OESTERREICHISCHE NATIONALBANK
EUROSYSTEM

FOCUS ON EUROPEAN ECONOMIC INTEGRATION | OeNB REPORTS

CESEE
ECONOMIC TRENDS

Security through stability.

2023/6

Contents

Editorial

Stability and security are the guiding principles of the Oesterreichische Nationalbank (OeNB). That means that we are determined to continue informing you on topical economic developments in Central, Eastern and Southeastern Europe (CESEE) – now and for many years to come. At the same time we are aware that, as Heraclitus put it, nothing is permanent except change. In this spirit, we are happy to announce that this issue of *Focus on European Economic Integration (FEEI)* marks an important change.

From now on, you will find our regular reporting on macroeconomic and macrofinancial developments in CESEE in the *OeNB Reports* series, which was introduced earlier this year. Our in-depth analyses of CESEE-relevant topics and one-off studies will be published in the *OeNB Bulletin,* which will be launched next year. With these changes to our publication outlets, we are responding to a modern and dynamic environment and are reflecting institutional and economic developments in the analyzed countries as well as the recent restructuring of the OeNB's Economic Analysis and Research Department.

For almost 30 years, the *FEEI* series and its predecessor, *Focus on Transition,* have been a channel for communicating the OeNB's ongoing research on Central, Eastern and Southeastern European countries, thus reflecting our strategic regional research priority. This research priority is well established within the European System of Central Banks and acknowledged by a broader public in the EU, the EU candidates and beyond. The OeNB's dedication to the CESEE region remains unchanged and we will continue to provide high-quality research and monitoring reports on these countries.

When reviewing the CESEE-related articles published in the *Focus on Transition* series and, later on, in *Focus on European Economic Integration,* it becomes clear that the evolution of topics reflects the progress in the economic transition of the analyzed economies. *Focus on Transition* was first published in 1996. Hence, early contributions centered predominantly on the transition from planned to market economies, with a focus on monetary policy and exchange rate regimes, central bank independence, exchange rate convertibility and developments, current account imbalances and capital account liberalization, as well as banking sector developments and the early EU enlargement plans. In the run-up to the EU's Eastern enlargement, the view on economic integration and convergence was broadened to include topics such as business cycle correlations, demand and supply shocks, the role of FDI and, in particular, the role of Austrian banks in the region. In 2004, when the first CESEE countries became members of the EU, *Focus on Transition* was renamed into *Focus on European Economic Integration.*

We marked the 20th anniversary of East-West integration in Europe with a FEEI Special Issue in 2009 – a year which also brought a switch from semiannual to quarterly publication in the FEEI series. But more important than this frequency change, topics became more diverse, reflecting the diversity of the region. Further, more attention was devoted to the financial sector as the Great Financial Crisis revealed its importance for macroeconomic developments. Candidate countries and potential candidates received greater attention and topics moved strongly toward financial stability, fiscal sustainability, crisis and policy spillovers and structural issues such as trade, labor markets and competitiveness. Increasingly, also research on individuals' financial behavior, perceptions and expectations took center stage, drawing from evidence from the OeNB Euro Survey. Since 2007, results from this survey have helped us build an in-house database that allows us to analyze – at the household level – the use of foreign currencies (in particular the euro), euro adoption expectations, lending and saving decisions, inflation and inflation expectations, foreign currency lending, overindebtedness and loan arrears, nonbank lending and contingent liabilities, the role of trust and perceptions of public debt.

While the first phase of transition may be well over, the CESEE countries continue to be of particular relevance for Austria, especially its banking sector, and therefore also for the OeNB. And they continue to undergo highly interesting and relevant developments which are still under-researched. We are therefore committed to our strategic research priority, and we are looking forward to exploring new topics in the context of European integration, economic convergence, financial stability and households' financial behavior in the CESEE region.

We are excited to enter a new phase of presenting our research findings and economic assessments on the CESEE region and we hope to count you among our valued readers for many years to come.

From now on, you will find our CESEE-specific analyses and reports on the CESEE pages of our website.

Julia Wörz
Head of the Central, Eastern and Southeastern Europe Section

Economic trends in CESEE EU member states

Some success in taming inflation but stalling general economic recovery[1, 2, 3]

1 Regional overview

As we approach the end of 2023, the economies of Central, Eastern and Southeastern Europe (CESEE) are still very busy absorbing the two major shocks of the past years – the pandemic and the Russian war of aggression against Ukraine – as well as the inflation wave unleashed by those events. While CESEE EU member states have made some progress tackling the challenges from inflation, the general economic recovery remains slow and uneven.

Economic activity still falls short of its pre-pandemic path as output has not yet returned to a stable upward trajectory. Average quarterly GDP growth in the CESEE EU members jumped from –0.7% in the final quarter of 2022 to 0.8% in the first quarter of 2023, only to dip back to –0.6% in the second quarter of 2023. The most recent negative reading is entirely attributable to the Polish economy. For a while now, regional variations have been large, and growth outcomes over the first two quarters of 2023 ranged from an average growth rate of more than 1% (quarter on quarter) in Slovenia and Croatia to negative readings in Hungary and Poland. Hungary has been in recession since the third quarter of 2022 and in particular Poland's economic activity has been very volatile (growth readings have oscillated between large positive and large negative figures for several quarters already).

Table 1

Real GDP growth

	2020	2021	2022	Q3 2021	Q4 2021	Q1 2022	Q2 2022	Q3 2022	Q4 2022	Q1 2023	Q2 2023
	Period-on-period change in %										
Slovakia	−3.3	4.8	1.8	0.6	0.5	0.3	0.1	0.3	0.2	0.2	0.5
Slovenia	−4.2	8.2	2.5	2.3	1.3	0.0	0.5	−0.5	0.7	0.2	1.1
Bulgaria	−4.0	7.6	3.4	1.9	1.5	0.4	0.7	0.5	0.5	0.4	0.4
Croatia	−8.5	13.1	6.2	2.3	2.2	2.4	1.2	−0.5	0.5	1.3	1.1
Czechia	−5.5	3.6	2.4	1.8	0.8	0.6	0.2	−0.2	−0.4	0.1	−0.0
Hungary	−4.5	7.1	4.6	1.4	2.5	1.4	1.0	−0.9	−0.9	−0.3	−0.2
Poland	−2.0	6.9	5.1	2.2	1.9	3.2	−1.4	1.2	−2.0	1.6	−2.2
Romania	−3.7	5.7	4.6	1.1	0.4	2.7	0.3	0.8	1.1	−1.0	1.7
CESEE average[1]	−3.5	6.5	4.3	1.7	1.4	2.2	−0.3	0.5	−0.7	0.5	−0.5
Euro area	−6.1	5.6	3.3	2.1	0.5	0.6	0.8	0.3	−0.1	0.1	0.1

Source: Eurostat, national statistical offices.

[1] *Average weighted with GDP at PPP.*

Weak private consumption and a turning inventory cycle are weighing on growth

A stronger recovery was held back by two factors in particular: weak private consumption and a strong drawdown of stocks. Stock changes lowered GDP growth as the unusually high inventories that had been built up in 2021 and early 2022 in response to supply chain issues were being depleted.

1 *Compiled by Josef Schreiner with input from Katharina Allinger, Mathias Lahnsteiner, Thomas Reininger, Thomas Scheiber, Tomáš Slačík and Zoltan Walko.*

2 *Cutoff date: October 22, 2023. This report focuses primarily on data releases and developments from April 2023 up to the cutoff date and covers Croatia, Slovakia, Slovenia, Bulgaria, Czechia, Hungary, Poland and Romania. The countries are ordered according to their level of EU integration (euro area countries and EU member states).*

3 *All growth rates in the text refer to year-on-year changes unless otherwise stated.*

Private consumption suffered from spiraling price increases that weighed on sentiment and purchasing power. The support from fiscal transfers and the spending of remaining pandemic-related savings as well as buoyant labor markets were not strong enough to prevent real consumption expenditure from declining. The period from the second quarter of 2022 to the first quarter of 2023 brought real wage decreases in almost all countries of the region, which erased a full three years of wage advances.

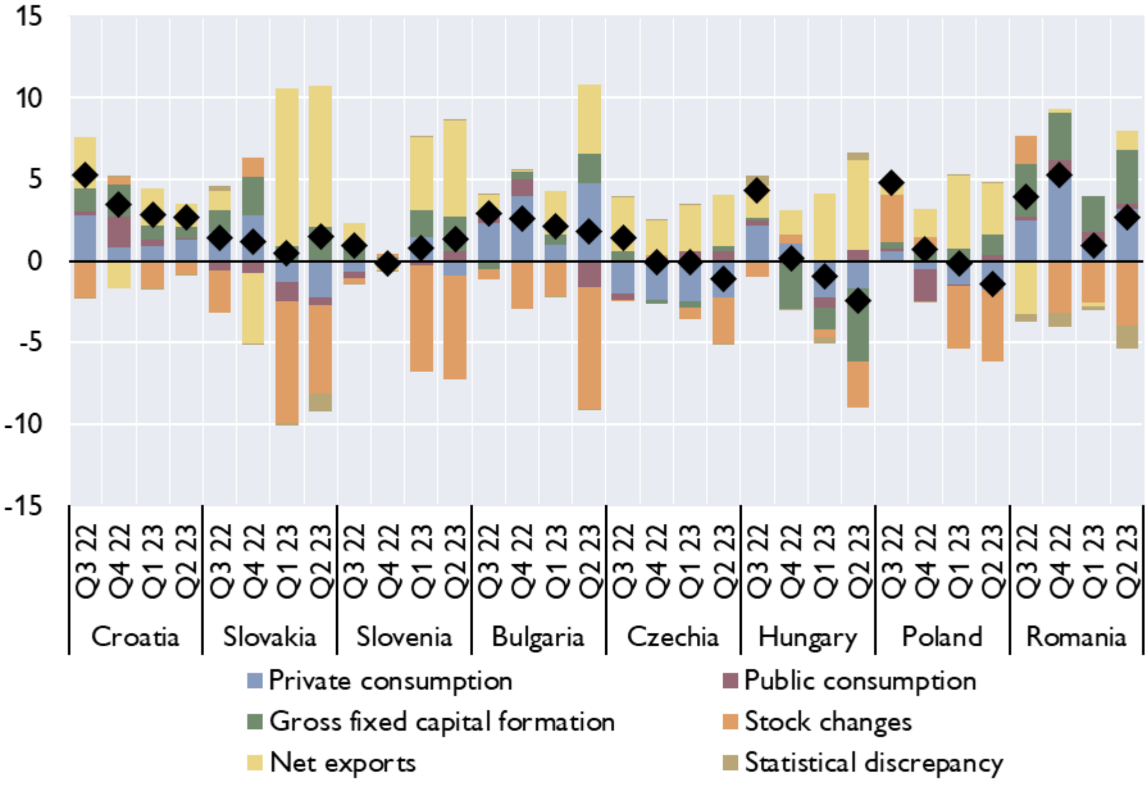
Labor market remains strong

Real wages, however, started to rise again in the second quarter of 2023 as inflation trended down and as nominal wage growth accelerated. At an average 13% in the second quarter of 2023, wage growth returned to the heights observed in 2018. These strong dynamics were supported by labor markets that remained largely unaffected by the broader economic slump. At 3.8% in August 2023, the unemployment rate stood only marginally above its pre-pandemic low (3.6% in December 2019), and a broader measure of the labor market slack – i.e. the share of persons with an unmet need for employment in the extended labor force – even beat its end-2019 record-low reading. Employment growth did deteriorate to some extent, but employment rates and activity rates kept up rather well and continued to hover around historical highs in most observed CESEE countries in mid-2023. Consequently, reported labor shortages stayed at a high level, especially in construction.

Chart 1

GDP growth and its main components

Percentage points, GDP growth in % (year on year)



Source: Eurostat.

Investments are moderately supporting the economy

Investment spending also proved resilient. Real gross fixed capital formation advanced by some 4% to 5% on average in the CESEE region during the first half of 2023, thereby contributing moderately to GDP growth. Investment benefited from disbursements from two overlapping EU financial programming periods and from the distribution of funds from the Recovery and Resilience Facility. This bolstered construction output, especially in Slovenia and Romania. The support from EU funds, however, was uneven across the region. While Romania has already received EUR 7.3 billion in loans and grants from the facility, no disbursements have yet been made to Poland and Hungary (due to ongoing discussions with the European Commission on issues such as the rule of law in these countries).

Investment in machinery also held up rather well throughout most of CESEE. This came somewhat surprisingly as nominal interest rates rose, lending conditions became stricter and uncertainties regarding export opportunities intensified. It needs to be borne in mind, however, that real interest rates remained negative throughout the first half of 2023 and that high profitability provided sources for internal financing. Moreover, above-average capacity utilization in some countries and/or efforts to save (increasingly scarce) labor may have stimulated some more investment spending as well.

Fiscal policy moderately supported GDP growth in the first half of 2023 as some measures to address the cost-of-living crisis were still in place in most countries. The support was based on governments using up the fiscal space created by inflation pushing up budgetary revenues, while substantially higher borrowing costs since the monetary policy U-turn were only slowly feeding through into debt-servicing costs.

Most momentum is coming from the external sector

The most important pillar of growth in the first half of 2023 was net exports. Given the weakness of international and domestic demand, both import and export dynamics decelerated markedly. However, import demand already dipped into the red at the beginning of 2023 (in some cases quite substantially so), while exports withstood the international headwinds somewhat better and only started to contract moderately in the second quarter of 2023. Moreover, a contraction in exports was seen in fewer countries than a contraction in imports.

Private consumption will probably pick up in the second half of 2023

In the second half of 2023, private consumption growth will probably pick up somewhat again as consumers have increasingly recovered from the price spikes, wages keep rising amid tight labor markets and as policymakers are determined to compensate households for their losses in purchasing power. The fiscal space to do so, however, is narrowing, as primary balances continue to push up debt ratios (that are already high in some cases), financing debt has become increasingly expensive and higher wage demands in the public sector and higher expenditure on defense could fuel spending. Meanwhile, the EU's Stability and Growth Pact is set to be reactivated from 2024 onward, with new excessive deficit procedures likely to be launched in spring 2024, adding consolidation pressure on fiscal policies.

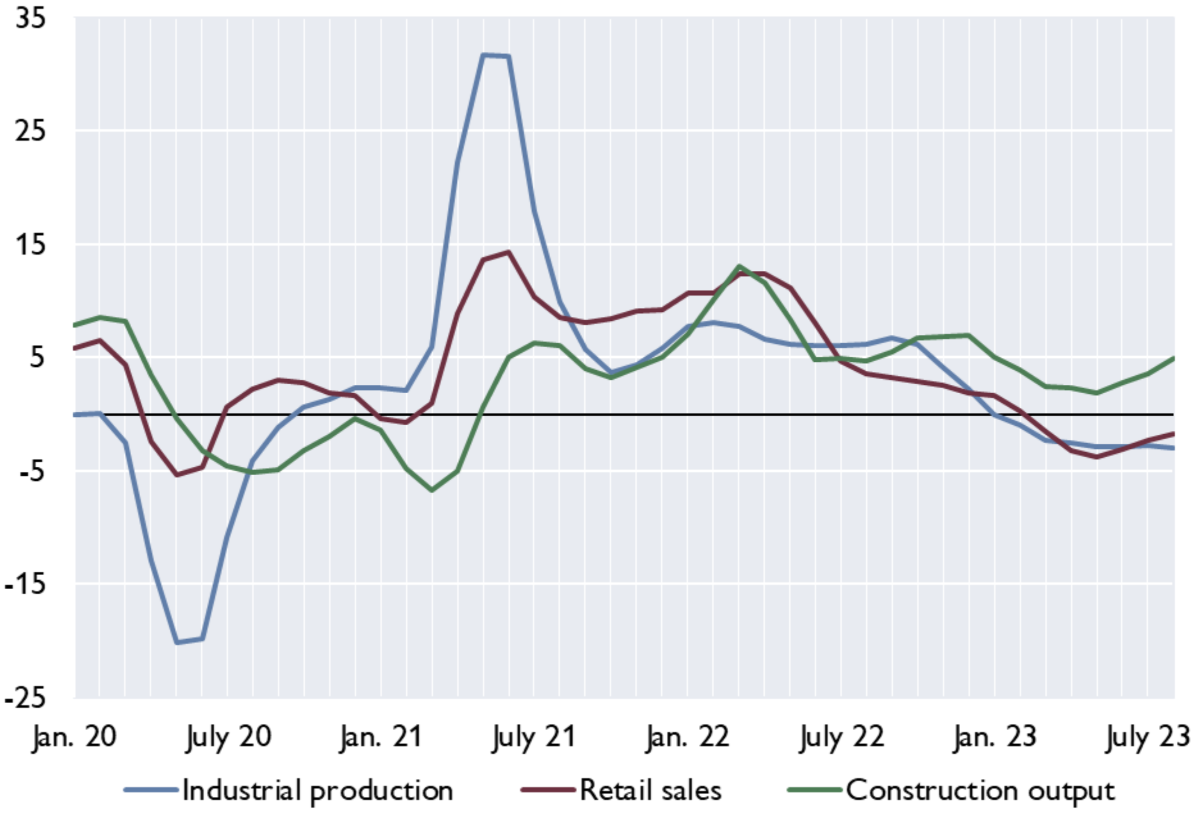
But the economy in general will remain weak for the remainder of the year

The outlook for investment is mixed, with positive impulses from EU fund disbursements, on the one hand, and restrictive financing conditions, on the other. Furthermore, challenges for the export-oriented sectors loom large, as the international environment is weakening and global geopolitical uncertainties are intensifying. The International Monetary Fund (IMF) recently revised downward its projections for the global economy, and medium-term projections are at their lowest in decades. Global trade volumes were down 3.2% already in July 2023 – the steepest drop since the early months of the pandemic – and are not expected to recover anytime soon. This reflects increasing geoeconomic fragmentation and the effects of synchronized monetary tightening across most economies. Growth outcomes in 2023 are expected to be especially dim for Germany, an economy central to many CESEE countries' growth models. This bodes ill for external growth impulses and suggests that the CESEE region's economies will not pick up any notable steam throughout the remainder of 2023. In fact, GDP projections have been revised downward since summer and most forecasting institutions currently expect an average annual growth rate of well below 1% in the region for 2023.

Chart 2

High-frequency activity indicators in CESEE EU

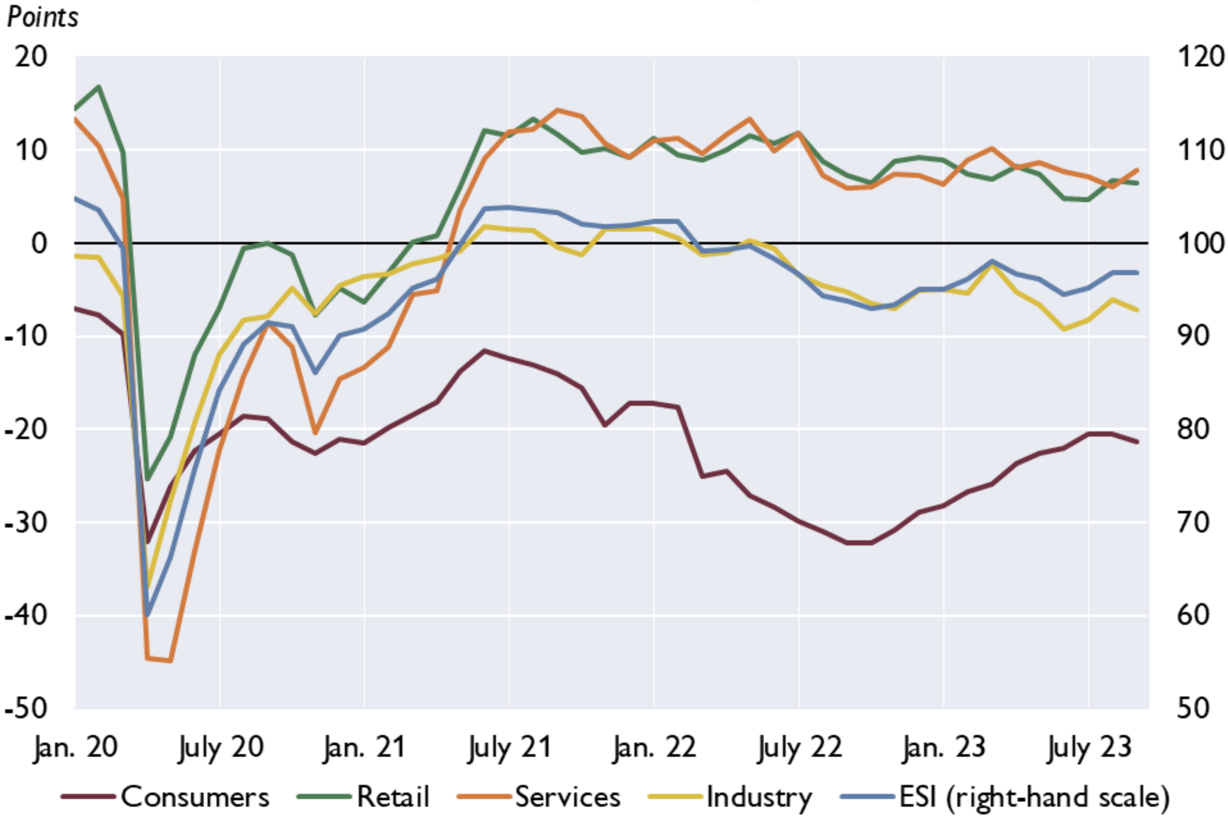
Year-on-year change in %, three-month rolling averages



Source: Eurostat.

Chart 3

Economic sentiment indicator and subcomponents in CESEE EU



Source: European Commission.

Industry and retail trade are in recession

Readily available high-frequency indicators support this picture: Production in the strongly export-oriented (and energy-intensive) industrial sector of the CESEE region has already been declining since February (–3% regional average in August 2023), with sales in domestic markets stagnating and sales in export markets declining strongly. Available purchasing managers' indices for the region are well below the 50-point threshold and reflect deteriorating new orders, both domestic and foreign. The weakness in the manufacturing sector is set to last as it is based on several factors, including the post-pandemic shift in consumption back toward services, weaker demand stemming from a higher cost of living, tighter credit conditions and general uncertainty amid intensified fragmentation and current geopolitical turbulences. Retail sales have also been contracting for some months already, but the contraction moderated more recently (–1.8% on average in August 2023). Construction was the only sector to report an ongoing increase in production (+4.9% in August on average).

Sentiment remains depressed despite some recent improvements

Sentiment readings continue to be well below long-term averages, with sentiment among consumers being especially dim. However, consumer sentiment has been brightening since late 2022, mirroring labor market resilience and the ebbing of the energy crisis. More recently, this positive momentum has also been supported by improving expectations concerning future price developments and income (as e.g. exemplified by a higher propensity to make major purchases and/or to save over the coming 12 months). Industrial, services and retail sentiment, however, have only stabilized, but have failed to embark on a clear upward trajectory yet.

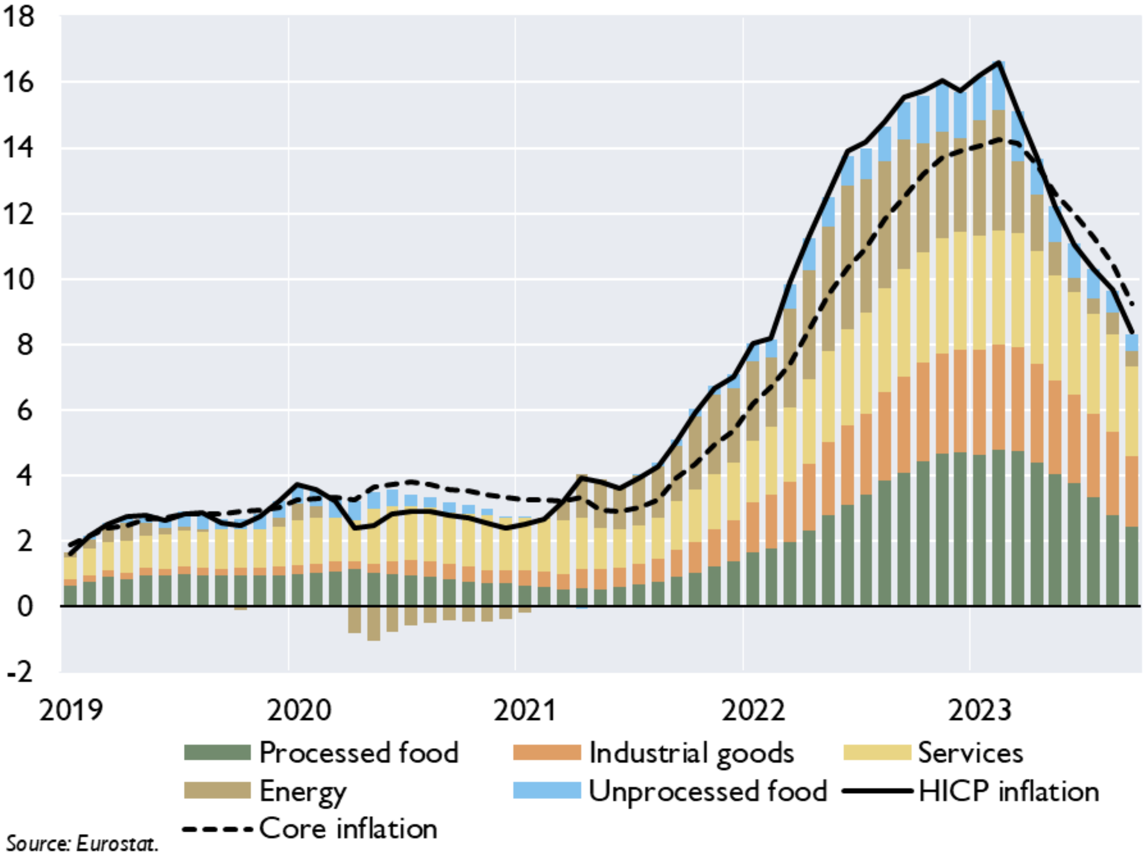
Inflation is on a clear downward trend

The average inflation rate in CESEE fell to 8.4% in September 2023 – the lowest level recorded since February 2022 – compared with almost 17% at the beginning of the year. The observed downward movement was strongly influenced by declining energy and food prices and a positive base effect, which ensured a more broad-based decline in price pressure. In September 2023, for instance, core inflation also declined noticeably (to an average of 9.3%) and the share and the combined weight of items with rising inflation rates in the total consumption basket fell to below 20% (from more than 50% at the beginning of 2023). However, core inflation remains above headline inflation, given a slow pass-through of decreasing energy prices into retail prices, particularly services.

Chart 4

Inflation in CESEE EU

Percentage points; HICP and core inflation in %, year on year



Source: Eurostat.

Inflation rates in the region are set to fall further. Cyclical demand pressure on prices has already weakened significantly and falling inflation expectations are supporting the restrictive monetary policy stance. According to the European Commission, price expectations among consumers at the 12-month horizon are currently at a lower level than before the outbreak of the COVID-19 pandemic and the associated onset of the current inflation wave. Moreover, producer price inflation is on a clear downward trend. In fact, the domestic producer price index decreased by an average of 2.4% in August 2023 amid lower prices for intermediate goods and energy and a base effect. This confirms a general reduction in upstream price pressures and the fading of external supply shocks. The Global Supply Chain Pressure Index provided by the Fed New York, for example, has fallen considerably over the past 12 months and stood below its long-term average in September 2023.

Still, inflation targets are out of reach in the near term

At the same time, the recovery in real incomes, strong labor markets and stubbornly high services prices could slow the pace of disinflation and keep inflation targets out of reach for the time being. A decomposition of quarterly national accounts data shows that the contribution of labor costs to the annual change in the gross value added (GVA) deflator already increased in the second quarter of 2023. In many cases, labor cost overtook profits as the single most important contributor to deflator changes. Yet, the relative level of unit labor cost (ULC) is still broadly in line with historical averages in most countries and there is generally still no evidence that wage-price spirals, in which prices and wages accelerate together for a sustained period, have taken hold.

