Outlook for Selected CESEE Countries:

Mixed External Environment Compounds Weak Domestic Demand[1, 2]

1 CESEE-7[3]: External and Domestic Factors Continue to Weigh on Economic Growth

The global economic outlook worsened considerably in autumn 2011, soon after the OeNB's previous CESEE forecast was compiled. The weak performance of major economies and, in particular, the intensification of the sovereign debt crisis in several euro area countries resulted in a considerable deterioration of confidence and growing concerns about negative spillovers of these developments to the CESEE region. Despite signs of stabilization both at the global level and in the euro area since the turn of the year, the weaker external environment is expected to halve economic growth in the CESEE-7 region to 1.4% in 2012, down from a rather strong performance of 3.2% in 2011. Growth dynamics are likely to remain uneven within the region. Poland, followed by Latvia and Lithuania, will continue to outperform the other CESEE countries. Bulgaria and Romania will post moderate growth rates of above 1%, while GDP growth in the Czech Republic will almost stagnate. Hungary is expected to go through a moderate recession – primarily caused by domestic factors – in the first half of 2012, and its annual GDP will contract marginally in 2012. For the region as a whole, the first half of 2012 will mark a turning point in growth dynamics that will be followed by a rather gradual pick-up (see chart 1). In 2013, growth in the CESEE-7 will move up to 2.6% as the external environment improves. Economic growth will become positive in all countries, and GDP growth rates are projected to range between 1.2% in Hungary and 3.1% in Poland.

Owing to weak external demand, export growth will roughly halve in 2012 in the CESEE-5 countries[4] covered by the OeNB's projections. Being strongly exposed to fluctuations in external

Table 1

GDP and Import Projections for 2012–13

	GDP			Imports		
	2011	2012	2013	2011	2012	2013
	Year-on-year growth in %					
CESEE-7	3.2	1.4	2.6	7.6	3.4	5.7
Bulgaria	2.1	1.3	2.4	8.7	4.5	7.0
Czech Republic	1.7	0.3	1.9	7.5	2.3	6.3
Hungary	1.7	–0.5	1.2	6.3	3.0	5.4
Poland	4.4	2.4	3.1	6.0	3.4	5.0
Romania	2.1	1.2	2.6	11.2	3.4	5.8
Croatia	0.3	–0.9	1.3	–6.5	0.5	4.9
Russia	4.3	3.7	3.7	22.0	8.0	6

Source: OeNB-BOFIT March 2012 forecast, Eurostat, Rosstat.

Note: CESEE-7= CESEE EU Member States that have not yet introduced the euro; seasonally adjusted data for 2011.

[1] *Compiled by Julia Wörz with input from Stephan Barisitz, Martin Feldkircher, Sándor Gardó, Mariya Hake, Mathias Lahnsteiner, Thomas Reininger, Jarmila Urvova and Zoltan Walko.*

[2] *The OeNB and the Bank of Finland Institute for Economies in Transition (BOFIT) compile semiannual forecasts of economic developments in selected CESEE countries (Bulgaria, the Czech Republic, Hungary, Poland, Romania, Russia and Croatia). These forecasts are based on a broad range of information, including country-specific time series models for Bulgaria, Croatia, the Czech Republic, Hungary, Poland and Romania (for technical details, see Crespo Cuaresma et al. 2009. Simple but Effective: The OeNB's Forecasting Model for Selected CESEE Countries. In: Focus on European Economic Integration Q4/09. 84–95). The projections for Russia were prepared by the Bank of Finland and are based on an SVAR model. Latvia and Lithuania are not covered by our own projections, but are included in the CESEE-7 aggregate based on the IMF World Economic Outlook (WEO) projections of April 2011. The cutoff date for all projections is March 16, 2012.*

