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Forecast Report

Overshadowed by War and Sanctions

Economic Analysis and Outlook for Central, East and Southeast Europe

The Vienna Institute for International Economic Studies
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Overshadowed by War and Sanctions

VASILY ASTROV

RICHARD GRIEVESON
BRANIMIR JOVANOVIĆ
ARTEM KOCHNEV
SEBASTIAN LEITNER
BERNHARD MOSHAMMER

et al. (including Alexandra Bykova, Rumen Dobrinsky, Selena Duraković, Doris Hanzl-Weiss, Gábor Hunya, Niko Korpar, Isilda Mara, Olga Pindyuk, Sándor Richter, Bernd Christoph Ströhm, Maryna Tverdostup, Nina Vujanović, Zuzana Zavarská and Adam Żurawski)

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Executive summary

After the COVID-related decline in 2020, last year saw the CESEE economies rebound sharply. The economy of the region expanded by 6.3%, 1 percentage point (pp) faster than in the euro area, and exceeded the pre-pandemic level of 2019 by 4.1 pp, with 17 of the region's 23 countries registering recovery stronger than the decline seen in 2020. This good showing by the CESEE economies reflected their adaptation to the pandemic and the reluctance of their governments to impose wide-ranging COVID restrictions. In contrast to Western Europe, the policy priority was typically on the economy, rather than public health, especially on the southern and eastern peripheries of the region. However, COVID-related scars are still visible in some CESEE countries and sectors, such as the automotive industry and tourism.

Thanks to the strong recovery, employment in CESEE has attained its pre-pandemic levels, with labour shortages resurfacing in many countries. In general, this attests to the success of government policies adopted during the COVID-19 crisis to stabilise demand and protect jobs. As the labour markets recovered, short-time work schemes and other support measures could be scaled back. At the same time, overall employment growth was accompanied by substantial labour reallocation across sectors, mirroring pandemic-induced changes in the structure of household demand (away from travel and leisure and towards real estate and consumer durables).

These largely positive developments will be knocked back by Russia's war in Ukraine and Western sanctions. The CESEE region is very exposed to the conflict zone: many countries directly border on it, have seen a large influx of Ukrainian refugees and are heavily dependent on it for imports of food and energy (the latter often coming from Russia); some also have extensive trade and investment links with the countries at war. As a result, economic sentiment in CESEE weakened considerably in March, with the Western Balkans being worst affected. Many regional currencies also experienced strong downward pressure in the early weeks of the conflict. However, after the initial 'overshooting', most of them have nearly recovered to pre-war levels, in some cases – such as Russia and Belarus – largely thanks to capital controls.

For the CESEE region, one channel of contagion from the war and the sanctions will be rising commodity prices, which will fuel inflation and depress economic growth. Both Russia and Ukraine are globally important food suppliers, and many CESEE countries are crucially dependent on imports of Russian energy. As a result, in the baseline scenario average inflation in the region is now forecast to accelerate to 23% this year. To counteract commodity price rises, many countries have resorted to regulating prices, cutting taxes and providing subsidies to vulnerable groups. Monetary policy has often been tightened, too. However, with policy rate hikes not keeping pace with the acceleration in inflation, real interest rates have even declined in many countries.

Another channel of contagion is the disruption to trade, which will cost most CESEE economies some 0.5 pp of GDP growth this year. For most of the region – with the exception of the CIS countries and, to a lesser degree, the Baltic states – Russia is not a very significant trading partner, while Ukraine's importance is even lower. However, certain sectors that have extensive cross-border production linkages will be affected much more. For instance, the automotive industry is already suffering on account of a shortage of car components (many of which come from Ukraine) and the large-scale, voluntary withdrawal from Russia of Western car manufacturers.

The massive influx of Ukrainian refugees should not put the regional labour markets under too much pressure, but it will strain public finances. Most of the refugees – women and children – will not immediately enter the labour force of the host countries. Besides, the demand for labour is high in many CESEE countries, and arriving Ukrainians could partly alleviate labour shortages. The chances for their long-term integration within the host countries are generally good – even if past experience strongly suggests that many of them are likely to be overqualified for the jobs available. However, given that an estimated EUR 40bn of EU-wide social spending will be required to accommodate the refugees in the initial stages, the fiscal burden on the most exposed countries – many of them in CESEE – will be substantial.

Largely on account of the war and the sanctions, growth in CESEE (leaving aside the CIS and Ukraine) will decelerate markedly. In the baseline scenario, growth should average around 3% this year – some 1 pp less than was forecast in January. The slowdown will be most pronounced in Turkey, where last year's credit boom has already run into balance-of-payments constraints and is unlikely to continue. For 2023-2024, downward forecast revisions prevail as well, suggesting that the legacy of the current crisis is likely to persist in the medium term. At the same time, energy and food subsidies and increased spending on refugees will support growth this year and possibly next.

Ukraine and the CIS countries (apart from Kazakhstan) will not be able to sidestep recession this year. In the baseline scenario, recession in Russia will reach 9% in 2022 and will persist into next year as well, while the country's long-term growth potential will be undermined by Western sanctions and the large-scale exodus of foreign firms. Ukraine is poised for imminent economic collapse, with its economy projected to shrink by 38% this year in the baseline scenario (which assumes a ceasefire from the middle of the year and the start of reconstruction). A large-scale Western assistance package akin to the Marshall Plan would provide a welcome boost to its economy, but the full effect is unlikely to be felt before 2024.

The forecast risks are clearly tilted to the downside. In the more adverse scenario – assuming a further major escalation of the war and an immediate EU embargo on Russian oil and gas – many CESEE countries will slide into recession this year, while inflation will soar into double figures nearly everywhere, on account of sharply rising energy costs. In this scenario, the Russian economy may contract by 15% or more this year, but those economies that are heavily dependent on Russian gas – e.g. Hungary, Slovakia and Turkey – will also be badly affected. In 2023-2024, the energy shock will subside, but growth will remain lower than in the baseline scenario.

Austria's overall exposure to the countries at war is limited, but an EU embargo on Russian gas would push its economy into recession. Russia accounts for only 1% of Austrian exports and 2% of its outward direct investments (although that share is higher in the banking sector), while Ukraine's importance is even lower. However, of all the EU countries, Austria is the third most dependent on Russian gas, which makes that a crucial area of vulnerability in the event of an embargo on gas imports. On a more positive note, the war in Ukraine will likely result in improved EU accession prospects for the countries of the Western Balkans – a traditionally important region for Austrian investment.

COUNTRY SUMMARIES

ALBANIA

Albania has a low volume of trade with Russia and Ukraine, but it will experience negative spill-overs from the war in Ukraine, on account of its strong trade relations with the EU. Monetary policy has shifted towards higher interest rates, and the government's fiscal stimulus measures will go some way to support consumption. Exports of minerals and fuel have gained momentum; however the country's current account balance will deteriorate. According to the baseline scenario, inflation this year will be 6% and growth 3.5%. In the medium term, inflation will fall to 3% and growth will rise to 3.9%.

BELARUS

Lukashenko's support for Russia's invasion of Ukraine triggered fresh economic sanctions by major Western countries. Subsequently there has been a rapid deterioration in the economic situation and havoc on the financial markets. Being cut off from the West, Belarus sought aid from, and further economic integration with, Russia. However, the latter has limited resources to support its ally. Recession seems inevitable in 2022, and economic weakness will prevail in the following years as well.

BOSNIA AND HERZEGOVINA

The economy grew more strongly than expected in 2021, due to a significant rise in industrial production, private consumption and exports. However, growth in 2022 is expected to be much weaker, given the threats of high inflation brought about by the war in Ukraine and the rise in local political tensions. The entity governments have failed to reach agreement on decisions that are important to the country's progress, and this is undermining its prospects for European integration, while also rendering it less attractive to both foreign investors and its own citizens, who are leaving the country in droves.

BULGARIA

Bulgaria is facing numerous challenges, on account of its chronic economic problems and the shocks resulting from the war in Ukraine. The diversity of the new government is in itself a source of weakness and is constraining its policy course. The recovery that was under way before the Russian invasion of Ukraine has come to a halt. The delays over approval of the National Recovery and Resilience Plan will mean a reduction in the transfer of EU funds in 2022. GDP is expected to grow by some 2% in 2022, and a moderate upturn is expected in 2023.

CROATIA

The Croatian economy has made a full recovery from the COVID-19 pandemic, with GDP increasing by 10.4% year on year in 2021. However, Russia's invasion of Ukraine has generated much uncertainty regarding Croatia's growth prospects for 2022. The surging energy costs, which are serving to boost inflation, will put pressure on government spending plans and will slow private consumption in 2022. The spill-over effects of the war will also adversely affect Croatia's summer tourist season, which is why we have adjusted the forecast for this year's GDP growth downward to 3.5%.

CZECHIA

The Czech economy grew in line with expectations in 2021, driven by household consumption as pandemic concerns faded into the background and savings started to be spent. Despite persistent supply-side troubles and sharply rising prices in the first two months of 2022, the pre-war outlook for growth over the forecast period was relatively favourable. The supply-chain pressures limiting exports showed signs of easing, and – boosted by the inflow of EU funds – investment activity was expected to accelerate. The war in Ukraine now limits these prospects. Great uncertainty, disruption and surging prices will dampen most channels of growth this year. We expect real GDP to grow modestly, by 2.6% in 2022, gradually picking up in 2023 and 2024.

ESTONIA

Economic performance in 2021 exceeded all expectations, with 8.3% GDP growth. This was steered by strong consumption, massive production expansion and a strengthening position on the global market. Yet the war has been a turning point. Because the Estonian economy started the year in excellent shape, economic recession will likely be avoided. However, real economic growth will fall to 1.8% in 2022, due mainly to rapid price rises, supply-side issues, disruptions to exports and a lack of major one-off investment – all magnified by the immense geopolitical uncertainty.

HUNGARY

Since mid-2021, the Hungarian economy has undergone a period of overheating that was intimately bound up with the extended campaign leading up to the parliamentary elections on 3 April. The excessive deployment of ‘election goodies’ by the government has resulted in large current account and fiscal deficits, rising inflation and a weak forint. Now that the election has been won, Prime Minister Orbán will have to deal with the unpopular task of economic consolidation. A relatively soft landing would require the country to gain access to the EU transfers from the Recovery and Resilience Facility, but the ongoing conflict with the EU over the ‘rule of law’ (primarily corruption related) renders this doubtful. Economic growth is expected to slow this year, to the range of 2-3%.

KAZAKHSTAN

Recession in Russia will drag down Kazakhstan’s economic performance in 2022. Inflation will accelerate on the back of high global food and energy prices, as well as high imported inflation from Russia. At the same time, elevated global commodity prices will have a beneficial impact on exports and tax revenues, and we expect net exports to make a positive contribution to economic growth. We have revised our real GDP growth forecast in the baseline scenario down to 1.5% for 2022 and 3.2% for 2023.

KOSOVO

Kosovo’s economic growth is likely to lose steam, owing to its high exposure to external shocks and certain domestic bottlenecks surrounding energy supplies. Consumption will spur growth, but at a slower pace. The restructuring of international trade will have negative spill-over effects, but there is also likely to be a silver lining in the shape of a surge in lignite exports. According to the baseline scenario – and on the assumption that the war in Ukraine will be over this year – inflation will climb to 7% and the growth rate will be 3.3%. In the medium term, inflationary pressure will slacken and growth will accelerate to 3.9%.

LATVIA

The Russian war in Ukraine will substantially drag down growth in the small, open economy of Latvia. Almost all sectors will be affected by a fall-off in demand and escalating prices. The influx of Ukrainian refugees (accounting for 0.5% of the Latvian population) may even induce additional consumption in the short run. In these uncertain times, enterprises will largely refrain from investment, preferring to deplete their stocks and wait for the price rises to stabilise. In 2022, we expect GDP growth to fall to 1.4%, but then to recover somewhat, to 2.2% in 2023. Our main scenario assumes no substantial intensification of economic sanctions. Later, we would expect a stabilisation of GDP growth in Latvia at 2.3% in 2024.

LITHUANIA

Following a strong recovery last year, economic growth in Lithuania has been dealt a blow by Russia's invasion of Ukraine. Big rises in the price of energy and other imported inputs for industrial production are hitting economies worldwide. In addition, the trade linkages with Russia, Belarus and Ukraine are obviously more intensive in the Baltics than in other parts of the EU. A decline in household and business sentiment alike means that consumption and investment activity will lose momentum in 2022. The government is trying to counter the loss of households' purchasing power with an anti-inflationary package, and it should manage to keep economic activity afloat with its planned public investments. In our main scenario, we expect real GDP to grow by 1.7% in 2022, followed by an upswing of 2.8% in 2023 and 2.6% in 2024.

MOLDOVA

After the boom fuelled by a bumper harvest in 2021, Moldova is facing negative growth in 2022. Soaring inflation – and especially the energy price shock – is hitting both consumption and production. The disruption to trade links with Russia and Ukraine is affecting production and causing a temporary shortage of basic goods. The country is providing refuge for many people who have fled Ukraine, which adds to demand. Generous Western aid and political support are crucial for the necessary economic adjustments.

MONTENEGRO

After the fall of the government at the beginning of the year, there is still no clear political solution in sight. Despite a growth rate of 12.4% in 2021, the pre-pandemic GDP level has not yet been reached, leaving further room for growth in 2022. There will be a decline in foreign direct investment, as a result of the sanctions against Russia. Despite rising inflation, household consumption will support growth in 2022, since the 'Europe Now' reform programme has led to an unprecedented increase in net earnings. The economy is expected to grow at a rate of 3.5% in 2022, 1 percentage point lower than initially expected.

NORTH MACEDONIA

The country has not yet recovered from the pandemic shock, and now the energy crisis and the war in Ukraine are rubbing salt into its wounds. The economic prospects appear gloomy, with weak growth and elevated inflation. We are revising our GDP projection for 2022 downwards, to 2.5% (from 3.5%); meanwhile, we expect inflation to be higher, at around 8% (from 3.5%).

POLAND

The Polish economy has proved surprisingly resilient so far. Industry has performed strongly in the first months of 2022, despite the unfavourable conditions. But growth will slow in 2022 and beyond. Rising interest rates are affecting consumption and investment, and inflation is eroding the real value of current incomes. In addition, the export prospects look less promising than before the war. To cap it all, essential imports (e.g. energy, metals) may be in short supply, or else become prohibitively expensive.

ROMANIA

Romania's energy and trade dependence on Russia and Ukraine is relatively modest, but still the energy price shocks and supply-chain disruptions have set back its economic performance. GDP will grow by no more than 2% in 2022, despite the generous inflows of EU funds. Inflation will rise to 9% on average, which will depress household demand. Currency devaluation will be modest, due to the central bank's interventions on the currency market.

RUSSIA

Tough Western sanctions in response to the Russian invasion of Ukraine will push the economy into deep recession this year and possibly next. Thanks to wide-ranging capital controls and monetary policy tightening, financial stability has been restored, and the rouble has recovered to nearly pre-war levels. However, the full effect of trade sanctions has yet to unfold and, along with the withdrawal of many foreign firms, this will hamper long-term growth prospects.

SERBIA

The war in Ukraine will be costly for Serbia, due to its close relations with Russia. In the short term, the country will face slower economic growth and higher prices: we are revising our GDP forecast for 2022 downwards to 3.6% (from 4.9%) and our inflation forecast upwards to 10% (from 4.5%). But the real challenges facing Serbia stem from its policy of attempting a balancing act between the EU and Russia, which will be hard to maintain in the coming years.

SLOVAKIA

By the end of 2021, Slovakia's GDP had still not fully recovered from the COVID-19 pandemic, showing annual growth of only 3%. Growth forecasts have been revised substantially downwards, reflecting the negative impact of the Russian war in Ukraine. Still, the inflow of EU funds should provide some growth impetus at a time of rising risk.

SLOVENIA

For 2022, we project real GDP to grow by 4.1% – unchanged from our previous forecast. Growth will be affected positively by strong private spending and investment, and negatively by the war in Ukraine, which will impact the economy through higher inflation and lower demand for exports. Inflation will reach 4.8%, and will spill over from energy into food and services. Due to the geopolitical situation, public finance is becoming a matter of some concern, following a period of high spending. The parliamentary elections in April will likely result in a new coalition.

TURKEY

Even before Russia invaded Ukraine, Turkey was in big trouble, with inflation at eye-watering levels, a currency that had halved in value in just a few months, a rapidly expanding current account deficit and rising pressure on external financing due to aggressive Fed tightening. Now the situation is even more difficult, owing to Turkey's strong economic ties with Russia and its heavy reliance on commodity imports. The best-case scenario is a sharp slowdown in growth; meanwhile, the risk of a renewed period of macroeconomic and financial instability has increased.

UKRAINE

The war has caused Ukraine significant economic and humanitarian losses. Economic activity has practically ceased in those regions where military operations are under way, and more than a quarter of the population has been displaced. We expect a gradual recovery of Ukraine's economy in 2023, but there is practically no chance of the recovery being even remotely V-shaped. GDP growth will accelerate in 2024, provided financial support is forthcoming from the West in the shape of a Marshall Plan-type reconstruction fund.

Keywords: CESEE, economic forecast, Central and Eastern Europe, Western Balkans, EU, euro area, CIS, Ukraine, Turkey, convergence, business cycle, coronavirus, labour markets, unemployment, Russia-Ukraine war, Russia sanctions, commodity prices, price controls, trade disruptions, Ukrainian refugees, energy embargo, 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: 7 April 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: Inflation up, growth down

BY RICHARD GRIEVESON, BRANIMIR JOVANOVIĆ AND ARTEM KOCHNEV

1.1. BASELINE SCENARIO: DOWNGRADES, BUT THE SHOW REMAINS ON THE ROAD

Russia's invasion of Ukraine will have substantial negative impacts for the global economy, and these are likely to last throughout the forecast period. The invasion has created a humanitarian crisis and has led to the mass destruction of physical infrastructure in Ukraine, but it has also had ripple effects that touch almost every country in the world. The decision by many Western and other countries to impose sweeping sanctions on Russia, combined with the systemic importance of both Russia and Ukraine in several global commodity markets, means that the economic and financial fallout will be significant and lasting.

Given the war, our spring 2022 forecasts come at a time of almost unprecedented global uncertainty. This stems from three main factors. First, the course of the war itself, which is impossible to predict. It is very difficult to say how long the conflict will last; whether the affected territory will expand or shrink; whether the intensity of the conflict will increase or decline; and whether a ceasefire will be reached soon. And all these factors will determine the economic fallout from the war. Second, the sanctions response, which continues to evolve. The truly 'nuclear' option in terms of sanctions – an EU decision to stop importing gas from Russia – has so far not been taken. If the EU opts for this, the consequences will be much more significant. The third main factor of uncertainty is the role of China. Although allied with Russia, and having so far largely kept quiet (including not joining sanctions), China remains something of a wildcard in the conflict. The extent to which it decides to help Russia deal with the fallout from existing and possible future sanctions, and the response that this elicits from the US, will both have a major bearing on the global economy in the coming years.

Our baseline scenario – which is subject to huge risks – is that there will be some kind of ceasefire by the middle of 2022. Such a ceasefire would come about because of a stalemate, with neither side able to advance further. This scenario assumes that Ukraine –thanks to an evidently very capable army, supplied with Western weapons – is able to fend off Russian forces, but not to defeat them entirely. Russia would control parts of the south and the east, but Ukraine's forces would hold the rest of the country. Such a ceasefire would end major combat operations and leave the Zelensky government in power in Kyiv. Talks, probably under Turkish mediation, could proceed along the lines that already seem to be broadly established (for example, with a Ukrainian commitment not to join NATO, in return for security guarantees). Nevertheless, this would be an uneasy truce, and we refrain from calling it 'peace'. Russia would continue its various unconventional warfare methods against Ukraine, while for its part Ukraine would seek reparations and war crimes trials. Most sanctions would remain on Russia for years, but not be materially increased from their current level.

For the global economy, this would not be the worst-case scenario, but clearly the situation requires a downgrade of projections vis-à-vis our previous, winter update. The euro area will be materially affected, primarily via a spike in inflation that will eat into real incomes, but also by a hit to confidence, which will weigh on investment and consumer spending. We project real GDP growth of 2.5% this year, 1.7 percentage points lower than we were anticipating in January (Table 1.1). Meanwhile we expect average inflation in the single currency area of 6%, up 2.8 percentage points from three months ago.

Table 1.1 / wiiw spring 2022 global assumptions

	Spring 2022			Changes since winter		
	2022	2023	2024	2022	2023	2024
Euro area real GDP growth, %	2.5	2.7	2.1	-1.7	-0.7	0.3
Euro area HICP, %	6.0	3.0	2.0	2.8	1.7	0.8
USD/EUR exchange rate, average	1.12	1.12	1.12	-0.02	-0.02	-0.02
USD per barrel Brent oil, average	105.0	90.0	90.0	27.0	17.0	22.0

Source: wiiw spring 2022 projections.

In the background, various other things will affect the global economy. On the positive side, the recovery from, and adaptation to, COVID-19 is continuing in large parts of the world, including the US and Europe. This will boost economic momentum this year. However, this is (probably more than) offset by negative effects from other sources, with two in particular standing out. First, even before the war began, global inflation was rising, driven by increasing commodity costs and supply-chain problems. In response, major central banks had started to tighten policy, most importantly the US Federal Reserve. As the Fed moves towards a more aggressive pace of tightening, this will weigh on economic activity in the US; but it also risks causing more serious financing difficulties in large parts of the developing world (World Bank, 2022). Meanwhile the second major negative for the global economy is the likelihood that China's zero-COVID policy – which is leading to massive restrictions on economic life across the country – will dampen economic growth.

1.2. ADVERSE SCENARIO: MUCH HIGHER ENERGY PRICES AND A RECESSION

Given the almost unprecedented level of uncertainty for global and CESEE economies in the current context, as part of our Spring Forecast we have also produced a second set of projections, this time for an 'adverse' scenario. We have conducted this exercise for the euro area and all 23 CESEE countries. For the latter, we have produced a second set of forecasts for all three years, for the consumer price index (CPI) and inflation (reference to CESEE table).

In this scenario, the war continues, and ever more evidence of war crimes by Russian forces emerges, leading to a ban on Russian energy imports by the EU (rather than the existing gradual phasing-out approach). While many are already calling for this step, some EU member states – most notably Germany – have demurred. Excuses offered for resisting this step include the likelihood that the economic impact for the EU would be quite severe. Many in the EU – and again perhaps especially in Germany – are worried about the impact of a sudden cessation of imports on key parts of the bloc's industry. In this scenario, the scale of atrocities committed by the Russian forces in Ukraine becomes so great that the heightened public pressure to increase sanctions outweighs the concerns outlined above.

This scenario would mean a substantial increase in energy prices in the euro area from their current levels, and a material further negative impact on growth. In addition, risk premia would rise, and confidence and investment would fall. There would also be lower demand from Russia for EU exports. According to this scenario, we model a doubling of energy prices in 2022, and continued effects on energy prices in 2023-2024 (albeit by then the effects would be less severe, relative to the baseline scenario).

In this scenario, the euro area would face a recession, albeit a fairly mild one, and a spike in inflation. Our results show a real GDP decline of 0.9% in 2022, 3.4 percentage points lower than the baseline (Table 1.2). In 2023 and 2024, real GDP in the euro area would be 0.4 and 0.7 percentage points lower than the baseline (respectively).

Table 1.2 / Adverse scenario and differences versus baseline

	Spring 2022 adverse scenario			Difference versus baseline		
	2022	2023	2024	2022	2023	2024
Euro area real GDP growth, %	-0.9	1.8	1.4	-3.4	-0.4	-0.7
Euro area HICP, %	9.5	4.0	2.7	3.5	-0.5	0.2

Source: wiiw.

BOX 1.1 / METHODOLOGY FOR THE ADVERSE SCENARIO SHOCK

Key assumptions

- Key shock: energy price increase:
  - Energy shock reduces GDP in the adverse scenario, compared to the baseline
  - Full weight of the shock in 2022. In 2023 and 2024, the shock values are smaller, depending on the speed of replacement of Russian energy supplies under the REpowerEU plan
- Energy shock derivation and assumptions:
  - We model the impact on GDP and inflation via energy price increases (oil and gas)
  - Energy prices double in 2022
  - Thereafter, energy prices decline, according to the European Commission's REpowerEU replacement plan: the EU replaces 72% of Russian gas by the end of 2023 and 79% by the end of 2024
- Other policy changes:
  - Monetary policy: no differentiation from the baseline scenario
  - Fiscal policy: neutral, no stimulus, no austerity

Modelling process

- Estimate one-year adverse impact (i.e. for 2022) of the energy price increases on German GDP and CPI, using a vector autoregression (VAR) estimation
- Model euro area GDP growth and inflation from bivariate regressions on German GDP and CPI, respectively, and predict changes in GDP and CPI for the euro area
- From the predicted values, generate shock values for 2022: add shock values to the baseline growth/inflation values in full for 2022
  For 2023, apply only 28% of the shock and 21% of the shock for 2024: 28% and 21% reflect the remaining deliveries of Russian gas to the EU, compared to 2021.

Method for estimating shocks to the German economy

- Time-series analysis using non-structural VAR, with two lags for the endogenous variables (GDP and CPI), and present values and one lag for the exogenous variables: gas and oil prices, European Central Bank rate, US GDP, Fed rates, time trend, and trend changes after 2008 and 2014
- Estimations performed in first differences
- The period of estimation is from Q1 2011 until Q4 2021
- Estimated on quarterly data from International Monetary Fund's International Financial Statistics and Investing.com
- Shock values generated from cumulative dynamic multiplier functions

Further details on the estimation results are available in Astrov et al. (2022).

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2. Overview CESEE: Overshadowed by war and sanctions

BY VASILY ASTROV, SEBASTIAN LEITNER AND BERNHARD MOSHAMMER[1]

2.1. COVID-RELATED SLUMP LEFT BEHIND, BUT SCARS STILL VISIBLE

After the COVID-related decline of 2020, last year witnessed a strong rebound in the CESEE economies. On a weighted average basis, the economy of the region expanded by 6.3% last year – 1 percentage point (pp) faster than in the euro area (Table 2.1). This is quite a remarkable achievement and cannot be explained simply by the effect of the statistical base: in 2020, regional GDP contracted by only 2.1%, compared to 6.4% in the euro area. Moreover, the aggregate fiscal and monetary response in CESEE was generally weaker than in the euro area. The strong showing of CESEE economies reflected first and foremost their adaptation to the pandemic and the reluctance of their governments to impose wide-ranging COVID restrictions. Although the numbers of new infections were comparable to those in Western Europe (Figure 2.1), the extent of the restrictions imposed was generally not as great (Figure 2.2), reflecting a more relaxed public attitude towards COVID, lower levels of trust in state institutions, thinner safety nets and tighter fiscal constraints. Under these circumstances, the policy priorities, especially on the southern and eastern peripheries of the CESEE region, typically focused on the economy, rather than public health.

The COVID-related slump has by and large been left behind. Last year, regional GDP exceeded the pre-pandemic level of 2019 by 4.1 pp, with 17 of the 23 countries registering recovery stronger than the decline in 2020 (Figure 2.3). In some cases, the pre-pandemic levels were surpassed by quite some margin: by 13% in Turkey, 6% in Serbia, and more than 5% in Moldova and Estonia. The Turkish economy was the only one in CESEE to avoid economic slump for the full year 2020, and it performed strongly last year on the back of rapid credit expansion and the boost to exports provided by its weaker currency. The Serbian economy has benefited from the generous fiscal stimulus offered in response to the pandemic; meanwhile, an exceptionally good harvest and an investment boom in digital industries played a role in Moldova and Estonia, respectively.

However, COVID-related scarring is still visible in some CESEE countries and sectors. In Czechia and Slovakia, for instance, GDP recovery last year was impeded by a shortage of semiconductor chips in the crucial automotive industry – a legacy of COVID-related disruptions to global value chains. In tourism-dependent Montenegro, the sharp downturn in visitor numbers was not entirely reversed. In North Macedonia, the policy mix adopted in response to the pandemic was arguably too restrictive and acted as a drag on growth. Bulgaria recorded a sharp drop in investment on the back of persistent political instability, while recovery in Ukraine suffered on account of export weakness. In those six CESEE countries, the pre-pandemic levels of economic activity were not reached in 2021.

1 The authors would like to thank Richard Grieveson, Doris Hanzl-Weiss and Branimir Jovanović for their valuable comments and suggestions on the first draft.

Table 2.1 / Indicators 2020-2021 and Outlook 2022-2024 - Baseline Scenario

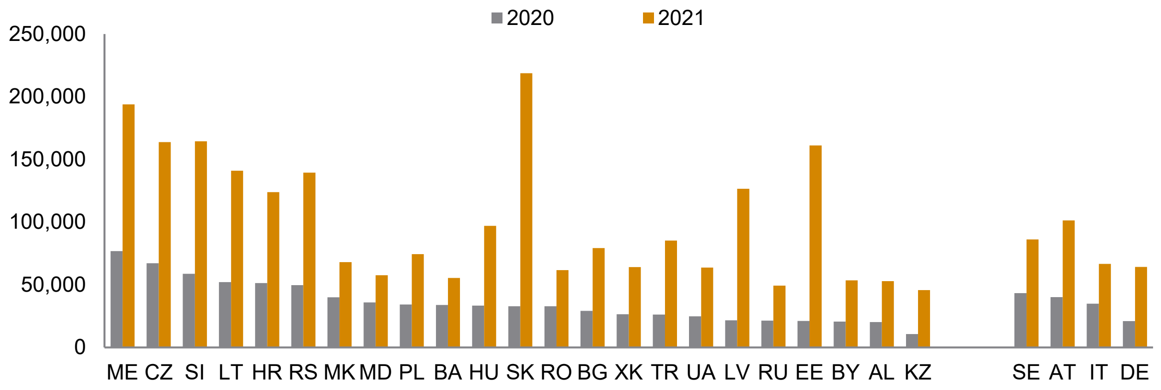
		GDP					Consumer prices					Unemployment (LFS)				
		real change in % against prev. year					average change in % against prev. year					rate in %, annual average				
				Forecast					Forecast					Forecast		
		2020	2021	2022	2023	2024	2020	2021	2022	2023	2024	2020	2021	2022	2023	2024
BG	Bulgaria	-4.4	4.2	2.0	3.7	3.5	1.2	2.8	14.0	8.0	5.0	5.1	5.3	5.0	4.5	4.0
CZ	Czechia	-5.8	3.3	2.6	3.5	4.2	3.3	3.3	8.7	3.8	2.3	2.6	2.8	2.5	2.5	2.2
EE	Estonia	-3.0	8.3	1.8	3.4	3.1	-0.6	4.5	11.0	3.5	2.8	6.8	6.2	8.0	6.0	5.2
HR	Croatia	-8.1	10.4	3.5	4.0	3.1	0.0	2.7	6.5	2.9	2.3	7.5	7.7	7.1	6.4	6.5
HU	Hungary	-4.7	7.1	2.5	3.9	4.5	3.4	5.2	9.0	5.0	3.5	4.3	4.1	3.9	3.8	3.5
LT	Lithuania	-0.1	5.0	1.7	2.8	2.6	1.1	5.5	12.0	6.5	4.0	8.5	7.1	6.8	7.0	6.0
LV	Latvia	-3.8	4.7	1.4	2.2	2.3	0.1	3.2	10.0	6.5	3.5	8.1	7.6	7.5	5.8	6.0
PL	Poland	-2.5	5.7	4.0	3.5	3.6	3.7	5.2	10.0	6.5	3.5	3.2	3.4	3.0	3.1	3.2
RO	Romania	-3.7	5.9	2.0	3.5	4.5	2.3	4.1	9.0	5.0	3.0	5.0	5.6	5.6	5.3	5.0
SI	Slovenia	-4.2	8.1	4.1	3.3	2.8	-0.3	2.0	4.8	1.7	1.4	5.0	4.8	4.5	4.3	4.1
SK	Slovakia	-4.4	3.0	2.4	3.1	3.0	2.0	2.8	8.0	4.5	2.0	6.7	6.8	6.5	5.9	5.7
	EU-CEE11 [1)2)]	*-3.7*	*5.6*	*3.0*	*3.5*	*3.8*	*2.7*	*4.3*	*9.5*	*5.4*	*3.2*	*4.4*	*4.5*	*4.3*	*4.1*	*3.9*
	EA19 [3)]	*-6.4*	*5.3*	*2.5*	*2.7*	*2.1*	*0.3*	*2.6*	*6.0*	*3.0*	*2.0*	*7.9*	*7.7*	*7.3*	*6.9*	*6.6*
	EU27 [3)]	*-5.9*	*5.3*	*2.7*	*2.9*	*2.3*	*0.7*	*2.9*	*6.2*	*3.2*	*2.2*	*7.1*	*6.9*	*6.5*	*6.1*	*5.8*
AL	Albania	-3.5	8.5	3.5	3.7	3.9	1.6	2.0	6.0	3.4	2.5	11.7	11.5	11.2	11.0	10.6
BA	Bosnia and Herzegovina	-3.1	7.1	1.8	2.3	2.3	-1.1	2.0	8.0	4.0	3.0	15.9	17.4	16.8	16.3	15.7
ME	Montenegro	-15.3	12.4	3.5	3.7	3.3	-0.3	2.4	6.4	3.0	2.0	17.9	16.6	15.3	14.8	14.0
MK	North Macedonia	-6.1	4.0	2.5	2.7	2.7	1.2	3.2	8.0	5.0	4.0	16.4	15.7	15.2	14.8	14.5
RS	Serbia	-0.9	7.4	3.6	3.4	3.4	1.6	4.1	10.0	6.0	4.0	9.0	11.0	10.5	10.0	9.5
XK	Kosovo	-5.3	10.5	3.3	3.7	3.9	0.2	3.4	7.0	4.0	2.0	25.9	24.5	24.3	23.8	23.5
	WB6 [1)2)]	*-3.2*	*7.6*	*3.1*	*3.2*	*3.3*	*0.9*	*3.2*	*8.5*	*4.9*	*3.4*	*13.0*	*13.9*	*13.4*	*13.0*	*12.6*
TR	Turkey	1.8	11.0	2.7	2.8	3.2	12.3	19.6	55.0	20.0	10.0	13.2	12.0	11.5	10.5	9.5
BY	Belarus	-0.7	2.3	-3.5	1.6	2.0	5.5	9.5	15.0	12.0	11.0	4.0	3.9	4.1	4.0	4.0
KZ	Kazakhstan	-2.5	4.0	1.5	3.2	4.0	6.8	8.0	11.0	8.0	6.0	4.9	4.9	5.0	4.8	4.8
MD	Moldova	-7.4	13.9	-3.0	3.0	4.0	3.8	5.1	20.0	10.0	4.0	3.8	3.2	3.5	3.3	3.2
RU	Russia	-2.7	4.7	-9.0	-1.5	1.0	3.4	6.7	20.0	14.0	4.0	5.8	4.8	7.5	7.0	6.5
UA	Ukraine	-3.8	3.4	-38.0	5.0	13.0	2.7	9.4	15.0	10.0	6.0	9.5	9.9	25.0	15.0	10.0
	CIS4+UA [1)2)]	*-2.7*	*4.5*	*-10.6*	*-0.3*	*2.4*	*3.7*	*7.1*	*18.6*	*13.0*	*4.6*	*6.2*	*5.6*	*9.5*	*7.5*	*6.5*
	V4 [1)2)]	*-3.6*	*5.3*	*3.4*	*3.5*	*3.8*	*3.4*	*4.7*	*9.5*	*5.6*	*3.2*	*3.5*	*3.7*	*3.4*	*3.4*	*3.3*
	BALT3 [1)2)]	*-1.8*	*5.7*	*1.6*	*2.8*	*2.6*	*0.4*	*4.7*	*11.2*	*5.8*	*3.6*	*8.0*	*7.0*	*7.3*	*6.4*	*5.8*
	SEE9 [1)2)]	*-4.1*	*6.5*	*2.4*	*3.5*	*3.9*	*1.6*	*3.6*	*9.3*	*5.2*	*3.3*	*8.1*	*8.7*	*8.5*	*8.2*	*7.8*
	CIS3+UA [1)2)]	*-2.9*	*3.8*	*-16.3*	*3.7*	*7.6*	*4.8*	*8.8*	*13.6*	*9.5*	*6.7*	*7.2*	*7.3*	*15.5*	*9.9*	*7.3*
	non-EU12 [1)2)]	*-1.4*	*6.5*	*-6.2*	*0.7*	*2.7*	*6.1*	*10.7*	*28.9*	*14.8*	*6.1*	*8.0*	*7.4*	*10.2*	*8.5*	*7.5*
	CESEE23 [1)2)]	*-2.1*	*6.3*	*-3.6*	*1.5*	*3.0*	*5.1*	*8.8*	*23.4*	*12.1*	*5.3*	*7.1*	*6.7*	*8.8*	*7.4*	*6.6*

Table 2.1 / (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	-0.1	-0.4	-1.5	-1.4	-0.7	-4.0	-3.0	-5.0	-4.0	-3.0
CZ	Czechia	2.0	-0.9	-2.2	-1.2	0.0	-5.6	-6.8	-5.0	-2.7	-0.5
EE	Estonia	-0.3	-1.1	-0.8	-0.5	-0.3	-5.6	-4.0	-3.0	-2.1	-1.2
HR	Croatia	-0.1	3.2	1.1	1.8	1.5	-7.4	-3.8	-3.5	-2.7	-2.5
HU	Hungary	-1.1	-3.1	-2.9	-1.6	-0.1	-8.0	-7.5	-5.5	-3.5	-3.0
LT	Lithuania	7.3	1.4	0.8	0.4	0.5	-7.2	-2.6	-4.0	-3.0	-2.0
LV	Latvia	2.9	-2.9	-3.8	-1.9	-2.0	-4.5	-7.3	-5.5	-3.5	-2.0
PL	Poland	2.9	-0.6	-0.8	-0.5	-0.4	-7.1	-5.5	-5.0	-4.0	-3.0
RO	Romania	-5.0	-7.0	-7.0	-6.2	-5.9	-9.3	-7.0	-7.0	-5.0	-4.0
SI	Slovenia	7.4	3.3	1.4	0.3	0.0	-7.7	-5.2	-3.6	-0.4	-0.2
SK	Slovakia	0.4	-2.0	-3.9	-3.7	-3.3	-5.5	-7.1	-5.1	-4.1	-3.5
	EU-CEE11 1)2)	*1.1*	*-1.6*	*-2.2*	*-1.7*	*-1.2*	*-7.0*	*-5.9*	*-5.2*	*-3.7*	*-2.6*
	EA19 3)	*2.8*	*2.0*	*1.5*	*1.5*	*1.5*	*-7.2*	*-5.9*	*-4.0*	*-2.8*	*-1.8*
	EU27 3)	*2.8*	*2.0*	*1.5*	*1.5*	*1.5*	*-6.9*	*-5.5*	*-3.6*	*-2.4*	*-1.4*
AL	Albania	-8.7	-7.7	-8.1	-7.3	-6.7	-6.7	-4.5	-4.6	-3.0	-2.0
BA	Bosnia and Herzegovina	-3.8	-2.1	-3.7	-3.9	-4.1	-5.3	3.5	0.0	0.5	1.0
ME	Montenegro	-26.1	-9.2	-12.5	-12.8	-12.3	-11.1	-1.8	-6.0	-4.5	-4.0
MK	North Macedonia	-3.4	-3.5	-6.8	-6.7	-6.8	-8.3	-5.4	-4.0	-3.0	-2.0
RS	Serbia	-4.1	-4.4	-6.5	-6.8	-7.2	-8.0	-4.1	-3.5	-3.0	-2.5
XK	Kosovo	-7.0	-8.8	-9.9	-9.8	-9.4	-7.6	-1.3	-2.0	-2.0	-0.5
	WB6 1)2)	*-5.7*	*-4.9*	*-6.8*	*-6.9*	*-7.0*	*-7.5*	*-2.7*	*-3.1*	*-2.4*	*-1.7*
TR	Turkey	-5.0	-1.8	-6.3	-5.8	-5.5	-2.9	-3.5	-3.2	-2.4	-2.0
BY	Belarus	-0.4	2.7	1.3	1.3	0.8	-1.7	-2.0	-4.0	-2.0	-1.0
KZ	Kazakhstan	-3.8	-3.0	-0.3	-1.0	-1.2	-4.0	-3.1	-3.5	-2.5	-2.0
MD	Moldova	-7.7	-11.6	-12.8	-11.6	-10.9	-5.3	-1.9	-5.0	-3.0	-2.0
RU	Russia	2.4	6.9	10.8	7.5	7.0	-4.0	0.8	-3.0	0.0	1.0
UA	Ukraine	3.4	-1.3	1.4	1.4	0.2	-5.3	-3.4	-25.0	-15.0	-8.0
	CIS4+UA 1)2)	*1.8*	*5.1*	*8.7*	*5.9*	*5.3*	*-4.0*	*0.0*	*-4.5*	*-1.3*	*-0.1*
	V4 1)2)	*1.9*	*-1.2*	*-1.7*	*-1.1*	*-0.5*	*-6.8*	*-6.2*	*-5.1*	*-3.6*	*-2.5*
	BALT3 1)2)	*4.2*	*-0.4*	*-0.9*	*-0.4*	*-0.4*	*-6.0*	*-4.1*	*-4.2*	*-2.9*	*-1.8*
	SEE9 1)2)	*-3.9*	*-4.3*	*-5.2*	*-4.7*	*-4.5*	*-7.9*	*-5.1*	*-5.4*	*-4.0*	*-3.1*
	CIS3+UA 1)2)	*-0.6*	*-1.7*	*0.0*	*-0.3*	*-0.8*	*-4.2*	*-3.1*	*-10.7*	*-6.6*	*-3.9*
	non-EU12 1)2)	*-0.3*	*2.9*	*4.5*	*2.4*	*1.9*	*-3.9*	*-1.0*	*-4.1*	*-1.6*	*-0.7*
	CESEE23 1)2)	*0.2*	*1.2*	*1.7*	*0.7*	*0.5*	*-5.1*	*-2.8*	*-4.6*	*-2.5*	*-1.5*

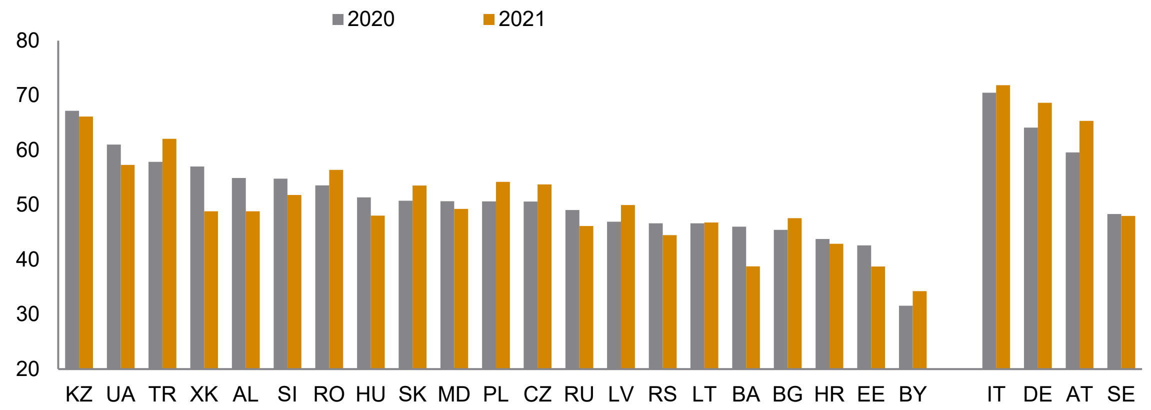
1) wiiw estimates. - 2) Current account data include transactions within the region (sum over individual countries). - 3) Forecasts estimated by wiiw.
Source: wiiw, Eurostat. Forecasts by wiiw. Cut-off date for historical data and forecasts: 7 April 2022.

Figure 2.1 / Number of new COVID-19 cases (per million population)



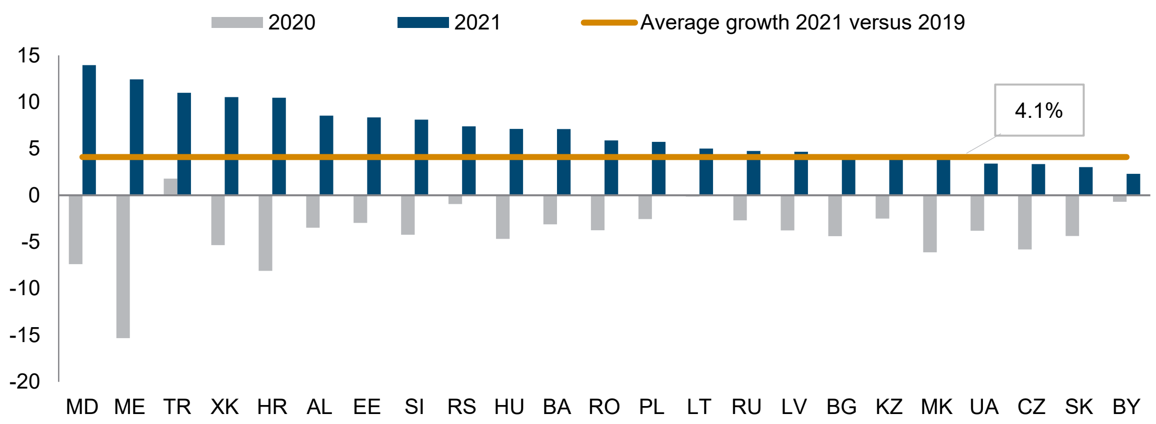
Source: Our World in Data, Oxford University, own calculations.

Figure 2.2 / Stringency Index



Source: Blavatnik School of Government, Oxford University, own calculations.

Figure 2.3 / Real GDP growth (%, year on year)



Note: Average growth 2021 versus 2019 is a weighted average over all countries.
Source: wiiw Annual Database incorporating national statistics and Eurostat.

2.2. SWIFT RECOVERY OF LABOUR MARKETS

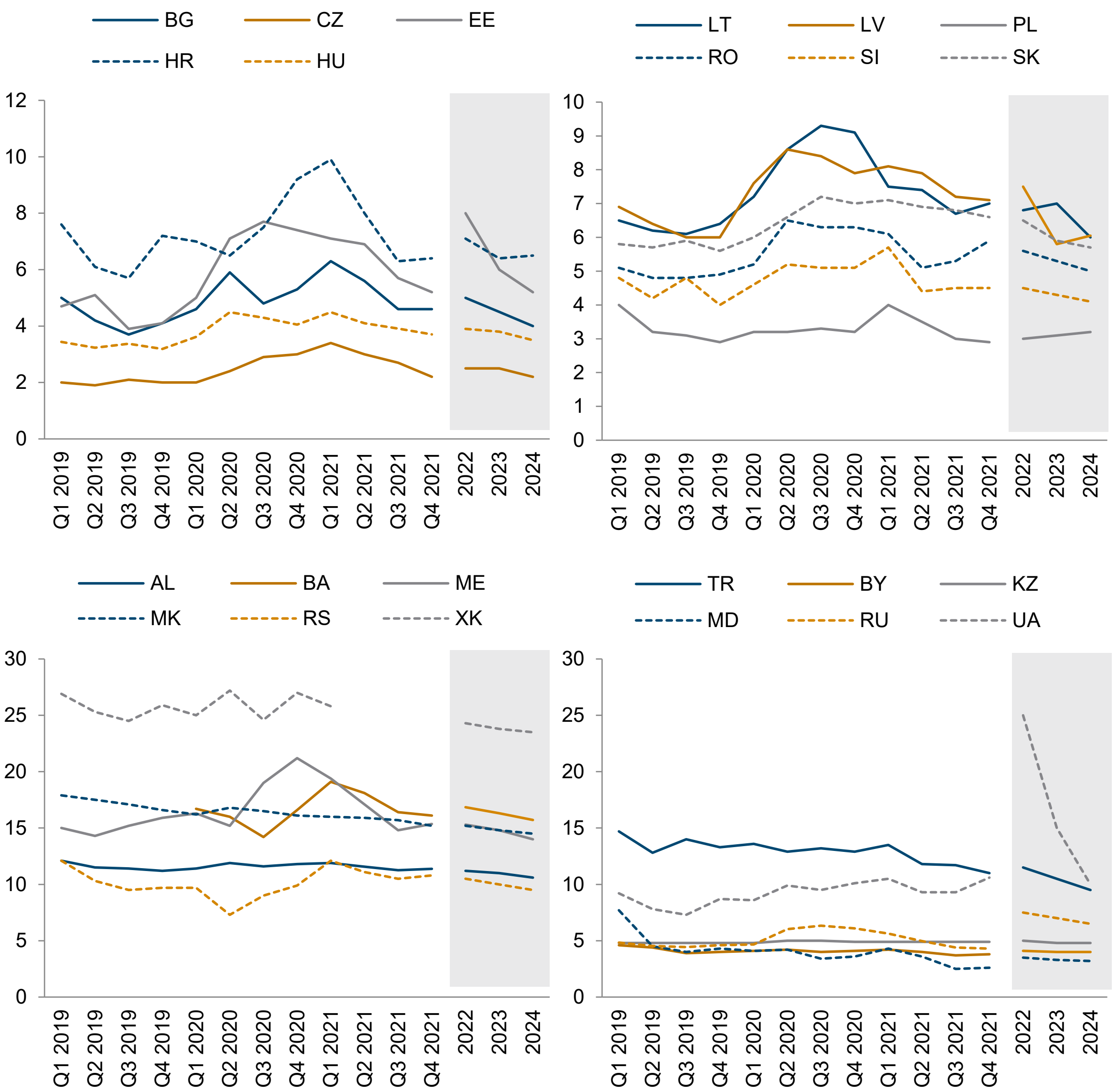
Employment in CESEE has attained pre-pandemic levels, with labour shortages resurfacing in many countries. After the economic slump of 2020, demand for labour recovered swiftly last year, particularly in Hungary, the Baltic states, Slovenia and Croatia. After accounting for the changes in Labour Force Survey (LFS) methodology (see Box 2.1 for details), employment grew nearly everywhere in the region: only in Ukraine, Belarus and Slovakia was there any discernible decline in employment. Simultaneously, unemployment fell gradually (Figure 2.4), and in many EU-CEE countries job vacancy rates approached high pre-crisis levels (Figure 2.5). In general, this attests to the success of policies adopted during the COVID-19 crisis. The uniform commitment of monetary and fiscal policies to demand stabilisation and job protection managed to keep the scarring and hysteresis effects in labour markets to a minimum. This meant that unemployment again declined rapidly and the growth of long-term unemployment could be tamed. As the labour markets recovered, so short-time work schemes and other support measures could be partially withdrawn. In Slovakia, for example, only 137,000 jobs were being subsidised in December 2021, compared to 264,000 a year before.

BOX 2.1 / CHANGES TO LABOUR FORCE SURVEY METHODOLOGY UNDERSTATE EMPLOYMENT GROWTH

Recent changes to the Labour Force Survey (LFS) methodology complicate comparisons, both across countries and over time, and understate the true extent of employment growth in CESEE last year. The most important change is that people who produce agricultural products for their own consumption (subsistence farming) are no longer regarded as employed, but are considered to be out of the labour force. Thus, the figures for employment in agriculture fell substantially in Poland, Bulgaria and Montenegro; and in Romania, they even halved (the unemployment rate in Romania would be about 1 pp lower if we excluded the impact of changes to the statistical methodology). As a result, total employment published from 2021 onwards is lower (based on the new LFS methodology) for many CESEE countries. The changes also had an impact in Bosnia and Herzegovina and in Serbia. In the latter, many who had remained inactive during the COVID-19 restrictions of 2020 again started to search for jobs in 2021, which increased the rate of those statistically registered as unemployed.

By contrast, only in 2021 did Hungary start to classify as employed those people on parental leave who had formerly been in work; this resulted in a statistical increase in employment of 3%.

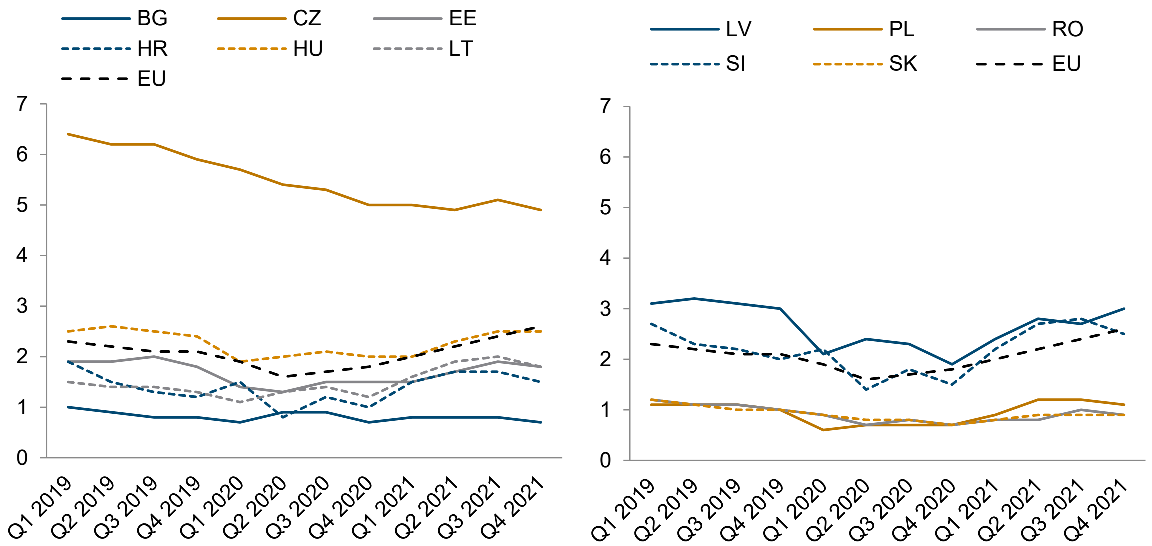
Figure 2.4 / Unemployment rate, in %, quarterly (LFS)



Note: BG, EE, HR, SI, SK, BA, ME, RS, TR: break due to new methodology 2021
Source: wiiw Monthly Database incorporating national statistics. wiiw forecasts for 2022-2024.

At the same time, strong overall employment growth last year was accompanied by a structural change across sectors. While some sectors, such as hospitality, were still ailing somewhat due to COVID-19 restrictions, both industry and business services recruited additional workers. This mirrored the general restructuring of the economies caused by pandemic-induced changes in the structure of household demand. Since, for example, many households could not spend their income on holidays abroad or various other types of leisure activities, they invested in their homes and in consumer durables generally. Those sectors were desperate for additional labour.

