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Forecast Report

Riding the Global Growth Wave

Economic Analysis and Outlook for Central, East and Southeast Europe

The Vienna Institute for International Economic Studies
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Riding the Global Growth Wave

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Executive summary

External conditions are highly supportive of economic growth in CESEE, and will remain so in 2018. All the big engines of the global economy – the US, China and the eurozone – are growing strongly together for the first time since 2010.

The eurozone is finally undergoing a proper recovery, with boom-like conditions visible in Germany, in particular. Strong demand is pushing firms up against capacity constraints, which will propel employment and investment higher, creating a virtuous cycle of strengthening economic activity. Extensive trade, investment, remittance and tourism links with the eurozone make the upswing in the single currency area particularly important from the perspective of CESEE.

Aggregate economic activity in CESEE is at its strongest level for six years, and in 2017 all countries in the region posted positive growth for the first time in a decade. Our core scenario is for another 2-3 years of strong regional growth in the post-crisis context; we forecast average expansion of 2.9% a year during the forecast period, almost double the 2014-2016 level. Thereafter, as the cyclical upswing in the eurozone (and at the global level) fades, we expect economic activity in CESEE to slow.

In EU-CEE, we expect growth to average 3.9% this year, down from 4.4% in 2017, but otherwise the strongest since 2008. We expect average real expansion of 3.5% a year in 2018-2020, slightly above the 2014-2016 level (3.3%). Romania will remain the star performer, but growth in most places will be above its post-crisis average, underpinned by strong growth in the core eurozone, a firming of the EU funds cycle, higher private investment and rising wages.

The Turkish economy will also continue to expand at a rapid rate in 2018, although growth will slow to 4.5%, from an estimated 6.5% last year. Growth will average 4.1% in 2018-2020, propelled by a combination of strong domestic stimulus and elevated external demand. However, these forecasts are subject to significant downside risks, reflecting political uncertainty and external imbalances.

The Western Balkans will have a better year in 2018, helped in particular by an improvement in Serbia. In 2018-2020, growth will average 3.2%, well above the 2014-2016 average (1.8%). Strong external conditions will be the key to this, driving exports, remittance inflows and tourist arrivals higher. A renewed effort to speed up EU accession could stimulate higher FDI inflows into the region.

The CIS and Ukraine will continue their slow and steady recovery from the oil price shock and conflict in the Donbass. Growth will average 2% in 2018-2020, a significant improvement on 2014-2016 (-0.7%). Stability has returned, but there are few significant drivers of growth. Higher oil prices and supportive external conditions will help. The Russian economy – the key to the whole region – remains characterised by a severe lack of dynamism.

Despite strong growth, especially in parts of EU-CEE and Turkey, we do not think that any economy in the region is ‘overheating’. We also do not expect overheating to emerge during the

forecast period, although we see the biggest risks in Romania and Turkey. The key areas to watch are tight labour markets, high external debt, negative real interest rates and booming property prices (in the case of the EU countries). However, there is little sign of inflation as a result, credit growth is overall contained (by historical standards) and fiscal balances are mostly under control.

We expect inflation to remain very subdued in both the eurozone and most of CESEE during the forecast period. In the single currency area, core inflation continues to show no signs of life. In parts of CESEE, wage growth is strong, notably in manufacturing sectors. However, this has been more than offset by increases in labour productivity and improvements in non-price competitiveness, meaning that external competitiveness has been maintained (or even increased, as indicated by improving trade balances). In EU-CEE, the strongest wage increases since 2010 have been in the countries with the lowest starting point (Romania and Bulgaria).

Relief for tight labour markets in parts of EU-CEE is partly being provided by Ukrainian immigrants. The numbers of Ukrainians working in EU-CEE has risen sharply in the last few years, and they now constitute an important part of the labour market in some countries of the region. This is likely to continue. From the Ukrainian perspective, EU-CEE labour markets offer higher wages. Meanwhile, from the EU-CEE side, Ukrainians offer a more politically acceptable means of addressing labour shortages than immigrants from the Middle East or Africa.

The ECB will only raise interest rates slowly, if at all, before 2020, and monetary tightening will proceed cautiously in CESEE. We expect further moderate tightening by the Czech, Turkish and Romanian central banks this year, while their Polish and Hungarian counterparts will remain on hold. In Russia, gradual monetary loosening is likely over the forecast period.

Across most of the region, investment should rise faster than headline real GDP growth during the forecast period. Capacity constraints are increasingly evident, especially in EU-CEE, while confidence is rising and interest rates are low. EU funds will also make an important contribution in the relevant countries. Almost everywhere, investment remains well below 2008 levels as a share of GDP.

Most countries across the region have seen their export/GDP shares rise in the past decade, and many are now more integrated than before with Western Europe. This increases their ability to take advantage of the current upswing. In general, the Western Balkans continues to specialise in lower value-added sectors, but this will change gradually, helping to drive faster convergence.

Most banking sectors in the region have stabilised, with asset quality much improved and credit growth picking up. This should continue and provide support for economic expansion throughout the forecast period. Nevertheless, the old pre-crisis highly leveraged model reliant on foreign inflows is gone (with a couple of exceptions), meaning that credit growth will be largely financed by deposits, and will therefore be very restrained by pre-crisis standards. Stability risks are more pressing in the CIS and Ukraine, with asset quality still very bad in some places (especially Ukraine). Nevertheless, in Russia and Ukraine, positive momentum to clean up the banking sector is visible.

There appears to be a perception that regional and global risks are lower than in the recent past, but we think that this is mistaken. At the global level, we are concerned that central banks will not be able to safely exit ultra-loose monetary policy, which would have a hugely destabilising impact on

countries in CESEE reliant on foreign capital flows, notably Turkey. Meanwhile the potential for a global trade war has risen, and this would have damaging consequences for much of CESEE. Regionally, we think that east/west splits within the EU (for example related to migration or the post-Brexit EU budget) represent a material medium-term risk to growth. A solution to the Ukraine crisis does not appear to be in sight. Meanwhile the eurozone remains in a fragile state: when the current upswing ends, many of the old problems are likely to return, with negative implications for CESEE. Global financial market volatility appears to have come back, linked to investor unease regarding the exit of central banks from ultra-loose monetary policy. Should global rates rise sharply, corporates in parts of CESEE look very vulnerable. Several governments may also run into financing difficulties.

The long-term growth outlook for the region is quite subdued. By the 2020s, growth in CESEE is likely to be much lower than current levels. Negative demographic trends are already making themselves felt, and will become an even bigger challenge by the 2020s. CESEE growth over the long run will be much less reliant on fiscal and external imbalances than in the pre-crisis years, making it more stable, but also slower. Convergence with Western European income levels will proceed, but at a pace that will remain disappointing to many in the region (with potentially further political implications).

Our research indicates that functional specialisation is an important constraint on convergence in parts of CESEE. As a consequence of the capital stock generally being owned by foreigners, firms in the region have increasingly specialised in parts of the supply chain where little value is created. This creates a significant risk that they will become stuck in a permanent ‘semi-periphery’ trap, and never catch up with Western European per capita income levels.

COUNTRY SUMMARIES

ALBANIA

The drivers of growth will continue to be consumption, big infrastructure projects and tourism. The investments in infrastructure will be channelled through public–private partnerships, which boost growth in the medium term, but pose certain risks in the longer run. There are high expectations that after five decades of self-imposed isolation and three decades of involuntary exclusion, Albania will become part of the EU by 2025.

BELARUS

GDP in Belarus grew by 2.4%, defying the expectations of a continuing recession. Thanks to an improvement in the external environment, manufacturing output and exports rebounded strongly. Tighter macroeconomic policies contributed to a shrinking of the current account deficit and a lowering of inflation expectations. Inflation reached a historic low in 2017. The short-term prospects have improved and positive economic growth should continue in the coming years.

BOSNIA AND HERZEGOVINA

The economy is benefiting from highly supportive external conditions, which are driving strong growth of remittances and exports. These trends should continue this year, and feed through to higher domestic employment and private consumption growth. The political situation remains problematic, and is unlikely to change before the upcoming election. During the forecast period, the economy should grow in the 3-3.5% per year range.

BULGARIA

In 2017, Bulgaria's GDP grew by close to 4%, similarly to the previous year. The pattern of growth switched from being export led in 2016 to being driven by domestic demand in 2017. Manufacturing, tourism and business services remained the main growth drivers. The rise in labour demand led to a labour shortage, which is turning into a constraint on growth. The Bulgarian economy is poised to preserve its momentum in the short run; however, it is unlikely that GDP growth will accelerate in the near future.

CROATIA

Croatia's GDP is projected to grow by up to 3% in the period 2018-2020, driven primarily by domestic demand. The general government is expected to report low deficits or even a surplus, and thus the debt-to-GDP ratio will continue declining gradually. The impact on growth of the Agrokor food-to-retail consortium's restructuring is still unknown.

CZECH REPUBLIC

The robust demand for consumer, investment and export goods is conducive to broad-based growth. However, deepening labour shortages are preventing further strong output expansion, while rapidly rising wages are starting to affect profitability. Monetary policy does not face any serious dilemmas. Under the new government, stability-oriented fiscal policy will be preserved.

ESTONIA

Investment activity picked up more strongly than expected in both the private and the public sectors, pushing GDP growth to 4.3% in 2017. Although it has already peaked, economic activity will remain

vibrant in 2018 and thereafter. External demand will continue to grow at a good pace, though somewhat more slowly than last year. Household consumption, backed by a considerable rise in real wages and tax cuts, continues to be a strong driver of economic activity. We project GDP to grow at a rate of 3.5% in 2018 and 2.9% in 2019, declining somewhat to 2.5% in 2020.

HUNGARY

Economic growth in 2017 amounted to 4%, with household consumption growing quicker than GDP, reflecting the dynamic expansion of real wages. Investments increased by about 20% as a direct consequence of the accelerated allocation of EU cohesion policy-related resources to recipients. The other side of the coin was the strong deterioration in the foreign trade balance. Economic growth remains dynamic this year, though a deceleration is expected from 2019 on, closely related to the depletion of EU resources due to a deliberate excessive utilisation of the respective resources in 2017-2019.

KAZAKHSTAN

The Kazakh economy has been expanding mainly on the back of the oil sector. Lack of economic diversification will limit the scale of GDP growth to about 3% per annum during 2018-2020. Households have not benefited from economic growth, as their incomes have dropped in real terms. The banking sector remains a bottleneck to economic diversification.

KOSOVO

The economy is growing strongly, reflecting a boom in key sources of remittances and export demand. With growth showing no signs of slowing in Western Europe, this is likely to remain the case this year. Meanwhile stronger employment growth should help to lift private consumption. Real GDP growth is likely to average around 4% per year over the forecast period, although a major new energy investment could lift this higher.

LATVIA

Following a remarkable 2017, when GDP growth attained 4.5%, Latvia's economy will keep prospering at its potential in both 2018 and 2019. Public spending is continuing to expand rapidly, driven by the inflow of EU funds, while enterprises will also increase their investments. Growth in exports will remain lively. Household consumption is developing rapidly, and this will continue in the coming years, thanks to rising minimum wages and the 2018 income tax reform. In both 2018 and 2019, we expect continuously robust GDP growth of 3.8% and 3.3%, followed by a slight slowdown to 2.7% in 2020.

LITHUANIA

In 2018, economic growth in Lithuania will be driven by ongoing strong public investment, underpinned by fresh funds from the EU. The continued decline in unemployment and rapid wage growth mean steady, strong growth in household consumption. External demand activity, having seen a remarkable revival, particularly from the CIS last year, will remain buoyant in 2018. For 2018, we forecast GDP to grow by 3.2% at potential, followed by 2.6% in 2019 and 2.2% in 2020.

MACEDONIA

Recovery of growth to around 3% should lead to growth accelerating to 3.5% and even 4% in the medium term under more positive external developments. Investments and net exports should contribute. External shocks, primarily within the region, can have a strong influence and that can go

either way, which is why the risks are more often than not on the downside. In that, the agreement with Greece on the 'name issue' is crucial.

MONTENEGRO

Overall, the economy should expand by 3% in the medium term. Assuming EU recovery is sustained, tourism should continue to support expansion. Infrastructure investments should continue and help as well. That should also lead to improvements in the labour market. In the same period, additional political stabilisation should take place and EU accession should advance steadily.

POLAND

Strong consumption-driven growth has been propelled by rising wages and employment. The economic conditions are conducive to a recovery in private-sector investment activities, though this has yet to materialise. The positive growth prospects may be endangered by the unwelcome effects of the ongoing evolution of the political system – including the country's progressive alienation from its EU partners.

ROMANIA

Economic growth in Romania is expected to decline from close to 7% last year to 4.7% in 2018, and even lower in the following two years. Fiscal imbalances will trigger restrictive policies. Household consumption will remain the main growth driver, while investments are expected to recover slowly and the current account deficits to shrink modestly. Political instability and unpredictable structural reforms will continue to put a drag on the economy, elevating investment risk.

RUSSIA

The Russian economy has returned to growth. The inflation target of 4% has been comfortably met, and the rouble has been appreciating. However, in the absence of reforms, GDP growth will not exceed 2% even in the medium run – lower than the country's European peers. No major changes in economic policies are expected, as stability at home coupled with external threats is cherished over reform risks. Sanctions and a poor investment climate are here to stay. Higher oil prices are once again serving as both a buffer and a deterrent to reform.

SERBIA

Slow recovery and tenuous political stability is the medium-term prospect. This means growth of around 3% on average in the medium run. A recovery of agriculture may push growth up this year, political support for the government may weaken and depress investment and growth in the medium run.

SLOVAKIA

Slovakia grew at a solid pace throughout 2017, fostered by accelerating household consumption. Forecasts for this and the next year amount to 3.8% and around 4%, respectively, thanks to capacity increases in the automotive industry, before falling back to 3.3% in 2020. However, growing wages and labour shortages may threaten future growth prospects.

SLOVENIA

GDP growth is set to remain high (3.6% p.a.) in the forecasting period, albeit moderating from the peak of 2017. Domestic demand and exports are expected to be the main growth drivers. The general government deficit and public debt ratios will continue declining. Upcoming elections will result again in a broad coalition.

TURKEY

The economy had a strong 2017, underpinned by significant government stimulus and booming external demand. Growth will be lower during the forecast period, but still robust, driven by private consumption, and helped by benign external conditions. However, the downside risks are significant. The large external financing requirement will leave Turkey exposed to a sharper-than-expected hike in US rates or change in global investor sentiment.

UKRAINE

Economic recovery is projected to accelerate from an estimated 2.1% last year to around 3% p.a. in 2018-2020, mostly thanks to an expected recovery of exports. In the short run, growth will also be helped by a more expansionary fiscal policy in the run-up to next year's presidential and parliamentary elections. Monetary policy, by contrast, has been tightened markedly in an attempt to tame the stubbornly high inflation.

Keywords: CESEE, economic forecast, Europe, Central and Eastern Europe, Southeast Europe, Western Balkans, new EU Member States, CIS, Russia, Ukraine, Poland, Romania, Czech Republic, Hungary, Turkey, convergence, overheating, external risks, EU funds, investment, exports, tourism, unemployment, employment, wage growth, unit labour costs, migration, inflation, competitiveness, external debt, public debt, semi-periphery trap, demographics.

JEL classification: E20, F34, G12, O47, O52, O57, P24, P27, P33, P52

Table 1 / 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	3.8	3.6	3.5	3.4	-1.3	1.2	2.5	3.0	3.0
CZ	Czech Republic	2.6	4.2	3.5	3.2	3.2	0.6	2.4	2.3	2.0	1.8
EE	Estonia	2.1	4.3	3.5	2.9	2.5	0.8	3.7	3.2	3.0	2.5
HR	Croatia	3.2	3.0	2.7	3.0	3.0	-0.6	1.3	1.6	1.6	1.6
HU	Hungary	2.2	4.0	3.8	2.6	1.7	0.4	2.4	2.8	2.9	2.9
LT	Lithuania	2.3	3.9	3.2	2.6	2.2	0.7	3.7	3.0	2.7	2.5
LV	Latvia	2.1	4.5	3.8	3.3	2.7	0.1	2.9	3.0	3.0	2.5
PL	Poland	2.9	4.6	3.8	3.5	3.3	-0.2	1.6	2.1	2.0	2.0
RO	Romania	4.8	6.9	4.7	3.8	4.2	-1.1	1.1	3.5	3.0	3.0
SI	Slovenia	3.1	4.6	3.9	3.5	3.5	-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	2.0	1.8	2.2
	EU-CEE [1)2)]	*3.1*	*4.4*	*3.9*	*3.4*	*3.2*	*-0.2*	*1.8*	*2.5*	*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*	*1.9*	*1.8*	.
AL	Albania	3.4	3.9	4.1	4.0	3.9	1.3	2.0	2.8	3.0	3.0
BA	Bosnia and Herzegovina	3.1	3.0	3.4	3.3	3.3	-1.1	1.2	1.6	1.9	1.9
ME	Montenegro	2.9	3.9	2.9	3.0	3.1	0.1	2.8	2.0	2.0	2.0
MK	Macedonia	2.9	0.5	3.4	3.4	3.2	-0.2	1.4	1.5	2.0	2.0
RS	Serbia	2.8	1.9	2.8	2.8	2.8	1.1	3.0	3.0	3.0	4.0
XK	Kosovo	4.1	3.9	3.9	3.8	3.8	0.3	1.5	1.9	2.3	2.3
	WB [1)2)]	*3.1*	*2.5*	*3.3*	*3.2*	*3.2*	*0.5*	*2.2*	*2.4*	*2.6*	*3.0*
TR	Turkey	3.2	6.5	4.5	4.1	3.9	7.7	11.1	9.8	7.2	6.8
BY	Belarus [3)]	-2.5	2.4	2.8	3.1	3.1	11.8	6.0	6.0	7.0	7.0
KZ	Kazakhstan	1.1	3.8	3.0	3.0	3.0	14.6	7.4	6.0	6.0	5.0
RU	Russia	-0.2	1.5	1.8	1.6	1.6	7.1	3.6	4.0	4.0	4.0
UA	Ukraine	2.4	2.1	2.9	3.2	3.2	13.9	14.4	10.8	6.7	6.0
	CIS + Ukraine [1)2)]	*0.1*	*2.1*	*2.0*	*1.9*	*1.9*	*8.6*	*5.0*	*4.8*	*4.5*	*4.4*
	V-4 [1)2)]	*2.8*	*3.9*	*3.8*	*3.4*	*3.1*	*0.0*	*1.9*	*2.2*	*2.1*	*2.1*
	BALT-3 [1)2)]	*2.2*	*4.2*	*3.4*	*2.9*	*2.4*	*0.6*	*3.5*	*3.0*	*2.9*	*2.5*
	SEE-9 [1)2)]	*4.1*	*4.9*	*4.0*	*3.5*	*3.7*	*-0.7*	*1.4*	*2.9*	*2.7*	*2.9*
	NON-EU-11 [1)2)]	*1.1*	*3.5*	*2.8*	*2.6*	*2.6*	*8.0*	*6.8*	*6.3*	*5.3*	*5.1*
	CESEE-22 [1)2)]	*1.7*	*3.7*	*3.1*	*2.9*	*2.8*	*5.6*	*5.3*	*5.2*	*4.4*	*4.3*

Table 1 / (ctd.)

		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	6.0	5.5	5.0	5.3	4.0	2.4	1.7	1.3
CZ	Czech Republic	4.0	2.9	2.9	2.8	2.8	1.1	1.3	0.7	1.0	0.9
EE	Estonia	6.8	6.1	5.4	5.2	5.5	1.9	2.7	1.4	0.7	0.8
HR	Croatia	13.1	11.5	10.5	9.5	9.0	2.5	4.0	2.2	1.3	0.9
HU	Hungary	5.1	4.2	4.1	4.1	4.1	6.1	3.8	3.2	2.6	2.7
LT	Lithuania	7.9	7.2	6.5	6.0	5.8	-1.1	0.9	-2.0	-2.4	-2.2
LV	Latvia	9.6	9.0	8.2	7.5	7.2	1.4	-0.7	-1.4	-2.3	-2.6
PL	Poland	6.2	4.7	4.3	4.2	4.0	-0.3	0.1	0.2	0.2	0.1
RO	Romania	5.9	5.0	4.8	4.6	4.6	-2.1	-3.5	-3.4	-3.2	-3.0
SI	Slovenia	8.0	7.3	6.5	6.0	5.5	5.2	6.5	5.5	4.3	3.6
SK	Slovakia	9.7	8.2	7.7	7.2	6.8	-1.5	-1.2	-0.6	0.3	0.5
	EU-CEE 1)2)	*6.5*	*5.3*	*5.0*	*4.7*	*4.6*	*0.8*	*0.6*	*0.2*	*0.2*	*0.1*
	EA-19	*10.0*	*9.1*	*8.5*	*7.9*	*.*	*3.6*	*3.5*	*3.0*	*2.9*	*.*
	EU-28	*8.6*	*7.7*	*7.3*	*7.0*	*.*	*2.0*	*2.2*	*1.8*	*1.8*	*.*
AL	Albania	15.2	14.0	13.0	12.5	12.0	-7.6	-8.6	-7.9	-7.5	-7.5
BA	Bosnia and Herzegovina	25.4	20.5	19.4	18.8	18.3	-5.1	-4.6	-4.6	-4.6	-4.5
ME	Montenegro	17.4	16.0	15.0	15.0	15.0	-18.1	-18.8	-20.2	-20.0	-17.7
MK	Macedonia	23.7	23.0	23.0	23.0	22.0	-2.7	-0.2	0.0	0.1	-1.0
RS	Serbia	15.3	15.0	13.0	13.0	12.0	-3.1	-4.9	-5.4	-6.1	-6.2
XK	Kosovo	27.5	30.2	27.0	25.2	24.0	-9.0	-5.6	-5.8	-6.0	-6.2
	WB 1)2)	*18.7*	*17.7*	*16.2*	*15.8*	*15.0*	*-5.2*	*-5.5*	*-5.7*	*-6.0*	*-6.0*
TR	Turkey	10.9	11.0	10.5	10.2	10.0	-3.8	-5.5	-5.5	-5.6	-5.9
BY	Belarus 3)	0.8	0.5	0.5	0.5	0.5	-3.5	-2.3	-3.4	-3.3	-3.4
KZ	Kazakhstan	5.0	5.0	5.0	5.0	5.0	-6.5	-2.9	-1.8	-2.2	-2.6
RU	Russia	5.5	5.2	5.4	5.2	5.2	2.0	2.5	3.4	3.0	2.4
UA	Ukraine	9.3	9.5	9.2	8.9	8.7	-3.7	-3.7	-3.5	-3.8	-5.4
	CIS + Ukraine 1)2)	*5.9*	*5.7*	*5.8*	*5.6*	*5.6*	*0.7*	*1.6*	*2.4*	*2.0*	*1.5*
	V-4 1)2)	*5.6*	*4.4*	*4.1*	*4.0*	*3.9*	*0.8*	*0.7*	*0.6*	*0.7*	*0.7*
	BALT-3 1)2)	*8.2*	*7.5*	*6.8*	*6.2*	*6.2*	*0.4*	*0.9*	*-1.0*	*-1.6*	*-1.6*
	SEE-9 1)2)	*11.2*	*10.1*	*9.3*	*9.0*	*8.6*	*-1.1*	*-1.9*	*-2.4*	*-2.6*	*-2.6*
	NON-EU-11 1)2)	*7.6*	*7.5*	*7.3*	*7.2*	*7.1*	*-1.0*	*-0.8*	*-0.2*	*-0.6*	*-1.1*
	CESEE-22 1)2)	*7.3*	*7.0*	*6.8*	*6.6*	*6.5*	*-0.4*	*-0.3*	*-0.1*	*-0.3*	*-0.7*

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 (February 2018) and European Commission for EU and Euro area (Winter Report, February 2018: GDP and CPI; Autumn Report, November 2017: unemployment rate and current account).

CONTENTS

Executive summary ... I

Country Summaries ... IV

Riding the global growth wave ... 1

I. A time of gifts: coordinated global upswing ... 1
II. Goldilocks conditions should persist in CESEE ... 4
III. Medium-term outlook: Gradually dragged down by weak potential ... 13
IV. The risks ... 23
V. Long-term convergence prospects: Hitting the limits? ... 33
References ... 34

Special section I: Wages in the EU-CEE countries: Manufacturing sector catching up ... 36

Overall wage dynamics ... 36
Regional wage disparities ... 38
Wage developments by sector ... 39
Conclusions ... 42

Special section II: Ukrainian migrants filling the employment gap ... 43

Special section III: EU-CEE's demographic challenge ... 47

Demographic trends in the EU-28 and the EU-CEE ... 47
Employment growth meets the demographic challange ... 49
Conclusions ... 53
References ... 53

Special section IV: Functional specialisation in CESEE: Key to escaping the semi-periphery trap? ... 54

References ... 65

Country reports ... 67

Albania: High expectations for the commencement of EU membership negotiations ... 68
Belarus: Improving external environment supports modest growth ... 72
Bosnia and Herzegovina: Positive external conditions driving growth ... 77
Bulgaria: Growth continues but may be close to the limits ... 81
Croatia: Moderate growth ahead ... 86

Czech Republic: Broad-based but quite moderate growth 90
Estonia: Investment keeps growth in high gear 94
Hungary: EU co-financed investment boom, surging wages, shrinking trade surplus 98
Kazakhstan: Oil sector growth benefits few 102
Kosovo: Growth at healthy levels, helped by boom in Western Europe 106
Latvia: Riding high on the investment cycle 110
Lithuania: EU funds foster growth at full potential 114
Macedonia: Political crisis and recovery 118
Montenegro: Tourism to the rescue 122
Poland: Steady consumption-driven expansion 125
Romania: Down from the peak 130
Russian Federation: Falling behind peers on meagre growth 134
Serbia: Slow recovery continues 138
Slovakia: Future growth constrained by labour shortages 142
Slovenia: Solid growth set to continue 146
Turkey: Growth will remain strong but external risks are significant 150
Ukraine: Reforms stall ahead of elections 154

Appendix 159

TABLES AND FIGURES

Table 1 / OVERVIEW 2016-2017 AND OUTLOOK 2018-2020 VIII
Table 2 / Global assumptions 1
Table 3 / Real GDP growth forecast and revisions 5
Table 4 / Overheating index 10
Table 5 / Private credit growth 19
Table 6 / Sovereign credit ratings 31
Table 7 / Robustness checks of alternative scenarios 1 51
Table 8 / Robustness checks of alternative scenarios 2 52
Table 9 / Country-specific results for the EU-CEE region 52
Table 10 / Albania: Selected economic indicators 71
Table 11 / Belarus: Selected economic indicators 76
Table 12 / Bosnia and Herzegovina: Selected economic indicators 80
Table 13 / Bulgaria: Selected economic indicators 85
Table 14 / Croatia: Selected economic indicators 89
Table 15 / Czech Republic: Selected economic indicators 93
Table 16 / Estonia: Selected economic indicators 97
Table 17 / Hungary: Selected economic indicators 101
Table 18 / Kazakhstan: Selected economic indicators 105
Table 19 / Kosovo: Selected economic indicators 109
Table 20 / Latvia: Selected economic indicators 113
Table 21 / Lithuania: Selected economic indicators 117
Table 22 / Macedonia: Selected economic indicators 121
Table 23 / Montenegro: Selected economic indicators 124
Table 24 / Poland: Selected economic indicators 129
Table 25 / Romania: Selected economic indicators 133
Table 26 / Russian Federation: Selected economic indicators 137
Table 27 / Serbia: Selected economic indicators 141
Table 28 / Slovakia: Selected economic indicators 145
Table 29 / Slovenia: Selected economic indicators 149
Table 30 / Turkey: Selected economic indicators 153
Table 31 / Ukraine: Selected economic indicators 158
Table 32 / European Union-Central and Eastern Europe (EU-CEE): an overview of economic fundamentals, 2017 160
Table 33 / Western Balkans and Turkey, selected CIS countries and Ukraine: an overview of economic fundamentals, 2017 161
Table 34 / GDP per capita at current PPPs (EUR), from 2018 at constant PPPs and population 162
Table 35 / Indicators of macro-competitiveness, 2013-2020, EUR based, annual averages 163
Table 36 / Indicators of macro-competitiveness, 2013-2020, annual changes in % 169

Figure 1 / Global commodity prices, 2010-2017 2
Figure 2 / Current level of capacity utilisation in Germany 1980-2018, in % 3
Figure 3 / Quarterly real GDP growth of the CESEE countries 5
Figure 4 / Current level of capacity utilisation in % 7
Figure 5 / Job vacancy rate, in % 7
Figure 6 / Monthly gross minimum wages, half-year data, NCU, 2013=100 8
Figure 7 / Core inflation (HICP/COICOP), overall index excluding energy 12
Figure 8 / GDP growth in 2017-2020 13
Figure 9 / Wages, unit labour costs and inflation, 2010-2020 14
Figure 10 / Total exports, in % of GDP 16
Figure 11 / Value added exports in % of GDP 17
Figure 12 / Share of foreign value added in gross exports in % 17
Figure 13 / Bank non-performing loans in % of total loans 20
Figure 14 / Loans to deposit ratio 21
Figure 15 / Real GDP growth of CESEE-22 22
Figure 16 / Stock market indices S&P 500 (US) 28
Figure 17 / Gross external debt by sectors in % of GDP, 2017 30
Figure 18 / General government gross debt 32
Figure 19 / Real wage dynamics in EU-CEE countries 36
Figure 20 / Average gross monthly wages in 2017, real growth year on year, in % 37
Figure 21 / Hourly compensation of employees by region (at NUTS 2 level) 38
Figure 22 / Regional wage inequalities, 2010 and 2015 39
Figure 23 / Real hourly wage in EU-CEE-8 average, by activity at NACE Rev. 2 1-digit level 40
Figure 24 / Real growth in hourly wages, total economy vs. manufacturing industry 41
Figure 25 / Trade balance in goods, as % of GDP 42
Figure 26 / Stock of Ukrainian immigrants, top 20 destinations in EU-28 43
Figure 27 / Residence permits issued to Ukrainian immigrants 44
Figure 28 / The share of residence permits issued to Ukrainians over total immigrants 44
Figure 29 / Residence permits by duration, 2016 45
Figure 30 / Residence permits by purpose, 2016 45
Figure 31 / Demographic forecasts for the EU-28, in million persons 47
Figure 32 / Population trends according to Eurostat baseline scenario (change in % compared to 2015) 48
Figure 33 / Demographic trends in working-age population (change in % compared to 2015) 48
Figure 34a / Scenario for the EU-28, in million persons 50
Figure 34b / Scenario for EU-CEE, in million persons 51
Figure 35 / Structural convergence in the EU 55
Figure 36 / Structural specialisation patterns of selected European economies, 2014 56
Figure 37a / Functional specialisation in the Visegrád-4 countries, Romania and Bulgaria, averages 2003-2015 57
Figure 37b / Functional specialisation in selected Western EU core countries, averages 2003-2015 59
Figure 38 / Relative production specialisation index (rpsi) for CESEE and selected other countries, averages 2003-2015 62
Figure 39 / The European semi-periphery trap, 1995-2016 64

Figure 40 / Albania: Main macroeconomic indicators 68
Figure 41 / Belarus: Main macroeconomic indicators 72
Figure 42 / Bosnia and Herzegovina: Main macroeconomic indicators 77
Figure 43 / Bulgaria: Main macroeconomic indicators 81
Figure 44 / Croatia: Main macroeconomic indicators 86
Figure 45 / Czech Republic: Main macroeconomic indicators 90
Figure 46 / Estonia: Main macroeconomic indicators 94
Figure 47 / Hungary: Main macroeconomic indicators 98
Figure 48 / Kazakhstan: Main macroeconomic indicators 102
Figure 49 / Kosovo: Main macroeconomic indicators 106
Figure 50 / Latvia: Main macroeconomic indicators 110
Figure 51 / Lithuania: Main macroeconomic indicators 114
Figure 52 / Macedonia: Main macroeconomic indicators 118
Figure 53 / Montenegro: Main macroeconomic indicators 122
Figure 54 / Poland: Main macroeconomic indicators 125
Figure 55 / Romania: Main macroeconomic indicators 130
Figure 56 / Russian Federation: Main macroeconomic indicators 134
Figure 57 / Serbia: Main macroeconomic indicators 138
Figure 58 / Slovakia: Main macroeconomic indicators 142
Figure 59 / Slovenia: Main macroeconomic indicators 146
Figure 60 / Turkey: Main macroeconomic indicators 150
Figure 61 / Ukraine: Main macroeconomic indicators 154

Box 1 / Linking the firm-level value chain to the functional specialisation of countries 59

Box Figure 1 / The smile curve – value creation along the value chain 59

The statistical data until 2017 presented in this report are as of 15 February 2018, forecasts as of February 2018. Most data are taken from the wiiw Databases. Direct access is available at: http://data.wiiw.ac.at/.

ABBREVIATIONS

AL	Albania
BA	Bosnia and Herzegovina
BG	Bulgaria
BY	Belarus
CZ	Czech Republic
EE	Estonia
HR	Croatia
HU	Hungary
KZ	Kazakhstan
LT	Lithuania
LV	Latvia
ME	Montenegro
MK	Macedonia
PL	Poland
RO	Romania
RS	Serbia
RU	Russia
SI	Slovenia
SK	Slovakia
TR	Turkey
UA	Ukraine
XK	Kosovo

BALT-3	Baltic countries: Estonia, Latvia, Lithuania
CESEE-22	Central, East and Southeast Europe: EU-CEE + NON-EU-11
CIS	Commonwealth of Independent States covered by wiiw: Belarus, Kazakhstan, Russia
EA-19	euro area 19 countries
EU-28	European Union 28 countries
EU-15	15 original members of the European Union
EU-CEE	European Union – Central and Eastern Europe: Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, Slovenia
NON-EU-11	Non-European Union countries: Albania, Bosnia and Herzegovina, Kosovo, Macedonia, Montenegro, Serbia, Turkey, Belarus, Kazakhstan, Russia, Ukraine
SEE-9	Southeast Europe: Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Kosovo, Macedonia, Montenegro, Romania, Serbia
V-4	Visegrád countries: Czech Republic, Hungary, Poland, Slovakia
WB	Western Balkans: Albania, Bosnia and Herzegovina, Kosovo, Macedonia, Montenegro, Serbia

ALL	Albanian lek
BAM	convertible mark of Bosnia and Herzegovina
BGN	Bulgarian lev
BYR	New Belarusian rouble
CZK	Czech koruna
EUR	euro
HRK	Croatian kuna
HUF	Hungarian forint
KZT	Kazakh tenge
MKD	Macedonian denar
PLN	Polish zloty
RON	Romanian leu
RSD	Serbian dinar
RUB	Russian rouble
TRY	Turkish lira
UAH	Ukrainian hryvnia
USD	US dollar

bbl	barrel
BPM5	Balance of Payments Manual Fifth Edition
BPM6	Balance of Payments and International Investment Position Manual Sixth Edition
BOP	balance of payments
CIS-STAT	Interstate Statistical Committee of the Commonwealth of Independent States
CPI	consumer price index
EC	European Commission
EBRD	European Bank for Reconstruction and Development
ECB	European Central Bank
EFSI	European Fund for Strategic Investments
EIB	European Investment Bank
ER	exchange rate
ESA'95	European system of national and regional accounts, ESA 1995
ESA 2010	European system of accounts, ESA 2010
ESIF	European Structural and Investment Funds
FDI	Foreign Direct Investment
FISIM	Financial Intermediation Services, Indirectly Measured
GFCF	gross fixed capital formation
GDP	Gross Domestic Product
GNI	Gross National Income
ICP	International Comparison Program
IMF	International Monetary Fund
LFS	Labour Force Survey
MFF	Multiannual Financial Framework
NACE	Nomenclature statistique des activités économiques dans la Communauté européenne (Statistical classification of economic activities in the European Community)
NACE Rev. 1	first revision of the original NACE (1970)
NACE Rev. 2	revised classification, introduced in 2008
NB	National Bank
NCU	national currency unit
NPL	Non-performing loans (more than 90 days overdue)

OECD	Organisation for Economic Co-operation and Development
OPEC	Organisation of the Petroleum Exporting Countries
pp	percentage points
PPI	producer price index
PPP	Purchasing Power Parity
SME	small and medium-sized enterprise
SNA	System of National Accounts
SPE	Special Purpose Entity
ULC	unit labour cost
VAT	value added tax
WIFO	Austrian Institute of Economic Research
wiiw	The Vienna Institute for International Economic Studies

.	not available (in tables)
bn	billion
mn	million
mom	month-over-month
lhs	left-hand side axis/panel
p.a.	per annum
rhs	right-hand side axis/panel
sa	seasonally adjusted
saar	seasonally adjusted annualised rate
qoq	quarter-over-quarter
yoy	year-over-year

Riding the global growth wave

BY RICHARD GRIEVESON[1]

I. A TIME OF GIFTS: COORDINATED GLOBAL UPSWING

Table 2 / Global assumptions

	2017	2018	2019	2020
Eurozone real GDP growth, %	2.4	2.3	2.0	-
German real GDP growth, %	2.2	2.3	2.2	-
US real GDP growth, %	2.3	2.7	2.5	-
Chinese real GDP growth, %	6.8	6.6	6.4	-
USD/EUR	1.13	1.20	1.20	1.20
Brent crude, USD per barrel	54.25	61.60	58.90	57.30

Source: IMF, European Commission.

Global growth has not looked this good for almost a decade; the world economy is in a highly positive phase from the perspective of Central, Eastern and Southeastern Europe (CESEE). Since the 2007-2008 global financial crisis, the global recovery has been generally characterised by spurts of growth and periods of slowdown or contraction in different parts of the world at different times. Recent quarters, however, have pointed to an increasingly synchronised upswing among most or all of the world's important economies, and in particular the Eurozone, US, China and Japan. The International Monetary Fund's (IMF) latest World Economic Outlook (WEO) update, released in January 2018, highlighted the 'broadest synchronised global growth upsurge since 2010' (IMF, 2018).

After estimated global growth of 3.7% last year, the IMF in its January WEO update said that it expects the world economy to expand by 3.9% this year and next, both representing a 0.2 percentage-point upgrade relative to its previous projections. US growth was revised upwards markedly, to 2.7% this year and 2.5% next (up 0.4 and 0.6 percentage points, respectively, compared with the previous forecast). Japanese growth was revised up by a hefty 0.5 percentage points for this year (and 0.1 percentage points for 2019). Chinese growth was pushed up by 0.1 percentage points for both years.

The IMF's view that the current upswing has quite a lot further to run appears reasonable. The US remains a key part of the global economy, and as a result events there will to a large extent dictate the pace of global growth. US growth is already at robust levels, and the massive tax cut for firms and the rich (and to a lesser extent everyone else) will be positive for economic activity, at least over a 1-2 year horizon. Estimates of the impact of tax cuts on growth vary, but 1.5 percentage points over the next two years is possible (the longer-term impacts are likely to be less positive). More generally, monetary policy remains extraordinarily loose at the global level. The aggregate stock of the balance sheets of the Fed,

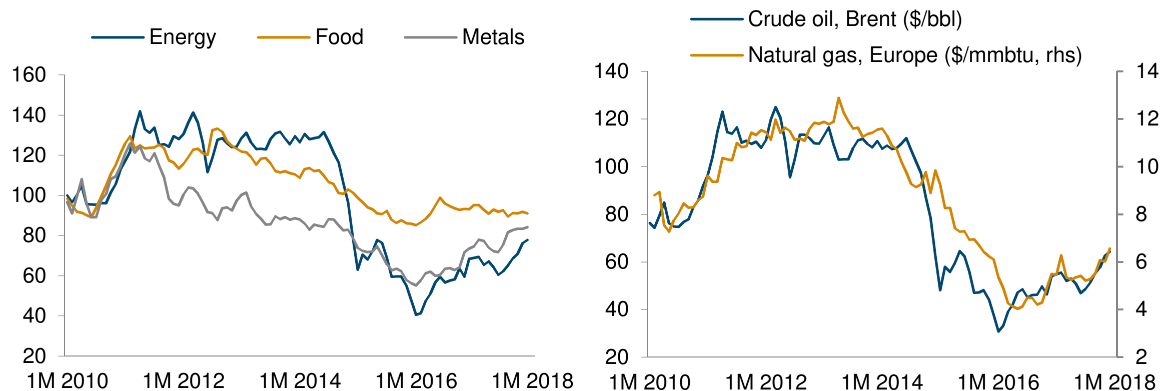
[1] The author would like to thank Robert Stehrer for valuable input on the external trade section, as well as Vasily Astrov, Vladimir Gligorov, Peter Havlik, Mario Holzner and Olga Pindyuk for comments.

European Central Bank (ECB), Bank of Japan and the Bank of England is close to 40% of GDP, according to the IMF (IMF, 2017).

The commodity markets appear likely to remain broadly supportive of growth. The oil price has risen, but at current levels represents something of a ‘sweet spot’: high enough to be acceptable to oil exporters, but low enough not to cause problems for oil importers. Food prices could tick higher in the near term, but neither they nor metals prices are likely to spike to the extent that they challenge growth. The IMF expects non-fuel commodity prices to fall by 0.5% this year, before rising by 1% in 2019.

Figure 1 / Global commodity prices, 2010-2017

World Bank's commodity price indices, 2010=100 **Crude oil and natural gas prices (USD)**



Source: World Bank.

EUROZONE: FROM LAGGARD TO LEADER

The upswing in the Eurozone – which is particularly important for CESEE countries, given the heavy levels of trade and investment integration[2] – appears as well established as at any point since 2011 (and maybe earlier). From the Eurozone perspective, the current recovery has been very slow by historical standards, consistent with the idea that crises caused by excessive leverage tend to be followed by relatively weaker upturns (Reinhart and Rogoff, 2014). The current recovery from the 2008-2009 global financial crisis and subsequent ‘double-dip’ Eurozone crisis began around 2013-2014. The conditions at that point included massive global stimulus, including ultra-loose monetary policy by the ECB, a (linked) weaker euro, the collapse in the oil price in 2014, and strong demand from key markets in the rest of the world.[3]

More recently, however, domestic drivers of growth have started to take up the slack, leading to a more broad-based, sustained and increasingly strong recovery in the single currency area. Private spending is now being supported by a much more pronounced recovery in employment across

[2] On average, 63% of CESEE nominal merchandise exports went to the EU in 2016. For many countries, the share was over 80%.

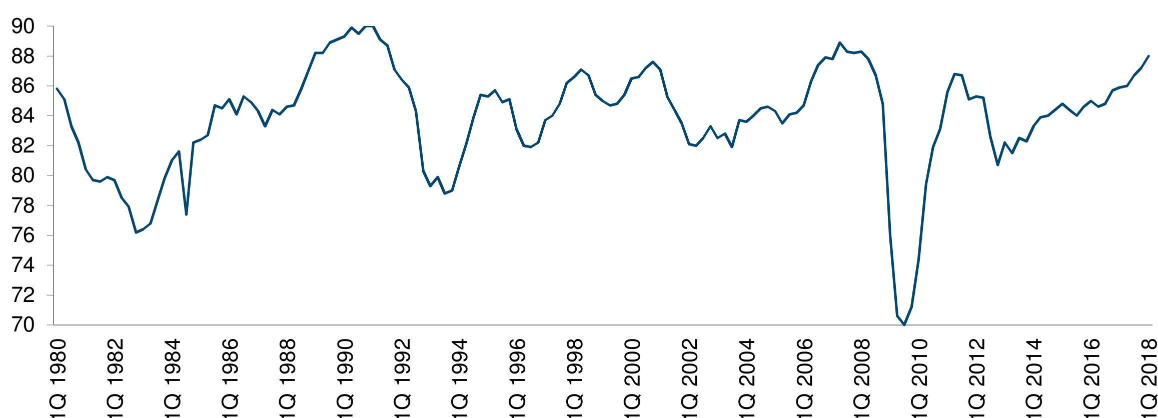
[3] The importance of external demand in driving the recovery is evidenced by the Eurozone current account with the rest of the world, which moved from a EUR 10 billion deficit in 2011 to a surplus of EUR 134 billion the following year, and EUR 331 billion by 2015, according to Eurostat.

most of the bloc. Higher demand has led to rising production of consumer and industrial goods,[4] meaning that firms are increasingly pushing up against capacity constraints, leading to more hiring and investment and therefore more demand, creating a virtuous cycle. The European Commission's economic sentiment indicator for the Eurozone was only slightly below a 17-year high in January 2018. Investment in the bigger countries – which has generally lagged behind the recovery and is important for lifting the recovery to the next stage – has risen, and was well above overall growth last year (investment data for the Eurozone on aggregate are distorted by huge swings in Ireland). This is happening in the context of highly supportive background conditions: financing is extremely cheap and easy to access (outside Greece, where the private sector continues to face some barriers in accessing credit), inflation remains at benign levels, and the ECB is only exiting its ultra-loose monetary policy extremely slowly.

Positive conditions are notably evident in Germany, the linchpin of the European economy. According to the European Commission Winter Forecast, released in February 2018 (European Commission, 2018), the German economy grew by 2.2% last year, and should expand by a further 2.3% this year. Recent high-frequency indicators point to boom-like conditions in Europe's most important economy. In January 2018, the Purchasing Managers' Index (PMI) for services – which accounts for most of the German economy – reached its highest level for 82 months. While Germany clearly leads the way, much of the rest of the Eurozone is following in its footsteps, pointing to an ever more broad-based recovery. The European Commission revised up its real GDP forecast for France, Spain, Italy and Austria this year. For the single currency area as a whole, the Commission's growth estimate for 2017 was 2.4%, while it forecast real GDP growth in 2018 at 2.3% and in 2019 at 2% (up 0.2, 0.2 and 0.1 percentage points, respectively, from the autumn 2017 forecast). Having piggy-backed on the global recovery for much of the time in recent years, the Eurozone now appears in many ways to be leading it.

Figure 2 / Current level of capacity utilisation in Germany 1980-2018, in %

seasonally adjusted data, not calendar adjusted data



Remark: Until 1990 former territory of the FRG.
Source: Eurostat.

The cyclical upturn is likely to peak this year; but even in 2019, the Commission expects headline real GDP growth in the Eurozone to be well above potential.[5] Although supply-side constraints are

4 For a more detailed examination of trends in industrial output, see Holzner (2017).

5 The European Commission estimates potential Eurozone growth at 1.5%.

increasingly evident in some countries (especially Germany), there are past examples where actual growth in the Eurozone has outpaced the expansion of potential output for several years after the closing of the output gap.[6] Moreover, according to the Organisation for Economic Co-operation and Development (OECD), output gaps are still negative for most of the key economies in the region; and for France, the output gap is expected to be still negative in 2019. The pick-up in investment could run for quite some time, with gross fixed capital formation's share of GDP still at only around 20% for the Eurozone as a whole, compared with over 23% before the crisis. Within investment, construction is the chief laggard, likely owing to both lower public investment in infrastructure and the long legacy of the crash in the residential construction sector in some countries (Buti et al., 2018).

II. GOLDILOCKS CONDITIONS SHOULD PERSIST IN CESEE[7]

Much of CESEE has joined the party at the global level. Two developments in particular emphasise the positive trends:

1. **Average growth in the 22 countries of CESEE has strengthened to a level not seen in six years. On average across the region, wiiw estimates that growth reached 3.7% last year, the highest level since 2011.**

2. **All countries in the CESEE region for which we provide forecasts posted positive growth in 2017, for the first time since 2007.**

High-frequency indicators suggest an increasingly positive near-term outlook. Manufacturing PMIs remain well above the 50 level separating contraction from expansion, and in many cases are continuing to rise from already historically high levels. The Czech manufacturing PMI reached its joint highest level since 2011 in January,[8] while in the same month output growth in Turkey hit a more than four-year high. In Poland, January marked the fastest increase in manufacturing new orders for three years. Although sentiment readings for the regional laggards (the CIS, Ukraine and parts of the Balkans) are lower, they nevertheless remain firmly in expansionary territory, and on balance have in recent months signalled a firming of momentum. Russia's manufacturing PMI reached a six-month high in January (although this contrasts with some domestic surveys, which point to weaker trends in industry).

Against the highly supportive global backdrop, growth in CESEE should continue to expand at a healthy rate this year and during the forecast period. While 2017 is likely to have marked the peak of the current upswing, we expect growth to remain at robust levels in the post-2011 context. After an estimated aggregate expansion of 3.7% last year, we forecast CESEE growth of 3.1% in 2018, 2.9% in 2019, and 2.8% in 2020. This is 0.8-0.9 percentage points higher than the forecast Eurozone rate for 2018-2019, indicating a relatively good pace of convergence over the period. Moreover, for 2018 in particular, the risks to growth in CESEE are probably to the upside.

---

[6] The European Commission's measure of the output gap has been questioned; see, for example, Heimberger and Kapeller (2017).

[7] The 'goldilocks economy' has been used regularly by commentators in recent years to describe conditions including low unemployment, inflation and interest rates, strong and steady economic growth and rising asset prices.

[8] All PMI data from IHS Markit, https://www.markiteconomics.com/public/page.mvc/pressreleases

Table 3 / Real GDP growth forecast and revisions

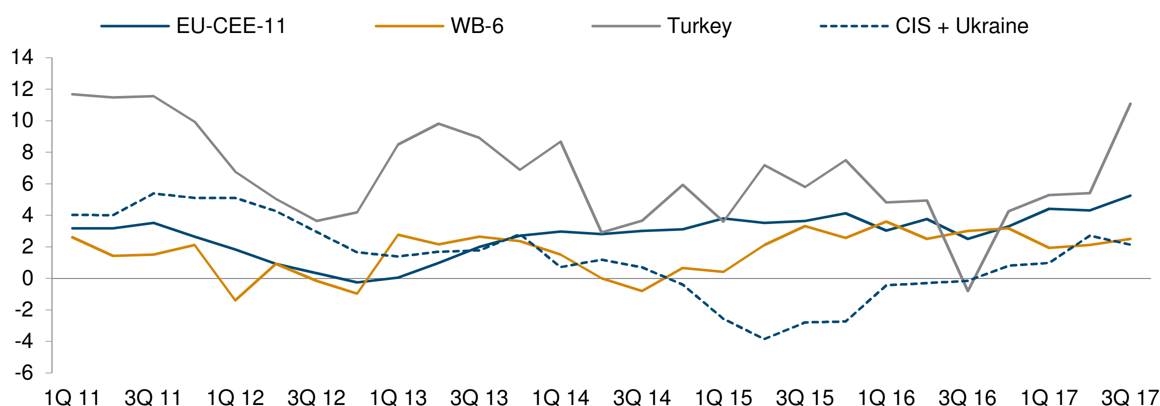
		Forecast, %				Revisions, pp		
		2017	2018	2019	2020	2017	2018	2019
EU-CEE	BG	3.8	3.6	3.5	3.4	→ 0.0	↓ -0.1	→ 0.0
	CZ	4.2	3.5	3.2	3.2	↑ 0.5	↑ 0.3	↑ 0.2
	EE	4.3	3.5	2.9	2.5	↑ 0.5	↑ 0.2	→ 0.0
	HR	3.0	2.7	3.0	3.0	→ 0.0	→ 0.0	→ 0.0
	HU	4.0	3.8	2.6	1.7	→ 0.0	↓ -0.1	↓ -0.4
	LT	3.9	3.2	2.6	2.2	↑ 0.1	↓ -0.3	↓ -0.2
	LV	4.5	3.8	3.3	2.7	↑ 0.3	→ 0.0	↑ 0.1
	PL	4.6	3.8	3.5	3.3	↑ 0.8	↑ 0.3	↑ 0.2
	RO	6.9	4.7	3.8	4.2	↑ 1.2	↑ 0.2	↓ -0.8
	SI	4.6	3.9	3.5	3.5	↑ 0.6	→ 0.0	↓ -0.2
	SK	3.4	3.8	4.2	3.3	↑ 0.1	↑ 0.2	↑ 0.2
WB	AL	3.9	4.1	4.0	3.9	→ 0.0	↓ -0.1	↓ -0.1
	BA	3.0	3.4	3.3	3.3	→ 0.0	→ 0.0	↓ -0.2
	ME	3.9	2.9	3.0	3.1	↑ 1.2	→ 0.0	→ 0.0
	MK	0.5	3.4	3.4	3.2	↓ -1.3	↑ 0.3	→ 0.0
	RS	1.9	2.8	2.8	2.8	→ 0.0	↑ 0.3	↑ 0.1
	XK	3.9	3.9	3.8	3.8	↑ 0.2	↑ 0.1	→ 0.0
Turkey	TR	6.5	4.5	4.1	3.9	↑ 1.1	↑ 0.6	↑ 0.2
CIS +UA	BY	2.4	2.8	3.1	3.1	↑ 0.4	↑ 0.5	↑ 0.5
	KZ	3.8	3.0	3.0	3.0	↑ 0.8	→ 0.0	↓ -0.5
	RU	1.5	1.8	1.6	1.6	↓ -0.2	↓ -0.1	↓ -0.3
	UA	2.1	2.9	3.2	3.2	↑ 0.1	↓ -0.1	↑ 0.2

Remark: Current forecast and revisions relative to the wiiw Autumn forecast 2017. Colour scale reflects variation from the minimum (red) to the maximum (green) values.
Source: wiiw forecast.

Within the region there is significant differentiation. The Romanian and Turkish economies, in particular, were booming last year, with growth estimated at 6.9% and 6.5%, respectively. Growth across the EU-CEE has generally been strong: the Czech Republic, the three Baltic states and Slovenia are all estimated to have grown by 4% or more in 2017. In the CIS, Ukraine and parts of the Balkans, however, while growth is back into positive territory and an upswing is under way, momentum is more subdued.

Figure 3 / Quarterly real GDP growth of the CESEE countries

change in % against preceding year



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

2018: FULL SPEED AHEAD FOR MOST, CONTINUED RECOVERY FOR THE REST

We expect Romania to be the fastest growing economy in the CESEE region again this year, although the rate of expansion will slow to 4.7% (up 0.2 percentage points on our autumn 2017 forecast). We think that parts of the policy mix will create bigger risks further down the line, and that growth is unbalanced and unsustainable (see 'Is CESEE overheating' section below), but the problems are unlikely to materialise this year.

Our biggest upward revision is for Turkey this year, with growth now forecast to be 4.5%, from 3.9% at the time of our last forecast. Turkish growth numbers have been highly volatile in recent quarters, but in general have been extremely strong, reflecting a combination of government stimulus and strong external demand. Growth is unlikely to get close to 2017's estimated 6.5%, but spill-over effects from last year, additional (albeit reduced) government stimulus, and highly supportive external conditions will continue to keep Turkey among the region's fastest growing economies.

No other country in the EU-CEE will match Romania's growth rate in 2017, but the region overall will have another good 12 months. Our forecast for EU-CEE aggregate real GDP growth of 3.9% this year is lower than the estimated 4.4% in 2017, but will keep the region on a clear convergence path with wealthier parts of the bloc (Germany is likely to grow at a bit over 2% in 2018). Along with Romania, we made upward revisions to our 2018 forecasts for Poland, the Czech Republic, Estonia and Slovakia.

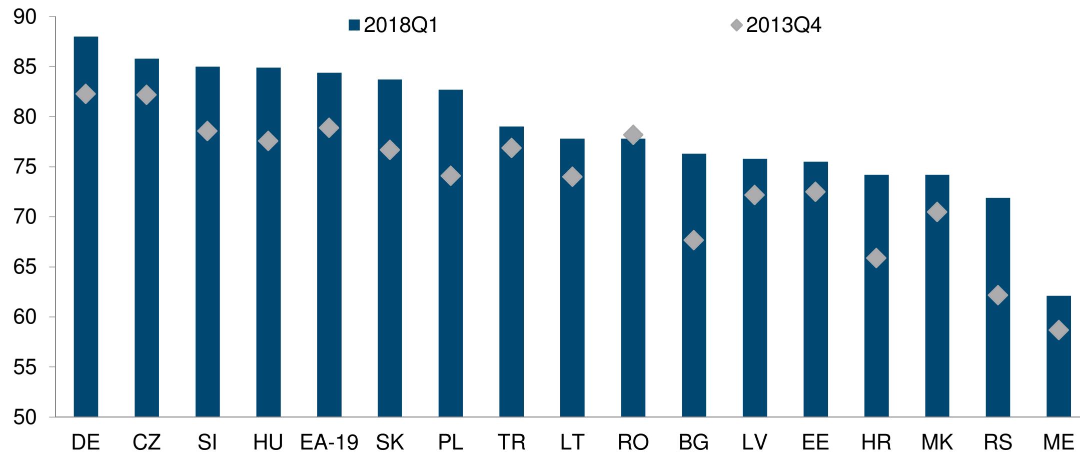
Across the EU-CEE countries, growth is becoming increasingly broad-based and entrenched, with most demand components of GDP contributing positively. Booming external demand on the back of the coordinated Eurozone and global upswing will continue to drive exports. In the Baltic states, part of the support for external demand is being driven by the recovery in the CIS and particularly Russia.[9] In Croatia, a tourism boom is helping to drive growth. The firming of the new EU funds cycle and pick-up in private investment on the back of better economic sentiment and higher capacity utilisation will boost gross fixed capital formation. Since 2013, capacity utilisation has risen strongly almost everywhere for which comparable data are available. In many countries of the region, capacity utilisation is back to (or even above) pre-crisis levels. Rising real wages (often partly reflecting increases in the minimum wage) will support private consumption, helped by strong labour market momentum and tighter labour markets. In the Czech Republic, for example, the vacancy rate reached 3.7% in 2017, a full percentage point higher than Germany.

---

9 Although the exchange of sanctions between the EU and Russia has seen some reorientation of Baltic states' exports away from their larger eastern neighbour since 2015, Russia remains an important source of external demand. In 2016 (latest full-year comparable data available), Lithuania still sent 13.5% of total nominal merchandise exports to Russia, with Latvia sending 11.4% and Estonia 6.5%; the average for the rest of CESEE (excluding the CIS and Ukraine) was just 1.7%. Source: wiiw Annual database.

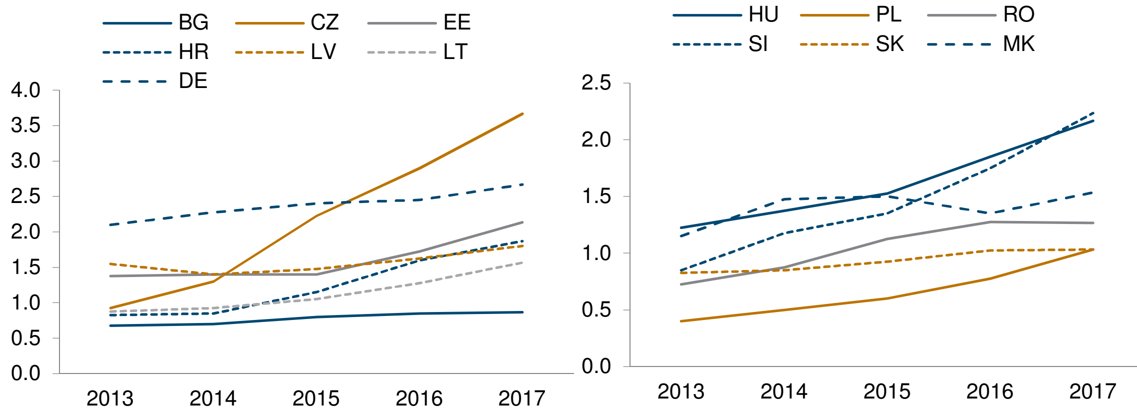
Figure 4 / Current level of capacity utilisation in %

seasonally adjusted



Source: Eurostat.

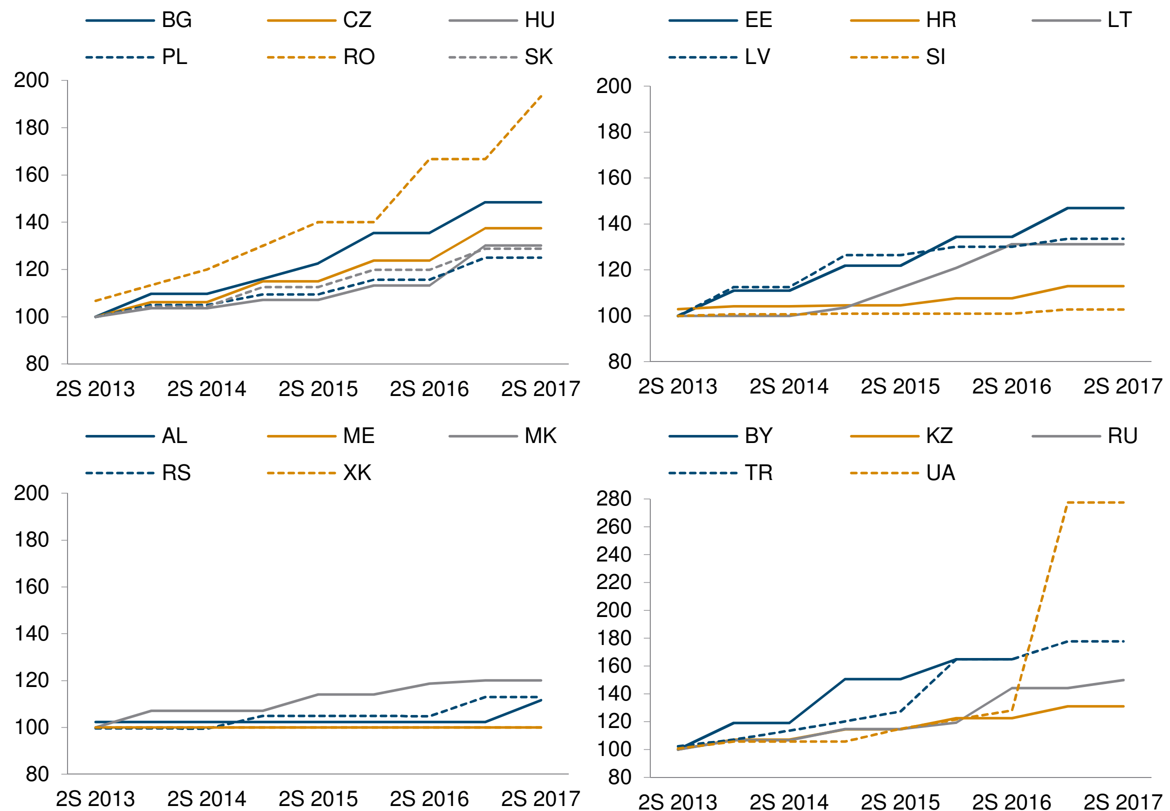
Figure 5 / Job vacancy rate, in %



2017 data are average of first three quarters of year.
Source: Eurostat.

Our aggregate forecast for real GDP growth in the Western Balkans rises to 3.3% for 2018, a 0.9 percentage-point improvement on 2017's estimated growth rate. A major factor here will be better growth in Serbia, the linchpin of the region, which we expect to expand by 2.8% – up from 1.9% last year on the back of rising wages and pensions and the consequent positive stimulus for consumption growth. The region's top performer will be Albania, where growth will reach 4.1%, helped by big infrastructure projects, rising consumption and tourism. Growth in Macedonia will surge to 3.4% (from 0.9% last year), helped by supportive external factors and subsiding political tensions. Kosovo and Bosnia will both grow at well above 3%. The only negative is Montenegro, where growth will slow to 2.9%, a full percentage point lower than last year, related in part to fiscal consolidation.

Figure 6 / Monthly gross minimum wages, half-year data, NCU, 2013=100



Source: Eurostat and national sources.

A key factor driving growth in the Balkans will be supportive external factors, with the region's economies increasingly integrated with Western Europe. The share of merchandise exports in GDP has reached fairly high levels in recent years in Macedonia (44.5% as of 2016), Serbia (38.8%) and Bosnia (31.5%), allowing all three to benefit from rising demand in key markets (see section III for a more extensive discussion of these trends). The new EU strategy for the Western Balkans, and the potential injection of new momentum into these countries' accession prospects, would result in higher FDI inflows.

A relative tourism boom in parts of the region is important, and should continue this year. This is being supported by heightened perceptions of security risk in Turkey, North Africa and other competitor markets, as well as strong income growth in sources such as Germany. Countries are getting better at encouraging year-round tourism (rather than just in the summer months), and have expanded their sources of tourists (particularly with more arrivals from Asia). As well as countries with long coastlines, such as Croatia, Montenegro and Albania, tourism growth numbers for countries with fewer geographical advantages, such as Bosnia, have also been impressive.

For several years the CIS and Ukraine region has been the weakest performer of the CESEE sub-regions, and this will remain the case in 2018. However, a recovery of sorts is under way, and we expect the region to grow by 2% on aggregate this year. Higher oil prices will be supportive in parts of the region, notably Kazakhstan, where we expect growth of 3%, easily the highest in the region. We

have revised our forecast for Belarus upwards by 0.5 percentage points to 2.8%, largely on the back of supportive external conditions. Ukraine will grow by 2.9%, a 0.1 percentage-point reduction compared with our previous forecast.

Russia remains the key to the wider region, but the economy is characterised by a severe lack of dynamism. Stability has returned after a difficult few years, but there are few drivers of growth in the near term, except rising oil prices. Import substitution in the wake of Western sanctions has had mixed results, although positive developments are visible in the agricultural and food sectors, helped by good recent harvests. We forecast growth of 1.8% this year, down 0.1 percentage points from our previous forecast. The upcoming presidential election will not result in any economic implications. Turnout will be a key factor to watch, especially in the cities (a lower turnout would confirm resignation and apathy). President Vladimir Putin and the system around him look safe, because of a lack of alternatives, as well as the mobilising effect of the annexation of Crimea and perceived external threats (the former was popular domestically, even among some who are otherwise not Putin supporters).

Higher growth in the region will be prevented by a lack of reforms and a generally tight policy mix. In Russia, the central bank has done a good job of stabilising the economy, but looks set to retain a relatively tight policy stance for the foreseeable future (although policy is being slowly loosened). Russia's sovereign credit rating was revised back up to investment grade by S&P in February. This could support sentiment, but is unlikely to be decisive on its own in lifting growth. The potential for new US sanctions creates additional uncertainty. Near-term risks remain multiple and significant in Ukraine, amid continued friction with the IMF and internal political instability. No IMF funding has been received since last April.

IS CESEE OVERHEATING?

On the back of ever-stronger growth numbers for much of CESEE, and especially EU-CEE, there has been media discussion about whether the region is overheating.[10] We have studied the issue, using the IMF's 2013 global overheating index (with some adjustments and using wiiw data) as a starting point and applying it to our region (the original IMF index only included Turkey and Russia from CESEE). In short, our answer is 'no' (see below).

Certainly, pockets of potential overheating are visible, including tight labour markets, high external debt (at least in the Visegrád countries, Turkey and the Western Balkans; less so in the CIS, Ukraine and the rest of the EU-CEE), negative real interest rates, and booming property prices (this only applies to the EU countries; comparable data for the rest of the region are not available). However, there is little sign of inflation as a result, credit growth is overall contained (by historical standards), and fiscal balances are mostly well under control. Regionally, the area where conditions approaching overheating are most concentrated is in the EU-CEE countries (particularly in some of the Visegrád states and Romania and Turkey). The Western Balkans are somewhere in between, while conditions in the CIS and Ukraine are more generally on the cool side.

[10] Following strong Q3 2017 releases, articles about potential overheating in the EU-CEE have appeared in, among others, the *Wall Street Journal*, Bloomberg, the *Economist*, the *Financial Times* and Reuters.

Table 4 / Overheating index

	Sub-category averages			Domestic economy			External finance			Domestic finance				
	Domestic economy	**External finance**	**Domestic finance**	Real GDP growth	Unemployment	CPI	Current account	RER	External debt	RIR	Private credit	M3	Fiscal balance	Property prices
	average	***average***	***average***	*% per year*	*%*	*% year on year*	*% of GDP*	*% year on year*	*% of GDP*		*% year on year*	*% year on year*	*% of GDP*	*% year on year*
Bulgaria	0.2	-0.5	-0.3	0.0	1.3	-0.7	-1.2	0.4	-0.7	-0.4	-0.5	-0.8	-0.3	0.3
Czech Republic	1.1	0.5	0.5	0.5	2.5	0.2	-1.6	0.7	2.4	1.4	-0.5	1.0	-1.7	2.5
Estonia	0.4	0.0	0.1	0.1	1.0	0.0	-1.2	1.4	-0.2	1.3	-0.5	-0.7	0.5	-0.2
Croatia	0.2	-0.6	-0.1	0.4	0.7	-0.6	-1.9	0.2	0.1	1.0	-0.7	-0.7	-1.9	1.7
Hungary	0.5	-0.6	0.5	0.7	1.7	-0.7	-1.2	-0.1	-0.3	2.3	-0.1	0.3	-1.0	1.1
Lithuania	0.5	0.3	0.0	-0.1	1.0	0.4	-1.1	1.2	1.0	1.4	-0.4	-0.6	-1.0	0.4
Latvia	0.2	0.3	-0.2	0.1	0.7	-0.2	-0.7	0.8	0.7	0.8	-0.5	-0.9	-0.5	0.3
Poland	0.6	-0.4	0.0	0.6	1.5	-0.4	-1.8	-0.6	1.1	1.1	-0.8	-0.9	-0.7	1.5
Romania	1.0	-0.2	0.1	0.9	2.8	-0.8	-0.6	0.0	0.1	0.5	-0.6	-0.7	-0.1	1.4
Slovenia	0.0	-0.5	0.4	0.7	-0.1	-0.6	-1.8	-0.1	0.4	1.4	-0.2	0.1	-0.9	1.4
Slovakia	0.3	0.5	-0.2	-0.2	1.8	-0.7	-0.9	0.7	1.7	0.7	-0.1	-0.5	-1.1	0.1
Albania	-0.1	0.7	-0.8	-0.2	0.4	-0.6	-0.3	1.2	1.3	1.7	-0.9	-1.5	-2.4	
Bosnia and Herzegovina	0.8	-0.4	-0.1	0.0	2.7	-0.3	-1.2	-1.4	1.5	0.8	-0.3	-0.4	-0.6	
Montenegro	0.4	0.5	-0.1	0.4	1.3	-0.4	-0.3	0.9	1.0	0.9	-0.4	-0.4	-0.3	
Macedonia	0.3	0.2	-0.3	-0.8	2.1	-0.3	-1.1	-0.2	1.9	0.7	-0.9	-0.9	-0.1	
Serbia	-0.1	0.2	-0.7	-0.4	0.7	-0.6	-0.6	0.7	0.5	-0.1	-1.0	-0.9	-0.7	
Turkey	-0.2	0.2	-0.1	0.3	-0.5	-0.3	0.5	-1.1	1.3	0.9	-0.7	-0.5	-0.4	
Kazakhstan	0.0	0.5	-0.7	-0.8	1.0	-0.4	0.5	-0.8	1.8	-1.7	-0.8	-1.4	1.1	
Russia	-0.3	0.4	-0.9	-0.5	1.2	-1.7	1.0	0.5	-0.3	-1.5	-1.4	-1.7	1.0	
Ukraine	-0.2	0.1	-0.6	-0.1	-0.8	0.1	0.5	-1.5	1.3	0.1	-0.9	-1.2	-0.1	
Regional averages														
V4	**0.6**	**0.0**	**0.2**	0.4	1.9	-0.4	-1.4	0.2	1.2	1.4	-0.4	0.0	-1.1	1.3
EU-CEE	**0.4**	**-0.1**	**0.1**	0.3	1.4	-0.4	-1.3	0.4	0.6	1.1	-0.5	-0.4	-0.8	1.0
CIS + Ukraine	**-0.2**	**0.4**	**-0.7**	-0.5	0.5	-0.6	0.7	-0.6	0.9	-1.0	-1.0	-1.4	0.7	
Non-EU WB	**0.3**	**0.2**	**-0.4**	-0.2	1.4	-0.5	-0.7	0.2	1.2	0.8	-0.7	-0.8	-0.8	

Note: Numbers refer to standard deviations from 2000-2017 average levels. Where relevant, negative data are adjusted to absolute values so that positive values always correspond to greater evidence of overheating. Colours correspond to range; red = overheating, blue = under-heating. CPI = consumer price inflation; RER = real exchange rate; RIR = real interest rate.
Source: wiiw Database incorporating national statistics and wiiw estimates.

According to our heat map, Romania and the Czech Republic are the clearest candidates for overheating. In both cases, this reflects very strong current levels of real GDP growth relative to the historical trend. For Romania, the overheating concerns are at least partly justified: the (unstable) government is pursuing a strongly pro-cyclical fiscal policy and rapidly increasing the minimum wage at a time of already very strong growth. The current account deficit is widening, and the currency depreciating. In the case of the Czech Republic, we are much less concerned. Growth is certainly strong, but is not being artificially stimulated by risky short-term policy measures, and the central bank is pursuing a prudent monetary policy. Strong growth does not appear to be leading to any signs of overheating more generally (inflation is remarkably subdued, considering the tightness of the labour market). Shortages in the labour market are being met, at least to an extent, by imported labour from Ukraine.

Turkey is also a potential candidate for overheating. Rising external debt, a widening current account deficit and very negative real interest rates are causes for concern, while real GDP growth is above trend. However, other indicators suggest less of a reason to worry. Bank lending growth is strong, but not especially elevated by historical standards. Marginal credit is coming from abroad, although the Credit Guarantee Fund (CGF) is quite strictly controlled; banks have strong incentives to maintain credit quality standards. Fiscal policy has been heavily pro-cyclical, but public debt is low (reflecting historical caution) and the fiscal deficit is not especially wide by regional standards. Although the current policy mix could produce risks over the medium term, particularly in relation to the external accounts (see section IV), this does not yet appear to be the case.

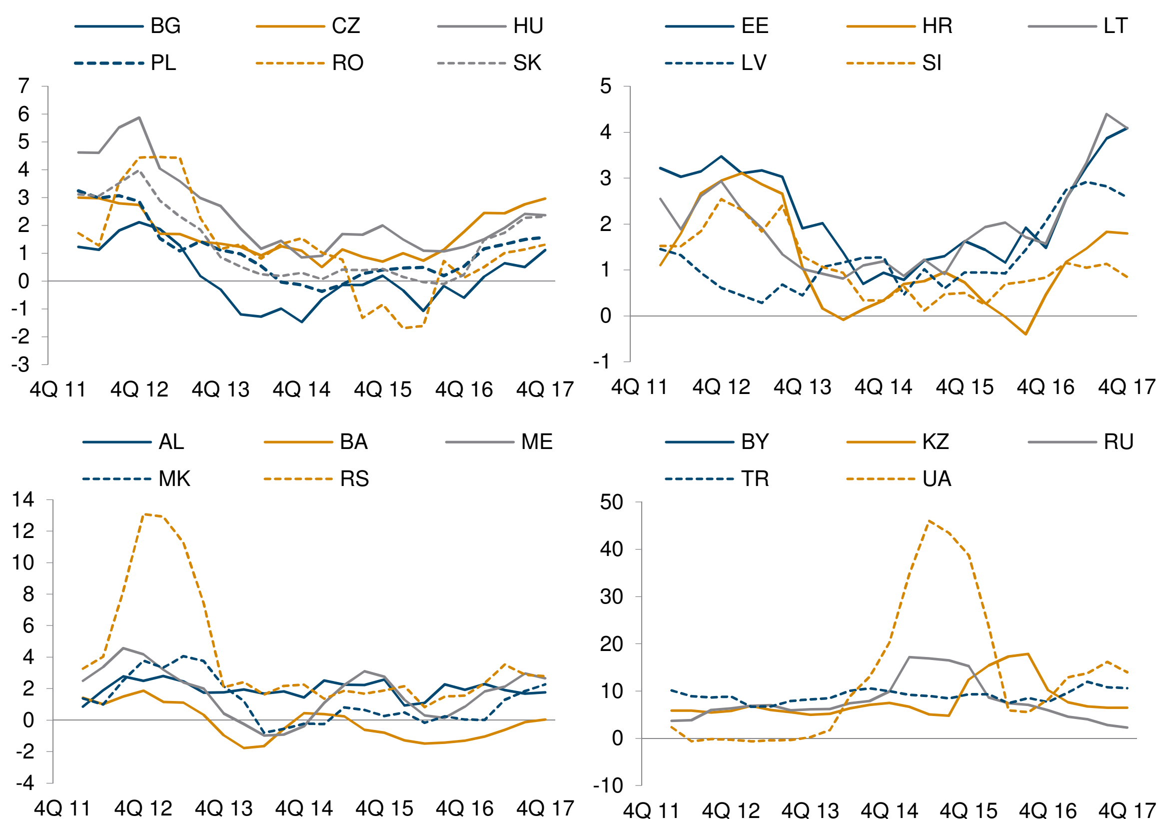
One area where overheating is potentially visible is property prices, at least for the EU Member States (comparable data for non-EU members is not available). Our analysis shows particularly strong growth relative to historical trends in the Czech Republic, Croatia, Hungary, Poland, Romania and Slovenia. Surging property prices have been a theme across much of Western Europe in recent years as well, reflecting ultra-loose monetary policy and a (linked) lack of yield across many asset classes, which has forced many investors into property. However, in EU-CEE this does not appear to have been combined with a big increase in household leverage. Of the countries for which data are available, only in Poland (+11.4 percentage points) and the Czech Republic (+8.4 percentage points) have household debt/income ratios risen since 2009, according to Eurostat. In 2016, both stood at around 60%, less than two-thirds of the Eurozone average.

