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Monthly Report

Central, East and Southeast Europe: Recent Economic Developments and Forecast

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The Vienna Institute for International Economic Studies
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Central, East and Southeast Europe: Recent Economic Developments and Forecast

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OVERVIEW 2016-2017 AND OUTLOOK 2018-2020

		GDP real change in % against prev. year					Consumer prices change in % against prev. year				
				Forecast					Forecast		
		2016	2017	2018	2019	2020	2016	2017	2018	2019	2020
BG	Bulgaria	3.9	3.6	3.5	3.4	3.1	-1.3	1.2	2.0	2.5	2.5
CZ	Czech Republic	2.6	4.4	3.7	3.3	3.2	0.6	2.4	2.3	2.0	1.8
EE	Estonia	2.1	4.9	3.5	3.1	3.0	0.8	3.7	3.3	2.8	2.7
HR	Croatia	3.2	2.8	2.5	2.7	2.8	-0.6	1.3	1.6	1.6	1.6
HU	Hungary	2.2	4.0	4.0	2.8	2.4	0.4	2.4	2.8	2.9	2.9
LT	Lithuania	2.3	3.8	3.3	3.0	2.6	0.7	3.7	3.0	2.7	2.5
LV	Latvia	2.2	4.5	3.9	3.6	3.1	0.1	2.9	3.0	3.0	2.5
PL	Poland	3.0	4.7	3.8	3.5	3.3	-0.2	1.6	2.1	2.1	2.0
RO	Romania	4.8	6.9	4.2	3.5	3.8	-1.1	1.1	4.2	3.0	3.0
SI	Slovenia	3.1	5.0	4.8	3.7	3.6	-0.2	1.6	1.8	1.8	1.8
SK	Slovakia	3.3	3.4	3.8	4.2	3.3	-0.5	1.4	2.8	2.5	2.2
	EU-CEE 1)2)	*3.2*	*4.7*	*3.8*	*3.4*	*3.2*	*-0.2*	*1.8*	*2.6*	*2.3*	*2.3*
	EA-19	*1.8*	*2.4*	*2.3*	*2.0*	*.*	*0.2*	*1.5*	*1.5*	*1.6*	*.*
	EU-28	*2.0*	*2.4*	*2.3*	*2.0*	*.*	*0.3*	*1.7*	*1.7*	*1.8*	*.*
AL	Albania	3.4	3.8	3.8	4.1	4.0	1.3	2.0	2.1	2.5	3.0
BA	Bosnia and Herzegovina	3.1	3.0	3.3	3.3	3.3	-1.1	1.2	1.2	1.9	1.9
ME	Montenegro	2.9	4.4	3.2	3.2	3.0	0.1	2.8	2.5	2.0	2.0
MK	Macedonia	2.9	0.0	3.5	3.1	3.3	-0.2	1.4	2.0	2.0	2.0
RS	Serbia	2.8	1.9	3.6	3.0	2.8	1.1	3.0	1.6	2.2	3.5
XK	Kosovo	4.1	3.7	3.9	3.8	3.8	0.3	1.5	1.9	2.3	2.3
	WB 1)2)	*3.1*	*2.4*	*3.6*	*3.3*	*3.2*	*0.5*	*2.2*	*1.7*	*2.2*	*2.8*
TR	Turkey	3.2	7.4	4.5	4.1	4.0	7.7	11.1	10.3	8.0	6.8
BY	Belarus 3)	-2.5	2.4	4.0	3.7	3.4	11.8	6.0	7.0	8.0	8.0
KZ	Kazakhstan	1.1	4.0	4.0	3.0	3.0	14.6	7.4	6.0	6.0	5.0
RU	Russia	-0.2	1.5	1.5	1.6	1.7	7.1	3.6	4.0	4.0	4.0
UA	Ukraine	2.4	2.5	3.3	3.1	2.0	13.9	14.4	11.6	7.0	6.0
	CIS + Ukraine 1)2)	*0.1*	*1.9*	*1.9*	*2.0*	*1.9*	*8.5*	*4.9*	*4.9*	*4.6*	*4.4*
	V-4 1)2)	*2.8*	*4.4*	*3.8*	*3.4*	*3.1*	*0.0*	*1.9*	*2.3*	*2.2*	*2.1*
	BALT-3 1)2)	*2.2*	*4.3*	*3.5*	*3.2*	*2.8*	*0.6*	*3.5*	*3.1*	*2.8*	*2.5*
	SEE-9 1)2)	*4.1*	*4.9*	*3.8*	*3.3*	*3.4*	*-0.7*	*1.4*	*3.0*	*2.6*	*2.7*
	NON-EU-11 1)2)	*1.1*	*3.6*	*2.7*	*2.7*	*2.6*	*8.0*	*6.7*	*6.4*	*5.5*	*5.1*
	CESEE-22 1)2)	*1.7*	*3.9*	*3.0*	*2.9*	*2.8*	*5.6*	*5.3*	*5.3*	*4.6*	*4.3*

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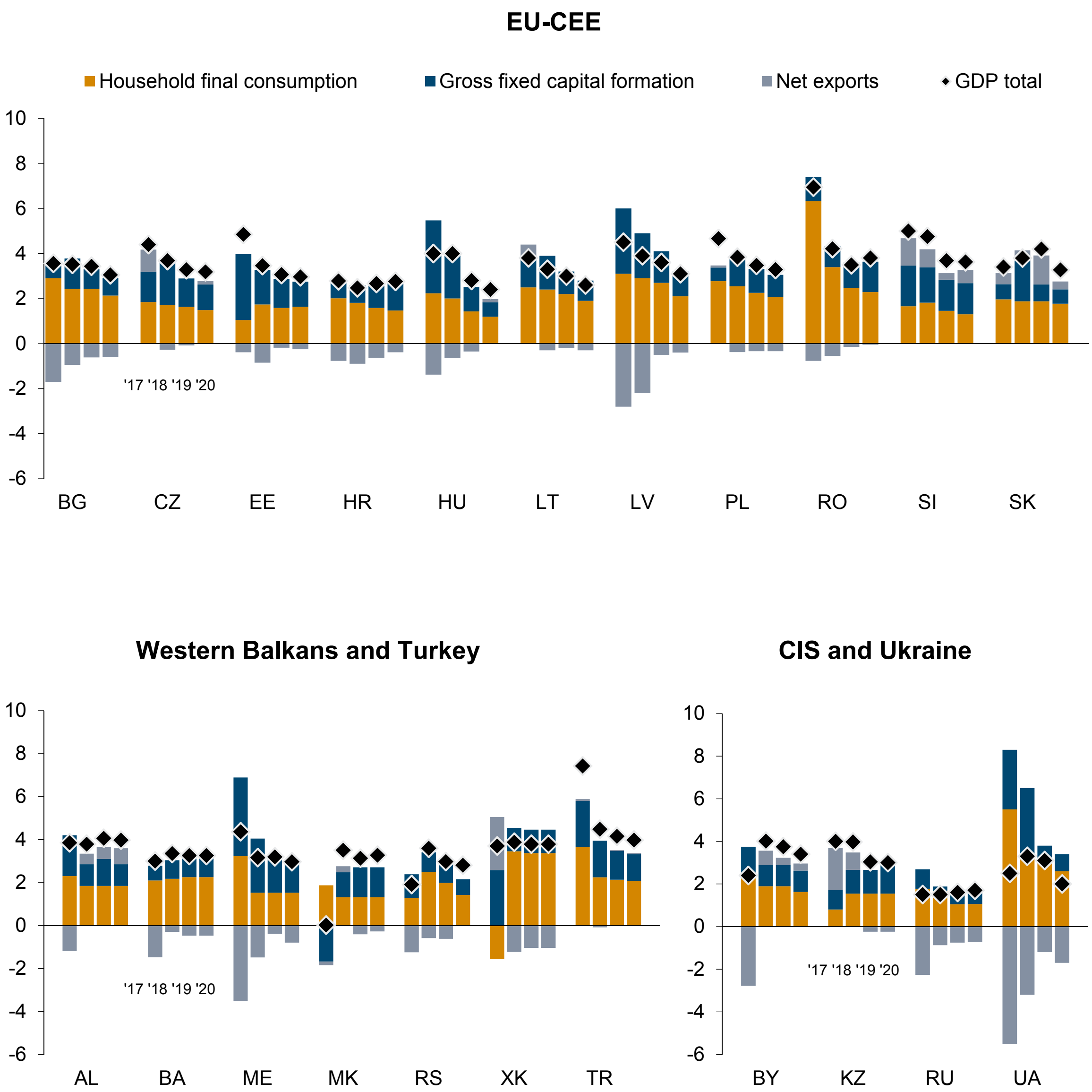
		Unemployment (LFS) rate in %, annual average					Current account in % of GDP				
				Forecast					Forecast		
		2016	2017	2018	2019	2020	2016	2017	2018	2019	2020
BG	Bulgaria	7.6	6.2	5.8	5.4	5.0	2.3	4.5	4.1	2.5	2.0
CZ	Czech Republic	4.0	2.9	2.4	2.3	2.3	1.6	1.0	0.6	0.8	0.7
EE	Estonia	6.8	5.8	6.0	5.8	5.5	1.9	3.2	0.8	0.5	0.5
HR	Croatia	13.1	11.2	9.8	9.0	8.8	2.6	3.9	2.6	1.9	1.5
HU	Hungary	5.1	4.2	3.7	3.6	3.6	6.0	2.9	2.7	2.6	2.7
LT	Lithuania	7.9	7.1	6.5	6.0	5.8	-1.1	0.8	-2.7	-1.9	-2.5
LV	Latvia	9.6	8.7	8.2	7.5	7.2	1.4	-0.8	-1.4	-2.3	-2.8
PL	Poland	6.2	4.9	4.3	4.2	4.0	-0.3	0.3	0.4	0.4	0.4
RO	Romania	5.9	4.9	4.6	4.5	4.3	-2.1	-3.4	-4.1	-4.0	-3.9
SI	Slovenia	8.0	6.6	5.8	5.4	5.0	5.2	6.4	6.1	5.1	4.4
SK	Slovakia	9.7	8.1	6.8	6.3	6.0	-1.5	-2.1	-1.5	-0.7	-0.5
	EU-CEE 1)2)	*6.5*	*5.3*	*4.8*	*4.5*	*4.4*	*0.7*	*0.5*	*0.2*	*0.1*	*0.0*
	EA-19	*10.0*	*9.1*	*8.4*	*7.9*	*.*	*3.7*	*3.9*	*3.4*	*3.4*	*.*
	EU-28	*8.6*	*7.6*	*7.1*	*6.7*	*.*	*2.0*	*2.5*	*2.2*	*2.2*	*.*
AL	Albania	15.2	13.7	13.0	12.5	12.0	-7.6	-6.9	-7.1	-6.6	-6.0
BA	Bosnia and Herzegovina	25.4	20.5	19.4	18.8	18.3	-4.9	-4.8	-4.7	-4.7	-4.7
ME	Montenegro	17.4	16.1	15.0	15.0	15.0	-16.2	-16.3	-17.1	-18.3	-18.4
MK	Macedonia	23.7	22.4	21.0	20.0	20.0	-2.7	-1.3	0.7	0.8	-0.2
RS	Serbia	15.3	13.5	13.0	13.0	12.0	-3.1	-5.7	-5.0	-5.1	-5.1
XK	Kosovo	27.5	30.5	27.0	25.2	24.0	-7.9	-6.6	-5.8	-6.0	-6.2
	WB 1)2)	*18.7*	*16.9*	*15.9*	*15.5*	*14.9*	*-5.0*	*-5.8*	*-5.3*	*-5.3*	*-5.4*
TR	Turkey	10.9	10.9	10.5	10.2	10.0	-3.8	-5.5	-6.2	-5.9	-5.8
BY	Belarus 3)	0.8	0.5	0.5	0.5	0.5	-3.5	-1.7	-2.6	-3.0	-3.1
KZ	Kazakhstan	5.0	4.9	5.0	5.0	5.0	-6.5	-3.4	-1.2	-1.5	-1.9
RU	Russia	5.5	5.2	5.1	5.0	4.9	1.9	2.2	4.5	3.7	3.5
UA	Ukraine	9.3	9.5	9.2	8.9	8.7	-1.4	-1.9	-2.1	-2.2	-3.2
	CIS + Ukraine 1)2)	*5.9*	*5.7*	*5.6*	*5.5*	*5.3*	*0.8*	*1.4*	*3.4*	*2.8*	*2.4*
	V-4 1)2)	*5.9*	*4.7*	*4.1*	*3.9*	*3.8*	*0.9*	*0.6*	*0.6*	*0.7*	*0.7*
	BALT-3 1)2)	*8.2*	*7.3*	*6.9*	*6.3*	*6.2*	*0.4*	*0.9*	*-1.5*	*-1.4*	*-1.8*
	SEE-9 1)2)	*11.2*	*9.7*	*9.1*	*8.7*	*8.4*	*-1.5*	*-1.9*	*-2.4*	*-2.7*	*-2.7*
	NON-EU-11 1)2)	*7.6*	*7.4*	*7.2*	*7.0*	*6.9*	*-1.0*	*-0.9*	*0.1*	*-0.2*	*-0.3*
	CESEE-22 1)2)	*7.3*	*6.9*	*6.6*	*6.4*	*6.3*	*-0.4*	*-0.4*	*0.1*	*-0.1*	*-0.2*

