AUTUMN 2022

Forecast Report

Bracing for the Winter

Economic Analysis and Outlook for Central, East and Southeast Europe

The Vienna Institute for International Economic Studies
Wiener Institut für Internationale Wirtschaftsvergleiche

Bracing for the Winter

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The authors of this report wish to thank Beata Borosak, Alexandra Bykova, Nadja Heger, Beate Muck, Monika Schwarzhappel, Galina Vasaros and David Zenz for statistical assistance, as well as Clive Liddiard for language editing and Michaela Bönisch for layout.

Press date: 19 October 2022

Executive summary

The CESEE region has so far coped relatively well with the economic and financial fallout from the Russian invasion of Ukraine. The economic results for the first half of 2022 were generally better than expected, owing mainly to the release of pent-up consumption as COVID restrictions were relaxed. Rising incomes from the beginning of the year and supportive credit activity also contributed, as did the fact that people brought forward purchases in anticipation of higher prices in the future.

Still, the surge in the global prices of food and energy caused by the war has generated runaway inflation everywhere in the region. Inflation has already reached double-digit levels in all CESEE countries, except Albania, and there are no signs of it slowing down. The most recent data available suggest that it continued to accelerate during Q3, and that it has not yet peaked.

The economic damage from the higher and more persistent inflation will become evident only as time progresses. Real incomes are in freefall almost everywhere in CESEE – their year-on-year growth rates turned negative in most of the countries back in June, when inflation was much lower than it was in August or September. Consumer confidence is lower than in the early days of the pandemic, and business sentiment is also deteriorating, though not yet to the same extent.

Central banks are hiking their rates, which will have only a limited effect on inflation, but will certainly take its toll on the economy. To some extent, the rises are understandable – the central banks have a legal mandate to fight inflation, and many countries are trying to prevent capital outflow and currency depreciation, following hikes by the Fed and the European Central Bank. But they will inevitably slow credit activity, and in turn the economy, and may magnify existing risks to the financial systems and property markets.

The higher interest rates will further limit the scope for CESEE governments to support their economies during the cost-of-living crisis. Fiscal policy was not very supportive during the first half of the year: government consumption was much weaker than at the start of the pandemic. And that trend will only intensify in the coming period, as governments experience increased difficulty in finding money, on account of the rising borrowing costs everywhere in the region.

On top of all this comes the cut in the supply of Russian gas to Europe. Different countries will be affected differently by this, but we see three main challenges for the region. The first arises from gas dependence. Some CESEE countries are heavy users of gas – half of the countries depend on gas more than Germany does. So they could well suffer from lack of the fuel. To some extent, the gas already set aside in storage facilities will help; but the volumes there are enough to cover only a fraction of annual consumption.

The second challenge arises from the high import of electricity among some of the countries. Because of the currently high electricity prices, these countries will have trouble finding affordable electricity, which could eventually lead to stoppages at some big industrial plants, at least for a while. The Baltic countries, North Macedonia and Hungary are particularly vulnerable to this risk.

The third challenge arises from high exposure to the German economy, which will almost certainly enter recession over the winter. For the Visegrád countries, North Macedonia and Slovenia, exports to Germany exceed 15% of GDP. If there is energy rationing in Germany and the temporary closure of some plants, those countries will be severely hit.

The better-than-expected first half of 2022 means that we are revising our growth forecasts for this year upwards for most of the CESEE countries. For 14 of the region's 23 countries, we now expect higher GDP growth; for four countries we keep the forecast unchanged; and for five we revise our projection downwards. Most notably, we raise the growth forecast for Ukraine by 5 percentage points (pp), because of the way the economy had adapted to war conditions, and because of the country's success on the battlefield. At the same time, we also upgrade our growth forecast for Russia by 3.5 pp, as the country's economic situation is obviously better than anybody expected, at least for the time being.

The higher and more persistent inflation over the first eight months means that we are also revising our inflation forecasts for 2022 upwards for almost all the countries. Russia is a notable exception – we revise its forecast for this year downwards (by 1.7 pp), due to the appreciation of the rouble in recent months. Turkey will have the highest inflation in 2022, of around 71% for the year as a whole. The only three countries that will have single-digit inflation are Albania (7%), Croatia and Slovenia (both around 9.5%).

Our forecasts for 2023 are far more pessimistic than three months ago. In a way, they are similar to our adverse scenario from spring, in which we assumed that the EU would ban Russian energy imports. The difference is that it was not the EU that banned Russian energy imports, but rather Russia that decided to cut its gas supply to the EU. The overall effect is similar, though: the unavailability of gas has led to its price increasing, fuelling inflation and crippling growth.

Consequently, our new inflation forecasts for 2023 are higher than before for almost all the countries. On a weighted average basis, we now expect inflation in CESEE in 2023 to be 11.6%, which is far higher than in the euro area (6%). This figure is greatly influenced by Turkey, which will have the highest inflation in 2023, of around 27%. Still, all the CESEE countries will have elevated inflation, and in only two (Albania and Slovenia) will it be lower than in the euro area.

GDP forecasts for 2023 are being revised downwards for almost all the CESEE economies. The biggest revisions are for Moldova (3 pp downwards), due to its dire energy situation, and Hungary (2.7 pp lower), on account of its twin deficits and the suspension of the EU transfers that it was supposed to receive. Despite the deteriorating outlook, we still anticipate that only two countries will see their GDP decline for the whole year – Russia (by 3%) and Hungary (by 1.2%). Ukraine will have the strongest growth (of 5.5%), although that forecast is subject to big downside risks related to the course of the war. On a weighted average basis, we forecast that the CESEE region will grow by 0.3% next year – close to the euro area growth of 0.2%. However, this forecast is heavily influenced by Russia, the biggest

economy in the region, which is expected to suffer a 3% decline next year. On a simple average basis, the CESEE region will grow by 1.5% next year, which is clearly better than the euro area.

There are various reasons why many CESEE countries will outperform the euro area in terms of economic growth next year, regardless of having higher inflation. The first is convergence: less-developed countries tend to have higher average growth than more-developed countries. A second reason is that some of the countries are in a better position than the euro area in terms of energy: some CESEE countries do not depend on gas at all, while others export large quantities of electricity. A third reason is that those CESEE countries that are members of the EU should receive sizeable amounts of money from the Recovery and Resilience Facility, which will help keep their economies afloat.

COUNTRY SUMMARIES

ALBANIA

GDP in 2022 will be 3.5%, backed by private consumption and, to a lesser extent, by investments. It will likely stay at above 3% over the forecast horizon. Inflation has been picking up very rapidly, but is still among the lowest in the region. Whether enough energy can be secured for the winter will depend on rainfall and on the volatile import prices, and is among the key risks to our growth forecast for this year and next.

BELARUS

The economy is in recession, as the impact of the war in Ukraine has been amplified by the new Western sanctions. The authorities have adopted some policy measures aimed at damping the shocks and have negotiated new support agreements with Russia. Public finances have been under considerable strain, inflation has kept rising, and problems have also emerged over the servicing of the external debt. GDP is expected to fall by 4.5% in 2022, and the prospects for the coming years remain bleak.

BOSNIA AND HERZEGOVINA

Growth in the first half of the year was better than expected, due to a sustained rise in industrial production and retail trade. But high inflation and the continued political risks will slow it down in the second half of the year, and also in 2023. A general election was held on 2 October and revealed the people's desire for something different: two of the three elected Presidency members are from non-nationalist parties. However, no great changes are expected: according to preliminary results, the nationalist parties won the majority of the vote at both state and entity level. This will continue to slow the country's progress generally and towards European integration.

BULGARIA

The outcome of the early election held on 2 October offers no ready solutions to the political stalemate in Bulgaria. Despite the political turmoil and the war-related shocks, GDP grew by 4.5% in the first half of the year, thanks to robust exports and strong industrial output. However, surging inflation and a large fiscal imbalance remained a serious concern. By mid-year the economic environment had worsened and output had weakened. We expect GDP to grow by 3% in 2022, with a weaker performance of 1.5% in 2023.

CROATIA

Croatia's economy grew strongly in the first half of 2022, thanks to robust household consumption. In addition, the summer tourist season was very solid. As a result, we have revised this year's GDP forecast up from 3.3% to 5%. Despite record levels of inflation, the European Commission has also confirmed that Croatia is set to join the euro area next year. Nevertheless, the high inflation and the war in Ukraine still promise much uncertainty for 2023.

CZECHIA

The resilience of the Czech economy is fading, and it is anticipated that the coming months will bring recessionary pressures. The reasons for pessimism are piling up: inflation will remain high, real wages will continue to decline, and industry will struggle with supply-chain issues. As a result, after 2% in 2022, growth will slow to a modest 1% in 2023.

ESTONIA

As the economic effects of the war in Ukraine gradually reveal themselves, the Estonian economy is heading for a difficult phase: inflation is extremely high; the foreign trade outlook is getting grimmer; and private consumption is being undermined by rocketing prices and shrinking savings. Yet, we expect the economic decline to be more of a dip, as energy prices are reined in, while purchasing power will be backed by state support and steady wage growth.

HUNGARY

After strong first half-year growth, the Hungarian economy is heading downhill. Inflation is accelerating, consumer demand is shrinking, public investment projects are being cancelled and private investments postponed. The fragile fiscal position renders unfeasible any substantial government intervention to counterbalance shrinking domestic demand. The foreign trade deficit has been growing rapidly. Unfreezing EU transfers could ease the problems; but that money will not reach Hungary any time soon – if at all.

KAZAKHSTAN

Amid all the geopolitical shocks, Kazakhstan's balancing act has helped it limit the economic damage. Nevertheless, the economy has been weakening, having been hit by all the disruptions, and is expected to grow by 2.8% this year. Although infrastructure investments, import substitution policies and fiscal stimulus to consumption should all go some way to supporting growth, in view of the lower oil prices, the further recession in Russia and the unfavourable external environment we have revised our real GDP forecast for 2023-2024 slightly downwards.

KOSOVO

The economy will grow by around 3% in 2022 and 2023, despite the war-related inflationary pressures and the energy crunch. Inflation is expected to soar to 10% this year, a casualty of rising food and energy prices. The country's trade deficit has deteriorated further, despite the big rise in exports. The positive trend in foreign direct investment has been maintained. The dire state of the labour market and high unemployment suggests that there will be a weakening in consumption, although support from the Kosovo diaspora has increased.

LATVIA

Although the boom continued in the first half of 2022, the Russian war in Ukraine will drag growth in Latvia down in the coming months. Almost all sectors will be affected by a substantial fall in demand growth and by escalating prices. Firms will largely refrain from investing, preferring to deplete their stocks. Moreover, the decline in the purchasing power of households will curb growth in consumption. However, the labour market will remain tight next year. For 2022, we still expect GDP growth to reach 2.9%, but it will then fall back to 0.6% in 2023. We expect a revival of GDP growth in Latvia to 2.3% in 2024 in line with the recovery in the EU.

LITHUANIA

The economy has had to deal with the blow caused by Russia's invasion of Ukraine. Steep rises in the cost of energy and other imported inputs will push the inflation rate close to 20% this year. A decline in household and business sentiment alike means that consumption and investment activity will lose momentum in the second half of this year, and particularly in 2023. The government is trying to counter the loss of households' purchasing power and to assist enterprises with energy support measures. It should also manage to keep economic activity afloat with its planned public investments. We expect real GDP to grow by 2.1% in 2022, to be followed by a slump to 0.9% in 2023 and then an upswing to 2.6% in 2024.

MOLDOVA

The effects of the prolonged Russian invasion of Ukraine, skyrocketing food and energy prices, trade disruptions, the influx of refugees and declining public confidence have all worsened Moldova's economic prospects. GDP is certain to decline in 2022 and to stagnate in 2023. Increased funding by international donors and creditors is necessary for the country to cope with the economic challenges and to keep the current Western-oriented leadership in power.

MONTENEGRO

Montenegro continued with its impressive growth in 2022, thanks to rising private consumption. This was a result of a tax reform that increased people's incomes, but which poses a serious threat to the state and the healthcare budget. The future will bring more inflation, which will act as a drag on consumption. Although not yet at pre-pandemic levels, tourism is on a solid path to recovery. The lack of political will to unblock the judiciary is extending the already lengthy road towards EU integration. Fresh parliamentary elections may be on the horizon.

NORTH MACEDONIA

Inflation is out of control and is eating into real incomes. Soaring global electricity prices are taking an additional toll, as some big industrial plants may be forced to close over the winter. Monetary and fiscal policies are becoming more and more restrictive, further crippling the economy. On top of that comes a possible recession in Germany, which takes half of all Macedonian exports.

POLAND

The Polish economy has proved surprisingly resilient so far. But growth will slow in the second half of 2022 and beyond. Rising interest rates are affecting consumption and investment, while inflation is eroding the real value of current wages. If the full disbursement of EU recovery funds continues to be delayed, public spending may become less lavish than before. To cap it all, essential imports such as energy and metals may be in short supply, or else become prohibitively expensive.

ROMANIA

Economic growth in Romania was among the most rapid in the EU in 2022, driven by household consumption and accumulation of inventories. However, future prospects are overshadowed by declining real wages and tightening fiscal policy. Still, with 2.2% growth in 2023, Romania will grow faster than most regional peers. The inflow of foreign direct investment (FDI) and EU funds will strengthen Romania's chances of balancing the fiscal and current account deficits and will maintain its ability to invest. The country's relatively modest dependence on energy imports from Russia also limits its vulnerability.

RUSSIA

So far, the effects of Western sanctions on the economy have been generally milder than expected. By Q3 2022, the economy had partly adjusted to the 'new normal', thanks to high energy prices, trade reorientation towards Asia and increased military spending. However, with the newly announced partial mobilisation, another wave of the crisis looks to be on the cards. After an estimated decline of 3.5% in 2022, the economy is heading for another recession next year.

SERBIA

Despite the hard times brought about by the Russian invasion of Ukraine, Serbia is doing relatively well in an economic sense, mainly because of supportive government measures. The country should be able to see the winter through without major problems, but its medium-term economic prospects remain uncertain, depending as they do essentially on how the country positions itself vis-à-vis Russia.

SLOVAKIA

The adverse impact of the Russian war in Ukraine, high inflation and the energy crisis are all taking their toll on the Slovak economy. We estimate real GDP growth of 1.8% in 2022, driven by private consumption. While household consumption will fall back in the face of soaring inflation, the inflow of EU funds could provide some growth impetus in 2023 and beyond.

SLOVENIA

In 2022, we estimate that Slovenia's real GDP will have expanded by 5.7%, mostly due to very high growth in the first half of the year. However, next year it will decline to 1.9%, as consumption and investments start to shrink due to inflation, and as manufacturing begins to feel the full extent of the energy crisis. To counter inflation, the government has introduced various support mechanisms and is trying to secure enough gas to last the winter; however, uncertainty over the energy supply and prices has contributed to falling business confidence.

TURKEY

After a strong first half year, driven by reopening effects and a boom in tourism, the economy looks set for a much bleaker winter. The boosts to external competitiveness that resulted from the weak lira were short lived and soon erased by inflation, while the main benefits of the rebound in tourism have already been reaped. The extremely high inflation is sharply reducing purchasing power and is putting pressure on industry. Risks are weighted to the downside, including the potential for domestic political noise ahead of the election, rising US interest rates and the geopolitical backdrop.

UKRAINE

The Russian invasion is causing significant human loss and physical capital destruction in Ukraine. However, after a sharp contraction, Ukraine's economy has started to show signs of adjusting to the war conditions. External financial assistance is crucial both to keep the economy functioning and to achieve military victory. An accelerated recovery in the post-war period will depend on the establishment of a Marshall Plan-style international agency capable of providing adequate financing for the reconstruction of Ukraine's economy.

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

JEL classification: E20, E21, E22, E24, E32, E5, E62, F21, F31, H60, I18, J20, J30, O47, O52, O57, P24, P27, P33, P52

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Cut-off date for historical data and forecasts: 3 October 2022. 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**	**BALT3**	**Baltic countries**
CZ	Czechia	EE	Estonia
HU	Hungary	LT	Lithuania
PL	Poland	LV	Latvia
SK	Slovakia		

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		

EA19 **Euro area**

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

ABBREVIATIONS

ALL	Albanian lek
BAM	convertible mark of Bosnia and Herzegovina
BGN	Bulgarian lev
BYN	Belarusian rouble
CZK	Czech koruna
EUR	euro
HRK	Croatian kuna
HUF	Hungarian forint
KZT	Kazakh tenge
MDL	Moldovan leu
MKD	North Macedonian denar
PLN	Polish złoty
RON	Romanian leu
RSD	Serbian dinar
RUB	Russian rouble
TRY	Turkish lira
UAH	Ukrainian hryvnia
USD	US dollar

BCI	Business Cycle Index (wiiw)
BIS	Bank for International Settlements
BOP	balance of payments
CA	current account
CARE	Cohesion’s Action for Refugees in Europe
CB	central bank
CBR	Central Bank of Russia
CIS	Commonwealth of Independent States
CNB	Czech National Bank
CPI	consumer price index/inflation
CSTO	Collective Security Treaty Organisation
EAEU	Eurasian Economic Union
EBRD	European Bank for Reconstruction and Development
EC	European Commission
ECB	European Central Bank
EPPO	European Public Prosecutor’s Office
ER	exchange rate
ESA 2010	European system of accounts
EU	European Union
FDI	foreign direct investment
FISIM	Financial Intermediation Services, Indirectly Measured

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

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

1. Global overview: Euro area heading into recession

BY RICHARD GRIEVESON

› **We expect the war in Ukraine to last until at least the end of 2023. This will continue to have a negative impact on the euro area economy.**

› **Global economic conditions are increasingly gloomy, and the euro area is already facing the risk of stagflation, with a recession now almost certain over the winter. We expect a gradual recovery starting in the first half of 2023, but energy prices will stay high, preventing a rapid bounce-back.**

› **Inflation in the euro area is higher than we previously anticipated, and will remain at a historically elevated level during 2023. It should fall back towards target by 2024.**

› **The ECB, Fed and other major central banks are hiking aggressively to try to tame inflation. This risks exposing vulnerabilities in the financial sector, places heavy pressure on emerging markets with large dollar borrowing needs, and is driving a coordinated global monetary tightening that will weigh further on growth.**

› **The risks to the outlook are skewed heavily to the downside. In terms of likelihood and impact, the biggest risk is a full cessation of Russian energy supplies to Europe.**

Table 1.1 / wiiw global assumptions, autumn 2022

	Autumn 2022			Changes since summer		
	2022	2023	2024	2022	2023	2024
Euro area real GDP growth, %	3.1	0.2	1.9	0.9	-2.3	-0.2
Euro area consumer price inflation, %	8.5	6.0	2.3	1.0	2.5	0.3
USD/EUR exchange rate, average	1.03	0.99	0.99	-0.05	-0.09	-0.09
USD per barrel Brent oil, USD, average	101.0	97.0	90.0	-9.0	7.0	0.0

Source: forecasts by wiiw. Cut-off date: 3 October 2022.

1.1. THE WAR WILL CONTINUE, WITH NO DECISIVE VICTORY FOR EITHER SIDE

The Russian invasion of Ukraine and the sanctions response by a broad range of countries has had – and will continue to have – a major impact on economic activity, inflation, commodity prices and exchange rates across the global economy. While all countries are affected, the strongest impact is generally being felt by other European countries, given their proximity to the hostilities. The pre-war reliance of many key euro area economies on Russian gas has created a very powerful contagion channel, with effects on inflation and growth already visible. Assumptions about how

much longer the war will last, what the future fallout will be and how it will end are therefore crucial underlying elements in all our forecasts.

We assume that the war will continue in 2023 (see chapter 2). At the time of writing, the Ukrainian army is pushing its Russian adversary back in certain areas of the country, but neither side has the weapons needed to achieve a decisive victory. Geographically, we assume that the war will remain centred on particular areas of southern and eastern Ukraine and will not spread further. We assume that Russia will not use nuclear weapons or attack a NATO member state, and therefore that the war will not expand to become a NATO-Russia conflict. In terms of energy supplies, we assume that Russia will continue to heavily restrict flows to most of Europe over the winter.

Economically, this means a continuation of the status quo in the euro area, with energy prices very high by historical standards, huge uncertainty among investors and caution among consumers. Throughout our forecast period, inflation will be higher, growth will be lower and the euro will be weaker than would otherwise have been the case. If the war spreads to become a NATO-Russia conflict, the economic consequences are too drastic to quantify. If the war ends sooner, then economic growth in the euro area could be higher than we currently project. However, this will depend on *how* the war ends, something that at present is impossible to predict with any certainty.

1.2. RECESSION NOW, RECOVERY FROM SPRING 2023

The euro area performed better than expected in 2022, with reopening effects contributing to a robust H1, in particular. Both firms and consumers demonstrated impressive resilience in the face of sharply rising prices in the middle of the year. Growth was supported by the reopening after the COVID lockdowns, a rebound in tourism, continued consumer willingness to spend (possibly bringing forward big purchases in view of high inflation) and resilience in industry.

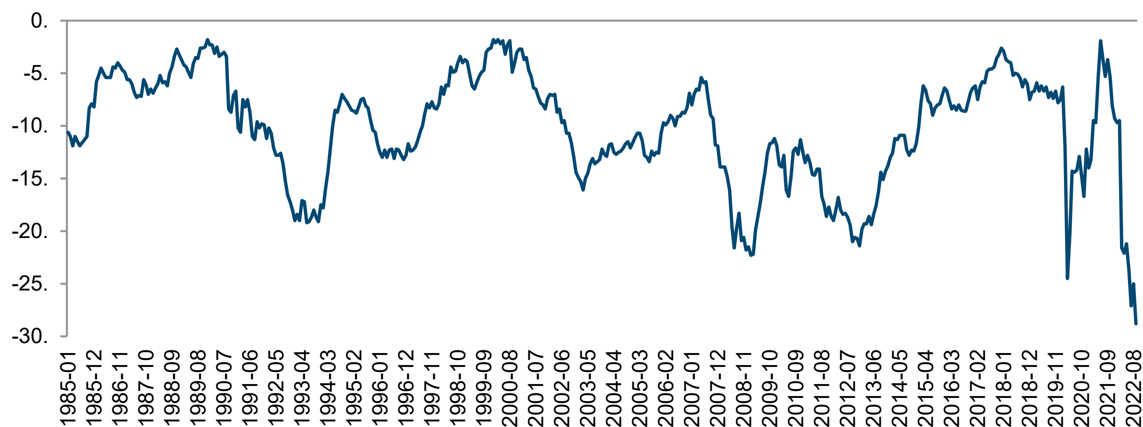
However, this resilience has faded, and the key global economies are all currently struggling. High-frequency indicators in the euro area indicate a major slowdown in the past couple of months, and we expect the single currency area to go into recession over the winter. Consumer confidence in the euro area is now weaker than in 2008 or 2020 (Figure 1.1). The latest industry sentiment data indicate a deep contraction in the manufacturing sector, especially in Germany. The negative fallout from higher energy prices and supply bottlenecks is really starting to become visible. Although gas storage tanks are filling up and governments are taking a variety of measures to reduce energy use, it looks as though it will be hard to avoid gas rationing in the euro area over the winter, which will mean further industrial shutdowns. At the time of writing, a gas price cap is being discussed by the EU, but details are scarce on how it will be implemented.

At the global level, the two key drivers of post-2008 economic growth – strong Chinese demand and loose US monetary policy – no longer exist. The latest OECD Economic Outlook, published in September, sees global growth at 2.2% next year, down 0.6 percentage points (pp) against the June forecast.[1] It expects the US to grow by just 0.5% in 2023, down 0.7 pp compared with the previous forecast. The sharp increase in US interest rates has caused a rapid tightening of financial conditions in

[1] https://www.oecd.org/economic-outlook/september-2022/

the global economy, which acts as a major brake on economic growth. Meanwhile, the crash in Chinese real estate has rippled out across the economy and, combined with the regular shutdowns due to China's zero-COVID policy, has resulted in much weaker growth there. The Chinese economy is also suffering from weaker export demand, owing to the slowdown in the US and the euro area.

Figure 1.1 / Euro area consumer confidence, balance of positive and negative responses, seasonally adjusted



Source: Eurostat.

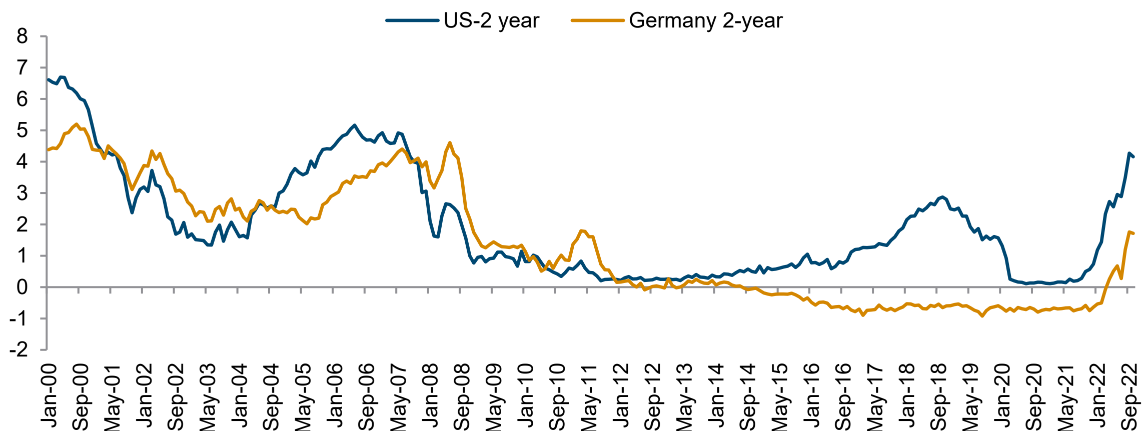
We expect the recovery in the euro area to begin in spring 2023, as the weather improves, thus easing the pressure on scarce gas supplies. Nevertheless, Europe's transition away from Russian gas – via a combination of diversification, a step back towards coal and other dirtier forms of energy, and an accelerated green transition – will take time. It is feasible that the gas supply will be tight by historical standards for many years, and it seems more than probable that gas prices will be very high in Europe next winter as well. Industry will continue to struggle with much greater input costs for some time to come. Meanwhile real wage growth will not return to positive territory any time soon, since we expect inflation to remain at a historically high level in the euro area (6%) next year as well.

1.3. INTEREST RATES HAVE BROKEN OUT OF THEIR DECADES-LONG DOWNWARD TREND

We have made upward revisions to our euro area inflation forecasts for all three years, but especially for 2023, as price growth has continued to rise. The original trigger for euro area and global inflation was a surplus of demand over supply for certain goods during the recovery from the pandemic, combined with surging energy costs from late 2021 on the back of rising Chinese demand for gas and cuts in Russian supplies to Europe. The Russian invasion of Ukraine and the sanctions response have, however, dramatically accelerated these trends, creating a further surge in both energy and food prices on the global markets. There is evidence that even in the euro area, this price growth is now increasingly broad based. Meanwhile, the weaker euro has contributed to higher import costs in the single currency area. The European Central Bank (ECB) expects all these factors to ease by the middle of next year, and inflation to fall back towards target by 2024. One of the main caps on inflation in the coming quarters will be the euro area recession, which will damp down demand-side pressures.

Inflation will also be somewhat tamed by much tighter monetary policy, with a fundamental change in monetary trends under way across the global economy. At their most recent meetings, both the Fed and the ECB increased their main policy rates by 75 basis points, both unusually big moves by historical standards. Any monetary tightening would be significant after over a decade of ultra-loose monetary policy by the major central banks. However, the scale of the recent interest rate increases indicates that a huge collective global monetary tightening is under way, in an attempt to put the brakes on inflation, which is way ahead of target. Short-term government bond yields, which are most sensitive to changes in monetary policy, have risen almost vertically in the last few months, as the markets have rapidly adjusted their interest rate expectations (Figure 1.2). One does not have to be a technical analyst to see a clear break in the multi-decade downward trend in long-term interest rates (Figure 1.3).

Figure 1.2 / Two-year government bond yields, %



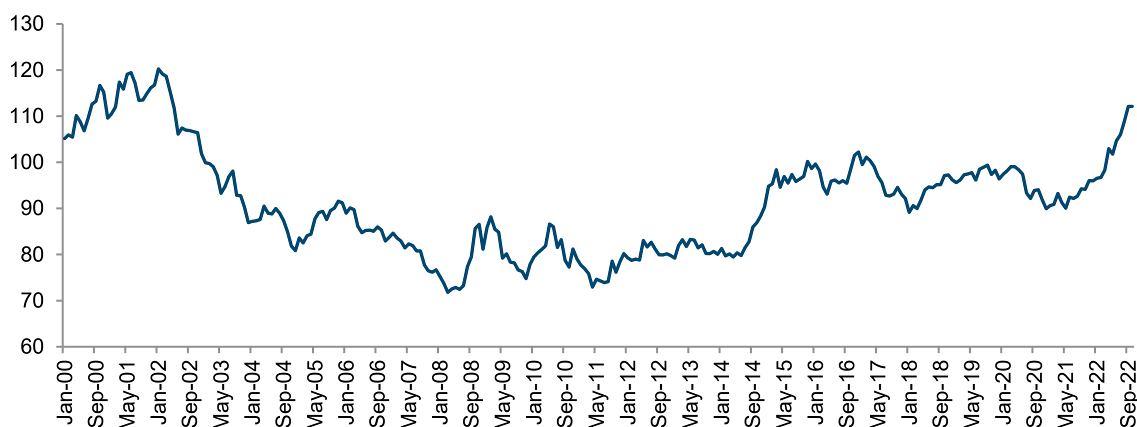
Source: Investing.com

Figure 1.3 / US 30-year bond yield, %

Source: Investing.com

Central banks are in an invidious position, both because it is not clear that tightening will solve the inflation issue and because higher rates could cause serious economic and financial problems. Especially in the euro area, the ECB is tightening into a recession; higher interest rates will not do anything to tackle the supply-side causes of inflation. Moreover, many (including us) have always feared that, after more than a decade of ultra-low interest rates, the euro area economy and financial sector may not be able to manage a significant tightening of policy. Recently, the crisis in the UK private pensions sector and the need for the Bank of England to conduct an emergency intervention provided a stark reminder of how ill-prepared pockets of the economy may be for higher rates. The US Treasury's Office of Financial Research recently flagged that its financial stress index was at its highest level since the peak of the pandemic sell-off in early 2020. There is a risk that, after a decade of low or negative rates, sharply higher interest rates will cause stress in a particular part of the financial sector that will spill over into a broader financial crisis. Fed tightening and general risk aversion have contributed to an extremely strong dollar (Figure 1.4), something that tends to go hand in hand with weak global economic conditions. Once again, the prophecies at the start of the Russian invasion about the end of the dollar have proved wrong; in fact, the dollar is as dominant as ever.

Figure 1.4 / US dollar index



Source: Investing.com

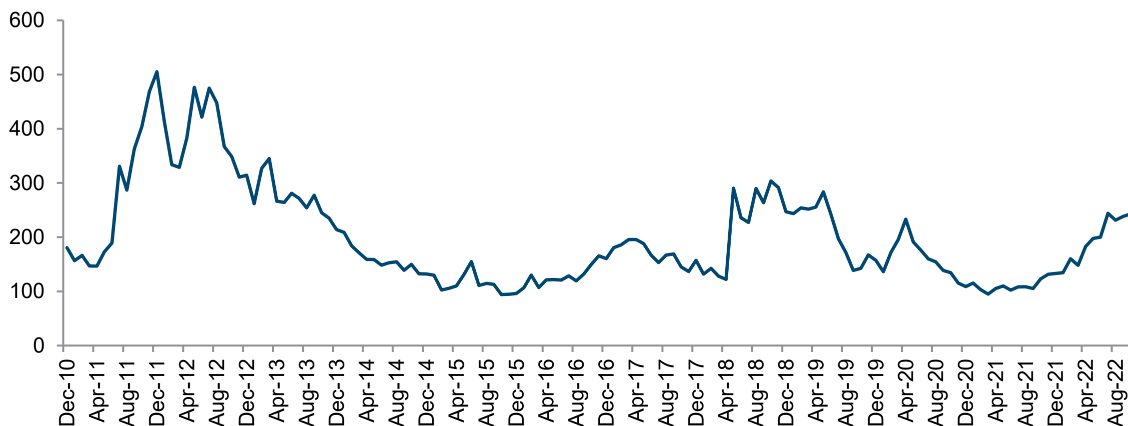
Across both the developed and the emerging world, central banks have been forced to respond to the Fed with their own aggressive hiking cycles. Currency weakness against the dollar (in which most commodities are priced) increases import costs and thus exacerbates already-high inflation. The strength of the dollar also presents clear risks for emerging markets with large dollar financing needs, of which Turkey is the clearest example in CESEE. The recent UNCTAD Trade and Development Report for 2022 noted that 'around 6 out of 10 low-income countries and 3 out of 10 emerging market economies are at or near debt distress'.[2]

There are various potential areas of stress in the euro area, not least the funding costs of peripheral euro area economies. Here, the spread over German yields has risen sharply in 2022, indicating increased wariness among investors. The difference between the yield on Italian 10-year sovereign debt and its German equivalent recently reached a higher level than at the start of the

[2] https://unctad.org/webflyer/trade-and-development-report-2022

pandemic, albeit still well below the levels of the euro area crisis of the early 2010s (Figure 1.5). For now, the ECB seems to have the situation under control; it has so far not had to use its new Transmission Protection Instrument (TPI) to cap Italian bond yields. As in previous cases of rising peripheral yields, it is possible that the existence (rather than the actual use) of such an instrument will be enough to calm the market. It is also possible that the new Italian government under Giorgia Meloni has not frightened the market in the way that perhaps many expected. Nevertheless, even if market panic is avoided, it is clear that much higher borrowing costs will limit fiscal space and dampen economic momentum across the euro area, including in Italy. Moreover, there are growing signs that higher rates are causing stress in European real estate markets.[3]

Figure 1.5 / Spread of Italian 10-year sovereign yields over German equivalent, basis points



Source: Investing.com

1.4. DOWNSIDE RISKS ARE PREVALENT

The risks to the outlook are strongly on the downside. In terms of likelihood, we see the most serious risk as stemming from a potential complete cessation of energy flows from Russia (Table 2). Medium-likelihood risks include global inflation staying higher for longer than expected, the emergence of a new and more dangerous COVID variant over the winter, an emerging markets debt crisis due to Fed tightening, higher interest rates causing a financial crisis in the developed world, and political gridlock in the US. Low-likelihood but high-impact risks are the use of nuclear weapons by Russia in Ukraine, a direct Russia-NATO conflict and a new euro area sovereign debt crisis.

[3] https://www.bloomberg.com/news/articles/2022-10-04/european-real-estate-s-decade-long-party-is-coming-to-an-end?sref=tvUbUFbg

Table 1.2 / wiiw risk matrix

		Impact		
Likelihood		**High**	**Medium**	**Low**
	High		› Russia cuts all remaining flows of energy to Europe	
	Medium	› Longer-than- expected period of high inflation	› New infectious, dangerous COVID variant › New stoppage of food exports from Ukraine › Stress in part of financial sector leads to broader financial crisis › Emerging markets debt crisis caused by Fed tightening	› Political gridlock in the US
	Low	› Nuclear 'incident' in Ukraine › Chinese invasion of Taiwan › Russia-NATO direct conflict › New euro area sovereign debt crisis	› Political gridlock in the euro area	

2. Russia's war in Ukraine: Variables, scenarios and outlook

BY MARCUS HOW*

› **The Russian invasion of Ukraine, which began in February 2022, is a key driver of the outlook not only in Central, East and Southeast Europe (CESEE), but in Europe more generally.**

› **It has strategic implications for European states with respect to security, as well as the economy. These will vary very considerably, depending on the trajectory of the war – specifically its development, length and final outcome.**

› **We identify four scenarios for the possible outcome of the war through 2023, not all of which are mutually exclusive, and to which we attribute percentage probabilities:**

1. **Attrition conflict (45%)**
2. **Negotiated settlement (15%)**
3. **Russian defeat (30%)**
4. **Ukrainian defeat (10%)**

› **We have identified six variables that inform the likelihood of these four scenarios:**

1. **The political aims of Russia and Ukraine;**
2. **The balance of military superiority;**
3. **The economic outlook for Russia and for Ukraine;**
4. **The international response to the war;**
5. **Government stability, especially in Russia; and**
6. **The nuclear wildcard.**

› **Our baseline scenario is that the war will continue through into 2023. Hostilities will be mainly based on attrition, hybrid and asymmetrical warfare. There is virtually no scope for a peace agreement at this stage.**

› **The likelihood of the defeat of Russia has increased, but that will hinge on the collapse of its military capabilities – which may occur if mobilisation proves ineffective.**

› **Imminent defeat would threaten the stability of the regime in Russia, which would in turn increase the likelihood that Moscow escalates the situation and resorts to nuclear weapons. A Western response with conventional weapons to devastate the Russian military capabilities in Ukraine would increase the political risks for Moscow, but would also threaten an exchange of strategic nuclear weapons if neither side backs down.**

› **The defeat of Ukraine at this stage seems unlikely, but would involve the seizure of territory beyond that which is already occupied, such as Kharkiv and the Black Sea coast up to Odesa.**

* Marcus How is Head of Analysis at VE Insight.

As it stands, the original maximalist goals of Russia when it invaded Ukraine in February have failed. Hostilities since then have been characterised largely by attrition warfare. The success of Ukraine's armed forces (ZSU) in this respect has allowed it to launch counter-offensives across multiple axes of the front line. This has wrested the strategic momentum away from Russia, which is now seeking to cement its territorial gains by launching a partial mobilisation of the male population, illegally annexing occupied territories and threatening the use of nuclear weapons.

The probability weightings assigned to the four scenarios we have identified are influenced by six variables.

2.1. THE POLITICAL AIMS OF RUSSIA AND UKRAINE

The objectives of Moscow and Kyiv are important because they inform the conditions under which the war could end. The administration of Russian President Putin has sent mixed signals in this respect.

The official stance of Moscow was to secure guarantees from NATO to allay its security concerns. This included ruling out both the admission of new members to the alliance (including Ukraine) and the supply of sophisticated long-range weaponry to Kyiv that could strike targets within the Russian Federation. Following failure to reach agreement on these points, Moscow launched its invasion, which sought to install a pro-Russian government in Kyiv, while occupying territory in eastern Ukraine. Putin threatened nuclear escalation if the West interfered.

Yet Putin has also repeatedly stated that the objective of the invasion was to 'gather in' formerly Soviet lands, in order to construct a 'Russian world'. Moreover, Moscow did not act when Finland and Sweden – previously neutral nations, the former of which shares a 1,340-kilometre land border with Russia – applied to join NATO in May. Nor did it escalate matters either when Kyiv received advanced weaponry from the West or when its application for candidate status of the EU was approved.

When the first phase of the invasion failed, Moscow slimmed down its objectives, placing emphasis on the annexation of the eastern Ukrainian Donbas regions of Donetsk and Luhansk. The incorporation of the southern regions of Kherson and Zaporizhzhia into the Russian Federation was also envisaged, in order to provide territorial continuity between Donbas, Crimea and the Dnieper River. Furthermore, by formally annexing these territories, Moscow can frame Ukrainian attacks as targeting the Russian Federation directly, potentially justifying the use of nuclear weapons.

Following the sham referendums in the aforementioned regions, Putin signed a decree on their annexation. He also called for an immediate ceasefire and the resumption of peace negotiations with Kyiv. This suggests that Moscow is attempting to consolidate its territorial gains, which could then be framed domestically as a victory. In practice, it is likely to entail an attrition conflict characterised by frequent stalemate, since Kyiv controls up to half of Donetsk and Zaporizhzhia regions, as well as small portions of Kherson and Luhansk. Nonetheless, Putin must formalise any gains, in order to guard against territorial losses and also to stabilise his political position at home, which has come under increasing criticism from the ultranationalist faction.

The reaching of a peace accord – provisional or otherwise – would strengthen the position of those European politicians and businesspeople arguing for the lifting of some of the sanctions, freeing Russia to speed up its economic recovery, while reinforcing its military capabilities. It is likely that Moscow would take advantage of the lull afforded by such a scenario to prepare for further hostilities not only against Ukraine, but against NATO as well.

It is our assessment that the conclusion of a peace agreement is very unlikely. Moscow can accept nothing less than it is tentatively offering, since its formal territorial gains would be so modest as to be pyrrhic. From this perspective, it is more likely that Moscow would opt for an escalation (including nuclear), as a means of intimidating the West into forcing Kyiv to accept Russian demands.

The willingness of Kyiv to negotiate has all but evaporated. When Kyiv was at a disadvantage, in the first months of the war, there was a window for agreement. But that has since closed, not least because the Ukrainian military – supported by Western weaponry and training – has halted the Russian offensive and is mounting one of its own, recapturing large swaths of territory in the process. The mood in Kyiv is uncompromising, amid a growing belief that the Russian invasion can be repelled altogether. Even if the administration of President Volodymyr Zelensky were prepared to cede territory, it would be in the face of massive opposition from within the political, military and security establishments, as well as from among the public.

The most the Zelensky administration could agree to would be autonomous status for Crimea. Yet the likelihood of such a prospect is diminishing. Before the Russian annexation of the four eastern and southern regions, the widespread feeling in the West – including the US – was that the forcible return of Crimea to Ukraine was a red line for Russia. Its 2014 annexation may have been illegal, crudely justified by a referendum that was not internationally recognised; but the seeming acquiescence of the local population led to a tacit acceptance by Western governments that Crimea is de facto part of the Russian Federation.

However, the repetition of that strategy in the aforementioned regions is undermining the geopolitical protection that Moscow enjoys with respect to Crimea. The West has openly condemned the newest annexations as entirely illegitimate and has endorsed the continued efforts of Kyiv to recapture them. Yet this logic also extends to Crimea, given that its status is now identical to that of the occupied regions.

The likelihood of Ukrainian incursions into Crimea has therefore risen. This was demonstrated by the targeting of Russian military assets in Crimea over the summer, and mostly recently by the attack on the Kerch Strait Bridge connecting Crimea with the Russian Federation.

2.2. THE BALANCE OF MILITARY SUPERIORITY

Russia

At the beginning of the war, Russia was widely regarded as holding overwhelming military superiority over Ukraine. Yet within weeks of the invasion, it became clear that military success along maximalist lines was not possible. Poor invasion planning, overstretched logistics (exacerbated by high levels of corruption in the defence sector),[4] a failure to establish air supremacy, and dysfunctional coordination

4 https://ti-defence.org/gdi/countries/russia/

between units at all levels resulted in heavy losses and severely limited the ability of the Russian Armed Forces (RAF) to recoup those losses.

This has narrowed the range of strategic options open to the RAF in Ukraine. Western sanctions have prevented the supply of crucial components for modern equipment (such as high-precision missiles and aircraft engines), prompting the RAF to increasingly source equipment from Soviet-era stocks. Moscow is also turning to its allies for stop-gap supplies. According to US intelligence sources, Russian missile stocks are so depleted that Moscow has approached North Korea for replacements, while Iran is supplying combat drones.

Manpower is a particular problem. Moscow initially committed some 190,000 troops to Ukraine (some 80% of the RAF) – a figure that has since risen. These troops were deployed across four axes of advance along a front line stretching over 1,000 kilometres. In the early stages of the invasion, they advanced rapidly, but found that the logistics networks could not keep up. Heavy losses were sustained during the chaotic advance towards Kyiv, the failure of which prompted the RAF to pursue a cautious approach on other fronts. Yet attrition continued to take its toll on the invasion force, and Moscow could not offset the losses with reserves mobilised during the spring conscription season.

Estimates of casualties on the Russian side vary widely – from approximately 6,000 to 60,000 dead, with 3-4 times that number wounded. Assuming that the lower and upper bounds of these estimates are exaggerated, the true figure would still account for a substantial proportion of the invasion force. Estimates of equipment losses are more reliable: open-source verification has determined that up to 10% of the total Russian tank and armoured vehicle inventory has been neutralised, while the ZSU puts the figure at 20%.[5]

As the situation became critical amid Ukrainian counter-offensives in the Kharkiv and Kherson regions, Moscow announced a partial mobilisation that will focus on reservists. Officially, the number to be mobilised is 300,000; however, there are indications that the figure could extend to 1m. Theoretically, the decree that President Putin issued would allow full mobilisation of the population. However, such a move would be high risk for the Kremlin, given the possibility of public unrest, as well as the fact that powers would have to be delegated to a military leadership that Putin does not trust.

Even with partial mobilisation, it will be very challenging to train and coordinate such an influx of recruits. Much of the Soviet-era infrastructure for mobilisation was dismantled over the last two decades, as the RAF modernised itself. Furthermore, the RAF typically undertakes the training of new recruits in existing units – but the majority of those are currently in Ukraine, along with the officer corps. The quality of the training is thus likely to be poor. At the very least, it will take some considerable time – 3-4 months.

At present, RAF positions in Ukraine are so overstretched that Moscow is aiming to deploy 60,000 to 120,000 recruits to the front within weeks. If this transpires, it is questionable what difference such inexperienced reinforcements can make. There is little indication that the coordination of the RAF will improve. Command chains are strictly hierarchical, inhibiting flexibility. They are not unified across the invasion force: the armies of the Luhansk and Donetsk separatists, the Wagner Group private mercenary company and the Chechen paramilitaries all have different hierarchies and operate semi-

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5 https://sofrep.com/news/soviet-weapons-bazaar-in-kharkiv-heres-a-list-of-the-weapons-russians-left-and-more/

autonomously. The Ukrainian counter-offensive in the Kharkiv region has also undermined Russian railway logistics networks in the east, since the seizure of the Kup'yans'k transport nexus by the ZSU is preventing the running of trains on the north-south axis.

It is our assessment that the best-case scenario for Moscow would be for the RAF to simply hold its defensive positions through the winter. It is very unlikely that it will be able to launch fresh offensives with a view to capturing new territory in the next 3-6 months. We note reports that large numbers of Russian troops are being stationed in Belarus[6] to conduct training and exercises in joint groups with the Belarusian military, which could presage the launch of fresh hostilities on the northern front. Yet these deployments are more likely being exploited by Moscow to tie up Ukrainian manpower and resources. If hostilities do resume, they would likely serve the same purpose, namely to ease pressure on the front lines in the south and east. Deeper incursions towards Kyiv are highly unlikely, not least because the ZSU has pre-emptively sabotaged most of the infrastructure in the border region.

If the RAF avoids further defeats, its ability to launch fresh offensives in the second half of 2023 and beyond will increase. Indeed, there are indications that Moscow is preparing for a long conflict, with the draft budget for 2023-2025 increasing planned defence spending from RUB 3.5 trillion (USD 59bn) to some RUB 5 trillion (USD 85bn).[7] The actual amounts are likely to be far higher, since a further RUB 6.5 trillion (USD 112bn) is reserved for 'classified' or 'unspecified' spending. However, the impact of this spending is not likely to be fully felt in the medium term.

It is our assessment that Moscow is more likely to rely increasingly on asymmetric and irregular warfare tactics against Ukraine. These will probably include targeting civilian infrastructure, logistics and cities with long-range shelling and cyber-attacks, reinforcing the trend of attrition. This strategy is increasingly in evidence, with Moscow launching a wave of cruise missile and suicide drone attacks on cities and infrastructure across Ukraine in October, including Kyiv. The extent to which further attacks on such a scale can be pursued will depend on the stock of precision missiles available to Moscow.

European states are also likely to be targeted with hybrid warfare attacks, in order to discourage material support for Ukraine, even as Moscow asserts plausible deniability. This was demonstrated by the sabotage on the Nord Stream gas pipelines in the Baltic Sea in September, which was most likely carried out by Russian actors. The Norwegian gas infrastructure, which is a major alternative source of supply for Europe, would be a likely target, should this trend continue. The electricity infrastructure is also at risk: the German authorities strongly suspect that Russian sabotage was responsible for a power outage along railway lines in northern Germany in early October.

The weapons facilities of NATO member states are similarly at risk, as they have been the target of espionage and sabotage over the past decade, including since the war began. Operations are known to have occurred in Czechia, Bulgaria and Albania. Given that Putin has specifically stated that the 'collective West' and NATO are waging war on Russia, further hybrid warfare operations are to be expected.

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6 https://www.reuters.com/world/europe/belarus-russia-form-joint-military-group-lukashenko-says-2022-10-10/

7 https://tass.com/economy/1514771

Ukraine

The military position of Ukraine has improved considerably since the beginning of the war, even though its air force and navy were largely neutralised. There are two reasons for this. First, the ZSU received advanced weaponry, intelligence support and training from NATO member states, allowing it to blunt the RAF offensive over the summer. Anti-aircraft systems strengthened its airspace defence, while long-range artillery allowed Russian weapons depots, command posts, airfields and infrastructure routes to be targeted up to 92 kilometres away.

Second, Kyiv quickly launched a full-scale wartime mobilisation of the male population, enabling its available manpower to reach between 500,000 and 700,000. Large numbers of the mobilised forces have military experience, owing to rotations through the Donbas front in 2014-2021, while training has been provided by NATO forces. Kyiv is circumspect about its casualties, stating that some 15,000 troops have been killed; meanwhile, Moscow claims the figure is over 60,000. Whatever the truth, the losses are more easily replenished by the ZSU, even as the share of experienced soldiers dwindles.

These advantages bolster the ability of the ZSU to engage in attrition warfare, exploiting RAF vulnerabilities on a targeted basis. The gradual overstretching of the invasion force across four axes ultimately allowed for counter-offensives to be mounted that rapidly penetrated occupied territory, while exposing RAF units that could then be isolated in pockets.

At present, the ZSU is attempting to capitalise on the momentum generated by its counter-offensives before the winter weather complicates operations. This is likely to lead to the recapture of the western bank of the Dnieper River, if not the city of Kherson itself. Further incursions into Luhansk region are also possible, with cities captured by the RAF earlier in the summer – such as Lysychans'k and Severodonets'k – coming back into play.

Such successes would be significant, but they are unlikely to alter the balance of the conflict in any decisive way. For that to occur, the ZSU would need to achieve breakthroughs in the Zaporizhzhia region, severing the land corridor between Donbas and Crimea by recapturing Melitopol', Mariupol' and the coastline of the Sea of Azov. There is already extensive Ukrainian partisan activity in this region, especially around Melitopol'.

By its own efforts, the ZSU is highly unlikely to achieve such a breakthrough: that would only be possible if the RAF experienced a more general collapse. The recent counter-offensives by the ZSU have hinged on exploiting the fact that the RAF is overstretched and its defences have become dysfunctional. In Kherson, where the RAF was reinforced by some 20,000 troops, the ZSU counter-offensive is much slower. An absence of heavy tanks and armoured transport vehicles has left ZSU units exposed in the flat terrain of the southern regions.

There is little indication that NATO member states will provide weaponry that would enable the ZSU to upgrade its military strategy from that of opportunistic counter-offensives amid dynamic attrition. Germany has repeatedly refused to provide Leopard 2 battle tanks from its arsenal. But it is not alone: the US, which has supplied by far the largest quantity of weaponry to Ukraine, is similarly reluctant to provide M1 Abrams tanks.

This is partly for geopolitical reasons, since it would represent an escalation in support. But there are other concerns, too. Such tanks are not produced on a large scale and cannot be replaced easily. They are costly to operate, requiring extensive support logistics, and are not compatible with the existing armour inventory of the ZSU. Furthermore, since they operate on the front line, it is easier for the RAF to capture them than artillery, which potentially compromises the armour inventories of the large number of states that use these tanks.

Weaponry supplies are thus likely to remain confined to what is currently being provided. The ZSU is doubling its inventory of US High Mobility Artillery Rocket Systems (HIMARS), which has enabled the strategic degradation of Russian logistical capabilities. Kyiv is pushing for the provision of army tactical missile systems (ATACMS), which would extend the range of its HIMARS to 300 kilometres; however, such a move would enable the systematic targeting of military assets in the Russian Federation – a situation that the West is seeking to avoid.

Despite the economic counter-warfare waged by Moscow, Western governments have remained united – if not strengthened – in their resolve to provide material support to Ukraine. However, it is our assessment that they are probably at the very limit of what can be provided. This is discussed under variable (4).

2.3. THE ECONOMIC OUTLOOK FOR RUSSIA AND UKRAINE

Economic resilience is key to influencing the respective abilities of Russia and Ukraine to continue the hostilities. It is particularly critical for Russia, which must balance the attainment of its geopolitical objectives with the ability of its economy to withstand the consequences and adapt to changing circumstances.

It is our assessment that the Russian and Ukrainian economies will continue to sustain their military capabilities through 2023, despite increasing structural dysfunctionalities. The respective outlook for the two economies is included in the relevant country reports.

2.4. THE INTERNATIONAL RESPONSE TO THE WAR

The West

Ukraine’s ability to withstand the Russian invasion to the extent that it has would not have been possible without the material support provided by the West (i.e. NATO and the EU, as well as Canada, Australia and Japan). However, this has had costly consequences for the West – and especially for the EU, which was already having to deal with increasing inflation even before the war.

Sanctions on primary Russian exports, such as oil, coal and fertilisers, have reduced the available supply and sharply increased the price of various global commodities. Moscow has exploited the market uncertainty wherever possible, for example by arbitrarily limiting the supply of gas to the EU – a move that pushed prices to record levels in August, though they have subsequently fallen. Moscow is calculating that, by creating an energy shortage in the EU in the short to medium term, it can cause member states to waver in their resolve to provide support to Ukraine.

As the winter season approaches, member state governments will very likely be forced to ration electricity and gas to the industrial sector. Although the EU's storage targets have been met,[8] it is likely that some member states will suffer periodic blackouts, especially if the winter is particularly cold and/or if alternative supply routes are disrupted. Germany's storage capacity stands at 25% of its annual gas consumption – and that could be depleted in as little as two months. Replenishing this capacity will be very costly, given that the gas supply is globally constrained. Most European economies could endure such a burden over the coming winter, but the costs are likely to persist beyond 2023 and will become unsustainable. The high costs are compounded by the fact that alternative markets for Russian gas exports – specifically those in Asia – are not yet served by the necessary pipeline infrastructure. Indeed, Russia will not be able to complete the necessary work to reorient its gas exports to the Asian markets until the latter half of the decade, forcing Europe, China and India to compete for supply.

Over the winter, the temporary closure of factories is very likely amid rationing, high inflation and possible restrictions to manage the COVID-19 pandemic during its annual peak. A deep recession is very probable, although a recovery is likely to follow in Q2 or Q3. However, there is an elevated likelihood of another recession at the end of 2023 if the status quo persists.

The political and economic impacts of this situation on member states will be asymmetric. At present, the EU remains united in its resolve to support Ukraine – with the exception of Hungary, whose prime minister, Viktor Orbán, has only very grudgingly backed sanctions. Even in those countries where populist parties have recently entered government, such as Italy, the policy stance with respect to Russia and Ukraine has not changed. Far-right populists, such as the newly elected Italian prime minister, Giorgia Meloni, and the French opposition leader Marine Le Pen, have expressly condemned the Russian invasion and voiced their support for the current EU strategy.

Nevertheless, there is an elevated risk that the Meloni government will waver. Meloni and her Brothers of Italy (FdI) party may support the sanctions, but its junior partners in government – namely, Matteo Salvini's Lega and Silvio Berlusconi's Forza Italia – are old populist allies of Moscow. As the energy crisis impacts the economy, Salvini and/or Berlusconi are likely to emerge as disruptors, as they posture to win back voters that they lost to the FdI in the recent election.

Italy is not the only member state where populists may waver. In Slovakia, whose economy has been particularly badly impacted by the war, the coalition government lost its absolute majority after one of its junior partners withdrew its support. If snap elections are held, the opinion polls indicate that former Prime Minister Robert Fico is likely to return to power at the helm of a populist nationalist coalition. Elsewhere, following a third set of snap elections in Bulgaria, any viable coalition in its fractured parliament will need to include the pro-Russian Revival party, which won 10% of the vote. In the likely event that government formation is not possible, a fourth snap election will need to be held, prolonging uncertainty and additionally granting disproportionate power to President Rumen Radev, who is sceptical of sanctions.

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[8] https://www.consilium.europa.eu/en/infographics/gas-storage-capacity/#:~:text=The%20chart%20shows%20the%20gas,with%20the%20largest%20storage%20capacity

Austria is also at risk, given the dependence of its economy on Russian gas and the scepticism about sanctions that is increasingly being voiced by politicians and businesspeople, especially the far-right Freedom Party (FPÖ).

Domestic political developments in various member states could, therefore, undermine EU unity. This is likely to have geopolitical consequences, given that sanctions fall within the remit of the Common Foreign and Security Policy (CFSP) of the EU, which requires EU Council decisions to be unanimous. If sanctions are not renewed every six months, they expire automatically. This will not be a factor over the winter, since the current sanctions regime runs until 23 March 2023. If member states wish to renew the sanctions but face a veto, as an alternative solution the EU is likely to coordinate the extension of sanctions at the national level.

Nonetheless, the likelihood of a veto in spring or autumn 2023 is reduced by the desire of member states to avoid difficult renegotiations of existing initiatives, as well as by peer pressure. If anything, most member states have stiffened their resolve to increase support to Ukraine, in spite – or even because – of the escalatory steps taken (or threatened) by Moscow and the high cost of these. The EU is thus locked into a path dependency from which it will find it hard to extricate itself.

Even if EU sanctions against Russia were to expire, and even if support for Ukraine were to be pared back, that would probably not make a decisive difference to the outcome of the war. Ukraine would continue to enjoy the material and financial backing of key allies, such as the UK, Poland, the Baltic states – and of course the US, which provides more support than all other states combined.[9] It is also unlikely to ease economic uncertainty in the EU, in whose recovery Moscow has no interest whatsoever these days, given that it is now openly viewed as Russia's strategic adversary (as opposed to rival).

The US policy stance on Ukraine will very likely remain unchanged until at least the 2024 presidential election. Even if the Republican party wins control of both houses of congress from the Democrats in the November 2022 midterms (which is increasingly unlikely), there is broad bipartisan consensus on the war. If Donald Trump (or a similar candidate) wins the presidency, uncertainty over the US stance will increase.

A potential concern in the medium term is the ability of the Western defence complex to continue to provide the weaponry Ukraine needs without exhausting its own stocks. Hitherto, military production has remained at peacetime levels, limiting the efficiency with which stocks can be replenished. The NATO general secretary and the EU high representative for foreign affairs have both highlighted this risk, stating that it will require months of preparation before production can be increased to the necessary levels.

China, India and other Russian-allied or neutral states

It has been possible for Moscow to minimise the economic damage from its war in Ukraine thanks to the refusal of major powers – namely, China and India – to support the Western coalition in penalising Russia. Indeed, Russia has expanded its trade relations with China and India, allowing it to source parallel import streams and cultivate alternative export markets. This increased cooperation has not,

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[9] https://www.statista.com/statistics/1303432/total-bilateral-aid-to-ukraine/

however, extended to Beijing or Delhi providing Moscow with direct material support. Indeed, the prolonged uncertainty that resulted from the failure of the first phase of the invasion is having an impact on the Chinese economy, which was already strained on account of structural imbalances in its growth model, as well as its zero-COVID policy.

Beijing and Delhi have made their concerns over the war increasingly public. Central Asian allies of Russia are distancing themselves, with Kazakhstan even offering to provide energy and uranium to Europe. These developments culminated in a promise made by President Putin at the summit of the Shanghai Cooperation Organisation to end the conflict quickly. Yet since the beginning of September, the RAF has experienced serious military setbacks, creating the impression that Russia is losing the war. In response, Putin has escalated the situation by announcing the sham referendums and the partial mobilisation. None of this is likely to inspire confidence in Beijing or Delhi that Putin is either able or willing to deliver on his promise.

The balance of geopolitical power is unlikely to change in the medium term, especially as the relative strength of Russia vis-à-vis China and India is weakening, given its heavy dependence on their markets. A major change is only likely if Moscow escalates the conflict to unacceptable levels, namely by using nuclear weapons. This possibility is discussed in variable (6).

2.5. GOVERNMENT INSTABILITY

In the early stages of the war, government instability was very high in Ukraine, with Moscow attempting to decapitate the national leadership. In the following six months, the risk of that has decreased on account of the national unity precipitated by the invasion. This has been reinforced by recent military successes, but that unity could crumble if Kyiv ends up being forced into painful territorial compromise. The prospect of this seems unlikely in 2023 or even beyond.

Meanwhile, the risk of government instability in Russia is increasing for two reasons. First, the military, security and business elites of the country are increasingly unhappy with the trajectory of the war. There are indications that senior military figures are dissatisfied with Putin because of his deficient leadership, while most of the oligarchs quietly bemoan the devastation of their assets. Various factions are starting to emerge, the most visible being the ‘war hawks’. For example, Wagner Group leader Yevgeny Prigozhin and Chechen head Ramzan Kadyrov are becoming increasingly autonomous, aggressively challenging the leadership of the Ministry of Defence and RAF. None of this grumbling has yet manifested itself as open dissent.

Second, as the tide of war shifts against Russia, Putin is attempting to create the conditions that might prevent outright defeat. Amid growing pressure from the ‘war hawks’, he has announced the partial mobilisation of the male population. This is politically high risk, because there is concern in the Kremlin that it will precipitate mass unrest. Accordingly, the regional distribution of the mobilisation was weighted to remote regions with a high share of non-Russian minorities, as well as lower income levels. The risk of contagion from protests is easier to contain in those regions than it would be in metropolitan centres such as Moscow and St Petersburg.

Nonetheless, the rapid mobilisation of poorly trained recruits will focus public awareness on the consequences of the war. High-profile supporters of the war are already publicly admitting that the mobilisation is being conducted poorly. Unrest on the front line in Ukraine is likely if casualties are high and conditions harsh. However, this is unlikely to result in the ousting of Putin via a popular uprising – not least because of the high levels of policing,[10] the funding for which is increasing.

If Putin were to be removed from office, it would more likely involve a palace coup by elements in his inner circle. But there is no indication that this is likely to happen, not least because it would expose the plotters. Regardless, the risks will increase if Putin is faced with outright defeat in the war. In such circumstances, there is a significant likelihood that he would be replaced by hard-line elements. These would not be inclined to end the war voluntarily, but they may have no choice amid internal instability.

The role that defeat would necessarily play in Putin's removal from office suggests that he would rather choose escalation than de-escalation, in order to safeguard his political position and legacy.[11]

2.6. WILDCARD: NUCLEAR ESCALATION

Putin and other senior Russian figures have repeatedly mooted the possibility of using nuclear weapons either in Ukraine or against the West. Initially, this was intended to deter Western interference in the war; but since then, it has become a fallback strategy for avoiding outright defeat by Ukraine.

According to Russian nuclear doctrine, such weapons are to be used only in the event of an existential threat to the Russian state, suggesting that the bar for their use is set high.[12] However, Putin has exhibited a flexible understanding of 'existential threat', extending it to include any threat to the territorial integrity of the country. Through the illegal annexation of Donetsk, Luhansk, Kherson, Zaporizhzhia and Crimea regions, Moscow may construe these territories as being part of the Russian Federation, thereby including them within its nuclear deterrence strategy.

Moscow has numerous options with respect to nuclear escalation. Its arsenal includes strategic, as well as non-strategic capabilities. The former would be reserved for use in a major exchange with NATO – a 'doomsday' scenario. The latter are for tactical use and vary in size, with some being very small and with low fallout. Tactical nuclear weapons are typically to be used to achieve a military breakthrough. In the context of the Ukraine conflict, this would make little sense, as the front line is very long and has no large troop build-ups. Moreover, if they were to be used to stop ZSU advances, the weapons would target territory that Moscow views as its own. Their use would also probably render the territory in question impassable, as the RAF is not equipped to operate in a nuclear environment.

More likely, Moscow would target ZSU bases outside the occupied territories. This would not confer any decisive military advantage, but it may weaken Western support for Ukraine. Escalation is likely to be staged, with the first move consisting of the test detonation of a tactical missile over uninhabited Ukrainian territory. The speed with which nuclear escalation occurs would depend on how rapidly Russia is facing defeat by Ukraine (assuming that it is defeated).