Figure 2.5 / Job vacancy rate, in %



Notes: The job vacancy rate measures the number of total posts that are vacant, divided by the sum (number of occupied posts + number of job vacancies), expressed as a percentage.
Data refer to B-S economic activities: Industry, construction and services (except activities of households as employers and extra-territorial organisations and bodies).
Source: Eurostat.

2.3. OUTBREAK OF WAR WEIGHS HEAVILY ON ECONOMIC SENTIMENT

These largely positive developments will be knocked back by Russia's war in Ukraine and by the subsequent sanctions. On 24 February 2022, Russia – partly assisted by Belarus – embarked on the large-scale military invasion of Ukraine. This led to a swift and strong response by the EU, the US and their Western allies, in the form of wide-ranging sanctions imposed on Russia and Belarus. These included financial, trade and personal sanctions against top politicians and oligarchs. In addition, many Western companies have announced their voluntary withdrawal from Russia and Belarus, reflecting their concern about the possibility of being sanctioned indirectly by the US,[2] fears of nationalisation of their assets and a desire to safeguard their public image.[3] In Ukraine itself, economic activity in the war-torn areas contracted sharply as the population fled those areas, logistics were disrupted and infrastructure was damaged. Those Ukrainian regions that have been directly affected by the war account for 53% of GDP, 43% of industrial production, 34% of agricultural production and 50% of goods exports (Table 2.2).

[2] This happened, for instance, in Iran, after the imposition of US sanctions.

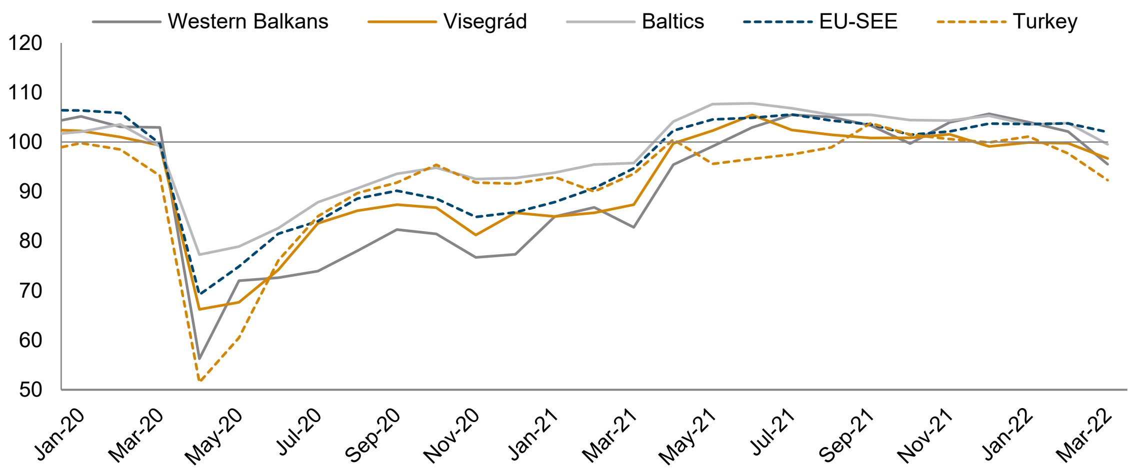
[3] At the time of writing, some 600 Western companies have suspended their operations in Russia or announced their withdrawal, while more than 200 have deferred new investment or scaled back their operations. See https://som.yale.edu/story/2022/over-600-companies-have-curtailed-operations-russia-some-remain (figures as of 19 April 2022).

Table 2.2 / Main characteristics of the Ukrainian regions on the front line

Regions	Population 2021	GDP 2019	Industrial production 2020	Goods exports 2020	Services exports* 2019	Agricultural production 2020	Foreign direct investment stock* 2020
	million people	share of the total for the country, %					
Kyiv city	2.95	23.9	11.8	25.3	48.5	-	46.4
Chernihiv	0.96	2.0	1.4	1.8	0.4	6.9	1.1
Kharkiv	2.60	6.2	7.1	3.0	4.6	6.4	2.2
Kherson	1.00	1.6	1.3	0.6	0.4	3.9	0.9
Kyiv	1.80	5.5	5.1	4.0	4.2	5.9	4.4
Mykolayiv	1.09	2.3	2.5	4.6	5.9	3.1	1.5
Donetsk	4.06	5.2	10.3	8.0	1.1	3.3	5.0
Luhansk	2.10	1.0	0.8	0.3	0.4	2.2	0.8
Total for the selected regions	**18.91**	**52.7**	**43.1**	**50.3**	**75.4**	**34.0**	**66.0**
Total for the selected regions without Kyiv city	***15.96***	***28.8***	***31.3***	***25.0***	***26.9***	***34.0***	***19.6***

* Excluding unallocated value.
Source: Astrov et al. (2022).

Figure 2.6 / European Commission economic sentiment indicator, long-term average = 100



Note: Simple average of each country group. Western Balkans: Albania, Montenegro, North Macedonia; EU-SEE: Bulgaria, Croatia, Romania, Slovenia.
Source: European Commission, Eurostat.

Economic sentiment in CESEE has already suffered as a result. The region is very exposed to the conflict zone: many countries directly border on Russia, Belarus or Ukraine, have seen a large influx of Ukrainian refugees and are heavily dependent on imported food and energy (the latter often coming from Russia); some also have extensive trade and investment links with the countries at war. Therefore, it comes as little surprise that economic sentiment in the CESEE region weakened considerably in March (Figure 2.6). Interestingly, the biggest impact was felt in the Western Balkan countries, despite the fact that many of them do not have very strong direct economic links with Russia and Ukraine. With the Western Balkans characterised by pronounced political instability in the not-too-distant past, there is an increased perception that the armed conflict could spill over into this region as well.

The immediate impact of the war and the sanctions was strong, albeit short-lived, downward pressure on many CESEE currencies. Unsurprisingly, the Russian rouble suffered the most:[4] during the first few weeks of the war, it lost nearly half of its value. The pressure on other CESEE currencies was far more limited, with the extent largely reflecting a country's proximity to, and its trade dependence on, Russia. Thus, the Belarusian rouble and the Kazakh tenge broadly followed the fluctuations in the exchange rate of the Russian rouble, losing 30% and 20% versus the US dollar, respectively, during the first few weeks of the war. Among those non-CIS currencies worst affected were the Hungarian forint and the Polish złoty, which depreciated by close to 10% initially. The Czech koruna was affected less (as has usually been the case in times of crisis), while in Serbia (which is relatively close to Russia economically and otherwise) and Romania (which has rather shaky fiscal and external fundamentals) the currencies remained largely stable, thanks to heavy forex interventions (Figure 2.7). However, after the initial 'overshooting', most CESEE currencies recovered (or nearly recovered) to their pre-war levels. In Russia and Belarus, the recovery has been facilitated by capital controls.

Figure 2.7 / Percentage change in the value of the national currency versus EUR, December 2021 to March 2022

Notes: Based on monthly averages. Data for Belarus refer to February 2022.
Source: wiiw Monthly Database incorporating national statistics and Eurostat, own calculations.

In what follows, we analyse the likely main channels by which the war and the sanctions will have an impact on CESEE economies: (i) rising commodity prices and monetary policy response, (ii) trade disruptions and (iii) the influx of Ukrainian refugees.

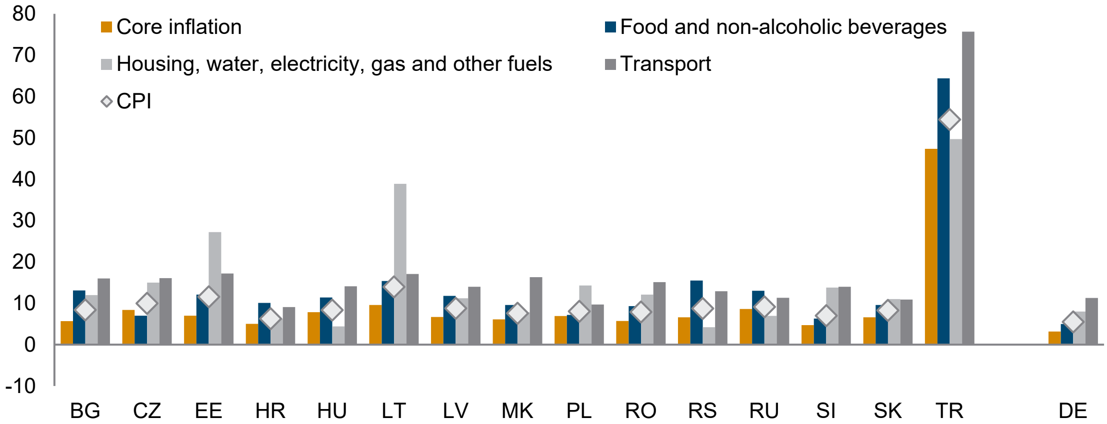
[4] By contrast, the exchange rate of the Ukrainian hryvnia was frozen at its pre-war level, in line with martial law.

2.4. RISING COMMODITY PRICES AND MONETARY POLICY TIGHTENING

CESEE countries were already facing significant inflationary pressures well before the war. Defying early predictions that the post-COVID spike in prices was transitory, inflation has been on the rise in CESEE (and elsewhere) over the past year or so. By February 2022, annual inflation had reached double-digit levels in Czechia, Estonia and Lithuania, and was approaching the 10% mark in most other countries. The wiiw Autumn 2021 Forecast Report[5] came to the conclusion at the time that inflation was primarily being driven by supply bottlenecks and the rising cost of energy and transportation, rather than broad-based demand-side pressures: the rise in core inflation was relatively limited (with the dramatic exception of Turkey). In February 2022, those conclusions still broadly held, although the role of food prices was more pronounced than last autumn (Figure 2.8).

The war in Ukraine and the sanctions on Russia have pushed up energy prices still further, reflecting concerns over Russian energy supplies and transit via Ukraine in wartime conditions. And some of those concerns have actually materialised. The EU has slapped an embargo on imports of Russian coal (with a four-month grace period); the US is banning the import of Russian oil, liquefied natural gas (LNG) and coal; and the UK is stopping imports of Russian oil and coal (by the end of 2022). Furthermore, although an oil embargo has not yet (at the time of writing) been enacted by the EU, oil imports from Russia are already effectively hampered by the disruption to payments and by the fact that some Russian oil majors feature on the sanctions list.[6] On top of everything else, Russia has demanded a switch to payment in roubles for its gas deliveries to the EU. This demand has not been accepted by the EU, and that has resulted in a further rise in concerns over supply.

Figure 2.8 / Consumer price inflation sub-components in February 2022, percentage change year on year



Source: National sources, Eurostat, wiiw.

Food prices have risen sharply as well. Russia and Ukraine together account for 53% of global trade in sunflower seed and 27% in wheat. In Ukraine, the war-related disruption to agricultural production is amplified by logistical challenges, with seaports – traditionally an important export route – either blockaded

5 wiiw (2021).

6 As a result of these sanctions, the Urals oil blend is now traded at a considerable discount of up to USD 30 per barrel compared to the benchmark Brent.

(such as Odesa) or at the epicentre of fighting (such as Mariupol). In turn, Russia and some other countries have introduced export bans on wheat and certain other commodities. Finally, metals prices have been on the rise, fuelled in part by bans on imports from Russia. In many CESEE countries, the impact of these developments was already being felt in March, when inflation climbed to new heights.

On account of sharply rising commodity prices, wiiw inflation projections for 2022 have been revised upwards. On average in the region, consumer price inflation is forecast to accelerate to 23% – from 8.8% last year (Table 2.1). Although this is partly driven by Turkey, where inflation will probably average 55% this year, it will pick up elsewhere in the region as well, doubling (or more) in many cases. With increased expenditure on essential items, such as food and energy, households in the region will be increasingly constrained in their purchases of other items, which will hamper the growth of private consumption and GDP. Besides, sharply rising energy prices will affect the performance of energy-intensive industries, possibly resulting in some business closures.

Table 2.3 / Policies to offset the impact of energy price rises on consumers

	Reduced energy tax/VAT	Retail price regulation	Transfers to vulnerable groups	Windfall profits tax/regulation
Albania		x		
Bosnia and Herzegovina	x	x		
Bulgaria		x		x
Croatia	x	x	x	
Czechia	x	x	x	
Estonia	x	x	x	
Hungary		x		
Kosovo			x	
Latvia	x		x	
Lithuania		x	x	
North Macedonia	x		x	
Poland	x	x	x	
Romania	x	x	x	x
Serbia	x	x		
Slovakia		x		
Ukraine	x			

Notes: Includes measures both announced and already approved. Fuel price regulation in Croatia ended at the end of March 2022. In Hungary, price regulation of gas and electricity has been in place since 2015.
Sources: Sgaravatti et al. (2022), Raiffeisen Research (2022), wiiw research.

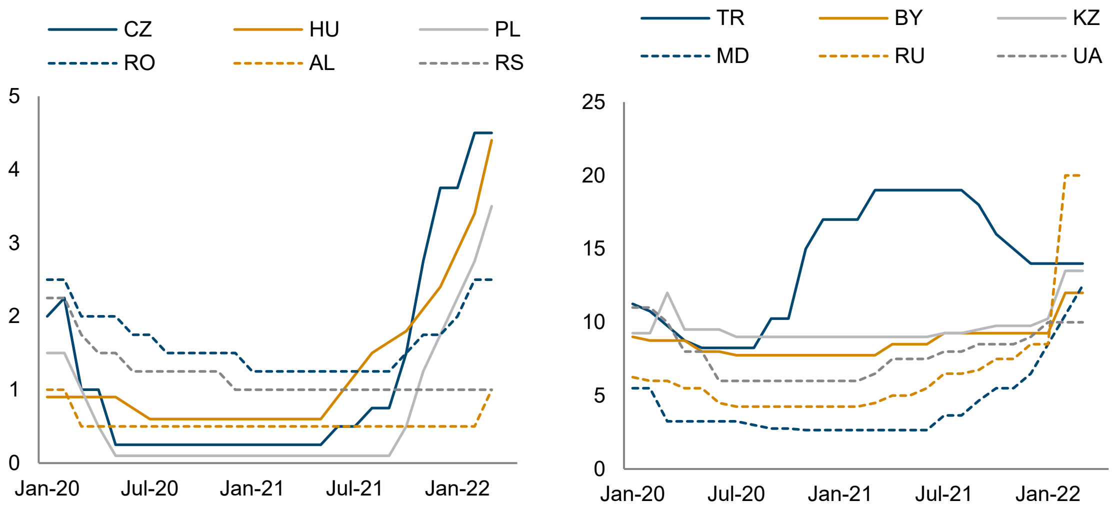
To counteract price increases, many CESEE countries have resorted to fiscal support measures. When it comes to energy, the most common measures have been the direct price regulation of fuel and electricity, while Poland and Albania have delayed the liberalisation of gas prices for households and small and medium-sized businesses. Cuts in taxes on energy and cash transfers to vulnerable social groups have also been common, while Bulgaria and Romania have imposed windfall profit taxes on domestic energy companies (Table 2.3). Also, a number of countries have introduced price caps on key foodstuffs (Hungary, Serbia, Russia, Ukraine, North Macedonia); tax cuts on food (Poland, Croatia, Bosnia and Herzegovina, North Macedonia) and fertilisers (Poland, Serbia, Croatia); and agricultural subsidies (Poland, Kosovo, Croatia).[7] Russia, Belarus, Kazakhstan and Serbia have all imposed export

[7] Raiffeisen Research (2022).

bans on certain essential food items, in order to boost domestic supply and tame price growth. Nevertheless, all these measures are likely to mitigate the increases in the price of commodities only partly, while resulting in widening budget deficits.

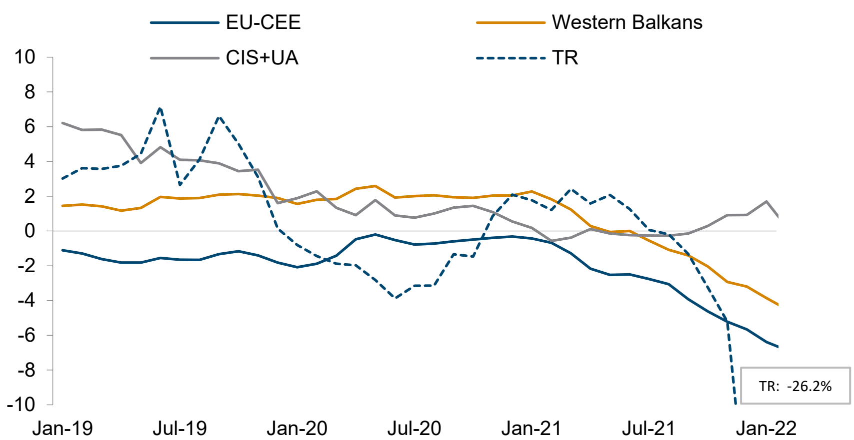
With inflation increasingly deviating from the official targets, many central banks in the region have continued the tightening cycle (Figure 2.9). Of those countries with flexible exchange rate regimes (and therefore with at least a degree of monetary policy autonomy), only Ukraine and Turkey refrained from interest rate hikes after the war started. In Turkey, the policy rate was cut last autumn and has stayed flat over the past few months. In Russia, the policy rate was initially more than doubled – to 20% – as part of the financial stabilisation package in response to Western sanctions.

Figure 2.9 / Central bank nominal policy rate, end of month, %



Source: wiiw Monthly Database incorporating national statistics.

Figure 2.10 / Real policy rate, CPI deflated, %



Note: Simple averages for country aggregates.
Source: wiiw Monthly Database incorporating national statistics.

Nevertheless, real interest rates are firmly in negative territory. The policy rate hikes, by and large, have not kept pace with the acceleration in inflation, so that real interest rates have even declined in many countries (Figure 2.10). Only in the CIS and Ukraine were real policy rates (adjusted for past inflation) in February marginally positive (and even those turn negative once adjusted for future inflation). Thus, there are good reasons to believe that it is primarily commodity price rises per se – rather than the restrictive monetary response to them – that will affect CESEE countries' growth prospects.

2.5. TRADE DISRUPTIONS

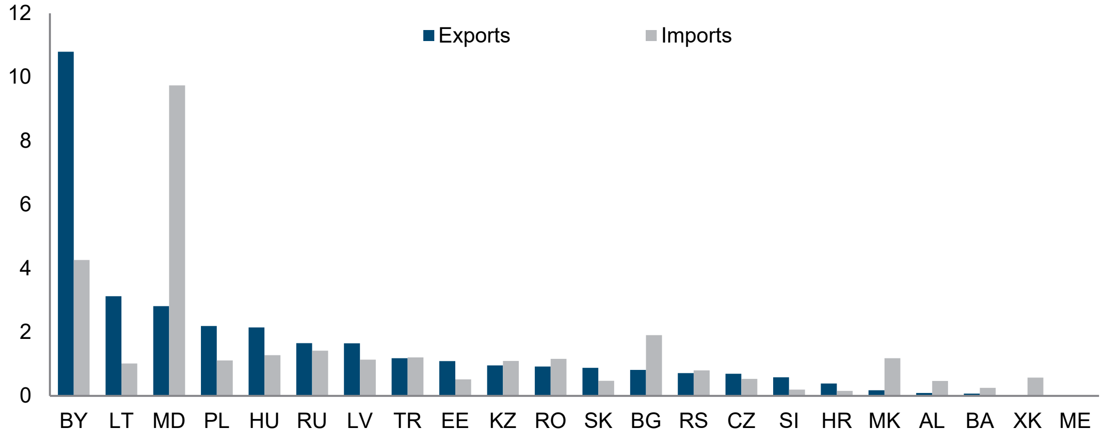
Russia is not a very important trading partner for most CESEE countries, and so that will limit the direct trade effects of the sharp recession there on most of the rest of the region. However, Russia is of much more importance to Belarus, where it accounts for around half of total exports and imports, and to Kazakhstan, where over 40% of imports come from Russia. The Baltic states and Moldova are also relatively dependent on trade with Russia, while that is not the case with many Western Balkan countries (Figure 2.11). However, Russian tourists have historically been an important source of revenue for Croatia and Montenegro, as well as for Turkey.

Figure 2.11 / Merchandise trade with Russia, as % of total

Note: Data refer to last available year.
Source: wiiw Annual Database incorporating national statistics and Eurostat.

The role of Ukraine as a trading partner is even lower – less than 2% in most cases. Again, notable exceptions are Belarus, where around 10% of exports go to Ukraine, and Moldova, which has around 10% of imports coming from there (Figure 2.12).

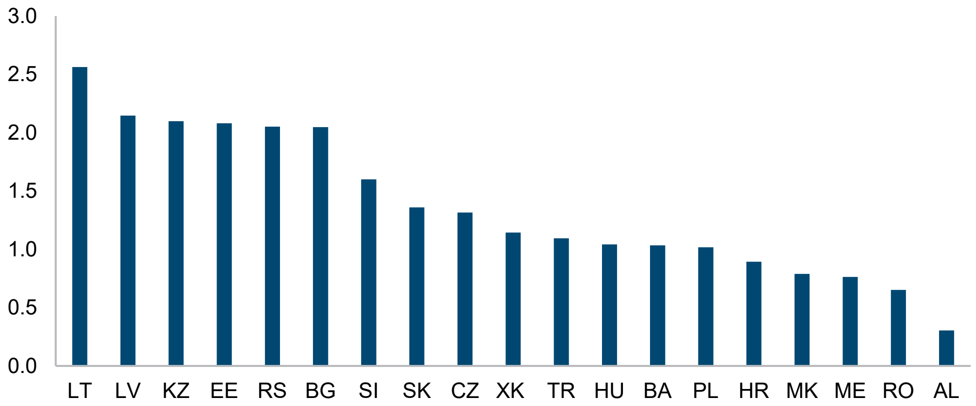
Figure 2.12 / Merchandise trade with Ukraine, as % of total



Note: Data refer to last available year.
Source: wiiw Annual Database incorporating national statistics and Eurostat.

Value-added exports to Russia account for only around 1% of GDP for most CESEE countries, limiting the negative effects of the downturn in Russia on regional economies (see Figure 2.13, which shows value added directly and indirectly involved in exports linked to Russian final domestic and imported demand). Accordingly, the impact on the CESEE economies of the looming Russian recession should be relatively small. Figure 2.14 shows these effects modelled according to two scenarios, which differ in terms of their underlying assumptions (see Box 2.2 for details). In the first scenario, the greatest negative effect should be on Bulgaria (-0.45 pp of GDP growth), while in the second scenario the negative impact on CESEE economies is even smaller, as they adjust to changes in sourcing structures. The economy of Kazakhstan might actually be boosted as a result, with domestic production benefiting from the reduction in (up until now very large) imports from Russia.

Figure 2.13 / Value-added in exports to Russia in 2018, share of GDP in %



Note: Western Balkan countries based on wiiw MC-IOT.
Source: OECD TiVA database, Release 2021, own calculations.

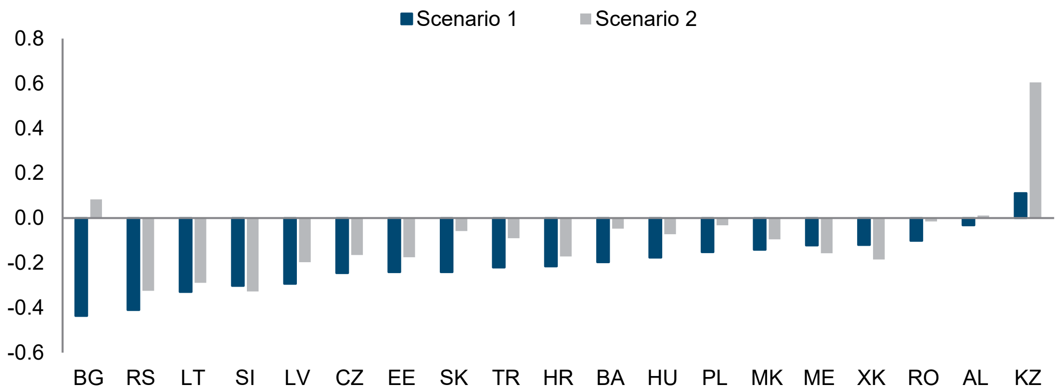
BOX 2.2 / SCENARIOS OF RUSSIAN RECESSION AFFECTING CESEE VIA THE TRADE CHANNEL

In the first scenario, we assume economic recession in Russia of 10%, and a reduction of 30% in Russian imports of final goods and of 13% in Russian exports of final goods. This is roughly in line with the current wiiw forecasts for Russia. These declines can be substituted by CESEE countries with domestic production or imports from other countries. Technically, for the sake of simplicity, we assume a proportional change in the sourcing structures of final goods. There is no change in the sourcing structures for intermediate inputs.

In the second scenario, as well as the trade decline in final goods outlined in scenario 1, we also assume a trade decline of the same magnitude in intermediate products. We assume that the decline in Russian exports of intermediate products can be countered by CESEE countries using substitutes from other countries (proportionally, according to the current sourcing structures of intermediate inputs), and that Russia is able to counter the decline in imports of intermediate products domestically. We allow for changes in the sourcing structures by applying the ‘partial global extraction method’. Such a scenario might be interpreted as the global economy responding to this shock by implementing longer-term structural changes to sourcing structures.

It should be stressed that these scenarios indicate only the direct effects of the recession in Russia via trade and production linkages. They do not take into account potential adverse effects on growth and demand in other countries, e.g. due to the rising cost of energy and raw materials, supply-chain disruptions, or dependence on critical inputs (like gas or oil), on specific commodities (like palladium or nickel) or on inputs like neon.

Figure 2.14 / Estimated GDP effects of projected recession in Russia in 2022 via the trade channel, in pp



Notes: For the assumptions underlying scenarios 1 and 2, see Box 2. For the Western Balkan countries simulations are based on the wiiw MC-IOT.
Source: OECD TiVA database, Release 2021, own calculations.

Overall, disruptions to trade with Russia and Ukraine should cost most CESEE economies some 0.5 pp of GDP growth this year.[8] However, sectors with a high degree of production fragmentation and extensive cross-border value-chain linkages will be affected much more. A case in point is the important automotive industry. Already weakened by the COVID-related shortages of semiconductor chips,[9] it now faces a fresh challenge, as the war has disrupted the production and shipment of cable looms produced in Western Ukraine. This has already resulted in production being halted in many car factories across the region (see Box 2.3).

BOX 2.3 / IMPACT ON THE AUTOMOTIVE INDUSTRY OF THE WAR AND SANCTIONS

The automotive industry has been hit by shortages and by the rising cost of inputs from Ukraine and Russia. Ukraine is a major supplier of cable looms. Following the Russian invasion, supply-chain disruptions have hit the big car manufacturers in Europe, and some have had to stop production for lack of cable looms from Ukraine. Also, Ukraine is a major producer of neon gas, which is used in the production of semiconductors. Thus, the chip shortage that has been plaguing the automotive industry since 2021 will be further aggravated. For its part, Russia is a major exporter of metals, including the palladium used in catalytic converters and the nickel used in batteries: it accounts for 25% and 14% of world exports of these metals, respectively.[10] Already, the price of these metals has soared as a result of the war and sanctions.

However, the direct impact of the fall-off in demand from Russia should be more limited. On the export side, the exposure of the EU-CEE automotive industry to Russia is generally quite small. In terms of motor vehicle exports,[11] the figure is highest for Slovakia (3.4% in 2019), followed by Poland (2%); other countries have shares of below 1%.[12] In terms of the export of car parts,[13] the figure is somewhat larger for Czechia and Romania (around 4%), followed by Slovakia (2.5%) and Poland (1.7%). Trade links, for example, exist between Romania's Dacia and the Renault factories in Russia.

The greatest impact of the war and the sanctions is being felt by Russia itself, with car production currently running at 50% of the level a year ago.[14] Apart from supply-chain disruptions, it is exposed to the additional shock of foreign car manufacturers leaving the country en masse. Among those foreign producers that have halted production in Russia are BMW, Ford, Toyota, Nissan and Mitsubishi, while Renault has announced its intention of selling its stake in the joint venture with Russia's Avtovaz. Failure of the ongoing negotiations between these companies and the Russian government would open up the possibility of their assets being nationalised.

8 The assumption here is that the much deeper recession in Ukraine (-38% projected for 2022) compared to Russia (-9%) will be offset by the much lower dependence of CESEE countries on trade with it.

9 For more on this, see Hanzl-Weiss and Reiter (2022).

10 OECD (2022).

11 NACE rev. 2, 29.1.

12 For some individual producers, this share is much higher: e.g. Kia in Slovakia exports around 12% of its cars to Russia; Suzuki in Hungary around 10%.

13 NACE rev. 2, 29.3.

14 ' Russia looks to shore up automotive market amid sanctions', 13 April 2022, https://www.wardsauto.com/industry-news/russia-looks-shore-automotive-market-amid-sanctions

2.6. INFLUX OF UKRAINIAN REFUGEES STRAINING GOVERNMENT BUDGETS

The massive influx of Ukrainian refugees fleeing the war should not place too much strain on CESEE labour markets. About half of all the refugees arriving in CESEE countries are children, while a large proportion of the adults are women with care responsibilities; they will not join the labour force of the host countries immediately. Besides, the demand for labour in many CESEE countries is high. In Poland, where more than 2m Ukrainian refugees have ended up, the unemployment rate stands at only 3.4%; meanwhile, in Czechia, where more than 300,000 people have arrived, it is as low as 2.8%. Also in other CESEE countries that are today hosting a large number of Ukrainians (Hungary, Romania and even Moldova), the unemployment rate hovers around 5%.

It is primarily the public spending of host countries that will come under strain. With activation of the EU Temporary Protection Directive on 8 March,[15] Ukrainian refugees will be entitled to full access to housing, health care, child care, education and social welfare assistance for the next 12 months. In order to finance this increased expenditure, the EU Council adopted the regulation on Cohesion's Action for Refugees in Europe (CARE) on 4 April; this allows countries to spend an additional EUR 17bn in total from cohesion and other EU funds.[16] Rough estimates, based on the 2015/2016 wave of refugees, suggest overall annual EU-wide expenditure of EUR 15,000 per refugee, or EUR 40bn in total. Since the majority of refugees are hosted in only a few EU countries, discussion is in progress on whether the EU might introduce additional funds or allocation mechanisms to distribute the costs more equitably.[17] Moldova – which is hosting more Ukrainian refugees per capita than any other CESEE country – will also get EU financial assistance.[18]

The chances are good that those Ukrainian refugees who are willing (and permitted) to stay in the EU long term will integrate quite quickly. The Ukrainian population is, in general, well educated.[19] This does not guarantee that they will easily find a job: highly skilled jobs require a good level of competence in the host country's language, and the transferability of skills is generally a problem for migrants. Experience shows that low-educated refugees are likely to find jobs more quickly. On the other hand, the incoming refugees will encounter existing migrant networks of fellow Ukrainians in the host countries: in 2020, 500,000 Ukrainians already had a temporary residence permit for Poland and 165,000 for Czechia – double the figure for Germany. The host countries' governments should, in any case, invest in language courses and other measures to raise the skills of the newcomers. That should allow them to integrate better into the labour market and society.

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15 https://ec.europa.eu/commission/presscorner/detail/en/ip_22_1469

16 https://www.consilium.europa.eu/en/press/press-releases/2022/04/04/ukraine-council-unlocks-17-billion-of-eu-funds-to-help-refugees/

17 Darvas (2022).

18 https://ec.europa.eu/commission/presscorner/detail/en/ip_22_2272

19 Astrov et al. (2022).

2.7. GROWTH SLOWDOWN AHEAD, BUT RECESSION ONLY IN THE CIS AND UKRAINE

Due to the adverse impact of the war and sanctions, wiiw growth forecasts for the region have been revised downwards, compared to January,[20] in some cases sharply (Table 2.4). The growth forecast for 2022 has not been revised upwards for a single CESEE country; for Slovenia it has been left unchanged.[21] The extent of the revision varies considerably by country, with Ukraine and Russia obviously being the worst affected, followed by their CIS neighbours. In most other countries, growth is now projected to be around 1 pp lower than was forecast in January; that said, the downward revisions are bigger in Romania, Bulgaria and the Baltic states, which are more vulnerable both to disruption in trade with Russia and to geopolitical risks. For 2023-2024, the pattern is more mixed, but downward revisions still prevail, suggesting that the current crisis is likely to leave its legacy over the medium term as well.

Table 2.4 / Real GDP growth forecasts and revisions – Baseline Scenario

		Forecast, %			Revisions, pp		
		2022	2023	2024	2022	2023	2024
EU-CEE	BG	2.0	3.7	3.5	-1.8	0.2	0.0
	CZ	2.6	3.5	4.2	-1.4	-0.1	0.6
	EE	1.8	3.4	3.1	-1.7	-0.6	-0.2
	HR	3.5	4.0	3.1	-1.2	-0.1	-0.2
	HU	2.5	3.9	4.5	-2.0	-0.1	0.8
	LT	1.7	2.8	2.6	-2.0	-0.5	-0.3
	LV	1.4	2.2	2.3	-2.9	-1.4	-0.7
	PL	4.0	3.5	3.6	-0.9	-1.4	-0.7
	RO	2.0	3.5	4.5	-2.3	-1.0	-0.3
	SI	4.1	3.3	2.8	0.0	0.0	-0.2
	SK	2.4	3.1	3.0	-1.5	-0.6	-0.3
Western Balkans	AL	3.5	3.7	3.9	-0.7	-0.3	0.1
	BA	1.8	2.3	2.3	-0.7	-0.5	-0.3
	ME	3.5	3.7	3.3	-1.0	0.7	0.6
	MK	2.5	2.7	2.7	-1.0	-0.5	-0.3
	RS	3.6	3.4	3.4	-1.3	-1.1	-0.6
	XK	3.3	3.7	3.9	-1.0	-0.3	-0.1
Turkey	TR	2.7	2.8	3.2	-0.8	-0.7	-0.8
CIS+UA	BY	-3.5	1.6	2.0	-4.5	-0.4	0.0
	KZ	1.5	3.2	4.0	-2.7	-1.2	-0.1
	MD	-3.0	3.0	4.0	-7.0	-1.5	-0.5
	RU	-9.0	-1.5	1.0	-11.0	-3.0	-0.5
	UA	-38.0	5.0	13.0	-41.5	1.5	9.0

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

[20] wiiw (2022).

[21] Slovenia is arguably the least exposed to these shocks and showed unexpectedly strong growth performance in the first quarter.

Most CIS countries covered in this report will not be able to avoid recession this year (Table 2.1). This will be determined by several factors: Western sanctions (Russia and Belarus), high trade exposure to Russia (Belarus and Moldova) and a steep rise in energy prices (Moldova). In Russia, recession is likely to persist into next year as well, reflecting economic stagnation under sanctions and this year's relatively high statistical basis, on account of the country's still strong performance in the first quarter. Only the economy of Kazakhstan will stay afloat and register positive growth this year on the back of high energy prices.

Ukraine is poised for imminent economic collapse. In the baseline scenario, which assumes that a ceasefire is signed by the middle of the year and reconstruction can get under way, its economy is projected to shrink by 38%, though it will return to growth next year. Needless to say, this forecast is subject to enormous risks, most of which are on the downside. Economic dynamics this year and next will obviously depend on the duration and intensity of the war, but also on the reconstruction effort once the war is over. A large-scale Western package akin to the Marshall Plan (currently under discussion) would provide a welcome boost to the economy, but its effect is unlikely to be fully felt before next year. Besides, private-sector investment will take much longer to return. Finally, there is a lot of uncertainty over the country's future borders, which will obviously affect economic dynamics as well.

Elsewhere in CESEE, recovery will decelerate markedly this year, before picking up slightly in 2023-2024. In EU-CEE, the recovery is expected to slow by 2.6 pp, which is roughly in line with the euro area; but the slowdown will be more pronounced in the Western Balkans (4.5 pp) and especially Turkey (8.3 pp), where the credit boom had already run into balance-of-payments constraints at the end of last year and is unlikely to carry on. In many countries, the slowdown can be directly attributed to the war and sanctions. It is indicative that in nearly all of them (except Romania, Turkey and Albania), net exports are likely to act as a drag on growth this year, reflecting war-related trade disruptions (Figure 2.15). In some cases, the war also has negative repercussions for domestic demand: in Estonia, for example, the investment boom observed last year is now falling flat and many projects are being cancelled in the face of dramatically increased risk perceptions.[22] In other countries, it is idiosyncratic factors that will come to the fore: in Hungary and Serbia, for instance, runaway public spending before the April 2022 elections will yield to budget consolidation.

The negative effects of the projected slowdown in growth on CESEE labour markets should be limited. Although the previously observed rapid labour market revival will run out of steam, unemployment rates in the region will still show a slight downward trend in years to come (Figure 2.4 above). Only in Estonia, Russia and Ukraine do we expect an increase in unemployment; in Ukraine this increase will obviously be enormous. As of mid-April, the number of Ukrainian refugees who left Ukraine after 24 February 2022 had reached 4.6m. Moreover, in Ukraine itself an additional 7.1m are internally displaced.[23] In most other CESEE countries, the remarkable pre-pandemic situation on the labour market is likely to be attained again in 2024.

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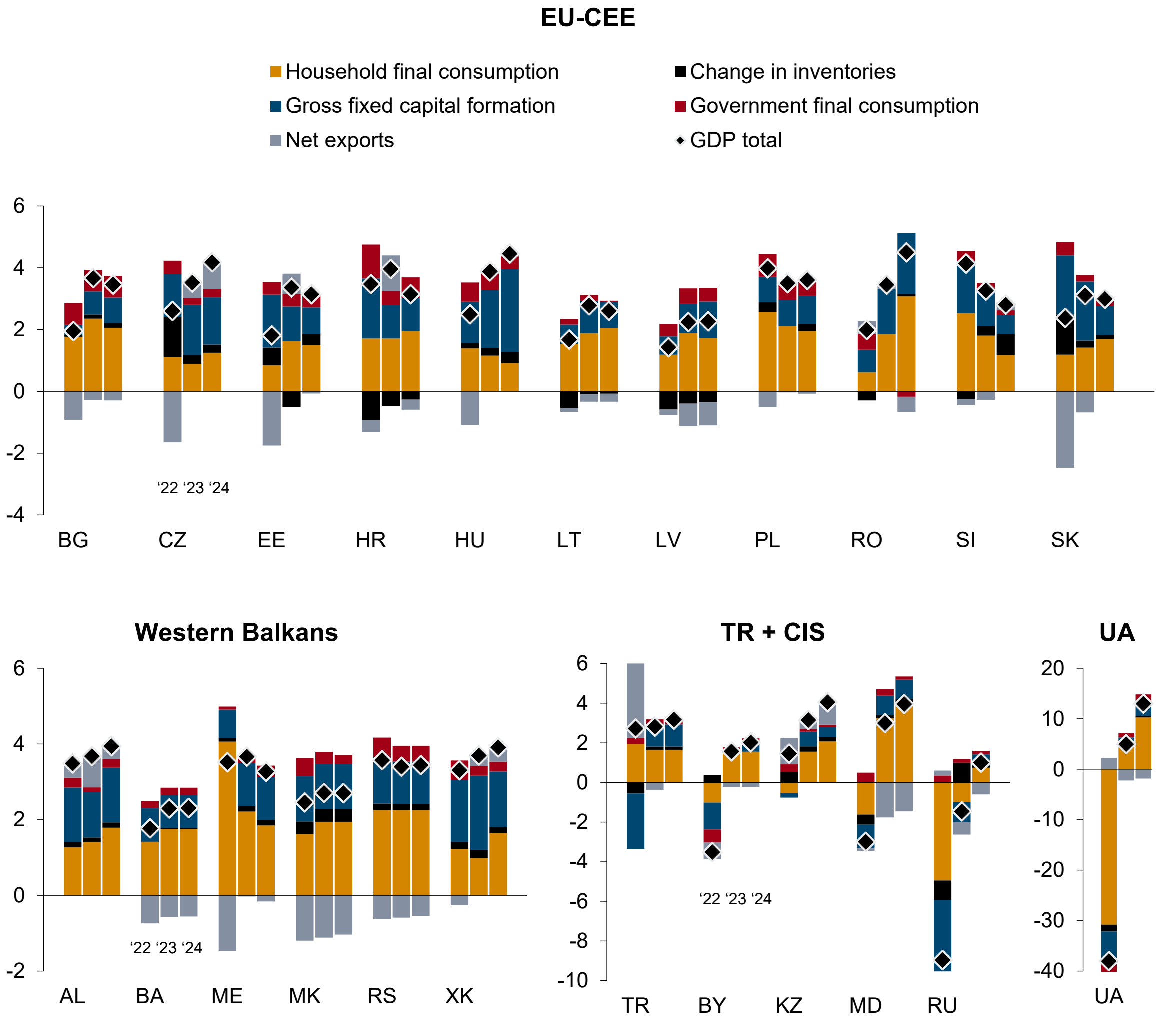
22 Estonia and the other Baltic states are located close to Russia. Despite their NATO membership, some people believe their security is in jeopardy.

23 These figures are as of 11 April 2022 and originate from the UNHCR data portal (https://data2.unhcr.org/en/situations/ukraine) or most recent press reports.

Figure 2.15 / GDP growth forecast for 2022-2024

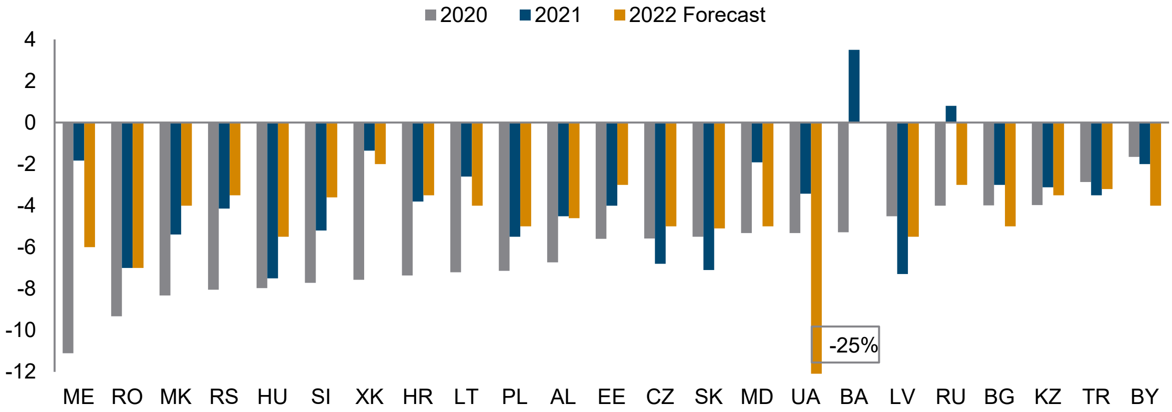
and contribution of individual demand components in percentage points



Source: wiiw forecasts.

Energy and food subsidies and increased social spending on refugees will hamper fiscal consolidation across CESEE. Last year, economic recovery and the partial withdrawal of COVID-related income support resulted in a marked improvement in fiscal balances (Figure 2.16). However, in 2022 this trend will be partly reversed, with increased public spending (and falling tax revenues in CIS countries as they enter recession) resulting in a renewed widening of the budget deficit in Bulgaria, Lithuania, Kazakhstan, Montenegro, Albania and Kosovo. In Ukraine, the war will wreck the government budget: the fiscal deficit is projected to balloon to 25% of GDP this year, and will have to be largely covered by Western official assistance.

Figure 2.16 / Fiscal balance, as % of GDP



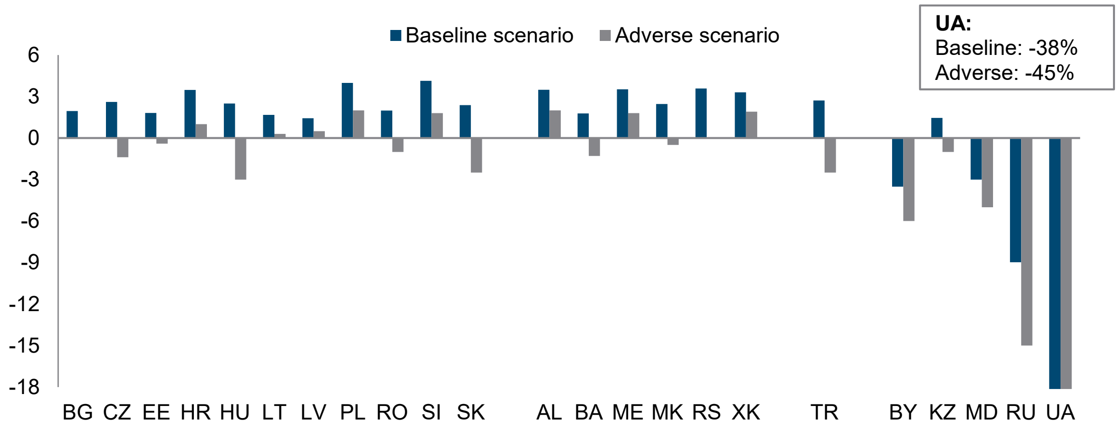
Note: 2021 data are partly wiiw estimates.
Source: wiiw Annual Database incorporating national statistics and Eurostat; wiiw forecasts.

In the more adverse scenario – assuming a further major escalation of the war and an immediate EU embargo on Russian oil and gas – many CESEE countries will slide into recession this year, while inflation will soar into double figures nearly everywhere. In this scenario, the Russian economy may contract by 15% this year (or more), primarily because the EU is the main export market for its gas, while export diversification towards Asia is hampered by infrastructure bottlenecks. Outside the CIS and Ukraine, recessions are likely to be deepest in Hungary, Slovakia and Turkey (Figure 2.17a), reflecting their heavy dependence on Russian gas and the limited short-term possibilities for its substitution. In other cases, where reliance on Russian gas is lower (Poland, Czechia, Romania), where it is technically feasible to replace it with alternative supplies, such as LNG (the Baltic states), or where the import embargo will not apply (the Western Balkans), the negative growth impact should be less pronounced. However, soaring energy prices will be felt everywhere in the region,[24] pushing inflation into double-digit territory (Figure 2.17b). In 2023-2024, the shock should subside, with alternative energy supplies becoming more readily available and CESEE economies gradually adjusting to the 'new normal'. However, growth will remain lower than in the baseline scenario, marred by scars left by the energy shock (Table 2.5).

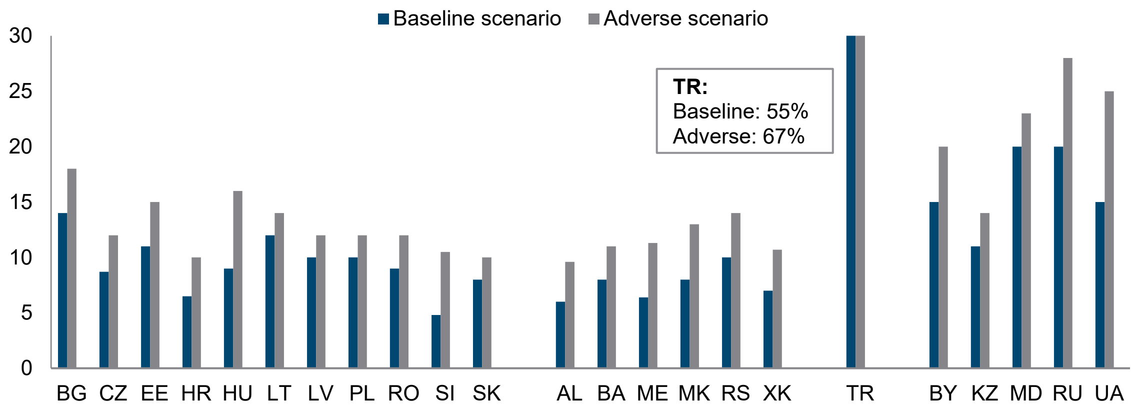
24 Technically, we assume that an EU import embargo on Russian energy will result in a doubling of global energy prices this year, to around USD 200 per barrel on an average annual basis, based on the available consensus expert forecast.

Figure 2.17 / wiiw forecasts for the baseline and adverse scenarios compared

(a) **Real GDP, % change year on year, 2022**



(b) **Average consumer price inflation, % change year on year, 2022**



Source: wiiw forecasts as of 7 April for basis scenario and as of 20 April 2022 for adverse scenario.

Table 2.5 / Indicators 2020-2021 and Outlook 2022-2024 - adverse scenario

		GDP real change in % against prev. year					Consumer prices average change in % against prev. year				
				Forecast					Forecast		
		2020	2021	2022	2023	2024	2020	2021	2022	2023	2024
BG	Bulgaria	-4.4	4.2	0.0	2.0	2.5	1.2	2.8	18.0	10.0	6.0
CZ	Czechia	-5.8	3.3	-1.4	1.5	3.5	3.3	3.3	12.0	6.5	3.2
EE	Estonia	-3.0	8.3	-0.4	2.0	3.4	-0.6	4.5	15.0	6.5	4.0
HR	Croatia	-8.1	10.4	1.0	2.5	3.0	0.0	2.7	10.0	6.0	5.0
HU	Hungary	-4.7	7.1	-3.0	0.5	2.5	3.4	5.2	16.0	8.0	5.0
LT	Lithuania	-0.1	5.0	0.3	1.4	1.8	1.1	5.5	14.0	7.0	4.0
LV	Latvia	-3.8	4.7	0.5	1.5	1.7	0.1	3.2	12.0	7.5	4.0
PL	Poland	-2.5	5.7	2.0	2.5	2.5	3.7	5.2	12.0	7.0	5.0
RO	Romania	-3.7	5.9	-1.0	3.0	4.0	2.3	4.1	12.0	7.0	4.0
SI	Slovenia	-4.2	8.1	1.8	2.7	3.1	-0.3	2.0	10.5	6.5	3.7
SK	Slovakia	-4.4	3.0	-2.5	1.0	2.5	2.0	2.8	10.0	7.5	3.0
	EA19 1)	*-6.4*	*5.3*	*-0.9*	*1.8*	*1.4*	*0.3*	*2.6*	*9.5*	*4.0*	*2.7*
AL	Albania	-3.5	8.5	2.0	2.2	2.6	1.6	2.0	9.6	5.0	3.6
BA	Bosnia and Herzegovina	-3.1	7.1	-1.3	1.1	1.8	-1.1	2.0	11.0	6.0	4.0
ME	Montenegro	-15.3	12.4	1.8	2.2	2.8	-0.3	2.4	11.3	6.0	3.2
MK	North Macedonia	-6.1	4.0	-0.5	1.5	2.0	1.2	3.2	13.0	9.0	5.0
RS	Serbia	-0.9	7.4	0.0	2.0	2.5	1.6	4.1	14.0	10.0	6.0
XK	Kosovo	-5.3	10.5	1.9	2.4	2.7	0.2	3.4	10.7	5.5	3.2
TR	Turkey	1.8	11.0	-2.5	1.5	3.5	12.3	19.6	67.0	26.0	15.0
BY	Belarus	-0.7	2.3	-6.0	0.0	1.5	5.5	9.5	20.0	15.0	12.0
KZ	Kazakhstan	-2.5	4.0	-1.0	2.7	4.0	6.8	8.0	14.0	10.0	7.0
MD	Moldova	-7.4	13.9	-5.0	3.0	4.0	3.8	5.1	23.0	12.0	6.0
RU	Russia	-2.7	4.7	-15.0	0.0	1.5	3.4	6.7	28.0	19.0	4.0
UA	Ukraine	-3.8	3.4	-45.0	4.0	12.0	2.7	9.4	25.0	15.0	7.0

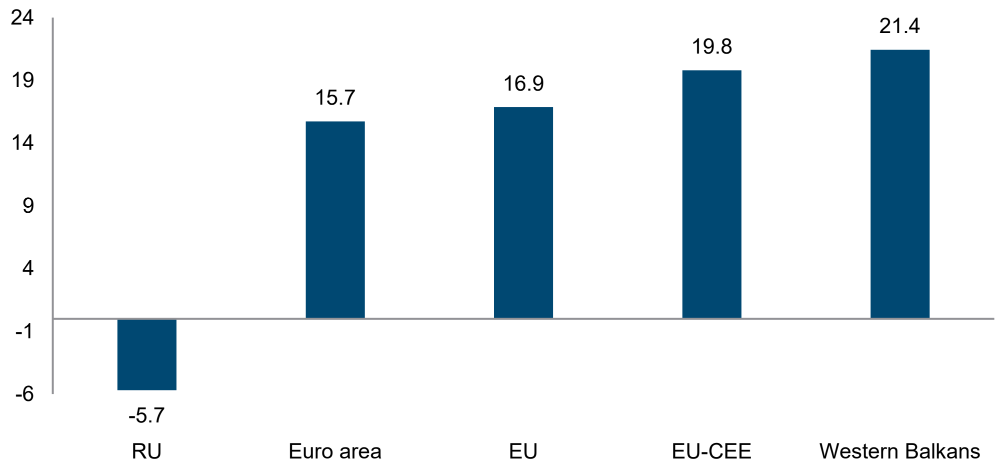
1) wiiw estimates.
Source: wiiw, Eurostat. Forecasts by wiiw. Cut-off date for historical data: 7 April 2022, for forecasts: 20 April 2022.

2.8. IMPLICATIONS FOR AUSTRIA

Austria's direct trade exposure to the CESEE economies most affected by the war in Ukraine is limited. Austria's merchandise exports are traditionally dominated by Germany: in 2021, it accounted for 30.1% of all Austria's exports. By contrast, Austria's exports to Belarus, Russia and Ukraine combined accounted for less than 2% (1.2% to Russia and 0.3% to Ukraine). If the Visegrád region were a country, it would be Austria's second-biggest trading partner, accounting for 13.3% of Austrian exports in 2021.

Exports to Russia were already declining in 2021, but this was of limited significance, given the strong growth in sales to more important markets in the EU and CESEE. In the whole CESEE region, only Russia and Montenegro experienced a drop-off in Austrian exports last year. Austria's exports to the EU as a whole increased by 16.9%, to EU-CEE countries by 19.8%, and to the Western Balkans by 21.4% (Figure 2.18). Exports to EU-CEE contributed decisively to Austria's swift economic recovery after the COVID shock: with that region accounting for 28% of Austria's exports in 2021, 32 percentage points of the overall increase in Austrian exports to the EU can be attributed to EU-CEE countries.