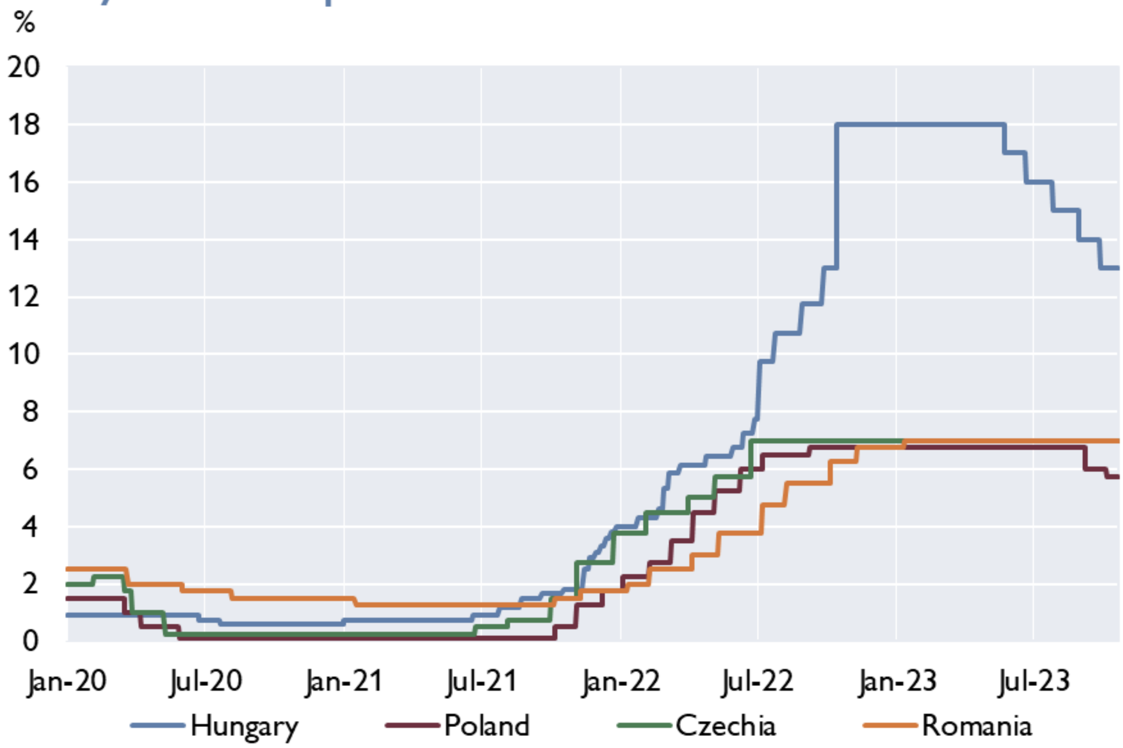
Nevertheless, first CESEE central banks started cutting policy rates

Some CESEE central banks consider the disinflation path sustainable enough to reverse initial interest rate hikes. The Hungarian central bank, for example, lowered its effective key interest rate (O/N deposit rate) in five steps from 18% in May to 13% in October 2023, thereby bringing it in line with the base rate. This signals the end of the 12-month emergency rate period and the return of the base rate as the policy rate. In October 2022, the central bank hiked rates by 500 basis points in response to forint weakness (the currency reached levels of about HUF 430 per EUR back then). This – together with an improving current account balance – brought the forint back on an appreciation path. After reaching its strongest level in 2023 at about HUF 370 per EUR in summer, however, monetary easing, coupled with external factors such as a higher oil price and general risk aversion, pushed the currency back to about HUF 390 per EUR in October 2023. This corresponds to a depreciation of about 5% against the euro over the past four months.

The Polish central bank also cut its key interest rate – surprisingly sharply for many market participants – by 75 basis points to 6% at the beginning of September 2023. This decision was based on unexpectedly weak demand as well as declining inflation expectations and producer price pressures, which could allow inflation to return to its target faster. In reaction to this decision, the Polish złoti lost around 3.5% of its value against the euro. Downward pressure on the currency combined with the risk of rising fuel prices after the election on October 15 could reduce the policy space going forward. (Retail fuel prices in Poland have decreased substantially compared to other countries, as Poland's dominant petrol retailer, which accounts for close to two-thirds of the market, is state controlled.) In fact, the Polish central bank already opted for a much smaller rate cut in October (–25 basis points to 5.75%). In response to this decision, the złoti strengthened again and recovered the losses after the previous rate cut.

Chart 5

Policy rate developments

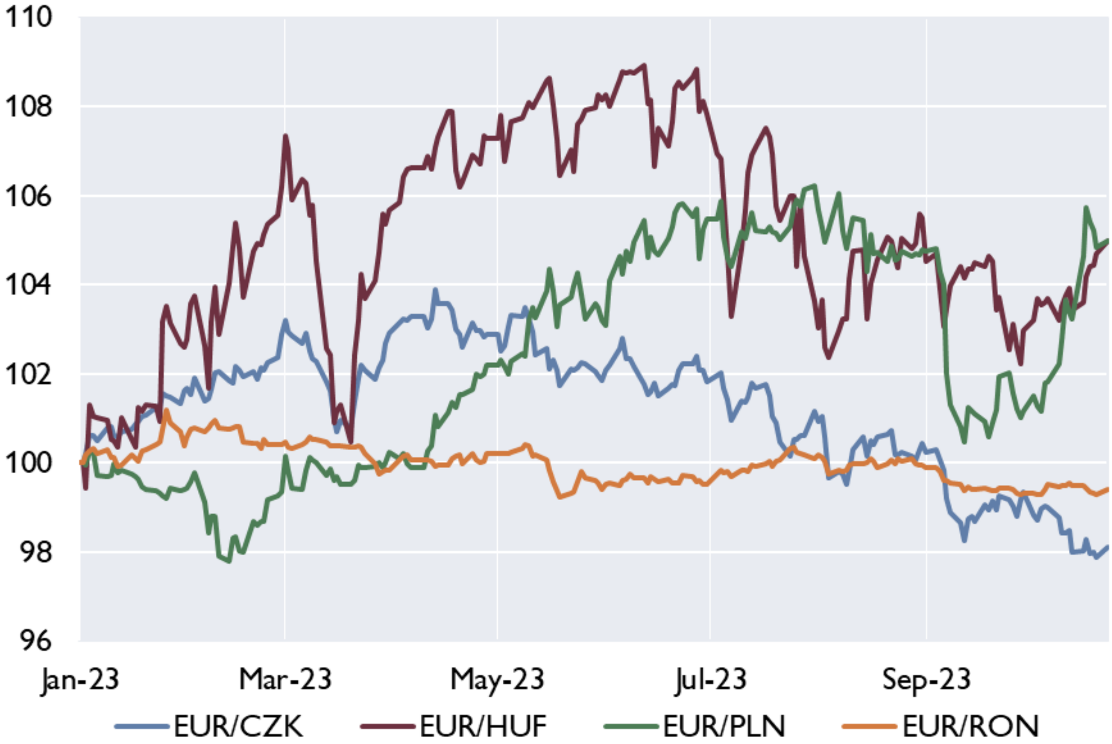


Note: The Hungarian policy rate refers to the base rate until March 27, 2020, the one-week deposit rate until October 13, 2022, the O/N deposit auction rate until September 23, 2023, and to the base rate from then on.
Source: Macrobond.

Chart 6

Exchange rate movements against the euro

Index: January 2, 2023 = 100, rise = appreciation



Source: Macrobond.

The Romanian central bank has kept rates steady so far to offset underlying inflationary pressures. Romania's GDP growth has still been running at close to 3% (the highest number in the region) in the second quarter and core inflation is proving stickier than in other CESEE countries (in fact, it increased somewhat in August 2023). The Romanian leu has been largely stable in recent months, with negative factors affecting currency developments, such as the high current account deficit or the slow progress in budget consolidation, canceling out positive factors, such as the continued interest of international investors in Romanian government bonds.

In Czechia, the policy rate has also remained unchanged at 7% since mid-2022. At the past two meetings, all members of the Bank Board of the Czech National Bank (CNB) expressed unanimous support for rate stability. The Czech koruna depreciated and lost around 5% of its value against the euro over the past six months. The latest trigger for the depreciation was the CNB's decision to formally end its intervention regime, even though the CNB had not intervened in real terms since autumn 2022.

Financing conditions remain very tight

While, recently, the monetary stance has been loosened somewhat by weakening currencies (also with respect to the EUR/USD exchange rate), financing conditions remained very tight. Interest rates for newly extended loans to the private sector increased significantly between mid-2021 and the end of 2022 and stabilized at a high level thereafter. This was also accompanied by some increases in the average interest rate on the outstanding loan portfolio. The extent of these increases, however, differed across the region.

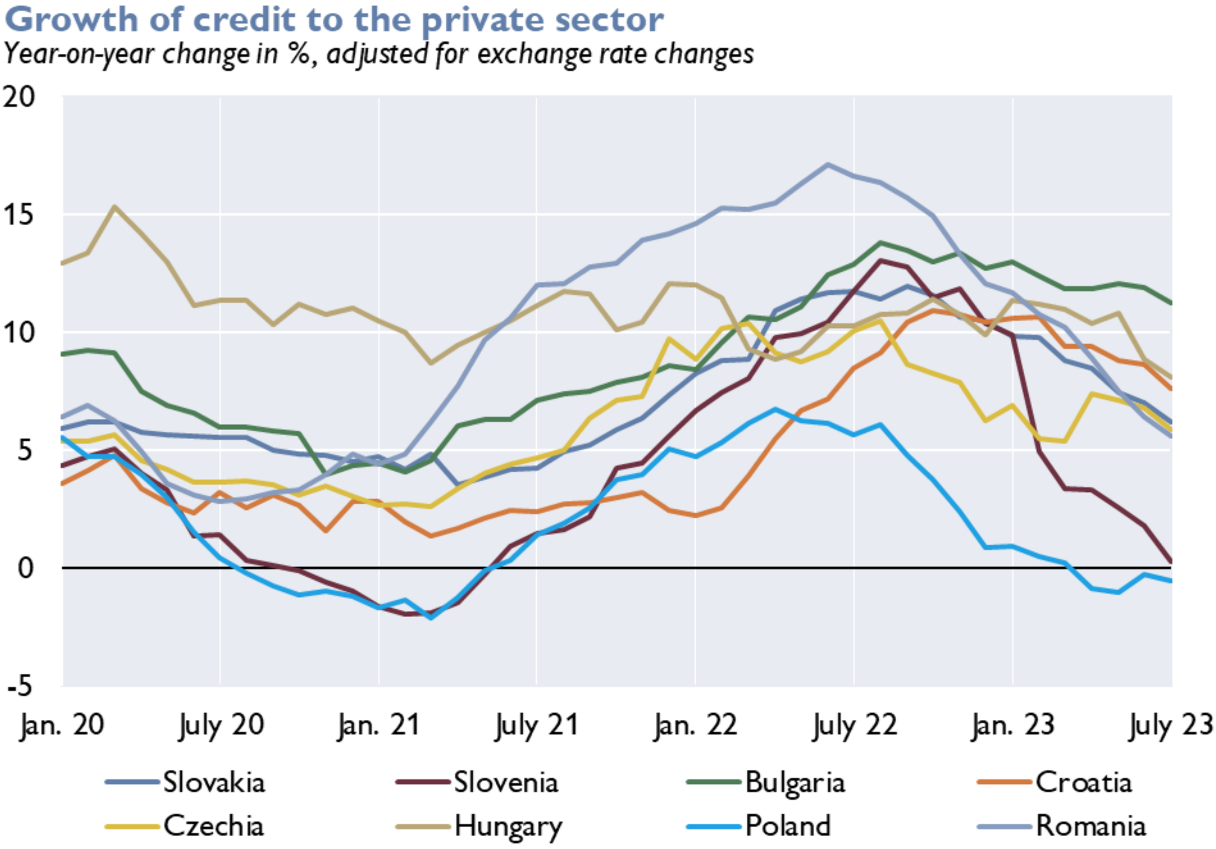
Since mid-2021, strong interest rate increases have also been observed for new deposits with agreed maturities. This contrasts with demand deposits and deposits redeemable at notice, which continue to bear very low interest. The widening spread triggered some shift from demand deposits to deposits with agreed maturities, especially in the corporate sector. However, most households still have demand deposits.

Surveys like the European Investment Bank's CESEE Bank Lending Survey suggest that credit supply conditions have been deteriorating steadily since mid-2022 for a multitude of reasons, including the war in Ukraine, higher inflation and, consequently, higher interest rates and the slowdown of economic momentum. All credit segments have been affected by tighter credit standards, especially regarding longer-term lending. While credit demand has been more resilient than supply so far, it is increasingly being driven by short-term demand for working capital. At the same time, uncertainty and the weak economic outlook are negatively influencing loan demand for fixed investments. Among households, housing market prospects as well as non-housing-related consumption expenditures are expected to drag down demand further.

Credit growth decelerated noticeably

Against this backdrop, credit dynamics in the CESEE region decelerated notably in the review period. Since the beginning of the year, growth of credit to the private sector decreased by an average 3.7 percentage points, driven by an especially strong weakening of growth of credit to corporates. On the level of individual countries, the deterioration was especially strong in Slovenia and Romania. In Poland, the stock of private sector credit has even been decreasing since April 2023.

Chart 7



Source: National central banks, ECB.

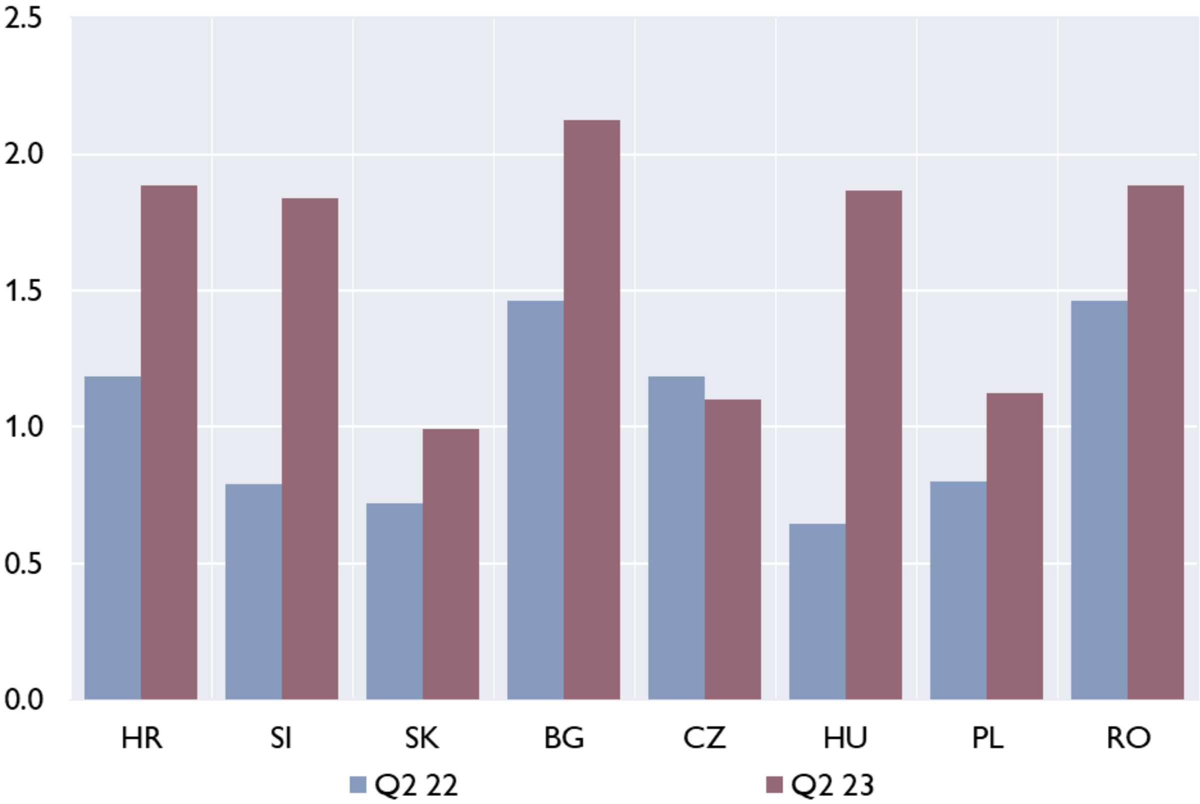
Banking sectors benefit from the prevailing interest rate environment

Banking sector performance in the region, however, has so far not suffered from the reduced credit momentum. To the contrary, the developments in lending and deposit rates as outlined above – i.e. the strong rise in lending rates coupled with a weak transmission of monetary policy signals to sight deposit rates – have positively impacted performance indicators. In particular, the widening interest rate spread between loans and deposits favored banks' net interest margins, which in turn boosted banking sector profitability. The average return on assets in the region climbed to 1.6% in mid-2023, a level that is far above its long-term average. Moreover, the rise in interest rates on the outstanding loan portfolio has not yet negatively impacted nonperforming loan (NPL) ratios, which continued to hover around historical lows in many CESEE countries. It needs to be noted, though, that the share of so-called "stage 2" loans, for which banks are less certain of credit quality, is well above NPL ratios (e.g. for Czechia, Croatia and Hungary). Therefore, banks seem to have taken some precautionary measures: In countries with a larger increase in interest rates on the outstanding loan portfolio, banks tended to increase provisioning for foul loans to above longer-term averages. Even if more substantial loan defaults were to occur, banks would have adequate capital buffers to cope with the situation. In fact, tier 1 capital ratios have increased over the past 12 months and frequently reached levels of about 20% and above in the second quarter of 2023.

Chart 8

Return on assets

%

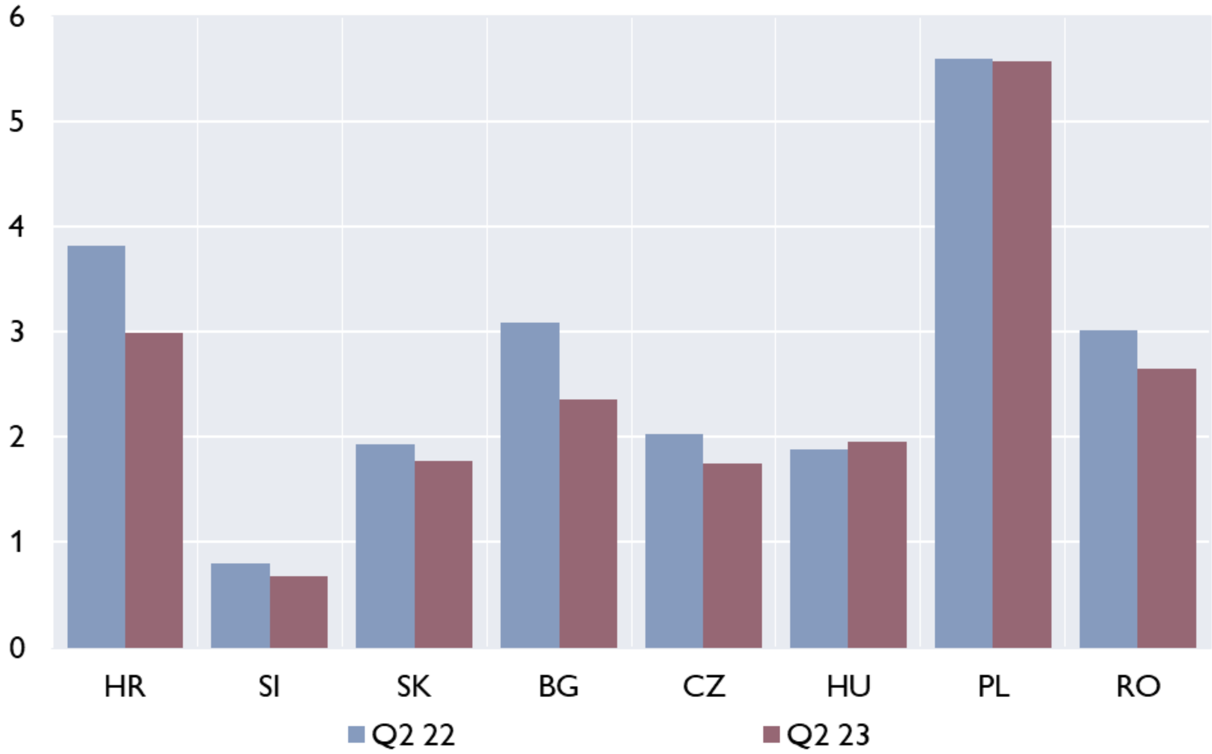


Source: National central banks.

Chart 9

Nonperforming loans

% of total loans



Note: Data are not strictly comparable across countries.
Source: National central banks.

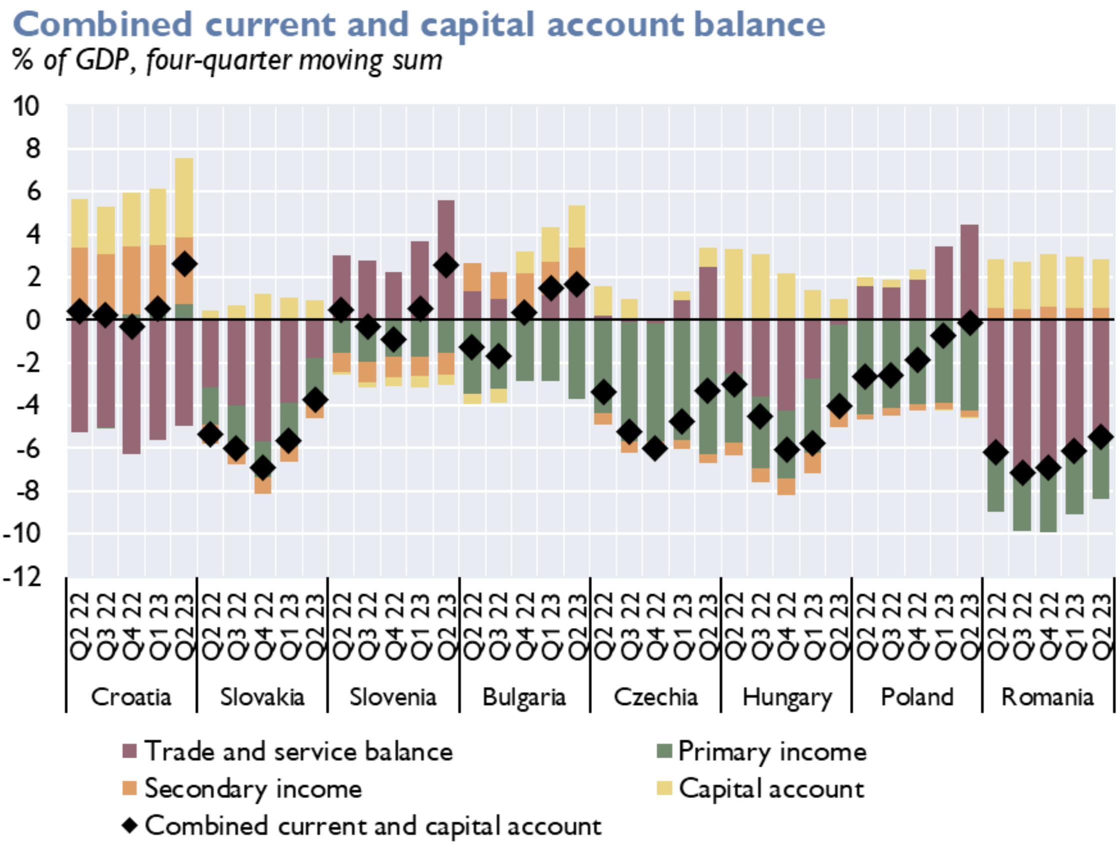
Improvements in trade balances boosted current accounts

The combined current and capital accounts displayed a favorable trend throughout the region in the first half of 2023. On average, the external balances improved by more than 2 percentage points of GDP between the fourth quarter of 2022 and the second quarter of 2023 (four-quarter moving sums). This positive momentum was largely based on improvements in the trade balance, reflecting satisfactory export growth, while imports performed poorly as lower energy prices dampened their value and weak domestic demand weighed on their volume. Higher inflows via the capital account further bolstered the external accounts in Bulgaria, Croatia and Czechia. Factors that weigh on the balance of payments included higher outflows of primary income (mainly repatriated FDI earnings amid generally strong corporate profits) and – in the case of Hungary and Poland – lower inflows via the capital account. The latter were related to ongoing disputes between Hungary and Poland with the European Commission on the disbursement of EU funds.

All of the above resulted in combined current and capital account balances returning into surplus in Slovenia, Bulgaria and Croatia and to a balanced position in Poland. The other countries continued to report deficits ranging from –3.3% of GDP in Czechia to –5.5% of GDP in Romania.

Net FDI inflows covered large parts of the remaining current account shortfalls in Czechia and Romania but not in Hungary and Slovakia, where FDI inflows decelerated – as was the case throughout most of the region. This development was very much driven by lower inflows of intercompany loans, partly in response to a narrowing interest rate differential between CESEE and (Western European) direct investor countries. Unlike the other countries of the region, however, Hungary and Slovakia also experienced some genuine disinvestment (amid a general weakening of FDI equity inflows into CESEE).

Chart 10



Source: Eurostat, IMF, national central banks.

2 Croatia: slow transmission of monetary policy hinders the fight against inflation

As in many other European countries, the macroeconomic situation in Croatia remains challenging, with decelerating economic growth and decelerating but still elevated inflation.

GDP growth in Croatia gradually slowed to 2.7% in the first half of 2023 (versus 8.2% in the first half of 2022). The largest positive contribution to growth came from net exports, as imports shrank in year-on-year terms, while exports continued to grow. Private consumption and gross fixed capital investments also continued to grow, albeit at a slower pace than in 2022.

Several factors still supported economic growth during the first half of 2023: The tourist season, for one, did not seem to be substantially affected by the difficult economic environment. Numbers of monthly tourist arrivals closely tracked those of the record year 2019. Moreover, the labor market remained resilient in the first half of 2023, with a low and stable unemployment rate and a mildly increasing employment rate. Average monthly gross wages grew by roughly 6% year on year in real terms. The government's anti-inflation packages have also supported the private sector. On October 1, 2023, the fifth package (worth roughly 0.7% of 2022 GDP) entered into force. Most of the money is allocated to reducing the cost of energy, the remainder to supporting vulnerable groups. The government also announced that it had agreed, with the retail sector, that prices for 30 essential products would be reduced and, with banks, that deposit interest rates would be increased.

The latter is good news, given that an analysis by the Croatian central bank[4] has shown that the transmission of ECB policy rates to private sector interest rates has been among the weakest in the euro area in Croatia. The analysis presented several potential explanatory factors, including lower risk premia from euro adoption and an ample liquidity surplus in the banking sector.

Weak interest rate transmission has likely supported growth but hindered the fight against high inflation. It is likely the reason why, contrary to most other CESEE countries, growth of loans to households has not slowed down in Croatia so far. Growth of loans to nonfinancial corporations (NFCs) remains very high but has decelerated compared to end-2022. This, coupled with increases in residential real estate prices, led the Croatian National Bank (HNB) to announce an additional increase in the countercyclical capital buffer from 1% to 1.5% from June 30, 2024.

The banking sector profited from higher interest rates and weak transmission. When looking at GDP growth from the output side, the agriculture, manufacturing and wholesale and retail trade sectors contracted in the first half of 2023. However, the sector of professional, scientific and technical activities and the financial sector expanded at a very fast rate and made the largest positive contributions to overall growth. The banking sector's return on assets (RoA) was 1.9% in the first half of 2023, 0.7 percentage points higher than in the first half of 2022. This was almost exclusively due to a strong increase of net interest income. Strong profitability was accompanied by stable asset quality metrics and a declining tier 1 capital ratio (22.6% at mid-2023).[5]

It is positive that inflation has decelerated compared to its peak of 13% in November 2022. However, the deceleration largely took place until May 2023 and since then inflation has been fluctuating around the same elevated level. HICP inflation was 7.4% year on year in

[4] *HNB. 2023. Box 2: Transmission of ECB interest rates to bank interest rates in Croatia. In: Macroeconomic Developments and Outlook. Year VIII. Number 14. July 2023.*

[5] *The decline was mostly the result of dividend payments and a regulatory technicality related to the transition to IFRS 9.*

September 2023. That was the second highest level in the euro area, following Slovakia. The HNB's latest projections predicted HICP inflation at 7.7% for 2023 and 3.9% for 2024.

