JULY-AUGUST 2023

Monthly Report

Summer Forecast Update

Southeast Europe Motors on while Rest of Region Struggles

Economic Forecasts for Eastern Europe for 2023-25

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

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VASILY ASTROV
RICHARD GRIEVESON
DORIS HANZL-WEISS
BERND CHRISTOPH STRÖHM

et al. (including Alexandra Bykova, Rumen Dobrinsky, Selena Duraković, Meryem Gökten, Gábor Hunya, Branimir Jovanović, Niko Korpar, Sebastian Leitner, Isilda Mara, Olga Pindyuk, Sándor Richter, Maryna Tverdostup, Nina Vujanović, Zuzana Zavarská and Adam Żurawski)

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

Press date: 5 July 2023

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TABLES AND FIGURES

Cut-off date for historical data and forecasts: 15 June 2023. Most data are taken from the wiiw Databases. Direct access is available at: https://data.wiiw.ac.at/.

ABBREVIATIONS

BIS	Bank for International Settlements
BOP	balance of payments
CIS	Commonwealth of Independent States
CPI	consumer price index/inflation
CSM	Community of Serb Municipalities
EBRD	European Bank for Reconstruction and Development
ECB	European Central Bank
EU	European Union
EU-CEE	Central and East European EU member states
EU-SEE	Southeast European EU member states (Bulgaria, Croatia, Romania)
FDI	foreign direct investment
GDP	gross domestic product
GERB	Bulgarian conservative party (Граждани за европейско развитие на България)
HICP	Harmonised Index of Consumer Prices (EU wide inflation measurement)
ICT	information and communication technology
IPA	Instrument for Pre-accession Assistance
IT	information technology
KFOR	NATO-led international peacekeeping force in Kosovo
NATO	North Atlantic Treaty Organisation
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
RRF	Recovery and Resilience Facility
S&P	Standard & Poor's
WB	Western Balkans
wiiw	The Vienna Institute for International Economic Studies

.	not available (in tables)	EUR	euro
bn	billion	USD	US dollar
eop	end of period		
m	million		
p.a.	per annum		
Q1 2023	first quarter of 2023		
sa	seasonally adjusted		
y-o-y	year on year		

Keywords: CESEE, Central and Eastern Europe, economic forecast, Western Balkans, Visegrád group, CIS, Ukraine, Russia, Turkey, euro area, EU, Russia-Ukraine war, Russia sanctions, commodity prices, inflation, monetary and fiscal policy, EU funds, interest rates, banking sector, credit, impact on Austria, macroeconomic forecasting

JEL classification: E20, E21, E22, E23, E24, E31, E32, E5, E62, F21, F31, H60, I18, J20, J30, O47, O52, O57, P24, P27, P33, P52

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		

EA20 **Euro area**

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

Summer 2023 interim forecast update

Table 1 / OVERVIEW 2021-2022 AND OUTLOOK 2023-2025

		GDP real change in % against prev. year					Consumer prices average change in % against prev. year					Unemployment (LFS) rate in %, annual average				
				Forecast					Forecast					Forecast		
		2021	2022	2023	2024	2025	2021	2022	2023	2024	2025	2021	2022	2023	2024	2025
BG	Bulgaria	7.6	3.4	1.3	2.0	2.5	2.8	13.0	10.0	7.0	5.0	5.3	4.3	4.3	4.2	4.2
CZ	Czechia	3.6	2.5	0.2	2.4	2.7	3.3	14.8	11.0	3.5	2.8	2.8	2.2	2.7	2.6	2.6
EE	Estonia	8.0	-1.3	0.2	2.8	3.1	4.5	19.4	10.1	3.0	1.8	6.2	5.6	6.7	6.2	5.6
HR	Croatia	13.1	6.2	2.5	2.9	3.1	2.7	10.7	6.5	4.0	3.0	7.6	7.0	6.8	6.7	6.6
HU	Hungary	7.2	4.6	-0.5	2.0	2.5	5.2	15.3	18.5	6.0	3.0	4.1	3.6	4.5	4.0	3.6
LT	Lithuania	6.0	1.9	0.3	2.7	3.0	4.6	18.9	10.0	2.8	2.0	7.1	6.0	7.2	6.7	6.3
LV	Latvia	4.3	2.8	0.8	2.8	3.0	3.2	17.2	11.0	2.7	2.6	7.6	6.9	6.9	6.5	6.0
PL	Poland	6.9	5.1	1.0	2.4	3.2	5.2	13.2	12.5	6.0	4.0	3.4	2.9	3.4	3.8	4.0
RO	Romania	5.8	4.7	3.0	4.0	4.3	4.1	12.0	9.0	6.0	4.0	5.6	5.6	5.5	5.4	5.2
SI	Slovenia	8.2	5.4	1.4	2.5	2.7	2.0	9.3	6.6	3.6	2.8	4.8	4.0	3.9	3.9	3.9
SK	Slovakia	4.9	1.7	0.6	2.0	2.4	2.8	12.1	10.2	5.0	3.0	6.8	6.1	6.3	6.2	6.0
	EU-CEE11 1)2)	*6.5*	*4.2*	*1.2*	*2.7*	*3.2*	*4.3*	*13.5*	*11.5*	*5.4*	*3.6*	*4.5*	*4.0*	*4.4*	*4.4*	*4.4*
	EA20 3)	*5.3*	*3.5*	*0.5*	*1.8*	*1.7*	*2.6*	*8.5*	*5.7*	*3.0*	*2.3*	*7.7*	*6.8*	*6.6*	*6.6*	*6.6*
	EU27 3)	*5.4*	*3.5*	*0.7*	*2.0*	*1.9*	*2.9*	*9.0*	*5.9*	*3.2*	*2.5*	*7.1*	*6.2*	*5.8*	*5.8*	*5.8*
AL	Albania	8.9	4.8	3.3	3.8	4.0	2.0	6.7	4.0	3.0	2.5	11.5	10.9	10.0	9.7	9.5
BA	Bosnia and Herzegovina	7.4	3.9	1.5	2.3	2.5	2.0	14.0	8.7	4.0	2.5	17.4	15.4	15.0	14.7	14.4
ME	Montenegro	13.0	6.1	3.5	2.9	3.0	2.4	13.0	9.7	4.0	2.8	16.6	14.7	13.8	13.1	12.0
MK	North Macedonia	3.9	2.1	1.6	2.5	3.0	3.2	14.2	9.0	4.0	3.0	15.7	14.4	13.0	12.5	12.0
RS	Serbia	7.5	2.3	1.3	2.5	3.0	4.1	11.9	12.0	5.0	3.0	11.0	9.4	9.0	8.5	8.0
XK	Kosovo	10.7	3.5	3.4	3.9	4.1	3.4	11.6	7.0	4.0	2.5	20.7	18.0	17.0	16.5	16.0
	WB6 1)2)	*7.8*	*3.2*	*1.9*	*2.8*	*3.1*	*3.2*	*11.9*	*9.5*	*4.3*	*2.8*	*13.6*	*12.1*	*11.4*	*10.9*	*10.5*
TR	Turkey	11.4	5.6	2.6	3.4	3.8	19.6	72.3	42.8	33.8	17.1	12.0	10.5	10.0	9.5	9.0
BY	Belarus	2.4	-4.7	1.9	2.2	2.5	9.5	15.2	9.0	8.0	8.0	3.9	3.6	3.5	3.5	3.5
KZ	Kazakhstan	4.3	3.3	4.5	4.0	4.0	8.0	15.0	14.5	9.0	6.0	4.9	4.9	4.8	4.8	4.8
MD	Moldova	13.9	-5.9	2.5	4.0	4.0	5.1	28.7	14.0	6.0	5.0	3.2	3.1	3.5	3.2	3.0
RU	Russia	5.6	-2.1	1.0	1.5	1.5	6.7	13.8	5.1	4.6	3.4	4.8	3.9	3.5	3.5	3.5
UA	Ukraine	3.4	-29.1	2.0	4.0	6.0	9.4	20.2	14.0	9.0	7.0	9.9	25.0	23.0	15.0	10.0
	CIS4+UA 1)2)	*5.3*	*-3.7*	*1.4*	*2.0*	*2.1*	*7.1*	*14.5*	*6.8*	*5.5*	*4.1*	*5.6*	*7.4*	*6.7*	*5.4*	*4.6*
	V4 1)2)	*6.2*	*4.3*	*0.6*	*2.3*	*2.9*	*4.6*	*13.7*	*12.9*	*5.5*	*3.6*	*3.7*	*3.2*	*3.7*	*3.8*	*3.9*
	BALT3 1)2)	*6.0*	*1.4*	*0.4*	*2.8*	*3.0*	*4.2*	*18.5*	*10.3*	*2.8*	*2.1*	*7.0*	*6.1*	*7.0*	*6.5*	*6.1*
	SEE9 1)2)	*7.3*	*4.3*	*2.5*	*3.3*	*3.6*	*3.6*	*12.0*	*9.0*	*5.6*	*3.8*	*8.7*	*7.9*	*7.6*	*7.3*	*7.1*
	CIS3+UA 1)2)	*3.9*	*-10.2*	*3.1*	*3.7*	*4.5*	*8.7*	*17.4*	*13.4*	*8.8*	*6.7*	*7.3*	*15.3*	*14.1*	*9.8*	*7.2*
	non-EU12 1)2)	*7.0*	*-0.7*	*1.8*	*2.4*	*2.7*	*10.5*	*31.5*	*17.6*	*13.8*	*7.9*	*7.4*	*8.4*	*7.7*	*6.6*	*6.0*
	CESEE23 1)2)	*6.9*	*0.8*	*1.6*	*2.5*	*2.8*	*8.7*	*25.9*	*15.7*	*11.2*	*6.5*	*6.7*	*7.3*	*6.9*	*6.1*	*5.5*

Table 1 / OVERVIEW 2021-2022 AND OUTLOOK 2023-2025 (contd.)

		Current account in % of GDP					Fiscal balance in % of GDP				
				Forecast					Forecast		
		2021	2022	2023	2024	2025	2021	2022	2023	2024	2025
BG	Bulgaria	-1.9	-0.7	-0.5	-0.3	0.3	-3.9	-2.8	-5.0	-4.0	-3.0
CZ	Czechia	-2.8	-6.1	-2.8	-1.7	-0.5	-5.1	-3.6	-4.2	-2.3	-1.5
EE	Estonia	-1.8	-2.2	0.5	1.7	1.3	-2.4	-0.9	-3.5	-3.2	-2.9
HR	Croatia	1.8	-1.6	-1.0	-0.4	0.2	-2.5	0.4	-2.4	-2.0	-1.8
HU	Hungary	-4.1	-8.1	-4.0	-2.8	-2.0	-7.1	-6.2	-4.5	-4.0	-3.3
LT	Lithuania	1.1	-5.1	-2.5	-2.0	-1.8	-1.2	-0.6	-2.0	-2.0	-1.5
LV	Latvia	-4.2	-6.4	-3.0	-2.0	-1.6	-7.1	-4.4	-4.0	-2.7	-2.0
PL	Poland	-1.4	-3.0	-0.3	0.4	1.0	-1.8	-3.7	-4.8	-4.0	-3.5
RO	Romania	-7.2	-9.3	-7.0	-6.0	-5.0	-7.1	-6.2	-5.0	-4.5	-4.0
SI	Slovenia	3.8	-0.4	0.8	1.1	1.4	-4.6	-3.0	-3.9	-2.6	-2.2
SK	Slovakia	-2.5	-8.2	-5.0	-3.1	-2.6	-5.4	-2.0	-6.0	-4.4	-4.5
	EU-CEE11 1)2)	*-2.5*	*-5.1*	*-2.4*	*-1.6*	*-0.8*	*-4.1*	*-3.9*	*-4.5*	*-3.6*	*-3.1*
	EA20 3)	*3.8*	*0.8*	*1.0*	*1.5*	*2.5*	*-5.3*	*-3.6*	*-3.7*	*-2.7*	*-2.6*
	EU27 3)	*3.4*	*0.6*	*1.0*	*1.5*	*2.5*	*-4.8*	*-3.4*	*-3.3*	*-2.3*	*-2.2*
AL	Albania	-7.7	-6.0	-5.9	-5.8	-5.8	-4.6	-3.7	-2.5	-2.5	-2.5
BA	Bosnia and Herzegovina	-2.4	-4.5	-4.0	-4.1	-4.3	-0.3	-1.0	0.5	1.0	1.0
ME	Montenegro	-9.2	-13.2	-11.9	-10.9	-10.4	-1.9	-5.2	-4.9	-4.8	-4.5
MK	North Macedonia	-3.1	-6.0	-4.0	-3.5	-3.5	-5.4	-4.5	-3.0	-2.5	-2.5
RS	Serbia	-4.2	-6.9	-5.5	-4.5	-4.0	-4.1	-3.2	-2.5	-2.0	-1.5
XK	Kosovo	-8.7	-10.5	-9.7	-9.4	-9.3	-1.3	-0.5	-0.5	-1.0	-1.0
	WB6 1)2)	*-4.8*	*-6.8*	*-5.7*	*-5.2*	*-4.9*	*-3.4*	*-2.9*	*-2.0*	*-1.7*	*-1.4*
TR	Turkey	-0.9	-5.3	-4.0	-3.0	-2.5	-2.4	-1.1	-4.0	-3.0	-3.0
BY	Belarus	3.1	3.7	1.5	1.3	1.0	0.2	-2.0	-3.0	-2.0	-1.0
KZ	Kazakhstan	-1.3	3.8	-2.0	-2.0	-2.4	-3.0	-2.1	-2.7	-2.5	-2.0
MD	Moldova	-12.4	-15.8	-14.5	-12.5	-11.0	-1.9	-3.3	-4.5	-3.5	-3.0
RU	Russia	6.7	10.4	4.3	3.4	2.7	0.8	-1.4	-3.5	-3.0	-2.5
UA	Ukraine	-1.9	5.0	2.0	-2.0	-4.6	-3.4	-16.3	-27.0	-15.0	-10.0
	CIS4+UA 1)2)	*5.0*	*9.2*	*3.4*	*2.4*	*1.5*	*0.1*	*-2.3*	*-4.5*	*-3.6*	*-3.1*
	V4 1)2)	*-2.2*	*-4.9*	*-1.8*	*-0.8*	*0.0*	*-3.7*	*-3.9*	*-4.7*	*-3.7*	*-3.1*
	BALT3 1)2)	*-1.1*	*-4.7*	*-1.9*	*-1.1*	*-1.0*	*-3.1*	*-1.7*	*-2.9*	*-2.5*	*-2.0*
	SEE9 1)2)	*-4.8*	*-6.5*	*-5.0*	*-4.3*	*-3.6*	*-5.2*	*-4.1*	*-4.0*	*-3.5*	*-3.0*
	CIS3+UA 1)2)	*-1.2*	*3.6*	*-0.5*	*-1.8*	*-2.9*	*-2.7*	*-7.0*	*-11.0*	*-6.7*	*-4.6*
	non-EU12 1)2)	*3.1*	*5.1*	*1.1*	*0.3*	*-0.2*	*-0.7*	*-2.1*	*-4.5*	*-3.4*	*-2.9*
	CESEE23 1)2)	*1.1*	*1.6*	*-0.2*	*-0.4*	*-0.4*	*-2.0*	*-2.7*	*-4.5*	*-3.5*	*-3.0*

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: 15 June 2023.

1. Global assumptions: Mood darkening as summer arrives

BY RICHARD GRIEVESON

The euro area economy last year showed impressive resilience to the energy price shock, but it has now slipped into technical recession and we continue to expect only a moderate positive outturn for the economy in 2023 as a whole. We have left our forecasts for euro area growth and inflation unchanged from spring, although we think that the downside risks are greater than they were then.

