Outlook for selected CESEE countries

CESEE-6 economic growth robust but moving sideways, Russia recovering only slowly[1,2]

We project that CESEE-6[3] GDP growth will reach 4.0% per annum in 2018 and then soften slightly to 3.6% and 3.4% in 2019 and 2020, respectively. Overall, consumer sentiment continues to be bright, supported primarily by favorable labor market and lending conditions. Hence private consumption growth will remain fairly strong. Investment growth will peak in 2018. Overall, investment activity is benefiting from a high absorption of EU funds, brisk construction activity as well as the need to increase production capacities. In line with our assumption on euro area import growth, export activity in the CESEE-6 will weaken in 2018 and revive in 2019 and 2020. In parallel with softening export growth, import growth will also ease marginally in 2018 and edge up in 2019. Income convergence with the euro area is expected to slow down from 2.0 to 1.7 percentage points over the projection horizon (2017: 2.3 percentage points). Risks are tilted to the downside and have increased since our previous forecast.

For Russia[4], we expect GDP to grow by 1.8% in 2018 and to ease to 1.6% and 1.5% in 2019 and 2020, respectively. This pace of growth is in line with growth potential, which is low as there are no significant market-friendly reforms in sight. Private consumption growth will be muted due to higher VAT rates and weak wage growth. We see no major growth impetus from investment activity. Export

Table 1

OeNB-BOFIT GDP projections for 2018 to 2020 compared with the IMF forecast

	Eurostat/ Rosstat	OeNB-BOFIT projections October 2018			IMF WEO forecast October 2018		
	2017	2018	2019	2020	2018	2019	2020
	Year-on-year growth in %						
CESEE-6	**4.9**	**4.0**	**3.6**	**3.4**	**4.0**	**3.3**	**2.9**
Bulgaria	3.8	3.6	3.3	3.0	3.6	3.1	2.8
Croatia	2.9	2.8	2.7	2.7	2.8	2.6	2.4
Czech Republic	4.5	3.2	3.1	3.3	3.1	3.0	2.5
Hungary	4.4	4.3	3.4	2.9	4.0	3.3	2.6
Poland	4.7	4.5	4.1	3.7	4.4	3.5	3.0
Romania	6.8	3.8	3.3	3.1	4.0	3.4	3.3
Russia	1.5	1.8	1.6	1.5	1.7	1.8	1.8

Source: OeNB-BOFIT October 2018 projections, ECB staff macroeconomic projections for the euro area of September 2018, IMF World Economic Outlook (WEO) of October 2018, Eurostat, Rosstat.

Note: 2017 figures are seasonally adjusted data.

[1] *Cutoff date for data underlying this outlook: September 20, 2018. The projections for the CESEE-6 countries were prepared by the OeNB, those for Russia were prepared by the Bank of Finland in cooperation with the OeNB. All projections are based on the assumptions contained in the September 2018 ECB staff macroeconomic projections for the euro area. This implies real annual GDP growth of 2.0% in 2018, 1.8% in 2019 and 1.7% in 2020 in the euro area.*

[2] *Compiled by Antje Hildebrandt with input from Katharina Allinger, Stephan Barisitz, Markus Eller, Martin Feldkircher, Thomas Reininger, Tomáš Slačík and Zoltan Walko.*

[3] *CESEE-6: Bulgaria, Croatia, the Czech Republic, Hungary, Poland, Romania.*

[4] *The oil price assumption used by the Bank of Finland corresponds to Brent futures (quarterly data) with September 4, 2018, as the cutoff date. We expect an average oil price of USD 75 per barrel in 2018 and 2019, and a modest decline to about USD 73 per barrel by 2020.*

growth is expected to accelerate over the projection horizon. Risks to the forecast are predominantly on the downside.