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10 https://twitter.com/samagreene/status/1574792161647894529

11 https://www.themoscowtimes.com/2022/09/29/putin-always-chooses-escalation-a78923

12 https://www.usni.org/magazines/proceedings/2017/february/escalate-de-escalate

If Moscow did deploy nuclear weapons, that would trigger an escalation. Western sources suggest that, in such an event, the West would not bring its own nuclear weapons into play, but would rely on conventional means to hasten the defeat of Russia in Ukraine. This would likely involve imposing a no-fly zone over Ukraine, with Russian anti-aircraft systems being neutralised both in Ukraine and in Russia's border regions. The Russian fleet in the Black Sea would be a potential target. The objective would be to completely disable Moscow's conventional ability to prosecute the war, without posing an existential threat to Russia itself.

However, the West is keeping up the uncertainty over the extent of its response. Prior to the war, it had ruled out certain types of sanctions against Russia in the event of escalation, such as excluding Russian banks from the SWIFT payments system – only to impose them immediately. Thus, it cannot be ruled out that the West would take stronger measures.

The use of nuclear weapons by Moscow would not only unite the West against Russia: the condemnation would likely be global. India's ongoing conflict with Pakistan in Kashmir means that it would wish to avoid setting a precedent for the use of nuclear weapons. China, which is seeking de-escalation, even as it learns certain lessons in advance of a potential invasion of Taiwan, has indicated that it would strongly condemn Russia for any such act.[13] In such circumstances, there is a high chance that Russia could become a pariah state among virtually all the countries of the world.

2.7. CONCLUSION

There are four scenarios in the outlook through 2023 to which we have assigned percentage probabilities. These depend on various combinations of the six variables described above and are outlined in the matrices below:

1. Attrition conflict (45%)

Variables	*Political objectives*	*Military balance*	*Economic outlook*	*International response to war*	*Government stability (Russia)*	*Nuclear wildcard*
Indicators	***Maximalist Russian***	Russian superiority	***Resilient Russia***	United global condemnation	Stable	Strategic escalation
	Compromise	***Balance***	Russian collapse	***Western unity***	***Weakening***	Tactical escalation
	Maximalist Ukrainian	Ukrainian superiority	Ukrainian collapse	Crumbling Western support	Regime change	***Intimidatory***
			Resilient Ukraine			

This is our baseline scenario. The ZSU may have prevented the RAF from conducting further offensive operations, but Moscow's current strategy indicates that it is preparing for a protracted conflict. The West will remain united in its support for Ukraine over the winter, but will not provide the type of weaponry that

[13] https://email.gmfus.org/rv/ff009a5b4b99eb7b762135335a479604b6231b07

could enable offensive operations capable of defeating the RAF outright. Territory may change hands in the meantime, but it will not make a decisive difference. Moscow will hope that, by freezing the front line, it can prepare for a renewed offensive in 2023, while simultaneously exploiting the energy crisis facing the EU to weaken its will within and beyond the 12-month horizon. Equally, while the Russian economy has remained relatively resilient in the face of Western sanctions, economic pressures will begin to build in 2023.

2. *Negotiated settlement (15%)*

Variables	*Political objectives*	*Military balance*	*Economic outlook*	*International response to war*	*Government stability (Russia)*	*Nuclear wildcard*
Indicators	Maximalist Russian	Russian superiority	***Resilient Russia***	United global condemnation	Stable	Strategic escalation
	Compromise	***Balance***	Russian collapse	Western unity	***Weakening***	Tactical escalation
	Maximalist Ukrainian	Ukrainian superiority	Ukrainian collapse	***Crumbling Western support***	Regime change	***Intimidatory***
			Resilient Ukraine			

The increasingly uncompromising stances of both Moscow and Kyiv render a negotiated settlement unlikely. The illegal annexation of the four occupied regions of Ukraine by Russia will reduce the likelihood that a compromise over Crimea can be reached. Moscow will seek to force the negotiation of a settlement through a combination of intimidation and the grinding down of Western support for Ukraine; but there is little indication that this will be successful. For the war to end, a settlement will ultimately need to be reached, regardless of whether it involves compromise or the defeat of one side or the other.

3. *Russian defeat (30%)*

Variables	*Political objectives*	*Military balance*	*Economic outlook*	*International response to war*	*Government stability (Russia)*	*Nuclear wildcard*
Indicators	Maximalist Russian	Russian superiority	Resilient Russia	***United global condemnation***	Strong	Strategic escalation
	Compromise	Balance	***Russian collapse***	***Western unity***	Weakening	***Tactical escalation***
	Maximalist Ukrainian	***Ukrainian superiority***	Ukrainian collapse	Crumbling Western support	***Regime change***	Intimidatory
			Resilient Ukraine			

The likelihood of a Russian defeat in Ukraine has increased very considerably since the beginning of the war. Poor planning by Moscow was a strategic error that severely inhibited its ability to conduct the war effectively. The partial mobilisation of the male population is militarily, as well as politically, high risk. As manpower and logistics problems on the front lines deepen, there is a moderate likelihood that the invasion force could collapse over the next 3-12 months. Outright defeat would ensue if the ZSU conducted an offensive that severed the land corridor between the Donbas region and Crimea. That would have consequences for regime stability in Russia. For that reason, there is an elevated likelihood that Moscow could authorise the use of tactical nuclear weapons to halt Ukrainian advances and intimidate the West into pushing for a settlement. This would be very unlikely to succeed, as NATO would probably use conventional means to devastate the remaining military capabilities of Russia in Ukraine. An escalation involving the use of strategic nuclear weapons would be possible thereafter; but it is more likely that the scale of the defeat suffered by Russia would prompt regime change.

4. Ukrainian defeat (10%)

Variables	*Political objectives*	*Military balance*	*Economic outlook*	*International response to war*	*Government stability (Russia)*	*Nuclear wildcard*
Indicators	***Maximalist Russian***	***Russian superiority***	***Resilient Russia***	United global condemnation	***Stable***	Strategic escalation
	Compromise	Balance	Russian collapse	Western unity	Weakening	Tactical escalation
	Maximalist Ukrainian	Ukrainian superiority	***Ukrainian collapse***	***Crumbling Western support***	Regime change	***Intimidatory***
			Resilient Ukraine			

The maximalist defeat of Ukraine envisaged by Moscow at the beginning of the war is no longer possible. A strategic defeat would involve the attrition of the ZSU to the point where the RAF is able to regain the offensive momentum, capturing the occupied territories in their administrative entirety, as well as pushing back towards Kharkiv and the Black Sea coast, including Odesa. This would be highly unlikely before spring 2023, but could become a possibility in the second half of the year, depending on the balance of military capabilities. The offensive capabilities of the RAF need to be rebuilt, while those of the ZSU would need to be degraded by dwindling Western support.

3. CESEE overview: Bracing for the Winter

BY BRANIMIR JOVANOVIĆ

- **Economic growth in the CESEE region in the first half of 2022 was, in general, better than expected, thanks largely to the release of pent-up consumption. Accordingly, we are revising our growth forecasts for this year upwards for most CESEE countries.**
- **Still, the surge in global food and energy prices has generated very aggressive inflation in the CESEE region. Consequently, we are also revising our inflation forecasts for 2022 upwards for most of the countries.**
- **The worst is yet to come. Inflation is eroding real incomes, consumer confidence is evaporating, business sentiment is deteriorating, interest rates are soaring and the fiscal space is shrinking. And on top of all that, there is the energy crunch.**
- **Our new inflation forecasts for 2023 are much higher than before. On a weighted average basis, we expect inflation in CESEE in 2023 to be 11.6% – far higher than the figure of 6% in the euro area.**
- **By the same token, we are revising our next year's GDP forecasts downwards for almost all CESEE economies. On a weighted average basis, we forecast that the CESEE region will grow by 0.3% next year, close to the 0.2% growth that we assume for the euro area.**

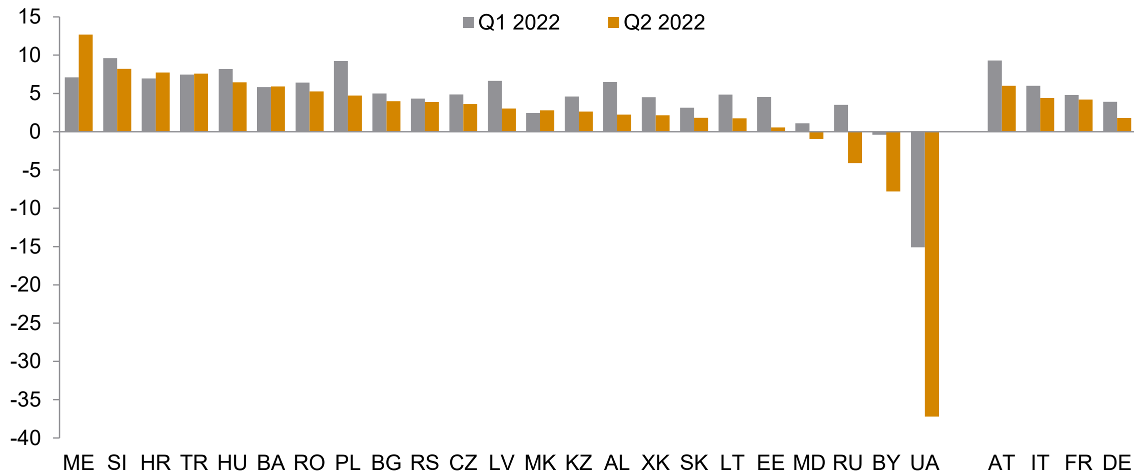
3.1. GROWTH BEAT EXPECTATIONS IN THE FIRST HALF OF 2022

Despite the war in Ukraine and the surge in global prices that it brought, economic growth in CESEE in the first half of the year turned out better than expected. On a simple average basis, the economies of the region (excluding Ukraine and Russia) grew by 4.6% in the first six months of 2022. This was on a par with the 4.7% growth in the euro area, although the CESEE economies were building on the much stronger growth they had seen in 2021, and some of them are also very close to the war-affected areas.

Notwithstanding the overall solid results, there are notable differences between individual countries (Figure 3.1). At one end of the spectrum are those countries that are geographically close to the conflict zone, like Belarus and Moldova, whose GDP either contracted or stagnated. The Baltic countries are in a similar position, especially Estonia and Lithuania. At the opposite end are the heavily tourist-oriented economies, like Montenegro, Croatia and Turkey, which all saw close to double-digit growth as tourism bounced back strongly, though in some cases, they were also helped by the low starting base – a consequence of the bigger contraction their economies experienced during the pandemic. Ukraine's GDP declined by 26% in the first half year (37% in Q2), while Russia's contracted by just 0.3% in the first six months (4.1% in Q2). If we compare the CESEE countries with Western European economies, we find that most of them performed better than Germany, but worse than Austria. It is also clearly the case that in most of the countries growth lost momentum in Q2 2022: in 18 of the

23 CESEE economies, GDP expanded less in the second quarter than in the first. This suggests that by Q2 the CESEE economies had started feeling the effects of the war in Ukraine.

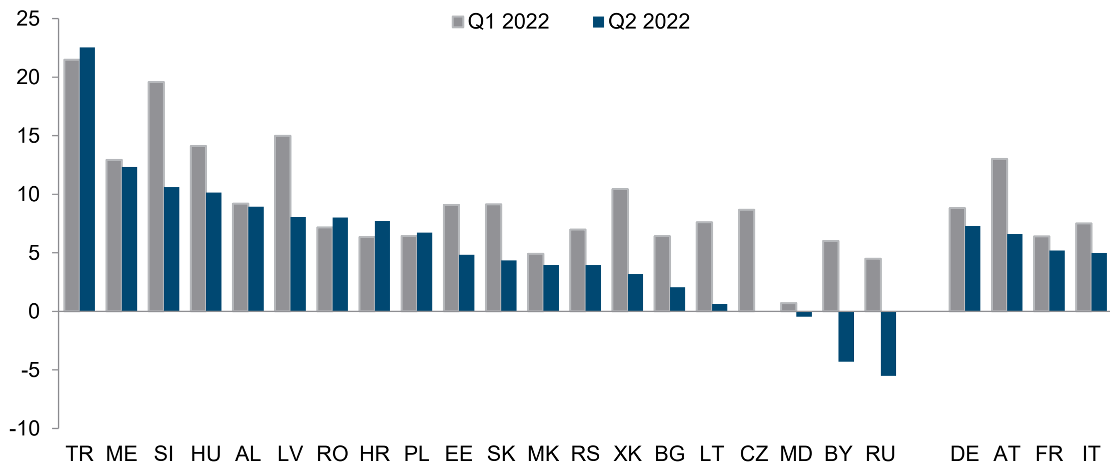
Figure 3.1 / Real GDP growth in the first half of 2022, %, year on year



Source: Eurostat and wiiw Monthly Database.

The driver of growth in the first half of the year was household consumption. It grew in 19 of the 20 countries that published data on GDP components. On a simple average basis, the growth in the first two quarters was 7.4% year on year (Figure 3.2). To a large extent, this was due to the low base the previous year – especially in Q1 2021, as many countries had quite strict COVID measures in place at the start of that year. Real wages were also still growing in many CESEE countries in the first half of 2022, and credit activity was supportive, as well. It is also possible that people brought forward big-ticket purchases, in anticipation of the approaching higher inflation. Turkey was a remarkable outlier: growth in consumption there exceeded 20%, despite the country's very high inflation. This can be attributed to the low base the previous year, the surge in tourism, the increase in wages and buoyant credit activity. On the other hand, Russia was the only country where consumption contracted in the first half year (Ukraine has not published data on its GDP components). Belarus also saw a decline in consumption in Q2, but there the growth in Q1 more than covered the decline in Q2. Compared to Western Europe, most of the CESEE countries witnessed weaker growth in consumption than Austria, and similar growth to Germany, Italy and France. As with GDP growth, one can discern a general slowdown in consumption in Q2: this was true of 16 of the 20 countries considered.

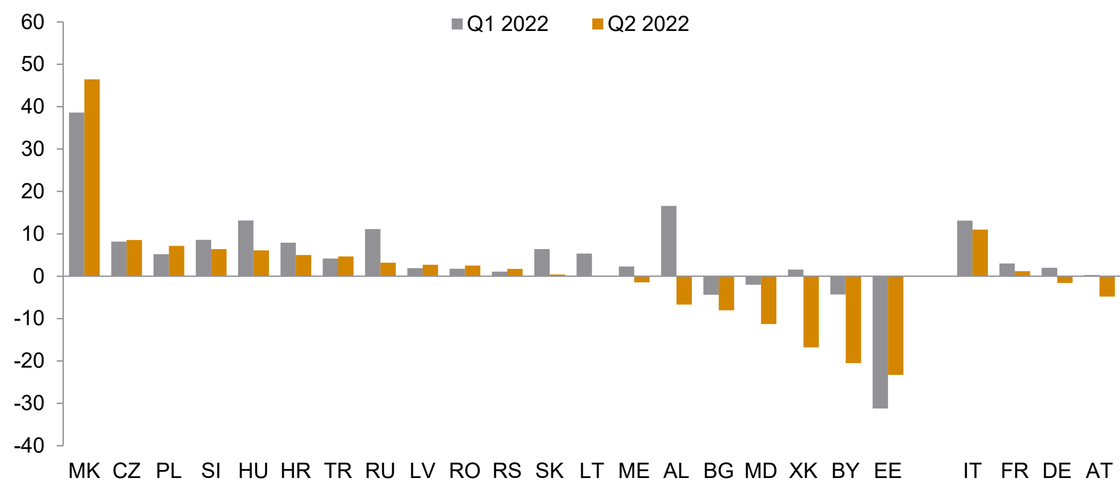
Figure 3.2 / Real growth in household consumption in first half of 2022, %, year on year



Note: Bosnia and Herzegovina, Kazakhstan and Ukraine have not published data on household consumption for Q2 2022.
Source: Eurostat and wiiw Monthly Database.

Investment, on the other hand, was much less impressive. It declined in 5 of the 20 CESEE countries for which data are available (Figure 3.3). Average growth in the region (simple average) in the first half year was 2.5%, which was below the growth in both GDP and consumption. This comes as no surprise, since investment is recognised as being the most volatile GDP component and the one to react first to negative shocks. North Macedonia was a positive exception: its growth in investment was an impressive 42% in the first half year; however, that was mainly due to the big decline over the previous two years.

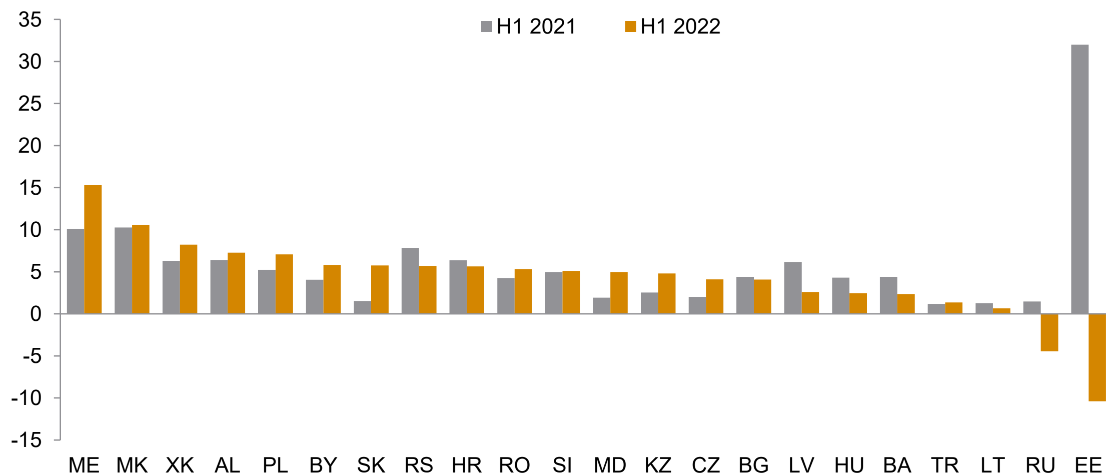
Figure 3.3 / Real growth in gross investment in first half of 2022, %, year on year



Note: Bosnia and Herzegovina, Kazakhstan and Ukraine have not published data on gross investment for Q2 2022.
Source: Eurostat and wiiw Monthly Database.

In contrast to the decline in gross investment, foreign direct investment (FDI) inflows remained strong in the first half year. They averaged 5.3% of GDP for the whole region (excluding Estonia). This was even better than the year before, when they had averaged 4.6% of GDP. In 15 of the 22 countries for which data are available, inflows in 2022 were greater than inflows in 2021 (Figure 3.4). It is hard to say what it was that drove these strong FDI figures, as FDI is known to be very volatile. The flows may slow substantially in the coming months; but if they continue to be strong, one possible explanation is that the region is benefiting from a shift to near-shoring, with Western European companies moving production closer to home on account of the heightened global uncertainty (Jovanović et al., 2021; Jovanović, 2021). Estonia is an interesting case, as it recorded negative FDI inflows of 10% of GDP in the first half year. It is as yet unclear what drove this, but it is likely to be related to the very strong inflows that the country enjoyed the previous year (32% of GDP). There may have been a reversal of some of this investment, or negative reinvested earnings (i.e. Estonian companies paying dividends greater than their profits). Russia is another notable case: it registered outflows of 3.4% of GDP, as many international companies left the country following the invasion of Ukraine.

Figure 3.4 / FDI inflows into CESEE countries in H1 2021 and H1 2022, % of GDP



Note: The data refer to FDI inflows (liabilities) from Balance of Payments statistics.
Source: central banks, wiiw calculations.

Table 3.1 / OVERVIEW 2020-2021 AND OUTLOOK 2022-2024

		GDP real change in % against prev. year					Consumer prices average change in % against prev. year					Unemployment (LFS) rate in %, annual average				
				Forecast					Forecast					Forecast		
		2020	2021	2022	2023	2024	2020	2021	2022	2023	2024	2020	2021	2022	2023	2024
BG	Bulgaria	-4.4	4.2	3.0	1.5	3.0	1.2	2.8	14.0	10.0	8.0	5.1	5.3	4.7	4.6	4.5
CZ	Czechia	-5.5	3.5	2.0	1.0	2.8	3.3	3.3	15.0	8.5	3.2	2.6	2.8	2.5	2.6	2.6
EE	Estonia	-0.6	8.0	1.0	1.4	3.1	-0.6	4.5	18.5	8.0	4.5	6.8	6.2	5.9	6.5	5.0
HR	Croatia	-8.1	10.2	5.0	2.5	3.1	0.0	2.7	9.5	6.0	3.0	7.5	7.6	7.3	7.4	7.4
HU	Hungary	-4.5	7.1	4.2	-1.2	1.7	3.4	5.2	16.0	15.0	8.0	4.3	4.1	3.6	4.5	4.0
LT	Lithuania	-0.1	5.0	2.1	0.9	2.6	1.1	4.6	19.5	8.0	4.0	8.5	7.1	6.2	7.0	6.5
LV	Latvia	-3.8	4.5	2.8	0.6	2.3	0.1	3.2	17.0	9.0	3.5	8.1	7.6	7.0	7.2	6.6
PL	Poland	-2.2	5.9	4.6	1.7	2.4	3.7	5.2	11.5	6.5	3.5	3.2	3.4	3.0	3.1	3.2
RO	Romania	-3.7	5.9	4.8	2.2	3.5	2.3	4.1	13.0	8.0	5.0	5.0	5.6	5.3	5.5	5.4
SI	Slovenia	-4.3	8.2	5.7	1.9	2.7	-0.3	2.0	9.4	5.5	2.3	5.0	4.8	4.1	4.0	4.3
SK	Slovakia	-4.4	3.0	1.8	0.6	2.4	2.0	2.8	11.4	8.0	3.0	6.7	6.8	6.0	5.9	6.2
	EU-CEE11 [1)2)]	*-3.5*	*5.7*	*3.9*	*1.4*	*2.6*	*2.7*	*4.3*	*13.1*	*8.1*	*4.3*	*4.4*	*4.5*	*4.1*	*4.3*	*4.3*
	EA19 [3)]	*-6.1*	*5.2*	*3.1*	*0.2*	*1.9*	*0.3*	*2.6*	*8.5*	*6.0*	*2.3*	*7.9*	*7.7*	*6.8*	*7.1*	*6.6*
	EU27 [3)]	*-5.7*	*5.3*	*3.3*	*0.4*	*2.1*	*0.7*	*2.9*	*9.0*	*6.3*	*2.5*	*7.1*	*7.0*	*6.0*	*6.6*	*5.8*
AL	Albania	-3.5	8.5	3.4	3.0	3.6	1.6	2.0	7.0	4.0	2.5	11.7	11.5	11.1	10.5	10.0
BA	Bosnia and Herzegovina	-3.1	7.5	2.6	1.5	2.5	-1.1	2.0	13.0	7.0	2.0	15.9	17.4	16.4	16.1	15.7
ME	Montenegro	-15.3	13.0	5.1	2.6	3.3	-0.3	2.4	12.5	6.0	2.0	17.9	16.6	15.2	14.9	13.9
MK	North Macedonia	-6.1	4.0	1.0	0.6	2.0	1.2	3.2	14.0	9.0	4.0	16.4	15.7	14.5	14.3	14.0
RS	Serbia	-0.9	7.4	3.6	1.9	2.7	1.6	4.1	11.0	8.0	4.0	9.0	11.0	9.5	9.0	8.5
XK	Kosovo	-5.3	10.7	3.1	2.9	3.8	0.2	3.4	10.5	6.5	2.0	25.9	24.5	24.2	23.5	23.2
	WB6 [1)2)]	*-3.2*	*7.7*	*3.1*	*1.9*	*2.8*	*0.9*	*3.2*	*11.2*	*7.2*	*3.2*	*13.0*	*13.9*	*12.8*	*12.3*	*12.0*
TR	Turkey	1.9	11.4	5.1	2.5	3.2	12.3	19.6	70.7	26.7	19.5	13.2	12.0	11.5	10.5	9.5
BY	Belarus	-0.7	2.3	-4.5	1.0	2.0	5.5	9.5	17.0	12.0	11.0	4.0	3.9	4.1	4.0	4.0
KZ	Kazakhstan	-2.5	4.3	2.8	3.6	4.1	6.8	8.0	14.0	10.0	7.0	4.9	4.9	4.9	4.8	4.8
MD	Moldova	-8.3	13.9	-2.0	0.0	2.0	3.8	5.1	30.0	15.0	8.0	3.8	3.2	2.7	3.5	4.0
RU	Russia	-2.7	4.7	-3.5	-3.0	1.0	3.4	6.7	13.9	6.7	4.0	5.8	4.8	4.2	4.8	4.5
UA	Ukraine	-3.8	3.4	-33.0	5.5	12.0	2.7	9.4	21.0	10.0	6.0	9.5	9.9	28.0	15.0	10.0
	CIS4+UA [1)2)]	*-2.7*	*4.6*	*-5.8*	*-1.4*	*2.4*	*3.7*	*7.2*	*14.8*	*7.5*	*4.7*	*6.2*	*5.6*	*8.1*	*6.1*	*5.2*
	V4 [1)2)]	*-3.3*	*5.4*	*3.8*	*1.1*	*2.4*	*3.4*	*4.7*	*12.8*	*8.2*	*4.1*	*3.5*	*3.7*	*3.3*	*3.5*	*3.5*
	BALT3 [1)2)]	*-1.2*	*5.6*	*2.0*	*0.9*	*2.6*	*0.4*	*4.2*	*18.6*	*8.3*	*4.0*	*8.0*	*7.0*	*6.4*	*6.9*	*6.2*
	SEE9 [1)2)]	*-4.1*	*6.5*	*4.2*	*2.1*	*3.2*	*1.6*	*3.6*	*12.3*	*7.9*	*4.8*	*8.1*	*8.7*	*8.1*	*8.0*	*7.9*
	CIS3+UA [1)2)]	*-2.9*	*3.9*	*-13.5*	*3.9*	*7.1*	*4.8*	*8.7*	*17.9*	*10.4*	*7.2*	*7.2*	*7.3*	*17.3*	*9.8*	*7.3*
	non-EU12 [1)2)]	*-1.4*	*6.6*	*-2.3*	*-0.2*	*2.6*	*6.0*	*10.6*	*30.6*	*13.0*	*8.9*	*8.0*	*7.4*	*9.1*	*7.4*	*6.6*
	CESEE23 [1)2)]	*-2.0*	*6.3*	*-0.5*	*0.3*	*2.6*	*5.0*	*8.7*	*25.5*	*11.6*	*7.6*	*7.1*	*6.7*	*7.9*	*6.7*	*6.0*

Table 3.1 / (contd.)

		Current account in % of GDP					Fiscal balance in % of GDP				
				Forecast					Forecast		
		2020	2021	2022	2023	2024	2020	2021	2022	2023	2024
BG	Bulgaria	0.0	-0.5	-1.3	-1.0	-0.5	-4.0	-4.1	-6.0	-5.0	-4.0
CZ	Czechia	2.0	-0.9	-2.6	-4.0	-3.1	-5.8	-5.9	-4.7	-3.7	-1.9
EE	Estonia	-1.0	-1.8	-0.7	0.1	0.3	-5.5	-2.3	-3.5	-4.2	-3.9
HR	Croatia	-0.5	3.2	-2.0	-2.4	-2.7	-7.3	-2.9	-3.0	-2.9	-2.5
HU	Hungary	-1.1	-4.2	-6.3	-5.7	-4.6	-7.8	-6.8	-6.5	-4.5	-4.0
LT	Lithuania	7.3	1.1	-6.2	-6.0	-5.3	-7.3	-1.0	-3.0	-2.5	-2.0
LV	Latvia	2.7	-4.3	-5.6	-3.5	-3.3	-4.5	-7.3	-6.5	-4.0	-2.0
PL	Poland	2.9	-0.7	-1.6	-0.2	1.2	-6.9	-1.9	-4.0	-3.4	-3.0
RO	Romania	-5.0	-7.0	-9.2	-8.6	-7.7	-9.3	-7.1	-6.5	-6.0	-5.5
SI	Slovenia	7.6	3.8	1.7	1.3	0.8	-7.8	-5.2	-3.8	-3.7	-1.8
SK	Slovakia	0.4	-2.0	-7.4	-8.4	-7.9	-5.5	-6.2	-5.1	-4.1	-3.5
	EU-CEE11 1)2)	*1.0*	*-1.8*	*-3.8*	*-3.4*	*-2.5*	*-6.9*	*-4.3*	*-4.8*	*-4.1*	*-3.3*
	EA19 3)	*2.8*	*3.7*	*0.5*	*1.0*	*1.5*	*-7.0*	*-5.1*	*-4.3*	*-3.1*	*-1.8*
	EU27 3)	*2.9*	*3.3*	*0.5*	*1.0*	*1.5*	*-6.7*	*-4.7*	*-3.9*	*-2.7*	*-1.4*
AL	Albania	-8.7	-7.6	-7.6	-6.4	-6.0	-6.7	-4.5	-0.5	0.0	0.5
BA	Bosnia and Herzegovina	-3.3	-2.4	-2.6	-2.0	-1.7	-5.3	-0.3	-1.0	0.5	1.0
ME	Montenegro	-26.1	-9.2	-11.7	-12.0	-10.7	-11.1	-1.8	-8.1	-7.5	-7.1
MK	North Macedonia	-3.0	-3.1	-9.2	-8.5	-7.3	-8.3	-5.4	-3.0	-2.0	-1.5
RS	Serbia	-4.1	-4.3	-8.3	-8.0	-7.8	-8.0	-4.1	-1.0	-2.0	-2.0
XK	Kosovo	-7.0	-8.7	-8.9	-7.8	-7.1	-7.6	-1.3	1.0	0.5	0.3
	WB6 1)2)	*-5.6*	*-4.8*	*-7.5*	*-7.0*	*-6.5*	*-7.5*	*-3.3*	*-1.3*	*-1.4*	*-1.2*
TR	Turkey	-5.0	-1.7	-4.9	-4.6	-4.1	-2.9	-2.3	-3.2	-2.4	-2.0
BY	Belarus	-0.3	3.2	2.2	1.8	1.4	-1.7	0.2	-4.0	-2.0	-1.0
KZ	Kazakhstan	-4.4	-4.0	3.0	-0.5	-1.5	-4.0	-3.0	-2.0	-2.7	-2.6
MD	Moldova	-7.7	-12.4	-12.6	-14.2	-13.7	-5.3	-1.9	-5.0	-4.0	-3.0
RU	Russia	2.4	6.9	13.0	10.2	10.1	-4.0	0.8	-2.0	-3.0	-2.0
UA	Ukraine	3.4	-1.6	5.5	5.0	-1.0	-5.3	-3.4	-25.0	-20.0	-8.0
	CIS4+UA 1)2)	*1.7*	*4.9*	*11.4*	*8.5*	*7.8*	*-4.0*	*0.1*	*-3.2*	*-3.8*	*-2.4*
	V4 1)2)	*1.9*	*-1.4*	*-3.0*	*-2.6*	*-1.4*	*-6.6*	*-3.9*	*-4.6*	*-3.7*	*-2.9*
	BALT3 1)2)	*3.9*	*-1.1*	*-4.6*	*-3.7*	*-3.3*	*-6.0*	*-3.1*	*-4.1*	*-3.4*	*-2.5*
	SEE9 1)2)	*-3.9*	*-4.3*	*-6.8*	*-6.5*	*-5.8*	*-7.9*	*-5.3*	*-4.8*	*-4.5*	*-4.0*
	CIS3+UA 1)2)	*-0.8*	*-2.2*	*3.1*	*0.9*	*-1.3*	*-4.2*	*-2.7*	*-9.4*	*-7.4*	*-3.9*
	non-EU12 1)2)	*-0.3*	*2.8*	*7.4*	*4.8*	*4.1*	*-3.9*	*-0.7*	*-3.1*	*-3.4*	*-2.2*
	CESEE23 1)2)	*0.2*	*1.1*	*3.6*	*1.7*	*1.5*	*-5.0*	*-2.0*	*-3.7*	*-3.6*	*-2.7*

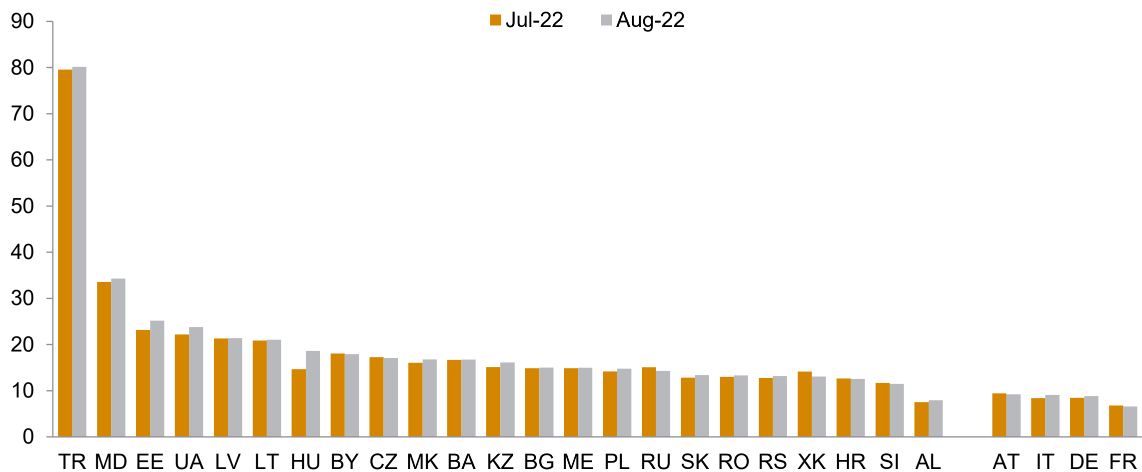
1) wiiw estimates. - 2) Current account data include transactions within the region (sum over individual countries). - 3) Forecasts estimated by wiiw.

Source: wiiw, Eurostat. Forecasts by wiiw. Cut-off date for historical data and forecasts: 3 October 2022.

3.2. INFLATION IS BEGINNING TO BITE

Inflation reached double-digit levels in all CESEE countries, except Albania, and is showing no sign of slowing down. Turkey had the highest inflation – 80.1% in August, largely due to depreciation of the lira. Albania's figure of 8% in August was substantially lower than anybody else's (Figure 3.5). This could owe something to the price controls introduced in March, but it may also be due to inaccurate measurement. All the CESEE countries (again excluding Albania) had higher inflation than the major Western European economies: that is not surprising, given that incomes in CESEE are generally lower, so that households spend more of their budget on food. Thus food, the price of which rose substantially in 2022, plays a much greater role in consumer price inflation in CESEE countries than it does in Western Europe. There is no indication of inflation coming down any time soon: in 17 of the 23 CESEE countries, it was higher in August than in July.

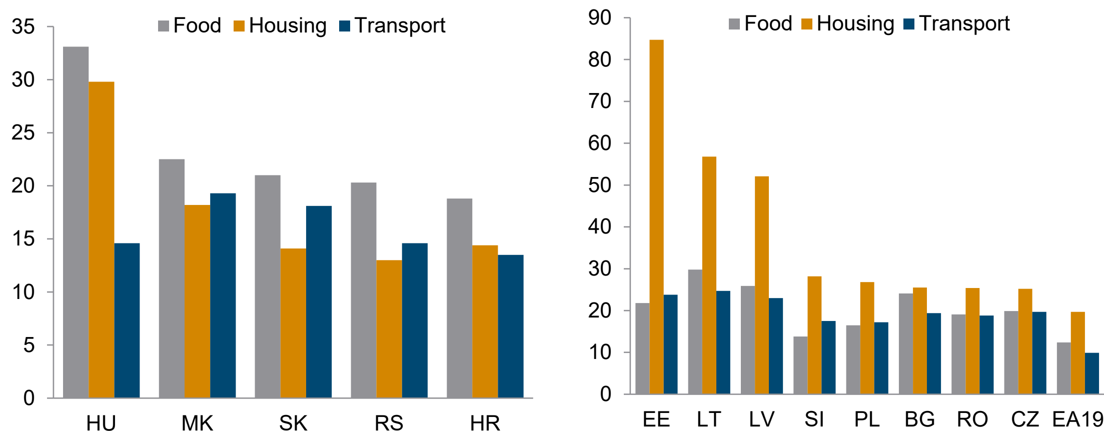
Figure 3.5 / Headline inflation in CESEE in July and August, %, year on year



Source: Eurostat and wiiw Monthly Database.

Three categories of expenditure have been driving inflation – food, housing and transport. Spending on food has risen on account of the global surge in food prices caused by the war in Ukraine. Expenditure on housing, water, electricity, gas and other fuels is higher due to the rise in domestic electricity and gas tariffs – again a result of global prices and the war. And transport costs have increased because of the rise in the price of fuel for personal vehicles – a consequence of the high oil prices on the international markets, again owing to the war in Ukraine. But although all the CESEE countries have witnessed an increase in all three categories of expenditure, there are some interesting differences between individual countries. In the less developed Balkan economies, as well as in Hungary and Slovakia, the biggest increase has been in food prices, which have risen more than in other regions – possibly owing to abuse of the market power of traders (Figure 3.6, left panel). In the more developed Baltic countries and most of the Central European economies, just as in the euro area the biggest increase has been in housing expenses – a result of the surge in electricity and gas prices (Figure 3.6, right panel). But Turkey and Russia are totally different: in those countries, it is transport costs that have increased most, due to the rise in the price of motor vehicle fuel (countries not shown in the figure).

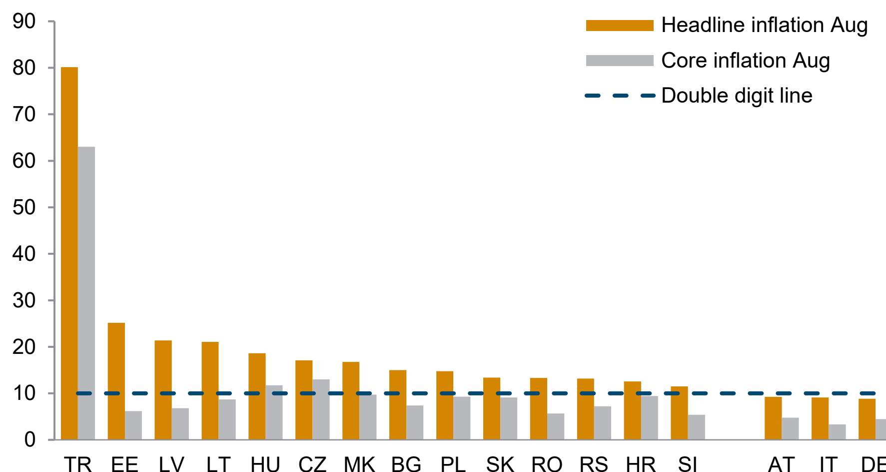
Figure 3.6 / Inflation in CESEE in August, by main sub-components, %, year on year



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

Disregarding these three categories, inflation remains in single figures in almost all CESEE economies. Only in Turkey, Hungary and Czechia was core inflation (thus defined) over 10% in August (Figure 3.7). Still, even core inflation exceeded 5% in all the CESEE countries, which clearly suggests that the price rises are broad based, rather than confined to food and energy.

Figure 3.7 / Headline and core inflation in CESEE in August, %, year on year

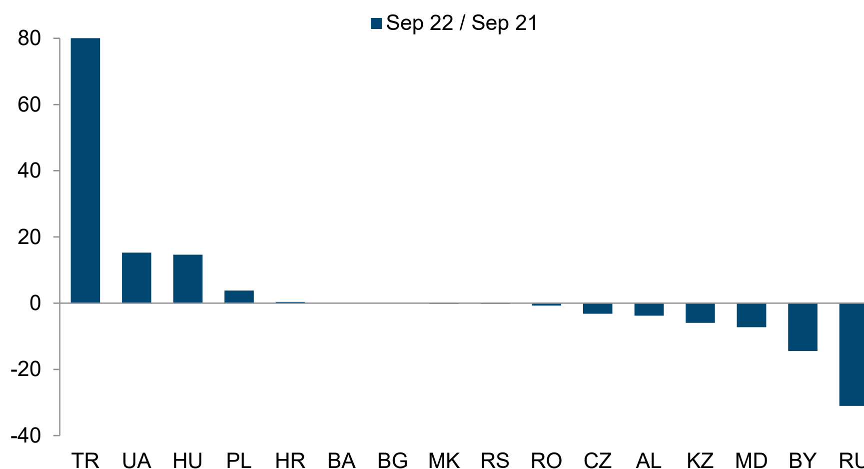


Note: Core inflation is defined as inflation excluding food, housing and transport costs.
Source: wiiw calculations, using data from Eurostat and wiiw Monthly Database.

The depreciating currency has also fuelled inflation in some countries. Turkey is the prime example of this. Its lira depreciated against the euro by around 80% in September 2022, compared to the same period last year (in September 2022, 1 euro was trading at around 18 lira, whereas in September 2021 it was trading at 10 lira), which is identical to the country's inflation rate in August (80%). The situation is similar in Hungary and Ukraine: their currencies depreciated against the euro by 15% and 18%, respectively, in September 2022, compared to the year before, and they had inflation

rates of 19% and 24%, respectively. At the other end of the spectrum is Russia, whose rouble in September 2022 was worth 31% more than a year ago, due to the capital controls that the country introduced to prevent fallout from the sanctions. This helped its inflation to slow somewhat – from around 18% in April to around 14% in August. The Belarusian rouble also appreciated against the euro – by 11% in September on an annual basis – but inflation in Belarus shows no sign of slowing. The other countries had more or less stable exchange rates (Figure 3.8). In many of them, this was due to interest-rate hikes by their central banks, which prevented capital outflow and currency depreciation.

Figure 3.8 / Exchange rate depreciation vs. EUR, September 2022, %, year on year

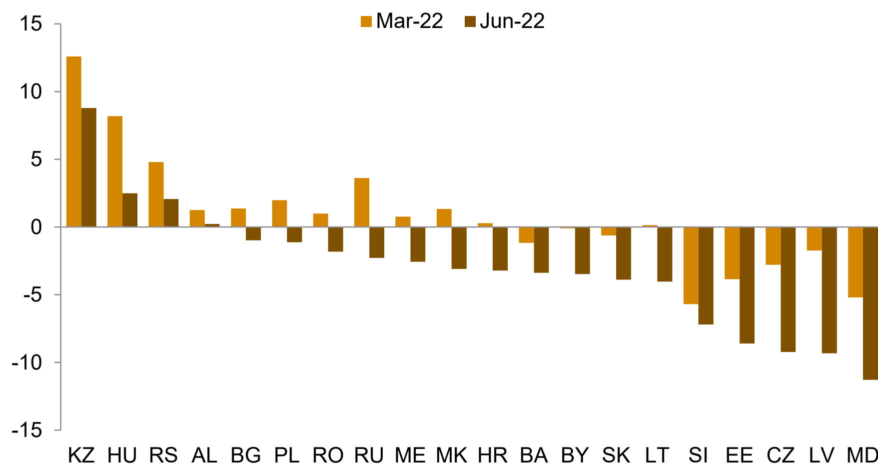


Note: A positive value = depreciation. Countries that have the euro as their national currency are not shown.
Source: wiiw Monthly Database.

3.3. REAL INCOMES ARE BEING ERODED BY INFLATION

Real wages are starting to decline almost everywhere in the region, and that will be a serious drag on the CESEE economies in coming months. Already in June, the average gross wage was worth less than the year before in 16 of the 20 CESEE countries for which data are available. This is in stark contrast to just three months previously, when only 8 of the 20 had seen a decline in real wages (Figure 3.9). With inflation having picked up further since June, real wages will probably have declined even more in most CESEE countries. This will drag down household consumption, the main driver of growth in the first half year. Accumulated savings may help for a while; but if inflation turns out to be persistent, and if nominal wages do not grow accordingly, then it is just a matter of time before household consumption declines as well.

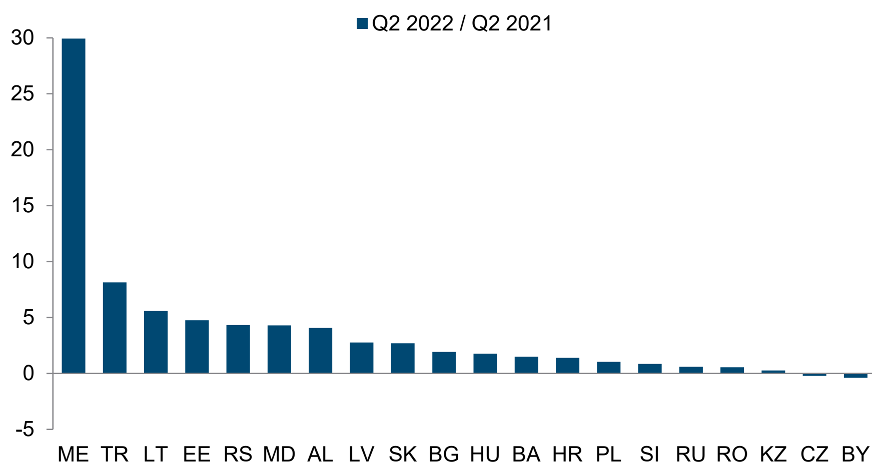
Figure 3.9 / Change in real gross wages in CESEE economies in March and June 2022, %, year on year



Note: Montenegro has seen a decline in the real gross wage, but a huge increase in the real net wage (30%), due to the tax reform it introduced at the beginning of the year, which scrapped the health insurance contribution and raised non-taxable income substantially.
Source: wiiw Monthly Database.

The labour markets, on the other hand, seem to be recovering well from the pandemic. Employment in Q2 2022 grew in virtually all the CESEE economies, compared to the previous year. Montenegro turned in the most impressive performance, with an increase in employment in Q2 of around 30% on an annual basis, thanks to a strong rebound in tourism. Only Czechia and Belarus saw a year-on-year decline in employment in Q2 2022, but even that decline was minor (Figure 3.10).

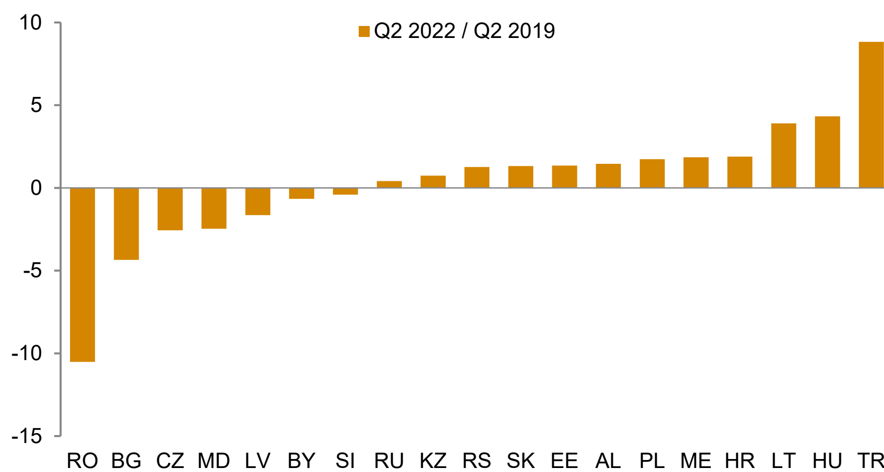
Figure 3.10 / Change in the number of employed persons in Q2 2022, %, year on year



Source: wiiw Monthly Database.

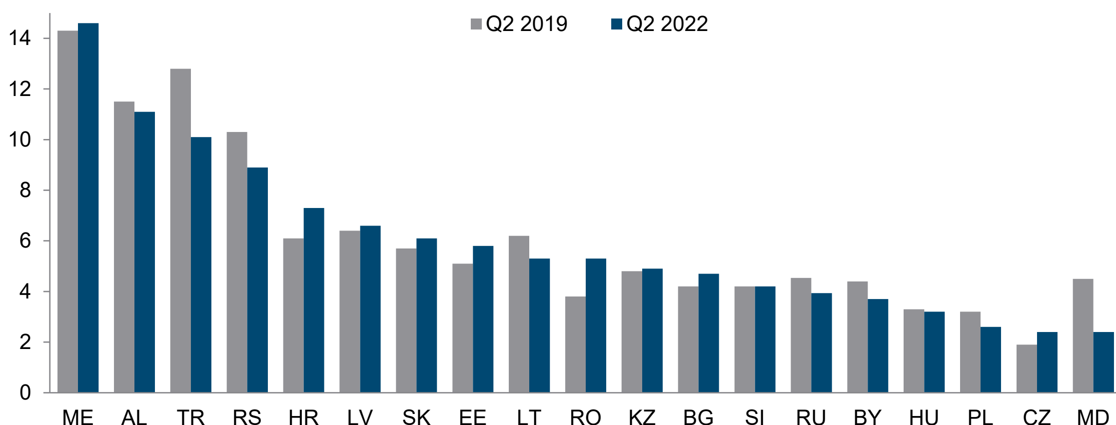
Nevertheless, a degree of labour market scarring from the pandemic is visible, at least in some CESEE countries. Employment is still below the pre-pandemic level (Q2 2019) in 7 of the 19 countries for which data are available (Figure 3.11). Similarly, the unemployment rate remains at above the pre-pandemic level in roughly half of the economies (Figure 3.12). These trends may also be driven by methodological changes, since several of the CESEE countries changed their Labour Force Survey methodologies in 2021, with implications especially for the treatment of workers in agriculture. In any case, unemployment remains elevated in many countries, especially in the Western Balkans, where it is close to or above 10%. On the other hand, some countries – like Czechia, Hungary and Poland – have unemployment close to or below 3%, and may even face labour shortages in certain sectors.

Figure 3.11 / Change in the number of employed persons in Q2 2022 with respect to Q2 2019, %, year on year



Note: Since 2021, a new methodology in line with the Integrated European Social Statistics (IESS) Regulation has been used for EU-CEE countries, Montenegro, Serbia and Turkey.
Source: wiiw Monthly Database.

Figure 3.12 / Unemployment rate in CESEE economies in Q2 2019 and Q2 2022, %

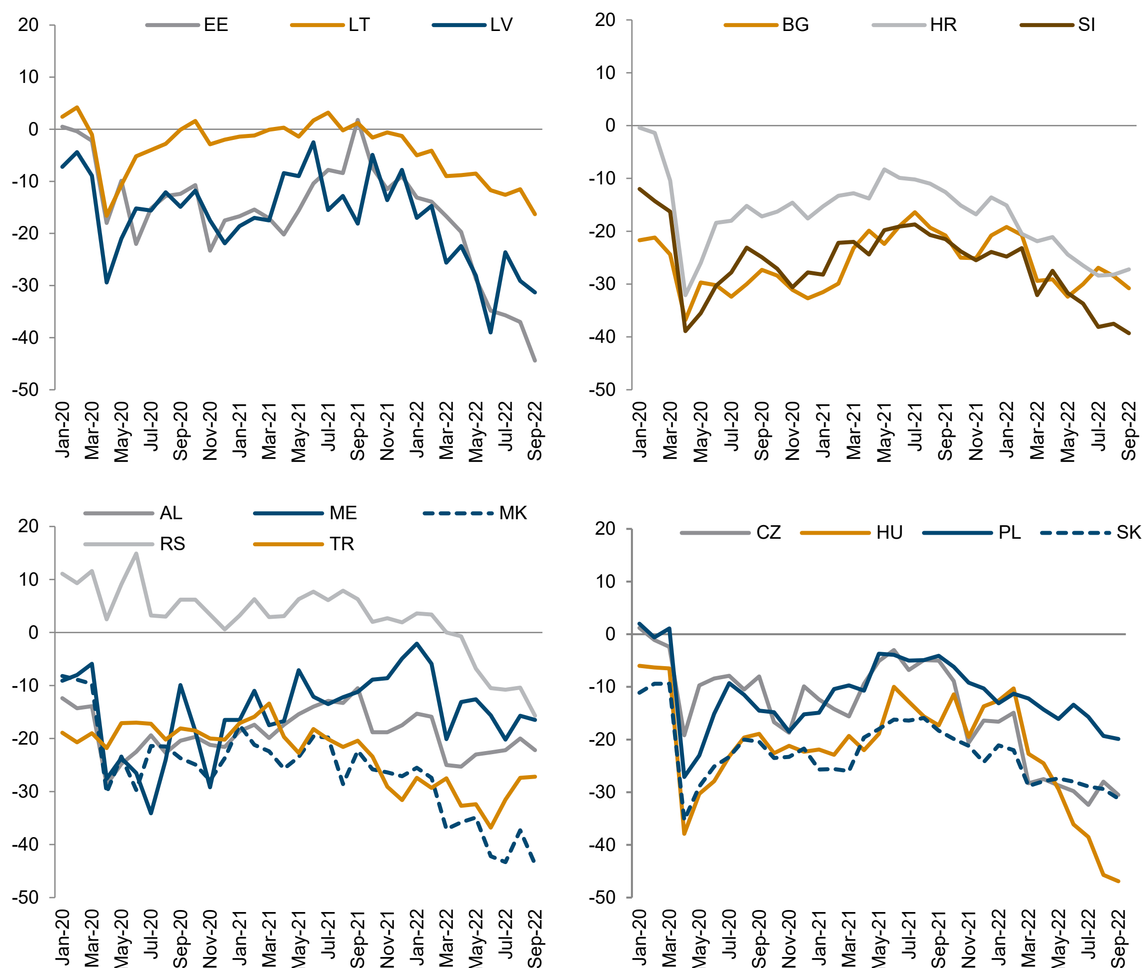


Note: Since 2021, a new methodology in line with the Integrated European Social Statistics (IESS) Regulation has been used for EU-CEE countries, Montenegro, Serbia and Turkey.
Source: wiiw Monthly Database.

3.4. CONSUMER CONFIDENCE IN FREEFALL

Rising inflation has depressed consumer confidence to levels unseen even at the onset of the pandemic. Of the 15 CESEE countries that publish data on this, in 12 consumer confidence in September 2022 was close to or below the April 2020 level (Figure 3.13). Only in Albania, Montenegro and Poland is consumer confidence still better than during the pandemic – in Albania probably because of the relatively low inflation; in Montenegro likely because of the strong rise in nominal incomes after the tax reform; and in Poland perhaps because of the historically low unemployment rate. Still, it is gradually declining even in those countries. As inflation is likely to remain close to or above the current level for some time, consumer confidence will probably continue to decline in coming months as well. This will be another channel that will tend to bring consumption down, along with declining real incomes.

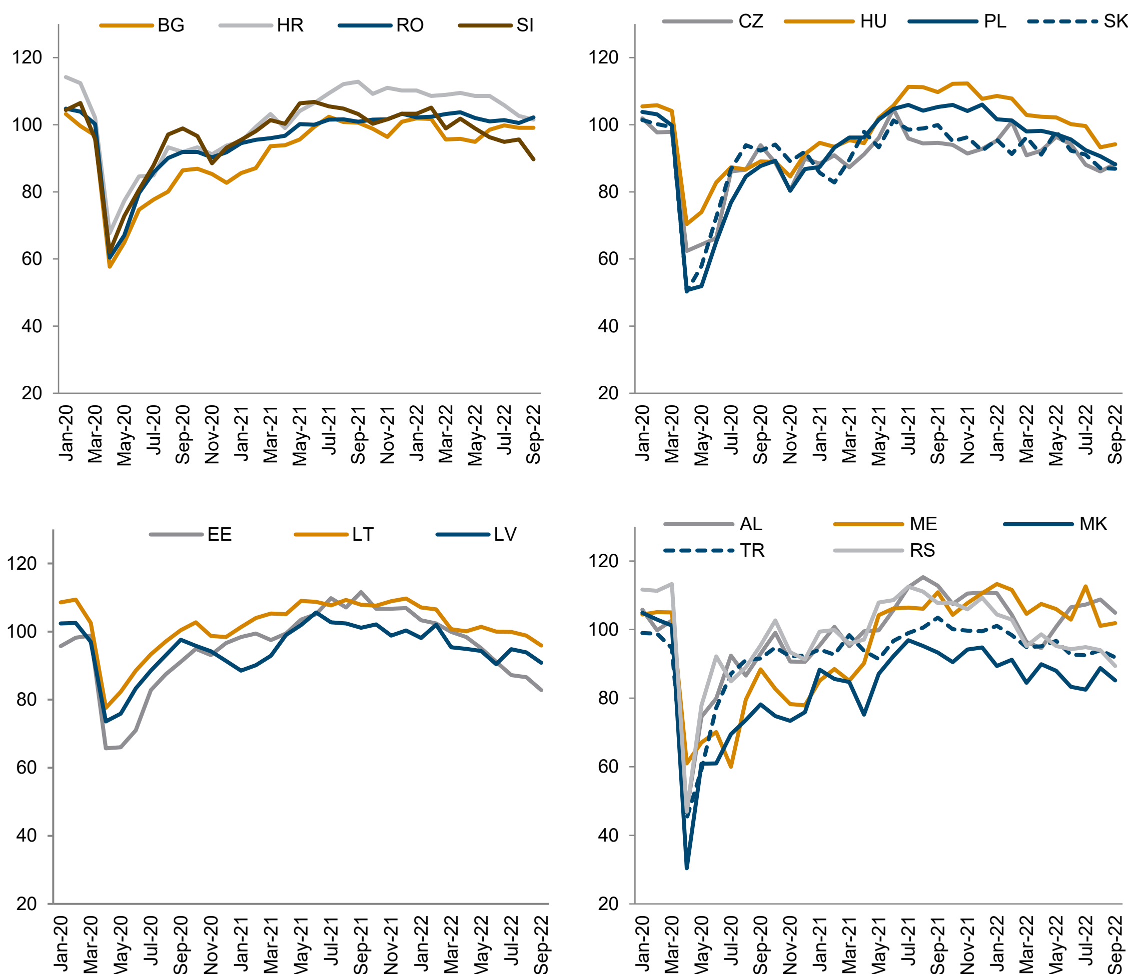
Figure 3.13 / Consumer confidence in CESEE, 2020-2022, balance of positive over negative answers



Note: Higher values indicate higher confidence.
Source: Eurostat.

Business sentiment is also deteriorating, although it is still far from the dire situation of early 2020. The Economic Sentiment Indicator is declining in 13 of the 15 CESEE countries that publish such data (Romania and Bulgaria are the two exceptions); but it is much better than in the early days of the pandemic, and the pace of decline is much slower than in the case of consumer confidence (Figure 3.14). This suggests that businesses have not yet been hit too badly by the cost-of-living crisis, and that the burden is falling on the shoulders of workers, at least for now. There may also be a delayed reaction: business confidence might decline sharply during the winter, when the energy crisis intensifies. Anyhow, even the current downward trends in the economic sentiment indicators suggest that business investment in CESEE is likely to slow in the second half of 2022, from the already low levels.

Figure 3.14 / Economic sentiment in CESEE, 2020-2022, index (long-term average = 100)

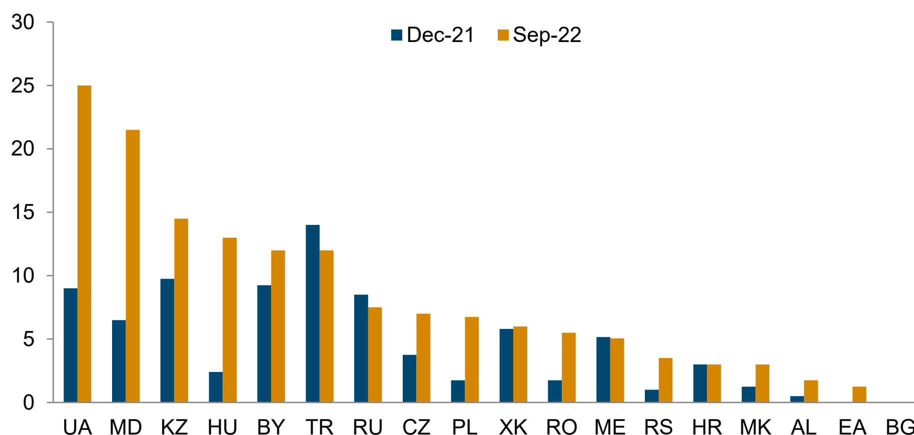


Note: Higher values indicate more optimistic sentiment.
Source: Eurostat.

3.5. IS MONETARY POLICY THROTTLING THE ECONOMY?

All the central banks in CESEE have tightened their monetary policy since the beginning of the year, except Turkey. Consequently, as of the end of September 2022, all central banks in the region had much higher interest rates than the European Central Bank (ECB): in Albania (where the rate is lowest), it stood at 1.75% in September, which is still higher than the ECB rate of 1.25% (Figure 3.15). Turkey is a notable outlier in this respect, due to the unique monetary policy philosophy of its president. Despite average inflation of around 70% over the first eight months of the year, it cut the interest rate twice, in August and September, from 14% to 12%. Russia is another interesting case – after hiking its rate following the invasion of Ukraine in February from 8.5% to 20%, it has gradually cut it on five separate occasions, so that it currently stands at 7.5%, below the level at the beginning of the year.

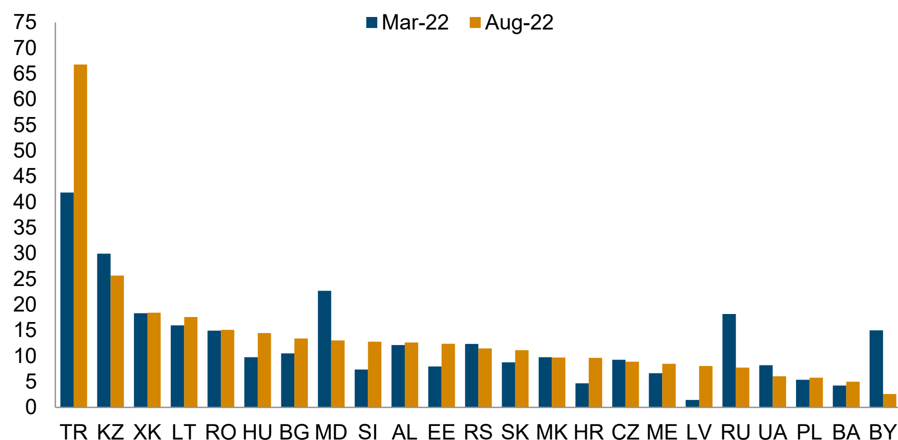
Figure 3.15 / Central bank policy rate in CESEE countries, end of period, %



Note: Countries that have the euro as their national currency are not shown.
Source: wiiw Monthly Database.

The tightening of monetary policy is understandable to some extent, but it comes with a big price tag. The region is facing double-digit inflation, and central banks have a clear mandate to control it. Some of the countries are also being forced to hike their rates to prevent capital outflow and currency depreciation, due to the rising interest rates of the US Fed. But excessive tightening could come at a substantial cost to the economy. The financial systems in CESEE have got used to low interest rates, so if rates rise sharply it is very likely that any vulnerabilities in those financial systems will be exposed. One area where this could happen is the property market, if a large share of the people have variable-rate mortgages. Monetary tightening is also likely to slow credit activity and, through it, economic growth. In nominal terms, credit activity in CESEE is continuing to grow, and the growth even appears to be accelerating: in 15 of the 23 countries, the nominal growth in loans to the non-financial private sector was higher in August than in March (Figure 3.16).

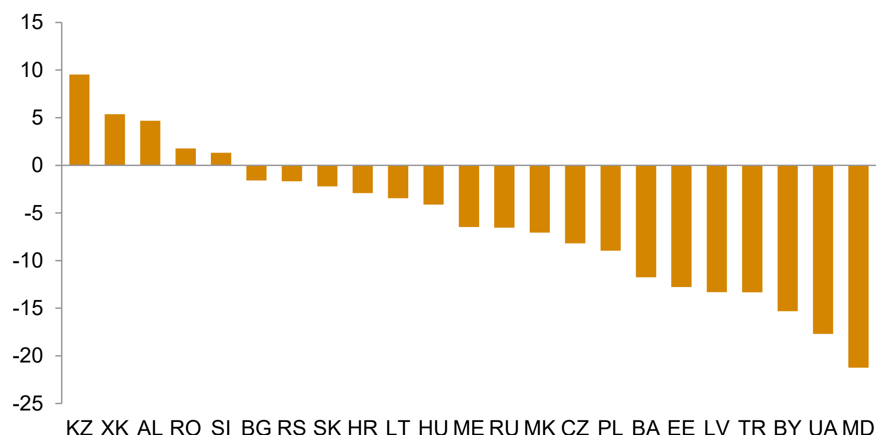
Figure 3.16 / Nominal growth in loans to non-financial private sector in March and August 2022, %, year on year



Note: data for Russia for July 2022.
Source: wiiw Monthly Database.