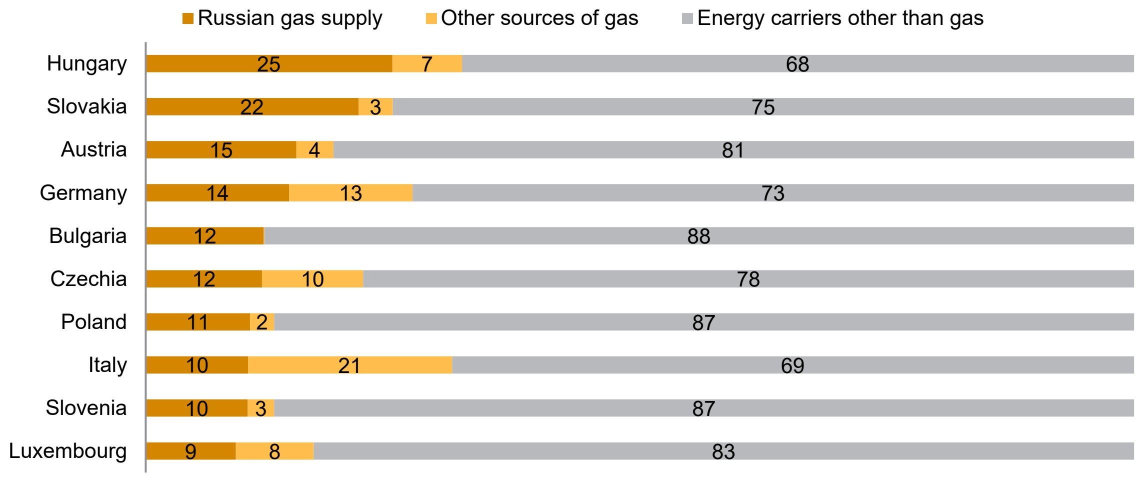
Figure 2.18 / Austrian merchandise exports by destination in 2021, % change year on year



Source: Statistik Austria.

On the import side, Austria's dependence on Russia, Ukraine and Belarus is not very great either, but Austria is highly dependent on Russian gas imports. In terms of the proportion of Russian gas in overall energy consumption, Austria ranks third among EU member states (Figure 2.19). Moreover, of the remaining nine top-ranked states, all but one (Luxembourg) feature among Austria's most important trading partners: these include Germany, the Visegrád countries and Italy. It should be noted that Austria's heavy reliance on Russian gas is a consequence of previous policy decisions. In recent years, some states have undertaken considerable efforts to diversify their gas supply: with EU support, Poland has built an LNG terminal that can now cover approximately a quarter of the country's demand for gas; and the Gas Interconnector Greece-Bulgaria pipeline is expected to be commissioned this year. Overall, Austria has failed to take similar steps.

Figure 2.19 / Dependence on Russian gas supplies as a share of overall final energy consumption, top 10 EU countries



Source: McWilliams et al. (2022).

Austria's heavy reliance on Russian gas is reflected in its current objection to the expansion of EU sanctions on Russian gas and oil. On 8 March, the European Commission set out a plan to cut Russian gas imports by two thirds this year,[25] and to stop importing Russian gas well before 2030.[26] This plan is already very challenging and would be associated with high costs. Should the EU, however, decide to go further and impose a full import embargo on Russian oil and gas (e.g. because of additional atrocities committed by Russian armed forces in Ukraine), the Austrian economy would be badly hit – albeit not as strongly as the Russian economy. The outcome in this scenario would likely be a recession in the euro area as a whole (see Table 2.5), including in Austria.

Austria's direct investment exposure to Russia, Ukraine and Belarus is limited. In 2021, 35% of its foreign direct investment (FDI) stocks were in CESEE (Figure 2.20), with Poland, Czechia and Romania accounting for half of that. Russia ranked sixth, with 2.3% of Austria's stocks, while Ukraine's share was just 0.3%. By way of comparison, Austrian FDI stocks in Germany amounted to more than 17% of the total. As regards Russia's investments in Austria, Vienna should step up its preparations for an expansion of EU sanctions or for asset freezes. As an example of what may need to be done, only recently the German authorities took over control of Gazprom Germania.

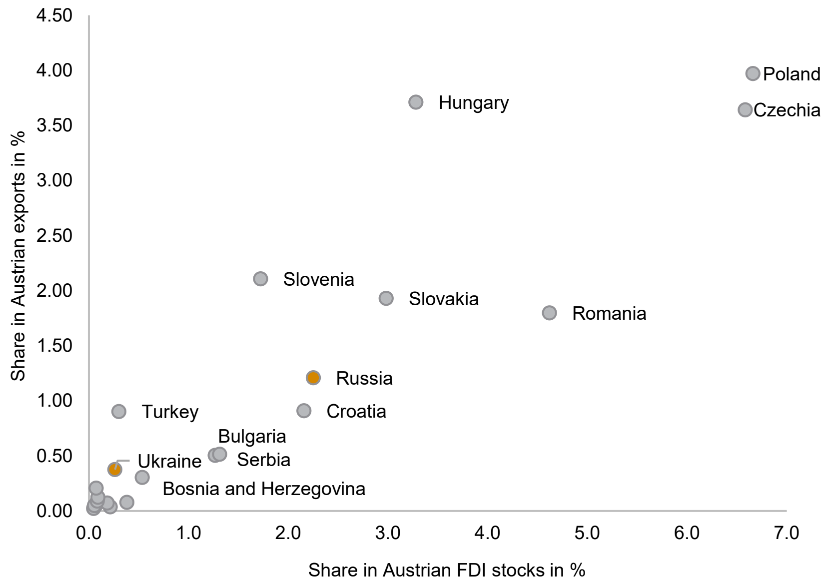
For Austria, the main channels of contagion from the war and sanctions will be via indirect effects: supply-chain disruptions and soaring energy prices. These negative effects apply both to Austria and to its key trading partners – and that fact could magnify the impact. In March, inflation already stood at 6.7% in Austria on an annual basis, with energy and food prices being the dominant drivers. The Austrian Purchasing Managers' Index (PMI) for manufacturing in March reached 59.3 – up from 58.4 in February and well above the 50 level that separates expansion from contraction. However, that is below the January level, as well as the levels observed between April and October last year, when it averaged 63.9. This

25 https://www.euractiv.com/section/energy/news/eu-rolls-out-plan-to-slash-russian-gas-imports-by-two-thirds-before-year-end/

26 This was part of the updated 'REPowerEU: Joint European action for more affordable, secure and sustainable energy' initiative, see https://ec.europa.eu/commission/presscorner/detail/en/IP_22_1511

suggests that supply-chain disruptions and elevated commodity prices are already having some impact on Austrian industry, and that impact could become bigger in the coming months.

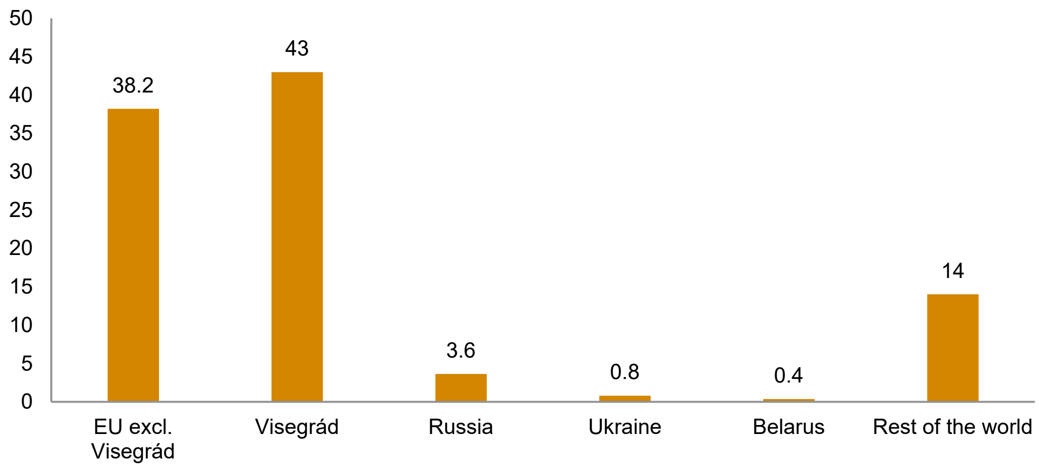
Figure 2.20 / Austrian trade and investment links with CESEE in 2021



Source: Statistik Austria 2022, wiiw.

A further area of possible contagion is via the banking sector, where Austrian lenders have built up a strong position in CESEE, including in Russia and Ukraine. Here again, the Austrian banking sector's exposure lies predominantly within the EU, which accounts for 81% of its foreign assets. Indeed, in Q3 2021, 43% of all its foreign assets were in just the four Visegrád countries (Figure 2.21), while Russia accounted for 3.6%. This is considerably above Russia's share of Austrian external trade or outward FDI.

Figure 2.21 / Foreign claims of Austrian banks, % share of total in Q3 2021

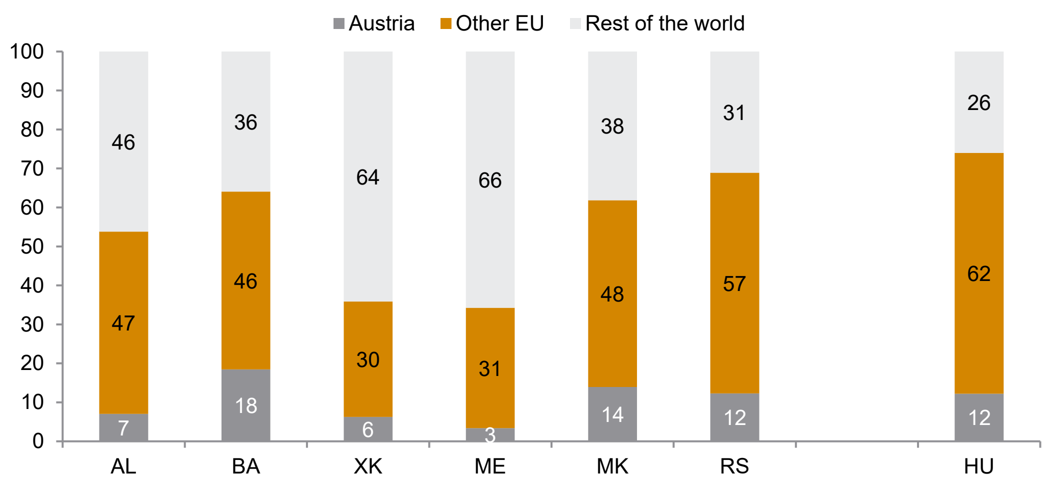


Source: BIS, wiiw.

In light of the war in Ukraine, there is an increased likelihood of political instability in the Western Balkans, a region of major importance to Austria. Russia could step up its efforts to destabilise the area. Serbia, which has so far avoided joining European sanctions against Russia, is expected to continue this policy, following President Vučić's re-election. Also, efforts to destabilise Bosnia and Herzegovina, particularly by the leadership of Republika Srpska, are expected to continue and intensify. China has also attracted recent public attention both for its arms deliveries to Serbia and for its investment in infrastructure, such as the construction of motorways in Croatia and Montenegro. Chinese geopolitical ambitions are increasingly coming to be regarded as critical – both by its European partners and by the EU itself. The EU has been gradually responding and has been focusing on its own supply chains: such as by monitoring its dependence on critical raw materials, or by starting to implement new investment screening policies in 2020 that involve eight member states, including Austria).[27]

Austria is one of the most important foreign investors in the Western Balkans, and any speeding up of the EU enlargement process would be good news for it. Austria is the biggest investor in both Bosnia and Herzegovina and North Macedonia; and in Serbia, it is the second biggest. European integration and stability in the region are in Austria's vital interests both politically and economically. Its strong presence in the region also gives it considerable leverage on domestic policy actors, and it should make good use of that. The recent focus on Ukraine, Moldova and Georgia and on their ambitions to join the EU could present an opportunity for the Western Balkan region, since the current war shines a spotlight on the geopolitical dimension of EU enlargement and on the ambitions of non-Western players in the region, such as Russia and China. This could help overcome the current anti-enlargement wariness among certain EU member states.

Figure 2.22 / FDI inward stock in 2020, selected countries, as % of total



Source: wiiw FDI Database incorporating national statistics.

The conflict between Hungary and the European Commission is expected to continue, and that could have negative spill-over effects for Austria. After Prime Minister Orbán won the Hungarian parliamentary election in April, the European Commission was quick to announce that it intended to apply the rule-of-law mechanism to withhold Recovery and Resilience Facility (RRF) funds earmarked

27 Oberhofer et al. (2022); Zavarská (2022).

for Hungary. This move is expected to emphasise Hungary's economic weakness and could also have a negative impact on Austrian trade and investment: Austria is Hungary's third-largest investor, and 12% of its outward FDI stocks are there. It might have expected to benefit from spill-overs from the RRF transfers that Hungary was due to receive.[28]

Finally, uncertainty about the continuation of the COVID-19 pandemic is also rife in the region. Vaccination rates are still lower than in Austria, and challenges remain in the various countries' healthcare sectors. Given that a war is raging, the COVID-19 pandemic is not expected to be the main economic peril to confront Austria's economy from the direction of CESEE; but it could continue to contribute to the melange of trade-related challenges.

2.9. CONCLUSIONS

The Russian invasion of Ukraine and the Western sanctions on Russia represent a monumental shock to the economy of the entire CESEE region – and not only of countries directly involved in the military conflict. This shock has come just as the region was recovering strongly from the COVID-related slump, and it will be a drag on further growth prospects. Via the rising prices of energy, food and other commodities, it adds to the existing inflation challenge in CESEE economies. Higher inflation will eat into real incomes and depress economic growth in the region. In the months ahead, this will be the most important mechanism by which the war and the sanctions impact on the region's economies.

Most CESEE economies will be able to take this shock in their stride – at least to some extent. This is largely because, leaving aside commodity trade, Russia is not a very important economic or financial partner for the region; furthermore, much of the unwinding of economic links had already taken place in the years since the annexation of Crimea. Therefore, our core prediction for the bulk of the CESEE region over the forecast horizon 2022-2024 is for weaker but still positive momentum, with the CIS and Ukraine being the main exceptions. Arriving Ukrainian refugees will not jeopardise the regional labour market – indeed, in many cases they may alleviate labour shortages. However, they will strain government budgets, as will the fiscal measures to contain rising energy and food prices.

The forecast risks are largely tilted to the downside. In the more adverse scenario –assuming a further escalation of the war and an immediate EU embargo on Russian oil and gas – many CESEE countries will slide into recession this year, while inflation will soar into double figures nearly everywhere.

[28] Astrov, Stehrer and Zavarská (2022).

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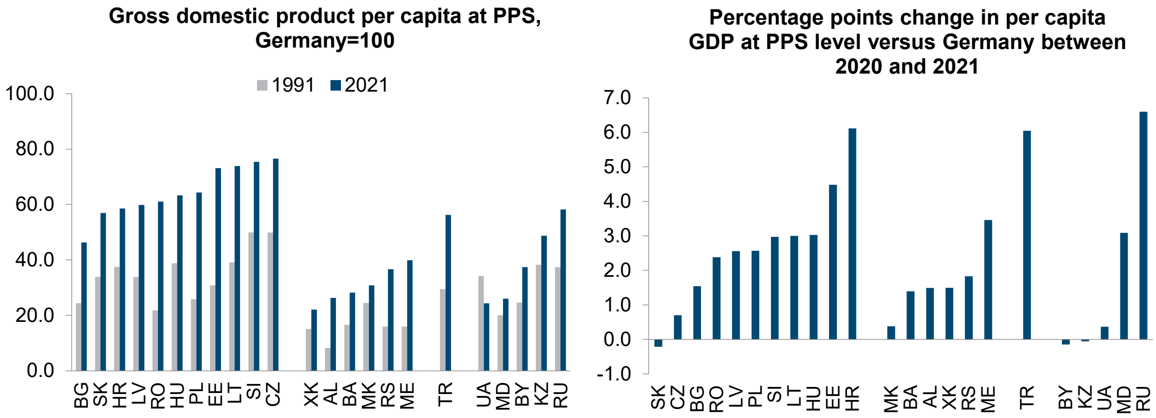
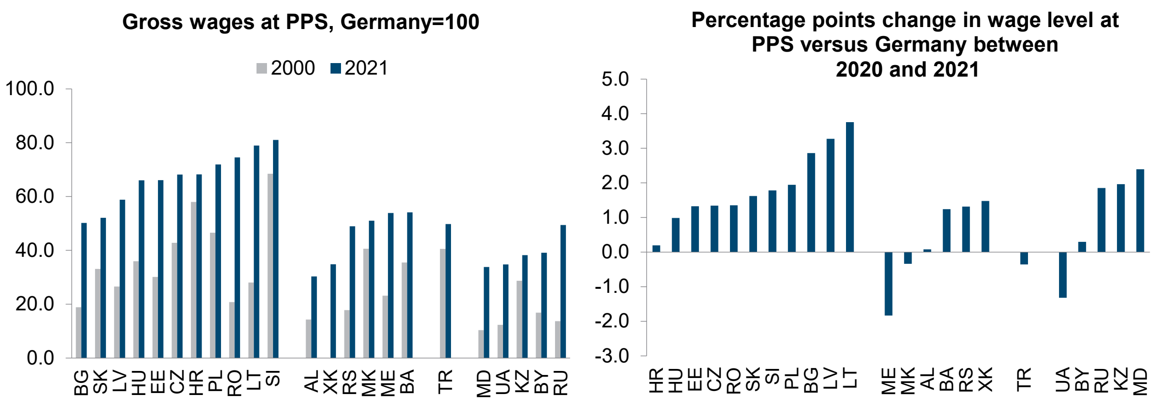
3. Convergence Monitor

BY RICHARD GRIEVESON

Figure 3.1 / 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. Lithuanian and Romanian wages include employers' social security contributions. Turkey: data 2000 refer to 2003, personnel costs.
Source: wiiw Annual Database incorporating national statistics and Eurostat.

Table 3.1 / CESEE GDP per capita and gross wages per employee at PPS, 2021

	BG	CZ	EE	HR	HU	LT	LV	PL	RO	SI	SK		EU-CEE
GDP per capita	17,860	29,520	28,200	22,590	24,420	28,490	23,070	24,810	23,540	29,070	21,960		24,490
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	10,160	10,890	14,430	18,790	10,040	15,390	11,900	14,130	22,450	21,700	9,390	8,520	19,440
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: personnel costs.
Source: wiiw Annual Database incorporating national statistics and Eurostat.

Table 3.2 / CESEE GDP per capita and gross wages per employee at EUR, 2021

	BG	CZ	EE	HR	HU	LT	LV	PL	RO	SI	SK		EU-CEE
GDP per capita	9,850	22,320	23,060	14,740	15,810	19,760	17,480	14,940	12,510	24,680	17,820		15,600
Gross wages	9,514	17,709	18,567	15,300	14,688	18,816	15,324	14,884	13,613	23,635	14,532		14,970

	AL	BA	BY	KZ	MD	ME	MK	RS	RU	TR	UA	XK	non-EU
GDP per capita	5,460	5,540	6,170	8,490	4,520	7,910	5,660	7,780	10,290	8,150	4,080	4,350	8,400
Gross wages	5,603	9,461	5,751	5,935	5,228	9,516	8,351	9,266	7,781	6,427	5,205	6,120	7,025

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

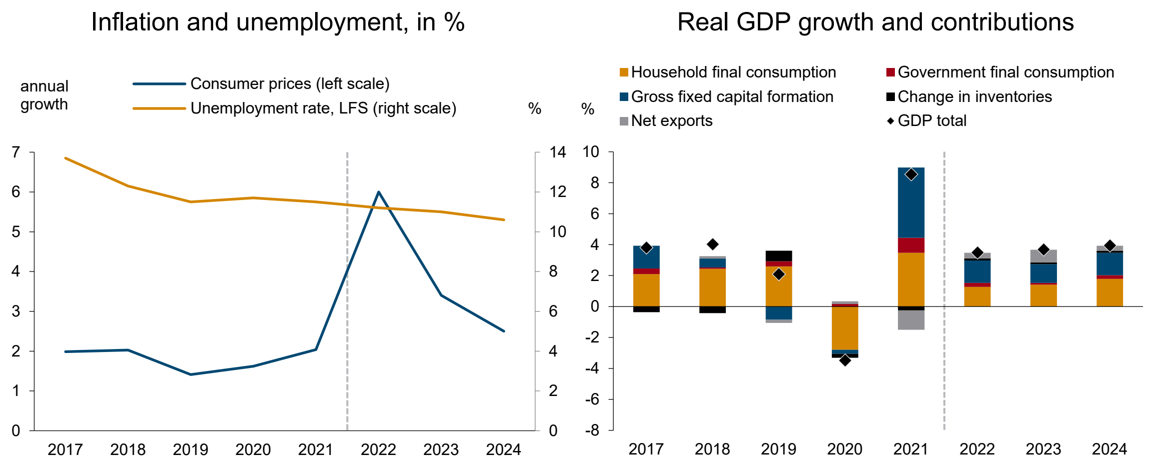
4. Country reports

ALBANIA: Price hikes and energy supply issues will hamper growth

ISILDA MARA

Albania has a low volume of trade with Russia and Ukraine, but it will experience negative spill-overs from the war in Ukraine, on account of its strong trade relations with the EU. Monetary policy has shifted towards higher interest rates, and the government's fiscal stimulus measures will go some way to support consumption. Exports of minerals and fuel have gained momentum; however the country's current account balance will deteriorate. According to the baseline scenario, inflation this year will be 6% and growth 3.5%. In the medium term, inflation will fall to 3% and growth will rise to 3.9%.

Figure 4.1 / Albania: Main macroeconomic indicators



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

The economic recovery in 2021 – at 8.6% – exceeded our expectations; but the rebound will not last. Both government and household consumption grew – by 8% and 4%, respectively – while investment picked up by 21%. The drivers of the economy were the construction and financial sectors (both of which expanded by 21%) and manufacturing (which grew at 15%). External demand bounced back: exports of services reached their pre-pandemic level – thanks to tourism, which almost doubled compared to 2020 - while merchandise exports performed even better. Foreign direct investment surged by 10% between 2020 and 2021, and was worth over EUR 1bn (7% of GDP). However, the good times could not last. The energy crisis (announced by the government in October of last year) and the inflationary pressure (which was already starting to be felt in Q4 2021 and has been exacerbated by the war in Ukraine) will act as a drag on the economy in the short and medium term.

Inflationary pressure will intensify in 2022 and will have several implications. Last year ended with a rapid rise in commodity prices that continued over the first three months of 2022: inflation grew by 3.7% in January and by 3.9% in February, year on year. The prices of food products, especially those which are mainly imported, rose by 10% in February (year on year). Fuel and electricity prices increased by 3.4% in the first two months of the year, and in March, the steep rise in the cost of fuel sparked considerable frustration and led to mass protests. The government intervened by imposing price controls. Two boards have been created to monitor prices and set a price ceiling on fuel and several other goods in the 'consumer basket' (by limiting the profit margins of traders); the level allowed is altered daily or weekly. Accordingly, the country's heavy reliance on imports, the external supply shocks and pessimistic expectations for domestic electricity generation (which is quite volatile and very dependent on the weather) hint at an intensification of the inflationary pressure that this year is expected to hover at around 6%, before falling back to around 2.5% by 2024.

The volume of trade that Albania has with Russia and Ukraine is small, but the country is, to a certain degree, dependent on specific commodity goods. In 2021, imports from Russia and Ukraine did not exceed 2% and 1%, respectively; meanwhile exports to those countries are negligible. However, 41% of all cereals come from Russia. In the first two months of 2022, year-on-year grain imports dropped in both real terms (by 46%) and nominal terms (by 7%). The country is also reliant on imported animal and vegetable fats and oils – 30% comes from Ukraine and Russia. However, Albania is not the only country that relies for these commodities on imports from Ukraine and Russia: the supply shock is also affecting Albania's main trading partners. Thus, the shortages of these products will not be resolved overnight and the inflationary pressure will not be a passing phenomenon.

The rise in consumer prices will depress consumption. Nominal wages have been picking up in both the private and the public sector (by 10% and 6%, respectively), but given the level of inflation, in real terms, the effect is fairly small. In 2021, the employment rate recovered, but has not yet returned to its pre-pandemic levels. Consumer confidence has dropped off and is now below its historical levels: people are pessimistic about their personal finances and their ability to make major purchases, as well as about the economic situation in the country generally. The poverty rate is among the highest in the region: according to the World Bank, a third of all Albanians were living on less than USD 5.50 a day in 2021. The government has introduced a new Social Resilience support package worth EUR 80m to support those at greatest risk of poverty (especially pensioners). In April, the minimum monthly wage was increased from LEK 30,000 to LEK 32,000 (approximately EUR 260). The income tax threshold was also raised – by 33%, to LEK 40,000 (EUR 326) – and the tax payable on salaries of up to LEK 50,000 (EUR 408) has been cut from 13% to 6.5%. Remittances will continue to provide a buffer for consumption, but this year their impact is expected to be lower than during the pandemic. Real wages are falling sharply in the EU – by 3% in Italy and Germany (the countries where most migrants, and especially recent ones, reside). Higher consumer prices are eating away at the income and savings of migrants, meaning they have less money to remit.

The government has responded swiftly, with new fiscal stimuli, but fiscal consolidation will be postponed. The general government budget has been revised and the fiscal deficit is expected to exceed 4%, while public debt will hover at close to 75% of GDP. The new Social Resilience support package has required a further readjustment of spending plans – rise in general government expenditure as well as cuts on capital expenditure. This hints at lower public investment than was initially planned.

The central bank has responded to the inflationary pressure by raising its policy interest rates. The exchange rate became volatile in March 2022, so that the central bank was forced to intervene. The euro was stabilised at a lower exchange rate than in 2021. The Albanian economy is quite closely linked to the euro, and exchange rate stability depends on external demand and the current account balance. In March 2022, the central bank changed its course of monetary stimulus and the interest rate was adjusted upwards, from 0.5% to 1%. The blow of higher energy prices and the expectation that there will be a further surge in consumer prices could prompt the central bank to increase interest rates again by the end of the year.

The trade deficit is expected to deteriorate further, though the signals are mixed. Exports of goods and services picked up remarkably in 2021, and in the first two months of 2022 the export of goods rose in both real and nominal terms – by 9% and 49%, respectively, year on year. The greatest contribution was made by exports of minerals, fuel and electricity, output of the garment industry and chemical products. This was due to high prices on the international markets – especially of oil and other energy sources, but also of minerals. Imports rose by 5% in nominal terms and by 27% in real terms, with fuel imports accounting for the largest slice. There are no great expectations from tourism this year: while there have been many visitors from Ukraine and Russia over the past four years, but the war in Ukraine will disrupt travel from those countries. Ethnic tourism and tourism from the neighbouring countries helped the sector during the pandemic, and may also do so now. That said, ballooning prices will erode the real income and savings of this category of tourists as well: this year, they may opt to holiday in their own countries. Consequently, the tourism momentum may weaken.

The energy crisis could have been avoided, had appropriate policies been pursued over the last decade. The consequences of the energy crisis – which was already announced by the government last October – will have a severe effect on the economy this year. Although Albania is a country rich in natural resources, there are several bottlenecks that prevent the economy from reaping the benefits of them. It is an oil-producing country, and certainly the huge surge in international market prices will be a boon for its exports. But for its own consumption, Albania relies exclusively on fuel imports – at much higher prices. According to Eurostat, the country's energy import dependency in 2020 was 35%. Its supply of electricity is very volatile, as it relies mainly on hydropower stations. The Trans Adriatic Pipeline (TAP) presents a missed opportunity: it delivers gas from Azerbaijan to Italy and crosses through several countries, including 215 km of Albania. However, Albania still does not have access to the gas flowing through the pipeline. Solar panel arrays account for no more than 1% of electricity produced – even though Albania boasts 300 days of sunshine a year. Several projects have tackled this sector, but progress has been very slow. In March 2022, in the face of the energy crisis, the government announced that households and small enterprises could install solar panels and produce electricity for their own consumption. The energy crisis could have been avoided if there had been greater diversification of energy resources.

COVID-19 seems to be the least of the country's concerns. The vaccination rate has reached 43%, restrictions have been greatly relaxed and there is no obligation even to wear a mask. The small number of daily infections (54 at the time of writing) and of COVID-related deaths (under 2 a day since February 2022) make for quite a relaxed attitude to the pandemic.

Overall, we expect the economy to lose vigour. Even on the twin assumptions that the war-related shocks do not extend beyond this year and that inflation does not exceed 6% this year, the economy will grow by no more than 3.5%. In the medium term, we expect international commodity prices to cool off, which will help Albania a bit. In the medium term, inflation will fall to 3%, while growth will rise to 3.9%.

Table 4.1 / Albania: Selected economic indicators

	2018	2019	2020	2021 1)	2022	2023	2024
						Forecast	
Population, th pers., average	2,866	2,854	2,838	2,829	2,810	2,800	2,800
Gross domestic product, ALL bn, nom.	1,637	1,692	1,644	1,890	2,100	2,300	2,500
annual change in % (real)	4.0	2.1	-3.5	8.5	3.5	3.7	3.9
GDP/capita (EUR at PPP)	9,150	9,520	9,110	10,160	.	.	.
Consumption of households, ALL bn, nom.	1,282	1,340	1,313	1,409	.	.	.
annual change in % (real)	3.1	3.3	-3.5	4.4	1.7	1.9	2.4
Gross fixed capital form., ALL bn, nom.	391	378	374	456	.	.	.
annual change in % (real)	2.3	-3.6	-1.1	19.9	6.0	5.0	6.0
Gross industrial production							
annual change in % (real)	18.7	-1.1	-6.3	26.6	5.0	8.0	8.0
Gross agricultural production 2)							
annual change in % (real)	1.8	-2.9	3.0	2.0	.	.	.
Construction output total							
annual change in % (real)	5.6	-2.5	9.5	18.0	.	.	.
Employed persons, LFS, th, average	1,231	1,266	1,243	1,249	1,267	1,275	1,280
annual change in %	3.0	2.8	-1.8	0.4	1.5	0.6	0.4
Unemployed persons, LFS, th, average	173	165	165	163	160	160	150
Unemployment rate, LFS, in %, average	12.3	11.5	11.7	11.5	11.2	11.0	10.6
Reg. unemployment rate, in %, eop	5.4	5.8	7.4	6.0	.	.	.
Average monthly gross wages, ALL	50,589	52,380	53,662	57,182	64,300	69,800	75,100
annual change in % (real, gross)	1.3	2.1	0.8	4.4	6.0	5.0	5.0
Consumer prices, % p.a.	2.0	1.4	1.6	2.0	6.0	3.4	2.5
Producer prices in industry, % p.a.	1.7	-0.8	-3.3	2.7	4.5	3.0	1.7
General governm. budget, nat. def., % of GDP							
Revenues	27.5	27.2	25.9	27.0	27.0	27.5	28.0
Expenditures	29.1	29.1	32.6	31.5	31.6	30.5	30.0
Deficit (-) / surplus (+)	-1.6	-1.9	-6.7	-4.5	-4.6	-3.0	-2.0
General gov. gross debt, nat. def., % of GDP	67.7	65.8	74.5	73.2	75.0	74.0	73.0
Stock of loans of non-fin. private sector, % p.a.	-3.6	6.6	6.9	9.6	.	.	.
Non-performing loans (NPL), in %, eop	11.1	8.4	8.1	5.7	.	.	.
Central bank policy rate, % p.a., eop 3)	1.00	1.00	0.50	0.50	1.0	1.2	1.2
Current account, EUR m	-866	-1,089	-1,153	-1,186	-1,390	-1,360	-1,350
Current account, % of GDP	-6.8	-7.9	-8.7	-7.7	-8.1	-7.3	-6.7
Exports of goods, BOP, EUR m	986	907	794	1,265	1,450	1,520	1,580
annual change in %	23.7	-8.1	-12.5	59.4	15.0	5.0	4.0
Imports of goods, BOP, EUR m	3,857	4,050	3,776	5,094	5,650	5,820	6,030
annual change in %	6.5	5.0	-6.8	34.9	11.0	3.0	3.6
Exports of services, BOP, EUR m	3,073	3,405	2,226	3,466	3,810	4,080	4,370
annual change in %	7.6	10.8	-34.6	55.7	10.0	7.0	7.0
Imports of services, BOP, EUR m	1,962	2,141	1,174	1,690	1,890	1,970	2,070
annual change in %	10.6	9.1	-45.1	43.9	12.0	4.0	5.0
FDI liabilities, EUR m	1,020	1,072	937	1,032	.	.	.
FDI assets, EUR m	-3	36	43	42	.	.	.
Gross reserves of CB excl. gold, EUR m	3,342	3,240	3,806	4,831	.	.	.
Gross external debt, EUR m	8,353	8,246	8,548	9,740	10,400	10,800	11,300
Gross external debt, % of GDP	65.1	60.0	64.3	63.1	61.0	58.0	56.0
Average exchange rate ALL/EUR	127.59	123.01	123.77	122.46	123.1	124.0	124.0

1) Preliminary and wiiw estimates. - 2) Based on UN-FAO data, wiiw estimate from 2020. - 3) One-week repo rate.

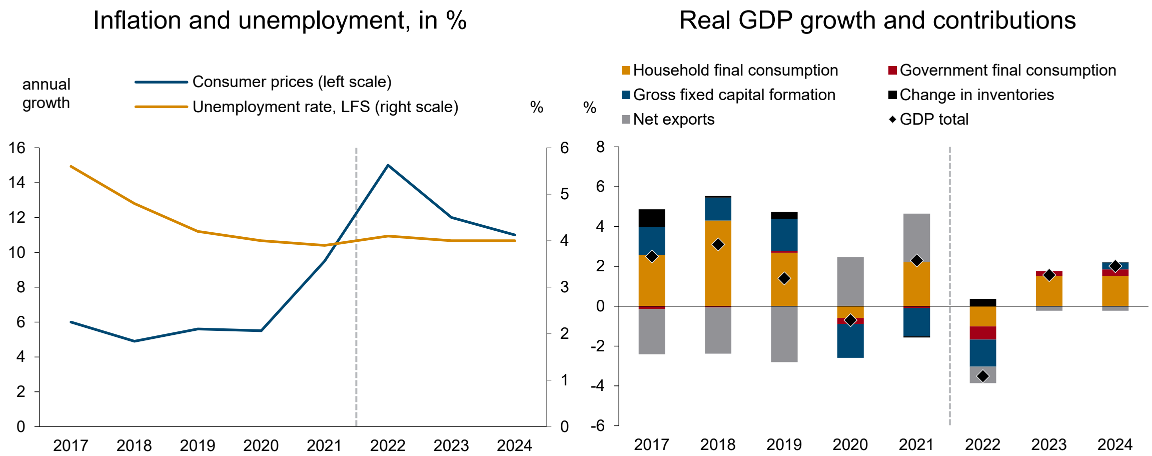
Source: wiiw Databases incorporating national statistics. Forecasts by wiiw.

BELARUS: Forced into a Russian orbit

RUMEN DOBRINSKY

Lukashenko's support for Russia's invasion of Ukraine triggered fresh economic sanctions by major Western countries. Subsequently there has been a rapid deterioration in the economic situation and havoc on the financial markets. Being cut off from the West, Belarus sought aid from, and further economic integration with, Russia. However, the latter has limited resources to support its ally. Recession seems inevitable in 2022, and economic weakness will prevail in the following years as well.

Figure 4.2 / Belarus: Main macroeconomic indicators



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

President Lukashenko's decision to support Russia's invasion of Ukraine wrecked the few remaining economic ties between Belarus and the West. The major Western countries imposed fresh economic sanctions on Belarus, on top of the severe sanctions that were in already effect. To all intents and purposes, Belarus is currently labouring under a far-reaching political and economic blockade on its Western borders, which is likely to remain in place for a long time to come. A signal to this effect was the decision by some major Western states to block further consideration of Belarus's application to join the World Trade Organization (WTO). The European Commission has suspended its last remaining cooperation agreement with Belarus, that on cross-border cooperation under the European Neighbourhood programme. The European Bank for Reconstruction and Development (EBRD) has also announced the closure of its Minsk office.

Given the circumstances, Belarus had no choice but to further reorient itself towards parts of the world that have not joined in the sanctions. First and foremost, this means that economic integration with Russia can be expected to deepen even further. Indeed, there have already been several rounds of high-level meetings between Belarusian and Russian leaders to consider steps to improve bilateral economic ties. The measures either discussed or already agreed include the possibility of arranging oil and gas trade in Russian roubles; the establishment of alternative transportation routes for Belarusian exports that bypass the Baltic states; the abolition of remaining cross-border restrictions on passenger flows; and options for deferred repayment of Russian government credit. The two countries are discussing the possibility of switching entirely to trade based on their national currencies over the longer term. However, given Russia's weakened economy and its isolation from the international financial markets, Belarus cannot expect much short-term support from that quarter. Nor will it be easy for Belarus to find alternative foreign markets for the export flows that have been hit by sanctions.

The available short-term indicators suggest a rapid deterioration in the country's economic situation in the first months of 2022. Industrial production, which had picked up in 2021 on the strength of exports, witnessed a slump even in February. Some major industrial companies (such as the potash producer and exporter Belaruskali) have reported serious disruption and even partial halts to their activities.

The new financial sanctions, including the disconnection from SWIFT of several large Belarusian banks, have wreaked havoc on the local financial market. Visa cards and Mastercards issued by some Belarusian banks have either been blocked or operate with reduced functionality. Western Union, a company that specialises in cross-border money transfers, has also discontinued its operations in Belarus. All this has further increased pressure on the exchange rate, which had already plummeted in the aftermath of the Russian invasion of Ukraine. Some Belarusian banks have stopped extending credit to their clients; others have substantially reduced their credit activity.

The Belarusian authorities adopted a series of emergency policy measures, in an attempt to dampen the effect of the sanctions. A presidential decree issued in March stipulated additional support for businesses affected by the sanctions, additional export-promotion and export-support measures, options for deferred payments to the budget, tax reliefs and VAT exemptions for affected businesses, tariff relief for importers, etc. The government was also granted new powers to introduce other emergency support measures. One such measure, adopted due to the disruption to imports, was an embargo on the export of a range of foods and industrial goods. The government is also considering a simplification of the existing unwieldy regulations on public procurement.

In turn, the monetary authorities and the banks have introduced measures that seek to reduce volatility on the financial markets. The most visible of these are the caps on the withdrawal of forex deposits and various other restrictions on forex transactions, which amount to partial capital controls. On the other hand, as an alternative to the dollar and euro, Belarusian banks have increased the options for international payments in Chinese renminbi.

Inflation in Belarus has been rising since mid-2021. All the indications are that this trend will continue in 2022, driven by various domestic and external inflationary pressures. Average consumer price inflation for the year as a whole is expected to reach 15 per cent or even more.

The reduction in exports to traditional markets brought about by the sanctions has significantly cut export-related public revenue. This is particularly visible as regards the two most important sources of exports: petroleum products and potash fertilisers. The expected plunge in economic activity will also result in shrinking contributions to the budget, while the government has already committed itself to quite significant new spending, which was not envisaged earlier in the 2022 budget. Consequently, the deficit will rise in the current year. The government has already indicated that a budget revision will be forthcoming, including curbs on previously planned public spending.

The labour market has also been affected by the new shocks. The overall weakening of economic activity has forced businesses to lay off employees or introduce reduced-hours working. Some foreign companies have either closed or significantly scaled back their operations in Belarus. The once flourishing IT sector has also been severely affected: anecdotal evidence suggests that about a quarter of Belarus's IT specialists have left the country since 2020, and another quarter is considering following suit.

Servicing of the external debt will probably be the biggest challenge facing the Belarusian authorities in the foreseeable future. Belarus was already cut off from the international financial markets in 2020, but it continued to rely on financial support from Russia. However, in the current climate, Russia is itself under huge financial strain and may not be able to provide Belarus with sufficient support, even if such had previously been pledged. So far, Belarus has managed to honour its foreign obligations, but whether it can continue to service its debt remains an open question. The agreed rescheduling of payments due to Russia under intergovernmental agreements has somewhat eased the pressure on Belarus's external finances; however, no information has been made public on any such deferral as regards debt to the Eurasian Development Bank. In any case, the risk of possible default on some foreign obligations has increased. At the same time, the effect of the balance-of-payments constraints will be more and more visible, dampening all components of final demand.

The combined effect of the myriad negative developments will inevitably push the Belarusian economy into recession in 2022. Our current forecast is for GDP to drop by some 3-4 per cent for the year as a whole, but the risks of a deeper recession remain. Default on some foreign obligations is a possibility, and that would further aggravate the economic situation.

In the current circumstances, economic weakness can be expected to continue in coming years as well. If Belarus manages to adjust to some extent to the sanctions and the war-related shocks, the recession may be limited to 2022, with a weak recovery resuming in 2023. Both the servicing of foreign debt and the threats to macroeconomic stability will remain a challenge for policy makers.

Table 4.2 / Belarus: Selected economic indicators

	2018	2019	2020	2021 1)	2022	2023	2024
						Forecast	
Population, th pers., average	9,439	9,420	9,380	9,380	9,380	9,350	9,320
Gross domestic product, BYN m, nom.	122,320	134,732	149,721	173,153	192,100	218,500	247,400
annual change in % (real)	3.1	1.4	-0.7	2.3	-3.5	1.6	2.0
GDP/capita (EUR at PPP)	13,180	13,670	13,770	14,430	.	.	.
Consumption of households, BYN m, nom.	64,491	71,630	77,101	87,768	.	.	.
annual change in % (real)	8.0	5.1	-1.1	4.3	-2.0	3.0	3.0
Gross fixed capital form., BYN m, nom.	32,081	36,424	37,977	39,141	.	.	.
annual change in % (real)	4.4	6.2	-6.3	-5.6	-6.0	0.0	1.5
Gross industrial production							
annual change in % (real)	5.7	1.0	-0.7	6.5	-3.0	1.0	2.0
Gross agricultural production							
annual change in % (real)	-3.3	2.9	4.8	-4.2	.	.	.
Construction industry							
annual change in % (real)	5.2	5.1	-1.6	-14.0	.	.	.
Employed persons, LFS, th, average	4,897	4,909	4,885	4,849	4,800	4,750	4,750
annual change in %	-0.1	0.2	-0.5	-0.7	-1.0	-1.0	0.0
Unemployed persons, LFS, th, average	245	213	206	197	205	198	198
Unemployment rate, LFS, in %, average	4.8	4.2	4.0	3.9	4.1	4.0	4.0
Reg. unemployment rate, in %, eop	0.3	0.2	0.2	0.1	.	.	.
Average monthly gross wages, BYN	971	1,093	1,255	1,434	1,620	1,830	2,070
annual change in % (real, gross)	12.6	6.5	8.8	4.4	-2.0	1.0	2.0
Consumer prices, % p.a.	4.9	5.6	5.5	9.5	15.0	12.0	11.0
Producer prices in industry, % p.a. 2)	6.8	6.3	5.6	12.1	16.0	14.0	12.0
General governm. budget, nat. def., % of GDP							
Revenues	41.5	40.0	35.5	38.0	35.0	37.0	38.0
Expenditures	37.5	37.6	37.2	40.0	39.0	39.0	39.0
Deficit (-) / surplus (+)	4.0	2.4	-1.7	-2.0	-4.0	-2.0	-1.0
General gov. gross debt, nat. def., % of GDP 3)	47.5	41.0	48.0	50.0	53.0	54.0	55.0
Stock of loans of non-fin. private sector, % p.a.	12.7	10.0	21.4	3.3	.	.	.
Non-performing loans (NPL), in %, eop 4)	5.0	4.6	4.8	5.0	.	.	.
Central bank policy rate, % p.a., eop 5)	10.00	9.00	7.75	9.25	12.0	11.0	10.0
Current account, EUR m 6)	20	-1,115	-221	1,564	700	700	500
Current account, % of GDP	0.0	-1.9	-0.4	2.7	1.3	1.3	0.8
Exports of goods, BOP, EUR m 6)	28,409	28,932	24,890	33,106	30,800	31,700	32,100
annual change in %	11.8	1.8	-14.0	33.0	-7.0	2.9	1.3
Imports of goods, BOP, EUR m 6)	30,536	32,684	26,637	33,777	31,700	32,600	33,000
annual change in %	8.9	7.0	-18.5	26.8	-6.1	2.8	1.2
Exports of services, BOP, EUR m 6)	7,511	8,628	7,704	8,682	8,600	8,800	8,900
annual change in %	7.3	14.9	-10.7	12.7	-0.9	2.3	1.1
Imports of services, BOP, EUR m 6)	4,594	5,237	4,287	4,812	4,600	4,700	4,900
annual change in %	7.5	14.0	-18.1	12.3	-4.4	2.2	4.3
FDI liabilities, EUR m 6)	1,212	1,139	1,220	1,039	.	.	.
FDI assets, EUR m 6)	47	-3	67	-79	.	.	.
Gross reserves of CB excl. gold, EUR m 6)	4,561	6,265	3,604	4,687	.	.	.
Gross external debt, EUR m 6)	34,307	36,416	34,229	36,450	39,200	40,100	41,000
Gross external debt, % of GDP	67.3	63.1	63.8	63.0	75.5	73.4	69.7
Average exchange rate BYN/EUR	2.4008	2.3342	2.7888	2.9923	3.70	4.00	4.20

1) Preliminary and wiiw estimates. - 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.

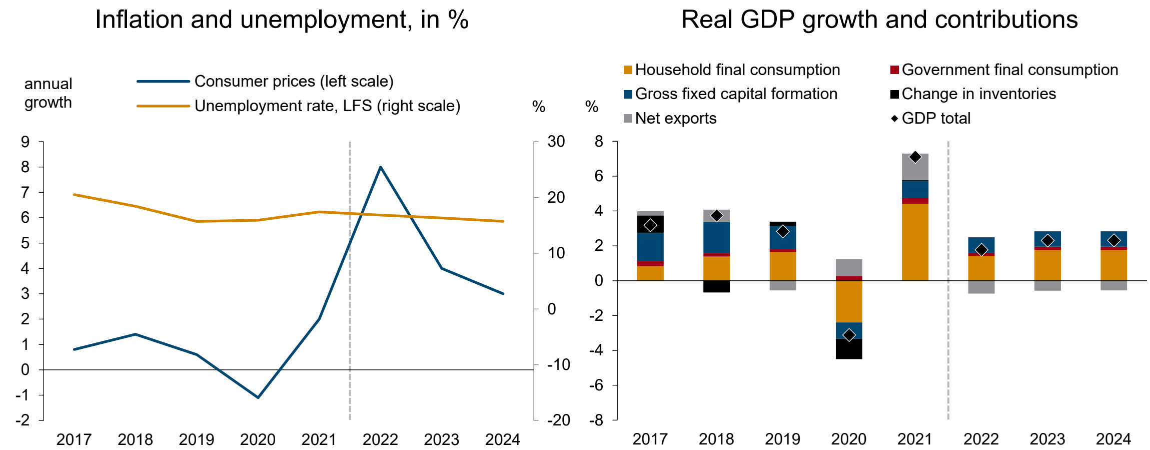
Source: wiiw Databases incorporating national statistics. Forecasts by wiiw.

BOSNIA AND HERZEGOVINA: Local political tensions leave the country in limbo

SELENA DURAKOVIĆ

The economy grew more strongly than expected in 2021, due to a significant rise in industrial production, private consumption and exports. However, growth in 2022 is expected to be much weaker, given the threats of high inflation brought about by the war in Ukraine and the rise in local political tensions. The entity governments have failed to reach agreement on decisions that are important to the country's progress, and this is undermining its prospects for European integration, while also rendering it less attractive to both foreign investors and its own citizens, who are leaving the country in droves.

Figure 4.3 / Bosnia and Herzegovina: Main macroeconomic indicators



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

The economy grew by an estimated 7.1% in 2021, thereby significantly exceeding the level of pre-pandemic 2019. The high growth rate is a result of a significant increase in industrial production (10.7%), private consumption (6.1%) and exports (42.3%), as the COVID-related restrictions were fairly mild in 2021. Tourism recovered significantly, with total visitor nights increasing by 79.6% in 2021, compared to the previous year. Remittances, which make up around 8% of GDP, increased by 20% in 2021, exceeding the pre-pandemic level. Steeply rising food and energy bills meant that inflation surged towards the end of the year, reaching 6.3% in December; however, the annual figure was just 2%, thanks to a low rate in the first half of the year. Economic recovery on the one hand, and a reduction in pandemic-related fiscal support on the other have turned a fiscal deficit of 5.3% of GDP in 2020 into an estimated surplus of 3.5% in 2021, providing a welcome fiscal buffer in light of the increased uncertainty caused by the Russia-Ukraine war.

Although direct economic ties with Russia and Ukraine are limited, the effect of the war in Ukraine can already be felt in the financial sector and prices. There was a run on one Russian-owned bank that operated across Bosnia and Herzegovina and that had a market share of around 5%. The bank was then bought by a domestic finance company, which put a stop to the run; however, the memory of the Bosnian war and the fear of conflict locally have resulted in reduced confidence in the banking sector. The increased demand for food – partly a consequence of the fear of further price rises occasioned by the Russia-Ukraine war and partly the result of anxiety about local conflict and food shortages – has led to additional pressure on the already high supply-side-driven inflation. Thus, inflation in February reached 8.1%, its highest level since 2008.

Due to the anticipated increase in international food and energy prices and weak domestic stocks and alternative sources, we expect inflation to grow significantly in 2022. Inflation is expected to climb to 8% in 2022 and to stand at 4% in 2023 – up 7 percentage points (pp) and 2.8 pp, respectively, on the previous forecast. These forecasts assume that there are no new shocks, as inflation in February (i.e. before the war), when oil and gas were still not that expensive, was above 8%. Since wages and pensions are not aligned with rising market prices, citizens are currently facing a lower standard of living. Since the central bank of Bosnia and Herzegovina operates a currency board, it does not have the tools necessary to combat rising inflation. The only instrument available is the bank reserve requirement; but banks already hold high levels of excess reserves, despite the negative rates on those that were introduced in 2016. Fiscal policy has so far failed to temper the inflation shock, as a lack of political consensus has meant that all proposals to temporarily abolish excise duties on oil and petroleum products and to introduce a lower value added tax on essential products have been rejected. No other measures (such as price controls) related to the new inflation threats in 2022 have been announced.

Political tensions have been growing since the end of 2021, threatening the country's internal security and stability and slowing the EU accession process. One part of the country, Republika Srpska, has been disrupting the work of state institutions since late 2021, and has started to take steps to create its own army, tax authority and judiciary, which could lead to its secession. The US, the UK and some EU countries have announced economic and financial sanctions on anyone who violates the constitutional order in Bosnia and Herzegovina, should the secession activities continue. Meanwhile, the entity governments have failed to reach agreements and take decisions that are important for the country's future. A law on the prevention of conflicts, which was stipulated as a condition by the European Commission for progress in the EU accession process, was rejected. Even the country's position on the subject of Russian aggression against Ukraine is not unified: two members of the presidency condemn the actions, while the member from Republika Srpska wants to maintain a neutral stance and even advocates a further strengthening of energy cooperation with Russia. Moreover, one part of the other entity, the Federation of Bosnia and Herzegovina, is insisting on changing the Election Law, but no agreement can be reached; this has resulted in heightened tension within this entity as well, and increased uncertainty about the October elections. Although all of these tensions might simply be a way for ruling politicians to boost their popularity ahead of the elections, they are jeopardising the country's political stability, its economic progress and the support of the EU, and are potentially opening up the possibility of renewed inter-ethnic violence.

Due to the rising inflation rates and the increase in political domestic and foreign risks, our forecasts for GDP growth have been revised downwards. We expect GDP to grow by 1.8% in 2022 and by 2.3% in 2023 – a downward revision of 1.3 and 1.2 pp, respectively. This is mostly a reflection of the increased political risks, which are likely to lead to postponement of the implementation of public infrastructure projects and private sector investment; reduced purchasing power due to inflation, which will slow consumer spending; and weaker exports, due to lower EU demand caused by the war in Ukraine. Exports of goods and services and private consumption will continue to increase (albeit at a slower pace), which will contribute to GDP growth, provided the political tensions do not escalate.

A further consequence of the increased tension and the fear of violent new conflicts is an upsurge in the number of people leaving the country, which only serves to damage the country's long-term prospects. In surveys across the country, citizens are voicing their dissatisfaction with their life in Bosnia and Herzegovina and their feeling of a lack of security and progress. As a result, the number of people leaving the country has been rapidly increasing. Governance weaknesses and inefficiencies are damaging the economic and business environment, as the country fails to implement the reforms needed to strengthen the single economic space and draw it towards further integration with the European Union. As a consequence, investment is less attractive, more people are leaving the country and employers have already started reporting a lack of quality workforce. This will weigh heavily on economic growth in years to come, reducing the country's long-term economic prospects.

