered an unexpected defeat in the March local elections. The main opposition party, the Republican People's Party (CHP), secured 38% of the popular vote, while the AKP obtained 36%. The results highlight the significance of inflation and cost-of-living challenges, particularly as they impact low-income earners and retirees. President Erdoğan, in his first post-election speech, acknowledged the outcome as a turning point and pledged to rectify his party's mistakes, though his next steps remain uncertain. Despite reaffirmations from the government, the election results have introduced a degree of uncertainty regarding its commitment to the current economic programme. Although the next presidential elections are four years away, President Erdoğan is seeking to change the constitution in the meantime in order to extend presidential authority and remove the absolute-majority rule for presidential elections. A potential referendum to amend the constitution could lead to the reversal of some current policies in the hope of gaining public support. In a probable scenario, the government might implement higher-than-expected increases in pensions and public-sector wages, along with an additional minimum wage adjustment in the second half of the year, confounding the stance of Finance Minister Şimşek and the CBRT. In a more extreme scenario, if the current economic programme fails to reduce inflation significantly in the second half of the year, President Erdoğan may revert to previous populist policies. This could involve increased redistribution of public resources, such as offering more public jobs, healthcare and housing to his voter base. Additionally, given his stance that interest rates are un-Islamic and the true cause of high inflation, he might consider reversing monetary policy.

The medium-term outlook for Turkey remains underwhelming. While the country is projected to be one of the fastest-growing countries in the region over the next three years, it is expected to perform at below its potential. Since last year's presidential election, both monetary and fiscal policy has been chaotic and uncoordinated, with short-term electoral priorities that result in a lack of fiscal discipline, the slow pace of monetary tightening and the introduction of complex macro-prudential regulations. The struggle to bring inflation down without sacrificing growth has affected inflation expectations and the growth outlook. This risk could lead to the economy being stuck in an environment of high inflation and high interest rates, resulting in growth that is only moderate, compared to past performance. If the country can effectively utilise this four-year period without elections to credibly control inflation, significant improvements could be achieved. Until there is a consistency of approach, we anticipate that both the inflation rate and the policy rate will remain in double digits.