Table 2 / wiiw summer 2023 global assumptions

	Spring 2023			Changes since spring		
	2023	2024	2025	2023	2024	2025
Euro area real GDP growth, %	0.5	1.8	1.7	0.0	0.0	0.0
Euro area CPI, %	5.7	3.0	2.3	0.0	0.0	0.0
Euro area unemployment rate, %	6.6	6.6	6.6	0.0	0.0	0.0
Euro area current account, % of GDP	1.0	1.5	2.5	0.0	0.0	0.0
USD/EUR exchange rate, average	1.08	1.08	1.08	0.0	0.0	0.0
ECB refinancing rate, %, eop	4.00	3.00	2.00	0.0	0.0	0.0
USD per barrel Brent oil, USD, average	80.0	75.0	71.0	-3.0	-3.0	-2.0

Source: wiiw summer 2023 forecasts. Cut-off date 15 June 2023.

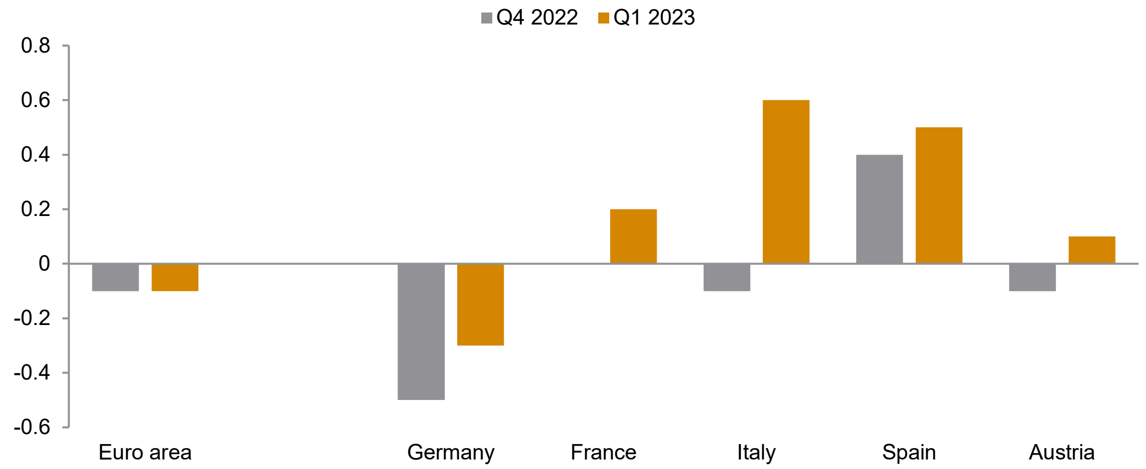
The latest data are very weak, suggesting that the underlying resilience of the euro area economy is being severely tested. The data are particularly concerning for manufacturing – and especially so for Germany, the key economy from a CESEE perspective. Sentiment data for Germany have been flashing red for several months, and in late May it was confirmed that the country had fallen into technical recession, having posted negative quarterly growth in both Q4 2022 and Q1 2023 (Figure 1).[1] These data have also contributed to a recession in the euro area as a whole, although in this case the contraction was of 0.1% in both quarters, meaning that the single currency is more or less flatlining, rather than experiencing anything more serious at this stage. The euro area outturn for Q1 2023 was also influenced by a sharp 4.6% contraction in Ireland, a country that often has sizeable GDP swings due to the major presence of foreign multinationals. France, Italy and Spain – the next biggest euro area economies after Germany – all showed improved performance in Q1 2023 versus the previous three months, as did Austria. Italy and Austria in particular are also important for the CESEE countries.

Germany's particular struggles seem to reflect above all the challenges faced by its manufacturing sector, which now has to contend with substantially higher energy prices and a broader weakness in demand from many key markets. Although the decline in the gas spot price to pre-invasion levels has been celebrated, the effective energy price paid by European firms is substantially higher than that facing their counterparts in the US. Clearly, this places European industry at a disadvantage. In May, Germany's manufacturing Purchasing Managers' Index (PMI) fell to its lowest level for three years. At 43.2, the index was well below the key 50 level that separates expansion from

1 https://ec.europa.eu/eurostat/en/web/products-euro-indicators/w/2-08062023-ap

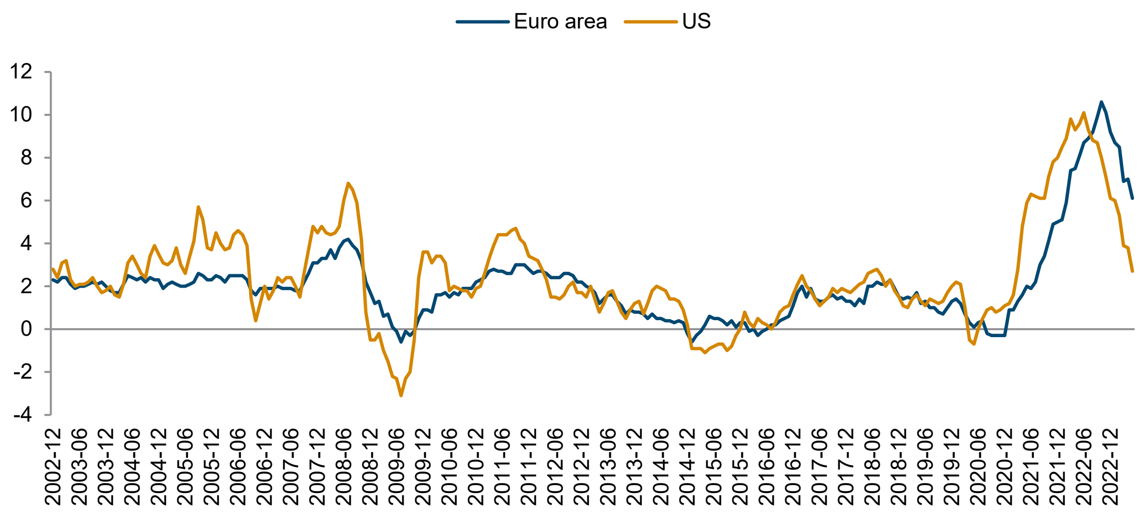
contraction. According to the survey, firms reported a perfect storm of challenges, including weaker client demand and lower investment on the back of tightening financial conditions. Foreign orders fell particularly sharply in May, with firms reporting weaker demand from Europe, China and the US.

Figure 1 / Real GDP, % change versus previous quarter



Source: Eurostat.

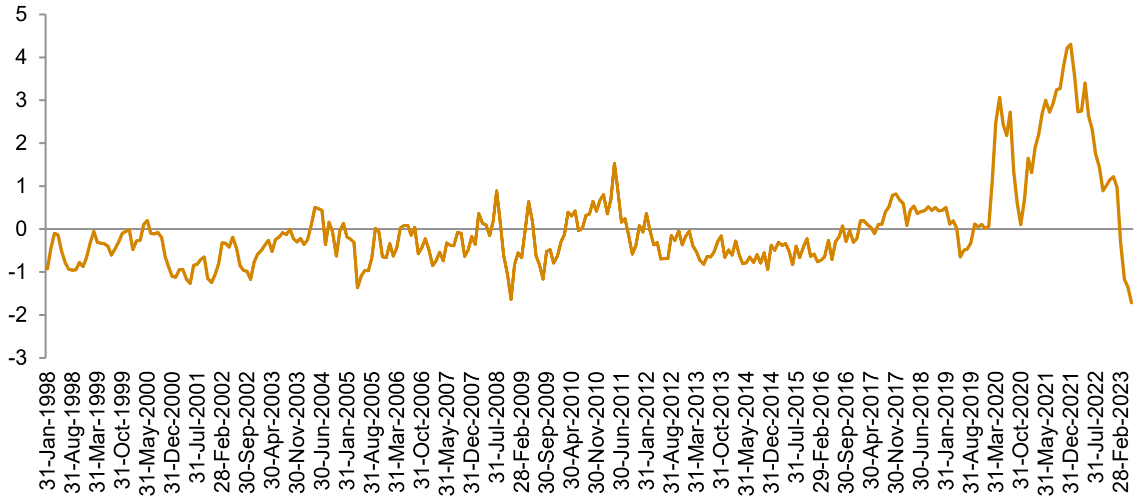
Figure 2 / Harmonised Index of Consumer Prices, % change year on year



Source: Eurostat.

We retain our view that euro area inflation has peaked and will continue to come down, for a combination of supply and demand reasons. According to Eurostat, and applying the Harmonised Index of Consumer Prices (HICP) methodology, inflation in the US peaked earlier and has fallen more than in the euro area; but inflation in both seems to be clearly on a downward path (Figure 2). In the manufacturing sector, the weakness of demand from all key areas of the global economy outlined above indicates that deflationary pressures are likely to become stronger. This is reinforced by the Federal Reserve Bank of New York's Global Supply Chain Pressure Index, which has plummeted in recent months (Figure 3). In services, sentiment remains more robust; but here, too, price pressures from the demand side are likely to ease. Although last year consumer spending growth was strong even as real wages fell, consumer demand will likely fade as savings are drawn down and fiscal stimulus is reduced or even reversed.

Figure 3 / Global Supply Chain Pressure Index, standard deviations from average value



Source: Federal Reserve Bank of New York.

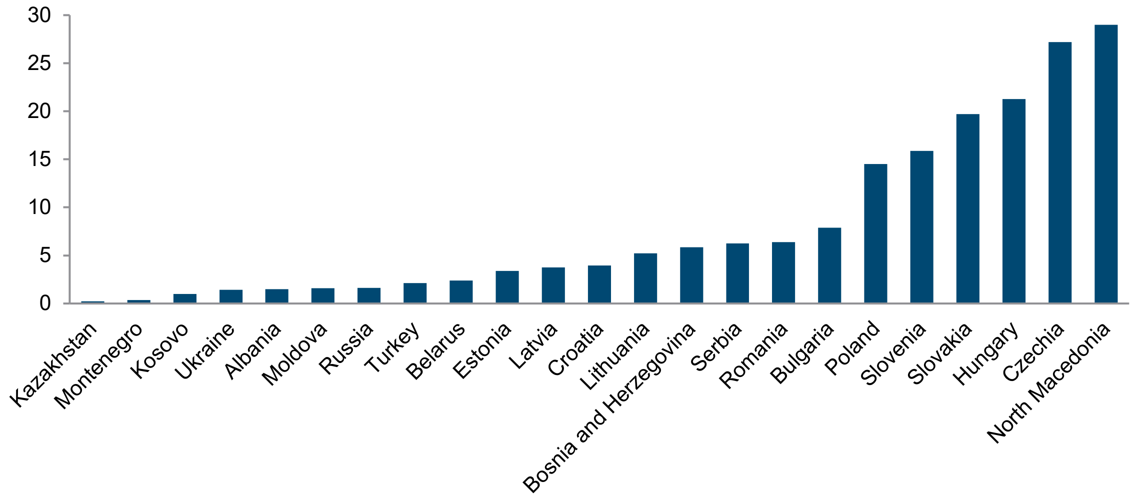
We continue to think that both the US Federal Reserve and the European Central Bank (ECB) are close to the end of their tightening cycles, although the balance of risk has in recent weeks tilted towards more tightening, as both banks have expressed concern that inflation is not falling as fast as they had expected. At its most recent meeting, the Fed held its rates; but both it and the ECB have recently communicated that they may need to keep hiking for longer than originally planned. Both will be aware that much of the impact of the tightening already undertaken has not yet filtered through to the real economy.

The US and China are both at the moment still broadly supportive of global economic activity, but in both cases there are grounds for concern. The much-predicted US recession has not yet arrived, and after rising by more than 20% since last October, the S&P 500 has entered a 'bull market'. However, there remains a decent chance that the US will enter technical recession at some point in the coming quarters, with the resilience of consumers there also likely to fade. Meanwhile China's post-COVID reopening means that growth will be higher this year than last; but the pace of recovery there has so far fallen short of expectations.

For CESEE, the implications of all this are similar to the situation in spring, with external demand from the euro area and other key markets like China unlikely to be a major growth driver for the region this year. The particular weakness of German manufacturing is especially concerning for the region, given the heavy dependence of most CESEE countries on Germany for export demand, and the high share of exports in GDP overall for much of the region (Figure 4). On the positive side, however, the fact that the ECB is probably close to the end of its tightening cycle will take some pressure off

CESEE's central banks. Meanwhile, tourism data suggest that here demand from the wealthy countries of Western Europe remains robust, which this year will benefit Southeast Europe, in particular.

Figure 4 / Exports to Germany, % of GDP, 2022 or latest available



Note: Belarus, Russia and Ukraine data for 2021.
Sources: National sources, Eurostat.

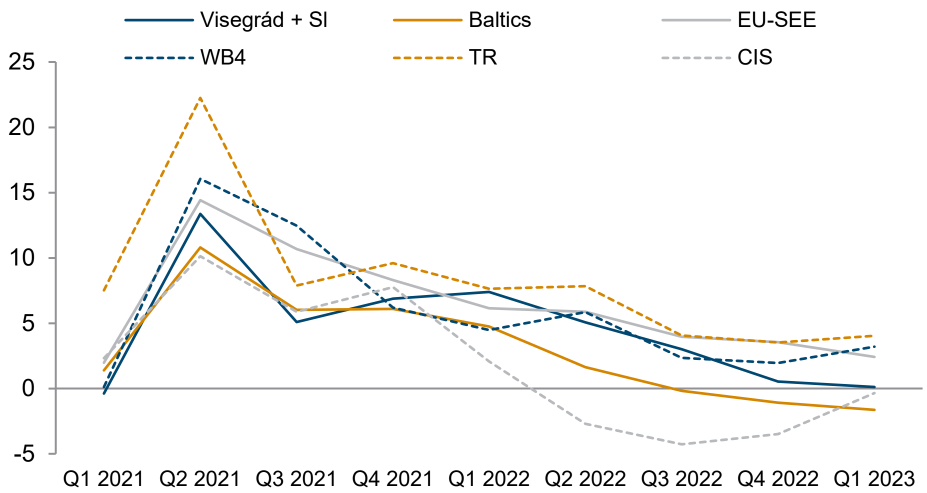
2. Southeast Europe motors on while rest of region struggles

BY VASILY ASTROV[1]

2.1 FURTHER GROWTH SLOWDOWN IN EU-CEE, IMPROVEMENTS ELSEWHERE

In Central and East European EU member states (EU-CEE), economic growth slowed further in Q1 2023, as still high inflation, monetary policy tightening and a weak external environment all dampened growth performance (Figure 5). After a meagre 0.5% in Q4 2022 (year on year),[2] GDP growth overall in the Visegrád region and Slovenia almost ground to a halt in Q1 2023, and actually turned negative in Poland, Czechia and particularly Hungary (-0.9%). Estonia and Lithuania both recorded declining GDP over two consecutive quarters (Q4 2022 and Q1 2023), which in the case of Lithuania deepened over time. This contrasts with the relatively resilient performance of Bulgaria, Croatia and Romania. Although growth in those countries subsided as well – on average from 3.5% in Q4 2022 to 2.4% in Q1 2023 – it remained quite robust, compared to all the other EU-CEE countries.

Figure 5 / Real GDP, percentage change year on year



Note: Simple averages for country aggregates. WB4 includes Kosovo, Montenegro, North Macedonia and Serbia. EU-SEE includes Bulgaria, Croatia and Romania. Ukraine is not included.
Source: wiiw Monthly Database, incorporating national and Eurostat statistics.

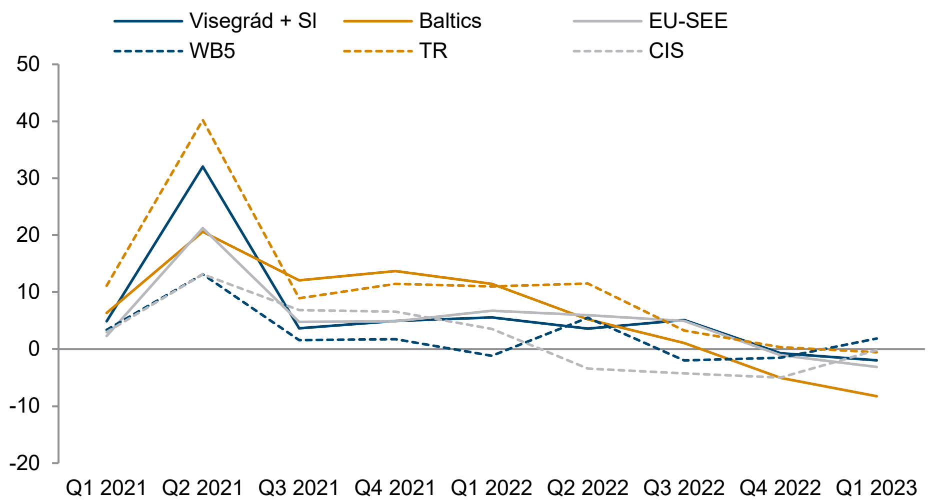
[1] The author would like to thank Meryem Gökten, Richard Grieveson, Branimir Jovanović, Olga Pindyuk and Nina Vujanović, all wiiw, for valuable comments and suggestions on the first draft.

