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# Contents

Call for applications: Klaus Liebscher Economic Research Scholarship	4
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## Recent economic developments and outlook

Developments in selected CESEE countries Coronavirus sends CESEE region into a deep recession	7
Box 1: Ukraine: GDP contraction accompanied by current account reversal, IMF program delay after disbursement of first tranche	17
Box 2: Western Balkans: GDP drops sharply upon introduction of lockdown measures <i>Compiled by Josef Schreiner</i>	18
Outlook for selected CESEE countries CESEE-6: deepest downturn after transformational recession, uncertain recovery; Russia: economy expected to recover gradually <i>Compiled by Antje Hildebrandt</i>	42

## Studies

What drives people's expectations of euro adoption? – Evidence from the OeNB Euro Survey on selected CESEE countries <i>Peter Backé, Elisabeth Beckmann</i>	57
Macroprudential policy in the Western Balkans: the last five years and COVID-19 crisis response <i>Stephan Barisitz, Antje Hildebrandt</i>	80

## Event wrap-ups

86 <sup>th</sup> East Jour Fixe: All about COVID-19? Geopolitical, economic and macrofinancial perspectives for the Western Balkans <i>Compiled by Antje Hildebrandt and Tomáš Šlačák</i>	97
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Statistical annex <i>Compiled by Zoltan Walko</i>	102
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*Opinions expressed by the authors of studies do not necessarily reflect the official viewpoint of the Oesterreichische Nationalbank or the Eurosystem.*

# Call for applications: Klaus Liebscher Economic Research Scholarship

Please e-mail applications to [scholarship@oenb.at](mailto:scholarship@oenb.at) by the end of October 2021. Applicants will be notified of the jury's decision by end-November 2021.

The Oesterreichische Nationalbank (OeNB) invites applications for the “Klaus Liebscher Economic Research Scholarship.” This scholarship program gives outstanding researchers the opportunity to contribute their expertise to the research activities of the OeNB's Economic Analysis and Research Department. This contribution will take the form of remunerated consultancy services.

The scholarship program targets Austrian and international experts with a proven research record in economics and finance, and postdoctoral research experience. Applicants need to be in active employment and should be interested in broadening their research experience and expanding their personal research networks. Given the OeNB's strategic research focus on Central, Eastern and Southeastern Europe, the analysis of economic developments in this region will be a key field of research in this context.

The OeNB offers a stimulating and professional research environment in close proximity to the policymaking process. The selected scholarship recipients will be expected to collaborate with the OeNB's research staff on a prespecified topic and are invited to participate actively in the department's internal seminars and other research activities. Their research output may be published in one of the department's publication outlets or as an OeNB Working Paper. As a rule, the consultancy services under the scholarship will be provided over a period of two to three months. As far as possible, an adequate accommodation for the stay in Vienna will be provided.<sup>1</sup>

Applicants must provide the following documents and information:

- a letter of motivation, including an indication of the time period envisaged for the consultancy
- a detailed consultancy proposal
- a description of current research topics and activities
- an academic curriculum vitae
- an up-to-date list of publications (or an extract therefrom)
- the names of two references that the OeNB may contact to obtain further information about the applicant
- evidence of basic income during the term of the scholarship (employment contract with the applicant's home institution)
- written confirmation by the home institution that the provision of consultancy services by the applicant is not in violation of the applicant's employment contract with the home institution

<sup>1</sup> We assume that the coronavirus crisis will abate in the course of 2021. We are also exploring alternative formats to continue research cooperation under the scholarship program for as long as we cannot resume visits due to the pandemic situation.

## Recent economic developments and outlook

# Developments in selected CESEE countries

Coronavirus sends CESEE region into a deep recession<sup>1, 2, 3</sup>

## 1 Regional overview

The spread of coronavirus and the ensuing pandemic sent large parts of the world economy into a deep contraction in the first half of 2020, and the economies of Central, Eastern and Southeastern Europe (CESEE) were no exception. In the second quarter of 2020, in fact, several CESEE countries reported the largest quarterly decline in economic activity since the early years of transition in the 1990s.

Despite the depth of the GDP decline, the CESEE region reported more benign growth figures than the euro area (–7.3% compared to –11.8% in the second quarter of 2020, quarter on quarter, see table 1). The more gradual spread of the pandemic eastward in spring and the quick reaction by local authorities prevented the type of public health crises that were observed in e.g. Italy or Spain and enabled CESEE to start lifting restrictions on public life and the economy at a comparatively early stage. This led to a somewhat smaller contraction of domestic demand (especially investments) in many countries, which explains some of the growth advantage vis-à-vis the euro area. The regional average was also heavily influenced by the rather small GDP contraction of the Russian economy (–3.2% in the second quarter, quarter on quarter). Russia benefited from a large positive growth contribution of net exports, as low domestic demand and ruble depreciation depressed imports. At the same time, export volumes of certain key products started to increase already in the spring, thanks in part to the rapid recovery of the Chinese economy.

At the same time, Croatia and Hungary were among the countries in Europe that were hit most severely by the COVID-19 pandemic in terms of GDP loss. This underlines the heterogeneity of current economic developments in the region. In Croatia, the sharp decline was mostly driven by tourism, which accounts for around one-quarter of the country's GDP (including indirect contributions). In Hungary, car production, tourism and transportation services weighed on growth.

In general, contact-intensive sectors (hospitality, travel and tourism) and those with complex value chains (electronics and automobiles) suffered the most throughout CESEE. Restricted cross-border mobility tremendously lowered hotel occupancy rates over the summer. In the automobile sector, factory shutdowns led to a decline of European car production by more than one-third in the first half of 2020 (when compared to a year earlier). This imposed a heavy burden on several CESEE countries where the automobile sector accounts for a large share of industrial production (besides Hungary also the Czech Republic, Romania and Slovakia).

Steepest decline of economic activity since the start of transition in several countries

Recession still less severe than in the euro area

<sup>1</sup> Compiled by Josef Schreiner with input from Katharina Allinger, Stephan Barisitz, Markus Eller, Clara de Luigi, Mathias Lahnsteiner, Thomas Reiningner, Tomáš Sláčík and Zoltan Walko.

<sup>2</sup> Cutoff date: October 7, 2020. This report focuses primarily on data releases and developments from April 2020 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 candidates and potential candidates and non-EU countries). For statistical information on selected economic indicators for CESEE countries not covered in the main text (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	2019	Q1 19	Q2 19	Q3 19	Q4 19	Q1 20	Q2 20
<i>Period-on-period change in %, seasonally and working day adjusted</i>									
Slovakia	3.0	3.9	2.4	0.6	0.4	0.4	0.6	-5.2	-8.3
Slovenia	4.8	4.4	3.2	0.9	0.0	0.8	0.4	-4.7	-9.9
Bulgaria	3.5	3.1	3.4	1.0	0.7	0.7	0.8	0.3	-10.0
Croatia	3.1	2.7	2.9	1.1	0.6	0.6	0.4	-1.3	-14.9
Czech Republic	5.2	3.2	2.3	0.5	0.5	0.5	0.4	-3.3	-8.7
Hungary	4.3	5.1	4.9	1.9	0.8	0.9	0.7	-0.4	-14.5
Poland	4.9	5.3	4.1	1.4	0.7	1.2	0.2	-0.4	-8.9
Romania	7.1	4.4	4.1	1.5	0.6	0.5	1.2	0.3	-12.3
Turkey	7.5	3.0	0.9	1.3	1.2	0.4	1.9	0.6	-11.0
Russia	1.8	2.5	1.3	-0.5	2.4	-0.9	-0.7	-0.9	-3.2
CESEE average <sup>1</sup>	4.0	3.2	2.1	0.5	1.5	0.0	0.3	-0.6	-7.3
Euro area	2.5	1.9	1.2	0.5	0.1	0.3	0.1	-3.7	-11.8

Source: Eurostat, national statistical offices.

<sup>1</sup> Average weighted with GDP at PPP.

### Private consumption severely impaired by COVID-19 containment measures

A look at the expenditure side of GDP shows that all countries of the region reported a notable reduction of domestic demand (see chart 1). Private consumption suffered from deteriorating sentiment, movement restrictions, (temporary) closures of nonessential shops and social distancing measures to contain COVID-19 infections. Furthermore, incipient labor market weaknesses also impacted on consumer spending, as furlough schemes and reduced working hours weighed on disposable income and unemployment was on the rise. The average unemployment rate of the region increased from 6.3% at the end of 2019 to 7.7% in August 2020, the highest level in five years.

This figure, however, still underestimates the current slack in the labor market. It is based on the International Labour Organization's standard definition of unemployment, which counts as unemployed people without a job who have been actively seeking work in the last four weeks and are available to start work within the next two weeks. The COVID-19 outbreak and the measures applied to contain it have impacted on both the ability to seek work (e.g. due to a lockdown) and the availability to start work (e.g. due to care obligations toward family members). Furthermore, active measures to contain employment losses have led to absences from work rather than dismissals (e.g. in the case of furlough schemes).

### Labor market conditions are worsening

An indicator of the actual labor market slack provided by Eurostat (not available for Russia) reveals that persons with an unmet need for employment<sup>4</sup> accounted for an average of 13.5% of the extended CESEE labor force in the second quarter of 2020. This figure was up 2.6 percentage points from the first quarter of 2020, which represented the strongest increase since the start of the series in 2008.

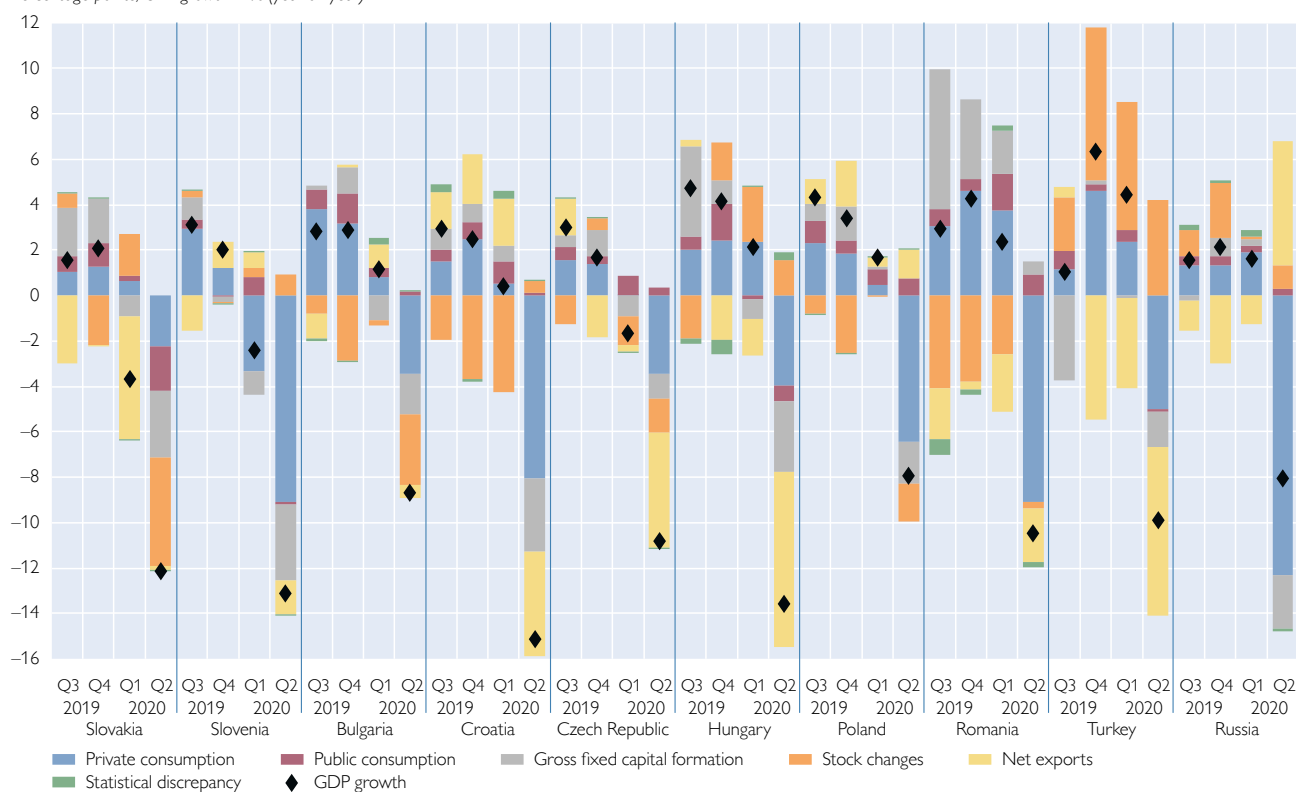
In the second quarter of 2020, absences from work more than tripled against the first quarter, amounting to a total of more than 3.8 million people in the CESEE region (again excluding Russia). As a percentage of total employment, the figure was especially high in Slovakia, Slovenia and Turkey (21.7%, 27.3% and 30.7%,

<sup>4</sup> This includes unemployed and underemployed persons, persons available for the labor market but not seeking employment, as well as persons seeking employment but not available for the labor market.

Chart 1

## GDP growth and its main components

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



Source: Eurostat, national statistical offices.

respectively, in the second quarter of 2020). In the other countries, however, it remained below the EU average of 21.8%.

After capital spending had already been impaired by rising uncertainty concerning the further spread of coronavirus and a weak absorption of EU funds at the beginning of the year, it declined notably in the second quarter of 2020. This was related to generally weak demand conditions (internationally and at home), the disruption of international production chains and a sharp drop in corporate profits and capacity utilization. Furthermore, growth of credit to corporations decelerated strongly in the review period.

Public consumption was the only part of domestic demand that delivered (moderately) positive growth contributions in most countries of the region in the second quarter of 2020 against the background of large fiscal support for households and companies (see below).

Some regional heterogeneity could be observed in external sector developments. The closing of borders, travel restrictions and the economic malaise in large parts of the world led to a strong decline in exports. At the same time, however, imports declined notably as well, mirroring weak demand conditions at home. Consequently, net exports often weighed negatively on GDP growth in many countries. In Slovakia, Slovenia, Bulgaria and Romania the negative growth contribution was only moderate. However, in the Czech Republic and Turkey, net exports

General economic environment not conducive to investment

Net exports mostly weigh negatively on growth



**Comprehensive  
policy support**

reduced GDP growth more strongly than domestic demand did. In contrast, in Poland and – as mentioned above – Russia, they contributed positively to growth.

Simultaneously with other European countries, the CESEE countries deployed large fiscal packages to support vulnerable households and firms, eased monetary policy to support the flow of credit and tackle financial market disruptions and adopted macroprudential measures that cushioned the impact of the crisis on both banks and borrowers.

**Fiscal policy relies  
on a broad set of  
measures**

Direct fiscal measures to mitigate the economic fallout from the coronavirus crisis included tax cuts, subsidies for wages and social security contributions, compensation for people in quarantine and firms affected by shutdown measures, higher allowances (e.g. for children) and bonuses (e.g. workers in health care), higher minimum wages and/or some sort of furlough schemes subsidizing wages and shorter work hours. The latter was imperative in preventing a sharper deterioration in labor market conditions. Furlough schemes covered up to 15% of the workforce in Slovenia, Turkey and Slovakia, up to 20% in Romania and about one-third in Croatia at their maximum usage.

Indirect fiscal measures included guarantees and deferrals for tax payments and social security contributions. Furthermore, all countries introduced moratoria on the repayment of loans to alleviate financial strains for borrowers. Concerning the latter, no more than 15% of borrowers renegotiated loan repayments in most CESEE countries. Even in countries where blanket moratoria were imposed by law (Hungary, Romania), penetration remained below 50% of private-sector loans. This is a sign that the remaining borrowers were able to service their debt amid falling interest rates and borrowing costs and despite the economic downturn.

The announced fiscal support was largest in the Czech Republic, with a package worth more than 20% of GDP. Rather large packages have also been deployed in Slovenia, Croatia, Hungary and Poland (of around 10% of GDP and more). The stimulus was comparatively moderate in Slovakia, Romania and Russia (at around 5% of GDP or below). As these numbers include direct as well as (in some cases very sizable) indirect measures (mainly guarantees and tax deferrals), the actual fiscal stimulus will crucially depend on the effective utilization of the available funds. Estimates of utilization by mid-September 2020 point to an already high usage in Turkey, Croatia, Hungary, Romania and Russia, while utilization remains more muted in the other countries. In addition to domestic spending, CESEE EU member states can make use of loans provided under the EU's SURE instrument (Support to mitigate Unemployment Risks in an Emergency) that was designed to tackle sudden increases in public expenditure for the preservation of employment.

**Central banks slash  
policy rates and  
resort to unconven-  
tional policy tools**

Monetary support in CESEE took the form of rate cuts, liquidity provision, quantitative easing and/or exchange rate stabilization. Since the escalation of the crisis in March, key policy rates were slashed throughout the region (in the Czech Republic by 200 basis points to 0.25%, in Poland by 140 basis points to 0.1%, in Hungary by 30 basis points to 0.6%, in Romania by 100 basis points to 1.5%, in Russia by 175 basis points to 4.25% and in Turkey by 250 basis points to 8.25%). To provide the banking sector with sufficient liquidity, central banks adjusted reserve requirements (e.g. in the Czech Republic, Croatia, Turkey), launched longer-term refinancing operations (e.g. in Croatia) and introduced new foreign currency-providing operations (e.g. in Turkey). New arrangements with the ECB need to be mentioned, in particular. The central banks of Hungary and Romania agreed on

new repo lines (EUR 4 billion and EUR 4.5 billion, respectively, until the end of June 2021) and the central banks of Croatia and Bulgaria agreed on new swap lines with the ECB (EUR 2 billion until the end of June 2021 and EUR 2 billion until the end of 2020). Furthermore, several central banks purchased bonds of their respective governments on the secondary market (e.g. in Poland, Hungary, Croatia, Romania and Turkey). Monetary authorities in Croatia and Russia also intervened in foreign exchange markets to ease depreciation pressures.

Banking sector regulation on liquidity, nonperforming exposures and reporting requirements was softened in many countries. Countercyclical capital and other mandatory capital buffers were reduced in the Czech Republic, Slovakia, Poland and Hungary. Several regulators also called on banks not to pay out dividends (e.g. in Hungary, Slovenia, Croatia and Bulgaria) and the Czech Republic adjusted its tool kit of borrower-based macroprudential measures.

Concerning general banking sector developments, the coronavirus pandemic brought about a reversal of previous years' trends. Most importantly, a slowdown in credit growth was observed in nearly all countries of the region (see chart 2). The only notable exception was Turkey, where (mostly state-owned) banks boosted consumer lending in an attempt to mitigate the general economic contraction. In the other CESEE countries, weaker demand and worsening credit supply conditions impacted on credit dynamics. Demand suffered from the faltering general economic momentum and deleveraging needs in the private sector. Supply was negatively affected by the local and international macroeconomic environment, local capital constraints, groups' funding and nonperforming exposures. While nonperforming loans (NPLs) have not yet embarked on an upward trend (also reflecting the policy measures outlined above), surveys among banks show that the quality of loan applications is expected to deteriorate sharply across the client spectrum and that NPLs are expected to increase markedly in the future.

The crisis has already had a notable impact on the profitability of the CESEE banking sectors. The average return on assets in mid-2020 was roughly 50% lower than a year earlier; in Slovenia and Hungary, it dropped to a quarter of the value

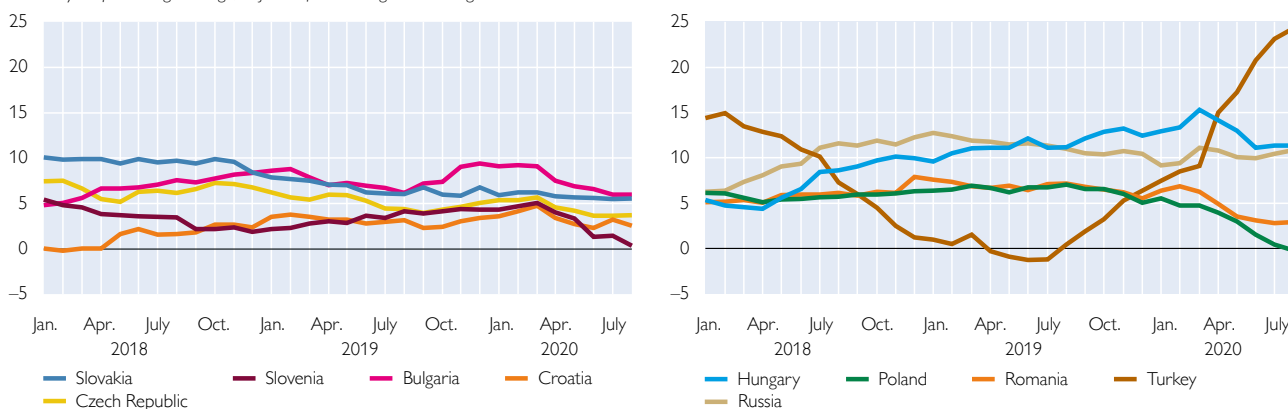
COVID-19 crisis weighs on credit growth...

...and negatively impacts banking sector profitability

Chart 2

### Growth of credit to the private sector

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



Source: National central banks.

Inflation mostly  
surprises on the  
upside

seen a year before. Rising loan loss provisions in response to the recession were a main driver of lower profits. Profitability will remain under pressure in the coming quarters, as eased regulatory requirements and loan moratoria only temporarily sheltered banking sectors from some of the COVID-19-related impact. Moratoria affect the timing of banks' interest income and the net present value of loans in countries where no interest can be charged on deferred payments. Central bank rate cuts put additional pressure on net interest margins and lower loan growth will weigh on operating income. Deteriorating profitability, coupled with rising NPLs, will likely weigh on banks' capital ratios. As of mid-2020, however, most CESEE banking sectors continued to report substantial capital buffers.

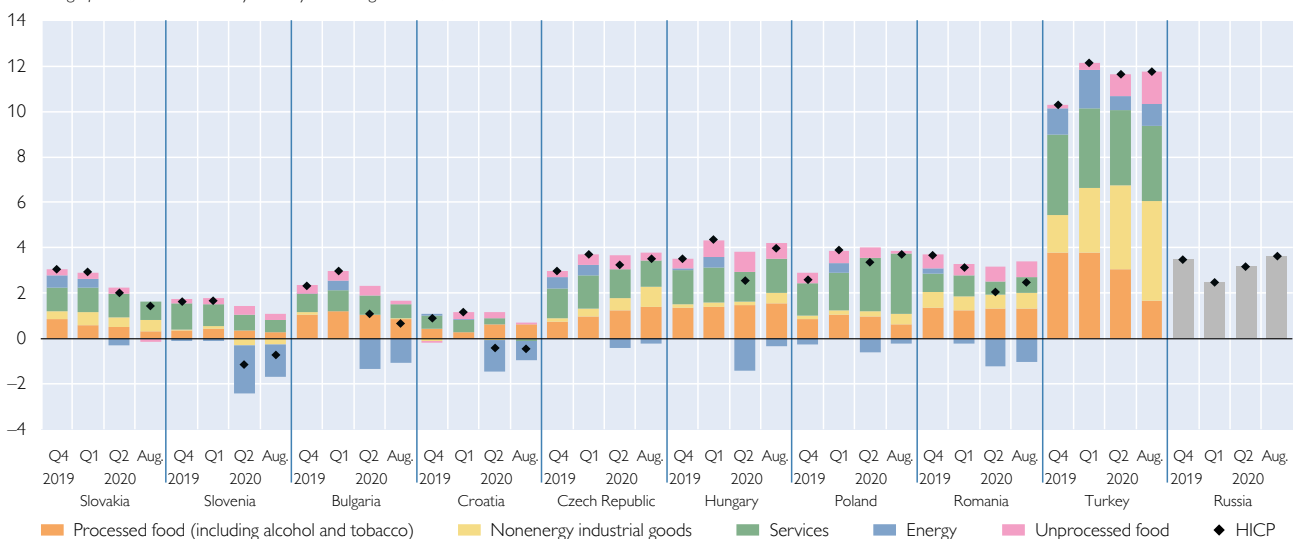
Inflation has surprised on the upside since the gradual reopening of CESEE economies in the second quarter of 2020 in many countries (including the Czech Republic, Hungary, Poland, Romania, Turkey and Russia) – despite the strong decline in economic activity (see chart 3). As price developments were heavily influenced by deflation in the energy component in recent months, several countries (e.g. the Czech Republic, Hungary and Poland) even reported rising core inflation rates in the midst of a deep recession.

When interpreting these trends, it should be noted that price data collection has been affected by the COVID-19 crisis. During lockdown periods, actual market prices for many goods and services were not available and had to be estimated from close substitutes or historical data. COVID-19 has probably also led to problems with recording seasonal price patterns (e.g. for flights, package holidays and accommodation services, or when seasonal sales in certain retail segments were postponed or canceled). On top of that, the actual consumption basket has likely changed during the pandemic and these changes in consumption patterns are not yet reflected in the HICP.

Chart 3

### 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.

Despite these caveats, unabated price pressures can be related to four factors: (1) Several CESEE currencies depreciated notably vis-à-vis the euro from March 2020 and retailers likely failed to reflect the effects of currency weakness in prices during lockdowns. (2) Administered price growth contributed positively to HICP dynamics in many CESEE countries as governments attempted to make up for at least a small part of missing budget revenues. (3) The lifting of the most severe restrictions released some pent-up demand. This sudden increase of demand met with incompletely restored production capacities in certain sectors (partly owing to disrupted supply chains), creating a mismatch between supply and demand (e.g. for certain industrial goods). (4) Capacity constraints related to social distancing measures and stepped up sanitary requirements contributed to price growth in certain service segments. Out of these four factors, currency depreciation has likely had the strongest effect on price growth, since inflation fell significantly in the euro area countries and in countries with a more stable or fixed exchange rate regime.

Price pressures, however, can be expected to moderate in the coming months as looser labor market conditions and weaker wage growth should start to weigh more strongly on core inflation. As of August 2020, inflation ran above the respective central bank targets in the Czech Republic, Hungary and Turkey. While the Czech and the Hungarian central banks expect a return to the target range until the end of 2020, the Turkish central bank expects inflation to remain elevated until late 2021.

Aggregate current account developments in the CESEE EU member states have so far only been little affected by the COVID-19 pandemic. In most countries, combined current and capital account balances remained broadly stable in mid-2020 when compared to the end of 2019 (see chart 4). Some changes in the composition of the current account, however, were visible. On the one hand, the lockdown-induced recession put a brake on profit outflows via the primary income account. On the other hand, trade and services balances tended to deteriorate somewhat in many countries, as external demand declined more strongly than domestic import demand.

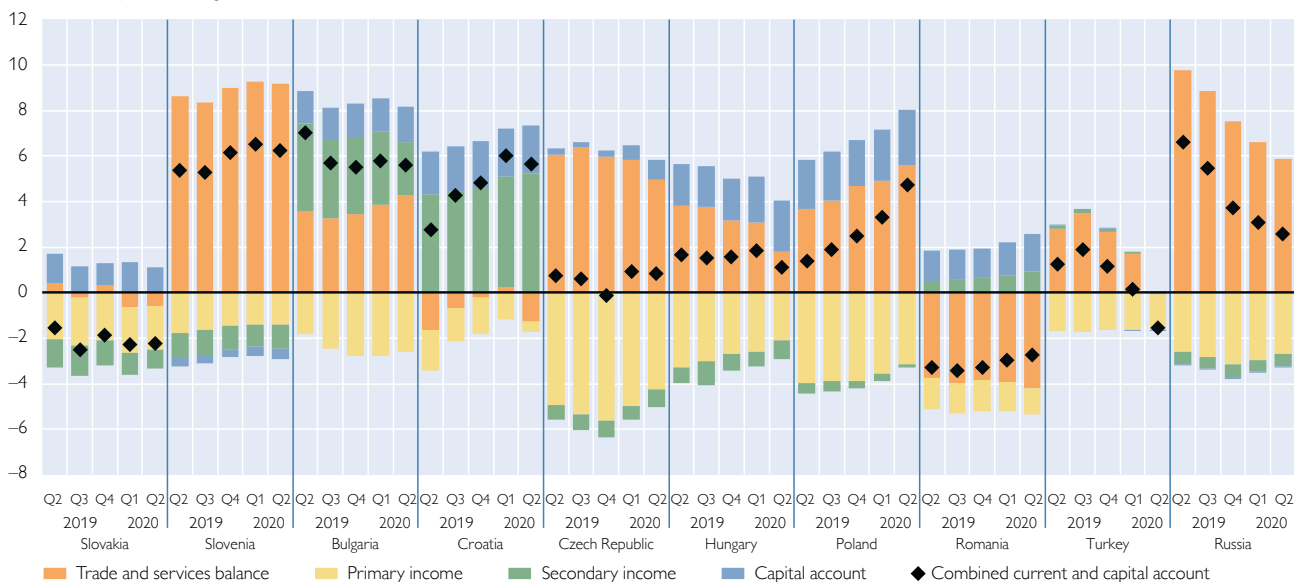
Despite currency weaknesses, Russia and Turkey reported a clear deterioration of their external accounts. In Russia, a notable decline of energy prices – the most important export commodity of the country – pushed nominal export growth deep into the red. In Turkey, the trade and services balance deteriorated already in the first quarter of 2020, as the recovery from the recession of 2018 and 2019 was still gathering steam and fueled import demand. The spread of coronavirus and the subsequent containment measures caused both imports and exports to contract strongly in the second quarter of 2020. While imports held up somewhat better due to government policies aimed at shoring up the economy, exports were severely impacted by the weak international environment and a sharp decline in foreign tourists' arrivals and travel revenues.

Stronger deterioration of the current account balance only in Russia and Turkey

Chart 4

### Combined current and capital account balance

% of GDP, four-quarter moving sum



Source: Eurostat, IMF, national central banks.

Financial stress eased after a short period in late March

Uncertainty at the start of the pandemic has led to currency depreciation, an increase in sovereign spreads and capital outflows from the region but monetary and financial easing in advanced economies contained financial stress and stabilized international markets. High-frequency fund flow data show that outflows from CESEE were mainly concentrated in the second half of March 2020 and that bond flows were far more strongly affected than equity flows. After this short episode, net fund flows hovered around zero until early October 2020. This is also underlined by more comprehensive quarterly financial accounts data. Financial account outflows spiked in the first quarter of 2020 in many countries and retreated again in the second quarter. Besides portfolio outflows, it was especially outflows from other investments that fueled this development. Among the countries of the region, only Russia continued to report a notable capital outflow also in the second quarter of 2020, mainly on account of stubbornly high portfolio outflows.

Uncertainty increased again in September

As the pressure on financial markets eased, also most CESEE currencies made up parts of their earlier losses between April and August 2020. The reacceleration of COVID-19 infections in recent weeks and/or numerous geopolitical concerns (e.g. unrest in Belarus, the poisoning of Russian opposition leader Alexei Navalny, the latest escalation of the Nagorno-Karabakh conflict, disputes around gas sources in the eastern Mediterranean), however, again weighed on currencies from August 2020. Especially the Hungarian forint, the Russian ruble and the Turkish lira lost in external value.

First central banks are (selectively) tightening monetary policy

In Hungary, this coincided with a selective tightening of monetary policy in September 2020, as the central bank raised its one-week deposit rate and its rate on three- and five-year covered loan tenders by 15 basis points to 0.75%.

After the Turkish central bank (TCMB) significantly loosened its monetary policy until June 2020 (see above), it discontinued its repo rate cuts from June onward, mainly because of stubbornly high inflationary pressures. In response to the nearly 7% depreciation of the lira against the euro in August alone, the TCMB progressively tightened monetary policy by canceling its one-week repo auctions and forcing banks to borrow at competitive one-month auctions or via the more expensive overnight markets. However, it left the repo rate unchanged at 8.25%. This policy did not stop the depreciation of the lira and the currency traded at historical lows in September 2020. On September 23, the central bank finally hiked its policy rate to 10.25%. The TCMB justified its rate move on the grounds of inflationary pressures caused by fast economic recovery with strong credit momentum and financial market developments. The depreciation of the lira has not halted at the cutoff date, though.

A reacceleration of newly detected COVID-19 infections since September has led to higher risks for general economic developments and the outlook for the CESEE region. Chart 5 shows that COVID-19 infections remained stable and at a rather low level in the CESEE EU member states during spring. Only Russia and Turkey experienced a first spike that more closely resembled the patterns observed throughout Western Europe. Against this background, containment measures were successively relaxed in many countries from mid-April onward.

Since early September, however, a clear upward trend in infections can be observed and numbers have bounced up to historical heights in many parts of CESEE. This has led to a tightening of containment measures in selected countries and an increase in uncertainty (as e.g. evidenced by renewed pressure on exchange rates).

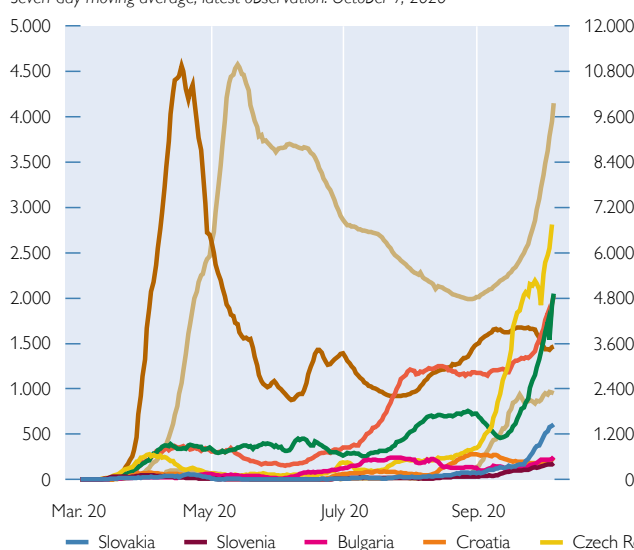
COVID-19 infections bounce to historical heights in several countries in September

Chart 5

### COVID-19 cases and government response

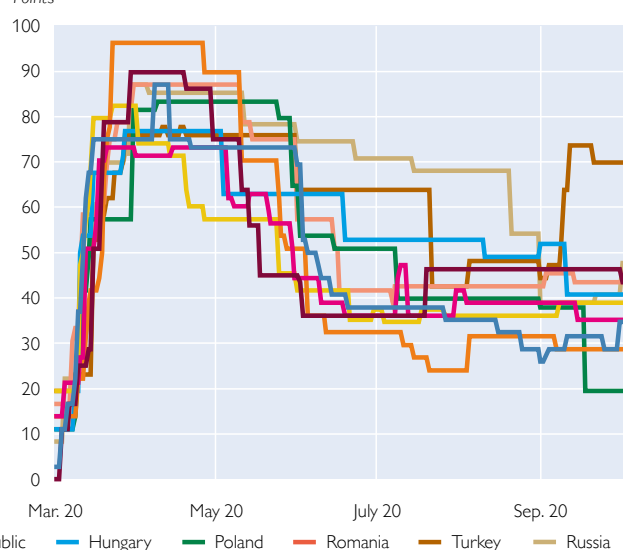
#### Number of newly confirmed COVID-19 cases

Seven-day moving average, latest observation: October 7, 2020



#### COVID-19 Government Response Stringency Index

Points

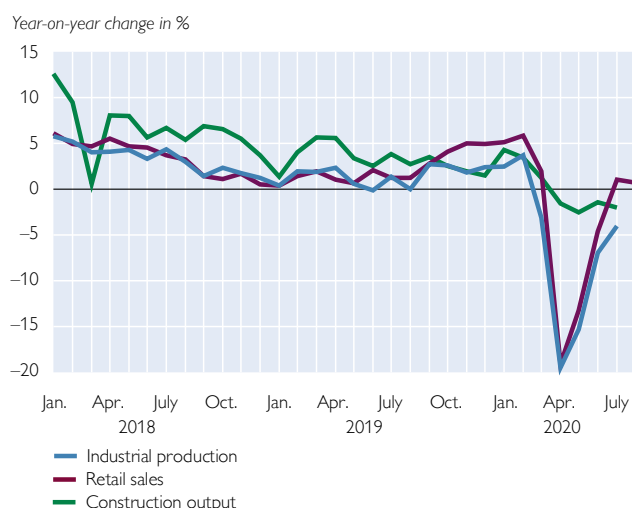


Source: European Centre for Disease Prevention and Control, Oxford COVID-19 Government Response Tracker, Blavatnik School of Government.

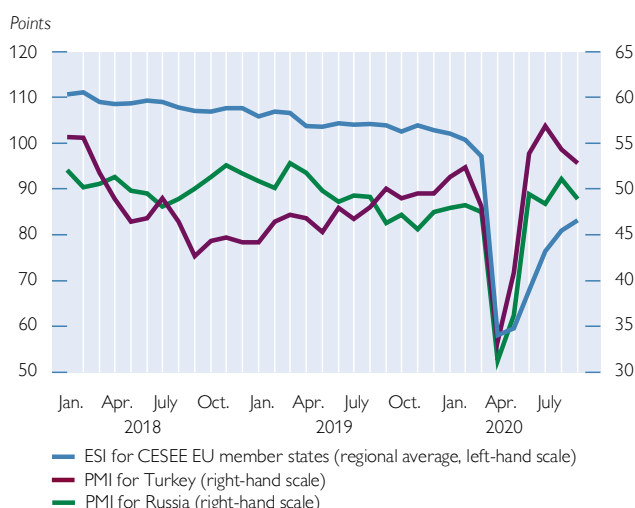
Note: The right-hand scale in the left panel shows the values for Russia.

## Leading indicators

### Activity indicators (CESEE regional average)



### Sentiment indicators



Source: Eurostat, wiw, European Commission, Markit.

High-frequency indicators suggest that the strong recovery after the lockdown could be short lived

After a collapse of partly historical dimensions in April 2020, retail sales and industrial production rebounded quickly in May and June (see chart 6), reflecting pent-up demand but also improving economic conditions in the region's main trading partner countries. Retail trade even returned to positive growth in July 2020. A similar pattern was observed for sentiment indicators, with a historic decline in April and a swift recovery afterward. None of the indicators, however, reached the levels observed before the lockdown.

Improvements, however, have stalled in most recent readings of activity as well as sentiment indicators, suggesting that the recovery could be short lived: Industrial production growth failed to accelerate more notably and remained clearly negative in July. The growth of retail sales remained positive but declined somewhat in August 2020. The growth of production in construction has declined since April, as fewer projects were started after the pandemic hit the region and as some countries scaled back infrastructure spending to make room for anti-crisis support. Readings of the Purchasing Managers' Index (PMI) for Russia and Turkey declined in September. In Russia, the PMI came in at below 50 points, thereby no longer signaling an economic expansion. The Economic Sentiment Indicator for the CESEE EU member states continued to improve throughout the past months, but it remained notably below its long-term average and improvements have successively become smaller. The beginning second wave will without any doubt further weigh on sentiment and endanger a quick and comprehensive recovery from the economic damage resulting from the lockdown in spring 2020. For more information on the outlook and risks for GDP growth please consult the Outlook for selected CESEE countries<sup>5</sup> in the current issue of *Focus on European Economic Integration*.

<sup>5</sup> Also available online at <https://www.oenb.at/en/Monetary-Policy/focus-area-central-eastern-and-southeastern-europe/economic-review-and-outlook.html>.