Table 6.22 / Turkey: Selected economic indicators

	2020	2021	2022	2023 ¹⁾	2024	2025	2026
					Forecast		
Population, th pers., average	83,385	84,147	84,980	85,326	87,213	88,260	89,100
Gross domestic product, TRY bn, nom.	5,049	7,256	15,012	26,276	43,200	58,900	77,600
annual change in % (real)	1.9	11.4	5.5	4.5	3.4	4.0	4.5
GDP/capita (EUR at PPP)	18,320	19,950	23,810	25,200	.	.	.
Consumption of households, TRY bn, nom.	2,847	3,983	8,564	15,540	.	.	.
annual change in % (real)	3.2	15.4	19.0	12.8	7.0	5.0	5.5
Gross fixed capital form., TRY bn, nom.	1,389	2,044	4,378	8,506	.	.	.
annual change in % (real)	7.3	7.2	1.3	8.9	2.0	3.0	4.0
Gross industrial production ²⁾							
annual change in % (real)	2.3	16.4	5.0	1.6	1.0	2.0	3.0
Gross agricultural production ³⁾							
annual change in % (real)	4.6	0.5	7.7	6.0	.	.	.
Construction industry ⁴⁾							
annual change in % (real)	-3.0	3.0	5.0	6.5	.	.	.
Employed persons, LFS, th, average ⁵⁾	26,808	28,827	30,725	31,607	32,400	33,200	34,200
annual change in %	-4.5	8.0	6.6	2.9	2.5	2.5	3.0
Unemployed persons, LFS, th, average ⁵⁾	4,063	3,916	3,592	3,275	3,600	3,890	3,800
Unemployment rate, LFS, in %, average ⁵⁾	13.2	12.0	10.5	9.4	10.0	10.5	10.0
Reg. unemployment rate, in %, eop					.	.	.
Average monthly gross wages, TRY ⁶⁾	4,594	5,846	10,276	16,460	26430	35320	46280
annual change in % (real, gross)	-8.5	6.4	2.0	4.0	1.0	2.0	4.0
Consumer prices (HICP), % p.a.	12.3	19.6	72.3	54.0	59.0	31.0	26.0
Producer prices in industry, % p.a. ⁷⁾	12.1	43.9	128.5	49.9	45.0	30.0	25.0
General governm. budget, nat. def., % of GDP							
Revenues	29.6	27.9	25.3	28.0	27.5	27.0	27.0
Expenditures	32.5	30.3	26.4	33.3	31.0	30.0	30.0
Deficit (-) / surplus (+)	-2.9	-2.4	-1.1	-5.3	-3.5	-3.0	-3.0
General gov. gross debt, nat. def., % of GDP	39.6	41.7	31.7	32.0	35.0	34.0	33.0
Stock of loans of non-fin. private sector, % p.a.	35.3	32.4	56.9	53.9	.	.	.
Non-performing loans (NPL), in %, eop	4.1	3.1	2.1	1.6	.	.	.
Central bank policy rate, % p.a., eop ⁸⁾	17.00	14.00	9.00	42.50	40.00	30.00	20.00
Current account, EUR m	-28,130	-6,108	-46,201	-42,093	-34,500	-33,500	-33,500
Current account, % of GDP	-4.5	-0.9	-5.4	-4.1	-3.1	-2.7	-2.3
Exports of goods, BOP, EUR m	147,045	190,354	241,087	232,098	237,000	244,000	254,000
annual change in %	-9.7	29.5	26.7	-3.7	2.0	3.0	4.0
Imports of goods, BOP, EUR m	180,244	215,204	326,559	312,385	305,000	311,000	320,000
annual change in %	1.4	19.4	51.7	-4.3	-2.5	2.0	3.0
Exports of services, BOP, EUR m	33,370	52,169	85,365	92,293	98,000	105,000	112,000
annual change in %	-44.5	56.3	63.6	8.1	6.0	7.0	7.0
Imports of services, BOP, EUR m	20,893	25,196	37,467	44,255	56,000	63,000	72,000
annual change in %	-18.4	20.6	48.7	18.1	26.0	12.0	15.0
FDI liabilities, EUR m	6,684	10,955	13,049	9,820	.	.	.
FDI assets, EUR m	2,803	5,495	4,677	5,407	.	.	.
Gross reserves of CB excl. gold, EUR m ⁹⁾	40,776	64,182	77,714	83,910	.	.	.
Gross external debt, EUR m ⁹⁾	349,204	385,292	429,357	452,385	476,300	527,600	600,300
Gross external debt, % of GDP	55.7	55.8	49.8	44.3	43.0	43.0	41.0
Average exchange rate TRY/EUR	8.0547	10.5124	17.4088	25.7597	39.00	48.00	53.00

Note: Introduction of new index 2021=100 (new weights) for gross industrial production and producer prices in industry.

1) Preliminary and wiiw estimates. - 2) Enterprises with 20 and more employees. - 3) Based on UN-FAO data, wiiw estimate in 2023. - 4) wiiw estimate. - 5) From 2021 new methodology in line with the Integrated European Social Statistics Regulation (IESS). - 6) 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. - 7) Domestic output prices. - 8) One-week repo rate. - 9) Converted from USD.

