Croatia

Highlights

- **Growth moderated in the first half of 2023 but was still above that of regional peers.** Gross domestic product (GDP) growth slowed towards the end of 2022 as headwinds strengthened, but remained resilient in the first half of 2023, helped by strong tourism figures.
- **Euro adoption and Schengen membership are boosting the country's integration with other European Union (EU) economies.** Export growth has been very strong since 2019, and euro adoption in January 2023 and the removal of border controls in the Schengen area have further cut trade and investment costs.
- **Measures are being taken to make the labour market more efficient and inclusive.** Croatia has introduced a voucher system to support green and digital skills development as one of its Recovery and Resilience Plan (RRP) milestones.

Key priorities for 2024

- **Challenging reforms are needed to implement the RRP.** The RRP schedule envisages a pipeline of more complex and politically difficult reforms, such as updating the public pay system and introducing a new law on state-owned enterprises (SOEs).
- **Inclusion issues and labour market outcomes need to improve.** The effectiveness of the Croatian social protection system and long-term care still lags behind that of its peers. Reforms need to go beyond narrow RRP commitments.
- **Efforts to attract foreign direct investment would boost long-term growth potential.** Historically, Croatia has not been a preferred destination for foreign direct investment, thanks to its higher labour costs and relatively unattractive business environment. Amid ongoing reforms and enhanced EU integration, the authorities and the private sector should grasp the opportunity to attract high-value-added investments.

Main macroeconomic indicators (per cent)

	2019	2020	2021	2022	2023 proj.
GDP growth	3.4	-8.6	13.8	6.3	2.5
Inflation (average)	0.8	0.0	2.7	10.7	8.6
Government balance/GDP	0.2	-7.3	-2.5	0.1	-0.8
Current account balance/GDP	2.9	-0.5	1.8	-1.9	-0.2
Net FDI/GDP [neg. sign = inflows]	-6.2	-1.4	-4.8	-5.7	n.a.
External debt/GDP	72.9	81.8	81.0	74.0	n.a.
Gross reserves/GDP	33.4	37.5	42.9	41.6	n.a.
Credit to private sector/GDP	52.1	58.5	51.9	49.8	n.a.

Macroeconomic developments and policy response

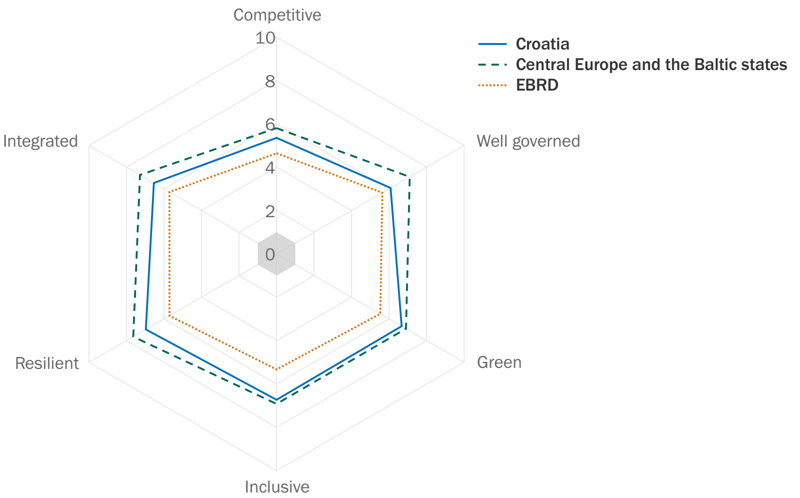
The economy is cooling after another year of strong growth. GDP growth was among the highest in the EU in 2022, at 6.3 per cent, driven by strong domestic demand, including an accumulation of inventories. In the first two quarters of 2023, GDP growth slowed to 1.6 per cent and 2.6 per cent year on year, respectively. However, quarter-on-quarter growth of more than 1 per cent in the second quarter, with private consumption accelerating amid declining inflation, suggests that the economy retains significant momentum. Still, exports recorded an annual decline in April and May 2023, largely owing to lower exports of fuels and crude materials. Industrial production also fell for six consecutive months up to May 2023, reflecting weak foreign demand and supply-side shocks. In the first half of 2023, tourist nights were 5 per cent higher than in the record year of 2019.

Inflation is declining while wage growth is picking up. Consumer price growth peaked at 13.5 per cent in November 2022, largely driven by food prices. Since then, inflation has been on a downward path, dipping to 6.7 per cent in September 2023. The adoption of the euro in January 2023 had only a marginal effect on inflation, according to estimates by the European Central Bank. Meanwhile, nominal wage growth has been brisk in 2023, averaging 12 per cent year on year. This has translated into relatively strong real wage growth (6.1 per cent year on year in July 2023), supporting household demand. The labour market remains tight, although the employment rate went down from a record high at the end of 2022, with unemployment rising to 7.3 per cent in the first quarter of 2023. Real-estate prices have risen significantly, posting a 17.3 per cent increase on the year in the fourth quarter of 2022.

The fiscal position is strong despite energy and cost-of-living support schemes. Strong economic growth, high inflation and an improving structural balance led to a fiscal surplus of 0.1 per cent of GDP in 2022. Government debt was down to 69 per cent of GDP at the end of 2022, below pre-pandemic levels. The 2023 budget is projected to post a small deficit of up to 0.3 per cent of GDP, according to the latest budget revision. The European Commission estimated the cost of energy support measures in 2023 at 1.5 per cent of GDP. In March 2023 the government introduced a lower value-added tax (VAT) rate on energy products, reduced excise duties on fuel, allocated additional social transfers and prolonged price caps on electricity and gas to October 2023 and March 2024, respectively. Hrvatska Elektroprivreda, the state-owned energy company, bore the financial impact of the price caps, for which the government approved a capital transfer of up to €900 million in March 2023.

Growth will moderate in the short term. We forecast GDP to grow by 2.5 per cent in 2023, as weak external demand and tighter financial conditions take a toll. Upside potential to the forecast comes from a strong tourism season, a recovery in domestic demand supported by a tight labour market, and an acceleration in investment driven by EU funds. GDP could expand by 2.3 per cent in 2024, as a moderation in domestic demand is offset by the recovery of key trading partners.

Assessment of transition qualities (1-10)



Structural reform developments

Croatia is benefiting from euro adoption and Schengen membership. Croatia joined the eurozone and the Schengen area in January 2023. As a result, the economy is benefiting from decreased trade and transaction costs, more foreign investment and greater inflows of tourists, some of whom are buying property. Consequently, there is a risk of faster real-estate price growth in the short to medium term.

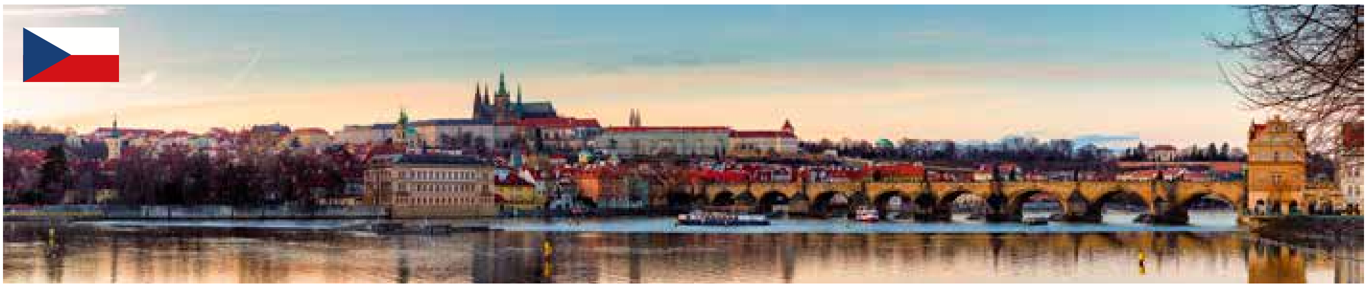
RRP implementation and associated reforms are advancing. With three payment requests already submitted, Croatia is progressing well on RRP implementation. Most of the reforms required in these initial stages pertain to updating and adopting national strategies and programmes around key transition topics, such as the green transition, good governance and competitiveness. Moreover, the authorities have also adopted a new hydrogen strategy and amended legislation on biofuels. The challenge now is to channel the available resources effectively into impactful projects and ensure that the legislative improvements translate into tangible outcomes. In addition, the upcoming payment requests will include more difficult reforms, such as updating the public pay system, launching a new procurement platform and adopting a new law on SOEs.

Additional efforts were made to strengthen competitiveness and improve the business environment. Under its second RRP payment request, Croatia committed to implementing an action plan set out in 2020 for reducing non-tax and para-fiscal charges, which the European Commission confirmed had been completed at the end of 2022. Moreover, the promised digital platform for firms to pay business fees online is now operational. Targeting specific sectors, the authorities updated the regulation to enable the digital single market to function, adopted a new law on agricultural land consolidation to increase productivity in the sector and launched a new sustainable tourism development strategy.

Several of the adopted measures target labour-market inefficiencies and skills development. A key objective of the Croatian RRP is to improve employment outcomes by increasing labour-market flexibility and addressing inequalities. Notable reforms so far include the adoption of the Labour Act, in force since January 2023, which clarifies fixed-term and remote work, and the Act on Elimination of Unregistered Work, which targets informal employment. An educational voucher system was introduced to promote digital and green skills. The government is also easing policy on seasonal workers in light of current labour shortages.

Gas infrastructure is being developed as Croatia becomes a regional hub. The energy crisis in 2022 accelerated plans for Croatia to develop its gas infrastructure. Key projects include the expansion of the Krk liquefied natural gas terminal, the Zlobin-Bosiljevo gas pipeline and the Southern Gas Interconnection with Bosnia and Herzegovina as part of the Ionian Adriatic Pipeline connecting Greece and Türkiye to central Europe. A potential gas interconnector between Croatia and Slovenia is also being discussed.

A corporate windfall tax was introduced in 2022. The one-off tax applied to companies with revenue of more than €40 million, to subsidise smaller firms and households struggling with the increased cost of living. The marginal 33 per cent rate was levied on any profits that were 20 per cent higher than a company’s 2018-21 average. The additional tax brought in €230 million in 2022. The authorities are considering extending the levy to 2024.



Czech Republic

Highlights

- **The economy remains in stagnation.** Gross domestic product (GDP) growth declined 0.6 per cent annually in the first half of 2023 but the first signs of improvement have started to appear, pointing to marginally positive growth for the entire year.
- **A new law will allow for easier corporate restructuring.** Under the new law approved by parliament, the majority threshold needed to approve a restructuring has been lowered from 90 per cent to 75 per cent. The new law could effectively enable the government to increase its control of the CEZ energy group.
- **The use of European Union (EU) funds has stepped up.** The country had used 87.1 per cent of its 2014-20 EU Multiannual Financial Framework funds by August 2023, alleviating concerns that major funds would be lost due to insufficient absorption.