But in real terms, adjusted for inflation, credit growth is deep in negative territory in most CESEE countries. Only 5 of the 23 countries had positive credit growth in August in real terms (Figure 3.17). Things will only get worse in coming months, as interest-rate hikes by central banks usually take some time to filter through. This will place an additional burden on economic growth in CESEE in the coming months.

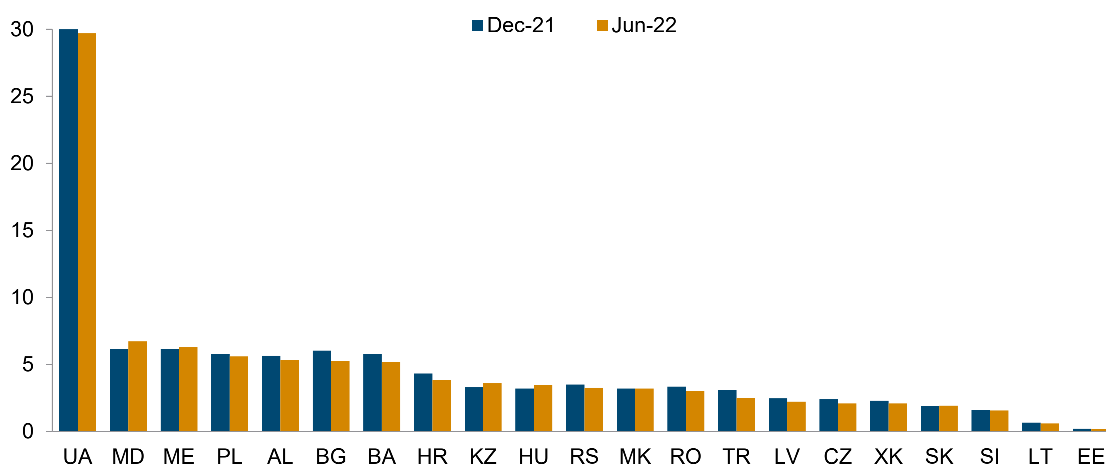
Figure 3.17 / Real growth in loans to non-financial private sector in August 2022, %, year on year



Note: Real credit growth is defined as nominal growth adjusted for consumer price inflation.
Source: wiiw Monthly Database.

Despite the rise in interest rates and the slowdown in real credit growth, the banking systems remain stable in all CESEE countries. In June, non-performing loans were below 7% in all the countries, except Ukraine. Furthermore, such loans have actually fallen in the course of 2022: in 13 of the 21 countries for which data are available, there were fewer non-performing loans in June 2022 than in December 2021 (Figure 3.18). It may be too early to see any effects of the tightening cycle on non-performing loans, as these things take time to filter through. One would not expect the deterioration in credit activity to destabilise the banking sector, but the rise in interest rates could increase the share of non-performing loans.

Figure 3.18 / Non-performing loans in CESEE in December 2021 and June 2022, % of total loans

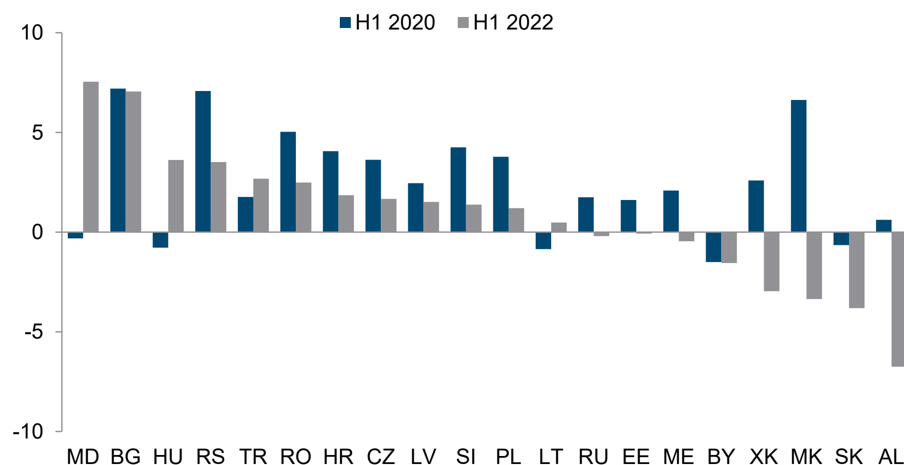


Source: wiiw Monthly Database.

3.6. FISCAL POLICY NOT SUPPORTIVE ENOUGH

Fiscal policy was only moderately supportive in the first half of the year. Government consumption increased in real terms in 12 of the 20 CESEE countries for which data are available (Figure 3.19), but in only two of them was the increase above 5% (Moldova and Bulgaria). The simple average increase for the region as a whole was just 0.8% year on year. This is much less than the increase during the early stages of the pandemic. In the first half of 2020, 15 of the 20 countries saw a rise in government consumption, and the simple average growth for the whole region was 2.5% year on year (Figure 3.19). Strong fiscal support during the pandemic was the main reason why the CESEE economies overcame that crisis without major scarring. By the same token, the weak fiscal support that we are currently seeing across the region will place an additional hurdle in the way of the CESEE economies as they seek to overcome this current crisis.

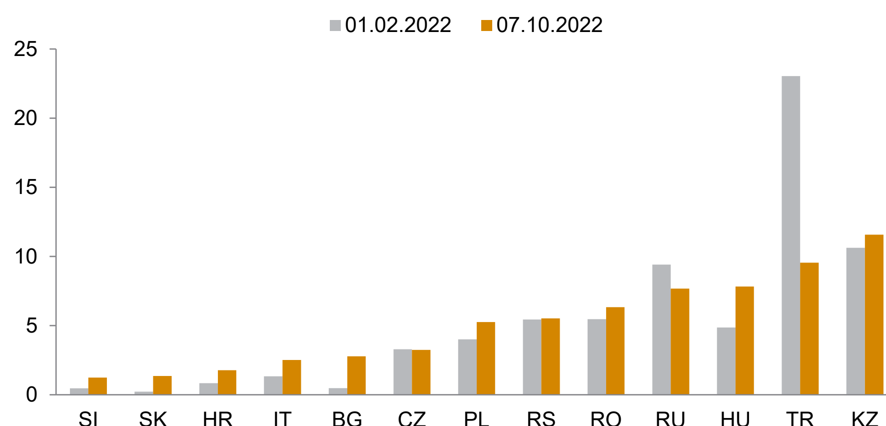
Figure 3.19 / Real growth in government consumption in CESEE in the first half of 2020 and 2022, %, year on year



Source: wiiw Monthly Database.

Governments are finding it increasingly difficult to borrow on international financial markets, and that is certainly limiting the fiscal support they can provide. Due to the interest-rate hikes of all the major central banks, government bond yields have also risen substantially. Furthermore, the spread of the government bond yields of CESEE countries over German government bond yields has also increased since the Russian invasion, reflecting investors' flight to quality in time of crisis (Figure 3.20). For most of the countries, the increase has been even bigger than that for Italy, which is often considered a risky country in the EU. The only two of the CESEE countries considered here that have not seen an increase in their government bond yields since February are Russia and Turkey, due to the better-than-expected performance of their economies in the first half of the year. In Turkey's case, it has also been government policy to push banks to buy lira-denominated bonds.

Figure 3.20 / Spread of 10-year government bonds over the German 10-year bond, February and October 2022, percentage points



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

Those CESEE economies that are EU member states benefit from support through the NextGenerationEU plan, though that support has been quite limited so far. Three of the countries have not yet received any disbursements; meanwhile, of the eight countries that have received some support, in just three has that support been greater than 1% of GDP (Table 3.2). This falls far short of what was promised. The reasons for the low rate of disbursement may relate to the low absorption capacity of the member states; but they may also have something to do with the complicated procedures on the EU side. Whatever the reason, if the disbursement rate does not improve in the coming period, even those CESEE countries that are EU member states will struggle to provide support to their economies in this crisis.

Table 3.2 / Disbursements made under the Recovery and Resilience Facility to EU member states from CESEE by end-July 2022

		Amount, EUR m	Share in 2021 GDP, %
RO	Romania	3,793.6	1.58
HR	Croatia	1,518.4	2.65
SK	Slovakia	1,221.4	1.26
CZ	Czechia	914.6	0.38
LT	Lithuania	289.1	0.52
LV	Latvia	237.4	0.72
SI	Slovenia	231.0	0.44
EE	Estonia	126.0	0.40
HU	Hungary	n/a	n/a
PL	Poland	n/a	n/a
BG	Bulgaria	n/a	n/a

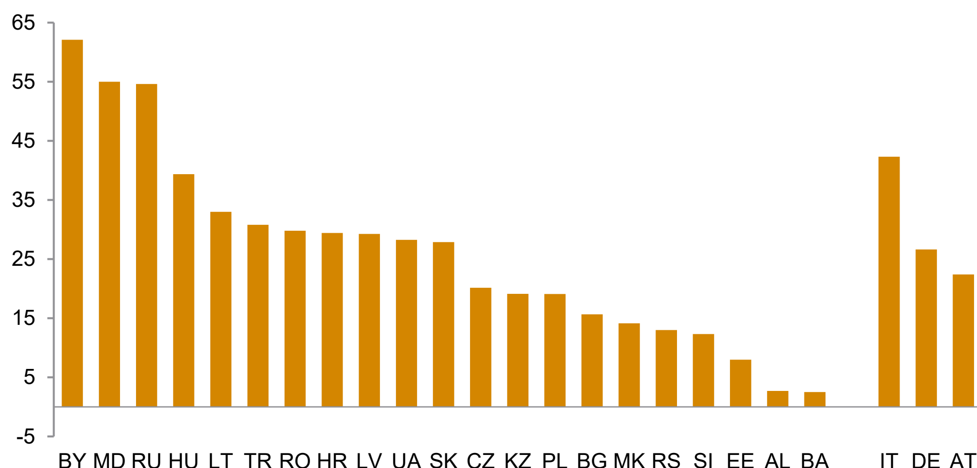
Source: European Commission.

3.7. THE WORST IS YET TO COME

But the real crisis for the CESEE economies will come only in the last quarter of 2022. Household consumption – the engine of growth in the first half year – will lose steam, as real incomes continue to drop, consumer confidence vanishes and credit activity slows down. Contractionary monetary policy and limited fiscal support will rub salt into the wounds. On top of all that, there is the energy crunch, which could get very serious during the winter.

Gas dependency in the CESEE region varies substantially, and so different countries will be affected in different ways. In Moldova, gas constitutes more than half of the total energy consumed, so the country might run into serious trouble during the winter, especially given its tense relations with Russia. Hungary is also very heavily dependent on gas, with around 40% of its energy consumption coming from that source. But given its rather more friendly relations with Russia, it should not have any great difficulty surviving the winter. Around half of the countries have gas dependency in excess of Austria's (22%) or Germany's (27%), most of them in the Baltic area or Central Europe (Figure 3.21). Those countries will be at serious risk both of gas shortages during the winter and of price hikes due to the high cost of gas. The other half of the countries – mostly from the Balkans – have a dependency of around or below 20% of their total energy consumption. They should be more secure over the winter – at least in this respect.

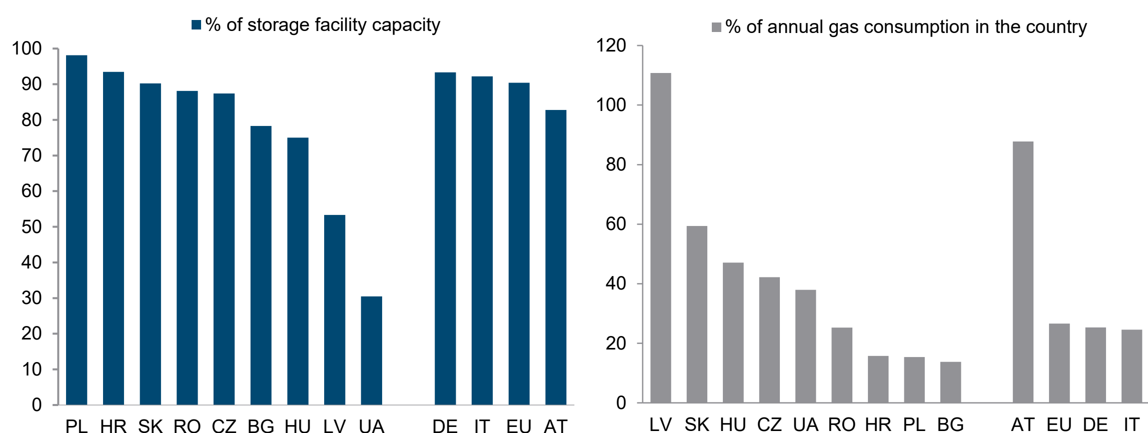
Figure 3.21 / Share of gas in total energy consumption in 2021, %



Note: Data on Moldova, Serbia, Albania and Bosnia and Herzegovina are from the International Energy Agency, refer to 2019, and reflect the share of gas in total energy supply, not consumption.
Source: Oxford University's Our World in Data and International Energy Agency.

Gas storage facilities are well filled up, but the volume of gas stored is sufficient for only a short period of time. As of early October, all the storage facilities in CESEE are more than 75% full, except for the one in Latvia (53% full) and the facilities in Ukraine (30% full) (Figure 3.22, left panel). But of the CESEE countries for which data are available, only Latvia has enough gas stored to meet its needs for a whole year (Figure 3.22, right panel). In Slovakia, the gas stored is enough to satisfy around 60% of the country's annual requirements; and in Hungary and Czechia – around 45%. Everywhere else, the volume of gas stored is only enough to satisfy 40% or less of the annual requirement. This means that if the winter is severe, most CESEE countries will struggle to meet their gas needs.

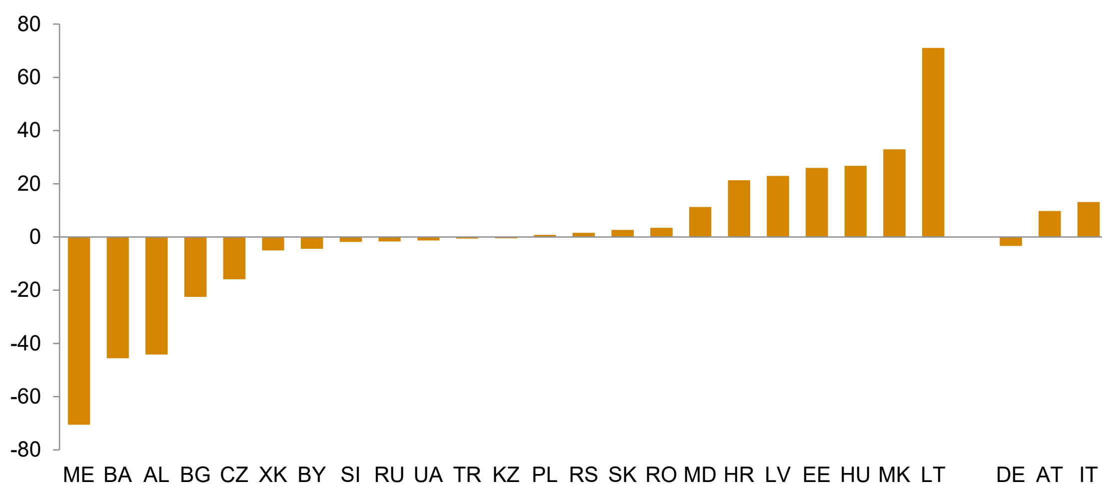
Figure 3.22 / Gas stored in storage facilities in CESEE and EU on 7 October 2022, %



Source: Gas Infrastructure Europe.

Another source of risk stems from the rather high imports of electricity in some CESEE countries. Again, there is wide divergence across the region regarding this (Figure 3.23). In some Balkan countries – like Montenegro, Bosnia and Herzegovina, and Bulgaria – net exports of electricity exceed 20% of the total demand for electricity, which means they might even benefit from the currently high electricity prices. On the other hand, the Baltic countries, as well as North Macedonia, Hungary and Croatia, import more than 20% of their total electricity requirements, so they could be in serious trouble this winter: some businesses may be forced to close temporarily during the winter on account of the high electricity prices. However, most of the countries (13 out of 23) are somewhere in between: the high electricity prices should not affect them much more than they have already been affected.

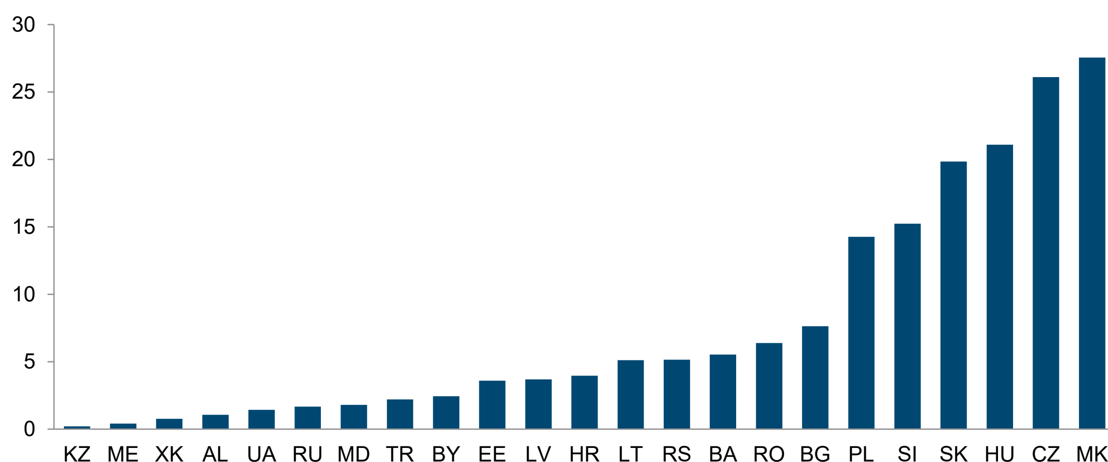
Figure 3.23 / Share of net imports of electricity in total electricity demand in the country in 2021, %



Note: Negative values represent net exports of electricity. Data for Albania and Kosovo are for 2020.
Source: Oxford University's Our World in Data.

Finally, some CESEE economies could be severely affected by the likely recession in Germany, due to their close integration into German value chains. This is particularly true for North Macedonia and Czechia, whose exports to Germany exceed 25% of their GDP. The other Visegrád countries and Slovenia are also very vulnerable, with exports to Germany of between 14% and 21% of GDP (Figure 3.24). Any temporary closure of certain industrial plants in Germany over the winter would likely lead to temporary closures in those countries, too. The other CESEE countries are in a somewhat better position, although the other Balkan countries also have exposure to Germany in excess of 5% of their GDP.

Figure 3.24 / Exports to Germany, as a share of GDP, in 2021, %



Source: wiiw Annual Database.

3.8. HIGHER GROWTH THIS YEAR, LOWER GROWTH NEXT

Due to the better-than-expected outturn from the first half of the year, we are upgrading our GDP forecasts for 2022 for most of the CESEE countries. Concretely, for 14 of the 23 countries, we now expect higher GDP growth; for four countries we are keeping the forecast unchanged; and for five we are revising the projection downwards (Table 3.3). Most notably, we are upgrading the growth forecast for Ukraine by 5 percentage points (pp), thanks to the way the economy has adjusted to war conditions, as well as to the country's success on the battlefield. At the same time, we are also upgrading our growth forecast for Russia, by 3.5 pp, since that country's economic situation is obviously better than anybody expected, at least for the time being. Turkey is another positive outlier: we are revising our projection for GDP growth there upwards by 2.4 pp, as its economy is continuing to perform, despite inflation approaching three digits. On the other hand, we have downgraded the growth forecasts for this year for Moldova and Estonia by around 1 pp, as those two countries seem to have been affected by the war in Ukraine much more than was previously thought, due to their proximity to the war-affected regions.

Table 3.3 / Real GDP growth forecasts and revisions over previous forecast, October 2022

		Forecast, %			Revisions, pp		
		2022	2023	2024	2022	2023	2024
EU-CEE	BG	3.0	1.5	3.0	0.5	-2.2	-0.5
	CZ	2.0	1.0	2.8	0.2	-1.9	-0.9
	EE	1.0	1.4	3.1	-1.1	-2.0	0.0
	HR	5.0	2.5	3.1	1.7	-1.0	-0.5
	HU	4.2	-1.2	1.7	1.1	-2.7	-1.0
	LT	2.1	0.9	2.6	0.2	-1.9	0.0
	LV	2.8	0.6	2.3	0.7	-1.8	-0.3
	PL	4.6	1.7	2.4	0.4	-1.9	-1.4
	RO	4.8	2.2	3.5	1.3	-1.3	-1.0
	SI	5.7	1.9	2.7	1.2	-1.1	-0.1
	SK	1.8	0.6	2.4	-0.4	-2.2	-1.0
Western Balkans	AL	3.4	3.0	3.6	-0.1	-0.5	-0.1
	BA	2.6	1.5	2.5	1.2	-0.3	0.2
	ME	5.1	2.6	3.3	1.5	-1.1	0.0
	MK	1.0	0.6	2.0	0.0	-1.9	-0.5
	RS	3.6	1.9	2.7	0.0	-1.5	-0.7
	XK	3.1	2.9	3.8	-0.2	-0.8	-0.1
Turkey	TR	5.1	2.5	3.2	2.4	-0.3	0.0
CIS+UA	BY	-4.5	1.0	2.0	0.0	0.0	0.0
	KZ	2.8	3.6	4.1	0.0	-0.3	-0.1
	MD	-2.0	0.0	2.0	-1.0	-3.0	-2.0
	RU	-3.5	-3.0	1.0	3.5	0.0	0.0
	UA	-33.0	5.5	12.0	5.0	0.5	-1.0

Note: Current forecast and revisions relative to the wiiw Summer Forecast Update (wiiw, 2022). Colour scale variation from the minimum (red) to the maximum (green).
Source: wiiw.

As the rise in prices has turned out to be much more aggressive than anticipated, we have revised our inflation forecasts for 2022 upwards for all but two CESEE countries (Table 3.4). Russia is a notable exception – we have revised its forecast for this year downwards by 1.7 pp, due to the slowdown in its inflation in recent months, mainly because of the appreciation of the rouble. For Bulgaria, we keep our forecast the same as three months ago (14%), as it turns out that the high forecast then was justified. Turkey will have the highest inflation in 2022, around 71% for the year as a whole. The only three countries that will have single-digit inflation are Albania (7%), Croatia and Slovenia (both around 9.5%).

Table 3.4 / Inflation forecasts and revisions over previous forecast, October 2022

		Forecast, %			Revisions, pp		
		2022	2023	2024	2022	2023	2024
EU-CEE	BG	14.0	10.0	8.0	→ 0.0	↑ 2.0	↑ 3.0
	CZ	15.0	8.5	3.2	↑ 2.8	↑ 2.7	↑ 0.9
	EE	18.5	8.0	4.5	↑ 4.0	↑ 0.5	↑ 0.5
	HR	9.5	6.0	3.0	↑ 1.3	↑ 2.5	→ 0.0
	HU	16.0	15.0	8.0	↑ 5.0	↑ 9.0	↑ 4.0
	LT	19.5	8.0	4.0	↑ 5.0	↑ 1.5	→ 0.0
	LV	17.0	9.0	3.5	↑ 4.0	↑ 2.5	↑ 0.5
	PL	11.5	6.5	3.5	↑ 1.0	↓ -1.5	↓ -1.0
	RO	13.0	8.0	5.0	↑ 1.0	↑ 1.0	↑ 1.0
	SI	9.4	5.5	2.3	↑ 1.3	↑ 1.2	→ 0.0
	SK	11.4	8.0	3.0	↑ 0.9	↑ 1.5	↑ 0.5
Western Balkans	AL	7.0	4.0	2.5	↑ 0.9	↑ 0.5	→ 0.0
	BA	13.0	7.0	2.0	↑ 3.0	↑ 3.0	↓ -1.0
	ME	12.5	6.0	2.0	↑ 2.5	↑ 2.0	→ 0.0
	MK	14.0	9.0	4.0	↑ 3.0	↑ 3.0	→ 0.0
	RS	11.0	8.0	4.0	↑ 1.0	↑ 2.0	→ 0.0
	XK	10.5	6.5	2.0	↑ 2.0	↑ 2.2	→ 0.0
Turkey	TR	70.7	26.7	19.5	↑ 3.0	↑ 4.1	↓ -0.1
CIS+UA	BY	17.0	12.0	11.0	↑ 2.0	→ 0.0	→ 0.0
	KZ	14.0	10.0	7.0	↑ 1.0	↑ 1.0	↑ 1.0
	MD	30.0	15.0	8.0	↑ 5.0	↑ 2.0	→ 0.0
	RU	13.9	6.7	4.0	↓ -1.7	↓ -3.0	↑ 0.3
	UA	21.0	10.0	6.0	↑ 1.0	↓ -2.0	→ 0.0

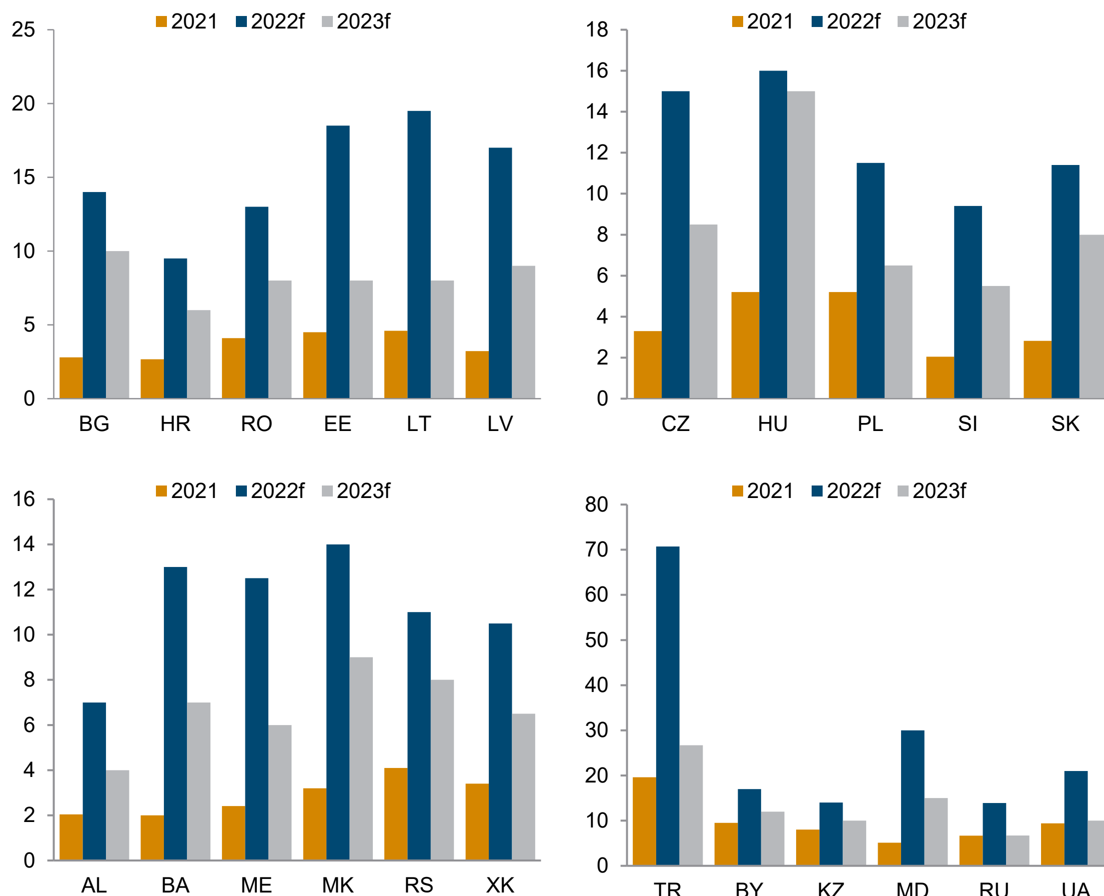
Note: Current forecast and revisions relative to the wiiw Summer Forecast Update (wiiw, 2022). Colour scale variation from the minimum (red) to the maximum (green).
Source: wiiw.

The economic outlook for 2023 is much gloomier now than it was three months ago, as the war is dragging on for longer than expected and the energy situation has gotten worse. In a way, our forecasts for 2023 are similar to our adverse scenario from this spring, when we assumed that the EU would ban Russian energy imports. The one difference is that it was not the EU that banned Russian energy imports, but rather Russia decided to cut the gas supply to the EU. The overall effect is similar, though – the unavailability of gas means its price increases, fuelling inflation and crippling growth.

Consequently, we have raised our inflation forecasts for next year for 19 of the 23 countries that we cover. Russia is again an exception, with a downward revision of 3 pp, due to its lower inflation from this year and the stronger rouble. Ukraine is another exception, with a downgrade of 2 pp on account of its military successes, which will ease some supply-chain issues. On the other hand, Turkey has the highest upward revision, of 4.1 pp, as its inflation this year is turning out to be higher than previously expected. On a weighted average basis, the region next year will have average inflation of 11.6% – very high and much higher than the euro area average of 6% (Table 3.1). This is dominated by the inflation in Turkey, of close to 27%. On a simple-average basis, the region will have an inflation of 9.3%, which is still well above the euro area one. Compared to this year's inflation, price growth next year will moderate

in all CESEE countries (Figure 3.25); but that is entirely to be expected, given the high comparative basis from this year.

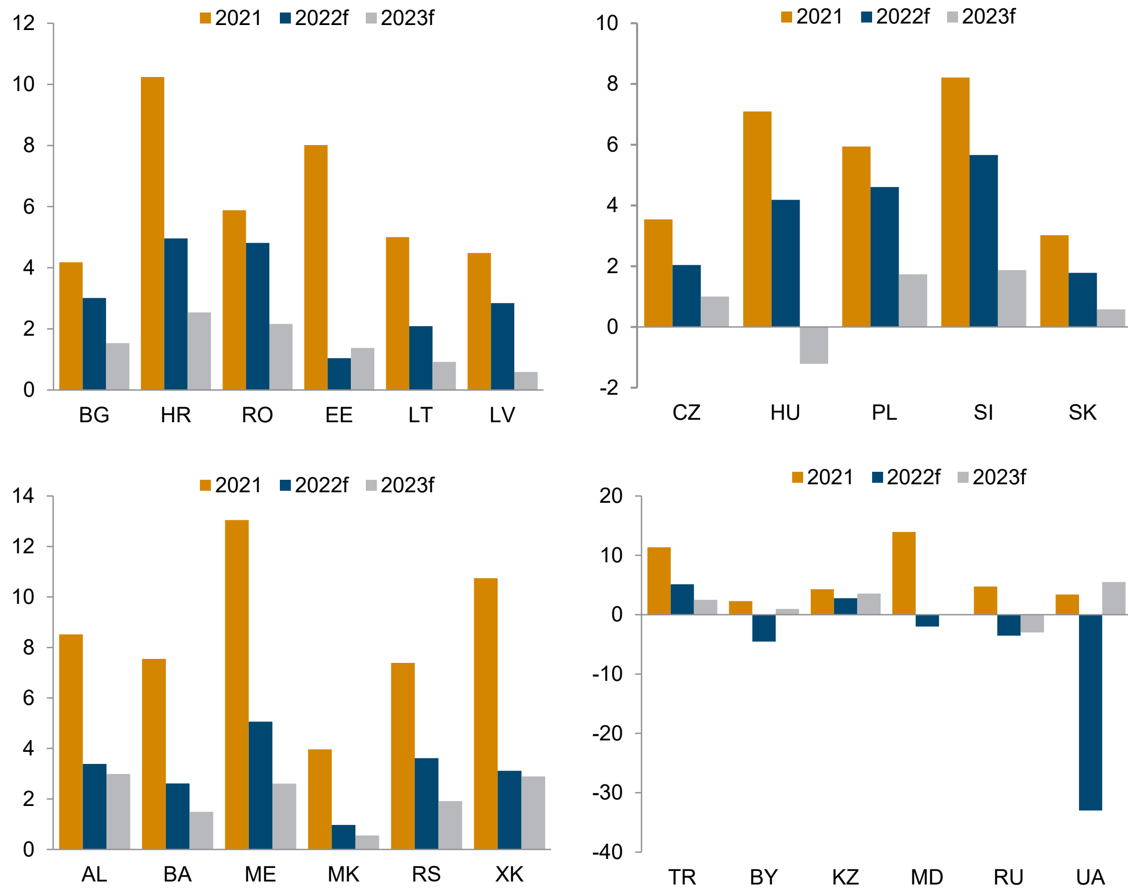
Figure 3.25 / Inflation in 2021 and forecast inflation for 2022 and 2023, %, year on year



Source: wiiw Annual Database for 2021 and wiiw forecasts for 2022 and 2023.

In turn, we have revised downwards the forecasts for next year's GDP growth for almost all CESEE countries. The biggest revisions are for Moldova (3 pp downwards), due to the dire energy situation there, and Hungary (2.7 pp), due to its twin deficits and the likely continued suspension of the EU transfers that it was supposed to receive. Despite the deteriorating outlook, we still project that only two countries will see their GDP decline in 2023 as a whole – Russia (by 3%) and Hungary (by 1.2%). Ukraine will have the strongest growth (5.5%), although that forecast is very uncertain and is dependent on the course of the war. In most of the countries, growth next year will be worse than this year (Figure 3.26). The CIS countries and Ukraine are clear exceptions to this: next year all those countries will have better economic growth than this year (Figure 3.26, bottom right panel). As a whole, on a weighted average basis, the region will grow by 0.3% next year, which is very close to growth in the euro area, which we assume to be 0.2% (Table 3.1). However, this figure is dominated by the largest economy in the region, Russia, which will suffer a decline next year. On a simple average basis, the growth in CESEE next year will be 1.5% – clearly better than growth in the euro area.

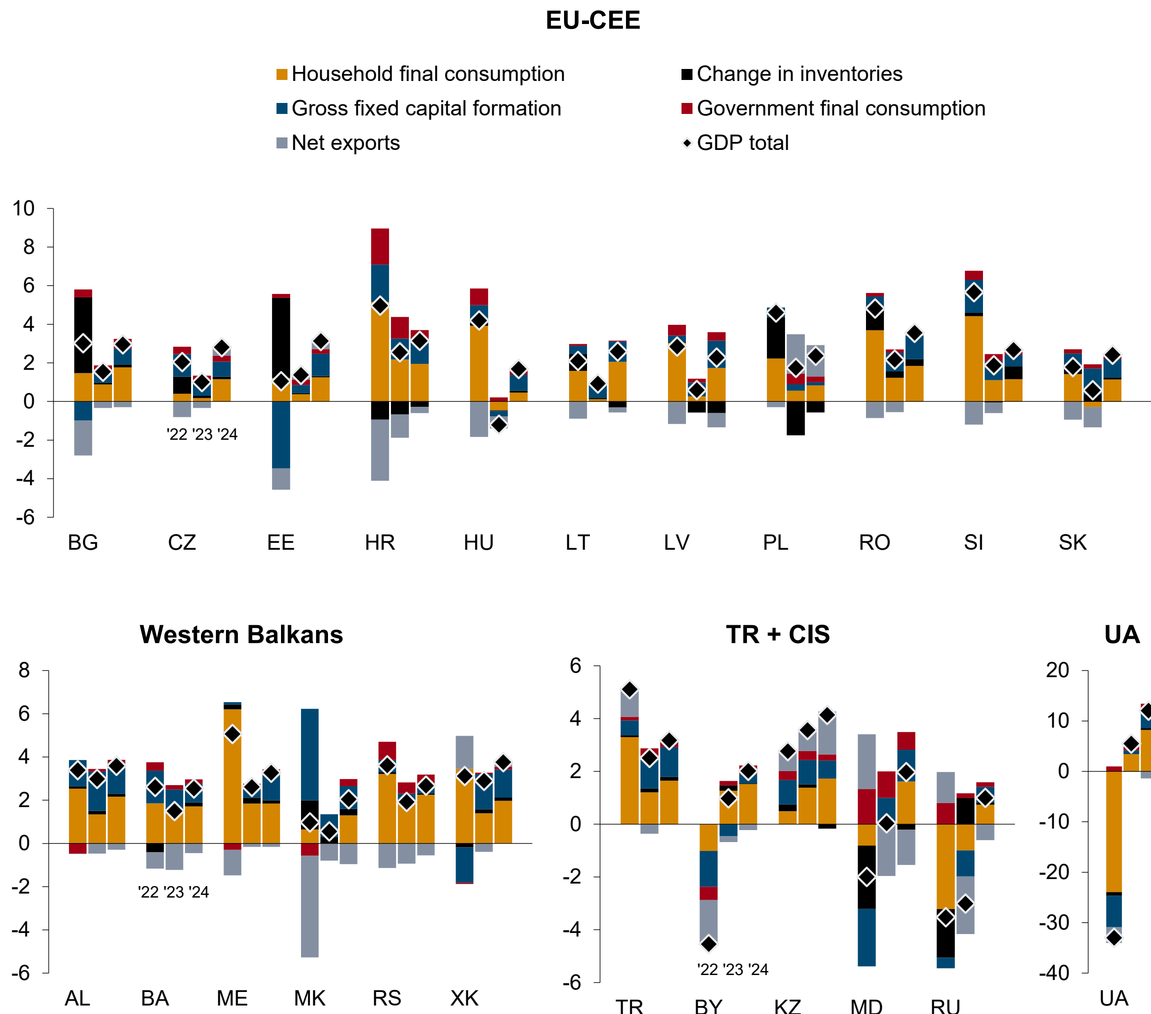
Figure 3.26 / GDP growth in 2021 and growth forecasts for 2022 and 2023, %, year on year



Source: wiiw Monthly Database for 2021 and wiiw forecasts for 2022 and 2023.

The main driver of growth in 2023 will again be household consumption; but because it will be much weaker than in 2022, overall growth will also be lower. In some countries from the Western Balkans and CIS, investment will also contribute. Net exports will make a negative contribution, except in the resource-exporting countries. The contribution of government consumption will be negligible virtually everywhere (Figure 3.27).

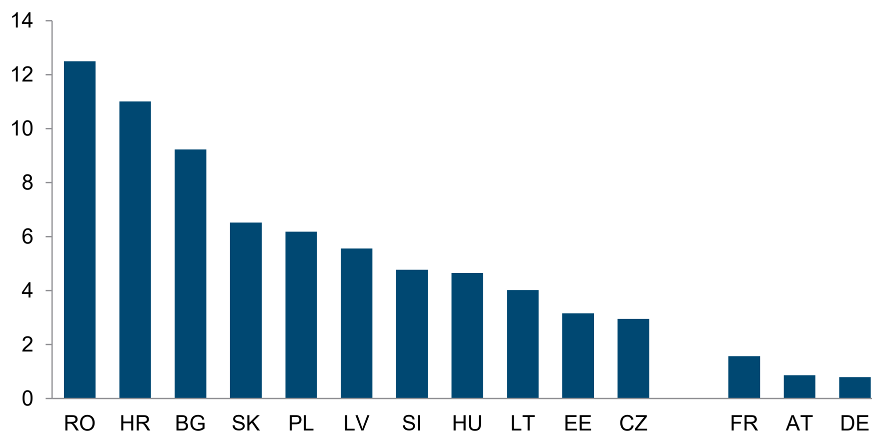
Figure 3.27 / Contribution of individual demand components to GDP growth for 2022-2024, percentage points



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

There are several reasons why most of the CESEE countries will outperform the euro area next year in terms of economic growth. The first is that these countries, being less developed, are still growing at a higher rate on average; this is due to the catching-up process, which – though perhaps slow in the region – is still ongoing. A second reason is that many of the CESEE countries will not have such serious energy issues as Western Europe – either because of their low reliance on gas, or because of their adequate domestic production of electricity, or because of their still close ties to Russia. The third reason is that many of the CESEE countries, especially those with a poor energy outlook, are expected to receive sizeable amounts of money next year through the EU's Recovery and Resilience Facility (RRF), which should help their economies remain afloat. Even Czechia and Estonia, the CESEE countries with the lowest allocated amounts of RRF funds, are still expected to receive total support of around 3% of GDP – far above the funding that Austria, Germany or France will receive (around 1% of GDP) (Figure 3.28). Those countries with the largest allocations – Romania and Croatia – are expected to receive RRF funding of more than 10% of GDP.

Figure 3.28 / RRF funds allocation per country, as a percentage of 2021 GDP



Source: European Commission.

Having said that, there is an important factor that may lead to weaker growth in CESEE next year, related to the limited fiscal space that these countries have. If things turn bad, CESEE governments will have less scope to support households and businesses than Western European governments; and that may result in lower growth. This is also likely to magnify the social disparities – already very high in most CESEE countries – which will again deal economic growth a blow.

Looking beyond the short term, the main question for the CESEE economies will be how they manage the green transition. This will be important in reducing the two key energy risks that they currently face – their heavy dependence on gas and their high imports of electricity. Investment in renewable energy will thus be crucial, if these countries are to improve their resilience and increase their longer-term growth prospects. The limited fiscal space that they currently have may be a serious obstacle to the achievement of this. But if the countries do find ways of improving their fiscal revenue – through windfall taxes or progressive taxation, for example – they could indeed emerge stronger from the current crisis.

3.9. CONCLUSIONS

Economic growth in CESEE in the first half of 2022 has generally been better than expected. Because of that, we are revising our growth forecasts for this year upwards for most of the CESEE countries.

Still, the surge in the global price of food and energy has led to very aggressive inflation in the CESEE region. Price rises have already reached double-digit levels in virtually all the CESEE countries. Because of that, we are also revising upwards our inflation forecasts for 2022 for most of the countries.

The economic damage from the higher and more persistent inflation will become evident only in the months and years to come. Real incomes are in freefall almost everywhere in CESEE; consumer confidence is evaporating; business sentiment is deteriorating; interest rates are soaring; and the fiscal

space is shrinking. On top of all this comes the energy crunch, caused by the cut in the supply of Russian gas to Europe.

Different countries will be affected differently by the energy crunch, but no country will be spared. Some countries are heavily dependent on gas, and they may suffer because of the lack of it. Others are large importers of electricity: they may have trouble finding affordable electricity, which could lead to the closure of some big industrial plants. Yet other countries will pay the price of their exposure to Germany, as their exports could collapse if the German economy enters a recession.

Our forecasts for 2023 are much more pessimistic than three months ago. On average, we expect inflation in CESEE in 2023 to be 11.6% – far higher than the 6% inflation in the euro area.

We have revised GDP prospects for next year downwards for almost all CESEE economies. We forecast that on average the CESEE region will grow by 0.3% next year, close to what we assume for the euro area (0.2%).

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4. Austria and CESEE: Growth badly affected by invasion fallout

BY BERNHARD MOSHAMMER

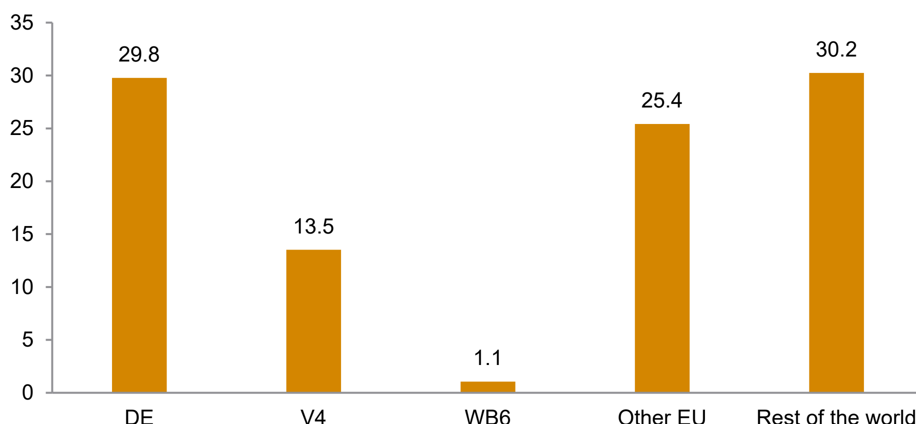
- **The sharp reduction in Russian gas flows to Europe has led to inflation in Austria exceeding the levels of the 1970s. This has dented consumption and business confidence.**
- **Germany and the Visegrád countries – Austria's key trading partners – have been especially badly affected by the fallout from the Russian invasion, due to their previously heavy reliance on Russian gas.**
- **Austria will therefore face serious direct and indirect effects, with manufacturing and tourism bracing themselves for a potentially tough winter.**
- **Central Europe will face a difficult 12-18 months at least, but over the medium term its decoupling from Russian energy, combined with large allocations from NextGenerationEU, will be a powerful driver of the green transition in the region.**

Record inflation has slammed the brakes on private consumption. In Austria, surging prices for food and energy have led private consumption to lose steam. On the back of the recent sharp reduction in Russian gas flows to Europe, in September inflation (measured by the Harmonised Index of Consumer Prices – HICP) hit a record 11% – above the figures observed during the oil price shocks of the 1970s. The consumer confidence indicator fell in September to -64, its lowest since April 2020. Revised estimates for private consumption clearly illustrate the economic consequences: last December, the Austrian Institute of Economic Research (WIFO) forecast growth of 6.3% in private consumption in 2022: in October, the figure was recently revised downwards to 3.8%.

The business outlook has also turned negative, though not overly pessimistic. In 2022, fixed capital investment will likely stagnate, though it may recover slightly in 2023. Recent WIFO estimates are for a 0.5% decline in 2022 and growth of 0.8% in 2023. Investment stagnation is also suggested by the Purchasing Managers' Index for Manufacturing (PMI). Although it fell to 48.8 in August – below the critical 50 points that separates growth and contraction – it did not deteriorate any further in September.

The looming recession in Germany will be a drag on Austria's economic growth. With an export ratio of 55.9% in 2021, Austria is a very open economy. Its most important trading partners remain Germany and the Visegrád region: Germany accounts for almost 30% of all Austrian exports, while 13.5% go to the Visegrád economies (Figure 4.1). Since Germany is expected to face a technical recession in Q4 2022 and Q1 2023 (largely on account of high energy prices), that will have an impact on the Austrian economy both directly and through indirect linkages – especially through the country's important trading partners, such as the Visegrád states. 27.6% of Czech, 23.6% of Hungarian, 26.3% of Polish and 18.9% of Slovak imports originated in Germany in 2021.

Figure 4.1 / Austrian goods exports by destination, Q2 2022, %



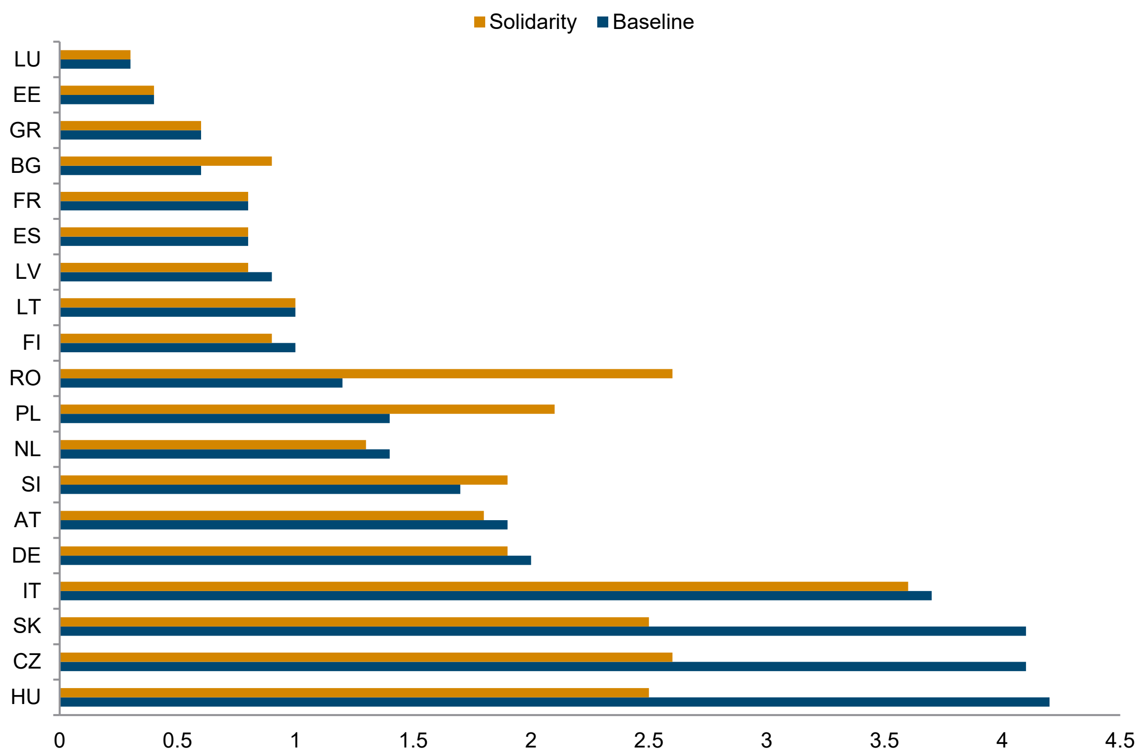
Source: Statistik Austria.

Energy shortages remain at the root of the uncertainty facing the Austrian economy and its key trading partners. This applies above all to industry, which in 2021 accounted for 35% of Austrian gas consumption. The country's most gas-intensive industries are paper, chemicals and steel. Paper production alone accounts for approximately a fifth of all gas consumed by industry in Austria. Surging energy prices have already left their mark on the economy, amid concerns over the gas supply this winter, possible gas rationing and the resultant supply-chain disruptions. This has led an increasing number of businesses to draw up contingency plans for a partial or complete halt to their production. Cellulose-fibre producer Lenzing AG has already announced that it will cut production at one of its plants.

Austria and some of its main trading partners, including Germany and the Visegrád countries, would be among those EU countries hit hardest if Russian gas were to stop flowing altogether. Austria and many of its key trading partners are heavily dependent on Russian gas (see Spring Forecast and the Summer Update). Supply-chain disruptions caused by the current energy crunch have already caused a domino effect across the thoroughly integrated European economies. A recently published International Monetary Fund (IMF) working paper (Di Bella et al., 2022) estimates that a potential full shut-off of Russian gas would lead in Austria to a GDP loss of approximately 2%. This includes both the direct impact (the stoppage itself) and the indirect impact (through spill-over effects) (Figure 4.2). Austria's top trading partners of Hungary, Czechia and Slovakia would be the countries hit hardest. The potential output loss for the worst-hit economy – Hungary – is estimated at 4.2%; for Czechia and Slovakia, the loss would be 4.1%. That is more than double the impact estimated for the entire EU of -1.8%.

Given that much of the Russian gas to Europe has already been shut off, the greater part of this impact has already been incorporated into our (quite pessimistic) baseline projections for Austria's key trading partners (albeit the Hungarian case is more complicated). Our baseline projections for economic growth in the key trading partners of Czechia, Hungary and Slovakia are now close to the negative scenario that we estimated in spring, which assumed a full cessation of Russian gas deliveries. Over the medium term, this will act as a powerful stimulus for the green transition in Central Europe, supported by NextGenerationEU funds; however, it is clear that over the next 12-18 months at least, high gas prices and inadequate supply will act as a brake on economic growth in the region, with negative direct and indirect effects for Austria.

Figure 4.2 / Estimates of GDP losses from a complete shut-off of Russian gas for selected EU economies, in percentage points

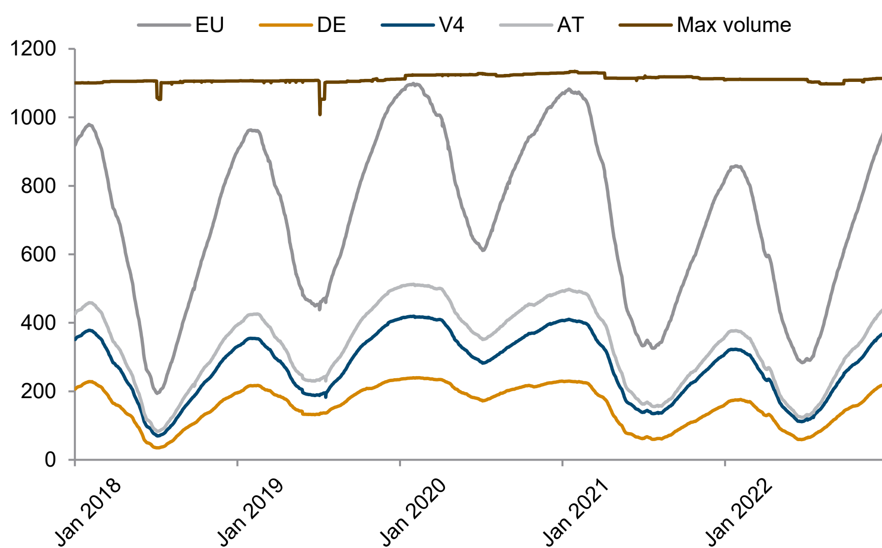


Note: The baseline scenario is based on the assumption of a total cessation of Russian gas supplies to Europe, starting from the end of June 2022 and lasting through the 2022-2023 winter. The scenario is compared to a counterfactual 'no shock' scenario, with consumption extrapolated from 2021 (but adjusted for current high prices). The solidarity scenario is Austria, Bulgaria, Croatia, Germany, Poland, Romania and Slovenia sharing gas with Czechia, Hungary and Slovakia: this would mean an even reduction in gas consumption of 15% for those seven donor countries.
Source: Di Bella et al. (2022).

Burden-sharing between EU member states could relieve the pressure on the worst-affected countries of Central Europe; but how this would work in practice remains very unclear. According to the above-mentioned IMF working paper, possible burden-sharing through a 15% reduction in gas consumption by countries like Germany or Austria could reduce the impact of a Russian gas shut-off on the potentially worst-hit economies of such as Czechia and Slovakia to approximately -2.5%. Recent statements by the German chancellor provide grounds for greater optimism for next winter (2023-2024). Germany expects to be fully independent of Russian gas supplies by the end of 2023, thanks to the provision of liquefied natural gas (LNG) terminals. Gas storage is currently also relatively high, and the amount of gas in storage is continuing to rise. The volume of gas now in storage is already above the maximum level in 2017, 2018 and 2021 (Figure 4.3).

Beyond manufacturing, Austria's tourism sector faces another challenging winter season. Surging energy prices (or even power rationing) could be tough for ski resorts, given their reliance on artificial snowmaking. The expected technical recession in Germany in Q4 2022 and Q1 2023 will also have an impact on the tourism sector: in 2021, 55% of all Austria's tourism services exports went to Germany.

Figure 4.3 / Gas in storage, in terawatt hours (TWh), September 2017 to September 2022



Source: Aggregated Gas Storage Inventory.

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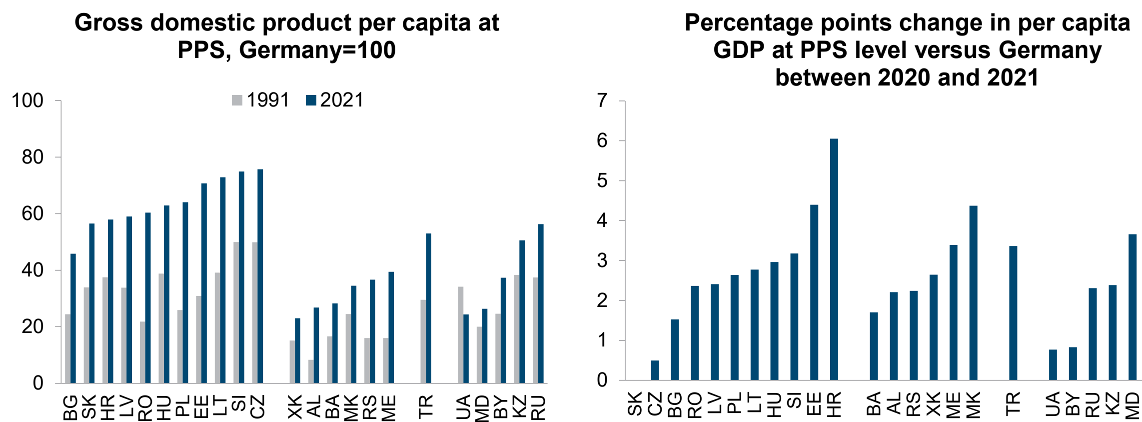
5. CESEE monitors

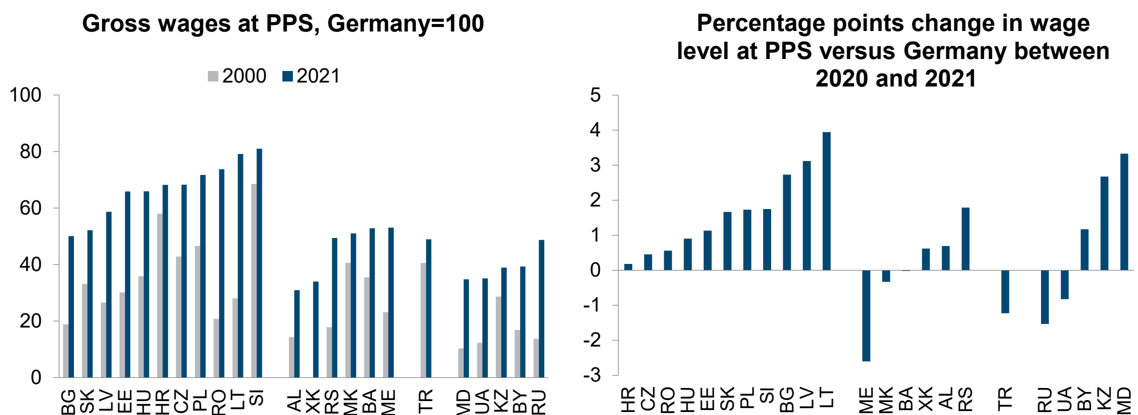
5.1. CONVERGENCE MONITOR

by Alexandra Bykova and Beate Muck

Figure 5.1 / GDP per capita and gross wages per employee at PPS convergence against 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. In 2020 Croatian wages based on FTE employees. Turkey: data 2000 refer to 2003 wiiw estimate from 2019.
Source: wiiw Annual Database incorporating national statistics and Eurostat.

Table 5.1 / CESEE GDP per capita and gross wages per employee at PPS (EU27), 2021

	BG	CZ	EE	HR	HU	LT	LV	PL	RO	SI	SK	EU-CEE
GDP per capita	17,850	29,500	27,560	22,580	24,530	28,400	23,010	24,960	23,530	29,210	22,020	24,750
Gross wages	17,252	23,429	22,706	23,447	22,687	27,127	20,217	24,716	25,618	27,836	17,910	23,604

	AL	BA	BY	KZ	MD	ME	MK	RS	RU	TR	UA	XK	non-EU
GDP per capita	10,440	11,010	14,540	19,720	10,270	15,370	13,450	14,290	21,930	20,670	9,490	8,970	19,030
Gross wages	10,430	18,593	13,450	13,139	11,626	18,512	17,541	16,822	16,983	17,109	11,963	11,972	15,977

Note: Gross wages are based on administrative data. Lithuanian and Romanian wages include employers' social security contributions. Turkey wages: wiiw estimate.
Source: wiiw Annual Database incorporating national statistics and Eurostat.

Table 5.2 / CESEE GDP per capita and gross wages per employee in EUR, 2021

	BG	CZ	EE	HR	HU	LT	LV	PL	RO	SI	SK	EU-CEE
GDP per capita	9,850	22,270	22,580	14,710	15,870	19,760	17,450	15,050	12,510	24,770	17,820	15,800
Gross wages	9,514	17,739	18,576	15,300	14,688	18,953	15,324	14,884	13,496	23,635	14,532	14,958

	AL	BA	BY	KZ	MD	ME	MK	RS	RU	TR	UA	XK	non-EU
GDP per capita	5,490	5,720	6,220	8,770	4,420	8,000	6,390	7,780	10,300	8,190	4,080	4,460	8,500
Gross wages	5,604	9,461	5,789	5,961	5,150	9,516	8,351	9,266	7,877	6,677	5,205	5,808	7,129

Note: Gross wages are based on administrative data. Lithuanian and Romanian wages include employers' social security contributions. Turkey wages: wiiw estimate.
Source: wiiw Annual Database incorporating national statistics and Eurostat.

5.2. BUSINESS CYCLE MONITOR: DOMINATED BY HIGH INFLATION

by Branimir Jovanović

The average value of our headline Business Cycle Index for the CESEE region as a whole in Q2 2022 has risen to 0.6; this is above the pre-pandemic level of Q4 2019 and is up where it was at the end of 2007 – one of the highest values on record. Still, one should be cautious about interpreting this as overheating of the economy, since the high value of the index largely reflects the high level of inflation (which is mainly being driven by supply, rather than demand) and the low real interest rates (caused by the high inflation). Nevertheless, the index does also reflect the strong post-pandemic recovery that is evident in solid GDP growth and low unemployment.

The highest value to be observed is in Czechia (1.4), followed by Lithuania and Estonia (1.0). This would normally mean that those three economies are the closest to overheating. At the other side of the spectrum are Russia, Ukraine and Belarus, which have negative values for the index, suggesting that those three economies are the closest to underheating (Figure 5.2).

The high overall values of the index are driven by domestic economy and domestic finance indicators. Among the **domestic economy indicators**, it is unemployment and inflation that stand out. Unemployment is lower than the historical mean in all but two countries (Ukraine and Turkey), reflecting the positive labour market trends that have been visible in the region for some time now. Inflation is above the historical average in all but three countries (Serbia, Romania and Belarus), for reasons that require no explanation. The GDP growth indicator is also positive in most of the countries, thanks to their solid post-pandemic recovery; that said, it does not deviate that much more from the historical average (Table 5.3 and Figure 5.3).

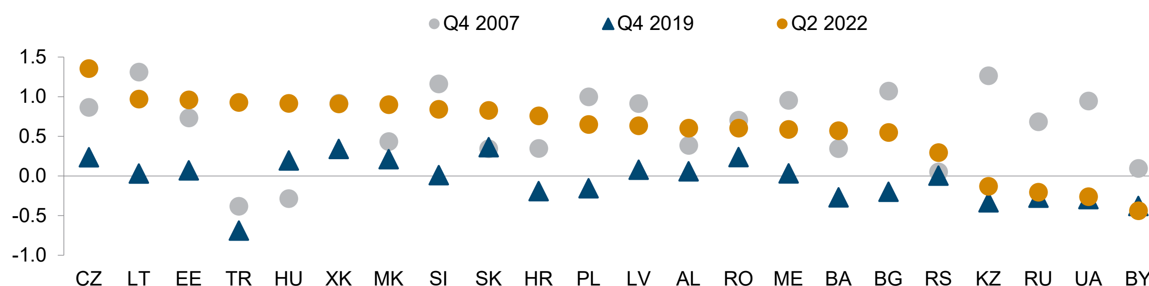
Among the **domestic finance indicators**, the highest scores are observed for the real interest rate indicator, which is positive for all countries, except Kazakhstan. This means that the countries are facing real interest rates that are lower than the historical average. This is because most of the countries have negative real interest rates, due to the high inflation. The property prices indicator is also higher than the average in all the countries for which data are available, with the exception of Serbia. This is because property prices have continued to rise sharply in the region, bolstered by the recent high inflation (Table 5.3).

The **external finance indicators** are much more subdued. The current account indicator is positive in many of the countries, since they have elevated current account deficits on account of high energy and food prices. However, its values are not radically different from the historical average. Interestingly, the external debt indicator is negative in many of the countries, reflecting a declining external debt/GDP ratio, due to the increase in nominal GDP caused by inflation (Table 5.3).

When the CESEE countries are compared against one another, two stand out as potentially at risk of overheating: Turkey and Montenegro (Table 5.4). In Turkey, the domestic finance indicators are pronounced – there is high nominal growth in credit activity, money supply and property prices, while the real interest rate is profoundly negative. Still, this is largely a consequence of the very high inflation, which is affecting all those indicators. In Montenegro, the external finance sector stands out, since the current account deficit is very high and the external debt is the highest in the region (over 170% of

GDP). On the other hand, Russia and Belarus are the two economies that are potentially at risk of underheating.

Figure 5.2 / Business Cycle Index



Note: Number of standard deviations from historical mean, average of 11 indicators. Indicators are those shown in Table 5.3.
Sources: wiiw Monthly Database incorporating national statistics and Eurostat; BIS.