Note: EU-CEE: Central and East European EU countries; V-4: Visegrád countries: Czech Republic, Hungary, Poland, Slovakia; BALT-3: Baltic countries: Estonia, Latvia, Lithuania; SEE-9: Southeast Europe: Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Kosovo, Macedonia, Montenegro, Romania, Serbia; NON-EU-11: Non-European Union countries: Albania, Bosnia and Herzegovina, Kosovo, Macedonia, Montenegro, Serbia, Turkey, Belarus, Kazakhstan, Russia, Ukraine; CESEE-22: Central, East and Southeast Europe: EU-CEE + NON-EU-11.

1) wiiw estimates. - 2) Current account data include transactions within the region (sum over individual countries). - 3) Unemployment rate by registration.

Source: wiiw, Eurostat. Forecasts by wiiw (June 2018) and European Commission for EU and euro area (EU Spring Forecast, May 2018).

GDP growth in 2017-2020 and contribution of individual demand components in percentage points



Source: wiiw Annual Database incorporating national and Eurostat statistics, own calculation. Forecasts by wiiw.

ALBANIA: Overvalued domestic currency

BY ISILDA MARA

In 2017 the economy grew by 3.8%, despite its deceleration in the second half of the year. All sectors of the economy contributed positively to growth. Construction and extraction industry and especially manufacturing experienced double-digit growth. The first five months of 2018 were characterised by a construction sector still in expansion, but at a slower pace than in 2017. Big infrastructure projects – the Trans Adriatic Pipeline and the Devoll Hydropower station – are approaching their final stage of completion, and new ones – Arberi Road and Vlora Airport – have been announced to be launched by the second half of 2018. Imports of machinery increased by 14% in January-April 2018 year on year, indirectly hinting at a surge in private investment.

2018 witnessed an unprecedented appreciation of the Albanian currency. In early June 2018, the ALL/EUR exchange rate stood at 124.7. Typically, the third quarter of the year is characterised by a minor (some 2%) appreciation of the lek owing to tourism, remittances and migrants' returns, so the current appreciation is very unusual. A very promising tourism season, restructuring of the banking sector and FDI inflows close to EUR 900 million in 2017 – but on a downward trend compared with the preceding two years – are insufficient to exclusively explain the strong appreciation of the lek. Exports of goods, after the surge experienced between January and March 2017, showed a downward trend in April. In such circumstances, in June the Central Bank decided to intervene, first, by reducing the excessive supply of EUR in circulation – despite the floating exchange regime in Albania – and, second, by cutting the interest rate by 0.25 pp down to 1%. The market reaction has been immediate and the ALL/EUR exchange rate jumped to 127.8 by mid-June 2018. Nonetheless, the seasonal effect is expected to induce volatile exchange rates in the coming months.

Despite the headwinds for the oil extraction industry, there are positive developments for the sector. Its exports rose in nominal terms, but continued shrinking in real terms in January-April 2018, year on year. However, the agreement signed between the Albanian government and the Royal Dutch Shell Company in February 2018 is a positive sign for the sector: Some EUR 34 million were agreed to be invested in exploring/detecting new wells in Shpirag, in the southern central part of Albania.

The unconditional start of EU membership talks with Albania was recommended by the European Commission in April 2018. The EU is, however, divided on this issue. The final decision of the European Council is expected during June 2018. Certainly, the start of negotiations for EU accession should provide a strong impetus to the country's economic growth. The main challenge is keeping the pace of structural reforms, fundamental for meeting the EU membership criteria. The performance of public finances has yet been below expectations. Revenues rose by 2.2% in January-April 2018 year on year, while overall expenditure grew by 8% and capital expenditure rose by 24%. According to the IMF, in 2017 arrears to VAT refunding and public investments amounted to close to EUR 200 million, and its warnings about the risks of private public partnership projects are getting louder.

Moderate consumption growth is expected in 2018. In 2017 50,000 persons entered into employment. Inactivity dropped more than did unemployment. About 30% of new jobs went to young people. Last year average monthly wages in the public sector rose by 10% but stagnated in the private sector. Remittances increased by 4%. Household consumption will continue to grow this year, even if at a moderate rate, backed by better job prospects and higher earnings. Given a number of downward risks we expect the Albanian economy to grow by 3.8% in 2018 – a rate 0.3 pp below our previous forecast – and to accelerate to above 4% in the medium term owing to big infrastructure projects to start by the second half of 2018.

BELARUS: Unexpected surge in economic activity

BY RUMEN DOBRINSKY

The beginning of 2018 was marked by a significant economic turnaround in Belarus: GDP surged by an unexpectedly high 5.1% year on year in the first quarter. This is a radical changeover from the meagre economic performance in the previous several years. While more recent statistics indicate some moderation of growth, the average figures for the year as a whole should be considerably above earlier expectations (even as late as February the Ministry Finance published its medium-term budgetary framework under the assumption of 1.2% GDP growth in 2018).

A combination of external and domestic factors contributed to such an outcome. As concerns the external environment, the main pull came from the rising oil prices and the recovery of Russian import demand (dollar exports to Russia grew by 10% year on year in the first quarter). On the domestic front, there was a positive policy impetus thanks to a loosening of the wage policy in the public sector (it had started already in the second half of 2017), with spillover effects on the whole economy. Concomitantly, the lasting reduction in interest rates which mirrored the declining inflation expectations incited a surge in credit demand, in particular, consumer credit. Both these developments propped up private consumption and provided a boost to economic growth. Among supply-side factors, public support to SMEs extended through the Belarusian Development Bank in the form of investment credit at preferential terms increased 7-fold in the first quarter compared to the same period of the previous year.

Economic activity picked up across the board in the first months of 2018. There was a sharp upturn in manufacturing output (by more than 9% year on year in the first quarter), as well as in merchandise exports, both of which had started already in 2017. Private consumption rebounded strongly already in the fourth quarter of last year (by 5.2% year on year) and remained robust in the first quarter of the current year. There was also a modest recovery in employment; however, no major improvements in the labour market can be expected in the short run due to the ongoing restructuring of some large state-owned firms.