[2] Here and below: simple averages.

However, elsewhere in Central, East and Southeast Europe (CESEE) the growth dynamics have improved. In the Western Balkans,[3] average growth picked up from 2% in Q4 2022 to 3.2% in Q1 2023, thanks to a good tourist season and strong inflows of remittances and foreign direct investment (FDI). In Turkey, the acceleration in growth from 3.5% to 4% largely reflects the spending spree ahead of the presidential election in May. In the CIS and Ukraine, growth performance improved as well, partly reflecting the lower statistical basis, but also the progressive adjustment of the economies of Russia, Belarus and Ukraine to war and sanctions. However, economic growth in those three countries, as well as in Moldova, remained negative in Q1. All in all, nine CESEE countries (Belarus, Czechia, Estonia, Hungary, Lithuania, Moldova, Poland, Russia and Ukraine) were in recession in Q1 2023 on an annual basis – up from six countries in the preceding quarter.

The recent slowdown in growth in EU-CEE reflects the downturn in industrial production on the back of a recession in Germany and high energy prices. In nearly all EU-CEE countries (except Czechia), the trend in industrial production turned negative in Q1 2023 (Figure 6), going hand in hand with a slowdown in exports (Figure 7). One important reason for this was that the German economy has been in recession since Q4 2022: this reflects the weakness of its manufacturing sector in the light of low demand from China, the US and the rest of Europe, as well as high energy prices for industry (reportedly 3-4 times higher than in the US, undermining export competitiveness). All this has had repercussions for the manufacturing sector in many EU-CEE countries, whose own energy price hikes have also affected manufacturing. Elsewhere in CESEE, developments in industrial production in Q1 2023 were more mixed, with growth reaching 9.5% in Montenegro (largely reflecting increased electricity production, thanks to abundant rainfall).

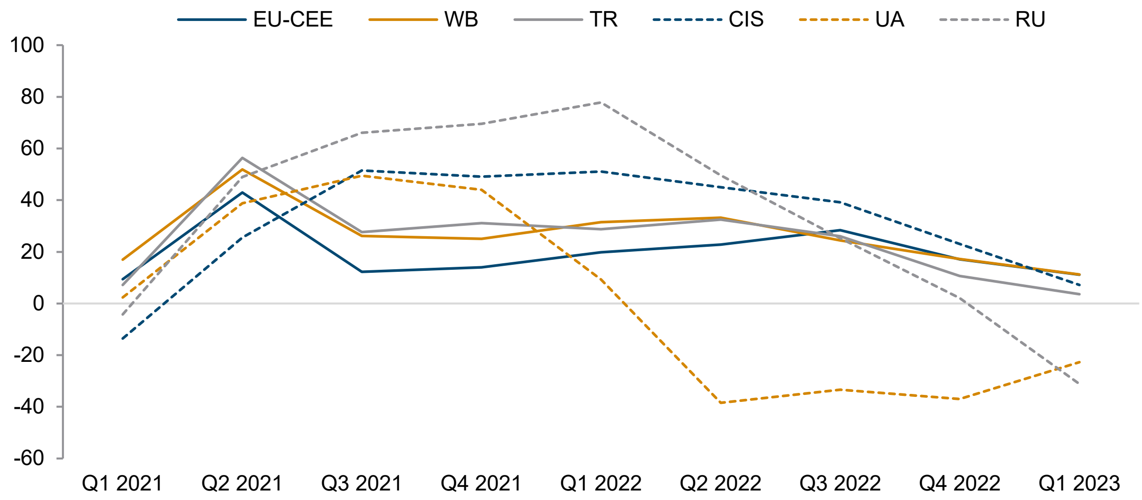
Figure 6 / Gross industrial output, percentage change year on year



Note: Simple averages for country aggregates. WB5 includes Bosnia and Herzegovina, Kosovo, Montenegro, North Macedonia and Serbia. EU-SEE includes Bulgaria, Croatia and Romania. Ukraine is not included.
Source: wiiw Monthly Database, incorporating national and Eurostat statistics.

[3] Without Albania and Bosnia and Herzegovina, for which Q1 2023 GDP data are not yet available.

Figure 7 / Annual growth in merchandise exports (euro based), %



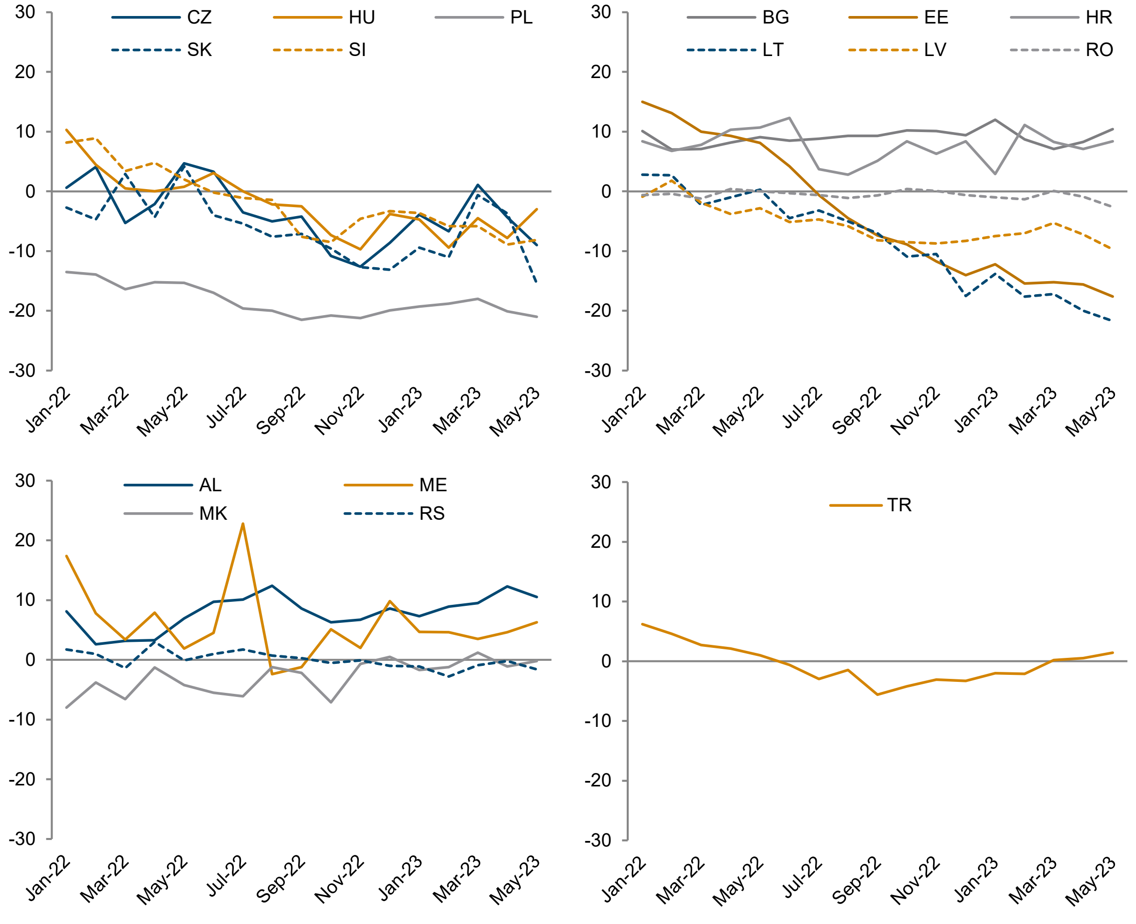
Note: CIS includes Belarus, Kazakhstan and Moldova. Data for Russia according to BOP methodology.
Source: wiiw Monthly Database, incorporating national statistics.

However, despite the recent slowdown, the picture for merchandise exports remained generally positive (Figure 7). In only three CESEE countries – Russia, Ukraine and Estonia – did exports register a marked decline in Q1 2023 on an annual basis (in euro terms). Russia's exports plummeted by 31% on the back of Western energy sanctions, which resulted in a substantial fall in the price of exported oil, while gas exports suffered on account of the ongoing de-coupling from EU markets. Ukraine's export performance continues to be constrained by the loss of production and transportation capacities in the occupied territories (with some important ports on the Azov Sea falling under Russian occupation), while the Black Sea grain deal and the EU preferential trade regime agreed last year have provided only partial relief. Finally, the decline in Estonia's exports of 8% can be explained by the fact that last year's very high inflation (the highest in the EU) eroded the country's competitiveness.

Forward-looking indicators do not suggest a rapid rebound in industrial production, though services are faring much better. In all EU-CEE countries (except Bulgaria and Croatia), the industrial confidence indicator (the balance of positive over negative survey results) has recently been in negative territory and declining further, although in the Western Balkans the picture is rather more mixed (Figure 8). This contrasts with the prevailing optimism in the services sector, which continues to benefit from fiscal stimuli and pent-up demand in the wake of COVID-19 (especially in tourism). Nearly everywhere in CESEE, the confidence indicator for the services sector has hovered in or around positive territory (Figure 9).

Figure 8 / Industrial confidence indicator

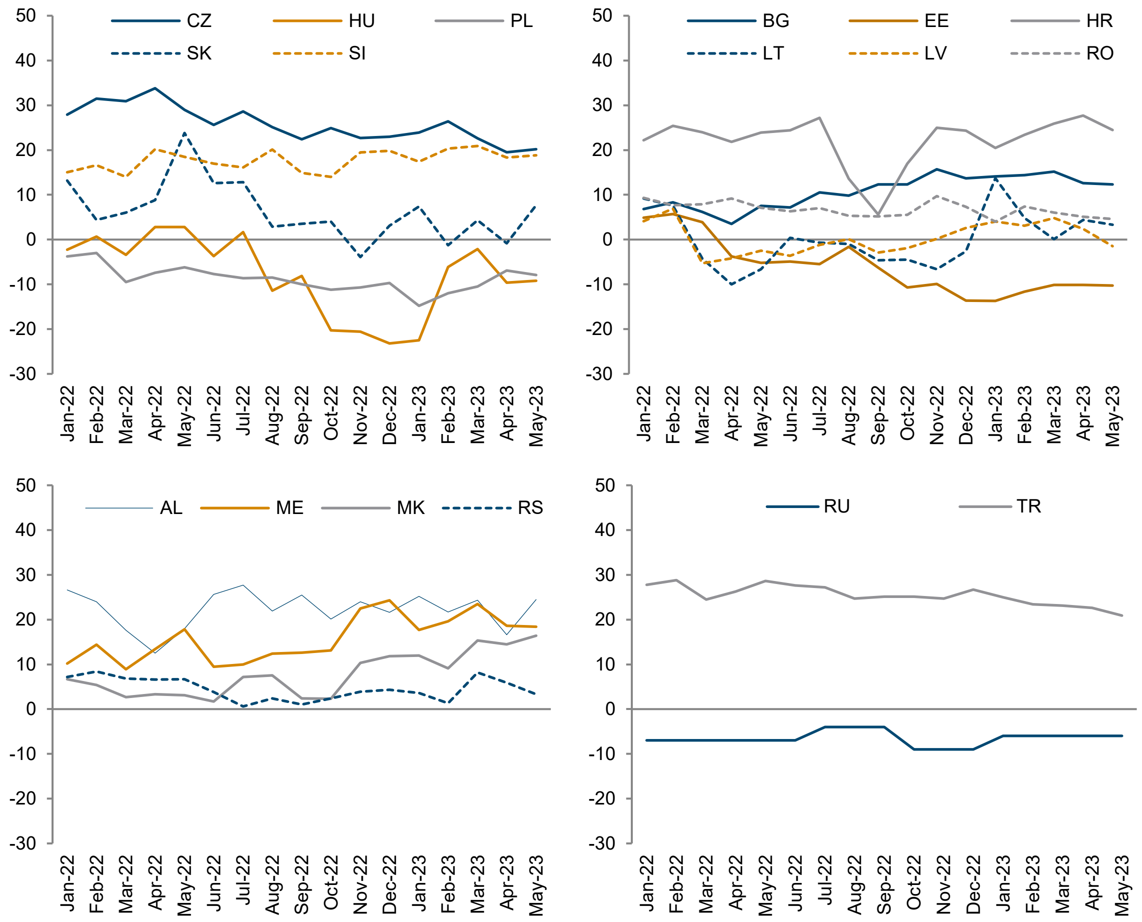
Balance of positive over negative survey results



Source: Eurostat and OECD statistics.

Figure 9 / Services confidence indicator, seasonally adjusted

Balance of positive over negative survey results



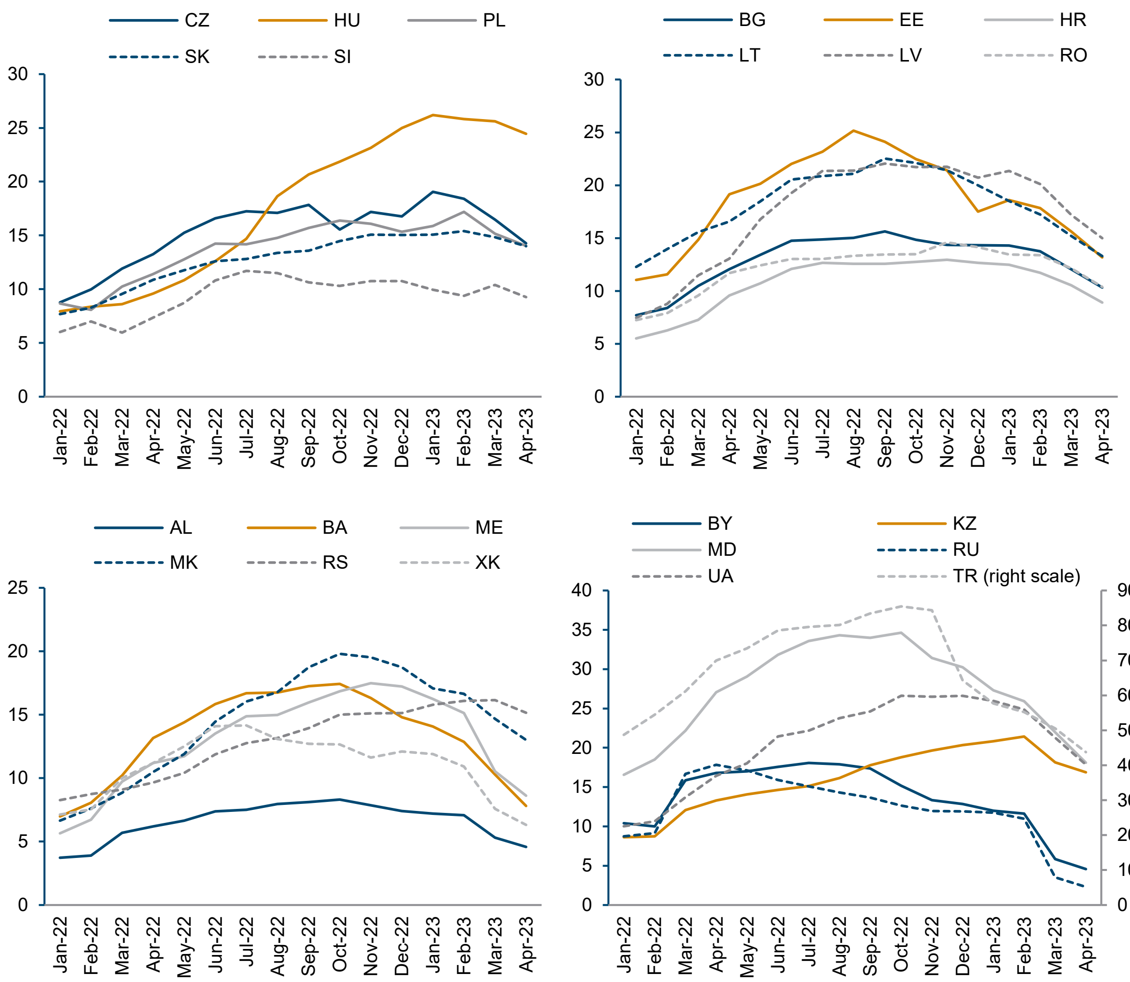
Source: Eurostat and national statistics.

