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Forecast Report

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Recovery Beating Expectations

Economic Analysis and Outlook for Central, East and Southeast Europe

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The Vienna Institute for International Economic Studies
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Recovery Beating Expectations

VASILY ASTROV

ALEXANDRA BYKOVA
RICHARD GRIEVESON
SEBASTIAN LEITNER

et al. (including, Rumen Dobrinsky, Selena Duraković, Doris Hanzl-Weiss, Gábor Hunya, Branimir Jovanović, Niko Korpar, Isilda Mara, Olga Pindyuk, Leon Podkaminer, Sándor Richter, Bernd Christoph Ströhm and Maryna Tverdostup)

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Executive summary

The economic recovery in Central, East and Southeast Europe (CESEE) identified in our Spring and Summer Forecasts has strengthened further in recent months. Current momentum across much of the region is buoyant: on average in the region, the pre-crisis level of 2019 was already exceeded in the second quarter. This has resulted in a number of additional upgrades to our forecasts for 2021 and beyond. This year, the economy of CESEE is estimated to grow by 5.4% – 1.4 percentage points faster than was projected in the summer, and faster than in the euro area (4.8%). This is quite a remarkable achievement, and cannot be explained simply by the effect of the statistical base: last year, regional GDP contracted by only 2.3%, compared to 6.3% in the euro area. Moreover, the aggregate fiscal (and indeed monetary) response has generally been weaker in CESEE than in the euro area.

This good performance has been built on two important foundation stones: the adaptation of the CESEE economies to the pandemic and the increasing reluctance of their governments to impose restrictions. As the pandemic unfolded, so people and companies adapted their behaviour and got on with 'business as usual', even during severe waves of the pandemic. Besides, the appetite for restrictions has gradually evaporated, and in nearly all of the countries they are now less stringent than, for instance, in Austria. As a result, the pandemic – which remains prevalent in large parts of CESEE, especially in those countries with low vaccination levels – has not exerted anything like the drag on economic growth this year that it did in 2020.

The main driver of the economic rebound in CESEE has been private consumption. That has benefited from the easing of COVID-19 restrictions, the effect of delayed consumption, rising employment and wages, and the release of savings accumulated during the pandemic – as well as, in some cases, the strong inflow of remittances and rapid credit expansion. Investment growth in the region has also been high, although this is, to a considerable degree, driven by developments in Estonia, which has capitalised hugely on its digital specialisation and has attracted large foreign investments in information and communications, biotechnology and a newly opened factory producing COVID-19 tests.

The exports of CESEE countries have been in recovery mode, helped by improved demand globally (and particularly in the euro area), a strong revival in energy prices and the recovery of cross-border tourism. However, the legacy of pandemic-related disruptions in value chains has not yet been fully overcome (e.g. the shortage of semiconductor chips that is affecting the production of cars and electronics). Nevertheless, the contribution of real net exports to GDP growth is negative in more than half of the CESEE countries, with export growth not keeping pace with the rise in imports.

The strong economic upswing in CESEE has resulted in labour demand reviving swiftly. However, for most CESEE countries, there is still some way to go to overcome last year's slump in employment – most notably in Montenegro, Moldova and Ukraine. Besides, the COVID-19 crisis has left scars in the form of underemployment, which is now everywhere higher than before the pandemic. Unemployment also remains a problem, especially in the Western Balkans. At the same time, paradoxically, the labour markets are becoming tighter again. While, in many countries, workers who were previously employed in the hospitality sectors are still jobless, there are numerous employers in business services, construction, health care and other public services who are again eagerly searching for labour. This ongoing structural change is resulting in a peculiar combination of strong wage growth and still relatively high underemployment.

Inflationary pressures in CESEE have increased markedly, especially in the non-euro countries. Currently, in most countries of the region, consumer price inflation is 3% to 4% higher than at the beginning of the year. In Czechia, Hungary, Poland, Romania, Russia, Ukraine, Belarus, Kazakhstan and Moldova, the policy rate has already been raised in response (in some cases markedly). Despite that, real interest rates have declined and are now nearly everywhere in negative territory. The recent spike in inflation has been supply-side driven (with energy prices featuring particularly prominently) and is likely to prove transitory. Overheating is hardly an issue in most CESEE countries at present, with the exceptions of Turkey and, possibly, Hungary, Serbia and Albania. However, housing prices have been booming, raising concerns about the formation of property-market bubbles.

The pace of economic recovery in CESEE is projected to slide to 3.7% next year and 3.5% in 2023. The effect of the low statistical base of 2020 will gradually fade, and monetary policy tightening will put the brakes on credit expansion. In EU-CEE countries, growth will be crucially helped by disbursements from the EU Recovery and Resilience Facility, which aims at facilitating economic recovery and simultaneously at fostering digital and green transition. However, approval of the Hungarian and Polish recovery and resilience plans is still pending, while Bulgaria has not even yet submitted its plan to the European Commission. Risks to the above forecasts are mostly on the downside, and include notably

(i) particularly unfavourable COVID-19 developments, which are more likely in countries on the eastern and southern periphery of the CESEE region, given their low vaccination rates;

(ii) premature fiscal consolidation, especially in the Western Balkans and the CIS; and

(iii) the upcoming monetary tapering in the US, which may have particularly severe repercussions for Turkey and Romania, but could impact other CESEE countries as well.

COUNTRY SUMMARIES

ALBANIA

The V-shaped recovery that we see suggests that the economy is back on track and will remain sound. GDP growth will accelerate to 6.4% in 2021 and will hover at above 4.5% in the medium term. The tourism sector has had an impressive year and is getting closer to its pre-pandemic level. Growth will be led by investment and by optimistic external and domestic demand, but downside risks stemming from the international markets and the pandemic call for vigilance.

BELARUS

The restoration of economic relations with Russia has outweighed the negative effect of the Western economic sanctions. Economic growth has been higher than expected, but the upturn has been accompanied by a surge in inflation. Belarus has taken an important step towards closer economic integration with Russia by signing 28 integration programmes. The figures for 2021 have improved slightly, and GDP is expected to grow by some 2.5% for the year as a whole. However, the prospects for the coming years remain bleak.

BOSNIA AND HERZEGOVINA

The economy has bounced back since restrictions were eased in Q2 2021, growing by 11.6% (and thus more than recouping last year's decline). Mass vaccination has started, but the public's interest in getting inoculated has been far lower than expected; this poses an additional risk to the health sector, as the fourth wave of the pandemic is already upon the country. The introduction of a law proscribing genocide denial has led to fresh political tensions in the country and disruption to the work of government institutions by politicians from Republika Srpska; this could have economic repercussions.

BULGARIA

Bulgaria goes to the polls in November for the third time in 2021, after two failed attempts in parliament to form a government. Despite the political impasse, a moderate recovery has been under way, mostly driven by domestic demand. In early autumn, the country was hit by a new and powerful wave of COVID-19 – in large part a consequence of the very low vaccination rate. The short-term outlook has improved slightly and GDP is expected to grow by 3.5% in 2021 as a whole. Growth is expected to remain moderate in the coming years.

CROATIA

In 2021, Croatia's GDP will grow more strongly than that of most EU-CEE member states, after the government succeeded in maintaining COVID-19 infections at a relatively low level during the summer season, which allowed tourism to do better than expected. With the economy further bolstered by a solid recovery in private consumption and by the influx of EU funds, we expect Croatia's GDP to rebound by 7.2% in 2021.

CZECHIA

Pandemic concerns have been fading. GDP has started to recover, and a rising wage bill is supporting a strong rise in consumption. Growth in gross fixed capital formation is still inadequate, but industrial production is performing very well. An upturn in inflation has led to a tightening of monetary policy. The interest rate hike may have negative consequences for growth, but fiscal policy will continue to be supportive. The prospects, though fairly good, remain unimpressive.

ESTONIA

The first half of 2021 showed Estonia to be another post-pandemic success story. Record high investment flooded into the ICT sector, while strong purchasing power and a rapid revival in foreign trade are the pillars of economic growth. We expect the economy to grow by 7.8% in 2021. Even by the middle of the year, the country's pre-pandemic level of output had been exceeded. Future growth will be driven by production expansion, steady consumer demand, rising investment, a strengthening position on the foreign market and further digital transformation.

HUNGARY

By summer 2021, Hungary's economy had regained its pre-pandemic level. Recovery was helped by dynamic growth in industry and a remarkable contribution by net exports. The economy is overheating, however, and inflation has climbed to around 5%. While the central bank has begun tightening monetary policy, the government has stepped up its expansionary fiscal policy, with an eye to the elections early next year. After the elections, the overheating will have to be tackled. The current dynamic growth cannot be maintained for the duration of the forecast.

KAZAKHSTAN

Economic revival is accelerating, with a full rebound to pre-pandemic performance in sight for this year. Rising consumer demand and new fiscal stimuli will support strong performance in the coming years, but inflationary pressure is re-emerging and is likely to persist next year. The forecasts for 2021 and 2022 have been revised upwards to 3.9% and 4.2%.

KOSOVO

The economy has recovered quickly to pre-pandemic levels, and this year GDP growth will accelerate to 6%. The momentum is likely to persist and will be backed by strong domestic and external demand. Both consumption and investment will continue to benefit, as remittances flood in. Foreign investors are turning their gaze towards Kosovo: foreign direct investment has kept pace with the positive developments of 2020 and will continue on this path. Exports of goods will maintain their positive trend.

LATVIA

Following a relatively mild recession in 2020, the Latvian economy is experiencing a remarkably strong revival in 2021. Household consumption has recouped most of the 10% loss it experienced last year, while enterprises are replenishing their depleted stocks. Public consumption and investment are acting as a growth driver, and external demand has similarly rebounded. In 2021, we expect GDP growth to increase to 4.5% and to remain strong in 2022 (4.3%). That will be followed by a somewhat gentler increase of 3.4% in 2023.

LITHUANIA

The Lithuanian economy recovered strongly in Q2 2021. Better-than-expected export performance and swiftly rebounding household consumption were coupled with an upswing in capital investment and a substantial accumulation of stocks. Sharply rising infection statistics may force the government to reintroduce stricter containment measures, but we do not expect that to choke off the ongoing revival. The government is continuing to deliver substantial fiscal stimuli, and the public investments announced will support recovery over the next two years. For 2021, we expect real GDP to grow by 4.4%, followed by a strong, steady increase of 3.7% in 2022 and 3.5% in 2023.

MOLDOVA

The economy will grow by 8% in 2021, against the 7% contraction of the previous year, bringing real GDP back to the pre-crisis level of 2019. The new western-oriented and reform-minded government enjoys overwhelming support in parliament and is able to attract ample foreign funds to finance the expansion of the fiscal and current account deficits.

MONTENEGRO

From Q2 2021, the economy has been enjoying a big increase in industrial production, retail sales, exports of goods and tourism. Accordingly, a high rate of GDP growth is expected in 2021. All the same, the huge contraction in 2020 means that the pre-crisis level will not be reached this year. Public debt and the budget deficit are falling but are still high, limiting fiscal space in the coming years. Despite improvements in economic activity, the unemployment rate remains high.

NORTH MACEDONIA

Weak government support, deep-seated structural problems and global issues in the automotive sector all combined to slow economic recovery in North Macedonia in the first half of 2021. We are downgrading our forecast for GDP growth in 2021 from 4.1% to 3.5%. Developments in the years to follow will depend on whether the government starts to undertake structural reforms and invests in green and digital transformation.

POLAND

The ‘fourth wave’ of the pandemic currently presents little cause for concern. From a mild decline in GDP, Poland has seen a shift towards recovery. The rising wage bill supports a strong recovery in consumption without jeopardising corporate profitability. Growth in gross fixed capital formation is still inadequate, but industrial production is performing very well. An upturn in inflation has not unduly affected the central bank’s monetary policy. However, the course of fiscal policy remains uncertain. Overall, Poland’s prospects are good, but conflicts with the European Commission need to be resolved.

ROMANIA

With expected growth of 6.8% in 2021, the Romanian economy will surpass the pre-crisis level of 2019. The high twin deficits on the fiscal balance and the current account could become a problem only in the event of negative external shocks. The short-term prospects are dimmed by three simultaneous crises in the areas of the pandemic, gas supply and government.

RUSSIA

Despite the persistently unfavourable COVID-19 situation, the economy has rebounded strongly and exceeded the pre-pandemic level in Q2 2021. But inflation has also accelerated markedly. In response, the policy interest rate has been hiked sharply, and more rises are likely to follow. Real GDP is projected to grow by 4% this year and by around 3% per year in 2022-23.

SERBIA

Firm government support and effective vaccine roll-out in the first half of the year have helped the Serbian economy offset the losses brought about by the pandemic. We are upgrading our GDP forecast for 2021 to 6.6%, from 6%. There are three issues that could potentially slow growth down in the coming period: the global problems in the automotive industry, the fiscal consolidation announced by the government and the recent political tensions in the region.

SLOVAKIA

Slovakia's GDP recovered by 9.6% in Q2 2021. Manufacturing – especially the automotive industry – is driving growth, but the shortage of semiconductors is of increasing concern. Slovakia's GDP is expected to rise by 4% this year, while the influx of EU money will drive up investment in coming years.

SLOVENIA

GDP has almost recovered to its pre-crisis levels. Strong economic performance has led our forecast for economic growth to be revised upwards to 5.2%. Q2 2021 saw an increase in private expenditure, a renewed growth in services and strong private investment activity. Exports and trade-oriented industrial sectors have already grown beyond 2019 levels. Inflation has stabilised and is not likely to exceed 2% in 2021. With a surge in infections, the slow progress of vaccination is a risk factor for the winter.

TURKEY

The economy is currently booming, underpinned by strong credit growth, robust domestic consumption, and the impact of the global recovery on export demand and tourism. Ultra-loose monetary policy by the major economies is supporting capital inflows; but as the US, in particular, starts to taper its asset purchases, the risks for Turkey's external financing will rise. While the short-term outlook is good, the usual vulnerabilities remain – not least high inflation and uncertainty over the direction of monetary policy.

UKRAINE

Economic recovery in 2021 will be slower than expected, with GDP growing by 3.8% in annual terms. Private consumption will remain the main driver of growth throughout the forecast period. The recent acceleration in inflation is only temporary: it will slow down in 2022-2023. Any further delays to IMF funding disbursements would constitute a major risk to growth.

Keywords: CESEE, economic forecast, Central and Eastern Europe, Western Balkans, EU, euro area, CIS, Turkey, US, convergence, business cycle, coronavirus, coronavirus restrictions, coronavirus vaccination, Recovery and Resilience Facility, private consumption, credit, investment, exports, labour markets, unemployment, short-time work schemes, monetary policy, fiscal policy

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

CONTENTS

TABLES AND FIGURES

Cut-off date for historical data and forecasts: 5 October 2021. Most data are taken from the wiiw Databases. Direct access is available at: http://data.wiiw.ac.at/.

wiiw Country groups

CESEE23 Central, East and Southeast Europe

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

EU-CEE11 Central and East European EU members

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

V4	**Visegrád countries**	**BALT3**	**Baltic countries**
CZ	Czechia	EE	Estonia
HU	Hungary	LT	Lithuania
PL	Poland	LV	Latvia
SK	Slovakia		

SEE9 Southeast Europe

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

non-EU12 non-European Union CESEE countries

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

WB6 Western Balkans

AL	Albania	MK	North Macedonia
BA	Bosnia and Herzegovina	RS	Serbia

ME	Montenegro	XK	Kosovo

CIS3+UA Commonwealth of Independent States-3 and Ukraine

BY	Belarus	MD	Moldova
KZ	Kazakhstan	UA	Ukraine

CIS4+UA Commonwealth of Independent States-4 and Ukraine

BY	Belarus	RU	Russia
KZ	Kazakhstan	UA	Ukraine
MD	Moldova		

EU27 European Union

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

EA19 Euro area

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

ABBREVIATIONS

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

BCI	Business Cycle Index (wiiw)
BIS	Bank for International Settlements
BOP	balance of payments
CA	current account
CB	central bank
CIS	Commonwealth of Independent States
CNB	Czech National Bank
CPI	consumer price index/inflation
EC	European Commission
ECB	European Central Bank
ESIF	European Structural and Investment Funds
ER	exchange rate
ESA 2010	European system of accounts
EU	European Union
FDI	foreign direct investment
FISIM	Financial Intermediation Services, Indirectly Measured
GDP	gross domestic product
GFCF	gross fixed capital formation
GVA	gross value added

HICP	Harmonised Index of Consumer Prices (EU wide inflation measurement)
ICT	information and communications technology
IMF	International Monetary Fund
LFS	Labour Force Survey
MFF	Multiannual Financial Framework
NACE	Nomenclature statistique des activités économiques dans la Communauté européenne (Statistical classification of economic activities in the European Community)
NBP	National Bank of Poland
NPL	non-performing loan
OPEC+	The members of the Organization of the Petroleum Exporting Countries (OPEC) plus 10 of the biggest non-OPEC oil-exporting countries
PMI	purchasing managers' index
PNL	National Liberal Party (Romania)
pp	percentage points
PPI	producer price index/inflation
PPP	Purchasing Power Parity
PSD	Social Democratic Party (Romania)
PPS	purchasing power standard
RER	real exchange rate
RIR	real interest rate
RRF	Recovery and Resilience Facility
SDR	special drawing rights
SPE	special purpose entity
UK	United Kingdom
US	United States
USR	Save Romania Union
VAT	value added tax
wiiw	The Vienna Institute for International Economic Studies
.	not available (in tables)
bn	billion
m	million
p.a.	per annum
sa	seasonally adjusted
y-o-y	year on year

1. Global Overview: Hitting the limits

BY RICHARD GRIEVESON

We have further revised upward our forecasts since the last update, reflecting stronger-than-expected activity during the middle of the year (see Table 1.1). We now estimate full-year growth of 4.8% in the euro area in 2021, up from 4.4% at the time of our previous report. This projection is actually slightly on the conservative side: it includes an assumption that momentum will wane towards the end of the year, owing to both a renewed rise in coronavirus infections over the winter (leading to greater caution and – at least in some countries – heightened restrictions on economic life) and increasingly significant supply-side constraints. Nevertheless, our core assumption is that the recovery will continue.

We expect growth of 4.4% in 2022 – another strong performance by euro area standards. This projection relies on three core assumptions. First, that the current spike in inflation will indeed be transitory, as the major central banks continue to emphasise (see below), and that the current supply-side constraints do not generate a more serious upward spiral in costs that ultimately dampens (or even puts an end to) the current robust growth momentum. Second, that vaccines continue to work against COVID-19 and any possible future variants, and that vaccination rates continue to rise in the developing world. This second assumption is, naturally, subject to huge uncertainty in both directions. Our third core assumption is that the significantly expanded EU budget will really start to have a strong positive impact on growth in the euro area from next year.

Table 1.1 / wiiw autumn 2021 global assumptions

wiiw forecasts autumn 2021	Euro area			EU		
	2021	2022	2023	2021	2022	2023
Real GDP growth, % per year	4.8	4.4	2.1	4.9	4.5	2.5
CPI, % per year	2.1	1.6	1.4	2.3	1.8	1.6
Unemployment rate, %	8.1	7.8	7.3	7.3	7.0	6.5
Current account, % of GDP	2.5	2.5	2.5	2.5	2.5	2.5
Fiscal balance, % of GDP	-7.1	-3.4	-2.6	-6.9	-3.2	-2.5
EUR/USD	1.18	1.18	1.18			
Brent crude, USD per barrel	68	66	65			

Changes since summer 2021	*Euro area*			*EU*		
	2021	*2022*	*2023*	*2021*	*2022*	*2023*
Real GDP growth, % per year	0.4	0.2	0.0	0.4	0.3	0.0
CPI, % per year	0.2	0.1	0.0	0.2	0.1	0.0
Unemployment rate, %	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Current account, % of GDP	0.0	0.0	0.0	0.0	0.0	0.0
Fiscal balance, % of GDP	0.0	-0.0	0.0	0.0	0.0	0.0
EUR/USD	-0.01	-0.01	-0.01			
Brent crude, USD per barrel	3.00	6.00	5.00			

Source: Forecasts by wiiw. Cut-off date: 5 October 2021.

While global momentum remains robust, at least in the US and China the current cycle appears to have peaked. Indicators of economic surprise have been trending down for some time in both economies. In the euro area, the sense of waning momentum is perhaps less stark, but – at least in part – this reflects the fact that the bloc's recovery came later, and has been less strong, than the other two pillars of the global economy. Put another way, the economy of the euro area still has some post-pandemic catching-up to do.

Global growth is coming up against increasing supply-side constraints – although for the time being these appear to be mostly manageable. Back in our Spring Forecast, we highlighted the rapidly rising price of commodities, and this trend has continued strongly (in year-on-year terms) in recent months. Although we mostly anticipated it, we have made a further upward revision to our oil price forecast for 2021. The recent gas crisis looks set to push up the cost of energy even further over the winter months, perhaps particularly in the euro area. Higher input costs are affecting industry around the world, with manufacturing surveys highlighting increased cost pressures; these can often only partly be passed on to consumers, which means that margins get squeezed. On top of this, firms are reporting increased waiting times for a host of inputs. Meanwhile, labour shortages – an important theme in pre-pandemic times –appear to have returned in many key markets, acting as a further check on the current strong momentum in the global economy.

We have made slight upward adjustments to our euro area inflation forecasts for 2021 and 2022, but we retain our baseline assumption that the current spike in prices will be transitory. Comparisons between the current era and the persistently high inflation of the 1970s, for example, seem to us to be very overblown: the oil price is not especially high by historical standards, and broader price pressures in the euro area do not look particularly strong. Among other factors, the relatively weak bargaining power of labour across much of the global economy today suggests that a wage-price spiral is quite unlikely to materialise. As commodity price inflation eases from next year (our baseline scenario), we expect headline consumer price inflation to do the same.

Given these assumptions about inflation, we do not expect any radical change in monetary policy either by the US Federal Reserve or by the European Central Bank (ECB) during the forecast period. We expect the Fed to start tapering its asset purchase programme before the end of the year, and to have fully wound it down by the end of 2022. We think the first hike will come from the Fed in 2023. By contrast, the ECB will remain in ultra-loose mode, and will not raise rates during the forecast period. The fact that the Fed will be making policy less loose more rapidly than the ECB (and at some point, also tightening it more quickly) will keep the dollar strong against the euro. The risks are certainly now weighted towards a quicker winding-down of asset purchases and tightening of policy (the most recent ECB minutes showed some support for quicker tapering, for example).

Our core assumptions surrounding fiscal policy are also that a fairly loose stance will be maintained throughout the forecast period, which will support headline economic expansion. In both the US and the EU, the fiscal response to the crisis has been huge. The harsh lessons of post-2008 austerity have been learned, as can be seen from the rather different (and much more fiscally dovish) fiscal policy recommendations of institutions such as the International Monetary Fund (IMF) over the past 18 months. Although public debt loads are high, in most major economies the real interest rates on government debt remain extremely low (by any historical standard), and this will not change dramatically during the forecast period.

The risks to this forecast are high and are primarily on the downside, reflecting the unusually large degree of uncertainty about economic projects in the context of the pandemic and its aftermath. There has been no comparable development in recent decades, and so there is no historical guide to how the modern economy will emerge from the pandemic. It is clear that, although the headline recovery looks strong, below the surface there is considerable variation in terms of how different sectors have been impacted, and in the shape and speed of their recovery. Labour market scarring almost certainly exists, although the extent and the implications remain hard to quantify at present. This also applies to different countries: even if the Western world looks well set to ride out the current challenges, this cannot be said so confidently of many emerging markets, where even inflation at its current level could cause serious macroeconomic dislocation, especially when combined with currency weakness. A stronger and/or more pronounced spike in inflation is a clear risk. Not only would that choke off the recovery (via a depression of real purchasing power), but it would also likely lead to considerably higher interest rates than we currently project. Europe could be facing a gas crisis over the winter, although recent noises out of Russia suggest that President Vladimir Putin is willing to allow increased production to avert this. The Evergrande affair in China has served as a reminder of underlying vulnerabilities in the economy that has done most to prop up global demand since 2008. Meanwhile the budget gridlock in Washington underlines the very real danger that partisan politics could limit (or even block) the major extra demand that the US is currently putting into the global economy. Should Chinese and/or US growth falter, there would be serious blowback for the European economies, too.

The implications of our baseline global outlook for CESEE are largely unchanged since our spring and summer updates. Given the euro area's central importance to CESEE as a source of export demand, remittances and foreign direct investment, the ongoing recovery in the bloc is good news. Continued ultra-loose monetary policy in the euro area will prevent CESEE central banks from tightening too quickly, not least because of concerns about the impact of exchange rate appreciation on exporters. Finally, the appreciation of the dollar and higher US rates could create difficulties for CESEE countries with large and especially short-term dollar-denominated external financing requirements.

2. CESEE Overview: Recovery beating expectations[1]

BY VASILY ASTROV AND SEBASTIAN LEITNER

The economic recovery in Central, East and Southeast Europe (CESEE) identified in our spring and summer Forecasts has strengthened further in recent months. Current momentum across much of the region is buoyant and has resulted in a number of additional upgrades to our forecasts for 2021 and beyond. This good performance has been built on two important (and linked) foundation stones: the adaptation of the CESEE economies to the pandemic and the increasing reluctance of their governments to impose restrictions. As a result, the pandemic – which remains prevalent in large parts of CESEE – has not exerted anything like the drag on economic growth this year that it did in 2020.

2.1. VACCINATION AS A GAME CHANGER[2]

The recent impact of the pandemic on public health has diverged in the countries of CESEE. During the summer, warmer temperatures, the headway made in the vaccination campaigns and the rising levels of natural immunity contained the spread of the virus in many countries of the region, effectively putting an end to the third wave of the pandemic. As a result, in the EU member states from Central and Eastern Europe (EU-CEE), Turkey, Ukraine and Bosnia and Herzegovina, the number of new COVID-19 cases declined in Q3 2021 on a quarterly basis (Figure 2.1). The drop was particularly dramatic in the Visegrád countries, which had been among the worst affected during the third wave in the spring. However, in several Western Balkan countries and in Russia, infections rose, driven by the more contagious – and more deadly – Delta variant. The policy of open borders during the tourist season certainly contributed to the rise, with Montenegro in particular recording nearly 50,000 new cases per million population in Q3.[3]

This divergence can, to a large extent, be explained by cross-country variations in vaccination rates. Most of the vaccines administered in CESEE – Pfizer/BioNTech, Moderna, Johnson & Johnson, AstraZeneca and Sputnik V – are effective against the Delta variant. Therefore, it is hardly surprising that the EU-CEE countries and Turkey, which have relatively high rates of vaccination, should also have performed better in terms of new COVID-19 cases (Figure 2.2). Hungary, Czechia, Turkey and Poland have now inoculated more than 50% of their populations, and Lithuania – the CESEE front-runner – has reached the level of Austria (60%). At the opposite end of the spectrum are Ukraine, Bosnia and Herzegovina and Belarus, which have very low vaccination rates and which saw a jump in infections in Q3. Ukraine is an extreme case, having inoculated only 13% of its population (yet it has so far

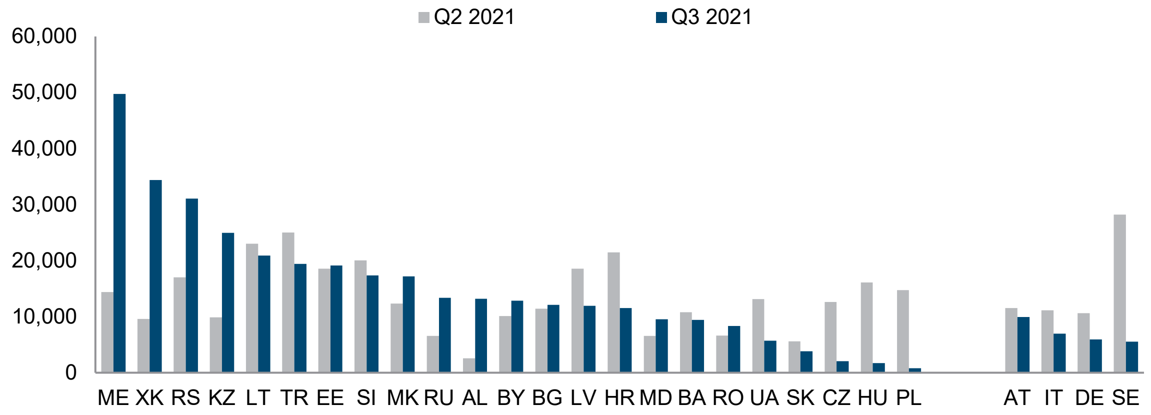
1 The authors thank Richard Grieveson, Gábor Hunya, Branimir Jovanović, Niko Korpar, Isilda Mara, Sándor Richter and Nina Vujanovic, all wiiw, for valuable comments and suggestions on the first draft.

2 This section draws partly on O. Pindyuk (2021), Chart of the month: A fourth wave of COVID-19 taking a grip, wiiw Monthly Report No. 9, pp 7-8.

3 Having said that, the number of cases in the region is likely to be under-reported. In nearly all CESEE countries, the number of COVID-19 tests carried out recently has been several times lower than at the beginning of 2021.

miraculously escaped the worst). On average, at 37%, the vaccination rate in the CESEE region remains rather low.

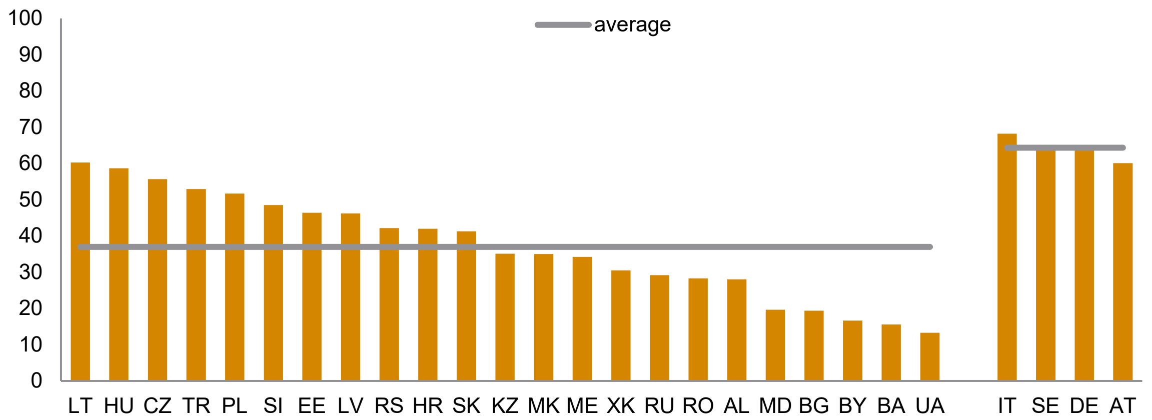
Figure 2.1 / Number of new COVID-19 cases (per million population)



Source: Our World in Data, Oxford University.

Figure 2.2 / Share of population fully vaccinated against COVID-19

at the end of September 2021, in %



Note: Data refer to 1, 2 or 3 October, except for HU and SK (30 September), BY (26 September) and BA (29 September). Simple averages for country groups.
Source: Our World in Data, Oxford University.

The low level of vaccination in many CESEE countries can partly be attributed to the slow start and, in some cases, the initial lack of access to the vaccines. Those CESEE countries that started their vaccination campaigns relatively early, such as Hungary, Slovakia and Serbia (thanks to procurements from Russia and China), are performing at above average in terms of their vaccination levels (Figure 2.2). By contrast, Ukraine, Moldova and Bosnia and Herzegovina lacked access to vaccines for quite some time; it was not until summer 2021 that the large-scale roll-out of vaccinations finally started in those countries, with crucial aid from the EU and other foreign donors.

But a more important reason is reluctance to have the jab. Despite the wealth of evidence confirming the safety and effectiveness of the vaccines, inoculation campaigns in many CESEE countries have struggled to raise take-up rates to the level of herd immunity. Russia and Albania are two cases in point: Russia was the first country in the world to register a COVID-19 vaccine, while Albania succeeded early on in procuring the Chinese Sinovac vaccine. Both countries started vaccinating their people early, and yet their vaccination rate is still below 30%. However, a reluctance to have the jab is also common in the more advanced EU-CEE countries.

The widespread vaccine scepticism in CESEE is fuelled by misinformation, COVID-19 denial and distrust of government. This last feature strikingly distinguishes the region from many parts of Western Europe, and especially the Nordic countries, where trust in government and institutions has been a key factor behind the success of the vaccination campaigns. The relatively low level of COVID-19 restrictions in CESEE also plays a role. Until such time as tests or proof of vaccination are required for an individual to visit a public place, there will be no great incentive to get vaccinated.

2.2. ECONOMIES AND GOVERNMENTS LEARNING TO LIVE WITH THE PANDEMIC

Over time, the economies of CESEE have shown progressively declining sensitivity towards the pandemic. Using data on Western European and CESEE economies up to Q1 2021, Jovanović has demonstrated econometrically that the impact of the pandemic (proxied by COVID-19 mortality) on economic growth has weakened considerably over time.[4] The same conclusion was reached with respect to the impact of government restrictions. As the pandemic unfolded, so people and companies adapted their behaviour – for instance, by switching to digital shopping and communication, ordering food in rather than dining out, etc. In this way, they could get on with ‘business as usual’ – even during severe waves of the pandemic.

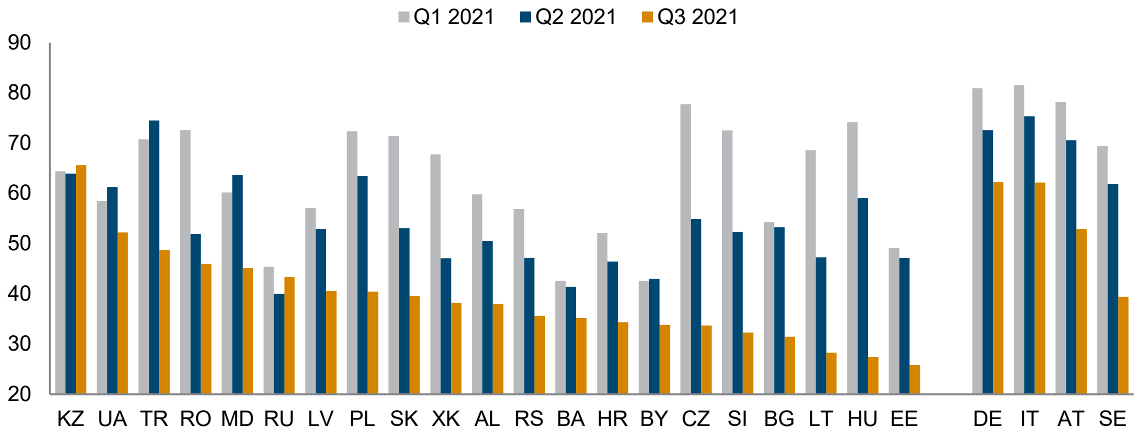
The CESEE governments, too, have learned to live with the pandemic and have gradually reduced the range of COVID restrictions... During the first wave, in spring 2020, all CESEE governments except Belarus imposed lockdowns that were at least as lengthy and strict as in Western Europe. These first lockdowns placed a heavy burden on the economies.[5] However, as the pandemic unfolded, so the appetite for restrictions gradually evaporated. Figure 2.3 shows how the stringency of COVID restrictions – which was still high in most CESEE countries during the second wave in Q1 2021 – has since moderated. In nearly all of the countries (except Kazakhstan), restrictions are now less stringent than, for instance, in Austria.[6]

4 B. Jovanović (2021), Regional overview, in: Light at the end of the tunnel? Economic forecasts for Eastern Europe for 2021-23, wiiw Monthly Report No. 7-8, pp 18-19.

5 The rule of thumb is that a one-week strict lockdown during the first wave of the pandemic (in spring-summer 2020) suppressed economic growth on average by 0.5 pp for the whole year.

6 Having said that, the green pass system in Slovenia is one of the strictest in Europe at the moment.

Figure 2.3 / Stringency Index



Note: Q3 2021 data for several countries are available only until the beginning of August.
Source: Blavatnik School of Government, Oxford University.

… by increasingly prioritising the economy over public health. The deep recessions recorded by some CESEE countries last year have certainly contributed to this.[7] The switch in priorities also partly reflects the shift in public sentiment, as people were getting increasingly fed up with restrictions, so that they were becoming too costly in the political sense. Another reason, especially in the Western Balkans and the CIS, has been the dwindling fiscal space. The lockdowns were accompanied by massive fiscal support for the sectors and households affected, which led to ballooning government deficits and debt. Finally, in some instances (e.g. the Visegrád countries), the imposition of harsh COVID-19 restrictions was simply no longer needed, in view of the vastly improved pandemic situation.

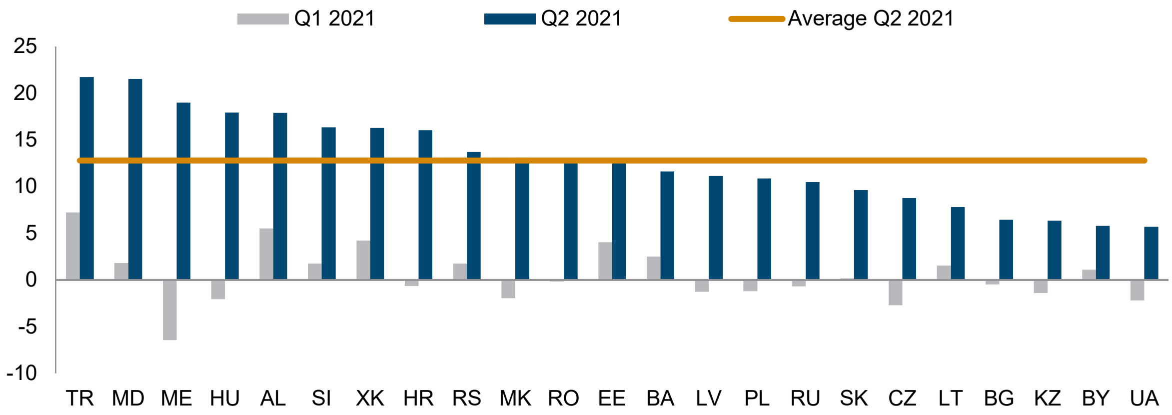
2.3. PRE-PANDEMIC LEVELS OF ACTIVITY LARGELY RESTORED

The CESEE economies have rebounded strongly – and in many cases now exceed pre-pandemic levels. On average,[8] real GDP in the region picked up by 12.8% in Q2 2021 (year on year). Many countries recorded double-digit growth rates: up to 22% in Turkey and Moldova (Figure 2.4). Of course, this very high growth should be viewed against the background of the low statistical basis of last year. But in 15 countries of the region, real GDP even outstripped the pre-pandemic level of Q2 2019 (Figure 2.5), suggesting that there has been more to growth than a mere rebound from the pandemic-related slump. In Turkey, the Q2 2019 figure was exceeded by as much as 9.1%; meanwhile, Serbia surpassed it by 6.6%, and Kosovo by 5.7%. On average, regional GDP exceeded the level of Q2 2019 by 1.4%.

7 For instance, Montenegro has kept its borders open until the end of the tourist season this year – despite the surge in the number of new cases.

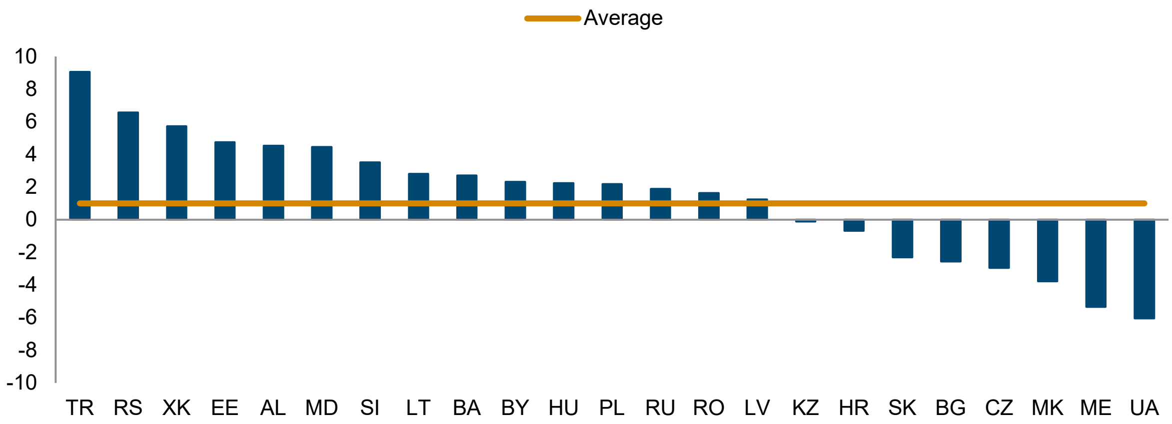
8 Here and below: unweighted averages.

Figure 2.4 / Real GDP growth, in %, year on year



Note: Simple average over all countries.
Source: Eurostat and wiiw Monthly Database.

Figure 2.5 / Real GDP growth in Q2 2021 versus Q2 2019, in %



Note: Simple average over all countries.
Source: own calculations based on Eurostat and wiiw Monthly Database.

The economic recovery in CESEE has been faster than expected, leading us to revise our growth forecasts for 2021 upwards nearly everywhere (Table 2.1).[9] The biggest revisions since the summer are in Estonia (by 3.6 percentage points (pp)) and Turkey (3.3 pp). With estimated growth of 7.8%, Estonia is one of the star performers in the region. As the digitalisation front-runner even prior to the pandemic, the country has capitalised hugely on this and has attracted large foreign investments. The other star performer is Turkey, whose economy, it is estimated, will grow by 9.1% this year, despite the high starting basis: Turkey was the only CESEE country to avoid recession last year. However, growth in Turkey has largely been driven by a credit boom and may not be sustainable. In contrast to those two countries, the strong estimated revival in Montenegro (8.4%), Moldova (8%) and Croatia (7.2%) can be

[9] Only for North Macedonia and Ukraine have the growth forecasts for this year been revised downwards. In North Macedonia, fiscal policy is arguably overly restrictive and acts as a brake on growth, while in Ukraine the downward revision comes on the back of a disappointing performance by trade and investments. For two other CESEE countries – Slovakia and Belarus – the forecasts have been left unchanged.

entirely explained by the base effect. Foreign tourists – who largely stayed at home during the initial stages of the pandemic – are now pouring into Montenegro and Croatia, while Moldova is benefiting from strong credit expansion and the solid recovery in neighbouring Romania. On the contrary, it is estimated that the economy of Belarus will bounce back by only 2.5% this year – a combined effect of the high statistical basis and the repercussions of the recent political crisis, including Western sanctions.

Table 2.1 / Real GDP growth forecasts and revisions

		Forecast, %			Revisions, pp	
		2021	2022	2023	2021	2022
EU-CEE	BG	3.5	3.3	3.2	0.5	-0.2
	CZ	3.4	3.7	3.6	0.4	-0.2
	EE	7.8	3.6	3.0	3.6	-0.9
	HR	7.2	5.0	4.5	2.1	-0.3
	HU	6.2	4.5	4.0	1.3	0.0
	LT	4.4	3.7	3.5	1.4	-0.3
	LV	4.5	4.3	3.4	1.3	-0.7
	PL	5.3	4.9	4.9	1.3	0.4
	RO	6.8	4.3	4.2	1.6	-0.2
	SI	5.2	4.1	3.3	1.2	-0.2
	SK	4.0	4.4	3.9	0.0	0.0
Western Balkans	AL	6.4	4.5	4.2	1.4	0.1
	BA	3.7	3.1	3.5	0.8	-0.2
	ME	8.4	4.8	2.4	1.9	-1.2
	MK	3.5	3.4	3.2	-0.6	0.0
	RS	6.6	4.6	4.5	0.6	0.4
	XK	6.0	4.8	4.0	0.7	0.1
Turkey	TR	9.1	3.8	3.8	3.3	0.4
CIS+UA	BY	2.5	2.0	2.3	0.0	0.4
	KZ	3.9	4.2	4.4	0.4	0.1
	MD	8.0	4.5	4.0	1.0	0.0
	RU	4.0	3.0	2.8	0.5	0.0
	UA	3.8	3.6	3.5	-0.5	0.1

Note: Current forecast and revisions relative to the wiiw July forecast 2021. Colour scale variation from the minimum (red) to the maximum (green).
Source: wiiw.

It is estimated that the CESEE economy will recover by 5.4% this year – more than the recovery in the euro area (4.8%), its main trading partner (see Overview Table 1). This is quite a remarkable achievement, and cannot be explained by the effect of the statistical base. Last year, regional GDP contracted by only 2.3%, compared to 6.3% in the euro area. Moreover, the aggregate fiscal (and indeed monetary) response has generally been weaker in CESEE than in the euro area. In our view, the remarkable resilience of the CESEE economies can largely be explained by two factors: (i) the less ambitious approach their governments have taken when it comes to COVID-19 restrictions, and (ii) the structure of their economies, with services – the sector worst affected by the pandemic – generally occupying a lower share of GDP than is the case in the euro area.[10]

[10] Growth in CESEE is obviously heavily driven by the outstanding performance of Turkey, its second-biggest economy. This is largely on account of idiosyncratic factors (for more on that, see below).

Table 2.2 / OVERVIEW 2019-2020 AND OUTLOOK 2021-2023

		GDP real change in % against prev. year					Consumer prices average change in % against prev. year					Unemployment (LFS) rate in %, annual average				
				Forecast					Forecast					Forecast		
		2019	2020	2021	2022	2023	2019	2020	2021	2022	2023	2019	2020	2021	2022	2023
BG	Bulgaria	3.7	-4.2	3.5	3.3	3.2	2.5	1.2	3.0	2.5	2.0	4.2	5.1	5.5	5.0	5.0
CZ	Czechia	3.0	-5.8	3.4	3.7	3.6	2.6	3.3	3.2	2.8	2.2	2.0	2.6	3.3	3.2	2.9
EE	Estonia	4.1	-3.0	7.8	3.6	3.0	2.3	-0.6	3.6	3.5	2.4	4.4	6.8	6.5	5.8	4.9
HR	Croatia	2.9	-8.0	7.2	5.0	4.5	0.8	0.0	2.2	1.9	1.8	6.6	7.5	8.0	7.4	6.2
HU	Hungary	4.6	-5.0	6.2	4.5	4.0	3.4	3.4	4.8	4.2	3.7	3.4	4.3	4.2	3.9	3.8
LT	Lithuania	4.3	-0.9	4.4	3.7	3.5	2.2	1.1	3.5	4.0	3.3	6.3	8.5	7.2	6.8	6.2
LV	Latvia	2.0	-3.6	4.5	4.3	3.4	2.7	0.1	2.7	3.7	3.2	6.3	8.1	7.6	6.8	6.5
PL	Poland	4.7	-2.5	5.3	4.9	4.9	2.1	3.7	4.4	3.3	3.0	3.3	3.2	3.2	3.0	2.9
RO	Romania	4.1	-3.9	6.8	4.3	4.2	3.9	2.3	4.2	4.0	3.5	3.9	5.0	5.4	4.8	4.5
SI	Slovenia	3.3	-4.2	5.2	4.1	3.3	1.7	-0.3	1.8	1.6	1.5	4.5	5.0	4.7	4.3	4.2
SK	Slovakia	2.5	-4.8	4.0	4.4	3.9	2.8	2.0	2.3	2.4	2.0	5.8	6.7	6.8	6.5	6.0
	EU-CEE11 [1)2)]	*4.1*	*-3.8*	*5.3*	*4.4*	*4.2*	*2.6*	*2.7*	*3.9*	*3.3*	*2.9*	*3.8*	*4.4*	*4.6*	*4.2*	*4.0*
	EA19 [3)]	*1.5*	*-6.3*	*4.8*	*4.4*	*2.1*	*1.2*	*0.3*	*2.1*	*1.6*	*1.4*	*7.6*	*7.9*	*8.1*	*7.8*	*7.3*
	EU27 [3)]	*1.8*	*-5.9*	*4.9*	*4.5*	*2.5*	*1.4*	*0.7*	*2.3*	*1.8*	*1.6*	*6.7*	*7.1*	*7.3*	*7.0*	*6.5*
AL	Albania	2.1	-4.0	6.4	4.5	4.2	1.4	1.6	2.1	2.5	2.8	11.5	11.7	11.4	11.2	11.0
BA	Bosnia and Herzegovina	2.8	-3.2	3.7	3.1	3.5	0.6	-1.1	1.3	1.0	1.2	15.7	15.9	16.9	16.5	15.9
ME	Montenegro	4.1	-15.3	8.4	4.8	2.4	0.4	-0.3	1.9	1.3	1.2	15.1	17.9	16.0	15.5	15.3
MK	North Macedonia	3.2	-4.5	3.5	3.4	3.2	0.8	1.2	3.0	2.5	2.0	17.3	16.4	16.0	15.5	15.0
RS	Serbia	4.2	-1.0	6.6	4.6	4.5	1.7	1.6	3.5	3.0	2.5	10.4	9.0	11.0	10.0	9.0
XK	Kosovo	4.8	-5.3	6.0	4.8	4.0	2.7	0.2	2.3	2.5	2.3	25.7	25.9	25.5	25.0	24.5
	WB6 [1)2)]	*3.6*	*-3.1*	*5.7*	*4.2*	*4.0*	*1.4*	*0.9*	*2.7*	*2.4*	*2.2*	*13.4*	*13.0*	*13.7*	*13.2*	*12.4*
TR	Turkey	0.9	1.8	9.1	3.8	3.8	15.2	12.3	17.5	12.2	10.0	13.7	13.2	13.1	12.2	11.1
BY	Belarus	1.4	-0.9	2.5	2.0	2.3	5.6	5.5	9.0	8.0	7.0	4.2	4.0	4.0	4.1	4.2
KZ	Kazakhstan	4.5	-2.5	3.9	4.2	4.4	5.3	6.8	7.9	6.7	5.9	4.8	4.9	4.9	4.8	4.8
MD	Moldova	3.7	-7.0	8.0	4.5	4.0	4.8	3.8	4.5	6.0	5.0	5.1	3.8	3.8	3.5	3.0
RU	Russia	2.0	-3.0	4.0	3.0	2.8	4.5	3.4	6.2	4.4	3.2	4.6	5.8	5.1	4.8	4.6
UA	Ukraine	3.2	-4.0	3.8	3.6	3.5	7.9	2.7	9.3	6.0	5.5	8.2	9.5	9.0	8.0	8.0
	CIS4+UA [1)2)]	*2.4*	*-3.0*	*3.9*	*3.1*	*3.0*	*5.0*	*3.7*	*6.7*	*4.9*	*3.8*	*5.2*	*6.2*	*5.5*	*5.1*	*5.0*
	V4 [1)2)]	*4.2*	*-3.7*	*5.0*	*4.6*	*4.4*	*2.4*	*3.4*	*4.1*	*3.3*	*2.9*	*3.3*	*3.5*	*3.7*	*3.5*	*3.4*
	BALT3 [1)2)]	*3.6*	*-2.1*	*5.2*	*3.8*	*3.4*	*2.4*	*0.4*	*3.3*	*3.8*	*3.1*	*5.9*	*8.0*	*7.2*	*6.6*	*6.0*
	SEE9 [1)2)]	*3.8*	*-4.1*	*6.1*	*4.2*	*4.1*	*2.8*	*1.6*	*3.5*	*3.2*	*2.8*	*7.4*	*8.1*	*8.8*	*8.2*	*7.7*
	CIS3+UA [1)2)]	*3.5*	*-3.0*	*3.7*	*3.6*	*3.7*	*6.5*	*4.8*	*8.6*	*6.6*	*5.9*	*6.6*	*7.2*	*6.9*	*6.4*	*6.4*
	non-EU12 [1)2)]	*2.0*	*-1.6*	*5.5*	*3.3*	*3.3*	*7.7*	*6.1*	*9.6*	*6.9*	*5.5*	*7.5*	*8.0*	*7.6*	*7.1*	*6.8*
	CESEE23 [1)2)]	*2.6*	*-2.3*	*5.4*	*3.7*	*3.5*	*6.2*	*5.1*	*8.0*	*5.8*	*4.7*	*6.6*	*7.1*	*6.8*	*6.4*	*6.1*

Table 2.2 / (ctd.)

