Central Europe

Outlook 2023

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Executive summary

The two most important events in Central Europe in 2022 were, first, the invasion of Ukraine by Russian dictator Vladimir Putin, and, secondly, the long-awaited hardening of the European Union ’s stance towards the breach of its values by the radical right-wing regimes in Poland and Hungary.

The invasion boosted the significance of the region (particularly Poland) through its role as a supply base for Ukraine, its sheltering of many refugees, as well as for its foresight in long warning of the threat from the Kremlin during a period when many in Western Europe were continuing to counsel appeasement.

However, the region struggled to cash in this new potential clout inside the EU and Nato because of the deepening rift between Brussels and Budapest and Warsaw.

Many expected – and Viktor Orban counted on it – that the EU would give up prosecuting Hungary and Poland’s flagrant breaches of the rule of law because of the need to present a united front to Russia.

Nevertheless, the bloc has stood firm and will withhold both Recovery and Resilience Facility (RRF) and Cohesion Funds until both countries fulfil a series of key reforms this year. Orban has blinked and agreed to the EU’s demands; Poland has yet to do so amid infighting within the ruling coalition.

By threatening to hold up financial flows if the rule of law is breached and EU money put at risk, the European Commission finally seems to have found a credible weapon to fight the populist contagion.

In Hungary, despite winning re-election in flawed elections in April, Orban ended the year isolated within the EU and even within the Central European Visegrad Group because of his continuing links with Putin and his refusal to give significant help to Ukraine. As Russian influence in Europe has collapsed, Orban has cut a lonely figure as one of Putin’s last remaining friends, together with Aleksandr Vukic’s Serbia. Even the election of radical right-wing allies in Italy and Sweden last year has so far done little to ease his isolation because they do not agree with his stance on Russia either.

This year will show whether Hungary can continue to balance its EU membership and its close relations with the Kremlin or whether it will finally have to make a choice as the war drags on.

In Poland, relations with the EU could worsen in the short term ahead of the elections this autumn, but if voters then unseat Jaroslaw Kaczynski's Law and Justice Party the country could realise the promise of its new geopolitical position by becoming a key player in Brussels.

In an optimistic scenario, if both countries head back to the political mainstream, the whole region could finally become much more embedded in the EU; however, in a pessimistic scenario, Budapest and Warsaw could once more unite against Brussels and the region could instead suffer a new wave of self-defeating populism as the cost of living crisis bites.

Turning to the economic outlook, Central Europe is currently facing rocketing inflation and recession, at a time when the region has barely emerged from the downturn caused by the COVID-19 pandemic.

As a region heavily dependent on Russian energy, Central Europe is entering the downturn earlier than Western Europe. Rises in energy prices – in large part due to the Ukraine war and the sanctions on Russia – have pushed up inflation, increased external deficits, squeezed businesses and households, and pushed most economies into recession. The region's downturn is forecast to last until the middle of this year, followed by feeble growth.

The Baltic states already entered recession (two consecutive quarters of quarter-on-quarter negative growth) around the middle of 2022 and are not expected to emerge from it until mid-2023.

Czech GDP growth turned negative in Q3 and is expected to also be negative in Q4, meaning the economy is probably already in recession. According to ING, the country will suffer the deepest recession in the region.

Hungarian growth also already turned negative in Q3 and is expected to be negative in Q4, putting the economy in recession. It is then forecast to be close to zero for much of 2023.

Poland could suffer negative growth in Q1 but is currently predicted by most economists to return to growth in Q2. This should help the populist Law and Justice Party ahead of the elections in the autumn, particularly if the government and its central bank try to engineer a pre-election boom as in Hungary.

Slovak growth remained in positive terms in Q3 and the economy is currently forecast to escape recession but with minimal growth.

At the same time, Central Europe is suffering the highest inflation in the

EU because of the high weighting of food and energy prices in its CPI baskets, with the rise in consumer prices reaching 25% year on year in Estonia in August. Wages are not keeping up, with workers in all countries suffering falls in real wages.

Central banks have reacted to the soaring inflation by hiking interest rates, which is depressing investment. On the positive side, as the region began tightening monetary policy earlier than Western Europe – in June 2021 – economists expect central banks led by the Czech CNB to start loosening monetary policy beginning in the middle of the year.

For citizens, the fall in real wages comes on top of lingering discontent with the region's slowness in catching up with Western living standards, particularly since the global financial crisis. Only Czechia (at 92% of the EU average GDP/capita on a purchasing power parity basis in 2021), Estonia and Lithuania (89%), have almost converged with EU levels – and are ahead of Spain, Portugal and Greece – while the remaining Central European countries still all hover around 70-75%. Czechia is the only CEE4 country classified by the IMF as an 'advanced economy' rather than an 'emerging economy'.

Some low-income groups – notably pensioners, rural dwellers, those with less education and skills – already felt they had not benefited from the transition from Communism since 1989. The risk is that they are becoming permanently disaffected with democracy and will keep voting for populist parties, which are already in power in Hungary and Poland, and are leading the opposition in Slovakia, Czechia and Estonia.

Radical right-wing populism continues to be fuelled by social disparities created by the transformation from communism, the cultural shock from accession to the EU and its values – on issues such as LGBT rights – as well as phantom fears about migration and other topics spread by misinformation.

This growing disgruntlement could also spill over into the international sphere, because patience could run thin with the cost of imposing sanctions on Russia in terms of higher energy prices, as well as the burden of looking after hundreds of thousands of Ukrainian refugees. At a demonstration in Prague in September, 70,000 protested against the government, but speakers also railed against sanctions, refugees, the EU and Nato.

To contain discontent, most governments have put in place energy price caps at a heavy cost, sometimes funded by windfall taxes. But across the region opposition parties are calling for governments to do more, at a time when budgets are already stretched from dealing with the pandemic.

The challenge of helping citizens cope with the cost of living crisis is also accentuating tensions in the ruling coalitions, with Estonia's Prime Minister Kaja Kallas reconstructing her government in June and the Slovak coalition being brought down by a vote of no-confidence in mid-December.

But the risk of a new populist wave in Central Europe is limited, given that only in Slovakia is there a real danger of populist parties seizing power this year. Former premier Robert Fico could return to power at snap elections sometime in the middle of the year, but his left-wing nationalist Smer party will struggle to find allies.

In Estonia, the radical right-wing EKRE party is expected to do well in April's general election, but Kallas' Reform Party is still far ahead in the opinion polls.

In Czechia, polls indicate "centrist populist" Andrej Babis would lose the run-off of this month's presidential two-round election to either of the two main government-supported candidates.

Moreover, this cost of living crisis may not necessarily benefit the existing radical right-wing governments in Hungary and Poland, precisely because they are the ones that are struggling to cope with it. Populist governments such as Hungary's were among the worst performers in the COVID-19 pandemic, and they are now being found wanting by the current cost of living crisis.

In fact the country facing the gravest economic challenge is Orban's Hungary itself, with the forint the worst performing European currency last year.

Orban is now in a very weak position to protect Hungarians' living standards because his pre-election spending spree had already pushed up inflation and blown out the budget deficit.

According to ING, "high levels of public and net foreign debt, combined with fiscal and current account deficits potentially raise concerns about medium-term sustainability, especially in an environment of rising interest rates".

Hungary's future economic stability will now depend on fulfilling the milestones to release EU funds, the flow of which will narrow the budget and external deficits and boost the economy and international confidence in the forint. But if the European Union maintains its surprisingly tough stance and the milestones actually work properly, these reforms will also start to undermine Orban's semi-authoritarian regime, making the country's future political 'stability' much more interesting and the next elections potentially much fairer.

1.0 Political outlook

1.1 Politics - Czech Republic

Czechia's centre-right cabinet of five parties was formed on the basis of opposition to the previous minority cabinet of populist billionaire Andrej Babis, which was narrowly ousted after the October 2021 general elections.

The five-party coalition led by Prime Minister Petr Fiala of the neoliberal ODS secured a vote of confidence in January 2022 amid arguably the most challenging circumstances since the fall of communism in 1989. It already faced the continuing COVID-19 pandemic and rising inflation and a ballooning budget deficit; just a little over a month later its agenda of budgetary austerity was ripped up by the Russian invasion of Ukraine as energy prices soared.

In response to the invasion, Czechia decoupled from Russian energy and business ownership ties, provided some 467,000 Ukrainians – largely women, children, and the elderly – with refuge during 2022, and established itself as one of the most active countries in the EU in providing military assistance to Ukraine. According to the interior minister, altogether 622,855 Ukrainians have registered with Czech foreign police, with the balance moving on to other countries or returning to Ukraine.

This improved its image internationally, particularly after it held the EU rotating presidency throughout the second half of 2022. Setbacks such as the double standard in the treatment of Roma Ukrainians or corruption probes involving justice minister Pavel Blazek of the ODS or the "Dozimetr" kickback scheme inside the Mayors party (which forced the education minister Petr Gazdik to resign) remained primarily a matter of domestic politics.

One of the most important events on Czechia's political map of 2023 is scheduled for January when presidential elections will be held, with the first round on January 13-14 and the second round two weeks later. Under the Czech constitution the incumbent Milos Zeman cannot run for a third term and Prague Castle will be taken over by a new head of state after Zeman's term ends in March.

Zeman is likely to be replaced by one of the trio of leading candidates, comprised of former Mendel University Chancellor Danuse Nerudova, opposition leader, billionaire, ex-premier and populist ANO party boss Andrej Babis, and former chief of staff and Nato commander General Petr Pavel. A December poll by Kantar CZ showed all three candidates virtually neck and neck. The polls have also indicated that Babis is likely to lose the second-round runoff to either Nerudova or Pavel.

The ruling coalition has a stable 108-strong majority in the Chamber of Deputies of 200 deputies and a further 58-strong majority in the Senate of 81. The coalition has so far cooperated well but it could see rows between the SPOLU bloc of three centre-right parties (ODS, Christian Democrats, and TOP 09) and the centrist junior coalition member Pirate Party, as indicated by the failure of the parties to form a ruling coalition in Prague together since municipal elections in September. The number of Pirate Party deputies in the parliament is only four, however, and even their unlikely departure wouldn't threaten the existence of the coalition.

1.2 Politics - Estonia

Estonia holds parliamentary (Rigiikogu) elections on March 5, 2023. As of the time of writing, the ruling Reform party and the opposition far-right EKRE party have the highest support ratings. In a November poll, 31% of eligible Estonian citizens said they would vote for the ruling Reform Party. EKRE was firmly in second place with 22% support. However, high energy bills and record-high inflation dampen Reform's election prospects.

EKRE is likely to benefit from the country's acute economic issues, as well as geopolitical tensions. The slogan of EKRE for the upcoming elections will be "Save Estonia!". However, EKRE's rating has been volatile for the past four months, fluctuating between 18% and 25%. Estonian analysts believe that its supporters tend to include people who change their mind often and whose decisions are affected by a given period's media coverage.

1.3 Politics - Hungary

Hungary's ruling radical right-wing Fidesz party won April's flawed election with the largest margin since 2010. The economic rebound after the pandemic, double-digit real wage growth, a populist spending splurge before the election and a tilted media landscape helped Viktor Orban to a fourth consecutive supermajority despite the opposition running on a joint list. If he serves out what is his fifth term, the 59-year-old politician will become the longest-serving prime minister in the country's history.

The war in Ukraine changed the narrative of the campaign, putting economic issues on the sidelines. The prime minister's tactics paid off. Orban positioned himself as a neutral player in the conflict. Hungary's strongman, who has long cosied up to the Russian president, condemned the invasion but never called Vladimir Putin an aggressor.

In its report after the election, the OSCE said the elections and simultaneous referendum were marred by the absence of a level playing field, and the pervasive overlap between the ruling coalition, the same dire conclusion it came to in 2018.

The anti-LGBT referendum, dubbed by the cabinet the child protection referendum, held simultaneously with the ballot, was invalid with less than 50% in support. Orban put divisive cultural issues at the forefront of the campaign and accused the European Commission of withholding EU funds from Hungary not because of his regime's rampant corruption but because of an infringement procedure launched in response to the discriminatory anti-LGBT legislation.

After the election disaster, Hungary's opposition is back to square one in terms of its future strategy. The leftist-liberal parties and the right-wing Jobbik failed to exploit the unfolding cost of living crisis after the government breached its key election promises, the scaling back of retail energy subsidies.

The government blamed EU sanctions for soaring energy and food prices. The disinformation campaign has worked as half of Fidesz voters believe the government did not vote for the sanctions. Protests erupted in the summer over the abolition of the small business tax (kata) but waned over time with a clear lack of political leadership.

October saw the largest mass demonstrations in Budapest since 2014 when an estimated 80,000 took to the streets on October 23 to protest for better working conditions and higher pay for teachers. The rallies grew in size after a dozen teachers were fired for civil disobedience. Students, teachers and parents held hundreds of smaller rallies and sit-ins in the autumn. Fidesz has clearly underestimated the impact of the "revolt" and although continuous protests have done little to dent its popularity, yet there is a risk of a snowballing effect if protests continue in 2023.

Without a comprehensive wage settlement, the country's education sector, already facing huge staff shortages, could be crippled in the short term. Hungarian teachers have the lowest wage among the 38 OECD countries.

Hungarian local governments, facing an energy crisis, will rely on state subsidies to survive in 2023. Fidesz has centralised state administration and curbed the independence of municipalities in the last 12 years. Local governments run by the opposition fear that energy subsidies will not be handed out evenly as happened during the pandemic.

Orban has found himself increasingly isolated in the EU with his pro-Russian stance and frequent use of the veto, blocking a string of EU initiatives linked to helping Ukraine. Orban's long-term allies from the V4 countries have abandoned him and it will take a lot of work to rebuild confidence. Budapest has also angered allies for holding up the ratification of Finland and Sweden's Nato membership, using that as blackmailing power to gain access to EU money.

Hungary avoided the worst-case scenario of losing vital EU funds in a last-minute agreement in early December. EU member states struck a deal securing Budapest's approval for the 15% global minimum corporate tax rate and financial aid for Ukraine in 2023 in exchange for agreeing to pay out the funds, totalling 8-9% of the country's GDP, but under the scrutiny of the ongoing conditionality mechanism, launched for the first time against a member country.

Hungary becomes the last country in the EU to gain access to the €5.8bn post-covid recovery fund (RRF) 15 months after submitting its plan, but the payout is linked to meeting 27 "super milestones" set by the European Commission for improving transparency of public procurements and judicial reforms. The EU has kept €6.3bn from Cohesion funds frozen, or 55% of the total Cohesion funds from the 2021-2027 EU budget, until the country lives up to its commitments. This is slightly below the EC's initial €7.5bn proposal, which deemed Hungary's efforts in the autumn to tackle corruption and improve the rule of law as insufficient.

The government expects EU money to start flowing in from Q2 2023 at the earliest, but Hungary's premier has little to celebrate as the country will remain under close scrutiny and future EU transfers could be withheld if compliance with 27 super milestones is not guaranteed, leaving the government scrambling to find other options to finance a widening twin deficit. It remains to be seen whether the government will request the €9.8bn credit leg of the RRF package.

1.4 Politics - Latvia

Latvia's New Unity, United List and National Alliance signed an agreement on forming a governing coalition on December 14 following the October general election, but Latvian analysts agree that the country will not have the stability it had during 2018-2022, when Krisjanis Karins' New Unity, the conservative-nationalist National Alliance and the New Conservative Party ruled for a full term.

New Unity won 26 seats in the 100-seat parliament. The opposition Union of Greens and Farmers received 16 mandates, United List – 15 , the right-wing National Alliance – 13, For Stability – 11, Progressives 10 and Latvia First – 9.

Due to the large number of elected parties in the parliament, the formation of a new government in Latvia is usually a relatively long and challenging process. This time was not an exception, but it took longer than before and the country's analysts doubt if the new government will last the entire four-year term.

In the current economic and energy crisis, the battle with the consequences of the pandemic and the war in Ukraine, Karins' government faces a rough ride. The conservative position of the National Alliance, together with the decentralisation and stubbornness of United List, is an unstable combination.

Previous experience points to the possible splitting of the United List and changes of the power balance in parliament. Additionally, the direct or indirect links between Latvian oligarchs and elected parties increase the possibility of hidden influence on the new government. In May 2023, Latvia also holds a new presidential election, which could cause further instability.

1.5 Politics - Lithuania

2023 will be a year of preparation for the Seimas election in 2024. At the moment Lithuania's ruling Homeland Union-Lithuanian Christian Democrats (TS-LKD) is in a good position to retain the relatively high support it has at the end of 2022. The party has avoided major scandals since the government formation in 2020 and the parliamentary opposition, consisting of the Farmers and Greens Union and the Social Democrats, is weak and without a strong leader.