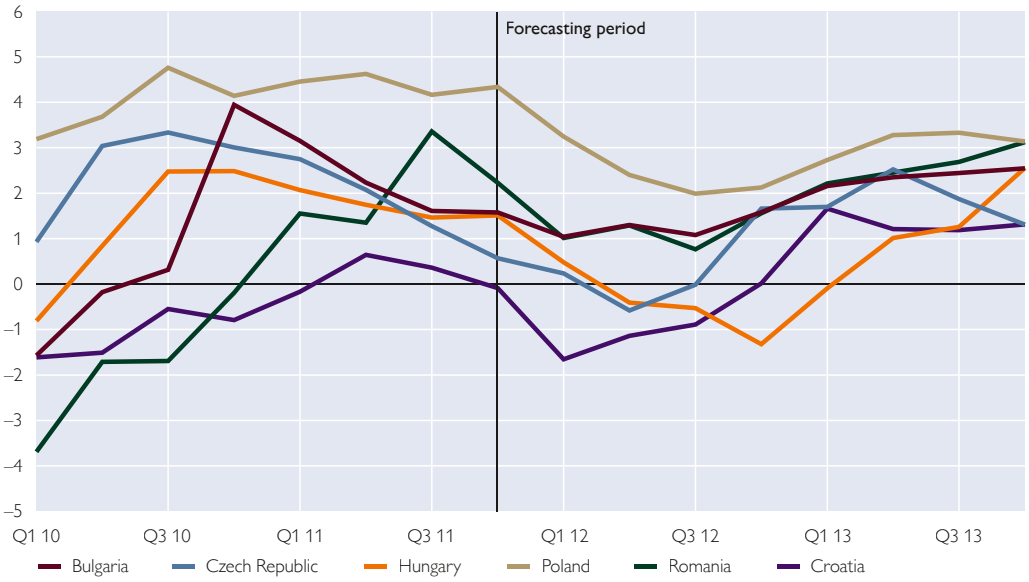
[3] *Bulgaria, Czech Republic, Hungary, Latvia, Lithuania, Poland and Romania.*

[4] *Bulgaria, Czech Republic, Hungary, Poland, Romania.*

Chart 1

Quarterly Profile of GDP Projections

Year-on-year change in %



Source: OeNB.

demand, export growth will decline more markedly in the Czech Republic while the slowdown in import dynamics will be slightly less pronounced. In all CESEE-5 countries (except in Romania), the contribution of net exports to GDP growth will shrink but nevertheless continue to be positive.

CESEE-5: Slowing external demand in 2012 …

Budget consolidation implies that public consumption will provide no impetus to growth in 2012. Private consumption will likewise be hampered by the current consolidation packages. Weak labor market conditions and tight private sector funding also weigh negatively on private consumption. Even in the absence of bottlenecks in private sector credit supply in all countries apart from Hungary, the need to reduce the currently elevated levels of private debt in the household sectors of some countries implies a continued drain on demand. However, developments within the region will remain mixed for country-specific reasons (see section 2). Private consumption will continue to decline somewhat in the Czech Republic and will fall considerably in Hungary. In Hungary, financial deleveraging in the private sector will further add to this renewed contraction in private consumption. By contrast, real wage growth in Romania will reinforce a base effect, leading to a notable increase in private consumption in 2012. Growth in gross fixed capital formation will remain weak in 2012, but will show a rising tendency in most countries except Poland, where rising private investment will only just compensate for diminishing public investment. Due to heightened uncertainty, restocking will be postponed into 2013.

… cannot be offset by domestic growth drivers

Taking into account the assumed stabilization in external demand from the euro area, we project GDP growth to rebound somewhat in 2013 but to remain rather weak. The recovery will again be led by Poland, the Baltic countries and the Southeastern European economies (Bulgaria and Romania). Growth in the Czech Republic will also pick up again, while growth dynamics will remain more

Moderate rebound in 2013 …

restrained in Hungary. Economic growth will become more balanced again in 2013 in terms of both regional composition and growth drivers.

… will be more balanced in terms of growth drivers

Domestic demand will pick up throughout the region and will contribute positively to GDP growth in all countries under review. The hesitant recovery of domestic demand in the five CESEE countries covered by our projections is related to slightly improving financing conditions for the private sector. Country-specific factors such as elections in Bulgaria and the increased utilization of EU funds in Romania will further reinforce domestic demand growth in Southeastern Europe. Apart from Poland, where private consumption will remain constant, consumer spending growth is expected to pick up to some extent and to once again make the strongest positive contribution to GDP growth in Southeastern Europe. Public consumption growth will remain subdued over the entire forecasting period; no notable growth impact can be expected from fiscal policy. Investment growth will show some signs of revival, which is partly related to inventory restocking and partly to previously postponed investment decisions, improved financing conditions and rising investor confidence.