2.2 THE PEAK OF INFLATION HAS ALREADY PASSED…

After a strong push in 2022, inflationary pressures in CESEE have recently abated somewhat... As in many other parts of the world, post-COVID-19 production bottlenecks and the sharp rise in commodity prices in the wake of the Russia-Ukraine war contributed to an unprecedented surge in inflation in CESEE. The peak of consumer price inflation was reached (at the latest) in the first months of 2023, since when there has been gradual disinflation on an annual basis (Figure 10).

… but they remain very high by historical standards. Despite the recent slowdown, annual inflation in CESEE continues in the double-digit range. In some countries, such as Serbia, disinflation has been hampered by recent hikes in administrative prices and tariffs and by the scrapping of previously imposed price caps. Only in Slovenia, Croatia, Russia, Belarus and four of the Western Balkan countries is annual inflation currently below 10%. In some of those countries, this can be attributed to the recent strengthening of their currencies: thanks to strong inflows of remittances and FDI in Albania, and because of massive import declines and capital controls in Russia and Belarus. However, the recent weakening of the Russian rouble will likely result in inflationary pressures in Russia gaining momentum (from the current very low level).

Figure 10 / Consumer Price Index, % change year on year



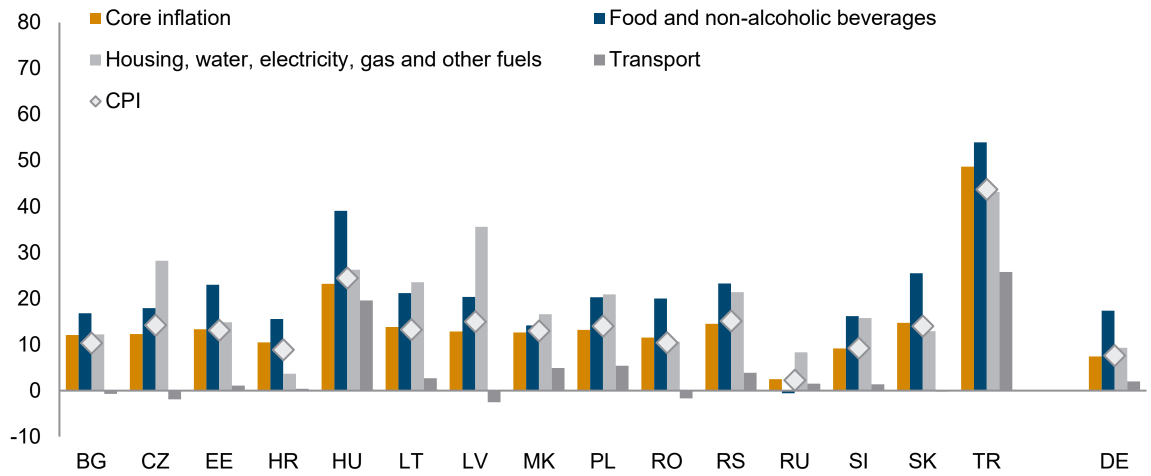
Note: Harmonised Index of Consumer Prices (HICP) for EU-CEE countries.
Source: wiiw Monthly Database, incorporating national and Eurostat statistics.

At the same time, the drivers of inflation have changed markedly over time and inflation has generally become more broad based. Figure 11 compares the current situation regarding the main inflation sub-components with the position in February 2022, which was analysed in our Spring 2022 Forecast Report.[4] Back then, it was primarily energy prices (represented by two bars: 'transport' and 'housing, etc.') that were driving headline inflation: food price inflation and especially core inflation were both more subdued. But the role of those two inflation sub-components has generally increased in the meantime, so that inflation has become more broad based. As of April 2023, food prices were the most important driver of inflation in nine of the 15 CESEE countries presented in Figure 11, while core inflation reached double-digit levels everywhere, except Russia and Slovenia.

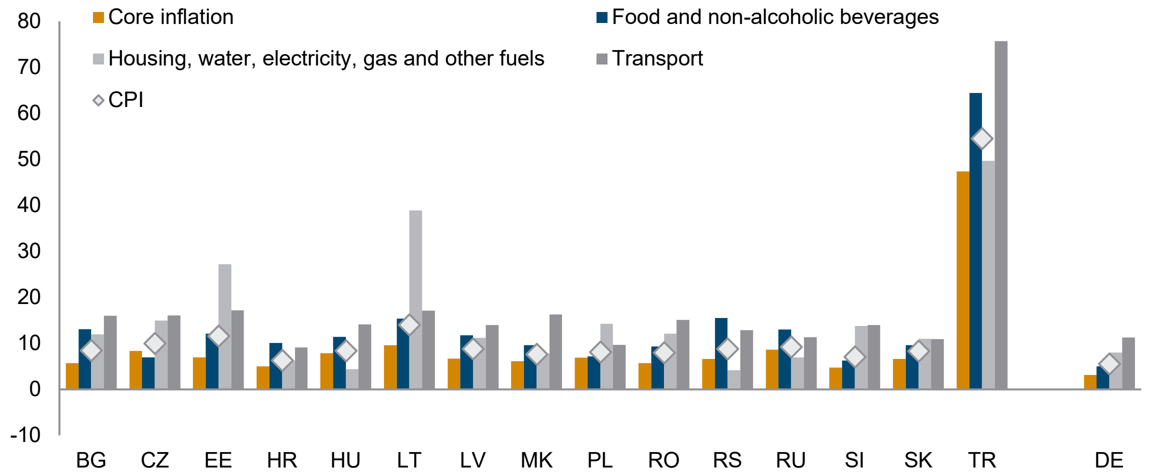
[4] wiiw (2022).

Figure 11 / Consumer price inflation sub-components in April 2023 and February 2022, percentage change year on year

April 2023



February 2022



Source: National sources, Eurostat, wiiw.

Inflation in CESEE has primarily been fuelled by widening profit margins, rather than wage pressures.[5] National accounts data for 2022 demonstrate that, in most countries, there was a redistribution of national income from wages to profits (Figure 12) – in some cases quite a marked one. In Turkey, Russia and Romania, for instance, the profit share of GDP jumped by around 3 percentage points (pp) in just one year, mirrored by declines in the wage share.[6] As demonstrated in our Spring 2023 Forecast Report,[7] real wages last year declined nearly everywhere in CESEE, and this development continued into the first few months of 2023. Thus – and despite the high core inflation – there is hardly any evidence of a wage-price spiral in the region (such as was observed in Western

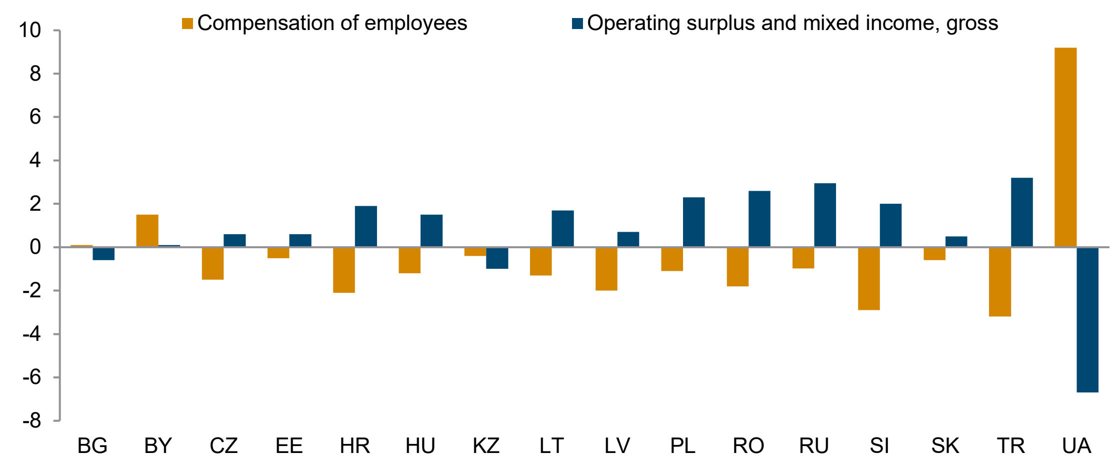
[5] This pattern conforms to developments in some other parts of the world, such as the US – see e.g. Weber and Wasner (2023).

[6] The changes in the wage and profit shares in Figure 12 do not necessarily add up to zero, reflecting changes in net taxes.

[7] wiiw (2023).

Europe in the 1970s), which would typically justify monetary policy tightening in order to curb inflation expectations (for more on that, see below).

Figure 12 / Change in GDP shares of wages and profits from 2021 to 2022, pp

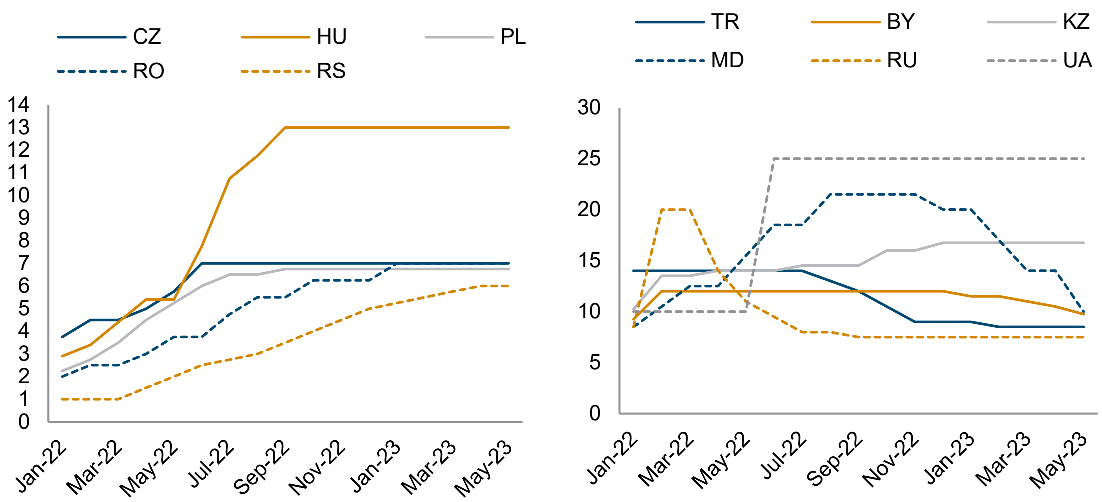


Source: National sources, Eurostat, wiiw.

2.3 … BUT POLICY EASING WILL LIKELY BE DELAYED

In response to rising inflation, monetary policy in most CESEE countries has been progressively tightened over the past year – as it has been in many other parts of the world. In those CESEE countries with flexible exchange rate regimes and higher monetary policy autonomy, policy rates have been progressively hiked (Figure 13), while Bulgaria, for example, raised minimum reserve requirements in order to curb credit expansion.

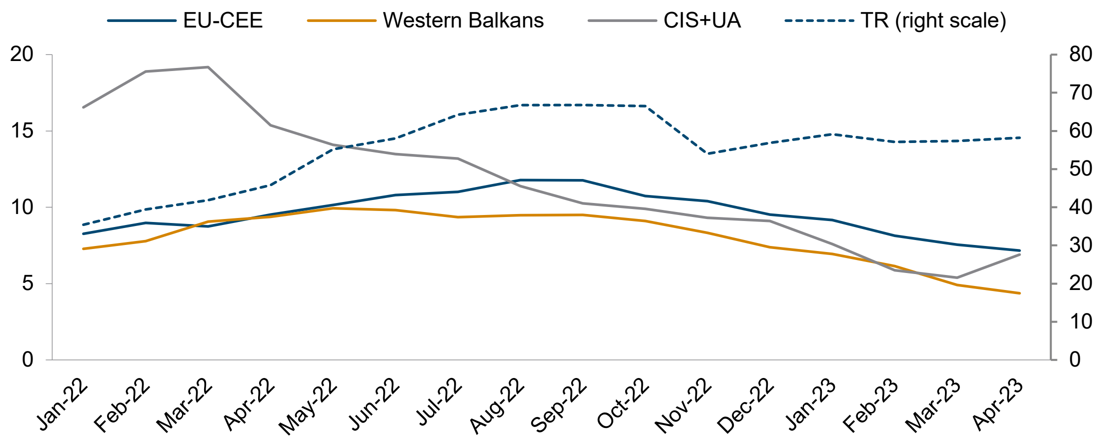
Figure 13 / Central bank nominal policy rate, end of month, %



Source: wiiw Monthly Database, incorporating national statistics.

Monetary tightening has had the predictable effect of curbing demand for loans; this has contributed to the slowdown in growth, but will arguably do little to tame inflation. Since around mid-2022, credit expansion in most EU-CEE and Western Balkan countries has been losing steam on an annual basis (Figure 14); indeed, in many cases it has turned negative in real terms, becoming a drag on domestic demand. In Poland, since February 2023 it has been negative even in nominal terms – despite double-digit inflation. However, monetary tightening is likely to have only a limited effect in taming inflation, which has been largely driven by supply-side factors (such as logistical bottlenecks and widening profit margins), rather than by excess demand. Arguably more effective in fighting inflation in these circumstances are administrative price regulations and fiscal instruments, such as consumer subsidies, often financed via windfall profit taxes. The latter have indeed been widely used in CESEE: government packages aimed at shielding households and firms from high energy prices last year ranged from below 2% of annual household consumption in Moldova and Montenegro to 8-9% in Bulgaria, Lithuania and Czechia (wiiw, 2023). In Montenegro, 'negotiations' are currently going on between the Ministry of Economy and the main companies in retail trade, telecommunications, etc., in order to limit profit margins (the move is called 'Stop inflation').

Figure 14 / Credit growth of non-financial private sector, % year on year

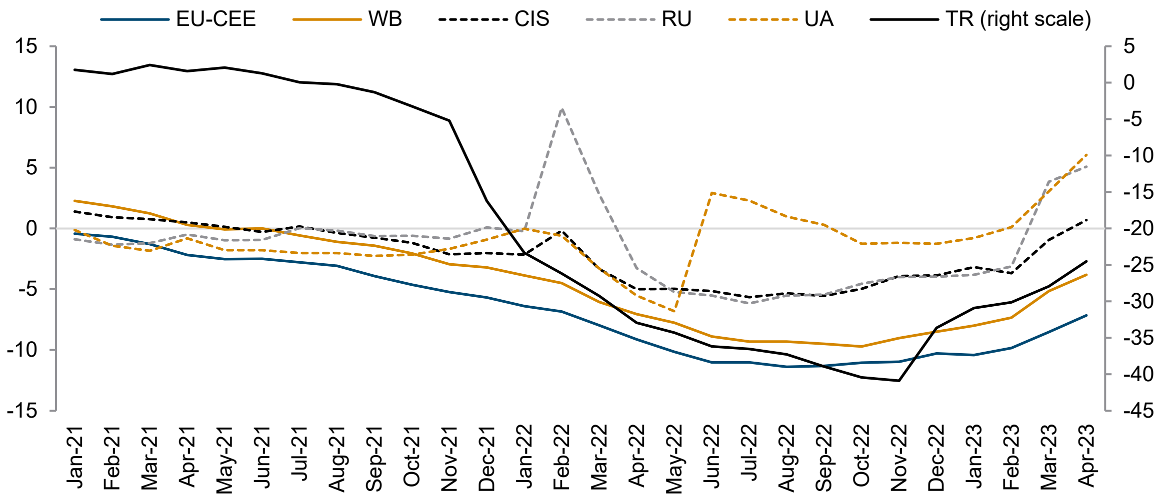


Note: Simple averages for country aggregates.
Source: wiiw Monthly Database, incorporating national statistics.