In a November poll, 14.2% of respondents said they favoured TS-LKD. Some 11.8% would have voted for the Social Democrats, up from 11.3% in September. The opposition Democratic Union For Lithuania was next in line with 7.4%, up from 6.5% in September. Further down the list was the opposition Lithuanian Farmers and Greens Union with 6.9% (6.5% in September).

This marked a recovery for the TS-LKD-Liberal government, which was at a low in the autumn. Only 29.2% of those polled in October had a positive or rather positive opinion, up from 23.9% in September, while 62.3% had a negative or rather negative opinion, down from 68.8% in September.

Acute economic issues, like high inflation and geopolitical tensions will affect government support in 2023. The results of the local government council elections in the first week of March 2023 are also to be watched, as a poor performance by TS-LKD would harm the government and dampen the party's prospects in the parliamentary election in 2024.

However, a change in the government composition before the election is unlikely, as the minor coalition partners, Laisve (Freedom) Party and Liberalu sajudis (the Lithuanian liberal movement) would be damaged by their exit from the government.

1.6 Politics - Slovakia

Slovakia has been going through a protracted political crisis during much of 2022, which impeded the implementation of effective measures to combat the energy crisis, and which led to the 2023 budget being approved only shortly before the end of the calendar year.

Deep animosity between Igor Matovic, leader of the OLaNO party, winner of the 2020 elections, and Richard Sulik, leader of the neoliberal SaS, came to a head in September when SaS left the ruling coalition, depriving Prime Minister Eduard Heger's cabinet of a majority in the parliament.

Opposition leader and controversial ex-premier Robert Fico has been undermining the cabinet by exploiting the rising costs of living, fatigue over the cost of helping Ukrainian refugees, and calling for an end to support for Ukraine. As he has moved into more extremist political positions, he has maintained close ties with the Russian and Belarusian diplomatic corps in the country.

In the summer his Smer-SD also initiated a petition which eventually triggered a referendum on the shortening of the parliament’s term to be held on January 21.

President Zuzana Caputova referred the first question in the petition to the Constitutional Court, which upheld its previous rulings on a similar referendum from 2021 also initiated by Smer-SD. The Constitutional Court ruled in October that the first question asking whether citizens wish the current cabinet to resign contradicts the Slovak constitution. A referendum with such a question “would be about an order to the cabinet to file its resignation” bypassing constitutional ways to end the cabinet’s term.

In mid-December SaS backed by opposition deputies from Hlas-SD initiated a no-confidence vote which after last-minute dramatic negotiations led to the Heger’s cabinet fall with a majority of 78 in a parliament of 150 deputies backing the motion. The opposition Smer-SD and Hlas-SD have called for early elections as soon as possible in 2023, such as May. However, for early elections to go ahead, a constitutional majority of 90 deputies is required, and an agreement on the date of the early elections may prove to be a difficult one to reach.

On December 22 the Slovak parliament approved the 2023 budget, backed by 93 out of 136 present deputies, including SaS. This came after an agreement between the parties that formed a coalition after the 2020 general elections, involving Igor Matovic’s departure from Heger’s cabinet. A day later President Caputova revoked Matovic’s credentials and Heger is now in charge of the finance portfolio. Sulik’s SaS did not rule out backing a reconstructed cabinet without Matovic.

A number of high profile corruption cases, which involve Robert Fico, his former minister of interior Robert Kalinak, or former high public officials and the controversial Penta financial group implicated in the corruption case Gorila, will be investigated in 2023 against the backdrop of the political turmoil.

2.0 Macroeconomic Outlook

2.1 Macroeconomy - Czech Republic

Czechia: key economic figures and forecasts	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**
Nominal GDP (EUR bn)	175	190	201	207	190	202	222
Real GDP (% y/y)	2.5	5.2	3.2	3.0	-5.5	3.6	2.4
Industrial output (% y/y)	0.8	7.5	3.5	0.9	-6.1	10.8	1.9
Unemployment rate (avg, %)	4.0	2.9	2.2	2.0	2.6	3.0	
Nominal industrial wages (% y/y)							
Producer prices (avg, % y/y)							
Consumer prices (avg, % y/y)	0.7	2.5	2.1	2.8	3.2	3.8	15.0
Consumer prices (eop, % y/y)	2.0	2.4	2.0	3.2	2.3	6.6	15.5
General budget balance (% of GDP)	0.7	1.5	0.9	0.3	-5.8	-5.1	-4.6
Public debt (% of GDP)	36.6	34.2	32.1	30.0	37.7	42.0	42.9
Current account balance (% of GDP)	1.8	1.5	0.4	0.3	2.0	-0.8	-5.1
Official FX reserves (EUR bn exc gold)	81	120	125	132	134	153	140
Gross foreign debt (% of GDP)	81.3	108.4	106.5	108.0	105.8	107.0	83.3
CZK/EUR (avg)	27.03	26.33	25.65	25.67	24.64	25.64	24.60
CZK/USD (avg)	24.44	23.37	21.75	22.93	23.21	21.69	23.90
Source: Thomson Reuters, RBI/Raiffeisen RESEARCH, ING							

2.1.1 GDP growth

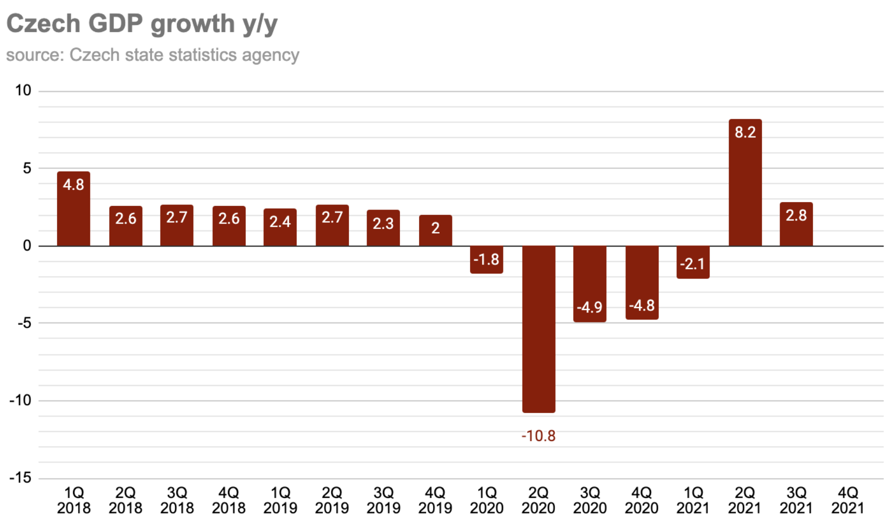
In its autumn forecast, the European Commission projected Czechia to be on the brink of recession in 2023, with just 0.1% annual growth. EC cited the high negative impact of energy prices on Czechia's industry-based economy, which is also exposed to supply chain disruptions. The Czech Banking Association projects GDP growth of 0.2%.

The latest figures emerging in December suggest that Czechia may be entering the new year in recession already. GDP decreased by 0.2% q/q in the third quarter – though in y/y comparison it increased by 1.7% – and analysts expect a further decrease in the fourth quarter following weakening domestic demand.

The chief economist of the Czech Banking Association Jakub Seidler commented on the latest 3Q 2022 GDP figures that "the published structure of the growth is a rather negative surprise and shows a hard-felt drop in household consumption exceeding the last CNB prognosis".

In its budgetary report from October the cabinet projected growth of 1.1% and average inflation of 8.8%. The International Monetary Fund predicted in its autumn World Economic Outlook a slowdown to 1.5% for the 2023 growth and 8.6% for average inflation.

By November the predictions further worsened with the finance ministry prognosis from November projecting the economy will drop by 0.2%.



2.1.2 External environment

The latest figures in the trade balance of goods for October 2022 ended in a deficit of CZK26.8bn, which is an increase of CZK10bn y/y. The trade balance has been in deficit for nine months in a row after the y/y increase in the trade deficit in crude petroleum and natural gas, driven by rising prices in world markets. This trend was mitigated somewhat by the favourable influence of a larger trade surplus in motor vehicles.

Czechia’s dependency on Russian energy imports makes it what the IMF called one of the “economies most exposed to the Russian gas supply cuts”, together with Hungary and Slovakia.

Czechia’s economy is an export-oriented one, particularly linked to its largest trading partner Germany and prone to be affected by developments in the German economy, which is expected to shrink.

2.1.3 Inflation and monetary policy

Czechia’s inflation is one of the highest in the EU at 16.2% y/y. After a welcome 2.9% m/m decrease in October to 15.1% it went up again by 1.2% m/m in November and is not yet expected to be at its peak. While the October drop was attributed to government interventions, the November spike was driven by rising housing and food prices.

Czech National Bank (CNB)mGovernor Ales Michl expects the peak of around 20% inflation to come after New Year. His colleague from the CNB board Tomas Holub told the Joint Vienna Institute webinar in mid-December that “most probably we have passed the peak of core inflation” at 13.8% in November, and that the momentum is now slowing. CNB does not expect to reach its target level of inflation of around 2% until 2024.

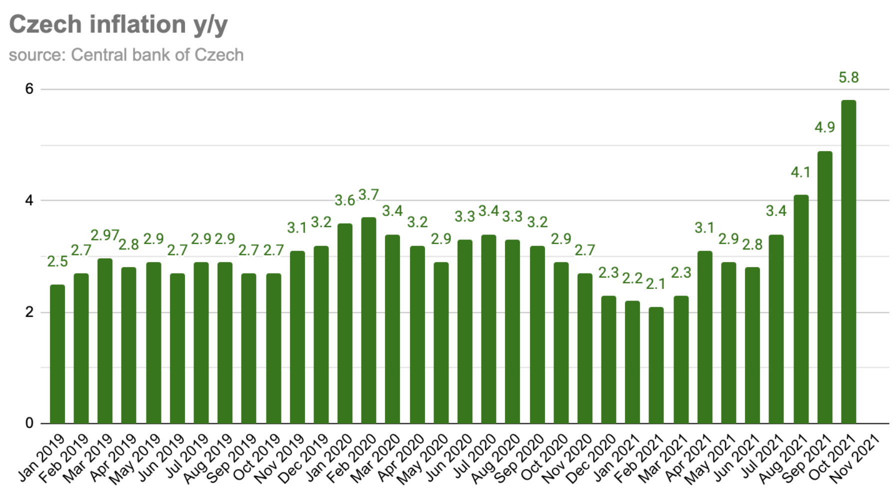
The EC predicts average annual inflation of 9.5% for 2023 and the Czech cabinet projected 8.8% for 2023 in its budgetary report.

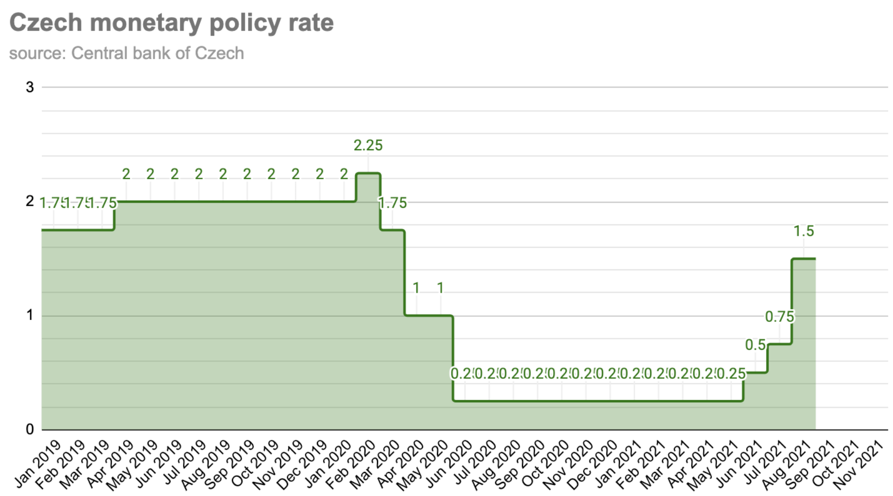
Since the current Governor Ales Michl was appointed to head the CNB together with two more changes on the board, the central bank went from being one of the most hawkish ones to one of the most dovish ones in the region.

Interest rates have remained at 7% under Michl and with one of the two critics of not raising the rates Marek Mora leaving the board in February, local market analysts do not expect the current CNB board to change its interest rate policy. In his comment after the last CNB board meeting in December, Michl, however, did not explicitly rule out hiking interest rates, saying the next board meeting will discuss this option.

Michl also reiterated his resolve to continue “to defend the koruna against excessive fluctuations.” The koruna had seen plunges during 2022 following the Russian invasion of Ukraine when it dropped to the rate of CZK25.77/€1. By November local market analysts estimated the CNB spent 16%-17.4% of its foreign currency reserves, or €25.5bn-€28bn on interventions in favour of the koruna since May.

In December the koruna reached its 11-year high on December 20 with the rate of CZK24.18/€1. CNB projects an average annual value of CZK24.80/€1 in 2023.





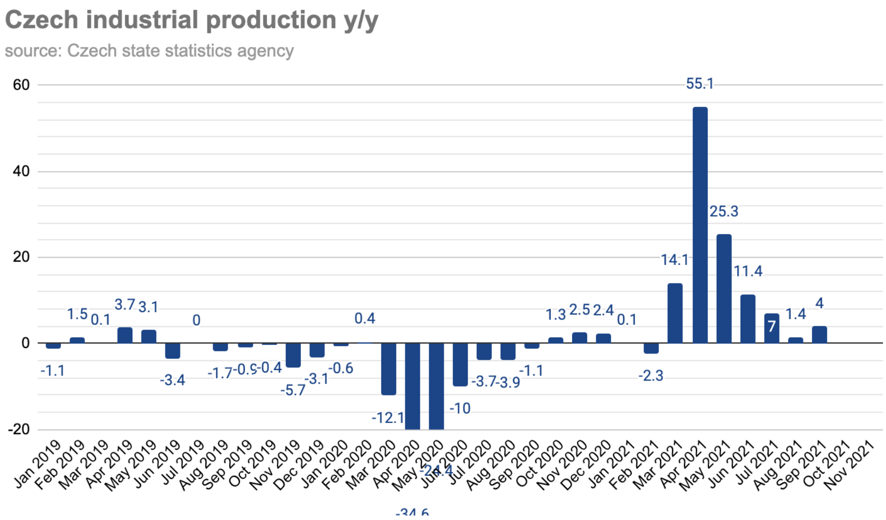
2.1.4 Industrial production

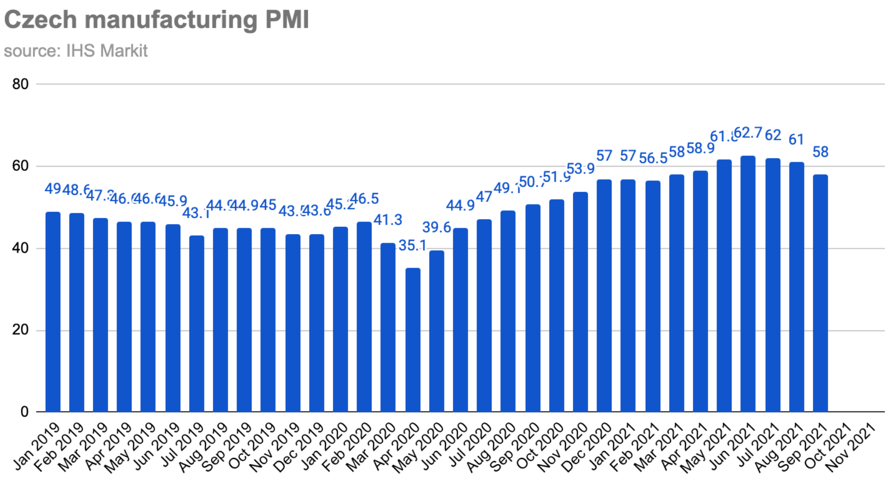
Industrial production has been driven by the automotive sector, which experienced a revival after the disruption of supply chains in semiconductor chips in 2021, but in 2023 it will face challenges stemming from the high energy prices.

Latest figures (October 2022) show industrial production increased in real terms by 3.1% y/y and decreased by 3.7% m/m. The value of new orders increased by 18.1% y/y, according to the data of the Czech Statistical Office.

As in the previous months, the growth has been driven by production in the car industry sector and the m/m decrease was also a result of a new supply chain disruption in the car industry. As analysts and statisticians note, the growth is also influenced by the low comparative base from 2021 when the car industry struggled with the global supply chain crisis.