1 CESEE-6: private sector demand expected to sustain economic growth

In the first half of 2018, CESEE-6 GDP grew at an annualized rate of 4.4%. This pace was similar to the growth rate achieved in the first half of 2017. Growth in Hungary and Poland was stronger than expected in the first half of 2018. In the countries that have shown some signs of overheating, namely the Czech Republic and Romania, economic growth surprised on the downside. For the second half of 2018, we expect to see sideways movement in most CESEE-6 countries with some moderation particularly in those countries that did better than expected in the first half. As a result, full-year GDP growth is expected to reach 4.0% in 2018 and then taper to 3.6% and 3.4% in 2019 and 2020, respectively. Domestic demand will continue to be an important growth driver in the period from 2018 to 2020: economic confidence will remain very strong, favorable labor market conditions will lift private consumption, and EU funding will boost gross fixed capital formation.[5]

Monetary conditions continue to be accommodative

Monetary conditions continue to be accommodative in the CESEE-6 countries. However, in the Czech Republic, some monetary tightening took place in light of stronger-than-expected inflationary pressure. For other CESEE-6 countries, we do not expect any decisive monetary tightening actions before mid- or end 2019. Against the background of prevailing monetary conditions in the CESEE-6 and the overall positive economic expectations of consumers and investors, we assume credit growth will remain strong over the projection horizon. Especially in Bulgaria, the Czech Republic and Romania, household loans are growing at a strong pace, and this is driving up private consumption. In Hungary, by contrast, credit to the corporate sector has been growing more dynamically than credit to the household sector.

Some countries in need of fiscal consolidation

Turning to fiscal policy, the picture is rather mixed across the CESEE-6 countries. Romania and Hungary need to consolidate their public finances, as they are both subject to Significant Deviation Procedures initiated by the European Commission. We expect the Czech Republic to take a rather expansionary fiscal stance in 2018 and 2019. The fiscal stance in Bulgaria, Croatia and Poland is expected to be neutral or somewhat expansionary over the projection horizon.

Private consumption growth will remain strong

In this environment, private consumption in the CESEE-6 will remain strong over the projection horizon. Labor market conditions will remain favorable and real wages will continue to post strong growth. Furthermore, robust lending to households will lift private consumption. However, several factors are expected to curtail private consumption growth: Given the need for fiscal tightening in Hungary and Romania, there appears to be no more room for major increases in public spending for households. Furthermore, in some CESEE-6 countries higher inflation has started to reduce real disposable income, leading to a moderation in consumption growth.

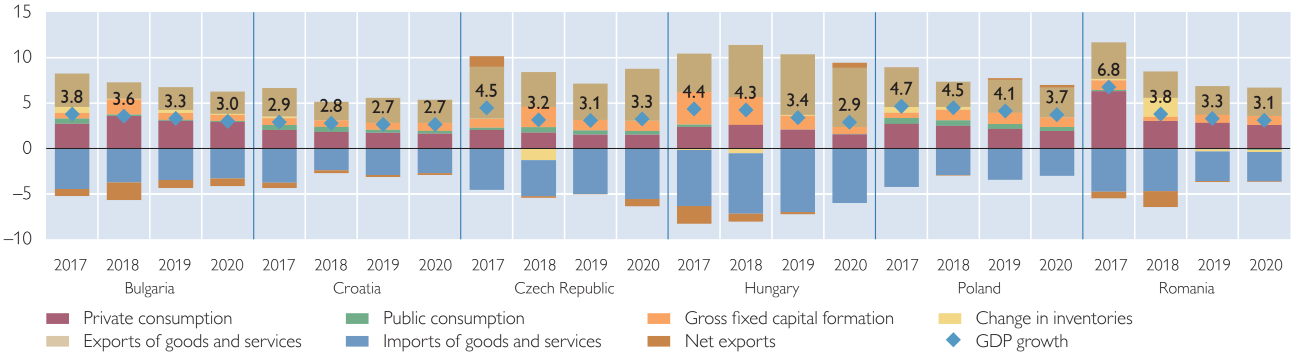
Public consumption growth has been rather mixed in 2018 so far. After a period of generous public spending, Hungary and Romania have cut public consumption in order to comply with EU requirements. Therefore, we expect

[5] *See the "Recent economic developments" section in this issue for more details.*

Chart 1

CESEE-6: GDP growth and contributions from 2017 to 2020

GDP contributions in percentage points, year-on-year GDP growth in %



Source: Eurostat, OeNB.

public consumption to post negative growth in Hungary and Romania in 2018 and 2019, and in Romania again in 2020. In Bulgaria, public consumption growth will also moderate over the projection horizon. By contrast, in the Czech Republic and Poland, public consumption growth will expand at a faster pace in 2018 than in 2017, partly due to a higher public wage bill.