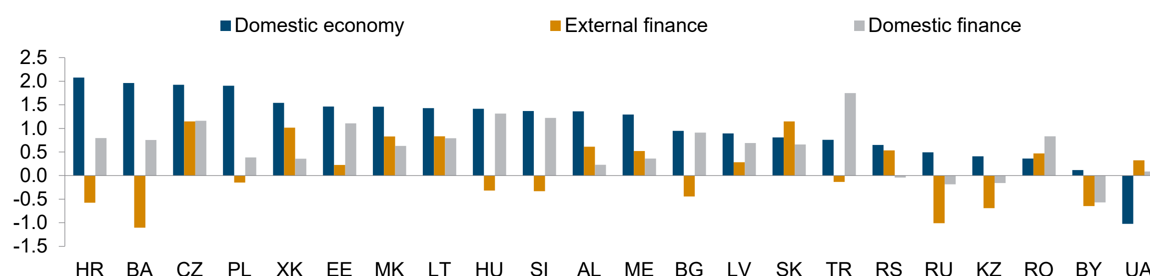
Table 5.3 / Number of standard deviations from historical mean, Q2 2022

	Domestic economy			External finance			Domestic finance				
	Real GDP	Unemployment	CPI	CA	RER	External debt	RIR	Private credit	Broad money	Fiscal balance	Property prices
BG	0.49	1.22	1.14	-0.64	0.68	-1.39	2.37	-0.17	-0.35	2.27	0.43
CZ	0.45	1.53	3.79	0.79	1.71	0.84	2.40	-0.18	-0.18	0.89	2.88
EE	0.26	0.91	3.22	-0.74	1.68	-0.28	4.10	-0.22	0.42	0.62	0.62
HR	2.08	1.63	2.47	-0.69	-0.63	-0.46	2.86	-0.07	0.34	-0.98	1.82
HU	1.47	1.35	1.43	0.95	-1.26	-0.41	1.98	0.56	1.34	0.92	1.77
LT	0.02	1.00	3.27	0.40	1.92	0.11	3.54	0.04	-0.15	-0.65	1.18
LV	0.17	1.04	1.48	0.00	1.17	-0.33	2.67	-0.24	-0.53	0.94	0.62
PL	1.68	1.32	2.72	0.48	-0.72	-0.23	2.33	-0.58	-0.42	-1.10	1.71
RO	0.40	0.73	-0.05	1.31	0.02	0.09	2.45	-0.06	-0.42	1.12	1.07
SI	1.74	1.36	1.01	0.12	-1.15	0.07	4.04	0.12	0.01	-0.06	2.01
SK	-0.48	1.45	1.46	0.50	0.87	2.01	3.15	-0.36	-0.27	0.25	0.52
AL	0.47	1.43	1.87	-0.94	1.84	0.63	2.29	-0.29	0.07	-1.31	
BA	1.53	1.64	2.71	-1.08	-1.54	-0.59	4.21	-0.48	-0.35	-0.35	
ME	2.41	1.13	0.35	-0.88	0.61	0.72	2.87	-0.38	0.04	-0.98	
MK	0.03	2.02	2.32	0.80	0.28	1.32	2.33	-0.38	-0.94	0.69	1.43
RS	0.72	1.49	-0.26	0.19	1.06	0.28	0.65	-0.37	-0.65	0.42	-0.27
XK	1.04	1.51	2.07	1.05	1.04	0.98	2.39	-0.08	-0.29	-0.60	
TR	0.68	-0.23	1.82	0.16	-2.48	1.53	2.46	0.59	2.07	-0.54	4.16
BY	-1.34	1.59	-0.39	-1.59	-1.13	0.78	0.20	-1.20	-0.90	-0.37	
KZ	-0.33	0.83	0.76	-0.82	-1.03	-0.06	-0.28	0.22	-0.57	0.01	
RU	-0.34	1.58	0.23	-1.56	-0.06	-1.50	0.60	-0.41	-0.97	-0.25	0.44
UA	-2.07	-1.07	0.07	-0.37	0.15	0.36	0.00	-0.49	-0.75	1.57	

overheating: > 1 SD above historical average
underheating: > 1 SD below historical average

Notes: CPI: consumer price index; CA: current account; RER: real exchange rate (EUR) CPI deflated, values more than 100 mean appreciation and vice versa; RIR: real interest rate CPI deflated. The data for unemployment, current account, real interest rate and fiscal balance are inverted (since for these indicators lower values would indicate overheating). The historical mean is calculated for Q4 2000 – Q2 2022. Calculations are based on four-quarter trailing averages.
Sources: wiiw Monthly Database incorporating national statistics and Eurostat; BIS.

Figure 5.3 / Sub-components of the Business Cycle Index, Q2 2022



Note: Number of standard deviations from the historical mean, average of indicators in each sub-component. Indicators are those shown in Table 5.3.
Sources: wiiw Monthly Database incorporating national statistics and Eurostat; BIS.

Table 5.4 / Over-/underheating in relation to regional peers, Q2 2022 (four-quarter trailing average)

	Domestic economy			External finance			Domestic finance				
	Real GDP	Unemployment	CPI	CA	RER	External debt	RIR	Private credit	Broad money	Fiscal balance	Property prices
	%	%	% yoy	% of GDP	2015 = 100	% of GDP	%	% yoy	% yoy	% of GDP	% yoy
BG	4.6	4.7	7.8	0.3	101.6	56.5	-7.1	9.6	11.2	-6.1	9.9
CZ	3.9	2.5	8.4	-3.4	117.4	69.0	-4.0	8.0	6.2	-5.0	24.2
EE	5.2	5.6	11.9	0.8	109.1	80.4	-10.4	7.9	16.8	-1.3	19.6
HR	9.9	6.8	6.2	-0.6	98.4	74.3	-3.0	4.3	12.8	-1.6	10.5
HU	7.0	3.6	7.9	-6.6	92.9	82.8	-3.5	11.9	16.7	-6.9	20.2
LT	4.2	6.4	11.8	-5.2	110.0	67.6	-10.4	13.0	11.8	-0.5	19.3
LV	4.4	7.1	9.1	-4.8	105.0	104.8	-8.2	2.9	7.7	-5.0	15.3
PL	7.0	2.9	8.5	-3.9	96.2	53.6	-5.2	4.6	8.0	-1.6	11.5
RO	5.2	5.6	7.9	-9.9	95.9	51.9	-5.1	14.7	13.8	-6.6	6.6
SI	8.3	4.4	5.5	0.9	97.9	92.3	-5.2	6.6	7.4	-3.4	15.2
SK	1.9	6.5	7.1	-5.4	103.2	125.9	-6.6	8.3	6.4	-4.7	11.0
AL	5.3	11.3	4.2	-6.7	115.6	58.3	-3.3	10.3	8.5	-2.0	
BA	6.7	16.2	7.7	-3.4	95.0	54.9	-7.0	3.9	9.3	0.7	
ME	13.8	15.4	6.7	-12.1	99.2	174.1	-1.4	5.2	18.2	-0.1	
MK	2.6	15.1	7.0	-6.7	99.8	79.1	-5.1	8.5	4.8	-4.1	9.8
RS	5.7	10.0	7.8	-7.7	108.6	64.3	-5.9	10.6	10.1	-3.5	6.3
XK	7.0	23.5	7.9	-10.7	101.3	35.4	-1.8	15.8	11.6	0.8	
TR	8.1	11.1	43.5	-4.2	54.1	57.2	-17.8	36.4	50.6	-1.3	68.5
BY	-1.5	3.7	12.4	2.1	85.7	60.0	-1.5	7.3	7.1	1.3	
KZ	4.6	4.9	10.3	1.4	71.2	78.4	1.2	25.6	15.2	-1.5	
RU	2.1	4.2	10.9	12.1	101.4	23.4	0.3	14.7	9.7	2.3	20.7
UA	-10.8	10.0	12.8	1.5	127.4	78.5	0.2	5.9	12.1	-4.9	

potential overheating/instability relative to regional peers — underheating/stability relative to regional peers

Notes: CPI: consumer price index; CA: current account; RER: real exchange rate (EUR) CPI deflated, values more than 100 mean appreciation and vice versa; RIR: real interest rate CPI deflated.
For all indicators higher values indicate overheating, except unemployment, current account, real interest rate and fiscal balance.
Sources: wiiw Monthly Database incorporating national statistics and Eurostat; BIS.

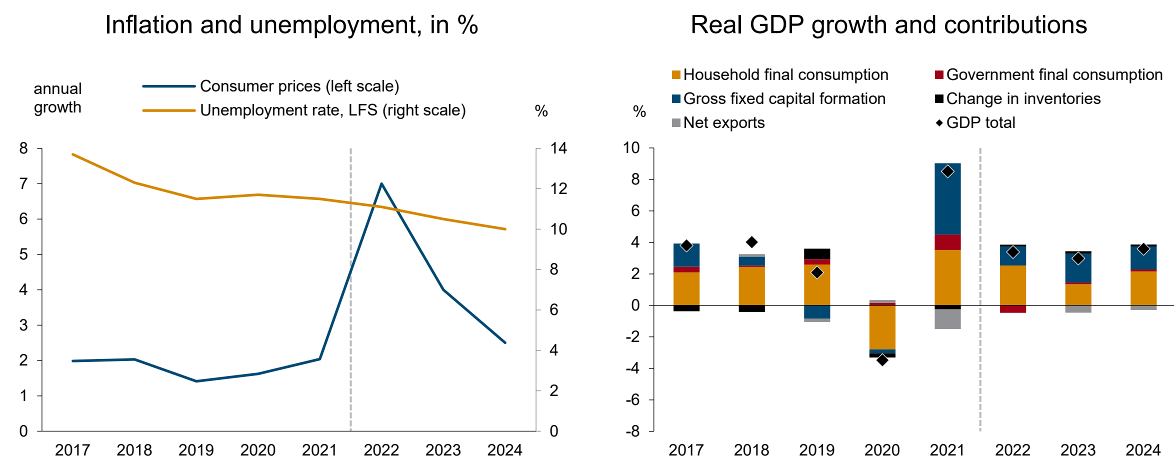
6. Country reports

ALBANIA: Fingers crossed for abundant rainfall

ISILDA MARA

GDP in 2022 will be 3.5%, backed by private consumption and, to a lesser extent, by investments. It will likely stay at above 3% over the forecast horizon. Inflation has been picking up very rapidly, but is still among the lowest in the region. Whether enough energy can be secured for the winter will depend on rainfall and on the volatile import prices, and is among the key risks to our growth forecast for this year and next.

Figure 6.1 / Albania: Main macroeconomic indicators



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

Growth slowed with the start of the war in Ukraine. Q1 2022 still had a strong growth showing of 6.5%, year on year (owing to a low base in 2021); but during Q2 2022, growth sank to 2.2%, year on year. Household consumption grew by 9% in the first half of the year, while government consumption dropped by 7% over the same period, year on year. Gross fixed capital formation rebounded by 16% in Q1, but Q2 recorded a contraction of 7%. Exports of goods and services rose steadily in the first half of the year. Viewed from the production side, growth was driven by manufacturing and real estate (both up 13% in the first half of 2022) and by wholesale and retail trade (again double-digit growth of 10%). However, Q2 2022 saw a major contraction in the construction sector (of 5%, year on year), following a surge of 26% in Q1.

Inflation has been picking up very quickly, but is still among the lowest in the region. Annual consumer price inflation reached 8% in August. The price hikes were particularly significant for food products (11%) and cereals (21%), which are traditionally mainly imported from Russia. The rise in the price of vegetable oils and fats – which are also largely imported from Russia and Ukraine – peaked at an unprecedented 31% in July, before falling back to 23% in August. By contrast, the price of fuel and

energy has recorded only a moderate increase, because of price controls imposed by the government back in April.

The acceleration of inflation to above the target level of 3% prompted the central bank to intervene by raising interest rates. It has hiked its policy rate four times since the beginning of the year – to 2.25%, up from 0.5% in 2021. Non-performing loans continued to drop – to 5% by July 2022, from 7.1% in 2021. Credit expansion reached 12% in July, year on year, with credit to households rising by 13% and to the corporate sector by 8.5%. The expectation is that the rise in interest rates will squeeze only slightly the demand for credit among both households and businesses.

The domestic currency (the lek) has appreciated 4% against the euro since January 2022. The reasons are manifold: a big rise in remittances and foreign direct investment (up 11% and 27%, respectively, in the first half of the year), but also in illicit money that mainly goes into real estate.

It will be challenging to secure energy for the winter. The country has zero dependence on Russian gas. However, it is very exposed to volatile energy prices on the international markets. The main source of electricity production is hydropower. This means that generation is rather dependent on rainfall, which is hard to predict. Consequently, the risk related to weather conditions – drought and floods alike – is high. The first half of this year has been particularly challenging in terms of ensuring electricity supply: domestic production contracted by 38%, and 14% of the energy requirements were met by imports. In the first half of the year, demand for electricity stayed at a level similar to the same period of 2021. However, it will likely decline over the remainder of the year, as the government has announced several new measures to curb energy consumption, such as progressive tariffs for households, limits on energy use in public offices, and restrictions on street lighting and illuminated advertising for shops after a certain hour. The government does offer vulnerable households subsidies on their energy consumption. The private sector has been more exposed to energy price hikes, and many companies have reported paying tariffs that are seven times higher than last year.

Investment in green energy is on the rise, but the effects of this on the energy supply will be visible only in the medium term. The government has been proactive and has offered support to both businesses and households to encourage the use of renewable energy sources, such as solar panels. From October 2022, 2,000 families will receive up to 70% financial support to install photovoltaics and produce electricity for their own consumption. In addition, the French company Voltalia's project for a solar power plant in Karavasta (west-central Albania) is making headway. Construction began in July of this year, though production is only expected to start in 2024. The government has been prompted to seek energy supplies from other sources. In April 2022, an agreement was signed with the US company Excelerate Energy for the construction of two floating power plants that use liquefied natural gas (LNG), as well as for a new LNG terminal in the southern Albanian city of Vlora, with power production due to start in January 2023. There is a possibility that in years to come this terminal could offer LNG to other countries in the region (e.g. a memorandum of understanding has already been signed with Kosovo and Bulgaria).

The employment rate is improving, and labour shortages are looming on account of high emigration. In Q2 2022, the unemployment rate declined further to 11.1%, while employment increased by 4%, year on year. More than 40,000 people entered the labour market, and in Q2 2022 the rate of employment reached 55% – 3 percentage points up on the same period last year. Emigration persists, but circular migration is also common – with spells of three months abroad and three months at home –

especially among the youth. The high level of emigration means that labour shortages are looming. As a consequence, nominal wages in the private sector have been rising steeply – by 12% in Q2 2022, year on year. The minimum wage has been raised to 340 lek (EUR 290), up 6.2%. Meanwhile, nominal wages in the public sector have stagnated. With an overall nominal wage increase of 7% over the period, real wages have been falling, suggesting that private consumption could contract as inflation soars.

The current account balance has improved thanks to buoyant remittances and rising tourist flows. In the first half of 2022, year on year, exports of goods and services rose at a similar pace as imports (17%). Though goods exports surged by 41% in nominal terms, in real terms they contracted by 6%. Fuel exports benefited from high oil prices and picked up in both volume and nominal terms – by 20% and 73%, respectively. Goods imports in nominal terms rose by 25%, whereas in real terms they contracted by 8%. Exports of services recorded a positive year, and especially the tourist season was very good: the number of tourists hit a new record of 5.3m in the period January to August – 30% higher than in the same period last year. Also, the number of nights spent in tourist accommodation rose by 40% (a 48% rise among visitors to Albania and 29% among Albanian residents). For the first half of the year, remittances continued on their positive trajectory, up 11%. The overall effect has been a decline in the current account deficit of 10%. Despite that, a less bright second half year is expected, owing to the strong rise in the price of imports and a weakening of the EU economies, Albania's main trading partners.

This is another year when it will be hard to achieve fiscal consolidation. Budget revenues improved, and the general government budget was reshuffled. Capital expenditure was cut, and more revenue was allocated to assistance for vulnerable groups. The Social Resilience Support Package introduced in the first half of the year has been extended, and pensions have been indexed by a combined 9.5% (3.5% in April and 6% in October). Meanwhile, the minimum wage has been increased by 6.2% and energy subsidies are envisaged for low earners.

Overall, we expect the economy to grow by 3.5% this year, backed by private consumption and, to a lesser extent, by investments. Growth in 2023 will be weaker (3%) because of the high level of uncertainty stemming from the energy sector and the international environment. Several big infrastructure projects have been announced. One is the Durrës tourist port, worth USD 2bn. In August 2022, a memorandum of understanding was signed between the founder of Emaar Properties, Mohamed Alabbar (an Emirati global developer), and the Albanian government. If the construction works can start next year, the impact on the economy in the medium-long term will be enormous. The start of EU accession talks in July 2022 is also certainly an important milestone, both domestically and internationally.

Table 6.1 / Albania: Selected economic indicators

	2019	2020	2021 1)	2021 January-June	2022 January-June	2022 Forecast	2023 Forecast	2024 Forecast
Population, th pers., average	2,854	2,838	2,812	.	.	2,810	2,800	2,800
Gross domestic product, ALL bn, nom.	1,692	1,644	1,890	916	1,059	2,100	2,200	2,300
annual change in % (real)	2.1	-3.5	8.5	11.1	4.2	3.4	3.0	3.6
GDP/capita (EUR at PPP)	9,520	9,110	10,440	.	.	.	.	.
Consumption of households, ALL bn, nom.	1,340	1,313	1,408	713	824	.	.	.
annual change in % (real)	3.3	-3.5	4.4	3.2	9.1	3.4	1.8	2.9
Gross fixed capital form., ALL bn, nom.	378	374	457	205	222	.	.	.
annual change in % (real)	-3.6	-1.1	19.9	32.8	2.5	5.0	7.5	6.0
Gross industrial production								
annual change in % (real)	-1.1	-6.3	26.6	36.0	0.2	5.0	8.0	8.0
Gross agricultural production 2)								
annual change in % (real)	-3.0	2.6	2.0	.	.	.	.	.
Construction output total								
annual change in % (real)	-2.5	9.5	18.0	25.6	7.2	.	.	.
Employed persons, LFS, th, average	1,266	1,243	1,249	1,231	1,278	1,290	1,295	1,305
annual change in %	2.8	-1.8	0.4	-0.8	3.7	3.3	0.4	0.8
Unemployed persons, LFS, th, average	165	165	163	164	161	160	150	150
Unemployment rate, LFS, in %, average	11.5	11.7	11.5	11.8	11.2	11.1	10.5	10.0
Reg. unemployment rate, in %, eop 3)	5.8	7.4	7.3	.	.	.	.	.
Average monthly gross wages, ALL	52,380	53,662	57,191	56,365	59,954	66,100	72,200	77,700
annual change in % (real, gross)	2.1	0.8	4.4	3.6	0.7	8.0	5.0	5.0
Consumer prices, % p.a.	1.4	1.6	2.0	1.4	5.6	7.0	4.0	2.5
Producer prices in industry, % p.a.	-0.8	-3.3	2.7	0.5	18.8	12.0	5.0	2.0
General governm. budget, nat. def., % of GDP								
Revenues	27.2	25.9	27.0	25.6	26.4	27.0	28.0	28.5
Expenditures	29.1	32.6	31.6	28.8	24.9	27.5	28.0	28.0
Deficit (-) / surplus (+)	-1.9	-6.7	-4.5	-3.2	1.4	-0.5	0.0	0.5
General gov. gross debt, nat. def., % of GDP	65.8	74.5	73.2	67.4	66.2	70.0	69.0	68.0
Stock of loans of non-fin. private sector, % p.a.	6.6	6.9	9.6	6.1	12.5	.	.	.
Non-performing loans (NPL), in %, eop	8.4	8.1	5.7	7.1	5.3	.	.	.
Central bank policy rate, % p.a., eop 4)	1.00	0.50	0.50	0.5	1.0	2.25	2.25	2.25
Current account, EUR m	-1,089	-1,153	-1,166	-520	-469	-1,340	-1,210	-1,200
Current account, % of GDP	-7.9	-8.7	-7.6	-7.0	-5.4	-7.6	-6.4	-6.0
Exports of goods, BOP, EUR m	907	794	1,265	602	1,003	1,450	1,570	1,630
annual change in %	-8.1	-12.5	59.4	62.4	66.8	15.0	8.0	4.0
Imports of goods, BOP, EUR m	4,050	3,776	5,094	2,209	2,806	5,500	5,830	6,040
annual change in %	5.0	-6.8	34.9	31.6	27.0	8.0	6.0	3.6
Exports of services, BOP, EUR m	3,405	2,226	3,486	1,434	2,077	3,870	4,140	4,430
annual change in %	10.8	-34.6	56.6	48.6	44.8	11.0	7.0	7.0
Imports of services, BOP, EUR m	2,141	1,174	1,690	710	1,069	1,940	2,020	2,120
annual change in %	9.1	-45.1	43.9	27.3	50.6	15.0	4.0	5.0
FDI liabilities, EUR m	1,072	937	1,032	470	634	1,100	.	.
FDI assets, EUR m	36	43	42	20	60	80	.	.
Gross reserves of CB excl. gold, EUR m	3,240	3,806	4,831	3,794	4,740	.	.	.
Gross external debt, EUR m	8,246	8,549	9,755	8,781	9,893	9,900	10,100	10,400
Gross external debt, % of GDP	60.0	64.4	63.2	56.9	56.0	56.0	53.0	52.0
Average exchange rate ALL/EUR	123.01	123.77	122.46	123.24	121.17	119.0	116.0	115.0

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

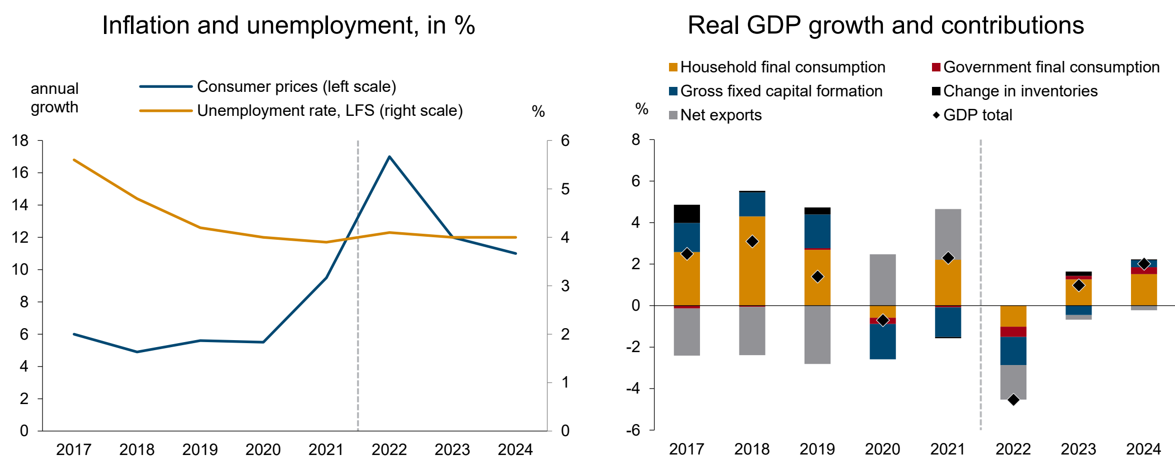
Source: wiiw Databases incorporating national statistics. Forecasts by wiiw.

BELARUS: Struggling to loosen the grip of sanctions

RUMEN DOBRINSKY

The economy is in recession, as the impact of the war in Ukraine has been amplified by the new Western sanctions. The authorities have adopted some policy measures aimed at damping the shocks and have negotiated new support agreements with Russia. Public finances have been under considerable strain, inflation has kept rising, and problems have also emerged over the servicing of the external debt. GDP is expected to fall by 4.5% in 2022, and the prospects for the coming years remain bleak.

Figure 6.2 / Belarus: Main macroeconomic indicators



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

Belarus's economy is in deep recession. The war in Ukraine has produced two main shocks for Belarus, as an ally of Russia: a new set of severe Western economic sanctions and the loss of the important Ukrainian market. The economy nosedived in Q2, which resulted in GDP falling by 4.2% in the first half of the year, while industrial production plunged by more than 10%. This was coupled with a sharp drop in the exchange rate and an upsurge in inflation. Any assessment of the current economic situation is complicated by the fact that the authorities have stopped publishing certain key statistics and have restricted access to some data sources. The short-term indicators available suggest that probably the bottom of the recession was reached mid-year. Thus, the monthly statistics suggest that in July and August there was a deceleration of the slowdown in gross industrial production and aggregate output, compared to the previous couple of months. A good harvest also seems to have contributed to the better aggregate performance in the summer months.

The authorities have adopted a range of policy measures aimed at mitigating the adverse effects of the sanctions and the war in Ukraine. These have included tax reliefs and generous directed lending to large state-owned companies. In turn, the Belarusian Development Bank has considerably increased the credit aimed at export promotion and import substitution, as well as lending to small and medium-sized businesses. Some large, state-owned banks have been recapitalised with capital injections from the budget to enable them to raise their credit activity. The central bank has maintained a relatively loose monetary stance, with its policy rate (at 12% since March) well below expected inflation.

In addition, Belarus has negotiated a set of new support agreements with Russia. The country has retained its preferential access to Russian gas at a price level that is now a fraction of current European prices. The two parties agreed further bilateral easing of access to their respective markets, where trade will increasingly be denominated in Russian roubles. Russia committed itself to supporting the establishment of new transportation routes for Belarusian exports. The two countries are also negotiating a partial rescheduling of Belarus's debt to Russia, as well as a large new loan from the Russian government. The new credit is intended for the funding of joint import-substitution projects.

Thanks to the policy support measures, Belarus has managed to reorient some of its exports to new markets. Exports to and imports from Russia have reached record high levels, while China has replaced Ukraine as Belarus's second-largest trading partner. Albeit at a reduced level, Belarus has kept on exporting refined oil products, benefiting from soaring prices on the international markets. Consequently, the value of total Belarusian trade flows has not been as badly hit by the external shocks as was earlier expected. Moreover, thanks to its continued access to cheap oil and gas supplies from Russia, in the first half year Belarus enjoyed a significant improvement in its international terms of trade. Trade reorientation will probably be more challenging on the import side, especially as regards hi-tech imports from the West; but the macroeconomic impact of such changes will not be immediate.

After an initial plunge, the Belarusian rouble recovered rapidly. By June, the exchange rate against the US dollar and the euro had recovered to approximately the same level as at the end of 2021. Meanwhile, the Belarusian currency depreciated considerably against the Russian rouble: the significant rise in Belarus's trade with Russia contributed to growing demand for Russian roubles. At the same time, the forced reorientation of certain trade flows to and from new markets resulted in declining demand among local importers for US dollars and euros. Demand for these currencies among households also dropped, due to the restrictions on travel imposed as part of the sanctions. Given the country's disconnect from the international financial markets, the authorities did not even need to introduce hard capital controls to contain capital flight.

In current US dollar terms, exports of goods in the first half of 2022 were just 2.8% down on the same period the previous year, while imports were 5.5% down. However, the dollar value of trade flows also reflect the exchange-rate movements in this period and, in particular, the appreciation of the Russian rouble against the dollar. As the substantial exchange of goods and services with Russia is now mostly conducted in Russian roubles, this produces inflated figures for Belarusian trade flows in current US dollars; in volume terms, both exports and imports dropped more substantially.

Inflation surged in March and April, and by June consumer price inflation was 17.4% higher than a year earlier, outstripping the rise in incomes. Real disposable income in the first half of the year fell by 2.7%, compared to the same period of 2021, depressing consumer confidence and demand.

Although inflation moderated somewhat in the months that followed, the inflationary pressures have not totally disappeared. In part, this can be attributed to the depreciation of the local currency vis-à-vis the Russian rouble, as a large and growing share of Belarusian imports are coming from Russia.

Public finances have been under considerable strain on both the revenue and the expenditure side. Given the considerable weakening of economic activity, real public revenue fell below the budgetary targets. However, what is now driving the fiscal balance most strongly into negative territory is the surge in extraordinary expenditure, as most of the policy support measures mentioned above entail large-scale unforeseen public spending. The financing of the fiscal deficit has been posing growing problems for the authorities. Being totally isolated from the Western financial markets, Belarus has sought to expand its access to the Russian market and has been placing increasing quantities of government bonds there.

Problems have also emerged over servicing the large external debt. The agreement to reschedule part of the debt to Russia did help somewhat to alleviate the burden of the overall debt servicing. Like Russia, Belarus started servicing some of its foreign dollar obligations in (Belarussian) roubles, which prompted some rating agencies to declare its partial default. However, the real challenge ahead will come in February 2023, when a USD 800m Eurobond reaches maturity and is due to be repaid. The main problem here is not so much the availability of forex funds for debt repayment, but the disconnect of the Belarusian banking sector from the international financial system, due to the Western sanctions.

The forecast for 2022 is basically unchanged from the summer forecast. We anticipate a GDP drop of some 4.5% in 2022, with both domestic absorption and net exports expected to contribute negatively to GDP growth for the year as a whole. Due to both the drop in domestic demand and the improved terms of trade, the current account balance should remain in positive territory. Average annual consumer price inflation and producer price inflation for the year as a whole are expected to be well above 15%, while the fiscal deficit may reach record levels.

The prospects for the coming years are also unchanged from the summer forecast and remain bleak. We see no prospect either of a marked recovery or of visible disinflation in 2023 and 2024. The positive (but meagre) GDP growth envisaged for the next two years reflects an expectation that there will be no severe future shocks, so that the current trend of slow emergence from the slump will continue. The fiscal situation will remain precarious, while the servicing of the foreign debt will present fresh headaches for the authorities.

Table 6.2 / Belarus: Selected economic indicators

	2019	2020	2021 [1)]	2021 January-June	2022 January-June	2022 Forecast	2023 Forecast	2024 Forecast
Population, th pers., average	9,420	9,380	9,303	.	.	9,200	9,150	9,100
Gross domestic product, BYN m, nom.	134,732	149,721	173,153	78,465	87,173	193,400	218,700	247,700
annual change in % (real)	1.4	-0.7	2.3	3.5	-4.3	-4.5	1.0	2.0
GDP/capita (EUR at PPP)	13,670	13,520	14,540	.	.	.	.	.
Consumption of households, BYN m, nom.	71,630	77,101	87,768	40,415	46,945	.	.	.
annual change in % (real)	5.1	-1.1	4.3	3.7	0.6	-2.0	2.5	3.0
Gross fixed capital form., BYN m, nom.	36,424	37,977	39,141	16,274	16,309	.	.	.
annual change in % (real)	6.2	-6.3	-5.6	-7.4	-13.0	-6.0	-2.0	1.5
Gross industrial production								
annual change in % (real)	1.0	-0.7	6.5	10.4	-5.2	-6.0	1.0	2.0
Gross agricultural production								
annual change in % (real)	2.9	4.8	-4.2	-0.3	-3.0	.	.	.
Construction industry								
annual change in % (real)	5.1	-1.6	-14.0	-16.6	-13.3	.	.	.
Employed persons, LFS, th, average	4,909	4,885	4,851	4,830	4,814	4,800	4,750	4,750
annual change in %	0.2	-0.5	-0.7	-0.2	-0.3	-1.0	-1.0	0.0
Unemployed persons, LFS, th, average	213	206	197	205	185	205	198	198
Unemployment rate, LFS, in %, average	4.2	4.0	3.9	4.1	3.7	4.1	4.0	4.0
Reg. unemployment rate, in %, eop	0.2	0.2	0.1	0.2	0.2	.	.	.
Average monthly gross wages, BYN	1,093	1,255	1,444	1,367	1,569	1,670	1,850	2,050
annual change in % (real, gross)	6.5	8.8	5.1	5.9	0.1	-1.0	-1.0	0.0
Consumer prices, % p.a.	5.6	5.5	9.5	8.8	14.6	17.0	12.0	11.0
Producer prices in industry, % p.a. [2)]	6.3	5.6	12.1	10.4	15.6	18.0	14.0	12.0
General governm. budget, nat. def., % of GDP								
Revenues	40.0	35.5	36.5	.	.	35.0	37.0	38.0
Expenditures	37.6	37.2	36.3	.	.	39.0	39.0	39.0
Deficit (-) / surplus (+)	2.4	-1.7	0.2	.	.	-4.0	-2.0	-1.0
General gov. gross debt, nat. def., % of GDP [3)]	41.0	47.5	41.2	.	.	53.0	54.0	55.0
Stock of loans of non-fin. private sector, % p.a.	10.0	21.4	3.3	7.7	8.4	.	.	.
Non-performing loans (NPL), in %, eop [4)]	4.6	4.8	5.3	.	.	.	.	.
Central bank policy rate, % p.a., eop [5)]	9.00	7.75	9.25	8.5	12.0	12.0	10.0	8.0
Current account, EUR m [6)]	-1,115	-156	1,827	264	286	1,500	1,300	1,100
Current account, % of GDP	-1.9	-0.3	3.2	1.0	1.0	2.2	1.8	1.4
Exports of goods, BOP, EUR m [6)]	28,932	24,890	33,189	14,384	15,460	35,900	36,400	37,400
annual change in %	1.8	-14.0	33.3	26.2	7.5	8.2	1.4	2.7
Imports of goods, BOP, EUR m [6)]	32,684	26,637	33,755	14,716	15,384	36,900	37,400	38,400
annual change in %	7.0	-18.5	26.7	18.5	4.5	9.3	1.4	2.7
Exports of services, BOP, EUR m [6)]	8,628	7,703	8,740	4,039	4,054	9,500	10,100	10,400
annual change in %	14.9	-10.7	13.5	8.0	0.4	8.7	6.3	3.0
Imports of services, BOP, EUR m [6)]	5,237	4,249	4,810	2,186	2,045	5,200	5,600	5,900
annual change in %	14.0	-18.9	13.2	9.4	-6.4	8.1	7.7	5.4
FDI liabilities, EUR m [6)]	1,139	1,221	1,044	941	1,646	1,000	.	.
FDI assets, EUR m [6)]	-3	72	-67	21	11	100	.	.
Gross reserves of CB excl. gold, EUR m [6)]	6,265	3,604	4,687	3,837	4,143	.	.	.
Gross external debt, EUR m [6)]	36,487	34,230	37,094	35,492	41,788	43,200	46,500	47,500
Gross external debt, % of GDP	63.2	63.8	64.1	61.3	60.5	62.5	63.7	61.3
Average exchange rate BYN/EUR	2.3342	2.7888	2.9923	3.1010	2.9699	2.80	3.00	3.20

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

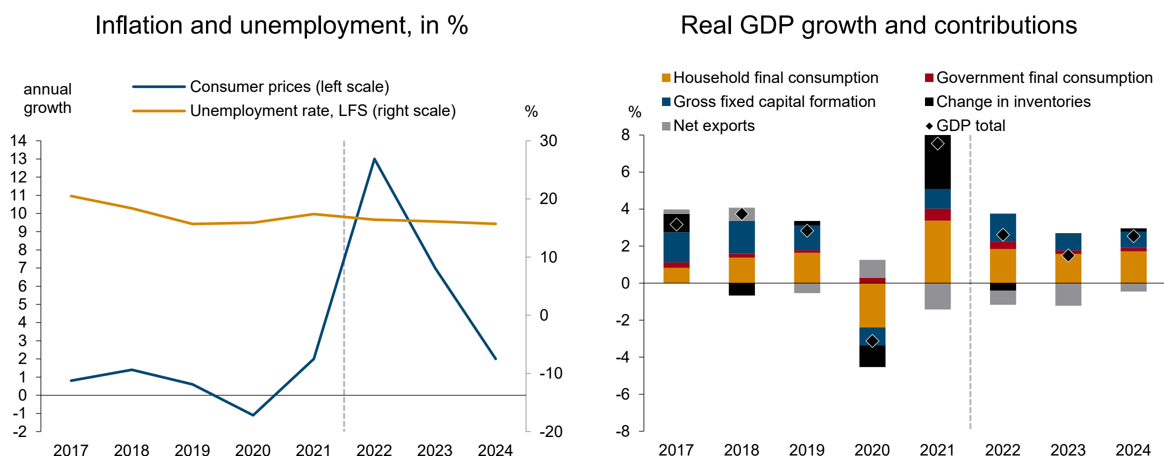
Source: wiiw Databases incorporating national statistics. Forecasts by wiiw.

BOSNIA AND HERZEGOVINA: October elections unlikely to bring needed change

SELENA DURAKOVIĆ

Growth in the first half of the year was better than expected, due to a sustained rise in industrial production and retail trade. But high inflation and the continued political risks will slow it down in the second half of the year, and also in 2023. A general election was held on 2 October and revealed the people's desire for something different: two of the three elected Presidency members are from non-nationalist parties. However, no great changes are expected: according to preliminary results, the nationalist parties won the majority of the vote at both state and entity level. This will continue to slow the country's progress generally and towards European integration.

Figure 6.3 / Bosnia and Herzegovina: Main macroeconomic indicators



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

The data for the first two quarters of 2022 suggest a higher-than-expected rebound in economic activity. Following Q1 GDP growth of 5.5% year on year, growth in Q2 2022 was 5.9%. This was largely driven by household consumption and exports. Remittances increased by 14% in the first two quarters of 2022, year on year, and the number of tourist arrivals rose by 77.8%. Industrial production and retail trade continued to increase throughout 2022, but at a much slower pace than in the previous year. The state budget for 2022 was finally adopted in June 2022, and it is expected that previously planned projects will now go ahead. Taking all this into consideration, we expect GDP growth in 2022 to be somewhat above that previously forecast – 2.6%, rather than the previous forecast of 1.8%. However, this growth is still lower than in most of the other Western Balkan countries, due to the political uncertainty.

Inflation over the first eight months was higher than expected, leading us to revise the forecast for 2022 and 2023 upwards. Inflation in August 2022 reached 16.8% (year on year) and was mainly driven by a rise in the cost of transport (30.1%) and food and beverages (27%). On an annual average basis, we forecast inflation of 13% in 2022 and 7% in 2023 – up 5 percentage points (pp) and 2 pp, respectively, on the previous forecast. High inflation is steadily eating away at the standard of living, as wages and pensions have not been adequately aligned with rising prices. Pensions and public-sector wages have recently been raised in both entities, but real wage growth has been negative (real gross wage growth for the first six months of the year was -1.8%). There are still no central government measures to ease the burden of increased prices, as all the proposals to temporarily abolish excise duties on oil and petroleum products and to introduce a lower value added tax on essential goods have been rejected.

The energy sector is currently stable. Bosnia and Herzegovina is the biggest exporter of electricity in the region, and the cost of electricity, gas and other energy sources rose by 'only' 21.4% in August 2022 (year on year); however, further increases are expected. Bosnia and Herzegovina is heavily dependent on Russia for its gas supply, but in fact gas constitutes only 2.5% of the country's total energy requirement. Besides, Republika Srpska did not join in the EU sanctions on Russia and has a special agreement with Russia for the supply of gas on preferential terms. Currently, there are no restrictions on energy consumption.

Due to the high inflation, reduced real incomes and the slowdown in economic activity in the EU, we expect GDP growth in Bosnia and Herzegovina to decelerate in 2023. We forecast growth of 1.5% in 2023 – a 0.7 pp downward revision on our previous forecast, on account of lower real incomes and the slowdown in economic activity and exports. The forecasts for household consumption and exports are therefore also revised downwards. As the October elections heralded no great change, the political tensions are likely to continue, consequently discouraging foreign investment and undermining the country's progress. We expect inflation to gradually decrease, but still to remain high in 2023.

The unemployment rate is falling, but the number of people emigrating is rising. Unemployment fell in the first half of the year from 18.6% in 2021 to 16.2% in 2022. However, this is partly a result of a decline in the working-age population and partly a consequence of the increased emigration of unemployed people. The number of those leaving the country has climbed steadily since the pandemic restrictions were lifted, and surveys show that many citizens are keen to emigrate in the future, which could adversely affect the country's long-term growth prospects. The main labour market problems continue to be long-term unemployment and the high rate of youth unemployment (32.9% in 2021).

The preliminary results of the October elections show a desire for change, but nevertheless the majority of votes were again cast for nationalist parties. Voters went to the polls on 2 October to elect representatives at the state, entity and cantonal levels. Ever since the Bosnian war, the country has been led mostly by nationalist parties, which have blocked the country's progress both generally and toward EU accession. The elections did bring about some change: as the Bosniak member of the Presidency, the voters chose a candidate from a non-nationalist party (in the last three elections, a nationalist party member was elected) and the Croatian member stayed the same (from non-nationalistic party). However, the elected Serb representative is again from a very nationalist party, and she is likely to block any decision at the state level if it does not align with the interests of Republika Srpska. Furthermore, according to preliminary results (last updated on 8 October, with more than 93% of the

votes counted) nationalist parties attracted the majority of votes for the state and entity parliaments. The elections were held following failed negotiations to reach a political agreement to amend the electoral law and introduce constitutional changes. A few minutes after the polling stations closed, the High Representative for Bosnia and Herzegovina imposed alterations to the electoral law, aimed at changing the post-election constitution to prevent the Croats from blocking the formation of a new government.

Table 6.3 / Bosnia and Herzegovina: Selected economic indicators

	2019	2020	2021 1)	2021 January-June	2022 January-June	2022 Forecast	2023 Forecast	2024 Forecast
Population, th pers., average	3,491	3,475	3,451	.	.	3,415	3,385	3,355
Gross domestic product, BAM m, nom. 2)	35,296	34,255	38,637	18,124	21,117	44,800	48,700	50,900
annual change in % (real)	2.8	-3.1	7.5	7.6	5.9	2.6	1.5	2.5
GDP/capita (EUR at PPP) 2)	10,110	9,840	11,010	.	.	.	.	.
Consumption of households, BAM m, nom. 2)	25,633	24,756	26,484	.	.	.	.	.
annual change in % (real)	2.2	-3.3	4.7	.	.	2.7	2.3	2.5
Gross fixed capital form., BAM m, nom. 2)	8,129	7,679	8,367	.	.	.	.	.
annual change in % (real)	5.8	-4.2	4.8	.	.	7.0	4.0	4.0
Gross industrial production								
annual change in % (real)	-5.3	-6.4	9.8	12.2	3.9	3.0	2.0	2.0
Gross agricultural production 3)								
annual change in % (real)	-8.7	9.1	0.3	.	.	.	.	.
Construction output total								
annual change in % (real)	-2.0	0.2	2.5	3.3	-0.6	.	.	.
Employed persons, LFS, th, average 4)	802.9	1,173.1	1,151.0	1,126	1,156	1,160	1,170	1,180
annual change in %	-2.4	.	.	.	2.6	0.5	0.5	0.5
Unemployed persons, LFS, th, average 4)	149.4	221.0	241.8	256	223	228	225	220
Unemployment rate, LFS, in %, average 4)	15.7	15.9	17.4	18.6	16.2	16.4	16.1	15.7
Reg. unemployment rate, in %, eop	32.8	33.7	31.2	32.3	30.0	.	.	.
Average monthly gross wages, BAM	1,421	1,476	1,542	1,520	1,664	1,790	1,920	1,980
annual change in % (real, gross)	3.7	5.0	2.4	3.8	-1.8	3.0	0.5	1.0
Average monthly net wages, BAM	921	956	998	980	1,085	1,160	1,250	1,290
annual change in % (real, net)	4.2	4.9	2.4	3.4	-0.7	3.0	0.5	1.0
Consumer prices, % p.a.	0.6	-1.1	2.0	0.1	11.5	13.0	7.0	2.0
Producer prices in industry, % p.a.	0.1	-1.2	5.6	2.7	18.5	15.0	9.0	3.0
General governm. budget, nat. def., % of GDP								
Revenues	42.5	42.1	41.6	.	.	39.0	39.5	40.0
Expenditures	40.6	47.4	41.8	.	.	40.0	39.0	39.0
Deficit (-) / surplus (+)	1.9	-5.3	-0.3	.	.	-1.0	0.5	1.0
General gov. gross debt, nat. def., % of GDP	32.7	36.6	34.4	.	.	34.0	35.0	35.0
Stock of loans of non-fin. private sector, % p.a.	6.7	-2.5	3.7	2.1	4.8	.	.	.
Non-performing loans (NPL), in %, eop	7.4	6.1	5.8	5.7	5.2	.	.	.
Central bank policy rate, % p.a., eop 5)	.	.	.	.	.	.	.	.
Current account, EUR m 6)	-474	-575	-472	-260	-513	-590	-500	-430
Current account, % of GDP	-2.6	-3.3	-2.4	-2.8	-4.8	-2.6	-2.0	-1.7
Exports of goods, BOP, EUR m 6)	5,205	4,818	6,499	2,954	4,160	8,030	9,030	9,750
annual change in %	-2.3	-7.4	34.9	30.2	40.8	23.5	12.5	8.0
Imports of goods, BOP, EUR m 6)	9,276	8,023	10,165	4,537	6,370	12,600	14,050	15,030
annual change in %	1.1	-13.5	26.7	19.1	40.4	24.0	11.5	7.0
Exports of services, BOP, EUR m 6)	2,121	1,251	1,930	710	1,020	2,770	3,250	3,610
annual change in %	8.3	-41.0	54.2	16.0	43.7	43.5	17.5	11.0
Imports of services, BOP, EUR m 6)	691	488	615	245	352	840	1,000	1,120
annual change in %	10.8	-29.4	26.2	12.7	43.7	37.0	19.5	12.0
FDI liabilities, EUR m 6)	397	384	529	451	255	600	.	.
FDI assets, EUR m 6)	20	62	69	42	3	50	.	.
Gross reserves of CB excl. gold, EUR m 6)	6,311	6,942	8,204	7,107	7,977	.	.	.
Gross external debt, EUR m	11,444	11,340	11,654	11,105	11,843	12,150	12,860	13,650
Gross external debt, % of GDP	63.4	64.7	59.0	56.2	51.7	53.0	51.6	52.4
Average exchange rate BAM/EUR	1.9558	1.9558	1.9558	1.9558	1.9558	1.9558	1.9558	1.9558

1) Preliminary. - 2) According to ESA'10 (FISIM not yet reallocated to industries). - 3) Based on UN-FAO data, wiiw estimate in 2021. - 4) In 2019 survey once a year and according to census 1991. From 2020 continuous quarterly survey based on census 2013 and according to EU + ILO definition. From 2021 new methodology in line with the Integrated European Social Statistics Regulation (IESS). - 5) Bosnia and Herzegovina has a currency board. There is no policy rate and even no money market rate available. - 6) Converted from national currency.

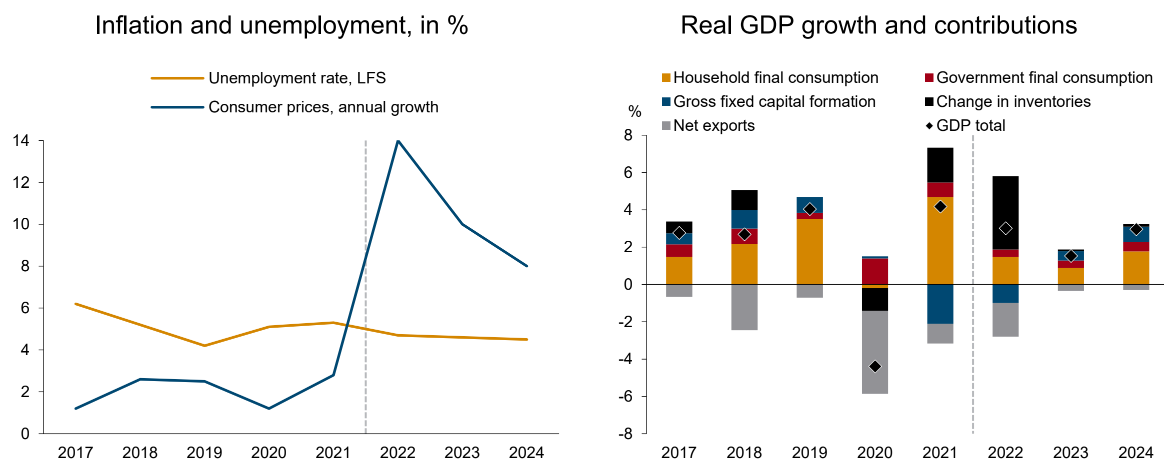
Source: wiiw Databases incorporating national statistics. Forecasts by wiiw.

BULGARIA: Snap election unlikely to reconcile the deep political rifts

RUMEN DOBRINSKY

The outcome of the early election held on 2 October offers no ready solutions to the political stalemate in Bulgaria. Despite the political turmoil and the war-related shocks, GDP grew by 4.5% in the first half of the year, thanks to robust exports and strong industrial output. However, surging inflation and a large fiscal imbalance remained a serious concern. By mid-year the economic environment had worsened and output had weakened. We expect GDP to grow by 3% in 2022, with a weaker performance of 1.5% in 2023.

Figure 6.4 / Bulgaria: Main macroeconomic indicators



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

The early election held on 2 October failed to produce any clear winners. The GERB party came first, but fell far short of a governing majority. The previous leading party – We Continue the Change – lost votes and came second. As the two parties regard each other as implacable rivals, it is difficult to see how the result will resolve the political stalemate in Bulgaria.

The previous two snap elections, both held in 2021, also produced a scattered vote, reflecting the country's deep societal rifts. The four-party government that was in office in the first half of 2022 pursued inconsistent policies, mirroring the diffuse nature of the coalition. This followed a messy policy agenda over the previous two years that was dominated by populist initiatives emanating from different ends of the political spectrum.

Despite the ongoing political turmoil and the war-related shocks, the economy performed relatively well in the first months of 2022. GDP grew by 4.5% in the first half of the year, boosted by booming exports and relatively robust private consumption in that period. Bulgaria focuses on the export of such products as electricity, fuel and vegetable oil, and so it benefited from the rising demand and the soaring international prices for these products. The war in Ukraine has been associated with rising international demand for armaments, and Bulgaria also specialises in certain specific categories of military equipment.

The favourable external environment contributed to an unprecedented surge in exports and industrial production in the first half of the year. The export of goods in current euros grew by almost 41% year on year (an increase of 7.6% in real terms over the same period), while real gross industrial production increased by 17.8%. This booming activity was accompanied by an even bigger rise in imports, and so in statistical terms the contribution of net exports to GDP growth turned out to be negative. Quite unusually, stockpiling made the largest positive contribution to GDP growth. Unfortunately, the information available at the time of writing is insufficient to provide any meaningful interpretation of this state of affairs.

However, the balance of factors affecting the economy changed rapidly, and by mid-year negative factors had come to the fore. The most serious concern was the uncertainty related to the supply of gas. Bulgaria refused to comply with the new payment conditions imposed by Gazprom, and this resulted in the abrupt discontinuation of gas deliveries from Russia, the country's largest supplier. At the time of writing, the authorities were still seeking to negotiate deliveries from alternative sources. The possible impact of gas shortages on the energy sector as a whole will be relatively limited, as gas is mostly used for heating and industrial production, rather than for electricity generation; however, the social implications could be grave.

The surging inflation has also been a serious concern. In August, year-on-year consumer price inflation topped 15%, while year-on-year producer price inflation exceeded 50%. Apart from the effect of common global factors, inflation in Bulgaria accelerated as a result of policy incoherence, including a series of populist measures and excessive public spending. In 2022, these policies backfired, as real wages fell by 1.3% year on year in the first six months. Real wages for the year as a whole are expected to decline by an even higher figure – the first time this will have happened in more than 20 years.

The changing international environment due to the war in Ukraine necessitated a revision of the 2022 budget. In July, when it was already clear that the country was heading for fresh early elections, parliament hastily adopted a revision to the budget. What happened during the drafting of the revision was typical of the policy inconsistency of the quadripartite coalition then in office: each party tried to promote measures that were aligned with its own agenda, and was prepared to support measures initiated by other parties simply in order to have its own measures adopted. The upshot was that, in the absence of meaningful reform, public expenditure ballooned. Accordingly, in order to provide scope to finance the increased spending, the revised budget raised the ceiling for new public borrowing in 2022 by BGN 3bn, to BGN 10bn.

One disturbing event in 2022 was the opening up of a large fiscal gap. According to the recent update of the mid-term budgetary framework prepared by the caretaker government, the expected cash fiscal deficit in 2022 will be close to 6% of GDP. The Ministry of Finance stated that, unless a major fiscal correction is undertaken, the cash deficit in the period 2023-2025 could remain in the range of 6-7%.

One immediate consequence of the imprudent policy course being pursued in the country was a surge in the cost of public borrowing. Thus, in mid-September, Bulgaria issued Eurobonds worth EUR 2.25bn at quite a high price: seven-year Eurobonds with a nominal value of EUR 1.5bn were sold with a 4.125% coupon (realised yield of 4.33%), while 12-year bonds worth EUR 0.75bn were sold with a coupon of 4.625% (realised yield of 4.81%). Later in September, the Ministry of Finance could not even place the whole envisaged BGN 200m issue of five-year government securities on the local market, due to the high yield required by investors. Only BGN 150m of the issue were sold, at a coupon of 4.13%.

The June 2022 European Commission Convergence Report contained an important warning about the worsening macroeconomic situation in Bulgaria. It concluded that Bulgaria did not fulfil the conditions for adoption of the euro, citing two problem areas: 1) its failure to fulfil the criterion on price stability; and 2) legislation in the monetary field is not fully compatible with the requirements of the euro area. Thus, Bulgaria's target date for joining the euro area (1 January 2024) now seems unrealistic.

Bulgaria also endured considerable delay in finalising its Recovery and Resilience Plan. After several iterations, the Commission gave it a provisional green light only in April 2022, conditional upon further policy steps being taken. The first funding claim under the plan was submitted to the Commission by the caretaker government only at the beginning of September. Given the delays already encountered, it is unlikely that the country will be able to avail itself of all the funds earmarked under the Recovery and Resilience Facility (RRF). These delays had a very damaging impact on public investment in 2022, as many of the budgeted investment projects for the year were contingent on RRF funding.

Output performance weakened in the second half of the year. Yet, thanks to the strong performance in the first half, we have revised our growth forecast for 2022 upwards. We now expect annual GDP growth of 3%, 0.5 percentage points higher than was envisaged in the Summer Forecast. In statistical terms, private consumption and stockpiling will remain the main growth drivers in 2022, while the contribution of gross fixed capital formation will be negative. Imports will continue to outpace exports, so net exports for the full year are expected to make a negative contribution to GDP growth. The recent deterioration in the current account balance suggests that it will likely remain in negative territory for the year as a whole. While the pace of inflation has subsided somewhat in recent months, average annual consumer price inflation will be the highest for 15 years – some 14%.

At the same time, in view of the worsening external environment and the uncertainties surrounding the energy sector, we have revised our forecast for 2023 downwards. We now expect much lower GDP growth in 2023 (1.5%) than was forecast in summer (3.7%). Inflation should gradually subside in the coming years, but it will remain high compared to recent figures. We also expect the current account balance to remain negative, albeit shrinking in 2023-2024.

Table 6.4 / Bulgaria: Selected economic indicators

	2019	2020	2021 1)	2021	2022	2022	2023	2024
				January-June			Forecast	
Population, th pers., average	6,976	6,934	6,878	.	.	6,800	6,750	6,700
Gross domestic product, BGN m, nom.	120,395	119,951	132,744	58,193	71,769	155,900	174,100	193,600
annual change in % (real)	4.0	-4.4	4.2	3.4	4.5	3.0	1.5	3.0
GDP/capita (EUR at PPP)	16,670	16,410	17,850	.	.	.	.	.
Consumption of households, BGN m, nom.	70,435	69,892	78,193	34,873	41,340	.	.	.
annual change in % (real)	5.9	-0.3	8.0	7.4	4.2	2.5	1.5	3.0
Gross fixed capital form., BGN m, nom.	22,404	22,981	21,993	9,586	10,516	.	.	.
annual change in % (real)	4.5	0.6	-11.0	-5.3	-6.6	-6.0	3.0	5.0
Gross industrial production 2)								
annual change in % (real)	0.6	-5.9	8.9	7.0	17.8	15.0	1.0	3.0
Gross agricultural production								
annual change in % (real)	-1.2	-11.0	17.5	.	.	.	.	.
Construction industry 3)								
annual change in % (real)	3.8	-5.3	2.6	3.9	1.9	.	.	.
Employed persons, LFS, th, average 4)	3,233	3,122	3,077	3,045	3,095	3,100	3,120	3,140
annual change in %	2.6	-3.4	-0.6	-0.7	1.6	0.8	0.5	0.5
Unemployed persons, LFS, th, average 4)	143	169	171	193	155	150	150	150
Unemployment rate, LFS, in %, average 4)	4.2	5.1	5.3	6.0	4.8	4.7	4.6	4.5
Reg. unemployment rate, in %, eop	5.9	6.7	4.8	5.2	4.2	.	.	.
Average monthly gross wages, BGN	1,267	1,391	1,551	1,494	1,667	1,680	1,850	2,040
annual change in % (real, gross)	7.2	7.9	8.0	11.2	-1.3	-5.0	0.0	2.0
Consumer prices (HICP), % p.a.	2.5	1.2	2.8	1.2	11.1	14.0	10.0	8.0
Producer prices in industry, % p.a.	3.0	-2.0	15.5	7.7	37.2	40.0	20.0	12.0
General governm. budget, EU def., % of GDP								
Revenues	38.4	38.1	39.0	.	.	40.0	40.0	40.0
Expenditures	36.3	42.0	43.1	.	.	46.0	45.0	44.0
Net lending (+) / net borrowing (-)	2.1	-4.0	-4.1	.	.	-6.0	-5.0	-4.0
General gov. gross debt, EU def., % of GDP	20.0	24.7	25.1	.	.	31.0	34.0	36.0
Stock of loans of non-fin. private sector, % p.a.	7.4	4.5	8.3	6.2	12.4	.	.	.
Non-performing loans (NPL), in %, eop	6.6	7.5	6.0	6.7	5.2	.	.	.
Central bank policy rate, % p.a., eop 5)	0.00	0.00	0.00	0.00	0.00	1.0	2.0	2.0
Current account, EUR m	1,148	24	-351	7	708	-1,000	-900	-500
Current account in % of GDP	1.9	0.0	-0.5	0.0	1.9	-1.3	-1.0	-0.5
Exports of goods, BOP, EUR m	29,119	27,272	34,405	16,265	22,915	40,000	38,000	39,000
annual change in %	5.0	-6.3	26.2	23.6	40.9	16.3	-5.0	2.6
Imports of goods, BOP, EUR m	32,028	29,213	37,291	17,263	24,460	45,000	42,500	43,000
annual change in %	5.2	-8.8	27.7	25.5	41.7	20.7	-5.6	1.2
Exports of services, BOP, EUR m	10,237	7,320	9,196	3,858	5,091	8,800	9,200	9,500
annual change in %	11.3	-28.5	25.6	16.5	32.0	-4.3	4.5	3.3
Imports of services, BOP, EUR m	5,342	4,171	5,114	2,241	2,933	4,200	4,700	5,000
annual change in %	5.5	-21.9	22.6	19.2	30.9	-17.9	11.9	6.4
FDI liabilities, EUR m	1,983	3,158	1,769	1,311	1,254	1,200	.	.
FDI assets, EUR m	745	396	782	577	683	500	.	.
Gross reserves of CB excl. gold, EUR m	23,072	28,830	32,490	27,763	31,195	.	.	.
Gross external debt, EUR m	37,716	39,297	41,491	39,522	41,677	43500	44000	44500
Gross external debt, % of GDP	61.3	64.1	61.1	58.2	52.0	55.0	49.0	45.0
Average exchange rate BGN/EUR	1.9558	1.9558	1.9558	1.9558	1.9558	1.9558	1.9558	1.9558

1) Preliminary. - 2) Enterprises with 10 and more employees. - 3) Enterprises with 5 and more employees. - 4) From 2021 the new LFS methodology is applied in line with the Integrated European Social Statistics Regulation (IESS). - 5) Base interest rate. This is a reference rate based on the average interbank LEONIA rate of previous month (Bulgaria has a currency board).

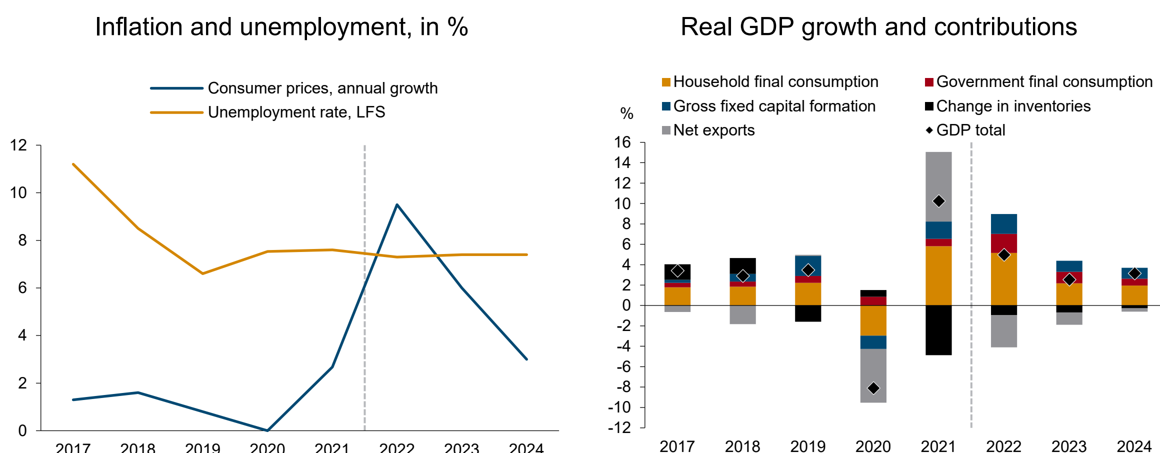
Source: wiiw Databases incorporating Eurostat and national statistics. Forecasts by wiiw.

CROATIA: Within a whisker of adopting the euro

BERND CHRISTOPH STRÖHM

Croatia's economy grew strongly in the first half of 2022, thanks to robust household consumption. In addition, the summer tourist season was very solid. As a result, we have revised this year's GDP forecast up from 3.3% to 5%. Despite record levels of inflation, the European Commission has also confirmed that Croatia is set to join the euro area next year. Nevertheless, the high inflation and the war in Ukraine still promise much uncertainty for 2023.

Figure 6.5 / Croatia: Main macroeconomic indicators



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

The Croatian economy continued to grow strongly in the first half of 2022. The country's GDP increased by 7.3% in real terms in the first six months, thanks to improved turnover in catering services, transport services and the retail trade. Household consumption helped with the growth by surging 7% year on year in the same period. In addition, exports of goods and services in Q2 increased by 41.9% year on year in the wake of a solid tourist season that led to a robust 65.7% year-on-year increase in the service side. The government's energy subsidies also supported household spending in the service sector.

Tourism has performed strongly. During the first eight months of 2022, 15m tourists arrived in Croatia and there were 86.6m overnight stays. That meant 40% more arrivals and 27% more overnight stays than in the same period of 2021: the number of overnight stays was thus only 4% below the same period of pre-pandemic 2019. The largest number of overnight stays was achieved by arrivals from Germany, Slovenia and Austria. Thanks to the bountiful tourist season, we have revised this year's GDP forecast up from 3.3% to 5%.

Growth has also been supported by the strong inflows of EU funds. Investment projects have been facilitated by allocations from the EU's Reconstruction and Resilience Facility (EUR 6.3bn). Nevertheless, investment projects have been hampered by surging energy prices and supply bottlenecks that have affected building materials, and this has slowed the reconstruction of earthquake-damaged infrastructure in the Zagreb, Krapina-Zagorje, Sisak-Moslavina and Karlovac counties. In September, the government finally signed a partnership agreement with the European Commission, aimed at allowing Croatia to receive EUR 9bn in EU Cohesion Policy grants for the financing period 2021-2027. Those funds should promote the economic, social and territorial cohesion of Croatia's regions and facilitate the country's green and digital transition.

The war in Ukraine will bring a high degree of uncertainty in 2023, mainly because of the fear of recession among Croatia's main trading partners. Even though Croatia's direct economic exposure to Russia is fairly low, we expect the Russo-Ukrainian war to dampen Croatia's economic growth prospects in 2023, mainly via the impact of a deteriorating EU-area economy – especially in Italy and Germany, which both face the prospect of recession next year. Because of this, we have revised Croatia's GDP growth forecast for 2023 down to 2.5%, from 3.5% previously.