The Czech Manufacturing Purchasing Managers' Index (PMI) has been significantly deteriorating in the second half of 2022. In September, it dropped to 44.7, its lowest level since May 2020, and in October it saw an even steeper fall to 41.7, followed by 41.6 in November. The index is well below the 50pt threshold between growth (+50) and decline (-50). Cost burdens are driving waning demand and decreasing orders below autumn market estimates.





2.2 Macroeconomy - Estonia

2.2.1 GDP growth

The EBRD expects 1.5% GDP growth in 2022 and 1.0% growth in Estonia in 2023. The Estonian finance ministry forecasts growth to be 1% in 2022 and 0.5% in 2023.

With the strong recovery in private consumption following the end of the restrictions imposed to stem the COVID-19 pandemic, and the only limited effects of the war, the Baltic states' economic growth was increasing in the first half of 2022, but in the second half the high prices and the drop in purchasing power caused a significant decrease in the consumption growth rate, as well as worsening the situation of local producers and maintaining low investment volumes.

High energy prices, rising production costs, and weakening demand in external markets will continue to have a negative impact on the Baltic economies in the first half of 2023. However, economic growth is expected to recover from the middle of the year as part of the general recovery of the EU and the world economy.

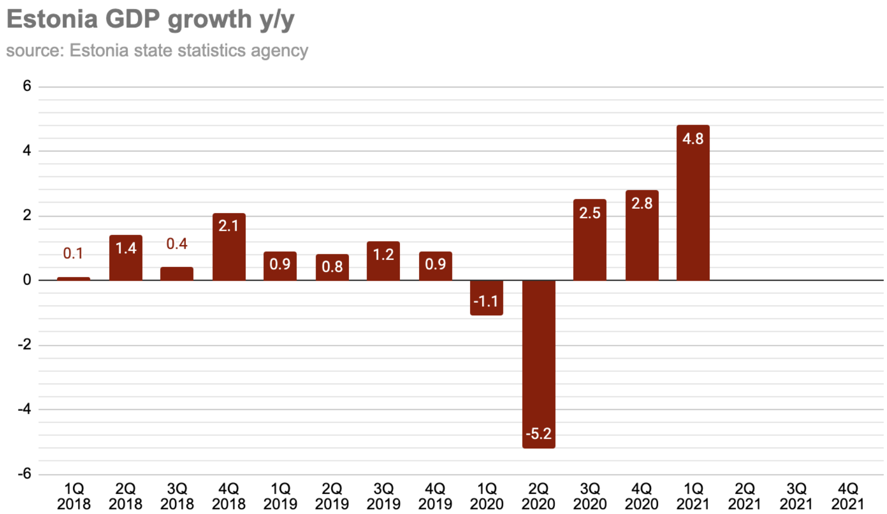
The impact of the crises like the COVID pandemic, as well as the direct impact of high-inflation, has been softened by people using their savings and by support from the state.

Even in the face of very high inflation, households have been able to use their savings to continue consuming, and private consumption in real terms fell less than one percent in each Baltic state. Using savings now means though that it will not be possible to use them in the future to cushion any more shocks that might happen.

As household buffers have shrunk, so has their ability to soften any negative impact on the economy, and if new risks are realised, they will affect economic developments much more.

At end-November 2022, registered unemployment rate in the Baltics was uneven. In Latvia, it was 5.9%, in Lithuania in November – 8.3%, in Estonia – at 5.6% in the third quarter of 2022.

The unemployment rate will most likely grow pan-Baltic in 2023 – due to the war spillovers and the anticipation of a recession.



2.2.2 External environment

The Bank of Estonia, the country's central bank, said that the surplus on the current account of the Estonian balance of payments was €329 million in the third quarter of 2022, or 3.5% of GDP, which was €213 million more than in the third quarter of 2021.

The net international investment position showed that at the end of the quarter the external liabilities of Estonian residents exceeded their external assets by €6.8 billion or 19% of the GDP of the previous four quarters. The external assets of Estonian residents increased over the year by €0.3 billion more than the external liabilities did, mainly because of intra-group transactions.

The current account and the international investment position remained within the limits of the European Union criteria for macroeconomic imbalance. The deficit on the current account over the past three years was 0.5% of GDP and the investment position of the past four quarters was -19% of GDP.

Net lending (+) or borrowing (-), or the net total of the current and capital accounts, saw a surplus of €477 million in the third quarter of 2022. The surplus of the balance of payments increased from 3.2% of GDP in the third quarter of 2021 to 5.1% of GDP.

According to Statistics Estonia, in the third quarter of 2022, exports were up by 16% and imports by 22%. Trade was mainly boosted by the increased exports and imports of mineral products as well as by rising prices in general. In September, Estonia's exports of goods amounted to nearly €1.9 billion and imports to €2.1 billion at current prices. The trade deficit was €155 million which is €92 million more than in September last year.

In the first three quarters of 2022, the main partner country for Estonia's exports of goods was Latvia (16% of total exports), followed by Finland (16%) and Sweden (9%). The biggest fall was recorded in exports to the USA and Netherlands.

The top partner countries for Estonia's imports of goods in the three quarters of 2022 were Finland (17% of total imports), Latvia (11%) and Germany (11%). Imports from Finland outweighed imports from all non-EU countries combined – this was due to increased imports from Finland and also the dramatic decline in imports from Russia. By September 1, 2022, the biggest decrease year on year occurred in imports from Russia (down by €132 million) and Belarus (down by €51 million).

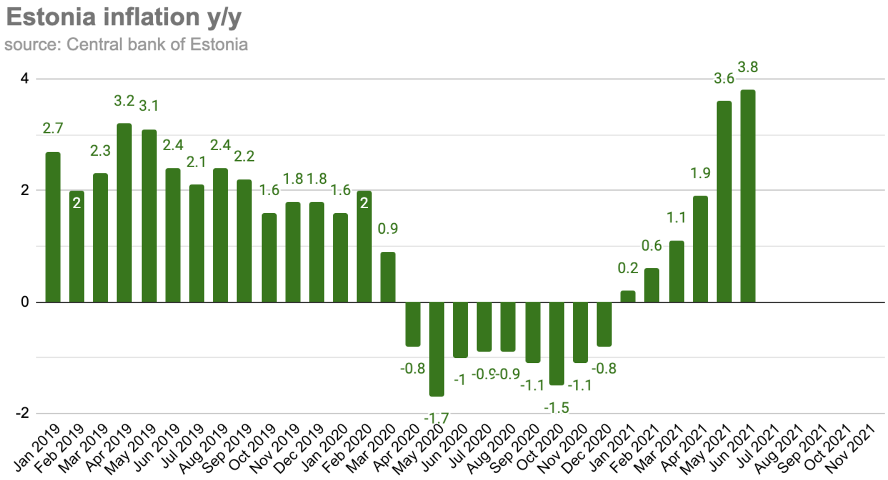
In Estonia, foreign direct investment (FDI) increased by €58.43 million in September 2022. The FDI prospects for 2023 in the country are rather bleaker than upbeat due to geopolitical tensions.

2.2.3 Inflation and monetary policy

The Baltic region has seen the highest inflation of all EU economies throughout 2022, with Lithuania, Estonia and Latvia experiencing a 22.5%, 24.1% and 21.8% respective increase in prices respectively. The annual HICP inflation was mainly driven by increased prices for milk and milk products, cheese and eggs, solid fuel, meat and meat products, heat energy, fuels and lubricants, electricity, bread and cereals, vegetables, products and materials for maintenance and repair of the dwelling, and restaurants, cafes and other food services.

In November 2022, inflation stood at 21.7% in Latvia and 21.4% in both Estonia and Lithuania, according to Eurostat, the EU's statistical bureau. Estonia is also expecting annual inflation at around 10% in 2023.

For interest rate rises, all the Baltic states are dependent on action by the European Central Bank.

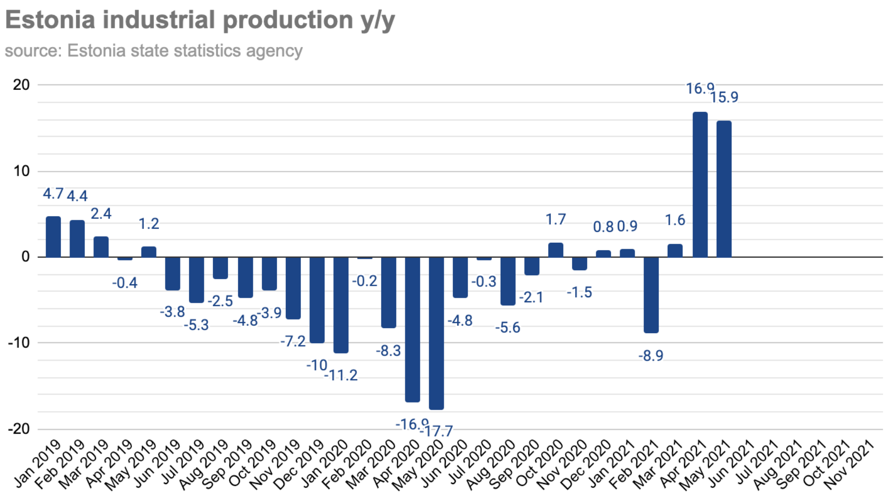


2.2.4 Industrial production

Industrial production was pointing down in the Baltics at the end of 2022 and will likely remain downward in the first half of 2023.

In Estonia, industrial production was also edging down in the last two quarters of 2022 and the trend will remain through the first half of 2023.

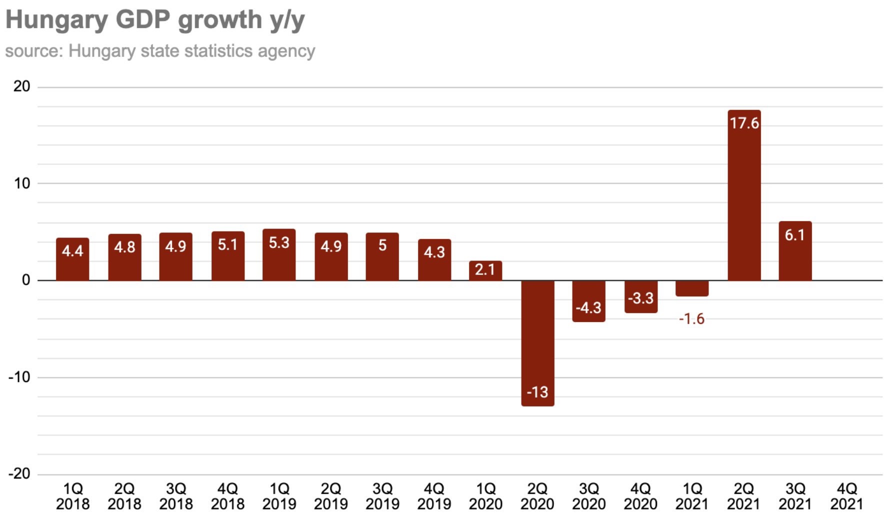
Industrial production in Estonia declined by 5.8% year-on-year in October 2022, after a revised 7.8% drop in the prior month, amid falls in the manufacture of wood (-15.4%), fabricated metal products (-1.3%), electrical equipment (-0.5%), and food products (-0.8%).



2.3 Macroeconomy - Hungary

Hungary: key economic figures and forecasts							
	2016	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**
Nominal GDP (EUR bn)	116.1	126.8	135.9	146.1	137.8	153.8	?
Real GDP (% y/y)	2.1	4.5	5.4	4.6	5.0	7.1	4.8?
Industrial output (% y/y)	0.9	4.6	3.5	5.6	-6.0	9.5	6.6?
Unemployment rate (avg, %)	5.2	4.2	3.7	3.4	4.3	3.7	3.6?
Nominal industrial wages (% y/y)							?
Producer prices (avg, % y/y)	-1.7	3.3	5.5	2.1	4.2	13.5	33.2?
Consumer prices (avg, % y/y)	0.4	2.4	2.8	3.4	3.3	5.1	14.6?
Consumer prices (eop, % y/y)							?
General budget balance (% of GDP)	-1.8	-2.5	-2.1	-2.0	-8.1	-7.5	-4.9?
Public debt (% of GDP)	75.5	72.9	70.2	66.3	80.4	76.8	75.9?
Current account balance (% of GDP)	4.6	1.9	0.4	-0.4	0.1	-3.0	7.0?
Official FX reserves (EUR bn)	24.5	23.4	27.4	28.4	33.7	37	29.6?
Gross foreign debt (% of GDP)	119.2	101.6	100.1	96.9	160	157.7	?
EUR/LC (avg)	311.5	309.2	318.9	325.4	351.2	358.5	391.1
USD/LC (avg)	281.4	274.3	270.3	290.7	307.9	303.3	373.0
Source: Thomson Reuters, RBI/Raiffeisen RESEARCH							

2.3.1 GDP growth



Growth remained robust in the first nine months, climbing 6.1% y/y boosted by massive pre-election transfers. Broken down by quarters, economic growth has been on a descending path with an 8.0% growth in Q1, 6.5% in Q2 and 4.0% in Q3. Hungary was among the fastest-growing economies in the EU on an annual basis in Q1-Q3, but quarterly data in the July-September period showed a contraction of 0.4%.

For 2023, most analysts and international organisations expect Hungary to escape a recession, with growth close to zero, with risks skewed to the downside. The forecasts assume the absorption of EU transfers from H2 2023.

The European Commission in its latest report raised its 2022 growth guidance from 5.2% to 5.5% but cut its 2023 estimate to 0.1% from 2.1%. The IMF projected that growth will decelerate from 5% in 2022 to near zero in 2023 as high inflation will erode households' real income, while higher funding costs will weigh on investments and external demand weakens. The projections assume that Hungary can unlock EU funds. The delay or lack of transfers could derail the country's economy and lead to recession.

The Hungarian central bank revised its macroeconomic outlook in September, putting GDP growth at 3-4% in 2022, down from 4.5-5.5% in the June report. The 2023 outlook was revised down from 3-4% to 0.5-1.5%, with downside risk from high energy prices and the dampening of private consumption from a deceleration of real wages. The 2022 and 2023 forecasts were confirmed in the latest quarterly report published on December 20.

Hungarian central bank governor Gyorgy Matolcsy warned that the county faces stagnation and stagflation unless the government implements a turnaround in its economic policies. The former economy minister unleashed a scathing criticism of the last 10-12 years, saying Hungary is one of the least competitive countries in the EU, and he blamed the dichotomy between the MNB and government for economic woes. The MNB's monetary tightening efforts were offset by the loose and expansionary fiscal policy of the government. Matolcsy, named by Orban as his right-hand man, openly criticised the government's crisis management and policies of using price caps, which are distorting the market and leading to higher inflation.

The government approved the 2023 budget with a 4.1% GDP growth and a 5.2% inflation target in the summer, dubbed by analysts as an unrealistic target from the onset. The government amended the budget bill in the last days of 2022 with a decree. It targets growth to slow from 4.8% in 2022 to 1.5%, and the budget deficit to decline from 4.9% in 2022 to 3.9%. The latter forecast was revised from 3.5%. Annual average inflation could be three-fold the initial target, at 15%, but even that could be an optimistic forecast, according to analysts.

2.3.2 External environment

Hungary, as a net energy importer and one of the most dependent EU countries on Russian energy sources, saw its trade surplus melt gradually from H2 2021 and the balance turned into a massive deficit in 2022, pushed by surging energy prices and the pick-up of imports and investment in 1Q2022 boosted by expansionary policies. For the full year, the deficit is expected to widen to a record €8bn, compared to a surplus of €1.9bn in 2021 and €5.8bn in 2020.

Hungary imports about 95% of its gas and 45% of its oil and petroleum products from Russia, and these shares are expected to remain unchanged with its exemptions from EU sanctions. The government has done little over the years to reduce its overdependence on Russia in its energy portfolio.

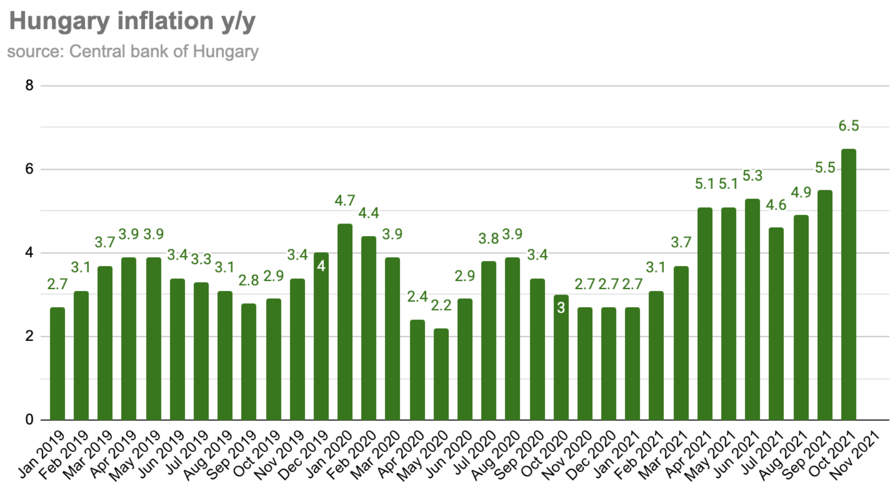
Hungary's energy bill is on track to rise by €10bn this year and by the same in 2023 from €7bn in 2021 to €17bn-20bn, which has put enormous pressure on the country's finances and pushed the currency to record lows.