The current account deficit seems to be at manageable levels and Belarus should be able to service its external debt without problems in the short run. In February, Belarus successfully placed a 12-year Eurobond emission worth USD 600 million at a coupon rate of 6.2% per annum which was a record low rate for its sovereign bonds. In March, Moody's upgraded Belarus' issuer and senior unsecured ratings to B3 from Caa1 with a stable outlook.

However, the loosening of wage policy was a departure from the stringent policy stance that prevailed in the past several years. The rising monetary incomes and the accompanying surge in consumer demand are already putting upward pressure on prices: while average annual CPI dropped to 6% in 2017, inflation was gaining momentum again at the beginning of 2018 and the annual figure for the year will be higher. If the loosening of the policy stance continues, this may give rise to risks to macroeconomic stability in the medium term.

In general, the short-term prospects for the Belarusian economy have improved and GDP could grow by some 4% in 2018 which would also allow for modest employment growth. However, if the policy concerns about macroeconomic stability bring about a new tightening of the policy stance, growth may moderate in the following years.

BOSNIA AND HERZEGOVINA: Risks high ahead of election

BY RICHARD GRIEVESON

Political risk is elevated ahead of the parliamentary election in October, and represents a downside risk to growth. A recent surge of migrants and refugees into Bosnia is being used by some to prey on fears about an increase in the country's Muslim population. Dissatisfaction with the political class is high. According to the Balkan Barometer, 44% of Bosnians are 'completely dissatisfied' with their life, easily the highest in the region. Moreover, there is a risk of a constitutional crisis and that the results of the election will not be accepted, given that a compromise between Croats and Bosniaks over a dispute regarding voting procedures in the Federation has not yet been found. Before October, reforms related to the Extended Fund Facility (EFF) with the IMF and EU membership path will face delays.

Bosnia has completed and returned its EU questionnaire, marking an important step forward in its accession to the bloc. However, big challenges remain, and the new Commission accession target of 2025 will certainly be too optimistic for Bosnia. We estimate that at its current reform pace, Bosnia may take at least two more decades to meet the EU accession governance criteria. The much-heralded EU-Western Balkans Sofia summit held in June 2018 produced disappointing outcomes. Public opposition to further enlargement is very high in France and Germany.

Bosnia's growth rate is low for a country at its stage of development, but should pick up a bit this year. Recent data suggest strong current activity: industrial output was up 5.3% in year to March, and retail sales 5.2% higher on the same measure. The fact that the economy is increasingly open (exports of goods and services were equivalent to 39% of GDP last year) will allow it to benefit from a generally positive external environment. Along with exports, growth this year will be driven by higher wages, credit, and a recovery in investment. The EBRD signed a MoU with Bosnia in February worth EUR 700 million for the upgrading of the country's road infrastructure.

The second tranche of IMF budget support under the EFF has been released. This provided budget support for local governments worth around 0.5% of GDP. Bosnia ran a fiscal surplus last year, contributing to the relatively subdued growth rate. Increases in public investment are planned, while reforms to reduce the public sector wage bill and improve tax collection could be delayed, which will see the fiscal position deteriorate.

Growth has been running ahead of employment, relying on higher productivity. The number of people registered officially as unemployed has been declining since 2014, and fell by 6% year on year in 2017 and 7% in Q1 2018. However, sizeable labour market slack means that there is little pressure on earnings. Net wages were up 1.7% in the year to March. Inflation is still very low, and has been stuck at around 1% for several months. Demand-side pressure is and will remain limited, but there should be some pass-through to inflation in the coming months from higher oil prices.

The current account deficit will widen over the forecast period, but remain contained in the historical context. Higher oil prices and growing import demand thanks to planned infrastructure projects will contribute to a wider goods deficit, but the services and secondary income surpluses are rising (reflecting tourism and remittances, respectively).

BULGARIA: Past the peak of the cycle?

BY RUMEN DOBRINSKY

Bulgaria's GDP grew by 3.5% year on year in the first quarter which was slightly below the 3.6% annual GDP growth in 2017 and also below the 2016 GDP growth figure (3.9%). Overall it seems that the economic cycle has probably passed its peak. Mirroring this dynamics, the exports of goods have also been losing some momentum: while their growth remained positive in the first months of 2018, they slowed down compared to 2016 and 2017. By contrast, the imports of goods kept rising and have been outpacing exports since the second half of 2017.

Similarly to 2017, domestic demand remained the main engine of growth of the Bulgarian economy. In particular, gross fixed capital formation surged by 10.2% year on year in the first quarter (following a robust recovery in 2017) largely thanks to the resumption of EU-funded public investment programmes. Compared to the previous year, private consumption slowed down a bit; nevertheless, its rate of growth remained decent.

On the supply side, manufacturing as well as business services (in particular, ICT services and partly tourism) continued to report robust output performance. Thanks to their solid performance during the past several years, these sectors have become the key engines of the modernisation of the Bulgarian economy and of the quality upgrading of its exports; they are also the main job creators but, at the same time, the focal points of growing labour shortages. There are signs that Bulgaria's labour market is becoming more and more tight. While total employment has still kept growing in 2018, the employment rate seems to be close to its limits; at the same time, there is a small but stable pool of structural unemployment.

Domestic consumer price inflation was modestly gaining pace in the first months of 2018 but still remained in low single digits. Real wages continued to rise but their growth seems to be slowing down compared to the previous years. Despite the swelling goods imports the current account surplus stayed high, largely thanks to a widening surplus in the services trade. Public finances were also in the positive territory reflecting a persistently conservative (and probably excessively so) fiscal stance.

In January-June 2018, Bulgaria for the first time held the rotating Presidency of the Council of the EU and the execution of this role to a large extent dominated the domestic socio-political scene. One of the highlights of the Bulgarian Presidency was the EU-Western Balkans summit held in Sofia in May. However, looking back on the outcomes of this and other events from the EU agenda in this period, no major breakthroughs were achieved during the Bulgarian Presidency. There was no progress either on the issue of ERM-2 entry as both the ECB and the EC reacted cautiously on the announcement by Bulgaria (back in January) that it would be interested to apply.

Given the expectations for somewhat weakening external demand and the existing supply constraints (due to labour shortages) the short-term prospects are for some moderation in economic growth. Nevertheless, given the generally healthy state of the economy, GDP growth should stay in the range of 3.0-3.5% per annum in the coming years.

CROATIA: Investments subdued

BY HERMINE VIDOVIC

Croatia's economy grew less dynamically in the first quarter of 2018 than in the same period a year earlier: GDP expanded by only 2.5%. Domestic demand, household consumption in particular, was the main driver behind this increase, while net exports contributed negatively to GDP growth. Gross fixed capital formation increased by 3.6% – at a much slower pace than anticipated considering the potential uptake of EU funding. Hence, the output growth in construction was only moderate, at 2.2%. Industrial production grew by less than 1% during the first four months of 2018, mainly due to noticeable declines in the manufacturing of machinery and equipment, fabricated metal products, chemical products and electrical machinery and equipment.

The creditors' settlement negotiations of Agrokor, Croatia's biggest private retailer and food producer, which had ran into trouble in early 2017, were completed by the end of May. The agreement should eventually be approved by 10 July 2018. Among other things it is envisaged to write off two thirds of bank claims. At the same time, the Russian Sberbank, Agrokor's single biggest creditor with loans worth EUR 1.1 billion, will have an option in getting shares in a new company to be established in exchange for its 18% share in Mercator, the Slovenian retailer owned by Agrokor. The labour market situation continued to improve during the first three months of 2018. According to Pension Insurance data, employment increased by 2.5%. The registered unemployment rate fell to 10.4% in April, mainly due to a clearing from the register for reasons other than employment. Despite still high unemployment, there are labour shortages in some industries. As for 2018 the government has issued altogether 31,000 work permits for foreign workers, most of which for construction, followed by tourism, shipbuilding and agriculture. Real gross wages increased by 3.8% in the first quarter of 2018, of which the most in construction and trade, while public sector wage growth remained almost stagnant. Goods exports stagnated in the first two months of the year while imports grew by 10% in euro terms. The current account deficit has likely deteriorated against the same period a year earlier, to about EUR 1.7 billion.

At the beginning of May 2018 the Croatian government adopted the strategy for the introduction of the euro. With respect to the convergence criteria Croatia currently satisfies the criteria on price stability and long-term interest rates. The debt to GDP ratio exceeds the 60% mark, but it is, according to the European Commission's 2018 Convergence Report, 'on a sufficiently diminishing trajectory and approaching 60% of GDP at a satisfactory pace, and can therefore be deemed compliant with the Stability and Growth Pact'. The introduction of the euro has been a long-time goal of the Croatian National Bank, as the country's economy is already highly euroised: about three quarters of the savings deposits and two thirds of total debts are indexed to the euro. According to the Croatian Minister of Economy, the introduction of the euro could be expected within the next five to seven years (in an earlier statement the Prime Minister mentioned that Croatia may join the ERM2 mechanism in 2020). There are growing signs that Croatia's GDP growth rate in 2018, forecast at 2.5%, will be lower than a year earlier – and the lowest among the EU-CEE countries. Apart from the slowdown of growth in industry, also the most recent consumer confidence index is pointing downwards. The impact of the Agrokor crisis is incalculable. Yet, a favourable tourist season may offset at least part of these negative tendencies. Also beyond 2018 GDP growth is expected to remain below the 3% mark. Household consumption should benefit from a further gradual improvement in the labour market, while a more pronounced increase in investments should be spurred by better absorption of EU funds. The current account will remain in positive territory, but is expected to decline along with higher trade deficits.