Key priorities for 2024

- **The authorities should discontinue energy compensation measures.** While these measures helped to support vulnerable groups through the energy crisis, stopping them now would aid fiscal tightening and allow price incentives to encourage energy savings.
- **Progress on implementing the Recovery and Resilience Plan (RRP) should be stepped up.** The authorities should focus on green transition, including large programmes to improve energy efficiency and heating systems.
- **Pension reform should be completed.** Outstanding steps include introducing a retirement age linked to life expectancy.

Main macroeconomic indicators (per cent)

	2019	2020	2021	2022	2023 proj.
GDP growth	3.0	-5.5	3.6	2.4	0.1
Inflation (average)	2.6	3.3	3.3	14.8	10.9
Government balance/GDP	0.3	-5.8	-5.1	-3.2	-4.1
Current account balance/GDP	0.3	2.0	-2.8	-6.1	0.5
Net FDI/GDP [neg. sign = inflows]	-2.4	-2.6	-0.5	-2.5	n.a.
External debt/GDP	75.7	75.7	74.0	65.6	n.a.
Gross reserves/GDP	58.5	62.2	62.4	46.7	n.a.
Credit to private sector/GDP	50.3	53.0	54.8	50.9	n.a.

Macroeconomic developments and policy response

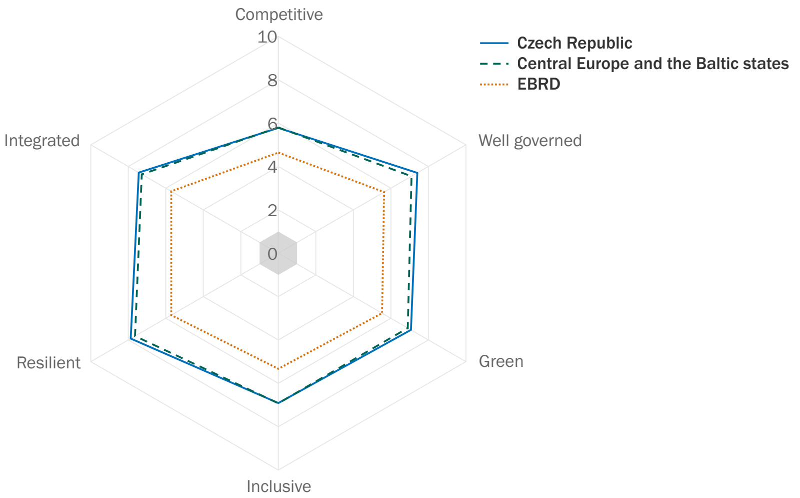
Economic growth has remained close to zero since the middle of 2022. The economy has been slow to recover from a collapse in consumption in the second half of 2022, resulting from a sharp drop in purchasing power. In addition, inventory adjustment is still taking its toll on the headline GDP numbers. On a positive note, consumption has started to show signs of improvement in 2023, as the structurally tight labour market prompts hoarding and wage growth. Amid rapidly declining inflation, sentiment and higher spending power have improved. The normalisation of energy prices has also provided a significant boost to Czech terms of trade, despite the uncertainty of the external demand outlook.

Inflation is moderating from a relatively high peak. The rate of consumer price growth reached 18 per cent in September 2022 but had returned to single digits by the summer of 2023, helped by a moderation in food and energy prices. Further declines are likely, as the strong base effects are still ahead. The Czech National Bank's (CNB) target inflation rate of 2 per cent could be achieved in early 2024.

Fiscal policy in early 2023 was accommodative, but tightening is on the horizon. In the first part of 2023, the authorities provided some counter-cyclical smoothing of demand, leading to a deficit of 6.1 per cent of GDP in the first quarter. In the second quarter, public finances improved and a fiscal surplus of 1.5 per cent of GDP was recorded. The government has committed to an austerity package, targeting a deficit of 2.1 per cent of GDP in 2024. The package includes eliminating tax exemptions, rebalancing local and central revenues, and increasing excise taxes on tobacco and alcohol.

Sticky inflation and weak foreign demand are the main drivers of downside growth. Considering how the economy performed in the first half of 2023, the remainder of the year should not bring major changes, putting GDP growth at around 0.1 per cent for the year as a whole. This will be driven by weaker consumption and exports, offset by a possible upturn in investor confidence arising from declining imports, rebounding investments, and enhanced political stability amid the formation of a new government. The economy should rebound by 2.5 per cent in 2024, supported by moderating inflation, accelerated absorption of EU funds, and revived foreign demand, although fiscal consolidation will damp growth in the short term. Another energy price shock and the protracted weakness of key trading partners are the main downside risks.

Assessment of transition qualities (1-10)



Structural reform developments

Financing conditions are easing. In June 2023 the CNB eased mortgage-lending limits and reduced the counter-cyclical capital buffer from 2.5 per cent to 2 per cent. This was in response to a major decline in loan volumes following an earlier tightening of monetary policy. In addition, from January 2024, businesses will be able to keep accounts in a foreign currency (euros, dollars or pounds) if they use that currency frequently.

Corporate restructuring is being made easier. In August 2023 parliament approved a law lowering the majority threshold needed for a decision to be made from 90 per cent to 75 per cent. The new bill, once signed into law, has potential consequences for the CEZ energy group, of which the state owns 70 per cent. Increased control over energy generation could allow the state to influence the energy market more directly, subject to EU notification procedures. Meanwhile, CEZ announced a potential bid for three small modular reactors, which could generate one gigawatt of power by 2040. The first reactor is planned to be completed in 2032 at the Temelín nuclear power station; the other two will eventually replace part of the capacity at the Dětmarovice and Tušimice coal-fired power plants. Contracting is still in the early phase, particularly for the latter two reactors.

Pension reform is advancing. Reforms in this area have been somewhat piecemeal, and some have faced significant opposition. The cabinet has announced reforms to the retirement age, but not yet signed them into law. So far, the legal changes to the system include smaller but more accurate indexation, conditions that limit early retirement through indexation cuts and adjustments to benefits for the self-employed.

Energy compensation measures are likely to be discontinued in 2024. This move would be in line with the European Commission's recommendations and falling energy prices. Current energy price ceilings apply to households and to small and large businesses, with additional limits and rules around profitability eligibility for the latter. They are theoretically financed by windfall taxes on the banking, energy and petrochemical sectors, which the government forecasts to reach CZK 46 billion (€1.9 billion) in 2023. Although the windfall taxes are due to be removed in 2025, the Ministry of Finance is considering removing them (and the energy price cap) sooner.

The use of EU funds has stepped up. The authorities had used 87.1 per cent of the country's 2014-20 EU Multiannual Financial Framework funds by August 2023, alleviating concerns that major funds would be lost due to insufficient absorption. Separately, the Czech Republic requested only CZK 19.4 billion (€800 million) in loans from the Recovery and Resilience Facility, effectively cancelling some planned investments as part of a fiscal tightening drive.

The economy is absorbing increasing numbers of Ukrainian refugees. As of the middle of 2023, 46 per cent of the approximately 220,000 Ukrainian refugees of working age in the Czech Republic were employed. According to rules announced in June 2023, the state will support refugee housing for five months, but will stop providing indefinite support to private families housing refugees.

Estonia

Highlights

- **The economy continues to contract.** Net exports have slumped, reflecting persistent inflationary pressures and subdued demand in the region, but domestic inflation is now on a downward trend, with real wage growth turning positive again.
- **Estonia aims to enhance energy independence and renewable energy with European Union (EU) REPowerEU funds.** Ninety million euros in funds from REPowerEU, approved in December 2022, are expected to help the country counteract future energy shocks and accelerate the move to renewable energy.
- **Healthcare reforms are under way, targeting the accessibility and affordability of long-term care.** The country implemented the first reform in July 2023, which focused on reducing the costs of general care services and prepared the way for further reforms to enhance the quality and affordability of healthcare services.

Key priorities for 2024

- **Further efforts are needed to achieve energy independence from Russia.** This will require, among other things, Estonia to disengage from the Belarus, Russia, Estonia, Latvia and Lithuania (BRELL) power system by early 2025 and take steps to ensure the country has stable liquefied natural gas (LNG) sources if there are supply disruptions.
- **Green transition should be advanced towards the 2030 energy and climate targets.** The focus in the short term should be on attracting enhanced investments in renewable energy sources and retrofitting the housing stock for energy efficiency.
- **The Recovery and Resilience Plan (RRP) should be implemented in a timely way.** The country is set to receive a total of €3.5 billion from the 2021-27 EU budget for the green transition and socioeconomic development. However, further efforts are needed as the country has been slow to fulfil its RRP milestones and targets.

Main macroeconomic indicators (per cent)

	2019	2020	2021	2022	2023 proj.
GDP growth	4.0	-1.0	7.2	-0.5	-1.8
Inflation (average)	2.3	-0.6	4.5	19.4	10.0
Government balance/GDP	0.1	-5.4	-2.5	-1.0	-3.5
Current account balance/GDP	2.5	-1.9	-2.6	-3.2	1.9
Net FDI/GDP [neg. sign = inflows]	-3.8	-10.7	-2.4	-0.3	-0.4
External debt/GDP	75.6	88.7	85.1	84.7	n.a.
Gross reserves/GDP	n.a.	n.a.	n.a.	n.a.	n.a.
Credit to private sector/GDP	59.8	63.8	60.3	58.3	n.a.

Macroeconomic developments and policy response

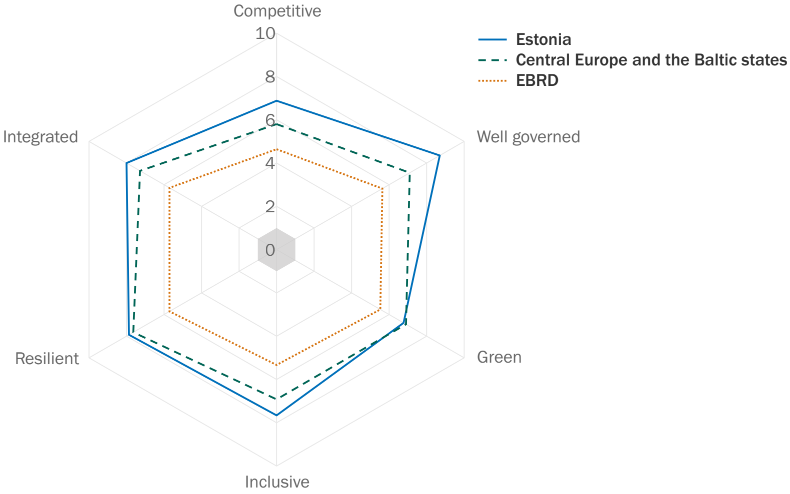
The economy remains in recession but is showing signs of a slow recovery. Gross domestic product (GDP) shrank by 3.3 per cent year on year in the first half of 2023 after contracting by 0.5 per cent in 2022, owing largely to the fallout from the war on Ukraine. Persistent inflation has taken a toll on real wages, and hence private consumption, while investment has continued to decline. Exports and imports are both falling due to weaknesses in the economies of key trading partners, resulting in worsening employment in sectors such as industry and trade.