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

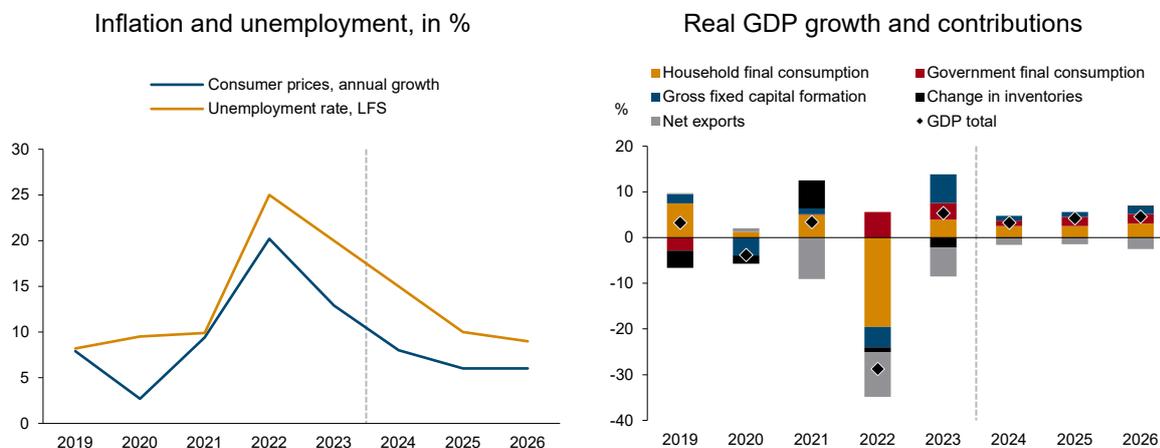


UKRAINE: Delays in providing Western aid pose existential threat

OLGA PINDYUK

GDP growth exceeded 5% in 2023, thanks to the resilience of the economy under war conditions and ample financial and military aid from the West. The establishment of a new shipping route in the Black Sea helped Ukraine partly offset the effects of the border blockade by Poland. However, friction has recently surfaced over the provision of military and financial assistance to Ukraine, and that could hamper further recovery of the economy in 2024. Economic growth will accelerate in 2025-2026, conditional on a reduction in security risks and an expansion of the reconstruction efforts. Downside risks to the forecast have increased: top among these is the risk that Ukraine could lose the war, due to inadequate support from the West.

Figure 6.23 / Ukraine: Main macroeconomic indicators



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

In 2023, the Ukrainian economy showed remarkable resilience, growing by 5.3% year on year. The low base of comparison, of course, played an important role here; nonetheless, there were many signs of a broad economic recovery in the midst of the war. Growth was registered in many sectors, especially in agriculture and food processing, the manufacturing of construction materials, weapons, motor vehicles and electronic equipment, as well as construction. The defence industry saw a rise in production, with drones being the fastest-growing segment – more than 200 drone-producing companies have been created, and the country is on track to produce 1m drones in 2024.²²

²² <https://kyivindependent.com/zelensky-ukraine-to-produce-1-million-drones-next-year/>

The establishment of a new shipping route in the Black Sea and better anti-missile defence capabilities have been crucial for the economy's functioning. The new sea corridor has compensated for the losses caused by Russia's termination of the grain deal in July 2023, and allows Ukrainian goods to be exported by sea without the need for them to undergo Russian inspection. Moreover, businesses are now able to transport not only grain, but also other goods, including metallurgical products – something that has helped with the recovery of the metallurgy sector. By preventing any significant damage to the energy system from Russian missile attacks, Ukraine was able to avoid widespread blackouts during the winter, and in recent months has been able to resume its export of electricity to Europe.

The opening of the new sea corridor also softened the blow from Poland's blockade of the border with Ukraine and the curbs on the import by the EU of many Ukrainian foodstuffs – a move introduced to appease farmers. The geographical structure of Ukraine's agricultural exports has been moving back toward the pre-2022 situation, when non-EU countries accounted for the bulk of them. For example, in 2021, Egypt, Indonesia, Turkey, Pakistan, Morocco, Bangladesh, Lebanon, Saudi Arabia and Tunisia together accounted for more than two thirds of Ukraine's wheat exports.

Ukraine's merchandise exports to Poland fell in 2023 by almost 30% year on year (in USD terms) – double the rate of decline for overall merchandise exports. The road blockade appears to have had the greatest adverse effect primarily on Ukraine's non-commodities exports, such as furniture, wood and articles of wood, textiles and apparel. For example, exports of furniture to Poland – which used to account for about 7% of Ukraine's merchandise exports to the country in 2021 – declined in 2023 by 20% year on year (in USD terms). Ukraine is currently unable to use the river and sea routes for the transportation of such goods, as this is mainly undertaken in containers. The Ukrainian government has been working to set up container transportation on the Danube and via the Black Sea; however, in the short term companies that used to export to Poland will have to go through a painful adjustment period.

Investment has been the biggest driver of growth in 2023, reflecting the need to boost Ukraine's defence against Russia and rebuild the infrastructure damaged by Russia's missile attacks. Gross fixed capital formation grew in 2023 by more than 50% in annual terms, which led to a 5 percentage point increase in its share in GDP (to 16.9%).

Final consumption also demonstrated robust expansion. Households increased their consumption in 2023 by 6.3% year on year in real terms on the back of the real wage growth (about 4% year on year) as well as the rapid fall in consumer inflation, which decreased from 26% year on year in January 2023 to 5.1% year on year in December 2023. Inflationary pressures have eased, owing to the strong harvest and a better supply of certain food products, a moratorium on rises in utility tariffs, a fall in the growth of global oil prices and a more stable situation on the foreign exchange market.