CZECH REPUBLIC: Balanced and moderate growth

BY LEON PODKAMINER

After an exceptionally strong performance throughout 2017, growth has moderated in the first quarter of 2018 with GDP rising by 3.7%. Household consumption increased by 3.8% – much less than throughout 2017. At the same time the compensation of employees increased in the first quarter of 2018 by 7.7% in real terms. This indicates that the households' saving rate must be increasing. Arguably, rising household incomes finance investment (e.g. into real estate) to a much larger extent than in the past.[1] Gross fixed capital formation, whose strong recovery started in the second quarter of 2017, has now increased again by a respectable 9.2%. Household consumption contributed 1.6 percentage points to the GDP growth rate, GFCF another 2.2 p.p., rising inventories 0.4 p.p. and public consumption 0.7 p.p.

Foreign trade growth slows down, the trade balance deteriorates. In the first quarter of 2018 exports of goods and non-factor services increased by 2.6% in real terms while the imports of the same rose 4.7%, so that the contribution of foreign trade to GDP growth was negative (-1.1 p.p.) – for the first time since the third quarter of 2015. The trade surplus/GDP ratio fell from over 10% a year earlier to 8.5%. Continuing weaker trade performance is a real possibility not only because of the speedup of capital formation and, in consequence, higher imports of capital goods but also on account of a rather strong appreciation of the Czech currency. From April 2017, when the National Bank gave up the control of the exchange rate, until mid-April 2018 the CZK had strengthened by 7% against the euro (although since mid-April 2018 the CZK has depreciated by 1.5%). In CZK terms the value of exports of goods declined in the first quarter of 2018 by 2% which must have adversely affected exporters' net incomes.

Close to full employment adds to the wage pressures. With the unemployment rate hovering at around 2.5%, the reserves of employable domestic labour may be rather limited. Although one observes a (slow) rise in the participation rates and longer working hours the labour shortages may persist also due to the pronounced population ageing. Amelioration of the labour market situation will necessitate even higher employment of guest-workers (coming primarily from Ukraine). Despite the large inflows of foreign workers, in the shorter run one must expect stronger wage pressures, higher unit labour costs and possibly depressed corporate profits. Indeed, in the first quarter of 2018 the average wage in industry increased by 7.6% in nominal terms (about 6% in real terms). In the same period the industrial output rose by 2.2% (in both nominal and real terms). Nominally the employees' compensation rose over 10% while the gross operating surplus (representing primarily profits) by a mere 3%.

Fiscal policy avoids deficit spending and monetary policy may need to avoid interest rate hikes. The fiscal policy eyes further cuts in public debt. This will be helping to keep inflation reasonably low. Keeping the monetary policy interest rates as low as possible may be essential in helping to prevent undue currency appreciation. As long as the wage pressures are not pushing the inflation rate outside the target range (currently 1-3%) the CNB is likely to remain 'dovish'.

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[1] This is evidenced by the price differentials. The producer price index for industry was nil in the first quarter of 2018 – but reached 4% for construction. This reflects a real estate boom. In Prague the price index for new flats stood at over 10% in 2017 while CPI was 2.4%. In addition, as in Poland, the earnings of a large number of foreigners employed are sent back home (mostly to Ukraine) thereby reducing effective domestic consumer demand in the Czech Republic.

ESTONIA: Growth boosted by internal demand

BY SEBASTIAN LEITNER

Investment activity of the public and private sectors will keep on supporting growth in the period 2018 to 2020. In 2017, increasing inflows of fresh EU funds from the 2014-2020 programming period resulted in peak growth rates. Thus, in 2018 investment, although still flourishing, will grow at lower pace. Given the favourable demand situation and further improving expectations, entrepreneurs increase their investments in equipment and buildings and construction activity is prospering as well. Strongly growing wages and very low interest rates resulted in new credits for households increasing by 7% year on year in April 2018. Apartment prices, growing swiftly at the moment, have again reached the pre-crisis levels in Tallinn. However, there is arguably no real estate bubble as yet, since income levels are much higher now than before the crisis and the financial situation of the households is more stable.

After expanding dynamically throughout 2017, export growth has slowed down this year. Goods exports to Russia, which increased by more than 20% nominally in 2017, have been on the decline in 2018. Besides, the Swedish construction sector is at the downturn, with repercussions for the Estonian wood manufacturing sector. More generally, strongly rising wages are putting pressure on exporting firms; thus, in order to sustain export growth, investments in higher segments of the value chain would be needed. Overall, we expect growth in goods exports to level off in 2018 to 2020. Given the swiftly rising household incomes, imports will increase more strongly than exports. At the same time, the exports of services are growing much livelier than those of goods.

In the first quarter of 2018, the unemployment rate (according to LFS) showed a small hike to 6.8%, and has continued to increase. As expected, the work ability reform of 2016 forced people having received incapacity pensions before to look more actively for jobs. This increases the labour supply to some extent and raises the unemployment rate temporarily, while the inactivity rate declines.

Real gross wages picked up by 7.7% in the first quarter of 2018 year on year and will support household consumption. Household incomes have been bolstered by the increase in the minimum wage from January 2018 onwards to EUR 500 and the reduction of the personal income tax. Also, after a 3.7% peak recorded last year (mostly caused by an increase in excise taxes and by rising energy prices), in 2018 consumer inflation started to decline slightly which is strengthening real incomes. Forward-looking consumer confidence indicators are positive and the most recent retail trade and credit statistics indicate a good spending mood.

Compared to our Spring Forecast we have become more optimistic, increasing the forecast GDP growth rate for this year to 3.5%. The projected acceleration of growth this year (compared to 2017) is above all on account of private consumption, whereas investment growth will lose steam somewhat and the contribution of net exports will become more negative. For 2019 and 2020, we also revised our GDP growth forecasts upwards, to 3.1% and 3.0%, respectively.

HUNGARY: Strong expansion on fragile fundaments

BY SÁNDOR RICHTER

First-quarter GDP growth (4.4% year on year) indicates a continuation of the economy's strong expansion. Growth was driven by a 5% increase in consumption and a remarkable 17.1% growth of gross fixed investment. The former was supported by real wage growth well above the GDP's expansion. Gross capital formation expanded by only 4.5%, reflecting an unusually large depletion of inventories. The positive gap between import and export growth rates also was surprisingly small in the first quarter, resulting in a neutral contribution of net exports to GDP growth. The respective gap between the growth rates was yet considerable in the trade of goods (2pp), but that was neutralised by the negative 8.2pp gap in services trade.

The fundaments of this strong GDP growth are however fragile. In the first quarter of the year the composition of the investment boom was unfavourable, with 65% expansion reported for budgetary units (providing 12% of all investments) while a drop of 1.1% was registered in investments by enterprises employing at least 50 persons (which account for more than half of all investments). In a sectoral breakdown, there have been further warning signs: investment in manufacturing slightly declined, just as in agriculture. The government's outstanding role in investment is tightly related to the spending of EU cohesion policy transfers at a deliberately forced pace, and that is obviously unsustainable. Simultaneously there are no signs that would sustain the hope cherished by the government that in the field of investment the business sector will take over once the EU transfers run out from 2019 onwards.

Valued added in industry expanded by mere 2%, in agriculture a decline was registered. Only the construction industry registered a remarkable 23% growth, primarily driven by projects supported by EU transfers, although households' housing construction undergoes a boom as well. On the production side of the GDP the contribution of the services sector was the strongest. In a sectoral breakdown it is remarkable that value added in public administration, education and health and social work activities declined, while arts, entertainment and other services, a category that includes PM Orbán's favourite, sports, increased by 7.5%.

The government claims to be able to maintain the current rate of growth in the forecast horizon and thereafter despite the forthcoming inevitable strong contraction of EU transfers. A 'high-pressure economy' should be achieved via 'lasting and reliable over-the-average demand stimulation'. The serious skills mismatch on the labour market, an important reason for labour shortages, is planned to be addressed by firms hiring unskilled persons who then undergo a 'learning-by-doing' process on the job. While the current strong growth would offer an opportunity to cut the budget deficit in order to keep the public debt reduction on track, the government seems to opt for further fiscal stimulation. This goes against the recently issued country-specific recommendations by the European Commission for Hungary, proposing a continuation of the fiscal deficit reduction programme. The idea of further fiscal stimulation is not fully shared even within the government itself. Minister of Finance Mihály Varga warned in a recent interview of the dangers of fiscal imbalances, voicing a highly unusual dissenting opinion in Orbán's government. All in all, this year will still be a year of formidable economic growth (wiiw revised the GDP growth forecast from 3.8% to 4%), but a slowdown during the next two years will be hardly avoidable.

KAZAKHSTAN: Benefiting from high oil prices

BY OLGA PINDYUK

Rising global oil prices are providing an unexpected windfall to the Kazakhstani economy. According to the preliminary balance of payments data, in the first quarter of 2018 the country's merchandise exports increased by 26% year on year in US dollar terms, primarily on the back of the oil sector. The current account balance during that period was almost at zero (-95 USD million), while in the first quarter of 2017 it had a deficit of USD 1.4 billion. Booming exports will allow a current account deficit decrease to about 1% of GDP by the year end – a noticeable shift compared with a deficit amounting to 3.4% of the GDP in 2017. Global oil prices are expected to decline in 2019-2020, which will cause a widening of the current account deficit.

Merchandise imports increased in the first quarter of 2018 by 15% year on year. This occurred primarily on the back of machinery and equipment with a 25% growth (this sector accounts for 38% of the country's merchandise imports). Both investment and consumption demand are behind the import dynamics. Oil extraction and oil processing continue to account for the bulk of fixed capital investment, and with oil prices being on the rise, the sector is likely to expand its investment. Infrastructure projects are expected to continue as Kazakhstan is a critical section of China's Belt and Road land routes to Europe. As a result, growth of gross fixed capital formation is expected to speed up to 5-6% during the forecast period.