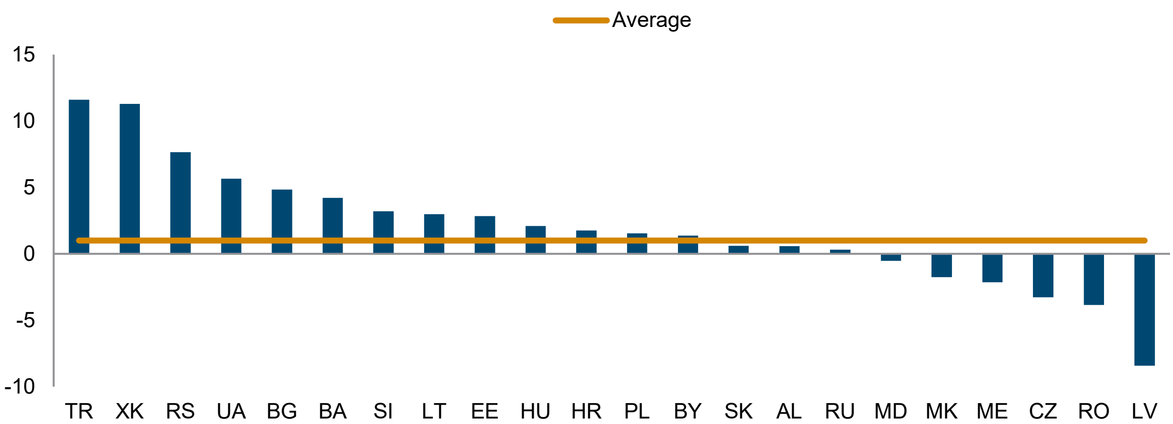
		Current account in % of GDP					Fiscal balance in % of GDP				
				Forecast					Forecast		
		2019	2020	2021	2022	2023	2019	2020	2021	2022	2023
BG	Bulgaria	1.9	-0.3	-1.2	-1.5	-1.3	2.1	-3.4	-3.0	-2.5	-2.0
CZ	Czechia	0.3	3.6	2.5	2.4	2.5	0.3	-6.1	-6.5	-5.6	-4.5
EE	Estonia	2.5	-0.3	-3.7	-0.5	-0.2	0.1	-5.0	-4.0	-2.0	-1.0
HR	Croatia	3.1	-0.1	0.6	0.4	-0.3	0.3	-7.4	-4.5	-3.0	-2.5
HU	Hungary	-0.7	-1.6	0.6	0.7	0.9	-2.1	-8.1	-8.0	-5.5	-3.5
LT	Lithuania	3.5	7.4	2.5	2.1	2.0	0.5	-7.4	-6.2	-4.0	-2.5
LV	Latvia	-0.7	2.9	-3.2	-2.6	-2.1	-0.6	-4.5	-8.0	-4.0	-2.0
PL	Poland	0.5	3.5	1.9	2.8	2.6	-0.7	-6.9	-5.5	-4.5	-3.0
RO	Romania	-4.9	-5.0	-5.8	-4.6	-4.0	-4.4	-9.2	-7.0	-6.0	-5.0
SI	Slovenia	6.0	7.4	5.7	5.4	4.8	0.4	-8.3	-7.3	-3.3	-0.8
SK	Slovakia	-3.4	0.1	-0.7	-0.6	-0.5	-1.3	-6.1	-7.1	-5.1	-4.1
	EU-CEE11 1)2)	*-0.3*	*1.4*	*0.3*	*0.8*	*0.9*	*-1.0*	*-7.1*	*-6.2*	*-4.8*	*-3.4*
	EA19 3)	*2.9*	*2.8*	*2.5*	*2.5*	*2.5*	*-0.6*	*-7.2*	*-7.1*	*-3.4*	*-2.6*
	EU27 3)	*2.9*	*2.8*	*2.5*	*2.5*	*2.5*	*-0.5*	*-6.9*	*-6.9*	*-3.2*	*-2.5*
AL	Albania	-7.9	-8.8	-8.5	-7.7	-7.1	-1.9	-6.8	-3.0	-1.5	-1.0
BA	Bosnia and Herzegovina	-2.8	-3.8	-2.3	-2.8	-3.2	1.9	-5.3	-2.0	-0.5	0.2
ME	Montenegro	-14.3	-26.1	-18.3	-16.9	-17.3	-2.0	-11.1	-5.5	-4.0	-3.0
MK	North Macedonia	-3.3	-3.4	-3.5	-4.0	-4.7	-2.2	-8.2	-3.0	-2.0	-1.0
RS	Serbia	-6.9	-4.2	-2.9	-3.0	-3.0	-0.2	-8.1	-3.0	-2.5	-2.0
XK	Kosovo	-5.7	-7.1	-8.4	-8.1	-7.2	-2.9	-7.6	-2.0	-2.0	-1.0
	WB6 1)2)	*-6.2*	*-5.7*	*-4.7*	*-4.6*	*-4.7*	*-0.5*	*-7.5*	*-2.9*	*-2.0*	*-1.4*
TR	Turkey	0.9	-5.2	-3.1	-2.9	-2.7	-3.2	-2.8	-3.5	-2.5	-1.5
BY	Belarus	-1.9	-0.4	0.7	0.9	0.5	2.4	-1.7	-2.0	-2.0	-1.0
KZ	Kazakhstan	-4.0	-3.8	-2.9	-2.0	-1.9	-1.8	-4.0	-3.5	-2.6	-2.0
MD	Moldova	-9.3	-7.5	-9.6	-6.9	-5.6	-1.4	-8.5	-6.0	-6.0	-5.0
RU	Russia	3.9	2.4	5.6	5.9	5.7	1.9	-4.0	1.0	1.5	1.5
UA	Ukraine	-2.7	3.4	-0.9	-2.4	-3.0	-2.2	-5.4	-5.0	-3.0	-2.0
	CIS4+UA 1)2)	*2.5*	*1.8*	*4.0*	*4.2*	*4.1*	*1.3*	*-4.1*	*0.0*	*0.6*	*0.8*
	V4 1)2)	*-0.1*	*2.5*	*1.6*	*2.1*	*2.0*	*-0.7*	*-6.8*	*-6.2*	*-4.9*	*-3.5*
	BALT3 1)2)	*2.1*	*4.2*	*-0.7*	*0.1*	*0.3*	*0.1*	*-6.0*	*-6.1*	*-3.5*	*-2.0*
	SEE9 1)2)	*-3.3*	*-3.9*	*-4.2*	*-3.6*	*-3.4*	*-2.0*	*-7.8*	*-5.2*	*-4.2*	*-3.5*
	CIS3+UA 1)2)	*-3.3*	*-0.6*	*-1.8*	*-1.9*	*-2.1*	*-1.3*	*-4.3*	*-3.9*	*-2.8*	*-2.0*
	non-EU12 1)2)	*1.7*	*-0.4*	*1.7*	*1.9*	*1.9*	*0.1*	*-3.9*	*-1.1*	*-0.4*	*0.1*
	CESEE23 1)2)	*1.0*	*0.3*	*1.2*	*1.5*	*1.5*	*-0.3*	*-5.1*	*-3.0*	*-2.0*	*-1.2*

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: 05 October 2021.

2.4. THE KEY ROLE OF DOMESTIC DEMAND

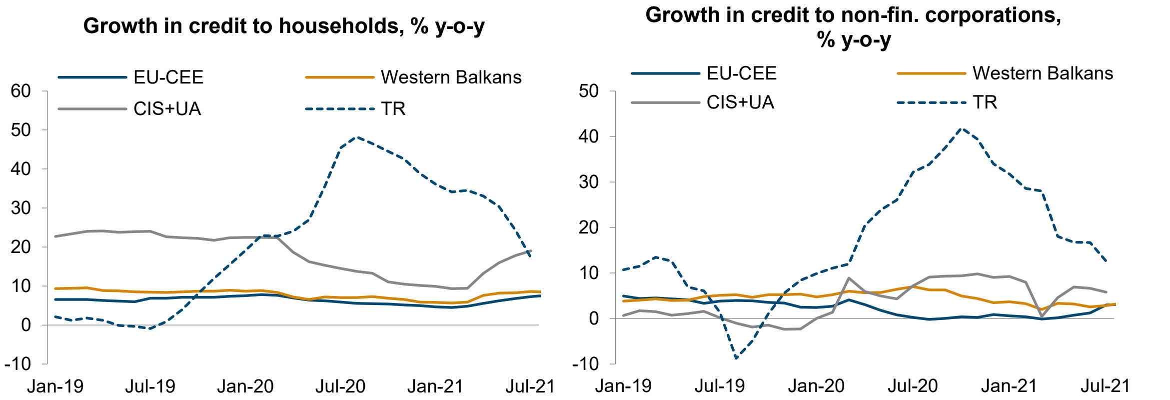
Private consumption has been the main driver of economic recovery. On average in CESEE, private consumption picked up by 14.5% year on year in Q2, surpassing the level of two years previously by 1.8% (Figure 2.6). It has benefited from the easing of COVID-19 restrictions, the effect of delayed consumption, rising employment and wages, and the release of savings accumulated during the pandemic. In the Western Balkans, it has also been supported by the strong inflow of remittances; and in the CIS, Hungary, Turkey and Kosovo by rapid credit expansion (Figure 2.7, left panel). At the same time, in six CESEE countries – Moldova, North Macedonia, Montenegro, Czechia, Romania and, most notably, Latvia – the pre-pandemic levels of private consumption have not been reached.

Figure 2.6 / Real growth in household consumption in Q2 2021 versus Q2 2019, in %



Note: Simple average over all countries. wiiw estimates for Bosnia and Herzegovina.
Source: own calculations based on Eurostat and wiiw Monthly Database.

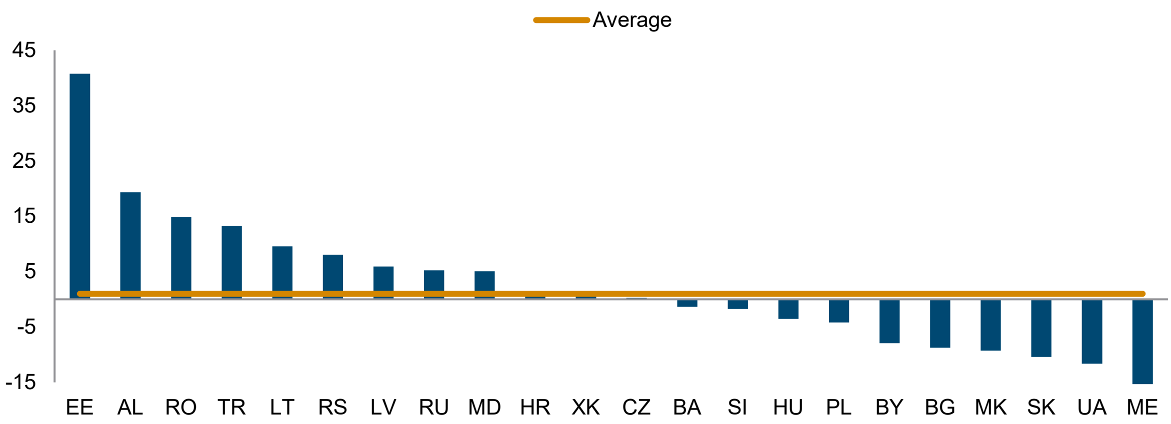
Figure 2.7 / Growth in credit to households and non-financial corporations, in %, year on year



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

Fixed capital investment picked up strongly, too, but its dynamics has been very uneven across countries. In general, investment growth in CESEE has benefited from reduced uncertainties, vastly improved sales, the recovery of foreign direct investment, and, in some cases, further declining real interest rates. On average across the region, gross fixed capital formation (GFCF) rose in Q2 by 17.7% year on year, to surpass the level of two years previously by 2.1% (Figure 2.8). However, the high average figure masks significant country heterogeneity, and is, to a considerable degree, driven by developments in Estonia. GFCF in Estonia skyrocketed by 60% in Q2, coming on top of the 54% increase in Q1, as the country attracted large investment projects in information and communications technology (ICT), biotechnology and a newly opened factory producing COVID-19 tests. Investments also picked up strongly in Albania, Romania, Kosovo and Turkey, but elsewhere their performance has been more mixed. In 13 CESEE countries, the investment slump of last year has not been fully recouped, most notably in Montenegro.

Figure 2.8 / Real growth in gross fixed capital formation in Q2 2021 versus Q2 2019, in %



Note: Simple average over all countries. wiiw estimates for Bosnia and Herzegovina.
Source: own calculations based on Eurostat and wiiw Monthly Database. Data for MK and XK refer to gross capital formation.

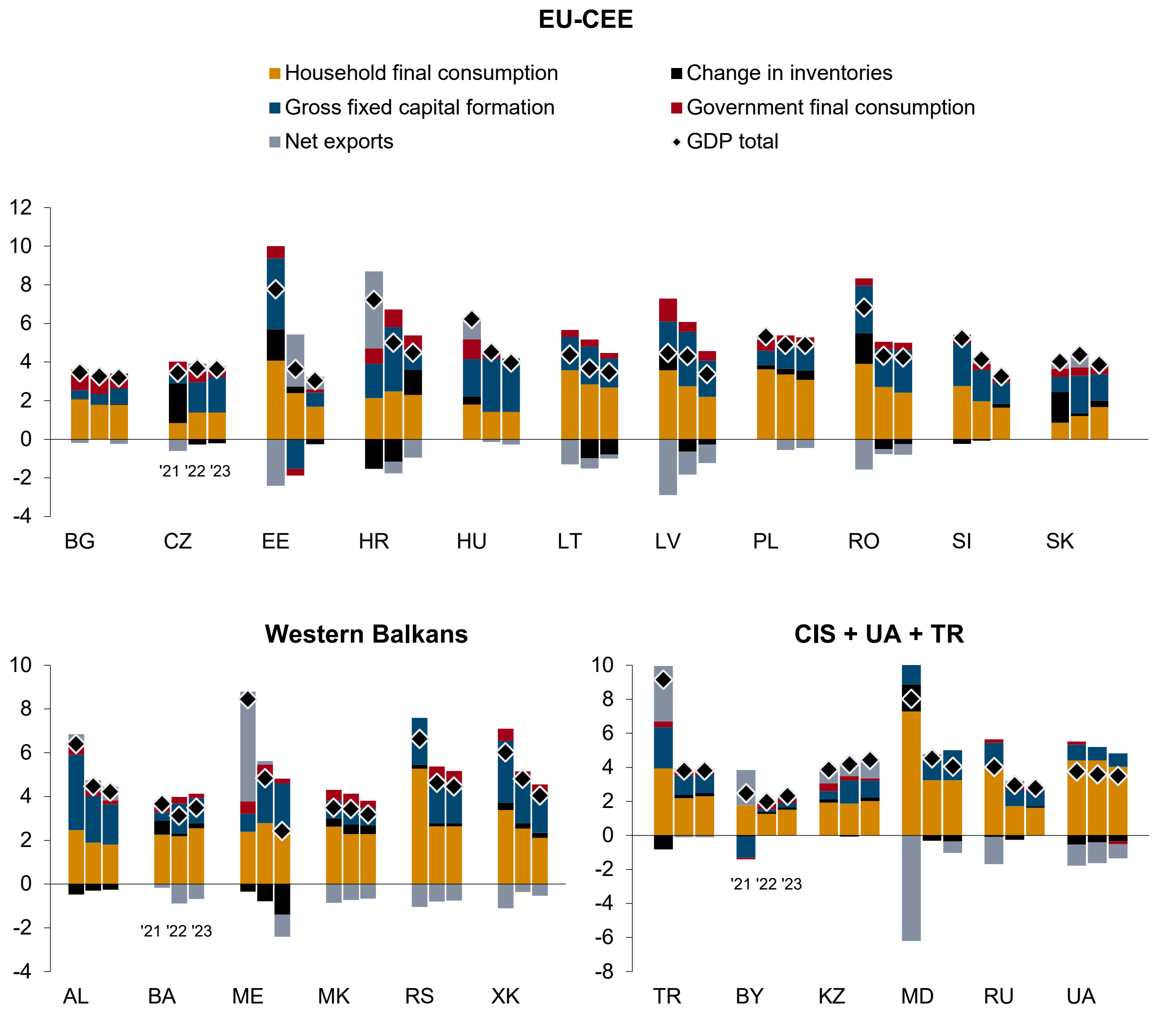
The exports of CESEE countries have been in recovery mode. Last year, the value of exports (of goods and services) from many CESEE countries suffered badly on account of the global recession, the disastrous tourist season, plunging energy prices (and restrictive oil production quotas decided by OPEC+) and disruptions in value chains. This last element particularly affected the automotive industry, in which especially the Visegrád countries (but also Slovenia, Serbia and North Macedonia) specialise. The legacy of these disruptions has not yet been fully overcome. This is manifested, for instance, in the persistent (and even increasing) shortages of semiconductor chips – a shortage that affects the production of cars and electronics and causes entire factories to halt their operations temporarily. Nevertheless, by and large the exports of CESEE countries have been in recovery mode, helped by improved demand globally and particularly in the euro area, a strong revival in energy prices and the recovery of cross-border tourism.[11]

[11] Country-specific circumstances play a role, too. For instance, Kosovo appears to have benefited greatly from Brexit, with the bulk of its exports now going to the UK.

Nevertheless, the contribution of net exports to GDP growth is mostly negative. This is demonstrated in Figure 2.9, which shows the estimated contribution of individual final demand components to the headline GDP growth this year. In the vast majority of CESEE countries, growth is being driven primarily by private consumption; in Hungary and Albania by GFCF; and in Czechia and Slovakia by the change in inventories. Only in Croatia and Montenegro is economic recovery primarily driven by net exports, thanks to the rebound in tourism. In 13 CESEE countries, the contribution of net exports to growth is estimated to be negative, with export growth not keeping pace with the rise in imports. This further attests to the primarily domestic-demand nature of recovery in the CESEE region.

Figure 2.9 / GDP growth forecast for 2021-2023

and contribution of individual demand components in percentage points



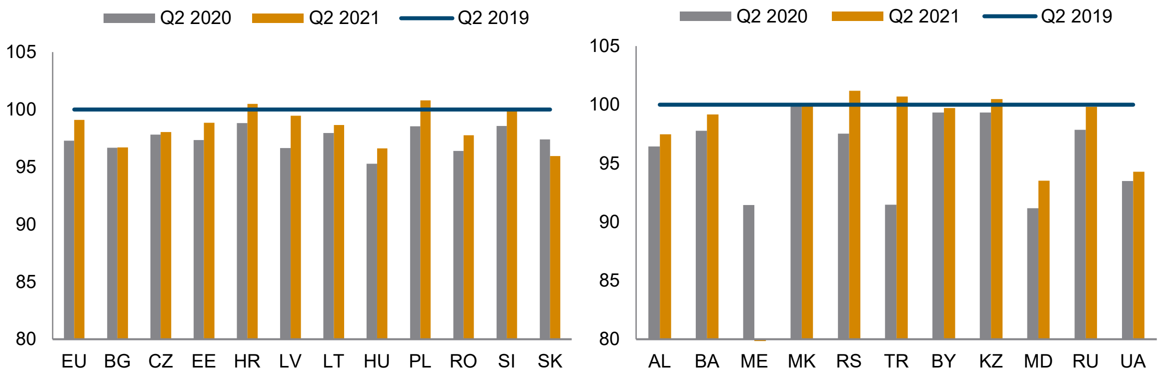
Note: wiiw estimates for Bosnia and Herzegovina.
Source: wiiw Annual Database incorporating national and Eurostat statistics, own calculations. Forecasts by wiiw.

2.5. RAPID RECOVERY IN LABOUR MARKETS, BUT UNDEREMPLOYMENT STILL AN ISSUE

The strong economic upswing in CESEE has resulted in labour demand reviving swiftly. In Croatia, Latvia, Hungary, Poland and Slovenia, the number of employed persons in Q2 2021 reached (or even surpassed) the level of two years previously, according to national accounts statistics. In a number of non-EU countries, this was also the case (Figure 2.10). Either the decline in employment during the first wave of COVID-19 infections was not significant (such as in North Macedonia, Belarus, Kazakhstan and Russia), or a remarkable rebound in labour demand has since occurred (such as in Serbia and Turkey). However, for most CESEE countries, there is still some way to go to overcome last year's slump – most notably in Montenegro, Moldova and Ukraine.

Figure 2.10 / Employment in CESEE countries

Q2 2020 and Q2 2021 relative to Q2 2019=100, in %

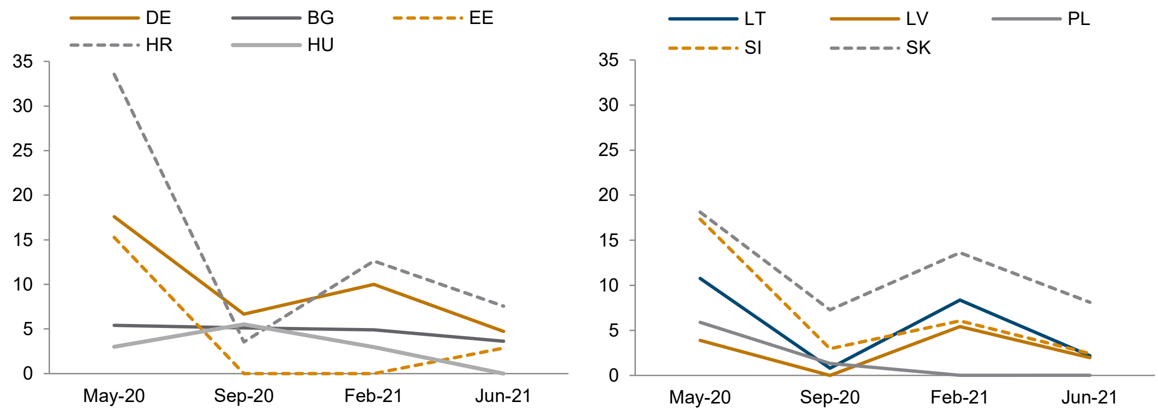


Note: Data for EU-CEE and EU based on national accounts statistics; HU, RO, SK (estimate); WB+TR and CIS4+UA according to Labour Force Survey (LFS) statistics. For BA, the data refer to the number of persons in paid employment.
Source: Eurostat and wiiw Annual Database incorporating national statistics.

Unemployment is returning to the situation it was in before the pandemic, but underemployment remains considerably higher than it was. Unmet demand for jobs (the so-called labour market slack) comprises – apart from the number of unemployed – a further three elements: (i) the number of part-time workers who are underemployed, (ii) the number of persons who want to work but are not immediately available, and (iii) the number of persons who want to work but are not actively searching for a job. In all EU-CEE countries, bar Poland, the rate of this unmet demand for jobs in Q2 2021 exceeded the level of Q2 2019. And in four EU-CEE countries, it was even higher than a year ago: in Czechia (4.4%), Romania (9%), Slovenia (9.2%) and Latvia (14.1%).

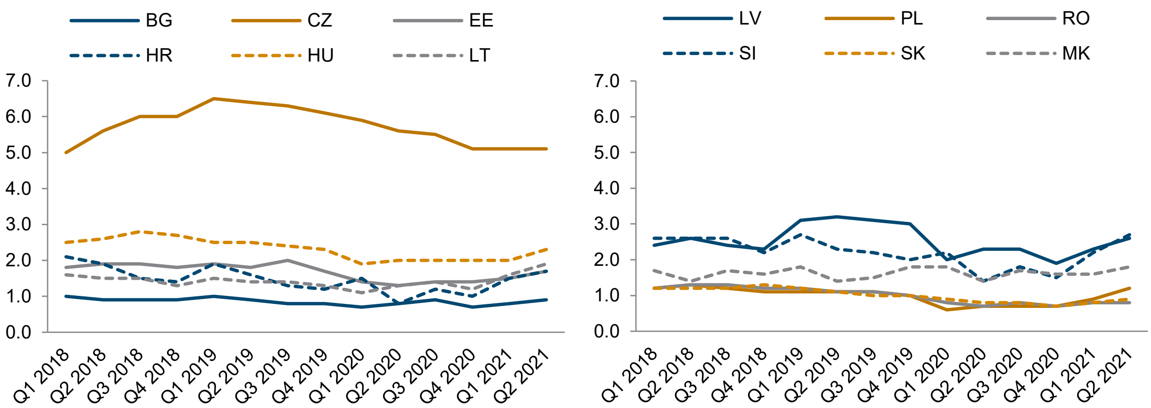
During the lockdown phases in 2020 and early 2021, job losses were partly averted by the application of various job-retention schemes. Short-time work, furlough schemes and wage subsidies have been widely used in response to the pandemic. In the EU-CEE countries, the share of employed and self-employed people supported during the first lockdown in May 2020 ranged from 3% in Hungary and Latvia to 15% in Estonia, Slovakia and Slovenia (Figure 2.11). In Croatia, where many people work in tourism, it was as high as 34% of the employed workforce. In February 2021, when lockdowns were generally less stringent, the figure declined to 7% on average in EU-CEE. The generosity of subsidies has varied greatly by country, with wage replacement ratios low in Poland and Hungary, for example, but relatively high in Croatia, Bulgaria and Slovenia. The Western Balkan countries, too, implemented job-retention schemes. However, the large share of informal employment – estimated to be about 20% in North Macedonia and 35% in Kosovo – meant that fewer firms and (self-)employed people had access to these benefits. In general, we would thus expect a bigger decline in earnings due to the pandemic among low-income households in the grey economy than might be assumed if one looked only at aggregate labour market figures.

Figure 2.11 / Proportion of jobs supported by government measures, %



Notes: The data comprise jobs supported by different schemes. Data are available only for selected EU countries.
Source: Eurostat database.

Figure 2.12 / Job vacancy rate, in %



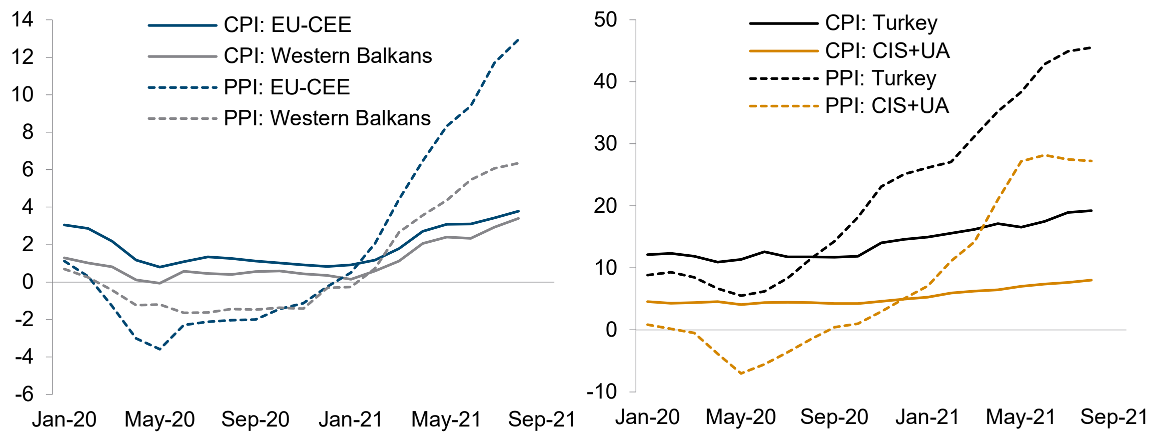
Notes: The job vacancy rate measures the number of total posts that are vacant, divided by the sum (number of occupied posts + number of job vacancies), expressed as a percentage.
Source: Eurostat database.

The rapid economic revival resulted in labour markets becoming tighter again – more like pre-pandemic times. In many countries of the region, job vacancy rates returned to the levels of 2018. As well as most EU-CEE countries (Figure 2.12), Montenegro, Serbia and Russia also recorded an upswing in labour scarcity.[12] While, in many countries, workers who were previously employed in the hospitality sectors (including tourism and transport) are still jobless, there are numerous employers in business services, construction, health care and other public services who are again eagerly searching for labour. This ongoing structural change is resulting in a peculiar combination of strong wage growth and still relatively high underemployment.

2.6. IS INFLATION REARING ITS UGLY HEAD?

Inflationary pressures in CESEE have increased markedly, especially in the non-euro countries. In 2020, consumer price inflation (CPI) in several parts of the CESEE region fell to very low levels (with a few countries recording outright deflation), as the demand for many goods and services collapsed and energy prices plummeted to very low levels.[13] But with domestic demand gradually recovering in line with the easing of COVID-19 restrictions, and with supply-side constraints starting to bite, inflation has started to rise again, typically by 3-4 pp (on an annual basis) since the beginning of this year (Figure 2.13). Interestingly, in those countries that use the euro (either as part of the euro area or unilaterally), the increase has been less pronounced than elsewhere. This is because their inflation rates are more aligned with the rate in the euro area (which is lower than in CESEE), and also because the commodity price increase in euro terms over the past year has been relatively less pronounced.

Figure 2.13 / Consumer and producer price inflation, year on year, in %



Note: Simple average over all countries. CPI – consumer price inflation; PPI – producer price inflation.
Source: wiiw Monthly Database incorporating national statistics.

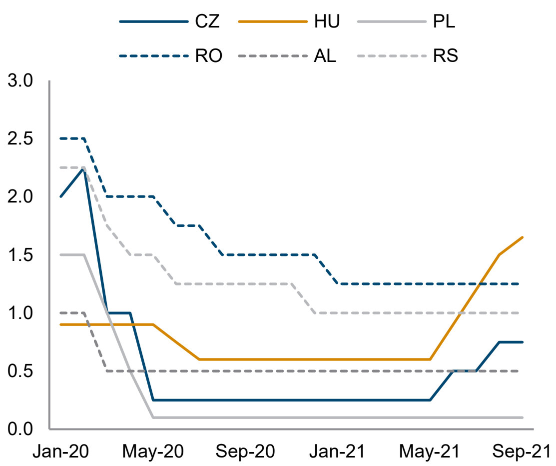
Many central banks in the region have tightened policy in response. In many CESEE countries, inflation is now well above the official targets, prompting central banks to intervene. In Czechia, Hungary, Poland, Romania, Russia, Ukraine, Belarus, Kazakhstan and Moldova, the policy rate has already been raised, in some cases markedly (Figure 2.14). In contrast, Serbia and Albania have so far refrained from interest rate hikes; meanwhile, in Turkey, the earlier tightening cycle was abruptly

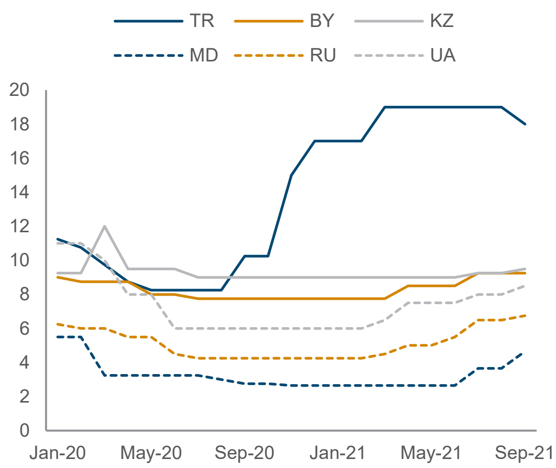
12 Due to differences in the applied methodology, job vacancy rates in Montenegro and Russia are not shown in Figure 2.12.

13 Turkey is a notable exception.

reversed in September. In the other CESEE countries, monetary policy is (effectively) decided by the European Central Bank (ECB), which has largely preserved its ultra-expansive course.

Figure 2.14 / Central bank nominal policy rate, end of month, in %

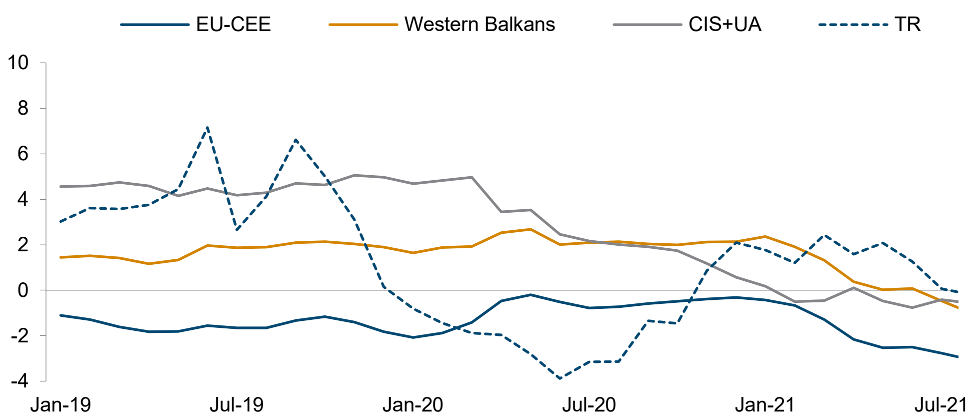




Source: wiiw Monthly Database incorporating national and Eurostat statistics.

Despite that, real interest rates have declined, probably suggesting more policy tightening to come. With interest rate hikes generally lagging behind the pick-up in inflation, real interest rates have declined in most CESEE countries (Figure 2.15). As of August 2021, real interest rates were in negative territory in nearly all of these countries, except Montenegro, Kosovo and Kazakhstan. In Poland, Estonia and Lithuania, they were as low as -4.7%. This may suggest that even in the absence of any further increase in inflation, the tightening cycle in many CESEE countries may continue in the months to come (albeit not necessarily in Turkey).

Figure 2.15 / Real policy rate, CPI deflated, in %



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

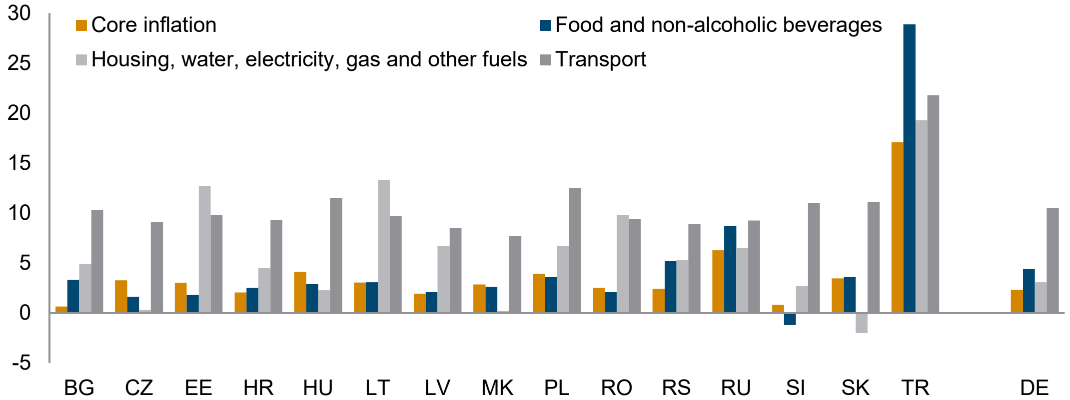
2.7. FEW SIGNS OF OVERHEATING – EXCEPT IN PROPERTY MARKETS

A search for the causes of inflation highlights the outstanding role of energy prices, while core inflation has been subdued. Figure 2.16 presents the sub-components of the headline consumer price index (CPI) in those CESEE countries for which the respective data are available during the year preceding August 2021. As can be seen, in the EU-CEE countries, it was transportation and, to a lesser extent, utilities that recorded the strongest price increases – both largely reflect rising energy prices. Elsewhere, headline inflation was more broad based, with food prices featuring quite prominently in Russia, Serbia and, particularly, Turkey. By contrast, core inflation has been subdued. In most EU-CEE countries, it stayed at below 4%: only in Russia and Turkey did it approach the headline inflation rate. Given the highly uneven dynamics across the individual CPI sub-components, the recent pick-up in headline inflation may well be a consequence of the adjustments in relative prices, partly unleashed by the COVID-19 shock, rather than inflation in the macroeconomic sense (defined as an increase in the *general* price level).[14]

The recent spike in inflation has been supply-side driven… Figure 2.15 shows that producer price inflation (PPI) in the region has been rising far ahead of CPI, with the gap between the two widening over time. This would suggest that supply-side factors (such as the disruptions in value chains) lie behind the recent spike in inflation. In the case of demand-driven inflation (overheating), one would rather expect the opposite: consumer prices rising faster than producer prices. Indeed, our analysis, which draws on a wide range of indicators, suggests that overheating is hardly an issue in most CESEE countries, at least at the aggregate level (see Chapter 3.2). As of Q2 2021, only Turkey and (arguably) Hungary, Serbia and Albania were showing signs of overheating.[15]

Figure 2.16 / Consumer price inflation sub-components in August 2021

percentage change year on year



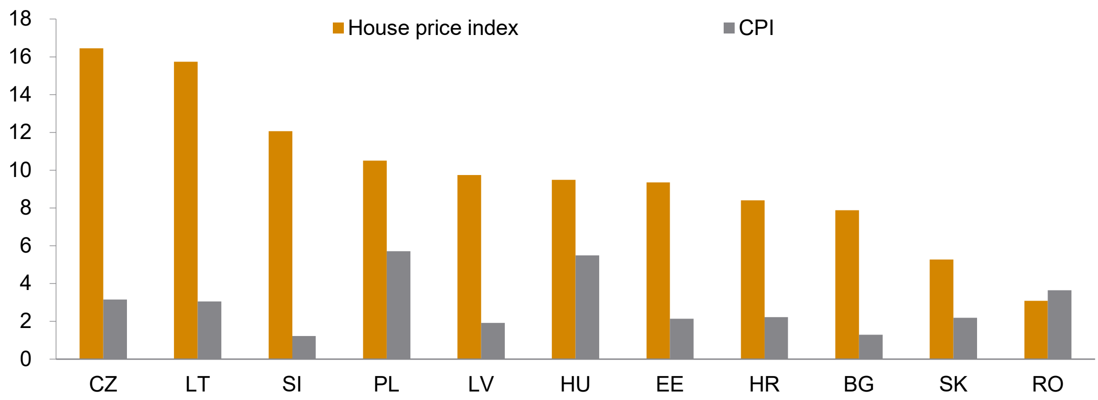
Source: National sources, Eurostat, wiiw.

[14] Similar reservations have been voiced when analysing inflation developments on a global scale. Besides, the usual problem of finding the right weights when measuring CPI becomes even greater in the face of big shocks, such as COVID-19. This complicates the interpretation of inflation numbers. See, for instance: https://adamtooze.substack.com/p/chartbook-42-the-great-inflation

[15] In Turkey, the wiiw Business Cycle Index (BCI) in Q2 2021 exceeded the level of Q4 2007 – the frequently used benchmark for overheating in the run-up to the global financial crisis – by a wide margin (and Serbia and Albania were very close to it). In Hungary, the BCI also exceeded the level of Q4 2007, but the latter benchmark may not be entirely appropriate in the Hungarian case.

… and is likely to be transitory. The disruptions in value chains are a legacy of the pandemic – as, to some extent, are higher food prices, since the cross-border travel restrictions imposed during the pandemic affected harvesting. With the legacy of the pandemic fading over time, supply-side disruptions will increasingly become less of an issue. Energy prices cannot rise indefinitely, either (although they will probably become much more volatile, as suggested by the current situation with the natural gas prices in Europe). The key question, however, is whether the recent price increases will translate into higher wage demands, potentially setting in motion an upward spiral of rising prices and wages. Such a scenario would be akin to the developments observed in Western Europe in the 1970s (when the oil price shock gave rise to high inflation over a protracted period), although it is unlikely to be repeated in CESEE now.[16] Instead, the current situation is arguably more similar to the one in 2007, when a sharp rise in energy prices proved short-lived, to be followed by a decade or more of (near) price stability.

Figure 2.17 / House price index and CPI, cumulative change in %, Q1 2020 - Q2 2021



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

But monetary policy tightening might cool the booming property markets. Housing prices in many CESEE countries have been rising rapidly for a number of years now, far outpacing CPI. The main reason has been the ultra-expansionary policy of the ECB, which – directly or indirectly – has had an impact on large parts of the CESEE region.[17] The COVID-19 pandemic has merely reinforced this trend, with many people aspiring to improve their living conditions, and with the price of construction materials soaring in the wake of the pandemic. For instance, in EU-CEE countries housing prices have picked up markedly since the beginning of last year – by up to 16% in Czechia and Lithuania, and almost everywhere faster than CPI (Figure 2.17).[18] The rapid and protracted increases in housing prices may not be sustainable, and that raises concerns about the formation of property-market bubbles. Against

16 The two main differences are (i) the power of trade unions and (ii) the extent of globalisation. In Western Europe in the 1970s, trade unions were much stronger than in CESEE today, and their wage demands contributed decisively to the price-wage spiral. Besides, there was less competition from China and other Asian economies in the 1970s than is the case today, which made wage demands easier to implement; see, for instance, V. Astrov et al. (2021), How do economies in EU-CEE cope with labour shortages? wiiw Research Report No. 452, February, Chapter 6, pp 59-64.

17 This essentially solves the 'mystery' of an ever-expanding money supply combined with stable (consumer) prices: most of the extra liquidity ends up in the property market. See also wiiw (2019), Braced for fallout from global slowdown, Economic Analysis and Outlook for Central, East and Southeast Europe, Forecast Report, Autumn, p. 19.

18 For non-EU CESEE countries, recent data on property prices are not yet available, but anecdotal evidence suggests that trends in many of them have been similar. Idiosyncratic factors, such as the programme of subsidised mortgages in Russia launched in response to the pandemic, have played a role as well.

this background, the ongoing monetary policy tightening in the region might have a welcome cooling effect, given that real estate purchases are mostly financed by credit. In this way, it may well represent the right policy choice, though not necessarily for the right reasons.[19]

2.8. MILD SLOWDOWN AHEAD, WITH RISKS TENDING TO BE ON THE DOWNSIDE

After an estimated 5.4% rebound in 2021, the pace of economic recovery in CESEE will slow in coming years. Our current projection is that regional growth will slide a little to 3.7% next year and 3.5% in 2023 (see Overview Table 1) – unless the downside risks described below come to pass. Even in the baseline scenario, growth deceleration seems unavoidable, as the effect of the low statistical base of 2020 gradually fades and monetary policy tightening puts the brakes on credit expansion. A sharp slowdown in growth is expected in Turkey, where the current boom is unlikely to be sustained. Within CESEE, the highest growth next year is projected for Croatia (5%) and Poland (4.9%), as well as Montenegro and Kosovo (4.8%).

The negative labour market effects of any further COVID-19 restrictions will most probably be limited. Governments have increased their efforts to weather the crisis via public investment, and to protect employees against job loss by using, for example, short-time work schemes until the recovery becomes sustainable. Thus, the medium-term forecast is quite rosy, showing a gradual decline in unemployment rates in EU-CEE towards 4% on average by 2023. A similar development is expected for the CIS, while in Ukraine the unemployment rate could decline to below 8%. In the countries of the Western Balkans, however, employment rates will remain relatively low and unemployment rates high, ranging from 9% in Serbia to 16% in Bosnia and Herzegovina.[20]

In EU-CEE countries, economic growth will be crucially helped by disbursements from the EU Recovery and Resilience Facility (RRF).[21] The RRF – worth EUR 723.8bn (in 2020 prices), of which up to EUR 338bn is in the form of grants and up to EUR 385.8bn is in cheap loans – aims at facilitating economic recovery and simultaneously fostering digital and green transition. To be eligible for RRF funding, EU member states need to submit national recovery and resilience plans, outlining the details of the proposed investments.[22] Interestingly, apart from Romania, no EU-CEE country has requested the full amount of the EU funds earmarked.[23] Poland and Slovenia have requested only part of the RRF loans available to them, while all the other countries have not requested any loans at all; Latvia has not even requested the full amount of grants. Besides, approval of the Hungarian and Polish plans is still pending and, given the ongoing political standoff between their governments and the European Commission, the issue is unlikely to be resolved soon.

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19 Within the framework of inflation-targeting regimes, housing prices are not part of the inflation target.

20 With 24.5% of the active population unemployed, Kosovo is an outlier due to its structurally weak economy.

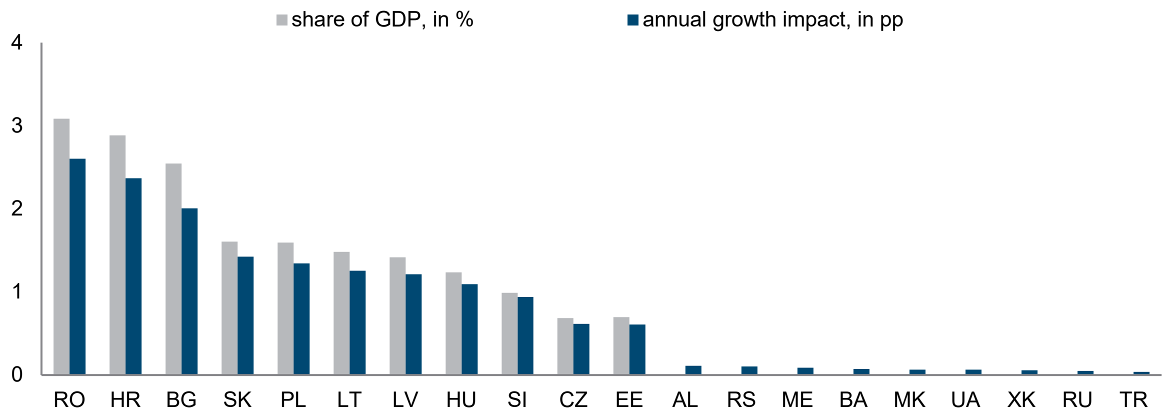
21 https://ec.europa.eu/info/business-economy-euro/recovery-coronavirus/recovery-and-resilience-facility_en For the Western Balkans, the EU has come up with an Economic and Investment Plan, worth EUR 9bn, to support economic recovery and convergence. Like the RRF, it targets above all investment projects in the areas of digital and green transition. See: https://ec.europa.eu/commission/presscorner/detail/en/IP_20_1811

22 At least 37% of investments proposed in the national recovery and resilience plans is to be spent on green transition, and at least 20% on digitalisation.

23 Romania may be particularly interested in cheap EU loans, since it typically faces high interest rates on the private markets.

The potential annual RRF transfers are very large, ranging on average from 0.7% of GDP in Czechia and Estonia to 3.1% in Romania (Figure 2.18).[24] However, the RRF's estimated impact on growth will be slightly lower, as part of the funds will leak out in the form of imports, mostly from Western Europe. Besides, the figures in Figure 2.18 represent the upper bound: the actual impact will almost certainly be lower. This is because (i) judging by past experience, the absorption capacity of the recipient countries will likely be far below 100%, and (ii) there will probably be items in the national recovery plans that would have been financed from national budgets anyway – even without RRF funding.[25]

Figure 2.18 / RRF transfers as a share of GDP and the growth impact of RRF spending



Notes: Share of GDP based on GDP in 2018. Annual average growth impact for 2021-2026, based on RRF spending in the EU as a whole, and not only in the EU-CEE countries.
Source: own calculations using wiiw multi-country input-output database (MC IOD) and based on Bruegel data: https://www.bruegel.org/publications/datasets/european-union-countries-recovery-and-resilience-plans/

Risks to the above forecasts are mostly on the downside, and include notably (i) particularly unfavourable COVID-19 developments, (ii) premature fiscal consolidation, and (iii) the upcoming monetary tapering in the US (and possibly in the euro area).

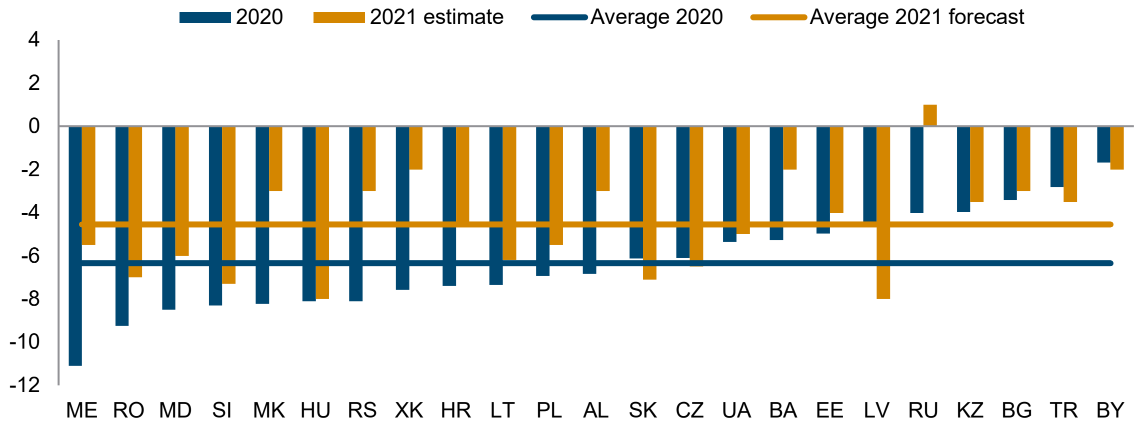
CESEE is in the grip of a fourth wave of the COVID-19 pandemic, and further waves cannot be ruled out next year and beyond. As elsewhere in Europe, the number of new infections in CESEE started to rise again in September, signalling the onset of the fourth wave, mostly on account of the Delta variant. Not only is this variant of the virus more contagious than previous variants, but it also significantly increases the risk of hospitalisation, especially among those who are unvaccinated. From this point of view, EU-CEE – and especially the Visegrád countries – are in a much better position than the rest of CESEE: given their relatively high vaccination rates, the burden on their healthcare systems and the pressure on governments to impose restrictions are unlikely to be high. In the Western Balkans and the CIS, the public health situation is likely to be worse; however, for the reasons outlined above, the economic fallout will probably be modest regardless. Still, a worst-case scenario cannot be ruled out, with catastrophic numbers of new infections and deaths potentially forcing governments to act decisively.

[24] The authors thank Robert Stehrer, wiiw, for providing the estimates presented in Figure 2.18.

[25] But this also means that RRF transfers will allow the budget deficits of recipient countries to be kept in check, without the need to resort to painful austerity measures.

The risks of premature fiscal consolidation are not negligible either, especially in the Western Balkans and the CIS. In 2020, fiscal deficits soared everywhere in CESEE, to a regional average of 6.3% of GDP (Figure 2.19). Economic recessions deprived the governments of a large part of tax revenues, while spending increased dramatically – mostly on account of labour market support measures. This year, thanks to the economic recovery, it is estimated that the deficits will shrink to 4.5% of GDP, on average. Russia will probably even return to a budget surplus, thanks to booming revenue from energy exports, a substantial part of which is appropriated by the state. Nevertheless, in many CESEE countries, public deficits are still rather high – and in Czechia, Slovakia, Latvia, Turkey and Belarus they have even increased this year.[26] Concerns over high fiscal deficits and debts may prompt governments to start consolidating earlier than they should, particularly if they face external headwinds blowing in from the global financial markets.

Figure 2.19 / Fiscal balance, in % of GDP



Note: Simple averages over all countries.
Source: Eurostat and wiiw Monthly Database; wiiw forecasts.

The forthcoming tapering of quantitative easing in the US may have severe repercussions for Turkey and Romania, and possibly for other CESEE countries as well. Turkey is currently exhibiting clear signs of overheating, supported by the high growth of credit, and its high short-term external debt rollover needs make it particularly vulnerable to any change of sentiment on the global financial markets. A reorientation of capital flows away from emerging markets – a consequence of the US tapering that is scheduled to start at the end of 2021 – will principally hit countries (such as Turkey) that are heavily reliant on inflows of hot money to finance their external deficits. However, Romania – with its stubbornly high 'twin deficits' – may also be affected. That said, unlike Turkey (where balance-of-payments crises have been a recurring feature of economic development), it has largely managed so far to get away with this situation. In other CESEE countries, the related risks should be more manageable, although they will also see capital outflows as a result of tapering and will face higher borrowing costs. Elsewhere, the dependence on volatile capital flows is not that high. Moldova and Bosnia and Herzegovina largely rely on official foreign assistance, while Ukraine depends on cooperation with the International Monetary Fund, which is unlikely to pull the plug on the country – if only for political reasons.

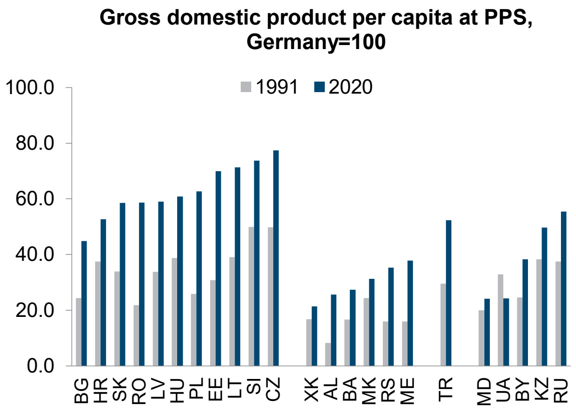
[26] Except for Belarus, in all these countries (as well as in Hungary) the current fiscal stance can be described as pro-cyclical.

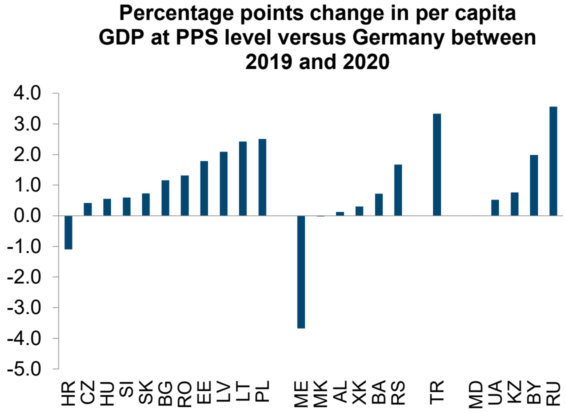
3. CESEE monitors

BY ALEXANDRA BYKOVA

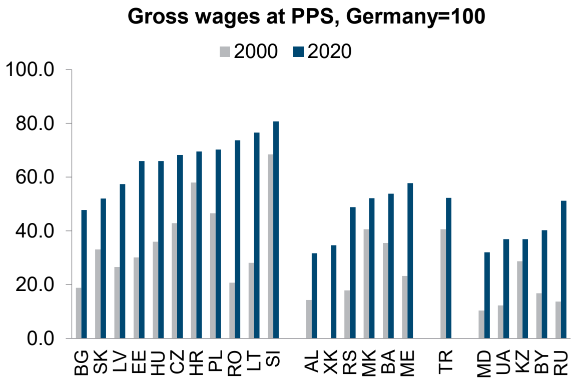
3.1. CONVERGENCE MONITOR

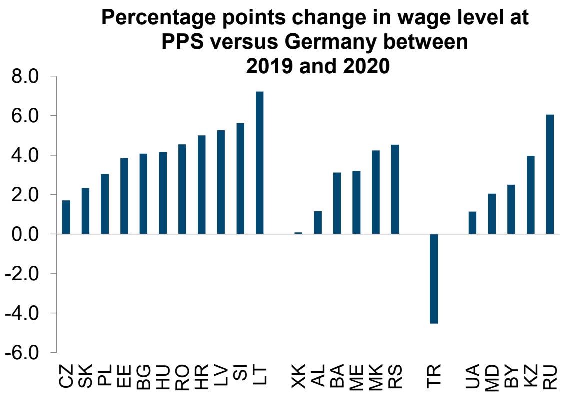
Figure 3.1 / GDP per capita and gross wages per employee at PPS convergence against Germany





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





Note: Gross wages are based on administrative data. From 2019 Lithuanian and Romanian wages include employers' social security contributions. In 2020 Croatian wages based on FTE employees. Turkey: data 2000 refer to 2003, personnel costs.
Source: wiiw Annual Database incorporating national statistics and Eurostat.