Table 2

Main economic indicators: Croatia

	2020	2021	2022	Q1 22	Q2 22	Q3 22	Q4 22	Q1 23	Q2 23
	Year-on-year change of the period total in %								
GDP at constant prices	−8.5	13.1	6.2	7.8	8.7	5.3	3.5	2.8	2.7
Private consumption	−5.1	9.9	5.1	6.2	7.5	5.4	1.3	1.3	2.3
Public consumption	4.3	3.0	3.2	5.7	−2.5	1.9	7.6	2.2	0.3
Gross fixed capital formation	−5.0	4.7	5.8	2.0	3.9	8.0	9.6	3.9	3.2
Exports of goods and services	−23.3	36.4	25.4	27.8	40.3	23.3	14.2	4.8	−1.6
Imports of goods and services	−12.4	17.6	25.0	29.5	26.5	30.5	14.6	−0.8	−3.6
	Contribution to GDP growth in percentage points								
Domestic demand	−3.1	6.5	6.4	14.1	5.5	2.2	5.1	0.6	1.2
Net exports of goods and services	−5.4	6.6	−0.2	−6.3	3.2	3.1	−1.7	2.3	1.5
Exports of goods and services	−11.8	15.1	13.0	9.4	17.2	17.7	6.8	1.9	−0.9
Imports of goods and services	6.3	−8.5	−13.2	−15.7	−14.0	−14.6	−8.5	0.4	2.4
	Year-on-year change of the period average in %								
Unit labor costs in the whole economy	..	..	..	..	..	..	..	..	..
Unit labor costs in manufacturing	2.4	−0.9	6.6	4.9	8.2	8.3	5.1	8.8	9.9
Labor productivity in manufacturing (real, per hour)	−1.9	4.2	1.2	4.3	0.3	0.7	−0.3	1.0	3.6
Labor costs in manufacturing (nominal, per hour)	0.3	3.4	7.9	9.4	8.5	9.0	4.7	9.9	13.9
Producer price index (PPI) in industry	−3.2	11.7	25.8	25.1	32.5	30.2	15.6	9.2	−0.7
Consumer price index (here: CPI)	0.0	2.7	10.7	6.4	10.8	12.6	12.8	11.6	8.5
EUR per 1 HRK, + = HRK appreciation	−1.6	0.1	−0.1	0.4	−0.1	−0.3	−0.3	..	..
	Period average levels								
Unemployment rate (ILO definition, %, 15–64 years)	7.6	7.6	7.1	7.2	7.4	6.8	6.8	7.4	5.7
Employment rate (%, 15–64 years)	62.0	63.4	65.0	64.2	64.9	65.1	65.6	64.6	66.0
Key interest rate per annum (%)	..	..	..	..	..	..	..	..	..
HRK per 1 EUR	7.5	7.5	7.5	7.5	7.5	7.5	7.5	..	..
	Nominal year-on-year change in period-end stock in %								
Loans to the domestic nonbank private sector[1]	2.8	2.4	10.4	3.9	7.2	10.4	10.4	9.4	8.7
of which:									
loans to households	1.6	4.1	5.3	4.0	5.1	4.9	5.3	5.8	6.1
loans to nonbank corporations	4.8	−0.1	18.6	3.6	10.4	19.5	18.6	14.9	12.5
Share of foreign currency loans in total loans	52.0	52.2	58.1	52.1	52.5	55.1	58.1	0.2	0.4
Return on assets (banking sector)	0.6	1.2	1.0	1.2	1.2	1.3	1.0	1.6	1.9
Tier 1 capital ratio (banking sector)	25.0	25.4	24.2	25.2	24.6	23.5	24.2	23.0	22.6
NPL ratio (banking sector)	5.4	4.3	3.0	4.2	3.8	3.3	3.0	3.2	3.0
	% of GDP								
General government revenues	46.8	46.2	45.2						
General government expenditures	54.1	48.7	44.8						
General government balance	−7.3	−2.5	0.4						
Primary balance	−5.3	−0.9	1.8						
Gross public debt	87.0	78.4	68.4						
	% of GDP								
Debt of nonfinancial corporations (nonconsolidated)	12.3	11.0	10.2						
Debt of households and NPISHs[2] (nonconsolidated)	5.0	4.5	4.1						
	% of GDP (based on EUR), period total								
Goods balance	−17.5	−19.6	−27.1	−29.0	−27.1	−26.1	−26.5	−26.1	−25.1
Services balance	10.5	16.8	20.8	4.5	17.1	46.3	10.0	6.8	18.0
Primary income	2.0	0.0	0.2	0.8	−0.3	−1.7	2.5	1.6	0.8
Secondary income	4.1	3.7	3.2	3.4	3.1	2.8	3.5	2.8	3.4
Current account balance	−1.0	1.0	−2.8	−20.3	−7.2	21.2	−10.4	−14.8	−2.9
Capital account balance	2.1	2.4	2.5	2.1	2.1	2.0	3.8	2.7	6.3
Foreign direct investment (net)[3]	−1.5	−5.2	−5.5	−6.9	−3.9	−4.5	−6.8	−3.2	−0.9
	% of GDP (rolling four-quarter GDP, based on EUR), end of period								
Gross external debt	79.6	76.8	74.0	80.2	79.8	75.1	74.0	82.0	79.4
Gross official reserves (excluding gold)	37.6	42.9	41.5	40.1	40.4	40.5	41.5	4.5	4.1
	Months of imports of goods and services								
Gross official reserves (excluding gold)	9.3	9.8	7.5	8.6	8.1	7.6	7.5	0.8	0.8
	EUR million, period total								
GDP at current prices	50,453	58,306	66,946	14,376	16,879	18,817	16,874	16,713	18,797

Source: Bloomberg, European Commission, Eurostat, national statistical offices, national central banks, wiiw, OeNB.

[1] Foreign currency component at constant exchange rates.

[2] Nonprofit institutions serving households.

[3] + = net accumulation of assets larger than net accumulation of liabilities (net outflow of capital).
- = net accumulation of assets smaller than net accumulation of liabilities (net inflow of capital).

3 Slovakia: new government will face a significant fiscal consolidation challenge

After modest GDP growth of 1.7% in 2022, the expansion of the Slovak economy slowed down further in the first half of 2023 (1.3% year on year). However, the composition of economic growth underwent a dramatic shift. In contrast to the previous two years, net exports replaced domestic demand in the growth driving seat. Paradoxically, this occurred despite a considerable year-on-year contraction of Slovak exports which reflected the challenging foreign demand environment. However, since the decline of exports was significantly outpaced by the shrinkage of imports, net exports contributed 9.2 percentage points to GDP growth in the first half of 2023. Domestic demand, in contrast, put a significant drag on growth (–7.9 percentage points contribution), particularly private consumption and changes in inventories. After a relatively robust expansion in 2022, household consumption has been contracting at a strong pace this year as consumers grapple with high inflation and have cut their spending. Private consumption thus chopped off nearly 2 percentage points from GDP growth in the first six months of this year, government spending subtracted almost another percentage point. Yet on the back of continued dynamic nominal wage growth, consumer demand is likely to strengthen as inflation slows down. Fixed investments contributed 1.6 percentage points to GDP growth in the first half of 2023 but were significantly boosted by EU funds. In contrast, the slowdown in the real estate market and subdued domestic and foreign demand put a damper on (construction) investments. Against this backdrop, senior representatives of the current caretaker government warned that one of the reasons for Slovakia's feeble growth is its extensive reliance on EU funds, too little investment of resources originating within the country and the failure to invest in national priorities and projects with good quality[6]. Strikingly, amid weak demand, falling prices and relaxed supply chain frictions, changes in inventories provided the strongest (negative) contribution to growth.

The labor market fared better than the growth performance of the Slovak economy would lead us to expect. The unemployment rate has followed a gradual downward trend for 2.5 years. It has thus declined from its pandemic peak of more than 7% in March 2021 to 5.8% in August 2023, levels last seen before the outbreak of the pandemic. In parallel, employment has continued to rise slightly and – with 72% of the total adult population in employment – shows the highest reading in Slovakia's modern history. While the average number of hours per employee has recovered since the pandemic-related trough in 2020, it is still well below the pre-pandemic level. In fact, average number of working hours per employee appear to have trended down for more than a decade. Hence, for various supply- and demand-side reasons, more and more people are employed yet they tend to work shorter hours. Against this background, labor cost increases have continued to outpace (negative) productivity growth in 2023, thus further raising unit labor cost.

Yet, growth in nominal wages has kept on lagging significantly behind the increasing cost of living. After headline inflation had continuously headed upward and peaked at 15.4% in February 2023 – levels unseen since mid-2000 – it has dropped sharply since, reaching 9% in September 2023. The easing of headline inflation is mainly ascribable to a significant slowdown in price hikes for processed and unprocessed food. In addition, weak consumer demand and rising interest rates have also dampened general price pressures. As a result, core inflation declined noticeably from more than 15% in February to still significantly elevated 9.2% in September.

According to Slovakia's fiscal council RRZ, the general government deficit is currently estimated to come in at 5.7% of GDP in 2023, a value that is better than the one approved by parliament

[6] *Vasakova: Slovakia Stagnating Partly Due to €40 Billion Investment Debt (tasr.sk).*

(6.4% of GDP) and the one expected by the finance ministry (6.8% of GDP). Government debt is expected to reach slightly below 57% of GDP by end-2023. Against this backdrop, whatever coalition comes in after the general election that took place on September 20 will face a great challenge of consolidating public finances. The RRZ estimates that consolidation measures worth at least 0.75% of GDP annually need to be implemented to stabilize the debt-to-GDP ratio just above 60% by 2027.

Table 3

Main economic indicators: Slovakia

	2020	2021	2022	Q1 22	Q2 22	Q3 22	Q4 22	Q1 23	Q2 23
	Year-on-year change of the period total in %								
GDP at constant prices	−3.3	4.8	1.8	3.1	1.4	1.5	1.2	0.5	1.5
Private consumption	−1.1	2.6	5.5	9.8	4.6	3.2	4.9	−2.2	−3.6
Public consumption	−0.6	4.2	−4.2	−2.4	−8.1	−3.1	−3.3	−5.8	−2.2
Gross fixed capital formation	−10.9	3.5	4.5	4.8	−5.9	6.6	10.4	5.7	12.4
Exports of goods and services	−6.3	10.5	3.0	−2.5	2.6	9.4	3.2	−3.7	−0.8
Imports of goods and services	−8.1	11.7	4.2	1.7	0.1	7.4	7.8	−12.3	−8.0
	Contribution to GDP growth in percentage points								
Domestic demand	−5.0	5.7	2.9	7.5	−0.9	−0.1	5.6	−9.0	−6.1
Net exports of goods and services	1.6	−0.9	−1.2	−4.3	2.3	1.5	−4.4	9.5	7.6
Exports of goods and services	−5.8	8.9	2.8	−2.3	2.4	7.2	3.0	−3.5	−0.8
Imports of goods and services	7.5	−9.8	−3.9	−2.1	−0.1	−5.7	−7.4	13.1	8.4
	Year-on-year change of the period average in %								
Unit labor costs in the whole economy (nominal, per person)	5.6	1.3	5.9	4.7	6.1	7.9	5.3	8.4	7.8
Unit labor costs in manufacturing (nominal, per hour)	1.5	−3.1	10.0	11.9	12.9	3.4	12.4	12.9	6.2
Labor productivity in manufacturing (real, per hour)	2.7	9.1	−1.2	−0.1	−0.9	3.5	−6.8	−4.2	1.1
Labor costs in manufacturing (nominal, per hour)	3.6	6.4	8.5	11.8	11.9	7.0	4.7	8.1	7.4
Producer price index (PPI) in industry	−0.5	6.8	27.8	24.4	30.6	31.0	25.0	20.1	9.4
Consumer price index (here: HICP)	2.0	2.8	12.1	8.5	11.8	13.3	14.9	15.1	12.5
EUR per 1 SKK, + = SKK appreciation	..	..	..	..	..	..	..	..	..
	Period average levels								
Unemployment rate (ILO definition, %, 15–64 years)	6.8	6.9	6.2	6.4	6.2	6.1	6.1	6.3	5.8
Employment rate (%, 15–64 years)	67.5	69.5	71.4	70.6	71.4	71.6	71.8	71.3	72.0
Key interest rate per annum (%)	0.0	0.0	0.6	0.0	0.0	0.5	1.8	2.8	3.7
SKK per 1 EUR	..	..	..	..	..	..	..	..	..
	Nominal year-on-year change in period-end stock in %								
Loans to the domestic nonbank private sector[1]	4.5	7.3	10.5	8.9	11.7	12.0	10.5	8.8	7.0
of which:									
loans to households	6.1	8.8	10.3	10.5	11.3	11.1	10.3	8.4	6.4
loans to nonbank corporations	1.4	4.3	10.8	5.5	12.6	13.9	10.8	9.6	8.3
Share of foreign currency loans in total loans to the nonbank private sector	0.1	0.1	0.1	0.1	0.1	0.0	0.1	0.1	0.0
Return on assets (banking sector)	0.5	0.7	0.8	0.5	0.7	0.7	0.8	0.8	1.0
Tier 1 capital ratio (banking sector)	18.1	18.5	18.0	18.1	17.8	17.8	18.0	18.1	18.1
NPL ratio (banking sector)	2.3	1.9	1.7	1.9	1.9	1.8	1.7	1.7	1.8
	% of GDP								
General government revenues	39.4	40.1	40.2						
General government expenditures	44.7	45.6	42.3						
General government balance	−5.4	−5.4	−2.0						
Primary balance	−4.1	−4.4	−1.1						
Gross public debt	58.9	61.0	57.8						
	% of GDP								
Debt of nonfinancial corporations (nonconsolidated)	54.4	51.7	50.3						
Debt of households and NPISHs[2] (nonconsolidated)	46.5	47.0	47.1						
	% of GDP (based on EUR), period total								
Goods balance	1.1	−0.5	−6.0	−6.6	−4.2	−4.7	−8.7	0.6	3.2
Services balance	1.0	0.5	0.3	0.5	0.1	0.2	0.6	0.9	0.7
Primary income	−0.8	−1.5	−1.7	−0.9	−1.8	−1.6	−2.3	−2.6	−2.2
Secondary income	−0.7	−1.0	−0.8	−1.5	−0.9	−1.2	0.3	−1.2	−0.7
Current account balance	0.6	−2.5	−8.2	−8.4	−6.8	−7.3	−10.0	−2.3	1.0
Capital account balance	0.8	1.3	1.2	−0.1	0.9	1.1	2.7	−0.8	0.5
Foreign direct investment (net)[3]	2.6	0.3	−2.1	−1.7	−2.1	−2.9	−1.7	3.0	−1.8
	% of GDP (rolling four-quarter GDP, based on EUR), end of period								
Gross external debt	119.6	132.7	103.1	139.0	127.3	109.6	103.1	101.5	100.1
Gross official reserves (excluding gold)	6.5	6.8	7.2	6.9	7.7	7.5	7.2	8.5	8.2
	Months of imports of goods and services								
Gross official reserves (excluding gold)	0.9	0.9	0.8	0.9	0.9	0.9	0.8	1.0	1.0
	EUR million, period total								
GDP at current prices	93,444	100,256	109,645	24,554	27,265	28,983	28,843	27,610	30,343

Source: Bloomberg, European Commission, Eurostat, national statistical offices, national central banks, wiiw, OeNB.

[1] *Foreign currency component at constant exchange rates.*

[2] *Nonprofit institutions serving households.*

[3] *+ = net accumulation of assets larger than net accumulation of liabilities (net outflow of capital).*
- = net accumulation of assets s+maller than net accumulation of liabilities (net inflow of capital).

4 Slovenia: early-August floods burden budget, but may support investments in the medium term

During the first half of 2023, Slovenia's GDP grew by 1.1% year on year, weakening from 2.5% registered for 2022 (which was revised down from the preliminary 5.4%). GDP expansion during the first half of 2023 was supported by a large contribution of net real exports, primarily on the back of a sharp contraction of imports as household consumption growth slowed and inventories faltered. Investment growth strengthened notably compared to the second half of 2022, and also public consumption recovered. Household consumption growth was suppressed by weak consumer confidence and the fading of the stimulus effect of previously accumulated savings, though real wage growth started to recover. Public consumption growth was lifted by the second phase of wage increases in the public sector agreed in autumn 2022. The biggest boost to the acceleration of investment growth came from nondwelling construction activity, in part supported by public investment projects, while investments in machinery and (nontransport) equipment contracted sharply, reflecting falling capacity utilization rates, rapidly deteriorating export expectations, tightening financing conditions and a weak corporate loan market.

In response to the devastating damage caused by heavy rains in early August 2023 (currently estimated at around 15% of GDP), the government has announced various measures to facilitate the cleanup and reconstruction (e.g. furlough subsidies, a one-year loan moratorium, tax waivers and the possibility of faster hiring of foreign workers for companies; a lump-sum solidarity aid, a waiver of energy bills, a subsidy for emergency apartment rent and a one-year loan moratorium for households). Financing will be channeled through a special reconstruction fund, which will be funded by the budget (including a temporary profit and income tax surcharge for companies and individuals to be paid in 2024 and 2025, respectively), a special bank tax for a period of five years, the EU's Solidarity Fund and the country's NextGeneration EU grants and loans. The measures are expected to lead to an increase in the planned general government budget deficit for 2023 to 4.5% of GDP (up from 4.1% of GDP expected in the spring forecast). Also, the deficit for 2024 was revised up to 3.8% of GDP from the original 2.8% of GDP due to flood reconstruction expenditure (without which the deficit would stay below 3% of GDP, according to the finance ministry).

Increased interest rates and the tightening of banks' lending standards continued to suppress lending growth to corporates and households during the reporting period: The outstanding amount of loans to nonbank corporations contracted by more than 5% in August 2023 compared to the same month of 2022, and the growth rate of loans to households more than halved from December to 3.4%. (The slowdown was most pronounced for housing loans, while the growth of consumption loans picked up, presumably partly in response to the easing of restrictions on consumer lending by the central bank as of July 2023). Despite slowing lending activity, rising interest rates mitigated banks' income risk and contributed to a significant improvement in their net interest income and after-tax profits during the first half of 2023. This also had a positive impact on capital adequacy while the ratio of nonperforming exposures in general continued to decline modestly.

HICP inflation had gradually slowed during the reporting period to 5.7% in July 2023 before it edged up to 7.1% in September. The deceleration (and the uptick till September) was driven by energy and unprocessed food prices; core inflation excluding these two categories receded less and fell continuously to 7.3% in September 2023 (after 8.3% in July). However, the stability of services price inflation at slightly above 8%, the pickup of nominal wage and ULC growth during the first half of 2023 along with some rise in households' inflation expectations in the third quarter of 2023 may forebode a deceleration of the disinflationary process.

Unfavorable trends in the balance of payments turned around in early 2023 and the country's net lending position vis-à-vis the rest of the world returned into positive territory. The improvement was driven by the goods and services balance as global energy and food prices receded, global supply chain pressures continued to ease and domestic demand weakened.

Table 4

Main economic indicators: Slovenia

	2020	2021	2022	Q1 22	Q2 22	Q3 22	Q4 22	Q1 23	Q2 23
	Year-on-year change of the period total in %								
GDP at constant prices	−4.2	8.2	2.5	5.0	4.4	0.9	−0.2	0.8	1.4
Private consumption	−6.5	10.3	3.6	9.6	7.7	−1.2	0.2	2.9	−1.5
Public consumption	4.2	6.1	−0.5	2.2	−0.6	−2.1	−1.6	−0.9	3.2
Gross fixed capital formation	−7.2	12.6	3.5	6.6	3.4	3.8	0.7	7.7	9.8
Exports of goods and services	−8.5	14.5	7.2	7.8	10.2	12.7	−1.3	2.2	−1.7
Imports of goods and services	−9.1	17.8	9.0	16.4	11.1	11.4	−1.1	−2.8	−8.1
	Contribution to GDP growth in percentage points								
Domestic demand	−3.9	9.2	3.5	10.8	4.4	−0.6	0.1	−3.7	−4.6
Net exports of goods and services	−0.3	−1.0	−1.0	−5.7	−0.0	1.6	−0.3	4.4	5.9
Exports of goods and services	−7.1	11.3	6.0	6.6	8.6	10.3	−1.1	2.0	−1.5
Imports of goods and services	6.8	−12.2	−7.0	−12.4	−8.6	−8.7	0.8	2.5	7.4
	Year-on-year change of the period average in %								
Unit labor costs in the whole economy (nominal, per person)	7.5	1.0	5.2	1.0	2.5	7.9	10.2	13.7	13.5
Unit labor costs in manufacturing (nominal, per hour)	6.7	−3.1	2.4	−3.4	2.8	−0.7	10.7	12.7	14.2
Labor productivity in manufacturing (real, per hour)	−3.2	9.9	5.0	10.1	6.6	4.7	−1.1	−4.4	−0.8
Labor costs in manufacturing (nominal, per hour)	3.1	6.8	7.4	6.4	9.6	4.0	9.6	7.7	13.3
Producer price index (PPI) in industry	−0.3	5.5	19.6	15.6	21.7	21.2	19.9	15.5	7.1
Consumer price index (here: HICP)	−0.3	2.0	9.3	6.3	9.0	11.3	10.6	9.9	7.9
EUR per 1 SIT, + = SIT appreciation	..	..	..	..	..	..	..	..	..
	Period average levels								
Unemployment rate (ILO definition, %, 15–64 years)	5.0	4.8	4.0	4.3	4.2	4.0	3.4	3.7	3.5
Employment rate (%, 15–64 years)	70.9	71.5	73.1	72.5	73.1	73.9	73.0	71.5	73.1
Key interest rate per annum (%)	0.0	0.0	0.6	0.0	0.0	0.5	1.8	2.8	3.7
SIT per 1 EUR	..	..	..	..	..	..	..	..	..
	Nominal year-on-year change in period-end stock in %								
Loans to the domestic nonbank private sector[1]	−1.0	5.6	10.4	8.0	10.4	12.8	10.4	3.4	1.8
of which:									
loans to households	0.1	5.0	7.5	6.7	7.9	8.2	7.5	6.0	4.0
loans to nonbank corporations	−2.2	6.2	13.4	9.4	13.2	17.6	13.4	0.7	−0.4
Share of foreign currency loans in total loans to the nonbank private sector	1.4	1.1	0.8	1.0	1.0	0.9	0.8	0.8	0.8
Return on assets (banking sector)	1.0	1.1	1.0	0.7	0.8	0.5	1.0	4.0	1.8
Tier 1 capital ratio (banking sector, consolidated)	16.7	16.9	16.2	15.7	15.7	15.5	16.2	16.7	..
NPL ratio (banking sector)	1.9	0.8	0.7	0.9	0.8	0.8	0.7	0.7	0.7
	% of GDP								
General government revenues	43.7	44.9	42.5						
General government expenditures	51.4	49.5	45.5						
General government balance	−7.7	−4.6	−3.0						
Primary balance	−6.1	−3.4	−1.9						
Gross public debt	79.6	74.5	69.9						
	% of GDP								
Debt of nonfinancial corporations (nonconsolidated)	47.7	46.1	44.5						
Debt of households and NPISHs[2] (nonconsolidated)	27.7	26.3	25.9						
	% of GDP (based on EUR), period total								
Goods balance	5.0	1.7	−4.0	−4.3	−4.3	−2.7	−5.0	0.9	3.5
Services balance	4.4	4.7	6.3	4.6	6.2	7.5	6.6	5.5	6.0
Primary income	−0.8	−1.7	−1.7	−1.3	−1.6	−2.7	−1.3	−1.2	−0.9
Secondary income	−1.0	−0.9	−0.9	−1.1	−1.0	−0.9	−0.8	−1.0	−1.4
Current account balance	7.6	3.8	−0.4	−2.0	−0.7	1.2	−0.5	4.2	7.1
Capital account balance	−0.5	0.1	−0.5	−0.3	−0.3	−0.1	−1.0	−0.7	−0.2
Foreign direct investment (net)[3]	0.6	−0.8	−2.1	−2.8	−1.9	−2.1	−1.8	−2.5	−1.7
	% of GDP (rolling four-quarter GDP, based on EUR), end of period								
Gross external debt	102.0	97.2	91.0	97.1	94.6	93.0	91.0	93.8	92.9
Gross official reserves (excluding gold)	1.9	3.5	3.4	3.6	3.6	3.6	3.4	3.4	3.3
	Months of imports of goods and services								
Gross official reserves (excluding gold)	0.3	0.5	0.4	0.5	0.5	0.5	0.4	0.5	0.5
	EUR million, period total								
GDP at current prices	47,045	52,279	57,038	12,807	14,486	14,907	14,839	14,358	16,061

Source: Bloomberg, European Commission, Eurostat, national statistical offices, national central banks, wiiw, OeNB.

[1] *Foreign currency component at constant exchange rates.*

[2] *Nonprofit institutions serving households.*

[3] *+ = net accumulation of assets larger than net accumulation of liabilities (net outflow of capital).*
- = net accumulation of assets smaller than net accumulation of liabilities (net inflow of capital).

5 Bulgaria: lack of policy coordination hampers inflation slowdown

Headline inflation in Bulgaria decelerated from its peak of 15.6% in September 2022 to 6.4% in September 2023 due to declining international energy and food prices and negative base effects. Food and services remained the largest contributors to headline inflation, with their combined share amounting to nearly 80% in August. Food inflation has slowed noticeably over the past six months and energy inflation turned negative in April due to negative base effects – but month-on-month energy prices started to rise again in July 2023. Core inflation slowed only gradually from 13.9% in December 2022 to 8.1% in September 2023 as services price inflation fluctuated around 10% in spring with seasonal peaks around Easter and July 2023.

Inflation dynamics in the coming months will be characterized by opposing forces. On the one hand, the pass-through of declining producer prices, in particular the sharp fall in intermediate goods and energy prices, will dampen inflation. On the other hand, upward price pressures continue to emanate from the domestic macroeconomic environment: Growth rates of unit labor cost slowed down from 13.1% in the first quarter of 2023 to 5.4% in the second quarter of 2023. In a context of increasing labor shortages, productivity increased by 1.6% in the second quarter of 2023 while real wages rose by 4%. As a result, consumer demand growth remained surprisingly robust, partly fueled by still cheap consumer credit.

The Bulgarian central bank (BNB) noted that strongly negative interest rates in the first half of 2023 had a potentially inflationary effect. Spillovers from rising ECB interest rates were counteracted by strong competition in the Bulgarian banking sector and thus proved insufficient to curb consumer credit. As of July 1, 2023, the BNB raised the minimum reserve requirements to 12%. Moreover, fiscal policy continued to have an ambiguous impact on inflation: Untargeted and generous compensations for electricity costs to businesses removed any incentive to reduce electricity consumption, while reduced excise duties and VAT rates on energy commodities and food dampened price pressures. According to the recent inflation forecasts, headline inflation is expected to remain high at around 10% in 2023 and between 4% and 7% in 2024.

After expanding by 3.4% in 2022, economic activity has been cooling down in Bulgaria amid weaker external demand and an inflation-induced slowdown in consumption. In the first half of 2023, real GDP grew by 2.0%. Private consumption growth was weak in the first quarter but recovered in the second quarter, due to improvements in real incomes, somewhat lower inflation and tight labor markets. Government consumption stagnated in the first and declined in the second quarter of 2023 with further fiscal consolidation ahead. Gross fixed capital formation (GFCF) contributed positively to real GDP growth with both the public and private sector supporting growth in similar proportions. GFCF is expected to grow robustly also in the second half of the year, in line with the absorption of EU funds, ending three years of disappointing performance.

