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Monthly Report

Recent Economic Developments in Central, East and Southeast Europe

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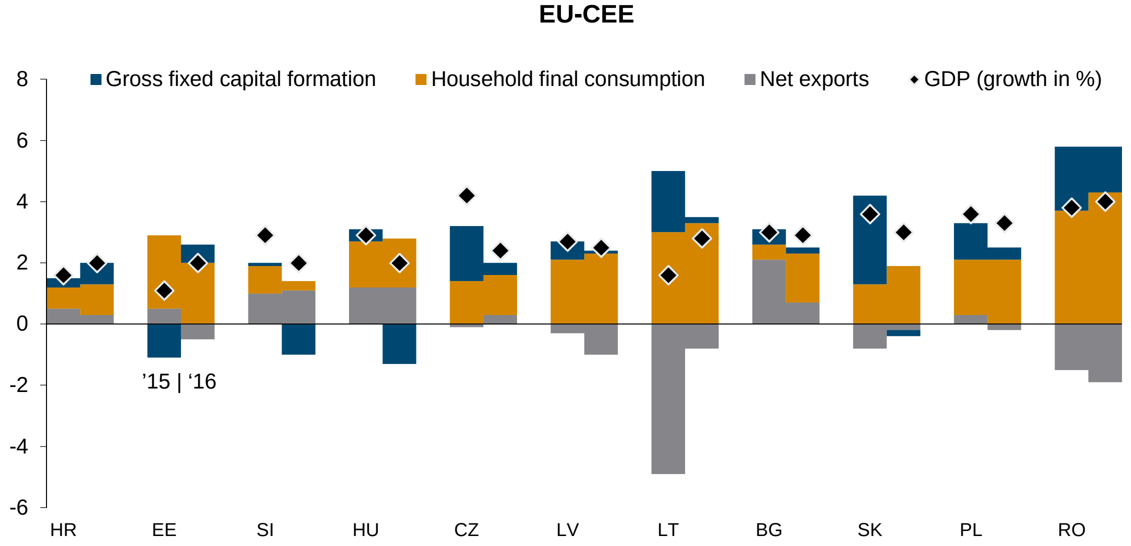
OVERVIEW 2015 AND OUTLOOK 2016-2018

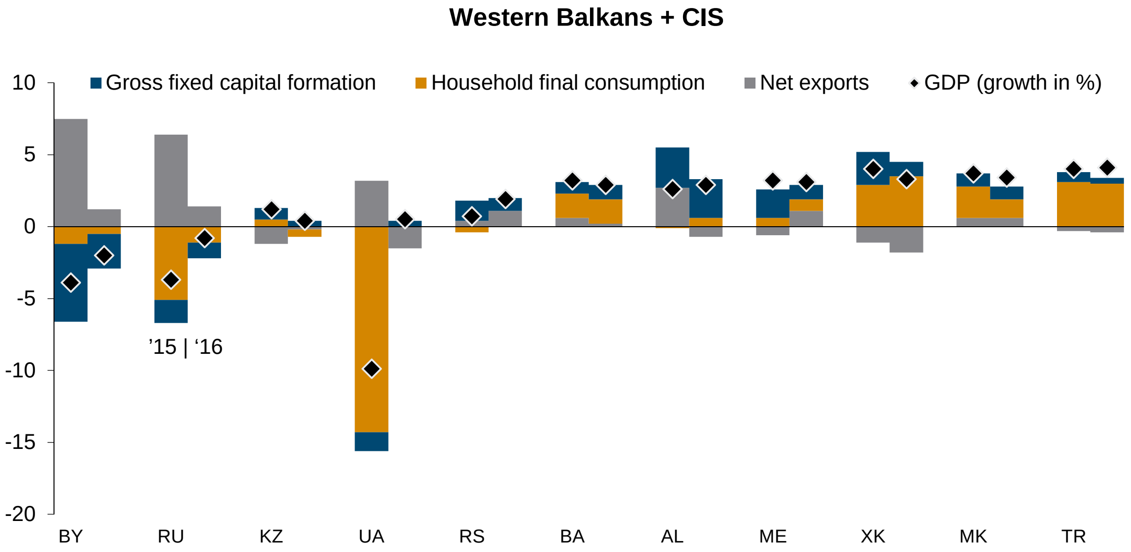
	GDP real change in % against prev. year				Investment (GFCF) real change in % against prev. year				Consumer prices change in % against prev. year				Unemployment (LFS) rate in %, annual average				Current account in % of GDP			
		Forecast				Forecast				Forecast				Forecast				Forecast		
	2015	2016	2017	2018	2015	2016	2017	2018	2015	2016	2017	2018	2015	2016	2017	2018	2015	2016	2017	2018
EU-CEE																				
Bulgaria	3.0	2.9	3.0	3.1	2.5	1.0	3.0	5.0	-1.1	0.0	0.5	1.0	9.2	8.5	8.0	7.5	1.4	1.5	1.3	0.8
Croatia	1.6	2.0	2.2	2.3	1.5	3.5	4.0	5.0	-0.3	-0.5	1.0	1.0	16.3	16.0	15.5	15.0	5.2	3.4	2.2	1.9
Czech Republic	4.2	2.4	2.6	2.6	7.2	1.5	3.5	4.3	0.3	0.7	1.7	1.9	5.1	5.0	4.5	4.5	0.9	1.2	1.0	0.8
Estonia	1.1	2.0	2.3	2.4	-4.4	2.5	4.5	5.0	0.1	0.3	1.5	2.5	6.2	6.4	6.6	6.5	1.9	0.0	-1.5	-2.5
Hungary	2.9	2.0	2.5	2.9	1.9	-6.0	3.0	6.0	0.1	0.6	2.0	3.0	6.8	6.5	6.3	6.1	4.4	4.3	4.1	4.0
Latvia	2.7	2.5	3.0	3.3	2.7	0.5	4.0	4.0	0.2	0.0	1.5	2.2	9.9	9.8	9.4	9.0	-1.2	-2.0	-2.5	-3.0
Lithuania	1.6	2.8	3.1	3.4	10.3	1.0	6.0	7.0	-0.7	0.7	2.1	2.3	9.1	8.5	8.0	7.5	-1.7	-2.2	-2.6	-2.8
Poland	3.6	3.3	3.3	3.4	6.1	1.8	4.5	7.0	-0.7	-0.5	1.3	1.8	7.5	6.6	6.3	6.2	-0.2	-0.3	-0.5	-0.8
Romania	3.8	4.0	3.2	3.5	8.9	6.0	5.0	5.0	-0.4	-1.0	2.0	2.5	6.8	6.5	6.3	6.0	-1.1	-2.5	-2.5	-3.0
Slovakia	3.6	3.0	3.2	3.3	13.9	-1.0	6.5	4.0	-0.3	-0.1	1.2	1.8	11.5	10.0	9.5	9.0	-1.3	-1.6	-2.0	-2.0
Slovenia	2.9	2.0	2.3	2.8	0.5	-5.0	3.0	4.0	-0.8	-0.5	1.0	1.0	9.0	8.5	8.0	7.5	7.3	7.0	6.0	5.0
EU-CEE 1)2)	*3.4*	*3.0*	*3.0*	*3.2*	*6.3*	*1.4*	*4.3*	*5.6*	*-0.4*	*-0.2*	*1.5*	*2.0*	*7.8*	*7.2*	*6.9*	*6.7*	*0.7*	*0.3*	*0.0*	*-0.3*
EA-19	*1.7*	*1.6*	*1.8*	.	*2.9*	*2.9*	*3.8*	.	*0.0*	*0.2*	*1.4*	.	*10.9*	*10.3*	*9.9*	.	*3.6*	*3.7*	*3.6*	.
EU-28	*2.0*	*1.8*	*1.9*	.	*3.4*	*3.0*	*3.8*	.	*0.0*	*0.3*	*1.5*	.	*9.4*	*8.9*	*8.5*	.	*2.0*	*2.2*	*2.1*	.
Western Balkans																				
Albania	2.6	2.9	3.3	3.3	11.3	10.0	8.0	7.0	1.9	0.9	1.5	2.0	17.1	17.0	16.8	16.7	-11.2	-11.0	-10.0	-10.0
Bosnia and Herzegovina	3.2	2.9	2.9	3.0	4.0	5.0	4.0	5.0	-1.0	1.0	2.0	2.0	27.7	27.2	26.1	25.0	-5.6	-8.0	-8.0	-7.0
Kosovo	4.0	3.3	4.2	4.0	10.0	4.0	5.0	4.0	-0.5	0.1	1.0	2.0	34.0	33.0	33.0	32.0	-9.1	-10.0	-10.0	-11.0
Macedonia	3.7	3.4	3.1	3.1	4.0	4.0	4.0	4.0	-0.3	1.0	2.0	2.0	26.1	27.0	26.0	25.0	-1.4	-2.0	-4.0	-4.0
Montenegro	3.2	3.1	3.3	3.5	10.5	5.0	4.0	4.0	1.4	2.0	2.0	2.0	17.6	17.5	17.0	16.5	-13.4	-14.6	-14.6	-14.0
Serbia	0.7	1.9	2.3	2.5	8.3	5.0	5.0	4.0	1.9	2.0	3.0	3.0	17.7	17.0	17.0	16.0	-4.8	-6.0	-6.0	-6.0
WB 1)2)	*2.2*	*2.6*	*2.8*	*2.9*	*7.6*	*5.7*	*5.2*	*4.7*	*0.9*	*1.4*	*2.3*	*2.4*	*21.4*	*21.0*	*20.7*	*19.8*	*-6.2*	*-7.5*	*-7.2*	*-7.2*
Turkey	4.0	4.1	3.7	3.5	3.6	2.0	1.0	1.0	7.7	7.8	7.3	6.8	10.3	10.2	10.1	10.0	-4.5	-4.7	-4.9	-5.0
Belarus 3)	-3.9	-2.0	0.5	1.4	-15.9	-8.5	-1.5	1.5	13.5	12.0	11.0	10.0	1.0	2.0	2.5	2.5	-3.9	-1.8	-1.3	-1.0
Kazakhstan	1.2	0.4	2.0	3.0	4.1	2.0	4.0	5.0	6.6	13.0	7.0	6.0	5.0	5.2	5.0	5.0	-3.2	-3.1	-1.6	-1.5
Russia 4)	-3.7	-0.8	0.8	1.8	-7.6	-5.0	1.0	3.0	15.5	10.0	6.0	6.0	5.6	5.3	5.3	5.3	5.2	4.8	4.2	4.9
Ukraine 5)	-9.9	0.5	1.9	2.4	-9.3	3.0	5.0	7.0	48.7	15.5	9.5	6.0	9.1	10.0	10.0	9.5	-0.2	-2.5	-2.5	-3.5

Note: GFCF: Gross fixed capital formation. LFS: Labour Force Survey. EU-CEE: European Union - Central and Eastern Europe. EA: Euro area. WB: Western Balkans.
1) wiiw estimates. - 2) Current account data include transactions within the region (sum over individual countries). - 3) Unemployment rate by registration. - 4) Including Crimea. - 5) Excluding Crimea and parts of Donbas.