Table 3.1 / CESEE GDP per capita and gross wages per employee at PPS, 2020

	BG	CZ	EE	HR	HU	LT	LV	PL	RO	SI	SK		EU-CEE
GDP per capita	16,270	28,090	25,380	19,100	22,100	25,880	21,400	22,740	21,300	26,770	21,260		22,510
Gross wages	15,823	22,587	21,838	23,026	21,862	25,339	19,020	23,250	24,394	26,727	17,240		22,440

	AL	BA	BY	KZ	MD	ME	MK	RS	RU	TR	UA	XK	non-EU
GDP per capita	9,290	9,920	13,920	18,020	8,770	13,720	11,370	12,810	20,120	19,000	8,820	7,760	17,460
Gross wages	10,491	17,837	13,335	12,228	10,610	19,142	17,272	16,177	16,976	17,308	12,221	11,478	15,921

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

Table 3.2 / CESEE GDP per capita and gross wages per employee at EUR, 2020

	BG	CZ	EE	HR	HU	LT	LV	PL	RO	SI	SK		EU-CEE
GDP per capita	8,750	20,120	20,190	12,170	13,940	17,510	15,430	13,650	11,290	22,310	16,770		14,100
Gross wages	8,509	16,176	17,376	14,670	13,789	17,143	13,716	13,957	12,929	22,274	13,596		13,954

	AL	BA	BY	KZ	MD	ME	MK	RS	RU	TR	UA	XK	non-EU
GDP per capita	4,610	5,040	5,620	7,990	3,990	6,740	5,190	6,710	8,860	7,510	3,260	3,780	7,400
Gross wages	5,203	9,055	5,382	5,422	4,828	9,396	7,893	8,469	7,478	6,846	4,518	5,592	6,790

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

3.2. BUSINESS CYCLE MONITOR: MOST COUNTRIES HAVE EXCEEDED THEIR PRE-PANDEMIC LEVELS

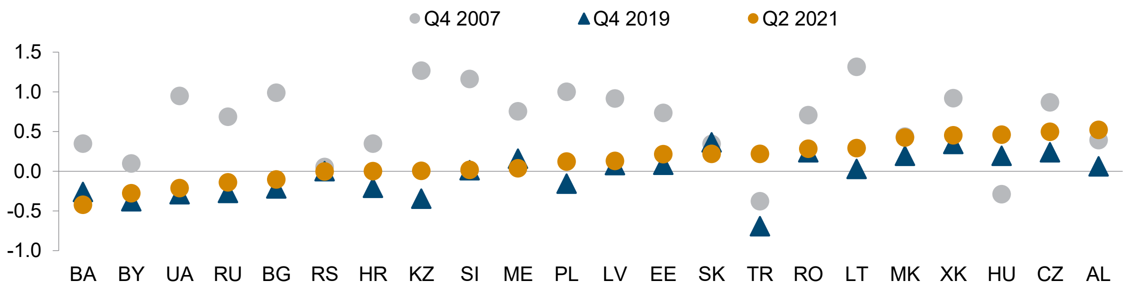
› The average value of our headline Business Cycle Index for the whole CESEE region has risen to 0.12 (from -0.01 in our previous update in spring 2021), reflecting the ongoing recovery in the first half of 2021. The region is neither overheating (values of above 1) nor underheating (values below -1). Comparison with the pre-crisis Q4 2019 for the headline index reveals that only four countries – Bosnia and Herzegovina, Montenegro, Serbia and Slovakia – are still slightly below their pre-pandemic values. Nevertheless, economic revival is not leading to general overheating of the economies, as for most countries the overall index remains significantly below its values for Q4 2007, which for many are the highest on record (Figure 3.2).

› Most of the visible underperformance in GDP (relative to the long-term average) identified in our previous update has vanished. On this indicator, only five CESEE economies – Bulgaria, Czechia, Poland, Montenegro and Kazakhstan – are still growing more slowly than their historical averages. On the more aggregated domestic economy sub-component (which also takes account of the unemployment rate and consumer price inflation (CPI)), two countries are outliers: Ukraine (with slow recovery) and Montenegro (which was badly hit by the pandemic last year). Despite the rise in inflation observed in many countries, no overheating relative to their historical average is visible yet (Table 3.3 and Figure 3.3).

› Several countries are outliers on the external finance sub-component. For those countries that are positive outliers, we see potential overheating in Montenegro and Kosovo (due to rising external debt) and in Albania (due to currency appreciation). Meanwhile, for those countries that are negative outliers – Bosnia and Herzegovina, Hungary, Poland and Slovenia – we see greater sign of potential underheating, due to their high current account balances (relative to their historical averages) and/or the real exchange rate depreciation (compared to average historical performance) (Table 3.3 and Figure 3.3).

› The picture for the domestic finance sub-component is mixed. While overheating of the fiscal balance due to anti-crisis fiscal packages is easing, and in 15 of the 22 countries covered the values of this indicator have fallen since spring, the budget deficit (relative to its historical average) has grown in Czechia and Lithuania since our previous update. This is not necessarily a warning sign, given the still extremely loose monetary policy and the low real interest rates on government debt (by any historical comparison). The private credit indicator has also fallen for most of the countries since spring 2021, with Poland already posting signs of underheating. By contrast, on the broad money and property prices indicators, most of the CESEE economies have the same (or slightly higher) values as in our previous update. Overheating of property prices is becoming visible in Czechia and is intensifying in Turkey, whereas it is easing slightly in Hungary and Poland (Table 3.3 and Figure 3.3).

Figure 3.2 / Business Cycle Index



Note: Number of standard deviations from historical mean, average of 11 indicators. Indicators are those in Table 3.3.
Sources: wiiw Monthly Database incorporating national statistics and Eurostat; BIS.

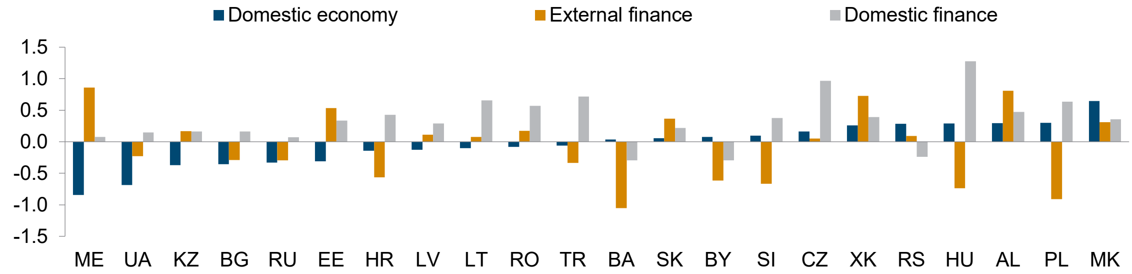
Table 3.3 / Number of standard deviations from historical mean, Q2 2021

	Domestic economy			External finance			Domestic finance				
	Real GDP	Unemployment	CPI	CA	RER	External debt	RIR	Private credit	Broad money	Fiscal balance	Property prices
BG	-1.36	1.09	-0.80	-0.39	0.52	-1.01	-0.56	-0.43	-0.30	1.93	0.18
CZ	-1.27	1.34	0.43	-1.96	1.03	1.08	1.42	-0.72	0.73	1.96	1.42
EE	-0.09	0.42	-1.25	0.33	1.12	0.14	-0.52	-0.40	0.67	1.96	-0.02
HR	-0.60	1.13	-0.95	-0.65	-0.88	-0.16	0.50	-0.28	0.00	0.77	1.14
HU	-0.12	1.14	-0.15	-0.42	-1.24	-0.56	2.01	0.52	1.72	1.85	0.29
LT	-0.40	0.54	-0.44	-1.46	1.18	0.51	0.35	-0.60	1.27	1.77	0.49
LV	-0.34	0.80	-0.83	-0.62	0.79	0.16	-0.21	-0.47	0.02	2.11	-0.01
PL	-1.12	1.31	0.72	-2.00	-0.78	0.04	2.12	-1.12	1.04	-0.22	1.36
RO	-0.61	0.96	-0.59	0.32	-0.05	0.25	0.98	-0.43	-0.29	2.21	0.37
SI	0.38	1.02	-1.10	-1.39	-0.98	0.37	-0.39	-0.35	0.77	1.01	0.83
SK	-0.66	1.41	-0.58	-1.58	0.82	1.86	0.58	-0.82	0.30	1.05	-0.01
AL	0.67	1.31	-1.10	-0.55	2.04	0.94	1.35	-0.53	0.17	0.89	
BA	-0.48	1.66	-1.07	-1.11	-2.24	0.19	-0.57	-0.95	-0.42	0.76	
ME	-1.91	0.11	-0.73	-0.14	0.54	2.18	0.10	-0.43	-0.64	1.26	
MK	-0.25	2.12	0.07	-0.39	-0.46	1.79	1.29	-0.67	-0.71	1.71	0.17
RS	-0.04	1.44	-0.54	-0.99	0.94	0.33	0.04	-0.40	-0.35	0.19	-0.68
XK	-0.22	1.42	-0.42	0.68	0.39	1.11	0.93	-0.57	-0.21	1.42	
TR	1.28	-1.37	-0.09	0.29	-2.54	1.24	0.39	0.20	0.63	-0.82	3.19
BY	-0.63	1.43	-0.56	-1.28	-1.55	0.98	-0.04	-0.94	-1.07	0.87	
KZ	-1.62	0.85	-0.34	1.29	-1.48	0.69	-0.53	-0.46	-0.38	2.01	
RU	-0.57	0.56	-1.00	0.75	-0.86	-0.77	0.89	-0.44	-0.73	0.74	-0.11
UA	-0.38	-1.04	-0.64	-0.13	-0.74	0.18	-0.09	-0.87	0.06	1.50	

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

Notes: CPI: consumer price index; CA: current account; RER: real exchange rate (EUR) CPI deflated, values more than 100 means appreciation and vice versa; RIR: real interest rate CPI deflated. Data for unemployment, current account, real interest rate, fiscal balance are inverted (as for these indicators lower values would indicate overheating). Historical mean calculated for Q4 2000 - Q2 2021. Calculations are based on four-quarter trailing averages.
Sources: wiiw Monthly Database incorporating national statistics and Eurostat; BIS.

Figure 3.3 / Sub-components of the Business Cycle Index, Q2 2021



Note: Number of standard deviations from historical mean, average of indicators in each sub-component. Indicators are those in Table 3.3.
Sources: wiiw Monthly Database incorporating national statistics and Eurostat; BIS.

Table 3.4 / Over-/under-heating in relation to regional peers, Q2 2021 (4-q trailing average)

	Domestic economy			External finance			Domestic finance				
	Real GDP	Unemployment	CPI	CA	RER	External debt	RIR	Private credit	Broad money	Fiscal balance	Property prices
	%	%	% yoy	% of GDP	2015 = 100	% of GDP	%	% yoy	% yoy	% of GDP	% yoy
BG	-0.7	5.5	0.8	-1.8	99.8	63.1	-0.8	4.9	11.7	-4.7	6.8
CZ	-1.2	3.1	2.8	3.5	109.5	72.7	-2.4	4.1	10.4	-7.5	11.0
EE	3.2	7.3	0.2	-5.9	103.3	89.0	-0.2	4.2	18.6	-3.7	7.9
HR	-0.5	8.9	0.6	-0.9	97.8	81.8	2.4	2.6	9.6	-5.8	6.1
HU	1.9	4.3	3.8	-0.6	93.5	79.0	-3.0	11.3	18.2	-9.3	7.3
LT	2.1	8.3	1.3	5.1	104.3	74.2	-1.2	-0.2	23.6	-7.8	10.3
LV	1.4	8.1	0.3	-0.4	101.9	120.8	-0.3	-2.6	14.2	-7.8	4.8
PL	1.3	3.5	4.0	2.0	96.1	57.0	-3.7	-0.1	13.8	-3.4	8.8
RO	1.4	5.4	2.4	-6.5	95.4	54.3	-1.0	6.7	15.6	-9.3	2.2
SI	3.4	5.1	0.0	6.3	98.2	100.7	0.0	0.1	11.7	-6.8	6.4
SK	1.3	7.1	1.6	1.1	102.0	117.1	-1.5	5.1	8.8	-6.8	5.6
AL	5.6	11.7	1.4	-7.8	115.4	63.6	-0.9	5.2	9.0	-5.8	
BA	1.6	17.0	-0.7	-3.6	93.5	63.3	0.7	-0.4	8.3	-1.7	
ME	-5.6	19.9	0.3	-19.5	98.5	76.6	5.5	3.5	-0.1	-8.5	
MK	1.8	16.1	2.1	-2.6	98.7	84.3	-0.7	5.5	7.1	-6.2	2.7
RS	3.3	10.5	2.0	-2.4	106.6	64.8	-0.9	10.4	17.0	-2.9	1.5
XK	3.7	25.8	0.5	-9.8	99.4	35.8	5.6	8.7	14.3	-5.3	
TR	10.4	12.9	14.5	-4.6	59.3	54.0	1.6	30.9	32.7	-0.5	30.4
BY	1.6	4.1	7.5	0.2	77.4	63.7	0.5	14.3	2.9	-0.9	
KZ	-0.3	4.9	7.2	-5.5	66.7	88.9	1.7	7.2	19.0	-4.2	
RU	1.1	5.8	4.9	3.4	89.5	29.1	-0.3	13.4	13.7	-1.7	11.4
UA	-0.1	9.9	5.7	0.2	113.1	73.5	0.8	-3.8	25.4	-4.7	

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

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

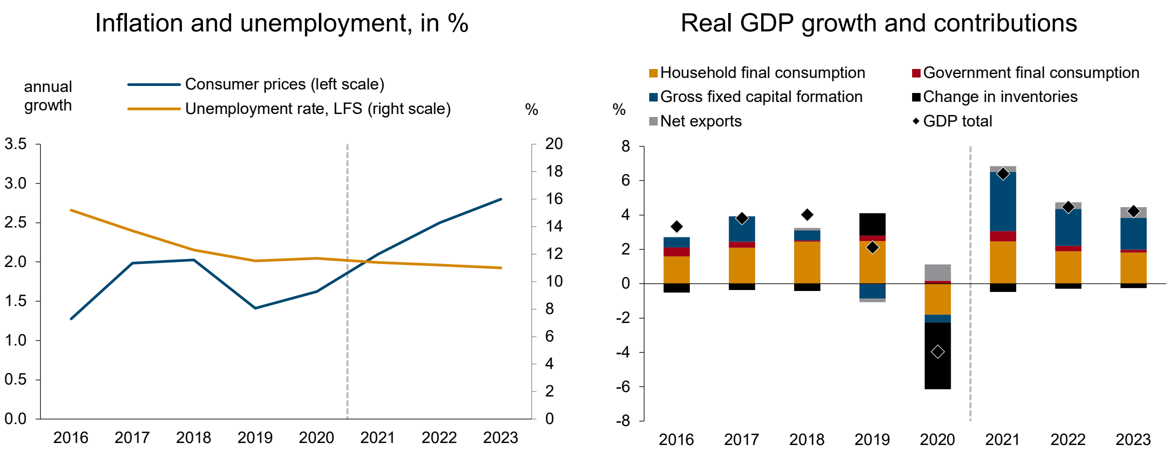
4. Country reports

ALBANIA: V-shaped and vibrant recovery of the economy

ISILDA MARA

The V-shaped recovery that we see suggests that the economy is back on track and will remain sound. GDP growth will accelerate to 6.4% in 2021 and will hover at above 4.5% in the medium term. The tourism sector has had an impressive year and is getting closer to its pre-pandemic level. Growth will be led by investment and by optimistic external and domestic demand, but downside risks stemming from the international markets and the pandemic call for vigilance.

Figure 4.1 / Albania: Main macroeconomic indicators



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

The evolution of COVID-19 looks manageable and does not appear to present that much risk. The third wave of the pandemic – which was in full swing in September – seems, at the beginning of October, to have settled down. The outstanding results of early summer 2021, when fewer than 10 infections a day were recorded, were ruined in September, when daily infections hovered at close to a thousand. By the start of October, however, the figure had halved, suggesting that the waves are becoming shorter and less virulent than in early 2021; the death toll is also much lower, at below five a day. The vaccination programme has enjoyed only moderate success: 1.6 million jabs delivered suggest that perhaps less than a third of the population has reached a certain level of immunity. The boom in tourism is certainly the principal cause of the third wave. In all likelihood, the vaccination programme has not prevented an upsurge in infections, but it has at least helped to reduce the number of severe cases, and has cut the risk of death in the event of infection. With winter approaching, other strains of COVID-19 – mingled with seasonal flu – will emerge; but their impact is expected to be lower, as the vaccination of the population improves.

The country's economic performance returned to pre-pandemic levels as early as Q2 2021, and the recovery is expected to be lasting. The way the economy bounced back in Q2 2021 was remarkable: the 18% real growth rate year on year was enough to claw back all the losses following the huge contraction of Q2 2020 (-11%) – and even to exceed the 2019 levels by 2.5%. The engines of growth have been the construction sector (which surpassed all expectations and rose by 30% in the first half of 2021) and (not to be outdone) the manufacturing sector – especially the extraction industry. Growth also benefited from a strong increase in government spending (8.9%) and household consumption (5.6%) in the first half of 2021 (and the figures for both were even in double digits in Q2 2021). Meanwhile, gross fixed capital formation expanded by 36% over the same period. Also exports of goods and services have made great strides and provide yet another positive impetus to growth performance. Expectations for the second half of 2021 are similarly optimistic, and growth is likely to be lasting.

Employment has not picked up at the same pace as the economy. Labour market signals are mixed. Unemployment for Q2 2021 was reported to be 11.6% – 0.1 percentage points (pp) lower than in Q4 2021. Employment is still a long way from the 2019 level – and in fact is closer to the 2018 level. For the first half of 2021, the pool of the employed expanded by fewer than 7,000 people. However, the younger age cohorts seem to be weathering the situation rather better than older age groups: most of the new jobs have been snapped up by younger people, while inactivity and unemployment have been rising especially within the age group 33-64. The strong economic growth has not translated into a wealth of new jobs. The culprit for this is the structure of the economy and its growth drivers. Construction (and also tourism) offers seasonal employment that is in large part informal. Therefore, the impact of any growth is both less visible and less durable. However, wages do seem to be edging up, and the government has announced further wage hikes by the beginning of next year for specific occupational groups – e.g. doctors, nurses and teachers. Consumer confidence seems to have been improving, but is still below its historical level. The surge in remittances from abroad in the first half of 2021 – up 25% on the same period in 2020, and 2% up on the first six months of 2019 – will continue to support consumption.

Public spending will continue to bolster growth. General government revenues soared by 19% for January–August 2021, year on year, to exceed the initial target by 5%. Spending also rose by 9.6%: this was driven by capital expenditure, which grew by 42% (to account for 18% of total spending). Nevertheless, a fiscal deficit of 3% of GDP is expected for this year, and public debt will remain elevated at 73%. The post-earthquake reconstruction work and health spending on vaccines will absorb the lion's share of the budget this year, too.

The banking sector has performed well during the pandemic and has been supportive of the economy. The demand for credit has been growing rapidly and non-performing loans have shrunk to 7.1% (as of July 2021). Up to the end of August 2021, the demand for credit grew by 7%, year on year. Demand for credit from both the non-financial private sector and households has expanded – particularly among the latter (by 11%). Households in particular have shown a much greater appetite for spending and for taking new risks: quite a large share of the new loans have been for consumer durables and the purchase of housing. The inflation rate has picked up (2.4% in August), but this is mainly in the wake of global trends. The central bank – with a target of 3% for consumer price index inflation – has announced that it will not intervene and has kept interest rates unchanged. Also, the exchange rate, following a degree of volatility in the early phase of the pandemic, seems to have stabilised and has hovered at between 121 and 123 LEK/EUR this year.

The external sector has been picking up steam. External demand has reflected improvements in the export of goods, with figures exceeding pre-pandemic levels. Up to the end of August 2021, merchandise exports rose by 62% compared to the same period of 2020, and by 33% for the first eight months of 2019. For all groups (apart from textiles and wood & paper manufacturing products), exports regained their pre-pandemic levels in both nominal and real terms. The structure of exports has also changed: textile industry goods have dropped from 40% to 31% of total exports, while other categories – such as construction materials and metals, minerals and fuel – have regained a market share of 20% each. Certainly, higher energy prices and demand for metals at the global level will continue to strengthen external demand. Imports have also been recovering lost ground quite remarkably, indicating that consumption is back. Imports of machinery, equipment and spare parts in January–August 2021 were 36% higher in nominal terms than in the same period of 2020, and 25% higher than in the same period of 2019. Such a strong performance suggests that investments are also back on track. Exports of services have also helped the economy heal the wounds of last year: tourism has been booming – in the first eight months of 2021, the number of visitors almost reached the levels of 2019 (a bumper year). Foreign direct investments have proved resilient, amounting to EUR 463m for the first half of the year (slightly above the same period of 2020). Sectors such as the extraction industry, real estate and financial intermediaries have benefited the most. The Netherlands, Italy, Turkey, France, Austria and Germany seem to be the main countries to have invested in Albania in the first half of the year.

The 'Rama 3' cabinet now in office will likely pave the way for the start of several large infrastructure projects and for the completion of others. The Arbri road (which will connect the central part of the country with the north east) is expected to be finished early next year. Meanwhile Vlora airport – a EUR 100m investment – is expected to see the start of construction by the end of this year. An unprecedented construction boom, especially in Tirana (where it is mainly emigrants and foreign residents who can afford to buy), continues unabated; prices in the centre are already comparable to those in some European capitals.

The EU integration process has stalled. The process seems to have become a pawn in the ongoing dispute between Bulgaria and North Macedonia. During her visit to Tirana on 28 September, Ursula von der Leyen reconfirmed that Albania has done its homework, and that the first intergovernmental conference should take place by the end of this year, so that EU accession talks can begin. However, it remains to be seen whether this is just another vague promise or an actual commitment.

Overall, the V-shaped recovery suggests that the economy is back on track and will remain sound. Still, we prefer to err on the side of caution. We have revised our GDP growth projections for 2021 upwards to 6.4% (from 5%). This reflects the strong domestic and external demand, but also the downside risks stemming from the dynamics in international markets – such as the strong rise in energy prices - and the pandemic. In the medium term, economic growth is expected to hover at above 4.5% and will likely be led by investment.

Table 4.1 / Albania: Selected economic indicators

	2018	2019	2020 1)	2020	2021	2021	2022	2023
				January-June			Forecast	
Population, th pers., average	2,866	2,854	2,838	.	.	2,820	2,810	2,800
Gross domestic product, ALL bn, nom.	1,637	1,692	1,618	764	885	1,800	1,900	2,000
annual change in % (real)	4.0	2.1	-4.0	-7.4	11.9	6.4	4.5	4.2
GDP/capita (EUR at PPP)	9,190	9,630	9,290	.	.	.	.	.
Consumption of households, ALL bn, nom.	1,282	1,338	1,329	670	717	.	.	.
annual change in % (real)	3.1	3.2	-2.3	-3.7	5.7	3.0	2.3	2.2
Gross fixed capital form., ALL bn, nom.	391	377	372	152	199	.	.	.
annual change in % (real)	2.3	-3.7	-2.0	-13.9	29.7	15.0	9.3	8.0
Gross industrial production								
annual change in % (real)	18.7	-1.1	-6.3	-12.8	36.5	15.0	5.0	8.0
Gross agricultural production 2)								
annual change in % (real)	1.8	-2.9	3.0	.	.	.	.	.
Construction output total								
annual change in % (real)	5.6	-2.5	9.5	-3.4	25.6	.	.	.
Employed persons, LFS, th, average	1,231	1,266	1,243	1,241	1,231	1,250	1,270	1,290
annual change in %	3.0	2.8	-1.8	-1.2	-0.8	0.5	1.6	1.6
Unemployed persons, LFS, th, average	173	165	165	164	164	160	160	160
Unemployment rate, LFS, in %, average	12.3	11.5	11.7	11.7	11.7	11.4	11.2	11.0
Reg. unemployment rate, in %, eop	5.4	5.8	7.4	7.1	8.1	.	.	.
Average monthly gross wages, ALL	50,589	52,380	53,662	53,691	56,365	57,000	61,300	66,200
annual change in % (real, gross)	1.3	2.1	0.8	1.3	3.6	4.0	5.0	5.0
Consumer prices, % p.a.	2.0	1.4	1.6	1.8	1.4	2.1	2.5	2.8
Producer prices in industry, % p.a.	1.7	-0.8	-3.3	-3.1	0.5	1.0	1.0	1.0
General governm.budget, nat.def., % of GDP								
Revenues	27.5	27.2	26.3	25.5	26.5	27.0	27.5	28.0
Expenditures	29.1	29.1	33.2	30.6	29.8	30.0	29.0	29.0
Deficit (-) / surplus (+)	-1.6	-1.9	-6.8	-5.1	-3.3	-3.0	-1.5	-1.0
General gov.gross debt, nat.def., % of GDP	67.7	65.8	75.7	78.2	70.8	73.0	71.0	70.0
Stock of loans of non-fin.private sector, % p.a.	-3.6	6.6	6.9	6.6	6.1	.	.	.
Non-performing loans (NPL), in %, eop	11.1	8.4	8.1	8.1	7.1	.	.	.
Central bank policy rate, % p.a., eop 3)	1.00	1.00	0.50	0.5	0.5	0.5	0.5	0.5
Current account, EUR m	-866	-1,089	-1,153	-613	-554	-1,250	-1,190	-1,160
Current account, % of GDP	-6.8	-7.9	-8.8	-9.9	-7.7	-8.5	-7.7	-7.1
Exports of goods, BOP, EUR m	986	907	794	370	602	1,010	1,100	1,200
annual change in %	23.7	-8.1	-12.5	-18.0	62.4	27.0	9.0	9.0
Imports of goods, BOP, EUR m	3,857	4,050	3,776	1,679	2,209	4,460	4,660	4,750
annual change in %	6.5	5.0	-6.8	-12.9	31.6	18.0	4.5	2.0
Exports of services, BOP, EUR m	3,073	3,405	2,226	965	1,425	2,850	3,090	3,280
annual change in %	7.6	10.8	-34.6	-35.4	47.7	28.0	8.5	6.0
Imports of services, BOP, EUR m	1,962	2,141	1,174	558	710	1,350	1,420	1,510
annual change in %	10.6	9.1	-45.1	-41.2	27.2	15.0	5.0	6.5
FDI liabilities, EUR m	1,020	1,072	937	460	463	880	.	.
FDI assets, EUR m	-3	36	43	9	20	60	.	.
Gross reserves of CB excl. gold, EUR m	3,342	3,240	3,806	4,026	3,794	.	.	.
Gross external debt, EUR m	8,353	8,246	8,572	8,944	8,811	8,900	9,500	9,800
Gross external debt, % of GDP	65.1	60.0	65.6	68.4	60.3	61.0	61.0	60.0
Average exchange rate ALL/EUR	127.59	123.01	123.77	123.68	123.24	123.0	122.5	122.0

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

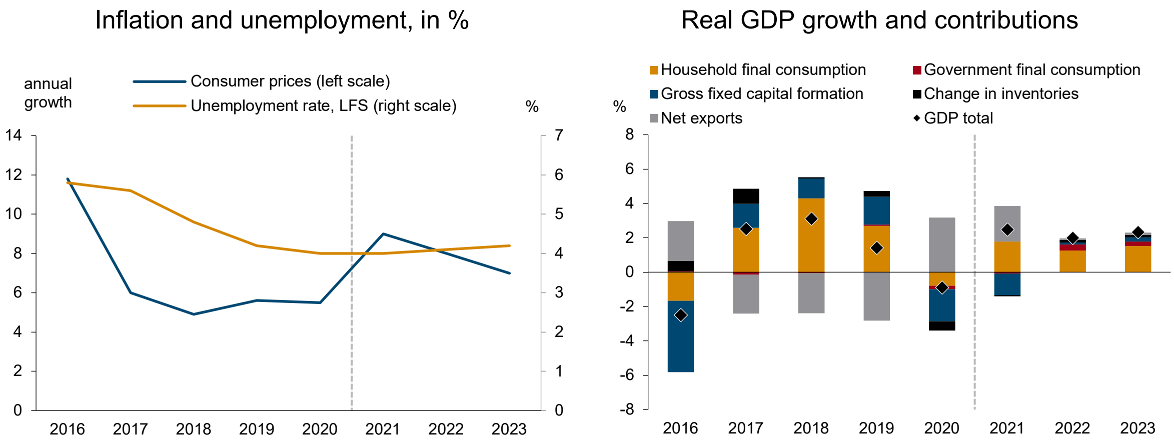
Source: wiiw Databases incorporating national statistics. Forecasts by wiiw.

BELARUS: Muddling through amidst sanctions

RUMEN DOBRINSKY

The restoration of economic relations with Russia has outweighed the negative effect of the Western economic sanctions. Economic growth has been higher than expected, but the upturn has been accompanied by a surge in inflation. Belarus has taken an important step towards closer economic integration with Russia by signing 28 integration programmes. The figures for 2021 have improved slightly, and GDP is expected to grow by some 2.5% for the year as a whole. However, the prospects for the coming years remain bleak.

Figure 4.2 / Belarus: Main macroeconomic indicators



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

The Belarusian economy is feeling the heat of the Western economic sanctions that were imposed following the forced landing of a Ryanair flight in May. For the first time, these include sectoral sanctions that target specific Belarusian industries and businesses, while Belarus's access to international financial markets is further restricted. In terms of their effect on the Belarusian economy, it is the sectoral sanctions imposed by the EU and the UK that are expected to have the strongest impact, as they envisage a ban (or restrictions) on the export of important Belarusian trade items, such as potash and petroleum products. According to estimates by Belarusian economists, these sanctions could have a negative effect on total Belarusian exports of between 10% and 13.5%. The potential cumulative macroeconomic losses from the sanctions – provided they are effectively enforced – could be between 6% and 10% of GDP over two years. However, as yet, solid evidence on the economic effect of the new sanctions is hard to come by; moreover, most sanctions were not introduced with immediate effect.

Aside from the worsening relations with the West, the overall external economic environment in the first half of the year was favourable to Belarus. Trade relations with Russia were restored (after the dispute over gas prices was settled in late 2020), and this contributed to a strong recovery of Belarusian exports. The higher international prices of hydrocarbons also benefited Belarus, which is a major exporter of petrochemicals.

GDP grew by 3.5% year on year in the first half year, but that was largely on account of the low base of the previous year. Gross industrial output in the first six months rose by 10.4% year on year, thanks to the resumption of oil and gas deliveries from Russia and the recovery of other trade flows. Exports of goods and services in the first half year soared, rising by 32.8% year on year in current dollar terms and significantly outperforming the recovery in imports.

Mirroring the dynamics of the trade flows, there was an upward shift in Belarus's current account balance, which is expected to turn positive for 2021 as a whole. This contributed to a certain easing of the chronic balance-of-payments constraints that Belarus has faced in recent years.

On the demand side, the recovery in the first half of 2021 reflects the upturn in private consumption and exports. In statistical terms, both private consumption and net exports made a significant positive contribution to GDP growth. By contrast, the decline in fixed investment continued and the contribution of gross fixed capital formation to GDP growth was largely negative. One should note, however, that the recovery in private consumption in this period needs to be judged against the very low base of the previous year. Furthermore, real disposable income in Belarus has remained stagnant since 2017.

Inflationary pressures have increased significantly in 2021, due to both imported inflation and rises in administered prices. In response to this development, the National Bank of Belarus has raised its policy rate, in two steps, from 7.75% at the beginning of the year to 9.25% in July. At the same time, overall monetary policy in 2021 can be considered lax, with the resumption on a massive scale of directed credit to state-owned companies by state-owned commercial banks. Such credit is equivalent to implicit subsidies to ailing state-owned firms, as the loans are extended on preferential conditions to loss-making firms that would otherwise have no access at all to credit on market terms. These transactions are sanctioned and tolerated by the central bank. On the one hand, they produce excessive money supply; on the other, they result in substandard and non-performing loans to state-owned firms. The latter effect is equivalent to the accumulation of quasi-fiscal deficit, which in time usually transforms into cash budget deficit. Past experience suggests that, in the medium term, such practices are a major source of Belarus's persistently high inflation.

The coronavirus situation worsened in early autumn. After several months of relatively low infection rates (between March and August), the number of daily new cases increased rapidly in September, reaching the highest levels since the start of the pandemic. The officially reported COVID-related death rate is still relatively low, but the reliability of the statistics remains questionable.

Probably the most important recent development in Belarus has been the move towards further economic integration with Russia. In September, the leaders of the two countries initialled 28 integration programmes, covering various spheres of economic life. In principle, this step can be regarded as part of the process of establishing the so-called Union State between Russia and Belarus under the treaty that the two countries signed back in 1997. That treaty set out an ambitious agenda of integrative economic measures, and also included security aspects referring to the joint territory of the two countries. However, the process of preparing and implementing this agenda has been very slow, and over the past decade Belarus has been reluctant to undertake concrete new commitments.

The situation changed radically after the events following the 2020 presidential election in Belarus. The brutal suppression of the protests against the alleged manipulation of the election led to the increased international political and economic isolation of Belarus. That, in turn, left its leaders with no choice but to seek support from – and closer ties with – their main ally, Russia. One of the consequences was the revival of the negotiations over the so-called ‘road maps’ for economic integration between the two countries.

The 28 integration programmes endorsed in September signal the two countries’ intention of moving towards the establishment of a common economic space. They cover some key spheres of economic relations, such as the coordination of macroeconomic policy, the unification of key energy markets (oil, gas and electricity), the coordination of industrial policy, the mutual liberalisation of public procurement, the harmonisation of labour legislation and social security, etc. Issues that were included on the initial Union State agenda, but that are notably absent from the September documents are the establishment of a common currency and a common parliament; these questions have been left to future negotiations.

So far, not much detail regarding the content of the 28 integration programmes has leaked into the public domain. Furthermore, the initialling of the programmes by the two leaders only marks one step in the process towards their formal adoption. Further steps will include the parliaments of the two countries deliberating on the programmes (which may prompt further negotiations and amendments) and their final formal signing at the top level. Nevertheless, the initial endorsement marks an important development in the process and suggests that some of the hurdles previously in the way have been cleared. Thanks to this rapprochement, Belarus is now hoping to receive fresh credits from Russia, which will ease the servicing of its foreign public debt.

Overall, the short-term outlook for the Belarusian economy has improved slightly since our spring forecast. The rate of GDP growth in 2021 may reach 2.5% for the year as a whole. As the growth in exports of both goods and services has outstripped the growth in imports, we expect a small positive current account balance for the year as a whole. If inflation continues to intensify, further policy rate hikes by the central bank are also possible in the remaining months of the year.

However, the favourable factors that prevailed in the first half of 2021 will probably not continue. Recent statistics suggest that even in the first months of the second semester, the pace of growth has been slackening. Moreover, the Belarusian economy is plagued by chronic structural problems, which will continue to weigh on its performance. It is difficult to imagine an upturn in domestic demand in the coming years, and so Belarus will most likely continue to rely on exports as the main growth driver. However, the negative effect of the Western economic sanctions and the continuing erosion of real disposable incomes by high inflation mean that there will be limits to the impact of these growth drivers. Given the constraints that Belarus is facing, sluggish economic performance will likely prevail in the short run, and GDP growth in 2022 and 2023 will probably be below the figure for 2021.

Table 4.2 / Belarus: Selected economic indicators

	2018	2019	2020 1)	2020 January-June	2021 January-June	2021 Forecast	2022 Forecast	2023 Forecast
Population, th pers., average	9,484	9,443	9,380	.	.	9,400	9,380	9,350
Gross domestic product, BYN m, nom.	122,320	134,732	147,006	65,990	78,465	164,200	180,800	197,900
annual change in % (real)	3.1	1.4	-0.9	-1.8	3.5	2.5	2.0	2.3
GDP/capita (EUR at PPP)	13,120	13,750	13,920	.	.	.	.	.
Consumption of households, BYN m, nom.	64,491	71,630	74,553	35,571	40,415	.	.	.
annual change in % (real)	8.0	5.1	-1.5	-1.0	3.8	3.5	2.5	3.0
Gross fixed capital form., BYN m, nom.	32,081	36,424	36,435	15,678	16,274	.	.	.
annual change in % (real)	4.4	6.2	-6.9	-1.1	-7.5	-5.0	0.5	1.0
Gross industrial production								
annual change in % (real)	5.7	1.0	-0.7	-3.1	10.4	5.0	3.0	3.0
Gross agricultural production								
annual change in % (real)	-3.3	2.9	4.9	3.7	-0.3	.	.	.
Construction industry								
annual change in % (real)	2.2	0.1	-4.6	3.4	-16.6	.	.	.
Employed persons, LFS, th, average	4,897	4,909	4,885	4,838	4,830	4,850	4,800	4,750
annual change in %	-0.1	0.2	-0.5	-1.4	-0.2	-0.7	-1.0	-1.0
Unemployed persons, LFS, th, average	245	213	206	210	205	202	205	208
Unemployment rate, LFS, in %, average	4.8	4.2	4.0	4.2	4.1	4.0	4.1	4.2
Reg. unemployment rate, in %, eop	0.3	0.2	0.2	0.2	0.2	.	.	.
Average monthly gross wages, BYN	971	1,093	1,251	1,187	1,367	1,400	1,560	1,720
annual change in % (real, gross)	12.6	7.3	7.4	8.8	5.9	3.0	3.0	3.0
Consumer prices, % p.a.	4.9	5.6	5.5	4.9	8.8	9.0	8.0	7.0
Producer prices in industry, % p.a. 2)	6.8	6.3	5.6	4.6	10.4	10.0	9.0	8.0
General governm.budget, nat. def., % of GDP								
Revenues	41.5	40.0	36.2	37.8	35.9	38.0	38.0	38.0
Expenditures	37.5	37.6	37.9	41.0	37.1	40.0	40.0	39.0
Deficit (-) / surplus (+)	4.0	2.4	-1.7	-3.2	-1.2	-2.0	-2.0	-1.0
General gov.gross debt, nat. def., % of GDP 3)	47.5	41.0	48.0	.	.	51.0	52.0	52.0
Stock of loans of non-fin.private sector, % p.a.	12.7	10.0	21.4	18.4	7.7	.	.	.
Non-performing loans (NPL), in %, eop 4)	5.0	4.6	4.8	5.1	5.0	.	.	.
Central bank policy rate, % p.a., eop 5)	10.00	9.00	7.75	8.0	8.5	10.0	9.5	8.5
Current account, EUR m 6)	20	-1,115	-221	-959	100	400	500	300
Current account, % of GDP	0.0	-1.9	-0.4	-3.7	0.4	0.7	0.9	0.5
Exports of goods, BOP, EUR m 6)	28,409	28,932	24,890	11,394	14,303	28,800	29,700	30,300
annual change in %	11.8	1.8	-14.0	-17.8	25.5	15.7	3.1	2.0
Imports of goods, BOP, EUR m 6)	30,536	32,684	26,637	12,414	14,694	30,100	30,900	31,600
annual change in %	8.9	7.0	-18.5	-18.3	18.4	13.0	2.7	2.3
Exports of services, BOP, EUR m 6)	7,511	8,628	7,704	3,741	4,013	8,500	8,600	8,900
annual change in %	7.3	14.9	-10.7	-3.0	7.3	10.3	1.2	3.5
Imports of services, BOP, EUR m 6)	4,594	5,237	4,287	2,009	2,217	4,700	4,900	5,300
annual change in %	7.5	14.0	-18.1	-12.4	10.4	9.6	4.3	8.2
FDI liabilities, EUR m 6)	1,212	1,139	1,220	1,208	941	1,300	.	.
FDI assets, EUR m 6)	47	-3	67	36	21	100	.	.
Gross reserves of CB excl. gold, EUR m 6)	4,561	6,265	3,604	5,324	3,837	.	.	.
Gross external debt, EUR m 6)	34,307	36,416	34,229	36,511	35,492	35,400	34,800	34,600
Gross external debt, % of GDP	67.3	63.1	64.9	69.3	62.7	62.5	59.7	57.7
Average exchange rate BYN/EUR	2.4008	2.3342	2.7888	2.5753	3.1010	2.90	3.10	3.30

1) Preliminary. - 2) Domestic output prices. - 3) Including publicly guaranteed debt. - 4) From 2018 doubtful, bad and small part of supervised assets; previously doubtful and large part of supervised assets. - 5) Refinancing rate of CB. - 6) Converted from USD.

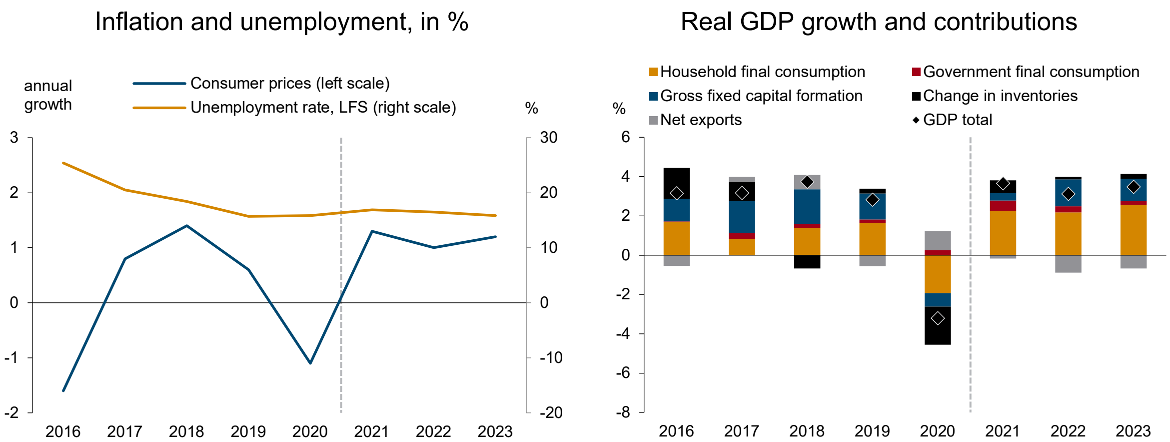
Source: wiiw Databases incorporating national statistics. Forecasts by wiiw.

BOSNIA AND HERZEGOVINA: Recovery transcends 2020 losses

SELENA DURAKOVIĆ

The economy has bounced back since restrictions were eased in Q2 2021, growing by 11.6% (and thus more than recouping last year's decline). Mass vaccination has started, but the public's interest in getting inoculated has been far lower than expected; this poses an additional risk to the health sector, as the fourth wave of the pandemic is already upon the country. The introduction of a law proscribing genocide denial has led to fresh political tensions in the country and disruption to the work of government institutions by politicians from Republika Srpska; this could have economic repercussions.

Figure 4.3 / Bosnia and Herzegovina: Main macroeconomic indicators



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

The easing of COVID restrictions in Q2 resulted in the economy bouncing back strongly. In May, following a sharp drop in the number of infected people, most of the COVID-19 restrictions were eased. While certain restrictions do still apply (e.g. the need to wear a mask in enclosed areas and limitations on the number of people in enclosed areas), those that directly affect economic activity were lifted. The upshot is that the number of COVID-19 infections has again started to trend upwards.

Mass vaccination started in August, but many people have proved reluctant to get the jab. Both entities in Bosnia and Herzegovina finally managed to arrange the direct procurement of bulk quantities of vaccines from August; this, together with donations and deliveries under the COVAX scheme, enabled mass vaccination to get under way. However, the interest of the public has been far more muted than expected, and as of 29 September, only 23% of the population had been vaccinated (16% fully). The health sector is coming under additional pressure, as the number of seriously ill patients is on the increase. The governments are considering introducing measures to target anti-vaxxers, but such a move is widely regarded as discriminatory.

Political tensions increased when the outgoing High Representative for Bosnia and Herzegovina imposed a law proscribing genocide denial. On 23 July, the Office of the High Representative – the international body which oversees the implementation of the peace agreement that ended Bosnia's war – imposed a law banning the denial of genocide and the glorification of war criminals. This resulted in a protest by some Bosnian Serb politicians, who do not accept that the Srebrenica massacre constituted genocide, despite the rulings of international courts. They refused to participate in the work of the country's multi-ethnic presidency, parliament and government for over a month, thereby disrupting the decision-making process at the state level. Political manoeuvring ensured that greater economic consequences were avoided; but if the boycott continues, there may well yet be more serious repercussions.

The data for the first two quarters of 2021 suggest a significant improvement in economic activity. Following Q1 growth in GDP of 2.5% year on year, growth in Q2 2021 was 11.6% – 3 percentage points (pp) greater than the decline witnessed in 2020. Thus, the economy has already surpassed the pre-pandemic level. The growth is largely driven by increases in the export of goods and services and in household consumption. The growth in both exports and imports of goods in Q2 2021 exceeded the fall in the same quarter of 2020, although the increase in trade in services was much lower. Remittances (which made up around 8% of GDP in 2019) fell by 40% in 2020, but rose by 27.8% in Q2 2021, year on year. Tourism (which accounted for around 9% of GDP in 2019) plummeted by 70% in 2020, but tourism revenue bounced back strongly in Q2 2021, with a year-on-year increase of 71.34%, as the country's borders were opened up to all tourists with a vaccination certificate or negative PCR test (and to tourists from neighbouring countries without any proof). Total industrial production increased in Q2 by 12.3% year on year, which more than recouped the decline seen in Q2 2020 (-9.4% year on year). Overall demand for loans – by companies and households alike – increased in Q2 2021, following three previous quarters of reduced demand. Taking all this into consideration, we expect GDP growth in 2021 to be greater than the decline in 2020.

The country's accommodative fiscal policy has continued in 2021, supporting firms, households and the health sector (albeit at a lower level than in 2020). The government budget recorded a deficit of 5.3% of GDP in 2020, after five years of surpluses. In Q1 2021, budget revenues increased and spending decreased, resulting in a surplus of 2.4% of GDP. We project that the budget will still be in deficit in 2021, but that this deficit will be lower than in 2020. Specifically, we project a deficit of 2% in 2021 (followed by 0.5% in 2022). Public debt increased in the first two quarters of 2021, but, at a forecast 39.5% of GDP in 2021, it is still much lower than in neighbouring countries, due to the country's limited ability to borrow. In the fist two quarters 2021, direct investments slightly increased compared to the same period 2020 and further increase is expected, as the intensification of construction work on the Sarajevo–Belgrade highway has been announced.

The rate of unemployment increased in Q2 2021 compared to Q2 2020. According to the Labour Force Survey, the unemployment rate in the first two quarters of 2021 was 19.1% and 18.6%, respectively. This is higher than in 2020, but the numbers are not directly comparable, as the Labour Force Survey methodology has changed since the start of 2021. We expect the unemployment rate to fall slowly in the coming period, to 16.9% by the end of the year and to 16.5% in 2022. The resumption of emigration among the unemployed (especially young people) once all restrictions are removed is likely to contribute to this downward trend. Wages are expected to rise slightly, due to an anticipated increase in private consumption, loans and remittances.

Because of the stronger-than-expected economic recovery in the first half of the year, our forecasts for GDP growth and inflation have been revised upwards. Thanks to a recovery in consumption and exports, we expect GDP to grow by 3.7% in 2021 and by 3.1% in 2022 – an upward revision of 0.4 pp and 0.1 pp, respectively. Following a spell of negative inflation in 2020 and Q1 2021, inflation picked up in the second quarter, due to higher energy and food prices, and in July and August it reached +1.9% and +2.3%, respectively. Still, the average for the first eight months remains rather low, at 0.6%. We have thus revised our forecast for 2021 upwards, but only marginally, by 0.5 pp. The new projections are that inflation will average 1.3% in 2021 and 1% in 2022. Downside risks to growth are the potentially slower recovery on the export markets and the possible negative impact of the new rising wave of the pandemic on business and tourism, if fresh restrictions are introduced.

Medium-term growth trends are potentially threatened by political instability. Frequent speculation by Republika Srpska officials about the country's disintegration has led to political tension rising. The general elections in 2022 could add to the political turmoil, as the leading party in Republika Srpska has already announced activities designed to prevent the elections from taking place on its territory. Constant political disagreements at all levels of government and an inability to implement adequate structural reforms for the creation of a single economic space are hampering the EU and NATO accession processes, and could also lead to a reduction in investment and international financial support, which would pose a threat to medium-term growth.

Table 4.3 / Bosnia and Herzegovina: Selected economic indicators

	2018	2019	2020 1)	2020 January-June	2021 January-June	2021 Forecast	2022 Forecast	2023 Forecast
Population, th pers., average	3,496	3,491	3,475	.	.	3,470	3,446	3,434
Gross domestic product, BAM m, nom. 2)	33,444	35,296	34,240	16,407	17,596	36,000	37,500	39,300
annual change in % (real)	3.7	2.8	-3.2	-2.5	7.0	3.7	3.1	3.5
GDP/capita (EUR at PPP) 2)	9,620	10,060	9,920	.	.	.	.	.
Consumption of households, BAM m, nom. 2)	24,639	25,633	24,919	12,218	13,058	.	.	.
annual change in % (real)	1.8	2.2	-2.7	-2.4	7.2	3.1	3.0	3.5
Gross fixed capital form., BAM m, nom. 2)	7,610	8,129	7,779	3673	3726	.	.	.
annual change in % (real)	8.1	5.8	-3.0	-6.2	2.2	1.7	6.0	5.0
Gross industrial production								
annual change in % (real)	1.6	-5.3	-6.4	-9.1	13.2	7.0	4.5	3.0
Gross agricultural production 3)								
annual change in % (real)	21.5	-8.4	-1.0	.	.	.	.	.
Construction output total								
annual change in % (real)	0.4	-2.0	0.2	-1.9	3.3	.	.	.
Employed persons, LFS, th, average 4)	822.4	802.9	1,173.1	1,154	1,126	1,180	1,190	1,210
annual change in %	0.8	-2.4	.	.	-2.4	1.0	1.2	2.0
Unemployed persons, LFS, th, average 4)	185.5	149.4	221.0	225	256	240	235	228
Unemployment rate, LFS, in %, average 4)	18.4	15.7	15.9	16.4	18.6	16.9	16.5	15.9
Reg. unemployment rate, in %, eop	34.7	32.8	33.6	34.3	32.4	.	.	.
Average monthly gross wages, BAM	1,363	1,421	1,476	1,463	1,520	1,550	1,580	1,610
annual change in % (real, gross)	1.7	3.7	5.0	4.8	3.8	4.0	1.2	1.0
Average monthly net wages, BAM	879	921	956	947	980	1,000	1,020	1,040
annual change in % (real, net)	1.9	4.2	4.9	4.6	3.4	3.5	1.1	0.9
Consumer prices, % p.a.	1.4	0.6	-1.1	-0.6	0.1	1.3	1.0	1.2
Producer prices in industry, % p.a.	3.5	0.1	-1.2	-1.3	2.7	1.8	1.5	1.6
General governm.budget, nat.def., % of GDP								
Revenues	43.0	42.5	42.1	.	.	41.0	40.5	41.0
Expenditures	40.8	40.6	47.4	.	.	43.0	41.0	40.8
Deficit (-) / surplus (+)	2.2	1.9	-5.3	.	.	-2.0	-0.5	0.2
General gov.gross debt, nat.def., % of GDP	34.2	32.8	36.6	.	.	39.5	39.0	38.0
Stock of loans of non-fin.private sector, % p.a.	5.5	6.7	-2.5	0.4	2.1	.	.	.
Non-performing loans (NPL), in %, eop	8.8	7.4	6.1	6.7	5.7	.	.	.
Central bank policy rate, % p.a., eop 5)	.	.	.	.	.	.	.	.
Current account, EUR m 6)	-559	-504	-657	-297	-302	-430	-550	-650
Current account, % of GDP	-3.3	-2.8	-3.8	-3.5	-3.4	-2.3	-2.8	-3.2
Exports of goods, BOP, EUR m 6)	5,327	5,205	4,818	2,269	2,933	5,240	5,490	5,650
annual change in %	11.5	-2.3	-7.4	-12.3	29.3	8.7	4.8	3.0
Imports of goods, BOP, EUR m 6)	9,172	9,277	8,034	3,815	4,539	8,560	9,200	9,570
annual change in %	7.1	1.1	-13.4	-17.2	19.0	6.5	7.5	4.0
Exports of services, BOP, EUR m 6)	1,959	2,117	1,229	601	660	1,380	1,680	1,780
annual change in %	10.0	8.0	-42.0	-38.5	9.8	12.5	22.0	6.0
Imports of services, BOP, EUR m 6)	624	689	457	205	220	530	590	630
annual change in %	5.7	10.4	-33.7	-29.6	7.4	16.0	10.5	6.0
FDI liabilities, EUR m 6)	507	388	364	241	396	380	.	.
FDI assets, EUR m 6)	16	111	68	12	20	15	.	.
Gross reserves of CB excl. gold, EUR m 6)	5,835	6,311	6,942	6,506	7,107	.	.	.
Gross external debt, EUR m	11,284	11,486	11,365	.	.	11,750	11,650	11,550
Gross external debt, % of GDP	66.0	63.6	64.9	.	.	63.8	60.8	57.5
Average exchange rate BAM/EUR	1.9558	1.9558	1.9558	1.9558	1.9558	1.9558	1.9558	1.9558

1) Preliminary. - 2) According to ESA'10 (FISIM not yet reallocated to industries). From 2020 wiiw estimates. - 3) Based on UN-FAO data, wiiw estimate in 2020. - 4) Until 2019, the LFS survey was carried out once a year in April and according to census 1991. From 2020 continuous quarterly survey based on census 2013 and according to EU + ILO definition. - 5) Bosnia and Herzegovina has a currency board. There is no policy rate and even no money market rate available. - 6) Converted from national currency.

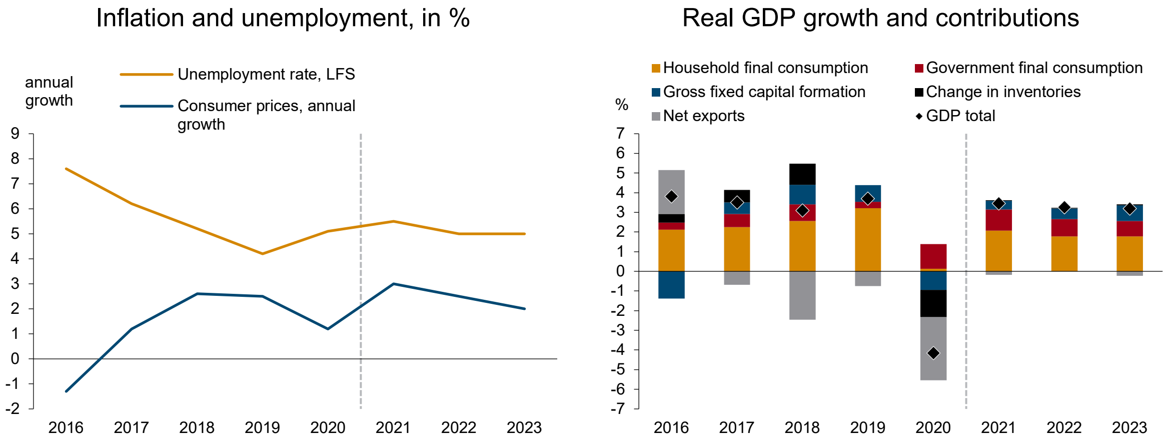
Source: wiiw Databases incorporating national statistics. Forecasts by wiiw.

