

# Developments in selected CESEE countries

Softening economic activity in late 2018 as international headwinds increase<sup>1, 2, 3</sup>

Weakening international environment has heterogeneous impact across CESEE

## 1 Regional overview

Following a broad-based upswing in cyclical growth that lasted nearly two years, global economic expansion decelerated in the second half of 2018. Economic activity softened amid growing trade tensions and tariff hikes between the United States and China, declining business confidence, tightening financial conditions and higher policy uncertainty across many economies. This environment contributed to a slowdown in global industrial production and a sharp reduction in world trade dynamics. At the beginning of 2019, world trade growth declined to the lowest level since 2009.

Euro area growth slowed more strongly than expected as a combination of factors weighed on economic activity across countries, including weakening consumer and business sentiment, disruptions in the German car industry after the introduction of new emission standards, uncertainty about the sustainability of fiscal policies and elevated sovereign spreads in Italy as well as street protests weighing on production in France. Most likely, growing concerns about a no-deal Brexit also weighed on investment spending in the euro area.

Given CESEE's strong integration in the world economy, these international headwinds had an impact on the region. The individual CESEE countries have been affected to different extents, however.

Turkey slides into recession

The economic slowdown was by far the most pronounced in Turkey. A combination of factors including deteriorating international relations with the U.S.A., worries about the future direction of economic policy, and financial and macroeconomic imbalances that had been building up over the past years triggered economic turbulences in mid-2018. The tightening of monetary policy intended to reduce these imbalances, in turn, led to a massive slowdown in economic activity in the second half of 2018 and sent the Turkish economy into recession for the first time since the global financial crisis. The decline in GDP growth was driven by private consumption and investments that suffered from souring economic sentiment and a sharp reduction of credit growth as financing conditions tightened. Employment contracted at end-2018, with especially strong decreases being observed in the (previously booming) construction sector. The unemployment rate rose to 13.5% in December 2018 – the highest level since 2009 and by far the highest rate in CESEE.

Net exports, on the other hand, contributed positively to growth in Turkey as exports accelerated and imports decelerated against the backdrop of weak domestic

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<sup>2</sup> Cutoff date: April 4, 2019. This report focuses primarily on data releases and developments from October 2018 up to the cutoff date and covers Slovakia, Slovenia, Bulgaria, Croatia, the Czech Republic, Hungary, Poland, Romania, Turkey and Russia. The countries are ranked according to their level of EU integration (euro area countries, EU Member States, EU candidate countries and non-EU countries). For statistical information on selected economic indicators for CESEE countries not covered in this report (Albania, Bosnia and Herzegovina, Kosovo, Montenegro, North Macedonia, Serbia and Ukraine), see the statistical annex in this issue.

<sup>3</sup> All growth rates in the text refer to year-on-year changes unless otherwise stated.

Table 1

**Real GDP growth**

	2017	2018	Q3 2017	Q4 2017	Q1 2018	Q2 2018	Q3 2018	Q4 2018
<i>Period-on-period change in %, seasonally and working day adjusted</i>								
Slovakia	3.2	4.1	0.9	1.2	1.0	1.1	1.0	0.8
Slovenia	4.9	4.5	0.9	2.2	0.6	0.9	1.3	0.8
Bulgaria	3.8	3.1	0.9	0.7	0.9	0.8	0.7	0.8
Croatia	2.9	2.6	0.7	0.4	0.7	1.0	0.6	0.1
Czech Republic	4.4	2.9	0.6	0.6	0.6	0.5	0.7	0.8
Hungary	4.1	4.9	0.9	1.4	1.3	1.0	1.4	1.0
Poland	4.8	5.1	1.1	1.4	1.5	1.0	1.6	0.5
Romania	7.0	4.1	2.0	0.7	0.2	1.4	1.7	0.7
Turkey	7.4	2.6	1.2	1.8	2.0	0.9	-1.1	-2.4
Russia	1.6	2.3	0.4	0.1	0.7	0.6	0.7	0.8
Euro area	2.4	1.8	0.7	0.7	0.4	0.4	0.1	0.2

Source: Eurostat, national statistical offices.

demand and a sharp depreciation of the Turkish lira. The Turkish currency lost some 25% against the euro in the course of 2018 but has been trading at a largely stable rate since mid-October 2018.

Another country that lagged behind was Russia. At 2.3% in 2018 (see table 1), GDP expanded at a notably slower pace than in other countries of the region. For many years now, Russia has been plagued with a weak growth potential that reflects the Russian economy's bias toward commodity exports and a lack of major structural reforms. Nevertheless, quarterly growth picked up somewhat in the second half of 2018 and lifted GDP growth to 2.3% for 2018 as a whole – the highest level in six years. The stronger growth momentum can be traced mainly to a substantial expansion of net exports against the background of higher oil prices and a weaker Russian ruble. The external value of the Russian currency suffered from elevated uncertainty triggered by waves of U.S. sanctions and threats thereof. Growth of domestic demand decelerated owing to stagnating real incomes and tight fiscal and monetary stances as well as international sanctions that have been taking a toll on foreign investment.

Russian growth remains comparatively weak

After an unexpectedly strong third quarter of 2018, economic momentum weakened in the CESEE EU Member States at the end of 2018. At an average rate of 0.8% in the fourth quarter of 2018 (quarter on quarter), regional growth declined to its lowest level in three years. This suggests that this group of countries has passed its cyclical peak. Several other pieces of evidence support this assessment. Most importantly, activity indicators (e.g. industrial production, construction output, retail sales) and sentiment indicators (e.g. the Economic Sentiment Indicator of the European Commission) weakened throughout 2018 and partly reached multiannual lows in early 2019. Furthermore, the purchasing managers' indices (PMI) that are available for the Czech Republic and Poland declined to a level of below 50 points (the threshold indicating an expansion) in late 2018 and remained below this threshold also in the first three months of 2019. The last prolonged period of such weak PMI readings dates back to early 2013.

Economic activity softens in CESEE EU Member States in late 2018

Despite these recent developments, however, it must be noted that economic dynamics in general remained remarkably strong. High GDP readings over the first

Strong domestic demand against the backdrop of tight labor markets

three quarters of 2018 pushed annual average growth in the CESEE EU Member States to 4.3% for the full year 2018. This represents the strongest expansion since 2006.

Output growth rested mostly upon domestic demand (see chart 1). Private consumption – which was responsible for the largest contributions to GDP growth in five of the eight CESEE EU Member States in the second half of 2018 – continued to benefit from benign labor market conditions and swift wage growth.

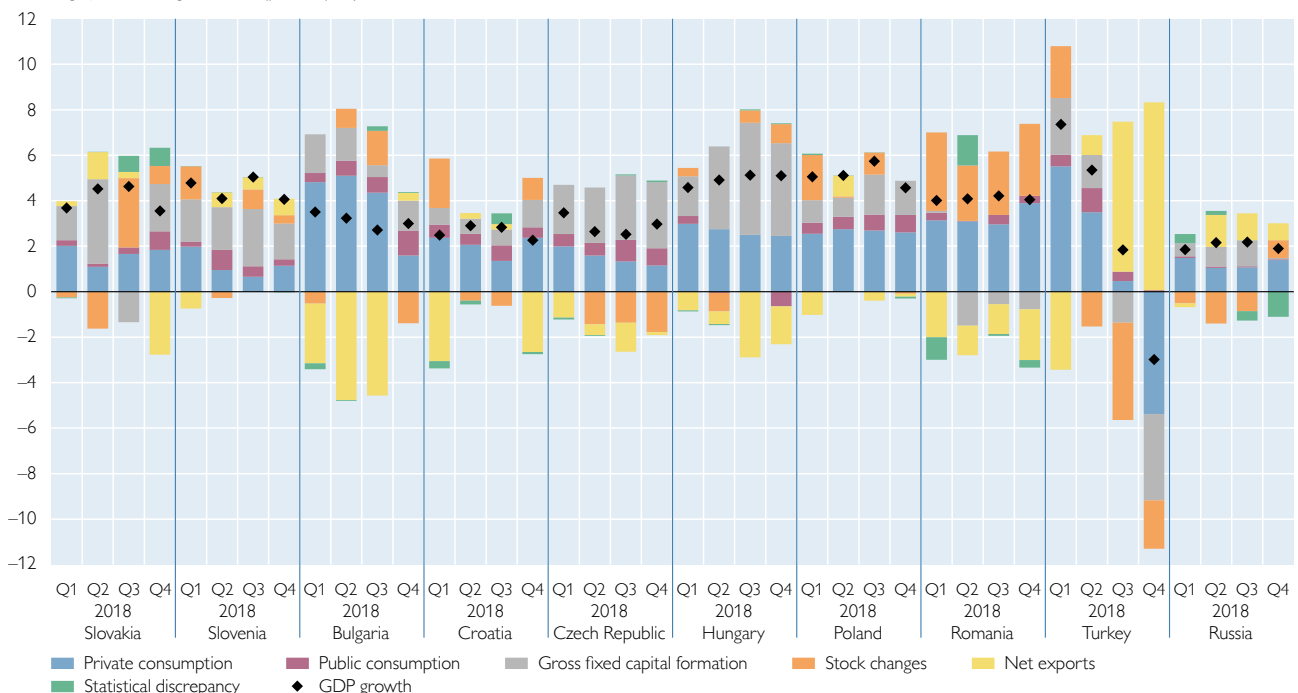
Labor markets were in full swing, with important labor market indicators at (or close to) historical heights. Unemployment rates have been falling consistently in recent years, from an average level of around 10% in early 2013 to 3.7% in February 2019. This represents the lowest reading since the start of transition. Positive labor market developments are also substantiated by several other indicators: Unemployment declined among the most vulnerable age cohorts, namely young persons (aged under 25) and older persons (aged 50+). The downward trend in long-term unemployment continued and was broadly based. Furthermore, employment kept expanding throughout the region, contributing to a convergence of employment rates toward euro area levels. By the fourth quarter of 2018, the employment rates of five CESEE EU Member States had already exceeded the euro area average.

The reverse side of these positive labor market trends were increasing labor market shortages. According to a survey by the European Commission, labor is perceived as a strongly limiting factor for production in the CESEE EU Member States: In the fourth quarter of 2018, some 44% of respondent employers in the region struggled to find labor. For Hungary, the respective figures went up to close to 90%.

Chart 1

## GDP growth and its main components

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



Source: Eurostat, national statistical offices.

The survey, however, reported slightly better outcomes for the first quarter of 2019 (42%), which might indicate that labor markets are finally starting to cool off somewhat. Labor shortages were possibly mitigated by immigration from the Western Balkans and Ukraine (e.g. in Poland), some re-migration of CESEE citizens from Western European countries, investment in labor-saving technologies as well as higher geographic mobility within the CESEE EU Member States.

Wage statistics also hint toward some easing of labor market strains. After a long period of increases, nominal wage growth softened in the second half of 2018. With an average plus of more than 10% year on year in the second half of 2018, wages nevertheless continued to rise at a rate close to historical peaks.

Dynamic labor markets and higher wages positively impacted on sentiment and prompted consumers to take out credit. Consumer confidence was the only component of the European Commission's Economic Sentiment Indicator that actually improved over the reporting period.

Gross fixed capital formation remained vivid in the second half of 2018, declining only marginally from the record highs seen in early 2018. Private investment continued to be fueled by high capacity utilization rates, full order books and improved credit market conditions amid low real interest rates and ample liquidity. Several countries also reported strong FDI inflows. Industrial sentiment was dented somewhat by external developments but remained solid in the longer run. Investment in construction and public investments increased strongly throughout most of the region, reflecting the importance of EU (co)financed investment projects as the 2014–2020 programming period is nearing its end.

Dynamic investment growth

The external sector was the part of the economy where the slowdown was most visible. Strong external headwinds caused export growth to moderate throughout CESEE EU Member States, especially when compared to 2017 dynamics. Given the region's strong integration into international production networks and the comparatively high import content of domestic export production, import growth moderated in tandem. Dynamic domestic demand, however, kept import growth rates (6.9% in the second half of 2018) above export growth rates (4.7% in the second half of 2018) on average. This translated into an (increasingly) negative contribution of net exports to GDP growth. Only in Slovenia did the external sector cause growth to lift somewhat in the second half of 2018.

External sector growth contributions weaken as international environment deteriorates

Export dynamics could have been even worse given the CESEE EU Members States' strong integration with the European – and especially the German – automotive sector. Between 20% to 30% of all exports from the Czech Republic, Hungary, Slovenia and Slovakia were related to exports of cars and/or car parts and accessories in 2017. A substantial share of these exports went to other EU countries, especially to Germany.

German car manufactures experienced delays in ensuring the environmental compliance of new passenger cars and reduced their car production significantly in the second half of 2018 (by some 7% year on year). So far, however, the CESEE region has remained rather resilient to this shock: While most countries reported lower growth rates in car production in the second half of 2018, output growth of the automotive sector remained positive in all countries but the Czech Republic. Hungary even recorded an acceleration of production growth since autumn 2018. Most likely, this resilience is an effect of the exact brands and car models produced per country and region. There is a risk, however, that the slowdown in the German

### Signs of a turnaround in ULC developments

car industry may also reflect longer-lasting factors such as uncertainty about partial driving bans for diesel cars and the rapid technological change that may have a longer-lasting impact on demand.

The erosion of international price competitiveness also seems to have lost some speed. For many quarters, unit labor cost (ULC) growth in manufacturing (measured in euro) was stronger, by some margin, in the CESEE EU Member States than in the euro area. In the review period, however, the difference in ULC dynamics moderated substantially. In fact, Slovenia, Slovakia and Hungary managed to (moderately) improve their competitive position vis-à-vis the euro area. Weak productivity readings that pushed up ULC growth in the euro area were the most important explanation for this turnaround. In the CESEE EU Member States, ULC developments were still burdened with high (though somewhat moderating) labor cost increases, while currency depreciation vis-à-vis the euro bolstered price competitiveness somewhat. The Hungarian forint lost some 4.5% vis-à-vis the euro in the second half of 2018 (year on year). The Polish zloty and the Romanian leu softened by some 1.5%.

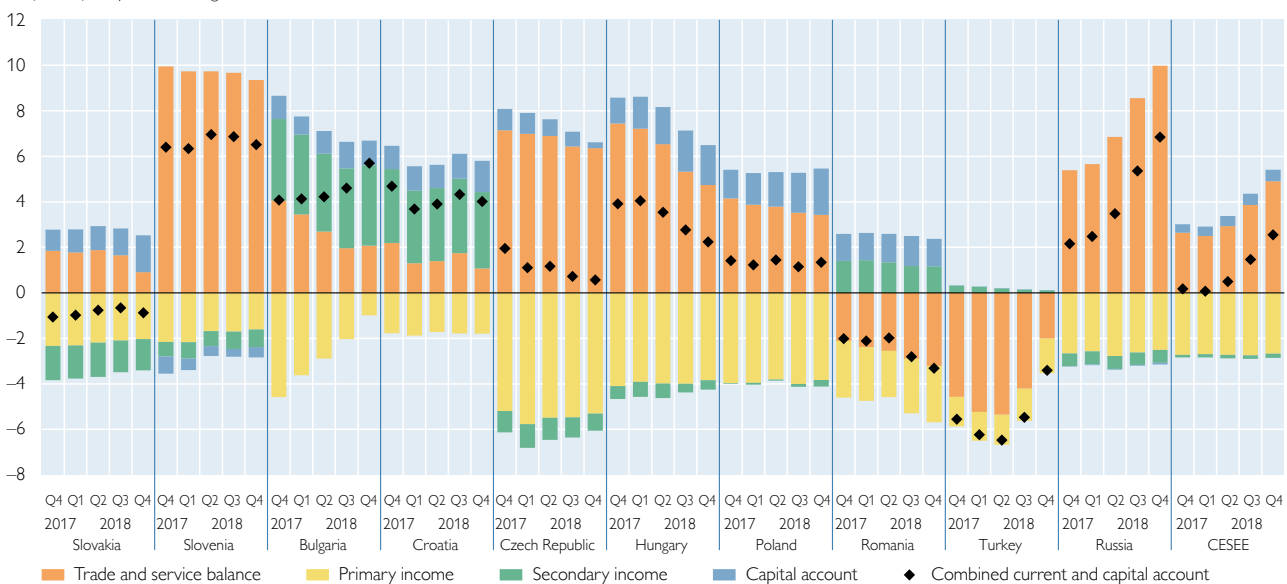
Russia and Turkey reported ULC growth substantially below euro area figures when measured in euro. In both cases, this was strongly related to currency depreciation. Measured in local currency, the competitive position of the Russian economy remained largely unchanged. Turkey continued to report labor cost increases in the double digits, while productivity plummeted amid the general economic recession.

In addition to ULC trends, survey data also hint toward some recovery of international competitiveness. The European Commission regularly polls firms on their competitive positions in markets inside and outside the EU. The most recent survey wave for the first quarter of 2019 indicated that firms in the region see their

Chart 2

### Combined current and capital account balance

% of GDP, four-quarter moving sum



Source: Eurostat, IMF, national central banks.

competitive position strengthening in both areas. An especially positive momentum was reported for EU markets.

The deteriorating international environment also impinged on CESEE EU Member States' external balances (see chart 2). Most countries reported a decline in their combined current and capital account surpluses, or increases in their deficits, during the review period. These developments were mostly related to weakening trade balances, while the other components of the current account remained broadly unchanged. In Romania, higher deficits in goods and services and in primary income pushed the combined current and capital account balance to  $-3.4\%$  of GDP in 2018. This has been the highest deficit since 2012, and it is also by far the highest deficit across CESEE EU Member States.

Notable current account improvements were reported for Russia and Turkey. In both countries, currency depreciation boosted the goods and services balances. Russia's trade balance was further bolstered by terms-of-trade effects relating to a higher average oil price in the reporting period. Turkey's external balances were also supported by depressed domestic demand, which weighed heavily on imports.

The aggregate financial account balance (i.e. the difference between the net acquisition of assets and the net incurrence of liabilities, excluding reserves) of the ten CESEE countries as a whole increased from  $0.6\%$  of GDP in the second quarter of 2018 to  $4.8\%$  of GDP in the fourth quarter of 2018 (four-quarter moving sums; see chart 3). This implies that capital outflows accelerated in the review period. The development was driven by two countries in particular: Russia and Turkey. In Russia, outflows were related to international sanctions against the country that led to a further cutback of banks' foreign liabilities and to outflows of foreign direct investment. Turkey reported a notable acceleration of net portfolio and net

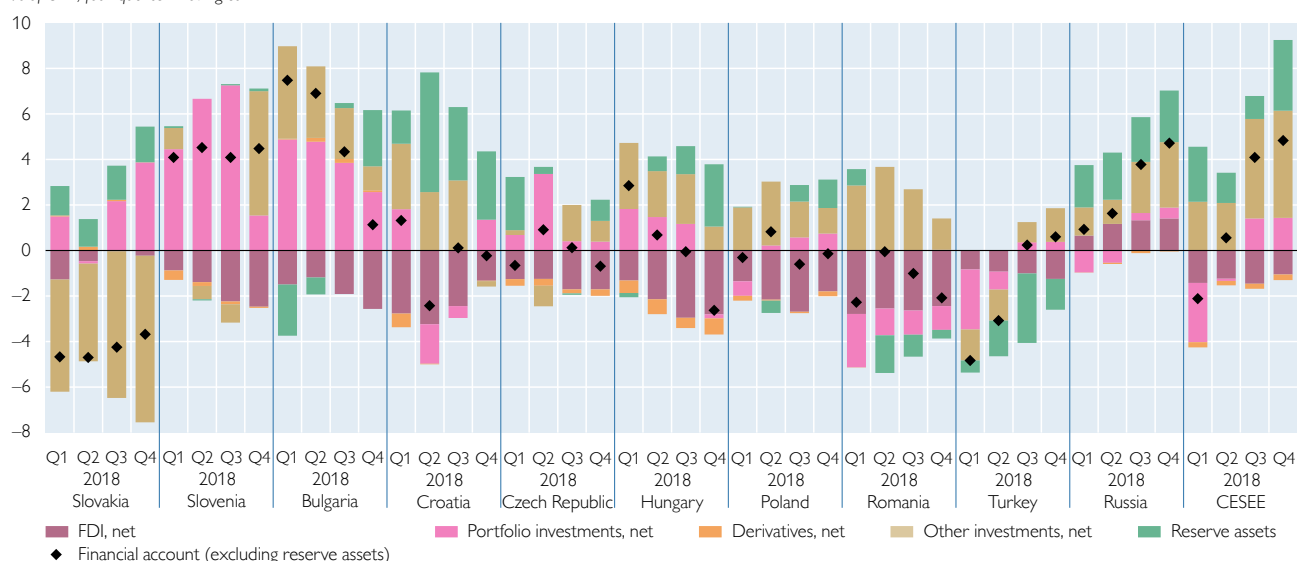
External headwinds also impact current account positions

Capital outflows accelerate in Russia and Turkey

Chart 3

### Financial account balance

% of GDP, four-quarter moving sum



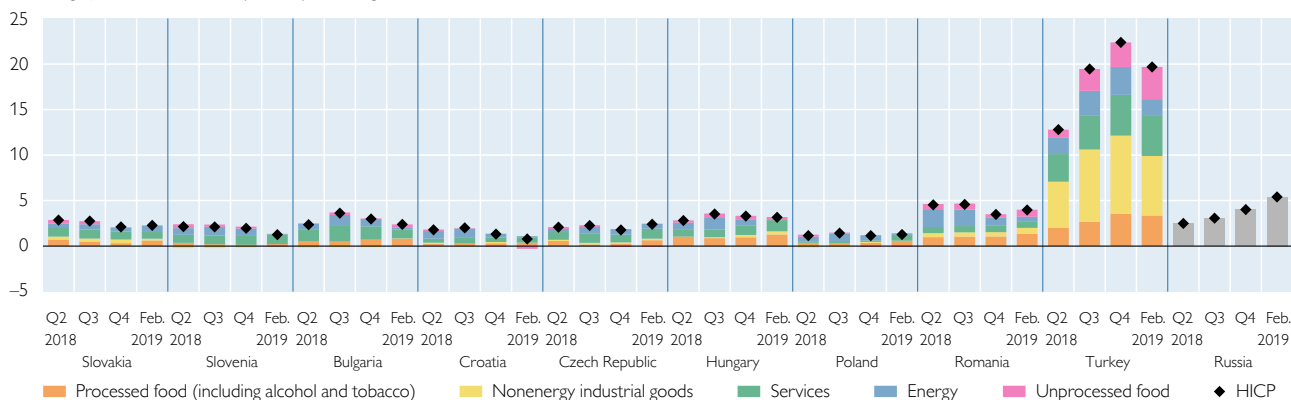
Source: National central banks.