Although the tightening cycle in EU-CEE has probably reached its peak, policy easing will likely be delayed. In countries with inflation-targeting regimes, inflation remains well above target, with core inflation mostly in double digits, and real policy rates remain negative – though they have been rising recently (Figure 15). Probably most importantly, the European Central Bank (ECB) looks set to continue tightening in the coming months, meaning that there is little room for manoeuvre for the majority of EU-CEE countries, which effectively depend on euro funding. Under the circumstances, monetary policy easing in most of these countries, as well as in Kazakhstan, will probably be delayed until at least the end of 2023. One exception to this is Hungary, which has started cautious policy relaxation in order to boost its ailing real economy (which is currently in recession). However, the combination of gradually subsiding inflation and still sluggish economic growth may prompt a more accommodative monetary policy stance in CESEE countries next year, which would be greatly facilitated by any policy reversal by the ECB.

In contrast to most other CESEE countries, monetary policy in Russia, Belarus and Moldova has been progressively relaxed over the past year. After initial sharp hikes in response to the first rounds of Western sanctions, policy rates in both Russia and Belarus have subsequently been cut (Figure 9), as their currencies have rebounded and inflation has subsided markedly. However, unlike in EU-CEE and the Western Balkans, real interest rates in the CIS (and Ukraine) are positive (Figure 15), reflecting the risks of financial instability in the current geopolitical climate. Should this situation deteriorate further, the easing cycle in the CIS countries pursued so far could well be reversed. Russia, Belarus and Ukraine also continue to maintain wide-ranging capital controls, essentially for the same reason.

Figure 15 / Real policy rate, CPI deflated, %



Note: Simple averages for country aggregates. CIS includes Belarus, Kazakhstan and Moldova.
Source: wiiw Monthly Database, incorporating national statistics.

In Turkey, monetary policy was relaxed in the run-up to the presidential elections in May 2023 – notwithstanding the extremely high inflation. This was entirely in line with the decade-long policy of boosting economic growth at the expense of financial stability. However, the appointment of a new and much more orthodox central bank governor following the recent elections has resulted in policy tightening, with the policy rate set to reach as high as 25% by the end of the year (although it will still remain negative in real terms).

2.4 OUTLOOK

The economic trends in most CESEE countries in the first months of 2023 were well in line with our earlier expectations, resulting in most cases in only minor changes to our forecasts. The most substantial upward forecast revisions since our Spring 2023 Forecast Report involve Russia and Kazakhstan (1 pp apiece), on the strength of their recent growth performance.[8] Elsewhere, the revisions generally do not exceed 0.5-0.6 pp (in both directions); and in nearly half of the region, there is no change at all to the forecasts (Table 1).

[8] wiiw (2023).

Table 3 / Real GDP growth forecasts and direction of revisions since wiiw Spring 2023 Forecast Report

Region	2023		2024		2025	
EU-CEE						
BG Bulgaria	1.3	▼	2.0	▼	2.5	▼
CZ Czechia	0.2		2.4		2.7	
EE Estonia	0.2	▼	2.8	▲	3.1	
HR Croatia	2.5		2.9		3.1	
HU Hungary	-0.5		2.0	▲	2.5	▲
LT Lithuania	0.3	▼	2.7	▲	3.0	▲
LV Latvia	0.8	▲	2.8	▲	3.0	▲
PL Poland	1.0		2.4		3.2	
RO Romania	3.0		4.0		4.3	
SI Slovenia	1.4		2.5		2.7	
SK Slovakia	0.6		2.0	▼	2.4	▲
Western Balkans						
AL Albania	3.3		3.8		4.0	
BA Bosnia and Herzegovina	1.5	▼	2.3	▲	2.5	
ME Montenegro	3.5	▲	2.9	▼	3.0	
MK North Macedonia	1.6		2.5		3.0	
RS Serbia	1.3	▼	2.5	▼	3.0	
XK Kosovo	3.4	▼	3.9		4.1	
Turkey						
TR Turkey	2.6		3.4		3.8	
CIS+UA						
BY Belarus	1.9	▲	2.2	▲	2.5	▲
KZ Kazakhstan	4.5	▲	4.0		4.0	
MD Moldova	2.5	▼	4.0		4.0	
RU Russia	1.0	▲	1.5	▲	1.5	
UA Ukraine	2.0	▲	4.0	▲	6.0	▲

Source: wiiw forecasts as of 15 June 2023.

The expected acceleration of growth in CESEE this year is almost entirely due to the turnaround in the CIS and Ukraine (Table 1). With a projected growth rate of 4.5%, Kazakhstan is poised to be the star performer this year, mostly thanks to large-scale infrastructure projects in transport and logistics. In Russia and Belarus, increased military production and robust real wage growth should enable GDP recovery of 1% and 1.9%, respectively. Both economies have succeeded in digesting the short-term shocks of the war and sanctions, although long-term scars are set to persist. In Moldova, economic recovery will be facilitated by increased foreign assistance and a better performance by agriculture. After a dramatic 29% contraction last year (about half of which was on account of territorial losses), Ukraine's economy is projected to recover by some 2% according to the baseline scenario, which crucially assumes no major escalation of the war. The problem of energy shortages in Ukraine following Russia's massive strikes on the country's critical infrastructure has been largely resolved, while the recent positive review of the International Monetary Fund's lending programme should ease the country's access to foreign financing.

In EU-CEE and Turkey, growth is projected to decelerate sharply this year (Table 1). This is partly due to near stagnation in the euro area, where the economy is expected to pick up by a mere 0.5% in 2023. On top of that, domestic demand in many EU-CEE countries will be affected by the carryover effects of high inflation (which is eating into the real purchasing power of households) and in many cases weak investment performance. Romania and Croatia will outperform their regional peers in terms of growth, largely thanks to major inflows of EU funds, especially within the framework of the Recovery and Resilience Facility (RRF). Besides, in Croatia tourism will receive a major boost from the country's accession to the euro and Schengen areas in January 2023. On the other hand, Hungary, which is doubly disadvantaged by the highest inflation in EU-CEE and politically motivated delays in the disbursement of EU funds, will be in recession. In Turkey, expected policy tightening will keep GDP growth down to a projected 2.6% this year.

Despite a strong showing in Q1, growth in the Western Balkans in 2023 as a whole is projected to slow as well, albeit relatively mildly (Table 1). The biggest economy in this sub-region, Serbia, is expected to grow by only 1.3% this year – partly for political reasons and partly because of the still raging inflation. Montenegro, Albania and Kosovo will all register growth in excess of 3% on the back of strong inflows of investments, remittances and tourism revenue. Last year, the region performed exceptionally well in terms of FDI inflows,[9] and this momentum is likely to largely carry on this year as well. However, the recent tensions in Northern Kosovo do not bode well for the prospects of Kosovo and Serbia (see Box 1) and may affect their attractiveness for future investments.

BOX 1 / POTENTIAL IMPLICATIONS OF RECENT ETHNIC AND POLITICAL TENSIONS IN NORTHERN KOSOVO

By Bernd Christoph Ströhm

Political and ethnic tensions in Northern Kosovo escalated in May and June 2023, following violent clashes between the NATO-led international Kosovo peacekeeping force (KFOR) and Kosovo Serb protesters. The Kosovo Serb community mounted protest rallies in several cities of Northern Kosovo to denounce the planned inauguration of ethnic Albanian candidates as mayors in Serb-majority municipalities. They claimed that the local elections were illegitimate, as the participation rate was only 3% (after the local ethnic Serb party 'Srpska Lista' called for a boycott of the elections).[10] The tensions erupted into violence on 26 and 29 May, after protesters attempted to break into municipal

[9] See Jovanović (2023).

[10] The initial reason for the boycott of the 'Srpska Lista' is rooted in the 2022 'licence-plate issue' – a bilateral spat between the governments of Kosovo and Serbia, due to which Kosovo authorities refused to grant entry to vehicles with Serbian-issued licence plates owned by Kosovo Serbs.

administration buildings in the towns of Zvečan, Leposavič and Zubin Potok, secured by the Kosovo police and KFOR soldiers. Those protests resulted in violent brawls that left at least 30 KFOR soldiers and 50 civilians injured. KFOR also recorded that local ‘criminal groups’ had provoked peaceful Serbian protesters into hurling projectiles and explosive devices at the KFOR troops. On account of the worsening security situation in Northern Kosovo, Serbia placed its armed forces on high alert, and on 26 May ordered some units to move up to the Kosovo-Serbian border. The US also condemned the actions of the Kosovo authorities and cancelled the ‘Defender 23’ military exercise in Kosovo. In view of the tension, the international community proposed that fresh municipal elections should be held in Northern Kosovo and called on Kosovo Serb officials to participate in the elections, in order to prevent any further escalation of the situation. On 13 June, the Kosovo government presented a plan aimed at defusing the tensions in Serb-majority municipalities by facilitating snap elections and by downsizing the Kosovo police presence at municipal buildings across Northern Kosovo.

The escalation of tension in Northern Kosovo comes at a singularly inopportune time: in February 2023, through EU mediation, Kosovo and Serbia agreed to normalise their relations through the ‘Agreement on the path to normalisation between Kosovo and Serbia’ – known informally as the Ohrid Agreement. However, the recent escalation of ethnic and political tension in Northern Kosovo means it looks very unlikely that the agreement will be properly implemented. As early as April 2023, the international community raised questions about Serbia’s commitment to the EU-negotiated agreement, after the Serbian government voted against Kosovo’s membership of the Council of Europe on 26 April 2023. Under the Ohrid Agreement, Serbia initially undertook not to veto Kosovo’s entry into international organisations – and in return, the Kosovo government pledged to establish a ‘Community of Serb Municipalities’ (CSM), a political association of ethnic Serb-majority municipalities in Kosovo.

The political and ethnic tensions in Northern Kosovo could lead to EU sanctions against Kosovo. Such sanctions would likely include the freezing of EU funds and a delay both to Kosovo’s EU visa liberalisation process[11] and to procedures leading to its membership of international institutions. The EU is currently the largest provider of financial assistance to Kosovo, supporting the country’s socioeconomic development through its Instrument for Pre-accession Assistance (IPA). In December 2022, the EU approved Kosovo’s 2023 Annual Action Plan under its 2021-2027 IPA III scheme, worth some EUR 75m, to support the country in reducing the socioeconomic impact of surging energy prices, caused by Russia's military invasion of Ukraine. EU sanctions will very likely impede the allocation and absorption of IPA III funds and lead to a decline in FDI from the EU over the next year. In June 2023, the international media reported that the European Union had already prepared a sanctions regime against Kosovo, due to the government’s initial disregard of requests to reduce the tensions in Northern Kosovo. The escalation in tension in the region has had a profound impact on Kosovo-Serbian relations – the creation of the CSM in Kosovo looks set to remain one of the main stumbling blocks in the dialogue between the two countries.

The normalisation of Kosovo-Serbian relations remains very unlikely. While the two governments seem prepared to make concessions to de-escalate the bilateral tensions and the protests in Kosovo’s Serb-majority municipalities, the polarisation of ethnic issues will likely lead to fresh bilateral spats between Kosovo and Serbia and new tensions in Northern Kosovo in the coming year. The deterioration in Kosovo-Serbian relations will have profoundly negative economic implications for both countries. For

[11] In April 2023, the European Parliament and the Council of the European Union signed a proposal aimed at facilitating Kosovo's EU visa liberalisation by January 2024 at the latest.

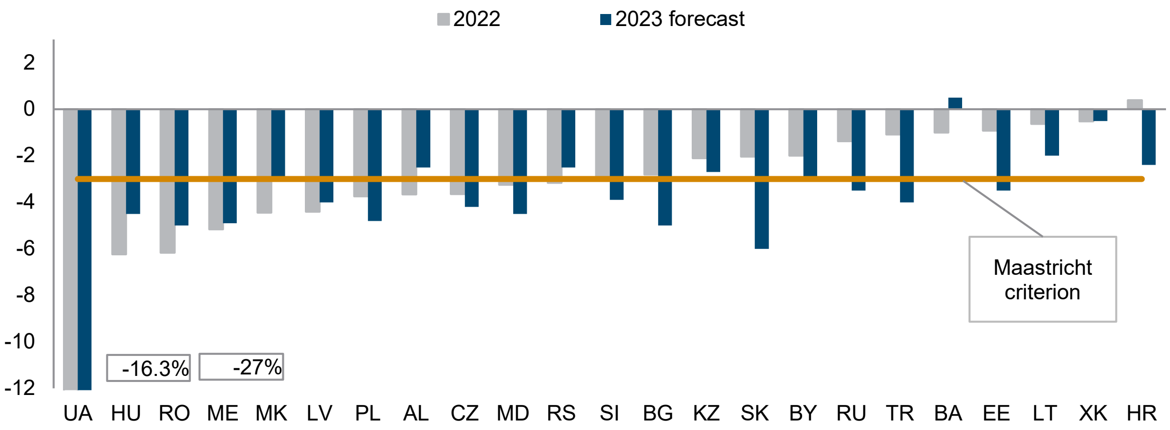
Kosovo, the tensions in Serb-majority municipalities will result in reduced support for international recognition of the country. In addition, a further escalation of ethnic/political tensions could result in a decrease in EU FDI, due to potential EU sanctions. For Serbia, deteriorating relations with Kosovo will most notably hinder the country's EU integration. Serbia must be prepared to compromise with Kosovo, if it wants to continue down the EU path. However, neither the current Serb nor the current Kosovo government seems willing to reach and uphold any such compromise.

Deteriorating Kosovo-Serbian relations will have repercussions for the Western Balkan region. Bilateral relations between Kosovo and Serbia deteriorated further in June 2023, following the arrest of three Kosovo police officers by Serbian security forces.[12] Albania demonstrated in June that it was unwilling to remain aloof from the ethnic tensions in Northern Kosovo, when it forwarded a new draft plan for the creation of the CSM to France, Germany, the EU and US. It also warned that bilateral relations between Albania and Serbia would be damaged if Serbia refused to release the officers detained. The tensions in Northern Kosovo also threaten to open the entire Western Balkan region up to foreign influence from countries such as China and Russia: both those countries voiced their support for Serbia in May, blaming the increased tension on Kosovo's alleged failure to respect Serbian political rights in Northern Kosovo. The close political ties between Russia and Serbia have been particularly noticeable since Russia's invasion of Ukraine: Serbia has so far refused to align its foreign policy with the EU's sanctions regime against Russia. On the investment side, China has assumed a powerful position in Serbia: Chinese investments there reached EUR 10.3bn in the period 2009-2021 – and in 2022, China even emerged as the biggest investor in Serbia, as a result of its 'Belt and Road' initiative. General EU frustration has led to a geopolitical vacuum in the Western Balkans, which is why China and Russia are eager to seize any opportunity – including the ethnic tensions in Northern Kosovo – to increase their geostrategic foothold in the region.

In 2024 and 2025, growth in the CESEE region is projected to pick up from the current low to 2.5% and 2.8%, respectively, on a weighted average basis. This means that, although the CESEE countries will generally continue to grow faster than the euro area, the growth differential will be confined to a relatively unimpressive 0.7-1 pp per year, resulting in only moderate catching-up (Table 1). In Russia and Belarus, the medium-term prospects are likely to be constrained by limited access to Western technology and by the emigration of their skilled labour forces. In many EU-CEE countries, growth may be suppressed by fiscal consolidation measures, as the reinstatement from 2024 of the EU Stability and Growth Pact requires, among other things, budget deficits of below 3% of GDP (only Lithuania and Croatia will likely satisfy this criterion in 2023 – Figure 16). Of all the CESEE countries, Kazakhstan and possibly Ukraine are likely to record the highest GDP growth in the medium term; in the case of Ukraine, however, this will be conditional on the end of military hostilities and a massive post-war reconstruction effort. However, with some 15% of its territory and population currently under Russian occupation, and with some 8m refugees abroad, the recovery of economic activity in Ukraine to its pre-war levels may take many years.

[12] Due to the incident, the Kosovo government decided to temporarily ban all vehicles with Serbian licence plates from entering the country.