Real household incomes finally started growing after two years of decline. In the first quarter of 2018, they increased by 3.7% compared with the same period of the previous year. This is translating into faster consumption growth. First evidence comes from statistics on sales of cars: they soared by 49% in the first quarter of 2018, with more than half of all cars being imported. Consumption growth is continuously supported by strong consumer loans dynamics (newly issued loans during the first quarter of 2018 increased by 30% year on year). We expect that households' consumption growth will speed up to 3% per annum during 2018-2020.

Kazakhstan's banking system remains vulnerable. According to recent IMF estimates, the level of non-performing loans in Kazakhstan is at about 45%, which means that banks have not yet been able to clean their balance sheets from distressed assets that appeared due to the crisis of 2008. Newly issued loans – both to consumers and corporate clients – have been growing at double-digit rates. At the same time, total corporate loans stock has been falling since the end of 2017 (-5.4% year on year in April 2018), implying that the newly extended loans to companies have been primarily used to repay old debts rather than for investment purposes.

The sanctions against Russia had a short-lived and contained effect on the exchange rate of Kazakhstan's tenge. Oil export revenues will support the KZT/USD exchange rate at a stable level through the year and will allow for further accumulation of National Bank reserves. Slight depreciation of the national currency with respect to the US dollar is likely only in 2019-2020.

All in all, the GDP growth forecast is revised upwards for 2018 – to 4%, owing to stronger export performance. In 2019-2020, as global oil prices are expected to fall, GDP growth will come down to 3% per annum.

KOSOVO: Growth accelerating amid political instability

BY ISILDA MARA

We expect real GDP growth of around 4% this year and through the medium term. The economy grew by 3.7% in 2017, driven primarily by investment and exports. An upsurge of gross fixed capital formation by 10%, merchandise exports by 23% and export of services by 18% provided the biggest support to the economy last year. By contrast, consumption remained subdued, mainly because of a declining consumer confidence provoked by the political instability. The current government – a coalition of AAK (Alliance for the Future of Kosovo), PDK (Democratic Party of Kosovo) and Nisma (Social Democratic Initiative) – has been weakened by the decision of the Serb List to abandon the alliance. This followed the arrest of Marko Đurić, the head of Serbia's office for Kosovo and Metohija, in northern Kosovo in March. However, the opposition, led by Vetevendosje, is losing support: currently the group has 19 out of 32 seats initially held in the parliament. Despite the political tensions, in March parliament ratified a border demarcation agreement with Montenegro. This was a precondition for granting Kosovans visa-free travel to the Schengen area.

Growth in 2018 will be investment driven, via public and private financing. The EBRD has provided a loan worth EUR 209 million for the rehabilitation of highways. Meanwhile, the construction of a coal-fired power plant is still awaiting parliamentary approval. This project, worth EUR 1.5 billion, would have a significant and positive economic impact, but also major negative implications for the environment and health. In May, the government floated the idea of building an economic zone for American companies interested in investing in Kosovo. A working group has been established to prepare the legislative and administrative framework. However, there is some scepticism about its implementation.

The fiscal stance and the financial sector remain supportive of growth. In 2017 the budget deficit was 0.1% of GDP, with public debt at 16.3%. For the coming period, the budget deficit is expected to widen, with expenditure projected to rise more than revenue. For the first four months of 2018, expenditures grew by 17% year on year, with capital expenditure up by more than 44% (suggesting for a big increase in public investment). Revenues rose by more than 6% thanks to a notable increase in collected personal income tax – mainly due to the strong rise in public employment. The financial sector remains supportive of growth. New loans rose by 13% year on year in January-April. Demand for new loans from the non-financial corporate sector increased by 6%, while among households it rose by 30%.

Consumption is expected to recover and will positively contribute to growth this year, underpinned by increases in remittance inflows and employment. The former rose by 10% in 2017 and 4% year on year for the first four months of 2018. More than 26,000 new jobs were created in 2017, but the unemployment rate remained very high at 30.6%. Gender and occupational segregation prevails. The most vulnerable groups are women (only 12.5% are employed) and those aged 15-24 (more than half are unemployed). Employment is very precarious; more than 70% of workers have temporary contracts. Meanwhile the average monthly wage shrank, both in real and gross terms, in 2017.

In 2018 the current account deficit is expected to widen. Merchandise exports dropped by 1.4% year on year in January-April 2018, while imports increased by 8% over the same period. FDI inflows dropped by 1% in the first four months of the year. The sectoral distribution of FDI inflows indicates that real estate, business activities and services, which usually tend to absorb the largest inflow of FDI, continued to do so in the early part of 2018. All in all, economic growth will accelerate to around 4% in 2018 and in the medium run.

LATVIA: Still riding high on the election and investment cycle but slowdown ahead

BY SEBASTIAN LEITNER

Data for the first quarter 2018 (+19.4% year on year) suggest that gross fixed capital investment will continue to grow at high pace in 2018. Fresh EU funds started to become available on a larger scale last year and the government continues to invest and also to raise public consumption in order to foster growth before the forthcoming parliamentary elections (October this year). However, the current investment boom is largely confined to construction: investment in machinery and equipment is stagnant.

Latvia's third largest bank, ABLV, was forced to initiate a shutdown of its operations. This followed a report by the US Treasury in February 2018, stating that the bank was involved in institutionalised money laundering. A large part of the Latvian banking sector was engaged in off-shore banking services – 11 banks were urged by the ECB to review their operations aimed at foreign customers. As a result, in the first quarter of 2018 deposits in the Latvian banking sectors declined by 11%.

Following a strong upturn in 2017, export growth has subsided in 2018. Given that imports are continuously increasing driven by household consumption, net exports will be negative again this year. Concerning inflation we expect the rise in consumer prices to abate in the second half of the year. However, strong wage growth has started to raise core inflation. We thus reckon with CPI inflation to remain at a level of about 3% this year and in 2019.

Job growth is gaining momentum, given the upswing in construction, but also the services sectors. Employment rates are strongly increasing and approach the levels of Scandinavian countries. We expect the unemployment rate to fall close to 8% in 2018 and to further decline to about 7% by the end of the forecast period in 2020. Following the elections in October, a new government may allow higher immigration to solve the problem of shortage of skilled labour.

Given the further tightening of the labour market, net real wages continue to rise at fast pace, by about 10% in the first quarter of 2018 year on year. This is also a result of the strong increase in the minimum wage (+13%) that came, inspired by the forthcoming elections, into force in January 2018. This fuels household consumption which is projected to increase by about 4.7% in real terms this year and the next and still by 3.5% in 2020.

All in all, compared to our Spring Forecast we have become more optimistic, increasing the forecast GDP growth rate for this year to 3.9%. Private investment activity has picked up more strongly than expected, although external demand is weakening. The strong upswing in public investment, not only this year but also in 2019 and 2020, will be facilitated by increasing inflows of EU funds. Rising household incomes will help private consumption to keep on growing steadily. For 2019 and 2020, we revised our GDP growth forecast upwards, to 3.6% and 3.1%, respectively.

LITHUANIA: Flourishing economy but lacking welfare state

BY SEBASTIAN LEITNER

GDP figures for the first quarter of 2018 substantiate expectations that gross fixed capital investment is likely to grow by another 8% this year. The inflow of fresh EU funds from the 2014-2020 programming period allows the government to increase capital spending. Investment is particularly lively in the energy sector, as well as in the road and railway infrastructure. The construction of new dwellings has started to increase again and the rising number of building permits indicates that the upswing will continue in 2018.

In 2018 the upswing of exports, in particular to Russia, is levelling off as expected. This is demonstrated by the January to April figures (+6% in net terms, year on year). Trade in services evolves much more dynamically – the trade surplus in services increased by almost 30% in the first four months of 2018; particularly transport services and tourism flourish. In spite of lively investment and consumption growth, imports are not increasing much faster than exports; still, the contribution of net exports to GDP growth is negative.

Employment is expected to remain stagnant in 2018. Demographic developments result in a continuously shrinking working-age population in Lithuania. Figures for the first months of 2018 show that the number of workers from e.g. Ukraine is on the rise. However, the need for scarce skills will not be fully met. The unemployment rate is likely to drop to 6.5% in 2018 and 5.8% in 2020. An increase in the minimum wage by 5% to EUR 400 from January 2018 onwards pushes the overall wage growth to about 6% in 2018. However, with import prices increasing less in 2018 compared to last year, we expect consumer inflation to decline to about 3% in both 2018 and 2019. Given the increase in households' purchasing power and rising consumer confidence in the first months of 2018, household consumption will further flourish throughout this year.

In April 2018 the government announced tax and pension reforms to be introduced next year. The tax burden on labour will be reduced, but the effects of this measure on reducing inequality and poverty will be modest, as even acknowledged by the IMF, OECD and the Lithuanian central bank. They emphasise that, in order to tackle these problems, the Lithuanian government should instead raise budget revenues. Higher social expenditures combined with lower taxes on low-income groups should also reduce emigration. The proposed measure to reach this goal is, in particular, the broadening of the real estate tax base to all private residences. The proposed changes to the funded pillar of the pension system are inadequate to reduce old-age poverty.

Compared to our Spring Forecast we have become more optimistic, increasing the forecast GDP growth rate for this year to 3.3%. Particularly private consumption has picked up more strongly than expected, while trade performs subdued. A continuous upswing in public investment, not only this year, but also in 2019 and 2020, will be facilitated by an increasing inflow of EU funds. Rising household incomes will help private consumption to keep on growing steadily. For 2019 and 2020, we also revised our GDP growth forecast upwards, to 3% and 2.6%, respectively.