Note: Positive values indicate a net outflow of capital, negative values indicate a net inflow of capital (vice versa for reserves).

Chart 4

## HICP inflation and its main drivers

Percentage points, contribution to year-on-year change in HICP; HICP in %



Source: Eurostat.

Note: CPI data for Russia. No breakdown according to COICOP available.

other investment outflows against the background of the economic turbulence the country has experienced especially since mid-2018. The deterioration was driven by both a higher acquisition of assets abroad and a lower incurrence of liabilities from abroad.

In most of the other CESEE countries, financial accounts balances improved somewhat, most notably in Hungary and Bulgaria. Net FDI was generally robust, and often strengthening, across the region.

Pickup in inflation,  
especially in the first  
months of 2019

In the review period, Russia and Turkey reported the highest inflation rates among the CESEE countries (see chart 4). In Russia, inflation doubled from a historical low in mid-2018, reaching 5.4% in February 2019. Higher price growth was related to currency depreciation and increases in indexed housing and communal tariffs. Price growth accelerated further after the VAT rate was raised in January 2019.

In Turkey, the weakening of the Turkish lira pushed annual price rises to above 25% in October 2018. Since then, inflation retreated to 19.7% on the back of weak demand conditions and a more stable development of the Turkish lira.

With the economy in full swing, inflation was rather contained, on average, throughout the second half of 2018 in the CESEE EU Member States. Inflation rates mostly hovered at around 2.5%, with some downward trend toward end-2018. Movements of the inflation rate were primarily related to volatile energy prices, so that core inflation remained largely stable at an average of around 1.5%. Since January 2019, however, inflationary pressures have increased. Headline inflation climbed from an average 1.7% in December 2018 to 2.2% in February 2019. More importantly, core inflation also picked up to reach 2.2% in February 2019. This represents the first notable increase since mid-2017 and also the highest reading of core inflation since December 2012.

This development possibly reflects domestic price pressures that have been building up over the past two years but have not (yet) materialized in measured inflation: tight labor markets and strong wage growth pushing up aggregate ULC growth, record-high capacity utilization and a positive output gap.



The Czech central bank (CNB) adhered to its policy of gradual monetary tightening during the review period and hiked its policy rate by 25 basis points to 1.75% in November 2018 (see chart 5). Since then, however, monetary policy has remained on hold. Despite an unexpectedly strong increase in headline and core inflation in the first months of 2019 (to 2.4% and 2.3% in February 2019, respectively), the CNB expects price growth to return to its target of 2% ( $\pm 1$  percentage point) and to remain very close to this level over the monetary policy horizon.

Further monetary tightening in many CESEE countries

Headline inflation in Hungary repeatedly rose to levels above target ( $3\% \pm 1$  percentage point) in the review period. A clear upward trend could also be observed in core inflation. Against this backdrop, the Hungarian central bank (MNB) raised its overnight deposit rate by 10 basis points to  $-0.05\%$  in March 2019, while leaving other rates (including the main policy rate) unchanged. Furthermore, it reduced the average amount of liquidity provisions by HUF 100 billion to HUF 300–500 billion, starting in the second quarter of 2019.

In Romania, the inflation target currently stands at  $2.5\% (\pm 1$  percentage point), and the inflation rate in February came in clearly above this threshold (HICP:  $4\%$ , CPI:  $3.8\%$ ). However, the Romanian central bank (NBR) kept its policy rate steady at  $2.5\%$  throughout the review period. In its April 2019 monetary policy meeting, the NBR acknowledged that inflation had exceeded its expectations in the first two months of 2019 and that it was likely to remain above the upper limit of the inflation target over the short-time horizon. The NBR also stated that it would maintain a strict control over money market liquidity.

In Poland, headline and core inflation remained moderate and below the lower bound of the Polish central bank's (NBP) inflation target ( $2.5\% \pm 1$  percentage point). However, inflation and core inflation started to pick up in February 2019 despite the freeze on electricity prices effective since January 1, 2019.

After pronounced hikes in June and September 2018 to combat currency depreciation and support price stability, the Turkish central bank (CBRT) refrained from making further adjustments to its policy rates in the review period. In late March 2019, however, the CBRT increased its average cost of funding from  $24\%$  to  $25.5\%$ , possibly in response to renewed currency depreciation and a drop in foreign exchange reserves. It also decided to suspend its one-week repo auctions for an undetermined period of time and thereby limited domestic Turkish lira liquidity.

The Russian central bank (CBR) raised its policy rate in two steps by a total of 50 basis points in the second half of 2018 to preempt the impact of the January 2019 VAT increase on inflation and to manage the risk of a potential currency shock from further U.S. sanctions.

Growth of domestic credit to the private sector (nominal lending to the nonbank private sector adjusted for exchange rate changes) was solid and broadly in line with fundamentals across most of CESEE. Credit growth accelerated moderately in most countries (see chart 6), reflecting generally favorable economic conditions in an environment of low interest rates and heightened competition among banks.

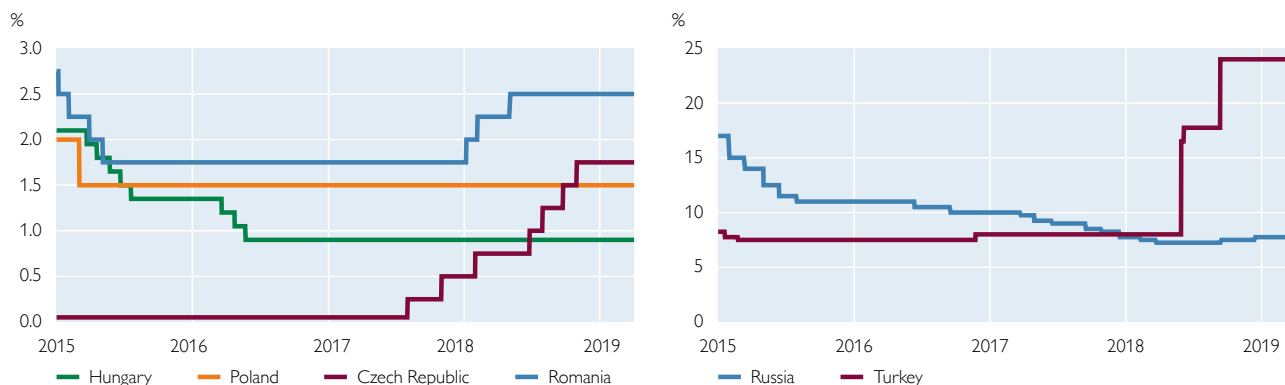
Modest acceleration of credit growth in most countries

The strongest credit expansion was reported for Hungary and Russia. In Hungary, lending was supported by various central bank measures. At the beginning of 2019, for example, the MNB introduced its “Funding for Growth Scheme Fix,” targeted at long-term lending to SMEs at fixed interest rates. In both countries, however, credit growth was especially dynamic in the household sector. Within this segment, housing loans have grown particularly briskly.



Chart 5

### Policy rate developments in CESEE



Source: Macrobond.

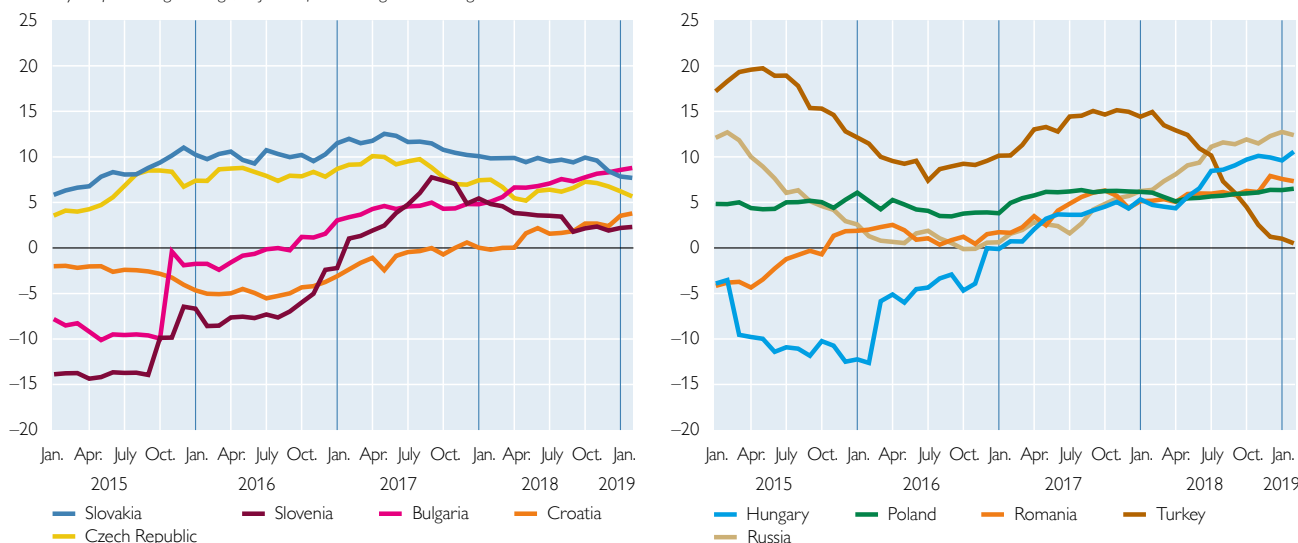
### Notable rise in housing prices and housing loans...

Also in other countries of the region, credit growth reflected to some extent a notable increase in housing loans, which went hand in hand with rising real estate prices. In the third quarter of 2018, housing prices rose by some 7.5% on average year on year (with growth rates ranging between 3.2% in Russia and 15.1% in Slovenia). While this represents some moderation compared to early 2018, housing prices continued to grow at a substantially stronger pace in CESEE than in the EU on average. These dynamics were related to strong housing demand against the backdrop of high wage growth, healthy consumer sentiment as well as favorable expectations concerning future income and general economic conditions. At the same time, regulatory requirements and a lack of skilled labor in the construction sector prevented supply from keeping track with demand.

Chart 6

### Growth of credit to the private sector

Year-on-year percentage change, adjusted for exchange rate changes



Source: National central banks.

Several CESEE countries had introduced macroprudential measures and/or issued recommendations to put a brake on the expansion of housing loans in the past and further tightened standards in the review period. Instruments include debt service-to-income ratios (e.g. in the Czech Republic, Hungary, Romania, Slovakia and Slovenia), higher risk weights (e.g. in Poland and Slovenia), loan-to-value ratios (e.g. in the Czech Republic and Slovakia) as well as loan-to-income ratios (e.g. in the Czech Republic and Slovakia). So far, these measures have contributed to a notable slowdown in mortgage loan growth especially in the Czech Republic and Slovakia (where such regulations have also been in force longest).

... led to further regulatory action

In the Czech Republic and Slovakia, credit growth has declined, from levels of 10% year on year and above to around 6% and 8%, respectively, in February 2019. Apart from slower housing loan growth, the imposition and subsequent increase of countercyclical capital buffers has contributed to this moderation. In the Czech Republic, the buffer currently stands at 1.25% and is to be raised to 1.5% in July 2019 and 1.75% in January 2020. In Slovakia, the buffer will be raised to 1.5% in August 2019 from its current level of 1.25%.

Slovenia reported the strongest deceleration of credit dynamics among the CESEE EU Member States, with growth rates coming down from close to 8% in late 2017 to 2.3% in February 2019. The reduction was driven by credits to nonfinancial corporations. Lower demand for loans primarily resulted from a change in corporate financing methods, an area where other instruments (namely internal resources, equity financing and trade credits) have gained importance.

In Turkey, credit growth practically came to a standstill in the review period despite support by the government's subsidized loan scheme. Tightening global financial conditions, increasing risks and adverse exchange rate developments contributed to tightening loan supply, while weakening domestic demand and a pronounced rise in interest rates impinged on loan demand.

Credit growth in Turkey comes to a standstill

Country-level bank lending surveys conducted by national central banks suggest some decrease in loan demand especially from households in late 2018 and early 2019 (e.g. in the Czech Republic and Romania). This might reflect slowing general economic dynamics. Lending conditions also appear to have tightened somewhat according to several country-level bank lending surveys, especially in the area of housing and consumer loans (e.g. in the Czech Republic, Romania and Poland).

Lending surveys indicate some moderation in credit market dynamics in early 2019 while the overall momentum remains strong

In contrast to that, the most recent CESEE Bank Lending Survey by the European Investment Bank (EIB) indicates persistently strong momentum in the region's credit market. According to the EIB, credit demand improved across the board in the second half of 2018. This marked the eleventh semester of favorable developments. All factors affecting demand made positive contributions. Notably, investment accounted for a good part of the strengthening in demand, while debt and corporate restructuring were almost irrelevant. Access to funding also continued to improve in CESEE, supported by easy access to domestic sources (mainly retail and corporate deposits).

Higher demand was paired with only marginally easing supply conditions in the second half of 2018, however. While this represents the third timid easing over the past two years, the gap between credit demand and credit supply that had been perceived for several quarters persisted. On balance, this would imply an improvement of the loan quality associated with most of new lending compared with previous credit cycles. Across the client spectrum, credit standards eased

Fiscal deficits persist in several CESEE EU Member States although economy is in full swing

again for SME lending and consumer credit, while they tightened for mortgages. Changes in local regulations and groups' NPLs were perceived as key factors adversely affecting supply conditions.

Russia reported a significant improvement in its general government figures as the budget deficit of –1.5% of GDP in 2017 turned into a surplus of 2.9% of GDP in 2018 (see chart 7). These dynamics were related to swelling revenues from higher oil prices combined with more efficient VAT collection and sustained prudence in spending.

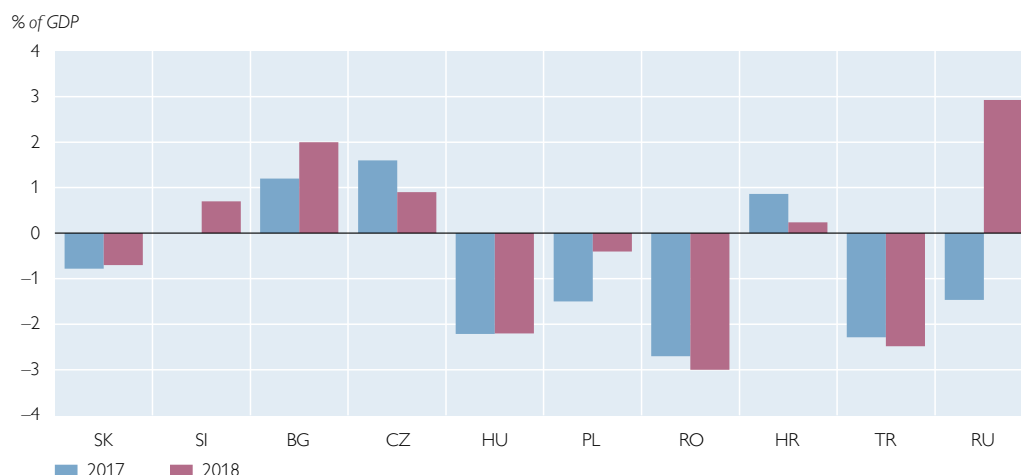
The fiscal stance in Turkey remained expansionary in 2018 although some fiscal measures were discontinued as from September 2018 due to high and rising inflation among other factors. On the back of temporary tax reductions, continued minimum wage subsidies, employment incentives schemes and the Credit Guarantee Fund loan support, the general government budget surpassed the budgetary target of –1.9% of GDP (as set in the New Economic Program of September 2018) to reach a deficit of –2.5% of GDP in 2018.

Although the economy is in full swing, the fiscal stance was mostly expansionary also in the CESEE EU Member States. While four countries of the group reported (partly minor) headline budget surpluses (ranging between 0.2% of GDP in Croatia and 2% of GDP in Bulgaria), cyclically adjusted budget figures were less favorable: Only Bulgaria and the Czech Republic were able to report a (moderate) surplus in their cyclically adjusted budget figures, while deficits were widening in the other countries.

Cyclically adjusted and headline deficits were highest in Hungary and Romania. Both countries are subject to a significant deviation procedure and were urged to take action to correct the deviation from the adjustment path toward their medium-term budgetary objective (MTO) to avoid the opening of an excessive deficit procedure. For both countries, the Council of the European Union concluded, in December 2018, that no effective action had been taken in response to the recommendations issued in June 2018. In order to correct for the cumulated deviation, an additional effort of 0.25% of GDP in Hungary and 0.2% of GDP in Romania was required to bring the countries back to an appropriate adjustment path toward the MTO.

Chart 7

### General government balances



Source: Eurostat, European Commission, wiiv.

Box 1

### Ukraine: official financing resumed to support foreign reserves in election year 2019

GDP growth accelerated to 3.3% in 2018 and continued to be driven by domestic demand. Private consumption grew briskly, benefiting from increasing real wages and pensions as well as from remittances and the growth of loans to households. Growth of gross fixed capital formation decelerated slightly but remained dynamic. Yet, the export performance was rather weak as real exports declined by 0.8% in 2018. Transportation bottlenecks related to the conflict in the Sea of Azov and repairs at several large metallurgical enterprises were among the special factors that put a drag on exports. Moreover, external price competitiveness suffered from ULC increases. The negative contribution of net exports declined, however, as import growth decelerated markedly in connection with lower gas purchases. At the same time, the current account deficit widened to 3.5% of GDP in 2018, mainly driven by an increase of the already sizeable trade deficit. Gas transit fee income, and hence the surplus in the services balance, might decline markedly as soon as pipelines bypassing Ukraine start to operate (around 2020). Income balances that counterbalance a large part of the trade deficit have been supported by inflows of income generated by Ukrainians working abroad, particularly in Poland.

After moving up toward the end of 2018, annual headline CPI inflation resumed its downward trend by falling to 8.8% in February 2019. At the same time, core inflation declined to 7.8%. After a hike in September 2018 to 18%, the National Bank of Ukraine (NBU) left its key policy rate unchanged. In March 2019, the NBU pointed out that the tight monetary conditions continued to be an important prerequisite for gradually reducing inflation to the 5% target in 2020, but also signaled the possibility of rate cuts under certain conditions in the future.

Ahead of the 2019 election year (presidential elections in spring and parliamentary elections scheduled for October), the IMF Executive Board had approved a 14-month Stand-By Arrangement (SBA) for Ukraine in December 2018, under which USD 3.9 billion are planned to be disbursed. The approval enabled the immediate disbursement of about USD 1.4 billion. The SBA succeeds an arrangement under the Extended Fund Facility (EFF) that would have expired in March 2019. Only about half of the total volume of USD 17.5 billion was disbursed under the EFF, as the reform drive lost momentum after initial successes. To get the new SBA started, Ukraine had to carry out several prior actions (including passing an IMF-compliant budget for 2019 with an envisaged deficit of 2.3% of GDP after 1.9% of GDP in 2018 and hiking household gas prices). Reaching an agreement with the IMF also made financing from other official sources available: from the EU under the fourth macro-financial assistance (MFA) program (EUR 0.5 billion out of EUR 1 billion have already been disbursed) and from the World Bank in the form of a policy-based guarantee (which has already been used to attract loans in the amount of about EUR 880 million). It is worth noting that international creditors regard the decision by the Constitutional Court of Ukraine to eliminate the illicit enrichment offense for public officials from the criminal code as a serious setback in the fight against corruption. Draft laws aiming to resolve this issue have not met with the expectations of international creditors so far. Moreover, the recent government decision to ban gas price hikes will also complicate the conclusion of the first IMF review scheduled for May 2019.

In recent months, official financing flows pushed up official foreign currency reserves to a five-year high of USD 20.8 billion at end-2018. Since then foreign reserves declined to USD 20.2 billion at end-February, due to spending on repaying and servicing public and publicly guaranteed debt in foreign currency. A larger decline was prevented through foreign currency purchases of the NBU (given favorable foreign currency market conditions) and the placement of domestic foreign currency bonds. As of March 1, 2019, official foreign reserves covered 3.3 months of future imports. Scheduled public external debt service from the second until the fourth quarter of 2019 amount to USD 4.5 billion.