Figure 16 / Fiscal balance, as % of GDP



Source: wiiw Annual Database, incorporating national statistics and Eurostat; wiiw forecasts.

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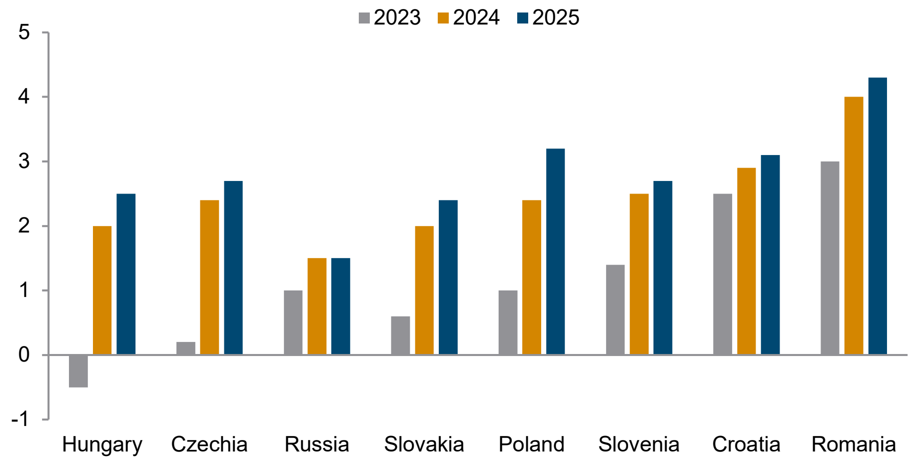
3. Two-speed CEE region can support Austrian growth

BY DORIS HANZL-WEISS

- Despite the gloomy environment, the CESEE region – in particular Slovenia, Croatia and Romania – can still offer Austria a fillip to its growth
- Germany, Hungary and Czechia entered a technical recession in Q1 2023, which could hit Austria's growth prospects
- Austrian trade and investment ties with the Western Balkans have expanded greatly
- Austria's ties with Russia are being dissolved only slowly: its gas dependence is still high and its banking sector is at risk
- General investment in CESEE grew robustly in 2022, but less so from Austria

Despite a challenging growth backdrop in Europe, Southeast Europe is showing impressive resilience, and Austria's close integration with such countries as Slovenia, Croatia and Romania will provide some welcome support for economic activity this year. The Russian war in Ukraine, a still high level of inflation and the rather bleak outlook are all affecting Europe this year and are all contributing to a gloomy environment for Austria. If we consider Austria's most important trading and investment partners – which include the Visegrád countries, Romania, Slovenia, Croatia and Russia – wiiw forecasts for 2023 are favourable for Slovenia, Croatia and Romania, with GDP forecast to grow there by 1.4%, 2.5% and 3%, respectively. While growth in the region will pick up generally in 2024 and 2025, again those three economies will provide a greater stimulus to Austrian growth than the Visegrád countries (Figure 17).

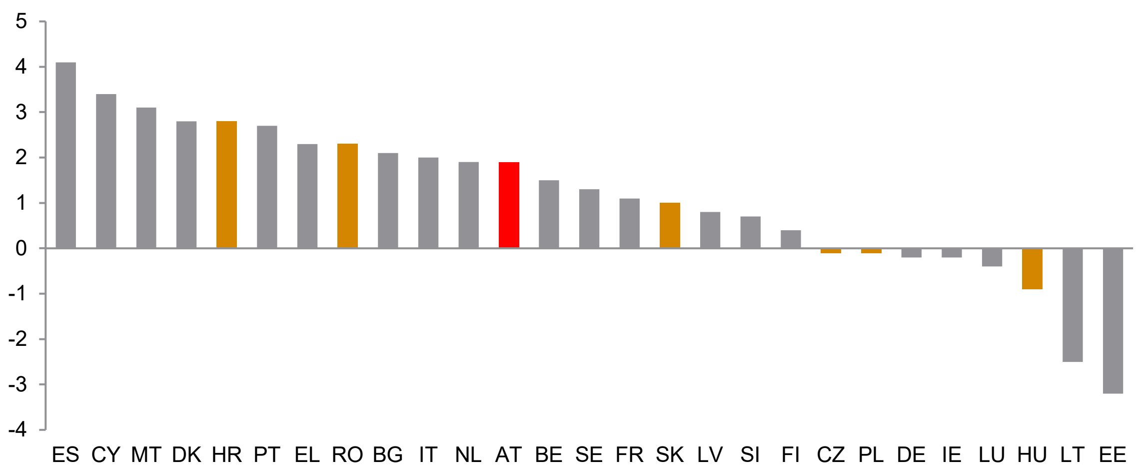
Figure 17 / Real GDP growth forecasts, percentage change compared to the previous year



Source: wiiw.

Austria will derive little benefit from its strong integration with the Visegrád countries this year, as Central Europe is suffering from feeble growth in Germany. The Visegrád countries are impacted by the anaemic growth in Germany through their linkages within the so-called German-CEE manufacturing core, which also includes Austria. The wiiw growth forecast is thus subdued for the four Visegrád countries. Indeed, the forecast for Hungary is negative (-0.5 %), while for Czechia and Slovakia the estimates are below 1% and for Poland 1% growth is forecast. The forecasts for all those countries have stayed stable over time, remaining unchanged from the wiiw Spring Forecast. Recent data for Q1 2023 confirm this assessment: alongside Hungary and Czechia, Germany has also entered a technical recession, with negative quarterly growth rates in both Q4 2022 and Q1 2023. Poland, on the other hand, experienced the highest quarterly change within the European Union in Q1 (+3.8%). In terms of year-on-year change, of the Visegrád countries only Slovakia reported a positive figure in Q1 2023; it was slightly negative for Czechia, Poland and Hungary (see Figure 18).

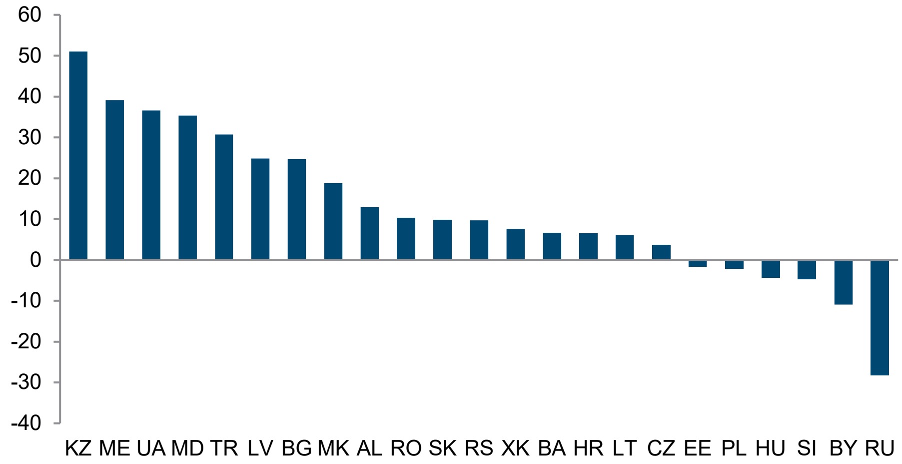
Figure 18 / Real GDP growth in Q1 2023, percentage change against the previous year



Source: Eurostat.

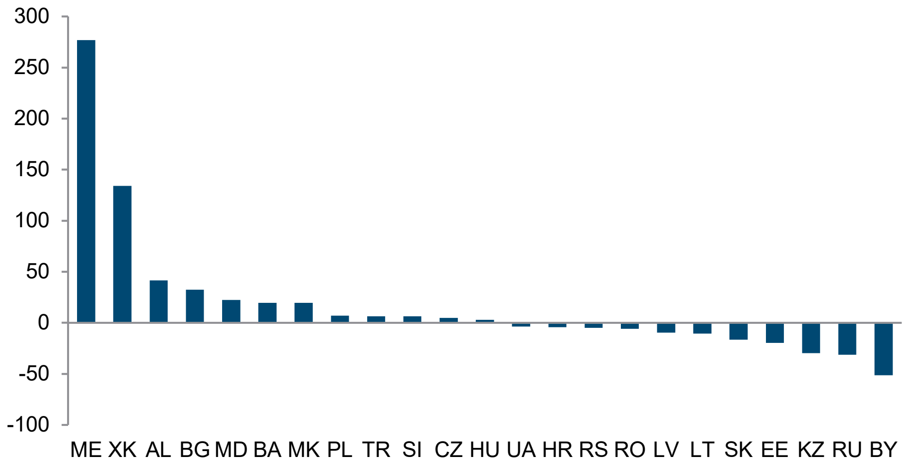
In Q1 2023, Austria's trade with its main CEE trading partners was already feeling the effects of the two-speed CEE, with trade with the Western Balkan countries growing most strongly. Alongside Germany (which accounts for a third of Austrian exports and imports), the CESEE region – and in particular the neighbouring countries – are Austria's major trading partners: 20% of Austrian exports in 2022 went to the EU-CEE. The Visegrád countries alone accounted for 13.3%. Thus, taken together, the four Visegrád countries were Austria's second-biggest trading partner. If we look at individual countries, included among the top 20 export countries for Austria were Hungary, Poland, Czechia, Slovenia, Romania, Slovakia, Croatia and Russia. On the import side, the region accounts for a somewhat smaller share: in 2022, about 16% of Austrian imports came from the EU-CEE, 12% from the Visegrád countries alone. The main countries supplying Austria's imports are pretty well the same as the main countries that take its exports: only Croatia drops out. In Q1 2023, the increase in Austrian exports to the region was less marked than the growth in its total exports (+8.6%): exports to EU-CEE increased by 2% (and to the Visegrád countries by even less). Austrian exports to the Western Balkan countries expanded considerably (+10%), and also to Kazakhstan, Ukraine, Moldova and Turkey; meanwhile, exports to Russia fell by 28% as an effect of the war. Exports to Austria's main export partners of Romania and Slovakia grew by 10% and to Croatia by 6.5% (Figure 19). The growth in imports resembled the pattern in exports: imports from the Western Balkans increased by 10%, with Montenegro and Kosovo showing exceptionally high growth rates (Figure 20). Compared to 2022, imports from Russia fell, with both gas volumes and the value of imported gas declining at the beginning of the year.

Figure 19 / Change in Austrian exports, percentage change Q1 2023 compared to Q1 2022



Source: Statistik Austria.

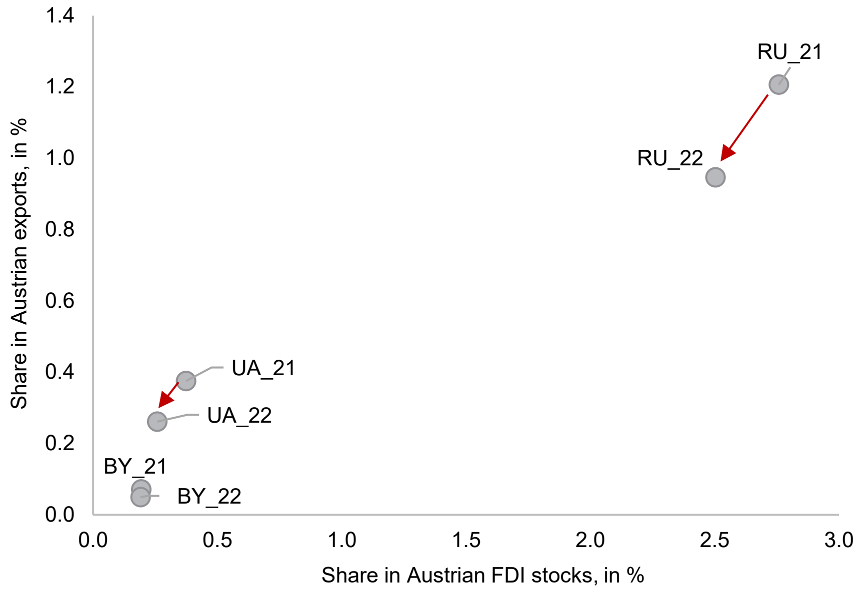
Figure 20 / Change in Austrian imports, percentage change Q1 2023 compared to Q1 2022



Source: Statistik Austria.

Austria's trade and investment ties with Russia are slowly declining, but there is still a heavy dependence on Russian imports of gas. If we look more closely at the country's trade and investment ties with Russia, Ukraine and Belarus, we find that overall they have been fairly limited and in 2022 declined due to the direct effects of the Russian invasion of Ukraine and the sanctions imposed on Russia. Trade relations are being dissolved slightly more rapidly than are investment links (Figure 21). As far as Ukraine is concerned, it accounted in 2022 for 0.3% of Austrian exports and 0.6% of Austrian imports (mainly raw materials). Austrian exports from and imports to Belarus were even tinier. While Russia was Austria's nineteenth-biggest export partner in 2022, it was the country's sixth-largest import partner: the price effects of energy imports meant that the value of imports from Russia last year increased by nearly 80%. If we focus on gas imports, the value of those soared by about 100% in 2022, whereas the volume of gas delivered declined by 38%.[1] In fact, while the other supply routes for Russian gas to Europe have ceased, gas transit via Ukraine and Slovakia is continuing, although the volume has declined. Slovakia, for example, learned from previous incidents, including the gas crisis of 2009, and had previously diversified its gas routes: only last year, the gas interconnector with Poland was completed. At the end of 2024, the contract between Ukraine and Gazprom comes to an end and will have to be renegotiated, probably again triggering difficulties with the supply of gas. The European Commission points to Austria's still heavy reliance on gas imports from Russia as a challenge to its energy security.[2] In fact, data for February 2023 show that while the overall volume of imports of Russian gas has been falling, it still accounts for 78% of Austrian gas imports.[3] The wiiw forecast for Russia has been revised upwards and now projects positive growth for this year. However, Austrian ties with Russia have declined only slightly since the start of the war in Ukraine, so there is still much 'unwinding' to be done: that will have a dampening effect in years to come.

Figure 21 / Austrian trade and investment links with Russia, Ukraine and Belarus



Source: Statistik Austria and OeNB.

Despite the last crisis years, Austria continues to be a stable investor in the region. The country's important role as an investor in the region – particularly in the Visegrád countries and the Western Balkans – is well known (Figure 22). In fact, Austria is the largest investor in Slovenia, Croatia, Bosnia and Herzegovina, and North Macedonia; the second largest in Slovakia, Serbia and Bulgaria; and the third largest in Romania and Hungary. It holds smaller shares of foreign direct investment (FDI) stock in Belarus

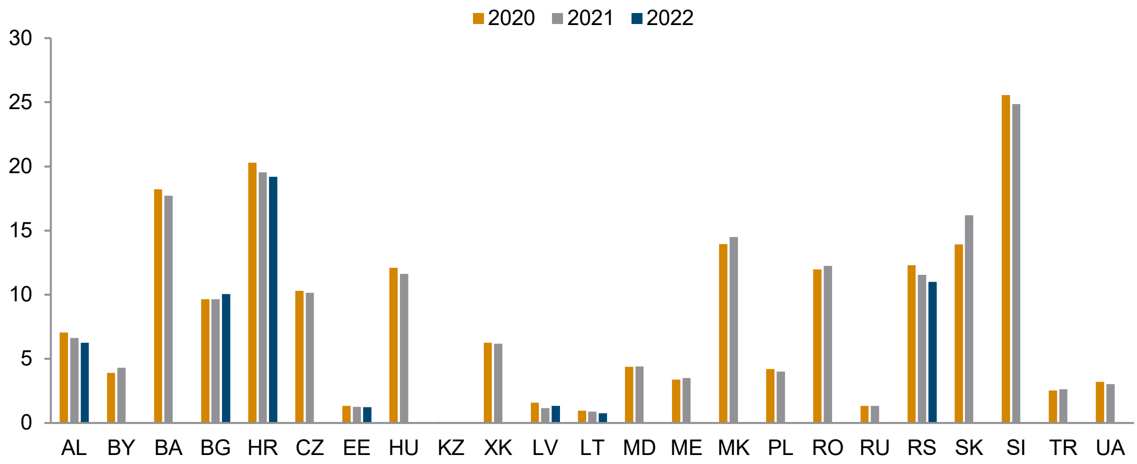
1 Statistik Austria (2023), 'Außenhandel 2022 zweistellig gewachsen, Wert der Gasimporte verdoppelte sich gegenüber 2021 preisbedingt', 10 March. https://www.statistik.at/fileadmin/announcement/2023/03/20230310Aussenhandel2022.pdf

2 European Commission (2023), Austrian Semester Report.

3 Statistik Austria (2023), 'Austrian Economic Barometer', 2 June. https://www.statistik.at/fileadmin/announcement/2023/06/2023-06-02_Praesentation_AustrianEconomicBarometer.pdf

(but is the third-largest investor there), while it ranks sixth in Ukraine and twelfth in Russia (2021 data). The Austrian share of the countries' FDI stock has remained fairly stable over the last three crisis years, as has its ranking: in the seven countries for which 2022 data are available, the Austrian share declined slightly in Albania, Croatia, Estonia, Lithuania and Serbia, and grew slightly in Bulgaria and Latvia.