In a bid to ease that pressure, the central bank began to provide foreign currency from its reserves to state utility company MVM to pay for its energy import bills. Due to this factor, net exports are forecast to contribute negatively to growth in 2023, even supply chain disruptions are expected to ease.

Rising energy prices will increase net energy imports by some 5% of GDP between 2021 and 2023, while non-energy imports are set to remain muted, in line with the slowdown of final demand, the European Commission forecast in its latest economic report.

The current account deficit is projected to peak at over 7% of GDP in 2022, and then gradually narrow to 4.3% in 2024. The balance in the trade of services is expected to post a massive surplus. Excluding the energy price shocks, the country's current account could be in balance.

2.3.3 Inflation and monetary policy



The National Bank was one of the first central banks in the region to start a monetary tightening cycle in June 2021, lifting rates from a record low of 0.6%. Policymakers raised the base rate in 2022 from 2.4% to 13% with 10 rate hikes.

The MNB closed its tightening cycle with a 125bp rate hike in September, saying that conditions were sufficiently strict to ensure meeting the inflation target, adding that "there is no sense in raising rates further". The news came after the MNB revised its inflationary forecast upward from 11-12.6% to 13.5-14.5% for 2022, and from 6.8-9.2% to 11.5-14% for 2023.

The forint weakened more than 5% following the September rate decision, leading to an intense sell-off of the forint, one of the weakest European currencies in 2022, forcing the MNB to intervene with the launch of the one-day deposit facility at 18%, which has become the reference lending rate. The 5pp daily hike was the largest ever one-day rate hike by the central bank. The move helped to contain the slide of the forint, after the EUR/HUF hit 434 and USD/HUF slid to over 450.

Such missteps by the central bank have raised concerns about the MNB's credibility. Analysts argued that government intervention in the market in the form of price caps and freezing lending rates have also weakened the effectiveness of monetary transmission.

In the autumn, the MNB discontinued government bond purchases and other crisis management programmes and tightened monetary conditions by absorbing liquidity through higher reserve requirements and the introduction of longer instruments.

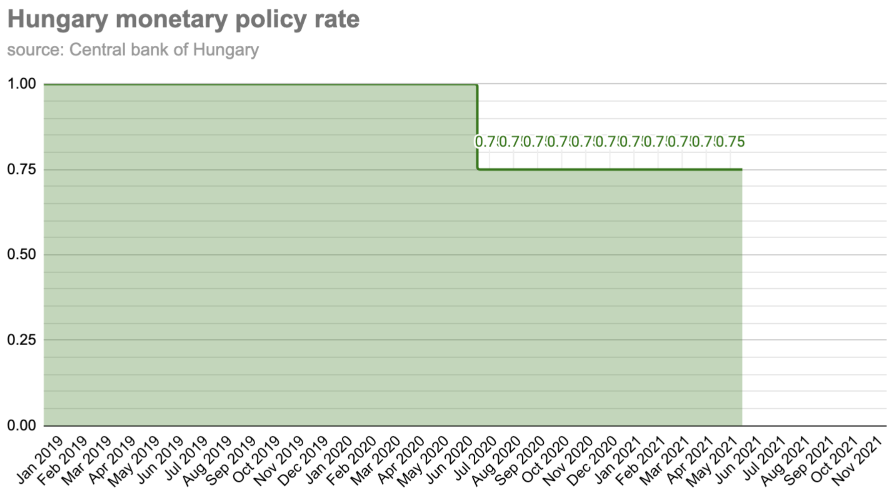
Hungary's headline inflation rate spiked from 2.7% in January to a 26-year high of 22.5% in November, core inflation in the same period rose from 4.2% to 24%, at the fastest pace in the EU, while food prices rose 43.8% y/y in November, the highest among the EU-27.

After the government phased out the fuel price cap in early December, analysts raised their inflation expectations further in 2023 to 16-18% as the measure could boost headline CPI by 2-2.5pp in December to 26%.

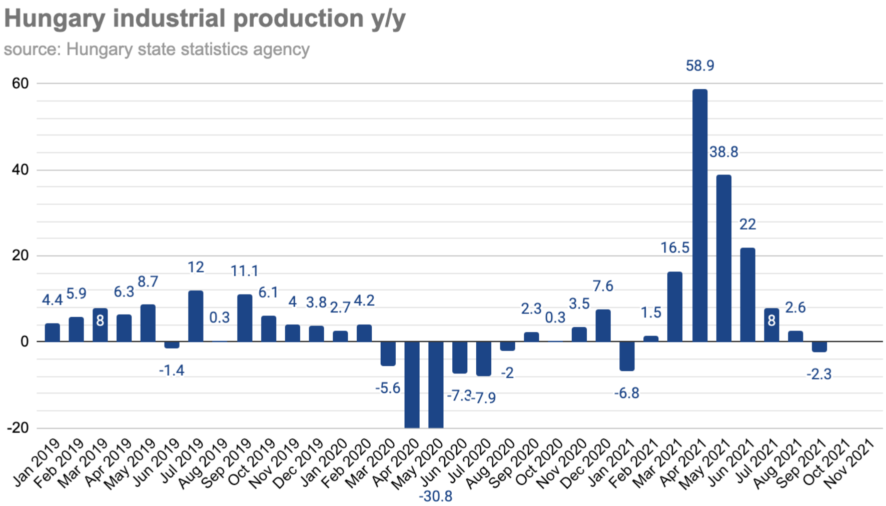
MNB policymakers vowed to keep monetary conditions tight for a prolonged period and expect inflation to return to its 4% tolerance band in 2024. The markets are not expecting the MNB to raise the effective rate from 18% further, the highest level in the CEE region.

The European Commission expects annual average inflation to accelerate to 15.7% in 2023 from 14.8% and the OECD sees the headline rate decelerating from 13.5 % to 12.7% in 2022. The government is expected to amend the 2023 inflation target in the budget bill from 5.2% to 15%.

The Monetary Council reviewed the central bank's latest quarterly Inflation Report on December 20 and published the main forecasts. The report puts average annual inflation at 14.5-14.7% for 2022 and at 15.0-19.5% for 2023, while it kept its 2023 GDP growth of 0.5-1.5% unchanged.



2.3.4 Industrial production



Hungary's export-oriented industry, with a 70% plus export ratio, bounced back dynamically after the pandemic as supply disruptions eased. Industrial exports remained stable throughout the year even as external markets slowed. The war and rising energy prices had so far mitigated the impact on the sector, which grew 9.6% y/y in Q3 and by 6.7% in Q1-Q3. Analysts expect industrial growth to decelerate from 9.6% in 2021 to 5-6% in 2022.

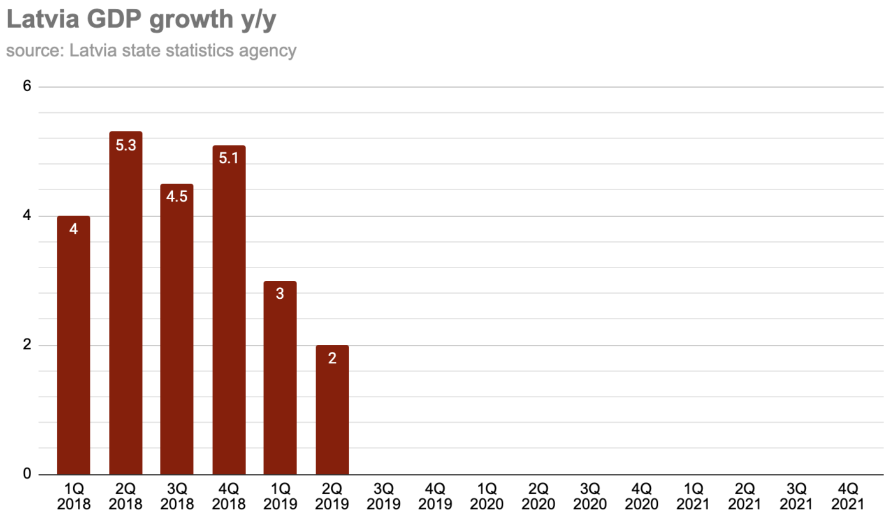
The main driver of growth was electronics and the vehicle industry. The production value of the vehicle sector rose 23% y/y in the first nine months, to HUF8.7 trillion (€21.8bn), and for the first time may exceed HUF10 trillion. The industry accounts for 5% of GDP, 25-30% of the manufacturing sector output, and employs 155,000 people.

The outlook for 2023 remains uncertain, but capacity expansions in the automotive and chemicals sectors could lead to a rebound in manufacturing output, provided that the global economy recovers quickly, analysts said. The order book of the industry was 21% above last year's level at the end of October.

2.4 Macroeconomy - Latvia

2.4.1 GDP growth

Latvia will grow 0.8% in 2023, according to the EBRD. The Latvian finance ministry's forecast for GDP growth for 2022 has been reduced to 1.6%, while a fall in GDP of 0.6% is forecast in 2023.



2.4.2 External environment

Latvia's current account recorded a deficit of €68.53 million in September 2022, compared with a deficit of €260.19 million in August 2022.

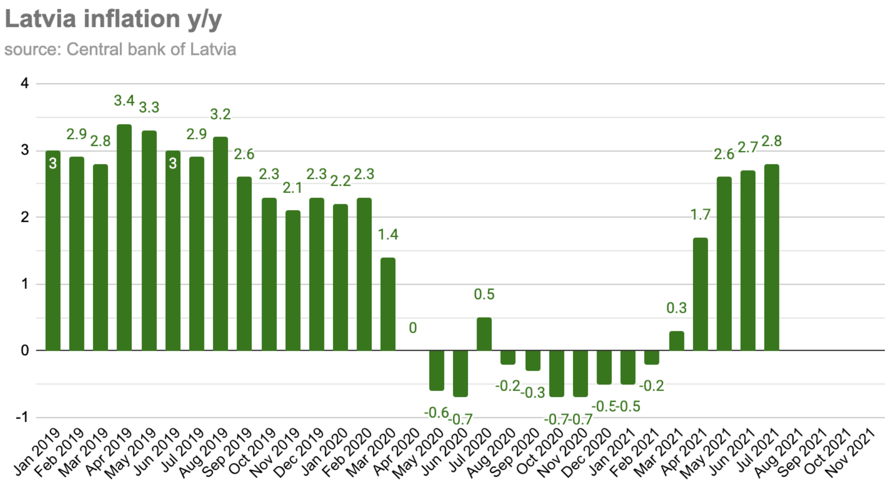
During the first nine months of 2022, the foreign trade turnover of Latvia at current prices reached €34.83bn – €8.86 billion or 34.1% more than in the corresponding period of 2021. The exports value constituted €15.42 billion (a growth of €3.72 billion or 31.9%), whereas the imports value comprised €19.42 billion, a rise of €5.14 billion or 36 %.

The main exports partners in September were Lithuania (18.6% of total exports), Estonia (9.8%), Germany (6.4%) and Netherlands (6%), whereas the main import partners were Lithuania (27.3% of total imports), Estonia (13.5%), Poland (9.5%) and Germany (8.5%).

Foreign direct investment (FDI) increased by €166.85 million in Latvia in September 2022. The FDI prospects for 2023 are rather bleaker than upbeat due to geopolitical tensions.

2.4.3 Inflation and monetary policy

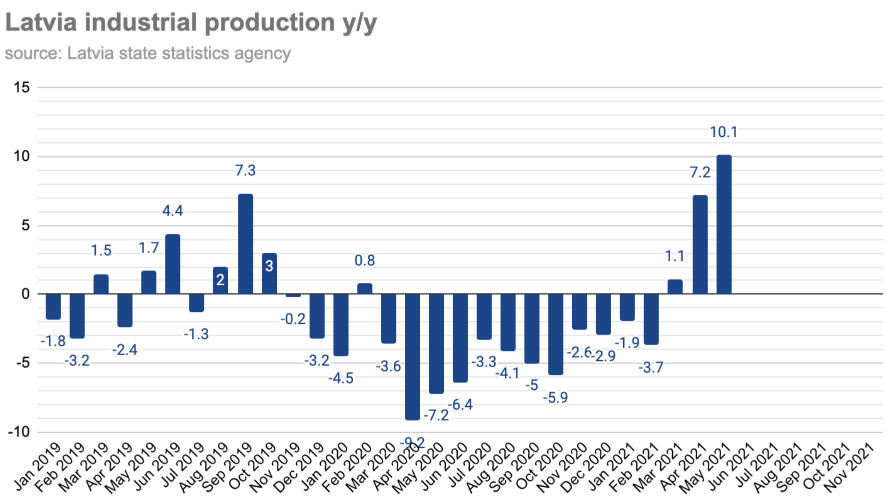
The Latvian finance ministry expects consumer price growth to fall to 8.5% in 2023.



2.4.4 Industrial production

Industrial production in Latvia fell 2.7% year on year in October of 2022, following an upwardly revised 3.8% decline in the previous month.

In September 2022, industrial production for Latvia was €584.4 million. Though Latvia industrial production fluctuated substantially in the second half of 2022, it tended to decrease through October 2021 – September 2022.



2.5 Macroeconomy - Lithuania

2.5.1 GDP growth

Lithuania is expected to show a 2.0% and 1.5% GDP growth in 2022 and in 2023 respectively, according to the EBRD. The Lithuanian finance ministry forecasts 2022 GDP growth at 1.6% despite slower growth in the second half of 2022. The ministry has also revised its GDP growth forecast for 2023 to 1.4%, down from its earlier estimate of 2.1%.

The IMF expects Lithuania's GDP to grow 1.8% in 2022 and 1.1% in 2023. While the forecast for 2022 remains unchanged from the one in April, the estimate for next year has been cut by 1.5 points, more than halving it.

The slower growth will be mainly due to slowing consumption, which is negatively affected by the declining purchasing power of the population due to inflation. Another important factor is the slowdown in major euro area economies, which is reducing demand for Lithuanian exports.

The IMF emphasises the importance of reinvigorating structural reforms to promote dynamic and inclusive growth, including through active labour market policies and efforts to integrate refugees in the Baltics. Noting that the Baltic social policies have effectively kept inequality on a declining path, the IMF has called for further actions to address social gaps that could be exacerbated by high food and energy prices. It has also called for further efforts to ensure energy security and for accelerating the green and digital transitions.

2.5.2 External environment

The Bank of Lithuania said in its report on the balance of payments for September 2022 that, compared to August, the deficit on the current account balance slightly narrowed (3.7%) to €276.2 million. This was due to an increase in the services surplus and a narrowing of the primary income deficit, which offset a significant widening of the foreign trade deficit. Lithuanian exports have been adversely affected by severed relations with China and Belarus, and by soaring prices of energy imports.

Exports of services, which increased by 11.0% more than imports (5.1%), contributed 23.4% to the services surplus, amounting to €533.0 million. The foreign trade deficit widened by 26.6% to €705.0 million, driven by an increase in goods imports outpacing goods exports (by

2.3% and 5.2% respectively). The primary income deficit decreased by 34.2% to €120.0 million.

The negative net flow of financial account investment (€677.3 million) was mainly driven by the negative net other investment and direct investment flows.

According to Lithuania’s Department of Statistics, exports of goods of Lithuanian origin reached €12.7 billion between January and June 2022, and increased by 31.1% compared to the corresponding period of the previous year.

Meanwhile, Lithuania’s total exports increased by 27.4 % over the same period and reached €20 billion.

The trend in exports to the Indo-Pacific was particularly encouraging. Goods of Lithuanian origin were actively imported by Singapore (€146 million, + 160.1 %), Australia (€79.7 million, + 109.6 %), South Korea (€55 million, + 48 %), and Indonesia (€8.7 million, + 84.2 %). Positive dynamics were also in the export of Lithuanian-origin goods to Taiwan (€11.5 million, + 30 %).