Table 4.3 / Bosnia and Herzegovina: Selected economic indicators

	2018	2019	2020	2021 1)	2022	2023 Forecast	2024
Population, th pers., average	3,496	3,491	3,475	3,445	3,415	3,385	3,355
Gross domestic product, BAM m, nom. 2)	33,444	35,296	34,255	37,324	41,000	43,600	45,900
annual change in % (real)	3.7	2.8	-3.1	7.1	1.8	2.3	2.3
GDP/capita (EUR at PPP) 2)	9,620	10,110	9,840	10,890	.	.	.
Consumption of households, BAM m, nom. 2)	24,639	25,633	24,756	26,225	.	.	.
annual change in % (real)	1.8	2.2	-3.3	6.1	2.0	2.5	2.5
Gross fixed capital form., BAM m, nom. 2)	7,610	8,129	7,690	8,164	.	.	.
annual change in % (real)	8.1	5.8	-4.1	4.4	4.0	4.0	4.0
Gross industrial production							
annual change in % (real)	1.6	-5.3	-6.4	10.7	3.0	2.0	2.0
Gross agricultural production 3)							
annual change in % (real)	21.5	-8.4	-1.0	0.3	.	.	.
Construction output total							
annual change in % (real)	0.4	-2.0	0.2	2.4	.	.	.
Employed persons, LFS, th, average 4)	822.4	802.9	1,173.1	1,151.0	1,160	1,170	1,180
annual change in %	0.8	-2.4	.	.	0.5	0.5	0.5
Unemployed persons, LFS, th, average 4)	185.5	149.4	221.0	241.8	235	228	220
Unemployment rate, LFS, in %, average 4)	18.4	15.7	15.9	17.4	16.8	16.3	15.7
Reg. unemployment rate, in %, eop	34.7	32.8	33.6	31.0	.	.	.
Average monthly gross wages, BAM	1,363	1,421	1,476	1,542	1,670	1,750	1,820
annual change in % (real, gross)	1.7	3.7	5.0	2.4	0.0	0.5	1.0
Average monthly net wages, BAM	879	921	956	998	1,080	1,130	1,180
annual change in % (real, net)	1.9	4.2	4.9	2.4	0.0	0.5	1.0
Consumer prices, % p.a.	1.4	0.6	-1.1	2.0	8.0	4.0	3.0
Producer prices in industry, % p.a.	3.5	0.1	-1.2	5.6	12.0	6.0	4.0
General governm. budget, nat. def., % of GDP							
Revenues	43.0	42.5	42.1	38.5	39.0	39.5	40.0
Expenditures	40.8	40.6	47.4	35.0	39.0	39.0	39.0
Deficit (-) / surplus (+)	2.2	1.9	-5.3	3.5	0.0	0.5	1.0
General gov. gross debt, nat. def., % of GDP	34.2	32.8	36.6	35.2	35.0	35.0	35.0
Stock of loans of non-fin. private sector, % p.a.	5.5	6.7	-2.5	3.7	.	.	.
Non-performing loans (NPL), in %, eop	8.8	7.4	6.1	5.3	.	.	.
Central bank policy rate, % p.a., eop 5)	.	.	.	.	.	.	.
Current account, EUR m 6)	-559	-504	-657	-410	-780	-870	-960
Current account, % of GDP	-3.3	-2.8	-3.8	-2.1	-3.7	-3.9	-4.1
Exports of goods, BOP, EUR m 6)	5,327	5,205	4,818	6,500	7,770	8,660	9,400
annual change in %	11.5	-2.3	-7.4	34.9	19.5	11.5	8.5
Imports of goods, BOP, EUR m 6)	9,172	9,277	8,034	10,179	12,320	13,820	15,060
annual change in %	7.1	1.1	-13.4	26.7	21.0	12.2	9.0
Exports of services, BOP, EUR m 6)	1,959	2,117	1,229	1,910	2,310	2,660	2,950
annual change in %	10.0	8.0	-42.0	55.4	21.0	15.0	11.0
Imports of services, BOP, EUR m 6)	624	689	457	587	690	770	850
annual change in %	5.7	10.4	-33.7	28.6	18.0	12.0	10.0
FDI liabilities, EUR m 6)	507	388	364	445	.	.	.
FDI assets, EUR m 6)	16	111	68	38	.	.	.
Gross reserves of CB excl. gold, EUR m 6)	5,835	6,311	6,942	8,204	.	.	.
Gross external debt, EUR m	11,211	11,395	11,264	11,470	13,000	14,000	15,000
Gross external debt, % of GDP	65.6	63.1	64.3	60.1	62.0	62.8	63.9
Average exchange rate BAM/EUR	1.9558	1.9558	1.9558	1.9558	1.9558	1.9558	1.9558

1) Preliminary and wiiw estimates. - 2) According to ESA'10 (FISIM not yet reallocated to industries). - 3) Based on UN-FAO data, wiiw estimate from 2020. - 4) Until 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.

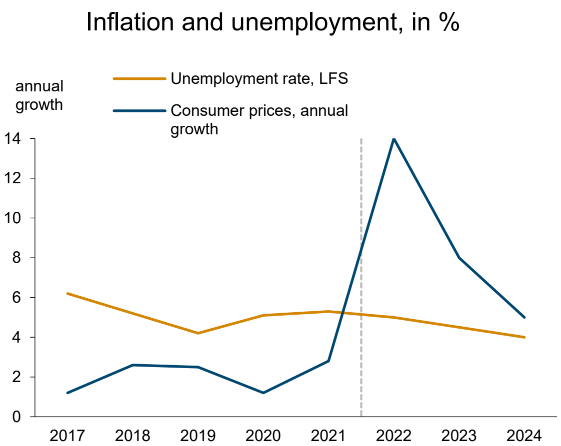
Source: wiiw Databases incorporating national statistics. Forecasts by wiiw.

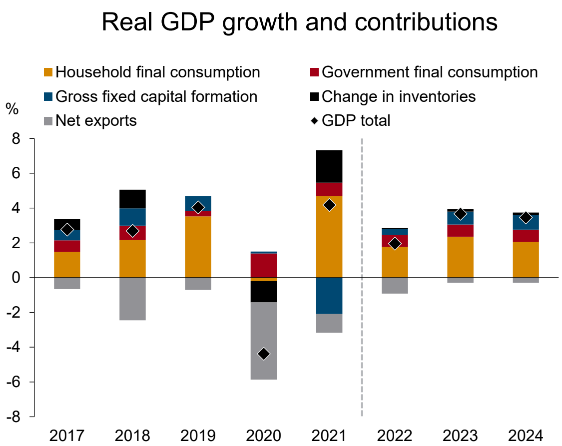
BULGARIA: A weak government struggles with mounting challenges

RUMEN DOBRINSKY

Bulgaria is facing numerous challenges, on account of its chronic economic problems and the shocks resulting from the war in Ukraine. The diversity of the new government is in itself a source of weakness and is constraining its policy course. The recovery that was under way before the Russian invasion of Ukraine has come to a halt. The delays over approval of the National Recovery and Resilience Plan will mean a reduction in the transfer of EU funds in 2022. GDP is expected to grow by some 2% in 2022, and a moderate upturn is expected in 2023.

Figure 4.4 / Bulgaria: Main macroeconomic indicators





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

During its first hundred days, the new government that took office in December 2021 failed to come up with a coherent programme and to create a distinctive political image. Backed as it is by a broad and diverse coalition that draws together four parties from the left, the right and the centre, the government has no clear stance either on economic issues or on foreign policy. In most cases, the need for compromise leads to a 'lowest common denominator' solution, avoiding the most sensitive and controversial policy issues.

In the economic sphere, the main cost of the compromise has been a missed opportunity to initiate debate on some chronic problems, such as those faced by the tax, pension and healthcare systems. In the ten years of lax rule under the populist Mr Borisov, no major reforms were undertaken in any of those spheres, and as a consequence the associated problems only intensified (e.g. the widening deficit in the pension system, the surge in income inequality and the deteriorating quality of public health care). Sooner or later, Bulgarian policy makers will have to address the problems in these spheres. However, if that did not occur during the ‘honeymoon’ phase of the new government, it is unlikely to happen at all during its time in office. Hence the problems will continue to get worse, making any future reform even more challenging.

Because of the delay in forming the government, Bulgaria’s 2022 budget was only adopted in January. The budget itself is a reflection of the eclectic nature of the new government’s policy course: it envisages increased spending in many areas (under different pressures from the four parties), but contains no indication of reform intentions in any of the above spheres. The planned cash deficit in this budget amounts to BGN 5.9bn, or 4.1% of GDP – the highest figure for Bulgaria’s public finances in the past two and a half decades.

The immediate economic consequences of the war in Ukraine – such as the latest hikes in energy prices – have given rise to fresh challenges for the authorities. The fact is that Bulgaria is one of the EU countries most dependent on gas and oil supplies from Russia, and is also the EU economy with the highest energy intensity. Due to this, the pass-through of energy cost increases to all other goods and services is more pronounced in Bulgaria than elsewhere in Europe. Moreover, the recent surge in energy prices has come on top of the significant rise in world commodity prices seen in 2021, which was already having a tangible effect on local prices.

As a result, the biggest surge in domestic prices for a quarter of a century is making itself felt. In January, the producer price index was 32.6% higher than a year before, and the short-term statistics suggest no reversal of this trend. Undoubtedly, this will also be reflected in consumer prices, albeit with a certain time lag. The expectations are that average annual consumer price inflation in 2022 will be well above the 10% mark.

Before the Russian invasion of Ukraine, the Bulgarian economy was on the path to moderate recovery, with GDP growing by 4.2% in 2021. Aggregate output growth was supported by both private consumption and exports. Private consumption in 2021 surged by an impressive 8% on the strength of improving consumer confidence. Real exports of goods and services grew by 9.9% – and real exports of services alone increased by 24.6% compared to the previous year, thanks to the recovery in tourism. Exports continued to grow strongly in the first two months of this year.

However, the war-related shocks will undoubtedly cause a reversal of this trend. The first noticeable sign of this has been the disruption to some supply chains for products traditionally imported from Russia and Ukraine, such as steel. The possibility also remains of disruption to the supply of Russian oil and gas. The tourist industry, which enjoyed a full winter season, is bracing itself for a very poor summer. There will also be secondary implications, due to the anticipated weakening of demand in key European markets. The influx of refugees from Ukraine has so far been relatively limited (compared to other European countries); but even so, it has been piling extra strain on Bulgaria’s public finances.

Given the war-related shocks, the 2022 budget will most likely have to be revised. The budgetary framework contained the rather optimistic assumption of GDP expansion of 4.8% in 2022. It is already clear that such growth will not materialise this year. On the other hand, it is also obvious that in 2022 inflation will substantially overshoot the 5.6% envisaged in the government’s budgetary forecast. In view of the new developments, some of the generous spending provisions will probably have to be scaled back. The budget revision will also need to reallocate some funds for the unanticipated support of Ukrainian refugees.

It is likely that the budgetary revisions will also affect planned public investment in 2022. Public investment in 2021 was 33% down on 2020, due to delays in mobilising EU funds from the new Multiannual Financial Framework. The expectation was that these delays would be partly overcome in 2022, and that the new transfers would to some extent offset their underutilisation in 2021.

However, at the time of writing, Bulgaria still does not have an operational National Recovery and Resilience Plan. In March, the European Commission failed to approve the version submitted by the new government and returned it for further amendment. For all practical purposes, the delay in approving the plan means that Bulgaria will not be able to avail itself of a large tranche of the generous grant allocations from the Recovery and Resilience Facility (RRF) that were offered to the country. According to the RRF regulation, 70% of the amount available for non-repayable financial support should be legally committed by 31 December 2022, and the remaining 30% between 1 January and 31 December 2023. Given these tight deadlines, it is technically next to impossible for Bulgaria to submit projects worth a total of EUR 4.6bn – and have them approved – in the time envisaged under the RRF framework.

Such an outcome could have both budgetary and macroeconomic implications. The 2022 budget adopted in January foresaw significant revenue in the shape of the European Commission transfers, which were to go on financing a substantial part of the planned 2022 public investment. If major downward revisions occur on the revenue side, public investment in 2022 will be way below the budget target, which will also have an impact on gross fixed capital formation.

So far, increases in nominal incomes have not kept pace with rising inflation. Thus it is to be expected that the erosion of real incomes will curb private consumption, which was the main growth driver in 2021.

In view of the increasing downside risks, at this point in time we expect GDP to grow by some 2% in 2022, which is 1.3 percentage points down on the January forecast. Despite an expected slowdown, private consumption should continue to support growth in 2022. Gross fixed capital formation may pick up from its meagre level in 2021; however, we do not expect it to contribute significantly to GDP growth in 2022. We anticipate that imports of goods will outpace exports in the short run. And the shock to the tourist industry is likely to result in a year-on-year decline in the export of services in 2022. Consequently, we expect the current account balance in 2022 to stay in negative territory.

If the war-related shocks are limited to 2022, we would expect output growth to strengthen in 2023. However, it will probably remain at below the level that it would have reached had there been no shocks. GDP will continue to be predominantly driven by domestic demand, while the current account balance will remain negative. If inflation is not contained through aggressive policy moves, it could become a major concern, given Bulgaria’s declared intention of joining the euro area in the next few years.

Table 4.4 / Bulgaria: Selected economic indicators

	2018	2019	2020	2021 1)	2022	2023 Forecast	2024
Population, th pers., average	7,025	6,976	6,934	6,850	6,800	6,750	6,700
Gross domestic product, BGN m, nom.	109,964	120,395	119,951	132,744	154,300	172,800	187,700
annual change in % (real)	2.7	4.0	-4.4	4.2	2.0	3.7	3.5
GDP/capita (EUR at PPP)	15,610	16,670	16,410	17,860	.	.	.
Consumption of households, BGN m, nom.	65,161	70,435	69,892	78,193	.	.	.
annual change in % (real)	3.6	5.9	-0.3	8.0	3.0	4.0	3.5
Gross fixed capital form., BGN m, nom.	20,624	22,404	22,981	21,993	.	.	.
annual change in % (real)	5.4	4.5	0.6	-11.0	2.0	4.5	5.0
Gross industrial production 2)							
annual change in % (real)	0.3	0.6	-5.9	8.9	3.0	4.0	3.0
Gross agricultural production							
annual change in % (real)	0.0	-1.2	-11.0	17.5	.	.	.
Construction industry 3)							
annual change in % (real)	1.6	3.8	-5.3	2.6	.	.	.
Employed persons, LFS, th, average 4)	3,153	3,233	3,122	3,077	3,080	3,100	3,120
annual change in %	0.1	2.6	-3.4	.	0.0	0.5	0.5
Unemployed persons, LFS, th, average 4)	173	143	169	171	160	150	130
Unemployment rate, LFS, in %, average 4)	5.2	4.2	5.1	5.3	5.0	4.5	4.0
Reg. unemployment rate, in %, eop	6.1	5.9	6.7	4.8	.	.	.
Average monthly gross wages, BGN	1,146	1,267	1,391	1,551	1,890	2,170	2,430
annual change in % (real, gross)	7.5	7.2	7.9	8.0	7.0	6.5	6.5
Consumer prices (HICP), % p.a.	2.6	2.5	1.2	2.8	14.0	8.0	5.0
Producer prices in industry, % p.a.	3.9	3.0	-2.0	15.5	25.0	10.0	8.0
General governm. budget, EU def., % of GDP							
Revenues	38.7	37.6	37.8	40.0	40.0	40.0	40.0
Expenditures	36.9	35.5	41.8	43.0	45.0	44.0	43.0
Net lending (+) / net borrowing (-)	1.7	2.1	-4.0	-3.0	-5.0	-4.0	-3.0
General gov. gross debt, EU def., % of GDP	22.1	20.0	24.7	26.5	30.0	31.0	32.0
Stock of loans of non-fin. private sector, % p.a.	7.7	7.4	4.5	8.3	.	.	.
Non-performing loans (NPL), in %, eop	7.8	6.6	7.5	6.0	.	.	.
Central bank policy rate, % p.a., eop 5)	0.00	0.00	0.00	0.00	0.0	0.0	0.0
Current account, EUR m	532	1,148	-41	-271	-1,200	-1,200	-700
Current account in % of GDP	0.9	1.9	-0.1	-0.4	-1.5	-1.4	-0.7
Exports of goods, BOP, EUR m	27,742	29,120	27,272	34,278	36,500	37,500	38,500
annual change in %	2.9	5.0	-6.3	25.7	6.5	2.7	2.7
Imports of goods, BOP, EUR m	30,449	32,028	29,213	37,574	41,000	42,000	43,000
annual change in %	9.8	5.2	-8.8	28.6	9.1	2.4	2.4
Exports of services, BOP, EUR m	9,195	10,237	7,260	9,277	8,800	9,200	9,500
annual change in %	11.5	11.3	-29.1	27.8	-5.1	4.5	3.3
Imports of services, BOP, EUR m	5,063	5,342	4,171	4,783	4,200	4,700	5,000
annual change in %	-2.5	5.5	-21.9	14.7	-12.2	11.9	6.4
FDI liabilities, EUR m	1,542	1,983	3,182	1,778	.	.	.
FDI assets, EUR m	785	745	397	640	.	.	.
Gross reserves of CB excl. gold, EUR m	23,620	23,072	28,830	32,490	.	.	.
Gross external debt, EUR m	37,190	37,716	39,813	41,965	42500	44000	46000
Gross external debt, % of GDP	66.1	61.3	64.9	61.8	54.0	50.0	48.0
Average exchange rate BGN/EUR	1.9558	1.9558	1.9558	1.9558	1.9558	1.9558	1.9558

1) Preliminary and wiiw estimates. - 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).

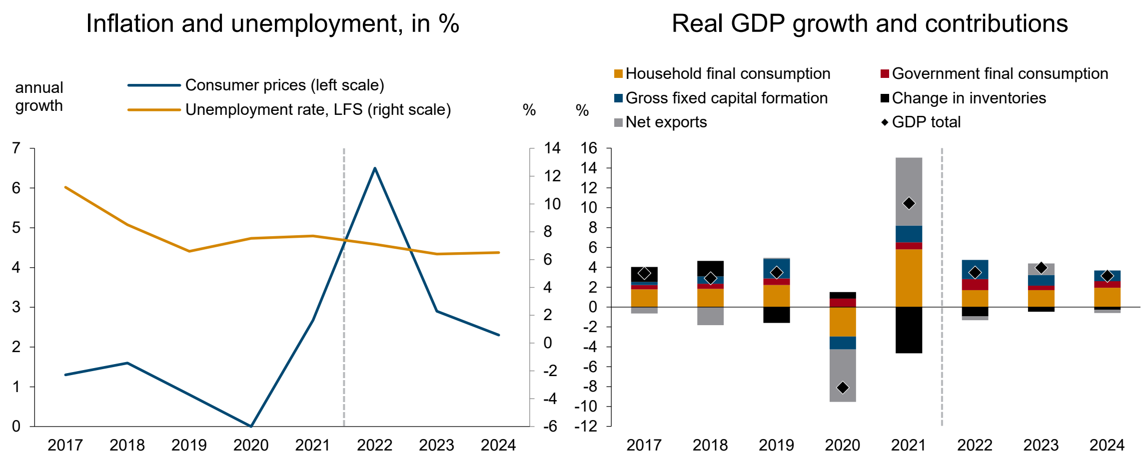
Source: wiiw Databases incorporating Eurostat and national statistics. Forecasts by wiiw.

CROATIA: War taking its toll on economic growth

BERND CHRISTOPH STRÖHM

The Croatian economy has made a full recovery from the COVID-19 pandemic, with GDP increasing by 10.4% year on year in 2021. However, Russia's invasion of Ukraine has generated much uncertainty regarding Croatia's growth prospects for 2022. The surging energy costs, which are serving to boost inflation, will put pressure on government spending plans and will slow private consumption in 2022. The spill-over effects of the war will also adversely affect Croatia's summer tourist season, which is why we have adjusted the forecast for this year's GDP growth downward to 3.5%.

Figure 4.5 / Croatia: Main macroeconomic indicators



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

Having had a superb 2021 economically, Croatia will find that the Russo-Ukrainian war will take the shine off its economic growth in 2022. Croatia's economy in 2021 grew faster than most other EU-CEE countries, with real GDP rebounding by 10.4%. This was a product of a bumper tourist season and a surge in private consumption, as well as stellar 15.8% year-on-year GDP growth in Q3 2021. Even though Croatia's direct exposure to Russia is fairly limited, we expect the war to damage Croatia's economic growth prospects in 2022, largely on account of the inflationary pressures, fewer tourist arrivals and reduced demand from Germany, Italy and Austria, Croatia's most important trading partners. As a consequence, we have reduced this year's GDP growth forecast to 3.5%, from the previous 4.7%.

The war in Ukraine will put a damper on Croatia's summer tourist season in 2022. Because of the spill-over effects of Russia's invasion of Ukraine – not least rising inflation and high energy costs – we expect tourist bookings for Croatia's upcoming summer season to drop off. This applies to bookings from EU countries such as Germany, Austria, Italy and Slovenia. Croatia's ban on flights to and from Russia, imposed as a retaliatory measure for the invasion of Ukraine, will only have a mildly negative impact on the country's tourist sector. In 2021, 145,000 Russian tourists visited Croatia, accounting for 800,000 overnight stays, some 1% of all overnight stays recorded last year. Nevertheless, it should be noted that before the war, the Croatian government was expecting 200,000 Russian tourists this year.

The government's efforts to diversify Croatia's energy supplies are bearing fruit in the light of events in Ukraine. A vital element of those efforts was the construction of the liquefied natural gas (LNG) terminal on the Croatian island of Krk. In 2021, some 23% of all natural gas consumed in Croatia was delivered via the LNG terminal; only 28% was imported from Russia; while Croatia produced some 30% of its gas supplies domestically. The rest was imported from other sources. We expect Croatia to be able to make up for the lost Russian gas imports through domestic production and additional imports via the Krk LNG terminal. In March 2022, the government said that it would consider expanding the capacity of the LNG terminal, in order to increase the country's energy independence – from 2.6bn to 2.9bn cubic metres. The terminal could also theoretically supply other countries in the Western Balkan region with natural gas. At the beginning of April 2022, Slovenian Infrastructure Minister Vrtovec announced that Slovenia would be interested in importing natural gas through the Krk terminal from October 2022, in a bid to diversify his country's energy supplies.

A government reshuffle is likely in 2022. Prime Minister Plenković's government has so far managed to head off the risk of a snap election, thanks to its successful management of the COVID-19 crisis in 2021. However, the stability of the government was dented in the first months of 2022 by corruption allegations against members of **Plenković's cabinet – such as former Construction Minister Horvat, who was arrested in February by the anti-corruption prosecutor's office USKOK. The risk of snap parliamentary elections still remains low; however,** to ease the policy-making process of the Croatian Democratic Union-led government, **Prime Minister Plenković is likely to reshuffle his cabinet** in 2022.

Croatia will see record levels of inflation in 2022. Inflation accelerated to 6.3% year on year in February – its highest since September 2008. Given the increase in the cost of energy and basic foodstuffs, alongside the persistent global supply-chain disruptions that have been exacerbated by the events in Ukraine, we expect inflation to average 6.5% in 2022. To limit the surge in energy prices, the government has **adopted** a set of measures worth some EUR 640m (about 1% of Croatia's 2021 GDP). The measures include a permanent reduction in VAT on electricity (from 25% to 13%) and a temporary cut in VAT on gas to 5% (from 1 April 2022 until 31 March 2023). In addition, it has also introduced caps on fuel and electricity prices.

Surging inflation will likely trigger additional fiscal costs, putting pressure on the country's spending plans. The rise in energy and food prices will increase pressure on the government to spend more, due to the likely wage demands and fiscal measures to offset the impact of higher energy prices on businesses and households. Despite the uncertainties surrounding the war and the increasing inflation, the government is still planning to maintain its pledge to introduce the euro in 2023, which is why it will attempt to maintain fiscal discipline at all costs. Nevertheless, the increasing prices mean that this year's budget deficit will rise to 3.5% – above the 3% Maastricht requirement, but still below the deficit of the previous two years (7.4% and 3.8%). The public debt-to-GDP ratio will fall to around 79%.

EU sanctions against Russia will have only a minor direct effect on Croatia's export economy. Bilateral trade between Russia and Croatia dropped off sharply following the first wave of EU sanctions against Russia, imposed in 2014 after Russia's annexation of Crimea. In 2020, goods exports to Russia amounted to just EUR 176m (only 0.3% of Croatia's 2021 GDP), compared to EUR 282m in 2013.

Despite the growing uncertainty, **it is expected that the inflow of EU Recovery and Resilience Facility (RRF) funds will support Croatia's growth dynamics in 2022.** In 2021, the European Commission approved a EUR 6.3bn grant (12.8% of Croatia's 2020 GDP) from the EU's RRF for the period 2021-2026. Those funds will facilitate long-term investment projects, such as modernisation of the Zagreb–Rijeka railway, which should be completed by 2027. According to government estimates, the implementation of RRF-financed projects, including the reconstruction of earthquake-damaged infrastructure in the Zagreb, Krapina-Zagorje, Sisak-Moslavina and Karlovac counties, will contribute 1.4 percentage points to headline GDP growth in both 2022 and 2023.

Unemployment will remain at some 7% – above the pre-COVID level. Croatia's unemployment rate stood at 7.8% year on year in February. The spill-over effects of the war in Ukraine, including higher energy prices, will negatively affect Croatia's tourist industry. This is why the unemployment rate in 2022 will remain higher than pre-COVID, in spite of the stellar performance of the country's tourist sector in 2021.

Table 4.5 / Croatia: Selected economic indicators

	2018	2019	2020	2021 1)	2022	2023	2024
						Forecast	
Population, th pers., average 2)	4,091	4,067	4,047	3,899	3,885	3,883	3,880
Gross domestic product, HRK bn, nom.	390.9	412.2	378.3	431.5	475	508	536
annual change in % (real)	2.9	3.5	-8.1	10.4	3.5	4.0	3.1
GDP/capita (EUR at PPP)	19,570	20,770	19,230	22,590	.	.	.
Consumption of households, HRK bn, nom.	218.4	229.6	218.2	246.6	.	.	.
annual change in % (real)	3.3	4.0	-5.3	10.1	3.0	3.0	3.4
Gross fixed capital form., HRK bn, nom.	78.5	88.7	84.4	93.0	.	.	.
annual change in % (real)	3.8	9.8	-6.1	7.6	9.0	5.0	5.0
Gross industrial production 3)							
annual change in % (real)	-1.0	0.6	-2.7	6.3	3.0	3.0	2.5
Gross agricultural production							
annual change in % (real)	6.4	-1.2	1.1	-6.0	.	.	.
Construction output 3)							
annual change in % (real)	4.9	8.3	4.4	9.5	.	.	.
Employed persons, LFS, th, average 4)	1,655	1,680	1,657	1,678	1,700	1,730	1,760
annual change in %	1.8	1.5	-1.3	1.3	1.5	1.5	1.5
Unemployed persons, LFS, th, average 4)	152	119	135	138	130	120	120
Unemployment rate, LFS, in %, average 4)	8.5	6.6	7.5	7.7	7.1	6.4	6.5
Reg. unemployment rate, in %, eop	8.9	7.8	9.3	7.3	.	.	.
Average monthly gross wages, HRK 5)	8,448	8,766	9,216	9,599	10,500	11,100	11,600
annual change in % (real, gross)	3.3	3.0	2.4	1.6	2.3	2.5	2.5
Average monthly net wages, HRK 5)	6,242	6,457	6,763	7,129	7,800	8,200	8,600
annual change in % (real, net)	2.8	2.6	2.6	2.7	2.5	2.5	2.5
Consumer prices (HICP), % p.a.	1.6	0.8	0.0	2.7	6.5	2.9	2.3
Producer prices in industry, % p.a.	2.2	0.8	-3.2	11.6	4.0	2.4	2.2
General governm. budget, EU def., % of GDP							
Revenues	45.7	46.3	47.2	50.0	48.5	46.0	46.0
Expenditures	45.5	46.0	54.5	53.8	52.0	48.7	48.5
Net lending (+) / net borrowing (-)	0.2	0.3	-7.4	-3.8	-3.5	-2.7	-2.5
General gov. gross debt, EU def., % of GDP	73.3	71.1	87.3	81.3	79.0	76.5	75.0
Stock of loans of non-fin. private sector, % p.a.	2.3	3.9	3.5	2.3	.	.	.
Non-performing loans (NPL), in %, eop 6)	7.5	5.5	5.4	4.3	.	.	.
Central bank policy rate, % p.a., eop 7)	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Current account, EUR m	976	1,677	-47	1,822	680	1,210	1,070
Current account, % of GDP	1.9	3.0	-0.1	3.2	1.1	1.8	1.5
Exports of goods, BOP, EUR m	12,236	12,858	12,169	15,722	17,530	19,460	20,720
annual change in %	4.5	5.1	-5.4	29.2	11.5	11.0	6.5
Imports of goods, BOP, EUR m	21,881	23,304	20,851	26,166	29,900	33,200	36,000
annual change in %	8.6	6.5	-10.5	25.5	14.1	10.9	8.3
Exports of services, BOP, EUR m	13,858	15,362	8,928	14,168	15,700	17,700	19,200
annual change in %	7.5	10.9	-41.9	58.7	10.5	12.5	8.4
Imports of services, BOP, EUR m	4,645	5,069	3,638	4,362	4,500	4,600	4,700
annual change in %	13.0	9.1	-28.2	19.9	3.0	3.0	3.0
FDI liabilities, EUR m	1,079	3,478	1,046	3,436	.	.	.
FDI assets, EUR m	236	80	374	1,180	.	.	.
Gross reserves of CB excl. gold, EUR m	17,438	18,560	18,943	25,022	.	.	.
Gross external debt, EUR m	42,583	40,278	40,074	44,610	44,900	46,900	48,700
Gross external debt, % of GDP	80.8	72.5	79.8	77.8	71.5	70.0	69.0
Average exchange rate HRK/EUR	7.4182	7.4180	7.5384	7.5284	7.6	7.6	7.6

1) Preliminary and wiiw estimates. - 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.

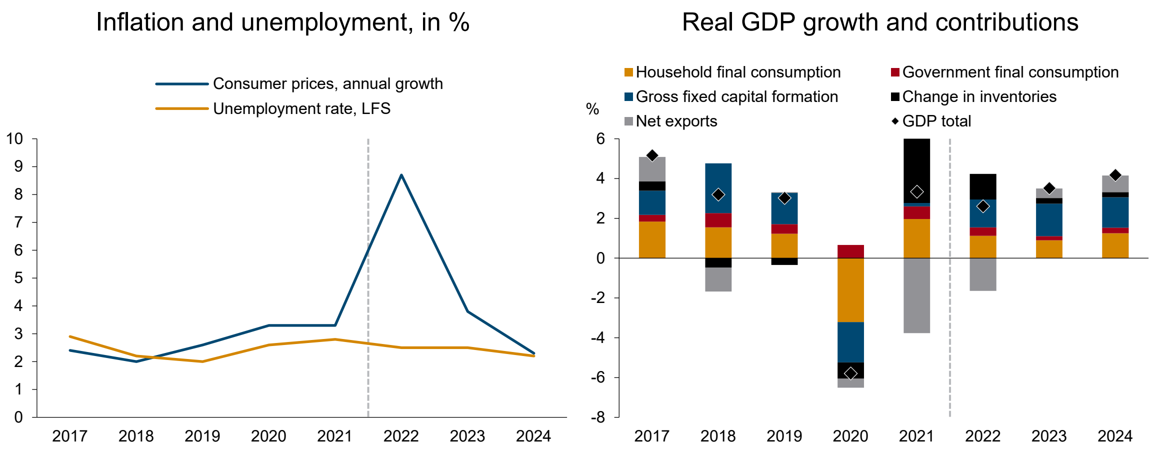
Source: wiiw Databases incorporating Eurostat and national statistics. Forecasts by wiiw.

CZECHIA: Mounting challenges depress otherwise solid growth prospects

ZUZANA ZAVARSKÁ

The Czech economy grew in line with expectations in 2021, driven by household consumption as pandemic concerns faded into the background and savings started to be spent. Despite persistent supply-side troubles and sharply rising prices in the first two months of 2022, the pre-war outlook for growth over the forecast period was relatively favourable. The supply-chain pressures limiting exports showed signs of easing, and – boosted by the inflow of EU funds – investment activity was expected to accelerate. The war in Ukraine now limits these prospects. Great uncertainty, disruption and surging prices will dampen most channels of growth this year. We expect real GDP to grow modestly, by 2.6% in 2022, gradually picking up in 2023 and 2024.

Figure 4.6 / Czechia: Main macroeconomic indicators



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

In 2021, the Czech economy expanded by 3.3% against the previous year, fuelled by household consumption and inventory accumulation. The easing of COVID-related restrictions put the economy on track for solid recovery in Q2 and Q3 2021, but the year-end exposed the vulnerabilities associated with the Czech export-oriented model. Strong domestic demand boosted imports by 11.5% year on year in 2021 in real terms. By contrast, exports struggled to keep pace amidst supply-chain disruptions, growing only modestly (5.1%). As a result, foreign trade put a major damper on real GDP growth, negatively contributing 3.8 percentage points (pp).

Prior to the war in Ukraine, Czech industry was dealing fairly well with the headwinds of rapidly rising input prices, supply-side issues and labour shortages. Operating conditions for goods manufacturers showed signs of improvement at the beginning of 2022, and industrial production picked up by 3.1% in January 2022 against the previous month. The Czech Purchasing Managers' Index remained above the threshold of 50 in the first two months of 2022, echoing signs of improved manufacturing-sector health. As a result, in the pre-war baseline, it was anticipated that pressures on producer prices would ease in the first half of the year, reviving the country's industrial core and releasing pent-up exports. Investments deferred due to the pandemic were also expected to gain momentum and to become a key driver of growth in the three years ahead.

Russia's invasion of Ukraine renders these prospects bleaker, as external pressures intensify. Inflation is unlikely to subside in the coming months, and will instead climb to historic highs. In February, even before the war, the rise in harmonised consumer prices was in double digits (10.0%) year on year – the steepest increase since 1998 and the third highest in the EU. Producer prices reached even higher levels (21.3%), with energy and chemical producers impacted most significantly.

The Czech National Bank (CNB) continues to adopt a tight monetary stance, again raising the policy rate by 50 basis points at its latest meeting, on 31 March. In what is now the seventh consecutive hike, the CNB showed its readiness to go beyond the nominal 5% mark to ensure price stability. Still, given the horizon of monetary policy, this year's inflation rate is expected to reach just below 9% and to return to the tolerance range only in 2024. In line with this outlook, another interest rate hike is likely in 2022, followed by a cut in 2023.

The Czech koruna was subject to considerable volatility in the days following the Russian invasion, depreciating by over 5% in the first week of the war. The value of Eastern European currencies – including the koruna – was initially driven downwards, as investors considered flocking to safety. The markets have since calmed down and the koruna has fully regained its pre-war strength, lessening concern about capital flight from the country. In the first instance, the rebound was also helped by the CNB's prompt interventions in the foreign exchange market.

In the light of recent events, we have revised our real GDP growth forecast for 2022 downwards by 1.4 pp, to 2.6%. Most channels of growth are expected to be depressed. Household consumption and gross fixed capital formation will grow modestly, amidst deteriorating purchasing power and high uncertainty. Despite the stretched labour markets exerting upward pressure on wages, wages failed to keep pace with prices in Q4 2021, falling by 2% in real terms. Consumer sentiment indicators crumbled in March (by 9.3 points, the largest decline in nine years), as Czechs became warier of their financial situation in the coming 12 months and deferred spending. In similar fashion, the index of business sentiment compiled by the Czech Chamber of Commerce reveals a reduced appetite for investment.[29] Still, supported by incoming EU funds, gross fixed capital formation is expected to fuel growth over the forecast period.

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29 https://komora.cz/press_release/index-podnikatelske-nalady-malych-a-strednich-podniku-klesl-skoro-polovina-podniku-je-nucena-utlumit-investice/

The main damper on growth in 2022 will again be the external environment. Ukraine and Russia are not significant trading partners for Czechia, jointly accounting for roughly 3% of Czech imports and exports. Therefore, reduced demand from these countries will not have any major repercussions. However, both economies are important suppliers of various critical goods, particularly for automobile production, including cable harnesses, palladium and aluminium. Disruption to the supply of these inputs has already led car makers to temporarily halt production. At the same time, the reintroduction of lockdowns in China not only offers a stark reminder that the pandemic is not yet over, but also points to the likelihood of more bottlenecks ahead. These factors are expected to dampen Czech exports. Soaring energy and other input prices will, on the other hand, push up imports, sending the current account into negative territory. This will be coupled with a build-up of inventory stock, temporarily contributing positively to GDP.

The Czech economy will continue to post twin deficits. The budget was approved in March: it contains a planned deficit of CZK 280bn (representing roughly 4% of GDP), which represents a 25% reduction against the proposal of the former administration. Despite the new Civic Democratic Party-led government's efforts to cut public spending, a return to a period of budget surpluses is unlikely over the forecast period. Plant stoppages, rising energy costs, increased defence spending and the ever-growing influx of Ukrainian refugees will likely put pressure on public expenditure and limit revenues.

Given the resilient underlying economic conditions, the Czech economy should regain reasonable dynamism by 2024, assuming that the acute impacts of the war are limited to this year. Yet, there are major downside risks to the forecast, dictated by the highly uncertain geopolitical environment and the ongoing pandemic.

Table 4.6 / Czechia: Selected economic indicators

	2018	2019	2020	2021 1)	2022	2023 Forecast	2024
Population, th pers., average	10,630	10,672	10,698	10,609	10,740	10,760	10,775
Gross domestic product, CZK bn, nom.	5,410	5,790	5,694	6,121	6,970	7,580	8,090
annual change in % (real)	3.2	3.0	-5.8	3.3	2.6	3.5	4.2
GDP/capita (EUR at PPP)	27,910	29,160	27,800	29,520	.	.	.
Consumption of households, CZK bn, nom.	2,524	2,663	2,545	2,737	.	.	.
annual change in % (real)	3.3	2.6	-7.0	4.4	2.5	2.0	2.8
Gross fixed capital form., CZK bn, nom.	1,423	1,568	1,490	1,559	.	.	.
annual change in % (real)	10.0	5.9	-7.5	0.6	5.5	6.4	6.0
Gross industrial production							
annual change in % (real)	3.1	-0.3	-7.2	6.9	2.5	5.0	3.5
Gross agricultural production							
annual change in % (real)	-0.9	2.0	5.1	-1.0	.	.	.
Construction industry							
annual change in % (real)	9.2	2.7	-6.3	2.7	.	.	.
Employed persons, LFS, th, average 2)	5,294	5,303	5,235	5,213	5,220	5,220	5,230
annual change in %	1.4	0.2	-1.3	-0.3	0.1	0.0	0.2
Unemployed persons, LFS, th, average 2)	122	109	137	150	130	130	120
Unemployment rate, LFS, in %, average 2)	2.2	2.0	2.6	2.8	2.5	2.5	2.2
Reg. unemployment rate, in %, eop	3.1	2.9	4.0	3.5	.	.	.
Average monthly gross wages, CZK	32,051	34,578	35,662	37,839	40,300	43,500	46,700
annual change in % (real, gross)	5.9	5.0	-0.1	2.1	-2.0	4.0	5.0
Consumer prices (HICP), % p.a.	2.0	2.6	3.3	3.3	8.7	3.8	2.3
Producer prices in industry, % p.a.	0.7	1.7	0.6	6.2	17.0	5.5	3.0
General governm. budget, EU def., % of GDP							
Revenues	41.5	41.4	41.6	40.2	40.5	41.5	41.5
Expenditures	40.6	41.1	47.2	47.0	45.5	44.2	42.0
Net lending (+) / net borrowing (-)	0.9	0.3	-5.6	-6.8	-5.0	-2.7	-0.5
General gov. gross debt, EU def., % of GDP	32.1	30.0	37.7	40.3	43.6	45.0	44.5
Stock of loans of non-fin. private sector, % p.a.	6.8	5.2	4.1	8.4	.	.	.
Non-performing loans (NPL), in %, eop	3.3	2.5	2.8	2.4	.	.	.
Central bank policy rate, % p.a., eop 3)	1.75	2.00	0.25	3.75	5.25	3.75	3.00
Current account, EUR m	962	747	4,393	-2,074	-6,200	-3,750	50
Current account, % of GDP	0.5	0.3	2.0	-0.9	-2.2	-1.2	0.0
Exports of goods, BOP, EUR m	136,370	139,428	128,226	148,002	173,200	191,200	204,000
annual change in %	5.5	2.2	-8.0	15.4	17.0	10.4	6.7
Imports of goods, BOP, EUR m	128,516	130,088	117,611	145,221	174,300	189,600	199,300
annual change in %	7.6	1.2	-9.6	23.5	20.0	8.8	5.1
Exports of services, BOP, EUR m	25,942	27,204	22,842	25,116	28,100	30,300	32,900
annual change in %	7.2	4.9	-16.0	10.0	12.0	8.0	8.6
Imports of services, BOP, EUR m	21,262	23,078	18,912	20,819	22,300	24,500	27,300
annual change in %	9.2	8.5	-18.1	10.1	7.0	9.7	11.5
FDI liabilities, EUR m	7,129	9,582	7,367	6,491	.	.	.
FDI assets, EUR m	5,156	4,243	1,788	6,280	.	.	.
Gross reserves of CB excl. gold, EUR m	124,142	133,059	134,899	152,755	.	.	.
Gross external debt, EUR m	171,534	172,544	164,648	179,866	214,500	236,100	252,000
Gross external debt, % of GDP	81.3	76.5	76.5	75.3	76.0	76.0	76.0
Average exchange rate CZK/EUR	25.65	25.67	26.46	25.64	24.7	24.4	24.4

1) Preliminary and wiiw estimates. - 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.

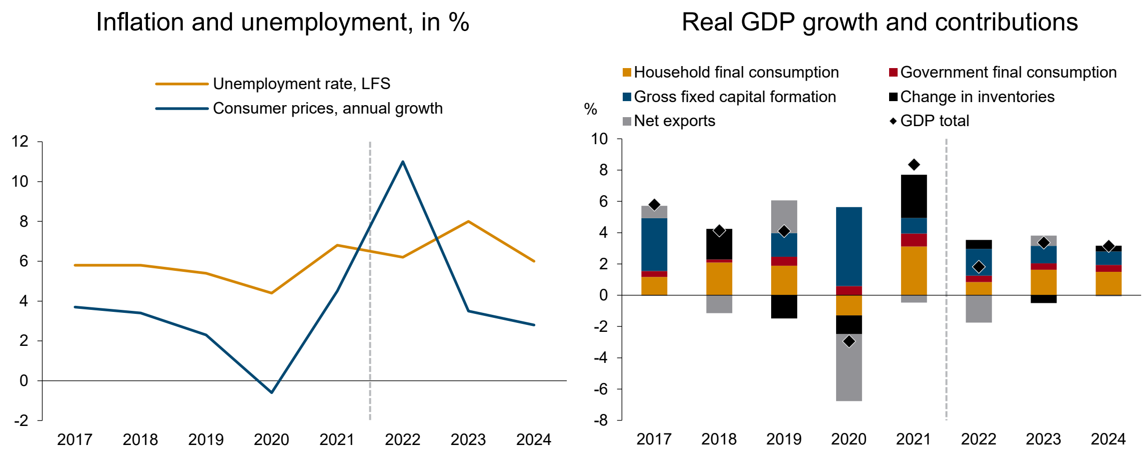
Source: wiiw Databases incorporating Eurostat and national statistics. Forecasts by wiiw.

ESTONIA: Heading into the unknown

MARYNA TVERDOSTUP

Economic performance in 2021 exceeded all expectations, with 8.3% GDP growth. This was steered by strong consumption, massive production expansion and a strengthening position on the global market. Yet the war has been a turning point. Because the Estonian economy started the year in excellent shape, economic recession will likely be avoided. However, real economic growth will fall to 1.8% in 2022, due mainly to rapid price rises, supply-side issues, disruptions to exports and a lack of major one-off investment – all magnified by the immense geopolitical uncertainty.

Figure 4.7 / Estonia: Main macroeconomic indicators



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

By the end of 2021, the Estonian economy was motoring in top gear, with growth reaching 8.3% as the economy bounced back from the COVID-19 crisis faster than nearly any other EU country. The utilisation of spare capacity, the expansion of its export portfolio in highly technological segments with greater value added, the combating of unemployment via the rapid redistribution of the workforce across sectors, and support for consumption – these were the main pillars on which the Estonian economy's striking success rested in 2021. While supply-side issues and the cross-sectoral economic imbalance caused by COVID-19 continued throughout last year, they could not hold back the positive momentum. But the war launched by Russia against Ukraine is one setback too far.

The consequences of the war for the Estonian economy will extend far beyond disruption to trade and higher energy prices. The disruption to business dealings with Russia, Belarus and Ukraine, including trade, will have only a moderate direct effect on the Estonian economy: the Russian market, for instance, accounted for less than 3% of total exports of Estonian origin in 2021. However, the disruption to supply chains, the uncertain outlook for investment and the jobs that will be affected are all of greater concern. Ukraine was a major exporter of wood, construction materials and agricultural products, and the first signs of looming deficit are already appearing, as ongoing constructions projects are delayed. The war may dent the country's rock-solid attractiveness to investors, given its geographical proximity of Russia, with the negative effect most evident in its eastern regions. While NATO's commitment to protect its members in the event of direct military aggression remains strong, the US elections on the forecast horizon sow a seed of doubt about future developments.

Inflation is no longer forecast to slow. The cost of a 'shopping basket' rose by 15.2% year on year in March, with the lion's share of the price hike stemming from energy and food. While previous forecasts projected a gradual decline in energy prices by summer 2022 and a diminishing snowball effect on the cost of food and commodities, the war has thrown this forecast into reverse. Inflation will likely remain at around 11% in 2022, with a subsequent decline to 3.5% in 2023 and 2.8% in 2024.

Despite remaining steadily high, income growth will not keep pace with price rises in 2022, so purchasing power will shrink. The increase in private consumption hit 6.5% year on year in 2021. With wage growth at 7.3% quarter on quarter in Q4, and with EUR 1.3bn withdrawn from the second pension pillar since pension reform was introduced (with around a fifth going on consumption), purchasing power was running strong up until February. But it will see a substantial setback in 2022. However, it is not solely inflation that is to blame for declining household and business demand: the war is holding back economic growth, as consumers and businesses become increasingly cautious. Higher prices per se yield less consumption; however, the undermining of consumer confidence in the face of war causes private demand to deteriorate even further and the consumption pattern to change.

Foreign trade witnessed a broad-based recovery in 2021, with exports of goods and services 23% higher in constant prices in Q4 2021 than the previous year. As forecast earlier, both imports and exports largely recovered from the big hit caused by the pandemic; yet the growth at the end of 2021 was partly due to the rapidly rising prices of both exports and imports, a low reference base and Estonia's improving position on the global market. That final element was largely thanks to an increased share of products in those sectors with greater value added and higher productivity. Moreover, the export of wood, wood products, machinery and equipment, and mineral products grew sharply. With their exports to Russia, Belarus and Ukraine falling off a cliff, Estonian companies will have to seek new markets and suppliers. But with every other country facing the same problem, adjustment to the new reality will take some time and will result in foreign trade losing momentum in 2022.

Those resources left idle during the pandemic were fully utilised in 2021. This makes further growth heavily dependent on new investment and on resolving the supply-side issues caused by the war. By the end of 2021, the Estonian economy was approaching its potential output, so that further growth would in any event have required investment. By that stage, labour shortages had been partly smoothed via the effective reallocation of labour from those sectors hit hard by the pandemic to those industries that were performing well and had increased demand for labour. With the escalating uncertainty, the investment outlook is now unsettled. But one thing is certain: no large one-off inflows of foreign direct investment like that streamed by the VW Group in 2020-2021 are expected in 2022.

Cost considerations outweigh the environmental hazards of oil shale, as energy prices rise and the price of CO_2 quotas falls. Long-criticised, environmentally hazardous oil shale production is gaining economic competitiveness and public acceptance. With almost 90% of Estonian energy generated using petroleum and gas derived from oil shale, the looming energy crisis, amplified even further by the war, will likely push environmental considerations into the shadows, at least in the short term. This is expected to ease the burden of energy costs for households and provide a boost to economic growth.

The unemployment rate fell to 5.2% in Q4 2021, signalling that the labour market was on the right track; but this will likely change. We project 8% unemployment in 2022, with two major factors causing a surge over the upcoming months: an influx of Ukrainians seeking protection in Estonia and redundancies caused by the war. With a large proportion of the expected 30,000 Ukrainian refugees hoping to remain economically active, integrating them will take time and will require additional infrastructural expenditure on child care and education – the most crucial factors in keeping mothers economically active. Similarly, those workers whose jobs have been directly affected by business closures or the suspension of operations – potentially up to 10,000 employees – may need to be reallocated across sectors. But the recent successful cross-sectoral redistribution of labour in response to the various effects of the pandemic could prove beneficial in combating the war-induced upswing in unemployment.

Nominal wage growth was 7.3% quarter on quarter in Q4 2021, but the markedly high inflation means that real wage growth will falter in 2022. With rapid economic recovery, the level of incomes rose substantially in 2021, yet the rapid price advancement has led to a sharp decline in real wages since the start of 2022. With inflation forecast to stay steadily high, and with additional wage pressures stemming from the 12% hike in the minimum wage planned for 2022, we project 3% real wage growth in 2022.

The narrowing deficit in 2021 signals that the government budget is in much better shape than a year ago, but spending will increase. The general government deficit stood at 2.4% and the debt level at 18% of GDP in 2021, which was below forecast levels, largely thanks to an upswing in tax revenues towards the end of the year. However, the greater need to strengthen national security, to provide subsistence benefits in conditions of high inflation and to cover the social protection, accommodation and education of refugees will force up government spending in 2022. The imperative of breaking Estonia's dependence on Russian gas is top of the government's priorities for 2022. This will involve substantial unforeseen expense, with a large proportion of that spending going on a joint Estonian-Latvian-Finnish liquefied natural gas terminal. Consequently, the country's debt is forecast to reach 19% of GDP in 2022. As some of the major expenditure will be one-off, the state budget is expected to partially restore the balance in subsequent years, with the budget deficit declining to 15% by 2024.

Although the Estonian economy has entered this phase of immense geopolitical uncertainty in the best possible shape, the outlook is clouded by the economic consequences of the war. Given the pace of recovery, growth was anyway forecast to slow to 3.6% in 2022 and 3.0% in 2023. But with the immense additional uncertainties generated by the war, GDP growth is now forecast to be 1.8% in 2022, 3.4% in 2023 and 3.1% in 2024. Economic growth in 2022 will depend on finding substitutes for Russian imports, the magnitude of inflation, the scale of the resulting slump in consumption and, above all, developments in Ukraine, as well as on the implementation of existing (and the introduction of new) sanctions on Russia and Belarus. Yet, the economy will probably avoid recession, thanks to the strong momentum built up by its exit from the COVID-19 crisis.

Table 4.7 / Estonia: Selected economic indicators

	2018	2019	2020	2021 1)	2022	2023	2024
						Forecast	
Population, th pers., average	1,322	1,327	1,329	1,340	1,370	1,370	1,372
Gross domestic product, EUR m, nom.	25,818	27,732	26,835	30,660	34,700	37,100	39,300
annual change in % (real)	4.1	4.1	-3.0	8.3	1.8	3.4	3.1
GDP/capita (EUR at PPP)	24,640	25,790	25,160	28,200	.	.	.
Consumption of households, EUR m, nom.	12,522	13,340	12,885	14,314	.	.	.
annual change in % (real)	4.3	3.9	-2.7	6.5	1.8	3.5	3.2
Gross fixed capital form., EUR m, nom.	6,376	7,054	8,233	8,755	.	.	.
annual change in % (real)	0.0	6.1	19.9	3.3	6.0	3.9	3.0
Gross industrial production							
annual change in % (real)	4.7	6.9	-3.0	7.2	3.5	4.8	4.2
Gross agricultural production							
annual change in % (real)	-6.3	22.8	0.0	-6.7	.	.	.
Construction industry							
annual change in % (real)	12.3	5.8	-6.1	9.4	.	.	.
Employed persons, LFS, th, average 2)	664.7	671.3	656.6	654.2	660	670	670
annual change in %	0.9	1.0	-2.2	-0.5	0.2	1.5	0.7
Unemployed persons, LFS, th, average 2)	37.7	31.3	47.9	43.1	57	43	37
Unemployment rate, LFS, in %, average 2)	5.4	4.4	6.8	6.2	8.0	6.0	5.2
Reg. unemployment rate, in %, eop 3)	4.8	5.3	8.3	6.8	.	.	.
Average monthly gross wages, EUR	1,310	1,407	1,448	1,547	1,770	1,930	2,060
annual change in % (real, gross)	3.8	5.0	3.4	2.1	3.0	5.5	4.0
Average monthly net wages, EUR	1,070	1,150	1,185	1,266	1,450	1,580	1,690
annual change in % (real, net)	5.0	5.1	3.5	2.0	3.0	5.5	4.0
Consumer prices (HICP), % p.a.	3.4	2.3	-0.6	4.5	11.0	3.5	2.8
Producer prices in industry, % p.a.	3.9	-0.6	-3.5	17.2	11.0	3.4	2.6
General governm. budget, EU def., % of GDP							
Revenues	38.9	39.6	40.3	41.5	41.0	42.2	43.0
Expenditures	39.4	39.4	45.9	45.0	44.0	44.3	44.2
Net lending (+) / net borrowing (-)	-0.6	0.1	-5.6	-4.0	-3.0	-2.1	-1.2
General gov. gross debt, EU def., % of GDP	8.2	8.6	19.0	20.0	19.0	17.0	15.0
Stock of loans of non-fin. private sector, % p.a.	5.1	3.3	4.8	7.5	.	.	.
Non-performing loans (NPL), in %, eop	0.5	0.5	0.4	0.2	.	.	.
Central bank policy rate, % p.a., eop 4)	0.00	0.00	0.00	0.00	.	.	.
Current account, EUR m	206	700	-69	-348	-280	-180	-100
Current account, % of GDP	0.8	2.5	-0.3	-1.1	-0.8	-0.5	-0.3
Exports of goods, BOP, EUR m	12,593	13,340	13,387	16,306	17,000	17,900	18,600
annual change in %	5.3	5.9	0.4	21.8	4.3	5.3	3.9
Imports of goods, BOP, EUR m	13,816	14,270	13,535	17,630	18,400	19,100	19,800
annual change in %	7.3	3.3	-5.2	30.3	4.4	3.0	3.7
Exports of services, BOP, EUR m	6,634	7,195	5,713	8,407	9,100	9,700	10,100
annual change in %	8.7	8.5	-20.6	47.2	8.2	6.6	4.1
Imports of services, BOP, EUR m	4,740	5,113	5,436	6,983	7,500	8,200	8,700
annual change in %	12.1	7.9	6.3	28.5	7.4	9.3	6.1
FDI liabilities, EUR m	1,039	2,718	3,055	6,550	.	.	.
FDI assets, EUR m	-209	1,629	275	7,021	.	.	.
Gross reserves of CB excl. gold, EUR m	651	1,256	1,615	2,081	.	.	.
Gross external debt, EUR m	20,189	21,161	24,452	26,351	31,900	28,200	30,500
Gross external debt, % of GDP	78.2	76.3	91.1	85.9	92.0	86.0	83.0

1) Preliminary and wiiw estimates. - 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).