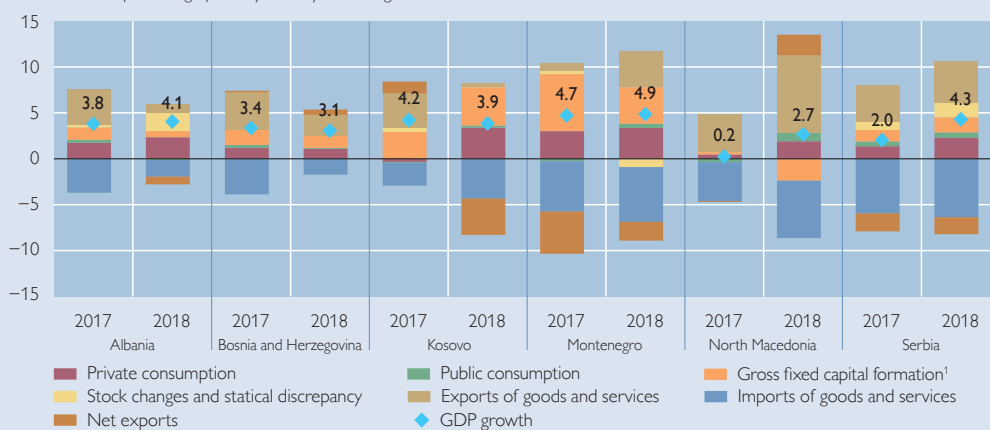
### Western Balkans<sup>4</sup>: strong domestic demand fuels economic growth

In the Western Balkans, real GDP growth accelerated strongly to 3.5% in 2018 (GDP weighted) compared to 2.6% in 2017. The favorable outcome primarily reflected North Macedonia's and Serbia's economic recovery from weak growth in 2017. In North Macedonia, the ending of the political stalemate revived economic activity; Serbia suffered from exceptionally low energy production in 2017. Only in Bosnia and Herzegovina did GDP growth ease slightly in 2018 compared to the previous year. After having stalled in 2017, income convergence gathered speed as average economic growth in the region was 1.6 percentage points higher than the EU average.

Chart 1

### GDP growth gained momentum in most Western Balkan countries in 2018

Contributions in percentage points; year-on-year GDP growth in %



Source: Eurostat, wiw, national statistical offices.

<sup>1</sup> Gross capital formation for Bosnia and Herzegovina, North Macedonia and Kosovo.

Private consumption growth accelerated in most Western Balkan countries on the back of a pronounced rise in real disposable income across the region. The drivers of higher spending capacity are many: remittances increased in all countries (particularly in Serbia and Montenegro), private and public wages grew strongly (in Albania, North Macedonia and Serbia), labor markets showed some positive trends and social benefits were lifted (e.g. in Kosovo and Serbia).

Turning to public consumption, we see stronger spending particularly in North Macedonia but also in Montenegro, Serbia and Kosovo. In North Macedonia, public consumption became a relevant growth pillar in 2018 to make up for two years of negative growth of public consumption.

Gross fixed capital formation has been supportive for economic growth in all Western Balkan countries, except for North Macedonia. In terms of investment activity Montenegro is still the frontrunner mainly due to its large highway project. Investment growth surpassed 20% year on year in each of the first three quarters of 2018 but remained flat in the last quarter. In North Macedonia, by contrast, gross capital formation declined in full-year 2018 but recovered in the final quarter of 2018 on the back of a revival of the construction sector.

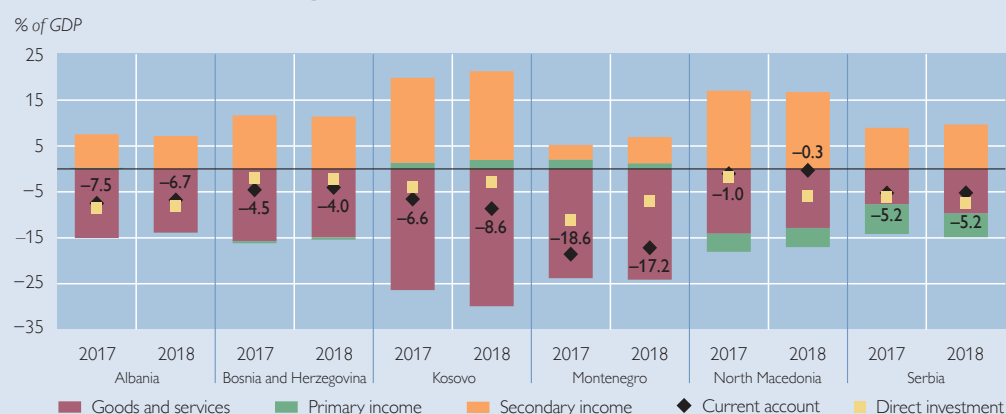
Export performance shows a rather mixed picture. In 2018, export growth was particularly strong in North Macedonia (due to rising export capacities and a steady reorientation of exports toward more sophisticated products) and Montenegro (mainly driven by energy, given

<sup>4</sup> The Western Balkans comprise the EU candidate countries Albania, Montenegro, North Macedonia and Serbia as well as the potential candidate countries Bosnia and Herzegovina, and Kosovo. The designation "Kosovo" is used without prejudice to positions on status and in line with UNSC 1244 and the opinion on the Kosovo Declaration of Independence.

favorable weather conditions for generating hydropower energy). Albania reported rather low export growth particularly in the second half of 2018 despite strong energy production and a strong tourist season. As a result of overall robust domestic demand, import growth of consumer and investment-linked goods gained speed in most Western Balkan countries. In Albania, however, import growth decelerated strongly, mainly because the large infrastructure project TAP (Trans Adriatic Pipeline) was phased out. In Bosnia and Herzegovina, the slowdown in import demand was obviously related to a generally weak economic momentum. In 2018, the contribution of net exports to growth was positive in North Macedonia and in Bosnia and Herzegovina; in Albania and Kosovo, it moved into negative territory. In Montenegro, the contribution of net exports registered some improvements but remained negative. Likewise, net exports continued to drag on GDP growth in Serbia.

Chart 2

### External imbalances slightly narrowed in some Western Balkan countries



Source: IMF, national central banks, World Bank.

Note: Primary income refers to factor income, e.g. from loans and investments. Secondary income refers to transfer payments. A positive (negative) value in the category of direct investments indicates that the net acquisition of assets is higher (lower) than net incurrence of liabilities.

External deficits in 2018 narrowed (or at least remained more or less unchanged) in most Western Balkan countries. North Macedonia managed to almost close the gap mainly due to a lower trade balance deficit. In Kosovo and Montenegro, the already large trade deficits widened even further because of strong import growth. Substantial inflow of remittances and FDI largely financed external shortfalls. However, a gap remained between stable capital inflows in the form of FDI and the current account deficit in Bosnia and Herzegovina, Montenegro and Kosovo.

In 2018, unemployment rates (according to labor force survey data) ranged from 12.8% in Albania to almost 30% in Kosovo. The countries managed to bring down their unemployment rates only marginally compared to 2017. Employment rates also improved only slightly. Albania reported the highest employment rate in the region (almost 60%) in 2018. Kosovo featured the lowest employment rate (28%) and, strikingly, the rate even declined by 1 percentage point compared with the 2017 rate.

Overall, inflation remained at moderate levels in 2018 (see statistical annex for 2018 data) but recent data for early 2019 showed a rather mixed picture. In North Macedonia, annual inflation decelerated slightly to about 1% in January and motivated the central bank to lower its key policy rate further by 0.25 percentage points to 2.25% in mid-March. In March 2019, inflation accelerated to 1.4% year on year. In Bosnia and Herzegovina and in Montenegro, inflation slowed down in early 2019 as well, after having accelerated in 2018 from 2017 levels. In Kosovo, interestingly, annual inflation started to accelerate at end-2018 and amounted to 3.2% in February 2019. Increasing inflation is largely related to high trade tariffs on Serbian as well as on Bosnian and Herzegovinian imports levied by the Kosovan authorities that raised



prices of imported goods or made it necessary to substitute these goods by possibly more expensive goods (particularly food products). Serbia also registered higher annual inflation in February 2019 (+2.4%) compared to the annual average for 2018, so inflation was within the lower half of the inflation target range ( $3\% \pm 1.5\%$ ). In Albania, the second inflation-targeting country besides Serbia, the significant appreciation trend of the currency against the euro in 2018 halted but the strong domestic currency still held inflation down at around 2% in 2018 and early 2019; inflation decelerated to 1.1% in March 2019, which is well below the inflation target of 3% set by the Bank of Albania.

The Western Balkan countries have progressed in bringing down their NPL ratios (see statistical annex for the latest data). This cleanup of banks' balance sheets is also reflected in robust growth of lending to the private sector (in particular to households). The annual growth of credit to households was particularly high in North Macedonia (exchange rate adjusted), Montenegro and Kosovo, whereas corporate lending lagged behind lending to households in most countries, particularly in Albania. The growth of credit to households is also driven – among other factors – by low interest rates and improved income prospects. On the supply side, credit supply conditions have been softened moderately in some countries.<sup>5</sup> Serbia introduced macroprudential measures to support more prudent consumer lending (effective since January 1, 2019). Overall, the banking systems in the Western Balkan countries remain sound and well capitalized, with selected pockets of risks that differ across countries but are mostly related to currency substitution, NPLs (except Kosovo), unsecured consumer lending and profitability issues of smaller banks.

Most Western Balkan countries reported fiscal shortfalls in 2018. Fiscal deficits were highest in Montenegro and North Macedonia (close to 3% of GDP), followed by Albania (2%) and Kosovo (0.6%). In Kosovo, the fiscal situation deteriorated most strongly compared to 2017 (when the country still reported a fiscal surplus), in particular due to increasing social benefits. Government debt increased in most Western Balkan countries, above all in Montenegro (by more than 5 percentage points to 70% of GDP) due to high capital spending. By contrast, Bosnia and Herzegovina reduced its debt level by more than 4 percentage points (to below 32% of GDP) and Serbia by 7 percentage points to 53%. In Serbia, fiscal consolidation measures were implemented in line with targets set by the IMF.

With respect to EU accession, the candidate countries Montenegro and Serbia are most advanced in the accession process. Albania and North Macedonia have lately taken important steps to clear the way to start accession negotiations in the near future. These steps include judiciary reforms in the case of Albania and solving the name dispute with Greece in the case of North Macedonia. With respect to Bosnia and Herzegovina, the opinion of the European Commission on its readiness to grant the country the status of an EU candidate country is expected for this year. Currently, Bosnia and Herzegovina as well as Serbia have programs with the IMF and there are not many news compared to our last reporting. The IMF program (Extended Fund Facility) with Bosnia and Herzegovina is still off track due to lacking fiscal policy reforms, among other issues. Serbia currently uses the IMF's Policy Coordination Instrument (PCI). The recent report of the IMF mission (February 2019) concluded that the reform program is well on track and the PCI targets are being met.

### **Spotlight: What does the OeNB Euro Survey tell us about accelerating non-housing related lending to households in the Western Balkans?**

Lending to the private sector, in particular lending to the household sector, has strengthened recently in the Western Balkan countries. In 2018, annual retail lending growth came to close to, or even above, 10% in Kosovo, Montenegro, North Macedonia and Serbia. Albania as well as Bosnia and Herzegovina registered lower but still strong annual household credit growth. Lately, lending to households for non-housing purposes has become a key driver of credit dynamics in some countries, in particular in Montenegro and Serbia. Loans for non-housing pur-

<sup>5</sup> For more information, see European Investment Bank. 2018. CESEE Bank Lending Survey. H2-2018. Details on credit demand and supply conditions are available for Albania, Bosnia and Herzegovina, Kosovo and Serbia.

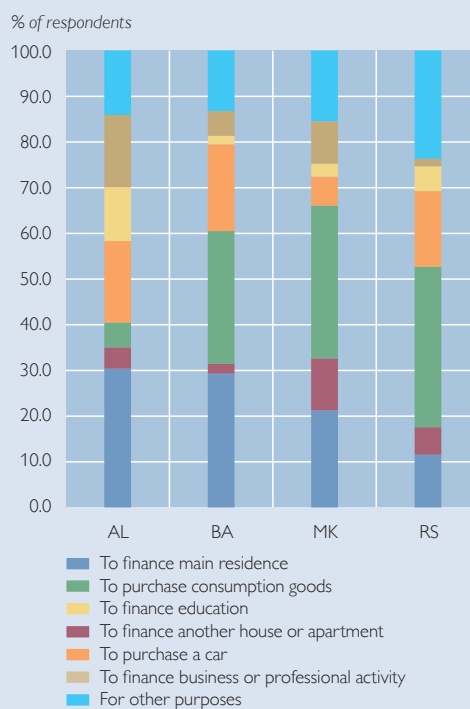
poses often have long maturities, are uncollateralized and their value is frequently quite substantial, e.g. when the loan is used for purchasing a car. In view of related risks to financial stability, some central banks have already intensified the monitoring of this loan category or – as in the case of Serbia<sup>6</sup> – have taken action to curb consumer lending.

So what can the OeNB Euro Survey<sup>7</sup> tell us about accelerating non-housing related lending in the Western Balkans?

For the non-EU countries covered by the OeNB Euro Survey<sup>8</sup>, we find that the purpose for which respondents take out a loan – i.e. their most important loan – differs strongly across countries: Albanian respondents reported a comparatively lower share of loans that are dedicated to consumption than respondents from the other Western Balkan countries. This outcome is also reflected in loan stock data provided by national central banks: In Albania, housing loans account for the largest share (60%) in total household loans while in the other three Western Balkan countries, their share in total loans to households is much lower (about 40% in Serbia, 30% in North Macedonia and 20% in Bosnia and Herzegovina). In North Macedonia, only a small share of households reported that they used their loan for financing the purchase of a car. In Serbia, noticeably, a large share of loans to households is dedicated to consumption and other purposes, which are not specified in detail, whereas housing loans are only of minor importance.

In a forward-looking question, respondents were asked whether they planned to take out a loan within the next year. Results of the latest survey wave of 2018 show that the share of respondents who intend to take out a loan has increased in Albania, North Macedonia and especially strongly in Bosnia and Herzegovina when compared with earlier survey waves. While this share dropped slightly in Serbia compared with figures of the 2017 survey wave, it still remained highest in a regional comparison (more than 10%). Generally, the main motives for taking out a loan are predominantly related to the low interest rate environment and the overall favorable macroeconomic environment, which also features considerable real wage growth in most Western Balkan countries.

Chart 3  
**Purpose of households' largest, most important loan**



Source: OeNB Euro Survey, fall wave 2018.

Note: Weighted percentages; excluding respondents who answered "Don't know" or who refused to answer.

<sup>6</sup> See press release of the National Bank of Serbia (NBS) of December 28, 2018, NBS Adopts Regulations to Promote Sustainable Household Lending Practices. [www.nbs.rs/internet/english/scripts/showContent.html?id=13706&konverzija=no](http://www.nbs.rs/internet/english/scripts/showContent.html?id=13706&konverzija=no)

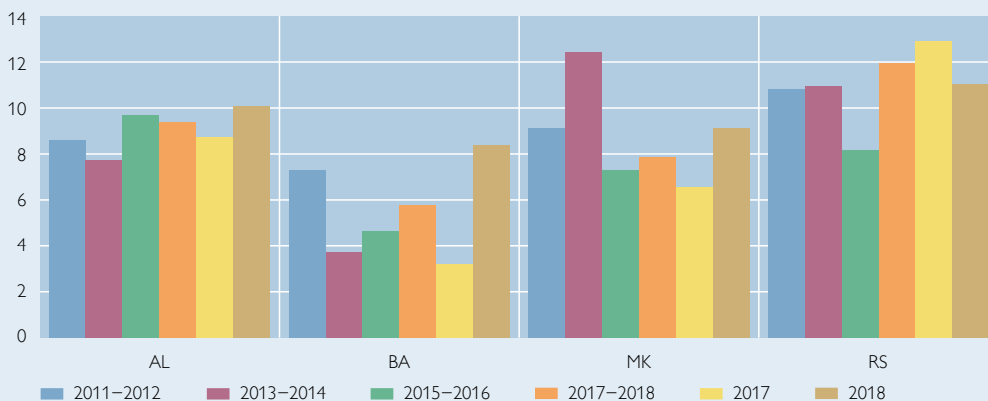
<sup>7</sup> The OeNB Euro Survey collects information from private individuals about their euro cash holdings, saving behavior and debt position and looks into respondents' economic opinions, expectations and experiences. The survey, which covers six EU Member States, three EU candidate countries (Albania, North Macedonia and Serbia) and the potential candidate country Bosnia and Herzegovina, has been conducted annually since fall 2007. In each country, face-to-face interviews are carried out with about 1,000 randomly selected individuals aged 14 and above. The sample is representative with respect to age, gender and regional distribution; see [www.oenb.at/en/Monetary-Policy/Surveys/OeNB-Euro-Survey.html](http://www.oenb.at/en/Monetary-Policy/Surveys/OeNB-Euro-Survey.html) for details.

<sup>8</sup> The OeNB Euro Survey does not cover Kosovo and Montenegro.

Chart 4

### Households' intentions to take out a loan within the next year

% of respondents planning to take out a loan



Source: OeNB Euro Survey.

Note: Weighted percentages; excluding respondents who answered "Don't know" or who refused to answer.

Respondents were also asked about the purpose of the loans they planned to take out. In answering this question, they had several options to choose from. The most relevant answer categories turned out to be "plan to take out a housing loan," "plan to take out a consumption loan" and "plan to take out a loan for purchasing a car."

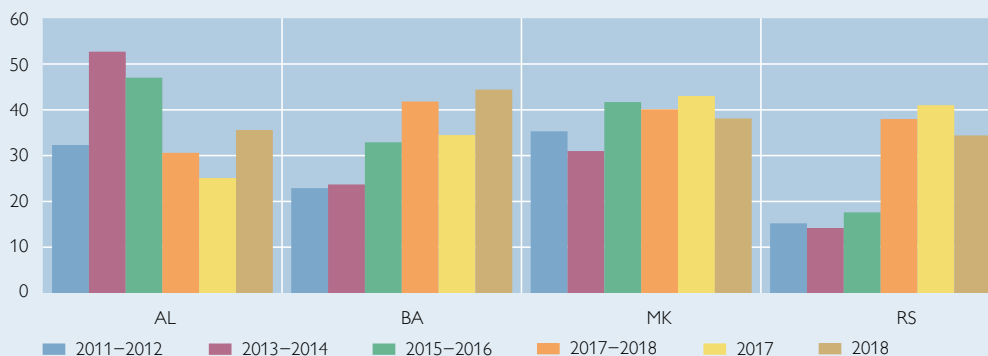
In the four Western Balkan countries covered by the OeNB Euro Survey, plans for housing loans are most widespread. In Albania, the share of respondents who said they wanted to take out a housing loan increased again in the 2018 wave after having dropped in the previous two waves. In Bosnia and Herzegovina, we see a similar pattern. In the remaining countries, this share has decreased recently. As mentioned before, the share of housing loans in total loans to household is still comparatively small in most Western Balkan countries (also compared with other CESEE countries), which might indicate the potential for catching up with their regional peers in terms of housing lending.

Generally, we observe a high – and increasing – share of respondents who plan to take a loan for non-housing purposes, namely for consumption and car purchase. This outcome generally corresponds to the growth rates of loans to households in the region. Both in Bosnia

Chart 5

### Households' intentions to take out a housing loan (mortgage)

% of respondents planning to take out a loan



Source: OeNB Euro Survey.

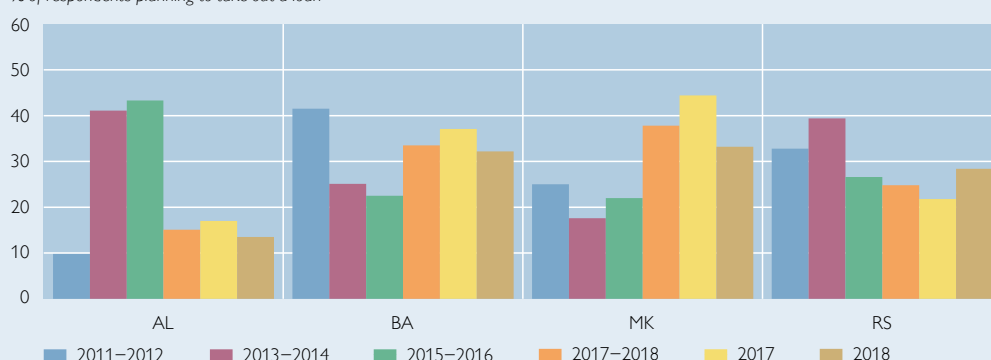
Note: Weighted percentages; excluding respondents who answered "Don't know" or who refused to answer.

and Herzegovina and in North Macedonia, the share of respondents who planned to use a loan for consumption went up strongly in 2017 compared with earlier OeNB Euro Survey waves and moderated somewhat in the 2018 wave. In Serbia, figures went up in 2018, and in Albania, by contrast, the share of respondents who plan to take out a consumption loan dropped significantly in 2017 and 2018 compared with earlier waves.

Chart 6

### Households' intentions to take out a consumption loan

% of respondents planning to take out a loan



Source: OeNB Euro Survey.