Source: wiiw (June, 2016), Eurostat. Forecasts by wiiw and European Commission for EU and Euro area (Spring Report, May 2016).

GDP growth in 2015-2016 and contribution of individual demand components in percentage points





Remark: Ranking 2016.
Source: wiiw Annual Database incorporating national and Eurostat statistics, forecasts by wiiw, June 2016.

ALBANIA: Mixed signals from domestic and external demand

BY ISILDA MARA

In the first quarter of 2016, an improvement in tax collection (7.9% year on year) and a contraction of expenditures (8.4%) resulted in a budget surplus and further fiscal consolidation. The inflation rate reached the floor at 0.1% in February 2016. At a 0.7% rate in May it is rising slowly again, but is still far from the Central Bank target of 3%. The policy rate was cut twice in a row by 0.25 pp. down to 1.25%. This certainly helps, but not a lot, as the economy is heavily euroised. The ratio of euro deposits to those in Albanian lek (ALL) was at 0.75 while the ratio of loans in EUR to ALL stood at 1.14 in March 2016. The level of non-performing loans rose again to 19% by April 2016 from 17% in December 2015, hinting at structural obstacles being still underneath.

Household consumption recovered in the second half of last year, but still shrank by 0.2% in 2015 as a whole. The first quarter of 2016 saw consumer confidence falling, mainly reflected in the decline of 'major purchases' – such as durable goods – and less optimistic expectations about the future financial situation. Nevertheless, household demand for new loans in ALL grew by 11%. In turn, remittances have hardly helped consumption, given that they fell by 10% and 17% in the first quarter 2016 and the fourth quarter 2015, respectively. In the first quarter of 2016, unemployment receded to 16.9%, from 17.7% in the last quarter of 2015. Informal employment persists to be important, and tackling structural unemployment by investing in professional and dual education systems – targeting sectors of the economy which produce new jobs – remains an important challenge for policy-makers. The low international oil prices have negatively affected the trade balance of oil-exporting Albania. In January-April 2016, exports fell by 6%, while imports rose by 8% year on year. The saving anchor of total exports was the food and garment industry with exports growing by 37% and 24%, respectively. The garment industry has reached a 47% share in total exports. In contrast, exports of the extraction industry – essentially oil – fell by 42% in nominal terms and 12% in real terms. Imports in this sector recovered by 7% in real terms but shrank by 18% in nominal terms. In April 2016, they showed however some signs of recovery, which is expected to continue if the higher level of oil prices persists.

FDI inflows in 2015 amounted to one third of gross fixed capital formation and the inward stock to 46.5% of GDP. The Trans-Adriatic Pipeline (TAP) project is progressing accordingly and has entered its intensive implementation phase. So far 65% of supporting infrastructure for the construction of the pipeline has already been built. Nevertheless, the first quarter 2016 saw a sharp drop in FDI inflows by 44% year on year, and by 14% compared with the last quarter 2015. A vital foreign company in Albania – Canadian Bankers Petroleum – which accounts for 85% of Albanian oil extraction is getting out of the scene, leaving the podium to the Chinese Geo-Jade Petroleum Corporation. The closing of the takeover deal is expected late June or early July 2016. Currently, Bankers Petroleum has an open dispute with the Albanian government concerning the tax obligations for 2011. An international expert audit is expected to provide a conclusion within the second quarter of 2016. All in all, given the ongoing weakness of private consumption, only moderate growth of investments (largely due to the pipeline construction) and fiscal consolidation, our GDP growth forecasts for 2016-2018 have been revised downwards. Still, GDP growth above 3% can be expected from 2017 onwards. External demand will contribute positively to GDP growth, if international oil prices stabilise at the recently recovered level.

BELARUS: Departing from the bottom

BY RUMEN DOBRINSKY

The Belarusian economy probably touched bottom around the turn of the year and is now slowly bottoming out. While aggregate output continued to slide, there has been a deceleration in the pace of decline over the course of the first months of 2016: from -4.3% year on year in January to -4.0% in January-February, to -3.6% year on year in the first quarter and to -3.0% in January-April. Industrial production was also on the road to recovery and in April monthly gross industrial output registered a positive year on year growth in real terms (by 2.9%), which happened for the first time since November 2014. The trend towards recovery was most visible in the export-oriented manufacturing sectors.

By contrast, employment continued to decline, largely reflecting an ongoing process of slashing existing slack in many state-owned enterprises. In April 2016, total employment in the Belarusian economy was by 1.5% lower than a year earlier and the pace of decline was accelerating in the first months of the year.

These mixed outcomes reflect both the unfavourable conditions in the external environment, in particular, the most important Russian market, but also a much tighter policy stance and a likely departure from the loose populist policies that were typical of previous years. Importantly, policy was tightened on virtually all fronts. The government is now considering slashing public expenditure for the year by some 7-8% from a planned budget that was already quite tight. The central bank is also sticking to a stringent monetary stance. The switch of the monetary regime in 2015 from exchange rate targeting to controlling the money supply has been instrumental in imposing the tighter stance pursued by the central bank. Respectively, the banking sector passed the credit squeeze onto firms and households.

Remarkably, there was also a visible policy-imposed wage restraint in the first months of 2016: average real monthly wages in January-April were 13.5% lower than in the same period of 2015. Respectively, average real incomes in the first quarter 2016 were 6.8% lower than a year before. On the negative side, the curbing of real incomes has hurt private consumption, with negative implications for growth. At the same time, suppressed consumer demand reduced the inflationary pressure and contributed to the lowering of inflation: in April, the annualised rate of CPI ran at around 12%, continuing the disinflationary tendency of 2015 and considerably below the rates of inflation seen in previous years. Suppressed consumer demand and a tight fiscal and monetary policy stance were probably the factors that prevented a full pass-through effect of the large exchange rate depreciation of 2015 onto consumer prices which had always been the case in previous devaluation episodes. In turn, the resulting real exchange rate depreciation as well as the downward adjustment in real wages should have contributed to an improvement in Belarus's international competitiveness.

Reflecting these changes, there has been a trend improvement in both trade and current account balances. This was a necessary adjustment given the balance of payments constraints that the country is facing. After long and difficult negotiations, the Eurasian Development Bank approved in March 2016 a USD 2 billion stabilisation credit to Belarus, of which USD 500 million were disbursed in the first tranche. Belarus also secured a total of USD 175 million credits from Russia and China. This funding should enable the country to meet its foreign debt payments in 2016. The negotiations with the IMF for a new standby agreement continue but their outcome is still unclear.

Full recovery is still not in sight in Belarus. However, if recent trends continue and the government sticks to the adjustment policy mix supporting improved competitiveness, the economy will probably be bottoming out in 2017 and may take a course towards a gradual recovery thereafter.

BOSNIA AND HERZEGOVINA: Time to get constructive

BY VLADIMIR GLIGOROV

After submitting the application for EU membership, the political situation has calmed down though there has been no change in the fundamentals of the country. However, in the Serbian Republic, which is one of the entities, i.e. something like federal units, political stability has not been secured with the opposition staging protests alleging corruption and misuse of power. In parallel, there have been some constructive political approaches to common problems from Serbian opposition parties, but also others. The country submitted its application for membership in the EU and expressed readiness to reform.

A problem has interfered, however, as was probably to be expected. The results of the census suggest that there is a 51% share of Bosniaks. Those allegedly include a couple of hundreds of thousands citizens with permanent residence abroad. If those are taken out, there will be a plurality, but not majority of Bosniaks. The conflict over whether or not these people should be included in the census figures has threatened to bring all the Serbian parties together in opposition to everybody else (which is to say Croats as well). There is no political significance to this number, but it has apparently symbolic importance as if the ethnic majority in a country actually owns that country. That is how precarious the equilibrium in Bosnia and Herzegovina indeed is.

It would have been clearly better if the issue had not been raised – because it immediately provokes the question, why are these people abroad? And then the whole history of this unhappy country gets to be considered in the public and in the political fora. There are human rights issues involved and all the wrongs that have not been righted, in a political and legal set-up in which justice cannot be had, which is to say only frustrations can be fuelled. So, now is the time to get constructive, but it is hard to see that actually happening. This will not, however, change the main dynamic. Slow political change is clearly what is going on in Bosnia and Herzegovina. A speed-up in EU negotiations would be helpful, as would be improved economic prospects. In terms of growth the country is doing better than its two bigger neighbours Serbia and Croatia. Growth of GDP is around 3% this year and is going to stay there in the medium term. The risks are on the upside primarily because of the improved prospects for the neighbouring countries and in the region. Exports are performing well and investments too. In terms of macroeconomic balances, due to the currency board and close supervision by the IMF, who is as ever watching the fiscal deficits and the development of the public debt, the country is stable. There is slow decline in the unemployment rate, but it remains among the highest anywhere. In the end, industrial production should prove to be where the comparative advantage is and it has been growing, though more in the energy and extraction sectors rather than in manufacturing. In addition, significant infrastructure investments are needed to connect the country to itself, let alone to the region and Europe.