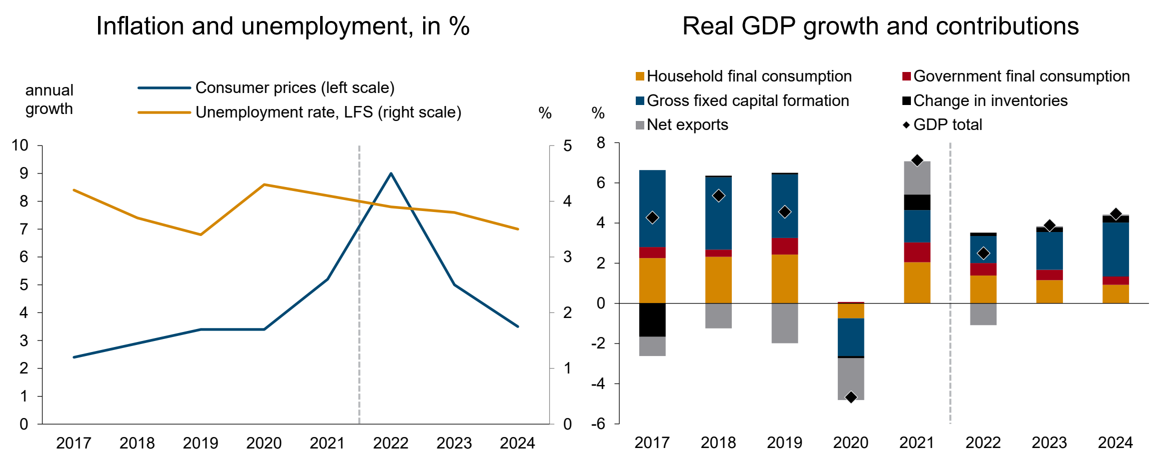
Source: wiiw Databases incorporating Eurostat and national statistics. Forecasts by wiiw.

HUNGARY: The party is over

SÁNDOR RICHTER

Since mid-2021, the Hungarian economy has undergone a period of overheating that was intimately bound up with the extended campaign leading up to the parliamentary elections on 3 April. The excessive deployment of 'election goodies' by the government has resulted in large current account and fiscal deficits, rising inflation and a weak forint. Now that the election has been won, Prime Minister Orbán will have to deal with the unpopular task of economic consolidation. A relatively soft landing would require the country to gain access to the EU transfers from the Recovery and Resilience Facility, but the ongoing conflict with the EU over the 'rule of law' (primarily corruption related) renders this doubtful. Economic growth is expected to slow this year, to the range of 2-3%.

Figure 4.8 / Hungary: Main macroeconomic indicators



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

The COVID-related recession has been overcome, with GDP growth amounting to 7.1% last year. That said, by the end of 2021 GDP was only 2.1% higher than in the last pre-COVID year of 2019. The two halves of last year showed very different characteristics: while the first half of 2021 was still shaped by the bounce-back from the COVID recession, the second half – and indeed especially Q1 2022 – witnessed some determined actions by the government to secure victory for Orbán's Fidesz party in the 3 April general election.

Domestic demand was boosted by some excessive central government spending on 'election goodies'. The list included the reintroduction of the 'thirteenth-month pension', the repayment of 2021 personal income tax to families with children, exemption from personal income tax for those aged below 25, a 20% rise in the minimum wage, extension of the moratorium on credit repayments, a centrally fixed price cap on various commodities, etc. In addition, net real wages increased by close to 10% in 2020-2021. The consequences of all this started to be clearly felt from summer 2021. The current account deteriorated sharply in the last two quarters of 2021, with a deficit that reached 3.1% of GDP by the end of the year, due primarily to a large deficit in the trade in goods. This represents a nearly threefold increase over the previous year. Inflation started to accelerate well before Putin's war in Ukraine began. The subsequent increases in the price of imported energy will fuel inflation. Elevated government spending increased the budget deficit in the second half of 2021 – a process that carried on into Q1 2022, when close to 75% of the planned annual fiscal deficit had already been attained.

Price caps on household energy are adding to the burdens of the budget. Keeping household energy prices decoupled from market prices has been a central element of Orbán's policy for several years. Nevertheless, since the start of the war the subsidies have become quite absurd: households currently pay (early April) only about a sixth of the actual market price for natural gas. Meanwhile, Hungary's reliance on energy imports is extremely high: 80% of the gas consumed comes from Russia. There is a somewhat smaller (yet still heavy) dependence on Russian crude oil deliveries, as well as a 100% exposure in imports of fuel for the nuclear power plant at Paks. The possible substitution with non-Russian sources would be logistically difficult and expensive, as well as acutely politically embarrassing for Putin loyalist Orbán.

The 3 April election will most probably count as a watershed for the Hungarian economy. Prime Minister Orbán, enjoying overwhelming support from the public and most of the privately owned media in an unfair election campaign – again managed to obtain more than two thirds of the seats in parliament, giving him a supermajority. With the election victory in his pocket, the leader of the Fidesz government has no time to lose: urgent steps are required to tackle the macroeconomic imbalances. The number one issue is how to curb inflation. The central bank has already engaged in a cycle of policy rate rises. This seems to have helped arrest the plummeting HUF exchange rate, albeit at a relatively low level. A weak HUF fuels imported inflation. Higher interest rates will pose a problem to the wide circles of the population that are locked into variable-interest mortgage loans. High inflation does have one positive side effect, however, insofar as the 'election goodies' distributed before April will lose a substantial part of their purchasing power and will thus help curtail excess demand. This also applies to the rapid increase in nominal wages.

Another crucial issue this year will be how to move towards a sustainable level of fiscal deficit. Unlike last year, the revenue side will receive no help in the shape of abundant tax receipts due to strong economic growth. If expenditure is to be cut, lifting the caps on household energy and petrol prices would seem to be unavoidable – even if keeping household spending down was a central plank of the Fidesz election campaign. The thirteenth-month pension may also turn out to be unsustainable. Consolidation of the budget will thus necessitate unpopular measures; later this year Fidesz supporters will be confronted with the harsh and bitter truth.

Gaining access to EU transfers from the Recovery and Resilience Facility (RRF), worth around 3-4% of Hungary's annual GDP, would seem to be essential if a soft landing is to be ensured. Disbursement of these EU resources would ease the burden of budget consolidation, substantially improve the external equilibrium of the economy and help stabilise the exchange rate. However, the re-election of Orbán renders that extremely problematic, unless he is prepared to make concessions over the disputed 'rule of law' issues. Positions may change, but on the anti-corruption issue it is hard to imagine Hungary making concessions. If the country were to join the European Public Prosecutor's Office (EPPO), that would present an existential threat to the prime minister, his family and key Fidesz-loyal magnates. However, the need for concerted action in the current tense international situation may incline the EU to be indulgent, in order to secure Orbán's assent to motions that require unanimity on the part of the member states.

Given the unfavourable international environment and the unavoidable consolidation measures to restore macroeconomic equilibrium, we forecast a substantial slowdown in economic growth in 2022. The current account will be affected negatively by the deteriorating terms of trade, but positively by the sharply reduced pace of economic growth. All in all, it is expected to remain nearly as high as last year. Investment will be influenced by whether or not the government gains access to the EU transfers, and also by the uncertainties surrounding large government projects like Paks 2, the Belgrade-Budapest railway line and the campus of the Chinese Fudan University. Summarized, GDP growth in 2022 is expected to be in the range of 2-3%, with large and hitherto unprecedented downside risks.

Table 4.8 / Hungary: Selected economic indicators

	2018	2019	2020	2021 1)	2022	2023	2024
						Forecast	
Population, th pers., average	9,776	9,771	9,750	9,710	9,700	9,650	9,650
Gross domestic product, HUF bn, nom.	43,392	47,531	47,988	55,046	62,100	68,400	74,300
annual change in % (real)	5.4	4.6	-4.7	7.1	2.5	3.9	4.5
GDP/capita (EUR at PPP)	21,640	22,800	22,100	24,420	.	.	.
Consumption of households, HUF bn, nom.	20,513	22,553	22,889	25,485	.	.	.
annual change in % (real)	4.8	5.1	-1.6	4.3	3.0	2.5	2.0
Gross fixed capital form., HUF bn, nom.	10,730	12,873	12,857	14,787	.	.	.
annual change in % (real)	16.3	12.8	-6.9	6.0	5.0	7.0	10.0
Gross industrial production							
annual change in % (real)	3.5	5.6	-6.0	9.7	6.0	5.0	7.0
Gross agricultural production							
annual change in % (real)	2.6	-0.1	-2.4	-2.1	.	.	.
Construction industry							
annual change in % (real)	21.2	20.7	-9.8	13.1	.	.	.
Employed persons, LFS, th, average 2)	4,470	4,512	4,461	4,642	4,690	4,690	4,690
annual change in %	1.1	1.0	-1.1	0.7	1.0	0.0	0.0
Unemployed persons, LFS, th, average 2)	172	160	198	196	190	190	170
Unemployment rate, LFS, in %, average 2)	3.7	3.4	4.3	4.1	3.9	3.8	3.5
Reg. unemployment rate, in %, eop 3)	5.2	5.1	6.2	5.1	.	.	.
Average monthly gross wages, HUF 4)	329,943	367,833	403,616	438,814	490,300	525,100	562,500
annual change in % (real, gross)	8.3	7.7	6.2	3.4	2.5	2.0	3.5
Average monthly net wages, HUF 4)	219,412	244,609	268,405	291,812	326,000	349,100	374,000
annual change in % (real, net)	8.3	7.7	6.2	3.4	2.5	2.0	3.5
Consumer prices (HICP), % p.a.	2.9	3.4	3.4	5.2	9.0	5.0	3.5
Producer prices in industry, % p.a.	5.6	2.1	4.3	13.6	15.0	5.0	4.0
General governm. budget, EU def., % of GDP							
Revenues	44.0	43.6	43.6	45.0	45.0	45.0	45.0
Expenditures	46.1	45.7	51.6	52.5	50.5	48.5	48.0
Net lending (+) / net borrowing (-)	-2.1	-2.1	-8.0	-7.5	-5.5	-3.5	-3.0
General gov. gross debt, EU def., % of GDP	69.1	65.5	80.1	78.0	77.5	77.0	76.0
Stock of loans of non-fin. private sector, % p.a.	10.5	13.2	13.4	12.8	.	.	.
Non-performing loans (NPL), in %, eop 5)	5.4	4.1	3.6	3.3	.	.	.
Central bank policy rate, % p.a., eop 6)	0.90	0.90	0.60	2.40	6.50	4.00	3.00
Current account, EUR m 7)	216	-1,018	-1,558	-4,736	-5,000	-3,000	-300
Current account, % of GDP 7)	0.2	-0.7	-1.1	-3.1	-2.9	-1.6	-0.1
Exports of goods, BOP, EUR m 7)	88,544	92,525	88,710	103,245	110,500	116,600	124,800
annual change in %	3.8	4.5	-4.1	16.4	7.0	5.5	7.0
Imports of goods, BOP, EUR m 7)	90,824	96,212	89,908	107,056	118,000	124,500	132,000
annual change in %	8.7	5.9	-6.6	19.1	10.2	5.5	6.0
Exports of services, BOP, EUR m 7)	25,396	26,917	19,916	22,069	25,200	28,200	31,600
annual change in %	6.6	6.0	-26.0	10.8	14.0	12.0	12.0
Imports of services, BOP, EUR m 7)	17,316	19,828	15,849	17,088	18,600	20,300	22,100
annual change in %	2.6	14.5	-20.1	7.8	9.0	9.0	9.0
FDI liabilities, EUR m 7)	6,671	2,882	2,879	5,067	.	.	.
FDI assets, EUR m 7)	4,059	1,888	568	2,925	.	.	.
Gross reserves of CB excl. gold, EUR m	26,273	27,010	32,115	33,501	.	.	.
Gross external debt, EUR m 7)	107,696	106,051	109,928	126,850	128,000	128,000	127,000
Gross external debt, % of GDP 7)	79.1	72.6	80.5	82.6	75.2	67.4	61.5
Average exchange rate HUF/EUR	318.89	325.30	351.25	358.52	365	360	360

1) Preliminary and wiiw estimates - 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. From 2019 based on tax administration data, survey data before. - 5) Loans more than 90 days overdue and those unlikely to be paid. - 6) Base rate. - 7) Excluding SPE.

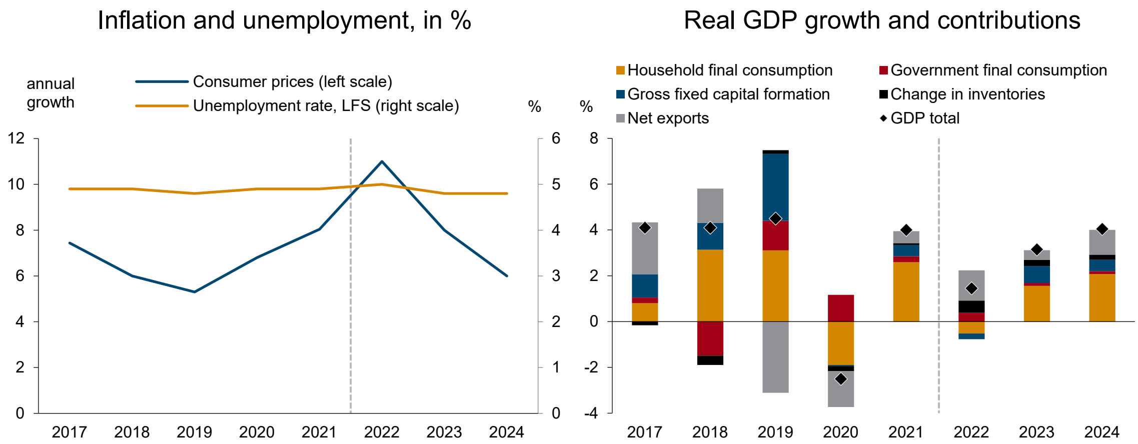
Source: wiiw Databases incorporating Eurostat and national statistics. Forecasts by wiiw.

KAZAKHSTAN: Challenges ahead

ALEXANDRA BYKOVA

Recession in Russia will drag down Kazakhstan's economic performance in 2022. Inflation will accelerate on the back of high global food and energy prices, as well as high imported inflation from Russia. At the same time, elevated global commodity prices will have a beneficial impact on exports and tax revenues, and we expect net exports to make a positive contribution to economic growth. We have revised our real GDP growth forecast in the baseline scenario down to 1.5% for 2022 and 3.2% for 2023.

Figure 4.9 / Kazakhstan: Main macroeconomic indicators



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

Due to Kazakhstan's strong trade, investment and production linkages with Russia, the contagion from a deep recession in Russia will negatively affect the country's economic growth in 2022. Kazakhstan's imports from Russia amounted to 42.1% of its total imports, or 9.1% of GDP in 2021, the second-largest figure in CESEE (after Belarus). The import structure points to a mixture of consumer goods (41%), intermediate goods (31%) and capital goods (21%). Its reliance on Russia for exports is less pronounced: 11.5% of total exports go to Russia – primarily minerals (28%), metals (28%) and chemical products (14%).[30] Sanctions-related distortions to production in some economic sectors in Russia are likely to disrupt imports to Kazakhstan, and we expect a reduction in volume and an increase in import prices. The latter is likely to be only partly offset by a tenge appreciation against the rouble. A partial diversion of imports from other trading partners, such as South Korea or China, as occurred in 2020, is possible, but is likely to push up costs. For example, pharmaceuticals and some food imports from Russia are generally much cheaper than from other countries. Amid already high

[30] Data on trade structure are based on UN COMTRADE statistics for 2019.

global energy and food prices, the war in Ukraine is contributing substantially to rising input prices, disruptions in logistics, raw material shortages and uncertainty in Kazakhstan – all of which dragged the manufacturing Purchasing Managers' Index (PMI) down from 50.1 in February to 46.8 in March 2022. We expect the impact of the distortions on production to be amplified along the value chain, and therefore to have a strongly negative impact on the domestic economy. Against this background, we anticipate that real investment and consumption will decline in 2022 and rebound next year. We expect real GDP growth to return to long-term averages of above 4% in 2024, especially thanks to the impetus it will receive from the planned expanded oil production in the Tengiz oil field.

Kazakhstan abstained from supporting the Russian invasion of Ukraine, which has helped it avoid sanctions and will likely cushion the negative impact on its economy. The country is seeking to avoid any involvement with the Russian invasion of Ukraine and to stick to its neutral stance, along with China and other Central Asian countries. This balanced approach is in keeping with its traditionally pragmatic multi- vector foreign policy. According to recent official statements, Kazakhstan sees no obligation to support Russia in the current situation either as a member of the Collective Security Treaty Organization or as a member of the Eurasian Economic Union. Official statements have also confirmed a strategy intended to prevent Kazakhstan from being used as a back door to circumvent sanctions imposed on Russia – helpful in protecting the economy against direct sanctions.[31] The US has already confirmed that Kazakhstan's oil exports will not be sanctioned, even though they are transported through a pipeline across Russian territory.[32] Economic linkages – such as the strong market presence of US oil companies, the fact that by the end of 2020 more than 75% of foreign direct investment inward stocks came from the EU and the US, and the high share of EU countries in Kazakhstan's total exports (38.5% in 2021) – are all arguments in favour of maintaining a balanced position.

Oil sector revenues, which are crucial to economic performance, are heavily exposed to geopolitical risks; that increases the uncertainty for both export revenues and the economic outlook. A major risk is the fact that 80% of oil exports are transported via the Caspian pipeline across Russian territory, to be loaded onto tankers in the port of Novorossiysk, with limited opportunity for alternative routes to be used. Reported damage to the loading facilities on 22 March, supposedly caused by a storm, will lead to the disruption of oil production and exports. With the recently reported daily drop in Kazakhstan's production of around 25%,[33] and assuming that the damage to the port facilities takes up to two months to repair,[34] we envisage a substantial reduction in oil exports in physical terms. Therefore, despite the anticipated easing of OPEC+ production restrictions and the expected high global oil prices, the revenues of the National Oil Fund and the budget will not be as great as one would have imagined. A non-negligible downside risk to projected export growth stems from possible restrictions on oil transport from the Russian side.

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31 https://www.euractiv.com/section/central-asia/interview/kazakh-official-we-will-not-risk-being-placed-in-the-same-basket-as-russia/; https://tengrinews.kz/kazakhstan_news/eto-nevozmojno-tleuberdi-o-voyskah-odkb-v-dnr-i-lnr-462558/ (in Russian); https://vlast.kz/novosti/49411-kazahstan-ne-dolzen-ispolzovatsa-dla-obhoda-antirossijskih-sankcij-mid.html (in Russian)

32 https://home.treasury.gov/policy-issues/financial-sanctions/faqs/1020

33 https://inbusiness.kz/ru/last/sutochnaya-dobycha-nefti-v-kazahstane-upala-na-25 (in Russian)

34 https://www.cpc.ru/EN/press/releases/2022/Pages/20220328.aspx; https://tass.com/economy/1425875 (in Russian)

The impact of high global commodity prices is mixed: on the one hand, export revenues will rise; but on the other hand, inflation will pick up. However, this will partly be mitigated by price controls. For Kazakhstan's exports, which are dominated by commodities, an increase in global prices immediately boosts fiscal revenues. Leaving aside the problems with oil exports mentioned above, an increase in the export of other commodities (also in physical terms) is to be expected. With only a slight decline in exports, but a sharp fall in imports in real terms, we anticipate that net exports will make a positive contribution to economic growth in 2022. On the other hand, rising global fuel and food prices are likely to precipitate inflation. The monthly CPI rose to 3% in March (from 0.9% in February), reflecting a mix of imported inflation from Russia, the depreciation of the tenge and a spike in global commodity prices – the food sub-component of the CPI surged by 5.8%. However, following protests in January, fuel prices in Kazakhstan are subject to price controls until the middle of the year; and due to its social importance, the policy measure is likely to be prolonged, so that it will restrain inflation.

Apart from inflation, the war in Ukraine has other negative economic implications for Kazakhstan's economy: instability of the national currency, distortions in logistics and risks to the banking sector from the subsidiaries of those Russian banks under sanctions. The spike in inflation in March was partly due to the drastic tenge depreciation against the US dollar, following the Russian invasion of Ukraine – 17% by mid-March. This comes despite rising oil prices and a 16% appreciation of the tenge against the rouble, as the tenge is dependent on the rouble, given Kazakhstan's high share of imports and its large trade deficit with Russia (USD 10bn in 2021). In response, the central bank hiked interest rates from 10.25% to 13.5% on 28 February and reportedly carried out interventions amounting to USD 990.5m to support the tenge. However, reserves had declined by only USD 310m (0.9%) by the end of March, relative to the end of February, due to the mitigating impact of a growth in the global price of gold and the bank's selling of some gold (which still makes up 69% of all reserves). This helped to maintain reserves at an adequate level (18.3% of GDP). Despite a recent rebound in the exchange rate, as of 7 April (this publication's cut-off date) the tenge had lost 7% of its value against the dollar, relative to the start of the year. The considerable volatility of the national currency remains a risk for economic performance. Moreover, credit growth is likely to slow in the context of high interest rates. Additionally, sanctions on Russian banks could affect the operations of three subsidiaries of Sberbank, VTB and Alfa-Bank in Kazakhstan, which at the end of February 2022 had market shares in total assets of 9.7% (the country's second-largest bank), 2.4% and 0.9%, respectively. However, according to the regulator, there is no risk to the stability of the banking system in the country generally, as there is adequate capital and liquidity.[35] The Alfa-Bank subsidiary in Kazakhstan is reportedly seeking a change of ownership, in order to avoid sanctions.[36] Finally, as a transit country, Kazakhstan will suffer from the decline in the transport of goods through Russia and Ukraine to the EU. This affects, in particular, connections between China and the EU. The transport of its own imports and exports has reportedly already been subject to some disruption from the sanctions against Russian ports, and alternative routes have driven up transport costs.

A new import substitution package will be implemented, but we expect any positive impact on domestic production to be visible only in the medium term. A new government anti-crisis package ('industrialisation map') was recently announced to stimulate import substitution. It amounts to 15% of GDP over the next few years, with investments of 1.5% of GDP in 2022. Altogether, it will seek to implement 444

35 https://www.gov.kz/memleket/entities/ardfm/press/news/details/353345?lang=ru (in Russian).

36 https://kapital.kz/finance/104498/v-al-fa-bank-kazakhstan-planiruyet-sya-smena-aktsionera.html (in Russian)

projects and create 88,000 new jobs. As just 90 projects and 11,000 new jobs are envisaged for this year, we expect only a small fillip to economic growth in 2022, with a stronger impact in the medium term. Production disruptions in Russia may have an additional positive impact on Kazakhstan, as the domestic automotive manufacturing sector could expand. The relocation of companies and skilled workers from Russia to Kazakhstan may likewise boost economic growth and exports.

On the negative side, high inflation and the economic slowdown could undermine wage and income growth and the progress of social reforms. After the January protests, President Tokayev consolidated his political power, and several members of the Nazarbayev family gave up their leading positions in key state-owned enterprises. This has fuelled expectations of a more active fight against corruption and rent-seeking, of more transparency in the state sector, of the greater social orientation of economic policy and of political reforms. However, we expect the budget deficit to grow only slightly to 3.5% of GDP in 2022 with a gradual decline to 2% of GDP in 2024. Despite adequate fiscal space being available for anti-crisis measures (thanks to National Oil Fund assets of around 30% of GDP), we expect no major changes to fiscal policy and no additional large social-support packages, due to the high inflationary pressure. Moreover, even the anticipated growth in wages, following a 41% hike in the minimum wage, is likely to be substantially distorted by higher inflation.

Given the balance of negative and positive drivers, we expect a sharp slowdown in the baseline scenario in 2022, but not yet a recession. Our forecasts for real GDP have been revised downwards by 2.7 pp (to 1.5%) in 2022, and by 1.2 pp (to 3.2%) in 2023. The coronavirus pandemic and the slowdown by the country’s main trading partners remain downside risks to the forecast. In the event of tougher sanctions against Russia and its energy exports, we assume that much higher inflation could lead to a sharper decline in real incomes and could inhibit consumption and investment. Higher oil prices are unlikely to fully offset these negative effects, given the geopolitical risks associated with oil transport volumes.

Table 4.9 / Kazakhstan: Selected economic indicators

	2018	2019	2020	2021 1)	2022	2023 Forecast	2024
Population, th pers., average	18,276	18,514	18,756	19,003	19,200	19,400	19,700
Gross domestic product, KZT bn, nom.	61,820	69,533	70,649	81,269	93,200	100,900	109,200
annual change in % (real)	4.1	4.5	-2.5	4.0	1.5	3.2	4.0
GDP/capita (EUR at PPP)	17,740	18,690	17,880	18,790	.	.	.
Consumption of households, KZT bn, nom.	31,514	35,571	36,661	41,600	.	.	.
annual change in % (real)	6.1	6.1	-3.7	5.0	-1.0	3.0	4.0
Gross fixed capital form., KZT bn, nom.	13,091	16,318	17,463	20,100	.	.	.
annual change in % (real)	5.4	13.8	-0.2	2.0	-1.0	3.0	2.0
Gross industrial production							
annual change in % (real)	4.4	4.1	-0.5	3.8	2.0	3.0	4.0
Gross agricultural production							
annual change in % (real)	3.5	-0.1	5.7	-2.4	.	.	.
Construction industry							
annual change in % (real)	4.6	13.2	11.6	7.6	.	.	.
Employed persons, LFS, th, average	8,695	8,781	8,732	8,803	8,760	8,850	8,970
annual change in %	1.3	1.0	-0.6	0.8	-0.5	1.0	1.3
Unemployed persons, LFS, th, average	444	441	449	451	460	450	450
Unemployment rate, LFS, in %, average	4.9	4.8	4.9	4.9	5.0	4.8	4.8
Reg. unemployment rate, in %, eop	1.0	1.1	1.5	1.1	.	.	.
Average monthly gross wages, KZT 2)	162,673	186,815	213,003	249,210	279,400	307,800	336,100
annual change in % (real, gross)	1.7	9.1	6.8	8.3	1.0	2.0	3.0
Consumer prices, % p.a.	6.0	5.3	6.8	8.0	11.0	8.0	6.0
Producer prices in industry, % p.a.	19.0	5.1	-8.0	32.5	25.0	3.0	2.0
General governm. budget, nat.def., % of GDP							
Revenues	17.5	18.3	20.6	19.5	18.0	19.0	20.0
Expenditures	18.8	20.2	24.5	22.6	21.5	21.5	22.0
Deficit (-) / surplus (+)	-1.3	-1.8	-4.0	-3.1	-3.5	-2.5	-2.0
General gov. gross debt, nat.def., % of GDP	26.0	24.9	30.5	28.5	29.0	29.0	28.5
Stock of loans of non-fin. private sector, % p.a.	3.0	5.9	5.5	26.5	.	.	.
Non-performing loans (NPL), in %, eop	7.4	8.1	6.9	3.3	.	.	.
Central bank policy rate, % p.a., eop 3)	9.25	9.25	9.00	9.75	13.00	10.00	9.00
Current account, EUR m 4)	-106	-6,427	-5,756	-4,850	-500	-1,900	-2,300
Current account in % of GDP	-0.1	-4.0	-3.8	-3.0	-0.3	-1.0	-1.2
Exports of goods, BOP, EUR m 4)	50,712	51,953	41,437	51,014	62,500	63,700	67,500
annual change in %	21.1	2.4	-20.2	23.1	22.5	1.9	6.0
Imports of goods, BOP, EUR m 4)	29,030	35,759	32,426	33,535	36,500	39,000	42,100
annual change in %	7.3	23.2	-9.3	3.4	8.8	6.8	7.9
Exports of services, BOP, EUR m 4)	6,205	6,926	4,423	4,916	3,600	3,800	4,000
annual change in %	7.8	11.6	-36.1	11.1	-26.8	5.6	5.3
Imports of services, BOP, EUR m 4)	10,156	10,199	7,149	6,480	7,100	7,400	7,800
annual change in %	13.8	0.4	-29.9	-9.4	9.6	4.2	5.4
FDI liabilities, EUR m 4)	299	3,332	6,302	3,704	.	.	.
FDI assets, EUR m 4)	-3,933	-1,941	1,194	2,263	.	.	.
Gross reserves of CB excl. gold, EUR m 4)	14,460	9,004	9,827	9,586	.	.	.
Gross external debt, EUR m 4)	139,732	142,125	133,807	146,067	154,000	155,000	156,000
Gross external debt, % of GDP	91.9	87.6	89.3	90.6	87.0	83.0	78.0
Average exchange rate KZT/EUR	406.66	428.51	471.44	503.88	526	538	549

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

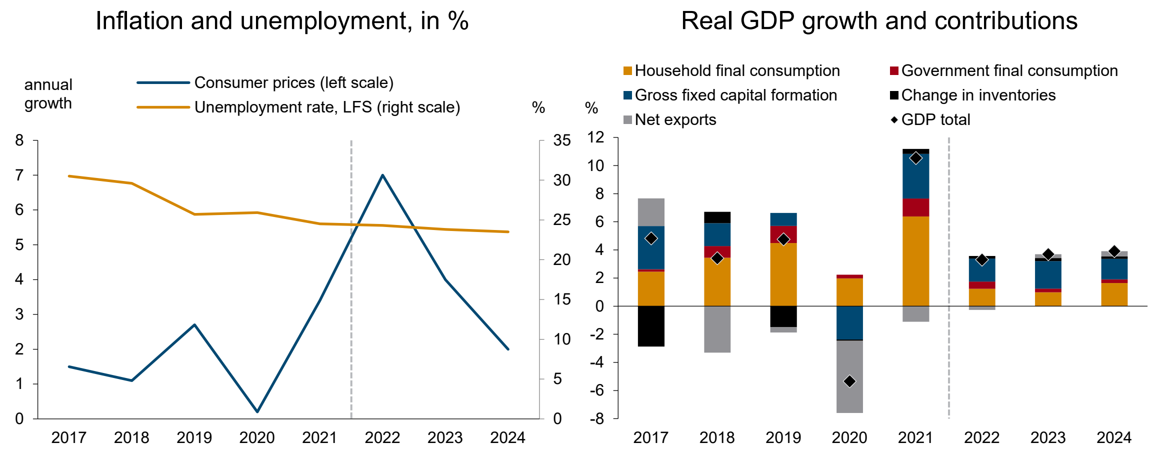
Source: wiiw Databases incorporating national statistics. Forecasts by wiiw.

KOSOVO: Positive and negative spill-over effects expected as international trade adjusts

ISILDA MARA

Kosovo's economic growth is likely to lose steam, owing to its high exposure to external shocks and certain domestic bottlenecks surrounding energy supplies. Consumption will spur growth, but at a slower pace. The restructuring of international trade will have negative spill-over effects, but there is also likely to be a silver lining in the shape of a surge in lignite exports. According to the baseline scenario – and on the assumption that the war in Ukraine will be over this year – inflation will climb to 7% and the growth rate will be 3.3%. In the medium term, inflationary pressure will slacken and growth will accelerate to 3.9%.

Figure 4.10 / Kosovo: Main macroeconomic indicators



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

Domestic demand, backed by buoyant household and government consumption, boosted economic activity by 10% in 2021. Rising consumption contributed 6.7 percentage points (pp) to GDP growth, while a 10% rise in gross fixed capital formation contributed a further 3.2 pp. Exports of goods and services rebounded by 51% and 91%, respectively. Meanwhile, imports of goods and services increased by 31% and 43%. The net effect on growth was -1.1 pp. In production terms, those activities that powered ahead were wholesale and retail trade (21%), manufacturing (8%), construction (7%) and scientific activities (7%). Q4 2021 saw a slowdown in economic activity, owing to high exposure to external trade and bottlenecks in the energy sector.

Kosovo's economy, being highly dependent on imports, is already on high alert. The huge uncertainty stemming from the invasion of Ukraine and the war's impact on international markets – especially on the EU, Kosovo's main trading partner – suggest that the effects will not just be transient. The steep rise in import, consumer and producer prices seen in Q4 2021 continued into Q1 2022: import and consumer prices rose by 6.5% over November/December 2021, year on year, and in February 2022, consumer prices jumped by 7.5% year on year. The price hikes have especially affected edible oils and fat (32%), fuels for personal transport means (28%), gas (19%), electricity (12%) and solid fuels and firewood (14%). Trade relations with Russia and Ukraine are very modest – imports in 2021 from the two countries did not exceed 1.5% – but there is a heavy dependence on certain specific commodity goods, especially base metals (29% and 30% are imported from Russia and Ukraine, respectively). The sanctions imposed by the EU on the import of metals and steel from Russia will very likely affect Kosovo. Aside from the other commodity goods, there is also a crisis in energy products.

The energy crisis in Kosovo is quite serious and there are no quick fixes. At the end of 2021, the government declared a state of emergency for 60 days, subsequently extended for another month at the end of February. According to Eurostat, Kosovo was dependent on imports for 30% of its annual consumption of energy in the period 2017-2020. In 2021, imports of electricity rose by 29%, as consumption expanded by 15% and domestic production dropped by 2%. This year, the early indications are that the picture will be similar: in January, imports surged by 37% year on year; production from power plants (mainly coal/lignite burning) contracted by 13%; and demand rose by 8%. The worst of it is that 97% of electricity generation depends on power plants that burn lignite: these are outdated, require huge investment and can only partially satisfy the demand for electricity. For Kosovo to import large quantities of energy is 'mission impossible', given the volatility of prices. Some positive steps have been taken in the direction of power production (renewable energy projects; the Selac Windpark in Mitrovica (EUR 170m, 100 megawatts); the Solar4Kosovo project (EUR 60m, 70 megawatts); however, this is still too little. The country's heavy dependence on imports of fuel and electricity, and the lack of strategic and large-scale projects in the energy sector, will leave it very exposed to external risks in the short-to-medium term. In March 2022, the government announced a ceiling on prices and on the profit margins of fuel retailers, in the hope of protecting consumers against price fluctuations.

Inflationary pressures will curb consumption. The strong economic growth recorded in 2021 did not translate into a major boost to employment. Real wages – up by 5% in 2021 – do not match the big rise in inflation. Negotiations are ongoing between the government and interest groups – the trade unions – which are seeking a rise in the minimum wage to EUR 400 a month. However, the government is not prepared to offer more than EUR 250 (up from the current EUR 150). If implemented by June 2022, an increase of some sort in the minimum wage could go some way to mitigating the erosion effect of high inflation on the purchasing power of households.

Remittances will continue to smooth consumption, though less than during the pandemic. Remittances will continue to assist Kosovo households. That said, this year inflation is hitting the very economies where most of the migrants from Kosovo reside. Accordingly, their saving power will decline, and with it the flow of remittances.

Public finances improved markedly in 2021. General government revenues rose by 27%. By contrast, expenditure grew by 2%, while capital expenditure surged by 25%. The year ended with a deficit of 2% of GDP and a slight rise in the public debt to 23.4%. This year there will most likely have to be a further revision to the budget to cope with the current energy crisis and the surge in consumer prices: this is way above what could have been expected and was not envisaged in the current budget planning. Public investment will be sacrificed to support vulnerable households (in 2021, the share of the population living on less than USD 5.50 a day stood at 23% in Kosovo).

But every cloud has a silver lining. Kosovo relies heavily on imports – for energy, of course, but also for other consumer and commodity goods. And meanwhile, its exports cover only 17% of its goods imports. The readjustment of international trade relations and the sanctions imposed by the EU on Russian imports will have both positive and negative spill-over effects for Kosovo. In particular, the EU bans on Russian steel and iron imports will hit the country, given its heavy dependence on Russia in this field. Besides, in April 2022 the EU announced that by August 2022 it will also ban Russian coal imports. Meanwhile, in order to gain some independence from Russian gas, some EU countries have announced that they will revert to coal in order to generate energy. This is a forced choice between the devil and the deep blue sea; and given the EU's green agenda, the move is expected to be only a temporary one. Nevertheless, in the meantime it will provide a welcome boost to Kosovo's lignite exports (it is one of the top five countries in the world in terms of lignite reserves). Indeed, lignite exports tripled in January and February 2022, year on year, in both real and nominal terms.

The sense surrounding the COVID-19 pandemic is that it 'is already a thing of the past'. The vaccination rate against COVID-19 has reached 46%; daily infections have dropped to very low numbers; and fatalities are close to zero.

We expect growth to lose steam owing to the country's high exposure to imports and the international market dynamics. Its volume of trade with Russia and Ukraine is below 2%, but for certain commodity goods imports from those countries are of considerable significance. Consumption will continue to spur growth, while external demand will act as a drag on the economy. According to the baseline scenario, and assuming an end to the war in Ukraine this year, inflation will climb to 7%, while the economy will grow at 3.3% this year. In the medium term, inflation will fall to 2%, while growth accelerates to 3.9%.

Table 4.10 / Kosovo: Selected economic indicators

	2018	2019	2020	2021 1)	2022	2023 Forecast	2024
Population, th pers., average	1,797	1,789	1,790	1,795	1,798	1,800	1,802
Gross domestic product, EUR m, nom.	6,672	7,056	6,772	7,817	8,600	9,300	9,900
annual change in % (real)	3.4	4.8	-5.3	10.5	3.3	3.7	3.9
GDP/capita (EUR at PPP)	7470	8030	7550	8520	.	.	.
Consumption of households, EUR m, nom.	5,296	5,621	5,720	6,414	.	.	.
annual change in % (real)	4.4	5.7	2.5	7.6	1.5	1.2	2.0
Gross fixed capital form., EUR m, nom.	2,116	2,190	2,012	2,547	.	.	.
annual change in % (real)	5.4	2.9	-7.6	10.7	5.0	6.0	4.5
Gross industrial production 2)							
annual change in % (real)	-1.3	6.3	0.8	21.7	6.0	4.0	4.0
Gross agricultural production							
annual change in % (real)	-8.8	9.5	2.7	4.0	.	.	.
Construction output 3)							
annual change in % (real)	1.5	1.5	-9.0	6.0	.	.	.
Employed persons, LFS, th, average 4)	345.1	363.2	347.1	375.0	377	379	383
annual change in %	-3.4	5.2	-4.4	8.0	0.5	0.5	1.0
Unemployed persons, LFS, th, average 4)	145.0	125.3	121.4	120.0	120	120	120
Unemployment rate, LFS, in %, average 4)	29.6	25.7	25.9	24.5	24.3	23.8	23.5
Reg. unemployment rate, in %, eop	.	.	.	.	.	.	.
Average monthly gross wages, EUR	453	477	466	510	580	630	670
annual change in % (real, gross)	4.0	2.5	-2.5	6.0	6.0	4.0	4.0
Average monthly net wages, EUR	409	430	416	450	490	520	540
annual change in % (real, net)	3.7	2.4	-3.4	5.0	1.0	2.0	2.0
Consumer prices (HICP), % p.a.	1.1	2.7	0.2	3.4	7.0	4.0	2.0
Producer prices, % p.a.	1.4	0.9	-0.6	4.9	6.0	3.0	2.0
General governm. budget, nat.def., % of GDP							
Revenues	26.3	26.8	25.4	27.9	28.0	29.0	29.5
Expenditures	29.2	29.7	33.0	29.3	30.0	31.0	30.0
Deficit (-) / surplus (+)	-2.9	-2.9	-7.6	-1.3	-2.0	-2.0	-0.5
General gov. gross debt, nat.def., % of GDP	16.4	17.0	22.0	23.0	23.3	22.5	22.0
Stock of loans of non-fin. private sector, % p.a.	10.8	10.0	7.1	15.4	.	.	.
Non-performing loans (NPL), in %, eop	2.7	2.0	2.7	2.3	.	.	.
Central bank policy rate, % p.a., eop 5)	5.99	6.42	6.01	5.80	6.00	6.00	6.00
Current account, EUR m	-509	-399	-472	-691	-850	-910	-930
Current account, % of GDP	-7.6	-5.7	-7.0	-8.8	-9.9	-9.8	-9.4
Exports of goods, BOP, EUR m	377	393	475	753	840	870	950
annual change in %	-0.4	4.4	20.8	58.4	11.0	3.5	9.0
Imports of goods, BOP, EUR m	3,114	3,233	3,048	4,320	4,710	4,840	5,030
annual change in %	9.6	3.8	-5.7	41.7	9.0	2.8	4.0
Exports of services, BOP, EUR m	1,562	1,675	995	1,946	2,080	2,160	2,200
annual change in %	14.9	7.3	-40.6	95.6	7.0	4.0	2.0
Imports of services, BOP, EUR m	706	749	603	864	1,000	1,100	1,150
annual change in %	32.8	6.1	-19.5	43.2	16.0	10.0	4.5
FDI liabilities, EUR m	272	255	346	421	.	.	.
FDI assets, EUR m	46	66	59	100	.	.	.
Gross reserves of CB excl. gold, EUR m	769	864	901	1,100	.	.	.
Gross external debt, EUR m	2,036	2,201	2,517	2,895	2,800	3,000	3,100
Gross external debt, % of GDP	30.5	31.2	37.2	37.0	33.0	32.0	31.0

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

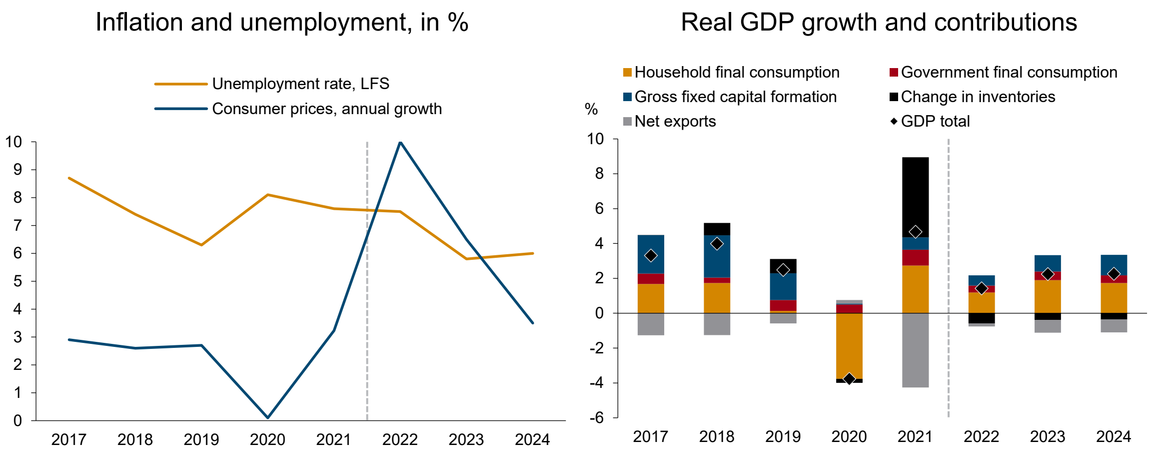
Source: wiiw Databases incorporating national statistics. Forecasts by wiiw.

LATVIA: Government ready to bear the high cost of cutting economic ties with Russia

SEBASTIAN LEITNER

The Russian war in Ukraine will substantially drag down growth in the small, open economy of Latvia. Almost all sectors will be affected by a fall-off in demand and escalating prices. The influx of Ukrainian refugees (accounting for 0.5% of the Latvian population) may even induce additional consumption in the short run. In these uncertain times, enterprises will largely refrain from investment, preferring to deplete their stocks and wait for the price rises to stabilise. In 2022, we expect GDP growth to fall to 1.4%, but then to recover somewhat, to 2.2% in 2023. Our main scenario assumes no substantial intensification of economic sanctions. Later, we would expect a stabilisation of GDP growth in Latvia at 2.3% in 2024.

Figure 4.11 / Latvia: Main macroeconomic indicators



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

Following its collapse in 2020, trade bounced back strongly last year, and particularly in the latter half of 2021. The disruptions caused by the war will have a powerful effect on the Latvian economy via the trade channel. While trade with Ukraine and Belarus alike accounts for only a little more than 1% of Latvia's total trade, Russia remains an important trade partner. As well as 11% of Latvian exports, a further 7% of goods of Latvian origin found their way there in 2021. Thus, particularly the food, machinery and electronics industries, chemicals, plastics and textiles will suffer from the slump in Russian demand. In the case of imports, obviously all manner of energy products are dominant, including electricity. However, iron and steel, fertilisers and wood are also important inputs for Latvian production, and these will be costly to replace. The linkages between the neighbouring economies via foreign direct investment (FDI) are fairly weak. Nevertheless, over the past five years about 10% of

Latvia’s FDI inward stock has stemmed from Russia. Investors have been particularly active in trade, real estate, energy and manufacturing. As for direct investment in Russia, Latvian entrepreneurs have been active in trade and financial and insurance activities. Given the war-induced shocks, which are aggravating price rises of the sort not seen since the 1970s, we predict a deterioration in external demand growth. However, Latvian consumers and producers are also reluctant to spend. Thus, we should not expect the current account deficit to grow by too much in 2022.

Contrary to speculation in the international press, the Latvian economy is not able to abandon Russian gas immediately; but the government is likely to ban such gas imports by June 2023. Last year, 90% of the country’s natural gas came from Russia; however, substitutes can be delivered via the liquefied natural gas (LNG) terminal at Klaipėda in Lithuania. However, it does not have the capacity to supply both of its neighbouring Baltic states (i.e. Latvia and Estonia) with sufficient gas. Therefore, the Latvian government joined Estonia and Finland in order to install another terminal at Paldinski on the coast of Estonia. The project ensures additional gas supplies to the region already for the coming heating season this winter.

Investment development will be dampened this year by the multiple uncertainties triggered by Russia’s war against Ukraine. Confidence levels in the construction and service sectors, as well as in industry, fell markedly in March 2022. Only retail trade entrepreneurs still expect sales to hold up. Supply difficulties and escalating prices alike will induce entrepreneurs to run down their stocks, and to revise and postpone their investment plans. However, the budget of the Latvian government envisages a big rise in public investment this year of more than 8%. The largest single project is Rail Baltica – the high-speed rail track linking the Baltic states with Warsaw and Berlin – which is now entering its construction phase. The railway line is planned to commence operations in 2026.

Yet again, for another year, average employment fell against expectations in 2021. Nevertheless, there was a marked rise in vacancies in the second half of the year. Still, substantially lower numbers of jobs are being recorded in construction and transport, accommodation and hospitality, and manufacturing. Following the money-laundering scandal that erupted in the Latvian banking sector in 2018, employment in financial services has gradually declined in recent years. The effects of the overall fall in employment were still being cushioned in 2021 by the short-time work schemes introduced by the government. The unemployment rate has also declined gradually over recent months. However, we expect no recovery on the labour market this year and the unemployment rate to decline to 6% only in 2024. As elsewhere, refugees from Ukraine are welcome in Latvia, although up to mid-April their number was still relatively low: 13,000, which corresponds to about 0.5% of the Latvian population. Thanks to an EU directive adopted at the beginning of March, the refugees have direct access to the labour market and are provided with education and childcare, housing and health care.

The Latvian government’s budget envisaged a substantial reduction in the deficit; but instead of another year of strong recovery, 2022 will see a slowdown in GDP growth. This has already resulted in additional unanticipated expenditure: a support package for low-income households to cushion the energy price rises. Moreover, the government has agreed to gradually increase spending on defence to 2.5% of GDP by 2025. The parliamentary elections scheduled for the end of the year will encourage the government to support economic activity and households, in order to win the approval of voters. This year, employees in health care, education and the so-called ‘interior sector’ (which includes the police and other emergency services, etc.) have received a wage increase, while the tax wedge for low earners is being reduced.

Opinion polls suggest that the elections (on 1 October 2022) will result in yet another big change in the composition of parliament. The most important left-wing party, which is strongly backed by Russian-speaking Latvians, has lost much of its support. Meanwhile, the revival of New Unity, a conservative people's party, looks to be on the cards. It was formerly led by Valdis Dombrovskis, who was prime minister for several years but, since 2017, has been an EU Commissioner. The second and the third-largest parties in the 2018 elections, which both had populist programmes, are expected to be no longer represented in parliament, while the conservative and right-wing spectrum will gain support.

Following a deflationary period at the beginning of 2021, consumer prices started to pick up in Q2 2021 – and have not stopped since. Energy products have pushed up the costs of housing and transport; however, of late it is food products that have been the single biggest driver of the consumer price index (CPI). We expect inflation to peak around mid-2022 and to reach 10% on average this year. Thereafter, price rises are set to moderate, as the CPI declines to 6.5% in 2023 and 3.5% in 2024.

After a big increase in real wages of more than 8% in 2021, income will almost stagnate on account of the price rises this year. At the same time, of all the countries in the EU only Bulgaria has a lower minimum wage level than Latvia. Consequently, income inequality and poverty in Latvia are among the highest in the EU. We expect a substantial increase in the minimum wage from 2023. Also, the growth of average wages should return to 3% annually.

In its latest report Economic Survey of Latvia, published this March, the Organisation for Economic Co-operation and Development (OECD) points out that if the country wants to narrow the welfare gap vis-à-vis its EU peers, it should not only strive for investment in skills and innovation. Yet, it should increase public spending on health, active labour market policies, housing and long-term care – some of the areas where Latvia spends far less than the OECD average.

Until recently retail trade figures showed that households were eager to spend the income they had saved during the lockdown periods. However, the escalating prices will result in a decline in real incomes. Since housing, transport and food cannot easily be substituted, households will have to spend more cautiously on other goods. In our main scenario, we expect growth in private consumption to halve in 2022, compared to last year. Nevertheless, we would expect sales to rebound in 2023 and household consumption to become again an important driver of growth.

All in all, for obvious reasons we have had to revise our forecast for GDP growth in 2022 significantly downwards – from 4.3% in January to 1.4% now. International trade is losing momentum, due to the loss of a great deal of exports to Russia, Belarus and Ukraine, a slump in the economic activity of trade partners generally, and substantially rising prices not only for energy products, but also for other imported inputs. The overall increase in uncertainty will dampen private investment, while public investment will remain an important driver of growth. Household incomes will suffer from escalating prices in 2022; thus, consumption will remain subdued this year, but will pick up in 2023 and thereafter. The unemployment rate will remain stagnant this year and start to fall again only from 2023, declining to 6% in 2024. Our main scenario assumes the gradual containment of Russian hostilities and a strong willingness on the part of EU actors to cushion the economic effects of the crisis through fiscal and monetary policies. In this scenario, GDP growth will pick up gradually to 2.2% in 2023 and 2.3% in 2024.

Table 4.11 / Latvia: Selected economic indicators

	2018	2019	2020	2021 1)	2022	2023	2024
						Forecast	
Population, th pers., average	1,927	1,914	1,900	1,883	1,870	1,855	1,840
Gross domestic product, EUR m, nom.	29,154	30,647	29,457	32,923	36,700	40,000	42,300
annual change in % (real)	4.0	2.5	-3.8	4.7	1.4	2.2	2.3
GDP/capita (EUR at PPP)	20,950	21,700	20,990	23,070	.	.	.
Consumption of households, EUR m, nom.	16,884	17,435	16,413	17,803	.	.	.
annual change in % (real)	2.9	0.2	-6.6	4.9	2.2	3.5	3.2
Gross fixed capital form., EUR m, nom.	6,449	7,102	7,217	7,755	.	.	.
annual change in % (real)	11.8	6.9	0.2	2.9	2.5	4.0	5.0
Gross industrial production 2)							
annual change in % (real)	1.5	0.9	-1.5	6.7	5.0	4.0	5.0
Gross agricultural production							
annual change in % (real)	-9.0	23.4	2.7	-7.1	.	.	.
Construction industry							
annual change in % (real)	21.8	2.9	2.7	-6.1	.	.	.
Employed persons, LFS, th, average 3)	909.4	910.0	893.0	869.5	870	874	877
annual change in %	1.6	0.1	-1.9	.	0.1	0.5	0.3
Unemployed persons, LFS, th, average 3)	72.8	61.3	78.7	70.6	71	54	56
Unemployment rate, LFS, in %, average 3)	7.4	6.3	8.1	7.6	7.5	5.8	6.0
Reg. unemployment rate, in %, eop 4)	6.4	6.2	7.7	6.7	.	.	.
Average monthly gross wages, EUR	1,004	1,076	1,143	1,277	1,430	1,570	1,690
annual change in % (real, gross)	5.7	4.2	6.0	8.2	1.5	3.0	4.0
Average monthly net wages, EUR	742	793	841	939	1,040	1,140	1,220
annual change in % (real, net)	7.0	3.9	5.8	8.1	1.0	2.5	3.5
Consumer prices (HICP), % p.a.	2.6	2.7	0.1	3.2	10.0	6.5	3.5
Producer prices in industry, % p.a.	4.3	1.8	-2.2	13.4	12.0	5.0	1.0
General governm. budget, EU def., % of GDP							
Revenues	38.5	37.6	38.7	37.0	39.0	38.0	37.0
Expenditures	39.3	38.2	43.2	44.3	44.5	41.5	39.0
Net lending (+) / net borrowing (-)	-0.8	-0.6	-4.5	-7.3	-5.5	-3.5	-2.0
General gov. gross debt, EU def., % of GDP	37.1	36.7	43.3	45.0	47.0	46.0	44.0
Stock of loans of non-fin. private sector, % p.a.	-5.2	-1.4	-3.8	3.2	.	.	.
Non-performing loans (NPL), in %, eop 5)	5.3	5.1	3.1	2.5	.	.	.
Central bank policy rate, % p.a., eop 6)	0.00	0.00	0.00	0.00	.	.	.
Current account, EUR m	-60	-203	845	-940	-1,400	-750	-850
Current account, % of GDP	-0.2	-0.7	2.9	-2.9	-3.8	-1.9	-2.0
Exports of goods, BOP, EUR m	12,588	12,761	13,428	16,241	18,500	20,500	22,000
annual change in %	8.3	1.4	5.2	20.9	13.9	10.8	7.3
Imports of goods, BOP, EUR m	15,108	15,403	14,917	18,680	21,800	23,800	25,500
annual change in %	7.4	2.0	-3.2	25.2	16.7	9.2	7.1
Exports of services, BOP, EUR m	5,336	5,577	4,375	4,817	5,500	6,100	6,500
annual change in %	6.9	4.5	-21.6	10.1	14.2	10.9	6.6
Imports of services, BOP, EUR m	3,019	3,151	2,541	3,062	3,600	3,900	4,200
annual change in %	11.2	4.4	-19.4	20.5	17.6	8.3	7.7
FDI liabilities, EUR m	373	975	820	4,581	.	.	.
FDI assets, EUR m	-269	78	166	2,922	.	.	.
Gross reserves of CB excl. gold, EUR m	3,578	3,700	3,982	4,504	.	.	.
Gross external debt, EUR m	35,942	35,802	36,775	36,816	40,400	42,000	42,300
Gross external debt, % of GDP	123.3	116.8	124.8	111.8	110.0	105.0	100.0

1) Preliminary and wiiw estimates. - 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 from 2018 also including loans unlikely to be paid. - 6) Official refinancing operation rates for euro area (ECB).