BULGARIA: Moderate recovery continues, despite the political stalemate

RUMEN DOBRINSKY

Bulgaria goes to the polls in November for the third time in 2021, after two failed attempts in parliament to form a government. Despite the political impasse, a moderate recovery has been under way, mostly driven by domestic demand. In early autumn, the country was hit by a new and powerful wave of COVID-19 – in large part a consequence of the very low vaccination rate. The short-term outlook has improved slightly and GDP is expected to grow by 3.5% in 2021 as a whole. Growth is expected to remain moderate in the coming years.

Figure 4.4 / Bulgaria: Main macroeconomic indicators



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

The year 2021 has been marked by protracted political stalemate. On two occasions – first, after the regular elections in April, and then after a snap election in July – the parliamentary parties failed to form a regular government. On both occasions, the group of recently emerged centre-right political parties that initiated the protests in 2020 against Mr Borisov's long-ruling GERB government could, in principle, have formed a coalition government with the Bulgarian Socialist Party. However, the new players were totally wrapped up in their own agendas and disregarded all possible compromise solutions – either with each other or with the socialists. Consequently, fresh snap elections are to be held in November, the third vote of 2021. In the meantime, the country's administration has been run by a caretaker government appointed by President Rumen Radev.

Despite the continuing political impasse, a modest but broad-based recovery has been under way. GDP grew by 6.4% year on year in the second quarter; this meant year-on-year GDP growth of 3.1% in the first semester. Manufacturing output has rebounded: its growth accelerated through the first six months of the year, keeping pace with a notable recovery in exports. On the other hand, gross construction output remained subdued, as public investment fell below its 2020 level.

On the demand side, the upturn was mostly driven by domestic demand. Private consumption bounced back, supported by a recovery in household credit and a continued rise in personal incomes. Net exports of services made a positive contribution to GDP growth in the first half of the year, thanks to robust growth in exports of business services and a strong recovery in the tourist industry. Though there was an upturn in goods exports, imports of goods grew even faster, mirroring strong domestic demand; thus, net exports of goods contributed negatively to GDP growth in both the first and the second quarters.

Although the pandemic subsided during the early summer, a fresh wave emerged in August and has since intensified. The severity of the new wave is largely due to Bulgaria's very low vaccination rate – the lowest in the EU: just 19.5% of the total population was fully vaccinated at the end of September. At the time of writing, the capacity of the country's healthcare system to cope with COVID cases is stretched to its limits and the authorities are contemplating the reintroduction of restrictions, including a partial lockdown. Bulgaria's vaccination failure is starkly reflected in its rising COVID-related mortality rate, which tops the EU statistics.

Producer prices have been rising, largely mirroring such global factors as higher energy and food prices, and supply-chain disruptions. In the early part of the year, the annualised consumer price index (CPI) dynamics remained more or less stable; but it is only a matter of time before these inflationary pressures are passed on to consumers. Consequently, the CPI for 2021 as a whole could approach 3%, significantly above the 2020 figure.

Real disposable incomes have continued their robust growth. Between 2014 and 2020, real monthly gross earnings grew by an annual average of 7.5%. Taking 2021 as a whole, however, the resurgence of inflation means that the rise in real average monthly gross wages is likely to fall short of what we have seen in recent years. Nevertheless, rising real disposable incomes have continued to boost consumer confidence and are an important factor underpinning buoyant private consumption. They have also encouraged households' appetite for real estate: this shows up in a notable rise in demand for mortgage loans. This has even prompted the Bulgarian National Bank to increase its countercyclical capital buffer rate, which applies to the local credit risk exposure of commercial banks.

The absence of a regular government has significantly complicated the management of public finances. The 2021 budget set out fiscal support measures for only the first few months of the year, given the uncertainties surrounding COVID-19. The implicit assumption was that the regular government – expected to be in office after the April elections – would propose a revised budget for the year that reflected the actual situation with the pandemic. The 2021 budget was actually adopted by the previous GERB government in late 2020 and was a very conservative one (in view of the prevailing uncertainties at the time of its adoption). As it turned out, the economic recovery contributed to a significant improvement in the fiscal outturn: in January-July 2021, the consolidated general government revenue was 15.8% higher than in the same period the previous year. However, the administration was not in any position to use the extra revenue, since, according to the Bulgarian constitution, a caretaker government has only limited fiscal freedom.

When even the July parliament failed to form a regular government, the fiscal situation became precarious. Any deviations in fiscal expenditure from approved budget lines (such as additional spending on policy support measures) need to be approved by parliament. However, in the absence of a working parliamentary majority, the necessary budgetary revisions became problematic. In the end, after hectic, last-minute debates, the July parliament adopted a hastily prepared and cobbled-together revision of the 2021 budget, which turned out to be the only piece of legislation that this parliament managed to pass.

Given the chaotic process of adopting the changes and the absence of agreed policies, the budget revision lacked overall coherence. The higher-than-expected fiscal revenues enabled total planned expenditure for 2021 to be raised by BGN 2.3bn (or 4.4% of the initial plan). The revised budget envisages a continuation of the pandemic-related policy support measures until the end of 2021 and generous new social assistance measures, including pension rises. Despite these spending hikes, the cash deficit for 2021 should remain broadly unchanged from the initial budget plan, at around 3.6% of GDP.

The National Recovery and Resilience Plan became another casualty of the messy political situation. While the caretaker government has continued to work on the draft of the plan, in consultation with the European Commission, it has kept postponing formal submission, as that is considered the prerogative of a regular government. Even if the caretaker government decides to submit it (now that the second attempt to form a government has failed), it is by no means certain that the plan will obtain the approval of the European Commission in the remaining months of 2021.

At the time of writing, the uncertainties regarding the future political situation remain. The novelty of the November ballot is that it will be ‘two-in-one’ poll, combining parliamentary and presidential elections. Such a situation is unprecedented in the past 30 years and may have an unpredictable effect on voter behaviour. At the same time, there is no certainty that these fresh snap elections will help to resolve the political stalemate. The ugly political infighting and horse-trading among the ‘new parties’ has resulted in a considerable deterioration in relations among them. Meanwhile, the political scene has been enriched with even newer players on the centre-right, and that may contribute to a very different outcome in November.

The outlook for 2021 has improved since our spring forecast. Bulgaria’s GDP is now forecast to grow by 3.5% for the year as a whole, compared to 2.5% forecast in March. However, the downside risks in the external environment remain significant, and if the economy continues to rely mainly on domestic demand, this growth rate will probably not be sustained in the years to come. Another negative factor is the delay in accessing EU funds, which is already having an adverse impact on public investment.

Given the above constraints, GDP growth in 2022-2023 will remain modest, in the range 3.0-3.5%. The rise in prices seen in 2021 is likely be have been a one-off event, and inflation should moderate in the coming years, remaining at below 3% a year on average. In the absence of a strong export push, the current account balance will likely stay in negative territory in the coming years.

Table 4.4 / Bulgaria: Selected economic indicators

	2018	2019	2020 1)	2020 January-June	2021 January-June	2021 Forecast	2022 Forecast	2023 Forecast
Population, th pers., average	7,025	6,976	6,934	.	.	6,850	6,800	6,750
Gross domestic product, BGN m, nom.	109,743	119,772	118,605	53,767	58,221	126,400	133,800	140,800
annual change in % (real)	3.1	3.7	-4.2	-3.8	3.1	3.5	3.3	3.2
GDP/capita (EUR at PPP)	15,530	16,510	16,270	.	.	.	.	.
Consumption of households, BGN m, nom.	64,936	69,853	70,353	32,562	34,901	.	.	.
annual change in % (real)	4.3	5.4	0.2	-0.7	6.1	3.5	3.0	3.0
Gross fixed capital form., BGN m, nom.	20,624	22,404	21,137	8,739	9,586	.	.	.
annual change in % (real)	5.4	4.5	-5.1	-11.2	3.0	2.5	3.0	4.5
Gross industrial production 2)								
annual change in % (real)	0.3	0.6	-5.9	-7.8	8.4	3.5	3.0	3.0
Gross agricultural production								
annual change in % (real)	-0.4	-1.4	-12.0	.	.	.	.	.
Construction industry 3)								
annual change in % (real)	1.6	3.8	-5.3	-7.1	3.9	.	.	.
Employed persons, LFS, th, average 4)	3,153	3,233	3,122	3,093	3,045	3,010	3,010	3,030
annual change in %	0.1	2.6	-3.4	-3.5	.	-0.5	0.0	0.5
Unemployed persons, LFS, th, average 4)	173	143	169	171	193	180	160	160
Unemployment rate, LFS, in %, average 4)	5.2	4.2	5.1	5.3	6.0	5.5	5.0	5.0
Reg. unemployment rate, in %, eop	6.1	5.9	6.7	8.3	5.2	.	.	.
Average monthly gross wages, BGN 5)	1,146	1,267	1,387	1,327	1,494	1,510	1,650	1,790
annual change in % (real, gross)	7.5	7.2	7.6	4.4	11.2	6.0	6.5	6.5
Consumer prices (HICP), % p.a.	2.6	2.5	1.2	2.0	1.2	3.0	2.5	2.0
Producer prices in industry, % p.a.	3.9	3.0	-2.0	-1.5	7.7	4.0	3.0	3.0
General governm.budget, EU-def., % of GDP								
Revenues	38.6	38.5	39.5	.	.	40.0	39.5	39.0
Expenditures	36.6	36.3	42.9	.	.	43.0	42.0	41.0
Net lending (+) / net borrowing (-)	2.0	2.1	-3.4	.	.	-3.0	-2.5	-2.0
General gov.gross debt, EU def., % of GDP	22.3	20.2	25.0	.	.	25.5	26.0	27.0
Stock of loans of non-fin.private sector, % p.a.	7.7	7.4	4.5	4.9	6.2	.	.	.
Non-performing loans (NPL), in %, eop	7.8	6.6	7.5	8.1	6.7	.	.	.
Central bank policy rate, % p.a., eop 6)	0.00	0.00	0.00	0.00	0.00	0.0	0.0	0.0
Current account, EUR m	532	1,148	-161	598	-380	-800	-1,000	-900
Current account in % of GDP	0.9	1.9	-0.3	2.2	-1.3	-1.2	-1.5	-1.3
Exports of goods, BOP, EUR m	27,742	29,120	27,272	13,155	16,138	30,500	30,800	31,300
annual change in %	2.9	5.0	-6.3	-6.5	22.7	11.8	1.0	1.6
Imports of goods, BOP, EUR m	30,449	32,028	29,218	13,759	17,378	33,000	33,500	35,000
annual change in %	9.8	5.2	-8.8	-11.6	26.3	12.9	1.5	4.5
Exports of services, BOP, EUR m	9,195	10,237	7,211	3,266	3,837	7,300	8,000	9,000
annual change in %	11.5	11.3	-29.6	-22.4	17.5	1.2	9.6	12.5
Imports of services, BOP, EUR m	5,063	5,342	4,152	1,870	2,053	4,400	5,200	5,700
annual change in %	-2.5	5.5	-22.3	-25.3	9.8	6.0	18.2	9.6
FDI liabilities, EUR m	1,542	1,983	2,384	845	1,050	1600	.	.
FDI assets, EUR m	785	745	267	203	641	300	.	.
Gross reserves of CB excl. gold, EUR m	23,620	23,072	28,830	25,972	27,763	.	.	.
Gross external debt, EUR m	37,190	37,716	39,627	37,058	39,581	40500	41000	41500
Gross external debt, % of GDP	66.3	61.6	65.3	61.1	61.2	63.0	60.0	58.0
Average exchange rate BGN/EUR	1.9558	1.9558	1.9558	1.9558	1.9558	1.9558	1.9558	1.9558

1) Preliminary. - 2) Enterprises with 10 and more employees. - 3) Enterprises with 5 and more employees. - 4) From 2021 the new LFS methodology is applied in line with the Integrated European Social Statistics Regulation (IESS). - 5) Half-year data excluding annual bonus payments. - 6) Base interest rate. This is a reference rate based on the average interbank LEONIA rate of previous month (Bulgaria has a currency board).

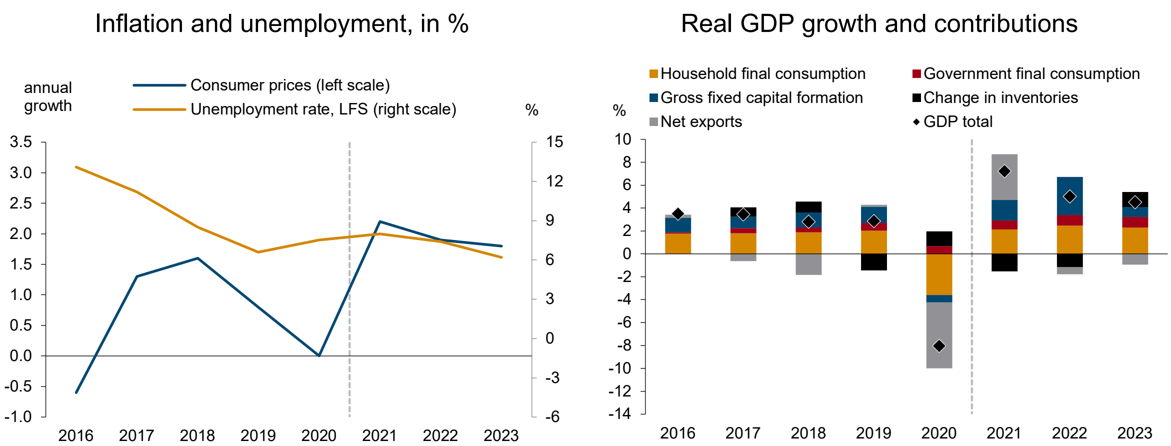
Source: wiiw Databases incorporating Eurostat and national statistics. Forecasts by wiiw.

CROATIA: Back on track

BERND CHRISTOPH STRÖHM

In 2021, Croatia's GDP will grow more strongly than that of most EU-CEE member states, after the government succeeded in maintaining COVID-19 infections at a relatively low level during the summer season, which allowed tourism to do better than expected. With the economy further bolstered by a solid recovery in private consumption and by the influx of EU funds, we expect Croatia's GDP to rebound by 7.2% in 2021.

Figure 4.5 / Croatia: Main macroeconomic indicators



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

A bumper tourist season and a surge in private consumption, as well as entirely unexpected 16.1% year-on-year GDP growth in Q2 2021, will help Croatia's GDP to bounce back in 2021. The country recorded a 46% increase in overnight stays from January to August, compared to the same period last year. Overnight stays in the first nine months of 2021 also surged to a promising 77.7% of the figure for 2019. It is expected that revenue from tourism in 2021 will reach 70% of the takings in the record season of 2019. In the first eight months of 2021, German tourists alone accounted for 23.3% of the total number of overnight stays, showing yet again Croatia's dependence on EU arrivals. In turn, the increased revenues from tourism fuelled household consumption, which grew by 18.4% year on year in Q2 2021, providing a further sound base for Croatia's economic recovery.

One of the reasons for the solid recovery of tourism was the government's successful pandemic management during the country's vital summer season. In order to prevent COVID-19 clusters, the health authorities set up an additional 350 testing centres across the country. The Tourism Ministry further ensured the distribution of over 1m COVID-19 tests at affordable prices for any tourist who decided to spend three nights or more in commercial accommodation across the country. In order to minimise pandemic-related travel restrictions and boost the country's inoculation rate, the government also undertook the vaccination of tourists and foreign nationals with permanent residence in Croatia, as well as of people without Croatian health insurance. Thanks to the government's successful COVID-19 crisis management in 2021, Prime Minister Plenković's cabinet moderated the risk of a snap election, maintaining the country's focus on membership of the European Monetary Union and its quest to join the Schengen area.

Solid export figures have provided further growth impetus in 2021. Boosted by the normalisation of tourist activity and the general economic recovery across the EU, exports of goods and services rose sharply – by some 41% year on year in Q2 2021. Imports also increased by 30.3% in Q2 2021, partly thanks to the successful launch of the country's tourist season, which led to an increase in demand for imported goods. Supported by a surge in exports, Croatia's current account surplus is expected to rise to 0.6% of GDP in 2021.

The influx of EU funds and investments will additionally boost recovery. In July, the European Commission finally approved a EUR 6.3bn grant (12.8% of Croatia's 2020 GDP) from the EU's Recovery and Resilience Facility (RRF) for the period 2021-2026, to support Croatia's COVID-19 recovery plan. Thanks to those funds, a gradual pick-up in long-term investment projects is expected in 2021 and 2022 (such as the modernisation of the Zagreb–Rijeka railway, which should be completed by 2027). An integral part of Croatia's National Recovery and Resilience Plan for 2021-2023 is financing for the reconstruction of earthquake-damaged infrastructure in the Zagreb, Krapina-Zagorje, Sisak-Moslavina and Karlovac counties. In September, the European Commission allocated an advance of EUR 818.4m from the RRF. The government also announced that it was to issue EUR 48m in interest-free loans to earthquake-hit counties for infrastructure repairs, adding that part of this loan would be covered by the EUR 683.7m allocated from the EU Solidarity Fund in 2020.

The government's fiscal support measures led to record levels of state debt in 2020, but they have so far successfully mitigated the fallout in the country's tourism-dominated labour market. In order to cushion the impact of the COVID-19 pandemic, Croatia put together a substantial support package in 2020, including wage subsidies, tax deferrals or waivers, access to cheap financing, and a short-time work scheme. Those labour support measures led to a 7.4% budget deficit and to record high state debt (which surged to 88.7% of GDP in 2020). In order to finance its 2021 fiscal support measures, the government will still post a 4.5% deficit this year. Nevertheless, in 2022, we expect the country's debt-to-GDP ratio to narrow to 83%, due to the stronger GDP growth. The state deficit in 2022 will also contract – back to within Maastricht's 3% requirements – helped by Croatia's fiscal consolidation efforts to facilitate the adoption of the euro by 2023.

Croatia's unemployment rate in 2021 will remain higher than the pre-COVID level, despite the strong recovery in the country's tourism industry. The recovery in tourist activity led to an increase in the number of people employed during Croatia's vital summer period. The effects of this were especially visible at the end of August, when the unemployment rate stood at 7.3% – the lowest since March 2020. While total employment reached pre-pandemic levels during this year's summer season, we still expect the country's 2021 unemployment rate to remain at above 2019 levels, at some 8%.

Croatia's economic recovery from 2020 still depends on the extent to which the COVID-19 Delta variant spreads in the region: with only 54% of the country's adult population fully vaccinated, COVID-19 related uncertainties remain high. Despite the inclusion of citizens without Croatian health insurance in the nationwide COVID-19 vaccination campaign, pronounced vaccine hesitancy has meant that the government has so far been unable to motivate the majority of the country's population to have the jab.

Higher energy prices have continued to exert pressure on inflation in 2021. In the first eight months of 2021, inflation averaged 1.6%. However, consumer prices in August rose by 3.1%, compared to the same month in 2020; this was the highest monthly inflation rate since April 2013. Due to the increase in energy prices and in the cost of food and non-alcoholic beverages, as well as to pandemic-related supply-chain disruptions, we expect inflation to remain elevated, averaging 2.2% in 2021.

Thanks to stronger investments and an increase in service exports and private consumption, as well as to the astonishing GDP growth recorded in Q2 2021, we have raised our 2021 GDP growth forecast for Croatia to 7.2%, from 5.1%. Even though revenue from this year's tourist season is projected to remain at below 2019 levels, it will still be substantially stronger than in 2020. Pre-pandemic levels of economic activity will likely be reached in 2022, with funds from the EU's RRF further boosting Croatia's GDP growth by some 5%.

Table 4.5 / Croatia: Selected economic indicators

	2018	2019	2020 1)	2020 January-June	2021 January-June	2021 Forecast	2022 Forecast	2023 Forecast
Population, th pers., average	4,091	4,067	4,047	.	.	4,000	3,995	3,990
Gross domestic product, HRK bn, nom.	385.4	402.3	371.5	177.2	195.3	407	436	464
annual change in % (real)	2.8	2.9	-8.0	-7.2	7.5	7.2	5.0	4.5
GDP/capita (EUR at PPP)	19,350	20,310	19,100	.	.	.	.	.
Consumption of households, HRK bn, nom.	218.4	228.0	214.0	104.6	115.0	.	.	.
annual change in % (real)	3.3	3.6	-6.4	-6.8	8.5	3.7	4.3	4.0
Gross fixed capital form., HRK bn, nom.	78.5	84.6	82.6	40.1	45.1	.	.	.
annual change in % (real)	6.5	7.1	-2.9	-6.3	11.2	8.0	15.0	4.0
Gross industrial production 2)								
annual change in % (real)	-1.0	0.6	-2.7	-5.7	9.0	7.0	3.3	2.5
Gross agricultural production								
annual change in % (real)	6.4	-0.5	4.1	.	.	.	.	.
Construction output 2)								
annual change in % (real)	4.9	8.3	4.4	3.1	12.2	.	.	.
Employed persons, LFS, th, average 3)	1,655	1,680	1,657	.	.	1,680	1,710	1,740
annual change in %	1.8	1.5	-1.3	.	.	1.3	1.5	1.5
Unemployed persons, LFS, th, average 3)	152	119	135	.	.	150	140	120
Unemployment rate, LFS, in %, average 3)	8.5	6.6	7.5	.	.	8.0	7.4	6.2
Reg. unemployment rate, in %, eop	8.9	7.8	9.3	9.0	7.5	.	.	.
Average monthly gross wages, HRK 4)	8,448	8,766	9,216	9,182	9,532	9,600	10,000	10,400
annual change in % (real, gross)	3.3	3.0	2.3	1.6	2.6	2.0	2.5	2.5
Average monthly net wages, HRK 4)	6,242	6,457	6,763	6,725	7,086	7,100	7,400	7,700
annual change in % (real, net)	2.8	2.7	2.6	1.7	4.1	2.1	2.2	2.2
Consumer prices (HICP), % p.a.	1.6	0.8	0.0	0.4	1.5	2.2	1.9	1.8
Producer prices in industry, % p.a.	2.2	0.8	-3.2	-2.8	4.3	6.0	4.0	2.4
General governm.budget, EU-def., % of GDP								
Revenues	46.3	47.5	48.0	.	.	49.0	46.0	46.0
Expenditures	46.1	47.2	55.4	.	.	53.5	49.0	48.5
Net lending (+) / net borrowing (-)	0.2	0.3	-7.4	.	.	-4.5	-3.0	-2.5
General gov.gross debt, EU def., % of GDP	74.3	72.8	88.7	.	.	85.5	83.0	80.5
Stock of loans of non-fin.private sector, % p.a.	2.3	3.9	3.5	4.1	1.6	.	.	.
Non-performing loans (NPL), in %, eop 5)	7.5	5.5	5.4	5.5	5.1	.	.	.
Central bank policy rate, % p.a., eop 6)	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Current account, EUR m	993	1,682	-54	-1,828	-2,101	340	220	-180
Current account, % of GDP	1.9	3.1	-0.1	-7.8	-8.1	0.6	0.4	-0.3
Exports of goods, BOP, EUR m	12,230	12,867	12,192	5,677	7,021	13,840	14,970	15,870
annual change in %	4.4	5.2	-5.2	-8.0	23.7	13.5	8.2	6.0
Imports of goods, BOP, EUR m	21,872	23,318	20,890	10,118	12,144	22,200	24,500	26,800
annual change in %	8.5	6.6	-10.4	-14.1	20.0	6.5	10.5	9.5
Exports of services, BOP, EUR m	13,873	15,375	8,938	2,839	3,515	10,800	11,900	13,000
annual change in %	7.4	10.8	-41.9	-43.9	23.8	21.0	10.0	9.0
Imports of services, BOP, EUR m	4,648	5,072	3,642	1,750	1,850	3,900	4,000	4,100
annual change in %	13.0	9.1	-28.2	-29.5	5.7	8.0	3.0	3.0
FDI liabilities, EUR m	1,077	3,477	1,046	647	1,696	1,100	.	.
FDI assets, EUR m	236	80	373	135	842	200	.	.
Gross reserves of CB excl. gold, EUR m	17,438	18,560	18,943	17,311	21,540	.	.	.
Gross external debt, EUR m	42,589	40,285	40,083	41,376	44,199	41,600	43,300	44,600
Gross external debt, % of GDP	82.0	74.3	81.3	84.0	81.9	77.0	75.0	73.0
Average exchange rate HRK/EUR	7.4182	7.4180	7.5384	7.5340	7.5508	7.5	7.6	7.6

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

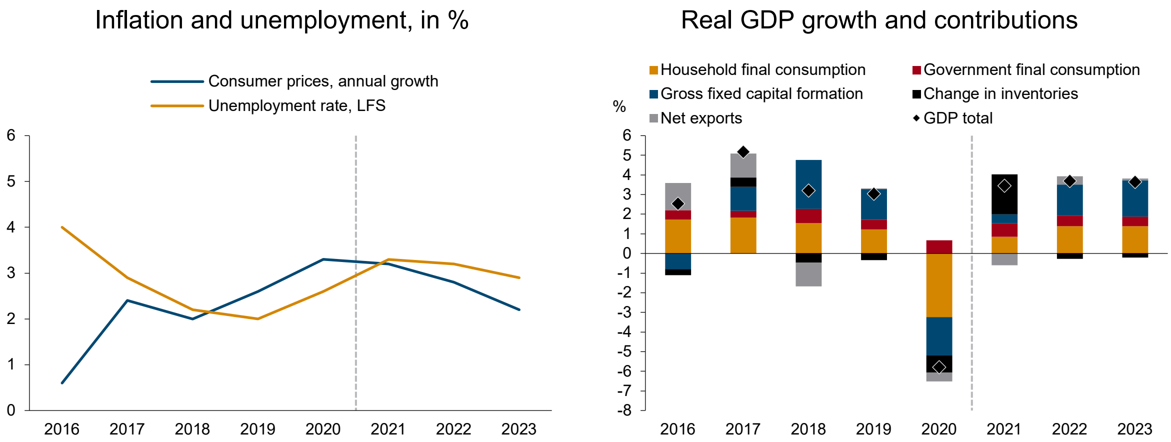
Source: wiiw Databases incorporating Eurostat and national statistics. Forecasts by wiiw.

CZECHIA: Turnaround subdued by central bank activity

LEON PODKAMINER

Pandemic concerns have been fading. GDP has started to recover, and a rising wage bill is supporting a strong rise in consumption. Growth in gross fixed capital formation is still inadequate, but industrial production is performing very well. An upturn in inflation has led to a tightening of monetary policy. The interest rate hike may have negative consequences for growth, but fiscal policy will continue to be supportive. The prospects, though fairly good, remain unimpressive.

Figure 4.6 / Czechia: Main macroeconomic indicators



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

Pandemic concerns have been fading: no new measures that essentially restrict economic activity are to be expected, while the existing measures are likely to be gradually revoked. Businesses, public institutions and households are returning to 'normality', more or less.

After a decline of 2.7% in Q1 2021, we saw GDP recover and increase by 8.2% in Q2 2021. This turnaround was due primarily to household consumption, which, from a deep trough in Q1, expanded strongly in Q2 to contribute 3.4 percentage points (pp) to overall growth. Gross fixed capital formation shifted from deep recession to an (albeit less pronounced) recovery. However, its contribution to growth was still minuscule (0.4 pp). This contrasted with the huge contribution made by growing inventories (3.2 pp), partly due to an accumulation of work in progress (caused by problems with supply chains). There was a spectacular surge in both imports and exports in Q2, adding 0.5 pp to overall growth.

The wage bill rose by nearly 18% (nominally) in Q2 2021, and this has clearly supported the recovery in household spending. The number of employed persons has been increasing, but only slowly – and it is still 2% shy of the 2019 figure. The number of vacancies again exceeds the number of unemployed people: labour shortages may be on their way back. On the other hand, recent statistics indicate a very strong increase in total hours worked. This may explain the big rise in average real wages – 4.7% in the first half of the year.

The volume of residential construction work has surged in the second quarter of 2021. The recovery in gross fixed capital formation is also visible for other forms of capital investment, and especially transport equipment and productive machinery and installations. Investment in non-residential structures – which currently remains depressed – is likely to accelerate as the EU 'recovery' funds become available.

Gross value added (GVA) in manufacturing recorded a rise of 25%, contributing 5.4 pp to overall growth. The GVA of the trade, accommodation, transportation and catering sector rose by close to 9% (having declined by nearly 14% in Q1). The other main sectors, which mostly stagnated or declined in Q1 (including construction), also reported a positive – albeit much less spectacular – growth in GVA.

Industrial production is performing very well. The automotive branch – the backbone of the country's manufacturing – outperformed all the other branches its output rose in real terms by close to 30% in the first half of 2021 – double the figure for manufacturing as a whole. This trend is likely to continue, though less vigorously. Manufacturing faces large and rising volumes of new orders – domestic, as well as external. But the actual rate of growth in industrial output in the second half of the year may be limited by the emerging shortage of some imported production inputs (e.g. microchips).

An upturn in inflation has already led to a tightening of monetary policy. Currently, the key Czech National Bank (CNB) interest rate is 1.5%. But the mood at the CNB is definitely hawkish, referring to rapidly rising property prices, etc. And so, 2021 may well end with an even higher rate. The irony of the situation is that the current inflation is fuelled by the high cost of imported energy and by rising indirect taxes. These two factors are projected to be important in 2022, as well (inflation next year will be bolstered further by hikes in administered prices). Core inflation – free of such extraneous factors – is not far off 2% now and should not be higher than (an otherwise acceptable) 2.5% in 2022, even allowing for some temporary hikes in food prices.

The factors responsible for the current inflation are plainly insensitive to the actions of the CNB. It is quite clear that the more restrictive monetary policy is intended to pre-empt extravagant wage settlements and runaway credit expansion that could fuel excessive demand for consumer goods at some point. But this preventive policy carries a high risk of actually depressing consumption and investment ahead of a possible boom. A strong rise in wages and consumption seems desirable to compensate for the losses of 2020 and Q1 2021. Moreover, the concerns about an undue expansion of credit are not entirely valid: the stock of credit extended to the business sector is actually declining, while the stock of credit extended to households is more or less stagnant (only the volume of credit to finance households' housing needs is increasing fairly rapidly). At the same time, both firms and households are increasing their bank deposit holdings.

The interest rate hike may have negative consequences for the exchange rate. A strengthening koruna (CZK) could alleviate domestic cost and price pressures. But it is unlikely to improve foreign trade and thus real activity. All in all, the CNB's recent activity is likely to limit the scope and size of the real economy, without actually helping to influence the progress of inflation. Inflation will subside on its own, if the exogenous factors permit.

Fiscal policy will continue to be supportive. The fiscal (general government) deficit ballooned in 2020. At an estimated 6.1% of GDP, it raised the public debt/GDP ratio to above 38%, still a very low level. In 2021, the fiscal deficit is likely to be even larger, contributing some 0.6% to GDP growth (via additional measures supporting private consumption and public investment). It is assumed that the deficits will decline steadily in 2022 and 2023, as the extraordinary measures to support household income are phased out.

Prospects are fairly good, but unimpressive. Despite promising signals from the manufacturing sector, the recovery in gross fixed investment is still inadequate. Although fiscal policy remains supportive for the time being, monetary policy – overreacting to inflation, which is largely insensitive to policy interest rates – is likely to subdue real growth, which may hover at around 3.5% in 2021-2023.

Table 4.6 / Czechia: Selected economic indicators

	2018	2019	2020 1)	2020 January-June	2021 January-June	2021 Forecast	2022 Forecast	2023 Forecast
Population, th pers., average	10,630	10,672	10,698	10,696	10,698	10,710	10,730	10,750
Gross domestic product, CZK bn, nom.	5,410	5,790	5,695	2,720	2,915	6,070	6,420	6,790
annual change in % (real)	3.2	3.0	-5.8	-6.1	3.0	3.4	3.7	3.6
GDP/capita (EUR at PPP)	27,900	29,100	28,090	.	.	.	.	.
Consumption of households, CZK bn, nom.	2,524	2,663	2,543	1,248	1,275	.	.	.
annual change in % (real)	3.3	2.6	-7.1	-6.4	0.4	1.9	3.1	3.1
Gross fixed capital form., CZK bn, nom.	1,423	1,568	1,495	690	710	.	.	.
annual change in % (real)	10.0	5.9	-7.2	-3.8	0.9	1.7	6.0	7.0
Gross industrial production								
annual change in % (real)	3.1	-0.3	-7.2	-13.2	15.2	10.0	5.0	5.0
Gross agricultural production								
annual change in % (real)	-0.9	2.1	3.9	.	.	.	.	.
Construction industry								
annual change in % (real)	9.2	2.7	-6.3	-2.4	-0.3	.	.	.
Employed persons, LFS, th, average 2)	5,294	5,303	5,235	5,245	5,168	5,250	5,260	5,270
annual change in %	1.4	0.2	-1.3	-1.1	.	0.2	0.1	0.1
Unemployed persons, LFS, th, average 2)	122	109	137	116	169	180	170	160
Unemployment rate, LFS, in %, average 2)	2.2	2.0	2.6	2.2	3.2	3.3	3.2	2.9
Reg. unemployment rate, in %, eop	3.1	2.9	4.0	3.7	3.7	.	.	.
Average monthly gross wages, CZK	32,051	34,578	35,662	34,290	36,802	38,300	40,600	42,500
annual change in % (real, gross)	5.9	5.0	-0.1	-1.0	4.7	4.0	3.0	2.5
Consumer prices (HICP), % p.a.	2.0	2.6	3.3	3.5	2.5	3.2	2.8	2.2
Producer prices in industry, % p.a.	0.7	1.7	0.6	0.5	2.8	5.0	2.5	1.5
General governm. budget, EU-def., % of GDP								
Revenues	41.5	41.4	41.0	.	.	40.3	40.0	40.0
Expenditures	40.6	41.1	47.1	.	.	46.8	45.6	44.5
Net lending (+) / net borrowing (-)	0.9	0.3	-6.1	.	.	-6.5	-5.6	-4.5
General gov.gross debt, EU def., % of GDP	32.1	30.0	37.8	.	.	43.3	46.7	48.4
Stock of loans of non-fin.private sector, % p.a.	6.8	5.2	4.1	5.6	4.2	.	.	.
Non-performing loans (NPL), in %, eop	3.3	2.5	2.7	2.4	2.7	.	.	.
Central bank policy rate, % p.a., eop 3)	1.75	2.00	0.25	0.25	0.50	1.50	1.75	1.50
Current account, EUR m	962	747	7,772	3,900	3,820	5,800	6,100	6,600
Current account, % of GDP	0.5	0.3	3.6	3.2	3.8	2.5	2.4	2.5
Exports of goods, BOP, EUR m	136,370	139,428	130,017	60,395	75,192	152,100	167,500	182,600
annual change in %	5.5	2.2	-6.7	-14.7	24.5	17.0	10.1	9.0
Imports of goods, BOP, EUR m	128,516	130,088	119,217	56,712	69,788	140,700	152,300	166,000
annual change in %	7.6	1.2	-8.4	-12.6	23.1	18.0	8.3	9.0
Exports of services, BOP, EUR m	25,942	27,204	22,878	11,626	11,651	24,700	26,200	28,400
annual change in %	7.2	4.9	-15.9	-11.2	0.2	8.0	6.0	8.5
Imports of services, BOP, EUR m	21,262	23,078	18,905	9,165	9,504	20,800	22,800	24,600
annual change in %	9.2	8.5	-18.1	-10.9	3.7	10.0	9.5	8.0
FDI liabilities, EUR m	7,129	9,582	5,539	1,763	2,415	7,000	.	.
FDI assets, EUR m	5,156	4,243	2,831	749	2,421	4,500	.	.
Gross reserves of CB excl. gold, EUR m	124,142	133,059	134,899	134,745	140,057	.	.	.
Gross external debt, EUR m	171,534	172,544	163,883	163,544	164,168	165,800	172,000	175,700
Gross external debt, % of GDP	81.3	76.5	76.1	76.0	70.3	71.0	69.0	66.0
Average exchange rate CZK/EUR	25.65	25.67	26.46	26.34	25.86	26.0	25.8	25.5

1) Preliminary. - 2) From 2021 a methodological change in the economic status of persons on parental leave. -3) Two-week repo rate.

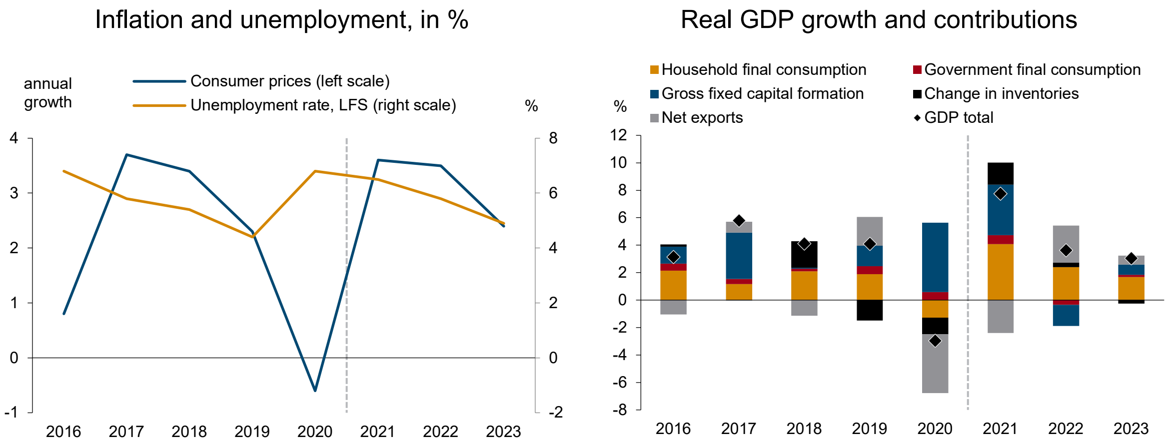
Source: wiiw Databases incorporating Eurostat and national statistics. Forecasts by wiiw.

ESTONIA: Full-speed growth riding on massive investment

MARYNA TVERDOSTUP

The first half of 2021 showed Estonia to be another post-pandemic success story. Record high investment flooded into the ICT sector, while strong purchasing power and a rapid revival in foreign trade are the pillars of economic growth. We expect the economy to grow by 7.8% in 2021. Even by the middle of the year, the country's pre-pandemic level of output had been exceeded. Future growth will be driven by production expansion, steady consumer demand, rising investment, a strengthening position on the foreign market and further digital transformation.

Figure 4.7 / Estonia: Main macroeconomic indicators



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

The powerful economic growth of the first half of 2021 exceeded all expectations. The economy commenced its dynamic recovery, with 4.3% quarter-on-quarter and 13.9% year-on-year GDP growth in Q2 2021, and the economic outlook for the coming years looks brighter than was predicted in spring 2021. The lockdown and the stringent restrictions imposed from March until May did nothing to retard the recovery: quite the reverse – economic growth proceeded full speed ahead, and the pre-pandemic levels of output were left trailing in its wake.

Business activity in the first half of 2021 signalled greater immunity of companies to the restrictions imposed. Companies outstripped pre-pandemic performance, as business learned to adjust. With the pandemic in full swing for a year and a half, adaptation is essential to survival – especially for service industries and retail trade. The last round of restrictions showcased the great capacity of businesses to adjust and stay afloat, mainly via an upswing in e-commerce and the digitalisation of operations. The climbing indexes of economic activity based on business surveys suggest rising confidence among business owners.

The overall positive dynamics are marred a little by the uneven speed of recovery across the economic sectors, as the powerful bounce-back is driven by those sectors least affected by the crisis. Through thick and thin, the ICT sector has remained a solid pillar of the Estonian economy: for a time, it largely drove the recovery, maintaining employment and wage growth, attracting massive investment and making a substantial contribution to the state budget revenues. However, in contrast to 2020, so far in 2021 the ICT sector has not been the only sector driving the recovery: business services, transportation and construction have been growing steadily since the beginning of the year. The retail sector posted a 14.8% increase (quarter on quarter) in Q2 2021, encouraged by booming e-commerce during the spring wave of the pandemic. However, some sectors are still lagging far behind the pre-crisis levels. The accommodation and food services sector saw a 40% drop last year, and it is unlikely to recover before the end of this year. It is a similar story with the leisure and support activities sectors.

The massive surge in investment at the end of last year persisted in 2021. With production capacity fully utilised in response to steadily rising demand, investment is crucial for further production expansion. The upswing in inward foreign direct investment in the equity of Estonian companies reached a record EUR 3bn in Q2 2021. Investments in fixed assets reached 60% year-on-year growth in that same quarter. Huge corporate investments, among other things, flooded into the biotechnology sector and a newly opened factory producing chemicals for COVID-19 tests. Unlike the previous year, investments in fixed assets in manufacturing, construction and agriculture climbed in the first two quarters of 2021. Savings accumulated during the pandemic and pension reform – designed to shift pension provision from the mandatory to the voluntary second pillar – provided a strong tailwind for private investments: these grew in Q2 2021 by 13% (seasonally adjusted, quarter on quarter). The investment capacity of people was remarkably high throughout the crisis, and is increasing as the pandemic fades, thanks to the extra EUR 50-70m added to private savings monthly since February 2021, as well as to the pension reform (resulting in over EUR 1bn released in the first half of 2021) and the sound investment capacity of the banks. The market in real estate has undergone an unprecedented boom, and private housing loans last year reached record levels. Investments will remain a core pillar of growth in the next few years.

Domestic demand is thriving, reaching 25.2% growth, year on year, in Q2 2021, thanks to increased purchasing power and improved consumer and producer confidence. With extra household savings and money withdrawn from the second pension pillar, private consumption will thrive once the restrictions are eased further and consumption options become unlimited. Private consumption is expected to grow by 8.5% this year and by 5.0% in 2022. However, the dismantling of the mandatory second pillar seems to be a zero-sum game, since it merely brings forward future consumption, and thereby will reduce the economy’s long-run growth performance.

An improved external environment has revived foreign demand and raised export receipts by over a third, compared to 2020. A boost in foreign trade in Q2 2021 was based on increased external demand for production inputs, recovering supply chains and restrictions being lifted worldwide. The growth in exports year on year in Q2 2021 was 36.5% for goods and 46.2% for services. The base effect is most apparent in services exports, as in 2020 they were hit harder in Estonia than in the other Baltic and Nordic countries: they declined by 21%, and this figure was moderated only by steadily high exports of ICT and other business services. Imports increased in both goods and services in the first half of

2021, with the latter largely driven by a huge purchase of computer services related to VW Group operations. We expect both exports and imports to grow substantially in 2021, with the increase reaching 15.5% for exports and 19.0% for imports; this will be followed by a gradual convergence with pre-pandemic growth by 2023.

With energy prices increasing further and mounting demand pressure, consumer price inflation reached 5% in August 2021. Yet it is not the massive rise in energy prices alone that has led to the reappearance of inflation: the prices of consumer durables and services (which started to rise from a low base), as well as the cost of food and industrial goods (mainly construction materials, home furnishing and used cars) also soared over the summer. With booming domestic demand and production capacity exploited to the limit, producers may face difficulties in keeping up with demand, which will create extra pressure on prices. As the energy price increase is expected to slow down in the second half of the year, we project inflation of 3.6% for 2021, with a gradual decline to 2.4% by 2023.

Structural changes are looming on the labour market, as the revival in employment and wage growth remain uneven across sectors. The spring wave of the pandemic caused no deterioration in the employment situation: unemployment declined from 7.1% in Q1 2021 to 6.9% in Q2 2021, and is likely to drop to pre-pandemic levels by 2023. As business activity flourished, labour shortages reasserted themselves: it is mostly employers in construction, industry and the service sector that have noticed a lack of workforce. Disproportionate economic decline and recovery rates across sectors have resulted in substantial labour reallocation across industries, and this change may prove lasting. Average wages were up 4.4% quarter on quarter (and 7.3% year on year) in Q2 2021, as a result of a recovery in working hours and a big wage boost in ICT and the healthcare sector. Yet future wage growth is expected to remain polarised, with low-earning workers restrained by an abandoned minimum wage increase.

The odds of the budget deficit narrowing to 1% of GDP by 2023 have increased, as the economy continues to recover strongly. The government support launched in 2020 and subsequent support measures introduced in 2021, coupled with high public healthcare spending and social transfers resulted in a cumulative budget deficit of 3.4% of GDP in the first half of 2021. As the economy has commenced a period of rapid growth, tax receipts are increasing; on the assumption that any increase in public spending is limited, fiscal balance may be achieved by the end of the forecast horizon. Since the relative contribution of production and consumption taxes is higher than in other EU countries, the state budget will reap the benefits of reviving private consumption and production in the coming years.

Every cloud has a silver lining – for Estonia, it is the country's further digital transition. As one of the most digitally advanced economies in the EU, Estonia experienced a further boost in digitalisation as a consequence of the pandemic. E-commerce, well-running digital services and the digitalisation of business operations converted the limitations posed by the pandemic into opportunities to expand and advance the e-economy. To facilitate this further, a large share of the European Union support funding – around EUR 3bn, will be channelled into further digital transformation in the coming years.

External factors were responsible for much of the economic downturn in 2020, and these will remain important for economic growth in subsequent years. Given the country's outstandingly good economic performance in the first half of 2021 – driven by strong domestic demand, the increased purchasing power of people, a massive influx of investment and a labour market revival – we project GDP growth of 7.8% in 2021, followed by 3.6% in 2022 and 3.0% in 2023. However, the forecast carries a good deal of uncertainty that is related to the external environment in 2022-2023. The reliable operation of supply chains is a crucial factor in further growth. With domestic demand climbing and foreign trade picking up, production capacity is nearing its historical peak, and supply difficulties may hinder further business growth. As a result, in the next few years the government agenda needs to focus on resolving supply difficulties, reallocating the workforce in response to looming labour shortages, and keeping inflation under control.

Table 4.7 / Estonia: Selected economic indicators

	2018	2019	2020 1)	2020 January-June	2021 January-June	2021 Forecast	2022 Forecast	2023 Forecast
Population, th pers., average	1,322	1,327	1,329	1,319	1,325	1,340	1,342	1,342
Gross domestic product, EUR m, nom.	25,818	27,732	26,835	12,718	14,120	30,000	32,200	34,000
annual change in % (real)	4.1	4.1	-3.0	-3.8	8.5	7.8	3.6	3.0
GDP/capita (EUR at PPP)	24,570	25,760	25,380	.	.	.	.	.
Consumption of households, EUR m, nom.	12,522	13,340	12,885	6,217	6,620	.	.	.
annual change in % (real)	4.3	3.9	-2.7	-4.1	4.7	8.5	5.0	3.5
Gross fixed capital form., EUR m, nom.	6,376	7,052	8,233	2,905	4,544	.	.	.
annual change in % (real)	0.2	6.1	19.9	-8.1	56.8	12.0	-5.0	2.4
Gross industrial production								
annual change in % (real)	4.7	6.7	-6.1	-11.2	7.1	6.2	5.9	4.0
Gross agricultural production								
annual change in % (real)	-6.3	22.8	-2.2	.	.	.	.	.
Construction industry								
annual change in % (real)	12.3	5.8	-6.1	-1.8	6.1	.	.	.
Employed persons, LFS, th, average 2)	664.7	671.3	656.6	657.1	645.6	670	680	690
annual change in %	0.9	1.0	-2.2	-1.2	.	1.5	1.2	0.8
Unemployed persons, LFS, th, average 2)	37.7	31.3	47.9	42.2	48.1	47	42	36
Unemployment rate, LFS, in %, average 2)	5.4	4.4	6.8	6.1	7.0	6.5	5.8	4.9
Reg. unemployment rate, in %, eop 3)	4.8	5.3	8.3	7.8	7.6	.	.	.
Average monthly gross wages, EUR	1,310	1,407	1,448	1,419	1,506	1,590	1,760	1,920
annual change in % (real, gross)	3.8	5.0	3.4	2.6	4.2	5.8	6.9	6.7
Average monthly net wages, EUR	1,070	1,150	1,185	1,161	1,232	1,300	1,410	1,510
annual change in % (real, net)	5.0	5.1	3.5	2.8	4.2	5.8	4.9	4.8
Consumer prices (HICP), % p.a.	3.4	2.3	-0.6	0.0	1.7	3.6	3.5	2.4
Producer prices in industry, % p.a.	3.9	-0.6	-3.5	-4.8	8.3	3.3	2.5	2.2
General governm. budget, EU-def., % of GDP								
Revenues	38.9	39.5	40.7	.	.	40.1	41.0	41.2
Expenditures	39.5	39.5	45.7	.	.	44.1	43.0	42.2
Net lending (+) / net borrowing (-)	-0.6	0.1	-5.0	.	.	-4.0	-2.0	-1.0
General gov.gross debt, EU def., % of GDP	8.2	8.6	18.5	.	.	20.0	18.5	15.0
Stock of loans of non-fin.private sector, % p.a.	5.1	3.3	4.8	1.9	5.5	.	.	.
Non-performing loans (NPL), in %, eop	0.5	0.5	0.4	0.5	0.4	.	.	.
Central bank policy rate, % p.a., eop 4)	0.00	0.00	0.00	0.00	0.00	.	.	.
Current account, EUR m	206	700	-69	665	-952	-1,120	-150	-70
Current account, % of GDP	0.8	2.5	-0.3	5.2	-6.7	-3.7	-0.5	-0.2
Exports of goods, BOP, EUR m	12,593	13,340	13,387	6,212	7515	14,850	15,200	15,600
annual change in %	5.3	5.9	0.4	-8.0	21.0	10.9	2.4	2.6
Imports of goods, BOP, EUR m	13,816	14,270	13,535	6,288	8129	16,300	16,200	16,600
annual change in %	7.3	3.3	-5.2	-11.4	29.3	20.4	-0.6	2.5
Exports of services, BOP, EUR m	6,634	7,195	5,713	2,767	3358.6	7,000	7,300	7,560
annual change in %	8.7	8.5	-20.6	-17.2	21.4	22.5	4.3	3.6
Imports of services, BOP, EUR m	4,740	5,113	5,436	1,875	3454	6,200	6,100	6,230
annual change in %	12.1	7.9	6.3	-20.6	84.2	14.1	-1.6	2.1
FDI liabilities, EUR m	1,039	2,718	3,055	895	4656	3700	.	.
FDI assets, EUR m	-209	1,629	275	5	3052	600	.	.
Gross reserves of CB excl. gold, EUR m	651	1,256	1,615	1,666	2,035	.	.	.
Gross external debt, EUR m	20,189	21,161	24,452	24,355	26,255	25,500	26,400	27,200
Gross external debt, % of GDP	78.2	76.3	91.1	90.8	87.5	85.0	82.0	80.0

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

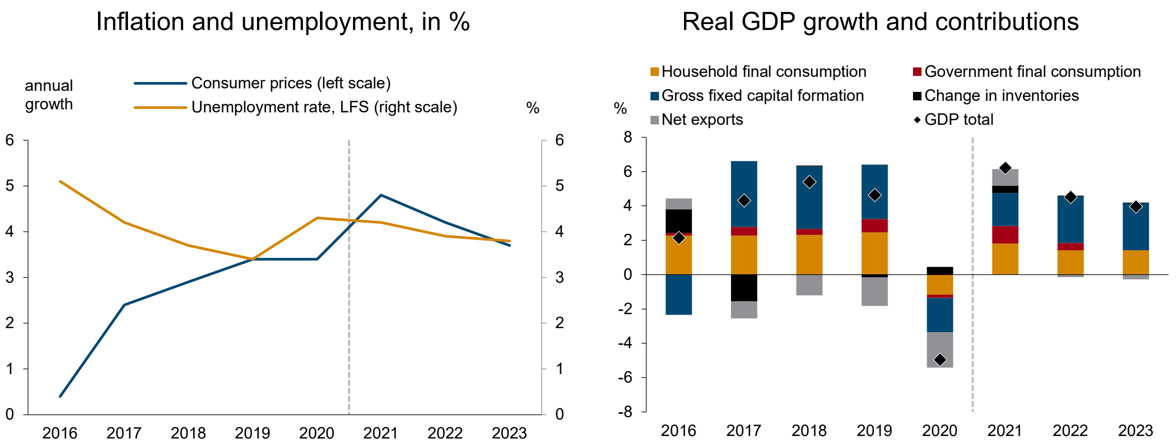
Source: wiiw Databases incorporating Eurostat and national statistics. Forecasts by wiiw.

HUNGARY: Tipping from recession to overheating

SÁNDOR RICHTER

By summer 2021, Hungary's economy had regained its pre-pandemic level. Recovery was helped by dynamic growth in industry and a remarkable contribution by net exports. The economy is overheating, however, and inflation has climbed to around 5%. While the central bank has begun tightening monetary policy, the government has stepped up its expansionary fiscal policy, with an eye to the elections early next year. After the elections, the overheating will have to be tackled. The current dynamic growth cannot be maintained for the duration of the forecast.

Figure 4.8 / Hungary: Main macroeconomic indicators



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

Overall, by summer 2021, the Hungarian economy's performance had reached its pre-pandemic level. In Q1 2021, economic performance was 7.6% higher than in the same period of the previous year (when GDP declined by 6%). And in Q2 this year, the level of GDP was even 2.2% above the (pre-pandemic) level of Q2 2019. The recovery has been driven primarily by industry (and to a smaller extent, by construction), while the largest sector – services – has not been able to completely recoup the losses suffered during the crisis. On the distribution side, private and public consumption and fixed capital formation increased by less than GDP; thus, the most important driver of the growth has been foreign trade.