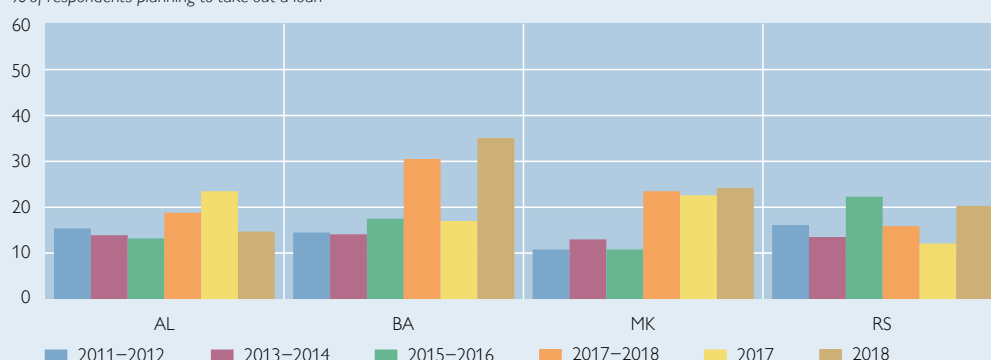
Note: Weighted percentages; excluding respondents who answered "Don't know" or who refused to answer.

Moreover, the share of respondents that said they intended to buy a loan-financed car has gone up. Both in Bosnia and Herzegovina and in Serbia, the respective figures have increased strongly in 2018. In North Macedonia, the share of respondents who planned to apply for a car loan was high in 2017 and 2018; in Albania, it went up only in 2017 and moderated again thereafter.

Chart 7

### Households' intentions to take out a loan for purchasing a car

% of respondents planning to take out a loan



Source: OeNB Euro Survey.

Note: Weighted percentages; excluding respondents who answered "Don't know" or who refused to answer.

Overall, OeNB Euro Survey data provide some evidence that non-housing related lending to households has become more prominent in most Western Balkan countries and – in light of financial stability risks arising from excessive consumer lending – should be monitored more closely by national authorities. Good knowledge about recent trends in credit growth in this segment is a prerequisite for implementing adequate and timely macroprudential measures to prevent financial sector vulnerabilities arising from this loan category.

### The automotive industry in CESEE, its linkages with Germany and challenges ahead

The European, and particularly the German, automobile industry is facing significant cyclical and structural challenges. The automotive sector is a major sector, both in terms of output and employment, in several CESEE countries as well as in Germany. CESEE and German automobile industries are closely intertwined, hence challenges in one of the countries will feed through integrated production networks, thus affecting all countries directly and indirectly. Against this background, this box will deal with the following three questions in greater depth: (1) Which role does the automobile industry play in the CESEE region? (2) To what extent is the industry entangled with Germany, the biggest European economy and leading car producer? (3) Which recent developments have there been in the automotive sector, which future risks and challenges are in store for the sector and how might these impact the CESEE region?

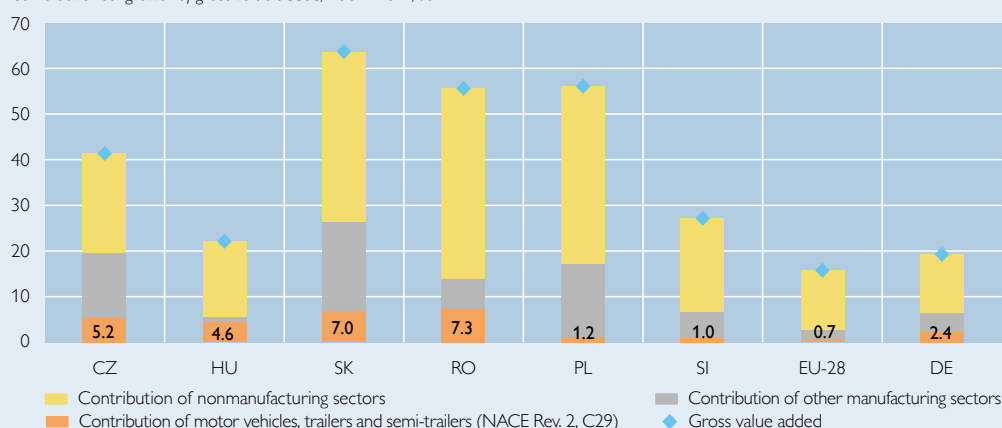
#### Automobile industry is key in the Czech Republic, Slovakia, Hungary and Romania

The CESEE economy is not all about the automobile industry but cars do play a crucial role in some CESEE countries. In the Czech Republic, Hungary and Slovakia – as in Germany – the production of motor vehicles and (semi-)trailers is the number one manufacturing segment, generating about one-fifth of gross value added (GVA) in the manufacturing sector. In Romania, the automotive industry ranks second, surpassed only by the production of food, beverages and tobacco products. In Poland and Slovenia, it is less dominant but still relatively important, in other CESEE countries it does not play a significant role. As a result, the car industry is an important driver of economic growth in some CESEE countries. Between 2004 and 2017, the industry contributed more than one-fifth to the cumulative real GVA expansion in Hungary, roughly 13% in the Czech Republic and Romania, and 11% in Slovakia (chart 1).

Chart 1

#### Contribution of “Manufacture of motor vehicles, trailers and semi-trailers” to GVA growth, 2004–2017

Cumulative real growth of gross value added, 2004–2017, %



Source: Eurostat.

This compares to about 12% in Germany and 4% in the EU on average. In contrast, in Slovenia and Poland, only small shares of real cumulative GVA growth in the period under review were ascribable to the automotive sector (less than 4% and roughly 2%, respectively). In the six above-mentioned CESEE countries<sup>9</sup> car production totaled more than 4.2 million

<sup>9</sup> Czech Republic, Hungary, Poland, Romania, Slovakia, Slovenia.

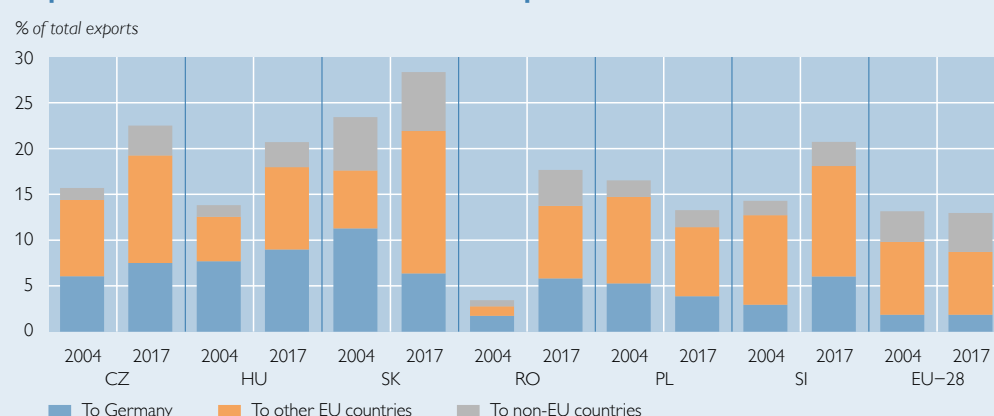
units last year. This is about 80% of the number produced in Germany and slightly less than one-quarter of all cars produced in the EU. However, car production in the reviewed CESEE countries is not only impressive in terms of total units but even more so in terms of cars produced per capita. In this respect, Slovakia ranks first, the Czech Republic second and Slovenia third in the world. In total, the industry directly employs more than 850,000 persons in the six examined CESEE countries. This almost matches the 880,000 employees in Germany so that employment in the automotive sector ranges between 1.3% of total employment in Slovenia and 3.7% in the Czech Republic. However, it has to be borne in mind that the quoted figures underestimate the importance of the automobile industry since both the number of employees as well as the contribution to growth indirectly linked to the sector are significantly higher due to deep integration in European supply chains<sup>10</sup>.

### **Automotive industry in CESEE is strongly intertwined with Germany, but bilateral integration is weakening relative to other countries**

Nearly 30% of Slovakia's and 25% of the Czech Republic's exports are related to the production of motor vehicles. In Poland, the most diversified among the examined economies, car-related exports amount to slightly less than 15%. While Germany is still the single-most important export partner for the automotive industry of our CESEE country group, it loses out relative to other foreign markets. Germany's share as an export market has been falling despite rising exports of the automotive industry relative to total exports (chart 2).

Chart 2

### **Exports: share of motor vehicle-related products**



Source: Eurostat.

Note: Product groups according to SITC Rev. 4: 722, 781, 782, 783 (tractors, motor cars and motor vehicles), 784 (parts and accessories), 786 (trailers and semi-trailers, containers), 7132 (piston engines) and 7783 (various electrical equipment for motor vehicles).

Hence, in 2004, an average 40% of the six CESEE countries' exports related to the production of motor vehicles – and even every other related product produced in Hungary, Romania and Slovakia – ended up in Germany. In contrast, less than one-third of automotive industry exports manufactured in the six examined countries went to Germany in 2017. Between 2004 and 2017, Germany's share in the automotive export market dropped for all examined CESEE countries but Slovenia. In 2017, it did not exceed 50% in any of these countries (the highest share was 43% in Hungary) and recorded the biggest drop in Slovakia from nearly 50% in 2004 to about 22%. A similar picture arises on the import side. Obviously,

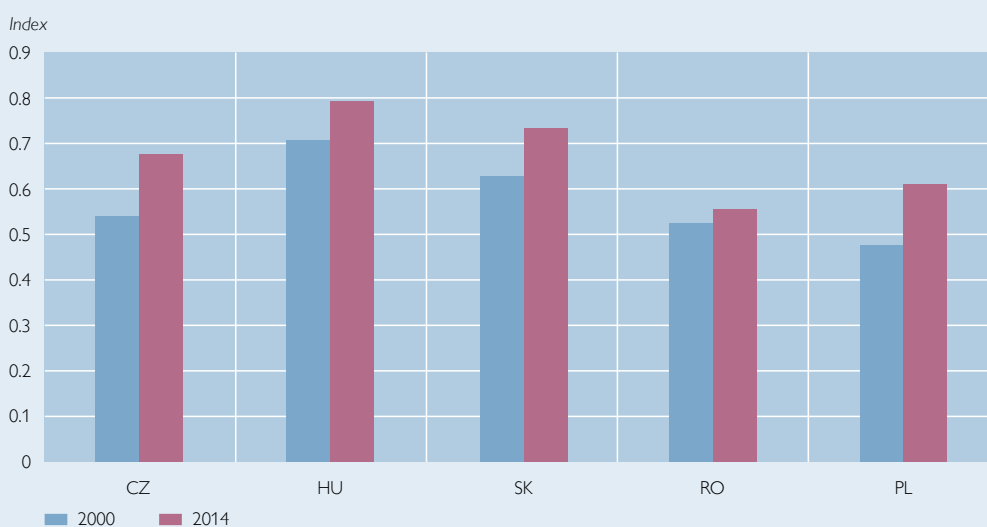
<sup>10</sup> E.g. the Czech Automotive Industry Association estimates that apart from about 150,000 people directly employed in the automotive industry there are a further 400,000 jobs indirectly linked to the sector. As a result, when the supply chain linkages are taken into account, the share of the automotive sector's contribution to GDP rises from about 6% to 9% (ING, 2019).



products related to the production of motor vehicles make up a significantly lower share in total imports than is the case with exports (maximum: 12% in Slovakia). Yet, just about one-third of all these imported goods originated in Germany in 2017, a noticeable drop compared to more than 40% in 2004. A look at the integration of the automotive industry in global value chains provides a more holistic view. It corroborates the previous outcome. While the automobile industry in the reviewed CESEE countries has become more integrated in global value chains, its integration with Germany has stagnated or even declined (charts 3a and 3b).<sup>11</sup>

Chart 3a

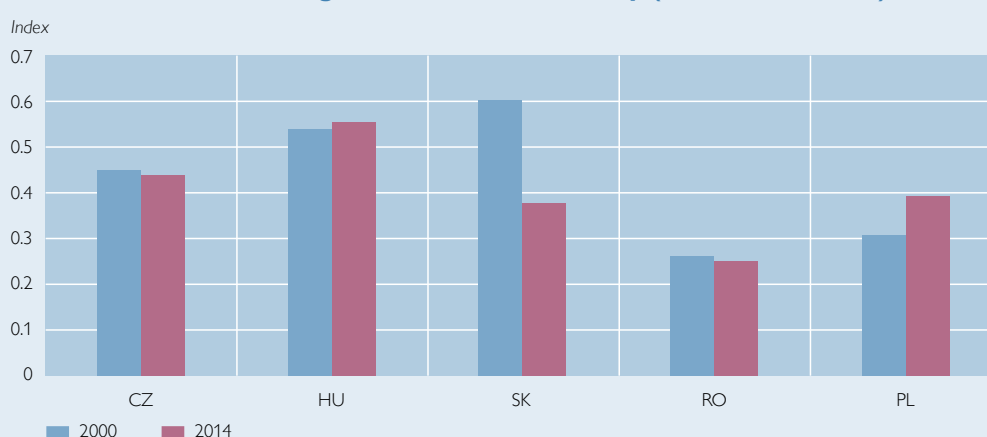
### Global value chain integration index (NACE Rev. 2 C29)



Source: wiiw.

Chart 3b

### Index of value chain integration vis-à-vis Germany (NACE Rev. 2 C29)



Source: wiiw.

<sup>11</sup> We would like to thank Robert Stehrer, The Vienna Institute for International Economic Studies (wiiw), for providing us with these figures based on the most recent vintage of the World Input-Output Database (WIOD).

### **European and especially German automobile industry is facing several cyclical and structural challenges and risks**

Recently, the European, and particularly the German, automobile industry has been confronted with several cyclical and structural factors that have impaired the industry's performance. The production of passenger cars dropped by about 2% year on year in 2018 in the EU on average, even though the picture was mixed across countries. German vehicle production fell by more than 9% year on year. This was primarily the result of weakened domestic demand and delivery delays caused by the introduction of new emissions standards (WLTP – Worldwide Harmonised Light Vehicle Test Procedure). A factor specific to Germany was the ban of older diesel engine cars in cities, which added to the long-term downward trend in demand for diesel cars. Some external factors such as the trade war between the U.S. and China and the slowdown of the Chinese economy have also left a mark on foreign demand for European, and particularly for German, cars. However, this impact has been relatively small so far.

Looking ahead, the European and German automotive industries face several risks and challenges. Major external risks are Brexit, a further cooldown of the Chinese economy or global trade wars. According to some estimates, Brexit could knock off some 30% of German car sales in the U.K. (ING, 2019). China is an increasingly crucial market for German car producers. Almost every fourth car sold in China originates in Germany and more than one-third of the production of the three biggest German car producers goes to China. The potential introduction of U.S. import tariffs on European cars would certainly also harm the industry, although the impact would be relatively limited. According to estimates by the ifo Institute (Felbermayr and Steininger, 2019) import tariffs of 25% would reduce GDP by about 0.15% in Germany, by less than 0.2% in Hungary and by about 0.1% in the Czech Republic. For most other European countries, the impact would be negligible. The wiiw (Stehrer, 2018) has estimated that in the EU more than 600,000 jobs, corresponding to 0.3% of total employment, depend on car imports to the U.S. Most of them are located in Germany (300,000). In CESEE, there are roughly 40,000 of such jobs in Poland, 25,000 in the Czech Republic and Hungary and 12,000 in Slovakia. The extent to which these jobs would be at risk depends very much on the elasticity of U.S. car imports vis-à-vis the price hikes, the exporting firms' pricing strategies as well as other countries' (e.g. China's) reactions.

However, the most important risk and challenge looming ahead for the automotive industry seems to lie in stricter CO<sub>2</sub> emission regulations at the EU level. While these will most certainly imply major structural changes in all countries with significant automobile industries and entail massive investments and most likely smaller margins and profits for automotive firms, the long-term effect of these shake-ups is uncertain at this stage.

To conclude, the automotive industry is a key manufacturing segment in some CESEE countries. It is closely intertwined with Germany, one of the world's leading car-producing economies. Germany is still by far the most important export and import partner for the CESEE automotive industry, even though its importance relative to other countries is stagnating or even declining. The recent slowdown in the automotive sector has been driven by several factors, many of them cyclical or one-off, so that a cyclical recovery is possible in the short run. Yet, in the medium to long run, the industry in its current form is facing big structural challenges and downside risks. Due to a particularly large exposure to Germany, any cyclical and/or structural shocks in the German economy are likely to have contagious harmful effects in the CESEE region.

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## 2 Slovakia: economic growth remains solid

Strong domestic demand drives GDP growth

Driven mainly by private consumption and gross capital formation, Slovakia's economy continued growing at a solid pace (around 4%), also in the second half of 2018. In the year as a whole, economic expansion thus accelerated almost by an entire percentage point to 4.1% compared to 2017. In the third quarter of 2018, the economy grew at the fastest rate in year-on-year terms since the end of 2015 but slowed down noticeably in the last three months of the year when the increasingly positive impact of domestic demand was more than offset by a significantly negative contribution of net exports.

The individual components of domestic demand saw a rather heterogeneous development in the second half of 2018. Private consumption growth picked up again, echoing households' rising disposable income. The latter, in turn, mirrored the ongoing positive trend in the labor market as well as moderating inflation. Public consumption growth was stimulated by municipal elections and still relatively strong wage growth in the public sector, among other factors. Fixed capital formation showed an uneven picture in the six months to December 2018. After it dropped in the third quarter as a result of weaker private investment in the car industry and a base effect, its growth recovered again in the last three months of the year. Regarding private investment, positive contributions came from renewed investment in, inter alia, car manufacturing and residential buildings. Public investment benefited from a higher absorption of EU funds. GDP growth in the second half of 2018 was also strongly affected by increases in inventories of materials and products. This can be largely ascribed to suppliers in the car industry who piled up their stocks due to weaker exports.

Looking at the external sector, we find that exports continued to be driven particularly by the car industry, although the positive effect of the launch of new car models gradually dwindled. However, the strong increase in imports toward end-2018 outpaced export growth significantly. As a result, the contribution of net exports to GDP growth was dragged into negative territory not only in the last quarter of 2018 but also in the year as a whole. In a similar vein, the goods trade balance soured in the second half of 2018. As the deficit of the primary account also widened, the current account deficit tripled between the first and the second half of 2018.

The falling trend of the general government deficit witnessed in the last decade continued in 2018 buttressed by the favorable macroeconomic situation and positive developments in the labor market. As a result, the general government debt came down to 48.9% of GDP at the end of 2018.

Labor market figures reflect robust but gradually decelerating economic growth

On the one hand, employment continued to rise and unemployment rates kept falling to new record levels. As a result, wage growth remained robust. On the other hand, however, employment and wage dynamics started to lose momentum toward the end of last year. In light of the slowing economy and weaker foreign demand, employers have become more cautious about hiring new employees, as also the declining number of vacancies suggests. After inflation followed an upward trend until August 2018, it moderated in the remainder of the year particularly as a result of a slowdown in food price hikes. At the beginning of 2019, CPI inflation steadily accelerated to 2.7% in March, fueled mainly by noncore food and energy prices.