Net exports made the largest contribution to real GDP growth as a sharp decline in imports outweighed a weak export performance. The loss of price competitiveness led to a decline in exports of raw materials and electricity after a strong performance in 2022. Manufacturing exports declined due to weak demand in the euro area, while the services trade surplus increased due to higher revenues from ICT exports and tourism. The downward dynamics of imports can mainly be explained by the reduction of large stocks held by companies since the end of 2022.

Recent economic forecasts expect that the slowdown of the Bulgarian economy will continue in the second half of 2023, ranging from 1.3% to 1.7%. The weak outlook for the euro area remains a headwind to industrial production in Bulgaria. Real GDP growth will pick up in 2024, with forecasts ranging from 2.0% to 3.2%, supported by moderating inflation and improving real incomes, stronger foreign demand and an accelerated absorption of EU funds. Downside risks are associated with rising energy prices, weak external demand and geopolitical risks.

Domestic events could also derail the recovery in 2024. Elections in April 2023 resulted in a government, but the two ruling parties have not concluded a formal coalition agreement. Upcoming local elections in October 2023 may increase pressure on the ruling coalition. Moreover, the fiscal position of the general government will continue to deteriorate throughout 2023. Persistently high inflation and the threat of an excessive deficit procedure could derail Bulgaria's plans to adopt the euro in 2025. Finally, the absorption of EU recovery and resilience funds is expected to be a major driver of investment, but the release of funds is linked to the implementation of challenging structural reforms.

Table 5

Main economic indicators: Bulgaria

	2020	2021	2022	Q1 22	Q2 22	Q3 22	Q4 22	Q1 23	Q2 23
	Year-on-year change of the period total in %								
GDP at constant prices	−4.0	7.6	3.4	4.4	3.9	2.9	2.6	2.1	1.8
Private consumption	−0.6	8.8	4.8	5.5	2.1	4.2	6.8	1.5	8.2
Public consumption	8.3	0.4	6.5	6.6	11.6	3.8	4.5	0.1	−8.0
Gross fixed capital formation	0.6	−8.3	−4.3	−7.4	−11.0	−3.3	2.4	5.4	10.8
Exports of goods and services	−10.4	11.0	8.3	4.8	8.9	9.7	9.4	2.3	−1.0
Imports of goods and services	−4.3	10.9	10.5	12.3	12.3	9.2	8.5	−1.5	−6.9
	Contribution to GDP growth in percentage points								
Domestic demand	0.1	7.4	4.6	9.6	6.1	1.7	2.5	−0.5	−2.5
Net exports of goods and services	−4.0	0.2	−1.2	−5.2	−2.2	1.2	0.1	2.7	4.3
Exports of goods and services	−6.6	6.2	5.1	3.9	6.0	5.9	4.4	2.1	−0.5
Imports of goods and services	2.6	−5.9	−6.3	−9.1	−8.2	−4.7	−4.3	0.5	4.8
	Year-on-year change of the period average in %								
Unit labor costs in the whole economy (nominal, per person)	8.9	3.8	15.6	10.3	17.9	16.1	18.8	13.6	5.4
Unit labor costs in manufacturing (nominal, per hour)	1.6	−1.9	3.7	3.0	−1.6	4.4	8.8	20.5	28.5
Labor productivity in manufacturing (real, per hour)	3.7	8.7	13.7	14.5	17.2	13.7	9.8	−1.3	−6.6
Labor costs in manufacturing (nominal, per hour)	5.2	6.9	17.9	17.8	15.3	18.8	19.5	18.9	20.1
Producer price index (PPI) in industry	−2.0	15.5	38.3	33.9	40.2	50.2	28.8	9.1	−7.3
Consumer price index (here: HICP)	1.2	2.8	13.0	8.9	13.4	15.2	14.5	13.4	8.8
EUR per 1 BGN, + = BGN appreciation	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
	Period average levels								
Unemployment rate (ILO definition, %, 15–64 years)	5.2	5.3	4.3	5.0	4.7	3.7	3.9	4.5	4.7
Employment rate (%, 15–64 years)	68.5	68.2	70.4	68.4	69.8	71.9	71.5	70.4	70.3
Key interest rate per annum (%)[1]	..	..	..	..	..	..	..	..	..
BGN per 1 EUR	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
	Nominal year-on-year change in period-end stock in %								
Loans to the domestic nonbank private sector[2]	4.3	8.6	12.7	10.6	12.5	13.5	12.7	11.8	11.9
of which:									
loans to households	6.6	13.4	14.6	14.1	14.7	15.2	14.6	14.6	14.0
loans to nonbank corporations	2.9	5.5	11.4	8.4	10.9	12.2	11.4	10.0	10.4
Share of foreign currency loans in total loans to the nonbank private sector	31.9	29.3	26.2	29.0	28.4	27.3	26.2	25.5	25.3
Return on assets (banking sector)	0.7	1.1	1.4	1.6	1.5	1.4	1.4	2.0	2.1
Tier 1 capital ratio (banking sector)	22.1	22.0	20.5	21.4	20.7	20.1	20.5	20.3	20.2
NPL ratio (banking sector)	4.3	3.7	2.8	3.3	3.1	3.1	2.8	2.5	2.4
	% of GDP								
General government revenues	37.7	37.7	38.5						
General government expenditures	41.5	41.6	41.3						
General government balance	−3.8	−3.9	−2.8						
Primary balance	−3.3	−3.4	−2.3						
Gross public debt	24.5	23.9	22.9						
	% of GDP								
Debt of nonfinancial corporations (nonconsolidated)	76.6	68.8	60.2						
Debt of households and NPISHs[3] (nonconsolidated)	24.3	23.8	22.8						
	% of GDP (based on EUR), period total								
Goods balance	−3.2	−4.1	−5.8	−5.8	−3.8	−5.3	−7.7	−3.4	−2.6
Services balance	5.1	5.7	6.3	5.4	6.4	8.4	4.8	5.9	6.8
Primary income	−3.5	−4.7	−2.8	−4.8	0.4	−4.1	−3.0	−4.5	−3.3
Secondary income	1.6	1.2	1.7	1.0	1.5	1.5	2.4	0.5	2.6
Current account balance	0.0	−1.8	−0.6	−4.2	4.5	0.5	−3.5	−1.5	3.5
Capital account balance	1.4	0.7	1.0	−2.3	0.0	−0.4	5.4	1.0	1.4
Foreign direct investment (net)[4]	−4.5	−1.8	−2.4	−7.0	2.7	−2.7	−3.0	−8.4	0.5
	% of GDP (rolling four-quarter GDP, based on EUR), end of period								
Gross external debt	63.3	58.0	52.5	56.0	54.0	54.5	52.5	51.6	49.2
Gross official reserves (excluding gold)	46.8	45.7	42.8	41.6	40.3	42.9	42.8	40.7	36.9
	Months of imports of goods and services								
Gross official reserves (excluding gold)	10.4	9.2	7.6	8.0	7.4	7.6	7.6	7.4	7.0
	EUR million, period total								
GDP at current prices	61,639	71,077	84,561	17,248	20,075	22,987	24,251	20,437	21,636

Source: Bloomberg, European Commission, Eurostat, national statistical offices, national central banks, wiiw, OeNB.

[1] *Not available in a currency board regime.*

[2] *Foreign currency component at constant exchange rates.*

[3] *Nonprofit institutions serving households.*

[4] *+ = net accumulation of assets larger than net accumulation of liabilities (net outflow of capital).*
- = net accumulation of assets smaller than net accumulation of liabilities (net inflow of capital).

6 Czechia: standstill of the economy contrasts with booming labor market

After 2.4% growth in 2022, the Czech economy stagnated in the first two quarters of 2023 in quarter-on-quarter terms and contracted (–0.6%) in year-on-year terms. The frail performance was owed mainly to shrinking private consumption (–2.4 percentage point contribution to GDP expansion in the first half of 2023) while net exports were the major growth driver (3 percentage point contribution in the six months to June 2023). The tense economic situation, in particular high inflation, has forced cautious Czech households to cut down consumption spending and increase savings. As a result, even though the saving rate of Czech households has dropped well below the peak reached during the COVID-19 pandemic (then: 23% of income), it keeps ranging among the highest in the EU (18% in Czechia compared to the EU average of just above 13%). Industry – on which the Czech economy is heavily reliant – paints a telling picture about the state of the economy. Key leading indicators demonstrate the struggle of the manufacturing sector due to feeble domestic demand and, particularly, weak export orders. Industrial production has been virtually stagnant for about three years. New orders in the manufacturing sector have been falling for 19 consecutive months. The deteriorating Purchasing Managers' Index (PMI) shows that survey respondents have been reporting massive cancellations of orders by clients. Interestingly, the automotive sector has withstood these trends so far. Passenger car production grew by 22% in the first half of 2023. The question is to what extent this boom has been spurred by the completion of backlogs and pent-up or stimulated demand that may lose steam. As a result, in view of the weak domestic and foreign demand compounded by tight monetary policy, fixed investment activity has been subdued, providing a neutral contribution to growth in 2023 thus far. In addition, change in inventories has put a significant drag on growth (–1.8 percentage points in the first half of 2023) on the back of low orders, the prospect of falling prices and easing supply chain shortages. Government spending has had a slightly positive impact on growth this year.

Czechia's current account deficit, which reached more than 6% of GDP in 2022 and even formidable 13% in the third quarter of 2022, was neutralized in the first half of 2023. This is mainly ascribable to the goods trade balance, which turned into a significant surplus this year. Goods trade benefited from the relaxation of energy import prices on the one hand and relatively buoyant automotive exports in the wake of easing supply chain frictions on the other. Most likely spurred by a continued outflow of dividends, the primary income balance keeps navigating in deeply negative territory thus counterweighing the trade balance surplus within the current account.

Despite a slight increase during 2023, the unemployment rate remains one of the lowest not only in the EU but worldwide. The extremely tight labor market contrasts with the subdued economic growth and has likely contributed to the inflationary pressure. After HICP inflation had been accelerating for 1.5 years, it peaked at 19.1% in January 2023. Since then, inflation has dropped sharply. While HICP inflation came in at just above 8.3% in September, the CNB's target index CPI increased by 6.9% in September 2023, still well above CNB's tolerance band (2% ± 1 percentage point). The deceleration has been driven particularly by a significant moderation of energy and food price inflation. Core inflation has slowed down too from about 15% at the beginning of the year to just above 7% in September 2023, even though price hikes in the service sector appear particularly persistent. The CNB has kept its key interest rate unchanged at 7% since August 2022. Even though the CNB representatives leave all options open, it seems most likely that key interest rates will stay at an elevated level for some time.

The general government aims at a fiscal deficit of CZK 295 billion, approximately 3.6% of GDP, in 2023. While this target looked rather ambitious in light of the fiscal deficit in the first half of the year, higher revenues over the summer have brought the budget back on the envisaged trajectory.

The revenue side has been supported lately particularly by EU funds (especially the Recovery and Resilience Facility), dividends from the energy company CEZ and taxation of corporate (windfall) income. Gross public debt is expected to increase slightly to 44.7% of GDP in 2023. On the back of a fiscal consolidation package, which is currently still being debated in parliament, the deficit should narrow to just above 2% of GDP in 2024. Yet, the Czech Fiscal Council has warned that there will be only a minimum improvement in the structural deficit (from 2.3% of GDP in 2023 to 2.2% in 2024) so that pressures on public finances will remain.

Table 6

Main economic indicators: Czechia

	2020	2021	2022	Q1 22	Q2 22	Q3 22	Q4 22	Q1 23	Q2 23
Year-on-year change of the period total in %									
GDP at constant prices	−5.5	3.6	2.4	5.0	3.4	1.4	−0.1	−0.1	−1.1
Private consumption	−7.2	4.1	−0.7	8.3	−0.2	−4.3	−5.3	−5.3	−4.8
Public consumption	4.2	1.4	0.6	1.5	1.7	−1.9	0.9	2.9	2.8
Gross fixed capital formation	−6.0	0.8	3.0	5.7	5.2	2.4	−0.6	−1.6	1.3
Exports of goods and services	−8.0	6.9	7.2	2.8	3.2	13.1	10.4	7.0	3.0
Imports of goods and services	−8.2	13.3	6.3	5.9	3.8	8.0	7.5	3.4	−1.1
Contribution to GDP growth in percentage points									
Domestic demand	−5.1	7.2	1.5	7.0	3.7	−1.9	−2.2	−3.0	−4.2
Net exports of goods and services	−0.4	−3.6	0.9	−2.0	−0.3	3.3	2.1	2.8	3.1
Exports of goods and services	−5.9	4.8	5.2	2.3	2.4	8.5	7.4	5.5	2.3
Imports of goods and services	5.6	−8.4	−4.4	−4.3	−2.7	−5.2	−5.3	−2.6	0.8
Year-on-year change of the period average in %									
Unit labor costs in the whole economy (nominal, per person)	7.2	1.8	5.1	4.5	3.2	4.9	7.7	10.0	9.3
Unit labor costs in manufacturing (nominal, per hour)	2.9	1.8	0.1	2.4	2.9	−3.4	−1.0	10.0	6.6
Labor productivity in manufacturing (real, per hour)	4.5	1.2	4.7	2.7	2.7	8.3	5.2	−1.8	1.2
Labor costs in manufacturing (nominal, per hour)	7.2	3.4	4.9	5.1	5.7	4.6	4.2	8.0	7.9
Producer price index (PPI) in industry	0.6	6.2	18.6	16.4	21.3	20.6	16.2	11.3	1.7
Consumer price index (here: HICP)	3.3	3.3	14.8	10.2	15.0	17.4	16.5	18.0	12.6
EUR per 1 CZK, + = CZK appreciation	−3.0	3.2	4.4	5.7	4.0	3.7	4.0	3.6	4.5
Period average levels									
Unemployment rate (ILO definition, %, 15–64 years)	2.6	2.9	2.3	2.3	2.2	2.3	2.3	2.7	2.6
Employment rate (%, 15–64 years)	74.4	74.4	75.5	75.1	75.3	75.8	75.8	74.5	75.2
Key interest rate per annum (%)	0.8	0.9	5.9	4.2	5.6	7.0	7.0	7.0	7.0
CZK per 1 EUR	26.5	25.6	24.6	24.7	24.6	24.6	24.4	23.8	23.6
Nominal year-on-year change in period-end stock in %									
Loans to the domestic nonbank private sector[1]	3.0	9.7	6.2	10.4	9.2	8.6	6.2	5.4	6.8
of which:									
loans to households	6.5	9.9	4.8	10.3	8.3	6.5	4.8	3.6	5.1
loans to nonbank corporations	−1.3	9.4	8.3	10.5	10.5	11.6	8.3	7.9	9.0
Share of foreign currency loans in total loans	14.6	14.6	19.4	15.6	17.3	19.4	19.4	20.3	20.7
Return on assets (banking sector)	0.6	0.8	1.1	1.0	1.2	1.2	1.1	0.9	1.1
Tier 1 capital ratio (banking sector)	23.6	22.8	21.5	21.7	20.9	21.1	21.5	21.8	22.0
NPL ratio (banking sector)	2.6	2.3	1.9	2.2	2.0	1.9	1.9	1.8	1.8
% of GDP									
General government revenues	41.5	41.4	41.0						
General government expenditures	47.2	46.5	44.6						
General government balance	−5.8	−5.1	−3.6						
Primary balance	−4.9	−4.3	−2.4						
Gross public debt	37.7	42.0	44.1						
% of GDP									
Debt of nonfinancial corporations (nonconsolidated)	56.1	53.6	51.6						
Debt of households and NPISHs[2] (nonconsolidated)	34.0	35.7	33.2						
% of GDP (based on EUR), period total									
Goods balance	4.9	1.1	−1.5	0.4	−2.2	−2.9	−0.9	4.7	4.4
Services balance	1.8	1.7	1.3	1.6	1.8	1.6	0.3	1.1	1.3
Primary income	−4.2	−5.1	−5.5	−1.9	−4.3	−11.3	−4.2	−2.6	−7.1
Secondary income	−0.5	−0.5	−0.5	−1.3	−0.4	−0.4	0.1	−1.2	−0.2
Current account balance	2.0	−2.8	−6.1	−1.2	−5.0	−13.0	−4.6	2.0	−1.6
Capital account balance	1.2	1.7	0.1	−0.3	0.9	0.8	−1.0	1.0	2.7
Foreign direct investment (net)[3]	−2.6	−0.5	−2.5	−1.1	−1.9	−1.8	−5.1	−1.9	−1.4
% of GDP (rolling four-quarter GDP, based on EUR), end of period									
Gross external debt	76.3	76.3	66.8	77.5	72.9	67.4	66.8	64.8	62.5
Gross official reserves (excluding gold)	62.5	64.1	47.3	62.9	57.7	50.9	47.3	45.1	43.7
Months of imports of goods and services									
Gross official reserves (excluding gold)	11.9	11.0	7.6	10.6	9.5	8.2	7.6	7.3	7.3
EUR million, period total									
GDP at current prices	215,824	238,361	276,282	62,534	68,834	71,328	73,586	72,099	78,412

Source: Bloomberg, European Commission, Eurostat, national statistical offices, national central banks, wiiw, OeNB.

[1] *Foreign currency component at constant exchange rates.*

[2] *Nonprofit institutions serving households.*

[3] *+ = net accumulation of assets larger than net accumulation of liabilities (net outflow of capital).*
- = net accumulation of assets smaller than net accumulation of liabilities (net inflow of capital).

7 Hungary: budget deficit set to increase notably in 2023

In the second quarter of 2023, Hungary's economy recorded a quarterly contraction for the fourth quarter in a row. The year-on-year contraction accelerated to –2.4%, resulting in a decline of GDP by 1.7% during the first half of 2023 compared to a year earlier. Private consumption fell by 3.4% during the first half of 2023 as high inflation eroded purchasing power, the counterbalancing effect of the withdrawal of savings wore off and employment stagnated. The rate of contraction of investment activity went into double digits amid tight lending conditions, sharply slowing corporate credit activity, high energy prices and the continued delay in the disbursement of EU funds to Hungary. Investments in nondwelling construction contracted by one-quarter but also investments in machinery and nontransport equipment and intellectual property products decreased compared to the first half 2022. The large positive contribution of net exports prevented an even bigger decline in GDP during the first half of 2023. Unfortunately, this came on the back of a major slowdown in import growth as a result of weak domestic demand, while export growth also decelerated sharply compared to the second half of 2022.

In response to underperforming VAT revenues, rising interest costs on government debt, the large burden of energy price subsidies and the supplementary inflation compensation for pensioners in autumn 2023, the government raised its 2023 budget deficit target from 3.9% to 5.2% of GDP in early October 2023. The official deficit target for 2024 has remained 2.9% of GDP. In order to mitigate fiscal pressures, the government has tightened the eligibility rules for the housing subsidy and preferential loan schemes for families (effective from 2024) and secured the ECB's consent to allow a multiyear period for the central bank to correct its negative capital before a capital injection by the state becomes necessary (under previous rules, the cost of necessary recapitalization in the 2024 budget had been estimated at 0.4% to 0.5% of GDP). In order to mobilize additional funds at lower costs for the financing of the budget deficit, the government has imposed a 13% social contribution tax on capital gains, dividend and interest income (on top of the 15% income tax), except for government securities (and real estate investment fund shares). In addition, it has raised the minimum shares for government securities in mutual funds' portfolios.

Following its peak in January 2023 at 26.2%, HICP inflation gradually receded to 12.2% by September 2023. The decline was caused mainly by falling energy and food price inflation but was also supported by weak consumption and the year-on-year strengthening of the forint. With effect from the beginning of August, the government abolished the price caps on selected basic food items. At the same time, it introduced mandatory discounts for these items with more stringent conditions than previously applied to the mandatory discounts for a broader group of products that had been introduced at the beginning of June 2023. In addition, an online price-monitoring platform was introduced at the beginning of July 2023, comprising of 62 products under scrutiny.

Falling inflation has been accompanied by gradual monetary easing by the central bank (MNB). Between late May and September 2023, MNB cut its operational policy rate from 18% to 13% and thus brought it into level with the base rate, which became again the policy rate. O/N quick deposit tenders were discontinued at the beginning of October 2023 and mandatory reserves became the main policy instrument. According to the central bank's latest assessment, inflation will fall back into the bank's tolerance band (3% ± 1 percentage point) at the beginning of 2025. Tight monetary policy and banks' lending standards led to a further deceleration of lending activity, in particular to nonbank corporations. Within the household segment, the dynamics of loans for house purchase and other purposes slowed most, while the growth of consumption loans accelerated, possibly in response to households' deteriorating real income situation. Amid the high interest environment and despite the broadening of the cap on selected interest rates toward the end of 2022, banks' net interest income improved visibly during the first half of 2023. This, together with lower provisioning costs (mirroring the falling NPL ratio) and despite increased taxation of banks, tripled the unconsolidated net profits of the banking sector.

The combined current and capital account developed favorably in the first half of 2023. On a four-quarter moving sum basis, the deficit decreased from 6% of GDP in the last quarter of 2022 to around 4% by the second quarter of 2023. The improvement was attributable to the goods and services balance, while the deficit on the primary and secondary income balance rose modestly and the capital account surplus halved to its lowest level since 2017.

Table 7

Main economic indicators: Hungary

	2020	2021	2022	Q1 22	Q2 22	Q3 22	Q4 22	Q1 23	Q2 23
	Year-on-year change of the period total in %								
GDP at constant prices	–4.5	7.1	4.6	7.9	6.7	4.3	0.2	–0.9	–2.4
Private consumption	–1.2	4.6	6.5	11.9	8.2	4.6	2.3	–4.3	–3.3
Public consumption	–0.3	1.8	3.0	6.5	4.9	1.7	–0.9	–2.8	3.3
Gross fixed capital formation	–7.1	5.8	0.1	9.7	4.9	0.1	–10.0	–3.9	–15.2
Exports of goods and services	–6.1	8.3	12.6	9.7	10.5	17.6	12.7	6.6	0.3
Imports of goods and services	–3.9	7.3	11.6	11.5	10.2	13.9	10.8	2.3	–6.0
	Contribution to GDP growth in percentage points								
Domestic demand	–2.6	6.2	3.7	9.5	6.3	1.7	–1.3	–4.6	–8.4
Net exports of goods and services	–2.0	0.9	0.8	–1.6	0.4	2.6	1.5	3.7	6.0
Exports of goods and services	–5.0	6.5	10.1	8.8	8.6	13.3	9.4	6.8	0.1
Imports of goods and services	3.1	–5.6	–9.3	–10.4	–8.2	–10.7	–8.0	–3.1	5.9
	Year-on-year change of the period average in %								
Unit labor costs in the whole economy (nominal, per person)	6.8	2.9	12.0	13.2	6.7	11.9	16.3	11.5	19.9
Unit labor costs in manufacturing (nominal, per hour)	8.4	0.2	7.8	6.8	7.6	4.8	11.8	25.3	24.9
Labor productivity in manufacturing (real, per hour)	–0.2	5.9	4.2	4.4	2.7	7.4	2.5	–3.4	–3.2
Labor costs in manufacturing (nominal, per hour)	7.4	6.9	12.4	11.5	10.6	12.5	14.6	21.0	20.9
Producer price index (PPI) in industry	4.3	13.5	33.4	23.4	32.0	41.2	36.9	27.2	10.2
Consumer price index (here: HICP)	3.4	5.2	15.3	8.3	11.0	18.0	23.3	25.9	22.1
EUR per 1 HUF, + = HUF appreciation	–7.4	–2.0	–8.4	–0.9	–8.1	–12.3	–11.3	–6.2	3.6
	Period average levels								
Unemployment rate (ILO definition, %, 15–64 years)	4.3	4.1	3.7	3.8	3.2	3.7	3.9	4.1	3.9
Employment rate (%, 15–64 years)	69.7	73.1	74.4	74.0	74.3	74.6	74.5	74.3	74.7
Key interest rate per annum (%)	0.8	1.1	8.0	3.1	5.3	10.6	13.0	13.0	13.0
HUF per 1 EUR	351.3	358.5	391.3	364.6	385.8	403.4	410.8	388.7	372.6
	Nominal year-on-year change in period-end stock in %								
Loans to the domestic nonbank private sector[1]	11.0	12.1	9.9	9.3	10.2	10.8	9.9	11.0	8.9
of which:									
loans to households	14.1	14.9	6.3	11.0	8.9	7.6	6.3	6.8	4.6
loans to nonbank corporations	8.8	9.9	12.6	7.9	11.3	13.3	12.6	14.0	12.0
Share of foreign currency loans in total loans to the nonbank private sector	22.3	20.3	23.3	21.3	22.3	23.6	23.3	23.7	24.1
Return on assets (banking sector)	0.4	0.9	0.7	1.1	0.6	0.7	0.7	1.3	1.9
Tier 1 capital ratio (banking sector)	17.4	18.1	17.5	17.3	16.7	16.2	17.5	16.3	16.7
NPL ratio (banking sector)	2.4	1.6	2.0	1.6	1.9	2.0	2.0	2.0	2.0
	% of GDP								
General government revenues	43.6	41.2	41.6						
General government expenditures	51.1	48.3	47.8						
General government balance	–7.5	–7.1	–6.2						
Primary balance	–5.2	–4.8	–3.4						
Gross public debt	79.3	76.6	73.3						
	% of GDP								
Debt of nonfinancial corporations (nonconsolidated)	68.7	76.8	80.1						
Debt of households and NPISHs[2] (nonconsolidated)	20.1	20.4	18.3						
	% of GDP (based on EUR), period total								
Goods balance	–1.0	–2.9	–9.0	–7.5	–7.0	–11.6	–9.7	–1.9	1.8
Services balance	2.9	3.1	4.8	4.3	4.9	5.8	4.1	5.2	4.9
Primary income	–2.6	–3.4	–3.2	–2.1	–3.3	–4.0	–3.3	–3.3	–4.3
Secondary income	–0.5	–1.0	–0.8	–0.4	–0.7	–1.1	–0.9	–1.4	–1.0
Current account balance	–1.1	–4.2	–8.3	–5.7	–6.2	–10.9	–9.8	–1.5	1.4
Capital account balance	2.1	2.5	2.2	4.5	2.8	1.0	0.8	1.1	1.1
Foreign direct investment (net)[3]	–1.6	–2.1	–2.8	3.8	–2.7	–8.4	–3.1	6.4	2.5
	% of GDP (rolling four-quarter GDP, based on EUR), end of period								
Gross external debt	81.2	84.9	89.2	85.8	83.7	85.3	89.2	94.7	93.4
Gross official reserves (excluding gold)	23.3	21.8	19.9	19.8	19.6	20.1	19.9	20.1	19.4
	Months of imports of goods and services								
Gross official reserves (excluding gold)	3.6	3.3	2.5	2.9	2.7	2.6	2.5	2.5	2.6
	EUR million, period total								
GDP at current prices	137,723	153,941	168,405	37,566	42,349	42,554	45,936	39,847	49,886

Source: Bloomberg, European Commission, Eurostat, national statistical offices, national central banks, wiiw, OeNB.

[1] *Foreign currency component at constant exchange rates.*

[2] *Nonprofit institutions serving households.*

[3] *+ = net accumulation of assets larger than net accumulation of liabilities (net outflow of capital).*
- = net accumulation of assets smaller than net accumulation of liabilities (net inflow of capital).