So, in the medium term a growth rate of around 3% or slightly above that number is a realistic forecast with investments and exports as driving forces. Inflation is stable and macroeconomic balances are not challenging, except for the unbalanced labour market.

BULGARIA: Private consumption buoys growth

BY RUMEN DOBRINSKY

Bulgaria's output performance continued defying expectations with GDP growing by some 3% year on year in the first quarter of 2016. However, while GDP growth in 2015 was predominantly export driven, it was private consumption that provided the most significant growth impetus in the first months of the current year. By contrast, the pace of exports lost much of its steam and in current euro terms export growth even went into negative territory in the beginning of 2016.

Private consumption has been growing steadily since the beginning of 2015, supported by rising real incomes and improving consumer confidence. The main factors behind this have been the significant improvements in the situation in the labour market with employment growing for a fourth consecutive year and a concomitant decline in the rate of unemployment. Net job creation between March 2015 and March 2016 amounted to some 50 thousand employees, an increase of 1.7%, with the private sector accounting for all new jobs.

There are already signs of labour shortages in some sectors, especially as regards skilled workers. Accordingly, average real wages continued their robust upturn, mostly pushed up by the upward pressure in the higher segments of the spectrum – the well-paid skilled workers, who also have increased their share in total employment. Overall, average nominal household income in the first quarter of 2016 was 4.2% higher than a year earlier which, given the negative inflation figures, amounts to a 5.3% rise in average real incomes.

The first months of 2016 also marked a noteworthy milestone in the evolution of Bulgaria's labour market performance: average monthly wages in the private sector in the first quarter surpassed those in the public sector for the first time since such statistics have been published (1997). The sustained pay rise for skilled workers (mostly employed in the private sector in growing businesses such as IT services but also in some manufacturing sectors) in recent years has been the main driver of this development.

On the supply side, the upturn in manufacturing also continued and the annualised rate of growth of total manufacturing output reached close to 5% in April. Recent business surveys suggest a significant improvement in economic sentiment in the manufacturing sector.

The continuing economic upturn contributed to a significant improvement in public finances: In January-April 2016, the total revenue of the consolidated general government was 7.4% higher than a year earlier and tax revenue alone was 10.4% above that recorded in the same period of 2015.

On the negative side, as already mentioned, export growth in the first months of 2016 was somewhat disappointing but this may also reflect a statistical effect due to the exceptionally robust performance in the same period of 2015. Gross fixed capital formation was also lacklustre at the beginning of the year mirroring weak performance of construction activity.

Most indications are that modest demand-driven GDP growth will continue in Bulgaria in the second half of the year and probably in the next two years at a rate around 3% per annum. Private consumption, supported by rising real incomes, will probably continue to be the main growth driver. Export performance remains a downside risk, and if the negative trends deepen it may become a drag on economic growth.

CROATIA: Economic recovery amid political mess

BY HERMINE VIDOVIC

The economic recovery that had started in 2015, after six years of recession, gained momentum during the first quarter of 2016. Domestic demand, both household consumption and rising investments, were the main drivers behind the 2.7% rise in GDP; foreign demand contributed negatively to this expansion. Gross fixed capital formation continued its growth path starting from the second quarter of 2015 and translated, among other things, into an increase in construction activities – which had declined for the past seven years. Industrial production expanded by 7.1% during the first four months of the year. The economic recovery also led to an improvement in the labour market: according to Pension Insurance data, employment increased by 1.7% during the first quarter of the year and the registered unemployment rate fell to 15.9% at the end of April. Both real gross and net wages increased, by 4% and 3.4% respectively, in the first quarter of 2016.

During the first three months of 2016 trade in goods performed less dynamically than a year earlier: according to customs statistics, goods exports and imports rose at almost the same rate: 4.5% and 4.7% in euro terms, respectively. Thus, the trade deficit has slightly increased against the same period a year earlier. Taking into account the deficit in the trade of goods and assuming no significant changes in the services trade surplus, the current account deficit has probably remained in the same magnitude as in the first quarter of 2015, at about EUR 1.5 billion.

The general government budget closed with a deficit of 3.2% of GDP in 2015, well below the 2015 Convergence Programme target (5%). The diminished deficit was mainly a consequence of shrinking public investment as well as cuts in subsidies and in the public wage bill, while budget revenues grew significantly, particularly those from indirect taxes. As a result of fiscal consolidation, in 2015 the primary budget balance had turned positive for the first time in more than a decade. The 2016 Convergence Programme submitted by the Croatian government in April envisages the reduction of the general government deficit to 2.6% and 2% of GDP by 2016 and 2017, respectively. Given the political crisis in the country, the implementation of the programme is highly uncertain.

After several weeks of controversial political debates, in mid-June the Croatian parliament dismissed the technocrat Prime Minister Tihomir Orešković in a notion of no confidence backed by the Social Democrats (opposition) and the national conservative HDZ, which had helped install him in January 2016. As this action marked also the end of the coalition government between HDZ and its junior partner MOST, the Croatian deputies decided on the dissolution of the parliament, to become effective on 15 July. New elections are expected to take place in early September, but may not solve the political stalemate since neither HDZ nor the biggest opposition party, the Social Democrats, are likely to win an absolute majority.

Driven by domestic demand, GDP is expected to grow at a slightly higher rate (2%) than initially expected by wiiw – a new trend which will continue during the whole forecasting period up to 2018. The expected boost in investments will be fuelled by transfers from the EU budget, while household consumption should benefit from a gradual improvement in the labour market. The current account will remain in surplus, but is expected to decline along with the economic upswing. A downside risk to the forecast is, apart from servicing the high public debt (87% of GDP), the continuation of political instability which will prevent the implementation of necessary reforms but will also negatively affect Croatia's creditworthiness.

CZECH REPUBLIC: Performance better than expected

BY LEON PODKAMINER

After an extraordinarily strong performance in 2015, growth slowed down in the first quarter of 2016 – though not as much as could have been expected. The real GDP growth rate (adjusted for seasonal and working-time effects) reached 3% vs. the same period of 2015. Consumption (both private and public) rose by 3.1% and 2.9% respectively – rather strongly by Czech standards. Rising private consumption contributed 1.5 percentage points (pp) to overall GDP growth in the first quarter. As elsewhere in the region, gross fixed capital formation (GFCF) performed weakly, essentially due to the finalisation of infrastructural investment projects co-financed under the EU financial perspective for 2007-2013. However, there was no decline in the volume of GFCF which managed to edge up slightly (by 0.6%). That result is attributed to the relatively strong investment into residential and industrial facilities (including into the stock of vehicles). Also inventory investment increased, though moderately. Rising inventories contributed about 0.2 pp to the overall GDP growth rate (while GFCF another 0.1 pp).

In real terms exports and imports of goods and non-factor services rose by 6% and 5.6%, respectively. Thus, external trade contributed about 0.5 pp to the overall growth. (In nominal CZK terms the rates of growth of exports and imports are less impressive because of the ongoing strengthening of the Czech currency.) In nominal terms the trade surplus increased by close to 20% during the first quarter of 2016. Currently the trade surplus represents 7.8% of GDP.

Given the large trade and respectable current account surpluses, it is quite natural that the Czech currency has been subject to a nominal appreciation tendency. For several years the Czech National Bank has been keeping the appreciation pressures in check by resolutely intervening, when the need arose, in the foreign exchange market. The policy of keeping the CZK/EUR exchange rate above the level of 27 through unsterilised interventions was easy to conduct as long as inflation was not a threat and it was possible to keep the policy interest rates low (technically at zero). At present inflation is still very low but the likelihood of inflation exceeding the official 2% target in the second half of 2017 is now considered quite substantial. The return to 'normal' inflation targeting with the policy interest rates used for controlling inflation may be incompatible, in the longer run, with the attempts to control the level of the exchange rate, as claimed by the proponents of the 'impossible trinity' thesis. Once the CZK is allowed to appreciate – possibly strongly – the cost-competitiveness of the economy may be gradually eroded. High dependence on exports is also not necessarily a good thing, given the turbulences shaking the global economy. Of course it is still much too early to be definitive about the risks facing the economy. These risks need not materialise anytime soon. The return of meaningful inflation is not quite certain and the eventual phasing out of the policy of controlling the exchange rate could take time. As the Czech labour market has proven to be quite exceptional (with very low unemployment rates coexisting with fairly stable wages) the eventual competitiveness losses due to a strong nominal appreciation might perhaps be partly neutralised through wage moderation. Besides, it remains to be seen whether the strong external performance of the economy is a matter of mere cost-competitiveness.

Moderate growth in employment and wages in 2016 (and beyond), underlying moderate growth in private consumption, will be the main driver of GDP growth. Gradually growth is likely to accelerate from 2.4% in 2016 to 2.6% in 2017-18 as infrastructural investment co-financed by the EU under the new financial perspective will be gaining momentum. Private investment is also likely to accelerate somewhat as the levels of utilisation of productive capacities are comparatively high and the financial standing of firms and banks is solid. All in all, the country's prospects are looking good, though this may change if the authorities decide to undertake another unneeded – and harmful – fiscal consolidation.

ESTONIA: Stagnant investment and external demand keep growth subdued

BY SEBASTIAN LEITNER

Estonian goods exports continued to decline in the first quarter of 2016, year on year. However, particularly goods and services exports to Russia are stabilising after having dropped by more than a third in 2015. Low oil prices render the production of shale oil – an important export product of Estonia – to be inefficient. As a result, mostly shale oil based electricity production is gradually declining due to higher electricity imports from Finland. Furthermore, the electronics sector suffers from ailing demand from its main Swedish business customers. Overall, we expect exports to recover slightly this year, although imports will grow even more strongly, dragging down overall GDP growth.