Policy responses to signs of overheating are most likely to come in Romania, although perhaps only from external (EU) sources. In 2017, pro-cyclical fiscal policies in particular stimulated a boom in household consumption. Our expectation that monetary and fiscal policy will become tighter is a key factor supporting our view that economic growth will slow from its 2017 level. Although the authorities may be slow to act, we expect the fiscal deficit this year to widen beyond 3% of GDP, which will prompt action from the European Commission. On the monetary side, the central bank has preferred to highlight tighter fiscal policy as a means of cooling the economy, but it increased its benchmark rate by 0.25 percentage points in both January and February, becoming the second central bank in the region (after the Czech Republic) to start to lift rates from record lows. Monetary tightening on a stronger scale has already taken place in financial markets, with the yield on 10-year government bonds rising to 4.7% in February 2018, compared with 3.5% in the first quarter of last year, according to Bloomberg data. We have revised down our 2019 real GDP forecast for Romania by 0.6 percentage points, partly in expectation that the policy stance will alter to cool growth.

Further monetary tightening in the Czech Republic and Romania is likely this year, but other central banks in the EU-CEE are unlikely to follow. Although some indicators, notably house prices and wage rises, will be closely watched, the pass-through to core inflation is likely to remain limited, which will keep central banks in generally dovish mode. The fact that the ECB will not raise rates this year is a further factor which will prevent rate rises in Poland and Hungary. We expect the implications for currency markets to be quite limited: the Czech koruna and Polish złoty will undergo moderate appreciation against the euro, while the Hungarian forint and Romanian leu will weaken somewhat.

Figure 7 / Core inflation (HICP/COICOP), overall index excluding energy

change in % against preceding year



Remark: Core inflation: refers to overall index (HICP) excluding energy (according to COICOP classification energy comprises: 045 Electricity, gas and other fuels and 0722 Fuels and lubricants for personal transport).
RU: COICOP 072 Operation of personal transport equipment instead of 0722 used.
KZ: Core inflation – excluding the rise in prices for fruits and vegetables, gasoline, and coal.
Source: Eurostat and national statistics.

In Turkey, the central bank will gradually tighten policy, but will maintain a monetary stance much looser than the market would like, and as a result the lira will stay weak. The muted monetary response to the conditions described above will be treated warily by the market, and we could see Turkey suffer at times of heightened global financial volatility (see section IV for a more extensive discussion of these issues). However, inflation should start to come down this year, and we expect the lira to stabilise somewhat. Fiscal policy is also likely to be less loose than last year, while the government's unwillingness to expand the CGF should see credit growth cool somewhat (other factors which could weigh on credit growth are discussed in the 'Banking sector' section below).

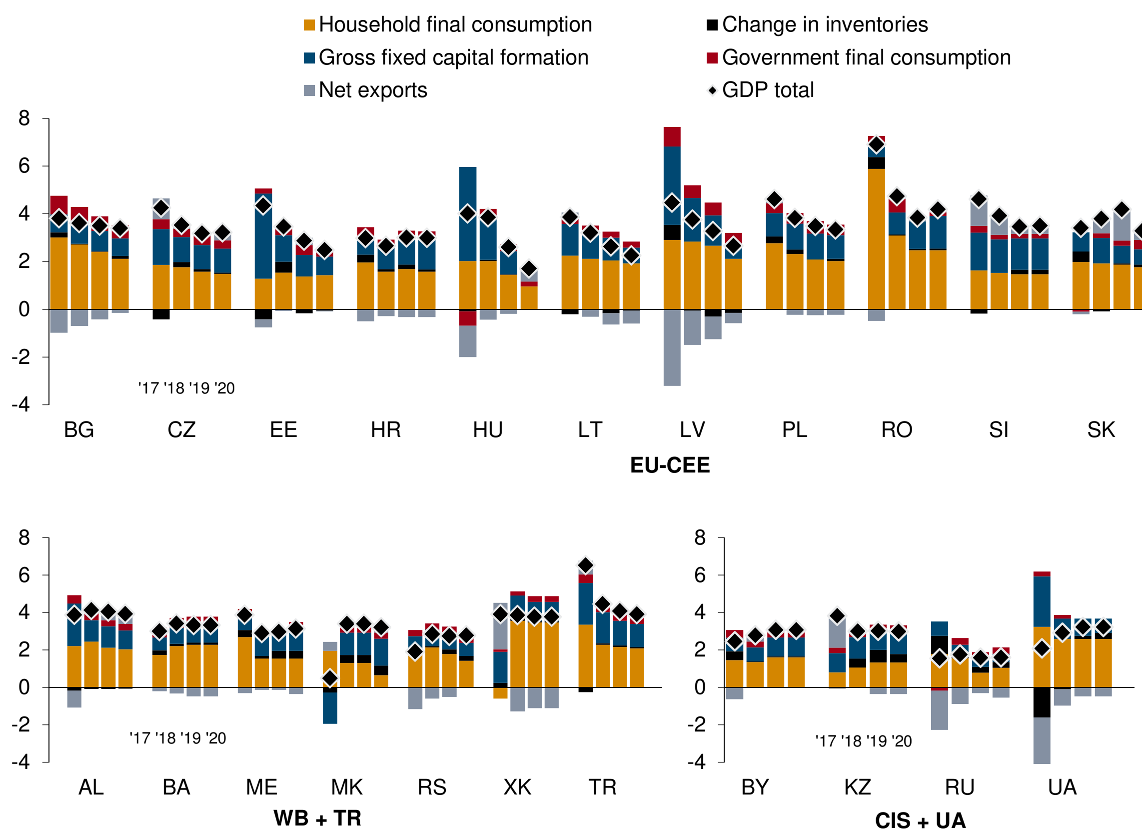
In Russia and Ukraine, the environment is very different, with under-heating more of a concern than overheating. We expect both currencies to weaken versus the euro over the forecast period.

III. MEDIUM-TERM OUTLOOK: GRADUALLY DRAGGED DOWN BY WEAK POTENTIAL

The medium-term outlook for most of the region appears quite healthy. Overall growth is at a high level in the post-crisis context, while inflation is low and there are few signs of the emergence of big imbalances. The 'goldilocks' conditions could feasibly last well beyond this year. In particular, conditions in the countries which have previously lagged in the recovery should improve. Across the CIS and Ukraine, growth will average around 2% per year in 2018-2020 (dragged down by Russia), compared with -0.3% in the three years to 2017. Serbia, Macedonia and Albania will also see considerable improvements in their average growth rates compared with the last three years.

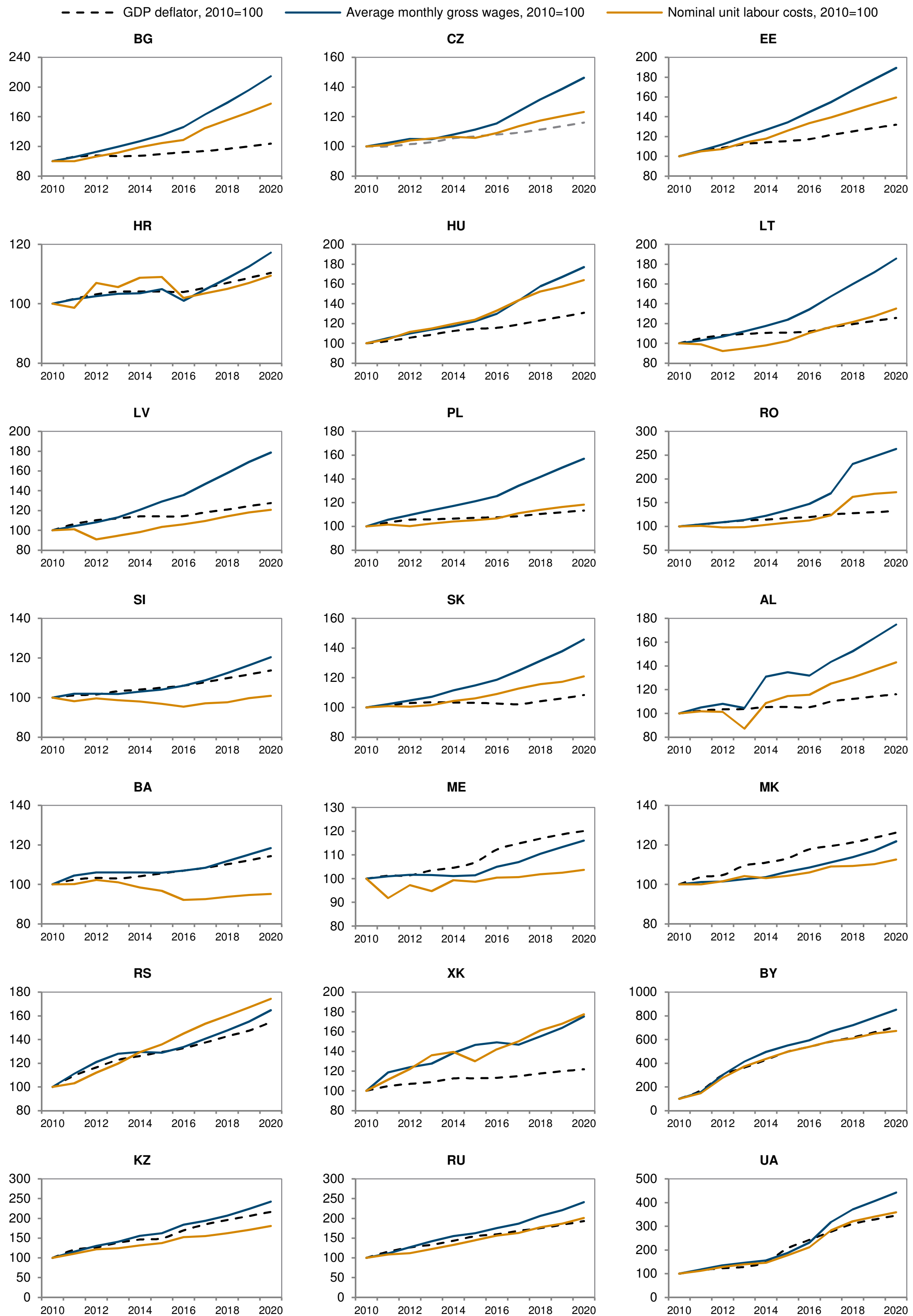
Figure 8 / GDP growth in 2017-2020

and contribution of individual demand components in percentage points



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

Figure 9 / Wages, unit labour costs and inflation, 2010-2020



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

Consumption will be the main driver of growth during the forecast period across most or all of the region. Positive labour market developments should continue: we expect the aggregate unemployment rate for CESEE to fall to 6.5% by 2020, from 7% in 2017. Some countries in the EU-CEE appear to be at, or close to, full employment, but jobless rates in other parts of the region, notably the Western Balkans, have much more room to fall. Tighter labour markets should contribute to moderate wage increases, while further hikes in the minimum wage in parts of CESEE are likely (the expected relationship between unemployment and wage growth appears still to be fairly strong in most of the EU-CEE, albeit less clear cut in the rest of the region). Robust remittance inflows (reflecting tight labour markets in Western Europe) will also support income growth in parts of the region, especially the Western Balkans. Consumer lending is likely to be less crucial, but should continue to recover (see the 'Banking sector' section below). Real income growth will be supported by low inflation: we expect average price growth in the EU-CEE of 2.4% over the period, and in the Western Balkans of 2.7%. Meanwhile consumer price growth will come down from higher levels in the rest of the region, especially Turkey and Ukraine.

Wage rises on the scale recently seen in parts of the EU-CEE are likely to generate fears about external competitiveness. However, our analysis – based on examination of the data – indicates that there remains little to worry about (with the possible exception of Romania). Nominal unit labour costs overall have grown considerably less than wages since 2010, reflecting improvements in productivity in a host of countries (this is part of the reason why inflation has remained so low). Unlike in the earlier transition years, labour productivity is unlikely to have been driven primarily by the supply side. As we argued in 2016, it is more likely that productivity gains have been driven by economies of scale and quality upgrading, with increases in overall output and export market shares raising the efficiency with which labour can be used.[11]

Investment is finally undergoing a significant upturn across most of the region, and this is likely to continue during the forecast period. Gross fixed capital formation has been comfortably the worst-performing component of GDP in the recovery across CESEE, and this remains the case in many countries. However, recent quarters indicate a pick-up in most places, and we expect this to continue. Gross fixed capital formation remains several percentage points below its pre-crisis levels almost everywhere, suggesting further room for growth. In the EU-CEE countries, the intensification of the current EU funds cycle will significantly support investment, as will efforts by countries such as Romania to increase their absorption capacity via reform. Meanwhile multilateral assistance will also be an important driver in the Western Balkans. Public investment is likely to remain elevated in Turkey.

Net exports are unlikely to make a big positive contribution to growth on aggregate across the region, reflecting rising consumption and investment, and consequently robust import growth. However, export growth is likely to be strong, owing to robust external demand. The CESEE region's ability to take advantage of better European and global growth is much higher than it was a decade ago. Particularly in the EU-CEE economies and parts of the Balkans, competitive export sectors have grown substantially over the past 10 (and indeed 20) years, concomitant with FDI-assisted greater integration into regional and global value chains. With export shares above 80% of GDP, the Czech Republic, Slovakia and Hungary are the most obvious beneficiaries. However, while starting from a low base, the growing importance of the external sector is also increasingly visible in other parts of the CESEE region.

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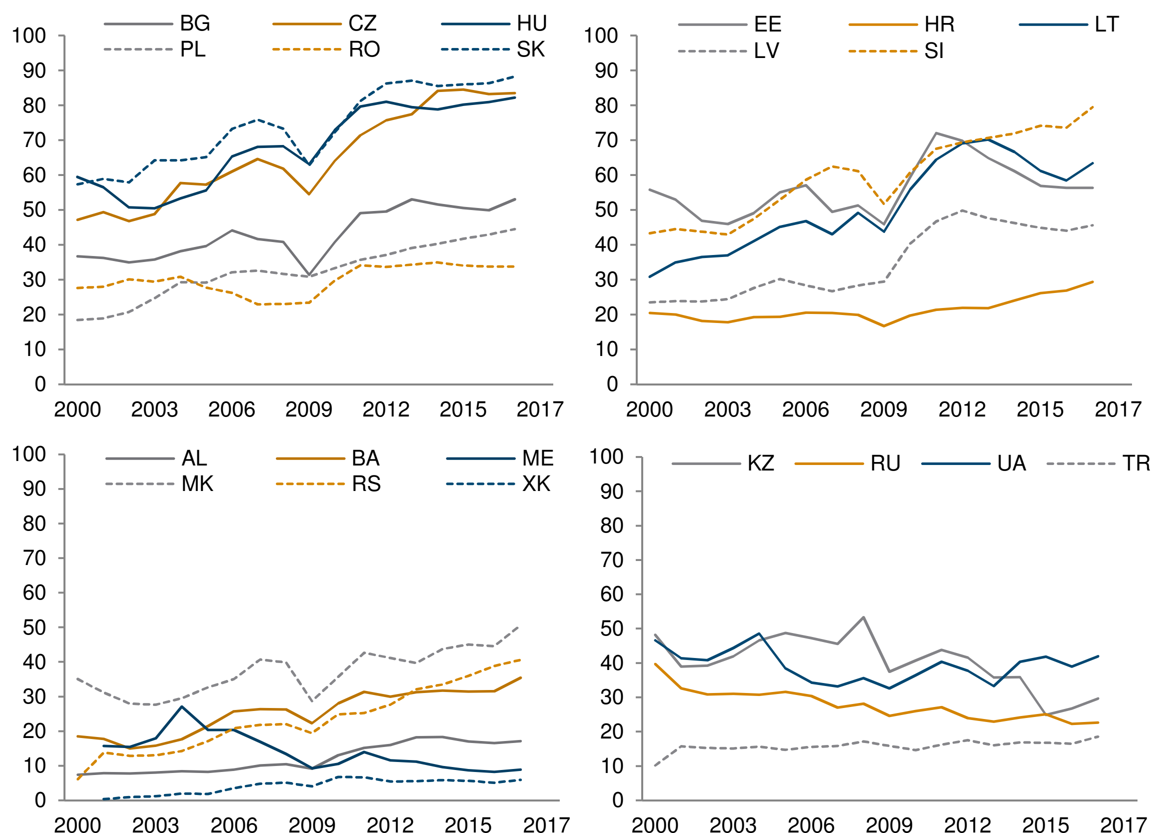
[11] For a longer explanation, see Astrov (2016).

Figure 10 / Total exports, in % of GDP

(based on customs statistics)



Source: wiiw Annual Database incorporating national and Eurostat statistics.

Like much else in Europe, Germany lies at the heart of this. The Visegrád countries in particular (but not only those) have integrated very heavily into the German supply chain in recent decades. The Czech Republic now exports more than one quarter of its GDP to Germany. A 2013 IMF study found notably high levels of business-cycle integration for the Visegrád countries with Germany (IMF, 2013). In the case of the Balkans, the integration into Western European value chains is also notable. Albania (69%) and Macedonia (65%), for example, both send a higher share of their exports to the EU-15 than any of the Visegrád countries.[12]

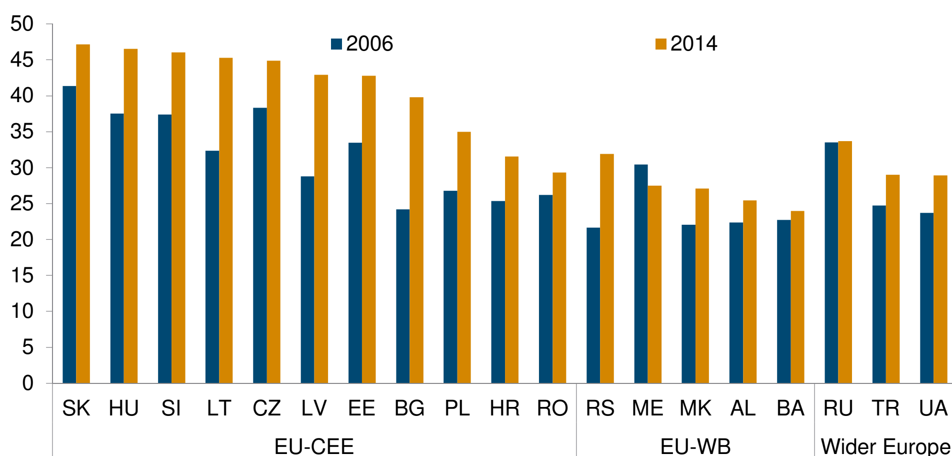
However, this integration does not mean a simple relationship between CESEE growth and German demand. Looking simply at export destinations often badly distorts the picture of which final-demand destinations are actually important for any particular economy. A closer examination of the data indicates that the relationship between CESEE and Germany is primarily in intermediate goods, meaning that final German demand is not the main determinant of CESEE exports to Germany (IMF, 2013). The main determinant of demand for CESEE exports is actually the rest of the world, i.e. where Germany exports to. In 2017, 37% of German nominal merchandise trade exports went to the rest of the Eurozone, 22% to the non-Eurozone EU (e.g. UK, Sweden and other parts of CESEE), and 41% to the rest of the world. Outside the EU, the most important export destinations for Germany are the US and

[12] wiiw Annual database, 2016 data.

China. These data indicate the crucial importance to CESEE economies of overall global growth, not just developments in the Eurozone.[13]

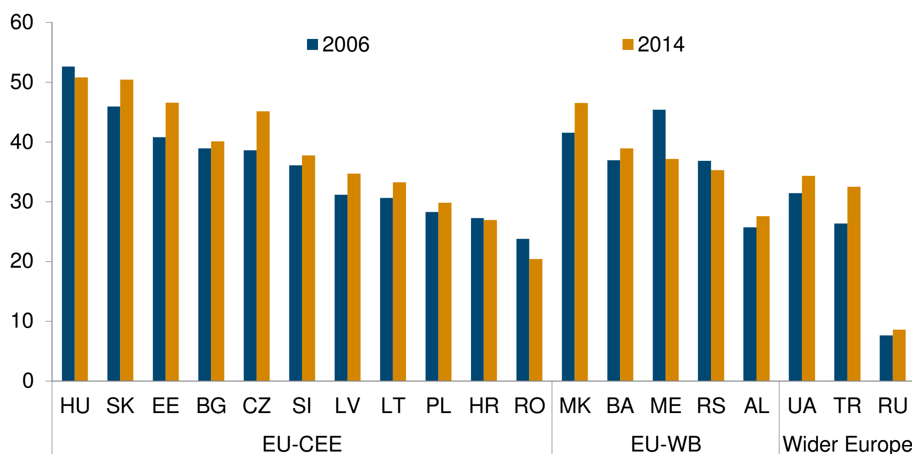
A further factor reinforcing the link between global growth and conditions in CESEE is the move up the value chain, at least in parts of the region, which is reflected in a higher share of value-added exports in GDP. The share of value-added exports in GDP increased in all countries of the region (with the exception of Montenegro) over the period 2006-2014 (latest data available). Many CESEE economies are generating substantially higher levels of income from what they export, and as long as global growth continues at a healthy rate, export sectors – and the wider economy – across much of CESEE will benefit.

Figure 11 / Value added exports in % of GDP



Source: wiiw Wider Europe Input-Output Database.

Figure 12 / Share of foreign value added in gross exports in %



Source: wiiw Wider Europe Input-Output Database.

[13] wiiw Annual database and World Input-Output Database.

Countries in the Western Balkans rely more heavily on foreign inputs than do countries in the EU-CEE, suggesting more scope to climb up the value chain in the future. At present in the Western Balkans, manufacturing bases are generally smaller, and there is specialisation in agriculture and low-tech manufacturing (e.g. food, textiles, basic metals). However, at least in some countries, this is changing, and there are reasons to think that positive momentum could be reinforced by a better EU accession perspective and higher FDI inflows.[14]

Fiscal support for growth differs across the region, but based on our estimates, at least half of the countries in CESEE can be said to have pursued 'expansionary' fiscal policy in 2017: a widening of the fiscal deficit concomitant with higher economic growth.[15] Latvia, Belarus, Poland, Kazakhstan, Kosovo, Hungary, Bosnia, Estonia, Turkey and Lithuania are all estimated to have recorded wider fiscal shortfalls relative to GDP in 2017, compared with the previous year. In other countries, such as Slovakia and the Czech Republic, we estimate only mild fiscal consolidation, despite robust rates of real GDP growth. Across the region, only in Russia was fiscal policy anything close to restrictive in 2017 on this measure.

BANKING SECTOR: STABILISATION AND GROWTH WITH SOME EXCEPTIONS

Conditions in the banking sector across the region are mixed, but in general are better than 10 years ago, and lenders in most countries of the region are in a position to support economic growth. On a four-quarter trailing average basis, lending to the private non-financial sector in the final quarter of 2017 was firmly positive in most countries in the EU-CEE, Turkey and the Western Balkans. Of these countries, only Latvia (-0.9%) and Croatia (-0.8%) showed negative credit growth on this measure. In the Czech Republic, Lithuania, Slovakia, Bosnia, Montenegro and Kosovo, credit growth was running at above 5%. Turkey has comfortably the highest rate of private credit growth in the region, although at 21.4% in Q4 it was barely half the level of 2012. Credit growth in Turkey has been very strong for some time: domestic credit provided by the financial sector rose above 80% of GDP in 2016, according to the World Bank, compared with 40% as recently as 2004, and well above the Europe and Central Asia (excluding high income) average of 60% recorded in 2015 (latest available).

Credit growth is on aggregate much more sluggish in the CIS and Ukraine, reflecting weaker macroeconomic conditions and continued problems in these countries' banking sectors. Of the four countries in the region that we cover, only Kazakhstan recorded positive credit growth as of Q4 2017 (1.6%; four-quarter trailing average). On the same measure, contractions were recorded in Russia (-1.2%), Ukraine (-1.4%) and Belarus (-2.8%). However, in Russia and Kazakhstan, while corporate credit remains weak, retail lending growth has been quite strong.

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[14] See, for example, Hunya et al. (2018b) and Stehrer and Holzner, (2018).

[15] For a more detailed explanation, see Astrov (2016).

Table 5 / Private credit growth

change in % against preceding year; 4-quarter trailing average

	1Q 15	2Q 15	3Q 15	4Q 15	1Q 16	2Q 16	3Q 16	4Q 16	1Q 17	2Q 17	3Q 17	4Q 17
Bulgaria	-3.3	-6.4	-9.4	-7.8	-6.0	-3.8	-1.4	-0.8	0.6	1.8	3.0	3.6
Czech Republic	3.3	3.8	5.2	6.2	7.3	7.4	6.9	6.9	6.6	6.8	6.8	6.8
Estonia	2.7	2.7	3.0	3.5	4.4	5.2	5.8	6.3	6.3	6.2	4.8	3.3
Croatia	-2.2	-1.7	-1.2	-1.4	-3.1	-4.5	-5.6	-5.9	-4.7	-3.5	-1.9	-0.8
Hungary	-3.3	-4.8	-6.2	-9.2	-9.1	-8.5	-7.3	-4.5	-2.9	-0.9	1.4	3.1
Lithuania	0.2	-0.1	0.2	1.4	3.4	5.3	6.8	7.6	7.6	6.9	5.9	5.2
Latvia	-3.4	-3.9	-4.6	-4.5	-4.0	-3.1	-2.2	-1.5	0.0	0.3	-0.6	-1.8
Poland	5.7	6.2	6.4	6.7	6.4	6.0	5.6	5.2	5.0	4.7	4.5	4.0
Romania	-4.1	-3.2	-1.9	-0.3	1.2	1.4	1.5	1.1	1.1	1.9	3.6	4.7
Slovenia	-15.3	-13.9	-12.3	-10.5	-9.8	-9.1	-8.0	-7.5	-5.0	-2.4	0.6	2.3
Slovakia	7.0	7.7	7.8	8.6	8.6	8.3	8.5	8.4	9.2	10.3	10.9	11.0
Albania	1.3	1.9	0.9	-0.3	-1.5	-1.7	-1.1	-0.4	0.2	-0.2	-0.1	0.0
Bosnia and Herzegovina	2.2	1.4	0.8	0.9	1.7	2.1	2.5	2.9	3.2	4.2	5.5	6.4
Montenegro	-1.6	-0.7	0.7	1.8	2.5	3.1	3.5	4.3	5.4	5.9	6.2	6.3
Macedonia	9.2	9.4	9.3	9.2	9.0	7.6	6.0	3.9	1.7	2.0	2.4	3.6
Serbia	1.6	4.1	5.1	4.7	3.4	3.2	3.9	3.8	4.4	3.8	2.5	2.4
Kosovo	5.2	6.2	7.0	7.2	7.9	8.0	8.5	9.3	9.9	10.3	10.5	10.5
Turkey	21.3	21.9	23.0	23.0	20.7	17.4	13.2	12.1	13.7	16.3	19.8	21.0
Belarus	23.1	23.5	26.8	26.4	22.6	17.5	8.9	2.5	-3.5	-7.1	-6.2	-2.8
Kazakhstan	8.3	1.5	-2.2	-2.9	-1.7	5.4	8.0	6.9	6.0	2.4	1.7	1.6
Russia	20.0	19.3	18.7	14.1	10.8	8.2	4.0	0.3	-2.8	-4.2	-3.8	-1.2
Ukraine	15.4	12.8	9.1	5.5	-2.3	-5.7	-5.4	-4.1	-2.0	-0.3	-0.9	-1.4

Note: Colours correspond to range; red = highest, blue = lowest for each sub-region for the 2010-2017 period.
Source: wiiw Monthly Database incorporating national statistics and wiiw estimates.

For the region as a whole, the prospects for lending growth during the forecast period are quite bright. Rising wages, employment and sentiment will increase individuals' appetite for taking on debt to fund bigger-ticket purchases, as will generally much lower interest rates than in the historical period. Meanwhile higher capacity utilisation and greater confidence about future demand should boost borrowing by firms. Political and regulatory factors may limit this appetite in Poland and Hungary (see section IV).

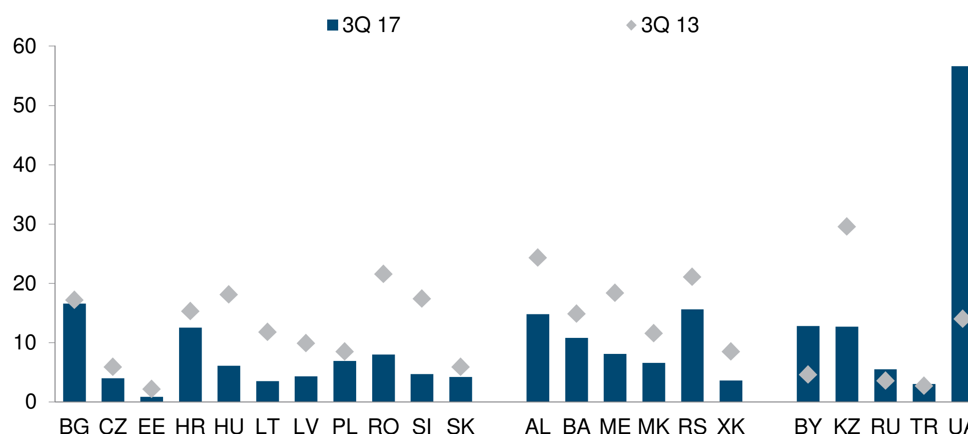
Credit growth will be supported by improvements in asset quality, with non-performing loans (NPLs) having been generally worked out of the system. In the EU-CEE, NPLs are mostly in the range of 3-6% of the total, with the key exceptions being Romania (8%), Croatia (12.5%) and Bulgaria (16.6%). However, even for those countries, the ratios are below their 2013 levels (when NPLs for the region as a whole peaked). NPL ratios in the Western Balkans are generally higher, but also well below 2013 levels. Serbia appears to have the biggest issue, with NPLs there still at 15.6%. For both regions, positive momentum has continued recently: in the year to Q3 2017, NPL ratios fell by an average 1.6 percentage points in EU-CEE, and 2.8 percentage points in the Western Balkans. In general across the EU-CEE and the Western Balkans, asset quality does not represent a risk to financial sector stability, although in some countries it may continue to constitute a constraint on faster lending growth.

Rapid lending growth and the existence of the CGF in Turkey have led to significant concerns about financial risks there. From an asset quality perspective, there appears to be no reason for alarm: as of Q3 2017, NPLs stood at 3% of total loans, the second-lowest level in the whole of CESEE (after Estonia). Capital adequacy ratios have been rising. Moreover, at present the financial sector is actually very profitable.[16] However, the Turkish corporate sector's hefty foreign currency exposure has already caused problems for some firms, as the lira has weakened (many do not have offsetting foreign currency earnings), and may increase banks' risk aversion during the forecast period. This was brought into sharp focus by a request in February 2018 from Yildiz Holding AS to its creditors to restructure up to USD 7 billion in loans.[17] In the context of heightened geopolitical risks, foreign banks with operations in Turkey may also be more worried. The fallout from the Zarrab case, and the potential for US action against one or more Turkish banks, could add to this.[18]

Ukraine has by far the biggest issue with asset quality in CESEE, and this will remain a challenge during the forecast period and beyond. The central bank has led a massive clean-up of the banking sector in recent years (this appears to be one of the few genuine successes of the current administration), but it emerged at end-2016 that asset quality at PrivatBank, the country's biggest lender, was much worse than previously thought, with auditors finding large-scale related-party lending on the bank's books (PrivatBank was subsequently nationalised). The recognition of these bad loans caused a rise in the sector-level NPL ratio to over 50%.

Figure 13 / Bank non-performing loans in % of total loans

end of period



Remark: Loans more than 90 days overdue. EE, LT – Loans that are more than 60 days overdue. RU – According to Russian Accounting Standards overdue debt is defined as debt service overdue, therefore the data are not fully comparable with other countries. UA – From 2017 including NPLs of the nationalised Privatbank and changes in rules of credit risk assessment.
Source: wiiw Monthly Database incorporating national statistics.

[16] The combined net income of Turkish banks rose by 31% in 2017.

[17] See Bloomberg, 21 February 2018, https://www.bloomberg.com/news/articles/2018-02-12/yildiz-7-billion-request-adds-to-asset-woes-for-turkish-banks

[18] See Bloomberg, 4 January 2018, https://www.bloombergquint.com/business/2018/01/04/turkey-s-halkbank-could-suffer-from-ex-banker-s-u-s-conviction

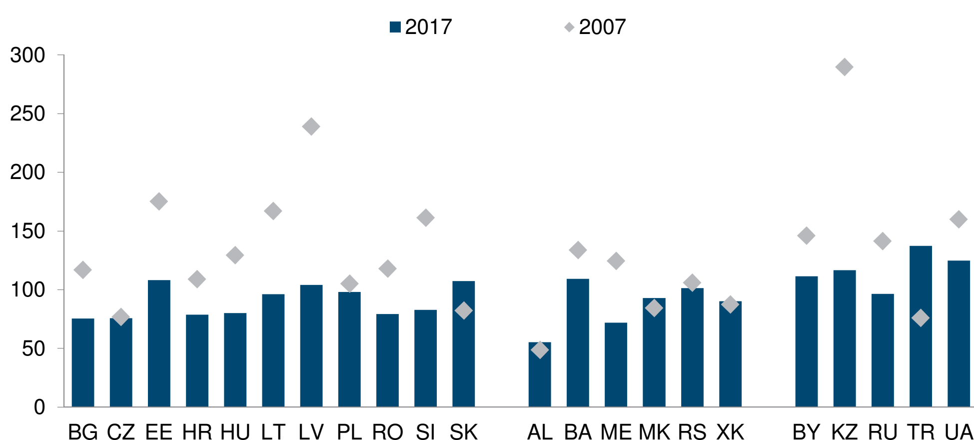
Elsewhere in the CIS and Ukraine region, banking sectors continue to face major challenges. NPLs remain at a very high level in Kazakhstan, despite official data showing a pronounced fall.[19] In Ukraine, Russia and Kazakhstan, governments were forced to step in to bail out failing banks last year. Public money was put into three troubled banks in Russia in 2017 – Promsvyazbank (the country's tenth biggest bank), Otkritie (seventh) and B&N Bank (twelfth) – indicating continued challenges in the sector there, in part caused by Western sanctions and low oil prices (all three banks were reported to have big exposure to energy firms).[20] In Ukraine, the cost of bailing out PrivatBank was reported to be USD 5.6 billion (roughly 5% of GDP). In Kazakhstan, the government bailout of Kazkommertsbank cost USD 7.5 billion.

While the situation will remain difficult, in general fairly significant clean-ups of the banking sector have been undertaken in Russia and Ukraine. In both countries, the number of banks is now only around half of what it was a few years ago, with many failing lenders having been wound down. Higher NPLs look bad, but are actually a recognition of what has existed for some time, and in the end this should be a good thing. In both Ukraine and Russia, moves are under way to force banks to hold more capital and to control related-party lending.

Significant deleveraging has taken place in most countries of the region, and the latest data indicate that in many countries this is not yet over. The pre-crisis model of rapid lending financed by foreign funding has largely ended (Turkey being a notable exception). Some foreign banks have pulled out of the region entirely and loan-to-deposit ratios have generally declined, with new credit growth having to be largely financed by local deposits. Loan-to-deposit ratios continued to fall in most of the region in 2017, and are well below 100% in most places.

Figure 14 / Loans to deposit ratio

share in %



Remark: Data are based on loans and deposits statistics of commercial banks for non-financial corporations and households. 2017 reflects the latest month available.
Source: wiiw Monthly Database incorporating national statistics.

[19] The official statistics drastically underestimate the true level of NPLs in Kazakhstan. S&P estimates the actual value of NPLs as being in the 35-45% range. See Kazakhstan country report below for more details.

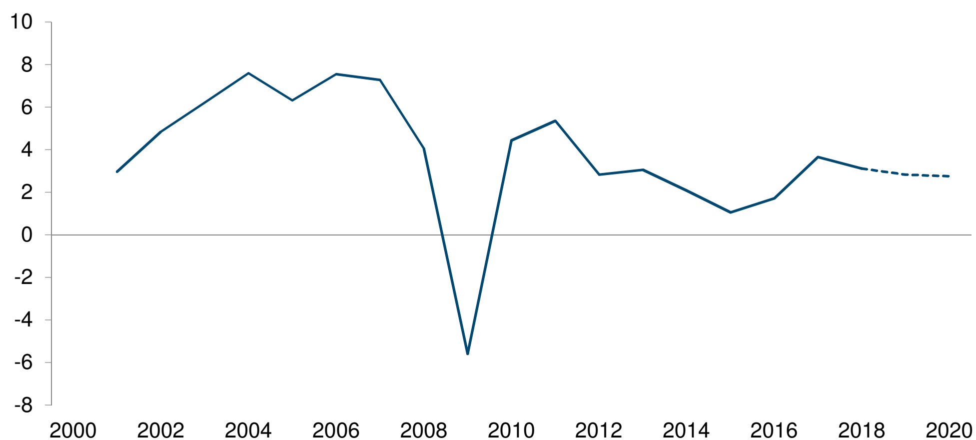
[20] See Reuters, 15 December 2017, https://www.reuters.com/article/us-russia-banks-promsvyazbank/russia-hit-by-3-4-billion-promsvyazbank-bailout-in-latest-bank-blow-idUSKBN1E91HD

FURTHER SLOWDOWN FROM 2019

On aggregate, regional growth will slow further from 2019. Even under current 'goldilocks' conditions, with external support so strong, growth in 2018-2020 is forecast to be less than half the 2002-2008 average for CESEE (6.3%). There has certainly been an improvement from recent years, but the 'new normal' for the region will be quite subdued. With certain exceptions (notably Turkey), the old pre-crisis growth models of large fiscal and/or external deficits is unlikely to return (and is also not desirable).

Figure 15 / Real GDP growth of CESEE-22

change in % against preceding year



Remark: Dashed line is forecast.
Source: wiiw Annual Database incorporating national and Eurostat statistics, own calculation. Forecasts by wiiw.

The extent of the global financial crisis and its aftermath appears to have delivered quite a blow to potential growth (see section V for a more detailed discussion of this), and there are no obvious factors that could lift it during the medium term. Demographic decline is already starting to have an impact (see section V for a more detailed discussion). Labour shortages – currently visible more in some countries than others – are likely to become an increasingly important constraint on growth across the continent in the next few years (see special section III).

External support for growth will also become less significant by 2019, which will contribute to a further drop in the rate of expansion in CESEE in that year. The Eurozone recovery is cyclical and will tail off at some point; potential growth rates in most of Western Europe are much lower than both current rates (especially in the case of Germany) and those in CESEE. The end of the current EU funds cycle, and the strong likelihood that the next one will include a lower level of structural and cohesion funds for less-developed regions, will also be important for the EU members in the region.

IV. THE RISKS

So far, with some exceptions, the heightened political risks of recent years have yet to have an impact on growth in the CESEE region. In Russia and Ukraine, and to a lesser extent their main trading partners, the impact of political developments on growth has been visible. However, for the rest of the region, well-flagged potential causes of disruption have not had the impact that many predicted.[21] There is a strong case to be made that the region will settle into a low, but stable growth path.

However, while CESEE is currently benefiting from generally supportive external conditions, it faces a number of potential external economic and financial headwinds during the forecast period and beyond. These have the potential to impact growth negatively. This is particularly important because of an apparent feeling among economic agents and financial markets that economic risk is currently low (in both CESEE and across the world), which could be feeding complacency and a lack of preparedness for when one or more risks materialise.[22] Complacency alone does not cause crises, but it can affect the timeliness and quality of the response when they hit.

One problem is whether key actors understand properly how to manage the risks of 2018. To an extent, policy-makers and firms are always planning for the previous crisis. As the World Economic Forum's 2018 Global Risks Report noted, for example, while economic actors have become good at managing discrete risks, the increasing interconnectedness of risks that has emerged over the past decade is much less well understood. In particular, the report noted that, while humans can manage conventional risks, we are 'much less competent when it comes to dealing with complex risks in the interconnected systems that underpin our world, such as organisations, economies, societies and the environment … When risk cascades through a complex system, the danger is not of incremental damage, but of "runaway collapse" or an abrupt transition to a new, suboptimal status.' Moreover, it argued that the geopolitical plates are moving, yet 'there is currently no sign that norms or institutions exist towards which the world's major powers might converge' (World Economic Forum, 2018).

We separate the risks facing the region into four: those emanating from within CESEE; those coming from Western Europe; global sources of risk; and 'slow burners', which may only become important over a much longer time horizon. In addition, we assess the channels whereby global risks could impact CESEE countries.

A. FROM WITHIN THE REGION

1. *Country-specific or bilateral risks*

Political risk is clearly elevated across the region. The war in eastern Ukraine has cost more than 10,000 lives according to the UN,[23] and the ceasefire is fragile. Tensions are high in some parts of the Balkans (albeit generally stable at the moment). In several countries, including Turkey, Poland and Hungary, key institutions are losing their independence and becoming increasingly politicised. Parts of

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[21] For a more detailed discussion of the risks, see Holzner (2017).

[22] The World Economic Forum's 2018 Global Risks Report noted that respondents viewed economic risk as generally low, particularly when compared with other risks, such as technological, environmental, societal and geopolitical.

[23] Report on the human rights situation in Ukraine, 16 August to 15 November 2017, Office of the United Nations High Commissioner for Human Rights, https://reliefweb.int/sites/reliefweb.int/files/resources/UAReport20th_EN.pdf

the EU-CEE are in open conflict with Berlin and Brussels. Social protests have broken out in many places, notably Romania (Hunya, 2018a).

However, as always, the question is whether these will have implications for economic growth. Other than in Russia and Ukraine, it is currently difficult to draw a hard line between politics and challenges to economic growth. Political factors certainly weigh on growth potential in the Balkans, but it is not clear that this is any worse now than at other points over the last 25 years, particularly now that relative stability has returned to Macedonia. At present, the two fastest-growing economies in the region, Turkey and Romania, are beset by high political risk; economic agents are just shrugging it off.

Nevertheless, various potential flashpoints exist in CESEE that could disrupt economic activity over the forecast period. In our country reports, we highlight several risks, including upcoming elections, social protests, and international tensions.

In EU-CEE, one of the key areas of risk is social protest in Romania. In January, Prime Minister Mihai Tudose resigned, plunging the country into its second political crisis in the space of a year. At present, conflicts within the ruling party are at the root of instability, but there are other potential sources. In particular, younger, urban voters have mobilised to protest against the authorities, motivated in particular by corruption. Investors and business appear increasingly concerned about the potential for elevated political risk and government instability to destabilise the economy.

Meanwhile, political developments in Poland and Hungary have so far not had a material negative impact on growth, but this is not likely to last indefinitely. A key channel by which these factors can influence the economy is private investment. Challenges to the rule of law, regulatory uncertainty, conflict with EU, and the undermining of the independence of institutions will all affect the sentiment of domestic and foreign private investors. Foreign investors have generally operated on the basis that countries in the EU-CEE will converge with EU law, and that there is a mechanism to enforce it. However, in the case of Hungary and Poland, both of these things are now in doubt.

The impact may already be becoming apparent. In Poland, the state is taking back ownership of the economy, and private investment has been persistently weak (this has been partly compensated for through higher investment by state firms). Despite the new EU funds cycle, the share of investment in Polish GDP is close to a two-decade low. Meanwhile in Hungary, the front-loading of EU funds spending may also be masking weaker underlying trends in private investment; this will become clearer from 2019, when, as we expect, EU funds drawdown will be much lower.

In the Western Balkans, political risk appears to be subsiding somewhat in Macedonia, after a volatile period. A solution to the name dispute with Greece appears to be increasingly likely, although it remains hostage to public opinion within Greece. The Serbia–Kosovo relationship remains a potential source of instability, not least following the assassination of the local Kosovo-Serb politician Oliver Ivanović in January 2018. However, we view signals of a more assertive EU stance in the region as positive.

In the CIS and Ukraine, although there is little doubt about the result of the upcoming Russian presidential election, there could be broader reasons to worry about political stability in Russia.[24] The recession and stagnation in living standards in recent years bring risks of social unrest. Attempting reform may be risky, but will probably be necessary. Without this, we think that resulting continued economic stagnation over the medium term will eventually endanger social and at some point political stability in Russia. Russians themselves appear torn between recognising the need for reform and being fearful of the short-term upheaval it could cause (the memory of the chaos of the 1990s remains central to this fear).[25] Threats to social and political stability also exist in other parts of the region, with declines and/or stagnation in living standards also being a powerful contributing factor. In Kazakhstan, strikes by coal miners spread across the country in December 2017. Meanwhile in Ukraine, political risk remains high and – if anything – is likely to increase in the run-up to next year's elections.

2. *Splits within the EU*

Divisions within the EU have existed for some time over various issues, such as migration, child benefit payments, the budget post-Brexit, relations with third countries such as Russia and China, Brussels' policing and enforcement of the rule of law in Member States, and alleged corruption in the use of EU funds. While the EU is adept at kicking the can down the road, there was a greater sense in 2017 of matters coming to a head – in part owing to political developments in several of the bigger Western European countries. Issues that cannot be avoided indefinitely – including who will plug the post-Brexit gap in the EU budget, or the reallocation of refugees among Member States – will either force one side to back down or will provoke a fight.

It is too simple to describe these divisions as purely east/west, although the correlation is quite strong. Countries such as Bulgaria have been partly involved in the conflict over refugees, but much less prominently than the Visegrád states. Meanwhile the Baltic states – motivated in part by fear of Russia – tend to align their positions closer to Germany and other Western European countries. Moreover, members of the so-called 'awkward squad' exist in the EU-15, notably the UK, but also (much more quietly) some other countries. However, in general, the fissures opening up in the EU are loosely along east/west lines.

One key implication is that the post-2020 EU budget looks highly likely to be smaller. Austria and the Netherlands have already ruled out filling the post-Brexit gap. It may also be the case that a smaller share of the smaller pie is allocated to the structural and cohesion funds that benefit the EU-CEE. That has been made more likely by recent stories about alleged massive corruption in the use of EU funds, which have received widespread media attention in net contributor states. These funds constitute 2-5 percentage points of EU-CEE countries' GDP, according to our estimates, and therefore a material reduction (we estimate the UK contribution at 20% of total net contributions) will have a visible impact.

The unwillingness of some parts of EU-CEE to take part in obligatory refugee reallocation schemes has received widespread attention in Western Europe, and has become a highly charged issue. It is difficult to see how either side can back down. Some countries in Western Europe – particularly Germany, Austria and Sweden – feel that they are being asked to shoulder almost all of the

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[24] See the country report below for more details.

[25] See, for example: 'The perils of change: Russians' mixed attitudes towards reform', Carnegie Moscow Centre, http://carnegie.ru/2018/02/06/perils-of-change-russians-mixed-attitudes-toward-reform-pub-75436

burden. However, opposition in at least some parts of EU-CEE runs much deeper than the current governments: 71% of Poles, for example, and 64% of Hungarians believe that all further immigration from mainly Muslim countries should be stopped.[26] In a recent blog post, economist Branko Milanović argued that CESEE countries' history means that these issues will inevitably be seen differently there (Milanović, 2017).

B. FROM WESTERN EUROPE

The Eurozone has been fairly quiet on the risk front in recent months, which is positive for CESEE. Aside from the risk that hard-right or far-right parties in Western Europe could take a more antagonistic stance towards the region, CESEE would be directly in the firing line for the fallout from any partial or total break-up of the single currency area. There was a lot of worry in 2017 about populism in the Eurozone, but this was mostly about selling newspapers: we did not think that the chances of populists leading a government in France, Germany or the Netherlands were realistic.[27] Moreover, populists in France and Austria were forced to back down from their positions on leaving the Eurozone referendums. The far right is now in power in Austria, but only as the junior partner in the coalition; its actual position is often not that different from those adopted by governments in other Eurozone countries. A tougher stance on migration, for example, has become the norm over the past two years.

Mario Draghi and the current robust cyclical upswing have created valuable breathing space for politicians in the Eurozone; the bigger problems for the single currency are longer term in nature. Germany's recent election has pointed to serious difficulties for the centrist parties. Governing in this context will be more difficult, particularly with the ever-stronger AfD as a significant force in parliament. France's Emmanuel Macron has made big promises, but it remains to be seen whether he will deliver, both at the national and the Eurozone/EU level. Some reforms of the single currency's architecture have begun, but when the next recession comes, it is not clear that the bloc will be much better prepared than last time. Political opposition to risk sharing in both the fiscal and financial spheres remains strong, and not just in Germany (although it remains by far the most important country and will continue to set the terms of the debate).

Meanwhile, Brexit is so far the dog that hasn't barked, but it is hard to imagine that this will remain the case. Neither the UK government nor the main opposition Labour party can decide what it wants (and time is running out). There are strong incentives on both sides to avoid the UK crashing out of the bloc without a deal (the economic disruption could be severe), but considering the capabilities of the current political class, particularly in the UK, this cannot be guaranteed. We think that the implications of Brexit for economies in CESEE could be quite significant in some areas, including migration flows, EU funding levels and trade.

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[26] See Chatham House, 7 February 2017, https://www.chathamhouse.org/expert/comment/what-do-europeans-think-about-muslim-immigration

[27] See https://wiiw.ac.at/growth-strengthens-and-inflation-returns-but-political-risk-warning-lights-are-flashing-red-n-194.html

C. GLOBAL ECONOMY AND FINANCIAL MARKETS

We see three key risks for CESEE emanating from the global economy and markets:

1. *A spike in inflation in the US, leading to faster monetary tightening by the Fed and putting a break on growth in the US and global economies*

A spike in inflation in the US would prompt the Fed to tighten policy quicker than currently expected, thereby – as a minimum – putting the brakes on US and global growth. US inflation has ticked up in recent months, with headline consumer prices rising by 2.1% year on year in January, above forecasts for a second consecutive month. There have recently been signs of a slight firming of core inflation pressures in the US. Hourly earnings rose by the fastest rate since 2009 in January 2018. The Fed has so far been extremely careful in lifting rates, and has provided forward guidance on its plans to calm markets. However, should inflation continue to rise, the Fed may start to hike more quickly, bringing rates to a level where they start to cool US and global growth.

We think that these concerns are overdone, and that the chances of the Fed hiking much more quickly than current expectations are quite low. Considering the strength of the labour market, inflation in the US is remarkably weak, indicating that something more structural is keeping – and will keep – price growth subdued. The potential causes for the apparent breakdown of the Phillips curve are numerous: for example, globalisation and automisation have reduced workers' bargaining power by creating one global labour market (in which there is always slack somewhere); persistently weak productivity growth has reduced the chance of real wage increases; firms' refusal or inability to cut nominal wages in 2008-2009 has left a legacy of 'pent-up wage deflation'; the recent increases in labour force participation; or generation factors (older workers are too worried about losing their jobs to ask for a pay rise, while younger workers care more about non-wage benefits). All appear to have some validity; but whatever the cause(s), a significant upward spike in inflation in the developed world does not look likely during the forecast period. Both the Fed and the ECB are likely to proceed extremely cautiously over the next few years.

2. *Faster-than-expected hikes in interest rates by major central banks (notably the Fed), or panic in financial markets caused by a currently unknown event, leading to a spike in US bond yields, collapse in equity prices, and capital flight from emerging markets*

A greater risk, in our view, is that the prospect of the global economy being weaned off its addiction to cheap credit, or the emergence of a currently unknown risk, could cause a major and destabilising flight to safety in financial markets. Even change in tone from the Fed or the ECB, and particularly a revision of medium-term inflation assumptions, could be enough. The '1994 scenario' has been discussed regularly in the financial press recently, in reference to a hike in US interest rates after a long hiatus, which had a big impact on the bond market and equities.

Central banks, and notably the Fed, had to change the rules of the game in 2008 to prevent a collapse. However, ultra-low interest rates over most of the past decade have contributed to the inflating of significant bubbles across a host of asset classes. Bitcoin is one recent prominent example, but bubble-like conditions are visible pretty much everywhere.[28] Property has been a major beneficiary of

[28] One particularly stark example in the CESEE region is the recent Tajik USD 10-year bond, issued last year, which paid a fixed yield of just 7.125%.

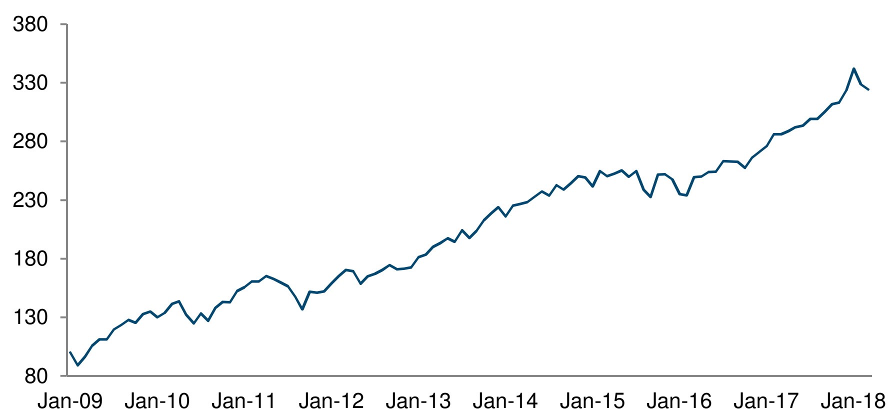
inflows; the IMF's global house price index is almost back to its pre-financial crisis level. There are concerns about property bubbles in many parts of the world; house-price-to-rent and house-price-to-income ratios have surged in many places. A rally in the corporate bond market has prompted a tidal wave of 'junk' issuance, meaning that on average corporate bonds are much riskier than a few years ago. Meanwhile much higher leverage in china is a growing concern. Total debt in the Chinese economy rose from 171% of GDP in 2008 to 295% as of September 2017, according to the Institute of International Finance.

Ultra-loose monetary policy has meant ever more money chasing an ever-dwindling supply of 'safe' assets at positive yields. Big money managers such as pension funds, who need returns to meet their liabilities, have been pushed into ever riskier positions (IMF, 2017). In some parts of the life insurance sector, there are notable mismatches between guarantees and returns (Germany is a big example here). Investors have sought out ever more exotic asset classes in the hope of generating a return. Many are increasingly exposed to assets that they do not really understand and are not very comfortable about owning.

One of the 'bubbles' that has received the most attention is the US stock market. Early February 2018 saw quite a marked correction in US equities, but at the time of writing they remain well above 2017 levels. The Shiller Cyclically Adjusted Price to Earnings (CAPE) ratio for the S&P 500 has only been higher twice since the late nineteenth century: ahead of the 1929 Wall Street Crash and the 2000 tech bubble.[29] Some market observers are sanguine, pointing to the fact that bull runs can continue for a long time after stocks become overvalued, or that the sheer scale of global liquidity makes historical comparisons meaningless. The underpinnings of the boom have recently been added to by the huge tax cut in the US, which is likely to increase profits for many firms.

Figure 16 / Stock market indices S&P 500 (US)

Jan. 2009=100



Source: Yahoo! Finance.

However, history shows that while markets can continue to rise despite being overvalued for some time, 'this time' is never different, and they will have to come down eventually. Two things have been notable about the current bull run: it has been particularly long-lasting and the volatility has

[29] See http://www.multpl.com/shiller-pe/

been low. The second factor now appears to have changed: the CBOE Volatility Index (VIX) surged higher in early February, suggesting that even if a collapse is not imminent, the period of tranquil increases in US stock prices is over.

This puts central banks in a very delicate position. They have to steer a fine line, gradually deflating these asset bubbles without causing financial panic. Concerns about monetary tightening have produced regular market panic in recent years, particularly in emerging markets (including in CESEE). A further signal was provided by the stock market correction and volatility of early February 2018, which was prompted by higher-than-expected wage growth in the US, and consequent speculation that the Fed could tighten policy more quickly than currently expected. As global rates continue to rise, no matter how slow and well-telegraphed these increases are, there is a risk of another market tantrum.

A collapse in US equities alone would not automatically matter, particularly for CESEE. It could have a dampening effect on growth in the US (and therefore the rest of the world) via the wealth effect, but it would not automatically trigger a US recession. Compared with 2008, the US is not an overly leveraged economy, which would limit the pass-through to the wider economy. One notable feature of the stock market gyrations of early February was that participants appeared aware of each other's and of their counterparts' exposure – something that was certainly not the case in 2008. More of an issue is the risk of a US stock market collapse ricocheting through the system and contributing to broader financial panic and a flight to safety. Volatility is now more of a concern than before, and looks to be here to stay.

3. *A trade war*

The potential for a global trade war triggered by the US has risen, and this would have damaging consequences for much of CESEE. Many CESEE economies are highly open, and would be particularly badly affected by a drop in global trade volumes, both directly and indirectly (via Germany). Moreover, a hike in US tariffs could push up inflation there, bringing forward monetary tightening, which would create further issues for parts of the region (see above).

D. POTENTIAL CHANNELS OF CONTAGION

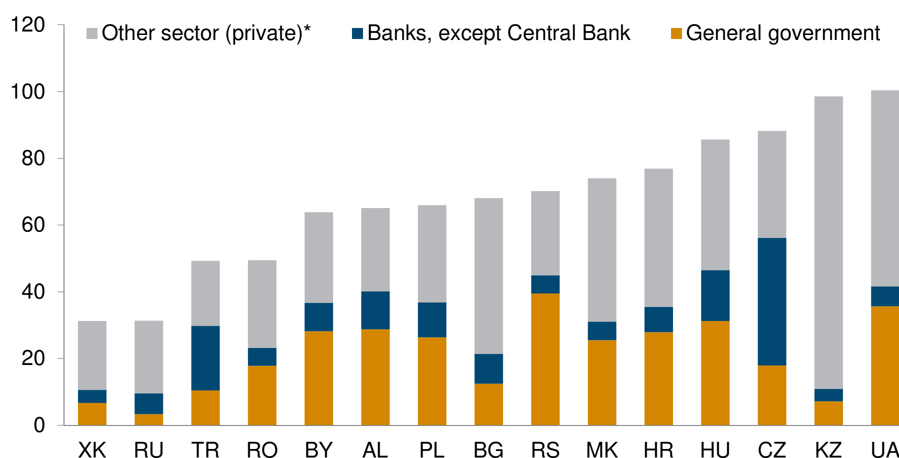
1. Corporate debt

CESEE is highly vulnerable to financial panic or a faster-than-expected rise in US rates, both of which would suck dollars back to the US and away from emerging markets in particular. The 2008 crisis showed how issues in the US can quickly spread to the rest of the world. The IMF has warned about a scenario where 'a repricing of risks leads to sharp increases in credit costs, falling asset prices, and a pullback from emerging markets'. It estimates that that would lead to USD 100 billion being withdrawn from emerging markets over four quarters (IMF, 2017).

The risks are compounded by the fact that corporates in emerging markets have generally increased their borrowing since the global financial crisis, including parts of CESEE. In both developed and emerging markets, even under currently benign global liquidity conditions, parts of the corporate debt market are showing strain – S&P Global reported 162 corporate defaults worldwide in 2016, the highest since 2009.

In the CESEE region, there are several countries where the corporate sector has significantly increased its external leverage since 2009. Overall gross external debt to GDP rose in most countries of the region between Q2 2009 and Q4 2017. The Czech Republic,[30] Ukraine, Belarus, Albania and Macedonia recorded the largest increases over the period (25 percentage points or more). The highest levels of external debt/GDP were recorded in Ukraine, Kazakhstan, the Czech Republic and Hungary. Corporate external borrowing is particularly high in Kazakhstan (88% of GDP), but it is also at 40% of GDP or more in Croatia, Macedonia, Bulgaria and Ukraine.

Figure 17 / Gross external debt by sectors in % of GDP, 2017



*Remark: Other sector (private) includes intercompany lending of direct investment (based on IMF external debt methodology). – HU excluding SPE (Special Purpose Entities).
Source: World Data Bank – Quarterly External Debt Statistics, National Banks, own calculations.

Within this, some countries have a particularly heavy reliance on short-term borrowing, which could create a particularly difficult situation if rates rose quickly and unexpectedly. Short-term external debt as a share of total external debt represents more than a quarter of GDP in the Czech Republic, Kosovo, Turkey and Belarus. Most countries of the region have reduced their reliance on short-term inflows over the past decade; Turkey stands out as a notable exception. Large levels of short-term foreign currency debt leave Turkish corporates facing big rollover risks.

Another indicator of potential vulnerability is the size of the current account deficit. Current account balances, especially when adjusted for net FDI inflows (which tend to be more stable than portfolio financing and loans) have improved for most countries in CESEE since the crisis. However, Montenegro, Albania, Serbia, Bosnia, Kosovo and Turkey are running shortfalls of 4% of GDP or more. While some (such as Kosovo and Bosnia) rely heavily on multilateral lending and/or FDI, others –notably Turkey – rely primarily on so-called ‘hot money’ (portfolio and other investment), leaving them exposed to a change in capital flows.

Turkey is the country in CESEE where we see the biggest risks from a faster-than-expected hike in US rates or a more general rise in risk aversion among investors. Among the G20 countries, only China has seen a faster rise in private sector debt/GDP and the debt service ratio over the last 10 years,

[30] The Czech Republic represents an outlier in this list. It has a huge foreign asset position, making it a net external creditor.

according to the IMF. Moreover, in its most recent Global Financial Stability Report, the IMF noted that Turkey has the second-biggest external financing need relative to GDP among the major emerging markets up to 2020, and is therefore particularly at risk of an increase in global investor risk aversion. Perhaps surprisingly, the country with the third-biggest external financing need over the same period is Poland.

2. Sovereign debt

The second key channel of potential contagion for CESEE is via sovereign borrowing. Looking at the assessments of ratings agencies, the outlook for sovereign credit risk in the region is better than it has been for some time. At the time of writing,[31] 10 countries in CESEE had a positive outlook from one or more of the major ratings agencies (see table below), with only one (Turkey) on negative outlook (from both S&P and Moody's).

Table 6 / Sovereign credit ratings

	S&P	Moody's	Fitch
Albania	B+	B1	
Belarus	B	Caa1	B
Bosnia and Herzegovina	B	B3	
Bulgaria	BBB-	Baa2	BBB
Croatia	BB (positive)	Ba2	BB+
Czech Republic	AA-	A1	A+ (positive)
Estonia	AA-	A1	A+ (positive)
Hungary	BBB- (positive)	Baa3	BBB- (positive)
Kazakhstan	BBB-	Baa3	BBB
Latvia	A- (positive)	A3	A-
Lithuania	A- (positive)	A3	A-
Macedonia	BB-		BB+ (positive)
Montenegro	B+	B1	
Poland	BBB+	A2	A-
Romania	BBB-	Baa3	BBB-
Russia	BBB-	Ba1 (positive)	BBB- (positive)
Serbia	BB	Ba3	BB
Slovakia	A+	A2 (positive)	A+
Slovenia	A+	Baa1	A-
Turkey	BB (negative)	Ba1 (negative)	BB+
Ukraine	B-	Caa2 (positive)	B-

Sources: S&P, Moody's and Fitch.

However, as we noted in a special topic accompanying our previous Forecast Report, the region is not in an obviously better position to deal with higher global rates than it was a decade ago, and in many cases it is in a worse position (Grieveson, 2017). In all, 21 of the 22 countries in CESEE (despite its negative outlooks, Turkey is the exception)[32] have higher public debt/GDP ratios than they did a decade ago, and seven are above the EU's 60% limit (Montenegro, Albania, Serbia, Hungary,

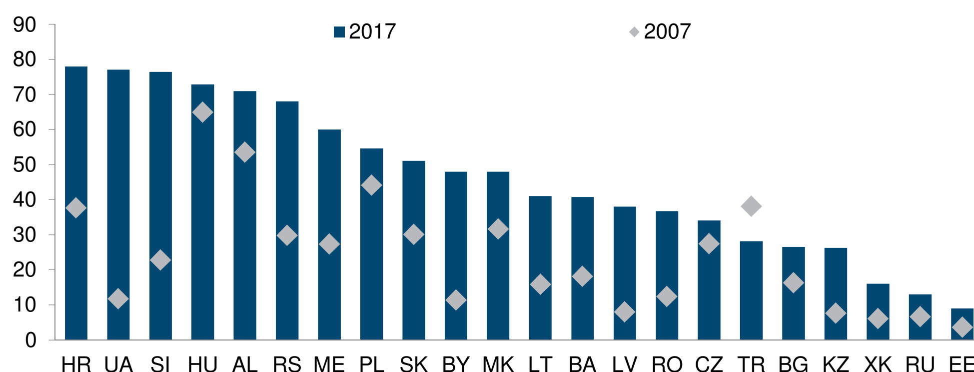
[31] Table up to date as of 2 March 2018. Sources: S&P, Moody's and Fitch.

[32] While the Turkish private sector is vulnerable (see previous section), the sovereign looks to be in quite a strong position compared with many or most regional peers, which creates a certain amount of room for the pro-cyclical fiscal policy currently being undertaken by the government.

Slovenia, Ukraine and Croatia). Although these rates have come down in most countries since 2015, this has been enabled by very benign global conditions, which are unlikely to last beyond the next couple of years. Lower real GDP growth and/or higher interest rates could easily bring these countries back into the firing line of financial markets. It is not clear that the weaker countries in the region have used the good years to make the structural changes required to allow them to handle the next crisis better.

Figure 18 / General government gross debt

in % of GDP



Remark: Kosovo 2007 data refer to 2009.
Source: wiiw Annual Database incorporating national and Eurostat statistics.

E. SLOWER-BURNING RISKS

There are plenty of risks around, but the most likely scenario is that there is a muddle-through at the global and Eurozone level, and CESEE enjoys another couple of good years of growth. The real risks for the region, which will be much more difficult to avoid or solve, are longer term in nature:

› First, **cyber risks** are an ever-growing threat to governments and companies. The WannaCry attack disappeared quickly from the public eye and newspapers, but could have caused much more damage if a kill switch had not been built in. It is feasible that such attacks will become more common, creating security challenges and economic disruption.

› Second, the CESEE region faces material challenges from **digitalisation and automisation**. In reality, automisation began decades ago, but many of its implications are only now becoming apparent. The implications are not yet fully clear, but it will contribute to the process of lower employment and wages, and a higher share of income and wealth at the top of the distribution. CESEE's poor record on innovation could make it particularly vulnerable in this regard. Among other things, much of CESEE is heavily reliant on the German automotive industry being able to handle the transition to electric cars.

› Third, **migration** has already shown itself to be a big challenge for Europe. The EU does not seem capable of coordinated strategy, and population growth, conflict and economic conditions in source countries suggest that the flows will not stop. Among other things, this increases the risks of a fragmentation within the EU, potentially to the detriment of CESEE countries.

V. LONG-TERM CONVERGENCE PROSPECTS: HITTING THE LIMITS?

For economists, but also for people living in the region, perhaps the single biggest question is whether CESEE will ever catch up with Western Europe in terms of income. The convergence progress so far has been mixed, to put it mildly. In a scathing assessment in 2014, Branko Milanović concluded that genuinely successful convergence had only been achieved in one country: Poland (Milanović, 2014). Given that Mr Milanović included the consolidation of democracy in his assessment, it may be the case that not even Poland would make the cut if he did the same exercise now.

While the rate of headline convergence in parts of the region has been decent, the extent of wage convergence has been much less so. A recent paper by Simon Tilford showed, for example, that wage convergence has lagged far behind headline real GDP per capita catch-up in the Visegrád states (Tilford, 2017). Visegrád countries also have a very low wage share in GDP (see special section I). The Visegrád case provides an illustrative example of how and why many in the region are disappointed with the extent of convergence so far, and points to some of the underlying factors driving political developments in Central Europe.

A debate has raged recently between several prominent economists on what is to blame for the disappointing pace of convergence, and what this means for future convergence prospects.[33] Much of the discussion has centred on the large-scale foreign ownership of firms in the region, which means that much of the income generated does not end up in the hands of locals. According to Thomas Piketty, Western investors (particularly Germans) own over half of the capital of firms in the EU-CEE. On average in 2010-2016, annual net outflow of profits and income from property per year was 4.2% in Slovakia, 4.7% in Poland, 7.2% in Hungary and 7.6% in the Czech Republic. All are well above the net inflows from EU transfers over the same period (Piketty, 2017). This view has, however, been questioned (Darvas, 2018).

The outlook for long-term convergence in the region certainly appears challenging. It has been clear for some time that the old pre-crisis growth model is dead (Dobrinsky and Havlik, 2014), but it is less apparent what the new drivers of growth will be. The World Bank's January 2018 Global Economic Prospects report noted that potential growth for Europe and Central Asia had fallen to 2.3%, 1.4 percentage points lower than its pre-crisis level, reflecting primarily weaker productivity growth, as well as labour supply developments (World Bank, 2018). It argued that these factors are likely to push down potential growth even further in the future. The region has been hit by several negative growth shocks in the last decade, and it is not surprising that this has resulted in lower growth potential (including via structurally depressed demand). Turkey is an exception to this generally, as a result of better demographics. For the commodity exporters, the outlook appears particularly challenging.

Our own analysis of the outlook for long-term convergence is not too positive. In our autumn 2015 Forecast Report we discussed the 'new normal' for the region, and argued that the outlook for growth in the region will be slower than in the pre-crisis years, in large part because of the integration with a much slower-growing Western Europe (although this alone does not preclude convergence *with* Western Europe). Meanwhile, in our autumn 2017 Forecast Report, we noted that CESEE convergence with Western European income levels will only be possible over a very long time horizon, and is not guaranteed for all countries (Podkaminer, 2017).

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[33] Including Paul Krugman, Thomas Piketty, Zsolt Darvas, Leonid Bershidsky and Simon Tilford.

Among other factors, we think that specialisation patterns are important in explaining why CESEE countries have been slow to catch up. Our research indicates that CESEE countries have become increasingly specialised in parts of the value chain production function associated with lower levels of value creation. FDI-led growth means that headquarters are elsewhere, and little R&D is done in CESEE. This creates a risk that countries will become stuck in a 'semi-periphery trap' and never make the last leap to catch up with Western European income levels.[34] wiiw's Leon Podkaminer has argued that history and geography have condemned the region to persistent economic backwardness (Podkaminer, 2013).

Wage convergence, at least, may start to catch up with per capita income convergence over the medium term. Increasingly evident labour shortages are driving wages higher in the region, well above wage increases in Western Europe, and there is little reason to think that this process will stop. The size of the gap with Western European income levels remains so large that it is unlikely that even big wage increases in the region will prevent the net outflow of workers from EU-CEE in particular.[35] Moreover, although we see some expansion of the German industrial supply chain into countries such as Romania and parts of the Western Balkans, the idea that German firms will simply move production east if workers demand higher wages seems fanciful. Proximity to Western markets, productivity and education levels, infrastructure quality, and a status quo bias all hugely favour keeping production in the Visegrád countries in particular. Whether foreign owners will move higher value-added production to these economies, however, is another question entirely.

In conclusion, most of the CESEE region is enjoying a strong cyclical upswing, which may well last for several more years (if global risks do not materialise). During the medium term, growth will fail to get close to pre-crisis levels, although it will also (in most cases) be more balanced and less reliant on large fiscal and/or external imbalances. Convergence with Western European levels of per capita income should continue, albeit increasingly slowly for the region's better performers.

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[34] See special section IV below.

[35] The wage gap is still massive: hourly wages at purchasing power standard in 2016 ranged from 20% of the Austrian level in Ukraine to 69% in Slovenia.

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Special section I: Wages in the EU-CEE countries: Manufacturing sector catching up

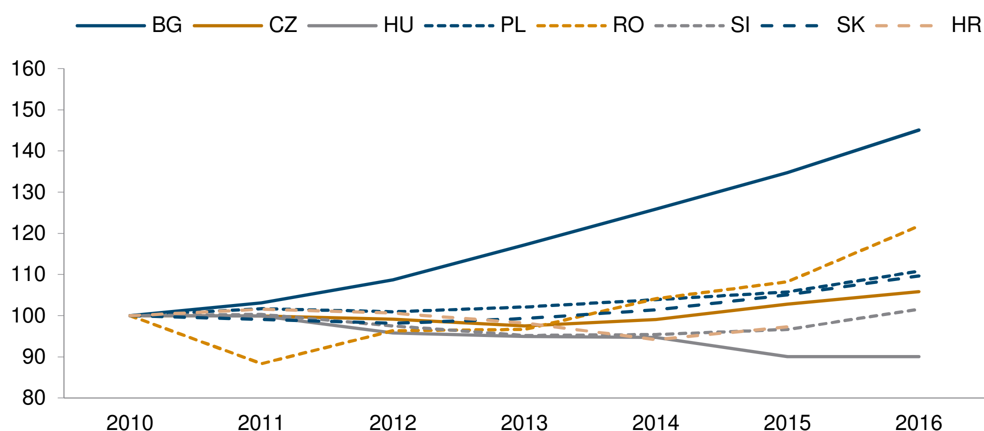
VASILY ASTROV[36]

OVERALL WAGE DYNAMICS

Wage growth in the EU-CEE countries has arguably not been as strong as generally expected, given the steadily falling unemployment rates. Since 2013-2014, economic growth in the EU-CEE countries has increasingly been driven by private consumption, supported primarily by rising wages and household incomes generally. However, the detailed National Accounts statistics, which allow us to compare hourly wage developments in individual EU-CEE countries on a methodologically similar basis, show that wage increases in general have not been as pronounced as suggested by, for example, company surveys.[37] Besides, they vary widely by country (see Figure 19).

Figure 19 / Real wage dynamics in EU-CEE countries

index, 2010=100



Note: Real (CPI-deflated) wages on hourly basis from the National Accounts.
Source: Eurostat, wiiw calculations.

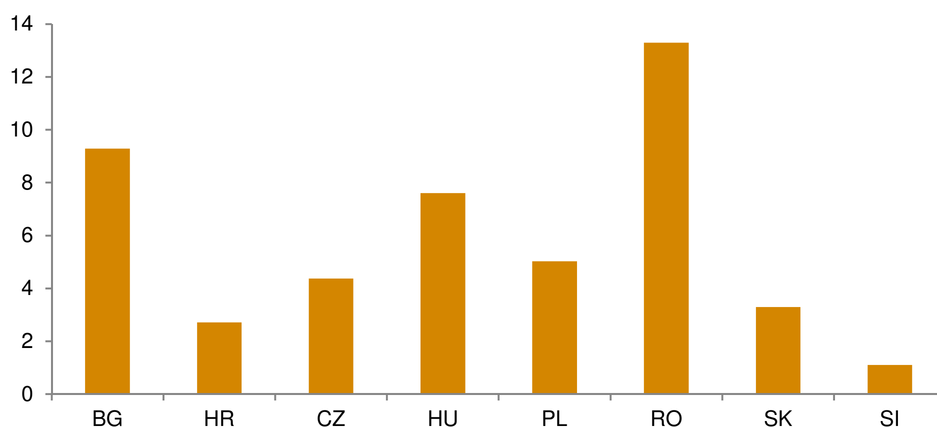
[36] The author thanks Peter Havlik and Mario Holzner for the valuable suggestions, as well as Alexandra Bykova and Beate Muck for statistical assistance.