Inflation is falling. The inflation rate peaked at 25.2 per cent in August 2022 but has been on a downward trend since then, reaching 6.4 per cent in July 2023, largely thanks to reductions in food, housing and transport prices. A further drop in inflation is likely as uncertainty concerning the war on Ukraine continues to translate into slower demand. Food and energy prices are easing, but retail sales (excluding vehicles) have fallen, reflecting the impact of past price increases on household consumption. The labour market remains tight, with an employment rate approaching historically high levels, but registered unemployment increased to 6.7 per cent in the second quarter of 2023. The country implemented several amendments to the Employment Contracts Act and Occupational Health and Safety Act, and the government raised the national monthly minimum wage from €654 to €725 in the winter of 2023.

Fiscal policy remains prudent. The government budget recorded a deficit of just 0.9 per cent of GDP in the first half of 2023. This result was better than expected and reflected higher tax revenues, partly owing to a strong rise in nominal wages. The deficit is forecast at 3.5 per cent of GDP for 2023 as a whole. To partially cover this deficit, in June 2023, the country increased the value of 10-year government bonds (worth €1 billion to date) by a further €500 million. General government debt in 2022 amounted to 18.4 per cent of GDP, still the lowest ratio in the EU.

An economic rebound is expected in 2024. Real GDP is forecast to shrink by 1.8 per cent in 2023, before recovering to 2 per cent growth in 2024. Private consumption is expected to pick up slowly in light of strong nominal wage growth in excess of inflation raising real disposable incomes. Exports are expected to remain subdued, given limited demand resulting from ongoing weaknesses in key trading partners. Key risks to the outlook are linked to the uncertainty caused by the war on Ukraine and concerns about energy security and energy price fluctuations.

Assessment of transition qualities (1-10)



Structural reform developments

Healthcare reforms have begun. The reforms adopted by the parliament in 2022 aim to improve the accessibility and affordability of long-term care and strengthen the quality of healthcare services. According to Eurostat data, self-reported, unmet healthcare needs amounted to 9.1 per cent in Estonia in 2022, versus an EU average of 2.2 per cent. The first reform, implemented in July 2023, aims to reduce out-of-pocket payments for general care services. The changes are part of Estonia's 16 key reforms under the RRP.

The pan-Baltic capital market is set to benefit from single index classification. The new single index, which was launched at the same time as the August 2023 Index Review, will allow the three markets to be integrated into the Morgan Stanley Capital International (MSCI) universe and will raise the region's profile among international investors who track MSCI indices. The approach is in line with efforts made by the ministries of finance in Estonia, Latvia and Lithuania, the European Bank for Reconstruction and Development, the European Commission and Nasdaq Baltic to create a single pan-Baltic capital market, as outlined by a memorandum of understanding signed in November 2017. The approach is also a building block of the EU's capital markets union initiative.

Efforts to become independent of Russian energy are intensifying. Estonia, along with Lithuania and Latvia, is continuing to move towards disengaging from the BRELL power system. In view of Russia's ongoing war on Ukraine, the three Baltic states have signed an agreement to accelerate this disengagement and focus instead on connecting to the European grid in early 2025. This means that the countries will officially inform all parties of their disconnection from the Russia-linked grid as early as August 2024. Estonia and Latvia signed a memorandum of understanding in May 2023 to jointly use the LNG terminal in the port of Paldiski in Estonia, via a floating storage re-gasification unit. The agreement aims to enable countries to purchase LNG if there are disruptions in natural gas supply.

The largest green energy tender has been held. This tender was launched in March 2023 and bids were submitted until September 2023. Power generation is expected to start no later than July 2027. The tender is expected to provide Estonia with 650 GWh of green energy, supplying around 215,000 households. This is the fifth national tender of this type in Estonia conducted by Elering, the national transmission system operator for electricity and natural gas. In February 2023 the country introduced subsidies for individuals and businesses to purchase zero-emission vehicles. The subsidies are worth €4,000 for individuals and €5,000 for companies per car, and €1,250 and €1,000, respectively, per bicycle.

There have been delays in the mobilisation of EU funds. The country is at risk of losing hundreds of millions of euros because of delays in meeting the necessary conditions. Of the €126 million of pre-financing the Ministry of Finance received in December 2021, €100 million remains unused. The EU recovery measures need to be aligned with a strict spending schedule, with operations of €1 billion to be completed by the first half of 2026. The country may otherwise lose funding intended to help mitigate the effects of the pandemic.

REPowerEU funds are targeting energy independence and renewable energy. The government approved €90 million of funding from the EU REPowerEU facility in December 2022 to counteract energy shocks and accelerate the development of renewable energy. The funding will help the country to achieve its target of full reliance on renewable energy sources by 2030, increase biogas production and deployment, strengthen grid integration capacity and allocate energy efficiency grants for small houses.

A major wind farm project is under way. The country's largest onshore wind farm, which should be completed in 2025, will increase national wind production by around 80 per cent. Enefit Green, an Estonian renewable energy company, secured €180 million to finance the project in September 2023. The wind farm is intended to cover 8.5 per cent of the country's electricity consumption and 40 per cent of households' energy needs.

A new car tax to reduce CO_2 emissions has been approved. The tax was adopted among several other amendments to tax legislation that parliament approved in July 2023. The tax includes a one-time registration fee and an annual fee based on CO_2 emissions and luxury car components.

Hungary

Highlights

- **The economy entered into recession in the first half of 2023.** Hungary currently has the highest inflation in the European Union (EU), damaging households' purchasing power since late 2022, and the slowdown in consumption has been accompanied by ongoing fiscal consolidation and subdued investment.
- **The government launched its economic protection plan.** It is designed to alleviate the negative impacts of the Russian war on Ukraine, including high energy and food inflation, energy insecurity, supply-chain disruptions and tight financing conditions for companies and households.
- **New energy supply routes and sources have been secured.** While the government signed agreements on gas supplies from new sources, it has not reduced its dependence on Russian energy, unlike Hungary's peers in central Europe and the Baltic states.

Key priorities for 2024

- **To unfreeze EU funds, including those from the Recovery and Resilience Facility (RRF), all super-milestones must be implemented.** Rule of law is one of the key concerns of the European Commission, and it will be important to follow the recommendations of the anti-corruption working group, established in 2022, which published its first report in March 2023.
- **Fiscal sustainability would benefit from more market-friendly support measures.** Ongoing fiscal consolidation will be critical once Hungary triggers the EU's excessive deficit procedure, and more targeted (rather than universal) fiscal support measures would put the economy on a more sustainable path.
- **Checks and balances need to be preserved amid increased state participation in the economy.** The government should take particular care to ensure high corporate governance standards in sectors where the state is expanding its ownership, following the recent acquisition of two major telecommunications companies and the announcement of plans to increase state ownership in other strategic sectors.

Main macroeconomic indicators (per cent)

	2019	2020	2021	2022	2023 proj.
GDP growth	4.9	-4.5	7.1	4.6	-0.2
Inflation (average)	3.4	3.4	5.2	15.3	18.0
Government balance/GDP	-2.0	-7.6	-7.2	-6.2	-5.5
Current account balance/GDP	-0.8	-1.1	-4.2	-7.2	-1.0
Net FDI/GDP [neg. sign = inflows]	-0.6	-1.6	-2.1	-2.8	-2.0
External debt/GDP	74.3	84.3	87.3	91.0	n.a.
Gross reserves/GDP	19.4	26.2	23.9	23.3	n.a.
Credit to private sector/GDP	31.8	34.9	34.7	32.6	n.a.

Macroeconomic developments and policy response

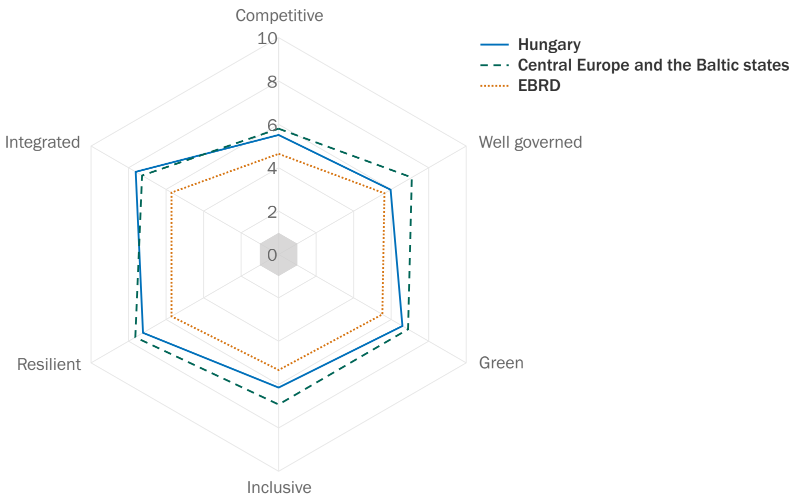
The economy entered a recession in the first half of 2023. Following robust growth in gross domestic product (GDP) of 4.6 per cent in 2022, economic activity shrank by 1.7 per cent year on year during the first half of 2023. The previous year's strong household consumption was largely fuelled by the government's pre-election fiscal expansion and anti-inflation shield programmes. But higher government spending led to elevated demand, and increased energy and food prices caused inflation to rise sharply, which has been damaging households' purchasing power since late 2022. Ongoing fiscal consolidation and decelerated investment have weighed on GDP performance since the fourth quarter of 2022. Fiscal consolidation in 2022 forced a freeze of several infrastructure investments, and total investment grew by just 0.1 per cent in 2022. It since plunged by 10.7 per cent in annual terms in the first half of 2023.

Inflation rates are the highest in the EU. The annual Harmonised Index of Consumer Prices (HICP) inflation rate peaked at 26.2 per cent in January 2023, and while it has been falling since then, it was still the highest among EU member states as at September 2023, at 12.2 per cent. As a result, real wages have been decreasing since the middle of 2022, dropping by 14 per cent year on year as at August 2023. The unemployment rate remains at a historical low, below 4 per cent since summer 2021, and the government relaunched its job-creation programme in January 2023 with the aim of keeping the economy at full employment during the current slowdown. Through subsidising employers' wage costs, the programme is expected to create more than 20,000 jobs, with a total cost of HUF 17.6 billion (€45.8 million).