Investment growth will peak in 2018

Investment activity in Bulgaria, the Czech Republic and Poland is expected to pick up sharply in 2018 compared to the previous year. In Hungary, gross fixed capital formation will moderate slightly but will continue to expand markedly by over 13% in 2018. The main factors driving this trend are the extensive use of EU funds (especially in Hungary, where EU funds have been heavily frontloaded in 2018), growing investment activity – partly due to capacity limits – as well as strong growth stimuli from the construction sector. For Romania, we expect gross fixed capital formation to decelerate somewhat due to some cooling down in certain sectors (e.g. housing construction). In Croatia, difficulties in some large companies that are important for the economy are expected to impair investment growth.

Weakening of export activity in 2018, revival in 2019 and 2020

In the CESEE-6 countries, exports will grow in line with euro area import demand. Therefore, we expect export growth to weaken year on year in 2018 and to gain some momentum thereafter. In addition to stronger external demand, new export production facilities – notably in the Czech Republic and Hungary – will support export dynamics. In parallel with decelerating consumption and export growth, import growth will moderate slightly in 2018. In 2019, we expect import growth to strengthen somewhat in most CESEE-6 countries. In all CESEE-6 countries, the contribution of net exports to GDP growth is expected to be negative in 2018, particularly in Romania (–1.7 percentage points). Going forward, the negative contribution of net exports will fade in Poland (already in 2019); in the Czech Republic and Hungary, the external sector is expected to make a slightly positive contribution to GDP growth (both in 2020).

Mounting risks cloud the CESEE-6 outlook

A wide range of downside risks und mounting uncertainties cloud the still favorable outlook for the CESEE-6 countries. In our view, the most acute risks emanate from trade tensions between the largest countries of the world as well as from the unclear modalities of Brexit, which will happen in March 2019. Adverse developments in these areas would impact strongly on sentiment and thus cloud the overall positive outlook for global and, in particular, euro area growth over our projection horizon and would create adverse spillovers in the CESEE-6 countries.

The negative consequences of escalating trade conflicts could unleash a spiral of protectionist measures and could spill over to the small, open CESEE-6 EU Member States. The region is highly integrated in global value chains and hence also indirectly dependent on demand from third countries outside the EU. Both suppressed export demand due to higher tariffs and higher import costs of components (especially in the car manufacturing industry, given the high dependence of some CESEE-6 countries on the automotive industry) are a significant downside risk factor in our CESEE-6 GDP forecasts.

As regards Brexit, there are still many open issues and major challenges related to the U.K.'s exit strategy that present clear downside risks to our projections. The negotiations between the EU and the U.K. are still ongoing. If no agreement on exit conditions can be reached, the EU countries would be affected in several ways. Such a "hard" Brexit would imply a major loss in confidence and elevated uncertainty among economic agents. However, even the more likely outcome of a Brexit that takes place under an agreed arrangement presents a risk factor to economic growth in the CESEE-6 countries. However, the full implications for growth would accumulate over a longer period of time. The effects on trade, migration, and EU budget constraints may not be felt during the projection period.

There is additional risk in connection with recent financial tensions in some emerging markets, particularly in Turkey, which have revealed deep vulnerabilities to changes in risk assessment and a consequent repricing of risk by global investors. So far, the CESEE-6 countries have been insulated from these adverse developments. However, more widespread risk aversion among global investors toward other emerging market economies – even if not justified by economic fundamentals – could have a negative impact on the CESEE-6 countries. Furthermore, elevated levels of private and public indebtedness fuel vulnerabilities in several advanced and emerging economies – also in the CESEE-6 – especially given the risk of stronger-than-expected monetary tightening in the United States. Some general risks also emanate from potential adverse developments in the euro area, particularly the potential reemergence of redenomination risk.

Furthermore, as in our previous forecasts, geopolitical tensions must still be taken into account in assessing risk. Armed conflicts like those in Ukraine or in the Middle East as well as further sanctions against specific countries could have a dampening effect on global growth prospects.

Domestic political developments remain a source of internal risks in some CESEE-6 countries. Tensions with the EU over compliance with EU laws resulted in disciplinary actions against Poland and more recently against Hungary. We do not expect this action to have any consequences for the flow of EU funds over the projection horizon, but the measures could impinge in particular on the overall confidence of (foreign) investors.