[37] There are important methodological differences in the wage data between the National Accounts and the company surveys. For instance, in Hungary and Poland company surveys only cover enterprises with more than five and ten employees, respectively. Besides, the methodologies in individual EU-CEE countries differ drastically when it comes to the treatment of the wages of part-time employees.

Of the EU-CEE countries, Bulgaria has recorded by far the highest real growth in hourly wages – 45% between 2010 and 2016, which corresponds to an average growth rate of about 7% a year. However, Bulgaria is also the poorest country in the region (with an average hourly wage of a mere EUR 4 in 2016), and so the catch-up potential is very high. In Romania, the second-poorest country, hourly wages have also risen relatively sharply, by 22% overall, although more than half of this increase is accounted for by a single year (2016), when wages picked up by 12%, mainly due to an increase in the official minimum wage.

In the rest of the EU-CEE region, however, hourly real wages have risen much less – generally by not more than 10% between 2010 and 2016, which corresponds to average annual growth of less than 2%. This performance is not very different from Austria's, where real hourly wages rose by a total of 4.6% over the same period. In Hungary, the average hourly wage has actually fallen by 10% in real terms since 2010. At the same time, there has been a general acceleration in wage growth over time, especially since 2015, which has gone hand in hand with a marked improvement in labour market conditions in the EU-CEE countries (see Overview). This trend continued in 2017, as shown by Figure 20, which presents the dynamics of real gross monthly wages on the basis of company surveys.[38]

Figure 20 / Average gross monthly wages in 2017, real growth year on year, in %



Source: wiiw Annual database.

Still, hourly wages in the EU-CEE countries remain considerably lower than in Austria or Western Europe in general. On the one hand, this is due to lower labour productivity in the region, which is partly a result of the generally lower capital endowment. Besides, in most EU-CEE countries (except Bulgaria, Croatia and Slovenia) the wage share tends to be rather low, ranging from 56.8% of GDP in Hungary to 50.7% in Slovakia (compared to 62.6% in Austria and 63.4% for the EU-15 average).[39]

[38] Wage data from the National Accounts are not yet available for 2017.

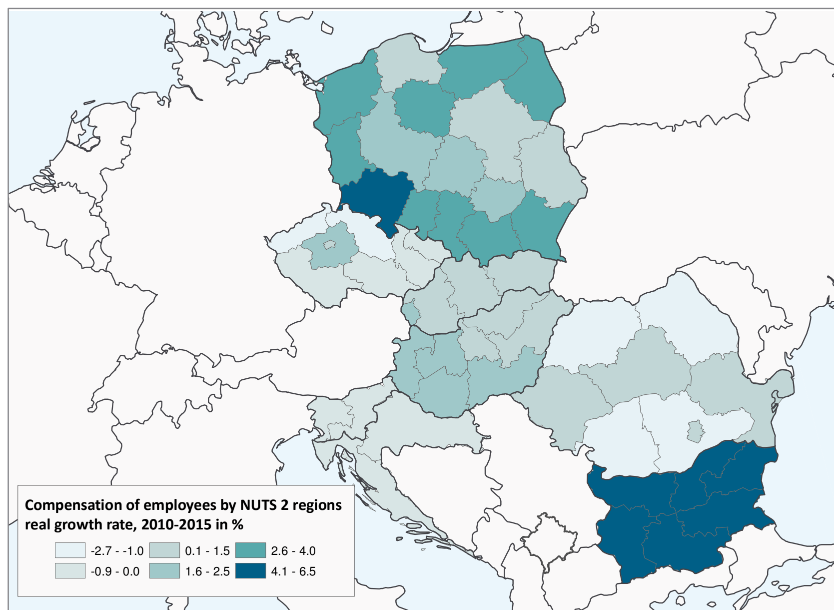
[39] Adjusted wage share in 2017, defined as the share of wages in GDP at factor costs, adjusted for the incomes of the self-employed (Source: EU AMECO database). However, in Croatia (66.3%), Bulgaria (66.7%) and particularly Slovenia (69.4%) – countries which have received less FDI inflow over the past decades – the adjusted wage share is much higher.

REGIONAL WAGE DISPARITIES

The statistics on the compensation of employees (available for the EU-CEE countries at the regional (NUTS 2) level) show in some cases significant regional disparities in wage developments (Figure 21).[40]

Figure 21 / Hourly compensation of employees by region (at NUTS 2 level)

real growth rate, in %, average of 2010-2015



Notes: National Accounts data. For the Czech Republic, Hungary, Poland, Romania and Slovakia average of 2010-2014. For Romania based on per employee basis. Regional data for Croatia are not available; the growth in the compensation of employees shown on the map applies to Croatia as a whole.
Source: Eurostat, own calculations.

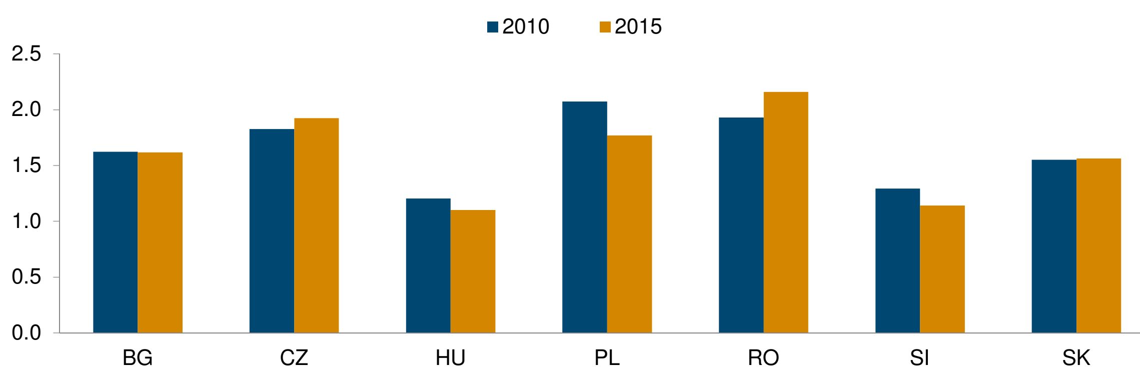
In many EU-CEE countries, wage growth has been stronger in regions that are close to richer neighbouring countries. For example, the region around Bratislava, which borders on Austria, recorded average wage growth of 1.7% a year in the period 2010-2014, compared with only 1.1% for Slovakia as a whole. In Poland, the south-western regions bordering Germany and the Czech Republic achieved above-average wage growth as well. This is particularly true of Lower Silesia, where wages rose by an average of 4.3% a year, compared with 2.4% for Poland as a whole. In Hungary's western provinces, too, wage growth has tended to be higher than in the country's east or in Budapest. In Romania, where most neighbouring countries tend to be even poorer, it is the central provinces and the Bucharest region that have recorded above-average wage increases.

A notable exception to the above pattern is the Czech Republic: wages in Prague and Central Bohemia rose between 2010 and 2014 by an average of 1.4% and 2.5%, respectively, whereas they stagnated in the country as a whole. Finally, in Slovenia and Bulgaria regional wage growth disparities have not been very strong (at least in relative terms, in the case of Bulgaria).

[40] Throughout this section, whenever we speak of wages, we refer to the compensation of employees (gross wages plus social security contributions paid by the employer), since the data on gross wages are not available at the regional level. Note that the dynamics of the compensation of employees over time may deviate substantially from that of gross wages.

Regional wage disparities do not show a uniform pattern across the EU-CEE over time. One indicator of regional disparities is the gap between average wages in a country's richest region and those in its poorest region. As can be seen from Figure 22, which shows the evolution of this gap over time, regional wage disparities narrowed between 2010 and 2015 in Hungary, Poland and Slovenia. This is an encouraging development, especially in Poland, where regional wage differentials were initially the highest. Wages on the Polish periphery have generally been rising faster than in the Warsaw region and have narrowed the gap. In the Czech Republic and Romania, on the other hand, regional discrepancies have increased. Above all, wages in Prague and Bucharest, where they were already high initially, rose disproportionately between 2010 and 2015.

Figure 22 / Regional wage inequalities, 2010 and 2015



Notes: Average compensation per employee in the wealthiest region of a country divided by the average compensation per employee in the poorest region. National Accounts data. Data for the Czech Republic, Hungary, Poland, Romania and Slovakia as of 2014. Regional data for Croatia are not available.
Source: Eurostat, wiiw calculations.

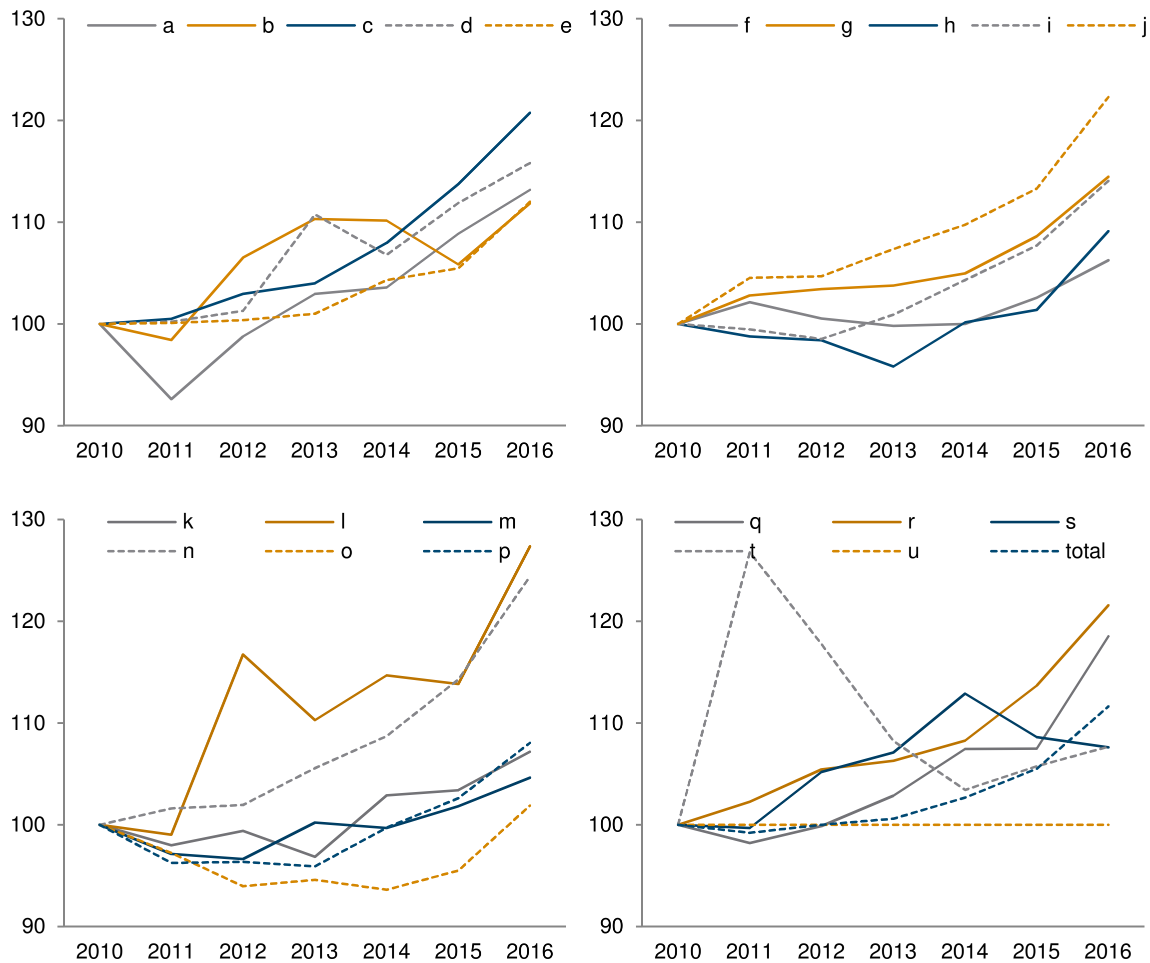
WAGE DEVELOPMENTS BY SECTOR

Behind the aggregated wage dynamics lie a variety of sector-specific developments. One way to approach this specificity is to aggregate hourly wage developments in a particular sector across the countries. Figure 23 shows real wage growth for the (unweighted) average across the EU-CEE-8 for each sector at the NACE Rev. 2 one-digit level for the period 2010-2016.

Real estate, administrative and support activities, and information and communication have recorded the highest real wage increase in the EU-CEE average. For instance, wages in 'real estate activities' (l) have picked up by 27% overall since 2010, mostly on account of Poland, Bulgaria and Romania. At the same time, employment in the real estate sector (as well as construction) has contracted in nearly all EU-CEE countries – with the notable exception of Croatia and (to a lesser extent) Slovakia, possibly suggesting 'labour shedding' and the related efficiency gains. Real estate apart, other sectors which have recorded a cumulative wage increase of more than 20% include 'administrative and support service activities' (n) and 'information and communication' (j). However, unlike in real estate, employment in these two sectors has grown sharply nearly everywhere in EU-CEE, by up to 30-40% in some cases. This suggests that the disproportionate wage increase can probably be attributed to increasing labour shortages, whereby the relevant labour supply has been unable to keep pace with the expansion of the sector.

Figure 23 / Real hourly wage in EU-CEE-8 average, by activity at NACE Rev. 2 1-digit level

index, 2010=100



a - Agriculture, forestry and fishing
b - Mining and quarrying
c - Manufacturing
d - Electricity, gas, steam and air conditioning supply
e - Water supply; sewerage, waste manag. & remediation act.
f - Construction
g - Wholesale & retail trade; rep. of motor veh. & motorcycles
h - Transportation and storage
i - Accommodation and food service activities
j - Information and communication
k - Financial and insurance activities
l - Real estate activities
m - Professional, scientific and technical activities
n - Administrative and support service activities
o - Public administration and defence; compulsory soc. sec.
p - Education
q - Human health and social work activities
r - Arts, entertainment and recreation
s - Other service activities
t – Act. of households as employers; undif. goods- & serv.-producing act. of households for own use
u - Activities of extraterritorial organisations and bodies
total - Total - all NACE activities

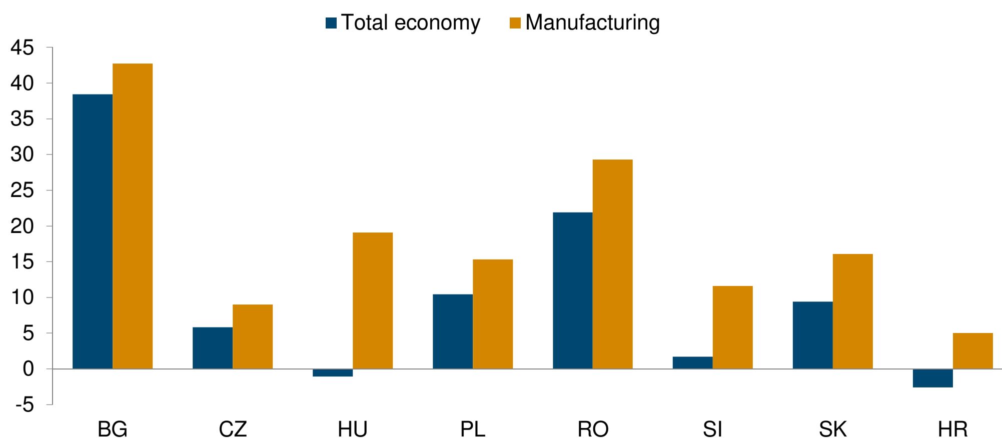
Notes: EU-CEE-8 includes Bulgaria, Croatia, Czech Republic, Hungary, Poland, Romania, Slovakia and Slovenia. Data for 2016 excluding Croatia. National Accounts data.
Source: Eurostat, wiiw calculations.

On the other hand, wages in 'public administration' (o) have recorded a cumulative average increase of only 2% since 2010. Figure 23 suggests that this can be attributed primarily to government austerity packages enacted in the early years of this decade. The increase in wages has also been very

modest in 'professional and scientific activities' (m), 'construction' (f) and 'financial and insurance activities' (k). In this last case, however, the moderate wage growth for EU-CEE as a whole has to be seen against the backdrop of a high initial level. In addition, the lackadaisical growth has almost entirely been driven by anaemic wage growth in Bulgaria and Romania, whereas in most other EU-CEE countries wages in the financial sector have been growing disproportionately strongly.

Figure 24 / Real growth in hourly wages, total economy vs. manufacturing industry

cumulative real growth in 2011-2016, in %

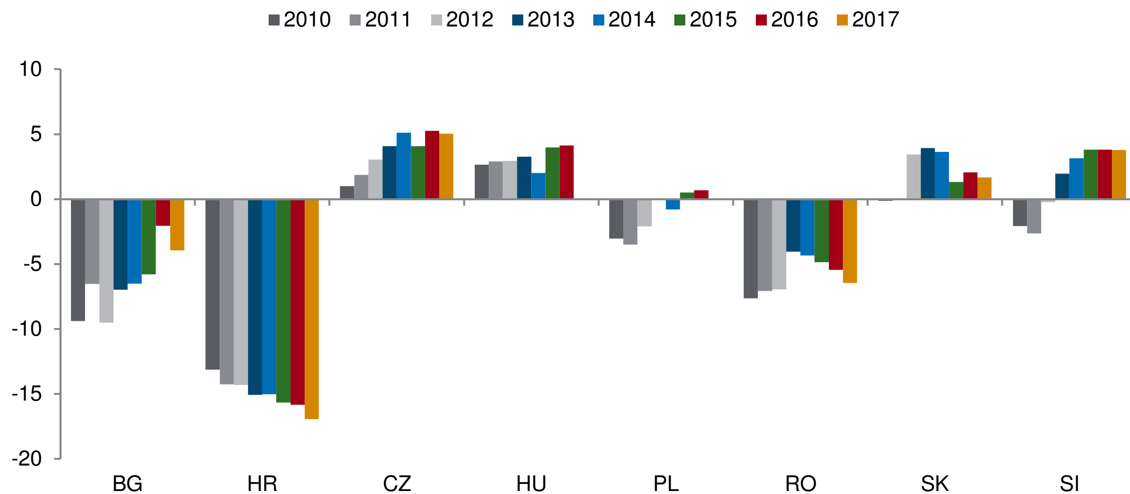


Notes: National Accounts data. For Croatia cumulated real growth for 2011-2015.
Source: Eurostat, wiiw calculations.

Wages in manufacturing have grown faster than in services and the economy as a whole ... This holds true not only for the EU-CEE region as a whole (which recorded a 21% wage growth in manufacturing, compared with 12% for the total economy), but also for each individual EU-CEE country (Figure 24). As a result, in some countries (Czech Republic, Slovenia) hourly wages in manufacturing have caught up with the average wage for the economy as a whole, and in others (Hungary, Slovakia) they have even surpassed that level. In the remaining EU-CEE countries, the wage gap between the manufacturing industry and the national average has also narrowed considerably (although it is still substantial in some countries, up to 23% in Bulgaria).

… but this has not translated into competitiveness losses. The above-average wage increases in the manufacturing industry are all the more impressive because this sector is the most exposed to international competition. Therefore, excessive wage increases in manufacturing could theoretically lead to a loss of external competitiveness. This has not happened, however – indeed, by and large the opposite has occurred, at least when measuring changes in competitiveness by the evolution of the trade balance. The trade balances of most EU-CEE countries have generally improved since 2010, as wage increases have largely been offset by gains in labour productivity and in the non-price competitiveness of EU-CEE products – e.g. quality improvements, or in some cases (e.g. Hungary) currency depreciations. As can be seen from Figure 25, the trade surpluses of the Czech Republic and Hungary have strengthened further since 2010, the trade deficits of Poland and Slovenia have turned into surpluses, and the trade deficit of Bulgaria has narrowed – notwithstanding a particularly strong wage growth in that country.

Figure 25 / Trade balance in goods (BOP), as % of GDP



Source: wiiw Annual Database.

CONCLUSIONS

In the EU-CEE countries, real hourly wages have generally been on the rise since the financial crisis of 2008-2009, and the trend has accelerated over time. This applies particularly to the manufacturing sector, where wages have grown disproportionately in all EU-CEE countries, though without detrimental effects on external competitiveness in most cases. Wages in information and communication and administrative and support service activities have increased markedly as well, as demand for labour has picked up strongly in those sectors. Also, in several EU-CEE countries, regional wage disparities have declined over time, most notably in Poland, where they were originally the highest.

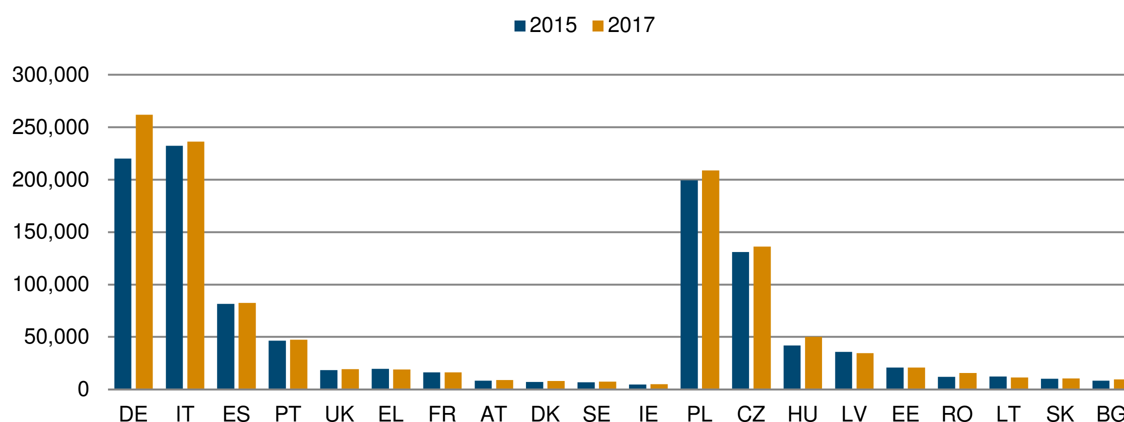
Special section II:
Ukrainian migrants filling the employment gap

ISILDA MARA

The media across Western Europe have focused heavily in recent years on migration from EU-CEE to the EU-15. A much less-reported story is that of migration flows within CESEE, and in particular from Ukraine to parts of EU-CEE. The number of Ukrainians working in EU-CEE has risen sharply in the last few years, and they now constitute an important part of the labour market in some countries of the region.

The EU-28 overall is an important destination for Ukrainian outward migration. Russia remains by far the most common destination for Ukrainian migrants, hosting 55% of the total. However, the EU-28 now has 22% (the rest have chosen other destinations, such as the USA, Kazakhstan, Israel and Uzbekistan). The estimated stock of immigrants from Ukraine to the EU-28 was around 1.22 million in 2017. Within the EU-28, the main hosting countries are Germany, Italy and Poland – with a stock of above 200,000 each (see Figure 26).

Figure 26 / Stock of Ukrainian immigrants, top 20 destinations in EU-28



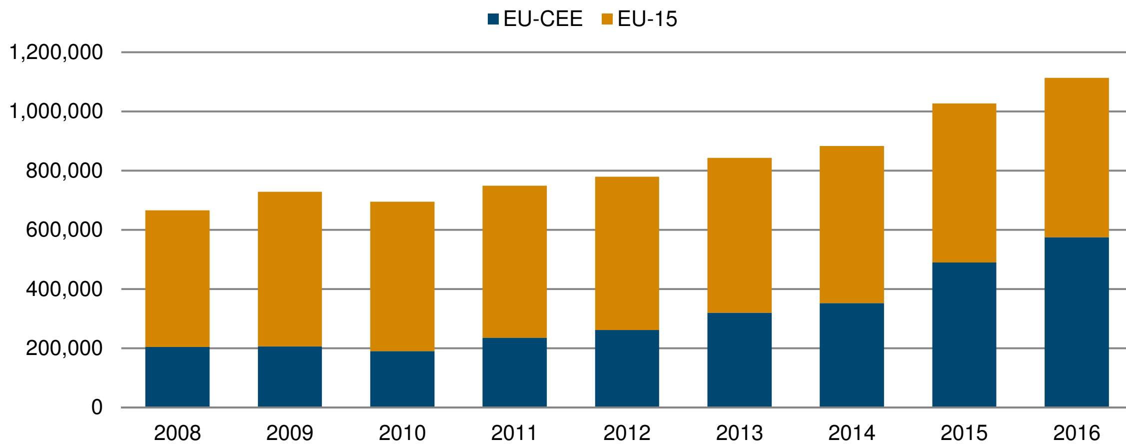
Source: UN Statistics (2018).

Recently, EU-CEE has actually attracted many more Ukrainian immigrants than the EU-15. Among EU-CEE countries, other important destinations are the Czech Republic and Hungary, with a stock of 130,000 and 50,000 Ukrainian immigrants, respectively. The number of residence permits[41] issued to Ukrainian immigrants in the EU-15 rose by 17% between 2008 and 2016, to 540,000. Over the same

[41] Residence permit statistics refers to third-country nationals (persons who are not EU citizens) receiving a residence permit or an authorisation to reside in one of the EU or EFTA Member States. A residence permit is: 'Any authorisation valid for at least 3 months issued by the authorities of a Member State allowing a third country national to stay legally on its territory.' Source: Eurostat (http://ec.europa.eu/eurostat/cache/metadata/en/migr_res_esms.htm).

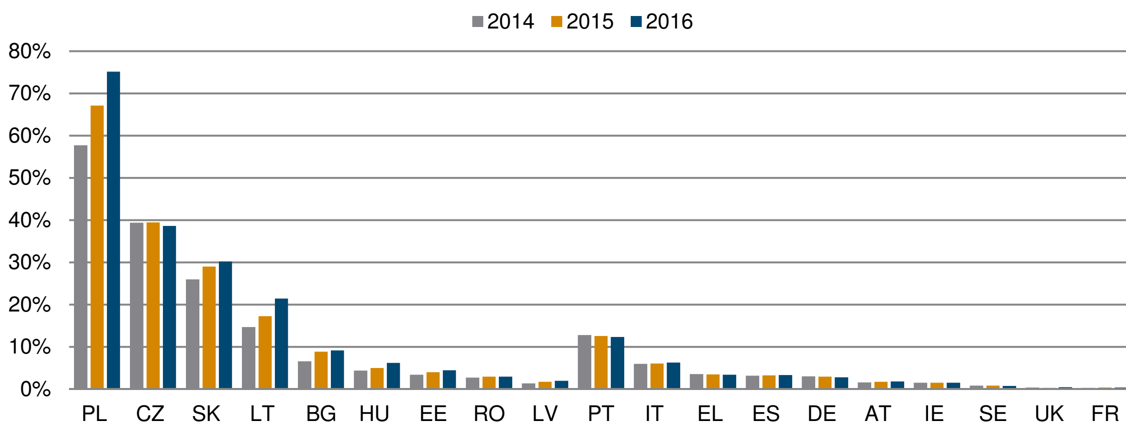
period, residence permits issued to Ukrainians to live in EU-CEE more than doubled, to 580,000 (see Figure 27). As a result, immigrants from Ukraine now represent more than 75% of total immigrants in Poland, around 40% in the Czech Republic and 30% in Slovakia (see Figure 28).

Figure 27 / Residence permits issued to Ukrainian immigrants



Source: Eurostat (2018).[42]

Figure 28 / The share of residence permits issued to Ukrainians over total immigrants



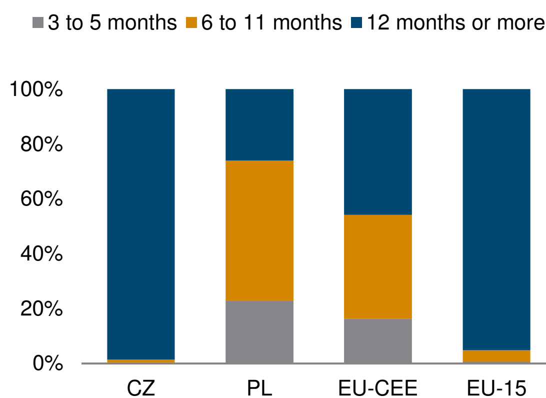
Source: Eurostat (2018).

The data indicate how indispensable Ukrainians have become to EU-CEE countries. In 2008, a third of residence permits issued to Ukrainian immigrants were in the EU-15. By 2016, however, more than half of permits issued to Ukrainians were in one of the EU-CEE countries. Such dynamics hint that Ukrainians have switched to choosing to migrate to EU-CEE more frequently than to the EU-15.

[42] All valid permits by reason, length of validity and citizenship on 31 December of each year [migr_resvalid], last update: 08.12.17; extracted on 16.02.18; source of data: Eurostat.

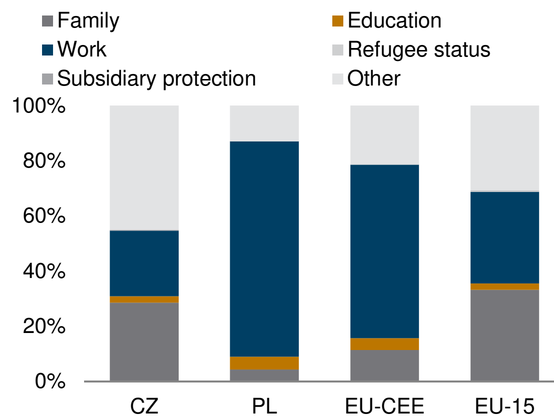
Official statistics underreport the current stock of Ukrainian immigrants in the main EU-CEE destinations: the actual numbers are likely to be much higher. Official national statistics on the number of Ukrainian immigrants in Poland are not available. International data sources (e.g. UN Statistics) report 210,000 Ukrainians in Poland. However, unofficial statistics and experts suggest a much larger number of Ukrainian immigrants in Poland, around 1.5 million, a number expected to rise further. Migration from Ukraine to the Czech Republic was in continuous decline until 2014. Then, in 2015 there was an upswing in net migration, which rose to 4,200 in 2016, and then more than doubled to 9,600 by 2017. Meanwhile, the Czech government has announced an increase in the quotas for Ukrainian immigrants to the Czech Republic to 19,600 – twice the level of net Ukrainian migration in 2017[43] – with the intention of enabling businesses to satisfy their demand for workers via immigrants from Ukraine.[44]

Figure 29 / Residence permits by duration, 2016



Source: Eurostat (2018).

Figure 30 / Residence permits by purpose, 2016



Source: Eurostat (2018).

Illegal migration from Ukraine to EU-CEE is also substantial. Frontex reports more than 10,000 refusals of entry to Ukrainians on the EU's eastern border in both the first and the second quarters of 2017. In both quarters, the number of illegal stays detected was above 4,000. The numbers have been rising steadily, and have probably been facilitated by the visa-free regime for Ukrainians, which came into force in the Schengen countries of the EU in June 2017.[45]

[43] https://www.euractiv.com/section/economy-jobs/news/czech-government-raises-quota-for-fast-lane-work-permits-for-ukrainians/

[44] In the Czech Republic, the vacancy rate is 3.7% – the highest in EU-CEE and in the EU-28. Also, the unemployment rate (at 2.9%) is the lowest in the region. A high vacancy rate, combined with a low unemployment rate, hints at unmet labour demand.

[45] Frontex (2017), *Eastern Partnership Risk Analysis Network Quarterly Report: Quarter 2 April-June 2017*, http://frontex.europa.eu/assets/Publications/Risk_Analysis/EaP_RAN/EaP-RAN_Q2_2017.pdf**.** The statistics reported in this report serve as a proxy for illegal migration, which is detected via Frontex (European Border and Coast Guard Agency).

Ukrainians tend to emigrate mainly for work purposes and for short-term migration spans, at least as far as the EU-CEE countries are concerned. Eurostat statistics on residence permits by duration of stay point out that in Poland more than half of Ukrainian immigrants spend 5-11 months, 22% reside for less than five months, and the rest reside permanently – or at least for more than 12 months (see Figures 29-30).

The push and pull factors for emigration from Ukraine remain strong. In 2017, the unemployment rate in Ukraine stood at 9.5%, in contrast to the low unemployment rates recorded in the Czech Republic, Hungary and Poland – respectively, 2.9%, 4.2% and 4.7%. In the Czech Republic, average gross monthly wages are EUR 1,120, almost five times higher than in Ukraine (EUR 236). In Hungary and Poland, the equivalent figure is close to EUR 1,000.

Overall, migration from Ukraine to the EU-CEE countries has risen strongly in recent years, and this is likely to continue. Immigrants from Ukraine are already the largest community of immigrants in Poland, and are quite vital for other EU-CEE countries, such as the Czech Republic, Slovakia and Latvia. Certainly, the mobility of Ukrainian immigrants is, to a large extent, supply driven, mainly because of the still strong push and pull factors governing emigration. At the same time, though, it is also demand driven. A number of EU-CEE countries are continuing to experience net emigration and a decline in the working-age population. As a result, they are facilitating immigration as a quick way of satisfying demand for workers. Ukrainians have shown themselves to be responsive and quite flexible to such an upsurge in demand. Moreover, Ukraine represents a much more politically acceptable source of immigrants than Middle East and African countries, as demonstrated by the refusal of several EU-CEE countries to participate in the EU's asylum-seeker relocation scheme.

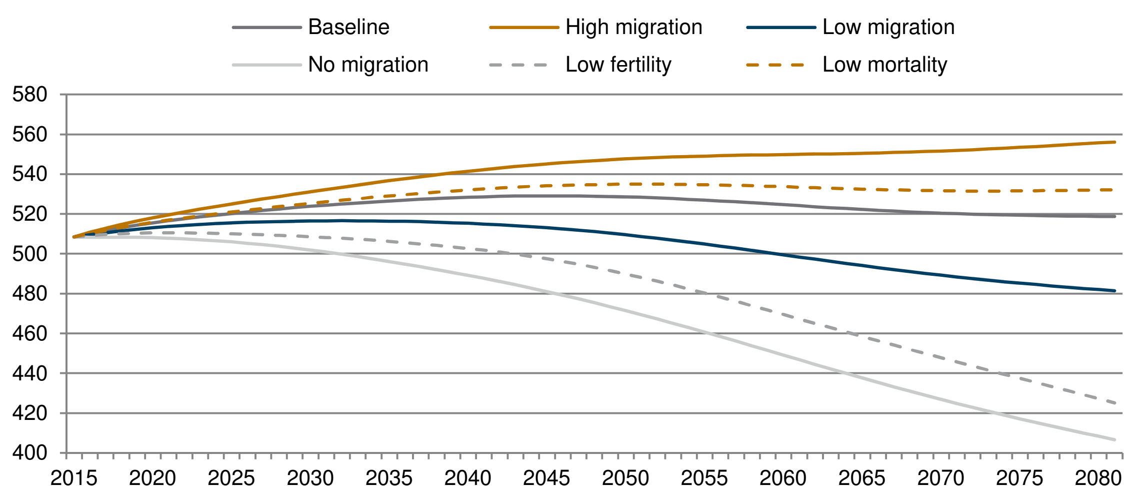
Special section III: EU-CEE's demographic challenge[46]

ROBERT STEHRER

DEMOGRAPHIC TRENDS IN THE EU-28 AND THE EU-CEE

The labour shortages that have arisen in a number of EU-CEE countries and in the region as a whole need to be assessed against the backdrop of negative population trends. Thanks to the much-improved economic outlook and higher growth rates, employment is growing and unemployment rates have started to decline. There are already signs of labour shortages arising in many countries, particularly in EU-CEE. These trends must be seen in the broader context of the medium- and long-term challenge of demographic trends in the EU – and in EU-CEE region in particular.[47] According to Eurostat's demographic forecasts, the EU-28 population is expected to increase slowly to about 530 million by around 2050, according to the baseline scenario (i.e. an increase of about 4% over 2015); from that point it should decline slowly to around 520 million by 2080 (see Figure 31).

Figure 31 / Demographic forecasts for the EU-28, in million persons



Source: Eurostat.

Such a decline could be countered by lower mortality rates and (particularly) higher migration; in the latter case, the EU-28 population would increase to almost 560 million by 2080 (i.e. an increase of about 10% over 2015). According to the other scenarios – low migration, no migration and low fertility – the

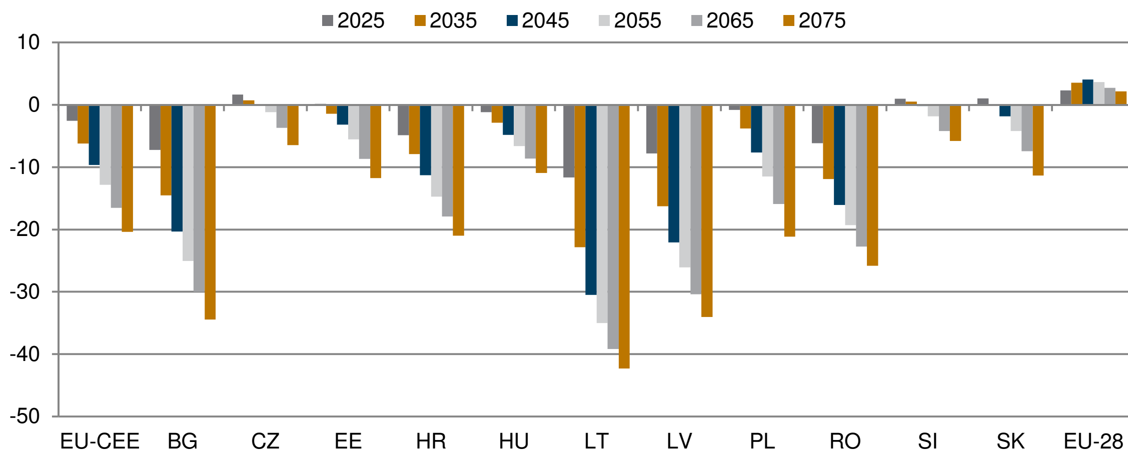
[46] I would like to thank Mario Holzner, Vladimir Gligorov, Peter Havlik and Michael Landesmann (all wiiw) for comments and discussions.

[47] This chapter focuses on the EU-CEE only for data reasons. Similar developments are also occurring in other countries of the CESEE region.

population would even start to shrink in the medium term: by the mid-2020s according to the low-fertility scenario and by the mid-2030s according to the low-migration scenario.

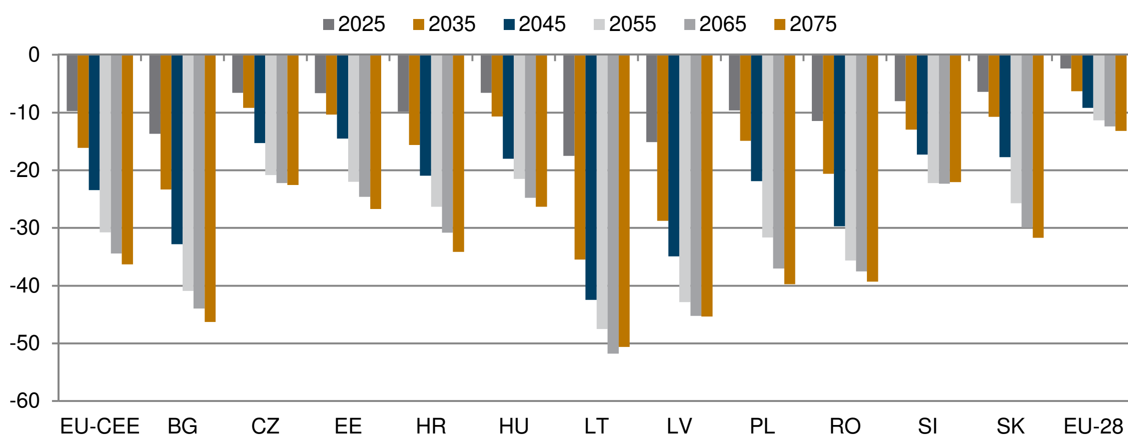
The population in most EU-CEE countries is already declining, according to the data. Figure 32 shows the percentage change in the population (relative to the population in 2015) in the EU-CEE region as a whole, its individual countries, and the EU-28. The population of the EU-CEE region is expected to decline by 10% by 2045, according to the baseline scenario. Even more rapid declines are anticipated in Bulgaria, Croatia, Lithuania, Latvia and Romania.

Figure 32 / Population trends according to Eurostat baseline scenario (change in % compared to 2015)



Source: Eurostat; own calculations.

Figure 33 / Demographic trends in working-age population (change in % compared to 2015)



Note: Figures based on Eurostat baseline scenario.
Source: Eurostat; own calculations.

The working-age population is declining at an even faster rate. These demographic trends also impact on the size of the working-age population (defined as the population aged between 20 and 64 years). In fact, the working-age population is declining even faster than the total population (see

Figure 33), due to the ageing structure of the countries. According to the benchmark scenario, all countries – including the EU-28 – face a decline in their working-age population as early as 2025. By that date, the EU-CEE region can expect a decline of almost 10% in its working-age population, and of 15% by 2035; and the trend is even stronger in Bulgaria, Lithuania, Latvia and Romania.

These trends are likely to lead to a tightening of the labour market, which will have an impact on longer-term growth performance. Such demographic trends may lead to a further tightening of the labour market, unless they are countered by migration policies, changes to the retirement age or other labour market policies to increase participation. There is little research that tackles the challenge of a declining population and workforce on economic performance. Some data indicate a positive correlation between population growth and growth of GDP per capita (e.g. Boussemart and Godet, 2018), though there may be some counteracting forces, like stronger capital investment or technological developments.

EMPLOYMENT GROWTH MEETS THE DEMOGRAPHIC CHALLANGE

The decrease in the working-age population will be a challenge for sustained employment growth in the medium term. The decline in the working-age population implies a decline in the active population (defined as people who are employed or unemployed) if the activity rate (i.e. the ratio of active population to working-age population) remains constant. This potential decline in the workforce is at odds with a growing demand for labour. The decrease in the size of the active labour force due to the demographic trend might, however, be countered by a rising activity rate. To evaluate the strength of these counteracting forces, scenarios are presented (following the approach by Peschner and Fotakis, 2013, and Fotakis and Peschner, 2015) that contrast the potential growth in labour demand with projections for the declining working-age population and a potential rise in the activity rate, which together determine the size of the available labour force. Specifically, it is assumed that employment will grow at 0.5% annually from 2016 (rather a cautious assumption, given recent trends). It is further assumed that all countries will reach an activity rate of 75% of the working-age population (age 20-64) by 2020 (which for some countries seems quite ambitious).[48] If a country had already met this target by 2016, the assumption is that the rate will stay constant at that level.

This scenario suggests that EU-CEE will reach a critical point in the mid-2020s. Figures 34a and 34b present the results of the scenario outlined above for the EU-28 and the EU-CEE countries. In the EU-28, labour demand would theoretically exceed the active working population around 2030; and in the EU-CEE region this would occur as early as 2023. Such a situation is clearly not possible, but it provides an indication of when the labour market shortages will turn into a constraint on growth. As the graphs also show, even if the number of active persons were to remain at its peak level (attained in 2020), the constraining point would still be reached in the EU-28 in 2033 and in EU-CEE even before 2030.[49]

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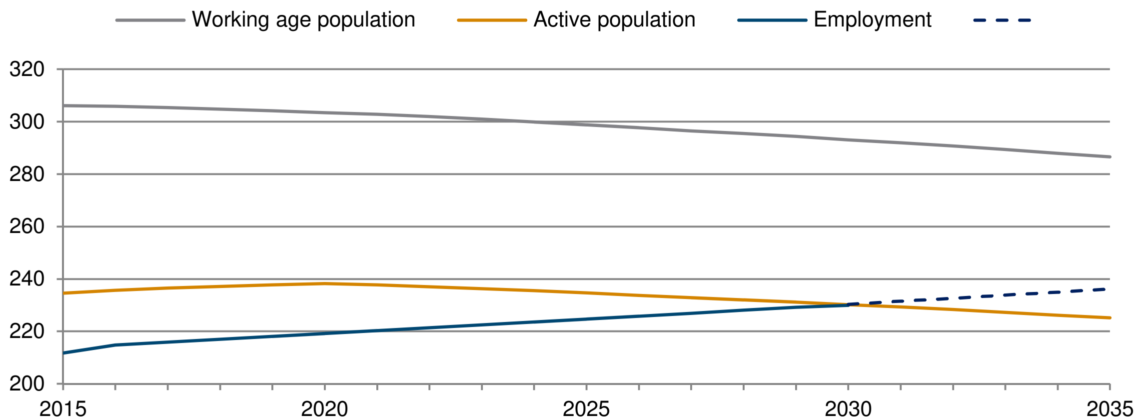
[48] Note that the Lisbon target is to reach an employment rate of 75% at the EU level, whereas here this benchmark is assumed across all countries. Further, if unemployment reaches zero, the activity rate would correspond to the employment rate. Reaching an employment rate of 75% would therefore be even more ambitious, and this needs to be taken into account when evaluating the results of the scenario analysis.

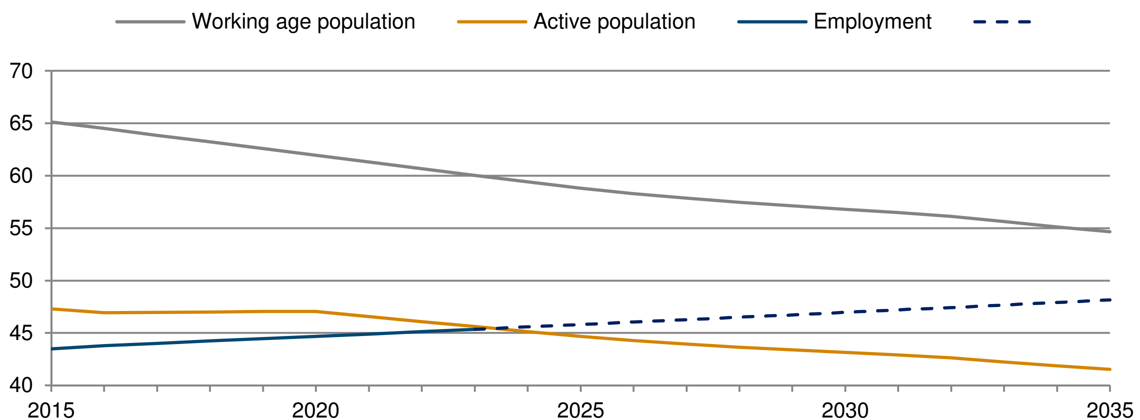
[49] The constraining point would be reached even slightly earlier, if one assumes that a certain number of unemployed persons (within the active population) will still exist even in tight labour markets.

Figure 34a / Scenario for the EU-28, in million persons



Note: Number of working-age population in population forecasts is scaled to Labour Force Survey (LFS) data.
Source: Eurostat; own calculations.

Figure 34b / Scenario for EU-CEE, in million persons



Note: Number of working-age population in population forecasts is scaled to Labour Force Survey (LFS) data.
Source: Eurostat; own calculations.

Only a dramatic change in the activity rates can delay labour market shortages. As these numbers depend on various assumptions, certain robustness checks are presented. First, the annual growth rate in employment is changed to a high-growth scenario of 1% and a low-growth scenario of 0.25%. Second, a change in the activity rate is modelled. Specifically, it is assumed that the activity rate will increase to 80% or even 85% in the period 2020-2030.[50] The results are presented in Table 7, which shows the ratio of the active population to labour demand, minus 1.[51] As one can see, a higher employment growth rate in the EU-28 would imply that the tipping point is reached in 2025, while a lower

[50] One needs to be aware that these are substantial changes. For example, in the EU-28 the activity rate is around 73% and the employment rate close to 67%.

[51] This might also be interpreted as the unemployed as a percentage of the active population. However, in terms of the unemployed, the interpretation would need to take into account issues like frictional unemployment, search unemployment, etc.

rate of employment growth would shift it to 2035. The change in the activity rate has less impact in the EU-CEE region, as the demographic trends are stronger. The tipping point would be between 2022 (1% employment growth rate) and 2025 (0.25% employment growth rate). The strongest impact would be felt from an increase in the activity rate to 85%, which would move the tipping point to 2033 (similar to in the EU-28).

Table 7 / Robustness checks of alternative scenarios 1

	EU-28					EU-CEE				
		Employment growth scenarios		Change in activity rate to ...			Employment growth scenarios		Change in activity rate to ...	
	Baseline	1%	0.25%	80%	85%	Baseline	1%	0.25%	80%	85%
2015	0.11	0.11	0.11	0.11	0.11	0.09	0.09	0.09	0.09	0.09
2016	0.10	0.10	0.10	0.10	0.10	0.07	0.07	0.07	0.07	0.07
2017	0.10	0.09	0.10	0.10	0.10	0.07	0.06	0.07	0.07	0.07
2018	0.09	0.08	0.10	0.09	0.09	0.06	0.05	0.07	0.06	0.06
2019	0.09	0.07	0.10	0.09	0.09	0.06	0.04	0.07	0.06	0.06
2020	0.09	0.07	0.10	0.09	0.09	0.05	0.03	0.06	0.05	0.05
2021	0.08	0.05	0.09	0.08	0.09	0.04	0.01	0.05	0.04	0.05
2022	0.07	0.04	0.09	0.08	0.09	0.02	-0.01	0.04	0.03	0.05
2023	0.06	0.03	0.08	0.07	0.09	0.01	-0.03	0.02	0.02	0.04
2024	0.05	0.01	0.07	0.07	0.09	-0.01	-0.05	0.01	0.01	0.04
2025	0.04	-0.00	0.07	0.06	0.09	-0.02	-0.07	-0.00	0.00	0.03
2026	0.04	-0.01	0.06	0.05	0.09	-0.04	-0.08	-0.01	-0.01	0.03
2027	0.03	-0.03	0.05	0.05	0.09	-0.05	-0.10	-0.02	-0.01	0.03
2028	0.02	-0.04	0.05	0.04	0.09	-0.06	-0.12	-0.03	-0.02	0.03
2029	0.01	-0.05	0.04	0.03	0.08	-0.07	-0.13	-0.04	-0.03	0.03
2030	-0.00	-0.07	0.03	0.03	0.08	-0.08	-0.14	-0.05	-0.03	0.03
2031	-0.01	-0.08	0.03	0.02	0.07	-0.09	-0.16	-0.06	-0.04	0.02
2032	-0.02	-0.09	0.02	0.01	0.06	-0.10	-0.17	-0.06	-0.05	0.01
2033	-0.03	-0.11	0.01	-0.00	0.05	-0.11	-0.19	-0.08	-0.07	-0.01
2034	-0.04	-0.12	0.01	-0.01	0.04	-0.13	-0.20	-0.09	-0.08	-0.02
2035	-0.05	-0.13	-0.00	-0.02	0.03	-0.14	-0.22	-0.10	-0.09	-0.03

Source: Own calculations.

The various demographic scenarios do not alter the situation for the EU-CEE countries. A second set of robustness checks is reported in Table 8. As shown above, Eurostat population forecasts provide various scenarios. Of these, the baseline (0.5% employment growth; 75% activity rate by 2020) is applied to the Eurostat migration scenarios and to the fertility and mortality scenarios. For the EU-28, the turning point would still lie between 2026 in the (highly unlikely) no-migration scenario and 2032 in the high-migration scenario. For the EU-CEE region, these specific scenarios do not change the overall outcome: constraints would still arise in the mid-2020s.

Differences across the EU-CEE countries are mostly driven by their distance to the target employment rate, and thus depend on their ability to achieve these goals. Finally, Table 9 reports the results for the individual countries of the EU-CEE region according to the baseline scenario (and the Eurostat baseline population forecasts). Most countries would reach the turning point between 2020 (Czech Republic) and 2026 (Poland), according to this scenario (though Croatia would only reach this point in 2031). However, one has to be aware that the results depend heavily on the assumption that these countries – Croatia and Poland, in particular – reach the target employment rate of 75% in 2020.[52]

[52] To gauge how ambitious this assumption is, note that the activity rates in Croatia and Poland are 66% and 69%, respectively, and the employment rates 57% and 65%.

Table 8 / Robustness checks of alternative scenarios 2

	EU-28					EU-CEE				
	High migration	Low migration	No migration	Low fertility	Low mortality	High migration	Low migration	No migration	Low fertility	Low mortality
2015	0.11	0.11	0.11	0.11	0.11	0.09	0.09	0.09	0.09	0.09
2016	0.10	0.10	0.10	0.10	0.10	0.07	0.07	0.07	0.07	0.07
2017	0.10	0.09	0.09	0.10	0.10	0.07	0.07	0.07	0.07	0.07
2018	0.10	0.09	0.08	0.09	0.09	0.06	0.06	0.06	0.06	0.06
2019	0.09	0.09	0.08	0.09	0.09	0.06	0.06	0.06	0.06	0.06
2020	0.09	0.08	0.07	0.08	0.09	0.05	0.05	0.06	0.05	0.05
2021	0.09	0.07	0.06	0.07	0.08	0.04	0.04	0.04	0.03	0.04
2022	0.08	0.06	0.05	0.06	0.07	0.02	0.02	0.03	0.01	0.02
2023	0.07	0.05	0.04	0.05	0.06	0.00	0.01	0.01	-0.01	0.01
2024	0.06	0.04	0.02	0.04	0.05	-0.01	-0.01	-0.00	-0.02	-0.01
2025	0.06	0.03	0.01	0.03	0.04	-0.03	-0.02	-0.02	-0.04	-0.02
2026	0.05	0.02	-0.00	0.02	0.04	-0.04	-0.03	-0.03	-0.05	-0.04
2027	0.04	0.01	-0.01	0.01	0.03	-0.05	-0.05	-0.04	-0.06	-0.05
2028	0.03	0.00	-0.03	0.00	0.02	-0.07	-0.06	-0.05	-0.07	-0.06
2029	0.02	-0.01	-0.04	-0.00	0.01	-0.08	-0.07	-0.06	-0.08	-0.07
2030	0.02	-0.02	-0.05	-0.01	0.00	-0.09	-0.08	-0.07	-0.09	-0.08
2031	0.01	-0.03	-0.06	-0.02	-0.01	-0.10	-0.09	-0.08	-0.10	-0.09
2032	-0.00	-0.04	-0.07	-0.03	-0.02	-0.11	-0.10	-0.09	-0.11	-0.10
2033	-0.01	-0.05	-0.09	-0.04	-0.03	-0.12	-0.11	-0.10	-0.12	-0.11
2034	-0.02	-0.06	-0.10	-0.05	-0.04	-0.13	-0.12	-0.11	-0.14	-0.12
2035	-0.02	-0.07	-0.11	-0.06	-0.05	-0.14	-0.13	-0.12	-0.15	-0.14

Note: The baseline scenario is reported in Table 9.
Source: Eurostat; own calculations.

Table 9 / Country-specific results for the EU-CEE region

	Czech Republic	Lithuania	Bulgaria	Hungary	Latvia	Estonia	Slovenia	Romania	Slovak Republic	Poland	Croatia
2015	0.05	0.10	0.10	0.07	0.11	0.07	0.10	0.08	0.13	0.08	0.20
2016	0.04	0.09	0.08	0.05	0.11	0.08	0.09	0.07	0.11	0.07	0.16
2017	0.03	0.06	0.07	0.05	0.09	0.06	0.08	0.06	0.10	0.07	0.16
2018	0.01	0.04	0.06	0.04	0.07	0.05	0.06	0.06	0.08	0.08	0.16
2019	0.00	0.02	0.04	0.03	0.05	0.04	0.05	0.06	0.07	0.08	0.16
2020	-0.01	0.00	0.03	0.02	0.03	0.03	0.03	0.06	0.06	0.08	0.15
2021	-0.02	-0.02	0.01	0.00	0.01	0.01	0.02	0.04	0.05	0.07	0.14
2022	-0.03	-0.05	-0.01	-0.01	-0.01	0.00	0.00	0.02	0.03	0.05	0.12
2023	-0.04	-0.07	-0.03	-0.02	-0.04	-0.01	-0.01	0.00	0.02	0.03	0.10
2024	-0.05	-0.10	-0.05	-0.03	-0.06	-0.02	-0.02	-0.01	0.01	0.02	0.09
2025	-0.06	-0.13	-0.06	-0.04	-0.08	-0.03	-0.03	-0.03	-0.00	0.00	0.07
2026	-0.07	-0.16	-0.08	-0.05	-0.11	-0.04	-0.05	-0.04	-0.01	-0.01	0.06
2027	-0.07	-0.19	-0.10	-0.05	-0.13	-0.05	-0.06	-0.06	-0.03	-0.03	0.04
2028	-0.08	-0.21	-0.11	-0.06	-0.15	-0.06	-0.07	-0.07	-0.04	-0.04	0.03
2029	-0.09	-0.24	-0.13	-0.07	-0.17	-0.07	-0.08	-0.08	-0.05	-0.05	0.02
2030	-0.09	-0.26	-0.14	-0.08	-0.19	-0.08	-0.09	-0.09	-0.05	-0.06	0.01
2031	-0.10	-0.28	-0.16	-0.08	-0.21	-0.08	-0.10	-0.10	-0.06	-0.06	-0.00
2032	-0.11	-0.30	-0.17	-0.09	-0.22	-0.09	-0.11	-0.11	-0.07	-0.07	-0.01
2033	-0.12	-0.32	-0.18	-0.10	-0.24	-0.10	-0.11	-0.13	-0.08	-0.08	-0.03
2034	-0.12	-0.34	-0.19	-0.12	-0.26	-0.11	-0.12	-0.15	-0.09	-0.09	-0.04
2035	-0.13	-0.35	-0.21	-0.13	-0.27	-0.12	-0.13	-0.17	-0.10	-0.10	-0.05

Source: Eurostat; own calculations.

CONCLUSIONS

The demographic challenge is looming, while the potential impacts are unclear and policy measures have yet to be developed. In summary, given the expected high growth rates of GDP and employment and the prevailing demographic trends, it is very likely that the countries of EU-CEE will reach the point of labour shortage-induced economic constraint somewhere in the 2020s. The consequences of the demographic challenges ahead are manifold and probably not yet well understood. The labour market shortages might dampen longer-run growth prospects, could easily have negative implications for productivity catch-up, and may impact on migration patterns and policies throughout Europe and beyond. Furthermore, these trends pose challenges in terms of the future of existing welfare systems. On the positive side, these pressures may also lead to higher investment and innovation, though such interactions have still to be explored. However, this section claims that these long-term trends are turning into a severe and imminent challenge, and should be considered just as important as – but also in conjunction with – future technological developments.

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Special section IV: Functional specialisation in CESEE: Key to escaping the semi-periphery trap?

ROMAN STÖLLINGER

In times of global value chains, functional specialisation supplements structural specialisation. *Over the past decades, the economies of Central, Eastern and South Eastern Europe (CESEE) have been remarkably successful in catching up with the 'old' EU Member States in terms of income per capita (Podkaminer, 2017; EBRD, 2017). Despite some setbacks during the Great Recession and a slowdown in the convergence process, the most advanced countries of the region, such as the Czech Republic and Slovenia, have attained a GDP per capita level of more than 80% of the EU average. A plethora of interrelated factors have contributed to this development, but one of the most obvious support factors has been foreign direct investment (FDI). The question is whether this convergence process will continue, given the position these countries occupy in international production networks and the income levels already attained.*

Foreign capital has been flowing in mainly from the EU partner countries and has brought new technologies and organisational capabilities. *The emergence of twenty-first-century trade (Baldwin, 2011) meant that the investment activities of multinational enterprises (MNEs) induced a structural convergence between the initial industrial core countries of the EU and the New Member States (and to a lesser extent the Western Balkan region) as they were integrated into European production networks.*[53] *International value chains are a defining feature of this integration process, which has meant that the international division of labour has become much more granular. In particular, countries no longer specialise only in certain industries (i.e. the structural component), but are also assigned certain functions along the firm's value chain (i.e. the functional component).*

This special section suggests a new approach to capture functional specialisation along the value chain. *Despite a flourishing theoretical literature on 'trade in tasks', which implies functional specialisation, the latter has received comparatively little attention in empirical research. The novel approach to identifying the functional specialisation of countries relies on project-level data for greenfield FDI projects.*[54] *Due to the importance of FDI inflows in the economic convergence process of the CESEE region, it is of particular interest to study the functional specialisation patterns of these countries.*

CESEE countries face the risk of becoming the EU's permanent semi-periphery. *The picture that emerges is one of a very strong specialisation along the value chain in the actual production process,*

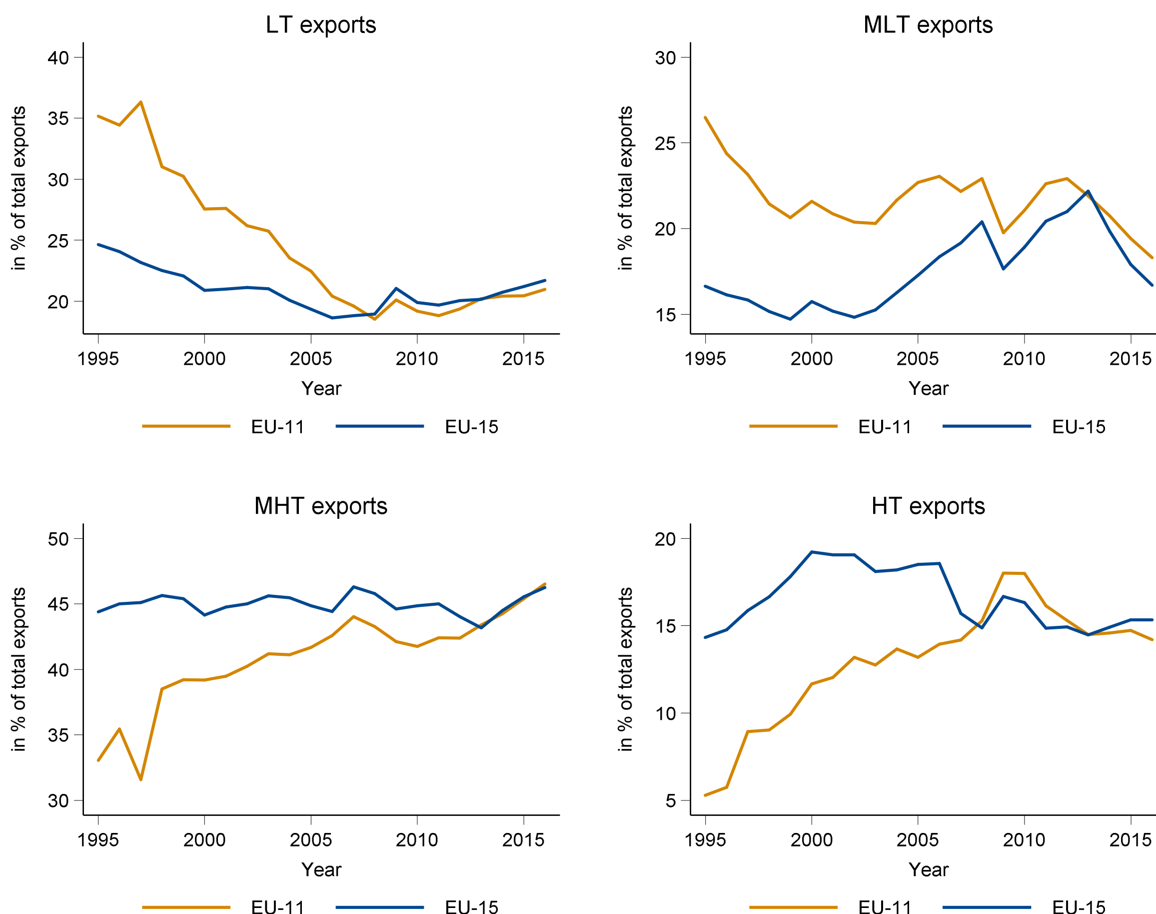
[53] The CIS region has not been left out of this process, but has been less integrated into European production networks.

[54] Existing approaches in the literature use the 'upwardness' of the output produced, which essentially measures the distance to final demand (Antràs et al., 2012), the specialisation in broadly defined industries (Baldwin et al., 2014) or the job composition (Lanz et al., 2011) within a country, to reveal patterns of 'trade in tasks' and the functional specialisation of that country.

which is associated with relatively little value creation (compared to research and development (R&D) and headquarter services, for example). This type of specialisation might become a 'functional trap' for several CESEE countries, meaning that the region risks ending up as a permanent semi-periphery with a high degree of economic dependence on the Western core EU countries, and income levels never reaching those of the leading economies.

The structural convergence of Central and Eastern European EU Member States (EU-CEE) with the Western EU core countries has been substantial. Within the CESEE region, convergence with the industrial structure of the Western EU core countries has been most pronounced in the 'new' EU Member States. This is because the EU-CEE countries were tightly integrated into the European production network, which led to the formation of a Central European Manufacturing Core (CEMC) (Stehrer and Stöllinger, 2015; Stöllinger, 2016). The pivotal economy of this core is Germany, but all members (i.e. Germany, Austria, the Czech Republic, Slovakia, Hungary and Poland) have benefited from the integration process, with success resting on numerous complementarities.

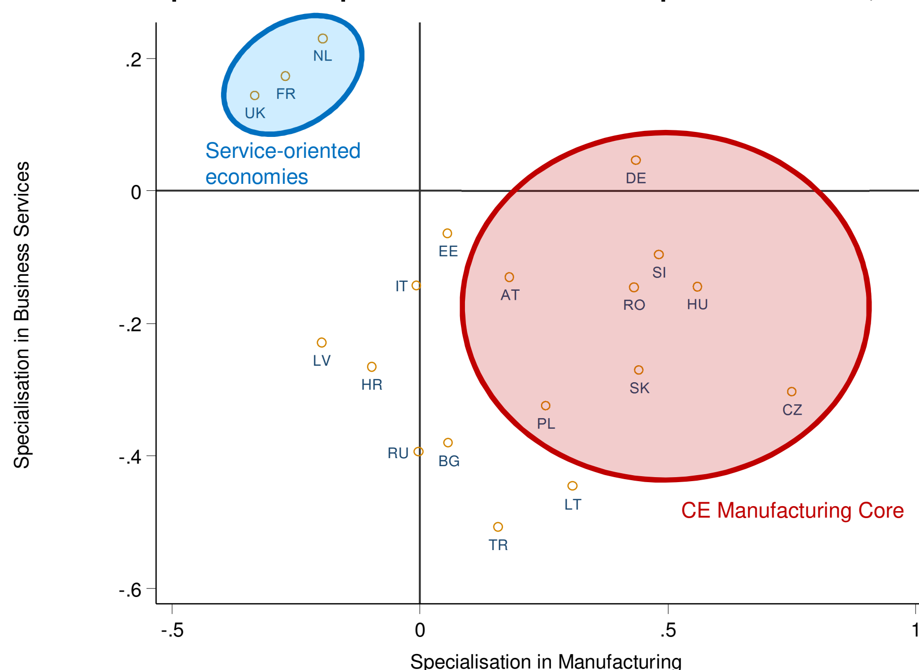
Figure 35 / Structural convergence in the EU



Note: Industry classification by technology content at the NACE Rev.2, 2-digit level. LT=low tech; MLT=medium-low tech; MHT=medium-high tech; HT=high tech. Aggregation using weighted averages of countries within the EU-11 and EU-15.
Source: UN Comtrade, wiiw calculations.

For German firms (and to some extent also Austrian),[55] **the EU-CEE countries have provided new investment opportunities in close geographical proximity, where the wage level was comparatively low, but the level of education was high.** The fact that the countries have become EU members has also meant that there is an institutional anchor that reduces political risk. From the perspective of the EU-CEE countries, the investments of German and Austrian firms have provided new employment opportunities, have helped restructure existing but unprofitable industrial estates and have provided access to new technologies and organisational skills. The result has been a de facto alignment of the production and export structures of these countries. While the complementarities have been strongest within the CEMC, the structural convergence process is an EU-wide phenomenon (Figure 35).

Figure 36 / Structural specialisation patterns of selected European economies, 2014



Note: 'Specialisation in business services' is the share of business services in total value added of the respective Member State, relative to the share of business services in total value added in the EU-28, minus 1. 'Specialisation in manufacturing' is the share of the manufacturing sector in total value added of the respective Member State, relative to the share of the manufacturing sector in total value added in the EU-28, minus 1.
Source: WIOD Release 2016, wiiw calculations.

A comparison of the EU-15's share of industrial exports by technology content (low, medium-low, medium-high, high) with the share of the EU-11 (i.e. the EU-CEE) illustrates that the export structures have indeed converged quite strongly. For example, the share of medium-to-high-tech exports – which comprise inter alia the important car industry – in EU-11 exports increased from 33% in 1995 to 43% in 2013, when it matched that of the EU-15.[56] One of the major reasons for this almost complete convergence in export structures is the international fragmentation of the production process that occurred with the emergence of global value chains. If, say, Germany, Austria, Slovakia and the Czech Republic are jointly producing cars, then the intensive trade in intermediate products that is

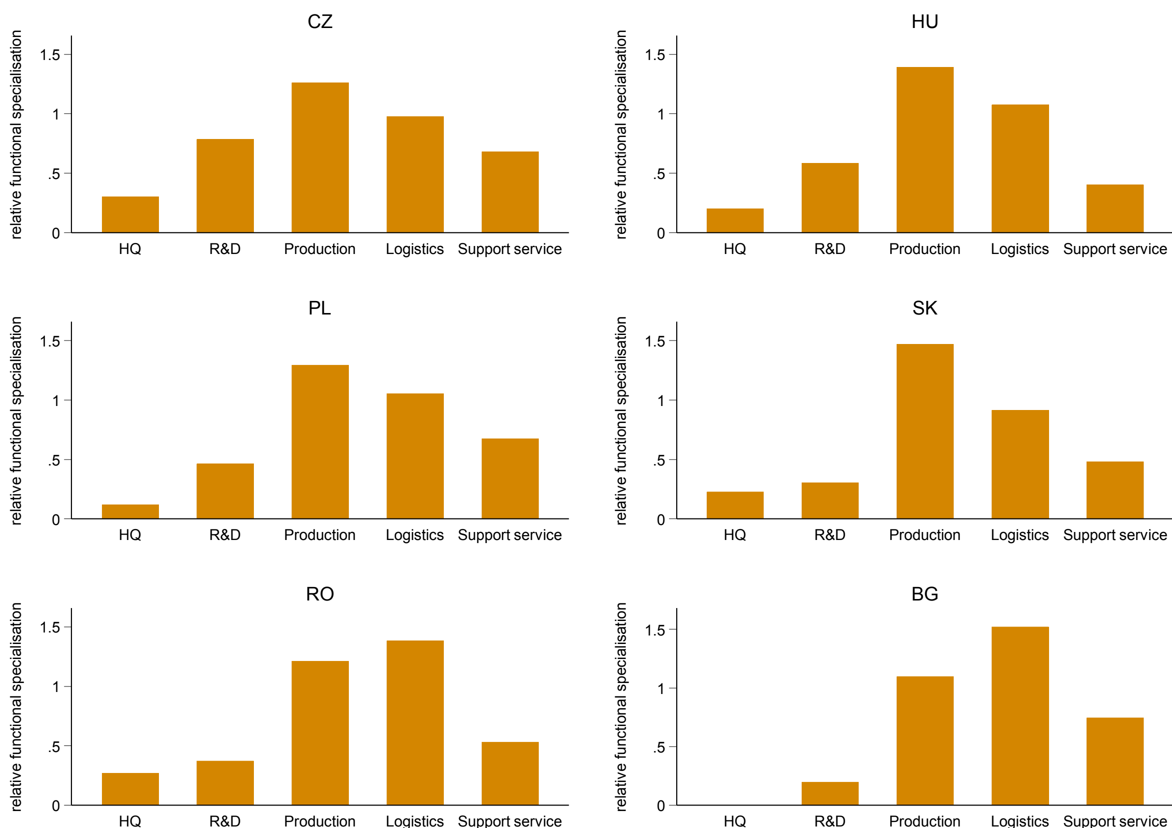
[55] The situation was, of course, similar for other 'old' EU countries, but here the focus is on the CEMC countries.

[56] Note that this structural convergence process set in long before EU enlargement in 2004. The figures are weighted averages within each of the two country groups.

required for this division of labour automatically leads to production and export specialisation in the same (broadly defined) industries. In fact, the economic importance of the CEMC has resulted in a situation whereby the economic structure of EU-CEE is now much more similar to that of Germany and Austria than are those of 'old' Member States such as France, the UK or the Netherlands (Figure 36). The economic structures of the latter are much more geared towards business services than manufacturing, which is obviously not the case in the CEMC.

The structural convergence coincides with a contrasting functional specialisation in the Western EU countries and EU-CEE. The high granularity of international trade allows for specialisation according to value chain functions, such as production. Production, in fact, emerges as the primary value chain function in the functional specialisation patterns of EU-CEE (Figure 37a). This is suggested by the countries' relative functional specialisation (*rfs*), as revealed by greenfield investment projects that have been realised in those countries (see Box 1 for details). A specialisation in actual production activities – which includes final assembly – is discernible in all six countries displayed in Figure 3a, as all of them have an *rfs* greater than 1. The *rfs* for production is particularly high in Slovakia and Hungary, reaching almost 1.5. In contrast, the relative functional specialisation values of the other value chain functions are comparatively low, especially for the knowledge-intensive pre-production functions: headquarter services and R&D.

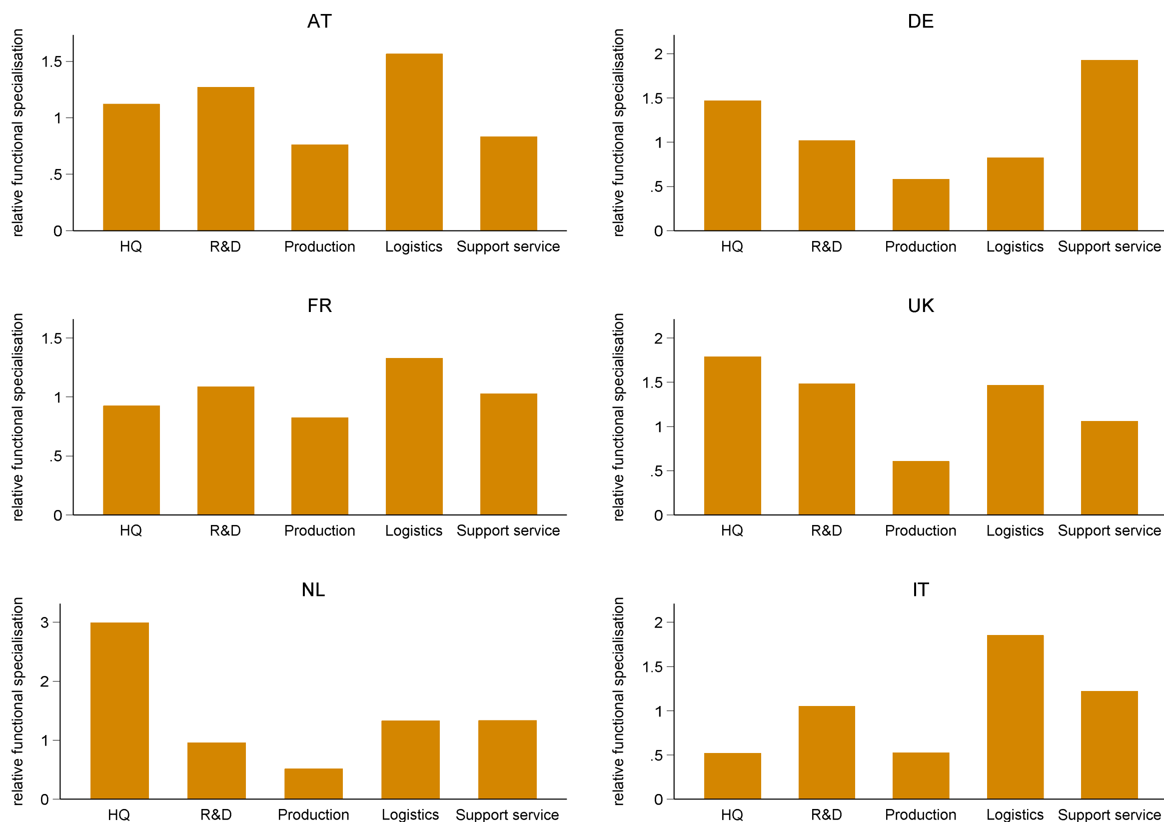
Figure 37a / Functional specialisation in the Visegrád-4 countries, Romania and Bulgaria, averages 2003-2015



Note: Visegrád-4 comprises Czech Republic, Hungary, Poland and Slovakia. Relative functional specialisation retrieved from inward greenfield FDI projects in the manufacturing sector.
Source: fDi markets database, wiiw calculations.