On account of the overall rather sluggish growth in external demand and industrial production, investment activity of the enterprise sector will remain mostly unchanged in 2016 after having declined in the past two years – there is still idle capacity in the manufacturing sector. Also, construction output started to grow only in the first quarter of 2016. The data on building permits and mortgage loan growth suggest that dwelling construction will rise only slightly in 2016. Public investments will gain momentum most probably only in 2017, when EU funds will again become available. The budget for 2016 does not foresee countercyclical fiscal measures.

The revival of economic growth in the years after the bust in 2008/2009 brought about a continuous decline of the unemployment rate, to 6.2% in 2015. This improvement of the labour market situation came to a halt in the first months of 2016. Apart from weak labour demand due to sluggish economic growth in this and the coming year, labour supply will increase temporarily due to the introduction of the ‘work capacity reform’ measures. The government intends to reduce the number of persons receiving work incapacity pensions by the introduction of activation measures and stricter eligibility criteria. Thus, the number of unemployed is expected to remain stagnant this year and the next and job growth will be only slightly positive in 2017, given the rather limited upswing in economic growth.

Strongly increasing real net wages further pushed consumption activity of Estonian households upwards, increasing it by 5.5% year on year in the first quarter of 2016. Forward-looking consumer confidence indicators remained stable towards the beginning of 2016 and most recent retail trade and credit statistics show an increasing propensity for spending. Thus we expect growth of household consumption to remain lively in 2016 and also thereafter. Monthly wages will keep on growing strongly, not least due to another planned increase in the minimum wage by 10% at the beginning of 2017, following a hike of the same magnitude at the beginning of 2016. Nevertheless the ratio of the minimum wage to the national average wage is still one of the lowest in the European Union.

The decline of import prices of oil, gas and electricity will come to a halt this year; overall consumer prices will nevertheless remain stagnant in 2016. Only in 2017 consumer prices will rise again more swiftly, driven inter alia by hikes in excise taxes.

Overall, we have made a slight downward revision of our forecast for GDP growth in 2016, to 2% in real terms, particularly due to lower expectations for external demand from Finland and Sweden and ailing private investment. For 2017 and 2018 we forecast a meagre upswing to 2.3% and 2.4%, respectively. We expect a recovery of external demand mostly from Western trade partners, while the decline in exports to Russia should come to a halt. An upswing in investments will be facilitated from 2017 onwards by public outlays co-financed by increasing inflows of EU funds.

HUNGARY: Investments implode, growth backed by household consumption

BY SÁNDOR RICHTER

Hungary's 2016 first-quarter GDP data show an increase of 0.9% (year on year). This is a cold shower after the formidable annual growth in 2015, and the 3.2% growth in the previous quarter. What we see here is the combined adverse effect of outgoing EU cohesion policy-related investment, a setback of the performance in the automotive cluster and a generally unfavourable climate for business investment in the country for several years in a row.

On the output side of the first-quarter GDP, the extreme decline in construction (-28%) is explained by the closure of large EU co-financed projects. However, the 0.7% drop in industry was not anticipated as this sector is much less exposed to EU support than construction. Here the explanation comes primarily from the most probably temporary weakening of the automotive cluster, which provides close to one third of the industrial output. Value added decreased in five other sub-branches of manufacturing as well. It was alone the services sector which contributed to GDP in a positive way in the first quarter: here value added expanded by 3%, primarily in retail trade, tourism and catering.

The 7.8% drop in investment is partially explained by the low tide of EU co-financed projects originating in the predictable cyclicality of the seven-year financial framework of the EU. The really unpleasant news is not that the largely EU-dependent public investment declined by 40% in the first quarter, but that about half of the overall investment decline is caused by the dip in the much less EU-dependent business sector investment. An international comparison of the business sector's net investment rates (gross investment net of amortisation, relative to the GDP) indicates a substantial setback of Hungary in comparison to regional peers. According to *Portfolio.hu* this rate was 1% in 2015, much less than in Romania (2.7%), the Czech Republic (4.2%) and Poland (6.6%). The other unpleasant news from the first-quarter data comes from foreign trade: export growth decelerated to 5.7%, coupled with a 7.8% increase in imports in real terms. Net exports diminished the GDP in the first quarter. Consumption came to the rescue: consumption expenditures of households expanded by 4.8% in the first quarter, and overall final consumption by 3.9%.

The mass migration of Hungarian workers to Western Europe has led to shortages of labour in a growing number of sectors of the economy, exerting an upward pressure on wages. In the first quarter net nominal wages increased by 7% in the business sector. On the one hand, this deteriorates wage competitiveness, but on the other hand, it contributes to further dynamic growth of consumption, which currently figures as the strongest driver of economic growth. Consumption growth is also supported by a 1 pp reduction of the statutory personal income tax rate to 15%.

The government announced that it will make efforts to disburse all EU cohesion policy-related payments of the 2014-2020 financial framework by early 2019. To accelerate the process it plans to pay 50% advance payments for private recipients and 100% for government bodies from the national budget. As of early June 2016, the results are not promising in this respect, as only a small proportion of the grants earmarked for this year has been disbursed as yet. The preferential credit line for residential housing construction, another government initiative to foster domestic demand, is a success: disbursed loans for households are increasing dynamically. However, deleveraging continues as more matured loans are paid back than new loans raised. The same applies for the business sector. The government's 2.5% and the central bank's 2.8% growth targets seem unattainable in 2016. Nevertheless, the likely improvement in industrial and related export performance over the year plus some of the growth stimulating efforts of the government may show effect in the rest of the year, lifting the annual GDP growth to 2%.

KAZAKHSTAN: Economy further loses strength

BY OLGA PINDYUK

In the first quarter of 2016, the Kazakh economy contracted for the first time since 2009 – by 0.2% year on year according to preliminary data. Both industry and services contributed to the decline of GDP. In industry, value added declined primarily due to the poor performance of the mining sector caused by weaker demand from China and other trading partners; at the same time, manufacturing registered a 0.3% increase in value added in annual terms. Retail and wholesale trade, and information and communication services dragged down the performance of the services sector – an indication of weakening domestic demand.

Households have been hit hard by the sharp depreciation of the tenge in 2015 as prices of consumption goods have increased significantly (in May 2016, CPI reached 16.7% year on year). In addition, around 14% of total loans to individuals are denominated in foreign currencies, which means an increased burden of servicing loans for the involved households. The share of non-performing loans in portfolios of physical persons increased by 1 percentage point to 14.1% in April 2016 as compared with April 2015.

The high inflation has contributed to the decrease of real wages by 2.7% year on year in the first quarter of 2016. Partly, this trend can be also explained by an increasing occurrence of part-time work and mandatory leaves. In addition, households have more limited access to loans to finance their consumption – in January-April 2016, the value of newly issued loans to individuals decreased by 17.7% year on year.

The exchange rate of the tenge has stabilised recently at around 335 KZT/USD. Provided global oil prices will remain on a slow upward trend, there should be no further depreciation in the near future. After accommodating the effects of last year’s depreciation in 2016 (when CPI is forecasted to average 13% p.a.), inflation is expected to remain in the target range of the 6-8% corridor in 2017-2018.

At its 6 June meeting, the National Bank of Kazakhstan decided to leave its policy rate (one-day repo rate) unchanged at 15%, in an attempt to counteract the risks to financial and price stability. This, however, will continue to constrain domestic borrowing – in April 2016, the average interest rate on newly issued loans stood at 19% for individuals, and at 14.7% for corporate clients. In 2016-2017, as macro-financial risks are expected to subside, the policy rate is likely to decrease noticeably.

Preliminary balance of payments data for the first quarter of 2016 show that both merchandise exports and imports continued their slump: they fell by 31% and 28% year on year in US dollar terms respectively. We forecast that by the year-end merchandise exports and imports dynamics will remain negative, and exports will fall to less than 50% of their 2013 level. The current account balance will be negative as well, at about 3% of GDP. In 2017-2018, as exports slowly recover the current account deficit will decrease to about 1.5% of GDP.

wiiw forecasts that household consumption will decrease in 2016 (by 1% year on year) for the first time since 1998. Sluggish external demand will be a constraint on industry growth, which will remain in the negative territory this year. However, as global oil prices have picked up recently and are expected to remain somewhat higher than previously assumed, the Kazakh economy should be able to slightly improve its performance in the second half of the year and grow by 0.4% in the full year of 2016. In 2017-2018, with the expected gradual improvement of the external conditions, the Kazakh economy is forecasted to pick up steam and grow by 2% and 3% respectively.

KOSOVO: SAA in force since April

BY MARIO HOLZNER

The Stabilisation and Association Agreement (SAA) between the European Union and Kosovo entered into force on 1 April 2016. The SAA aims at fostering free trade between the EU and Kosovo, applying EU standards in various areas such as competition policy, state aid and intellectual property rights. It also includes cooperation in a wide variety of sectors ranging from education and employment to energy, the environment, and justice and home affairs. The reforms to be introduced are supported by the EU with pre-accession assistance, of which EUR 645.5 million is allocated to Kosovo for the period 2014-2020 (this is equivalent to about 10% of Kosovo's 2016 GDP, or annually 1.4% of GDP). It is expected that the agreement will be a game-changer concerning trade and investment opportunities for Western companies.

The future of another important investment project in Kosovo is less clear. Though government officials have claimed that French investors in the Brezovica ski resort have met a deadline to submit the documentation required for the development of the EUR 410 million project, at the time of writing it is not known whether the essential proof that the consortium has EUR 164 million to finance the first stage of the project was submitted as well and the project will go ahead. The realisation of the project would be of high importance for the economy of Kosovo, which is in great need of foreign direct investments and technology transfer. In the first quarter of 2016 FDI inflows were 13% below the relatively high level of the respective period of 2015.