Figure 22 / Inward FDI stock, percentage from Austria



Source: wiiw FDI Database.

The Western Balkan country grouping stood out as the top performer in terms of attracting overall investment in 2022, and also in terms of Austrian investment. While global FDI in 2022 fell sharply due to geopolitical tensions, the war in Ukraine, rising interest rates and turmoil on the financial markets, total FDI inflows into the CESEE region were more buoyant (except for Russia and Ukraine, of course).[4] Overall, total FDI inflows into EU-CEE increased by 14% in 2022 – and into the Visegrád countries by 17%. The Western Balkans stood out as top performers last year, with FDI inflows increasing by 27% year on year. Overall trends in the region have shown a sectoral shift towards investment in the software and IT services sector and renewable energy. In the Western Balkans, FDI in the real estate sector was also up, thanks to a revival in the tourism sector following the COVID-19 pandemic. In the wake of the war, preliminary data show heavy disinvestment in Russia of about EUR 40bn. Uncertainty due to the war led to FDI inflows into Ukraine almost drying up. Preliminary data for the Austrian FDI stock abroad suggest a slight decline in Austrian stock in the CESEE region in 2022, in particular in the Visegrád countries.[5] Again, the Western Balkans seem to be more attractive to Austrian investment: Austrian FDI stock there increased by 6%.

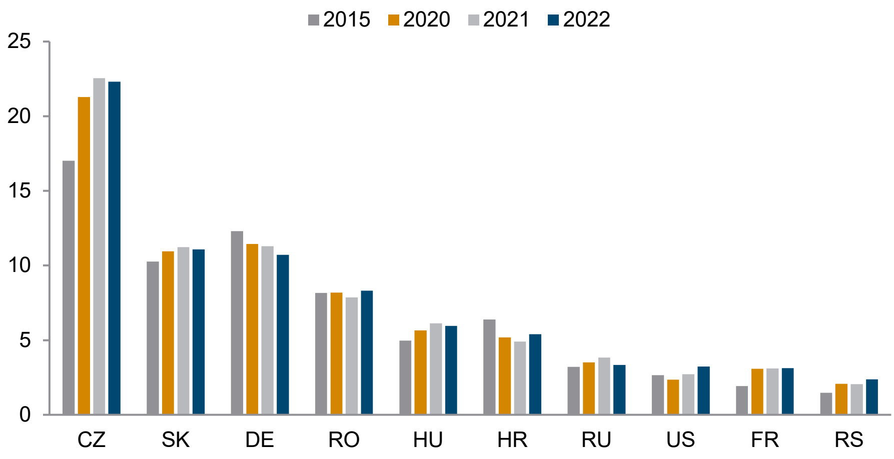
The Austrian banking sector in the region is solid and has not so far been threatened by rising interest rates, though concern is growing over Raiffeisen in Russia. Despite the difficulties in some economies of the region and the rapidly rising interest rates, so far there has been no major decline in asset quality, and therefore the impact on Austrian banks has so far been limited. Austria's banking sector exposure in the CESEE region in 2022 is high, accounting for 58% of its foreign assets. Indeed, 42% of all its foreign assets were located in just the four Visegrád countries. In that year, exposure in

4 wiiw (2023), 'FDI in Central, East and Southeast Europe', Monthly Report, May.

5 https://www.oenb.at/isaweb/report.do?lang=DE&report=9.3.01

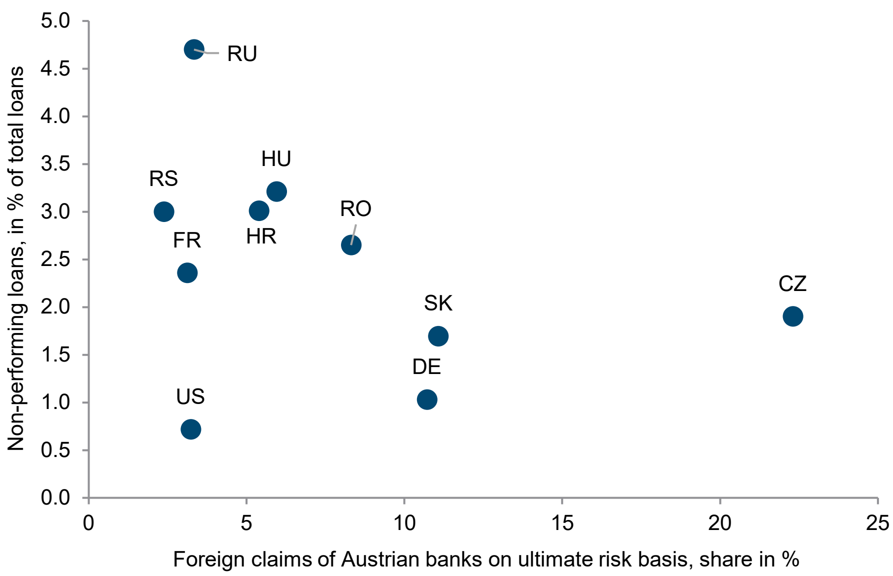
Romania, Croatia and Serbia increased, with Serbia becoming the tenth most important country for Austrian banks (Figure 23). In those markets with the biggest Austrian presence – Czechia, Slovakia and Romania – non-performing loan (NPL) rates were especially low in 2022 and posed no threat to the banking sector (Figure 24). Only in Russia was the NPL rate a bit higher. A major concern, however, is the continued presence of Austria's Raiffeisen in Russia. While the bank is examining possible options – including ways of leaving the country – the European Central Bank (ECB) has recently been urging banks to leave Russia quickly.[6]

Figure 23 / Foreign claims of Austrian banks on ultimate risk basis, in %



Source: BIS, wiiw.

Figure 24 / Foreign claims of Austrian banks on top 10 countries and non-performing loans in 2022 (according to 2022 ranking), in %



Source: BIS, wiiw.

6 https://www.reuters.com/markets/europe/ecb-putting-pressure-remaining-euro-zone-banks-quit-russia-2023-06-13/

4. Country updates

ALBANIA: ECONOMY TO BENEFIT FROM GROWING TOURISM

by Isilda Mara

The Albanian economy will continue on its positive trajectory, though at a pace slower than in 2022. Growth will be backed by private consumption, investment and a boom in tourism. This year's real GDP is expected to grow by 3.3%, while it will hover at around 4% in 2024-2025. Inflation has decelerated since October 2022 and is expected to average 4% in 2023. It will mainly be driven by food products, whose prices were still growing at double-digit rates in the first five months of 2023 (year on year). Energy prices have been rising only slightly and core inflation has been moderate. The banking sector has continued to perform decently. Demand for credit has expanded further – driven mainly by households – while non-performing loans have kept on falling. The domestic currency has appreciated markedly. Its strength is likely to be maintained, as tourism is thriving and remittances and foreign direct investments are continuing on their upward trend. Labour and skills shortages are beginning to make an appearance, as emigration persists – especially among young professionals. This is pushing up wages in the private sector. Together with reform of public-sector wages – expected to boost average monthly wages in the sector from the current EUR 520 to EUR 900 by 2024 – this could provide an additional nudge to inflation in the medium term.

BELARUS: ADJUSTING TO THE ECONOMIC BLOCKADE

by Rumen Dobrinsky

After plummeting in 2022, the economy has shown some sign of adjusting, thanks to the further opening up of Russia's markets to Belarussian products. Things picked up in the first months of 2023, though performance was mixed. Industrial output in the first four months was up 2.7% year on year. GDP in the first quarter was 2.1% down on the same period in 2022; but in April alone, aggregate output (a proxy for GDP) was 3.7% up year on year. The ICT sector was in recession in Q1, as a number of software firms quit the country. Investment activity also remained subdued due to the continued uncertainty. On the other hand, private consumption picked up, thanks to wage and pension rises and soft monetary conditions. In the first half of the year, the central bank trimmed its key policy rate five times, resulting in a cumulative 2.25 percentage-point reduction compared to the end of 2022. While disinflation has continued, the price dynamics is expected to go into reverse, due to the government's loose monetary and fiscal stance. Still, average annual consumer price inflation in 2023 may move into single digits. We have raised our GDP growth forecast for 2023 by 0.6 percentage points, to 1.9%, and we expect growth of 2.2% in 2024 and 2.5% in 2025.

BOSNIA AND HERZEGOVINA: INFLATION IS COOLING, BUT SO IS THE ECONOMY

by Selena Duraković

Inflation has reverted to single digits for the first time since the beginning of 2022. Consequently, we have revised our inflation forecast for 2023 downward by 0.3 percentage points (to 8.7%). Despite this, the economy is showing no sign of improvement: industrial production declined by around 4% in the first four months of 2023, compared to the same period last year. Exports of goods also fell, while imports rose. On the other hand, tourist nights increased by 16% in the first quarter, compared to the same period last year. Credit activity has continued to grow slowly, despite the higher interest rates, which have risen by much less than in the euro area. Considering recent developments, we now expect GDP to grow by 1.5% in 2023 – a revision of 0.2 percentage points down on our spring forecast. This is largely in anticipation of feebler private consumption and weaker exports, stemming from less disposable income and lower demand from the main export markets in the EU. Eight months after the elections, governments have finally been formed at all levels. This may have a positive effect on the economy and could speed up reform, as there has been a drift away from nationalist parties at some levels of government.

BULGARIA: WILL A NEW GOVERNMENT MANAGE TO ADDRESS THE MOUNTING FISCAL PROBLEMS?

by Rumen Dobrinsky

The political horse-trading after the April elections resulted in a government supported by two main parties (GERB and 'We Continue the Change') – which, however, have not concluded a formal coalition agreement. Economic activity weakened in Q1 2023, and both GDP and industrial production grew by just 2.1% year on year. The central bank has raised the minimum reserve requirements, in an attempt to cool the credit expansion, which it considered pro-inflationary. The rising interest rates have started to curb consumer credit, which was an important driver of private consumption in 2022. Meanwhile the fiscal position has continued to deteriorate. The cash deficit in 2023 may reach 6-7% of GDP; and unless some radical corrections are undertaken, this could continue in the coming years. Headline inflation has slowed, but annual average consumer price inflation is likely to remain high, at around 10%, due to carryover effects from 2022. Given the country's poor performance in the first months of 2023, we expect the slowdown to continue. Compared to spring, we have cut our GDP growth forecast for 2023 by 0.4 percentage points, to 1.3%.

CROATIA: BUMPER TOURIST SEASON IN PROSPECT

by Bernd Christoph Ströhm

Croatia is hoping to take full advantage of its 2023 accession to the euro area and the Schengen area. The Tourism Ministry reports that total income from tourism, including revenue from domestic tourists, reached EUR 15bn in 2022 (22.2% of GDP). This figure will likely be matched in 2023. The tourism sector started the year strongly, recording 5.3m overnight stays in Q1 2023 – up 19.6% year on year. Investment in infrastructure is also expected to grow, driven by transfers from the EU budget: under the EU's recovery and resilience facility, the country has been allocated EUR 6.3bn, largely to support the implementation of its climate change adaptation measures by 2026; and it will receive some EUR 9.1bn from the EU Cohesion Fund in the 2021-2027 financing period. Inflation is in single digits, and we maintain our earlier, pring projection that it will average 6.5% for the year as a whole. Despite the recent slowdown, however, inflation will remain elevated, limiting household purchasing power and raising uncertainty. For this reason, we maintain our spring 2023 growth forecast that the economy will grow by only 2.5% in 2023.

CZECHIA: SIGNS OF INFLATION MODERATING, BUT STILL PAINFULLY HIGH

by Zuzana Zavarská

Against the previous quarter, the Czech economy in Q1 remained static, while year on year it contracted slightly (-0.4%). Household consumption and inventories hampered growth, and investment was anaemic; meanwhile net exports and government consumption contributed positively. Industry has so far proved resilient, driven as it is by export-oriented automotive and electronics production. Yet, with new orders declining and the Purchasing Managers' Index dipping in April, a loss of momentum is to be expected. Certain services (hospitality, transport, IT) have proved exceptionally strong, as if shielded from the weak demand that has constrained other sectors. Inflation was well above 10% in the first five months of the year and, despite signs of moderation, it appears inevitable that the Harmonised Index of Consumer Prices will remain in double figures in 2023 (11%). There is starting to be talk of monetary easing, probably some time towards the year end. On the fiscal side, the government is negotiating pension and tax reforms to tackle the deterioration in public finances. Overall, it is expected that the inflationary environment will result in sluggish growth in 2023 (0.2%), to be followed by a gradual recovery in 2024 and 2025 (2.4% and 2.7%, respectively).

ESTONIA: PRESSURES ON COMPETITIVENESS MOUNT

by Maryna Tverdostup

Q1 2023 saw an economic decline of 0.6% quarter on quarter – smaller than expected, given the major dip in consumption. The downturn in economic activity was spread across the economic sectors, and foreign trade volumes fell considerably. As we can see no sign of any notable economic revival in 2023, we have reduced our GDP forecast to a modest 0.2% growth in 2023. Growth (such as it is) will be driven by a gradual recovery in industrial production, a resilient labour market and domestic consumption. Although inflation has been slowing due to steadily declining energy prices, it still stood at well above 10% in April. Core inflation remains elevated, with domestic factors playing an increased role. This continues to affect the country's competitiveness on foreign markets – something that was already being undermined by the country having the highest inflation in the EU in 2022. Foreign trade deteriorated further in Q1 2023, with exports down by 10.5% and imports 17% lower. Since taming inflation and securing longer-term competitiveness remain the government's priorities, it is likely that a slowdown in public-sector wage growth and an increase in taxes are on their way.

HUNGARY: NET EXPORTS WILL FAIL TO COMPENSATE FOR THE DROP IN CONSUMPTION AND INVESTMENT

by Sándor Richter

GDP fell by 1% in Q1 2023 – largely the result of a decline in industry and construction; meanwhile services saw a slight growth. Consumption and investment both decreased in Q1, while net exports performed well. Inflation has continued to slow, but it remains far and away the highest in the EU, at over 20% in May. Real wages fell by close to 7% in April, year on year. With the government struggling to keep the fiscal deficit under control, new taxes have been introduced, while others have not been phased out (as earlier promised). The central bank has embarked cautiously on monetary easing: the caution is warranted, as the currently relatively strong forint could weaken dangerously if the markets feel the interest-rate cuts are coming too soon or are too large. Tensions with the EU are continuing to escalate, and the release of suspended EU transfers may be further delayed. This, together with the anticipated reduction in consumption and investment, explains why our forecast for the country's growth prospects this year remains unchanged (a decline in GDP of 0.5%), despite external balances that are improving thanks to lower energy prices.

KAZAKHSTAN: POSITIVE OUTLOOK DESPITE EXTERNAL HEADWINDS

by Alexandra Bykova

The economy started off 2023 better than expected, with GDP growth of 4.9% year on year in Q1, driven by construction, trade, transport, communication and manufacturing. Still, producer sentiment is lacking any clear upwards trend. Oil production grew by 3% year on year in the first four months, but forthcoming maintenance work and OPEC+ production cuts will moderate the whole-year result. Consumer sentiment has been deteriorating amid a Q1 real-wage decline of 0.6% year on year. Though it has slowed, consumer inflation remained above 15% in May, and the expectation is that it will remain high. Monetary policy easing has been delayed, with the policy rate left at 16.75%. Pro-inflationary factors are mainly domestic: fiscal support, increased regulated fuel prices and anticipated hikes in housing rents. Lower global oil prices have led us to revise our current account forecast for 2023 downwards, to -2% of GDP. Subdued consumption and weak oil exports are likely to drag economic performance down in the second half of the year. However, in view of higher-than-expected investment, especially in transport and logistics, and an overall robust growth in previous months, we have revised our GDP forecast for 2023 upwards, to 4.5%.