Trade growth will accelerate, but only in line with the moderately improving external environment. Therefore, the expansion of external trade will fall considerably short of the strong rebound recorded in the two years following the severe trade collapse of 2009. Import and export dynamics will be roughly equal; as a result, the contribution of net exports to growth will remain almost unchanged compared with 2012.

Downside risks continue to prevail

The risks to this outlook continue to be tilted downward, albeit less obviously so than in our September forecast. A further intensification of the sovereign debt problems in the euro area's southern periphery, in particular the occurrence of a shock in a larger country, would have a negative impact on the projection outcome in at least two ways: First, investor and business confidence would severely drop in all catching-up economies in Europe, leading to a more protracted weakness in domestic demand. Second, demand for CESEE-7 exports would immediately go down, thus weakening the most robust growth pillar of recent years. In addition, the effects of the European Banking Authority's capital requirements, which were laid down in late 2011, are still partly unclear and imply some continued deleveraging risk for the region, even though initial concerns related to deleveraging may turn out to have been too strong. By contrast, if growth in Germany was stronger than assumed as a result of recently accelerating world trade growth and the rather promising cyclical developments in the U.S.A. in the fourth quarter of 2011, this would pose an upside risk to our projections.

2 CESEE-5: Substantial Differences across Bulgaria, the Czech Republic, Hungary, Poland and Romania

Resting exclusively on the contribution of net exports, real GDP growth accelerated somewhat in 2011 in *Bulgaria*. As a consequence of the economic slowdown in the euro area, however, annual GDP growth started to decline in the fourth quarter of 2011. Moreover, high-frequency and confidence indicators developed unfavorably in the first two months of 2012. This led us to revise our real GDP growth forecast for 2012 downward, to 1.3%. Still, private consumption is expected to show signs of a modest recovery on the back of strong real wage growth (i.a. as a consequence of the rise in minimum wages of May 2012) despite the fact that the labor market

has been stagnating so far. Investment activity (in particular construction), which remained depressed throughout 2011, will recover somewhat as a result of the stronger absorption of EU structural funds despite weak private investment activity. The growth contribution of net exports will remain positive in 2012, but will decline, given already high capacity utilization levels and an acceleration of import growth due to strengthening domestic demand. Going forward, we expect economic growth to gradually pick up and reach 2.4% in 2013, driven by strengthening domestic demand. Private consumption should gather momentum as first signs of improving labor market conditions become apparent and planned measures (i.e. a VAT decrease in two steps from 20% to 18%) fully materialize. Against the background of the parliamentary elections scheduled for the first half of 2013, some stimuli will also come from public consumption. Export growth is expected to increase somewhat in 2013 but alongside further accelerating import growth, the positive contribution of net exports to GDP growth is likely to turn negative.

The downward revision of *Czech* annual GDP growth to 0.3% for 2012 is mainly due to the change in external assumptions and, to a lesser extent, also to recent revisions of the quarterly GDP components data. For 2013, we forecast a rebound of growth to 1.9%. As in 2011, net exports will remain the only positive contribution to growth in 2012 even though both the growth pace of imports and exports as well as their combined growth contribution (0.3 percentage points) will decelerate substantially due to stalling economic activity in the main trading partner countries. Subject to the EU Excessive Deficit Procedure, Czech government consumption will continue to contract in 2012. The austerity measures, notably the lower-rate VAT hike (from 10% to 14%) and the public wage freeze, will also put a drag on private consumption and will weigh on the stagnating labor market and the general uncertainty about further economic developments as reflected in the currently low levels of consumer confidence indicators, which are comparable to those recorded during the 2009 crisis. High capacity utilization near its long-term average, low interest rates, a low investment basis in 2011 as well as the most recent improvement of manufacturing indicators point toward a likely recovery of gross fixed capital formation. However, other factors such as moderating credit growth, the effect of the VAT hike, the reduction of state subsidies to building loan contracts, the stagnation of government investment plans due to fiscal consolidation as well as subdued consumption and the slowdown in external demand suggest that this recovery is not likely to take place before the second half of 2012. As a result, the development of overall gross fixed investment will stagnate in 2012. In 2013, with improvements in the labor market and less stringent fiscal consolidation, private consumption is expected to recover, supporting rising imports together with reaccelerating external demand. Investment will continue to grow from the second half of 2012, making overall GDP growth in 2013 more balanced. Apart from external factors, the possible failure of the government to meet its consolidation targets poses a downside risk to our projection.