Box 1

### **Ukraine: GDP contraction accompanied by current account reversal, IMF program delay after disbursement of first tranche**

After GDP had already contracted slightly in the first quarter of 2020, the impact of the COVID-19 crisis fully came to the fore in the spring. In the second quarter, GDP shrank by 11.4% year on year, as domestic demand was hit by quarantine restrictions and uncertainties related to the pandemic. While private consumption declined by about 10% year on year, gross fixed capital formation even shrank by 22%. The drop in external demand hit exports severely, yet the export decline clearly undershot the import decline leading to a substantial positive growth contribution of net exports. The resulting improvement in the trade balance together with a rise in the surplus of the primary income balance (mainly due to losses of foreign investors) led to a reversal in the current account balance. The current account recorded a surplus of 6% of GDP in the first half of 2020 compared to a deficit of about 3% in the first half of 2019.

Following two interest rate cuts in the first quarter of 2020, the National Bank of Ukraine (NBU) continued its monetary easing policy with two further rate cuts in April and June (200 basis points each time), bringing the key policy rate down to 6%. Year-on-year inflation rates averaged about 2.5% in the first eight months of the year and, thus, were clearly below the central bank target range of 5%  $\pm$  1 percentage point. Yet, the NBU expects inflation to return to the target range in the second half of 2020. Nevertheless, when announcing its decision to keep the key policy rate stable in September, it signaled readiness to react if the adverse impact of the coronavirus pandemic on the economy increases.

In June 2020, the IMF Executive Board approved an 18-month Stand-By Arrangement (SBA) for Ukraine, with a total volume of about USD 5 billion. The program was designed to help Ukraine cope with COVID-19 challenges, while safeguarding the achieved macroeconomic stabilization and reform progress and advancing a small set of key structural reforms. A first tranche of USD 2.1 billion was disbursed immediately after approval. The IMF program was complemented with funding and funding commitments from other official creditors such as the EU and the World Bank. Thanks to official funding flows, a successful eurobond placement in July and NBU foreign currency purchases, foreign currency reserves increased to USD 29 billion at end-August from USD 25 billion at end-March. The end-August level corresponds to about 4.8 months of future imports according to the NBU.

A first review under the SBA was initially scheduled for September. In mid-September, the IMF explained that an effective anti-corruption framework in Ukraine was vital for the IMF and said that there was still no concrete date for the first review. This statement followed a controversial constitutional court ruling with regard to the National Anti-Corruption Bureau (declaring the appointment of its head under the previous president unconstitutional, among other things). Earlier, in July, the IMF Managing Director had called on the Ukrainian political leadership to preserve the independence of the NBU after its governor resigned, citing systematic political pressure. Though the first review has not started yet, the government budget for 2021 has become subject to discussions between the Ukrainian authorities and the IMF. It is worth noting that there has been progress on structural benchmarks under the SBA (e.g. the financial stability council approved an NPL reduction plan at state-owned banks).



### Western Balkans<sup>6</sup>: GDP drops sharply upon introduction of lockdown measures

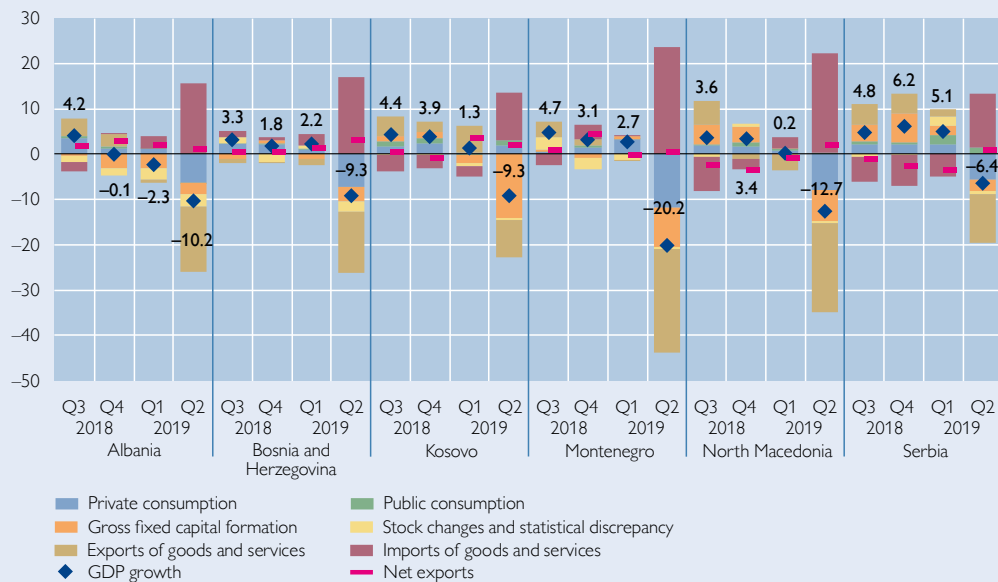
Western Balkan countries have been severely affected by the COVID-19 crisis. GDP dropped sharply in the second quarter of 2020, with contractions ranging between 6.4% in Serbia and 20.2% year on year in Montenegro. The latter country has been hit most strongly in the region due to its reliance on the tourism sector (accounting for more than 20% of GDP). Compared to the previous season, tourism revenues in Montenegro declined by approximately 80% this summer. Albania was the first country in the region showing negative GDP growth as early as in the first quarter of 2020 due to the consequences of the earthquake in November 2019 and the close trade ties to Italy (the first country strongly hit by the pandemic in Europe). By contrast, Serbia has proven to be more resilient to the negative impact of the crisis on the back of solid pre-pandemic GDP growth. Its more diversified production structure, and recent years' consolidation efforts which enabled the government to react with a large support package (the largest among the Western Balkan countries relative to GDP), helped mitigate the negative impact of the crisis.

A large decline in domestic demand contributed to the drop in GDP growth in all Western Balkans in the second quarter of 2020. With the introduction of lockdown measures, total private consumption declined in almost all countries in the region. Serbia's private consumption declined in the second quarter of 2020 by 7.3% year on year. In the other countries the decline was even larger: 10.3% in Albania, 13.4% in North Macedonia and 15.5% in Montenegro on

Chart 1

### GDP dropped with the introduction of lockdown measures

Percentage points, year-on-year GDP growth in %



Source: Eurostat, wiw, national statistical offices.

<sup>6</sup> The Western Balkans comprise Albania, Bosnia and Herzegovina, Kosovo, Montenegro, North Macedonia and Serbia. 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.

a year-on-year basis. Only in Kosovo, private consumption increased by 2.2% annually in the second quarter of 2020. Investments in gross capital formation have also declined in the region, by more than 20% year on year, on average, compared to the same quarter in the previous year. The decline was driven by a reduction in both public and private investments when the crisis hit. The most modest decline in investments has been observed in Serbia and Albania, with spending in gross fixed capital formation declining by 11.9% and 11.1% year on year, respectively. In the other CESEE countries, the decrease has been larger, reaching –26.3% in Montenegro, –25.6% year on year in North Macedonia (gross capital formation) and even –42% in Kosovo in the second quarter of 2020.

In line with global developments, both imports and exports decreased substantially in the region. In countries most integrated in global supply chains, like Serbia and North Macedonia, the decline in exported goods (amounting to –20.7% year on year in Serbia and –31.3% in North Macedonia) was partially offset by a decline in imports (–19.3% and –29.6% year on year, respectively) in the second quarter of 2020. On the other hand, countries relying on tourism, such as Montenegro, Albania and Kosovo, observed the largest decline in exports in the second quarter of 2020 (–55.9%, –49.9% and –39.7% year on year, respectively). However, due to the decline in imports in all countries, we could observe a narrowing of the trade deficit compared to the second quarter of 2019, reaching –9.5% of GDP in Serbia, –14.6% of GDP in North Macedonia, –21.1% of GDP in Albania, –34.1% of GDP in Kosovo and –44.7% of GDP in Montenegro.

The combined current and capital account deficit as a share of GDP widened in the second quarter of 2020 compared to the same period of the previous year, in all countries except Serbia and Kosovo. The largest increase in the deficit was observed in Montenegro, where it reached –35.1% of GDP, compared to –28.5% in the same quarter in 2019. Remittances experienced a large drop in Serbia and to a lesser extent in the other Western Balkan countries. By contrast, remittances have increased in yearly terms in Kosovo and North Macedonia. Developments in FDI inflows have been heterogeneous across the Western Balkans. In Albania, net FDI inflows increased in the second quarter of 2020 compared to the previous year, reaching –7.2% of GDP. In the other countries of the region, FDI inflows decreased in the second quarter of 2020 compared to the same quarter in 2019 but net FDI inflows increased in % of GDP in Kosovo and Montenegro. North Macedonia saw net FDI outflows of 0.6% of GDP in the second quarter of this year. Finally, Serbia also recorded a decline in FDI inflows, both in absolute and in net terms, reaching –6.1% of GDP in the second quarter of 2020.

Despite the severity of the economic downturn, the unemployment rate remained relatively stable compared to 2019 in most countries in the region up to the second quarter of 2020, averaging around 12.6% based on the available data (Bosnia and Herzegovina and Kosovo excluded). Following the downward trend of the previous year, unemployment (according to labor force survey data) decreased from 10.9% in 2019 to 7.7%, year on year, in the second quarter of 2020 in Serbia, and to 16.9% in North Macedonia, compared to 17.5% in the previous year. Nevertheless, labor market participation (especially of women) in the region remains low and the countries continue to experience strong brain drain. Average gross nominal wages in the Western Balkans continue to increase, but at a generally lower speed. Annual change in gross wages averaged 4.4% in the second quarter of 2020 (excluding Kosovo, where no data are available yet), reaching the highest growth rate in Serbia (8.7%, year on year). The slowdown due to the pandemic is likely to pose further challenges for labor markets in the coming months.

Inflation slowed down in almost all countries in the region in the second quarter of 2020, entering negative territory in Bosnia and Herzegovina and in Montenegro. Only Albania experienced an increase in CPI inflation in the beginning of 2020, reaching 1.9% in the second quarter. Higher inflation in Albania is mainly due to the increase in the price of food, nonalcoholic beverages and housing over the past months. On the other hand, Bosnia and Herzegovina, which had experienced a slowdown already before the crisis hit, had shown decreasing inflation in 2019 and even reached a deflation rate of 1.6% in the second quarter of 2020 due to decreasing oil prices and the imposed maximum margins on the local price of gasoline in the Federation of Bosnia and Herzegovina. Exchange rate developments in Albania and Serbia (the only two countries in the region with flexible exchange rate regimes) have been rather stable in recent months. Following temporary pressure on the Albanian lek in March, the central bank has supported the currency, and the exchange rate against the euro has stabilized at a slightly lower level compared to pre-crisis times.

In response to the pandemic, the Western Balkan countries have reacted with lockdown measures and monetary and fiscal policy steps. The National Bank of Serbia has progressively lowered the reference interest rate, from 3% in June 2019 to 1.25% in June 2020. North Macedonia has also decreased the policy rate in several steps, from 2.25% at the beginning of 2020 to 1.5% in May. The Bank of Albania decreased the policy rate from 1% to 0.5% in March. Next to interest rate reductions, all central banks (except the Central Bank of Bosnia and Herzegovina) have provided liquidity to the banking sector and introduced additional easing measures including the suspension of dividend payments of banks and the forbearance of loan repayments. A number of fiscal measures aimed at mitigating the short-run negative effects of the pandemic have been in place in all countries in the region. Economic support measures were often targeted at the most vulnerable households, the health care system, agricultural, tourism and banking sectors, and at employees affected by the crisis. Among other measures, tax payments and loan repayment moratoria were introduced. Additional measures taken by the governments in the region are limits to price hikes (Bosnia and Herzegovina, Serbia and Montenegro) and the lifting of import tariffs (Kosovo). The EU and international organizations like the IMF, the World Bank and the European Bank for Reconstruction and Development (EBRD) have been supporting the region with several packages in support of the health care system and with macrofinancial assistance (EU) or rapid financial assistance (IMF) and business competitiveness programs, also favoring energy efficiency technology investments and supporting small- and medium-sized enterprises. Further, the ECB has provided euro liquidity to several countries in the region through repo lines and the newly established Eurosystem repo facility for central banks EUREP<sup>7</sup>.

Fiscal positions are rather heterogeneous across the Western Balkans. General government debt at the end of 2019 varied between 16.9% of GDP in Kosovo and 77.2% of GDP in Montenegro, with Albania recording the second highest debt ratio (66.1% of GDP). Fiscal positions have deteriorated in all Western Balkan countries due to the COVID-19 crisis and budgetary revisions that now foresee much higher budget deficits. The most recent change of budgetary plans was undertaken in North Macedonia in October 2020. According to the second revision, the government now expects a budget deficit of 8.4% of GDP in 2020 compared to the 6.8% still projected in May 2020 after the first revision.

<sup>7</sup> Repo lines have been set up with the National Bank of the Republic of North Macedonia and the Bank of Albania (EUR 400 million each) and with the National Bank of Serbia (EUR 1 billion). These arrangements are to remain in place until June 2021.

Regarding the EU enlargement process, Albania and North Macedonia showed some progress in strengthening democracy and the rule of law. If the conditions set in the EU Council conclusions are met, the two countries are expected to formally start EU accession talks by the end of the year. The 2020 enlargement progress reports also note positive developments in addressing the need for reforms in Bosnia and Herzegovina (which might receive EU candidate status by the summer of next year), but are cautious about the situation in Kosovo due to the limited progress in tackling corruption and in reforming the justice and education system. With respect to Serbia and Montenegro, the EU Commission remains critical about Serbia's progress, especially due to its lack of progress in judiciary reforms, and Montenegro, where challenges in terms of independence, professionalism, efficiency and accountability of the judiciary remain. On a general note, the EU Council stresses the need to focus on fundamental reforms for improving the rule of law, democracy and the respect for fundamental rights in the region. The EU will support the region's political, economic and social transformation, assisting in boosting regional GDP through an Economic and Investment Plan (up to 9 billion euro in grant funding and 20 billion in guarantees), and providing Guidelines for the Implementation of the Green Agenda for the Western Balkans.

## 2 Slovakia: coronavirus knocked down an already slowing economy

The economy had been slowing down on the back of cooling foreign demand when the pandemic hit

Before recording a historically large drop in GDP in Q2 (−12.1%), the Slovak economy slid into recession already in Q1 2020 (−3.7%). This downturn reflected a continued, gradual cooling of foreign demand, which resulted in a significantly negative contribution of net exports and fixed investment to economic growth.

Coronavirus began to cast dark clouds on the economy in late March after it had spread across Europe, including Slovakia. To slow down the spread of the virus, Slovakia, like the rest of Europe, imposed a broad lockdown of the economy in spring. Hence, while private consumption growth took a significant hit, it was still positive in the first quarter of 2020, partially benefiting from households' stockpiling of food and medicines. In the second quarter, in contrast, household consumption saw a record contraction, a slump in consumer confidence and weakening household income. The decline of fixed investment accelerated in the second quarter, especially in the automotive industry, for various reasons, ranging from firms' depressed liquidity to elevated uncertainty. The worldwide containment measures hit the car industry particularly hard and brought about a massive contraction of exports. Nonetheless, as imports shrank at a similar rate, the contribution of net exports to growth in the second quarter of 2020 was broadly neutral. It is worth mentioning that the automotive industry, which accounts for about 12% of Slovak GDP, took the largest hit from falling exports, but has recovered fast since the relaxation of containment measures in early summer.

A broad fiscal and monetary response aims to mitigate the massive economic damage

The plunge in economic activity has sparked a corresponding reaction in the labor market, which had shown signs of overheating before the crisis hit. The unemployment rate increased from 5.6% in December 2019 to 6.8% in August 2020. A stronger hike in unemployment has been avoided by the introduction of a furlough scheme by the government. Deteriorating labor market conditions have been mirrored by weakening wage growth, which started to show already at the beginning of the year. Wage growth was impaired by a combination of factors such as firm closures and more people on sick or care leave, which also led to a massive decline in the number of hours worked. However, the latter recovered to nearly pre-crisis levels in early summer as economic activity started to normalize. Headline inflation came down from 3.2% in December 2019 to 1.4% in August 2020, owing to lower price rises of food and several services as well as due to declining prices of transportation and energy. The government introduced fiscal measures to counteract the crisis amounting to more than EUR 2 billion (about 2.3% of 2019 GDP). These include wage compensations, rental subsidies and moratoria, higher medical spending, enhanced unemployment, sickness and nursing benefits as well as deferral or waiver of health insurance and social security contributions, some taxes or loan repayments. In addition, several state guarantee schemes (worth up to EUR 4 billion) were adopted. As a result, the general government fiscal deficit is now expected to rise to 6% of GDP in 2020, compared to the December 2019 estimate of 1.6% of GDP, and general government debt is projected to go up to roughly 63% this year. As to monetary policy, Národná banka Slovenska (NBS) has adopted a highly accommodative monetary stance. Apart from the measures it implemented in its role as Eurosystem member, the central bank lowered the countercyclical capital buffer rate from 1.5 to 1.0% as of August 1, 2020, revoking its previous decision to increase it to 2.0%. Moreover, the NBS reduced the capital buffer for systemically important banks for Postova Banka from 1% to 0.25%, effective from January 1, 2021.

Table 2

## Main economic indicators: Slovakia

	2017	2018	2019	Q1 19	Q2 19	Q3 19	Q4 19	Q1 20	Q2 20
<i>Year-on-year change of the period total in %</i>									
GDP at constant prices	3.0	3.9	2.4	3.7	2.5	1.5	2.1	-3.7	-12.1
Private consumption	4.5	4.1	2.1	1.3	3.1	1.9	2.3	1.1	-4.0
Public consumption	1.0	0.2	4.6	3.5	6.0	4.2	4.7	1.1	-10.4
Gross fixed capital formation	3.5	2.6	6.8	3.1	4.2	10.4	8.3	-4.8	-14.6
Exports of goods and services	3.6	5.3	1.7	9.0	-0.9	-0.1	-0.5	-6.8	-26.8
Imports of goods and services	3.9	4.9	2.6	6.5	1.4	3.3	-0.5	-1.5	-27.0
<i>Contribution to GDP growth in percentage points</i>									
Domestic demand	3.2	3.4	3.1	1.1	4.6	4.5	2.1	1.9	-11.9
Net exports of goods and services	-0.2	0.5	-0.7	2.6	-2.2	-3.0	0.0	-5.4	-0.2
Exports of goods and services	3.4	5.0	1.7	8.9	-0.9	-0.1	-0.5	-7.0	-24.6
Imports of goods and services	-3.5	-4.6	-2.4	-6.3	-1.3	-2.9	0.5	1.5	24.4
<i>Year-on-year change of the period average in %</i>									
Unit labor costs in the whole economy (nominal, per person)	4.5	3.9	5.9	4.7	7.9	6.5	4.6	8.9	6.6
Unit labor costs in manufacturing (nominal, per hour)	6.5	3.5	5.7	1.7	4.3	7.7	8.7	8.6	20.8
Labor productivity in manufacturing (real, per hour)	1.0	4.7	1.3	7.4	2.6	-2.4	-2.0	-0.7	-11.7
Labor costs in manufacturing (nominal, per hour)	7.5	8.4	6.9	9.2	7.1	5.0	6.5	7.9	6.8
Producer price index (PPI) in industry	2.5	2.4	1.8	2.7	2.9	1.1	0.7	1.7	-1.4
Consumer price index (here: HICP)	1.4	2.5	2.8	2.4	2.6	3.0	3.1	2.9	2.0
<i>Period average levels</i>									
Unemployment rate (ILO definition, %, 15–64 years)	8.2	6.6	5.8	5.9	5.8	5.9	5.7	6.0	6.7
Employment rate (%, 15–64 years)	66.2	67.6	68.4	68.6	68.1	68.5	68.5	68.0	66.8
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>	10.2	8.4	8.4	7.5	6.2	6.8	6.8	6.2	5.6
of which: loans to households	11.8	11.3	11.3	9.5	8.5	8.1	8.0	7.9	7.0
loans to nonbank corporations	7.6	3.4	3.4	3.9	2.1	4.4	4.4	3.0	3.0
<i>%</i>									
Share of foreign currency loans in total loans to the non-bank private sector	0.2	0.1	0.1	0.2	0.1	0.1	0.1	0.3	0.3
Return on assets (banking sector)	0.8	0.8	0.8	0.8	0.9	0.8	0.8	0.3	0.3
Tier 1 capital ratio (banking sector)	16.6	16.6	16.6	16.7	16.8	16.6	16.6	17.3	18.0
NPL ratio (banking sector)	3.6	3.0	2.8	2.9	2.8	2.8	2.8	2.8	2.7
<i>% of GDP</i>									
General government revenues	40.5	40.7	41.5	..	..	..	..	..	..
General government expenditures	41.5	41.8	42.8	..	..	..	..	..	..
General government balance	-1.0	-1.0	-1.3	..	..	..	..	..	..
Primary balance	0.4	0.2	-0.1	..	..	..	..	..	..
Gross public debt	51.3	49.4	48.0	..	..	..	..	..	..
<i>% of GDP</i>									
Debt of nonfinancial corporations (nonconsolidated)	60.0	54.6	26.0	..	..	..	..	..	..
Debt of households and NPISHs <sup>2</sup> (nonconsolidated)	41.0	42.5	20.2	..	..	..	..	..	..
<i>% of GDP (based on EUR), period total</i>									
Goods balance	0.7	-0.2	-0.8	1.3	-0.8	-3.1	-0.3	-3.4	0.1
Services balance	1.1	1.0	1.1	0.8	1.6	1.6	0.4	1.3	1.3
Primary income	-2.1	-2.0	-2.1	-1.1	-2.3	-2.4	-2.5	-0.7	-2.0
Secondary income	-1.5	-1.4	-1.1	-1.9	-1.3	-1.1	0.0	-1.4	-0.8
Current account balance	-1.9	-2.6	-2.9	-1.0	-2.8	-5.1	-2.4	-4.2	-1.4
Capital account balance	0.1	1.4	1.0	0.2	1.3	0.0	2.4	1.7	0.3
Foreign direct investment (net) <sup>3</sup>	-2.8	-0.9	-2.2	-0.5	1.0	-2.0	-6.9	-1.6	3.9
<i>% of GDP (rolling four-quarter GDP, based on EUR), end of period</i>									
Gross external debt	108.2	113.7	111.9	110.4	112.3	113.4	111.9	112.5	123.5
Gross official reserves (excluding gold)	2.3	3.8	5.3	4.4	4.8	5.6	5.3	5.5	6.7
<i>Months of imports of goods and services</i>									
Gross official reserves (excluding gold)	0.3	0.5	0.7	0.5	0.6	0.7	0.7	0.7	0.9
<i>EUR million, period total</i>									
GDP at current prices	84,521	89,606	94,171	21,657	23,667	24,597	24,251	21,485	21,200

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: recession lets budget deficit soar and sends banks' profitability into nosedive

GDP severely hit by COVID-19, but gradual recovery has started

Slovenia's GDP contracted by 13.1% year on year during Q2 2020, which brought the decline in economic activity during the first half of the year to around 8% year on year. Domestic demand was heavily hit by the COVID-19 crisis, with both private consumption and investments contracting by more than 16% year on year during Q2 2020. This reflected collapsing economic sentiment, declining employment, a rise in part-time employment and slowing real average wage growth, a sharp drop in capacity utilization and a slowdown in lending to households and corporates. Public consumption increased modestly, reflecting measures taken by the government in response to the pandemic. Net real exports had a negative effect on the overall growth rate, as both exports and imports decreased by roughly 25% year on year. For both exports and imports, services trade collapsed more than trade in goods, as the transportation and tourism sector belonged to those hit most severely by the lockdown measures. High-frequency indicators suggest that the economy started to slowly but steadily recover from May onward. However, confidence indicators as well as the index levels of "hard" data (industrial output, construction, retail sales) continued to be substantially lower than in February.

Government budget to slip into large deficit in 2020

As a result of the pandemic, the general government budget balance turned into a deficit of around 4.7% of GDP during the first half of 2020, compared to a surplus of 0.5% of GDP in the same period of 2019. In late September, parliament adopted changes to the 2020 budget, increasing the deficit target to 9.3% of GDP, as opposed to the original target of a surplus of around 1% of GDP. The large deficit is the result of the fiscal impact of the recession and the government measures taken in response. Compared to the original plan, revenues are expected to drop by around 15% while expenditure is set to rise by 30%.

Nosediving domestic demand and temporary cut in electricity prices drive inflation into negative territory

The sharp contraction of economic activity went hand in hand with slowing price pressures, with inflation remaining in negative territory since April 2020. Deflation was primarily driven by energy prices, not least due to the temporary cut in household electricity prices in response to the pandemic. Core inflation has slowed substantially as well on the back of price developments in services and non-energy industrial goods.

Slowing credit growth and increased provisioning bites into bank profitability

The growth of credit to the private sector has slowed markedly in recent months (from around 5%–6% in early 2020 to 1%–2% in June 2020), with corporate and retail loans having been affected to a similar extent. Presumably both supply and demand factors have been at work. In the retail segment, housing loans have been least affected, while the growth rate of loans for consumption and other purposes even turned negative. Take-up under the debt service moratorium scheme was very limited, covering only 3.1% of the total number of household loans and 5.6% of the total number of corporate loans by the end of June 2020. Slowing credit activity was mirrored in the decrease in the banking sector's net interest income during the first half of 2020. Net noninterest income fell even more. The deteriorating economic situation resulted in an increase in impairment and provisioning costs. Overall, the banking sector's net profit fell by two-thirds during the first half of 2020. Nonperforming exposures continued to decline both in absolute terms and as a percentage of total exposures. However, classified claims in arrears for more than 90 days increased, indicating some deterioration in the quality of banks' credit portfolios.

Table 3

## Main economic indicators: Slovenia

	2017	2018	2019	Q1 19	Q2 19	Q3 19	Q4 19	Q1 20	Q2 20
<i>Year-on-year change of the period total in %</i>									
GDP at constant prices	4.8	4.4	3.2	4.4	3.3	3.1	2.0	-2.4	-13.1
Private consumption	1.9	3.6	4.8	4.8	6.5	5.8	2.3	-6.4	-17.4
Public consumption	0.4	3.0	1.7	2.5	2.4	2.5	-0.3	4.2	-0.9
Gross fixed capital formation	10.2	9.6	5.8	11.9	9.2	4.8	-1.2	-5.4	-16.5
Exports of goods and services	11.1	6.3	4.1	5.0	5.4	4.9	1.1	-0.9	-23.5
Imports of goods and services	10.7	7.2	4.4	4.8	6.0	7.6	-0.3	-1.9	-24.4
<i>Contribution to GDP growth in percentage points</i>									
Domestic demand	3.6	4.5	3.1	3.8	3.2	4.6	0.9	-3.1	-11.6
Net exports of goods and services	1.2	-0.1	0.1	0.6	0.1	-1.5	1.1	0.7	-1.5
Exports of goods and services	8.6	5.2	3.5	4.3	4.6	4.1	0.9	-0.8	-20.0
Imports of goods and services	-7.4	-5.3	-3.4	-3.7	-4.6	-5.7	0.3	1.5	18.5
<i>Year-on-year change of the period average in %</i>									
Unit labor costs in the whole economy (nominal, per person)	1.2	2.8	4.2	3.1	5.6	4.2	3.9	6.9	11.0
Unit labor costs in manufacturing (nominal, per hour)	-2.4	-2.6	0.0	1.5	-0.4	-1.9	0.6	2.8	20.7
Labor productivity in manufacturing (real, per hour)	9.2	6.5	4.0	5.3	4.9	3.8	2.1	1.6	-13.9
Labor costs in manufacturing (nominal, per hour)	6.7	3.7	3.9	6.9	4.5	1.8	2.7	4.4	3.9
Producer price index (PPI) in industry	2.2	2.1	0.6	1.1	0.8	0.3	0.4	-0.1	-0.6
Consumer price index (here: HICP)	1.6	1.9	1.7	1.3	1.7	2.1	1.6	1.6	-1.2
<i>Period average levels</i>									
Unemployment rate (ILO definition, %, 15–64 years)	6.7	5.2	4.5	4.9	4.3	4.8	4.0	4.6	5.2
Employment rate (%, 15–64 years)	69.3	71.1	71.9	71.3	72.5	72.1	71.6	71.5	70.0
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>	4.9	1.9	1.9	2.8	3.6	3.9	4.3	5.1	1.3
of which: loans to households	6.8	6.4	6.4	6.3	5.9	5.7	5.8	4.1	1.6
loans to nonbank corporations	3.1	-2.2	-2.2	-0.6	1.4	2.1	2.8	6.1	1.1
<i>%</i>									
Share of foreign currency loans in total loans to the non-bank private sector	2.4	2.0	1.7	1.9	1.8	1.8	1.7	1.6	1.6
Return on assets (banking sector)	1.1	1.3	1.3	1.3	1.8	1.6	1.3	0.6	0.6
Tier 1 capital ratio (banking sector)	17.7	17.6	17.8	17.6	17.6	17.7	17.8	..	..
NPL ratio (banking sector)	3.7	2.3	1.1	2.0	1.5	1.5	1.1	1.1	1.2
<i>% of GDP</i>									
General government revenues	44.0	44.3	44.2	..	..	..	..	..	..
General government expenditures	44.1	43.6	43.7	..	..	..	..	..	..
General government balance	0.0	0.7	0.5	..	..	..	..	..	..
Primary balance	2.4	2.7	2.2	..	..	..	..	..	..
Gross public debt	74.1	70.4	66.1	..	..	..	..	..	..
<i>% of GDP</i>									
Debt of nonfinancial corporations (nonconsolidated)	55.4	51.5	24.4	..	..	..	..	..	..
Debt of households and NPISHs <sup>2</sup> (nonconsolidated)	27.1	26.9	12.8	..	..	..	..	..	..
<i>% of GDP (based on EUR), period total</i>									
Goods balance	3.7	2.5	2.7	3.7	3.6	1.6	2.2	5.1	5.5
Services balance	5.2	5.8	6.3	5.2	6.1	7.4	6.3	4.9	3.8
Primary income	-2.1	-1.8	-1.4	-1.1	-1.9	-1.6	-1.1	-0.9	-2.0
Secondary income	-0.7	-0.9	-1.0	-1.9	-0.8	-1.0	-0.5	-1.5	-1.2
Current account balance	6.1	5.7	6.5	5.9	7.0	6.3	6.8	7.7	6.0
Capital account balance	-0.8	-0.5	-0.3	-0.2	-0.1	-0.2	-0.9	-0.5	-0.2
Foreign direct investment (net) <sup>3</sup>	-1.2	-2.0	-1.4	-3.9	-1.1	-1.0	0.0	-1.7	-1.3
<i>% of GDP (rolling four-quarter GDP, based on EUR), end of period</i>									
Gross external debt	100.4	91.8	91.1	91.1	92.5	93.6	91.1	94.7	102.3
Gross official reserves (excluding gold)	1.5	1.5	1.6	1.6	1.7	1.6	1.6	1.7	1.8
<i>Months of imports of goods and services</i>									
Gross official reserves (excluding gold)	0.2	0.2	0.3	0.2	0.3	0.3	0.3	0.3	0.3
<i>EUR million, period total</i>									
GDP at current prices	43,009	45,863	48,393	11,252	12,190	12,489	12,462	11,270	10,828

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).



Slowing economic recovery due to deteriorating COVID-19 situation in summer

#### 4 Bulgaria: severest recession since 1999 amid rising political uncertainty

Having avoided a severe first wave in spring 2020, Bulgaria saw a substantially faster spread of COVID-19 in July after gradually reopening its economy. As a result, the so-called “epidemic declaration” that succeeded the two-month state of emergency in mid-May has been repeatedly extended.

Due to a sharp fall in external demand and lockdown measures, real GDP dropped by nearly 9% in annual terms in the second quarter of 2020 (the strongest quarterly contraction since 1999). A production-side view reveals that the recession was mainly driven by wholesale and retail trade, transportation, accommodation and industry sectors, while the contribution of information and communication sectors was still positive. HICP inflation fell from 3.1% in February to 0.6% in August 2020, mainly driven by a decline in energy prices. On the other hand, Bulgaria’s utilities regulator decided to raise gas prices by 20% as of September 2020 and by another 10% as of October. Compared to the sharp GDP contraction, labor market distortions have been moderate so far, mostly due to government support measures. At end-August, the unemployment rate (seasonally adjusted) stood at 6.2% and was thus about 2 percentage points higher than before the crisis.

Rising COVID-19 cases had a severe impact on tourism, which saw a stronger decline than in most other EU countries. Nights spent by nonresidents in Bulgaria were lower by 96% in June and by 78% in July compared to the same period a year ago. Domestic tourism slowed less severely but still substantially. Preliminary data indicate an even steeper annual decline in August as compared to July.

The so-called 60:40 job retention scheme has emerged as one of the main crisis mitigation measures adopted by the government. Under this scheme, the state supported affected businesses by taking over 60% of gross salaries of employees under the condition that employers retain their staff and pay the remaining 40%. The scheme expired in September, and although the government had signaled its willingness to extend it, no decision had been taken at the time of writing. For the particularly hard-hit hospitality industry, an analogous 80:20 scheme with a duration until the end of 2020 was set up, with discussions going on about extending it until May 2021.

Despite the economic policy measures, the consolidated general government budget remained in surplus through the first eight months of the year, partly reflecting a reprioritization of expenditures and some delay in implementing the measures. So far, the government has been successful in issuing long-term bonds at favorable conditions, exploiting in September already half of the annual borrowing amount.

ERM II accession overshadowed by mass anti-government protests

Marking an important milestone, the Bulgarian lev was included in the exchange rate mechanism ERM II on July 10, 2020, with its existing currency board arrangement in place. The latter remains comfortably backed by a comparatively large share of gross official reserves (excluding gold) of more than 43% of GDP. Also, on October 1, Bulgaria joined the SSM, which implies that the ECB started to directly supervise five banks in Bulgaria; three of these banks are the largest banks of the country and the other two are part of important cross-border groups.

Quite in parallel to ERM II accession, mass anti-government protests erupted in early July and persisted until most recently. These protests are rooted in people’s perception of state capture, a lack of judiciary independence and widespread corruption and are calling for a resignation of the government and the chief prosecutor. On a related note, political struggles between the opposition-backed president and the government have intensified.

Table 4

**Main economic indicators: Bulgaria**

	2017	2018	2019	Q1 19	Q2 19	Q3 19	Q4 19	Q1 20	Q2 20
<i>Year-on-year change of the period total in %</i>									
GDP at constant prices	3.5	3.1	3.4	4.5	3.6	2.9	2.9	1.2	-8.7
Private consumption	3.8	4.4	5.8	3.8	7.1	7.0	5.3	1.2	-5.8
Public consumption	4.3	5.3	5.5	6.9	1.4	6.1	7.5	2.0	1.1
Gross fixed capital formation	3.2	5.4	2.2	0.2	0.9	0.9	5.6	-7.1	-8.8
Exports of goods and services	5.8	1.7	1.9	4.1	0.3	3.7	-0.3	1.8	-19.6
Imports of goods and services	7.4	5.7	2.4	2.8	1.2	6.3	-0.5	0.3	-18.9
<i>Contribution to GDP growth in percentage points</i>									
Domestic demand	4.2	5.5	3.6	3.5	4.2	4.0	2.8	-0.1	-8.2
Net exports of goods and services	-0.7	-2.4	-0.3	0.8	-0.6	-1.1	0.1	1.1	-0.6
Exports of goods and services	3.7	1.1	1.3	2.9	0.2	2.5	-0.2	1.3	-12.2
Imports of goods and services	-4.4	-3.6	-1.5	-2.1	-0.8	-3.6	0.3	-0.2	11.6
<i>Year-on-year change of the period average in %</i>									
Unit labor costs in the whole economy (nominal, per person)	8.4	6.3	3.0	2.9	4.1	1.5	3.3	4.6	10.0
Unit labor costs in manufacturing (nominal, per hour)	6.0	2.0	6.3	2.5	6.5	8.9	7.6	7.8	9.8
Labor productivity in manufacturing (real, per hour)	6.2	7.7	3.7	10.1	2.9	-0.3	3.3	1.2	0.9
Labor costs in manufacturing (nominal, per hour)	12.6	9.8	10.5	12.9	9.7	8.6	11.1	9.1	10.7
Producer price index (PPI) in industry	4.9	4.0	3.0	3.3	2.7	3.4	2.8	1.4	-4.4
Consumer price index (here: HICP)	1.2	2.6	2.5	2.5	2.8	2.2	2.3	3.0	1.1
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)	6.3	5.3	4.3	5.1	4.2	3.7	4.1	4.6	6.0
Employment rate (%, 15–64 years)	66.9	67.7	70.1	68.3	70.7	71.4	70.0	68.1	67.4
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>	4.8	8.3	8.3	7.9	6.9	7.2	9.4	9.1	6.6
of which: loans to households	6.1	11.2	11.2	11.0	8.1	9.1	9.5	9.9	8.0
loans to nonbank corporations	4.1	6.6	6.6	6.1	6.2	6.0	9.3	8.7	5.7
<i>%</i>									
Share of foreign currency loans in total loans to the non-bank private sector	37.9	34.9	33.2	34.1	33.5	33.1	33.2	32.7	32.6
Return on assets (banking sector)	1.2	1.7	1.5	1.2	1.7	1.6	1.5	1.0	0.9
Tier 1 capital ratio (banking sector)	20.9	19.4	19.5	18.3	19.7	20.2	19.5	19.8	22.5
NPL ratio (banking sector)	6.9	5.1	4.2	4.9	4.8	5.0	4.2	4.2	5.2
<i>% of GDP</i>									
General government revenues	36.0	38.5	38.4	..	..	..	..	..	..
General government expenditures	34.9	36.6	36.3	..	..	..	..	..	..
General government balance	1.1	2.0	2.1	..	..	..	..	..	..
Primary balance	1.9	2.6	2.7	..	..	..	..	..	..
Gross public debt	25.3	22.3	20.4	..	..	..	..	..	..
<i>% of GDP</i>									
Debt of nonfinancial corporations (nonconsolidated)	85.2	83.2	76.9	..	..	..	..	..	..
Debt of households and NPISHs <sup>3</sup> (nonconsolidated)	22.6	23.0	21.3	..	..	..	..	..	..
<i>% of GDP (based on EUR), period total</i>									
Goods balance	-1.5	-3.3	-2.8	-2.7	-4.0	-1.6	-2.9	-3.0	-1.1
Services balance	5.9	6.3	6.2	3.1	5.6	12.1	3.5	5.4	4.2
Primary income	-4.4	-1.2	-2.8	-2.9	-3.2	-3.2	-1.8	-2.9	-2.5
Secondary income	3.5	3.5	3.4	4.3	4.7	2.9	2.0	3.6	1.1
Current account balance	3.5	5.3	4.0	1.8	3.1	10.2	0.7	3.1	1.8
Capital account balance	1.0	1.1	1.5	1.5	1.6	1.6	1.2	1.4	2.0
Foreign direct investment (net) <sup>4</sup>	-2.5	-0.6	-1.3	-0.7	-0.8	-2.3	-1.2	-2.1	-0.8
<i>% of GDP (rolling four-quarter GDP, based on EUR), end of period</i>									
Gross external debt	71.8	65.9	62.2	65.6	64.5	64.5	62.2	61.2	62.0
Gross official reserves (excluding gold)	42.5	42.1	38.0	41.0	40.1	39.5	38.0	40.3	43.3
<i>Months of imports of goods and services</i>									
Gross official reserves (excluding gold)	8.1	8.1	7.6	7.9	7.9	7.7	7.6	8.1	9.1
<i>EUR million, period total</i>									
GDP at current prices	52,310	56,087	60,675	12,711	15,070	16,184	16,710	13,076	14,007

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: exports plummet as spring tourist season falls victim to lockdown

Largest GDP contraction in the region in the second quarter

In the first half of 2020, Croatia's GDP contracted by 7.4%, and by as much as 15.1% in the second quarter alone, the largest drop among the CESEE countries covered in this article. The contraction in the first half of 2020 was broadly based with sharp falls in all components. Net exports made a negative contribution as exports contracted more (–21.8% year on year) than imports (–17%), largely due to a sharp drop in service exports: tourist arrivals in the first half of 2020 fell by 80% compared to the same period in 2019. As a result, also the current account deficit widened to 6% of GDP in the second quarter of 2020 (versus 2.6% of GDP a year earlier). On the output side, wholesale and retail trade, transportation, accommodation and food service activities contracted the most (–20% year on year), followed by taxes (less subsidies on products), which decreased by 18%. These categories combined accounted for most of the drop in GDP. Industry contracted, but some sectors continued to grow in the first half of 2020, including construction, ICT and public administration.