Inflation has slowed further this year: in February, the consumer price inflation was recorded at 4.3% year on year, its lowest level since 2020. At the same time, core inflation has fallen more slowly than anticipated, due to the restricted supply of certain imported goods (due to the Polish border blockade) and stronger wage growth brought about by the restricted supply of labour caused by emigration and military mobilisation. Inflationary pressures are expected to rise in the coming months, in particular following a likely rise in electricity tariffs in the wake of recent Russian strikes on the energy infrastructure. Therefore average annual inflation is expected to accelerate to 8% in 2024. In 2025-2026,

it is anticipated that inflation will slow to 6% per annum, assuming the availability of adequate external financial aid.

Foreign financial assistance has been crucial for the economy: in 2023, inflows totalled around USD 43bn, or about 25% of GDP. This has allowed the government to increase its consumption by 9% year on year in real terms, in order to finance its defence needs and social spending. It has also been essential for assuring macro-financial stability in the country. The national bank could increase its forex reserves in 2023 by 42%, to over USD 40.5bn, which covers more than five months of imports.

Military support has been very important as well: Ukraine's ability to successfully defend itself against Russia is a prerequisite for its economic recovery. In 2023, according to the Ukraine Support Tracker of the Kiel Institute, Ukraine received commitments of military equipment, weapons and ammunitions put at more than USD 40bn (this figure is actually likely to be higher, since for many transactions value estimates were not available). The US accounted for more than half of the value of these commitments.

However, this year foreign financial and military aid has been disrupted by both the inability of the US Congress to approve the promised funds and delays surrounding the approval of aid by the EU. In January-February 2024, Ukraine received only USD 809m of foreign aid, and the government has had to issue domestic bonds to finance the fiscal deficit. The approval of the EU Ukraine Facility (EUR 50bn for four years) and the disbursement of EUR 4.5bn from it at the end of March are positive developments, but will not make up for the missing US funds, given that the total foreign financing needs in 2024 alone are estimated by the International Monetary Fund at around USD 40bn. The government has taken steps to increase fiscal revenues, but these will not be sufficient to offset the missing foreign aid.

The lack of military support from the US is particularly critical. Dwindling ammunition stocks and inadequate air defence against Russian missile attacks pose a grave threat to Ukraine. In March alone, Russia fired over 3,000 guided aerial bombs, 600 drones and 400 missiles at Ukraine. The EU has been working on ramping up its defence industry and increasing the production of weapons and ammunitions, as well as on providing additional funds for Ukraine's military needs; but the process is too slow to allow Ukraine to match its military capabilities with those of the aggressor.

In light of the friction surrounding the provision of military and financial assistance to Ukraine, GDP growth in 2024 is expected to slow to 3%. In the baseline scenario, we assume that the EU will be able to adequately scale up its military and financial assistance to Ukraine by the end of this year, and that the US will not withdraw from its support for Ukraine, whatever the outcome of the presidential elections in November 2024. This will mean a reduction in the security risks in 2025-2026 and an expansion of the reconstruction efforts, partially financed by increasing inflows of foreign direct investment. As a result, GDP growth will gradually accelerate to 4.5% in 2026.

Risks to the forecast continue to be on the downside, with the principal risk being that Ukraine could lose the war due to insufficient support from the West. Mr Trump's (re)election as president in 2024 and the EU's inability to expand its defence sector and provide greater military and financial support to Ukraine could lead to that very outcome. Intensified missile attacks by Russia and lack of anti-missile defence capability in Ukraine could lead to bigger disruptions to the economy and a growing exodus from the country.