Total exports of Lithuanian-origin goods to the10 Indo-Pacific countries (Australia, Japan, India, South Korea, Singapore, Indonesia, Taiwan, Vietnam, Malaysia, and Thailand) increased by 60.4 % in the first half of 2022 (from €249 million to €400 million respectively) and already more than four times exceeds the volume of exports to China between January and June of the last year.

Total exports to these 10 Indo-Pacific countries increased by 56.5% in the first half of 2022, y/y, from €297.6 million to €456.7 million. Exports to China decreased by almost 87 % in the first half of 2022, amounting to €11.8 million.

Germany, Poland and the US remained the leading destinations of exports of Lithuanian origin goods (exports increased by 27, 5, 76, 1, and 1.5%, respectively) in the first half of 2022.

The main ten markets for Lithuania's exports are topped by Latvia (+ 60%), Sweden (+ 28%), the Netherlands (+ 28%), and the United Kingdom (+ 24.2%). Estonia was the eighth leading destination of exports of Lithuanian origin goods. It is exceptional because exports of goods of Lithuanian origin increased by 9 % to this country. Estonia is followed by Norway (+ 6.8%) and Denmark (+ 28.4%).

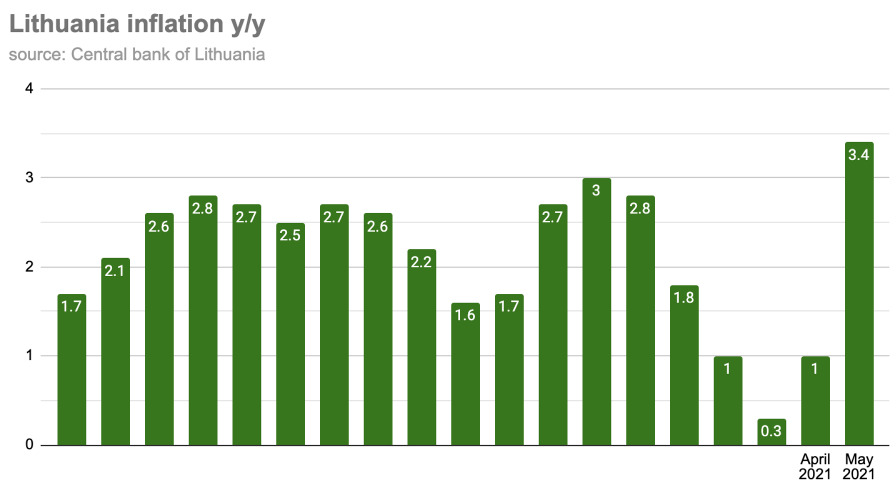
As of the time of writing the report, the newest export-import data came from the Statistics Lithuania, showing that Lithuania's exports totalled €4.21 billion in October, down by 4.7% m/m, but up by 30.6% from a year ago.

Imports amounted to €5.06 billion, down 3.7% m/m, but up by 42.6% y/y. The country's foreign trade deficit stood at €850.1 million.

Foreign direct investment (FDI) increased by €163.45 million in Lithuania in August 2022. The FDI prospects for 2023 are rather bleaker than upbeat due to geopolitical tensions.

2.5.3 Inflation and monetary policy

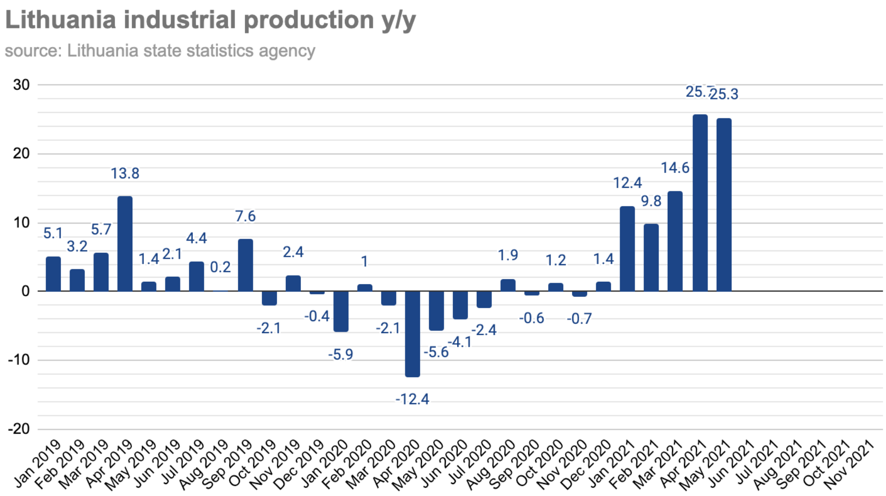
The Bank of Lithuania and the finance ministry forecast that the average annual inflation rate will be less than 10% in 2023, but some analysts say the prognosis is too optimistic.



2.5.4 Industrial production

As of October 2022, in Lithuania, the total volume of industrial production was €3.5 billion at current prices, up 1.1% over the last month. It was the smallest increase in production since June as output growth slowed sharply for electricity, gas, steam and air conditioning supply (21% vs 40.4%). At the same time, output declined for mining & quarrying (-0.1% vs 8.9%), manufacturing (-0.4% vs 1.5%), and water supply, sewerage & waste management (-0.9% vs -6.1%). Considering January 2022 to October 2022, industrial production advanced 12.5% over a year earlier.

Experts expect Lithuania's industrial output to fall 0.3% in 2023.



2.6 Macroeconomy - Slovakia

Slovakia: key economic figures and forecasts							
	2016	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**
Nominal GDP (EUR bn)	81.5	83.9	87.0	89.2	84.9	88.0	
Real GDP (% y/y)	2.1	3.0	3.7	2.5	-4.8	4.4	
Industrial output (% y/y)	4.6	3.3	4.3	0.5	-9.1	9.9	
Unemployment rate (avg, %)	9.6	8.1	6.5	5.8	6.7	7.0	
Nominal industrial wages (% y/y)							
Producer prices (avg, % y/y)							
Consumer prices (avg, % y/y)	-0.5	1.3	2.5	2.7	1.9	2.5	
Consumer prices (eop, % y/y)							
General budget balance (% of GDP)	-2.6	-1.0	-1.0	-1.3	-6.2	-6.5	
Public debt (% of GDP)	52.4	51.6	49.7	48.2	60.3	64.1	
Current account balance (% of GDP)	-2.7	-1.9	-2.2	-2.7	-0.4	0.3	
Official FX reserves (EUR bn)							
Gross foreign debt (% of GDP)							

USD/LC (avg)

Source: Thomson Reuters, RBI/Raiffeisen RESEARCH

2.6.1 GDP growth

Slovak GDP grew by 1.4% y/y in 3Q 2022 and by 0.4% q/q, which was a moderately better slowdown than market expectations. Overall, the GDP in the first three quarters reached €79.4bn and rose by 1.9%. It is above the pre-pandemic level by 0.9%.

Moderate growth was recorded in individual sectors, with industry surpassing the pre-pandemic level from 3Q 2019 by 1.1.%. Even though manufacturing grew by 3.7%, it lagged pre-pandemic levels by 4.7%.

The National Bank of Slovakia (NBS) writes in its winter report that the risk of recession is increasing in 2023, but the slowdown at the beginning of 2023 should only be a moderate one following EU-level and national interventions into energy pricing. It improved its projections of GDP growth in 2023 to 1.6%.

The European Commission's autumn forecast predicts a slowdown in Slovak GDP growth to 0.5% in 2023. The 2023 slowdown is expected as "higher energy prices will erode households' purchasing power and increase the production costs of firms, which are already facing supply bottlenecks and will now also be affected by lower demand".

Successful absorption of EU funds complemented by government investments will be crucial for maintaining growth in the years 2023 and 2024. NBS expects an increase in the drawing of EU funds despite setbacks in a swifter transition to a carbon-free economy.

The nominal monthly wage for January-October 2022 increased between 5% to 19% y/y in all 10 monitored sectors of the economy, but real wages fell in nine of the sectors, except for the accommodation sector where real wages increased by 6% in the first 10 months of 2022. A significant decline in real wages was registered in industry, which employs more than half a million, and where real wages fell by 3.6% y/y.

Unemployment rates have been decreasing in the autumn, with the rate going from 6.1% in September to 5.9% in October and 5.8% in November.

2.6.2 External environment

From January to October 2022, the total export of goods increased y/y by 17.7% to €85.1bn, and total imports were up by 24.7% to €87.6bn. The balance of foreign trade was in a deficit of €2.5bn while it was in a surplus of more than €2.1bn during the corresponding period in 2021.

In the first 10 months of 2022, exports to EU member states increased by 18.7% y/y and represented 80.6% of the total exports. Imports from EU member states represented 62.7% of total imports and increased by 21% y/y. Exports to non-EU countries increased by 13.4% y/y and imports from non-EU countries increased by 31.5% y/y.

The latest figures in the balance of foreign trade from October show a surplus of €199.5mn. The balance was in positive numbers after four months of decline, and for only the second time in 2022. The positive change was mainly driven by a significant m/m increase in the difference between the export and import of motor vehicles.

The increase in total imports has been influenced by mineral fuels which include imports of natural gas, oil, and electricity, and has been growing since April 2021.

More than 35% of output comes from work for global supply chains, the EBRD's 2022/23 Transition Report notes.

Slovakia is exempted from the EU embargo on Russian oil, but its dependency on imports of Russian oil and gas has been pointed out by IMF as one of the risk factors, with the economy exposed to import disruptions.

The Russian embargo on oil imports is primarily directed against G7 countries importing crude oil by sea and should not impact the Druzhba pipeline which is used for oil imports into Slovakia, Hungary, and Czechia.

2.6.3 Inflation and monetary policy

Inflation in November reached 15.4%, which is the highest level in more than two decades and above the Eurozone average of 10.6%. y/y inflation has been on the rise since January. The European Commission projected average annual inflation of 13.9% in 2023 after averaging 11.5% in 2022.

Food prices were up by 29% y/y in November. When speaking at a Joint Vienna Institute webinar in mid-December, deputy governor of the National Bank of Slovakia (NBS) Ludovit Odor estimated that food prices represent some 50% of the inflation basket in Slovakia. In its winter forecast, NBS expects inflation to remain above or at 10% throughout 2023.

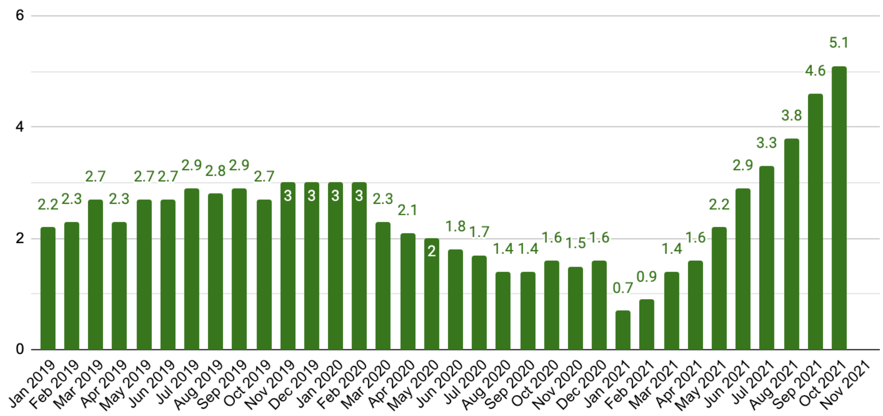
In total for January-November 2022 consumer prices in households of employees increased by 12.5% y/y, in low-income households by 12.8%, and households of pensioners by 13.6%. The high inflation level saw real wages drop across all monitored sectors of the economy for the first time in October.

High energy prices are still expected to be fully translated into consumer prices. Secondary effects from the supply side shocks will also continue to keep inflation high. NBS expects inflation to ease in the second half of 2023.

Slovakia is a eurozone member country and the European Central Bank (ECB) could see more hikes in interest rates in 2023.

Slovak inflation y/y

source: Central bank of Slovak

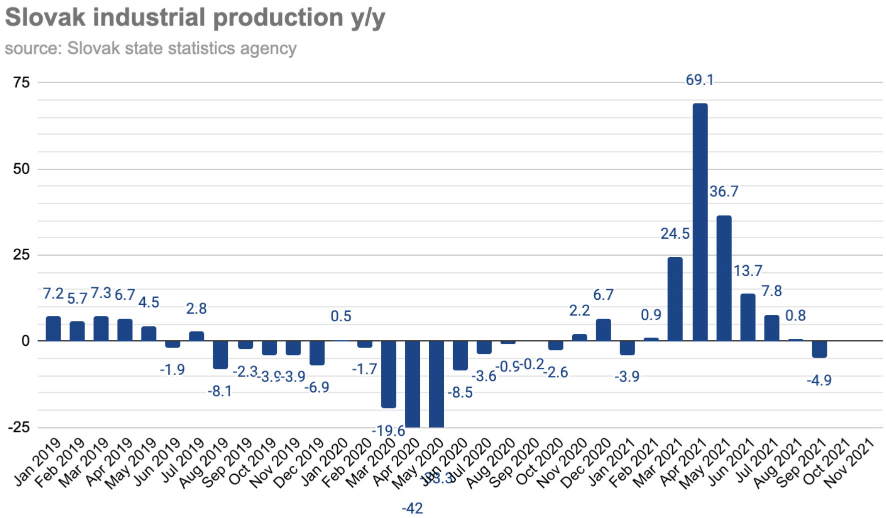


2.6.4 Industrial production

In January-October 2022 industrial production dropped by 3.2% y/y. The latest figures for October 2022 show that industrial production decreased by 2.6% y/y but increased by 1.3% m/m.

The most significant factor affecting industrial production was lower production in the supply of electricity, gas, and steam (28%). Manufacture of transport equipment, which is overall the most influential segment in the Slovak industry, grew by 1.7% y/y.

The Economic Sentiment Indicator (ESI) in December increased by 1.2 points m/m, but the ESI value of 88.8 points was among the lowest in 2022. The increase in confidence was in services, trade, and construction, but pessimism in the industry deepened. The ESI value was lower by 6 points y/y, and it was lagging behind the long-term average by 13.7 points.



3.0 Real economy outlook

3.1 Real economy - Czech Republic

3.1.1 Retail

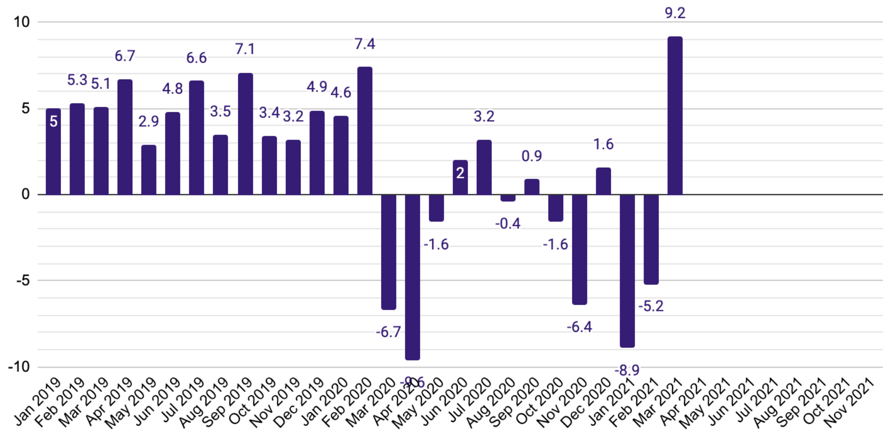
The retail sector has been hit by the fall in household income. The situation of households is deteriorating as rising inflation is causing a fall in real income for most households. The country's real wages are set to drop by 8.3%, the steepest decrease in all Visegrad (V4) countries as well as considerably below the EU average drop of 2.3%, an analysis by investment and consulting company Cyrrus showed in November.

Due to the soaring inflation Czechia is also projected to see a decline in real wages by 0.1% next year. In comparison, real wages are expected to grow by 0.6% on average in the EU, which is also the case in the remaining V4 countries.

A significant drop in real wages was seen in the figures for 3Q 2022 when the gross monthly nominal wage increased by 6.1% compared to the previous year, but in real terms it decreased by 9.8%, which is the same decrease as in the previous quarter.

Czech retail turnover (inc. cars) change y/y

source: Czech state statistics agency



3.1.2 Banks

Worsening real incomes of households could also be felt in the banking sector in 2023, but they were offset by the impact of rising net interest margins, with large banks recorded profits based on incomplete results. Moneta expects to exceed the 2022 forecast results, and profits were recorded by UniCredit Bank, Ceska Sporitelna (Erste), Komercni Banka (Societe Generale), and CSOB (KBC) driven by the high interest rate environment.

Those households with disposable cash made greater use of savings accounts to safeguard cash from inflation. Encor Wealth Management partner Lubor Zalman cited a figure of CZK220bn (€9.1bn) in savings accounts on the Czech market but expects attractive interest rates for savings to gradually drop in 2023.