The *Hungarian* economy is expected to contract by 0.5% in 2012 and to expand only modestly, by 1.2%, in 2013. In both years, growth impulses will come mostly from external demand. In 2012, net exports will constitute the only positive contribution to Hungarian GDP growth. Domestic demand is likely to contract considerably in 2012 and to recover slowly from 2013 onward. The VAT hike of

early 2012 and changes to the income tax system will lead to a decline in real incomes in 2012. In addition, uncertainties regarding future real income growth, higher debt servicing costs and deleveraging will weigh on private consumption, while fiscal consolidation will cause public consumption to contract further. Given bleak growth prospects, weak household incomes and sizeable budgetary savings, investment will decline again in 2012, though less sharply than in 2011. Moreover, as banks must absorb the financial burden resulting from bank tax, mortgage relief schemes and increased provisioning needs while facing a difficult funding environment, they will keep credit conditions tight, which will adversely affect both consumption and investment activity. A cautious recovery may take root from the second half of 2013 onward if we assume that foreign demand picks up, fiscal consolidation becomes less contractionary and financing conditions start to ease.

For *Poland,* we forecast GDP growth to reach 2.4% in 2012, implying a substantial slowdown from the previous year's high growth rate of 4.4%. In 2012, the effects of the assumed economic slowdown in the euro area on Polish exports will be cushioned by the delayed impact of the substantial currency depreciation observed in the second half of 2011, which came on top of a previous strong decline in unit labor costs in the manufacturing sector. By contrast, the weakening of the Polish złoty against the Swiss franc may have induced a number of households holding Swiss franc-denominated debt to restrain their consumption expenditures. In both years, continued fiscal consolidation will be a growth-dampening factor. In particular, the spending rule for the central government wage bill and excise tax increases will weaken public and private consumption growth. The clouded outlook for foreign and domestic demand will reduce fixed-investment growth, which had not turned positive until 2011. However, ongoing public nonresidential construction (linked to the 2012 European football championship), rising EU-cofinanced investments and – to a lesser extent – households' residential building (financed by double-digit mortgage lending growth) will keep gross fixed capital formation growth substantially positive. The combination of a strong export-import link, weaker domestic demand growth and the delayed effects of currency depreciation will cause import growth to decelerate even more than export growth, lifting the previous year's positive contribution of net exports to GDP growth slightly. In 2013, GDP growth will accelerate to 3.1%, reflecting mainly the recovery of euro area demand and the fact that inventory build-up stopped decreasing. Given further fiscal consolidation, public consumption growth will hardly speed up. Regarding investment growth, additional EU-cofinanced investments and the accelerating growth of corporate sector investment (on the back of strong liquidity positions and sufficient credit supply) will largely substitute for the decline in public investment growth after the 2012 boom.

After two years of recession, economic growth in *Romania* recovered in 2011, with GDP growth partly driven by a very good harvest. It is also worth noting that private consumption as well as gross fixed capital investment started to recover in 2011 and posted positive annual growth rates in the second half of the year (3.1% and 10.9%, respectively). We forecast growth to decelerate to 1.2% in 2012 due to the weakening external environment and negative base effects stemming from the extraordinarily high agricultural output in 2011. For 2013, we expect growth to accelerate to 2.6%. In line with our external assumptions, real export growth

in Romania will decelerate considerably in 2012 and will pick up speed in 2013. Given the high import content of exports, import growth will follow a similar pattern. In both 2012 and 2013, growth will be driven most strongly by private consumption and gross fixed capital formation. Real wage growth turned positive in mid-2011, thus supporting private consumption. Against the background of disinflationary developments and the government's plans to hike public wages in June 2012 (the size of the boost is still unclear), real wage growth will most likely remain positive. Moreover, high-frequency indicators (retail sales, consumer confidence) developed favorably in early 2012. However, the recovery of private consumption will only be gradual, as the growth of domestic credit to households remains subdued and is unlikely to pick up markedly. The recovery of construction output is likely to remain a key driver of investment growth. Moreover, the Romanian authorities have taken several steps to increase the absorption of EU funds. Provided that these measures are successful, improved EU fund absorption could also support the growth of gross fixed capital formation.