Kosovo's most important source of foreign exchange, the remittances sent by migrant workers especially from Germany and Switzerland, in the first quarter of 2016 have almost reached the level of the same period a year earlier. Although remittances are to a certain extent demand-driven, it is promising that the German labour market is expected to develop favourably and wages will increase also in the years to come. Positive GDP growth forecasts for both Germany and Switzerland could facilitate these developments. Hence Kosovo household final consumption can be expected to further expand in 2016. This expectation is also confirmed by data on new loans. In the first four months of 2016, new consumer and mortgage loans soared by almost 17% as compared to the same period of last year, while interest rates declined further, by close to one percentage point, to levels of around 6% to 8% and the non-performing loans ratio dropped to below 6%.

Although public sector revenues increased more than expenditures in the first quarter of 2016 as compared to the same period a year earlier (and thus caused an overall dampening net fiscal effect), government outlays provided for some stimulus to the economy. Public wages and salaries as well as subsidies and transfers increased by some 7%, expenditures for goods and services by almost 21% and, most importantly, government investments by a remarkable 60%. Especially roads construction experienced a revival, lending an important impulse to the whole economy.

Following a 20% decline in metals prices in the first quarter of this year compared to the previous year, Kosovo's nominal exports dropped by more than 8% in the first four months of 2016 as base metals account for a significant share of total exports. At the same time, total imports increased by more than 12%, reflecting growth of domestic demand. Given that these trends in foreign trade are likely to persist throughout the whole year, albeit probably in weaker form, and given a likely dampening effect on growth from the fiscal side, we expect somewhat slower GDP growth of 3.3% in 2016 as compared to the surprisingly successful year 2015 with an estimated 4.0% GDP growth, largely driven by investment and construction. In the medium term, if metals prices rebound significantly, as can already be observed in recent months, if the Brezovica ski resort project is realised and the potential benefits of the SAA with the EU are exploited, a GDP trend growth rate of around 4% can be expected for both 2017 and 2018.

LATVIA: Growth acceleration delayed

BY SEBASTIAN LEITNER

The negative development of Latvia's trade balance has been caused by the ongoing recession in Russia. Although this impact is diminishing – in the first quarter of 2016 exports to the eastern neighbour declined by 17% in nominal terms compared to 25% in the year 2015 – a revival of trade with Russia cannot be expected before 2017. Also the Baltic neighbours Estonia and Lithuania are both performing below potential, causing Latvia's exports to these two most important trading partners to fall. However, trade with almost all other EU Member States and with the rest of the world has expanded, although not too lively. Exports of fish and products thereof are still ailing due to the Russian embargo and those of mineral products due to low oil price. Good news comes from the wood sector reporting strong export growth figures. In general, we have to revise our forecast for external demand in 2016 downwards, while a stronger revival will take place only in 2017.

As expected, the production of Liepajas Metalurgs, the only steel mill in the Baltic States (owned by the Ukrainian KVV group), is again standing idle. Over the past months its staff was reduced by about two thirds. The government refrained from subsidising the heavily indebted company, which has problems to pay the wages of employees and the gas and electricity bills. The Latvian authorities seem to be interested in letting the company go into insolvency which would allow for finding new investors for the ailing enterprise.

Given the modest expansion of industrial production, capacity utilisation has remained almost stagnant. Thus we do not expect private fixed capital investments to expand this year. Construction output was down by almost 20% year on year in the first quarter of 2016 and negative prospects in the sector are aggravated by declining numbers of building permits also for residential buildings. Private non-residential construction is likely to increase slightly this year; however, public investment in infrastructure will remain low in 2016 and only revive next year, when fresh EU funds will become available. Overall, we expect total gross fixed investment to remain almost stagnant in 2016 and to grow at a rate of 4% in 2017.

The recent significant decrease of oil prices should keep consumer prices almost stagnant also in 2016. Strong wage growth has pushed up core inflation. However, only in 2017 and thereafter rising prices in the service sector and an upswing in import prices will result in consumer inflation rising to about 2%.

The declining activity in the transport sector and partly also in construction will result in lower employment there, while particularly business and recreational services sectors will provide for job creation. However, demographic developments – including continuing net emigration – result in a further decline in the working-age population; thus growth in employment is likely to decrease as well. Towards the end of 2015 the unemployment rate became one-digit for the first time since the outbreak of the global financial crisis in 2008. However, for this year we expect it to remain almost unchanged and in the years to come to decline more gradually. Gross and net wages will keep on growing by more than 5% in 2016. Thus, the increase in consumption of households, still benefiting from low inflation, will be even higher than last year. Hence domestic demand will keep the Latvian economy developing at a good pace. Lower than expected government revenues will result in a higher than envisaged budget deficit amounting to about 1.5% of GDP this year. In the medium term, the government reckons with lower refinancing costs as Prime Minister Kucinskis signed an accession agreement with the OECD in June 2016, allowing Latvia to become the 35th member of the organisation.

Due to the lower than earlier assumed expansion of external demand and investment, we had to revise our GDP forecast for 2016 down to 2.5%. However, with regard to the expected speed-up in demand in the EU and a rise in domestic investment activity driven by the inflow of EU funds, we reduced the GDP growth forecast for 2017 and 2018 only slightly, to 3.0% and 3.3%, respectively.

LITHUANIA: Export-supported growth revival

BY SIMONA JOKUBAUSKAITĖ

After a year of slow growth, exports increased by 8.8% in the first quarter of 2016. Due to strong wage growth, final household consumption rose by 5.6%. Public investment plummeted by 20%, pulling down gross fixed capital formation to -6.8%. Taking into account this development, GDP is expected to grow by 2.8% this year and about 3% in 2017-2018. The downward revision of the GDP growth forecast reflects above all the lagging absorption of EU funds.

Despite decreasing exports to the main trading partner Russia, total exports of goods grew by 1.4% in nominal terms and 8.2% in real terms, as the falling oil price influences the export deflator greatly. Trade ties with the US and the Nordic region are getting stronger. Mostly mineral fuels, chemical products, furniture and electric machinery are exported to these countries. At the same time, less mineral fuels are imported from Russia. In January 2016 an agreement between Litgas and Statoil was signed according to which half of the required gas will be imported from Norway in the form of LNG at a cost similar to that of gas imported through the pipeline from Russia. In addition, Litgas is now allowed to re-export gas directly. This could bring a new dynamics into the regional gas market. Despite the encouraging export development, the forecast for the current account remains negative, as income repatriation is high.

Although gross fixed capital formation (GFCF) fell in the first quarter of the year, for the first time since 2012, investment is expected to recover in the following quarters, as capacity utilisation and demand are high. EU co-funded projects worth of EUR 0.9 billion started at the beginning of the year. Beyond transfers from the EU structural funds, also financing through the European Investment Bank (EIB) should reach Lithuania in the forthcoming years. So far two big infrastructural projects are planned. The modernisation of Lithuanian airports is estimated at about EUR 75 million, 40% of which should be financed with the EIB loan. Another project is a new cogeneration plant estimated at more than EUR 325 million. Furthermore, Swedbank and OP Corporate Bank will be the redistributors of EIB loans in the Baltic region and will lend EUR 165 million during the period 2016-2018 to small and medium-sized enterprises. GFCF is expected to grow by 1% in 2016 and 6-7% in the upcoming two years.

Although deflation was recorded in 2015, black clouds of Lithuanians' dissatisfaction with food prices started to gather in the social media. At the beginning of the year any remaining patience was finally exhausted by the price of cauliflower (3.5 EUR per head) and a three-day boycott of supermarkets followed. At first glance, supermarkets in Lithuania do not have monopolistic power, but the difference in market shares of the largest supermarket chain (40%) and the second largest (16%) is worrying. It restricts competition and feeds suspicion about possible unwritten agreements between retailers and producers. According to official statistics, food prices have finally pulled away from the bottom and grew by 2.1% in April. Higher energy prices combined with rising prices of services, caused by the robust wage growth, should result in about 0.7% consumer price inflation this year.

With parliamentary elections approaching, the Lithuanian political scene is in turmoil. The recent game changer was the bribery allegation against the leader of the 'Liberal Movement' party and his resignation. Another bolt from the blue struck when the interim leader resigned from the party, having before expressed his wish to test all party members with a lie detector and to vote for the conservative party in the upcoming elections. The ratings of the 'Liberal Movement', once the most popular party, are experiencing a free fall. Also, the Social Democrats and their coalition partners are losing their supporters. Only the conservative and 'Peasant and Green' parties seem to enjoy a robust reputation, but it is not clear whether they will get enough seats to form the majority. Even in that case, the change of powers should not lead to any reforms that could significantly change the current economic situation.

MACEDONIA: Political instability affects investments

BY VLADIMIR GLIGOROV

The early elections planned for the end of April and postponed to early June were further postponed indefinitely. The political crisis has now been going on for at least a year and while it is clear how it should end, it is yet not clear when that will happen. The obstacle is the demand of the opposition for a number of measures to be adopted by the Parliament, which will ensure that the elections will be free and fair. The crisis deepened when the President of the Republic extended amnesty to all the politicians that were facing possible criminal investigations. That ignited a new round of protests, which made it impossible for the planned early election to take place. So, as often happens, an intervention of a government which has lost legitimacy to force the outcome tends to backfire. With this move, the resolution of the political crisis and the restoration of legitimacy are all but impossible without a change in government.

The EU has been mediating the negotiations between the ruling and the opposition parties, but it does not have the needed weight to pull the lever. This is mainly because of the stalled process of Macedonia's accession to the EU due to Greece's objection to its name. While initially, it may have been clear what the problem was and what the possible solutions are, now this is all quite unclear. The issue is not just the name of the state but also of the people living in it, which is why the problem is increasingly hard to solve. In any case, the EU has made very little if any effort to come up with principle and proposals for a resolution of this conflict.