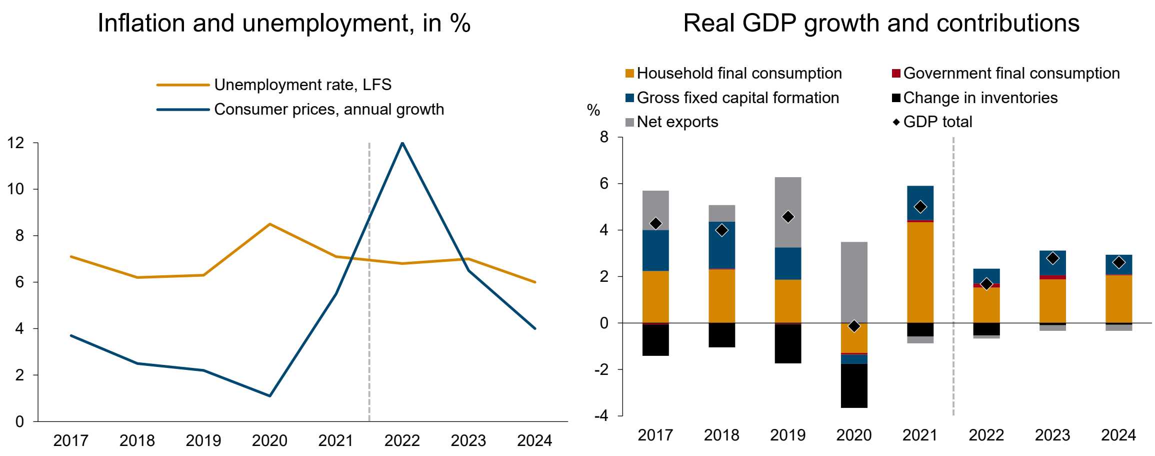
Source: wiiw Databases incorporating Eurostat and national statistics. Forecasts by wiiw.

LITHUANIA: At the frontline of economic sanctions

SEBASTIAN LEITNER

Following a strong recovery last year, economic growth in Lithuania has been dealt a blow by Russia's invasion of Ukraine. Big rises in the price of energy and other imported inputs for industrial production are hitting economies worldwide. In addition, the trade linkages with Russia, Belarus and Ukraine are obviously more intensive in the Baltics than in other parts of the EU. A decline in household and business sentiment alike means that consumption and investment activity will lose momentum in 2022. The government is trying to counter the loss of households' purchasing power with an anti-inflationary package, and it should manage to keep economic activity afloat with its planned public investments. In our main scenario, we expect real GDP to grow by 1.7% in 2022, followed by an upswing of 2.8% in 2023 and 2.6% in 2024.

Figure 4.12 / Lithuania: Main macroeconomic indicators



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

The Lithuanian government and the political community are seeking an end to the Russian war against Ukraine. However, the means that are proposed will also result in Lithuania's own economy paying a high price. Together with Estonia, Latvia and Poland, Lithuania is pushing for additional sanctions to be imposed on Russia – for example, a ban on Russian and Belarusian road freight transport and on the entry of vessels from those two countries into EU ports. Moreover, that group of countries is pushing for an EU embargo of Russian energy products, including oil, gas and coal, arguing that the utmost economic pressure needs to be brought to bear on Russia to get it to stop its aggression.

Compared to other EU countries, trade linkages between Russia and the Baltics states are relatively close – and that is particularly true of Lithuania. However, a reorientation of trade was already under way even before Russia's annexation of Crimea and the war in Donbas; but since 2014, that process has gathered pace. The share of Lithuania's exports to Russia in its total exports fell from about 20% in 2014 to 10% in 2021. Russia is still the most important export destination for Lithuania, but most of its trade with Russia is transit trade. When it comes to the export of goods of Lithuanian origin, Russia's share is below 3%. Adding up the exports of Lithuanian goods to Russia, Belarus and Ukraine, it is clear that Lithuanian producers can expect a loss of more than 5% of total exports in 2022. Moreover, the transport sector, which has profited from the transit to and from Lithuanian ports of goods destined for the country's eastern neighbours (or exported by them), will also suffer a severe blow.

The downturn in sentiment among businesses across Europe is likely to act as a drag on external demand for Lithuanian goods elsewhere, too. Following a swift post-pandemic revival in trade last year, we expect export growth to be substantially down in real terms in 2022. We anticipate a gradual revival of export activity in 2023, although that does depend on de-escalation of the conflict in Ukraine.

The opening in 2014 of the liquefied natural gas (LNG) terminal in the port of Klaipėda made the country technically independent of Russian gas. Thus, Lithuania has been able to ban Russian gas imports from the beginning of April this year. Gas is supplied by Norway, as well as by the US (through fracking). However, the capacity of the terminal means that it cannot also cope with the total demands of neighbouring Latvia and Estonia in the coming winter period. Thus, those Baltic states are planning an additional LNG terminal, to be built at Paldinski on the northern coast of Estonia, in cooperation with Finland.

Overall, goods from Russia still accounted for about 10% of Lithuania's total imports last year. Apart from natural gas, crude oil, iron and steel, aluminium, fertilisers and timber were the most important inputs from Russia. Thus, the sectors engaged in construction, metal processing and furniture production will be among those worst affected**.** The Lithuanian government and the Polish-owned refinery Orlen are seeking to replace the Russian crude oil used up to now with supplies from Saudi Arabia. However, it is technically harder and definitely more expensive for Lithuania to become totally independent of Russia for its electricity supplies (although these have been reduced in recent years).

In general, the war in Ukraine has dramatically exacerbated the upsurge in consumer prices that was already gaining momentum in the second half of 2021. To a large extent, the rise has been driven by the aforementioned imports of energy and other production inputs. As a result, consumer prices will pick up to about 12% this year, and inflation is likely to remain elevated in 2023 and 2024. Thus, real wages are likely to stagnate in 2022, even though the government did increase the minimum wage in January 2022 by over 13%, to EUR 730 a month.

Although the purchasing power of households is coming under pressure, the release of pent-up demand following the COVID lockdowns is likely to lead to private consumption increasing in 2022 by 2.6% in real terms. Consumer surveys show confidence declining in March 2022; however, they also reveal that people are still planning to spend money on consumer durables. In 2023-2024, we expect household consumption to regain some of its momentum; however, smaller increases in income will limit that upswing.

The latest business sentiment figures show that entrepreneurs are predicting tough times ahead. Confidence has fallen markedly in all sectors, and that will result in investment plans being revised or shelved. Even recently, labour shortages and flourishing demand were encouraging us to forecast another year of strong revival; but today only investment in public 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 railway line starts this year. Given the big increase in the cost of construction materials, however, we would expect lower growth in volume terms in 2022 in both rail and road construction. Companies will run down their stocks, and overall investment will stagnate this year, before reviving in 2023. Given the uncertainty in terms of jobs and income development, households will reduce their investment in dwellings. However, we expect this expenditure to be only postponed for a while, given the ongoing demand for better and more living space.

The Lithuanian government was planning to cut the budget deficit substantially this year; however, with the economic downswing and the surge in inflation, it is likely to end up at around 4% of GDP in 2022. At the beginning of April, the government presented a package of anti-inflationary measures for households: 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 energy. An additional amendment to the state budget envisages a rise in defence spending from slightly above 2% of GDP in 2021 to almost 2.7% of GDP. Most likely, the additional expenditure on military equipment, etc. will not be reduced in the medium term.

On average, the employment rate last year attained the pre-crisis level of 2019. Only in domestic trade, accommodation and education was it still lower, while the gradual decline in agricultural employment is chronic. A substantial increase in the number of vacancies in the business sector indicated that at the beginning of this year demand for skilled labour was even higher than before the COVID pandemic. The unemployment rate in 2021 declined by more than expected, to 7.1% on average. The anticipated slowdown in economic growth will put the brakes on any revival in the labour market. Only in 2024 is the unemployment rate likely to fall to 6.5%.

Up to the beginning of April, about 40,000 Ukrainian refugees had been registered in Lithuania, which amounts to somewhat over 1% of the population of the host country. Until fairly recently, the Ukrainian community was not very large (again about 1% of the population); however, in the past few years Lithuania has tried to attract workers from Ukraine (and Belarus) with temporary work permits, in order to meet the demand for labour. The effects of the surge in refugees on the labour market will not be very marked in the short run. On 3 March, the EU activated its temporary refugee directive, which allows Ukrainian refugees temporary protection for three years. Thus, they are provided with direct access to the labour market, as well as accommodation, health care and education; and they are free to move within the EU, just like any other person with refugee status. However, about half of those who have registered in Lithuania are children, and a large proportion are women with care responsibilities. Thus, we would expect only a minority of the refugees to look for a job immediately, though in the medium-term things are likely to look rather different. Children are provided with places in kindergartens and schools. Depending on the humanitarian and economic situation in the Ukraine, longer-term settlement in an EU country will be an option both for those that are already in Lithuania, and for additional refugees, including men who are now engaged in fighting.

Considering the overall effects of the war in Ukraine, we have had to revise our GDP forecast for 2022 substantially downwards, from 3.7% (interim report in January 2022) to 1.7%. The deceleration of economic activity is affecting all channels and sectors. Growth in trade will decline most, and price rises will mean that households and enterprises have to revise their expenditure plans downwards. The government, however, is trying to bolster the purchasing power of households with anti-inflationary measures and to stimulate the investment climate through public investment. For the medium-term forecast, we are still optimistic that the economic slump will prove short lived, and that inflation will gradually decline. Thus, we expect GDP growth to revive to 2.8% in 2023 and 2.6% in 2024.

Table 4.12 / Lithuania: Selected economic indicators

	2018	2019	2020	2021 1)	2022	2023 Forecast	2024
Population, th pers., average	2,802	2,794	2,795	2,795	2,820	2,830	2,820
Gross domestic product, EUR m, nom.	45,515	48,860	49,507	55,383	63,100	69,100	73,700
annual change in % (real)	4.0	4.6	-0.1	5.0	1.7	2.8	2.6
GDP/capita (EUR at PPP)	24,670	26,220	25,980	28,490	.	.	.
Consumption of households, EUR m, nom.	27,890	29,347	28,958	32,524	.	.	.
annual change in % (real)	3.7	3.0	-2.1	7.4	2.6	3.2	3.5
Gross fixed capital form., EUR m, nom.	9,531	10,482	10,424	11,691	.	.	.
annual change in % (real)	10.0	6.6	-1.8	7.0	3.0	5.0	4.0
Gross industrial production (sales)							
annual change in % (real)	5.5	3.0	-1.3	19.5	8.0	4.0	6.0
Gross agricultural production							
annual change in % (real)	-10.0	10.1	10.3	-5.5	.	.	.
Construction industry							
annual change in % (real)	13.8	8.4	-1.6	4.6	.	.	.
Employed persons, LFS, th, average	1,375	1,378	1,358	1,369	1,380	1,390	1,400
annual change in %	1.5	0.3	-1.5	0.8	0.5	1.0	0.8
Unemployed persons, LFS, th, average	90	92	126	105	101	105	89
Unemployment rate, LFS, in %, average	6.2	6.3	8.5	7.1	6.8	7.0	6.0
Reg. unemployment rate, in %, eop 2)	8.9	8.7	16.1	10.2	.	.	.
Average monthly gross wages, EUR 3)	924	1,296	1,429	1,568	1,770	1,910	1,870
annual change in % (real, gross)	7.1	6.4	8.9	4.8	1.0	1.5	1.8
Average monthly net wages, EUR 3)	720	822	913	995	1,120	1,090	1,180
annual change in % (real, net)	6.2	11.6	9.8	4.1	0.5	1.0	1.2
Consumer prices (HICP), % p.a.	2.5	2.2	1.1	5.5	12.0	6.5	4.0
Producer prices in industry, % p.a.	5.6	0.0	-9.0	9.5	17.0	6.0	3.0
General governm. budget, EU def., % of GDP							
Revenues	34.5	35.2	35.7	38.5	38.0	37.0	36.0
Expenditures	34.0	34.8	42.9	41.1	42.0	40.0	38.0
Net lending (+) / net borrowing (-)	0.5	0.5	-7.2	-2.6	-4.0	-3.0	-2.0
General gov. gross debt, EU def., % of GDP	33.7	35.9	46.6	45.0	48.0	50.0	48.0
Stock of loans of non-fin. private sector, % p.a.	6.0	3.3	-1.8	13.4	.	.	.
Non-performing loans (NPL), in %, eop	2.4	1.6	1.3	0.7	.	.	.
Central bank policy rate, % p.a., eop 4)	0.00	0.00	0.00	0.00	.	.	.
Current account, EUR m	132	1,702	3,633	788	500	300	400
Current account, % of GDP	0.3	3.5	7.3	1.4	0.8	0.4	0.5
Exports of goods, BOP, EUR m	24,552	25,954	25,536	31,656	37,300	40,900	43,800
annual change in %	7.9	5.7	-1.6	24.0	17.8	9.7	7.1
Imports of goods, BOP, EUR m	27,398	28,303	25,938	34,532	41,900	46,200	49,300
annual change in %	10.4	3.3	-8.4	33.1	21.3	10.3	6.7
Exports of services, BOP, EUR m	9,678	11,822	10,853	12,864	15,200	16,700	17,900
annual change in %	15.9	22.2	-8.2	18.5	18.2	9.9	7.2
Imports of services, BOP, EUR m	6,003	6,902	5,854	7,661	9,300	10,300	11,000
annual change in %	12.9	15.0	-15.2	30.9	21.4	10.8	6.8
FDI liabilities, EUR m	1,096	3,060	3,979	1,605	.	.	.
FDI assets, EUR m	866	1,921	3,438	429	.	.	.
Gross reserves of CB excl. gold, EUR m	4,831	4,273	3,662	4,626	.	.	.
Gross external debt, EUR m	35,619	34,266	37,457	42,448	49,200	52,500	54,500
Gross external debt, % of GDP	78.3	70.1	75.7	76.6	78.0	76.0	74.0

1) Preliminary and wiiw estimates. - 2) In % of working age population. - 3) Including earnings of sole proprietors. From 2019 income tax reform and transfer of the employer's social security contribution (28.9%) to employees; real growth in 2019 estimated by wiiw. - 4) Official refinancing operation rate for euro area (ECB).

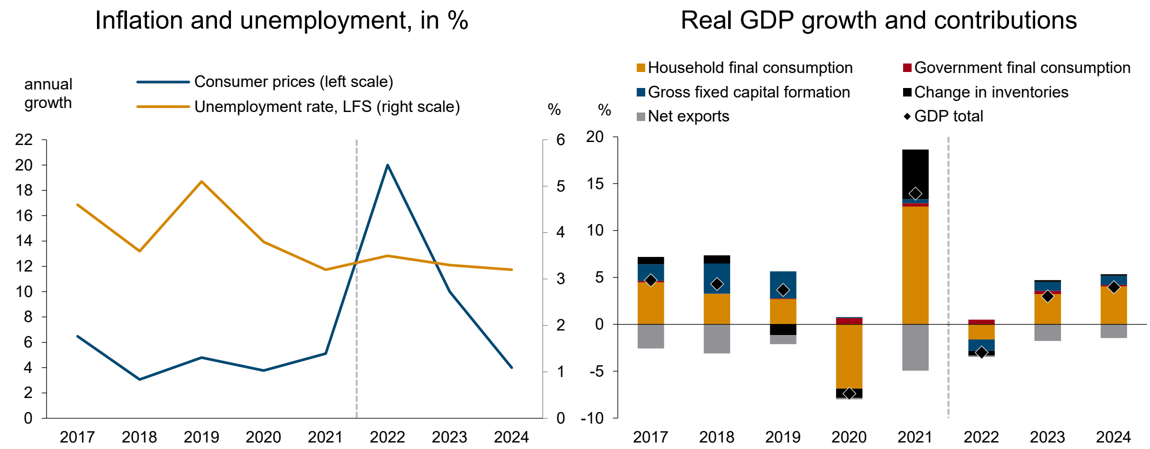
Source: wiiw Databases incorporating Eurostat and national statistics. Forecasts by wiiw.

MOLDOVA: From boom to bust

GÁBOR HUNYA

After the boom fuelled by a bumper harvest in 2021, Moldova is facing negative growth in 2022. Soaring inflation – and especially the energy price shock – is hitting both consumption and production. The disruption to trade links with Russia and Ukraine is affecting production and causing a temporary shortage of basic goods. The country is providing refuge for many people who have fled Ukraine, which adds to demand. Generous Western aid and political support are crucial for the necessary economic adjustments.

Figure 4.13 / Moldova: Main macroeconomic indicators



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

Having emerged from the COVID-related recession of 2021, Moldova is facing a new crisis, triggered by the Russian invasion of Ukraine. The country experienced robust economic growth in 2021 (13.9%), especially in the fourth quarter (18.9% year on year). Household consumption was the main driver throughout the year. Gross fixed capital formation was close to stagnating, but inventories skyrocketed. Net exports made a negative contribution to GDP, as buoyant consumption led to a surge in imports. A significant driver of all these developments was the bumper harvest (grain production up by 75%), which benefited both consumption and exports and has left abundant grain stocks for 2022. But weather conditions have a habit of fluctuating, and so economic growth in 2022 would most likely have been much slower anyway – even without any calamities. The adverse effects of inflation and the disruption caused by the war in the neighbouring country will push GDP growth into negative territory.

The first blow to economic growth came when Russia's Gazprom revised its pricing policy in September 2021. The owner of the local gas distributor, Moldovagaz, tied Moldova's import prices to the European market price for gas and oil (albeit with a significant discount and monthly revisions). As a result of the dynamic price setting, local gas prices have soared sevenfold in just six months. This has hit consumers and producers alike, although households receive their gas at subsidised (though rising) tariffs. The elevated cost of fuel and chemicals has led to spring agricultural fieldwork being delayed. International food prices have doubled over the past 12 months, in line with oil prices, and a further increase is in prospect, since Ukraine is prevented from bringing its products onto the world market. Thus, Moldovan farmers may gain in the longer run.

Since the outbreak of the war, temporary shortages of goods have led to a surge in prices; this has come on top of the imported inflation. Inflation has accelerated, reaching 18.5% (year on year) in February – 2 percentage points higher than in January. The policy rate was hiked by the same amount, to 12.5% in mid-March. Interest rates have remained negative in real terms, resulting in a rapid expansion of loans; these could later prove unsustainable. Meanwhile, the local currency has been relatively stable, recording only 1% depreciation against the euro and 3.8% against the US dollar since the beginning of the year. The central bank often intervenes in the market as part of its battle with inflation. Increased macro-financial assistance from international organisations and bilateral aid are keeping the country's head above water.

Moldova is extremely exposed to the consequences of the war in Ukraine, both politically and economically. Its geographical location (between the EU and Ukraine) and its Russian-oriented separatist part, Transnistria, render it vulnerable to Russian aggression. The Black Sea port of Odesa, a potential target for a Russian assault, is just 50km from Moldova's border. To reduce the risk, the pro-EU leadership of the country is trying not to provoke Russia. Neutrality and non-alignment with NATO are anchored in the constitution. The country has not joined the sanctions against Russia and is providing no assistance to Ukraine (except for taking in refugees). In their own economic interests, both the Transnistrian leaders and the Russia-oriented opposition to the government in Chișinău are keeping a low profile and are avoiding challenging Moldova's position by courting Russia. Relations with the EU have intensified since the two parties signed an Association Agreement, and Moldova has benefited from the Deep and Comprehensive Free Trade Area, which came fully into effect in July 2016. This has allowed the country to reorient its foreign trade away from Russia and towards the West; most Moldovan migrants have also switched direction.

Moldova benefits from aid and loans to support democratic reforms and economic development. The agreement with the EU provoked Russian retaliation in the form of embargoes on certain significant exports. But this served to stimulate Moldovan exporters to turn even more to the EU, and especially to neighbouring Romania. The EU has offered EUR 60m budgetary support to help it provide energy subsidies, strengthen its natural gas storage capacities and ensure energy interconnection with Romania. Moldova formally applied to join the EU on 3 March 2022, following a similar move by Ukraine and Georgia; however, that will not change the country's status in the foreseeable future.

Despite the shift towards the West, significant trade links with Russia have remained – although these have now been curtailed by the war in Ukraine. Ukraine and Belarus accounted for 3% apiece of Moldova's exports in 2021, while Russia took almost 9%. Most exports to Russia have now ceased. Imports from Belarus constituted about 2% of Moldova's imports in 2021; from Ukraine – 9% and from

Russia – 14%. Most of these flows have also stopped, except for gas transported via pipelines from Russia through Ukraine. Temporary shortages of particular goods, such as salt and poultry, emerged in Moldova in March 2022, when the Ukrainian authorities banned the export of some cereals, sugar, salt and meat. More lasting supply-chain disruptions have surfaced in the automotive components sector, which has been developed in cooperation with plants in Ukraine. (The automotive industry provided 15% of Moldovan exports in 2021.) A further problem is that transport routes to the east and north of the country have been closed, and the main port that handles Moldovan goods – Odesa, in Ukraine – is not functioning. Overseas commerce has been redirected through Constanța in Romania; but there is a bottleneck in the connecting infrastructure.

Moldova has taken in the largest number of refugees from Ukraine, relative to its population size and economic strength. Nearly 400,000 individuals had fled from Ukraine through Moldova by the end of March, and about a quarter of them have remained in the country. The government has provided much organisational help, but capacity is limited. The labour market effect of the mainly female refugees with children has been moderate, although those who stay in the country are seeking to earn some income. The service sector and agriculture may provide temporary jobs. The financing of support for refugees depends mainly on foreign aid: the US has pledged USD 30m to support refugees and another USD 50m to cover related costs during the year. In early April, the country's EU partners pledged EUR 695m for the same purpose.

The duration, intensity and possible escalation of the war in Ukraine presents a major risk to any forecast concerning Moldova. Even if the international political and economic environment stabilises one way or the other in the coming months, adjustment will be cumbersome and will depress the economy for quite some time. A GDP contraction of about 3% seems unavoidable in 2022. Despite the moderating effect of consumption by refugees, household consumption will fall on account of shrinking real wages. The recession would be much more severe had it not been for international assistance financing the current account and fiscal deficits. Over and above the assistance already approved, Moldova has requested USD 1.4bn in emergency financing under the International Monetary Fund's Rapid Financing Instrument; if granted, this will cover a significant part of the balance of payments deficit in coming years as well. Moderate growth may resume in 2023, if the reorientation of trade succeeds and if inflation is brought under control. In future, foreign investors may relocate some of their production capacities from Russia and Ukraine to Moldova, insofar as the limited size and quality of the local labour force permits it.

Table 4.13 / Moldova: Selected economic indicators

	2018	2019	2020	2021 1)	2022	2023	2024
						Forecast	
Population, th pers., average	2,708	2,665	2,620	2,560	2,500	2,500	2,500
Gross domestic product, MDL bn, nom.	192.5	210.4	199.7	241.9	293	332	362
annual change in % (real)	4.3	3.7	-7.4	13.9	-3.0	3.0	4.0
GDP/capita (EUR at PPP)	8,590	9,240	8,410	10,040	.	.	.
Consumption of households, MDL bn, nom.	160.5	174.1	162.2	195.6	.	.	.
annual change in % (real)	3.9	3.2	-8.3	15.5	-2.0	4.0	5.0
Gross fixed capital form., MDL bn, nom.	46.8	53.0	49.8	58.5	.	.	.
annual change in % (real)	14.5	11.9	0.4	1.7	-5.0	4.0	4.0
Gross industrial production							
annual change in % (real)	3.7	2.0	-5.5	12.1	-5.0	5.0	6.0
Gross agricultural production							
annual change in % (real)	2.9	-1.6	-27.2	49.9	.	.	.
Construction industry							
annual change in % (real)	17.6	12.8	3.7	-0.3	.	.	.
Employed persons, LFS, th, average 2)	794.1	872.4	834.2	843.4	840	850	860
annual change in %	-0.8	9.9	-4.4	1.1	0.0	1.0	1.0
Unemployed persons, LFS, th, average 2)	29.6	46.9	33.1	28.2	30	30	30
Unemployment rate, LFS, in %, average 2)	3.6	5.1	3.8	3.2	3.5	3.3	3.2
Reg. unemployment rate, in %, eop	1.7	1.8	2.9	2.3	.	.	.
Average monthly gross wages, MDL	6,268	7,234	7,943	9,116	10,400	12,000	13,100
annual change in % (real, gross)	8.8	10.1	5.8	9.2	-5.0	5.0	5.0
Average monthly net wages, MDL	5,142	6,010	6,617	7,600	8,700	10,000	10,900
annual change in % (real, net)	9.3	11.5	6.1	9.3	-5.0	5.0	5.0
Consumer prices, % p.a.	3.1	4.8	3.8	5.1	20.0	10.0	4.0
Producer prices in industry, % p.a.	0.3	1.8	2.6	8.4	25.0	3.0	3.0
General governm. budget, nat. def., % of GDP							
Revenues	30.1	29.9	31.4	32.0	31.0	32.0	32.0
Expenditures	31.0	31.4	36.7	33.9	36.0	35.0	34.0
Deficit (-) / surplus (+)	-0.8	-1.4	-5.3	-1.9	-5.0	-3.0	-2.0
General gov. gross debt, nat. def., % of GDP	27.2	25.1	34.2	30.2	29.9	29.4	29.0
Stock of loans of non-fin. private sector, % p.a.	6.0	13.9	13.2	22.6	.	.	.
Non-performing loans (NPL), in %, eop 3)	12.5	8.5	7.4	6.1	.	.	.
Central bank policy rate, %, p.a., eop 4)	6.50	5.50	2.65	6.50	14.00	10.00	4.00
Current account, EUR m 5)	-1026	-993	-783	-1344	-1,780	-1,750	-1,800
Current account, % of GDP	-10.6	-9.3	-7.7	-11.6	-12.8	-11.6	-10.9
Exports of goods, BOP, EUR m 5)	1,672	1,892	1,706	2,165	2,430	2,530	2,750
annual change in %	1.0	13.1	-9.8	26.9	12.2	4.1	8.7
Imports of goods, BOP, EUR m 5)	4,462	4,850	4,420	5,706	6,600	6,720	7,170
annual change in %	13.6	8.7	-8.9	29.1	15.7	1.8	6.7
Exports of services, BOP, EUR m 5)	1,251	1,379	1,121	1,381	1,550	1,670	1,890
annual change in %	12.4	10.2	-18.7	23.2	12.2	7.7	13.2
Imports of services, BOP, EUR m 5)	950	1,065	785	995	1,060	1,100	1,180
annual change in %	12.7	12.2	-26.3	26.6	6.6	3.8	7.3
FDI liabilities, EUR m 5)	248	453	138	207	.	.	.
FDI assets, EUR m 5)	29	35	5	5	.	.	.
Gross reserves of CB excl. gold, EUR m 5)	2,628	2,731	3,079	3,442	.	.	.
Gross external debt, EUR m 5)	6,448	6,653	6,875	7,960	9,800	10,700	11,800
Gross external debt, % of GDP	66.5	62.2	68.0	68.9	70.0	71.0	72.0
Average exchange rate MDL/EUR	19.84	19.67	19.74	20.93	21.0	22.0	22.0

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

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

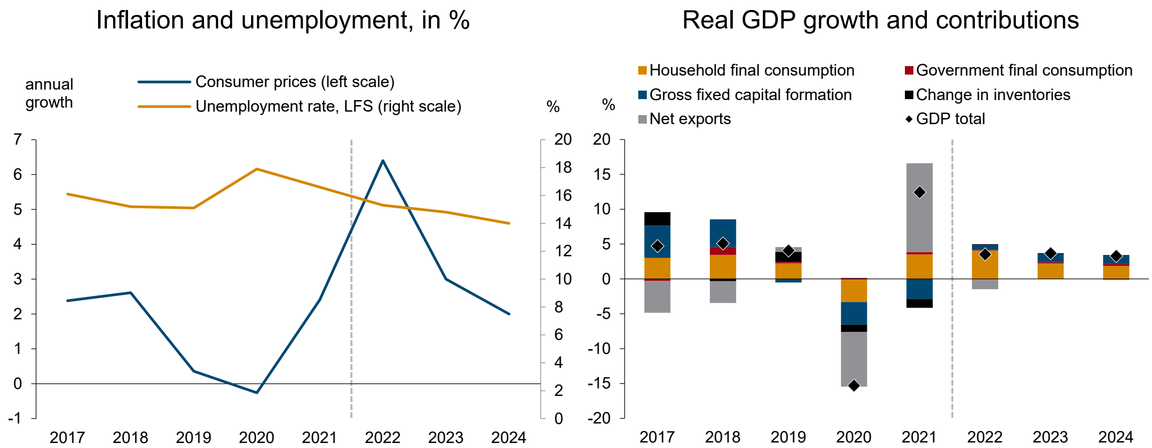
Source: wiiw Databases incorporating national statistics. Forecasts by wiiw.

MONTENEGRO: Mired in uncertainty

NINA VUJANOVIĆ

After the fall of the government at the beginning of the year, there is still no clear political solution in sight. Despite a growth rate of 12.4% in 2021, the pre-pandemic GDP level has not yet been reached, leaving further room for growth in 2022. There will be a decline in foreign direct investment, as a result of the sanctions against Russia. Despite rising inflation, household consumption will support growth in 2022, since the 'Europe Now' reform programme has led to an unprecedented increase in net earnings. The economy is expected to grow at a rate of 3.5% in 2022, 1 percentage point lower than initially expected.

Figure 4.14 / Montenegro: Main macroeconomic indicators



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

In economic terms, Montenegro forged ahead in 2021, thanks to the growth in tourism. The estimated GDP growth rate of 12.4% in 2021 was one of the highest in Europe, showing that the country can pick up rapidly, if the macroeconomic conditions allow it. Despite the fact that the number of tourists almost quadrupled between 2020 and 2021, still revenue from tourism fell short of the 2019 figure. The number of tourists was lower than before COVID-19 and the season was dominated by regional and local visitors (52% of all visitors), at the cost of the Western markets. Nor will the tourist sector reach its full potential in 2022, given the loss of the Ukrainian market (and part of the Russian market) when direct flights ceased in March 2022. Russian and Ukrainian tourists accounted for 12% of the tourist market last year. A solid summer season could be on the cards, given this year's successful winter season. Visitors from the EU and other foreign markets, encouraged by more frequent flights to Montenegro, may make up for the loss of Ukrainian tourists, while Russian visitors are expected to enter via Serbia, which maintains air transport links to Russia.

However, sanctions against Russia will significantly dampen foreign direct investment (FDI). After much agonising, the caretaker government supported sanctions, which will hit the Montenegrin economy hard, mainly because of the fall-off in FDI. Russian investments used to account for approximately 10% of total FDI inflows, but that share rose to 18% in 2021 – probably because the ousted government managed to steer a middle course between the EU and Russia. But only with political certainty is there any real hope of attracting FDI from other Western markets. The global financial crisis and the COVID-19 pandemic showed that FDI is very sensitive to global shocks, which is why FDI sentiment could suffer this year. We have lowered our projections by 1 percentage point (pp) to 3.5% of GDP in 2022, on the assumption that the Ukrainian-Russian crisis is settled by summer.

Industrial production is already suffering after the closure of the country's largest industrial plant, the aluminium company Uniprom, in the wake of its failure to reach agreement with the national energy company on electricity subsidies. These subsidies had long been essential to profitable aluminium production. The closure will lead to a sharp decline in manufacturing and goods exports in 2022, and will further increase the country's dependence on services in the medium term, which will complicate the reforms being undertaken to restructure the economy. However, the growth of the energy sector may compensate for the loss of aluminium production, now that the Uniprom subsidies are no longer dragging profits down.

The substantial decline in the current account deficit from 2021 will not last long. Exports of services, driven mainly by tourism, increased by a nominal 135% and helped slash the current account deficit to an estimated 9.2% of GDP in 2021 – the lowest for 12 years. However, this upswing will be short-lived, on account of the supply-chain disruptions that have been further intensified by the war in Ukraine – and consequently by higher import and export prices. When war erupted in Ukraine, Serbia limited its exports of wheat, forcing Montenegro to import grain from Bulgaria for the time being. If the war drags on and if sanctions against Russia prevail, further such supply-chain disruptions are likely this year. Besides large external shocks to trade and prices, the closure of Uniprom, the most significant goods exporter, will further widen the current account deficit, which we forecast will be 12.5% of GDP in 2022.

Montenegro will experience its highest inflation for 14 years. The supply-chain disruption and the rising energy and food prices are having a severe impact on Montenegro, which is importing inflation from abroad, but has limited monetary policy tools to control it. Inflation in January and February 2022 was 5.7% and 6.7%, respectively. The government has suggested amendments to the law on excise duties, which would allow the duty on fuel to be cut by up to 20%. However, a lack of political will means that voting has not taken place yet in parliament. Our baseline projections are that inflation will be an average 6.4% in 2022.

The impact of inflation on households will be moderated by rising wages, following implementation of the 'Europe Now' reform package. 'Europe Now' is the most significant reform programme that the country has experienced since independence and has led to a sharp increase in average net earnings – from EUR 537 in December 2021 to EUR 706 in February 2022, or a nominal 31%. This rise in earnings comes about after the abolition of compulsory health insurance, a rise in the minimum wage (from EUR 250 to EUR 450 a month) and the introduction of a progressive personal income tax (no taxation on a monthly salary of under EUR 700). Altogether, we expect this to push household spending up, despite inflation. Retail trade already grew by 18.1% in February (which could partly be due to the low base and the good winter tourist season). Yet, this rise in net earnings comes at the cost of uncertain financing of the healthcare system and rising fiscal risks.

The fiscal risks remain the country's biggest weakness. The 'Europe Now' reform is being implemented without adequate analysis of its effects on the budget and fiscal risks. It is our assessment that, as a consequence of the reform, budget revenue will fall substantially, creating a budget deficit that will rise to 6% of GDP in 2022 and that will limit fiscal space in the years to come. Budget spending has been quite high in recent years, mainly due to the pandemic; for that reason, we do not expect to see a substantial rise in 2022. It is uncertain how the budget deficit will be financed this year, as parliament has limited its external financing through debt to a maximum of EUR 70m in 2022. Public debt fell substantially as a share of GDP in 2021 (by about 20 pp), but it remains the biggest source of systemic risk.

The political uncertainty in Montenegro is depressing growth. Ever since the formation of a new government in December 2020, the political situation in the country has been complicated. The disparate parties that went to make up that government proved a source of weakness that deepened the social divide and ultimately led to a vote of no confidence early this year. This has put the brakes on the country's progress towards EU accession, as the chances of any improvement in Montenegro's democratic capacity have completely vanished. The agreements on the formation of the minority government have been obscure, while its biggest supporter in terms of size (Democratic Party of Socialists) is not even actively participating in it. Thus, while the minority government is expected to contribute to the country's EU prospects, it is unlikely to continue in power beyond next year's presidential elections.

Table 4.14 / Montenegro: Selected economic indicators

	2018	2019	2020	2021 1)	2022	2023 Forecast	2024
Population, th pers., average	622	622	621	621	621	621	621
Gross domestic product, EUR m, nom.	4,663	4,951	4,186	4,912	5,400	5,800	6,100
annual change in % (real)	5.1	4.1	-15.3	12.4	3.5	3.7	3.3
GDP/capita (EUR at PPP)	14,590	15,700	13,360	15,390	.	.	.
Consumption of households, EUR m, nom. 2)	3,425	3,534	3,400	3,629	.	.	.
annual change in % (real)	4.6	3.1	-4.6	4.3	5.5	3.0	2.5
Gross fixed capital form., EUR m, nom.	1,364	1,352	1,166	1,116	.	.	.
annual change in % (real)	14.7	-1.7	-12.0	-10.3	3.3	5.0	5.0
Gross industrial production 3)							
annual change in % (real)	22.4	-6.3	-0.9	4.9	-14.0	7.0	9.0
Net agricultural production 4)							
annual change in % (real)	3.3	-2.2	1.1	4.0	.	.	.
Construction output							
annual change in % (real)	24.9	10.7	-5.5	-4.8	.	.	.
Employed persons, LFS, th, average 5)	237.4	243.8	219.4	212.6	216	220	226
annual change in %	3.5	2.7	-10.0	.	1.8	2.0	2.5
Unemployed persons, LFS, th, average 5)	42.5	43.4	47.8	42.2	40	40	40
Unemployment rate, LFS, in %, average 5)	15.2	15.1	17.9	16.6	15.3	14.8	14.0
Reg. unemployment rate, in %, eop	17.8	16.2	20.1	24.7	.	.	.
Average monthly gross wages, EUR	766	773	783	793	890	930	970
annual change in % (real, gross)	-2.4	0.6	1.6	-1.1	5.0	1.0	2.0
Average monthly net wages, EUR 6)	511	515	524	532	700	730	760
annual change in % (real, net)	-2.3	0.4	2.1	-0.9	22.8	1.0	1.5
Consumer prices, % p.a.	2.6	0.4	-0.3	2.4	6.4	3.0	2.0
Producer prices in industry, % p.a. 7)	1.7	2.4	-0.1	1.3	6.0	2.0	1.8
General governm. budget, nat. def., % of GDP							
Revenues	42.2	43.4	44.6	43.7	38.0	39.0	40.0
Expenditures	46.2	45.4	55.7	45.5	44.0	43.5	44.0
Deficit (-) / surplus (+)	-3.9	-2.0	-11.1	-1.8	-6.0	-4.5	-4.0
General gov. gross debt, nat. def., % of GDP	70.1	76.5	105.3	85.0	85.5	83.0	82.0
Stock of loans of non-fin. private sector, % p.a.	9.1	6.6	2.9	3.4	.	.	.
Non-performing loans (NPL), in %, eop	6.7	4.7	5.5	6.2	.	.	.
Central bank policy rate, % p.a., eop 8)	5.75	5.46	5.33	5.16	5.3	5.4	5.5
Current account, EUR m	-793	-707	-1,090	-453	-675	-740	-750
Current account, % of GDP	-17.0	-14.3	-26.1	-9.2	-12.5	-12.8	-12.3
Exports of goods, BOP, EUR m	436	466	409	526	440	460	490
annual change in %	14.0	6.8	-12.2	28.7	-17.0	5.0	6.0
Imports of goods, BOP, EUR m	2,485	2,531	2,051	2,440	2,640	2,800	2,940
annual change in %	10.8	1.8	-19.0	19.0	8.0	6.1	5.0
Exports of services, BOP, EUR m	1,563	1,705	679	1,597	1,760	1,880	2,020
annual change in %	13.1	9.1	-60.2	135.1	10.0	7.0	7.7
Imports of services, BOP, EUR m	627	687	503	641	670	690	720
annual change in %	18.1	9.6	-26.8	27.5	5.0	3.5	4.0
FDI liabilities, EUR m	415	372	463	561	.	.	.
FDI assets, EUR m	92	67	-5	9	.	.	.
Gross reserves of CB excl. gold, EUR m 9)	1,050	1,367	1,739	1,749	.	.	.
Gross external debt, EUR m	7,631	8,369	9,381	9,234	10,260	10,730	10,980
Gross external debt, % of GDP	163.7	169.0	224.1	188.0	190.0	185.0	180.0

1) Preliminary and wiiw estimates. - 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.

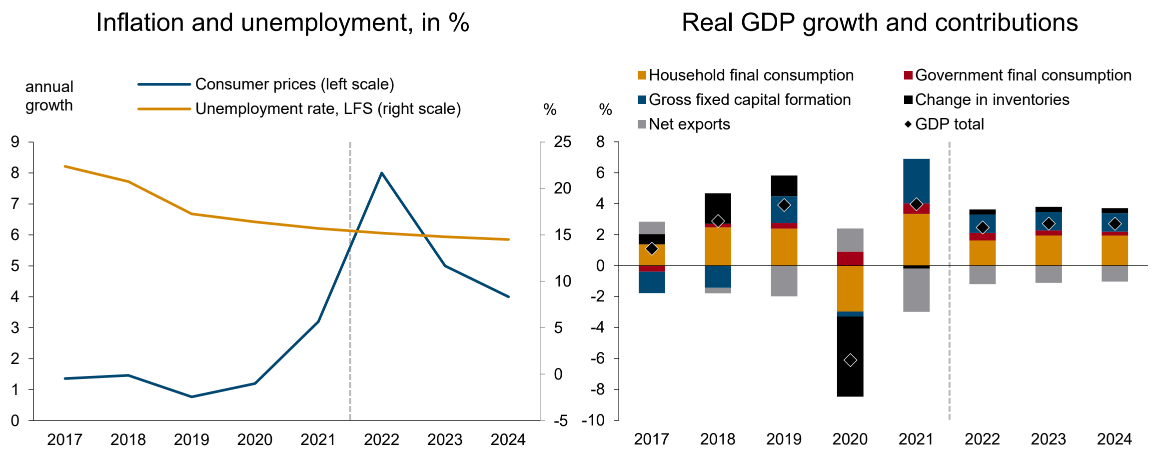
Source: wiiw Databases incorporating national statistics. Forecasts by wiiw.

NORTH MACEDONIA: Too fragile for so many shocks

BRANIMIR JOVANOVIĆ

The country has not yet recovered from the pandemic shock, and now the energy crisis and the war in Ukraine are rubbing salt into its wounds. The economic prospects appear gloomy, with weak growth and elevated inflation. We are revising our GDP projection for 2022 downwards, to 2.5% (from 3.5%); meanwhile, we expect inflation to be higher, at around 8% (from 3.5%).

Figure 4.15 / North Macedonia: Main macroeconomic indicators



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

North Macedonia is one of the few Eastern European economies not to have recovered yet from the pandemic downturn. GDP fell by 6.1% in 2020 and bounced back by just 4% in 2021, meaning that the country is still below its pre-pandemic income level. One of the reasons for this is certainly the inappropriate fiscal support provided by the government: it was poorly targeted and did not reach those who were most affected by the pandemic, but was instead snatched up by the high-profit companies. The bleak results are also due to certain objective factors: the problems faced by the automotive industry globally have also affected the North Macedonian automotive sector.

The situation has been further aggravated by the energy crisis, which struck at the end of 2021. The country had not invested in the energy sector for decades, so that its current level of electricity generation is below the levels seen in Yugoslav times. This has made it heavily dependent on imports, with 63% of its total energy needs coming from abroad (the highest figure in the Western Balkan region). When global electricity prices soared at the end of 2021, North Macedonia found itself in deep trouble. The government cobbled together a plan that consisted of restarting some old coal-fired plants, spending public money on supporting the energy companies (including private ones) and raising the price of electricity. It managed to avoid power cuts, but its fiscal space was eroded.

The rise in the cost of electricity added to the already growing inflation, pushing it to its highest level in 15 years. Annual inflation in March reached 8.8%, and there is no indication that it will slow down any time soon. The government tried to tame it by introducing price controls; but they turned into a textbook example of how *not* to use price controls. First, the prices of basic foodstuffs were frozen in December 2021; but then, just three months later, in March 2022, the emphasis switched to limiting companies' profit margins. This change in strategy resulted in food shortages and panic buying, as both people and firms knew that prices would rise following the switch. To cushion the jump in prices, the government decided to reduce taxes (VAT, excise duties and import tariffs) on food and energy products; but this does not seem to have proved too effective – between February and March, food prices rose by 2.3%, fuel prices by 6.1% and the overall price level by 1.6%.

The negative effects of inflation on the economy are already visible. Purchasing power has been eroded, and average real wages in the country in January were 0.6% lower than a year before. Retail trade (excluding fuel) in January and February saw real growth of just 0.8% year on year, whereas just a few months earlier, in September 2021, it had been growing at a rate of 10.9%. Business sentiment in manufacturing in February 2022 was at its lowest ebb since January 2021, when the country was in the grip of the pandemic. This comes despite the fact that industrial production in January and February 2022 grew by 3.6% year on year.

The war in Ukraine will add to these woes, primarily through the higher price of energy and food. The unavailability of data makes it hard to gauge the effects, but the March price hike, which came despite the reduction in taxes, suggests that prices will continue to rise, eating into real incomes, reducing household consumption and slashing business investment. In addition to the inflation channel, the trade channel may also play a role, leading to reduced exports to the EU. Heightened uncertainty about how the war will unfold may also lead to the postponement of foreign and domestic investment. Direct effects from the war will be small, as both Russia and Ukraine are only small trade and investment partners for North Macedonia.

Remittances from abroad could provide some cushioning, though it will be limited, as the European economies where most of the country's diaspora is located will also slow down. Secondary income in the balance of payments grew by around 40% in 2021, having declined in 2020 by about 20%. As the level in 2021 was very high, and as remittances to North Macedonia are procyclical (i.e. they decline in bad years), we expect them to remain at a similar level in 2022 as in 2021.

Due to the upsurge in inflation, the central bank raised its policy rate to 1.5% in April (from 1.25%), which is the first hike since the onset of the pandemic. The increase is modest, more of a symbolic gesture, and in real terms, the interest rate remains deeply negative. It is unlikely to have any major impact on inflation, though it is likely to push commercial banks' interest rates up, which may slow down the economy a bit. Since the central bank decided to make a move on inflation, one might expect further hikes by the end of the year, though they will be also modest.

To offset the adverse social effects of inflation, the government has raised the minimum wage by roughly 20% from March 2022. While reactions to this have been mostly positive, it has created an obligation on the part of the government to adjust all wages in the public sector to the higher minimum wage, as stipulated in the collective agreement. The government has so far refused to do this, claiming that it would fuel inflation. As a consequence, several trade unions have initiated protests and strikes, including a general strike in schools. It is hard to see at the moment how the situation will develop, but it is possible that the protests will grow and add to the political tensions in the country, which are already high. That would take a further toll on the economy.

One event that heightened the tension – or perhaps just reflected the deep divisions in society – was the announcement of the preliminary results of the census conducted towards the end of 2021. This, the first census since 2002, had been eagerly anticipated for years; but nevertheless, around 7% of residents refused to take part, claiming that it was rigged. Accordingly, the authorities had to use data from the administrative records for these people. In consequence, the census results did not contain information on their ethnic or religious background. This sparked unrest in society, with many ethnic and religious groups denouncing the results.

Leaving that to one side, the census officially confirmed the demographic decline in the country. The resident population of North Macedonia has fallen by about 10% over the past two decades – from 2m in 2002 to 1.8m in 2021. The main economic implication of this decline is that the growth prospects for the country will be lower than previously expected, due to the smaller and contracting labour force. It is also more obvious now that the population is ageing, which places additional strain on the social system. Most of the macroeconomic and social indicators for the country will also be affected by the revised population statistics: GDP per capita is likely to be slightly higher than before; the unemployment rate will be lower; and the poverty rate probably higher.

One potential positive development for the coming period could be the unlocking of the process leading to the country's accession to the EU. Bulgaria famously vetoed the start of accession talks with North Macedonia in December 2020, and since then the process has been stalled. The new Bulgarian prime minister, Kiril Petkov, visited North Macedonia in January 2022, in a move that was widely interpreted as a conciliatory step. Bilateral relations between the two countries have improved over the past few months: among other things, a direct air link between the two capitals has been re-established. The war in Ukraine could act as a catalyst, as the EU tries to limit the scope for Russian interference in the region – and especially if the EU decides to fast-track Ukraine's accession. But uncertainties remain, as many Bulgarian parties continue to oppose any lifting of the veto. Even if the process is unlocked, it is unlikely to have any major short-term effects: the positive impact of the move will be felt mainly over the medium term.

In light of all this, we are revising our GDP forecasts downwards, and our inflation forecasts upwards. For 2022, we now expect GDP to grow by 2.5% (down from the January figure of 3.5%), and inflation to average 8% (up from 3.5%). For 2023 and 2024, we project GDP to grow by 2.7% in both years, and inflation to moderate slightly, to 5% in 2023 and 4% in 2024.

Table 4.15 / North Macedonia: Selected economic indicators

	2018	2019	2020	2021 1)	2022	2023 Forecast	2024
Population, th pers., average	2,076	2,077	2,073	2,072	2,071	2,070	2,069
Gross domestic product, MKD bn, nom.	660.9	692.7	655.9	723.2	800	863	922
annual change in % (real)	2.9	3.9	-6.1	4.0	2.5	2.7	2.7
GDP/capita (EUR at PPP)	11,390	11,940	11,170	11,900	.	.	.
Consumption of households, MKD bn, nom.	429.2	447.1	434.9	469.3	.	.	.
annual change in % (real)	3.8	3.7	-4.6	5.0	2.5	3.0	3.0
Gross fixed capital form., MKD bn, nom.	132.4	145.8	144.8	191.4	.	.	.
annual change in % (real)	-6.4	8.7	-1.6	13.0	4.5	4.5	4.5
Gross industrial production 2)							
annual change in % (real)	5.4	3.7	-9.6	1.4	1.5	2.0	2.0
Gross agricultural production 3)							
annual change in % (real)	10.0	-5.4	1.7	-1.2	.	.	.
Construction industry							
annual change in % (real)	-6.8	3.8	1.4	-11.4	.	.	.
Employed persons, LFS, th, average	759.1	797.7	794.9	795.1	800	800	800
annual change in %	2.5	5.1	-0.3	0.0	0.5	0.5	0.5
Unemployed persons, LFS, th, average	198.6	166.4	155.9	147.9	140	140	140
Unemployment rate, LFS, in %, average	20.7	17.3	16.4	15.7	15.2	14.8	14.5
Reg. unemployment rate, in %, eop	19.3	19.6	25.8	19.7	.	.	.
Average monthly gross wages, MKD	35,626	37,446	40,566	42,887	46,300	49,100	52,100
annual change in % (real, gross)	4.2	4.3	7.0	2.4	0.0	1.0	2.0
Average monthly net wages, MKD	24,276	25,213	27,182	28,718	31,000	32,900	34,900
annual change in % (real, net)	4.4	3.1	6.5	2.3	0.0	1.0	2.0
Consumer prices, % p.a.	1.5	0.8	1.2	3.2	8.0	5.0	4.0
Producer prices in industry, % p.a.	0.9	2.1	0.6	11.1	15.0	4.0	3.0
General governm. budget, nat. def., % of GDP							
Revenues	30.4	31.4	30.5	32.3	31.0	31.0	31.0
Expenditures	31.5	33.5	38.9	37.7	35.0	34.0	33.0
Deficit (-) / surplus (+)	-1.1	-2.1	-8.3	-5.4	-4.0	-3.0	-2.0
General gov. gross debt, nat. def., % of GDP	40.4	40.4	51.9	51.8	55.0	57.0	58.0
Stock of loans of non-fin. private sector, % p.a.	7.2	6.1	4.6	8.2	.	.	
Non-performing loans (NPL), in %, eop	5.1	4.6	3.3	3.2	.	.	
Central bank policy rate, %, p.a., eop 4)	2.50	2.25	1.50	1.25	1.50	2.00	2.00
Current account, EUR m	-7	-368	-366	-416	-880	-940	-1,010
Current account, % of GDP	-0.1	-3.3	-3.4	-3.5	-6.8	-6.7	-6.8
Exports of goods, BOP, EUR m	4,883	5,347	4,817	5,996	7,230	8,240	9,190
annual change in %	19.8	9.5	-9.9	24.5	20.5	14.0	11.5
Imports of goods, BOP, EUR m	6,619	7,296	6,622	8,371	10,170	11,540	12,870
annual change in %	12.9	10.2	-9.2	26.4	21.5	13.5	11.5
Exports of services, BOP, EUR m	1,580	1,625	1,447	1,742	2,070	2,320	2,550
annual change in %	10.2	2.8	-10.9	20.4	19.0	12.0	10.0
Imports of services, BOP, EUR m	1,209	1,289	1,021	1,243	1,480	1,670	1,850
annual change in %	14.1	6.6	-20.8	21.8	19.0	12.5	10.5
FDI liabilities, EUR m	539	488	28	615	.	.	.
FDI assets, EUR m	-65	125	-127	180	.	.	.
Gross reserves of CB excl. gold, EUR m	2,619	2,961	3,019	3,288	.	.	.
Gross external debt, EUR m	7,844	8,154	8,536	9,547	12,200	13,600	14,900
Gross external debt, % of GDP	73.0	72.4	80.3	81.4	94.0	97.0	100.0
Average exchange rate MKD/EUR	61.51	61.50	61.67	61.63	61.7	61.7	61.7

1) Preliminary and wiiw estimates. - 2) Enterprises with 10 and more employees. - 3) wiiw estimate from 2020. - 4) Central Bank bills (28-days).

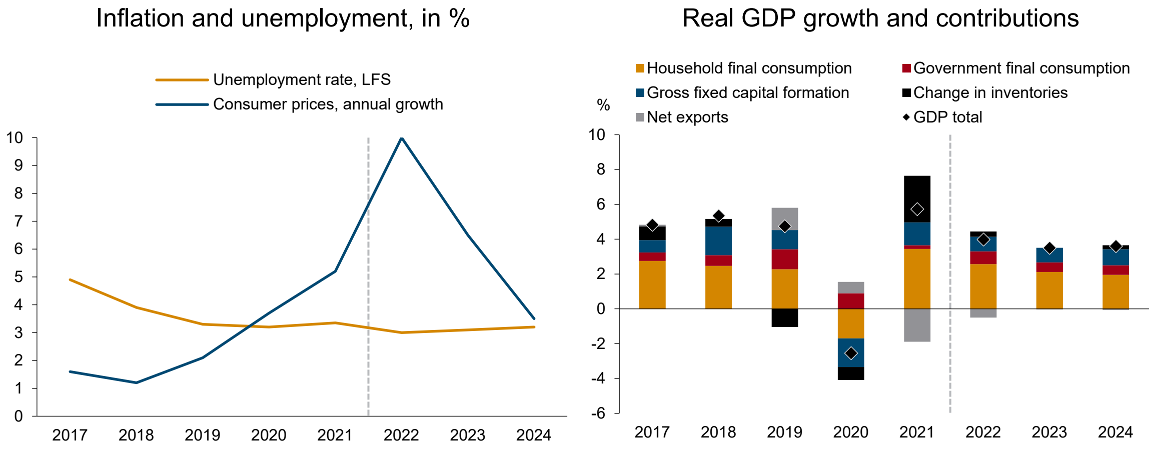
Source: wiiw Databases incorporating national statistics. Forecasts by wiiw.

POLAND: The fight against inflation set to cause collateral damage

ADAM ŻURAWSKI

The Polish economy has proved surprisingly resilient so far. Industry has performed strongly in the first months of 2022, despite the unfavourable conditions. But growth will slow in 2022 and beyond. Rising interest rates are affecting consumption and investment, and inflation is eroding the real value of current incomes. In addition, the export prospects look less promising than before the war. To cap it all, essential imports (e.g. energy, metals) may be in short supply, or else become prohibitively expensive.