Table 2

**Main economic indicators: Slovakia**

	2016	2017	2018	Q3 17	Q4 17	Q1 18	Q2 18	Q3 18	Q4 18
<i>Year-on-year change of the period total in %</i>									
GDP at constant prices	3.1	3.2	4.1	3.0	3.7	3.7	4.5	4.6	3.6
Private consumption	2.9	3.5	3.0	4.0	3.4	3.5	2.0	3.1	3.4
Public consumption	1.6	1.7	1.9	1.5	1.2	1.2	0.7	1.6	3.8
Gross fixed capital formation	-9.4	3.4	6.8	14.9	2.2	8.1	18.5	-5.7	9.0
Exports of goods and services	5.5	5.9	4.8	5.6	6.3	1.3	7.6	5.6	4.7
Imports of goods and services	3.4	5.3	5.3	6.9	4.1	1.1	6.6	5.4	7.8
<i>Contribution to GDP growth in percentage points</i>									
Domestic demand	1.1	2.5	4.0	3.9	1.4	3.5	3.3	3.6	5.6
Net exports of goods and services	2.0	0.7	-0.3	-0.9	2.2	0.2	1.2	0.3	-2.8
Exports of goods and services	5.1	5.5	4.7	4.8	6.1	1.3	7.3	5.0	4.7
Imports of goods and services	-3.1	-4.8	-5.0	-5.7	-3.8	-1.1	-6.1	-4.7	-7.5
<i>Year-on-year change of the period average in %</i>									
Unit labor costs in the whole economy (nominal, per person)	1.3	4.2	3.4	5.4	3.4	3.9	3.2	2.6	3.7
Unit labor costs in manufacturing (nominal, per hour)	2.5	6.2	4.3	6.6	5.5	8.5	4.6	2.3	2.4
Labor productivity in manufacturing (real, per hour)	1.5	0.8	4.7	0.5	1.0	0.5	4.9	7.2	6.3
Labor costs in manufacturing (nominal, per hour)	4.0	7.1	9.3	7.1	6.6	9.1	9.7	9.7	8.9
Producer price index (PPI) in industry	-3.9	2.5	2.4	2.3	1.9	0.9	1.6	3.6	3.6
Consumer price index (here: HICP)	-0.5	1.4	2.5	1.6	2.0	2.4	2.9	2.7	2.1
<i>Period average levels</i>									
Unemployment rate (ILO definition, %, 15–64 years)	9.7	8.2	6.6	8.0	7.8	7.2	6.7	6.4	6.1
Employment rate (%, 15–64 years)	64.9	66.2	67.6	66.4	66.4	67.1	67.1	67.9	68.2
Key interest rate per annum (%)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
<i>Nominal year-on-year change in the period-end stock in %</i>									
Loans to the domestic nonbank private sector <sup>1</sup>	10.3	10.2	8.4	11.5	10.2	9.9	9.9	9.4	8.4
of which: loans to households	13.4	11.8	11.3	12.3	11.8	12.4	12.3	12.0	11.3
loans to nonbank corporations	5.4	7.6	3.4	10.0	7.6	5.6	5.9	5.0	3.4
<i>%</i>									
Share of foreign currency loans in total loans to the nonbank private sector	0.4	0.2	0.2	0.4	0.2	0.2	0.2	0.2	0.2
Return on assets (banking sector)	1.1	0.8	0.8	0.9	0.8	0.9	0.9	0.9	0.8
Tier 1 capital ratio (banking sector)	16.2	16.6	16.5	16.5	16.6	16.4	16.3	16.7	16.5
NPL ratio (banking sector)	4.3	3.6	3.0	4.0	3.6	3.5	3.4	3.4	3.0
<i>% of GDP</i>									
General government revenues	39.2	39.4	39.9	..	..	..	..	..	..
General government expenditures	41.5	40.2	40.6	..	..	..	..	..	..
General government balance	-2.2	-0.8	-0.7	..	..	..	..	..	..
Primary balance	-0.7	0.6	0.6	..	..	..	..	..	..
Gross public debt	51.8	50.9	48.9	..	..	..	..	..	..
<i>% of GDP</i>									
Debt of nonfinancial corporations (nonconsolidated)	55.6	59.6	54.0	..	..	..	..	..	..
Debt of households and NPISHs <sup>2</sup> (nonconsolidated)	38.2	40.8	42.2	..	..	..	..	..	..
<i>% of GDP (based on EUR), period total</i>									
Goods balance	2.0	0.8	0.1	-0.8	1.0	1.2	2.0	-1.3	-1.5
Services balance	0.6	1.0	0.9	1.6	0.6	0.8	1.1	1.3	0.2
Primary income	-3.1	-2.3	-2.0	-2.5	-2.8	-1.3	-2.0	-2.2	-2.5
Secondary income	-1.7	-1.5	-1.4	-1.3	-0.8	-1.4	-2.4	-0.9	-0.8
Current account balance	-2.2	-2.0	-2.5	-3.1	-2.0	-0.7	-1.4	-3.1	-4.6
Capital account balance	2.0	0.9	1.6	0.4	1.5	0.4	1.9	0.9	3.2
Foreign direct investment (net) <sup>3</sup>	-0.8	-2.0	-0.2	-3.1	0.0	-1.2	2.3	-1.3	-0.7
<i>% of GDP (rolling four-quarter GDP, based on EUR), end of period</i>									
Gross external debt	92.2	111.0	113.3	97.6	111.0	108.1	109.6	109.7	113.3
Gross official reserves (excluding gold)	2.0	2.3	3.8	2.1	2.3	2.8	3.2	3.5	3.8
<i>Months of imports of goods and services</i>									
Gross official reserves (excluding gold)	0.3	0.3	0.5	0.3	0.3	0.4	0.4	0.4	0.5
<i>EUR million, period total</i>									
GDP at current prices	81,226	84,851	90,202	22,233	22,156	20,425	22,653	23,799	23,325

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

<sup>1</sup> Foreign currency component at constant exchange rates.<sup>2</sup> Nonprofit institutions serving households.<sup>3</sup> + = 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 Slovenia: healthy economic growth benefits budget in 2018

GDP continued to grow strongly in the second half of 2018

GDP grew by 4.5% year on year during the second half of 2018, maintaining the momentum seen in the first half. Growth relied heavily on domestic demand, but net real exports contributed around half a percentage point to the overall growth rate. Investment grew particularly strongly, reflecting lively activity in nonhousing construction and machinery and equipment. Investment activity benefited from strong albeit somewhat moderated economic sentiment, high capacity utilization, shortages of skilled labor and good corporate profitability. Household consumption growth slowed markedly in line with a modest deterioration in consumer confidence, weakening employment and wage growth, and despite persistently strong growth in household credit. Export growth slowed somewhat from the first to the second half of 2018, but as import growth decelerated even more strongly, the contribution of net real exports improved over the year.

Improved budget surplus in 2018, but fiscal loosening planned for 2019

The general government budget recorded a surplus of 0.7% of GDP in 2018, thanks to favorable macroeconomic conditions and lower interest expenditure. The public debt ratio fell to 70.1% of GDP. The 2019 budget projects a decline in the headline surplus to 0.6% of GDP. At the same time, the structural budget deficit is expected to widen from 0.4% of GDP in 2018 to 1.1% in 2019, i.e. further away from the country's medium-term objective (MTO, i.e. a surplus of 0.25% of GDP). The widening of the deficit is the result of a further relaxation of temporary crisis-related restrictive measures, a rise in public sector wages and increases in pension expenditure. Overall, the EU Commission has assessed Slovenia's 2019 budgetary plans as being at risk of a significant deviation from the recommended adjustment path to the MTO. Therefore, the authorities have been requested to take the necessary measures to ensure that the 2019 budget becomes compliant with the Stability and Growth Pact.

With respect to long-term fiscal sustainability, the government has drafted new bills to reform the healthcare and long-term care systems, but these bills – according to the EU Commission – have not specified new measures to ensure long-term sustainability. Neither have concrete measures been taken to ensure the sustainability of the pension system.

Subdued inflation and credit growth

Inflation stabilized at slightly above 2% until November 2018, before falling quickly to reach 1.2% to 1.3% by early 2019. Inflation developments were mainly driven by prices for unprocessed food and energy, while core inflation was stable at around 1% before accelerating to 1.4% to 1.5% in January and February 2019. The latest pickup in core inflation was primarily driven by industrial goods and services.

The government sold a 65% stake in the country's largest bank, Nova Ljubljanska Banka. A U.S. financial fund and the EBRD became the biggest institutional shareholders of the bank. To comply with EU regulations, the government is planning the sale of a further 10% stake (plus 1 share) by end-2019. The process of privatizing the third-largest bank, Abanka, is also on track for the mid-2019 deadline.

Banking sector profitability improved modestly in 2018, owing mainly to improved net noninterest income, but net interest income and operating costs were also slightly more favorable than in 2017. The release of provisions once again improved profitability and reflected the ongoing reduction in nonperforming exposures. Notwithstanding the favorable developments in 2018, the only modest growth of credit to the domestic private sector highlights the need for banks to find new sources of income and ways to further reduce operating costs.

Table 3

## Main economic indicators: Slovenia

	2016	2017	2018	Q3 17	Q4 17	Q1 18	Q2 18	Q3 18	Q4 18
<i>Year-on-year change of the period total in %</i>									
GDP at constant prices	3.1	4.9	4.5	4.2	6.3	4.8	4.1	5.0	4.1
Private consumption	3.9	1.9	2.2	1.6	3.1	3.9	1.9	1.3	2.1
Public consumption	2.7	0.5	2.6	-0.2	1.3	1.2	4.9	2.6	1.5
Gross fixed capital formation	-3.7	10.7	10.6	7.4	12.0	10.1	10.3	13.8	8.3
Exports of goods and services	6.4	10.7	7.2	12.1	12.7	8.0	8.6	5.4	6.8
Imports of goods and services	6.6	10.3	7.7	10.9	11.8	10.2	8.9	5.5	6.6
<i>Contribution to GDP growth in percentage points</i>									
Domestic demand	2.6	3.6	4.2	2.3	4.7	5.5	3.4	4.5	3.4
Net exports of goods and services	0.5	1.3	0.3	2.0	1.5	-0.7	0.6	0.5	0.7
Exports of goods and services	5.0	8.4	6.0	9.3	9.9	6.7	7.0	4.5	5.7
Imports of goods and services	-4.5	-7.0	-5.7	-7.3	-8.4	-7.5	-6.3	-4.0	-5.0
<i>Year-on-year change of the period average in %</i>									
Unit labor costs in the whole economy (nominal, per person)	1.8	1.2	2.5	1.9	1.2	2.4	3.5	1.1	2.8
Unit labor costs in manufacturing (nominal, per hour)	-5.3	-1.7	-1.1	-0.3	-5.3	-1.1	-3.8	-2.7	3.2
Labor productivity in manufacturing (real, per hour)	9.0	8.8	5.0	10.1	11.7	8.8	7.0	4.1	0.6
Labor costs in manufacturing (nominal, per hour)	3.3	7.0	3.8	9.8	5.7	7.6	2.9	1.3	3.8
Producer price index (PPI) in industry	-1.4	2.2	2.1	2.3	2.4	2.2	2.1	2.4	1.6
Consumer price index (here: HICP)	-0.2	1.6	1.9	1.3	1.5	1.5	2.1	2.1	2.0
<i>Period average levels</i>									
Unemployment rate (ILO definition, %, 15–64 years)	8.1	6.7	5.2	6.4	5.9	6.0	5.3	5.1	4.4
Employment rate (%, 15–64 years)	65.9	69.3	71.1	70.4	70.3	69.7	71.1	71.9	71.8
Key interest rate per annum (%)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
<i>Nominal year-on-year change in the period-end stock in %</i>									
Loans to the domestic nonbank private sector <sup>1</sup>	-2.4	4.9	1.9	7.8	4.9	4.6	3.6	1.8	1.9
of which: loans to households	3.3	6.8	6.4	7.3	6.8	6.5	6.5	5.6	6.4
loans to nonbank corporations	-7.0	3.1	-2.2	8.2	3.1	2.9	0.9	-1.7	-2.2
<i>%</i>									
Share of foreign currency loans in total loans to the nonbank private sector	3.2	2.4	2.0	2.5	2.4	2.2	2.2	1.7	2.0
Return on assets (banking sector)	0.9	1.1	1.3	1.2	1.1	1.4	1.5	1.3	1.3
Tier 1 capital ratio (banking sector)	20.2	19.4	19.4	19.7	19.4	19.8	20.2	19.4	19.4
NPL ratio (banking sector)	5.5	3.7	2.3	4.7	3.7	3.2	2.9	2.7	2.3
<i>% of GDP</i>									
General government revenues	43.4	43.2	43.1	..	..	..	..	..	..
General government expenditures	45.3	43.2	42.4	..	..	..	..	..	..
General government balance	-1.9	0.0	0.7	..	..	..	..	..	..
Primary balance	1.1	2.5	2.7	..	..	..	..	..	..
Gross public debt	78.7	74.1	70.1	..	..	..	..	..	..
<i>% of GDP</i>									
Debt of nonfinancial corporations (nonconsolidated)	60.9	55.4	51.3	..	..	..	..	..	..
Debt of households and NPISHs <sup>2</sup> (nonconsolidated)	27.4	27.1	26.9	..	..	..	..	..	..
<i>% of GDP (based on EUR), period total</i>									
Goods balance	3.8	3.6	2.5	4.4	2.7	3.1	3.7	3.1	0.2
Services balance	5.6	6.3	6.8	7.3	5.6	5.8	6.4	8.2	6.9
Primary income	-3.0	-2.2	-1.6	-2.0	-2.0	-1.3	-1.4	-2.0	-1.7
Secondary income	-0.9	-0.6	-0.8	-0.6	-0.4	-1.2	-0.6	-1.0	-0.4
Current account balance	5.5	7.2	7.0	9.1	5.9	6.4	8.1	8.3	5.0
Capital account balance	-0.8	-0.8	-0.5	-0.5	-0.5	-0.4	-0.3	-0.2	-1.0
Foreign direct investment (net) <sup>3</sup>	-2.1	-1.0	-2.5	-0.9	-1.9	-1.4	-1.3	-4.2	-2.8
<i>% of GDP (rolling four-quarter GDP, based on EUR), end of period</i>									
Gross external debt	111.0	101.9	92.5	103.3	101.9	99.5	97.8	94.1	92.5
Gross official reserves (excluding gold)	1.5	1.5	1.5	1.6	1.5	1.4	1.4	1.5	1.5
<i>Months of imports of goods and services</i>									
Gross official reserves (excluding gold)	0.3	0.2	0.2	0.3	0.2	0.2	0.2	0.2	0.2
<i>EUR million, period total</i>									
GDP at current prices	40,357	43,000	45,948	10,995	11,201	10,595	11,689	11,835	11,829

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

<sup>1</sup> Foreign currency component at constant exchange rates.<sup>2</sup> Nonprofit institutions serving households.<sup>3</sup> + = 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).



#### 4 Bulgaria: fewer exports and slowing domestic demand curb growth

Exports shrank in 2018, on an annual basis, for the first time since 2009

Bulgarian exports suffered considerably in the third quarter of 2018, on the back of decelerating economic activity in its major trading partners, and shrank on an annual basis. Domestic demand remained robust but also lost some pace compared to the first half of 2018. Against this background, GDP growth decelerated to 2.9% in the second half of 2018. A production-side view reveals that economic growth is mainly and increasingly driven by the services sector (particularly real estate and financial sectors), while the contributions of agriculture and industry are modest.

The considerable deceleration of private consumption in the fourth quarter went hand in hand with deteriorating consumer confidence and weakening real wage growth – the latter declining to about 4% on an annual basis in the fourth quarter of 2018 (compared to nearly 10% a year before). At the same time, lending to the domestic nonbank private sector – especially to households – accelerated in the review period. This prompted the Bulgarian National Bank to announce a gradual tightening of lender-based macroprudential policies.

Despite still positive wage growth, the annual HICP inflation rate has come down from the peak of 3.7% in August 2018 to 2.4% in February 2019. Alleviating price pressure was mostly due to abating service and energy price hikes, reflecting the decline in international oil prices. Processed food prices, on the other hand, have gained some additional momentum. It should also be noted that in the past 12 months, HICP inflation in Bulgaria was about 2 percentage points higher than in the three EU countries with the lowest inflation rates.

While unemployment rates have reached post-communist lows, employment rates improved only slightly throughout the year. Labor market shortages and mismatches, as also indicated by a far stronger growth of job vacancies compared to that of occupied jobs, are probably limiting production and investment. Despite still favorable capacity utilization and lending dynamics, gross fixed capital formation lost some steam in the second half of 2018. On the other hand, Bulgaria registered a comparatively strong inflow of FDI in the review period.

In line with the government's priorities of strengthening education, health and public wages, public consumption gained more momentum in the second half of the year, but, at the same time, the general government budget balance recorded a surplus in 2018 for the third consecutive year – on the back of still robust tax collection.

Measures to simultaneously join ERM II and the banking union are underway

Following Bulgaria's July 2018 application for close cooperation with the ECB in the context of the SSM, the ECB started a comprehensive assessment of the Bulgarian banking sector in November 2018 which will focus on the country's six largest banks. The results of the related asset quality review and stress tests are expected to be published in July 2019 and would be followed by the implementation of identified follow-up measures (if any). The preparation of legislative amendments to pave the way for banking union participation has been accompanied by policy measures in other areas, in line with the Action Plan approved by the Bulgarian government in August 2018. In early April 2019, the planned measures related to macroprudential and nonbanking supervision had already been implemented, while there was still some way to go in building stronger insolvency and anti-money-laundering frameworks and in reforming the governance of state-owned enterprises. The implementation of these commitments is monitored by the ECB and the European Commission in their respective areas of competence.

Table 4

**Main economic indicators: Bulgaria**

	2016	2017	2018	Q3 17	Q4 17	Q1 18	Q2 18	Q3 18	Q4 18
<i>Year-on-year change of the period total in %</i>									
GDP at constant prices	3.9	3.8	3.1	4.3	3.4	3.5	3.2	2.7	3.0
Private consumption	3.6	4.5	6.4	4.3	4.9	7.1	8.6	8.1	2.5
Public consumption	2.2	3.7	4.7	3.0	3.9	2.4	4.0	5.2	6.8
Gross fixed capital formation	-6.6	3.2	6.5	0.5	5.6	10.9	7.0	3.0	6.7
Exports of goods and services	8.1	5.8	-0.8	7.0	3.9	1.1	-2.3	-3.2	2.2
Imports of goods and services	4.5	7.5	3.7	5.9	8.6	4.6	4.9	3.8	1.6
<i>Contribution to GDP growth in percentage points</i>									
Domestic demand	1.6	4.6	5.9	3.0	6.0	6.3	8.0	6.9	2.8
Net exports of goods and services	2.3	-0.8	-2.8	1.5	-2.6	-2.6	-4.8	-4.6	0.3
Exports of goods and services	5.2	3.7	-0.5	4.9	2.2	0.8	-1.6	-2.3	1.3
Imports of goods and services	-2.9	-4.5	-2.3	-3.3	-4.8	-3.4	-3.2	-2.2	-0.9
<i>Year-on-year change of the period average in %</i>									
Unit labor costs in the whole economy (nominal, per person)	2.5	8.1	2.4	10.2	10.9	3.3	2.3	1.4	2.4
Unit labor costs in manufacturing (nominal, per hour)	6.5	1.0	7.0	2.2	2.1	6.8	8.7	5.9	6.5
Labor productivity in manufacturing (real, per hour)	2.9	11.1	2.6	10.5	11.5	3.4	1.6	4.4	1.0
Labor costs in manufacturing (nominal, per hour)	9.5	12.2	9.7	12.9	13.8	10.4	10.5	10.6	7.6
Producer price index (PPI) in industry	-3.1	4.9	4.0	5.2	5.1	3.1	5.1	4.1	3.5
Consumer price index (here: HICP)	-1.3	1.2	2.6	0.9	1.7	1.6	2.4	3.6	3.0
EUR per 1 BGN, + = BGN appreciation	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
<i>Period average levels</i>									
Unemployment rate (ILO definition, %, 15–64 years)	7.7	6.3	5.3	5.9	5.7	5.8	5.5	5.0	4.7
Employment rate (%, 15–64 years)	63.4	66.9	67.7	68.5	67.5	66.5	67.9	68.8	67.7
Key interest rate per annum (%) <sup>1</sup>	..	..	..	..	..	..	..	..	..
BGN per 1 EUR	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
<i>Nominal year-on-year change in the period-end stock in %</i>									
Loans to the domestic nonbank private sector <sup>2</sup>	1.6	4.8	8.3	5.0	4.8	5.6	6.8	7.3	8.3
of which: loans to households	2.0	6.1	11.2	6.0	6.1	6.4	9.2	9.7	11.2
loans to nonbank corporations	1.3	4.1	6.7	4.4	4.1	5.1	5.4	5.9	6.7
%									
Share of foreign currency loans in total loans to the nonbank private sector	44.4	37.9	34.9	39.7	37.9	37.0	36.3	35.6	34.9
Return on assets (banking sector)	1.4	1.2	1.7	1.2	1.2	1.1	1.6	1.6	1.7
Tier 1 capital ratio (banking sector)	20.9	20.9	19.4	21.0	20.9	19.8	19.7	19.0	19.4
NPL ratio (banking sector)	9.0	6.9	5.1	8.1	6.9	6.6	6.6	6.1	5.1
%									
General government revenues	35.2	36.2	36.8	..	..	..	..	..	..
General government expenditures	35.1	35.0	34.8	..	..	..	..	..	..
General government balance	0.1	1.2	2.0	..	..	..	..	..	..
Primary balance	1.0	2.0	2.7	..	..	..	..	..	..
Gross public debt	29.6	25.6	22.6	..	..	..	..	..	..
%									
Debt of nonfinancial corporations (nonconsolidated)	91.4	86.3	81.7	..	..	..	..	..	..
Debt of households and NPISHs <sup>3</sup> (nonconsolidated)	23.2	22.9	23.4	..	..	..	..	..	..
<i>% of GDP (based on EUR), period total</i>									
Goods balance	-2.1	-1.5	-4.1	1.6	-4.0	-5.6	-5.2	-1.7	-4.4
Services balance	6.4	5.5	6.2	13.0	1.6	2.7	5.5	12.8	2.7
Primary income	-5.0	-4.6	-1.0	-3.9	-4.1	-1.7	-1.5	-0.8	-0.3
Secondary income	3.3	3.6	3.5	4.3	2.0	4.6	3.1	4.5	2.2
Current account balance	2.6	3.1	4.6	15.0	-4.5	0.1	1.9	14.8	0.2
Capital account balance	2.2	1.0	1.1	1.0	1.3	0.0	1.4	1.6	1.0
Foreign direct investment (net) <sup>4</sup>	-1.3	-3.9	-2.6	-1.7	-8.4	0.6	-0.3	-3.4	-6.1
<i>% of GDP (rolling four-quarter GDP, based on EUR), end of period</i>									
Gross external debt	79.3	72.4	66.7	73.6	72.4	71.3	70.8	69.8	66.7
Gross official reserves (excluding gold)	46.7	43.1	42.8	45.6	43.1	40.5	41.6	42.7	42.8
<i>Months of imports of goods and services</i>									
Gross official reserves (excluding gold)	9.4	8.2	8.2	8.8	8.2	7.7	7.9	8.1	8.2
<i>EUR million, period total</i>									
GDP at current prices	48,129	51,663	55,182	14,072	14,441	11,240	13,451	15,248	15,243

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

<sup>1</sup> Not available in a currency board regime.<sup>2</sup> Foreign currency component at constant exchange rates.<sup>3</sup> Nonprofit institutions serving households.<sup>4</sup> + = 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 Croatia: mild growth slowdown, but lower imbalances

Mildly lower growth  
due to weak  
external demand,  
investments have  
picked up

GDP growth in Croatia decelerated in the second half of 2018 and reached 2.6% for the full year. Private consumption grew by 3.5% in 2018, benefiting from positive labor market developments and accelerated credit growth. Investment growth accelerated in the second half of the year and reached 4.1% in 2018. EU fund absorption is a key factor supporting investments but it remained low compared to levels seen in CESEE peer countries. The manufacturing sector contracted in 2018, but construction rebounded and reported the highest growth rate since 2008.