The relative functional specialisation of Germany and Austria is basically the opposite of the Visegrád-4 (Figure 37b). While these countries together form the CEMC and have been shown to be structurally similar, in terms of functional specialisation they are rather complementary. With regard to value chain functions, the Western EU core countries – despite the variance in their structural specialisation (e.g. Germany vs. UK) – are still comparatively homogeneous, with below-average specialisation in production and relatively higher values for the pre-production functions of headquarter services and R&D.

Figure 37b / Functional specialisation in selected Western EU core countries, averages 2003-2015



Note: Relative functional specialisation retrieved from inward greenfield FDI projects in the manufacturing sector.
Source: fDi markets database, wiiw calculations.

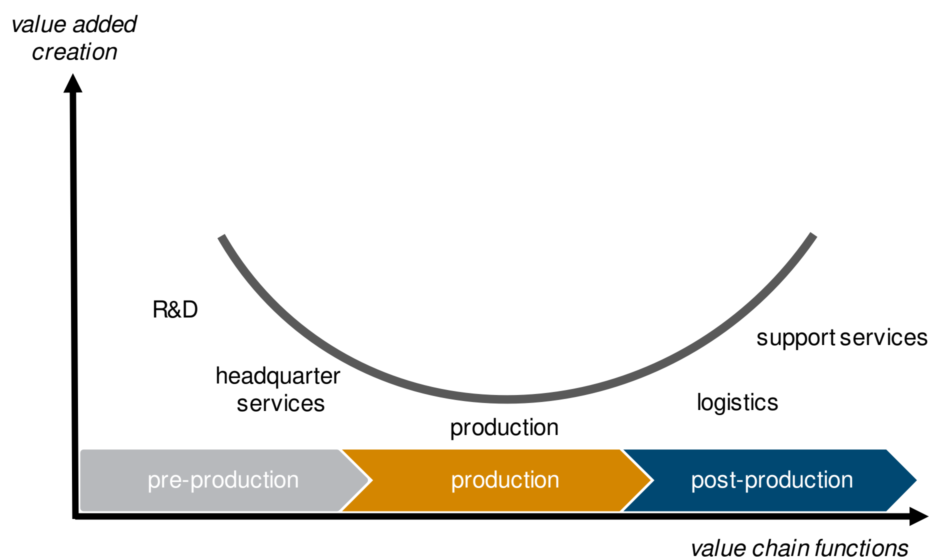
Invoking once more the German-led CEMC, these functional specialisation patterns are in line with predictions for offshoring models in international trade theories (Feenstra and Hansen, 1996; Grossman and Rossi-Hansberg, 2008). In these models, trade can take place in 'intermediate components' or 'tasks', with specialisation being driven by differences in technologies, where the 'North' – the offshoring country – has technology superior to that available in the 'South'. In this constellation, there will also be differences in real wages, and the offshoring countries will exploit these wage differences by offshoring labour-intensive tasks to the 'South', while utilising their own better technologies. Hence, while technological progress and advances in information technology have made offshoring possible, it is wage differences that have made it profitable (Baldwin, 2011; 2016). Within the EU, the same economic mechanism drives functional specialisation (which can be interpreted as the result of trade in 'tasks') between EU partners from the 'West' and the 'East'. In the language of

offshoring theory, the Western EU countries act as 'headquarter economies', while the EU-CEE countries take the role of 'factory economies' (Baldwin, 2016).

BOX 1 / LINKING THE FIRM-LEVEL VALUE CHAIN TO THE FUNCTIONAL SPECIALISATION OF COUNTRIES

The value-creation process of a firm relies on various functions that a firm has to perform successfully, in order to come up with a competitive product. While the exact categorisation of these functions varies, there is a common distinction between the pre-production, production and post-production phases (Box Figure 1).

Box Figure 1 / The smile curve – value creation along the value chain



Source: wiiw representation.

The key functions in the pre-production phase are R&D (including associated activities, such as testing) and headquarter functions, which comprise general management tasks, such as controlling or designing the firm's strategy and business plans. Once a business plan exists and a product has been developed, the firm can move into the production phase. However, the value creation does not stop at the factory floor, but extends further into the post-production phase, which includes transport and logistics, as well as after-sales and other support services. The concept of the value chain attracted a lot of attention when Acer's former chief executive office, Stan Shih, suggested that the value chain of a firm resembles a 'smile curve'. What he meant was that in today's business world, the actual production process often entails the lowest value added, whereas the potential for value-added creation is very high in R&D and many post-production services, such as marketing and customer services.

This concept of the creation of value along a value chain has attracted a lot of interest among trade economists, as the international fragmentation of the production process within global value chains allows countries to specialise according to their comparative advantages in certain industries, but also in a functional dimension. The best-known case of this functional specialisation is the focus of countries with relatively low labour costs on parts of the production process. This type of specialisation is propelled by MNEs via FDI and outsourcing to (legally independent) contract manufacturers. Hence, the extent to which foreign investors establish new enterprises for performing, say, R&D, production or after-sales services provides insights into the functional specialisation of individual countries. To this end, project-level data on greenfield FDI projects (retrieved from the fDi greenfield database maintained by the *Financial Times*) can be exploited. This is because these data contain information on the function that the newly established subsidiary is to perform. In particular, it allows the relative functional specialisation (*rfs*) of each country (i) in each of the functions (f) to be constructed, relative to the world as a whole:

$$rfs_i^f = \frac{n^\circ\ of\ projects_i^f \big/ n^\circ\ of\ projects_i}{n^\circ\ of\ projects_{world}^f \big/ n^\circ\ of\ projects_{world}}$$

If one takes the total number of projects in a country, the higher the share of greenfield FDI projects that serve (for example) the performance of R&D, the greater the functional specialisation of that country in the function R&D. An *rfs* of above 1 in any value chain function f indicates that that particular country is more often used as the location for that value chain function than the world average. Likewise, an *rfs* value of less than 1 indicates that the country receives comparatively few projects serving that function. Importantly, this kind of analysis only includes projects in the *manufacturing sector*.

Since the concept of the smile curve assumes that specialisation in the value chain function production entails comparatively little value added, the five functions shown in Box Figure 1 are further aggregated as the function ‘production’ and the function ‘non-production’ (consisting of the pre-production and post-production functions). The ratio of the two yields a relative production specialisation index (*rpsi*), which shows the extent to which a country serves as a production platform:

$$rpsi_i = \frac{rfs_i^{production}}{rfs_i^{pre-production} + rfs_i^{post-production}}$$

In Baldwin’s terms, countries that have a functional specialisation in production activities are ‘factory economies’, whereas countries that perform non-production activities to a greater extent are ‘headquarter economies’ (Baldwin, 2016).

Functional specialisation has facilitated catch-up. EU-CEE and parts of the wider CESEE region are a showcase for the huge developmental impact that multinational firms can have. There can be little doubt that FDI inflows to the CESEE region have strongly supported – or even ignited – the catch-up process of countries which had to manage the transition process from a command economy to a market economy. The relatively strong absorptive capacities (due to high human capital) helped linkages to be established with the domestic economy, which enabled knowledge flows from multinational firms to

trickle down to local firms. Therefore it is fair to say that the CESEE region's functional specialisation in production is evidence of successful integration into international production networks. This is especially true of the Visegrád-4 countries, but the same goes for Slovenia and Romania. After all, a wage cost structure that brings comparative advantage in production to a country must be seen as a blessing. In other words, comparative advantage in production is a prerequisite for attracting manufacturing firms, and there is ample evidence that attracting more FDI in tradable sectors has a stabilising effect on the current account, i.e. the external equilibrium (Hanzl-Weiss and Landesmann, 2016). It has also been shown that the manufacturing industries act as convergence accelerators (Rodrik, 2013), thus supporting the catch-up process. Such an FDI-led catch-up process constitutes a promising development path – at least until a certain level of development.

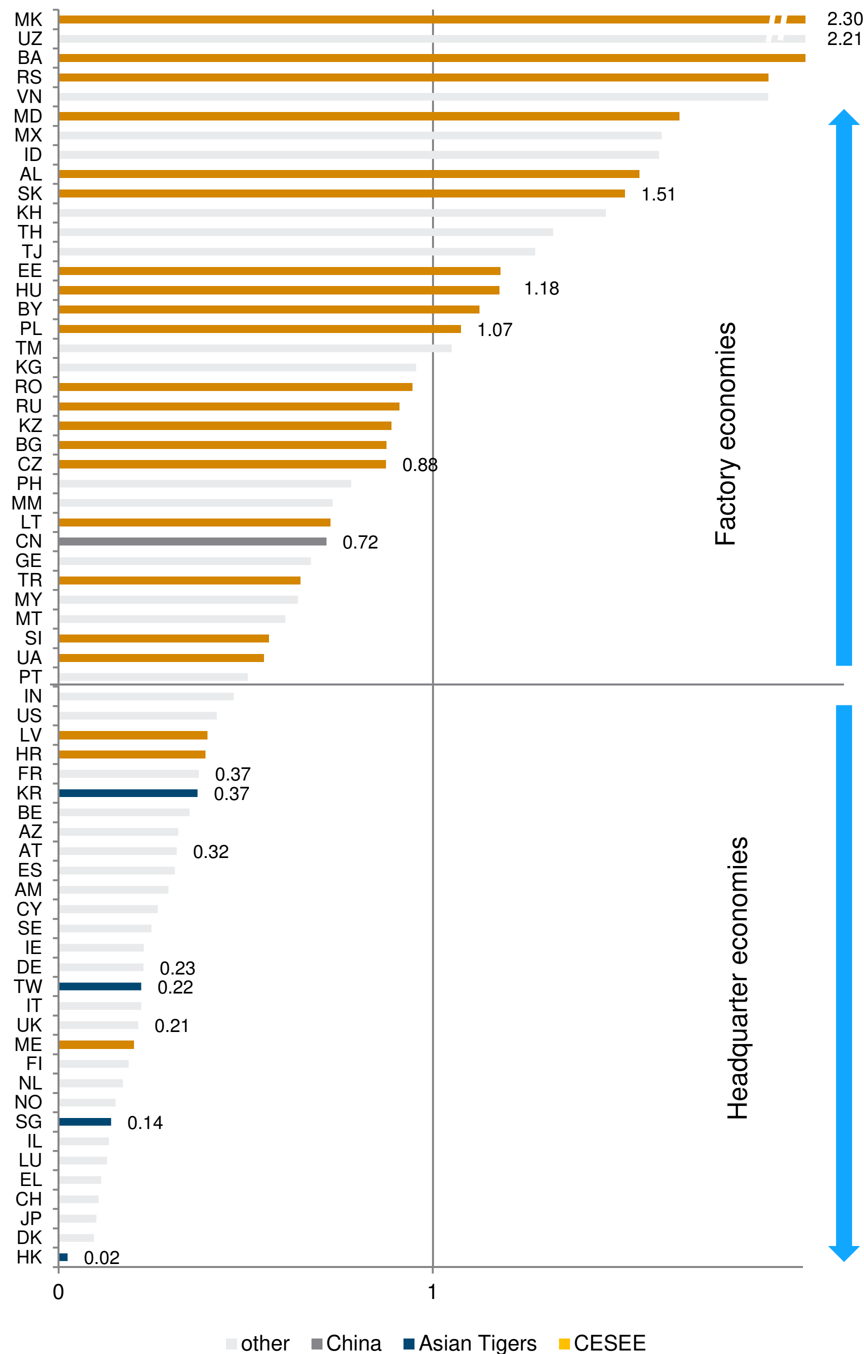
But CESEE's current functional specialisation also represents a formidable development challenge for the future. Despite all the advantages that the attraction of FDI brings with it, functional specialisation in actual production activities almost always implies neglect (or at least lagging development) of the most knowledge-intensive functions in the value chain (R&D and headquarter function). Business people in particular often argue that specialisation in production activities (especially assembly) entails little value added, compared to the other functions in the supply chain. Hence, while production activities may fit EU-CEE's (and potentially the CESEE region's) comparative advantages, from a dynamic perspective this kind of specialisation as a 'factory economy' may backfire at a certain stage of development. This point should be emphasised, as in general the extent of relative functional specialisation in production activities of the CESEE region is quite high (Figure 38).

The role of most CESEE countries in globalised production is that of a 'factory economy'. With the exception of Latvia, Croatia and Montenegro, which have attracted few production facilities, all CESEE countries have quite high relative production specialisation indices (for details of *rpsi*, see Box 1). In fact, most of the top places are occupied by countries in the CESEE region, with a degree of relative specialisation in production that is only matched by countries like Vietnam, Mexico or Indonesia. It is also noteworthy that the *rpsi* of most CESEE countries exceeds that of China, which is generally regarded as the 'workshop of the world'. Hence, judged on this functional specialisation indicator, much of the CESEE region, including the Visegrád-4 countries, would merit the description of 'workshop of the EU'. In any case, the extent of relative production specialisation qualifies the overwhelming majority of CESEE countries as factory economies.

The premature vanishing of income convergence is prevalent among factory economies. Over the past 50 years, only about 12 countries have, after a successful catch-up process, graduated to the club of high-income countries (Wade, 2016). This suggests that there is a sort of invisible ceiling that middle-income countries cannot break through; it has given rise to the notion of a 'middle income trap' (MIT), first introduced by Gill and Kharas (2007). The MIT is primarily associated with emerging countries, such as China (Glawe and Wagner, 2017) or Malaysia (Cherif and Hasanov, 2015); but the fact that the MIT issue is also discussed in Poland (Radvan, 2014; Riedel, 2017) shows that the debate has reached the CESEE region. Moreover, the MIT also featured prominently in last year's EBRD transition report (EBRD, 2017), which found that middle-income countries, including many Central and Eastern European countries, underperform in terms of productivity growth.[57]

[57] More precisely, the contribution of total factor productivity to GDP growth is lower than in low-income and high-income countries. For details, see Chart 1.5 in the transition report (EBRD, 2017).

Figure 38 / Relative production specialisation index (rpsi) for CESEE and selected other countries, averages 2003-2015



Note: The threshold between headquarter economy and factory economy was (somewhat arbitrarily) set at 0.5, which is the value a country would obtain if its functional specialisation equalled that of the world.
Source: fDi markets database, wiiw calculations.

The European variant of the middle income trap is the 'semi-periphery trap'. The explanation for the problem middle-income countries have in breaching the high-income ceiling is that the switch from an extensive growth process that relies on capital accumulation and imitation to an intensive growth

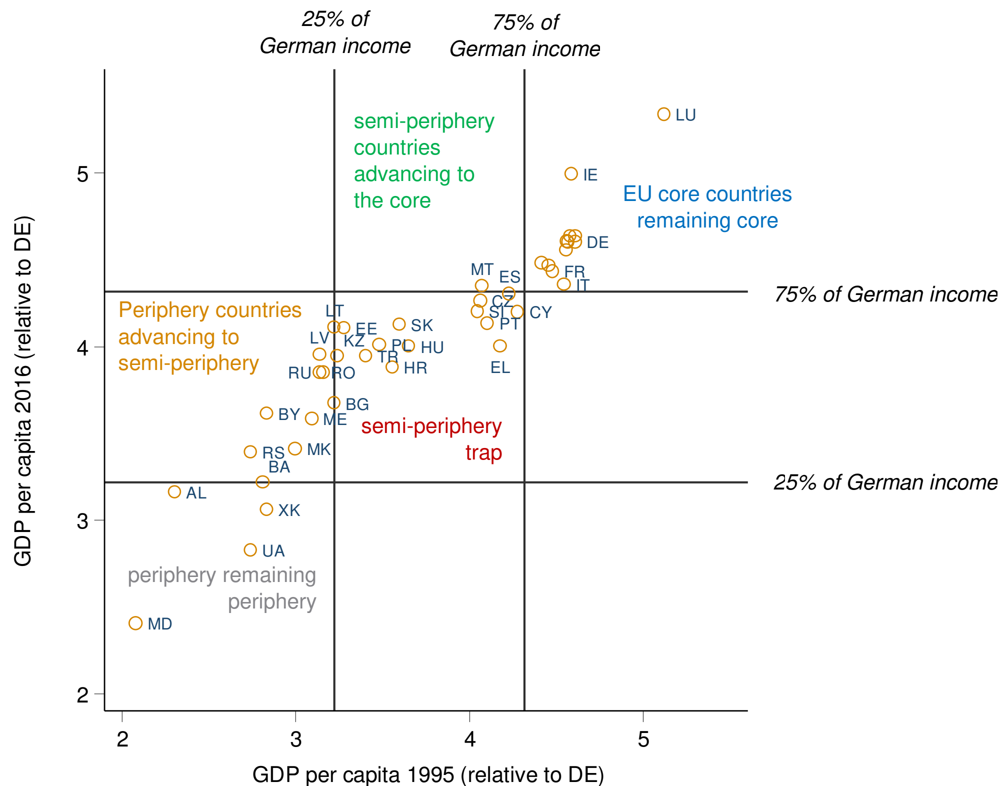
model based on the national innovation system (NIS) is difficult to accomplish. As mentioned, this also constitutes a formidable challenge for a number of EU-CEE countries, despite the fact that some of them have actually reached the high-income level (e.g. Slovenia and the Czech Republic). Given their functional specialisation patterns, it is fair to say that in a European context the CESEE countries form a semi-periphery, whose economic development is to a large extent driven by foreign firms, which account for a large part of exports and R&D activities. Semi-periphery here refers to a region or country which has (i) a high degree of economic integration into European production networks (which distinguishes it from peripheral countries); (ii) a functional specialisation as a factory economy, with particularly few pre-production activities; (iii) a high dependence on foreign firms; (iv) no (or only very few) domestically owned multinational firms (‘global players’); (v) few firms earning high economic rents; (vi) substantial net outflows of profits and income on property rights (see also Piketty, 2018); and (vii) a limited domestic policy space.[58] Obviously, all these characteristics are strongly interrelated. They imply that the chances are slim of developing an entrepreneurial state (Mazzucato, 2013) and of creating an effective NIS with strong linkages and cooperation between the government, state agencies, universities and firms. However, all these elements are necessary for the graduation to a ‘headquarter’ economy and for attaining the income levels of the Western core EU countries.

The idea of a semi-periphery in the eastern part of the EU and beyond finds some empirical support. If one uses GDP per capita (at purchasing power parities – PPP) and defines the EU semi-periphery as those countries with a relative per capita income of between 25% and 75% of German income, one finds that over the period 1995-2016 – a time span of more than 20 years – no country in the CESEE region has surpassed 75% of the German income level (Figure 39). Some of the most advanced countries, such as the Czech Republic and Slovenia, are approaching the 75% mark, but as of 2016 had not yet reached it. Hence, as with emerging economies that are bound to remain middle-income countries, the transition economies of the CESEE region have remained in the band of 25-75% of German income for the last 25 years. Taking Poland as an example, Figure 5 illustrates that the country grew faster than Germany, but convergence was limited, with Polish income rising from 33% of the German level in 1995 to 56% in 2016. The same is true of the overwhelming majority of the other CESEE countries. This is visible from Figure 39: all have remained in the middle segment of the figure, and no country has moved to the upper-middle cell.

Globalisation and the digital economy make functional specialisation even more important for economic success. Despite successful structural convergence, the convergence process remains incomplete, as in terms of value chain functions the EU-CEE countries have the opposite specialisation to Western EU countries. This implies that profits derived in production networks are highly unequally distributed, as the CESEE countries own very few ‘superstar firms’ (Autor et al., 2017) earning high economic rents. With globalisation and the digital age creating more and more industries with ‘winner-takes-all’-style competition – which gives rise to superstar firms – functional specialisation matters even more and risks derailing the convergence process in terms of income.

[58] This characteristic is also related to country size. Therefore it is less applicable to Russia and Turkey, which qualify as regional powers.

Figure 39 / The European semi-periphery trap, 1995-2016



Note: Logarithmic scales. The thresholds are set at 25% of German GDP per capita at PPP to delineate the periphery from the semi-periphery, and at 75% to delineate the semi-periphery from the European core. Initial GDP per capita in 1995 is the GDP per capita in 2000 for Bosnia and Herzegovina, Kosovo and Montenegro and GDP per capita in 1998 for Ireland.
Source: wiiw Database, wiiw calculations.

Escaping the semi-periphery trap requires active management of the economic integration process, with the aim of 'functional upgrading'. Since functional specialisation patterns reflect the existing comparative advantages of countries within production networks, market forces alone are unlikely to fundamentally change these patterns. Rather, specific policies aimed at attracting knowledge-intensive segments of the value chain will be required. Active trade and industrial policies are also what helped the South East Asian 'Tiger States'[59] to graduate from being middle-income to being high-income countries, and all of those have equally become headquarter economies (see Figure 4). While there is still no agreement on what caused the 'Asian miracle', most experts assign a considerable role to active industrial policies, including the deliberate use of export subsidies, exchange rate policy, capital controls and even import protection (e.g. on luxury goods). This would point to the prominent role for a 'development state' (in the case of middle-income countries) and an 'entrepreneurial state' (for countries close to or beyond the high-income threshold) to handle and guide the economic integration process. Such an active role on the part of the state in managing the integration process into the European economy is largely absent in most CESEE countries (with notable exceptions, such as Turkey). Arguably, the reinforced World Trade Organization rules and (especially) the strict EU state aid rules do not give the EU-CEE countries the policy space they need to implement active industrial policies, even if they wished to do so. Apart from FDI-attraction policies and the support programmes financed by the EU

[59] Korea, Singapore, Hong Kong and Taiwan.

Cohesion Funds,[60] industrial policies have been used only moderately. Scaling up these policies with a view to ‘functional upgrading’ would be desirable. This is particularly true of the EU-CEE countries, some of which have reached an income level where a switch from an imitation-based growth model (fuelled by foreign technologies) to an innovation-based model relying on an NIS is due. However, without a state that considers itself an entrepreneur and with comparatively low levels of R&D (given the income level),[61] functional upgrading becomes even more difficult. Moreover, the little R&D activity that is taking place in the CESEE region is, to a large extent, driven by foreign companies. Mastering all these challenges is necessary, though, if the CESEE region is to avoid being caught in a European semi-periphery trap.

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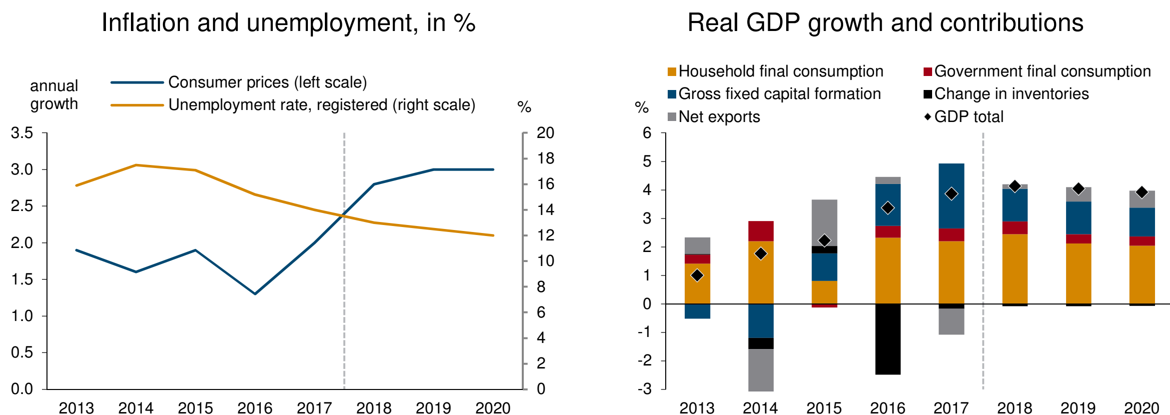
Country reports

ALBANIA: High expectations for the commencement of EU membership negotiations

ISILDA MARA

The drivers of growth will continue to be consumption, big infrastructure projects and tourism. The investments in infrastructure will be channelled through public–private partnerships, which boost growth in the medium term, but pose certain risks in the longer run. There are high expectations that after five decades of self-imposed isolation and three decades of involuntary exclusion, Albania will become part of the EU by 2025.

Figure 40 / Albania: Main macroeconomic indicators



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

Albania aims to open EU accession talks in 2018. Democratically run parliamentary elections (held last June) and progress in judicial reform (apparently under way) were two of the preconditions imposed by the EU for opening negotiations on EU membership. However, political tensions exist and are expected to remain. The opposition has started another wave of protests, seeking the formation of a new government to combat organised crime and corruption. According to the IMF (2018)[62], the shadow economy in Albania accounts for 28.5% of GDP. The high level of corruption, especially in the judiciary, has been one of the most persistent obstacles to investment over the past three decades. Therefore, Brussels expects reform of the judicial system which is simultaneously moving ahead both de jure and

[62] Medina, L. and F. Schneider (2018), 'Shadow Economies Around the World: What Did We Learn Over the Last 20 Years?', *IMF Working Papers*, No. 18/17, International Monetary Fund, https://EconPapers.repec.org/RePEc:imf:imfwpa:18/17

de facto. EU membership 'by 2025' (mentioned in the Commission's new strategy) is an indicative date (not a target date). How realistic that timeframe is will depend on actual progress made and catching up in implementation of the structural reforms, especially of the judicial system.

In 2018, as in 2017, growth drivers are expected to be consumption, investments in infrastructure projects and export of services. On an annual basis, real GDP growth in the third quarter of 2017 stood at 3.55%, down from 3.95% in the first quarter and 4.06% in the second. This rate of growth was reflected in an increase in consumption of more than 3% for the third quarter of 2017, again on an annual basis. Gross fixed capital formation rose by 4% in the third quarter of 2017, compared to double-digit growth rates in the first and second quarters. Basically, all the sectors of the economy contributed positively to growth, but construction grew particularly strongly. A similar positive trend is forecast for 2018.

Consumption is expected to rise further, due to higher wages, improvements in the labour market and the creation of jobs via new infrastructure investment projects. Despite job creation having improved, employment opportunities for young people remain scarce. The period from the third quarter of 2016 to the third quarter of 2017 saw an increase in overall employed persons by 22 thousand, raising the overall employment rate from 49.3% to 50.7%. Nevertheless, only 400 of those jobs went to the age group 15-29, whose inactivity rose more than the drop in unemployment, while their employment rate was stuck at 33.5%. The government urgently needs to tackle youth employability. Proactive employment programmes specifically targeting young people should be introduced, otherwise emigration will intensify further. Dual vocational schemes – such as those run in Austria or Germany – could be the way to go.

Starting in 2018, the government launched a USD 1 billion programme for infrastructure projects. This involves the construction of a number of infrastructure projects in the form of public–private partnerships (PPPs) over the next four years. There is scepticism surrounding the transparency of this programme's implementation and monitoring, as well as its impact on public debt in the long run. Meanwhile, the EUR 1.5 billion infrastructure projects within the framework of the Trans Adriatic Pipeline and the Devoll Hydropower projects are on schedule and expected to be completed in 2019. The negotiations for the construction of the Arbri Highway – the first PPP project in the framework of the USD 1 billion programme – have closed. The local company Gjoka Construction will be in charge of building it. This highway (75 km long) will connect the north-east of the country with the west. With investment worth EUR 180 million, construction is expected to start in the first half of 2018. Towards the end of January 2018, an offer was submitted to the Albanian government for the construction of a new airport in southern Albania, close to the city of Vlora – an investment worth about EUR 100 million. The offer came from a consortium of three Turkish construction companies (Cengiz, Kalyon and Kolin) – the same consortium that is currently building Istanbul's third airport. If the negotiations are successfully concluded in the first half of 2018, construction work might start as early as June 2018, to last at least three years. Innovative investment projects with the support of international donors – EBRD and the World Bank – are expected to be launched in 2018. The chances are good that a first photovoltaic power plant will be built in the country at the end of 2018 or in early 2019. EBRD has confirmed that it will launch the tender process in 2018. Investments in this type of project are estimated to be around EUR 70 million.

During 2017, lending from the banking sector has been modest, but is expected to rise in 2018. The central bank has kept the interest rate down and unchanged, at 1.25%. On an annual basis, by the end of 2017 the stock of loans to the non-financial private sector had dropped by 2.4%, and its share of overall loans had fallen to 60%. More than 53% of such loans are denominated in euros. The high level of credit (and of deposits) held in euros, and the predominance of transactions executed in euros, prompted the central bank to launch a package of measures targeting de-euroisation of the economy. The aim is to reduce the economy's dependence on foreign currency, by restraining the issuing of loans and deposits in euros. Non-performing loans dropped by a further 5 percentage points, down to 13.2% in December 2017, year on year. However, demand for credit remained weak. Nevertheless, for 2018, the demand for credit is expected to improve, thanks to the PPP projects. A number of local companies involved in the PPP projects will certainly have to rely on banking sector loans for their investment funding.

In 2018, exports of goods and services will continue on a positive and upward path. During the first three quarters of 2017, in nominal terms, exports experienced double-digit growth, year on year. For the same period, exports of goods recovered by 12%, emerging from the negative trend endured between 2014 and 2016. The garment industry continues to drive exports, with a 43% share in total goods exports in 2017. However, it is worth mentioning that exports of 'machinery, equipment and spare parts' saw a surge of 34%. This rise was mainly due to the export of cabling systems produced by the German company Forschner, which is rapidly expanding its activities in Albania. Export of agricultural products rose by 19%, jumping to a share of 11% of total exports. This sector is expected to keep surging forward. Thanks to IPARD (Instruments for Pre-Accession Assistance in Rural Development funding provided by the EU for the next three years, the investments planned for the agricultural sector amount to EUR 96 million. Tourism is another sector that is expected to continue its good performance in 2018. The government is aiming to expand it further by offering fiscal incentives for investments in 4- or 5-star hotels. In contrast, the export of 'fuels and minerals' dropped by 7% in 2017 (despite rising oil prices), falling to a share of 16% of total exports (compared to 40% in 2014). Since the acquisition of Albania's main oil drilling company Bankers Petroleum by the Chinese company Geo-Jade in 2016, foreign direct investment in this sector has been close to zero. Therefore, the expectations for this sector – in terms of investment and exports – are not very high.

Overall, in 2018 and the next two years, the drivers of growth will continue to be consumption, big infrastructure projects and tourism. Investments in infrastructure via PPPs will boost growth in the medium term, but they pose certain risks in the longer run. Political tensions and the uncooperative attitude of the opposition (especially over judicial system reform) might hamper not only the economy, but also progress on the structural reforms required by the process leading toward EU accession. The completion of the Trans Adriatic Pipeline and the Devoll infrastructure projects by 2019 might hint at a lower inflow of FDI during the coming years. So far, there is no indication of any reassuring signals about how this gap in FDI might be filled. But at least the signals from the external environment and the economies of the eurozone – Albania's main trading and investment partners – are positive, and so we expect the economy to continue to grow at close to 4% over the next three years.

Table 10 / Albania: Selected economic indicators

	2013	2014	2015	2016	2017 1)	2018	2019	2020
							Forecast	
Population, th pers., average	2,895	2,889	2,881	2,876	2,877	2,870	2,870	2,870
Gross domestic product, ALL bn, nom.	1,350	1,395	1,428	1,473	1,600	1,700	1,800	1,900
annual change in % (real)	1.0	1.8	2.2	3.4	3.9	4.1	4.0	3.9
GDP/capita (EUR at PPP)	7,800	8,300	8,500	8,500	8,900	.	.	.
Consumption of households, ALL bn, nom.	1,074	1,120	1,150	1,201	1,260	.	.	.
annual change in % (real)	1.8	2.8	1.0	2.9	2.7	3.0	2.6	2.5
Gross fixed capital form., ALL bn, nom.	352	337	352	373	420	.	.	.
annual change in % (real)	-2.0	-4.5	4.0	6.0	9.0	4.5	4.5	4.0
Gross industrial production								
annual change in % (real)	28.2	1.5	-2.1	-16.6	4.0	3.0	2.0	1.0
Gross agricultural production 2)								
annual change in % (real)	0.5	0.7	2.9	0.5	4.0	.	.	.
Construction output total								
annual change in % (real)	-13.0	5.0	19.3	5.1	12.0	.	.	.
Employed persons, LFS, th	1,024	1,037	1,087	1,157	1,195	1,220	1,240	1,260
annual change in %	-10.2	1.3	4.8	6.5	3.3	2.1	1.6	1.6
Unemployed persons, LFS, th	194	220	224	208	190	180	180	170
Unemployment rate, LFS, in %	15.9	17.5	17.1	15.2	14.0	13.0	12.5	12.0
Reg. unemployment rate, in %, eop	13.5	13.0	12.9	8.8	7.1	.	.	.
Average monthly gross wages, ALL 3)	36,332	45,539	46,829	45,845	49,840	53,000	56,800	60,800
annual change in % (real, gross)	-5.0	-0.7	0.9	-3.4	6.6	3.5	4.0	4.0
Consumer prices, % p.a.	1.9	1.6	1.9	1.3	2.0	2.8	3.0	3.0
Producer prices in industry, % p.a.	-0.4	-0.5	-2.1	-1.5	3.0	2.0	2.0	1.5
General governm.budget, nat.def., % of GDP								
Revenues	24.2	26.3	26.6	27.6	28.0	28.2	28.5	29.0
Expenditures	29.2	31.4	30.6	29.4	28.2	30.0	30.5	31.0
Deficit (-) / surplus (+)	-5.0	-5.2	-4.1	-1.8	-0.2	-1.8	-2.0	-2.0
General gov.gross debt, nat.def., % of GDP	65.6	70.1	73.1	72.4	71.0	69.0	67.0	65.0
Stock of loans of non-fin.private sector, % p.a.	-1.2	2.4	-2.6	0.2	0.7	.	.	.
Non-performing loans (NPL), in %, eop	23.2	22.8	18.2	18.3	13.2	.	.	.
Central bank policy rate, % p.a., eop 4)	3.00	2.25	1.75	1.25	1.25	1.3	1.5	1.5
Current account, EUR mn	-891	-1,076	-884	-812	-1,030	-1,010	-1,010	-1,070
Current account, % of GDP	-9.3	-10.8	-8.6	-7.6	-8.6	-7.9	-7.5	-7.5
Exports of goods, BOP, EUR mn	1,067	932	771	714	800	870	930	990
annual change in %	21.9	-12.7	-17.2	-7.4	12.1	8.5	6.5	6.5
Imports of goods, BOP, EUR mn	3,030	3,147	3,070	3,317	3,760	4,070	4,310	4,530
annual change in %	-2.3	3.9	-2.5	8.0	13.4	8.3	6.0	5.0
Exports of services, BOP, EUR mn	1,715	1,881	2,028	2,396	2,790	3,120	3,400	3,670
annual change in %	-9.7	9.7	7.8	18.1	16.5	12.0	9.0	8.0
Imports of services, BOP, EUR mn	1,489	1,558	1,503	1,599	1,780	1,940	2,060	2,200
annual change in %	2.0	4.6	-3.5	6.4	11.3	9.0	6.0	7.0
FDI liabilities, EUR mn	945	869	890	943	900	.	.	.
FDI assets, EUR mn	22	58	72	6	7	.	.	.
Gross reserves of NB excl. gold, EUR mn	1,971	2,142	2,831	2,889	2,941	.	.	.
Gross external debt, EUR mn	6,368	6,927	7,634	7,882	7,990	8,700	9,100	9,600
Gross external debt, % of GDP	66.2	69.5	74.7	73.5	67.0	68.0	67.0	67.0
Average exchange rate ALL/EUR	140.26	139.97	139.74	137.36	134.15	133.0	133.2	133.2

1) Preliminary and wiiw estimates. - 2) Based on UN-FAO data, from 2015 wiiw estimate. - 3) From 2014 based on data of General Directorate of Taxation, Structural Business Statistics (market producers) used before. - 4) One-week repo rate.

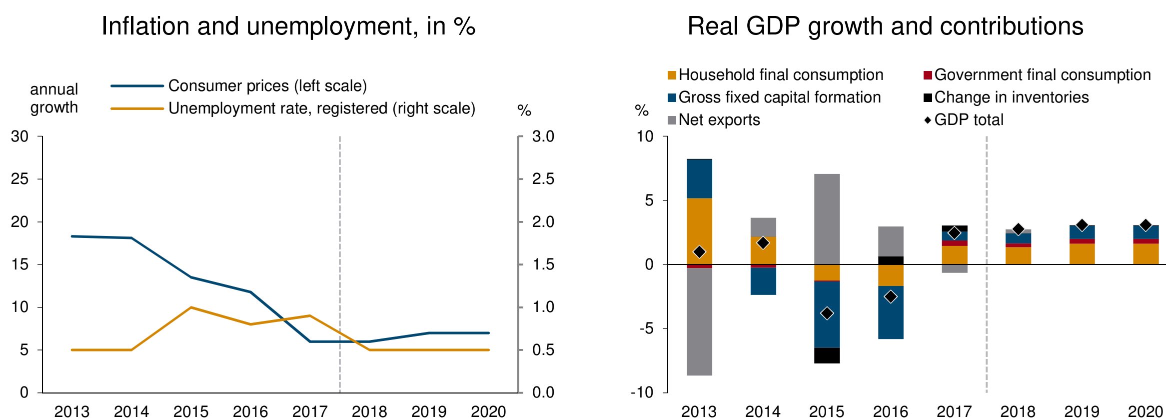
Source: wiiw Databases incorporating national statistics and IMF. Forecasts by wiiw.

BELARUS: Improving external environment supports modest growth

RUMEN DOBRINSKY

GDP in Belarus grew by 2.4%, defying the expectations of a continuing recession. Thanks to an improvement in the external environment, manufacturing output and exports rebounded strongly. Tighter macroeconomic policies contributed to a shrinking of the current account deficit and a lowering of inflation expectations. Inflation reached a historic low in 2017. The short-term prospects have improved and positive economic growth should continue in the coming years.

Figure 41 / Belarus: Main macroeconomic indicators



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

In 2017, GDP in Belarus grew by 2.4%, defying the prevailing ex ante expectations of a continuing recession. It was the improving external environment that contributed to this positive outcome. Settlement of the gas dispute with Russia paved the way for the resumption of normal deliveries of oil from Russia and of funding under the existing agreement with the Eurasian Development Bank. Rising oil prices contributed to an improvement in Belarus's terms of trade and higher fiscal revenue.

However, the unreformed economy lacks dynamism and, in the absence of restructuring, its potential for more robust growth in the future is limited. During the prolonged and deep recession of 2015-2016, Belarusian GDP plunged by a cumulative 5.5%. Thus, although the economic upturn in 2017 was a welcome outcome, real GDP in 2017 was still below its 2014 level. Nevertheless, recent data indicate that the recovery has been gaining momentum and is likely to continue in the immediate future.

Thanks to an improvement in external conditions and the presence of underutilised capacity, manufacturing rebounded strongly in 2017, with annual gross output growing by 7%; meanwhile the export of goods in dollar terms surged by more than 20% compared to 2016. However, the recovery was uneven across manufacturing sectors, and much of the overall output growth was due to a strong performance in a few branches, such as wood processing, mechanical engineering and chemicals. At the same time, the recession continued and deepened in the sector of transport equipment.

The output recovery did not bring about growth in employment, as the Belarusian economy is undergoing a lasting – but slow – process of restructuring, which involves steadily picking up the slack in large state-owned enterprises (SOEs).

The upturn in output contributed to a gradual recovery of domestic demand (both personal consumption and fixed investment), which became especially pronounced in the second half of the year. The real disposable income of the population increased by an estimated 1.5% after two consecutive years of decline. Real retail trade in 2017 grew by 2.8% year on year, and the positive growth was entirely due to the upturn in the second half. Gross fixed capital formation surged sharply in the third quarter, after a weak performance in the first half year. Overall, domestic demand made a positive contribution to GDP growth, after contributing negatively in 2015-2016.

Importantly, the recovery was accompanied by notable progress towards macroeconomic stability. Average annual inflation grew by 6% in 2017 (4.6% December over December) – a historic low for Belarus. The curbing of inflation was the result of a change in the macroeconomic policy mix in 2015, which combined tight monetary and fiscal policy with a steady reduction in directed credit. Reflecting the reduction in inflation expectations, the National Bank of Belarus reduced its key intervention rate in several stages from 18% at end-2016 to 10.5% in February 2018. The nominal exchange rate (which has floated since 2015) remained relatively stable vis-à-vis the USD through the year, which was another sign of increasing macroeconomic stability.

It is estimated that regulated prices in 2017 grew 1.8 times faster than unregulated prices. This indicates that under the present circumstances, the mechanism of price regulation (which still covers a significant basket of goods and services) has been operating in a pro-inflationary rather than an anti-inflationary way.

The level of 'directed credit' (subsidised credit allocated to state-owned firms participating in government programmes) has been on the decline in recent years. According to a government decision, such credit should be reduced in 2018 by a third, compared to 2017. However, there is still a large pool of loss-making SOEs that are being supported through directed credit, which then turns into bad debt. Over the period 2015-2016, the government restructured bad enterprise debt worth a total of USD 1.8 billion, which was transferred to the newly established Agency for Asset Management.

However, unless the flow of newly generated bad loans is stopped, loss-making SOEs will continue to accumulate new stocks of bad debt, as is evident from the dynamics of non-performing loans.

Tighter macroeconomic policies have contributed to a gradual shrinking of the current account deficit, which at present seems to be at manageable levels. In 2017, Belarus managed to raise significant external funding, which allowed comfortable servicing of its external debt. The authorities secured new borrowing totalling USD 4.04 billion, including three tranches worth a total USD 0.8 billion from the current funding agreement with the Eurasian Development Bank (following USD 0.8 billion received in 2016); USD 1.3 billion from the Russian government and Russian banks; USD 306 million from Chinese banks; and a Eurobond issue worth USD 1.4 billion, which was successfully placed in June. As total debt servicing in 2017 amounted to USD 1.03 billion, these moves allowed Belarus to raise its international reserves.

So far Belarus has been a conscientious borrower on the international financial markets. In January 2018, it made the last coupon payment and retired its 2011 Eurobond issue, worth USD 800 million. Also in January 2018, Fitch Ratings upgraded Belarus's long-term default ratings from 'B-' to 'B' with a 'Stable' outlook. At the same time, the servicing of the swelling public external debt remains a serious and growing burden both on Belarus's public finances and on its balance of payments. Over the course of 2017, public external debt increased by 22.6%, to USD 16.7 billion at end-December, and in 2018 Belarus faces upcoming debt service payments totalling USD 2.54 billion. The opportunity cost of this burden is the underfinancing of public services and investment, which, in the long run, reduces the potential for future growth.

One important policy document adopted in 2017 was the Presidential Decree No. 7 on entrepreneurship. It contains a number of regulatory changes aimed at further liberalisation of entrepreneurial activity, in the first place, by reducing administrative controls and hurdles for SMEs and individual entrepreneurs (such as scrapping the previous need to obtain permission for a range of business activities). Another related policy step was the liberalisation as of 1 March 2018 of forex purchases by Belarusian importers (proof of purpose is no longer required). These changes have been welcomed by the business community, but it remains to be seen how they are implemented in reality.

Higher oil prices in 2017 provided an estimated extra budgetary revenue of BYN 1.1 billion (EUR 0.5 billion), which, in turn, contributed to a surplus in the cash fiscal balance for the year. Subsequently, most of this surplus was channelled to the Social Security Fund to boost pensions and other allowances, thus contributing to the rise in real disposable income. Should oil prices continue to rise in 2018, one can expect a similar windfall gain in Belarus's public finances.

In general, the short-term prospects for the Belarusian economy have improved, and positive economic growth should continue in the coming two to three years. Oil deliveries from Russia in 2018 should reach the annual level of 24 million tonnes, as per the bilateral mid-term agreement – a level that was not attained in 2017, as the dispute between the two countries was only settled in April (it is estimated that deliveries in 2017 amounted to some 18 million tonnes). This should provide the Belarusian economy with a further external boost compared to 2017. The Belarusian government is targeting GDP growth of 3.5% in 2018, and annual inflation (December over December) of no more than 6%.

This may be a somewhat ambitious target: wiiw expects that GDP will grow by 2.8% in 2018. We envisage that growth will be predominantly driven by domestic demand – private consumption and fixed investment, both of which should continue their moderate recovery. If the recovery in Russia strengthens, this could support a further upturn in Belarus's exports. However, with the recovery in domestic demand, import growth may also pick up and the current account deficit may widen; that said, it should remain at a reasonable level. Overall we expect a negligible contribution of net exports to GDP growth.

If the authorities retain macroeconomic stability as a policy priority, the potential for a notable acceleration of growth in the future seems limited. The tight policy stance, the curbing of directed credit and the ongoing restructuring in the labour market would likely keep GDP rates of growth in the range of 3% p.a. in the coming years.

Table 11 / Belarus: Selected economic indicators

	2013	2014	2015	2016	2017 [1]	2018	2019 Forecast	2020
Population, th pers., average	9,466	9,475	9,490	9,502	9,498	9,530	9,550	9,560
Gross domestic product, BYN mn, nom. [2]	67,069	80,579	89,910	94,949	105,200	114,600	126,400	139,400
annual change in % (real)	1.0	1.7	-3.8	-2.5	2.4	2.8	3.1	3.1
GDP/capita (EUR at PPP) [2]	13,400	13,900	13,900	13,400	13,800	.	.	.
Consumption of households, BYN mn, nom. [2]	33,970	42,082	47,006	51,122	58,700	.	.	.
annual change in % (real)	10.9	4.3	-2.4	-3.2	2.7	2.5	3.0	3.0
Gross fixed capital form., BYN mn, nom. [2]	24,941	26,772	25,763	24,155	27,760	.	.	.
annual change in % (real)	9.0	-5.7	-15.5	-14.5	2.8	3.0	4.0	4.0
Gross industrial production								
annual change in % (real)	-4.9	1.9	-6.6	-0.4	6.1	4.0	4.0	4.0
Gross agricultural production								
annual change in % (real)	-4.0	3.1	-2.5	3.3	4.1	.	.	.
Construction industry								
annual change in % (real)	4.7	-5.7	-11.3	-14.8	-3.8	.	.	.
Reg. employment, th, average	4,578	4,551	4,496	4,406	4,352	4,330	4,310	4,290
annual change in %	-0.7	-0.6	-1.2	-2.0	-1.2	-0.5	-0.5	-0.5
Reg. unemployed persons, th, eop	21.0	24.2	43.3	35.3	22.9	22.0	22.0	22.0
Reg. unemployment rate, in %, eop	0.5	0.5	1.0	0.8	0.5	0.5	0.5	0.5
Average monthly gross wages, BYN	506.1	605.2	671.5	722.7	815.2	880	960	1,040
annual change in % (real, gross)	16.4	1.3	-2.3	-3.8	6.2	1.5	1.5	1.5
Consumer prices, % p.a.	18.3	18.1	13.5	11.8	6.0	6.0	7.0	7.0
Producer prices in industry, % p.a. [3]	13.7	12.4	17.2	12.0	9.8	9.0	8.0	8.0
General governm.budget, nat. def., % of GDP								
Revenues	39.0	37.3	41.3	40.9	40.0	39.0	39.0	39.0
Expenditures	38.8	36.1	39.9	39.4	39.0	38.0	38.0	38.0
Deficit (-) / surplus (+)	0.2	1.3	1.4	1.5	1.0	1.0	1.0	1.0
General gov.gross debt, nat. def., % of GDP [4]	34.5	38.0	53.0	53.9	48.0	47.0	46.0	45.0
Stock of loans of non-fin.private sector, % p.a.	28.8	21.1	19.4	-6.2	7.2	.	.	.
Non-performing loans (NPL), in %, eop	4.4	4.4	6.8	12.8	13.5	.	.	.
Central bank policy rate, % p.a., eop [5]	23.5	20.0	25.0	18.0	11.0	9.0	8.0	7.0
Current account, EUR mn [6]	-5,737	-4,057	-1,669	-1,523	-1,100	-1,500	-1,500	-1,600
Current account, % of GDP [6]	-10.1	-6.7	-3.3	-3.5	-2.3	-3.4	-3.3	-3.4
Exports of goods, BOP, EUR mn [6]	27,701	27,492	23,854	20,988	25,400	25,000	26,700	29,200
annual change in %	-21.7	-0.8	-13.2	-12.0	21.0	-1.6	6.8	9.4
Imports of goods, BOP, EUR mn [6]	31,183	29,537	25,807	23,270	28,000	26,700	28,300	30,800
annual change in %	-10.8	-5.3	-12.6	-9.8	20.3	-4.6	6.0	8.8
Exports of services, BOP, EUR mn [6]	5,690	6,115	6,048	6,194	6,900	6,800	7,000	7,200
annual change in %	16.1	7.5	-1.1	2.4	11.4	-1.4	2.9	2.9
Imports of services, BOP, EUR mn [6]	3,983	4,449	4,003	3,983	4,200	4,300	4,500	4,800
annual change in %	26.8	11.7	-10.0	-0.5	5.4	2.4	4.7	6.7
FDI liabilities, EUR mn [6]	1,703	1,445	1,506	1,133	1,100	.	.	.
FDI assets, EUR mn [6]	199	57	97	112	100	.	.	.
Gross reserves of NB excl. gold, EUR mn [6]	3,589	2,820	2,510	3,071	4,502	.	.	.
Gross external debt, EUR mn [6]	28,807	32,982	34,996	35,930	35,200	30,900	30,700	30,700
Gross external debt, % of GDP [6]	50.8	54.1	69.4	83.3	73.1	70.0	68.0	66.0
Average exchange rate BYN/EUR	1.1834	1.3220	1.7828	2.2010	2.1833	2.6	2.8	3.0

1) Preliminary and wiiw estimates. - 2) According to SNA 2008. - 3) Domestic output prices. -4) Including publicly guaranteed debt. - 5) Refinancing rate of NB. - 6) Converted from USD.

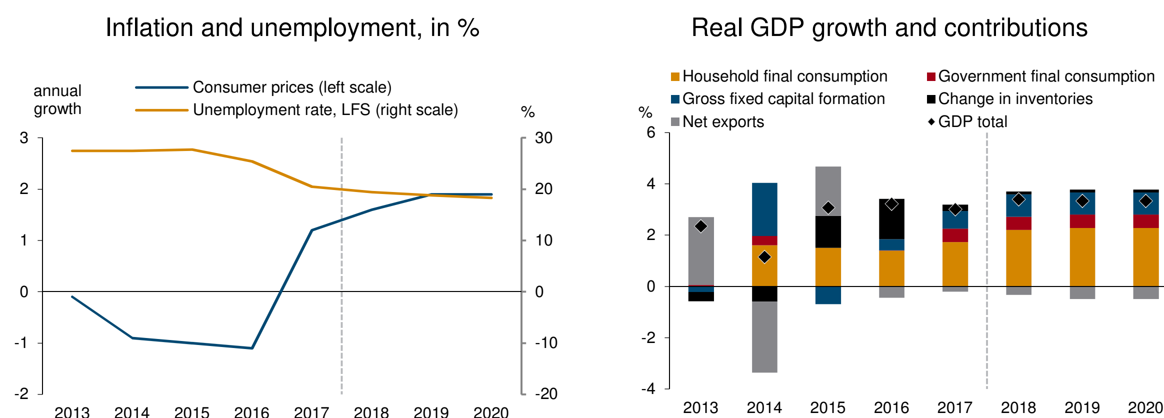
Source: wiiw Databases incorporating Eurostat and national statistics. Forecasts by wiiw.

BOSNIA AND HERZEGOVINA: Positive external conditions driving growth

RICHARD GRIEVESON

The economy is benefiting from highly supportive external conditions, which are driving strong growth of remittances and exports. These trends should continue this year, and feed through to higher domestic employment and private consumption growth. The political situation remains problematic, and is unlikely to change before the upcoming election. During the forecast period, the economy should grow in the 3 3.5% per year range.

Figure 42 / Bosnia and Herzegovina: Main macroeconomic indicators



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

The economy performed well on the back of supportive external factors in 2017, and we expect these conditions to remain firmly in place this year. High frequency indicators suggest a strong end to 2017, with industrial output, merchandise exports, tourism arrivals and retail trade volumes all maintaining high growth rates. After estimated 3% growth in 2017, we expect the economy to expand by around 3.5% this year, and at a similar rate during the rest of the forecast period.

External developments have been crucial in supporting growth, and this will remain the case during 2018 at least. Economic activity was notably strong in the eurozone – a key market for Bosnia and Herzegovina (BiH) – last year, above all as a result of boom-like conditions in Germany. Sentiment indicators for the single currency area suggest a further firming of positive momentum in recent months. Bosnian nominal merchandise exports rose by an average 17.4% year on year in 2017, helping to drive

a 3.2% increase in industrial output. Export growth has been notably strong to nearby markets, especially Croatia and Slovenia, as well as others in the Western Balkans. This is a positive development, given that regional growth has generally been subdued in the period since the global financial crisis.

The tourism sector is booming, driving up services export values. Total tourism arrivals increased by an average 12.3% year on year in January-November 2017, including a 16.5% increase in visitors from abroad. The main sources of tourists remain nearby countries; the four most popular tourism sources in 2017 were Croatia, Serbia, Turkey and Italy. However, notably strong growth last year was recorded from non-European sources including China (+123% year on year in January-November) and Saudi Arabia (+37%).

Strong external trends have fed through to much better domestic employment conditions, and this trend looks set to continue during the forecast period. Although it continues to suffer from major structural deficiencies, the labour market is improving quite significantly, with the unemployment rate falling fast. BiH's registered unemployment rate stood at 38.7% in November 2017 according to the statistics agency, a 2.2 percentage point improvement compared with a year earlier. Employment growth is likely to have been over 3% in 2017. Manufacturing has accounted for around half of recent job growth. By contrast, construction activity – which tends to be labour intensive – was relatively subdued in 2017, and political bottlenecks remain a risk for construction activity during the forecast period (see below). Nevertheless, our core view is that further disbursements of external funding and rising economic activity should spur a gradual recovery in construction in the coming years.

Robust growth in the external sector has seen the economy's structure start to shift, with exports rising as a share of GDP. Moreover, the structure of goods exports is becoming more diversified, with industries including machinery and mechanical appliances and transport equipment accounting for a greater share of the total. However, private consumption will remain the main driver of growth during the forecast period, owing to positive employment and wage growth, and its large share of overall economic activity. Consumption has benefited from strong external conditions, including remittance inflows and better employment and earnings growth on the back of rising exports. Retail trade volumes rose by an average 5.1% year on year in 2017.

Despite rising employment and wages, economic confidence remains fairly weak, which could limit consumer spending during the forecast period. According to the 2017 Balkan Barometer, only 19% of Bosnians thought that their financial situation would improve in the next 12 months, and only 15% were optimistic about the state of the economy over the same period (both were the lowest levels in the region). 73% of Bosnian respondents felt that unemployment was one of the two most important issues facing the economy (the highest in the region).

Major slack in the labour market will continue to contribute to historically low inflation rates during the forecast period. Price growth in BiH averaged 1.4% in 2017, reflecting the lack of upward pressure on prices across the eurozone. Some further short-term upward pressure on prices could come from energy costs, but this will not be long-lasting; behind that, core inflation is likely to remain subdued. While the labour market is improving, it is far from tight, indicating that demand-pull pressure on prices will remain very muted.

Growth in 2017 was negatively impacted by a delay to the disbursement of the next tranche of IMF funding, and further delays are fairly likely during the forecast period. BiH signed a three-year programme with the IMF in September 2016. However, the IMF delayed the release of the second tranche in May 2017, owing to a failure of the Bosnian authorities to meet the necessary conditions. In December 2017, the IMF announced that it had reached a staff-level agreement with BiH to release the next tranche (subject to fulfilment of outstanding conditions). We expect the IMF programme to remain in place, although future disbursements may also be subject to delays.

Beyond 2018, we expect growth to remain in the 3-3.5% per year range. This will be driven primarily by private consumption, which accounts for the majority of overall GDP. Foreign demand will also contribute, although 2017-18 is likely to mark the peak of the economic cycle in the eurozone. Investment growth will be positive, although the contribution of investment to overall GDP growth will rely on disbursements of official funding from external sources, which could be delayed owing to political developments. The potential for further delays represents the biggest downside risk to our growth forecasts. On the flipside, better-than-expected progress on reforms to unlock official funding represent the best chance of increasing BiH’s growth rate to 4% or above.

Rising exports will not significantly change current account dynamics, with the external deficit set to remain large during the forecast period. Strong growth of exports and remittances has provided important support for the external accounts, although the large absolute size of imports will keep the deficit elevated. Moreover, imports should pick up on the back of rising private consumption growth this year, and higher investment during the forecast period. The deficit should continue to be largely covered by concessional funding and FDI, reducing stability risks.

Politically, conditions remain generally unsupportive of economic growth, and there is a potential for additional volatility in the run-up to the general election in October. Although officially the campaign has not yet started, in practice it is already underway. This on its own is unlikely to significantly derail growth; economic agents in BiH are well used to political noise and should ride it out. More of an issue is that in the Republika Srpska, long-standing President Milorad Dodik has to step down having served two terms, and the battle over who will succeed him could be destabilising (it is not yet clear whether Mr Dodik will run for the Serb position in BiH’s tripartite presidency).

The most significant political issue is the current stalemate over proposed changes to the Federation’s electoral law. Bosnian Croats in the Federation are demanding a new electoral law to prevent the possibility of Bosniaks electing Croat representatives. In practice, this would mean dividing the whole Federation into ethnically-based electoral units, which is resisted by most Bosniaks. Without a new law, however, it may not be possible to form the House of Peoples (the upper chamber) either in the Federation or at the state level after the election. The possibility that the elections could be postponed, prolonging political deadlock and potentially further delaying the release of tranches of IMF funding, cannot be ruled out.

Table 12 / Bosnia and Herzegovina: Selected economic indicators

	2013	2014	2015	2016	2017 [1]	2018	2019	2020
							Forecast	
Population, th pers., mid-year [2]	3,531	3,526	3,518	3,511	3,510	3,506	3,503	3,499
Gross domestic product, BAM mn, nom. [3]	26,779	27,359	28,586	29,900	31,200	32,800	34,500	36,300
annual change in % (real)	2.3	1.1	3.1	3.1	3.0	3.4	3.3	3.3
GDP/capita (EUR at PPP) [3]	8,100	8,300	8,700	9,000	9,300	.	.	.
Consumption of households, BAM mn, nom. [3]	22,521	22,830	23,157	23,538	24,350	.	.	.
annual change in % (real)	0.0	1.9	1.8	1.7	2.2	2.8	2.9	2.9
Gross fixed capital form., BAM mn, nom. [3]	4,808	5,330	5,097	5,189	5,460	.	.	.
annual change in % (real)	-1.2	11.5	-3.5	2.5	4.0	5.0	5.0	5.0
Gross industrial production								
annual change in % (real)	5.2	0.2	3.1	4.4	3.1	3.3	3.0	2.8
Gross agricultural production [4]								
annual change in % (real)	15.2	-14.2	5.0	2.0	3.0	.	.	.
Construction output total								
annual change in % (real)	-2.4	6.8	-3.2	-1.0	-2.1	.	.	.
Employed persons, LFS, th, April	821.6	812.0	822.0	801.0	815.7	830	840	850
annual change in %	1.0	-1.2	1.2	-2.6	1.8	1.8	1.5	1.3
Unemployed persons, LFS, th, April	311.5	308.0	315.0	273.0	210.7	200	195	190
Unemployment rate, LFS, in %, April	27.5	27.5	27.7	25.4	20.5	19.4	18.8	18.3
Reg. unemployment rate, in %, eop	44.5	43.6	42.9	40.9	38.8	.	.	.
Average monthly gross wages, BAM	1,291	1,290	1,289	1,301	1,320	1,360	1,400	1,440
annual change in % (real, gross)	0.2	0.8	1.0	2.0	0.3	1.1	0.9	0.8
Average monthly net wages, BAM	827	831	830	838	850	870	900	930
annual change in % (real, net)	0.2	1.3	1.0	2.0	0.2	1.0	1.0	0.9
Consumer prices, % p.a.	-0.1	-0.9	-1.0	-1.1	1.2	1.6	1.9	1.9
Producer prices in industry, % p.a.	-1.8	-0.5	0.6	-2.1	3.0	1.8	2.1	2.1
General governm.budget, nat.def., % of GDP								
Revenues	42.6	43.7	43.2	42.7	42.5	42.7	42.9	43.2
Expenditures	44.8	45.8	42.5	41.5	41.5	41.7	42.5	42.9
Deficit (-) / surplus (+)	-2.2	-2.0	0.7	1.2	1.0	1.0	0.4	0.3
General gov.gross debt, nat.def., % of GDP [5]	37.6	41.6	41.9	40.5	40.8	39.9	39.6	39.7
Stock of loans of non-fin.private sector, % p.a.	2.9	1.7	2.0	3.5	7.4	.	.	.
Non-performing loans (NPL), in %, eop	15.1	14.2	13.7	11.8	10.7	.	.	.
Central bank policy rate, % p.a., eop [6]	.	.	.	.	.	.	.	.
Current account, EUR mn [7]	-728	-1,033	-826	-776	-740	-773	-804	-844
Current account, % of GDP [7]	-5.3	-7.4	-5.7	-5.1	-4.6	-4.6	-4.6	-4.5
Exports of goods, BOP, EUR mn [7]	3,397	3,501	3,678	3,935	4,350	4,590	4,870	5,170
annual change in %	9.5	3.0	5.1	7.0	10.5	5.5	6.1	6.1
Imports of goods, BOP, EUR mn [7]	7,027	7,527	7,355	7,535	8,060	8,450	8,890	9,350
annual change in %	-0.7	7.1	-2.3	2.4	7.0	4.8	5.2	5.2
Exports of services, BOP, EUR mn [7]	1,223	1,253	1,378	1,436	1,540	1,630	1,730	1,830
annual change in %	-1.0	2.5	9.9	4.3	7.2	6.1	5.9	5.9
Imports of services, BOP, EUR mn [7]	392	401	445	457	470	500	530	570
annual change in %	-2.2	2.1	11.2	2.7	2.7	6.0	6.0	7.0
FDI liabilities, EUR mn [7]	239	408	334	247	320	.	.	.
FDI assets, EUR mn [7]	64	7	85	6	30	.	.	.
Gross reserves of NB excl. gold, EUR mn	3,530	3,908	4,307	4,768	5,293	.	.	.
Gross external debt, EUR mn [5]	7,092	7,470	7,936	8,378	8,645	9,077	9,622	10,199
Gross external debt, % of GDP [5]	51.8	53.4	54.3	54.8	54.2	54.1	54.5	55.0
Average exchange rate BAM/EUR	1.9558	1.9558	1.9558	1.9558	1.9558	1.9558	1.9558	1.9558

1) Preliminary and wiiw estimates. - 2) According to census October 2013. - 3) According to ESA'10 (FISIM not yet reallocated to industries). - 4) Based on UN-FAO data, from 2015 wiiw estimate. - 5) Public debt, based on IMF estimates. - 6) Bosnia and Herzegovina has a currency board. There is no policy rate and even no money market rate available. - 7) Converted from national currency.

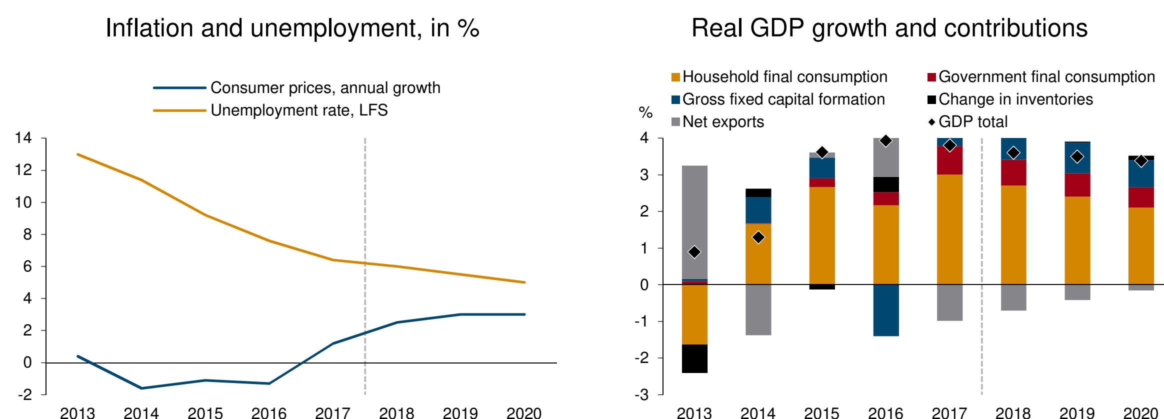
Source: wiiw Databases incorporating national statistics and IMF. Forecasts by wiiw.

BULGARIA: Growth continues but may be close to the limits

RUMEN DOBRINSKY

In 2017, Bulgaria's GDP grew by close to 4%, similarly to the previous year. The pattern of growth switched from being export led in 2016 to being driven by domestic demand in 2017. Manufacturing, tourism and business services remained the main growth drivers. The rise in labour demand led to a labour shortage, which is turning into a constraint on growth. The Bulgarian economy is poised to preserve its momentum in the short run; however, it is unlikely that GDP growth will accelerate in the near future.

Figure 43 / Bulgaria: Main macroeconomic indicators



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

The Bulgarian economy has fully recovered from the prolonged slump that followed the global financial crisis, with GDP growing by close to 4% in 2017, replicating the performance of the previous year. While the present GDP growth rates are below the highs recorded prior to the crisis, growth is much more balanced and is not accompanied by visible macroeconomic imbalances.

Both private consumption and gross fixed capital formation rebounded strongly in 2017 and contributed positively to GDP growth. Consequently, the pattern of growth changed: whereas in 2016 it was predominantly export driven, in 2017 the main growth impetus came from domestic demand. The pace of growth in private consumption in 2017 exceeded that of aggregated output and made a hefty contribution to GDP growth. The dynamics of fixed investment changed radically: while gross fixed capital formation plunged sharply (by 6.6% year on year) in 2016, mostly due to delays in the start of

public investment programmes co-funded by the EU, it rebounded by some 4% in 2017, when these programmes were gradually brought back on track. Although exports of goods and services also continued to grow strongly, they were outpaced by the growth of imports – which, in turn, reflected the surge in domestic demand. Overall this resulted in a negative contribution of net exports to GDP growth.

On the supply side, economic expansion continued across the board, but manufacturing, tourism and business services remained the main growth drivers, repeating the pattern of the last few years. Gross manufacturing output grew by 6.0% in 2017, 2 percentage points above the growth rate in 2016, supported by the upturn in EU import demand. Outsourcing services have become the most dynamic sector of the Bulgarian economy: 2017 was the seventh consecutive year with double-digit rates of growth for outsourcing output and exports. At present, this sector accounts for almost 4% of Bulgaria's GDP. The boom in the tourism industry also continued: while 2016 was regarded as an exceptional year (due to the diversion of Russian tourist flows from Turkey), the total number of tourists grew by a further 7% in 2017. Construction activity mirrored the pattern of fixed investment in the previous two years: construction output started to recover in 2017 after a dismal performance in 2016.

Bulgaria's macroeconomic fundamentals are sound and stable, with a positive current account balance and balanced public finances. The current account reported large surpluses in both 2016 and 2017, reflecting the surge in exports of services, but also a declining deficit in goods trade thanks to the sharp rebound in the exports of goods in these years.

The fiscal outturn in 2017 was also better than expected, largely thanks to cyclical effects that produced windfall revenue, and public finances ended the year with a large cash surplus. However, repeating fiscal practices in other similar cases, the government engaged in an extravagant spending spree in December, allocating some BGN 1.5 billion (1.5% of GDP) of the surplus revenue to spontaneous public spending unforeseen in the 2017 budget. Some of these extra spending items pursued obviously populist goals. This notwithstanding, public finances still ended the year with an estimated cash surplus of BGN 0.8 billion (0.8% of GDP).

After three years of deflation (from 2014 to 2016), consumer price inflation turned positive in 2017, but remained low. Under the currency board arrangement, and in the absence of large capital flows or domestic cost-push factors, Bulgaria to a large extent follows the price dynamics of its largest markets. This is what happened in the previous three years. But 2017 saw an end to this pattern, and one of the main factors was the changed situation in the labour market.

The improving business expectations translated into a rise in labour demand and a tightening labour market, as firms competed to hire workers from a shrinking pool of candidates. The rate of unemployment in 2017 fell to levels close to its historic lows, while the employment rate reached its highest level since the end of central planning. The number of employed persons grew by 4.4%, a pace of expansion not seen since 2007.

The long period of negative or low inflation, coupled with the ongoing rise in labour demand, has allowed for a prolonged surge in real wages, which grew by 40% between 2011 and 2017. This boosted consumer confidence and buoyed up spending not only on basic necessities, but also on consumer durables and housing. On the other hand, wage pressures and robust consumer demand were among the factors that produced the turnaround in the dynamics of inflation. Domestic producer prices also increased notably in 2017.

However, the labour market is becoming increasingly tight, which creates supply bottlenecks, especially as regards skilled workers. This is now becoming the main constraint on the future expansion of businesses: in January 2018, 40% of the firms surveyed reported that labour shortages were hampering the expansion of their business. In macroeconomic terms, this suggests certain limits to economic growth in the short run. At the same time, the average share of gross fixed capital formation in Bulgaria has been relatively low compared to other central and eastern European countries, which does not suggest that capital accumulation could become a key growth driver in the immediate future. FDI has also been moderate in recent years, and the accumulation of such investment does not suggest major new sources of growth originating in foreign capital. Moreover, even if there is a future surge in FDI (which does not seem likely), the economy will face difficulties in absorbing the extra, due to the shortages of skilled labour. A medium-term change to this pattern is probably only possible if there is a notable upturn in factor productivity, which could require an upgrade of production models and/or be associated with a surge in FDI.

In 2017, there were no significant developments in the macroeconomic policy agenda; in fact, the government was visibly absent from the economic arena. The budget for 2018 closely follows the structure of its predecessors, which implies no change in policy priorities. Given the ongoing cyclical upturn, it is not excluded that the fiscal year 2018 will also end with a cash surplus, providing the authorities with a free ride on the windfall. However, a persistent repeat of this pattern may lead to a systemic deterioration in the structural fiscal balance.

The one important policy development at the beginning of 2018 was the assumption (from Estonia) of the rotating Presidency of the Council of the EU, a role that Bulgaria is playing for the first time. While this is largely a technical function that places extra strain on the public administration, the Bulgarian authorities are seeking to present it to the local public as something more momentous. The government will obviously also seek to capitalise on this role in its relations with its Western Balkan neighbours. In fact, the deepening of economic and integrative ties between the EU and the Western Balkans has been widely publicised as Bulgaria's No.1 priority during the Presidency. However, the bulk of the Presidency agenda closely follows the European Commission work programme for the first half of 2018.

At the beginning of 2018, the Bulgarian authorities announced that in the course of the year they would seek to negotiate with the European Central Bank an entry date to ERM-II. Such a move had been widely expected, but the timing of its announcement was likely chosen to coincide with the start of the Presidency.

Overall, the Bulgarian economy appears to be in relatively good shape. The short-term prospects remain positive, with growth being predominantly driven by domestic demand. Both private consumption and fixed investment are expected to rise steadily, contributing positively to GDP growth. By contrast, imports may continue to outpace exports, and thus the contribution of net exports could remain negative.

In the current circumstances, however, it is unlikely that GDP growth in Bulgaria will speed up in the near future, as labour shortages are likely to get worse. Some signs of a deceleration of growth could actually be discerned in the final months of 2017. Thus, we envisage GDP growing by 3.6% in 2018 and possibly decelerating slightly more in 2019-2020.

There are no obvious macroeconomic risks, and growth should remain balanced in the forecast period. Inflation is expected to rise, but should remain in the low single-digit range. Unemployment will continue to fall, but given the situation in the labour market, a significant further rise in employment levels is unlikely.

Table 13 / Bulgaria: Selected economic indicators

	2013	2014	2015	2016	2017 1)	2018	2019 Forecast	2020
Population, th pers., average	7,265	7,224	7,178	7,128	7,080	7,000	6,950	6,900
Gross domestic product, BGN mn, nom.	82,166	83,634	88,571	94,130	99,080	105,200	112,100	119,400
annual change in % (real)	0.9	1.3	3.6	3.9	3.8	3.6	3.5	3.4
GDP/capita (EUR at PPP)	12,200	12,900	13,700	14,200	14,900	.	.	.
Consumption of households, BGN mn, nom.	50,660	51,963	54,831	56,715	59,700		.	.
annual change in % (real)	-2.5	2.7	4.3	3.5	5.0	4.5	4.0	3.5
Gross fixed capital form., BGN mn, nom.	17,365	17,653	18,612	17,484	18,800		.	
annual change in % (real)	0.3	3.4	2.7	-6.6	4.0	4.5	4.5	4.0
Gross industrial production 2)								
annual change in % (real)	-0.2	1.8	2.9	2.6	3.5	4.0	4.0	3.5
Gross agricultural production								
annual change in % (real)	14.2	-0.6	-8.2	1.7	-0.5	.	.	.
Construction industry 3)								
annual change in % (real)	-3.7	7.0	11.2	-16.8	4.5	.	.	.
Employed persons, LFS, th, average	2,935	2,981	3,032	3,017	3,150	3,200	3,230	3,260
annual change in %	0.0	1.6	1.7	-0.5	4.4	1.5	1.0	1.0
Unemployed persons, LFS, th, average	436	385	305	247	207	200	190	170
Unemployment rate, LFS, in %, average	13.0	11.4	9.2	7.6	6.2	6.0	5.5	5.0
Reg. unemployment rate, in %, eop	11.8	10.7	10.0	8.0	7.1	.	.	.
Average monthly gross wages, BGN	775.1	821.7	877.9	948.3	1,057.8	1,160	1,270	1,390
annual change in % (real, gross)	5.1	7.5	7.0	8.9	9.3	7.0	6.5	6.0
Consumer prices (HICP), % p.a.	0.4	-1.6	-1.1	-1.3	1.2	2.5	3.0	3.0
Producer prices in industry, % p.a.	-1.5	-1.2	-1.9	-3.1	4.8	3.0	2.5	2.5
General governm.budget, EU-def., % of GDP								
Revenues	37.2	36.6	39.1	34.9	36.5	36.0	36.0	36.0
Expenditures	37.6	42.1	40.7	35.0	36.0	36.0	36.0	36.0
Net lending (+) / net borrowing (-)	-0.4	-5.5	-1.6	0.0	0.5	0.0	0.0	0.0
General gov.gross debt, EU def., % of GDP	17.0	27.0	26.0	29.0	26.5	25.5	24.0	22.0
Stock of loans of non-fin.private sector, % p.a.	0.0	-8.2	-1.6	1.0	3.3	.	.	.
Non-performing loans (NPL), in %, eop	16.9	16.7	20.4	18.3	14.8	.	.	.
Central bank policy rate, % p.a., eop 4)	0.02	0.02	0.01	0.00	0.00	0.0	0.0	0.0
Current account, EUR mn	536	35	-17	2,561	2,050	1,300	1,000	800
Current account in % of GDP	1.3	0.1	0.0	5.3	4.0	2.4	1.7	1.3
Exports of goods, BOP, EUR mn	21,218	21,027	21,920	23,104	26,000	27,500	29,000	30,200
annual change in %	7.8	-0.9	4.2	5.4	12.5	5.8	5.5	4.1
Imports of goods, BOP, EUR mn	24,151	23,803	24,542	24,088	28,000	30,000	31,500	33,000
annual change in %	2.0	-1.4	3.1	-1.8	16.2	7.1	5.0	4.8
Exports of services, BOP, EUR mn	5,889	6,738	6,967	7,591	7,700	8,100	8,500	8,800
annual change in %	1.2	14.4	3.4	8.9	1.4	5.2	4.9	3.5
Imports of services, BOP, EUR mn	3,235	4,224	3,964	4,498	4,650	4,900	5,100	5,300
annual change in %	0.2	30.6	-6.2	13.5	3.4	5.4	4.1	3.9
FDI liabilities, EUR mn	1,509	1,539	2,430	1,042	850	.	.	.
FDI assets, EUR mn	266	657	101	702	600	.	.	.
Gross reserves of NB excl. gold, EUR mn 5)	13,303	15,276	19,022	22,475	22,257	.	.	.
Gross external debt, EUR mn 5)	36,936	39,338	33,317	34,046	32,200	31,800	31,200	31,000
Gross external debt, % of GDP 5)	87.9	92.0	73.6	70.7	64.0	59.0	54.0	51.0
Average exchange rate BGN/EUR	1.9558	1.9558	1.9558	1.9558	1.9558	1.9558	1.9558	1.9558

1) Preliminary and wiiw estimates. - 2) Enterprises with 10 and more employees. - 3) All enterprises in public sector, private enterprises with 5 and more employees. - 4) Base interest rate. This is a reference rate based on the average interbank LEONIA rate of previous month (Bulgaria has a currency board). - 5) BOP 5th edition.