Central bank and government policies prevented worse economic contraction

Without a stabilizing monetary policy and substantial government support measures, the slump could have been much worse. Government packages amounted to an estimated 11% of GDP and included mainly state guarantees for loans, tax deferrals and write-offs. Most of direct fiscal spending was for the wage support scheme for enterprises affected by COVID-19. The scheme was recently extended until end-2020, but eligibility criteria were tightened over time. Since the peak in May, the number of workers for which employers received wage support declined from around 550,000 (more than 30% of Croatia's labor force) to around 57,500 at end-July. In August, the unemployment rate was 8.3%, 1.8 percentage points higher compared to August 2019.

The Croatian central bank (HNB) was very active in the early stages of the pandemic, conducting foreign currency interventions and liquidity operations and establishing a swap line with the ECB (agreed until June 2021). Foreign currency interventions led to a temporary decline of international reserves to EUR 15.7 billion in May, but reserves had returned to their end-2019 level of around EUR 18 billion by end-July (approximately 9 months of imports). In April, monthly HICP inflation turned negative and stood at –0.4% in August, largely due to a strong contraction in energy prices. Core inflation also declined but remained positive at 0.5% in August 2020.

Banking sector profits halved, NPL ratio still unchanged

The HNB reported that the banking sector's return on assets in the first half of 2020 halved to 0.76% compared to last year. Four out of twenty banks were recording losses. The tier 1 capital ratio stood at a high level of 24% in mid-2020, and the ratio of nonperforming loans (NPL ratio) was 5.5%, both roughly unchanged compared to end-2019. The rise in NPLs was prevented by regulatory easing, but IFRS 9 "stage 2" loans increased strongly. As of June 10, 2020, 8% of the banking sector's credit volume was covered by a moratorium, according to the HNB. 76% of moratoria were granted to households, while corporates accounted for the bulk of the volume (71% of the total).

Fiscal imbalances and debt indicators worsen due to COVID-19

The fiscal response to the crisis has led to a sharp increase of the already high level of sovereign debt, which reached 85.3% of GDP in the second quarter of 2020 versus 73.2% of GDP in 2019, and the budget deficit stood at 7.5% of GDP in the first half of 2020. Croatia's external debt increased to 79.7% of GDP in the second quarter of 2020 from 75.8% at end-2019.

Table 5

## Main economic indicators: Croatia

	2017	2018	2019	Q1 19	Q2 19	Q3 19	Q4 19	Q1 20	Q2 20
<i>Year-on-year change of the period total in %</i>									
GDP at constant prices	3.1	2.7	2.9	4.1	2.4	2.9	2.5	0.4	-15.1
Private consumption	3.1	3.2	3.5	4.3	2.7	3.0	4.0	0.8	-13.8
Public consumption	2.2	1.3	3.3	3.1	3.9	2.9	3.5	4.8	0.7
Gross fixed capital formation	5.1	4.1	7.1	11.5	8.2	5.0	4.0	3.1	-14.7
Exports of goods and services	6.8	3.7	4.6	4.1	3.3	5.1	5.6	-3.0	-40.6
Imports of goods and services	8.4	7.5	4.8	6.5	8.3	4.3	0.1	-5.8	-28.1
<i>Contribution to GDP growth in percentage points</i>									
Domestic demand	3.8	4.5	3.1	6.4	5.2	1.0	0.4	-2.0	-10.6
Net exports of goods and services	-0.6	-1.8	-0.1	-2.1	-2.7	1.6	2.2	2.1	-4.6
Exports of goods and services	3.3	1.8	2.3	1.5	1.6	3.6	2.3	-1.1	-19.8
Imports of goods and services	-3.9	-3.7	-2.5	-3.6	-4.3	-2.0	-0.1	3.2	15.2
<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)	1.1	6.5	11.4	8.0	11.3	12.2	14.5	5.4	6.7
Labor productivity in manufacturing (real, per hour)	3.6	2.2	-7.2	-0.1	-9.3	-8.1	-10.3	-5.1	-6.2
Labor costs in manufacturing (nominal, per hour)	4.6	9.0	3.6	7.9	0.9	3.2	2.7	0.0	0.1
Producer price index (PPI) in industry	2.0	2.2	0.8	1.4	1.6	-0.2	0.3	-0.1	-5.4
Consumer price index (here: HICP)	1.3	1.6	0.8	0.8	0.8	0.7	0.9	1.2	-0.4
EUR per 1 HRK, + = HRK appreciation	0.9	0.6	0.0	0.2	-0.3	0.3	-0.3	-0.9	-2.1
<i>Period average levels</i>									
Unemployment rate (ILO definition, %, 15–64 years)	11.3	8.6	6.7	7.6	6.2	5.8	7.3	7.1	6.5
Employment rate (%, 15–64 years)	58.9	60.7	62.1	61.2	61.8	63.0	62.2	61.4	62.2
Key interest rate per annum (%)	..	..	..	..	..	..	..	..	..
HRK per 1 EUR	7.5	7.4	7.4	7.4	7.4	7.4	7.4	7.5	7.6
<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	2.4	2.4	3.5	2.8	2.3	3.4	4.7	2.3
of which: loans to households	2.2	4.7	4.7	5.9	6.0	6.3	6.7	5.3	3.0
loans to nonbank corporations	-1.6	-0.8	-0.8	0.2	-1.6	-3.3	-1.3	3.9	1.2
<i>%</i>									
Share of foreign currency loans in total loans to the non-bank private sector	56.9	54.7	51.5	54.4	53.0	51.9	51.5	51.5	51.4
Return on assets (banking sector)	0.9	1.2	1.4	1.3	1.5	1.4	1.4	1.0	0.8
Tier 1 capital ratio (banking sector)	22.3	22.1	24.0	21.6	22.2	22.0	24.0	22.7	24.0
NPL ratio (banking sector)	8.8	7.6	5.5	7.4	7.3	6.0	5.5	5.4	5.5
<i>% of GDP</i>									
General government revenues	46.1	46.5	47.5	..	..	..	..	..	..
General government expenditures	45.3	46.3	47.1	..	..	..	..	..	..
General government balance	0.8	0.2	0.4	..	..	..	..	..	..
Primary balance	3.5	2.5	2.6	..	..	..	..	..	..
Gross public debt	77.8	74.7	73.2	..	..	..	..	..	..
<i>% of GDP</i>									
Debt of nonfinancial corporations (nonconsolidated)	93.8	92.2	88.0	..	..	..	..	..	..
Debt of households and NPISHs <sup>2</sup> (nonconsolidated)	34.2	34.1	32.5	..	..	..	..	..	..
<i>% of GDP (based on EUR), period total</i>									
Goods balance	-17.2	-18.7	-19.4	-21.8	-22.3	-15.8	-18.4	-20.9	-17.1
Services balance	17.9	17.9	19.2	1.9	17.5	43.6	8.2	3.4	4.2
Primary income	-1.4	-1.6	-1.6	-1.5	-2.7	-1.6	-0.6	0.6	0.2
Secondary income	4.2	4.3	4.6	3.8	5.0	3.6	6.0	5.1	6.7
Current account balance	3.5	1.8	2.7	-17.5	-2.6	29.8	-4.8	-11.9	-6.0
Capital account balance	1.1	1.4	2.1	1.7	2.8	1.5	2.4	1.9	3.1
Foreign direct investment (net) <sup>3</sup>	-2.3	-1.6	-2.0	-4.3	0.6	-2.3	-2.4	-2.8	-1.6
<i>% of GDP (rolling four-quarter GDP, based on EUR), end of period</i>									
Gross external debt	89.0	82.7	75.8	83.7	85.1	80.6	75.8	74.7	79.7
Gross official reserves (excluding gold)	32.0	33.8	34.4	35.0	37.7	38.2	34.4	30.5	33.5
<i>Months of imports of goods and services</i>									
Gross official reserves (excluding gold)	7.8	7.9	7.9	8.1	8.6	8.7	7.9	7.1	8.0
<i>EUR million, period total</i>									
GDP at current prices	49,105	51,631	53,943	11,871	13,542	15,271	13,259	12,045	11,171

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: economy in worst doldrums in country's history

COVID-19 crisis has magnified the earlier economic slowdown

GDP growth turned negative in the first quarter of 2020 (–1.6% year on year), given a steep decline in investment exacerbated by suddenly stalling private consumption. The latter suffered noticeably from the large-scale lockdown that was introduced to contain the spread of COVID-19 in mid-March. Fixed investment as well as net exports suffered from a sharp deterioration of global economic sentiment and external demand. In the second quarter the government declared a state of emergency that lasted until mid-May. Consumer and business sentiment indicators plummeted to historic lows. 90% of the automobile industry –accounting for more than 8% of GDP – had to stop or restrain production for nearly two months. As a result, and despite highly accommodative monetary and fiscal policies, the economy experienced the largest quarterly crash since the beginning of transition in the early 1990s (nearly 11% year on year). Both domestic and external demand provided an almost equal negative contribution to this slump, whereas public consumption was the only component to contribute positively to economic growth, not least owing to higher expenditures on health care.

With regard to the balance of payments, the COVID-19 crisis has led to a significantly lower outflow of dividends. As a consequence, the deficit of the primary income balance was unusually low in the six months to June 2020 so that the current account recorded a significant surplus. The originally envisaged general government deficit of CZK 40 billion (0.7% of GDP) for 2020 has been revised three times to currently CZK 500 billion (around 9.3% of GDP). Public debt is projected to rise accordingly, to about 37% of GDP in 2020. Until the outbreak of the crisis, GDP growth was held back by a tight labor market characterized by labor shortages, buoyant wage growth and record low unemployment. As the crisis started to unfold, the unemployment rate rose only modestly from a low of 2% in February to 2.7% in August. A more significant rise in unemployment has been prevented (or delayed) by the government's job retention scheme as well as the fact that some foreign and older workers pulled out of the labor force. Despite the resulting lower pressure on wages and a significant drop in the oil price, inflation (averaging 3.5% in the first eight months of 2020) remains above the central bank's tolerance band (2%  $\pm$  1 percentage point). This is due to a weaker koruna, higher food and administered prices as well as increased costs for firms due to supply restrictions and new sanitary requirements.

Sustained vigorous economic policy response to counteract the economic slump

The country's favorable fiscal position provided the government with ample space to introduce a large set of measures to mitigate the economic damage caused by the pandemic. Hence, a job retention scheme, benefit payments to self-employed, income support to workers caring for children and deferrals of taxes, loan and rent repayments were put in place. In addition, a loan and guarantee program worth 16% of GDP was launched to preserve the liquidity of firms. While a fiscal package totaling more than 20% of GDP is rather generous by international standards, the disbursements recorded so far suggest that actual anti-crisis support is likely to turn out notably lower. The Czech central bank eased its monetary policy in the reporting period by cutting its policy rate by 200 basis points to 0.25% between end-March and end-May. Moreover, the central bank further reduced the counter-cyclical capital buffer, broadened the range of eligible collateral, introduced liquidity-providing operations with longer maturities and relaxed regulatory limits for mortgages.

Table 6

## Main economic indicators: Czech Republic

	2017	2018	2019	Q1 19	Q2 19	Q3 19	Q4 19	Q1 20	Q2 20
<i>Year-on-year change of the period total in %</i>									
GDP at constant prices	5.2	3.2	2.3	2.5	2.1	3.0	1.7	-1.6	-10.8
Private consumption	4.0	3.5	3.1	2.8	3.2	3.3	3.0	0.0	-7.3
Public consumption	1.8	3.8	2.3	1.9	2.7	3.2	1.5	4.4	1.8
Gross fixed capital formation	4.9	10.0	2.2	2.8	-0.3	1.9	4.0	-3.8	-4.6
Exports of goods and services	7.2	3.7	1.3	1.1	1.8	4.3	-1.7	-1.5	-23.1
Imports of goods and services	6.3	5.8	1.4	1.9	0.7	2.2	0.7	-1.3	-18.4
<i>Contribution to GDP growth in percentage points</i>									
Domestic demand	3.9	4.4	2.3	3.1	1.3	1.4	3.4	-1.3	-5.7
Net exports of goods and services	1.2	-1.2	0.0	-0.5	0.9	1.6	-1.8	-0.3	-5.1
Exports of goods and services	5.7	2.9	1.0	0.9	1.4	3.1	-1.3	-1.2	-17.4
Imports of goods and services	-4.5	-4.1	-1.0	-1.4	-0.5	-1.5	-0.5	0.9	12.4
<i>Year-on-year change of the period average in %</i>									
Unit labor costs in the whole economy (nominal, per person)	3.5	6.2	4.1	4.6	4.7	3.1	4.2	5.7	9.4
Unit labor costs in manufacturing (nominal, per hour)	1.4	4.7	7.7	8.2	7.6	6.8	8.1	3.2	16.0
Labor productivity in manufacturing (real, per hour)	6.5	3.9	-0.8	-1.0	-0.7	0.1	-1.7	3.6	-8.3
Labor costs in manufacturing (nominal, per hour)	8.0	8.8	6.8	7.1	6.8	6.8	6.3	6.8	6.3
Producer price index (PPI) in industry	0.8	0.7	1.7	3.1	2.5	1.2	0.1	0.1	1.0
Consumer price index (here: HICP)	2.4	2.0	2.6	2.3	2.4	2.6	3.0	3.7	3.3
EUR per 1 CZK, + = CZK appreciation	2.7	2.7	-0.1	-1.1	-0.3	-0.1	1.1	0.3	-5.1
<i>Period average levels</i>									
Unemployment rate (ILO definition, %, 15–64 years)	2.9	2.3	2.1	2.1	1.9	2.2	2.1	2.0	2.4
Employment rate (%, 15–64 years)	73.6	74.8	75.1	75.0	75.0	75.2	75.3	74.8	74.1
Key interest rate per annum (%)	0.2	1.1	1.9	1.8	1.9	2.0	2.0	2.0	0.6
CZK per 1 EUR	26.3	25.6	25.7	25.7	25.7	25.7	25.6	25.6	27.1
<i>Nominal year-on-year change in the period-end stock in %</i>									
Loans to the domestic nonbank private sector <sup>1</sup>	6.9	6.8	6.8	5.4	5.3	3.9	5.0	5.6	3.7
of which: loans to households	7.5	7.5	7.5	7.0	6.6	6.3	6.1	6.3	6.1
loans to nonbank corporations	6.2	5.8	5.8	3.6	3.9	1.2	3.8	4.8	0.7
<i>%</i>									
Share of foreign currency loans in total loans to the non-bank private sector	13.3	14.1	14.5	14.9	14.8	15.3	14.5	16.9	16.1
Return on assets (banking sector)	1.1	1.1	1.2	1.0	1.2	1.2	1.2	0.7	0.7
Tier 1 capital ratio (banking sector)	18.7	19.1	20.8	19.1	19.8	19.8	20.8	20.9	22.5
NPL ratio (banking sector)	4.1	3.1	2.4	3.0	2.7	2.5	2.4	2.3	2.4
<i>% of GDP</i>									
General government revenues	41.0	42.2	42.1	..	..	..	..	..	..
General government expenditures	39.5	41.2	41.9	..	..	..	..	..	..
General government balance	1.5	0.9	0.3	..	..	..	..	..	..
Primary balance	2.2	1.8	0.9	..	..	..	..	..	..
Gross public debt	34.7	32.6	30.8	..	..	..	..	..	..
<i>% of GDP</i>									
Debt of nonfinancial corporations (nonconsolidated)	57.4	55.9	53.3	..	..	..	..	..	..
Debt of households and NPISHs <sup>2</sup> (nonconsolidated)	32.2	31.6	30.1	..	..	..	..	..	..
<i>% of GDP (based on EUR), period total</i>									
Goods balance	5.0	3.7	4.2	5.5	5.5	3.4	2.4	4.7	2.4
Services balance	2.5	2.3	1.8	2.6	2.6	1.4	0.8	2.7	2.1
Primary income	-5.0	-4.8	-5.6	-3.1	-6.2	-8.2	-4.8	-0.3	-3.2
Secondary income	-0.9	-0.7	-0.7	-2.0	-0.1	-0.9	0.0	-1.6	-0.8
Current account balance	1.6	0.4	-0.4	3.0	1.8	-4.3	-1.5	5.5	0.6
Capital account balance	0.8	0.3	0.2	-0.5	0.6	0.1	0.7	1.4	1.6
Foreign direct investment (net) <sup>3</sup>	-0.9	-0.9	-1.1	-0.3	-2.0	-1.8	-0.1	0.0	-3.3
<i>% of GDP (rolling four-quarter GDP, based on EUR), end of period</i>									
Gross external debt	88.0	81.4	77.0	79.8	79.1	78.2	77.0	72.8	75.3
Gross official reserves (excluding gold)	63.3	58.9	59.4	59.5	59.4	59.8	59.4	58.6	61.7
<i>Months of imports of goods and services</i>									
Gross official reserves (excluding gold)	10.6	10.0	10.5	10.1	10.2	10.4	10.5	10.6	11.4
<i>EUR million, period total</i>									
GDP at current prices	194,418	210,846	223,955	51,705	56,097	57,132	59,021	52,808	49,438

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: despite deep recession inflation among the highest in the EU

V-shaped recovery  
becomes unlikely

After holding up fairly well in the first quarter of 2020, GDP slumped by almost 14% year on year in the second quarter. Net real exports were the biggest source of this decline as the pandemic hit exports much more severely than imports. This also showed in a marked widening of the current deficit in the second quarter in year-on-year terms. Investment activity declined due to the worsening of global growth prospects, the sharp fall in capacity utilization, the notable deceleration of the growth of credit to corporates and the likely deterioration in corporate profitability as a result of COVID-19. Private consumption declined heavily as well, mirroring the sharp deterioration in consumer confidence, the fall in full-time-equivalent employment and the deceleration in real wage growth. High-frequency indicators suggest that the economy hit bottom in April and May 2020 and started to recover in the third quarter. However, sentiment indicators suggest that the pace of recovery slowed in August and September, not least due to the reintroduction of border restrictions at the beginning of September and increased uncertainty upon the resurgence of new COVID-19 infections.

Budget deficit and  
government debt set  
to skyrocket in 2020

According to preliminary data, the budget showed a deficit of 5.1% of GDP in the year up to mid-2020 (compared to a deficit of 1.3% in the same period of 2019). Given these unfavorable developments, the finance ministry now expects the budget deficit to soar to a level of 7% to 9% of GDP in 2020 (compared to a forecast level of 3.8% to 4.0% in the spring).

MNB maneuvers to  
sustain funding to  
the economy but  
keep inflation inside  
its target band

After temporarily retreating in the second quarter, inflation reaccelerated to around 4% in July and August, the highest rate in the EU. Core inflation (excluding unprocessed food and energy prices) picked up as well to just above the 3%  $\pm 1$  percentage point target range set by Magyar Nemzeti Bank (MNB). Notwithstanding the acceleration of inflation, the MNB strived to sustain credit to the economy by expanding its various funding programs. Also, in June and July, it lowered its base rate from 0.9% to 0.6%. It also relaxed provisioning rules in July, and in September, the government decided to prolong the debt service moratorium for vulnerable clients until mid-2021 (as of September 2020, the moratorium, which was implemented as an opt-out scheme, covered 40% to 50% of loans to the private sector). Despite these efforts, credit growth to the corporate sector faltered between March and July 2020. By contrast, the growth rate of credit to households remained roughly unchanged during the same period, as the expansion of highly preferential “baby loans” more than compensated for the slowdown in loans for housing and other purposes.

Amid a fresh wave of forint weakness, the MNB decided in September to reimpose fines for banks’ breaches of their mandatory reserve requirements and their obligation to pay no interest or its effective O/N deposit rate (currently at  $-0.05\%$ ), whichever is lower, on banks’ excess reserves on their reserve accounts. Furthermore, to ease tensions on the foreign currency market, it relaunched short-term weekly foreign currency swaps, supplying euro to banks. For the refinancing of these swaps, the MNB can resort to its foreign currency swap and repo arrangements concluded with major central banks (including the ECB and the BIS) earlier in 2020 in the magnitude of around EUR 10 billion. With effect of October 1, 2020, the MNB also took back the tightening of its foreign exchange funding adequacy ratio and foreign exchange coverage ratio, thus easing banks’ access to foreign exchange funding. As these measures did not yield sufficient results, the MNB raised the interest rate at its one-week deposit and three- and five-year covered loan tenders by 15 basis points to 0.75% in late September.

Table 7

## Main economic indicators: Hungary

	2017	2018	2019	Q1 19	Q2 19	Q3 19	Q4 19	Q1 20	Q2 20
<i>Year-on-year change of the period total in %</i>									
GDP at constant prices	4.3	5.1	4.9	5.3	4.9	5.0	4.5	2.2	-13.6
Private consumption	4.7	4.8	5.1	5.0	5.0	4.8	5.3	4.9	-8.1
Public consumption	2.4	0.9	1.7	0.3	0.5	1.3	4.6	1.7	-2.7
Gross fixed capital formation	18.7	17.1	15.3	24.9	17.8	16.1	7.0	-2.6	-13.5
Exports of goods and services	6.9	4.3	6.0	7.3	3.7	10.2	3.3	-0.5	-24.0
Imports of goods and services	8.2	6.8	6.9	7.1	4.6	10.2	5.9	1.3	-15.8
<i>Contribution to GDP growth in percentage points</i>									
Domestic demand	4.8	6.7	5.4	4.9	5.4	4.7	6.4	3.8	-5.8
Net exports of goods and services	-0.5	-1.7	-0.4	0.5	-0.5	0.3	-1.9	-1.6	-7.7
Exports of goods and services	6.0	3.8	5.1	6.6	3.3	8.2	2.7	-0.5	-20.3
Imports of goods and services	-6.4	-5.4	-5.6	-6.1	-3.7	-7.9	-4.6	-1.1	12.6
<i>Year-on-year change of the period average in %</i>									
Unit labor costs in the whole economy (nominal, per person)	4.5	3.5	6.0	5.5	7.5	5.6	5.6	4.4	15.1
Unit labor costs in manufacturing (nominal, per hour)	5.4	7.3	6.4	7.0	8.9	3.6	6.3	5.6	25.7
Labor productivity in manufacturing (real, per hour)	2.5	1.6	4.2	5.0	2.5	6.7	2.9	2.9	-12.0
Labor costs in manufacturing (nominal, per hour)	8.0	9.0	10.9	12.4	11.6	10.6	9.4	8.7	10.5
Producer price index (PPI) in industry	3.3	5.6	2.2	3.2	2.3	1.2	2.1	4.1	2.8
Consumer price index (here: HICP)	2.4	2.9	3.4	3.2	3.8	3.1	3.5	4.4	2.5
EUR per 1 HUF, + = HUF appreciation	0.7	-3.0	-2.0	-2.1	-1.8	-1.2	-2.7	-6.3	-8.2
<i>Period average levels</i>									
Unemployment rate (ILO definition, %, 15–64 years)	4.2	3.8	3.5	3.6	3.4	3.5	3.4	3.8	4.7
Employment rate (%, 15–64 years)	68.2	69.3	70.1	69.9	70.0	70.3	70.3	69.7	68.7
Key interest rate per annum (%)	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9
HUF per 1 EUR	309.3	318.8	325.2	317.9	322.9	328.2	331.9	339.1	351.7
<i>Nominal year-on-year change in the period-end stock in %</i>									
Loans to the domestic nonbank private sector <sup>1</sup>	4.3	9.9	9.9	11.0	12.1	12.2	12.4	15.3	11.1
of which: loans to households	1.3	5.8	5.8	7.7	7.6	12.7	15.4	18.0	18.5
loans to nonbank corporations	6.8	13.1	13.1	13.5	15.4	11.8	10.3	13.5	6.2
<i>%</i>									
Share of foreign currency loans in total loans to the non-bank private sector	23.5	24.0	23.8	23.8	24.1	24.0	23.8	25.6	24.4
Return on assets (banking sector)	1.8	1.4	1.2	1.4	1.3	1.3	1.2	0.2	0.3
Tier 1 capital ratio (banking sector)	21.1	17.8	16.4	16.3	16.8	15.8	16.4	15.6	15.8
NPL ratio (banking sector)	3.7	2.2	2.6	3.4	3.1	3.0	2.6	2.5	2.9
<i>% of GDP</i>									
General government revenues	44.5	44.5	44.0	..	..	..	..	..	..
General government expenditures	47.0	46.7	46.1	..	..	..	..	..	..
General government balance	-2.5	-2.1	-2.0	..	..	..	..	..	..
Primary balance	0.2	0.2	0.2	..	..	..	..	..	..
Gross public debt	72.9	70.2	66.3	..	..	..	..	..	..
<i>% of GDP</i>									
Debt of nonfinancial corporations (nonconsolidated)	65.7	65.4	59.1	..	..	..	..	..	..
Debt of households and NPISHs <sup>2</sup> (nonconsolidated)	18.5	17.6	15.9	..	..	..	..	..	..
<i>% of GDP (based on EUR), period total</i>									
Goods balance	1.4	-1.3	-2.1	-0.7	-1.0	-3.3	-3.0	-0.6	-2.6
Services balance	5.5	5.8	5.3	5.0	5.9	6.0	4.1	4.5	2.1
Primary income	-4.0	-3.7	-2.7	-2.3	-3.6	-2.5	-2.4	-1.7	-1.6
Secondary income	-0.9	-0.5	-0.7	-1.6	-0.1	-1.1	-0.2	-1.2	-0.8
Current account balance	2.0	0.3	-0.3	0.5	1.2	-0.9	-1.6	1.0	-2.8
Capital account balance	0.9	2.2	1.8	1.0	1.3	1.3	3.5	1.8	2.2
Foreign direct investment (net) <sup>3</sup>	-1.6	-2.0	0.1	-1.3	2.2	0.6	-1.2	-1.8	-0.9
<i>% of GDP (rolling four-quarter GDP, based on EUR), end of period</i>									
Gross external debt	84.1	80.8	73.6	82.3	81.6	78.0	73.6	71.8	77.8
Gross official reserves (excluding gold)	18.5	19.7	18.8	19.3	18.6	19.1	18.8	16.9	20.7
<i>Months of imports of goods and services</i>									
Gross official reserves (excluding gold)	2.8	2.9	2.8	2.9	2.8	2.8	2.8	2.5	3.2
<i>EUR million, period total</i>									
GDP at current prices	125,575	133,661	143,701	32,093	35,854	36,706	39,049	31,876	30,294

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: comprehensive policy response as monetary policy focuses on the medium term

Import slump contained GDP contraction and lifted current account surplus

GDP contracted by 3.1% in the first half of 2020, after having grown by 4.1% in 2019. The second quarter registered a year-on-year contraction of –7.9%. Total final demand dropped by 5.3% in the first half-year, with foreign demand decreasing substantially more than domestic demand, while imports fell even more than export growth. Hence, the net export contribution to GDP growth remained positive, corresponding to an increase in the goods and services balance to 6.7% of GDP in the first half of 2020. Coupled with a lower primary balance deficit, the current account surplus rose markedly, to 4.6% of GDP in the same period. The capital account surplus and net FDI inflows remained at about 2% of GDP. Public consumption provided a positive contribution to growth (0.7 percentage points) and public fixed investment likely helped contain total fixed investment's year-on-year decline close to that of private consumption. Residential investment in terms of the number of dwellings under construction continued to grow, albeit at a lower rate. The decline of inventory buildup lowered GDP growth by about 1 percentage point. Private consumption contraction stemmed primarily from lockdown measures, the confidence slump and increased precautionary savings, as the real wage sum declined far less and real pension payments even increased. From June to August, real retail sales were increasingly above 2019 levels.

In the first half-year of 2020, given the fall in labor productivity, annual growth of nominal ULC in manufacturing accelerated in both Poland and the euro area and reached double-digit levels in mid-2020. The slightly higher ULC rise in Poland was more than offset by the 6% depreciation of the złoty to 4.50 per euro from February to April 2020. The złoty remained close to this value until October 2020. Annual headline inflation declined from a peak of 4.1% (HICP) and 4.7% (national CPI) in February to 3.7% and 2.9% (CPI), respectively, in August 2020. By contrast, core inflation increased due to services prices from 3.6% in February 2020 (both HICP excluding energy and unprocessed food and CPI excluding energy and all food) to 4.6% and 4.0% (core CPI), respectively, in August 2020.

Monetary and fiscal policy responses to the COVID-19 impact

On May 29, 2020, the Monetary Policy Council (MPC), pursuing an inflation target of  $2.5\% \pm 1$  percentage point (CPI), continued its comprehensive easing measures of March and April by cutting the main policy rate further to 0.1% from 0.5%. At the same time, it cut the Lombard rate to 0.5% from 1.0%, but maintained its deposit rate at 0.0%, preferring an asymmetric band to negative rates. On October 7, 2020, the MPC declared to continue its outright purchases of government(-guaranteed) debt securities in the secondary market to ensure the liquidity of these markets and to strengthen the monetary transmission mechanism. Moreover, the MPC declared that it would offer bill discount credit aimed at refinancing loans granted to enterprises by banks. In parallel, commercial banks' moratoria options to households and SMEs were prolonged.

Regarding fiscal policy, Polish authorities expect the headline deficit to rise to about 12% of GDP in 2020 (from 0.7% in 2019) and to decline to about 6% of GDP in 2021. General government gross debt is projected to rise to 62% of GDP in 2020 (from 46% at the end of 2019) and further to 64% of GDP at the end of 2021. Recently, Poland received EU support to mitigate unemployment risk during an emergency (SURE) of about EUR 11 billion, which might partly finance the job protection component (amounting to EUR 7 billion) of the March economic support package (EUR 46 billion, 8.5% of GDP).

Table 8

## Main economic indicators: Poland

	2017	2018	2019	Q1 19	Q2 19	Q3 19	Q4 19	Q1 20	Q2 20
<i>Year-on-year change of the period total in %</i>									
GDP at constant prices	4.9	5.3	4.1	4.9	4.2	4.3	3.4	1.7	-7.9
Private consumption	4.5	4.5	3.8	3.7	4.0	3.9	3.6	0.8	-11.0
Public consumption	2.9	3.7	4.9	7.5	3.9	5.7	3.3	3.9	4.3
Gross fixed capital formation	4.0	9.4	7.2	12.0	9.3	4.1	5.9	0.8	-11.1
Exports of goods and services	9.5	7.0	4.7	8.5	3.6	5.0	1.9	0.6	-14.3
Imports of goods and services	9.8	7.6	2.7	5.9	4.0	3.2	-2.1	-0.1	-18.2
<i>Contribution to GDP growth in percentage points</i>									
Domestic demand	4.7	5.4	2.9	3.2	4.2	3.2	1.3	1.2	-9.2
Net exports of goods and services	0.3	0.0	1.2	1.7	-0.1	1.1	2.0	0.4	1.3
Exports of goods and services	5.0	3.8	2.6	4.9	2.1	2.8	1.0	0.4	-8.2
Imports of goods and services	-4.7	-3.8	-1.4	-3.2	-2.1	-1.7	1.0	0.0	9.5
<i>Year-on-year change of the period average in %</i>									
Unit labor costs in the whole economy (nominal, per person)	2.1	3.1	3.1	2.9	2.3	3.4	3.9	5.9	11.5
Unit labor costs in manufacturing (nominal, per hour)	2.8	4.7	4.2	2.5	4.7	5.5	4.3	6.3	15.3
Labor productivity in manufacturing (real, per hour)	3.5	3.1	2.4	3.5	2.4	1.7	2.2	2.1	-7.8
Labor costs in manufacturing (nominal, per hour)	6.4	8.0	6.8	6.1	7.2	7.3	6.6	8.5	6.3
Producer price index (PPI) in industry	2.7	2.1	1.3	2.6	1.6	0.8	0.3	0.3	-1.2
Consumer price index (here: HICP)	1.6	1.2	2.1	1.2	2.2	2.5	2.6	3.9	3.4
EUR per 1 PLN, + = PLN appreciation	2.5	-0.1	-0.9	-2.9	-0.5	-0.4	0.3	-0.5	-4.9
<i>Period average levels</i>									
Unemployment rate (ILO definition, %, 15–64 years)	5.0	3.9	3.4	4.0	3.3	3.2	2.9	3.2	3.2
Employment rate (%, 15–64 years)	66.1	67.4	68.2	67.2	68.2	68.9	68.5	68.4	67.9
Key interest rate per annum (%)	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.4	0.4
PLN per 1 EUR	4.3	4.3	4.3	4.3	4.3	4.3	4.3	4.3	4.5
<i>Nominal year-on-year change in the period-end stock in %</i>									
Loans to the domestic nonbank private sector <sup>1</sup>	6.2	6.4	6.4	6.9	6.7	6.6	5.0	4.7	1.5
of which: loans to households	4.8	5.6	5.6	5.6	5.9	6.1	5.6	5.1	2.9
loans to nonbank corporations	8.7	7.6	7.6	9.2	8.2	7.3	4.1	4.1	-0.9
%									
Share of foreign currency loans in total loans to the non-bank private sector	21.3	20.8	19.2	20.6	19.8	20.0	19.2	20.2	19.8
Return on assets (banking sector)	0.8	0.7	0.7	0.6	0.8	0.8	0.7	0.3	0.3
Tier 1 capital ratio (banking sector)	17.2	17.1	17.0	17.0	16.9	17.0	17.0	16.3	17.9
NPL ratio (banking sector)	6.8	6.8	6.6	6.8	6.8	6.8	6.6	6.6	6.9
%									
<i>% of GDP</i>									
General government revenues	39.8	41.3	41.3	..	..	..	..	..	..
General government expenditures	41.2	41.5	42.0	..	..	..	..	..	..
General government balance	-1.5	-0.2	-0.7	..	..	..	..	..	..
Primary balance	0.2	1.2	0.7	..	..	..	..	..	..
Gross public debt	50.6	48.8	46.0	..	..	..	..	..	..
<i>% of GDP</i>									
Debt of nonfinancial corporations (nonconsolidated)	47.2	45.1	42.8	..	..	..	..	..	..
Debt of households and NPISHs <sup>2</sup> (nonconsolidated)	35.6	34.7	33.0	..	..	..	..	..	..
<i>% of GDP (based on EUR), period total</i>									
Goods balance	-0.1	-1.3	0.2	0.1	0.0	-0.1	0.7	0.8	3.3
Services balance	3.8	4.3	4.5	4.7	4.6	4.5	4.1	4.9	4.4
Primary income	-4.0	-4.0	-3.9	-2.6	-4.3	-4.6	-3.8	-1.5	-2.5
Secondary income	0.0	-0.3	-0.3	-0.9	-0.2	-0.3	-0.1	-0.6	0.5
Current account balance	-0.3	-1.3	0.5	1.3	0.2	-0.5	1.0	3.6	5.6
Capital account balance	1.3	2.1	2.0	0.7	2.2	1.9	3.0	1.8	3.0
Foreign direct investment (net) <sup>3</sup>	-1.4	-2.6	-1.6	-4.8	0.5	-2.6	0.0	-3.6	-0.5
<i>% of GDP (rolling four-quarter GDP, based on EUR), end of period</i>									
Gross external debt	68.4	63.7	59.7	62.3	61.6	60.7	59.7	56.4	57.1
Gross official reserves (excluding gold)	19.5	19.6	19.8	19.1	18.5	19.4	19.8	18.6	19.7
<i>Months of imports of goods and services</i>									
Gross official reserves (excluding gold)	4.6	4.5	4.6	4.4	4.2	4.5	4.6	4.4	4.9
<i>EUR million, period total</i>									
GDP at current prices	467,607	497,394	529,101	121,284	127,992	131,029	148,797	127,709	116,567

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: investments cushion COVID-19-induced economic plunge, while trade deficit widens

Economic activity  
fully hit by  
COVID-19 in the  
second quarter

In the first quarter of 2020, the Romanian economy still grew at a moderate rate on the back of robust domestic demand. Yet, the tide turned abruptly in the second quarter, as the economy was hit by the COVID-19 crisis through various channels. Exports suffered from plummeting external demand and the temporary shutdown of key export companies (e.g. within the car industry). Despite the considerable import drop, the contribution of net exports remained clearly negative, as the decline in imports fell short of the export decline. Private consumption was hit by movement restrictions, containment measures affecting the services sector (such as restaurants), income losses under furlough schemes and deteriorating consumer confidence. The unemployment rate went up somewhat, but government-supported furlough schemes prevented a more pronounced rise. While investment activity was also negatively affected by the crisis, especially construction activity in tandem with public investments contributed to a slightly positive year-on-year growth rate of gross fixed capital formation in the second quarter. In addition to the construction sector, gross value added also rose markedly in the information and communication sector, while the drought in the spring had a negative impact on agricultural output.

Trade deficit widens,  
global liquidity  
conditions facilitate  
budget financing

Despite the economic contraction, Romania's trade deficit widened noticeably in the first half of 2020. In the run-up to the crisis, Romania's unit labor costs in the manufacturing sector had increased markedly. The nominal exchange rate vis-à-vis the euro depreciated only a little in the course of 2020. Yet, the current account deficit narrowed slightly, as income balances improved. Better EU fund absorption led to an increase in the capital account and, hence, the net borrowing position from the current and capital accounts declined somewhat. A reduction in intercompany lending caused net FDI outflows in the first quarter of 2020. In the second quarter, modest equity and net FDI inflows combined with a reduction of foreign assets led to positive net FDI inflows again. The bulk of financing in the financial account stemmed from net portfolio inflows, as the government accessed international markets to fund the budget deficit, benefiting from favorable global liquidity conditions. The government estimates the budget deficit to rise to 8.6% of GDP this year. In addition to domestic and international bond issuances, the government can make use of loans in the amount of EUR 4 billion provided under the EU's SURE instrument, which was designed to tackle sudden increases in public expenditure for the preservation of employment.

Agreement on repo  
line between ECB  
and NBR

To address possible euro liquidity needs during the COVID-19 crisis, the National Bank of Romania (NBR) set up a repo line with the ECB in May. The arrangement was initially planned to remain in place until end-2020 but was prolonged until mid-2021 in August. Under the repo line, the NBR has the possibility to borrow up to EUR 4.5 billion from the ECB in exchange for adequate euro-denominated collateral. Meanwhile, the NBR carried on with its policy response package launched in March 2020 by continuing repo transactions and purchases of leu-denominated government securities on the secondary market. After a 50-basis point rate cut in March 2020, the NBR further cut its key policy rate in two 25-basis point steps to 1.5%. Consumer price inflation, which is relevant for monetary policy, stood at 2.7% year on year in August and has been relatively close to the mid-point of the NBR's target band of  $2.5\% \pm 1$  percentage point in recent months.