The performance of net exports remained weak in the second half of 2018, leading to a substantial increase in their negative contribution to growth compared to 2017. Export growth decelerated sharply in 2018 compared to previous years, largely due to a contraction of exports of chemicals, machinery and transport equipment to non-EU countries. The current account surplus stood at 2.6% of GDP in 2018 compared to 3.7% of GDP a year earlier. After years of double-digit growth rates in the tourism sector, the expansion moderated in 2018 – most likely due to a recovery of tourist arrivals in nearby competitor countries.

Unfavorable  
developments in the  
shipbuilding sector,  
but only limited risks

In 2018, Uljanik Group – one of Croatia's largest shipbuilding companies with roughly 4,200 employees – reported severe financial difficulties. According to the Finance Minister, between 2010 and 2018, the government had provided state guarantees of roughly HRK 7.5 billion (2% of GDP) for the company. In 2018, it made related payments of HRK 2.4 billion and stated that further payments would follow in 2019. It is not yet clear how the situation of Uljanik Group will be resolved.

Imbalances no  
longer “excessive” –  
upgrade to  
investment grade

The general budget balance showed a surplus of 0.2% of GDP in 2018 – well above the targeted deficit of 0.5% of GDP. The extraordinary payments related to Uljanik Group were offset by higher than expected revenues from VAT tax, contributions, excises and income tax. The gross public debt level continued to decline to 73.5% of GDP in 2018 from 77.5% at end-2017. Over the same period, Croatia's external debt declined from 82.1% to 75.4% of GDP. Positive developments are expected to continue, especially since the Croatian government is planning to send a letter of intent to join the exchange rate mechanism II before mid-2019. In early 2019, the European Commission reclassified Croatia as facing “imbalances” instead of “excessive imbalances” within the framework of its European Semester, and Standard & Poor's upgraded Croatia's sovereign rating to investment grade.

HNB continues  
expansionary stance  
as inflation remains  
low

HICP inflation peaked at around 2.2% in July 2018 but decelerated toward 1% in December 2018, largely due to energy price developments. Core inflation averaged around 1.1% throughout 2018. Surplus kuna liquidity in the banking sector increased to HRK 29.2 billion in 2018. Throughout 2018, Hrvatska narodna banka (HNB) purchased EUR 1.8 billion from the banking sector to counteract appreciation pressures on the kuna, leading to increases in gross international reserves to EUR 18.5 billion in January 2019 (roughly 9 months of imports). Banking sector claims on nonfinancial enterprises continued to contract in 2018, but at a slower pace. Growth of lending to households picked up. In February 2019, the HNB started to tighten lending standards for nonhousing consumer loans, which had been growing at a particularly rapid pace. The return on assets of the Croatian banking system was 1.2% in 2018 and capitalization remained among the highest in the region. The nonperforming loan ratio decreased to 9.8% in 2018.

Table 5

**Main economic indicators: Croatia**

	2016	2017	2018	Q3 17	Q4 17	Q1 18	Q2 18	Q3 18	Q4 18
<i>Year-on-year change of the period total in %</i>									
GDP at constant prices	3.5	2.9	2.6	3.4	2.2	2.5	2.9	2.8	2.3
Private consumption	3.5	3.6	3.5	3.7	3.4	3.9	3.6	2.7	3.9
Public consumption	0.7	2.7	2.9	3.1	3.4	2.8	2.5	3.9	2.3
Gross fixed capital formation	6.5	3.8	4.1	3.7	1.9	3.6	3.1	3.7	6.1
Exports of goods and services	5.6	6.4	2.8	5.6	3.8	-0.5	5.6	3.7	1.3
Imports of goods and services	6.2	8.1	5.5	8.3	6.8	5.5	4.7	5.1	6.6
<i>Contribution to GDP growth in percentage points</i>									
Domestic demand	3.7	3.5	3.8	3.4	3.7	5.9	2.8	2.1	5.0
Net exports of goods and services	-0.1	-0.6	-1.2	0.1	-1.5	-3.1	0.2	0.2	-2.7
Exports of goods and services	2.7	3.1	1.5	3.7	1.7	-0.2	2.6	2.5	0.6
Imports of goods and services	-2.8	-3.7	-2.7	-3.6	-3.1	-2.9	-2.3	-2.3	-3.2
<i>Year-on-year change of the period average in %</i>									
Unit labor costs in the whole economy (nominal, per person)	..	..	..	..	..	..	..	..	..
Unit labor costs in manufacturing (nominal, per hour)	-3.1	2.1	7.6	0.9	2.0	4.0	10.9	9.1	6.9
Labor productivity in manufacturing (real, per hour)	7.0	3.5	2.2	4.7	2.3	2.5	3.7	1.5	1.1
Labor costs in manufacturing (nominal, per hour)	4.2	5.5	10.1	5.7	4.3	6.5	15.1	10.8	8.1
Producer price index (PPI) in industry	-4.3	2.0	2.2	1.8	2.2	1.1	2.5	3.8	1.6
Consumer price index (here: CPI)	-0.6	1.3	1.6	1.4	1.5	1.1	1.8	2.0	1.3
EUR per 1 HRK, + = HRK appreciation	1.1	0.9	0.6	0.9	-0.1	0.4	0.4	0.1	1.5
<i>Period average levels</i>									
Unemployment rate (ILO definition, %, 15–64 years)	13.3	11.3	8.6	9.1	11.0	10.5	7.7	7.4	8.7
Employment rate (%, 15–64 years)	56.9	58.9	60.7	61.0	59.6	59.0	61.1	61.9	60.6
Key interest rate per annum (%)	..	..	..	..	..	..	..	..	..
HRK per 1 EUR	7.5	7.5	7.4	7.4	7.5	7.4	7.4	7.4	7.4
<i>Nominal year-on-year change in the period-end stock in %</i>									
Loans to the domestic nonbank private sector <sup>1</sup>	-3.7	0.6	2.4	-0.0	0.6	0.0	2.2	1.8	2.4
of which: loans to households	-4.6	2.2	4.7	0.7	2.2	2.3	4.0	4.3	4.7
loans to nonbank corporations	-2.6	-1.6	-0.8	-0.9	-1.6	-3.0	-0.3	-1.4	-0.8
<i>%</i>									
Share of foreign currency loans in total loans to the nonbank private sector	60.1	56.9	54.7	57.7	56.9	56.1	55.5	55.5	54.7
Return on assets (banking sector)	1.3	0.9	1.2	0.7	0.9	1.4	1.5	1.5	1.2
Tier 1 capital ratio (banking sector)	21.3	22.3	21.8	21.3	22.3	21.6	21.4	21.1	21.8
NPL ratio (banking sector)	13.8	11.3	9.8	12.5	11.3	11.4	11.2	10.3	9.8
<i>% of GDP</i>									
General government revenues	46.0	45.8	45.1	..	..	..	..	..	..
General government expenditures	46.9	45.0	44.9	..	..	..	..	..	..
General government balance	-0.9	0.9	0.2	..	..	..	..	..	..
Primary balance	2.1	3.5	2.7	..	..	..	..	..	..
Gross public debt	80.2	77.5	73.5	..	..	..	..	..	..
<i>% of GDP</i>									
Debt of nonfinancial corporations (nonconsolidated)	96.3	94.9	88.9	..	..	..	..	..	..
Debt of households and NPISHs <sup>2</sup> (nonconsolidated)	35.0	34.2	34.1	..	..	..	..	..	..
<i>% of GDP (based on EUR), period total</i>									
Goods balance	-15.8	-16.8	-18.0	-15.8	-14.3	-20.9	-18.3	-15.9	-17.5
Services balance	18.7	19.0	19.1	43.2	5.3	2.8	18.8	43.4	6.3
Primary income	-3.2	-1.8	-1.8	-2.2	0.3	-2.4	-2.5	-2.4	0.2
Secondary income	2.9	3.2	3.4	2.6	3.9	3.0	3.5	2.8	4.2
Current account balance	2.6	3.7	2.6	27.8	-4.9	-17.5	1.5	27.9	-6.8
Capital account balance	1.4	1.0	1.4	0.7	0.9	1.0	1.4	1.0	2.1
Foreign direct investment (net) <sup>3</sup>	-4.2	-2.4	-1.3	-2.4	-3.7	-3.7	-3.3	0.3	0.9
<i>% of GDP (rolling four-quarter GDP, based on EUR), end of period</i>									
Gross external debt	89.3	82.1	75.4	81.9	82.1	82.3	80.5	76.8	75.4
Gross official reserves (excluding gold)	29.0	32.1	33.9	30.8	32.1	33.3	33.3	32.7	33.9
<i>Months of imports of goods and services</i>									
Gross official reserves (excluding gold)	7.6	7.8	8.0	7.6	7.8	8.1	8.0	7.8	8.0
<i>EUR million, period total</i>									
GDP at current prices	46,656	48,999	51,473	13,746	12,107	11,297	13,004	14,414	12,758

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

<sup>1</sup> Foreign currency component at constant exchange rates.<sup>2</sup> Nonprofit institutions serving households.<sup>3</sup> + = 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 Czech Republic: economic boom is gradually losing steam

Economic growth  
has moderated  
toward its potential

After 2017 had seen the second-strongest GDP expansion in a decade, real economic growth gradually lost steam during 2018. It thus averaged around 3% in the second half of 2018, similar to the growth dynamics observed in the first half of the year. As a result, the previously positive output gap has been largely closed according to estimates by the Czech National Bank (CNB). As external demand remains relatively weak, the negative contribution of net exports to GDP growth stayed roughly unchanged in the second half of 2018. The main driver of the economic expansion in that period was still domestic demand even though it lost some momentum. Household consumption continued to grow at a solid but declining pace, being kept afloat by strong yet plateaued growth in disposable income. Despite a recent slight decline, consumer confidence remains solid by long-term standards. Real public consumption growth halved in the second half of 2018 on the back of fast growth in public wages. The single most important demand side component contributing to economic growth was fixed investment, which continued to edge up. This was largely thanks to strengthening growth in public investment on the back of a higher drawdown of EU funds. In addition, private fixed capital formation benefited from still strong domestic demand as well as firms' determination to counteract the short labor supply by investing in automation. While demand for housing has been dampened by tighter lending conditions, growth in household investment remained relatively strong.

The current account balance turned negative in the second half of 2018. This was brought about particularly by a lower surplus of the trade and services balance on the one hand and a strong outflow of dividends in the primary income balance on the other. The fiscal surplus recorded in 2017 moderated somewhat as the rising wage and investment bill of the government was not fully offset by increased revenues thanks to buoyant economic growth. As a result of strong GDP dynamics, gross public debt declined by some 2 percentage points to 32.7% of GDP in 2018.

Labor market still  
tight but the peak of  
the cycle looks near

While the labor market situation remains tight with historically high employment levels and the lowest unemployment rate in the EU, the currently tight labor market might be approaching the tipping point of its cycle. Overall, employment growth has started to slow down and has even turned negative in some sectors. Nonetheless, the record-high number of vacancies in combination with an all-time low number of unemployed persons has resulted in significant real wage hikes (5% in 2018 year on year). Strong consumer demand and wage dynamics have only partially been transmitted to core and headline inflation. Despite the tense labor market, the increase in core inflation has been relatively moderate and it has been counteracted by falling inflation of food and fuel prices. As a result, consumer price inflation kept on hovering around the CNB's target (2%  $\pm$  1 percentage points) in the second half of 2018. Most recently, headline inflation ticked up to 2.4% in February thanks to both core and noncore factors. However, the CNB expects headline inflation to return to the target level of 2% soon, after the temporary increase in early 2019, and stay on target over the monetary policy horizon (about 12–18 months ahead). Against this background, the pace of monetary policy tightening has slowed down. The most recent hike of the key policy rate by 25 basis points (to 1.75%) took place on November 1, 2018.

Table 6

## Main economic indicators: Czech Republic

	2016	2017	2018	Q3 17	Q4 17	Q1 18	Q2 18	Q3 18	Q4 18
<i>Year-on-year change of the period total in %</i>									
GDP at constant prices	2.5	4.4	2.9	5.0	5.0	3.5	2.6	2.5	3.0
Private consumption	3.6	4.3	3.2	4.4	4.4	4.1	3.4	2.8	2.4
Public consumption	2.7	1.3	3.7	0.6	0.9	2.8	3.0	5.2	3.6
Gross fixed capital formation	-3.1	3.7	10.5	5.0	5.0	9.3	10.3	11.3	10.9
Exports of goods and services	4.3	6.7	4.5	6.7	7.8	4.0	4.2	4.1	5.7
Imports of goods and services	2.8	5.9	6.0	6.4	8.1	6.0	5.4	6.4	6.3
<i>Contribution to GDP growth in percentage points</i>									
Domestic demand	1.0	3.3	3.6	4.3	4.6	4.7	3.1	3.7	3.1
Net exports of goods and services	1.4	1.1	-0.7	0.7	0.3	-1.1	-0.5	-1.3	-0.1
Exports of goods and services	3.5	5.3	3.6	5.0	6.2	3.4	3.4	3.1	4.5
Imports of goods and services	-2.1	-4.3	-4.3	-4.3	-5.9	-4.5	-3.8	-4.4	-4.7
<i>Year-on-year change of the period average in %</i>									
Unit labor costs in the whole economy (nominal, per person)	3.1	3.5	6.2	3.1	3.3	6.5	6.9	6.7	4.9
Unit labor costs in manufacturing (nominal, per hour)	2.6	0.6	5.2	2.1	0.0	4.0	6.9	4.8	5.0
Labor productivity in manufacturing (real, per hour)	2.1	6.5	3.4	5.3	6.3	4.3	2.9	2.9	3.4
Labor costs in manufacturing (nominal, per hour)	4.9	7.0	8.7	7.5	6.3	8.5	10.0	7.9	8.5
Producer price index (PPI) in industry	-3.2	0.8	0.7	0.1	-0.9	-2.4	-0.2	2.2	3.2
Consumer price index (here: HICP)	0.6	2.4	2.0	2.4	2.5	1.7	2.1	2.3	1.8
EUR per 1 CZK, + = CZK appreciation	0.9	2.7	2.7	3.6	5.4	6.4	3.7	1.4	-0.8
<i>Period average levels</i>									
Unemployment rate (ILO definition, %, 15–64 years)	4.0	2.9	2.3	2.8	2.4	2.4	2.2	2.4	2.1
Employment rate (%, 15–64 years)	72.0	73.6	74.8	74.1	74.3	74.2	74.7	75.0	75.4
Key interest rate per annum (%)	0.1	0.2	1.1	0.2	0.4	0.7	0.8	1.2	1.7
CZK per 1 EUR	27.0	26.3	25.6	26.1	25.6	25.4	25.6	25.7	25.9
<i>Nominal year-on-year change in the period-end stock in %</i>									
Loans to the domestic nonbank private sector <sup>1</sup>	7.8	6.9	6.8	8.8	6.9	6.7	6.3	6.6	6.8
of which: loans to households	7.2	7.5	7.5	7.7	7.5	7.6	7.5	7.6	7.5
loans to nonbank corporations	8.5	6.2	5.8	10.1	6.2	5.6	4.9	5.4	5.8
<i>%</i>									
Share of foreign currency loans in total loans to the nonbank private sector	13.0	13.3	14.1	15.2	13.3	14.5	14.8	15.3	14.1
Return on assets (banking sector)	1.3	1.1	1.1	1.2	1.1	1.0	1.2	1.1	1.1
Tier 1 capital ratio (banking sector)	17.9	18.7	19.1	18.0	18.7	18.1	18.3	18.3	19.1
NPL ratio (banking sector)	4.6	3.7	3.1	3.8	3.7	3.4	3.3	3.2	3.1
<i>% of GDP</i>									
General government revenues	40.2	40.5	41.7	..	..	..	..	..	..
General government expenditures	39.5	38.9	40.8	..	..	..	..	..	..
General government balance	0.7	1.6	0.9	..	..	..	..	..	..
Primary balance	1.6	2.3	1.7	..	..	..	..	..	..
Gross public debt	36.8	34.7	32.7	..	..	..	..	..	..
<i>% of GDP</i>									
Debt of nonfinancial corporations (nonconsolidated)	58.5	58.1	57.0	..	..	..	..	..	..
Debt of households and NPISHs <sup>2</sup> (nonconsolidated)	31.2	32.6	32.2	..	..	..	..	..	..
<i>% of GDP (based on EUR), period total</i>									
Goods balance	5.2	4.7	4.1	3.3	2.8	6.6	5.1	2.3	2.6
Services balance	2.3	2.4	2.3	2.4	2.2	2.6	2.7	1.7	2.1
Primary income	-5.3	-5.2	-5.3	-7.3	-4.8	-3.3	-6.4	-7.1	-4.2
Secondary income	-0.6	-0.9	-0.8	-1.1	-0.2	-1.7	-1.0	-0.8	0.3
Current account balance	1.6	1.0	0.3	-2.7	-0.1	4.2	0.4	-3.9	0.8
Capital account balance	1.1	0.9	0.3	0.6	2.2	0.1	-0.1	0.3	0.7
Foreign direct investment (net) <sup>3</sup>	-3.9	-2.7	-1.7	-0.9	-2.6	0.6	-2.0	-2.8	-2.5
<i>% of GDP (rolling four-quarter GDP, based on EUR), end of period</i>									
Gross external debt	73.4	89.1	81.9	92.5	89.1	85.6	82.6	82.5	81.9
Gross official reserves (excluding gold)	45.9	64.1	60.0	66.7	64.1	61.4	61.2	60.1	60.0
<i>Months of imports of goods and services</i>									
Gross official reserves (excluding gold)	7.7	10.7	10.0	11.0	10.7	10.3	10.4	10.1	10.0
<i>EUR million, period total</i>									
GDP at current prices	176,368	192,000	206,778	49,438	52,008	48,268	51,904	52,398	54,207

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

<sup>1</sup> Foreign currency component at constant exchange rates.<sup>2</sup> Nonprofit institutions serving households.<sup>3</sup> + = 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: turning cycles

GDP growth in the second half of 2018 highest since 2004

GDP grew by 5.1% in the second half of 2018, the highest growth rate recorded since 2004. Domestic demand remained the driving factor and accelerated sharply compared to the first half of 2018. Investments expanded by close to 20% during the second half of 2018 on the back of strong construction activity and EU fund disbursement. In addition, high capacity utilization, robust economic sentiment and the acceleration of corporate credit growth were supportive as well. Private consumption growth slowed modestly but was still expanding at around 5%, reflecting similar trends in consumer confidence and real wage growth and underpinned by accelerated credit growth and still rising employment. The contribution of net real exports became more strongly negative than during the first half of 2018 as export growth slowed amid a simultaneous acceleration of imports.

2018 budget deficit smaller than predicted, but measures to reduce structural budget deficits required

In November 2018, the EU Council concluded that Hungary had not taken effective action in response to its Recommendation of mid-2018 in the framework of the Significant Deviation Procedure. Therefore, the Council reiterated its recommendation for the needed structural adjustment of 1% of GDP for 2019 and gave Hungary time until mid-April 2019 to report on planned measures.

The 2018 budget deficit amounted to 2.2% of GDP and was thus lower than previously planned and estimated (2.4% of GDP). Public debt decreased to 70.8% of GDP, its lowest level in a decade. For 2019, the government plans a budget deficit of 1.8% of GDP. It remains to be seen whether the government is ready to implement the additional measures required by the EU Council. Instead, it will likely proceed with its economic policy priorities, such as the new “Family Protection Plan,” announced in mid-February 2019. In late February, the government also presented a set of measures to enhance Hungary’s competitiveness (Programme for a more competitive Hungary). According to the EU Commission’s assessment, Hungary made limited progress in addressing the country-specific recommendations issued by the EU Council to Hungary in 2018, which covered some of the areas targeted by the competitiveness strategy.

MNB tightened policy in March 2019

The period between September 2018 and February 2019 was characterized by volatile inflation developments, with annual changes in the HICP temporarily climbing to 3.9%, i.e. well above the mid-point target of the central bank (3%  $\pm$  1 percentage point). Responding to the volatility in headline inflation, the Hungarian central bank (MNB), in its communication, gradually put more emphasis on its own measure of core inflation, which excludes indirect tax effects and which also gradually increased from the beginning of 2018 to reach 3.2% by February 2019. In March 2019, MNB therefore hiked its overnight deposit rate by 10 basis points to –0.5% and decided to modestly reduce the volume of its HUF liquidity-providing FX swaps. At the same time, it announced the start of a new corporate bond purchase program from mid-2019 onward, complementing its “Funding for Growth Scheme Fix,” which had been launched at the beginning of 2019 (to raise the share of long-term fixed-interest loans in total lending to small and medium-sized enterprises (SMEs). The two programs should bolster lending to businesses further, which had already sharply accelerated during the second half of 2018. Growth of credit to the household sector also picked up notably, mainly on the back of housing loans. Considering the further expansion of state housing subsidies, housing loans can be expected to grow dynamically in 2019 as well.