Fiscal consolidation continues, but subsidised utility prices have been extended into 2024. The government has focused on fiscal consolidation, which led to a narrowing of the general government deficit to 6.2 per cent of GDP in 2022. Further savings are expected in 2023 and 2024, in line with plans to generate savings and enhance the efficiency of public spending. The government launched a public spending review to address the EU country-specific recommendations from May 2023. The general government deficit is expected to fall to 5.5 per cent of GDP this year before dipping below 3 per cent of GDP in 2024, as stated in the 2024 budget law, which parliament approved in July 2023. At the same time, the government earmarked HUF 1,340.7 billion (€3.5 billion, 2 per cent of GDP) in the 2024 budget to support regulated utility prices, to be largely financed out of windfall taxes on energy suppliers. These measures include subsidies to utilities to cover losses stemming from the fixed regulated utility prices, and support schemes for energy-intensive companies.

Economic growth stalled in 2023 but should pick up in 2024. Stagnant external demand and postponed investments, amid tight financing conditions and delayed inflows of EU funds, will likely result in a 0.2 per cent contraction of GDP in 2023. However, with inflation on a downward path from current highs, household purchasing power is expected to start improving in late 2023, as nominal wages continue to grow at double-digit rates. A recovery in economic activity, of 2.8 per cent, is forecast in 2024, when domestic demand strengthens and planned investments, some funded by the EU and others by foreign direct investors, materialise.

Assessment of transition qualities (1-10)



Structural reform developments

New energy supply routes and sources have been secured. The government wants to reduce its dependence on energy imports. Amid increasing solar electricity generation, more electricity should be produced in the new Russian-built Paks nuclear power plant. In August 2023 the expansion of the nuclear plant entered the construction phase and electricity production is expected by the beginning of the next decade. The government has secured new liquefied natural gas (LNG) deliveries from Azerbaijan and Croatia, and is working on new potential deliveries from Romania and Qatar, as well as from Algeria through a new gas pipeline with Slovenia. At the same time, in April 2023 Hungary signed a new agreement with Russia to buy additional quantities of gas on top of the 4.5 billion cubic metres per year under the ongoing long-term gas contract. There is also a continuous oil supply from Russia through the Druzhba pipeline through Ukraine. Meanwhile, in May 2023 the state-owned oil and gas group, MOL, signed a contract for oil deliveries via a Croatian pipeline, and in March 2023 it started supplying its refinery in Bratislava with its own crude oil extracted in Azerbaijan, where the company has a 9.57 per cent stake in an oil field.

Mandatory food price discounts and a price monitoring system have been introduced. Both initiatives were launched in June 2023 because the food price caps were set to terminate in August 2023. The mandatory price discount scheme is another anti-inflation tool that forces supermarkets to provide a 15 per cent discount, from the lowest price in the preceding 30 days, on one food product from each of 20 categories, to be applied on a weekly basis. At the same time, the competition authority launched a new price monitoring system that allows customers to browse through the offers of six retail chains.

Progress on the rule of law is uneven, delaying the disbursement of EU funds. Hungary will be able to tap into funding from the RRF only once it has fulfilled 27 super-milestones, mostly concerning the rule of law, requested by the European Commission in November 2022. In addition, in December 2022 the Commission approved Hungary's partnership agreement on 2021-27 cohesion funds worth €21.7 billion, to be allocated among 11 operational programmes supporting regional development, digitalisation, green investment and inclusion. In its July 2023 Rule of Law Report, the Commission noted some progress, but reiterated its concerns with respect to Hungary's judicial system, especially its lack of transparency around case allocations in lower courts and the lack of a robust track record of investigating corruption allegations concerning high-level officials. Pending the Commission's green light, further delays in the disbursement of EU funds are possible.

Subsidised loan programmes have been launched. In December 2022 state-owned development bank MFB launched its lending scheme for small and medium-sized enterprises (SMEs), worth HUF 313 billion (€820 million), to help reduce SMEs' operating costs through fixed, zero-interest-rate loans. In January 2023 state-owned Eximbank launched a corporate lending programme, extended to HUF 1,000 billion (€2.6 billion), to provide companies with forint loans capped at 6 per cent interest and euro-denominated loans fixed at 3.5 per cent interest. On top of the existing subsidised loan schemes, a three-pillar capital support programme worth HUF 600 billion (€1.6 billion) was launched in March 2023. Its first pillar, worth HUF 150 billion (€390 million), is designed to support the construction sector, including green construction, and investments on the Budapest stock exchange. The government aims to provide financial support to the economy worth HUF 3,600 billion (€9.4 billion or 5 per cent of GDP) in order to help companies secure cheaper financing and refinance their maturing loans from the Funding for Growth Scheme (FGS), the central bank's previous subsidised lending scheme. The schemes damp the negative economic impact of tight monetary policy, but also weaken the monetary transmission mechanism.

The government is encouraging savings in sovereign bonds. In June 2023 the government introduced a new 13 per cent social contribution tax on incomes generated from exchange-rate gains on bank deposits, investment funds and life insurance. In practice, it constitutes a form of capital control. The personal income tax rate of 15 per cent on capital gains is still in place on the remaining taxable income once payments to the new social contribution tax is deducted. In contrast, investments in government bonds are exempt from the new tax.

Latvia

Highlights

- **The economy continues to stagnate in 2023, but inflation is falling.** Inflationary pressures in the past year have contributed to reduced private consumption, low investment growth and disruptions in industrial production.
- **European Union (EU) funds are being targeted at energy efficiency and the electricity transmission system.** In October 2022 the country received the first disbursement of €201 million as a part of the EU's Recovery and Resilience Facility (RRF) and is now planning to invest in the electricity transmission system with the support of EU funds amounting to €135 million between 2024 and 2033.
- **The government launched programmes to enhance leadership skills and innovation in higher education institutions.** The programmes are expected to be supported by the European Regional Development Fund (ERDF).

Key priorities for 2024

- **Further efforts are needed to achieve energy independence from Russia.** The authorities should push ahead with plans to disconnect from the Belarus, Russia, Estonia, Latvia and Lithuania (BRELL) power system and connect instead to the European grid. Progress should also be made towards investing in reconstructing the energy system's substations, lines and distribution points.
- **The Green Economy Transition (GET) approach should be pursued vigorously.** The authorities should continue to focus on reducing greenhouse gas emissions and increasing the use of renewable energy based on improved energy and resource efficiency, including by using RRF funds to implement a programme on the energy efficiency of apartment buildings.
- **Further reforms of the higher education system are needed.** Following the programmes aimed at facilitating innovation and expanding leadership capabilities in 2023, the authorities should focus on increasing competitiveness by creating new opportunities to improve the development and governance of higher education institutions.

Main macroeconomic indicators (per cent)

	2019	2020	2021	2022	2023 proj.
GDP growth	0.6	-3.5	6.7	3.4	0.3
Inflation (average)	2.7	0.1	3.2	17.2	9.0
Government balance/GDP	-0.5	-4.5	-7.2	-4.6	-3.7
Current account balance/GDP	-0.6	2.9	-3.9	-4.7	-3.0
Net FDI/GDP [neg. sign = inflows]	-2.9	-2.2	-2.5	-3.2	-2.6
External debt/GDP	116.7	121.5	109.6	100.5	n.a.
Gross reserves/GDP	n.a.	n.a.	n.a.	n.a.	n.a.
Credit to private sector/GDP	36.7	34.9	32.4	29.4	n.a.

Macroeconomic developments and policy response

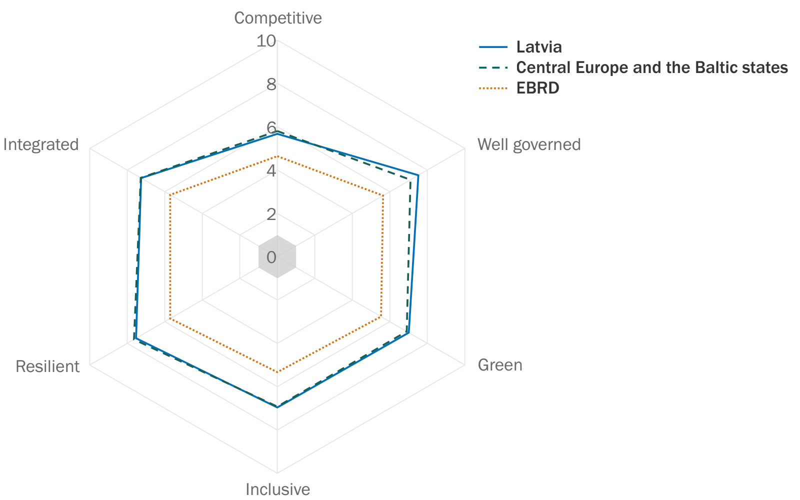
Economic growth remains subdued. The economy grew by 3.4 per cent in 2022, but high inflation and soaring energy prices have affected private consumption and investment. As a result, the gross domestic product (GDP) growth in the first half of 2023 was around zero year on year. Real wages have been falling because of the elevated inflation rate, while the ongoing war on Ukraine is taking a toll on Latvian exports. Industrial production has struggled, given energy supply difficulties and supply chain disruptions, which have led to a fall in manufacturing output.

Inflation is falling gradually from double-digit levels. The annual inflation rate peaked at 22 per cent in September 2022, but has fallen to single-digit levels since June 2023, with a further decline expected in the second half of the year, partly as a result of stabilising energy prices. Despite economic difficulties, the registered unemployment rate remains historically low, at 6.5 per cent in the middle of 2023, contributing to rising nominal wages and some persistence in inflationary pressures. Labour shortages are the main driver of wage growth, especially in the agriculture, mining and utilities sectors.

The general government budget deficit is declining. The government's fiscal deficit amounted to €137.7 million (around 0.4 per cent of GDP in 2022) in the first half of 2023, nearly 40 per cent lower than in the same period in 2022. Key spending priorities include pursuing the country's energy transition and maintaining national security as the war on Ukraine persists. The government is continuing to compensate for high energy prices with a spending package amounting to €417 million (0.96 per cent of GDP) in the first half of 2023 and a €34 million support package for Ukrainian refugees. These measures are planned to be phased out gradually.

Low economic growth is set to continue. The economy is projected to return to modest growth in the second half of 2023, following the contraction in the second quarter. We forecast 0.3 per cent GDP growth in 2023, increasing to 2 per cent in 2024. The outcome will be largely influenced by falling, but still significant, price growth and persistently weak consumer sentiment reflecting inadequate private consumption. Low investment is expected to continue, but a slight boost is likely given structural EU funds are available. Downside risks to the forecast remain, associated with high core inflation supported by wage increases.