MACEDONIA: New name and improved connectivity may boost growth

BY PETER HAVLIK

The Macedonian economy stagnated in 2017 as investment plunged by 7% and the construction industry shrank by a quarter, largely due to the political crisis with violent street protests and clashes in the parliament. Curiously, the crisis apparently did not have any effect on employment and the rate of unemployment even declined slightly (to just over 20% as of end-2017). After the parliamentary and municipal elections, internal political stability was partly restored towards the end of the year and domestic conditions supporting the economic recovery were thus established. Also, the new government has made great strides in improving fiscal transparency and in tackling the issue of unpaid public sector liabilities.

Some progress has been achieved also in external political relations as the new government signed an agreement with Bulgaria and approached Serbia as well. Most importantly, some progress was achieved in negotiations regarding the 'name issue' with Greece as well. Following this, the European Commission recommended in April 2018 to open the accession negotiations with Macedonia, even prior to the resolution of the 'name issue' expected in late June. The Economic and Financial Dialogue between the EU and the Western Balkans and Turkey on 25 May 2018 provided a number of policy recommendations. Macedonia should develop a proper medium-term fiscal consolidation strategy, stabilise the public debt ratio, streamline social spending and agricultural subsidies, reduce public sector payment arrears, develop an arrears prevention strategy, improve tax collection, conduct monetary policy consistent with the exchange rate peg (to the euro), using available scope within this framework in line with safeguarding price stability, etc. In addition, a number of labour market related recommendations was suggested as well.[1] However, in light of sustained primary fiscal deficits and continued financing needs of state-owned enterprises, public debt stabilisation remains a challenge. In fact, the debt-to-GDP ratio is projected to increase a bit in 2018, followed by a moderate decline in 2020.

The economy returned to growth already towards the end of last year. In 2018, GDP growth is projected to reach about 3% and even slightly accelerate thereafter, stimulated by domestic demand, thanks to rising wages and social transfers. Investments are expected to rebound strongly as well. With the completion of the 30 km highway corridor to Thessaloniki in April 2018, the improved connectivity in the Western Balkans and Macedonia should benefit industry, exports and employment. Inflation will stabilise at slightly above 2%, with the nominal exchange rate remaining stable as well. At the same time, a new outburst of political instability cannot be dismissed. The fragility of the new government persists, and the 'name issue' remains disputed despite a preliminary agreement between Prime Ministers Zoran Zaev and Alexis Tsipras of 12 June – in particular by nationalist forces in Greece who oppose the suggested name compromise, Republic of North Macedonia, on the grounds that people speaking a Slavic language do not have the right to identify as 'Macedonian'.

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1 See: http://www.consilium.europa.eu/en/press/press-releases/2018/05/25/western-balkans-and-turkey-joint-conclusions-of-the-economic-and-financial-dialogue/

MONTENEGRO: Stable outlook

BY OLGA PINDYUK

Montenegro's economy continues its robust performance. Industrial production was growing at a double-digit rate in January-February 2018. Retail trade has also been on the rise: +5% year on year in the first quarter of 2018, suggesting expanding household consumption. First-quarter balance of payments data show double-digit growth in services exports primarily on the back of transport services, as well as other business services and tourism. Goods exports grew at par, partly owing to higher aluminium and aluminium ore prices.

Tourism will continue being the main driving force of growth for the forecast period. Prospects for the current season look good. In 2019-2020, the expected growth slowdown in the EU and the expected fall in oil prices will likely constrain increase in demand for tourism services by EU citizens and Russians.

Infrastructure investment will be further expanding, albeit at a slower rate in 2019-2020. The ongoing Bar-Boljare motorway construction project is to be completed in 2019. Besides, the government seeks to build a Montenegrin section of the Adriatic-Ionian motorway. On 18 May, the European Commission announced that it will extend funds for the construction of this section to Montenegro as a part of its European Corridor agenda. It is not clear yet when the project will start and what will be its schedule, but it will likely be less investment-intensive than the Bar-Boljare one, which demands construction of about 50 tunnels and 95 bridges and viaducts due to the rugged mountainous terrain.

Foreign investors appear to be optimistic about the country's economic prospects, especially after Montenegro received positive reviews by the IMF and the World Bank, and its credit rating was confirmed to be B1 by Moody's. Evidence of this is the successful issuance on 12 April of a 7-year EUR 500 million Eurobond at a favourable interest rate of 3.375%. The new Eurobond is aimed at refinancing previous bond issues with a total amount of EUR 362 million.

The presidential elections in April 2018 were won by pro-EU candidate Milo Đukanović. This is considered to be a positive signal for the economy and reassured investors. Đukanović, a representative of an incumbent party, pledged stability of the government policies, in particular the country's EU integration course.

A downside risk for Montenegro's economic outlook is public debt growth fuelled by the infrastructure expansion. The first phase of the Bar-Boljare motorway has been primarily financed through a loan from China Exim Bank amounting to about 16% of GDP. Phases 2-4, which are to be finalised by 2019, are likely to require even higher investment costs. General government gross debt is at about 60% of GDP currently, and is expected to grow to 64% of GDP by the year end. The fiscal consolidation undertaken by the government is intended to gradually curb the debt increase in order to assure public debt sustainability. Obtaining EU funding in the European Corridor framework for the Adriatic-Ionian motorway construction is another welcome development.

All in all, we forecast economic growth to be at about 3% annually during 2018-2020. Ongoing fiscal consolidation and less favourable external conditions in 2019-2020 are the primary reasons for growth slowdown. Inflation will be at 2.5% in 2018 as numerous tax hikes will push prices upwards (VAT increase from 19% to 21%, several excise taxes rise). This is lower than in 2017, but still noticeably higher than in 2014-2016. Further on CPI growth will reduce its speed to 2% per annum.

POLAND: First clouds on the horizon

BY LEON PODKAMINER

Strong consumption-driven GDP growth continues. Starting from the first quarter of 2017, the growth reported has been quite fast. In the first quarter of 2018, real GDP grew again by a respectable 5.2%. Consumption, rising by 4.5%, was an essential driver of growth (with private consumption rising 4.8%). However, a much higher growth in household consumption could have been expected. In the first quarter of 2018, the wage bill rose by close to 8% in real terms and social transfers (including pensions) by about 6%. The gap between real wage incomes and consumption spending primarily reflects rising saving propensities.[1] Gross fixed investment gained momentum with an 8.1% growth rate (following weak performance throughout much of 2017 and a strong recession throughout 2016).

Foreign trade in goods and non-factor services performed weakly but inventories boom. Growth of both exports and imports slowed down radically in the first quarter of 2018. Moreover, as imports rose faster than exports, the trade surplus was reduced. The negative contribution of foreign trade to the GDP growth rate was large (-1.2 percentage points). The fast rise in inventories is another potentially disturbing development. Rising inventories contributed 1.9 percentage points to GDP growth in the first quarter of 2018 (twice the contribution of fixed capital formation).

Output of construction and also of manufacturing performs quite well. The volume of sales by construction firms rose by 24.8% during the first four months of 2018. Sales of civil engineering works (predominantly infrastructure-related) increased by 32% and of buildings by 29%. For industry the respective rate is 7.3% (with sales of intermediate goods rising 7.5%, investment goods by 3.7%, durable consumer goods by 6.8% and non-durable consumer goods by 3.5%).

Corporate profitability deteriorates. Net profits of the corporate non-financial sector declined sharply (by 9%) in the first quarter of 2018. The food processing industry and retail trade have been particularly affected while profits improved quite strongly in transportation and construction of buildings. Profits are squeezed by the diminishing gap between producer prices received and costs. Producer prices rise very weakly (on average by about 1.5%) while costs are increasing quite strongly (under the impact of a close to 8% hike in the average nominal wage rate recorded in the first quarter of 2018). Structurally, investment outlays appear to be correlated with the profitability developments. In the first quarter of 2018, investment outlays in retail trade fell by close to 4%, stagnated at 1.3% in manufacturing but rose by 16% in the construction sector and by 50% in transportation. Investment outlays in the water supply, sewage etc. sector is rising at a 33% rate. That investment is likely to be financed largely out of the EU cohesion funds (similarly as much of investment in transportation).

The weakening exchange rate may neutralise the effects of rising wages on firms' profitability. In May 2018, the zloty weakened against the euro, possibly representing a 'contagion' effect. However, if the weakness proves only temporary, the trade performance may become a drag on growth, especially if domestic unit costs are not arrested. At the same time, despite lower profits, the corporate sector's financial standing is strong. Conditions are conducive to an expansion of corporate investment in 2018-2020, also on account of larger public investment (co-financed by the EU).

1 The earnings of a large number of foreigners employed are sent back home (mostly to Ukraine) thereby reducing effective domestic consumer demand in Poland.

ROMANIA: Economic growth falters

BY GÁBOR HUNYA

Economic growth lost dynamics in the first quarter of 2018, as GDP did not grow compared with the last quarter of 2017 and only by 4.0% year on year. The main cause was slowing household consumption growth (5.1% vs 10.2% in 2017 as a whole). Gross fixed capital formation grew by 4.8% driven by projects in the private sector. Investments went into equipment while construction investments contracted, leaving much of the infrastructure projects unfinished again.

Consumer confidence was shaken by the chaotic implementation of wage reforms at the beginning of the year. The reforms had two main components: transferring the full burden of social security contributions from the employers to the employees and reducing the flat personal income tax rate from 10% to 6%. The combined impact on net wages should have been neutral, but this was not the case for large parts of the wage-earners and thus required ex-post adjustments by employers. Real wages and retail sales recovered only in March so that household consumption may be more robust in the rest of the year. Consumption will also be supported by a 10% increase in pensions as of 1 July.