Table 7

## Main economic indicators: Hungary

	2016	2017	2018	Q3 17	Q4 17	Q1 18	Q2 18	Q3 18	Q4 18
<i>Year-on-year change of the period total in %</i>									
GDP at constant prices	2.3	4.1	4.9	4.1	4.5	4.6	4.9	5.1	5.1
Private consumption	4.0	4.8	5.4	5.0	5.6	5.8	5.5	5.3	5.0
Public consumption	0.7	1.3	-0.5	2.8	6.4	1.6	-0.2	-0.1	-3.1
Gross fixed capital formation	-11.7	18.2	16.5	18.8	11.6	10.5	15.6	20.0	17.2
Exports of goods and services	5.1	4.7	4.7	3.1	5.4	4.0	7.1	2.3	5.6
Imports of goods and services	3.9	7.7	7.1	7.8	7.0	5.3	8.5	6.2	8.2
<i>Contribution to GDP growth in percentage points</i>									
Domestic demand	0.9	6.1	6.5	7.4	5.3	5.4	5.5	8.0	6.7
Net exports of goods and services	1.4	-1.9	-1.5	-3.3	-0.8	-0.8	-0.6	-2.9	-1.7
Exports of goods and services	4.5	4.2	4.2	2.7	4.5	3.8	6.3	2.0	4.7
Imports of goods and services	-3.1	-6.2	-5.7	-6.0	-5.4	-4.6	-6.9	-4.9	-6.3
<i>Year-on-year change of the period average in %</i>									
Unit labor costs in the whole economy (nominal, per person)	5.3	4.0	6.8	4.5	3.9	10.2	6.5	5.7	4.8
Unit labor costs in manufacturing (nominal, per hour)	8.6	5.8	7.6	7.5	5.5	7.9	6.7	8.4	7.3
Labor productivity in manufacturing (real, per hour)	-2.7	2.4	1.6	1.0	2.2	1.5	2.0	0.8	2.0
Labor costs in manufacturing (nominal, per hour)	5.6	8.3	9.2	8.6	7.8	9.5	8.8	9.3	9.4
Producer price index (PPI) in industry	-1.7	3.3	5.6	2.6	4.3	3.6	5.3	7.9	5.5
Consumer price index (here: HICP)	0.4	2.4	2.9	2.5	2.3	2.0	2.8	3.5	3.3
EUR per 1 HUF, + = HUF appreciation	-0.5	0.7	-3.0	1.5	-0.7	-0.6	-2.3	-5.4	-3.5
<i>Period average levels</i>									
Unemployment rate (ILO definition, %, 15–64 years)	5.2	4.2	3.8	4.1	3.8	3.9	3.6	3.9	3.6
Employment rate (%, 15–64 years)	66.5	68.2	69.3	68.7	68.8	68.7	69.3	69.5	69.5
Key interest rate per annum (%)	1.0	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9
HUF per 1 EUR	311.5	309.3	318.8	306.5	311.7	311.1	317.1	324.1	323.0
<i>Nominal year-on-year change in the period-end stock in %</i>									
Loans to the domestic nonbank private sector <sup>1</sup>	-0.0	4.3	9.9	4.1	4.3	4.5	6.6	9.1	9.9
of which: loans to households	-2.8	1.3	5.8	1.6	1.3	-0.1	2.1	3.2	5.8
loans to nonbank corporations	2.3	6.8	13.1	6.3	6.8	8.3	10.1	13.7	13.1
<i>%</i>									
Share of foreign currency loans in total loans to the nonbank private sector	22.4	23.5	24.0	23.1	23.5	23.5	24.7	24.1	24.0
Return on assets (banking sector)	1.3	1.8	1.4	1.8	1.8	1.7	1.6	1.5	1.4
Tier 1 capital ratio (banking sector)	19.2	21.1	17.8	19.6	21.1	20.2	19.3	19.2	17.8
NPL ratio (banking sector)	5.6	3.7	2.2	4.1	3.7	3.1	2.8	2.6	2.2
<i>% of GDP</i>									
General government revenues	45.1	44.7	44.2	..	..	..	..	..	..
General government expenditures	46.8	46.9	46.5	..	..	..	..	..	..
General government balance	-1.6	-2.2	-2.2	..	..	..	..	..	..
Primary balance	1.5	0.6	0.2	..	..	..	..	..	..
Gross public debt	76.0	73.4	70.8	..	..	..	..	..	..
<i>% of GDP</i>									
Debt of nonfinancial corporations (nonconsolidated)	71.8	67.3	66.5	..	..	..	..	..	..
Debt of households and NPISHs <sup>2</sup> (nonconsolidated)	20.4	18.7	17.8	..	..	..	..	..	..
<i>% of GDP (based on EUR), period total</i>									
Goods balance	4.0	1.5	-1.1	0.6	0.7	0.8	0.5	-3.8	-1.4
Services balance	5.9	5.9	5.8	7.0	4.7	5.5	6.5	6.7	4.6
Primary income	-2.5	-4.1	-3.8	-3.7	-3.9	-3.3	-5.0	-3.8	-3.3
Secondary income	-1.3	-0.6	-0.4	-0.9	-0.8	-0.8	-0.2	0.2	-0.9
Current account balance	6.2	2.8	0.5	3.0	0.7	2.2	1.8	-0.7	-1.0
Capital account balance	-0.0	1.1	1.8	0.5	1.4	2.4	2.4	1.2	1.2
Foreign direct investment (net) <sup>3</sup>	-2.0	-1.5	-2.8	-3.0	-3.5	-1.2	-0.7	-6.1	-3.0
<i>% of GDP (rolling four-quarter GDP, based on EUR), end of period</i>									
Gross external debt	97.3	85.2	80.6	89.5	85.2	83.1	82.7	81.4	80.6
Gross official reserves (excluding gold)	21.4	18.8	19.9	18.3	18.8	18.2	18.6	18.2	19.9
<i>Months of imports of goods and services</i>									
Gross official reserves (excluding gold)	3.2	2.8	2.9	2.7	2.8	2.7	2.8	2.7	2.9
<i>EUR million, period total</i>									
GDP at current prices	113,933	124,023	131,821	32,069	34,262	29,496	32,665	33,471	36,189

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

<sup>1</sup> Foreign currency component at constant exchange rates.<sup>2</sup> Nonprofit institutions serving households.<sup>3</sup> + = 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: fiscal policy in the focus ahead of elections in fall

Signs that growth has remained strong in early 2019

GDP growth accelerated to 5.1% in 2018, with quarter-on-quarter growth at 1.6% in the third quarter before falling to only 0.5% in the final quarter. Total final demand growth decelerated as the higher contribution of domestic demand only partially offset the smaller contribution of export growth. Accelerating import growth in the second half of 2018 pushed the external sector's growth contribution into slightly negative territory in the full year 2018. Accordingly, the current account balance slipped into deficit in 2018. This resulted from the deterioration of the goods balance. Strong EU-fund utilization contributed to an increase in the capital account surplus to 2.0% of GDP. Net FDI inflows rose to 1.8% of GDP. Fixed investment growth accelerated in the second half of 2018, while the contribution of the inventory buildup decreased markedly. Business investment was still supported by strong demand, high capacity utilization rates, a stable liquidity position and low real lending rates, while growth of unit labor costs in the manufacturing sector accelerated and profitability marginally declined after mid-year 2018 and industrial confidence continued to erode slightly up to early 2019. However, after a slowdown toward the end of 2018, industrial production rose strongly in early 2019. Housing investment, as indicated by the number of dwellings under construction, accelerated further, benefiting from income and financing conditions. Private consumption growth in line with GDP growth was supported by unabated real wage and employment growth, higher real pensions growth and strong consumer confidence, which recovered in early 2019 after a temporary weakening in late 2018.

Stable external price competitiveness and increasing core inflation in the second half of 2018

In the second half of 2018, given rising ULC growth in the euro area, the manufacturing ULC growth differential shrank markedly, which together with modest nominal depreciation of the zloty in euro terms led to a halt of real appreciation. In February, annual headline inflation stood at 1.3% (HICP) and 1.2% (national CPI), while core inflation stood at 1.5% (HICP excluding energy and unprocessed food) and 1.0% (CPI excluding energy and all food). Both core figures show an increase that accelerated in early 2019. The Polish Monetary Policy Council (MPC), pursuing an inflation target of 2.5% (CPI), has kept its policy rate steady at 1.5% since March 2015. On April 3, 2019, it assessed that inflation will stay close to the target in the monetary policy transmission horizon and that the current level of interest rates is conducive to keeping the economy on a sustainable growth path.

No fiscal consolidation but a stimulus package ahead of parliamentary elections in autumn

The gross general government deficit amounted to 0.4% of GDP in 2018. For 2019, the European Commission forecasts 0.9% of GDP, as a result of higher revenues outpacing the rise of expenditures on the back of higher public investment. By contrast, the structural deficit is forecast at 2.0% of GDP in 2019. This implies a structural primary deficit of 0.5% of GDP and a persistent deviation from the medium-term objective of a structural deficit of 1% of GDP, even though in June 2018, the Council had recommended that the Polish government take action to ensure a structural adjustment of 0.6% of GDP by 2019. General government gross debt is expected to reach 48.3% of GDP at end-2019 according to the European Commission, after 50.6% of GDP at end-2017. At the end of February 2019, the ruling party announced a fiscal stimulus package to the tune of about 1% of GDP in 2019 and 1.5% in 2020, which will be difficult to reconcile with the national expenditure rule. Parliamentary elections will be held before mid-November 2019.

Table 8

## Main economic indicators: Poland

	2016	2017	2018	Q3 17	Q4 17	Q1 18	Q2 18	Q3 18	Q4 18
<i>Year-on-year change of the period total in %</i>									
GDP at constant prices	3.1	4.8	5.1	5.4	4.6	5.1	5.1	5.7	4.6
Private consumption	3.9	4.9	4.5	4.8	5.0	3.9	4.6	4.4	5.2
Public consumption	1.9	3.5	3.6	3.7	4.5	2.8	3.1	4.1	4.1
Gross fixed capital formation	-8.2	3.9	7.3	4.0	6.3	8.4	5.1	10.3	6.1
Exports of goods and services	8.8	9.5	6.2	10.4	10.1	3.4	7.9	5.5	7.9
Imports of goods and services	7.6	10.0	7.0	8.4	12.0	5.7	6.7	6.7	8.9
<i>Contribution to GDP growth in percentage points</i>									
Domestic demand	2.2	4.7	5.3	4.1	5.0	6.1	4.2	6.1	4.7
Net exports of goods and services	0.8	0.1	-0.1	1.3	-0.4	-1.0	0.9	-0.4	-0.1
Exports of goods and services	4.4	4.9	3.4	5.5	4.9	2.0	4.4	3.0	4.0
Imports of goods and services	-3.5	-4.8	-3.5	-4.2	-5.3	-3.0	-3.5	-3.4	-4.1
<i>Year-on-year change of the period average in %</i>									
Unit labor costs in the whole economy (nominal, per person)	2.5	2.5	1.2	2.4	3.5	0.0	2.2	0.6	2.0
Unit labor costs in manufacturing (nominal, per hour)	3.5	2.7	4.8	2.3	2.6	4.6	3.7	4.4	6.5
Labor productivity in manufacturing (real, per hour)	0.6	3.5	3.1	4.2	4.1	3.4	4.4	2.7	1.9
Labor costs in manufacturing (nominal, per hour)	4.1	6.4	8.1	6.6	6.8	8.2	8.3	7.2	8.6
Producer price index (PPI) in industry	-0.3	2.7	2.1	2.6	1.6	0.1	2.4	3.1	2.7
Consumer price index (here: HICP)	-0.2	1.6	1.2	1.5	1.8	1.0	1.1	1.4	1.1
EUR per 1 PLN, + = PLN appreciation	-4.1	2.5	-0.1	1.9	3.5	3.4	-1.0	-1.1	-1.6
<i>Period average levels</i>									
Unemployment rate (ILO definition, %, 15–64 years)	6.3	5.0	3.9	4.8	4.5	4.2	3.6	3.9	3.9
Employment rate (%, 15–64 years)	64.5	66.1	67.4	66.5	66.4	66.6	67.7	68.0	67.3
Key interest rate per annum (%)	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.5
PLN per 1 EUR	4.4	4.3	4.3	4.3	4.2	4.2	4.3	4.3	4.3
<i>Nominal year-on-year change in the period-end stock in %</i>									
Loans to the domestic nonbank private sector <sup>1</sup>	3.9	6.2	6.4	6.1	6.2	5.6	5.5	5.9	6.4
of which: loans to households	4.0	4.8	5.7	4.5	4.8	5.1	5.2	5.4	5.7
loans to nonbank corporations	3.8	8.7	7.6	9.1	8.7	6.3	6.0	6.9	7.6
<i>%</i>									
Share of foreign currency loans in total loans to the nonbank private sector	25.8	21.3	20.8	22.6	21.3	21.2	21.5	20.9	20.8
Return on assets (banking sector)	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.8
Tier 1 capital ratio (banking sector)	16.1	17.2	17.2	17.2	17.2	17.0	17.0	17.3	17.2
NPL ratio (banking sector)	7.1	6.8	6.8	6.9	6.8	7.7	7.0	7.0	6.8
<i>% of GDP</i>									
General government revenues	38.9	39.7	41.2	..	..	..	..	..	..
General government expenditures	41.1	41.2	41.5	..	..	..	..	..	..
General government balance	-2.2	-1.5	-0.4	..	..	..	..	..	..
Primary balance	-0.5	0.1	1.1	..	..	..	..	..	..
Gross public debt	54.2	50.6	48.9	..	..	..	..	..	..
<i>% of GDP</i>									
Debt of nonfinancial corporations (nonconsolidated)	49.1	47.2	45.0	..	..	..	..	..	..
Debt of households and NPISHs <sup>2</sup> (nonconsolidated)	36.2	35.6	34.8	..	..	..	..	..	..
<i>% of GDP (based on EUR), period total</i>									
Goods balance	0.7	0.3	-1.0	0.5	-0.4	-1.3	-0.5	-1.1	-1.2
Services balance	3.3	3.8	4.5	3.9	3.6	4.7	4.9	4.3	4.1
Primary income	-4.2	-4.0	-3.8	-4.3	-4.3	-2.7	-3.9	-5.0	-3.7
Secondary income	-0.3	-0.0	-0.3	-0.1	0.2	-0.2	-0.1	-0.4	-0.4
Current account balance	-0.5	0.2	-0.7	0.0	-0.9	0.5	0.3	-2.2	-1.3
Capital account balance	1.0	1.3	2.0	0.9	2.5	1.2	1.3	1.9	3.5
Foreign direct investment (net) <sup>3</sup>	-0.9	-1.2	-1.8	-2.1	-2.0	-3.0	-1.6	-4.2	1.2
<i>% of GDP (rolling four-quarter GDP, based on EUR), end of period</i>									
Gross external debt	75.3	68.2	63.2	69.2	68.2	67.2	64.6	64.6	63.2
Gross official reserves (excluding gold)	24.5	19.5	19.7	20.0	19.5	19.5	18.6	19.0	19.7
<i>Months of imports of goods and services</i>									
Gross official reserves (excluding gold)	6.1	4.7	4.6	4.8	4.7	4.7	4.4	4.5	4.6
<i>EUR million, period total</i>									
GDP at current prices	426,485	467,465	496,429	115,456	132,703	116,411	118,965	122,072	138,981

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

<sup>1</sup> Foreign currency component at constant exchange rates.<sup>2</sup> Nonprofit institutions serving households.<sup>3</sup> + = 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: external imbalances widen, spotlight on fiscal measures

Robust private consumption, weak export performance

In the second half of 2018, GDP grew at a similar rate as in the first half, bringing the full-year figure to 4.1%. Private consumption growth remained robust, supported by increasing household income and consumer lending. The unemployment rate declined further amid tightening labor market conditions. Moreover, Romania's outstanding agricultural output lifted private consumption through consumption of household-produced agri-foodstuffs and purchases on the agri-food market. Also, changes in inventories delivered a considerable growth contribution. Gross fixed investments recorded a decline in year-on-year terms but started to expand in seasonally adjusted quarter-on-quarter terms in mid-2018 thanks to equipment purchases by companies. Export growth weakened considerably in the second half of 2018. Changes in automobile emissions testing at the EU level, effective as of September 1, 2018, negatively affected exports of motor parts. In addition, ULCs in the manufacturing sector have been rising for some time and their increase accelerated again from mid-2018. Import growth decelerated but clearly surpassed export growth in the second half of 2018.

Current account deficit widens markedly

The current account deficit increased by 2.5 percentage points to 4.9% of GDP in the second half of 2018. Real export and import dynamics were reflected in a worsening trade balance for goods and services. At the same time, surpluses in the income balance fell. After broadly stable net FDI inflows (at about 2.5% of GDP in recent years) had more than covered the shortfall in the combined current and capital account balance in 2017, the coverage ratio (net FDI as a share of the combined current and capital account balance) stood at about 70% in 2018.

Significant deviation procedure ongoing, budget deficit at 3%, ad hoc fiscal measures taken

Within the framework of the significant deviation procedure, the EU Council concluded, in November 2018, that Romania had not taken effective action in response to its recommendation issued in June. It stated, that in addition to the structural adjustment need of 0.8% of GDP as proposed in June, structural efforts in the amount of 0.2% of GDP will be required in 2019. Romania was asked to report on action taken by mid-April 2019.

The budget deficit reached the 3% of GDP limit in 2018. Amid a challenging fiscal situation, the government introduced various fiscal measures through an emergency ordinance at end-2018, including additional taxes for banks, telecom and energy companies. The initial version of the tax on banks' financial assets was met with strong national and international criticism, in particular due to its hasty introduction, the linkage to interbank market rates and the scale of the tax burden. In response, the tax was amended at end-March 2019: the linkage to interbank market rates was dropped and the tax burden was lowered so that banks with a market share above 1% will now be required to pay 0.4% of their financial assets, while banks with a market share below 1% will have to pay 0.2% of their financial assets. Some items (such as government bonds) are now deductible from the tax base, while lending increases and interest margin decreases can lower the tax.

Inflation moves up again in early 2019

CPI inflation increased from 3.3% at end-2018 to 3.8% in February and exceeded the upper bound of Banca Națională a României's target band of  $2.5\% \pm 1$  percentage point. Core inflation rose to 2.7% in February, reflecting inter alia demand-pull and wage cost-push inflationary pressures as well as the weakening of the leu. In early April 2019, the central bank left its key policy rate unchanged at 2.5% and stated that it will maintain strict control over money market liquidity.

Table 9

**Main economic indicators: Romania**

	2016	2017	2018	Q3 17	Q4 17	Q1 18	Q2 18	Q3 18	Q4 18
<i>Year-on-year change of the period total in %</i>									
GDP at constant prices	4.8	7.0	4.1	8.8	6.8	4.0	4.1	4.2	4.1
Private consumption	8.2	10.0	5.2	13.4	11.8	5.9	5.1	4.4	5.6
Public consumption	3.2	1.9	3.8	7.9	1.1	2.1	-1.8	4.0	7.3
Gross fixed capital formation	-0.0	3.3	-3.1	5.2	8.7	1.4	-4.9	-3.9	-3.3
Exports of goods and services	16.8	8.9	4.7	8.2	8.2	7.9	7.1	2.3	1.1
Imports of goods and services	16.5	11.2	8.6	11.7	11.7	11.7	9.3	6.7	7.3
<i>Contribution to GDP growth in percentage points</i>									
Domestic demand	5.1	7.6	5.9	8.6	9.2	7.0	4.0	5.6	7.0
Net exports of goods and services	-0.3	-0.7	-1.8	-1.2	-1.2	-2.0	-1.3	-1.3	-2.5
Exports of goods and services	6.6	4.1	1.9	3.7	3.3	3.7	2.9	1.3	0.7
Imports of goods and services	-6.9	-4.8	-3.8	-5.0	-4.6	-5.7	-4.2	-2.6	-3.3
<i>Year-on-year change of the period average in %</i>									
Unit labor costs in the whole economy (nominal, per person)	8.6	8.2	13.6	5.3	9.4	17.3	14.2	14.5	7.4
Unit labor costs in manufacturing (nominal, per hour)	8.4	5.6	4.9	5.2	2.0	5.5	2.5	4.9	6.6
Labor productivity in manufacturing (real, per hour)	1.2	8.3	5.5	7.8	10.4	5.3	7.8	5.4	3.5
Labor costs in manufacturing (nominal, per hour)	9.7	14.3	10.6	13.5	12.6	11.1	10.4	10.5	10.3
Producer price index (PPI) in industry	-1.8	3.5	5.0	3.6	3.7	3.9	5.2	5.8	5.2
Consumer price index (here: HICP)	-1.1	1.1	4.1	1.0	2.4	3.7	4.5	4.6	3.5
EUR per 1 RON, + = RON appreciation	-1.0	-1.7	-1.8	-2.6	-2.4	-2.9	-2.2	-1.4	-0.9
<i>Period average levels</i>									
Unemployment rate (ILO definition, %, 15–64 years)	6.1	5.1	4.3	4.9	4.9	4.8	4.3	4.0	4.2
Employment rate (%, 15–64 years)	61.6	63.9	64.8	65.3	63.4	63.1	65.5	66.2	64.5
Key interest rate per annum (%)	1.8	1.8	2.4	1.8	1.8	2.1	2.4	2.5	2.5
RON per 1 EUR	4.5	4.6	4.7	4.6	4.6	4.7	4.7	4.6	4.7
<i>Nominal year-on-year change in the period-end stock in %</i>									
Loans to the domestic nonbank private sector <sup>1</sup>	1.5	4.4	7.9	6.1	4.4	5.4	6.0	5.8	7.9
of which: loans to households	4.5	7.1	9.1	6.5	7.1	8.8	9.3	9.0	9.1
loans to nonbank corporations	-2.4	2.5	6.6	5.6	2.5	1.7	2.5	2.4	6.6
<i>%</i>									
Share of foreign currency loans in total loans to the nonbank private sector	43.3	37.2	34.0	38.6	37.2	36.4	35.0	34.6	34.0
Return on assets (banking sector)	1.1	1.3	1.6	1.4	1.3	1.6	1.7	1.8	1.6
Tier 1 capital ratio (banking sector)	17.6	18.0	17.6	17.2	18.0	17.9	17.6	17.8	17.6
NPL ratio (banking sector)	9.6	6.4	5.0	8.0	6.4	6.2	5.7	5.6	5.0
<i>% of GDP</i>									
General government revenues	31.8	30.9	32.0	..	..	..	..	..	..
General government expenditures	34.5	33.6	35.0	..	..	..	..	..	..
General government balance	-2.7	-2.7	-3.0	..	..	..	..	..	..
Primary balance	-1.2	-1.4	-1.8	..	..	..	..	..	..
Gross public debt	37.3	35.2	35.0	..	..	..	..	..	..
<i>% of GDP</i>									
Debt of nonfinancial corporations (nonconsolidated)	39.8	35.1	33.0	..	..	..	..	..	..
Debt of households and NPISHs <sup>2</sup> (nonconsolidated)	16.5	15.9	15.9	..	..	..	..	..	..
<i>% of GDP (based on EUR), period total</i>									
Goods balance	-5.5	-6.5	-7.3	-5.8	-7.0	-7.0	-7.3	-6.5	-8.3
Services balance	4.5	4.4	4.0	4.2	3.5	4.9	4.3	3.6	3.5
Primary income	-2.6	-2.5	-2.5	-2.5	-0.1	-1.5	-4.2	-3.7	-0.5
Secondary income	1.5	1.4	1.1	1.5	1.4	0.9	1.5	0.9	1.2
Current account balance	-2.1	-3.2	-4.7	-2.6	-2.1	-2.7	-5.7	-5.7	-4.2
Capital account balance	2.5	1.2	1.2	0.6	2.4	0.7	1.0	0.9	2.0
Foreign direct investment (net) <sup>3</sup>	-2.6	-2.6	-2.4	-4.1	-1.9	-3.9	-0.5	-4.2	-1.3
<i>% of GDP (rolling four-quarter GDP, based on EUR), end of period</i>									
Gross external debt	54.6	51.9	48.7	51.8	51.9	51.1	50.0	48.9	48.7
Gross official reserves (excluding gold)	20.1	17.9	16.4	18.3	17.9	18.3	16.5	15.9	16.4
<i>Months of imports of goods and services</i>									
Gross official reserves (excluding gold)	5.7	4.9	4.4	5.1	4.9	5.0	4.4	4.3	4.4
<i>EUR million, period total</i>									
GDP at current prices	170,382	187,282	202,077	51,764	56,000	38,659	46,557	56,607	60,254

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

<sup>1</sup> Foreign currency component at constant exchange rates.<sup>2</sup> Nonprofit institutions serving households.<sup>3</sup> + = 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).