Table 9

**Main economic indicators: Romania**

	2017	2018	2019	Q1 19	Q2 19	Q3 19	Q4 19	Q1 20	Q2 20
<i>Year-on-year change of the period total in %</i>									
GDP at constant prices	7.1	4.4	4.1	5.0	4.4	3.0	4.3	2.4	-10.5
Private consumption	9.9	7.2	5.9	7.4	5.1	4.3	7.2	3.8	-13.3
Public consumption	4.5	3.1	7.1	2.4	11.4	2.2	9.4	3.5	4.7
Gross fixed capital formation	3.5	-1.0	17.9	3.2	20.5	25.6	15.7	13.1	1.8
Exports of goods and services	7.8	5.9	3.8	2.9	3.0	3.2	6.2	-1.6	-28.7
Imports of goods and services	10.7	9.2	8.3	11.5	5.5	9.1	7.3	2.2	-21.5
<i>Contribution to GDP growth in percentage points</i>									
Domestic demand	8.5	5.9	5.8	7.4	5.6	5.7	4.8	4.6	-7.9
Net exports of goods and services	-1.4	-1.4	-1.7	-3.5	-1.3	-2.3	-0.3	-2.6	-2.4
Exports of goods and services	3.1	2.6	1.9	2.0	1.4	1.8	2.3	-0.4	-11.9
Imports of goods and services	-4.5	-4.0	-3.6	-5.5	-2.7	-4.1	-2.6	-2.2	9.5
<i>Year-on-year change of the period average in %</i>									
Unit labor costs in the whole economy (nominal, per person)	9.9	9.1	4.5	5.3	3.3	3.5	5.8	6.7	10.4
Unit labor costs in manufacturing (nominal, per hour)	5.6	7.0	12.7	8.0	14.0	14.4	14.4	13.2	27.9
Labor productivity in manufacturing (real, per hour)	8.3	5.5	-0.8	4.1	-1.9	-2.2	-2.6	-2.7	-4.9
Labor costs in manufacturing (nominal, per hour)	14.3	12.8	11.9	12.5	11.9	11.9	11.4	10.2	21.7
Producer price index (PPI) in industry	3.5	5.0	4.0	4.6	4.5	3.5	3.2	2.7	-1.4
Consumer price index (here: HICP)	1.1	4.1	3.9	3.8	4.3	3.9	3.7	3.1	2.1
EUR per 1 RON, + = RON appreciation	-1.7	-1.8	-1.9	-1.7	-2.0	-1.8	-2.2	-1.3	-1.9
<i>Period average levels</i>									
Unemployment rate (ILO definition, %, 15–64 years)	5.1	4.3	4.0	4.2	3.9	4.0	4.0	4.4	5.5
Employment rate (%, 15–64 years)	63.9	64.8	65.8	64.2	66.4	66.7	66.0	65.4	65.2
Key interest rate per annum (%)	1.8	2.4	2.5	2.5	2.5	2.5	2.5	2.4	1.9
RON per 1 EUR	4.6	4.7	4.7	4.7	4.7	4.7	4.8	4.8	4.8
<i>Nominal year-on-year change in the period-end stock in %</i>									
Loans to the domestic nonbank private sector <sup>1</sup>	4.4	7.9	7.9	6.8	6.4	6.8	5.5	6.2	3.1
of which: loans to households	7.1	9.1	9.1	7.3	6.3	6.6	6.7	7.1	5.3
loans to nonbank corporations	2.5	6.6	6.6	6.3	6.5	7.1	4.2	5.3	0.6
<i>%</i>									
Share of foreign currency loans in total loans to the non-bank private sector	37.2	34.0	32.4	34.2	33.4	33.4	32.4	32.8	32.2
Return on assets (banking sector)	1.3	1.6	1.4	1.6	1.2	1.5	1.4	1.3	1.1
Tier 1 capital ratio (banking sector)	18.0	18.6	20.1	17.9	17.7	17.9	20.1	18.5	20.7
NPL ratio (banking sector)	6.4	5.0	4.1	4.9	4.7	4.6	4.1	3.9	4.4
<i>% of GDP</i>									
General government revenues	30.8	31.9	31.7	..	..	..	..	..	..
General government expenditures	33.5	34.8	36.0	..	..	..	..	..	..
General government balance	-2.6	-2.9	-4.3	..	..	..	..	..	..
Primary balance	-1.4	-1.8	-3.1	..	..	..	..	..	..
Gross public debt	35.1	34.7	35.2	..	..	..	..	..	..
<i>% of GDP</i>									
Debt of nonfinancial corporations (nonconsolidated)	35.1	32.8	29.4	..	..	..	..	..	..
Debt of households and NPISHs <sup>2</sup> (nonconsolidated)	15.8	15.8	14.1	..	..	..	..	..	..
<i>% of GDP (based on EUR), period total</i>									
Goods balance	-6.5	-7.2	-7.8	-8.7	-7.7	-7.3	-7.7	-9.7	-9.3
Services balance	4.4	4.1	3.9	4.2	4.4	3.4	3.8	4.9	4.9
Primary income	-1.4	-1.8	-1.4	1.4	-3.2	-2.6	-0.7	1.8	-2.8
Secondary income	0.8	0.6	0.7	0.5	0.1	0.7	1.2	0.9	0.8
Current account balance	-2.8	-4.4	-4.6	-2.6	-6.3	-5.8	-3.3	-2.1	-6.4
Capital account balance	1.2	1.2	1.3	1.6	0.9	0.9	1.7	2.6	1.7
Foreign direct investment (net) <sup>3</sup>	-2.6	-2.4	-2.4	-2.9	-2.8	-2.8	-1.4	0.9	-3.3
<i>% of GDP (rolling four-quarter GDP, based on EUR), end of period</i>									
Gross external debt	51.9	48.8	47.3	47.7	49.6	49.7	47.3	47.9	50.6
Gross official reserves (excluding gold)	17.8	16.2	14.7	15.3	15.3	16.3	14.7	15.1	15.9
<i>Months of imports of goods and services</i>									
Gross official reserves (excluding gold)	4.8	4.3	4.0	4.1	4.1	4.4	4.0	4.1	4.5
<i>EUR million, period total</i>									
GDP at current prices	187,540	204,637	223,259	42,842	51,618	61,388	67,411	45,022	46,355

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: low level of international reserves increasingly limits space for crisis response

Sharply rising external deficit, sizable currency depreciation and very low foreign currency reserves

GDP contracted by 2.3% in the first half of 2020, after having grown by 0.9% in 2019. Over the past years, the quarterly profile of annual GDP growth resembled a roller coaster, from a boom of almost 7.5% in the fourth quarter of 2017 and a slump of –3% in the fourth quarter of 2018 to booming 6.4% in the fourth quarter of 2019 and another slump of about –10% in the second quarter of 2020. Total final demand showed a similar, but even more pronounced pattern, but neither its export component nor domestic fixed investment contributed to booming growth at the end of 2019 and early 2020. However, particularly exports contributed disproportionately to the contraction thereafter. Hence, the boom of total final demand around end-2019 and early 2020 stemmed exclusively from private consumption on the back of sharp policy-induced credit expansion and implied inventory change. The private consumption boom led to double-digit import growth in these two quarters, and the ensuing COVID-19-induced final demand contraction implied import compression, by far smaller, however, than the fall in exports. Hence, net export contribution to annual GDP growth was highly negative in the three quarters to mid-2020. Thus, in the first half-year, the goods and services balance was negative at –4.6% of GDP, compared to a surplus of 1.8% a year earlier, and the current account deficit reached 6.2% of GDP, from a balanced position in the first half of 2019, while net FDI inflows declined to 0.6% of GDP. The authorities responded by raising customs duties on many products and hiked taxes on most imported cars at end-August. Still, by end-September, official foreign currency reserves apart from gold had declined to less than the foreign currency amount borrowed via swaps. A strong contraction in exports in the second quarter of 2020 apparently did not stem from manufacturing ULC growth, which further moderated (toward the euro area level). The lira lost a quarter of its value against the euro between February and October 2020. Given considerable demand contraction, the strong lira depreciation has not (yet) translated into higher inflation. Both headline and core HICP inflation were only marginally higher in June than in February and even declined by roughly 1 percentage point in August, with national indices not indicating a strong rise in September either.

Monetary and fiscal policy response to the COVID-19 impact

In addition to launching a comprehensive set of liquidity-enhancing measures in March, the Turkish central bank cut its one-week repo rate, the main policy rate, by another 100 basis points on April 22, 2020, and by 50 basis points to 8.25% on May 21. However, in response to year-on-year industrial production and retail sales figures turning positive in July and given continued and sizable lira depreciation, the central bank started to tighten liquidity in early August and hiked the policy rate by 200 basis points to 10.25% on September 24, noting inflation expectations containment as the main reason. Between March and October, wage support for short-time work schemes were in place. In April, parliament approved a ban on layoffs until November, which will possibly be extended until mid-2021. On April 25, the Turkish government doubled its COVID-19-related economic support package to 4.4% of GDP, including deferrals of taxes and social insurance payments by six months for all companies in particularly affected industries, support to export companies, benefits for senior citizens and new funds for low-income families. In early October, the authorities published the actual general government deficit figure of end-August, which was 2.4% of annual GDP.

Table 10

## Main economic indicators: Turkey

	2017	2018	2019	Q1 19	Q2 19	Q3 19	Q4 19	Q1 20	Q2 20
<i>Year-on-year change of the period total in %</i>									
GDP at constant prices	7.5	3.0	0.9	-2.6	-1.7	1.0	6.4	4.4	-9.9
Private consumption	5.9	0.5	1.6	-3.9	-0.5	2.0	8.2	4.0	-8.5
Public consumption	5.0	6.6	4.4	7.3	3.4	6.3	1.6	3.3	-0.8
Gross fixed capital formation	8.3	-0.3	-12.4	-14.2	-20.9	-14.0	0.6	-0.3	-6.1
Exports of goods and services	12.4	9.0	4.9	9.1	6.2	4.7	0.6	0.3	-35.3
Imports of goods and services	10.6	-6.4	-5.3	-29.6	-18.6	3.6	27.8	21.9	-6.4
<i>Contribution to GDP growth in percentage points</i>									
Domestic demand	6.7	1.1	-2.0	-5.5	-6.2	-1.8	5.1	2.8	-6.6
Net exports of goods and services	0.2	3.6	2.3	9.6	5.7	0.5	-5.5	-4.0	-7.5
Exports of goods and services	2.7	2.0	1.2	2.0	1.4	1.2	0.1	0.1	-8.7
Imports of goods and services	-2.5	1.5	1.2	7.6	4.3	-0.7	-5.6	-4.1	1.2
<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)	4.0	18.0	22.0	24.7	25.1	22.5	15.7	15.7	13.2
Labor productivity in manufacturing (real, per hour)	6.3	1.7	1.6	-0.4	2.5	0.9	3.4	4.2	13.8
Labor costs in manufacturing (nominal, per hour)	10.5	20.4	23.8	24.2	28.1	23.6	19.7	20.5	28.9
Producer price index (PPI) in industry	15.8	27.0	17.6	30.7	27.9	12.0	4.4	8.9	6.1
Consumer price index (here: HICP)	11.1	16.3	15.2	19.9	18.0	13.5	10.3	12.1	11.7
EUR per 1 TRY, + = TRY appreciation	-18.9	-27.7	-10.4	-23.2	-20.9	4.7	-2.1	-9.4	-12.7
<i>Period average levels</i>									
Unemployment rate (ILO definition, %, 15–64 years)	11.1	11.1	14.0	15.0	13.1	14.3	13.5	13.9	13.1
Employment rate (%, 15–64 years)	51.6	52.0	50.3	49.3	50.7	51.0	50.2	47.6	45.9
Key interest rate per annum (%)	8.0	15.5	20.6	24.0	24.0	20.3	14.3	11.0	8.8
TRY per 1 EUR	4.1	5.7	6.4	6.1	6.6	6.3	6.4	6.7	7.6
<i>Nominal year-on-year change in the period-end stock in %</i>									
Loans to the domestic nonbank private sector	20.7	12.0	11.2	12.9	6.7	-2.2	11.2	15.2	29.1
of which: loans to households	16.3	3.2	15.9	1.5	-0.6	3.7	15.9	23.4	36.4
loans to nonbank corporations	22.3	15.0	9.8	16.6	8.9	-3.8	9.8	12.9	27.0
<i>%</i>									
Share of foreign currency loans in total loans to the nonbank private sector	33.0	38.5	35.1	38.6	38.2	35.5	35.1	34.9	31.6
Return on assets (banking sector)	1.6	1.5	1.1	1.2	1.2	1.1	1.1	1.3	1.2
Tier 1 capital ratio (banking sector)	13.6	13.4	13.9	12.6	13.1	13.9	13.9	13.3	14.8
NPL ratio (banking sector)	3.1	4.1	5.7	4.3	4.7	5.3	5.7	5.3	4.7
<i>% of GDP</i>									
General government revenues	31.4	32.3	32.8	..	..	..	..	..	..
General government expenditures	34.1	35.1	35.8	..	..	..	..	..	..
General government balance	-2.8	-2.8	-3.0	..	..	..	..	..	..
Primary balance	-0.6	0.1	0.5	..	..	..	..	..	..
Gross public debt	28.2	30.4	33.1	..	..	..	..	..	..
<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	-6.8	-5.1	-2.2	-1.6	-2.4	-2.1	-2.6	-5.5	-5.7
Services balance	3.0	4.0	4.9	2.6	4.9	7.4	4.1	2.5	-0.4
Primary income	-1.3	-1.5	-1.6	-1.3	-2.2	-1.5	-1.6	-1.3	-1.7
Secondary income	0.3	0.1	0.1	0.1	0.0	0.2	0.2	-0.1	0.0
Current account balance	-4.7	-2.5	1.1	-0.2	0.3	4.0	0.2	-4.5	-7.9
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>	-1.0	-1.2	-0.7	-1.2	-0.6	-0.6	-0.6	-1.0	-0.1
<i>% of GDP (rolling four-quarter GDP, based on EUR), end of period</i>									
Gross external debt	50.6	57.3	54.3	60.6	59.5	58.7	54.9	53.5	52.6
Gross official reserves (excluding gold)	9.3	9.6	10.3	10.4	10.3	10.6	10.3	8.1	6.3
<i>Months of imports of goods and services</i>									
Gross official reserves (excluding gold)	3.7	3.7	4.1	4.0	4.0	4.2	4.1	3.2	2.5
<i>EUR million, period total</i>									
GDP at current prices	758,255	662,351	679,154	151,445	155,685	183,630	188,394	159,309	137,692

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: partial recovery of oil price, sizable fiscal stimulus and strong buffers help the economy to overcome the recession

Lockdown combined with oil price plunge triggers economic contraction

The coronavirus crisis pushed Russia into recession in Q2 2020, while Q1 had still seen positive year-on-year economic growth. The lockdown, combined with the plunge of the oil price (–65% on average between April and May 2020 against April to May 2019) on top of the OPEC+ production limitation agreement, triggered a sizable decline of economic activity, resulting in an overall decrease of GDP by –3.2% in the first half of 2020. In the following months, the oil price recovered partially (to –28% in July and August 2020 year on year). Unemployment rose sharply from 4.7% in March to 6.4% in August 2020 (ILO methodology).

Given low inflation, CBR modifies its policy stance to accommodative

The Russian currency has so far not declined as much as it had during the crises of 2008–09 and 2014–15. This contributed to reducing the contraction of imports, and, to some degree, stabilizing the banking sector. Overall, from January to August 2020, the average exchange rate of the ruble lost about 7% against the U.S. dollar and 6% against the euro (year on year). Given that prior to the coronavirus crisis, consumer price inflation had already been clearly below the 4% target of the Central Bank of Russia (CBR) and given the strong compression of demand due to the lockdown measures, the CBR swiftly switched from its previously restrictive monetary policy stance to an accommodative stance, cutting its key rate in three steps by a total of 175 basis points to 4.25%. In August, inflation stood at 3.6%.

Federal anti-crisis budget expenditures expand by over a fifth, financed by domestic debt

Russia's federal budget moved into the red in the second quarter of 2020, resulting in a deficit of about 2% of GDP in the first six months of the year. However, the shortfall would have been higher by about 2 percentage points of GDP had it not been for the large one-off transfer related to payments received by the CBR from the government for Sberbank shares. Until April 2020, the majority of shares had belonged to the CBR, the transfer was paid out of the National Welfare Fund (NWF). Under the National Plan for Economic Recovery, federal expenditure has been rising strongly since early 2020. A large part of this rise is due to increased health and social spending as well as support for enterprises. Moreover, tax deferrals and benefits have played an important role. The budget shortfall is largely being financed by placement of domestic debt. The NWF's volume stood at 12% of GDP (at end-August 2020), two-thirds of which made up by liquid assets.

Current account surplus shrinks, while international reserves remain at near-record level

The much lower prices and quantities of oil and gas exports, coupled with the relatively modest depreciation of the ruble, contributed to the sharp contraction of the current account surplus to EUR 20.9 billion from January to August 2020, against EUR 43.5 billion in the corresponding period of 2019. Private net capital outflows rose to EUR 31.2 billion in the first eight months of 2020. Russia's gross foreign debt slightly declined to EUR 424 billion (as of mid-2020), largely on account of cross-border banking sector deleveraging. Limited foreign exchange sales to support the ruble coupled with exchange rate changes contributed to a modest erosion of the country's international reserves to EUR 498 billion in late September 2020.

Credit activity weakens against backdrop of regulatory lenience

The coronavirus crisis and regulatory lenience is reflected in a still relatively high, but not sharply increasing, NPL ratio (end-June 2020: 17.4%). On a year-on-year basis (until end-June 2020), loans to enterprises continued to grow modestly (+5% in real terms and exchange rate-adjusted), while retail lending was stronger (+12%) but losing momentum, partly due to CBR regulatory restrictions against unsecured consumer credit. As of mid-2020, 7% to 8% of loans had reportedly been restructured.

Table 11

**Main economic indicators: Russia**

	2017	2018	2019	Q1 19	Q2 19	Q3 19	Q4 19	Q1 20	Q2 20
<i>Year-on-year change of the period total in %</i>									
GDP at constant prices	1.8	2.5	1.3	0.4	1.1	1.5	2.1	1.6	-8.0
Private consumption	3.7	3.3	2.5	2.6	2.5	2.5	2.5	3.4	-22.1
Public consumption	2.5	1.3	2.2	2.0	2.1	2.3	2.3	1.4	1.6
Gross fixed capital formation	4.7	0.2	1.5	-2.3	5.1	-1.1	2.9	1.8	-11.7
Exports of goods and services	5.0	5.5	-2.3	-0.6	-5.3	-0.8	-2.5	-3.4	0.3
Imports of goods and services	17.3	2.6	3.4	-2.0	-0.2	4.5	10.1	1.1	-22.2
<i>Contribution to GDP growth in percentage points</i>									
Domestic demand	3.9	1.9	2.7	0.2	2.4	2.7	4.9	2.6	-13.4
Net exports of goods and services	-2.3	0.9	-1.4	0.3	-1.4	-1.3	-3.0	-1.2	5.5
Exports of goods and services	1.3	1.5	-0.6	-0.2	-1.5	-0.2	-0.7	-1.0	0.1
Imports of goods and services	-3.6	-0.6	-0.8	0.5	0.1	-1.1	-2.3	-0.3	5.4
<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 person)	17.9	1.8	4.5	2.9	6.3	4.2	4.7	7.1	13.4
Labor productivity in manufacturing (real, per person)	7.4	4.9	3.0	3.5	2.2	3.6	2.8	0.8	-8.1
Labor costs in manufacturing (nominal, per person)	26.7	6.6	7.7	6.5	8.6	8.0	7.7	8.0	4.1
Producer price index (PPI) in industry	7.7	12.1	2.3	9.3	6.6	-1.0	-5.7	-2.4	-12.1
Consumer price index (here: CPI)	3.6	3.0	4.6	5.3	5.1	4.4	3.5	2.5	3.2
EUR per 1 RUB, + = RUB appreciation	12.6	-11.0	2.2	-6.6	2.0	6.2	7.7	1.6	-8.9
<i>Period average levels</i>									
Unemployment rate (ILO definition, %, 15–64 years)	5.2	4.8	4.6	4.8	4.5	4.4	4.6	4.7	6.0
Employment rate (%, 15–64 years)	..	..	..	..	..	..	..	..	..
Key interest rate per annum (%)	9.1	7.4	7.3	7.8	7.7	7.3	6.6	6.1	5.5
RUB per 1 EUR	65.9	74.1	72.5	74.9	72.6	71.8	70.5	73.7	79.7
<i>Nominal year-on-year change in the period-end stock in %</i>									
Loans to the domestic nonbank private sector <sup>1</sup>	5.7	12.3	12.3	11.9	11.6	10.5	10.4	11.1	10.0
of which: loans to households	12.7	22.2	22.2	23.5	22.8	20.7	18.5	17.7	12.5
loans to nonbank corporations	3.1	8.3	8.3	7.2	6.9	6.1	6.7	8.0	8.7
<i>%</i>									
Share of foreign currency loans in total loans to the non-bank private sector	14.7	13.6	11.4	12.2	11.6	11.4	11.4	13.1	11.9
Return on assets (banking sector)	1.0	1.5	2.2	2.5	2.2	2.1	2.2	2.4	1.6
Tier 1 capital ratio (banking sector)	8.5	8.9	9.2	9.6	9.2	9.4	9.2	10.1	10.6
NPL ratio (banking sector)	19.1	18.0	17.1	18.0	18.0	17.7	17.1	16.9	17.4
<i>% of GDP</i>									
General government revenues	33.8	35.7	35.5	..	..	..	..	..	..
General government expenditures	35.3	32.8	33.6	..	..	..	..	..	..
General government balance	-1.5	2.9	1.9	..	..	..	..	..	..
Primary balance	..	..	..	..	..	..	..	..	..
Gross public debt	12.6	12.0	12.3	..	..	..	..	..	..
<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	7.3	11.7	9.6	12.4	9.6	8.5	8.5	8.6	4.8
Services balance	-2.0	-1.8	-2.1	-1.6	-2.2	-2.6	-2.1	-1.8	-0.7
Primary income	-2.7	-2.5	-3.1	-1.3	-4.8	-3.1	-3.2	-0.6	-3.7
Secondary income	-0.6	-0.5	-0.6	-0.7	-0.2	-0.4	-1.0	-0.3	-0.5
Current account balance	2.1	6.9	3.8	8.9	2.4	2.4	2.2	5.8	-0.2
Capital account balance	0.0	-0.1	0.0	0.0	-0.1	0.0	-0.1	0.0	-0.1
Foreign direct investment (net) <sup>3</sup>	0.5	1.4	-0.5	-0.3	-0.3	-1.5	0.0	1.2	-0.5
<i>% of GDP (rolling four-quarter GDP, based on EUR), end of period</i>									
Gross external debt	31.2	28.2	29.2	29.5	29.7	29.8	29.2	27.5	30.1
Gross official reserves (excluding gold)	21.3	23.6	26.0	25.0	25.5	26.2	26.0	26.4	26.8
<i>Months of imports of goods and services</i>									
Gross official reserves (excluding gold)	12.3	13.7	15.0	14.4	14.8	15.2	15.0	15.2	15.6
<i>EUR million, period total</i>									
GDP at current prices	1,392,185	1,410,411	1,521,628	333,112	363,984	401,915	422,618	343,514	292,334

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).



# Outlook for selected CESEE countries

CESEE-6: deepest downturn after transformational recession, uncertain recovery; Russia: economy expected to recover gradually<sup>1, 2</sup>

According to our projections, economic growth in the CESEE-6 countries<sup>3</sup> will slump by 5.0% in 2020. We expect a moderate economic recovery of 3.8% in 2021 and of 3.6% in 2022. Croatia and Hungary are expected to be hit strongest by the COVID-19 crisis in 2020 but both economies will rebound somewhat more strongly in 2021. In 2020, private consumption will severely curb GDP growth in all CESEE-6 countries as a result of lockdown measures, income losses and great uncertainty among households. For 2021 and 2022, we expect a gradual recovery. The picture is similar for gross fixed capital formation. In line with our assumptions on euro area imports, exports will take a deep blow in 2020 in all CESEE-6 countries and the subsequent recovery will be somewhat muted. Import growth will turn negative in 2020 due to both lower domestic demand and lower intermediate demand for the production of export goods. In 2021, export and import growth will start to recover. Unlike during the global financial crisis, the contribution of net exports will be negative in all CESEE-6 countries in 2020 apart from Poland, and particularly so in Croatia and Hungary. From 2021 onward, we expect the contribution of net exports to become slightly more favorable in most CESEE-6 countries. The catching-up process will also be affected by the COVID-19 crisis: In our baseline, GDP growth in the CESEE-6 region will surpass euro area growth by 3 percentage points in 2020. However, the growth differential will turn negative in 2021

Table 1

## OeNB-BOFIT GDP projections for 2020 to 2022 compared with the IMF forecast

	Eurostat/ Rosstat	OeNB-BOFIT projections October 2020			IMF WEO forecast October 2020		
	2019	2020	2021	2022	2020	2021	2022
Year-on-year growth in %							
<b>CESEE-6</b>	<b>3.9</b>	<b>−5.0</b>	<b>3.8</b>	<b>3.6</b>	<b>−4.8</b>	<b>4.6</b>	<b>4.2</b>
Bulgaria	3.4	−5.3	4.3	3.4	−4.0	4.1	3.7
Croatia	3.0	−8.6	4.9	4.1	−9.0	6.0	4.4
Czech Republic	2.3	−5.3	2.3	3.7	−6.5	5.1	4.3
Hungary	4.9	−6.3	5.2	3.3	−6.1	3.9	4.0
Poland	4.2	−4.2	4.1	3.6	−3.6	4.6	4.5
Romania	4.1	−4.9	3.3	3.6	−4.8	4.6	3.9
Russia	1.3	−4.0	2.4	2.2	−4.1	2.8	2.3

Source: IMF World Economic Outlook (WEO) of October 2020, Eurostat, Rosstat, OeNB-BOFIT projections.

<sup>1</sup> Cutoff date for data underlying this outlook: September 29, 2020. The projections for the CESEE-6 countries were prepared by the OeNB, those for Russia were prepared by the Bank of Finland in cooperation with the OeNB. In our projections, we assume economic developments in the euro area as set out in the September 2020 ECB staff Macroeconomic Projection Exercise (MPE).

<sup>2</sup> Compiled by Antje Hildebrandt, with input from Katharina Allinger, Stephan Barisitz, Markus Eller, Thomas Reininger, Tomáš Sláček and Zoltan Walko.

<sup>3</sup> CESEE-6: Bulgaria, Croatia, the Czech Republic, Hungary, Poland, Romania.

(−1.2 percentage point) and be almost zero in 2022. Our forecast is surrounded by an exceptionally high degree of uncertainty related to the future development of the COVID-19 pandemic, connected economic developments in the euro area and the future EU budget (including the recovery fund). Overall, risks are mainly tilted to the downside.

In Russia, GDP growth<sup>4</sup> is expected to contract by 4% in 2020 but return to a moderate growth rate of 2.4% next year. The Russian economy has had to endure the combined effects of the COVID-19 pandemic and an upheaval in oil markets. The risk of a weaker-than-expected outcome is significant due to the continuing uncertainty related to COVID-19 and commodity market developments.

## 1 CESEE-6: unprecedented crisis with severe growth impact

Against the background of negative economic growth in the first half of 2020, we expect real GDP growth in the CESEE-6 to amount to a GDP-weighted average of −5.0% in 2020.<sup>5</sup> Annual full-year growth in 2020 will be lower than GDP growth in the first half of 2020 in most CESEE-6 countries. The opposite is the case for the Czech Republic due to already negative growth in the first quarter of 2020 (−1.9% annually). For the third quarter of 2020, we expect a strong rebound in particular in Croatia and the Czech Republic (by 7.5% and 7.9%, respectively, quarter on quarter) that will compensate for some losses recorded in the second quarter of 2020. This development is in line with euro area growth, for which a strong rebound in the third quarter of 2020 is part of our external assumptions. In 2020, growth will be weakest in Croatia (−8.6%) and the economic deterioration will be most contained in Poland (−4.2%).

In 2021, average economic growth in the CESEE-6 region will come to 3.8%, and for 2022, we expect some leveling off to 3.6%. Countries with the strongest slump in 2020 (namely Croatia and Hungary) will see the strongest recovery next year, with growth rates reaching around 5%. For the Czech Republic, however, we foresee a rather subdued recovery for country-specific reasons. For the CESEE-6 average, GDP losses are expected to be compensated only in the course of 2022.

### Accommodative monetary policy to continue but challenges ahead

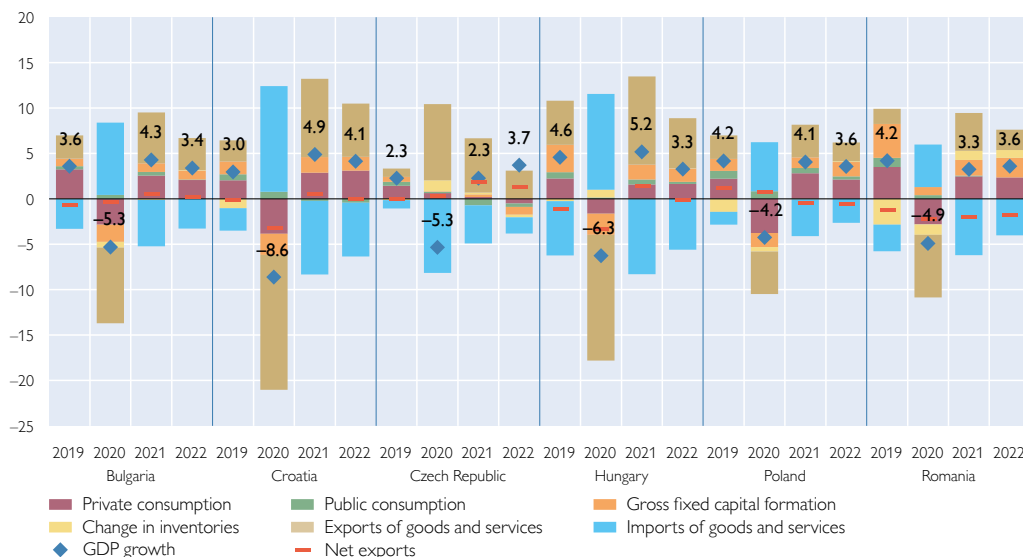
So far, monetary policy has been accommodative in the CESEE-6, also in reaction to needs related to the COVID-19 crisis. However, inflation rates have started to accelerate recently, which might challenge the central banks of inflation-targeting countries (i.e. the Czech Republic, Hungary, Poland). Furthermore, the growth of credit to the private sector has weakened since the beginning of the COVID-19 crisis both for households and corporates, and therefore is expected to provide limited support for economic activity at the moment.

<sup>4</sup> Forecast oil prices based on the average for oil futures contracts for the ten days preceding September 14, 2020, yield the following oil prices per barrel: USD 42 in 2020, USD 45 in 2021 and USD 48 in 2022.

<sup>5</sup> In our baseline, we assume that the COVID-19 pandemic will be contained or that there will be some form of treatment (e.g. vaccination) around mid-2021. Furthermore, we assume that no full lockdown will be enacted in the CESEE-6 over our projection horizon. Regarding EU funds, the EU multiannual financial framework (MFF) for the period from 2021 to 2027 will be in place while the Next Generation EU (NGEU) framework for the period from 2021 to 2026 is not part of our baseline.

**CESEE-6: GDP and GDP components**

GDP contributions in percentage points, year-on-year GDP growth in %



Source: Eurostat, OeNB.

Note: Realized data for 2019, projections for 2020 to 2022.

**Tighter fiscal stance from 2021 onward**

With regard to fiscal policy, we still assume a positive impetus for the economy, in particular until the end of 2020. Measures in reaction to the crisis have been implemented in all CESEE-6 countries (even so, they varied in size relative to GDP) and have put severe strain on public finances. Therefore, we assume a tighter fiscal stance from 2021 onward. Against this backdrop, the first round of policy measures taken to dampen the economic fallout from the COVID-19 crisis is unlikely to serve as a blueprint for a second round of policy measures if needed.

**COVID-19 crisis weighs strongly on private consumption**

For the CESEE-6 average, private consumption will decline by more than 5% in 2020, with the strongest slumps by more than 6% projected for Croatia and Poland. As private consumption is an important growth contributor, this reduction will significantly burden CESEE-6 GDP growth. For 2021 and 2022, we expect private consumption growth to recover and to contribute positively to growth. Importantly, the base effect will help lift private consumption growth into positive territory in 2021, with growth being strongest in countries that experienced the strongest decline. However, there will also be negative carry-over effects from 2020 that will weigh on private consumption, in addition to income losses and the uncertainty of households. In the Czech Republic, private consumption growth will be particularly low compared to other CESEE-6 countries in 2021 for various reasons, such as very little support from fiscal or regulatory policy from 2021 onward.

Public consumption growth is expected to contribute positively to GDP growth in all CESEE-6 countries in 2020. However, despite support packages for households and corporates, public consumption growth will weaken, compared to previous years, in all countries with the exception of Croatia and the Czech Republic, both

of which have introduced relatively sizable support packages. In 2021 and 2022, public consumption growth in the CESEE-6 countries will slow down further compared to 2020, possibly due to limited fiscal space. Only in Hungary will growth gain speed because of carry-over effects from 2020 and the upcoming parliamentary elections.

Gross fixed capital formation will be negative in 2020 in all CESEE-6 countries with the notable exception of Romania. The drop will be strongest in Poland (−7.6% in 2020, following a growth rate of above 7% in 2019). In Romania, gross fixed capital formation accelerated by 16% in 2019 and is expected to come to 3.5% in 2020 due to a good first half of the year. The lockdown in spring 2020 meant a temporary standstill for many projects in the CESEE-6. Furthermore, an uncertain future, financial constraints or shortage of labor from abroad due to travel restrictions (particularly in the construction sector) will reduce investment activity visibly in 2020. For 2021, we foresee a recovery, which will also be based on EU funds. The recovery will be muted, though, by tightening financing conditions, a rising number of bankruptcies and idle capacities.

Our export growth projections are in line with the MPE assumption on euro area imports. Accordingly, export growth will collapse in 2020 in all CESEE-6 countries, with growth figures ranging between −30.5% in Croatia (here, the service sector including tourism exports weighs on growth) and around −14% in Hungary and Romania. Importantly, due to weaker global demand, export growth had already lost some steam in a number of CESEE-6 countries prior to the COVID-19 crisis. Most CESEE-6 countries are strongly integrated in supply chains, especially of the automotive sector, which has been particularly strongly hit by the crisis. For 2021 and 2022, we expect a rather modest recovery in line with assumptions on euro area imports. Import growth in the CESEE-6 will turn negative in 2020 due to both weaker domestic demand and lower export growth, given the high import content of traded goods. In 2021, both imports and exports will recover. In sharp contrast to the global financial crisis ten years ago, the contribution of net exports in 2020 will be clearly negative in all CESEE-6 countries, particularly in Croatia and Hungary (reaching −3.2 and −3.3 percentage points, respectively). Only for Poland do we expect a positive contribution of net exports in the current year. From 2021 onward, we expect the contribution of net exports to become slightly more favorable in most CESEE-6 countries.

### **Risks to CESEE-6 projections point downward**

Currently, the most striking risk to our forecast – namely an increased spreading of the coronavirus in the CESEE-6, accompanied by renewed lockdown measures – is materializing in more and more instances. The Czech Republic e.g. already returned to a state of emergency in early October 2020, after the number of cases of COVID-19 infections had accelerated strongly. However, we do not expect such broad-based lockdown measures as in spring 2020. Still, the so-called second wave presents a severe downside risk to our forecast for the last quarter of 2020 and early 2021. Measures to support the economy will cushion some of the negative impacts but we do not foresee any far-reaching support comparable to what we saw during the first wave, given diminishing fiscal and monetary policy space. On the upside, a containment of the spreading of the coronavirus, new ways of reducing the dangers of COVID-19 infections, e.g. by some new treatment, or the availability

of vaccination earlier than in mid-2021 (as assumed in our baseline) would improve our outlook for 2021 and 2022.

Economic growth in the CESEE-6 countries depends largely on economic growth in their trading partners. Therefore, higher (lower) growth of the world economy or of the euro area, in particular, than assumed in our baseline scenario would translate into higher (lower) growth prospects for the CESEE-6. However, we see downside risks to external growth due to the negative impacts of an emerging second wave of COVID-19 infections in the CESEE-6 trading partners. In all euro area countries, COVID-19 infection rates have recently increased strongly, with some hotspots emerging, such as France and Spain. Infection rates are now on the rise also in Germany, one of the most important trading partners of the CESEE-6.

On the upside, the CESEE-6 countries would benefit particularly strongly, compared to other EU countries in relation to their GDP, from the July European Council agreement on the EU recovery instrument Next Generation EU (NGEU) for the period from 2021 to 2026 and the multiannual financial framework (MFF) for the period from 2021 to 2027 – even though it is currently not clear (1) whether the agreed package will remain the same after the adoption of the EU budget later this year, (2) when the concrete pay-outs can start in 2021 and (3) to which extent the available funds can be absorbed domestically. Better-than-assumed usage of the MFF could lift our projections. In any case, the likely overlap of projects in 2021 and 2022 stemming from the current and the future MFF period could stimulate investment more strongly than expected in some, but not all, countries.

However, different points of view in several political areas, such as migration or climate policy, open and deepen trenches between the EU and some CESEE-6 countries. Furthermore, some CESEE-6 countries' deficiencies in aligning with the EU's democratic standards are challenging these countries' relations with other EU members and present a downside risk for the countries concerned if the EU were to condition the pay-out of EU funds on respecting the rule of law. This could also pose a more general downside risk to all CESEE-6 countries if potentially affected countries vetoed the NGEU.

Regarding Brexit, it is still unclear how the agreement between the EU and Great Britain will be designed after transitional regulations will expire in mid-2021. A hard Brexit cannot be ruled out and could likely impact our growth projections negatively, especially via trade disruptions.

In the context of international trade, disruptions in supply chains could last longer and leave deeper traces than assumed. On the other hand, a relocation of production to European countries in the process of shortening supply chains could also give a positive impetus to trade in the CESEE-6 region. Concerning the automotive sector, a slower-than-assumed recovery resulting from a combination of the COVID-19 crisis-related containment measures and climate-related policies would impact several CESEE-6 countries more strongly than expected.

On the national level, there are political risks, e.g. in Bulgaria, where strong opposition against political elites has been on the rise. More generally, demonstrations against potential new lockdown measures cannot be ruled out, either.

Second-round effects of the COVID-19 crisis are difficult to assess and present a downside risk to our forecast. In our view, additional risks to our baseline projections – namely risks arising from the phasing-out of loan moratoria, wage support, short-time work schemes, tax deferrals or other measures implemented to protect households

and companies from the immediate consequences of the coronavirus-induced slump – seem contained overall. In our baseline, we assume a gradual and well-communicated phasing-out of these support measures as is suggested by recent extensions and a more stringent targeting of moratoria and support schemes in many countries. However, an unexpected or too early phasing-out could result in a stronger-than-expected increase in nonperforming loans, lower credit activity or a stronger rise in unemployment. Furthermore, a high degree of uncertainty may prevail among economic agents, both for households and corporates, which might result in higher-than-assumed precautionary saving or in lower-than-assumed investment activity.

We also see moderate downside risks to our growth projections coming from a potentially less accommodative monetary policy in light of modestly accelerating inflation rates in the CESEE-6 countries, in particular in the inflation-targeting countries. In the Czech Republic, for example, the inflation rate is already above the inflation target and thus somewhat limits the space for more accommodative monetary policy measures.