Table 6.23 / Ukraine: Selected economic indicators

	2020	2021	2022	2023 ¹⁾	2024	2025	2026
					Forecast		
Population, th pers., average	41,745	41,378	35,000	36,700	37,000	37,300	37,500
Gross domestic product, UAH bn, nom.	4,222	5,451	5,239	6,538	7,300	8,100	9,000
annual change in % (real)	-3.8	3.4	-28.8	5.3	3.2	4.2	4.6
GDP/capita (EUR at PPP)	8,580	9,470	8,580	8,760	.	.	.
Consumption of households, UAH bn, nom.	3,054	3,718	3,284	4,078	.	.	.
annual change in % (real)	1.7	6.9	-28.7	6.3	4.0	4.0	5.0
Gross fixed capital form., UAH bn, nom.	564	720	622	1,105	.	.	.
annual change in % (real)	-21.3	9.3	-33.9	52.9	6.0	6.0	10.0
Gross industrial production							
annual change in % (real)	-4.5	1.9	-36.7	6.0	3.0	5.0	7.0
Gross agricultural production							
annual change in % (real)	-10.1	16.4	-25.0	6.0	.	.	.
Construction output							
annual change in % (real)	5.6	6.8	-64.8	22.6	.	.	.
Employed persons, LFS, th, average	15,915	15,610	13,000	13,500	14,000	14,500	14,600
annual change in %	-4.0	-1.9	-16.7	3.8	3.7	3.6	0.7
Unemployed persons, LFS, th, average	1,674	1,712	4,330	3,380	2,470	1,610	1,440
Unemployment rate, LFS, in %, average	9.5	9.9	25.0	20.0	15	10	9
Reg. unemployment rate, in %, eop ²⁾	1.6	1.1
Average monthly gross wages, UAH ³⁾	11,591	14,014	14,847	17,442	19,400	22,000	25,700
annual change in % (real, gross)	7.5	10.5	-11.9	4.1	3.0	7.0	10.0
Consumer prices, % p.a.	2.7	9.4	20.2	12.9	8.0	6.0	6.0
Producer prices in industry, % p.a.	-1.6	40.8	7.6	10.0	9.0	5.0	5.0
General governm. budget, nat. def., % of GDP							
Revenues	32.6	30.5	41.9	47.5	40.0	40.0	40.0
Expenditures	37.9	33.9	58.1	67.8	57.0	55.0	52.0
Deficit (-) / surplus (+)	-5.3	-3.4	-16.1	-20.3	-17.0	-15.0	-12.0
General gov. gross debt, nat. def., % of GDP	60.4	49.0	77.8	84.4	90.0	93.0	95.0
Stock of loans of non-fin. private sector, % p.a.	-2.8	8.2	-3.1	-0.4	.	.	.
Non-performing loans (NPL), in %, eop	41.0	30.0	38.1	37.4	.	.	.
Central bank policy rate, % p.a., eop ⁴⁾	6.00	9.00	25.00	15.00	13.0	11.0	8.0
Current account, EUR m ⁵⁾	4,612	-3,278	7,587	-8,514	-7,300	-8,300	-12,500
Current account, % of GDP	3.4	-1.9	4.9	-5.2	-4.3	-4.7	-6.4
Exports of goods, BOP, EUR m ⁵⁾	39,527	53,301	38,926	32,062	33,100	34,700	36,800
annual change in %	-3.9	34.8	-27.0	-17.6	3.2	4.8	6.1
Imports of goods, BOP, EUR m ⁵⁾	45,462	58,911	52,871	58,684	61,700	65,400	72,000
annual change in %	-15.6	29.6	-10.3	11.0	5.1	6.0	10.1
Exports of services, BOP, EUR m ⁵⁾	13,628	15,532	15,816	15,177	15,700	16,100	17,600
annual change in %	-12.6	14.0	1.8	-4.0	3.4	2.5	9.3
Imports of services, BOP, EUR m ⁵⁾	9,775	12,178	26,366	23,128	22,200	23,300	24,500
annual change in %	-30.3	24.6	116.5	-12.3	-4.0	5.0	5.2
FDI liabilities, EUR m ⁵⁾	266	6,717	235	4,007	.	.	.
FDI assets, EUR m ⁵⁾	317	368	32	119	.	.	.
Gross reserves of CB excl. gold, EUR m ⁵⁾	22,422	25,920	25,282	34,840	.	.	.
Gross external debt, EUR m ⁵⁾	102,293	114,426	122,948	145,362	153,000	167,000	176,000
Gross external debt, % of GDP	74.6	67.8	79.7	88.0	90.0	93.0	91.0
Average exchange rate UAH/EUR	30.79	32.31	33.98	39.56	43.2	45.4	46.4

Note: Excluding the territories occupied by the Russian Federation until 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 (partly wiiw estimates). This means that all Ukraine forecasts are subject to an unusually high degree of uncertainty.

- 1) Preliminary and wiiw estimates. - 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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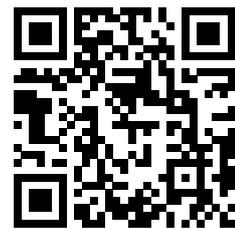
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