At the same time, energy shortages are much less of an issue in Croatia than in some other CESEE countries. The government announced in August 2022 that it was to invest EUR 180m to expand the annual capacity of the Omišalj liquefied natural gas (LNG) terminal on the island of Krk (built in 2020) from 2.9bn to 6.1bn cubic metres in 2024-2025, and to build a new gas pipeline in a bid to diversify supplies. The Krk terminal could theoretically supply natural gas to neighbouring countries, such as Slovenia or Bosnia and Herzegovina. Slovenia has already expressed interest in importing natural gas from the LNG terminal from October 2022.

Inflation picked up to 12.3% year on year in July and August – the highest level since the hyperinflationary days of the early 1990s. August was the fourth straight month with double-digit inflation. Persistent global supply-chain disruptions and higher energy prices will continue to exert upward pressure on prices, which is why double-digit inflation will persist in Q4 2022, despite the government's price-cap measures. For the year as a whole, inflation is expected to average some 9.5%.

To support households and businesses in the face of surging inflation, the government drafted a new set of measures in September, worth some EUR 2.8bn (4.8% of GDP). It introduced price caps on foodstuffs, including sunflower oil, milk, flour, white sugar, whole chickens, pork and minced meat. The government also introduced a cap on electricity prices for local businesses and households from 1 October 2022 to 31 March 2023. In addition to the relief for energy consumers, the government plans to allocate subsidies to the tune of EUR 252m for local companies, in a bid to encourage the introduction of energy-saving technology. The extra expenditure means that this year's budget deficit will rise to 3% of GDP. The government has managed to contain the increase in the public debt, though, thanks to the country's stellar economic recovery in 2021. The public debt-to-GDP ratio will fall to around 76% by the end of 2022.

Croatia will introduce the euro in January 2023. Despite record levels of inflation, the European Commission confirmed in June that Croatia had fulfilled all the economic criteria for it to join the euro area in January 2023. The kuna will be converted to the euro at an exchange rate of EUR/HRK 7.53 – the current central rate in the European Exchange Rate Mechanism (ERM II). Stores already began to

display prices in both HRK and EUR in September. The government had managed to keep the budget deficit below the Maastricht Treaty's 3% criterion in 2021 and has kept the exchange rate stable against the euro for at least two years. However, the European Commission has been obliged to turn a blind eye to Croatia's public finance situation: despite a marked reduction, public debt still stood at almost 80% of GDP in 2021 – well above the 60% condition notionally required by the EU.

The government is struggling to counter emigration and the brain drain. Croatia's labour market is characterised by labour shortages in some occupations, partly on account of emigration to other EU member states. According to calculations by the Croatian National Bank, an average of 2% of Croatia's population migrated annually in the first three years after Croatia joined the EU. The results of the 2021 population census show that Croatia's population has contracted by over 400,000 (nearly 10% of the country's population) over the past 10 years. The census also reveals that one Croat in five is aged 65 or over, making Croatia among the 'oldest' countries in the EU.

Table 6.5 / Croatia: Selected economic indicators

	2019	2020	2021 [1]	2021	2022	2022	2023	2024
				January-June		Forecast		
Population, th pers., average [2]	4,067	4,047	3,958	.	.	3,885	3,883	3,880
Gross domestic product, HRK bn, nom.	412.2	378.3	430.6	199.0	231.2	495	538	572
annual change in % (real)	3.5	-8.1	10.2	7.7	7.4	5.0	2.5	3.1
GDP/capita (EUR at PPP)	20,770	19,230	22,580	.	.	.	.	.
Consumption of households, HRK bn, nom.	229.6	218.2	246.6	117.5	136.5	.	.	.
annual change in % (real)	4.0	-5.3	10.1	8.5	7.0	9.0	3.8	3.4
Gross fixed capital form., HRK bn, nom.	88.7	84.4	93.0	46.0	52.9	.	.	.
annual change in % (real)	9.8	-6.1	7.6	11.3	6.4	9.0	5.0	5.0
Gross industrial production [3]								
annual change in % (real)	0.6	-2.7	6.3	9.0	2.8	2.0	2.8	2.5
Gross agricultural production								
annual change in % (real)	-1.2	1.1	-6.0	.	.	.	.	.
Construction output [3]								
annual change in % (real)	8.3	4.4	9.3	12.0	4.4	.	.	.
Employed persons, LFS, th, average [4]	1,680	1,657	1,678	1,658	1,699	1,700	1,720	1,740
annual change in %	1.5	-1.3	1.3	-0.1	2.5	1.5	1.3	1.3
Unemployed persons, LFS, th, average [4]	119	135	138	162	132	130	140	140
Unemployment rate, LFS, in %, average [4]	6.6	7.5	7.6	9.0	7.3	7.3	7.4	7.4
Reg. unemployment rate, in %, eop	7.8	9.3	7.3	7.4	6.1	.	.	.
Average monthly gross wages, HRK [5]	8,766	9,216	9,599	9,532	10,266	10,800	11,700	12,400
annual change in % (real, gross)	3.0	2.4	1.6	2.6	-0.9	2.3	2.5	2.5
Average monthly net wages, HRK [5]	6,457	6,763	7,129	7,086	7,564	8,000	8,700	9,200
annual change in % (real, net)	2.6	2.6	2.7	4.1	-1.7	2.5	2.5	2.5
Consumer prices (HICP), % p.a.	0.8	0.0	2.7	1.5	8.6	9.5	6.0	3.0
Producer prices in industry, % p.a.	0.8	-3.2	11.6	4.3	28.8	5.0	3.0	2.2
General governm. budget, EU def., % of GDP								
Revenues	46.3	47.2	46.4	.	.	49.0	45.8	46.0
Expenditures	46.1	54.5	49.2	.	.	52.0	48.7	48.5
Net lending (+) / net borrowing (-)	0.2	-7.3	-2.9	.	.	-3.0	-2.9	-2.5
General gov.gross debt, EU def., % of GDP	71.1	87.3	79.8			76.0	72.5	71.0
Stock of loans of non-fin. private sector, % p.a.	3.9	3.5	2.3	1.6	8.0	.	.	.
Non-performing loans (NPL), in %, eop [6]	5.5	5.4	4.3	5.1	3.8	.	.	.
Central bank policy rate, % p.a., eop [7]	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Current account, EUR m	1,578	-267	1,807	-2,123	-3,785	-1,310	-1,720	-2,050
Current account, % of GDP	2.8	-0.5	3.2	-8.1	-12.3	-2.0	-2.4	-2.7
Exports of goods, BOP, EUR m	12,819	12,028	15,611	6,947	9,708	17,440	19,530	20,800
annual change in %	5.1	-6.2	29.8	23.8	39.7	11.7	12.0	6.5
Imports of goods, BOP, EUR m	23,313	20,883	26,256	12,172	18,153	31,800	35,300	38,200
annual change in %	6.6	-10.4	25.7	20.3	49.1	21.0	10.9	8.3
Exports of services, BOP, EUR m	15,375	8,927	14,314	3,670	5,927	15,800	16,900	18,300
annual change in %	10.8	-41.9	60.3	30.0	61.5	10.5	7.0	8.4
Imports of services, BOP, EUR m	5,087	3,622	4,494	1,899	2,473	4,600	4,700	4,800
annual change in %	9.4	-28.8	24.1	9.1	30.2	3.0	3.0	3.0
FDI liabilities, EUR m	3,508	1,109	3,930	1,785	1,716	2,300	.	.
FDI assets, EUR m	82	408	1,150	830	-13	-500	.	.
Gross reserves of CB excl. gold, EUR m	18,560	18,943	25,022	21,540	25,243	.	.	.
Gross external debt, EUR m	40,330	40,124	44,802	44,416	46,730	46,500	48,900	51,200
Gross external debt, % of GDP	72.6	79.9	78.3	77.7	71.4	71.0	69.0	68.0
Average exchange rate HRK/EUR	7.4180	7.5384	7.5284	7.5508	7.5414	7.6	7.6	7.6

1) Preliminary. - 2) From 2021 based on Census 2021. - 3) Enterprises with 20 and more employees. - 4) From 2021 the new LFS methodology is applied in line with the Integrated European Social Statistics Regulation (IESS). - 5) From 2020 employees expressed in full-time equivalents (FTE). - 6) Loans more than 90 days overdue and those unlikely to be paid. - 7) Discount rate of CB.

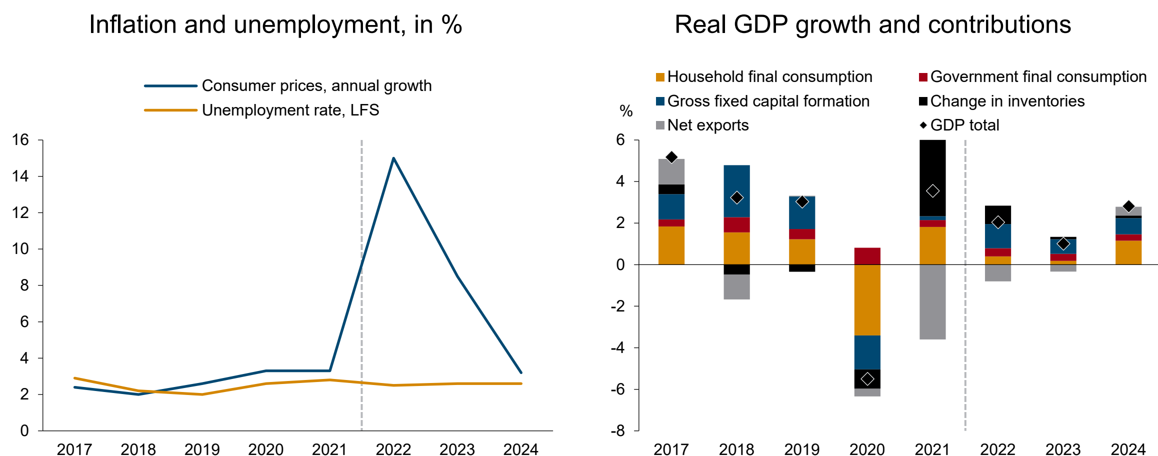
Source: wiiw Databases incorporating Eurostat and national statistics. Forecasts by wiiw.

CZECHIA: Outlook lukewarm at best

ZUZANA ZAVARSKÁ

The resilience of the Czech economy is fading, and it is anticipated that the coming months will bring recessionary pressures. The reasons for pessimism are piling up: inflation will remain high, real wages will continue to decline, and industry will struggle with supply-chain issues. As a result, after 2% in 2022, growth will slow to a modest 1% in 2023.

Figure 6.6 / Czechia: Main macroeconomic indicators



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

Czechia continued to deal relatively well with the mounting geo-economic challenges in the first half of 2022, although Q2 already started to reveal some signs of weakening momentum. GDP expanded by 0.5% quarterly and 3.7% annually in Q2 2022 – a performance that places the Czech economy at the lower end of the EU spectrum. Gross capital formation was the main growth driver, linked primarily to inventory accumulation (contributing +2.2 percentage points (pp) to year-on-year growth), but also supported by fixed investment (+1.6 pp). Private consumption stagnated in annual terms (0 pp) and shrank against the previous quarter, as households struggled with the ever-increasing cost of living. The consumption of durables fell particularly markedly, suggesting that consumers had previously stocked up on those items, in order to shield themselves from further price rises. Net exports continued to place a damper on growth (-0.6 pp) amidst persistent supply-chain issues that hampered the export of manufactured goods.

The growth prospects going into winter are bleak. A mild recession in the second half of the year is anticipated, moderating the solid growth witnessed so far. The full cost of the Russian war against Ukraine will become apparent in early 2023 and will affect nearly all the demand components of GDP. Gross fixed capital formation will continue to contribute most strongly to an unimpressive real GDP

growth of 1% projected for next year. While the appetite is low for private investment in conditions of high uncertainty and rising borrowing costs, the anticipated disbursement of EU funds is expected to provide a boost to public-sector investments.

Real wages will inevitably be hit in the coming months, and will only begin to recover in 2024, once the inflationary pressures subside. In Q2 2022, real wages took a hit of 9.8%, significantly reducing the purchasing power of the Czech people. Overall, we expect real wages to shrink by 6% in 2022, followed by a further decrease of 1.2% in the coming year. As a result, consumers will increasingly be faced with the choice of dipping into their savings or tightening their belts. As more households become inclined to opt for the latter, domestic consumption will likely be anaemic in 2023, before picking up again towards the end of the forecast period.

The unsupportive environment for industrial production will continue to hurt exporters, resulting in a negative contribution of net exports to growth over the next two years. Industrial performance has been unimpressive and sluggish; but as energy shortages become more acute going into winter, and as supply-chain bottlenecks continue to bite, industrial production is expected to shrink year on year in 2022. In the automotive industry, declining new orders suggest an imminent deterioration in Czechia's most prominent sector. For several reporting periods in a row now, the adverse operating conditions in industrial value chains have been a sore point for the heavily export-oriented Czech economy. Consequently, the current account deficit as a share of GDP is expected to widen to a 15-year high of 4% in 2023, cushioned somewhat by the strong performance of services. While it is anticipated that the downward trend will be reversed in 2024, once the economy begins to regain its dynamism, a current account deficit will be maintained over the whole forecast horizon.

Soaring prices are troubling the Czech economy, with core inflation the highest in the EU. It is expected that inflation will prove finally to have peaked in Q3 2022, at slightly below 20%. However, the spectacle of prices rising at well above the central bank's target of 2% is far from over: next year will still see high single-digit growth in consumer prices, driven predominantly by the developments on global commodity markets. An analysis of the different inflation channels also points to the presence of factors that are not just imported, but are a result of domestic forces. This makes the Czech situation somewhat unique. Here, imputed rents are the major driver, though other items also play a role.

Still, the prevailing sentiment is that monetary policy has now done all it can to tame the price pressures. The Czech National Bank was among the first in the region to sharply raise its policy rates, engaging in nine interest rate hikes since mid-2021. With the nominal two-week repo rate presently at 7%, the policy rate remains in negative territory in real terms. However, as inflation figures are expected to return to much more moderate levels towards the end of next year, further major hikes in interest rates are deemed unlikely.

By contrast, the government has moved far more slowly in putting forward a policy response to the soaring energy prices. Only in September – and following public pressure to lend a helping hand to struggling households and firms – did the government finally introduce support packages. Under the proposed plan, a price cap will be placed on electricity and gas for all retail consumers, including households and small firms. Large firms are to be offered a separate subsidy programme worth an estimated CZK 30bn. The plan proposes financing these packages from the increased government revenues that Czechia has enjoyed thanks to its position as a net exporter of electricity. Nevertheless,

this wide-ranging, untargeted support, combined with the lack of demand reduction incentives, is likely to result in a mild deterioration in the budget deficit.

Despite the headwinds blowing from several directions, the labour market continues to remain stretched. The issue of labour shortages has proved strikingly persistent, weathering all the recent storms. The influx of Ukrainian refugees has slightly alleviated the pressure: as of August 2022, the Czech labour ministry reported that roughly 100,000 Ukrainian refugees had joined the labour market[14] (about a quarter of the influx of refugees into Czechia estimated by UNHCR), with official labour bureau statistics showing a 12% increase in Ukrainian employees in Czechia since February, driven entirely by women. All in all, compared to our previous forecasts, only a marginal deterioration (-0.1 pp) in the unemployment rate is anticipated in 2023, despite a much more significant downward revision of the country's economic growth prospects (-1.9 pp).

[14] https://www.ceskenoviny.cz/zpravy/praci-ma-107-000-uprchliku-s-vizem-k-ochrane-jurecka-to-oznacil-za-uspech/2246440

Table 6.6 / Czechia: Selected economic indicators

	2019	2020	2021 [1]	2021	2022	2022	2023	2024
				January-June			Forecast	
Population, th pers., average	10,672	10,698	10,506	.	.	10,600	10,650	10,690
Gross domestic product, CZK bn, nom.	5,791	5,709	6,108	2,921	3,238	7,170	7,860	8,340
annual change in % (real)	3.0	-5.5	3.5	3.5	4.2	2.0	1.0	2.8
GDP/capita (EUR at PPP)	29,160	27,870	29,500	.	.	.	.	.
Consumption of households, CZK bn, nom.	2,663	2,536	2,715	1,280	1,521	.	.	.
annual change in % (real)	2.6	-7.4	4.1	1.4	4.1	0.9	0.4	2.6
Gross fixed capital form., CZK bn, nom.	1,568	1,516	1,586	721	843	.	.	.
annual change in % (real)	5.9	-6.0	0.7	0.4	8.4	4.5	2.7	3.0
Gross industrial production								
annual change in % (real)	-0.3	-7.2	6.9	15.7	0.2	-0.7	2.5	4.0
Gross agricultural production								
annual change in % (real)	2.0	5.1	-1.0	.	.	.	.	.
Construction industry								
annual change in % (real)	2.7	-6.3	2.7	0.9	5.8	.	.	.
Employed persons, LFS, th, average [2]	5,303	5,235	5,213	5,168	5,150	5,200	5,170	5,170
annual change in %	0.2	-1.3	-0.5	-1.4	-0.3	-0.2	-0.5	0.0
Unemployed persons, LFS, th, average [2]	109	137	151	169	128	130	140	140
Unemployment rate, LFS, in %, average [2]	2.0	2.6	2.8	3.2	2.5	2.5	2.6	2.6
Reg. unemployment rate, in %, eop	2.9	4.0	3.5	3.7	3.1	.	.	.
Average monthly gross wages, CZK	34,578	36,176	37,903	36,893	39,008	41,000	44,000	46,200
annual change in % (real, gross)	4.9	1.4	0.9	3.3	-6.9	-6.0	-1.2	1.8
Consumer prices (HICP), % p.a.	2.6	3.3	3.3	2.5	12.6	15.0	8.5	3.2
Producer prices in industry, % p.a.	1.7	0.6	6.2	2.8	18.9	25.8	16.0	5.5
General governm. budget, EU def., % of GDP								
Revenues	41.3	41.5	40.6	.	.	40.8	41.5	41.5
Expenditures	41.1	47.2	46.5	.	.	45.5	45.2	43.4
Net lending (+) / net borrowing (-)	0.3	-5.8	-5.9	.	.	-4.7	-3.7	-1.9
General gov. gross debt, EU def., % of GDP	30.0	37.6	42.0	.	.	43.0	43.8	44.2
Stock of loans of non-fin. private sector, % p.a.	5.2	4.1	8.4	4.2	8.1	.	.	.
Non-performing loans (NPL), in %, eop	2.5	2.8	2.4	2.7	2.1	.	.	.
Central bank policy rate, % p.a., eop [3]	2.00	0.25	3.75	0.50	7.00	7.00	4.00	3.00
Current account, EUR m	747	4,393	-2,074	3,331	-3,488	-7,500	-12,750	-10,750
Current account, % of GDP	0.3	2.0	-0.9	2.9	-2.7	-2.6	-4.0	-3.1
Exports of goods, BOP, EUR m	139,428	128,226	148,002	75,295	85,141	170,900	181,200	189,200
annual change in %	2.2	-8.0	15.4	26.6	13.1	15.5	6.0	4.4
Imports of goods, BOP, EUR m	130,088	117,611	145,221	70,173	86,317	176,000	187,300	194,200
annual change in %	1.2	-9.6	23.5	25.6	23.0	21.2	6.4	3.7
Exports of services, BOP, EUR m	27,204	22,842	25,116	11,594	14,326	30,900	33,600	36,500
annual change in %	4.9	-16.0	10.0	0.1	23.6	23.0	8.8	8.6
Imports of services, BOP, EUR m	23,078	18,912	20,819	9,458	12,136	26,100	29,100	32,000
annual change in %	8.5	-18.1	10.1	3.1	28.3	25.5	11.5	10.0
FDI liabilities, EUR m	9,582	7,367	6,491	2,370	5,409	7,000	.	.
FDI assets, EUR m	4,243	1,788	6,280	2,434	2,589	4,500	.	.
Gross reserves of CB excl. gold, EUR m	133,059	134,905	152,755	140,064	148,258	.	.	.
Gross external debt, EUR m	172,544	164,648	179,866	165,938	184,595	219,600	244,800	259,800
Gross external debt, % of GDP	76.5	76.3	75.5	69.7	63.0	75.5	76.0	76.0
Average exchange rate CZK/EUR	25.67	26.46	25.64	25.86	24.64	24.7	24.4	24.4

1) Preliminary. - 2) From 2021 new methodology in line with the Integrated European Social Statistics Regulation (IESS), excluding persons on parental leave from employed persons. - 3) Two-week repo rate.

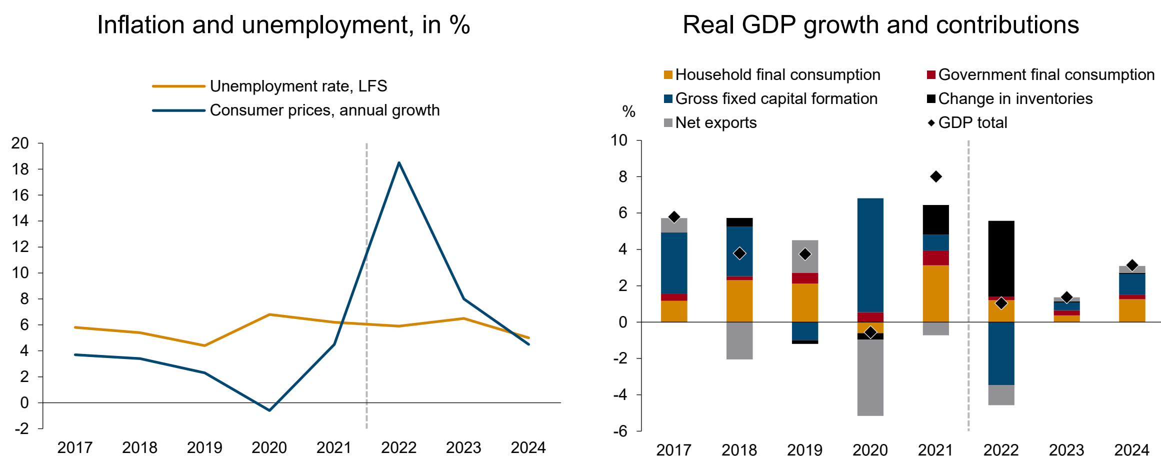
Source: wiiw Databases incorporating Eurostat and national statistics. Forecasts by wiiw.

ESTONIA: Restraining inflation as a test for resilience

MARYNA TVERDOSTUP

As the economic effects of the war in Ukraine gradually reveal themselves, the Estonian economy is heading for a difficult phase: inflation is extremely high; the foreign trade outlook is getting grimmer; and private consumption is being undermined by rocketing prices and shrinking savings. Yet, we expect the economic decline to be more of a dip, as energy prices are reined in, while purchasing power will be backed by state support and steady wage growth.

Figure 6.7 / Estonia: Main macroeconomic indicators



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

Following a strong economic performance in Q1 2022, the first indications of looming economic decline came in the summer, with GDP growth of 0.6% year on year in Q2 2022 – well below other EU-CEE countries. Good sectoral performance, strong consumption and active foreign trade had reinforced growth up until the summer, despite overall uncertainty and mounting inflation. However, a slowdown in manufacturing and retail trade, as well as deteriorating economic sentiment, foreshadowed a downturn, if not a recession. For the full year, GDP growth is expected to be 1.0% (almost the same as our previous forecast), while the projection for 2023 is cut to 1.3%, followed by 3.2% in 2024. The economic downswing in the second half of 2022 is being driven by high inflation and deteriorating domestic and foreign demand.

Estonia faces the highest inflation in the euro area. Reaching almost 25% year on year in August, half of this figure is accounted for by the rise in the cost of energy, which was almost 90% more than last August. Despite rising food prices being responsible for a large chunk of inflation, the price spike in this commodity group was below that seen in the other Baltic states, thanks to increased competition on the local market, with the market newcomer Lidl proving a game-changer. Taking 2022 as a whole, we

forecast inflation to average 18.5%, as the overall economic decline will take some of the edge off inflation growth by the end of the year. With the European Central Bank tightening its monetary policy and with the imposition of domestic restrictions on energy prices, we project inflation to decline to 7.5% in 2023 and 4.5% in 2024.

Industrial output remained high in the first half of 2022, with capacity utilisation staying strong and the dreaded supply difficulties proving smaller than expected. However, producer sentiment dropped abruptly in August, driven by mounting uncertainty over future developments in Europe as a whole. With stratospheric energy prices and severe wage pressures, companies keep raising their prices, although this comes at the expense of export competitiveness (especially in the Nordic markets, where energy prices are notably lower) and domestic demand (as the price differential between imported and domestically produced goods narrows). Hence it will become increasingly difficult to pass on to consumers the higher prices paid for production inputs. As the effects of the sanctions on Russia unfold, supply issues may intensify, as imports from Russia – still ongoing in the first half of 2022 – gradually dry up. This will lead to further supply difficulties for producers and will be reflected in nominal production levels.

Foreign trade was in relatively good shape in Q2 2022, driven largely by a strong performance in services. As inflation increased rapidly, exports grew by around 5% in constant prices, with a major chunk of the growth coming from service exports (inflation-adjusted 17% quarter-on-quarter growth in Q2 2022), while imports fell by 0.2% in Q2 2022. We expect the current account deficit to persist at around 0.7% of GDP in 2022, fuelled primarily by exports lagging behind imports, even in those sectors that previously engaged in major export activity. As of early autumn 2022, export orders are already down, reflecting the weakening competitiveness of Estonian producers on foreign markets in light of the severe inflation.

There were no surprises in sectoral dynamics in the first half of 2022. These reflected long-standing trends, with the ICT and business services sectors growing steadily, despite a marked drop in foreign investments. After almost two years in recession, the tourism and hospitality sectors recovered in summer 2022 to make a major contribution to service exports in Q2 2022.

The high level of purchasing power, driven by steadily rising incomes, low unemployment and a liberalisation of the pension system, has been another pillar of economic growth in Estonia – and remained so in Q1 2022, despite soaring inflation and mounting uncertainty. Private consumption grew by 4.8% year on year in Q2 2022, largely funded by savings and money withdrawn from the second pension pillar. Even though purchasing power will likely be undermined in the coming months, as price rises outstrip wage growth in many sectors and as savings shrink, the outlook is not too bleak. Various state benefits approved under the 2023 budget plan will support purchasing power via generous energy price subsidies for households, an increase in family benefits and additional wage rises of up to 15% (or more for some public-sector jobs). Nonetheless, given that we are unlikely to witness an abrupt drop in inflation in 2023, we anticipate that purchasing power will decline to that of pre-pandemic years (at best) and that private consumption growth will slow to 0.8% in 2023 and 2.7% in 2024.

The labour market remained buoyant in the first half of 2022, as the dreaded spike in unemployment caused by the influx of Ukrainian refugees did not materialise; however, it will likely do so in the coming year. With unemployment standing at 5.8% in Q2 2022 and with around 4% growth year on year in the number of those employed in Q2 2022, the labour market coped reasonably

well with the initial shock caused by the war in Ukraine. Despite the severe labour shortages (particularly in trade, construction, manufacturing and education), increased uncertainty over future foreign demand and domestic consumption serves to undermine the outlook for employment. Unemployment is expected to stay at 5.9% in 2022. This will be followed by a rise to 6.5% in 2023, as more and more Ukrainian refugees look for a job and as the anticipated overall economic downturn in the second half of 2022 leads to a decline in employment. However, those two effects are likely to be short-lived, and unemployment will decline to 5.0% in 2024.

The steadily upward trend in wages also indicates a strong labour market, yet it is unlikely to be enough for earnings to keep pace with inflation in the second half of 2022. Wage growth reached 10.1% year on year in Q2, largely driven by those sectors with the most desperate need for workers and by a 12% hike in the minimum wage. Wages are likely to keep growing in the second half of 2022 and especially in 2023 in nominal terms, fuelled by the planned wage rises for public-sector workers; however, the real growth will be around 1.4% in 2022, 2.2% in 2023 and 3.8% in 2024.

The state budget will run at a deficit for the foreseeable future, yet on a less dramatic scale than one would anticipate in the current circumstances. High inflation and a strong labour market have netted exceptionally large tax receipts in the year so far. This will enable a bigger chunk of the state support for households and small businesses planned under the 2023 budget to be covered. However, as tax revenues dwindle – due both to a fall in the inflation rate and a rise in the tax-free income threshold in 2023 – the state budget will likely run a deficit of around 4% in coming years.

For a country with an established reputation of having almost zero debt, the relaxation of fiscal policy indicates a paradigm shift – one that has already generated heated political debate. As any major investment in state defence and security, which will be as high as EUR 1bn in 2023, is likely to be funded through loans, an increase in gross government debt is inevitable. Yet, leading political and economic thinkers are calling for a cautious fiscal policy and for the avoidance of further debt accumulation. Those advocating sufficient fiscal space to allow the state to borrow will likely remain in a minority for as long as the current economic crisis lasts.

Table 6.7 / Estonia: Selected economic indicators

	2019	2020	2021 [1]	2021	2022	2022	2023	2024
				January-June			Forecast	
Population, th pers., average	1,327	1,330	1,331	.	.	1,380	1,375	1,372
Gross domestic product, EUR m, nom.	27,765	27,465	31,445	14,383	17,084	37,600	41,200	44,400
annual change in % (real)	3.7	-0.6	8.0	8.2	2.4	1.0	1.4	3.1
GDP/capita (EUR at PPP)	24,560	24,580	27,560	.	.	.	.	.
Consumption of households, EUR m, nom.	13,451	13,171	14,618	6,751	8,274	.	.	.
annual change in % (real)	4.4	-1.2	6.5	5.3	6.9	2.6	0.8	2.7
Gross fixed capital form., EUR m, nom.	7,056	8,563	9,076	4,676	3,970	.	.	.
annual change in % (real)	-3.7	24.7	2.8	58.0	-27.0	-12.0	1.5	4.0
Gross industrial production								
annual change in % (real)	6.9	-3.0	7.2	7.5	4.0	4.3	3.0	5.3
Gross agricultural production								
annual change in % (real)	22.8	0.0	-6.7	.	.	.	.	.
Construction industry								
annual change in % (real)	5.8	-6.1	9.4	6.1	4.7	.	.	.
Employed persons, LFS, th, average [2]	671.3	656.6	654.2	645.6	676.8	680	710	720
annual change in %	1.0	-2.2	-0.5	-1.7	4.8	4.0	4.5	1.0
Unemployed persons, LFS, th, average [2]	31.3	47.9	43.1	48.1	40.7	43	49	38
Unemployment rate, LFS, in %, average [2]	4.4	6.8	6.2	7.0	5.7	5.9	6.5	5.0
Reg. unemployment rate, in %, eop [3]	5.3	8.3	6.8	7.6	7.1	.	.	.
Average monthly gross wages, EUR	1,407	1,448	1,548	1,506	1,643	1,860	2,050	2,220
annual change in % (real, gross)	5.0	3.4	2.1	4.2	-6.4	1.4	2.2	3.8
Average monthly net wages, EUR	1,150	1,185	1,266	1,232	1,338	1,520	1,680	1,820
annual change in % (real, net)	5.1	3.5	2.0	4.2	-6.8	1.4	2.3	3.9
Consumer prices (HICP), % p.a.	2.3	-0.6	4.5	1.7	16.5	18.5	8.0	4.5
Producer prices in industry, % p.a.	-0.6	-3.5	17.2	8.3	40.0	20.0	8.5	5.0
General governm. budget, EU def., % of GDP								
Revenues	39.5	39.4	39.0	.	.	45.3	42.0	42.0
Expenditures	39.4	44.8	41.3	.	.	48.8	46.2	45.9
Net lending (+) / net borrowing (-)	0.1	-5.5	-2.3	.	.	-3.5	-4.2	-3.9
General gov. gross debt, EU def., % of GDP	8.5	18.6	17.6	.	.	19.5	21.5	20.7
Stock of loans of non-fin. private sector, % p.a.	3.3	4.8	7.5	5.5	10.6	.	.	.
Non-performing loans (NPL), in %, eop	0.5	0.4	0.2	0.4	0.2	.	.	.
Central bank policy rate, % p.a., eop [4]	0.00	0.00	0.00	0.00	0.00	.	.	.
Current account, EUR m	658	-272	-568	-1,038	91	-260	30	120
Current account, % of GDP	2.4	-1.0	-1.8	-7.2	0.5	-0.7	0.1	0.3
Exports of goods, BOP, EUR m	13,317	13,290	16,367	7,484	9,792	16,450	16,950	17,400
annual change in %	5.8	-0.2	23.2	20.9	30.8	0.5	3.0	2.7
Imports of goods, BOP, EUR m	14,245	13,533	17,662	8,150	11,021	18,900	19,500	20,220
annual change in %	3.1	-5.0	30.5	29.6	35.2	7.0	3.2	3.7
Exports of services, BOP, EUR m	7,197	5,736	8,254	3,522	4,637.0	8,950	9,450	10,150
annual change in %	7.7	-20.3	43.9	28.3	31.6	8.4	5.6	7.4
Imports of services, BOP, EUR m	5,154	5,470	7,073	3,670	3,514	6,800	6,900	7,150
annual change in %	8.6	6.1	29.3	94.5	-4.3	-3.9	1.5	3.6
FDI liabilities, EUR m	2,708	3,122	6,169	4,699	-1,865	1,400	.	.
FDI assets, EUR m	1,634	253	5,558	3,118	-612	860	.	.
Gross reserves of CB excl. gold, EUR m	1,256	1,615	2,081	2,035	2,237	.	.	.
Gross external debt, EUR m	21,135	24,382	26,630	26,285	29,781	34,400	39,300	41,700
Gross external debt, % of GDP	76.1	88.8	84.7	83.6	79.2	91.5	95.5	94.0

1) Preliminary. - 2) From 2021 the new LFS methodology is applied in line with the Integrated European Social Statistics Regulation (IESS). - 3) In % of labour force (LFS). - 4) Official refinancing operation rate for euro area (ECB).

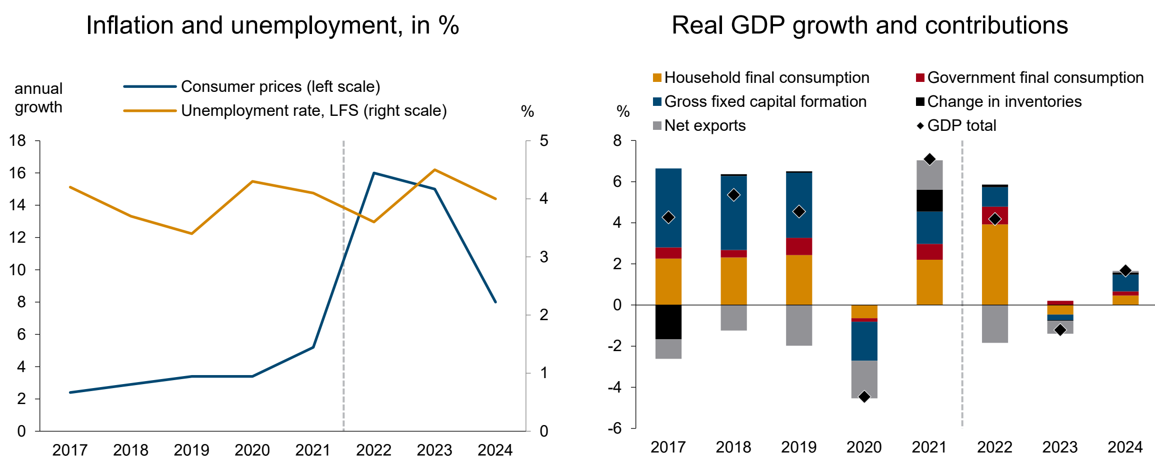
Source: wiiw Databases incorporating Eurostat and national statistics. Forecasts by wiiw.

HUNGARY: Heading into recession

SÁNDOR RICHTER

After strong first half-year growth, the Hungarian economy is heading downhill. Inflation is accelerating, consumer demand is shrinking, public investment projects are being cancelled and private investments postponed. The fragile fiscal position renders unfeasible any substantial government intervention to counterbalance shrinking domestic demand. The foreign trade deficit has been growing rapidly. Unfreezing EU transfers could ease the problems; but that money will not reach Hungary any time soon – if at all.

Figure 6.8 / Hungary: Main macroeconomic indicators



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

Inflation was a headache for Hungary well before Russia's February invasion of Ukraine – a consequence of the overheating related to the April 2022 elections. But it has been picking up further over the year: in September, consumer prices were 20.1% higher (year on year). Within the overall inflation there has been a veritable explosion in food prices: bread 76%, dairy products 66%, etc.. The relaxation of several price caps by the government has sent shockwaves that have been buffeting households in September: household energy prices were 62% higher than a year earlier. Inflation is squeezing the purchasing power of household incomes, which had soared thanks to the election cookies distributed prior to April 2022. The central bank was slow to react and stepped in only in the wake of a serious weakening of the HUF/EUR exchange rate: on 27 September, the policy rate was raised to 13.00%. After further rapid fall of the HUF on 14 October the upper bound of the interest rate corridor was substantially raised allowing for a higher effective policy rate than the official policy rate of 13%. The HUF has been volatile and has depreciated by close to 18% since the beginning of the year, reaching historically low levels in mid-October.

The budget is under intense pressure. The good news is that the taxes collected have exceeded original expectations, on account of inflation. Also, a substantial new source of revenue has appeared, thanks to the introduction of a 'windfall profit' tax on firms in selected sectors and scrapping a generous taxation system for small enterprises. The focus, however, is on the expenditure side. The soaring cost of imported energy is the key issue. For years, it has been a flagship policy of the Orbán regime to keep household overheads artificially low, and this has been a major factor in the victory of the Fidesz party at two successive elections. The price caps on household energy and other utilities – introduced long before the current worldwide energy crisis – are now unsustainable. Moreover, some elements of the election-related government spending are now 'built in' (e.g. the 13th month pension), and their withdrawal would be politically embarrassing. Meanwhile pressure is growing for substantial pay rises in some long-neglected areas of the public sector, particularly in education. Interest payments on the public debt are increasingly becoming a burden, as the yields on government securities are rising sharply. The reduction in EU transfers has had an adverse impact on fiscal expenditure, and especially on public investment, where these grants have played a decisive role in enabling modernisation and environmental protection projects to go ahead. Related to this, the government has announced the suspension of many public investment projects. All in all, the fiscal deficit could amount to 6.5% of GDP this year and 4.5% in 2023.

The deterioration in foreign balances – triggered originally by the overheated economy in 2021 and early this year – has gained momentum, due to the soaring cost of imported energy. While the government from time to time mentions just how advantageous its price agreements with Russia on imported energy are, the actual details of the deals are confidential. A further role in the worsening situation is being played by the struggling exports of the transport vehicle sector. All in all, in the first half of the year, the difference between the growth rates of goods imports and exports was no less than 10 percentage points – in favour of imports. In June 2022, the terms of trade worsened by 5.6% compared to the same month in 2021. The current account deficit showed a deterioration of over EUR 4bn in the first half year, compared to the same period last year, and it is expected to climb to over 6% of GDP by the end of 2022. The withholding of EU transfers can also be felt in the evolution of international reserves, which, relative to imports, have fallen to an uncomfortably low level.

The growth prospects are bleak. The era of excessive real wage rises is over (e.g. 9.8% in total 2020-2021, at a time of 2.3% GDP growth). Household consumption, the main driver of growth up until the middle of this year, will be in negative territory in 2023, and is expected to recover only marginally in 2024. Inflation is forecast to remain nearly as high in 2023 as this year, which will further erode the purchasing power of households; and the shock of the extraordinary rise in energy and food prices will make broad swathes of consumers uncertain and cautious in their spending. The earlier expansion of credit with very low (or even negative) real interest rates tempted households to overextend themselves, with the result that now the debt service/household income rates are uncomfortably high. The moratorium on loan repayments for households, introduced in the wake of the COVID crisis, is in the process of being phasing out, and the cap on interest rates will most probably be lifted next year. Both these moves will add to the burden of those households affected. Uncertainty on the labour market is growing, as a large number of enterprises will have to fight to survive in the wake of the huge rise in energy costs, shrinking consumer demand and more expensive credit. This will lead to unemployment rising, even if only temporarily. Investment is expected to fall slightly: several public investment projects have already been suspended and others will follow. Business sector investment will suffer under the weight of the uncertainty surrounding domestic and foreign demand, and the higher cost of borrowing. In

foreign trade, the unfavourable trend will continue over the coming year, with important export markets likely slipping into recession or near stagnation and with further on high prices for imported energy. With negative GDP growth rates in Q4 of this year and Q1-3 of 2023 (year on year), the Hungarian economy will be in recession in 2023. 2024 will see a return to moderate economic growth.

Transfers from the EU budget would help enormously in ensuring a half-way soft landing for the economy. The EU's decision on whether to allow its transfers to Hungary could ease the imbalances in the economy or exacerbate them – depending on which way it goes. The Commission has proposed withholding a third of the funds allocated to Hungary under the cohesion policy programmes in the Multiannual Financial Framework 2021-2027, on account of concerns over the rule of law. The sum at stake is about EUR 7.5bn. A further EUR 5.8bn in grants from the Recovery and Resilience Facility is being withheld by the EU. The issues that have attracted EU criticism include checks and balances being undermined, the government's influence over the judiciary, its dominance of a large part of the media, deficiencies in public procurement, and corruption. Altogether, some 7.4% of Hungary's annual GDP is at stake. The government has promised substantial changes to the legal system in an attempt to comply with the Commission's requests. The Council of the European Union will make a final decision by the end of 2022, at the latest. Though it is very far from certain, currently the most likely outcome will be a compromise, under which part of the withheld transfers will be released. But the money is unlikely actually to reach the economy before the middle of next year. Thorough and conscientious monitoring of the Hungarian government's promises to make substantive changes to the disputed rule-of-law issues will most likely lead to repeated disputes and suspensions of the transfers over the whole forecast horizon.

Table 6.8 / Hungary: Selected economic indicators

	2019	2020	2021 [1]	2021	2022	2022	2023	2024
				January-June			Forecast	
Population, th pers., average	9,771	9,750	9,710	.	.	9,700	9,650	9,650
Gross domestic product, HUF bn, nom.	47,531	48,276	55,257	25,373	29,981	66,200	73,900	79,700
annual change in % (real)	4.6	-4.5	7.1	7.6	7.3	4.2	-1.2	1.7
GDP/capita (EUR at PPP)	22,800	22,230	24,530	.	.	.	.	.
Consumption of households, HUF bn, nom.	22,553	22,928	25,494	11,990	15,004	.	.	.
annual change in % (real)	5.1	-1.4	4.6	1.7	12.0	8.5	-1.0	1.0
Gross fixed capital form., HUF bn, nom.	12,873	12,857	14,987	6,120	8,051	.	.	.
annual change in % (real)	12.8	-7.0	5.9	4.2	8.8	3.5	-1.0	3.0
Gross industrial production								
annual change in % (real)	5.6	-6.0	9.6	18.3	5.2	4.0	1.5	5.0
Gross agricultural production								
annual change in % (real)	-0.1	-2.4	-2.1	.	.	.	.	.
Construction industry								
annual change in % (real)	20.7	-9.8	11.9	6.8	7.3	.	.	.
Employed persons, LFS, th, average [2]	4,512	4,461	4,642	4,599	4,697	4,700	4,700	4,720
annual change in %	1.0	-1.1	0.7	0.3	2.1	1.3	0.0	0.5
Unemployed persons, LFS, th, average [2]	160	198	196	206	169	180	220	200
Unemployment rate, LFS, in %, average [2]	3.4	4.3	4.1	4.3	3.5	3.6	4.5	4.0
Reg. unemployment rate, in %, eop [3]	5.1	6.2	5.1	5.7	4.8	.	.	.
Average monthly gross wages, HUF [4]	367,833	403,616	438,814	428,191	505,249	516,700	585,300	638,400
annual change in % (real, gross)	7.7	6.2	3.4	3.9	7.8	1.5	-1.5	1.0
Average monthly net wages, HUF [4]	244,609	268,405	291,812	284,747	335,990	343,600	389,200	424,500
annual change in % (real, net)	7.7	6.2	3.4	3.9	7.8	1.5	-1.5	1.0
Consumer prices (HICP), % p.a.	3.4	3.4	5.2	4.3	9.7	16.0	15.0	8.0
Producer prices in industry, % p.a.	2.1	4.3	13.6	9.4	27.8	30.0	20.0	8.0
General governm. budget, EU def., % of GDP								
Revenues	43.9	43.4	41.1	.	.	45.0	44.5	44.0
Expenditures	46.0	51.2	47.9	.	.	51.5	49.0	48.0
Net lending (+) / net borrowing (-)	-2.1	-7.8	-6.8	.	.	-6.5	-4.5	-4.0
General gov. gross debt, EU def., % of GDP	65.5	79.6	76.8	.	.	78.0	77.0	76.0
Stock of loans of non-fin. private sector, % p.a.	13.2	13.4	12.8	10.2	13.4	.	.	.
Non-performing loans (NPL), in %, eop [5]	4.1	3.6	3.2	3.4	3.5	.	.	.
Central bank policy rate, % p.a., eop [6]	0.90	0.60	2.40	0.90	7.75	14.00	12.50	7.00
Current account, EUR m [7]	-1,148	-1,561	-6,426	-757	-5,097	-10,700	-10,000	-8,100
Current account, % of GDP [7]	-0.8	-1.1	-4.2	-1.1	-6.4	-6.3	-5.7	-4.6
Exports of goods, BOP, EUR m [7]	92,525	88,655	103,232	51,429	60,385	120,800	131,100	140,300
annual change in %	4.5	-4.2	16.4	24.4	17.4	17.0	8.5	7.0
Imports of goods, BOP, EUR m [7]	96,212	89,990	107,794	51,060	65,871	134,700	148,200	157,800
annual change in %	5.9	-6.5	19.8	20.1	29.0	25.0	10.0	6.5
Exports of services, BOP, EUR m [7]	26,918	19,889	22,120	9,739	12,592	27,000	32,400	36,300
annual change in %	6.0	-26.1	11.2	1.0	29.3	22.0	20.0	12.0
Imports of services, BOP, EUR m [7]	19,828	15,885	17,090	7,639	9,472	19,700	22,300	24,300
annual change in %	14.5	-19.9	7.6	-3.1	24.0	15.0	13.0	9.0
FDI liabilities, EUR m [7]	3,058	3,169	7,065	2,957	1,795	3,000	.	.
FDI assets, EUR m [7]	1,930	809	4,233	3,200	2,769	3,000	.	.
Gross reserves of CB excl. gold, EUR m	27,010	32,115	33,501	26,314	32,195	.	.	.
Gross external debt, EUR m [7]	107,005	111,557	130,097	122,435	137,832	140,000	143,000	144,000
Gross external debt, % of GDP [7]	73.2	81.2	84.4	79.4	81.2	82.5	81.3	81.3
Average exchange rate HUF/EUR	325.30	351.25	358.52	357.85	374.71	390	420	450

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

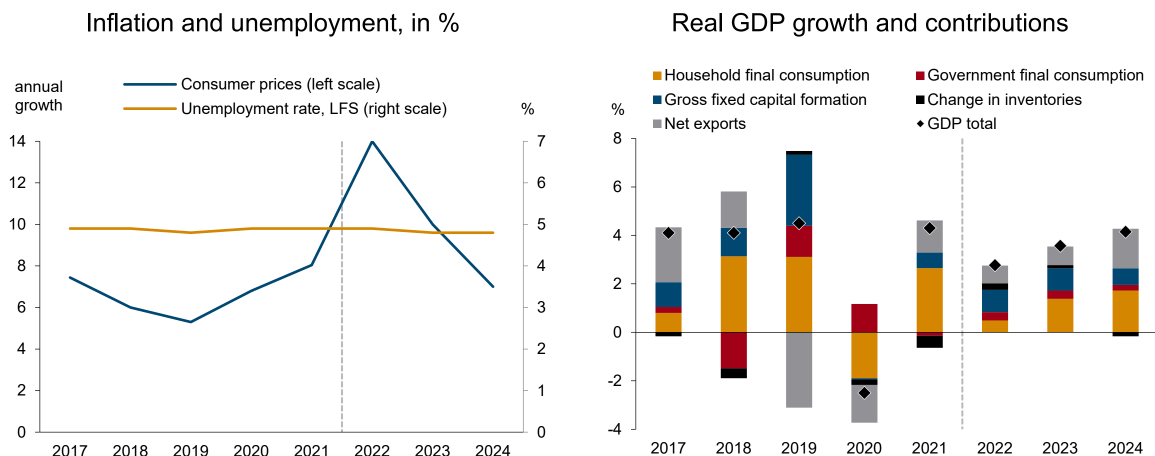
Source: wiiw Databases incorporating Eurostat and national statistics. Forecasts by wiiw.

KAZAKHSTAN: Geopolitical balancing act to limit economic damage

ALEXANDRA BYKOVA

Amid all the geopolitical shocks, Kazakhstan's balancing act has helped it limit the economic damage. Nevertheless, the economy has been weakening, having been hit by all the disruptions, and is expected to grow by 2.8% this year. Although infrastructure investments, import substitution policies and fiscal stimulus to consumption should all go some way to supporting growth, in view of the lower oil prices, the further recession in Russia and the unfavourable external environment we have revised our real GDP forecast for 2023-2024 slightly downwards.

Figure 6.9 / Kazakhstan: Main macroeconomic indicators



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

Economic growth is slowing down, having been hit by high inflation and disruptions caused by the economic shocks in the wake of the Russian invasion of Ukraine. Since it peaked in March, the short-term economic indicator that captures annual real growth in the main sectors of the economy[15] has been slipping gradually each month: from 6.5% over the first three months to 3.7% in January-August. The slightly poorer sentiment indicators for manufacturing and services in August also point to an expected cooling later this year.[16] Manufacturing and construction are likely to suffer further from disruptions to logistics and high input prices caused by both global trends and robust linkages with the Russian economy.

[15] The main sectors include agriculture, industry, construction, trade, transport and communications; value added in those economic activities amounts to more than 60% of GDP.

[16] The Tengri Partners Kazakhstan Manufacturing and Services PMI, compiled by IHS Markit.

The strong ties with Russia have hurt the economy less than we anticipated in our Spring Report, but a sharper decline in exports is expected later, when controls on the export of sanctioned goods become stricter. In dollar terms, exports to and imports from Russia fell by 5.1% and 1%, respectively, in March-July, compared to the same period of 2021. Given Russia's large shares in commodity trade – 11.5% of exports and 42.1% of imports last year – such a modest reduction has proved less damaging to the economy than we previously expected. The smaller impact is a result of the shallower recession in Russia, a restructuring in trading partners[17] and anecdotal evidence of 'grey' exports to Russia.[18] Although Kazakhstan has officially declared its compliance with the Western sanctions and the restrictions on trade, official trade statistics depict a 180% increase in exports of 'machinery and equipment' to Russia over seven months.[19] Following recent official statements, stricter control of sanctioned goods is to be expected.

In the face of increasing external pressure, Kazakhstan's geopolitical balancing act to avoid economic damage is becoming more difficult. The escalation of the Russian war in Ukraine has intensified the external shocks to Kazakhstan, which is heavily exposed to external pressure, due to its high trade and investment dependence, as well as its geographical location and the transport routes it uses. Kazakhstan has been complying with the anti-Russian sanctions on trade in order to avoid secondary sanctions, but it now faces Russian disgruntlement amid the fading hopes of 'grey' imports. President Tokayev continues to reaffirm his friendly relations with Russia and his commitment to the Eurasian Economic Union (EAEU), despite some existing tensions, such as disruptions to the Caspian Pipeline Consortium (CPC) pipeline in the Russian port of Novorossiysk (most probably politically motivated). The state management company has had to bail out and take over Kazakhstan's second-largest bank, a subsidiary of the Russian Sberbank, which is under sanctions. Although banks in Kazakhstan have, to some extent, benefited from the influx of money from Russian clients, some – including the largest Halyk bank – have recently been refusing to use the Russian Mir payment system, due to the threat of secondary sanctions by the US. The labour and housing markets are facing certain challenges, after several tens of thousands of people fled Russia to Kazakhstan to escape mobilisation.

The reorientation of trade, transport and investment flows is gradually taking shape, but its impact will be felt predominantly in the long term. Kazakhstan is seeking to secure political support from China to counterbalance Russia and protect its political independence from Moscow. The government is prioritising domestic production so as to reduce import dependence. Kazakhstan is looking for new partnerships in logistics, trade and investment. The strategic partnership with Turkey has been expanded, and now also focuses on military cooperation. New investments of around USD 0.9bn are expected from the United Arab Emirates. Cooperation has begun with Azerbaijan, Georgia and Turkey on the Trans-Caspian East-West transport corridor, which bypasses Russia. However, as these projects are mostly long term, a very substantial vulnerability to geopolitical risk will likely remain in the near future.

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17 For example, Kazakhstan was able to rapidly diversify its imports of 'machinery and equipment' away from Russia: these grew by 10.8% over the first seven months of 2022, despite a decline by 20.4% in Russian imports.

18 The media have reported unauthorised exports to Russia – without the trademark owner's permission – of cars, smartphones and soft drinks.

19 Harmonised System (HS) codes 84-92: machinery, equipment, vehicles, instruments and apparatus.

After impressive growth in the first half of the year, driven by high global commodity prices, exports are expected to weaken, given the projected drop in oil prices and constraints on oil production growth. Strong export growth (56.8%), mainly driven by the high price of oil, metals and wheat, and much lower import growth (14.8%) led to a current account surplus of 6.4% of GDP in the first half of 2022. A turnaround in oil prices in the second half of the year is likely to limit the current account surplus to 3% of GDP for the whole year. Real oil-sector growth will be weak in 2022, due to several CPC pipeline disruptions and the recent drop in production at the Kashagan oil field, following an accident and the subsequent repair work. Although the recent announcement of a cut in OPEC+ quotas led to a slight increase in oil prices, we do not expect quotas to fully offset the downward pressure generated by the global economic slowdown. We assume that oil prices will fall on an annual basis in 2023 and 2024. Oil production is set to recover after the turmoil of this year, but growth will be constrained by quotas. However, according to official estimates, oil production should increase by around 10% in 2024, when the Tengiz oil field finally expands its capacity. Possible new disruptions to the CPC pipeline remain a serious downside risk for the oil sector.

We expect substantial investment in infrastructure and construction over the forecast horizon. Real fixed capital investment grew by 5.7% over the first eight months of 2022, mainly driven by housing construction, numerous publicly funded infrastructure projects, private expansion investments at the Tengiz oil field, and maintenance and repair work in other oil fields. Kazakhstan is keen to attract private foreign investment into import-substituting production. President Tokayev officially announced in September that there would be new public investment in hospitals and road construction in rural areas. Large public and private investment in transport and logistics infrastructure is expected to encourage the diversification of transport routes. An upgrade to the capacity of the port of Aktau and of domestic pipelines should ensure greater use of the Baku-Tbilisi-Ceyhan pipeline and oil shipments across the Caspian Sea.

Although business sentiment is clouded by worsening access to credit and uncertainty about the economic outlook, import substitution policies are likely to support manufacturing growth further. Manufacturing posted real growth of 4.8% over the first eight months, but business surveys in August showed mixed feelings about future demand: around 15% of respondents expected an improvement, while around 12% thought there would be a deterioration. Around 11% pointed to a worsening of credit conditions, given the high interest rates. By contrast, a slowdown in input costs is seen as a positive sign. We expect import substitution measures – such as subsidised loans, direct funding of investment projects and tax preferences – to support the production of food, fuels, chemical and construction materials. The relocation of large companies from Russia to Kazakhstan is likely to have a moderately positive impact, though probably rather in the medium term,[20] with IT services likely to benefit the most.

Our forecasts for inflation have been revised upwards, as the figures for the second half of the year so far have been higher than anticipated, and the expectation is that this trend will continue. Annual consumer price inflation accelerated from 8.5% in January to 16.1% in August, driven by food prices (sugar and flour prices soared by 90% and 49%, respectively), rents and utility bills, which picked up after the moratorium ended in July, though the prices of key vehicle fuels continue to be regulated. Inflationary pressure is also coming from the depreciation of the tenge: 44% against the rouble and

[20] According to official data, only a few of the 43 companies that expressed interest in a relocation have actually done so or are planning to do so in the near future. They include Honeywell, Huawei, Ural Motors, Carlsberg and Philip Morris.

10.5% against the dollar by the end of September, compared to the beginning of the year. Inflation expectations remained high in August. Nevertheless, the central bank kept the policy rate unchanged at 14.5% in September, in view of the slower growth of the country's main trading partners and the recent decline in global food and energy prices. Against this backdrop, we expect inflation to moderate gradually, albeit from a higher level; we have therefore revised our inflation forecasts upwards to the end of the forecast horizon.

Sluggish private consumption in 2022 should improve next year, as inflation gradually eases and the new fiscal stimulus takes effect. Although there is no sign of a deterioration in the labour market so far, real income increased by only 1.4% over the first seven months on account of the high inflation. Real wages grew by 12.6% year on year in Q1, boosted by a minimum wage hike in January; but their growth slowed to 8.8% in Q2. Weak retail trade (2.1% real annual growth over the first eight months) also points to weak consumption in 2022. The still high growth in loans to households has decelerated slightly, from 42% in January (year on year) to 38% in August, mostly at the expense of long-term loans. The recently announced new fiscal package includes a minimum wage hike of 16% in 2023, a gradual increase in pensions and maternity benefits over the next few years, and subsidised loans for education. These new fiscal measures, along with the easing of inflation, should help consumption growth to recover. Transfers from the National Oil Fund (which recorded high revenues this year), the privatisation of state enterprises and a 'luxury tax' from 2024 will finance those fiscal measures and keep the budget deficit under control.

We expect the early presidential election in November – ahead of the parliamentary elections in 2023 – to strengthen President Tokayev's hold on power and reinforce the current policy stance. After recent constitutional amendments, Tokayev continues to distance himself from former President Nazarbaev: an amnesty was announced for those convicted in the wake of the January protests, the capital city reverted from Nur-Sultan (in honour of Nazarbaev) to its previous name of Astana, and a relative of the former president was convicted of corruption. These policies, along with new social support measures, are likely to stave off broad social discontent and ensure the current president's smooth re-election.

In summary, we expect the economy to grow by 2.8% in 2022 and to accelerate in coming years, driven by investment and a recovery in consumption. The growth forecast for 2022 remains unchanged, as a sharper slowdown in the second half of the year should be offset by the lower than previously expected negative impact of trade with Russia. We have revised our GDP forecast for 2023 downwards to 3.6%, due to the expected sharper decline in oil prices and a growth slowdown among the country's major trading partners. The revisions are not great, however, as new infrastructure investment and the financial stimulus for consumption should cushion the adverse impact.

Table 6.9 / Kazakhstan: Selected economic indicators

	2019	2020	2021 1)	2021	2022	2022	2023	2024
				January-June			Forecast	
Population, th pers., average	18,514	18,756	19,001	18,696	18,932	19,200	19,400	19,700
Gross domestic product, KZT bn, nom.	69,533	70,649	83,952	32,265	40,034	103,500	112,600	122,000
annual change in % (real)	4.5	-2.5	4.3	2.4	3.6	2.8	3.6	4.1
GDP/capita (EUR at PPP)	18,680	17,870	19,720	.	.	.	.	.
Consumption of households, KZT bn, nom.	35,571	36,661	41,440	.	.	.	.	.
annual change in % (real)	6.1	-3.7	5.1	.	.	1.0	2.8	3.5
Gross fixed capital form., KZT bn, nom.	16,318	17,463	19,276	.	.	.	.	.
annual change in % (real)	13.8	-0.2	2.6	.	.	4.0	4.0	3.0
Gross industrial production								
annual change in % (real)	4.1	-0.5	3.6	1.5	3.5	2.6	3.5	4.0
Gross agricultural production								
annual change in % (real)	-0.1	5.7	-2.3	3.5	1.4	.	.	.
Construction industry								
annual change in % (real)	13.2	11.6	8.3	11.9	9.2	.	.	.
Employed persons, LFS, th, average	8,781	8,732	8,807	8,793	8,822	8,870	8,980	9,100
annual change in %	1.0	-0.6	0.9	0.5	0.3	0.7	1.2	1.3
Unemployed persons, LFS, th, average	441	449	450	451	453	460	450	460
Unemployment rate, LFS, in %, average	4.8	4.9	4.9	4.9	4.9	4.9	4.8	4.8
Reg. unemployment rate, in %, eop	1.1	1.5	1.1	2.4	2.2	.	.	.
Average monthly gross wages, KZT 2)	186,815	213,003	250,311	241,187	298,722	299,600	342,700	377,700
annual change in % (real, gross)	9.1	6.8	8.8	9.0	10.6	5.0	4.0	3.0
Consumer prices, % p.a.	5.3	6.8	8.0	7.3	11.9	14.0	10.0	7.0
Producer prices in industry, % p.a.	5.1	-8.0	32.5	22.3	37.0	36.0	10.0	5.0
General governm. budget, nat. def., % of GDP								
Revenues	18.3	20.6	18.9	22.5	24.8	23.0	20.0	20.0
Expenditures	20.2	24.5	21.9	26.0	25.1	25.0	22.7	22.6
Deficit (-) / surplus (+)	-1.8	-4.0	-3.0	-3.5	-0.3	-2.0	-2.7	-2.6
General gov. gross debt, nat. def., % of GDP	24.9	30.5	27.6	27.6	22.2	23.0	24.0	25.0
Stock of loans of non-fin. private sector, % p.a.	5.9	5.5	26.5	12.9	27.5	.	.	.
Non-performing loans (NPL), in %, eop	8.1	6.9	3.3	4.8	3.6	.	.	.
Central bank policy rate, % p.a., eop 3)	9.25	9.00	9.75	9.00	14.00	14.50	11.00	8.00
Current account, EUR m 4)	-7,398	-6,648	-6,648	-3,112	5,177	6,500	-1,200	-3,700
Current account in % of GDP	-4.6	-4.4	-4.0	-4.9	6.4	3.0	-0.5	-1.5
Exports of goods, BOP, EUR m 4)	51,953	41,437	50,999	22,397	38,658	82,000	81,900	83,900
annual change in %	2.4	-20.2	23.1	-6.0	72.6	60.8	-0.1	2.4
Imports of goods, BOP, EUR m 4)	36,729	33,335	35,140	15,496	19,579	46,400	54,100	58,900
annual change in %	23.8	-9.2	5.4	1.1	26.4	32.0	16.6	8.9
Exports of services, BOP, EUR m 4)	6,926	4,423	4,916	2,227	2,984	6,500	7,100	7,400
annual change in %	11.6	-36.1	11.1	-6.0	34.0	32.2	9.2	4.2
Imports of services, BOP, EUR m 4)	10,199	7,149	6,455	2,811	3,600	8,500	9,100	9,600
annual change in %	0.4	-29.9	-9.7	-29.2	28.0	31.7	7.1	5.5
FDI liabilities, EUR m 4)	3,332	6,324	3,876	1,657	3,878	8,300	.	.
FDI assets, EUR m 4)	-1,941	1,199	2,252	515	1,323	1,900	.	.
Gross reserves of CB excl. gold, EUR m 4)	9,004	9,827	9,586	11,117	9,110	.	.	.
Gross external debt, EUR m 4)	142,474	134,102	145,784	140,246	156,236	157,000	158,000	160,000
Gross external debt, % of GDP	87.8	89.5	87.5	93.6	73.1	73.0	68.0	65.0
Average exchange rate KZT/EUR	428.51	471.44	503.88	511.27	491.33	484	485	495

1) Preliminary. - 2) Excluding small enterprises, engaged in entrepreneurial activity. - 3) Base rate (overnight repo rate as a target). - 4) Converted from USD.