In parallel with the revival of the economy, inflation has become a major issue. In the months April-September, year-on-year monthly consumer price inflation ranged from 4.6% to 5.5% – well above the central bank's inflation target of 3%. Producer prices increased by 9% in the first half year. Nevertheless, inflationary pressure has been present for some time now: an increasing shortage of labour meant that net real wages rose by close to 24% in 2018-2020, while GDP grew by only 4.7% and private consumption by 7.5%. Monetary policy was ultra-relaxed in that period, with policy rates of from 0.6% to 0.9%. Meanwhile, average inflation in those three years amounted to 3.2%, which contributed considerably to the strong negative real interest rates. This and the generous preferential credit schemes offered by the central bank led to a huge expansion in the volume of loans. In this period, there was an ample inflow of EU funds as well, and the value of the Hungarian forint declined steadily. From early 2020, the relaxed monetary policy helped to cushion the crisis. The central bank also started to purchase government securities, in order to support the expansionary fiscal policy in the wake of the crisis triggered by the lockdowns. By spring 2021, however, the situation had changed: instead of the deflationary international environment characteristic of the pre-crisis years, signs of rising inflation were appearing in the global economy. With the Hungarian economy returning to normality in spring 2021, the pre-existing levers of inflation started to exert greater pressure. Exchange rate volatility and the rising monthly inflation figures alarmed the central bank.

The shift in monetary policy has had an impact that goes far beyond its economic significance. The governor of the central bank, Mr Matolcsy – for two decades, Prime Minister Orbán's designated 'right hand' on economic matters – has started to criticise the government (and thereby indirectly Orbán), warning that the recovery is strong, and – given the changed conditions – inflation is too high, the fiscal policy should become less expansive. The central bank embarked on a cycle of tightening by raising interest rates. The policy rate was increased in small steps, from 0.6% in June to 1.65% by the end of September. The central bank also started to withdraw from its government securities purchase programme. It believes that the high fiscal deficit – equivalent to 8.1% of GDP last year – was justified, but that the planned budget deficit of 7.5% this year and 5.9% in 2022 represents a pro-cyclical economic policy that endangers monetary stability.

The government clearly has priorities other than to curb inflation: April 2022, the date of the general election is getting closer. According to opinion polls, there is a chance that the united list of the opposition parties could defeat Fidesz. That explains why economic policy is now clearly subordinate to the election campaign, which has already got under way. The government has announced that, thanks to the strong economic growth, the personal income tax paid in 2021 by families with children will be refunded in early 2022. The 13th monthly pension (which was abolished in the wake of the retrenchment following the 2008/2009 economic crisis) will be restored. And the minimum wage will be raised by 20%. All these measures will come into force just a few months before the elections and will make it hard to carry through the planned reduction in next year's fiscal deficit. The second half of 2022 will be critical for the future of inflation. That said serious efforts to consolidate the budget may render the current high inflation transitory over the forecast horizon.

Meanwhile the conflicts with the European Union have become more acute. The funds earmarked for Hungary from the Recovery and Resilience Facility (RRF) scheme have not yet been released, and those from the traditional EU budget may also be delayed (or even suspended). The government is trying to downplay the significance of this and has renounced the credit element of the RRF (EUR 9.4bn). To compensate for the grants withheld from the RRF (EUR 7.6bn), Hungary raised EUR 4.5bn in credit on the markets (amounting to 3% of GDP) within just two days (two USD bonds with a maturity of 10 and 30 years, plus a euro bond with a 7-year maturity, all on favourable terms). The stated aim of the move is to enable the immediate start of project financing from the national budget, well before genuine financing from the RRF becomes available.

Whether or not Orbán remains in power after the elections, the number one economic priority will be to tackle the overheating in the economy. That will require monetary and fiscal policy steps to reduce aggregate demand and lead to a slowdown in economic growth. If Orbán remains in power, a downside risk to the current growth forecast would be continued conflict with the EU, potentially resulting in a significant delay of transfers. Conversely, if Orbán is voted out of office, another downside risk would be the possible economic consequences of what are very likely to be the intense political conflicts between any new government and a handful of key state institutions that are headed by persons close to Orbán whose mandate will extend for years beyond the current legislative period. A critical issue of these conflicts may well be the dismantling of the Orbán loyalists' economic empire, as part of an anticorruption programme – the flagship project of the current opposition.

Table 4.8 / Hungary: Selected economic indicators

	2018	2019	2020 1)	2020	2021	2021	2022	2023
				January-June			Forecast	
Population, th pers., average	9,776	9,771	9,750	.	.	9,680	9,620	9,600
Gross domestic product, HUF bn, nom.	43,350	47,524	47,743	21,884	24,971	54,000	59,300	64,100
annual change in % (real)	5.4	4.6	-5.0	-6.0	7.6	6.2	4.5	4.0
GDP/capita (EUR at PPP)	21,580	22,810	22,100	.	.	.	.	.
Consumption of households, HUF bn, nom.	20,522	22,542	22,681	11,050	11,854	.	.	.
annual change in % (real)	4.8	5.2	-2.5	-1.6	2.6	3.8	3.0	3.0
Gross fixed capital form., HUF bn, nom.	10,740	12,890	13,054	5,550	6,406	.	.	.
annual change in % (real)	16.4	12.8	-7.3	-8.2	4.8	7.0	10.0	10.0
Gross industrial production								
annual change in % (real)	3.5	5.6	-6.0	-12.6	18.4	11.0	6.0	5.0
Gross agricultural production								
annual change in % (real)	2.7	0.4	-2.2	.	.	.	.	.
Construction industry								
annual change in % (real)	21.2	20.7	-9.8	-7.8	7.1	.	.	.
Employed persons, LFS, th, average 2)	4,470	4,512	4,461	4,437	4,593	4,650	4,700	4,700
annual change in %	1.1	1.0	-1.1	-1.5	0.3	1.0	1.0	0.0
Unemployed persons, LFS, th, average 2)	172	160	198	194	206	200	190	190
Unemployment rate, LFS, in %, average 2)	3.7	3.4	4.3	4.2	4.3	4.2	3.9	3.8
Reg. unemployment rate, in %, eop 3)	5.2	5.1	6.2	8.1	5.7	.	.	.
Average monthly gross wages, HUF 4)	329,943	367,833	403,616	395,605	428,191	439,500	469,400	496,500
annual change in % (real, gross)	8.3	7.7	6.2	6.4	3.9	3.9	2.5	2.0
Average monthly net wages, HUF 4)	219,412	244,609	268,405	263,078	284,747	292,300	312,200	330,200
annual change in % (real, net)	8.3	7.7	6.2	6.4	3.9	3.9	2.5	2.0
Consumer prices (HICP), % p.a.	2.9	3.4	3.4	3.4	4.3	4.8	4.2	3.7
Producer prices in industry, % p.a.	5.6	2.1	4.3	3.5	9.4	9.0	6.0	4.0
General governm.budget, EU-def., % of GDP								
Revenues	43.8	43.6	43.5	.	.	45.0	45.0	45.0
Expenditures	45.9	45.7	51.6	.	.	53.0	50.5	48.5
Net lending (+) / net borrowing (-)	-2.1	-2.1	-8.1	.	.	-8.0	-5.5	-3.5
General gov.gross debt, EU def., % of GDP	69.1	65.5	80.4	.	.	81.0	81.0	79.9
Stock of loans of non-fin.private sector, % p.a.	10.5	13.2	13.4	13.7	10.3	.	.	.
Non-performing loans (NPL), in %, eop 5)	5.4	4.1	3.6	4.0	3.4	.	.	.
Central bank policy rate, % p.a., eop 6)	0.90	0.90	0.60	0.75	0.90	1.90	2.30	2.50
Current account, EUR m 7)	216	-1,017	-2,167	-1,876	-598	900	1,100	1,700
Current account, % of GDP 7)	0.2	-0.7	-1.6	-3.0	-0.9	0.6	0.7	0.9
Exports of goods, BOP, EUR m 7)	88,544	92,525	89,227	41,647	51,211	99,900	106,900	112,800
annual change in %	3.8	4.5	-3.6	-10.8	23.0	12.0	7.0	5.5
Imports of goods, BOP, EUR m 7)	90,824	96,212	90,626	42,871	50,552	99,700	107,200	113,100
annual change in %	8.7	5.9	-5.8	-10.0	17.9	10.0	7.5	5.5
Exports of services, BOP, EUR m 7)	25,396	26,917	19,409	9,568	9,206	19,200	22,100	24,300
annual change in %	6.6	6.0	-27.9	-24.7	-3.8	-1.0	15.0	10.0
Imports of services, BOP, EUR m 7)	17,316	19,828	15,668	7,856	7,193	15,400	17,700	19,500
annual change in %	2.6	14.5	-21.0	-14.7	-8.4	-2.0	15.0	10.0
FDI liabilities, EUR m 7)	6,671	2,698	2,873	1,242	2,678	3,000	.	.
FDI assets, EUR m 7)	4,059	1,926	684	-599	2,796	3,000	.	.
Gross reserves of CB excl. gold, EUR m	26,273	27,010	32,115	28,593	26,314	.	.	.
Gross external debt, EUR m 7)	107,696	105,799	109,356	108,569	119,474	123,000	125,000	127,000
Gross external debt, % of GDP 7)	79.2	72.4	80.5	79.9	78.1	80.4	74.8	70.3
Average exchange rate HUF/EUR	318.89	325.30	351.25	345.40	357.85	353	355	355

1) Preliminary. - 2) From 2021 the new LFS methodology is applied in line with the Integrated European Social Statistics Regulation (IESS). - 3) Unemployed in % of LFS labour force. - 4) Enterprises with 5 and more employees. From 2019 based on tax administration data, survey data before. - 5) Loans more than 90 days overdue and those unlikely to be paid. - 6) Base rate (two-week CB bill). - 7) Excluding SPE.

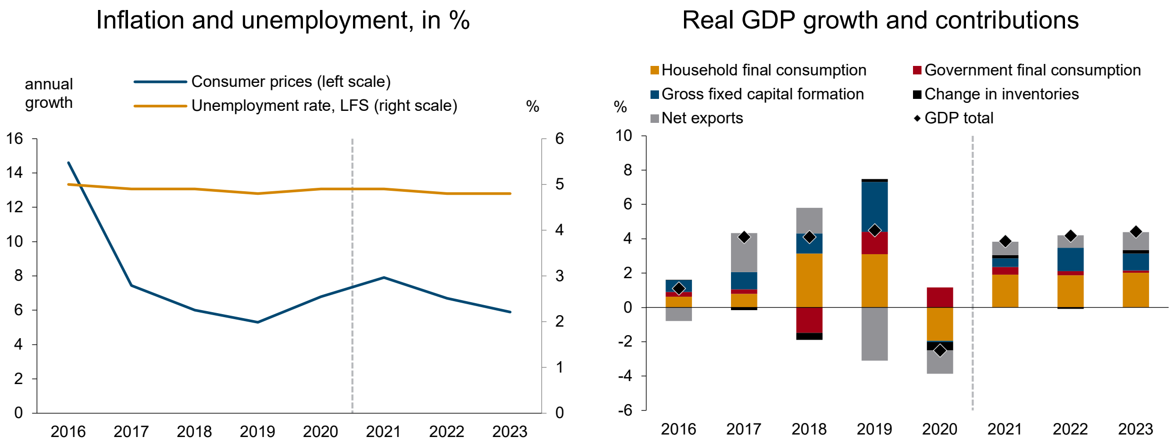
Source: wiiw Databases incorporating Eurostat and national statistics. Forecasts by wiiw.

KAZAKHSTAN: Full recovery in sight

ALEXANDRA BYKOVA

Economic revival is accelerating, with a full rebound to pre-pandemic performance in sight for this year. Rising consumer demand and new fiscal stimuli will support strong performance in the coming years, but inflationary pressure is re-emerging and is likely to persist next year. The forecasts for 2021 and 2022 have been revised upwards to 3.9% and 4.2%.

Figure 4.9 / Kazakhstan: Main macroeconomic indicators



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

Economic revival is more robust than previously expected, and indicators of sentiment are capturing positive expectations for the future. The economic recovery has been gaining momentum this year. After real GDP growth of 2.3%, year on year, in the first half year, the short-term indicator compiled by the national statistical office has suggested 3.9% annual growth for the first eight months of 2021.[27] The recovery is being driven by a positive performance in almost all the economic sectors that go to make up this indicator – apart from transportation, which is still in recession (-1.4%, year on year, over January-August 2021). In July, consumer confidence reached its highest level since 2018. Simultaneously, business expectations also point to rising demand. Hence, we expect a stronger recovery for this year and next than our summer projections suggested.

Manufacturing is likely to perform strongly, while the impact on mining of the easing of oil production cuts remains to be seen. While manufacturing grew by 5.6% over January-August 2021 (compared to the corresponding period of 2020), mining continued to decline (by 1.4%). We expect

[27] The short-term indicator used captures, on a monthly basis, the real output of the main economic sectors – agriculture, industry, construction, trade, transport and communications. Altogether, these account for more than 60% of GDP and have proved to be a good approximation of real GDP growth.

manufacturing to remain strong amid rising demand, with pharmaceuticals, machinery and food (meat) benefiting most. Moreover, manufacturing production will get an additional boost from two state support programmes – the Economy of Simple Things and the Business Road Map – which will be extended to next year, with allocated funding of around 1% of GDP (or USD 2.3bn). Thus, pandemic-induced anti-crisis measures to retain jobs and maintain production are evolving to fit the longer-term state goal of import substitution and diversification of production and export. To give an example, pharmaceuticals are evolving on the back of pandemic response measures: the total output of medical products is reportedly expected to meet 17% of domestic demand this year (up from 14% in 2019); the state target is 50% by 2025. Kazakhstan has even started producing its own vaccine against COVID-19 – QazVac. Unlike manufacturing, oil production posted an overall annual decline of 4% over the first eight months of 2021, but the relaxation of OPEC+ production cuts is likely to become more visible only later this year.

Despite the favourable global oil markets – with their high prices and growing demand – Kazakhstan's oil sector is likely to need another year to bounce back fully to its 2019 export level; but the medium-term prospects are favourable. Oil exports in dollar terms grew by only 2%, year on year, over the first seven months of 2021, reflecting a decline of 11.6% in volume and (surprisingly) an increase in value of only around 15%, despite global oil prices rising by over 60% over the same period. Nevertheless, we expect the recent relaxation of OPEC+ production cuts to result in positive annual real oil production for this year. The authorities also expect an increase in oil production in tonnes, which will result in 0.5% growth in 2021 and 3% in 2022. To sum up, both oil exports and overall goods exports are likely to reach their 2019 values (in dollar terms) only in 2022. On the other hand, if the Tengiz oil field completes its enlargement project in time and can start operating with expanded capacity in 2023, then the additional 10% increase in oil production will provide an impetus to economic growth over the medium term.

The performance of gross fixed investments has been mixed, reflecting the continued boom in construction and the decline in investment in the mining sector observed so far. Over January-August 2021, investment grew by 1%, compared to the same period of 2020, owing to the negative contribution of a 22% decline in mining (almost a third of all investments), which almost undid the booming investment in other sectors. The most dynamic growth in investment over the period was observed in construction (150%), manufacturing (80%) and agriculture (43%).

In the medium term, investment is expected to rise on the back of improvements in the mining sector and the continuing government housing and infrastructure programmes. We expect investment in mining to pick up later this year and in 2022, given the favourable global markets and the further growth in housing, transport, water and energy infrastructure construction, due to the priority given to these in the state support programmes for the coming years. Energy infrastructure projects will focus on renewable energy sources. The recent debate on the construction of nuclear power plants to achieve this goal has provoked a mixed public response. Instead of subsidising lending for housing (a programme that expires this year), a new support scheme is to be developed soon, to be managed by the Housing Construction Savings Bank of Kazakhstan. The use of excess pension fund savings for housing (started in 2021) will remain, and those funds will be handled via accounts with the above-mentioned bank.

Fiscal stimuli are likely to persist in the medium term, which will require changes in the public finance system. Traditionally, funding for fiscal packages has occurred through an increase in transfers from the National Oil Fund to the budget,[28] and an additional expansion of the budget deficit. To counteract the depletion of the National Oil Fund reserves, a budgetary rule is to be implemented. In order to cover the generous social fiscal support and meet the active industrial policy needs without swelling the budget deficit, the government envisages improving tax collection and introducing measures to control the volume and efficiency of budget expenditure by the end of 2021. However, amendments to the legislation, with specific measures, have yet to be drawn up. As a first step, it is likely that the collection of various taxes will be transferred to local authorities (after the transfer of the collection of tax on small and medium-sized enterprises netted an extra 25% in 2020).

Despite the ongoing health crisis and the reintroduction of regional containment restrictions, real private consumption growth in 2021 is likely to bounce back almost to 2019 levels, thanks to strong growth in real wages and a return of consumer credit growth. Retail trade recorded annual growth of 6.1% in real terms over the first eight months of 2021, despite restrictions being partially reimposed in several regions following a spike in coronavirus infections in July-August. Although trade has not yet reached the 2019 level, growth is expected to accelerate by the end of the year. Private consumption is supported by rising real wages and consumer lending. The labour market situation is improving. Real wages in the whole economy rose by 9% annually for the first half of the year (albeit unevenly across sectors). Larger gains are visible in finance, trade and communications, thanks to their robust performance; but also in health and education, which were targeted by state support. The cumulated volume of new credits for consumption was 50% higher in January-August 2021 than in the same period of pre-crisis 2019. Consumption growth will remain strong for the coming year, due to the ongoing recovery and the recently announced 50% hike in the minimum wage (from 42,500 to 60,000 tenge) and in public-sector salaries in 2022.

The high rate of inflation is unlikely to be brought under control by the end of this year. Against earlier expectations, the consumer price index picked up to reach 8.9%, year on year, in September 2021 – 1.7 percentage points (pp) above the year's lowest figure for annual inflation (7.2% in April). A rise in food prices in September (11.5% year on year) represented the main driver of annual inflation (a contribution of 4.5 pp). A combination of high global food prices, drought (which has affected domestic agriculture) and market inefficiencies (leading to an increase in the costs of distribution chains) lay behind the upwards trend. For month-on-month growth, the contribution of the food sub-component peaked in June, with a 0.7 pp contribution to the 1% monthly growth (monthly food inflation was far above what would normally be expected). Non-food and services inflation was almost totally responsible for the monthly inflation of 0.5% and 0.4% in August and September. The figures are exacerbated by the revival in demand, as well as by rising global commodity prices, an increase in transportation costs, imported inflation from the country's trading partners (Russia) and high fuel prices (which producers partly pass on to final goods).

Balancing the effects of inflation control measures and new fiscal stimuli, we expect only a gradual slowdown of inflation in the medium term. The central bank reacted with two policy rate hikes, each of 25 basis points, in July and September. Additional state measures to curb food prices are to be expected – especially price control along the value and distribution chains from producer to

28 Those transfers are accounted on the revenue side of the budget; thus they do not augment the budget deficit.

consumer, aimed at creating greater competition and at avoiding additional costs through intermediation along the whole agri-food value chain. On the other hand, new fiscal measures to stimulate investment and consumption in the coming years will make the inflation-containment task more difficult. Additionally, the great uncertainty is related to the balance of global development factors. To sum up, we expect the fight against inflation to still be on the agenda in the years to come.

The low uptake of vaccination suggests that the health crisis will persist next year and will be a negative risk for recovery speed. As of 30 September, just 34.5% of the population of Kazakhstan was fully vaccinated, while an additional 5.7% had had a first dose. However, experience shows that any restrictions on economic activity are likely to be mitigated by additional fiscal support measures.

Given the better-than-expected economic performance, we have revised our forecasts for 2020 upwards. New fiscal stimuli and a full recovery in exports and investments are likely to support further high growth in the medium term. A full recovery in 2021 to the 2019 level is expected for the baseline scenario, and we have revised our real GDP growth forecasts for this year up by 0.4 pp – from 3.5% to 3.9%. Stronger-than-anticipated economic growth in many sectors and a recovery in private consumption (despite restrictions remaining) lie behind this revision. Along with a recovery in oil production and exports, the recently announced new fiscal stimuli for the coming years – consisting of an increase in wages and public investments – will be supportive of real GDP growth of above 4% for 2022 and 2023. An additional impetus to growth in 2023 will come from the expanded oil production in the Tengiz oil field. High inflation (expected to moderate only next year) remains a downside risk for 2021, along with possible fresh lockdowns on account of the low rate of vaccination. Higher-than-expected oil and commodity prices present an upside risk for the development of exports (although they are a downside risk in terms of bringing inflation under control).

Table 4.9 / Kazakhstan: Selected economic indicators

	2018	2019	2020 1)	2020 January-June	2021 January-June	2021 Forecast	2022 Forecast	2023 Forecast
Population, th pers., average	18,276	18,514	18,756	18,696	18,932	19,000	19,200	19,400
Gross domestic product, KZT bn, nom.	61,820	69,533	70,649	28,400	32,265	80,700	89,100	97,700
annual change in % (real)	4.1	4.5	-2.5	-1.8	2.4	3.9	4.2	4.4
GDP/capita (EUR at PPP)	17,740	18,480	18,020	.	.	.	.	.
Consumption of households, KZT bn, nom.	31,514	35,571	36,620	.	.	.	.	.
annual change in % (real)	6.1	6.1	-3.8	.	.	3.7	3.6	3.9
Gross fixed capital form., KZT bn, nom.	13,091	16,318	17,445	.	.	.	.	.
annual change in % (real)	5.4	13.8	-0.3	.	.	2.0	5.5	4.0
Gross industrial production								
annual change in % (real)	4.4	4.1	-0.5	3.1	1.5	2.9	3.8	4.5
Gross agricultural production								
annual change in % (real)	3.5	-0.1	5.7	3.0	3.2	.	.	.
Construction industry								
annual change in % (real)	4.6	13.2	11.6	11.2	11.9	.	.	.
Employed persons, LFS, th, average	8,695	8,781	8,732	8,749	8,793	8,820	8,950	9,070
annual change in %	1.3	1.0	-0.6	0.0	0.5	1.0	1.5	1.3
Unemployed persons, LFS, th, average	444	441	449	448	451	450	450	460
Unemployment rate, LFS, in %, average	4.9	4.8	4.9	4.9	4.9	4.9	4.8	4.8
Reg. unemployment rate, in %, eop	1.0	1.1	1.5	2.0	2.4	.	.	.
Average monthly gross wages, KZT 2)	162,673	186,815	213,003	206,184	241,187	244,300	271,100	297,100
annual change in % (real, gross)	1.7	9.1	6.8	9.2	9.0	6.3	4.0	3.5
Consumer prices, % p.a.	6.0	5.3	6.8	6.4	7.3	7.9	6.7	5.9
Producer prices in industry, % p.a.	19.0	5.1	-8.0	-8.6	22.3	25.0	3.0	3.0
General governm.budget, nat.def., % of GDP								
Revenues	17.5	18.3	20.6	24.9	22.5	18.0	18.5	19.0
Expenditures	18.8	20.2	24.5	27.7	26.0	21.5	21.1	21.0
Deficit (-) / surplus (+)	-1.3	-1.8	-4.0	-2.8	-3.5	-3.5	-2.6	-2.0
General gov.gross debt, nat.def., % of GDP	26.0	24.9	30.5	27.0	28.7	30.5	30.0	30.0
Stock of loans of non-fin.private sector, % p.a.	3.0	5.9	5.5	7.9	12.9	.	.	.
Non-performing loans (NPL), in %, eop	7.4	8.1	6.9	9.0	4.8	.	.	.
Central bank policy rate, % p.a., eop 3)	9.25	9.25	9.00	9.50	9.00	9.50	9.25	8.75
Current account, EUR m 4)	-117	-6,519	-5,681	451	-2,003	-4,600	-3,600	-3,600
Current account in % of GDP	-0.1	-4.0	-3.8	0.7	-3.2	-2.9	-2.0	-1.9
Exports of goods, BOP, EUR m 4)	50,712	51,953	41,437	23,826	22,332	48,500	51,700	54,800
annual change in %	21.1	2.4	-20.2	-6.1	-6.3	17.0	6.6	6.0
Imports of goods, BOP, EUR m 4)	29,030	35,759	32,426	15,018	14,547	32,900	35,200	37,400
annual change in %	7.3	23.2	-9.3	-3.7	-3.1	1.5	7.0	6.3
Exports of services, BOP, EUR m 4)	6,205	6,918	4,411	2,365	2,213	4,700	5,100	5,300
annual change in %	7.8	11.5	-36.2	-24.3	-6.4	6.5	8.5	3.9
Imports of services, BOP, EUR m 4)	10,156	10,238	7,126	3,982	2,794	6,600	7,200	7,500
annual change in %	13.8	0.8	-30.4	-15.9	-29.8	-7.4	9.1	4.2
FDI liabilities, EUR m 4)	71	3,322	6,488	4,386	1,995	4,200	.	.
FDI assets, EUR m 4)	-3,933	-1,944	1,183	617	546	1,200	.	.
Gross reserves of CB excl. gold, EUR m 4)	14,460	9,004	9,827	10,066	11,117	.	.	.
Gross external debt, EUR m 4)	139,732	141,596	133,159	141,966	140,046	141,000	142,500	143,000
Gross external debt, % of GDP	91.9	87.3	88.9	94.7	87.5	88.0	81.0	75.0
Average exchange rate KZT/EUR	406.66	428.51	471.44	444.89	511.27	504	507	513

1) Preliminary. - 2) Excluding small enterprises, engaged in entrepreneurial activity. - 3) One-day (overnight) repo rate. - 4) Converted from USD.

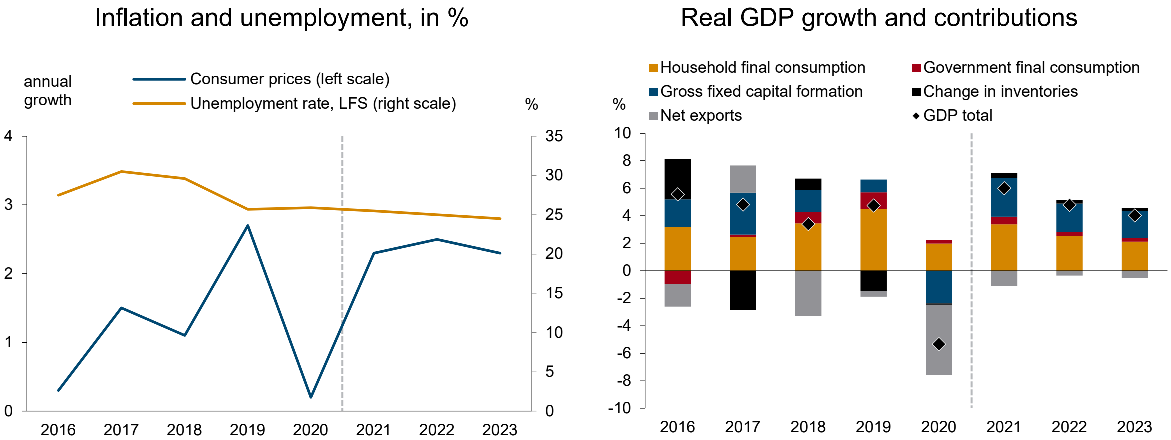
Source: wiiw Databases incorporating national statistics. Forecasts by wiiw.

KOSOVO: Strong growth momentum and reciprocity with Serbia

ISILDA MARA

The economy has recovered quickly to pre-pandemic levels, and this year GDP growth will accelerate to 6%. The momentum is likely to persist and will be backed by strong domestic and external demand. Both consumption and investment will continue to benefit, as remittances flood in. Foreign investors are turning their gaze towards Kosovo: foreign direct investment has kept pace with the positive developments of 2020 and will continue on this path. Exports of goods will maintain their positive trend.

Figure 4.10 / Kosovo: Main macroeconomic indicators



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

Household spending and investment have driven the economy on. In Q2 2021, year on year, GDP growth accelerated to 16.3%, following the 4.2% of Q1. The economy is back in gear, thanks to advances made in all its sectors – apart from real estate activities. The construction sector was an important driver of growth in the first half of 2021, while manufacturing activity picked up in Q2. Information and communication activities have been gaining traction, encouraged by the expanding demand for such activities, not least at the global level. The economic revival reflects a sharp acceleration in both household spending and government consumption (10% and 15%, respectively) in the first half of 2021, year on year; meanwhile, gross fixed capital formation also rose by more than 22% over the same period. In contrast, external demand made a negative contribution to growth: despite a remarkable upsurge in merchandise and services exports in the first half of the year (62% and 56%, respectively), imports also grew substantially.

The vaccination rollout has been very slow, and partial restrictions may have to return. More than 1m doses have been administered, and close to 440,000 people have received two shots – less than 25% of the total population. August was quite a dramatic month, with new daily infections exceeding 2,500. The upsurge of infections coincided with the easing of restrictions, the greater mobility in and out of the country, the tourist season and the return of migrants for the summer holidays. Meanwhile, the COVID-related daily death toll hovered at around 30. However, the wave is receding: the number of daily infections has dropped to around 50 new cases and the daily death toll is below 5. Although new infections are declining, the slow pace of vaccination of the vulnerable population carries with it certain risks that may prompt the government to reintroduce further containment measures, which could hit economic activity for the rest of the year.

Government spending has accelerated, but the fiscal position has improved beyond all expectations. The general government budget has managed to avoid a fiscal deficit – at least up to August, both revenue and expenditure stood at 27.8% of GDP. Revenues surged by 32%, while expenditure rose by 6%. Still, expenditure could pick up by the end of the year, given the EUR 420m recovery plan and the increased subsidies that the government has committed to over the coming months. A number of wage subsidies have been announced for those who lost their jobs during the pandemic: these range from EUR 50 to EUR 150 for a period of three months. Also, child benefits of EUR 24 a month will be introduced for children up to the age of 16. Other means-tested benefits to encourage female employment will be introduced. The year may close with a fiscal deficit that will not swell the public debt (as it did in 2020): this debt is projected to rise from 22% to 23% of GDP.

The financial sector has been supportive, and lending activity has expanded significantly. Lending to households and non-financial sector corporations picked up by 12.5% in the first half of the year, encouraged by an easing of the terms and conditions for new loans. The demand for new loans came mainly from small and medium-sized enterprises seeking fixed investment financing, but also inventories and working capital; this indicates that there has been a recovery in economic activity that will remain solid. Furthermore, the new loans taken out by households are intended as housing loans, rather than consumer credit, suggesting that consumer confidence has been restored. Also, as of 1 October 2021, the government is offering subsidies for consumer credit loans (up to 10% on credit of up to EUR 10,000), with the aim of alleviating the liquidity constraints on households – a manoeuvre that will certainly help the strong consumption momentum to continue.

Inflation has been rising, mainly driven by global trends. Inflation doubled between June and August 2021, to reach 4.7%, year on year. This has been caused by the higher prices for food, electricity, gas and other fuels internationally – and consequently domestically. Over the first eight months of the year, inflation rose by 2% on average. Given that the inflationary pressure stemming from international price dynamics – especially the cost of fuel and energy – will persist, we project that by the end of the year inflation will have reached 2.3% and will rise to 2.5% in 2022.

Employment has been catching up with pre-pandemic levels. The negative effects of the pandemic on the labour market were especially felt in the initial phase, and overall 2020 closed with a 0.2 percentage point rise in unemployment, although close to 20,000 jobs were lost. However, preliminary data from the administrative office suggest that employment has picked up, and by the second half of 2021 had returned to pre-pandemic levels. This upturn has been driven by a number of support schemes introduced by the government to assist access and re-entry to the labour market (EUR 50m), as well as other subsidies offered to companies to relaunch their business activity (EUR 43m). Also, the employment situation has benefited from the bounce-back of those sectors of the economy that are also the main sources of employment – such as construction, manufacturing, wholesale and retail trade – which have been catching up on their pre-pandemic levels.

The diaspora and remittances are keystones of Kosovo's economy and will continue to be supportive this year. In 2020, remittances exceeded EUR 1bn and accounted for almost 15% of GDP; in the first eight months of 2021, the inflow of remittances was 23% higher than in the same period last year. Because of high long-term unemployment (and particularly youth unemployment – one of the highest rates in Europe), remittances are mainly used to smooth consumption and to assist those families and social groups that are most vulnerable and at highest risk of poverty. In July 2021, the current government issued, for the first time, a 'Diaspora Bond' to the value of EUR 20m, with a maturity of three or five years and an interest rate of 1.2% and 2.4%, respectively. The amount that can be invested ranges from EUR 10,000 to EUR 500,000. The capital invested in these bonds by emigrants will be used for strategic investment projects that generate employment. This initiative seeks to boost the role of the diaspora and ensure that its financial support creates the momentum for investment and job creation.

External demand has grown hugely and will remain solid. External demand – for exports of both goods and services – has been growing. Especially goods exports have maintained the momentum of 2020, rising by over 62% in the first half of the year. However, when we consider the net trade balance, their effect is overshadowed by Kosovo's heavy dependence on imports. Brexit seems to have had a positive effect on goods exports from Kosovo: up to August 2021, the UK was the country that Kosovo exported most to – almost six times more than in the same period of 2020; previously, exports to the UK had been almost non-existent. Exports to Germany and Italy have also been increasing rapidly. Of the neighbouring countries, Albania continued to have the same weight, while exports to North Macedonia more than doubled to reach 30% of Kosovo's total exports to neighbouring Western Balkan countries. As the upturn in imports was also quite strong (41%), the current account deficit widened to 12% of GDP in the first half of the year. In particular, imports from Serbia have gained momentum – more than doubling in the period January-August 2021, year on year – and seem to have re-established their market share in Kosovo, following the abolition in March 2020 of the 100% tariff on Serbian imports.

Foreign investors are turning their gaze towards Kosovo. During the first pandemic year, foreign direct investment (FDI) in Kosovo rose by 40% to EUR 345m (5% of GDP). This year looks even better: foreign capital investment in Kosovo in the first seven months of the year was greater than the total amount invested in 2019 – and 33% higher than in the first seven months of 2020. The FDI pouring into the country originated mainly in Germany, Switzerland, Austria, Albania and the USA. Germany has been the main foreign investor, having invested EUR 56m up to July 2021 – 46% more than in the same period of 2020. Also, Austrian investment in Kosovo rose significantly – up 68% to EUR 26m over the same period. The sectors of the economy that have mainly attracted FDI are real estate, information and communications, and financial and insurance activities. Certainly, Kosovo is benefiting from the difficulties that emerged due to supply-chain disruptions after the start of the pandemic. Apart becoming a magnet for investment from EU countries, it has also succeeded in attracting FDI in certain sectors where demand is high at the global level – e.g. information and communications technology services. This could become an important source of employment, especially for young people.

The Kurti government is committed to reciprocity in its dealings with Serbia. The last days of September were quite chilly for Kosovo-Serbia relations. The reason was a dispute over vehicle licence plates and the state symbols used on them. The free-movement agreement between the countries reached 10 years ago stipulated that vehicles in Kosovo should use number plates issued by the Interior Ministry of Kosovo – with the symbol of Kosovo – replacing those issued previously by the Interior Ministry of Serbia. All this time, Serbia has refused to recognise these plates, so that any vehicles from Kosovo that enter Serbia are expected to affix temporary licence plates. On 20 September, Kosovo decided to apply the same rules to vehicles from Serbia that enter Kosovo. This decision sparked tension between the two. Local Serbs organised protests and blocked two border crossings in the north of Kosovo. The situation escalated, with the mobilisation of special police forces in Kosovo, the NATO-led Kosovo Force (KFOR) and armed forces in Serbia at the border between the two countries. Thanks to mediation by Brussels, a temporary solution was found, and from 2 October 2021 both countries will use stickers – rather than temporary plates – when crossing the border.

The economy will continue to recover steadily. Already, in the first half of 2021 economic activity had caught up with pre-pandemic levels. The main driver of growth will continue to be solid domestic demand. External and near-shore demand will expand further, and especially FDI from Germany and other European countries may well continue on an upward trajectory. Consumption will stay solid, as remittances continue to flood into the country. Given the strong growth momentum, we have revised our GDP forecast for this year upwards – from 5.3% to 6%.

Table 4.10 / Kosovo: Selected economic indicators

	2018	2019	2020 1)	2020	2021	2021	2022	2023
				January-June		Forecast		
Population, th pers., average	1,797	1,789	1,790	.	.	1,795	1,798	1,800
Gross domestic product, EUR m, nom. 2)	6,672	7,056	6,772	3,145	3,540	7,300	7,800	8,300
annual change in % (real)	3.4	4.8	-5.3	-4.3	10.5	6.0	4.8	4.0
GDP/capita (EUR at PPP)	7510	7970	7760	.	.	.	.	.
Consumption of households, EUR m, nom. 2)	5,296	5,621	5,720	2,759	3,105	.	.	.
annual change in % (real)	4.4	5.7	2.5	1.0	9.8	4.0	3.0	2.5
Gross fixed capital form., EUR m, nom.	2,116	2,190	2,012	.	.	.	.	.
annual change in % (real)	5.4	2.9	-7.6	.	.	9.5	7.0	6.5
Gross industrial production 3)								
annual change in % (real)	-1.3	6.3	0.8	-8.9	32	8.0	5.0	4.0
Gross agricultural production								
annual change in % (real)	-8.8	9.5	2.7	.	.	.	.	.
Construction output 4)								
annual change in % (real)	1.5	1.5	-9.0	.	.	.	.	.
Employed persons, LFS, th, average 5)	345.1	363.2	347.1	.	.	364	371	378
annual change in %	-3.4	5.2	-4.4	.	.	5.0	2.0	2.0
Unemployed persons, LFS, th, average 5)	145.0	125.3	121.4	.	.	120	120	120
Unemployment rate, LFS, in %, average 5)	29.6	25.7	25.9	.	.	25.5	25.0	24.5
Reg. unemployment rate, in %, eop	.	.	.	.	.	.	.	.
Average monthly gross wages, EUR	453	477	466	.	.	490	510	530
annual change in % (real, gross)	6.1	8.7	6.0	.	.	3.0	2.0	2.0
Average monthly net wages, EUR	409	430	416	.	.	440	460	480
annual change in % (real, net)	3.7	2.4	-3.4	.	.	3.0	2.0	2.0
Consumer prices (HICP), % p.a.	1.1	2.7	0.2	0.6	1.3	2.3	2.5	2.3
Producer prices, % p.a.	1.4	0.9	-0.6	-0.8	2.8	1.4	1.5	1.7
General governm.budget, nat.def., % of GDP								
Revenues	26.3	26.8	25.4	24.2	27.8	28.0	29.0	30.0
Expenditures	29.2	29.7	33.0	28.3	27.8	30.0	31.0	31.0
Deficit (-) / surplus (+)	-2.9	-2.9	-7.6	-4.2	-0.1	-2.0	-2.0	-1.0
General gov.gross debt, nat.def., % of GDP	16.4	17.0	22.0	18.2	23.2	23.0	23.0	22.5
Stock of loans of non-fin.private sector, % p.a.	10.8	10.0	7.1	6.4	12.2	.	.	.
Non-performing loans (NPL), in %, eop	2.7	2.0	2.7	2.6	2.5	.	.	.
Central bank policy rate, % p.a., eop 6)	5.99	6.42	6.01	6.3	6.0	6.00	6.00	6.00
Current account, EUR m	-509	-399	-481	-217	-450	-610	-630	-600
Current account, % of GDP	-7.6	-5.7	-7.1	-6.9	-12.7	-8.4	-8.1	-7.2
Exports of goods, BOP, EUR m	377	393	475	213	344	580	630	670
annual change in %	-0.4	4.4	20.8	16.7	61.6	23.0	8.5	6.0
Imports of goods, BOP, EUR m	3,114	3,233	3,048	1,352	1,912	3,400	3,540	3,680
annual change in %	9.6	3.8	-5.7	-8.9	41.4	11.5	4.0	4.0
Exports of services, BOP, EUR m	1,562	1,675	994	396	616	1,180	1,260	1,340
annual change in %	14.9	7.3	-40.7	-32.5	55.6	19.0	7.0	6.0
Imports of services, BOP, EUR m	706	749	602	247	335	650	700	730
annual change in %	32.8	6.1	-19.6	-15.9	35.9	8.0	7.0	4.0
FDI liabilities, EUR mn	272	255	342	174	230	400	.	.
FDI assets, EUR mn	46	66	59	17	38	10	.	.
Gross reserves of CB excl. gold, EUR m	769	864	901	900	947	.	.	.
Gross external debt, EUR m	2,036	2,201	2,517	2,259	2,691	2,700	2,600	2,500
Gross external debt, % of GDP	30.5	31.2	37.2	33.4	36.9	37.0	33.0	30.0

1) Preliminary. - 2) Half-year data unrevised. - 3) Turnover in manufacturing industry (NACE C). - 4) Value added. - 5) Population 15-64. - 6) Average weighted effective lending interest rate of commercial banks (Kosovo uses the euro as national currency).

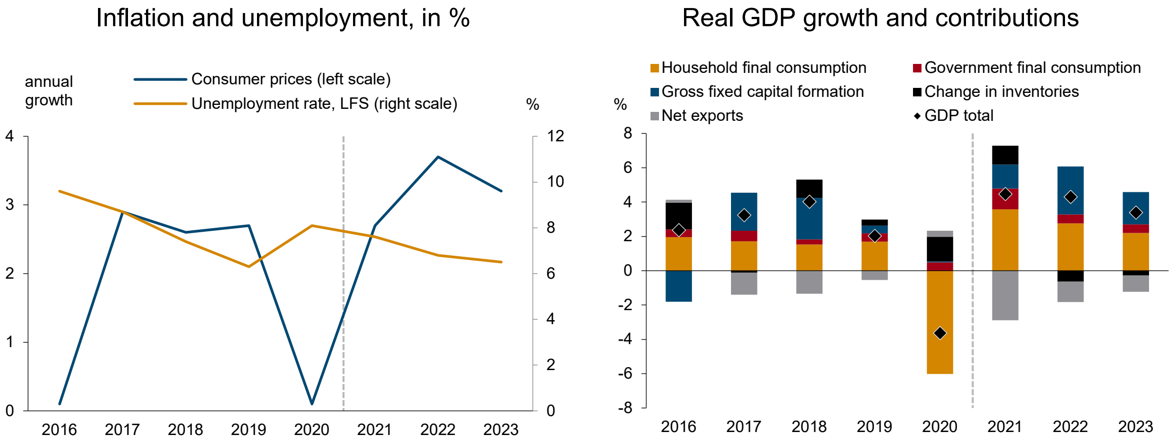
Source: wiiw Databases incorporating national statistics. Forecasts by wiiw.

LATVIA: Faster recovery than expected, driven by release of pent-up demand

SEBASTIAN LEITNER

Following a relatively mild recession in 2020, the Latvian economy is experiencing a remarkably strong revival in 2021. Household consumption has recouped most of the 10% loss it experienced last year, while enterprises are replenishing their depleted stocks. Public consumption and investment are acting as a growth driver, and external demand has similarly rebounded. In 2021, we expect GDP growth to increase to 4.5% and to remain strong in 2022 (4.3%). That will be followed by a somewhat gentler increase of 3.4% in 2023.

Figure 4.11 / Latvia: Main macroeconomic indicators



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

Following a further decline in economic activity during the lockdown phase in the early months of this year, GDP bounced back strongly in Q2 2021 (+11.1% year on year). By mid-2021, the level of economic activity in most sectors had reached or surpassed that seen in 2019. Only transport and the hospitality and leisure sectors were (understandably) still lagging behind. With household consumption, foreign trade and investment again flourishing, a period of strong recovery is the baseline scenario for the forecast period 2021-2023.

Yet, risks are building that the approaching fourth wave of COVID-19 will have an adverse effect on the economy. Now, at the beginning of October, COVID-19 infections have already started to escalate, and there has been a big surge in coronavirus-related deaths in Latvia (as indeed throughout the Baltic states and in the south east of the EU). By the end of autumn, another lockdown could be inevitable. Progress with vaccination in Latvia is rather slow: by the beginning of October, only about 40% of the total population was fully vaccinated against COVID-19 (within the EU, only Bulgaria and

Romania have lower figures). Thus, harsher restrictions are likely to become necessary again to contain the spread of infections, given that the capacity of intensive care will probably be stretched not only this year, but throughout 2022. Declining business sentiment indicators – among both enterprises and consumers – were already reflecting increased concern in September 2021. This underlines the need to support economic activity through fiscal measures, comprising investments and income support alike, until the recovery is firmly established.

Compared to Q2 2020, when foreign trade collapsed, exports of goods this year have witnessed a strong – and unexpectedly rapid – recovery. In January-July 2021, there was a surge in foreign demand, particularly for mineral products, iron and steel, machinery and equipment, chemical and wood products. At the same time, imports of goods rebounded even more strongly: while the revival of commodity prices played a part, imports also increased in volume terms. Nevertheless, we expect the current account to remain positive this year, before turning negative in 2022 and 2023 due to the continuing economic upswing. In general, we expect growth in goods exports to decline slightly, following the rebound this year, and imports to pick up in line with household consumption. Compared to trade in goods, trade in services has rallied much more slowly. Exports of transport services, which fell by a third in 2020, only stabilised at that level in the first half of 2021. Income from travel declined further in the same period, to 20% of the pre-crisis (2019) level. ICT and other business services, which remained buoyant last year, have both gained further momentum in 2021.

Investment has bounced back substantially in 2021, following the flat line of 2020. Last year's stasis in investment was rather surprising: most other EU countries witnessed a steep decline. As expected, investment in real estate fell this year, particularly in residential buildings. However, the most recent rebound in housing prices, in line with overall demand from households, has resulted in an increase in construction projects in the pipeline: building permits granted in Q2 2021 are back at the level of 2019. There has also been a strong recovery in the number of projects commissioned by the public sector. Meanwhile, the household sector, which last year was cautious and preferred to build up its savings stock, is again taking out more credit, particularly mortgage loans. According to the latest figures, the loan stock of the enterprise sector, which fell by more than 10% in 2020, remains stagnant. This is another indication that the government needs to offer some economic stimulus to improve business sentiment.

Following the second lockdown, household consumption picked up strongly in Q2 2021. Retail trade figures show that a big backlog in demand for durable and non-durable goods will likely result in increased spending in the second half of 2021 and 2022. Thus, household consumption will again become the most important driver of growth in the Latvian economy.

The budget plan of the Latvian government envisages expenditure to support workers and enterprises that would lead to a deficit of 9% of GDP in 2021. Given the strong revival of the economy, these funds will most likely not be fully tapped. Meanwhile, the steady provision of loans, state guarantees and public investment in ailing businesses, plus the financing of short-time work schemes, is allowing the recovery to get firmly established. The preliminary budget for 2022 envisages wage increases for employees in health, education and the so-called 'interior sector' (which includes the police and other emergency services, etc.). Additional funds will be provided for regional and municipal development, while the budget deficit is expected to attain 4% of GDP in 2022. An important measure to relieve low wage earners is to raise non-taxable minimum income from EUR 300 in 2021 to EUR 500 in June 2022.

Employment recovered to pre-crisis levels in most sectors in Q2 2021, and vacancies are on the rise. Substantial job losses are still being recorded in accommodation and hospitality, transport and construction. Following the money-laundering scandal that erupted in the Latvian banking sector in 2018, employment in financial services has gradually declined over the past three years. The overall loss in employment has been cushioned by the short-time working schemes introduced by the government. About 5% of jobs (which would most probably have been lost otherwise) were supported by government measures in February of this year (in the second lockdown), and 2% were still being supported in June 2021. The SURE loan facility of the European Commission, which is designed to help finance short-time work schemes, was increased for Latvia towards the end of March 2021 to slightly over EUR 300m. The unemployment rate rose to 8.1% in 2020 on average, but has declined slightly in recent months. We expect the situation on the labour market to improve in the coming quarters, and the unemployment rate to decline gradually to its pre-crisis level over the next three years.

The slowdown in wage growth experienced in 2020 was fairly short lived; salaries are likely to rise sharply in 2021, by 8% in real terms. One important reason for this is the hike in the national minimum wage, from EUR 430 to EUR 500 a month, in January 2021. Within the EU, Latvia's minimum wage level only exceeds those of Bulgaria, Romania and Hungary. The revival in vacancy rates shows the scarcity of skilled labour; thus, wage growth will remain strong throughout the forecast period, while the planned increase in the non-taxable minimum wage will further strengthen the purchasing power of households.

Following a deflationary period in 2021, consumer prices started to pick up in Q2 2021. Global energy prices have soared, pushing up the domestic prices of fuel, heating, gas and electricity. We expect inflation to peak in 2022 at 3.7% and thereafter to decline somewhat, once commodity prices calm down again.

All in all, since our previous interim update in the summer, we have increased the forecast GDP growth rate for 2021 significantly – from 3.2% to 4.5%. External demand has rebounded quickly following this year's second lockdown, and capacity utilisation levels in the economy have almost returned to the peak levels of 2019. On the other hand, the release of pent-up demand has resulted in soaring household consumption and rapidly rising stocks of enterprises. However, the perils of the fourth wave of infections (and the almost inevitable restrictions) may attenuate the ongoing recovery. Still, our base scenario is for a further strong growth in demand in 2022. The government is prepared to offer further support to ailing enterprises and workers, and will increase its investments next year to support economic growth. Household incomes will continue to rise, spurred by a reduced income tax burden. Thus, private consumption will again grow steadily. The unemployment rate will fall more markedly only from 2022 onwards. We forecast GDP growth of 4.5% for 2021; in 2022, external and domestic demand should keep real GDP growth at 4.3%.

Table 4.11 / Latvia: Selected economic indicators

	2018	2019	2020 1)	2020	2021	2021	2022	2023
				January-June			Forecast	
Population, th pers., average	1,927	1,914	1,900	1,918	1,906	1,890	1,885	1,880
Gross domestic product, EUR m, nom.	29,143	30,421	29,334	13,613	14,847	31,500	34,100	36,400
annual change in % (real)	4.0	2.0	-3.6	-5.3	5.1	4.5	4.3	3.4
GDP/capita (EUR at PPP)	20,890	21,500	21,400	.	.	.	.	.
Consumption of households, EUR m, nom.	16,839	17,845	16,147	7,737	8,101	.	.	.
annual change in % (real)	2.6	2.9	-10.3	-12.6	3.5	6.5	5.0	4.0
Gross fixed capital form., EUR m, nom.	6,449	6,758	6,868	2,881	3,036	.	.	.
annual change in % (real)	11.8	2.1	0.2	-0.7	4.0	6.0	12.0	8.0
Gross industrial production 2)								
annual change in % (real)	1.5	0.9	-1.5	-3.6	8.1	7.0	6.0	4.0
Gross agricultural production								
annual change in % (real)	-9.0	21.0	3.7	.	.	.	.	.
Construction industry								
annual change in % (real)	21.8	2.9	2.7	5.5	-4.7	.	.	.
Employed persons, LFS, th, average 3)	909.4	910.0	893.0	896.8	862.5	870	870	870
annual change in %	1.6	0.1	-1.9	-0.9	.	-3.0	0.6	0.6
Unemployed persons, LFS, th, average 3)	72.8	61.3	78.7	78.9	74.1	72	63	60
Unemployment rate, LFS, in %, average 3)	7.4	6.3	8.1	8.1	8.0	7.6	6.8	6.5
Reg. unemployment rate, in %, eop 4)	6.4	6.2	7.7	8.6	7.4	.	.	.
Average monthly gross wages, EUR	1,004	1,076	1,143	1,112	1,222	1,270	1,410	1,540
annual change in % (real, gross)	5.7	4.2	4.0	4.7	8.7	8.0	7.0	6.0
Average monthly net wages, EUR	742	793	841	820	903	930	1,030	1,130
annual change in % (real, net)	7.0	3.9	4.0	4.6	8.8	8.0	7.0	6.0
Consumer prices (HICP), % p.a.	2.6	2.7	0.1	0.6	1.1	2.7	3.7	3.2
Producer prices in industry, % p.a.	4.3	1.8	-2.2	-2.2	4.9	5.5	4.0	3.0
General governm.budget, EU-def., % of GDP								
Revenues	38.6	37.8	39.1	.	.	36.3	36.5	36.5
Expenditures	39.4	38.4	43.6	.	.	44.3	40.5	38.5
Net lending (+) / net borrowing (-)	-0.8	-0.6	-4.5	.	.	-8.0	-4.0	-2.0
General gov.gross debt, EU def., % of GDP	37.1	37.0	43.5	.	.	49.0	50.5	48.0
Stock of loans of non-fin.private sector, % p.a.	-5.2	-1.4	-3.8	-4.3	-1.4	.	.	.
Non-performing loans (NPL), in %, eop 5)	5.3	5.1	3.1	3.8	3.2	.	.	.
Central bank policy rate, % p.a., eop 6)	0.00	0.00	0.00	0.00	0.00	.	.	.
Current account, EUR m	-60	-203	845	306	-652	-1,000	-900	-750
Current account, % of GDP	-0.2	-0.7	2.9	2.2	-4.4	-3.2	-2.6	-2.1
Exports of goods, BOP, EUR m	12,588	12,761	13,428	6,183	7288	15,000	16,100	17,700
annual change in %	8.3	1.4	5.2	-0.9	17.9	11.7	7.3	9.9
Imports of goods, BOP, EUR m	15,108	15,403	14,917	6,962	8422	17,600	19,200	20,800
annual change in %	7.4	2.0	-3.2	-6.9	21.0	18.0	9.1	8.3
Exports of services, BOP, EUR m	5,336	5,577	4,375	2,137	2156	4,400	5,000	5,600
annual change in %	6.9	4.5	-21.6	-19.6	0.9	0.6	13.6	12.0
Imports of services, BOP, EUR m	3,019	3,151	2,541	1,205	1340	2,800	3,150	3,600
annual change in %	11.2	4.4	-19.4	-19.3	11.2	10.2	12.5	14.3
FDI liabilities, EUR m	373	975	820	313	914	1400	.	.
FDI assets, EUR m	-269	78	166	55	-86	-200	.	.
Gross reserves of CB excl. gold, EUR m	3,578	3,700	3,982	3,882	4,124	.	.	.
Gross external debt, EUR m	35,942	35,802	36,775	36,763	36,260	39,400	40,900	43,700
Gross external debt, % of GDP	123.3	117.7	125.4	125.3	115.1	125.0	120.0	120.0

1) Preliminary. - 2) Enterprises with 20 and more employees. - 3) From 2021 the new LFS methodology is applied in line with the Integrated European Social Statistics Regulation (IESS). - 4) In % of labour force (LFS). - 5) Loans more than 90 days overdue, and from 2018 also including loans unlikely to be paid. - 6) Official refinancing operation rates for euro area (ECB).