Inflation is another factor that has eaten up some of the wage hikes of last year. Consumer prices were up 5.2% in April 2018 compared to April 2017, corresponding to an annual inflation rate of 4.3%. The main drivers were food, fuel and energy prices as well as currency depreciation, which stopped only after the central bank had increased the reference rate by 0.25 percentage points to 2.5% in May. This corresponds to a National Bank lending rate of 3.5%, which is about the same as the GDP deflator in the first quarter of 2018.

The performance of manufacturing production and exports is good; in particular, the automotive, electrical machinery and electronics industries are buoyant. But imports have increased even more rapidly than exports; thus the current account deficit is expected to widen to at least 4% of GDP this year. Beyond trade, the income of foreign investors is an expanding component of the current account deficit, following a very successful financial year 2017.

Labour shortages are a serious complaint of employers and investors. The unemployment rate went down from 5.2% in March 2017 to 4.5% in March 2018, coupled with a rising vacancy rate. Still, a lot of the labour shortage is structural: there is a large pool of underemployed in rural households engaged in subsistence farming but with no proper industrial skills.

The coalition government led by the Social Democratic Party initiates contradictory laws and is neither able to efficiently implement public investments nor to provide satisfactory access to EU funds. Political instability is worsening as former PM Victor Ponta has been cleared from corruption charges by which he has been allowed to return to politics and set up a new party, 'Pro Romania'. The latter has taken over MPs from the ruling Social Democrats, shaking the governing coalition's majority in parliament.

The wiiw GDP growth forecast has been revised downwards to 4.2% in 2018 based on the expected slowdown in consumption and, to a lesser extent, investments. The budget deficit is expected to widen to more than 3% of GDP and enforce a consolidation course in 2019 that will further depress growth. A minor acceleration in 2020 is expected when EU funds disbursement will be getting momentum.

RUSSIAN FEDERATION: More of the same will not be helpful

BY PETER HAVLIK

GDP growth slowed down in the first quarter of 2018, to just 1.3% compared to the same period of the previous year, according to preliminary data. Consumer price inflation continued to decline and the growth of real wages and disposable income recovered. Export revenues jumped by more than 20% in nominal USD terms thanks to higher oil prices; imports expanded strongly as well.

On 18 March, President Vladimir Putin was re-elected for his fourth and presumably last term. The election was free but not completely fair according to some observers since the opposition candidates, in particular Alexei Navalny, who was banned to participate in the contest, have not been treated fairly by the state-controlled media. Without genuine opponents and enjoying factual popularity, Mr Putin achieved a landslide victory with almost 77% of the casted votes at a high voters' turnout. The economy was almost absent from the pre-election debates; the conflict with the West prevailed. Following Dmitri Medvedev's re-appointment as prime minister in May – signalling stability instead of liberal reforms associated with the former Finance Minister Alexei Kudrin – President Putin announced a decree on 'The national targets and strategic development priorities of the Russian Federation until 2024'. Similar to previous reform plans, the Decree contains a comprehensive list of areas to be addressed in order to achieve a 'breakthrough in technological and social-economic development, increase living standards … and conditions for the self-realisation and discovery of individual capabilities'. Policy focus will be on social developments, health improvements and rising life expectancy. Defence expenditures will be reduced. Instruments and policies needed for achieving these ambitious goals, including economic modernisation, diversification of exports and SME development are to be elaborated by the government before 1 October 2018.

One of the prerequisites of reform success is a correction of illiberal tendencies in Russian economic policies.[1] There has been hardly any sign of change in this direction and the meeting of key decree targets – among them to elevate the Russian economy to one of the world's top five – appears largely unrealistic in the absence of reforms, economic opening, more foreign direct investments and deeper restructuring. For the time being, it is more likely that instead of 'achieving above-average growth rates', the Russian economy will fall further behind. A new round of US sanctions introduced in April hit several Russian 'oligarchs' and exporters, the exchange rate depreciated. On the other hand, the oil price exceeding USD 70/bbl and the resulting higher export and budget revenues will partly compensate the sanctions' negative effects. Our GDP growth forecast has been revised slightly downwards (to 1.7% in 2018), partly on account of escalating US sanctions. Import substitution and trade reorientation strategies represent two responses that Russia will follow with even more rigour in future. The fostering of cooperation with China, including the development of Silk Road/OBOR transport corridors and rising energy exports, will underpin the trade diversification strategy away from the EU. With expected growth rates below 2% even in the medium term, Russia will not meet Putin's ambitious target to become the 5th largest world economy by the end of his current presidency.

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1 See wiiw Policy Note No. 20, March 2018 (https://wiiw.ac.at/russia-s-reform-failures-and-putin-s-future-challenges-p-4448.html).

SERBIA: Cautiously optimistic

BY RICHARD GRIEVESON

After a disappointing 2017, there is a certain amount of optimism around the Serbian economy. Real GDP rose by 4.5% year on year in Q1 2018, the best performance since the third quarter of 2008. Sentiment has been further bolstered by sovereign ratings upgrades, the announcement of the 2025 target for EU accession, and the likelihood of a new IMF programme (without financing).

Growth will be higher this year than last, and we have revised up our forecast in light of the strong Q1 number. The agricultural sector is expected to perform better after a difficult 2017 caused by a drought. Private consumption will be supported by wage growth (including higher public sector salaries) and a pension increase. External demand should remain strong (the fact that the export sector has basically doubled relative to GDP since the crisis means this is now much more important than it was in the past). Investment will continue its recovery (construction rose by 28% year on year in Q1). The labour market has performed reasonably well recently amid meagre growth, suggesting declining productivity, but in Q1 2018 the relationship flipped.

The fiscal contribution to growth should also be positive: we expect a gradual loosening after several years of tough austerity (the budget posted a strong surplus last year). Since 2012, the fiscal balance has improved by 8 percentage points of GDP, easily the greatest degree of fiscal tightening (on this measure) in CESEE. However, contingent liabilities from SOEs remain a medium-term fiscal risk.

Recent data indicate that Serbia's growth model is ever more FDI driven, and the government continues to focus on domestic stability and good international relations. FDI inflows have comfortably covered the current account deficit for the last three years, providing relative stability. We see the current account deficit hovering at around 5% of GDP during the forecast period, but expect this to be more than covered by net FDI inflows. Serbia still faces a big infrastructure deficit, which is a barrier to competitiveness and a stronger development of a higher value industrial base. Limited fiscal space and the weakness of public investment management frameworks will hamper efforts to address this.

Serbia's EU accession is moving forward, although the 2025 target date is highly ambitious and probably won't be achieved. The recent Commission progress report on Serbia was fairly positive. At least in economic terms, Serbia is along with Montenegro the frontrunner among the Western Balkan hopefuls for EU accession. However, the implementation of a legally binding agreement on relations with Kosovo will be necessary, and the challenges here shouldn't be underestimated. Negotiation chapters continue to be opened, but delays have emerged. France and Germany are not satisfied with progress on chapter 23, which includes judicial reforms and anti-corruption policy. The Commission has also noted issue is with development of functioning market economy and coping with competitive pressures and market forces inside EU.

The central bank has loosened policy amid low inflation and a strong currency. Core inflation dropped to 0.8% year on year in March, its lowest level on record. We expect the policy rate to be kept at 3% for the remainder of the year. Inflation will only pick up slowly, probably not reaching 3% (the midpoint of the central bank's target range) until the second half of next year. The credit growth outlook is fairly positive, reflecting better confidence, low interest rates, and banks gradually cleaning up balance sheets. According to official data, Serbia has the second highest rate of non-performing loans (NPLs) in the region after Ukraine.

SLOVAKIA: Solid growth with extra kick from automotive industry

BY DORIS HANZL-WEISS

Robust growth continued in the first quarter of 2018, driven by household consumption and investment. After registering growth of 3.4% in 2017, Slovakia's GDP increased by a robust 3.6% in the first quarter of 2018. Household consumption slightly slowed down at the beginning of the year but yet increased by 3.5%; final government consumption grew by 3.1%. Gross fixed capital formation finally saw an impressive surge, soaring by 12.5%. Due to destocking, gross capital formation rose by 8.8% only. Construction did well and increased by 7.7% in the first quarter. Expansion of exports of goods and services decelerated and reached only 2.4% in the first quarter, compared to imports registering growth of 3.2%, resulting in a negative contribution of foreign trade to GDP growth.

Household consumption is fostered by the tight labour market and wage increases; inflation is picking up. Employment continued growing in the first quarter, rising by 1.2%. The unemployment rate fell by 1.6pp (compared to the first quarter of 2017) and now stands at only 7.1% – a record low for Slovakia. Still there are large regional disparities: unemployment ranges between 3.2% (Trenčin region) and 11% (Košice region). However, labour shortages are increasing. Simplified rules for employing foreign workers became effective as of May this year. Nominal wages grew by 6.5% in the first quarter, although real wages rose much less (by 4.1% – still the highest value since 2014) on account of the higher than expected inflation: consumer prices rose by 2.4% in the first quarter (year on year).

Industrial output was stagnant in the first quarter of 2018, due to declines in the mining and electricity sectors and low growth in manufacturing. The main industry sector – the automotive sector – grew only by 1.5% and thus did not regain its role as Slovakia's main growth driver. In fact, basic metals and fabricated metal products, rubber and plastic products as well as other non-metallic mineral products contributed most to manufacturing growth.

There is 'business as usual' despite the political crisis in March. The murder of the investigative journalist Ján Kuciak and his fiancée in February this year led to a political crisis in March and the resignation of then Prime Minister Robert Fico. His successor, Peter Pellegrini, continues Fico's policies. For 2018, the government envisages a budget deficit at -0.8% of GDP and a debt level of 49.9% of GDP; a balanced budget is targeted for 2020. Nonetheless, the three-party coalition announced a new social package for 2019 (with general elections in 2020) including free school lunches, loans for newly-married couples and support for tourism.