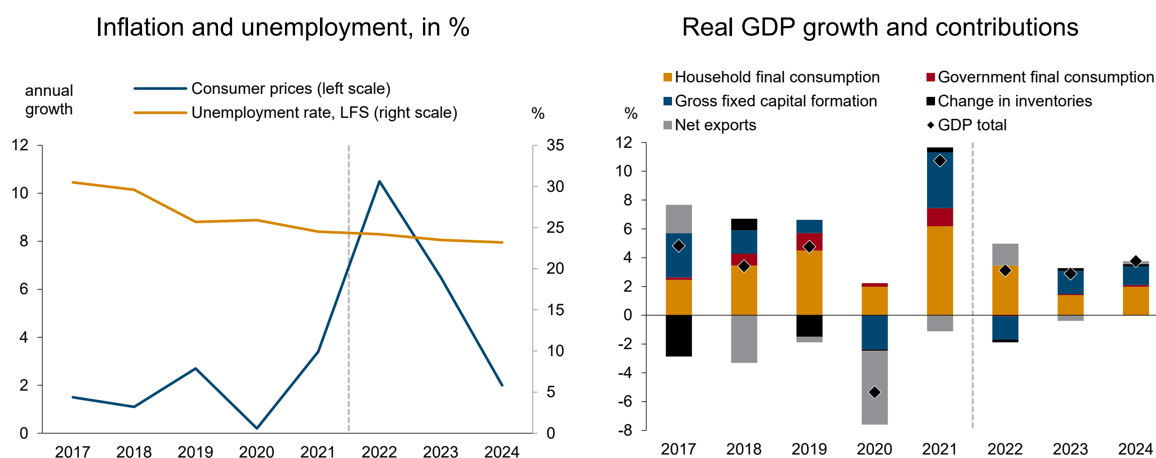
Source: wiiw Databases incorporating national statistics. Forecasts by wiiw.

KOSOVO: Headwinds from soaring inflation and the energy crunch

ISILDA MARA

The economy will grow by around 3% in 2022 and 2023, despite the war-related inflationary pressures and the energy crunch. Inflation is expected to soar to 10% this year, a casualty of rising food and energy prices. The country's trade deficit has deteriorated further, despite the big rise in exports. The positive trend in foreign direct investment has been maintained. The dire state of the labour market and high unemployment suggests that there will be a weakening in consumption, although support from the Kosovo diaspora has increased.

Figure 6.10 / Kosovo: Main macroeconomic indicators



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

Economic activity has slowed markedly due to the war-related inflationary pressures. After a strong rebound of 10.5% in 2021, economic growth lost steam in the first half of the year, when it hovered at 3.3%. Household consumption stayed strong for Q1, but when Russia invaded Ukraine the resulting strong inflationary pressure curbed both household and government consumption quite swiftly. Still, it was investment that suffered the most, falling 8% in the first half year. Since the pandemic crisis began, Kosovo has more than doubled its goods exports, and the trend continued this year, too. However, this has not prevented the trade balance from deteriorating further, as imports have grown even faster. In production terms, growth has been supported by the expansion of financial activities and by wholesale and retail trade. Industrial activity, especially manufacturing, has also expanded, although more slowly than last year. The energy crisis has been a drag on economic activity.

Inflation is expected to hit 10% this year, driven by food and energy prices. Consumer price inflation in Kosovo jumped to 13% in August and averaged 11.2% for January-August. Over the same period, the cost of transport, food and fuel increased by 19%, 15% and 12%, respectively. That said, from August, inflation has been decelerating, but the lasting effects of the war and the inflationary pressure stemming from the energy crisis suggest that inflation will remain high – at 10% this year and 6.5% next.

The energy crunch will continue to act as a drag on the economy. Kosovo is not self-sufficient in energy, and is dependent on imports for close to a third of its requirements (including solid fossil fuels, oil and petroleum, natural gas and renewables). As for electricity, the country seesaws between being a net exporter and a net importer. This year, however, up until July it was a net importer of electricity – and at very high prices. In August, the intolerable electricity prices on the international market forced the Kosovo government to reintroduce a state of emergency and impose energy rationing: power cuts of two hours a day, with the possibility that this state of affairs could continue for six months. This will certainly have repercussions for businesses, production and export-oriented firms.

The domestic supply of energy and electricity remains dire, as power sources have not been diversified. Power generation plants are predominantly fired by lignite. Renewable energy production contributes a mere 7% of domestic production. However, the government is seeking to double renewable energy production by 2025, and several hydropower, wind and solar farm projects are in the pipeline.

The country's trade deficit has deteriorated further, despite the robust rise in exports. Since the pandemic crisis started, exports have risen steadily, and in 2021 were more than double the pre-pandemic level. Also, in the first half of this year, goods exports surged by roughly 30%. In particular, year-on-year exports of minerals more than doubled in the period to July, thanks to a steep rise in international prices. Nevertheless, this has not been enough to prevent the current account deficit from deteriorating further on account of the high growth in imports. Moreover, because of the trade supply disruptions at the international level, Kosovo has further strengthened trade relations with its neighbours – especially North Macedonia and Serbia – with both exports and imports increasing this year.

The support of the Kosovo diaspora has grown further. The diaspora has proved an important source of financing through remittances, foreign direct investment (FDI) and trade. Last year, remittances reached EUR 1.2bn – 15% of GDP. This year, remittances continued to rise – by at least 2% in the first half year. That said, the expectation is that, as the economies of the EU countries – where most Kosovan emigrants reside – head into recession, they will find it harder to save money, so remittances might decline.

Foreign direct investment has kept growing. This has been rising steadily – up 40% in the first half of 2022, year on year – and is expected to reach 5% of GDP this year. FDI has continued to be concentrated in real estate. That said, this year the mining and quarrying sector absorbed almost a tenth of FDI, reflecting rising market prices in this sector.

Demand for credit has expanded rapidly, but the pace is expected to slow as monetary policy tightens. Credit to households and non-financial private corporations rose by 18% from January to July 2022. Companies – which account for two thirds of the credit – have needed it mainly for inventories and fixed investments. Meanwhile, household credit has gone largely on consumer credit rather than housing loans. The surge in inflation is curbing household spending. The level of non-performing loans is still low

(3%), but is expected to rise as the inflationary pressures persist. In September 2022, the commercial banks increased the loan interest rates to 6.1%, up from 5.6% in January, and this move is expected to rein in demand for credit.

The dire state of the labour market and high unemployment presage a weakening of consumption. Nominal wages have not grown at the same pace as inflation. The available short-term statistics indicate that employment has been rising in manufacturing and other production activities. Employment in the services sector as a whole has also been rising, but has fallen in retail trade. Kosovo has one of the highest unemployment rates in the region, especially among the youth: a third of those aged 15-24 are reported as being unemployed. At 18%, the poverty rate is also among the highest in the region. Remittances remain the main financial source for struggling families. Strikes are an ongoing feature among teachers and other professional groups that are seeking higher wages to cope with the soaring prices.

More support has been made available to help private companies and the most vulnerable groups cope with the steep rise in prices. In September 2022, the government extended its April Recovery Package at a cost to the budget of EUR 150m (2% of GDP). Pensioners will receive an additional one-off cash payment of EUR 100; public employees will receive a one-off EUR 50; private businesses will have wage rises subsidised up to EUR 100 a month for three months; while students will also get a lump sum of EUR 100 to cope with the steep rise in prices. Other measures have been introduced, such as a price cap on fuel and subsidies on electricity, especially for low earners. This will certainly place the general government budget under strain, despite the fiscal surplus recorded in the year up to July. Because of the energy crunch and the inflationary pressures, public capital expenditure contracted by almost 38% in the year to July, claiming a very small share of total budget expenditure (6%).

In a nutshell, we expect the economy to grow by 3.1% this year. We have revised our forecast for inflation slightly upwards (from 8.5% to 10%) and for GDP slightly downwards (from 3.3% to 3.1%) owing to the energy and inflationary pressures. With the approach of winter, these pressures are expected increasingly to be felt – and particularly in 2023. Accordingly, we have revised our forecast for growth in 2023 slightly downwards, to 2.9%.

Table 6.10 / Kosovo: Selected economic indicators

	2019	2020	2021 1)	2021	2022	2022	2023	2024
				January-June			Forecast	
Population, th pers., average	1,789	1,790	1,786	.	.	1,798	1,800	1,802
Gross domestic product, EUR m, nom.	7,056	6,772	7,958	3,554	3,911	9,100	10,000	10,600
annual change in % (real)	4.8	-5.3	10.7	10.8	3.2	3.1	2.9	3.8
GDP/capita (EUR at PPP)	8020	7550	8970	.	.	.	.	.
Consumption of households, EUR m, nom.	5,621	5,718	6,572	3,088	3,604	.	.	.
annual change in % (real)	5.7	2.5	7.3	8.7	6.7	4.2	1.7	2.4
Gross fixed capital form., EUR m, nom.	2,190	2,012	2,617	.	.	.	.	.
annual change in % (real)	2.9	-7.6	13.0	.	.	-5.0	5.0	4.0
Gross industrial production 2)								
annual change in % (real)	6.3	0.8	21.7	32.2	0.3	4.5	4.0	4.0
Gross agricultural production								
annual change in % (real)	9.5	2.7	4.0	.	.	.	.	.
Construction output 3)								
annual change in % (real)	1.5	-9.0	8.8	.	.	.	.	.
Employed persons, LFS, th, average 4)	363.2	347.1	375.0	.	.	378	380	385
annual change in %	5.2	-4.4	8.0	.	.	0.8	0.5	1.0
Unemployed persons, LFS, th, average 4)	125.3	121.4	120.0	.	.	120	120	120
Unemployment rate, LFS, in %, average 4)	25.7	25.9	24.5	.	.	24.2	23.5	23.2
Reg. unemployment rate, in %, eop	.	.	.	.	.	.	.	.
Average monthly gross wages, EUR	477	466	484	.	.	560	620	660
annual change in % (real, gross)	2.5	-2.5	0.4	.	.	5.0	4.0	4.0
Average monthly net wages, EUR	430	416	432	554.2	493.5	500	540	560
annual change in % (real, net)	2.4	-3.4	0.4	0.5	-19.4	4.0	2.0	2.0
Consumer prices (HICP), % p.a.	2.7	0.2	3.4	10.4	10.4	10.5	6.5	2.0
Producer prices, % p.a.	0.9	-0.6	4.9	2.8	9.8	10.0	6.5	3.0
General governm. budget, nat. def., % of GDP								
Revenues	26.8	25.4	27.4	27.6	28.9	28.0	28.5	28.8
Expenditures	29.7	33.0	28.8	27.7	24.9	27.0	28.0	28.5
Deficit (-) / surplus (+)	-2.9	-7.6	-1.3	0.0	4.0	1.0	0.5	0.3
General gov. gross debt, nat. def., % of GDP	17.0	22.0	21.1	23.2	20.8	20.0	19.0	18.0
Stock of loans of non-fin. private sector, % p.a.	10.0	7.1	15.4			.	.	.
Non-performing loans (NPL), in %, eop	2.0	2.7	2.3	2.5	2.1	.	.	.
Central bank policy rate, % p.a., eop 5)	6.42	6.01	5.80	6.0	6.0	6.0	6.0	6.0
Current account, EUR m	-399	-472	-695	-468	-627	-810	-780	-750
Current account, % of GDP	-5.7	-7.0	-8.7	-13.2	-16.0	-8.9	-7.8	-7.1
Exports of goods, BOP, EUR m	393	475	753	344	451	880	970	1,060
annual change in %	4.4	20.8	58.4	61.6	31.1	17.0	10.0	9.0
Imports of goods, BOP, EUR m	3,233	3,048	4,320	1,912	2,425	4,790	4,980	5,180
annual change in %	3.8	-5.7	41.7	41.4	26.8	11.0	4.0	4.0
Exports of services, BOP, EUR m	1,675	995	1,906	575	875	2,130	2,260	2,350
annual change in %	7.3	-40.6	91.6	44.8	52.1	12.0	6.0	4.0
Imports of services, BOP, EUR m	749	603	871	337	466	980	1,080	1,130
annual change in %	6.1	-19.5	44.4	36.3	38.3	12.0	10.0	4.5
FDI liabilities, EUR mn	255	346	421	225	327	460	.	.
FDI assets, EUR mn	66	59	100	45	82	20	.	.
Gross reserves of CB excl. gold, EUR m	864	901	1,100	947	1,280	.	.	.
Gross external debt, EUR m	2,201	2,517	2,976	2,692	3,192	3,200	3,200	3,200
Gross external debt, % of GDP	31.2	37.2	37.4	33.8	35.1	35.0	32.0	30.0

1) Preliminary. - 2) Turnover in manufacturing industry (NACE C). - 3) Based on gross value added data. - 4) Population 15-64. - 5) Average weighted effective lending interest rate of commercial banks (Kosovo uses the euro as national currency).

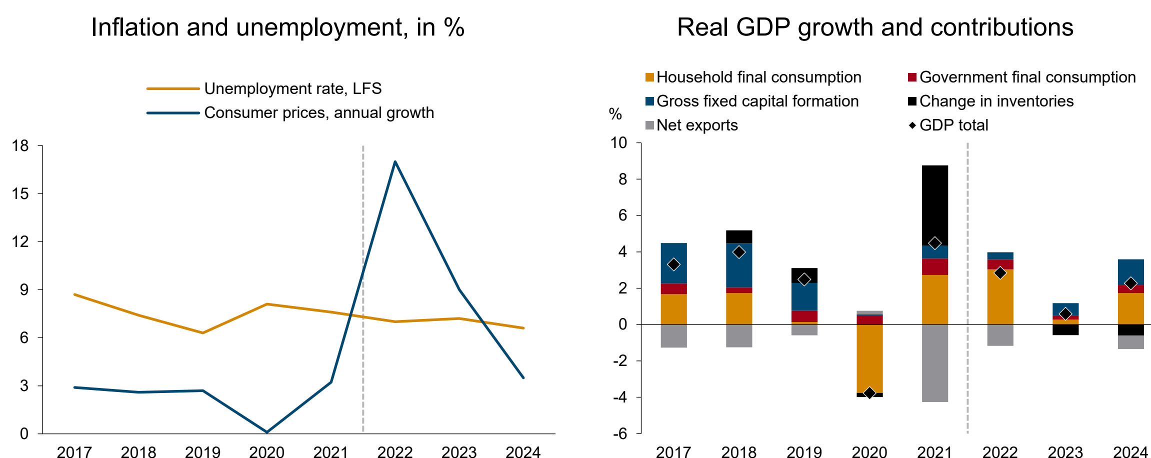
Source: wiiw Databases incorporating national statistics. Forecasts by wiiw.

LATVIA: Government backs households and enterprises to survive escalating energy prices

SEBASTIAN LEITNER

Although the boom continued in the first half of 2022, the Russian war in Ukraine will drag growth in Latvia down in the coming months. Almost all sectors will be affected by a substantial fall in demand growth and by escalating prices. Firms will largely refrain from investing, preferring to deplete their stocks. Moreover, the decline in the purchasing power of households will curb growth in consumption. However, the labour market will remain tight next year. For 2022, we still expect GDP growth to reach 2.9%, but it will then fall back to 0.6% in 2023. We expect a revival of GDP growth in Latvia to 2.3% in 2024 in line with the recovery in the EU.

Figure 6.11 / Latvia: Main macroeconomic indicators



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

Trade dynamics remained strong in the first half of 2022, but a substantial decline in growth is on the cards. Since economic activity remained upbeat in the EU, Latvian exports continued to grow satisfactorily. Moreover, the transport sector was able to profit from the most recent trade developments. Contrary to expectations, trade with Russia and Belarus remained relatively stable in the first half of the year, as the sanctions included wind-down periods. Thus, entrepreneurs in Latvia could still stock up on cheap inputs from Russia and Belarus, and this also resulted in the current account deficit reaching quite a high level. This was particularly on account of fertilisers, oil products, wood, and iron and steel products. In the following months, however, we started to see a sharp decline in imports and exports, reflecting the severance of economic ties. Although we expect imports to attenuate towards the end of the year, the current account deficit will attain 5.6% in 2022.

The reduction in Russian gas supplies to the West, as well as the war-induced disruption to Ukrainian exports, has resulted in escalating prices worldwide. Along with the other Baltic states, Latvia has been the worst affected of the EU countries by the recent commodity price increases. In August 2022, the consumer price index (CPI) soared by 21.5%. Inflation is being driven particularly by energy for heating and transport, but also by food products. We expect inflation to have peaked by the end of 2022, resulting in an average of 17% for the year. Thereafter, the price rises are set to moderate; however, the CPI will still hit 9% in 2023 and 3.5% in 2024.

Latvia imported heavily from Russia in previous years. However, the country has enough gas to last through the winter. Its gas storage facilities are adequately filled (also to serve the needs of its Baltic neighbours), and from the end of the year there will be access to liquefied natural gas (LNG) via the new Estonian terminal in the port of Paldiski. This has enabled parliament to pass an amendment to the energy law, banning Russian gas imports from January 2023.

Despite the projected rise in net wages of more than 10% in nominal terms in 2022, real wages will decline by about 6% on account of high inflation. The government has postponed a planned increase in the statutory minimum wage to January 2023. The Ministry of Welfare has proposed an increase of at least 28%, to EUR 640 a month. Because of this and the tightness of the labour market, we expect average real net wages to increase again by 2% in 2023 and by even more in 2024.

The labour market slack created over the past two years by the pandemic was taken up, and employment increased substantially in the first half of 2022. The number of jobs grew, particularly in manufacturing and the previously ailing hospitality sector. The share of job vacancies returned to its pre-COVID level and remained there in Q2 2022. The unemployment rate has continued to decline gradually over recent months. Although economic activity will stagnate next year, we expect unemployment to increase only a little in 2023. As elsewhere, refugees from Ukraine are welcome in Latvia. Up to end-September, more than 36,000 had arrived – a figure close to 2% of the Latvian population. Thanks to the favourable labour market conditions at the moment, about 25% of the refugees of working age have found a job in Latvia.

Investment will be further dampened both this year and next by the multiple uncertainties triggered by Russia's war with Ukraine. Confidence levels in all sectors – including construction and industry – fell throughout the year and even more markedly in September 2022. Even retail trade entrepreneurs – who until recently were anticipating favourable sales developments – have started to voice negative sentiments. After building up their stocks with cheap inputs and goods in the first half of the year, businesses have now started running down their stocks. Figures on the number of building permits granted show that investment in real estate will remain low in 2023. However, the budget of the Latvian government envisages a steep rise in public investment in infrastructure in 2023. The largest single project is Rail Baltica, which is now entering its construction phase.

The Latvian government has already applied a range of measures to contain the escalating energy prices and to support real household incomes. As far back as late autumn 2021, when energy prices started to climb, both vulnerable households with disabled people or children and people over the age of 60 started to receive monthly benefits of between EUR 15 and EUR 50 per target person. Moreover, the government defrays half of the standing charge for electricity distribution for all households. Moreover, above certain consumption levels it covers 50-90% of the energy price increase for households, businesses and other legal entities, such as educational or healthcare establishments. All these measures will apply until at least April 2023, and additional plans to subsidise large, energy-intensive companies are still under discussion. All in all, the measures agreed upon and enacted up to October 2022 add up to more than 4% of GDP, which is in the upper range of EU countries.

The government budget plan envisaged a substantial reduction in the deficit; however, the war in Ukraine and the energy price hike will keep it at a high level this year and next. The government has particularly boosted defence spending to 2.2% of GDP, and over the medium term – up to 2025 – an increase to 2.5% of GDP is planned. The reintroduction of compulsory military service for young men is in the pipeline: until now, Latvia has been the only Baltic state with a professional army. The first round of conscription is scheduled for January 2023. In view of the additional measures outlined above to support households and enterprises throughout the heating season, the deficit will amount to 6.5% in 2022 and will still be 4% in 2023. Thereafter, the plan is to reduce it again to 2% of GDP.

As expected, the general election (on 1 October 2022) resulted in yet another sweeping change in the composition of parliament. The four strongest parties from the last election (2018) suffered a dramatic decline in voter support or else have split, so they are no longer represented in parliament. Among them is the social-democratic Harmony party, which used to be strongly backed by Russian-speaking Latvians. Those voters seem to have switched to the For Stability! party, which was founded just a year ago. Prime Minister Kariņš is likely again to lead a transformed coalition government: the election brought strong gains for his conservative people’s party New Unity, which used to be led by Valdis Dombrovskis, who was prime minister for several years but, since 2017, has been an EU Commissioner. PM Kariņš has several new potential partners for his coalition to choose from on the conservative-to-populist spectrum. We expect the new government to follow the path of economic policies already pursued by the previous one.

Following a release of pent-up demand in the first half of 2022, retail figures show that private consumption started to drop off in the summer. The strong decline in real incomes caused by escalating prices will result in a reduction in household consumption in the second half of this year and stagnation in 2023. A rebound is only expected in 2024.

All in all, we have revised our forecast for GDP growth in 2022 upwards – from 2.1% in the summer to 2.9% now. According to the baseline scenario, GDP growth will almost stagnate in 2023, reaching only 0.6%, but will revive to 2.3% in 2024. This scenario assumes a strong willingness on the part of EU actors to cushion the economic effects of the crisis through fiscal policies.

Table 6.11 / Latvia: Selected economic indicators

	2019	2020	2021 1)	2021	2022	2022	2023	2024
				January-June		Forecast		
Population, th pers., average	1,914	1,900	1,884	.	.	1,870	1,855	1,840
Gross domestic product, EUR m, nom.	30,647	29,457	32,867	14,988	17,656	39,500	43,300	45,800
annual change in % (real)	2.5	-3.8	4.5	5.0	4.7	2.8	0.6	2.3
GDP/capita (EUR at PPP)	21,700	20,990	23,010	.	.	.	.	.
Consumption of households, EUR m, nom.	17,435	16,413	17,803	8,191	10,175	.	.	.
annual change in % (real)	0.2	-6.6	4.9	2.0	11.4	5.6	0.5	3.2
Gross fixed capital form., EUR m, nom.	7,102	7,217	7,755	3,151	3,610	.	.	.
annual change in % (real)	6.9	0.2	2.9	4.3	2.4	1.5	3.0	6.0
Gross industrial production 2)								
annual change in % (real)	0.9	-1.5	6.7	8.1	4.2	2.0	-0.5	4.5
Gross agricultural production								
annual change in % (real)	23.4	2.7	-7.1	.	.	.	.	.
Construction industry								
annual change in % (real)	2.9	2.7	-6.1	-4.7	-11.6	.	.	.
Employed persons, LFS, th, average 3)	910.0	893.0	869.5	862.5	882.3	887	891	895
annual change in %	0.1	-1.9	-3.0	-4.1	2.3	2.0	0.5	0.5
Unemployed persons, LFS, th, average 3)	61.3	78.7	70.6	74.1	65.4	67	69	63
Unemployment rate, LFS, in %, average 3)	6.3	8.1	7.6	8.0	7.0	7.0	7.2	6.6
Reg. unemployment rate, in %, eop 4)	6.2	7.7	6.7	7.4	5.9	.	.	.
Average monthly gross wages, EUR	1,076	1,143	1,277	1,235	1,330	1,400	1,560	1,660
annual change in % (real, gross)	4.2	6.0	8.2	9.9	-4.6	-6.0	2.0	3.0
Average monthly net wages, EUR	793	841	939	911	974	1,030	1,130	1,200
annual change in % (real, net)	3.9	5.8	8.1	9.9	-5.3	-6.5	1.0	2.5
Consumer prices (HICP), % p.a.	2.7	0.1	3.2	1.1	12.8	17.0	9.0	3.5
Producer prices in industry, % p.a.	1.8	-2.2	13.4	4.9	31.0	32.0	7.0	0.0
General governm. budget, EU def., % of GDP								
Revenues	37.6	38.8	37.6	.	.	41.0	38.0	37.0
Expenditures	38.2	43.3	45.0	.	.	47.5	42.0	39.0
Net lending (+) / net borrowing (-)	-0.6	-4.5	-7.3	.	.	-6.5	-4.0	-2.0
General gov. gross debt, EU def., % of GDP	36.7	43.3	44.8	.	.	45.0	46.0	44.0
Stock of loans of non-fin. private sector, % p.a.	-1.4	-3.8	3.2	-1.4	5.6	.	.	.
Non-performing loans (NPL), in %, eop 5)	5.1	3.1	2.5	3.2	2.2	.	.	.
Central bank policy rate, % p.a., eop 6)	0.00	0.00	0.00	0.00	0.00	.	.	.
Current account, EUR m	-177	790	-1,415	-980	-1,554	-2,200	-1,500	-1,500
Current account, % of GDP	-0.6	2.7	-4.3	-6.5	-8.8	-5.6	-3.5	-3.3
Exports of goods, BOP, EUR m	12,761	13,440	16,194	7,233	9,588	21,000	22,900	24,500
annual change in %	1.4	5.3	20.5	16.9	32.6	29.7	9.0	7.0
Imports of goods, BOP, EUR m	15,400	14,991	18,968	8,606	11,749	25,400	27,000	28,600
annual change in %	2.1	-2.7	26.5	23.2	36.5	33.9	6.3	5.9
Exports of services, BOP, EUR m	5,589	4,706	5,193	2,288	3,095	6,100	6,700	7,200
annual change in %	4.9	-15.8	10.3	1.9	35.3	17.5	9.8	7.5
Imports of services, BOP, EUR m	3,152	2,861	3,573	1,546	2,126	3,900	4,300	4,700
annual change in %	4.3	-9.2	24.9	14.7	37.5	9.2	10.3	9.3
FDI liabilities, EUR m	1,000	816	3,183	1,001	479	2,000	.	.
FDI assets, EUR m	80	168	2,338	-47	-392	500	.	.
Gross reserves of CB excl. gold, EUR m	3,700	3,982	4,504	4,124	4,285	.	.	.
Gross external debt, EUR m	35,803	36,751	36,834	36,342	38,290	39,500	41,100	41,200
Gross external debt, % of GDP	116.8	124.8	112.1	110.6	96.9	100.0	95.0	90.0

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

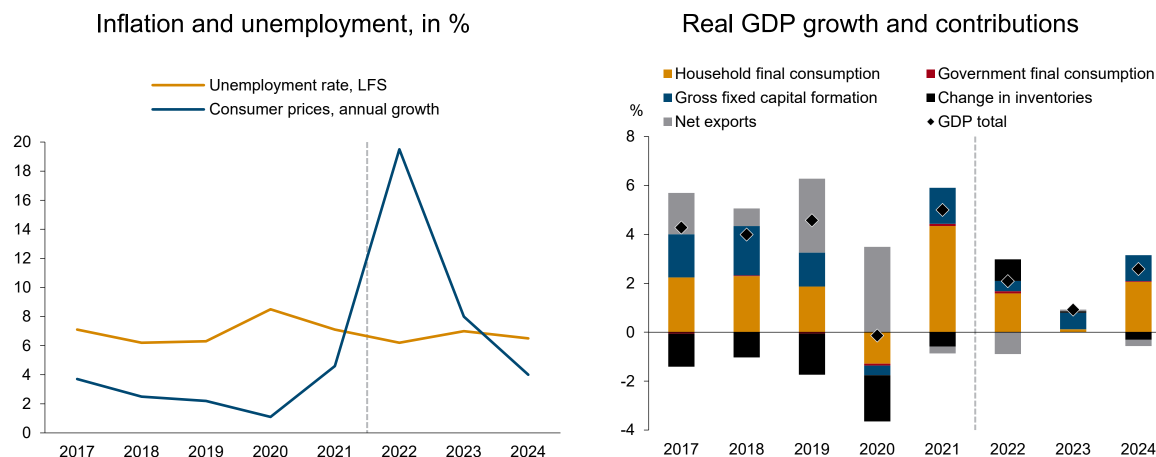
Source: wiiw Databases incorporating Eurostat and national statistics. Forecasts by wiiw.

LITHUANIA: Keeping growth afloat in times of strain

SEBASTIAN LEITNER

The economy has had to deal with the blow caused by Russia's invasion of Ukraine. Steep rises in the cost of energy and other imported inputs will push the inflation rate close to 20% this year. A decline in household and business sentiment alike means that consumption and investment activity will lose momentum in the second half of this year, and particularly in 2023. The government is trying to counter the loss of households' purchasing power and to assist enterprises with energy support measures. It should also manage to keep economic activity afloat with its planned public investments. We expect real GDP to grow by 2.1% in 2022, to be followed by a slump to 0.9% in 2023 and then an upswing to 2.6% in 2024.

Figure 6.12 / Lithuania: Main macroeconomic indicators



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

The war in Ukraine has dramatically exacerbated the surge in consumer prices that was already gaining momentum towards the end of 2021: in September 2022, the inflation rate climbed to 22.5% year on year. To a large extent, this rise has been driven by imports of energy, other production inputs and also food products. As a result, consumer prices will pick up by about 19.5% on average this year, and inflation is likely to remain elevated in 2023 and 2024. Thus, although nominal wages are rising rapidly, real incomes are going to decline this year and next (albeit to a lesser extent). In order to maintain the purchasing power of low-income earners, the government has announced a further 15% increase in the minimum wage from January 2023. In addition, the plan is to raise the non-taxable minimum income threshold substantially.

In the first half of 2022, the release of pent-up demand following the COVID-19-induced lockdowns still caused private consumption to surge, but a decline is on the cards in the second half of the year. With the purchasing power of households coming under pressure, we expect private consumption in 2022 to increase by only 2.7% in real terms. Consumer surveys show confidence declining month by month following last winter's energy price rises, and particularly since the start of the war in Ukraine. From this summer onwards, retail trade figures have shown a drop-off in household spending, especially on consumer durables. Since real incomes will continue to fall in 2023, we also expect consumption to stagnate next year. Only in 2024 do we expect household consumption to regain some of its momentum; however, smaller increases in income will limit that upswing.

External demand remained strong in the first half of 2022, but export growth declined thereafter. In the first six months of 2022, exporters in the chemical industry, plastics and the furniture industry could still benefit from buoyant demand in the EU. However, the recent downturn in sentiment among businesses across Europe is likely to act as a drag on external demand for Lithuanian goods and services. Next year, export growth will fall even further. We anticipate a gradual revival of export activity only in 2024, although that does depend on how well the EU succeeds in restoring energy security. The trade linkages with Russia and Belarus are being steadily loosened. Before the sanctions entered into force, many enterprises in Lithuania seized the chance to purchase cheap inputs from those two countries (steel, wood, fertilisers, etc.); however, imports will decline in the second half of the year. This will particularly hit the transport sector, which used to profit from the transit of goods between Lithuanian ports and the country's eastern neighbours.

For some time now, the liquefied natural gas (LNG) terminal in the port of Klaipėda has allowed the country to be technically independent of Russian gas, should that be necessary. Gas is supplied by Norway, as well as by the US (shale gas). The move to become independent of energy supplies from Russia and Belarus finally resulted in Lithuania ceasing to import not only Russian gas, but also Russian oil and electricity at the end of May 2022. In the case of Belarus, Lithuania had already ceased purchasing electricity by the end of 2021. The Lithuanian government opposed the commissioning of the Astravets nuclear power plant in Belarus, viewing it as an imminent danger to the health and safety of its people.

The ongoing deterioration in business sentiment suggests tough times ahead, but this will be partly offset by public infrastructure investment. September 2022 saw a marked decline in confidence in all sectors for the second month in a row. Thus, investment plans will be revised, and entrepreneurs will run down their stocks in the coming months. While private investment is slowing down, public investment in infrastructure, underpinned by EU funds (including the NextGenerationEU recovery package), can be taken for granted. For Lithuania, the biggest single investment project is Rail Baltica, the high-speed rail service linking the capital of Estonia (Tallinn) with Latvia, Lithuania and Poland. The main construction work on the Lithuanian section of the railway started in mid-2022. Given the huge increase in the cost of building materials, we would expect a slowdown in road construction next year. And the uncertainty in terms of income and interest-rate development means that households will also reduce their investment in dwellings. Figures on construction permits granted show that fewer residential and commercial buildings will be erected in 2023. Overall investment is expected to revive more substantially only in 2024.

Contrary to earlier government plans, the economic downturn and the measures taken to offset the energy price increase will likely result in a budget deficit of around 4% of GDP in 2022. At the beginning of April, the government presented a package of anti-inflationary measures for households and enterprises, and in the months since it has expanded further: a rise in the non-taxable minimum income; increased benefits for families and pensioners; additional public investment in renewable energy sources and energy-saving buildings; direct support for enterprises; and caps on the cost of gas and electricity. In addition, the poorest 110,000 households can apply for an additional energy support benefit. Even before the war in Ukraine, energy poverty was an important issue in Lithuania: in 2021, 22.5% of households reported being unable to keep the home adequately heated over the winter period (in the other Baltic states, the figure was below 5%).

Following the positive economic developments of 2021 and the beginning of this year, the employment rate even topped the pre-crisis level of 2019. Those sectors that were hit hard by the COVID-19 pandemic (such as hospitality, trade and transport) saw a substantial increase in jobs. The job vacancy rate in a couple of sectors remains high and is not expected to decline, given the tight situation in the labour market generally. Unemployment in 2022 will decline further to 6.2% on average. The anticipated slowdown in economic growth will put the brakes on further labour market improvement; however, the rise in the unemployment rate will be small – 7% in 2023. Thereafter we expect a further tightening to come soon.

Up to the beginning of October, more than 65,000 Ukrainian refugees had been registered in Lithuania – a figure that amounts to almost 2.5% of the population. Over the past few years, Lithuania has attracted numerous workers from Ukraine (and Belarus) on temporary work permits, in order to meet the demand for labour. Since the labour market is rather tight in Lithuania, enterprises are glad of the additional work force. As a result, half of the arriving refugees of working age – the majority of them women – are already in employment.

In light of the still positive growth dynamics in the second quarter of the year, we have revised our GDP forecast for 2022 upwards somewhat, to 2.1%. However, the effects of the war in Ukraine will bring a deceleration in economic activity in all sectors and via all channels. Thus, we forecast GDP growth to decline to 0.9% in 2023, and then to revive to 2.6% in 2024.

Table 6.12 / Lithuania: Selected economic indicators

	2019	2020	2021 1)	2021	2022	2022	2023	2024
				January-June			Forecast	
Population, th pers., average	2,794	2,795	2,801	.	.	2,820	2,830	2,820
Gross domestic product, EUR m, nom.	48,860	49,507	55,383	25,467	30,452	67,600	73,700	78,600
annual change in % (real)	4.6	-0.1	5.0	5.0	3.2	2.1	0.9	2.6
GDP/capita (EUR at PPP)	26,220	25,980	28,400	.	.	.	.	.
Consumption of households, EUR m, nom.	29,347	28,958	32,524	14,971	18,030	.	.	.
annual change in % (real)	3.0	-2.1	7.4	7.2	3.9	2.7	0.2	3.5
Gross fixed capital form., EUR m, nom.	10,482	10,424	11,691	5,356	6,130	.	.	.
annual change in % (real)	6.6	-1.8	7.0	14.3	2.4	2.0	3.2	5.0
Gross industrial production (sales)								
annual change in % (real)	3.0	-1.3	19.5	18.1	16.3	12.0	3.0	6.0
Gross agricultural production								
annual change in % (real)	10.1	10.3	-5.5	.	.	.	.	.
Construction industry								
annual change in % (real)	8.4	-1.6	4.6	6.2	3.1	.	.	.
Employed persons, LFS, th, average 2)	1,378	1,358	1,369	1,356	1,408	1,410	1,420	1,430
annual change in %	0.3	-1.5	0.8	-0.9	3.9	3.0	1.0	0.8
Unemployed persons, LFS, th, average 2)	92	126	105	109	86	93	107	99
Unemployment rate, LFS, in %, average 2)	6.3	8.5	7.1	7.5	5.9	6.2	7.0	6.5
Reg. unemployment rate, in %, eop 3)	8.7	16.1	10.2	12.9	8.6	.	.	.
Average monthly gross wages, EUR 4)	1,296	1,429	1,579	1,530	1,743	1,820	1,960	1,920
annual change in % (real, gross)	6.4	8.9	5.6	8.8	-2.2	-3.8	-0.5	1.6
Average monthly net wages, EUR 4)	822	913	1,002	974	1,095	1,150	1,070	1,210
annual change in % (real, net)	11.6	9.8	4.8	8.7	-3.5	-4.2	-0.5	1.2
Consumer prices (HICP), % p.a.	2.2	1.1	4.6	2.0	16.3	19.5	8.0	4.0
Producer prices in industry, % p.a.	0.0	-9.0	9.5	4.2	25.5	28.0	9.0	3.0
General governm. budget, EUdef., % of GDP								
Revenues	35.2	35.7	37.7	.	.	38.0	37.0	36.0
Expenditures	34.8	42.9	38.7	.	.	41.0	39.5	38.0
Net lending (+) / net borrowing (-)	0.5	-7.3	-1.0	.	.	-3.0	-2.5	-2.0
General gov. gross debt, EU def., % of GDP	35.9	46.6	44.3	.	.	42.0	42.0	40.0
Stock of loans of non-fin. private sector, % p.a.	3.3	-1.8	13.4	3.1	16.7	.	.	.
Non-performing loans (NPL), in %, eop	1.6	1.3	0.7	0.9	0.6	.	.	.
Central bank policy rate, % p.a., eop 5)	0.00	0.00	0.00	0.00	0.00	.	.	.
Current account, EUR m	1,733	3,637	631	481	-1,943	-4,200	-4,400	-4,200
Current account, % of GDP	3.5	7.3	1.1	1.9	-6.4	-6.2	-6.0	-5.3
Exports of goods, BOP, EUR m	25,954	25,535	31,648	14,322	18,911	38,600	41,500	44,500
annual change in %	5.7	-1.6	23.9	22.2	32.0	22.0	7.5	7.2
Imports of goods, BOP, EUR m	28,303	25,940	34,544	15,567	22,326	45,700	50,100	53,400
annual change in %	3.3	-8.3	33.2	29.0	43.4	32.3	9.6	6.6
Exports of services, BOP, EUR m	11,864	10,921	13,571	6,325	7,897	16,500	17,800	19,100
annual change in %	22.6	-8.0	24.3	20.3	24.9	21.6	7.9	7.3
Imports of services, BOP, EUR m	6,914	5,886	8,137	3,515	5,003	10,800	11,800	12,600
annual change in %	15.1	-14.9	38.2	22.7	42.3	32.7	9.3	6.8
FDI liabilities, EUR m	3,060	3,979	2,512	724	83	1,000	.	.
FDI assets, EUR m	1,921	3,438	1,296	348	-1,008	-1,700	.	.
Gross reserves of CB excl. gold, EUR m	4,273	3,662	4,626	4,244	4,846	.	.	.
Gross external debt, EUR m	34,267	37,493	43,239	39,029	42,007	41,900	44,200	45,600
Gross external debt, % of GDP	70.1	75.7	78.1	70.5	62.1	62.0	60.0	58.0

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

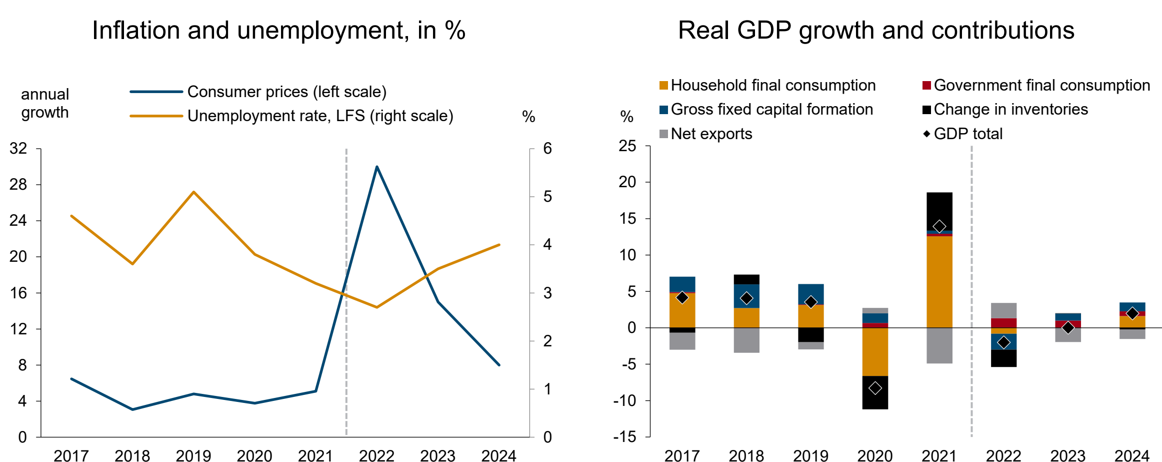
Source: wiiw Databases incorporating Eurostat and national statistics. Forecasts by wiiw.

MOLDOVA: Outlook worsens as war in neighbourhood persists

GÁBOR HUNYA

The effects of the prolonged Russian invasion of Ukraine, skyrocketing food and energy prices, trade disruptions, the influx of refugees and declining public confidence have all worsened Moldova's economic prospects. GDP is certain to decline in 2022 and to stagnate in 2023. Increased funding by international donors and creditors is necessary for the country to cope with the economic challenges and to keep the current Western-oriented leadership in power.

Figure 6.13 / Moldova: Main macroeconomic indicators



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

The economy stagnated in the first half of 2022 and is certain to contract over the remainder of the year. Household consumption stayed flat, despite the remarkable demand generated by refugees from Ukraine, which contributed 0.7% to GDP growth. Retail trade contracted, while on-the-farm consumption expanded, thanks to the extraordinarily high yields of the previous year that were stockpiled. Investment activity shrank, as the construction industry was hit by soaring prices for energy and building materials: the private housing construction boom came to an end, though corporate investment continued to expand. Increased government consumption mitigated the decline.

Net exports made a positive contribution to growth in the first six months, on account of rapidly expanding exports and less-dynamic imports. Exports of agricultural and food products benefited from the stockpiling that followed last year's bumper harvest. Russia banned fruit imports from Moldova in August, but EU quotas were increased. The low crop yields triggered by drought in 2022 will curtail food production and exports next year and will also depress domestic consumption. Farmers are also

suffering from high fuel and fertiliser prices. They have benefited from relief on the excise duty on fuel and from certain other subsidies; but that has gone only some way toward compensating them.

Inflation has accelerated in 2022, from 6% in January to 34.3% in August. Gas prices have trebled since the beginning of the year, as the main supplier Gazprom has been adjusting prices monthly to the spot-market rates since September 2021. Domestic household gas tariffs are regulated, but they have been changing month by month, based on the market price. Food prices have doubled in the course of the year in response to global trends and elevated foreign demand. As a response to the price hikes, imports of natural gas from Russia diminished in the first half year, and gas was partly replaced by oil products in the energy mix. Biofuel and wood will increase their share of heat production during the winter. Still, gas remains the main source of heat and of power generation. Gazprom has repeatedly threatened Moldova that it will cease supplies unless the country pays some of its accumulated debt. Romania has promised to help if Gazprom does fully halt the supply.

The National Bank of Moldova (NBM) has responded to the inflation with aggressive monetary tightening. It increased its base rate from 8.5% in January to 21.5% in August and kept it flat in September. The liquidity of banks was curtailed also by an increase in the mandatory reserve requirement to 40%. The cost of borrowing rose not only for the population, but also for the government, as it also borrows domestically. Inflation is expected to peak in November at 36% and the base rate may hit 23%. Inflation may subside in subsequent months, due to base effects and declining demand. To counteract the adverse effects of inflation on the population, the government has given various groups of public-sector employees pay rises, has provided one-off assistance to pensioners and has prescribed a hike in the minimum wage in the private sector. Nevertheless, real wages declined by more than 8% in the first six months of 2022, and no recovery is in sight for the rest of the year.

The Moldovan leu is relatively stable against the main foreign currencies. Against the US dollar it has depreciated by about 9% so far this year, but has appreciated against the euro, reflecting the change in the EUR/USD exchange rate. As an anti-inflationary measure, the NBM regularly intervenes on the forex market to prevent shocks and excessive volatility.

Economic prospects are bleak, as the military conflict in Ukraine goes on and foreign financing does not look generous. The positive effects of the 2021 bumper harvest have petered out, which will have repercussions for consumption, industrial production and exports over the next 12 months. Agriculture and the food industry – which together provide a living for a third of the population – will suffer from elevated input prices, including fuel and fertilisers, even if the weather conditions improve next year. The gas supply will remain at the mercy of Gazprom, although alternative import routes will gradually become available. Purchasing power will be further eroded by wage restraint in the public sector and by declining revenues in the private sector. Fiscal revenues will barely expand, thus social benefits and support for small producers cannot possibly increase in real terms. Remittances – a major source of income for the population – are losing their purchasing power under the conditions of a stable exchange rate. Even without any further international price shocks, inflation will remain in double digits in 2023. The international aid already pledged and the available credit lines enable the economy to just keep going and provide basic support for refugees. Taking all factors into consideration, we forecast a recession over the next four quarters on a yearly basis, which may be followed by a modest upturn (from a low base) in the second half of 2023.

The erosion of living conditions has brought people out onto the streets, and the political tension may increase further if the winter is a harsh one. Thousands of protesters, the largest crowd for two years, gathered in Chisinau on 18 September to protest about high inflation and fuel prices and to demand the resignation of the government. Opposition parties friendly towards Russia are benefiting from the social discontent and are doing their best to undermine popular support for the EU-friendly government. Therefore, increased funding from international donors and creditors is necessary for the country not only to cope with the economic challenges, but also to keep the current leadership in power. The disbursement of EU and IMF funds needs to gather momentum, and new donor agreements must be reached.

Relations with the separatist region of Transnistria have settled down, since Russia has apparently given up trying to stoke conflict in Moldova's immediate neighbourhood. The Russia-friendly separatists tried in vain to increase tension in mid-2022, in order to provoke Russian intervention. But since then, they have come to realise that Transnistria's economic interests are linked to the rest of Moldova, rather than just to the cash and gas flowing from Russia. Transnistria does not have direct land access to Russia and can only trade with the West. Moldova draws two thirds of its electricity from the Russian-owned power station in Transnistria, which burns Russian gas but has no market other than the rest of the country. Meanwhile, the Chisinau government has taken steps to diversify supply, which may reduce its purchases from Transnistria and put the region under pressure. A further major cash cow for Transnistria is its steel plant, which needs to export its products and depends on transit through Moldova. Transnistrian companies are also facing some important challenges on Moldova's road to the adoption of EU rules. The Chisinau government recently renewed the steel plant's environmental certificate, but the special treatment it enjoys cannot go on for ever: the EU may not tolerate the competitive advantage enjoyed by Moldovan steel, produced using Russian gas that Transnistria receives free of charge from Gazprom. Mutual dependence could draw Moldova's regions together.

Table 6.13 / Moldova: Selected economic indicators

	2019	2020	2021 1)	2021 January-June	2022 January-June	2022 Forecast	2023 Forecast	2024 Forecast
Population, th pers., average	2,665	2,620	2,615	.	.	2,600	2,580	2,560
Gross domestic product, MDL bn, nom.	206.3	199.7	241.9	105.1	120.6	296	326	349
annual change in % (real)	3.6	-8.3	13.9	12.7	0.0	-2.0	0.0	2.0
GDP/capita (EUR at PPP)	9,050	8,410	10,270	.	.	.	.	.
Consumption of households, MDL bn, nom.	172.8	162.2	195.6	84.1	98.3	.	.	.
annual change in % (real)	3.7	-7.9	15.5	18.7	0.1	-1.0	0.0	2.0
Gross fixed capital form., MDL bn, nom.	48.3	49.8	58.5	26.2	27.5	.	.	.
annual change in % (real)	12.0	5.6	1.7	13.1	-7.3	-9.0	4.0	5.0
Gross industrial production								
annual change in % (real)	2.0	-5.5	12.1	14.2	0.5	-1.0	-2.0	3.0
Gross agricultural production								
annual change in % (real)	-1.6	-27.2	49.9	.	.	.	.	.
Construction industry								
annual change in % (real)	12.8	3.7	-0.3	17.1	-11.6	.	.	.
Employed persons, LFS, th, average 2)	872.4	834.2	843.4	820.3	853.7	870	890	900
annual change in %	9.9	-4.4	1.1	0.8	4.1	3.0	2.0	1.0
Unemployed persons, LFS, th, average 2)	46.9	33.1	28.2	33.6	23.6	20	30	40
Unemployment rate, LFS, in %, average 2)	5.1	3.8	3.2	4.0	2.7	2.7	3.5	4.0
Reg. unemployment rate, in %, eop	1.8	2.9	2.3	2.4	1.5	.	.	.
Average monthly gross wages, MDL	7,234	7,943	8,980	8,757	9,969	10,600	12,400	14,100
annual change in % (real, gross)	10.1	5.8	7.6	11.0	-8.4	-9.0	2.0	5.0
Average monthly net wages, MDL	6,010	6,617	7,635	.	.	9,000	10,600	12,000
annual change in % (real, net)	11.5	6.1	9.8	.	.	-9.0	2.0	5.0
Consumer prices, % p.a.	4.8	3.8	5.1	1.9	24.3	30.0	15.0	8.0
Producer prices in industry, % p.a.	1.8	2.6	8.4	6.6	23.0	28.0	12.0	5.0
General governm. budget, nat. def., % of GDP								
Revenues	30.5	31.4	32.0	33.3	34.6	34.0	33.0	33.0
Expenditures	32.0	36.7	33.9	36.5	37.4	39.0	37.0	36.0
Deficit (-) / surplus (+)	-1.5	-5.3	-1.9	-3.3	-2.8	-5.0	-4.0	-3.0
General gov. gross debt, nat. def., % of GDP	25.7	34.2	32.6	31.5	27.0	29.7	30.9	31.9
Stock of loans of non-fin. private sector, % p.a.	13.9	13.2	22.6	19.7	19.1	.	.	.
Non-performing loans (NPL), in %, eop 3)	8.5	7.4	6.1	7.5	6.7	.	.	.
Central bank policy rate, %, p.a., eop 4)	5.50	2.65	6.50	2.65	18.50	23.00	12.00	6.00
Current account, EUR m 5)	-988	-778	-1436	-702	-898	-1,870	-2,310	-2,270
Current account, % of GDP	-9.4	-7.7	-12.4	-14.2	-15.0	-12.6	-14.2	-13.7
Exports of goods, BOP, EUR m 5)	1,892	1,706	2,165	853	1,795	4,020	4,650	4,930
annual change in %	13.1	-9.8	26.9	0.2	110.4	85.7	15.7	6.0
Imports of goods, BOP, EUR m 5)	4,850	4,420	5,706	2,527	3,702	8,660	10,030	10,430
annual change in %	8.7	-8.9	29.1	25.9	46.5	51.8	15.8	4.0
Exports of services, BOP, EUR m 5)	1,379	1,121	1,381	603	920	2,100	2,430	2,670
annual change in %	10.2	-18.7	23.2	12.3	52.7	52.0	15.7	9.9
Imports of services, BOP, EUR m 5)	1,053	772	982	420	555	1,330	1,460	1,540
annual change in %	10.9	-26.7	27.3	11.9	32.2	35.4	9.8	5.5
FDI liabilities, EUR m 5)	453	138	331	125	289	380	.	.
FDI assets, EUR m 5)	35	5	8	-7	30	0	.	.
Gross reserves of CB excl. gold, EUR m 5)	2,731	3,079	3,442	3,167	3,434	.	.	.
Gross external debt, EUR m 5)	6,458	6,626	7,741	6,991	8,259	10,100	11,600	12,000
Gross external debt, % of GDP	61.6	65.5	67.0	60.5	56.0	68.0	71.0	72.0
Average exchange rate MDL/EUR	19.67	19.74	20.93	21.29	20.20	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. - 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.

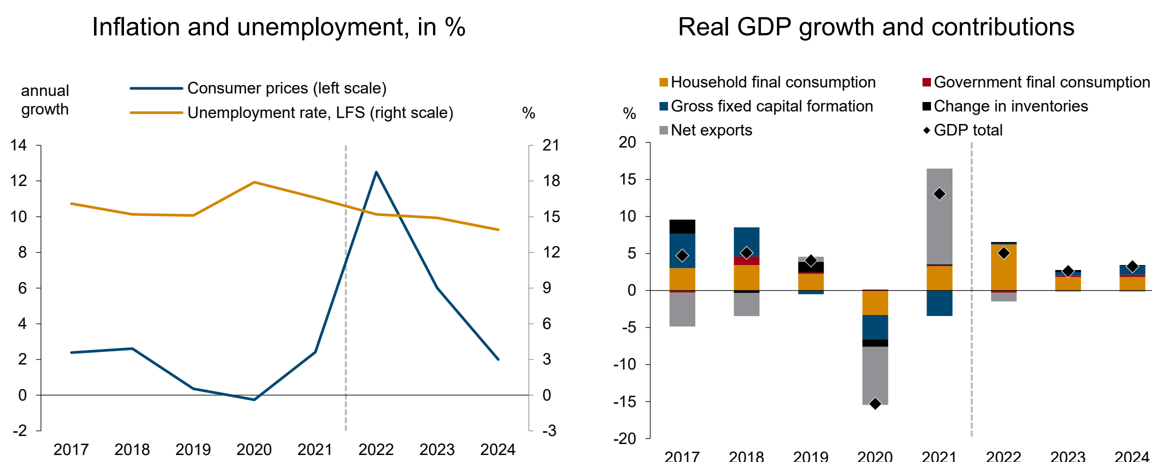
Source: wiiw Databases incorporating national statistics. Forecasts by wiiw.

MONTENEGRO: Paralysed judicial system hampers EU integration progress

NINA VUJANOVIĆ

Montenegro continued with its impressive growth in 2022, thanks to rising private consumption. This was a result of a tax reform that increased people's incomes, but which poses a serious threat to the state and the healthcare budget. The future will bring more inflation, which will act as a drag on consumption. Although not yet at pre-pandemic levels, tourism is on a solid path to recovery. The lack of political will to unblock the judiciary is extending the already lengthy road towards EU integration. Fresh parliamentary elections may be on the horizon.

Figure 6.14 / Montenegro: Main macroeconomic indicators



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

Real GDP grew markedly in the first half of 2022 – by 7.2% in Q1 and 12.7% in Q2 – driven by a rise in household consumption. Increased spending resulted from a tax reform that put an end to compulsory health insurance, raised the minimum monthly wage to EUR 450 (from EUR 250) and introduced progressive personal income tax, with a zero rate for monthly earnings of below EUR 700. Altogether, these tax reforms raised average earnings by a nominal 30%, which is unprecedented in a country that has been dealing with stagnant wages for many years now. On top of that, the government introduced a phased increase in the minimum pension (of about 80%) this autumn, and that will also to some extent support consumption. Thanks to this cash influx, private consumption increased by over 12% in the first half of 2022. Household credit also rose, by 7% annually.

Migration from Ukraine has also contributed to the growth in private consumption. Consumption has been supported by Ukrainians who have fled the war and settled in Montenegro, and also by Russians who have bought property in Montenegro to safeguard their savings. For that reason, the first half of the year saw a big increase in foreign direct investment, due to an increase of 123% in real-estate investment. It is not unlikely that, with the migration of younger men from Russia to avoid mobilisation, the trend will continue to the end of this year. This increased investment has pushed up real-estate prices tremendously (in Q2 2022 they increased by 12% annually).

Given this, we project GDP growth to reach 5.1% in 2022, 1.5 percentage points higher than previously expected. At the same time, we have cut the growth projection for 2023 from 3.7% to 2.6%, on account of rising macroeconomic uncertainty.

However, high inflation is becoming a drag on consumption. Inflation picked up in summer to reach 15% in August, mainly on account of food and beverage prices (25.5%) and the cost of transport, housing, water and electricity (all with rises of over 14%). Montenegro is a big importer of food, and is thus at greater risk of inflation via this channel. As the scope for monetary policy is very limited, certain fiscal measures were taken to control prices – the excise duty on fuel was halved and value-added tax was scrapped on some basic food products. But this came too late: the higher food and energy prices had already spilled over into the tourism sector, and so the policies were rendered pretty much ineffective. Food prices will remain a key driver of inflation in the future, while energy prices will probably not rise so much in 2022. Over 55% of all electricity is produced from renewable energy sources (mostly hydropower plants), and the rest from coal. We expect a substantial rise in electricity prices only in the event of a lack of rainfall in 2022. All in all, we project average inflation to be 12.5% in 2022 and 6% in 2023.

While consumers are spending, the state and healthcare budgets are being squeezed. The tax reform was not properly planned, and its implementation was rushed and interrupted by the fall of one government early this year and of another in August. In the aftermath of the serious global health crisis, the healthcare system has lost an important source of financing because of this reform. The official state pharmaceutical supplier is still lacking basic medicines. It is not evident how the healthcare system will be financed in the long term, but it is already clear that it is at high risk. And so is the state budget. This reform and the fiscal measures taken to control inflation deprived the state of EUR 200m. The reduction in some public revenues and the pre-existing budget allocations mean that a new loan of EUR 450m will be taken out from local banks and in the form of a Eurobond placement. The budget deficit will probably reach 8.1% of GDP in 2022 and will stay at a similar level in 2023 and 2024. These are big deficits for the already highly indebted Montenegro.

The tourist industry recorded a good season, especially over the winter. Tourist arrivals rose substantially in the period January-July (by 79% annually), although they are still 10% down on pre-pandemic times. For the second year in a row, more tourists have come from the Balkan region, since there are currently fewer cheap air routes. Local and regional tourists accounted for 46% of total arrivals in the first seven months (compared to 30% before the pandemic). As the purchasing power of these tourists is lower, so are the revenues from the tourist sector. The winter season (Q4 2022) will likely be very successful, thanks to the inauguration this summer of the first highway leading to the ski centres. Overall, the sector is still the main driver of economic growth, while diversification toward other industries has not yet taken place.

A paralysed judiciary has become the 'new norm' for Montenegro. The EU has long stressed that the main obstacle to EU accession is the country's slow progress in the area of the rule of law. However, almost all the institutions in the judicial system have been pretty much paralysed for several years. The **Constitutional Court** has not functioned properly since January 2021: four of the seven judges of the Constitutional Court have retired (although, at different points in time), essentially disabling the court, as no decision can be taken without a majority. Three members of the **Supreme Court** council have been without a 'proper' mandate for six years now (i.e. their mandates have expired); the court also lacks a head, so that for the past two years it has been presided over by a deputy head. The country has also been without a **Supreme State Prosecutor** for about three years now. The key to unblocking the judicial system rests with parliament, but there has been no political majority to do anything. The EU had hoped that the institutions would be 'unblocked', so that reforms could start. That, however, has not happened.

Instead, agreement with the Serbian Orthodox Church was prioritised. Various elements of this agreement have sparked ethnic tension. The first is that the preamble ties the establishment of the Orthodox religion in Montenegro to the date of the establishment of the Serbian Orthodox Church. Given that Montenegro was a theocratic state until the nineteenth century, much of its historical heritage is (according to this agreement) linked to the Serbian Orthodox Church. Second, the preamble thus denies the existence of the Montenegrin Orthodox Church. Third, the agreement obliges the state to provide religious education for pupils whose parents demand such education, which makes the country more theocratic in nature and contravenes Montenegrin law. Fourth, the agreement grants possession rights to the Serbian Orthodox Church over property that, according to Montenegrin law, is a cultural heritage protected by the state.

EU accession is no longer a topic. After only a few months in power, the government lost its majority over the agreement with the Serbian Orthodox Church, thus opening a fresh chapter of political instability. Since the August 2020 election, two governments have fallen because of lack of consensus among the coalition parties. Reforms cannot be properly implemented with all the systemic changes. With this much uncertainty, the country risks its future with the EU. The political scene has been very heated for two years now and fresh general elections are being discussed.

Table 6.14 / Montenegro: Selected economic indicators

	2019	2020	2021 1)	2021	2022	2022	2023	2024
				January-June			Forecast	
Population, th pers., average	622	621	619	.	.	619	619	618
Gross domestic product, EUR m, nom.	4,951	4,186	4,955	2,018	2,428	5,900	6,400	6,700
annual change in % (real)	4.1	-15.3	13.0	6.8	10.3	5.1	2.6	3.3
GDP/capita (EUR at PPP)	15,700	13,360	15,370	.	.	.	.	.
Consumption of households, EUR m, nom. 2)	3,534	3,400	3,617	1,655	1,996	.	.	.
annual change in % (real)	3.1	-4.6	4.0	4.4	12.6	8.4	2.5	2.5
Gross fixed capital form., EUR m, nom.	1,352	1,166	1,096	526	599	.	.	.
annual change in % (real)	-1.7	-12.0	-12.3	-10.6	12.6	0.5	2.0	5.0
Gross industrial production 3)								
annual change in % (real)	-6.3	-0.9	4.9	10.6	-2.3	2.0	7.0	9.0
Net agricultural production 4)								
annual change in % (real)	-2.2	1.1	-0.5	.	.	.	.	.
Construction output								
annual change in % (real)	10.7	-5.5	-4.8	-1.3	-1.8	.	.	.
Employed persons, LFS, th, average 5)	243.8	219.4	212.6	193.3	243.6	244	249	256
annual change in %	2.7	-10.0	.	.	26.0	15.0	2.0	3.0
Unemployed persons, LFS, th, average 5)	43.4	47.8	42.2	43.2	45.2	40	40	40
Unemployment rate, LFS, in %, average 5)	15.1	17.9	16.6	18.3	15.7	15.2	14.9	13.9
Reg. unemployment rate, in %, eop	16.2	20.1	24.7	23.6	21.5	.	.	.
Average monthly gross wages, EUR	773	783	793	790	876	880	940	980
annual change in % (real, gross)	0.6	1.6	-1.1	-0.2	1.0	-0.8	0.3	2.0
Average monthly net wages, EUR 6)	515	524	532	529	704	710	760	790
annual change in % (real, net)	0.4	2.1	-0.9	0.0	.	18.0	0.6	1.5
Consumer prices, % p.a.	0.4	-0.3	2.4	1.2	9.8	12.5	6.0	2.0
Producer prices in industry, % p.a. 7)	2.4	-0.1	1.3	1.3	8.8	12.0	5.1	1.8
General governm. budget, nat. def., % of GDP								
Revenues	43.4	44.6	43.3	.	.	33.9	35.5	37.0
Expenditures	45.4	55.7	45.1	.	.	42.0	43.0	44.1
Deficit (-) / surplus (+)	-2.0	-11.1	-1.8	.	.	-8.1	-7.5	-7.1
General gov.gross debt, nat.def., % of GDP	76.5	105.3	84.0	.	.	82.0	80.0	78.0
Stock of loans of non-fin. private sector, % p.a.	6.6	2.9	3.4	2.3	9.1	.	.	.
Non-performing loans (NPL), in %, eop	4.7	5.5	6.2	5.7	6.3	.	.	.
Central bank policy rate, % p.a., eop 8)	5.46	5.33	5.16	5.28	5.06	5.1	5.0	5.0
Current account, EUR m	-707	-1,090	-455	-412	-540	-690	-770	-720
Current account, % of GDP	-14.3	-26.1	-9.2	-20.4	-22.2	-11.7	-12.0	-10.7
Exports of goods, BOP, EUR m	466	409	526	242	413	740	780	820
annual change in %	6.8	-12.2	28.6	32.4	70.9	40.0	5.5	5.0
Imports of goods, BOP, EUR m	2,531	2,051	2,441	1,062	1,564	3,920	4,310	4,530
annual change in %	1.8	-19.0	19.0	5.0	47.2	60.5	10.0	5.0
Exports of services, BOP, EUR m	1,705	679	1,597	427	735	3,010	3,410	3,680
annual change in %	9.1	-60.2	135.1	44.4	72.2	88.3	13.2	8.0
Imports of services, BOP, EUR m	687	503	641	244	419	970	1,050	1,090
annual change in %	9.6	-26.8	27.5	-2.7	72.1	52.0	8.0	4.0
FDI liabilities, EUR m	372	466	590	204	368	506	.	.
FDI assets, EUR m	67	-5	9	-2	12	16	.	.
Gross reserves of CB excl. gold, EUR m 9)	1,367	1,739	1,749	1,372	1,657	1,790	1,800	1,810
Gross external debt, EUR m	8,287	9,275	9,488	9,159	9,317	10,920	11,460	11,590
Gross external debt, % of GDP	167.4	221.6	191.5	184.8	157.9	185.0	179.0	173.0

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

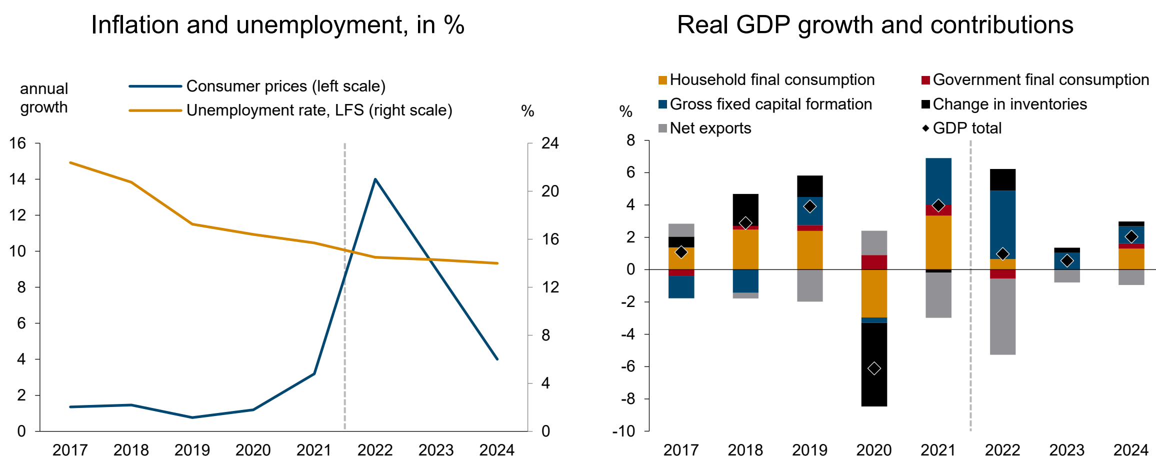
Source: wiiw Databases incorporating national statistics. Forecasts by wiiw.