## 2 Projections for Bulgaria, Croatia, the Czech Republic, Hungary, Poland and Romania

### **Bulgaria: severe GDP contraction this year and increased political uncertainty**

The COVID-19 pandemic-induced recession in Bulgaria – especially the decline in private consumption – was not as severe in the first half of the year as expected at the time of our spring forecast. Therefore, we revise our 2020 real GDP growth projections somewhat upward, expecting a decline of a bit more than 5%. In quarter-on-quarter terms, there will be a rebound of economic activity in the third quarter of 2020 while in year-on-year terms, there will still be a considerable decline. In 2021, there will be a considerable rebound helped by favorable base effects. In 2022, growth will decelerate to pre-crisis dynamics. On balance, the economy will not return to pre-crisis GDP levels before mid-2022. Private consumption remains the main driving force for the slump this year and the recovery thereafter. Net exports will contribute negatively this year before returning to making a positive contribution next year. This positive contribution will diminish somewhat in 2022 in line with external assumptions.

This baseline forecast is subject to several country-specific uncertainties. First, on the downside, the economic outcome of the summer season is, at the time of writing, still not fully visible. On the back of an intensified spread of the coronavirus in the middle of the summer of 2020, preliminary data indicate that the number of foreign tourists in the summer season amounted to only about 80% of the number recorded in 2019 and, as a result, hotels did either not open or had to shut ahead of schedule. Moreover, the recovery of several high-frequency indicators, especially of retail sales, was more restrained during the summer months than for the country's regional peers. Second, it is currently not clear when the economic policy measures adopted to mitigate the impact of the recession will terminate. The main wage support scheme – the so-called 60:40 scheme – terminated already at the end of September 2020, but there are discussions on its prolongation, whereas a second scheme with a far smaller dotation targeting tourism, transportation companies and self-employed persons should last until end-2020. Loan repayment moratoria are scheduled to remain active until end-March 2021. Amid continuing mass anti-government protests, several government support measures might



remain in place until the next parliamentary election, which will either be a snap poll or take place at the scheduled date in March 2021. Political instability could also continue after the elections as traditional parties have lost support and new populist movements are on the rise, potentially hampering coalition building and thus the timely response to the crisis-induced economic shortfall.

On the upside, we must consider that Bulgaria belongs to the EU countries that would benefit most from the NGEU (with an average share of 2.7% of its 2019 GDP expected annually during the period from 2021 to 2026, according to the July European Council agreement). This could stimulate more gross fixed capital formation than assumed in our forecast. Last but not least, Bulgaria's participation in ERM II since July 2020 and in the EU banking union as of October 2020 as well as the country's gradual process toward euro adoption in the next few years will help anchor macrofinancial stability.

### **Croatia: downward revision due to abrupt end of tourist summer season**

We revise our 2020 GDP forecast for Croatia downward to  $-8.6\%$  year on year (from  $-7.6\%$  year on year in the previous forecast). A key reason behind this downward revision is the resurgence of COVID-19 infections in Croatia and in important tourist home countries since mid-August and related containment measures, in particular travel warnings. Our view on the remainder of the tourist season and the recovery in Croatia has therefore become more pessimistic.

We also revise the composition of growth drivers in Croatia. Private consumption is now expected to drop by less than envisaged in April, namely by  $6.6\%$  year on year. After a strong contraction related to lockdown measures in the second quarter of 2020, we are expecting a substantial rebound in the third quarter and subsequently a gradual further recovery of consumption, supported by government measures. In September 2020, the Croatian government announced, for instance, the prolongation of the wage support scheme until end-2020 (with tightened eligibility criteria) and planned income tax cuts effective from January 1, 2021. The prolonged uncertainty and slack in the labor market will likely lead to a lag in the recovery of durable goods consumption.

Gross fixed capital formation is expected to shrink by  $10\%$  year on year in 2020. Investments already contracted sharply in the first half of 2020 and we do not expect a noteworthy recovery in the second half of the year given high economic uncertainty. Loan repayment moratoria were still in place at the time of writing and used by many firms, likely masking the solvency issues of some firms. Bankruptcies and lingering uncertainty will likely subdue private investments in the coming years. However, EU funds play an important role for investments in Croatia and will support the recovery as Croatia is likely to be allocated substantial funds in the EU budget negotiations.

The realized contraction in exports and imports in the first half of 2020 has led us to revise downward our forecast for both components. Given the realized dynamics in the first half of 2020 and the fact that the tourist season was cut short in August, we now expect a strong negative contribution of net exports to GDP growth in 2020. We expect a rebound in tourism in 2021, but not to pre-crisis levels, due to several factors. In our baseline, a medical solution to the COVID-19 pandemic will not be widely available before mid-2021. Moreover, the severe economic downturn could dampen tourists' ability and willingness to spend and leave scars on the supply side if tourism-related enterprises go out of business.



Overall, we continue to expect a moderate recovery of the Croatian economy, with growth rates of 4.9% and 4.1% year on year in 2021 and 2022. Croatia will therefore need some years to recover the GDP losses of the current crisis. The substantial allocation of EU funds is one of the few upside risks, amidst a highly uncertain outlook with many downside risks related to the evolution of the COVID-19 pandemic and macroeconomic imbalances. It also remains to be seen how the Croatian government will balance fiscal stimulus and fiscal consolidation needs in the light of its targeted adoption date for the euro.

**Czech Republic: despite strongly accommodative economic policies, recovery from this year's deep dive will be difficult**

In spite of some relaxation in the second half of this year, economic activity in the Czech Republic is heading for a deep plunge in 2020 which will likely dwarf even the recession seen in 2009. We expect the economy to recover only very gradually over the forecast horizon as a result of long-tailed repercussions of the COVID-19 crisis as well as possible structural factors.

Economic growth in the Czech Republic had been gradually losing steam even before the COVID-19 shock hit in mid-March 2020, and the remainder of the year will continue to be heavily clouded by the COVID-19 pandemic. Nonetheless, we expect the latter to have a less detrimental effect than in the first six months to June 2020 as, inter alia, the profoundly dented but improving business sentiment indicators suggest. This is because most of the anti-coronavirus restrictions that are significant in economic terms have been wound down or largely relaxed. It currently seems that their re-introduction on a large scale would be met with a somewhat fiercer political, legal and social opposition than in spring 2020 despite rising numbers of COVID-19 infections. Moreover, the economic impact on private consumption and investment in the second half of 2020 will be mitigated by highly accommodative fiscal and monetary policy. Overall, we expect real GDP in the Czech Republic to plummet by 5.3% this year (while growth declined by 6.4% year on year in the first six months of 2020). The negative contributions of all expenditure-side GDP components will be counteracted only by accelerated growth in government consumption due to, inter alia, higher COVID-19-related expenditures (not only in healthcare).

Looking further ahead – even if the acute COVID-19 pandemic threat were to abate relatively soon (which does not seem very likely from the current perspective) – we expect economic recovery in the Czech Republic to remain rather moderate next year and to strengthen gradually toward the end of the forecast horizon. This is because private consumption, which is generally recovering, investment and export demand will be held back by several factors. On the one hand, the current fiscal and regulatory support measures for households and corporates will most likely terminate during the next months. As a result, a growing number of firms will be forced into bankruptcy, and unemployment will rise. On the other hand, several economic sectors are quite likely to suffer from long-lasting damage as a result of residual fear and prevalent uncertainty before demand and investment will return to their pre-pandemic behavioral patterns. In addition, the automobile industry, the heart of the Czech economy, was facing significant cyclical and structural demand- and supply-side challenges which will be compounded in the wake of the COVID-19 pandemic and ever-stricter EU-wide regulation. In sum, we expect domestic demand

to be the main driver of relatively moderate but strengthening economic growth over the next two years. The contribution of net exports will be broadly neutral in 2021 and turn more significantly positive only toward the end of the forecast horizon.

The risks to our forecast are clearly tilted to the downside. In particular, the (structural) damage to the economy described above will be all the more pronounced the longer the COVID-19 pandemic and the ensuing restrictions and uncertainty will last.

### **Hungary: COVID-19 crisis causes bigger drop in GDP than expected**

During the first half of 2020, GDP in Hungary performed worse than we had anticipated in March, and we now also expect a later and slower rebound than previously forecast. Therefore, we revise our forecast for 2020 downward to a GDP contraction by 6.2% year on year. For 2021 we expect a rebound by 5.2%, but at the same time we lower our forecast for 2022 to 3.3%. With inflation running near the upper bound of the central bank's target range and the Ministry of Finance expecting the 2020 budget deficit to almost double compared to its spring forecast and state debt to swell to 75% to 80% of GDP by end-2020 (from 66% at end-2019), economic policy will have hardly any room to fuel economic growth over the forecast horizon in any way similar to what it was doing over the past several years.

Following the lifting of the lockdown in May and June 2020, private consumption in Hungary will likely start to recover in the third quarter of 2020. Until end-2020, it will continue to benefit from a number of supporting policy measures taken in response to the COVID-19 pandemic. Also, the availability of various preferential loan facilities, together with central bank efforts to ensure smooth lending activity to households, should support consumption. Nevertheless, the contraction in employment, the increase in the share of part-time workers and the slowing of real average wage growth (not least due to elevated inflation) will put a brake on the recovery.

Public consumption in Hungary decreased only modestly in the first half of 2020, and we expect it to expand during the second half of the year as a result of various fiscal measures taken in response to the COVID-19 pandemic. We expect public consumption to remain strong in 2021 as a whole, due to both the carry-over effects from late 2020 and increased spending in the second half of 2021 in line with the electoral cycle (parliamentary elections are due in spring 2022).

Gross fixed capital formation in Hungary was heavily hit by the COVID-19 crisis in the first half of 2020, and we expect a notable recovery of investment activity only from the second half of 2021. EU fund inflow under the 2021–2027 MFF should aid this recovery. On the other hand, capacity utilization in manufacturing fell sharply during the crisis, the outstanding stock of credit to the corporate sector declined sharply between March and July 2020 despite the beneficial effect of the debt service moratorium and the expansion of the Hungarian central bank's various funding schemes, while corporate profitability was likely adversely affected by the COVID-19 crisis, reducing the availability of internal funds for investment as well.

External trade volumes contracted sharply during the second quarter of 2020. We expect trade volumes to start recovering in the second half of 2020, but given carry-over effects from the first half of 2020 and a strong base in the third quarter of 2019, both export and import volumes are expected to decline substantially in full-year 2020, resulting in a negative contribution of net real exports by almost

3 percentage points. Exports and imports should recover sharply in 2021, with net real exports again contributing positively to the overall GDP growth rate. With import growth overtaking export growth in 2022 in line with the further recovery of domestic demand, the growth contribution of net real exports is expected to become broadly neutral.

### **Poland: partial recovery in 2021 albeit still marked by COVID-19 effects**

In Poland, GDP is forecast to contract by 4.2% in 2020. Growth in 2020 reflects a sharp fall of both gross exports and domestic demand. Exports will shrink by close to 9% in line with the decline in imports by the euro area, Poland's main trading partner, with no other trading partners offering substantial offset. Domestic demand, albeit severely hit by lockdown measures like in other countries, will shrink by about 5% and hence by considerably less than exports. However, the weight of domestic demand in total final demand is about 65%, i.e. almost twice the weight of exports. Thus, both exports and domestic demand render a contribution of roughly the same size to overall GDP contraction.

In 2021, the Polish economy is expected to grow by about 4.1%. While growth will be supported by a beneficial base effect, it will not be larger in absolute terms than the previous decline, as economic hysteresis effects and the number of bankruptcies postponed to 2021 will have dampening effects. Exports will start expanding again, driven by the recovery of demand in both the euro area and other parts of the world. However, foreign demand will recover substantially less strongly than it previously shrank. Moreover, some Polish export companies might go bankrupt while others will find it difficult to enter the export business in the current circumstances. Hence, export growth in 2021 is expected to come in at about 7%, only partially offsetting the previous decline. Domestic demand will show a similar pattern, with growth predicted to reach about 4.5%. Thus, both exports and domestic demand will render a large contribution to overall GDP growth in 2021.

As a result of the combined strong contraction of both export and domestic demand, imports will fall by about 11% in 2020, even more strongly than exports. Thus, there will be a positive contribution of net exports to GDP growth of more than half a percentage point. By contrast, in 2021, import growth is forecast to outpace export growth, as pent-up domestic demand will compound the effect of restarting foreign demand growth. This will imply a swing of the contribution of net exports to GDP growth into negative territory, to reach about -0.5 percentage points.

Both private consumption and gross fixed capital formation will register severe year-on-year contraction in the second half of 2020, albeit less severe than in the second quarter of 2020, especially in the case of private consumption. In the full year of 2020, private consumption is foreseen to contract by 6.5%, reflecting the comparatively low level and short duration of unemployment benefits and the high uncertainty among consumers, who likely spend only a fraction of the income support received in various forms (including partial exemptions of social security payments and banks' moratoria) out of precautionary motives. Public consumption will rise strongly countercyclically but it has a limited weight in overall GDP growth. Gross fixed capital formation is forecast to contract by 7.6% in the wake of lacking demand. A deeper contraction will likely be avoided thanks to fiscal support for companies, a more optimistic outlook for 2021 and larger public investment, which should offset the impact of the fading-out EU funding cycle on

local governments and (publicly owned) companies. In 2021, domestic demand components will grow again, although the route toward normalization is not likely to be straightforward. Private consumption will benefit from pent-up demand while being held back by adverse effects from bankruptcies and the deteriorated labor market situation. Public consumption growth will moderate, but not fully reverse. Gross fixed capital formation will benefit from restarting foreign and consumer demand and from continuously stronger public investment, underpinned by the overlapping of old and new MFF funding cycles.

### **Romania: recovery subject to fiscal policy uncertainty**

After the COVID-19-related lockdown and disruptions in global supply chains caused a deep economic plunge in the second quarter of 2020, the easing of containment measures and the resumption of production in important industries will result in a partial recovery of earlier GDP losses starting from the third quarter of 2020. After a rebound in the third quarter, recovery in Romania will likely be gradual as uncertainties will keep economic sentiment subdued and fiscal correction is imminent. According to our current projection, seasonally adjusted GDP will only in the course of 2022 reach the level recorded in the first quarter of 2020. Downside risks to our forecast for 2020 stem from this year's drought that started in spring and might cause agricultural output to be substantially lower this year than in 2019.

Turning to individual demand components, retail sales suggest that the recovery in private consumption has proceeded well. Moratoria increased households' room for maneuver while government-supported furlough schemes, in particular, averted a steep rise in unemployment. Income losses under furlough schemes and short-time work, precautionary savings as long as uncertainties remain elevated as well as gradually rising unemployment will restrict private consumption growth, however. Given the strained fiscal situation, hardly any support from fiscal policy can be expected in the coming years. In this respect, uncertainties are very high as a fiscal strategy will only be available after the parliamentary election scheduled for early December 2020. It is still unclear, moreover, whether and when the parliamentary decision to stick to a 40% pension expenditure hike, as opposed to the 14% hike envisaged by the minority government, will be enforced. If it will be enforced, this step will probably go hand in hand with counterbalancing budgetary measures.

After gross fixed capital formation (supported by vivid construction activity) showed positive year-on-year growth in the first half of 2020, the investment growth outlook for Romania appears encouraging. Gross fixed capital formation will benefit from EU funds allocated to Romania via the EU's multiannual budget for the period from 2021 to 2027 and remaining funds flowing from the 2014 to 2020 multiannual budget. Plans for new motorways and for the modernization of railway lines (both partially EU funded) have already been announced. On top of this, a substantial upside risk stems from the EU's economic recovery instrument NGEU. Moreover, state-guaranteed loans for corporates (under the IMM Invest Romania Program, which was introduced in response to the COVID-19 crisis) continue to positively affect investment activity. In the medium term, Romania could also benefit from a reallocation of production capacities as multinational European companies might try to increase capacities in Europe to make production chains less vulnerable to global disruptions.

The resumption of production of the two major car producers Dacia and Ford in May 2020 bodes well for a recovery in exports in quarter-on-quarter terms in the third quarter of 2020. With year-on-year growth in industrial production still clearly negative in July 2020, export recovery might turn out to be sluggish, however. The recovery in external demand, as predicted in our external assumptions, will result in positive export growth in 2021 (on top of the base effect) and 2022. The growth contribution of net exports will remain negative, however, as the projected pick-up in domestic demand will entail a marked rise in imports.

### 3 Russian economy expected to recover gradually

Russia's GDP is expected to contract by 4% this year and to return to moderate growth rates of 2.4% in 2021 and 2.2% in 2022. The Russian economy has had to endure the combined effects of the COVID-19 pandemic and an upheaval in oil markets. Preliminary figures suggest that Russian GDP contracted by 8% year on year in the second quarter of 2020 and by 3.4% year on year in the first half of 2020. As the COVID-19 pandemic has eased in Russia and other countries since spring and the situation in commodity markets has stabilized, we expect the Russian economy to recover gradually. Yet, with renewed high infection rates in late September and early October in Russia, the recovery may be subdued in the months ahead.

Private consumption has been a major factor behind Russia's sharp GDP contraction. The lockdown and other restrictions implemented to deal with the spread of the coronavirus have cut consumption substantially. Consumption is also restricted by a strong decline in real disposable income and by increased unemployment. Since the lifting of most COVID-19 restrictions, a brisk recovery in private consumption appears to be underway. The recovery in consumption is expected to continue through the end of this year, but slowly and gradually.

Preliminary data show that fixed investment declined by 6% year on year in the first half of 2020. Uncertainty about the future makes firms reluctant to invest in new capital projects. Despite monetary policy easing, the sharp drop in corporate profits in the first half of this year has made the financing of investment more difficult for firms. Public-sector investment is constrained as some spending for investment is being redirected to social issues to relieve the economic impact of the COVID-19 pandemic on households.

The volume of Russian exports shrank in the first half of this year as the COVID-19 pandemic chewed through the global economy. In the second quarter of 2020, the volume of exports, however, already posted a slight growth even in annual terms. The improvement in goods exports has been supported by the brisk recovery of the Chinese economy. Russian exports should come back gradually and grow modestly next year as global commodity demand slowly revives. Russian imports are expected to fall substantially this year on the back of a contraction in domestic demand. In particular, the COVID-19 pandemic has caused a spectacular collapse in tourism abroad. In addition, the depreciation of the Russian ruble has dampened import developments. Imports should return to modest growth next year.

The three-year budget framework for the period from 2020 to 2022, which was approved by the Russian cabinet prior to the COVID-19 pandemic, anticipated increases in government spending. As the pandemic grinds on, budget spending is to be raised further this year to support the economy. With a substantial decline in budget income, government finances should finish 2020 deeply in the red. The

government will cover some of the deficit with money set aside from oil earnings in the National Welfare Fund and by increasing domestic debt. From the start of next year, however, fiscal policy is planned to moderate again, reducing the supportive effect of public spending on the economy.

**Oil market and COVID-19 infection rates mark crucial risks to our Russia forecast**

Also, our forecast for Russia is subject to large downside risks. If the COVID-19 pandemic or the oil market situation worsen significantly, Russia's economic outlook may deteriorate substantially. On the other hand, the recovery of the Russian economy could be slightly stronger if consumption resumes faster or if fixed investment falls more slowly than expected as households' and companies' perceptions of the economic outlook improve. Longer-term growth remains limited by the Russian economy's structural challenges. As yet, there is no evidence that the Russian authorities intend to move ahead with major reforms which would be needed to tackle the country's structural economic issues such as inadequate property protection, corruption and the state's oversized footprint in the economy.

## Studies



# What drives people's expectations of euro adoption? – Evidence from the OeNB Euro Survey on selected CESEE countries

Peter Backé, Elisabeth Beckmann<sup>1</sup>

*Recently, the monetary integration of some countries in Central, Eastern and Southeastern Europe (CESEE) has gained new momentum. Based on data from the OeNB Euro Survey from 2007 to 2019, we present evidence on individuals' expectations regarding accession to the euro area and examine how the framework that governs euro area accession, the different monetary policy regimes and de facto euroization affect expectations. We find that expectations have become less optimistic over time and that individuals' uncertainty in forming expectations has increased. Exposure to de facto euroization increases optimism in expectations regarding euro introduction and decreases uncertainty. Individuals who trust their national central bank and the EU expect accession to the euro area to take place sooner. Expectations of inflation or depreciation of the local currency are related to more pessimistic expectations regarding euro introduction. Monetary expectations (i.e. inflation and exchange rate expectations) play a stronger role for EU member states than for EU candidates and potential candidates; regarding trust in institutions the picture is reversed.*

JEL classification: D12, D84, E50, O52

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On July 10, 2020, Bulgaria and Croatia joined the exchange rate mechanism (ERM II) and thus took an important step in their endeavors to accede to the euro area over the medium term. After Slovenia, Slovakia and the Baltic states had joined the single currency area between 2007 and 2015, the recent ERM II entry by Bulgaria and Croatia suggests some renewed movement in the monetary integration of Central, Eastern and Southeastern Europe (CESEE), at least in some countries of the region, after largely stagnating for a few years. At the same time, policy positions about future euro accession continue to vary greatly among those CESEE countries that continue having their own national currencies.

Against this background, this paper focuses on two issues: What expectations do people in the CESEE region have regarding euro adoption? And what is driving these expectations? This is a highly relevant research topic given that euro adoption expectations do shape important economic and financial decisions among individuals, for example in the realm of saving and borrowing decisions when it comes to the choice of the currency in which assets and liabilities are denominated.

More specifically, we concentrate on exploring euro adoption expectations in ten CESEE countries that are not (yet) members of the single currency area, namely six EU members – Bulgaria, Croatia, the Czech Republic, Hungary, Poland and Romania – as well as four EU candidates and potential candidates (CPCs) from the Western Balkans – Albania, Bosnia and Herzegovina, North Macedonia and Serbia. Our analysis is based on data from the OeNB Euro Survey, which is, to our knowledge, the only dataset covering this issue for CESEE EU members and for

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CPCs.<sup>2</sup> We cover developments from 2007 to 2019.<sup>3</sup> We first describe the distribution of expectations and how uncertain individuals are when forming expectations of euro adoption. We then focus on how (de facto) euroization as well as differences in monetary policy regimes and institutions affect expectations. Of course, there are many more aspects of how individuals form their expectations regarding euro adoptions that could be analyzed. However, we prioritize depth over breadth and have limited the scope of our analysis to those aspects that are related to institutional determinants. We do not address heterogeneities that are related to individuals' cognitive abilities, preferences or beliefs.

Gaining a better understanding about the determinants of euro adoption expectations is crucial from a policy perspective, given that these expectations impact on numerous economic and financial decisions people take. Moreover, implementing strategies for preparing euro adoption is certainly facilitated if expectations are well aligned with policy plans.

Our analysis is related to the growing effort by central banks around the world to gain a more precise understanding of how households form expectations and how these expectations affect their behavior.<sup>4</sup> This effort is reflected in the strong increase in research on households' expectations: Between 2000 and 2005, on average, 41 publications referenced on EconLit per year refer to "expectations" in the abstract and mention "households" in the main body of the paper. In the years from 2015 to 2020, this admittedly very rough indicator increases to 125 publications on average per year. And for the first half of 2020 alone, there are already 140 publications with these characteristics. We will not attempt to review or do justice to this mushrooming literature in this paper. We note, however, that we are not aware of any other analytical paper that has studied the determinants of euro adoption expectations in CESEE. Based on OeNB Euro Survey data, Scheiber (2019a and 2019b) addresses the question of whether euro adoption expectations have an impact on people's propensity to hold euro cash. He finds a positive and significant influence of expected euro adoption on the likelihood that individuals hold euro cash, however not on the amounts of euro cash held.

Our study is structured as follows: In section 1, we describe the data we used, and section 2 presents results on how households' expectations regarding euro introduction are distributed and how certain households are in forming expectations. Section 3 presents our empirical approach. In section 4, we discuss which factors determine euro introduction expectations, before summarizing our findings and concluding.

<sup>2</sup> For more details on the survey see: <https://www.oenb.at/en/Monetary-Policy/Surveys/OeNB-Euro-Survey.html>

<sup>3</sup> The European Commission regularly commissions a survey on the introduction of the euro in EU member states that have not yet adopted the common currency, which also covers Sweden but not the CPCs (European Commission, 2020).

<sup>4</sup> See, for example, the well-known survey of consumer expectations conducted by the Federal Reserve Bank New York at <https://www.newyorkfed.org/microeconomics/sce>, the newly established Bundesbank Online Pilot Survey on Consumer Expectations at <https://www.bundesbank.de/en/bundesbank/research/pilot-survey-on-consumer-expectations/bundesbank-online-pilot-survey-on-consumer-expectations-794568> and the European Central Bank's newly established Consumer Expectations Survey (European Central Bank, 2020b) at [https://www.ecb.europa.eu/stats/ecb\\_surveys/consumer\\_exp\\_survey/html/index.en.html](https://www.ecb.europa.eu/stats/ecb_surveys/consumer_exp_survey/html/index.en.html).

## 1 Data: the OeNB Euro Survey

The main source of data for our analysis is the OeNB Euro Survey – a repeated cross-sectional survey of individuals, aged 15 or older. The survey has been carried out by the Oesterreichische Nationalbank (OeNB) in ten Central, Eastern and Southeastern European countries (CESEE-10) since 2007, i.e. in the ten countries that we focus on in this study. In each country and in each survey wave, a sample (based on multistage random sampling procedures) of around 1,000 individuals is polled.

Each sample reflects a country's population characteristics in terms of age, gender, region and ethnicity. Weights are calibrated separately for each wave on census population statistics.

The survey questionnaire elicits a rich set of information on socioeconomic characteristics, indicators of wealth and finances, individual beliefs, expectations and trust. The questionnaire is composed of a core set of questions regarding the extent of euroization as well as varying questions that focus on a specific research question. One of the central aims of these specific research questions is to understand the determinants of euroization in the CESEE-10 countries. The volatility of inflation and the exchange rate and individuals' inflation and exchange rate expectations as well as expectations regarding accession to the euro area are important determinants of the different dimensions of euroization (e.g. Ize and Levy Yeyati, 2003; Jeanne, 2005; Stix, 2013; Fidrmuc et al., 2013; and Brown and Stix, 2015).

The central variable for our analysis, which measures expectations regarding accession to the euro area, is based on the following question:

*When, in which year, do you think the euro will be introduced in your country?*

*Year: #####*

*Never*

*Don't know*

*No answer*

*Interviewer instruction: Albania, Bosnia, North Macedonia and Serbia: We do not mean joining the European Union but introducing the euro.*

*Bulgaria and Bosnia and Herzegovina: We mean when the national currency will be entirely replaced by the euro.*

This question was included in the survey waves of 2007, 2008, 2010, 2011, 2014, 2017, 2018 and 2019 with a total of around 92,000 observations.<sup>5</sup> Due to a different research focus, the question on euro introduction expectations was not asked in the survey waves of 2012, 2013, 2015 and 2016. As we believe recent developments are of more interest and want to avoid cluttering the descriptive analysis below, we pool the waves 2007–2008 and 2010–2011. Despite the fact that the time series of euro introduction expectations is not without interruption, the long time span covered by the survey is a unique asset for our analysis: The survey covers a time span of 13 years, albeit not at an annual frequency, with no changes to question wording or survey methodology, which is a rare asset.<sup>6</sup> Moreover, the OeNB Euro Survey has been conducted in a way that provides comparable data for

<sup>5</sup> We do not use data for Bosnia and Herzegovina that was collected between 2007 and 2011 as the central question of interest is not comparable with that asked in the other countries.

<sup>6</sup> For example, the well-known Survey of Household Income and Wealth already included a measure of inflation expectations in 1989 but the survey question was changed between then and 2016, complicating analyses that pool several waves (Rondinelli and Zizza, 2020).

ten countries with diverse institutional and policy backgrounds. Finally, the questionnaire also includes questions on inflation and exchange rate expectations as well as on trust in institutions, which makes it possible to analyze how different expectations and trust relate to each other. Nevertheless, it is important to bear in mind the survey was not designed as an expectations survey, where it has become the established practice to ask questions about expectations in (1) qualitative form, i.e. asking about the direction of changes, (2) quantitative form, i.e. asking for a point estimate of expected changes in percent, and (3) probabilistic form, i.e. asking respondents to evaluate the likelihood of economic variables being within specific ranges (for example, Manski, 2004; Van der Klaauw et al., 2008; Deutsche Bundesbank, 2019; European Central Bank, 2020b).

Moreover, expectations about euro introduction are likely influenced not only by policymakers and institutions but also by individuals' preferences and wishes. In the current analysis, we do not attempt to disentangle these two aspects – also due to a lack of additional data on individuals' wishes.<sup>7</sup>

## 2 Euro introduction expectations: past and present

How are individuals' expectations regarding euro introduction distributed? Did expectations change over time? How certain are individuals in their expectation formation?

When we look at the evidence to come up with answers to these questions, we must bear in mind that the CESEE-10 countries we analyze are very diverse with respect to their current monetary policy regimes and with respect to euro area accession policies. In the following, we will first give a quick overview of the framework that governs euro area accession, and then present results on how expectations are distributed across countries and over time. We will then focus on three aspects of this distribution: the role of monetary policy regimes for expectation formation, the role of the euro area accession framework and the role of uncertainty.

### 2.1 Distribution of euro introduction expectations from 2007 to 2019

What are the key features of the euro adoption framework? To start with, participation in the single currency area is only open to countries that are EU member states. Moreover, accession to the euro area is technically possible, at the earliest, in the third year after EU accession, given that it requires a smooth participation in ERM II for at least two years<sup>8</sup> and some lead time for the decision-making on euro area enlargement and for logistical preparations.<sup>9</sup> Based on this framework, one can determine the earliest possible year of euro area accession for each country and each survey wave that we include in this paper – and thus distinguish expectations

<sup>7</sup> In addition to the question on when individuals expect the euro to be introduced, the fall 2020 wave of the OeNB Euro Survey again includes a question on when they would like the euro to be introduced.

<sup>8</sup> Participation in ERM II is a necessary condition for joining the euro area from a legal as well as a practical point of view. Even EU member states with a pegged exchange rate regime or a currency board arrangement have to participate in ERM II for at least two years, observing normal fluctuation bands without devaluing against the euro (European Central Bank, 2003).

<sup>9</sup> In recent euro area enlargement rounds, this lead time amounted to about 6 to 7 months.

that are in principle congruent with the framework from those that are not.<sup>10</sup> We dub those expectations that are not in line with the monetary integration framework as “overly optimistic” and suppose that they are to a considerable extent due to incomplete knowledge about the euro area accession process, but also – as we will explain in more detail below – an outcome of rounding behavior, which in turn appears to mainly reflect uncertainty.

Three issues need to be noted in this context: First, expectations that are in line with the technical rules may also turn out to be too bullish, given that euro area accession requires a high degree of sustainable convergence, which may not yet be fully in place at the earliest technically feasible point in time; and in fact, euro area accession in the minimum timeframe so far has been the exception rather than the rule. Second, joining the euro area in the third year after EU accession presupposes that a country is willing and sufficiently prepared to enter ERM II shortly after EU accession. Again, this may not necessarily be the case; in fact, in the past it was only the case for two out of the five CESEE euro area countries. Third, we take the OeNB Euro Survey question on euro introduction expectations to refer to euro area accession and not to a unilateral adoption of the euro. We think this is a reasonable specification given that no CESEE country has been considering a go-alone strategy toward adopting the euro during the sample period and that EU institutions have repeatedly stressed elementary objections against a potential unilateral euro adoption.

We now turn to the question of how expectations are distributed across countries and over time. Chart 1 shows the developments in EU member states from 2007 to 2019. Strikingly, expectations have become less optimistic<sup>11</sup> over time in the majority of countries, as expected euro adoption lead times have become longer with the passage of time. “Never” answers have also tended to rise over time – especially in the Czech Republic, Hungary and Poland. We see an exception in Croatia, where expectations oscillated quite a bit over time but were somewhat more optimistic in 2019 than they had been back in 2007.<sup>12</sup> In turn, the development of “don’t know” shares has been diverse across countries. It is particularly interesting to note that it has substantially fallen in recent years in Croatia, while increasing to very high levels in Bulgaria and Poland. The recent decrease of “don’t know” responses in Croatia is likely also related to the very active information campaign by the authorities, in particular the central bank.

A multitude of partly related factors come to mind as possible explanations for the lengthening of expected lead times. We can only sketch a number of them briefly, while emphasizing that their relevance differs from country to country.

<sup>10</sup> By the latter, we mean expectations of euro adoption before such a step is actually technically feasible given the euro adoption rulebook, which is – for EU members – within less than two and a half years after the field phase of the survey, and – for non-EU members – less than two and a half years after the earliest feasible time of EU accession (with EU accession prospects being based on available information at the time of each survey wave, e.g. for the 2018 wave, we take 2025 as the earliest possible EU accession year for CPCs, based on the European Commission’s Western Balkans strategy released in February 2018). Moreover, we assume that euro area accession only takes place at the beginning of a calendar year, as it has always done in the past.

<sup>11</sup> We define “optimistic” strictly in a temporal sense, i.e. expectations are more optimistic if from one survey year to the next, the expected euro introduction is shifted forward by less than one year. When using “optimistic” we therefore do not refer to any potential benefits or risks for the economy that euro introduction may entail.

<sup>12</sup> Note that expectations may have developed quite differently in those CESEE countries that have already joined the euro area.

Upon EU accession, euro adoption strategies of CESEE authorities were rather ambitious in most cases; only the Czech Republic (and to some extent Romania) took a more gradual approach.<sup>13</sup> In a number of countries, the ambitious plans proved unfeasible for a variety of reasons. As a consequence, timelines were lengthened, and later dropped in a number of cases. The sovereign debt crisis in several euro area countries certainly affected perceptions about cost-benefit balances of euro area membership. At the same time, inflation targeting and flexible exchange rates were seen to serve some countries well, while fixed and quasi-fixed pegs also proved durable. These factors certainly impacted on people's euro adoption expectations in the six CESEE EU member states covered here. Changes in expectations, in turn, equally surely fed back into policy positions regarding euro adoption.

As Bulgaria and Croatia joined ERM II in July 2020, it is interesting to take a closer look at the development of euro adoption expectations in these two countries in the recent past.<sup>14</sup> To do so, we briefly recall at what stage the preparations for closer monetary integration were when the field phases of the last three OeNB Euro Survey waves took place (i.e. in the fall of 2017, 2018 and 2019). As of the fall 2017 wave, the Bulgarian authorities had indicated their intention to apply for ERM II entry (once ERM II stakeholders were ready to accept such an application). In Croatia, the central bank issued, in the fall of 2017, a strategy document on euro adoption which arrived at the conclusion that it would be favorable for the country to proceed toward joining the euro area (without indicating a timeline). In July 2018, ERM II stakeholders clarified, against the backdrop of EMU deepening (and, in particular, the creation of banking union), that countries willing to join ERM II also ought to enter into close cooperation with the ECB in the area of banking union. At the same time, Bulgaria expressed its firm intention to join ERM II within a year. In Croatia, the government adopted a euro introduction strategy in May 2018, based on an earlier central bank strategy document. Moreover, the central bank communicated the strategy very actively in numerous road shows across the country. As of fall 2019, preparations for ERM II entry and, alongside, for close cooperation with the ECB, were advancing for Bulgaria and Croatia, while it was not yet clear how much time they would take until being completed. How did expectations develop during this period? In Bulgaria, “don't know” dominated in recent waves, with a slight decline from 2017 to 2018, followed by almost no change in 2019 (57%). Notably, only about one-third of respondents had expectations of euro adoption that relate to a specific introduction year in 2018 and 2019 (slightly up from 28% back in 2017). Zooming in on the latter, we see a shift to more optimistic expectations from 2017 to 2018, which was partly reversed in 2019 (as overly optimistic expectations of a rapid euro adoption decreased). “Never” responses hover around 10%, with little change. In Croatia, we see that expectations have become more optimistic in recent waves (including also a rise in expectations of a very fast euro adoption), while the share of “never” responses decreased mildly from already low levels. At the same time, the share of respondents who answered that they “don't know” fell substantially from 2014 to 2017 and again from 2018 to 2019.

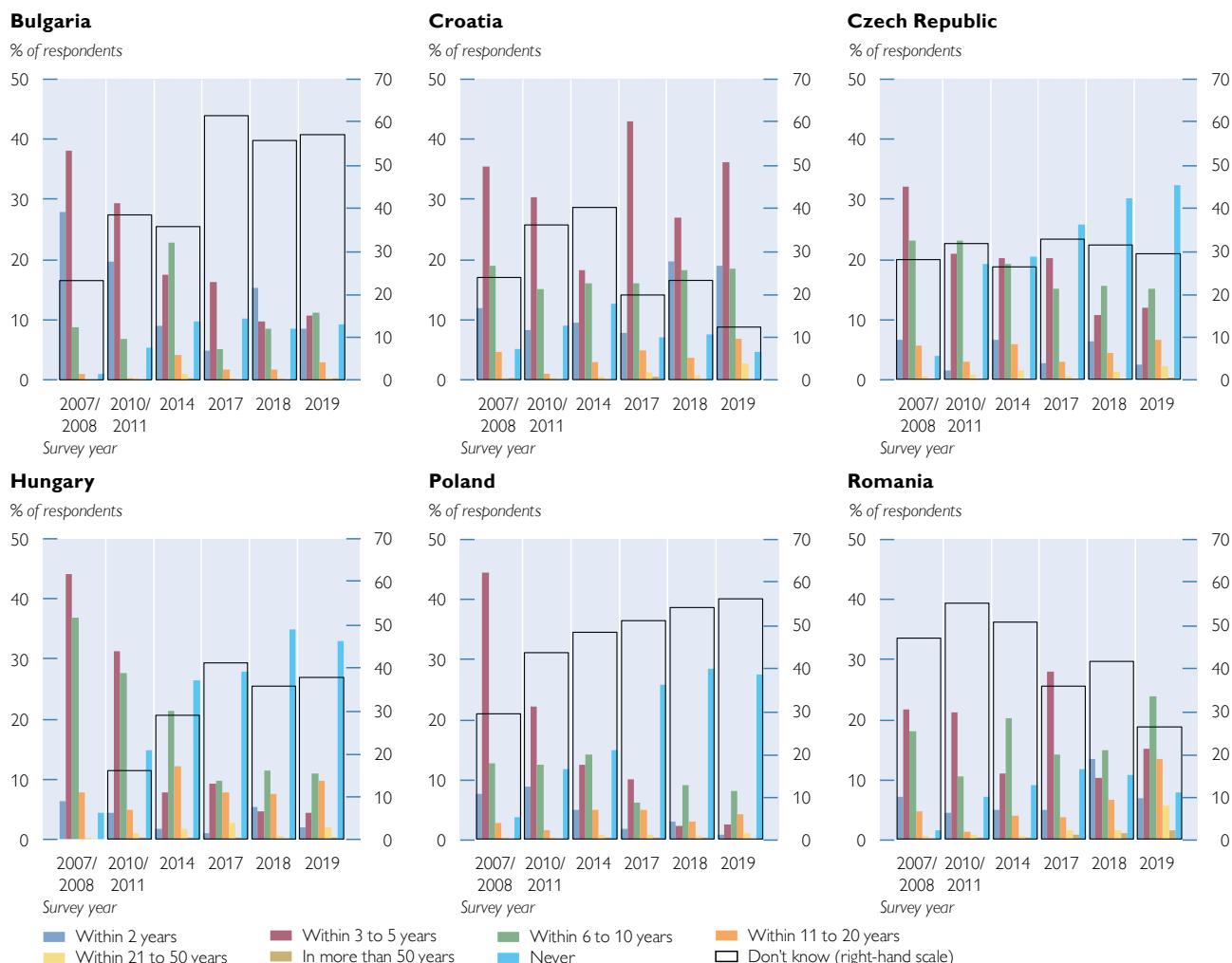
<sup>13</sup> See Backé, Thimann et al. (2004).