The six largest banks in Czechia will also be affected by the windfall tax approved by the cabinet late in 2022 and aimed at collecting excessive profits in 2023-25. While 2023 profits are all but certain to be subject to taxation, and the cabinet is making calculations on the expected revenues from the levy to mitigate the impact of the energy crisis, Finance Minister Zbynek Stanjura reiterated that the taxation will be reviewed before being applied to the 2024 or 2025 profits.

Erste, which together with KBC has the largest presence in CEE, is set to take over the local Sberbank CZ’s bank loan portfolio for CZK41bn (€1.7bn). Sberbank was forced to file for insolvency after Czech authorities revoked its banking licence amid rumours that the branch wouldn’t have enough cash to withstand the impact of sanctions.

2022 also saw a rise in loans offered in euro currency as a result of the lower interest rates in euro. The new loans are now almost evenly split between the euro and koruna.

3.1.3 Industry

Major Czech brands including Skoda Auto or Skoda Transportation made their exit from the Russian market after the Kremlin’s invasion of Ukraine and imposition of sanctions. A focus on decoupling from Kremlin-linked business can still play a role in business mergers and acquisitions in 2023.

Late in 2022 CEZ completed the takeover of Skoda JS, one of the country’s main nuclear energy companies, previously owned by Russian engineering group OMZ, which is controlled by Gazprombank.

Military materiel production will receive a further boost from the government's plans to revive Soviet-era production lines staffed by Ukrainian engineers and technicians. The project is coordinated with the Ukrainian government and is expected to be financed by countries supporting Ukraine financially and militarily, headed by the US, UK, and several EU member states.

The largest company on the market Skoda Auto is switching to euro currency from January 2023 as most of its sales are in the euro currency and this trend is further boosted with the rise of electric car sales.

3.1.4 Energy & power

Majority-state-owned energy utility CEZ is responsible for organising a tender for the construction of the 1,200 MW third block at the Dukovany NPP. The utility is expected to lead negotiations with the bidders and receive final offers from France's EDF, South Korea's KHNP, and the US' Westinghouse by the end of September 2023.

The planned year of completion of the Dukovany expansion is 2036, but this together with CZK160bn (€6.6bn) investment costs have been contested as unrealistic by independent energy analysts. Additionally, security and environmental analysts objected that the investment is not addressing Czechia's short-term needs to decouple from Russian energy or to boost renewable energy.

The Kremlin's military campaign combined with the prospects of energy supplies disruptions prompted the cabinet to take more action in addressing the country's high dependency on Russian energy imports, which at the time of the invasion meant that over 90% of gas had been coming from Russia.

Due to its about 30% dependency on Russian oil from the Druzhba pipeline, Czechia has been exempted from the EU embargo on imports of Russian oil. Following the shareholders' November agreement to increase the TAL pipeline capacity, Czechia could become independent from Russian oil imports by 2025.

Through CEZ, Czechia also secured 3bn cubic metres of annual gas capacity at an LNG terminal in the Netherlands. It also resumed work on the shelved project of Stork II pipeline bringing gas from the Polish LNG terminal at Swinoujscie to Czechia's northern Moravian region.

Nine gas storage facilities in Czechia were at nearly 100% capacity ahead of winter and dropped to 86% following the frosty weather in the first half of December. Energy analysts estimate about ¾ of winter gas consumption comes from gas storage facilities. Czechia is expected to maintain 21% capacity by March if last winter's temperatures are projected. If the winter season is frostier, Czechia could be down to 11% capacity in March.

Windfall tax measures on energy companies have been criticised by the two largest privately-held energy companies, EPH of Daniel Kretinsky and Patrik Tkac, and Sev.En of Pavel Tykac. EPH announced it will relocate its trading branch EP Commodities outside of Czechia in 2023 so as to avoid being taxed.

The community energy bill is set to be submitted to the cabinet and both chambers of the parliament for approval in 2023. If ratified, the bill could pave the way for villages, small towns or city quarters to be sustained from renewable energy, possibly transforming the Czech energy market with its centralised energy distribution. The bill was withdrawn in the autumn 2022 by the industry ministry over worries whether the energy grid will be able to accommodate the renewables, but the ministry eventually submitted the draft bill on December 5, 2022.

The cabinet also plans to transform the majority-state-owned energy utility CEZ. Few official details have been given but it is expected to involve nationalisation of energy production, while leaving distribution with the listed company.

The government’s response to the energy crisis has been criticised by independent analysts as too expensive and not effective enough in helping the most vulnerable households.

3.1.5 Construction

The latest figures for October show that construction output increased by 1.0% y/y and by 1.8% m/m. The production in building construction increased by 1.2% and the production of civil engineering construction increased by 0.4% y/y.

The planning and building control authorities granted 7.178 building permits, which was 6.5% less y/y. The approximate value of the permitted constructions reached CZK 38.2bn, which is an increase of 11.1% y/y.

The number of newly started dwellings is down by 27.7% and the number of completed ones is down by 0.6% y/y. The decrease holds particularly true for the number of dwellings started in multi-dwelling buildings, the Czech statistical office points out.

3.1.6 Major Sectors

Major Czech brands including Skoda Auto or train and tram manufacturer Skoda Transportation of PPF Group made their exit from the Russian market after the Kremlin’s invasion of Ukraine and imposition of sanctions. A focus on decoupling from Kremlin-linked business can still play a role in business mergers and acquisitions in 2023.

Late in 2022, CEZ completed the takeover of Skoda JS, one of the country’s main nuclear energy companies, previously owned by Russian engineering group OMZ, which is controlled by Gazprombank.

Military materiel production will receive a further boost from the government's plans to revive Soviet-era production lines and bring in Ukrainian engineers and technicians. The project is coordinated with the Ukrainian government and is expected to be financed by countries supporting Ukraine financially and militarily headed by the US, UK, and several EU member states.

Czechoslovak Group (CSG) concluded major deals – not subject to public procurement as a result of the war situation in Ukraine – with the

Czech army in 2022 for the supply of Tatra vehicles. CSG has been expanding abroad and also offered to take over Explosia, the state-owned Semtex explosives manufacturer.

The largest company on the market Skoda Auto is switching to the euro currency from January 2023 as most of its sales are in the euro currency and this trend is rising with the rise of electric car sales.

The Czech cabinet has proposed a location near Pilsen to Skoda Auto's parent company Volkswagen, which late in 2022 refrained from making a decision as to its immediate "Gigafactory" electric battery plant construction plans in Europe. The cabinet views the Gigafactory project as a key one for the transformation of the Czech automobile industry, which represents a quarter of the country's exports and a tenth of its GDP.

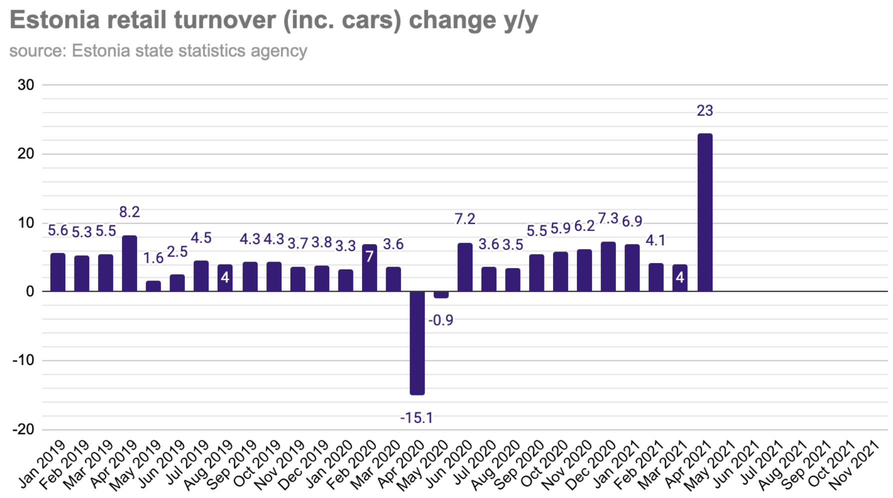
The country's largest agriculture, food, and chemistry company Agrofert, linked to the ex-premier and populist presidential candidate Andrej Babis, took over the Czech TOP HOP company. TOP HOP produces one-quarter of the hops in a country with the largest per capita beer consumption in the world, and supplies hops to some of the largest breweries in Czechia including Pilsner Urquell or state-owned Budweiser Budvar. The deal was reported to be worth up to CZK1bn (€40mn).

3.2 Real economy - Estonia

3.2.1 Retail

Retail sales in the Baltics were uneven at the end of 2022 and were likely to edge down in the first half of 2023 due to the expected recession.

In Estonia, the year-over-year change in retail sales was also negative at the end of 2022. Estonian retail trade fell by 4.0% y/y in October of 2022, following a 5.8% drop in the prior month.



3.2.2 Banks

Despite the shock from the war, there have been limited capital outflows from the three Baltic states following the war, and the corporate sector remains robust. Baltic banks are well capitalised and businesses maintain substantial cash reserves.

The Baltic banking system remained stable throughout 2022 despite the heavy impact of war on the local economies.

3.2.3 Industry

Industrial production was edging down in the Baltics at the end of 2022 and will likely stagnate in the first half of 2023.

Before the war, the medium and long-term manufacturing growth rate remained relatively fast and growth was becoming not so much related to the extensive increase of material-intensive production volumes, as much with the usage of the newest technological processes, digitisation, process optimisation, etc. Due to the above-mentioned factors, faster development was expected in the high and medium technology sectors – chemistry, pharmacy, electronics, etc.

However, the war disrupted the existing supply chains and the new ones are much farther and costlier. The year of 2023 will be a year of adaptation for Baltic industries.

Also, the region faces some other work productivity-related challenges, especially that the rise in wages outpaces Baltic productivity, and the shift from labour-intensive production to high value-added products is slower than in Western Europe.

One of the other challenges the Baltics face is labour availability and practical and professional skills. The lack of the labour force in the long term could really affect the possibility to raise the productivity of Baltic industry. The ageing population and poor demographic indicators will have to be addressed.

Although some expect that the Ukrainian refugees – around 150,000 fled to the Baltic states following the war – will give a boost to the labour market, this is doubtful. Many of them are low-skilled workers, besides the states had to allot significant funds to accommodate them and pay social allowances.

Responding to the lack of labour force, Baltic industry needs to intensify the use of various IoT solutions to improve production processes. The Baltic states will have to pay special attention to the integration of new technology solutions into manufacturing companies in 2023 and beyond.

Since manufacturing industry is energy intensive, many Baltic companies struggled in 2022 and will likely struggle in 2023 despite government support. Energy efficiency is one more aspect to improve to stabilise the development of industry

3.2.4 Energy & power

With the region's dependence on imported energy – one of the leading factors of historically high inflation – it's vital for the Baltic states to develop domestic energy production and support the transition to green energy. Renewable energy and green transition are high on the agenda in all three Baltic states.

In 2023, the region will most likely make concrete the plans for building compact nuclear plants after 2028, in particular Lithuania and Estonia. Amid the crises, Estonia resumed production of electricity in its shale oil-fired plants, which had been previously been mothballed under a EU directive.

3.2.5 Construction

The real estate market, especially its residential sector, stagnated in the second half of 2022 and was expected to remain such in the entire Baltic states throughout 2023.

Potential homebuyers will remain cautious and won't rush their decision-making when it comes to buying a dwelling, whereas home sellers will be trying in 2023 to find a balance between their own expectations, and the real estate market price.

In the environment of rapidly increasing housing prices, vendors often entered the market during 2022 with prices higher than the current market price. In demanding a higher price, they expect the general level of housing prices to quickly catch up with the prices they have set, thereby hoping to have their real estate sell for the highest possible price.

Earlier, in the context of the previously prevailing optimism and fast price growth, such expectations would actually turn out to be well-founded for the majority of sellers. But the purchasers' optimism in the real estate market has faded in the second half of 2022, which has reduced the market activity overall, and extended the whole deal process. The vendors who have to sell housing more quickly are therefore forced to reconsider the purchase prices offered and reduce their expectations, which no longer match the current reality. So, sellers will need in 2023 to gradually decrease the asking price of their property, although usually, even after the price correction, they still will likely remain above the dominant price level in the market.

Meanwhile, the sellers who carry a realistic outlook on the current situation and offer housing at the market price might expect their housing to attract enough interest from potential buyers and be sold in a more usual period in 2023 too. The most recent apartment market data shows that the activity in the largest and the most important housing segment in the Baltics, despite a slight reduction, has remained stable during the second half of 2022.

The industrial premises sector in the Baltic countries has also shown growth potential in 2022 with various production purpose, logistics centre projects and stock-office type projects being implemented not only in areas around the Baltic capitals but also in other big cities and their surroundings. The growing consumption and the expanding e-commerce have provided momentum not only for the construction of bigger projects but also for the development of smaller multifunctional projects close to the final user in the Baltic states' second and third largest cities.

The trend is likely to remain throughout 2023, however, at a much slower pace – due to the war spillovers and a possible recession in the Baltics, the EU and the world.

3.2.6 Major Sectors

Tourism in the Baltics has been hit hard by the depth and duration of the crisis triggered by the COVID-19 pandemic. Just as the sector was starting to rebound, the economic fallout from Russia's aggression against Ukraine has dealt a fresh blow to recovery prospects. After Russia's invasion of Ukraine on February 24, approximately seven out of 10 foreign customers who were planning a trip to the Baltics cancelled it.

The Baltic governments were doing a lot though to convince foreigners that the Baltics were a safe destination. The Estonian Hotel and Restaurant Association says that in most cases group bookings were cancelled, and individual bookings were more frequent.

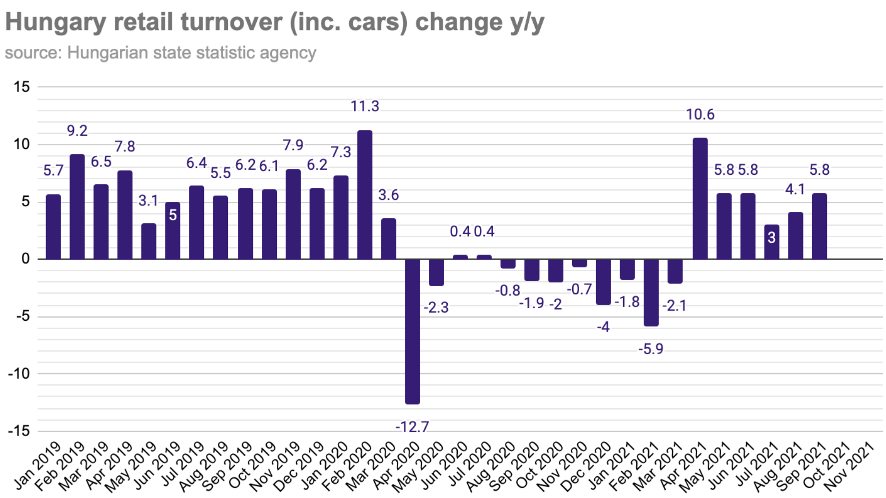
Yet, compared to the COVID-struck 2021, 2022 saw more tourists in the Baltics. The seaside municipalities did relatively better in 2022.

The war has drastically affected the cruise passenger sector in the Baltic ports of Klaipeda, Tallinn and Riga, which, in 2022, saw on average 20% fewer cruise ships, when compared to the pre-pandemic level.

The security problem in 2023 will remain highly relevant across the Baltic Sea Region, where travelling is to a large extent based on the maritime sector.

3.3 Real economy - Hungary

3.3.1 Retail



Household consumption is set to decrease in 2023 from a projected 4-5% growth in 2022 as household income will be eroded by high inflation and rising food and energy prices. The minimum wage increase of 14% for skilled workers and 16% for unskilled workers will only keep real wages flat after years of double-digit expansion.

First-half growth of 9.6% in retail sales was lifted by the pre-election stimulus, including a one-time income tax refund to families with children, an income tax cut for workers under age 25, the re-introduction of the 13th monthly pension and administrative wage increases. As the year advanced, households have begun to adjust their spending patterns to higher inflation, the impact of fiscal tightening, and the phase-out of energy subsidies in the summer.

Food sales contracted for the fifth straight month in October as food inflation was the highest in Hungary among EU countries. Price caps on food staples have been ineffective in tackling overall inflation as retailers spread losses and raised the price of non-capped products. The 4% windfall tax levied on the largest food retailers had the same impact. In November food prices rose at 43.8% y/y in November with egg prices jumping 103%, bread by 82% and milk products by 79%.