NORTH MACEDONIA: Perfect storm brewing

BRANIMIR JOVANOVIĆ

Inflation is out of control and is eating into real incomes. Soaring global electricity prices are taking an additional toll, as some big industrial plants may be forced to close over the winter. Monetary and fiscal policies are becoming more and more restrictive, further crippling the economy. On top of that comes a possible recession in Germany, which takes half of all Macedonian exports.

Figure 6.15 / North Macedonia: Main macroeconomic indicators



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

The inflation genie is out of the bottle and the government has so far failed to get it back in. In August, inflation reached 16.8%, the highest since hyper-inflationary 1994. The main driver was foodstuffs, whose prices rose by 22.5%. Transport and housing followed, with increases of 19.3% and 18.2%, respectively. The government has been trying to tame inflation by imposing limits on the sales margin that companies can charge on basic foodstuffs, but the measure, in force since March 2022, has proved totally ineffective.

Because of inflation, real wages are in freefall, despite their nominal growth. In nominal terms, the average net wage in the country in the month of July grew by 11.5% year on year; but in real terms, it declined by 3.9%. Since the 18% rise in the minimum wage at the start of the year, the government has done nothing to prop up wages. It even rejected the idea of indexing other public-sector wages to the new minimum wage, which led to strikes and protests over the summer.

This all made for only lukewarm economic activity in the first half of the year. GDP grew by 2.4% in Q1 and by 2.8% in Q2 – among the lowest in the whole CESEE region. What growth did occur was driven by investment: the increase of 42% in real terms (!) in the first half of the year was certainly impressive, but was mainly due to the previous year's low base. It was also followed by a surge in imports: up 25% over the same period (again in real terms), they fully offset the growth in investment. Among the other components, household consumption grew by a solid 4.5%, reflecting a post-pandemic recovery, while government consumption declined by 3.4%, due to the fiscal problems the country is facing.

The current account deficit widened significantly under pressure from high food and energy prices. In the first half of the year, it reached 10.3% of GDP, the highest for 12 years. Strong foreign direct investment (FDI) inflows helped maintain the external balance: they grew by 15% year on year in nominal terms in the first half of the year to reach 4% of GDP, which is high for the country. Remittances (proxied by 'secondary income' in the balance of payments accounts) grew even more, by 24%, providing a lifebelt for many households.

But the real problems seem to have emerged only in the third quarter of the year. Industrial production in July declined by 5% year on year, after growth of 2.5% in the first six months. Meanwhile, retail trade declined by 4.5%, having grown by 2.6% in the first half year.

Despite the tough economic times, monetary policy is not providing any support; quite the reverse – it is getting more and more restrictive. The central bank has hiked its interest rate five times since April, to 3% in September (from the earlier 1.25%). Bank interest rates have already started rising because of this, though still only marginally. The growth in credit to the private sector has started to wilt, from 9.9% in April to 9.7% in July (in nominal terms), with the deceleration evident in both the corporate and the household sector. While the slowdown is still small, it is likely to get bigger, especially as monetary policies take some time to filter through.

Fiscal policy has not been very supportive either. The budget deficit for the first half of the year was 2.6% of GDP, which was just half of the planned deficit of 5.3%. Despite the buoyant revenues brought about by inflation (total budget receipts grew by 2% year on year in the first seven months, in real terms), government spending has been very weak. Total budget spending, in real terms, declined by 7% year on year in the first seven months. This slide was especially evident in public investment, which declined by 20% year on year over the same period, in real terms. Public debt declined from 61% of GDP at the end of 2021 to 56% at the end of June 2022, but this was entirely due to the inflation, which raised the nominal GDP.

The government is having a hard time borrowing on the markets. It announced in May that it was carving out a deal with the International Monetary Fund, but to date nothing has come of that. It managed to borrow EUR 250m (2% of GDP) in September, in the form of registered bonds (*Namensschuldverschreibungen*) sold to German investors. But this falls far short of the external financing requirements of the budget adopted, which exceed EUR 1bn (8% of GDP). A tax reform has been announced, starting from 2023, but that does not envisage the introduction of a progressive tax, focusing instead on taxing companies' reinvested earnings and heaping social contributions on the self-employed. The additional revenues from the reform are estimated at EUR 50m (0.4% of GDP), which is clearly inadequate.

On top of all that comes the energy crisis, which is especially challenging for North Macedonia. The country does not depend too much on gas – only 14% of its total energy demand is for gas, which is among the lowest figures in CESEE. But as of early October, it is still unclear whether the capital city will have centrally supplied heating in the coming winter. Furthermore, the country imports around a third of its electricity requirements, which is the highest of all CESEE countries. With electricity prices soaring, the government is having difficulty finding affordable power. It tried to reach a deal with some neighbouring countries, but the high prices involved meant that none of the attempts has been successful. The cost of electricity for households and small companies is capped, but bigger companies have to pay market prices: given the surge in prices, they may be forced to close for a while. Some big industrial plants have already announced temporary closures during the winter.

A further problem is the country's heavy reliance on exports to Germany, which could be painful if there is energy rationing in Germany in the coming months. Almost half of the country's exports (47% in 2021) go to Germany – a figure that is far and away the highest of all the CESEE countries. Exports to Germany account for 28% of North Macedonia's GDP, meaning that a recession in Germany would, almost inevitably, imply a recession in North Macedonia.

The dire economic situation will have severe social impacts as well. The proportion of people at risk of poverty or social exclusion in North Macedonia stands at around 40%. With a current poverty rate of 22%, this means that an additional 18% of the population could now easily fall into poverty because of the crisis. Absolute poverty in the country – defined as having to live on less than USD 2.15 per day (based on 2017 purchasing power parities) – stands at 3.4%, according to the latest available data. That figure could easily escalate now, given that the government is not taking any particular measures to protect the poor.

The upshot of all this is that we now take a gloomier view of the coming period than three months ago. As far as GDP growth is concerned, we keep the forecast for 2022 unchanged at 1%, which means that for the second half of the year we are forecasting a slight decline in GDP. For 2023, we now forecast GDP growth of 0.6%, which is a downward revision of almost 2 percentage (pp) points compared to the previous forecast.

Our current view on inflation is that it will be much higher and much more persistent than previously thought. Specifically, we now forecast that inflation in 2022 will average 14% for the whole year (3 pp above our summer forecast). For 2023, we forecast inflation of 9% – again 3 pp higher than was anticipated three months ago.

Table 6.15 / North Macedonia: Selected economic indicators

	2019	2020	2021 [1]	2021	2022	2022	2023	2024
				January-June			Forecast	
Population, th pers., average [2]	2,077	2,073	1,837	.	.	1,827	1,817	1,807
Gross domestic product, MKD bn, nom.	692.7	655.9	723.2	333	384	832	912	968
annual change in % (real)	3.9	-6.1	4.0	5.5	2.6	1.0	0.6	2.0
GDP/capita (EUR at PPP)	11,940	11,170	13,450	.	.	.	.	.
Consumption of households, MKD bn, nom.	447.1	434.9	469.3	228	259	.	.	.
annual change in % (real)	3.7	-4.6	5.0	6.0	4.4	1.0	0.0	2.0
Gross fixed capital form., MKD bn, nom.	145.8	144.8	191.4	.	.	.	.	.
annual change in % (real)	8.7	-1.6	13.0	.	.	16.0	4.0	4.0
Gross industrial production [3]								
annual change in % (real)	3.7	-9.6	1.4	6.6	2.5	1.0	0.5	2.0
Gross agricultural production [4]								
annual change in % (real)	-5.4	1.7	-1.2	.	.	.	.	.
Construction industry								
annual change in % (real)	3.8	1.4	-11.4	-6.1	-5.5	.	.	.
Employed persons, LFS, th, average [5]	797.7	794.9	795.1	794	693	695	700	710
annual change in %	5.1	-0.3	0.0	-1.0	.	.	0.5	1.0
Unemployed persons, LFS, th, average [5]	166.4	155.9	147.9	150	119	120	120	120
Unemployment rate, LFS, in %, average [5]	17.3	16.4	15.7	16.0	14.7	14.5	14.3	14.0
Reg. unemployment rate, in %, eop	19.6	25.8	19.7	20.9	17.6	.	.	.
Average monthly gross wages, MKD	37,446	40,566	42,887	42,386	46,237	46,900	50,100	52,600
annual change in % (real, gross)	4.3	7.0	2.4	3.9	-0.8	-4.0	-2.0	1.0
Average monthly net wages, MKD	25,213	27,182	28,718	28,390	30,950	31,400	33,500	35,200
annual change in % (real, net)	3.1	6.5	2.3	3.8	-0.9	-4.0	-2.0	1.0
Consumer prices, % p.a.	0.8	1.2	3.2	2.4	10.0	14.0	9.0	4.0
Producer prices in industry, % p.a.	2.1	0.6	11.1	7.0	19.5	17.5	5.0	3.0
General governm. budget, nat. def., % of GDP								
Revenues	31.4	30.5	32.3	30.4	30.3	30.0	30.5	31.0
Expenditures	33.5	38.9	37.7	35.6	33.0	33.0	32.5	32.5
Deficit (-) / surplus (+)	-2.1	-8.3	-5.4	-5.2	-2.7	-3.0	-2.0	-1.5
General gov. gross debt, nat. def., % of GDP	40.4	51.9	51.8	54.7	45.2	50.0	51.0	52.0
Stock of loans of non-fin. private sector, % p.a.	6.1	4.6	8.2	5.0	9.9	.	.	
Non-performing loans (NPL), in %, eop	4.6	3.3	3.2	3.4	3.2	.	.	
Central bank policy rate, %, p.a., eop [6]	2.25	1.50	1.25	1.25	2.00	3.50	3.00	2.50
Current account, EUR m	-335	-318	-366	-144	-629	-1,240	-1,260	-1,150
Current account, % of GDP	-3.0	-3.0	-3.1	-2.7	-10.1	-9.2	-8.5	-7.3
Exports of goods, BOP, EUR m	5,347	4,820	6,000	2,926	3,554	7,380	8,270	9,100
annual change in %	9.5	-9.9	24.5	45.2	21.5	23.0	12.0	10.0
Imports of goods, BOP, EUR m	7,296	6,623	8,371	3,995	5,301	10,880	12,190	13,290
annual change in %	10.2	-9.2	26.4	37.2	32.7	30.0	12.0	9.0
Exports of services, BOP, EUR m	1,625	1,445	1,744	779	998	2,210	2,480	2,730
annual change in %	2.8	-11.1	20.7	15.4	28.2	27.0	12.0	10.0
Imports of services, BOP, EUR m	1,289	1,021	1,248	458	673	1,620	1,780	1,960
annual change in %	6.6	-20.8	22.2	12.1	47.1	30.0	10.0	10.0
FDI liabilities, EUR m	488	28	575	533	633	800	.	.
FDI assets, EUR m	125	-127	187	349	386	300	.	.
Gross reserves of CB excl. gold, EUR m	2,961	3,019	3,288	3,704	2,734	.	.	.
Gross external debt, EUR m	8,154	8,536	9,577	10,165	10,379	10,800	12,600	13,700
Gross external debt, % of GDP	72.4	80.3	81.6	86.6	76.7	80.0	85.0	87.0
Average exchange rate MKD/EUR	61.50	61.67	61.63	61.6	61.7	61.5	61.5	61.5

1) Preliminary. - 2) From 2021 according to census September 2021. - 3) Enterprises with 10 and more employees. - 4) wiiw estimate in 2021. - 5) From 2022 according to Census September 2021. - 6) Central Bank bills (28-days).

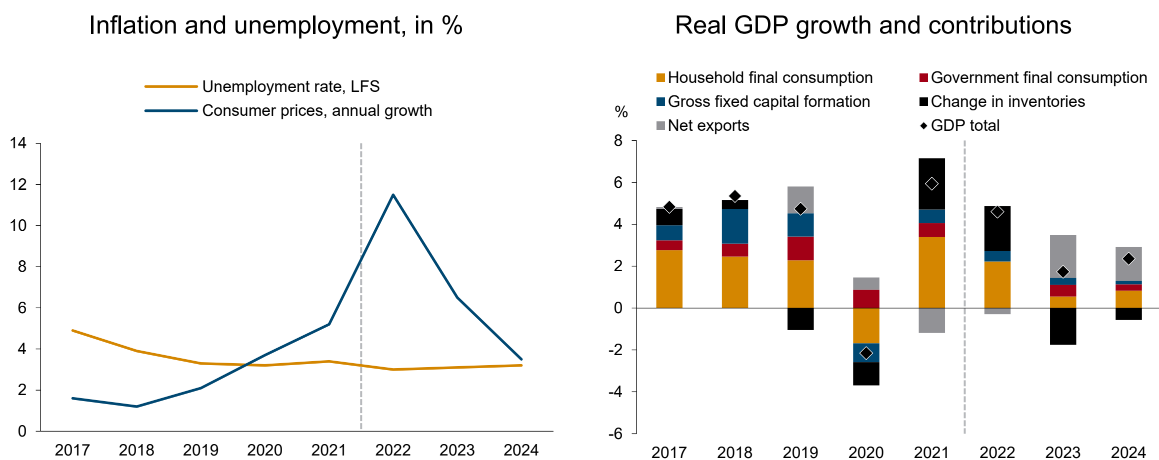
Source: wiiw Databases incorporating national statistics. Forecasts by wiiw.

POLAND: Short of energy

ADAM ŻURAWSKI

The Polish economy has proved surprisingly resilient so far. But growth will slow in the second half of 2022 and beyond. Rising interest rates are affecting consumption and investment, while inflation is eroding the real value of current wages. If the full disbursement of EU recovery funds continues to be delayed, public spending may become less lavish than before. To cap it all, essential imports such as energy and metals may be in short supply, or else become prohibitively expensive.

Figure 6.16 / Poland: Main macroeconomic indicators



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

GDP grew by 5.5%, year on year, in Q2 2022, down from 8.5% in Q1. The slowdown was due to much weaker growth in inventories, whose contribution to overall growth fell from 7.7 percentage points (pp) to 1.9 pp. Household consumption kept growing at over 6%, while gross fixed capital formation and exports speeded up appreciably. Public consumption hardly expanded. The contribution to growth of foreign trade improved from -3.8 pp in Q1 2022 to -1.2 pp in Q2. Poland's economy would seem to be more resilient than those of its partners – perhaps the Poles are more 'enterprising spirits' than others.

The data available for August 2022 indicate some acceleration of output in the industrial and construction sectors. This belies the recession fears widely suggested by earlier estimates. Apparently, industry (and manufacturing, in particular) no longer suffers from shortages of critical components or labour. On the other hand, producer prices in industry continue to rise at a double-digit rate (primarily on account of the soaring cost of energy). This may constitute a drag on further output

growth in those sectors that are heavily reliant on industrial inputs and that lack the scope to pass costs on to final customers.

The labour market is in good shape, unemployment is low and falling, while employment in the corporate sector keeps rising. Close to 400,000 Ukrainians have been registered as employees, while only a tiny number are recorded as unemployed. In fact, the unregistered employment of Ukrainians is likely to be quite high, too. Wages generally trail slightly behind inflation, implying a gentle deterioration in the real incomes of wage-earning households. Unit labour costs have tended to decline somewhat as labour productivity improves. This further benefits the profitability of the corporate sector. Thus, inflation serves the business sector quite well. Firms co-owned by the public authorities (fuel and power companies) are reaping extraordinary profits, which then partly find their way back to the state.

Energy shortages are widely feared. The problems to do with the soaring cost of energy are now overshadowed by concerns about its physical availability. Supplies may well turn out to be inadequate this coming winter, and a number of critical services may be seriously affected. In addition, at present a few million households that rely on anthracite for heating must fear the worst. The coal shortage may be put down to the ban on imports from Russia that was introduced well before it became EU policy. But it is a sign of mismanagement: while boasting that Poland has anthracite deposits sufficient for another 200 years, still the government is unable to guarantee adequate supplies for 200 days. The offer of subsidies to help households (and communal establishments) that consume expensive forms of energy, or a definite cap on the price of such sources would, of course, be welcome – provided the sources of energy are actually physically available.

Inflation is still regarded as a main concern – particularly as it rather undermines the government's claim of economic competence. In fact, global factors (energy and food prices) are the main culprits, while the state-owned energy and fuel cartels play a secondary role (through exorbitant mark-ups). Nonetheless, the government is trying to shield consumers by means of 'temporary' cuts to VAT and excise tax rates, and through a plethora of measures that include subsidies for households and firms suffering from the exorbitant cost of energy or the higher costs of servicing their bank loans.

The fiscal system is in disarray. The much-trumpeted reform of the personal income tax system, which promised greater tax progressivity and which took effect on 1 January 2022, has proved a complete fiasco. All attempts to patch it up failed, as its internal inconsistencies became all too apparent, so that an entirely new system had to be introduced in the middle of the year. In all likelihood, it will result in a further reduction in total personal income tax revenue, and thus increase the public-sector deficit (estimated at around or even above 4% of GDP in 2022, up from about 1.9% in 2021). In addition, the government is now pondering the idea of levying an extra tax on highly profitable firms. This may apply to all (larger) firms – even those outside the energy sector. Clearly, this could improve the overall fiscal balance of the public sector in the short term. But a burden placed indiscriminately on all firms is likely to cause grave damage to the economy in the longer term.

Monetary policy is being tightened, but this will have little impact on inflation. For most of 2021, the National Bank of Poland (NBP) stoically turned a blind eye to rising inflation. Only in October, as the clamour of concern from the opposition and 'experts' became too hard to ignore, did it raise its main interest rate from 0.1% to 0.5%. Further hikes have followed. Now the rate stands at 6.75%, and it looks as though the rising trend will continue, albeit gradually. Naturally, monetary tightening can do little (if

anything) to bring down inflation (which is primarily imported and internally generated by the domestic state-owned oligopolies active in the energy sector), at least over a meaningful time horizon. Quite the contrary, higher interest rates are likely to support cost-push in firms that depend on credit to finance their working capital. Above all, higher interest rates will most probably adversely affect investment and consumer spending. Contrary to expectations, higher rates are unlikely to have much of an impact on the PLN exchange rate, which has been quite ‘weak’ recently (largely for geopolitical reasons).

The government does not conceal its fairly illiberal inclinations in terms of the treatment of the media, the judicial system and sexual minorities, the rights of women, the alleged bugging of the opposition, etc. Though hostile to Russia, the government is friendly towards Mr Orbán’s regime in Hungary, and never tires of castigating ‘Brussels’, Germany, France and the ‘liberal West’ as a whole. Despite the war, its relationship with the European Commission has not improved at all. The national recovery plan has not been approved by Brussels, which is still waiting (probably in vain) for the dissolution of the unconstitutional bodies created to ‘discipline’ Poland’s judiciary. The lower (or absent) transfers of EU money will aggravate public finances (or else reduce the scale of spending).

A slowdown in growth is on the cards. The economy, which has proved surprisingly resilient so far, is now set to slow down in the second half of 2022 and throughout 2023. Apart from the negative impact of rising interest rates on consumption and investment, inflation is actively eroding the purchasing power of current incomes and accumulated household wealth. Public consumption is likely to stagnate, while household consumption will be anaemic. Only in 2024 are the reasons for weak growth likely to be mitigated somewhat.

Table 6.16 / Poland: Selected economic indicators

	2019	2020	2021 1)	2021	2022	2022	2023	2024
				January-June			Forecast	
Population, th pers., average	37,965	37,899	37,747	38,162	38,000	38,360	38,360	38,370
Gross domestic product, PLN bn, nom.	2,293	2,339	2,622	1,212	1,407	2,990	3,220	3,410
annual change in % (real)	4.7	-2.2	5.9	4.7	6.9	4.6	1.7	2.4
GDP/capita (EUR at PPP)	22,740	22,760	24,960	.	.	.	.	.
Consumption of households, PLN bn, nom.	1,299	1,303	1,458	704	838	.	.	.
annual change in % (real)	4.0	-3.0	6.1	6.0	6.6	4.0	1.0	1.5
Gross fixed capital form., PLN bn, nom.	420	403	434	169	194	.	.	.
annual change in % (real)	6.1	-4.9	3.8	1.0	6.3	3.0	2.0	1.0
Gross industrial production (sales) 2)								
annual change in % (real)	4.1	-1.2	14.5	17.8	14.7	10.0	3.0	5.0
Gross agricultural production								
annual change in % (real)	-0.9	8.0	-0.7	.	.	.	.	.
Construction industry 2)								
annual change in % (real)	3.7	-3.5	1.5	-4.4	15.0	.	.	.
Employed persons, LFS, th, average 3)	16,461	16,441	16,656	16,515	16,742	16,810	16,840	16,890
annual change in %	-0.1	-0.1	2.6	2.3	1.4	0.9	0.2	0.3
Unemployed persons, LFS, th, average 3)	558	537	580	647	495	520	540	560
Unemployment rate, LFS, in %, average 3)	3.3	3.2	3.4	3.8	2.9	3.0	3.1	3.2
Reg. unemployment rate, in %, eop	5.2	6.3	5.4	6.0	4.9	.	.	.
Average monthly gross wages, PLN 4)	4,920	5,226	5,663	5,713	6,422	6,500	7,160	7,670
annual change in % (real, gross)	4.8	2.9	3.0	3.4	1.3	3.0	3.5	3.5
Consumer prices (HICP), % p.a.	2.1	3.7	5.2	4.2	10.9	11.5	6.5	3.5
Producer prices in industry, % p.a.	1.3	-0.5	8.1	4.6	22.0	1.0	8.5	5.5
General governm. budget, EU def., % of GDP								
Revenues	41.0	41.3	42.3	.	.	41.0	40.6	40.5
Expenditures	41.8	48.2	44.2	.	.	45.0	44.0	43.5
Net lending (+) / net borrowing (-)	-0.7	-6.9	-1.9	.	.	-4.0	-3.4	-3.0
General gov. gross debt, EU def., % of GDP	45.6	57.1	53.8	.	.	51.5	49.0	48.0
Stock of loans of non-fin. private sector, % p.a.	4.7	0.4	4.6	0.5	5.7	.	.	.
Non-performing loans (NPL), in %, eop	6.7	7.0	5.8	6.5	5.6	.	.	.
Central bank policy rate, % p.a., eop 5)	1.50	0.10	1.75	0.10	6.00	7.00	6.25	5.00
Current account, EUR m 6)	2,520	15,293	-4,129	4,556	-15,315	-10,300	-1,400	9,200
Current account, % of GDP 6)	0.5	2.9	-0.7	1.7	-5.0	-1.6	-0.2	1.2
Exports of goods, BOP, EUR m 6)	232,930	236,002	280,330	135,639	160,240	317,300	346,500	372,800
annual change in %	7.3	1.3	18.8	24.7	18.1	13.2	9.2	7.6
Imports of goods, BOP, EUR m 6)	231,403	223,523	280,798	130,742	171,331	324,900	343,100	360,300
annual change in %	3.6	-3.4	25.6	25.5	31.0	15.7	5.6	5.0
Exports of services, BOP, EUR m 6)	62,749	58,056	68,160	31,319	37,087	76,300	81,600	86,100
annual change in %	8.6	-7.5	17.4	12.6	18.4	12.0	7.0	5.5
Imports of services, BOP, EUR m 6)	38,883	35,220	41,742	18,149	22,111	48,000	50,400	53,400
annual change in %	6.5	-9.4	18.5	10.9	21.8	15.0	5.0	6.0
FDI liabilities, EUR m 6)	14,976	15,192	28,420	13,810	21,234	24,000	.	.
FDI assets, EUR m 6)	4,593	4,055	7,090	3,594	1,766	6,000	.	.
Gross reserves of CB excl. gold, EUR m	104,526	114,299	134,654	123,090	134,943	.	.	.
Gross external debt, EUR m 6)	316,730	307,412	322,710	311,567	334,636	321,500	322,000	326,200
Gross external debt, % of GDP 6)	59.4	58.4	56.2	54.2	52.0	50.0	46.0	44.0
Average exchange rate PLN/EUR	4.2976	4.4430	4.5652	4.5366	4.6329	4.65	4.60	4.60

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

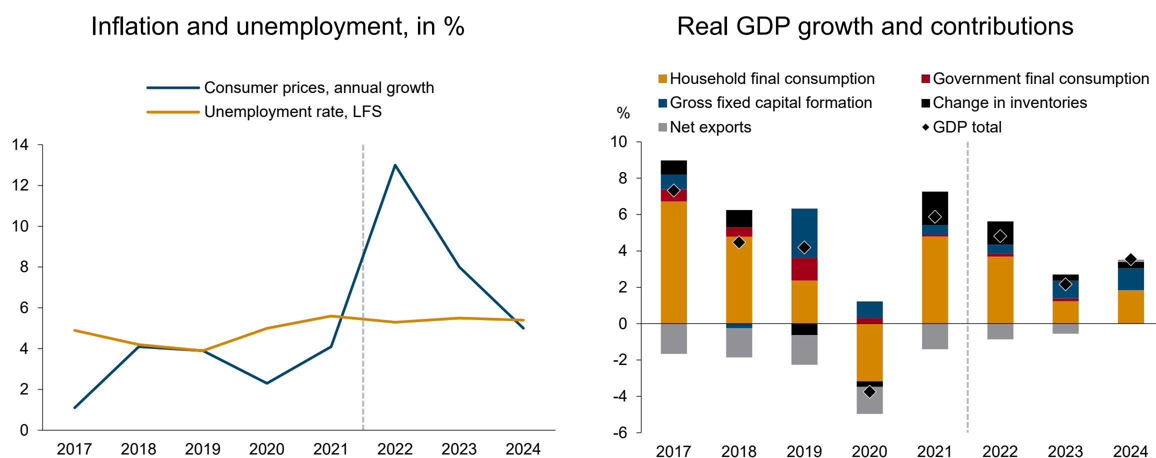
Source: wiiw Databases incorporating Eurostat and national statistics. Forecasts by wiiw.

ROMANIA: EU funds help to weather the storm

GÁBOR HUNYA

Economic growth in Romania was among the most rapid in the EU in 2022, driven by household consumption and accumulation of inventories. However, future prospects are overshadowed by declining real wages and tightening fiscal policy. Still, with 2.2% growth in 2023, Romania will grow faster than most regional peers. The inflow of foreign direct investment (FDI) and EU funds will strengthen Romania's chances of balancing the fiscal and current account deficits and will maintain its ability to invest. The country's relatively modest dependence on energy imports from Russia also limits its vulnerability.

Figure 6.17 / Romania: Main macroeconomic indicators



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

Romania experienced rapid economic growth in Q2 2022 of 5.3% year on year, or 2.1% against Q1 2022 – the second fastest in the EU, after the Netherlands. Household consumption and change in inventories made the largest positive contribution to growth. Gross fixed capital formation's contribution was modest, while that of net exports was very negative. Drivers of growth were retail trade, info-communications and other services that are still recovering from the COVID-19-related recession. But agriculture and industrial production stagnated in Q2 2022, while residential construction fell, showing that the economy is losing steam.

Employment rose in the first half year, almost entirely on account of hiring in the private sector. Minimum wages in agriculture and construction were hiked to mitigate the labour shortage. But in the public sector, no hiring or wage adjustments have been allowed since July, which has placed a burden

on employers and employees alike. The unemployment rate fell marginally, but remained at above 5%. Average gross nominal wages recorded double-digit annual growth without, however, keeping pace with inflation. Declining real wages will persist in the coming months, thus reducing consumption spending.

The consumer price index (CPI) rose month by month in the first half of 2022, but stabilised at 15% in Q3. As in most other European countries, energy and foodstuffs have been the main drivers. Inflation should start cooling in Q4, on the back of energy price caps and base effects. The National Bank of Romania's (BNR) monetary policy remains lax: the policy rate was increased to only 5.5% in August, with the argument that core inflation is much lower than the CPI and stability is provided by the exchange rate. The BNR is pursuing a policy of managed flotation, making interventions on the currency market when it considers it necessary to keep the exchange rate stable and contain inflation. The money market interest rate, more important than the policy rate, stood at 8-8.5% in September, similar to the 10-year government bond yields. Expensive financing of the fiscal deficit of about 6.5% of GDP is increasingly becoming a burden, although the debt-to-GDP ratio is still below 50%.

The BNR estimates that the current rate of inflation would be not 15%, but 21% had the government not introduced corrective measures to protect the population. Petrol prices have been kept under control through subsidies, but have not been capped. From November 2021, price caps were applied to gas and power bills for households, small businesses, hospitals, schools and public institutions – up to certain monthly consumption levels. Suppliers were compensated for the price difference, while producers' windfall profits were taxed. In a new scheme put in place in September 2022 and due to last for one year, the monthly consumption levels that benefit from the price caps have been reduced by 15%, putting an extra burden on consumers. It also stipulates a contribution tax to be paid to an energy transition fund by not only producers, but also traders in energy. The capping scheme is expected to cost about 0.8% of GDP and should be totally covered by the new levies.

The potential shortage of natural gas could be a risk to the economy and the population during the winter. In 2021, the country's dependence on oil imports stood at 69%, and for natural gas – 28%. Imports of gas from Russia doubled to 3.5bn m^3 last year, via intermediaries through TurkStream (as Romania has no direct contract with Gazprom). Domestic production was in decline until last year, although it should increase in the future. Exploitation of the first offshore gas field has started and will deliver 1bn m^3 in 2023. An onshore project of similar capacity is due to start in two years' time. Besides, cross-border inter-connections built in the last couple of years will allow a diversification of imports and will open transit routes for neighbouring countries. The connection to the Trans-Anatolian gas pipeline will be ready later this year, at which point imports from Azerbaijan could commence. Of the country's crude oil imports, only a third came from Russia in 2021, and several refineries have already managed to find other suppliers.

The current account deficit saw a rapid deterioration in Q2, mainly due to energy imports and worsening terms of trade. Exports also expanded, mainly of food and agricultural products. As an effect of the war in the neighbourhood, Romanian salt exports registered a significant increase, filling the gap left by Ukraine. Trade in services grew even faster than in goods. Computer services are a booming export sector, and transport services exports also expanded, due to trade routes diverted from Ukraine. The primary income balance deteriorated on account of outflows of investors' income, partly counterbalanced by reinvestments as FDI inflows. Net FDI in 2022 is expected to surpass last year's

figure and provides an important support in financing the current account deficit, which will reach almost 10% of GDP. Beyond private capital inflows, external financing relies massively on EU funds.

The timely inflow of EU funds is a major support to economic stability and growth. The European Commission has given a positive assessment of Romania's first payment request under the Recovery and Resilience Facility (RRF) to the tune of EUR 2.6bn, of which EUR 1.8bn is in the form of grants and EUR 0.8bn in loans. This comes on top of EUR 3.7bn prefinancing that the country received late last year. These funds will be available for a series of investment projects mainly in the transport infrastructure and the health and education sectors. There will also be funds to hand to support private investment in selected sectors, regions, and small and medium-sized enterprises. The approval of the Commission comes in response to the request for payment that Romania submitted in June 2022, when it reported progress on the milestones and targets set as conditions. The milestones referred to the progress of reforms regarding sustainable transport, decarbonisation, road safety, the electricity market, the improvement of fiscal administration and the intensification of the fight against corruption, among others. A request for the next RRF tranche of EUR 3.2bn is to be submitted in October, provided Romania can report progress on another 24 milestones. The administrative and legislative capacity may not be in place to meet all the conditions, but some delay in disbursement would not be detrimental. To cover the needs of national co-financing, the government has applied for a loan of EUR 4bn from the European Investment Bank. Back in June, the bank transferred EUR 1.4bn to Romania under the Modernisation Fund scheme to finance strategic projects in the country's energy sector.

There are uncertainties and risks associated with the fiscal policy. Even before the COVID crisis, the government was under the EU excessive deficit procedure, owing to its lax fiscal policy. The government therefore has its eyes set on a deficit in 2022 of 6.5% of GDP, lower than last year. The chances appear good that the target will be reached, thanks to higher-than-planned revenues triggered by upbeat consumption in the first half year and tighter policy measures. Fiscal measures introduced on 1 July stipulate a reduction in budget expenditure of at least 10% over the remainder of the year, except for the purposes of investment, salaries, pensions and social assistance, with a net effect of about 0.5% of GDP. As for social measures, the debt service moratorium was extended and the lowest pensions have been topped up with a one-off payment. The future fiscal deficit depends on the government's ability to finance the energy price subsidies by taxing windfall profits and to control wage demands. The social democrats in the governing grand coalition would prefer to boost minimum wages and pensions, but the liberals (who have provided the current prime minister) are trying to keep expenditure under greater control. In May 2023, when the position of prime minister switches to the social democrats, fiscal policy may loosen.

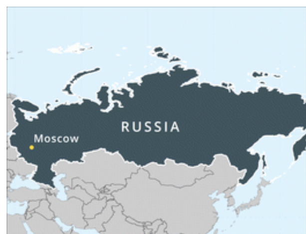
Growth will slow down in the second half of 2022 and beyond. Declining real wages and the burden of energy prices will weigh heavily on the population, despite the price caps and other corrective measures. GDP may stagnate in Q1 2023, to be followed by a modest recovery. The negative effects of inflation on consumption will dominate, while investments may pick up, financed by EU funds. A slowdown in demand on the main foreign markets will depress the export sector. Putting the effects of these processes on GDP growth into numbers, the wiiw forecast is revised upwards for 2022 (by 1.3 percentage points, to 4.8%); downwards for 2023 (from 3.5% to 2.2%); and also downwards for 2024 (from 4.5% to 3.5%). Should energy prices stabilise, economic growth could pull off a welcome surprise. The current account and fiscal deficits will not cause problems, so long as the inflow of EU funds is assured.

Table 6.17 / Romania: Selected economic indicators

	2019	2020	2021 1)	2021	2022	2022	2023	2024
				January-June			Forecast	
Population, th pers., average	19,372	19,265	19,120	.	.	19,000	18,900	18,800
Gross domestic product, RON bn, nom.	1,059.0	1,058.9	1,181.9	503.2	609.0	1,420	1,600	1,760
annual change in % (real)	4.2	-3.7	5.9	7.9	5.8	4.8	2.2	3.5
GDP/capita (EUR at PPP)	21,670	21,500	23,530	.	.	.	.	.
Consumption of households, RON bn, nom.	655.8	637.3	726.1	309.3	378.2	.	.	.
annual change in % (real)	3.8	-5.1	8.0	5.9	7.6	6.0	2.0	3.0
Gross fixed capital form., RON bn, nom.	239.4	252.5	285.0	110.7	136.7	.	.	.
annual change in % (real)	12.9	4.1	2.3	12.2	2.2	2.0	4.0	5.0
Gross industrial production 2)								
annual change in % (real)	-2.3	-9.2	7.1	16.1	-0.9	-2.0	1.0	4.0
Gross agricultural production								
annual change in % (real)	-3.8	-15.4	16.9	.	.	.	.	.
Construction industry 2)								
annual change in % (real)	27.6	15.9	-0.6	5.9	4.4	.	.	.
Employed persons, LFS, th, average 3)	8,680	8,521	7,756	7,740	7,815	7,830	7,830	7,830
annual change in %	-0.1	-1.8	0.7	0.7	1.0	1.0	0.0	0.0
Unemployed persons, LFS, th, average 3)	353	452	459	457	467	440	460	450
Unemployment rate, LFS, in %, average 3)	3.9	5.0	5.6	5.6	5.7	5.3	5.5	5.4
Reg. unemployment rate, in %, eop	3.0	3.4	2.7	3.0	2.6	.	.	.
Average monthly gross wages, RON 4)5)	4,853	5,213	5,535	5,685	6,284	6,200	6,800	7,300
annual change in % (real, gross)	7.3	4.7	1.1	4.4	-1.1	-1.0	1.0	2.0
Average monthly net wages, RON 5)	2,986	3,217	3,416	3,484	3,871	3,800	4,100	4,400
annual change in % (real, net)	8.8	4.9	1.1	4.5	-0.5	-1.0	1.0	2.0
Consumer prices (HICP), % p.a.	3.9	2.3	4.1	2.7	10.3	13.0	8.0	5.0
Producer prices in industry, % p.a.	3.8	0.0	14.9	6.1	46.7	45.0	15.0	5.0
General governm. budget, EU def., % of GDP								
Revenues	31.9	32.7	32.8	.	.	34.0	33.0	33.0
Expenditures	36.2	42.0	39.9	.	.	40.5	39.0	38.5
Net lending (+) / net borrowing (-)	-4.3	-9.3	-7.1	.	.	-6.5	-6.0	-5.5
General gov. gross debt, EU def., % of GDP	35.3	47.2	48.8	.	.	49.5	50.0	50.0
Stock of loans of non-fin. private sector, % p.a.	7.0	5.0	14.3	10.9	16.6	.	.	.
Non-performing loans (NPL), in %, eop	4.1	3.8	3.4	3.8	3.0	.	.	.
Central bank policy rate, % p.a., eop 6)	2.50	1.50	1.75	1.25	3.75	5.75	4.50	4.00
Current account, EUR m	-10,906	-10,893	-16,723	-7,197	-16,279	-26,400	-27,900	-27,200
Current account, % of GDP	-4.9	-5.0	-7.0	-7.0	-13.2	-9.2	-8.6	-7.7
Exports of goods, BOP, EUR m	63,056	57,532	70,170	34,049	41,793	84,200	90,100	97,300
annual change in %	2.0	-8.8	22.0	28.8	22.7	20.0	7.0	8.0
Imports of goods, BOP, EUR m	80,900	76,476	93,324	44,306	56,214	116,700	127,200	136,100
annual change in %	4.9	-5.5	22.0	25.5	26.9	25.0	9.0	7.0
Exports of services, BOP, EUR m	27,058	23,764	27,909	12,508	16,730	34,900	38,400	43,000
annual change in %	13.7	-12.2	17.4	9.4	33.8	25.0	10.0	12.0
Imports of services, BOP, EUR m	18,408	14,321	18,343	8,242	11,078	23,800	26,700	29,900
annual change in %	19.3	-22.2	28.1	17.6	34.4	30.0	12.0	12.0
FDI liabilities, EUR m	6,574	3,056	8,813	4,210	6,370	11,000	.	.
FDI assets, EUR m	1,721	112	1,508	588	1,994	3,000	.	.
Gross reserves of CB excl. gold, EUR m	32,927	37,379	40,475	36,831	42,033	.	.	.
Gross external debt, EUR m	109,783	126,750	136,585	128,903	137,225	145,000	155,000	170,000
Gross external debt, % of GDP	49.2	57.9	56.9	53.7	47.6	50.3	48.0	48.1
Average exchange rate RON/EUR	4.7453	4.8383	4.9215	4.9014	4.9457	4.93	4.95	4.98

1) Preliminary. - 2) Enterprises with 4 and more employees. - 3) From 2021 the new LFS methodology is applied in line with the Integrated European Social Statistics Regulation (IESS). - 4) Including the employers' social security contribution. - 5) Half-year data refer to enterprises with 4 and more employees. - 6) One-week repo rate.

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

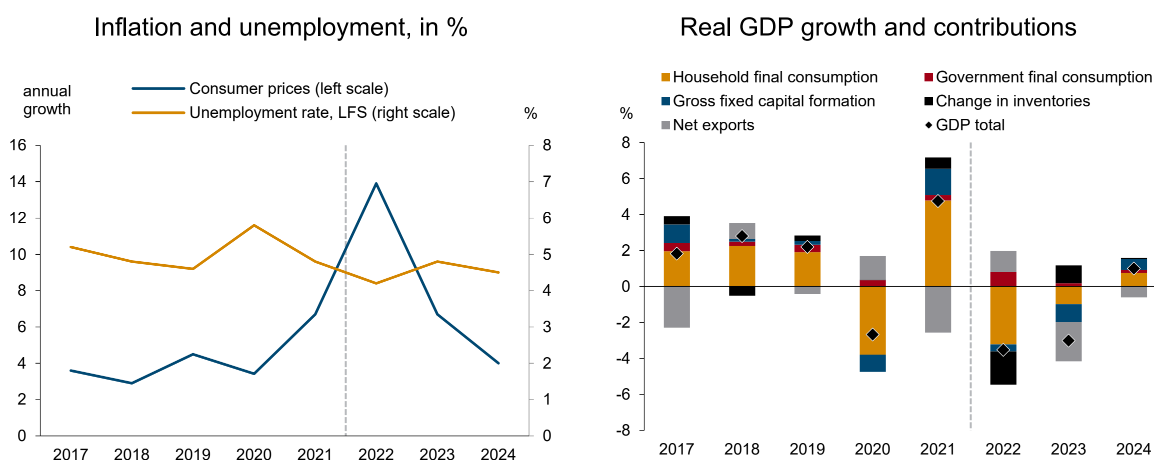


RUSSIA: The crisis in instalments

VASILY ASTROV

So far, the effects of Western sanctions on the economy have been generally milder than expected. By Q3 2022, the economy had partly adjusted to the 'new normal', thanks to high energy prices, trade reorientation towards Asia and increased military spending. However, with the newly announced partial mobilisation, another wave of the crisis looks to be on the cards. After an estimated decline of 3.5% in 2022, the economy is heading for another recession next year.

Figure 6.18 / Russia: Main macroeconomic indicators



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

The impact of Western sanctions on the Russian economy has been clearly felt, even if less than generally expected. It has become increasingly difficult to gain a comprehensive picture of the state of the Russian economy, since many statistical data have become patchy or are no longer published at all (including on foreign trade, foreign reserves, external debt, the energy sector and the government budget). Still, official statistics and anecdotal evidence suggest that the economy **has** been badly affected by Western sanctions, albeit less than expected. After still solid growth of 3.5% (year on year) in Q1, the economy slid into recession in Q2, with real GDP declining by 4.1%. The main drivers of recession were the downturn in private consumption (-5.5%) and the depletion of inventories. Public consumption was nearly flat (-0.4%), while net exports of goods and services contributed positively to growth (an estimated 1.7 percentage points (pp)), as imports suffered much more than exports. Gross capital formation plummeted by 13.8%, but gross fixed capital formation recorded an increase of 3.2%, partly on account of subsidized mortgage lending.

Industries directly exposed to Western sanctions have been hit the worst. In general, the worst affected were two types of industries: (i) export-oriented industries, which were directly affected by the Western sanctions, such as steel and timber;[21] and (ii) industries serving predominantly the domestic market that were largely foreign-owned and/or heavily dependent on imported parts and components, such as the automotive industry and factories producing household appliances. Other industries held up much better, and some reported increases in production. A similar diversity could be observed in services: half of the GDP decline in Q2 was on account of a single sector – wholesale and retail trade (-14%) – whereas construction, finance and public administration all reported solid growth.

Private consumption has suffered primarily on account of declining real wages and incomes, while the labour market has been generally resilient. Sharply rising inflation in the first few weeks of the war and sanctions meant that the annual dynamics of real wages turned negative from April – despite nominal wages continuing to rise by 10% or more. The high growth in nominal wages is partly to do with the general resilience of the labour market: unemployment (according to the Labour Force Survey) has remained at historically low levels of around 4% or below. However, the real picture is certainly not as rosy as the headline unemployment rate would suggest: 'hidden unemployment' is widespread, with firms typically cutting wages and salaries, pushing employees to take unpaid leave, and firing those over the age of retirement – rather than resorting to outright layoffs. Also, the very low level of unemployment benefits provides a strong incentive to take any job, rather than stay unemployed.

After initial sharp tightening, monetary policy has been markedly relaxed, in response to declining inflation. After an initial spike in March (of 7.6% against February), inflation was tamed very rapidly, and since May consumer prices have been essentially stable. Apart from the usual seasonal factors (falling price of food), price stability has been supported by the strong recovery of the rouble, which is now trading at above pre-war levels. In annual terms, inflation declined from 17.7% in April to 13.7% in September, allowing a marked relaxation of monetary policy. Since February, the policy rate has been cut six consecutive times, by a combined 12.5 pp. Standing at 7.5% at the time of writing, it is 2 pp below the pre-war level and – unlike before the war – is deep into negative territory in real terms.

Imports have been recovering on the back of the legalisation of 'parallel' imports and trade reorientation towards Asia. Trade sanctions, the departure of many Western companies and disruptions to cross-border payments led to a 23% decline in imports of goods and services in Q2 (year on year). 'Mirror statistics' from the country's main trading partners suggest that the bottom was probably reached in April, when merchandise imports plunged by half and imports from the West by two thirds or more. In response, the government drew up a list of 92 product categories that were eligible for 'parallel' imports, and this has helped with the partial revival of imports in subsequent months.[22] Nevertheless, as of July, imports were still an estimated 17% below the level of last year. Another factor that has facilitated recovery has been the trade reorientation towards Asia. Merchandise imports from China picked up by an estimated 22% year on year in July and by 26% in August, while those from Turkey – an important transit route for parallel imports – rose by 75% and 87%, respectively, in those two months. However, import recovery has so far been confined largely to consumer goods. Imports of investment goods in July were still an estimated 44% below last year's level – and from the EU, the fall was around 70%.

[21] Production of fertilisers suffered on account of Russia's own export restrictions.

[22] Parallel imports do not need to be authorised by producers and/or distributors, but they are not illegal per se.

Exports and the current account surplus surged on the back of high energy prices and the resilience of oil production in the face of sanctions. Since the start of the Ukraine war, oil prices have stayed at a fairly high level (though declining since mid-June), while oil production posted 3% growth in the first eight months of the year. In particular, Asian countries have been taking advantage of the price discount on Russian oil (although at the time of writing, the discount has narrowed to USD 15-20 per barrel, from some USD 30 in spring). In July, Russian total merchandise exports to India soared sixfold year on year; to Malaysia – by 2.5 times; to Turkey – by 78%; and to China – by 47%. Energy accounted for a large part of these increases. By contrast, gas exports dropped markedly in Q3, as supplies via the Nord Stream 1 pipeline were increasingly squeezed by Russia and were stopped altogether on 31 August (well before the explosions). Certain other export items (such as coal and metals) continued to suffer on account of Western sanctions. Overall, exports of goods and services increased by 27% year on year in Q2, so that the current account surplus tripled in January-August and will likely approach 13% of GDP for the whole year.

Many foreign companies have left Russia, which has contributed to its increasing economic isolation. By early September, of the 600 biggest foreign companies active in Russia, 34% had curtailed their operations, 15% had sold their assets and 7% had left their assets behind without selling them.[23] This trend reflects a multitude of factors, including concern among the companies for their public image, the sanctions, and logistical and payment disruptions. Anecdotal evidence suggests that the fear of potential nationalisation by Russia in response to the freezing of Russian assets in the West has also played a role. However, leaving Russia is not an easy task these days: selling Russian assets typically comes with a 70% discount,[24] while the withdrawal of Western investors from ‘strategic’ sectors, including energy and banking, was forbidden altogether by a presidential decree in August. The mass exodus of foreign firms contributed to a disastrous foreign direct investment (FDI) performance in the first half of the year, with FDI divestments of over USD 30bn, mirrored by a similar magnitude of divestments of Russian FDI abroad.

With rising expenditure on war, the days of fiscal surpluses are over. In the first eight months of 2022, federal government revenues picked up by 12.2% in nominal terms, while expenditure was up 19.5% – mainly on account of a sixfold rise in ‘other expenditure’, probably military related. With the economic recession deepening, the gap between revenue and expenditure will widen in the coming months, resulting in a likely budget deficit of 3% of GDP for the full year. Despite elevated expenditure and falling revenue, the federal budget for 2023 envisages a deficit of only 2% of GDP, which is to be attained thanks to increased taxation, particularly of the energy sector. However, the budget was prepared before the announcement of partial mobilisation and the annexation of the occupied Ukrainian territories of Donetsk, Luhansk, Kherson and Zaporizhzhia, and now appears quite unrealistic. Its financing will also become more challenging: while this year, the budget deficit should be covered by the National Welfare Fund (which stands at 8.9% of GDP), next year its financing will rely partly on domestic borrowing, which will become more expensive in the face of the heightened uncertainty.

By Q3, the economy had partly adjusted to the ‘new normal’, not least on the back of increased military spending. According to the estimates of the Ministry of Economic Development, the decline in GDP on an annual basis has been steadily moderating: from 5% in June to 4.3% in July and 4.1% in August, resulting in a recession of 1.5% in the first eight months. High-frequency data suggest that the

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[23] Companies with at least RUB 5.7bn market turnover in Russia, https://www.rbc.ru/economics/07/10/2022/633e94809a79475aa5d84f00

[24] Ibid.

dynamics of retail trade turnover became less negative, with an annual decline of 8.7% in July and 8.8% in August (compared to around 10% in Q2). Falling inflation contributed to a smaller decline in real wages, while credit expansion picked up markedly in response to monetary policy easing.[25] A good harvest contributed to a strong growth in agricultural production (+8.8% year on year in August), while the decline in industrial output almost came to a halt in August (-0.1%), thanks to the rising production of pharmaceuticals (+14.3%), 'fabricated metal products' (which includes weapons) (+16%), 'other machinery and equipment' (+9.1%) and metals (+4.1%). It is almost certain that at least some of these industries have benefited from increased military spending, which possibly hints at the forthcoming structural transformation of the economy towards the defence sector.

However, following the announcement of partial mobilisation, the economy is heading for another wave of crisis. The partial mobilisation announced on 21 September in response to a series of military defeats in Ukraine will likely deepen the economic recession in Q4 and remove some 0.5 pp of GDP growth for the full year. While the currently planned mobilisation of 300,000 people may not sound dramatic, the figure may end up being much higher – and could potentially affect 1.2m people. In addition, an estimated 500,000-700,000 reportedly left the country in the two weeks following the announcement, while many more have probably changed their residence within Russia. All this may have severe repercussions for the labour supply, with some of the most active and productive sections of the labour force being 'lost'. Consumer and investor sentiment is likely to suffer as well, and part of household income will probably be diverted, in order to bribe military officials. Besides, the tightening of cross-border restrictions by both Russia and the EU does not bode well for parallel imports, which may fuel inflation. Public consumption, associated with the deployment of the newly drafted army, will inevitably go up, but this will probably not be enough to offset the weakening in private demand.

Still, on the back of a surprisingly good economic performance in the first three quarters, the growth forecast for 2022 as a whole has been improved to -3.5% (from -7% in summer). Next year, the recession will almost certainly continue and will probably reach a similar magnitude as this year, as the effects of the Western trade sanctions increasingly come to be felt and as the EU oil embargo takes effect (in December 2022 on crude oil and in February on oil products). In response to the recent annexations, on 6 October the EU announced its eighth package of sanctions against Russia, which reportedly includes a price cap on Russian oil. Even though such a cap may be very difficult to implement in practical terms, it is likely that the discount on Russian oil on other markets will again widen. At the same time, Russia's own strategy of restricting gas supplies to Europe will weigh on its gas production and exports, given the near impossibility of diversification, on account of infrastructure bottlenecks.

Barring any major political change, the economy is poised for long-term stagnation. The main reason for this will be reduced access to Western imports and technology, with imports from third countries providing only partial relief. China does not produce the most sophisticated high-tech inputs that are needed for many sectors of the Russian economy (including the defence sector), while parallel imports are logistically challenging and inherently unstable. The potential for import substitution is limited as well, given the vastly different specialisation of domestic producers, who are unlikely to be able to take advantage of the new opportunities (with some niche exceptions). Having said that, the mobilisation announced may be a game-changer, undermining the hitherto solid popular support for President Putin and potentially triggering an overthrow of the political regime. But that would probably require sections of the ruling elite to switch sides, and at the time of writing it is unclear whether the cracks within the ruling elite are deep enough for such a scenario to materialise.

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[25] Still, on an annual basis the dynamics of credit for the non-financial private sector remains negative in real terms.

Table 6.18 / Russia: Selected economic indicators

	2019	2020	2021 1)	2021	2022	2022	2023	2024
				January-June			Forecast	
Population, th pers., average	146,765	146,460	145,864	146,017	145,648	145,000	144,800	144,700
Gross domestic product, RUB bn, nom.	109,608	107,390	131,015	58,006	69,293	147,900	150,600	158,900
annual change in % (real)	2.2	-2.7	4.7	5.1	-0.5	-3.5	-3.0	1.0
GDP/capita (EUR at PPP)	20,450	20,000	21,930	.	.	.	.	.
Consumption of households, RUB bn, nom.	56,110	54,046	64,805	30,105	33,891	.	.	.
annual change in % (real)	3.8	-7.4	9.5	11.0	-0.6	-6.5	-2.0	1.5
Gross fixed capital form., RUB bn, nom.	22,911	23,073	25,969	9,259	11,263	.	.	.
annual change in % (real)	1.0	-4.6	6.8	7.5	6.5	-2.0	-5.0	3.0
Gross industrial production 2)								
annual change in % (real)	3.4	-2.1	6.4	5.2	1.3	0.0	2.0	2.5
Gross agricultural production								
annual change in % (real)	4.3	1.3	-0.4	-0.2	2.2	.	.	.
Construction output								
annual change in % (real)	2.1	0.7	6.0	6.5	4.0	.	.	.
Employed persons, LFS, th, average	71,933	70,601	71,719	71,169	71,733	71,360	71,720	72,440
annual change in %	-0.8	-1.9	1.6	0.7	0.8	-0.5	0.5	1.0
Unemployed persons, LFS, th, average	3,465	4,321	3,631	3,969	3,074	3,000	3,400	3,300
Unemployment rate, LFS, in %, average	4.6	5.8	4.8	5.3	4.1	4.2	4.8	4.5
Reg. unemployment rate, in %, eop 3)	0.9	3.7	1.0	1.6	0.9	.	.	.
Average monthly gross wages, RUB	47,867	51,344	57,244	54,587	61,853	63,200	68,100	72,900
annual change in % (real, gross)	4.8	3.8	4.5	4.2	-0.8	-3.0	1.0	3.0
Consumer prices, % p.a.	4.5	3.4	6.7	5.8	14.3	13.9	6.7	4.0
Producer prices in industry, % p.a. 4)	2.0	-3.8	24.5	20.4	23.5	20.0	5.0	5.0
General governm. budget, nat. def., % of GDP								
Revenues	36.0	35.6	36.7	37.2	38.0	36.5	37.5	37.5
Expenditures	34.1	39.6	35.9	34.8	33.9	38.5	40.5	39.5
Deficit (-) / surplus (+)	1.9	-4.0	0.8	2.4	4.1	-2.0	-3.0	-2.0
General gov. gross debt, nat. def., % of GDP	12.4	17.6	16.0	15.6	13.3	13.0	15.0	15.5
Stock of loans of non-fin. private sector, % p.a.	7.1	14.4	18.8	18.0	6.2	.	.	.
Non-performing loans (NPL), in %, eop 5)	6.0	6.1	5.1	.	.	.	.	.
Central bank policy rate, % p.a., eop 6)	6.25	4.25	8.50	5.50	9.50	7.25	8.00	6.00
Current account, EUR m 7)	58,518	31,533	103,080	32,963	133,819	295,000	204,300	189,200
Current account, % of GDP	3.9	2.4	6.9	5.1	16.1	13.0	10.2	10.1
Exports of goods, BOP, EUR m 7)	374,738	291,760	417,102	193,064	301,687	623,300	551,200	551,200
annual change in %	-0.5	-22.1	43.0	15.7	56.3	49.4	-11.6	0.0
Imports of goods, BOP, EUR m 7)	226,668	209,726	256,766	142,901	146,773	265,600	277,700	291,600
annual change in %	7.4	-7.5	22.4	11.1	2.7	3.4	4.6	5.0
Exports of services, BOP, EUR m 7)	55,275	42,080	47,259	.	.	48,900	48,300	50,700
annual change in %	0.8	-23.9	12.3	.	.	3.5	-1.2	5.0
Imports of services, BOP, EUR m 7)	87,954	56,448	63,750	.	.	66,000	72,000	75,600
annual change in %	9.4	-35.8	12.9	.	.	3.5	9.1	5.0
FDI liabilities, EUR m 7)	28,548	8,296	33,639	9,405	-36,221	-48,500	.	.
FDI assets, EUR m 7)	19,574	5,117	55,061	14,765	-30,100	-38,800	.	.
Gross reserves of CB excl. gold, EUR m 7)8)	396,378	372,318	439,693	496,806	554,838	.	.	.
Gross external debt, EUR m 7)	438,757	380,941	426,062	397,058	447,126	432,300	341,400	299,100
Gross external debt, % of GDP	29.0	29.2	28.4	26.4	19.7	19.0	17.0	16.0
Average exchange rate RUB/EUR	72.51	82.39	87.20	89.54	83.31	65.0	75.0	85.0

Note: Including Crimean Federal District.

1) Preliminary. - 2) Excluding small enterprises. - 3) In % of labour force (LFS). - 4) Domestic output prices. - 5) According to Russian Accounting Standards overdue debt is defined as debt service overdue, therefore the data are not fully comparable with other countries. - 6) One-week repo rate. - 7) Converted from USD. Annual data for BOP unrevised. Half-year data for trade in goods and services together. - 8) Including part of resources of the National Wealth Fund of the Russian Federation. Half-year data including gold.

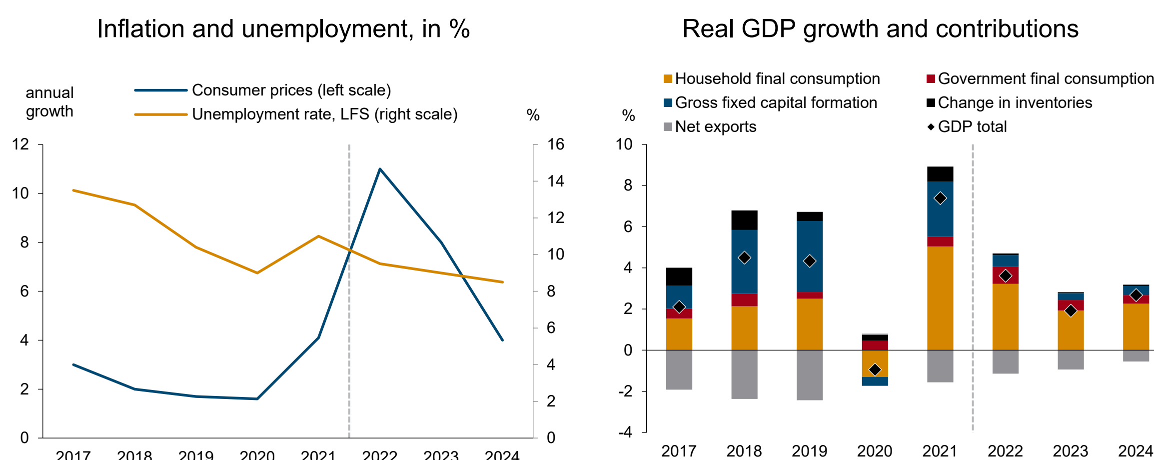
Source: wiiw Databases incorporating national statistics. Forecasts by wiiw.

SERBIA: Problems extending far beyond winter

BRANIMIR JOVANOVIĆ

Despite the hard times brought about by the Russian invasion of Ukraine, Serbia is doing relatively well in an economic sense, mainly because of supportive government measures. The country should be able to see the winter through without major problems, but its medium-term economic prospects remain uncertain, depending as they do essentially on how the country positions itself vis-à-vis Russia.

Figure 6.19 / Serbia: Main macroeconomic indicators



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

Inflation in Serbia is proving more persistent than was previously thought, but is still among the lowest in the region. In August it reached 13.2%, which is the highest since 2011, but is still the second lowest in the Western Balkans, with only Albania performing better. The government is maintaining the price freeze on basic foodstuffs (10 months now), and this does seem to be working, at least partially. The cost of electricity is capped, and the price of fuels is heavily regulated, which also helps.

Real wages are continuing to grow, despite inflation. In June, real growth in the average net wage was 2.1% year on year, among the highest in the whole CESEE region. The government raised the minimum wage and public-sector wages from the start of the year, and this has certainly helped the situation; but the wage increase was evident in all sectors, and indeed was higher in the private sector than in the public. Further increases in the minimum wage and public-sector wages have been announced for the coming period, which should prevent inflation from eating into real incomes.

Thanks to these measures, GDP growth in the first half of the year remained solid, reaching 4.1% year on year. This indeed represents a slowdown compared to last year, when GDP grew by 7.4%, but it is still in line with our previous forecasts. Growth in the first half of 2022 was driven by household consumption, which expanded by 5.5%, due to the post-pandemic release of pent-up demand, and also supported by the positive trend in real wages. By contrast, investment was rather weak in the first six months of 2022, growing by only 1.4%. Exports and imports both expanded by around 20% (all in real terms).

The slowdown in investment was partly due to weaker foreign direct investment (FDI). FDI inflows in the first six months of 2022 declined by 9% nominally, and by 20% in real terms, which runs counter to developments in previous years, when Serbia was something of an FDI champion in the wider region. This is even more surprising, given that most of the CESEE countries experienced an increase in FDI inflows in the first half of 2022. It is hard to say what the reasons were for the decline, as there are as yet no data on FDI inflows by country of origin for 2022; but the most obvious explanation would be that Serbia has lost its Russian FDI, which provided around 7% of FDI in the country before the war. The second explanation is that EU companies have turned their backs on Serbia, due to its close ties with Russia. It may also be that FDI inflows are simply too volatile from year to year. Only with time can a firmer conclusion be reached, but it should come as no surprise if Serbia continues to receive less FDI in the coming period than over the past few years.

Elevated global energy prices pushed the current account deficit to 9.3% of GDP in the first half of the year. High current account deficits are not uncommon for Serbia – the country ran a deficit of 20% of GDP in 2008 – but the deficit in the first six months of 2022 was still the highest for 10 years. On the plus side, remittances (approximated by 'secondary income' in the balance of payments accounts) expanded by 25% over the same period (in nominal terms), signalling that workers abroad are sending more money back home to help their families deal with the crisis. The higher current account deficit, in combination with the lower FDI inflows, may put Serbia's external balance under pressure in the coming period.

The central bank is continuing to tighten its monetary policy, and this could slow the economy. The policy rate has been hiked six times since April, to stand at 3.5% in September, up from 1% prior to April. While it is unclear whether this will have any effect on inflation, it is already retarding credit activity: the rate of growth of total credit to the private sector fell to 11.5% in August, from 13.4% in May. This refers both to corporate and household loans, and may indeed be one of the headwinds to growth in months to come, especially as the effects of the tighter monetary policy will take some time to filter through. On the other hand, the higher interest rates have strengthened the dinar, which in September was trading at 117.3 to the euro, whereas in April the rate had stood at 117.7. Foreign exchange reserves have also increased by 8% since May.

Fiscal policy remains supportive. Government expenditure in the first seven months rose by 12.7% year on year in nominal and by 2.3% in real terms, owing to higher public-sector wages, social assistance and pensions. Government capital spending likewise grew substantially, by 44% nominally (to reach 6% of GDP), due to the ambitious infrastructure investment agenda. Despite the government's spending spree, the budget was still in surplus during those seven months, as revenue grew even more than expenditure (14.4% nominally), bolstered by inflation. Due to the high market borrowing costs, the government took out a loan of EUR 1bn from the United Arab Emirates, at an interest rate of 3%. Despite the favourable interest rate, many of the loan's conditions remain unknown, including its

repayment schedule, which may prove problematic. The country is also negotiating a stand-by arrangement with the International Monetary Fund, which should calm investors and improve the stability of public finances ahead of the winter.