<sup>14</sup> See European Central Bank (2020a) for the ERM II entries by Bulgaria and Croatia. See Backé and Dvorsky (2018) for a more general account of euro area enlargement toward CESEE and Backé et al. (2019) for a succinct update. More specifically on Croatia, see Allinger (2018).



Chart 1

### Expectations in CESEE EU member states: Respondents think euro will be introduced...



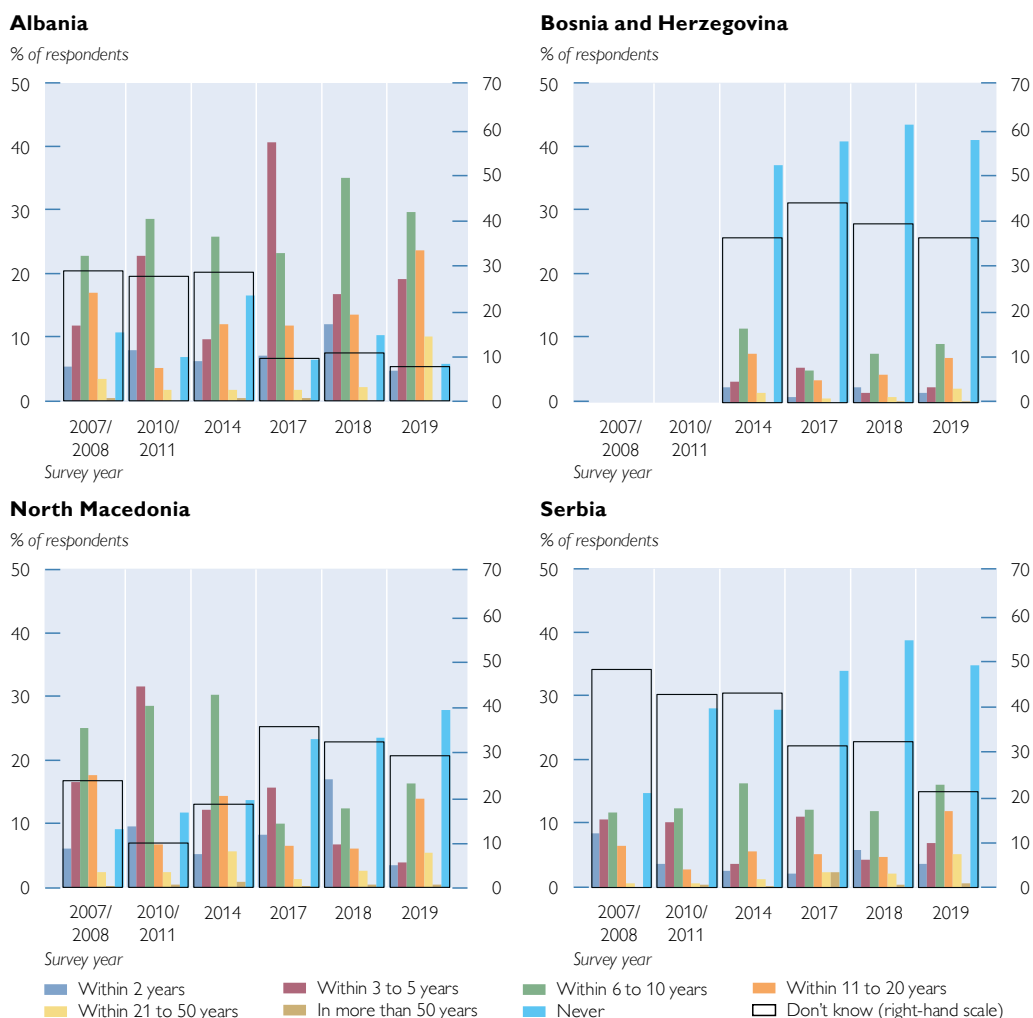
Source: OeNB Euro Survey.

Chart 2 depicts how expectations of euro introduction have changed over time in the CPCs. For this country grouping, heterogeneities are particularly pronounced. Bosnia and Herzegovina is a rather extreme case, with very high shares of “don’t know” answers. Among the remainder of respondents, “never” answers exceed the combined shares of those respondents that expect euro adoption at any future point in time. The share of the latter is also rather low in Serbia and roughly equals the “never” shares that have hovered around 30% during the past decade (in 2018 even getting close to 40%). In contrast, “don’t know” shares have substantially fallen in Serbia in recent waves. A considerable and in fact rising “never” share is also characteristic for North Macedonia, while the opposite can be observed for Albania where this answer category was starkly lower than in the other three CPCs in the last three waves. Moreover, in recent years, Albania also boasts the by far smallest “don’t know” shares among the four CPCs covered here. Comparing expectations in 2007 and in 2019, Albania stands out as the only CPC where expectations have become more optimistic. The opposite is true for Serbia and North Macedonia.



Chart 2

### Expectations in CESEE EU candidates and potential candidates: Respondents think euro will be introduced...



Source: OeNB Euro Survey.

Expectations in Bosnia and Herzegovina have barely altered. It needs to be noted that expected EU accession timelines for the CPCs have also slipped, as time went on, which in turn has also shifted expectations toward a later euro adoption.

How do the differences in monetary policy regimes across the CESEE-10 countries relate to euro adoption expectations? To address this question, we group countries based on their monetary policy regimes and compare euro adoption expectations across these groupings, i.e. we capture in how many years (mean and median) respondents expect the euro to be introduced in their respective home countries. Table 1 shows that there were surprisingly contained differences in expectations by different country groups in 2019. (Of course, these fairly moderate differences could either point to a limited impact of regimes on expectations or to other factors that dampen these differences.) An interesting distinction can be seen between EU member states and CPCs, as regards fixed versus floating regimes:

Table 1

### Expectations across countries and monetary policy regimes

	Mean	Median
<i>Years until expected euro introduction</i>		
EU member states	7.5	6
EU candidates and potential candidates	10.5	8
Fixed exchange rate (de jure or de facto): BG, HR; MK, BA	7.4	6
Float or managed float: CZ, HU, PL, RO; AL, RS	9.7	6
EU member states: fixed	5.4	4
EU member states: float	9.1	6
CPCs: fixed	10.9	10
CPCs: float	10.3	7
Inflation targeting	9.7	6
No inflation targeting	7.4	6

Source: OeNB Euro Survey (2019).

Note: The sample is reduced to respondents who name a year in which they expect the euro to be introduced, i.e. “don't know” and “never” responses are dropped.

While there is a clear difference between these two types of regimes in EU members in terms of expectations, this is not the case in CPCs. Moreover, we also examined correlations between exchange rate volatility and euro adoption expectations (mean, median and individual expected euro adoption). Here, we find that exchange rate volatility in the 12 months before a survey wave is mostly negatively correlated to the expected lead time until euro introduction.<sup>15</sup>

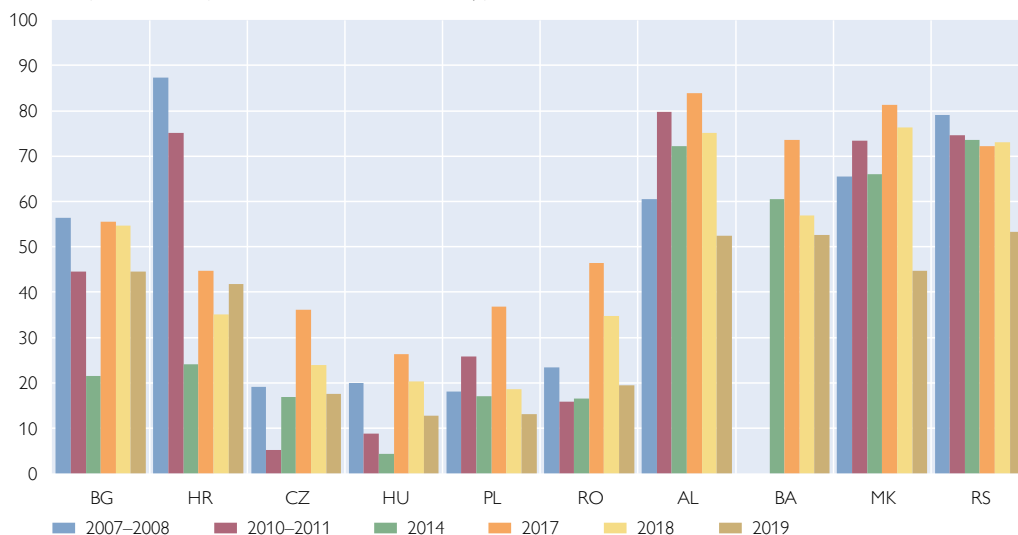
How is the framework for euro area accession reflected in expectations? We focus on the issue of overly optimistic expectations and display their development over time. Chart 3 shows the share of respondents with overly optimistic expectations, i.e. those who indicate a specific year in which they expect the euro to be adopted in their country that is not in line with the framework for euro introduction. Despite considerable variation over time, the share of overly optimistic expectations was lower, for most countries, at the end of the sample period than at the beginning. Among EU member states, overly optimistic expectations are clearly less widespread in countries in which authorities are reluctant or not eager at all to join the euro area in the foreseeable future, while the opposite is true for countries where authorities strive for progress toward euro adoption. The efforts of Croatia and Bulgaria (in the latter case, the renewed efforts) to advance on the road to the euro may have affected uncertainty but have not had any major effects on the share of overly optimistic expectations (some downward movement in Bulgaria, more mixed developments in Croatia). However, such policy efforts likely occasion a better understanding of the institutional framework in the general public and thus, if anything, moderate overly optimistic expectations. In CPCs, the share of overly optimistic expectations is higher than in CESEE EU member states. Presumably, this is mainly due to overly optimistic expectations about EU accession that add to other factors that can be considered to play a role for all ten countries under review here – in particular limitations in knowledge about euro area accession rules, but also uncertainty.

<sup>15</sup> Detailed results available from the authors upon request.

Chart 3

### Overly optimistic expectations: development over time

Share of respondents who expect euro introduction before technically possible, %



Source: OeNB Euro Survey.

Note: The sample is reduced to respondents who name a year in which they expect the euro to be introduced, i.e. “don't know” and “never” responses are dropped.

## 2.2 Euro adoption expectations and uncertainty

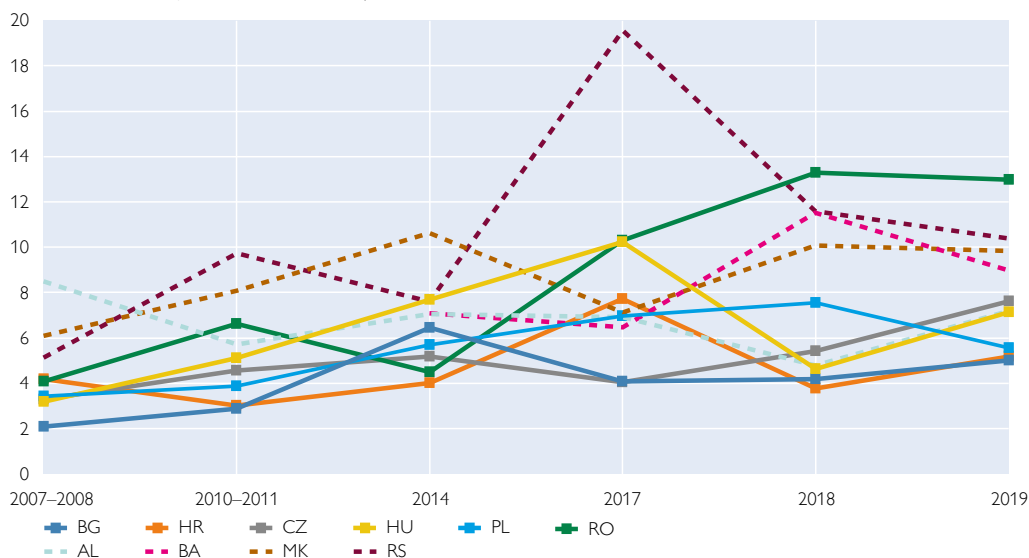
To conclude the descriptive analysis, we zoom in on the issue of uncertainty. Given the multitude of political, economic and institutional factors that can affect euro accession prospects as well as the complex interaction between these factors, uncertainty very likely plays a role in the formation of expectations. As mentioned, for CPCs, uncertainty is aggravated by uncertain EU accession timelines.

Research on expectations, in particular inflation expectations, has recently focused on understanding the role of uncertainty. For example, Ben-David et al. (2018) show that households differ in how uncertain they are in their expectations regarding personal and macroeconomic outcomes, which in turn affects their economic decisions. From a survey perspective, there are different ways to measure uncertainty. Brown and Stix (2015) and Dovern (2020) ask respondents directly to assess their uncertainty in expressing their expectations. An alternative has been to employ probabilistic questions, where respondents are asked to assess the likelihood of inflation or other macroeconomic outcomes falling within specified intervals. These responses are then used to calculate the standard deviation of the expected mean outcome for each individual. The standard deviation is interpreted as a measure of uncertainty, an approach which has, however, also been criticized (see e.g. Krüger and Pavlova, 2020). Finally, some researchers have argued that rounding is an expression of uncertainty (see e.g. Binder, 2017, and Manski and Molinari, 2010): Respondents report one – rounded – value rather than reporting a range. Rounding is certainly also an issue in our context, given that the OeNB Euro Survey asks respondents to indicate specific years rather than intervals or timespans (e.g. “during the first half of the 2020s”), which would seem to correspond more closely to individual expectations in a setting that is characterized by uncertainty.

Chart 4

### How uncertain are expectations?

Standard deviation of expected euro introduction in years



Source: OeNB Euro Survey.

Turning now to our dataset on euro adoption expectations, a first clear indication of uncertainty is the high share of “don’t know” responses, as documented in charts 1 and 2.

Chart 4 corroborates, based on the development of the standard deviation of the timespan until expected euro introduction, that uncertainty in euro introduction expectations has tended to increase over time.<sup>16</sup>

With regard to the issue of rounding, chart 5 confirms that our data contain substantial shares of answers that refer to years that are multiples of 10 in the six CESEE EU member states.<sup>17</sup> For the three survey waves shown in the chart (but also more generally), the share of answers that are multiples of 10 ranges from 27% to 55%, while if evenly distributed it would be 10%. In chart 5, we juxtapose this share with the share of expectations that the euro will be adopted in 2020 from the vantage point of three different survey waves. By doing so, we illustrate the connection between rounding (i.e. uncertainty) and overly optimistic expectations. This link can be seen neatly when looking at the 2017 survey wave. At the time of that wave, the technically earliest possible year for euro adoption was 2021. We suppose that rounding pushed expectations for 2020 upward (i.e. that some respondents named 2020 as a rounded figure, while they may have actually been thinking of a range extending into the first part of the 2020s). One year later, in the 2018 wave, a number of respondents still expect that the euro will be introduced in their country

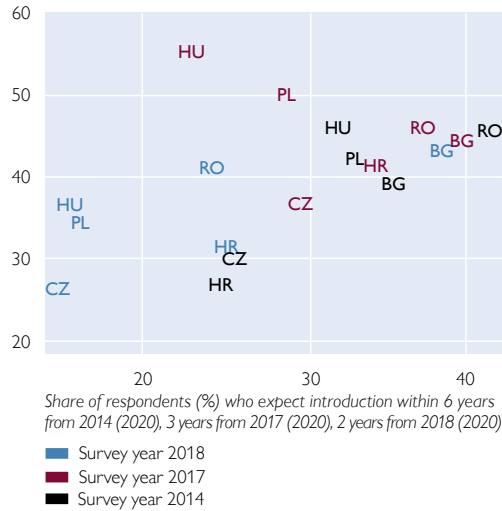
<sup>16</sup> The exceptionally high standard deviation for Serbia in 2017 appears to be due to some outlier answers, i.e. expectations of euro adoption in an extremely distant future. Moreover, after a successful macroeconomic stabilization in the preceding years, the denar started to appreciate nominally vis-à-vis the euro at the turn of 2016/17 and this appreciation process, though overall fairly moderate, continued throughout the year 2017. This constituted a clear break with previous exchange rate developments and could have contributed to the temporary widening of the dispersion of expectations regarding the date of euro adoption.

<sup>17</sup> The same is true (though not shown in detail) for the CPCs. In both country groupings, multiples of 5 are even substantially more frequent.

Chart 5

### Rounding and overly optimistic expectations

Share of respondents (%) who name years that are multiples of 10



Source: OeNB Euro Survey.

in 2020, apparently thinking of the next year that represents a “round” figure, even though 2020 was already very near at the time of the 2018 wave. Rounding to multiples of 10 would also suggest that “underlying” expectations relate to fairly long intervals that are in themselves an additional indication for uncertainty.

### 3 Empirical framework and strategy

The purpose of our empirical analysis is to explore how monetary institutions and euroization affect individuals’ expectations regarding euro introduction.

The large share of “don’t know” answers to the central question of our analysis also poses a challenge for our empirical analysis. One option would be to follow the usual practice and set

“don’t know” responses to missing, thereby assuming these responses are in fact randomly distributed. However, considering the content of the question, this assumption would not be justified as it would ignore the extent of uncertainty surrounding euro introduction expectations. We therefore opt to include the responses in our analysis as a meaningful separate response option. In addition, the response behavior for the remaining responses shows that respondents tend to round their answers. Therefore, instead of following the prevalent practice of taking numerical responses at face value, we draw on Manski and Molinari (2010) and construct interval data from the survey responses. Based on both of these decisions combined, our dependent variable  $E$  for respondent  $i$  takes the values:

$$E_i = \begin{cases} 0 & \text{expect euro introduction before technically possible} \\ 1 & \text{expect euro introduction } \leq 10 \text{ years} \\ 2 & \text{expect euro introduction } > 10 \text{ years } \leq 20 \text{ years} \\ 3 & \text{expect euro introduction } > 20 \text{ years} \\ 4 & \text{expect euro never to be introduced} \\ 5 & \text{don't know when to expect euro introduction} \end{cases}$$

The outcomes are defined as mutually exclusive, i.e. a respondent cannot simultaneously be in categories 0 and 1. If the response of “within 10 years” is overly optimistic, the response will be coded as 0. The resulting dependent variable  $E_i$  is a variable where not all response categories can be ordered meaningfully, in particular outcomes 0, 4 and 5. Put differently, the distribution of the dependent variable is multinoulli. In our baseline specification, the probability of answering

0 to 5 is modeled as the multinomial logistic function  $G$  of respondents' characteristics, monetary institutions and euroization:

$$Pr(E_i \in \{0,1,2,3,4,5\}) = G(\mathbf{S}_i \mathbf{M}_i \mathbf{X}_i)$$

where  $\mathbf{S}_i$  is a vector of respondent-specific controls, in particular sociodemographic characteristics and  $\mathbf{M}_i$  is a vector of respondents' economic expectations and trust in monetary institutions and  $\mathbf{X}_i$  controls for respondents' exposure to euroization and euro usage. We define category 3 ("expect euro introduction >20 years") as the reference category, i.e. the probability of answering 0, 1, 2, 4 or 5 is compared to the probability of answering 3.

An alternative to estimating a multinomial logistic model would be to run separate regressions for the determinants (1) of "don't know" and "never" responses and (2) of responses in years regarding expectations. For the first case, we would run logistic regressions, however, imposing a Bernoulli distribution on the dependent variable. For the second case, we would analyze the subsample of respondents that name a year of expected introduction only, likely introducing selection bias into the analysis. Considering these disadvantages, the main results are based on multinomial logit models; in robustness checks we also run separate logit and ordered logit models.

The control variables  $\mathbf{S}_i$  are informed by empirical results from the expectations literature and consist of gender, age, education and income (see e.g. Bryan and Ventaku, 2001a and 2001b; Easaw et al., 2013).<sup>18</sup> In analyzing the role of monetary institutions for expectations, we follow Mellina and Schmidt (2018) and Christelis et al. (2020) and control for trust in the central bank.<sup>19</sup> In addition, we control for trust in the stability of the local currency and in the stability of the euro. In an alternative specification, we analyze how expectations regarding inflation and the exchange rate are correlated with  $E_i$ .

A recent body of research argues that humans cannot absorb all information and choose which information to attend to. Usually, people devote more attention to issues with which they are confronted more directly or more frequently and, as a consequence, they form clearer – though not necessarily more realistic – expectations on related matters. Against this background, we also control for respondents' exposure to the euro. In particular, we include proxies for the extent of euroization in respondents' immediate environment. We also analyze whether expectations are correlated with respondents' financial choices, namely whether the respondent has a deposit or loan denominated in foreign currency. We further analyze whether respondents' exposure to the euro affects formation of expectations by analyzing the role of foreign currency income and remittances and controlling for proximity to the euro area.

As not all control variables are available in all waves, we reduce the sample to those waves where we have a consistent set of controls, namely: 2014, 2017, 2018 and 2019. All specifications include country and wave fixed effects. Standard errors are

<sup>18</sup> In contrast to the research on inflation expectations, we find that employment status, marital status and household composition do not affect euro introduction expectations. Therefore, our baseline specification does not control for these characteristics. Results are reported in table A2 in the annex.

<sup>19</sup> We acknowledge that in contrast to, e.g., inflation expectations, expectations regarding accession to the euro area are likely influenced by communication both of national central banks and national governments. We find that trust in the government does not have a significant effect on expectations regarding euro introduction.



clustered at the country-wave level. We estimate multinomial logit models. To facilitate interpretation of our results, we calculate average marginal effects and analyze some of the effects in more detail by calculating marginal effects at representative values. The categories of the dependent variable are defined by economic rationale; we check this definition and whether dependent categories could be combined by conducting Wald tests for combining dependent categories.

#### 4 Determinants of euro introduction expectations

In this section, we concentrate on presenting results regarding determinants of euro introduction expectations that relate to institutional aspects – in line with the focus of this paper. All estimations shown here also include key sociodemographic determinants (see table A2 in the annex for results).

How does exposure to aspects of euroization affect people's euro adoption expectations? That exposure indeed does have an impact is shown in table 2 (based on two alternative models<sup>20</sup>): Those who consider that holding euro cash is common and those that have foreign currency deposits are more likely to expect an early (overly optimistic) or relatively early (within a decade) euro introduction compared to those that do not. At the same time individuals displaying these euroization-related characteristics are less likely to give “don't know” answers (i.e. they are in a better position to form expectations). The latter is also true for individuals who receive remittances. Those who have a regular income in euro are also more likely to expect a relatively early euro adoption and less likely to answer “don't know” (the latter is only weakly statistically significant). The only euroization-related characteristic that reduces the likelihood of “never” answers is the perception that it is common to have foreign currency deposits. Of course, we do not interpret these results as causal effects as some of the control variables may well be endogenous, i.e. respondents may choose to hold foreign currency deposits or loans because they expect accession to the euro area in the near future.

The significance and direction of effects remains the same if we re-estimate table 2 using alternative reference categories. For all combinations of outcome categories, having a foreign currency loan has no statistically significant effect on expectations. Both model 1 and 2 also control for how far from the euro area the respondents live. We find that distance has an extremely heterogeneous effect across countries, very likely related to cross-border commuting in some countries and urbanicity in others.<sup>21</sup>

Looking at EU member states and CPCs separately yields further insights.<sup>22</sup> We do so by (1) including a dummy variable for CPCs in the model and (2) by splitting the sample into EU member states and CPCs. As regards significance, the main differences between the two country groupings relate to three respondent

<sup>20</sup> We control for the determinants listed in model 1 and model 2 consecutively. Both models control for sociodemographic determinants and country and wave fixed effects.

<sup>21</sup> In the interest of brevity, and as this is a factor not affected by policy measures, we do not present detailed results by country.

<sup>22</sup> Results available upon request from the authors.

Table 2

## How significant is exposure to euroization and the euro area for expectations?

Dependent variable outcome category	Respondents expect euro introduction...					
	Before theoretically possible	Within 10 years	Within 20 years	In more than 20 years	Never	Don't know
<b>Model 1</b>						
common to hold euro cash	0.022*** (0.008)	0.019*** (0.007)	−0.003 (0.005)	−0.006* (0.003)	−0.005 (0.008)	−0.027*** (0.008)
common to have foreign currency deposits	0.021** (0.009)	0.001 (0.006)	0.008* (0.005)	0.001 (0.003)	−0.035*** (0.011)	0.004 (0.009)
has foreign currency deposits	0.036** (0.018)	0.035*** (0.007)	0.012 (0.014)	0.000 (0.006)	−0.029** (0.014)	−0.055*** (0.012)
has local currency deposits	0.01 (0.013)	0.022*** (0.006)	0.017*** (0.006)	0.000 (0.007)	−0.026*** (0.009)	−0.024* (0.013)
has local currency loan	0.005 (0.008)	0.011* (0.007)	−0.003 (0.005)	−0.001 (0.003)	−0.012 (0.009)	−0.001 (0.009)
has foreign currency loan	−0.004 (0.010)	−0.009 (0.007)	0.011 (0.007)	0.007 (0.005)	0.009 (0.011)	−0.013 (0.011)
N	32,575	32,575	32,575	32,575	32,575	32,575
Log-L	−45,810	−45,810	−45,810	−45,810	−45,810	−45,810
country and wave fixed effects	Yes	Yes	Yes	Yes	Yes	Yes
further control variables	Yes	Yes	Yes	Yes	Yes	Yes
<b>Model 2</b>						
receives remittances	−0.003 (0.013)	0.011* (0.006)	0.009* (0.005)	0.008** (0.004)	−0.002 (0.014)	−0.024** (0.010)
regular income in euro	0.016 (0.012)	0.022** (0.009)	0.006 (0.007)	−0.005 (0.005)	−0.007 (0.013)	−0.032* (0.017)
N	39,880	39,880	39,880	39,880	39,880	39,880
Log-L	−54,862	−54,862	−54,862	−54,862	−54,862	−54,862
country and wave fixed effects	Yes	Yes	Yes	Yes	Yes	Yes
further control variables	Yes	Yes	Yes	Yes	Yes	Yes
<b>Model 3</b>						
common to hold euro cash	0.022*** (0.008)	0.019*** (0.007)	−0.003 (0.005)	−0.006* (0.003)	−0.005 (0.008)	−0.028*** (0.008)
common to have foreign currency deposits	0.022** (0.009)	0.001 (0.006)	0.008* (0.005)	0.000 (0.003)	−0.035*** (0.011)	0.004 (0.009)
has foreign currency deposits	0.038** (0.018)	0.032*** (0.007)	0.011 (0.014)	0.000 (0.005)	−0.028* (0.014)	−0.053*** (0.012)
has local currency deposits	0.011 (0.013)	0.022*** (0.006)	0.016*** (0.006)	−0.001 (0.006)	−0.026*** (0.009)	−0.023* (0.013)
has local currency loan	0.005 (0.008)	0.011* (0.007)	−0.003 (0.005)	−0.001 (0.003)	−0.012 (0.009)	−0.001 (0.009)
has foreign currency loan	−0.004 (0.010)	−0.009 (0.007)	0.011 (0.007)	0.007 (0.005)	0.009 (0.011)	−0.013 (0.011)
receives remittances	−0.01 (0.014)	0.009 (0.006)	0.007 (0.006)	0.009** (0.004)	0.001 (0.016)	−0.016* (0.009)
regular income in euro	0.004 (0.014)	0.016 (0.011)	0.004 (0.008)	−0.005 (0.006)	−0.006 (0.014)	−0.013 (0.020)
N	32,571	32,571	32,571	32,571	32,571	32,571
Log-L	−45,781	−45,781	−45,781	−45,781	−45,781	−45,781
country and wave fixed effects	Yes	Yes	Yes	Yes	Yes	Yes
sociodemographic control variables	Yes	Yes	Yes	Yes	Yes	Yes

Source: OeNB Euro Survey (2014–2019). Authors' calculations.

Note: Multinomial logit results, average marginal effects reported. Further sociodemographic controls are included but not reported. Standard errors, in parentheses, are clustered at the country-wave level. The Wald test for combining dependent categories is significant for all outcomes of the dependent variable at the 1% level.

characteristics: (1) *perception that it is common to hold euro cash*: while individuals in CESEE EU member states who have this perception are more likely to expect relatively early euro adoption, this is not the case for people in CPCs; (2) those who state that they have *no deposits* are more likely to expect late euro adoption if they are CESEE EU citizens; this is not so for respondents in CPCs; and (3) *receives remittances*: individuals in CESEE EU member states to whom this characteristic applies are more likely to expect early or relatively early euro adoption; this is not the case for people in CPCs. Moreover, there are notable differences in the size of some significant effects. For example, having foreign currency deposits correlates with expectations much more strongly in CESEE EU member states than in CPCs.

Moving on to the second subset of determinants that we are interested in in this paper: Which role does trust in institutions and monetary expectations play in shaping euro adoption expectations? Our results are displayed in table 3, with model 1 focusing on trust and model 2 on monetary expectations.

Table 3 shows that those who trust in the euro, in the EU and in their national central bank are more likely to expect an early or relatively early euro adoption, while at the same time they are less likely to think that their country will never join the euro area. Trust in the local currency increases the likelihood of medium- to longer-term euro adoption expectations but has no impact on the likelihood of “never” answers. Those who expect inflation or depreciation of the local currency tend to be more likely to have somewhat more negative euro adoption expectations than those who do not.

Again, we look at the subsamples of CESEE EU members states and CPCs to examine possible heterogeneities among these two sets of economies.<sup>23</sup> Two main points stand out: Regarding the size of the effects, trust in institutions has a larger impact in CPCs than it has in CESEE EU member states. As for significance, depreciation expectations have somewhat varying effects in CESEE EU members states as compared to CPCs, while expectations of inflation imply a higher likelihood that respondents expect a later euro adoption in CPCs than this is the case in CESEE EU member states.

We conduct several robustness checks. First, we rerun regressions including all control variables in models 1 and 2 of tables 2 and 3 jointly to examine issues of multicollinearity among other issues. Results do not change significantly and are shown in the annex (tables A3 and A4). Second, taking into account that our sample includes a very diverse set of countries we rerun regressions dropping one country at a time to ensure results are not driven by a single country. We do not find evidence that this is the case. In further robustness analyses, following research by Malmendier and Nagel (2016), who show that experience of economic crises has long-lasting effects on expectations, and Goldfayn-Frank and Wohlfart (2020), who show that Germans who lived in the German Democratic Republic hold different inflation expectations than Germans who did not, we analyze whether experience of economic turbulence during transition affects expectations. We do not find that memories of hyperinflation or memories of banking crises have a significant effect on expectations of euro area accession.

<sup>23</sup> Results available upon request from the authors.

Table 3

## How significant are monetary expectations and trust in institutions for expectations?

Dependent variable outcome category	Respondents expect euro introduction...					
	Before theoretically possible	Within 10 years	Within 20 years	In more than 20 years	Never	Don't know
<b>Model 1</b>						
LC future stable	−0.002 (0.008)	0.017** (0.007)	0.012** (0.005)	−0.002 (0.003)	−0.013 (0.011)	−0.011 (0.007)
EUR future stable	0.025*** (0.009)	0.026*** (0.007)	−0.006 (0.005)	−0.003 (0.004)	−0.049*** (0.010)	0.007 (0.009)
trust in central bank	0.033*** (0.010)	0.024*** (0.008)	−0.001 (0.006)	−0.010*** (0.003)	−0.039*** (0.009)	−0.007 (0.010)
trust in EU	0.049*** (0.010)	0.027*** (0.006)	0.001 (0.005)	−0.004 (0.004)	−0.074*** (0.008)	0.000 (0.008)
N	31,875	31,875	31,875	31,875	31,875	31,875
Log-L	−44,534	−44,534	−44,534	−44,534	−44,534	−44,534
country and wave fixed effects	Yes	Yes	Yes	Yes	Yes	Yes
further control variables	Yes	Yes	Yes	Yes	Yes	Yes
<b>Model 2</b>						
expect depreciation	0.011 (0.009)	−0.017*** (0.006)	−0.009* (0.005)	0.002 (0.002)	0.027*** (0.009)	−0.014* (0.008)
expect inflation	−0.023** (0.011)	−0.009* (0.005)	0.008 (0.005)	0.008*** (0.003)	0.020** (0.009)	−0.003 (0.008)
N	33,636	33,636	33,636	33,636	33,636	33,636
Log-L	−47,418	−47,418	−47,418	−47,418	−47,418	−47,418
country and wave fixed effects	Yes	Yes	Yes	Yes	Yes	Yes
further control variables	Yes	Yes	Yes	Yes	Yes	Yes
<b>Model 3</b>						
LC future stable	0.001 (0.008)	0.018*** (0.007)	0.013** (0.005)	−0.001 (0.003)	−0.01 (0.010)	−0.020*** (0.007)
EUR future stable	0.029*** (0.009)	0.022*** (0.007)	−0.007 (0.005)	−0.004 (0.004)	−0.050*** (0.010)	0.01 (0.009)
trust in central bank	0.037*** (0.010)	0.024*** (0.008)	−0.001 (0.006)	−0.010*** (0.003)	−0.040*** (0.009)	−0.01 (0.010)
trust in EU	0.049*** (0.010)	0.028*** (0.006)	0.001 (0.005)	−0.004 (0.004)	−0.076*** (0.009)	0.001 (0.008)
expect depreciation	0.022** (0.008)	−0.005 (0.006)	−0.006 (0.005)	−0.001 (0.003)	0.009 (0.009)	−0.018** (0.009)
expect inflation	−0.022* (0.013)	−0.006 (0.005)	0.009* (0.005)	0.009*** (0.003)	0.018* (0.010)	−0.006 (0.008)
N	29,010	29,010	29,010	29,010	29,010	29,010
Log-L	−40,786	−40,786	−40,786	−40,786	−40,786	−40,786
country and wave fixed effects	Yes	Yes	Yes	Yes	Yes	Yes
sociodemographic control variables	Yes	Yes	Yes	Yes	Yes	Yes

Source: OeNB Euro Survey (2014–2019). Authors' calculations.

Note: Multinomial logit results, average marginal effects reported. Further sociodemographic controls are included but not reported. Standard errors, in parentheses, are clustered at the country-wave level. The Wald test for combining dependent categories is significant for all outcomes of the dependent variable at the 1% level.

## 5 Conclusions

In this paper, we focus on euro adoption expectations expressed by individuals in ten CESEE countries that (still) have retained their national currencies, namely six EU member states – Bulgaria, Croatia, the Czech Republic, Hungary, Poland and Romania – as well as four EU candidates and potential candidates (CPCs) in the Western Balkans – Albania, Bosnia and Herzegovina, North Macedonia and Serbia. For our analysis, we use data from the OeNB Euro Survey ranging from 2007 to 2019.

We first describe the distribution of expectations and show how it has changed during the sample period. We find that, in general, the time horizons until expected euro adoption in the countries under review have tended to lengthen with the passage of time, and uncertainty appears to have played a substantial and, over time, increasing role in the formation of these expectations. More specifically, we also explore rounding behavior as an expression of uncertainty. Rounding behavior is of interest because, together with limitations of knowledge about euro area accession, it relates to the phenomenon of expectations that are not in line with the institutional framework that governs the adoption of the euro (i.e. expectations that the euro could be introduced before the earliest technically feasible point in time).

In the second part of the paper we focus on how (de facto) euroization as well as differences in monetary policy regimes and institutions affect expectations. Based on multinomial logit models, we substantiate that the exposure of individuals to features of de facto euroization has an impact on euro adoption expectations. Exposure to euroization tends to increase the likelihood of more optimistic euro adoption expectations and lowers the likelihood of “don’t know” answers. In a similar vein, trust in institutions (national central bank, EU) and in the stability of currencies (euro, local currency) is associated with a higher likelihood of more optimistic euro introduction expectations. Both main results broadly hold – with some heterogeneity – for both CESEE EU member states and CPCs.

In policy terms, we would offer the following takeaways and implications: First, a successful promotion of the use of local currencies (de-euroization strategies, as applied e.g. in Serbia and Albania) could have some effect on euro adoption expectations going forward (e.g. dampen expectations of a swift euro introduction). Second, our results reinforce the notion that trust and stable monetary expectations are key for the formation of euro adoption expectations. Third, improving the knowledge about the framework of euro adoption might help reduce the share of overly optimistic expectations as regards euro adoption. In turn, this might help to improve the quality of financial decisions taken by individuals. Fourth, the same could hold true for policies that reduce uncertainty with respect to future euro adoption, including a clear and time-consistent communication on these issues, as witnessed in recent years in Croatia. At the same time, a note of caution needs to be added here: The large heterogeneity across countries which we document in this study needs to be considered when designing policies. What works in one country, may not necessarily work in another.

Our study has intentionally focused on a rather narrow research question but also points to several possible future avenues of research. Beyond distance to the euro area, are there regional heterogeneities such as local economic development that affect expectations of accession to the euro area? Inspired by research on inflation expectations (e.g. D’Acunto et al., 2019), interesting research questions for the future might also include: What is the role of cognitive abilities and financial literacy

for the formation of euro introduction expectations and how does literacy affect uncertainty? How do individual attitudes and beliefs, including political attitudes as well as personal preferences for introduction affect expectations? The fall 2020 wave of the OeNB Euro Survey will include survey questions designed to address some of these issues. In addition, future research may look at the relationship of changing expectations on households' investment and saving behavior in more detail.

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## Annex

Table A1

### Variable definitions

Variable name	Definition
common to hold euro cash	Dummy variable based on the following question: "Please tell me whether you agree with the following statement on a scale from 1 (strongly agree) to 6 (strongly disagree): In [MY COUNTRY] it is very common to hold euro cash." Answers 1 to 3 are coded as 1, else as zero.
common to have foreign currency deposits	Dummy variable based on the following question: "Please tell me whether you agree with the following statement on a scale from 1 (strongly agree) to 6 (strongly disagree): In [MY COUNTRY] it is very common to hold foreign currency deposits." Answers 1 to 3 are coded as 1, else as zero.
has foreign / local currency / no deposits	Dummy variable that takes the value 1 if the respondent has deposits denominated in foreign / local currency or no deposits, else zero. Base category: Respondents who refuse to answer.
has foreign / local currency loan	Dummy variable that takes the value 1 if the respondent has a loan denominated in foreign / local currency, else zero. Base category: Respondents who do not have a loan.
receives remittances	Dummy variable that takes the value 1 if the respondent receives remittances from abroad, else zero.
regular income in euro	Dummy variable that takes the value 1 if the respondent receives regular income in euro, else zero.
LC future stable	Dummy variable based on the following question: "Please tell me whether you agree with the following statement on a scale from 1 (strongly agree) to 6 (strongly disagree): Over the next five years, the [LOCAL CURRENCY] will be very stable and trustworthy." Answers 1 to 3 are coded as 1, else as zero.
EUR future stable	Dummy variable based on the following question: "Please tell me whether you agree with the following statement on a scale from 1 (strongly agree) to 6 (strongly disagree): Over the next five years, the euro will be very stable and trustworthy." Answers 1 to 3 are coded as 1, else as zero.
trust in central bank, trust in EU	Dummy variable based on the following question: "Please tell me how much trust you have in the following institutions: (...) The European Union (...) the national central bank. For each of the institutions, please tell me if you tend to trust it or tend not to trust it. 1 means 'I trust completely,' 2 means 'I somewhat trust,' 3 means 'I neither trust nor distrust,' 4 means 'I somewhat distrust' and 5 means 'I do not trust at all.' " Answers 1 and 2 are coded as 1, else zero.
expect depreciation	Dummy variable based on the following question: "How do you think will the exchange rate of the [LOCAL CURRENCY] against the euro develop over the next five years?" The answer "The local currency will lose value" is coded as 1, answers "The exchange rate will stay the same" and "The local currency will gain value" are coded as zero.
expect inflation	Dummy variable based on the following question: "Please tell me whether you agree with the following statement on a scale from 1 (strongly agree) to 6 (strongly disagree): Over the next year, prices will strongly increase in [MY COUNTRY]." Answers 1 to 3 are coded as 1, else as zero.