## 10 Turkey: economy slides into recession, macrofinancial risks high

GDP growth slowed down markedly in the second half of 2018

The Turkish economy slid into recession in the second half of 2018. All domestic demand components contributed to the slowdown. Gross fixed capital formation growth sharply reversed its sign on an annual basis and declined strongly by 8.8%, mainly because a number of public investment projects were discontinued. At the same time, private consumption contracted by 4.1% due to a marked slowdown of consumer credit along with elevated unemployment at 12.5% in the fourth quarter of 2018. Unlike in the first quarter of 2018, net exports became supportive of economic growth. Due to the continuous depreciation of the Turkish lira (TRL), the recovery of the tourism sector and robust external demand (despite continued jitters about the U.S.A), real exports shot up by 12.1%. In contrast to 2017 and in line with waning investment activity, real depreciation and lower private consumption, real imports contracted by 20.6%.

External imbalances narrowed sizeably in 2018

The current account balance turned positive in the second half of 2018 (0.9% of GDP), narrowing the full-year deficit to 3.5% of GDP, driven by both an increased services surplus and a shrinking trade deficit. On the financing side, net FDI inflows modestly increased to 1.8% of GDP. The economy – traditionally highly reliant on more volatile capital inflows – experienced net outflows in the second and third quarters of 2018. Gross external debt soared in 2018 coming to 58.9% of GDP as of end-2018. Gross external financing needs remained among the highest in emerging markets and came close to 25% of GDP in 2018. Debt rollover needs for 2019 are substantial and the ratio of short-term debt to foreign exchange reserves came close to an alarming 300% in the fourth quarter of 2018, with the nonfinancial corporate sector accounting for the lion's share.

Central bank has not increased policy rate since September 2018

Following a peak of 25% in October 2018, headline inflation came slightly down to 20.3% in December 2018 – clearly above the monetary policy target of 5% – and further down to 19.7% in February 2019. Previously, inflation had shot up mainly due to the large TRL depreciation, higher prices of core goods (mainly food products) and some expansionary fiscal measures. The TRL's depreciation trend accelerated in the second half of 2018, peaking in mid-August, but after that the TRL made up for some of the losses. In the second half of 2018, the TRL lost some 13% and 15% vis-à-vis the euro and the U.S. dollar, respectively. In January 2019, the Central Bank of the Republic of Turkey (CBRT) revised its inflation forecast upward to 14.6% and 8.2% for 2019 and 2020, respectively. Although CBRT has refrained from increasing the one-week repo rate since September 2018 (24%), the central bank's borrowing has been mostly made at the upper bound of the late liquidity window (27%), implying an increase in the effective costs of bank funding.

Financial conditions more restrictive in the second half of 2018

In line with the slowdown of the economy, annual growth of credit to the non-financial private sector slowed down considerably and stood at 1.2% year on year in exchange rate-adjusted terms in December 2018. Credit risk vis-à-vis the private sector remains contained but started to increase in the second half of 2018, and in December 2018, the share of nonperforming loans in total loans increased to the highest level (4.1%) since 2011. In spite of the surge in TRL loans since 2017 due to the loan guarantees through the Credit Guarantee Fund, the exchange rate risk of the nonfinancial corporate sector remains a major risk for financial stability, and the corporate sector's foreign currency debt reached almost 30% of GDP in the fourth quarter of 2018.

Table 10

## Main economic indicators: Turkey

	2016	2017	2018	Q3 17	Q4 17	Q1 18	Q2 18	Q3 18	Q4 18
<i>Year-on-year change of the period total in %</i>									
GDP at constant prices	3.2	7.4	2.6	11.5	7.3	7.4	5.3	1.8	-3.0
Private consumption	3.7	6.1	1.1	10.3	6.3	8.9	5.8	0.8	-8.9
Public consumption	9.5	5.0	3.6	7.6	5.9	3.5	7.8	3.4	0.5
Gross fixed capital formation	2.2	7.8	-1.7	12.8	6.6	8.8	4.8	-4.7	-12.9
Exports of goods and services	-1.9	11.9	7.5	17.7	9.2	0.7	4.1	13.6	10.6
Imports of goods and services	3.7	10.3	-7.9	15.0	22.8	15.4	0.1	-16.8	-24.4
<i>Contribution to GDP growth in percentage points</i>									
Domestic demand	4.1	6.7	0.7	10.7	6.7	8.5	6.0	-0.5	-9.1
Net exports of goods and services	-1.3	0.1	3.5	0.3	-3.2	-3.4	0.9	6.6	8.3
Exports of goods and services	-0.4	2.5	1.6	3.5	1.8	0.2	0.9	2.8	2.1
Imports of goods and services	-0.9	-2.4	1.9	-3.2	-5.0	-3.6	-0.0	3.8	6.1
<i>Year-on-year change of the period average in %</i>									
Unit labor costs in the whole economy (nominal, per person)	..	..	..	..	..	..	..	..	..
Unit labor costs in manufacturing (nominal, per hour)	15.8	4.0	18.0	0.7	4.0	11.6	15.1	18.5	28.0
Labor productivity in manufacturing (real, per hour)	4.4	6.2	1.8	8.1	6.5	6.0	3.0	2.0	-3.1
Gross wages in manufacturing (nominal, per hour)	21.0	10.4	20.5	8.8	10.8	18.2	18.5	20.9	24.1
Producer price index (PPI) in industry	4.3	15.8	27.0	16.0	16.7	13.4	20.1	34.5	39.0
Consumer price index (here: HICP)	7.7	11.1	16.3	10.6	12.2	10.3	12.8	19.4	22.4
EUR per 1 TRY, + = TRY appreciation	-9.6	-18.9	-27.7	-19.8	-20.9	-16.1	-24.5	-37.5	-28.6
<i>Period average levels</i>									
Unemployment rate (ILO definition, %, 15–64 years)	11.1	11.1	11.1	10.7	10.4	10.8	9.8	11.3	12.5
Employment rate (%, 15–64 years)	50.7	51.6	52.0	52.6	51.9	51.1	52.7	53.0	51.1
Key interest rate per annum (%)	7.5	8.0	15.5	8.0	8.0	8.0	11.2	18.9	24.0
TRY per 1 EUR	3.3	4.1	5.7	4.1	4.5	4.7	5.2	6.6	6.3
<i>Nominal year-on-year change in the period-end stock in %</i>									
Loans to the domestic nonbank private sector	15.8	20.8	12.4	23.2	20.8	19.7	21.7	27.6	12.4
of which: loans to households	9.6	16.3	3.2	17.6	16.3	14.8	14.1	9.2	3.2
loans to nonbank corporations	18.2	22.3	15.5	25.3	22.3	21.4	24.3	33.9	15.5
<i>%</i>									
Share of foreign currency loans in total loans to the nonbank private sector	35.8	32.9	38.5	32.4	32.9	33.4	35.2	41.0	38.5
Return on assets (banking sector)	1.5	1.6	1.5	1.7	1.6	1.7	1.7	1.5	1.5
Tier 1 capital ratio (banking sector)	12.7	13.6	13.4	13.9	13.6	13.5	13.1	13.9	13.4
NPL ratio (banking sector)	3.4	3.1	4.1	3.2	3.1	3.0	3.2	3.4	4.1
<i>% of GDP</i>									
General government revenues	..	..	..	..	..	..	..	..	..
General government expenditures	..	..	..	..	..	..	..	..	..
General government balance	-2.3	-2.3	-2.5	..	..	..	..	..	..
Primary balance	0.1	0.3	0.3	..	..	..	..	..	..
Gross public debt	29.4	28.3	31.2	..	..	..	..	..	..
<i>% of GDP</i>									
Debt of nonfinancial corporations (nonconsolidated)	..	..	..	..	..	..	..	..	..
Debt of households and NPISHs <sup>1</sup> (nonconsolidated)	..	..	..	..	..	..	..	..	..
<i>% of GDP (based on EUR), period total</i>									
Goods balance	-4.7	-6.9	-5.3	-7.8	-7.7	-8.3	-8.1	-4.1	-0.4
Services balance	1.8	2.3	3.2	4.2	1.9	1.5	2.6	6.0	3.0
Primary income	-1.1	-1.3	-1.5	-1.0	-1.4	-1.1	-1.8	-1.3	-1.8
Secondary income	0.2	0.3	0.1	0.3	0.4	0.1	-0.0	0.1	0.3
Current account balance	-3.8	-5.6	-3.5	-4.2	-6.9	-7.9	-7.4	0.8	1.1
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) <sup>2</sup>	-1.3	-1.0	-1.2	-1.2	-1.1	-0.6	-1.0	-1.5	-2.0
<i>% of GDP (rolling four-quarter GDP, based on EUR), end of period</i>									
Gross external debt	50.3	51.2	58.9	50.5	51.2	50.8	53.2	55.0	58.9
Gross official reserves (excluding gold)	11.2	9.3	9.8	10.1	9.3	9.1	8.8	8.4	9.8
<i>Months of imports of goods and services</i>									
Gross official reserves (excluding gold)	5.4	3.8	3.8	4.4	3.8	3.7	3.5	3.2	3.8
<i>EUR million, period total</i>									
GDP at current prices	778,812	751,693	652,581	201,532	198,788	168,160	169,610	154,002	160,808

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

<sup>1</sup> Nonprofit institutions serving households.<sup>2</sup> + = 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).

## 11 Russia: robust macroeconomic data in an uncertain environment

Rising oil price and weaker ruble help Russia recover

Helped by a rise of the oil price combined with a weaker ruble, Russia's modest economic recovery has picked up some speed lately. Based on revised Rosstat figures, GDP growth accelerated from 0.3% in 2016 to 1.6% in 2017 and 2.3% in 2018. While growth in domestic demand decelerated in 2018 owing to stagnating real incomes and tight fiscal and monetary stances, net exports expanded substantially on the back of terms of trade gains. Both, private consumption dynamics and gross fixed investment growth slowed down. The volume of exports expanded by 5.5% in 2018, while the growth of imports slowed sharply to 2.7%. On the production side of GDP, resource extraction, construction and automobile production led the recovery, while agricultural production stagnated. The unemployment rate (ILO definition, seasonally adjusted) declined to 4.8% (annual average in 2018), a post-Soviet record low.

New Western sanctions have affected FDI

Notwithstanding a substantial rise in the price of Urals grade crude in 2018 (by 32%, annual average), the Russian ruble's external value declined considerably (by 7% against the U.S. dollar and 11% against the euro). This was due to (still persisting) economic uncertainty triggered by waves of U.S. sanctions or threats thereof. Some punitive measures were imposed in April 2018 (extraterritorial restrictions against a number of Russian businessmen and companies) and August 2018 (additional trade-related constraints); some further sanctions may or may not be enacted in the spring of 2019 (possibly targeting sovereign debt, Russian banks and energy projects). U.S. and EU sanctions have primarily affected foreign investment and are estimated to have cut Russian GDP growth by 0.5 to 0.75 percentage points annually on average since the outbreak of the Ukraine conflict in 2014.

Ruble depreciation and recent tariff increases have pushed up inflation to above 5%

The ruble's depreciation and increases in indexed housing and communal tariffs as well as in VAT in January 2019 caused CPI inflation to more than double from 2.6% at end-July 2018 to 5.4% at end-February 2019. In a preemptive step, the Russian central bank (CBR) had slightly raised the already relatively high key interest rate by 25 basis points in September 2018 and again in December by the same amount to 7.75%.

But record twin surpluses, modest external debt and high international reserves strengthen the economy's resilience

Swelling revenues from rising oil prices combined with improved tax administration and sustained prudence in spending pushed the general budget surplus to 2.9% of GDP in 2018 (2017: deficit of 1.5%). The oil price-triggered expansion of exports (valued in U.S. dollars) coupled with the weakening of the Russian ruble were the main factors driving up Russia's current account surplus, which reached a record 6.9% of GDP in 2018. In late 2018, the country even recorded a trade surplus net of oil exports (a first for Russia). However, net private capital outflows also rose sharply to 4.1% of GDP (reflecting net FDI outflows and banks' further cutting their foreign liabilities). Russia's total external debt shrank further to EUR 396 billion or 28.3% of GDP at end-2018, which is now lower than the country's expanding international reserves (including gold, end-2018: EUR 409 billion or 29.2% of GDP). Notwithstanding Russia's modest economic growth and its still relatively high, if easing, NPL ratio (18% at end-2018), lending has been regaining momentum; however, this revival is partly driven by unsecured consumer credit and thus gives rise to concern.

Table 11

## Main economic indicators: Russia

	2016	2017	2018	Q3 17	Q4 17	Q1 18	Q2 18	Q3 18	Q4 18
<i>Year-on-year change of the period total in %</i>									
GDP at constant prices	0.3	1.6	2.3	2.3	0.3	1.9	2.2	2.2	2.7
Private consumption	-1.9	3.3	2.3	4.4	4.0	2.7	1.9	2.0	2.6
Public consumption	1.5	2.5	0.3	2.5	2.5	0.3	0.3	0.3	0.3
Gross fixed capital formation	1.0	5.2	2.9	5.0	0.5	3.5	4.2	5.5	0.2
Exports of goods and services	3.2	5.0	5.5	4.5	5.2	7.2	7.8	4.8	2.6
Imports of goods and services	-3.6	17.4	2.7	17.1	14.9	10.0	2.8	0.1	-0.3
<i>Contribution to GDP growth in percentage points</i>									
Domestic demand	-1.1	3.6	1.5	4.4	2.1	1.6	0.6	1.4	2.3
Net exports of goods and services	1.6	-2.3	0.8	-2.6	-1.7	-0.2	1.4	1.2	0.7
Exports of goods and services	0.8	1.3	1.5	1.1	1.3	2.0	2.1	1.2	0.7
Imports of goods and services	0.8	-3.6	-0.6	-3.7	-3.1	-2.2	-0.7	-0.0	0.1
<i>Year-on-year change of the period average in %</i>									
Unit labor costs in the whole economy (nominal, per person)	..	..	..	..	..	..	..	..	..
Unit labor costs in industry (nominal, per hour)	4.3	17.7	2.3	14.4	18.9	2.7	0.9	2.6	3.3
Labor productivity in industry (real, per hour)	4.7	7.5	4.2	7.9	6.0	5.1	4.5	4.2	3.0
Average gross earnings in industry (nominal, per person)	9.1	26.7	6.6	23.4	26.3	7.9	5.4	7.0	6.3
Producer price index (PPI) in industry	4.3	7.8	12.0	4.5	8.0	5.0	12.0	15.9	15.1
Consumer price index (here: CPI)	7.1	3.6	3.0	3.3	2.6	2.3	2.5	3.1	4.0
EUR per 1 RUB, + = RUB appreciation	-8.4	12.6	-11.0	4.1	-1.2	-10.6	-14.9	-9.3	-9.4
<i>Period average levels</i>									
Unemployment rate (ILO definition, %, 15–64 years)	5.5	5.2	4.8	5.0	5.1	5.1	4.8	4.6	4.8
Employment rate (%, 15–64 years)	..	..	..	..	..	..	..	..	..
Key interest rate per annum (%)	10.6	9.1	7.4	8.9	8.2	7.6	7.3	7.3	7.5
RUB per 1 EUR	74.2	65.9	74.1	69.3	68.8	69.9	74.0	76.3	75.9
<i>Nominal year-on-year change in the period-end stock in %</i>									
Loans to the domestic nonbank private sector <sup>1</sup>	0.6	5.7	12.3	4.2	5.7	7.3	9.4	11.4	12.3
of which: loans to households	1.6	12.7	22.2	8.8	12.7	15.5	18.8	21.4	22.2
loans to nonbank corporations	0.2	3.1	8.3	2.5	3.1	4.3	5.8	7.5	8.3
<i>%</i>									
Share of foreign currency loans in total loans to the nonbank private sector	18.9	14.7	13.6	16.5	14.7	14.5	14.7	14.4	13.6
Return on assets (banking sector)	1.2	1.0	1.5	1.1	1.0	1.7	1.5	1.7	1.5
Tier 1 capital ratio (banking sector)	9.2	8.5	8.9	8.6	8.5	9.9	9.0	9.5	8.9
NPL ratio (banking sector)	18.9	19.1	18.0	18.8	19.1	19.4	19.2	18.7	18.0
<i>% of GDP</i>									
General government revenues	32.8	33.7	35.5	..	..	..	..	..	..
General government expenditures	36.4	35.2	32.6	..	..	..	..	..	..
General government balance	-3.7	-1.5	2.9	..	..	..	..	..	..
Primary balance	..	..	..	..	..	..	..	..	..
Gross public debt	12.9	12.6	12.1	..	..	..	..	..	..
<i>% of GDP</i>									
Debt of nonfinancial corporations (nonconsolidated)	..	..	..	..	..	..	..	..	..
Debt of households and NPISHs <sup>2</sup> (nonconsolidated)	..	..	..	..	..	..	..	..	..
<i>% of GDP (based on EUR), period total</i>									
Goods balance	7.0	7.4	11.8	5.1	8.0	11.2	11.3	11.6	12.9
Services balance	-1.8	-2.0	-1.8	-2.4	-1.9	-1.7	-1.9	-2.1	-1.6
Primary income	-2.7	-2.7	-2.5	-2.8	-2.4	-1.3	-4.6	-2.2	-2.0
Secondary income	-0.5	-0.6	-0.6	-0.7	-0.6	-0.7	-0.4	-0.6	-0.6
Current account balance	1.9	2.2	6.9	-0.8	3.1	7.6	4.5	6.6	8.7
Capital account balance	-0.1	-0.0	-0.1	-0.0	0.0	-0.1	-0.1	-0.0	-0.1
Foreign direct investment (net) <sup>3</sup>	-0.8	0.5	1.4	0.4	2.2	1.4	0.6	1.0	2.4
<i>% of GDP (rolling four-quarter GDP, based on EUR), end of period</i>									
Gross external debt	41.5	31.1	28.3	32.7	31.1	30.7	30.7	29.4	28.3
Gross official reserves (excluding gold)	25.7	21.3	23.8	21.6	21.3	22.1	23.7	23.8	23.8
<i>Months of imports of goods and services</i>									
Gross official reserves (excluding gold)	15.0	12.4	13.7	12.7	12.4	12.7	13.4	13.6	13.7
<i>EUR million, period total</i>									
GDP at current prices	1,171,677	1,396,089	1,399,910	343,601	373,249	320,790	335,393	355,474	388,253

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

<sup>1</sup> Foreign currency component at constant exchange rates.<sup>2</sup> Nonprofit institutions serving households.<sup>3</sup> + = 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).