The economy seems to have slowed down in the third quarter, but growth should still remain in positive territory. Industrial production in July and August declined by 0.7% year on year, but retail trade grew by 4.3% in real terms. Real wages in July were still growing on an annual basis – though only marginally, by 0.2%.

The winter will be tough, but the country should be able to endure it without any great difficulty. The government signed a favourable gas deal with Russia in May, which covers around 75% of the industrial needs of the country. Nor should electricity be a problem, as the country meets almost all of its requirement through domestic generation. Industry is one channel through which Serbia could suffer during the winter, given the country's high level of integration into European value chains. However, it is not as exposed as certain regional peers, such as North Macedonia. Exports to Germany constitute around 13% of total exports and 5% of the country's GDP; that represents moderate dependence, and is much lower than in some other CESEE countries.

In light of all this, we are keeping our growth forecast for 2022 the same as three months ago, but have revised our forecast for 2023 substantially downwards. Specifically, we still project GDP to grow by 3.6% for 2022 as a whole, which implies a moderate slowdown over the remainder of the year vis-à-vis the first half of the year. For 2023, we now forecast that GDP will grow by 1.9%, which is almost half of the previous forecast. That implies that economic activity next year will decelerate further.

Regarding inflation, as it is proving more persistent than was previously anticipated, we have revised it upwards for both 2022 and 2023. Specifically, for 2022, we now project that it will average 11% for the whole year. That is an upward revision of 1 percentage point (pp) compared to the summer forecast, and means that inflation will stay close to the current level until the end of the year. It will then begin to moderate gradually, declining to 8% for 2023 as a whole – an upward revision of 2 pp over the previous forecast.

Despite the relatively benign short-term economic outlook, Serbia's medium-term prospects are much harder to assess. It has retained close ties to Russia, mainly because of its gas dependence, but until now this has not come with a particularly high price tag. The only cost in the economic sense seems to be the slightly lower FDI inflows, but those are not yet of a magnitude that should raise concern. In the political sense, the price is rather higher, as the country has obviously lost some of its Western support, though not excessively so. But the real price may become evident only after some time, especially if Russia loses the war, which no longer seems that unlikely. The key question thus appears to be: how will Serbia position itself in the future, especially in the event of a Russian defeat in Ukraine? If it distances itself from Russia, its medium-term economic prospects may remain solid. The first indication that this could already be happening is that several Serbian officials have stated that the country will not recognise the referendums on the annexation of parts of Ukraine by Russia. Still, this could simply be on account of the status of Kosovo, which previously held a referendum on independence that Serbia does not recognise. Whatever the reason, the uncertainties facing Serbia extend far beyond the current winter.

Table 6.19 / Serbia: Selected economic indicators

	2019	2020	2021 [1]	2021	2022	2022	2023	2024
				January-June			Forecast	
Population, th. pers., mid-year	6,945	6,899	6,834	.	.	6,800	6,750	6,700
Gross domestic product, RSD bn, nom.	5,422	5,502	6,269	2,897	3,280	7,200	7,900	8,400
annual change in % (real)	4.3	-0.9	7.4	7.5	4.1	3.6	1.9	2.7
GDP/capita (EUR at PPP)	12,800	12,760	14,290	.	.	.	.	.
Consumption of households, RSD bn, nom.	3,637	3,604	4,035	1,887	2,177	.	.	.
annual change in % (real)	3.7	-1.9	7.7	7.7	5.3	5.0	3.0	3.5
Gross fixed capital form., RSD bn, nom.	1,218	1,180	1,409	608	699	.	.	.
annual change in % (real)	17.2	-1.9	12.5	14.5	1.4	2.5	1.5	2.0
Gross industrial production [2]								
annual change in % (real)	0.3	0.4	6.4	10.0	3.2	2.5	1.5	2.5
Gross agricultural production								
annual change in % (real)	-1.2	2.0	-6.0	.	.	.	.	.
Construction output								
annual change in % (real)	35.5	-2.5	17.0	18.6	-8.6	.	.	.
Employed persons, LFS, th, average [3]	2,901	2,895	2,849	2,777	2,912	2,910	2,940	2,970
annual change in %	2.4	-0.2	2.6	1.2	4.9	2.0	1.0	1.0
Unemployed persons, LFS, th, average [3]	336	287	352	376	314	310	290	280
Unemployment rate, LFS, in %, average [3]	10.4	9.0	11.0	12.0	9.8	9.5	9.0	8.5
Reg. unemployment rate, in %, eop	18.7	17.9	17.4	.	.	.	.	.
Average monthly gross wages, RSD	75,814	82,984	90,784	88,652	100,622	103,300	114,900	123,700
annual change in % (real, gross)	8.4	7.8	5.2	5.9	3.5	2.5	3.0	3.5
Average monthly net wages, RSD	54,919	60,073	65,864	64,287	72,945	74,900	83,300	89,700
annual change in % (real, net)	8.5	7.7	5.4	6.1	3.4	2.5	3.0	3.5
Consumer prices, % p.a.	1.7	1.6	4.1	2.3	9.7	11.0	8.0	4.0
Producer prices in industry, % p.a.	0.6	-1.3	8.7	5.0	14.8	15.0	5.0	3.5
General governm. budget, nat. def., % of GDP								
Revenues	42.0	41.0	43.3	44.4	45.2	45.0	44.0	44.0
Expenditures	42.2	49.0	47.4	45.7	45.6	46.0	46.0	46.0
Deficit (-) / surplus (+)	-0.2	-8.0	-4.1	-1.3	-0.5	-1.0	-2.0	-2.0
General gov. gross debt, nat. def., % of GDP	52.8	57.8	57.1	53.7	53.8	57.0	58.0	59.0
Stock of loans of non-fin. private sector, % p.a.	8.9	11.1	10.2	7.3	12.8	.	.	.
Non-performing loans (NPL), in %, eop	4.1	3.7	3.5	3.6	3.3	.	.	.
Central bank policy rate, % p.a., eop [4]	2.3	1.0	1.0	1.0	2.5	4.0	3.5	3.0
Current account, EUR m	-3,161	-1,929	-2,296	-681	-2,616	-5,100	-5,400	-5,600
Current account, % of GDP	-6.9	-4.1	-4.3	-2.8	-9.4	-8.3	-8.0	-7.8
Exports of goods, BOP, EUR m	16,415	16,079	20,783	9,633	12,787	27,400	30,000	33,200
annual change in %	8.7	-2.0	29.3	31.2	32.7	32.0	9.5	10.5
Imports of goods, BOP, EUR m	22,038	21,280	26,707	12,217	17,586	36,900	40,400	44,400
annual change in %	9.1	-3.4	25.5	23.1	43.9	38.0	9.5	10.0
Exports of services, BOP, EUR m	6,934	6,191	7,800	3,444	4,692	10,300	11,300	12,500
annual change in %	14.4	-10.7	26.0	17.7	36.3	32.0	10.0	11.0
Imports of services, BOP, EUR m	5,922	5,090	6,402	2,693	3,840	8,800	9,600	10,600
annual change in %	16.9	-14.1	25.8	10.9	42.6	38.0	9.5	10.0
FDI liabilities, EUR m	3,815	3,039	3,886	1,909	1,608	3,600	.	.
FDI assets, EUR m	264	100	229	153	101	300	.	.
Gross reserves of CB, excl. gold, EUR m	12,042	11,732	14,523	12,358	12,642	.	.	.
Gross external debt, EUR m	28,254	30,787	36,488	32,272	38,287	43,000	49,300	54,800
Gross external debt, % of GDP	61.4	65.8	68.4	60.5	62.4	70.0	73.0	76.0
Average exchange rate RSD/EUR	117.85	117.58	117.57	117.58	117.59	117.3	117.0	116.5

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

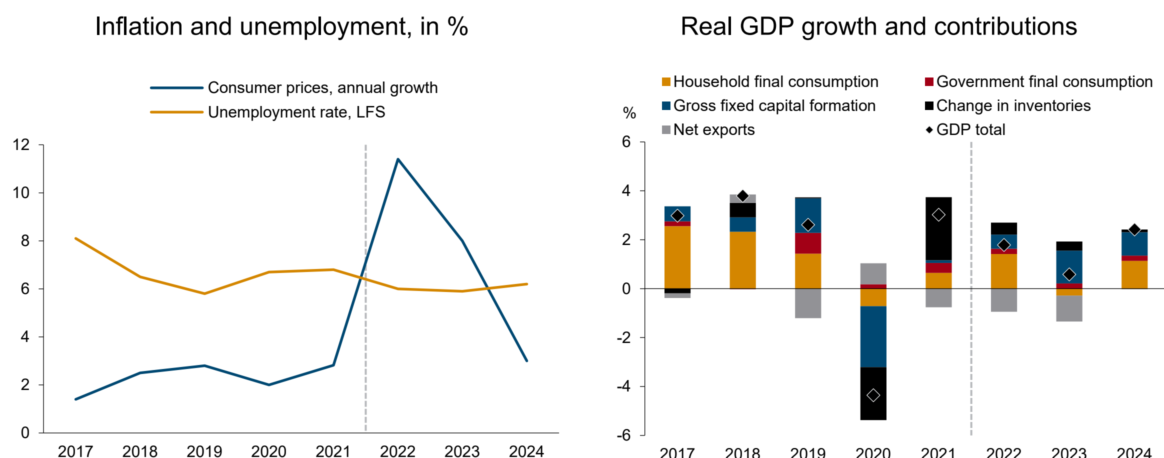
Source: wiiw Databases incorporating national statistics. Forecasts by wiiw.

SLOVAKIA: Heavy reliance on Russian energy renders the economy vulnerable

DORIS HANZL-WEISS

The adverse impact of the Russian war in Ukraine, high inflation and the energy crisis are all taking their toll on the Slovak economy. We estimate real GDP growth of 1.8% in 2022, driven by private consumption. While household consumption will fall back in the face of soaring inflation, the inflow of EU funds could provide some growth impetus in 2023 and beyond.

Figure 6.20 / Slovakia: Main macroeconomic indicators



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

Slovak growth in the first half of 2022 reached 2.4%, but showed a downward trend. In Q1, GDP grew by 3.1% compared to the previous year, but in Q2 the figure was only 1.8%, on account of declining household consumption. The Russian invasion of Ukraine on 24 February sent shockwaves throughout Europe and led to inflation and an energy crisis, which has been affecting all parts of the Slovak economy during the second half of the year. Also, the important automotive industry has been exposed to further trade-link disruption by the war, which comes on top of the ongoing semiconductor shortages and the zero-COVID strategy in China that has led to supply-chain disruption. Meanwhile, for the Slovak people and policy makers, the COVID-19 pandemic has faded into the background.

Growth in the first half of the year was founded on household consumption and investment. Household consumption was up 7% in the first half of 2022, spurred by pent-up demand after the COVID-19-related lockdowns. Gross capital formation grew by 6%, but gross fixed capital formation by a disappointing 3%. Construction output was practically flat year on year, which is disappointing, as that sector's output had been falling for the previous three years; however, the promised EU funds have

been slow to arrive. In addition, net exports made a negative contribution to GDP growth: while exports of goods and services (in real prices) declined by 2.4%, imports fell by only 0.7%.

Industry and automotive production have been badly affected and are in decline. Industrial production fell by almost 4% in the first seven months of 2022. The main manufacturing industry in Slovakia – the automotive sector – fared even worse, suffering a 6.3% decline in the same period. It is troubled by the continuing shortage of chips and the disruption of its supply chains: the Russian invasion of Ukraine has affected supply chains since March, and there were extensive lockdowns in China (e.g. in Shanghai) in April and May. In addition to the four major existing automotive companies – Volkswagen Slovakia, KIA Motors Slovakia, Stellantis (previously PSA Peugeot-Citroen) and Jaguar Land Rover, all based in the west of the country – a fifth producer is shortly to arrive in Slovakia, which is a positive development. In July 2022, Volvo Cars[26] announced that it is to build its third European production plant near Košice, in eastern Slovakia (it already has factories in Belgium and Sweden) and will focus on electric car production. It will manufacture about 250,000 vehicles a year and will employ 3,300 workers. The investment will amount to EUR 1.2bn.[27]

The labour market is recovering from the COVID-19 shock, but inflation will deter household consumption in the near future. In the first half of 2022, there was a big improvement in the labour market: employment increased by 2.8%, with a continuing favourable trend; and the unemployment rate fell to 6.2%. Those sectors that suffered most from the COVID-19 pandemic registered the largest relative increases in the number of employees: accommodation and catering services, professional, scientific and technical activities, and art, entertainment and recreation. However, a nominal wage increase of 7.7% in the first half year was swallowed up by soaring inflation, which resulted in real wages declining by 3%. This will deter household consumption in the second half of 2022 and next year. Consumer price inflation peaked in August at 13%, while producer price inflation has been even higher, reaching 35% in April. Electricity and gas prices for households and small businesses are regulated by the Regulatory Office for Network Industries. Prices are due to rise in 2023. Large companies have long-term contracts for electricity. Measures proposed by the government to help families with an anti-inflation package worth EUR 1bn led to a political crisis, which culminated at the beginning of September in Richard Sulík's SaS party leaving the four-party governing coalition, which now must operate as a minority government.

With the drop in car exports and with imports soaring due to higher energy prices, the current account has found itself in record negative territory. In nominal terms, exports of goods increased by 14.5% in the first half of the year, while goods imports rose by 23%, resulting in a negative trade balance. While Ukraine is only a minor trade partner for Slovakia, the same cannot be said of Russia – at least in terms of imports. During the first half of 2022, trade with Ukraine expanded (exports 115% up and imports 97% up); meanwhile exports to Russia shrank by 50%, but imports increased by 96% (on account of higher energy prices). Thus, Slovakia recorded its largest ever trade deficit with Russia. In terms of its main products, car exports declined during the first half of the year. Also, in terms of trade in services, imports grew more strongly than exports (30% versus 25%), though the trade in services balance remained positive. Altogether, the current account deficit reached a record 7% of GDP in the first half of 2022.

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[26] Volvo Cars was taken over by the Chinese Geely in 2010.

[27] https://spectator.sme.sk/c/22951744/volvo-is-coming-slovakia-will-get-the-fifth-carmaker.html published on 1 July 2022.

The country's energy dependence on Russia is still very high, despite measures taken in recent years to diversify its gas suppliers. Slovakia's energy dependence on Russia is the second highest in the EU, with imports from Russia accounting for almost 60% of gross available energy in 2020.[28] Gas is supplied from Russia via the southern branch of the Druzhba pipeline, via Ukraine, and Slovakia is a main gas transit country to Europe. Since the gas crisis in 2009, Slovakia has invested in its gas transmission infrastructure through projects to enable reverse gas flows; also, a Slovak-Hungarian interconnector was launched in 2015 and a Polish-Slovak interconnector opened this August. Since the Russian war in Ukraine, Slovakia has diversified its gas suppliers and now receives gas from Norway, liquefied natural gas from the US, and Algerian gas via Italy. At the time of writing, gas storage was at 85% capacity,[29] and the gas pipeline was still operating. As regards electricity, the third reactor of the Mochovce nuclear power plant has finally been certified after a 10-years delay. It will operate at full capacity from the start of next year. Planned in the 1980s during communist times, the first two units were completed in 1998 and 2000; a fourth reactor will probably be ready in two years' time.

The first effects of the soaring energy prices on the economy are already in evidence. Slovalco, Slovakia's only aluminium producer and its largest consumer of electricity (accounting for a tenth of national electricity consumption), has announced it is switching to crisis mode from the end of the year and is shutting down most of its furnaces. However, alongside the soaring energy prices, emissions restrictions and falling aluminium prices, the company also cites the lack of Slovak legislation on compensation for the cost of emission allowances (legislation that is in place in other European countries). While waiting for the legislation, the company failed to secure its electricity contract in time.[30]

Due to the Russian war in Ukraine and its knock-on effects, wiiw has revised its growth forecast downwards. Slovak GDP is now expected to grow by 1.8% in 2022, by 0.6 % in 2023 and by 2.4% in 2024. This year's growth will still be based on rising household consumption, fuelled by the pent-up demand following the COVID-19 pandemic. However, that will slow during the second half of the year and particularly next year, on account of the growing impact of inflation. Investment should become a pillar of growth from next year, helped by the influx of EU funds, including the Recovery and Resilience Facility. Net exports will act as a drag on growth over the coming two years. Germany's negative economic prospects will also have a significant adverse impact on Slovakia because of the strong trade linkages. Risks are primarily on the downside: the COVID-19 pandemic and the chip shortage are ongoing, and the Russian war in Ukraine is escalating. Its effects pose the most severe risks, with the energy and inflation crisis now in full swing.

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[28] https://ec.europa.eu/eurostat/statistics-explained/index.php?title=EU_energy_mix_and_import_dependency&stable=1 Data extracted on 4 March 2022.

[29] https://www.bruegel.org/dataset/european-natural-gas-imports

[30] https://spectator.sme.sk/c/22971453/too-late-for-the-governemnt-to-react-why-slovalco-has-to-lay-people-off.html published on 28 July 2022.

Table 6.20 / Slovakia: Selected economic indicators

	2019	2020	2021 [1)]	2021	2022	2022	2023	2024
				January-June			Forecast	
Population, th pers., average	5,454	5,459	5,447	.	.	5,470	5,475	5,480
Gross domestic product, EUR m, nom.	94,048	92,079	97,123	45,897	50,330	110,100	119,600	126,200
annual change in % (real)	2.6	-4.4	3.0	4.9	2.4	1.8	0.6	2.4
GDP/capita (EUR at PPP)	21,750	20,940	22,020	.	.	.	.	.
Consumption of households, EUR m, nom.	52,334	52,748	55,075	26,053	31,115	.	.	.
annual change in % (real)	2.6	-1.3	1.1	-0.5	6.6	2.5	-0.5	2.0
Gross fixed capital form., EUR m, nom.	20,296	18,073	18,571	7,965	9,010	.	.	.
annual change in % (real)	6.7	-11.6	0.6	-1.6	3.1	3.0	7.0	5.0
Gross industrial production								
annual change in % (real)	0.4	-9.0	10.4	19.4	-3.2	-3.0	2.0	5.0
Gross agricultural production								
annual change in % (real)	-4.2	3.4	0.3	.	.	.	.	.
Construction industry								
annual change in % (real)	-3.6	-11.3	-2.0	-4.3	-0.1	.	.	.
Employed persons, LFS, th, average [2)]	2,584	2,531	2,561	2,519	2,588	2630	2670	2670
annual change in %	0.7	-2.0	-1.7	-3.2	2.8	2.6	1.5	0.0
Unemployed persons, LFS, th, average [2)]	158	181	188	190	172	170	170	180
Unemployment rate, LFS, in %, average [2)]	5.8	6.7	6.8	7.0	6.3	6.0	5.9	6.2
Reg. unemployment rate, in %, eop	4.9	7.6	6.8	7.8	6.3	.	.	.
Average monthly gross wages, EUR	1,092	1,133	1,211	1,163	1,252	1300	1390	1450
annual change in % (real, gross)	5.0	1.9	3.6	5.3	-3.0	-3.4	-1.0	1.5
Consumer prices (HICP), % p.a.	2.8	2.0	2.8	1.5	10.1	11.4	8.0	3.0
Producer prices in industry, % p.a.	1.9	-0.6	6.8	1.7	27.6	28.0	18.0	6.0
General governm. budget, EU def., % of GDP								
Revenues	39.4	39.9	40.7	.	.	40.0	40.0	39.5
Expenditures	40.7	45.3	46.8	.	.	45.1	44.1	43.0
Net lending (+) / net borrowing (-)	-1.3	-5.5	-6.2	.	.	-5.1	-4.1	-3.5
General gov. gross debt, EU def., % of GDP	48.1	59.7	63.1	.	.	62.2	60.0	58.0
Stock of loans of non-fin. private sector, % p.a.	6.6	5.0	7.2	5.1	11.3	.	.	.
Non-performing loans (NPL), in %, eop	2.8	2.3	1.9	2.1	1.9	.	.	.
Central bank policy rate, % p.a., eop [3)]	0.00	0.00	0.00	0.00	0.00	.	.	.
Current account, EUR m	-3,163	330	-1,910	-68	-3,569	-8,100	-10,000	-10,000
Current account, % of GDP	-3.4	0.4	-2.0	-0.1	-7.1	-7.4	-8.4	-7.9
Exports of goods, BOP, EUR m	75,522	70,011	81,464	40,500	46,389	92,100	96,700	101,500
annual change in %	0.5	-7.3	16.4	27.9	14.5	13.0	5.0	5.0
Imports of goods, BOP, EUR m	76,658	68,996	81,539	39,690	48,836	100,300	107,300	112,700
annual change in %	1.7	-10.0	18.2	23.0	23.0	23.0	7.0	5.0
Exports of services, BOP, EUR m	10,981	9,032	9,459	4,220	5,284	11,400	12,300	13,300
annual change in %	7.4	-17.8	4.7	-3.4	25.2	20.0	8.0	8.0
Imports of services, BOP, EUR m	9,763	7,944	8,663	3,913	5,082	10,800	11,200	11,600
annual change in %	5.0	-18.6	9.0	2.6	29.9	25.0	4.0	4.0
FDI liabilities, EUR m	2,042	-214	818	616	2,919	500	.	.
FDI assets, EUR m	-162	1,683	1,097	1,043	1,906	200	.	.
Gross reserves of CB excl. gold, EUR m	5,002	6,050	6,850	6,160	8,094	.	.	.
Gross external debt, EUR m	106,016	111,746	133,051	111,445	132,676	135,000	140,000	145,000
Gross external debt, % of GDP	112.7	121.4	137.0	114.7	120.5	122.6	117.1	114.9

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

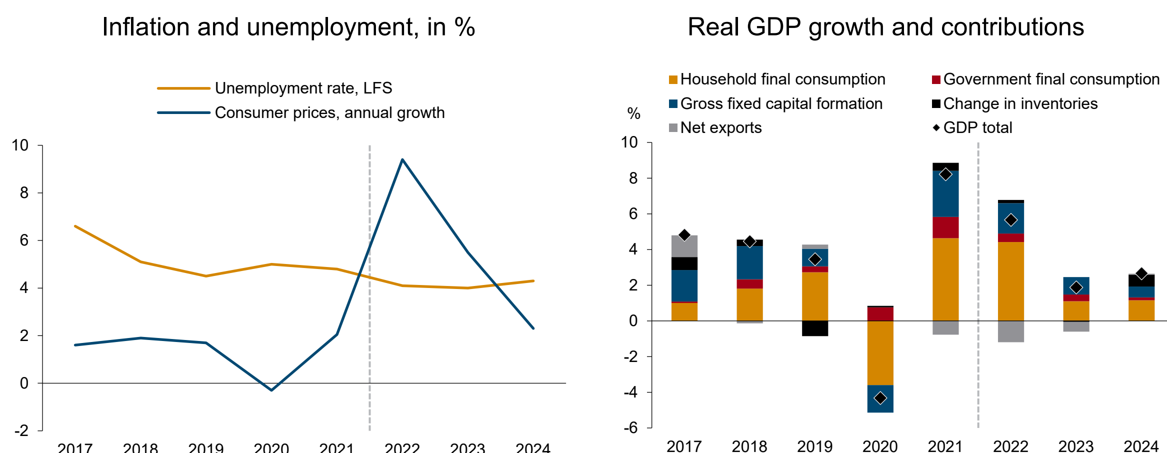
Source: wiiw Databases incorporating Eurostat and national statistics. Forecasts by wiiw.

SLOVENIA: Solid economic performance, with a downturn just around the corner

NIKO KORPAR

In 2022, we estimate that Slovenia's real GDP will have expanded by 5.7%, mostly due to very high growth in the first half of the year. However, next year it will decline to 1.9%, as consumption and investments start to shrink due to inflation, and as manufacturing begins to feel the full extent of the energy crisis. To counter inflation, the government has introduced various support mechanisms and is trying to secure enough gas to last the winter; however, uncertainty over the energy supply and prices has contributed to falling business confidence.

Figure 6.21 / Slovenia: Main macroeconomic indicators



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

Entering Q4 of 2022, Slovenia's economy is still performing strongly, but there are signs of a coming downturn. In the first half of 2022, real GDP increased by 8.9% and is forecast to grow by 5.7% for the full year – 1.3 percentage points (pp) better than our previous forecast. The upwards revision is due to resilient exports, strong private spending after the end of the pandemic-enforced period of saving, renewed growth in services (especially tourism), and resilient manufacturing and exports. However, the recent sharp downturn in consumer confidence, which has reached its lowest point since the COVID-19 pandemic began, indicates that the two-year period of high GDP growth is coming to an end. Private spending and investments are likely to contract as winter approaches. Industrial output, forecast to increase by 3.4% in 2022, has also started to fall since June. Manufacturing industries are suffering from the high cost of energy. Uncertainty over the extent of government support and the availability of gas over the winter has also led several exporters to announce cuts in production. The construction industry contributed strongly to growth in the first half of the year, but its activity has also started to cool.

In 2023, all drivers of growth are forecast to slow down as a consequence of inflation, volatile energy markets and uncertainty over the future external economic outlook. Growth is forecast to be 1.9% – 0.9 pp less than our previous forecast. Consumer spending will grow by just 2.5%, as households are expected to delay any significant expenditure – at least until winter is over. The manufacturing sector will be adversely affected by the delayed effects of inflation, as price hikes move along the supply chains and begin to affect foreign demand. However, the export markets should begin to recover in Q2 2023. Growth will also be supported by disbursements from the NextGenerationEU recovery funds and government spending, which should grow by 1.8% in 2023.

The extent of the winter downturn will also depend on the gas reserves. As elsewhere, the risk of a recession is tied to the possibility of a complete shutdown of Russian gas imports, since Slovenia lacks the infrastructure to build up large natural gas reserves and does not have its own gas terminals. Thus far, the government has relied on securing bilateral solidarity agreements that will provide cover in the event of severe disruption to the gas supply. One such document was signed with Italy in July 2022. Other attempts, such as signing another solidarity pact with Austria have so far failed. However, an agreement with Croatia is still likely to be signed in autumn.

Inflation has so far exceeded the EU average and the figure for 2022 as a whole is projected to reach 9.6%. Since the beginning of 2022, the government has announced a series of measures to slow the rise in the price of food and energy, such as cutting the excise duty on energy sources and providing energy vouchers for poorer households. The Bank of Slovenia estimates that such measures reduced inflation by 1.6 pp in the first seven months of 2022. In September, the government imposed a cap on electricity and gas prices for one year for households and small businesses, reduced VAT on the main energy sources and announced its intention of regulating the price of heating oil. Other measures, such as tax cuts and greater social support for lower-income households, were also announced. The total value of these measures will be well in excess of 1% of GDP. In 2023, considering the base scenario, inflation should be 5.5%, with the bulk of the price hikes expected to occur in the first half of the year.

International trade remained resilient in 2022, but the uncertainty makes exporters anxious about next year. As in 2021, real imports continued to grow faster than exports in 2022. A current account deficit of EUR 283m was recorded in the first seven months of 2022, but for the full year a current account surplus of 1.5% of GDP is expected. Next year will see a considerable reduction in the growth of foreign trade, with possible cuts to production and disruption to value chains as a result of the high energy prices. Nevertheless, exports are still expected to grow by 4.6% and imports by 5.6%.

The labour market is continuing to perform better than ever before, but real wage growth is lagging behind inflation. Unemployment will be 4% on average in 2022 and the high employment figures are expected to carry over into 2023. The shortage of workers has already begun to put a strain on certain sectors, such as services and manufacturing. Increased immigration may help to offset the shortage, but not in the short term. Nominal wages are expected to grow by 4.3% in 2022, and momentum is building to increase wages in both the public and the private sector, as well as pensions. However, real wages will fall by 3.4% this year because of inflation.

High growth has helped keep a lid on certain worrying trends in the state of the national budget. Revenue increased by 16.7% year on year in the first eight months of 2022. Although revenue growth has surpassed projections, in part due to the effect of inflated prices, new fiscal burdens have also been

added, due to the need to provide relief from inflation and address pressing issues in the healthcare system. In September, the government announced a planned 20% hike in the wages of public-sector employees, which will place additional strain on the budget. Although the national Fiscal Council has warned against depending on inflation-fuelled revenue to increase spending, rather than reducing debt, Slovenia's long-term budgetary outlook is by no means precarious – although the rising cost of debt does present an element of heightened risk should severely unbalanced budgets continue in the following years. The public deficit is forecast to be 3.8% of GDP in 2022 and 3.7% of GDP in 2023. Public debt will hover at around 72% of GDP, and is expected to fall below 70% by 2023.

After four months in power, the government led by former electricity company CEO Dr Robert Golob is still enjoying a honeymoon phase. However, its popularity is slowly starting to wane, as expectations of support for the economy and households grow. The crisis-management style of government – essential if high inflation is to be tackled successfully – has so far prevented serious progress on structural reform. Autumn will bring presidential and municipal elections, and several potential referendums on new laws, demanded by the opposition, which could act as an early vote of confidence in the centre-left coalition.

Table 6.21 / Slovenia: Selected economic indicators

	2019	2020	2021 1)	2021	2022	2022	2023	2024
				January-June			Forecast	
Population, th pers., average	2,088	2,102	2,108	.	.	2,108	2,115	2,119
Gross domestic product, EUR m, nom.	48,533	47,021	52,208	24,716	28,334	60,300	64,800	68,100
annual change in % (real)	3.5	-4.3	8.2	8.7	8.9	5.7	1.9	2.7
GDP/capita (EUR at PPP)	27,740	26,600	29,210	.	.	.	.	.
Consumption of households, EUR m, nom.	25,022	23,145	26,206	11,539	14,727	.	.	.
annual change in % (real)	5.3	-7.0	9.4	5.3	15.8	8.8	2.2	2.3
Gross fixed capital form., EUR m, nom.	9,496	8,870	10,619	4,975	6,119	.	.	.
annual change in % (real)	5.1	-7.9	13.7	15.0	7.5	8.4	4.8	3.0
Gross industrial production								
annual change in % (real)	3.1	-5.3	10.3	13.5	3.4	3.4	2.3	3.6
Gross agricultural production								
annual change in % (real)	-7.8	5.5	-12.0	.	.	.	.	.
Construction industry								
annual change in % (real)	3.3	-0.7	-0.5	5.8	23.7	.	.	.
Employed persons, LFS, th, average 2)	982.5	978.0	971.6	953.5	983.5	1,000	1,010	1,020
annual change in %	0.2	-0.5	0.3	-1.4	3.2	2.8	1.2	0.7
Unemployed persons, LFS, th, average 2)	45.7	51.2	48.4	50.0	43.9	40	40	50
Unemployment rate, LFS, in %, average 2)	4.5	5.0	4.8	5.1	4.3	4.1	4.0	4.3
Reg. unemployment rate, in %, eop	7.7	8.9	6.7	7.3	5.5	.	.	.
Average monthly gross wages, EUR 3)	1,754	1,856	1,970	1,981	1,976	2,250	2,450	2,570
annual change in % (real, gross)	2.7	5.9	4.1	7.3	-7.0	4.3	3.1	2.6
Average monthly net wages, EUR 3)	1,134	1,209	1,270	1,273	1,282	1,340	1,430	1,500
annual change in % (real, net)	2.1	6.6	3.1	5.7	-6.1	-3.4	1.1	2.2
Consumer prices (HICP), % p.a.	1.7	-0.3	2.0	0.7	7.7	9.4	5.5	2.3
Producer prices in industry, % p.a.	0.6	-0.3	5.5	2.4	18.7	8.8	4.5	1.9
General governm. budget, EU def., % of GDP								
Revenues	43.6	43.4	43.8	.	.	46.4	45.1	45.4
Expenditures	43.2	51.2	48.9	.	.	50.2	48.8	47.2
Net lending (+) / net borrowing (-)	0.4	-7.8	-5.2	.	.	-3.8	-3.7	-1.8
General gov. gross debt, EU def., % of GDP	65.4	79.6	74.4	.	.	72.3	71.0	68.5
Stock of loans of non-fin. private sector, % p.a.	3.5	0.0	5.9	1.7	10.4	.	.	.
Non-performing loans (NPL), in %, eop 4)	2.9	2.6	1.6	1.9	1.6	.	.	.
Central bank policy rate, % p.a., eop 5)	0.00	0.00	0.00	0.00	0.00	.	.	.
Current account, EUR m	2,884	3,552	1,986	1,328	-181	1,000	820	520
Current account, % of GDP	5.9	7.6	3.8	5.4	-0.6	1.7	1.3	0.8
Exports of goods, BOP, EUR m	31,999	29,622	35,255	17,083	20,951	40,400	45,810	48,790
annual change in %	3.9	-7.4	19.0	19.7	22.6	14.6	13.4	6.5
Imports of goods, BOP, EUR m	30,701	27,289	34,373	16,103	22,074	41,140	46,080	49,400
annual change in %	3.9	-11.1	26.0	22.5	37.1	19.7	12.0	7.2
Exports of services, BOP, EUR m	8,659	6,956	8,447	3,490	4,840	9,840	10,850	11,570
annual change in %	6.6	-19.7	21.4	7.2	38.7	16.5	10.3	6.6
Imports of services, BOP, EUR m	5,751	4,899	5,992	2,457	3,249	7,230	8,570	9,270
annual change in %	4.6	-14.8	22.3	6.6	32.3	20.6	18.6	8.2
FDI liabilities, EUR m	1,919	446	1,795	1,250	1,431	1,510	.	.
FDI assets, EUR m	1,157	708	1,397	497	782	500	.	.
Gross reserves of CB excl. gold, EUR m	767	913	1,838	970	1,965	.	.	.
Gross external debt, EUR m	44,442	47,998	50,818	50,156	51,940	52,800	55,900	58,200
Gross external debt, % of GDP	91.6	102.1	97.3	96.1	86.1	87.5	86.3	85.4

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

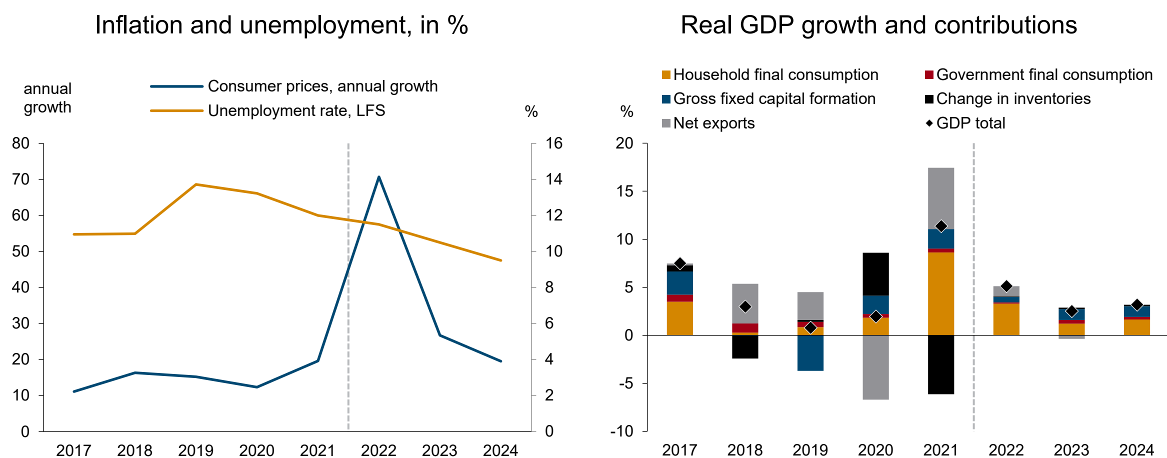
Source: wiiw Databases incorporating Eurostat and national statistics. Forecasts by wiiw.

TURKEY: The slowdown has arrived

RICHARD GRIEVESON

After a strong first half year, driven by reopening effects and a boom in tourism, the economy looks set for a much bleaker winter. The boosts to external competitiveness that resulted from the weak lira were short lived and soon erased by inflation, while the main benefits of the rebound in tourism have already been reaped. The extremely high inflation is sharply reducing purchasing power and is putting pressure on industry. Risks are weighted to the downside, including the potential for domestic political noise ahead of the election, rising US interest rates and the geopolitical backdrop.

Figure 6.22 / Turkey: Main macroeconomic indicators



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

The economy performed very well in the first half of 2022, despite increasing headwinds. Growth stayed strong in Q2 2022, reaching 7.6% year on year in real terms, which was almost identical to the performance over the previous three months (7.5%). In quarterly terms, the pace of growth actually quickened to 2.1%, from 0.7% in Q1. This robust Q2 outturn came despite a further weakening of the lira, a rise in the already-high inflation and lower consumer confidence. A breakdown of Q2 growth indicates robust positive contributions from both consumption and net exports, while investment declined sharply. Both goods and services exports rose strongly, the former helped by a short-lived boost from the weaker lira (an effect that faded rapidly due to the high inflation) and the latter by a huge rebound in tourism inflows.

However, the most recent high-frequency indicators suggest a slowdown from the middle of the year. In July, the manufacturing purchasing managers' index (PMI) fell further below the key 50 level that separates expansion from contraction. Consumer confidence is likewise subdued. Moreover, hard data have increasingly started to mirror the negative sentiment: industrial output fell by 6.2% month on month in July, while retail sales contracted in monthly terms in both July and August. In September, consumer prices soared by 83.5% year on year, the biggest rise for 24 years. This is significantly squeezing real income growth. However, despite the clearly more challenging picture for H2 2022, we have revised our full-year growth estimate for 2022 upwards to 5.1%, reflecting the better-than-expected first half year.

The slowdown will intensify over the winter, reflecting a multitude of headwinds for the economy; accordingly, we have revised our forecast for 2023 growth downwards, to 2.5%. There will be no let-up over the winter in the squeeze on consumption caused by the sky-high inflation, suggesting that growth will struggle until at least the end of Q1 2023. However, this will partly be offset by an expected increase in government spending ahead of the presidential election next year.

A key driver of the positive performance in early 2022 was the recovery in tourism, with arrivals from the key countries of origin up dramatically. The latest data show a boom in the sector, with 21m foreign tourists arriving in the first seven months of this year, compared with 8m in the same period of 2021. Crucially, 11m of these tourists came from Europe, up from 3m a year earlier. Tourists from countries such as Germany, the UK and France tend to spend more on average than tourists from many other origins. Tourism from Russia also increased over this period – although, at around 2m in total, arrivals from this source are far less important for the sector. Tourism's strong performance drove a substantial increase in the services surplus on the balance of payments, which reached USD 42bn in January-July, up from USD 25bn a year earlier; the services surplus itself more than doubled, to USD 20bn.

Despite the increase in the services surplus, the current account deficit almost tripled in January-July, raising concerns about the economy's external vulnerabilities. The current account deficit reached USD 36.7bn in January-July 2022, up from USD 13.7bn a year earlier. While the value of goods exports increased by 20% year on year in nominal terms, the value of goods imports (which are also much bigger than exports) rose by 42%. The latter reflected a combination of rising energy prices and resilient domestic demand. Separate monthly data for August showed a trade deficit of USD 11.2bn, the highest monthly gap on record. According to data provided by the central bank, around two thirds of the current account deficit in the first seven months was financed by net errors and omissions. This makes it very difficult to judge the sustainability and resilience of the financing. We estimate a current account deficit equivalent to 5.3% of GDP this year, and expect the shortfall to remain greater than 4% of GDP throughout the forecast period. External financing needs are set to remain elevated, making Turkey reliant on hot money inflows and the support of external partners to prevent a balance-of-payments crisis. The combination of domestic policy loosening with Fed tightening has already led to a weakening of the lira, but it also creates risks to Turkey's ability to roll over external debt. Short-term external debt reached USD 134.6bn in July 2022, according to the central bank – around 20% of GDP.

The government's New Economic Model, launched in September 2021, has certainly had an impact on the economy; but we are still a long way off being able to declare it a success. The New Economic Model aims to support exports, increase private investment and reduce the size of the

current account deficit. While export performance has been decent, the overall effectiveness of the policy is questionable. Goods export growth relies on short-lived bouts of increased competitiveness, linked to the tumbling lira. The New Economic Model's aim of price stability, meanwhile, is far from consistent with the monetary policy of the central bank.

The combination of the New Economic Model and external factors means that the economy is hamstrung by sky-high inflation, which will not fall any time soon. Despite inflation topping 80%, the central bank has continued to cut interest rates; but this weakens the lira and provides an additional fillip to inflation via higher import costs. In late September, the central bank again ignored galloping inflation and cut the policy rate by 100 basis points to 12%. Combined with the September inflation outturn, this took the real interest rate beyond -70%. This may stimulate lending, but it will do nothing to bring down inflation or support the lira, and it serves to indicate that the authorities are doubling-down on their efforts to push the economy as hard as possible before the election. We expect consumer price inflation to average 70.7% this year, with producer price inflation reaching almost double that (130% for the year as a whole). In 2023, we forecast consumer price inflation to average 26.7%, indicating that it will remain a serious headwind for economic growth.

Given its high import requirements, Turkey is particularly exposed to rising energy costs. According to the government, the country relies on imports for 74% of its energy needs. Energy costs have been surging since 2021 – a trend that only intensified following the Russian invasion of Ukraine. This has drastically increased costs for households and businesses alike, and has contributed to the elevated inflation more generally. The weak lira has further amplified this effect in local currency terms. The government has attempted to use its relatively good relations with Russia to secure discounts, but as yet with no (official) success. Up to half of Turkey's gas comes from Russia. So far, the only concession secured by Turkey is that it can pay for 25% of its Russian gas imports in roubles; that said, on its own this is unlikely to make much difference from a Turkish perspective.

The downside risks to the outlook are substantial. Persistently high inflation, a plunging lira, large external financing needs, the adverse external environment and general macro-financial volatility are already creating serious headwinds to economic growth. There are various ways in which these factors could intensify and have further repercussions for the economy. But the biggest challenge is that they may interact with one another – and that could amplify the effects significantly. Any further deterioration in the geopolitical situation that affects Turkey in particular would make things much worse. The combination of US monetary tightening and Turkish monetary loosening could also further seriously cloud the outlook. Despite these challenges, households, firms and banks have repeatedly proved themselves capable of riding out periods of stress in the economy.

The next presidential election must take place by the middle of next year. There is likely to be a sharp increase in political noise in the run-up to polling, and that could have a negative impact on the economy. Turkey's opposition represents a threat to President Erdogan, and defeat for the incumbent is not unthinkable. However, the opposition will be hamstrung by the need to come together and unite, despite being very broad based and holding divergent views on a number of issues. Moreover, even a narrow opposition victory could result in lengthy court challenges and re-runs, and would not necessarily result in a change in who holds power.

Table 6.22 / Turkey: Selected economic indicators

	2019	2020	2021 1)	2021	2022	2022	2023	2024
				January-June			Forecast	
Population, th pers., average	82,579	83,385	84,147	.	.	85,157	86,179	87,213
Gross domestic product, TRY bn, nom.	4,312	5,048	7,249	2,989	5,927	13,000	16,900	20,800
annual change in % (real)	0.8	1.9	11.4	14.8	7.5	5.1	2.5	3.2
GDP/capita (EUR at PPP)	18,440	18,410	20,670	.	.	.	.	.
Consumption of households, TRY bn, nom.	2,441	2,847	3,983	1,635	3,429	.	.	.
annual change in % (real)	1.5	3.2	15.3	15.8	22.0	6.0	2.2	3.0
Gross fixed capital form., TRY bn, nom.	1,117	1,383	2,040	854	1,810	.	.	.
annual change in % (real)	-12.5	7.4	7.4	16.7	4.4	2.0	4.0	4.0
Gross industrial production 2)								
annual change in % (real)	-0.6	2.2	16.5	24.3	10.5	8.5	2.8	2.8
Gross agricultural production 3)								
annual change in % (real)	4.2	2.3	3.0	.	.	.	.	.
Construction industry 2)								
annual change in % (real)	-8.0	-3.0	3.0	.	.	.	.	.
Employed persons, LFS, th, average 4)	28,081	26,808	28,827	27,920	30,092	30,100	31,100	31,900
annual change in %	-2.3	-4.5	8.0	6.3	7.8	4.5	3.3	2.5
Unemployed persons, LFS, th, average 4)	4,461	4,063	3,916	4,036	3,666	3,910	3,650	3,350
Unemployment rate, LFS, in %, average 4)	13.7	13.2	12.0	12.7	10.9	11.5	10.5	9.5
Reg. unemployment rate, in %, eop	.			.	.	.	.	.
Average monthly gross wages, TRY 5)	4,470	4,595	5,849	.	.	15780	24390	32640
annual change in % (real, gross)	7.9	-8.5	6.4	.	.	58.0	22.0	12.0
Consumer prices (HICP), % p.a.	15.2	12.3	19.6	16.3	64.6	70.7	26.7	19.5
Producer prices in industry, % p.a. 5)	17.6	12.1	43.9	33.6	118.6	130.0	60.0	21.5
General governm. budget, nat. def., % of GDP								
Revenues	29.8	29.6	28.0	.	.	29.4	30.6	31.0
Expenditures	33.0	32.5	30.3	.	.	32.6	33.0	33.0
Deficit (-) / surplus (+)	-3.2	-2.9	-2.3	.	.	-3.2	-2.4	-2.0
General gov. gross debt, nat. def., % of GDP	32.6	39.7	41.8	.	.	43.5	46.4	48.0
Stock of loans of non-fin. private sector, % p.a.	10.2	35.3	32.4	18.7	58.1	.	.	.
Non-performing loans (NPL), in %, eop	5.4	4.1	3.1	3.7	2.5	.	.	.
Central bank policy rate, % p.a., eop 6)	12.00	17.00	14.00	19.0	14.0	12.00	12.00	12.00
Current account, EUR m	4,777	-31,325	-11,449	-11,199	-29,559	-35,400	-35,500	-35,600
Current account, % of GDP	0.7	-5.0	-1.7	-3.6	-8.1	-4.9	-4.6	-4.1
Exports of goods, BOP, EUR m	162,777	147,053	190,374	86,142	115,196	232,000	244,000	256,000
annual change in %	7.3	-9.7	29.5	27.2	33.7	22.0	5.0	5.0
Imports of goods, BOP, EUR m	177,804	180,242	215,190	97,275	152,668	293,000	308,000	323,000
annual change in %	-4.2	1.4	19.4	15.4	56.9	36.0	5.0	5.0
Exports of services, BOP, EUR m	56,149	30,903	49,434	16,487	30,411	74,000	80,000	86,000
annual change in %	12.5	-45.0	60.0	20.7	84.4	50.0	8.0	8.0
Imports of services, BOP, EUR m	25,612	20,896	26,803	11,575	17,029	39,000	42,000	45,000
annual change in %	6.0	-18.4	28.3	13.7	47.1	45.0	7.0	7.0
FDI liabilities, EUR m	8,547	6,815	11,770	3,741	5,048	13,500	.	.
FDI assets, EUR m	2,630	2,798	5,489	1,536.5	2,298.5	6,300	.	.
Gross reserves of CB excl. gold, EUR m 7)	69,975	40,776	64,182	48,100	55,069	.	.	.
Gross external debt, EUR m 7)	370,097	352,839	390,766	373,890	427,835	433,300	476,300	515,600
Gross external debt, % of GDP	54.6	56.3	56.7	54.2	59.2	60.0	62.0	59.0
Average exchange rate TRY/EUR	6.3578	8.0547	10.5124	9.5126	16.2330	18.00	22.00	23.80

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

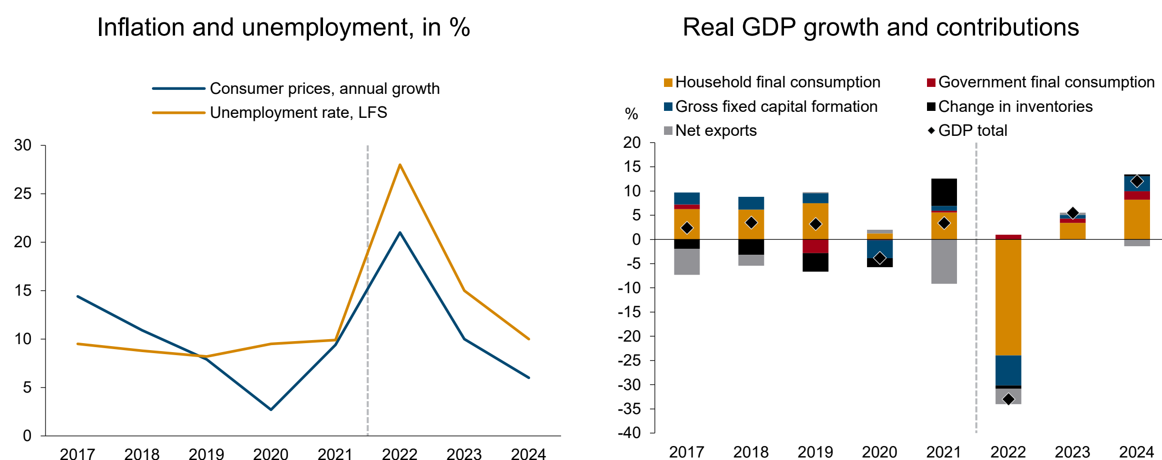
Source: wiiw Databases incorporating national statistics. Forecasts by wiiw.

UKRAINE: Economy adjusting to the war

OLGA PINDYUK

The Russian invasion is causing significant human loss and physical capital destruction in Ukraine. However, after a sharp contraction, Ukraine's economy has started to show signs of adjusting to the war conditions. External financial assistance is crucial both to keep the economy functioning and to achieve military victory. An accelerated recovery in the post-war period will depend on the establishment of a Marshall Plan-style international agency capable of providing adequate financing for the reconstruction of Ukraine's economy.

Figure 6.23 / Ukraine: Main macroeconomic indicators



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

Ukraine's economy has been severely affected by Russia's war, which is now in its eighth month… As of the beginning of September, the damage caused to Ukraine's infrastructure was estimated at USD 114.5bn (or 58% of 2021 GDP).[31] Some 422 enterprises had been totally or partially destroyed, while the assets of the basic metals industry, one of the key industrial sectors in Ukraine, had been almost completely wiped out. According to the UN High Commissioner for Refugees, more than 7.6m refugees have been registered across Europe (with 4.2m individual refugees registered for temporary protection or similar national protection schemes), while more than 6.9m people have been internally displaced since 24 February.

[31] The assessment is the result of joint work by the Kyiv School of Economics and government authorities under the leadership of the Ministry of Reintegration of Temporarily Occupied Territories, the Ministry for Communities and Territories Development and the Ministry of Infrastructure, in cooperation with other ministries and partner organisations under the umbrella of the National Council for the Recovery of Ukraine from the Consequences of the War. https://kse.ua/about-the-school/news/due-to-the-last-estimates-damage-caused-to-ukraine-s-infrastructure-during-the-war-is-114-5-bln/

…but appears to be adjusting to the new reality of operating in conditions of war. The Ministry of Economy estimates that in August 2022, the real GDP decline slowed to about 35% in annual terms, having falling by 37.2% year on year in Q2. According to a recent survey of small and medium-sized enterprises carried out by the Center for Innovations Development, Entrepreneurship and Export Promotion Office, in conjunction with the Advanter Group,[32] the number of businesses that have fully or almost fully suspended their operations had fallen from 80% in March to 40% in July. We expect that for the full year the economy will contract by about a third.

One positive factor has been an increase in the export of agricultural commodities after an agreement was signed by Ukraine and Russia on 22 July for a grain shipping corridor in the Black Sea. Still, the volume of exports languishes at less than half the 2021 level. At the current rate, it will take around six months to ship the grain remaining from last year's harvest through the three ports included in the pact (with the help of rail exports).[33] Given that situation, if farmers are unable to sell part of their harvest, they are unlikely to have sufficient funds to invest in their fields, which means that winter sowing and next year's harvest will be significantly lower than in 2022.

A significant positive development has been an increase in the external financing of the state budget, which is crucial in keeping the economy functioning, as fiscal revenues have fallen dramatically because of the economic downturn, while expenditure has risen to finance the military effort. In August, the amount of assistance rose significantly (to USD 4.7bn), thanks to a USD 3bn grant from the US. As of 6 September, total international financial support exceeded USD 19bn (about 15% of forecast 2022 GDP). This leaves USD 16.6bn of aid promised but not yet disbursed, with the EU having disbursed only EUR 1bn of the EUR 9bn pledged. The share of foreign aid going to finance the budget deficit has been gradually increasing since the start of the war, and reached 57% in August. This relieves the pressure on the National Bank of Ukraine (NBU) to purchase domestic government bonds, a move that would have had a strong inflationary effect.[34]

As the war is expected to drag on for at least another year, the external financial assistance needs will remain high. The draft law on the central government budget for 2023, approved by the government on 13 September, envisages a budget deficit at the level of 20% of GDP, to be covered mainly by financing from the US, the EU and the International Monetary Fund. National security and defence account for 45% of the budget expenditure envisaged.

Unemployment remains very high, at about 30% in August 2022, with internally displaced persons (IDPs) disproportionately affected. According to a survey by the International Organization for Migration in August 2022,[35] of those IDPs who were employed before the war, 60% had lost their jobs since their displacement, and in August only 33% of the IDPs aged 18-64 indicated 'salary' as their primary source of income. At the same time, companies that face rising costs and falling demand are quite cautious about hiring additional labour. According to an Institute for Economic Research survey,[36]

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32 https://decentralization.gov.ua/en/news/15408

33 https://www.reuters.com/markets/europe/even-with-un-deal-ukraine-faces-long-haul-shift-grain-mountain-2022-09-08/

34 For more on the recent fiscal developments in Ukraine, see T. Bogdan, Ukraine's public finances: Radical change in time of war, wiiw Monthly Report No. 10, October (forthcoming).

35 https://dtm.iom.int/reports/ukraine-%E2%80%94-internal-displacement-report-%E2%80%94-general-population-survey-round-8-17-23-august

36 http://www.ier.com.ua/ua/institute/news?pid=6973

in July only 15.6% of companies expected to increase their staffing in the next three months (in June, the figure was 17.4%); the majority (79.1%) did not expect any change.

Inflation continues to accelerate. Consumer prices increased in August by 23.8% year on year, and this figure is likely to rise to 31% year on year by December. In addition to global factors, prices have been rising because of the war. The destruction of production facilities and infrastructure is creating supply-chain disruption. At the same time, a slowdown in the rise in the cost of fuel (owing to a fall in global oil prices and the normalisation of logistics) and the government's freezing of gas and heat tariffs have constrained the growth of inflation.

The National Bank of Ukraine was forced to devalue the hryvnia, which was contributing to the acceleration of inflation, primarily through the cost of imported goods and components. On 21 July, the currency was devalued by 25% against the US dollar (to 36.6 UAH/USD), as maintaining the previous exchange rate was deemed unsustainable (it took more than USD 7bn of forex reserves to defend the previous exchange rate in May-June 2022). As the exchange rate on the cash forex market has increasingly been diverging from the official exchange rate (reaching about 41.5 UAH/USD by mid-September), we believe a further devaluation of the national currency is likely.

The trade deficit widened dramatically, but the current account balance remains in a strong surplus. Over the period January-July 2022, the trade deficit reached USD 10.0bn, compared with USD 0.7bn over the same period of 2021. The main reasons for this were a smaller decline in merchandise imports relative to merchandise exports, and a significant increase in services imports (of 71% year on year, to USD 13.0bn) on the back of spending by refugees abroad. Telecommunications and computer services, which accounted for about 9% of total exports in 2021, remained the only sector with rising exports (+26% year on year in January-July 2022). The current account, by contrast, had a surplus of USD 4.4bn, owing to a decline in the repayment of investment income and a more than threefold increase in inflows of secondary income on the back of external grants and humanitarian aid. This allowed the NBU to boost its gross international reserves to USD 25.4bn in August, which covers four months of future imports.

Preparations for the heating season are complicated by challenges due to Russia's invasion. Ukraine is currently relatively well prepared for the heating season, as the gas accumulated in the storage facilities is at approximately the same level as this time last year, while demand for gas over the coming winter is forecast to be 19% less than last year. Domestic gas extraction is expected to cover almost 90% of gas consumption; however, according to the national oil and gas company Naftogaz, approximately 94% of its gas production is at high risk of having to cease because of the proximity of facilities to the front line. In addition, the possible destruction of the power lines at the Zaporizhzhia nuclear power plant – the largest in Europe – would be a serious blow to the supply of electricity this winter.

We expect the Ukrainian economy to start a modest recovery in 2023 and growth to speed up significantly in 2024. Although the war is likely to persist, the recent success of the Ukrainian counter-offensive suggests that it will probably be limited in scale. We assume that there will be continuous advances by the Ukrainian army, that nuclear weapons will not be used by Russia on the major urban areas, that the grain deal will continue and that there will be a greater influx of international aid. The economy will adapt further to conditions of war, and reconstruction work will continue on the main infrastructure in those territories freed from Russian occupation. Accelerated recovery in the post-war

period will depend on the establishment of a Marshall Plan-style international agency capable of providing adequate financing for the reconstruction of Ukraine's economy.

The biggest risk to the forecast continues to be related to the duration and outcome of the war. Russia's poor military performance and economic troubles, as well as the apparent loss of support from China and India, point to the increased likelihood of a Ukrainian victory, but the course of the war is difficult to predict. The partial mobilisation announced by the Kremlin is not expected to significantly boost the Russian military advantage, as the new conscripts are largely untrained and unmotivated. If the willingness of Ukraine's allies to support it militarily and financially falters, that could have a crucial impact on both the country's military success and its macro-financial stability. If the war drags on for too long and job opportunities remain scarce, there is a risk that many of the refugees will not return to Ukraine, which will damage the prospects for its long-term economic growth. Last, but not least, the attacks by the Russian army on the Zaporizhzhia nuclear power plant increase the risks of nuclear disaster.

Table 6.23 / Ukraine: Selected economic indicators

	2019	2020	2021 1)	2021	2022	2022	2023	2024
				January-June			Forecast	
Population, th pers., average	42,028	41,745	41,378	.	.	37,000	38,000	39,000
Gross domestic product, UAH bn, nom.	3,977	4,222	5,460	2,209	1,850	4,400	5,100	6,100
annual change in % (real)	3.2	-3.8	3.4	2.2	-27.3	-33.0	5.5	12.0
GDP/capita (EUR at PPP)	9,080	8,740	9,490	.	.	.	.	.
Consumption of households, UAH bn, nom.	2,918	3,054	3,736	.	.	.	.	.
annual change in % (real)	10.9	1.7	7.7	.	.	-35.0	5.0	12.0
Gross fixed capital form., UAH bn, nom.	701	564	679	.	.	.	.	.
annual change in % (real)	11.7	-21.3	7.5	.	.	-50.0	6.0	25.0
Gross industrial production								
annual change in % (real)	-0.5	-4.5	1.9	.	.	-40.0	10.0	15.0
Gross agricultural production								
annual change in % (real)	1.4	-10.1	16.4	.	.	.	.	.
Construction output								
annual change in % (real)	23.6	5.6	6.8	.	.	.	.	.
Employed persons, LFS, th, average	16,578	15,915	15,610	.	.	13,000	13,500	14,500
annual change in %	1.3	-4.0	-1.9	.	.	-16.7	3.8	7.4
Unemployed persons, LFS, th, average	1,488	1,674	1,712	.	.	5,060	2,380	1,610
Unemployment rate, LFS, in %, average	8.2	9.5	9.9	.	.	28.0	15.0	10
Reg. unemployment rate, in %, eop 2)	1.2	1.6	1.1	.	.	.	.	.
Average monthly gross wages, UAH 3)	10,497	11,591	14,014	.	.	11,900	14,400	17,600
annual change in % (real, gross)	9.7	7.5	10.5	.	.	-30.0	10.0	15.0
Consumer prices, % p.a.	7.9	2.7	9.4	8.3	15.1	21.0	10.0	6.0
Producer prices in industry, % p.a.	4.1	-1.6	40.8	.	.	20.0	8.0	5.0
General governm. budget, nat. def., % of GDP								
Revenues	32.4	32.6	30.4	34.3	43.7	40.0	30.0	30.0
Expenditures	34.6	37.9	33.9	34.9	62.6	65.0	50.0	38.0
Deficit (-) / surplus (+)	-2.2	-5.3	-3.4	-0.7	-18.9	-25.0	-20.0	-8.0
General gov. gross debt, nat. def., % of GDP	50.2	60.4	48.9	46.1	70.1	90.0	95.0	90.0
Stock of loans of non-fin. private sector, % p.a.	-9.8	-2.8	8.2	-2.1	4.8	.	.	.
Non-performing loans (NPL), in %, eop	48.4	41.0	30.0	37.2	29.7	.	.	.
Central bank policy rate, % p.a., eop 4)	13.50	6.00	9.00	7.50	25.00	25.0	15.0	10.0
Current account, EUR m 5)	-3,682	4,612	-2,744	-139	3,069	7,100	6,100	-1,400
Current account, % of GDP	-2.7	3.4	-1.6	-0.2	5.3	5.5	5.0	-1.0
Exports of goods, BOP, EUR m 5)	41,146	39,527	53,301	22,760	18,923	45,900	57,300	65,900
annual change in %	12.2	-3.9	34.8	18.7	-16.9	-13.9	24.8	15.0
Imports of goods, BOP, EUR m 5)	53,877	45,462	58,911	24,465	22,904	54,200	67,600	84,500
annual change in %	13.6	-15.6	29.6	15.1	-6.4	-8.0	24.7	25.0
Exports of services, BOP, EUR m 5)	15,591	13,628	15,532	6,761	7,467	15,900	18,200	20,000
annual change in %	16.3	-12.6	14.0	0.7	10.4	2.4	14.5	9.9
Imports of services, BOP, EUR m 5)	14,029	9,775	12,178	5,221	9,832	22,400	21,000	18,900
annual change in %	14.3	-30.3	24.6	6.0	88.3	83.9	-6.3	-10.0
FDI liabilities, EUR m 5)	5,174	266	6,183	2,718	-146	600	.	.
FDI assets, EUR m 5)	554	317	368	470	119	100	.	.
Gross reserves of CB excl. gold, EUR m 5)	21,590	22,422	25,920	22,593	20,172	.	.	.
Gross external debt, EUR m 5)	109,134	102,293	114,426	105,299	121,710	141,000	136,000	121,000
Gross external debt, % of GDP	79.4	74.6	67.7	62.3	94.0	109.0	111.0	87.0
Average exchange rate UAH/EUR	28.95	30.79	32.31	33.49	31.74	34.0	41.6	43.6

Note: Excluding the occupied territories of Crimea and Sevastopol and, with the exception of the population, excluding the temporarily occupied territories in the Donetsk and Luhansk regions. Due to the war in Ukraine, most of the usual statistical data are not being collected or published. This means that all Ukraine forecasts are subject to an unusually high degree of uncertainty.

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

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

IMPRESSUM

Herausgeber, Verleger, Eigentümer und Hersteller:
Verein „Wiener Institut für Internationale Wirtschaftsvergleiche“ (wiiw),
Wien 6, Rahlgasse 3

ZVR-Zahl: 329995655

Postanschrift: A 1060 Wien, Rahlgasse 3, Tel: [+431] 533 66 10, Telefax: [+431] 533 66 10 50
Internet Homepage: www.wiiw.ac.at

Nachdruck nur auszugsweise und mit genauer Quellenangabe gestattet.

Offenlegung nach § 25 Mediengesetz: Medieninhaber (Verleger): Verein "Wiener Institut für Internationale Wirtschaftsvergleiche", A 1060 Wien, Rahlgasse 3. Vereinszweck: Analyse der wirtschaftlichen Entwicklung der zentral- und osteuropäischen Länder sowie anderer Transformationswirtschaften sowohl mittels empirischer als auch theoretischer Studien und ihre Veröffentlichung; Erbringung von Beratungsleistungen für Regierungs- und Verwaltungsstellen, Firmen und Institutionen.

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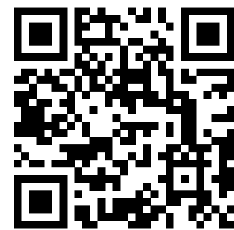
ISBN-978-3-85209-076-4



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