It was only recorded fuel sales that kept the sector's sales in positive territory in the autumn months due to the regulated prices. After major supply shortages in the first days of December, the government phased out the HUF480/litre price cap on December 8, pushing up prices by 30-40%, which will likely trigger a fall in retail sales in the first half of 2023 in addition to lifting the headline CPI by 2-2.5pp.

Households remain partially shielded from rising energy prices and financing costs through administrative caps on residential energy prices and mortgage rates.

3.3.2 Banks

As in the past, the financial sector seemed an obvious target for the government to raise funds to fill the gap in the budget left by the pre-election splurge. The Banking Association estimated the total levy on the sector to have reached HUF500bn (€1.23bn) in 2022. The government decree on windfall taxes in June requires banks to pay a special tax on net revenue of 10% in 2022, a HUF200bn-250bn levy. The tax rate will go down to 8% in 2023. Banks will pay HUF50bn in financial transaction duty this year and the levy to state deposit fund OBA after the bankruptcy of Sberbank cost them HUF73.5 bn. The freeze on interest payments for variable-rate mortgage loans has cost lenders HUF190bn.

To mitigate the impact of rising interest rates, the government extended the mortgage rate freeze for some 330,000 families holding some HUF330bn in outstanding variable-rate home loans. These borrowers are expected to save HUF350,000 over an 18-month period. The price cap was recently extended to five-year mortgage loans until June 2023 as well. The government also capped lending rates for some 60,000 SMEs, which is expected to hit banks with an additional HUF80bn.

As a result, the non-consolidated after-tax profit of Hungarian banks fell 12.4% y/y to HUF562bn (€1.37bn) in Q1-Q3. The lending stock rose

25.1% to HUF52.47 trillion, while the stock of deposits increased by 22.2% to HUF66.22 trillion.

Tight lending conditions have already slowed lending in September after dynamic growth in previous years, and more pain is to come from borrowers if the government scales back state subsidies. New home loans fell by 30% y/y in Q3 and by nearly 40% in September. Demand for consumer loans fell 17% in the same period. With the successive rate hikes by the MNB, mortgage rates have climbed over the psychological 10%.

Among corporate news, the merger between MKB Bank, Takarekbank and Budapest Bank has entered the final stage and will be completed in the spring of 2023. The new bank under the MBH Bank brand has over HUF10 trillion in total assets and around 2.3mn clients. While its balance sheet will make it runner-up behind OTP, it will be the market leader in the corporate lending and farm lending markets.

3.3.3 Industry

Hungary drew a record €6.5bn of investments in 2022 led by South Korean companies. Investments in the electric and hybrid vehicle sector accounted for 30% of the total and battery production for 43%.

In terms of output, Hungary is the third-largest producer of EV batteries, even as the €7bn battery plant China's CATL will be counted in next year's investments. The largest greenfield investment in the history of Hungary is also one of the five largest in Europe in the past 10 years.

These investments signal the government's strategy to diversify dependence on traditional vehicle manufacturing and make Hungary a hub for EV battery production.

German carmaker BMW Group also announced the doubling of the value of its investment to €2bn by building a 140,000 sqm high-voltage battery assembly plant next to its e-vehicle production base under construction, also in Debrecen.

Adapting to the energy crisis will be a major challenge for the sector in the short-run, but the sector's outlook is rather bullish with new capacities coming to stream. The government provided subsidies to energy-intensive companies and raised the subsidised credit schemes and extended a freeze on lending rates to SMEs.

3.3.4 Energy & power

Earlier in December, Hungary’s parliament approved the extension of the lifespan of four existing blocks at the Russian-built reactors of the Paks nuclear power plant, greenlighting the government's plans of operating them for 20 more years from the current timeline of 2032-2037. The move signals that the government is drawing up plan “B” should the expansion of the power plant suffer further delays.

Nuclear authority OAH gave the final licence to Russian state energy giant Rosatom to build two 1,200 MW reactors in Paks for €12.5bn, financed by a €10bn Russian loan. The government expects the two new blocks to go online in 2030, a five to six year delay compared to the initial 2024-2025 schedule. After winning a fourth straight supermajority win, the government accelerated the largest investment on record even as many analysts questioned the viability of the project in view of the sanctions against Russian companies.

The spread of renewable energy continued in 2022. Hungary's built-in solar energy capacity rose to 3,400 MW in the first half, up from 2,950 MW at the end of 2021, and accounted for 14% of electricity generation in 2021. Capacities are set to reach the 6,500-MW target, set by the government in its energy strategy, years before the 2030 deadline when some 90% of the country's electricity production could be carbon-free.

Hungary imports about 95% of its gas and 45% of its oil and petroleum products from Russia. These shares are expected to remain unchanged because of the exemptions from EU sanctions. State-energy MVM received deferred payments for gas supplied by Gazprom that eased pressure on Hungary's widening current account deficit and its currency, which plunged to historic lows in October.

In the wake of the energy crisis, the government signalled plans to spend €16bn in investments on the electricity system by 2030, much of this to be financed from the RRF.

Citing the lack of grid capacity, MVM suspended taking over solar energy produced by households, a blow to tens of thousands of households scrambling to find cheaper alternatives after the government scaled back retail energy subsidies.

The overhaul of the energy subsidy system, pushing up gas and electricity bills by 30-50% for some households, triggered an upswing in energy efficiency investments, including solar panels. Over the years, regulated energy prices did not provide incentives for these investments.

Hungary aims to reduce its gas consumption by 2030 to cover a quarter of its needs from domestic sources and cut off gas imports entirely from Russia by 2050, according to government projections. Natural gas accounts for 44% of the country's energy usage, including electricity production and district heating.

3.3.5 Construction

Much like the retail sector, the construction industry got a boost from the government's pre-election stimulus in H1, but output slowed in the second part of the year as energy prices and construction costs climbed upward. The sector reported double-digit growth in 10 out of 13 months before June 2022.

Runaway material and energy prices, skyrocketing financing costs, and falling private and public demand all point to a slowdown, according to analysts. The government postponed some HUF2 trillion of state investments to plug the budget holes. On a positive note, the extension of the 5% VAT on residential home construction and robust growth in the industrial logistics market could lend support to growth.

The sector's output in the first nine months increased by 4.8% from the base period and with the Q4 slowdown of the economy it is expected to slow further in the coming quarters compared to a 16.7% growth in 2021, lifted by a low base. Construction association Evosz has warned of double-digit declines in 2023 for the first time since 2020, because of falling new orders.

The order stock was 8.2% lower at the end of September and buildings segment orders dropped 15% and civil engineering orders fell 3.6%. New orders declined 20.9% as new orders in the buildings segment slipped 5.8% and new civil engineering orders were down 34.4%.

Construction producer prices continued to rise above the rate of inflation, up 26.2% y/y in September. Home prices continued to grow by double-digits in 2022, extending seven to eight years of growth, but prices are set to stagnate amid tighter lending conditions and faltering demand due to expected real wage contraction.

The MNB warned of the risk of overvaluation in the housing market, adding that the developments in credit trends point to a potential build-up of risks in the medium term due to rising yields and the weakening of the purchasing power of households.

3.3.6 Major Sectors

The tourism sector, generating 10% of GDP, took a hard hit during the pandemic, which ended years of record growth. Guest numbers in Budapest hotels plunged from 4.6mn in 2019 to 1mn in 2020, with foreign guests accounting for 75-80% of the total. Hungarian hotels with at least three stars recorded an 11.3% increase in guest nights to 15.2mn or just 42.5% of the pre-crisis level in 2021.

From a low base, the sector has staged a recovery. The number of guest nights climbed 50.4% y/y in the January-October period to 22.81mn. The number of guest nights spent by domestic travellers rose 20.0% to 13.22mn and foreign guest night numbers jumped 131.6% to 9.58mn.

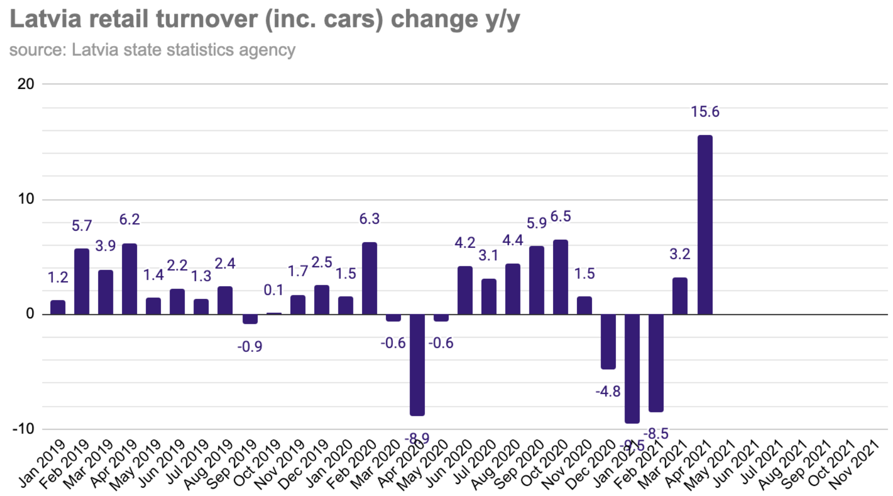
The position of Budapest improved as international tourism recovered from the pandemic. Hungary's tourism sector could also exploit its comparative advantage from the weak currency.

The sector's outlook is clouded by the energy crisis and the decline of purchasing power as households are cutting back on spending on services amid surging inflation. Spa hotels outside of Budapest are reeling from skyrocketing energy prices, and many operators are closing down for the winter. The Hotel Association warned of great uncertainty in the coming months.

3.4 Real economy - Latvia

3.4.1 Retail

Retail sales in Latvia rose by 5.8% from a year ago in October 2022, following a downwardly revised 1.2% increase in the previous month. It was the strongest growth in retail activity since March, as higher sales of non-food products (14.9%) and automotive fuel (2.7%) more than offset decreases in those of food (-3.8%). On a seasonally adjusted monthly basis, retail sales went down by 0.8%, after increasing 1.2% in the previous month.



3.4.2 Banks

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The Baltic banking system remained stable throughout 2022 despite the heavy impact of war on the local economies.

3.4.3 Industry

Industrial production was edging down in the Baltics at the end of 2022 and will likely stagnate in the first half of 2023.

3.4.4 Energy & power

With the region's dependence on imported energy – one of the leading factors of historically high inflation – it's vital for the Baltic states to develop domestic energy production and support the transition to green energy. Renewable energy and green transition are high on the agenda in all three Baltic states.

3.4.5 Construction

It is the Latvian capital, Riga, which is believed to have the best office RE development prospects in 2023. Around 10-12 new office buildings are scheduled to come on stream in Riga in 2023, offering total office space of around 137,000 sqm. Such a surge in supply will open up real opportunities for the expansion of both domestic and foreign companies. In addition, new and well-paid jobs will also give the housing segment an extra boost. Lithuanian-owned capital entering the Riga market shows that the city's potential is untapped.

The data of the Central Statistical Bureau of Latvia (CSB) for the third quarter of 2022 show that construction output fell by 13.6 %, y/y, according to calendar adjusted data at constant prices.
A decline was observed in construction of buildings (of 14.2 %), specialised construction activities (13.3 %) and civil engineering (12.2 %).

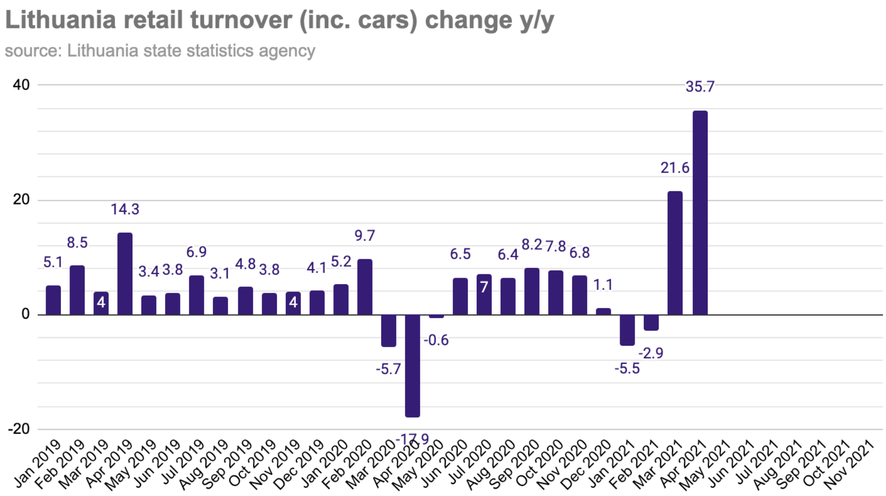
3.4.6 Major Sectors

The Latvian Hotel and Restaurant Association estimates that 60% of hotel bookings were cancelled after the Russian invasion of Ukraine.

3.5 Real economy - Lithuania

3.5.1 Retail

In Lithuania, retail volume fell by 3.5% y/y in October 2022, after a 1.2% drop in the previous month. This was the fifth straight month of decline in retail trade, with sales falling at faster rates for food, beverages, and tobacco (-8.2% vs -5.0% in September) while non-food products dropped (-2.8% vs 0.2%). Meanwhile, sales growth of automotive fuel in specialised stores accelerated (2.1% vs 1.6%). On a monthly basis, retail sales dropped by 1.5% in October, following a 5.5% gain in September.



3.5.2 Banks

Despite the shock from the war, there have been limited capital outflows from the three Baltic states following the war, and the corporate sector remains robust. Baltic banks are well capitalised and businesses maintain substantial cash reserves.

The Baltic banking system remained stable throughout 2022 despite the heavy impact of war on the local economies.

3.5.3 Industry

Industrial production was edging down in the Baltics at the end of 2022 and will likely stagnate in the first half of 2023. However, relatively fast growth rates are forecast in the biggest manufacturing sector – wood-processing, especially in Latvia and Lithuania.

3.5.4 Energy & power

With the region's dependence on imported energy – one of the leading factors of historically high inflation – it's vital for the Baltic states to develop domestic energy production and support the transition to green energy. Renewable energy and green transition are high on the agenda in all three Baltic states.

Lithuania has postponed the final stage of household electricity market liberalisation until 2024, a result of collapse of an independent electricity provider that could not afford buying electricity at a record-high market price from NordPool Exchange.

3.5.5 Construction

According to the data of Lithuania's State Enterprise Centre of Registers, the general activity in the country's secondary apartment market has dropped 15% (during the period from July to October 2022 as compared with July to October 2021), but analysts believe that namely the secondary apartment market, especially its sector of old apartments, will be livelier than the others.

3.5.6 Major Sectors

Lithuania had a similar situation to Latvia as a large proportion of hotel reservations have been cancelled because of the war in Ukraine. These have mostly been group bookings from Germany, as well as the United States and Asia.

Lithuania's Hotel and Restaurant Association (LHRA), says that the country's inbound tourism has shrunk 47% over the last two years. Over the period, the number is approximately 30% in Estonia and over 55% in Latvia.

To ensure that the upcoming winter is not too difficult for the tourism sector, Lithuania reduced the VAT rate for hotels for an indefinite period and extended the VAT exemption for restaurants for a half a year. A part of the cost of electricity will also be reimbursed to operators of hotels and restaurants in the Baltics. The other two Baltic states passed similar measures.

3.6 Real economy - Slovakia

3.6.1 Retail

Retail turnover has been declining since August. September figures show the retail trade down y/y by 4.9% despite the turnover in sales and repair of motor vehicles and motorcycles increasing by 5.2% y/y, which was driven by an 11.2% increase in turnover of vehicles. In October retail trade fell by 4.4%.

In retail trade real wages decreased by 5% y/y in October.

3.6.2 Banks

Close to €20bn were provided in new loans for housing and some €4bn in consumer loans in the past two years, according to the Slovak Banking Association (SBA). Banks in Slovakia also own state bonds worth €9bn which is a sixth of the emitted value.

NBS puts the net profit of the banking sector for January-September 2022 at €572mn, which is comparable to the corresponding period in 2021 despite the spike in interest rates.

Local banking analysts expect a further drop in mortgage loans, which was already apparent in the second half of 2022, and consequently a decrease in real estate prices. The consumer loans segment can in fact grow because of the lower purchasing power of households which can seek short-term consumer loans as a way out of the pressure on the cost of living.

More banks are offering to finance green-oriented projects with a positive impact on sustainability and the circularity of the economy.

3.6.3 Industry

In its winter forecast, the National Bank of Slovakia (NBS) sums up that the easing of external pressure in supply chains in 2022, in comparison to 2021, helped Slovak car, machine, and electronic producers. On the other hand, the high energy prices were dampening energy-intensive production, which includes the metal and chemistry industries.