Assessment of transition qualities (1-10)



Structural reform developments

Support programmes to be phased out. Crisis-support programmes covering energy price subsidies and support for Ukrainian refugees are planned to be progressively withdrawn in favour of one-off safety measures and possible compensation for future energy surges. The energy support included a fixed tariff of up to 100 kWh for households, compensation for central heating costs, transfers to households in difficult situations, and a suspension of the electricity services tariff for legal entities.

The pan-Baltic capital market is set to benefit from single index classification. The new single index, which was launched at the same time as the August 2023 Index Review, will allow the three markets to be integrated into the Morgan Stanley Capital International (MSCI) universe and will raise the region's profile among international investors who track MSCI indices. The approach is in line with efforts made by the ministries of finance in Estonia, Latvia and Lithuania, the European Bank for Reconstruction and Development, the European Commission and Nasdaq Baltic to create a single pan-Baltic capital market, as outlined by a memorandum of understanding signed in November 2017. The approach is also a building block of the EU's capital markets union initiative.

Higher education reforms are under way. The government launched new programmes funded by the ERDF in January 2023, following the legislative changes adopted in 2022. The programmes cover modules to enhance leadership and support innovative projects in higher education institutions. Latvia ranked third lowest among all EU member states on the European Innovation Scoreboard in 2023, lagging behind in financing research and development in particular. In addition, Latvia is expected to receive a total of €82.5 million in RRF grants to improve the capacity of educational institutions.

Latvia is moving towards energy independence from Russia. Along with its neighbours Lithuania and Estonia, the country is focused on disconnecting from the BRELL power system. The three Baltic countries have signed an agreement to accelerate this disconnection and focus on connecting to the European grid in early 2025. This means that the countries will officially inform all parties of their disconnection from the Russia-linked grid as early as August 2024. Latvia and Estonia signed a memorandum of understanding in May 2023 to jointly use the liquefied natural gas (LNG) terminal in the port of Paldiski in Estonia, via a floating storage regasification unit. The agreement aims to enable countries to purchase LNG if there are disruptions in natural gas supply.

EU funds are supporting investment in the electricity transmission system. A total of €509.8 million will be allocated to investments connecting Latvia to the EU energy system. Of this total, approximately €135.8 million will come from EU funds. The measures are aimed at reducing dependence on Russian electricity while synchronising with the European grid. The allocation plan will run until 2033 and includes €188.8 million for the network and between €21 million and €30 million to be invested annually in reconstructing substations, lines or distribution points.

A new energy efficiency programme is in place. The energy efficiency of apartment buildings 2022-26 programme financed by the RRF was launched in December 2022. The programme includes €57.3 million of financial assistance in the form of subsidies, loans and guarantees to improve efficiency and energy management, and the use of renewable energy sources. When completed, the programme is expected to deliver at least 30 per cent energy savings in multi-family buildings.

A large solar park is being built. European Energy, a privately owned Danish renewable energy developer, will build a solar park in the south-western part of the country. The project entered the final development stages in August 2023, and the park is expected to be connected to the Latvian grid by 2025. When completed, the installed capacity of the park is set to be 115 MW, projected to generate enough energy for around 57,000 Latvian households per year.

Lithuania

Highlights

- **Gross domestic product (GDP) fell in the first half of 2023.** The drop is largely the result of reduced industrial activity that reflects weak external demand, subdued consumption amid high inflation, and persistent uncertainty, which is affecting confidence.
- **The European Union's (EU) Recovery and Resilience Facility (RRF) funds have helped the country to boost investment.** The country received the first payment of €542 million under the RRF in May 2023, having fulfilled 31 out of 33 milestones required for the disbursement. In October 2023 Lithuania's Recovery and Resilience Plan (RRP) was being amended to include a new REPowerEU chapter and will be submitted to the European Commission by the end of 2023. In addition, Lithuania has requested that the RRP be supplemented with an additional €1.6 billion in loans to promote business investments in green, innovative and digital technologies, and in producing and exporting high value-added products.
- **In 2022 Lithuania stopped importing energy from Russia, marking an important step towards energy independence.** Lithuania continues to work towards an ambitious goal of meeting all of its domestic electricity needs with renewables by 2030.

Key priorities for 2024

- **Further measures to become fully independent from the Russian power system are being implemented.** A key step will be to disconnect from the Belarus, Russia, Estonia, Latvia and Lithuania (BRELL) power system and to synchronise the Baltic states' electricity systems with the synchronous area of continental Europe, planned to take place in February 2025.
- **Investments in offshore wind farms will help the country to become an energy exporter by 2030.** Successful completion of a tender in October 2023 for a €1.83 billion investment for the construction of an offshore wind farm would help reach the target of making it operational by 2030, with a capacity of 700 MW. Another tender for a wind farm, also with a capacity of 700 MW, is planned to be announced in January 2024, and it is expected that two offshore wind power plants will become operational by 2030.
- **Full use of all EU funds under the RRF is needed.** The concentration of domestic reforms and investments should be aimed at stimulating the economy and gradually eliminating structural weaknesses, along with a green and digital transition. The consolidation of four Lithuanian development agencies into one is well under way and could boost further mobilisation of the RRF funds.

Main macroeconomic indicators (per cent)

	2019	2020	2021	2022	2023 proj.
GDP growth	4.7	0.0	6.3	2.4	-0.5
Inflation (average)	2.2	1.1	4.6	18.9	9.0
Government balance/GDP	0.5	-6.5	-1.1	-0.7	-1.8
Current account balance/GDP	3.5	7.3	1.1	-5.5	0.5
Net FDI/GDP [neg. sign = inflows]	-2.3	-1.1	-2.2	-2.5	-2.0
External debt/GDP	70.0	80.7	78.9	67.6	n.a.
Gross reserves/GDP	n.a.	n.a.	n.a.	n.a.	n.a.
Credit to private sector/GDP	39.6	37.5	37.4	35.9	n.a.

Macroeconomic developments and policy response

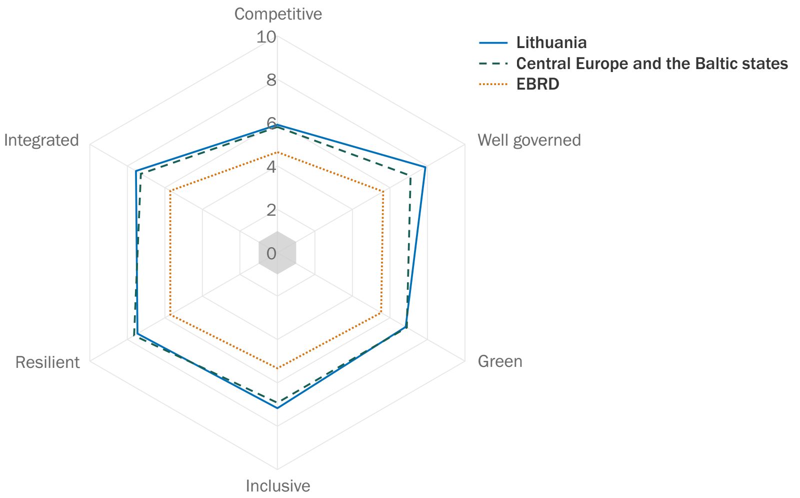
The economy is set to contract mildly in 2023, although a strong rebound of 2.4 per cent in the second quarter suggests there may be a recovery. Following a slowdown in GDP growth to 2.4 per cent in 2022, the economy shrank by 0.8 per cent on a year-on-year basis in the first half of 2023. Weak economic performance was largely driven by uncertainty related to Russia's war on Ukraine, inflationary pressures, tightening credit conditions and sluggish external demand, which affected industrial activity. Unemployment remains close to historically low levels, reaching 6.3 per cent in the second quarter of 2023. Despite elevated energy prices and weakness in the industrial sector, the labour market remains resilient.

Inflation has declined from high levels. After peaking at 24.1 per cent in September 2022, the inflation rate has been decreasing steadily, reaching 4.1 per cent in September thanks to lower food, transport and housing utility prices. Inflation should be on a further downward trend in 2024. Average wages continue to rise strongly, to double digits, surpassing the rate of inflation and supporting the recovery of households' purchasing power. The 15 per cent rise in the minimum wage in January 2023, along with the government's temporary subsidy programmes during the energy-price-shock period, provided substantial support for individuals at the lower end of the income distribution. The demand for household loans is on a downward trend, reflecting elevated uncertainty and high interest rates.

The government introduced subsidies for energy and gas prices. To mitigate the economic and social impacts of high energy prices, the government adopted a new support package worth €557 million at the start of 2023, introducing subsidies on energy and gas for households and businesses. As the energy market stabilises, the energy support measures have been gradually withdrawn: the partial subsidy on electricity prices for businesses was terminated in the first quarter of 2023; the electricity support scheme for households was discontinued in the second half of 2023; and gas subsidies for households and business will not continue beyond the end of 2023. The drop in wholesale gas and energy prices has resulted in the government spending significantly less than planned on these schemes, and the budget deficit is now expected at 1.9 per cent of GDP in 2023. No support measures are planned for 2024.

Negative growth in 2023 should be followed by a modest recovery in 2024. GDP is projected to grow by 1.5 per cent in 2024, driven by recovering household consumption, as wage growth will substantially outpace inflation. This growth will also be driven by better external demand for Lithuanian exports. EU funds directed towards public investment will also contribute to increased economic activity. However, downside risks remain, associated mostly with geopolitical developments and main trading partners' economic conditions.

Assessment of transition qualities (1-10)



Structural reform developments

The government presented and submitted a tax reform to parliament for discussion. The tax reform aims to provide a tax system that is more balanced, supports growth and improves social fairness. The package responds to some of the key recommendations made over the years by international organisations and financial institutions, such as broadening the tax base and addressing the complexity of the various forms of economic activity. Among the measures in the package aimed at stimulating growth are the immediate depreciation deduction for fixed assets to encourage productive investments, and the increase in the annual income threshold for businesses to register as value-added tax (VAT) payers. The reform also proposed expanding the scope of real-estate tax, introducing more consistent progressivity on high-income earners and bringing the taxation of self-employed workers' incomes closer to that of workers in standard employment, thus broadening the coverage of social security guarantees.