Further domestic risks originate from CESEE-6 labor markets, which are increasingly characterized by labor shortages in certain sectors amid strongly rising unit labor costs (ULC). While this has not had a visible negative impact on the competitiveness of the CESEE-6 countries so far, it may do so if productivity growth does not keep pace. In addition, a stronger-than-expected rise of nominal wages could lead to higher-than-anticipated inflationary pressure and to faster-than-assumed monetary tightening in some countries of the region. We already see cost-push price pressure that has resulted in higher service inflation. Higher-than-expected oil prices also present a clear upward risk to inflation expectations in the region.

We see only a few risks on the upside. The most important one would be a higher-than-foreseen absorption rate of EU funds in some CESEE-6 countries. There is still room for further improvements – mostly in the field of administrative efficiency – which could boost investment growth above expectations in some CESEE-6 countries. We also consider as an upside risk the possibility that a sustainable solution to the trade conflicts will be reached. This would certainly increase export confidence and – in the end – global trade. Furthermore, if stronger-than-expected growth occurs in the euro area, our growth expectations would be beaten on the upside.

2 Projections for Bulgaria, Croatia, the Czech Republic, Hungary, Poland and Romania

Bulgaria: investment expected to play larger role in boosting robust economic growth

Our spring 2018 forecast remains largely unchanged, with minor upward revisions for 2018 and 2019. GDP growth continues to be driven predominantly by domestic demand but is expected to decelerate somewhat by 2020. At the same time, we expect some changes in the short-run growth composition.

On the one hand, the growth contribution of exports is expected to decrease considerably in 2018 as external demand conditions have worsened since our spring forecast and export growth experienced a marked deceleration already in the first half of 2018. Nearly unchanged external demand assumptions for 2019 and 2020 should contribute to some recovery in those years, however. At the same time, due to brisk domestic demand, import growth will continue to outpace export growth, thus prolonging the negative contribution of net exports to GDP growth.

On the other hand, gross fixed capital formation will gain importance in 2018. It grew with surprising dynamism in the first half of 2018. Driven in particular by the government's public infrastructure priorities and improving EU fund absorption, investment should make a significant contribution to GDP growth in 2018, namely at a rate not seen in the past 10 years. A reform push to prepare the country for joining ERM II and the banking union could further feed investor confidence. Over the forecasting horizon, however, investment growth will lose some momentum, partly due to the effects of a high base, and partly because tightening global financial conditions could impede progress in overcoming crisis legacies such as the comparatively elevated levels of nonfinancial corporate debt and nonperforming loans. Moreover, an increasingly tight labor market may also put a drag on investment growth.

Growing labor shortages could also prove to be an obstacle to the further acceleration of private consumption in the years to come. Nonetheless, we expect private consumption to lose steam only slightly over the forecasting horizon and to remain the Bulgarian economy's most important growth engine. Private consumption will continue to benefit from favorable trends in real wages and household lending. However, it remains to be seen whether the recent pickup in consumer prices will continue for a prolonged period. Public consumption remains strong in 2018 due to significant wage increases in the education sector. For 2019 and 2020, however, we expect some moderation in line with budgetary surplus targets, and because the next parliamentary election is not scheduled to take place until 2021.

Croatia: somewhat weaker growth despite strong private consumption

GDP grew by 2.7% in the first half of 2018, having reaccelerated after a temporary slowdown in the fourth quarter of 2017. Nonetheless, recent developments, particularly in connection with exports and investment, have prompted us to mildly revise our GDP forecast downward over the entire forecast period, to 2.8% in 2018 and 2.6% in 2019 and 2020.

Private consumption remains the main growth driver and expanded by 3.7% year on year in the first half of 2018. We expect private consumption growth to slow down mildly over the forecast period, as positive effects from labor market improvements and government stimulus packages fade. Public consumption grew by 2.6% in the first half of the year and is expected to remain high in the second half of the year. Public consumption growth will be positive, but lower in 2019 and 2020 as fiscal consolidation continues.

Gross fixed capital formation growth was 3.3% year on year in the first half of 2018 and we expect it to remain at similar levels in the second half of the year. While some positive effects could come from planned investments and EU fund absorption, the impending restructuring of Agrokor, difficulties at the shipbuilding group Uljanik and indicators such as declining business confidence and lower loan growth will counteract these developments. However, we expect a mild acceleration in investment growth in 2019 and 2020 as EU fund absorption increases and concerns in connection with Agrokor diminish further.

Net exports made a strong negative contribution to growth in the first half of 2018 as export growth temporarily turned negative in the first quarter of the year[6], while import growth remained strong, fueled by domestic demand. We expect both export and import growth to remain strong over the forecast horizon, driven by stable external and domestic demand. Net exports should make a small negative contribution to growth over the projection horizon.