An extra growth kick will come from automotive industry expansion in the near future. Despite the disappointing performance of industry and exports at the beginning of 2018, we expect GDP growth to accelerate to 3.8%, mainly thanks to the expansion of exports from the new Jaguar Land Rover plant which should be put in operation in the final quarter of the year. This trend should accelerate in 2019, with a projected GDP growth rate of over 4%. Internal risks such as increasing labour shortages, rising wages, growing indebtedness of households and external debt, as well external ones such as US tariff increases on cars and lower foreign demand, are looming around the corner yet.

SLOVENIA: Broad-based growth continues

BY HERMINE VIDOVIC

Slovenia's GDP grew by 4.6% in the first quarter of 2018 (year on year), backed by strong domestic demand. Private consumption growth has been formidable, supported by favourable labour market conditions and rising household loans. Gross fixed capital formation remained on its growth path (9.1%), with an above-average increase in construction investment (12.6%), of which particularly in non-residential buildings. Noticeable investment growth was also reported in machinery and equipment and transport equipment. Changes in inventories contributed positively to the GDP expansion as well, but the contribution of net exports was negative. Industrial output grew by close to 8% in the first three months of the year, with the highest growth rates reported for car production (35%) and the manufacturing of textiles (29%).

The situation on the labour market continued to improve. Employment has been rising (including also inward migrant workers) and unemployment further declined, to 5.9%. Average real gross wages increased moderately, by 2.3% compared with the first quarter of 2017, with rises being higher in the private than in the public sector.

External trade developed favourably in the first quarter of 2018, but less dynamically than in the same period a year earlier. Goods exports went up by 8.8% and imports expanded by 9.3%, resulting in a similar trade surplus as in the same period of 2017. The surplus in services trade was higher than a year earlier due to exports – of transportation services in particular – rising ahead of imports. Overall, the current account closed with a surplus of EUR 660 million in the first quarter of 2018, an improvement by EUR 80 million. The net FDI inflow was negative (EUR 100 million) in the first quarter of 2018.

Data indicate a further improvement of the general government balance: the deficit was less than half of that reported in the first quarter of 2017. Last year the general government closed with a small surplus for the first time since comparable data are available (1995). Given the strong GDP growth and the corresponding rise in tax revenues, the general government should end up with a surplus in 2018 and probably in the two coming years as well. The debt to GDP ratio is expected to fall below the 70% mark in 2018.

Loans to the real sector have strengthened since the end of 2017 and rose by 5.1% in March (year on year). Loans increased both to non-financial corporations (3.4%) and to the household sector (6.5%). In the latter the strongest expansion was reported for housing loans, albeit at a lower rate than in the first quarter of 2017.

The outcome of the parliamentary elections held on 3 June points to difficult and long-lasting coalition negotiations ahead. Most parties have rejected to form a coalition with Janez Janša. His party, the right-wing Slovenian Democratic Party (SDP), won 25% of the votes, followed by the List Marjan Šarec (12.7%), the Social Democrats (9.9%), the Party of the Modern Centre led by the current Prime Minister Miro Cerar (9.7%) and the Left (9.2%). The result of the coalition talks is completely open.

Given the continued growth momentum during the first months of the year, wiiw revised the GDP growth outlook for 2018 upwards from the earlier 3.9% to 4.8%. Also beyond 2018 we expect GDP growth to remain above 3% annually, driven primarily by private consumption and enhanced investment activities spurred by EU transfers. Unemployment will continue to decline amid rising labour shortages, which will exert some upward pressure on wages.

TURKEY: Sailing close to the wind

BY RICHARD GRIEVESON

Political and economic uncertainty remains highly elevated, and this has been exacerbated by the calling of an early election for 24 June. Polls show the race for the presidency – a role that will have much more power from now on under the new constitution – as too close to call. A second round on 8 July is likely to be necessary. The chances of the incumbent Recep Tayyip Erdoğan winning are high: employment is rising strongly, he benefits from high media exposure, the snap poll leaves little time for the opposition to prepare, and military interventions in Syria have stoked nationalist sentiment. However, a recent collapse in the lira and the delayed response of the authorities will work in the opposition's favour.

The lira has weakened considerably against the dollar, eventually prompting a sharp tightening of monetary policy by the central bank. The delayed response has damaged the credibility of the authorities, although three rounds of tightening in the space of two months have stemmed the lira's sell-off for now. Given the trend in the lira, inflation will remain very elevated this year. Consumer price inflation has been in double digits for 14 of the last 15 months, a long way from the central bank's 5% target (inflation has not been at this level since early 2011) which further undermines credibility.

Economic data for the first quarter were strong, but early indications for Q2 are more mixed. The economy expanded by 7.2% in Q1 year on year. External factors remained broadly supportive of growth. Total tourism arrivals rose by 30% in Q1. Nominal merchandise exports rose by an average of over 10% year on year in January to April 2018. However, the PMI in April fell below 50 (the level separating expansion from contraction) for the first time in over a year, driven in part by a slowdown in new orders. Confidence in the services, retail and construction sectors have all fallen since the start of the year.

Downside risks to the outlook have increased since our Spring Forecast. The government is targeting growth of 5.5% in 2018-2020, and extra fiscal stimulus has been introduced compared with the original 2018 budget. However, support from credit will be less than last year, exacerbated by monetary tightening. We think growth will be lower than the government target, both this year and next. Turkey's external vulnerabilities remain high. In Q1 2018 the current account deficit almost doubled compared to a year earlier, and net FDI inflows financed only 6% of it, compared to 67% for hot money (portfolio and other income). As a result, short-term external debt in US dollar terms rose by 14.3% (USD 15.3 billion) year on year in Q1. Gross external debt is over 50% of GDP, and annual rollover needs are around 20% of GDP, leaving the economy exposed to high liquidity risks.

Tensions with the US and the threat of sanctions on the banking sector are a concern. An outright crisis is not our core scenario, but the risks have increased. Several offsetting factors continue to act in Turkey's favour. First, global monetary conditions remain favourable, with the US Fed only tightening slowly (and in a well-telegraphed manner). Second, the banking sector has a good starting position. Third, Turkey's fiscal position is still quite strong, and public debt is low.

Over the long run, the current growth model is not sustainable. A reliance on hot money inflows to fund a gaping current account deficit cannot be maintained indefinitely. Turkey will either have to find a new growth model (for example based on attracting more FDI and gains in productivity), or get used to a much lower growth rate than has been the case recently.

UKRAINE: Remittances offset growing trade deficit

BY VASILY ASTROV

After decent GDP growth recorded last year (2.5%, according to revised data), in the first quarter of 2018 the economy expanded by 3.1% year on year and by 0.9% on a quarterly basis. In all likelihood, growth continues to be driven exclusively by domestic demand, particularly fixed capital investments, which soared by 37% in the first quarter (although the dynamics of construction was flat). Private consumption remains vibrant as well: retail sales went up by 7% in real terms in January-April, driven by the strong growth of real wages (by 11.2%) amid fiscal policy relaxation and progressive tightening in some labour market segments. Strong consumer demand – coupled with soaring food prices – is also one of the factors behind the high inflation, which in May stood at 11.7% on an annual basis. The persistently high inflation is all the more surprising as the exchange rate has been stable and even appreciated somewhat during recent months, in part thanks to the recent monetary tightening.

The trade deficit widened further. Growth of merchandise imports (by 13.9% in nominal USD terms in the first four months of 2018) outpaced once again significantly that of exports (11.3%). However, the growing trade deficit has been more than offset by higher inflows of remittances. Generally, the role of remittances for the Ukrainian economy appears to be much greater than assumed earlier: methodological changes in estimates undertaken by the National Bank in March 2018 resulted in a drastic upward revision of data on remittances for 2015-2017. The revised data suggest that inflows of remittances reached USD 9.3 billion last year, 23% more than in 2016 and corresponding to 8.4% of Ukraine's GDP. In the first four months of 2018, remittances probably rose by another up to 30%, with Poland becoming an increasingly important source country.[1] The upward revision of data on remittances has also implied that the current accounts for the past three years improved accordingly: e.g. the current deficit in 2017 is now estimated at a mere 1.9% of GDP – 1.8pp lower than prior to the revision.

Barring major shocks, the current economic trends are set to continue at least in the short and medium run, with projected real GDP growth of above 3% this year and the next. At the same time, the approaching presidential elections in March 2019 potentially pose a number of risks. First, at the time of writing this report, the incumbent President Poroshenko looks unlikely to be re-elected, and that implicates major political and economic uncertainties ahead. Second, in the pre-election context the unpopular IMF demands such as a further hike in domestic gas tariffs have little chances of being implemented (despite the rising European gas prices).

This puts in question the resumption of the IMF loan programme, which has effectively stalled since April 2017. The latter should not be a problem *per se*, as long as the Ukrainian authorities can rely on borrowing from financial markets to (re-)finance upcoming external debt service obligations: USD 8.5 billion up until the end of 2019, mostly to official lenders such as the IMF, the World Bank and the US government. At present, this is still possible, as suggested by the low (for Ukraine's standards) yields on government bonds denominated in foreign currency: 4-5%. However, should the recent global trend of US dollar appreciation continue and lead to a general re-orientation of capital flows away from emerging markets, the hryvnia may find itself under renewed depreciation pressure, which could undermine the country's fragile economic stability.

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[1] Poland accounts now for around one third of total remittances to Ukraine – see also https://wiiw.ac.at/ukrainian-workers-in-poland-demand-by-far-exceeds-supply-n-308.html.

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