8 Poland: signs of incipient recovery prompted rate cuts

Poland's GDP contracted by about 1% year on year in the first half of 2023, after more than 5% growth in 2022. The quarter-on-quarter pattern shows a recovery in the first quarter of 2023 after a contraction in the fourth quarter of 2022 but further shrinking in the second quarter of 2023. It further shows that the quarterly decline of private consumption already bottomed out in the fourth quarter of 2022 with very weak growth thereafter, while the shrinkage of real exports aggravated in the first half of 2023 and inventory change rendered a more negative contribution to growth due to slower inventory buildup. As real imports shrank even more than exports on the back of weak domestic demand, net exports rendered a positive contribution to GDP growth.

As a result, in year-on-year terms, private consumption contracted even more strongly during the first half of 2023 and export growth turned negative in the second quarter. In contrast, gross fixed capital formation growth accelerated both in quarter-on-quarter and year-on-year terms. Private consumption contraction reflects the annual decline of both, the real wage sum and real gross retirement pensions for several quarters up to the first quarter of 2023. Next to first signs of growth in these income indicators in the second quarter of 2023, consumer confidence improved, too. Fixed investment was mainly driven by corporate investment on the back of the still sound, albeit slightly deteriorating, financial position indicated by e.g. sales profitability, the share of profitable enterprises and corporate liquidity. Residential investment, however, shrank, as indicated e.g. by the number of dwellings under construction, which mirrored the nominal decline in housing loans.

In the first half of 2023, corresponding to the sizable positive contribution of net exports to annual growth, the surplus of the goods and services balance in the balance of payments increased strongly from a year earlier to 7.2% of GDP and the combined current and capital account deficit turned positive to reach 1.1% of GDP. Net FDI inflows declined but continued to be substantial at 3.2% of GDP.

On average in this period, nominal ULC of manufacturing gross value added was higher than a year earlier and its increase exceeded that in the euro area by more than 8 percentage points, while the złoty's nominal value in euro was roughly unchanged. Thus, in real (ULC-deflated) terms, the złoty was more than 8% stronger than a year earlier. After nominal appreciation against the euro from February to July by about 6.5%, the złoty depreciated by 3.5% until September, settling at 4.6 złoty for one euro.

According to HICP (and national CPI) definition, annual headline inflation declined from 15.9% (17.3%) in the fourth quarter of 2022 to 12.5% (13.1%) in the second quarter of 2023 and stood at 7.7% (8.2%) in September 2023, while core inflation came down to 8.7% (8.4%). Within core HICP, nonenergy industrial goods inflation stood at 5.7% in September, while the annual change in manufacturing PPI was negative from May onward, reaching –5.5% in September. The Monetary Policy Council (MPC), pursuing a CPI inflation target of 2.5% ± 1 percentage point, lowered its main policy rate to 6% in September and 5.75% in early October 2023, after holding this key rate at 6.75% for about a year. In early October 2023, the MPC stated that incoming data confirmed weak demand and lower cost pressure, that the time lags in monetary transmission and current interest rates would lead to meeting the inflation target in the medium term, and that disinflation would be faster if supported by an appreciation of the złoty, which, in the MPC's assessment, would be consistent with the economic fundamentals.

Based on the government's convergence program, the European Commission staff forecast, in May, that the general government deficit would rise to 5.6% of GDP in 2023 (from 3.7% of GDP in 2022), while general government debt would rise to 50.5% of GDP at end-2023. The rise in the deficit stems from the higher expenditure-to-GDP ratio despite the phasing out of COVID-19 measures. Expenditures rose as a result of (1) the indexation of pensions, (2) inflation-driven higher public consumption via both wages and purchases, (3) higher defense spending, (4) higher spending on healthcare and (5) extraordinary aid granted to farmers.

Table 8

Main economic indicators: Poland

	2020	2021	2022	Q1 22	Q2 22	Q3 22	Q4 22	Q1 23	Q2 23
	Year-on-year change of the period total in %								
GDP at constant prices	−2.0	6.9	5.1	10.7	5.5	4.8	0.7	−0.1	−1.4
Private consumption	−3.4	6.1	3.3	6.5	6.7	1.1	−1.0	−2.6	−3.1
Public consumption	4.9	5.0	−2.0	1.5	1.9	0.7	−9.7	−0.4	1.9
Gross fixed capital formation	−2.3	1.2	5.0	7.7	9.5	2.3	3.1	6.1	8.2
Exports of goods and services	−1.1	12.3	6.2	5.5	6.2	8.6	4.5	3.0	−3.0
Imports of goods and services	−2.4	16.1	6.2	8.4	7.9	7.5	1.3	−4.3	−8.1
	Contribution to GDP growth in percentage points								
Domestic demand	−2.6	8.0	4.9	12.1	6.1	4.1	−1.0	−4.6	−4.5
Net exports of goods and services	0.6	−1.1	0.2	−1.4	−0.6	0.7	1.7	4.5	3.1
Exports of goods and services	−0.6	6.5	3.6	3.5	3.9	4.8	2.2	1.9	−1.8
Imports of goods and services	1.2	−7.6	−3.3	−4.9	−4.5	−4.1	−0.5	2.6	4.9
	Year-on-year change of the period average in %								
Unit labor costs in the whole economy (nominal, per person)	7.5	0.3	7.9	1.2	9.8	11.6	9.5	15.5	16.1
Unit labor costs in manufacturing (nominal, per hour)	4.7	−4.6	1.8	−1.5	2.2	2.5	4.3	11.9	11.6
Labor productivity in manufacturing (real, per hour)	1.8	12.9	8.8	12.6	9.7	9.1	4.3	−1.4	−0.4
Labor costs in manufacturing (nominal, per hour)	6.2	8.0	10.9	10.9	12.1	11.8	8.8	10.3	11.2
Producer price index (PPI) in industry	−0.5	8.1	23.8	18.5	25.3	27.5	23.7	18.9	5.0
Consumer price index (here: HICP)	3.7	5.2	13.2	9.0	12.8	14.9	15.9	16.1	12.5
EUR per 1 PLN, + = PLN appreciation	−3.3	−2.7	−2.6	−1.7	−2.6	−3.7	−2.3	−1.8	2.5
	Period average levels								
Unemployment rate (ILO definition, %, 15−64 years)	3.2	3.4	3.0	3.2	2.7	3.0	2.9	3.0	2.6
Employment rate (%, 15−64 years)	68.7	70.3	71.4	71.0	71.4	71.2	71.8	72.0	72.1
Key interest rate per annum (%)	0.5	0.3	5.3	2.7	5.1	6.5	6.8	6.8	6.8
PLN per 1 EUR	4.4	4.6	4.7	4.6	4.6	4.7	4.7	4.7	4.5
	Nominal year-on-year change in period-end stock in %								
Loans to the domestic nonbank private sector[1]	−1.2	5.0	0.8	6.1	6.1	4.8	0.8	0.2	−0.3
of which:									
loans to households	1.6	4.2	−4.7	3.1	0.4	−2.5	−4.7	−5.4	−4.5
loans to nonbank corporations	−6.0	6.5	10.8	11.7	16.9	18.5	10.8	9.9	6.5
Share of foreign currency loans in total loans to the nonbank private sector	19.6	17.5	18.5	17.6	17.7	19.0	18.5	18.6	17.7
Return on assets (banking sector)	−0.0	0.2	0.4	1.0	0.8	0.3	0.4	1.3	1.1
Tier 1 capital ratio (banking sector)	18.5	17.4	18.3	16.7	17.1	16.4	18.3	18.5	19.7
NPL ratio (banking sector)	7.0	5.8	5.5	5.7	5.6	5.7	5.5	5.4	5.6
	% of GDP								
General government revenues	41.3	42.3	39.8						
General government expenditures	48.2	44.1	43.5						
General government balance	−6.9	−1.8	−3.7						
Primary balance	−5.6	−0.7	−2.1						
Gross public debt	57.2	53.6	49.1						
	% of GDP								
Debt of nonfinancial corporations (nonconsolidated)	44.9	43.3	40.3						
Debt of households and NPISHs[2] (nonconsolidated)	33.7	32.0	26.5						
	% of GDP (based on EUR), period total								
Goods balance	1.3	−1.3	−3.7	−4.2	−3.5	−4.1	−3.1	1.8	1.6
Services balance	4.4	4.6	5.6	5.1	6.5	5.7	4.9	5.5	5.5
Primary income	−3.8	−4.5	−3.9	−4.4	−4.7	−4.3	−2.6	−4.1	−5.9
Secondary income	0.5	−0.1	−0.3	−0.3	−0.4	−0.4	−0.1	−0.2	−0.6
Current account balance	2.4	−1.3	−2.4	−3.7	−2.1	−3.1	−0.9	3.0	0.7
Capital account balance	1.8	0.7	0.5	−0.7	1.3	1.6	−0.1	−2.6	1.0
Foreign direct investment (net)[3]	−2.4	−3.8	−3.6	−7.1	−3.4	−3.8	−0.9	−5.4	−1.1
	% of GDP (rolling four-quarter GDP, based on EUR), end of period								
Gross external debt	58.5	56.0	52.7	55.1	55.0	54.1	52.7	52.4	53.1
Gross official reserves (excluding gold)	21.7	23.4	21.9	21.8	22.1	22.6	21.9	21.2	21.7
	Months of imports of goods and services								
Gross official reserves (excluding gold)	5.5	5.2	4.3	4.6	4.5	4.5	4.3	4.2	4.5
	EUR million, period total								
GDP at current prices	526,034	576,150	656,534	150,159	156,076	165,363	184,936	170,001	177,822

Source: Bloomberg, European Commission, Eurostat, national statistical offices, national central banks, wiiw, OeNB.

[1] *Foreign currency component at constant exchange rates.*

[2] *Nonprofit institutions serving households.*

[3] *+ = net accumulation of assets larger than net accumulation of liabilities (net outflow of capital).*
- = net accumulation of assets smaller than net accumulation of liabilities (net inflow of capital).

9 Romania: economic growth relatively robust, but marked twin deficits persist

Despite a challenging external environment, Romania's economic activity continued to grow in the first half of 2023. In quarter-on-quarter terms, GDP expanded at a similar speed as in the second half of 2022, when growth started to decelerate. Year-on-year growth rates, on the other hand, have come down somewhat this year.

Even though real wage growth was slightly negative until March 2023, private consumption grew strongly in the first quarter before decelerating in the second quarter. Meanwhile, the labor market has remained relatively robust. As gross fixed capital formation continued to grow vividly, it became the most important growth driver in the second quarter. Brisk construction activity, particularly in the context of EU-funded infrastructure projects, as well as equipment purchases in the area of renewable energy contributed to the remarkable performance of investments. In an overall lending slowdown, year-on-year nominal growth of domestic credit came to a standstill in the household sector, while the credit stock vis-à-vis nonbank corporations still showed double-digit year-on-year growth. Both real export and import growth turned negative in the second quarter of 2023. As the decline in exports was below the import contraction, the contribution of net exports became slightly positive in this quarter. Subdued export dynamics amid dwindling external demand were also reflected in a continued contraction in industrial production, where the weakness became broader based beyond energy-intensive industries. As regards external price competitiveness it should be noted that unit labor cost increases in the manufacturing sector accelerated markedly in the first half of 2023, while the Romanian leu stayed largely unchanged vis-à-vis the euro. After the minimum wage was increased by 17.6% as of January 2023, it was hiked again by 10% as of October 2023.

The net lending position from the current account deficit has remained large but narrowed noticeably to 6.4% of GDP in the first half of 2023 from almost 10% in the first half of 2022, mainly due to a smaller deficit in the goods balance. The net lending position from the current and capital account deficit (including EU fund inflows) came down to 5.1% of GDP, 43% of which were financed by net FDI inflows. Strong portfolio inflows related to large-scale sovereign Eurobond issuances, contributed to financing the current account gap and lifted gross official FX reserves, but are also reflected in a rising gross external debt ratio.

Consumer price inflation went down from 16.4% at end-2022 to 9.2% in September 2023. Core inflation declined as well but remained clearly above headline inflation (10.7% in September 2023). After having hiked its key policy rate to 7% in January 2023, the National Bank of Romania (NBR) has left it unchanged. The NBR currently projects inflation to fall to 7.5% at end-2023 and to 3.8% in mid-2025. Hence, the central bank assumes that inflation will remain above the upper bound of the inflation target variation band of 2.5% ± 1 percentage point until the end of its forecast horizon.

The government adopted a corrective fiscal package in September, that includes measures to broaden the tax base, new excise duties, a special tax on immovable and movable assets of high value, an increase in the microenterprise tax and a turnover tax for large enterprises and banks. The government now expects the deficit to decrease below 5.5% of GDP (compared to the 4.4% of GDP originally planned). The government also said that it will try to convince the European Commission to accept a higher deficit. Romania has been subject to an excessive deficit procedure. According to the corresponding Council recommendation adopted in June 2021, Romania should reach a deficit of 4.4% of GDP in 2023 and 2.9% in 2024. In the framework of its Article IV mission that ended in early October 2023, IMF staff projected a deficit of 6% of GDP for this year and just above 5% of GDP for 2024. It specified that the fiscal package was a step in the right direction, but further adjustment was needed.

Table 9

Main economic indicators: Romania

	2020	2021	2022	Q1 22	Q2 22	Q3 22	Q4 22	Q1 23	Q2 23
Year-on-year change of the period total in %									
GDP at constant prices	−3.7	5.7	4.6	4.6	4.5	3.9	5.3	1.0	2.7
Private consumption	−3.9	7.2	6.9	7.0	8.4	4.1	8.3	1.2	5.3
Public consumption	1.1	1.8	3.1	4.1	0.8	1.6	5.5	5.2	1.8
Gross fixed capital formation	1.1	2.9	5.6	−7.5	−1.6	10.3	14.2	13.3	13.3
Exports of goods and services	−9.5	12.6	9.6	5.8	9.6	14.3	8.5	1.8	0.6
Imports of goods and services	−5.2	14.8	9.9	2.7	6.0	21.6	9.3	2.3	0.9
Contribution to GDP growth in percentage points									
Domestic demand	−2.2	7.2	5.3	3.3	3.3	7.7	5.9	1.5	2.8
Net exports of goods and services	−1.5	−1.5	−0.7	1.3	1.2	−3.8	−0.7	−0.5	−0.2
Exports of goods and services	−3.8	4.6	3.9	3.2	4.2	5.1	3.0	1.0	0.3
Imports of goods and services	2.3	−6.1	−4.6	−1.9	−3.0	−8.9	−3.6	−1.5	−0.5
Year-on-year change of the period average in %									
Unit labor costs in the whole economy (nominal, per person)	5.5	1.4	2.7	1.9	0.1	4.6	5.1	14.2	15.3
Unit labor costs in manufacturing (nominal, per hour)	7.7	3.9	14.5	11.8	15.0	13.8	17.1	20.5	24.0
Labor productivity in manufacturing (real, per hour)	0.4	3.1	−1.6	−0.1	−2.5	−0.6	−2.9	−3.3	−6.0
Labor costs in manufacturing (nominal, per hour)	8.1	7.1	12.7	11.6	12.1	13.1	13.7	16.5	16.6
Producer price index (PPI) in industry	−0.0	14.9	44.7	46.2	47.3	50.5	36.2	19.5	7.6
Consumer price index (here: HICP)	2.3	4.1	12.0	8.2	12.4	13.3	14.1	13.0	9.8
EUR per 1 RON, + = RON appreciation	−1.9	−1.7	−0.2	−1.4	−0.4	0.4	0.6	0.5	−0.1
Period average levels									
Unemployment rate (ILO definition, %, 15–64 years)	5.2	5.6	5.6	6.0	5.3	5.4	5.8	..	5.4
Employment rate (%, 15–64 years)	65.6	61.9	63.0	62.4	63.5	63.4	62.8	..	63.0
Key interest rate per annum (%)	1.9	1.4	4.3	2.3	3.4	5.1	6.5	7.0	7.0
RON per 1 EUR	4.8	4.9	4.9	4.9	4.9	4.9	4.9	4.9	4.9
Nominal year-on-year change in period-end stock in %									
Loans to the domestic nonbank private sector[1]	4.8	14.2	12.1	15.2	17.1	15.7	12.1	10.2	6.4
of which:									
loans to households	4.2	9.3	4.3	9.3	8.6	6.3	4.3	2.1	0.1
loans to nonbank corporations	5.5	19.8	20.0	21.7	26.4	25.7	20.0	18.2	12.2
Share of foreign currency loans in total loans to the nonbank private sector	30.5	27.6	31.1	27.3	28.0	29.4	31.1	32.2	32.1
Return on assets (banking sector)	1.0	1.4	1.5	1.2	1.5	1.5	1.5	1.9	1.9
Tier 1 capital ratio (banking sector)	23.2	20.9	20.5	19.0	18.9	18.8	20.5	18.8	19.7
NPL ratio (banking sector)	3.8	3.4	2.7	3.3	3.0	2.8	2.7	2.7	2.7
% of GDP									
General government revenues	32.3	32.7	33.5						
General government expenditures	41.5	39.8	39.7						
General government balance	−9.2	−7.1	−6.2						
Primary balance	−8.0	−6.0	−5.0						
Gross public debt	46.9	48.6	47.3						
% of GDP									
Debt of nonfinancial corporations (nonconsolidated)	33.0	33.1	31.0						
Debt of households and NPISHs[2] (nonconsolidated)	16.0	15.7	13.8						
% of GDP (based on EUR), period total									
Goods balance	−8.6	−9.6	−11.3	−12.3	−11.5	−11.7	−10.2	−10.2	−8.6
Services balance	4.3	3.9	4.4	4.2	4.9	4.0	4.7	5.9	4.5
Primary income	−1.5	−2.0	−3.1	−2.4	−3.8	−4.1	−2.1	−2.1	−3.1
Secondary income	0.9	0.4	0.6	0.6	0.6	0.6	0.7	0.4	0.5
Current account balance	−4.9	−7.2	−9.3	−10.0	−9.8	−11.2	−6.9	−6.0	−6.7
Capital account balance	1.9	2.2	2.5	1.0	2.1	1.5	4.6	0.8	1.8
Foreign direct investment (net)[3]	−1.3	−3.7	−3.4	−5.3	−2.3	−3.9	−2.5	−3.4	−1.1
% of GDP (rolling four-quarter GDP, based on EUR), end of period									
Gross external debt	57.6	56.5	50.6	54.7	52.6	51.0	50.6	51.5	52.2
Gross official reserves (excluding gold)	17.0	16.8	16.3	16.1	16.2	16.1	16.3	18.0	17.5
Months of imports of goods and services									
Gross official reserves (excluding gold)	4.9	4.3	3.9	4.1	4.0	3.9	3.9	4.4	4.4
EUR million, period total									
GDP at current prices	220,320	241,443	285,993	54,593	67,106	79,014	85,280	64,745	76,222

Source: Bloomberg, European Commission, Eurostat, national statistical offices, national central banks, wiiw, OeNB.

[1] *Foreign currency component at constant exchange rates.*

[2] *Nonprofit institutions serving households.*

[3] *+ = net accumulation of assets larger than net accumulation of liabilities (net outflow of capital).*
- = net accumulation of assets smaller than net accumulation of liabilities (net inflow of capital).

Focus on the Western Balkans

Housing markets and house price expectations[7]

This report continues the analysis[8] of property markets in the Western Balkans[9] and shifts the focus from slow-moving structural features to indicators that are faster-moving and influenced by cyclical factors. First, we provide an overview of the economic importance of housing markets in the Western Balkans and compare the Western Balkan economies with EU countries in Central, Eastern and Southeastern Europe (CESEE EU[10]). Second, we show data on house price dynamics. Third, we combine the evidence from official statistics with survey data on households' expectations regarding property price developments and study within-country heterogeneities in expectations.

1 The economic importance of housing markets in the Western Balkans

Homeownership rates are particularly high in the Western Balkan countries as well as in the CESEE EU countries. In all of these countries, the share of owner-occupied housing stood above the EU-27 average of 69.1% in 2022 (according to data published by Eurostat). In Kosovo, Albania and Romania, owner-occupied housing was an almost universal phenomenon, whereas with shares of 77.1% and 75.4%, respectively, homeownership rates were comparably low in Czechia and Slovenia (chart 1). The high share of owner-occupied housing highlights the importance of housing markets for households. Further indicators underline the exceptional importance of housing markets for the economies of the Western Balkans in general. Moreover, housing market developments have a sizable impact not only on the economy in general but also on the banking sector.

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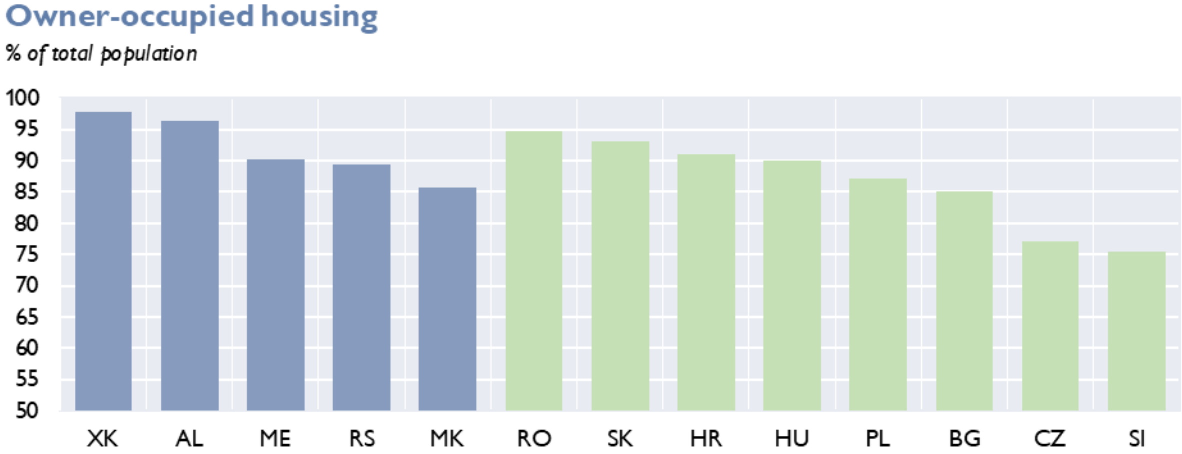
[7] *Compiled by Elisabeth Beckmann and Antje Hildebrandt.*

[8] *For the previous analysis see: Focus on European Economic Integration Q4/22. OeNB.*

[9] *The Western Balkans comprise the EU candidate countries Albania, Bosnia and Herzegovina, Montenegro, North Macedonia and Serbia as well as the potential candidate Kosovo. The designation "Kosovo" is used without prejudice to positions on status and in line with UNSCR 1244 and the ICJ Opinion on the Kosovo declaration of independence.*

[10] *CESEE EU includes Bulgaria, Croatia, Czechia, Hungary, Poland, Romania, Slovakia and Slovenia.*

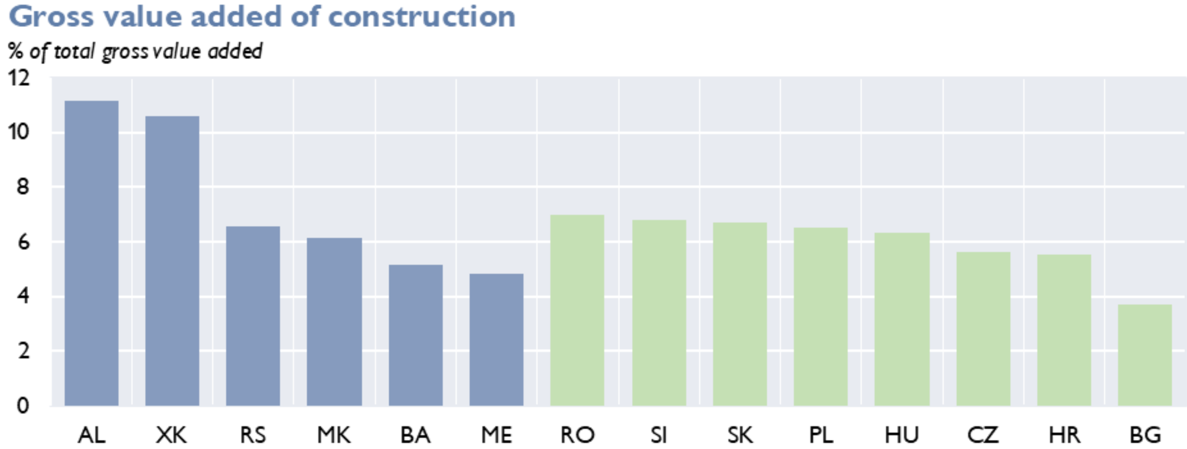
Chart 1



Source: Eurostat.
Note: Data from 2022 (CESEE EU), 2021 (RS), 2020 (AL, ME, MK) and 2018 (XK); no data available for BA.

Looking at the production side, gross value added of construction as a share of total gross value added reached outstandingly high levels of above 10% in Albania and Kosovo in 2022, almost twice as high as in other Western Balkan and CESEE EU countries (chart 2). The high share of construction in value added can partly be explained by a booming construction sector, particularly in Albania. Moreover, both countries receive substantial remittances (particularly Kosovo with personal remittances as a share of GDP of above 17% in 2022 according to the World Bank[11]), from which a large part flows into the construction sector. This is also the case in other Western Balkan countries, for example in Montenegro, but other economic activities are playing a larger role (e.g. tourism in Montenegro) and are making the countries less dependent on the construction sector.

Chart 2



Source: Eurostat.
Note: Data from 2022.

On the expenditure side, gross fixed capital formation of dwellings (i.e. housing investment) as a share of GDP plays an important role in Albania, with a share of almost 12% in 2022. In the

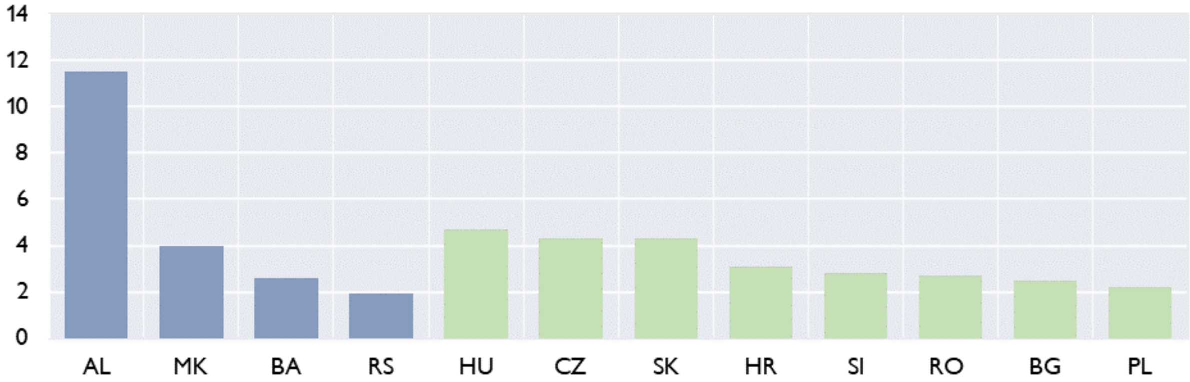
[11] *According to the central bank of Kosovo (2022), remittances amounted to about 14% of GDP and real estate investment of the diaspora to close to 6% of GDP in 2022.*

remaining Western Balkan countries, housing investments were much less relevant (no data available for Kosovo and Montenegro), and also in the CESEE EU countries, the shares ranged only between 2% to 5% (chart 3).

Chart 3

Investment in housing

% of GDP



Source: Eurostat.
Note: Data from 2022 except for MK (2021); no data available for XK and ME.

The share of employment in the construction sector was highest in Kosovo (above 10% of total employment according labor force survey data) and lowest in Serbia (close to 6%) among the Western Balkan countries. Among the CESEE EU countries, Slovakia and Romania reached shares close to 10% of total employment. Slovenia has the lowest share of employment in construction.

Overall, the data shows clear cross-country differences in the extent of housing market activities. This is not only the case regarding the real economy but also regarding the interconnection between the financial sector and housing markets.