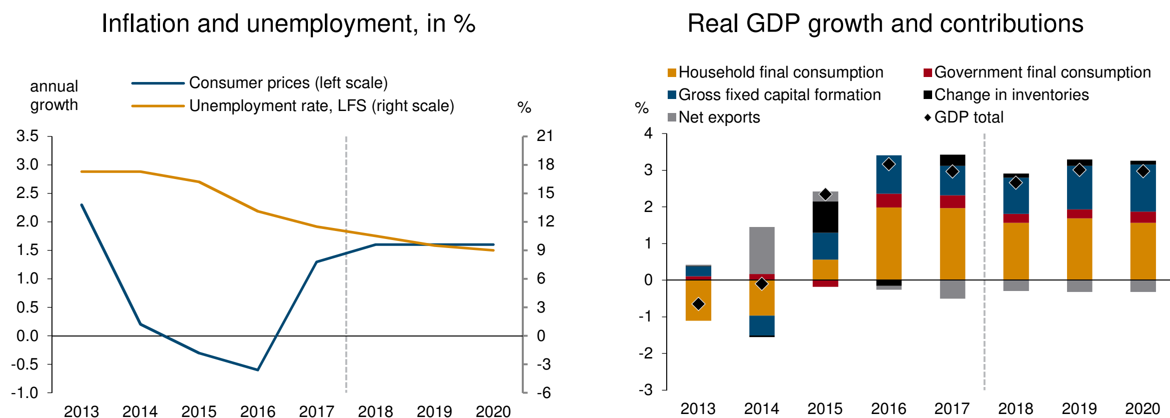
Source: wiiw Databases incorporating Eurostat and national statistics. Forecasts by wiiw.

CROATIA: Moderate growth ahead

HERMINE VIDOVIC

Croatia's GDP is projected to grow by up to 3% in the period 2018-2020, driven primarily by domestic demand. The general government is expected to report low deficits or even a surplus, and thus the debt-to-GDP ratio will continue declining gradually. The impact on growth of the Agrokor food-to-retail consortium's restructuring is still unknown.

Figure 44 / Croatia: Main macroeconomic indicators



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

Croatia's real GDP grew by 3% year on year in 2017. Growth was supported by domestic demand: both private consumption and investments expanded. Private consumption growth was at its highest level since the onset of the global financial crisis, gaining momentum thanks to rising employment, real wage increases and rising household loans. Gross fixed capital formation went up only modestly, probably on account of the financial problems of the Agrokor group. The contribution of net exports was negative, due to rising imports. Industrial production grew less dynamically than in 2016, and was up by some 2.3% in 2017. Construction output rose by only 2%, but activities in this sector, the construction of buildings in particular, intensified towards the end of the year. Also the recent survey of business expectations shows growing business confidence in construction, which had suffered from a long and deep downturn in the aftermath of the crisis.

The labour market situation has continued to improve, but unemployment is still high by European standards. According to Labour Force Survey data, employment increased by 1.7%, while the unemployment rate fell to slightly below 12% in 2017. The fall in unemployment was mainly due to continued emigration and ageing of the population, and was only partly a result of rising employment. Real net wages increased by almost 4% in 2017, on account of income tax changes and as a result of both private and public sector wage increases. The rise in public sector wages – including those of civil servants and government employees – took place in three stages, growing by 2% in each of the months of January, August and November.

Foreign trade picked up in 2017, and both exports and imports of goods have experienced strong growth (12.5%) in euro terms. The trade deficit was an estimated EUR 900 million higher than in 2016, while the surplus in the services trade rose, thanks to another record-breaking tourist season. Tourism continued to benefit from the political uncertainties in Turkey and Northern Africa. The repatriation of profits was lower, as banks absorbed losses from Agrokor. Hence, the current account recorded a strong surplus in 2017, at an estimated 4% of GDP. The inflow of FDI was somewhat lower compared with 2016, at EUR 1.5 billion.

In 2017, the general government ran the first surplus in the country's history, resulting from higher than expected revenues. The primary budget closed with a surplus for the second consecutive year. The reduction in the deficit also translated into a reduction in public debt, to an estimated 78% of GDP (from 82.7% in 2016). The budget plans approved in November 2017 envisage a budget deficit of 0.5% of GDP in 2018, a balanced budget in 2019 and a surplus of 0.8% in 2020. Reaching these targets will be very important, given the authorities' intentions of adopting the euro in the foreseeable future. In January 2018, Fitch upgraded Croatia's credit rating for the first time since 2004 – from 'BB' to 'BB+' – on account of strong revenues from tourism, the current account surplus and the improvement in public finances, among other things.

A first draft of settlement with the creditors of Agrokor foresees a debt-for-equity swap and a debt write-off. Accordingly, the creditors – suppliers, bondholders and banks – should become owners of a newly established (downsized) holding, including the profitable parts of the company. The non-profitable parts will undergo bankruptcy procedures, and part of the claims will be written off. As for the time line of the settlement, the crisis manager of Agrokor, Mr. Ramljak, asked for an extension of the deadline by three months until July at the latest. The intention is also to get Sberbank, the single biggest creditor, on board for a settlement; Sberbank had earlier launched legal action against Agrokor firms. The settlement with creditors requires the backing of creditors holding at least two-thirds of the claims, totalling about EUR 7.4 billion. Along with the adoption of an emergency law, which is to prevent the company from starting bankruptcy proceedings, the management of the company was handed over to a government-appointed manager in April 2017. So far new loans have been provided to pay out old debt of small suppliers and to ensure the continuation of regular business operations.

The introduction of the euro is one of the stated aims of the government and the Croatian National Bank. This was laid down in a joint strategy, presented at the beginning of November 2017. Croatia's economy is highly euroised: three-quarters of domestic savings and two-thirds of debts are denominated in euro. With respect to the convergence criteria, Croatia does not yet fulfil the criterion on sustainable public finances (the debt-to-GDP ratio is above 60%). Apart from further fiscal adjustments, for Croatia to join the ERM II it will be important to get the support of EU Member States and institutions

– provided they are willing to enlarge the eurozone. The application for ERM II entry and eventual adoption of the euro has to be done in consultation with EU institutions. According to Prime Minister A. Plenković, Croatia wants to enter ERM II before the country takes over the presidency of the European Union in 2020.

GDP growth is forecast to be around 3% in the period 2018-2020, driven by private consumption and a continued recovery in investments. Investments are expected to intensify, spurred by an increased absorption of EU funds, while household consumption will be driven by a further improvement in the labour market, along with rising wages. Inflation is expected to remain moderate, at below 2%, over the forecast period. As the strengthening of domestic demand will lead to rising imports, the trade deficit will increase further, but will largely be offset by the surplus in services due to high earnings from tourism. Hence, the current account surplus will persist, but will gradually decrease from an estimated 4% in 2017 to less than 1% in 2020. Assuming that the general government closes with even a slight surplus in the coming years, the public debt is expected to continue its downward path in the forecasting period. Downside risks are related to the potential impact of the Agrokor case, which may affect exports or private consumption if there are substantial layoffs during the restructuring of the company. In the longer run, demographic issues – the shrinking of the working-age population due to population ageing and continued emigration – constitute an additional downside risk. If Croatia were to settle a number of bilateral issues, the country could join important institutions that would give the economy an additional positive spin.

Becoming a member of the Schengen area and the OECD, which are among the foreign policy priorities for 2018, might be further blocked by Slovenia and Hungary. Slovenia wants to block Croatia's bid for membership so long as Croatia rejects the ruling of the international arbitration tribunal on the bilateral border dispute, while Hungary withdrew its support over tensions due to the INA-MOL oil company dispute.

Table 14 / Croatia: Selected economic indicators

	2013	2014	2015	2016	2017 [1)]	2018	2019	2020
							Forecast	
Population, th pers., average	4,254	4,236	4,208	4,172	4,150	4,100	4,050	4,000
Gross domestic product, HRK mn, nom.	331,374	331,266	338,975	349,410	364,500	380,200	397,900	416,300
annual change in % (real)	-0.6	-0.1	2.3	3.2	3.0	2.7	3.0	3.0
GDP/capita (EUR at PPP)	16,000	16,300	17,200	17,500	18,100	.	.	.
Consumption of households, HRK mn, nom.	195,623	191,407	192,250	196,505	206,020	.	.	.
annual change in % (real)	-1.9	-1.6	1.0	3.5	3.5	2.8	3.0	2.8
Gross fixed capital form., HRK mn, nom.	65,257	63,797	66,401	69,516	73,240	.	.	.
annual change in % (real)	1.4	-2.8	3.8	5.3	4.0	5.0	6.0	6.5
Gross industrial production [2)]								
annual change in % (real)	-1.8	1.2	2.7	5.3	1.4	2.5	3.0	3.0
Gross agricultural production								
annual change in % (real)	5.5	-6.9	2.9	6.9	-3.6	.	.	.
Construction output [2)]								
annual change in % (real)	-4.6	-7.3	-0.6	2.6	2.0	.	.	.
Employed persons, LFS, th, average	1,524	1,566	1,585	1,590	1,600	1,610	1,630	1,650
annual change in %	-2.7	2.7	1.3	0.3	0.6	0.8	1.0	1.0
Unemployed persons, LFS, th, average	318	327	306	240	210	190	170	160
Unemployment rate, LFS, in %, average	17.3	17.3	16.2	13.1	11.5	10.5	9.5	9.0
Reg. unemployment rate, in %, eop	21.5	19.4	17.6	14.7	12.2	.	.	.
Average monthly gross wages, HRK [3)]	7,939	7,953	8,055	7,753	8,050	8,340	8,640	9,000
annual change in % (real, gross)	-1.4	0.4	1.8	3.0	2.7	2.0	2.0	2.0
Average monthly net wages, HRK [3)]	5,515	5,533	5,711	5,685	6,000	6,280	6,570	6,900
annual change in % (real, net)	-1.5	0.5	3.7	2.7	4.4	3.0	3.0	3.0
Consumer prices (HICP), % p.a.	2.3	0.2	-0.3	-0.6	1.3	1.6	1.6	1.6
Producer prices in industry, % p.a.	-0.4	-2.7	-3.9	-4.3	1.9	2.0	2.0	2.0
General governm.budget, EU-def., % of GDP								
Revenues	42.4	42.9	44.3	46.2	45.4	44.9	44.0	43.9
Expenditures	47.7	48.0	47.6	47.1	46.3	45.4	44.0	43.4
Net lending (+) / net borrowing (-)	-5.3	-5.1	-3.3	-0.9	-0.9	-0.5	0.0	0.5
General gov.gross debt, EU def., % of GDP	81.7	85.8	85.4	82.7	78.0	76.0	74.0	72.0
Stock of loans of non-fin.private sector, % p.a.	-1.5	-2.0	-3.1	-4.3	0.1	.	.	.
Non-performing loans (NPL), in %, eop	15.7	17.1	16.7	13.8	12.5	.	.	.
Central bank policy rate, % p.a., eop [4)]	7.0	7.0	3.0	3.0	3.0	3.0	3.0	3.0
Current account, EUR mn	415	858	2,019	1,172	1,930	1,100	700	500
Current account, % of GDP	0.9	2.0	4.5	2.5	4.0	2.2	1.3	0.9
Exports of goods, BOP, EUR mn	8,924	9,440	10,193	10,511	11,810	12,800	13,700	14,700
annual change in %	2.9	5.8	8.0	3.1	12.4	8.0	7.0	7.0
Imports of goods, BOP, EUR mn	15,511	15,952	17,168	17,849	20,080	21,900	23,700	25,600
annual change in %	3.6	2.8	7.6	4.0	12.5	9.0	8.0	8.0
Exports of services, BOP, EUR mn	9,844	10,238	11,279	12,269	13,360	14,300	15,200	16,000
annual change in %	2.1	4.0	10.2	8.8	8.9	7.0	6.0	5.5
Imports of services, BOP, EUR mn	3,088	2,900	3,274	3,585	3,960	4,200	4,500	4,800
annual change in %	-2.2	-6.1	12.9	9.5	10.5	7.0	7.0	6.0
FDI liabilities, EUR mn	737	2,297	189	1,699	1,500	.	.	.
FDI assets, EUR mn	-111	1,608	-44	-178	500	.	.	.
Gross reserves of NB excl. gold, EUR mn	12,908	12,688	13,707	13,514	15,706	.	.	.
Gross external debt, EUR mn	45,803	46,416	45,384	41,668	39,800	39,000	39,800	40,500
Gross external debt, % of GDP	104.8	107.0	101.9	89.8	81.5	77.0	75.0	73.0
Average exchange rate HRK/EUR	7.5786	7.6344	7.6137	7.5333	7.4637	7.5	7.5	7.5

1) Preliminary and wiiw estimates. - 2) Enterprises with 20 and more employees. - 3) From 2016 data are based on tax records (survey JOPPD); prior to that data are based on a monthly survey covering 70% of persons in employment. - 4) Discount rate of NB.

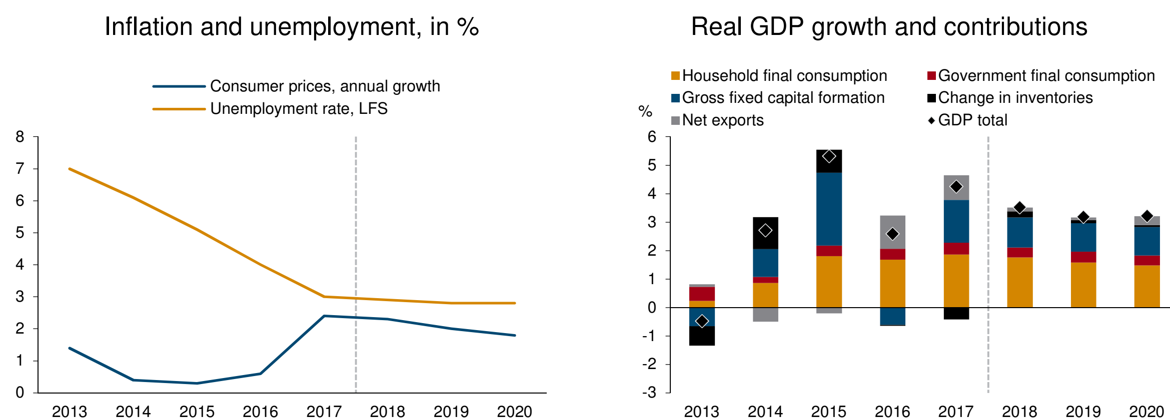
Source: wiiw Databases incorporating national statistics. Forecasts by wiiw.

CZECH REPUBLIC: Broad-based but quite moderate growth

LEON PODKAMINER

The robust demand for consumer, investment and export goods is conducive to broad-based growth. However, deepening labour shortages are preventing further strong output expansion, while rapidly rising wages are starting to affect profitability. Monetary policy does not face any serious dilemmas. Under the new government, stability-oriented fiscal policy will be preserved.

Figure 45 / Czech Republic: Main macroeconomic indicators



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

After quite a strong performance in the first half of 2017, growth speeded up further in the third quarter, with GDP growth rates (year on year, seasonally unadjusted) rising by 4.7% (up from about 3.7% in the first half of the year). Growth in household consumption accelerated from 3.7% in the first half of 2017 to about 4.1% in the third quarter. Gross fixed capital formation expanded even more rapidly – by 6.3% (from 3.5% in the first half of the year). Foreign trade in goods and services performed quite well in the first half of 2017, with volumes of exports and imports rising by 5.8% and 4.3%, respectively. In the third quarter, the volumes grew much more rapidly (but at a fairly similar pace) – 6.3% and 6.2%, respectively. The large trade surplus recorded in the first quarter (10.2% of GDP) fell to a surplus of 8.3% of GDP in the second quarter and to 5.5% in the third. Foreign trade's contribution to GDP growth fell from about 1.7 percentage points (pp) in the first half of the year to about 0.4 pp in the third quarter.

Unemployment is very low and falling. This has much to do with unfavourable demography (but not so much with outward migration as in the case of other CESEE countries). The size of the working-age

population has been contracting since at least 2010 (on average by close to 1% annually). This tendency will continue in the foreseeable future. The strong output growth observed recently has also been important in raising the number of employees (as well as lengthening working hours), and thus reducing the size of unemployment.

Emerging labour shortages are being felt throughout the economy and may already be reducing the levels of output. Firms tend to alleviate their staffing problems by hiring foreign workers (primarily recruited in Slovakia and Poland or from Ukraine). A longer-term option could require the introduction of more labour-saving and efficiency-raising technologies and production modes. This option would include moving parts of any particularly labour-intensive (and low value-added) production abroad. Apart from this, one may anticipate a strengthened reallocation of the domestic labour force from low value-added activities (such as agriculture or certain services) into more promising sectors, such as some higher-tech branches of manufacturing.

Under the impact of tightening labour markets, wage rates are now rising quite strongly. The Czech labour market has long been characterised by the coexistence of low unemployment with a good deal of wage moderation, which to some extent reflects the age structure of the Czech labour force. But given the scale of labour shortages, a stronger push for higher wages is now under way. In many industrial branches, the effects of the wage hikes are neutralised by rising productivity. Nonetheless the unit labour costs are generally on the rise – restricting improvements in profitability and at the same time contributing to a return to more 'normal' levels of inflation, after a long spell of price stability.

The rising wage bill underlies continuing growth in private consumption and will also be vital for the expansion of households' housing investment. Conditions are conducive for an acceleration of firms' productive investments as well. The financial position of firms remains quite strong (although it has worsened recently under the impact of rising labour costs). The interest rates on loans to firms are low, and firms' order books (including export orders) are full. Public investment (co-financed by EU structural funds) in infrastructure projects is also expected to gain momentum from 2018.

The Czech currency has been strengthening. The floating of the Czech koruna (on 6 April 2017) was followed by a continuing strong nominal (as well as real) appreciation. This trend was temporarily reversed in December 2017, but resumed in January 2018. In the absence of the National Bank's active participation in the foreign exchange market, it is still too early to discern the emergence of a new stable level for the exchange rate. The huge CZK positions taken before April 2017 (primarily by speculative investors who had correctly anticipated imminent CZK nominal appreciation) do not seem to have been liquidated. After rising turbulently in the first quarter of 2017, the foreign exchange reserves of the Czech National Bank (CNB) have since remained unchanged. This may be due to high demand for Czech government securities, which, despite the relatively low yields offered, have proved attractive – understandably so, given the country's low public debt, 'sound fiscal policy' and overall economic and social stability.

There is a real possibility that imports could rise faster than exports. The extraordinary foreign trade developments in the first half of 2017 may have occurred in rather exceptional circumstances that may not have repeated themselves during the rest of 2017. The expectation of currency appreciation may have provided incentives to sign export contracts in advance and to suppress or delay imports accordingly. It is natural to expect that, with a strong CZK, exports will have been less dynamic in the

second half of 2017. Another reason for expecting exports to lose momentum and imports to surge is that the Czech economy could already be close to exhausting its spare production capacities, as shortages of labour (and possibly of domestically produced intermediate inputs) are becoming widespread. However, even if imports rise faster than exports, the trade surplus is highly unlikely to turn to a deficit in the foreseeable future.

Inflation is 'back to normal'. One of the (declared) reasons for giving up control over the exchange rate was the prospect of inflation returning to 'normal' (after running at close to zero since the beginning of 2014). The return of moderate inflation is a fairly natural consequence of the tight labour market and very low levels of unemployment – and, consequently, of rising wages and costs (e.g. seen in the prices of raw materials and components, which could temporarily be in short supply). Inflation in excess of 2% is expected in 2018, following temporary hikes in the price of foodstuffs and one-off rises in controlled prices (electricity and other utilities). The effects of these additional factors will fade in 2019. Strengthened CZK exchange rates would also help contain inflation.

The CNB is unlikely to oppose moderate inflation very actively, as that would harm investment activities, and possibly also additionally strengthen the Czech currency. In August 2017, the policy rate was increased (for the first time since February 2008) from a symbolic 0.05% to (almost equally symbolic) 0.25%. Other small increases in the policy rate are possible in 2018, but the CNB may prefer to rely on the currency strengthening on its own. The recent 'hike' in the policy interest rates has not affected the market interest rates on loans. The latter remain unchanged nominally (and have fallen in real terms), encouraging a stronger rise in the demand for loans (by firms, and especially by households).

Fiscal policy has been successfully targeting a balanced budget for the general government. In fact, the Finance Ministry plans a fiscal surplus (over 1% of GDP) each year until 2020, implying a decline in the public debt/GDP ratio to about 30% in 2019. The very low cost of servicing public debt is one component of successful fiscal consolidation. Rapid growth and dwindling unemployment (as well as the corresponding decline in spending on unemployment benefits) may facilitate fiscal consolidation.

Overall, the orientation of economic policy will remain unchanged. The parliamentary elections held on 21–22 October 2017 were won by the ANO party, the junior partner in the coalition government that had been in power since 2013. ANO's leader, Mr Babiš, has so far failed to build a broad-based coalition government. The presidential election held on 26–27 January was won by Mr Zeman, who has been siding with Mr Babiš. Most probably (notwithstanding his problems in the courts) Mr Babiš will run the government without a parliamentary majority. His government's economic policy agenda is likely to remain unchanged. Given ANO's (and Mr Babiš's personal background)[63] one may perhaps expect a slightly more pro-(domestic) business emphasis in matters of taxation and administrative regulation. Neither the CNB nor the new government is likely to change its sceptical stance on the issue of euro accession. Also on other important European matters (e.g. on the readiness to accept large-scale quotas of migrants), the new government will remain uncooperative.

To sum up, there is a virtuous cycle of rising incomes, demand and output. Despite the emergence of labour shortages (and supply bottlenecks), inflation will be contained, while the growth rate may well exceed 3% in the period 2017-2019.

[63] Mr Babiš is a successful businessman, active primarily in the food-processing and distribution industry. He is considered the second-richest Czech citizen ('worth' some USD 4 billion).

Table 15 / Czech Republic: Selected economic indicators

	2013	2014	2015	2016	2017 [1]	2018	2019	2020
							Forecast	
Population, th pers., average	10,514	10,525	10,546	10,566	10,570	10,580	10,590	10,610
Gross domestic product, CZK bn, nom.	4,098	4,314	4,596	4,773	5,030	5,310	5,590	5,890
annual change in % (real)	-0.5	2.7	5.3	2.6	4.2	3.5	3.2	3.2
GDP/capita (EUR at PPP)	22,400	23,800	25,300	25,600	26,700	.	.	.
Consumption of households, CZK bn, nom.	1,997	2,044	2,125	2,214	2,330	.	.	.
annual change in % (real)	0.5	1.8	3.8	3.6	4.0	3.8	3.4	3.2
Gross fixed capital form., CZK bn, nom.	1,027	1,084	1,216	1,192	1,280	.	.	.
annual change in % (real)	-2.5	3.9	10.2	-2.3	6.0	4.2	4.0	4.0
Gross industrial production								
annual change in % (real)	-0.1	5.0	4.6	3.5	5.7	4.5	4.0	4.0
Gross agricultural production								
annual change in % (real)	6.0	10.1	-4.8	7.0	-8.6	.	.	.
Construction industry								
annual change in % (real)	-6.7	4.3	7.0	-5.9	1.8	.	.	.
Employed persons, LFS, th, average	4,937	4,974	5,042	5,139	5,222	5,240	5,260	5,270
annual change in %	1.0	0.8	1.4	1.9	1.6	0.4	0.3	0.2
Unemployed persons, LFS, th, average	369	324	268	211	155	160	150	150
Unemployment rate, LFS, in %, average	7.0	6.1	5.1	4.0	2.9	2.9	2.8	2.8
Reg. unemployment rate, in %, eop	8.2	7.5	6.2	5.2	3.8	.	.	.
Average monthly gross wages, CZK	25,035	25,768	26,591	27,575	29,500	31,400	33,100	34,900
annual change in % (real, gross)	-1.5	2.5	2.9	3.0	4.4	4.0	3.5	3.5
Consumer prices (HICP), % p.a.	1.4	0.4	0.3	0.6	2.4	2.3	2.0	1.8
Producer prices in industry, % p.a.	0.7	0.9	-2.4	-3.2	1.8	1.0	1.5	1.0
General governm. budget, EU-def., % of GDP								
Revenues	41.4	40.3	41.1	40.1	40.7	41.0	41.0	41.0
Expenditures	42.6	42.2	41.7	39.4	39.8	40.2	40.3	40.4
Net lending (+) / net borrowing (-)	-1.2	-1.9	-0.6	0.7	0.9	0.8	0.7	0.6
General gov.gross debt, EU def., % of GDP	44.9	42.2	40.0	36.8	34.1	32.4	31.0	31.0
Stock of loans of non-fin.private sector, % p.a.	4.1	2.7	6.6	6.7	6.5	.	.	.
Non-performing loans (NPL), in %, eop	5.9	6.1	5.8	4.8	4.0	.	.	.
Central bank policy rate, % p.a., eop [2]	0.05	0.05	0.05	0.05	0.50	0.75	1.00	1.00
Current account, EUR mn	-829	296	368	1,946	2,408	1,400	2,210	2,100
Current account, % of GDP	-0.5	0.2	0.2	1.1	1.3	0.7	1.0	0.9
Exports of goods, BOP, EUR mn	103,184	110,401	115,573	118,494	128,218	135,900	144,100	152,700
annual change in %	-1.1	7.0	4.7	2.5	8.2	6.0	6.0	6.0
Imports of goods, BOP, EUR mn	96,735	102,406	108,701	109,224	118,605	126,300	133,900	141,900
annual change in %	-2.7	5.9	6.1	0.5	8.6	6.5	6.0	6.0
Exports of services, BOP, EUR mn	18,059	18,915	20,603	21,618	23,491	24,900	26,400	28,000
annual change in %	-4.3	4.7	8.9	4.9	8.7	6.0	6.0	6.0
Imports of services, BOP, EUR mn	15,346	16,892	17,742	17,880	18,968	20,200	21,400	22,700
annual change in %	-2.7	10.1	5.0	0.8	6.1	6.5	6.0	6.0
FDI liabilities, EUR mn	5,544	6,101	1,521	5,875	8,283	.	.	.
FDI assets, EUR mn	5,831	3,175	3,357	661	3,077	.	.	.
Gross reserves of NB excl. gold, EUR mn	40,460	44,528	58,903	80,999	123,067	.	.	.
Gross external debt, EUR mn	99,652	109,067	118,252	130,573	164,300	183,200	199,200	216,800
Gross external debt, % of GDP	63.2	69.6	70.2	74.0	86.0	88.0	90.0	92.0
Average exchange rate CZK/EUR	25.98	27.54	27.28	27.03	26.33	25.50	25.25	25.00

1) Preliminary and wiiw estimates. -2) Two-week repo rate.

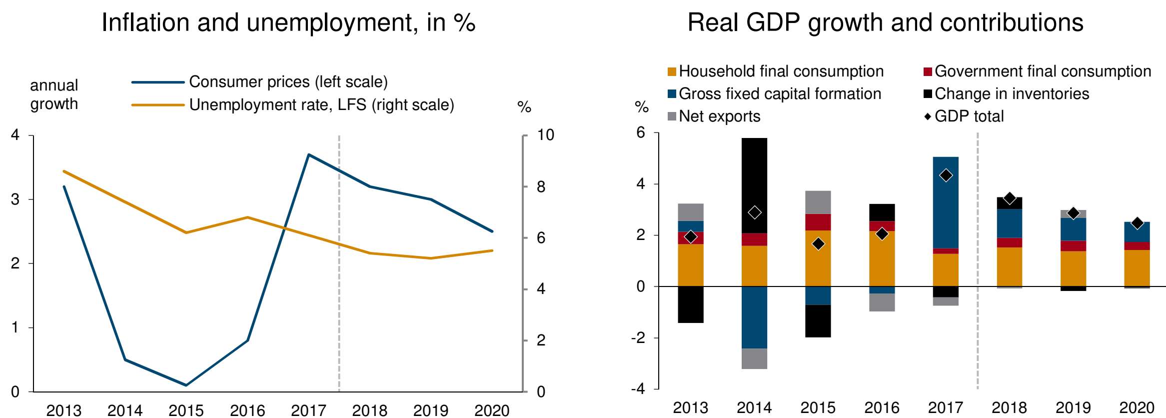
Source: wiiw Databases incorporating Eurostat and national statistics. Forecasts by wiiw.

ESTONIA: Investment keeps growth in high gear

SEBASTIAN LEITNER

Investment activity picked up more strongly than expected in both the private and the public sectors, pushing GDP growth to 4.3% in 2017. Although it has already peaked, economic activity will remain vibrant in 2018 and thereafter. External demand will continue to grow at a good pace, though somewhat more slowly than last year. Household consumption, backed by a considerable rise in real wages and tax cuts, continues to be a strong driver of economic activity. We project GDP to grow at a rate of 3.5% in 2018 and 2.9% in 2019, declining somewhat to 2.5% in 2020.

Figure 46 / Estonia: Main macroeconomic indicators



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

Investment activity in the public and private sectors will keep on supporting growth in 2018 and 2019. In 2017, increasing inflows of fresh EU funds from the 2014-2020 programming period allowed the government to increase capital outlays substantially, particularly in road and railway infrastructure. The 2018 budget foresees a further rise in public investment, to 5.6% of GDP, and a stabilisation at that level thereafter. Rising expenditure will be devoted to defence and the health sector. The government foresees a budget deficit of 0.3% for 2018, and a further reduction in public debt to close to 8% of GDP is to be expected by 2019. Private investment by both enterprises and households will continue to develop swiftly in 2018. Given the favourable demand situation and still rising levels of sentiment, entrepreneurs are increasing their investments in equipment and buildings. Building permits for dwellings and non-residential buildings suggest that construction activity will flourish in 2018. Growing

wages and very low interest rates – the average interest rate on housing loans was 2.3% in December 2017 – have resulted in a double-digit increase in new credits for households. Apartment prices, which are rising swiftly at the moment, have reached pre-crisis levels in Tallinn. Today, however, the situation is less overheated than in the boom years before 2008, the financial situation of households is more stable and there is no credit bubble in sight.

Export activity evolved dynamically throughout 2017 and is expected to keep going this year, too. In particular, goods exports to Russia gained strongly in momentum, increasing by more than 20% nominally in 2017. This also fosters growth in services exports, since transit trade with Russia has revived as well. Moreover, activity in the tourism industry has regained its momentum. In the coming years, Russian import growth will slow (see country report on Russia). The economy of neighbouring Sweden is expected to expand at close to 3% per annum in 2018, in line with that of Finland, which has lately experienced new dynamism. Export activity to neighbouring Latvia and Lithuania has also regained momentum. Only the highly export-oriented machinery and electronics industry is currently suffering from sector-specific low external demand. Rising wages are putting pressure on assembly work performed in Estonia for Nordic firms. In order to remain competitive, Estonian producers will have to move up the value-added chain. Overall, in 2018 we expect growth in goods exports to keep pace with last year, but to level off in 2019 and 2020. Given the swiftly rising household incomes, imports should increase even more strongly than exports.

The unemployment rate continued to decline slightly to 6% through 2017, while the employment rate has almost attained the level of the Scandinavian economies. While employment in the services sectors has continued to rise, it is stagnant in agriculture and industry. The work ability reform of 2016 forced people who had previously received incapacity pensions to look more actively for jobs. This temporarily increased the labour supply and the unemployment rate. However, the recent strong labour demand resulted in declining unemployment in 2017, and will lead to a further fall in the unemployment rate to close to 5% in the coming two years. Moreover, the employment rate among those aged 15 to 64 years increased to over 73% of the population in 2017; on that indicator, Estonia ranks 7th among the EU countries.

The increase in real net wages dropped to 3.5% in 2017 year on year, but still pushed household consumption upwards. We expect the pace of growth to remain at that level in real terms in 2018, too. Consumer inflation rose throughout last year, and in December 2017 the rate was even 3.8% year on year. However, the upward price movement was mostly caused by an increase in excise taxes and by rising energy prices. In 2018, consumer prices will continue to rise more swiftly, pushed up by rising import prices. Forward-looking consumer confidence indicators show an improvement at the beginning of 2018, and the most recent retail trade and credit statistics indicate a good spending mood. Monthly incomes will continue to grow considerably in 2018, not least thanks to another increase in the monthly minimum wage from January 2018 to EUR 500. Moreover, the government's 2018 budget contains additional measures to reduce the income tax burden – in particular, an increase in the non-taxable basic exemption from EUR 180 to EUR 500, which substantially increases the net income of low- and middle-income earners.

Overall, GDP growth will remain strong in 2018. The 2017 GDP growth of 4.3% in real terms was somewhat higher than forecast, due to an unexpectedly sharp upswing in public and private investment and strong export demand from Russia and the euro area. An ongoing good (though somewhat slower) growth in public investments both this year and in 2019 will be facilitated by increasing inflows of EU funds. Private investment in construction and equipment will foster growth, but external demand will also remain quite lively in 2018. Rising private income will also help household consumption to grow swiftly. Thus, for 2018 we forecast real GDP growth to remain strong at 3.5%; due to a flattening of the investment cycle and lower external demand activity, we expect economic activity to calm down slightly in 2019 (2.9%) and 2020 (2.5%).

Table 16 / Estonia: Selected economic indicators

	2013	2014	2015	2016	2017 1)	2018	2019	2020
							Forecast	
Population, th pers., average	1,318	1,315	1,315	1,316	1,315	1,318	1,320	1,322
Gross domestic product, EUR mn, nom.	18,932	19,766	20,348	21,098	22,800	24,300	25,700	27,000
annual change in % (real)	1.9	2.9	1.7	2.1	4.3	3.5	2.9	2.5
GDP/capita (EUR at PPP)	20,200	21,000	21,700	21,900	22,900	.	.	.
Consumption of households, EUR mn, nom.	9,457	9,813	10,232	10,771	11,400	.	.	.
annual change in % (real)	3.3	3.2	4.4	4.3	2.5	3.0	2.7	2.8
Gross fixed capital form., EUR mn, nom.	5,253	4,829	4,807	4,712	5,700	.	.	.
annual change in % (real)	1.5	-8.7	-2.9	-1.2	16.0	5.0	4.0	3.5
Gross industrial production								
annual change in % (real)	4.1	3.9	0.3	2.4	7.7	7.0	5.0	5.0
Gross agricultural production								
annual change in % (real)	4.7	4.6	8.7	-17.2	7.4	.	.	.
Construction industry								
annual change in % (real)	-0.1	-2.1	-3.4	2.6	20.0	.	.	.
Employed persons, LFS, th, average	621.3	624.8	640.9	644.6	655.0	660	665	668
annual change in %	1.0	0.6	2.6	0.6	1.6	0.8	0.8	0.5
Unemployed persons, LFS, th, average	58.7	49.6	42.3	46.7	42.0	38	37	39
Unemployment rate, LFS, in %, average	8.6	7.4	6.2	6.8	6.1	5.4	5.2	5.5
Reg. unemployment rate, in %, eop 2)	5.3	4.4	4.7	4.4	4.8	.	.	.
Average monthly gross wages, EUR	949	1,005	1,065	1,146	1,226	1,320	1,410	1,500
annual change in % (real, gross)	4.1	6.0	6.5	7.4	3.5	4.0	4.0	3.5
Average monthly net wages, EUR	757	799	859	924	985	1,050	1,120	1,190
annual change in % (real, net)	4.3	5.7	8.0	7.4	3.0	3.5	4.0	3.5
Consumer prices (HICP), % p.a.	3.2	0.5	0.1	0.8	3.7	3.2	3.0	2.5
Producer prices in industry, % p.a.	7.2	-2.7	-3.0	-1.3	3.0	3.2	3.0	2.5
General governm. budget, EU-def., % of GDP								
Revenues	38.3	39.1	40.3	40.3	39.5	38.6	38.6	38.6
Expenditures	38.5	38.4	40.2	40.6	40.0	39.0	38.8	38.6
Net lending (+) / net borrowing (-)	-0.2	0.7	0.1	-0.3	-0.5	-0.4	-0.2	0.0
General gov.gross debt, EU def., % of GDP	10.2	10.7	10.0	9.4	9.0	8.5	8.0	8.0
Stock of loans of non-fin.private sector, % p.a.	0.7	2.6	4.8	6.6	0.7	.	.	.
Non-performing loans (NPL), in %, eop	1.7	1.5	1.1	1.0	0.8	.	.	.
Central bank policy rate, % p.a., eop 3)	0.25	0.05	0.05	0.00	0.00	.	.	.
Current account, EUR mn	99	51	398	400	610	333	183	229
Current account, % of GDP	0.5	0.3	2.0	1.9	2.7	1.4	0.7	0.8
Exports of goods, BOP, EUR mn	10,968	10,998	10,757	11,168	11,820	13,100	13,800	14,490
annual change in %	2.0	0.3	-2.2	3.8	5.8	10.8	5.3	5.0
Imports of goods, BOP, EUR mn	11,893	12,089	11,612	11,958	12,754	13,900	14,900	15,645
annual change in %	-1.1	1.6	-3.9	3.0	6.7	9.0	7.2	5.0
Exports of services, BOP, EUR mn	4,992	5,323	5,237	5,496	6,058	6,400	6,800	7,140
annual change in %	6.8	6.6	-1.6	4.9	10.2	5.6	6.3	5.0
Imports of services, BOP, EUR mn	3,535	3,673	3,568	3,892	4,148	4,500	4,800	5,040
annual change in %	13.5	3.9	-2.9	9.1	6.6	8.5	6.7	5.0
FDI liabilities, EUR mn	834	1,308	-661	665	645	.	.	.
FDI assets, EUR mn	641	847	-532	156	186	.	.	.
Gross reserves of NB excl. gold, EUR mn	222	352	373	325	279	.	.	.
Gross external debt, EUR mn	17,618	19,062	19,178	19,072	19,380	19,400	20,600	21,600
Gross external debt, % of GDP	93.1	96.4	94.3	90.4	85.0	80.0	80.0	80.0

1) Preliminary and wiiw estimates. - 2) In % of labour force (LFS). - 3) Official refinancing operation rate for euro area (ECB).

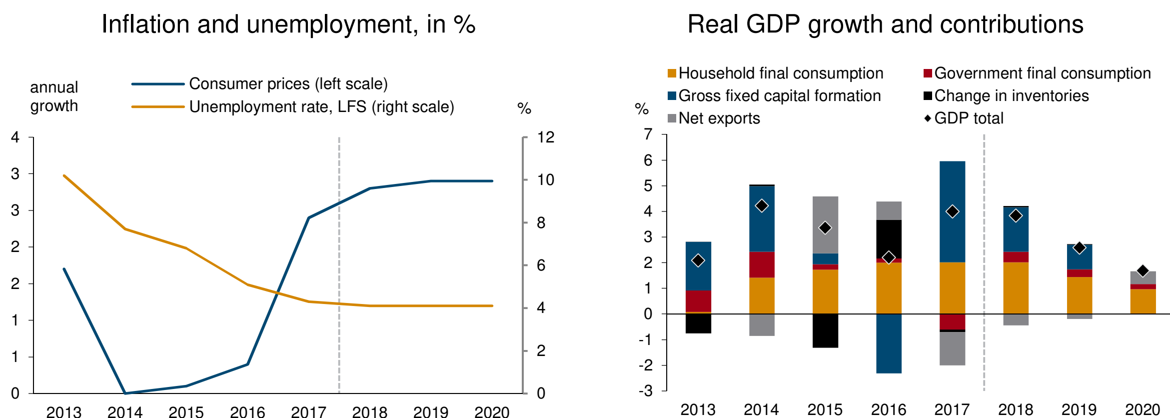
Source: wiiw Databases incorporating Eurostat and national statistics. Forecasts by wiiw.

HUNGARY: EU co-financed investment boom, surging wages, shrinking trade surplus

SÁNDOR RICHTER

Economic growth in 2017 amounted to 4%, with household consumption growing quicker than GDP, reflecting the dynamic expansion of real wages. Investments increased by about 20% as a direct consequence of the accelerated allocation of EU cohesion policy-related resources to recipients. The other side of the coin was the strong deterioration in the foreign trade balance. Economic growth remains dynamic this year, though a deceleration is expected from 2019 on, closely related to the depletion of EU resources due to a deliberate excessive utilisation of the respective resources in 2017-2019.

Figure 47 / Hungary: Main macroeconomic indicators



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

According to preliminary data, economic growth in 2017 amounted to 4%, Hungary's best result since 2014, although somewhat weaker than the EU-CEE average. As in 2015 and 2016, the pace of increase in household consumption exceeded that of GDP. In part, this reflects the very dynamic growth in real wages in the last two years. Gross fixed capital formation recorded a huge turnaround: from a decline of over 10% in 2016, investments increased by about 20% in 2017, as a direct consequence of the accelerated allocation of EU cohesion policy-related resources to recipients. The EU resources-driven expansion of investment, complemented by a revival in long-flagging homebuilding, is reflected in the outstanding performance of the construction sector as well. Investment growth was well below the national average in the business sector. In industry, a much less EU resources-dependent sector of the

economy, growth in value added was around 7%; but in weather-dependent agriculture, a strong decline was registered. The services sector expanded in line with GDP growth, with laggard sub-sectors like public administration, education and health care recording a decline.

Strong expansion of investments and household consumption left a visible impact on foreign trade. In goods trade, the growth rate of exports lagged about 3 percentage points behind that of imports. The discrepancy may have been smaller in foreign trade in services. All in all, the balance of goods and services is assumed to have deteriorated by about EUR 1.5 billion. Despite this deterioration, the trade balance remained highly positive (about EUR 10 billion). Nevertheless the contribution of foreign trade to GDP growth has turned negative (-1.3 percentage points).

In 2018, the dynamic increase in wages will continue for a third consecutive year. The compound growth rate of net real wages in 2016-2018 will be around 28%. Behind this development, we find the effect of compulsory minimum wage rises in the previous year and this year, and the ever-increasing shortage of labour, particularly skilled labour. Respondents in company surveys name the labour shortage as the most important obstacle to expansion of their businesses. Obligatory minimum wage rises make the life of SMEs operating with low productivity difficult, especially in less developed regions of the country, where the share of employees on the minimum wage is especially high and where the increase in purchasing power of households and businesses alike does not keep pace with that in the more developed parts of the country.

Inflation, though, accelerated from nearly zero in 2014-2016, and will remain close to 3% annually over the forecast horizon. Meanwhile, the impact of the strong wage rises has been relatively small. The reason for this is that, with the higher mandatory minimum wage, there has been no proportional increase in the disposable income of a considerable part of those employees affected: what was previously often an unreported part of employee compensation has now started to be reported, appearing in the wage statistics for the first time, but not increasing actual demand. This is also one reason why the expansion of household consumption lags far behind that of wages. Furthermore, increased purchasing power was matched mostly by increasing imports, narrowing the trade surplus but reducing inflationary pressures. A reduction in the VAT rate on a few important items and a cut in the social contribution tax rate for employers in both 2017 and 2018 have helped curb inflation.

While a general election is just around the corner (8 April) macroeconomic topics have been missing from the election campaign. The ruling Fidesz party's campaign is organised around combating fabricated enemies: George Soros, 'Brussels', illegal migrants/refugees. It involves agitation, relying on fear-based hostility toward those 'enemies', as well as the opposition parties and NGOs critical of the government. The opposition parties are preoccupied with addressing the government's increasingly autocratic tendencies, the declining state of health care and education, 'status-enhancing' projects and, above all, signs of increasing corruption. Public opinion polls suggest a victory for Viktor Orbán's Fidesz, perhaps even with a constitutional (two-thirds) majority, and therefore a continuation of current economic policy is the likely scenario in the short run. Nevertheless, in 2019 or 2020 at the latest, a low-water mark for EU cohesion policy transfers will be reached, posing a challenge for the Hungarian government. A significant part of aggregate demand will drop out, requiring a fiscal and monetary policy response. A similar low level occurred in 2016, leading to a deceleration of economic growth and a deep fall in investment. A considerable difference between the two episodes is that the 2016 event lasted only about a year, and the subsequent continued influx of EU transfers had already

been secured. This time, though, the forthcoming episode will be less condensed in time, due to the forced allocation of EU co-financed resources in the first half of the seven-year planning period. The ‘lean years’ will be 2019, but mainly 2020 and 2021. Moreover, in this case, a revival of EU resources coinciding with the start of the new seven-year financing period of the EU in 2021 is far from assured. Less ample resources after Brexit, possible new spending priorities, dissatisfaction with Hungary’s (and other Visegrad countries’) compliance with EU policies regarding refugees, and last but not least, the issue of corruption may substantially reduce the available resources from the EU budget. That may mean no return to the comfortable expansion of aggregate demand with EU support.

Summarising our forecast, after relatively strong GDP growth in 2017 and 2018 (4.0% and 3.8%) driven by both strong expansion of investment and household consumption, economic growth is projected to lose momentum. As a consequence of substantially diminished cohesion policy resources from the EU budget and constraints on further strong expansion of household consumption, the pace of economic growth will decelerate to 2.6% in 2019 and 1.7% in 2020. The trade surplus will further shrink this year. The slowdown in economic growth will help curb a further deterioration in the trade balance; by 2020 net exports will again become a driver of expansion. Inflation will remain at around 3% over the forecast horizon, with the risk of upward movement. The general government budget deficit will be kept below the 3% Maastricht threshold, and public debt is expected to decrease marginally.

Table 17 / Hungary: Selected economic indicators

	2013	2014	2015	2016	2017 [1]	2018	2019	2020
							Forecast	
Population, th pers., average	9,893	9,866	9,843	9,814	9,780	9,750	9,720	9,700
Gross domestic product, HUF bn, nom.	30,247	32,592	34,324	35,420	37,900	40,700	43,100	45,200
annual change in % (real)	2.1	4.2	3.4	2.2	4.0	3.8	2.6	1.7
GDP/capita (EUR at PPP)	18,000	18,800	19,800	19,700	20,600	.	.	.
Consumption of households, HUF bn, nom.	15,311	15,874	16,377	17,020	18,250	.	.	.
annual change in % (real)	0.2	2.8	3.6	4.2	4.2	4.2	3.0	2.0
Gross fixed capital form., HUF bn, nom.	6,308	7,223	7,525	6,812	8,445	.	.	.
annual change in % (real)	9.8	12.3	1.9	-10.6	20.5	9.0	5.0	0.0
Gross industrial production								
annual change in % (real)	1.1	7.7	7.4	1.0	4.8	5.0	4.0	4.0
Gross agricultural production								
annual change in % (real)	12.5	11.4	-2.4	9.3	-6.1	.	.	.
Construction industry								
annual change in % (real)	8.4	13.5	3.0	-18.8	29.5	.	.	.
Employed persons, LFS, th, average	3,893	4,101	4,211	4,352	4,421	4,440	4,440	4,440
annual change in %	1.7	5.3	2.7	3.4	1.6	0.5	0.0	0.0
Unemployed persons, LFS, th, average	441	343	308	235	192	190	190	190
Unemployment rate, LFS, in %, average	10.2	7.7	6.8	5.1	4.2	4.1	4.1	4.1
Reg. unemployment rate, in %, eop	9.3	8.9	7.6	6.1	5.6	.	.	.
Average monthly gross wages, HUF [2]	230,714	237,695	247,924	263,171	290,300	319,300	338,400	358,700
annual change in % (real, gross)	1.7	3.2	4.4	5.7	7.6	7.0	3.0	3.0
Average monthly net wages, HUF [2]	151,118	155,690	162,391	175,009	197,700	219,500	232,600	246,500
annual change in % (real, net)	3.1	3.2	4.4	7.4	10.2	8.0	3.0	3.0
Consumer prices (HICP), % p.a.	1.7	0.0	0.1	0.4	2.4	2.8	2.9	2.9
Producer prices in industry, % p.a.	0.6	-0.4	-0.9	-1.7	3.3	2.0	1.0	1.0
General governm.budget, EU-def., % of GDP								
Revenues	46.6	46.8	48.2	44.8	48.3	47.5	47.7	47.7
Expenditures	49.3	49.5	50.2	46.7	50.4	50.4	50.4	50.4
Net lending (+) / net borrowing (-)	-2.6	-2.7	-2.0	-1.9	-2.1	-2.9	-2.7	-2.7
General gov.gross debt, EU def., % of GDP [3]	76.0	75.2	74.7	73.9	72.9	73.2	72.4	71.9
Stock of loans of non-fin.private sector, % p.a.	-4.4	-0.3	-12.3	-1.3	5.4	.	.	.
Non-performing loans (NPL), in %, eop	17.7	16.7	13.5	8.9	6.0	.	.	.
Central bank policy rate, % p.a., eop [4]	3.00	2.10	1.35	0.90	0.90	1.00	1.50	2.00
Current account, EUR mn [5]	3,892	1,587	3,838	6,967	4,637	4,100	3,500	3,800
Current account, % of GDP [5]	3.8	1.5	3.5	6.1	3.8	3.2	2.6	2.7
Exports of goods, BOP, EUR mn [5]	70,243	73,826	79,638	80,188	88,203	94,800	100,500	105,500
annual change in %	0.4	5.1	7.9	0.7	10.0	7.5	6.0	5.0
Imports of goods, BOP, EUR mn [5]	66,912	71,701	75,236	75,482	85,284	93,000	99,500	104,500
annual change in %	-0.2	7.2	4.9	0.3	13.0	9.0	7.0	5.0
Exports of services, BOP, EUR mn [5]	16,993	18,727	20,289	21,659	22,367	24,000	25,400	26,700
annual change in %	5.8	10.2	8.3	6.8	3.3	7.5	6.0	5.0
Imports of services, BOP, EUR mn [5]	13,232	14,120	14,885	14,892	15,714	17,100	18,300	19,200
annual change in %	7.9	6.7	5.4	0.0	5.5	9.0	7.0	5.0
FDI liabilities, EUR mn [5]	4,986	7,134	6,667	-7,140	5,430	.	.	.
FDI assets, EUR mn [5]	3,848	4,186	5,574	-9,052	3,299	.	.	.
Gross reserves of NB excl. gold, EUR mn	33,696	34,481	30,226	24,384	23,261	.	.	.
Gross external debt, EUR mn [5]	119,963	121,129	118,613	109,411	109,000	107,000	105,000	101,000
Gross external debt, % of GDP [5]	117.7	114.7	107.1	96.2	88.9	82.3	77.2	71.3
Average exchange rate HUF/EUR	296.87	308.71	310.00	311.44	309.19	313	317	319

1) Preliminary and wiiw estimates. - 2) Enterprises with 5 and more employees. - 3) Data until 2017 exclude debt of Eximbank, from 2018 including debt of Eximbank. - 4) Base rate (two-week NB bill). - 5) Excluding SPE.

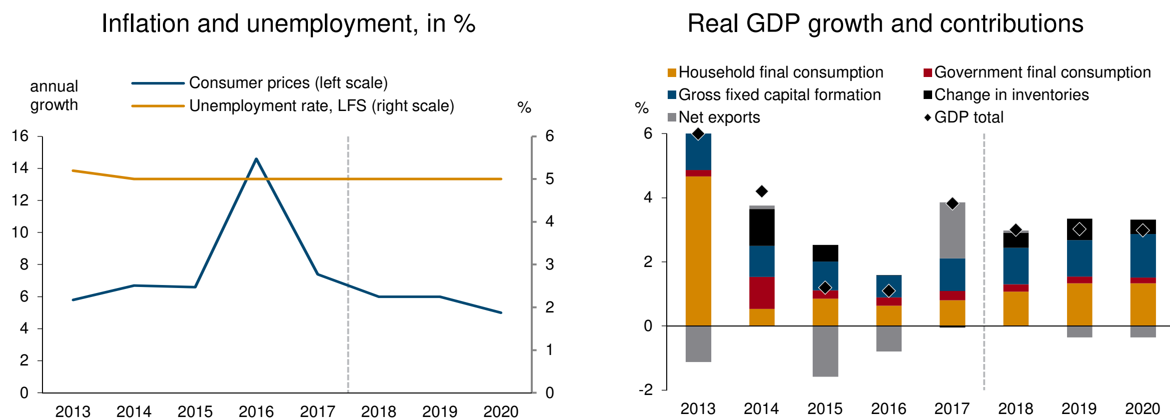
Source: wiiw Databases incorporating Eurostat and national statistics. Forecasts by wiiw.

KAZAKHSTAN: Oil sector growth benefits few

OLGA PINDYUK

The Kazakh economy has been expanding mainly on the back of the oil sector. Lack of economic diversification will limit the scale of GDP growth to about 3% per annum during 2018-2020. Households have not benefited from economic growth, as their incomes have dropped in real terms. The banking sector remains a bottleneck to economic diversification.

Figure 48 / Kazakhstan: Main macroeconomic indicators



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

Oil sector performance was key to the economic recovery in 2017. According to our estimates, real GDP growth in Kazakhstan reached 3.8% last year on the back of a surge in global oil prices and increased production from the recently launched Kashagan oil field. Industrial production increased last year by 7.1% (in real terms), the biggest growth since 2010. Merchandise exports were up by about 30% (in USD terms) – positive dynamics recorded for the first time since 2012.

Reliance on the oil sector will constrain growth in the near future. We forecast that annual GDP growth will be around 3% throughout 2018-2020, as it is assumed that global oil prices will rise only slightly over the next three years. In addition, Kazakhstan gave a commitment to OPEC to cut its oil production by about 1% in 2018. It is quite likely that the country will not fulfil this commitment, as was the case in 2017; but still any increase in output can only be moderate.

External conditions will remain favourable for Kazakhstan as an oil exporter. We expect that exports will continue to grow during 2018-2020, albeit not so spectacularly as in 2017. Imports will also increase, primarily on the back of investment demand. As a result, the current account balance will remain in deficit during the forecast period. The deficit will be low (in the range of 2-3% of GDP), which will not create significant depreciation pressures. This, together with slow household income growth, will help keep inflation relatively moderate by the region's standards – at about 5-6%.

Households have not felt the benefits of economic growth, as real household income continued to decline in 2017 – for the third year in a row – as did real wages. Real wages rose only in agriculture and some service sectors; meanwhile, in the mining sector real wages kept falling, regardless of a robust output performance. There are occasional signs of social tension when strikes break out, as was the case in December 2017, when coalminers' strikes spread across the country. The strikes were called off soon after a court ruled them illegal – a typical outcome of protest actions, which the Kazakh government is usually quick to suppress. However, accumulating social tensions may pose a risk for the future.

Still, private consumption was on the rise in 2017, increasing by 1.5% year on year according to our estimates. It appears that consumption growth is being financed primarily through credit. Our calculations show that in 2017, loans for personal consumption were 49% higher than in the previous year and their value was equivalent to about 10% of private consumption that year. In 2018-2020, private consumption is expected to experience rather sluggish growth of 2-2.5% per annum, as the government appears to prioritise fiscal consolidation and investment promotion over social policies. Such a rapid growth in consumer loans poses the risk of a bubble.

Investment has been growing more dynamically than private consumption – gross fixed capital formation is estimated to have increased by about 4% in 2017. Such a situation will likely persist during the forecast period, when gross fixed capital formation is expected to grow by 5-6% per annum. Investment will be directed mainly into the oil extraction sector (which will continue to attract the bulk of FDI for oil fields development), and into construction and infrastructure projects that are funded by the fiscal programme 'Nurly Zhol' and joint investment projects.

Pursuit of economic diversification has so far been unsuccessful. The economy's dependence on oil remains strong, exposing the country to volatility in terms of trade and fiscal revenues. Slow restructuring of the banking sector remains one of the major impediments to diversification. According to the estimates by Standard & Poor's, the share of problem loans in Kazakh banks stands at 35-45%.[64] This prevents them from being able to expand credit significantly. In 2017, the total stock of loans stagnated at the level of the previous year, while the stock of loans to corporate clients decreased by 6%, which indicates that companies (especially outside the oil sector) have difficulty in finding sources of financing for their investment projects.

[64] The official statistics published by the National Bank of Kazakhstan significantly underestimates the share of non-performing loans (10% in November 2017), as many problem loans are either incorrectly classified, or are hidden off balance sheets.

Other obstacles to diversification include systemic corruption and autocratic decision-making, which means increased policy unpredictability. These challenges are not likely to be solved in the short run. President Nazarbayev is expected to serve his full term to 2020; it is not yet clear how the transition of power will be implemented afterwards.

Government efforts to restructure the banking sector have not been adequate. In the second half of 2017, the government allocated the equivalent of around 4% of GDP to the distressed assets fund, so that the fund could purchase non-performing loans from Kazkommertsbank. Additionally, about 1% of GDP was provided to five banks in the form of subordinated debt. Government intends to introduce a law on bankruptcy of individuals and to strengthen the oversight of banks. However, additional measures would be needed to cleanse banks' balance sheets and release them from limbo.

In 2018-2020, the Kazakh economy will sustain a modest growth trend of about 3% per annum. As the oil sector will remain crucial to the GDP dynamics, a slow increase in global oil prices and limitations on the supply side will be the main constraints on growth. Consumer demand will pick up only slightly during this period, and will continue to lag behind investment. A major risk to the forecast is a significant drop in global oil prices, which will threaten both growth prospects and macro-financial stability.

Table 18 / Kazakhstan: Selected economic indicators

	2013	2014	2015	2016	2017 [1]	2018	2019	2020
							Forecast	
Population, th pers., average	17,035	17,289	17,544	17,794	18,038	18,350	18,600	18,970
Gross domestic product, KZT bn, nom.	35,999	39,676	40,884	46,971	53,200	58,100	62,900	68,100
annual change in % (real)	6.0	4.2	1.2	1.1	3.8	3.0	3.0	3.0
GDP/capita (EUR at PPP)	17,500	18,300	19,000	18,600	19,200	.	.	.
Consumption of households, KZT bn, nom.	17,617	18,806	21,492	25,087	27,400	.	.	.
annual change in % (real)	10.6	1.1	1.8	1.2	1.5	2.0	2.5	2.5
Gross fixed capital form., KZT bn, nom.	7,877	8,552	9,355	10,671	12,900	.	.	.
annual change in % (real)	5.5	4.4	4.2	3.0	4.5	5.0	5.0	6.0
Gross industrial production								
annual change in % (real)	2.5	0.3	-1.6	-1.1	7.1	4.0	4.0	5.0
Gross agricultural production								
annual change in % (real)	9.7	1.0	3.4	5.4	2.9	.	.	.
Construction industry								
annual change in % (real)	3.5	4.6	5.8	7.4	1.9	.	.	.
Employed persons, LFS, th, average	8,571	8,510	8,624	8,553	8,600	8,640	8,680	8,720
annual change in %	0.7	-0.7	1.3	-0.8	0.5	0.5	0.5	0.5
Unemployed persons, LFS, th, average	471	452	451	446	450	450	460	460
Unemployment rate, LFS, in %, average	5.2	5.0	5.0	5.0	5.0	5.0	5.0	5.0
Reg. unemployment rate, in %, eop	0.3	0.4	0.4	0.4	0.8	.	.	.
Average monthly gross wages, KZT [2]	109,141	121,021	126,021	142,898	150,200	160,800	173,900	188,100
annual change in % (real, gross)	1.9	3.9	-2.3	-1.1	-2.1	1.0	2.0	3.0
Consumer prices (HICP), % p.a.	5.8	6.7	6.6	14.6	7.4	6.0	6.0	5.0
Producer prices in industry, % p.a.	-0.3	9.5	-20.5	16.8	15.3	9.0	5.0	4.0
General governm.budget, nat.def., % of GDP								
Revenues	17.7	18.5	18.7	19.8	21.7	19.5	19.0	19.0
Expenditures	19.7	21.2	20.9	21.4	24.5	21.0	20.2	20.0
Deficit (-) / surplus (+)	-1.9	-2.7	-2.2	-1.6	-2.7	-1.5	-1.2	-1.0
General gov.gross debt, nat.def., % of GDP	12.6	14.6	22.7	25.0	26.3	23.0	23.0	23.0
Stock of loans of non-fin.private sector, % p.a.	13.4	7.2	4.7	0.3	0.0	.	.	.
Non-performing loans (NPL), in %, eop	31.2	23.5	8.0	6.7	9.3	.	.	.
Central bank policy rate, % p.a., eop [3]	5.50	5.50	16.00	12.00	10.25	9.25	8.75	8.00
Current account, EUR mn [4]	894	4,621	-4,632	-8,066	-4,135	-2,600	-3,400	-4,200
Current account in % of GDP [4]	0.5	2.8	-2.8	-6.5	-2.9	-1.8	-2.2	-2.6
Exports of goods, BOP, EUR mn [4]	64,435	60,440	41,961	33,673	43,593	45,600	47,400	49,300
annual change in %	-4.7	-6.2	-30.6	-19.8	29.5	4.6	3.9	4.0
Imports of goods, BOP, EUR mn [4]	38,244	33,162	30,530	25,366	28,109	28,300	30,600	33,000
annual change in %	0.8	-13.3	-7.9	-16.9	10.8	0.7	8.1	7.8
Exports of services, BOP, EUR mn [4]	3,988	4,981	5,842	5,699	5,692	5,500	5,700	5,900
annual change in %	6.2	24.9	17.3	-2.4	-0.1	-3.4	3.6	3.5
Imports of services, BOP, EUR mn [4]	9,379	9,721	10,448	9,997	9,589	9,300	9,600	9,900
annual change in %	-5.5	3.6	7.5	-4.3	-4.1	-3.0	3.2	3.1
FDI liabilities, EUR mn [4]	7,536	5,437	5,568	15,340	3,703	.	.	.
FDI assets, EUR mn [4]	1,488	1,982	2,990	3,130	607	.	.	.
Gross reserves of NB excl. gold, EUR mn [4]	13,940	17,920	18,555	19,191	15,227	.	.	.
Gross external debt, EUR mn [4]	109,137	129,438	140,232	156,368	150,500	143,100	144,500	146,000
Gross external debt, % of GDP [4]	61.3	77.7	84.3	126.0	104.2	97.5	93.7	90.0
Average exchange rate KZT/EUR	202.09	238.10	245.80	378.63	368.32	396	408	420

1) Preliminary and wiiw estimates. - 2) Excluding small enterprises, engaged in entrepreneurial activity. - 3) From 2015 one day (overnight) repo rate, refinancing rate of NB before. - 4) Converted from USD.

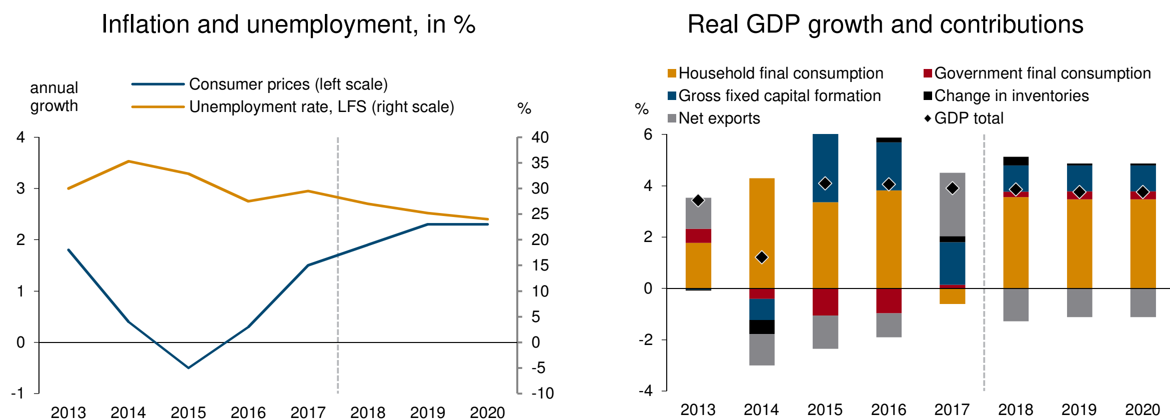
Source: wiiw Databases incorporating national statistics. Forecasts by wiiw.

KOSOVO: Growth at healthy levels, helped by boom in Western Europe

RICHARD GRIEVESON

The economy is growing strongly, reflecting a boom in key sources of remittances and export demand. With growth showing no signs of slowing in Western Europe, this is likely to remain the case this year. Meanwhile stronger employment growth should help to lift private consumption. Real GDP growth is likely to average around 4% per year over the forecast period, although a major new energy investment could lift this higher.

Figure 49 / Kosovo: Main macroeconomic indicators



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

The economy is estimated to have grown by around 4% in 2017, a strong rate in the regional context, and Kosovo is likely to remain an outperformer compared with neighbouring countries during the forecast period. Growth in 2017 was driven chiefly by a combination of exports and investment. External factors were strongly supportive, not least the boom in the EU and Switzerland, which drove an uptick in demand for exports and remittances inflows. Nominal euro-denominated remittances rose by an average 10% year on year in the first three quarters of 2017. On the same basis, merchandise exports rose by 22% last year as a whole.

Kosovo remains a relatively closed economy, but the external sector is growing quickly as a share of GDP, and positive external conditions are feeding through to stronger domestic activity. After rising by a subdued 1.5% year on year in Q1, real GDP growth picked up to 5.2% in Q2 and 4.9% in Q3. External factors were the dominant driver; net exports contributed an average 4.2 percentage

points to real year-on-year headline growth of 3.9% in the first three quarters of last year. A further 2.1 percentage points came from gross capital formation, helping to offset a sharp decline in household consumption (which fell by an average 3.1% year on year over the period, in part owing to very high base effects).

The near-term outlook for the economy is strong, with high-frequency indicators suggesting that the boom-like conditions in key Western European markets will continue this year. Remittance inflows from key sources, notably Germany and Switzerland, are likely to continue growing strongly, reflecting the tightness of labour markets in those two countries. We expect a headline real GDP growth rate of around 4% this year and during the rest of the forecast period, driven primarily by private consumption, as real wages and employment continue to rise. However, investment will also make positive contributions.

Booming exports have helped to drive up employment growth, and further positive momentum is likely during the forecast period. Total employment rose by an average 10% year on year in the first three quarters of 2017. However, the labour force rose by 15% over the same period, leading to an increase in the unemployment rate. Joblessness reached 30.2% in Q3 2017, up 2.7 percentage points year on year. Kosovo continues to face very low levels of labour force participation by European standards, which act as a significant constraint on the country's growth potential.

Major slack in the labour market and weak inflation in the rest of Europe will keep price growth relatively subdued during the forecast period. The headline harmonised index of consumer prices (HICP) rose by just 0.5% year on year in Kosovo in December 2017, its lowest level for well over a year, and despite further increases in global energy prices over the period. Inflation may rise in the near term, reflecting elevated oil prices. Beyond that, we expect inflation to strengthen moderately during the forecast period, mirroring trends across Europe, but at a forecast average 2.2% per year in 2018-20, price growth will remain at low levels in the historical context.

A major investment in a 500-megawatt coal-fired power plant announced in December could provide an important boost to growth over the forecast period. The deal is reported to be worth EUR 1.3 billion, equivalent to around one fifth of Kosovo's 2016 GDP, and will be financed by US firm ContourGlobal. Construction is set to begin either late this year or early in 2019, and the plant is expected to be completed in 2023. Kosovo has 14 billion tonnes of proven lignite reserves, the fifth largest in the world, and a large share of domestic energy comes from coal power stations. The project is expected to create 10,000 new jobs during construction, and some estimates have suggested that it could lift the rate of real GDP growth by 1-2 percentage points per year. However, with the timing of construction remaining uncertain, and EU rules on environmental standards set to be a roadblock, the investment is not yet built into our baseline forecasts.

Despite narrowing significantly in 2017, the current account deficit should widen during the forecast period, owing to rising domestic demand and slower export growth. The external deficit narrowed considerably last year, to an estimated 5.6% of GDP, from 9% in 2016. This reflected booming goods and services exports, and higher surpluses on the primary and secondary income accounts (the latter indicating a sharp uptick in remittance inflows). These developments more than offset the increase in energy import costs. Data for January-November show that the current account deficit narrowed to EUR 265 million, representing a decrease of more than a third compared with the same period of the

previous year. Net FDI inflows rose to EUR 241 million over the same period, and thereby covering the majority of the current account deficit. During the forecast period we expect the current account deficit to average 6% of GDP. This will continue to be financed by a combination of net FDI inflows and concessional lending, mitigating stability risks.

The recent elections produced a broad coalition with a tiny majority and facing major political challenges, which will make significant political reform difficult. A new administration formed under the premiership of Ramush Haradinaj in September 2017 is made up of 12 parties, and commands only 61 deputies in the 120-seat parliament. The new government's early months have been difficult, including a spat with the US and other important international partners over a desire to withdraw from an international criminal court investigating alleged war crimes, and the assassination of a key ethnic Serb politician in the North of the country. More broadly, the government will face political challenges that its predecessor struggled with, including a resolution on border demarcation with Montenegro and a solution to the status of ethnic Serbs living in Kosovo.

Political noise could distract the government from bigger economic challenges facing the country over the medium term. These include the gaping trade deficit, issues in the education system and low levels of labour productivity. Addressing these issues will be required to lift Kosovo's growth rate above 4%, and thereby speed up its convergence with wealthier countries in the region.

Table 19 / Kosovo: Selected economic indicators

	2013	2014	2015	2016	2017 [1]	2018	2019	2020
							Forecast	
Population, th pers., average	1,818	1,813	1,788	1,778	1,784	1,777	1,770	1,763
Gross domestic product, EUR mn, nom.	5,327	5,568	5,807	6,070	6,400	6,800	7,200	7,600
annual change in % (real)	3.4	1.2	4.1	4.1	3.9	3.9	3.8	3.8
GDP/capita (EUR at PPP)	6500	6700	7400	7700	8000	.	.	.
Consumption of households, EUR mn, nom.	4,652	4,926	5,045	5,268	7,902	.	.	.
annual change in % (real)	2.0	4.9	3.8	4.4	-0.7	4.1	4.0	4.0
Gross fixed capital form., EUR mn, nom.	1,323	1,294	1,499	1,550	2,326	.	.	.
annual change in % (real)	-0.2	-3.3	12.1	7.3	6.5	4.0	4.0	4.0
Gross industrial production [2]								
annual change in % (real)	6.5	-1.3	4.8	2.8	4.0	3.6	3.5	3.2
Gross agricultural production [2]								
annual change in % (real)	1.4	0.8	-4.1	3.1	3.0	.	.	.
Construction output [2]								
annual change in % (real)	2.6	-6.1	15.8	4.5	4.0	.	.	.
Employed persons, LFS, th, average [3]	338.4	323.5	296.9	331.8	370.0	390	400	410
annual change in %	11.7	-4.4	-8.2	11.7	11.5	4.3	3.1	3.0
Unemployed persons, LFS, th, average [3]	144.8	176.7	145.8	126.1	160.0	140	130	130
Unemployment rate, LFS, in %, average [3]	30.0	35.3	32.9	27.5	30.2	27.0	25.2	24.0
Reg. unemployment rate, in %, eop	.	.	.	.	.	.	.	.
Average monthly net wages, EUR	393	430	451	457	450	470	490	510
annual change in % (real, net)	0.5	9.0	5.4	1.0	-3.0	1.5	1.5	1.5
Consumer prices, % p.a.	1.8	0.4	-0.5	0.3	1.5	1.9	2.3	2.3
Producer prices, % p.a.	2.3	1.6	2.7	-0.1	4.3	3.5	2.5	2.5
General governm.budget, nat.def., % of GDP								
Revenues	25.5	24.2	29.4	29.3	29.4	29.8	30.0	30.2
Expenditures	28.0	27.2	27.8	29.1	29.5	30.5	30.8	31.0
Deficit (-) / surplus (+)	-2.5	-2.9	1.6	0.2	-0.1	-0.7	-0.8	-0.8
General gov.gross debt, nat.def., % of GDP	8.9	10.5	12.9	14.0	16.0	16.7	18.0	19.0
Stock of loans of non-fin.private sector, % p.a.	2.6	6.2	7.2	10.5	9.7	.	.	.
Non-performing loans (NPL), in %, eop	8.7	8.3	6.2	4.9	3.9	.	.	.
Central bank policy rate, % p.a., eop [4]	10.90	9.29	7.69	7.22	6.72	7.00	7.30	7.50
Current account, EUR mn	-179	-385	-497	-549	-360	-396	-434	-475
Current account, % of GDP	-3.4	-6.9	-8.6	-9.0	-5.6	-5.8	-6.0	-6.2
Exports of goods, BOP, EUR mn	291	324	322	308	370	396	424	453
annual change in %	3.4	11.3	-0.6	-4.5	20.2	7.0	7.0	7.0
Imports of goods, BOP, EUR mn	2,287	2,383	2,432	2,599	2,835	2,977	3,126	3,282
annual change in %	-1.9	4.2	2.1	6.9	9.1	5.0	5.0	5.0
Exports of services, BOP, EUR mn	875	929	952	1,038	1,300	1,369	1,441	1,518
annual change in %	-2.2	6.1	2.5	9.1	25.2	5.3	5.3	5.3
Imports of services, BOP, EUR mn	355	469	494	473	495	523	553	585
annual change in %	-10.1	32.0	5.5	-4.3	4.6	5.7	5.7	5.7
FDI liabilities, EUR mn	280	151	309	216	450	.	.	.
FDI assets, EUR mn	30	27	37	40	40	.	.	.
Gross reserves of NB excl. gold, EUR mn	694	645	734	830	850	.	.	.
Gross external debt, EUR mn	1,608	1,737	1,932	2,045	2,080	2,300	2,500	2,700
Gross external debt, % of GDP	30.2	31.2	33.3	33.7	32.5	34.0	35.2	35.7

1) Preliminary and wiiw estimates. - 2) According to gross value added (manufacturing industry for industrial production). - 3) Population 15-64. - 4) Average weighted effective lending interest rate of commercial banks (Kosovo uses the euro as national currency).

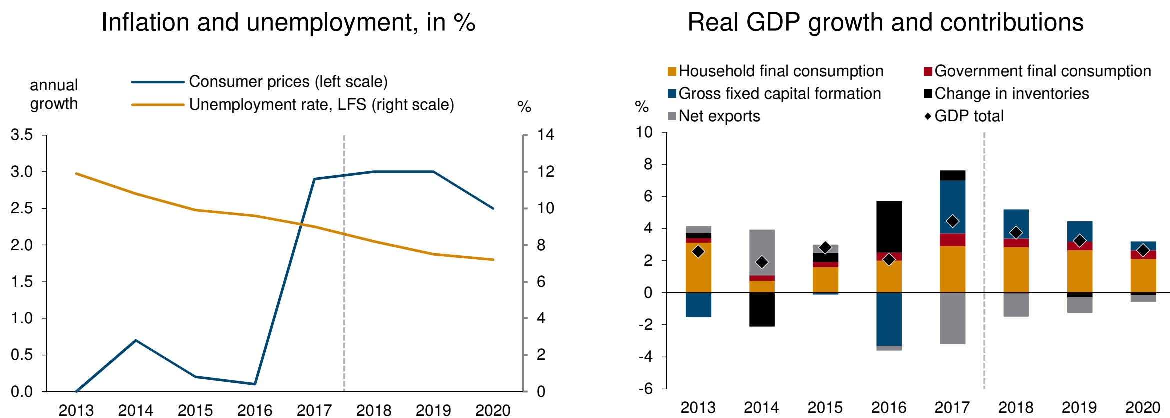
Source: wiiw Databases incorporating national statistics. Forecasts by wiiw.

LATVIA: Riding high on the investment cycle

SEBASTIAN LEITNER

Following a remarkable 2017, when GDP growth attained 4.5%, Latvia's economy will keep prospering at its potential in both 2018 and 2019. Public spending is continuing to expand rapidly, driven by the inflow of EU funds, while enterprises will also increase their investments. Growth in exports will remain lively. Household consumption is developing rapidly, and this will continue in the coming years, thanks to rising minimum wages and the 2018 income tax reform. In both 2018 and 2019, we expect continuously robust GDP growth of 3.8% and 3.3%, followed by a slight slowdown to 2.7% in 2020.