That of course affects the EU's ability to influence the development in Macedonia. The hopeful aspect of the current crisis is that it is not an inter-ethnic but rather a democratic conflict. By its nature, democracy is prone to crisis of legitimacy, which emerges when the government loses the support of the electorate. Legitimacy of a government is often tested by an act that goes against the will of the majority or of a substantial part of the population. In the Macedonian case, it was revealed that there have been attempts to rig the elections and to target the opposition or the critical parts of the civil society, but the decision by the President to extend blanket amnesty turned out to be the straw that broke the camel's back. So, now it is all about the management of the transition in such a way that it will reaffirm the democratic character of the state.

For the most part, the crisis did not have a negative impact on the economy. Indeed, it performed rather better than most other economies in the region. Growth was tending towards 4% in the medium term, and the unemployment rate, for a long time at catastrophic levels, started to go down. Private consumption, public investments, and exports were the driving forces of growth. In the first quarter of this year, however, investments declined by almost 10% and growth slowed down to 2% quarter over quarter. Private consumption continued to expand as did public consumption and exports too. If investment recovers going forward, GDP may expand by 3.4% in 2016 as forecasted. But, the risks are now on the downside given that the political crisis will linger on. The new government may find itself facing problems which are not clearly visible now.

Monetary policy will continue to be supportive, which is the most that can be asked of the quasi currency board regime that is in place. Inflation remains subdued and the policy rate is low by the standards of that exchange rate regime. Fiscal policy has been expansionary, but that is probably ending. The policy of welcoming foreign investments will continue. With all that, the medium-term growth rate should settle somewhere between 3% (more likely) and 4%.

MONTENEGRO: Building a road and democracy

BY VLADIMIR GLIGOROV

The government, or rather the Prime Minister, has withstood an enduring challenge to legitimacy without giving up practically on any of its policy commitments. The ruling party did have to welcome some of the opposition parties into the government and is preparing for general election later this year. The fraction of the opposition, which continues to contest the legitimacy of the government, is staging protests, but the dividing lines are already drawn and the final judgement is going to be made by the voters. However, while a change in government is probable and indeed welcome, the protesters did not succeed in shaking the strategic determination of the public. Montenegro is joining NATO, is continuing to negotiate membership in the EU, and does not doubt its independence. However, democratisation and strengthening of the rule of law are certainly the expected outcomes of this prolonged political crisis.

The problems that need political solutions are two: one is how to manage the transition of power from the long-term leader of the country, Milo Djukanovic, who has been at the centre of the key decisions made in the last thirty years or so, and who is just 54. The other is how to preserve the stability of this small, open, and diverse country. The public seems to have found a way by setting up an alternative party or coalition of parties which does not challenge the key achievements, the central one being independence from Serbia, but also promises greater accountability and responsiveness to economic and social needs. The first step to making that transition should be taken at the upcoming general elections.

The economics of this country is different from all the other countries in the Balkans. This is a small country (around 650 thousand citizens) with a coastal and a mountainous area. Regional disparities, between the coast and the interior, are quite large, in part because they are not all that well connected. In terms of comparative advantages, services of one kind or another, predominantly but not exclusively connected with tourism, are clearly the backbone of the economy. However, investments in e.g. tourism are concentrated on the coast, which makes it imperative that infrastructure is improved in order for the country as a whole to take part in the growing services sector. In addition, the coast provides for an exit to the sea to more continental Balkan economies, e.g. Serbia, but potentially Bosnia and Herzegovina too. So, building roads and railroads from the coast to the interior makes eminent sense. This is what the government has decided to do with the investment in a modern road from the sea to the northern border with Serbia. This project is, however, a significant burden on the budget and the EU and the IMF have voiced concerns whether this debt can be serviced. Public debt is going to increase indeed, while immediate benefits are not realistic. Still, strategically, the infrastructure needs of the country are practically the foundation of its development. In the very long run, the fiscal balances will add up.

Political instability notwithstanding, growth is hovering somewhat above 3%, mostly due to investment and exports of services. This year's revenue from tourism is expected to be a record one in part because there are no signs that Russian tourists are abandoning this country even though the Russian government is quite unhappy with Montenegro's decision to join NATO. Foreign investments are certainly not coming in as much as before, but infrastructure investments are substituting for them. Also, the somewhat improved economic situation in the neighbouring countries is supporting the tourist industry. Inflation is subdued as elsewhere in the region. In the medium run, growth should remain above 3% per year barring political or financial shocks.

POLAND: Unexpectedly weak start into 2016

BY LEON PODKAMINER

GDP growth in the first quarter of 2016 turned out perceptibly weaker than generally expected. Unfavourable foreign trade developments are the main factor responsible for the GDP growth rate falling to 3% – from 3.3% and 3.6% recorded in the first quarters of 2014 and 2015, respectively. In real terms exports of goods and non-factor services rose by 6.9% while imports by 9.3%. The external trade balance remains positive and reassuringly large (close to 2% of GDP). Yet net exports depressed the overall growth in the first quarter of 2016 massively, by 0.9 percentage points.

The weakening foreign trade performance, if sustained, could become the main worry for the future. If the spell of unusually low energy prices comes to an end, the present trade surpluses will be eroding. Besides, it is disquieting to find that the recent unfavourable trends in exports and imports have materialised despite sustained real (and nominal) currency depreciation and falling unit labour costs. This might suggest that the country has reached a stage where the improvements in cost competitiveness have exhausted their potential as a reliable source of balanced longer-term growth. Poland may be entering ‘a middle-income trap’. Getting out of that trap may require the institution of radically new economic and social policies, with priorities given, among other items, to the accumulation of human rather than physical capital. Under the present government led by the Law and Justice Party (in office for about six months), no such radically new policy is to be expected. If anything, the policies imposed (or contemplated) are quite likely to lead the country astray.

For the first time since the third quarter of 2013, gross fixed capital formation (GFCF) declined in the first quarter 2016. The scale of the decline (1.8%) seems rather moderate – yet it must disappoint the widely held expectations of a continuing investment boom over the entire year 2016 (this April the National Bank of Poland foresaw gross fixed capital formation growing over 5% per annum in 2016 and beyond). The arithmetic impact of the decline in GFCF on real GDP growth was minute (-0.2 percentage points). However, it should be noted that in the first quarter of the year there was a very strong increase in inventories (contributing 1.3 percentage points to the GDP growth rate). Even if investment in fixed assets recovers somewhat over the coming quarters, one must have doubts about the sustained expansion of inventories. The contribution of gross capital formation (comprising GFCF and the inventory changes) to GDP growth in the entire year 2016 may fall short of the relatively large (and positive) figures recoded in 2014 and 2015. As elsewhere in the region, the decline in GFCF has been primarily due to the completion of infrastructural projects co-financed by the EU transfers under the 2007-2013 financial perspective. It will take some time before the means available under the new perspective feed the new investment projects. In the meantime the private sector, whose financial standing is very good, may be expected to engage in faster expansion of the productive capacities.

Household consumption rose by 3.2% in the first quarter of 2016, essentially at the speed prevailing throughout 2015, while public consumption growth accelerated. Given the ongoing labour market improvements (rising employment and nominal wages) the reported increase in household consumption does not seem impressive. Household consumption growth may strengthen in the coming months as (eligible) families with children start receiving additional budgetary transfers. However, the scale of the additional disposable incomes accruing to the household sector, though large in absolute terms (estimated at PLN 20 billion in 2016), will not be as impressive in relative terms (falling short of about 1.5% of total household consumption). A private consumption boom need not develop in the coming months (possibly also because the persistent deflationary expectations might result in purchases of ‘bulky’ consumer goods being intentionally deferred).

All in all, an annual GDP growth rate of about 3.3% is expected in 2016-2018.

ROMANIA: Weak production response to consumption boom

BY GÁBOR HUNYA

The economic boom generated by fiscal loosening resulted in 4.3% GDP growth in the first quarter of 2016. Household consumption (up by 9.2% against the first quarter of 2015) has been the main driving force but also investments made a positive contribution to growth with the expansion of gross fixed capital formation by 7%. Domestic demand expansion boosted imports thus net exports' contribution to GDP was becoming increasingly negative.

Hikes in minimum and public sector wages coupled with consumer price deflation caused real earnings to surge by 16% in April, in annual terms. The minimum wage was raised, to RON 1,250 (EUR 280) from last year's RON 1,050 (EUR 235) as of 1 May 2016, benefiting about 1.1 million wage-earners. In addition, a cut in the standard VAT rate from 24% to 20% is effective since the beginning of the year. Together with the even more drastic cut in the VAT rate for foodstuffs introduced in mid-2015 this pushed inflation into the negative (-3.25%, April 2016 over April 2015). The National Bank of Romania (BNR) calculated a 71% pass-through coefficient for the lower VAT rate. BNR officials emphasised however that the underlying inflation remained positive at 2% – in line with inflationary expectations. VAT rate cuts and additional deflationary effects of low energy, food and metal prices have concealed the looming demand-side inflationary pressures. The current deflation is considered to be transitory; therefore the BNR does not intend to lower the policy rate from the current level of 1.75%.

Industrial production has not been stimulated by the consumption boom yet. Manufacturing output was sluggish in the first quarter of the year. But investment outlays in machinery and equipment were up by 16% which may be the forerunner of future production recovery. Business sentiments are upbeat especially concerning domestic sales opportunities. Foreign sales are however sluggish; exports of goods and services were only 1.2% higher in nominal euro terms in the first quarter of 2016 than a year earlier. The widening trade gap coupled with higher earnings of foreign investors is expected to increase the current account deficit in 2016 to 2.5% of GDP.

The current economic boom artificially generated by fiscal stimuli is thought to subside in the second half of 2016. Domestic demand will be less bullish after the one-time effects have phased out. It is expected that imports will grow further on account of higher import prices while exports may not grow faster. With domestic demand being stronger but foreign demand weaker than expected, wiiw sees no reason to make an upward revision of its 4% GDP forecast for 2016. Going against the official Romanian forecast, wiiw expects a marked deceleration of economic growth to 3.2% in 2017. Stronger economic growth would only be possible with more fiscal easing, which in turn would push the central government deficit above the 3% limit imposed by the EU rules. It is expected that the new government to be installed following the general elections in late 2016 will put an end to fiscal expansion.