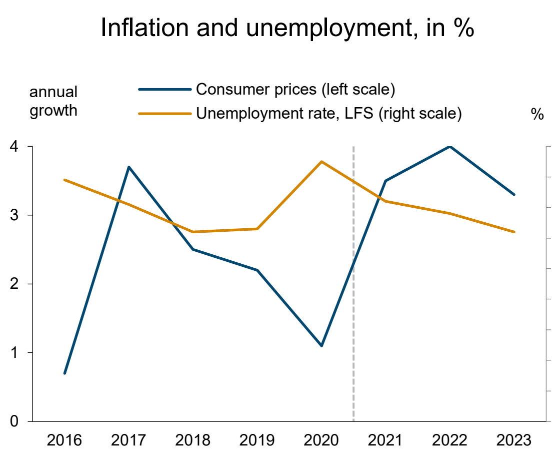
Source: wiiw Databases incorporating Eurostat and national statistics. Forecasts by wiiw.

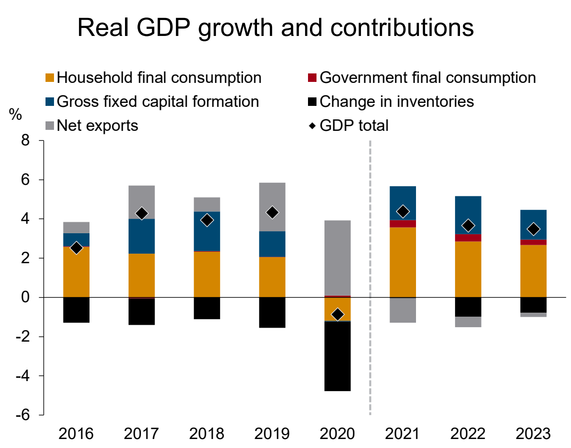
LITHUANIA: After the storm, the prospects are bright

SEBASTIAN LEITNER

The Lithuanian economy recovered strongly in Q2 2021. Better-than-expected export performance and swiftly rebounding household consumption were coupled with an upswing in capital investment and a substantial accumulation of stocks. Sharply rising infection statistics may force the government to reintroduce stricter containment measures, but we do not expect that to choke off the ongoing revival. The government is continuing to deliver substantial fiscal stimuli, and the public investments announced will support recovery over the next two years. For 2021, we expect real GDP to grow by 4.4%, followed by a strong, steady increase of 3.7% in 2022 and 3.5% in 2023.

Figure 4.12 / Lithuania: Main macroeconomic indicators





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

With COVID-19 infections and related deaths rising rapidly in Lithuania, the government was forced to reintroduce restrictions in mid-September – however, these largely affect only unvaccinated persons. At the beginning of October, the European Centre for Disease Prevention and Control ranked Lithuania second highest on its list of countries by epidemiological risk. In particular, the maximum capacity of intensive care may be reached by late autumn. The number of beds for COVID-19 patients has increased; however, skilled personnel are in short supply. Thus, even harsher lockdown measures may need to be reintroduced. At the same time, Lithuania is one of the most successful EU-CEE countries in terms of its vaccination programme: by the beginning of October, close to 60% of the total population had been fully vaccinated.

Compared to other EU countries, goods exports did not fall much last year (-1.6% in nominal terms); nevertheless, the first half of 2021 saw a substantial hike of 21.7%. In a few product categories with a high share of value added of Lithuanian origin, the growth rates were substantial: pharmaceuticals, plastics, chemical and refined petroleum products, metals and furniture. Like exports, total industrial production also rebounded strongly: from January to August 2021, real growth attained almost 17% year on year. At the same time, capacity utilisation reached an all-time high in the Lithuanian economy. Goods imports have picked up even more strongly, as businesses have sought to replenish their depleted stocks. Trade in services has likewise bounced back: exports attained a level last seen in 2019, and the service account surplus amounts to almost 10% of GDP. With the slump in domestic demand, the current account surplus jumped to an unprecedented 8% of GDP last year; this year and in 2022, we expect the surplus to remain at above 2% of GDP.

In September 2021, the Lithuanian government started to build a fence along its eastern border with Belarus, in order to keep refugees from entering the country. Following economic sanctions by the EU against the government of Belarus and the country's enterprises, migration has increased substantially: whereas in the previous four years, only about 100 individuals (or even fewer) had crossed the Belarus-Lithuania border in search of asylum annually, in the first half of 2021 over 4,000 refugees, mainly from Iraq, arrived via that route. The Lithuanian government has asked the EU to revise its migration policy and legalise the pushback of migrants; such action has already been taken by Lithuanian forces and has been criticised by EU and NGO observers. Erection of the fence along the 670 km border is due to be completed by September 2022. The EU sanctions against Belarus (particularly on its potash products) affect Lithuania's transport sector, especially its railways and ports. The estimated economic loss may attain about 0.5% of GDP annually.

Following quite a slight decline in 2020 overall, investment activity has revived strongly this year. Business is again spending heavily on machinery, equipment and vehicles. Looking ahead, we expect a sharp increase in overall investment, as the public sector in particular acts as an engine of growth. Investment by households in real estate is again increasing this year, according to the latest figures on dwelling construction and building permits. House prices are continuing to grow and were not even depressed in 2020. After a slump in Q2 2020, new mortgage loans have also continued to rise. Since incomes are rising steadily, the robust demand for real estate is likely to continue.

The government's substantial fiscal support initiatives are expected to result in a budget deficit of 6.2% in 2021, down from 7.4% in 2020. The measures cover wage subsidies for affected firms, additional public investment, loan guarantees and support for the health sector and agriculture. At the beginning of 2021, during the second lockdown, more than 10% of Lithuanian employees were supported by short-time work measures (as in the first lockdown of March-May 2020). In the medium term, the Lithuanian government has ample resources available to invest in the recovery and restructuring of the economy. As in the previous planning period (2014-2020), the annual inflow of EU funds (including from the Next Generation EU recovery package) in 2021-2027 will amount to about 4% of Lithuanian GDP. About a third of the funds are earmarked for agriculture and fisheries, and about 20% for climate-related projects. There is a further focus on digital transformation, health, science and innovation, education and social issues. The biggest single investment project is Rail Baltica, the high-speed rail service linking the capital of Estonia (Tallinn) with Latvia, Lithuania and Poland. The main construction work on the railway line will take place in 2022-2026. More than 80% of the cost is covered by EU capital.

In many sectors, employment in Q2 2021 already surpassed the pre-crisis levels of 2019. This is particularly the case in business services and manufacturing. The job losses sustained in hospitality services, domestic trade and agriculture will persist for some time yet (though jobs in construction are growing again). We expect the growth in total employment that has already begun this year to gain momentum in 2022. The increase in vacancies in the business sector indicates that demand for skilled labour is even higher today than it was in pre-crisis Lithuania. The unemployment rate has already declined and is likely to drop to 7.2% in 2021 on average. We expect this rate to fall to 6.2% in 2022. Net migration into Lithuania remains positive; however, more is needed to compensate for the adverse natural demographic trend and to provide workers for the growing economy.

Following a remarkable rise of 6.6% in January 2021, the government is planning another massive hike in the minimum wage in 2022 – of more than 13%, to EUR 730 a month. Taken together, these measures will deliver a huge impetus to overall income growth that – alongside a tighter labour market – will result in wages increasing by about 10% this year and in 2022. Last year household consumption declined markedly only during the first lockdown. The release of last year's pent-up demand resulted in private consumption increasing by more than 13% in real terms in Q2 2021. Consumer surveys show household confidence to be robust in early autumn 2021. Over 2021 as a whole, we expect a rise in consumer demand of 6%; and in the coming two years we anticipate a high propensity for households to spend their rapidly growing income.

Due to the upsurge in international energy costs, consumer prices picked up strongly this year and will attain 3.5% in 2021. The substantial growth in wages will further push inflation upwards to 4% next year. Thereafter, in 2023, we expect price rises to slow to 3.3% per year.

Since our previous interim report in the summer, the faster recovery has allowed us to improve our GDP forecast for 2021 to 4.4%. And in 2022, we expect the strong recovery to continue at 3.7%. In terms of both external and domestic demand, growth in Q2 2021 picked up much faster than anticipated. Exports have increased substantially this year; however, imports have revived even more rapidly, as entrepreneurs ran down their stocks in 2020. Public investment has picked up strongly in 2021, and that will continue in coming years. Sharply rising household incomes – pushed upwards by increases in the minimum wage – will help private consumption to grow steadily again. Thus, we expect GDP growth to be 4.4% in 2021 and 3.7% in 2022, and to continue in 2023 at a rapid 3.5%.

Table 4.12 / Lithuania: Selected economic indicators

	2018	2019	2020 1)	2020 January-June	2021 January-June	2021 Forecast	2022 Forecast	2023 Forecast
Population, th pers., average	2,802	2,794	2,795	2,801	2,794	2,780	2,770	2,760
Gross domestic product, EUR m, nom.	45,491	48,809	48,930	22,799	25,052	52,900	57,000	60,900
annual change in % (real)	3.9	4.3	-0.9	-1.2	4.7	4.4	3.7	3.5
GDP/capita (EUR at PPP)	24,640	26,040	25,880	.	.	.	.	.
Consumption of households, EUR m, nom.	27,903	29,445	29,105	13,743	15,002	.	.	.
annual change in % (real)	3.8	3.3	-2.0	-4.1	7.0	6.0	4.8	4.5
Gross fixed capital form., EUR m, nom.	9,531	10,429	10,585	4,620	5,483	.	.	.
annual change in % (real)	10.0	6.2	-0.2	-4.6	14.8	8.0	9.0	7.0
Gross industrial production (sales)								
annual change in % (real)	4.8	3.4	-1.8	-4.7	17.0	14.5	7.0	4.0
Gross agricultural production								
annual change in % (real)	-10.0	10.1	10.6	.	.	.	.	.
Construction industry								
annual change in % (real)	13.8	8.4	-1.6	-1.8	1.8	.	.	.
Employed persons, LFS, th, average	1,375	1,378	1,358	1,369	1,356	1,350	1,360	1,360
annual change in %	1.5	0.3	-1.5	-0.7	-0.9	-0.5	0.5	0.4
Unemployed persons, LFS, th, average	90	92	126	116	109	105	99	90
Unemployment rate, LFS, in %, average	6.2	6.3	8.5	7.9	7.5	7.2	6.8	6.2
Reg. unemployment rate, in %, eop 2)	8.9	8.7	16.1	12.1	12.9	.	.	.
Average monthly gross wages, EUR 3)	924	1,296	1,429	1,379	1,530	1,630	1,860	2,050
annual change in % (real, gross)	7.1	6.4	8.3	7.2	11.0	10.0	10.0	6.5
Average monthly net wages, EUR 3)	720	822	913	878	974	1,040	1,190	1,310
annual change in % (real, net)	6.2	11.6	9.3	7.5	10.9	10.0	10.0	6.5
Consumer prices (HICP), % p.a.	2.5	2.2	1.1	1.5	2.0	3.5	4.0	3.3
Producer prices in industry, % p.a.	5.6	0.0	-9.0	-8.8	4.2	6.0	3.0	4.0
General governm.budget, EU-def., % of GDP								
Revenues	34.5	35.1	36.0	.	.	35.0	34.8	35.0
Expenditures	33.8	34.6	43.4	.	.	41.2	38.8	37.5
Net lending (+) / net borrowing (-)	0.6	0.5	-7.4	.	.	-6.2	-4.0	-2.5
General gov.gross debt, EU def., % of GDP	33.7	35.9	47.1	.	.	49.0	49.0	48.0
Stock of loans of non-fin.private sector, % p.a.	6.0	3.3	-1.8	0.0	3.1	.	.	.
Non-performing loans (NPL), in %, eop	2.4	1.6	1.3	.	.	.	.	.
Central bank policy rate, % p.a., eop 4)	0.00	0.00	0.00	0.00	0.00	.	.	.
Current account, EUR m	132	1,702	3,633	1,639	603	1,300	1,200	1,200
Current account, % of GDP	0.3	3.5	7.4	7.2	2.4	2.5	2.1	2.0
Exports of goods, BOP, EUR m	24,552	25,954	25,536	11,721	14,301	29,200	31,000	32,500
annual change in %	7.9	5.7	-1.6	-6.9	22.0	14.4	6.2	4.8
Imports of goods, BOP, EUR m	27,398	28,303	25,938	12,067	15,490	31,300	33,900	36,000
annual change in %	10.4	3.3	-8.4	-13.8	28.4	20.7	8.3	6.2
Exports of services, BOP, EUR m	9,678	11,822	10,853	5,242	5,941	11,600	12,900	14,600
annual change in %	15.9	22.2	-8.2	-5.8	13.3	6.9	11.2	13.2
Imports of services, BOP, EUR m	6,003	6,902	5,854	2,857	3,341	6,400	7,300	8,400
annual change in %	12.9	15.0	-15.2	-12.9	16.9	9.3	14.1	15.1
FDI liabilities, EUR m	1,096	3,060	3,979	2,849	131	100	.	.
FDI assets, EUR m	866	1,921	3,438	2,797	-49	200	.	.
Gross reserves of CB excl. gold, EUR m	4,831	4,273	3,662	3,934	4,244	.	.	.
Gross external debt, EUR m	35,619	34,266	37,457	35,601	38,731	38,600	39,900	40,800
Gross external debt, % of GDP	78.3	70.2	76.6	72.8	73.2	73.0	70.0	67.0

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

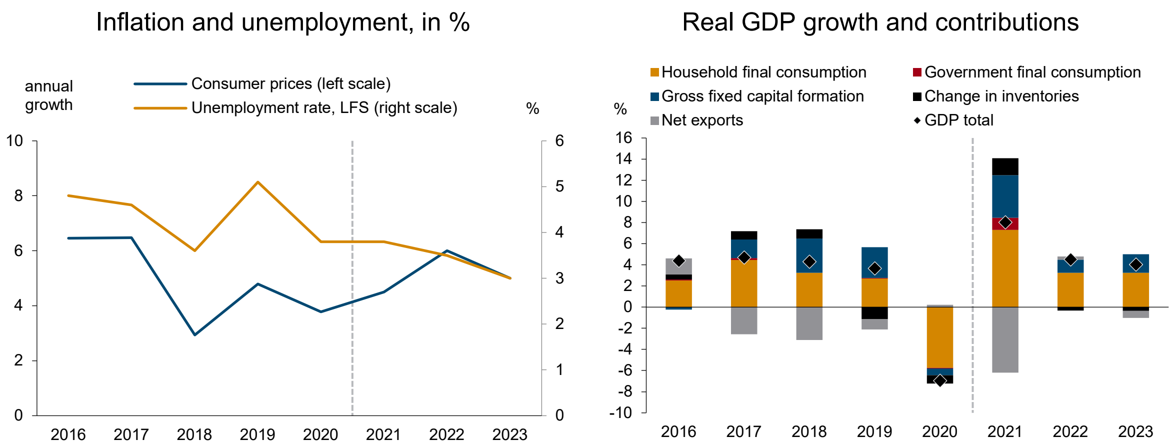
Source: wiiw Databases incorporating Eurostat and national statistics. Forecasts by wiiw.

MOLDOVA: Reorientation towards the West

GÁBOR HUNYA

The economy will grow by 8% in 2021, against the 7% contraction of the previous year, bringing real GDP back to the pre-crisis level of 2019. The new western-oriented and reform-minded government enjoys overwhelming support in parliament and is able to attract ample foreign funds to finance the expansion of the fiscal and current account deficits.

Figure 4.13 / Moldova: Main macroeconomic indicators



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

GDP bounced back in the first half of 2021 by 11.7%, from the depressed level of the previous year, when it fell by 7.2%. The current recovery has been very uneven by activity and use categories. Household consumption grew by more than 11%, and gross fixed capital formation expanded by 20% – far more rapid growth than the decline a year previously. Net exports, on the other hand, made a huge negative contribution to GDP growth, counteracting the expansion of domestic demand. We expect the same trends to continue in the second half of 2021, albeit at a more modest rate (largely due to base effects) leading to overall GDP growth of 8% in 2021.

Industrial production expanded by 14% in the first half of 2021, after a decline of 7% in the same period of 2020. The production of consumer goods grew rapidly, while it was slower in the main export industries, including food and car parts. Falling production and the declining export of agricultural products were the result of a bad harvest in 2020. The production of iron and steel and of electricity from Transnistrian plants rose significantly, buoyed by international demand. The foreign trade balance may improve in the second half of the year on account of a bumper grain harvest, which promises a recovery in agricultural exports. Nevertheless, the export structure will continue to shift to machinery and transport equipment, which accounted for 25% of exports in the first half of the year. The main export market is the EU, with 70% – most prominently Romania, which offers an expanding market for Moldovan products.

Improved economic performance has supported public revenues, which, in turn, have been spent on underpinning the economic recovery. In early October, parliament adopted amendments increasing revenue and expenditure, but reducing the deficit target of the 2021 budget. The fiscal deficit may still rise, in view of the needs announced by various public institutions. Spending on health needs to increase to treat the rising number of COVID patients; meanwhile, compensation is to be paid to users of gas for the price rises, and VAT has been reduced for the accommodation and catering sector.

Inflation came close to the central bank target of 5% in August 2021, having started from almost zero in January. The National Bank of Moldova reacted by changing the aim of monetary policy from mitigating the impact of the pandemic to fighting inflationary pressures generated by accelerating domestic demand and imported inflation. The bank hiked its base rate in three consecutive months to 5.5% in October. As well as restricting credit growth, the depreciation of the local currency has been reversed by this move.

Until Q3 2021, Moldova had been only moderately affected by the rise in international gas prices, but this is now set to change. Prices are regulated by agreement with Russia's Gazprom, and that agreement is due to be extended in October. The price in Q4 2021, as set by the agreed formula, will be double the Q1 level, or about half of the expected spot price. The calculated tariff hike for customers will be 35%, and the government promises some compensation for vulnerable consumers. Moldovagaz has called on consumers to reduce their consumption of gas and to use alternative fuels, wherever possible, which means that it is reckoning on bottlenecks in supply. The gas pipeline connecting Moldova to Romania (fed from Russia via TurkStream) has become operational, allowing for a diversification in supply of up to half of Moldova's needs. However, Moldova does not wish to exploit the new alternative, as it wants to improve relations with Ukraine (which is dependent on transit revenue). The government may have to change its mind if that is the condition that Gazprom lays down for a new contract to be signed.

The pandemic-related lockdown had little lasting negative impact on the labour market. People were not fired, but instead worked part time; and most of them returned to full time when the restrictions ended. Employment has expanded, and unemployment remained low in both 2020 and 2021, although – given the widespread refusal to be vaccinated – many who usually work abroad have had to stay at home. The economic situation of Moldovans who live and work abroad long term improved in the first half of 2021, so that remittances increased by 17%, year on year, amounting to 14% of GDP.

The EU-oriented government that came to power following the July 2021 elections has a comfortable majority in parliament. The Russia-oriented opposition (and Russia itself) seems to be tolerating the political reorientation. The government has avoided confrontation with the Russian-speaking population in Moldova and the Russian-backed separatist part of the country, Transnistria. Normal relations with Russia are required for Moldova to keep the gas flowing, to restore the access of its food products to the Russian market, and to represent the interests of its migrant citizens in Russia. But Moldova is also interested in improving its relationship with Ukraine – and even more so with the EU. This political reorientation is not without its risks, as Russia has the capacity to undermine stability in Moldova if it perceives the status quo to be in danger.

Top priorities for the new government in the domestic arena are strengthening the rule of law and combating corruption. As initial steps, several state institutions have been brought under the control of parliament and new leaders have been appointed. The selection of judges has become more transparent, and the division between the branches of the judiciary has been clarified. In early October, the government suspended and detained the opposition-backed prosecutor general on charges of corruption. Germany has agreed to support the development of reforms in the public sector to the tune of EUR 10m.

The government's readiness to reform is being rewarded by the EU and other international donors. On 15 September, the European Commission released non-reimbursable funds of EUR 36m – an instalment of the EUR 600m to support the three-year Economic Recovery Plan approved in June. A further EUR 50m is expected in October. The European Bank for Reconstruction and Development has decided to offer Moldovan railways a loan worth EUR 23.5m to modernise its infrastructure. The country will also receive a EUR 24.8m loan from the World Bank to finance the purchase of COVID-19 vaccines. Moldova is entitled to USD 236m of special financing that the International Monetary Fund (IMF) approved for its members in August, to be used to finance the state budget deficit. The former government of Moldova abrogated the reform programme that was a precondition for the disbursement of funds under the stand-by agreement reached with the IMF in September 2020. A new deal is currently under negotiation and should provide the necessary underpinning for the balance of payments.

The pandemic is proving a lasting drag on the economy and society. The number of new cases of COVID-19 and the number of deaths from it are both on the rise, but (as of early October) are still significantly lower than the peak reached in March 2021. Steps are required to lift the vaccination rate above the current level of 30% – a figure that is due partly to popular resistance, but also to inadequate vaccination capacity. The government has introduced thresholds for the incidence of COVID-19 infections, as recommended by the World Health Organization, by which population settlements are grouped into four alert levels, based on the incidence of COVID-19 infections. Restrictions are triggered automatically when certain incidence levels are reached.

In 2022 and 2023, Moldova's economy will return to a growth rate of 4-4.5%, the average for the previous years. Investments will increase to support economic growth, while the trade deficit will contract due to less robust household demand and a consolidation of external demand. Modernisation and growth can be sustained by improving public governance and attracting more abundant capital inflows within the context of a stable political environment.

Table 4.13 / Moldova: Selected economic indicators

	2018	2019	2020 1)	2020	2021	2021	2022	2023
				January-June		Forecast		
Population, th pers., average	2,708	2,665	2,620	.	.	2,560	2,500	2,500
Gross domestic product, MDL bn, nom.	192.5	210.4	206.4	88.3	104.2	236	259	283
annual change in % (real)	4.3	3.7	-7.0	-7.2	11.7	8.0	4.5	4.0
GDP/capita (EUR at PPP)	8,590	9,130	8,770	.	.	.	.	.
Consumption of households, MDL bn, nom.	160.5	174.1	167.2	71.0	80.6	.	.	.
annual change in % (real)	3.9	3.2	-6.9	-9.7	11.3	9.0	4.0	4.0
Gross fixed capital form., MDL bn, nom.	46.8	53.0	51.9	21.7	27.5	.	.	.
annual change in % (real)	14.5	11.9	-2.4	-6.6	20.1	16.0	5.0	7.0
Gross industrial production								
annual change in % (real)	3.7	2.0	-5.5	-7.3	14.1	10.0	6.0	5.0
Gross agricultural production								
annual change in % (real)	2.9	-1.9	-27.1	.	.	.	.	.
Construction industry								
annual change in % (real)	17.6	12.8	3.7	.	.	.	.	.
Employed persons, LFS, th, average 2)	794.1	872.4	834.2	813.9	820.4	840	850	860
annual change in %	-0.8	9.9	-4.4	-5.9	0.8	1.0	1.0	1.0
Unemployed persons, LFS, th, average 2)	29.6	46.9	33.1	35.2	33.6	30	30	30
Unemployment rate, LFS, in %, average 2)	3.6	5.1	3.8	4.2	4.0	3.8	3.5	3.0
Reg. unemployment rate, in %, eop	1.7	1.8	2.9	4.0	2.4	.	.	.
Average monthly gross wages, MDL	6,268	7,234	7,943	7,741	8,757	9,000	10,000	11,000
annual change in % (real, gross)	9.0	10.1	6.2	3.2	11.0	9.0	5.0	5.0
Average monthly net wages, MDL	5,142	6,010	6,617	.	.	7,500	8,300	9,200
annual change in % (real, net)	9.4	11.5	6.1	.	.	9.0	5.0	5.0
Consumer prices, % p.a.	2.9	4.8	3.8	5.5	1.9	4.5	6.0	5.0
Producer prices in industry, % p.a.	0.3	1.8	2.6	2.7	6.6	7.0	4.0	3.0
General governm.budget, nat.def., % of GDP								
Revenues	30.1	29.9	29.7	32.9	33.5	33.0	33.0	33.0
Expenditures	31.0	31.4	38.2	36.8	36.8	39.0	39.0	38.0
Deficit (-) / surplus (+)	-0.8	-1.4	-8.5	-3.9	-3.3	-6.0	-6.0	-5.0
General gov.gross debt, nat.def., % of GDP	27.2	25.1	33.1	.	.	35.0	37.9	39.7
Stock of loans of non-fin.private sector, % p.a.	6.0	13.9	13.2	8.1	19.7	.	.	.
Non-performing loans (NPL), in %, eop 3)	12.5	8.5	7.4	8.7	7.5	.	.	.
Central bank policy rate, %, p.a., eop 4)	6.50	5.50	2.65	3.25	2.65	5.50	5.50	5.50
Current account, EUR m 5)	-1026	-993	-783	-204	-713	-1,080	-850	-720
Current account, % of GDP	-10.6	-9.3	-7.5	-4.5	-14.6	-9.6	-6.9	-5.6
Exports of goods, BOP, EUR m 5)	1,672	1,892	1,706	851	853	1,940	2,120	2,230
annual change in %	1.0	13.1	-9.8	-2.6	0.2	13.7	9.3	5.2
Imports of goods, BOP, EUR m 5)	4,462	4,850	4,420	2006	2527	5,340	5,400	5,460
annual change in %	13.6	8.7	-8.9	-11.9	26.0	20.8	1.1	1.1
Exports of services, BOP, EUR m 5)	1,251	1,379	1,121	537	597	1,280	1,490	1,620
annual change in %	12.4	10.2	-18.7	-18.4	11.3	14.2	16.4	8.7
Imports of services, BOP, EUR m 5)	950	1,065	785	384	426	910	950	990
annual change in %	12.7	12.2	-26.3	-21.1	11.1	15.9	4.4	4.2
FDI liabilities, EUR m 5)	248	453	138	9	70	250	.	.
FDI assets, EUR m 5)	29	35	5	6	-9	0	.	.
Gross reserves of CB excl. gold, EUR m 5)	2,628	2,731	3,079	2,826	3,167	.	.	.
Gross external debt, EUR m 5)	6,448	6,653	6,875	6,947	7144	7,600	8,600	9,100
Gross external debt, % of GDP	66.5	62.2	65.8	66.5	63.6	68.0	70.0	71.0
Average exchange rate MDL/EUR	19.84	19.67	19.74	19.5	21.3	21.0	21.0	22.0

Note: All series excluding data on districts from the left side of the river Nistru and municipality Bender.
1) Preliminary. - 2) Based on May 2014 census and the new methodology in line with the Integrated European Social Statistics Regulation (IESS). - 3) Substandard, doubtful and loss credit portfolio. - 4) Overnight (refinancing) operations rate. - 5) Converted from USD.

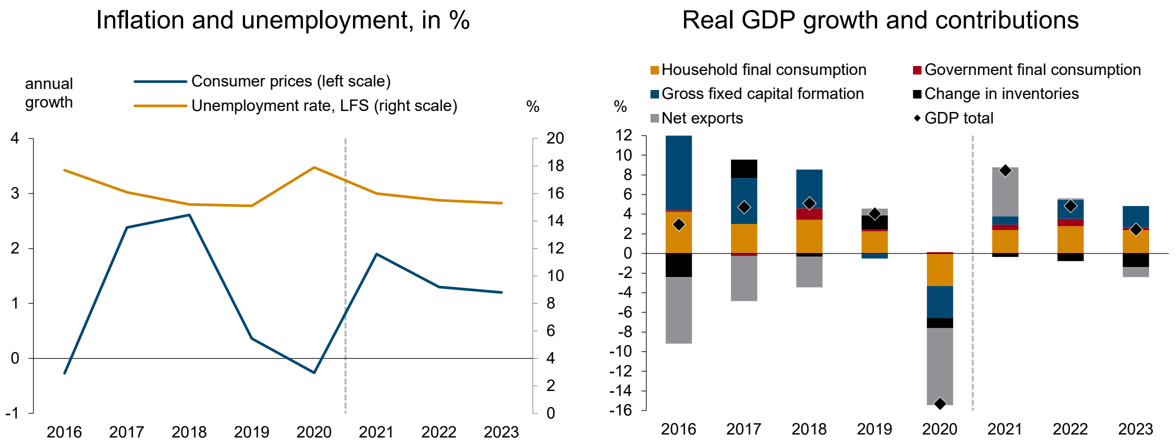
Source: wiiw Databases incorporating national statistics. Forecasts by wiiw.

MONTENEGRO: Tourism pushes GDP up

SELENA DURAKOVIĆ

From Q2 2021, the economy has been enjoying a big increase in industrial production, retail sales, exports of goods and tourism. Accordingly, a high rate of GDP growth is expected in 2021. All the same, the huge contraction in 2020 means that the pre-crisis level will not be reached this year. Public debt and the budget deficit are falling but are still high, limiting fiscal space in the coming years. Despite improvements in economic activity, the unemployment rate remains high.

Figure 4.14 / Montenegro: Main macroeconomic indicators



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

Since August, the country has been in the grip of a fourth wave of the COVID-19 pandemic. There has been a steep rise in the number of people infected, as a result of the increase in tourism and public gatherings. People are still reluctant to get vaccinated, though: mass vaccination started in May, but as of 10 October, just 40% of the adult population had been vaccinated (36% fully). Some minor restrictions remain in place, but they do not appear to affect the economy.

After a significant decline in 2020, there have been signs of economic recovery in Q2 and Q3 2021. In 2020, Montenegro suffered the biggest decline in GDP in Europe (-15.3%). This came as a result of the collapse of consumption and a slump in the tourism sector, which was hit hard by the pandemic and the associated containment measures, such as the tough travel restrictions. GDP growth was still negative in Q1 2021 (-6.4% year on year), but in Q2 it grew by 19%, year on year – just 2 percentage points (pp) less than the previous year's decline. This growth came about due to a strong revival in exports and consumption. The tourist season seems to have been a good one, so that GDP is likely to grow strongly in Q3 as well. Visitor nights in July and August 2021 were four times up on 2020, and were just 13% below the 2019 level, meaning that tourism has recovered almost completely from the pandemic-induced decline. Accordingly, we are revising our forecast for GDP growth upwards by 1.9 pp (to 8.5%) in 2021, but slightly downwards (by 0.2 pp) to 4.8% in 2022. GDP will not reach its pre-pandemic level before the start of 2023.

Inflation is on the rise. In July and August 2021, annual consumer price inflation amounted to 3.1%, due to the increases in energy prices. Average inflation over the first eight months was 1.65%. Given the economic recovery witnessed in 2021, and the rise in prices globally, we expect inflation to increase in 2021 to 1.9% (an upwards revision of 1 pp since our last forecast).

The current account deficit narrowed in the first two quarters of 2021. As a result of the pandemic, exports of services declined significantly in 2020, so that Montenegro's current account deficit widened to 26% of GDP. The deficit then narrowed in the first two quarters of 2021, thanks to an increase in services revenues and secondary income. In Q2, exports of goods rose by 32.3% and exports of services by 43.6%, compared to Q2 2020. At the same time, imports of goods in Q2 increased by only 4.9%, while imports of services decreased by 2.7%; thus the current account deficit dropped to 20.4% of GDP. We have, therefore, revised our forecast for the current account deficit upwards by 2.7 pp, compared to our previous report, and we now project a current account deficit of 18.3% of GDP in 2021. We expect this deficit to continue to narrow thereafter. Remittances made up around 14% of GDP in 2020 (which was 2.5 pp up on 2019), and the figure continued to rise in the first two quarters of 2021. The increase in Q2 was 89.6%, compared to Q2 2020.

The budget deficit and public debt are both decreasing, although they are still high. In 2020, public debt and the general government budget deficit reached all-time highs of 105% and 11.1% of GDP, respectively. At the end of June 2021, public debt fell to 89% of GDP, thanks to the repayment of treasury bills, and the government budget was in surplus in June, July and August. However, public debt is still high and fiscal space in the coming years is seriously limited. Since China holds approximately a quarter of Montenegro's total debt, there are concerns about the country's dependence on its eastern partner. Repayment of the first tranche of the loan has been deferred to late 2022, and Montenegro has managed to secure a deal with three international banks to hedge against foreign exchange risk on the Chinese debt. The hedging will also reduce the interest rate it pays on the debt (it will pay interest of 0.88% in EUR, rather than the 2% it was paying in USD). The government measures to mitigate the COVID-19 economic downturn mean that the country is expected to post a budget deficit of 5.5% of GDP in 2021; that would still bring the debt-to-GDP ratio down, because of the higher nominal GDP growth. Over the medium term, debt will remain elevated, at around 90% of GDP – well above the pre-pandemic level of 77%. As a consequence of its high public debt, its government deficit and the sharp drop in GDP in 2020, Standard and Poor's has downgraded Montenegro's credit rating from B+ to B; that could result in a reduced inflow of foreign direct investment, which was a significant factor in the country's economic growth during the previous period.

On 28 September, the government announced a plan to raise the minimum wage and introduce tax reform. The plan, among other things, suggests the introduction of progressive income and profit tax, the abolition of healthcare contributions and an increase in non-taxable income; the outcome would be a significant reduction in the labour tax wedge. Essentially, it proposes a substantial rise in the minimum wage (to EUR 450 a month), which would maintain total labour costs at about the current level, but would result in higher net wages and lower taxes. There is still not enough information for a concrete assessment of the effects of the plan, but – given the significant reduction in the labour tax – it poses the risk of a further rise in the budget deficit.

Despite the improvements in the economy, unemployment remains high. In the wake of the enormous contraction in GDP in 2020, unemployment in Montenegro soared – from 15.1% to 17.9%. This was the biggest rise in unemployment in the whole of Europe, and returned the country to its 2014 level. According to the Labour Force Survey, the unemployment rate increased further in Q1 2021, to 19.4% (although this is not directly comparable to previous figures, as the Labour Force Survey methodology changed). According to data on the registered jobless, unemployment rose in Q2 2021, compared to Q2 2020. As COVID-19 subsides, unemployment will decline; for 2021, we project that the rate will drop to 16%. It will continue to fall in coming years, but the pre-pandemic level will not be reached anytime soon.

Alongside the limited fiscal space mentioned above, political tension also poses a downside risk to growth. Violence erupted in the Montenegrin town of Cetinje at the beginning of September, as opposition parties and patriotic groups of protesters sought to prevent the enthronement of the new head of the Serbian Orthodox Church there. They viewed the event as an attempt to impose Serbian dominance on Montenegro. The heightened tension between citizens and the political instability it has engendered could potentially jeopardise the EU accession process.

Table 4.14 / Montenegro: Selected economic indicators

	2018	2019	2020 1)	2020 January-June	2021 January-June	2021 Forecast	2022 Forecast	2023 Forecast
Population, th pers., average	622	622	621	.	.	630	630	630
Gross domestic product, EUR m, nom.	4,663	4,951	4,186	1,817	2,004	4,600	4,900	5,100
annual change in % (real)	5.1	4.1	-15.3	-10.5	6.4	8.5	4.8	2.4
GDP/capita (EUR at PPP)	14,610	15,680	13,720	.	.	.	.	.
Consumption of households, EUR m, nom. 2)	3,425	3,534	3,400	1,574	1,636	.	.	.
annual change in % (real)	4.6	3.1	-4.6	-6.5	3.2	3.0	3.5	3.0
Gross fixed capital form., EUR m, nom.	1,364	1,352	1,166	563	537	.	.	.
annual change in % (real)	14.7	-1.7	-12.0	-14.5	3.2	3.0	7.0	8.0
Gross industrial production 3)								
annual change in % (real)	22.4	-6.3	-0.9	-0.8	10.6	8.0	3.0	2.5
Net agricultural production 4)								
annual change in % (real)	3.3	-2.2	1.1	.	.	.	.	.
Construction output 4)								
annual change in % (real)	24.9	10.7	-5.5	-6.9	-1.3	.	.	.
Employed persons, LFS, th, average 5)	237.4	243.8	219.4	.	.	224	228	233
annual change in %	3.5	2.7	-10.0	.	.	2.0	2.0	2.0
Unemployed persons, LFS, th, average 5)	42.5	43.4	47.8	.	.	40	40	40
Unemployment rate, LFS, in %, average 5)	15.2	15.1	17.9	.	.	16.0	15.5	15.3
Reg. unemployment rate, in %, eop	17.8	16.2	20.5	16.6	23.9	.	.	.
Average monthly gross wages, EUR	766	773	783	783	790	800	810	820
annual change in % (real, gross)	-2.4	0.6	1.6	1.6	-0.2	0.5	0.3	0.2
Average monthly net wages, EUR	511	515	524	523	529	540	550	560
annual change in % (real, net)	-2.3	0.4	2.0	1.9	0.0	0.4	0.2	0.2
Consumer prices, % p.a.	2.6	0.4	-0.3	0.1	1.2	1.9	1.3	1.2
Producer prices in industry, % p.a. 6)	1.7	2.4	-0.1	0.4	1.3	1.3	1.7	1.6
General governm.budget, nat.def., % of GDP								
Revenues	42.2	43.4	44.6	.	.	44.8	41.0	41.0
Expenditures	46.2	45.4	55.7	.	.	50.3	45.0	44.0
Deficit (-) / surplus (+)	-3.9	-2.0	-11.1	.	.	-5.5	-4.0	-3.0
General gov.gross debt, nat.def., % of GDP	70.1	76.5	105.3	.	.	91.0	90.0	85.0
Stock of loans of non-fin.private sector, % p.a.	9.1	6.6	2.9	7.0	2.3	.	.	.
Non-performing loans (NPL), in %, eop	6.7	4.7	5.5	5.3	5.7	.	.	.
Central bank policy rate, % p.a., eop 7)	5.75	5.46	5.84	5.93	5.78	5.9	5.5	5.4
Current account, EUR m	-793	-707	-1,090	-644	-409	-843	-830	-880
Current account, % of GDP	-17.0	-14.3	-26.1	-35.4	-20.4	-18.3	-16.9	-17.3
Exports of goods, BOP, EUR m	436	466	409	182	241	480	510	530
annual change in %	14.0	6.8	-12.2	-15.3	32.3	18.0	6.0	3.0
Imports of goods, BOP, EUR m	2,485	2,531	2,051	1,012	1,062	2,130	2,340	2,480
annual change in %	10.8	1.8	-19.0	-16.2	4.9	4.0	10.0	6.0
Exports of services, BOP, EUR m	1,563	1,705	679	296	424	920	1,200	1,310
annual change in %	13.1	9.1	-60.2	-45.1	43.6	35.5	30.0	9.0
Imports of services, BOP, EUR m	627	687	503	251	244	540	590	630
annual change in %	18.1	9.6	-26.8	-23.5	-2.7	7.0	10.0	6.0
FDI liabilities, EUR m	415	372	463	254	204	460	.	.
FDI assets, EUR m	92	67	-5	-5	-2	10	.	.
Gross reserves of CB excl. gold, EUR m 8)	1,050	1,367	1,739	1,212	1,372	.	.	.
Gross external debt, EUR m	7,631	8,369	9,381	.	.	9,020	9,460	9,690
Gross external debt, % of GDP	163.7	169.0	224.1	.	.	196.0	193.0	190.0

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

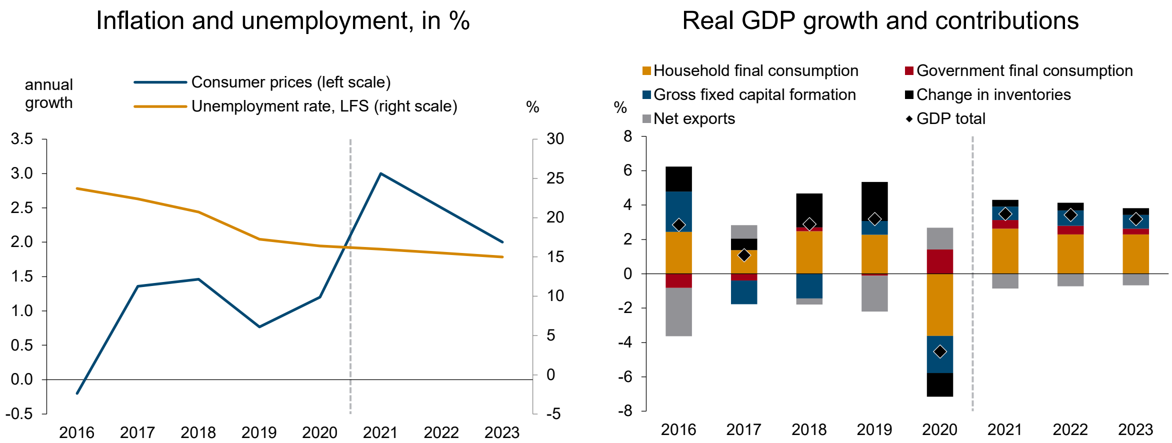
Source: wiiw Databases incorporating national statistics. Forecasts by wiiw.

NORTH MACEDONIA: COVID-19 lethargy

BRANIMIR JOVANOVIĆ

Weak government support, deep-seated structural problems and global issues in the automotive sector all combined to slow economic recovery in North Macedonia in the first half of 2021. We are downgrading our forecast for GDP growth in 2021 from 4.1% to 3.5%. Developments in the years to follow will depend on whether the government starts to undertake structural reforms and invests in green and digital transformation.

Figure 4.15 / North Macedonia: Main macroeconomic indicators



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

The economy of North Macedonia seems to be stuck in a COVID-19 lethargy. GDP in Q2 2021 grew 13.1% year on year, which is the highest growth rate ever observed in the quarterly GDP data for the country – yet that was still 2 percentage points (pp) shy of the decline seen in the corresponding period last year (-14.9%). Thus, the economy is still below its pre-pandemic level. Compared to the previous quarter, growth in Q2 was just 0.3% (seasonally adjusted), which is very weak and much poorer than expected. From a structural perspective, all GDP components grew in Q2 – though that is not surprising, given the steep decline the year before. Imports of goods and services grew most strongly (by 47%), which was due to their weak performance in previous periods.

Industry is growing, but by much less than the decline witnessed last year. Growth in the first half of the year was 6.6% – far short of the fall in the same period of 2020 (-14.6%). Three important sectors of the economy recorded a sizeable decline – mining, energy and manufacture of apparel – reflecting deep structural problems and the government's failure to tackle them. Energy and mining have declined due to lack of investment in renewable energy; in the case of apparel, the problem is the inability on the part of that technologically backward and low-value-added sector to catch up with contemporary trends.

The automotive industry, on the other hand, saw robust growth in the first half of the year (11.5%), though that was still much less than the decline the year before (21.1%). After production in the sector reached pre-crisis levels at the end of 2020, growth slowed markedly – a result of the global problem facing the automotive industry that is caused by the shortage of microchips.

Fiscal policy has not been supportive enough, and that has again taken its toll on the economy. Total government spending in the first half of the year was 34.8% of GDP – well short of the previous year (38.4%). This reflects the decline in government support measures for businesses and households (which were much more generous last year), but also weak capital spending: that averaged only 2% of GDP in the first six months of the year, just half of the planned amount. Had the government carried through its planned level of public investment, the economy would already have reached the pre-crisis level.

Despite the lukewarm fiscal support, public debt has continued to rise in 2021. By the end of Q2, it had reached 64.4% of GDP – 4.2 pp up from 2020. The reason for the rise is the issuance of a 7-year euro-denominated bond in March 2021, with a value of EUR 700m and a historically low yield of 1.866%. Part of the money is being used to repay old loans.

The anaemic economic activity has left its mark on the labour market. Employment in Q2 2021 was 2% below the pre-crisis level of Q1 2020, which means that around 16,000 people have lost their jobs during the pandemic. The sectors that have seen the greatest declines are agriculture, industry, transportation and tourism – all sectors with a sizeable degree of informality, suggesting that the decline in formal employment may be also due to a shift to informality. Despite the fall in employment, unemployment has not risen: during the same period, it also declined – by some 6,000 people, pushing the rate of unemployment to a historical low of 15.9%. The explanation for the divergent dynamics is that the pandemic has led to a pronounced drop-off in labour market activity: some 22,000 people have become inactive during the observed period (bigger than the fall in employment).

Despite the decline in employment, wages have continued to grow. In the first seven months of 2021, they grew by a nominal 6.1%. While the increase can partly be explained by higher inflation and the rise in the minimum wage (1.7% increase in April 2021), there are several additional factors: wages in the cultural sector have risen thanks to a new collective agreement; salaries in health care were increased by the government in response to the pandemic; IT remuneration has risen in line with the boom in that sector; and wages in tourism have grown thanks to the post-pandemic recovery there.

Inflation has been on the rise all year, reaching 3.6% in August. The average for the first eight months of 2021 was 2.7%. While the rise is partly due to higher wages, the main reason is the global increase in energy costs: prices in the ‘transportation’ sub-category of the national consumer price index were up 6% in the first eight months of the year. The increase in producer prices has been even more pronounced – an average of 8% in the first seven months, culminating in 14% in July, which could be a sign that inflation will remain elevated for some time to come. We are still inclined to believe that this will not continue for too long, and that the country will not see persistently higher inflation. We are upgrading our inflation forecast for 2021 to 3% (from 2.5%), and for 2022 to 2.5% (from 2.2%).

Monetary policy has remained supportive of the economy throughout 2021, and we expect that to continue over the coming months. The central bank cut its main interest rate in March to a historical low of 1.25%, and has given no indication that it will hike the rate any time soon. Given the anaemic economy and (still) not very high inflation, we see no reason for it to do so.

The financial sector has remained stable. Non-performing loans at the end of June 2021 remained close to the level of June 2020 (3.4%). Credit growth is continuing as last year: total private loans in July were 5% higher than the year before. Banks are lending more to households than to companies – household credit is 8.7% up, year on year, while corporate loans are just 1.2% up.

The external sector has been very positive in 2021, but this has had only a limited impact on economic activity. Inflows of foreign direct investment (FDI) were very buoyant in the first half of the year, amounting to EUR 527m, or 9.7% of GDP – the highest in years. To a large extent, this is delayed investment, i.e. investment that was postponed in 2020, due to the pandemic: last year FDI totalled just EUR 74m. But there may also be some indirect near-shoring trends, in the sense that European companies have started investing in the Western Balkans, rather than in Asia, due to the ongoing supply-chain problems. Remittances also held up very well in the first half of 2021: approximated by current transfers, they were 38% up on the same period of 2020 (EUR 773m). The current account deficit in the first half of the year was 3.2% of GDP, which is a normal level for North Macedonia.

Q3 seemed to start out in the same way as the previous six months. Industrial production in July declined by 0.6% year on year, mainly on account of the weak production in the food, apparel and energy sectors, which are all burdened by deep structural problems, low value added, low innovation and low productivity. Retail trade, on the other hand, grew in July by 8.9% in real terms; but again, that is less than the previous year's decline (-11.9%), meaning that the economy is continuing to operate at below its pre-crisis level.

One positive development from Q3 is that the government seems to be stepping up its support for the economy. In July and August, total government spending was 11.7% up year on year, while capital spending was 57% up. Still, it is unclear whether these trends will continue for long, as the country is holding local elections in October, and government spending is restricted during any election campaign.

Another positive development is that the country finally managed to organise a census in September – the first since 2002. Although it will be several months before the official results are announced, on the final day of the census, officials stated that 1.8m people had been recorded – 10% below the population figure from the previous census and the estimates of the Statistical Office. That would mean that many statistical indicators for the country have been inaccurately calculated for years: GDP per capita, the unemployment rate, poverty, etc.

In September and October, the country has been weathering a new and severe wave of COVID-19, but there seems to have been little impact on the economy. The COVID-19 death rate in September was among the highest in the region – a consequence of the weak vaccination programme, the poor health system and widespread COVID scepticism. By the start of October, only 35% of the population had been fully vaccinated, as many people doubt the usefulness of the vaccines. This also makes it highly unlikely that restrictions will be introduced, as they carry a substantial political cost. But as the experience of spring showed, life in North Macedonia will go on as normal, even through a severe pandemic wave. Thus, we do not foresee any serious adverse economic consequences of the ongoing wave.

On account of the weaker-than-expected economic results from the first half of the year, the anaemic start to Q3 and the slim chances of more substantial government support in the remaining months of the year, we are downgrading our GDP growth forecast for 2021 – from 4.1% to 3.5%.

The prospects for the years to come will depend on whether the government starts to tackle the structural problems that burden the country and the economy: widespread corruption, non-functioning institutions, poor infrastructure, low investment in public goods, lack of investment in green and digital transformation, absence of industrial policy and weak innovation capacity.

Table 4.15 / North Macedonia: Selected economic indicators

	2018	2019	2020 1)	2020 January-June	2021 January-June	2021 Forecast	2022 Forecast	2023 Forecast
Population, th pers., average	2,076	2,077	2,073	.	.	2,075	2,075	2,075
Gross domestic product, MKD bn, nom.	660.9	689.4	664.0	304.6	335.6	708	751	790
annual change in % (real)	2.9	3.2	-4.5	-7.3	5.2	3.5	3.4	3.2
GDP/capita (EUR at PPP)	11,340	11,850	11,370	.	.	.	.	.
Consumption of households, MKD bn, nom.	429.2	446.4	434.5	210.3	228.0	.	.	.
annual change in % (real)	3.8	3.5	-5.6	-7.1	6.7	4.0	3.5	3.5
Gross fixed capital form., MKD bn, nom.	132.4	146.1	132.0	.	.	.	.	.
annual change in % (real)	-6.4	4.0	-10.2	.	.	4.0	4.5	4.0
Gross industrial production 2)								
annual change in % (real)	5.4	3.7	-9.6	-14.6	6.6	6.0	5.5	5.0
Gross agricultural production 3)								
annual change in % (real)	10.0	-5.4	7.2	.	.	.	.	.
Construction industry								
annual change in % (real)	-6.8	3.8	1.3	-0.7	-6.1	.	.	.
Employed persons, LFS, th, average	759.1	797.7	794.9	802.3	794.2	800	810	820
annual change in %	2.5	5.1	-0.3	1.3	-1.0	0.5	1.5	1.5
Unemployed persons, LFS, th, average	198.6	166.4	155.9	158.1	150.5	150	150	140
Unemployment rate, LFS, in %, average	20.7	17.3	16.4	16.5	16.0	16.0	15.5	15.0
Reg. unemployment rate, in %, eop	19.3	19.6	25.8	22.7	20.8	.	.	.
Average monthly gross wages, MKD	35,626	37,446	40,566	39,864	42,386	43,500	45,900	47,800
annual change in % (real, gross)	4.2	4.3	7.0	7.9	3.9	4.0	3.0	2.0
Average monthly net wages, MKD	24,276	25,213	27,182	26,709	28,390	29,100	30,700	31,900
annual change in % (real, net)	4.4	3.1	6.5	7.3	3.8	4.0	3.0	2.0
Consumer prices, % p.a.	1.5	0.8	1.2	0.5	2.4	3.0	2.5	2.0
Producer prices in industry, % p.a.	0.9	2.1	0.6	0.9	7.0	8.0	5.0	3.0
General governm.budget, nat.def., % of GDP								
Revenues	30.4	31.5	30.2	28.7	30.1	30.0	30.0	30.0
Expenditures	31.5	33.7	38.4	37.2	34.8	33.0	32.0	31.0
Deficit (-) / surplus (+)	-1.1	-2.2	-8.2	-8.5	-4.7	-3.0	-2.0	-1.0
General gov.gross debt, nat.def., % of GDP	40.4	40.6	51.2	51.7	55.9	52.5	53.0	53.0
Stock of loans of non-fin.private sector, % p.a.	7.2	6.1	4.6	6.7	5.0	.	.	.
Non-performing loans (NPL), in %, eop	5.1	4.6	3.3	4.6	3.4	.	.	.
Central bank policy rate, %, p.a., eop 4)	2.50	2.25	1.50	1.50	1.25	1.25	1.50	2.00
Current account, EUR m	-7	-368	-366	-246	-175	-400	-490	-600
Current account, % of GDP	-0.1	-3.3	-3.4	-5.0	-3.2	-3.5	-4.0	-4.7
Exports of goods, BOP, EUR m	4,883	5,347	4,817	2,014	2,924	5,490	6,150	6,830
annual change in %	19.8	9.5	-9.9	-22.5	45.2	14.0	12.0	11.0
Imports of goods, BOP, EUR m	6,619	7,296	6,622	2,911	3,992	7,520	8,420	9,350
annual change in %	12.9	10.2	-9.2	-17.0	37.1	13.5	12.0	11.0
Exports of services, BOP, EUR m	1,580	1,625	1,447	676	778	1,610	1,790	1,970
annual change in %	10.2	2.8	-10.9	-7.4	15.1	11.0	11.0	10.0
Imports of services, BOP, EUR m	1,209	1,289	1,021	408	455	1,130	1,240	1,360
annual change in %	14.1	6.6	-20.8	-24.0	11.6	10.5	10.0	9.5
FDI liabilities, EUR m	539	488	28	214	527	700	.	.
FDI assets, EUR m	-65	125	-127	99	337	400	.	.
Gross reserves of CB excl. gold, EUR m	2,619	2,961	3,019	3,292	3,704	.	.	.
Gross external debt, EUR m	7,844	8,154	8,536	8,771	10,159	9,900	10,700	11,500
Gross external debt, % of GDP	73.0	72.7	79.3	81.5	88.5	86.0	88.0	90.0
Average exchange rate MKD/EUR	61.51	61.50	61.67	61.7	61.6	61.7	61.7	61.7

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

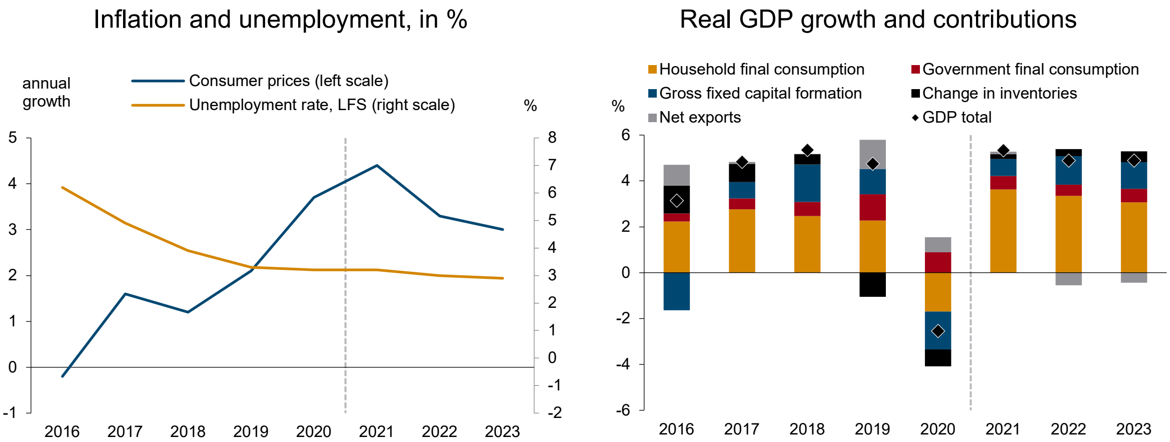
Source: wiiw Databases incorporating national statistics. Forecasts by wiiw.