Figure 50 / Latvia: Main macroeconomic indicators



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

Gross fixed capital investment will continue to grow strongly in 2018. In 2017, fresh EU funds started to become available on a larger scale, thus allowing public investment in infrastructure to grow. However, the recent EBRD Transition report highlights the need for the Latvian government to raise the quality of project applications, in order to boost the absorption of EU funds. In the private sector, capital expenditure is expected to broaden in 2018, as capacity utilisation has reached relatively high levels in industry. In 2017, growth in enterprise investment was limited to the transport and trade sectors. Almost 40% of the increase in enterprise investment stemmed from the Latvian carrier airBaltic's replacement of part of its fleet. The airline was nationalised in the course of the economic crisis in 2011, but last year the government announced its re-privatisation; so far it has failed to find strategic investors, and given the high competition among low-cost carriers, the authorities will most probably be stuck with their 80%

share for some time to come. Private residential construction remained sluggish in 2017. The upward trend in the number of building permits, for residential and non-residential buildings alike, means that the prospects for the sector look rosier in 2018. Overall, we forecast total gross fixed investment to increase somewhat more slowly than in 2017, but still strongly – by another 10% in real terms in 2018 and 7% in 2019.

Following a year of stagnation, Latvian goods exports grew strongly in 2017 and will continue to do so throughout 2018. In 2017, exports to the CIS countries even increased by 25% in nominal year-on-year terms. But trade with Western Europe, the Scandinavian countries and the rest of the world also gradually gained momentum. Wood and food producers report an upswing in export growth figures, but the strongest increases are observed in the re-exporting wholesale sector. In general, we expect growth in both goods and services exports to slow slightly, but still to remain lively in 2018. With capital investment and household consumption increasing strongly, imports are expected to pick up again, and the goods trade balance is likely to turn more negative.

As expected, the rising level of prices for imported goods in 2017, compared to the previous year, resulted in an increase in consumer inflation to 2.9% p.a. Strong wage growth has started to raise core inflation. As the effect of increasing energy prices abates, we expect consumer inflation to remain at the level of about 3% this year and in 2019.

Still ample capacity in the construction sector led to a decline in employment in 2017 there, while job growth has been recorded in the service sectors. Overall employment will remain stagnant in the coming two years. In the medium term, demographic developments – including continuing net emigration – will result in a further decline in the working-age population and also in employment. Giving the mounting demand for skilled employees, the Latvian government may reverse its restrictive stance on labour immigration. Employment rates are gradually increasing to the levels of the Scandinavian countries. Towards the end of 2017, the unemployment rate dipped below 9%. Up to the end of the forecast period in 2020, we expect it to decline gradually to about 7%.

Gross real wages will continue to rise, by another 4.5% in 2018 and about 3.5% in 2019. Inspired by the forthcoming parliamentary elections in October of this year, the government approved a substantial increase in the minimum wage, from EUR 380 to EUR 430 in January 2018. Thus, we expect household consumption to increase by about 4.5% in real terms this year and next, and by 3.5% in 2020.

As from January 2018, Latvia introduced a progressive component to its personal income tax scheme, having pursued a flat tax system for more than 20 years. The government reduced the rate of tax on annual income of below EUR 20,000 to 20%, kept it at 23% for higher earnings, and increased it to 31.4% for income above EUR 55,000. European Commission (EC) analysis has concluded that the government's stated aim of the reform, i.e. to reduce income inequality, will not be met. The bulk of the tax relief is received by middle and higher-income households, while the high tax wedge of low-income earners has not been reduced sufficiently. Moreover, among other measures, the tax reform includes the abolition of taxation on retained profits for enterprises, which is likely to reduce government revenues by 1% of GDP. The EC states that the reduction in the already low government revenue share in GDP will limit the financing of structural reforms, the redistributional function of the state and the additional resources required for the health and pension systems. The tax reform and election-biased expenditure

increases this year will result in a one-year increase in the budget deficit to 1% of GDP in 2018, followed by a decline to 0.5% in 2020.

Overall, broader-based economic activity is expected to grow at potential in both 2018 and 2019. External demand will continue to grow at a lively pace, not only in nominal but also in real terms. After a stronger than anticipated investment hike in 2017, we expect a continued – also election-induced – free-spending mood in 2018. Household demand is continuing to evolve at a remarkable pace, and will be underpinned by high wage increases and income tax reductions. Due to further lively import demand from the EU and domestic investment activity driven by the inflow of EU funds, we expect GDP growth to remain high – at 3.8% in 2018 and 3.3% in 2019 – before declining slightly to 2.7% in 2020.

Table 20 / Latvia: Selected economic indicators

	2013	2014	2015	2016	2017 1)	2018	2019	2020
							Forecast	
Population, th pers., average	2,013	1,994	1,978	1,960	1,950	1,930	1,920	1,915
Gross domestic product, EUR mn, nom.	22,832	23,682	24,353	24,927	26,900	28,600	30,400	32,000
annual change in % (real)	2.6	1.9	2.8	2.1	4.5	3.8	3.3	2.7
GDP/capita (EUR at PPP)	16,700	17,600	18,500	18,800	19,800	.	.	.
Consumption of households, EUR mn, nom.	13,780	14,178	14,393	15,040	16,300	.	.	.
annual change in % (real)	5.3	1.2	2.7	3.4	4.7	4.7	4.4	3.5
Gross fixed capital form., EUR mn, nom.	5,291	5,337	5,385	4,538	3,743	.	.	.
annual change in % (real)	-6.0	0.1	-0.5	-15.0	16.0	10.0	7.0	3.0
Gross industrial production 2)								
annual change in % (real)	-0.9	-1.0	3.6	5.4	8.4	7.0	5.0	4.0
Gross agricultural production								
annual change in % (real)	2.3	4.5	14.0	-7.3	-1.5	.	.	.
Construction industry								
annual change in % (real)	8.1	7.9	-1.2	-17.9	19.5	.	.	.
Employed persons, LFS, th, average	893.9	884.6	896.1	893.3	890.0	893	893	890
annual change in %	2.1	-1.0	1.3	-0.3	-0.4	0.3	0.0	-0.3
Unemployed persons, LFS, th, average	120.4	107.6	98.2	95.3	90.0	80	70	70
Unemployment rate, LFS, in %, average	11.9	10.8	9.9	9.6	9.0	8.2	7.5	7.2
Reg. unemployment rate, in %, eop 3)	9.5	8.5	8.7	8.4	6.8	.	.	.
Average monthly gross wages, EUR	715.7	765.0	818.0	859.0	930.0	1,000	1,070	1,130
annual change in % (real, gross)	4.6	6.2	6.7	3.8	4.5	4.5	3.5	3.0
Average monthly net wages, EUR	515.4	560.0	603.0	631.0	680.0	730	770	810
annual change in % (real, net)	5.6	8.0	7.4	4.3	3.8	3.8	3.0	2.8
Consumer prices (HICP), % p.a.	0.0	0.7	0.2	0.1	2.9	3.0	3.0	2.5
Producer prices in industry, % p.a.	1.6	0.4	-1.0	-3.0	2.2	2.5	2.0	2.0
General governm.budget, EU-def., % of GDP								
Revenues	36.7	37.0	37.2	37.4	37.0	36.0	35.7	35.6
Expenditures	37.7	38.2	38.4	37.3	37.8	37.0	36.4	36.1
Net lending (+) / net borrowing (-)	-1.0	-1.2	-1.2	0.0	-0.8	-1.0	-0.7	-0.5
General gov.gross debt, EU def., % of GDP	38.9	40.8	36.8	40.5	38.0	36.0	34.5	34.0
Stock of loans of non-fin.private sector, % p.a.	-7.0	-3.3	-2.8	0.1	-4.7	.	.	.
Non-performing loans (NPL), in %, eop	8.3	6.9	6.0	4.4	4.2	.	.	.
Central bank policy rate, % p.a., eop 4)	0.25	0.05	0.05	0.00	0.00	.	.	.
Current account, EUR mn	-621	-411	-116	342	-185	-411	-711	-821
Current account, % of GDP	-2.7	-1.7	-0.5	1.4	-0.7	-1.4	-2.3	-2.6
Exports of goods, BOP, EUR mn	9,810	10,242	10,336	10,391	11,349	12,100	12,700	13,300
annual change in %	1.7	4.4	0.9	0.5	9.2	6.6	5.0	4.7
Imports of goods, BOP, EUR mn	12,431	12,621	12,538	12,310	13,953	15,200	16,200	17,010
annual change in %	1.2	1.5	-0.7	-1.8	13.3	8.9	6.6	5.0
Exports of services, BOP, EUR mn	3,900	4,105	4,355	4,575	4,822	5,200	5,500	5,750
annual change in %	3.5	5.3	6.1	5.1	5.4	7.8	5.8	4.5
Imports of services, BOP, EUR mn	2,127	2,066	2,276	2,433	2,589	2,800	3,000	3,150
annual change in %	-0.8	-2.9	10.2	6.9	6.4	8.1	7.1	5.0
FDI liabilities, EUR mn	743	704	752	222	1,169	.	.	.
FDI assets, EUR mn	373	409	126	217	467	.	.	.
Gross reserves of NB excl. gold, EUR mn 5)	5,565	2,448	2,957	3,100	3,617	.	.	.
Gross external debt, EUR mn	30,501	34,035	34,921	37,079	37,660	37,800	39,500	40,000
Gross external debt, % of GDP	133.3	143.7	143.4	148.8	140.0	132.0	130.0	125.0
Average exchange rate EUR-LVL/EUR	0.9981	1.0000	1.0000	1.0000	1.0000	1	1	1

1) Preliminary and wiiw estimates. - 2) Enterprises with 20 and more employees. - 3) In % of labour force (LFS). - 4) From 2014 official refinancing operation rate for euro area (ECB), refinancing rate of National Bank before. - 5) From January 2014 (Euro introduction) only foreign currency reserves denominated in non-euro currencies.

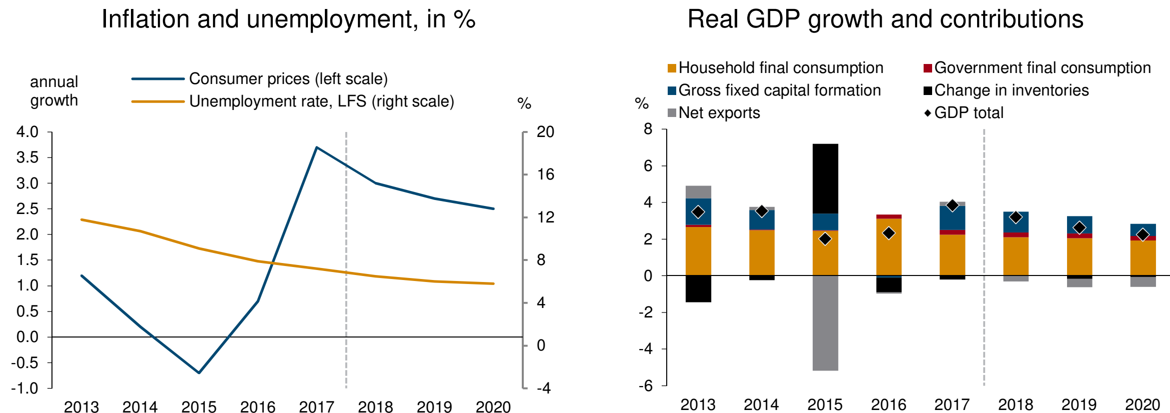
Source: wiiw Databases incorporating Eurostat and national statistics. Forecasts by wiiw.

LITHUANIA: EU funds foster growth at full potential

SEBASTIAN LEITNER

In 2018, economic growth in Lithuania will be driven by ongoing strong public investment, underpinned by fresh funds from the EU. The continued decline in unemployment and rapid wage growth mean steady, strong growth in household consumption. External demand activity, having seen a remarkable revival, particularly from the CIS last year, will remain buoyant in 2018. For 2018, we forecast GDP to grow by 3.2% at potential, followed by 2.6% in 2019 and 2.2% in 2020.

Figure 51 / Lithuania: Main macroeconomic indicators



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

After stagnation in goods exports in 2016, in 2017 Lithuanian exporters experienced a strong revival to all destinations. Exports to the CIS region increased by almost 30% nominally year on year. In 2018, the further upswing in trade to Russia, Lithuania's single most important trading partner, will be attenuated, given the expected slight slowdown in economic growth in the neighbouring country. External demand from the EU partners in general, and from the Baltic States in particular, will still be buoyant, driven by the ongoing upswing in the European investment cycle. In addition, services exports grew more strongly in 2017, and will continue to do so in the coming years, also thanks to lively transit trade to Russia. Tourism exports grew at a good pace in 2017, and quarterly figures show that an increase of about 10% in overnight stays is likely in 2018. Since household demand keeps on flourishing, and investment activity is undergoing a strong revival, imports in 2018 are expected to

increase even faster than exports. Nevertheless, we expect the current account deficit to remain at below 2% of GDP and to increase only gradually over the medium term.

Gross fixed capital investment revived by about 7% in 2017 in real terms year on year, and is likely to maintain that pace in 2018. The inflow of fresh EU funds from the 2014-2020 programming period allows the government to increase capital spending. Investment is particularly expected in energy, as well as in the road and railway infrastructure – an ongoing major EU-funded project is Rail Baltica, connecting the Baltics with the European rail network. By the end of 2017, Lithuania was the EU-CEE country that had used its structural funds fastest, having already spent 19% of the money assigned to it in the programming period 2014-2020. The construction of new dwellings and refurbishment co-financed by public sources started to increase swiftly in 2017, and the rising number of building permits indicates that the upswing will continue in 2018. In addition, the stock of mortgage loans granted to households is continuing to grow by about 8% annually.

Rising prices for imports, particularly oil and gas, resulted in consumer prices increasing more swiftly, by 3.7% in 2017. Apart from energy, the price of food also started to grow faster. In addition, inflation was fuelled by higher excise duties. The ongoing robust increase in wages is pushing up core inflation. In real terms, gross and net wages grew by almost 7% in 2017. In January 2018, the minimum wage was increased by 5% to EUR 400; thus we expect overall real wages to rise by another 5.5% this year. The economic stimulus in the rest of the EU and high investment activity will keep economic activity vibrant. However, since the effect of rising import prices and tax hikes will abate this year, we expect consumer inflation to decline to about 3% in both 2018 and 2019.

Employment is expected to remain stagnant in 2018, after a decline of 0.5% last year, although the employment rate is rising. Demographic developments are resulting in a steadily shrinking working-age population in Lithuania, although net outward migration is declining. However, in manufacturing and most service sectors, robust economic activity still resulted in an increase in jobs in 2017. In Lithuania, the employment rate among those aged 15-64 already climbed above 70% in the second quarter of last year, almost the level of Austria, and the unemployment rate dropped to close to 7% of the labour force in 2017.

The government plans to attain a budget surplus in 2018. Buoyant state revenues will allow the government to increase social spending more considerably this year. However, a large part of the rising government outlays will be devoted to defence spending, which will increase to 2% of GDP in 2018. The European Commission and the OECD have recently emphasised that not only is income inequality in Lithuania among the highest in the EU, but it has also been rising continuously since 2012. One of the reasons is that the tax wedge for low-income earners is much higher than the average of EU countries. Apart from that, the level of public expenditure is one of the lowest in the EU. Moreover, the Lithuanian welfare system cannot prevent its citizens from suffering poverty in the case of major life risks, like disability. The policy recommendation is thus to build up a proper welfare state that can offer its citizens a better standard of living, in order to reduce emigration.

Given the EU funds flowing into the country, public investment and private and government consumption are the most important drivers of growth for the Lithuanian economy in 2018. The favourable situation in the labour market and the resultant rising incomes will keep household consumption flourishing this year and thereafter. Following the peak of GDP growth of 3.9% in 2017, we

expect the economy to expand by another 3.2% in 2018. A slowdown in external demand activity and a flattening of the investment cycle are likely to result in an attenuation of GDP growth to 2.6% in 2019 and 2.2% in 2020. The general government finances will most probably remain in surplus over the whole forecast period. In the years to come, Lithuania will thus observe a steadily falling public debt to GDP ratio – down from the current 40% to about 35% in 2020.

Table 21 / Lithuania: Selected economic indicators

	2013	2014	2015	2016	2017 [1]	2018	2019	2020
							Forecast	
Population, th pers., average	2,958	2,932	2,905	2,868	2,830	2,800	2,780	2,760
Gross domestic product, EUR mn, nom.	34,960	36,568	37,427	38,668	41,700	44,200	46,600	48,800
annual change in % (real)	3.5	3.5	2.0	2.3	3.9	3.2	2.6	2.2
GDP/capita (EUR at PPP)	19,600	20,800	21,700	22,000	23,200	.	.	.
Consumption of households, EUR mn, nom.	21,792	22,686	23,375	24,771	26,700	.	.	.
annual change in % (real)	4.3	4.0	4.0	5.0	4.0	3.3	3.2	3.0
Gross fixed capital form., EUR mn, nom.	6,455	6,906	7,325	7,314	8,100	.	.	.
annual change in % (real)	8.3	5.8	4.8	-0.5	7.0	6.0	5.0	3.5
Gross industrial production (sales)								
annual change in % (real)	3.2	0.1	4.9	2.8	7.2	6.0	4.5	4.0
Gross agricultural production								
annual change in % (real)	-1.8	8.4	8.6	-1.7	-1.9	.	.	.
Construction industry								
annual change in % (real)	11.3	17.0	-3.5	-9.4	9.6	.	.	.
Employed persons, LFS, th, average	1,293	1,319	1,335	1,361	1,358	1,353	1,350	1,350
annual change in %	1.3	2.0	1.2	2.0	-0.2	-0.4	-0.2	0.0
Unemployed persons, LFS, th, average	173	158	134	116	105	94	86	83
Unemployment rate, LFS, in %, average	11.8	10.7	9.1	7.9	7.2	6.5	6.0	5.8
Reg. unemployment rate, in %, eop [2]	11.1	9.3	9.0	8.5	8.7	.	.	.
Average monthly gross wages, EUR [3]	646.3	677.4	714.1	774.0	850.0	920	990	1,070
annual change in % (real, gross)	4.0	4.7	6.4	7.4	6.5	5.5	5.0	5.0
Average monthly net wages, EUR [3]	501.1	527.2	553.9	602.3	670.0	730	790	850
annual change in % (real, net)	3.8	5.1	6.1	7.7	6.5	5.2	5.3	5.0
Consumer prices (HICP), % p.a.	1.2	0.2	-0.7	0.7	3.7	3.0	2.7	2.5
Producer prices in industry, % p.a.	-2.4	-4.9	-9.7	-4.3	4.9	3.5	3.5	3.5
General goverm.budget, EU-def., % of GDP								
Revenues	32.9	34.0	34.6	34.5	34.0	33.5	33.3	33.3
Expenditures	35.5	34.6	34.9	34.2	33.8	33.2	33.1	33.3
Net lending (+) / net borrowing (-)	-2.6	-0.6	-0.2	0.3	0.2	0.3	0.2	0.0
General gov.gross debt, EU def., % of GDP	38.8	40.5	42.6	40.1	41.0	38.0	36.0	34.0
Stock of loans of non-fin.private sector, % p.a.	-2.3	-0.9	4.1	7.1	4.5	.	.	.
Non-performing loans (NPL), in %, eop	11.0	6.5	5.5	3.8	3.2	.	.	.
Central bank policy rate, % p.a., eop [4]	0.27	0.12	0.05	0.00	0.00	.	.	.
Current account, EUR mn	292	1,158	-1,050	-433	385	-900	-1,100	-1,095
Current account, % of GDP	0.8	3.2	-2.8	-1.1	0.9	-2.0	-2.4	-2.2
Exports of goods, BOP, EUR mn	23,998	23,750	22,309	21,922	25,753	28,500	30,200	31,710
annual change in %	7.0	-1.0	-6.1	-1.7	17.5	10.7	6.0	5.0
Imports of goods, BOP, EUR mn	24,918	24,686	24,296	23,690	27,814	30,700	33,200	34,860
annual change in %	5.9	-0.9	-1.6	-2.5	17.4	10.4	8.1	5.0
Exports of services, BOP, EUR mn	5,390	5,850	6,011	6,845	8,273	9,100	9,700	10,185
annual change in %	12.5	8.5	2.7	13.9	20.9	10.0	6.6	5.0
Imports of services, BOP, EUR mn	4,033	4,212	4,266	4,599	5,376	6,100	6,600	6,930
annual change in %	18.5	4.4	1.3	7.8	16.9	13.5	8.2	5.0
FDI liabilities, EUR mn	531	387	873	870	1,065	.	.	.
FDI assets, EUR mn	322	382	164	732	352	.	.	.
Gross reserves of NB excl. gold, EUR mn [5]	5,705	6,991	1,376	2,263	3,509	.	.	.
Gross external debt, EUR mn	24,596	25,551	28,332	33,091	35,450	36,200	37,300	38,100
Gross external debt, % of GDP	70.4	69.9	75.7	85.6	85.0	82.0	80.0	78.0

1) Preliminary and wiiw estimates. - 2) In % of working age population. - 3) Including earnings of sole proprietors. - 4) From 2015 official refinancing operation rate for euro area (ECB), VILIBOR one-month interbank offered rate before (Lithuania had a currency board until Euro introduction). - 5) From January 2015 (Euro introduction) only foreign currency reserves denominated in non-euro currencies.

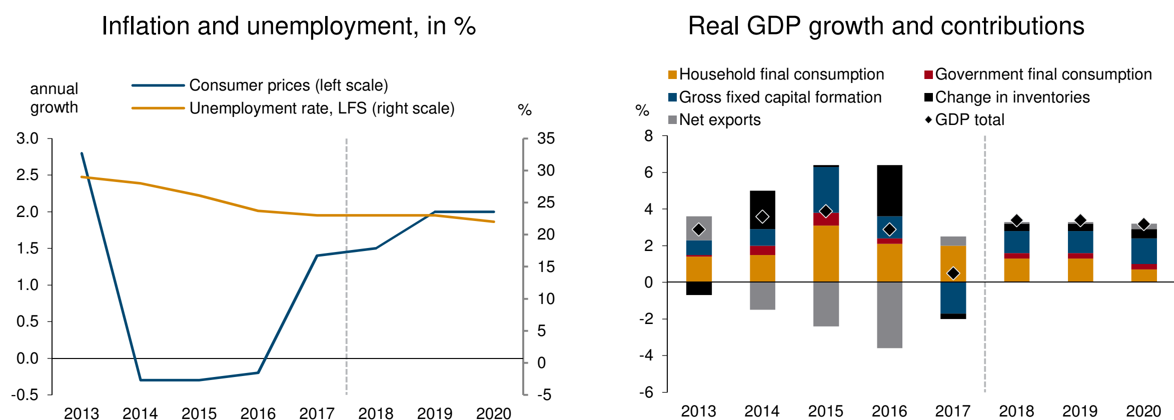
Source: wiiw Databases incorporating Eurostat and national statistics. Forecasts by wiiw.

MACEDONIA: Political crisis and recovery

VLADIMIR GLIGOROV

Recovery of growth to around 3% should lead to growth accelerating to 3.5% and even 4% in the medium term under more positive external developments. Investments and net exports should contribute. External shocks, primarily within the region, can have a strong influence and that can go either way, which is why the risks are more often than not on the downside. In that, the agreement with Greece on the 'name issue' is crucial.

Figure 52 / Macedonia: Main macroeconomic indicators



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

There was barely growth in 2017. The country was going through a prolonged political crisis after an inconclusive election. It took almost half a year of protests in the streets and clashes in the parliament for the opposition Macedonian party to form a coalition government. It took another quarter or more until the local elections for voters to decisively swing in favour of the new government and in particular towards the Social Democrats, the key party in the governing coalition. As a result, the first three quarters were lost to growth, with recovery starting in the last quarter of 2017.

During the political crisis, investments declined strongly, both public and private. Consumption held up and net exports contributed positively to growth of GDP, but that was barely enough to maintain the existing level of production. In the fourth quarter, from the data that are available, it appears that investments recovered rather strongly suggesting that recovery should be also expected in 2018. In addition, the new government has adopted a programme of continued support for public investments

and some support for employment and consumption, the latter by an increase in the minimum wage. And exports have continued to perform well even during the crisis year, so they too should support the recovery.

With political stability having such an important contribution to economic activity, the much improved support for the government after the local election should provide for the needed political framework in the medium term. The new government's programme is pro-growth and pro-employment as it intends to continue to support foreign investments but also local entrepreneurship and to shift public investments from government buildings and historical monuments to infrastructure and various types of support for exports and human capital accumulation. In the medium term, if employment continues to grow, which should be possible given the still very high unemployment rate of over 20%, and with productivity improving too due to investments in the tradable sector, potential growth of GDP should be close to 4%. Improving regional and EU economic prospects should prove helpful.

Internal political stability has improved markedly after the resolution of the political crisis. The new government has taken steps to implement some of the outstanding commitments under the Ohrid Agreement from 2001, which ended the violent internal ethnic conflict. The intention of the government is to improve inter-ethnic political equality e.g. in the right to use the Albanian language more extensively and equally with the Macedonian one. In general, democratisation has proved supportive of continued improvement in inter-ethnic relations. This should also improve the rule of law, one of the key priorities of the new government. Finally, that should provide the basis for the decline of corruption, which was one of the main reasons for the dissatisfaction with the previous government and led to the political change.

External stability is as important as the internal one given the unresolved issues with the neighbours. The new government has initiated improved relations with all its neighbours. It signed an agreement of good neighbourly relations with Bulgaria and has reassured the Serbian government, which was suspicious of its intentions initially. Most important is the willingness to settle the so-called name issue with Greece. The aim is to unlock the process of EU integration, which is premised on the solution to the disagreements with Greece. The Macedonian government would like to have an agreement with Greece until June of this year to become eligible for membership in NATO and to start negotiations with the EU.

Stability has been the key goal of economic policy for more than two decades now. Monetary and fiscal policies have been geared towards the stability of the exchange rate with the interest rate and thus investments and ultimately growth being dependent on the perceived risks to political and economic stability. That has meant, more often than not, that growth has been lower than it could have been under a different policy regime. The policy framework will not be changed, as the economy has adjusted to the exchange rate fix and to monetary dominance over fiscal policy, thus the importance of improved internal and external stability. In that, regional stability is important, but Macedonia can do little to improve it beyond working for the normalisation of its relations with its neighbours. Even that is conditional on EU integration and integration in the collective security agreement that is NATO. This should be possible as the country has no open issues with any of the big powers or with any of the EU countries except for Greece.

That is why the agreement in the name issue with Greece is so crucial. If an agreement is reached, prospects for the medium term and even beyond should be positive. Initially, recovery of growth to around 3% should lead to growth accelerating to 3.5% and even 4% under more positive external developments. External shocks, primarily within the region, can have a strong influence and that can go either way, which is why the risks are more often than not on the downside.

Table 22 / Macedonia: Selected economic indicators

	2013	2014	2015	2016	2017 [1]	2018	2019 Forecast	2020
Population, th pers., mid-year	2,064	2,067	2,070	2,072	2,090	2,095	2,100	2,100
Gross domestic product, MKD mn, nom.	501,891	527,631	558,954	598,881	610,000	640,000	675,000	711,000
annual change in % (real)	2.9	3.6	3.9	2.9	0.5	3.4	3.4	3.2
GDP/capita (EUR at PPP)	9,300	9,900	10,500	10,900	10,900	.	.	.
Consumption of households, MKD mn, nom.	355,959	363,629	380,240	390,345	407,500	.	.	.
annual change in % (real)	1.9	2.1	4.5	3.1	3.0	2.0	2.0	1.0
Gross fixed capital form., MKD mn, nom.	119,003	123,549	133,254	143,496	133,500			
annual change in % (real)	3.5	4.0	10.5	5.1	-7.0	5.0	5.0	6.0
Gross industrial production [2]								
annual change in % (real)	3.2	4.8	4.9	3.4	0.2	5.0	4.0	6.0
Gross agricultural production								
annual change in % (real) [3]	6.4	1.7	5.2	6.0	4.0	.	.	.
Construction industry								
annual change in % (real)	43.1	-3.4	40.8	8.0	-25.0	.	.	.
Employed persons, LFS, th, average	678.8	690.2	706.0	723.6	731.0	740	750	760
annual change in %	4.3	1.7	2.3	2.5	1.0	1.0	2.0	1.0
Unemployed persons, LFS, th, average	277.2	268.8	248.9	225.1	220.0	220	220	210
Unemployment rate, LFS, in %, average	29.0	28.0	26.1	23.7	23.0	23.0	23.0	22.0
Reg. unemployment rate, in %, eop	22.8	23.4	22.1	21.2	20.1	.	.	.
Average monthly gross wages, MKD	31,025	31,325	32,171	32,821	33,600	34,400	35,400	36,800
annual change in % (real, gross)	-1.6	1.3	3.0	2.2	1.0	1.0	1.0	2.0
Average monthly net wages, MKD	21,145	21,394	21,904	22,342	22,900	23,500	24,200	25,200
annual change in % (real, net)	-1.6	1.5	2.7	2.2	1.0	1.0	1.0	2.0
Consumer prices, % p.a.	2.8	-0.3	-0.3	-0.2	1.4	1.5	2.0	2.0
Producer prices in industry, % p.a.	-1.4	-1.9	-3.9	-2.4	3.5	2.0	2.0	3.0
General governm. budget, nat.def., % of GDP								
Revenues	30.1	29.7	31.0	30.3	31.0	31.0	31.0	32.0
Expenditures	34.1	33.9	34.4	33.0	33.0	33.0	33.0	33.0
Deficit (-) / surplus (+)	-4.0	-4.2	-3.4	-2.7	-2.0	-2.0	-2.0	-1.0
General gov.gross debt, nat.def., % of GDP	40.2	45.7	46.6	48.4	48.0	48.0	47.0	46.0
Stock of loans of non-fin.private sector, % p.a.	6.4	9.9	9.5	0.9	5.7	.	.	.
Non-performing loans (NPL), in %, eop [4]	11.3	11.1	10.7	6.5	6.3	.	.	.
Central bank policy rate, %, p.a., eop [5]	3.25	3.25	3.25	3.75	3.25	3.25	3.50	3.50
Current account, EUR mn	-134	-43	-177	-265	-20	0	10	-120
Current account, % of GDP	-1.6	-0.5	-2.0	-2.7	-0.2	0.0	0.1	-1.0
Exports of goods, BOP, EUR mn	2,375	2,784	3,047	3,471	3,817	4,240	4,710	5,130
annual change in %	2.9	17.2	9.4	13.9	10.0	11.0	11.0	9.0
Imports of goods, BOP, EUR mn	4,238	4,640	4,870	5,279	5,650	6,100	6,590	7,120
annual change in %	-1.8	9.5	5.0	8.4	7.0	8.0	8.0	8.0
Exports of services, BOP, EUR mn	1,155	1,304	1,378	1,395	1,535	1,640	1,770	1,890
annual change in %	8.2	12.9	5.7	1.3	10.0	7.0	8.0	7.0
Imports of services, BOP, EUR mn	780	920	1,029	1,048	1,174	1,230	1,330	1,420
annual change in %	2.9	18.0	11.8	1.8	12.0	5.0	8.0	7.0
FDI liabilities, EUR mn	302	37	262	495	300	.	.	.
FDI assets, EUR mn	73	-160	59	179	90	.	.	.
Gross reserves of NB excl. gold, EUR mn	1,803	2,221	2,049	2,370	2,096	.	.	.
Gross external debt, EUR mn	5,220	5,992	6,291	7,217	7,700	7,900	8,300	8,700
Gross external debt, % of GDP	64.0	70.0	69.3	74.2	78.0	76.0	76.0	75.0
Average exchange rate MKD/EUR	61.58	61.62	61.61	61.60	61.57	61.5	61.5	61.5

1) Preliminary and wiiw estimates. - 2) Enterprises with 10 and more employees. - 3) From 2016 wiiw estimate. - 4) The decline in the loans in 2016 was due to the write-off of doubtful and contested claims on loans. - 5) Central Bank bills (28-days).

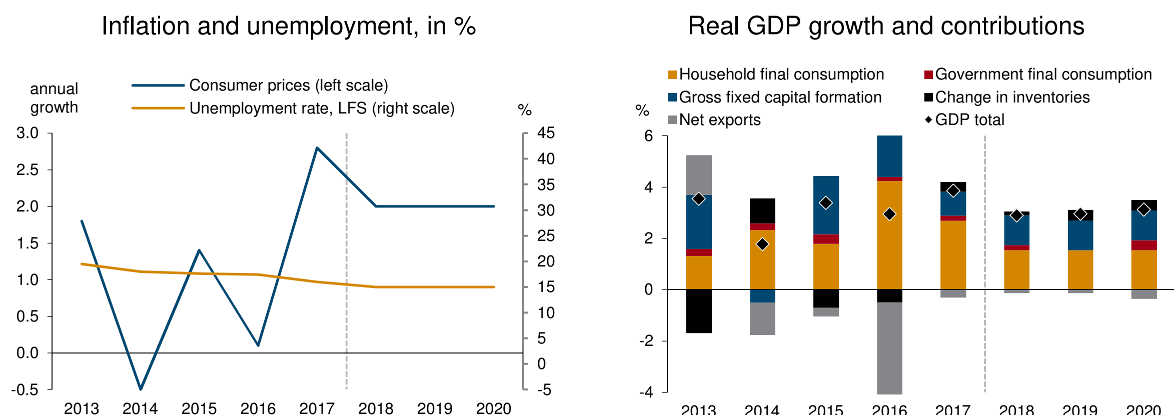
Source: wiiw Databases incorporating national statistics. Forecasts by wiiw.

MONTENEGRO: Tourism to the rescue

VLADIMIR GLIGOROV

Overall, the economy should expand by 3% in the medium term. Assuming EU recovery is sustained, tourism should continue to support expansion. Infrastructure investments should continue and help as well. That should also lead to improvements in the labour market. In the same period, additional political stabilisation should take place and EU accession should advance steadily.

Figure 53 / Montenegro: Main macroeconomic indicators



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

Growth last year exceeded all expectations. The initial assumption was that the fiscal consolidation that the new government had announced would slow down the expansion of GDP. In addition, lower growth rates, below 3%, were forecasted for the medium term. Indeed, public consumption grew more slowly than the GDP, but tourism had a very good year. Also, with political stabilisation after the parliamentary elections last year, investments recovered and overall growth came at 4% (this is still a preliminary figure).

The economy is primarily based on the services sector. Industrial production and agriculture are contributing little to GDP. However, it seems that these two sectors are also undergoing a change because heavy industry has practically disappeared, while some recovery of small and medium-size manufacturing is taking place. Similarly, agricultural production is more oriented towards fruits and

vegetables, for which the climate is accommodating. It is probable that these sectors will continue to expand.

Unemployment seems to be stuck at a relatively high level, which will probably go down slowly as new activities with the demand for new skills advance. Montenegro has deindustrialised, and the unemployment which comes with that is harder to deal with – especially if there is limited support for flexibility in the labour market and in the activation institutions.

Officially, the next two to three years should see a slowdown in growth due to fiscal consolidation. Public debt is relatively high and has been increasing due to ambitious infrastructure investments. Those are needed in a mountainous country which specialises in services. Investment needs are huge, but foreign financial obligations are also quite high. The latter is also a consequence of Montenegro being an attractive place to invest in real estate. The risk of a real estate bubble is smaller than in some other countries because the rest of the economy is relatively small. So, as long as tourism and the connected activities continue to do well, possible fluctuations in real estate prices should not have strong negative effects on the overall economic activity.

The banking sector seems to have stabilised and is performing rather well. There are remaining weaknesses in one or two banks, which are more closely connected with the public sector. With that in mind, the strategy to narrow down the fiscal deficit and put the public and foreign debts on a sustainable path seems to be what indeed should be done. Assuming that tourism will continue to perform well, in part due to the recovery in the EU, gradual fiscal consolidation should not prove to be all that costly in terms of GDP. With that, the economy should expand at a rate of around 3% in the medium run. It could do better if employment increases faster than has been the case so far.

There will be presidential elections in mid-April. The odds are even that a representative of the ruling party or the one standing for the new Democratic Party will win. It may be the best if the political change starts with the presidential elections. Democratisation of Montenegro would be conducive to the speed-up of EU integration, which is needed for enduring stability of the state. The president does not have much of a role of power, but the change in the government in a few years' time would be made easier with the change at the head of the state.

Overall, the economy should expand by 3% in the medium term. Assuming EU recovery is sustained, tourism should continue to support expansion. Infrastructure investments should continue and also help. That should also lead to improvements in the labour market. In the same period, additional political stabilisation should take place and EU accession should advance steadily.

Table 23 / Montenegro: Selected economic indicators

	2013	2014	2015	2016	2017 1)	2018	2019	2020
						Forecast		
Population, th pers., average	621	622	622	622	625	625	625	630
Gross domestic product, EUR mn, nom.	3,362	3,458	3,655	3,954	4,200	4,400	4,600	4,800
annual change in % (real)	3.5	1.8	3.4	2.9	3.9	2.9	3.0	3.1
GDP/capita (EUR at PPP)	10,900	11,300	12,300	13,000	13,500	.	.	.
Consumption of households, EUR mn, nom. 2)	2,724	2,775	2,893	3,035	3,240	.	.	.
annual change in % (real)	1.6	2.9	2.2	5.4	3.5	2.0	2.0	2.0
Gross fixed capital form., EUR mn, nom.	678	657	736	917	960	.	.	.
annual change in % (real)	10.7	-2.5	11.9	27.5	4.0	5.0	5.0	5.0
Gross industrial production 3)								
annual change in % (real)	10.6	-11.4	7.9	-3.3	-4.2	5.0	4.0	4.0
Net agricultural production								
annual change in % (real)	5.0	3.0	3.0	5.0	4.0	.	.	.
Construction output 3)								
annual change in % (real)	41.6	34.1	20.3	47.4	15.0	.	.	.
Employed persons, LFS, th, average	201.9	216.3	221.7	224.2	229.0	231	233	238
annual change in %	1.0	7.1	2.5	1.1	2.1	1.0	1.0	2.0
Unemployed persons, LFS, th, average	48.9	47.5	47.2	48.3	50.0	40	40	40
Unemployment rate, LFS, in %, average	19.5	18.0	17.6	17.4	16.0	15.0	15.0	15.0
Reg. unemployment rate, %, average	15.8	16.1	16.5	21.9	21.7	.	.	.
Average monthly gross wages, EUR	726	723	725	751	765	790	810	830
annual change in % (real, gross)	-1.9	0.1	-1.1	3.5	-1.1	1.0	1.0	1.0
Average monthly net wages, EUR	479	477	480	499	510	530	550	570
annual change in % (real, net)	-3.4	0.1	-0.8	3.9	-0.8	1.0	1.0	1.0
Consumer prices, % p.a.	1.8	-0.5	1.4	0.1	2.8	2.0	2.0	2.0
Producer prices in industry, % p.a. 4)	1.6	0.1	0.3	-0.1	0.4	2.0	2.0	2.0
General governm.budget, nat.def., % of GDP								
Revenues	42.6	44.8	41.8	42.6	43.0	40.0	40.0	40.0
Expenditures	47.2	47.7	50.0	46.2	45.0	42.0	42.0	41.0
Deficit (-) / surplus (+)	-4.6	-2.9	-8.3	-3.6	-2.0	-2.0	-2.0	-1.0
General gov.gross debt, nat.def., % of GDP	55.7	56.2	62.3	60.8	60.0	60.0	60.0	59.0
Stock of loans of non-fin.private sector, % p.a.	5.0	-1.5	2.9	6.0	6.4	.	.	.
Non-performing loans (NPL), in %, eop	18.4	16.8	13.4	11.1	11.0	.	.	.
Central bank policy rate, % p.a., eop 5)	8.68	8.41	8.53	7.45	6.81	8.00	8.00	8.00
Current account, EUR mn	-487	-526	-483	-715	-790	-890	-920	-850
Current account, % of GDP	-14.5	-15.2	-13.2	-18.1	-18.8	-20.2	-20.0	-17.7
Exports of goods, BOP, EUR mn	396	357	325	345	355	390	430	450
annual change in %	2.1	-9.7	-9.0	6.2	2.8	9.0	9.0	5.0
Imports of goods, BOP, EUR mn	1,724	1,734	1,789	2,003	2,180	2,380	2,590	2,770
annual change in %	-2.7	0.6	3.2	12.0	8.9	9.0	9.0	7.0
Exports of services, BOP, EUR mn	994	1,031	1,214	1,255	1,390	1,540	1,710	1,920
annual change in %	4.6	3.6	17.8	3.3	10.8	11.0	11.0	12.0
Imports of services, BOP, EUR mn	341	340	425	486	515	540	570	600
annual change in %	1.0	-0.3	24.8	14.3	6.1	5.0	5.0	6.0
FDI liabilities, EUR mn	337	375	630	205	500	.	.	.
FDI assets, EUR mn	13	21	11	-167	-60	.	.	.
Gross reserves of NB excl. gold, EUR mn 6)	424	545	674	803	898	.	.	.
Gross external public debt, EUR mn	1,433	1,562	1,956	2,003	2,310	2,510	2,710	2,780
Gross external public debt, % of GDP	42.6	45.2	53.5	50.6	55.0	57.0	59.0	58.0

1) Preliminary and wiiw estimates. - 2) Including expenditures of NPISHs. - 3) Enterprises with 5 and more employees. - 4) Domestic output prices. - 5) Average weighted lending interest rate of commercial banks (Montenegro uses the euro as national currency). - 6) Data refer to reserve requirements of Central Bank.

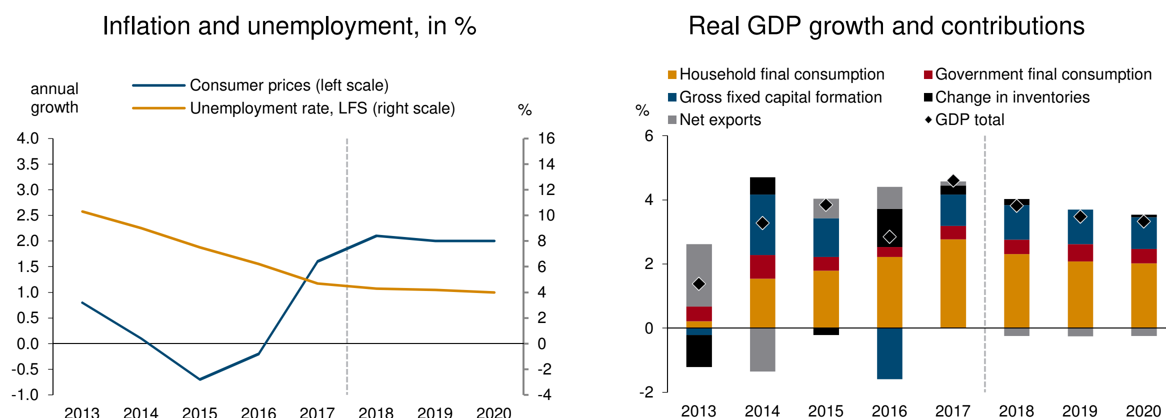
Source: wiiw Databases incorporating national statistics. Forecasts by wiiw.

POLAND: Steady consumption-driven expansion

LEON PODKAMINER

Strong consumption-driven growth has been propelled by rising wages and employment. The economic conditions are conducive to a recovery in private-sector investment activities, though this has yet to materialise. The positive growth prospects may be endangered by the unwelcome effects of the ongoing evolution of the political system – including the country's progressive alienation from its EU partners.

Figure 54 / Poland: Main macroeconomic indicators



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

At a provisional rate of 4.6%, GDP growth in 2017 turned out to be more robust than generally expected. Growth in household consumption remained strong and steady (about 4.8%) throughout the year. Rising household consumption contributed 2.9 percentage points (pp) to overall growth in 2017, and increased public consumption contributed an additional 0.5 pp.

The performance of foreign trade was strong, though variable, across 2017. Foreign trade made a positive contribution to GDP growth in the first quarter (+0.4 pp), a negative contribution in the second (-1.3 pp) and again a positive contribution in the third (+1.1 pp). For the year as a whole, the estimated contribution of the trade balance to GDP growth was close to zero.

Provisional calculations suggest that gross fixed capital formation (GFCF) shot up by about 12% in the fourth quarter of 2017. Such a sudden acceleration in GFCF seems rather unusual: it virtually stagnated in the first half of 2017 and was reported to have increased weakly in the third quarter (by 3.3%, year on year). Anyway, the provisionally reported GFCF growth rate for the whole of 2017 (5.4%) implies that the GFCF contribution to GDP growth in 2017 was about 1 pp, with rising inventories adding 0.2 pp.

Household consumption is set to continue to grow quite robustly in 2018-2019. This is primarily due to a relatively strong rise in employment and wages (with a resultant sharply increased wage bill). Government policy measures supporting household incomes and growing private consumption include quite generous transfers to families with children, increased official minimum wage rates and higher tax-free personal income thresholds. On the other hand, the government is trying to 'economise' on pensions expenditure (the growth in the average retirement pension is lagging behind the growth in average wages and inflation).

Rising demand for (primarily skilled) labour is one aspect of the labour market situation that is currently shifting in favour of employees. Average wages are growing under the impact of tightening labour markets. The wage hikes are still quite moderate though, roughly in line with rising productivity. The presence of a large 'shadow labour army', consisting of potentially employable migrants (primarily from Ukraine), seems to be limiting the wage pressures. Also, the introduction of sizeable social transfers may have reduced, at least temporarily, the income aspirations of wage earners. In addition, the still relatively low inflation may be moderating wage claims. Labour costs are not expected to bring about much stronger cost-push inflation, although they may prevent further growth in the corporate sector's profitability indicators.

Wage developments have also much to do with the demography-related weakening of the labour supply. The lowering of the retirement age (from 67 years for both sexes to 65 for men and 60 for women), effective as of October 2017, will further reduce the labour supply – and as such may be conducive to a further growth in wages.

The financial standing of the non-financial corporate sector has been pretty strong. Net profits of the sector rose by 7.8% in the first three quarters of 2017 (compared to the same period in 2016), reaching an equivalent of about EUR 23 billion (over 6.7% of the period's GDP). Profitability of the sector is high and – though firms do generally expect some deterioration in the financial indicators in the future (on account of possibly rising costs and more intense competition). Actually, there has already been a fairly substantial deterioration across most of the branches of manufacturing and in construction (while marked improvements have been registered in mining). Financial sector corporations have also been faring relatively well. Although the net profits of commercial banks in 2017 as a whole declined by 7% (on account of higher personal costs, much higher obligatory contributions to the (centralised) banking system reserve fund and a higher tax burden), they reached an equivalent of over EUR 2.5 billion in the first three quarters of the year.

Indebtedness in the non-financial private sector remains relatively low. Borrowing by firms and households is not expensive, and the interest rates on loans are quite stable. Despite this, loans to the non-financial corporate and household sectors have grown quite moderately (the stocks of such loans rose in the space of 12 months by about 6% and 3.3%, respectively). A stronger growth in loans is

observed in the segment of small and medium-sized enterprises (larger firms still prefer to ‘sit’ on cash reserves). Borrowing by households predominantly supports the satisfaction of housing needs. Overall, the levels of private-sector indebtedness are comparatively low, and the share of non-performing loans is low and falling.

Private-sector investment remains depressed. The GFCF expansion must be attributed to the rising investment of local (and central) government, supported by the fast-growing financing through EU funds. (During the first three quarters of 2017, local government investments financed from EU funds rose four-fold.) The data available suggest that investment by private corporations remains flat. For example, in the third quarter of 2017, investment outlays by private corporations declined by 0.4% (at current prices), following a decline of 2.4% in the second quarter. But publicly owned corporations increased their investment outlays by 2.8% in the second quarter and by 11.4% in the third. Also, the information available on the structure of investment is not very encouraging. The increased investment by firms takes the form of higher outlays on means of transport (rising by close to 29% in the third quarter of 2017), while expenditure on machinery and installations and on buildings continued to decline.

Purely economic factors would suggest that fixed investment by the private sector could be expanding strongly – even if the decline in profitability of manufacturing may negatively affect that sector’s propensity to invest. The basic reason why corporate investment has been sluggish has much to do with the political climate that set in after the electoral victory of the Law and Justice (PiS) party. The PiS government, in power since late 2015, blatantly flouts the constitution. In fact, it is now subordinating the judiciary system to its own will. That cannot but evoke anxiety among private (domestic) businessmen, who have reason to fear the advent of legally unrestrained arbitrary administrative harassment and interference in their activities. The importance of the ‘intangible’ reasons for the private sector’s lack of investment is underscored by the ranking of ‘obstacles to development’ reported in the business climate surveys available from the National Bank of Poland (NBP). According to the most recent survey (January 2018), the ongoing regulatory (including taxation) changes are ranked as the most severe factor limiting development (ahead of the lack of skilled labourers, general uncertainty and the rising cost of raw materials).

More rapid growth in public investment co-financed by EU funds is expected in 2018-2020. The private sector is also likely to benefit, directly and indirectly, from the increased absorption of EU money. This should add much more vigour to private-sector investments.

Macroeconomic policies continue to be relaxed. Although the deflationary tendencies that have been observed since 2013 are now being overcome, the NBP is very likely to leave its policy rates unchanged. This is not a bad position, because – in spite of the vigorous rise in wages and consumer demand – the risk of any disquieting inflationary acceleration still seems rather remote. Nor is there any need to pre-empt a build-up of investment bubbles. But NBP policy follows from the fact that the bank is now dominated by ‘doves’ who are unconditionally loyal to the ruling party. Their priority is to avoid decisions that could slow down real growth. The Finance Ministry seems to share much the same perspective. In effect, despite relatively high growth, the financial deficit of the general government should not be expected to fall significantly below the 3% of GDP mark. That is not necessarily a bad development – at least so long as public debt is still quite low, inflation is not significant and the foreign trade balances remain positive.

Failure to respect the budget deficit limits is still a relatively minor offence against EU rules (especially given that the authorities do not intend to join the eurozone anytime soon). But domestic political developments have been more disquieting. The ruling party, which enjoys a parliamentary (though not a constitutional) majority, is violating the constitution. It is bent on subjugating all public institutions, including those in charge of controlling and balancing the powers of the government. The political system currently developing in Poland is unlikely to do any good to the country in the longer run.

The PiS authorities' sustained assault on the basic principles and institutions of a law-abiding democratic system constitutes a truly grave problem, both for Polish society and for the rest of the EU. For the time being, it is difficult to see how that assault can be contained. On the other hand, it may also be hard to square Poland's continued EU membership with its becoming another 'sovereign democracy' of an East European (rather than Western) persuasion. In practical terms, the conflict with the European institutions over the direction of Poland's internal politics is very likely to result in reduced access to EU funds after 2020.

To sum up, at present Poland's economy is in good shape. Driven primarily by consumption, its GDP is likely to rise by close to (or in excess of) 3.5% in 2018-2020 – roughly in line with our autumn 2017 forecast. Rising investment is likely to complement rising consumption in 2018-2020 on account of EU co-financing of infrastructure projects that is higher than in 2017. However, in the medium term, the positive growth prospects may be endangered by the unwelcome effects of the ongoing evolution of the political system – including the country's alienation from its major EU partners.

Table 24 / Poland: Selected economic indicators

	2013	2014	2015	2016	2017 1)	2018	2019	2020
							Forecast	
Population, th pers., average	38,514	38,487	38,458	38,435	38,400	38,400	38,400	38,400
Gross domestic product, PLN bn, nom.	1,657	1,720	1,799	1,859	1,960	2,070	2,170	2,270
annual change in % (real)	1.4	3.3	3.8	2.9	4.6	3.8	3.5	3.3
GDP/capita (EUR at PPP)	17,900	18,600	19,800	19,900	20,900	.	.	.
Consumption of households, PLN bn, nom.	995	1,019	1,038	1,074	1,140	.	.	.
annual change in % (real)	0.3	2.6	3.0	3.9	4.8	4.0	3.6	3.5
Gross fixed capital form., PLN bn, nom.	312	339	361	336	350			
annual change in % (real)	-1.1	10.0	6.1	-7.9	5.4	6.0	6.0	5.5
Gross industrial production (sales) 2)								
annual change in % (real)	2.3	3.4	4.8	2.8	6.6	5.5	5.0	4.8
Gross agricultural production								
annual change in % (real)	0.5	6.9	-2.6	8.4	3.9	.	.	.
Construction industry 2)								
annual change in % (real)	-10.2	4.3	0.3	-14.5	13.7	.	.	.
Employed persons, LFS, th, average	15,568	15,862	16,084	16,197	16,490	16,610	16,660	16,690
annual change in %	-0.1	1.9	1.4	0.7	1.8	0.7	0.3	0.2
Unemployed persons, LFS, th, average	1,793	1,567	1,304	1,063	810	750	730	700
Unemployment rate, LFS, in %, average	10.3	9.0	7.5	6.2	4.7	4.3	4.2	4.0
Reg. unemployment rate, in %, eop	13.4	11.4	9.7	8.3	6.6	.	.	.
Average monthly gross wages, PLN	3,659	3,777	3,908	4,047	4,330	4,570	4,820	5,060
annual change in % (real, gross)	2.8	3.2	4.5	4.2	5.0	3.3	3.3	3.0
Consumer prices (HICP), % p.a.	0.8	0.1	-0.7	-0.2	1.6	2.1	2.0	2.0
Producer prices in industry, % p.a.	-1.3	-1.3	-2.0	-0.3	2.7	2.0	1.8	1.8
General governm.budget, EU-def., % of GDP								
Revenues	38.5	38.7	38.9	38.7	39.0	39.0	39.5	40.0
Expenditures	42.6	42.3	41.6	41.2	42.0	42.0	42.5	42.5
Net lending (+) / net borrowing (-)	-4.1	-3.6	-2.6	-2.5	-3.0	-3.0	-3.0	-2.5
General gov.gross debt, EU def., % of GDP	55.7	50.2	51.1	54.1	54.6	54.7	54.7	54.7
Stock of loans of non-fin.private sector, % p.a.	3.3	5.8	7.1	5.3	3.1	.	.	.
Non-performing loans (NPL), in %, eop	8.5	8.1	7.5	7.1	6.9	.	.	.
Central bank policy rate, % p.a., eop 3)	2.5	2.0	1.5	1.5	1.5	1.75	1.50	1.50
Current account, EUR mn 4)	-5,028	-8,529	-2,409	-1,250	346	900	1,100	700
Current account, % of GDP 4)	-1.3	-2.1	-0.6	-0.3	0.1	0.2	0.2	0.1
Exports of goods, BOP, EUR mn 4)	149,113	158,656	172,150	177,412	197,836	210,500	226,300	239,900
annual change in %	5.7	6.4	8.5	3.1	11.5	6.4	7.5	6.0
Imports of goods, BOP, EUR mn 4)	149,448	161,911	169,937	174,479	197,338	211,200	227,700	243,600
annual change in %	0.2	8.3	5.0	2.7	13.1	7.0	7.8	7.0
Exports of services, BOP, EUR mn 4)	33,592	36,743	40,663	45,018	52,059	55,400	59,200	62,800
annual change in %	5.1	9.4	10.7	10.7	15.6	6.5	6.8	6.0
Imports of services, BOP, EUR mn 4)	25,948	27,679	29,749	30,941	34,123	35,800	38,800	41,100
annual change in %	0.0	6.7	7.5	4.0	10.3	5.0	8.5	5.8
FDI liabilities, EUR mn 4)	658	14,824	13,534	15,213	4,826	.	.	.
FDI assets, EUR mn 4)	-2,524	5,096	4,385	10,233	3,118	.	.	.
Gross reserves of NB excl. gold, EUR mn	74,257	79,379	83,676	104,440	90,967	.	.	.
Gross external debt, EUR mn 4)	278,948	293,510	303,120	318,956	343,000	365,300	390,100	410,800
Gross external debt, % of GDP 4)	70.7	71.4	70.5	74.9	74.5	75.0	75.5	76.0
Average exchange rate PLN/EUR	4.1975	4.1843	4.1841	4.3632	4.2570	4.25	4.20	4.20

1) Preliminary and wiiw estimates. - 2) Enterprises with 10 and more employees. - 3) Reference rate (7-day open market operation rate). - 4) Including SPE.

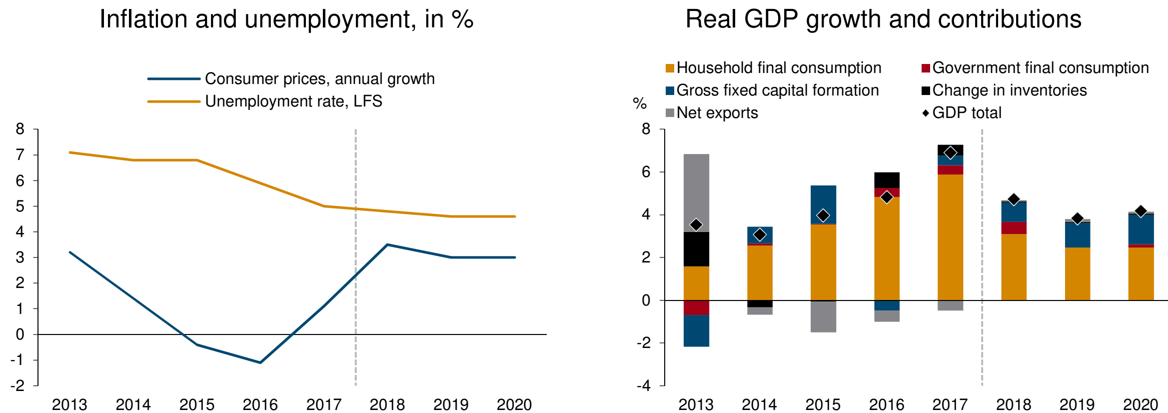
Source: wiiw Databases incorporating Eurostat and national statistics. Forecasts by wiiw.

ROMANIA: Down from the peak

GÁBOR HUNYA

Economic growth in Romania is expected to decline from close to 7% last year to 4.7% in 2018, and even lower in the following two years. Fiscal imbalances will trigger restrictive policies. Household consumption will remain the main growth driver, while investments are expected to recover slowly and the current account deficits to shrink modestly. Political instability and unpredictable structural reforms will continue to put a drag on the economy, elevating investment risk.

Figure 55 / Romania: Main macroeconomic indicators



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

The Romanian economy will descend from the peak and grow much more slowly in 2018 than the year before. The extraordinary growth rate of 6.9% in 2017 increased the base level for subsequent years, but external demand has improved and the expectations of business are positive; thus the 2018 wiiw forecast has been adjusted slightly upwards, to 4.7%. Last year, pro-cyclical fiscal measures stimulated a boom in household consumption, while gross fixed capital formation almost stagnated. Demand on the main foreign markets expanded, pulling up production in manufacturing. A deterioration in the external balance occurred in the wake of surging imports of consumer goods and despite rapidly rising exports; thus net exports made a negative contribution to GDP growth. In the real sector, industry attained a high rate of output growth (8.2%), while construction contracted (-5.4%). A bumper harvest (agricultural production +10.3%) added to the amount of available goods and stimulated on-farm consumption.

Investments, which grew very modestly in 2017, need to be revamped. Public investments declined, as did private investments in buildings. There were delays to infrastructure investment, including motorway construction which is badly needed to clear major bottlenecks. At the same time, bullish investments in machinery and equipment supported an increase in labour productivity. A change in the public procurement law and a new organisation of EU project implementation are expected to bring better access to EU funds in the future. But budgetary resources may still fall short of requirements, if investment expenditures again fall victim to deficit balancing.

With economic growth probably slower than expected by the government, the fiscal deficit will widen to beyond 3% of GDP and austerity measures will be demanded by the EU Commission. The 2018 budget law is based on an over-ambitious assumption of 5.5% GDP growth and 3% of GDP budget deficit (the spring 2018 forecast of the National Commission of Forecasting for GDP growth in 2018 is even higher, at 6.1%). In 2017, the consolidated budget deficit reached 2.9% of GDP – marginally less than expected, but well above the level of 2016. Revenues went up by 12.5% and expenses by 14% in current RON terms. Public investments were sacrificed (10.5% less than in 2016 and 33% less than provided for under the 2017 budget law) to keep expenditure under control and to finance public sector wage rises. On the revenue side, the state failed to draw the estimated amount of EU funds, but compensated for this by extracting dividends from state-owned companies, thus blocking their investment plans. Personal income taxation was reformed as of 1 January 2018, shifting the total social security contribution to gross wages and simultaneously reducing the flat tax from 16% to 10%. At the same time, the minimum gross wage increased from RON 1,450 to RON 1,900 (EUR 408). Income from dividends will continue to be taxed at 5%, but will also be subject to a 10% health insurance contribution.

The overall effect of the 2018 changes to the personal income tax system is expected to be net-wage neutral. The government does not plan major wage increases in the public sector of the sort seen in previous years. But there will be carryover effects from the hikes last year. Wages in the private sector may rise due to labour shortages, as reflected in trade union demands. In view of inflation climbing above 3%, the net wage increase may turn out to be meagre and may put the brakes on household consumption. This is a major change compared with the growth scenario in the two previous years.

Consumer price inflation is expected to peak in the middle of 2018 at well over 4%, then moderate to 3%, provided commodity prices do not surge. The cyclical element of inflation is the result of excess demand, and also of rising import prices leading to year-on-year consumer price inflation of 4.3% in January 2018. Government-managed energy prices have increased, as these are tied to the import price of gas and oil (with some delay). In response, the National Bank of Romania (BNR) has hiked the monetary policy rate twice already in 2018 – by 0.25 percentage points each time – to 2.25%, leaving it negative in real terms. The BNR has stated that it will not push for a tightening in the monetary conditions, but has called for fiscal action to cool the economy.

The economic upturn has had positive labour market effects, which could stabilise over the next few years. The number of employed persons grew and the activity rate increased to above 66% of the working-age population – a trend that may remain. The unemployment rate is set to fall to just below 5% in 2018. Labour shortages are widely present, demand being especially buoyant for a skilled workforce. Combined with higher wages, this may reduce the push to emigrate. The government will allow 7,000

new non-EU foreigners into the Romanian labour market in 2018, a 40% increase over the previous year.

Exports and imports are expected to grow more slowly in 2018 than in the previous year, while the contribution of net exports to GDP will turn slightly positive. Exports will expand on account of rising demand on the main markets, while slower expansion in household demand will put the brakes on imports. In 2017, high demand in Europe stimulated goods exports, which grew by 9.5% in current euro terms, while the domestic demand surge triggered an import increase of 12.6%. Even the imports of services grew more rapidly than exports for the first time in many years, especially on the transport and travel accounts. The current account deficit of 3.5% of GDP in 2017 will come down to 3% over the forecast period. About two-thirds of it can comfortably be financed by the inflow of FDI.

Government instability will continue, despite the reshuffle in January 2018. The coalition led by the Social Democratic Party (PSD) enjoys a majority in both houses of parliament after the election of December 2016. The recurring government crisis (three prime ministers in one year) is the result of infighting within the PSD. Party boss Liviu Dragnea wants to rule over the government, which leads to tensions with the prime minister. Also the conflict between the National Anti-corruption Directorate (DNA) and the government is set to continue, as the DNA will continue prosecuting PSD politicians and has Mr Dragnea as its ultimate target. At the same time, DNA chief prosecutor Laura Codruța Kövesi is being investigated by the Judicial Inspection for possible misconduct, despite the support of President Iohannis and Western embassies.

Investors and business perceive an elevated political risk, as government instability may lead to economic destabilisation. Ten-year government bond yields rose from an average of 3.8% in the first half of 2017 to 4.4% in the last quarter and through January 2018. (In comparison, Hungarian bonds were traded at 3.5% in the first quarter of 2017, falling to 2% in January 2018.) Direct investors have not become hesitant yet, as the conditions for doing business are relatively good. Romania ranks 45th on the World Bank's Ease of Doing Business index, just ahead of Italy and Hungary. In addition, the European growth cycle is generating demand for Romanian exports, although this is expected to subside in 2019. Machinery investments are expected to remain strong and FDI inflow may stay in the range of EUR 4.5 billion.

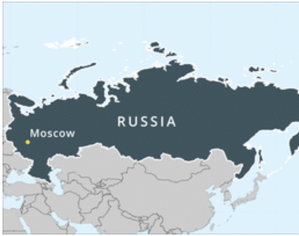
Economic growth will hover at around 4% over the coming two years. The precondition for this is that the country manages to shift the growth driver from consumption to investments. Export expansion will slow when EU growth subsides, but imports may grow even less, and net exports could make a marginally positive contribution. External and fiscal imbalances will persist, but will not present a danger of serious instability. Some fiscal austerity will become necessary, which will curtail GDP growth to 3.9% in 2019. Government plans for further cuts in the VAT rate will most probably be abandoned. Access to EU funds may accelerate in the later years when funds under the current financing period can be drawn (2020-2022), which may boost GDP growth above 4% again.

Table 25 / Romania: Selected economic indicators

	2013	2014	2015	2016	2017 [1]	2018	2019	2020
							Forecast	
Population, th pers., average	19,984	19,909	19,815	19,699	19,650	19,600	19,500	19,400
Gross domestic product, RON bn, nom.	637.5	668.1	712.7	762.3	850.0	910	960	1,020
annual change in % (real)	3.5	3.1	4.0	4.8	6.9	4.7	3.8	4.2
GDP/capita (EUR at PPP)	14,600	15,200	16,300	17,000	18,200	.	.	.
Consumption of households, RON bn, nom.	385.5	406.4	433.1	471.6	540.0	.	.	.
annual change in % (real)	2.6	4.2	5.8	7.9	9.5	5.0	4.0	4.0
Gross fixed capital form., RON bn, nom.	157.5	162.4	176.3	175.1	185.0	.	.	.
annual change in % (real)	-5.4	3.2	7.4	-2.0	2.0	4.0	5.0	6.0
Gross industrial production [2]								
annual change in % (real)	7.8	6.1	2.8	1.7	8.2	6.0	5.0	4.0
Gross agricultural production								
annual change in % (real)	24.5	2.9	-6.8	2.5	10.3	.	.	.
Construction industry [2]								
annual change in % (real)	-0.6	-6.7	10.3	-4.8	-5.4	.	.	.
Employed persons, LFS, th, average	8,549	8,614	8,535	8,449	8,660	8,830	8,960	9,050
annual change in %	-0.7	0.8	-0.9	-1.0	2.5	2.0	1.5	1.0
Unemployed persons, LFS, th, average	653	629	624	530	460	450	430	440
Unemployment rate, LFS, in %, average	7.1	6.8	6.8	5.9	5.0	4.8	4.6	4.6
Reg. unemployment rate, in %, eop	5.7	5.4	5.0	4.8	4.0	.	.	.
Average monthly gross wages, RON [3]	2,163	2,328	2,555	2,809	3,225	4,400	4,700	5,000
annual change in % (real, gross)	0.8	6.5	10.4	11.7	13.3	.	4.0	4.0
Average monthly net wages, RON	1,579	1,697	1,859	2,046	2,337	2,500	2,700	2,900
annual change in % (real, net)	0.8	6.4	10.1	11.8	12.7	5.0	4.0	4.0
Consumer prices (HICP), % p.a.	3.2	1.4	-0.4	-1.1	1.1	3.5	3.0	3.0
Producer prices in industry, % p.a.	2.0	-0.2	-2.4	-1.9	3.7	2.0	2.0	2.0
General governm.budget, EU-def., % of GDP								
Revenues	33.3	33.5	34.9	31.0	33.0	30.0	31.0	31.0
Expenditures	35.4	34.9	35.7	34.0	36.0	33.5	34.0	33.5
Net lending (+) / net borrowing (-)	-2.1	-1.4	-0.8	-3.0	-3.0	-3.5	-3.0	-2.5
General gov.gross debt, EU def., % of GDP	37.8	39.4	37.9	37.6	36.7	37.7	38.7	38.9
Stock of loans of non-fin.private sector, % p.a.	-3.4	-3.7	2.5	0.9	5.1	.	.	.
Non-performing loans (NPL), in %, eop	21.9	13.9	13.5	9.6	7.4	.	.	.
Central bank policy rate, % p.a., eop [4]	4.00	2.75	1.75	1.75	1.75	2.75	3.00	3.00
Current account, EUR mn	-1,542	-1,004	-1,977	-3,496	-6,463	-6,600	-6,500	-6,400
Current account, % of GDP	-1.1	-0.7	-1.2	-2.1	-3.5	-3.4	-3.2	-3.0
Exports of goods, BOP, EUR mn	43,893	46,839	49,111	52,164	57,100	61,700	66,000	70,000
annual change in %	10.1	6.7	4.8	6.2	9.5	8.0	7.0	6.0
Imports of goods, BOP, EUR mn	49,709	53,375	56,896	61,412	69,128	74,700	80,300	85,500
annual change in %	1.2	7.4	6.6	7.9	12.6	8.0	7.5	6.5
Exports of services, BOP, EUR mn	13,434	15,104	16,640	18,006	20,576	22,800	25,300	27,800
annual change in %	36.1	12.4	10.2	8.2	14.3	11.0	11.0	10.0
Imports of services, BOP, EUR mn	8,733	9,236	9,849	10,284	12,613	13,900	15,000	16,200
annual change in %	18.1	5.8	6.6	4.4	22.6	10.0	8.0	8.0
FDI liabilities, EUR mn	2,894	2,931	3,885	5,656	4,380	.	.	.
FDI assets, EUR mn	-24	227	930	1,143	-197	.	.	.
Gross reserves of NB excl. gold, EUR mn	32,525	32,216	32,238	34,242	33,494	.	.	.
Gross external debt, EUR mn	98,069	94,744	92,069	92,910	93,954	98,000	100,000	103,000
Gross external debt, % of GDP	68.0	63.0	57.4	54.7	50.5	50.1	49.0	48.0
Average exchange rate RON/EUR	4.4190	4.4437	4.4454	4.4904	4.5688	4.65	4.70	4.75

1) Preliminary and wiiw estimates. - 2) Enterprises with 4 and more employees. - 3) In 2018 the social security contribution paid by employers was added to gross wages increasing the latter by 25%. - 4) One-week repo rate.

Source: wiiw Databases incorporating Eurostat and national statistics. Forecasts by wiiw.

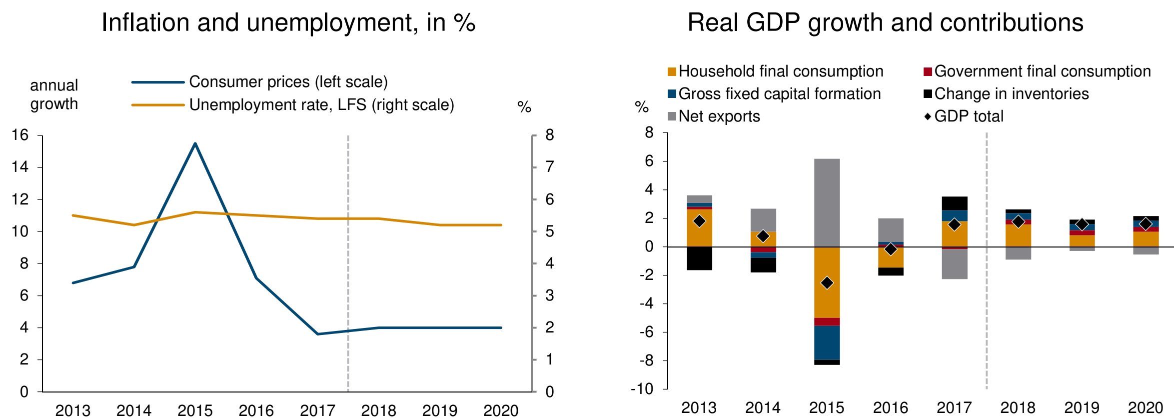


RUSSIAN FEDERATION: Falling behind peers on meagre growth

PETER HAVLIK

The Russian economy has returned to growth. The inflation target of 4% has been comfortably met, and the rouble has been appreciating. However, in the absence of reforms, GDP growth will not exceed 2% even in the medium run – lower than the country's European peers. No major changes in economic policies are expected, as stability at home coupled with external threats is cherished over reform risks. Sanctions and a poor investment climate are here to stay. Higher oil prices are once again serving as both a buffer and a deterrent to reform.

Figure 56 / Russian Federation: Main macroeconomic indicators



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

The Russian economy emerged from recession in 2017. Preliminary data indicate that GDP increased by some 1.6%, owing to a recovery in household consumption and in investment (both grew by 3.5%). Government consumption dropped by 1%. Along with rising domestic demand, the contribution of real net exports to GDP growth was negative, as import volumes grew much faster than exports. On the supply side, industrial production (particularly the extraction industry), transport and business services are growing again, while construction has stagnated. Agriculture was again one of the better performers: its output has expanded by a cumulative 10% since 2014, when restrictions on Western food imports were introduced.

The inflation target envisaged (annual average of 4%) was reached as early as mid-2017. In fact, the annual CPI inflation in December was just 2.5%, and the key interest rate of the Central Bank of Russia (CBR) was reduced to 7.75% p.a. Both employment and unemployment remain stable (and the latter low); there are sectoral/regional labour shortages, especially in higher-skill segments. These shortages are aggravated by outward migration and can hardly be mitigated by inflows of foreign workers.

Thanks to rising oil prices in 2017 (+25% in USD terms compared to a year earlier), export revenues grew by more than 20% (EUR based). The share of energy in exports exceeded 60%. In relative terms, trade turnover with the EU is declining, while with China it is increasing, and indeed China has become Russia's single most important trading partner. The rouble appreciated in both nominal and real terms by around 10% compared to the previous year with respect to both the US dollar and (a bit less) the euro. As a consequence, imports recovered strongly as well: the import volume is estimated to have increased by about 17% in 2017; that of exports by 5%. The growth contribution of net exports was thus negative and is expected to remain negative in the coming years as well.

The federal budget for the period 2018-2020 was approved by the Duma at the end of November 2017. It reckons with annual inflation of 4% and is based on a conservative forecast of the oil price (below USD 44 per barrel (bbl)). The federal budget deficit for 2018 is projected to be 1.3% of GDP, with subsequent further reductions below 1% of GDP in the rest of the decade – despite planned cuts in revenues, related to rather conservative expectations of oil price developments. Also the CBR is rather cautious with respect to oil price expectations: its basic scenario from December 2017 rests on the assumption of an oil price of USD 55/bbl in 2018 and USD 45/bbl afterwards. Even with a higher oil price (USD 60/bbl), the projected GDP growth is unlikely to exceed 2% in the forecast period.

A major reason for the disappointing growth prospects is that no substantial reforms are on the horizon, even after the presidential elections in March (which Vladimir Putin is poised to win). The Russian economy has seemingly adjusted to the 'new normal' of depressed oil prices, sanctions and mediocre growth. After the recent bankruptcies of several major companies and banks, the government stepped in to rescue them and took the remaining assets under its control. The huge FDI flows officially reported in 2016 (both inflows to and outflows from Russia – see Table 26) reflected transactions with offshore destinations. Nothing similar was reported in 2017, and yet the share of Cyprus and other offshore tax havens in total FDI stocks remains extremely high (around 50% of the total). This is a reflection, inter alia, of the poor domestic investment climate, including sanctions. The net capital outflow of the private sector in 2017 exceeded USD 30 billion, largely owing to operations of the banking sector related to debt repayments. Indeed, Russian banks and top businessmen have been increasingly nervous in anticipation of the new wave of US financial sanctions (the list of 210 top government officials and leading businessmen published on 30 January is largely symbolic and threatens no immediate impact, but it further poisons the already bad US-Russian relations).