The pan-Baltic capital market is set to benefit from single index classification. The new single index, which was launched at the same time as the August 2023 Index Review, will allow the three markets to be integrated into the Morgan Stanley Capital International (MSCI) universe and will raise the region's profile among international investors who track MSCI indices. The approach is in line with the efforts made by the ministries of finance in Estonia, Latvia and Lithuania, the European Bank for Reconstruction and Development, the European Commission and Nasdaq Baltic to create a single pan-Baltic capital market, as outlined by a memorandum of understanding signed in November 2017. The approach is also a building block of the EU's capital markets union initiative.

Lithuania successfully cut off fossil-fuel imports from Russia. Following the opening of the Poland-Lithuania gas interconnection in May 2022, Lithuania strengthened its links with Latvia by completing a gas interconnection in December 2022. Moreover, Lithuania, together with Estonia and Latvia, took measures to synchronise with the western European power system and disconnect from the BRELL power system. The country has installed four large-scale electricity storage facilities in Vilnius, Siauliai, Alytus and Utena with a total capacity of 200 MW to provide a reserve of energy. According to the Ministry of Energy, the country is on track to notify BRELL counterparts in August 2024 of its disconnection, and to cut off the eastern power system by early 2025.

New EU funds are being added to foster green transition and digitalisation. In June 2023 the authorities requested a REPowerEU chapter to be added to Lithuania's RRP. In addition, the government plans to expand the RRP with an additional €1.6 billion in loans to promote business investments in green, innovative and digital technologies, and in producing and exporting high value-added products. Lithuania expects amendments to be adopted by the end of this year.

In May 2023 the country received the first payment of €542 million under the RRF. Once all conditions are met, a further payment of €260 million is expected before the end of 2023. The funds are directed at supporting climate objectives and fostering the digital transition. According to the European Commission, the country satisfactorily fulfilled 31 out of 33 milestones before receiving the payment.

Excise tax reform is contributing to the green transition. In May 2023 the parliament approved a package of fuel excises discouraging the use of the environmentally harmful fuels. The package includes withdrawing (narrowing) subsidies for fossil fuels, and introducing CO_2 components to the excise duty structure, which will support the country's green transition.

Renewable energy is being developed. In March 2023 the Lithuanian National Energy Regulatory Council (VERT) opened the tender process for the construction of an offshore wind farm. The investment will amount to €1.83 billion, with an estimated capacity to provide up to a quarter (700 MW) of the country's total electricity needs. The wind farm is expected to be operational by 2030. In 2022 wind power production in Lithuania accounted for 13.5 per cent of total consumed energy. In the longer term, Lithuania has set an ambitious target for renewables (mainly offshore wind and solar) to cover all domestic electricity demand by 2030.

Poland

Highlights

- **Economic activity has slowed sharply, as higher prices are affecting households' purchasing power.** Following strong gross domestic product (GDP) growth of 5.3 per cent in 2022, the economy shrank in annual terms during the first half of 2023 amid still high, though falling, inflation.
- **Child benefits and pensions have been increased.** The per-child allowance was raised from PLN 500 (€110) to PLN 800 (€180) per month from January 2024, while pensioners will now benefit from payments of 13th and 14th month pension bonuses, which are set to be paid on a permanent basis in the future.
- **A subsidised mortgage loan programme for first-time house buyers has been launched.** The subsidised loans have an interest rate of just 2 per cent, plus the bank's margin, for the first 10 years, with the state covering the difference between the average fixed market rate and 2 per cent.

Key priorities for 2024

- **Investments in renewable energy and energy storage should be scaled up.** More investment in grid infrastructure, including grid connections, grid strengthening and cross-border electricity interconnections, is required to align with the requirements of a modern energy system that can accommodate a high share of intermittent renewable energy sources, such as offshore and onshore wind or solar.
- **Transport and logistics infrastructure in eastern Poland needs to be developed.** Better intermodal transport infrastructure, including road, rail and shipping, would improve connectivity, increase capacity and ensure smoother border crossings. Together with increased warehouse space in eastern Poland, investment in infrastructure will be critical for Polish companies wishing to expand eastwards once Ukraine's post-war reconstruction is under way.
- **Social support should be targeted at the most vulnerable groups only.** The current fiscal position highlights the need to avoid making commitments to untargeted and costly social programmes.

Main macroeconomic indicators (per cent)

	2019	2020	2021	2022	2023 proj.
GDP growth	4.4	-2.0	6.9	5.3	0.6
Inflation (average)	2.1	3.6	5.2	13.2	12.0
Government balance/GDP	-0.7	-6.9	-1.8	-3.7	-5.3
Current account balance/GDP	-0.2	2.4	-1.3	-2.4	1.0
Net FDI/GDP [neg. sign = inflows]	-2.0	-2.4	-3.8	-3.7	-3.5
External debt/GDP	58.9	60.7	56.5	53.0	n.a.
Gross reserves/GDP	21.6	25.6	24.4	24.2	n.a.
Credit to private sector/GDP	50.3	47.7	45.2	39.2	n.a.

Macroeconomic developments and policy response

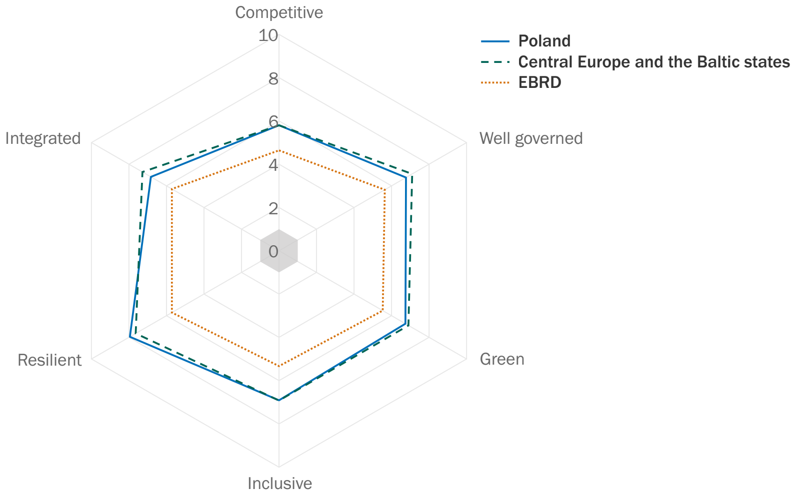
High inflation and tighter financing conditions are weighing on GDP growth. Economic activity remained robust in 2022, with GDP growing by 5.3 per cent, but it dropped sharply to -1 per cent year on year in the first half of 2023. The high growth in inventories has been the key economic driver for the last two years, amid uncertainty related to disrupted value chains and weakening household consumption. Subdued external demand has negatively affected exports, but recently stabilised energy prices have provided some relief to the economy, helping to turn the current account into a surplus in the first half of 2023. Investment remains robust, recovering to 8 per cent year on year in the first half of 2023, but the high financing costs weigh mostly on housing investments.

Inflation is coming down and real wage growth has turned positive again. The harmonised index of consumer prices (HICP) peaked in February 2023 at 17.2 per cent and has fallen since then, settling at 7.7 per cent in September 2023. As a result, the economy-wide real wage growth turned positive in June 2023 for the first time since the end of 2021. While the average household budget is expected to gain amid double-digit nominal wage growth and decelerating inflation, household purchasing power is expected to rise only slightly in 2023. Structurally, labour market pressures have been eased to some extent by the inflows of refugees and migrants, counterbalancing unfavourable demographic trends. However, this effect has not endured, as some Ukrainian refugees have been conscripted into Ukraine's army.

The general government deficit remains high. Substantial energy support measures, estimated at 2.4 per cent of GDP, remaining anti-Covid expenditures (0.7 per cent of GDP) and the costs of supporting Ukraine's refugees (0.5 per cent of GDP) all contributed to a general government deficit of 3.7 per cent of GDP in 2022. Further, increased defence spending, expected at 4.2 per cent of GDP in 2023, and possible enhanced energy support measures (depending on energy prices), are expected to substantially increase government spending this year and in 2024. As a result, the budget law was amended in July 2023 to include a "defence clause" to reflect the discrepancy between prepayments for the purchase of military equipment and actual deliveries of equipment. Poland is likely to find itself operating under the European Union's (EU) excessive deficit procedure in 2024, based on the deficit out-turn of 2023. The European Commission forecasts Poland's general government deficit at 5 per cent and 3.7 per cent of GDP in 2023 and 2024, respectively.

The current drop in GDP growth should ease in 2024. GDP is forecast grow by just 0.6 per cent in 2023. However, further positive real wage growth, low unemployment, an improvement in consumer sentiment and a slight easing in monetary policy are expected to fuel a recovery in GDP growth in 2024, forecast at 2.7 per cent. Further delays in Recovery and Resilience Facility (RRF) transfers and uncertainty about potential increases in energy prices constitute the main risks to that scenario.

Assessment of transition qualities (1-10)



Structural reform developments

The government is pre-financing some RRF-related programmes. In March 2023 the wind farm bill, which liberalises where onshore windfarms can be located, was passed into law. The bill was one of two milestones that Poland had to pass to unlock RRF transfers. The other milestone concerns judicial reform (see below), but an unresolved dispute means this has stalled. As a result, the Polish Development Fund (PFR) started to pre-finance RRF programmes using its own resources. Poland's Recovery and Resilience Plan (RRP) was approved by the European Commission in June 2022 and is based on €23.9 billion in grants and €33.5 billion in loans. The government boosted the latter amount in April 2023 to enable greater investments in the energy system, the green transition of cities, gas infrastructure and the healthcare sector.

EU concerns about the rule of law are not yet resolved. In February 2023 the parliament passed an amended law on the Supreme Court, which was meant to address a key European Commission milestone to unlock RRF funds. However, the bill was not signed by the president and it is currently with the Constitutional Tribunal for examination. Meanwhile, the Court of Justice of the European Union (CJEU) ruled in June 2023 that the Polish justice reform of December 2019 "infringes EU law".

Poland's first offshore wind farm is expected to support the country's renewable energy generation and help it reach its decarbonisation targets. In October 2023 Baltic Power, a special purpose vehicle jointly owned by ORLEN, the Polish multi-utility company, and Northland Power, a Canadian independent power producer, received a final investment decision to construct the wind project in the Baltic Sea. Once fully operational, the wind farm, which will have a capacity of up to 1.2 GW, is expected to generate electricity equivalent to 4,000 GWh or approximately 2-3 per cent of Poland's current electricity generation.

Coal mining companies need to pay a windfall tax. In July 2023 parliament approved a 33 per cent windfall tax on coal-mining companies, to be levied on profits exceeding 120 per cent of 2018-21 average profits. The expected revenues amount to PLN 2 billion (around €450 million) in 2023. At the same sitting, a bill was approved that raises the maximum amount of household energy consumption covered by capped prices (at 2022 levels) by 1,000 kWh annually. Price caps will likely remain as such until the end of 2023, when all electricity subsidy schemes are set to expire. The cost of these energy subsidy schemes, including those for gas bills, is expected to be partially covered by windfall tax revenues, as well as temporary levies imposed on firms engaged in production and distribution of electricity and gas, which were legislated on in October 2022.