Source: OeNB Euro Survey.

Table A2

## How do sociodemographic heterogeneities affect expectations of euro introduction?

Dependent variable outcome category	Respondents expect euro introduction...					
	Before theoretically possible	Within 10 years	Within 20 years	In more than 20 years	Never	Don't know
female	–0.001 (0.004)	–0.015*** (0.004)	–0.017*** (0.003)	–0.004*** (0.002)	–0.017*** (0.004)	0.054*** (0.006)
age	–0.001*** (0.000)	0.000 (0.000)	0.000 (0.000)	–0.000*** (0.000)	0.001** (0.000)	0.001** (0.000)
married	0.014** (0.006)	–0.004 (0.005)	–0.001 (0.004)	–0.003 (0.002)	–0.014** (0.007)	0.008 (0.008)
1 person household	0.011 (0.009)	–0.011* (0.007)	–0.01 (0.007)	–0.003 (0.004)	–0.015** (0.007)	0.028*** (0.010)
3+ person household	0.016*** (0.006)	0.001 (0.003)	–0.002 (0.004)	–0.004 (0.003)	–0.023*** (0.006)	0.011 (0.007)
education: secondary	0.038** (0.015)	0.027*** (0.007)	0.006 (0.006)	0.005 (0.004)	–0.007 (0.008)	–0.070*** (0.012)
education: tertiary	0.060*** (0.016)	0.053*** (0.008)	0.007 (0.007)	0.007 (0.006)	–0.027** (0.011)	–0.100*** (0.017)
income: refused answer	–0.053*** (0.010)	–0.026*** (0.007)	–0.023*** (0.005)	–0.009*** (0.002)	0.009 (0.009)	0.102*** (0.011)
income: medium	0.008 (0.007)	0.020*** (0.007)	0.008* (0.004)	0.000 (0.003)	–0.011* (0.007)	–0.025*** (0.008)
income: high	0.015 (0.009)	0.039*** (0.007)	0.005 (0.006)	0.001 (0.003)	–0.022*** (0.007)	–0.039*** (0.009)
retired	–0.006 (0.008)	–0.004 (0.008)	–0.004 (0.007)	–0.001 (0.004)	–0.015* (0.008)	0.030*** (0.010)
unemployed	0.007 (0.007)	–0.013* (0.007)	–0.012** (0.004)	0.001 (0.002)	0.006 (0.010)	0.011 (0.010)
student	0.023** (0.011)	0.005 (0.012)	0.009 (0.009)	0.003 (0.004)	–0.043*** (0.014)	0.002 (0.013)
self-employed	0.004 (0.013)	0.015*** (0.005)	–0.006 (0.007)	0.003 (0.003)	–0.004 (0.009)	–0.012 (0.013)
N	39,536	39,536	39,536	39,536	39,536	39,536
Log-L	–54,431	–54,431	–54,431	–54,431	–54,431	–54,431
country and wave fixed effects	Yes	Yes	Yes	Yes	Yes	Yes

Source: OeNB Euro Survey (2014–2019). Authors' calculations.

Note: Multinomial logit results, average marginal effects reported. Standard errors, in parentheses, are clustered at the country-wave level. The Wald test for combining dependent categories is significant for all outcomes of the dependent variable at the 1% level.

Table A3

### Robustness analysis: How significant is exposure to euroization and the euro area for expectations?

Dependent variable outcome category	Respondents expect euro introduction...					
	Before theoretically possible	Within 10 years	Within 20 years	In more than 20 years	Never	Don't know
common to hold euro cash	0.022*** (0.008)	0.019*** (0.007)	−0.003 (0.005)	−0.006* (0.003)	−0.005 (0.008)	−0.028*** (0.008)
common to have foreign currency deposits	0.022** (0.009)	0.001 (0.006)	0.008* (0.005)	0.000 (0.003)	−0.035*** (0.011)	0.004 (0.009)
has foreign currency deposits	0.038** (0.018)	0.032*** (0.007)	0.011 (0.014)	0.000 (0.005)	−0.028* (0.014)	−0.053*** (0.012)
has local currency deposits	0.011 (0.013)	0.022*** (0.006)	0.016*** (0.006)	−0.001 (0.006)	−0.026*** (0.009)	−0.023* (0.013)
has local currency loan	0.005 (0.008)	0.011* (0.007)	−0.003 (0.005)	−0.001 (0.003)	−0.012 (0.009)	−0.001 (0.009)
has foreign currency loan	−0.004 (0.010)	−0.009 (0.007)	0.011 (0.007)	0.007 (0.005)	0.009 (0.011)	−0.013 (0.011)
receives remittances	−0.01 (0.014)	0.009 (0.006)	0.007 (0.006)	0.009** (0.004)	0.001 (0.016)	−0.016* (0.009)
regular income in euro	0.004 (0.014)	0.016 (0.011)	0.004 (0.008)	−0.005 (0.006)	−0.006 (0.014)	−0.013 (0.020)
EU member state (0/1)	−0.044 (0.029)	0.316*** (0.070)	−0.079*** (0.011)	−0.044*** (0.016)	−0.241*** (0.029)	0.092* (0.055)
N	32,571	32,571	32,571	32,571	32,571	32,571
Log-L	−45,781	−45,781	−45,781	−45,781	−45,781	−45,781
country and wave fixed effects	Yes	Yes	Yes	Yes	Yes	Yes
sociodemographic control variables	Yes	Yes	Yes	Yes	Yes	Yes

Source: OeNB Euro Survey (2014–2019). Authors' calculations.

Note: Multinomial logit results, average marginal effects reported. Further sociodemographic controls are included but not reported. Standard errors, in parentheses, are clustered at the country-wave level. The Wald test for combining dependent categories is significant for all outcomes of the dependent variable at the 1% level.

Table A4

### Robustness analysis: How significant are monetary expectations and trust in institutions for expectations?

Dependent variable outcome category	Respondents expect euro introduction...					
	Before theoretically possible	Within 10 years	Within 20 years	In more than 20 years	Never	Don't know
LC future stable	0.001 (0.008)	0.018*** (0.007)	0.013** (0.005)	−0.001 (0.003)	−0.01 (0.010)	−0.020*** (0.007)
EUR future stable	0.029*** (0.009)	0.022*** (0.007)	−0.007 (0.005)	−0.004 (0.004)	−0.050*** (0.010)	0.01 (0.009)
trust in central bank	0.037*** (0.010)	0.024*** (0.008)	−0.001 (0.006)	−0.010*** (0.003)	−0.040*** (0.009)	−0.01 (0.010)
trust in EU	0.049*** (0.010)	0.028*** (0.006)	0.001 (0.005)	−0.004 (0.004)	−0.076*** (0.009)	0.001 (0.008)
expect depreciation	0.022** (0.008)	−0.005 (0.006)	−0.006 (0.005)	−0.001 (0.003)	0.009 (0.009)	−0.018** (0.009)
expect inflation	−0.022* (0.013)	−0.006 (0.005)	0.009* (0.005)	0.009*** (0.003)	0.018* (0.010)	−0.006 (0.008)
EU member state (0/1)	−0.070** (0.029)	0.331*** (0.069)	−0.072*** (0.012)	−0.045*** (0.015)	−0.238*** (0.028)	0.095 (0.058)
N	29,010	29,010	29,010	29,010	29,010	29,010
Log-L	−40,786	−40,786	−40,786	−40,786	−40,786	−40,786
country and wave fixed effects	Yes	Yes	Yes	Yes	Yes	Yes
sociodemographic control variables	Yes	Yes	Yes	Yes	Yes	Yes

Source: OeNB Euro Survey (2014–2019). Authors' calculation.

Note: Multinomial logit results, average marginal effects reported. Further sociodemographic controls are included but not reported. Standard errors, in parentheses, are clustered at the country-wave level. The Wald test for combining dependent categories is significant for all outcomes of the dependent variable at the 1% level.

# Macroprudential policy in the Western Balkans: the last five years and COVID-19 crisis response<sup>1</sup>

Stephan Barisitz, Antje Hildebrandt<sup>2</sup>

*This study takes stock of macroprudential policy instruments and their recent development (since 2015) in Western Balkan<sup>3</sup> economies. Banks in the region, which are dominated by institutions headquartered in the EU, tend to be in good shape, profitable and well capitalized. All countries under review are oriented toward EU macroprudential policies, given that they strive to join the European Union. However, the pace at which the required policy frameworks are being put into place differs across countries. Preparatory work for the creation of large parts or entire macroprudential and prudential toolkits is still ongoing in Kosovo and Montenegro, while Serbia and North Macedonia have already accumulated some experience in using related instruments (including capital buffers, reserve requirements, risk weights, etc.). Albania and Bosnia and Herzegovina are situated somewhere in between these two groups of economies in terms of the range and the timing of measures put in place. The biggest remaining challenges include elevated growth rates of partly unsecured consumer loans, and still high shares of foreign currency loans in total loans – notwithstanding de-euroization measures. The COVID-19 crisis triggered the immediate relaxation of some macroprudential measures and regulatory standards. Yet, the bulk of COVID-19 response steps is situated outside the macroprudential realm and includes moratoria on loan repayments, adjustments in loan classification and provisioning rules, which in turn, may (temporarily) undermine the economic substance of capital buffers.*

JEL classification: F34, F36, G21, G28

Keywords: banking sector, financial stability, macroprudential policy, Western Balkans

This study constitutes a stocktaking exercise addressing macroprudential instruments and toolkits in a European region that unfortunately often tends to receive less attention: the Western Balkans (Albania, Bosnia and Herzegovina, Kosovo, Montenegro, North Macedonia, Serbia). As far as the authors are aware, no such comparative inventory of regulatory measures aimed at safeguarding financial stability, countering systemic risks and enhancing financial system resilience<sup>4</sup> has been done in recent years for this region. Our chosen delimitation of macroprudential

<sup>1</sup> Cutoff date for data: September 15, 2020.

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<sup>3</sup> The Western Balkan economies comprise: Albania, Bosnia and Herzegovina, Kosovo (this designation is without prejudice to positions on the status of this territory and is in line with UNSCR 1244/1999 and the ICJ Opinion on the Kosovo declaration of independence), Montenegro, North Macedonia and Serbia.

<sup>4</sup> For more detailed indications of aims of macroprudential policies, see International Monetary Fund (2014, pp. 4–5).

instruments largely corresponds to the compilation established in chart 1 of Eller et al. (2020, p. 67).<sup>5</sup>

A brief snapshot of financial sectors in the Western Balkans (section 1) leads to the core of the study, a detailed comparative table of macroprudential policy tool-kits (including information on legal bases, goals, institutions and actual implementation of measures). The table provides country-by-country information for the period from 2015 leading up to the recent COVID-19 crisis period (which started in March 2020 for the countries under review). Information provided is discussed in sections 2 (2015 to early 2020) and 3 (coronavirus response). Section 4 wraps up and summarizes the article and provides some conclusions.

## 1 The financial sectors of the Western Balkans – a snapshot

The financial sectors of the Western Balkan<sup>6</sup> countries are primarily bank based while nonbank financial institutions only play a minor role. The banking landscape is dominated by foreign-owned banks mainly headquartered in the EU. As of June 2020, the number of banks ranged between 10 in Kosovo and 26 in Serbia. The concentration of banks is higher in Albania, Kosovo and North Macedonia, with around 60% of assets being held by the three biggest banks; in the larger Western Balkan countries, around 40% of assets are held by the three largest banks.<sup>7</sup>

The overall situation of the banking sectors in the region is assessed to be good (also refer to footnote 6). Banks generally are in a good shape, profitable and well capitalized. The capitalization of banks (tier 1 ratio) surpasses regulatory requirements by far. The banking sectors in the Western Balkans are overall profitable (see table 1). Furthermore, the liquidity of banking sectors is high and loan-to-deposit ratios have remained well below 100% in most countries.

Financial intermediation in the Western Balkan economies is rather moderate, with ratios of private sector credit to GDP ranging between around 34% in Albania and 50% in Montenegro. Generally, financial intermediation has not changed significantly since 2015 and has, on average, not expanded more strongly than GDP. Overall, from 2015 to the first quarter of 2020, growth of credit to the private sector (households and nonfinancial corporations) was strongest in Kosovo with annual average growth rates of around 10%. It was weakest in Albania (around 1%), where credit initially slumped and only recovered in 2019. In all countries under review, credit to households recorded higher growth rates from 2015 in the light of better income prospects and more favorable lending conditions. It is noteworthy that lending to households for nonhousing purposes – so-called consumer loans – has become a key driver of credit dynamics in many Western Balkan economies, particularly in Montenegro and Serbia. These nonhousing-purpose loans

<sup>5</sup> Thus, without pretense to exhaustiveness, we consider as (macro)prudential measures (if adopted): (1) Capital-based measures (minimum capital requirements, risk weights for banks' exposures, countercyclical capital buffer, capital conservation buffer, systemic risk buffer, capital buffer for systemically important banks, leverage ratio, other systemically important institutions (O-SII) buffer), (2) borrower-based measures (limits on loan-to-value, debt service-to-income and debt-to-income ratios; foreign currency lending bans, mandatory write-offs of fully provisioned/long-term impaired exposures), (3) liquidity-based measures (minimum reserve requirements, liquidity requirements, loan-to-deposit limits, single client exposure limits, sectoral and market segment exposure limits, intragroup exposure limits, foreign currency exposure limits, foreign currency mismatch limits).

<sup>6</sup> For a detailed overview of the banking sectors in the Western Balkans, see Comunale et al. (2019).

<sup>7</sup> According to latest data provided by S&P Global Market Intelligence. For Kosovo, we use data published by the central bank of Kosovo: [https://bqk-kos.org/repository/docs/2018/Final\\_Financial%20System\\_April%202020.pdf](https://bqk-kos.org/repository/docs/2018/Final_Financial%20System_April%202020.pdf)



Table 1

## Banking sector indicators

	2015	2016	2017	2018	2019	Q1 20	Q2 20
<b>Tier 1 capital ratio</b>	%						
Albania	13.5	13.8	15.1	17.0	17.1	17.9	17.0
Bosnia and Herzegovina	13.8	15.0	14.8	16.5	17.5	16.7	17.3
Kosovo	19.0	17.9	18.0	17.0	15.9	15.1	16.7
Montenegro	14.2	14.7	15.0	14.4	18.1	17.4	19.6
North Macedonia	13.9	13.9	14.2	15.0	14.8	15.0	15.5
Serbia	18.8	20.0	21.6	21.1	22.4	21.9	21.8
<b>Return on equity</b>	% of average equity						
Albania	13.2	7.2	15.7	12.4	13.3	3.5	9.1
Bosnia and Herzegovina	0.9	6.2	9.0	8.5	9.1	9.4	7.1
Kosovo	26.8	18.6	19.0	18.2	16.9	16.3	14.5
Montenegro	-0.7	1.5	7.0	5.3	9.0	8.9	5.3
North Macedonia	10.4	13.3	13.3	15.7	11.4	7.5	8.6
Serbia	1.2	2.9	9.8	10.5	9.3	10.5	8.4
<b>Bank loans to the domestic nonbank private sector</b>	%, as a share of GDP						
Albania	38.1	37.1	35.4	32.5	34.0	35.8	35.4
Bosnia and Herzegovina	52.8	52.3	54.0	54.2	55.1	53.8	53.6
Kosovo	34.8	36.7	38.7	41.0	42.8	43.5	44.1
Montenegro	50.6	49.4	48.8	49.3	50.1	51.0	..
North Macedonia	50.8	47.8	48.5	48.8	48.9	49.0	51.8
Serbia	45.1	44.1	42.9	44.1	45.0	45.5	48.0
<b>Bank loans to the domestic nonbank private sector</b>	Annual change in %						
Albania <sup>1</sup>	-4.0	1.0	2.1	1.3	4.6	6.2	4.9
Bosnia and Herzegovina <sup>1</sup>	1.0	2.8	6.5	6.6	6.0	3.6	0.4
Kosovo	7.3	10.4	11.5	10.9	10.0	9.2	6.4
Montenegro	2.4	5.7	7.5	9.6	6.8	5.6	7.1
North Macedonia <sup>1</sup>	5.8	3.6	3.8	7.4	6.2	4.6	5.7
Serbia <sup>1</sup>	-2.3	3.0	4.9	7.8	8.1	9.6	12.4
<b>Foreign currency loans to the private sectors</b>	% of total loans						
Albania <sup>1</sup>	52.2	47.9	47.2	47.9	45.9	45.8	46.0
Bosnia and Herzegovina <sup>1</sup>	71.0	64.5	62.9	59.0	52.6	52.2	52.2
Kosovo	0.3	0.2	0.2	0.2	0.1	0.1	0.1
Montenegro	..	..	..	..	..	..	..
North Macedonia <sup>1</sup>	43.5	40.5	39.5	37.8	38.4	38.0	38.1
Serbia <sup>1</sup>	60.6	59.7	59.8	59.5	59.1	59.0	58.3
<b>NPL ratio</b>	% of total loans						
Albania	18.2	18.3	13.2	11.1	8.4	8.2	8.1
Bosnia and Herzegovina	13.7	11.8	10.0	8.8	7.4	6.6	6.7
Kosovo	6.2	4.9	3.1	2.7	2.0	2.5	2.6
Montenegro	12.6	10.3	7.3	6.7	4.7	5.1	5.3
North Macedonia	10.8	6.6	6.3	5.2	4.8	5.0	4.7
Serbia	21.6	17.0	9.8	5.7	4.1	4.0	3.7

Source: National central banks, OeNB calculations, statistical offices.

<sup>1</sup> Foreign currency component at constant exchange rates.

are often relatively large, long term and uncollateralized.<sup>8</sup> Due to heightened uncertainty and income losses, the annual growth of loans to the private sector, as is to be expected, has decelerated in most economies of the region since the start of the COVID-19 crisis, particularly in Bosnia and Herzegovina as well as in Kosovo. By contrast, Serbia has registered stronger credit growth, especially to corporates.

<sup>8</sup> For details see: Box 2: Western Balkans: strong domestic demand fuels economic growth. In: Focus on European Economic Integration Q2/19. OeNB. 18–23.

Credit quality clearly improved in all Western Balkan economies during the second half of the 2010s. In 2015, Albania and Serbia had reported nonperforming loan (NPL) ratios close to 20%; the best performers, Kosovo and North Macedonia, had recorded around 6% to 8%. At the end of the first quarter of 2020, NPL ratios stood between 2.5% in Kosovo and 8.2% in Albania.

A special feature of those Western Balkan economies that are not unilaterally euroized<sup>9</sup> is the high degree of de facto euroization. Despite some decline, the share of foreign currency lending to the private sector is still at elevated levels. At the end of the first quarter of 2020, Serbia featured the highest share of foreign currency lending to the private sector, with 66% of total lending. The ratio of private sector foreign currency loans to private sector foreign currency deposits was below 100% in all countries of the region save Bosnia and Herzegovina, and even below 50% in Albania, North Macedonia and Serbia.

## 2 Stocktaking of macroprudential policies before COVID-19

The global financial crisis of 2008–2009 was the starting point for launching macroprudential policy strategies. In the Western Balkans, Serbia can be seen as a pioneer in implementing a macroprudential framework in reaction to the boom-bust cycle that preceded the global financial crisis<sup>10</sup>, especially considering that a supranational macroprudential framework was not established until the year 2011 (European Systemic Risk Board, 2011). Also, North Macedonia applied macroprudential policies relatively early on.<sup>11</sup> In the Western Balkans, determining factors have been Basel III<sup>12</sup> as well as EU policies. The latter are especially important for two reasons: the progressive integration of financial markets of Western Balkan countries into the European system against the background of these countries' aspirations to join the EU in the future, as well as the importance of EU-headquartered banks in the region.

As table 2 shows, the Western Balkan central banks and policymakers have shown different speeds in creating and refining toolkits of macroprudential instruments and preparing them for implementation in recent years.<sup>13</sup> Indeed, preparatory work is still ongoing with respect to large parts or entire toolkits in three countries (Albania, Kosovo and Montenegro). The sudden onset of the COVID-19 crisis has further extended the maturing phase of toolkits prior to their effective application (see section 3). As can be expected, the institutional framework is dominated by national central banks that have the mandate to conduct macroprudential policies. In the case of Bosnia and Herzegovina, the banking agencies of the two entities are in charge of applying most available instruments. The official goals

<sup>9</sup> The euro is used as the legal tender in Kosovo and Montenegro.

<sup>10</sup> During the boom years (pre-2008), Serbia introduced a variety of measures to curb lending and particularly foreign currency lending; during the ensuing bust, several measures were loosened (for more details see Dimova et al., 2016).

<sup>11</sup> For instance, for an overview of macroprudential measures implemented from 2004 to 2010 by the National Bank of the Republic of North Macedonia refer to Celeska et al. (2011).

<sup>12</sup> Basel III constitutes a global regulatory framework for more resilient banks and banking systems (Bank for International Settlements, 2011).

<sup>13</sup> In the table, measures are taken into account insofar as they are mentioned in the respective national central banks' financial stability reports and/or in IMF staff reports, financial system stability assessments or program monitoring reports from 2015. This implies that all measures cited in the above sources and valid in or from 2015 are included in the table, even if some of these measures were adopted before that year.

of macroprudential policies pertain to general aims (mitigation of systemic risks), on the one hand, and to de-euroization objectives (alleviation of foreign exchange risks in countries that are not officially euroized or administered by a currency board), on the other. Intermediate objectives often include preventing excessive credit growth, excessive leverage, maturity mismatches and illiquidity, supporting credit growth and promoting use of the local currency.

Looking at the various instruments actually used, one can argue that only Serbia and North Macedonia have accumulated some years of experience in applying a variety of measures. To a clearly minor degree, this applies to Albania as well as to Bosnia and Herzegovina. At the same time, there appears to be some reticence in activating capital buffers, typically a core element of the macroprudential toolkit: Albania had scheduled to implement its capital buffers only in March 2020; while their formal coming into force was not deferred due to the coronavirus crisis, the buffers' planned ratios were immediately set at zero and thus do not have any economic impact for the time being (see table 2); Montenegro is still taking preparatory steps for implementing its capital buffers; Bosnia and Herzegovina has only introduced the capital conservation buffer and is still considering the introduction of other buffers; Kosovo for the moment is not planning the introduction of any capital buffers. Again, only Serbia and North Macedonia have gathered some experience in using capital buffers (both from 2017).

Given that many of these measures have only been applied for a comparatively short time (if at all) in the Western Balkans, it would seem too early to try to econometrically establish a track record of their effectiveness.<sup>14</sup> In any case, since their inception and until the COVID-19 crisis, most measures have not been decisively altered. At least at first sight (without any econometric analysis, which is not the object of this study), the measures appear to have been successful. Previously high credit growth slowed down on average and even fell below GDP growth in 2015 to 2019, although notably in Serbia, Montenegro and Kosovo expansion rates of household loans, and here, particularly general purpose consumer loans as well as real estate loans, have continued to raise concern and merit close monitoring.<sup>15</sup> Credit quality has increased across the board, even if NPLs still remain rather elevated in Albania and Bosnia and Herzegovina. Perhaps most problematic, shares of foreign currency loans in total loans, while slightly declining, continue to be at relatively high double digits – notwithstanding de-euroization strategies<sup>16</sup> (see also related assessments in European Commission, 2019).

<sup>14</sup> Accordingly, to the best of our knowledge, authorities in the Western Balkans do not yet have at their disposal econometric impact analyses of macroprudential instruments, but only the information that the situation in the banking sectors has largely improved since the very recent introduction of macroprudential tools (where they were introduced) at least until early 2020.

<sup>15</sup> In reaction, Serbia raised capital requirements regarding general purpose consumer loans in 2019 (as shown in table 2). In contrast, Montenegro and Kosovo – for lack of readily available toolkits – have not yet taken macroprudential action in this respect.

<sup>16</sup> Thus, Serbia remains committed to its dinarization strategy, North Macedonia continues to differentiate reserve requirement rates between dinar and foreign currency deposits, and Albania resorted to various measures in 2018 to strengthen use of the lek (for more details see table 2).

Table 2

## Macroprudential policy in the Western Balkans<sup>1</sup>

### Albania

Legal and regulatory basis	Objectives and involved institutions	Instruments	Actual application
<p>2015: Regulatory framework of the Bank of Albania (BoA) "On the capital adequacy ratio"</p> <p>2017: "Macro-prudential Policy Strategy" (approved on August 2 by BoA Supervisory Council, decision no. 38)</p> <p>March 2019: "On the Liquidity Coverage Ratio" (regulation no. 27)</p> <p>June 2019: "On macro-prudential capital buffers" (adopted on 5 June by BoA Supervisory Council, regulation no. 41); followed by decision no. 3368 issued by the Governor of the BoA on June 28, 2019: "On determining macro-prudential capital buffers"</p> <p>September 2019: "On determination of countercyclical capital buffer" (decision no. 4913, September 30, 2019); December 2019: "On determination of countercyclical capital buffer" (decision no. 6476, December 24, 2019)</p> <p>March 2020: "For the determination of the macroprudential capital buffers and of the systemically important banks" (decision no. 1714, issued March 25, 2020)</p> <p>June 2020: "On determination of countercyclical capital buffer" (decision no. 3044, June 30, 2020)</p>	<p>2015: assessment, prevention and mitigation of systemic risk (that threatens financial stability): shielding the rest of the system from negative consequences in case of failure of systemically important bank, strengthening the financial system's capacities to avoid or cope with these risks with as little loss as possible</p> <p>De-euroization: reducing exposure of financial system to unfavorable developments in the exchange rate and to stress situations of FX liquidity</p> <p>2017: ultimate objective: preventing systemic risks and strengthening resilience of the financial system in order to safeguard financial stability</p> <p>Intermediate objectives: mitigating and preventing excessive credit growth and leverage, excessive maturity mismatch and market illiquidity; limiting direct and indirect exposure concentrations; limiting excessive risk-taking by systemically important financial institutions</p> <p>Institutions: BoA (Financial Stability Department, Financial Stability Advisory Committee, Governor (deciding authority), Supervisory Council)</p> <p>De-euroization: cooperation: BoA, Ministry of Finance and Economy, Financial Supervision Authority</p>	<p>2013/2015: minimum capitalization levels, countercyclical requirements; stress tests (aimed at improving the banking sector's ability to cope with losses resulting from the materialization of adverse, but possible, events in the real and financial sector)</p> <p>2017/2019: <b>capital buffers</b> (originally planned to be implemented in phases from end-March 2020 to end-December 2023, but due to COVID-19 crisis initial application with 0% ratios and with zero economic impact; increase of ratios deferred for a year: buffers will comprise common equity tier 1 (CET1) capital: capital conservation buffer (CCoB): 0.5% to 2.5% of risk-weighted exposures; countercyclical capital buffer (CCyB): 0% to 2.5% of risk-weighted exposures; systemic risk buffer (SyRB): 1% to 3% of risk-weighted exposures; capital buffer for systemically important banks: at least 0.5%</p>	<p>Stress tests carried out quarterly (top-down) and annually (bottom-up) for capitalization as well as annually for liquidity risks</p> <p>2013: countercyclical requirements for bank capital for investments in nonresident financial institutions (but no longer in force since beginning of 2019)</p> <p>2015: minimum capitalization levels, capital requirements for market and operational risk</p> <p>March 2017: Countercyclical requirements (of May 2013) refined in that higher capital is required for extent of change regarding placements with nonresidents, while base period of comparison is adjusted based on a two-year rolling period (but no longer in force since beginning of 2019)</p> <p>February 2018: measures taken to strengthen use of lek in banking activity: (1) change in reserve requirement rates for Albanian lek as well as for FX, (2) higher minimum requirement of ratio of liquid assets to short-term liabilities in FX, (3) banks requested to carry out moral suasion measures among potential unhedged FX borrowers</p> <p>Liquidity coverage ratio (LCR): On a solo basis, banks have to comply with the minimum level of LCR starting from March 1, 2020; on a consolidated basis, from January 1, 2022</p> <p><b>Exceptional measures due to the COVID-19 crisis:</b></p> <ul style="list-style-type: none"> <li>– Loan repayment moratorium: relaxation of requirements for loan classification and provisioning to allow banks to defer loan installments of households and corporates without penalties (expired), extended to three important sectors: tourism (until end-2020), clothing and manufacturing sector (until autumn)</li> <li>– Making it possible for banks to restructure current loans considering the solvency of borrowers without additional costs and without downgrading the status of borrowers (until end-2020)</li> <li>– Suspension of dividend distribution for banks until end-2020</li> <li>– Suspension of the creation of reserve funds for real estate obtained versus the payment of loans until end of 2020</li> </ul>

Source: National central banks, IMF.

<sup>1</sup> The list is not exhaustive.

Table 2.1

## Macroprudential policy in the Western Balkans<sup>1</sup>

### Bosnia and Herzegovina

Legal and regulatory basis	Objectives and involved institutions	Instruments	Actual application
<p>Law on the Central Bank of Bosnia and Herzegovina (CBBH) (Official Gazette of Bosnia and Herzegovina (FBIH), no. 1/1997)</p> <p>2014: Banking Agency of the FBIH (FBA): "Decision of Minimum Standards for Capital Management" in Banks and Capital Hedge" (Official Gazette of FBIH, no. 48/14)</p> <p>2014: Banking Agency of Republika Srpska: "Decision of Minimum Standards for Capital Management in Banks and Capital Hedge" (Official Gazette of Republika Srpska, no. 57/14)</p> <p>2017: Law on Banks of FBIH (Official Gazette of FBIH, no. 27/17)</p> <p>2017–2019: Law on Banks of Republika Srpska (Official Gazette of Republika Srpska, no. 41/17, 19/18 and 54/19)</p> <p>Decision on calculation of capital in banks, Official Gazette of FBIH, no. 81/17 and Decision on calculation of capital in banks, Official Gazette of Republika Srpska, no. 74/17</p> <p>Decision on Liquidity Risk management, Official Gazette of FBIH, no. 81/17 and Decision on Liquidity Risk management, Official Gazette of Republika Srpska, no. 04/18</p>	<p>CBBH: monitoring systemic risks and actively cooperating with all institutional stakeholders</p> <p>CBBH: active role in maintaining financial stability through coordinating the activities of the two entities' banking agencies; cooperating with relevant international and domestic institutions to ensure continuity of systemic risk monitoring. CBBH contributes to the preservation of financial stability within its membership in the Standing Committee for Financial Stability of Bosnia and Herzegovina</p> <p>2014: FBA: strengthening the resilience of banks in the face of potentially severe crisis situations</p> <p>2014: Banking Agency of Republika Srpska: strengthening the resilience of banks in the face of potentially severe crisis situations</p> <p><b>Institutions:</b> mandate for macroprudential policy not explicitly delegated to any specific institution; CBBH, banking agencies of the two entities</p>	<p>CBBH: minimum reserve requirements, systemic liquidity management</p> <p>FBA: end-2015: capital leverage ratio, end-2016: capital conservation buffer</p> <p>Banking Agency of Republika Srpska: end-2015: capital leverage ratio, end-2016: capital conservation buffer</p> <p>From 2017: FBA, Banking Agency of Republika Srpska (see actual application)</p> <p>Agencies are considering introduction of countercyclical capital buffer and systemic risk buffer</p>	<p>CBBH: recently (up to 2020): minimum required reserve ratio: 10%</p> <p>FBA, Banking Agency of Republika Srpska: from January 2017 (in both entities): minimum CET1 ratio: 6.75%, minimum CET1 ratio: 9%, minimum total regulatory capital ratio: 12%, capital conservation buffer: 2.5% of total amount of risk-weighted exposure, minimum leverage ratio: 6%, minimum liquidity coverage ratio: 100%, limits on net open FX exposures for EUR: 30% of capital, for all other currencies: 20%, and for total FX position: 30%</p> <p>FBA introduces liquidity coverage ratio (LCR) from Q2 2018, and Banking Agency of Republika Srpska from Q2 2019</p> <p><b>Exceptional measures due to the COVID-19 crisis:</b></p> <ul style="list-style-type: none"> <li>– 2020: During the state of "natural or other disaster in the territory of Bosnia and Herzegovina" banks are allowed to use the capital conservation buffer if they retained earnings from 2019 and postponed the payout of dividends and bonuses</li> <li>– Banking Agencies instructed banks to support customers in case of repayment difficulties, e.g. by offering a loan moratorium of a maximum of six months and the revision of fees; extended until end-2020; a one-year moratorium on loans for hotel investments was agreed between the Federal Ministry for Environment and Tourism and the FBA</li> <li>– Approval of an additional exposure amount for overcoming client liquidity problems</li> <li>– Relaxation of loan settlement requirements for customers; extension of regulatory forbearance measures, in combination with easing of reclassification and provisioning</li> </ul>

Source: National central banks, IMF.

<sup>1</sup> The list is not exhaustive.

Table 2.2

## Macroprudential policy in the Western Balkans<sup>1</sup>

### Kosovo

#### Legal and regulatory basis

2016: Executive Board of the Central Bank of the Republic of Kosovo adopts "Macroprudential Policy" (August 10)

Objectives and involved institutions	Instruments	Actual application
<p>Helping safeguard the stability of the Kosovo financial system by strengthening the latter's resilience and decreasing the buildup of systemic risk</p> <p>Intermediate objectives:</p> <ul style="list-style-type: none"> <li>–Mitigating and preventing excessive credit growth and leverage as well as excessive maturity mismatch and illiquidity</li> <li>–Limiting direct and indirect exposure concentrations as well as systemic impact of misaligned incentives aimed at reducing moral hazard</li> <li>–Strengthening the resilience of financial infrastructures</li> </ul> <p><b>Institutions:</b> Executive Board of the Central Bank of the Republic of Kosovo, supported by Macroprudential Advisory Committee</p>	<ul style="list-style-type: none"> <li>–To mitigate and prevent excessive credit growth: reserve requirements, aggregate lending limits, lending limits on specific sectors, leverage ratio, countercyclical capital requirements, capital adequacy ratio, loan-to-value ratio, loan-to-borrower's income ratios, loan-to-deposit cap</li> <li>–To counter maturity mismatch: maturity mismatch limits</li> <li>–To counter illiquidity: reserve requirements, liquidity ratios, emergency liquidity facility</li> <li>–To limit exposure concentrations: large exposure restrictions, related party lending limits, large exposure limits on funding, FX exposure limits</li> <li>–To limit systemic impact of misaligned incentives: limits on dividend payments, limits on remuneration levels and systems, SIFI capital surcharge</li> <li>–To strengthen resilience of financial infrastructures: increased disclosure, limits on external funding, limits on wholesale market funding</li> </ul>	<p>Continuation of work for operationalizing macroprudential policy and instruments</p> <p><b>Exceptional measures due to the COVID-19 crisis:</b></p> <ul style="list-style-type: none"> <li>–Loan repayment moratorium for corporates and households, expired; extension of the deadline for the submission of applications for loan restructuring until September 30, 2020</li> <li>–Revision of requests for the suspension of credit repayments and the freezing of individual credit ratings</li> </ul>

Source: National central banks, IMF.

<sup>1</sup> The list is not exhaustive.



Table 2.3

## Macroprudential policy in the Western Balkans<sup>1</sup>

### Montenegro

Legal and regulatory basis	Objectives and involved institutions	Instruments	Actual application
Law on Credit Institutions (Official Gazette of Montenegro, no. 72/2019) – planned implementation from January 1, 2021	Preventing financial crisis of systemic proportions, combating credit risks, liquidity risks and other sector risks <b>Institution:</b> Central Bank of Montenegro	Large exposure limits (liquidity-based measure, see actual application) <b>Capital buffers</b> (comprising CET1 capital): capital conservation buffer: 2.5% of total risk exposure, countercyclical capital buffer: 0% to 2.5% of total risk exposure, structural systemic risk buffer: at least 1% of exposure, G-SII buffer: 1% to 3.5% of total risk exposure, O-SII buffer: up to 2% of total risk exposure	<b>Large exposure limits:</b> exposure to one person or group of connected persons may not exceed 25% of CET1 capital Application of capital buffers planned from January 1, 2021 <b>Exceptional measures due to the COVID-19 crisis:</b> –Permission to increase exposures to a person or group of related parties beyond the prescribed exposure limits (25% of the bank's own funds) without prior central bank approval –Reduction of the fee that banks have to pay for withdrawing reserve requirement liquidity and of the mandatory reserve requirement for deposits with a maturity of up to one year from 7.5% to 5.5% and for deposits with a maturity of more than one year from 6.5% to 4.5% –Banks may treat the restructured loan as a newly approved loan, provided that the loan beneficiary documents to the bank that financial position has or will deteriorate in the near future due to the adverse impact of COVID-19 on its operations and that the bank estimates that the loan beneficiary's creditworthiness will improve upon restructuring –Banks can restructure and classify loans under certain conditions –Loan repayment moratorium for households and corporates up to 90 days, expired; new moratorium for up to 90 days to creditors whose financial situation was negatively affected by the COVID-19 crisis; moratorium on loan repayment from priority sectors (tourism) from September 1, 2020, to August 31, 2021 –Temporary prohibition for banks of paying dividends to shareholders, except in the form of bank shares

Source: National central banks, IMF.

<sup>1</sup> The list is not exhaustive.

Table 2.4

## Macroprudential policy in the Western Balkans<sup>1</sup>

### North Macedonia

Legal and regulatory basis	Objectives and involved institutions	Instruments	Actual application
<p>Absence of explicit macroprudential legal framework</p> <p>Amendments to Banking Law from October 2016 (Official Gazette of the Republic of Macedonia 190/16)</p>	<p>Curbing financial vulnerabilities, containing buildup of systemic risk over time, and adjusting the resilience of the banking sector; and, more generally, preventing and reducing risks that affect financial stability</p> <p><b>De-euroization</b> in order to rein in currency risk</p> <p><b>Institutions:</b> National Bank of Republic of North Macedonia (NBRNM); de facto assumption of role of macroprudential authority), assisted by Financial Stability Unit (within NBRNM Financial Stability, Banking Regulations and Bank Resolution Department)</p> <p>Moreover, signing of MoU in Q1/2020 constituting the Financial Stability Committee (comprising all regulatory and supervisory authorities of the republic including the NBRNM), the Ministry of Finance, the Agency for Insurance Supervision and others) to serve as principal domestic coordination body for macroprudential policy and crisis management, by i.a. monitoring systemic risks and recommending macroprudential measures</p>	<p>Risk weights (with respect to capital requirements) for banks' exposures</p> <p>Mandatory write-offs of credit exposures that are fully provisioned/impaired</p> <p>From 2016: capital conservation buffer, capital buffer for systemically important banks, countercyclical capital buffer, systemic risk buffer; reserve requirements (for de-euroization, differentiated)</p>	<p>2015: <b>increase of risk weights</b> to curb excessive credit growth in various types of exposures (e.g. consumer loans)</p> <p><b>Mandatory write-offs</b> of credit exposures fully provisioned/impaired for two years (since July 2019; for one year) Extension (from 2013) until end-2017 of nonstandard <b>reduction of reserve requirement</b> base for banks for amount of newly approved loans to net exporters and domestic producers of electricity</p> <p>From March 2017: <b>capital conservation buffer</b>: 2.5% of risk-weighted assets (minimum)</p> <p>From March 2018: <b>banks identified as systemically important</b> as of April 2017 are required to fulfill adequate level of respective <b>capital buffers</b> (ranging from 1% to 2.5%)</p> <p><b>Reserve requirements:</b> differentiation of rates on denar and FX deposits, from 2016 increase on FX-linked deposits</p> <p><b>Exceptional measures due to the COVID-19 crisis:</b></p> <ul style="list-style-type: none"> <li>–Banks are not allowed to implement higher risk weights for consumer loans with maturities that were prolonged in the period from March to September 2020, which resulted in contractual maturity of more than 8 years</li> <li>–Postponement of the deadline for submitting ILAAP (internal liquidity adequacy assessment process) forms (from May 30 to September 20, 2020)</li> <li>–Banks can initiate changes in loans' contractual terms without client request, which clients can accept/decline within 10 days; extended: banks can allow a second period of deferred payment of loan liabilities (with clearly defined criteria by banks for approval of a second period of deferred payment up to six months; in addition, in the period from March to September 2020, banks' clients can also request changes in their loans' contractual terms (only for loans with performing status before the pandemic), without considering such change as restructuring (forbearance)</li> <li>–Relaxation of classification of nonperforming loans, but only until September 2020. Banks will be required to comply with the rules existing prior to March 2020 in terms of identification of NPLs and their adequate provisioning no later than December 2020.</li> </ul>

Source: National central banks, IMF.