The overall assessment of Russian economic prospects has not changed very much in the last couple of years, although the current growth forecast for 2018 was revised slightly upwards, owing to the price of oil being higher than previously expected. Still, GDP growth will remain sluggish (below 2%) in the medium term, too, constrained by shortages of labour, capital and especially economic and institutional reforms. Owing to the lack of investments (domestic and especially foreign), the structure of the economy will not change and will remain skewed towards the extraction sector. The

CBR will proceed with a prudent monetary policy and with cleaning up the banking sector. Even with an oil price above USD 60/bbl and associated higher export and fiscal revenues, substantially higher GDP growth (above 2% per year) is unlikely in an environment of rising autarky and international isolation. Most importantly, with this meagre growth rate the Russian economy will not catch up with its more advanced EU-CEE peers – to say nothing of China. Nor will it help to underpin the country's aspirations to (re)gain geopolitical parity with the USA. The next presidential term of Mr Putin may thus resemble closely the late Soviet period of stagnation under Leonid Brezhnev. It remains to be seen whether it will be followed by a Gorbachev-like 'perestroika' or otherwise.

A revival of dialogue with the EU could happen in the wake of the new coalition government in Germany, yet a normalisation of Russia's relations with its neighbours (especially Ukraine, but also Poland and the Baltics) will be difficult, and the damage incurred so far will be lasting. A revival of the Minsk process and an agreement on more OSCE involvement in Ukraine would be helpful. Whether Putin's next presidency brings any change in domestic economic policies remains to be seen. With respect to external policies, no major turnaround is expected, and many uncertainties and associated risks (relations with the EU and the US, Donbas, the future of the Eurasian Economic Union, etc.) will persist.

To sum up, the forecast GDP growth will remain at below 2% per year in the medium term, and the process of economic convergence will thus stall. This is a disappointing performance for an emerging economy with aspirations to regain its superpower status – especially given the fairly robust growth in the US, EU, China and elsewhere.

Table 26 / Russian Federation: Selected economic indicators

	2013	2014	2015	2016	2017 [1]	2018	2019 Forecast	2020
Population, th pers., average	143,507	146,091	146,406	146,675	146,841	146,400	146,300	146,200
Gross domestic product, RUB bn, nom.	73,134	79,200	83,387	85,918	92,082	97,400	103,900	110,800
annual change in % (real)	1.8	0.7	-2.5	-0.2	1.5	1.8	1.6	1.6
GDP/capita (EUR at PPP)	19,300	18,800	17,900	17,000	17,300	.	.	.
Consumption of households, RUB bn, nom.	38,465	42,016	43,337	44,901	47,955	.	.	.
annual change in % (real)	5.2	2.0	-9.4	-2.8	3.4	3.0	1.5	2.0
Gross fixed capital form., RUB bn, nom.	15,926	16,828	16,942	18,403	19,944	.	.	.
annual change in % (real)	1.3	-1.8	-11.2	0.8	3.6	2.0	2.0	2.0
Gross industrial production [2]								
annual change in % (real)	0.4	1.7	-0.8	1.3	1.0	2.0	3.0	3.0
Gross agricultural production								
annual change in % (real)	5.8	3.5	2.6	4.8	2.4	.	.	.
Construction output [3]								
annual change in % (real)	0.1	-2.3	-4.8	-2.2	-1.4	.	.	.
Employed persons, LFS, th, average	71,392	71,539	72,324	72,393	72,142	72,300	72,200	72,200
annual change in %	-0.2	0.2	-0.4	0.1	-0.3	0.2	-0.1	0.0
Unemployed persons, LFS, th, average	4,137	3,889	4,264	4,243	3,967	4,100	4,000	4,000
Unemployment rate, LFS, in %, average	5.5	5.2	5.6	5.5	5.2	5.4	5.2	5.2
Reg. unemployment rate, in %, eop [4]	1.2	1.2	1.3	1.2	1.0	.	.	.
Average monthly gross wages, RUB	29,792	32,495	34,030	36,709	39,085	42,300	46,200	50,500
annual change in % (real, gross)	4.8	1.2	-9.3	0.8	3.4	4.0	5.0	5.0
Consumer prices, % p.a.	6.8	7.8	15.5	7.1	3.6	4.0	4.0	4.0
Producer prices in industry, % p.a. [5]	3.3	6.4	13.5	4.2	7.7	5.0	5.0	5.0
General governm.budget, nat.def., % of GDP								
Revenues	33.4	33.8	32.3	32.8	35.0	35.0	35.0	35.0
Expenditures	34.6	34.9	35.7	36.5	37.5	38.0	38.0	37.5
Deficit (-) / surplus (+)	-1.2	-1.1	-3.4	-3.7	-2.5	-3.0	-3.0	-2.5
General gov.gross debt, nat.def., % of GDP	10.3	13.0	13.1	12.9	13.0	14.0	15.0	16.0
Stock of loans of non-fin.private sector, % p.a.	17.1	25.9	7.6	-6.9	3.5	.	.	.
Non-performing loans (NPL), in %, eop [6]	3.5	3.8	5.3	5.2	5.2	.	.	.
Central bank policy rate, % p.a., eop [7]	5.50	17.00	11.00	10.00	7.75	6.50	6.00	6.00
Current account, EUR mn [8]	25,164	43,477	61,898	23,064	35,609	49,900	44,800	39,200
Current account, % of GDP [8]	1.5	2.8	5.0	2.0	2.5	3.4	3.0	2.4
Exports of goods, BOP, EUR mn [8]	392,827	375,561	307,040	254,498	313,308	336,000	352,800	366,900
annual change in %	-4.3	-4.4	-18.2	-17.1	23.1	7.2	5.0	4.0
Imports of goods, BOP, EUR mn [8]	256,901	232,739	173,585	172,996	210,732	222,000	233,100	247,100
annual change in %	-1.6	-9.4	-25.4	-0.3	21.8	5.3	5.0	6.0
Exports of services, BOP, EUR mn [8]	52,787	49,700	46,491	45,648	51,465	54,200	57,500	58,600
annual change in %	8.8	-5.8	-6.5	-1.8	12.7	5.3	6.1	1.9
Imports of services, BOP, EUR mn [8]	96,643	91,487	79,694	67,163	78,216	80,900	85,000	89,200
annual change in %	14.1	-5.3	-12.9	-15.7	16.5	3.4	5.1	4.9
FDI liabilities, EUR mn [8]	52,107	16,655	6,163	29,381	18,100	.	.	.
FDI assets, EUR mn [8]	65,120	43,151	19,861	20,149	21,300	.	.	.
Gross reserves of NB excl. gold, EUR mn [8][9]	341,787	279,383	292,467	301,871	297,823	.	.	.
Gross external debt, EUR mn [8]	530,481	493,861	474,681	488,752	442,504	436,100	455,000	481,700
Gross external debt, % of GDP [8]	30.7	31.7	38.6	42.2	31.7	30.0	30.0	30.0
Average exchange rate RUB/EUR	42.27	50.77	67.76	74.26	65.87	67.0	68.5	69.0

Note: From 2014 including Crimean Federal District (for LFS and wages from 2015, growth rates for employment and real wages from 2016).

1) Preliminary and wiiw estimates. - 2) Excluding small enterprises. Until 2014 according to NACE Rev.1. - 3) Until 2016 according to NACE Rev.1. -4) In % of labour force (LFS). - 5) Domestic output prices, in 2013 according to NACE Rev.1. - 6) According to Russian Accounting Standards overdue debt is defined as debt service overdue, therefore the data are not fully comparable with other countries. - 7) One-week repo rate. - 8) Converted from USD. - 9) Including part of resources of the Reserve Fund (until 2017) and the National Wealth Fund of the Russian Federation.

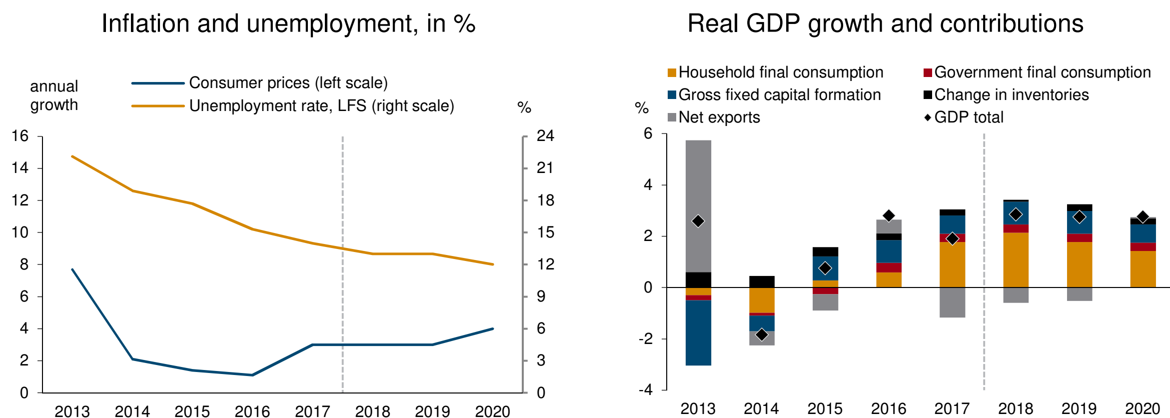
Source: wiiw Databases incorporating national statistics. Forecasts by wiiw.

SERBIA: Slow recovery continues

VLADIMIR GLIGOROV

Slow recovery and tenuous political stability is the medium-term prospect. This means growth of around 3% on average in the medium run. A recovery of agriculture may push growth up this year, political support for the government may weaken and depress investment and growth in the medium run.

Figure 57 / Serbia: Main macroeconomic indicators



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

Last year's performance was disappointing, with GDP growth of 1.9%. Manufacturing advanced, but electricity production underperformed, and agriculture suffered from bad weather. On the demand side, investments grew less than expected, in part because of slow implementation of public projects, while consumption increased after few years of stagnation and slow growth. Exports continued to grow, but imports speeded up, with net exports contributing negatively to growth of GDP in 2017. Employment continued to grow, with the unemployment rate also declining. However, the continued improvement of the labour market with disappointing growth of production indicated a decline in productivity. Also, real wage growth is very slow, while the average wage is low, e.g. by regional standards.

Official forecasts, by the government and by the Fiscal Council, are optimistic at least for this year. The economy is seen expanding by 3.5% to 4%. The forecasts for the medium term diverge, with the government expecting growth to accelerate to 4% by 2020, while the Fiscal Council worries that the underlying potential growth rate is closer to 3%. All see the potential for a growth speed-up in more

public investments and in increasing private consumption, e.g. through higher public-sector wages and pensions.

A change in fiscal policy, primarily, is seen as manageable due to an improved fiscal position, credited to the programme of fiscal consolidation from 2015. This year's fiscal deficit is below 1% of GDP and should remain close to 1% in the medium term. In addition, a stronger dinar and lower interest rates have contributed to the decline of the public debt to GDP ratio, which is officially expected to be close to 60% at the end of this year. In addition, nominal GDP is growing faster due to some speed-up of inflation, which is now around 3%.

Interestingly, public revenues have also been supported by growing imports. VAT is the most important source of the general government budget, besides social contributions. Together with excises, growing imports are quite supportive of fiscal balances. Of course, they also lead to higher foreign financial obligations, with the net foreign investment position being above 100% of GDP now.

Overall, the new economic policy stance is in a way a reversal to the one preceding the 2008 crisis: domestic consumption plus foreign investments. Aggregate domestic consumption is around 90% of GDP while investments are around 18% of GDP. If both continue to grow as intended and if domestic consumption advances faster than GDP, investments will have to be increasingly financed from foreign sources. That is a possible development if indeed, as has been the case historically, and certainly before 2008, imports grow faster than exports. With current elasticities, that is to be expected.

In addition, the central bank has let the dinar appreciate in 2017 and seems intent on continuing to implement a fixed exchange rate policy to support foreign financial inflows and consumption and also as a way to control inflation, which is the policy followed in the past, e.g. between 2004 and 2008. This time it may be somewhat different because the economy is more open, in terms of exports to GDP, now than it was then, but it remains to be seen how resilient the exporting sector has become.

Assuming a recovery of agriculture and industry, electricity production in particular, GDP could grow by around 3% in the medium term. There is some substitutability between agriculture and industry because better weather conditions support growth of the former but not of the latter. Also, investments in both are not growing, which is why they are so dependent on the climate. So, while an average year in agricultural production will support economic recovery this year, it will do nothing in the medium term with risk exposure to changing weather staying as it is. So, having in mind that growth was just 2.6% in the fourth quarter of 2017 when the effects of bad weather had already been gone, it is probably realistic to expect slow recovery of up to 2.8% growth in 2018 and up to 3% in 2019 and 2020.

Given the economic strategy of reliance on foreign investments, and increasingly on public investments too, political risks are seen as important, which is why there is an effort to improve international relations as much as possible. In that, regional normalisation is of key importance. That, however, is a very slow process, as is the negotiation with the EU. Also, internally and internationally normalisation efforts is are under constant pressure from nationalists and their international supporters, not only in Russia, but from populists everywhere. Finally, the current government has been in charge for six years now with not much to show in terms of welfare and political and institutional development and so public support is declining and politics may become more uncertain in the medium term.

Overall, a slow recovery and tenuous political stability is the medium-term prospect. This means growth of around 3% on average in the medium run, which is close to the past forecast. The upside risks are a good year for agriculture and better than anticipated foreign investments due to sustained recovery in the EU. Downside risks are mostly political as support for the government wanes in the medium run.

Table 27 / Serbia: Selected economic indicators

	2013	2014	2015	2016	2017 [1]	2018	2019	2020
							Forecast	
Population, th. pers., mid-year	7,167	7,132	7,095	7,058	7,000	7,000	7,000	6,950
Gross domestic product, RSD bn, nom.	3,876	3,908	4,043	4,262	4,500	4,800	5,100	5,500
annual change in % (real)	2.6	-1.8	0.8	2.8	1.9	2.8	2.8	2.8
GDP/capita (EUR at PPP)	10,100	10,100	10,500	10,700	11,000	.	.	.
Consumption of households, RSD bn, nom.	2,886	2,922	2,982	3,041	3,211	.	.	.
annual change in % (real)	-0.4	-1.3	0.4	0.8	2.5	3.0	2.5	2.0
Gross fixed capital form., RSD bn, nom.	668	652	715	756	804	.	.	.
annual change in % (real)	-12.0	-3.6	5.6	5.1	4.0	5.0	5.0	4.0
Gross industrial production [2]								
annual change in % (real)	5.4	-6.4	8.3	4.7	2.0	4.0	5.0	4.0
Gross agricultural production								
annual change in % (real)	21.8	2.4	-8.4	8.3	-12.0	.	.	.
Construction output								
annual change in % (real)	-20.0	2.4	20.9	7.1	6.9	.	.	.
Employed persons, LFS, th, average [3]	2,311	2,421	2,574	2,719	2,790	2,850	2,910	2,940
annual change in %	3.7	4.8	0.6	5.6	2.6	2.0	2.0	1.0
Unemployed persons, LFS, th, average [3]	656	563	552	489	490	430	430	400
Unemployment rate, LFS, in %, average [3]	22.1	18.9	17.7	15.3	15.0	13.0	13.0	12.0
Reg. unemployment rate, in %, eop [4]	29.1	28.4	26.8	25.7	23.0	.	.	.
Average monthly gross wages, RSD	60,708	61,426	61,145	63,474	66,700	70,100	73,600	78,100
annual change in % (real, gross)	-1.9	-1.7	-2.4	2.6	2.0	2.0	2.0	2.0
Average monthly net wages, RSD	43,932	44,530	44,432	46,097	48,400	50,800	53,400	56,600
annual change in % (real, net)	-1.5	-1.5	-2.1	2.5	2.5	2.0	2.0	2.0
Consumer prices, % p.a.	7.7	2.1	1.4	1.1	3.0	3.0	3.0	4.0
Producer prices in industry, % p.a.	2.7	1.3	1.0	0.0	2.3	1.2	2.0	3.0
General governm.budget, nat.def., % of GDP								
Revenues	39.7	41.5	41.9	43.2	44.0	44.0	44.0	43.0
Expenditures	45.1	48.1	45.6	44.5	45.0	45.0	46.0	46.0
Deficit (-) / surplus (+)	-5.5	-6.6	-3.7	-1.3	-1.0	-1.0	-2.0	-3.0
General gov.gross debt, nat.def., % of GDP	59.6	70.4	74.7	71.9	68.0	68.0	68.0	67.0
Stock of loans of non-fin.private sector, % p.a.	-4.9	4.5	3.0	2.3	2.1	.	.	.
Non-performing loans (NPL), in %, eop	21.4	21.5	21.5	17.0	17.0	.	.	.
Central bank policy rate, % p.a., eop [5]	9.50	8.00	4.50	4.00	3.50	3.75	4.00	4.00
Current account, EUR mn	-2,098	-1,985	-1,577	-1,075	-1,800	-2,100	-2,500	-2,700
Current account, % of GDP	-6.1	-6.0	-4.7	-3.1	-4.9	-5.4	-6.1	-6.2
Exports of goods, BOP, EUR mn	10,515	10,641	11,357	12,814	14,400	15,400	16,500	17,800
annual change in %	25.5	1.2	6.7	12.8	12.4	7.0	7.0	8.0
Imports of goods, BOP, EUR mn	14,674	14,752	15,350	15,933	18,200	19,500	20,900	22,600
annual change in %	4.7	0.5	4.1	3.8	14.2	7.0	7.0	8.0
Exports of services, BOP, EUR mn	3,422	3,810	4,273	4,571	5,030	5,300	5,700	6,200
annual change in %	10.6	11.3	12.2	7.0	10.0	6.0	7.0	8.0
Imports of services, BOP, EUR mn	3,109	3,344	3,548	3,664	3,950	4,400	4,800	5,100
annual change in %	4.3	7.6	6.1	3.3	7.8	9.0	8.0	7.0
FDI liabilities, EUR mn	1,548	1,500	2,114	2,127	2,100	.	.	.
FDI assets, EUR mn	250	264	310	228	100	.	.	.
Gross reserves of NB, excl. gold, EUR mn	10,734	9,351	9,812	9,543	9,287	.	.	.
Gross external debt, EUR mn [6]	25,644	25,679	26,234	26,488	28,000	27,000	28,000	29,000
Gross external debt, % of GDP [6]	74.8	77.1	78.3	76.5	75.5	69.0	68.0	66.0
Average exchange rate RSD/EUR	113.14	117.31	120.76	123.12	121.34	123	124	126

1) Preliminary and wiiw estimates. -2) Excluding arms industry. - 3) In 2013 survey of April and October, quarterly thereafter. From 2015 adjustments according to ILO, Eurostat and EU-LFS. - 4) From 2015 new source for labour force potential. -
5) Two week repo rate. - 6) BOP 5th Edition.

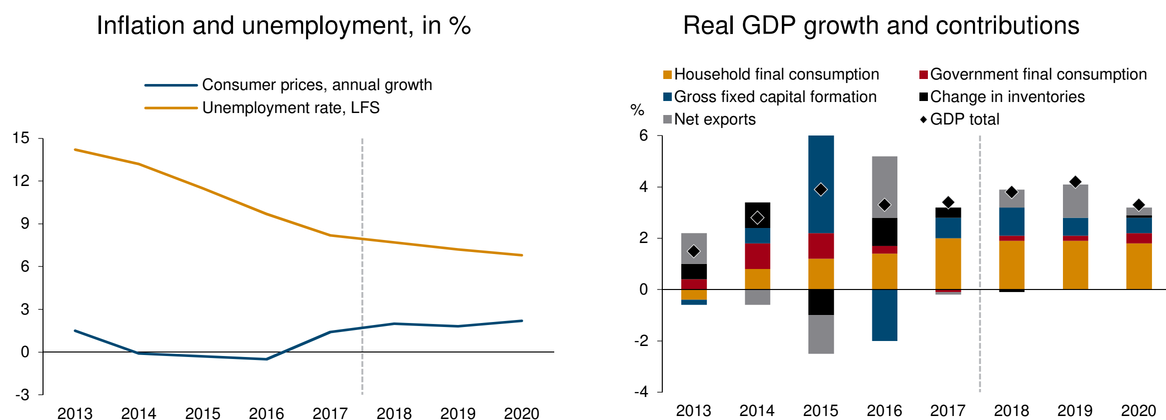
Source: wiiw Databases incorporating national statistics. Forecasts by wiiw.

SLOVAKIA: Future growth constrained by labour shortages

DORIS HANZL-WEISS

Slovakia grew at a solid pace throughout 2017, fostered by accelerating household consumption. Forecasts for this and the next year amount to 3.8% and around 4%, respectively, thanks to capacity increases in the automotive industry, before falling back to 3.3% in 2020. However, growing wages and labour shortages may threaten future growth prospects.

Figure 58 / Slovakia: Main macroeconomic indicators



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

The stable growth performance has been driven mainly by household consumption. In 2017, Slovak real GDP expanded by 3.4% year on year, only slightly more than in 2016 (3.3%). Although stable, this was below the average of the Central and East European EU countries (EU-CEE) and represented one of the lowest growth rates in the EU-CEE region. Household consumption was the main growth driver, thanks to favourable developments in the labour market. In fact, growth of household consumption accelerated over the first three quarters of 2017 and reached a peak of 3.7%, the highest rate since the 2008 recession. It was backed by rising employment and declining unemployment rates: the number of employed persons increased by 1.5% while the unemployment rate (LFS) fell by 1.5pp to 8.2%. Although the latter rate appears to be high in comparison with other neighbouring countries, it was in fact at a historic low level in Slovakia. Moreover, strong regional differences continue to exist within Slovakia, with low unemployment rates in the West – where most of the manufacturing companies are located – and high unemployment rates in the East with fewer job opportunities.

Household consumption has been fostered by growing wages. Real wages grew by 3.3% in the first three quarters of 2017, still at moderate levels. Inflation made up part of nominal wage increase and reached 1.4% in 2017, after three years of deflation. Wages are pushed up by administrative measures, e.g. government measures to introduce surcharges for night and weekend work (in two steps, May 2018 and May 2019) or continuous increases in the minimum wage. Also, the shortage of skilled labour puts pressure on wages to rise. There is a risk of labour-intensive jobs moving out of Slovakia, also discouraging new foreign investors. At the beginning of 2018, Samsung confirmed that it will shut down its smaller plant in Voderady probably already in April; production and employees are said to move to the Galanta plant (in Western Slovakia). Entrepreneurs have called for legislation to be simplified allowing foreign workers (in particular, Ukrainians and Serbs) to work legally in Slovakia – a step that has been accomplished recently.

Investments are still underperforming. While investment picked up finally in the third quarter of 2017 (+10% in Q3 year on year), gross fixed capital formation was still underperforming over the first three quarters of 2017 (2%). The construction sector improved only marginally, also due to the delay of major infrastructure projects, such as the construction of the Bratislava Ring Road. The never-ending project, the construction of the Bratislava-Košice motorway, may be finished in 2026 ‘at the earliest’. Absorption of EU funds has been typically slow in Slovakia. Overall, however, inventories were built up, raising gross capital formation by 6% in the first three quarters of 2017.

Industrial production went up but automotive industry growth was low in 2017. Regarding the sectoral structure, industrial production grew by 4% in 2017 on an annual basis. Overall, the major industrial sector in Slovakia – the automotive industry – showed a weak performance in 2017 and contributed to growth only at the end of the year. The three Slovak car plants – VW Bratislava, KIA Motors and PSA Peugeot-Citroën – produced a slightly lower number of cars in 2017 than the year before (1.025 million compared to 1.04 million). Still, Slovakia has remained on the first place as the largest car producer per capita worldwide. A change of models and the new Jaguar Land Rover plant (starting production at the end of 2018) will provide a new growth impetus in the coming years. The main sectors contributing to growth in 2017 were thus basic metals & fabricated metal products and rubber & plastic & other non-metallic mineral products, followed by transport and electrical equipment. Only two industries showed declining production figures: computer, electronic & optical products and the textile & leather sector.

The external sector had a slightly negative impact on growth. Goods imports increased faster than goods exports over the first eleven months of 2017. Goods imports rose by 8.6% whereas exports increased by about 7%. While exports to Slovakia’s main trading partner Germany declined slightly (by 1%), those to the Czech Republic (Slovakia’s second major trading partner) rose by some 4%. The trade balance was positive with a surplus of EUR 1 billion (balance of payments statistics). Looking at services trade, exports expanded more dynamically with 10% (e.g. transport services), whereas imports rose by 4%. Overall, the impact of net exports on growth was most probably slightly negative for the whole year 2017. The balance of payments for 2017 remained negative as negative primary and secondary incomes outweighed positive goods and services trade balances.

There are new general government deficit and debt targets. The government deficit figure for 2016 has been revised and became larger, finally reaching -2.2% (instead of -1.7%), while the debt to GDP ratio remained at 51.8%. For 2017, the estimated figures are at 1.6% and 50.9%, respectively. The

General Government Budget Proposal 2018-2020 foresees deficit figures at -0.8% for 2018 and -0.3% for 2019 and 2020. However, these figures must be regarded as lower limits as they are constantly being revised upwards. For 2018, the impact of social measures on the budget is still unclear; wages of civil servants increased as of 1 January. Furthermore, changes within the Fiscal Responsibility Law have to be kept in mind: Thresholds for the debt to GDP ratio will decline from the fiscal year 2018 onwards (the 50-60% debt to GDP thresholds will continuously decline, by 1 percentage point per year, to 40% by 2027).

Capacity increases in the automotive industry will spur growth in the coming years, but some shadows are still ahead. The wiiw forecast for this year and the next has been revised slightly upwards due to stronger expected household consumption. For 2018, growth is going to reach 3.8%; it will accelerate and amount to more than 4% in 2019 before falling back to about 3.3% in 2020. With the new Jaguar Land Rover car manufacturing plant – planned to start operation at the end of 2018 – exports will increase and provide a major impetus to growth. Besides, the booming economy in Slovakia's main trading partners (Germany, Czech Republic) with rising private consumption in these countries will support Slovak exports. In addition, growing household consumption will form the basis of sustained growth. A substantial recovery of investment will occur only beyond the time horizon of our forecast, owing to delayed drawing of EU funds. The booming automotive industry in Slovakia has attracted new investment, plants and suppliers in recent years. Hence, the information that one of the Samsung plants is closing down comes as a surprise. Overall, Samsung is listed as the fourth largest company in Slovakia (after Volkswagen Bratislava, Kia Motors, and Slovnaft, and before PSA Peugeot-Citroën) and flat TV screens are a major export item apart from cars and car parts. Thus, the main risks to our forecast are growing labour shortages and the consequences thereof. External risks such as the Brexit and possible related shrinkage of EU funds remain but will materialise only in the longer run.

Table 28 / Slovakia: Selected economic indicators

	2013	2014	2015	2016	2017 [1]	2018	2019	2020
							Forecast	
Population, th pers., average	5,413	5,419	5,424	5,431	5,430	5,440	5,440	5,450
Gross domestic product, EUR mn, nom.	74,170	76,088	78,896	81,154	83,490	88,400	93,800	99,000
annual change in % (real)	1.5	2.8	3.9	3.3	3.4	3.8	4.2	3.3
GDP/capita (EUR at PPP)	20,500	21,300	22,300	22,400	23,300	.	.	.
Consumption of households, EUR mn, nom.	41,084	41,605	42,496	43,473	44,900	.	.	.
annual change in % (real)	-0.8	1.4	2.3	2.6	3.8	3.6	3.5	3.3
Gross fixed capital form., EUR mn, nom.	15,374	15,772	18,890	17,196	17,470	.	.	.
annual change in % (real)	-0.9	3.0	19.8	-8.3	2.1	5.0	3.5	3.0
Gross industrial production								
annual change in % (real)	3.8	3.6	7.3	4.8	3.9	5.0	6.0	3.0
Gross agricultural production								
annual change in % (real)	6.7	7.4	-3.2	13.9	-9.6	.	.	.
Construction industry								
annual change in % (real)	-5.3	-4.1	17.9	-10.7	3.2	.	.	.
Employed persons, LFS, th, average	2,329	2,363	2,424	2,492	2,530	2560	2580	2600
annual change in %	0.0	1.5	2.6	2.8	1.5	1.0	0.7	0.7
Unemployed persons, LFS, th, average	386	359	314	267	230	210	200	190
Unemployment rate, LFS, in %, average	14.2	13.2	11.5	9.7	8.2	7.7	7.2	6.8
Reg. unemployment rate, in %, eop	13.5	12.3	10.6	8.8	5.9	.	.	.
Average monthly gross wages, EUR	824	858	883	912	960	1010	1060	1120
annual change in % (real, gross)	1.0	4.2	3.2	3.8	3.3	3.5	3.5	3.0
Consumer prices (HICP), % p.a.	1.5	-0.1	-0.3	-0.5	1.4	2.0	1.8	2.2
Producer prices in industry, % p.a.	-1.0	-3.5	-2.9	-4.1	2.4	3.0	2.5	2.5
General governm.budget, EU-def., % of GDP								
Revenues	38.7	39.3	42.5	39.3	39.8	39.8	40.2	39.5
Expenditures	41.4	42.0	45.2	41.5	41.4	40.9	40.7	39.7
Net lending (+) / net borrowing (-)	-2.7	-2.7	-2.7	-2.2	-1.6	-1.1	-0.6	-0.2
General gov.gross debt, EU def., % of GDP	54.7	53.5	52.3	51.8	51.1	49.4	48.5	47.3
Stock of loans of non-fin.private sector, % p.a.	5.4	6.7	9.7	9.3	9.9	.	.	.
Non-performing loans (NPL), in %, eop	5.8	6.0	5.2	4.7	3.9	.	.	.
Central bank policy rate, % p.a., eop [2]	0.25	0.05	0.05	0.00	0.00	.	.	.
Current account, EUR mn	1,379	871	-1,391	-1,205	-1,000	-500	300	500
Current account, % of GDP	1.9	1.1	-1.8	-1.5	-1.2	-0.6	0.3	0.5
Exports of goods, BOP, EUR mn	62,410	62,581	64,650	67,206	70,200	74,800	81,200	85,000
annual change in %	3.7	0.3	3.3	4.0	4.5	6.5	8.5	4.7
Imports of goods, BOP, EUR mn	59,503	59,823	63,601	65,542	68,800	72,900	78,400	81,900
annual change in %	3.2	0.5	6.3	3.1	5.0	6.0	7.6	4.5
Exports of services, BOP, EUR mn	6,965	6,889	7,301	7,588	8,300	8,700	9,000	9,300
annual change in %	15.1	-1.1	6.0	3.9	9.4	5.0	3.0	3.0
Imports of services, BOP, EUR mn	6,481	6,713	7,144	7,180	7,400	7,800	8,200	8,600
annual change in %	15.2	3.6	6.4	0.5	3.1	5.0	5.0	5.0
FDI liabilities, EUR mn	757	-324	1,357	3,234	3,000	.	.	.
FDI assets, EUR mn	976	94	1,266	3,725	2,500	.	.	.
Gross reserves of NB excl. gold, EUR mn	670	1,165	1,648	1,624	1,609	.	.	.
Gross external debt, EUR mn	60,444	67,776	67,225	73,750	80,000	82,500	84,000	85,500
Gross external debt, % of GDP	81.5	89.1	85.2	90.9	95.8	93.3	89.6	86.4

1) Preliminary and wiiw estimates. - 2) Official refinancing operation rates for euro area (ECB).

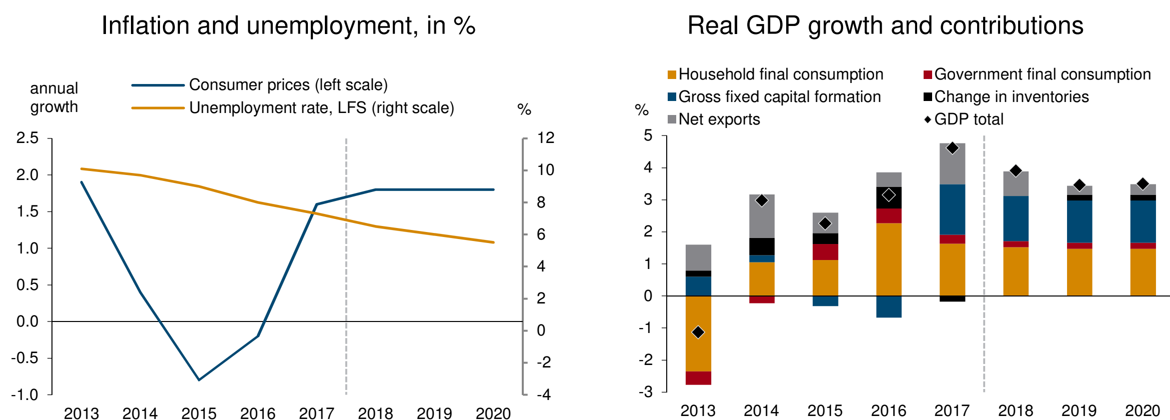
Source: wiiw Databases incorporating Eurostat and national statistics. Forecasts by wiiw.

SLOVENIA: Solid growth set to continue

HERMINE VIDOVIC

GDP growth is set to remain high (3.6% p.a.) in the forecasting period, albeit moderating from the peak of 2017. Domestic demand and exports are expected to be the main growth drivers. The general government deficit and public debt ratios will continue declining. Upcoming elections will result again in a broad coalition.

Figure 59 / Slovenia: Main macroeconomic indicators



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

Slovenia's GDP is estimated to have grown by 4.6% in 2017, which was far above earlier expectations. Growth was mainly driven by household consumption, exports and rebounding investments. The rise in investments, coupled with a recovery in the real estate market, has translated into an increase in construction activities (18%), particularly in buildings and, to a lesser extent, in civil engineering. Investments in machinery and equipment continued to grow as well. Industrial production expanded by 7.4%, with the strongest output increases reported for the car-manufacture, leather, machinery and equipment, and electrical equipment industries.

The labour market continued to improve quite significantly. Labour Force Survey data indicate an employment increase of close to 4% in 2017 and a fall in the unemployment rate to 7.3%, which is, however, still higher than in the pre-crisis period. Jobs were created particularly in the low-skill segment, and the employment of foreigners has been on the increase. In the first ten months of 2017, a total of 76,000 foreign workers were registered, mainly from the Western Balkans (Bosnia and Herzegovina, in

particular); they tend to work in construction, manufacturing and transport. Future employment creation will be constrained by demographic change, including population ageing and a declining labour force. Average real net wages rose only modestly in 2017, by 1.5%. In the medium term, the tightening of the labour market and labour shortages may bring upward pressure on wages. After two years of deflation, consumer prices rose by 1.6% in 2017, mainly driven by energy prices.

External trade expanded remarkably in 2017, with goods exports and imports up 13.8% and 14.4%, respectively, closing with a higher surplus than a year earlier. Services trade, too, reported double-digit growth rates, with the surplus widening thanks to exports – travel, transport, construction and technical, trade-related and other business services in particular – rising faster than imports. Tourism reported another record year, with overnight stays increasing by 11%. The deficit in both the primary and the secondary income balance has been narrowing. Hence, the current account surplus increased over 2016 and amounted to an estimated 6.5% of GDP. Foreign direct investment inflows in 2017 were by EUR 390 million lower than in 2016, amounting to EUR 920 million.

Public finances benefited from strong GDP growth in 2017. The general government deficit narrowed to an estimated 0.8% of GDP, and the share of the public debt to GDP decreased to 76%. The deficit reduction was primarily made possible through a marked increase in revenues (6.1%), mainly from taxes (VAT, personal and corporate income taxes). Expenditure rose by 1.7%, especially on investments in maintenance and construction of roads, but also on healthcare, due to the bailout of hospitals and rising wages. Interest payments fell after almost half of the outstanding USD-denominated bonds were bought back. As for 2018, the government envisages a surplus of 0.4% of GDP, which seems feasible, given the favourable growth forecast. Thus, public debt is expected to continue its downward path to about 70% by the end of the forecasting period.

The sale of Nova Ljubljanska Banka (NLB) is becoming a never-ending story. The privatisation of the country's biggest bank formed part of the restructuring plan submitted to the European Commission in December 2013, in order to gain approval for state aid used for the bank's bailout. In May 2017, the Commission accepted Slovenia's request to sell 50% of NLB by the end of 2017 (rather than 75%, as originally agreed upon in 2013) and the remainder by the end of 2018. Slovenia put the sale on hold in June 2017, and in late January 2018 the Commission launched an in-depth investigation to assess whether new measures proposed by the Slovenian authorities regarding the restructuring of NLB (primarily a three-year extension on the sales deadline) provide sufficient compensation for delaying the bank's sale beyond the end of 2017.

In the first 11 months of 2017, Slovenian banks' net profits increased by 15% year on year, to EUR 400 million. Lending activities to the corporate sector started to increase in mid-2017, thanks to new investment loans rather than to refinancing of existing liabilities. Lending to the household sector strengthened further, with respect to both consumer loans and housing loans. Non-performing loans have been steadily on the decline, accounting for 4.6% of total loans in 2017, down from 5.5% a year earlier.

Parliamentary elections are to be held in May or June 2018. Recent opinion polls have shown the former presidential candidate Marjan Šarec (a former comedian) to be in the lead, followed by the Social Democrats and the Slovenian Democratic Party, headed by Janez Janša, a former prime minister. The party of Prime Minister Miro Cerar of the Modern Centre lags far behind, in fourth place. No matter what the outcome of the elections, there will have to be a coalition of several parties again.

After surging in 2017, economic growth is expected to moderate, running at about 3.6% annually in the period 2018 to 2020. Growth will be supported by domestic demand and exports. Household consumption will remain an important driver, boosted by rising employment, wages and bank lending. Investment growth is expected to remain at high levels, fuelled by EU transfers under the current financial perspective. This will also translate into a recovery in construction, hit hard by the financial crisis. The labour market situation is expected to improve further over the forecast horizon, not least because of the shrinking working-age population. Inflation will remain moderate (below 2%) over the forecast horizon. The current account surplus is forecast to narrow, due to a strengthening of domestic demand and accelerating imports. Earnings from services exports – travel and transport – will remain high.

Table 29 / Slovenia: Selected economic indicators

	2013	2014	2015	2016	2017 [1]	2018	2019	2020
							Forecast	
Population, th pers., average	2,060	2,062	2,064	2,065	2,066	2,066	2,066	2,066
Gross domestic product, EUR mn, nom.	36,239	37,615	38,837	40,418	43,000	45,500	47,900	50,500
annual change in % (real)	-1.1	3.0	2.3	3.1	4.6	3.9	3.5	3.5
GDP/capita (EUR at PPP)	21,900	22,700	23,800	24,100	25,300	.	.	.
Consumption of households, EUR mn, nom.	19,785	20,141	20,437	21,250	22,300	.	.	.
annual change in % (real)	-4.2	1.9	2.1	4.3	3.1	2.9	2.8	2.8
Gross fixed capital form., EUR mn, nom.	7,175	7,292	7,322	7,105	7,900	.	.	.
annual change in % (real)	3.1	1.1	-1.7	-3.6	9.0	8.0	7.5	7.5
Gross industrial production								
annual change in % (real)	-1.0	2.2	5.6	7.1	7.4	5.0	4.5	4.5
Gross agricultural production								
annual change in % (real)	-1.9	11.1	3.7	-3.6	-9.8	.	.	.
Construction industry [2]								
annual change in % (real)	-2.6	19.5	-8.1	-17.8	17.8	.	.	.
Employed persons, LFS, th, average	906	917	917	915	950	960	980	990
annual change in %	-1.9	1.2	0.1	-0.3	3.8	1.5	2.0	1.5
Unemployed persons, LFS, th, average	102	98	90	80	75	67	63	58
Unemployment rate, LFS, in %, average	10.1	9.7	9.0	8.0	7.3	6.5	6.0	5.5
Reg. unemployment rate, in %, eop	13.5	13.0	12.3	10.8	8.9	.	.	.
Average monthly gross wages, EUR [3]	1,523	1,540	1,556	1,585	1,625	1,680	1,740	1,800
annual change in % (real, gross)	-2.0	0.9	1.2	1.9	1.1	1.5	1.5	1.5
Average monthly net wages, EUR [3]	997	1,005	1,013	1,030	1,060	1,100	1,140	1,180
annual change in % (real, net)	-1.2	0.6	0.9	1.8	1.5	1.5	1.6	2.0
Consumer prices (HICP), % p.a.	1.9	0.4	-0.8	-0.2	1.6	1.8	1.8	1.8
Producer prices in industry, % p.a.	0.0	-0.7	-0.3	-1.3	2.1	2.0	2.0	2.0
General governm.budget, EU-def., % of GDP								
Revenues	44.8	44.3	44.9	43.3	42.8	42.5	42.2	42.0
Expenditures	59.5	49.6	47.7	45.1	43.6	42.5	41.8	42.0
Net lending (+) / net borrowing (-)	-14.7	-5.3	-2.9	-1.9	-0.8	0.0	0.4	0.0
General gov.gross debt, EU def., % of GDP	70.4	80.3	82.6	78.5	76.4	74.0	72.5	70.0
Stock of loans of non-fin.private sector, % p.a.	-16.1	-13.7	-6.4	-4.0	2.7	.	.	.
Non-performing loans (NPL), in %, eop	13.4	11.9	9.9	5.5	4.6	.	.	.
Central bank policy rate, % p.a., eop [4]	0.25	0.05	0.05	0.00	0.00	.	.	.
Current account, EUR mn	1,594	2,179	1,698	2,108	2,813	2,500	2,040	1,840
Current account, % of GDP	4.4	5.8	4.4	5.2	6.5	5.5	4.3	3.6
Exports of goods, BOP, EUR mn	21,692	22,961	24,039	24,991	28,448	31,010	33,180	35,500
annual change in %	2.1	5.9	4.7	4.0	13.8	9.0	7.0	7.0
Imports of goods, BOP, EUR mn	20,984	21,780	22,563	23,454	26,822	29,370	31,870	34,420
annual change in %	-1.7	3.8	3.6	3.9	14.4	9.5	8.5	8.0
Exports of services, BOP, EUR mn	5,318	5,558	5,866	6,410	7,148	7,720	8,300	8,800
annual change in %	4.1	4.5	5.5	9.3	11.5	8.0	7.5	6.0
Imports of services, BOP, EUR mn	3,586	3,862	4,007	4,236	4,584	4,930	5,250	5,570
annual change in %	-0.3	7.7	3.8	5.7	8.2	7.5	6.5	6.0
FDI liabilities, EUR mn	71	739	1,560	1,312	923	.	.	.
FDI assets, EUR mn	24	155	292	432	389	.	.	.
Gross reserves of NB excl. gold, EUR mn	580	736	687	593	632	.	.	.
Gross external debt, EUR mn	41,644	47,287	46,627	44,805	43,456	44,100	45,500	47,500
Gross external debt, % of GDP	114.91	125.71	120.06	110.85	101.06	97.0	95.0	94.0

1) Preliminary and wiiw estimates. - 2) Enterprises with 20 and more employees and output of some non-construction enterprises. - 3) From 2015 new data sources in public sector. - 4) Official refinancing operation rates for euro area (ECB).

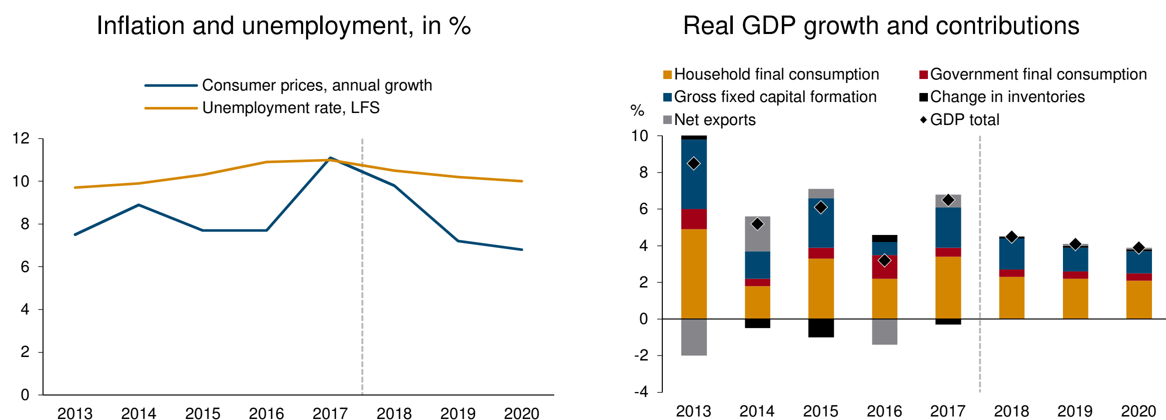
Source: wiiw Databases incorporating Eurostat and national statistics. Forecasts by wiiw.

TURKEY: Growth will remain strong but external risks are significant

RICHARD GRIEVESON

The economy had a strong 2017, underpinned by significant government stimulus and booming external demand. Growth will be lower during the forecast period, but still robust, driven by private consumption, and helped by benign external conditions. However, the downside risks are significant. The large external financing requirement will leave Turkey exposed to a sharper-than-expected hike in US rates or change in global investor sentiment.

Figure 60 / Turkey: Main macroeconomic indicators



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

The economy had a very good 2017, and is likely to continue growing fairly strongly during the forecast period. Real GDP growth is estimated to have reached 6.5% in 2017, on the back of significant government stimulus and robust foreign demand. Fiscal and monetary policy were highly supportive of growth, while the Credit Guarantee Fund (CGF) underpinned a strong expansion of lending. Booming foreign demand – not least from the EU – drove merchandise exports higher, while a surge of Russian tourists helped to offset continued declines in arrivals from Western Europe.

Some high frequency indicators suggest slower momentum towards end of 2017, but short-term momentum still remains strong in the context of the last few years. Consumer confidence fell somewhat towards the end of the year, likely reflecting the gradual withdrawal of stimulus measures (in particular the removal of tax incentives for the purchase of durable goods). However, employment,

industrial output (especially capital goods), credit and tourism growth were still high and/or rising in the final months of 2017. Notably, manufacturing growth strengthened in Q4 according to the purchasing managers' index (PMI), reflecting strong increases in both domestic and external demand, and contributing notably to a further uptick in employment.

There are two big questions for the Turkish economy during the forecast period: a) how much longer will the government continue to push the economy, and b) how much longer will the external boom last? The former will at least partly depend on the latter; a continuation or further strengthening of already robust foreign demand will make the government more confident about withdrawing stimulus measures. Our view is that, while there are clearly risks, the coordinated global upswing (evident in the eurozone, the US and China) will continue, which will further support export growth and contribute to the recovery in the tourism sector. Most importantly, this will keep global investor sentiment bullish, supporting continued portfolio inflows (see below).

As a result, we expect the economy to grow at around 4% during the forecast period, driven primarily by household consumption. Investment should also be supportive, although this will depend on a more sustained recovery in private fixed capital formation (which has so far been quite tentative, perhaps reflecting domestic and geopolitical uncertainty). External trade is unlikely to make a material positive contribution to growth, given strong increases in private consumption and the much larger absolute size of imports compared with exports. However, robust manufacturing export growth is likely to continue for as long as the EU upswing remains on course. Real exchange rate depreciation will remain a supportive factor for export growth, although the long-standing ability of Turkish exporters to switch between markets will be more decisive.

The labour market has performed strongly in recent quarters on the back of robust headline growth, and we expect this to continue. Headline employment growth has picked up, while the labour force participation and employment rates rose notably in 2017 compared with the previous year. As of October 2017, the unemployment rate stood at 10.3%, a 1.5 percentage point decline compared with 12 months earlier; this was particularly impressive considering the 3.2% increase in the size of the labour force over the same period. Further expansion of employment will be a key driver of private consumption growth during the forecast period.

As a result of strong external demand, and with employment growing, the government will feel more confident about easing off its stimulus. A significant further expansion of the CGF looks very unlikely (although it also won't be drawn down). The corporate tax rate has already been hiked by 2 percentage points for 2018-20, although a planned increase in income tax on one bracket was abandoned. Additional revenues from corporate taxation have been earmarked to support an increase in military spending.

Inflation will remain far above the central bank's 5% target this year, and will be slow to come down during the forecast period. Monetary policy was tightened quite significantly in 2017, although the market continues to view it as too loose. The combination of a weak lira (meaning higher import costs), rising domestic demand, and higher oil prices, pushed up price growth in 2017. Core inflation was above 12% in the final quarter of 2017. We expect all of these factors to remain relevant in 2018, which will keep inflation in double digits for the year as a whole. Beyond that, price growth should slow,

but only gradually, and will only get close to the central bank's target at the end of our forecast period. According to the central bank, medium-term inflation expectations hit an all-time high in 2017.

Relatively loose monetary policy and investor caution will probably keep the lira weak during 2018, although a sell-off on the scale of recent years is unlikely. The lira had a very weak second half of 2017, especially against the euro, but it has since stabilised and even come back a bit against the US dollar. The market was disappointed by a small rate hike in 2017, and significant monetary tightening looks unlikely this year.

Our long-held view has been that the main risk to the Turkish economy comes from its large external financing requirement, and this is likely to be even more the case this year. The current account deficit widened during 2017, with a large share of the uptick in consumption-driven growth financed by new foreign borrowing. As a result, while the rate of growth has risen, so have the risks and vulnerabilities. A very large share of Turkey's current account deficit is financed by potentially volatile portfolio inflows.

As a result, Turkey is highly exposed to a sharp hike in US rates, a change in global investor sentiment, or negative geopolitical developments. Corporates with a large share of US dollar-denominated debt and a lack of offsetting foreign exchange revenues are particularly at risk. Debt levels among some Turkish corporates have increased markedly in recent years. If the US Fed continues on its moderate tightening course (as appears likely), these risks are unlikely to materialise. However, a more aggressive series of hikes from the Fed – for example as a result of a faster-than-expected pick-up in inflation in the US – would certainly cause problems in Turkey.

We expect the current account deficit to remain in the 4-5% of GDP range during the forecast period, and for only a small share of this to be financed by foreign direct investment (FDI). This means that these vulnerabilities will not go away. Subdued oil prices (by the standards of recent years), the tourism recovery, and stronger merchandise export growth will provide some sources of stability.

Beyond the next three years, Turkey has one of the best long-term growth outlooks in the CESEE region. However, this relies heavily on positive demographic trends, particularly in the regional context, and is subject to domestic and geopolitical risks. The Medium Term Economic Programme for 2018-20 announced plans for structural reforms, fiscal transparency, disinflation, and an increase in high value-added manufacturing and FDI. However, it remains to be seen to what extent these aims will be achieved. FDI as a share of GDP has long been low in the regional context, and has fallen further recently. Domestic private investment remains subdued, while low productivity remains a long-standing issue. An upgrading of the customs union agreement with the EU beyond industrial goods could significantly lift medium-term growth prospects, but looks challenging in the current environment.

Table 30 / Turkey: Selected economic indicators

	2013	2014	2015	2016	2017 [1]	2018	2019	2020
							Forecast	
Population, th pers., average	76,148	77,182	78,218	79,278	80,313	80,900	81,700	82,500
Gross domestic product, TRY bn, nom. [2]	1,810	2,044	2,339	2,609	3,100	3,600	4,000	4,400
annual change in % (real)	8.5	5.2	6.1	3.2	6.5	4.5	4.1	3.9
GDP/capita (EUR at PPP) [2]	16,300	17,700	18,800	18,600	19,700	.	.	.
Consumption of households, TRY bn, nom. [2]	1,120	1,242	1,412	1,561	1,729	.	.	.
annual change in % (real)	7.9	3.0	5.4	3.7	5.6	3.8	3.6	3.5
Gross fixed capital form., TRY bn, nom. [2]	516	591	695	765	847	.	.	.
annual change in % (real)	13.8	5.1	9.3	2.2	7.6	5.7	4.5	4.2
Gross industrial production								
annual change in % (real)	3.0	3.6	3.2	1.9	6.3	3.3	3.0	2.8
Gross agricultural production [3]								
annual change in % (real)	3.2	-4.3	2.0	2.0	2.0	.	.	.
Construction industry								
annual change in % (real)	7.7	3.0	1.7	3.1	3.8	.	.	.
Employed persons, LFS, th, average	25,520	25,931	26,619	27,216	28,150	29,300	30,200	31,000
annual change in %	2.8	5.4	2.7	2.2	3.4	4.0	3.2	2.5
Unemployed persons, LFS, th, average	2,750	2,854	3,050	3,332	3,525	3,440	3,430	3,440
Unemployment rate, LFS, in %, average	9.7	9.9	10.3	10.9	11.0	10.5	10.2	10.0
Reg. unemployment rate, in %, eop	.	.	.	.	.	.	.	.
Average monthly gross wages, TRY	.	.	.	.	.	.	.	.
annual change in % (real, gross)	.	.	.	.	.	.	.	.
Consumer prices (HICP), % p.a.	7.5	8.9	7.7	7.7	11.1	9.8	7.2	6.8
Producer prices in industry, % p.a. [4]	5.7	10.1	5.3	4.3	15.8	8.4	7.0	6.0
General governm. budget, nat.def., % of GDP								
Revenues	32.7	31.9	31.9	33.0	32.3	33.0	33.2	33.5
Expenditures	34.0	32.7	32.9	34.7	34.2	35.0	35.5	35.7
Deficit (-) / surplus (+)	-1.3	-0.8	-1.0	-1.7	-1.9	-2.0	-2.3	-2.2
General gov.gross debt, nat.def., % of GDP [2]	31.4	28.8	27.6	28.3	28.2	27.9	27.7	28.0
Stock of loans of non-fin.private sector, % p.a.	33.6	19.4	19.4	15.2	19.9	.	.	.
Non-performing loans (NPL), in %, eop	2.8	2.8	3.1	3.2	2.9	.	.	.
Central bank policy rate, % p.a., eop [5]	4.50	8.25	7.50	8.00	8.00	8.00	8.00	8.00
Current account, EUR mn	-47,989	-33,011	-28,926	-29,809	-41,515	-43,400	-47,700	-54,100
Current account, % of GDP	-6.7	-4.7	-3.7	-3.8	-5.5	-5.5	-5.6	-5.9
Exports of goods, BOP, EUR mn	121,819	127,237	136,978	135,795	146,961	153,000	161,000	169,000
annual change in %	-3.4	4.4	7.7	-0.9	8.2	4.0	5.0	5.0
Imports of goods, BOP, EUR mn	182,057	175,312	180,341	172,671	198,386	208,000	221,000	236,000
annual change in %	2.8	-3.7	2.9	-4.3	14.9	5.0	6.2	7.0
Exports of services, BOP, EUR mn	36,306	39,105	42,279	34,070	38,550	40,000	43,000	46,000
annual change in %	6.5	7.7	8.1	-19.4	13.2	4.0	7.0	7.0
Imports of services, BOP, EUR mn	18,457	18,915	20,445	20,247	21,026	22,000	24,000	26,000
annual change in %	12.9	2.5	8.1	-1.0	3.8	5.0	7.0	7.0
FDI liabilities, EUR mn	9,682	9,637	15,811	11,637	9,606	.	.	.
FDI assets, EUR mn	2,716	5,379	4,594	2,845	2,418	.	.	.
Gross reserves of NB excl. gold, EUR mn	80,435	88,058	85,355	87,331	70,119	.	.	.
Gross external debt, EUR mn	282,707	331,065	364,115	384,338	372,000	391,300	438,300	476,700
Gross external debt, % of GDP	39.6	47.1	47.1	49.3	49.4	50.0	51.5	52.0
Average exchange rate TRY/EUR	2.5335	2.9065	3.0255	3.3433	4.1206	4.60	4.70	4.80

1) Preliminary and wiiw estimates. - 2) According to SNA 2010. - 3) Based on UN-FAO data, from 2015 wiiw estimate. - 4) Domestic output prices. - 5) One-week repo rate.

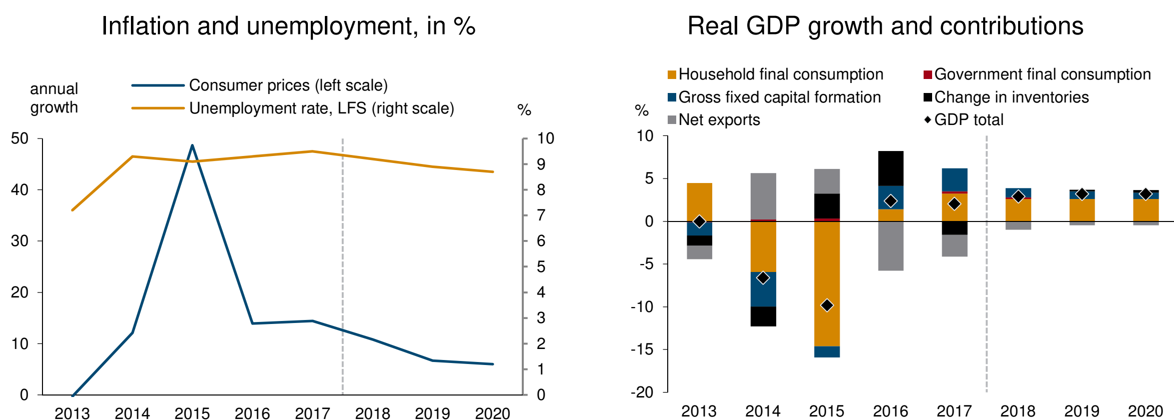
Source: wiiw Databases incorporating Eurostat and national statistics. Forecasts by wiiw.

UKRAINE: Reforms stall ahead of elections

VASILY ASTROV

Economic recovery is projected to accelerate from an estimated 2.1% last year to around 3% p.a. in 2018-2020, mostly thanks to an expected recovery of exports. In the short run, growth will also be helped by a more expansionary fiscal policy in the run-up to next year's presidential and parliamentary elections. Monetary policy, by contrast, has been tightened markedly in an attempt to tame the stubbornly high inflation.

Figure 61 / Ukraine: Main macroeconomic indicators



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

In 2017, the economy expanded by 2.1% according to the National Bank of Ukraine's (NBU) estimates – broadly in line with our earlier projections. Although on an annual basis, growth was continuously decelerating (from 2.5% in the first quarter to 2.3% in the second, 2.1% in the third, and 1.8% in the fourth quarter), this was primarily due to the effect of the increasing statistical base – particularly in the fourth quarter, as the record-high harvest of 2016 could not be repeated. Overall, agricultural production declined by 2.7% last year, and gross industrial output was stagnant – largely because of the enacted trade ban with the separatist-controlled areas of Donbas, which led to the disruption of important industrial production linkages. In contrast, services posted solid growth on the back of the strong domestic demand. Retail trade turnover – the proxy for private consumption – picked up by 8.8% last year, largely thanks to the doubling of the minimum wage and the resulting 19% overall real wage growth, while construction output soared by 20.9% thanks to the vibrant investment activity.

Despite the negative contribution of real net exports to GDP growth, external imbalances have not widened. After two consecutive quarters of decline, real exports (of goods and services) returned to growth in the third quarter of 2017 (+6.9% year on year). However, real imports continued growing ahead of exports, so that the contribution of real *net* exports to GDP growth remained strongly negative. Despite that, the current account deficit in 2017 increased only marginally in absolute terms and was unchanged in relation to GDP (at 3.7%, according to our estimates). One reason for this was the fact that in nominal terms, the gap between the exports and imports dynamics (17.3%[65] versus 18.1% in US dollar terms, respectively) was much less pronounced than in real terms, reflecting improved terms of trade. In particular, the prices of steel and iron ore picked up markedly last year. Another factor which mitigated the current account deficit was the strong inflow of remittances; the net 'secondary incomes' of the balance of payments were 28% higher than the year before.

The labour market is yet to show improvement. According to LFS data for the first three quarters of 2017, employment declined by 0.7% and the unemployment rate increased by 0.2 pp, to 9.4% – despite the shrinking labour force. At the same time, the demand for labour actually strengthened: the number of job vacancies grew by 29%, and the vacancy ratio fell from 6 to 4 during the same period. This suggests mismatches in the labour market, possibly facilitated by the ongoing structural change (away from metals and chemicals towards agriculture and certain types of services, such as ICT). In the years to come, increased labour migration to EU countries (particularly to Poland, the Czech Republic and Hungary) will likely accelerate the decline of the labour force, thereby improving the labour market – even if domestic employment does not recover.

Inflation has surprised on the upside… Inflationary pressures remain stubbornly strong: last year CPI reached 13.7% on an end-year basis. This is all the more surprising given the relative currency stability (the hryvnia weakened only marginally by the end of the year) and the historically high degree of 'pass-through' of the exchange rate to consumer prices. Instead, other supply-side factors have played a role, including the hikes in administrative prices and the soaring prices of meat and dairy products (which account for 18% of the consumer basket) on account of bottlenecks in animal production and increased exports. On top of that, according to the NBU's estimates, the doubling of the minimum wage added some 2-2.5 pp and the increase in pensions another 0.3-0.6 pp to the inflation by creating extra demand pressures. Going forward, we expect only moderate disinflation in 2018, to around 9% on an end-year basis.

… and prompts monetary tightening. The stubbornly high inflation has prompted the NBU, whose inflation target for 2017 of 8+/-2% was missed by a wide margin, to reverse its easing cycle. Since September 2017, the discount rate has been hiked in four steps by a total of 4.5 pp, to 17%. In our view, these developments illustrate the flaws of the newly adopted inflation targeting regime, which is ill-suited in the country's economic context.[66] At the moment, tight monetary policy may be less of a problem, given that investments are booming and are predominantly financed from enterprises' own funds rather than by taking credit. However, it may become more of a problem going forward, constraining the country's growth prospects by unduly supressing domestic demand.

[65] Goods exports to EU countries grew particularly strongly last year: by 31.9% in US dollar terms.

[66] For more on that, see Astrov, V. and L. Podkaminer (2017), 'Ukraine: Selected Economic Issues', wiiw Policy Notes and Reports, No. 19, December, https://wiiw.ac.at/ukraine-selected-economic-issues-p-4370.html

In contrast, fiscal policy is being relaxed in the run-up to next year's elections. In 2017, the doubling of the minimum wage led to an increased wage bill of public sector employees. However, the strong tax collection (partly thanks to higher than expected inflation) and one-off receipts, such as the property seized under the anti-corruption law, limited the budget deficit to a mere 1.5% of GDP. The central budget law for 2018 reckons with an increase in revenues and expenditures by 16% and 19% in nominal terms, respectively, resulting in a projected widening of the deficit to 2.5% of GDP – a sign of policy loosening. Specifically, the 2018 budget law envisages another hike of the minimum wage by 16%, to UAH 3,723 (some USD 130) per month. Judging by the experience from last year, this should benefit not only low-wage earners and public sector employees, but boost the wage level in general. In addition, the government considers another 10% hike in the minimum wage later this year, depending on the budget performance. The higher state expenditures should be partly offset by increased taxation, especially from excise taxes.

The pre-election political context also makes the implementation of reforms demanded by the IMF highly unlikely. The latest IMF demands include the creation of an anti-corruption court, progress on privatisation, another hike in gas tariffs for households, and land market reform. The fight against corruption remains half-hearted at best, and last year's privatisation target was met by only 20%: asset prices are still depressed, the overall business climate (including for foreign investors) remains challenging, while Russian bidders are typically excluded for political reasons. As for the land market reform, the long-standing moratorium on the free sale of agricultural land (which has been in place for the past 16 years) has been prolonged for another year. All this makes the NBU's hopes of receiving another USD 2 billion from the IMF in the course of 2018 fairly unrealistic. In fact, Ukraine has not received any IMF money since April 2017, while the allocation of EUR 600 million from the EU planned for December 2017 has been postponed as well (also because of the lacking progress in fighting corruption). These delays did not result however in marked depreciation pressures. Although since September 2017 the hryvnia has weakened by around 10% (against the US dollar), this should not come as a surprise given the high inflation and will help keep external imbalances at bay. Going forward, Ukraine will likely continue to be able to borrow from international financial markets to make up for any shortfall in lending from official creditors.[67] Although monetary policy in the US will probably be tightened further, its effects are likely to be offset by the upbeat global economic sentiments, resulting in ample supply of liquidity even for financially 'vulnerable' emerging economies such as Ukraine.

In the baseline scenario, economic growth is projected to pick up somewhat, close to 3% in 2018-2020. The main factor behind should be further recovery of exports, as the global economy gains momentum and last year's negative shock from the trade ban with the separatist-controlled areas of Donbas is gradually absorbed. Growth is likely to become more balanced also because domestic demand will likely lose steam somewhat. The current exceptionally high growth rate of fixed investments is unlikely to be sustained, while the more restrictive wage policy will mitigate the growth of private consumption. Still, even under this (relatively optimistic) scenario, Ukraine's GDP in 2020 will be still below that in 2013, on the eve of the 'Maidan revolution'. Growth higher than 3% appears to be unlikely; it will require increased inflows of Western FDI, which are currently not in sight. Although FDI inflows into the real sector (i.e. disregarding the recapitalisation of foreign-owned banks, which used to represent the bulk of statistically recorded FDI inflows during the previous years) picked up by 26% last year, at a mere USD 1.8 billion they remain far below the country's actual needs.

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[67] The government hopes to place another USD 2 billion of Eurobonds this year, following USD 3 billion in September 2017.

The major risks to the above upbeat forecast include (i) a possible escalation of military conflict in Donbas and (ii) starting from 2020, the clouded future of the gas transit. The implementation of the Minsk II agreement signed back in 2015, which envisages granting both a special status to the separatist-controlled areas of Donbas and an amnesty to rebel fighters, continues to be utterly unrealistic in Ukraine's current political climate. Even the deployment of UN peacekeeping troops, which has recently been suggested by Russia, is far from certain and continues to be a subject of difficult US-Russia negotiations. As for the gas transit, the current ten-year gas contract between Russia and Ukraine will expire at the end of 2019. Russia has repeatedly indicated that it is not planning to prolong it, hoping to divert the bulk of its gas shipments to Europe to the Nord Stream 2 pipeline crossing the Baltic Sea (which is currently under construction). In a 'worst-case scenario', this may deprive Ukraine of more than USD 2 billion of annual transit fees (some 2% of GDP) and will in any case increase Russia's leverage in negotiations with Ukraine.

Political risks cannot be disregarded either. The outcome of the next presidential elections scheduled for spring 2019 is highly uncertain. The incumbent President Petro Poroshenko will probably make it into the second round (his victory already in the first round, akin to 2014, appears now very unlikely). However, his victory in the run-off will be largely conditional on his potential opponents being sufficiently 'marginal', such as the leader of the extremely populist Radical Party, Oleh Lyashko, or the head of the relatively pro-Russian Opposition Block, Yuriy Boyko. When facing a more 'mainstream' candidate, such as the former prime-minister Yulia Tymoshenko, former defence minister Anatoliy Hrytsenko or the mayor of Lviv, Andriy Sadovyi, Mr. Poroshenko may easily lose. Such an outcome is likely to result in policies being both more populist and more nationalistic, with potentially negative repercussions on the economy as well.[68] Having said that, more than one year left until the elections is still a lot of time, particularly by Ukrainian standards.

[68] For instance, both Ms Tymoshenko and Mr Sadovyi actively supported the trade blockade of the separatist-controlled areas of Donbas, which slowed down Ukraine's economic growth last year.

Table 31 / Ukraine: Selected economic indicators

	2013	2014	2015	2016	2017 1)	2018	2019 Forecast	2020
Population, th pers., average	45,490	43,001	42,845	42,673	42,490	42,330	42,180	42,050
Gross domestic product, UAH bn, nom.	1,523	1,587	1,989	2,385	2,780	3,200	3,500	3,800
annual change in % (real)	0.0	-6.6	-9.8	2.4	2.1	2.9	3.2	3.2
GDP/capita (EUR at PPP)	6,600	6,400	6,000	6,100	6,300	.	.	.
Consumption of households, UAH bn, nom.	1,099	1,121	1,317	1,545	1,860	.	.	.
annual change in % (real)	6.5	-8.3	-20.7	2.1	5.0	4.0	4.0	4.0
Gross fixed capital form., UAH bn, nom.	264	224	269	369	550	.	.	.
annual change in % (real)	-8.0	-24.0	-9.2	20.4	17.4	7.0	6.0	5.0
Gross industrial production								
annual change in % (real)	-4.3	-10.1	-13.0	2.8	-0.1	4.0	3.5	3.0
Gross agricultural production								
annual change in % (real)	13.3	2.2	-4.8	6.3	-2.7	.	.	.
Construction output								
annual change in % (real)	-11.0	-20.4	-12.3	17.4	20.9	.	.	.
Employed persons, LFS, th, average	20,404	18,073	16,443	16,277	16,170	16,150	16,150	16,150
annual change in %	0.2	-6.4	-0.4	-1.0	-0.7	-0.1	0.0	0.0
Unemployed persons, LFS, th, average	1,577	1,848	1,655	1,678	1,700	1,640	1,580	1,540
Unemployment rate, LFS, in %, average	7.2	9.3	9.1	9.3	9.5	9.2	8.9	8.7
Reg. unemployment rate, in %, eop 2)	1.8	1.7	1.6	1.5	1.4	.	.	.
Average monthly gross wages, UAH 3)	3,265	3,480	4,195	5,183	7,104	8,300	9,100	9,900
annual change in % (real, gross)	8.2	-5.4	-18.9	8.5	19.8	5.0	3.0	3.0
annual change in % (real, net)	8.2	-6.5	-20.2	9.0	19.0	5.0	3.0	3.0
Consumer prices, % p.a.	-0.3	12.1	48.7	13.9	14.4	10.8	6.7	6.0
Producer prices in industry, % p.a. 4)	-0.1	17.1	36.0	20.5	26.4	15.0	7.0	7.0
General governm.budget, nat.def., % of GDP								
Revenues	29.1	28.7	32.8	32.8	36.6	36.0	36.0	36.0
Expenditures	33.3	33.3	34.3	35.1	38.1	38.5	38.0	38.0
Deficit (-) / surplus (+) 5)	-4.2	-4.5	-1.6	-2.3	-1.5	-2.5	-2.0	-2.0
General gov.gross debt, nat.def., % of GDP	38.4	69.4	79.1	80.9	77.0	76.0	74.0	73.0
Stock of loans of non-fin.private sector, % p.a.	11.6	11.8	-2.8	2.4	0.7	.	.	.
Non-performing loans (NPL), in %, eop 6)	12.9	19.0	28.0	30.5	56.0	.	.	.
Central bank policy rate, % p.a., eop 7)	6.50	14.00	22.00	14.00	14.50	12.50	11.00	10.00
Current account, EUR mn 8)	-12,441	-3,476	-170	-3,116	-3,399	-3,200	-3,600	-5,300
Current account, % of GDP 8)	-8.7	-3.4	-0.2	-3.7	-3.7	-3.5	-3.8	-5.4
Exports of goods, BOP, EUR mn 8)	44,518	38,235	31,935	30,309	35,347	35,200	36,600	38,100
annual change in %	-11.2	-14.1	-16.5	-5.1	16.6	-0.4	4.0	4.1
Imports of goods, BOP, EUR mn 8)	61,185	43,626	35,050	36,579	43,465	42,900	44,600	46,400
annual change in %	-8.8	-28.7	-19.7	4.4	18.8	-1.3	4.0	4.0
Exports of services, BOP, EUR mn 8)	17,032	11,257	11,218	11,242	12,481	12,300	12,900	11,900
annual change in %	-0.9	-33.9	-0.4	0.2	11.0	-1.4	4.9	-7.8
Imports of services, BOP, EUR mn 8)	12,141	9,350	9,639	9,913	10,433	10,300	10,800	11,400
annual change in %	7.0	-23.0	3.1	2.8	5.3	-1.3	4.9	5.6
FDI liabilities, EUR mn 8)	3,396	641	2,750	3,108	2,088	.	.	.
FDI assets, EUR mn 8)	324	414	34	156	43	.	.	.
Gross reserves of NB excl. gold, EUR mn 8)	13,592	5,429	11,320	13,965	14,872	.	.	.
Gross external debt, EUR mn 8)	102,852	103,557	108,666	108,714	100,000	101,000	104,000	105,000
Gross external debt, % of GDP 8)	71.7	102.6	132.4	128.9	107.9	110.5	109.9	107.8
Average exchange rate UAH/EUR	10.61	15.72	24.23	28.29	30.00	35.0	37.0	39.0

Note: from 2014 excluding the occupied territories of Crimea and Sevastopol and from 2015 (except for population) parts of the anti-terrorist operation zone.

1) Preliminary and wiiw estimates. - 2) In % of working age population. - 3) Enterprises with 10 and more employees. - 4) Domestic output prices. - 5) Without transfers to Naftohaz and other bail-out costs, in 2014 including VAT refund via issued government bonds. - 6) From 2017 including NPLs of the nationalized Privatbank and changes in rules of credit risk assessment. - 7) Discount rate of NB. - 8) Converted from USD.

Source: wiiw Databases incorporating national statistics. Forecasts by wiiw.

Appendix

Table 32 / European Union-Central and Eastern Europe (EU-CEE): an overview of economic fundamentals, 2017

	BG	CZ	EE	HR	HU	LT	LV	PL	RO	SI	SK	*EU-CEE* [1]	*EU-28* [2]
Gross domestic product													
EUR bn, at ER	50.7	191.1	22.8	48.8	122.6	41.7	26.9	460.4	186.0	43.0	83.5	*1,277*	*15,302*
EUR bn, at PPP	105.1	282.6	30.1	75.3	201.3	65.7	38.7	803.3	358.6	52.2	126.3	*2,139*	*15,302*
EU-28=100, at PPP	0.7	1.8	0.2	0.5	1.3	0.4	0.3	5.2	2.3	0.3	0.8	*14.0*	*100.0*
Per capita, EUR, at PPP	14,900	26,700	22,900	18,100	20,600	23,200	19,800	20,900	18,200	25,300	23,300	*20,700*	*29,800*
Per capita, EU-28=100, at PPP	50	90	77	61	69	78	66	70	61	85	78	*69*	*100*
1990=100	157.6	165.2	164.2	115.3	146.7	142.6	127.6	233.8 [3]	172.2	171.2	200.6	*193.3*	*160.4*
2007=100	120.5	116.1	105.1	98.0	110.9	113.7	100.7	138.7	127.1	106.1	126.9	*124.8*	*109.3*
Price level													
EU-28=100 (PPP/ER)	48	68	76	65	61	63	70	57	52	82	66	*60*	*100*
Industrial production													
2007=100 [4]	98.4	116.0	129.1	92.0	116.7	126.5	122.2	144.1	145.8	111.8	149.4	*132.4*	*100.5*
Population													
in thousand, average	7,080	10,570	1,315	4,150	9,780	2,830	1,950	38,400	19,650	2,066	5,430	*103,221*	*512,907*
Employed persons, LFS													
in thousand, average	3,150	5,222	655	1,600	4,421	1,358	890	16,490	8,660	950	2,530	*45,926*	*227,655*
Unemployment rate, LFS													
in %	6.2	2.9	6.1	11.5	4.2	7.2	9.0	4.7	5.0	7.3	8.2	*5.3*	*7.7*
Average gross monthly wages													
EUR	541	1,121	1,226	1,079	939	850	930	1,017	706	1,625	960	*938*	*2,423* [5]
EU-28=100	22.3	46.2	50.6	44.5	38.7	35.1	38.4	42.0	29.1	67.1	39.6	*38.7*	*100.0*
General government budget, EU-def., % of GDP													
Revenues	36.5	40.7	39.5	45.4	48.3	34.0	37.0	39.0	33.0	42.8	39.8	*39.4*	*44.7*
Expenditures	36.0	39.8	40.0	46.3	50.4	33.8	37.8	42.0	36.0	43.6	41.4	*41.2*	*46.0*
Balance	0.5	0.9	-0.5	-0.9	-2.1	0.2	-0.8	-3.0	-3.0	-0.8	-1.6	*-1.8*	*-1.2*
Public debt, EU def., % of GDP	26.5	34.1	9.0	78.0	72.9	41.0	38.0	54.6	36.7	76.4	51.1	*49.8*	*83.5*
BOP items, % of GDP													
Current account	4.0	1.3	2.7	4.0	3.8	0.9	-0.7	0.1	-3.5	6.5	-1.2	*0.6* [6]	*2.2* [6]
Exports of goods	51.3	67.1	51.8	24.2	72.0	61.8	42.2	43.0	30.7	66.2	84.1	*51.4* [6]	*32.9* [6]
Imports of goods	55.3	62.1	55.9	41.1	69.6	66.7	51.9	42.9	37.2	62.4	82.4	*52.3* [6]	*31.0* [6]
Exports of services	15.2	12.3	26.6	27.4	18.2	19.8	17.9	11.3	11.1	16.6	9.9	*13.6* [6]	*13.0* [6]
Imports of services	9.2	9.9	18.2	8.1	12.8	12.9	9.6	7.4	6.8	10.7	8.9	*8.9* [6]	*11.1* [6]
FDI stock per capita, 2016													
EUR [7]	5,606	10,333	13,966	6,304	7,705	4,890	6,900	4,580	3,570	6,268	7,635	*5,779*	*13,197*

1) wiiw estimates. - 2) wiiw estimates and Eurostat. - 3) 1989=100, which in the Polish case is the appropriate reference year. - 4) EU-28 working-day adjusted. - 5) Gross wages according to national accounts concept. - 6) Data for EU-CEE and EU-28 include transactions within the region (sum over individual countries). - 7) Excluding SPE.