Figure 4.16 / Poland: Main macroeconomic indicators



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

Last year saw a strong recovery that, on most counts, recouped the losses caused by the COVID-19 pandemic in 2020. Growth even accelerated in Q4 2021, when GDP rose by 7.3%, household consumption by 7.9%, gross fixed capital formation by close to 12% and exports by 6% (although imports jumped by over 11%).

The data available for the first two months of 2022 suggested a continuation of those recent trends, both positive and negative. Industry performed very well, with a double-digit increase in sales (in real terms), record levels of profitability and high investment activity. Similarly, the construction sector fared very well and merchandise exports rose strongly (albeit trailing far behind imports). On the clearly negative side, inflation – already unusually high in the final months of 2021 – intensified in the first months of 2022: in March, the consumer price index stood at 10.9%.

In March, the government lifted all COVID restrictions, thereby declaring victory over the pandemic. In fact, this is a rather Pyrrhic victory: since March 2020, the nation has suffered over 115,000 COVID-related deaths (as well as innumerable further fatalities, due to the inability of the overcrowded hospitals to treat cancer, cardiac and other emergency cases). In all probability, it is far too early to celebrate the end of the pandemic: it may yet return and play havoc again. The massive influx of refugees from Ukraine, where the vaccination rates are even lower than in Poland, increases the risk to public health.

Over 2.5m refugees have crossed into Poland from Ukraine since the Russian invasion of that country. It is roughly estimated that about half a million of them have since moved on to other countries (or back to Ukraine). Ordinary Poles – and the local authorities across the country – have been welcoming, and have assisted the refugees in exemplary fashion. The central government has also helped in terms of administrative measures (e.g. by granting them access to the labour market and social services) and financially (e.g. providing certain social security benefits).

The inflow of Ukrainians is unlikely to have much impact on the labour market, since most of the refugees are women with children or the elderly. Moreover, there is some evidence that those Ukrainian males who were working in Poland prior to the war are returning to their own country now. This will affect some male-dominated sectors, such as construction. On balance, the total labour supply may remain much the same, at least in the short-to-medium term.

The refugee influx is creating some longer-term problems. The provision of additional adequate housing cannot be achieved fast enough. Nor will the integration of refugee children into the local education system be without its difficulties. Also, there must be a question mark over the public health system, which was creaking even before the war. Moderating the strain caused by the influx will require rather a lot of extra money. And that will further expand the fiscal deficit – even if the EU and the US assist with donations.

The government does not conceal its fairly illiberal inclinations in terms of the treatment of the media, the judicial system, sexual minorities, the rights of women, the alleged bugging of the opposition, etc. The government, though hostile to Russia, 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 much. The national recovery plan has not yet been approved by Brussels, which is still waiting for Poland to disband the institution created to 'discipline' Poland's judges.

The fiscal system is in disarray. The trumpeted reform of the personal tax system, which has been in place since 1 January 2022, has proved a complete fiasco. Attempts to patch it up have failed, as its internal inconsistencies have become all too obvious. An entirely new system is to be introduced by the middle of the year. In all probability, it will result in a further reduction in total personal tax revenues, thus increasing the public sector deficit. As a consequence, social spending and public investment may have to be reined in – particularly if the awaited EU transfers are withheld.

Inflation is felt to be the major problem, as it apparently undermines the government's claim to be competent at running the economy. In fact, global factors (energy and food prices) are the main culprits, with the state-owned energy and fuels cartels playing second fiddle (through exorbitant markups).

Nonetheless, the government is trying to shield consumers by means of ‘temporary’ cuts to VAT and excise tax rates. Clearly, this will do nothing to improve the overall fiscal balance of the public sector.

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 the rising inflation. Only in October, as the vocal expressions of concern by 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, in April, the rate stands at 4.5%, and it looks as though the trend will continue. Naturally, it will not do much (if anything) to help with inflation (which is primarily imported), at least over a meaningful time horizon. 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 negatively affect investment and consumer spending, but will not necessarily have much impact on the PLN exchange rate. (The invasion of Ukraine led to panic, which resulted in a very strong depreciation of the PLN; the NBP responded with a small-scale forex intervention that proved sufficient to prevent the slide. Currently the PLN trades at rates not much different from the pre-war levels.)

The economy has proved surprisingly resilient so far. As evidenced by the performance of industry and construction in the first months of the year, it has withstood fairly well the failed experiments with the tax system, the rising cost of energy, the shortages of certain critical imported production inputs, and even the first steps of a more hawkish monetary policy.

Growth is expected to slow in 2022 and beyond. Apart from the negative impact of rising interest rates on consumption and investment, inflation is eroding the purchasing power of current incomes. This will restrict domestic aggregate demand. In addition, the prospects for exports now look less rosy than before the war. Certainly, exports to Russia and Belarus will be dramatically reduced. In addition, essential imported raw materials (whether energy carriers or some metals) may be in short supply, or could become prohibitively expensive. All these factors suggest that growth in 2022 and 2023 will be less impressive than in 2021.

Table 4.16 / Poland: Selected economic indicators

	2018	2019	2020	2021 1)	2022	2023	2024
						Forecast	
Population, th pers., average	38,423	38,397	38,324	38,370	38,360	38,360	38,370
Gross domestic product, PLN bn, nom.	2,122	2,293	2,327	2,603	2,950	3,240	3,470
annual change in % (real)	5.4	4.7	-2.5	5.7	4.0	3.5	3.6
GDP/capita (EUR at PPP)	21,420	22,740	22,640	24,810	.	.	.
Consumption of households, PLN bn, nom.	1,221	1,299	1,301	1,454	.	.	.
annual change in % (real)	4.3	4.0	-3.0	6.2	4.6	3.8	3.5
Gross fixed capital form., PLN bn, nom.	386	420	386	433	.	.	.
annual change in % (real)	9.4	6.1	-9.0	7.9	5.0	5.0	5.5
Gross industrial production (sales) 2)							
annual change in % (real)	5.9	4.1	-1.2	14.5	6.5	5.0	5.0
Gross agricultural production							
annual change in % (real)	-0.4	-0.9	8.0	-0.7	.	.	.
Construction industry 2)							
annual change in % (real)	19.7	3.7	-3.5	1.5	.	.	.
Employed persons, LFS, th, average 3)	16,484	16,461	16,442	16,656	16,740	16,870	17,000
annual change in %	0.4	-0.1	-0.1	2.6	0.5	0.8	0.8
Unemployed persons, LFS, th, average 3)	659	558	537	580	520	540	560
Unemployment rate, LFS, in %, average 3)	3.9	3.3	3.2	3.4	3.0	3.1	3.2
Reg. unemployment rate, in %, eop	5.8	5.2	6.3	5.4	.	.	.
Average monthly gross wages, PLN 4)	4,590	4,920	5,226	5,663	6,420	7,080	7,580
annual change in % (real, gross)	5.4	4.8	2.9	3.0	3.0	3.5	3.5
Consumer prices (HICP), % p.a.	1.2	2.1	3.7	5.2	10.0	6.5	3.5
Producer prices in industry, % p.a.	2.1	1.3	-0.5	8.1	9.0	6.0	3.0
General governm. budget, EU def., % of GDP							
Revenues	41.3	41.0	41.5	40.0	41.0	39.0	41.5
Expenditures	41.5	41.8	48.7	45.5	46.0	43.0	44.5
Net lending (+) / net borrowing (-)	-0.2	-0.7	-7.1	-5.5	-5.0	-4.0	-3.0
General gov. gross debt, EU def., % of GDP	48.8	45.6	57.4	59.8	59.6	59.3	59.0
Stock of loans of non-fin. private sector, % p.a.	7.1	4.7	0.4	4.6	.	.	.
Non-performing loans (NPL), in %, eop	6.9	6.7	7.0	5.8	.	.	.
Central bank policy rate, % p.a., eop 5)	1.50	1.50	0.10	1.75	5.25	4.50	3.25
Current account, EUR m 6)	-6,513	2,520	15,293	-3,540	-4,900	-3,500	-2,900
Current account, % of GDP 6)	-1.3	0.5	2.9	-0.6	-0.8	-0.5	-0.4
Exports of goods, BOP, EUR m 6)	217,110	232,930	236,002	280,337	308,400	351,600	383,200
annual change in %	7.4	7.3	1.3	18.8	10.0	14.0	9.0
Imports of goods, BOP, EUR m 6)	223,330	231,403	223,523	280,936	314,600	362,100	394,700
annual change in %	10.3	3.6	-3.4	25.7	12.0	15.1	9.0
Exports of services, BOP, EUR m 6)	57,780	62,749	58,056	68,160	72,900	81,300	87,800
annual change in %	13.0	8.6	-7.5	17.4	7.0	11.5	8.0
Imports of services, BOP, EUR m 6)	36,508	38,883	35,220	41,738	44,200	49,300	55,200
annual change in %	9.8	6.5	-9.4	18.5	6.0	11.5	12.0
FDI liabilities, EUR m 6)	14,809	14,976	15,192	27,925	24,000	22,000	26,000
FDI assets, EUR m 6)	1,954	4,593	4,055	7,066	6,000	4,000	8,000
Gross reserves of CB excl. gold, EUR m	97,633	104,526	114,299	134,654	.	.	.
Gross external debt, EUR m 6)	316,683	316,569	305,694	320,374	336,200	359,200	362,100
Gross external debt, % of GDP 6)	63.6	59.3	58.4	56.2	53.0	51.0	48.0
Average exchange rate PLN/EUR	4.2615	4.2976	4.4430	4.5652	4.65	4.60	4.60

1) Preliminary and wiiw estimates. - 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.

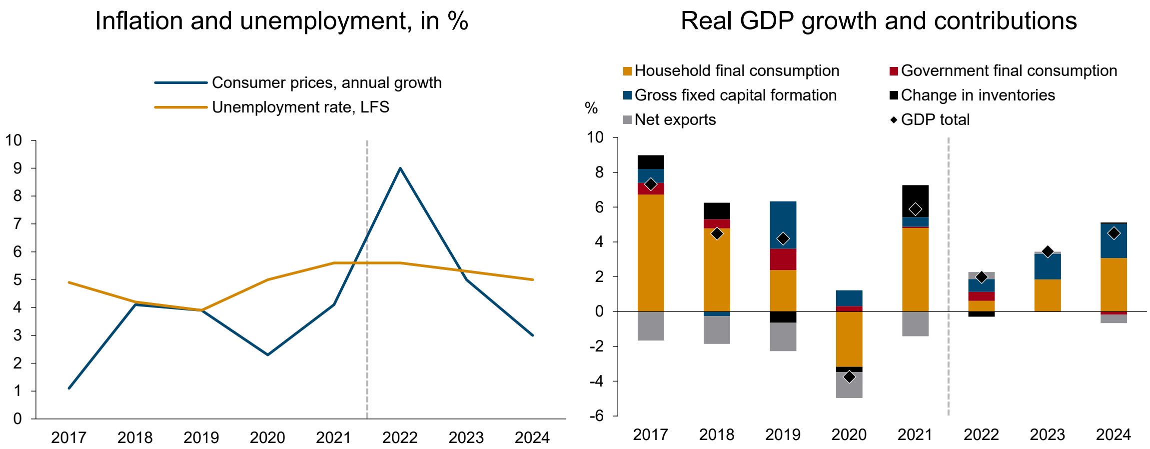
Source: wiiw Databases incorporating Eurostat and national statistics. Forecasts by wiiw.

ROMANIA: On the bumpy road to readjustment

GÁBOR HUNYA

Romania's energy and trade dependence on Russia and Ukraine is relatively modest, but still the energy price shocks and supply-chain disruptions have set back its economic performance. GDP will grow by no more than 2% in 2022, despite the generous inflows of EU funds. Inflation will rise to 9% on average, which will depress household demand. Currency devaluation will be modest, due to the central bank's interventions on the currency market.

Figure 4.17 / Romania: Main macroeconomic indicators



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

Romania's economic growth in 2021 was 5.9% – below the wiiw forecast. GDP expanded rapidly in the first half of the year, mainly on account of base effects; but that was followed by stagnation in the second half. Fiscal consolidation curtailed demand and investment, while the external balance saw a deterioration. Soaring energy prices and supply-chain bottlenecks depressed the economy months before the Russian attack on Ukraine. Thus, the huge challenges presented by the war came on top of pre-existing woes.

The international price shock hit Romanian producers and consumers back in September 2021. For household consumers, this only added to the energy price increases that came in the wake of price liberalisation at the beginning of the year. To put people out of their misery, the retail price of electricity and gas supplied to households and smaller business consumers was capped in October. Higher caps have since been introduced, to run from April 2022 until the end of the year. This move is to be funded from taxes levied on the extra profits of the electricity companies.

Inflation has been on the rise since Q3 2021 and will reach about 9% on average in 2022. The central bank has made modest upward adjustments to the policy rate, which currently stands at 3%, but may rise to 4% in the course of the year. Despite negative real interest rates, financial conditions have tightened, and consumer lending weakened in Q1 2022. The national currency has been pretty stable, losing only 1% against the euro between the start of the year and early April, and it displayed only a minor reaction to the outbreak of the war. The central bank is following a policy of managed flotation, making interventions when it considers it necessary to keep the exchange rate stable. As a result, euroisation has been on the decline in recent years. (This policy stands in contrast to that of countries such as Hungary, which follows pure inflation targeting.)

Romania's trade dependence on those countries involved in the war is generally fairly small, though it is relatively significant in specific industries. In 2021, 1.3% of Romania's exports went to Russia and 0.8% to Ukraine. Romania supplied mainly finished or processed products to these markets. The dependence is stronger on the import side: 2.3% of the country's imports originated in Russia and 1.2% in Ukraine. Romania's energy dependence on Russia increased in 2021, when it got access to abundant gas deliveries through TurkStream. In 2021, the country's overall dependence on energy imports stood at 45% – 69% for oil and 28% for natural gas. Its gas dependence is much lower than the EU average and could in future be substituted by local production: the Black Sea Oil & Gas consortium (owned by Carlyle International Energy Partners and the European Bank for Reconstruction and Development) could commence extraction operations in 2022, while Romgaz (in partnership with OMV Petrom) could also be ready in a few years' time. The implementation of major new investments and the start of extraction will depend on the government undertaking to reduce the excessive offshore tax, which has so far delayed exploitation by some four years.

Those sectors worst affected by the war are the metallurgical, automotive and furniture industries. Car manufacturer Dacia is the largest exporter – both overall and to Russia. This Renault subsidiary has lost markets and is also missing components that should have been delivered from Russia. Since Renault is withdrawing from Russia, the value chains will have to be completely reorganised. The furniture industry is facing reduced deliveries of wood from Ukraine and the loss of markets in Russia. Bottlenecks have also appeared in other economic branches: construction work has been hampered by the lack of steel and cement, usually supplied from Ukraine. Russian-owned companies face additional problems. The accounts of TMK-Artrom – one of the largest industrial pipe producers in Romania and Europe, and until recently owned by a Russian oligarch – have been frozen. The high cost of energy has led to production being cut in another Russian-owned company, Alro, a big aluminium producer and Romania's single largest consumer of electricity. Moreover, this company may also be hit by sanctions on Russian multinationals owned by oligarchs.

The repercussions of the war in neighbouring Ukraine have affected the workforce. When production was curtailed in the Dacia factories, workers voiced their discontent over falling wages. The authorities expect up to 30,000 employees of larger companies to be affected by redundancy. They will be eligible to receive 75% of their gross wages from the state budget (up to 75% of the gross average wage) – just like those workers affected by the pandemic. A modest increase in unemployment is to be expected, alongside a drop in household demand. Two further consequences are that the wage-price spiral that evolved at the start of 2022 will come to an end, and the 100,000 non-EU workers who are expected may not arrive – or else may come from Ukraine, rather than Asia.

Romania is one of the main transit countries for refugees from Ukraine and for aid deliveries to the war zones. Of the 515,000 or more Ukrainian citizens who had entered the country up to the end of March, some 79,000 had decided to stay in Romania. Local and international organisations are taking care of the refugees, and some of them have joined the local labour force, finding employment in the service sector. Romania is sending aid to Ukraine, including military equipment, along with other NATO countries. Important support is also being given to neighbouring Moldova, which has shouldered a disproportionately large burden of refugees and is enduring severe supply-chain bottlenecks. Commercial consignments of Moldovan exports have been redirected from the seaport of Odesa in Ukraine to Constanța in Romania. The Romanian government has started to eliminate those bottlenecks in the connecting infrastructure that have been hindering rapid access to the port.

Economic growth will slow to 2% at best in 2022. Real wages will stagnate and household consumption will be sluggish in an inflationary environment of 9% on average. The government will temporarily suspend fiscal consolidation. A social and economic support package to compensate for the effects of soaring inflation will come into force on 1 May. The package is worth 1.2% of GDP, and half of its costs will be financed from EU funds. It will provide income support to about half of the population and will benefit a wide range of small and medium-sized businesses and other companies. Gross fixed capital formation will again expand in 2022, according to the government's ambitious investment plans, which will mainly be financed by EU funds. Romania has already received 13% of the NextGenerationEU funds, and further instalments are due on top of the funds it will receive from the multiannual financial framework. As a side-effect of the war, services exports will receive a boost from the diversion of international trade routes from Ukraine and Moldova to Romanian harbours and transit routes. In agriculture, crop yields could be boosted to replace some of Ukraine's lost exports. The impact of further sanctions on Russia – above all, the European oil and gas import embargo – is the most severe downside risk to growth and is an upside risk for inflation. There could be a significant negative impact from falling demand for Romanian products on shrinking EU markets.

Next year may witness higher growth and lower inflation under a 'new normal'. The economy will continue along the road of bumpy adjustment to elevated energy prices and the loss of Russian and Ukrainian suppliers and markets. Increased energy self-sufficiency – based on offshore gas fields, reopened coal mines and new solar park investments – will render the country less vulnerable. Romania may attract foreign investments that leave Russia and Ukraine, and could benefit from the potential reconstruction of war-torn areas.

Table 4.17 / Romania: Selected economic indicators

	2018	2019	2020	2021 1)	2022	2023 Forecast	2024
Population, th pers., average	19,474	19,372	19,258	19,250	19,200	19,100	19,000
Gross domestic product, RON bn, nom.	951.7	1,059.0	1,058.9	1,181.9	1,330	1,440	1,570
annual change in % (real)	4.5	4.2	-3.7	5.9	2.0	3.5	4.5
GDP/capita (EUR at PPP)	19,900	21,670	21,500	23,540	.	.	.
Consumption of households, RON bn, nom.	599.4	655.8	637.3	726.1	.	.	.
annual change in % (real)	7.6	3.8	-5.1	8.0	1.0	3.0	5.0
Gross fixed capital form., RON bn, nom.	200.4	239.4	252.5	285.0	.	.	.
annual change in % (real)	-1.1	12.9	4.1	2.3	3.0	6.0	8.0
Gross industrial production 2)							
annual change in % (real)	3.5	-2.3	-9.2	7.1	1.0	4.0	5.0
Gross agricultural production							
annual change in % (real)	7.2	-3.8	-15.4	16.9	.	.	.
Construction industry 2)							
annual change in % (real)	-4.1	27.6	15.9	-0.6	.	.	.
Employed persons, LFS, th, average 3)	8,689	8,680	8,521	7,756	7,780	7,780	7,780
annual change in %	0.2	-0.1	-1.8	0.7	0.3	0.0	0.0
Unemployed persons, LFS, th, average 3)	380	353	452	459	460	440	410
Unemployment rate, LFS, in %, average 3)	4.2	3.9	5.0	5.6	5.6	5.3	5.0
Reg. unemployment rate, in %, eop	3.3	3.0	3.4	2.7	.	.	.
Average monthly gross wages, RON 4)	4,357	4,853	5,213	5,583	6,100	6,600	7,000
annual change in % (real, gross)	8.0	7.3	4.7	1.9	0.0	3.0	3.0
Average monthly net wages, RON	2,642	2,986	3,217	3,445	3,800	4,100	4,300
annual change in % (real, net)	8.0	8.8	4.9	1.9	0.0	3.0	3.0
Consumer prices (HICP), % p.a.	4.1	3.9	2.3	4.1	9.0	5.0	3.0
Producer prices in industry, % p.a.	5.1	3.8	0.0	14.9	20.0	3.0	3.0
General governm. budget, EU def., % of GDP							
Revenues	32.0	31.9	32.7	34.0	33.0	34.0	34.0
Expenditures	34.9	36.3	42.0	41.0	40.0	39.0	38.0
Net lending (+) / net borrowing (-)	-2.9	-4.4	-9.3	-7.0	-7.0	-5.0	-4.0
General gov. gross debt, EU def., % of GDP	34.7	35.3	47.2	49.0	51.0	51.0	50.0
Stock of loans of non-fin. private sector, % p.a.	7.9	7.0	5.0	14.3	.	.	.
Non-performing loans (NPL), in %, eop	5.0	4.1	3.8	3.4	.	.	.
Central bank policy rate, % p.a., eop 5)	2.50	2.50	1.50	1.75	3.50	3.00	2.00
Current account, EUR m	-9,497	-10,906	-10,893	-16,723	-18,700	-17,600	-18,200
Current account, % of GDP	-4.6	-4.9	-5.0	-7.0	-7.0	-6.2	-5.9
Exports of goods, BOP, EUR m	61,814	63,056	57,532	70,170	74,400	79,600	84,400
annual change in %	8.1	2.0	-8.8	22.0	6.0	7.0	6.0
Imports of goods, BOP, EUR m	77,153	80,900	76,476	93,324	101,700	107,800	114,300
annual change in %	10.3	4.9	-5.5	22.0	9.0	6.0	6.0
Exports of services, BOP, EUR m	23,791	27,058	23,764	27,909	30,700	33,200	35,900
annual change in %	9.5	13.7	-12.2	17.4	10.0	8.0	8.0
Imports of services, BOP, EUR m	15,431	18,408	14,321	18,343	19,300	20,800	22,500
annual change in %	13.9	19.3	-22.2	28.1	5.0	8.0	8.0
FDI liabilities, EUR m	6,205	6,574	3,056	8,813	.	.	.
FDI assets, EUR m	1,259	1,721	112	1,508	.	.	.
Gross reserves of CB excl. gold, EUR m	33,065	32,927	37,379	40,475	.	.	.
Gross external debt, EUR m	99,841	109,783	126,750	134,617	150,000	160,000	170,000
Gross external debt, % of GDP	48.8	49.2	57.9	56.1	56.4	56.1	55.2
Average exchange rate RON/EUR	4.6540	4.7453	4.8383	4.9215	5.00	5.05	5.10

1) Preliminary and wiiw estimates. - 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) Average gross wages include the employers' social security contribution. - 5) One-week repo rate.

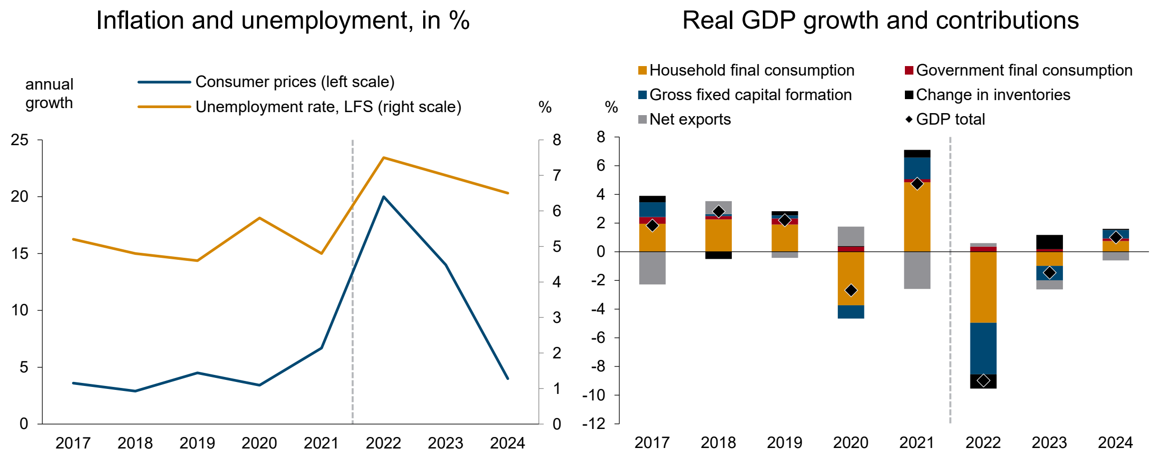
Source: wiiw Databases incorporating Eurostat and national statistics. Forecasts by wiiw.

RUSSIA: Entering the deepest crisis since the early nineties[37]

VASILY ASTROV

Tough Western sanctions in response to the Russian invasion of Ukraine will push the economy into deep recession this year and possibly next. Thanks to wide-ranging capital controls and monetary policy tightening, financial stability has been restored, and the rouble has recovered to nearly pre-war levels. However, the full effect of trade sanctions has yet to unfold and, along with the withdrawal of many foreign firms, this will hamper long-term growth prospects.

Figure 4.18 / Russia: Main macroeconomic indicators



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

Last year, the economy successfully emerged from the COVID-related slump. Real GDP, household consumption and gross fixed capital formation (GFCF) exceeded the pre-pandemic levels of 2019 by 2-3 percentage points (pp), while unemployment receded to 2018 levels. By contrast, real exports did not recover fully, largely on account of the OPEC+ oil production quotas, which were relaxed only gradually. However, in value terms, merchandise exports soared by nearly 50% on the back of strongly rising energy prices; the current account surplus climbed to 6.9% of GDP; and the government budget moved back into surplus. High-frequency data suggest that the strong growth momentum continued unabated in the first two months of 2022. Industrial production was up 8.6% in January and 6.3% in February (year on year), whereas retail sales expanded by 3.6% and 5.9%, respectively. On a negative note, inflationary pressures picked up markedly as well: by February, consumer price inflation had climbed to 9.2% on an annual basis. This was not confined to food and energy, but was largely broad-based, suggesting some degree of overheating of the economy.

37 The author thanks Artem Kochnev, wiiw, for his valuable suggestions.

The Western sanctions in response to the Russian invasion of Ukraine have put an end to this recovery. The sanctions imposed have been quite unprecedented in terms of their scope and the speed with which they have been implemented. They have been coordinated between the EU and other Western countries, notably the US and the UK, and a number of East Asian countries have joined at least some of them. From the economic point of view, the most painful measures have arguably been the freezing of the Central Bank of Russia's (CBR) assets held in Western jurisdictions; the blocking sanctions against some of the biggest Russian banks and their removal from the SWIFT payment system; and the wide-ranging export bans on high-tech products, such as semiconductors, machinery and transport equipment, parts and components for the aviation industry, telecom and IT security devices, sensors, laser equipment, and jet and marine engines. The US and the UK have also imposed an import embargo on Russian energy, while the EU has banned the import of Russian coal, steel and timber, with the possibility of an oil embargo under discussion at the time of writing. Besides, Russia's most-favoured-nation status in trade has been revoked by certain Western countries, and some of them have imposed a 35% tariff on imports from Russia. On top of that, many Western and East Asian companies have stopped exporting to Russia and/or have announced their withdrawal from the country.[38] Russia has retaliated, inter alia, by discriminating against foreign-based entities and individuals from 'unfriendly' jurisdictions in financial transactions, and by preparing legislation on the 'external management' of the assets of some of the companies that are leaving Russia.

The central bank has resorted to wide-ranging capital controls and sharp monetary tightening. Russia was reasonably well prepared for at least some of the sanctions. For instance, since 2014 it has been developing its own payment system, SPFS, which can take the place of SWIFT in domestic and at least some cross-border payments. However, the freezing of nearly half of its foreign reserves (USD 300bn out of USD 643bn) came as a shock and has reduced the scope for foreign exchange interventions. In these circumstances, the CBR had little choice but to resort to capital controls. These have included, inter alia, restrictions on the purchase of foreign currency and its withdrawal from FOREX-denominated accounts; caps on money transfers abroad; and the opportunity for domestic borrowers to service FOREX-denominated debts in roubles. Besides, the policy rate has been hiked to 20% (from 9.5%), and an 80% surrender requirement on the proceeds from exports has been introduced. Also, the CBR has softened the regulatory requirements on banks, making it possible for them to book assets on their balance sheets at pre-war valuations.

These measures, in combination with high energy revenues, have prevented a run on the banks and have helped restore financial stability. The liquidity of the banking sector, which dried up initially, has now been restored, and the financial markets have gradually reopened (albeit with heavy restrictions). Probably the most visible sign of financial stabilisation has been the recovery of the rouble, which, having lost nearly half of its value in the first few weeks of the war, has rallied to the pre-war levels of 75-80 RUB/USD at the time of writing. Although remarkable, this recovery may not be as telling as it first appears, given that it comes on the back of pervasive capital controls and thin trading volumes; nevertheless, a strong rouble – if sustained over the coming months – will help contain inflation via import prices (even if it is unable to offset the negative impact of trade sanctions reducing the supply of imports). These achievements allowed the CBR to relax some of its policies from 8 April: this has included a certain liberalisation of capital controls and a reduction in the policy rate to 17%.

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38 At the time of writing, around 600 Western companies have announced their withdrawal or suspended their operations in Russia, and a further 200 or more have deferred further investment or scaled back operations.

By contrast, the fiscal response to the unfolding crisis has so far been very modest. The government is largely using support mechanisms similar to those introduced during the COVID-19 pandemic: regulatory easing, subsidies for small and medium-sized businesses, financial support for low-income families and pensioners, and credit lines to regional budgets. However, the stimulus package announced so far is much smaller and amounts to only 2.4% of GDP at the time of writing.[39] Pensions and public-sector wages were raised by 8.6% from April, but this is still much less than the inflation recorded in just the first three months of 2022 (9.9%), making further upgrades to the government package highly likely. But probably more importantly, demand-side measures are not very well suited to addressing the root causes of the unfolding crisis, which are largely supply-side in nature. For instance, they cannot fix the disruptions to cross-border value chains arising from the Western trade sanctions and the withdrawal of foreign firms.

The impact of sanctions on the real economy has so far been relatively modest and largely confined to a sharp acceleration in inflation. In March alone, consumer prices jumped by 7.6%, bringing inflation to 16.7% on an annual basis. Unlike in previous months, this time around it was the prices of non-food products that were the main driver of inflation (+20.3% on an annual basis), although food prices also picked up markedly (by 18%). The short-lived rouble depreciation was only one factor in the sharp acceleration in inflation. Another, more durable, factor has been the trade sanctions. On the one hand, the export bans and voluntary export restrictions by Western companies have affected the import of final goods into Russia, such as cars and consumer electronics, and have encouraged stockpiling. On the other hand, they have reduced the supply of imported intermediates, thereby undermining domestic production. The more limited choice of suppliers has increased the market power of those that remain (including those from China), resulting in higher prices and deadweight welfare costs. A similar effect can be observed in air travel. After Western countries and Russia closed their airspace to each other and Russian airlines stopped flying to non-Western destinations to avoid the impounding of planes leased from abroad, the price of air tickets soared, doubling in some instances.

However, the full effect of Western sanctions has yet to unfold and will be increasingly felt in the months to come. One indication of this is the recent sharp downturn in business sentiment. The S&P Services Purchasing Managers' Index (PMI) plunged from 52.1 in February to 38.1 in March.[40] The Manufacturing PMI recorded a much smaller decline (from 48.6 to 44.1), but that was still the steepest fall since May 2020. With the full effect of trade sanctions yet to unfold, supply shortages and higher prices will be felt for an increasing range of products – even if the one-off spike observed in March is unlikely to be repeated. For the whole year, consumer prices may pick up on average by around 20%, eating into real incomes. With the imminent laying off of at least some of the labour force previously employed by Western companies, unemployment will rise, too, probably reaching 7-8% this year on an annual average basis. The sharp rise in borrowing costs following monetary policy tightening will kill off the demand for credit, which has been an important driver of domestic demand up until now. Exports will suffer on account of both Western import bans and Russia's own export restrictions (such as on wheat). However, with imports falling even more, real net exports will contribute positively to GDP growth this year.

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39 For more details on the package announced, see 'Russia's invasion of Ukraine: Assessment of the humanitarian, economic and financial impact in the short and medium term', wiiw Policy Note No. 59, April 2022, p. 29.

40 A reading of above 50 indicates an expansion compared to the previous month; below 50 represents a contraction.

All in all, the economy will slide into deep recession this year, while 2023 may post another GDP contraction. In the baseline scenario, which crucially assumes no major further strengthening of Western sanctions, and above all no EU embargo on Russian oil and gas, we project real GDP to shrink by 9% this year. Unlike during the financial crises of 1998 and 2008-2009, which both witnessed sharp economic downturns followed by swift recoveries, a V-shaped recovery is unlikely this time around. With many of the sanctions likely to stay in place (barring a change in Russia's political regime, which still appears unlikely), the economic dynamics this year and thereafter will be rather L-shaped. In addition, the still strong showing of the economy in the first quarter of 2022 may create a high base effect, resulting in another, albeit shallower, recession next year.

Russia's long-term growth potential has been undermined as well. As things stand now, Russia will be largely cut off from the opportunity to import technology and high-tech goods from top producers and leaders in the advanced industries. Increased trade and investment cooperation with China (and other countries in Asia and Latin America) will provide some relief, but will hardly compensate fully for the disruption of Russia's economic ties with the West. Reduced access to advanced technologies means that the country will likely remain stuck with the parameters that have constrained its economic growth over the past decade: low levels of investment,[41] together with its generally low productivity. For these reasons, Russia's long-term growth is likely to remain below the global average, resulting in its increasing backwardness compared to the rest of the world. To make matters worse, Russia may lose part of its energy revenues because of the EU's plans to reduce dependence on Russian energy. With an ensuing switch to external (and fiscal) deficits and constraints on external borrowing, the Russian economy may become vulnerable to any future external shocks.

[41] The share of GFCF in Russian GDP in 2010-2020 averaged a mere 21.4%, which is too low to ensure sustainable catching-up with advanced economies.

Table 4.18 / Russia: Selected economic indicators

	2018	2019	2020	2021 1)	2022	2023	2024
						Forecast	
Population, th pers., average	146,831	146,765	146,460	145,825	145,000	144,800	144,700
Gross domestic product, RUB bn, nom.	103,862	109,608	107,315	130,795	148,800	165,700	174,900
annual change in % (real)	2.8	2.2	-2.7	4.7	-9.0	-1.5	1.0
GDP/capita (EUR at PPP)	19,450	19,920	18,920	22,450	.	.	.
Consumption of households, RUB bn, nom.	51,884	56,110	54,120	64,785	.	.	.
annual change in % (real)	4.3	3.8	-7.3	9.6	-10.0	-2.0	1.5
Gross fixed capital form., RUB bn, nom.	21,452	22,911	23,120	26,110	.	.	.
annual change in % (real)	0.6	1.0	-4.4	7.0	-18.0	-5.0	3.0
Gross industrial production 2)							
annual change in % (real)	3.5	3.4	-2.1	5.3	-12.0	2.0	2.5
Gross agricultural production							
annual change in % (real)	-0.2	4.3	1.3	-0.9	.	.	.
Construction output							
annual change in % (real)	6.3	2.1	0.7	6.0	.	.	.
Employed persons, LFS, th, average	72,532	71,933	70,601	71,700	69,550	69,900	70,600
annual change in %	0.3	-0.8	-1.9	1.6	-3.0	0.5	1.0
Unemployed persons, LFS, th, average	3,658	3,465	4,321	3,600	5,200	4,900	4,600
Unemployment rate, LFS, in %, average	4.8	4.6	5.8	4.8	7.5	7.0	6.5
Reg. unemployment rate, in %, eop 3)	0.9	0.9	3.7	1.0	.	.	.
Average monthly gross wages, RUB	43,724	47,867	51,344	56,545	62,400	71,800	76,900
annual change in % (real, gross)	8.5	4.8	3.8	2.9	-8.0	1.0	3.0
Consumer prices, % p.a.	2.9	4.5	3.4	6.7	20.0	14.0	4.0
Producer prices in industry, % p.a. 4)	12.1	2.0	-3.8	24.5	30.0	10.0	5.0
General governm. budget, nat. def., % of GDP							
Revenues	35.9	36.0	35.6	36.8	36.5	37.0	36.5
Expenditures	33.0	34.1	39.6	36.0	39.5	37.0	35.5
Deficit (-) / surplus (+)	2.9	1.9	-4.0	0.8	-3.0	0.0	1.0
General gov. gross debt, nat. def., % of GDP	12.1	12.4	17.6	16.0	17.0	15.0	13.0
Stock of loans of non-fin. private sector, % p.a.	13.9	6.5	12.4	19.8	.	.	.
Non-performing loans (NPL), in %, eop 5)	5.3	6.0	6.1	5.1	.	.	.
Central bank policy rate, % p.a., eop 6)	7.75	6.25	4.25	8.50	14.00	9.00	6.00
Current account, EUR m 7)	98,142	58,518	31,533	103,080	161,000	113,000	102,100
Current account, % of GDP	7.0	3.9	2.4	6.9	10.8	7.5	7.0
Exports of goods, BOP, EUR m 7)	376,612	374,738	291,760	417,102	418,900	370,700	370,700
annual change in %	20.5	-0.5	-22.1	43.0	0.4	-11.5	0.0
Imports of goods, BOP, EUR m 7)	211,127	226,668	209,726	256,766	203,600	204,600	214,800
annual change in %	0.0	7.4	-7.5	22.4	-20.7	0.5	5.0
Exports of services, BOP, EUR m 7)	54,845	55,275	42,080	47,259	45,000	47,200	49,600
annual change in %	7.6	0.8	-23.9	12.3	-4.8	4.9	5.1
Imports of services, BOP, EUR m 7)	80,366	87,954	56,448	63,750	57,300	60,100	63,200
annual change in %	2.1	9.4	-35.8	12.9	-10.1	4.9	5.2
FDI liabilities, EUR m 7)	7,453	28,548	8,296	33,639	.	.	.
FDI assets, EUR m 7)	26,620	19,574	5,117	55,061	.	.	.
Gross reserves of CB excl. gold, EUR m 7)8)	333,617	396,378	372,318	439,693	.	.	.
Gross external debt, EUR m 7)	397,860	438,645	380,540	424,145	476,200	451,900	422,700
Gross external debt, % of GDP	28.3	29.0	29.2	28.3	32.0	30.0	29.0
Average exchange rate RUB/EUR	73.87	72.51	82.39	87.20	100.0	110.0	120.0

Note: Including Crimean Federal District.

1) Preliminary and wiiw estimates. - 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. - 8) Including part of resources of the National Wealth Fund of the Russian Federation.

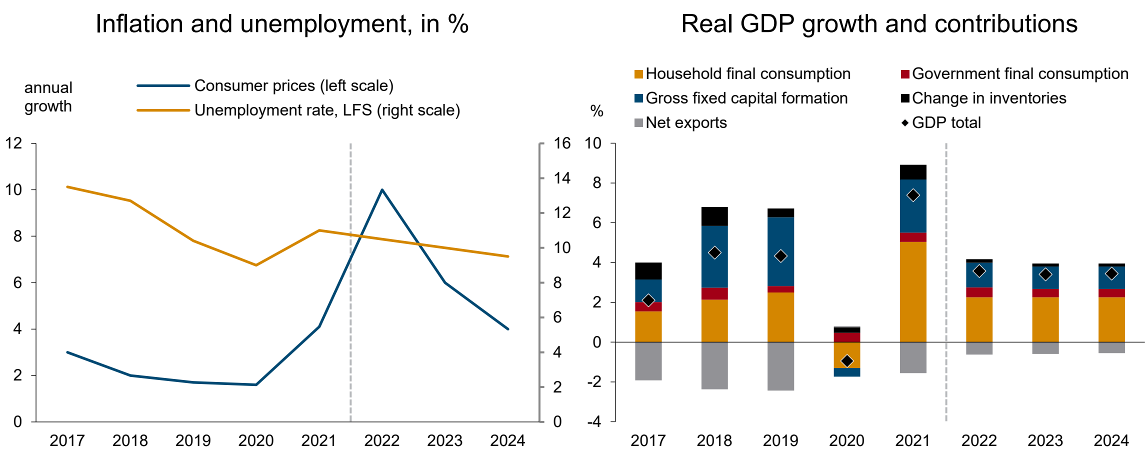
Source: wiiw Databases incorporating national statistics. Forecasts by wiiw.

SERBIA: Walking a tightrope

BRANIMIR JOVANOVIĆ

The war in Ukraine will be costly for Serbia, due to its close relations with Russia. In the short term, the country will face slower economic growth and higher prices: we are revising our GDP forecast for 2022 downwards to 3.6% (from 4.9%) and our inflation forecast upwards to 10% (from 4.5%). But the real challenges facing Serbia stem from its policy of attempting a balancing act between the EU and Russia, which will be hard to maintain in the coming years.

Figure 4.19 / Serbia: Main macroeconomic indicators



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

Serbia's economy weathered the pandemic rather well. GDP declined by just 1% in 2020, and then rebounded strongly in 2021, by 7.5%, making the country one of the best in Europe in terms of its current level of income vis-à-vis the pre-pandemic level. The good results were largely a consequence of the government's sensible economic policies during the pandemic: it spent promptly and it spent big, cushioning the decline in private spending. Total government spending in 2020 and 2021 averaged 48% of GDP, some 7 percentage points (pp) up on the pre-pandemic period. It also continued its ambitious programme of investing in infrastructure, with public investment averaging 6% of GDP during 2020 and 2021. Finally, the country managed to remain attractive to foreign investors even during the pandemic, receiving gross foreign direct investment (FDI) inflows of around 7% of GDP in 2020-2021 (mostly from the EU); this can also be attributed, at least partly, to the government's policies for attracting FDI.

But 2022 started badly. Industrial production contracted by 1.4% year on year in January and February, as a result of the energy crisis. Output in the energy sector (electricity, gas, steam and air conditioning) declined by 22% year on year in the first two months. Inflation reached 8.8% in February, eating away at real incomes. The real growth in the average wage fell to 3.9% in January, and the weaker purchasing power slowed retail trade growth to just 4.3% in January, in real terms (whereas as recently as July 2021 it was growing by 11.8%).

The government tried to tame inflation with price controls, but they do not seem to have had much success. The prices of basic foodstuffs have been frozen since November 2021, but the index of food prices still increased by 3.4% between November 2021 and February 2022. The prices of oil products were capped in February 2022, but the ceilings were set so high that they have not had any real impact.

On top of this came the war in Ukraine. It will affect Serbia more than most other Eastern European countries, due to its close economic and political ties to Russia. Russia ranks among Serbia's top five partners in terms of both FDI and exports. Between 2010 and 2020, the country received EUR 1.5bn in FDI inflows from Russia, which accounts for around 7% of its total FDI. Serbia exported around EUR 900m of goods to Russia in 2021 (mostly food and agricultural products), which made up around 4% of Serbian exports. Both trade and investment flows related Russia will suffer in the coming period as a consequence of the economic downturn there. The fact that Serbia has not imposed sanctions on Russia will not change anything. Russian businesses are suffering right now, and are facing very hostile European markets, so it is unlikely that they will increase their presence in Serbia (away from other countries) or try to use Serbia as a back door to Europe.

Yet, the real challenges for Serbia stem not from these direct and immediate effects, but from its policy of balancing on a tightrope between the EU and Russia. That will be a hard trick to pull off in the coming period, although Serbia will try. Its refusal to impose sanctions on Russia did not receive a warm welcome from the EU; rather, it was regarded as undermining EU efforts to make Russia accountable for its actions. But still, no steps have been taken against Serbia – at least not yet. Serbia has also offered to host any negotiations between Russia and Ukraine, which can be read as an attempt to maintain its current 'balanced' position. It is hard to predict how the situation will evolve, but it is very easy to imagine a scenario in which Serbia will have to pick one side or the other.

Should that occur, the apparent dilemma of 'Russia or the EU' is actually a no-brainer for Serbia, at least from the economic point of view: Serbia derives much greater economic gain from the EU than from Russia. Russia may provide 7% of Serbia's FDI inflows, but the EU supplies 66%; Russia may take 4% of Serbia's exports, but the EU absorbs 65%. And Serbia may have received a favourable price on its Russian gas (USD 270 per 1,000 m^3), which, according to Serbia's President Vučić, saves the country around EUR 300m, but between 2014 and 2020 it received around EUR 1.5bn from the EU's Instrument for Pre-accession Assistance (IPA) II funds.

Of course, political decisions are not always made on economic grounds, and the close political ties between Serbia and Russia may eventually prevail. Russia has been Serbia's biggest ally in the Kosovo dispute, and a large section of the public in Serbia is favourably inclined towards Russia. Because of that, Serbia may now decide to stand with Russia. But if it does, it will pay a hefty economic price – in both the short and the medium term, for it will lose its carefully crafted status as economic leader of the Western Balkans, which it has nurtured for years.

Even if Serbia decides to take the more pragmatic course, siding with the EU and imposing restrictions on Russia, it will still stand to lose. Its economic ties with Russia will be weakened, leading to lower FDI and exports, and higher gas prices. Thus, whatever the outcome of the Serbia-Russia-EU rope trick, it is certain that Serbia will lose out economically, both in the short and the medium term.

The main takeaway from the country's general election in April is that the political landscape remains largely unaltered, although things could start to change soon. As expected, the incumbent president, Aleksandar Vučić, triumphed in the first round of the presidential election; and the coalition he leads won most seats in parliament, so it is clear who will form the next government. But certain opposition parties that boycotted the previous elections have now entered parliament, which will give them greater visibility and voice – something that is very important, given the dire media situation in the country. Furthermore, at the time of writing, the outcome of the elections for the city of Belgrade remains undecided: it could be that the opposition eventually wins the capital, which could spark a turnaround in the political cycle. Thus, although Team Vučić will continue to lead Serbia in the immediate future, the political situation in the country is about to get much more interesting.

Fiscal policy will stay supportive, but less so than over the past two years. The planned deficit for 2022 is 3% of GDP, which signals an intention to achieve gradual consolidation, after the deficits in 2020 and 2021 reached 8.0% and 4.1%. Public spending was front-loaded, ahead of the general elections in April. Total public spending in January and February grew year on year by 20% in real terms (nominally, 30%). This was due to higher pensions and public-sector wages, but also to discretionary spending ahead of the elections (such as the programme to give EUR 100 to every young person in the country). This means that fiscal support in the remainder of the year will be weaker, both because of the end of the spending spree and because of higher inflation, which will erode the real value of the public spending.

For the first time since the start of the pandemic, the central bank raised its base interest rate in April – to 1.5% (from 1%) – prompted by the sharp surge in inflation. We see this as more of a symbolic gesture than a measure that will have any real impact on inflation, since current inflation is clearly supply-driven. Since the central bank has decided to act on inflation, however, we expect further hikes in the interest rate in coming months, as inflation picks up. Though this is unlikely to prevent a further rise in prices, it may have some adverse effects on economic activity.

Bearing all this in mind, we are revising our growth forecast for the coming period downwards and our inflation forecast upwards. GDP growth for 2022 is predicted to slow down to 3.6% (1.3 pp down on the previous forecast), and to continue to slide in 2023 to 3.4% (down 1.1 pp), where it will remain for 2024 (down 0.6 pp). Our inflation forecast for 2022 is revised upwards to 10% (6 pp up on the previous figure); for 2023 it is forecast to be 6% (up 3.5 pp) and for 2024 – 4% (up 1.5 pp). We also note the predominance of downside risks for both GDP and inflation: if there is any escalation of the war in Ukraine, or some EU measures against Serbia, growth will be lower and inflation higher.

Table 4.19 / Serbia: Selected economic indicators

	2018	2019	2020	2021 1)	2022	2023 Forecast	2024
Population, th. pers., mid-year	6,983	6,945	6,899	6,850	6,800	6,750	6,700
Gross domestic product, RSD bn, nom.	5,073	5,422	5,502	6,269	7,100	7,800	8,400
annual change in % (real)	4.5	4.3	-0.9	7.4	3.6	3.4	3.4
GDP/capita (EUR at PPP)	12,020	12,800	12,760	14,130	.	.	.
Consumption of households, RSD bn, nom.	3,463	3,637	3,604	4,035	.	.	.
annual change in % (real)	3.1	3.7	-1.9	7.7	3.5	3.5	3.5
Gross fixed capital form., RSD bn, nom.	1,017	1,218	1,180	1,409	.	.	.
annual change in % (real)	17.5	17.2	-1.9	12.5	5.5	5.0	5.0
Gross industrial production 2)							
annual change in % (real)	1.3	0.3	0.4	6.4	2.5	3.0	3.0
Gross agricultural production							
annual change in % (real)	14.3	-1.2	2.0	-6.0	.	.	.
Construction output							
annual change in % (real)	14.1	35.5	-2.5	13.8	.	.	.
Employed persons, LFS, th, average 3)	2,833	2,901	2,895	2,849	2,860	2,890	2,920
annual change in %	1.4	2.4	-0.2	.	0.5	1.0	1.0
Unemployed persons, LFS, th, average 3)	412	336	287	352	340	320	310
Unemployment rate, LFS, in %, average 3)	12.7	10.4	9.0	11.0	10.5	10.0	9.5
Reg. unemployment rate, in %, eop	20.3	18.7	17.9	17.4	.	.	.
Average monthly gross wages, RSD	68,629	75,814	82,984	90,784	101,900	111,300	120,400
annual change in % (real, gross)	3.9	8.4	7.8	5.2	2.0	3.0	4.0
Average monthly net wages, RSD	49,650	54,919	60,073	65,864	73,900	80,700	87,300
annual change in % (real, net)	4.4	8.5	7.7	5.4	2.0	3.0	4.0
Consumer prices, % p.a.	2.0	1.7	1.6	4.1	10.0	6.0	4.0
Producer prices in industry, % p.a.	0.9	0.6	-1.3	8.7	15.0	5.0	3.5
General governm. budget, nat. def., % of GDP							
Revenues	41.5	42.0	41.0	43.3	43.0	43.0	43.0
Expenditures	40.9	42.2	49.0	47.4	46.5	46.0	45.5
Deficit (-) / surplus (+)	0.6	-0.2	-8.0	-4.1	-3.5	-3.0	-2.5
General gov. gross debt, nat. def., % of GDP	54.4	52.8	57.8	56.5	58.5	60.0	61.5
Stock of loans of non-fin. private sector, % p.a.	9.9	8.9	11.1	10.2	.	.	.
Non-performing loans (NPL), in %, eop	5.7	4.1	3.7	3.5	.	.	.
Central bank policy rate, % p.a., eop 4)	3.0	2.3	1.0	1.0	2.0	2.5	3.0
Current account, EUR m	-2,076	-3,161	-1,929	-2,343	-3,900	-4,500	-5,100
Current account, % of GDP	-4.8	-6.9	-4.1	-4.4	-6.5	-6.8	-7.2
Exports of goods, BOP, EUR m	15,106	16,415	16,079	20,756	25,100	27,900	30,600
annual change in %	7.4	8.7	-2.0	29.1	21.0	11.0	9.5
Imports of goods, BOP, EUR m	20,191	22,038	21,280	26,685	33,100	36,900	40,400
annual change in %	11.8	9.1	-3.4	25.4	24.0	11.5	9.5
Exports of services, BOP, EUR m	6,061	6,934	6,191	7,801	9,300	10,400	11,400
annual change in %	15.5	14.4	-10.7	26.0	19.0	12.0	10.0
Imports of services, BOP, EUR m	5,066	5,922	5,090	6,380	7,500	8,300	9,200
annual change in %	18.4	16.9	-14.1	25.3	17.0	11.0	11.0
FDI liabilities, EUR m	3,464	3,815	3,039	3,863	.	.	.
FDI assets, EUR m	308	264	100	238	.	.	.
Gross reserves of CB, excl. gold, EUR m	10,526	12,042	11,732	14,523	.	.	.
Gross external debt, EUR m	26,662	28,254	30,787	36,536	43,300	48,700	53,600
Gross external debt, % of GDP	62.2	61.4	65.8	68.5	72.0	74.0	76.0
Average exchange rate RSD/EUR	118.27	117.85	117.58	117.57	118.0	118.5	119.0

1) Preliminary and wiiw estimates. - 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.

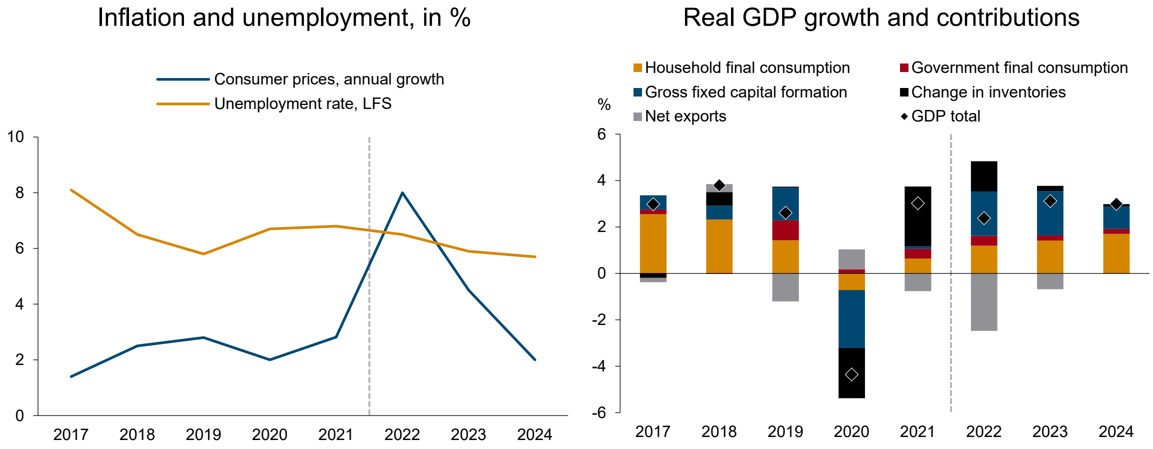
Source: wiiw Databases incorporating national statistics. Forecasts by wiiw.

SLOVAKIA: Yet another blow to the automotive industry

DORIS HANZL-WEISS

By the end of 2021, Slovakia's GDP had still not fully recovered from the COVID-19 pandemic, showing annual growth of only 3%. Growth forecasts have been revised substantially downwards, reflecting the negative impact of the Russian war in Ukraine. Still, the inflow of EU funds should provide some growth impetus at a time of rising risk.