POLAND: Prospects reasonably good, but extraordinarily uncertain

LEON PODKAMINER

The 'fourth wave' of the pandemic currently presents little cause for concern. From a mild decline in GDP, Poland has seen a shift towards recovery. The rising wage bill supports a strong recovery in consumption without jeopardising corporate profitability. Growth in gross fixed capital formation is still inadequate, but industrial production is performing very well. An upturn in inflation has not unduly affected the central bank's monetary policy. However, the course of fiscal policy remains uncertain. Overall, Poland's prospects are good, but conflicts with the European Commission need to be resolved.

Figure 4.16 / Poland: Main macroeconomic indicators



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

The 'fourth wave' of the pandemic is gathering momentum. However, it is affecting primarily the eastern, generally less-developed rural regions that are resisting vaccination. New measures that restrict economic activities nationwide are unlikely to be instituted.

GDP shifted from decline in Q1 2021 (-0.9% year on year) to recovery in Q2 2021 (+11.1%), bringing the GDP growth rate for the first half of the year to 4.6%. This turnaround was due primarily to household consumption, which moved from stagnation in the first quarter to very strong expansion in the second; it has contributed 7.4 percentage points (pp) to the growth in Q2. Gross fixed capital formation has gone from near stagnation to fairly strong recovery; its contribution to growth rose from 0.2 pp in Q1 to 0.8 pp in Q2. This contrasts with the huge contribution of growing inventories (2.9 pp). Growth in both imports and exports accelerated spectacularly in Q2, though the growth of imports outpaced that of exports. Though still negative, the contribution of trade to overall growth in Q2 (-0.7 pp) was a clear improvement on the previous quarter (-1.9 pp).

GDP is back where it was two years ago. In Q2 2021, GDP surpassed (albeit marginally) the level it had attained in the second quarter of 2019. However, there has been a change in the structure of GDP on both the demand and the supply side. Compared to Q2 2019, private consumption in Q2 2021 was over 1% higher; public consumption was more than 4% up; exports and imports were both over 5% greater – and yet gross fixed capital formation was still some 2% shy of its level two years previously. Gross value added was over 4% greater in industry, but was 3% lower in the construction sector and almost 30% lower in catering and accommodation.

The wage bill in the corporate sector rose over 8% in nominal terms in the first half of 2021 (8.5% in the first eight months of 2021). Average employment in the corporate sector has barely changed, despite the recovery in output. On the other hand, recent statistics suggest a rise in the hours worked per employee (by close to 3% in manufacturing). This may explain the strong rise in average real wages, which increased by 4% in the corporate sector (January-August 2021).

The profitability of firms is high and rising. Despite the wage hikes, rising producer prices mean that the corporate sector has not experienced any erosion of profits. In fact, the net turnover profitability of the whole corporate sector has hit a record level (5.8%). Manufacturing's profitability is also at a record high (6.7%) – though that is not as high as in the power generation and distribution sector (9.5%).

In Q2 2021, gross value added in manufacturing was over 27% higher than a year previously. Since then, the strong industrial dynamics have been maintained: in the first eight months of the year, sales of manufacturing output rose by close to 17%, year on year, in real terms. Sales of manufactured intermediate goods and of capital goods both rose by about 20%; and sales of consumer durables – by 30%. Meanwhile, sales of non-durables rose by less than 5%. The volume of sales of electrical equipment and of electronics both increased by about 40%, and of motor vehicles and parts by 28%. About a quarter of manufacturing output is exported. Manufacturing is enjoying large (and rising) volumes of new orders, both domestic and external. So far, firms have not complained of shortages of imported production inputs (for example, microchips), but this could change in the fourth quarter of 2021.

The construction sector has been performing weakly. Inadequate demand and rising costs are regarded as the main limiting factors. During the first eight months of 2021, its output rose by a mere 0.2%. Construction of buildings declined by over 5%, and civil engineering works by 1.2%. Only specialised construction work saw a rise in sales – of over 9%. Investment-construction work fell by 4.5% (meanwhile, the volume of renovation work rose by 12%). The sector's capacity utilisation is relatively low (83%). Clearly, the construction sector is waiting for a boost to investment, which could come if the European Commission decides to approve the Polish government's recovery and resilience plan.

A fairly sharp upturn in inflation has finally led to a tightening of monetary policy. For over a year the key National Bank of Poland (NBP) interest rate was maintained at 0.1%. But the mood surrounding the NBP policy is changing: the bank has just moderately tightened its policy – primarily to please its critics. In actual fact, current inflation is being fuelled by the cost of imported energy and by hikes in electricity prices, which are dictated by the state-owned power plants. These hikes cannot be justified by concern about production costs (the profitability of the power generation and distribution sector has always been exceptionally high). Core inflation is not far off 2.5% (the NBP's target). Also, any concerns about an undue expansion of credit are unwarranted at present: the stock of credit extended to the business sector is actually declining, while the stock of household credit is pretty well stagnant (only the volume of mortgages is increasing relatively rapidly). At the same time, both firms and households are increasing their holdings of bank deposits.

The recent weakness of the exchange rate (PLN/EUR) and its greater volatility could be attributed to enhanced uncertainties over the disbursement to Poland of funds from the EU's Recovery and Resilience Facility. Poland's reconstruction plan has not so far been approved. Apparently, the European Commission is awaiting the repeal of a number of dubious 'reforms' of Poland's judicial system. Should the European Commission and the Polish government manage to resolve their disagreements (which centre on the rule of law in Poland), the Polish currency may regain some of its customary strength, even if domestic interest rates do not rise much. However, it is far from certain whether (or when) the dispute can be settled.

Fiscal policy has adopted an ambiguous stance. Fiscal policy responded vigorously to the pandemic: from January 2020 to the end of June 2021, the public debt rose by the equivalent of about EUR 36bn – far more than in the previous four years combined (EUR 25bn). But apparently, the government is now rather uneasy about the debt dynamics. The 'Polish Deal' – a programme that was cobbled together by the government and that has just squeaked through the Sejm – hints at some reduction in the public sector deficit. At the same time, it promises rather more progressivity in personal income taxation (primarily at the expense of medium, rather than high incomes).

The prospects for the country are quite good, but are rather uncertain. Despite promising indications from manufacturing, the recovery of gross fixed investment is still rather slow. The direction of the fiscal (and monetary) policy is uncertain but greater uncertainty concerns future relations with the EU, which are seriously threatened by the policies pursued by Poland's government.

Table 4.16 / Poland: Selected economic indicators

	2018	2019	2020 1)	2020 January-June	2021 January-June	2021 Forecast	2022 Forecast	2023 Forecast
Population, th pers., average	38,423	38,397	38,324	38,354	38,162	38,370	38,360	38,360
Gross domestic product, PLN bn, nom.	2,122	2,293	2,327	1,089	1,204	2,550	2,750	2,960
annual change in % (real)	5.4	4.7	-2.5	-2.9	4.6	5.3	4.9	4.9
GDP/capita (EUR at PPP)	21,430	22,740	22,740	.	.	.	.	.
Consumption of households, PLN bn, nom.	1,221	1,299	1,301	638	702	.	.	.
annual change in % (real)	4.3	4.0	-3.0	-4.7	6.1	6.5	6.0	5.5
Gross fixed capital form., PLN bn, nom.	386	420	386	155	166	.	.	.
annual change in % (real)	9.4	6.1	-9.0	-4.1	3.4	4.5	7.5	7.0
Gross industrial production (sales) 2)								
annual change in % (real)	5.9	4.1	-1.2	-6.7	17.8	13.0	6.0	5.0
Gross agricultural production								
annual change in % (real)	-0.9	-1.1	7.2	.	.	.	.	.
Construction industry 2)								
annual change in % (real)	19.7	3.7	-3.5	0.5	-4.4	.	.	.
Employed persons, LFS, th, average 3)	16,484	16,461	16,442	16,350	16,515	16,360	16,440	16,600
annual change in %	0.4	-0.1	-0.1	-0.2	.	-0.5	0.5	1.0
Unemployed persons, LFS, th, average 3)	659	558	537	528	647	540	510	500
Unemployment rate, LFS, in %, average 3)	3.9	3.3	3.2	3.1	3.8	3.2	3.0	2.9
Reg. unemployment rate, in %, eop	5.8	5.2	6.2	6.1	5.9	.	.	.
Average monthly gross wages, PLN 4)	4,590	4,920	5,167	5,299	5,713	5,640	6,060	6,520
annual change in % (real, gross)	5.4	4.8	1.7	2.0	4.3	4.5	4.0	4.5
Consumer prices (HICP), % p.a.	1.2	2.1	3.7	3.6	4.2	4.4	3.3	3.0
Producer prices in industry, % p.a.	2.1	1.3	-0.6	-0.4	4.5	5.0	3.0	2.0
General governm.budget, EU-def., % of GDP								
Revenues	41.3	41.1	41.7	.	.	40.0	40.0	39.0
Expenditures	41.5	41.8	48.6	.	.	45.5	44.5	42.0
Net lending (+) / net borrowing (-)	-0.2	-0.7	-6.9	.	.	-5.5	-4.5	-3.0
General gov.gross debt, EU def., % of GDP	48.8	45.6	57.4	.	.	59.8	61.1	60.1
Stock of loans of non-fin.private sector, % p.a.	7.1	4.7	0.4	2.9	0.5	.	.	.
Non-performing loans (NPL), in %, eop	6.9	6.7	7.0	7.0	6.5	.	.	.
Central bank policy rate, % p.a., eop 5)	1.50	1.50	0.10	0.10	0.10	0.50	1.00	1.50
Current account, EUR m 6)	-6,514	2,604	18,110	10,539	3123	10,400	17,000	16,800
Current account, % of GDP 6)	-1.3	0.5	3.5	4.3	1.2	1.9	2.8	2.6
Exports of goods, BOP, EUR m 6)	217,110	232,971	232,852	107,761	136038	270,100	307,900	332,500
annual change in %	7.4	7.3	-0.1	-6.8	26.2	16.0	14.0	8.0
Imports of goods, BOP, EUR m 6)	223,330	231,766	220,454	102,973	131119	257,900	292,700	321,100
annual change in %	10.3	3.8	-4.9	-10.8	27.3	17.0	13.5	9.7
Exports of services, BOP, EUR m 6)	57,672	62,480	58,815	28,111	29498	62,000	68,800	74,400
annual change in %	13.1	8.3	-5.9	-5.1	4.9	5.5	11.0	8.2
Imports of services, BOP, EUR m 6)	36,403	38,831	35,289	16,336	17398	37,800	42,000	47,000
annual change in %	9.9	6.7	-9.1	-9.0	6.5	7.0	11.0	12.0
FDI liabilities, EUR m 6)	14,809	12,809	12,454	5,285	12088	12,000	.	.
FDI assets, EUR m 6)	1,954	4,268	3,843	-1,612	3490	5,400	.	.
Gross reserves of CB excl. gold, EUR m	97,633	104,526	114,299	103,455	123,090	.	.	.
Gross external debt, EUR m 6)	316,683	316,569	305,694	300,108	308,360	313,200	326,400	338,300
Gross external debt, % of GDP 6)	63.6	59.3	58.4	57.3	54.9	56.5	54.0	52.0
Average exchange rate PLN/EUR	4.2615	4.2976	4.4430	4.4136	4.5366	4.60	4.55	4.55

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

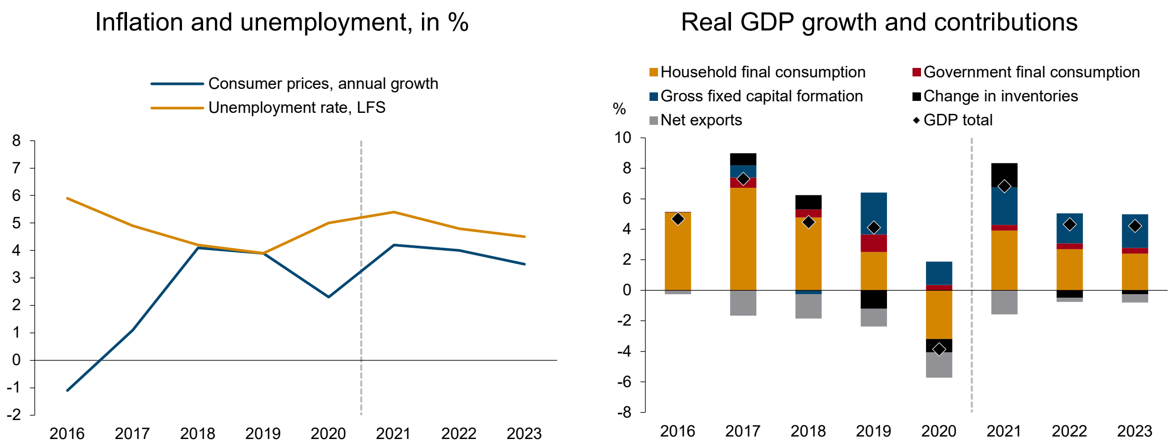
Source: wiiw Databases incorporating Eurostat and national statistics. Forecasts by wiiw.

ROMANIA: Recovery shaken by triple crisis

GÁBOR HUNYA

With expected growth of 6.8% in 2021, the Romanian economy will surpass the pre-crisis level of 2019. The high twin deficits on the fiscal balance and the current account could become a problem only in the event of negative external shocks. The short-term prospects are dimmed by three simultaneous crises in the areas of the pandemic, gas supply and government.

Figure 4.17 / Romania: Main macroeconomic indicators



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

The Romanian economy experienced robust GDP growth of 6.6% in the first half of 2021, following a decline of 4.4% the year before. Investments and household consumption boosted the economy, while deteriorating trade balances exerted a moderating influence. We witnessed strong growth in Q3, but expect a more modest increase in Q4. The expansion in demand will slow, and thus the annual growth rate for 2021 will be only marginally higher than for the first half of the year. With growth forecast at 6.8%, 2021 real GDP will be 2.6% above the pre-COVID level of 2019 – a strong performance in international terms.

With 12% growth in the first half of 2021, gross fixed capital formation was a major driver of economic development. Gross capital formation expanded by as much as 27%, making the accumulation of stocks an important contributor to growth. It remains to be seen what proportion of the unfinished investments can be completed by the end of the year, thus turning stocks into fixed assets. An increasing part of the new investment in the first half of the year went into construction, while less went into new equipment than before. Stimulated by low interest rates, the housing market became overheated, resulting in a rapid rise in prices during the current year. The construction industry is at the very limits of its capacity, and in the short run will be unable to increase its contribution to economic growth beyond the current level.

Household consumption has made up for the losses of the previous year, but will be depressed during the winter. The relaxation of COVID-related rules boosted the accommodation and catering sector in Q3. Renewed restrictions (due to rapidly rising COVID-19 cases) will again depress demand in Q4. The very modest (33%) vaccination rate is not expected to improve substantially, despite the need for a 'green card' to enter public places. Late-night curfews and online education are again on the agenda in major cities. As of early October, hospitals are overcrowded and there is limited access for non-urgent cases. The COVID-related death rate has again reached the peak last seen in April 2021, so that Romania (together with Bulgaria and Montenegro) leads the rankings of the worst-affected European countries. Everyday life is again coming under increased stress, with a negative impact on attitudes to work and consumption. The accelerating inflation is yet another burden.

Inflation has been steadily rising throughout the year – partly driven by demand, but mainly as a result of higher import prices. Energy has become far more expensive, not only on account of international price developments, but also due to the domestic price liberalisation introduced at the beginning of the year. The outgoing government has not intervened in price setting, but instead offered support for consumers. About 60% of households will be eligible for a subsidy of 22% on their electricity bills and 25% on their gas bills, up to a certain consumption ceiling. This compensation will cover about half of the tariff hikes announced by distributors. The most needy households will receive additional cash support for heating. All in all, inflation will eat up much of the nominal wage increases introduced during the year. Therefore, real wages will increase by only 3.8% in 2021, less than in the crisis year 2020. Increased uncertainty caused by elevated inflation may depress household consumption next year, too. A 10% rise in the minimum wage announced for 2022 does not seem very high now, in view of the fact that inflation is expected to be close to 7% by the end of 2021.

The post-pandemic export rebound is being hampered by a shortage of production inputs in the car industry. But the macroeconomic effect is smaller than in more open economies that have a heavier reliance on automotive exports. The Romanian car industry is relatively small, and – compared to Slovakia or Czechia –it tends to export more components than ready-built vehicles. Following the European trend, the main fertiliser factory in the country will be working at half capacity in Q4, due to a natural gas shortage.

In October, the central bank hiked its base rate by 0.25 percentage points (to 1.5%), and we expect at least one more correction this year. The bank had let it be known in September that most of the inflation witnessed was due to one-off rises in household energy prices, and that core inflation had hardly moved, so that no change to the base rate would be needed. But inflation targeting does not stand still: despite its conviction that the spike in inflation was supply driven and transitory, now the board of the central bank believes that higher rates are needed to maintain capital inflows in order to fund the rising current account deficit, particularly in the context of heightened political risk.

Fiscal revenues have expanded more than envisaged, due to stronger economic growth and the recouping of taxes deferred by companies. But the pressure to raise expenditure allows only for a moderate narrowing of the deficit. An extra rise in pensions and the energy price compensation are unplanned burdens on the expenditure side. The fiscal deficit can be financed from the market, albeit at a heightened rate of interest (due to the political uncertainty). The 10-year yield on government bonds rose to 4.4% in early October – the highest level since May 2020.

Romania entered a political crisis in mid-September. The reformist element of the three-party coalition – the Save Romania Union (USR) – left the government led by the National Liberal Party (PNL), saying it would only return if Prime Minister Cîţu was replaced. That did not happen, as he had won the election as leader of the PNL and enjoyed the strong support of President Iohannis. On 5 October, the government fell after nine months in office, when parliament passed a motion of no confidence that was introduced by the Social Democratic Party (PSD). A caretaker government will take over for a limited period, during which time several options may be tested, and a restored coalition may emerge only after the other short-term options have been exhausted; early elections – an unusual option in Romania – cannot be ruled out this time. In any case, no government with wide legislative support will emerge in the next few months. A weak government may not be able to combat the pandemic and get to grips with the fiscal and current account imbalances. Businesses will have to operate in an uncertain environment.

In the period 2021-2027, Romania will have at its disposal loans and grants from the EU worth around EUR 80bn (a quarter of the 2021 GDP). Of this, close to EUR 50bn will be made available from the Multiannual Financial Framework (MFF) – the bulk of it (EUR 26.8bn) from the European Structural and Investment Funds (ESIF) and a further EUR 18.6bn allocated for agriculture and rural development. While the new MFF is being phased in, the money provided under the 2014-2020 ESIF has to be spent by the end of 2023. Since only half of that money had been disbursed by mid-2021, over the next two years the government will need to concentrate on spending that, rather than the new funds.

About EUR 30bn from the EU's Recovery and Resilience Facility (RRF) – a combination of loans and grants – is due to be allocated to mitigate the economic and social impact of the coronavirus pandemic in the period 2022-2026. The national RRF programme was agreed with the European Commission (EC) before the government crisis, and thus it could be disbursed from 1 October. The content of the RRF had to be renegotiated with the EC several times: the government had wanted to have the delayed motorway programme financed, but that did not fit with the green and innovative targets of the RRF. A compromise was found, but conditionalities have been imposed: one of those stipulates that Romania must pursue fiscal policies aimed at increasing the budget-revenue-to-GDP ratio by 2.5 percentage points by 2025. That target could be reached by increasing the tax collection rate through digitalisation, while leaving the statutory tax rates untouched. Such reforms will not be easy to implement, as the administration is unprepared. The upshot of failure would be delays in fund disbursement or the forgoing of some of the loans.

Despite the potential problems related to disbursement, the EU funds will make a positive contribution to growth, alongside foreign and domestic private investment. Economic growth will be maintained at an annual rate of somewhat above 4% over the next two years. The slowdown compared to 2021 reflects the elevated base effect and the change in the global environment following the bounce-back from the COVID crisis. The GDP forecast has both upside and downside risks. On the one hand, investments may rise more rapidly if the absorption of EU funds improves under a new government. On the other hand, the continuation of epidemic-related restraints and supply-chain disruptions may put the brakes on the economy.

Table 4.17 / Romania: Selected economic indicators

	2018	2019	2020 1)	2020 January-June	2021 January-June	2021 Forecast	2022 Forecast	2023 Forecast
Population, th pers., average	19,474	19,372	19,258	.	.	19,200	19,100	19,000
Gross domestic product, RON bn, nom.	951.7	1,058.2	1,055.5	443.7	493.8	1,180	1,280	1,390
annual change in % (real)	4.5	4.1	-3.9	-4.4	6.6	6.8	4.3	4.2
GDP/capita (EUR at PPP)	19,830	21,690	21,300	.	.	.	.	.
Consumption of households, RON bn, nom.	599.4	654.8	635.6	278.7	306.1	.	.	.
annual change in % (real)	7.6	4.0	-5.2	-4.5	5.1	6.5	4.5	4.0
Gross fixed capital form., RON bn, nom.	200.4	239.4	259.2	95.2	112.7	.	.	.
annual change in % (real)	-1.1	13.0	6.8	8.7	11.9	10.0	8.0	9.0
Gross industrial production 2)								
annual change in % (real)	3.5	-2.3	-9.2	-16.3	16.1	10.0	6.0	5.0
Gross agricultural production								
annual change in % (real)	7.2	-3.8	-15.3	.	.	.	.	.
Construction industry 2)								
annual change in % (real)	-4.1	27.6	15.9	19.4	5.9	.	.	.
Employed persons, LFS, th, average 3)	8,689	8,680	8,521	8,512	7,740	7,800	7,900	7,900
annual change in %	0.2	-0.1	-1.8	-1.6	.	0.5	0.3	0.0
Unemployed persons, LFS, th, average 3)	380	353	452	432	457	450	400	370
Unemployment rate, LFS, in %, average 3)	4.2	3.9	5.0	4.9	5.6	5.4	4.8	4.5
Reg. unemployment rate, in %, eop	3.3	3.0	3.4	3.0	3.0	.	.	.
Average monthly gross wages, RON	4,357	4,853	5,213	5,269	5,685	5,600	6,000	6,400
annual change in % (real, gross)	8.0	7.3	4.7	2.4	4.4	3.8	3.6	3.8
Average monthly net wages, RON	2,642	2,986	3,217	3,224	3,484	3,500	3,800	4,100
annual change in % (real, net)	8.0	8.8	4.9	2.7	4.5	4.0	3.8	4.0
Consumer prices (HICP), % p.a.	4.1	3.9	2.3	2.6	2.7	4.2	4.0	3.5
Producer prices in industry, % p.a.	5.1	3.8	0.0	0.6	6.2	7.0	4.0	3.0
General governm.budget, EU-def., % of GDP								
Revenues	31.9	31.8	33.1	.	.	34.0	34.0	34.0
Expenditures	34.9	36.2	42.4	.	.	41.0	40.0	39.0
Net lending (+) / net borrowing (-)	-2.9	-4.4	-9.2	.	.	-7.0	-6.0	-5.0
General gov.gross debt, EU def., % of GDP	34.7	35.3	47.3	.	.	49.0	51.0	52.0
Stock of loans of non-fin.private sector, % p.a.	7.9	7.0	5.0	4.1	10.9	.	.	.
Non-performing loans (NPL), in %, eop	5.0	4.1	3.8	4.4	3.8	.	.	.
Central bank policy rate, % p.a., eop 4)	2.50	2.50	1.50	1.75	1.25	1.75	2.00	2.00
Current account, EUR m	-9,497	-10,906	-10,970	-4,050	-7,500	-14,000	-11,700	-10,900
Current account, % of GDP	-4.6	-4.9	-5.0	-4.4	-7.4	-5.8	-4.6	-4.0
Exports of goods, BOP, EUR m	61,814	63,056	57,541	26,440	34,105	67,300	71,300	74,900
annual change in %	8.1	2.0	-8.7	-17.0	29.0	17.0	6.0	5.0
Imports of goods, BOP, EUR m	77,153	80,900	76,479	35,316	44,586	89,500	93,100	96,800
annual change in %	10.3	4.9	-5.5	-11.2	26.3	17.0	4.0	4.0
Exports of services, BOP, EUR m	23,791	27,058	23,768	11,431	12,523	26,100	28,400	30,700
annual change in %	9.5	13.7	-12.2	-9.9	9.6	10.0	9.0	8.0
Imports of services, BOP, EUR m	15,431	18,408	14,321	7,006	8,189	16,000	17,300	18,700
annual change in %	13.9	19.3	-22.2	-18.8	16.9	12.0	8.0	8.0
FDI liabilities, EUR m	6,205	6,574	3,056	-26	4,210	5,000	.	.
FDI assets, EUR m	1,259	1,721	112	-1,015	588	500	.	.
Gross reserves of CB excl. gold, EUR m	33,065	32,927	37,379	35,002	36,831	.	.	.
Gross external debt, EUR m	99,841	109,783	126,807	113,705	129,087	135,000	142,000	150,000
Gross external debt, % of GDP	48.8	49.2	58.1	52.1	53.9	56.4	55.7	55.3
Average exchange rate RON/EUR	4.6540	4.7453	4.8383	4.8174	4.9014	4.93	5.02	5.12

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

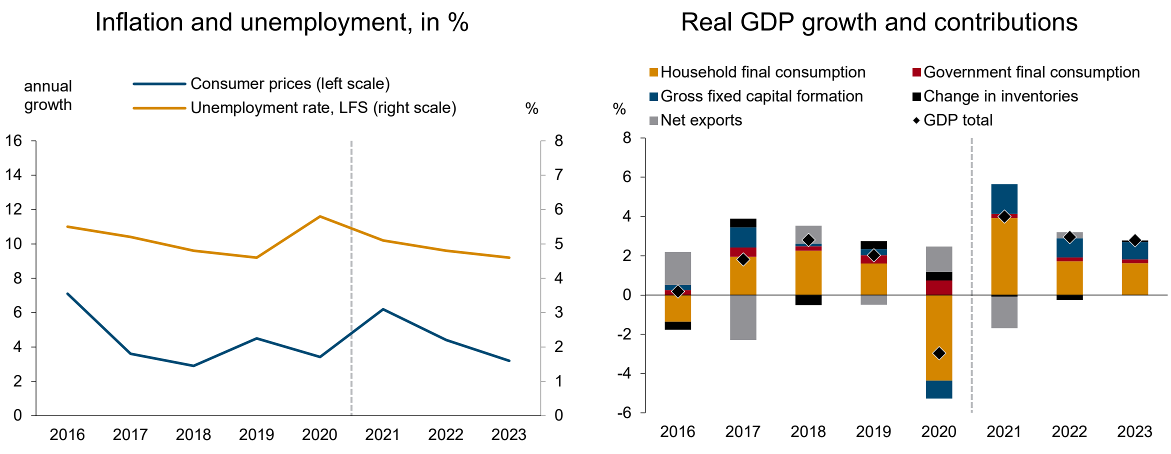
Source: wiiw Databases incorporating Eurostat and national statistics. Forecasts by wiiw.

RUSSIA: Back to 'twin surpluses'

VASILY ASTROV

Despite the persistently unfavourable COVID-19 situation, the economy has rebounded strongly and exceeded the pre-pandemic level in Q2 2021. But inflation has also accelerated markedly. In response, the policy interest rate has been hiked sharply, and more rises are likely to follow. Real GDP is projected to grow by 4% this year and by around 3% per year in 2022-23.

Figure 4.18 / Russia: Main macroeconomic indicators



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

Russia is on the brink of a fourth wave of the pandemic. This comes on top of the third wave, which started in June 2021 and has never really abated. Even prior to the fourth wave, the official statistics were recording around 800 COVID-related deaths and close to 20,000 new cases a day; on both counts, the situation has deteriorated further with the arrival of colder temperatures, bringing the daily number of deaths to nearly 1,000 at the time of writing. The true extent of the pandemic is likely much worse than the official data would suggest. As in many other CESEE countries, the rapid spread of the virus in Russia has been facilitated by the low inoculation rate (only 29% are fully vaccinated), which reflects primarily a low willingness to have the jab. Moreover, even if there were greater willingness, the inoculation rate would probably not increase all that much, given the vaccine production bottlenecks and problems with honouring export contracts.

On the face of it, the Russian economy has come through the COVID-19 pandemic relatively well. Last year, real GDP fell by only 3%, 1 percentage point (pp) of which was on account of the OPEC+ oil production cuts, rather than the pandemic itself. In Q1 2021, it still declined by 0.7% (year on year), but it surged by 10.5% in Q2. Although this is primarily explained by the low statistical basis (there were strict lockdowns in many Russian regions throughout much of spring 2020), it more than made up for the slump in Q2 2019. As a result, real GDP in Q2 2021 was 1.9% higher than in Q2 2019, suggesting that the economic fallout from the pandemic has probably been left behind.

But this success is due in large part to policies that have prioritised the economy over public health. In contrast to the first wave of the pandemic, restrictions from the second wave onwards have been very mild: strict lockdowns are no longer imposed, and even the existing restrictions are generally observed only half-heartedly. These policies have also allowed the government to keep the fiscal stimulus to a bare minimum. Besides, this year has brought about a dramatic turnaround in the general government balance. While the recovery and surging energy prices boosted revenues by 21% in the first half of the year, expenditures picked up by only 8%, translating into a fiscal surplus of 2.4% of GDP. This is in stark contrast to most other CESEE countries, where budgets have remained in the red, despite the recovery.

The recovery has been driven exclusively by domestic demand. In the first half of 2021, private consumption surged by 11%, bringing it to pre-pandemic levels. The strong growth in consumption was fuelled by improved consumer sentiment, the release of accumulated savings and rapid credit expansion. By August, the pace of credit expansion to households had accelerated to 24% year on year, giving rise to sustainability concerns, especially against the background of nearly stagnant real incomes. Continued restrictions on foreign travel have also strengthened domestic spending. Travel to some traditional destinations has been hampered by COVID-19, while recognition by the EU of the Russian vaccines is still pending. Gross fixed capital formation also performed strongly, growing by 7% and far outpacing the decline in the first half of last year.

Foreign trade has rebounded impressively in nominal terms, but has been a drag on real growth. In the first half of the year, merchandise exports and imports alike soared by 27-28% in US dollar terms, reflecting the recovery in the Russian and global economies and in global energy demand. More recently, import growth has slowed somewhat, contributing to a surge in the current account surplus: in January-August, it almost tripled on an annual basis, to USD 70bn. However, the high growth of nominal exports in the first half was entirely due to the price effect, reflecting the recovery in energy prices from last year's dip; meanwhile export volumes declined by 2.5%. In contrast, real imports surged by 12.4% in the first half (mostly on account of machinery, equipment and textiles), so that the contribution of real net exports to GDP growth turned negative (-3.2 pp).

Despite the recent signs of a growth slowdown, the forecast for 2021 has been revised upwards. High-frequency indicators suggest that the economic recovery has lost some of its momentum in recent months, with the effect of the low statistical basis gradually fading, the release of accumulated savings largely exhausted, and with unfavourable weather conditions (rains and floods) affecting the harvest. Still, on the strength of economic performance in Q2, our growth forecast for the whole year has been revised to 4% (from 3.5%), whereas for 2022-2023 we project a minor slowdown to around 3% per year.

Defying earlier predictions, annual inflation has been accelerating, and reached 7.4% in September. As in many parts of the world, it has been predominantly supply-side driven, fuelled by disruptions in supply chains, rising energy prices and specific factors in selected food product markets (such as poultry). Therefore, we view the current spike in inflation as largely transitory, requiring little monetary policy response. However, demand-side factors have increasingly played a role as well, prompting the central bank to tighten policy. Overall, the policy rate has been raised by 2.5 pp since the start of the year, to 6.75% at the time of writing. With inflation hovering well above the central bank target (4%) and the real policy rate still around zero, further hikes are likely in the months to come. This will likely slow the pace of lending and suppress both inflation and economic growth next year and in 2023. For 2022-2023, we expect growth of around 3% per year, also on account of the fading statistical basis effect and the usual structural constraints (unfavourable business climate and low investment rate) again increasingly making their presence felt.

The parliamentary election in September 2021 preserved the constitutional majority of the ruling United Russia party. However, the Communist Party came a strong second, with 18.9% of the votes, according to the official results (and almost certainly far more in reality). This should come as no surprise, given the recent rise in poverty in the wake of the pandemic and the protracted stagnation in living standards over the past decade. Between 2014 and 2020, real disposable incomes declined by 11%; though they picked up by 1.7% in the first half of this year, that did little to reverse the trend. Depressed living standards may become a political problem for the authorities, potentially forcing them to switch to rather more socially oriented economic policies, above all fiscal policy. The latest government proposal to substantially increase state spending next year may well be the first sign of a forthcoming policy shift.

Table 4.18 / Russia: Selected economic indicators

	2018	2019	2020 1)	2020 January-June	2021 January-June	2021 Forecast	2022 Forecast	2023 Forecast
Population, th pers., average	146,831	146,765	146,460	146,640	146,017	145,850	145,800	145,800
Gross domestic product, RUB bn, nom.	103,862	109,242	106,967	48,419	57,624	122,400	131,900	140,500
annual change in % (real)	2.8	2.0	-3.0	-3.4	4.9	4.0	3.0	2.8
GDP/capita (EUR at PPP)	19,450	19,610	20,120	.	.	.	.	.
Consumption of households, RUB bn, nom.	51,884	55,448	52,425	24,399	29,113	.	.	.
annual change in % (real)	4.3	3.2	-8.6	-10.0	11.0	8.0	3.5	3.3
Gross fixed capital form., RUB bn, nom.	21,452	23,087	23,273	8,497	9,463	.	.	.
annual change in % (real)	0.6	1.5	-4.3	-4.1	7.0	7.0	4.5	4.0
Gross industrial production 2)								
annual change in % (real)	3.5	3.4	-2.2	-1.7	4.0	4.2	3.0	2.5
Gross agricultural production								
annual change in % (real)	-0.2	4.3	1.5	3.0	0.2	.	.	.
Construction output								
annual change in % (real)	6.3	2.1	0.1	-1.2	6.4	.	.	.
Employed persons, LFS, th, average	72,532	71,933	70,601	70,700	71,169	71,310	71,310	71,310
annual change in %	0.3	-0.8	-1.9	-1.1	0.7	1.0	0.0	0.0
Unemployed persons, LFS, th, average	3,658	3,465	4,321	3,966	3,969	3,600	3,400	3,300
Unemployment rate, LFS, in %, average	4.8	4.6	5.8	5.4	5.3	5.1	4.8	4.6
Reg. unemployment rate, in %, eop 3)	0.9	0.9	3.7	3.7	1.6	.	.	.
Average monthly gross wages, RUB	43,724	47,867	51,344	49,509	54,587	56,700	61,000	64,500
annual change in % (real, gross)	8.5	4.8	3.8	4.3	4.2	4.0	3.0	2.5
Consumer prices, % p.a.	2.9	4.5	3.4	2.8	5.8	6.2	4.4	3.2
Producer prices in industry, % p.a. 4)	12.1	2.0	-3.8	-7.3	20.4	15.0	5.0	4.0
General governm.budget, nat.def., % of GDP								
Revenues	35.9	36.2	35.7	36.9	37.5	37.5	37.5	37.5
Expenditures	33.0	34.2	39.7	38.7	35.0	36.5	36.0	36.0
Deficit (-) / surplus (+)	2.9	1.9	-4.0	-1.8	2.4	1.0	1.5	1.5
General gov.gross debt, nat.def., % of GDP	12.1	12.4	17.7	13.8	16.7	15.5	12.5	10.0
Stock of loans of non-fin.private sector, % p.a.	13.9	6.5	12.4	8.9	17.4	.	.	.
Non-performing loans (NPL), in %, eop 5)	5.3	6.0	6.1	6.0	5.7	.	.	.
Central bank policy rate, % p.a., eop 6)	7.75	6.25	4.25	4.50	5.50	7.00	7.50	7.00
Current account, EUR m 7)	98,142	58,390	31,510	22,777	34,354	78,100	89,900	93,500
Current account, % of GDP	7.0	3.9	2.4	3.6	5.3	5.6	5.9	5.7
Exports of goods, BOP, EUR m 7)	376,612	374,738	291,760	144,983	172,777	372,900	412,100	432,700
annual change in %	20.5	-0.5	-22.1	-19.7	19.2	27.8	10.5	5.0
Imports of goods, BOP, EUR m 7)	211,127	226,668	209,726	99,607	116,880	253,900	279,200	293,200
annual change in %	0.0	7.4	-7.5	-4.0	17.3	21.1	10.0	5.0
Exports of services, BOP, EUR m 7)	54,845	55,275	41,165	21,399	19,719	41,900	43,900	46,100
annual change in %	7.6	0.8	-25.5	-17.5	-7.8	1.8	4.8	5.0
Imports of services, BOP, EUR m 7)	80,366	88,081	56,082	28,856	25,028	48,900	51,300	53,900
annual change in %	2.1	9.6	-36.3	-26.4	-13.3	-12.8	4.9	5.1
FDI liabilities, EUR m 7)	7,453	28,548	8,296	2,266	8,724	11,000	.	.
FDI assets, EUR m 7)	26,620	19,574	5,117	4,770	14,191	25,400	.	.
Gross reserves of CB excl. gold, EUR m 7)8)	333,617	396,378	372,318	389,476	387,293	.	.	.
Gross external debt, EUR m 7)	397,860	438,645	380,738	429,814	396,482	391,700	414,100	432,900
Gross external debt, % of GDP	28.3	29.1	29.3	33.1	28.3	28.0	27.0	26.5
Average exchange rate RUB/EUR	73.87	72.51	82.39	76.38	89.54	87.5	86.0	86.0

Note: Including Crimean Federal District.

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

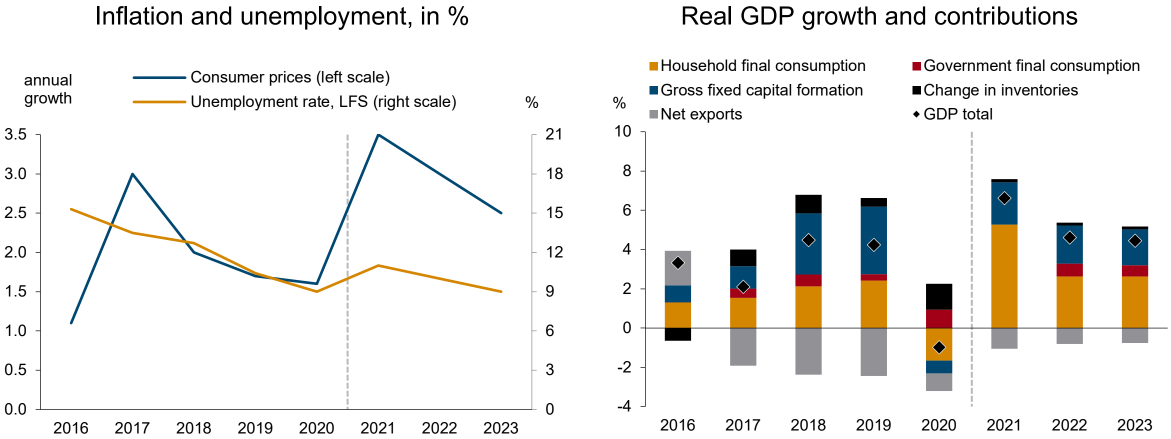
Source: wiiw Databases incorporating national statistics. Forecasts by wiiw.

SERBIA: The good results continue, but a trinity of headwinds is looming

BRANIMIR JOVANOVIĆ

Firm government support and effective vaccine roll-out in the first half of the year have helped the Serbian economy offset the losses brought about by the pandemic. We are upgrading our GDP forecast for 2021 to 6.6%, from 6%. There are three issues that could potentially slow growth down in the coming period: the global problems in the automotive industry, the fiscal consolidation announced by the government and the recent political tensions in the region.

Figure 4.19 / Serbia: Main macroeconomic indicators



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

Serbia continued with its impressive economic results in Q2 2021. GDP grew by 13.7% year on year – a much stronger improvement than the 6.3% decline the previous year, meaning that the economy is already well ahead of its pre-pandemic level. The buoyant growth this time was brought about by robust investment and household consumption. Gross fixed capital formation grew by 22.5% year on year, while household consumption increased by 17.6% – both growth rates much higher (approximately 10 percentage points) than the declines witnessed in the same period last year. The good results were helped by the solid vaccine roll-out in this period, which allowed social and economic life to get back to something like normal.

Industry, the dominant sector of the economy, has kept on growing, though the speed has moderated in recent months. In the first eight months, its growth averaged 6.9% – quite a performance, given that last year it declined by only 0.7%. Still, after peaking in February 2021, production has moderated somewhat; this may be linked to issues surrounding global supply chains. The automotive industry (which has been particularly badly affected by these issues) expanded its production in Serbia in the first eight months of 2021 by 25.9%, year on year; while that figure is high, it does not make up for the decline in the same period of 2020 (34.8%). This could imply that growth in the second half of the year will not be as strong as in the first half.

Government support for the economy has weakened a little, but remains strong. Government consumption in Q2 declined by 3.8%, year on year, but that was due to the big increase the previous year (8.9%). The budget deficit in the first half of 2021 was just 1.3% of GDP – far lower than either the deficit in 2020 (8.1%) or the planned deficit for 2021 (3%). However, this was a consequence of the exceptionally high revenues from the first half of the year: those reached 44.6% of GDP (some 3 percentage points (pp) more than in the pre-pandemic period), due to the buoyant economic activity and the collection of certain taxes that had been deferred in 2020. Government spending remained strong in the first half of the year – 45.9% of GDP, some 4-5 pp above the pre-pandemic level. Especially solid was government investment, which reached 4.6% of GDP, as the government continued its ambitious infrastructure investment plan.

After increasing last year, public debt stabilised in 2021. At the end of July, it stood at 55.2% of GDP, slightly below the level at the end of 2020 (57.4%). In September, the government issued two euro-denominated bonds on quite favourable conditions. The first is a seven-year 'green' bond, with a value of EUR 1bn and a coupon rate of 1% (yield of 1.26%); the money raised will be used for green projects. The second is a 15-year bond, with a value of EUR 750m and a coupon rate of 2.05% (yield of 2.3%), which will be used to help repay old debt. We thus expect public debt to increase a little by the end of the year, but not by much.

Developments in the external sector have also been good. The current account deficit in the first half of 2021 narrowed to 1.8% of GDP, which is the lowest for years. The reason was that the growth in exports was much higher than the growth in imports. We expect some widening of the deficit in the second half of the year, as exports in small economies like Serbia's cannot grow much more than imports over a prolonged period of time.

Foreign direct investment (FDI) has continued to be solid. It reached EUR 1.7bn in the first half of the year, or 7% of GDP, which is 20% up on the same period a year before. This was not just delayed investment, as 2020 was also good in terms of FDI: it suggests, rather, that Serbia has managed to establish itself as a regional hub for investment in manufacturing. The solid FDI inflows might also reflect indirect near-shoring trends, i.e. the decision by European companies to invest in the Eastern European region, instead of in Asia.

The solid economic performance has led to an increase in employment. The rate of employment in Q2 2022 reached 48.3%, which is the highest ever recorded. The number of people employed in Q2 was 71,000 (2.5%) higher than in the pre-pandemic period (Q1 2020). An improvement can be observed in both formal and informal employment. Perhaps surprisingly, the rate of unemployment has also increased, to stand at 11.1% in Q2 – markedly higher than in the same quarter of the previous year (7.9%). The reason is that unemployment in Q2 2020 was artificially low, due to the lockdown and the government-supported furlough schemes – because of them, people were not looking for jobs. A year on, with the weakening of the pandemic, the opening-up of the economy and the withdrawal of the furlough schemes, people have again started looking for jobs. Since not all of them manage to find employment, unemployment also increases.

The improvement in the labour market was also seen in average wages. For the first seven months, average wages increased nominally by 8.2%, year on year. Although the improvement may have been triggered by the increase in the minimum wage and in public-sector wages, it has been broad based, covering all industries and regions; both the public and the private sector; both people employed full time and those in occasional employment.

Higher wages, combined with higher global energy and food prices, have pushed inflation up. In August, it reached 4.3% (the highest rate since the end of 2013). The average rate for the first eight months was 2.7%. Producer prices are also rising – in August, they were 10.4% above the level of a year before. Because of this, we are upgrading our consumer price inflation projection for 2021 to 3.5% (from 3%). Due to the carry-over effects, we are also raising our forecast for 2022 to 3% (from 2.6%).

The higher inflation and the buoyant economic activity may induce the central bank to raise its policy interest rate by the end of the year. Monetary policy throughout the pandemic has been supportive: the central bank reduced its policy rate four times during 2020, from 2.25% in February to 1% in December. But conditions since then have changed substantially – economic activity has improved considerably and inflation has been rising. Several Eastern European central banks have already hiked their rates, and the US Fed is for ever talking about tapering. It is just a question of time when the Serbian central bank will increase its rate, but we believe that this will happen by the end of the year. The increase will not be large, though, but will rather be a symbolic 0.25 pp.

The indicators available for Q3 suggest that the economy is generally doing well, though there have been some changes since the previous quarter. The growth in industrial production slowed in July and August to 0.9%, year on year. This is partly a consequence of the high growth in the previous year, but is also due to the weaker output of the automotive sector (which is clearly affected by the global microchip shortage). Retail trade, on the other hand, grew strongly in July and August, by 9.4% year on year (in real terms), indicating that the driver of growth in Q3 will be private consumption.

The country has been enduring a new and severe wave of the pandemic in September-October, but we do not foresee this causing major economic damage. After the excellent vaccine roll-out in the first half of the year, inoculation in Q3 almost ground to a halt because of pronounced COVID denial and vaccine hesitancy. Since almost all restrictions had been removed and social life had been getting back to normal, this led to an upsurge in COVID infections. Still, experience from Q2 teaches us that the economy can perform well even under such conditions, as people and businesses continue their activities.

We are upgrading our GDP forecast for 2021 to 6.6% (from 6%), on the grounds of the strong outturn in the first half of the year and the decent preliminary results in Q3. We are still aware of certain headwinds over the coming period that could retard growth. The first is the global problem that the automotive industry is facing with a shortage of semiconductors: this could limit production and investment by Serbian automotive factories, at least for some time. The second is the fiscal consolidation announced by the government, which may retard growth if undertaken too quickly or too vigorously.

The third – and perhaps the most serious – headwind refers to the new wave of political tensions in the Western Balkan region. From Montenegro, through Bosnia and Herzegovina, to Kosovo, various political tensions have been in evidence in recent months – and all could have implications for Serbia, one way or another. While the tensions seem to have eased for now, they serve to recall the unresolved political issues in the region, which, if ignored, could easily flare up, increasing political instability and indirectly also affecting economic growth.

Table 4.19 / Serbia: Selected economic indicators

	2018	2019	2020 1)	2020 January-June	2021 January-June	2021 Forecast	2022 Forecast	2023 Forecast
Population, th. pers., mid-year	6,983	6,945	6,899	.	.	6,885	6,855	6,830
Gross domestic product, RSD bn, nom. 2)	5,073	5,418	5,464	2,576	2,885	6,000	6,500	7,000
annual change in % (real)	4.5	4.2	-1.0	-0.7	7.6	6.6	4.6	4.5
GDP/capita (EUR at PPP)	12,030	12,710	12,810	.	.	.	.	.
Consumption of households, RSD bn, nom. 2)	3,463	3,634	3,603	1,708	1,890	.	.	.
annual change in % (real)	3.1	3.5	-2.5	-3.1	7.9	8.0	4.0	4.0
Gross fixed capital form., RSD bn, nom. 2)	1,017	1,218	1,174	517	612	.	.	.
annual change in % (real)	17.5	17.2	-2.8	-0.9	15.6	10.0	9.0	8.5
Gross industrial production 3)								
annual change in % (real)	1.3	0.3	0.4	-1.9	9.0	8.0	6.0	5.0
Gross agricultural production								
annual change in % (real)	14.3	-1.2	4.3	.	.	.	.	.
Construction output								
annual change in % (real)	14.1	35.5	-2.5	11.7	18.2	.	.	.
Employed persons, LFS, th, average 4)	2,833	2,901	2,895	2,861	2,777	2,895	2,960	3,030
annual change in %	1.4	2.4	-0.2	-0.1	.	2.5	2.4	2.3
Unemployed persons, LFS, th, average 4)	412	336	287	267	376	360	330	300
Unemployment rate, LFS, in %, average 4)	12.7	10.4	9.0	8.5	11.6	11.0	10.0	9.0
Reg. unemployment rate, in %, eop	20.3	18.7	17.9	19.2	19.2	.	.	.
Average monthly gross wages, RSD	68,629	75,814	82,984	81,828	88,652	91,000	98,400	104,900
annual change in % (real, gross)	3.9	8.4	7.8	8.0	5.9	6.0	5.0	4.0
Average monthly net wages, RSD	49,650	54,919	60,073	59,220	64,287	65,900	71,300	76,000
annual change in % (real, net)	4.4	8.5	7.7	7.9	6.1	6.0	5.0	4.0
Consumer prices, % p.a.	2.0	1.7	1.6	1.4	2.3	3.5	3.0	2.5
Producer prices in industry, % p.a.	0.9	0.6	-1.3	-1.2	5.0	7.5	5.0	3.0
General governm.budget, nat.def., % of GDP								
Revenues	41.5	42.1	41.3	39.3	44.6	43.0	42.0	42.0
Expenditures	40.9	42.3	49.4	51.4	45.9	46.0	44.5	44.0
Deficit (-) / surplus (+)	0.6	-0.2	-8.1	-12.0	-1.3	-3.0	-2.5	-2.0
General gov.gross debt, nat.def., % of GDP	54.4	52.9	58.2	56.6	55.7	56.0	55.0	54.0
Stock of loans of non-fin.private sector, % p.a.	9.9	8.9	11.1	13.9	7.3	.	.	.
Non-performing loans (NPL), in %, eop	5.7	4.1	3.7	3.7	3.6	.	.	.
Central bank policy rate, % p.a., eop 5)	3.0	2.3	1.0	1.3	1.0	1.3	2.0	2.5
Current account, EUR m	-2,076	-3,161	-1,929	-1,246	-518	-1,500	-1,650	-1,830
Current account, % of GDP	-4.8	-6.9	-4.2	-5.7	-2.1	-2.9	-3.0	-3.0
Exports of goods, BOP, EUR m	15,106	16,415	16,079	7,343	9,620	19,600	22,500	25,300
annual change in %	7.4	8.7	-2.0	-8.7	31.0	22.0	15.0	12.5
Imports of goods, BOP, EUR m	20,191	22,038	21,280	9,923	12,222	24,700	28,200	31,700
annual change in %	11.8	9.1	-3.4	-6.1	23.2	16.0	14.0	12.5
Exports of services, BOP, EUR m	6,061	6,934	6,191	2,926	3,456	7,200	8,100	9,200
annual change in %	15.5	14.4	-10.7	-5.4	18.1	16.0	13.0	13.0
Imports of services, BOP, EUR m	5,066	5,922	5,090	2,428	2,647	5,500	6,100	6,800
annual change in %	18.4	16.9	-14.1	-10.8	9.0	8.0	10.0	11.0
FDI liabilities, EUR m	3,464	3,815	3,039	1,450	1,755	3,800	.	.
FDI assets, EUR m	308	264	100	30	166	300	.	.
Gross reserves of CB, excl. gold, EUR m	10,526	12,042	11,732	12,360	12,358	.	.	.
Gross external debt, EUR m	26,662	28,254	30,787	30,959	32,291	35,700	40,000	42,700
Gross external debt, % of GDP	62.2	61.5	66.3	66.6	63.3	70.0	72.0	71.0
Average exchange rate RSD/EUR	118.27	117.86	117.58	117.57	117.58	117.6	117.0	116.5

1) Preliminary. - 2) Half-year data unrevised. - 3) Excluding arms industry. - 4) From 2021 the new LFS methodology is applied in line with the Integrated European Social Statistics Regulation (IESS. - 5) Two-week repo rate.