<sup>1</sup> The list is not exhaustive.

Table 2.5

## Macroprudential policy in the Western Balkans<sup>1</sup>

### Serbia

Legal and regulatory basis	Objectives and involved institutions	Instruments	Actual application
<p>2010: assignment of legal mandate for macroprudential policy to the National Bank of Serbia (NBS); Article 4, Item 3 of the Law on the National Bank of Serbia (RS Official Gazette, nos. 72/2003, 55/2004, 85/2005, 44/2010, 76/2012, 106/2012, 14/2015, 40/2015, 44/2018); 2011/17: NBS Decision on measures for safeguarding and strengthening stability of the financial system</p> <p>March 2015: adoption of Macroprudential Framework by NBS</p> <p>December 2016: adoption of secondary legislation on capital adequacy, liquidity risk management, reporting requirements and other items applicable as of June 30, 2017</p>	<p>Reducing financial system vulnerability and increasing resilience to financial and economic shocks; mitigating cyclical as well as structural dimensions of systemic risk</p> <p><b>Dinarization strategy:</b> limiting euroization risk and promoting the use of domestic currency</p> <p>Intermediate macroprudential objectives:</p> <ul style="list-style-type: none"> <li>–Mitigating and preventing excessive credit growth and leverage</li> <li>–Preventing excessive maturity mismatch between funding sources and placements of financial institutions</li> <li>–Limiting systemic impact of misaligned incentives in terms of favoring certain financial institutions, strengthening resilience of financial infrastructure</li> </ul> <p><b>Institution:</b> NBS</p>	<p>Stress tests to assess sector solvency risks (related to excessive credit expansion) and liquidity risks (related to rapid outflow of deposits) in case of unfavorable macro-economic conditions or loss of depositor confidence</p> <p>Increase of capital requirements: see actual application</p> <p>Dinarization: see actual application</p> <ul style="list-style-type: none"> <li>–To counter excessive credit growth and leverage: countercyclical capital buffer, sectoral capital buffer, limit on leverage ratio, loan-to-value limit (mortgage), loan-to-income limit</li> <li>–To counter excessive maturity mismatch: liquidity coverage ratio, net stable funding ratio, loan-to-deposit ratio</li> <li>–To check exposure concentrations: cap on exposure to particular sector or asset class</li> <li>–To limit systemic impact of misaligned incentives: capital buffer for systemically important financial institutions</li> <li>–To strengthen resilience of financial infrastructure: systemic risk buffer</li> </ul>	<p><b>Stress tests</b> (solvency and liquidity) carried out quarterly</p> <ul style="list-style-type: none"> <li>–Dinarization measures: <b>80% loan-to-value limit</b> (for FX or FX-indexed housing loans); permission of banks to provide FX or FX-indexed loans to natural persons subject to a down-payment or placement of deposit of no less than 30% of the loan amount (no such restriction for euro-indexed loans); loosening through reduction of reserve requirements on FX deposits</li> <li>–From mid-2017: capital buffers: <b>capital conservation buffer</b> (2.5% of risk-weighted assets), countercyclical capital buffer (0%), systemic risk buffer (3% of FX and FX-indexed domestic bank exposures), <b>capital buffer for a systemically important bank</b> (1% to 2% of risk-weighted assets)</li> <li>–January 2019: increase of capital requirements regarding general-purpose consumer loans</li> </ul> <p><b>Exceptional measures due to the COVID-19 crisis:</b></p> <ul style="list-style-type: none"> <li>–March 2020: relaxation of loan-to-value limit for mortgages of first-home buyers from 80% to 90%</li> <li>–90-day loan repayment moratorium for all bank loans and financing leasing agreements with opt-out clause; extended until end-September</li> <li>–Regulation encourages banks to offer debtors options for refinancing consumer, cash and other loans for up to two years. The relief can be offered to debtors even if, after refinancing, the credit burden to a debtor's income is higher than 60%</li> <li>–July 2020: NBS regulations adopted in order to facilitate repayment of household loans granted by March 18, 2020</li> </ul>

Source: National central banks, IMF.

<sup>1</sup> The list is not exhaustive.

### 3 Macprudential policies since COVID-19: What has changed?

The COVID-19 crisis has significant implications for financial stability and hence for macroprudential policies in the Western Balkans. Overall, the authorities in the region reacted swiftly and forcefully at the onset of the crisis in all policy spheres, and central banks have implemented measures to combat the negative impact of the crisis, taking into consideration country-specific factors. But also international institutions providing guidance with respect to prudential regulations (e.g. the Bank for International Settlements and the European Banking Authority) have given some direction how to address financial stability challenges arising from COVID-19 from a macroprudential viewpoint.<sup>17</sup> Generally, measures have tended to focus on the relaxation of regulatory standards to cushion the negative impact on households, corporates and banks (see table 2).

While the relaxation of macroprudential measures has played a role, the Western Balkan economies' policy response to COVID-19 was largely beyond the macroprudential realm as understood above. In the following, we therefore provide a somewhat more comprehensive overview of measures implemented by central banks in response to the COVID-19 crisis.<sup>18</sup> The bulk of measures comprises some form of moratoria on loan repayment for households and corporates that were implemented in all Western Balkan economies at the onset of the crisis. Loan moratoria differ in length of the postponement (up to six months in Bosnia and Herzegovina) and in terms of opt-in or opt-out options (the latter in Serbia, where a loan moratorium is applied to all bank loans and financing leasing agreements unless the client declines the moratorium). Furthermore, there have been several changes to, or relaxations of, loan classification and provisioning rules to prevent loans from being classified as nonperforming.

Regarding the use of capital buffers, no changes occurred that can be directly linked to the COVID-19 crisis – apart from the postponement of planned ratio hikes in the case of Albania.<sup>19</sup> At the same time, crisis-triggered temporary lenience in the assessment of credit quality and, more generally, in the calculation of capital, may have undermined the economic substance of capital buffers and thus may have made it easier for banks to observe them – in a purely formal way. In its June 2020 quarterly assessment of the countercyclical capital buffer, the National Bank of Serbia (2020) however argued that the buffer remains at zero to support the credit activity of banks and to mitigate the adverse effects of the crisis on the financing of corporates and households.

<sup>17</sup> For instance, the Bank for International Settlements announced the postponement of Basel III implementation to support banks and supervisors in coping with the current entirely unexpected challenges to financial stability (press release March 27, 2020: <https://www.bis.org/press/p200327.htm>) and the European Banking Authority put up several guidelines on the implementation of prudential policies in the context of COVID-19 (e.g. press release March 25, 2020: <https://eba.europa.eu/eba-provides-clarify-banks-consumers-application-prudential-frame-work-light-covid-19-measures>).

<sup>18</sup> That said, explicit monetary policy measures such as changes of key policy rates or liquidity support to the banking sector are outside the scope of our study. For an overview, refer to the IMF policy tracker: <https://www.imf.org/en/Topics/imf-and-covid19/Policy-Responses-to-COVID-19>.

<sup>19</sup> While this development appears to differ from reactions in EU countries, where particularly countercyclical capital buffers were loosened in a number of cases, one has to add of course that in the majority of Western Balkan economies (including Albania), capital buffers do not yet play a meaningful economic role. For more information on macroprudential and policy measures taken in response to the coronavirus crisis in EU member and euro area countries, see European Systemic Risk Board (2020) and European Central Bank (2020).

We only found one easing measure that can be clearly related to a borrower-based instrument, simply because not so many borrower-based instruments are in use in the Western Balkans: Serbia relaxed the loan-to-value limit for first-time home buyers from 80% to 90%, but without explicitly stating that the relaxation was related to the COVID-19 crisis.

Central banks in the Western Balkans introduced several measures with the aim of facilitating lending activity by banks. In Montenegro, the limit on exposures vis-à-vis an individual (or a group of related parties) was relaxed. Now the exposure limit of 25% of a bank's own funds can be exceeded with the approval of the Central Bank of Montenegro. Furthermore, the central banks of Montenegro and North Macedonia relaxed reserve requirements.

As the region is in the midst of the pandemic, further measures to support the financial sector are likely to be put in place. Overall, for the time being and based on information available, financial stability seems to be preserved in the Western Balkan economies despite strong headwinds as the COVID-19 crisis unfolds. So far, there is only scarce evidence on the actual impact of crisis-related measures, for instance, how many households and corporates have used a loan moratorium. Furthermore, the share of loans now under a temporary moratorium that will eventually turn nonperforming is currently incalculable.<sup>20</sup> This is certainly not only the case for the Western Balkan countries but also true for more advanced economies, such as the euro area. The effectiveness of measures to mitigate the adverse impact of the crisis as well as its medium- to long-term impact on macro-financial stability will only be assessable with a certain lag of time.

#### 4 Summary and conclusions

This short study tries to take stock of macroprudential policy instruments and their recent development in Western Balkan economies. As far as the authors are aware, no such comparative stocktaking has been done in recent years for this region. We cover the last five years (since 2015), and of course, take a particular look at developments since the outbreak of the COVID-19 crisis in March 2020. Our delimitation of macroprudential instruments largely corresponds to that applied by Eller et al. (2020).<sup>21</sup> The banking landscape in the region is dominated by foreign-owned credit institutions domiciled in the EU, and banks tend to be generally in good shape, profitable and well capitalized. Credit growth has been relatively weak in most countries, if fueled by partly uncollateralized general purpose household loans. Shares of foreign currency loans in total loans – disregarding unilaterally euroized Kosovo and Montenegro – continue to hover at rather high double digits, and deposit euroization also remains stubbornly at elevated levels.

In recent years, the Western Balkan economies have shown different speeds in creating and refining toolkits of (macro)prudential instruments and in preparing

<sup>20</sup> According to the NPL monitor for the CESEE region (Vienna Initiative, 2020) different waves of new flows of non-performing loans can be expected: an immediate spike in the fourth quarter of 2020, a slower but more widespread wave in the first half of 2021 and a third wave toward the end of 2021 related to sectoral spillovers.

<sup>21</sup> Based on the findings of this study, it might be possible to carry out further research. For instance, the CESEE macroprudential policy index (MPPI) established by Eller et al. (2020) might be enlarged to include the Western Balkan economies, which would make it possible to analytically discuss the intensity of measures in the respective economies. While a full econometric impact analysis covering the entire Western Balkan region will still have to wait some years owing to the, on average, still short data series, countries like Serbia and North Macedonia, which have more extended track records, might merit a closer look.

them for implementation. Indeed, preparatory work is still ongoing with respect to large parts or entire toolkits in three countries (Albania, Kosovo and Montenegro). All countries of the region are generally oriented toward Basel III-related harmonization, e.g. concerning minimum capital requirements, and toward EU macroprudential policies, given that they strive to (eventually) join the European Union. Apart from combating systemic risks, macroprudential goals notably include de-euroization or promotion of national currencies in those countries that possess their own legal tender. Serbia and North Macedonia have clearly gathered the most experience in the region when it comes to using macroprudential instruments (including capital buffers, reserve requirements, single client exposure limits, risk weights and loan-to-value limits), followed at a distance by Albania and Bosnia-Herzegovina. The biggest challenges (at least prior to the COVID-19 crisis) have included (1) the elevated growth rates of partly unsecured consumer loans – to which Serbia has responded by increasing related capital requirements; (2) the (to different extents) still high shares of foreign currency loans in total loans in the individual countries – notwithstanding various de-euroization measures and (3) elevated ratios of nonperforming loans.

The COVID-19 crisis quickly triggered the relaxation of some measures and regulatory standards to cushion short-term negative impacts on households, corporates and banks. However, the bulk of crisis containment measures being applied is situated outside the macroprudential realm and includes e.g. moratoria on loan repayments, adjustments in loan classification and provisioning rules. While the COVID-19 crisis has hardly changed official capital buffer policies (except in Albania, which has effectively relaxed its stance), temporary lenience in the assessment of credit quality and the calculation of capital may have undermined the economic substance of the buffers and thus made it easier for banks to formally observe them.

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Event wrap-ups

# 86<sup>th</sup> East Jour Fixe: All about COVID-19? Geopolitical, economic and macrofinancial perspectives for the Western Balkans

*Compiled by Antje Hildebrandt and Tomáš Slačik<sup>1</sup>*

The OeNB's most recent East Jour Fixe<sup>2</sup> on September 28, 2020, was both a time-honored event – the 86<sup>th</sup> East Jour Fixe organized to discuss CESEE-related topics since 1991 – and a first: the first purely virtual event ever hosted by the OeNB. More than 80 registered participants followed the workshop online and gave the organizers credit for the new format, including the virtual coffee breaks, which enabled participants to have a personal online exchange in small groups with the speakers and panelists.

In his welcome remarks, *OeNB Governor Robert Holzmann* reviewed the COVID-19 situation in the Western Balkans, virus-induced vulnerabilities as well as the potential macro- and microeconomic impact. He voiced expectations that the macroeconomic impact of the coronavirus crisis is likely to be less severe in the Western Balkan region than in other CESEE countries as the latter are more integrated in global value chains. At the same time, countries highly reliant on tourism will be hit most harshly. In addition, he pointed to the expected sharp decline in remittances and its implications for the fiscal and external balances as well as for the private and banking sectors in the region. Governor Holzmann closed his speech with a broad call for action which should focus above all on (1) providing (orchestrated) liquidity support for the region, especially from international financial institutions, (2) adjusting trade policies to facilitate cross-border commercial exchanges and (3) reducing transaction costs of remittances and, last but not least, (4) avoiding brain drain and population shrinkage. Most of these topics were picked up and discussed in greater depth by the subsequent speakers.

Session 1 was devoted to policy options and challenges ahead for the Western Balkan countries and was chaired by *Doris Ritzberger-Grünwald, Director of the OeNB's Economic Analysis and Research Department*. In his keynote speech, *Wolfgang Petritsch, President of the Austrian Marshall Plan Foundation*, addressed the autocratic, populist tendencies toward illiberal democracy that have been gaining momentum in the region, fueling legitimate concerns among EU enlargement skeptics such as France. Add to this the widespread phenomenon of corruption and clientelism, which has been long ignored or even tacitly accepted by the European Commission. Unfortunately, prospective EU membership has not produced a sustainable drive to embark on reforms; much rather, the status quo has been cemented into a “stabilocracy.” Given changing geopolitical conditions, the EU is no longer the only major stakeholder in the region. Old and new players, particularly China, Russia and Turkey, have been expanding their role and pursuing their own objectives. Russia, for instance, may benefit from a prolonged instability of the region, while China has been increasing its influence in the Western Balkans through infrastructure investments

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<sup>2</sup> The presentations and the workshop program are available at: <https://www.oenb.at/Termine/2020/2020-09-28-east-jour-fixe-86.html>

while eyeing the EU market. Petritsch also addressed the rather gloomy demographic projections for the region. He concluded by saying that the EU would need to shape a more strategic view vis-à-vis the Western Balkans and double down on its investments while engaging with China as a partner. In the ensuing discussion he elaborated further by calling for a combination of more accountability and greater openness and for a more sincere discussion from both the EU and the Western Balkan countries. He also advocated interim solutions that would allow the EU candidate countries to participate in different projects before entering the EU.

In the following panel discussion, *Marcus How*, *Head of Research and Analysis at ViennEast*, picked up on the enlargement skepticism in the region to which the EU has contributed. Yet, rather than subscribing to the general tendency to victimize EU candidates in the Western Balkans because of the enlargement standstill, How believes that the region's state of limbo about EU accession provides room for competition among other players. This may be beneficial for further development and may in fact be seen positively by foreign investors, who honor above all predictability, whereas the usual narrative pictures the rule of law and functioning democratic institutions as a prerequisite for successful economic development. That is, even if the rules of the game are rigged, investors can cope with the situation if the rules are predictable. As a case in point, FDI in Serbia – 60% of which comes from EU-based firms that like to use Serbia as a gateway to Russia – has been increasing despite eroded checks and balances and a deteriorated rule of law. Moreover, the assets invested by foreign investors contribute to the accumulation of resources which may ultimately serve to support the organic development of institutions. Finally, How expects the current COVID-19-crisis to boost existing trends rather than creating new ones. At the same time, as socioeconomic indicators deteriorate as a result of the crisis, opposition toward ruling elites may emerge very fast.

Adding to these views, *Othon Anastasakis*, *Director of South East European Studies at Oxford (SEESOX)*, argued that the geopolitical agenda in the region has been growing in the sense that themes go beyond the strictly ethno-national, post-Yugoslav post-conflict issues and include other important global issues such as the environment, migration, religious radicalization, energy, cybersecurity, misinformation or organized crime. This makes the region more vulnerable globally. Anastasakis stressed that despite the predominance of the transatlantic impact, the latter is not always uniform. There are some disagreements among EU countries and more so between the EU and the United States as far as the region's progress is concerned. Regarding external geopolitical actors that have become increasingly visible and seek to de-westernize the region, Anastasakis pointed out that these players have their own agendas which are not necessarily compatible with each other and that their influence is usually opportunistic and short-term. According to Anastasakis we observe an instrumentalization of these geopolitical influences with local rulers who play external actors off against each other. He cautioned against overestimating the influence exerted by non-European actors: they tend to get more prominence than they deserve. To conclude, Anastasakis urged participants to see the biggest threat arising from internal vulnerabilities of the Western Balkan countries in terms of their problematic rule of law, institutional weaknesses, illiberal elites and democratic backsliding.

The second session was designed to shed light on the threats to macrofinancial stability due to the COVID-19 crisis with two kick-off presentations. It was chaired by *Helene Schuberth, Head of the OeNB's Foreign Research Division*.

Regarding key macrofinancial stability issues that are likely to be affected by the COVID-19 crisis, *Antje Hildebrandt, Senior Economist in the OeNB's Foreign Research Division*, singled out financial deepening and the de-euroization process. Financial deepening may be slowed down by lower credit growth, and de-euroization may be decelerated by the economic fallout from the pandemic, because a high degree of uncertainty or a severe economic crisis are after all major drivers of euroization. Additionally, but more in the short run, a high degree of euroization makes economies with a flexible exchange rate more vulnerable in case of sizable currency depreciation. Regarding the impact of the crisis on nonperforming loans, Hildebrandt pointed out that this impact will depend on measures implemented (e.g. loan moratoria) to support households as well as on the economic recovery path.

Regarding the financial vulnerability of households in the Western Balkans due to the COVID-19 crisis, *Aleksandra Riedl, Senior Economist in the OeNB's Foreign Research Division*, shared research data collected with the OeNB Euro Survey. Specifically, she presented debt service-to-income (DSTI) ratios estimated for individuals covered by the survey and found the median DSTI ratio to be relatively high in the Western Balkan region. While households' wealth position is rarely known, the income situation points to little room for maneuver. In a second step, Riedl assessed the impact of job losses due to the COVID-19 slump on DSTI ratios and found that a significant share of households in Bosnia and Herzegovina as well as in Serbia may end up having trouble repaying their loans. Offsetting factors include, to some extent, unemployment benefits as well as the fact that the countries facing the highest impact from job losses are not the ones with the highest share of vulnerable households in the region.

These two kick-off presentations were followed by a discussion among three high-ranking panelists. First, *Stephanie Eble, the IMF Regional Resident Representative for the Western Balkans*, gave an overview of economic developments and challenges of the Western Balkan region. Accordingly, all countries have been heavily hit by the crisis, particularly Montenegro, Albania and Kosovo. These countries are strongly dependent on tourism, which almost came to a standstill following the lockdown in March. Overall, she sees risks to economic growth on the downside, and projections surrounded by a high degree of uncertainty. Inflation in the Western Balkan countries has remained rather subdued, and financial packages to support the economy have been smaller than in advanced countries with the notable exception of Serbia. Furthermore, foreign currency reserves have remained stable and deposits have increased due to precautionary savings. Informal remittances have declined in the course of the crisis, but there was some mitigation due to higher formal transfer payments. Eble pointed out that the Western Balkan countries are in a better situation regarding cross-border exposure than during the global financial crisis. Furthermore, not only foreign-owned banks but also domestic banks are exposed due to lower capital inflows (tourism remittances).

Second, *Sokol Havolli, Deputy Governor of the Central Bank of the Republic of Kosovo*, gave a broad picture on how the pandemic has affected the Kosovar economy. Travel restrictions by European countries are one of the major drags on the country, as travel exports, which are an important source of income, have declined significantly.

Havolli emphasized that quick and creative measures, such as loan moratoria, the lifting of regulatory requirements and other unorthodox regulatory measures, were implemented to overcome economic difficulties and to preserve liquidity in the economy. Other measures such as a government support package were put in place as well. According to Havolli, the future is surrounded by many uncertainties, given the uncertainty about the evolution of the pandemic. A worsening of the current situation would certainly imply a further deterioration of economic conditions, and additional measures would be needed. In his view, such measures can only be in place for a limited period without compromising the main objective of the Central Bank of Kosovo, which is safeguarding financial stability.

Finally, Ana Mitreska, *Vice Governor of the National Bank of the Republic of North Macedonia*, pointed toward stronger fundamentals and smaller vulnerabilities in the current COVID-19 crisis compared to the global financial crisis of 2008. This is reflected in a more resilient banking sector, stronger external positions and a higher level of foreign reserves. According to Mitreska, the economy has been affected via several channels: private consumption and investment have been negatively affected by lower confidence and more pessimistic expectations, exports by lower foreign demand. However, the opening of the economy was immediately followed by a rebound. Mitreska also referred to monetary policy and regulatory changes adopted by the National Bank of the Republic of North Macedonia, including interest rate cuts, the provision of additional liquidity and regulatory flexibility to support corporates and households. Mitreska emphasized the unusually high degree of uncertainty which requires close monitoring of all economic developments.

Issues touched upon in the ensuing general *discussion* included the impact on the de-euroization process. Overall, the pandemic has been observed to have changed the structure of the portfolio toward more liquid forms of assets and toward more savings in foreign currency in highly euroized countries. Another question touched upon global value chains, particularly in the automotive sector, in North Macedonia. Ana Mitreska explained that global value chains have been interrupted severely by the crisis. During the complete lockdown, exports of the automotive sector declined by around 60%. By the end of September, capacity utilization had reached about 70%. In her *concluding remarks*, Helene Schuberth summarized the main points: There are potential risks for macrofinancial stability in the Western Balkan countries – and not only there but also in more advanced countries – due to the COVID-19 crisis. She emphasized the importance of detecting risks as early as possible and of reacting in an appropriate way. She concluded by saying that macroprudential measures and other supportive action can help to mitigate negative effects of the crisis on the real economy.

## Statistical annex

## Statistical annex

This section provides tables detailing selected economic indicators for Albania, Bosnia and Herzegovina, Kosovo, Montenegro, North Macedonia, Serbia and Ukraine, i.e. CESEE countries not covered in the “Recent economic developments and outlook” section.

Table 1

### Output, unemployment and prices

	2017	2018	2019	Q1 19	Q2 19	Q3 19	Q4 19	Q1 20	Q2 20
<b>Gross domestic product</b>	<i>Annual real change in %</i>								
Albania	3.8	4.1	2.2	2.4	2.6	4.2	-0.1	-2.3	-10.2
Bosnia and Herzegovina <sup>1</sup>	3.2	3.7	2.7	2.6	3.0	3.3	1.8	2.2	-9.3
Kosovo	4.2	3.8	4.2	4.2	4.1	4.4	3.9	1.3	-9.3
Montenegro	4.7	5.1	3.6	3.0	3.2	4.7	3.1	2.7	-20.2
North Macedonia	1.1	2.7	3.6	3.8	3.4	3.6	3.4	0.2	-12.7
Serbia	2.0	4.4	4.2	2.6	2.9	4.8	6.2	5.1	-6.4
Ukraine	2.5	3.4	3.2	2.9	4.7	3.9	1.5	-1.3	-11.4
<b>Industrial production</b>	<i>Annual real change in %</i>								
Albania	-0.8	18.7	-1.1	-11.7	-6.7	2.1	14.9	-0.1	-22.0
Bosnia and Herzegovina <sup>2</sup>	3.1	1.6	-5.3	-5.0	-3.6	-5.7	-6.9	-3.6	-14.0
Kosovo	2.9	2.4	4.7	-2.1	6.7	7.9	4.7	4.1	19.8
Montenegro	-4.2	22.4	-6.3	-14.4	-9.5	0.1	-1.6	12.7	-15.9
North Macedonia	0.2	5.4	3.7	8.8	1.1	7.2	-1.3	-3.7	-25.0
Serbia	3.9	1.3	0.2	-2.0	-2.6	1.9	3.1	4.4	-4.2
Ukraine	1.1	3.0	-0.5	-0.1	2.7	1.1	-5.1	-4.8	-11.7
<b>Average gross wages – total economy</b>	<i>Annual change in %</i>								
Albania	3.0	3.1	3.8	4.9	4.5	3.7	2.2	3.3	2.9
Bosnia and Herzegovina	1.6	3.1	4.3	4.0	4.4	4.5	4.3	4.7	3.6
Kosovo	5.8	1.8	1.7	..	..	..	..	..	..
Montenegro	2.0	0.1	0.8	0.6	0.5	1.0	1.3	2.2	1.2
North Macedonia	2.6	5.8	5.1	4.6	4.8	5.3	5.7	11.4	5.7
Serbia	4.0	4.0	10.5	9.3	9.9	10.8	11.9	10.4	8.7
Ukraine	37.0	24.8	18.5	20.8	18.8	18.4	16.3	14.3	4.0
<b>Unemployment rate<sup>3</sup></b>	<i>%</i>								
Albania	14.1	12.8	12.0	12.6	12.0	11.8	11.6	11.9	12.5
Bosnia and Herzegovina	21.1	18.9	16.4	..	..	..	..	..	..
Kosovo	30.5	29.5	25.7	26.9	25.3	24.5	25.9	25.0	..
Montenegro	16.4	15.5	15.4	15.2	14.7	15.6	16.1	16.6	15.7
North Macedonia	22.6	21.0	17.5	18.1	17.6	17.3	16.8	16.4	16.9
Serbia	14.1	13.3	10.9	12.7	10.8	10.0	10.2	10.2	7.7
Ukraine	9.9	9.1	8.6	9.6	8.0	7.6	9.2	8.9	10.3
<b>Consumer price index</b>	<i>Period average, annual change in %</i>								
Albania	2.0	2.0	1.4	1.6	1.4	1.4	1.3	1.6	1.9
Bosnia and Herzegovina	0.8	1.4	0.6	1.0	0.7	0.4	0.2	0.4	-1.6
Kosovo	1.5	1.1	2.7	3.2	3.3	2.6	1.7	1.1	0.2
Montenegro	2.4	2.6	0.4	0.5	0.5	-0.3	0.7	0.8	-0.7
North Macedonia	1.4	1.5	0.8	1.2	1.2	0.6	0.1	0.6	0.5
Serbia	3.1	2.0	1.9	2.4	2.2	1.3	1.4	1.8	1.0
Ukraine	14.4	11.0	7.9	8.9	9.1	8.5	5.2	2.6	2.1

Source: Eurostat, Macrobond, national statistical offices, wiw.

<sup>1</sup> Expenditure-side data.

<sup>2</sup> Value added in the national accounts.

<sup>3</sup> Labor force survey.



Table 2

**External accounts**

	2017	2018	2019	Q1 19	Q2 19	Q3 19	Q4 19	Q1 20	Q2 20
<b>Trade balance</b>	% of GDP								
Albania	-24.4	-22.4	-23.0	-22.5	-21.6	-23.5	-24.6	-21.5	-21.1
Bosnia and Herzegovina	-23.6	-22.4	-22.6	-23.4	-23.8	-21.1	-22.4	-20.2	-17.1
Kosovo	-38.4	-40.7	-40.1	-40.7	-39.6	-38.6	-41.7	-40.4	-34.1
Montenegro	-43.3	-43.9	-42.1	-46.2	-50.6	-34.9	-40.7	-46.6	-44.7
North Macedonia	-17.8	-16.2	-17.3	-17.9	-16.0	-15.1	-20.1	-20.4	-14.6
Serbia	-10.2	-11.9	-12.2	-12.4	-11.0	-10.7	-14.5	-14.7	-9.5
Ukraine	-8.6	-9.8	-9.2	-7.5	-9.2	-10.1	-9.4	-5.0	-1.9
<b>Current plus capital account balance</b>	% of GDP								
Albania	-6.4	-5.9	-7.1	-7.4	-7.5	-4.1	-9.3	-6.9	-11.4
Bosnia and Herzegovina	-3.3	-2.8	-2.6	-4.8	-3.3	-0.1	-2.6	-4.0	-2.4
Kosovo	-5.6	-7.7	-5.9	-6.1	-11.4	7.4	-14.5	-5.3	-9.3
Montenegro	-16.1	-17.0	-15.1	-35.7	-28.5	14.7	-27.3	-35.3	-35.1
North Macedonia	-0.9	0.0	-2.7	-5.9	-1.7	6.4	-9.5	-5.5	-3.5
Serbia	-5.2	-4.9	-7.1	-8.1	-6.4	-5.1	-8.8	-8.9	-3.5
Ukraine	-3.1	-4.9	-2.6	-2.0	-3.6	-8.4	3.2	6.7	5.2
<b>Foreign direct investment<sup>1</sup></b>	% of GDP								
Albania	-8.6	-8.0	-7.6	-9.2	-6.3	-7.6	-7.3	-7.3	-7.2
Bosnia and Herzegovina	-2.1	-2.5	-2.7	-3.4	-4.6	-1.9	-1.0	-2.9	-1.5
Kosovo	-3.3	-3.4	-2.9	-4.3	-1.6	-4.0	-2.0	-6.7	-3.2
Montenegro	-11.3	-6.9	-7.0	-9.3	-12.6	-2.4	-6.3	-14.7	-13.9
North Macedonia	-1.8	-5.6	-2.6	-1.5	-0.4	-2.2	-5.8	-4.7	0.6
Serbia	-6.2	-7.4	-7.8	-7.8	-9.0	-7.7	-6.8	-7.2	-6.2
Ukraine	-3.3	-3.4	-3.4	-3.2	-3.9	-4.5	-2.0	4.6	-3.9
<b>Gross external debt</b>	End of period, % of GDP								
Albania	68.7	65.1	60.5	64.3	62.5	61.3	60.5	60.3	68.1
Bosnia and Herzegovina	67.6	66.7	64.5	66.3	66.0	65.3	64.5	63.8	63.9
Kosovo	32.6	30.3	30.8	30.0	31.0	30.7	30.8	31.1	32.9
Montenegro	160.6	164.7	169.3	..	..	..	..	..	..
North Macedonia	73.4	73.3	71.9	75.7	75.6	76.6	71.9	73.0	79.5
Serbia	85.6	83.1	83.2	83.6	84.9	85.0	83.2	82.8	87.4
Ukraine	97.3	90.1	78.1	87.2	83.4	83.6	78.1	76.8	77.7
<b>Reserve assets excluding gold</b>	Period average, annual change in %								
Albania	25.4	26.0	23.7	25.1	24.1	24.7	23.7	23.5	30.8
Bosnia and Herzegovina	33.2	34.1	34.9	33.2	34.3	35.1	34.9	34.6	36.6
Kosovo <sup>2</sup>	10.7	11.4	12.2	13.1	14.6	15.2	12.2	11.9	13.0
Montenegro	19.7	22.5	26.9	20.1	17.2	18.0	27.4	18.7	25.4
North Macedonia	20.9	24.5	26.1	24.0	24.1	25.3	26.1	23.7	29.8
Serbia	23.7	24.6	26.2	24.6	25.7	27.6	26.2	24.9	26.8
Ukraine	15.0	15.6	15.5	15.0	14.1	14.3	15.5	15.1	17.1

Source: National central banks, national statistical offices, wiw.

<sup>1</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).

<sup>2</sup> Reserve assets (including gold).

Table 3

**Banking sector indicators**

	2017	2018	2019	Q1 19	Q2 19	Q3 19	Q4 19	Q1 20	Q2 20
<b>Bank loans to the domestic nonbank private sector</b>	<i>End of period, annual change in %</i>								
Albania <sup>1</sup>	3.6	-0.3	6.9	0.6	4.5	6.5	6.9	6.2	4.9
Bosnia and Herzegovina <sup>1</sup>	7.5	5.7	6.7	5.3	6.1	6.1	6.7	3.6	0.4
Kosovo	11.5	10.9	10.0	11.4	10.5	10.3	10.0	9.2	6.4
Montenegro	7.5	9.6	6.8	10.1	6.2	6.2	6.8	5.6	7.1
North Macedonia <sup>1</sup>	7.4	6.4	5.2	7.8	7.1	4.7	5.2	4.6	5.7
Serbia <sup>1</sup>	7.9	8.4	8.1	8.2	7.6	8.7	8.1	9.6	12.4
Ukraine <sup>1</sup>	-0.6	6.5	-3.6	1.4	0.1	-3.9	-3.6	-2.4	-3.9
<b>Share of foreign currency loans<sup>2</sup></b>	<i>End of period, %</i>								
Albania	51.1	50.4	48.8	51.1	50.4	49.8	48.8	50.6	49.4
Bosnia and Herzegovina	62.9	59.0	52.6	54.2	53.2	52.7	52.6	52.1	52.2
Kosovo	..	..	..	..	..	..	..	..	..
Montenegro <sup>3</sup>	5.1	5.7	3.1	5.2	3.2	3.4	3.1	2.7	2.9
North Macedonia	41.7	40.4	41.5	40.5	40.8	41.3	41.5	41.4	41.3
Serbia <sup>4</sup>	66.2	66.3	66.1	66.0	65.9	65.9	66.1	66.1	64.8
Ukraine	43.9	42.9	37.0	42.2	40.6	37.7	37.0	39.8	39.0
<b>NPL ratio</b>	<i>%</i>								
Albania	13.2	11.1	8.4	11.4	11.2	10.6	8.4	8.2	8.1
Bosnia and Herzegovina	10.0	8.8	7.4	8.5	8.0	7.7	7.4	6.6	6.7
Kosovo	3.1	2.7	2.0	2.6	2.5	2.3	2.0	2.5	2.6
Montenegro	7.3	6.7	4.7	5.9	4.8	4.7	4.7	5.1	5.3
North Macedonia	5.1	4.8	3.8	4.7	4.7	4.1	3.8	4.0	4.4
Serbia	9.8	5.7	4.1	5.5	5.2	4.7	4.1	4.0	3.7
Ukraine	54.5	52.9	48.4	51.7	50.8	48.9	48.4	48.9	48.5
<b>Tier 1 capital ratio</b>	<i>%</i>								
Albania	15.1	17.0	17.1	16.6	17.3	17.6	17.1	17.9	17.0
Bosnia and Herzegovina	14.8	16.5	17.5	16.1	16.9	17.1	17.5	16.7	17.3
Kosovo <sup>5</sup>	18.0	17.0	15.9	17.1	16.8	16.5	15.9	15.1	16.7
Montenegro <sup>5</sup>	16.4	15.6	17.7	15.3	19.5	17.7	17.7	17.4	19.6
North Macedonia	14.2	15.0	14.8	15.5	15.8	15.4	14.8	15.0	15.5
Serbia	21.6	21.1	22.4	22.6	22.1	22.5	22.4	21.9	21.8
Ukraine	12.1	10.5	13.5	10.9	13.0	13.1	13.5	13.0	15.8

Source: National central banks.

<sup>1</sup> Foreign currency component at constant exchange rates.<sup>2</sup> In total loans to the nonbank private sector. Including loans indexed to foreign currencies, as far as available.<sup>3</sup> Share in total loans to all sectors.<sup>4</sup> Including securities.<sup>5</sup> Overall capital adequacy ratio.

Table 4

**Monetary and fiscal policy indicators**

	2017	2018	2019	Q1 19	Q2 19	Q3 19	Q4 19	Q1 20	Q2 20
<b>Key interest rate</b>	End of period, %								
Albania (one-week repo rate)	1.3	1.0	1.0	1.0	1.0	1.0	1.0	0.5	0.5
Bosnia and Herzegovina <sup>1</sup>	..	..	..	..	..	..	..	..	..
Kosovo <sup>1</sup>	..	..	..	..	..	..	..	..	..
Montenegro <sup>1</sup>	..	..	..	..	..	..	..	..	..
North Macedonia (28/35-day central bank bills)	3.3	2.5	2.3	2.3	2.3	2.3	2.3	2.0	1.5
Serbia (one-week repo rate)	3.5	3.0	2.3	3.0	3.0	2.5	2.3	1.8	1.3
Ukraine (discount rate)	14.5	18.0	13.5	18.0	17.5	16.5	13.5	10.0	6.0
<b>Three-month interbank rate</b>	Period average, %								
Albania	2.2	1.8	1.4	1.4	1.4	1.5	1.5	1.5	1.5
Bosnia and Herzegovina	..	..	..	..	..	..	..	..	..
Kosovo	..	..	..	..	..	..	..	..	..
Montenegro	..	..	..	..	..	..	..	..	..
North Macedonia	1.8	1.5	1.5	1.5	1.5	1.5	1.5	1.4	1.4
Serbia	3.4	3.0	2.5	3.0	3.0	2.3	1.8	1.6	1.2
Ukraine	14.3	13.7	14.8	14.8	14.6	15.0	14.8	12.6	11.0
<b>Exchange rate</b>	Period average, national currency per EUR								
Albania	134.2	127.6	123.0	124.6	123.1	121.6	122.7	122.8	124.5
Bosnia and Herzegovina	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Kosovo	..	..	..	..	..	..	..	..	..
Montenegro	..	..	..	..	..	..	..	..	..
North Macedonia	61.6	61.5	61.5	61.5	61.5	61.5	61.5	61.6	61.7
Serbia	121.4	118.3	117.9	118.2	118.0	117.7	117.5	117.6	117.6
Ukraine	30.0	32.1	28.9	31.0	29.8	28.1	26.8	27.6	29.6
	2017	2018	2019	2017	2018	2019			
	General government balance			General government debt					
	End of period, % of GDP								
Albania	-2.0	-1.6	-1.8	66.9	67.7	66.1			
Bosnia and Herzegovina	2.6	2.2	1.9	36.1	34.2	32.8			
Kosovo	1.3	0.4	1.0	15.5	16.3	16.9			
Montenegro	-5.6	-2.6	-2.0	64.2	70.0	77.2			
North Macedonia	-2.7	-1.8	-2.1	39.4	40.6	38.9			
Serbia	1.1	0.6	-0.2	60.1	54.4	52.8			
Ukraine	-1.4	-1.9	-2.2	71.8	60.9	50.3			

Source: European Commission (Ameco), Macrobond, national central banks, wiiv.

<sup>1</sup> No policy rate available (unilateral euroization or currency board).**Conventions used**

.. = data not available.

Discrepancies may arise from rounding.