Chart 4

Employment in construction

% of total employment (LFS)

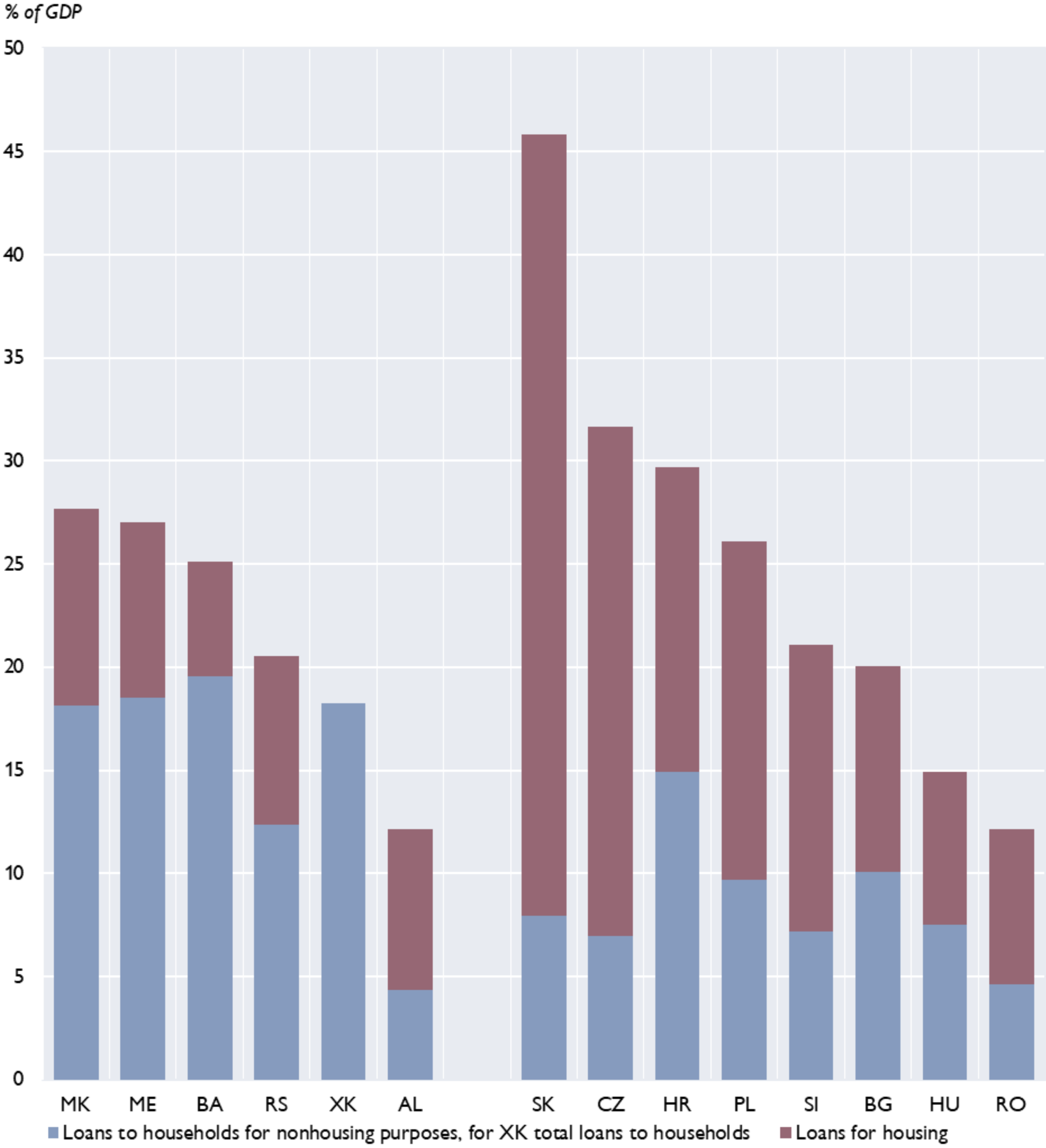
Source: wiiw.
Note: Data from 2022

2 The relevance of housing markets for financial stability

Across the Western Balkan and CESEE EU countries, overall indebtedness of households differs strongly in terms of size. In the Western Balkan countries, loans to households as a share of GDP ranged between 12% in Albania and 28% in North Macedonia in 2022. In the CESEE EU countries, the cross-country differences regarding financial intermediation of households were even greater, with shares ranging between 12% in Romania to 45% in Slovakia. Despite above-average homeownership rates, the exposure of the banking sector associated with housing loans in the Western Balkans is much lower compared to most CESEE EU countries (chart 5). Debt incurred for housing purposes was highest in Slovakia and Czechia, reaching close to 40% of GDP and 25% of GDP, respectively. By contrast, the level of housing loan indebtedness stood below 10% of GDP in all Western Balkan countries and is thus comparable to levels seen in Hungary and Romania. In other words, housing loans do not dominate lending to households in the Western Balkan countries, whereas this is the case in most CESEE EU countries except for Bulgaria, Croatia and Hungary, where the two loan categories make up roughly equal parts of total loans to households. The reason for the dominance of nonhousing loans (particularly of consumption loans) in total loans in the Western Balkans could partly be explained by two factors: On the one hand, GDP per capita in the Western Balkans is lower compared to the CESEE EU countries: In the process of catching up, households might have strong preferences for consumption goods that are often loans-financed. On the other hand, a large part of remittances to the Western Balkan countries might be used for housing purposes, which may have replaced loan financing of housing to some extent.

Chart 5

Housing loans less important in the Western Balkans than in CESEE EU countries



Source: ECB, national central banks.
Note: Data from 2022; no data on housing loans available for Kosovo.

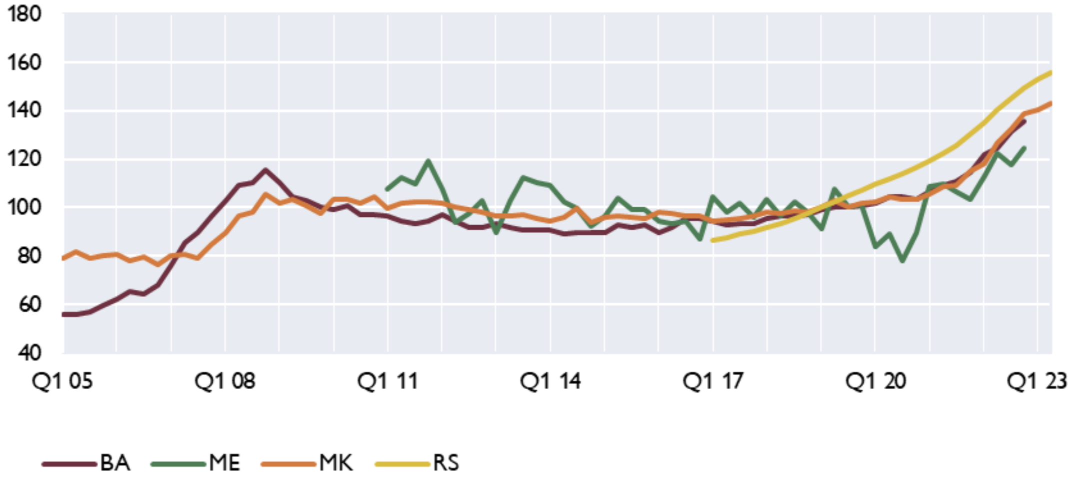
3 House prices in the Western Balkan and CESEE EU countries

Western Balkan and CESEE EU countries generally saw a steep rise in house prices before the global financial crisis of 2007–2008 (GFC). The GFC induced a bust, which was followed by a recovery period.

Chart 6

House price developments: Western Balkan countries

House price index, 2019 = 100

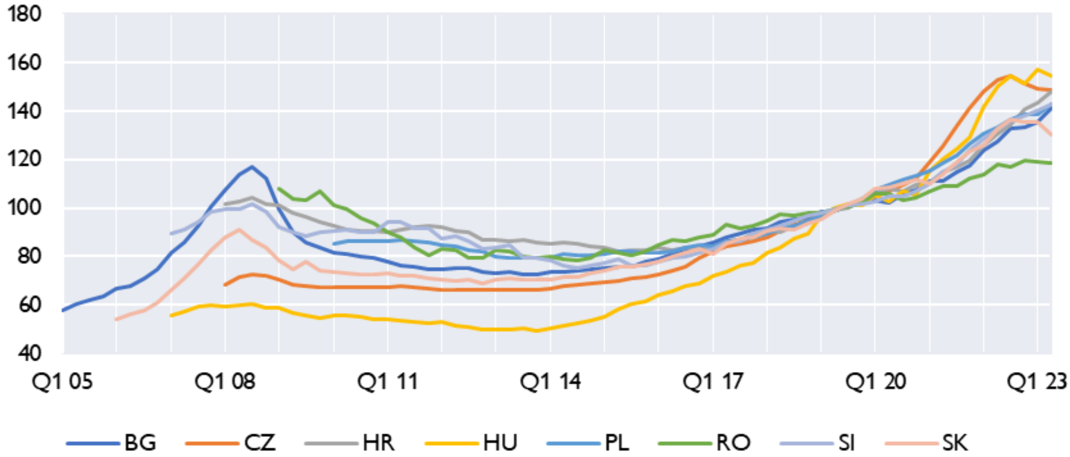


Source: BIS, national central banks.
Note: No comparable data available for Albania and Kosovo.

Chart 7

House price developments: CESEE EU countries

House price index, 2019 = 100



Source: Eurostat.

In 2020 and 2021, house prices accelerated strongly in most countries under review. From mid-2022, house price growth started to moderate again in CESEE EU countries.[12] For the Western Balkan, generally, house prices continued to increase strongly on the back of significant wage increases, a strong inflow of remittances and robust housing loan growth supported by (still) historically low interest rates.

Overall, house price dynamics and house price levels can differ notably across countries, but differences can also be sizable within countries. For instance, house prices are generally much higher in economic centers of a country compared to remote areas. However, dynamics can also change over time. During the COVID-19 pandemic, for instance, the different dynamics between rising house prices in economic centers and weaker price increases in more rural areas narrowed or even reversed in several countries because many households were looking for larger housing with outdoor areas. The increased use of remote work in particular has been a driving force of this development. However, comparable regional house price data is rare. Numbeo, a crowd-based platform on cost of living, property prices and quality of life, provides information on average prices per square meter inside and outside the city center for various cities and gives a good overview of current price differences at the local level (table 1).

[12] *For more details on recent developments in CESEE EU housing markets see the OeNB's latest CESEE Property Market Review from October 2023 (OeNB Report 2023/4).*

Table 1

Regional house prices in the Western Balkan countries

		Price per square meter for buying apartment in city center, EUR	Price per square meter for buying apartment outside of center, EUR
Albania	Tirana	2,484	1,271
	Ballsh	2,297	1,421
	Fier	600	375
	Elbasan	487	400
Bosnia and Herzegovina	Neum	3,577	2,657
	Sarajevo	2,488	1,446
	Brod	588	588
	Doboj	91	843
Kosovo	Decani	1,800	900.0
	Pristina	1,783	915
	Pec	700	600
	Skendaraj	700	500
Montenegro	Bar	2,700	2,300
	Tivat	2,633	2,033
	Cetinje	1,200	825
	Niksic	1,067	750
North Macedonia	Skopje	1,792	1,304
	Ohrid	1,491	992
	Negotino	500	300
	Resen	400	350
Serbia	Pozarevac	4,126	3,328
	Belgrad	3,722	2,191
	Zajecar	619	469
	Aleksinac	522	757

Source: Numbeo.

Note: For each country, two regions with the lowest and two regions with the highest house prices are shown. For several regions, house price data are not available. Data retrieved early in November 2023.

4 Housing markets from the perspective of households: insights from the OeNB Euro Survey

For many households, buying a house is the largest purchase in their lifetime. It is no surprise that households pay particular attention to house prices and future house prices. House price swings may also have repercussions on households' consumption: In case of booming housing markets and accelerating house prices, households that own real estate might feel wealthier and eventually increase their consumption. The opposite might occur in case of housing market downturns and decelerating house prices.

Perception and expectations regarding house price growth

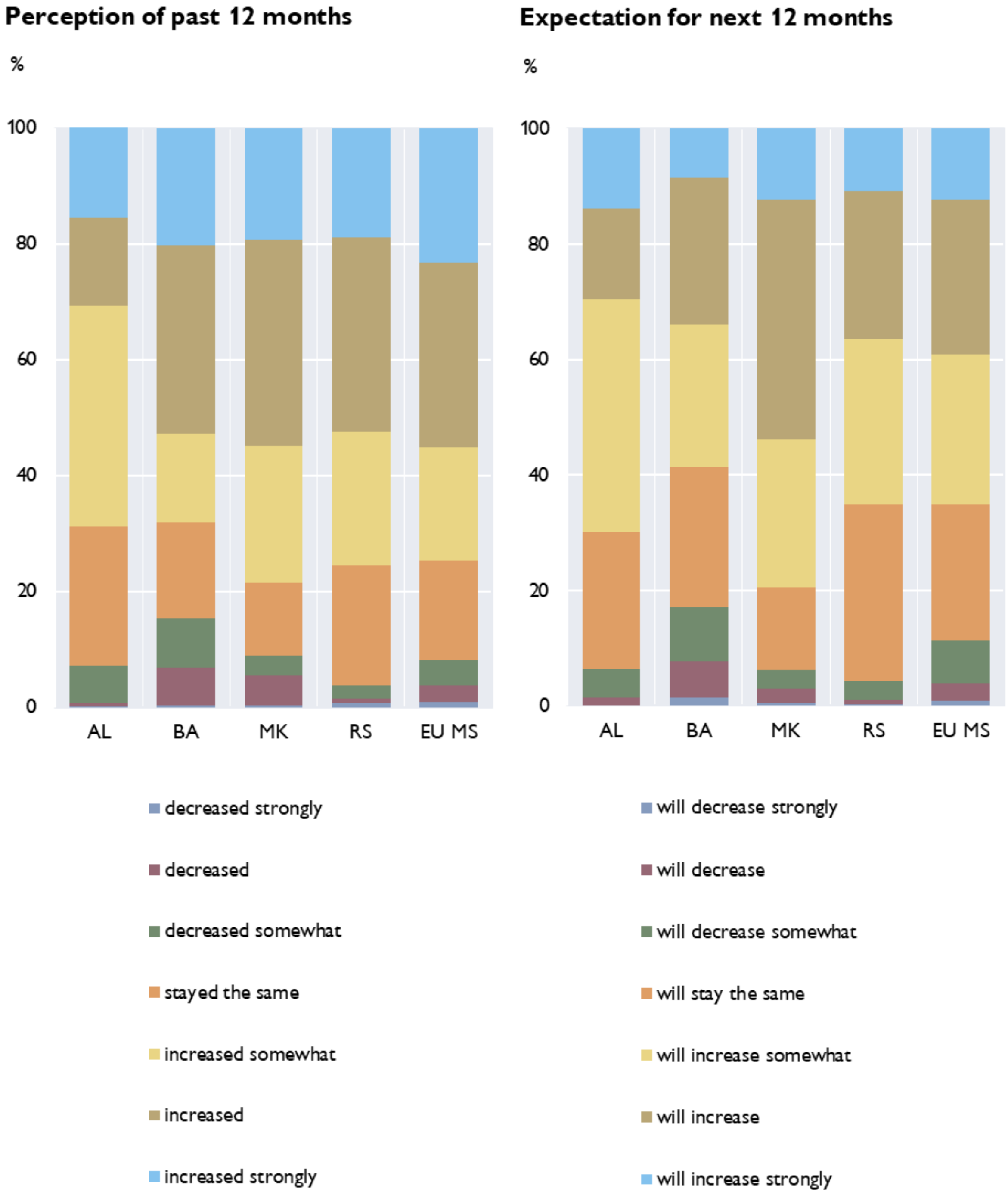
We present evidence from the OeNB Euro Survey[13], collected in 2022, about how households perceived the development of property prices in their area over the past 12 months and what they expect for the next 12 months.

Chart 8 shows that the vast majority of households think that property prices in their area increased in all countries. In all countries except Albania, more than 50% shared the perception that property prices increased even strongly. For the next 12 months, less than 40% of households expected an increase or a strong increase of property prices. North Macedonia is the only country, where a majority of households expected an increase or a strong increase over the next 12 months.

[13] *For more information see: OeNB Euro Survey - Oesterreichische Nationalbank (OeNB).*

Chart 8

Property prices…

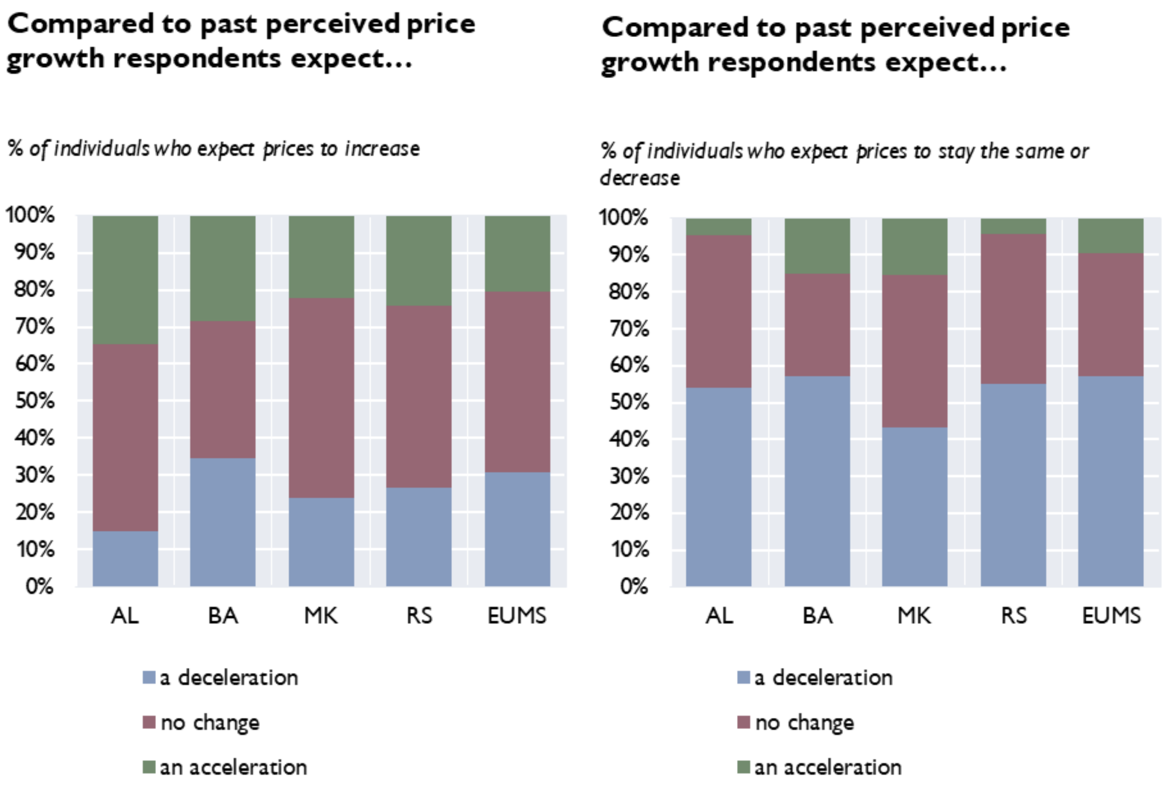


Source: OeNB Euro Survey, 2022.
Note: Data are weighted. EU MS shows the average for BG, HR, CZ, HU, PL, RO weighted by population size. AL does not cover North Albania.

Chart 9 combines the backward- and forward-looking responses presented in chart 8 to show whether individual perceptions and future expectations indicate property price acceleration or deceleration. The left panel shows individuals who expect property prices to increase. An individual who responds “increased” and “will decrease” is coded as “deceleration” and someone who responds “increased somewhat” and “will increase” is coded as “acceleration.” Someone who responds “increased somewhat” and “will increase somewhat” is coded as “no change.” The right panels show individuals who expect property prices to stay the same or decrease. The coding is the same as in the left panel. Individuals who respond “decreased” and “will decrease somewhat” is coded as “acceleration,” someone who responds “decreased” and “will decrease” is coded as “no change.” Though this coding is a very rough approximation, chart 9 indicates that on average every third household that expects a price increase thinks price growth is going to accelerate compared to the past 12 months. Comparing these results with actual house price developments shows that households, on average, have not perceived the slight deceleration in price growth.

Chart 9

Perceptions vs. expectations in property price developments



Source: OeNB Euro Survey, 2022.
Note: Data are weighted. EU MS shows the average for BG, HR, CZ, HU, PL, RO weighted by population size. AL does not cover North Albania.

House price expectations of renters versus owners

The long-standing U.S. Housing Confidence Survey[14] finds that homebuyers are more or less rational in their perception and expectation how house prices have developed in their area. We cannot distinguish recent homebuyers from outright owners in our survey at present. However, given the high ownership rate in the Western Balkans, we expect that property price expectations differ between homeowners and renters. Table 2 confirms this is the case. The percentage of individuals who expect property prices to grow is higher among homeowners than among renters in all countries except Albania.

Table 2

Property price expectations of home owners versus renters

	Expect property prices to grow	
	Home owners	*Renters*
AL	70%	81%
BA	59%	57%
MK	83%	60% ***
RS	65%	64%
EU MS	65%	65% ***

Source: OeNB Euro Survey, 2022.

Note: Data are weighted. EU MS shows the average for BG, HR, CZ, HU, PL, RO weighted by population size. AL does not cover North Albania. *** $p<0.01$

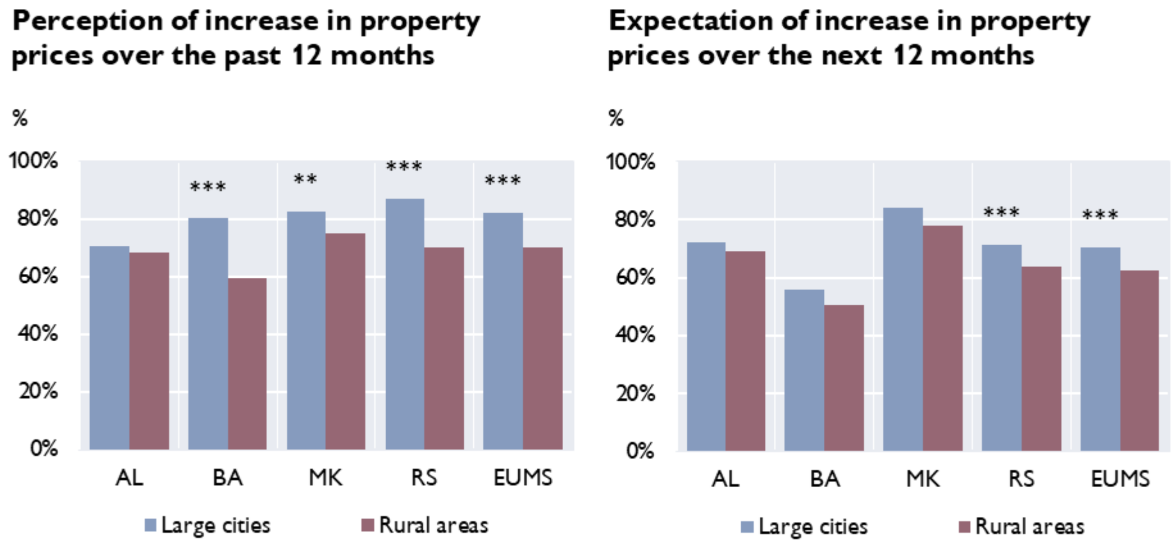
Regional differences regarding house price expectations

The disaggregate data from Numbeo indicates large regional discrepancies within countries in house prices (table 1). Chart 10 compares how house price perceptions and expectations differ between urban and rural areas. It shows that the percentage of households that perceive or expect increasing house prices is higher in urban areas than in rural areas. However, the difference is significant mostly for the perception of developments over the past 12 months. Regarding developments for the next 12 months, the difference is only significant in Serbia. This might indicate that rural and urban areas are aligning their expectations in terms of property prices.

[14] *See: Surveys | Quantifying home price expectations (pulsenomics.com).*

Chart 10

Urban versus rural areas



*Source: OeNB Euro Survey, 2022. Note: Data are weighted. EU MS shows the average for BG, HR, CZ, HU, PL, RO weighted by population size. AL does not cover North Albania. ** p<0.05, *** p<0.01.*

How are house price expectations related to perceptions of past developments, inflation expectations and economic activity?

Previous research has studied how house price expectations are linked to characteristics of households (such as gender, education, financial literacy) as well as to local housing markets. Gohl et al. (2022) show for Germany that individual characteristics as well as local housing market conditions are strongly linked to house price expectations. Niu and van Soest (2014) use survey data for the USA and find that house price expectations are related to the economic sentiment of survey respondents, among other factors. Dhamija, Nunes and Tara (2023) conclude that households have the tendency to put stronger weight on house price expectations when forming their inflation expectations. This is particularly interesting because house price developments are not directly linked to inflation. However, house prices seem to have a signaling effect for inflation expectations, which might be for instance due to strong media attention on housing markets and because many households are feeling affected by booming or busting house prices.

Within our limited space in the current contribution, we do not repeat these fully-fledged research papers, but provide a glimpse into whether property price expectations are correlated with similar factors in the Western Balkan countries. Table 3 shows results. First, it shows that, in all countries, expectations regarding property prices are highly and significantly correlated with perceptions of past developments. Second, inflation expectations are positively and significantly correlated with property price expectations. The correlation is lowest in Bosnia and Herzegovina and highest in North Macedonia. As would be expected, this correlation is much higher if we only look at renters (results not shown). Property price expectations are not significantly correlated with financial literacy (results not shown). The correlation with personal income expectations is much lower than with inflation. Again, the correlation differs if we look at homeowners or renters only: In Serbia and Albania, renters' expectations regarding personal income developments are negatively correlated with expectations regarding property price developments. Finally, we look at how property price expectations are correlated with local economic activity by using satellite data on nightlights[15] (Henderson et al., 2012). In all observed countries except Albania, we find a positive and significant correlation, which is highest in Serbia and lowest in North Macedonia.

Table 3

Correlates of property price expectations

	Perceptions of property price developments over past 12 months	Inflation expectations over next 12 months	Household income expectations over next 12 months	Average annual nightlight in 5 km radius around residence
AL	0.2031***	0.1291***	0.0207	0.0832**
BA	0.3947***	0.0677**	0.1168***	0.0542*
MK	0.5974***	0.2993***	0.067**	0.0903***
RS	0.4593***	0.2828***	-0.1573***	0.0779***
EU MS	0.5043***	0.1559***	0.0950***	0.0779***

Source: OeNB Euro Survey, 2022.

*Note: Data are weighted. EU MS shows the average for BG, HR, CZ, HU, PL, RO weighted by population size. AL does not cover North Albania. * p<0.1, ** p<0.05, *** p<0.01.*

5 Summary and outlook

Housing markets constitute a significant sector for all Western Balkan economies and are therefore key for the real economy and for financial stability. Overall, house prices have increased strongly over the last years in the Western Balkan countries and, as shown by the OeNB Euro Survey, the majority of households expect property prices to increase further. We show that particularly homeowners – which represent the dominant segment of contractual housing in the Western Balkan countries – expect house prices to accelerate further. House price expectations are correlated with local economic activity as well as with inflation expectations. According to Dhamija et al. (2023) inflation expectations of households can be biased due to overweighting of house price expectations. Therefore, monetary policymakers in the Western Balkan countries should not only care about inflation expectations but moreover about house price expectations.