Price-suppressing measures on food have been extended. In June 2023 the government extended a zero VAT rate on most food products until the end of the year. The measure is expected to cost PLN 11 billion (€2.5 billion) in 2023. According to government estimates, this measure should cut about 0.3-0.5 percentage points from headline inflation.

Child benefits and pensions have been increased. In August 2023 the government increased the current per-child monthly payment of PLN 500 (€112) to PLN 800 (€180) from January 2024. The programme is effectively an indexation of the Family 500+ scheme introduced in April 2016. The total cost of the programme is expected to be PLN 63.7 billion annually (€14.3 billion, 1.9 per cent of GDP), or about 1 per cent of GDP higher than the existing costs of the scheme. In addition, in May 2023 the government approved payment of a permanent 14th-month pension bonus (according to ESA 2010 not classified as pension expenditures), after approving a (13th-month) pension bonus in 2019. The total cost of the indexed pension expenditures, including the two pension bonus payments, is estimated at PLN 80 billion (€18 billion), which brings total spending on pensions to PLN 320 billion (€71.7 billion, 9.7 per cent of GDP) in 2023.

A subsidised mortgage loan programme has been launched. The "Safe Credit 2 per cent" subsidised mortgage loan scheme started in July 2023 and is expected to attract up to 50,000 first-time house buyers by the end of 2024, according to the government. The subsidised mortgage loan has a reduced interest rate of 2 per cent, plus the bank's margin and commission (if it is charged), for the first 10 years, with the state covering the difference between the average fixed market rate and the 2 per cent rate. The programme is limited to those aged 45 or younger with loans up to PLN 600,000 (€134,000), and can be used for a first-time purchase, with PLN 200,000 (€45,000) as the maximum down payment. According to the Polish Bank Association (ZBP), the number of total mortgage loans is estimated to drop by 30 per cent in 2023 amid increased interest rates. The subsidised mortgage loan programme offsets that decrease to a large extent.

The banking sector remains profitable but legal risks related to Swiss franc mortgages have risen. The CJEU ruled in June 2023 that banks could not seek remuneration for invalidated Swiss franc loans, although borrowers might be able to. As a result, banks with significant Swiss franc loan portfolios now need to increase provisions in case of legal action, which would reduce their ability to finance the economy. According to the central bank, additional provisions needed to cover the cost of legal risk materialisation of Swiss franc housing loans would be about PLN 40 billion to PLN 50 billion (€9 billion to €11 billion) in 2023-25, depending on the number of out-of-court settlements signed. In 2022 Poland's banks increased their net profits to PLN 10.7 billion (€2.4 billion), from PLN 6.1 billion (€1.4 billion) in the previous year, largely due to high interest rates and strong economic activity.

Slovak Republic

Highlights

- **Gross domestic product (GDP) growth has slowed further in 2023.** Household disposable income has fallen, investment remains subdued amid high financing costs, and the use of European Union (EU) funds has been sluggish.
- **The country's Recovery and Resilience Plan (RRP) has been revised.** In July 2023 the EU Economic and Financial Affairs Council (ECOFIN) approved an amended RRP for the Slovak Republic, worth €6.4 billion in grants. The revised plan includes reforms and investments linked to REPowerEU, aimed at reducing the country's energy dependence on Russia and supporting the transition to a green economy.
- **Energy security has increased.** The third unit of the Mochovce nuclear power plant is expected to be running at 100 per cent by autumn 2023 and will cover nearly 13 per cent of the country's total electricity needs.

Key priorities for 2024

- **Energy price subsidies should be provided to vulnerable groups only.** Any extension of existing support schemes, which have kept energy price increases low, should be targeted at those most in need, in order to protect public finances and encourage the switch to more efficient and green energy production.
- **Reforms to support economic convergence with the EU need to be relaunched.** According to the latest central bank report, in addition to improving the business environment, reducing red tape and speeding up the digitalisation of the economy, the management of EU funds needs to be improved, as it has constituted a major constraint on economic development.
- **Investments in e-mobility need to be accelerated.** Amid growing technological competition from China, rapidly stepping up concentration on electric vehicle and battery production will help the Slovak Republic to maintain international competitiveness and employment in the automotive industry.

Main macroeconomic indicators (per cent)

	2019	2020	2021	2022	2023 proj.
GDP growth	2.5	-3.3	4.8	1.8	1.0
Inflation (average)	2.8	2.0	2.8	12.1	11.0
Government balance/GDP	-1.2	-5.4	-5.2	-2.0	-5.0
Current account balance/GDP	-3.3	0.6	-4.0	-7.3	-2.7
Net FDI/GDP [neg. sign = inflows]	-2.3	2.6	-1.3	-2.1	-1.0
External debt/GDP	112.3	119.6	134.1	103.1	n.a.
Gross reserves/GDP	n.a.	n.a.	n.a.	n.a.	n.a.
Credit to private sector/GDP	63.2	67.1	67.0	67.9	n.a.

Macroeconomic developments and policy response

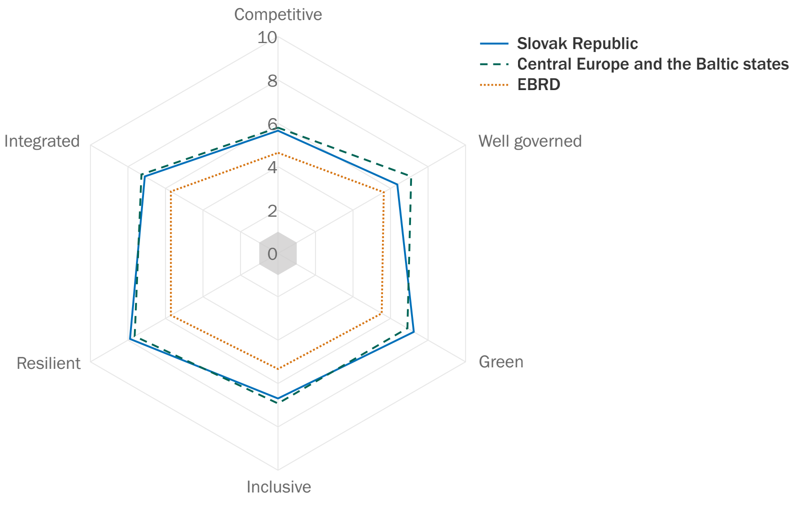
GDP growth has decelerated. After an impressive recovery in GDP growth to 4.8 per cent in 2021, economic growth slowed to 1.8 per cent in 2022 and 1 per cent year on year in the first half of 2023. High inflation rates have weighed on household disposable income, while elevated prices for imported energy have negatively affected the terms of trade. Increased financing costs, triggered by higher policy rates and an increased risk premium amid regional uncertainty related to the war on Ukraine, together with the slow use of EU funds, have held back domestic investment, although new investments in e-mobility are under way.

High inflation and rising indebtedness have triggered a surge in personal bankruptcies. In 2022 the number of personal bankruptcies increased almost 12 per cent from 2021 to 9,674 individuals, according to the Slovak Credit Bureau. At the same time, about 63 per cent of Slovaks are having difficulty making ends meet, with only 35 per cent living comfortably compared with the EU average of 54 per cent, according to the latest Eurobarometer survey. Inflation peaked at 15.4 per cent in February 2023 and has fallen since then, coming in at 9 per cent in September 2023.

Fiscal consolidation is needed amid widening budget deficits. Following a low budget deficit of 2 per cent of GDP in 2022, the European Commission expects the general government deficit to widen to more than 6 per cent of GDP in 2023, partly because of new measures to mitigate the effects of high energy bills. It forecasts public debt to increase to 58.3 per cent of GDP by the end of 2023. Fiscal consolidation will be a task for the new government to be formed after the September 2023 elections.

Economic activity is likely to pick up from current low levels in 2024. We forecast GDP growth of just 1 per cent in 2023, rising to 2.2 per cent in 2024, when households' purchasing power starts to improve (as inflation continues to fall) and external demand picks up. Key risks to the outlook include the persistently slow use of EU funds and potential political instability, which would hold back public investment. The labour market is expected to remain tight, with unemployment rates at historically low levels, but skills mismatches, a deteriorating demographic profile and high structural unemployment rates will all weigh on the country's medium- and long-term growth potential.

Assessment of transition qualities (1-10)



Structural reform developments

The country's RRP has been revised. In July 2023 ECOFIN approved an amended RRP for the Slovak Republic, worth €6.4 billion in grants. The revised plan includes reforms and investments linked to REPowerEU, aimed at reducing the country's energy dependence on Russia and supporting the green economy transition. In March 2023 the Slovak Republic received the second tranche of its Recovery and Resilience Facility (RRF) grants, amounting to one-third of the total package that needs to be used by the end of 2026. Moreover, as of the end of July 2023 the Slovak Republic had only absorbed about 75 per cent of the €14.5 billion in EU funds allocated to it in the 2014-20 programming period, which concludes at the end of 2023. In January 2023 the government started to draw down funds from its new EU allocation for the 2021-27 programming period, which totals close to €13 billion, following the European Commission's approval of the country's Operational Programme in November 2022. The new programme focuses on enhancing energy security, digitalisation, green investment and improving the quality of people's lives.

Government measures have kept household energy prices in check. According to Ministry of Finance estimates, consumers in the Slovak Republic experienced one of the smallest increases in electricity and gas prices in the EU in the second half of 2022. Prices have been held down by a combination of price caps, financial compensation schemes for the business sector and exceptional agreements with utility companies. In March 2023 the government approved electricity prices for 2024. These are expected to remain the same as in 2023, thanks to a memorandum of understanding with power utility Slovenske Elektrarne. In line with European Commission recommendations, however, the government is working on an energy support scheme that targets vulnerable groups only, rather than applying across-the-board assistance. Vulnerable households will be eligible for a subsidy covering the difference between market prices and a limit set by government.

The Ministry of Agriculture proposed seven measures for reducing food inflation, excluding any potential value-added tax (VAT) cuts or price caps. In June 2023, in response to a request from parliament, the Ministry of Agriculture announced one-off financial transfers to the most vulnerable households, as well as measures to increase food-chain efficiency, improve food-industry competition and trade, and improve the transparency of companies' economic results. At the same time, parliament approved a waiver of social contributions for employees of food producers and farmers for a six-month period to end 2023. Labour costs per employee are expected to be reduced by 24 per cent and capped at the level of the minimum wage of €700. The gap in social contributions should be covered by the state budget.