The local elections held on 5 June confirmed the leading position of the Socialist Party of Romania (PSD) that had given over power to a caretaker government last December. The current government lacks initiatives and administrative skills, and just implements the popular measures planned by its predecessor. Access to EU funds has not improved; it is left to the forthcoming government to improve the efficiency of public services. The forthcoming elections may be won by the PSD as the National Liberal Party (PNL) could not gain in popularity, not the least due the widely perceived weak performance of Klaus Iohannis, the President of Romania, who was earlier a leading figure of PNL.

RUSSIAN FEDERATION: Bottoming out, feeble recovery ahead

BY PETER HAVLIK

The Russian economy is finally bottoming out. The adjustment to the collapse in oil prices and the subsequent devaluation of the rouble, as well as the imposition of Western sanctions and Russian counter-sanctions, has been by and large over by mid-2016. Multiple shocks that hit domestic demand and foreign trade have already been largely absorbed and the economy has stabilised at a new ‘stagnation normal’. Yet in nominal terms, Russian GDP shrank by about EUR 500 billion (nearly one third) between 2013 and 2015.

External shocks and related overall adjustments have been most spectacular in trade with the EU which suffered more than average: Russian imports from the EU fell by nearly 40% between 2013 and 2015. Estimated EU loss in exports to Russia during that period exceeds EUR 40 billion (about 0.3% of EU GDP). Russian trade with Ukraine shrank by more than 60%, even Belarus and Kazakhstan were hit by the Russian crisis. In addition, FDI inflows nearly dried out in the course of 2015 and FDI stocks were drastically reduced – no good sign for modernisation and diversification prospects. The reduction in FDI flows results from recession, Western financial sanctions and the associated worsening of the investment climate; part of the disinvestment can also be attributed to the official ‘de-offshorisation’ campaign launched in 2014 and implemented since the beginning of 2015 (part of the capital outflows can be attributed to debt service payments).

The year 2016 started with another plunge in the oil price and a complementary rouble devaluation. Export revenues dropped by about 30%, imports by 20% in USD terms during January-April 2016. The Russian Central Bank estimates a reduction of the current account surplus to USD 16.3 billion in that period (from USD 37 billion in the corresponding 2015 period); the external debt is being continuously repaid and net capital outflows shrank further. In response to these developments, the Russian government, domestic and foreign think tanks and analysts reacted with another downward revision of economic forecasts. At the same time, external risks (Syria, the conflict with Turkey, ongoing frictions with Ukraine, etc.) which may lead to additional costs in terms of growth, investment and trade have seemingly stabilised. The recent modest rebound of oil prices (to some USD 50 per bbl) may act as a (weak) GDP growth stimulus, too.

With sanctions essentially remaining in place, prospects for modernisation cum restructuring are bleak due to the lack of investment resources and other bottlenecks – even in the medium term. There seems to be a consensus that Russia is facing a prolonged period of stagnation in both economic and societal developments. Turning inwards and continuing with more assertive policies is not helpful. Changing the pivot to China cannot compensate for the trade and investment setback with the EU. The damaged links with most of the near neighbourhood in both west and south (Ukraine and Turkey in particular) will be hard to restore. Moreover, even the recently established Eurasian Economic Union flagship project has been adversely affected by these policies and other ill-considered Russian unilateral steps. Overall, our forecast remains unchanged: we expect a mild recession for 2016 (-0.8%) and a gradual yet rather slow GDP growth acceleration in 2017 and 2018 (about 1-2%). Inflation will return to single digits and unemployment will fall.

SERBIA: Recovery continues, but something is rotten

BY VLADIMIR GLIGOROV

Early elections were held at the end of April. The ruling Progressive Party won the plurality of votes just shy of 50%. However, it was awarded fewer representatives because a number of opposition parties passed the 5% threshold. The government, or rather the Prime Minister, expects to lose support because it needs to restructure the public sector and public administration, but the almost complete control over all levels of government should deliver another term in office in four years' time. This strategy looks a bit ambitious now, primarily because of rising opposition in the capital city. As is often the case, a scandal, in this case the use of brute force to remove some possibly illegal settlements in the city centre that stood in the way of a major building plan, has mobilised the civil society and introduced elements of political instability. The government, which indeed is yet to be formed, will have no problem in stabilising its position, but its popularity can only decline from now until the next elections. So, what looked certain does not look so any more, and indeed the stability and the endurance of the Progressive Party reign are not as certain as they were prior to the early elections. In fact, it all now depends on the economic performance.

Recovery started in the second quarter of last year and while it was tepid in the second half, it was extended through the first quarter of this year. Year on year, GDP grew by 3.5%, but only by 1.6% over the previous quarter. All components of GDP contributed to growth – public consumption by 3.2%, household consumption by 0.7%, but investment by 7.9% and net exports by almost 3%. However, the first quarter of 2015 was quite bad, so growth going forward will moderate due to statistical reasons. Growth should continue to be driven by investment and net exports rather than consumption. There is a continuing debate with the IMF on whether public wages and pensions could see some rise. The disagreement has proved to be a stumbling block to successful conclusions of IMF programmes. Now that political stability has not been conclusively secured with early elections, the government is signalling that it would like to raise public wages and pensions some time later this year. It feels that it needs it to be able to implement increasingly unpopular cuts in public employment and to push the programme of privatisation of the remaining mainly loss-making public enterprises. The new parliament and the government will be less enthusiastic about EU integration. The premise of the government centred on the Progressive Party since 2012 has been that progress towards EU integration should deliver higher foreign investments and improved regional and international stability. The former did not materialise as much as was hoped for, while the latter did indeed help. The Serbian government normalised relations with Kosovo and stopped supporting, however implicitly, the disintegration of Bosnia and Herzegovina. Also, it refrained from interfering in internal conflicts in Montenegro and developed good working relations with Albania. Relations with Croatia appear to have deteriorated, which is always the case when one or the other side is looking for a cheap way to increase its domestic popularity. But generally, regional cooperation has improved and there is more stability. However, all of that is a de facto state of affairs; irrevocable steps are yet to follow.

At the beginning of the term of the new government, which should be in place by the end of June at the latest, it looks as if there is no expectation of additional benefits from closer links with the EU. Increasingly, investments are coming from other directions, e.g. from Russia and China; at least that is what the public looks to. The Prime Minister in particular is increasingly suspicious of US and EU intentions. He is cultivating his relations with Russia, to the point where he travelled to Moscow to consult with Putin on the composition of the new government. Looking forward, recovery should strengthen somewhat and medium-term growth of around 3% is realistic. Inflation will remain subdued at around 2%, while monetary policy will continue to target a stable exchange rate; further cuts in the interest rate, now at 4.25%, are unlikely.

SLOVAKIA: Growth slowdown expected this year

BY DORIS HANZL-WEISS

In the first quarter of 2016, Slovak GDP rose by 3.4% year on year, at a slightly slower pace than in 2015 when growth reached 3.6%, but still higher compared to most other European countries. Growth accelerated during last year with gross fixed capital formation benefiting from the speeding-up of spending from EU structural funds at the end of the drawing period of the 2007-2013 financial framework. While in the first quarter of 2016 the growth rate of gross fixed capital formation was considerably lower than in 2015, it still grew by 1.5%. As inventories were stocked up overall capital formation increased by 9%. Household consumption expanded by 2.5%, less than one would expect given the positive trends in the labour market. Employment increased by almost 3% in the first quarter of 2016 – the highest increase since the outbreak of the global financial crisis of 2008-2009. The unemployment rate fell to 10.4%. Real wages rose by almost 4%, also due to deflation continuing in 2016 (-0.5% in the first quarter). Shortage of qualified labour (especially in the IT sector and industry) has been on the rise. Government consumption saw an increase of 3%. By contrast, trade performance was disappointing in the first quarter, as exports of goods and services grew only marginally (+0.2%), while imports increased slightly more (+0.4%). The contribution of net exports to real GDP growth was thus negative. Goods exports to Slovakia's main export partner Germany were growing slightly whereas deliveries to neighbouring countries (Czech Republic, Austria, Poland, and Hungary) were falling.

Industrial production increased by a mere 2% in the first quarter. The automotive industry, being the largest industrial sector in Slovakia, remained the most important contributor to growth. Construction of the new automotive plant by Jaguar Land Rover should start this year and is expected to draw also additional investment by car parts suppliers. Volkswagen Bratislava is building a new assembly hall for production of the Porsche Cayenne. The construction sector, experiencing a hard time since the crisis and finally recovering in 2015 for the first time, also grew in the first quarter of 2016 by 10%. While civil engineering construction (including e.g. roads) declined by 13% due to the end of the previous drawing period of EU structural funds, construction of buildings expanded by 21%. New large public investment projects include the southern part of the Bratislava ring road, whose construction will take four years and which is planned to start at the end of this year.

The general government budget deficit, having declined each year from 2011, went up again in 2015 and reached almost 3% of GDP (instead of the targeted 2.5%). The public debt to GDP ratio remained at slightly below 53%. At the beginning of 2016, measures initiated by the previous government came into force, including a reduction of the VAT rate for basic foodstuffs from 20% to 10% as well as gas rebates (cash payments), both contributing to consumer price deflation. Parliamentary elections took place on 5 March 2016 and the new four-party coalition government is promising to create new jobs, reduce unemployment and decrease the corporate tax rate by 1 percentage point to 21%. The realisation of a balanced state budget has been postponed by two years to 2020. Slovakia will take over the presidency of the Council of the European Union as of 1 July 2016, for the first time since joining the EU in 2004. In this quality Slovakia plans to focus on issues such as growth, the digital single market and the energy union, and current issues including the consequences of the Brexit referendum and migration.

Overall, our forecast for Slovakia has not changed. For this year, we expect slightly reduced GDP growth of 3% as the previous year's high growth rates of gross fixed capital formation cannot be sustained. Domestic consumption will become the main engine of growth for the years to come, while net exports will remain negative and constrain faster growth. Growth acceleration can be expected with the start of production at the new Jaguar Land Rover plant from 2018/2019 onwards.