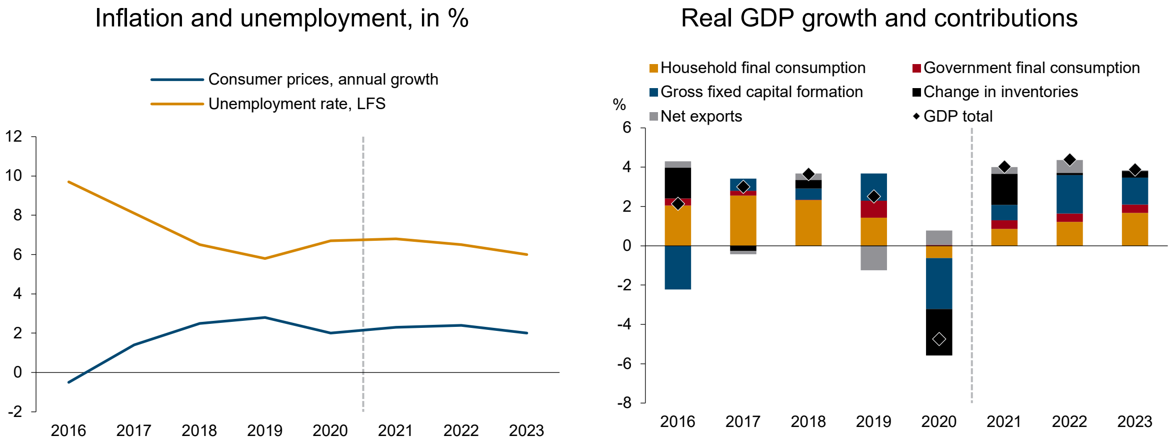
Source: wiiw Databases incorporating national statistics. Forecasts by wiiw.

SLOVAKIA: Shortage of semiconductors starting to bite

DORIS HANZL-WEISS

Slovakia's GDP recovered by 9.6% in Q2 2021. Manufacturing – especially the automotive industry – is driving growth, but the shortage of semiconductors is of increasing concern. Slovakia's GDP is expected to rise by 4% this year, while the influx of EU money will drive up investment in coming years.

Figure 4.20 / Slovakia: Main macroeconomic indicators



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

Slovakia's GDP grew by 4.9% in the first half of 2021, but has not yet reached its pre-COVID level. The picture for the two quarters is very different. Q1 2021 was hampered by a lockdown and the closure of non-essential retail outlets shops, and so GDP increased by only 0.2% year on year. The crisis measures were then lifted on 19 April. The Q2 results were better, but not as good as expected, leading to GDP growth of 9.6%. The main driver of growth in Q2 was gross capital formation – especially the accumulation of inventories, which is also related to supply-chain bottlenecks. Markedly positive contributions also came from the revival of household consumption after the lockdown and government consumption. Net exports, which were the main growth driver in Q1, likewise made a positive contribution, but less than might have been the case had imports not had such a negative effect in Q2. Thus, overall, growth rates for the first half of 2021 were still negative for household consumption (-0.5%) and gross fixed capital formation (-1.9%), but were positive for government consumption (+3.5%) and gross capital formation (10.8%). Exports of goods and services increased by 23% in the first half of the year, and imports by 20%.

Manufacturing is driving growth, while some service sectors are still suffering. Looking at sectoral developments, industry – in particular, manufacturing – fuelled growth in the first half of the year, with value added increasing by 19% year on year. Services grew by only 1.6% in H1, as that sector was still badly affected by the lockdown in Q1. Arts, entertainment and recreation (R-U) and professional, scientific and technical activities (M-N) fell by 14% and 7%, respectively, in H1. Construction also performed poorly in H1 (-3%), though it improved during Q2. However, the prospects are rather gloomy, as bottlenecks in building materials, a shortage of labour and rising prices are all affecting the sector. If we look at the situation in more detail, the main Slovak manufacturing industry – the automotive sector – contributed most to growth in the first half of the year, followed by basic metals and fabricated metal products, and machinery & equipment. However, from June onwards the automotive sector lost steam, and thereby its position as the ‘engine of growth’. The major automotive companies – Volkswagen Slovakia, KIA Motors Slovakia, Stellantis (previously PSA Peugeot-Citroen) and Jaguar Land Rover – were troubled by a shortage of semiconductors and either suspended production for several days, cut work shifts or dropped certain production lines (e.g. large SUVs for VW). Thus, the semiconductor shortage is already thought to have affected Q2 results.

The labour market improved modestly in Q2 2021, and there was a wage hike. While still hampered by lockdown in Q1 2021, the situation on the labour market improved in Q2, albeit slowly. Overall, employment fell by 3.1% year on year in H1. Although employment still declined in Q2, the figure was much smaller than in the previous quarter (-1.5% in Q2, compared to -4.8% in Q1). The unemployment rate reached 7% on average for H1 2021, with a declining trend in the second quarter (6.9% in Q2, compared to 7.1% in Q1). Government measures (‘Kurzarbeit’ or short-time working) stabilised the labour market during the COVID-19 pandemic in 2020 and go some way to explaining the slower reactions now. The third wave of the pandemic and the supply-chain bottlenecks may further retard full recovery on the labour market. Real monthly wages climbed by 5.3% during the first half of the year – a consequence of the strong base effect in Q2, when wages rose by 8.1%. However, full-year data will be more moderate. Inflation reached only 1.5% in H1 – very low by comparison with other countries, as inflation was very low at the start of the year. However, it began to rise and reached 3.3% in August, with the expectation of further increases. Administered prices will also rise at the beginning of next year.

Trade in goods recovered, while services exports were still affected by the pandemic. Over the first half of the year, goods exports increased by 29.5% year on year, while imports rose by 25.5% (based on trade statistics). Exports to the country’s main trading partners of Germany and Czechia grew by 32% and 31%, respectively, and imports by 57% and 15%. Slovakia’s main export product – cars (HS 87), which make up 35.6% of total exports – saw an increase of 46%. Trade in services did not recover so quickly, and services exports continued to decline in H1 2021 (by 2%), while imports were already growing (by 4%). The current account will be negative and could further deteriorate due to the higher dynamics of imports.

Pandemic-related expenditure is still affecting the budget. The COVID-19 pandemic bumped up the level of government deficit and debt in 2020, as there was less revenue but greater expenditure (including on pandemic aid measures). In 2020, the government deficit reached 6%, and the government debt-to-GDP level was about 60.3% (up from 48% in 2019). Thus, the debt was pushed up above the highest sanction bracket of the debt-brake rule. Debt will grow further this year, as a record high budget deficit (-10%) was approved in June.[29] Higher expenditure is partly – but not exclusively – related to the pandemic (e.g. subsidies to maintain employment, healthcare expenditure and assistance to the affected sectors. Slovakia’s recovery plan – which takes advantage of the EU’s Recovery and Resilience Facility for Slovakia and is worth EUR 6.3bn – was among the 12 plans of member states approved by the European

29 https://spectator.sme.sk/c/22673820/mps-okayed-record-high-budget-deficit-critics-expect-future-tax-hike.html as of 03/06/2021

Commission in July. Areas that are to receive funding first include health (hospitals), the judiciary (reorganisation of courts) and education (changes in the financing and evaluation of universities).

The third wave of the pandemic is building up. Since September, Slovakia has witnessed the start of the third wave of the pandemic: whereas there were 417 new cases on 7 September, that figure had climbed to 1,500 by 28 September.[30] The rate of vaccination is very low: at the end of September, only 51.3% of the adult population was fully vaccinated, compared to an EU average of 79.3%.[31] Measures are being taken at the regional level and are applied according to the current alert system, called 'Covid Automat'. In the week of 27 September to 3 October, only one district was green (good level); 34 were amber, 39 were red; and 5 were dark red (no district was in the worst – black – tier).[32] Measures in the black tier, for example, include takeaway meals only from restaurants and the de facto closure of hotels. It is mostly regions in the eastern part of Slovakia that are affected by a higher number of COVID cases, due to the lower rates of vaccination there.

Robust growth is expected, but the risks are rising. wiiw growth forecasts for Slovakia have not changed, compared to the summer forecast. Slovak GDP is expected to grow by 4% this year, 4.4% in 2022 and by about 3.9% in 2023. The good GDP performance this year rests on the strong base effect. Domestic demand, including household and government consumption and the accumulation of inventories, should form the backbone of this year's growth. The impact of net exports remains a risk, as imports are showing a stronger dynamic than exports (also due to rising prices). In the years to come, gross fixed capital formation should provide an extra impetus to growth, as the EU's budgeting period 2014-2020 is coming to an end and recovery plan funds are distributed. In addition, household consumption should recover next year, on the back of improving labour markets. The risks are still manifold and include developments surrounding the pandemic and related measures (although these are tending to shift to the regional level and not to encompass national lockdowns), as well as the shortage of semiconductors, which is affecting production of the important automotive industry and which has become more acute in the course of the year.

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30 https://spectator.sme.sk/c/22365153/coronavirus-in-slovakia-statistics-and-graphs.html (position as at 29 September 2021).

31 https://qap.ecdc.europa.eu/public/extensions/COVID-19/vaccine-tracker.html#uptake-tab (position as at 29 September 2021).

32 https://korona.gov.sk/

Table 4.20 / Slovakia: Selected economic indicators

	2018	2019	2020 1)	2020 January-June	2021 January-June	2021 Forecast	2022 Forecast	2023 Forecast
Population, th pers., average	5,447	5,454	5,459	.	.	5,465	5,470	5,475
Gross domestic product, EUR m, nom.	89,357	93,901	91,555	42,934	45,648	97,400	104,100	110,300
annual change in % (real)	3.7	2.5	-4.8	-7.4	4.9	4.0	4.4	3.9
GDP/capita (EUR at PPP)	21,360	21,870	21,260	.	.	.	.	.
Consumption of households, EUR m, nom.	49,683	52,334	52,837	25,843	26,111	.	.	.
annual change in % (real)	4.2	2.6	-1.1	-1.6	-0.5	1.5	2.1	2.9
Gross fixed capital form., EUR m, nom.	18,707	20,184	17,879	7,886	7,853	.	.	.
annual change in % (real)	2.7	6.6	-12.0	-11.8	-1.9	4.0	10.0	7.0
Gross industrial production								
annual change in % (real)	4.4	0.4	-9.0	-17.7	19.4	12.0	5.0	5.0
Gross agricultural production								
annual change in % (real)	-2.4	-4.2	1.5	.	.	.	.	.
Construction industry								
annual change in % (real)	8.5	-3.6	-11.3	-7.4	-4.3	.	.	.
Employed persons, LFS, th, average 2)	2,567	2,584	2,531	2,528	2,519	2490	2510	2540
annual change in %	1.4	0.7	-2.0	-2.0	-3.1	-1.6	1.0	1.0
Unemployed persons, LFS, th, average 2)	180	158	181	170	190	180	170	160
Unemployment rate, LFS, in %, average 2)	6.5	5.8	6.7	6.3	7.0	6.8	6.5	6.0
Reg. unemployment rate, in %, eop	5.0	4.9	7.6	7.4	7.8	.	.	.
Average monthly gross wages, EUR	1,013	1,092	1,133	1,087	1,163	1190	1260	1330
annual change in % (real, gross)	3.6	5.0	1.9	0.0	5.3	2.4	3.0	3.5
Consumer prices (HICP), % p.a.	2.5	2.8	2.0	2.5	1.5	2.3	2.4	2.0
Producer prices in industry, % p.a.	2.3	1.9	-0.6	0.1	1.7	3.5	4.0	3.0
General governm.budget, EU-def., % of GDP								
Revenues	40.7	41.3	41.6	.	.	40.4	40.9	41.2
Expenditures	41.7	42.7	47.8	.	.	47.5	46.0	45.3
Net lending (+) / net borrowing (-)	-1.0	-1.3	-6.1	.	.	-7.1	-5.1	-4.1
General gov.gross debt, EU def., % of GDP	49.7	48.2	60.3	.	.	62.5	61.2	60.0
Stock of loans of non-fin.private sector, % p.a.	9.8	6.6	5.0	6.1	5.1	.	.	.
Non-performing loans (NPL), in %, eop	3.1	2.8	2.3	2.7	2.1	.	.	.
Central bank policy rate, % p.a., eop 3)	0.00	0.00	0.00	0.00	0.00	.	.	.
Current account, EUR m	-1,973	-3,163	105	-1,114	-166	-700	-600	-600
Current account, % of GDP	-2.2	-3.4	0.1	-2.6	-0.4	-0.7	-0.6	-0.5
Exports of goods, BOP, EUR m	75,142	75,522	70,011	31,663	40,710	80,200	85,000	89,000
annual change in %	6.6	0.5	-7.3	-17.7	28.6	14.5	6.0	4.7
Imports of goods, BOP, EUR m	75,381	76,658	68,996	32,270	39,697	78,700	83,000	87,200
annual change in %	7.8	1.7	-10.0	-16.4	23.0	14.0	5.5	5.1
Exports of services, BOP, EUR m	10,228	10,981	9,032	4,368	4,224	9,100	9,600	10,200
annual change in %	9.5	7.4	-17.8	-16.4	-3.3	1.0	6.0	6.0
Imports of services, BOP, EUR m	9,300	9,763	7,944	3,815	3,914	8,600	8,900	9,300
annual change in %	10.0	5.0	-18.6	-16.7	2.6	8.0	4.0	4.0
FDI liabilities, EUR m	1,906	2,042	-214	1,159	650	1,000	.	.
FDI assets, EUR m	760	-162	1,683	1,472	1,035	1,000	.	.
Gross reserves of CB excl. gold, EUR m	3,426	5,002	6,050	6,111	6,160	.	.	.
Gross external debt, EUR m	102,870	106,016	110,925	113,330	110,779	115,000	119,000	123,000
Gross external debt, % of GDP	115.1	112.9	121.2	123.8	113.7	118.1	114.3	111.5

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

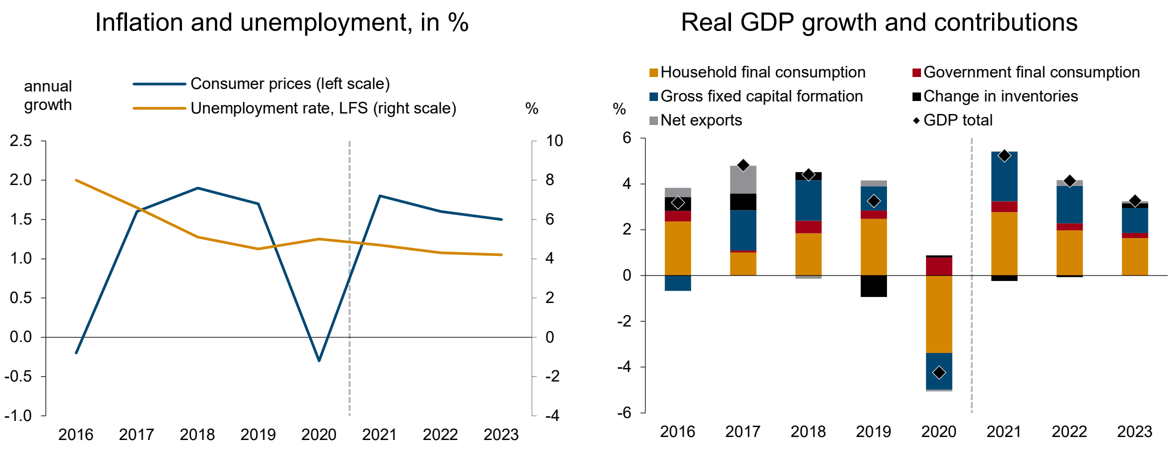
Source: wiiw Databases incorporating Eurostat and national statistics. Forecasts by wiiw.

SLOVENIA: Racing towards full economic recovery while combating vaccine hesitancy

NIKO KORPAR

GDP has almost recovered to its pre-crisis levels. Strong economic performance has led our forecast for economic growth to be revised upwards to 5.2%. Q2 2021 saw an increase in private expenditure, a renewed growth in services and strong private investment activity. Exports and trade-oriented industrial sectors have already grown beyond 2019 levels. Inflation has stabilised and is not likely to exceed 2% in 2021. With a surge in infections, the slow progress of vaccination is a risk factor for the winter.

Figure 4.21 / Slovenia: Main macroeconomic indicators



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

Economic recovery is proceeding more rapidly than was previously expected. Despite the long second wave of the pandemic, the first half of 2021 saw a rebound in both private and public economic activity. In Q2 2021, the economy grew by 16.3% (partly due to the recession of Q2 2020). In July 2021, Slovenia's real GDP was just 0.2% smaller than in 2019. Strong investment activity and increased spending by households are two of the main developments of Q2 2021. Investments are projected to grow by 10% in 2021, and a major share of capital accumulation is being directed towards equipment. Private consumption has grown by 4.4% quarter on quarter, providing a boost in particular to retail trade and services, which grew by 30% year on year in Q2 2021. After reaching record levels of 25% in 2020, the savings rate has also declined, indicating a new propensity to make larger purchases, mostly in real estate. Manufacturing and exports have benefited from strong foreign demand, as has the transport sector. Construction, which boomed in late 2020, has since slowed: it contracted in the first half of 2021 on account of supply issues, but that state of affairs is expected to be only temporary.

In 2021, real GDP is now expected to grow by 5.2% – up 1.6 percentage points (pp) on our previous forecast. The solid performance of the economy in the first half of the year – coupled with rising foreign demand, the continuation of government support measures and a re-emerging consumer confidence – gives good reason to expect another strong (albeit slightly more subdued) showing in the second half of the year, despite what is shaping up to be a new wave of infections. This has prompted us to revise our forecasts for economic growth upwards.

Resurgent hospitalisation rates and low vaccine uptake give grounds for concern, although further lockdowns are unlikely. After a long second lockdown period, most restrictions were lifted around mid-April. After the initial success of the vaccination programme, vaccination rates slowed considerably after June. As of mid-September, 45% of the total population is fully vaccinated. Vaccine scepticism is rampant among large sections of the population. After August, infection rates started to rise again and in mid-September were comparable to those in April. In response, the government has instituted a mandatory 'green pass' system for almost all public spaces and retail outlets (including filling stations), and for non-essential hospital appointments. This move has proved unpopular and has led to protests that have erupted into violence. According to (rather inconclusive) statements by politicians, lockdown measures will not be instituted again.

Manufacturing, construction and transport services are leading the way. Most industrial sectors, as well as the related transport services, actually exceeded pre-crisis levels of value added in the first half of 2021. The key exception is the automotive sector, which is still 10% below its 2019 output – largely because of an inadequate supply of semiconductors and the high cost of other inputs, especially metals. Expensive raw materials are also causing issues in other industrial sectors that cannot easily raise their output prices, because of heavy competition. Autumn is likely to witness a general slowdown in industrial activity, due to the aforementioned supply-side issues.

The volume of trade in goods has exceeded pre-crisis levels, but trade in services is still lagging. A strong upsurge in demand from Slovenia's key trade partners (expected to exceed 9% in 2021) was instrumental in the recovery of exports of goods, which exceeded pre-crisis levels in Q1 2021. The export of services has seen a year-on-year rise for the first time since the beginning of the pandemic, growing by almost 30% year on year in Q2 2021. However, a return to the 2019 levels is expected only in 2022 – and tourism is likely to require significantly longer. Strong domestic demand has led to imports rising faster than exports: they will grow by 12% in 2021. Nevertheless, Slovenia will continue its long run of high current account surpluses, with 5.7% of GDP in 2021 and beyond.

So far, fears of high inflation have not materialised and are unlikely to do so during the forecast period. The deflation of 2020 was followed by a prolonged lockdown, which acted as a brake on price hikes. After the reopening in April, prices rose by 2% year on year. From then until mid-September, growth stabilised at around 2%. In 2021, we expect the consumer price index to grow by 1.8% for the year. The largest contributor to inflation is the cost of energy. Food prices in September 2021 are still lower than in 2020. In August, the cost of services began to rise for the first time since the pandemic struck. Meanwhile, producer prices have grown considerably, due to the rising cost of raw materials: in July 2021, they were 6% higher than in July 2020. Most of these price hikes involve products destined for export, and so do not pass through to domestic consumer prices. Next year, inflation should hover around 1.6%, depending on the pressures on the labour market and movements in oil prices.

The demand for labour has been growing steadily since February 2021. The labour market – still supported by government measures, such as basic income for the self-employed and furlough schemes – showed resilience in the long lockdown of Q1 2021, and since then has been performing better than expected. From the beginning of 2021 until July 2021, the unemployment rate fell from 5.3% to 4.0%. At the end of August, there were 21% fewer unemployed workers than in August 2020. For 2021, we project an unemployment rate of 4.7%, a downward revision of 0.8 pp compared to our previous forecast. After a prolonged period of shedding employees, the service sector is once again on the lookout for new workers – a development that benefits mostly women and the young. We expect the continued revival of the economy in 2022 to lead to a further reduction in the unemployment rate to 4.3%. Due to the altered methodology, which considers COVID-related payments and benefits, wages in 2021 will once again grow markedly, by 4.5%, largely because of the lockdown in Q1 and Q2 2021. Next year, wage growth should slow to 1.8%.

Key government support schemes have been extended until the end of the year, but participation is decreasing. Government-sponsored furlough, basic income for the self-employed, the debt moratorium and tourist vouchers continue to support the economy and preserve jobs. It is estimated that they cushioned the fall in GDP by 4 pp in 2020. The removal of restrictions after spring automatically reduced the share of workers and companies covered under these schemes. In June 2021, 27,000 workers were still included on various government schemes designed to protect employees – 13,000 down on the previous month. Nevertheless, about 38% of all self-employed workers received basic income in June 2021.

The fiscal situation remains the most problematic consequence of the pandemic. In 2021, government spending is projected to grow by 2.3%. Early signs point to the government's spending exceeding its own targets. Therefore, we forecast a public deficit of 7.3% of GDP, 2 pp higher than was set by the government at the beginning of the year. As a result of two consecutive years of high budget deficits, public debt will increase again in 2021, but only by 1 pp, compared to 2020. Our projections for public debt as a share of GDP place it at 80.8%. This represents an almost 20 pp rise in public debt since 2019. Government spending in the first half of 2021 was 18.6% higher than in the first half of 2020, mostly due to investments and COVID-related costs. The total direct cost of COVID-related measures from January 2021 to September 2021 was EUR 2.25bn, or 4.5% of real GDP in 2021. Public debt will shrink in the coming years (to 80.5% in 2022); this will mostly be due to economic growth, as no significant reductions in spending are likely in 2022, an election year. Although the gradual end of the pandemic should act as an automatic brake on public expenditure, the government is expected to keep running deficits in the coming years.

The government is keeping up its feuding with national and international institutions, with few real-world consequences. With the exception of the occasional inflammatory statement or Tweet by Prime Minister Janez Janša (from which the EU Commission is quick to distance itself) and apart from the ongoing European Parliament investigation into the state of media freedom in Slovenia, the country's Presidency of the Council of the EU is progressing relatively calmly. In his European agenda, Prime Minister Janša sticks to promoting the sovereignty-oriented and anti-immigration rhetoric of his Polish and Hungarian counterparts. Domestically, the Slovenian Democratic Party-led government operates with a parliamentary minority and is unlikely to pass any major reforms until the next parliamentary elections, scheduled for spring 2022. An early election cannot be ruled out – potentially in response to the public outcry over the handling of the pandemic, disagreements over the 2022 budget, or further strife within the minority coalition partner DeSUS.

In 2022, the recovery will be almost complete. Aside from tourism, services should also catch up with their 2019 level of employment and output. International trade will continue to act as a driver of growth, as will construction, both private and public. The EU’s Recovery and Resilience Facility will also become an important factor. The first tranche (about 13%) of the EUR 2.764bn of funds and loans should be available to the government by the end of 2021. Investments in public infrastructure will also be boosted by the approaching end of the current EU budget – a time when the acquisition of EU funds usually accelerates. The key risk factor remains the pandemic. A slow rate of vaccination and new variants could put the brake on private spending. Some of the other variables that may adversely affect the economy in 2022 include the premature removal of the remaining COVID-related measures, high rates of inflation and a low intensity of absorbing European funds.

Table 4.21 / Slovenia: Selected economic indicators

	2018	2019	2020 1)	2020 January-June	2021 January-June	2021 Forecast	2022 Forecast	2023 Forecast
Population, th pers., average	2,074	2,088	2,102	.	.	2,115	2,120	2,125
Gross domestic product, EUR m, nom.	45,864	48,397	46,918	22,336	24,768	50,300	53,200	55,800
annual change in % (real)	4.4	3.3	-4.2	-6.3	8.8	5.2	4.1	3.3
GDP/capita (EUR at PPP)	26,410	27,660	26,770	.	.	.	.	.
Consumption of households, EUR m, nom.	23,463	24,919	23,160	10,889	12,004	.	.	.
annual change in % (real)	3.6	4.8	-6.6	-8.2	8.8	5.6	4.0	3.3
Gross fixed capital form., EUR m, nom.	8,834	9,495	8,861	4,203	4,912	.	.	.
annual change in % (real)	9.7	5.5	-8.2	-12.3	13.4	11.5	8.6	5.8
Gross industrial production								
annual change in % (real)	5.1	3.1	-5.3	-9.6	14.3	6.9	4.2	3.0
Gross agricultural production								
annual change in % (real)	28.5	-7.8	8.9	.	.	.	.	.
Construction industry								
annual change in % (real)	20.0	3.3	-0.7	-6.8	-2.9	.	.	.
Employed persons, LFS, th, average 2)	980.6	982.6	978.1	974.8	953.5	990	1,010	1,020
annual change in %	2.2	0.2	-0.5	-1.0	.	1.0	1.6	1.4
Unemployed persons, LFS, th, average 2)	52.8	45.7	51.2	49.7	50.0	50	50	40
Unemployment rate, LFS, in %, average 2)	5.1	4.5	5.0	4.9	5.1	4.7	4.3	4.2
Reg. unemployment rate, in %, eop	8.1	7.7	8.9	9.2	7.3	.	.	.
Average monthly gross wages, EUR 3)	1,682	1,754	1,856	1,834	1,981	1,970	2,040	2,120
annual change in % (real, gross)	1.7	2.7	5.9	5.8	7.3	4.5	1.8	2.5
Average monthly net wages, EUR 3)	1,093	1,134	1,209	1,196	1,273	1,290	1,340	1,390
annual change in % (real, net)	1.2	2.1	6.6	7.0	5.7	5.0	1.9	2.1
Consumer prices (HICP), % p.a.	1.9	1.7	-0.3	0.2	0.7	1.8	1.6	1.5
Producer prices in industry, % p.a.	2.1	0.6	-0.3	-0.3	2.4	2.5	1.4	0.6
General governm.budget, EU-def., % of GDP								
Revenues	44.3	43.7	43.0	.	.	44.0	44.5	44.8
Expenditures	43.5	43.3	51.3	.	.	51.3	47.8	45.6
Net lending (+) / net borrowing (-)	0.7	0.4	-8.3	.	.	-7.3	-3.3	-0.8
General gov.gross debt, EU def., % of GDP	70.3	65.6	79.8	.	.	81.7	80.5	79.6
Stock of loans of non-fin.private sector, % p.a.	3.0	3.5	0.0	0.9	1.7	.	.	.
Non-performing loans (NPL), in %, eop 4)	5.6	2.9	2.6	2.6	1.9	.	.	.
Central bank policy rate, % p.a., eop 5)	0.00	0.00	0.00	0.00	0.00	.	.	.
Current account, EUR m	2,731	2,898	3,462	1,702	1,338	2,890	2,880	2,660
Current account, % of GDP	6.0	6.0	7.4	7.6	5.4	5.7	5.4	4.8
Exports of goods, BOP, EUR m	30,808	32,013	29,656	14,287	16,991	33,360	36,230	38,840
annual change in %	8.6	3.9	-7.4	-12.2	18.9	12.5	8.6	7.2
Imports of goods, BOP, EUR m	29,535	30,702	27,290	13,151	16,219	31,140	34,100	36,830
annual change in %	10.4	4.0	-11.1	-14.8	23.3	14.1	9.5	8.0
Exports of services, BOP, EUR m	8,124	8,659	6,900	3,217	3,427	7,840	8,870	9,620
annual change in %	9.9	6.6	-20.3	-19.1	6.5	13.6	13.1	8.5
Imports of services, BOP, EUR m	5,500	5,751	4,904	2,304	2,451	5,460	6,220	6,970
annual change in %	7.0	4.6	-14.7	-13.4	6.4	11.3	14.0	12.1
FDI liabilities, EUR m	1,307	1,919	431	262	1,078	730	.	.
FDI assets, EUR m	373	1,157	697	205	392	470	.	.
Gross reserves of CB excl. gold, EUR m	702	767	913	859	970	.	.	.
Gross external debt, EUR m	42,139	44,277	47,792	48,183	50,002	49,000	51,100	53,300
Gross external debt, % of GDP	91.9	91.5	101.9	102.7	99.4	97.5	96.0	95.5

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

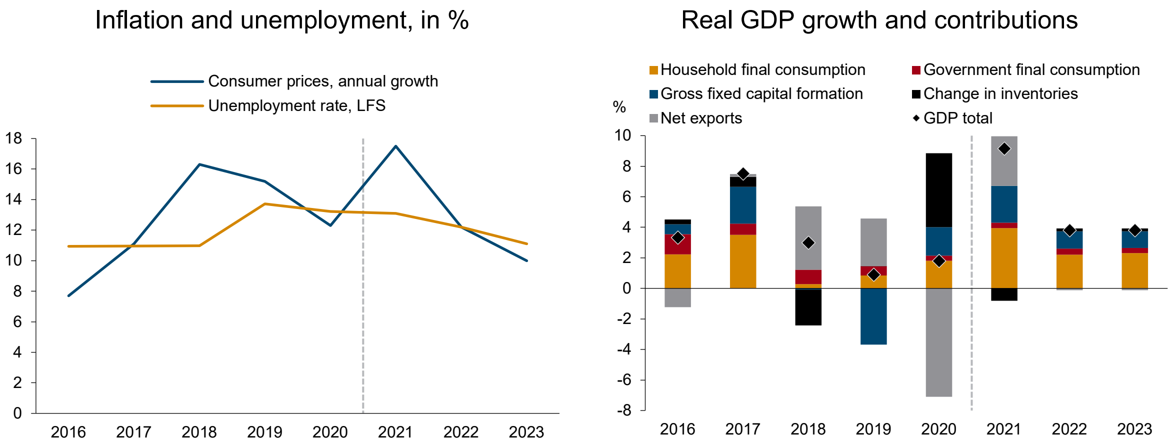
Source: wiiw Databases incorporating Eurostat and national statistics. Forecasts by wiiw.

TURKEY: Outperforming the region – for now

RICHARD GRIEVESON

The economy is currently booming, underpinned by strong credit growth, robust domestic consumption, and the impact of the global recovery on export demand and tourism. Ultra-loose monetary policy by the major economies is supporting capital inflows; but as the US, in particular, starts to taper its asset purchases, the risks for Turkey's external financing will rise. While the short-term outlook is good, the usual vulnerabilities remain – not least high inflation and uncertainty over the direction of monetary policy.

Figure 4.22 / Turkey: Main macroeconomic indicators



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

The Turkish economy has built on its relatively good performance in 2020 with – so far – a very strong 2021. Turkey's economy grew by 1.8% in 2020, making it the only country in CESEE to post full-year growth last year. Growth this year has surged even higher, with the economy expanding by 7.2% year on year in Q1 2021, and by 21.7% in Q2. This particularly strong growth in Q2, however, was significantly influenced by the low base period, with the economy having contracted by 10.4% in the same period of last year. In quarterly terms, the economy expanded by 0.9% in Q2, a significant slowdown from the 2.2% expansion in the first three months of the year.

The improved external environment has significantly helped the Turkish economy. Exports of goods and services increased by 59.9% year on year in Q2 in real terms, easily outpacing the 19.2% increase in imports over the same period. The weaker lira (as well as Turkish exporters' proven track record of adjusting to and finding new markets amid volatility in the global economy) certainly helped this export performance. However, it is also worth noting that the base effects were quite different: exports fell by 36.4% in Q2 of last year, whereas imports declined by just 8%. Household consumption and investment also contributed very strongly to growth in Q2 2021, rising by 22.9% and 20.3%, respectively, year on year. Government spending played a less significant (though still clearly positive) role, rising by 4.2%.

Credit growth has slowed from its peak in 2020, but remains strong and has been a further key driver of economic expansion so far in 2021. In August 2021, credit extended by banks to households rose by 15.4% year on year, according to the central bank. Although still strong, this is down from a peak of around 50% growth in the second half of last year, reflecting the tighter monetary policy that began in the latter half of 2020 and the phasing out of some supportive lending measures ('credit campaigns'). With the central bank having apparently now embarked on a new cycle of monetary easing (see below), credit growth could again pick up in the remainder of 2021 and into 2022.

Fiscal policy, by contrast, has remained relatively conservative, in line with historical trends. Although the pandemic has led to higher spending, this has generally been offset by an increase in revenues on the back of the strong performance of the economy. Public debt as a share of GDP remains low (particularly compared to the country's main regional peers and other major emerging markets around the world), and is unlikely to present a problem during the forecast period.

As a result of the very strong Q2 performance, we have revised our forecasts upwards for 2021. For this year, we now expect the economy to expand by 9.1% – a major upgrade on our previous forecast of 5.8%, reflecting the extremely strong performance of the first two quarters of the year. This forecast implies more or less a continuation of the quarterly momentum of April-June for the remainder of the year (something that high-frequency indicators suggest was the case at least through most of Q3). For 2022, we expect growth of a bit below 4%, similar to that projected during our last forecasting round. This implies a slight decrease in quarterly growth rates next year, but not a huge slowdown relative to current momentum.

The latest high-frequency indicators give little indication that the economy is slowing. Retail sales volumes continued to increase in July (latest data available), by 0.7% month on month and 12.3% year on year, pointing to robust momentum in consumer spending (unsurprisingly, retail sales volume online and via mail order rose by 46.1% year on year, underlining the shift towards online retail driven by the pandemic). Consumer confidence increased in September, relative to August. Meanwhile, the latest Istanbul Chamber of Industry purchasing managers' index (PMI) for manufacturing was 54.1 in August – well above the level of 50 that separates expansion from contraction. Although industrial production declined fairly sharply in July (by 4.2% month on month), the annual growth rate was still very robust, at 8.7%. The PMI survey indicated that Turkish manufacturers are facing similar challenges to those across Europe, with increased pressures on the supply side leading to sharply rising input costs (and with the weakness of the lira compounding this in Turkey's case). One positive from the September survey was that firms reported an easing of delays caused by supply-chain disruptions, with import delays and raw material shortages said to be the 'least marked for a year'.

The effect of robust economic growth has been increased labour demand, which is supporting a decline in the headline unemployment rate. Joblessness was recorded at 12% in July 2021, 2.4 percentage points lower than a year earlier. Headline employment has risen this year: in July 2021, the total number of people in employment was almost 2.4m greater than a year earlier. While labour market data have been affected by the pandemic and may not be fully comparable with pre-pandemic times, the available figures suggest that the labour market in Turkey has been much less badly affected over the last 18 months than is the case in most of the rest of CESEE.

Despite the fairly positive current backdrop, however, there are growing signs of difficulties facing the economy. One key challenge (which is not new to Turkish firms or consumers) is inflation, which rose by 19.3% year on year in August. Even by Turkish standards, inflation is currently very high, and is eating into real income gains. As everywhere in the world, domestic prices are being heavily influenced by the cost of commodities. In Turkey in August, the costs of food and transport increased by over 20% year on year, above the level of headline inflation. However, Turkey is also affected by the weaker lira, which is increasing imported inflation. Even a measure of 'core' inflation that excludes volatile items, such as energy and unprocessed food, rose by 18.5% year on year in August.

As we predicted in the summer, the central bank cut interest rates, despite the very high inflation. This suggests another period of uncertainty ahead for monetary policy. The bank cut its target interest rate by 100 basis points to 18% in September, putting real rates firmly into negative territory. Governor Şahap Kavcıoğlu, who was appointed to the position in March, had previously kept rates unchanged, but now looks to have embarked on a new easing cycle. The risks are clear: the central bank is cutting rates with inflation close to 20%, with the US Federal Reserve about to start tapering its asset purchases, and with the lira hitting new all-time lows against the dollar. It is likely that even the best-case scenario will see a weaker lira and more imported inflation. Although looser policy will support economic growth in the short term, there is a chance that a period of loosening will have to be followed by a sharp rise in rates further down the line, in order to support the currency and bring inflation back under partial control (a pattern that is now very familiar in Turkey).

Turkey's current account deficit has so far narrowed during 2021, but it is likely to remain fairly large as a share of GDP throughout the forecast period. The current account deficit totalled USD 13.7bn in January-July 2021 – quite significantly less than the shortfall of USD 23.2bn (5.3% of GDP) over the same period last year. This reflected strong year-on-year growth in exports of merchandise goods (in US dollar terms) and a recovery in tourism (total arrivals from abroad rose 52% year on year in January-July). However, given the very unusual base period, year-on-year comparisons could paint a false picture. A notable development is the 25% year-on-year expansion of goods imports in January-July (in US dollar terms), driven by credit-financed import demand and higher prices, especially for energy. If these trends on the import side continue, the current account deficit will remain elevated. We expect a shortfall of around 3% of GDP in 2021-2023 (down from last year). Short-term external-debt rollover needs remain substantial, totalling USD 125bn as of July 2021 and equivalent to about 17% of GDP (one of the highest ratios among the CESEE countries for which comparable data are available). Some 41% of this is in US dollars and another 26% in euros, underlining both how problematic the persistent depreciation of the lira is, and Turkey's high level of vulnerability to US interest rate rises.

The risks to the outlook are certainly on the downside, and stem from the usual sources: US monetary policy tightening, high short-term external debt refinancing needs, the blowback from geopolitics, erratic monetary policy, persistently high inflation and the weakness of the lira. These factors interact with (and in many ways reinforce) each other, and the pressure is likely to grow, rather than diminish in the coming years. This is certainly true of US monetary policy, with tapering set to begin by the end of 2021, and with higher US rates from 2022 or 2023. In the past –most notably during the taper tantrum of 2013 – even the possibility of tighter US policy caused huge volatility on Turkish markets. Given that this looks set to coincide with a cycle of monetary loosening in Turkey, the risks are even higher.

Table 4.22 / Turkey: Selected economic indicators

	2018	2019	2020 1)	2020	2021	2021	2022	2023
				January-June			Forecast	
Population, th pers., average	81,407	82,579	83,385	.	.	84,385	85,398	86,423
Gross domestic product, TRY bn, nom.	3,759	4,318	5,047	2,109	2,970	6,500	7,600	8,700
annual change in % (real)	3.0	0.9	1.8	-3.5	14.4	9.1	3.8	3.8
GDP/capita (EUR at PPP)	19,170	18,530	19,000	.	.	.	.	.
Consumption of households, TRY bn, nom.	2,099	2,441	2,845	1,204	1,620	.	.	.
annual change in % (real)	0.5	1.5	3.2	-2.6	14.8	7.0	3.9	4.1
Gross fixed capital form., TRY bn, nom.	1,115	1,117	1,382	568	852	.	.	.
annual change in % (real)	-0.2	-12.4	7.2	-3.3	16.4	8.8	4.1	4.0
Gross industrial production 2)								
annual change in % (real)	1.1	-0.6	2.2	-5.8	24.5	8.0	3.1	2.8
Gross agricultural production 3)								
annual change in % (real)	-0.9	4.1	3.0	.	.	.	.	.
Construction industry 2)								
annual change in % (real)	-5.0	-8.0	-3.0	.	.	.	.	.
Employed persons, LFS, th, average 4)	28,734	28,081	26,808	26,306	27,920	28,100	28,800	29,500
annual change in %	1.9	-2.3	-4.5	-5.4	6.3	5.0	2.5	2.5
Unemployed persons, LFS, th, average 4)	3,535	4,461	4,063	4,027	4,036	4,240	4,000	3,680
Unemployment rate, LFS, in %, average 4)	11.0	13.7	13.2	13.3	12.7	13.1	12.2	11.1
Reg. unemployment rate, in %, eop	.	.		.	.	.	.	.
Average monthly gross wages, TRY 5)	3,597	4,470	4,595	.	.	5530	6360	7170
annual change in % (real, gross)	-0.7	7.9	-8.5	.	.	2.5	2.5	2.5
Consumer prices (HICP), % p.a.	16.3	15.2	12.3	11.9	16.3	17.5	12.2	10.0
Producer prices in industry, % p.a. 5)	27.0	17.6	12.1	7.5	33.6	18.8	13.5	11.3
General governm.budget, nat.def., % of GDP								
Revenues	29.8	29.8	29.7	.	.	30.0	31.0	32.0
Expenditures	32.5	32.9	32.5	.	.	33.5	33.5	33.5
Deficit (-) / surplus (+)	-2.8	-3.2	-2.8	.	.	-3.5	-2.5	-1.5
General gov.gross debt, nat.def., % of GDP	30.2	32.7	39.5	.	.	40.4	43.5	46.4
Stock of loans of non-fin.private sector, % p.a.	9.6	10.2	35.3	28.4	18.7	.	.	.
Non-performing loans (NPL), in %, eop	3.9	5.4	4.1	4.4	3.7	.	.	.
Central bank policy rate, % p.a., eop 6)	24.00	12.00	17.00	8.3	19.0	18.00	12.00	10.00
Current account, EUR m	-17,579	6,106	-32,886	-19,255	-10,836	-22,300	-22,400	-22,500
Current account, % of GDP	-2.7	0.9	-5.2	-6.5	-3.5	-3.1	-2.9	-2.7
Exports of goods, BOP, EUR m	151,681	162,818	147,064	67,748	86,158	171,000	180,000	189,000
annual change in %	1.2	7.3	-9.7	-14.3	27.2	16.0	5.0	5.0
Imports of goods, BOP, EUR m	185,543	177,819	180,271	84,322	97,303	196,000	206,000	216,000
annual change in %	-7.8	-4.2	1.4	-1.1	15.4	9.0	5.0	5.0
Exports of services, BOP, EUR m	49,928	56,908	30,412	13,379	16,237	36,000	38,000	40,000
annual change in %	6.4	14.0	-46.6	-41.3	21.4	20.0	5.0	5.0
Imports of services, BOP, EUR m	24,154	25,082	22,501	11,019	11,063	24,000	25,000	26,000
annual change in %	0.8	3.8	-10.3	-5.6	0.4	7.0	5.0	5.0
FDI liabilities, EUR m	10,931	8,274	6,814	2,881	3,656	7,155	.	.
FDI assets, EUR m	3,019	2,630	2,799	855.8	1,536.7	2,939	.	.
Gross reserves of CB excl. gold, EUR m 7)	63,666	69,975	40,776	42,219	48,100	.	.	.
Gross external debt, EUR m 7)	373,278	370,674	352,944	365,337	375,664	418,900	427,000	439,200
Gross external debt, % of GDP	56.7	54.6	56.3	53.8	60.0	58.0	54.5	52.0
Average exchange rate TRY/EUR	5.7077	6.3578	8.0547	7.1521	9.5126	9.00	9.70	10.30

1) Preliminary. - 2) Enterprises with 20 and more employees; for construction wiiw estimate. - 3) Based on UN-FAO data, wiiw estimate in 2020. - 4) From 2021 new methodology in line with the Integrated European Social Statistics Regulation (IESS). - 5) Personnel costs. Data based on Annual Industry and Service Statistics excluding NACE activities agriculture and fishing, finance and insurance, public administration, defence and social security. - 5) Domestic output prices. - 6) One-week repo rate. - 7) Converted from USD.

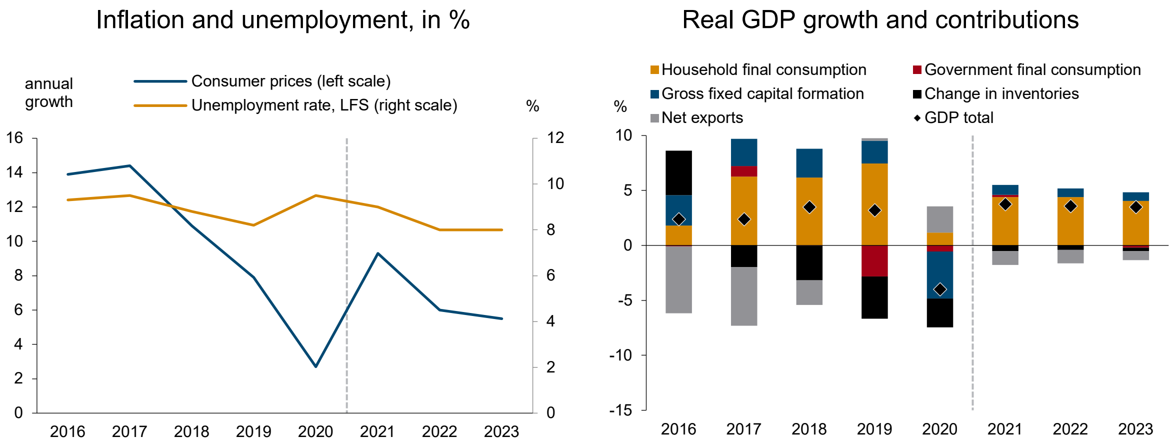
Source: wiiw Databases incorporating national statistics. Forecasts by wiiw.

UKRAINE: Underwhelming recovery against background of mounting risks

OLGA PINDYUK

Economic recovery in 2021 will be slower than expected, with GDP growing by 3.8% in annual terms. Private consumption will remain the main driver of growth throughout the forecast period. The recent acceleration in inflation is only temporary: it will slow down in 2022-2023. Any further delays to IMF funding disbursements would constitute a major risk to growth.

Figure 4.23 / Ukraine: Main macroeconomic indicators



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

At 5.4% year on year, Ukraine's GDP growth in Q2 2021 was lower than expected. Sluggish investment and falling export volumes lay behind this unexpectedly slow recovery. Private consumption has continued to be the main driver of growth, increasing in Q2 2021 by 17.4% in annual terms. It has been supported both by a double-digit rise in real wages and by increased remittances; however, inflation – which has soared to over 10% year on year in recent months – is acting as a drag on real wages.

We expect GDP growth to increase slightly in the second half of 2021, on the back of a better harvest than last year. That will allow a rise in the volume of exports. Consequently, annual GDP growth in 2021 is forecast to be 3.8%. In 2022-2023, the stabilisation of external demand for major export commodities and the lack of any great improvement in the investment climate will cause the economy to grow rather sluggishly (by about 3.5% per year), still largely on the back of private consumption.

Attempts to improve the investment climate in the country have met with mixed success. To curb the influence of business tycoons on the country's politics, Ukraine's parliament has passed a law defining the term 'oligarch' and establishing a register of individuals who meet the definition. They are required to disclose their assets and will be banned from funding political parties. However, the lack of judicial reform remains one of the main barriers to eradicating corruption; moreover, according to a study by the American Chamber of Commerce and Citi Ukraine, the courts create the biggest obstacles to business.[33] Judicial reform has stalled: on 13 September 2021, the Ukrainian Council of Judges failed to nominate members to the Ethics Council, a key body for judicial reform.

To combat the high inflation, the National Bank of Ukraine raised its policy rate to 8.5% on 7 September 2021. In addition, the bank took the decision to phase out its anti-crisis monetary measures (long-term refinancing tenders and interest rate swap auctions) at the beginning of Q4 2021. Higher base effects in the second half of this year, plus an increased supply of food on the back of a better harvest, will reduce the rate of year-on-year inflation by the end of 2021. As commodity and energy prices are expected to stabilise in the near future, annual inflation will slow from 9.3% in 2021 to 5.5% in 2023.

The USD 2.7bn that Ukraine is due to receive as part of a Special Drawing Rights (SDR) allocation by the International Monetary Fund (IMF) will help finance its short-term budget needs this year, including external debt repayments.[34] The next IMF mission was due in September 2021: if it makes a positive assessment of the government's progress in implementing reforms to fulfil the conditions of the stand-by agreement, Ukraine is likely to receive about USD 700m in the next tranche before the end of 2021. The government borrowing plan for 2022, submitted to parliament along with the draft budget, envisages an issue of Eurobonds, with a maturity of 5–15 years, for the equivalent of USD 1.5bn; it also plans to raise an additional USD 2.9bn from the IMF. Given the country's hefty external financing needs, maintaining cooperation with the IMF is crucial for Ukraine's macro-financial stability. Any failure to do so would present a major risk to the growth forecast.

The recent spike in gas prices in Europe renders it increasingly likely that the Nord Stream 2 pipeline from Russia to Germany across the Baltic Sea will soon start operating. As a consequence, we expect Ukraine to lose a proportion of its gas transit revenues as early as 2022; that will increase its current account deficit. However, this is not likely to have a major effect on the exchange rate dynamics, as pipeline transport accounts for only 4% of total exports.

The fourth wave of COVID-19 could pose an additional risk to growth. Since late August, the number of confirmed COVID-19 cases and hospitalisations has been growing rapidly in Ukraine. Moreover, the country has the lowest vaccination rate in the CESEE region – as of the end of September, about 13% of the population were fully vaccinated. If the situation deteriorates, stricter quarantine rules could be introduced, with a knock-on effect on economic activity. However, the pandemic will not have such a strong impact on the economy as last year, partly because the economy has adapted and partly because governments in CESEE are tending to prioritise the economy over public health.

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[33] https://www.kyivpost.com/ukraine-politics/survey-ukraines-businesses-financially-recovering-from-covid-19-pandemic.html

[34] The first tranche (USD 1.9bn) landed in the government's account on 23 August 2021. Ukraine has also received EUR 600m assistance from the EU.

Table 4.23 / Ukraine: Selected economic indicators

	2018	2019	2020 1)	2020 January-June	2021 January-June	2021 Forecast	2022 Forecast	2023 Forecast
Population, th pers., average	42,270	42,028	41,745	.	.	41,370	41,080	40,790
Gross domestic product, UAH bn, nom.	3,560	3,977	4,192	1,728	2,178	4,800	5,300	5,800
annual change in % (real)	3.5	3.2	-4.0	-6.8	2.0	3.8	3.6	3.5
GDP/capita (EUR at PPP)	8,570	8,990	8,820	.	.	.	.	.
Consumption of households, UAH bn, nom.	2,439	2,918	3,079	1,380	1,705	.	.	.
annual change in % (real)	9.3	10.9	1.6	-1.8	11.1	6.0	6.0	5.5
Gross fixed capital form., UAH bn, nom.	628	701	547	214	247	.	.	.
annual change in % (real)	16.6	11.7	-24.4	-22.1	5.0	7.0	6.0	6.0
Gross industrial production								
annual change in % (real)	3.0	-0.5	-4.5	-7.6	2.1	2.0	3.0	3.0
Gross agricultural production								
annual change in % (real)	8.2	1.4	-11.5	.	.	.	.	.
Construction output								
annual change in % (real)	8.6	23.6	5.6	-4.3	0.2	.	.	.
Employed persons, LFS, th, average	16,361	16,578	15,915	16,056	15,589	16,200	16,500	16,600
annual change in %	1.3	1.3	-4.0	-2.6	-2.9	1.8	1.9	0.6
Unemployed persons, LFS, th, average	1,579	1,488	1,674	1,631	1,713	1,600	1,430	1,440
Unemployment rate, LFS, in %, average	8.8	8.2	9.5	9.3	9.9	9.0	8.0	8.0
Reg. unemployment rate, in %, eop 2)	1.3	1.3	1.7	.	.	.	.	.
Average monthly gross wages, UAH 3)	8,865	10,497	11,591	10,928	13,309	13,600	15,300	17,300
annual change in % (real, gross)	13.2	9.7	7.4	6.4	12.5	7.0	6.0	7.0
Consumer prices, % p.a.	10.9	7.9	2.7	2.4	8.3	9.3	6.0	5.5
Producer prices in industry, % p.a.	17.4	4.1	-1.6	-5.0	28.5	25.0	3.0	4.0
General governm.budget, nat.def., % of GDP								
Revenues	33.3	32.4	32.8	37.8	34.7	32.0	33.5	33.0
Expenditures	35.2	34.6	38.2	38.0	35.4	37.0	36.5	35.0
Deficit (-) / surplus (+)	-1.9	-2.2	-5.4	-0.2	-0.7	-5.0	-3.0	-2.0
General gov.gross debt, nat.def., % of GDP	60.9	50.2	60.9	52.9	54.1	58.0	56.0	54.0
Stock of loans of non-fin.private sector, % p.a.	5.6	-9.8	-2.8	-3.3	-2.1	.	.	.
Non-performing loans (NPL), in %, eop	52.8	48.4	41.0	48.5	37.2	.	.	.
Central bank policy rate, % p.a., eop 4)	18.00	13.50	6.00	6.00	7.50	8.5	7.5	6.5
Current account, EUR m 5)	-5,443	-3,682	4,612	3,673	-542	-1,400	-3,800	-4,900
Current account, % of GDP	-4.9	-2.7	3.4	6.1	-0.8	-0.9	-2.4	-3.0
Exports of goods, BOP, EUR m 5)	36,677	41,146	39,527	19,167	22,772	43,900	44,900	46,200
annual change in %	4.2	12.2	-3.9	-3.6	18.8	11.1	2.3	2.9
Imports of goods, BOP, EUR m 5)	47,436	53,877	45,462	21,263	24,592	50,500	53,700	56,300
annual change in %	8.4	13.6	-15.6	-14.0	15.7	11.1	6.3	4.8
Exports of services, BOP, EUR m 5)	13,401	15,591	13,628	6,712	6,662	14,100	12,000	12,200
annual change in %	6.1	16.3	-12.6	-7.2	-0.7	3.5	-14.9	1.7
Imports of services, BOP, EUR m 5)	12,270	14,029	9,775	4,924	5,156	10,400	11,200	12,100
annual change in %	3.9	14.3	-30.3	-25.6	4.7	6.4	7.7	8.0
FDI liabilities, EUR m 5)	3,872	5,207	215	-156	2,788	3,400	.	.
FDI assets, EUR m 5)	98	554	317	124	470	400	.	.
Gross reserves of CB excl. gold, EUR m 5)	15,955	21,590	22,422	24,139	22,593	.	.	.
Gross external debt, EUR m 5)	92,352	109,134	102,293	108,907	105,402	110,000	113,000	114,000
Gross external debt, % of GDP	83.4	79.4	75.1	80.0	71.4	74.0	72.0	70.0
Average exchange rate UAH/EUR	32.14	28.95	30.79	28.60	33.49	32.5	33.6	35.4

Note: Excluding the occupied territories of Crimea and Sevastopol and, with the exception of the population, excluding the temporarily occupied territories in the Donetsk and Luhansk regions.
1) Preliminary. - 2) In % of working age population. From 2019 wiiw estimate. - 3) Enterprises with 10 and more employees. - 4) Discount rate of CB. - 5) Converted from USD.

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

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Internet Homepage: www.wiiw.ac.at

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