New energy windfall taxes were introduced. In April 2023 the president signed into law an increase in the windfall tax on refineries from 55 to 70 per cent until the end of 2023, with coal mining remaining exempt. In addition, in January 2023 the government approved a 90 per cent windfall tax on power producers' excess revenues, effective December 2022 for a period of two years. According to some market estimates, the two windfall taxes are likely to generate additional budget revenues of €435 million in 2023.

Energy security has increased. In February 2023 the third unit of the Mochovce nuclear power plant came into operation. It is expected to be running at 100 per cent by autumn 2023, covering about 13 per cent of the country's total electricity consumption, and has an expected service life of 60 years. The Slovak Republic is now electricity self-sufficient. In addition, by the middle of 2023 state-owned gas company SPP had secured more than 70 per cent of its gas supply needs from sources other than Russia. This includes access to LNG terminals and regasification facilities by signing memoranda of understanding with key partners, such as Italy's Edison in June 2023, and other countries earlier this year. In the middle of 2023 gas reservoirs had already been 76 per cent filled, thus exceeding the EU average of 73 per cent.

A proposed EU ban on combustion engines is meeting resistance. In May 2023 parliament approved a resolution on the EU's proposed ban on the production of new combustion engines after 2035. The resolution urges the government to oppose any EU-wide regulation that would disadvantage, overprice or ban internal combustion engines. Rather, the government should actively support the principle of "technological neutrality". At the same time, electric vehicle production is on the rise in the Slovak Republic. German company VW is planning to increase its share of electric and hybrid car production in the country to 17 per cent from 2025, while Swedish company Volvo is expected to launch the production of electric vehicles only near Košice from 2027. The country's car sector accounts for more than 50 per cent of domestic industrial production and 42 per cent of total exports.

The government is encouraging the development of rental apartments. In December 2022 the government approved pilot contracts with several large investors to build 9,000 rental flats worth some €1.5 billion. These apartments are intended for lifelong living and will be partially subsidised by the state to the tune of 30-40 per cent of market prices. The availability of rental and social housing remains a key challenge in addressing social exclusion.

Slovenia

Highlights

- **Economic growth has slowed considerably.** Gross domestic product (GDP) growth in the first half of 2023 was only 1.1 per cent year on year following growth of 2.5 per cent in 2022, with private consumption weakening amid falling real wages.
- **Slovenia was hit by flash floods in August 2023, causing significant damage.** On 4-5 August 2023 Slovenia experienced its most catastrophic natural disaster since independence, with reconstruction costs estimated at €6.7 billion (11 per cent of GDP). The government has already revised the 2023 budget to include some relief measures and will access €265 million of additional European Union (EU) funds.
- **The government formally requested a revision of the Recovery and Resilience Plan (RRP).** In July 2023 Slovenia submitted a revision of its national RRP to include two reforms and four investments under the REPowerEU initiative and to reschedule some milestones. A loan top-up of up to €750 million was requested, following the floods, to foster climate resilience and green infrastructure.

Key priorities for 2024

- **RRP implementation needs to be re-energised.** The government formally requested the second payment from the Recovery and Resilience Facility (RRF) in September 2023, initially scheduled for December 2022, while the revised plan was approved by the European Commission in October 2023.
- **Long-term care and healthcare system reforms need to be finalised.** The government's priority to ensure a sustainable long-term care system for Slovenia's ageing population has yet to translate into the adoption and implementation of all necessary legislative changes.
- **A more balanced budget will be needed to allocate flood relief funds while ensuring some consolidation.** As the fiscal deficit will reach a projected 4.9 per cent of GDP in 2023, some consolidation will be needed next year. With most flood relief costs pushed into 2024, it will be a challenge to achieve both aims.

Main macroeconomic indicators (per cent)

	2019	2020	2021	2022	2023 proj.
GDP growth	3.5	-4.2	8.2	2.5	1.5
Inflation (average)	1.6	-0.1	1.9	8.8	7.4
Government balance/GDP	0.7	-7.6	-4.6	-3.1	-4.9
Current account balance/GDP	5.9	7.2	3.3	-1.0	4.4
Net FDI/GDP [neg. sign = inflows]	-1.6	0.6	-0.8	-2.3	n.a.
External debt/GDP	90.1	101.6	97.2	90.9	n.a.
Gross reserves/GDP	n.a.	n.a.	n.a.	n.a.	n.a.
Credit to private sector/GDP	42.2	43.4	41.4	40.2	n.a.

Macroeconomic developments and policy response

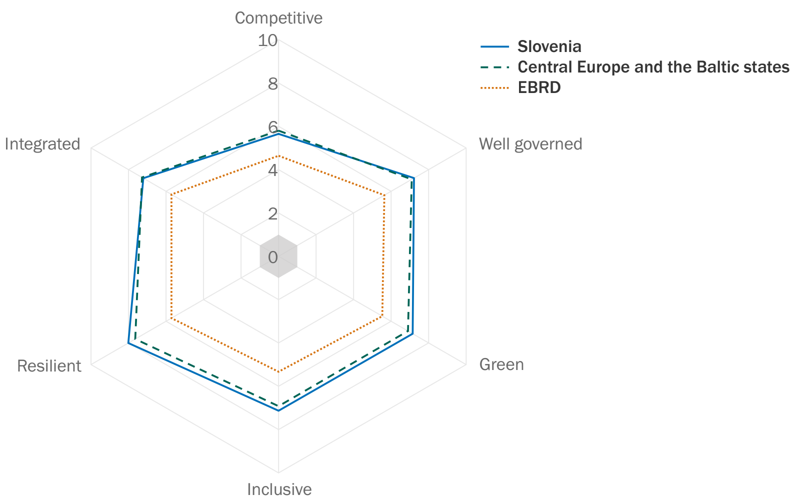
GDP growth decelerated in the first half of 2023. After expanding 2.5 per cent in 2022, the economy entered a phase of milder growth, with GDP growing only 1.1 per cent year on year in the first half of 2023. Behind the slowdown were a fall in private consumption, weaker exports and a continued decline in industrial output (since September 2022). Nevertheless, a sharp fall in imports resulted in a strong increase in the trade surplus in 2023. Investment was also robust, expanding almost 10 per cent year on year in the first two quarters of 2023.

Inflation will be stickier following the reversal of cost-of-living crisis measures from last year. Inflation inched up to 7.4 per cent in September 2023, higher than the 6.1 per cent recorded in July, mainly due to the expiry of energy price caps. Despite relatively strong nominal wage growth of 10.4 per cent in the first quarter of 2023, private consumption remains depressed, with retail sales recording annual declines since March 2023. The labour market remains very tight, with employment at record levels in 2022. This could contribute to some recovery in consumption, but carries risks of stickier inflation.

The fiscal position has worsened in 2023. Flash floods in early August 2023 forced the government to revise its 2023 budget to a projected deficit of 4.9 per cent of GDP, even though most relief costs will be budgeted in 2024. In the first three quarters of 2023, the central government deficit more than doubled compared with the same period in 2022. The government also approved certain financial support measures for affected municipalities. Flood-affected businesses will be provided with subsidies, loan deferrals and tax waivers, and hiring foreign workers will be made easier. To finance the reconstruction, at an estimated cost of €6.7 billion, the government introduced a 0.3 per cent tax for citizens, a 0.8 per cent levy for firms and a 0.2 per cent tax on banks' total assets. The levies will apply for the next five years. The budget deficit for 2024 is targeted at 3.8 per cent of GDP.

Short-term growth will remain subdued. We forecast GDP growth of 1.5 per cent in 2023, with significant downside risks stemming from weaker growth in the first half of the year, the decline in trade and depressed private consumption. On the upside, investment could accelerate as flood reconstruction starts and EU funds are disbursed. In 2024 we expect growth of 2.3 per cent, closer to the economy's potential, as falling inflation improves confidence.

Assessment of transition qualities (1-10)



Structural reform developments

The European Commission disbursed the first RRF payment in April 2023 amid mounting delays. The implementation of the RRP is ongoing, albeit behind schedule, with the second request planned for autumn 2023, later than the originally envisaged December 2022. Among the reforms that delayed the first payment request are legislation on promoting renewables, the reform of long-term care and the operationalisation of cloud infrastructure. The government is proposing to reschedule the latter two reforms in the amended RRP. In the second payment request (for the third instalment, as the first request covers two tranches), the main unfulfilled reforms as of June 2023 included operationalising a public transport company for passenger traffic and selecting a contractor for the construction of an infection clinic in Maribor.

The authorities submitted the REPowerEU chapter and requested amendments to the RRP. The chapter covers two reforms – shorter permitting procedures for renewables and promoting sustainable mobility – and four associated investments. Slovenia is entitled to €116 million from this initiative. When the government submitted its official request in July 2023, it also requested a decrease in loans due to the removal of some flood protection measures. After the floods in August, the authorities requested additional loans for a total of €1.3 billion from the RRF to address three main areas: (1) reducing the risk of floods and other climate-related disasters; (2) the sustainable renovation of buildings; and (3) increasing the capacity of railways. The European Commission's final decision on the top-up should be made by the end of 2023.

Measures are being taken to ensure energy security and accelerate the green transition. Following the energy crisis of 2022, the authorities are prioritising gas interconnectors with Croatia and Hungary to improve regional connectivity and supply routes. In January 2023 a comprehensive new law on the promotion of renewables entered into force, essentially transposing EU Directive 2018/2001 on promoting the use of renewable energy and Directive 2012/27/EC on energy efficiency improvements. Among the greatest challenges for the green transition is the need for major investments in grid capacity to absorb renewables.

Investments in railway infrastructure continue. In recent years the government has prioritised investments in railway infrastructure as a more sustainable form of transport. These investments include buying 20 rolling stock and modernising part of the Ljubljana-Divača railway line, for which a contract worth €204 million was signed in September 2023 and which should be completed by 2025. Total rail investments in 2023 may amount to €470 million. Improved connections with Croatia and Serbia are also being considered. The key reform in the sector to date has been legislation to establish an operator of integrated public passenger transport to cover rail, bus and other transportation modes.

Healthcare reform suffers a setback. Wider reform of the healthcare system was put on hold due to a bill focusing on health-system digitalisation and data consolidation. After government approval in June 2023, the bill was rejected by parliament on data protection grounds. The authorities then withdrew the bill in order to address its shortcomings and should propose an amended law some time in autumn 2023.

Nova Ljublianska Banka (NLB) issues a large green bond. The largest bank in the country, NLB, issued a four-year inaugural green bond worth €500 million to finance sustainable projects in Slovenia and the Western Balkans. The issuance was deemed a success as oversubscription translated into a rather low 7.1 per cent coupon with an option for early redemption.