3 Croatia: Prolonged Weakness Mainly Caused by Domestic Factors

Domestic factors trigger renewed recession in 2012

Economic conditions will remain gloomy in *Croatia* in 2012, as the economy is forecast to slide back into recession (–0.9%). In particular, adverse labor market conditions, the increase of the VAT rate from 23% to 25% as of March 2012 and the ongoing process of financial deleveraging in the household sector will weigh on private consumption while the pressing need to consolidate public finances will compromise public consumption. At the same time, a less supportive international environment is expected to hurt exports. Given the gradual recovery of investments and strong base effects, imports are likely to post moderate growth, so that the contribution of net exports to GDP growth can be assumed to turn negative in 2012.

Strong investment activity ahead of EU accession will bolster growth in 2013

Driven by a recovery in domestic demand, GDP growth in Croatia is expected to reach 1.3% in 2013. Consumption will remain rather weak, though. In fact, while private consumption is estimated to pick up due to the base effects related to the 2012 VAT hike and advanced purchases before EU accession on July 1, 2013, ongoing fiscal consolidation will continue to weigh on public consumption. Investment activity is expected to become the main pillar of growth in 2013. After having contracted strongly for several years in a row, gross fixed capital formation is forecast to grow robustly thanks to increasing FDI inflows ahead of EU accession, and inventory restocking is expected to provide a strong impetus to economic growth as well. At the same time, the investment-driven recovery of domestic demand will also contribute to accelerating import growth. Together with moderately firming export growth in a gradually improving global environment, this will result in an increasingly negative contribution of net exports to GDP growth.

4 Russia: Brisk Economic Recovery to Level Off Somewhat Owing to Uncertainties

We forecast annual GDP growth in *Russia* to moderate to 3.7% in both 2012 and 2013 from 4.3% in 2011. This leveling-off tendency is influenced by the expected turnaround in oil price dynamics and a modest decline in oil prices over the entire forecasting period by about 10% from a currently relatively high level. The forecast decline of GDP growth in 2012 is attributed to uncertainties in the global

economy as well as in Russia. Another point is that farming simply cannot count on another large rebound of the kind it experienced in 2011. In 2013, we expect growth in Russia to be supported by revived confidence, recovering global economies and trade, and waning uncertainty, provided that economic policies become clearer after the March 2012 presidential election.

Export growth to remain low in 2012

Given an expected overall tendency of somewhat slower wage increases, consumer demand is assumed to decelerate slightly over the forecasting period.[5] The current rapid growth in household borrowing may be reined in as real interest rates on short-term credit (i.e. with maturities of under one year) have risen to exceptionally high levels. After three slow years, growth in public consumption is expected to pick up a bit in 2012, with government spending rising and the Ministry of Economic Development's forecast suggesting that public investment may expand modestly. Growth in export volumes is expected to remain low during the forecasting period. Indeed, the Russian authorities have adjusted their own export estimates for crude oil and petroleum products slightly downward for the coming years as increased domestic oil consumption exceeds growth in domestic oil production. The impact will, however, be moderated by rising exports of natural gas and other basic commodities. Growth in corporate fixed capital investment could dip in 2012 amidst economic uncertainties and should recover in 2013 and 2014 as these uncertainties fade.

Net capital outflows may persist throughout 2012

The momentous inventory restocking activities following the recession are expected to ease off in 2012 and the next few years. Net capital outflows from Russia may persist this year until uncertainties in international financial markets recede and the new government takes measures to improve Russia's business climate. In that case, the direction of net capital flows could also reverse. After rebounding strongly from the recession, import growth eased in recent months. We expect import expansion to average around 7% a year in the forecasting period, reflecting lower post-crisis GDP growth.

Downside risks emanating from uncertain consumer and investor confidence

Risks to the forecast are largely on the downside. For instance, Russian consumer confidence could erode for domestic reasons even if the global economy develops as assumed. Corporate investors could become more cautious if the prevailing global and domestic uncertainties do not dissipate over the short term. Moreover, Russia would be quick to feel any shock to the world economy if it triggered a sharp drop in oil prices or jolted financial markets anew. In such a case, Russia's leadership would retain the means for stimulus measures and can be expected to respond actively to cushion adverse impacts on the economy if necessary.

[5] *However, during his presidential campaign, Prime Minister Putin promised sizeable public sector wage adjustments for the years to come.*