[15] *We use the Visible Infrared Imaging Radiometer Suite annual VNL V2 data (https://eogdata.mines.edu/products/vnl/#annual_v2) and compute the intensity within a radius of 5 km of the respondent's place of residence.*

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Economic trends in Türkiye, Ukraine and Russia[16,17]

1 Türkiye: steps toward more orthodox monetary policy

Published annual GDP growth amounted to about 4% in the first half of 2023, with seasonally and working day-adjusted data showing strong acceleration of growth in the second quarter. The main driving force was private consumption again, which continued to grow at double-digit rates, followed by public consumption, which registered accelerated growth of 5.7% in the first half of 2023 – likely election-related. Gross fixed capital formation moderately recovered with growth of almost 5% by the second quarter of 2023. By contrast, the contraction of real exports accelerated in the first half of the year. However, despite shrinking exports, published real import growth rates even exceeded those of private consumption so that the negative contribution of net exports to GDP growth widened considerably. The difference between the sum of growth contributions of all published demand components and the lower published rate of GDP growth suggests a large negative contribution of inventory changes, which, however, was clearly less pronounced than a year ago. About half of the strong growth of imports resulted from the sharp increase in imports of nonmonetary gold, which, however, did not affect GDP growth as it also implied higher, i.e. less strongly negative, inventory change. Still, the deterioration of net exports would be considerable even at constant nonmonetary gold imports.

Both, the goods and services balance and the current account balance showed a large deficit of about 6% and 7.3% of GDP, respectively, in the first half of 2023, almost unchanged on a year earlier. The rise in net imports of nonmonetary gold from 1.2% to 3% of GDP prevented an improvement. Including the entire tourism season, the current account deficit in full-year 2022 stood at 5.4% of GDP. Net FDI inflows shrank to only 0.5% of GDP and, together with net other investment inflows, financed less than half of the current account deficit, while reserve assets covered the other part. Thus, after a sharp decline in the first half of the year and some tourism-related recovery thereafter, official FX reserves stood at only 2 months of imports at end-August 2023, down from 2.6 at end-2022. At the same time, off-balance net short positions due within one year amounted to almost 105% of official FX reserves, with about half from FX swaps with domestic banks and the other half from swaps with Arabian and Asian central banks.

Both HICP headline and core inflation continued to decelerate further from a peak in October 2022 of 85% and 79%, respectively, to 38% and 47% in June 2023 but rose strongly again in July and further in August to reach 59% and 65%, respectively. The recent rise likely resulted from the strong month-on-month depreciation of the lira against the euro by 17% in June and 12% in July 2023, after the lira had depreciated by less than 25% year on year until May, which had implied considerable real (CPI-deflated) appreciation, possibly contributing to the large external deficit. In August, about 29 Turkish lira exchanged for one euro. During this recent lira depreciation that started after the second round of the presidential elections at the end of May 2023, the Turkish central bank delivered its first policy rate hikes after a series of cuts since September 2021. Thus, the key rate rose from 8.5% to 15% in June, 17.5% in July, 25% in August and 30% in September 2023, which, nevertheless, continued to imply a large negative real

[16] *Compiled by Stephan Barisitz, Mathias Lahnsteiner and Thomas Reininger.*
[17] *Cutoff date: October 22, 2023.*

key rate. In parallel, the authorities weakened some of their regulatory ("macroprudential") measures that fostered a "liraization" of both banks' assets and liabilities. Banks continue to run a negative net FX position on balance, which they close by entering swaps with the central bank by initial FX sale. In parallel, nonfinancial corporations (NFCs) run a negative overall net FX position on balance, with about one-quarter due to overall net domestic FX liabilities (mostly vis-à-vis banks).

The authorities' new medium-term economic program of September 2023 expects the general government fiscal deficit to rise to 6.4% of GDP in 2023 from 1.2% of GDP in 2022 mainly due to earthquake-related expenditures. General government debt remains below 40% of GDP.

Table 1

Main economic indicators: Türkiye

	2020	2021	2022	Q1 22	Q2 22	Q3 22	Q4 22	Q1 23	Q2 23
	Year-on-year change of the period total in %								
GDP at constant prices	1.9	11.4	5.5	7.8	7.6	4.1	3.3	3.9	3.8
Private consumption	3.2	15.4	18.9	19.6	21.5	19.5	15.8	17.3	15.6
Public consumption	2.2	3.0	4.2	4.3	1.7	3.8	6.5	6.1	5.3
Gross fixed capital formation	7.3	7.2	1.3	2.8	3.8	−1.8	0.6	3.7	5.1
Exports of goods and services	−14.6	25.1	9.9	17.0	18.8	11.7	−3.3	−2.6	−9.0
Imports of goods and services	6.8	1.7	8.6	2.8	6.5	13.3	10.4	14.2	20.3
	Contribution to GDP growth in percentage points								
Domestic demand	4.0	11.5	12.5	13.1	14.3	11.8	11.2	13.3	12.6
Net exports of goods and services	−5.5	5.3	0.6	3.5	3.3	0.2	−3.5	−3.7	−6.9
Exports of goods and services	−3.9	5.7	2.5	4.2	4.7	2.9	−0.9	−0.7	−2.5
Imports of goods and services	−1.6	−0.4	−1.9	−0.6	−1.4	−2.7	−2.6	−3.0	−4.4
	Year-on-year change of the period average in %								
Unit labor costs in the whole economy (nominal, per person)	..	..	..	..	..	..	..	..	..
Unit wage costs in manufacturing (nominal, per hour)	10.0	19.0	74.4	48.4	53.8	93.7	100.0	115.1	102.3
Labor productivity in manufacturing (real, per hour)	8.3	−0.3	−0.5	2.2	2.6	−0.9	−5.1	−1.5	1.7
Gross wages in manufacturing (nominal, per hour)	18.9	19.0	73.9	51.6	57.8	92.0	89.9	111.9	105.8
Producer price index (PPI) in industry	12.2	43.9	128.5	104.7	131.0	146.7	127.7	74.5	44.1
Consumer price index (here: HICP)	12.3	19.6	72.3	54.8	74.1	81.0	77.3	54.4	40.5
EUR per 1 TRY, + = TRY appreciation	−21.1	−23.4	−39.6	−43.1	−39.9	−44.3	−32.4	−22.7	−26.5
	Period average levels								
Unemployment rate (ILO definition, %, 15–64 years)	13.4	12.2	10.7	11.8	10.4	10.3	10.3	10.6	9.5
Employment rate (%, 15–64 years)	47.5	50.3	52.8	50.8	53.0	53.5	54.0	52.7	53.6
Key interest rate per annum (%)	10.2	17.8	12.9	14.0	14.0	13.4	10.2	8.8	9.1
TRY per 1 EUR	8.1	10.5	17.4	15.7	16.9	18.1	19.0	20.3	22.9
	Nominal year-on-year change in period-end stock in %								
Loans to the domestic nonbank private sector[1]	4.3	8.6	12.7	45.1	60.4	68.7	56.3	57.0	60.5
of which:									
loans to households	6.6	13.4	14.6	22.7	37.5	42.0	55.4	77.5	81.1
loans to nonbank corporations	2.9	5.5	11.4	52.4	67.4	77.5	56.8	51.8	55.0
Share of foreign currency loans in total loans to the nonbank private sector	30.9	38.1	27.7	37.0	33.9	31.1	27.7	25.2	28.5
Return on assets (banking sector)	1.0	1.3	3.8	2.6	3.3	3.5	3.8	2.8	3.0
Tier 1 capital ratio (banking sector)	14.1	13.2	15.3	15.4	13.6	14.4	15.3	14.1	13.9
NPL ratio (banking sector)	4.4	3.4	2.2	3.0	2.7	2.4	2.2	2.0	1.8
	% of GDP								
General government revenues	31.2	32.6	32.5						
General government expenditures	35.9	33.8	33.7						
General government balance	−4.7	−1.1	−1.2						
Primary balance	−1.6	2.1	1.1						
Gross public debt	39.7	41.8	31.7						
	% of GDP								
Debt of nonfinancial corporations (nonconsolidated)	..	..	..						
Debt of households and NPISHs[1] (nonconsolidated)	..	..	..						
	% of GDP (based on EUR), period total								
Goods balance	−5.3	−3.6	−10.0	−11.8	−9.1	−11.3	−8.5	−12.0	−8.2
Services balance	2.0	3.9	5.6	3.5	5.4	8.3	4.7	3.1	4.6
Primary income	−1.2	−1.3	−1.0	−1.3	−1.2	−0.9	−0.6	−1.0	−1.3
Secondary income	0.0	0.1	−0.0	−0.2	−0.1	0.0	0.1	−0.0	0.1
Current account balance	−4.5	−0.9	−5.4	−9.9	−5.1	−3.9	−4.2	−9.9	−4.8
Capital account balance	−0.0	−0.0	−0.0	−0.0	−0.0	−0.0	−0.0	−0.0	−0.0
Foreign direct investment (net)[2]	−0.6	−0.8	−0.9	−0.4	−1.8	−0.7	−0.8	−0.5	−0.4
	% of GDP (rolling four-quarter GDP, based on EUR), end of period								
Gross external debt	50.9	50.4	44.0	51.6	51.2	51.1	44.0	42.2	40.1
Gross official reserves (excluding gold)	6.5	9.3	9.1	8.3	7.5	8.9	9.1	7.0	6.5
	Months of imports of goods and services								
Gross official reserves (excluding gold)	2.4	3.2	2.6	2.6	2.2	2.5	2.6	2.0	2.0
	EUR million, period total								
GDP at current prices	625,415	687,586	852,655	160,778	203,213	236,398	252,266	229,116	239,927

Source: Bloomberg, European Commission, Eurostat, national statistical offices, national central banks, wiiw, OeNB.

[1] *Nonprofit institutions serving households.*

[2] *+ = net accumulation of assets larger than net accumulation of liabilities (net outflow of capital).*
- = net accumulation of assets smaller than net accumulation of liabilities (net inflow of capital).

2 Ukraine: economy faces multiple challenges on the way to recovery

This year, Ukraine's economy is expected to recover slightly from last year's 29.1% GDP contraction, according to the IMF and the National Bank of Ukraine. After a further year-on-year GDP decline was recorded in the first quarter of 2023, the low basis of the previous year (as a result of a 37% year-on-year GDP drop in the second quarter of 2022) drove GDP growth up to 19.5% in the second quarter of 2023.

Russia's war of aggression has continued to directly target the Ukrainian economy. In this respect, it is worth noting that Ukraine's energy sector recovered relatively quickly from Russian attacks launched in autumn 2022. The stabilization of the energy system facilitated the ongoing economic recovery. However, missile attacks hit energy infrastructure again in mid-September 2023. Moreover, Russia's war increasingly involved drone and missile strikes on port infrastructure and grain silos in recent months, including on the Danube river, where ports have served as alternatives to Black Sea ports. In parallel, Russia refused to prolong the Black Sea Grain Initiative in July, that enabled the export of grain from some Black Sea ports under Ukrainian control. Unilateral restrictions on grain imports imposed by some neighboring CESEE EU countries have worsened the situation further. However, despite Russia's Black Sea blockade, Ukraine managed to encourage some cargo vessels to make use of its own safe corridor. In addition, efforts of the Ukrainian authorities to establish and improve alternative export routes (e.g. via Croatia and Romania) have intensified.

Ukraine recorded a large deficit in the goods and services balance in the first eight months of the year (USD 24.5 billion compared to USD 14.4 billion in the first eight months of 2022, corresponding to about 22.7% of GDP in the first half of 2023), given large import demand (repair and reconstruction needs, transport services, expenses by Ukrainians who went abroad due to the war) and limited export possibilities (loss of production capacities and war-related restrictions on export routes). Despite the large number of Ukrainians who left the country after the start of the full-scale invasion, personal remittances declined by about USD 700 million (or 8%) in year-on-year terms. Surpluses in the primary income and secondary income balances (covering i.a. US grants and humanitarian aid from abroad) compensated for a large part of the trade deficit, so that the current account gap amounted to USD 4.8 billion in the first eight months of the year (corresponding to about 2.6% of GDP in the first half of 2023).

Strong public sector net inflows in the financial account (i.a. loans from the EU, IMF, World Bank and bilateral G7 and EU donor countries) not only financed the current account deficit, but also resulted in a marked increase of the international reserves held by the National Bank of Ukraine (NBU). Yet, after having risen strongly from USD 28.5 billion at end-2022, international reserves peaked at USD 41.7 billion at end-July, before declining slightly to USD 39.7 billion at end-September 2023. Net FX sales carried out by the NBU to cover the gap between supply and demand on the FX market picked up starting from August. Weak FX sales by exporters contributed to the increased need for NBU FX sales. In this setting, market observers pointed to devaluation expectations among market participants. In early October 2023, the NBU decided to move from a fixed exchange rate to a managed float regime, citing progress in bringing down inflation and the accumulation of FX reserves among the reasons for this move. The NBU emphasized that it would remain a key player in the market and significantly limit exchange rate fluctuations.

Marked disinflation laid the ground for considerable interest rate cuts. Headline inflation came down rapidly from 26.6% at end-2022 to 8.6% in August, supported by good harvests. Yet, also core inflation clearly fell from 22.6% at end-2022 to 10% in August. Against this background, the NBU cut its key policy rate in two steps during summer by 500 basis points in total, down to 20%. The NBU plans to continue its key policy rate cutting cycle but highlighted the need to balance the cuts against the need to maintain the attractiveness of hryvnia assets, which it sees as a key condition to a sustainable FX market.

The government's budget plan for 2024 foresees a deficit of 20.4% of GDP compared to 27% of GDP expected for this year (excluding grants). Ukraine plans to attract USD 42 billion from international partners in 2024, similar to the amount it expects for 2023. Yet, as of early October 2023, external funding for 2024 was still not fixed (neither on the part of the EU nor the US, the two most important sources of funding). In this context, it is worth mentioning that the European Commission proposed a Ukraine Facility in June 2023 to support Ukraine with EUR 50 billion from 2024 to 2027. The required EU budget increase needs consent from all EU member states.

The IMF's Extended Fund Facility (EFF), approved by the IMF Executive Board at end-March 2023, has served as an import policy anchor. At end-June 2023, the first review was completed, enabling the disbursement of the second tranche in the amount of about USD 890 million after Ukraine had met all quantitative performance criteria and structural benchmarks. Measures in the area of governance and anti-corruption as well as fiscal and energy policy are being assessed by the IMF during the second review, on which discussions started at end-September. According to an IMF official, Ukraine had not met all conditions for the disbursal of the third tranche as of early October 2023. Ukrainian authorities expect that the disbursement of the third tranche will come with a two-month delay (in December instead of October). During summer, the fulfillment of structural benchmarks that address governance and anti-corruption issues, met with some political resistance. A parliamentary bill on the restoration of mandatory asset declaration by officials was vetoed by the president (after being publicly criticized for being too soft), before a new version was adopted again by parliament.

The banking sector recorded high profitability with an RoA of 4.8% in the first half of 2023 (compared to 1% in 2022). The tier 1 capital adequacy ratio increased to 14.5% in mid-2023 from 13.1% at end-2023. The domestic credit stock contracted by about 10% in year-on-year terms in August 2023. New lending, however, has taken place particularly under the subsidized "5-7-9%" loans program, which aims to support businesses through loans at reduced interest rates. Under the IMF EFF, the Ukrainian authorities committed to preparing a concept note with proposals for containing potential fiscal risks related to this lending program. As recognition of credit losses encountered by banks due to the war has been suspended, the NPL ratio rose only slightly to 38.9% in mid-2023 from 38.1% at end-2022. The NBU has launched a resilience assessment that includes an asset valuation and solvency assessment of banks (to be completed at end-2023) and it is also preparing for a subsequent independent asset quality review. According to the NBU, preliminary results of its resilience assessment suggest that there are no significant understatements of credit risk. The NBU says that capital needs of the sector are unlikely to be significant and that most banks will probably be able to recapitalize using their current earnings.

Table 2

Main economic indicators: Ukraine

	2020	2021	2022	Q1 22	Q2 22	Q3 22	Q4 22	Q1 23	Q2 23
	Year-on-year change of the period total in %								
GDP at constant prices	−3.8	3.4	−29.1	−14.9	−36.9	−30.6	−31.4	−10.5	19.5
Private consumption	1.7	6.8	−26.1	−9.1	−33.8	−30.9	−29.2	..	..
Public consumption	−0.7	0.8	18.0	4.1	14.3	35.0	18.7	..	..
Gross fixed capital formation	−21.3	9.3	−34.3	−30.5	−40.8	−32.3	−33.3	..	..
Exports of goods and services	−5.8	−8.6	−42.4	−22.0	−58.3	−46.4	−41.6	..	..
Imports of goods and services	−6.4	14.2	−18.5	−3.2	−23.6	−23.3	−21.8	..	..
	Contribution to GDP growth in percentage points								
Domestic demand	−5.3	14.7	−27.1	−11.8	−30.8	−27.4	−34.9	..	..
Net exports of goods and services	1.1	−12.9	−5.6	−8.5	−11.7	−5.8	1.3	..	..
Exports of goods and services	−2.9	−4.2	−18.2	−10.8	−26.2	−20.5	−14.8	..	..
Imports of goods and services	4.0	−8.7	12.6	2.4	14.5	14.6	16.2	..	..
	Year-on-year change of the period average in %								
Unit labor costs in the whole economy (nominal, per person)	..	..	..	..	..	..	..	..	..
Unit labor costs in industry (nominal, per person)	9.1	12.5	..	..	..	..	..	..	..
Labor productivity in industry (real, per person)	−0.7	3.7	..	..	..	..	..	..	..
Average gross earnings in industry (nominal, per person)	8.2	16.8	..	..	..	..	..	..	..
Producer price index (PPI) in industry	−1.5	40.5	..	..	..	..	..	..	..
Consumer price index (here: CPI)	2.7	9.3	20.0	11.5	18.6	23.5	26.6	24.0	15.3
EUR per 1 RUB, + = RUB appreciation	−6.0	−4.7	−4.9	4.6	6.5	−9.6	−18.1	−17.7	−21.6
	Period average levels								
Unemployment rate (ILO definition, %, 15−64 years)	9.5	9.9	..	..	..	..	..	..	..
Employment rate (%, 15−64 years)	65.6	65.3	..	..	..	..	..	..	..
Key interest rate per annum (%)	7.9	7.5	18.6	9.8	14.5	25.0	25.0	25.0	25.0
RUB per 1 EUR	30.8	32.3	34.0	32.3	31.2	35.1	37.3	39.2	39.8
	Nominal year-on-year change in period-end stock in %								
Loans to the domestic nonbank private sector[1]	9.6	15.3	14.0	15.6	11.7	12.1	14.0	14.3	18.5
of which:									
loans to households	12.9	22.1	9.4	20.3	12.2	10.2	9.4	10.1	17.2
loans to nonbank corporations	8.0	12.2	16.4	13.3	11.4	13.0	16.4	16.5	19.1
Share of foreign currency loans in total loans to the nonbank private sector	37.1	28.6	27.0	26.4	24.6	28.0	27.0	26.6	26.1
Return on assets (banking sector)	2.1	3.7	1.3	−0.0	−0.3	0.6	1.3	5.9	5.7
Tier 1 capital ratio (banking sector)	15.7	12.0	13.1	11.7	11.4	12.8	13.1	13.4	14.5
NPL ratio (banking sector)	41.0	30.0	38.1	27.1	29.7	33.6	38.1	37.9	38.9
	% of GDP								
General government revenues	32.6	30.5	42.3						
General government expenditures	37.9	33.9	58.6						
General government balance	−5.3	−3.4	−16.3						
Primary balance	..	..	..						
Gross public debt	60.4	49.0	78.5						
	% of GDP								
Debt of nonfinancial corporations (nonconsolidated)	..	..	..						
Debt of households and NPISHs[2] (nonconsolidated)	..	..	..						
	% of GDP (based on EUR), period total								
Goods balance	−4.3	−3.3	−9.4	−2.6	−10.0	−10.0	−13.5	−17.2	−14.5
Services balance	2.8	2.0	−7.1	−1.3	−9.5	−8.4	−8.5	−10.2	−4.2
Primary income	2.3	−2.9	5.4	3.1	6.8	6.5	5.0	4.1	3.1
Secondary income	2.6	2.3	16.1	6.2	15.0	24.0	17.2	18.1	15.1
Current account balance	3.5	−2.0	5.1	5.3	2.3	12.1	0.2	−5.1	−0.5
Capital account balance	−0.0	0.0	0.1	0.2	0.0	0.1	0.1	0.1	0.1
Foreign direct investment (net)[3]	0.1	−3.7	−0.2	1.5	−0.8	−0.8	−0.4	−3.3	−3.2
	% of GDP (rolling four-quarter GDP, based on EUR), end of period								
Gross external debt	75.3	67.2	81.0	65.9	71.1	75.2	81.0	85.6	88.1
Gross official reserves (excluding gold)	16.5	15.2	16.7	13.7	11.9	14.0	16.7	18.5	22.1
	Months of imports of goods and services								
Gross official reserves (excluding gold)	4.9	4.4	3.8	3.9	3.2	3.6	3.8	3.9	4.8
	EUR million, period total								
GDP at current prices	136,088	170,372	151,587	33,759	32,906	41,316	43,607	32,341	38,022

Source: Bloomberg, national statistical offices, national central banks, wiiw, OeNB.

[1] *Foreign currency component at constant exchange rates.*

[2] *Nonprofit institutions serving households.*

[3] *+ = net accumulation of assets larger than net accumulation of liabilities (net outflow of capital).*
- = net accumulation of assets smaller than net accumulation of liabilities (net inflow of capital).

3 Russia: sanctions are triggering fiscal and inflationary risks while military spending is supporting economic recovery

Sharply rising budgetary expenditure, recovering consumer spending and expanding capital expenditure contributed to renewed growth for the Russian economy in the spring and summer of 2023. Hence, the recovery rested on booming war-driven armaments production, rising incomes and accelerating lending. This followed the Western sanctions-driven slump of 2022 and early 2023, which however had been softened by high oil prices last year.

After contracting by 2.1% in 2022, Russian GDP declined by another 1.8% in the first quarter of 2023 (year on year) before expanding again by 4.9% in the second quarter. Recovery in the second quarter was i.a. due to the weak reference base of the sanctions-triggered sharp contraction in March and June 2022. While government consumption led the recovery, already expanding by 13.5% in the first quarter of 2023 (year on year), private consumption only gained momentum in the second quarter. Overall, private consumption grew by 4.3% in the first half of the year. In contrast, public consumption lost momentum in the second quarter (+1.9%). Inventories accumulated again in the first six months of 2023 after they had been partly depleted in 2022. Meanwhile fixed investment, following a spurt in 2022, continued its robust expansion in the first half of 2023 (+6.7%). GDP is estimated (Rosstat) to have increased by 2.1% in the first seven months of 2023. Production-wise, manufacturing led the way, growing 6.6% in January and August (year on year).

The recovery of private consumption has benefited from solid wage and income growth against the backdrop of tightening labor markets and a post-Soviet record-low unemployment rate (3% in August). Private consumption has now regained its pre-crisis level of 2021. That said, the tight labor markets i.a. reflect staff shortages throughout various industries, after up to 800,000 (often skilled) employees left Russia following the start of the Ukraine invasion and the mobilization wave in the fall of 2022. Although a major influx in 2022 of about 3.5 million guestworkers, mostly from Central Asia, somewhat relaxed the overall labor market situation, the Russian economy continues to lack highly qualified staff.

Expanding war-related spending, coupled with the shrinkage of oil-related budget revenues by about 40%, mostly due to the impact of the EU oil embargo, drove the Russian federal budget deficit to about 3% to 4% of (pro rata) GDP in the first eight months of 2023. The shortfall has mostly been funded out of government accounts as well as from liquid assets of the National Wealth Fund and from bond issuance. However, in the summer months, the fiscal situation started to improve, supported by recovering Urals oil prices (to an average of USD 73 per barrel in July to September – clearly above the oil price cap of USD 60 that G7 governments had attempted to impose on Russia).

Substantially lower energy export proceeds combined with recovering imports cut Russia's current account surplus by no less than 86% in the first eight months of 2023 compared to the corresponding period of the previous year, bringing it to USD 25.6 billion. The months of June and July even showed small deficits (of a total of USD 1.7 billion, the first time since 2020). This deterioration contributed to the ruble's slide of about 30% against the US dollar and the euro in the course of the first nine months of 2023. This slide as well as strong government demand and the recent upswing of consumer demand refueled inflationary pressure in the spring and summer of 2023. The base effect of the sanctions-and-depreciation-triggered spike of price rises of spring 2022 helped inflation to decline to 2.3% in April before it ticked up again to 5.5% in mid-September.

The Bank of Russia held its key rate, the refinancing rate, at 7.5% from mid-September 2022 to late July 2023, when it again hiked its key rate by 100 basis points to 8.5% and by another 350 basis points to 12% in an extraordinary session in mid-August. As this was reportedly not sufficient to rein in inflationary pressure stemming from weakness of the ruble, another 100 basis point hike to 13% followed in mid-September. The Bank of Russia has not excluded the possibility of further rate increases and/or of tightening of exchange controls if perceived necessary. Russia's gross international reserves (of which about USD 300 billion had been frozen by Western jurisdictions in February 2022) have declined by USD 12 billion over the course of 2023, coming down to USD 568 billion in late September. This corresponds to a decline of 2% (respectively 4% of the nonfrozen part) so far in 2023.

As mentioned above, the revival of lending has been one of the factors driving Russia's economic recovery. Thus, corporate credit growth gained momentum and reached 14% in August (year on year, in real terms and exchange rate-adjusted), while loans to households increased by 14.7%. Among the latter, (subsidized) mortgage loans continued to grow most swiftly (20%). After a weak patch in 2022, banks' profitability recovered. The sector's net profit came to USD 29.8 billion in January to August 2023. The sharp key interest rate adjustment since late July is already starting to show a cooling effect on corporate lending, while retail lending is somewhat less affected, given that more than a third of household debtors benefit from some form of state subsidy. Yet, the rate hike will render these subsidy programs more costly for the government to finance.