Czech Republic: gradual deceleration of growth toward potential

Economic expansion will remain solid but decelerate steadily from an exceptionally strong 4.5% in 2017 toward its potential[7]. Hence, GDP growth is expected to average just above 3% over the forecasting horizon. Our projection has been revised slightly downward due to weaker external demand and a lower contribution of private consumption as a result of higher inflation pressures. Nonetheless, economic growth will be driven predominantly by strong domestic activity on the back of robust private consumption and investment. Both factors mirror consumers' and firms' continued optimistic stance, their confident view of future demand, the ongoing low interest rate environment and significant wage growth.

The latter particularly reflects the increasingly tight conditions on the labor market, with vacancies significantly outnumbering jobless persons. Labor shortages are thus increasingly constraining the economy. However, strong wage growth – echoed inter alia in the high wage bill of the government, thus pushing up public consumption – has been counteracted by rising prices. Inflation has risen faster

[6] *Partially due to the strong base effects from Q1 17.*

[7] *The Czech National Bank's estimates of potential output growth range – depending on the method – between 3% and 4%.*

than previously expected due to a combination of domestic and foreign factors. Yet the single most important factor in the acceleration of inflation has been the rather unanticipated depreciation of the koruna in the wake of a change in market sentiment. As a result, inflation will remain in the upper half of the CNB's tolerance band longer than previously expected and will – according to the CNB – return to the 2% target in mid-2019. Increased inflationary pressures are likely to entail faster monetary policy tightening[8].

After particularly vigorous expansion in the first half of 2018, investment growth will peak this year and slow down thereafter amid tightening monetary policy. Investment will continue to be driven by revived construction activity, a more significant drawdown of EU funds and firms' intensified investment in automation and labor-saving technologies due to the shortage of labor.

Net exports are projected to detract from GDP growth in 2018, and the negative contribution is expected to be more significant than in the previous forecast due to a noticeable cooling of external demand, particularly in the automotive industry. In the medium term, however, the expansion of exports will pick up again despite a resumed appreciation of the koruna. The contribution of net exports to GDP growth is thus expected to be broadly neutral in 2019 before turning positive toward the end of the horizon.

Major downside risks to the forecast are associated with the overheated labor market, a continuation of the change in sentiment on global markets that caused the depreciation of the koruna, and global trade-hindering protectionist measures by the world's large economies.

Hungary: strong domestic demand expected to lift economic growth

GDP grew at an annualized rate of 4.7% during the first half of 2018 (after 4.2% in 2017). Given the stronger-than-expected growth recorded in the first half of 2018, we have revised our forecast for 2018 upward from 3.5% to 4.3%. We continue to expect moderation thereafter, but at somewhat higher growth rates than previously forecast.

Economic policies will remain supportive of growth in the short run but will then turn neutral to modestly restrictive. Increased inflation is forcing the central bank to start gradually normalizing monetary conditions.[9] Given that Hungary became subject to the EU's Significant Deviation Procedure in mid-2018, fiscal policy will also likely become restrictive. In addition, the use of EU funds is set to slow down markedly in 2019 and 2020, as the government has already pre-financed most of the projects in the current programming period.

Investment growth will remain strong in 2018, supported by factors such as the overall good economic outlook, the stepped-up disbursement of EU funds, high capacity utilization rates, a further acceleration of lending to corporates and the expansion of housing subsidies. Investment growth will likely slow in 2019 and 2020 due to the above-mentioned reasons. Changes in VAT on new homes, the expansion of housing subsidies, a new instrument for lending to SMEs, and newly

[8] *Thus far, the key policy rate has been increased by a total of 120 basis points to 1.25% since August 2017. The CNB expects domestic interest rates to converge smoothly to their assumed long-run neutral level (i.e. 3% for the three-month PRIBOR) in 2019.*

[9] *To this end, the MNB at end-September decided to eliminate its three-month deposit facility and to discontinue its monetary interest rate swaps and its mortgage bond purchase program by end-2018. In the future, required reserves will be the main policy instrument. At the same time, the MNB decided to introduce a new, liquidity-neutral "Funding for Growth Scheme Fix" from the beginning of 2019 to promote long-term lending to SMEs at fixed interest rates.*

announced investments in the auto industry have led to an upward revision in our investment forecast.