Figure 4.20 / Slovakia: Main macroeconomic indicators



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

The Russian invasion of Ukraine is sending shockwaves around the world and will also have repercussions for Slovakia, which has not yet fully recovered from the COVID-19 pandemic. Slovakia has been welcoming refugees from Ukraine, its immediate neighbour to the east: more than 300,000 crossed the border between 24 February and the start of April. The war will depress Slovak growth prospects through a combination of increased uncertainty and rising prices, and both consumers and investors are likely to be hit. Also, the important automotive industry will be exposed to another external shock – its third, following COVID-19 and the semiconductor shortage – and will see trade links disrupted further. Furthermore, the country's heavy dependence on Russian energy presents a threat to Slovakia's future prospects. A halt to energy imports would push Slovakia's growth into negative territory.

After the COVID-19-induced decline in 2020, GDP increased by 3% in 2021 – much less than expected. Still troubled by waves of the pandemic in the first and the fourth quarters, and by semiconductor shortages throughout the year (which affected the all-important automotive industry), the Slovak recovery in 2021 was less strong than expected. GDP increased by only 3% and has still not reached its 2019 value. If we look at the components of GDP, growth was supported by household consumption, up by 1.1% on the back of pent-up demand. Overall, however, growth was driven largely by an increase in inventories related to the supply-chain bottlenecks. Gross capital formation surged by 15%, while investment (gross fixed capital formation) increased by only 0.6%. Also, government consumption contributed to growth, rising by 1.9%. Net exports had a negative effect on growth: although exports of goods and services increased by 10.2%, imports of goods and services grew by even more (11.2%).

The important automotive industry still faces a rough ride in 2022. The main manufacturing industry in Slovakia – the automotive sector – was troubled by a shortage of semiconductors last year. It experienced ups (March) and downs (August) during the year, but overall grew by 4% year on year. The major automotive companies – Volkswagen Slovakia, KIA Motors Slovakia, Stellantis (previously PSA Peugeot-Citroen) and Jaguar Land Rover – had to either suspend production for several days, cut work shifts or drop certain production lines. Nevertheless, the output of passenger cars did increase slightly, compared to 2020, again reaching 1 million cars in 2021. In the neighbouring countries, passenger car production decreased. Slovakia thus retained its position as the world's number one producer of passenger cars per capita. The automotive industry faces tough conditions in 2022, too: the semiconductor shortage has still not been resolved and will last throughout 2022. Supply-chain disruptions could emerge as a result of outbreaks of COVID-19 in China. The war in Ukraine is also affecting supplies (in particular wiring harnesses) and raw materials. Volkswagen Slovakia, for example, had to suspend production for two days at the end of March, and Jaguar Land Rover for three days at the beginning of April. Thus, industrial production in the automotive sector fell by 3% in the first two months of 2022. In terms of exports, Slovakia has the largest share of its motor vehicle exports (NACE rev.2, 29.1) going to Russia (3.4%). Car parts (NACE rev.2, 29.3) have a lower exposure to Russia, however: only 2.5% of total car parts exports go to that country (compared to 4% to Czechia and Romania). That said, there are differences between the various companies, with KIA being the most exposed: 12% of its cars are exported to Russia.

Household consumption will be supported by an improving labour market, but is threatened by rising inflation. The situation on the labour market improved in the second half of 2021. Overall, however, employment fell by 1.4% in 2021. The services sector was still affected by the pandemic, and employment in accommodation and food services and in arts, entertainment and recreation fell by more than 10%. The unemployment rate declined throughout the year, but was on average slightly higher than in 2020 (6.8% compared to 6.7%). As the labour market reacts with a time lag, the situation will improve this year. There is a fear that the war in Ukraine will mean that Ukrainian workers will return home, leading to the loss of Ukrainian doctors in Slovak hospitals and of Ukrainian workers in the construction sector. The Ukrainian refugees are mainly women and children, and thus will not contribute to any easing of labour shortages. Inflation could threaten consumer sentiment and consumer spending. The Harmonised Index of Consumer Prices (HICP) was up 7.7% in January and 8.3% in February. The outlook for the whole year is grim, with inflation reaching about 8%. Producer prices have surged even more, rising by 21% in January and 28% in February 2022. The cost of electricity is regulated and electricity prices for households are frozen for three years, up to 2024. An 'inflation assistance' scheme is in preparation to help the most vulnerable groups. Another government support just established is financial support for anyone who provides accommodation for Ukrainian refugees.

The good export performance of 2021 – including in car exports – is threatened this year, while imports are skyrocketing as a result of higher prices. Together, these trends are pushing the current account into negative territory. In 2021, goods exports increased by 16.2%, while imports grew by 22.6% – both up on the 2019 figures (as measured by Slovak trade statistics data). Exports stood at a record high in 2021, having recovered from the COVID-19-induced slump of 2020. Car exports were also higher in 2021, despite the shortage of semiconductors hampering the industry that year. Trade in goods with the country's most important trading partners of Germany and the Czech Republic recovered in 2021: exports of goods to Germany increased by 12.5% and to the Czech Republic by almost 30%. Imports from those two countries likewise increased – by 21% and 14%, respectively. In 2021, imports from Russia surged by 63%, so that Slovakia recorded its second-largest trade deficit with Russia. If we look at trade with Ukraine and Russia in more detail, exports to those two countries are fairly limited, accounting for only 0.9% and 1.5% of total exports. While imports from Ukraine are also tiny (0.9%), imports from Russia are important and account for 6.4%. The main import products from Russia are crude oil, natural gas, nuclear fuel, iron ore and coal (used, for example, in U.S. Steel Košice). Slovakia's energy dependence on Russia is the second highest in the EU, with imports from Russia accounting for more than 50% of gross available energy in 2020.[42] Trade data available for January and February 2022 already show the main trends for this year: exports increased by 13.5% and imports by 25%, leading to a trade deficit of EUR 600m already in the first two months.

Inflows of EU funds should promote a recovery in investment, but there are still some problems. Slovakia should benefit this year (and in coming three years) from the increased inflow of EU funds. However, problems have recently emerged relating to projects for the previous programme period 2014-2020 (the final deadline for which is 2023) and concerning money for roads and railways. In addition, regional governors have expressed concern about the low allocation of funds under the new programme period 2021-2027. On the other hand, the chances are better for the disbursement of funds from the EU's Recovery and Resilience Facility: Slovakia's recovery plan is worth EUR 6.3bn, and the first payment request can be made at the end of April, once all the milestones and targets have been met. Of the 14 milestones, 13 have already been met, including university reform and the introduction of budget expenditure caps. Only the new court map, which is part of the judicial reform, is still missing.

The Russian war in Ukraine means that the forecasts for Slovakia have been revised downwards. The wiiw growth forecasts for Slovakia have been revised substantially downwards both for this year and for coming years, due to the growing uncertainty. Slovak GDP is expected to grow by 2.4% in 2022, 3.1% in 2023 and about 3% in 2024. This year, growth should come from household consumption, due to pent-up demand, and also from government consumption. Gross fixed capital formation, which has suffered badly over the past two years, should see a boost, helped along by the inflow of EU funds and the base effect. Net exports will continue to have a negative impact on growth, due to sluggish exports and growing imports. The risks are large and mounting: the Russian war in Ukraine means greater uncertainty, which could drag down consumer sentiment, consumer spending and also investment. The worst scenario would be a halt to energy imports from Russia, which would have severe implications for industry. Finally, the COVID-19 pandemic has moved backstage, but it still affected the economy in the Q1 2022 and is not yet over.

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42 https://ec.europa.eu/eurostat/statistics-explained/index.php?title=EU_energy_mix_and_import_dependency&stable=1 (data extracted 4 March 2022).

Table 4.20 / Slovakia: Selected economic indicators

	2018	2019	2020	2021 1)	2022	2023 Forecast	2024
Population, th pers., average	5,447	5,454	5,459	5,447	5,470	5,475	5,480
Gross domestic product, EUR m, nom.	89,430	94,048	92,079	97,123	107,400	115,700	121,500
annual change in % (real)	3.8	2.6	-4.4	3.0	2.4	3.1	3.0
GDP/capita (EUR at PPP)	21,170	21,750	20,950	21,960	.	.	.
Consumption of households, EUR m, nom.	49,683	52,334	52,748	55,075	.	.	.
annual change in % (real)	4.2	2.6	-1.3	1.1	2.1	2.5	3.0
Gross fixed capital form., EUR m, nom.	18,787	20,296	18,073	18,571	.	.	.
annual change in % (real)	2.8	6.7	-11.6	0.6	10.0	10.0	5.0
Gross industrial production							
annual change in % (real)	4.4	0.4	-9.0	10.4	2.0	5.0	3.0
Gross agricultural production							
annual change in % (real)	-2.4	-4.2	3.4	0.3	.	.	.
Construction industry							
annual change in % (real)	8.5	-3.6	-11.3	-2.0	.	.	.
Employed persons, LFS, th, average 2)	2,567	2,584	2,531	2,561	2590	2630	2660
annual change in %	1.4	0.7	-2.0	-1.4	1.0	1.5	1.0
Unemployed persons, LFS, th, average 2)	180	158	181	188	180	160	160
Unemployment rate, LFS, in %, average 2)	6.5	5.8	6.7	6.8	6.5	5.9	5.7
Reg. unemployment rate, in %, eop	5.0	4.9	7.6	6.8	.	.	.
Average monthly gross wages, EUR	1,013	1,092	1,133	1,211	1290	1370	1440
annual change in % (real, gross)	3.6	5.0	1.9	3.6	-1.5	1.5	3.0
Consumer prices (HICP), % p.a.	2.5	2.8	2.0	2.8	8.0	4.5	2.0
Producer prices in industry, % p.a.	2.3	1.9	-0.6	6.8	17.5	7.0	3.0
General governm. budget, EU def., % of GDP							
Revenues	38.8	39.3	40.1	40.4	40.0	40.0	39.5
Expenditures	39.8	40.7	45.6	47.5	45.1	44.1	43.0
Net lending (+) / net borrowing (-)	-1.0	-1.3	-5.5	-7.1	-5.1	-4.1	-3.5
General gov. gross debt, EU def., % of GDP	49.6	48.1	59.7	62.5	61.2	60.0	58.0
Stock of loans of non-fin. private sector, % p.a.	9.8	6.6	5.0	7.2	.	.	.
Non-performing loans (NPL), in %, eop	3.1	2.8	2.3	1.9	.	.	.
Central bank policy rate, % p.a., eop 3)	0.00	0.00	0.00	0.00	.	.	.
Current account, EUR m	-1,973	-3,163	330	-1,910	-4,200	-4,300	-4,000
Current account, % of GDP	-2.2	-3.4	0.4	-2.0	-3.9	-3.7	-3.3
Exports of goods, BOP, EUR m	75,142	75,522	70,011	81,464	83,900	87,500	91,900
annual change in %	6.6	0.5	-7.3	16.4	3.0	4.3	5.0
Imports of goods, BOP, EUR m	75,381	76,658	68,996	81,539	86,400	90,800	95,300
annual change in %	7.8	1.7	-10.0	18.2	6.0	5.1	5.0
Exports of services, BOP, EUR m	10,228	10,981	9,032	9,459	9,800	10,600	11,400
annual change in %	9.5	7.4	-17.8	4.7	4.0	8.0	8.0
Imports of services, BOP, EUR m	9,300	9,763	7,944	8,663	9,200	9,600	10,000
annual change in %	10.0	5.0	-18.6	9.0	6.0	4.0	4.0
FDI liabilities, EUR m	1,906	2,042	-214	818	.	.	.
FDI assets, EUR m	760	-162	1,683	1,097	.	.	.
Gross reserves of CB excl. gold, EUR m	3,426	5,002	6,050	6,850	.	.	.
Gross external debt, EUR m	102,870	106,016	110,925	133,057	113,000	110,000	110,000
Gross external debt, % of GDP	115.0	112.7	120.5	137.0	105.2	95.1	90.5

1) Preliminary and wiiw estimates. - 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).

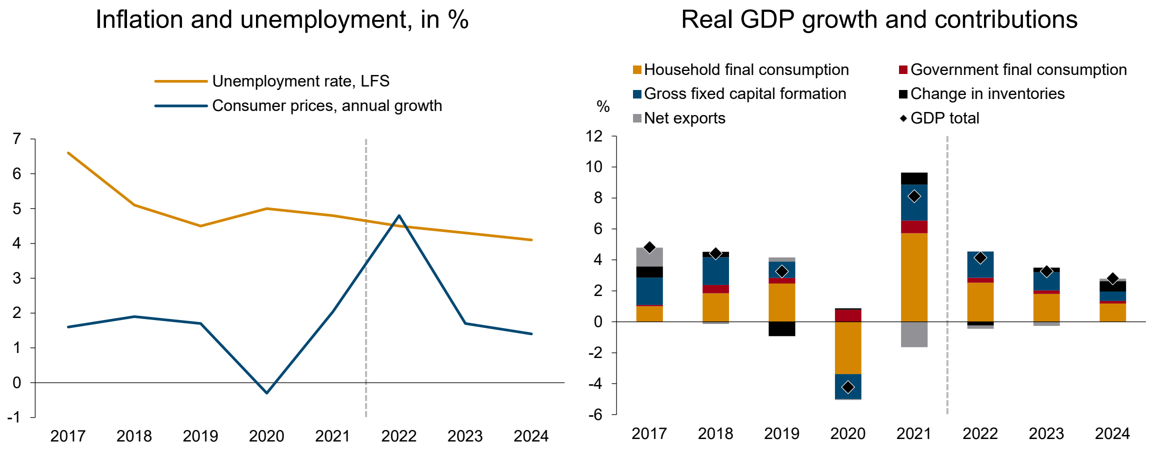
Source: wiiw Databases incorporating Eurostat and national statistics. Forecasts by wiiw.

SLOVENIA: Encouraging economic performance tempered by concerns over inflation

NIKO KORPAR

For 2022, we project real GDP to grow by 4.1% – unchanged from our previous forecast. Growth will be affected positively by strong private spending and investment, and negatively by the war in Ukraine, which will impact the economy through higher inflation and lower demand for exports. Inflation will reach 4.8%, and will spill over from energy into food and services. Due to the geopolitical situation, public finance is becoming a matter of some concern, following a period of high spending. The parliamentary elections in April will likely result in a new coalition.

Figure 4.21 / Slovenia: Main macroeconomic indicators



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

Up to the beginning of the Ukrainian crisis, economic momentum in Slovenia was strong. In Q4 2021, growth was the highest in the euro area (10.4% year on year) – largely a result of further increases in private consumption, investment and a strong trade performance. All this occurred during the fifth wave of the pandemic (which saw the highest daily number of infections since the beginning of the pandemic) and during a prolonged period of rising energy prices. Although inflation was already starting to have an adverse impact on manufacturing, the automotive industry saw a rise in exports. This situation was also reflected in the labour market, which saw the pool of available workers almost depleted. In 2021, real GDP grew by 8.1%, the highest rate since Slovenia's independence in 1991. And the actual growth rate for 2021 was considerably higher than wiiw's most recent forecast of 6.6%.

The scale of the repercussions of the war in Ukraine is difficult to estimate. In recent years, Slovenia has recorded a surplus in trade with both Russia and Ukraine. Together, those countries represented only 2.7% of Slovenia's exports, with the pharmaceutical industry accounting for almost half of that. Although there is some exposure to sanctions, the main channel by which negative spill-overs will be felt is increased inflation. The higher prices for raw materials and energy sources will place additional pressure on operational costs in export-oriented manufacturing industries, which claim a higher share of Slovenia's GDP than the EU average. Inflation could be accompanied by falling demand for products from abroad, amidst a downturn in consumer confidence, as well as by potential disruptions to supply chains. Since Germany is likely to be badly impacted by events in Ukraine, the overall effect of the crisis could be disproportionately felt in Slovenia, owing to the prominent role of its exports to Germany; this reinforces the rule that the magnitude of an economic shock suffered by small, open economies is typically greater than that experienced by their larger trade partners. One way of illustrating the deterioration in the economic outlook is through our forecast for industrial production for 2022 (3.9%), which is 3 percentage points (pp) lower than our previous forecast (6.9%).

Further economic woes could arise if it is necessary to discontinue the flow of Russian oil and gas rapidly. In 2020, Slovenia imported 45% of its energy (below the EU average), with gas providing about 13% of all its energy needs. Imports of Russian gas represented about 9% of the country's total energy consumption in 2020; however, Russia provided 77% of its imported natural gas. A large part of the gas imports is utilised by industry. The size of Slovenia's economy means that the volume is small in absolute terms; however, the pressure to reduce the country's reliance on Russian oil and gas will be felt by households and companies alike. As a response, the government has started to explore new opportunities to secure a gas supply in the Middle East.

Despite the considerable uncertainty, we forecast strong growth of 4.1% for 2022. While this forecast is consistent with our previous projection, issued in December 2021, it should be noted that the current forecast has been generated in a markedly different economic context, with momentum operating in two opposing directions. On the positive side, strong growth from Q4 2021, supported by private spending (which received an additional boost in February, when most COVID restrictions were lifted), suggests that the economy and households have largely adapted to the new reality and have not been fazed by the rising prices and the early signs of geopolitical tension. Private spending is forecast to remain strong in 2022, increasing by 4.9%; government spending will rise by 1.6%, as will investment (6.9%). On the negative side, the war in Ukraine will assuredly decrease the potential for growth in 2022, mostly because of inflation, supply-side issues and reduced demand for exports. Prolonged conflict, a possible embargo on Russian oil and gas and early signs that high inflation could continue in 2023 may act to suppress Slovenia's GDP growth in 2022.

International trade will suffer due to the crisis, but is likely to remain buoyant: exports are projected to grow by 6.4% and imports by 7.1% in real terms. As a consequence of high domestic demand for imported products, the current account surplus more than halved in 2021, compared to 2020, reaching 3.3% of GDP. In 2022, we expect this trend to continue, with imports growing faster than exports, thus denting the net contribution of trade to economic growth. The rising prices of manufactured products have considerably increased the value of exports: in December 2021, the nominal value of exports was 30% higher year on year. However, the nominal value of imports was 43% higher. Should inflation exceed the projections, trade is likely to decrease further.

In 2022, we expect inflation to reach 4.8% on average – an upwards revision of 1.6 pp, compared to the previous forecast. Slovenia had one of the highest inflation rates in the euro area in February – 7%, an 18-year high. High inflation is being felt predominantly in the cost of energy and food, and is likely to spill over to wage growth. The government has responded to the issue of rapidly rising prices for municipal heating and energy by introducing a cap on fuel prices and initiating direct transfers to households and companies worth EUR 200m. These measures will likely assist in keeping inflation somewhat lower than in other countries in Slovenia's eastern neighbourhood. It should be stressed that the forecast does not assume drastic escalations or a prolonged conflict in Ukraine. If things pan out differently, and if energy prices keep on rising, inflation could end up much higher and may exceed 10%. Especially worrying are the hikes in producer prices, which could reach 6% in 2022. In 2023 and beyond, we expect inflation to fall back substantially and to return to a rate of 2%.

Pressure on wage growth could add to the pressures on prices. After growing by 6% in 2021, real wages are expected to increase by 2.6% in 2022. The reasons are not related solely to inflation: for months, medical doctors have been demanding higher salaries. Their protests are threatening to undermine the system of public salaries and have already sparked similar demands from other public-sector workers. These calls for public-sector wage rises could have repercussions for the public finances.

This will be the third consecutive year to be marked by high public deficits – the downside to high growth figures. The deficit in 2021 was somewhat lower than expected, at 5.2%, and the national treasury will benefit from the lifting of the COVID-19 restrictions. However, given the need to subsidise energy, and in light of the lower growth projections, we forecast that the public deficit in 2022 will be 3.6% of GDP. Public debt has fallen to below 80% of GDP as a consequence of high growth, and in 2022 it will hover at around 74%.

Despite positive short-term signs, the long-term fiscal outlook has raised some concern among Slovenia's top economists. Interest rate hikes by the European Central Bank, coupled with the effects of the Ukrainian war on the financial markets, could lead to higher costs for debt refinancing, especially for smaller countries. Since 2020, Slovenia has increased its structural deficit considerably, and the current government has been spending freely (including on the adoption of a regressive income tax reductions in March 2022). This has resulted in a high level of public debt and several consecutive years of deficit. The country could soon face the need to cut public spending, if its credit ratings are not to suffer. An additional cause for concern is the uncertainty over the future system of fiscal rules at the EU level.

The ruling Slovenian Democratic Party could again gain most votes in the parliamentary elections at the end of April, but it is unlikely to end up in a position to form an administration. Despite Prime Minister Janša's attempts to present himself as an experienced war leader and his use of strong rhetoric against Russia, his visit to Kyiv has not translated into increased support in the polls. The government's latest push to influence programming and staffing at the national radio and television service RTV has led to outrage in the media and civil society. Any potential new coalition will have to deal with the legacy of an altered media environment, politically influenced staffing decisions in various public institutions and populist spending choices. Responding to these challenges could serve to unite a coalition formed from several opposition parties; but the need for tough decisions to rein in public expenditure, provide housing and reform the health and pension systems could split it asunder.

In 2023, we expect GDP growth to slow and settle down at around 3% per year. In general, all components of GDP are likely to see a drop compared to 2022. Private consumption will subside, growing at about 3.5% per year, while investment activity is likely to remain strong, boosted by the incoming funds from the Recovery and Resilience Facility. The growth in trade will also slow somewhat, since the high figures for 2021 and 2022 have benefited from a strong base effect; but it should still exceed 5% in 2023. The labour market is likely to see further issues, as the pool of available workers is virtually depleted: there will be a need to bring more workers in from abroad. Finally, the issue of the cost of housing has begun to dominate public discourse and is likely to remain of key importance: in 2021, the cost of new housing units rose by 15% – a matter of great concern to the younger generation, which is struggling to reap the benefits of strong economic growth.

Table 4.21 / Slovenia: Selected economic indicators

	2018	2019	2020	2021 1)	2022	2023 Forecast	2024
Population, th pers., average	2,074	2,088	2,102	2,108	2,112	2,115	2,119
Gross domestic product, EUR m, nom.	45,864	48,397	46,918	52,020	56,800	59,700	62,200
annual change in % (real)	4.4	3.3	-4.2	8.1	4.1	3.3	2.8
GDP/capita (EUR at PPP)	26,450	27,660	26,540	29,070	.	.	.
Consumption of households, EUR m, nom.	23,463	24,919	23,160	26,835	.	.	.
annual change in % (real)	3.6	4.8	-6.6	11.6	4.9	3.5	2.3
Gross fixed capital form., EUR m, nom.	8,834	9,495	8,861	10,483	.	.	.
annual change in % (real)	9.7	5.5	-8.2	12.3	8.4	5.8	3.0
Gross industrial production							
annual change in % (real)	5.1	3.1	-5.3	10.3	3.9	3.8	4.2
Gross agricultural production							
annual change in % (real)	28.5	-7.8	5.5	-12.0	.	.	.
Construction industry							
annual change in % (real)	20.0	3.3	-0.7	-5.8	.	.	.
Employed persons, LFS, th, average 2)	980.6	982.6	978.1	971.6	990	1,000	1,010
annual change in %	2.2	0.2	-0.5	.	1.7	1.4	1.1
Unemployed persons, LFS, th, average 2)	52.8	45.7	51.2	48.6	50	40	40
Unemployment rate, LFS, in %, average 2)	5.1	4.5	5.0	4.8	4.5	4.3	4.1
Reg. unemployment rate, in %, eop	8.1	7.7	8.9	6.7	.	.	.
Average monthly gross wages, EUR 3)	1,682	1,754	1,856	1,970	2,120	2,210	2,280
annual change in % (real, gross)	1.7	2.7	5.9	4.1	2.6	2.4	1.9
Average monthly net wages, EUR 3)	1,093	1,134	1,209	1,270	1,370	1,430	1,480
annual change in % (real, net)	1.2	2.1	6.6	3.1	2.7	2.4	1.8
Consumer prices (HICP), % p.a.	1.9	1.7	-0.3	2.0	4.8	1.7	1.4
Producer prices in industry, % p.a.	2.1	0.6	-0.3	5.5	6.1	4.5	1.9
General governm. budget, EU def., % of GDP							
Revenues	44.2	43.8	43.6	43.9	44.6	45.1	45.4
Expenditures	43.5	43.3	51.3	49.1	48.2	45.5	45.6
Net lending (+) / net borrowing (-)	0.7	0.4	-7.7	-5.2	-3.6	-0.4	-0.2
General gov. gross debt, EU def., % of GDP	70.3	65.6	79.8	74.7	74.4	71.3	68.5
Stock of loans of non-fin. private sector, % p.a.	3.0	3.5	0.0	5.9	.	.	.
Non-performing loans (NPL), in %, eop 4)	5.6	2.9	2.6	1.6	.	.	.
Central bank policy rate, % p.a., eop 5)	0.00	0.00	0.00	0.00	.	.	.
Current account, EUR m	2,731	2,898	3,462	1,736	820	200	-10
Current account, % of GDP	6.0	6.0	7.4	3.3	1.4	0.3	0.0
Exports of goods, BOP, EUR m	30,808	32,013	29,656	35,335	39,720	42,980	45,730
annual change in %	8.6	3.9	-7.4	19.1	12.4	8.2	6.4
Imports of goods, BOP, EUR m	29,535	30,702	27,290	34,816	40,390	43,980	47,060
annual change in %	10.4	4.0	-11.1	27.6	16.0	8.9	7.0
Exports of services, BOP, EUR m	8,124	8,659	6,900	8,254	9,180	9,790	10,440
annual change in %	9.9	6.6	-20.3	19.6	11.2	6.6	6.6
Imports of services, BOP, EUR m	5,500	5,751	4,904	5,859	6,740	7,320	7,870
annual change in %	7.0	4.6	-14.7	19.5	15.0	8.6	7.5
FDI liabilities, EUR m	1,307	1,919	431	1,569	.	.	.
FDI assets, EUR m	373	1,157	697	1,066	.	.	.
Gross reserves of CB excl. gold, EUR m	702	767	913	1,838	.	.	.
Gross external debt, EUR m	42,139	44,277	47,792	50,477	54,100	57,000	59,200
Gross external debt, % of GDP	91.9	91.5	101.9	97.0	95.3	95.5	95.1

1) Preliminary and wiiw estimates. - 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.

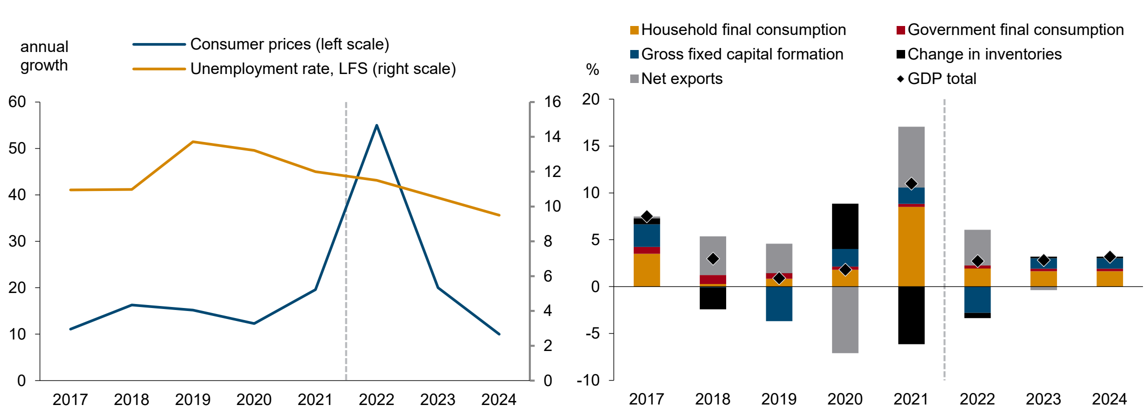
TURKEY: Back to the eye of the storm

RICHARD GRIEVESON

Even before Russia invaded Ukraine, Turkey was in big trouble, with inflation at eye-watering levels, a currency that had halved in value in just a few months, a rapidly expanding current account deficit and rising pressure on external financing due to aggressive Fed tightening. Now the situation is even more difficult, owing to Turkey's strong economic ties with Russia and its heavy reliance on commodity imports. The best-case scenario is a sharp slowdown in growth; meanwhile, the risk of a renewed period of macroeconomic and financial instability has increased.

Figure 4.22 / Turkey: Main macroeconomic indicators

Inflation and unemployment, in % | Real GDP growth and contributions



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

Turkey's economy grew by 11% last year, one of the fastest rates of growth across CESEE. This achievement was all the more remarkable for the fact that Turkey was the only CESEE country to avoid full-year negative growth in the pandemic year of 2020, so that base effects were much less favourable than anywhere else in the region. That Turkey achieved such high growth is largely a reflection of the very expansionary policy mix – not least the credit-financed spending generated by ever-more negative real interest rates. Growth was also supported by a 24.9% real increase in exports, on the back of the strong global recovery and improved price competitiveness due to lira depreciation. Altogether in 2021, household consumption added 8.5 percentage points (pp) to growth, with a further 6.5 pp coming from net exports. Investment added 1.7 pp, while government consumption played its usual minor role in economic performance.

However, even before the Russian invasion of Ukraine, there were signs that some momentum was being lost (though it remained strong). Industrial output expanded by 7.6% year on year in January – still a healthy rate, but the weakest outturn for a year and a half. Retail sales volume growth also slowed to 7.9% in January, its lowest rate of expansion since before the pandemic.

Much of the weaker momentum at the start of this year can be attributed to the crisis in Turkish markets towards the end of 2021, which was triggered by massive monetary loosening in the second half of the year. Some 400 basis points of interest rate cuts in the face of high and rising inflation caused the lira to roughly halve in value in just a few months. In combination with rising international commodity prices, this pushed inflation up to eye-watering levels: by March of this year, consumer prices were growing at over 61% year on year. In the face of all this, the central bank has resolutely stuck to its course of keeping the nominal policy rate at 14%, thus driving real rates very deep into negative territory. While this has contributed to another boom in lending, the consequent levels of inflation are having a seriously negative impact on real incomes and on consumer and business confidence.

In this already challenging environment, Russia's invasion of Ukraine is an economic and financial disaster for Turkey. As a country heavily reliant on commodity imports, with strong economic ties to both countries, and with a currency that tends to weaken sharply at times of elevated risk aversion, Turkey finds itself somewhat in the eye of the storm. About 75% of all its wheat imports come from Ukraine and Russia. Meanwhile, its exports to Russia were worth about USD 6bn last year. There are few available data points to gauge the concrete impact so far, but what information is available suggests that the effects have already started to be felt. In March, Turkey's manufacturing Purchasing Managers' Index (PMI), for example, fell below the crucial 50 level (which separates expansion from contraction) for the first time in 10 months. Business confidence also fell in March, while consumer confidence remains profoundly gloomy. The lira has also weakened further since the invasion.

One area where the impact will immediately be felt is in Turkey's external accounts, with the current account deficit set to widen considerably in 2022. The collapse of the value of the lira, combined with the doubling of oil prices over the last year, means that in local currency terms the cost of energy imports has skyrocketed. Much the same can be said of imported food. Although one month's data should always be treated with caution, it is notable that, according to the central bank, in January 2022 the current account deficit increased by 300% year on year, driven above all by the increase in the value of goods imports. As the year wears on, the external balance may also suffer from a reduction in tourism flows from Russia. Turkey hosted 4.7m Russian tourists in 2021 – 19% of all visitors, and the most from any single country. There are, however, two factors that will partially offset the increase in the current account deficit. First, goods exports will rise sharply in volume terms, reflecting the improvement in external competitiveness caused by the weaker lira. And second, the steep increase in import prices will weaken demand, which in turn will lead to slower growth in goods imports. We expect the current account shortfall to reach the equivalent of 6.3% of GDP this year, compared to 1.8% in 2021.

The authorities are pursuing an unorthodox policy in their attempt to stabilise the lira, and further currency weakness looks likely. A resistance to conventional monetary tightening, reinforced by the president's view that higher interest rates lead to higher inflation, meant that even in the face of sharp depreciation in late 2021, the central bank did not raise the policy rate. Instead, the authorities introduced a new policy, encouraging residents to save lira deposits in special accounts that compensate for currency loss. This seems to have had some impact on the lira: although the currency has continued to depreciate, the pace has slowed considerably since the measures were announced. The president's unorthodox views on inflation no doubt play an important role in this stance. But in addition, it would seem that, faced with the existing currency depreciation and rocketing international commodity prices, the authorities have given up trying to control inflation, and will instead seek to pump as much stimulus as possible into the economy ahead of the 2023 election. Needless to say, that is an extremely high-risk strategy.

As a result of this position, inflation will remain high for some time, even by Turkish standards. We expect consumer price inflation to average 55% this year, while producer price inflation could be around 20 pp above that. Import prices will be a major part of this story, due to the double effect of lira depreciation and increases in dollar-denominated commodity prices. Wages may keep up – the authorities have increased the minimum wage by 50% for this year – but that will not fully cushion the blow, especially for the poorest households. Surveys show rising dissatisfaction with the government over the cost of living.

Putting all this together, clearly the economy is going to struggle this year. Growth may remain positive, but not by much. We expect a real expansion of 2.7% in 2022 – a sharp slowdown from last year, but otherwise not too far above the average rate for 2018-2020. This great volatility in the growth rate reflects the high-risk policy mix that prioritises short-term growth momentum above all else and that has locked Turkey into a boom-bust cycle. We expect the drivers of growth to be similar to last year, with credit-financed consumption and exports playing a key role. The latter will again be supported by the sharp depreciation of the currency, and the former by the negative real interest rates. Government spending will make a marginally positive contribution, while investment will subtract from growth, amid high uncertainty and caution among businesses.

The Turkish private sector has shown itself to be remarkably resilient over the past few years, and this resilience will again be tested in 2022. Since 2018, there have been two quite dramatic currency collapses; given the scale of FX short-term debt, these could have resulted in a more serious economic crisis. Hedging of foreign currency exposure has certainly helped, as has the smaller current account deficit (until recently). In addition, the foreign presence in local debt and equity markets has been much reduced, limiting the impact of capital flight at times of increased risk aversion. In recent years, Turkey's credit ratings have been cut deeper into 'junk' territory, so that some portfolio managers can no longer invest in Turkey, while many others no longer want to.

Despite this, the big risk for Turkey remains its external finances, and this risk is higher than usual due to both domestic and external factors. Domestically, a deeply negative real interest rate offers no protection for the lira, and although the rather unusual policy outlined above may have reduced 'domestic' capital flight (i.e. locals converting lira into dollars), it is unlikely to deliver lasting protection. Internally, a myriad factors create external financing risks, including higher commodity prices (and the consequent expansion of the current account), general global risk aversion and increasingly aggressive Fed tightening. The latter is very important for Turkey: it was one of the countries most affected when the initial 'taper tantrum' of 2013 caused capital flight from emerging markets, and each episode of US monetary tightening since then has created elevated external financing risks. With the external financing requirement set to rise sharply this year, at the very least Turkey can expect to pay higher interest rates to roll over its external debt.

The geo-politics and geo-economics of the war are very important for Turkey, and Ankara now has a role as the only realistic interlocutor between Russia and Ukraine – or indeed Russia and the West. Turkey supplied the Bayraktar TB2 drones that seem to have played a big part in the Ukrainian success so far; but it has also resisted joining most of the sanctions on Russia, and has very successfully positioned itself as a mediator. The US seems to be taking a softer line on Turkey than in the recent past.

The medium-term outlook remains quite underwhelming for Turkey, and it seems that the economy will continue to struggle to tap its undoubted potential. We maintain our view that the Turkish economy could develop in a very positive way – ensuring rising per capita incomes and a generally higher standard of living for its citizens, and at the same time offering an interesting destination for foreign investors. However, at present (and for some time past), the policy mix is too chaotic and too focused on short-term priorities, and it has created a damaging boom-bust cycle of ever-increasing frequency. Until that changes, we believe that the average growth rate is likely to be around 3% per year – a disappointing outturn, given the economy's potential.

Table 4.22 / Turkey: Selected economic indicators

	2018	2019	2020	2021 1)	2022	2023 Forecast	2024
Population, th pers., average	81,407	82,579	83,385	84,147	85,157	86,179	87,213
Gross domestic product, TRY bn, nom.	3,759	4,318	5,047	7,209	11,500	14,200	16,100
annual change in % (real)	3.0	0.9	1.8	11.0	2.7	2.8	3.2
GDP/capita (EUR at PPP)	19,180	18,470	18,410	21,700	.	.	.
Consumption of households, TRY bn, nom.	2,099	2,441	2,845	3,970	.	.	.
annual change in % (real)	0.5	1.5	3.2	15.1	3.5	3.0	3.0
Gross fixed capital form., TRY bn, nom.	1,115	1,117	1,382	2,016	.	.	.
annual change in % (real)	-0.2	-12.4	7.2	6.4	-10.0	4.0	4.0
Gross industrial production 2)							
annual change in % (real)	1.1	-0.6	2.2	16.5	3.1	2.8	2.8
Gross agricultural production 3)							
annual change in % (real)	-0.9	4.1	3.0	3.0	.	.	.
Construction industry 2)							
annual change in % (real)	-5.0	-8.0	-3.0	3.0	.	.	.
Employed persons, LFS, th, average 4)	28,734	28,081	26,808	28,827	30,100	31,100	31,900
annual change in %	1.9	-2.3	-4.5	8.0	4.5	3.3	2.5
Unemployed persons, LFS, th, average 4)	3,535	4,461	4,063	3,916	3,910	3,650	3,350
Unemployment rate, LFS, in %, average 4)	11.0	13.7	13.2	12.0	11.5	10.5	9.5
Reg. unemployment rate, in %, eop	.	.			.	.	.
Average monthly gross wages, TRY 5)	3,597	4,470	4,595	5,630	13790	20190	24870
annual change in % (real, gross)	-0.7	7.9	-8.5	2.5	58.0	22.0	12.0
Consumer prices (HICP), % p.a.	16.3	15.2	12.3	19.6	55.0	20.0	10.0
Producer prices in industry, % p.a. 5)	27.0	17.6	12.1	43.9	75.0	22.0	11.0
General governm. budget, nat. def., % of GDP							
Revenues	29.8	29.8	29.6	30.0	29.4	30.6	31.0
Expenditures	32.5	32.9	32.5	33.5	32.6	33.0	33.0
Deficit (-) / surplus (+)	-2.8	-3.2	-2.8	-3.5	-3.2	-2.4	-2.0
General gov. gross debt, nat. def., % of GDP	30.2	32.7	39.5	40.4	43.5	46.4	48.0
Stock of loans of non-fin. private sector, % p.a.	9.6	10.2	35.3	32.4	.	.	.
Non-performing loans (NPL), in %, eop	3.9	5.4	4.1	3.1	.	.	.
Central bank policy rate, % p.a., eop 6)	24.00	12.00	17.00	14.00	14.00	14.00	12.00
Current account, EUR m	-17,586	4,777	-31,325	-12,484	-37,300	-37,400	-37,500
Current account, % of GDP	-2.7	0.7	-5.0	-1.8	-6.3	-5.8	-5.5
Exports of goods, BOP, EUR m	151,681	162,777	147,053	190,413	232,000	244,000	256,000
annual change in %	1.2	7.3	-9.7	29.5	22.0	5.0	5.0
Imports of goods, BOP, EUR m	185,543	177,804	180,242	215,159	293,000	308,000	323,000
annual change in %	-7.8	-4.2	1.4	19.4	36.0	5.0	5.0
Exports of services, BOP, EUR m	49,925	56,149	30,901	48,276	72,000	78,000	84,000
annual change in %	6.4	12.5	-45.0	56.2	50.0	8.0	8.0
Imports of services, BOP, EUR m	24,153	25,612	20,898	26,818	39,000	42,000	45,000
annual change in %	0.8	6.0	-18.4	28.3	45.0	7.0	7.0
FDI liabilities, EUR m	10,662	8,547	6,815	11,586	.	.	.
FDI assets, EUR m	3,019	2,630	2,798	5,491	.	.	.
Gross reserves of CB excl. gold, EUR m 7)	63,666	69,975	40,776	64,182	.	.	.
Gross external debt, EUR m 7)	372,689	370,292	352,739	389,426	353,800	400,200	399,100
Gross external debt, % of GDP	56.6	54.5	56.3	56.8	60.0	62.0	59.0
Average exchange rate TRY/EUR	5.7077	6.3578	8.0547	10.5124	19.50	22.00	23.80

1) Preliminary and wiiw estimates. - 2) Enterprises with 20 and more employees; for construction wiiw estimate. - 3) Based on UN-FAO data, wiiw estimate from 2020. - 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. wiiw estimate in 2021. - 5) Domestic output prices. - 6) One-week repo rate. - 7) Converted from USD.

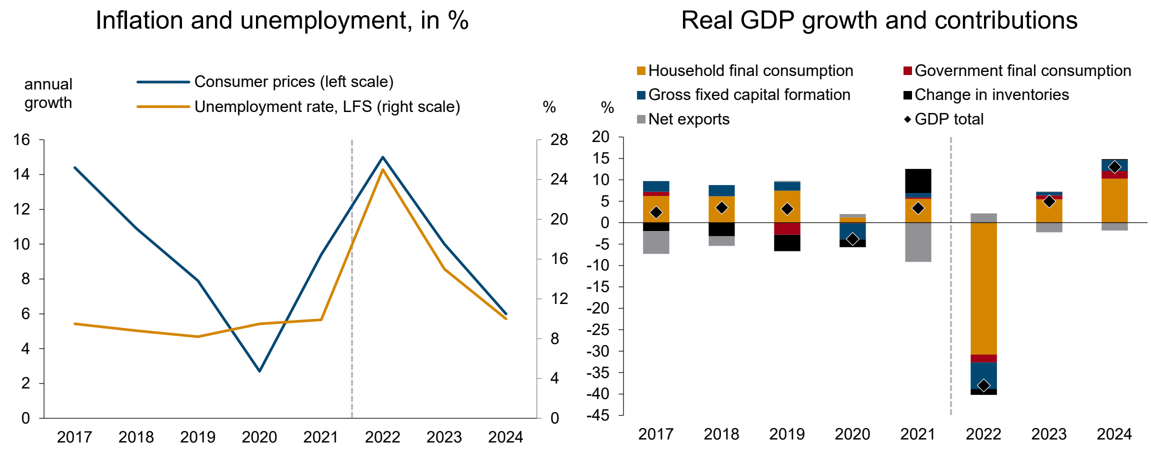
Source: wiiw Databases incorporating national statistics. Forecasts by wiiw.

UKRAINE: Losses from the war are mounting

OLGA PINDYUK

The war has caused Ukraine significant economic and humanitarian losses. Economic activity has practically ceased in those regions where military operations are under way, and more than a quarter of the population has been displaced. We expect a gradual recovery of Ukraine's economy in 2023, but there is practically no chance of the recovery being even remotely V-shaped. GDP growth will accelerate in 2024, provided financial support is forthcoming from the West in the shape of a Marshall Plan-type reconstruction fund.

Figure 4.23 / Ukraine: Main macroeconomic indicators



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

The economy of Ukraine has been severely affected by the Russian invasion. Indiscriminate bombardment by the Russian army has led to the destruction of much of the infrastructure and many buildings in several regions of Ukraine. According to the Kyiv School of Economics, as of 1 April the damage caused to Ukraine's infrastructure by the war was at least USD 68.2bn;[43] but the final figure will certainly be much higher than that. According to Ukrainian government calculations, the cost of the damage to the property of households and firms, taken together with the lost economic activity, raises the current estimated total figure to USD 565bn.[44]

[43] At least 411 educational institutions, 36 healthcare facilities, 1,600 residential buildings, 26 factories, 6 thermal power plants/hydroelectric power plants, more than 23,000 km of roads, 5,000 km of railways, 15 airports and 350 bridges and overpasses had been damaged.

[44] https://www.me.gov.ua/News/Detail?lang=uk-UA&id=f951df0a-e65c-4b0e-871f-9bf1a857fe57&title=UkrainaZaznala564-9-MiliardivDolarivVtratVidRosiiskogoVtorgnennia

In those regions that are the scene of military operations, economic activity has practically ceased – apart from the routine maintenance of public utilities, basic retail trade and medical services (where possible). According to a survey conducted by the European Business Association in Ukraine on 14 March, 42% of small and medium-sized enterprises (SMEs) had completely ceased operations.[45] According to another survey conducted by the Association at the end of March,[46] the biggest problems for business are logistical and supply-chain issues, the low purchasing power of the population and corporate clients, damaged production facilities and lack of financial resources.

Ukraine has lost the ability to sell more than half of its exports, primarily agricultural commodities and metals, since the Black Sea ports in the south of the country have been brought to a virtual standstill by the Russian assault. Merchandise exports accounted for more than a third of the country's GDP in 2021. According to the Ministry of Economy of Ukraine, in March 2022, exports of goods declined by 44% year on year, as efforts to establish alternative overland export routes have been hampered by logistical challenges, such as a shortage of railway freight wagons and staff, and the destruction of grain storage facilities, railway lines and stations. Arable land is being contaminated with landmines and metallurgical plants are being damaged by the Russian army, so that will also contribute to a significant decline in both output and exports this year.

The war has furthermore led to a massive deterioration in the humanitarian situation in Ukraine. According to the UN Refugee Agency (UNHCR), by 7 April more than 10.5m Ukrainians (about a quarter of the population) had been displaced. Of those, more than 4.3m had fled abroad, mainly women and children. The displaced population is likely to increase even more as people leave the regions in the east of the country in the face of an intensification of the fighting there. According to a representative survey conducted in Ukraine by Info Sapiens during 24-28 March,[47] unemployment in the country has reached 29%. Of those who have not lost their jobs, only 37% received their March salary in full, while 26% did not receive any salary at all. Predictably, private consumption has suffered a sharp contraction. Available estimates of merchandise imports in March (which reflect both consumer and investment dynamics) show a 69% decrease compared to the same month in 2021.

The economy has so far shown remarkable resilience in terms of its macro-financial stability. The government has reassured foreign investors that it does not plan to default on its debt. The banking system remains stable and liquid; nearly all banks have offered their customers credit repayment holidays. Additionally, the government has introduced a programme of zero-interest loans for farmers and 5% interest loans for retail trade companies. The exchange rate of the national currency has been fixed in accordance with martial law at UAH 29.25 to the US dollar. The National Bank of Ukraine is allowing banks to purchase foreign currency and make transfers from Ukraine, so that residents can carry out transactions to buy essential imports. The government has introduced price controls on key food categories for the duration of the war.

In future, however, the inflow of money into accounts is likely to decline, as many companies cease operating. Further down the line, banks will face substantial losses as a result of the damage caused to their physical assets and the likely defaults on many loans, which will wipe out much of the banks' capital.

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45 https://eba.com.ua/en/finansovi-rezervy-chverti-predstavnykiv-malogo-biznesu-vzhe-vycherpani/

46 https://eba.com.ua/vtraty-biznesu-za-misyats-vijny/?fbclid=IwAR1yyu8yLY-jEhn5NtPaP70i5vv7ycRtPNCpyf9k4-EBEX5djGZgfvRbDek

47 https://sapiens.com.ua/ua/publication-single-page?id=214

Other measures introduced by the government to support the economy include a tax reform. VAT and income tax have been replaced for the duration of the war by a 2% turnover tax, and SMEs are allowed to decide for themselves whether to pay tax (a simplified flat tax). The self-employed, individual entrepreneurs and farmers have been exempted from social contributions. Excise tax on fuel has been set at 0% until martial law is lifted. For people who lose their jobs because of the war, a monthly allowance of UAH 6,500 (about USD 220) will be provided.

After an unsuccessful attempt to capture the northern regions of Ukraine, Russia is moving its forces to the east. According to NATO Secretary General Jens Stoltenberg, a major offensive is expected there. He envisages that it may last 'for a long time, for many months, for even years'.[48] The regions of eastern and southern Ukraine that are currently under attack (Donetsk, Dnipropetrovsk, Kharkiv, Kherson, Luhansk, Mykolayiv, Odesa and Zaporizhzhya) together account for about 40% of GDP, 55% of industrial production, 34% of agricultural production and 43% of merchandise exports.

Based on the experiences of the government-controlled areas in the Donbas region, we can expect economies in the regions under attack to undergo a deep recession this and next year. Moreover, they will be unable to recover within the forecast period, due to the remaining high risks for economic activity. The government-controlled parts of Donetsk and Luhansk regions lost 59% and 68%, respectively, of their gross regional product during 2014-2015; and in the period 2016-2019, the economies there stagnated.

Because of the war, in 2022 we will see the sharpest economic contraction for 30 years. We estimate that real GDP will decline by 38% this year; however, that forecast is subject to an unusually high level of uncertainty, since the lack of current statistical data – and indeed the lack of any clarity about the duration and scale of the war – significantly complicates economic forecasting for Ukraine.

We expect Ukraine's economy to start to recover in 2023, but real growth will be sluggish (only about 5%); GDP growth will accelerate in 2024 (to 13%), provided there is Western financial support in the form of a Marshall Plan-type reconstruction fund. It will not really be possible for the country to receive reparations from Russia during the forecast period, as the Kremlin is unlikely to agree to pay; and using the frozen assets of the Central Bank of Russia and of Russian oligarchs to that end would require lengthy legal proceedings in international courts. Corruption and a lack of skilled personnel are likely to limit the capacity to absorb money from the Marshall Plan-type reconstruction fund. More rapid economic growth would be possible if the war with Russia were to end sooner than currently expected (and with a victory for Ukraine).

We expect the gradual return of refugees to start as early as this year. According to the survey by Info Sapiens,[49] 88% of those people who fled abroad are planning to come back to Ukraine. Private consumption will again be a driving force for economic growth in 2023-2024. We expect investment growth to outpace the rise in household consumption in 2024 as the reconstruction fund money becomes available.

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48 https://www.nato.int/cps/en/natohq/opinions_194326.htm

49 https://sapiens.com.ua/ua/publication-single-page?id=216&fbclid=IwAR2A8-4lawHh_c3Faz6lLzXBFls2OI0sTeepwBUB9u-gZRfyu0Cs8UfWgW0

Table 4.23 / Ukraine: Selected economic indicators

	2018	2019	2020	2021 1)	2022	2023	2024
						Forecast	
Population, th pers., average	42,270	42,028	41,745	41,378	37,000	38,000	39,000
Gross domestic product, UAH bn, nom.	3,560	3,977	4,222	5,460	3,900	4,500	5,400
annual change in % (real)	3.5	3.2	-3.8	3.4	-38.0	5.0	13.0
GDP/capita (EUR at PPP)	8,570	9,080	8,790	9,390	.	.	.
Consumption of households, UAH bn, nom.	2,439	2,918	3,054	3,736	.	.	.
annual change in % (real)	9.3	10.9	1.7	7.7	-45.0	8.0	15.0
Gross fixed capital form., UAH bn, nom.	628	701	564	679	.	.	.
annual change in % (real)	16.6	11.7	-21.3	7.5	-50.0	6.0	20.0
Gross industrial production							
annual change in % (real)	3.0	-0.5	-4.5	1.9	-40.0	10.0	15.0
Gross agricultural production							
annual change in % (real)	8.2	1.4	-10.1	14.4	.	.	.
Construction output							
annual change in % (real)	8.6	23.6	5.6	6.8	.	.	.
Employed persons, LFS, th, average	16,361	16,578	15,915	15,610	13,000	13,500	14,500
annual change in %	1.3	1.3	-4.0	-1.9	-16.7	3.8	7.4
Unemployed persons, LFS, th, average	1,579	1,488	1,674	1,712	4,330	2,380	1,610
Unemployment rate, LFS, in %, average	8.8	8.2	9.5	9.9	25.0	15.0	10
Reg. unemployment rate, in %, eop 2)	1.3	1.3	1.7	1.1	.	.	.
Average monthly gross wages, UAH 3)	8,865	10,497	11,591	14,014	9,700	11,700	14,300
annual change in % (real, gross)	12.5	9.7	7.5	10.5	-40.0	10.0	15.0
Consumer prices, % p.a.	10.9	7.9	2.7	9.4	15.0	10.0	6.0
Producer prices in industry, % p.a.	17.4	4.1	-1.6	40.8	15.0	8.0	5.0
General governm. budget, nat. def., % of GDP							
Revenues	33.3	32.4	32.6	30.4	15.0	23.0	26.0
Expenditures	35.2	34.6	37.9	33.9	40.0	38.0	34.0
Deficit (-) / surplus (+)	-1.9	-2.2	-5.3	-3.4	-25.0	-15.0	-8.0
General gov. gross debt, nat. def., % of GDP	60.9	50.2	60.4	46.7	90.0	85.0	75.0
Stock of loans of non-fin. private sector, % p.a.	5.6	-9.8	-2.8	8.2	.	.	.
Non-performing loans (NPL), in %, eop	52.8	48.4	41.0	30.0	.	.	.
Central bank policy rate, % p.a., eop 4)	18.00	13.50	6.00	9.00	12.0	10.0	8.0
Current account, EUR m 5)	-5,443	-3,682	4,612	-2,229	1,600	1,700	300
Current account, % of GDP	-4.9	-2.7	3.4	-1.3	1.4	1.4	0.2
Exports of goods, BOP, EUR m 5)	36,677	41,146	39,527	53,316	31,000	33,500	38,500
annual change in %	4.2	12.2	-3.9	34.9	-41.9	8.1	14.9
Imports of goods, BOP, EUR m 5)	47,436	53,877	45,462	58,858	31,200	37,400	46,600
annual change in %	8.4	13.6	-15.6	29.5	-47.0	19.9	24.6
Exports of services, BOP, EUR m 5)	13,401	15,591	13,628	15,735	11,700	12,800	15,400
annual change in %	6.1	16.3	-12.6	15.5	-25.6	9.4	20.3
Imports of services, BOP, EUR m 5)	12,270	14,029	9,775	12,112	9,000	10,300	12,400
annual change in %	3.9	14.3	-30.3	23.9	-25.7	14.4	20.4
FDI liabilities, EUR m 5)	4,210	5,174	266	6,066	.	.	.
FDI assets, EUR m 5)	98	554	317	368	.	.	.
Gross reserves of CB excl. gold, EUR m 5)	15,955	21,590	22,422	25,920	.	.	.
Gross external debt, EUR m 5)	92,352	109,134	102,293	114,424	130,000	121,000	107,000
Gross external debt, % of GDP	83.4	79.4	74.6	67.7	110.0	96.0	76.0
Average exchange rate UAH/EUR	32.14	28.95	30.79	32.31	33.0	35.8	38.1

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

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

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Internet Homepage: www.wiiw.ac.at

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