The latest figures for October show that industry recorded a y/y increase in turnover by 7%. This is an increase in turnover for the sixth consecutive month. In total for January-October 2022, turnover increased y/y in all sectors but construction.

3.6.4 Energy & power

Following the government measures dampening price growth, NBS expects a more moderate increase with gas and heat prices increasing by some 15%.

The cabinet set price caps for companies at €199/MWh and €99/MWh for gas applicable to the period of January-March 2023 after which the measure will be reviewed. The state would cover 80% of expenses above these levels, and was conditioned by the approval of the state budget.

Early in 2023 the third block at the Mochovce Nuclear Power Plant is set to run at full capacity, according to the plans of the Mochovce operator Slovenske Elektrarne. The new bloc reached minimum controlled output in October and Slovakia is poised to export more electricity than it imports after the reactor is fully operational.

In December Slovak parliament approved taxation aimed at the gas transit pipeline operator Eustream. The Slovak state retains a 51% share in Eustream, but regional energy powerhouse EPH controls the remaining shares and exercises managerial control. EPH is also a one-third shareholder in Slovenske Elektrarne.

Eustream objected to the taxation and said it will approach President Zuzana Caputova with a request to veto the law.

Under the exemption from the EU embargo on Russian oil imports, the Slovak oil-processing refinery Slovnaft, which is owned by Hungary's MOL, has to curtail the export of produced fuel from Russian crude oil and will have to replace the Russian imports over the next 18 months.

3.6.5 Construction

For January-October 2022, a decrease in turnover by 2.5% y/y was recorded in construction. Prices of construction work increased by 19.1% y/y in November and in total for January-November 2022 construction work increased by almost 18%. Prices of construction materials rose by 13% y/y, but showed a slight decrease m/m. The total growth of prices for construction materials for January-November was almost 24%.

A mid-year survey conducted by CEEC Research showed that 71% of construction companies experienced complications resulting from soaring prices while only 12% said they experienced no complications. Only 7% of companies said it was aided by public investors when dealing with the rise in construction materials.

More than 40% of companies said they experienced a situation when an investor cancelled a contract due to an increase in prices for the contracted works and this translates to cancelling of 18% of contracts on average. More than half of the companies are exploring the usage of alternative construction materials.

3.6.6 Major Sectors

The Slovak capital Bratislava saw tourism at 65% in January-October 2022 when compared to the pre-pandemic levels in 2019. Bratislava Tourist Board does not expect the return of tourism in Slovakia to pre-pandemic levels until 2024. BTB notes that tourism in Slovakia is also weakened by the proximity of the war in Ukraine and Slovakia being Ukraine's neighbouring country.

J&T Finance Group (JTFG), the Czech-registered financial company with majority owners consisting of Slovak billionaire Tkac family and their local partner Ivan Jakabovic, is limiting its activities on the Russian market following the February invasion of Ukraine by Russian military and security forces.

JTFG's Russian exposure should now be limited to J&T Bank Moscow which represents less than 2% of JTFG's assets, according to the information provided by the company. In December Czech National Bank also greenlighted JTFG's J&T ARCH INVESTMENTS participation in the Moneta Money Bank after it acquired shares from Petrus Advisers in June.

4.0 Budget and debt outlook

4.1 Budget and debt - Czech Republic

The Czech budget for 2023 was approved by the Chamber of Deputies in October and signed off by President Zeman in December with a deficit of CZK295bn (€12bn), revenue of CZK1.93 trillion and expenses of CZK2.22 trillion.

The state is calculating to collect CZK1.636tn from taxes and CZK382bn on added value tax, which is CZK83bn more than it did for last year. Some CZK200bn from the budget is expected to be used to combat the soaring energy prices and costs of living and CZK859bn is the cost of welfare support. CZK203bn is allocated for investments. Salaries of state employees including police or teachers will amount to CZk264bn.

Overall, the cabinet expects state debt to increase up to CZK3.075 trillion. Expenses to maintain the debt are expected to increase up to CZK70bn.

The deficit has been decreasing compared to the 2022 budget, by CZK80bn from the deficit of CZK375 which was approved in the course of 2022. This follows huge budget deficits for 2021 and 2020 as the public finances were stretched during the COVID-19 pandemic

Czechia's public debt is well below the EU's average of 41.9%, but the country's Supreme Audit Office warned in August that with a 4.2% y/y increase Czechia also has one of the fastest-growing debts and one of the slowest economic growths in the EU.

Despite the increasing expenditures, the European Commission forecasts the budget deficit to continue to decrease from 5.1% of GDP in 2021 to a projected 4.3% in 2022 and 4.1% in 2023. An increase in expenditures in 2023, including the reimbursement of energy suppliers for eventual losses resulting from capping of electricity and gas prices, is "assumed to be covered by revenue from a windfall tax applied to the largest energy companies and banks".

4.2 Budget and debt - Estonia

Government debts of the Baltic states were increasing throughout 2022 and will continue to grow in 2023, with the European Commission likely to intervene in their fiscal affairs, especially that of Lithuania.

Fast growing current spending and a downward revision of growth potential could make it difficult to arrest the upward debt trajectory for the Baltics in 2023.

Significantly higher government debt/GDP reflecting persistently loose fiscal policy could also lead to negative rating actions by international lenders.

Estonia’s state revenues were set at €15.58 billion for 2023, while expenses will total €16.81 billion.

Investments will total close to €775 million, a rise of around €30 million on this year's figure.

The structural budget deficit will remain at 2.6% in 2023.

Estonia entered the pandemic with one of the lowest general government debt ratios across Fitch-rated sovereigns, at just 8.6% of GDP in 2019. But now the ratings agency projects the debt/GDP ratio to reach 28.4% by 2024.

Ratings agency Standard and Poor's (S&P) affirmed Estonia's rating at the recent 'AA-' level at the end of 2022, but changed the outlook from positive to negative. However, Estonia's credit could be affected by economic, financial or foreign effects associated with the war and the threat of recession could be more lasting, S&P said. It is expected that the agency will change the outlook of Lithuania and Latvia from positive to negative too.

4.3 Budget and debt - Hungary

The government slapped windfall taxes on the banking, insurance, energy, retail, telecommunications, airline, pharmaceutical and advertising industries to fill the gaping hole in the budget, which widened to 85% of the full-year target.

Extra profit taxes are set to generate HUF800bn in 2022 and HUF 1 trillion in 2023. Some HUF2 trillion of state investments were suspended. As energy prices went through the roof, pushing Hungary’s trade deficit to a new record, the cabinet was forced to overhaul the energy subsidy scheme, a cornerstone of Fidesz’s election promises.

The restrictive fiscal measures are aimed at keeping the deficit target at 4.9% in 2022. In the following years, fiscal policy will continue to be restrictive as the temporary measures are phased out. Nonetheless, the public deficit will decline only gradually as the economy slows.

Parliament approved the 2023 budget in mid-July, in line with the practice of previous years, with a deficit target of 3.5% and a 4.1% GDP growth projection, with inflation rising by 5.2% on average.

At the end of the year, the government will amend the 2023 budget bill by decree, bypassing parliament thanks to extended emergency powers. In the updated target, the government sees GDP slowing to 1.5%, the budget deficit falling to 3.5% and inflation at 15%.

A tighter fiscal stance is required to keep state debt on a downward path amidst decreasing but still-sizeable financing needs and rising costs, and to complement monetary policy in dampening demand and inflation, the IMF said.

The European Commission said the deficit is forecast to remain high at 6.2% of GDP despite robust revenue growth from inflation. Increased spending in response to high energy prices is forecast to put pressure on the public finances in 2022 and beyond.

The deficit is set to narrow to 4.4% of GDP, driven by additional windfall profits and sectoral tax revenues, reaching an estimated 1.4% in 2023, which are set to be largely phased out in 2024. OECD's forecast in October put the 2023 deficit at 4.6%, falling from 5.6% in 2022.

4.4 Budget and debt - Latvia

Government debt to GDP in Latvia is expected to reach 47% of GDP by the end of 2022. It stood at €15,146 million in the second quarter of 2022.

4.5 Budget and debt - Lithuania

Lithuania’s state budget revenue is expected to grow by 3.4%, or by (€510 million) in 2023 and stand at €15.62 billion, including EU funds. Expenditure is projected to go up by 6.1% (by €1.07 billion) to €18.61 billion in 2023.

The projected state budget deficit stands at 4.9% and the public debt will rise to 43% of GDP in 2023.

Government debt in Lithuania increased to €24819.50 million in October 2022.

Brussels has said that Lithuania's 2023 budget is not in line with the EU Commission's recommendations, which call for a neutral fiscal policy and limited growth in spending. The country will now be subject to an in-depth review.

4.6 Budget and debt - Slovakia

The budget for 2023 was subject to domestic political struggles and was approved by the caretaker cabinet just before the end of the year after a political agreement that involved the dismissal of the then finance minister Igor Matovic.

The budget was eventually approved with a deficit of €8.3bn or 6.4% of GDP. In 2022 the deficit was close to 5% of GDP. Revenues in 2023 should be €26.7bn and investments €35bn. There is an investment cap of €41.3bn which Slovakia imposed to comply with the EC's expectations.

It was described as "a historic budget" or as a "budget of assistance to people" by cabinet officials because it will see the highest salary rise for teachers (up to 23.2%), 17.7% for other state officials, a rise in pensions (11.8%), and it includes aid package to families with kids of more than €1.1bn and a €500mn rise of salaries for medical workers.

Another €3.4bn is allocated in compensation for soaring energy prices. The budget also includes taxes on Russian crude oil, gas transportation, gambling, and alcohol.

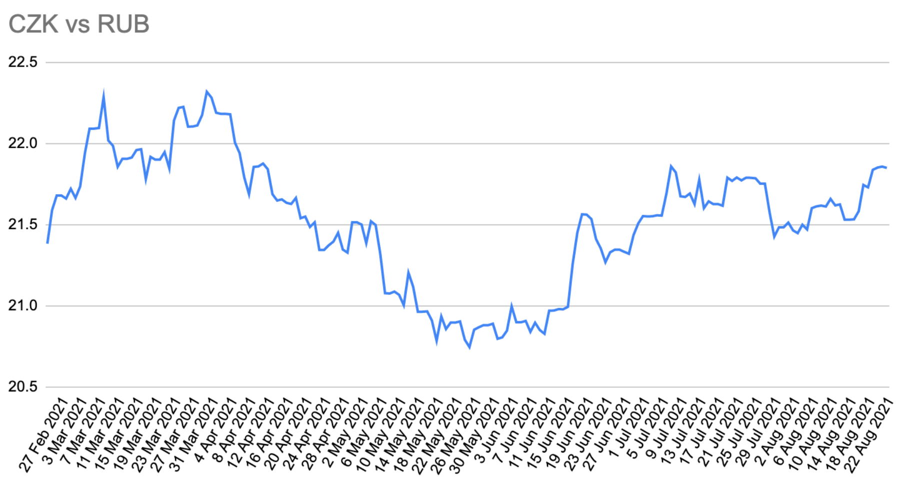
In its winter forecast, the NBS expects a worsening of conditions in public finance with a projected deficit of 5.9% of GDP in 2023. Even without further government measures, the NBS forecast puts the public debt at around 60% of GDP in 2023 and 2024. The finance ministry expects a lowering of public debt to 59.4% of GDP in 2022 from last year's 62.2%, and below 58% in 2023.

5.0 Markets outlook

5.1 Markets - Czech Republic

Shares of the majority-state-owned utility CEZ, which in November announced record profits of CZK18.7bn (€0.8bn) in 3Q 2022 results, experienced few plunges as windfall tax measures were debated in November, but were gaining following the dropping of plans to tax 2022 profits and following the release of the company's prediction for 2023 taxation. In this respect, CEZ shares gains reflected a greater trend of the energy sector benefiting from the global rise of energy prices.

Banks have been generally doing well, including Erste Bank and Moneta Money bank shares, though in autumn these also experienced several plunges as the windfall taxation was being ratified by the parliament.



5.2 Markets - Estonia

Nasdaq Baltic operates three stock exchanges – in Estonia, Latvia and Lithuania – and the Nasdaq CSD under one Baltic entity, providing the capital market infrastructure across the whole value chain – from listing, trading, and market data to clearing and settlement and safe-keeping of securities.

Strengthening the capital markets in the region in 2023 remains a priority for the local central banks which have spoken in 2022 of integrating the three national markets into a pan-Baltic capital market, to attract investors and give rise to a larger pool of liquidity.

5.3 Markets - Hungary

The Hungarian currency was by far the worst-performing currency in the region in 2022 even as the central bank raised rates aggressively throughout the year to combat rising inflation. The forint shed 9% of value against the euro and 21% versus the dollar by mid-December.

The currency's slide accelerated in late September when the MNB called an end to its monetary tightening policy after a 125bp rate hike, above the consensus, even as inflation was still on the rise. The EUR/HUF peaked at 434 in mid-October and versus the dollar, the forint was quoted at 450. The MNB introduced an 18% deposit rate in an emergency meeting in mid-October to contain the market turbulence and the rate was left unchanged at the last rate-setting meeting on December 20.

Unlike its peers in the region, such as the Czech National Bank, the MNB does not have ample FX reserves to protect the forint, which has been under pressure in 2022 from the deterioration of the current account balance and news on the negotiations with the EU on releasing Cohesion Funds and post-pandemic recovery funds. The agreement in early December fuelled a forint rally, and the USD/HUF rate strengthened to 380.

After the government phased out the fuel price cap in early December, analysts raised their inflation expectations further in 2023 to 16-18%. These projections fuelled fears of real interest rates falling deeper into negative territory, further weakening the currency.

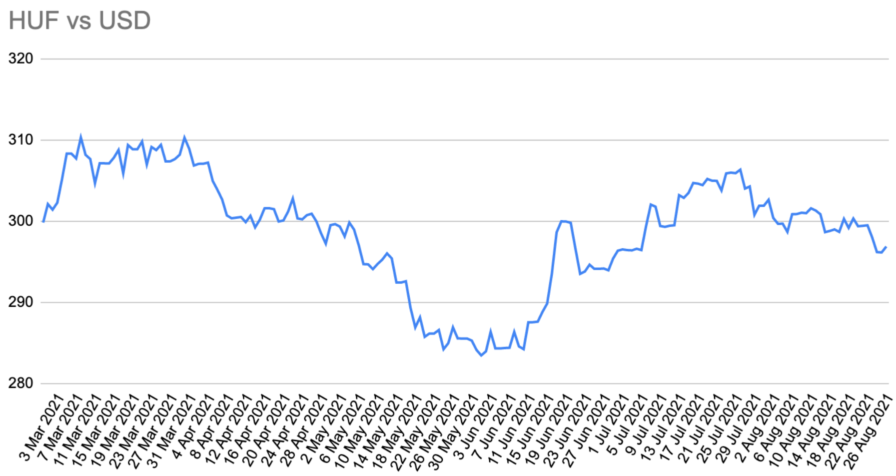
The failure to make a deal with the EU could push the forint even beyond the previous low, analysts warned before the agreement on the EU on frozen funds was reached. Taking short positions against the forint has become much more costly with the effective base rate at 18%, the highest in the CEE region.

Hungary's state debt manager was active in H2 on the FX bond markets in H2, with new issues to make up for trickling EU funds and to finance the trade gap. Hungary issued a €1bn green eurobond in November, followed by a green panda bond issuance of RMB2bn (€270mn). The transactions lifted the share of FX debt to over 25% of the total.

The net financing requirement of the budget is set to reach HUF3.2 trillion in 2023, according to AKK's financing plan released on December 20. The AKK targets net issuance targets of HUF3.4 trillion and plans to issue $4bn in H1, as well as buybacks of $1bn of FX bonds maturing in 2023-2024.

A benchmark-sized eurobond issue is also planned for H2 2023. The debt manager will set an upper threshold for the ratio of FX debt at 30% in 2023, compared to a 10-25% range at present. The ratio is down from over 50% in 2010 as the government prioritised retail financing in debt management.

The Monetary Council reviewed the central bank's latest quarterly Inflation Report on December 20 and published the main forecasts. The report puts average annual inflation at 14.5-14.7% for 2022 and at 15.0-19.5%c for 2023. It forecasts GDP growth of 0.5-1.5% for next year.



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5.6 Markets - Slovakia

Slovakia's 10-year government bond yield was 3.64% at the end of the last working day in December. Trading Economics analysts expect the 10-year bond to be traded at 4.01% at the end of 3Q2023 and 5.33% at the end of 2023. During 2022 the 10-year bond reached a maximum yield of 3.87% on October 23, and a minimum yield of 0.01% on January 1.