KOSOVO: TROUBLE BREWING, BUT WHO GAINS FROM ANOTHER CRISIS IN NORTHERN KOSOVO?

by Isilda Mara

Growth in 2023 is expected to reach 3.4% on the back of higher domestic and external demand; however, downside risks predominate, due to the political tension in Northern Kosovo. High-frequency data indicate a positive first quarter of 2023 for manufacturing, energy production and services. Inflation is slowing, and will fall back to 7% in 2023, though food and energy prices are continuing to rise at a double-digit level. Increased electricity imports, combined with declining exports and domestic production, suggest that high energy prices are likely to persist. Remittances increased by 10% up to April 2023, year on year, and these will support household consumption. Foreign direct investment is also growing, but the main pitfall is that it continues to be channelled into real estate. Exports of goods seem to have lost momentum, but exports of services have thrived. However, the effect of net exports on growth will be negative, as imports are continuing to grow. Local elections in Northern Kosovo in April 2023 were boycotted by ethnic Serbs. The inauguration of the newly elected ethnic Albanian mayors led to clashes, with soldiers from KFOR – the NATO-led international peacekeeping force in Kosovo – and civilians being injured. In an effort to de-escalate the tension, international partners have suggested rerunning the local elections, making sure that the Serb population participates, and also finally establishing an association of Serb-majority municipalities.

LATVIA: FROM STAGNATION TO MODERATE GROWTH

by Sebastian Leitner

Thanks to somewhat better economic developments in the first months of the year, we have revised our GDP growth forecast for 2023 upwards, to 0.8%. While consumer price inflation remains in double digits, strongly rising wages have enabled real incomes and consumption to grow again from Q2 onwards. Sluggish economic activity in the rest of the Baltic States and Scandinavia, together with sharply rising unit labour costs for Latvian producers, will result in a decline in real terms this year in both industrial production and exports. However, the Latvian government will keep growth afloat by using funds from the NextGenerationEU programme for public investments more intensively this year, while aiming at a deficit of 4% of GDP. The labour market will remain tight in 2023, and the unemployment rate is likely to stay at around 7%. In the coming years, growth is projected to pick up to 2.8% in 2024 and 3% in 2025.

LITHUANIA: RESISTING A WAR-INDUCED RECESSION

by Sebastian Leitner

In early 2023, the Lithuanian economy performed worse than had previously been expected. In the first three months of the year, household consumption declined for the third quarter in a row and is likely to revive only slightly during the rest of the year. Although public gross fixed investment is growing more strongly this year than in 2022, overall investment will decline as firms deplete their inventories. The budgetary stance remains rigid, and following a mild 0.7% in 2022, the deficit is likely to reach around 1.5% this year. External demand from EU countries has been weaker than expected. The ongoing recession means that the unemployment rate in 2023 is expected to increase by more than 1 percentage point, to 7.2%. Although energy prices have fallen substantially, solid fuel, food and hospitality kept inflation running at more than 10% in May 2023; that figure will drop below 3% only in 2024. We expect real GDP to grow slightly (by 0.3%) in 2023, to be followed by an upswing of 2.7% in 2024 and 3% in 2025.

MOLDOVA: INCREASED INTERNATIONAL ASSISTANCE AND BETTER HARVEST IMPROVE GROWTH PROSPECTS

by Gábor Hunya

In 2023, Moldova will emerge slowly from the difficulties that in 2022 brought economic contraction: the energy crisis, soaring inflation and a drop in agricultural production. However, in Q1 2023 it had not yet turned the corner, so that quarter saw a fall in industrial production and real wages. With support from Romanian companies and loans from the European Bank for Reconstruction and Development (EBRD), there has been an acceleration in energy diversification away from Russian gas. Inflation is on its way down, but is still close to 20%: the base effect and lower international commodity prices will support a fall to single digits by the end of the year. International donors have stepped up their assistance, realising that the country is in dire economic straits and subject to Russian hybrid warfare. Nonetheless, Moldova is committed to fulfilling the conditions of EU alignment. The influx of foreign financing will allow it to survive with large current account and fiscal deficits and to attain modest growth of 2.5% in 2023. Moldova has taken steps to withdraw from some of the institutions of the Commonwealth of Independent States (CIS) that were perpetuating Russian influence. Full withdrawal is not on the agenda, however, as Moldova derives economic benefits from cooperating with some member countries.

MONTENEGRO: TOURISM AND THE ENERGY SECTOR SUPPORT GROWTH

by Nina Vujanović

In Q1 2023 Montenegro posted another impressive growth rate of 6.1% year on year. The number of tourists increased by around 60% year on year in the first four months of 2023, supporting private consumption, which grew by 16.3% in Q1. Even though the figure is inflated by Ukrainian and Russian citizens who are registered as tourists in Montenegro, in 2023 we expect a full rebound in tourism to pre-pandemic levels, helped along by improved flight connections. The solid rainfall season this year supported hydropower electricity generation and contributed to industrial production growth of around 10% year on year in Q1. Inflation in April declined to single figures for the first time in more than a year. Given these developments, we have revised our GDP growth projection for 2023 upwards by 0.6 percentage points (pp), to 3.5%, and our forecast for inflation downwards by 0.3 pp, to 9.7%. However, the country's economic performance in the medium term may be distorted by political instability that is not yet fully resolved. Despite a record low turnout (55%) in the parliamentary elections in June, the results confirmed that the new 'Europe Now' party will lead the country, though it is as yet unclear whether it will be able to form a stable government.

NORTH MACEDONIA: A PROMISING START TO THE YEAR, BUT AN UNCERTAIN OUTLOOK

by Branimir Jovanović

GDP growth exceeded expectations in Q1, reaching 2.1% year on year. However, it is uncertain whether the good news will continue: that growth was driven primarily by a decline in imports, which was a consequence of a significant drop in gross investment and which is unlikely to persist. Inflation has started to slow, following the government's reinstatement of price caps on a number of staple foodstuffs, but it remains in double figures. Despite inflation cooling, the central bank has continued to hike its interest rate without offering any clear indication of whether the tightening cycle could end soon. Inflows of foreign direct investment (FDI) in Q1 were 7% lower than the year before (in nominal terms), suggesting that the previous year's strong FDI performance may only have been temporary. However, remittances are growing robustly, with secondary income in the balance of payments rising by 45% in Q1 (nominally), potentially supplying a positive impetus to consumption, despite declining real wages. Given this mixed picture, our forecasts remain largely unchanged: we expect GDP to expand by 1.6% in 2023 and inflation to average 9%. We acknowledge, though, that the risks to the outlook for GDP growth are primarily on the upside. All is quiet on the EU front, as the constitutional changes required for accession talks to get under way seem as distant as ever.

POLAND: A RECESSION IN THE MAKING

by Adam Żurawski

GDP growth turned negative (-0.2%) in Q1 2023, primarily on account of sharply reduced inventories and private consumption. A strong decline in imports, coupled with resilient exports, limited the recession. Fixed investment, including by the private sector, performed well. Industrial production is continuing to contract sharply. Inflation – currently driven by the cost of food and energy – is still high and is running ahead of nominal wages, which is serving to erode household disposable income and is affecting consumption spending. Meanwhile, the corporate and banking sectors are raking in big profits. To a large extent, inflation continues to reflect certain oligopolistic features of the economy (e.g. its retail and wholesale segments). The unintended strengthening of the Polish currency is contributing to disinflation: overall, inflation (also its core component) is receding gradually, making monetary easing possible this coming autumn. However, we expect inflation to still average 12.5% this year, with real GDP expected to only expand by 1%.

ROMANIA: BOTH GROWTH AND INFLATION SLOWING

by Gábor Hunya

Economic growth slowed to 2.3% in Q1 2023. Household consumption and public investment were both buoyant, while the depletion of inventories applied a powerful brake on growth. Industrial production contracted, as power-intensive companies curtailed production in order to save energy. Economic sentiment is generally positive, and growth may pick up in the second half of the year. Domestic demand will be moderately depressed by sluggish real wage growth, but the level of employment will be maintained. The current account deficit narrowed in Q1 2023 and may fall to 7% of GDP for the year as a whole, although the risk of a higher level persists. Inflation has been slowing since December, and dropped below 10% in May to reach 9% on average in 2023. The drivers of inflation are foodstuffs and services, while disinflation is supported by subsiding commodity prices and base effects. The fiscal deficit was very elevated in Q1, at some 6.5% of GDP: this was on account of lower-than-expected revenues. Efforts to achieve fiscal consolidation by saving on public-sector wages have been derailed by the decision to meet most of the demands of the striking teachers. The dynamic expansion of investment – financed mainly by EU programmes and foreign direct investment – will continue in the coming years and support economic growth of 3% in 2023 and 4% in 2024 but not more.

RUSSIA: RECESSION HAS BEEN LEFT BEHIND

by Vasily Astrov

The economy has, by and large, adjusted to last year's multiple shocks caused by the war, sanctions and the withdrawal of many foreign firms. After falling by 2.1% in 2022 and by 1.8% in Q1 2023 year on year, GDP growth turned positive in April, when it reached around 3% year on year, according to estimates by the Ministry of Economy. Private spending recovered to the same level as two years ago, while gross industrial output exceeded that level by 2.4%. Nominal and real wages have recorded solid growth on the back of tight labour markets, with the unemployment rate declining to an all-time low of 3.3% in April. Manufacturing has benefited from the sharp upturn in military spending, while the difficulties of travelling abroad have boosted domestic tourism. However, exports of goods declined by 31% in Q1 (in euro terms) on the back of lower oil prices (due not least to the West's energy sanctions) and sharply reduced gas export volumes. Accordingly, the energy revenues of the federal budget plummeted by half in January-May, and the budget deficit will almost certainly exceed 3% of GDP for the year as a whole – despite some corrective measures, such as the planned introduction of a windfall profit tax. Barring fresh negative shocks, economic growth is projected to reach around 1% this year, to be followed by a modest acceleration to 1.5% in 2024-2025.

SERBIA: OUTLOOK STILL CLOUDY

by Branimir Jovanović

Inflation has begun to decelerate, but much more slowly than elsewhere in the Western Balkans, owing to the government's decision to raise the price of electricity and gas from the start of the year, and to remove the price caps on certain essential food items that were imposed last year. High inflation eroded real incomes in the first quarter of the year, dragging down household consumption. Additionally, government consumption also declined. As a result, GDP expanded by just 0.7% in Q1, falling short of our earlier expectations. Following a brief hiatus in May, the central bank decided to raise its interest rate once again in June, making it unclear whether the tightening cycle is over. Given these developments, we have adjusted our 2023 inflation forecast 2 percentage points (pp) upwards, to 12%; at the same time, we have revised our GDP forecast 0.2 pp downwards, to 1.3%. An upside risk to the outlook is the robust performance of foreign direct investment and remittances, which both grew by more than 30% in Q1. On the other hand, downside risks stem from the emergence of a new wave of anti-government protests in the country and the deteriorating situation in Northern Kosovo.

SLOVAKIA: FUTURE OUTLOOK JEOPARDISED BY POLITICAL UNCERTAINTY

by Doris Hanzl-Weiss

Compared to its annual GDP growth of 1.7% in 2022, Slovakia's performance in early 2023 was weak: GDP grew by only 1% year on year in Q1. This was driven by positive net exports and investments: in real terms, exports fell by around 5%, but imports dropped by as much as 13%. Due to a reduction in inventories, gross capital formation declined by nearly 30%. Household consumption dropped by 2%, as consumers became more cautious in the face of high inflation and as the savings that they drew on last year started to dry up. Industrial production declined in Q1, though trends in the important automotive industry were positive. For this year as a whole, growth will remain low, reaching just 0.6%. Household consumption will be supported by government measures, but will nevertheless be adversely affected by inflation. This was still close to 15% in April, but it should drop to single figures in the second half of 2023 and average about 10% for the year as a whole. Some growth impetus will come from the influx of EU funds this year. Downside risks stem from Slovakia's main export market of Germany, which entered a recession in Q1. Political chaos continues ahead of the parliamentary elections due on 30 September. Growth will pick up in 2024 and 2025, thanks to recovering household consumption and a good trade performance.

SLOVENIA: CAUTIOUS OPTIMISM, BUT UNEASE OVER PERFORMANCE OF KEY TRADING PARTNERS

by Niko Korpar

Our expectations for 2023 remain fairly optimistic: we forecast real GDP to grow by 1.4%, outstripping most EU-CEE countries. While there are worrying signs in the economic performance of key trading partners, we expect private consumption and public investment to drive a modest level of growth, mainly through construction. Trade in goods is likely to contract over the summer, but trade in services will expand, as tourism continues to bounce back after the pandemic. Inflation will remain high, but it has witnessed a slowdown, falling to around 8% in May. Energy prices have cooled considerably, but food, housing and services are still contributing to monthly inflation. For 2023, we expect inflation of 6.6%, followed by 3.6% in 2024. The jobs market will remain tight, with historically low unemployment of 3.9% in 2023 and a growth in nominal wages of 4%. The government's ability to push through critical reforms in areas such as health care and public-sector salaries will be the key story for 2023. These long-awaited reforms will also have major implications for the budget and for Slovenia's welfare model.

TURKEY: SIGNALLING A SHIFT TO ORTHODOX MONETARY POLICIES

by Meryem Gökten

The May elections secured President Erdoğan another term in office. The appointment of market-friendly policy makers to the finance ministry and the central bank signals a shift towards a more orthodox monetary policy, justifying our upward revision of the policy rate to 25% by the end of 2023. Yet the lack of acknowledgement of past policy failures suggests that this policy shift could be short lived: as inflation decreases, the central bank will likely cut its policy rate in 2024. The government's decision to supply natural gas to households free of charge resulted in a notable reduction in inflation in May. While the recent depreciation in the exchange rate may offset these gains, we have lowered our inflation forecast to 42.8% for 2023 and 33.8% for 2024. Overall, in Q1 2023 the economy grew by 4%, despite contractions in agriculture, industry and exports; this was driven primarily by fiscal stimuli ahead of the elections. The latest indicators for Q2 paint a mixed picture, with strong consumer confidence and retail sales, but signs of stagnation in industrial production and exports. We have maintained our GDP forecast, on the assumption that the fiscal stimuli and household consumption will continue to support growth.

UKRAINE: FRAGILE RECOVERY AMID THE WAR

by Olga Pindyuk

Economic activity picked up in Q1 2023, as the energy system recovered from the damage caused by Russian missiles: real GDP increased by 2.4% relative to Q4 2022 (seasonally adjusted). Stabilisation of the energy market, together with falling food and fuel prices, contributed to a rapid slowdown in consumer inflation to around 15% in May. Capital inflows from international partners allowed the financing of a high budget deficit and an increase in forex reserves to an 11-year high of USD 37.3bn – enough to cover five months' worth of imports. However, in light of the not inconsiderable downside risks to financial stability due to the war, the central bank has kept its policy rate unchanged at 25%. The fact that staff-level agreement was reached with the International Monetary Fund on the first review of the Extended Fund Facility Arrangement sends out a strong and positive signal to international investors, and should facilitate future access to external financing. We expect the economy to grow by 2% in 2023; future growth prospects will depend on the severity and duration of the war.

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The *wiiw Monthly Report* summarises wiiw's major research topics and provides current statistics and analyses exclusively to subscribers to the wiiw Service Package. This information is for the subscribers' internal use only and may not be quoted except with the respective author's permission and express authorisation. Unless otherwise indicated, all authors are members of the Vienna Institute's research staff or research associates of wiiw.

Economics editors: Vasily Astrov and Richard Grieveson

IMPRESSUM

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

ZVR-Zahl: 329995655

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

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

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