Private consumption will remain steady but slow down markedly by 2020. Strong wage growth in a tightening labor market, some employment growth, the continued brightening of consumer confidence, and households' improved financial position are expected to lift private consumption growth in 2018. Thereafter, we expect employment gains to diminish gradually, as labor reserves will be exhausted. At the same time, real wage growth should also moderate from 2019 onward, because there will be no new major minimum wage increases and because such moderation will better match productivity growth.

Public consumption growth started to ease in the first half of 2018. We expect this trend to continue given the need to reduce the budget deficit without endangering outlays for major policy priorities.

Following a dip in export growth, we expect exports to reaccelerate in 2019 in line with growing momentum from external demand. Export activity should see a boost over the medium term as new export capacities go into production, whereas strong wage growth could negatively affect export competitiveness. Moderating domestic demand will likely reduce the dynamism of imports, so that the contribution of net real exports should gradually improve over the forecast horizon and turn positive in 2020.

Poland: moderation of economic growth despite stronger investment activity

In Poland, GDP growth will slow down to 4.5% in 2018 from 4.7% in 2017. The contribution of domestic demand to GDP growth will remain stable overall in 2018, while the contribution of export growth will shrink, resulting in a growth structure tilted toward domestic demand. In 2019, the economy is projected to expand at a slower rate of 4.1%. This moderate deceleration will result from a slowdown in domestic demand that more than offsets the increase in export growth. Stronger export growth in 2019 will mainly reflect the expected growth in foreign demand but is expected to be dampened by rising manufacturing ULC and the appreciation of the zloty.

Private consumption growth will decelerate to 4.3% in 2018 and further – to 3.7% – in 2019. On the one hand, wage and employment growth as well as low interest rates continue to support robust consumption growth. On the other hand, fading stimuli from significant earlier measures (an increase in child benefit, higher tax rate thresholds, hikes in official minimum wage rates), the adverse impact of other measures (lower retirement age, wage freezes in certain public sector segments) and higher consumer price inflation will dampen private consumption growth. Public consumption growth will change only minimally and will remain substantially below GDP growth, due in part to the partial wage freeze in the public sector in 2018 and the assumption that this policy will not change significantly thereafter.

Overall, we expect gross fixed capital formation to expand by 6.3% in 2018 and by 6.6% in 2019. Emerging labor supply shortages will prevent investment growth from accelerating further over the projection horizon. Corporate investment activity will benefit from robust domestic consumption and, in 2019, stronger foreign demand growth, high capacity utilization rates, and the favorable financing situation with respect to both own funds (profitability, accumulated deposits) and external funds (low interest rates and, in particular for publicly owned companies, EU funds). Public sector investment (especially by local governments) will continue to post strong gains thanks to EU funds. Residential investment will expand on the back of strong household income growth, low interest rates and the state-subsidized housing program for young people, which is being discontinued in 2018, however.

In 2018, import growth will slow to 5.8%, but imports will grow at a somewhat higher rate than exports given roughly unchanged domestic demand growth. In 2019, import growth will pick up speed to 6.8% but will be lower than export growth because external demand will gain speed. Hence the contribution of net exports to GDP growth will again be slightly negative in 2018, but slightly positive in 2019.

Romania: growth to weaken markedly in 2018

After peaking at 7% in 2017, Romanian GDP growth is expected to fall below 4% in 2018 and to slip further toward 3% in 2019 and 2020. Notably, changes in inventories delivered a large contribution to overall GDP growth in the first half of 2018. Hence, in addition to uncertainties about the 2018 agricultural output, the difficulty in predicting inventory changes represents a marked downside risk for this year's projection. Should the inventory cycle turn earlier than anticipated, 2018 growth will come in lower than projected (and 2019 growth will possibly be somewhat higher).

We expect private consumption to remain the main growth driver but to decelerate due to fading fiscal stimuli. After consumer confidence was shaken in early 2018 inter alia by uncertainties over the impact of significant changes in the tax system, it recovered somewhat over the summer months. Labor market conditions have remained tight. Net real wage growth (at a robust 8.4% in July), a 10% increase in average pensions effective from July 2018 and a further 15% increase in 2019 will further support private consumption. A pick-up in consumer lending represents an additional supporting factor. Despite a recent budget revision, it will be challenging to keep this year's general government deficit below 3% of GDP. Due to the need for correction, we expect public consumption to decrease slightly over the forecast horizon.