Source: wiiw Annual Database, Eurostat.

Table 33 / Western Balkans and Turkey, selected CIS countries and Ukraine: an overview of economic fundamentals, 2017

	AL	BA	ME	MK	RS	XK	TR	BY	KZ	RU [1]	UA [2]	*EU-CEE [3]*	*EU-28 [4]*
Gross domestic product													
EUR bn, at ER	11.9	16.0	4.2	9.9	37.1	6.4	752.3	48.2	144.4	1,398.0	92.7	*1,277*	*15,302*
EUR bn, at PPP	25.5	32.6	8.4	22.8	77.1	14.3	1,579.2	131.0	346.0	2,544.5	266.5	*2,139*	*15,302*
EU-28=100, at PPP	0.2	0.2	0.1	0.1	0.5	0.1	10.3	0.9	2.3	16.6	1.7	*14.0*	*100.0*
Per capita, EUR, at PPP	8,900	9,300	13,500	10,900	11,000	8,000	19,700	13,800	19,200	17,300	6,300	*20,700*	*29,800*
Per capita, EU-28=100, at PPP	30	31	45	37	37	27	66	46	64	58	21	*69*	*100*
1990=100	231.7	.	.	142.6	.	.	328.5	191.2	202.9	117.9	61.1	*193.3*	*160.4*
2007=100	135.2	117.1	121.5	126.8	109.5	145.1	161.5	125.9	148.1	111.0	84.0	*124.8*	*109.3*
Price level													
EU-28=100 (PPP/ER)	47	49	50	44	48	45	48	37	42	55	35	*60*	*100*
Industrial production													
2007=100 [5]	259.2	123.8	66.6	111.5	102.4	209.8	136.1	133.1	129.4	110.2	67.9	*132.4*	*100.5*
Population													
in thousand, average	2,877	3,510	625	2,090	7,000	1,784	80,313	9,498	18,038	146,841	42,490	*103,221*	*512,907*
Employed persons, LFS													
in thousand, average	1,195	816	229	731	2,790	370	28,150	4,352	8,600	72,142	16,170	*45,926*	*227,655*
Unemployment rate, LFS													
in %	14.0	20.5	16.0	23.0	15.0	30.2	11.0	0.5 [6]	5.0	5.2	9.5	*5.3*	*7.7*
Average gross monthly wages													
EUR at ER	372	675	765	546	550	450 [7]	1,204	373	408	593	237	*938*	*2,423 [8]*
EU-28=100	15.3	27.9	31.6	22.5	22.7	18.6	49.7	15.4	16.8	24.5	9.8	*38.7*	*100.0 [8]*
General government budget, nat. def., % of GDP													
Revenues	28.0	42.5	43.0	31.0	44.0	29.4	32.3	40.0	21.7	35.0	36.6	*39.4 [9]*	*44.7 [9]*
Expenditures	28.2	41.5	45.0	33.0	45.0	29.5	34.2	39.0	24.5	37.5	38.1	*41.2 [9]*	*46.0 [9]*
Balance	-0.2	1.0	-2.0	-2.0	-1.0	-0.1	-1.9	1.0	-2.7	-2.5	-1.5	*-1.8 [9]*	*-1.2 [9]*
Public debt, nat. def., % of GDP	71.0	40.8	60.0	48.0	68.0	16.0	28.2	48.0	26.3	13.0	77.0	*49.8 [9]*	*83.5 [9]*
BOP items, % of GDP													
Current account	-8.6	-4.6	-18.8	-0.2	-4.9	-5.6	-5.5	-2.3	-2.9	2.5	-3.7	*0.6 [10]*	*2.2 [10]*
Exports of goods	6.7	27.3	8.5	38.5	38.8	5.8	19.5	52.7	30.2	22.4	38.1	*51.4 [10]*	*32.9 [10]*
Imports of goods	31.5	50.5	51.9	57.0	49.1	44.3	26.4	58.1	19.5	15.1	46.9	*52.3 [10]*	*31.0 [10]*
Exports of services	23.4	9.7	33.1	15.5	13.6	20.3	5.1	14.3	3.9	3.7	13.5	*13.6 [10]*	*13.0 [10]*
Imports of services	14.9	2.9	12.3	11.9	10.7	7.7	2.8	8.7	6.6	5.6	11.3	*8.9 [10]*	*11.1 [10]*
FDI stock per capita, 2016													
EUR [11]	1,974	1,888	6,616	2,246	4,082	1,930	1,684	1,876	7,564	2,447	1,087	*5,779*	*13,197*

Note: PPP: Purchasing power parity, wiiw estimates for Belarus, Kazakhstan, Russia and Ukraine.

1) Including Crimean Federal District. - 2) Exluding the occupied territories of Crimea and Sevastopol. - 3) wiiw estimates. - 4) wiiw estimates and Eurostat. - 5) EU-28 working-day adjusted. - 6) Unemployment rate by registration. - 7) Average net monthly wages in state administration. - 8) Gross wages according to national account concept. - 9) EU definition: expenditures and revenues according to ESA 2010, excessive deficit procedure. - 10) Data for EU-CEE and EU-28 include transactions within the region. - 11) Excluding SPE.

Source: wiiw Annual Database, Eurostat, AMECO.

Table 34 / GDP per capita at current PPPs (EUR), from 2018 at constant PPPs and population

		1991	1995	2000	2005	2010	2014	2015	2016	2017	2018	2019	2020
												Forecast	
BG	Bulgaria	4,300	5,000	5,600	8,600	11,200	12,900	13,700	14,200	14,900	15,400	15,900	16,400
CZ	Czech Republic	8,800	11,600	14,200	18,600	21,100	23,800	25,300	25,600	26,700	27,600	28,500	29,400
EE	Estonia	5,400	5,300	8,200	14,000	16,500	21,000	21,700	21,900	22,900	23,700	24,400	25,000
HR	Croatia	6,600	7,000	9,400	13,000	15,100	16,300	17,200	17,500	18,100	18,600	19,200	19,800
HU	Hungary	6,800	7,700	10,400	14,500	16,500	18,800	19,800	19,700	20,600	21,400	22,000	22,400
LT	Lithuania	6,900	5,000	7,400	12,300	15,400	20,800	21,700	22,000	23,200	23,900	24,500	25,000
LV	Latvia	6,000	4,600	7,000	11,800	13,400	17,600	18,500	18,800	19,800	20,600	21,300	21,900
PL	Poland	4,600	6,500	9,300	11,800	15,900	18,600	19,800	19,900	20,900	21,700	22,500	23,200
RO	Romania	3,900	4,600	5,100	8,300	13,000	15,200	16,300	17,000	18,200	19,100	19,800	20,600
SI	Slovenia	8,800	11,400	15,800	20,300	21,200	22,700	23,800	24,100	25,300	26,300	27,200	28,200
SK	Slovakia	6,000	7,300	9,900	14,100	19,000	21,300	22,300	22,400	23,300	24,200	25,200	26,000
	EU-CEE	5,400	6,600	8,800	12,200	15,800	18,300	19,400	19,700	20,700	21,500	22,200	22,900
AL	Albania	1,500	2,000	3,400	5,000	7,400	8,300	8,500	8,500	8,900	9,300	9,700	10,100
BA	Bosnia & Herzeg.	.	.	4,000	5,400	6,900	8,300	8,700	9,000	9,300	9,600	9,900	10,200
ME	Montenegro	.	.	5,300	7,100	10,400	11,300	12,300	13,000	13,500	13,900	14,300	14,700
MK	Macedonia	4,300	4,000	5,400	6,700	8,700	9,900	10,500	10,900	10,900	11,300	11,700	12,100
RS	Serbia	.	3,100	5,000	7,400	9,200	10,100	10,500	10,700	11,000	11,300	11,600	11,900
XK	Kosovo	.	.	4,100	5,300	5,900	6,700	7,400	7,700	8,000	8,300	8,600	8,900
TR	Turkey	5,200	6,000	8,100	10,000	13,200	17,700	18,800	18,600	19,700	20,600	21,400	22,200
BY	Belarus	4,900	3,400	5,300	8,500	12,200	13,900	13,900	13,400	13,800	14,200	14,600	15,100
KZ	Kazakhstan	7,100	5,100	6,900	12,100	15,100	18,300	19,000	18,600	19,200	19,800	20,400	21,000
RU	Russia	6,800	4,700	6,000	10,000	15,700	18,800	17,900	17,000	17,300	17,600	17,900	18,200
UA	Ukraine	5,500	3,100	3,300	5,700	6,100	6,400	6,000	6,100	6,300	6,500	6,700	6,900
AT	Austria	18,900	20,000	25,700	29,800	32,100	36,000	37,700	37,200	38,400	39,500	40,400	41,200
DE	Germany	19,300	20,000	24,100	27,500	30,500	34,700	36,100	36,000	36,800	37,600	38,400	39,200
EL	Greece	12,900	13,000	17,100	21,700	21,500	19,800	20,200	19,700	20,000	20,500	21,000	21,400
IE	Ireland	13,300	16,000	26,500	34,400	33,100	37,900	52,400	53,300	57,200	59,700	61,600	62,800
IT	Italy	17,900	18,800	23,700	25,400	26,500	26,600	27,700	28,200	28,600	29,000	29,300	29,900
PT	Portugal	11,500	12,100	16,500	19,300	20,900	21,200	22,300	22,500	23,100	23,600	24,000	24,500
ES	Spain	13,300	13,700	18,900	23,500	24,400	24,900	26,300	26,700	27,500	28,200	28,800	29,400
US	United States	21,000	24,200	31,900	37,600	36,900	40,200	42,300	42,200	42,900	43,900	44,800	45,700
	EU-28 average	14,200	15,200	19,800	23,400	25,500	27,600	29,000	29,200	29,800	30,500	31,100	31,700

European Union (28) average = 100

		1991	1995	2000	2005	2010	2014	2015	2016	2017	2018	2019	2020
BG	Bulgaria	30	33	28	37	44	47	47	49	50	50	51	52
CZ	Czech Republic	62	76	72	79	83	86	87	88	90	90	92	93
EE	Estonia	38	35	41	60	65	76	75	75	77	78	78	79
HR	Croatia	46	46	47	56	59	59	59	60	61	61	62	62
HU	Hungary	48	51	53	62	65	68	68	67	69	70	71	71
LT	Lithuania	49	33	37	53	60	75	75	75	78	78	79	79
LV	Latvia	42	30	35	50	53	64	64	64	66	68	68	69
PL	Poland	32	43	47	50	62	67	68	68	70	71	72	73
RO	Romania	27	30	26	35	51	55	56	58	61	63	64	65
SI	Slovenia	62	75	80	87	83	82	82	83	85	86	87	89
SK	Slovakia	42	48	50	60	75	77	77	77	78	79	81	82
	EU-CEE	38	43	44	52	62	66	67	67	69	70	71	72
AL	Albania	11	13	17	21	29	30	29	29	30	30	31	32
BA	Bosnia & Herzeg.	.	.	20	23	27	30	30	31	31	31	32	32
ME	Montenegro	.	.	27	30	41	41	42	45	45	46	46	46
MK	Macedonia	30	26	27	29	34	36	36	37	37	37	38	38
RS	Serbia	.	20	25	32	36	37	36	37	37	37	37	38
XK	Kosovo	.	.	21	23	23	24	26	26	27	27	28	28
TR	Turkey	37	39	41	43	52	64	65	64	66	68	69	70
BY	Belarus	35	22	27	36	48	50	48	46	46	47	47	48
KZ	Kazakhstan	50	34	35	52	59	66	66	64	64	65	66	66
RU	Russia	48	31	30	43	62	68	62	58	58	58	58	57
UA	Ukraine	39	20	17	24	24	23	21	21	21	21	22	22
AT	Austria	133	132	130	127	126	130	130	127	129	130	130	130
DE	Germany	136	132	122	118	120	126	124	123	123	123	123	124
EL	Greece	91	86	86	93	84	72	70	67	67	67	68	68
IE	Ireland	94	105	134	147	130	137	181	183	192	196	198	198
IT	Italy	126	124	120	109	104	96	96	97	96	95	94	94
PT	Portugal	81	80	83	82	82	77	77	77	78	77	77	77
ES	Spain	94	90	95	100	96	90	91	91	92	92	93	93
US	United States	148	159	161	161	145	146	146	145	144	144	144	144
	EU-28 average	100	100	100	100	100	100	100	100	100	100	100	100

Sources: wiiw Annual Database incorporating national and Eurostat statistics; forecasts by wiiw and EC - Winter Report 2018.

Table 35 / Indicators of macro-competitiveness, 2013-2020, EUR based, annual averages

	2013	2014	2015	2016	2017	2018	2019	2020
							Forecast	
Bulgaria								
Producer price index, 2010=100	112.3	110.9	108.8	105.4	110.5	113.8	116.7	119.6
Consumer price index, 2010=100	106.3	104.6	103.5	102.1	103.3	105.9	109.1	112.4
GDP deflator, 2010=100	106.9	107.4	109.8	112.2	113.8	116.7	120.1	123.7
Exchange rate (ER), NC/EUR	1.9558	1.9558	1.9558	1.9558	1.9558	1.9558	1.9558	1.9558
ER, nominal, 2010=100	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Real ER (CPI-based), 2010=100	99.0	96.9	95.9	94.3	93.9	94.6	95.7	96.8
Real ER (PPI-based), 2010=100	103.8	104.5	105.1	103.5	105.0	106.5	107.4	108.3
PPP, NC/EUR	0.9258	0.8972	0.9021	0.9325	0.9423	0.95	0.96	0.98
Price level, EU28 = 100	47	46	46	48	48	49	49	50
Average monthly gross wages, EUR (ER)	396	420	449	485	541	590	650	710
Average monthly gross wages, EUR (PPP)	837	916	973	1,017	1,123	1,220	1,320	1,420
GDP per employed person, 2010=100	106.9	106.6	108.7	113.5	112.8	115.1	118.0	120.9
Unit labour costs, ER adj., 2010=100	111.8	118.9	124.7	128.9	144.7	155.5	166.1	177.5
Unit labour costs, PPP adj., Austria=100	31.3	33.0	33.9	34.1	37.9	40.0	42.3	44.3
Czech Republic								
Producer price index, 2010=100	106.9	107.9	105.3	101.9	103.7	104.8	106.3	107.4
Consumer price index, 2010=100	107.3	107.7	108.0	108.7	111.3	113.8	116.1	118.2
GDP deflator, 2010=100	102.9	105.5	106.7	108.0	109.3	111.4	113.7	116.1
Exchange rate (ER), NC/EUR	25.98	27.54	27.28	27.03	26.33	25.50	25.25	25.00
ER nominal, 2010=100	102.8	108.9	107.9	106.9	104.1	100.9	99.9	98.9
Real ER (CPI-based), 2010=100	97.2	91.6	92.8	93.9	97.1	100.8	102.0	102.9
Real ER (PPI-based), 2010=100	96.2	93.4	94.3	93.5	94.6	97.2	98.0	98.4
PPP, NC/EUR	17.41	17.24	17.24	17.66	17.80	17.9	17.9	18.0
Price level, EU28 = 100	67	63	63	65	68	70	71	72
Average monthly gross wages, EUR (ER)	964	936	975	1,020	1,121	1,230	1,310	1,400
Average monthly gross wages, EUR (PPP)	1,438	1,495	1,542	1,561	1,657	1,760	1,840	1,940
GDP per employed person, 2010=100	99.4	101.4	105.3	106.0	108.7	112.1	115.2	118.7
Unit labour costs, ER adj., 2010=100	102.7	97.8	98.1	102.0	109.2	116.4	120.5	124.6
Unit labour costs, PPP adj., Austria=100	50.0	47.1	46.3	46.9	49.7	52.2	53.2	54.3
Estonia								
Producer price index, 2010=100	114.7	111.6	108.3	106.9	110.1	113.6	117.0	120.0
Consumer price index, 2010=100	113.0	113.6	113.7	114.6	118.8	122.7	126.3	129.5
GDP deflator, 2010=100	112.4	114.1	115.5	117.4	121.6	125.2	128.7	131.9
Real ER (CPI-based), 2010=100	105.3	105.3	105.4	105.9	108.0	109.6	110.9	111.5
Real ER (PPI-based), 2010=100	106.1	105.2	104.6	104.9	104.6	106.3	107.7	108.7
PPP, NC/EUR	0.7113	0.7149	0.7141	0.7325	0.7562	0.77	0.78	0.78
Price level, EU28 = 100	71	71	71	73	76	77	78	78
Average monthly gross wages, EUR (ER)	949	1,005	1,065	1,146	1,226	1,320	1,410	1,500
Average monthly gross wages, EUR (PPP)	1,334	1,406	1,491	1,564	1,621	1,720	1,820	1,920
GDP per employed person, 2010=100	105.1	107.6	106.6	108.2	111.0	114.1	116.4	118.7
Unit labour costs, ER adj., 2010=100	113.9	117.9	126.1	133.7	139.3	146.1	152.9	159.5
Unit labour costs, PPP adj., Austria=100	54.9	56.2	58.9	60.8	62.8	64.9	66.8	68.6
Croatia								
Producer price index, 2010=100	111.9	108.9	104.7	100.2	102.1	104.1	106.2	108.3
Consumer price index, 2010=100	108.1	108.3	108.0	107.3	108.7	110.5	112.3	114.0
GDP deflator, 2010=100	104.1	104.1	104.1	104.0	105.4	107.0	108.7	110.4
Exchange rate (ER), NC/EUR	7.579	7.634	7.614	7.533	7.464	7.50	7.50	7.50
ER, nominal, 2010=100	104.0	104.7	104.5	103.4	102.4	102.9	102.9	102.9
Real ER (CPI-based), 2010=100	96.8	95.8	95.8	96.0	96.5	95.9	95.7	95.5
Real ER (PPI-based), 2010=100	99.5	98.0	96.8	95.2	94.7	94.7	95.0	95.4
PPP, NC/EUR	4.868	4.808	4.700	4.797	4.841	4.84	4.84	4.84
Price level, EU28 = 100	64	63	62	64	65	65	65	65
Average monthly gross wages, EUR (ER) [1)]	1,048	1,042	1,058	1,029	1,079	1,110	1,150	1,200
Average monthly gross wages, EUR (PPP) [1)]	1,631	1,654	1,714	1,616	1,663	1,720	1,790	1,860
GDP per employed person, 2010=100	97.9	95.2	96.2	99.0	101.3	103.4	105.2	107.1
Unit labour costs, ER adj., 2010=100	101.6	103.9	104.4	98.7	101.0	102.1	104.0	106.4
Unit labour costs, PPP adj., Austria=100	59.4	60.1	59.3	54.5	55.3	55.0	55.1	55.6

1) From 2016 lower wages due to new data sources.

(Table 35 ctd.)

Table 35 / (ctd.)

	2013	2014	2015	2016	2017	2018	2019	2020
							Forecast	
Hungary								
Producer price index, 2010=100	109.1	108.7	107.7	105.9	109.4	111.6	112.7	113.8
Consumer price index, 2010=100	111.7	111.7	111.8	112.2	114.9	118.2	121.6	125.1
GDP deflator, 2010=100	108.8	112.5	114.6	115.7	119.1	123.2	126.9	130.9
Exchange rate (ER), NC/EUR	296.9	308.7	310.0	311.4	309.2	313	317	319
ER, nominal 2010=100	107.8	112.1	112.5	113.1	112.2	113.6	115.1	115.8
Real ER (CPI-based), 2010=100	96.5	92.4	92.1	91.7	93.0	92.9	92.7	93.0
Real ER (PPI-based), 2010=100	93.6	91.4	92.4	91.9	92.6	91.9	90.1	89.0
PPP, NC/EUR	170.2	175.6	176.6	183.7	188.3	191.9	194.4	197.3
Price level, EU28 = 100	57	57	57	59	61	61	61	62
Average monthly gross wages, EUR (ER)	777	770	800	845	939	1,020	1,070	1,120
Average monthly gross wages, EUR (PPP)	1,356	1,354	1,404	1,433	1,542	1,660	1,740	1,820
GDP per employed person, 2010=100	99.2	98.1	98.8	97.7	100.0	103.4	106.2	108.1
Unit labour costs, ER adj., 2010=100	106.6	106.7	110.1	117.7	127.7	134.3	136.7	141.5
Unit labour costs, PPP adj., Austria=100	42.1	41.7	42.2	43.9	47.2	48.9	49.1	49.7
Lithuania								
Producer price index, 2010=100	116.7	111.0	100.2	95.9	100.6	104.1	107.8	111.5
Consumer price index, 2010=100	108.7	108.9	108.2	108.9	113.0	116.4	119.5	122.5
GDP deflator, 2010=100	109.5	110.6	110.9	112.0	116.2	119.4	122.7	125.7
Real ER (CPI-based), 2010=100	101.3	101.0	100.3	100.7	102.6	103.9	104.9	105.5
Real ER (PPI-based), 2010=100	107.9	104.6	96.8	94.1	95.6	97.4	99.2	101.0
PPP, NC/EUR	0.6036	0.6006	0.5928	0.6134	0.6344	0.64	0.65	0.65
Price level, EU28 = 100	60	60	59	61	63	64	65	65
Average monthly gross wages, EUR (ER)	646	677	714	774	850	920	990	1,070
Average monthly gross wages, EUR (PPP)	1,071	1,128	1,205	1,262	1,340	1,430	1,530	1,640
GDP per employed person, 2010=100	118.4	120.2	121.2	121.6	126.7	131.4	134.7	137.6
Unit labour costs, ER adj., 2010=100	94.8	97.9	102.3	110.5	116.5	121.6	127.6	135.1
Unit labour costs, PPP adj., Austria=100	36.1	36.8	37.8	39.7	41.5	42.7	44.0	45.9
Latvia								
Producer price index, 2010=100	114.0	114.5	113.3	109.9	112.3	115.1	117.4	119.8
Consumer price index, 2010=100	106.6	107.3	107.6	107.7	110.8	114.1	117.5	120.5
GDP deflator, 2010=100	112.1	114.1	114.1	114.4	118.2	121.0	124.5	127.6
Real ER (CPI-based), 2010=100	100.3	100.3	100.5	100.3	101.5	102.8	104.0	104.6
Real ER (PPI-based), 2010=100	106.5	108.8	110.3	108.8	107.6	108.6	109.0	109.4
PPP, NC/EUR	0.6798	0.6751	0.6645	0.6755	0.6950	0.70	0.71	0.72
Price level, EU28 = 100	68	68	66	68	70	70	71	72
Average monthly gross wages, EUR (ER)	717	765	818	859	930	1,000	1,070	1,130
Average monthly gross wages, EUR (PPP)	1,053	1,133	1,231	1,272	1,338	1,430	1,510	1,580
GDP per employed person, 2010=100	119.5	123.1	124.9	127.9	134.2	138.5	143.2	147.9
Unit labour costs, ER adj., 2010=100	95.6	99.0	104.3	106.9	110.4	115.0	119.0	121.7
Unit labour costs, PPP adj., Austria=100	46.9	48.1	49.7	49.6	50.7	52.1	53.0	53.3
Poland								
Producer price index, 2010=100	109.4	108.0	105.8	105.5	108.4	110.6	112.6	114.6
Consumer price index, 2010=100	108.6	108.7	108.0	107.7	109.5	111.8	114.0	116.3
GDP deflator, 2010=100	106.0	106.5	107.3	107.7	108.6	110.5	111.9	113.4
Exchange rate (ER), NC/EUR	4.198	4.184	4.184	4.363	4.257	4.25	4.20	4.20
ER, nominal, 2010=100	105.1	104.7	104.7	109.2	106.6	106.4	105.1	105.1
Real ER (CPI-based), 2010=100	96.3	96.2	95.5	91.1	93.3	93.8	95.1	95.2
Real ER (PPI-based), 2010=100	96.3	97.2	97.6	94.8	96.6	97.3	98.5	98.7
PPP, PLN/EUR	2.399	2.398	2.359	2.429	2.440	2.45	2.44	2.43
Price level, EU28 = 100	57	57	56	56	57	58	58	58
Average monthly gross wages, EUR (ER)	872	903	934	928	1,017	1,080	1,150	1,200
Average monthly gross wages, EUR (PPP)	1,525	1,575	1,657	1,666	1,775	1,870	1,980	2,080
GDP per employed person, 2010=100	110.9	112.4	115.1	117.6	120.8	124.5	128.5	132.5
Unit labour costs, ER adj., 2010=100	97.4	99.5	100.5	97.7	104.3	107.0	110.6	112.6
Unit labour costs, PPP adj., Austria=100	47.9	48.4	48.0	45.4	48.0	48.8	49.5	49.3

(Table 35 ctd.)

Table 35 / (ctd.)

	2013	2014	2015	2016	2017	2018	2019	2020
							Forecast	
Romania								
Producer price index, 2010=100	115.0	114.8	112.1	110.0	114.1	116.4	118.7	121.1
Consumer price index, 2010=100	112.9	114.5	114.0	112.8	114.0	118.0	121.5	125.2
GDP deflator, 2010=100	112.5	114.4	117.4	119.8	125.0	127.8	129.9	132.4
Exchange rate (ER), NC/EUR	4.419	4.444	4.445	4.490	4.569	4.65	4.70	4.75
ER, nominal, 2010=100	104.9	105.5	105.5	106.6	108.5	110.4	111.6	112.8
Real ER (CPI-based), 2010=100	100.2	100.6	100.1	97.7	95.5	95.5	95.6	95.6
Real ER (PPI-based), 2010=100	101.4	102.6	102.6	101.3	99.9	98.7	97.9	97.3
PPP, NC/EUR	2.187	2.209	2.208	2.281	2.370	2.39	2.39	2.40
Price level, EU28 = 100	49	50	50	51	52	51	51	50
Average monthly gross wages, EUR (ER) 2)	489	524	575	626	706	950	1,000	1,050
Average monthly gross wages, EUR (PPP) 2)	989	1,054	1,157	1,232	1,361	1,840	1,970	2,090
GDP per employed person, 2010=100	115.6	118.2	124.1	131.4	137.0	142.7	146.5	152.6
Unit labour costs, ER adj., 2010=100	93.8	98.1	102.6	105.4	114.1	146.8	151.1	152.7
Unit labour costs, PPP adj., Austria=100	34.8	36.0	36.9	36.9	39.5	50.4	50.8	50.4
Slovenia								
Producer price index, 2010=100	105.5	104.8	104.5	103.1	105.3	107.4	109.6	111.7
Consumer price index, 2010=100	107.0	107.4	106.5	106.3	108.0	110.0	111.9	113.9
GDP deflator, 2010=100	103.2	104.0	105.0	106.0	107.8	109.8	111.7	113.7
Real ER (CPI-based), 2010=100	99.6	99.5	98.7	98.2	98.1	98.2	98.2	98.1
Real ER (PPI-based), 2010=100	97.6	98.8	100.9	101.2	100.0	100.5	100.8	101.2
PPP, NC/EUR	0.8038	0.8022	0.7920	0.8127	0.8236	0.83	0.83	0.83
Price level, EU28 = 100	80	80	79	81	82	83	83	83
Average monthly gross wages, EUR (ER)	1,523	1,540	1,556	1,585	1,625	1,680	1,740	1,800
Average monthly gross wages, EUR (PPP)	1,895	1,920	1,964	1,950	1,973	2,030	2,110	2,170
GDP per employed person, 2010=100	103.3	105.1	107.4	111.1	111.9	115.1	116.7	119.4
Unit labour costs, ER adj., 2010=100	98.7	98.0	96.9	95.4	97.1	97.6	99.7	100.9
Unit labour costs, PPP adj., Austria=100	76.7	75.4	73.1	70.1	70.6	70.0	70.3	70.0
Slovakia								
Producer price index, 2010=100	105.4	101.7	98.7	94.7	97.0	99.9	102.4	105.0
Consumer price index, 2010=100	109.6	109.5	109.1	108.6	110.1	112.3	114.3	116.8
GDP deflator, 2010=100	103.5	103.3	103.1	102.7	102.2	104.2	106.1	108.4
Real ER (CPI-based), 2010=100	102.1	101.4	101.1	100.3	100.0	100.3	100.3	100.6
Real ER (PPI-based), 2010=100	97.5	95.9	95.3	92.9	92.1	93.5	94.2	95.1
PPP NC/ EUR	0.6687	0.6586	0.6525	0.6666	0.6608	0.66	0.67	0.67
Price level, EU28 = 100	67	66	65	67	66	66	67	67
Average monthly gross wages, EUR (ER)	824	858	883	912	960	1,010	1,060	1,120
Average monthly gross wages, EUR (PPP)	1,232	1,303	1,353	1,368	1,453	1,520	1,590	1,670
GDP per employed person, 2010=100	105.5	106.9	108.2	108.8	110.8	113.5	117.6	120.4
Unit labour costs, ER adj., 2010=100	101.5	104.4	106.1	109.0	112.7	115.7	117.2	121.0
Unit labour costs, PPP adj., Austria=100	41.1	41.8	41.7	41.7	42.7	43.3	43.1	43.8
Albania								
Producer price index, 2010=100	103.3	102.9	100.7	99.2	102.2	104.2	106.3	107.9
Consumer price index, 2010=100	107.6	109.3	111.4	112.8	115.1	118.3	121.8	125.5
GDP deflator, 2010=100	103.7	105.3	105.4	105.2	110.0	112.2	114.3	116.1
Exchange rate (ER), NC/EUR	140.3	140.0	139.7	137.4	134.2	133.0	133.2	133.2
ER, nominal, 2010=100	101.8	101.6	101.4	99.7	97.4	96.5	96.7	96.7
Real ER (CPI-based), 2010=100	98.4	99.7	101.8	104.6	107.4	109.5	110.6	111.8
Real ER (PPI-based), 2010=100	93.9	95.5	95.9	97.6	99.7	101.0	101.2	101.1
PPP, NC/EUR	60.06	58.20	58.18	60.29	62.82	63.2	63.2	63.2
Price level, EU28 = 100	43	42	42	44	47	47	47	47
Average monthly gross wages, EUR (ER) 3)	259	325	335	334	372	400	430	460
Average monthly gross wages, EUR (PPP) 3)	605	782	805	760	793	840	900	960
GDP per employed person, 2010=100	119.8	120.3	117.4	114.0	114.7	116.9	119.6	122.3
Unit labour costs, ER adj., 2010=100	85.7	107.1	113.1	116.1	128.4	135.1	141.3	147.9
Unit labour costs, PPP adj., Austria=100	27.5	34.1	35.3	35.2	38.6	40.2	41.5	42.7

2) In 2018 the employers' social security contribution will be added to gross wages increasing the latter by 25%. - 3) From 2014 higher wages due to new data sources.

(Table 35 ctd.)

Table 35 / (ctd.)

	2013	2014	2015	2016	2017	2018	2019	2020
							Forecast	
Bosnia and Herzegovina								
Producer price index, 2010=100	104.1	103.5	104.1	101.9	105.0	106.9	109.1	111.4
Consumer price index, 2010=100	105.8	104.8	103.8	102.6	103.9	105.5	107.5	109.6
GDP deflator, 2010=100	103.0	104.1	105.5	107.0	108.4	110.2	112.2	114.3
Exchange rate (ER), NC/EUR	1.9558	1.9558	1.9558	1.9558	1.9558	1.9558	1.9558	1.9558
ER, nominal, 2010=100	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Real ER (CPI-based), 2010=100	98.5	97.1	96.2	94.8	94.4	94.3	94.4	94.4
Real ER (PPI-based), 2010=100	96.2	97.6	100.5	100.0	99.7	100.0	100.4	100.9
PPP, NC/EUR	0.9342	0.9324	0.9288	0.9490	0.9580	0.96	0.96	0.96
Price level, EU28 = 100	48	48	47	49	49	49	49	49
Average monthly gross wages, EUR (ER)	660	659	659	665	675	700	720	740
Average monthly gross wages, EUR (PPP)	1,382	1,383	1,388	1,371	1,378	1,420	1,460	1,490
GDP per employed person, 2010=100	105.1	107.6	109.6	116.0	117.3	119.3	121.6	124.3
Unit labour costs, ER adj., 2010=100	101.0	98.5	96.7	92.2	92.5	93.7	94.6	95.2
Unit labour costs, PPP adj., Austria=100	46.8	45.1	43.5	40.3	40.1	40.3	40.0	39.6
Montenegro								
Producer price index, 2010=100	106.8	107.0	107.3	107.2	107.6	109.7	111.9	114.2
Consumer price index, 2010=100	109.4	108.8	110.3	110.5	113.5	115.8	118.1	120.5
GDP deflator, 2010=100	103.5	104.6	106.9	112.3	114.8	116.9	118.7	120.1
Real ER (CPI-based), 2010=100	101.9	100.8	102.3	102.1	103.2	103.5	103.7	103.8
Real ER (PPI-based), 2010=100	98.8	100.8	103.6	105.2	102.2	102.7	103.0	103.4
PPP, NC/EUR	0.4956	0.4909	0.4780	0.4896	0.4987	0.50	0.50	0.50
Price level, EU28 = 100	50	49	48	49	50	50	50	50
Average monthly gross wages, EUR (ER)	726	723	725	751	765	790	810	830
Average monthly gross wages, EUR (PPP)	1,465	1,473	1,517	1,534	1,534	1,580	1,620	1,670
GDP per employed person, 2010=100	107.2	101.8	102.7	104.6	106.4	108.6	110.6	111.9
Unit labour costs, ER adj., 2010=100	94.7	99.3	98.7	100.4	100.6	101.8	102.5	103.7
Unit labour costs, PPP adj., Austria=100	51.1	53.0	51.7	51.1	50.7	50.6	50.1	49.9
Macedonia								
Producer price index, 2010=100	111.8	109.7	105.4	102.9	106.5	108.6	110.8	114.1
Consumer price index, 2010=100	110.3	110.0	109.7	109.5	110.9	112.6	114.9	117.2
GDP deflator, 2010=100	109.5	111.0	113.2	117.8	119.4	121.2	123.6	126.2
Exchange rate (ER), NC/EUR	61.58	61.62	61.61	61.60	61.57	61.5	61.5	61.5
ER, nominal, 2010=100	100.1	100.2	100.2	100.1	100.1	100.0	100.0	100.0
Real ER (CPI-based), 2010=100	102.6	101.8	101.5	101.0	100.7	100.6	100.8	100.9
Real ER (PPI-based), 2010=100	103.3	103.2	101.6	100.8	101.0	101.7	102.0	103.4
PPP, NC/EUR	26.01	25.77	25.83	26.54	26.81	26.8	26.9	27.0
Price level, EU28 = 100	42	42	42	43	44	44	44	44
Average monthly gross wages, EUR (ER)	504	508	522	533	546	560	580	600
Average monthly gross wages, EUR (PPP)	1,193	1,215	1,246	1,237	1,253	1,280	1,320	1,360
GDP per employed person, 2010=100	98.5	100.5	102.0	102.5	101.9	104.1	106.2	108.1
Unit labour costs, ER adj., 2010=100	104.1	103.0	104.2	105.8	109.0	109.4	110.3	112.6
Unit labour costs, PPP adj., Austria=100	42.8	41.8	41.5	41.1	41.9	41.5	41.4	41.4
Serbia								
Producer price index, 2010=100	123.6	125.2	126.5	126.5	129.4	131.0	133.6	137.6
Consumer price index, 2010=100	128.4	131.1	132.9	134.4	138.4	142.6	146.8	152.7
GDP deflator, 2010=100	122.8	126.1	129.5	132.7	137.5	142.7	147.5	154.7
Exchange rate (ER), NC/EUR	113.14	117.31	120.76	123.12	121.34	123	124	126
ER, nominal, 2010=100	109.8	113.8	117.2	119.5	117.8	119.4	120.3	122.3
Real ER (CPI-based), 2010=100	108.9	106.7	105.1	103.9	106.8	106.7	107.1	107.6
Real ER (PPI-based), 2010=100	104.1	103.7	104.3	103.9	104.4	102.7	102.1	101.9
PPP, NC/EUR	53.54	54.00	54.31	56.52	58.36	59.7	60.6	62.6
Price level, EU28 = 100	47	46	45	46	48	49	49	50
Average monthly gross wages, EUR (ER)	537	524	506	516	550	570	590	620
Average monthly gross wages, EUR (PPP)	1,134	1,137	1,126	1,123	1,143	1,170	1,210	1,250
GDP per employed person, 2010=100	106.8	100.0	94.8	92.2	91.6	92.2	92.8	94.5
Unit labour costs, ER adj., 2010=100	109.1	113.7	116.0	121.4	130.3	134.2	138.9	142.5
Unit labour costs, PPP adj., Austria=100	41.9	43.1	43.2	44.0	46.7	47.5	48.0	48.8

(Table 35 ctd.)

Table 35 / (ctd.)

	2013	2014	2015	2016	2017	2018	2019	2020
							Forecast	
Kosovo								
Producer price index, 2010=100	109.1	110.9	113.9	113.8	118.7	122.8	125.9	129.1
Consumer price index, 2010=100	112.0	112.4	111.8	112.2	113.9	116.0	118.7	121.4
GDP deflator, 2010=100	109.0	112.6	112.8	113.3	115.0	117.6	119.9	121.9
Real ER (CPI-based), 2010=100	104.3	104.2	103.7	103.7	103.5	103.7	104.2	104.6
Real ER (PPI-based), 2010=100	100.9	104.5	110.0	111.7	112.7	115.0	115.9	116.9
PPP, NC/EUR	0.4504	0.4553	0.4398	0.4440	0.4490	0.45	0.45	0.45
Price level, EU28 = 100	45	46	44	44	45	45	45	45
Average monthly gross wages, EUR (ER)	444	482	510	519	511	540	570	610
Average monthly gross wages, EUR (PPP)	986	1,059	1,160	1,169	1,138	1,190	1,260	1,340
GDP per employed person, 2010=100	93.9	99.4	112.7	105.0	97.8	96.2	97.5	98.8
Unit labour costs, ER adj., 2010=100	135.9	139.4	130.0	142.1	150.1	161.3	168.0	177.4
Unit labour costs, PPP adj., Austria=100	30.3	30.7	28.1	29.9	31.2	33.1	33.9	35.2
Belarus								
Producer price index, 2010=100	337.3	379.1	444.3	497.7	546.4	595.6	643.3	694.7
Consumer price index, 2010=100	288.5	340.8	386.8	432.4	458.3	485.8	519.8	556.2
GDP deflator, 2010=100	363.1	428.9	497.5	538.9	583.0	617.8	661.0	707.0
Exchange rate (ER), NC/EUR	1.183	1.322	1.783	2.201	2.183	2.6	2.8	3.0
ER, nominal, 2010=100	295.4	330.0	445.0	549.3	544.9	648.9	698.8	748.8
Real ER (CPI-based), 2010=100	91.0	95.7	80.6	72.7	76.4	66.9	65.3	64.0
Real ER (PPI-based), 2010=100	105.6	108.3	96.4	88.9	95.2	85.9	84.7	84.0
PPP, NC/EUR	0.528	0.610	0.683	0.745	0.803	0.84	0.88	0.93
Price level, EU28 = 100	45	46	38	34	37	32	32	31
Average monthly gross wages, EUR (ER)	428	458	377	328	373	340	340	350
Average monthly gross wages, EUR (PPP)	959	991	984	970	1,015	1,050	1,090	1,120
GDP per employed person, 2010=100	111.3	113.9	110.9	110.3	114.4	118.6	121.4	126.9
Unit labour costs, ER adj., 2010=100	126.5	132.3	111.8	97.9	107.4	93.9	93.0	89.9
Unit labour costs, PPP adj., Austria=100	36.7	37.9	31.5	26.8	29.1	25.2	24.2	23.5
Kazakhstan								
Producer price index, 2010=100	131.3	143.7	114.3	133.5	153.9	167.7	176.1	183.2
Consumer price index, 2010=100	120.5	128.6	137.1	157.1	168.8	178.9	189.7	201.1
GDP deflator, 2010=100	138.4	146.4	149.2	169.5	184.7	195.9	205.9	216.4
Exchange rate (ER), NC/EUR	202.1	238.1	245.8	378.6	368.3	396	408	420
ER, nominal, 2010=100	103.3	121.7	125.6	193.5	188.2	202.4	208.5	214.6
Real ER (CPI-based), 2010=100	108.7	98.0	101.1	75.0	81.5	79.0	79.8	80.7
Real ER (PPI-based), 2010=100	117.5	111.3	87.9	67.7	77.7	77.6	77.7	77.3
PPP, NC/EUR	121.0	125.3	123.0	141.6	153.8	160.6	166.0	171.8
Price level, EU28 = 100	60	53	50	37	42	41	41	41
Average monthly gross wages, EUR (ER)	540	508	513	377	408	410	430	450
Average monthly gross wages, EUR (PPP)	902	966	1,025	1,009	977	1,000	1,050	1,100
GDP per employed person, 2010=100	112.9	118.4	118.2	120.5	124.6	127.7	130.9	134.2
Unit labour costs, ER adj., 2010=100	120.6	108.2	109.4	79.0	82.5	80.2	82.1	84.1
Unit labour costs, PPP adj., Austria=100	37.0	32.8	32.6	22.9	23.7	22.9	23.0	23.1
Russia [4)]								
Producer price index, 2010=100	129.9	138.1	156.8	163.4	176.0	184.8	194.1	203.8
Consumer price index, 2010=100	121.7	131.2	151.5	162.3	168.1	174.8	181.8	189.1
GDP deflator, 2010=100	133.3	143.3	154.8	159.8	168.6	175.2	183.9	193.1
Exchange rate (ER), NC/EUR	42.27	50.77	67.76	74.26	65.87	67.0	68.5	69.0
ER, nominal, 2010=100	105.0	126.1	168.3	184.4	163.6	166.4	170.1	171.3
Real ER (CPI-based), 2010=100	108.0	96.4	83.4	81.3	93.4	93.9	93.8	95.0
Real ER (PPI-based), 2010=100	114.4	103.3	90.0	87.0	102.2	104.0	105.0	107.7
PPP, NC/EUR	26.44	28.87	31.76	34.41	36.19	37.0	38.2	39.5
Price level, EU28 = 100	63	57	47	46	55	55	56	57
Average monthly gross wages, EUR (ER)	705	640	502	494	593	640	670	730
Average monthly gross wages, EUR (PPP)	1,127	1,125	1,071	1,067	1,080	1,170	1,210	1,280
GDP per employed person, 2010=100	116.1	116.7	112.5	112.2	114.3	116.1	118.2	120.0
Unit labour costs, ER adj., 2010=100	116.7	105.4	85.8	84.7	99.8	106.7	109.7	117.2
Unit labour costs, PPP adj., Austria=100	44.4	39.7	31.7	30.4	35.5	37.2	37.6	39.7

4) From 2014 including Crimean Federal District (for LFS employment and wages from 2015).

(Table 35 ctd.)

Table 35 / (ctd.)

	2013	2014	2015	2016	2017	2018	2019	2020
							Forecast	
Ukraine [5]								
Producer price index, 2010=100	123.3	144.4	196.3	236.6	299.0	343.9	368.0	393.7
Consumer price index, 2010=100	108.3	121.4	180.6	205.7	235.3	260.7	278.2	294.8
GDP deflator, 2010=100	128.6	149.1	207.1	242.5	277.2	310.1	328.6	345.7
Exchange rate (ER), NC/EUR	10.61	15.72	24.23	28.29	30.00	35.0	37.0	39.0
ER, nominal, 2010=100	100.8	149.2	230.0	268.6	284.9	332.3	351.3	370.3
Real ER (CPI-based), 2010=100	100.1	75.4	72.7	70.7	75.0	70.1	69.5	68.6
Real ER (PPI-based), 2010=100	113.1	91.2	82.4	86.4	99.7	96.9	96.4	96.3
PPP, NC/EUR	5.082	5.766	7.717	9.158	10.431	11.50	11.98	12.41
Price level, EU28 = 100	48	37	32	32	35	33	32	32
Average monthly gross wages, EUR (ER)	308	221	173	183	237	240	250	250
Average monthly gross wages, EUR (PPP)	643	604	544	566	681	720	760	800
GDP per employed person, 2010=100	104.9	106.5	105.6	109.3	112.2	115.6	119.2	123.2
Unit labour costs, ER adj., 2010=100	137.9	97.8	77.1	78.8	99.3	96.5	97.1	97.0
Unit labour costs, PPP adj., Austria=100	49.9	35.0	27.1	26.9	33.6	32.6	32.3	30.8
Austria								
Producer price index, 2010=100	104.0	102.9	101.4	99.5	101.5	103.3	105.1	107.2
Consumer price index, 2010=100	107.9	109.7	110.7	111.7	114.1	116.3	118.6	120.9
GDP deflator, 2010=100	105.6	107.7	110.2	111.4	113.3	115.3	117.4	119.7
Real ER (CPI-based), 2010=100	100.5	101.7	102.6	103.2	103.6	103.9	104.0	104.1
Real ER (PPI-based), 2010=100	96.2	97.0	97.9	97.7	96.4	96.7	96.7	97.1
PPP, NC/EUR	1.085	1.084	1.058	1.088	1.081	1.084	1.084	1.088
Price level, EU28 = 100	109	108	106	109	108	108	108	109
Average monthly gross wages, EUR	2,899	2,950	3,013	3,087	3,152	3,230	3,320	3,400
Average monthly gross wages, EUR (PPP)	2,671	2,721	2,847	2,839	2,916	2,980	3,060	3,120
GDP per employed person, 2010=100	101.4	102.1	102.3	102.0	103.1	104.3	105.3	106.2
Unit labour costs, ER adj., 2010=100	105.5	106.7	108.7	111.7	112.8	114.4	116.3	118.2
Unit labour costs, PPP 2010 adjusted	0.51	0.52	0.53	0.54	0.55	0.56	0.57	0.57

6) From 2014 excluding the occupied territories of Crimea and Sevastopol and from 2015 parts of the anti-terrorist operation zone.

Notes:
From February 2018 average monthly gross wages for Austria have been changed to gross wages per employee instead of gross wages per full-time employee. This lower Austrian wage level affects the ULC comparison of CESEE countries with Austria.
Unit labour costs are defined as average gross wages per employee relative to labour productivity (real GDP per employed person, LFS). Average gross monthly wages refer to register-based survey data, those for Austria are based on National Accounts data (annual gross wages divided by employees (domestic concept) and by 12 months). For level comparisons, labour productivity is converted with the PPP rate 2010 (PPP adjusted).
PPP rates have been taken from Eurostat based on the benchmark results 2011. Missing data have been extrapolated by wiiw with GDP deflators. Belarus, Kazakhstan, Kosovo, Russia and Ukraine are converted from the USD parity provided by IMF (WDI).

Real exchange rates: Increasing values mean real appreciation.
ER = Exchange Rate, PPP = Purchasing Power Parity, Price level: PPP/ ER.

Sources: wiiw Annual Database incorporating national and Eurostat statistics; WIFO; IMF (WDI - World Development Indicators).
wiiw estimates and forecasts.

Table 36 / Indicators of macro-competitiveness, 2013-2020, annual changes in %

	2013	2014	2015	2016	2017	2018	2019	2020	2013-17
							Forecast		average
Bulgaria									
GDP deflator	-0.7	0.5	2.2	2.2	1.4	2.5	3.0	3.0	1.1
Real ER (CPI-based)	-1.1	-2.1	-1.1	-1.6	-0.5	0.8	1.2	1.1	-1.3
Real ER (PPI-based)	-1.4	0.7	0.5	-1.5	1.5	1.5	0.8	0.9	-0.1
Average gross wages, real (PPI based)	7.6	7.4	8.9	11.5	6.4	6.5	6.8	6.8	8.3
Average gross wages, real (CPI based)	5.6	7.7	8.0	9.4	10.2	7.0	6.3	6.3	8.2
Average gross wages, EUR (ER)	6.0	6.0	6.8	8.0	11.5	9.1	10.2	9.2	7.7
Employed persons (LFS)	0.0	1.6	1.7	-0.5	4.4	1.6	0.9	0.9	1.4
GDP per empl. person, NC at 2010 ref. pr.	0.9	-0.3	1.9	4.5	-0.6	2.1	2.5	2.4	1.2
Unit labour costs, ER (EUR) adjusted	5.1	6.3	4.9	3.4	12.2	7.5	6.8	6.9	6.3
Czech Republic									
GDP deflator	1.4	2.5	1.2	1.2	1.1	2.0	2.0	2.1	1.5
Exchange rate (ER), EUR/NC	-3.2	-5.7	0.9	0.9	2.7	3.2	1.0	1.0	-0.9
Real ER (CPI-based)	-3.3	-5.7	1.2	1.2	3.4	3.8	1.2	0.9	-0.7
Real ER (PPI-based)	-2.5	-2.9	0.9	-0.8	1.2	2.7	0.8	0.4	-0.8
Average gross wages, real (PPI based)	-0.8	2.0	5.7	7.2	5.1	5.4	3.9	4.4	3.8
Average gross wages, real (CPI based)	-1.5	2.5	2.9	3.1	4.5	4.0	3.3	3.6	2.3
Average gross wages, EUR (ER)	-3.3	-2.9	4.2	4.6	9.9	9.8	6.5	6.9	2.4
Employed persons (LFS)	1.0	0.8	1.4	1.9	1.6	0.4	0.4	0.2	1.3
GDP per empl. person, NC at 2010 ref. pr.	-1.4	1.9	3.9	0.7	2.5	3.1	2.8	3.0	1.5
Unit labour costs, ER (EUR) adjusted	-1.9	-4.7	0.3	4.0	7.1	6.5	3.6	3.4	0.8
Estonia									
GDP deflator	3.6	1.5	1.2	1.6	3.6	3.0	2.8	2.5	2.3
Real ER (CPI-based)	1.7	0.0	0.1	0.5	2.0	1.5	1.2	0.6	0.8
Real ER (PPI-based)	7.3	-0.8	-0.6	0.3	-0.3	1.7	1.3	0.9	1.1
Average gross wages, real (PPI based)	-0.2	8.8	9.2	9.0	3.9	4.3	3.7	3.8	6.1
Average gross wages, real (CPI based)	3.7	5.4	5.9	6.8	3.2	4.3	3.7	3.8	5.0
Average gross wages, EUR (ER)	7.0	5.9	6.0	7.6	7.0	7.7	6.8	6.4	6.7
Employed persons (LFS)	1.0	0.6	2.6	0.6	1.6	0.8	0.8	0.5	1.3
GDP per empl. person, NC at 2010 ref. pr.	0.9	2.3	-0.9	1.5	2.6	2.7	2.0	2.0	1.3
Unit labour costs, ER (EUR) adjusted	6.0	3.5	6.9	6.0	4.2	4.8	4.7	4.3	5.3
Croatia									
GDP deflator	0.8	0.1	0.0	-0.1	1.3	1.6	1.6	1.6	0.4
Exchange rate (ER), EUR/NC	-0.8	-0.7	0.3	1.1	0.9	-0.5	0.0	0.0	0.2
Real ER (CPI-based)	0.0	-1.0	0.0	0.2	0.5	-0.6	-0.2	-0.3	-0.1
Real ER (PPI-based)	-1.1	-1.5	-1.2	-1.7	-0.5	0.0	0.3	0.4	-1.2
Average gross wages, real (PPI based) [1]	1.3	2.9	5.3	6.5	1.9	1.6	1.6	2.1	3.6
Average gross wages, real (CPI based) [1]	-1.5	0.0	1.6	2.5	2.5	2.0	2.0	2.5	1.0
Average gross wages, EUR (ER) [1]	0.1	-0.6	1.6	3.0	4.8	2.9	3.6	4.3	1.8
Employed persons (LFS)	-2.7	2.7	1.3	0.3	0.6	0.6	1.2	1.2	0.4
GDP per empl. person, NC at 2010 ref. pr.	2.1	-2.8	1.1	2.9	2.3	2.1	1.7	1.8	1.1
Unit labour costs, ER (EUR) adjusted	-2.0	2.3	0.5	0.1	2.4	1.0	1.8	2.3	0.6
Hungary									
GDP deflator	2.9	3.4	1.9	1.0	2.9	3.5	3.0	3.1	2.4
Exchange rate (ER), EUR/NC	-2.6	-3.8	-0.4	-0.5	0.7	-1.2	-1.3	-0.6	-1.3
Real ER (CPI-based)	-2.4	-4.3	-0.3	-0.4	1.4	-0.1	-0.2	0.3	-1.2
Real ER (PPI-based)	-1.9	-2.3	1.1	-0.5	0.7	-0.7	-1.9	-1.2	-0.6
Average gross wages, real (PPI based)	2.9	3.4	5.3	8.0	6.8	7.8	4.9	4.9	5.2
Average gross wages, real (CPI based)	1.7	3.0	4.2	5.7	7.7	7.0	3.0	3.0	4.5
Average gross wages, EUR (ER)	0.8	-0.9	3.9	5.7	11.1	8.6	4.9	4.7	4.0
Employed persons (LFS)	1.7	5.3	2.7	3.4	1.6	0.4	0.0	0.0	2.9
GDP per empl. person, NC at 2010 ref. pr.	0.4	-1.1	0.7	-1.1	2.4	3.4	2.8	1.7	0.2
Unit labour costs, ER (EUR) adjusted	0.4	0.1	3.2	6.8	8.5	5.1	1.8	3.6	3.8
Lithuania									
GDP deflator	1.3	1.0	0.3	1.0	3.8	2.7	2.8	2.5	1.5
Real ER (CPI-based)	-0.3	-0.3	-0.7	0.4	2.0	1.3	0.9	0.6	0.2
Real ER (PPI-based)	-2.3	-3.0	-7.5	-2.7	1.5	2.0	1.8	1.9	-2.9
Average gross wages, real (PPI based)	7.7	10.2	16.8	13.2	4.7	4.6	4.0	4.4	10.4
Average gross wages, real (CPI based)	3.8	4.6	6.2	7.6	5.9	5.1	4.8	5.4	5.6
Average gross wages, EUR (ER)	5.1	4.8	5.4	8.4	9.8	8.2	7.6	8.1	6.7
Employed persons (LFS)	1.3	2.0	1.2	2.0	-0.2	-0.4	-0.2	0.0	1.3
GDP per empl. person, NC at 2010 ref. pr.	2.1	1.5	0.8	0.4	4.2	3.7	2.6	2.1	1.8
Unit labour costs, ER (EUR) adjusted	2.9	3.3	4.6	8.0	5.4	4.4	4.9	5.8	4.8

1) From 2016 new data sources, growth rates comparable.

(Table 36 ctd.)

Table 36 / (ctd.)

	2013	2014	2015	2016	2017	2018	2019	2020	2013-17
							Forecast		average
Latvia									
GDP deflator	1.7	1.8	0.0	0.3	3.3	2.4	2.9	2.5	1.4
Real ER (CPI-based)	-2.1	0.0	0.2	-0.2	1.2	1.3	1.2	0.6	-0.2
Real ER (PPI-based)	1.1	2.2	1.4	-1.4	-1.1	1.0	0.3	0.4	0.4
Average gross wages, real (PPI based)	2.9	6.4	8.1	8.3	6.0	4.9	4.9	3.5	6.3
Average gross wages, real (CPI based)	4.6	6.1	6.7	4.9	5.2	4.4	3.9	3.0	5.5
Average gross wages, EUR (ER)	3.9	6.7	6.9	5.0	8.3	7.5	7.0	5.6	6.2
Employed persons (LFS)	2.1	-1.0	1.3	-0.3	-0.4	0.3	0.0	-0.3	0.3
GDP per empl. person, NC at 2010 ref. pr.	0.5	3.0	1.5	2.4	4.9	3.2	3.4	3.3	2.4
Unit labour costs, ER (EUR) adjusted	3.5	3.6	5.3	2.6	3.2	4.2	3.5	2.2	3.6
Poland									
GDP deflator	0.3	0.5	0.8	0.4	0.8	1.7	1.3	1.3	0.6
Exchange rate (ER), EUR/NC	-0.3	0.3	0.0	-4.1	2.5	0.2	1.2	0.0	-0.3
Real ER (CPI-based)	-1.0	-0.1	-0.7	-4.6	2.4	0.6	1.4	0.1	-0.8
Real ER (PPI-based)	-1.5	0.9	0.4	-2.8	1.9	0.7	1.3	0.2	-0.2
Average gross wages, real (PPI based)	5.0	4.6	5.6	3.9	4.1	3.5	3.6	3.1	4.6
Average gross wages, real (CPI based)	2.8	3.1	4.2	3.8	5.3	3.4	3.4	2.9	3.8
Average gross wages, EUR (ER)	3.3	3.5	3.5	-0.7	9.7	6.2	6.5	4.3	3.8
Employed persons (LFS)	-0.1	1.9	1.4	0.7	1.8	0.7	0.3	0.2	1.1
GDP per empl. person, NC at 2010 ref. pr.	1.5	1.4	2.4	2.1	2.7	3.0	3.3	3.1	2.0
Unit labour costs, ER (EUR) adjusted	1.8	2.1	1.0	-2.8	6.7	2.6	3.3	1.8	3.0
Romania									
GDP deflator	3.4	1.7	2.6	2.1	4.3	2.3	1.6	2.0	2.8
Exchange rate (ER), EUR/NC	0.9	-0.6	0.0	-1.0	-1.7	-1.7	-1.1	-1.1	-0.5
Real ER (CPI-based)	2.6	0.3	-0.4	-2.4	-2.3	0.0	0.1	0.0	-0.5
Real ER (PPI-based)	3.1	1.2	0.0	-1.3	-1.3	-1.3	-0.8	-0.7	0.3
Average gross wages, real (PPI based) [2]	2.8	7.8	12.4	12.0	10.7	33.8	4.7	4.3	9.1
Average gross wages, real (CPI based) [2]	1.6	6.1	10.2	11.2	13.6	31.8	3.7	3.3	8.4
Average gross wages, EUR (ER) [2]	5.8	7.0	9.7	8.8	12.8	34.6	5.3	5.0	8.8
Employed persons (LFS)	-0.7	0.8	-0.9	-1.0	2.5	0.6	1.0	0.0	0.1
GDP per empl. person, NC at 2010 ref. pr.	4.2	2.3	4.9	5.9	4.3	4.1	2.7	4.2	4.3
Unit labour costs, ER (EUR) adjusted	1.5	4.6	4.6	2.8	8.2	28.7	2.9	1.1	4.3
Slovenia									
GDP deflator	1.6	0.8	1.0	0.9	1.7	1.8	1.7	1.9	1.2
Real ER (CPI-based)	0.4	-0.1	-0.8	-0.5	-0.1	0.1	0.0	-0.1	-0.2
Real ER (PPI-based)	0.1	1.3	2.2	0.3	-1.2	0.5	0.3	0.4	0.5
Average gross wages, real (PPI based)	-0.2	1.8	1.0	3.2	0.4	1.4	1.5	1.4	1.2
Average gross wages, real (CPI based)	-2.0	0.7	1.5	2.1	0.9	1.6	1.7	1.6	0.6
Average gross wages, EUR (ER)	-0.2	1.1	0.7	1.8	2.5	3.4	3.6	3.4	1.2
Employed persons (LFS)	-1.9	1.2	0.1	-0.3	3.8	1.1	2.1	1.0	0.6
GDP per empl. person, NC at 2010 ref. pr.	0.8	1.8	2.2	3.4	0.7	2.9	1.4	2.3	1.8
Unit labour costs, ER (EUR) adjusted	-1.0	-0.6	-1.4	-1.5	1.8	0.5	2.2	1.1	-0.6
Slovakia									
GDP deflator	0.5	-0.2	-0.2	-0.4	-0.5	2.0	1.8	2.2	-0.2
Real ER (CPI-based)	0.0	-0.6	-0.3	-0.8	-0.3	0.3	0.0	0.3	-0.4
Real ER (PPI-based)	-0.9	-1.6	-0.6	-2.5	-0.9	1.5	0.8	0.9	-1.3
Average gross wages, real (PPI based)	3.4	7.9	6.0	7.6	2.8	2.1	2.4	3.1	5.5
Average gross wages, real (CPI based)	0.8	4.2	3.2	3.8	3.8	3.1	3.1	3.4	3.2
Average gross wages, EUR (ER)	2.4	4.1	2.9	3.3	5.3	5.2	5.0	5.7	3.6
Employed persons (LFS)	0.0	1.5	2.6	2.8	1.5	1.2	0.8	0.8	1.7
GDP per empl. person, NC at 2010 ref. pr.	1.5	1.3	1.2	0.5	1.9	2.5	3.6	2.3	1.3
Unit labour costs, ER (EUR) adjusted	0.9	2.8	1.7	2.8	3.3	2.7	1.3	3.3	2.3
Albania									
GDP deflator	0.3	1.5	0.1	-0.2	4.6	2.1	1.8	1.6	1.2
Exchange rate (ER), EUR/NC	-0.9	0.2	0.2	1.7	2.4	0.9	-0.2	0.0	0.7
Real ER (CPI-based)	-0.4	1.3	2.1	2.7	2.7	2.0	1.0	1.1	1.7
Real ER (PPI-based)	-1.2	1.7	0.5	1.8	2.1	1.4	0.1	-0.1	1.0
Average gross wages, real (PPI based) [3]	-2.8	1.4	5.0	-0.6	5.5	4.3	5.1	5.5	1.7
Average gross wages, real (CPI based) [3]	-5.0	-0.7	0.9	-3.3	6.6	3.4	4.0	3.9	-0.4
Average gross wages, EUR (ER) [3]	-4.0	1.1	3.0	-0.4	11.3	7.7	7.5	7.0	2.1
Employed persons (LFS)	-10.2	1.3	4.8	6.5	3.3	2.1	1.6	1.6	0.9
GDP per empl. person, NC at 2010 ref. pr.	12.5	0.5	-2.4	-2.9	0.6	2.0	2.3	2.3	1.5
Unit labour costs, ER (EUR) adjusted	-14.7	0.6	5.6	2.6	10.6	5.2	4.6	4.7	0.6

2) In 2018 the employers' social security contribution will be added to gross wages increasing the latter by 25% in NC (23.6% in EUR terms). - 3) From 2014 new data sources, growth rates comparable. (Table 36 ctd.)

Table 36 / (ctd.)

	2013	2014	2015	2016	2017	2018	2019 Forecast	2020	2013-17 average
Bosnia and Herzegovina									
GDP deflator	-0.2	1.0	1.4	1.4	1.3	1.7	1.8	1.9	1.0
Real ER (CPI-based)	-1.6	-1.4	-1.0	-1.4	-0.5	-0.1	0.1	0.0	-1.2
Real ER (PPI-based)	-1.7	1.4	3.1	-0.5	-0.3	0.3	0.4	0.5	0.4
Average gross wages, real (PPI based)	1.9	0.4	-0.6	3.1	-1.5	1.2	0.8	0.7	0.6
Average gross wages, real (CPI based)	0.2	0.8	1.0	2.0	0.3	1.4	1.0	0.9	0.8
Average gross wages, EUR (ER)	0.1	-0.1	0.0	0.9	1.5	3.7	2.9	2.8	0.5
Employed persons (LFS)	1.0	-1.2	1.2	-2.6	1.8	1.8	1.2	1.2	0.0
GDP per empl. person, NC at 2010 ref. pr.	1.4	2.3	1.8	5.8	1.1	1.7	1.9	2.2	2.5
Unit labour costs, ER (EUR) adjusted	-1.3	-2.4	-1.8	-4.7	0.3	1.3	1.0	0.7	-2.0
Montenegro									
GDP deflator	2.1	1.0	2.2	5.1	2.2	1.8	1.5	1.2	2.5
Real ER (CPI-based)	0.3	-1.0	1.4	-0.2	1.1	0.3	0.2	0.1	0.3
Real ER (PPI-based)	1.7	2.0	2.8	1.5	-2.8	0.5	0.3	0.4	1.0
Average gross wages, real (PPI based)	-1.7	-0.5	0.0	3.7	1.5	1.2	0.5	0.5	0.6
Average gross wages, real (CPI based)	-1.9	0.1	-1.1	3.5	-0.9	1.2	0.5	0.5	-0.1
Average gross wages, EUR (ER)	-0.1	-0.4	0.3	3.6	1.9	3.3	2.5	2.5	1.0
Employed persons (LFS)	1.0	7.1	2.5	1.1	2.1	0.9	0.9	2.1	2.7
GDP per empl. person, NC at 2010 ref. pr.	2.6	-5.0	0.9	1.8	1.7	2.0	1.8	1.2	0.4
Unit labour costs, ER (EUR) adjusted	-2.6	4.8	-0.6	1.8	0.1	1.2	0.7	1.2	0.7
Macedonia									
GDP deflator	4.5	1.4	2.0	4.1	1.4	1.5	2.0	2.1	2.7
Exchange rate (ER), EUR/NC	-0.1	-0.1	0.0	0.0	0.0	0.1	0.0	0.0	0.0
Real ER (CPI-based)	1.2	-0.9	-0.3	-0.5	-0.3	-0.1	0.2	0.1	-0.1
Real ER (PPI-based)	-1.4	-0.1	-1.5	-0.8	0.2	0.6	0.3	1.4	-0.7
Average gross wages, real (PPI based)	2.6	3.0	6.9	4.5	-1.1	0.4	0.9	0.9	3.1
Average gross wages, real (CPI based)	-1.6	1.3	3.0	2.2	1.0	0.9	0.9	1.9	1.2
Average gross wages, EUR (ER)	1.1	0.9	2.7	2.0	2.4	2.6	3.6	3.4	1.8
Employed persons (LFS)	4.3	1.7	2.3	2.5	1.0	1.2	1.4	1.3	2.4
GDP per empl. person, NC at 2010 ref. pr.	-1.4	2.0	1.5	0.4	-0.5	2.1	2.0	1.8	0.4
Unit labour costs, ER (EUR) adjusted	2.5	-1.1	1.2	1.6	3.0	0.4	0.9	2.1	1.4
Serbia									
GDP deflator	5.4	2.7	2.7	2.5	3.6	3.8	3.4	4.9	3.4
Exchange rate (ER), EUR/NC	0.0	-3.6	-2.9	-1.9	1.5	-1.4	-0.8	-1.6	-1.4
Real ER (CPI-based)	6.1	-2.0	-1.5	-1.1	2.8	-0.1	0.4	0.4	0.8
Real ER (PPI-based)	2.8	-0.4	0.6	-0.3	0.4	-1.6	-0.5	-0.2	0.6
Average gross wages, real (PPI based)	2.9	-0.1	-1.5	3.8	2.7	3.9	2.9	3.0	1.6
Average gross wages, real (CPI based)	-1.8	-0.9	-1.8	2.7	2.0	2.0	1.9	2.0	0.0
Average gross wages, EUR (ER)	5.7	-2.4	-3.3	1.8	6.6	3.7	3.5	5.1	1.6
Employed persons (LFS)	3.7	4.8	0.6	5.6	2.6	2.2	2.1	1.0	3.4
GDP per empl. person, NC at 2010 ref. pr.	-1.1	-6.3	0.2	-2.7	-0.7	0.6	0.7	1.8	-2.1
Unit labour costs, ER (EUR) adjusted	6.9	4.2	-3.5	4.6	7.4	3.0	3.4	2.6	3.8
Kosovo									
GDP deflator	1.8	3.3	0.2	0.4	1.5	2.3	2.0	1.7	1.4
Real ER (CPI-based)	0.3	-0.1	-0.5	0.0	-0.2	0.2	0.5	0.4	-0.1
Real ER (PPI-based)	2.4	3.6	5.2	1.5	0.9	2.0	0.8	0.9	2.7
Average net wages, real (PPI based)	0.7	6.8	3.0	1.9	-5.6	2.1	3.0	4.4	1.3
Average net wages, real (CPI based)	1.2	8.1	6.3	1.5	-3.0	3.7	3.2	4.6	2.7
Average net wages, EUR (ER)	3.0	8.6	5.8	1.8	-1.5	5.7	5.6	7.0	3.5
Employed persons (LFS)	11.7	-4.4	-8.2	11.7	11.5	5.4	2.6	2.5	4.1
GDP per empl. person, NC at 2010 ref. pr.	-7.4	5.9	13.4	-6.9	-6.8	-1.6	1.4	1.3	-0.7
Unit labour costs, ER (EUR) adjusted	11.3	2.5	-6.7	9.3	5.7	7.4	4.1	5.6	4.2
Belarus									
GDP deflator	21.3	18.1	16.0	8.3	8.2	6.0	7.0	7.0	14.3
Exchange rate (ER), EUR/NC	-8.9	-10.5	-25.8	-19.0	0.8	-16.0	-7.1	-6.7	-13.2
Real ER (CPI-based)	6.2	5.2	-15.8	-9.7	5.1	-12.5	-2.4	-2.0	-2.3
Real ER (PPI-based)	3.7	2.6	-11.0	-7.8	7.1	-9.8	-1.4	-0.8	-1.3
Average gross wages, real (PPI based)	21.1	6.4	-5.3	-3.9	2.7	-1.0	1.0	0.3	3.8
Average gross wages, real (CPI based)	16.4	1.3	-2.2	-3.7	6.4	1.8	2.0	1.2	3.4
Average gross wages, EUR (ER)	25.4	7.0	-17.7	-12.8	13.7	-8.9	0.0	2.9	1.8
Employment registered	-0.7	-0.6	-1.2	-2.0	-1.2	-0.5	-0.5	-0.5	-1.2
GDP per empl. person, NC at 2010 ref. pr.	1.7	2.3	-2.6	-0.5	3.7	3.7	2.3	4.5	0.9
Unit labour costs, ER (EUR) adjusted	23.3	4.6	-15.5	-12.4	9.7	-12.6	-1.0	-3.3	0.9

(Table 36 ctd.)

Table 36 / (ctd.)

	2013	2014	2015	2016	2017	2018	2019	2020	2013-17
							Forecast		average
Kazakhstan									
GDP deflator	9.5	5.8	1.9	13.6	9.0	6.0	5.1	5.1	7.9
Exchange rate (ER), EUR/NC	-5.2	-15.1	-3.1	-35.1	2.8	-7.0	-2.9	-2.9	-12.2
Real ER (CPI-based)	-1.1	-9.9	3.3	-25.8	8.6	-3.1	1.1	1.1	-5.8
Real ER (PPI-based)	-5.3	-5.3	-21.1	-22.9	14.7	-0.1	0.2	-0.6	-9.0
Average gross wages, real (PPI based)	8.1	1.3	31.0	-2.9	-8.8	-1.8	3.0	4.0	4.9
Average gross wages, real (CPI based)	1.9	3.9	-2.3	-1.1	-2.2	1.0	2.0	2.0	0.0
Average gross wages, EUR (ER)	2.2	-5.9	0.9	-26.4	8.1	0.5	4.9	4.7	-5.0
Employed persons (LFS)	0.7	-0.7	1.3	-0.8	0.5	0.5	0.5	0.5	0.2
GDP per empl. person, NC at 2010 ref. pr.	5.2	4.9	-0.2	2.0	3.3	2.5	2.5	2.5	3.0
Unit labour costs, ER (EUR) adjusted	-2.8	-10.3	1.1	-27.8	4.6	-2.9	2.4	2.5	-7.8
Russia 4)									
GDP deflator	5.4	7.5	8.0	3.2	5.5	3.9	5.0	5.0	5.9
Exchange rate (ER), EUR/NC	-5.5	-16.7	-25.1	-8.8	12.7	-1.7	-2.2	-0.7	-9.5
Real ER (CPI-based)	-0.6	-10.7	-13.5	-2.6	14.9	0.5	-0.1	1.3	-3.0
Real ER (PPI-based)	-2.3	-9.7	-12.9	-3.3	17.5	1.7	1.0	2.6	-2.7
Average gross wages, real (PPI based)	8.3	2.5	-7.8	3.5	-1.1	5.3	1.9	4.1	0.9
Average gross wages, real (CPI based)	4.8	1.2	-9.3	0.7	2.8	6.3	2.8	5.1	-0.1
Average gross wages, EUR (ER)	5.7	-9.2	-21.5	-1.6	20.0	7.9	4.7	9.0	-2.3
Employed persons (LFS)	-0.2	0.2	-0.4	0.1	-0.3	0.2	-0.1	0.0	-0.1
GDP per empl. person, NC at 2010 ref. pr.	2.0	0.5	-2.1	-0.3	1.9	1.6	1.7	1.6	0.4
Unit labour costs, ER (EUR) adjusted	3.6	-9.7	-19.8	-1.3	17.8	7.0	2.8	6.8	-2.7
Ukraine 5)									
GDP deflator	4.3	15.9	38.9	17.1	14.3	11.9	6.0	5.2	17.6
Exchange rate (ER), EUR/NC	-3.2	-32.5	-35.1	-14.4	-5.7	-14.3	-5.4	-5.1	-19.3
Real ER (CPI-based)	-4.9	-24.7	-3.5	-2.7	6.1	-6.6	-0.9	-1.3	-6.6
Real ER (PPI-based)	-3.2	-19.4	-9.6	4.9	15.3	-2.9	-0.5	-0.1	-3.1
Average gross wages, real (PPI based)	8.0	-9.5	-11.4	2.5	8.4	1.6	2.5	1.7	-0.7
Average gross wages, real (CPI based)	8.2	-5.4	-18.9	8.5	19.8	5.4	2.8	2.6	1.5
Average gross wages, EUR (ER)	4.4	-28.4	-21.8	5.8	29.2	1.4	4.2	0.0	-4.4
Employed persons (LFS)	0.2	-6.4	-0.4	-1.0	-0.7	-0.1	0.0	0.0	-1.7
GDP per empl. person, NC at 2010 ref. pr.	-0.2	-0.2	-9.4	3.5	2.6	3.0	3.1	3.3	-0.8
Unit labour costs, ER (EUR) adjusted	4.6	-28.3	-13.7	2.2	25.9	-2.8	0.6	-0.1	-3.6
Austria									
GDP deflator	1.6	2.0	2.3	1.1	1.7	1.7	1.8	2.0	1.8
Real ER (CPI-based)	0.5	1.2	0.9	0.6	0.4	0.3	0.1	0.1	0.7
Real ER (PPI-based)	-0.8	0.9	1.0	-0.3	-1.3	0.3	0.1	0.4	-0.1
Average gross wages, real (PPI based)	3.0	2.8	3.7	4.4	0.1	0.7	1.0	0.4	2.8
Average gross wages, real (CPI based)	0.1	0.1	1.2	1.6	0.0	0.5	0.9	0.4	0.6
Average gross wages, EUR (ER)	2.1	1.8	2.1	2.5	2.1	2.5	2.8	2.4	2.1
Employed persons (LFS)	0.5	0.2	0.9	1.7	1.9	1.9	1.1	1.1	1.0
GDP per empl. person, NC at 2010 ref. pr.	-0.5	0.6	0.2	-0.3	1.1	1.1	1.0	0.8	0.2
Unit labour costs, ER (EUR) adjusted	2.6	1.1	1.9	2.8	1.0	1.4	1.7	1.6	1.9

4) From 2014 including Crimean Federal District (for LFS employment and wages from 2015), growth rates comparable. - 5) From 2014 excluding the occupied territories of Crimea and Sevastopol and from 2015 parts of the anti-terrorist operation zone, growth rates comparable.

NC = national currency (including euro-fixed series for euro area countries - AT, EE, LT, LV, SI, SK). ER = Exchange Rate, PPI = Producer price index, CPI = Consumer price index. Positive growth of real exchange rates means real appreceition.

Sources: wiiw Annual Database incorporating national and Eurostat statistics, WIFO, wiiw estimates. Forecasts by wiiw, WIFO (for Austria).

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