SLOVENIA: Exit from excessive deficit procedure

BY HERMINE VIDOVIC

Slovenia's GDP was up 2.5% in the first quarter of 2016, backed by rising inventories and net exports. Household consumption grew only modestly, while gross fixed capital formation contracted sharply after three years of moderate growth. The latter was mainly due to a drop in public investment following the ending of the EU funding period 2007-2013. The decrease in investments was particularly felt in construction, reporting a continued decline (27%) in the first quarter of 2015; conversely, investments in machinery and equipment rose significantly. Industrial production grew by 4.8% in the first three months of the year. The highest growth was reported for manufacturing of computer and optical products, fabricated metal products and wearing apparels. By contrast, car production – one of Slovenia's major industrial branches – reported a strong decline. GDP growth was not sufficient to generate new jobs: based on Labour Force Survey data, the country's workforce fell by 0.4% in the first quarter of 2016, while unemployment decreased to 8.9% (from 9.8% in the respective period of 2015) partly because of rising inactivity. Average real gross wages grew by 0.3%, net wages were 1% higher than in the first three months of 2015.

In external trade, goods exports rose by 2.5% during the first quarter and imports even shrank slightly, resulting in a EUR 200 million higher trade surplus than in the same period of 2015. Also the surplus in services trade was higher than a year earlier due to rising exports – of transport and travel in particular – ahead of imports growth. Overall, the current account closed with a surplus of EUR 703 million, a large improvement (by EUR 260 million). The FDI inflow was, however, less dynamic than in the respective period of 2015.

The 2015 general government deficit amounted to 2.9% of the GDP; deficits in the years to come are planned to be cut further, which might hamper economic growth. Based on the progress achieved, the European Commission recommended for Slovenia to exit the 'excessive deficit procedure' (EDP), which was launched against the country in 2009. Leaving the EDP, Slovenia has changed to the preventive arm of the Stability and Growth Pact. For further budgetary and reform action, the Commission recommended to reform the healthcare system, increase employability of low-skilled and older workers, improve the financing conditions for creditworthy business, modernise public administration and reduce the administrative burden on business.

Household credits grew moderately in the first quarter of 2016, with housing loans expanding above average. The upturn happens against the backdrop of a relatively low level of household indebtedness, affordable real estate prices and low interest rates. By contrast, loans to the corporate sector continued to shrink in the first quarter of 2016, albeit at a slower pace than a year earlier, which is due to the still high debt burden of companies. Non-performing loans continued to decline, to 8.2% of total loans in the first quarter of 2016.

Based on available data for the first months of the year, wiiw sticks to its earlier GDP growth forecast of +2% for 2016. In 2017 and 2018, GDP growth is likely to accelerate to 2.3% and 2.8%, respectively. The main growth driver will be domestic demand, i.e. expansion of investments fuelled by EU transfers under the new financial perspective and rising private consumption. The latter should be spurred by a gradual improvement in the labour market and rising wages. High current account surpluses are expected to decline once domestic demand strengthens and company deleveraging comes to an end.

TURKEY: Consumption-based growth

BY SERKAN ÇİÇEK

The political tensions in the Kurdish-majority region in Turkey and along the southern border of the country have given rise to both social and political uncertainties. Relations with Russia continue to be unstable since the downing of a Russian warplane by the Turkish Air Force at the end of 2015. Additionally, Binalim Yildirim, a strong supporter of President Erdogan, was appointed as the new Prime Minister of Turkey on 22 May 2016 following Ahmet Davutoglu's resignation. Since Mr Davutoglu was the main supporter of the migrant deal between Turkey and the EU, his resignation threatens to ruin the agreement. Ankara has yet threatened to scrap the migrant deal with the EU altogether unless visa-free travel for Turkish citizens to the EU is forthcoming. Since final decisions are de facto made by President Recep Tayyip Erdogan, it is not clear whether Turkey will be able to restore stability in its internal and external relations, which compounds the uncertainties affecting the Turkish economy.

Despite these unfavourable developments, Turkey's GDP grew by an unexpectedly strong 4.8% in the first quarter of 2016 year on year thanks to a strong rise in domestic demand. Household final consumption rose by 6.9% in this period, the fastest pace recorded in the last 18 quarters. This was due to a strong rise in hourly wages in real terms following a 30% hike in the minimum wage at the beginning of 2016. During the same period, the real growth rate of government spending was 10.9%, the almost strongest expansion in the last five years. Current transfers (especially in health, pension and social benefit expenditures), purchases of goods and services and compensation of employees rose by 29.9%, 25.8% and 19.6% in nominal terms, respectively. Related to increasing private and public consumption, net exports made a negative contribution to GDP growth in the first quarter of 2016 due to a sharp rise in import growth, 7.5% in real terms in the same period, while exports expanded by 2.4% year on year in real terms despite the decelerating global demand. The overall growth performance was 4.0% in 2015 and should further improve in 2016 (4.1%) on account of the rise in real wages and ongoing higher government spending in addition to increasing foreign demand. A slight rise in oil prices may hinder the growth of net external demand for this period. As for 2017 and 2018, we expect GDP to grow by 3.7% and 3.5%, respectively, owing to weakening but positive domestic demand and the slowdown in gross fixed capital formation since 2012.

In 2015, the CPI inflation rate was 8.8% (end of the year), well above the targeted 5%. In the first five months of 2016, year-on-year inflation dropped however to 6.6% thanks to sharp declines in food prices. The main reason behind this decline has been the ban on food imports from Turkey to Russia because of the political tensions between the two countries. With global oil prices rising slightly, strong domestic demand, the ongoing pass-through from the depreciating exchange rate and the search for new export markets for food products, the wiiw forecast for consumer price inflation in 2016 is 7.8% and decreasing for the following years.

In mid-April 2016, a new governor was appointed to the Central Bank of the Republic of Turkey (CBRT). Following his appointment, the CBRT has cut its upper bound interest rate twice amid a fierce debate about government pressure on the central bank. Previously, we expected the CBRT to keep the policy rate at the current level at 7.50% until inflation pressures subside but now we forecast that it will decrease to 7.0% in the coming months.

The current account deficit has been decreasing since the beginning of 2014. The trade deficit has been declining as well, but the pace of decline has been slowing down recently. Given the slowdown and the current upward trend in global oil prices, we forecast that the current account deficit as a share of GDP will rise from 4.7% to 5% between 2016 and 2018.

UKRAINE: Muddling through

BY VASILY ASTROV

Data for the first quarter 2016 may give the impression that the Ukrainian economy has finally bottomed out: year on year, real GDP was nearly flat (+0.1%). However, against the fourth quarter 2015, it dropped by 0.7% in seasonally-adjusted terms. One reason for this drop was the erection of new import barriers in Russia: in response to Ukraine implementing the Deep and Comprehensive Free Trade Area (DCFTA) with the EU on 1 January 2016, Russia revoked the existing free trade agreement with Ukraine, imposed an import embargo on Ukrainian food, and hampered the transit of Ukrainian goods to the Central Asian countries.[1] As a result, merchandise exports to Russia dropped by another nearly 40% in January-April (in US dollar terms). Exports to most other destinations declined as well (albeit not as strongly), largely because of the depressed global prices for metals and iron ore. Finally, exports to the EU were nearly unchanged, indicating that Ukrainian producers cannot take full advantage of the free access to EU markets because of the existing gap in standards and EU tariff quotas for a number of agricultural products. As a result, total goods exports shrank by 15% in January-April – more than imports (-10.5%, mostly on account of sharply reduced gas purchases). However, in real terms the export decline (of goods and services) in the first quarter 2016 was less pronounced than that of imports, hence the contribution of net exports to GDP growth turned once again positive.

Among domestic demand components, only investments posted a solid growth in the first quarter: gross fixed capital formation picked up by 4.2% year on year. However, this result is to be seen against the background of the very low basis: over the past three years, it had plunged by an enormous 38%. In the current crisis environment, investments are almost exclusively financed from enterprises' own funds, while the role of bank credits and investment from the budget has become marginal. Private consumption was still in decline (-2.2%), although this was a dramatic improvement after a 20% fall last year, as inflationary pressures eased markedly thanks to exchange rate stabilisation. Going forward, private consumption should also be boosted by the less restrictive fiscal policy, following the departure of former prime minister Arseniy Yatsenyuk and the formation of a new government under President Poroshenko's ally Volodymyr Groysman. The minimum wage and pension will be hiked in two steps this year – on 1 May and 1 December – by a combined 16%, roughly in line with the projected inflation. Still, further prospects for disinflation – and the real purchasing power of households – are clouded by the recent government decision to raise retail gas tariffs to cost-recovery levels, effectively resulting in a 42% price hike. The full impact of the hike is yet to be felt, as its pass-through on many households will materialise only starting from 1 July in the form of the near-doubling of tariffs for hot water and heating (which are supplied by district heating companies).

With the new government and new gas tariffs in place, a resumption of the IMF loan programme, which has effectively stalled since autumn 2015, looks now almost certain. The upcoming IMF tranches should replenish the still meagre foreign exchange reserves (USD 13.5 billion as of 1 June, covering 3.5 months of imports) and support the stability of the exchange rate. However, the unresolved status of Donbas remains an important risk factor, which cannot but affect the investment climate, including for FDI. The slight recovery of domestic demand – particularly investments and possibly public consumption – will probably bring GDP growth into positive territory this year, accompanied by a moderate widening of the current account deficit. However, the pace of economic recovery in 2016 is likely to be constrained by stagnant private consumption and disappointing foreign trade developments. An acceleration of growth to more respectable levels (2% and above) can be expected not before next year, with inflation subsiding further, fiscal policy becoming more accommodative and export re-orientation away from Russia and towards the EU potentially starting to bear fruit.

[1] Ukraine responded with a number of countermeasures, which are hampering mutual trade.

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