The projected recovery of gross fixed capital formation is largely based on the assumption that the absorption of EU structural and investment funds will improve gradually, while the contribution from residential construction will likely be limited due to recent downward trends.

Export growth is expected to remain sound. As euro area import demand is projected to increase in 2019, a slight acceleration of export growth seems likely. As import growth will decline due to weakening domestic demand, the contribution of net exports will improve and turn out to be only marginally negative (i.e. almost balanced) in 2019 and 2020.

3 Russia: stagnant reforms and sanctions expected to dampen economic prospects

Economic recovery continues in 2018 at a pace similar to that seen in 2017, with growth coming in at an annualized rate of 1.7% in the first half. Meanwhile, the oil price has risen strongly, but Russia's fiscal and monetary stance as well as sanctions have continued to partly moderate the effect of higher oil prices on GDP growth. Unlike in 2017, however, the floating ruble exchange rate did not appreciate but instead weakened in spring 2018 due to new U.S. sanctions. The federal budget rule continued to limit some expenditures due to the fixed low oil price benchmark[10], while non-oil budget revenues allowed consolidated government budget spending to increase quite briskly against the backdrop of improved revenue collection and planned public sector wage hikes. Private consumption and fixed investments recovered at a moderate pace, and real export growth accelerated. The recovery of imports slowed down significantly in the spring as the ruble weakened.

The oil price assumption has been raised considerably since our previous forecast, to around USD 75 per barrel for 2018 and 2019, followed by a slight decline to about USD 73 per barrel in 2020. Even so, our GDP growth forecast remains unchanged at 1.8% for 2018 and 1.6% for both 2019 and 2020. This pace reflects the growth potential of the Russian economy, which is low as there are no significant market-friendly reforms in sight.

For 2018, increases in government expenditure and exports will support the economy, but private consumption and fixed investments will pick up only marginally. The VAT rate will rise at the beginning of 2019 (from 18% to 20%), which will heighten inflation and dampen private consumption growth. Relatively slow growth of public sector wages and pensions in 2019 and 2020 will not lead to higher private consumption growth over the projection horizon. Rather low productivity growth should contain the rise of corporate sector wages, while employment is expected to expand only modestly even when the gradual increase in the statutory retirement age from the beginning of 2019 onward is taken into account. Household borrowing will likely have limited impact on private consumption due to uncertainties and due to CBR measures that aim to constrain the growth of consumer lending.

Government expenditures will rise as a result of additional spending caused by the implementation of tasks that President Putin assigned to the government in his inaugural decree of May 7, 2018. This marks the start of a relaxation of budget rules regarding the deficit limit. The decree has also induced the government to steer investments by large companies toward so-called new national projects. However, these national projects will start to materialize only later in 2019 and it remains uncertain to what degree this will lead to higher total business investment. At the same time, uncertainty surrounding corporate investment has risen due to increased government interference as well as the introduction and threat of new U.S. sanctions. Furthermore, the inflation outlook is not conducive to monetary policy easing.

Russia's export volume should continue growing reasonably well, largely thanks to non-energy commodities supported by the rather weak ruble. As the real exchange rate is not anticipated to appreciate considerably and the revival of domestic demand remains unpromising, we have strongly lowered our year-on-year forecast for Russian imports in 2018. For 2019 and 2020, we expect imports to grow at a similar rate as in 2018.

Risks to the forecast for Russia

The risks to the forecast for Russia are predominantly on the downside. Even if the Russian economy's sensitivity to swings in the oil price has somewhat diminished, deviations from the assumed oil price remain a risk to the forecast. Risks to the global growth outlook are mainly skewed downward, posing a potential detri-

[10] *Among other things, the fiscal rule limits federal budget expenditure to a revenue frame which is currently determined by a fixed, relatively low, oil price.*

ment to Russia both directly and via the oil price. Geopolitical risks and other risks such as new unexpected sanctions remain elevated. Given that the U.S. has drafted legislation for further punitive measures against Russia, uncertainty appears particularly pronounced in the immediate future.

In terms of domestic risks, higher government expenditures may support GDP growth more than anticipated. On the other hand, production capital in Russia may become an unexpectedly strong constraint on growth, as uncertainties surround the volume and quality of the capital stock. Russia's imports remain sensitive to changes in the oil price, export revenue and the ruble exchange rate.