Main economic indicators: Russia

	2020	2021	2022	Q1 22	Q2 22	Q3 22	Q4 22	Q1 23	Q2 23
	Year-on-year change of the period total in %								
GDP at constant prices	−2.7	5.6	−2.1	3.0	−4.5	−3.5	−2.7	−1.8	4.9
Private consumption	−5.9	9.9	−1.4	5.6	−4.4	−3.6	−2.7	−0.1	8.8
Public consumption	1.9	2.9	2.8	1.9	2.3	2.4	4.7	13.5	1.9
Gross fixed capital formation	−4.0	9.1	3.3	7.4	2.7	1.8	3.0	0.6	12.8
Exports of goods and services	−4.2	3.3	−13.9	3.6	−15.8	−26.6	−14.6	..	..
Imports of goods and services	−11.9	19.1	−15.0	1.4	−27.6	−20.5	−11.2	..	..
	Contribution to GDP growth in percentage points								
Domestic demand	−3.5	8.2	−1.4	1.9	−5.9	−0.1	−1.2	4.4	8.8
Net exports of goods and services	1.1	−2.5	−1.1	0.8	1.2	−3.9	−1.9	..	..
Exports of goods and services	−1.3	1.0	−4.2	1.1	−4.8	−8.1	−4.1	..	..
Imports of goods and services	2.4	−3.5	3.1	−0.3	6.0	4.2	2.2	..	..
	Year-on-year change of the period average in %								
Unit labor costs in the whole economy (nominal	..	..	..	..	..	..	..	..	..
Unit labor costs in industry (nominal, per person	7.6	3.3	15.1	10.9	13.6	17.7	18.6	15.4	12.7
Labor productivity in industry (real, per person)	−1.4	7.2	−0.1	5.9	−2.2	−1.2	−2.2	−2.2	4.3
Average gross earnings in industry (nominal, per	5.9	10.9	15.2	17.7	11.0	16.4	16.0	12.6	17.6
Producer price index (PPI) in industry	−3.7	24.6	12.8	25.6	21.4	5.2	−1.2	−7.1	−5.3
Consumer price index (here: CPI)	3.4	6.7	13.7	11.5	16.9	14.4	12.2	8.7	2.7
EUR per 1 RUB, + = RUB appreciation	−12.3	−5.3	18.1	−8.7	24.3	42.7	28.6	25.0	−18.9
	Period average levels								
Unemployment rate (ILO definition, %, 15−64 y	5.8	4.8	3.9	4.2	3.9	3.9	3.8	3.5	3.2
Employment rate (%, 15−64 years)	..	..	..	..	..	..	..	..	..
Key interest rate per annum (%)	5.0	5.7	10.6	12.7	13.9	8.3	7.5	7.5	7.5
RUB per 1 EUR	82.6	87.2	73.9	98.3	72.0	60.7	64.6	78.6	88.7
	Nominal year-on-year change in period-end stock in %								
Loans to the domestic nonbank private sector[1]	9.6	15.3	14.0	15.6	11.7	12.1	14.0	14.3	18.5
of which:									
loans to households	12.9	22.1	9.4	20.3	12.2	10.2	9.4	10.1	17.2
loans to nonbank corporations	8.0	12.2	16.4	13.3	11.4	13.0	16.4	16.5	19.1
Share of foreign currency loans in total loans to	12.6	10.8	7.5	11.2	7.3	6.7	7.5	7.8	8.1
Return on assets (banking sector)	1.9	2.4	0.2	−0.8	−2.4	−0.9	0.2	2.9	2.8
Tier 1 capital ratio (banking sector)	9.7	9.6	10.4	..	..	10.6	10.4	10.7	9.8
NPL ratio (banking sector)	17.1	15.1	15.3	..	..	15.9	15.3	15.0	14.6
	% of GDP								
General government revenues	35.5	35.6	34.6						
General government expenditures	39.5	34.8	36.0						
General government balance	−4.0	0.8	−1.4						
Primary balance	..	..	..						
Gross public debt	17.6	15.5	14.9						
	% of GDP								
Debt of nonfinancial corporations (nonconsolida	..	..	..						
Debt of households and NPISHs[2] (nonconsolida	..	..	..						
	% of GDP (based on EUR), period total								
Goods balance	6.3	10.4	13.5	20.0	17.4	11.4	8.7	6.1	5.7
Services balance	−1.1	−1.1	−1.0	−0.9	−0.6	−1.1	−1.2	−1.5	−1.8
Primary income	−2.3	−2.3	−2.0	−2.0	−2.0	−2.4	−1.5	−1.2	−1.7
Secondary income	−0.4	−0.3	−0.4	−0.3	−0.5	−0.3	−0.3	−0.4	−0.2
Current account balance	2.4	6.7	10.2	16.8	14.3	7.6	5.6	3.0	2.0
Capital account balance	−0.0	0.0	−0.2	−0.0	−0.2	−0.3	−0.2	−0.0	−0.0
Foreign direct investment (net)[3]	−0.2	1.4	1.3	0.2	2.2	1.6	0.9	1.7	0.9
	% of GDP (rolling four-quarter GDP, based on EUR), end of period								
Gross external debt	29.9	27.4	16.6	25.3	26.1	22.5	16.6	14.6	14.3
Gross official reserves (excluding gold)	28.6	28.2	19.3	25.9	24.4	21.5	19.3	18.3	18.5
	Months of imports of goods and services								
Gross official reserves (excluding gold)	16.8	16.4	15.0	15.0	15.9	15.6	15.0	14.5	13.5
	EUR million, period total								
GDP at current prices	1,301,316	1,558,582	2,162,355	370,340	507,680	630,437	653,898	457,779	444,048

Source: Bloomberg, European Commission, Eurostat, national statistical offices, national central banks, wiiw, OeNB.

[1] *Foreign currency component at constant exchange rates.*

[2] *Nonprofit institutions serving households.*

[3] *+ = net accumulation of assets larger than net accumulation of liabilities (net outflow of capital).*
- = net accumulation of assets smaller than net accumulation of liabilities (net inflow of capital).

Event wrap-ups

28th Global Economy Lecture: Carmen M. Reinhart on "China's Overseas Lending: From Boom to Bust"

Compiled by Wolfgang Lechthaler[18]

On September 28, 2023, the Oesterreichische Nationalbank (OeNB) and The Vienna Institute for International Economic Studies (wiiw) hosted the 28th Global Economy Lecture,[19] which was delivered by Carmen M. Reinhart, the Minos A. Zombanakis Professor of the International Financial System at Harvard Kennedy School and former Senior Vice President and Chief Economist at the World Bank Group. Before that, she was Chief Economist at the investment bank Bear Stearns (1985–1986), Senior Policy Advisor and Deputy Director at the International Monetary Fund (2001–2003), a member of the Advisory Panel of the Federal Reserve Bank of New York, and a member of the Congressional Budget Office Panel of Economic Advisors.

In his introductory remarks, OeNB Governor Robert Holzmann said that Carmen Reinhart was one of the top economists worldwide, based on publications and scholarly citations. He made particular reference to her invaluable work in gathering and analyzing new data and her pathbreaking research in the fields of capital flows, capital controls, exchange rate policy, banking and sovereign debt crises and contagion. She is probably best known for her book "This Time Is Different: Eight Centuries of Financial Folly," coauthored with Kenneth Rogoff. In this seminal work she analyzes the data on financial crises in 66 countries over eight centuries, finding striking similarities in these crises and the booms that preceded them and contradicting experts claiming that "this time is different."

Carmen Reinhart started her speech by pointing out the vast research and surveillance gap related to China's overseas lending. While China's immense and growing importance in global trade is well understood and receives a lot of attention, its role in international finance is less clear. This is partly due to the opacity of China's capital exports: Data are scarce, and the process of lending is not transparent. Five years ago, Carmen Reinhart, together with her coauthors Sebastian Horn (World Bank) and Christoph Trebesch (Kiel Institute), started to tackle this problem by using data from numerous sources, cleaning the data and merging them into a new database that covers more than 5,000 Chinese official loans and grants from 1950 to 2020, and a total volume of around USD 700 billion.

The new database confirms the notion that China is an important player in international lending. In fact, China is not only the largest lender to developing and emerging economies, but its lending even surpasses that of all Paris Club members taken together. Aside from that, China's central bank, the People's Bank of China, holds more US Treasuries than the Federal Reserve. Perhaps the most striking and surprising result is that a big chunk of Chinese loans was "hidden" and not reflected in the statistics of the main international organizations. In fact, during the boom years

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[19] *The Global Economy Lecture is an annual event organized jointly by the OeNB and The Vienna Institute for International Economic Studies (wiiw).*

after the Great Recession, about 50% of Chinese lending went unreported, which is why official statistics by the World Bank vastly underestimated the exposure of many developing countries to China. Consequently, debt statistics were revised upward – often in the midst of on an already ongoing debt crisis. The discrepancy between officially reported debt and actual debt was especially large for Turkmenistan, Guinea and Chad, where debt statistics were revised upward by around 100%.

One important reason for this massive underreporting is China's extensive use of confidentiality clauses. A typical confidentiality clause reads like this: "The Borrower shall keep all the terms, conditions and the standard of fees hereunder or in connection with this Agreement strictly confidential. Without the prior written consent of the Lender, the Borrower shall not disclose any information hereunder or in connection with this Agreement to any third party unless required by applicable law." While clauses like this were not used extensively before 2013, virtually all new debt contracts signed since 2015 include such provisions.

Apart from the extensive use of confidentiality clauses, a second outstanding feature of Chinese contracts is the widespread use of collateralized loans. Although the posting of seaports as collateral makes headlines, a more common practice is the collateralization of revenue accruing from sales of commodities, such as oil and other minerals.

While the first part of the lecture focused on the past boom in Chinese lending, the second part concentrated on its more recent bust. New lending by Chinese official creditors started to decline as early as 2017, but during the COVID-19 crisis, net transfers turned negative and have remained so until now. This has the troubling implication that Chinese lending dried up when it was needed most, during times of crisis, making Chinese lending procyclical, i.e. fueling booms and busts.

The unfolding debt crisis is also reflected in the vast increase in the number of debtor countries in distress and in downgrades of loan portfolio ratings. The share of cumulative Chinese loan claims to borrowers in distress remained mostly below 10% before 2014. That percentage stayed below 20% until 2018 but then rose to about 60%, mainly due to economic problems related to the COVID-19 pandemic and Russia's invasion of Ukraine. Again, the analysis is hampered by a lack of data and opaqueness. The confidentiality clauses mentioned above also play an important role in this regard, and many Chinese loans are not tracked by rating agencies because they are officially considered private loans. Thus, similarly to the hidden debt problem, there is also a hidden default problem. Generally, Chinese lenders are reluctant to consider debt restructuring, and if they do offer such debt relief, it mainly takes the form of payment extensions rather than haircuts. In this regard, Carmen Reinhart sees parallels to the behavior of Western banks during the Latin American debt crisis of the 1980s and is skeptical that China will be more successful in dealing with distressed debtors.

The subsequent Q&A session was kicked off by Governor Holzmann, who raised the question of how so many countries were able to hide so much of their debt from the experts of the World Bank and other institutions. Carmen Reinhart pointed to a lack of consolidated fiscal accounts and the importance of confidentiality clauses. Another controversial issue raised was the risk that bailouts of indebted developing countries might effectively be bailouts of Chinese entities because "money is fungible" and thus might be used by debtor countries to pay back their Chinese loans.

Conference on European Economic Integration (CEEI) 2023: Geopolitical shifts and economic strategies: China's role for CESEE and the euro area

Compiled by Julia Wörz[20]

On November 6 and 7, 2023, the Oesterreichische Nationalbank (OeNB) and the Bank of Finland Institute for Emerging Economies (BOFIT) hosted the Conference on European Economic Integration[21]. Europe's economic model has traditionally been based on open economies and a multilateral order. However, Europe is also dependent on a few suppliers of vital commodities and services, as was clearly demonstrated by the COVID-19 pandemic and Russia's war of aggression against Ukraine. When it comes to the green transition and public health, Europe, and particularly Central, Eastern and Southeastern Europe (CESEE), is heavily reliant on foreign inputs. Thus, while a rebalancing is needed, it must not come at the cost of disrupting reliable trade relations and global cooperation. Against this backdrop, more than 300 participants from various countries gathered at the conference in person and online to discuss Europe's relations with China.

In his opening remarks, *OeNB Governor Robert Holzmann* called China's rise in the world "nothing short of a modern economic miracle" and pointed out several elements that China's and Europe's economies have in common. At the same time, he emphasized that "striking a balance between reaping the benefits of Chinese investment and safeguarding national interests remains an issue for many CESEE countries." While Holzmann said that the economic relationship between Europe and China had been mutually beneficial so far, he cautioned that it would be important to consider concerns about one-sided dependencies. However, Holzmann left no doubt that cooperation between China, CESEE and the EU more broadly was more important than ever in the fight against climate change: By aligning their efforts and expertise, all three regions could accelerate the joint mission toward a climate-neutral world, he said. Finally, Holzmann stressed that "peaceful coexistence is an essential precondition for economic globalization that allows all nations to share prosperity." He also said that the dialog on issues such as human rights and strategic autonomy needed to continue.

Iikka Korhonen, Head of BOFIT, praised the long-standing successful and reliable cooperation between OeNB and BOFIT, not only in hosting the CEEI. Turning to China, he said that he did not consider its economic growth as unique since it followed the models of Japan and South Korea, even though it had not yet fully caught up with the US. He said that growth would decelerate and that it had in recent years relied on high levels of investment and increasing debt, with a public debt ratio of about 110% of GDP. Despite these challenges, Korhonen was positive that China's growth performance would continue.

In his keynote lecture, *Hyun Song Shin*, Economic Adviser and Head of Research at the Bank for International Settlements (BIS), analyzed recent geopolitical shifts and economic strategies. He

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[21] The CEEI is an annual conference hosted by the OeNB. In 2023 it was jointly organized with the Bank of Finland Institute for Emerging Economies (BOFIT).

presented the highlights of a recent BIS bulletin about a realignment of global value chains that was informed by a database on corporates containing information on financial accounts and customer-supplier relationships. Shin explained the network structure – links between firms along the supply chains that could be mapped into two major regional clusters, an Atlantic and an Asian one. Direct cross-border linkages decreased between end-2021 and mid-2023, a trend that could be attributable to onshoring. However, indirect linkages did not change much in the period under review and even increased in some cases. Mean distances increased, lengthening the tail of the distance distribution. Distances of bilateral relations between the US and China became even longer, while Japan and South Korea displayed more direct links to the US and China. Shin concluded that the lengthening of supply chains reflected the interposition of firms from Asian companies outside China. So far, however, he said, the long-run trend of regionalization continued. Shin concluded that from a network theory perspective, there seemed to be no linear trade-off between resilience and efficiency, i.e. longer trade links were not necessarily less risky. When asked whether the observed fall in trade volumes was inconsistent with his findings, he answered that the size of connections had not been investigated and that additional research would be needed.

Governor *Robert Holzmann* continued to moderate the monetary policy panel and focused, inter alia, on China's growth outlook and its consequences for European countries and the potential risks and opportunities of nearshoring.

Hatice Karahan, Deputy Governor of Türkiye Cumhuriyet Merkez Bankası, noted that in the short term, developments in China, particularly regarding deflation, were reducing inflation in Türkiye by tamping down price pressures on imported goods. She doubted that the medium-term outlook for China was as gloomy as was often assumed. Karahan argued that Chinese policymakers had tools at their disposal to support demand. The impact of Chinese economic developments on European countries would depend on whether China achieved a meaningful rebalancing, she said. China had focused strongly on infrastructure investments and external demand, but it was now time to rebalance the economy toward domestic consumption, said Karahan. Regarding Turkish-Chinese relations, she viewed the Belt and Road (BRI) Initiative as a positive development as it helped Türkiye to realize its export diversification strategy. At the same time, she noted that Türkiye was aware of the risks of overdependence on one supplier and had therefore started to diversify its supplies of minerals and rare earths.

Csaba Kandrács, Deputy Governor of Magyar Nemzeti Bank, assessed the outlook for China's economy in a way that was similar to the previous speaker. He noted that deflation in China was not comparable with the situation in Japan. It reflected a rebalancing of the economy and China still had ample room to grow and tools to support growth, said Kandrács. In response to a question on the impact of demographics, he argued that the negative impact could be offset by productivity growth. Regarding Hungarian-Chinese economic ties, he emphasized China's importance for Hungary and that the relationship had been built over a long time.

Iikka Korhonen, Head of BOFIT, noted that muted price pressure from China was helping to bring down global inflation. Imported goods from China were mitigating inflation in Finland as the Asian country was an important trading partner, he said. The BOFIT forecast expected Chinese growth to slow to around 3% in the medium term, partially reflecting adverse demographic trends.

Regarding nearshoring, he noted that recent evidence did not suggest that large companies were pulling out of China. However, companies were also investing in other countries, such as Vietnam.

The academic keynote panel focused on China's growth prospects and their short- and long-term global implications. Moderator Iikka Korhonen was joined by *Joyce Chang*, Global Head of Research at J.P. Morgan, *Lina Song*, Professor of Economic Sociology and Chinese Studies at Nottingham University Business School, and *Guanghua Wan*, Director of the Institute of World Economy at Fudan University. All speakers agreed that China's growth was decelerating. Wan emphasized that the pace of slowdown was unexpected, and that it was impossible to predict when the slowdown would end. It was also highlighted that the economic slowdown was caused by internal as well as external developments. Domestic demand has been weak particularly due to low household and business confidence. Furthermore, unemployment has increased, with a lack of stable income acting as a drag on household consumption, and external demand has been declining as well. Taking a somewhat longer perspective, deglobalization tendencies are not yet clearly noticeable in China, which still dominates the global supply chain. This becomes evident when considering that one-third of global manufacturing output originates from China. However, relocation efforts of foreign firms aim at reducing dependence on China and new trade corridors are emerging, which will have negative repercussions on China's growth.

In her introduction to the next session, *Birgit Niessner*, Director of the OeNB's Economic Analysis and Research Department, outlined three key aspects of international trade: (1) Europe's rule-based open trade approach in the new geopolitical environment, (2) reciprocity in Europe's economic relations with the US and China, and (3) reshoring, nearshoring, friendshoring and investment opportunities in CESEE. In a lively and insightful discussion, three distinguished trade economists shared their views on these issues. *Roberta Piermartini*, Chief of Trade Costs Analysis at the World Trade Organization (WTO), argued that an open and predictable global trading system has delivered and can still deliver. She highlighted that despite the growing tensions, 75% of trade is still covered by WTO rules. In her view, reciprocity is a key element of any trade agreement, but this does not mean that there is a one-to-one correspondence in commitments as agreements should be seen as packages. She also said that new digital services would give fresh impetus to trade and globalization. *Zuzana Zavarská*, Economist at the Vienna Institute for International Economic Studies, focused on the CESEE countries. She pointed out that since 2008 it had generally become more difficult to receive productivity-increasing foreign direct investment (FDI). With regard to the question to what extent CESEE countries could benefit from nearshoring, she noted that there was a lot of optimism, but also highlighted some trade-offs and caveats. She emphasized that it was important for countries to follow strategies that make them attractive for FDI and said that labor shortages were a constraining factor in more developed CESEE countries. *Julia Grübler*, Economic Affairs Officer at the United Nations Conference on Trade and Development (UNCTAD), warned that trade war rhetoric could have an impact on public opinion and limit space for trade cooperation. On efficiency and concepts of reshoring, nearshoring and friendshoring, she made the point that trade diversification could be seen as an insurance policy, making trade more costly but paying off when crises hit. Nearshoring and friendshoring involve speculation about the nature of future crises – the insurance premium is lower, but so is the risk coverage, said Grübler.

In her enlightening dinner speech, *Isabella Weber* from the University of Massachusetts Amherst provided a comprehensive long-term view of China's growth models, unraveling a historical tapestry that significantly influences the nation's stance on inflation and deflation. From the era of Mao, characterized by self-reliance in the face of a US trade embargo, to the ideologically motivated command economy, inflation was low, reflecting a mostly rural population with limited spending capacity. The late 1970s marked a turning point with China's reform and opening-up but the country retained its command economy structure, relying heavily on internal demand. The subsequent shift in the 1980s toward a state-owned enterprise-led investment strategy propelled China into a phase of constant inflation pressures, driven by robust exports and demand surpassing aggregate supply. Only in 1988–1989, when the political system was under stress during the Tiananmen Square crisis, there was a short inflationary period which subsided subsequently.

Fast forward to 2021, when China's real GDP grew at a remarkable rate of 8.4% amid a global energy price shock: What stands out is China's sophisticated system that is adept at buffering its economy from external price shocks, largely facilitated by state-owned companies absorbing cost shocks. However, the narrative took a turn as Weber highlighted a new challenge for China – deflation, the flip side of the inflation challenges faced by the US and Europe. It is worth noting that due to a low ratio of foreign debt and substantial state assets, China's fiscal stance appears to be more expansionary than its debt-to-GDP ratio would imply. Weber emphasized that contrary to the notion of indiscriminate stimulus, splashing money into the economy is inconsistent with China's growth policy. The current challenge looms large as China engages in a profound discourse, contemplating a shift from a command system to a state-constitution market economy.

The second day of the conference was opened by a keynote speech on China's economic rebalancing and its global impact. *Alicia García-Herrero*, Chief Economist for Asia Pacific at Natixis, a French corporate and investment bank, provided several key insights into China's economic outlook and its implications for the world. According to García-Herrero, China's economic growth is expected to rebound somewhat in the short to medium term after a period of stagnation caused by the COVID-19 pandemic. However, this growth is likely to remain moderate, falling short of previous expectations. Despite the challenges it faces, China is actively focusing on bolstering its manufacturing sector and maintaining a trade surplus. The latter is becoming increasingly important as a source of foreign reserves, particularly in light of significant capital outflows. In this context, China's competitiveness benefits from low inflation (and possibly deflation) combined with a weak Chinese currency. These factors make China a formidable competitor for European companies in international markets. Moreover, China's increasing connections with the Global South play a crucial role in its rapid expansion into third markets. Nonetheless, Ms. García-Herrero pointed out that China's longer-term structural prospects are rather gloomy. The country's economic growth is projected to continue decelerating owing to its aging population and diminishing productivity, ongoing innovation efforts notwithstanding. In addition, China's influence on the Western world, both in terms of trade and (inbound and outbound) investments, is shrinking, according to García-Herrero. To counterbalance this decline, China is pursuing strategies that create a critical global dependence on its key goods, particularly in sectors like green technology. In response to this trend, the EU has adopted a strategy of de-risking to reduce its dependence on China. However, she warned that de-risking should not take the form of reshoring, which is a very costly and complex endeavor. As an alternative, García-Herrero called for partnership which she said could offer a viable solution. Such a partnership would foster cooperation among countries that could build supplementary supply chains based on coordinated specialization even if Chinese supply chains continued to dominate the market. Countries would thus join parts of the supply chain partnership on the basis of their capacity and comparative advantage. In summary, García-Herrero's speech highlighted the complex economic landscape in China, the main challenges and the strategies it employs to maintain its competitive edge in the world. Against this background, she emphasized the need for collaborative approaches to address economic dependencies. The general discussion centered on, inter alia, the real estate market in China, the country's dilemma between rising wages and competitiveness, the EU's increasing dependence on China that is not limited to raw materials, and its know-how and technology.

The keynote was followed by a session on the BRI and its economic impact on CESEE countries, moderated by *Julia Wörz*, Head of the Central, Eastern and Southeastern Europe Section at the OeNB. In her introduction, she emphasized the immense strategic importance of the BRI to China, which is not always clear from Western media reports on the initiative. She then gave some examples of recent investments in Eastern and Southeastern European countries. *Stephan Barisitz*, Senior Economist at the OeNB, opened the session with a short overview of Chinese overseas investment in the last decade. He pointed to the decline in investments since 2017, which he attributed, among other things, to political blowback against Chinese investments in the West and recent setbacks that China faced in some large traditional partner and neighboring countries such as Pakistan, Russia and India. In a sectoral perspective, investments in energy, transportation and metals account for more than two-thirds of Chinese overseas commitments between 2019 and 2023 and despite the overall slowing of overseas engagement, the shares of private and greenfield investments have increased. To compete with China, Japan launched a Partnership for Quality Infrastructure, which has been most successful in neighboring countries, the US established a Program for Global Infrastructure and Investment (PGII) in June 2022, and the EU started its Global Gateway in December 2021. *Christoph Trebesch*, head of the Research Center International Finance and Macroeconomics at the Kiel Institute for the World Economy, agreed with the previous speaker that the initial boom of the BRI was over. While the economic success of the initiative may have been limited, he considered the initiative a huge political success for China, which had managed to expand its influence. Nevertheless, lending had gone down, partly because Chinese loans had created debt problems in recipient countries, said Trebesch. He criticized Chinese debt contracts for a lack of transparency rendering analyses on underlying developments difficult. While he also concluded that the BRI had entered a new phase of a more focused and greener approach, he warned that these investments and implied dependencies were increasing China's political influence. *Alicia García-Herrero* joined the discussion supporting the view that the initiative had moved away from connectivity and infrastructure projects and toward serving China's foreign policy and security objectives. The panelists agreed that the reaction of Western countries had been too little, too late. According to Trebesch and García-Herrero, Western countries should, in addition to making sizable investments, put their emphasis on security aspects, adopt a geo-economic view and build a better narrative around their – already large – investments. García-Herrero also concluded that the West should do something new and not simply imitate China by launching similar initiatives.

Andreas Breitenfellner, Senior Principal at the OeNB, opened the session on "Financing the green transition" with a reference to the collective action problem and asked how China and Europe could initiate a cooperation to unlock funds for greening their economies. *Jun Ma*, Chairman of the Green Finance Committee of the China Society for Finance and Banking, alluded to China's important role as the world's largest producer of renewable energy, electric vehicles, batteries as well as wind and solar equipment. Chinese firms benefit from economies of scale due to the large domestic market, which lead to lower unit costs. Lower production costs yield higher consumer welfare in countries importing from China. In his view, the perceived geopolitical risk of relying on Chinese imports might be exaggerated, and China and Europe have the potential to cooperate in developing climate technologies, especially for industry and agriculture. This could lead to cheaper green technologies which would also be exported, speeding up the global process of decarbonization. *Xiaodong Wang*, Senior Energy Specialist at The World Bank Group, emphasized that China is both the largest coal consumer and the largest renewable energy producer globally. China faces the challenge to decarbonize at a lower income level and faster than the EU and the US. To reach its policy objectives of achieving peak emissions by 2030 and net zero by 2060, China needs to improve its energy efficiency, green its power mix by abolishing its coal quota to reduce its reliance on coal-fired power, decarbonize its industrial and transport sectors, and ensure a just transition for six million miners in the coal industry by retraining these low-skilled workers in the country's inland regions, she said. The World Bank has supported China in its energy transition since the 1990s by providing assistance in developing and implementing relevant policies and market-based reforms as a complement to China's more mandatory policy approaches. *Niko Korpar,* Research Associate at the Vienna Institute for International Economic Studies, observed that in the past global climate policy tended to focus on the geographic distribution of emissions. In that respect, China still accounts for the largest share of the EU's imported emissions. The EU aims at implementing its domestic climate agenda while shielding its energy-intensive industries but it has fallen behind China in the development of new green technologies. The US is a critical factor in EU-China climate relations due to its implementation of the Inflation Reduction Act. Emissions reduction should be the primary goal of collective policy efforts, and that could imply importing cheap green technologies from China or elsewhere. Based on his empirical work, Korpar concluded that the EU's carbon border adjustment mechanism (CBAM) will not have significant macroeconomic effects.

In the subsequent discussion, there was a consensus that CBAM likely has considerable indirect and dynamic effects by advancing CO_2 mitigation policies in third countries like China, while purely static analyses tend to underestimate its impact. Panelists discussed to what extent full internalization of external transport costs would make imports from China more expensive. There was a common understanding that the significant greenhouse gas emissions of the agricultural sector pose a challenge for decarbonization in China and India. Furthermore, urban planning and zoning laws were mentioned as policy areas with a potentially high impact on emission reduction in China and elsewhere. Finally, a pragmatic approach for the EU automotive industry could avoid a "triangle of doom," i.e. a trade war, a watering down of climate policies and a substantial decline of the EU car industry.

OeNB Vice Governor Gottfried Haber moderated the final panel on "Bulls, bears and dragons: China's role in global financial markets." He reminded the audience of the relatively strong performance of Chinese banks and the large number of Chinese banks active in Europe and European banks operating in China. *Gene Ma*, Head of China Research at the Institute of International Finance, said that the Chinese banking sector was facing three main challenges: recession, fiscal difficulties of local governments and a deteriorating quality of external assets (although with a small impact on banks given their small share in total banking assets). He said that Chinese banking sector data may be too good to be true considering that banks were forced to aggressively write off bad loans. When asked about pre-emptive steps to protect the banking system, Ma referred to the People's Bank of China (PBoC) as a "big mama" with five sons. As such, the PBoC was supporting the biggest state-owned banks. He said he expected the housing market to stabilize at low levels in 2024. *Michael J. Paulus*, Managing Director at Citigroup, was convinced that China continued to offer good investment opportunities. He expected the Chinese financial sector to become the world's second largest. Paulus said the biggest challenge for China was to continuously encourage and incentivize energetic and innovative entrepreneurs. He agreed that it would be necessary to readjust the regulatory frameworks for the banking sector, but that was not only true for China. Further, data quality needed to be improved and the recent high volatility meant that new types of data were necessary, said Paulus. The third panelist, *Christoph Pesau*, Senior Advisor to the Board of Raiffeisen Bank International, said that the Chinese banking system was rather different from the Western system, with a focus on policy lending and sufficient availability of assets as the banking sector was cleaned up by four large asset management companies some 20 years ago. There were also stark differences in digital payment systems, he said, pointing out that China had had a duopoly of WeChat and AliPay since 2010, which almost eliminated cash and cut out banks. Therefore, the PBoC was now helping banks to reenter this market, he said. Pesau said he did not see the e-yuan as a tool to control the people because this could be done with the existing duopoly of payment providers, and mobile phones. He concluded by referring to the rising importance of environmental, social and corporate governance (ESG) – in this context, environmental concerns clearly dominated over social concerns. In his view, advances in ESG are mostly driven by regulation.

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