Box 2

OeNB-BOFIT Outlook for CESEE Countries: The Region Is Reaching the Trough, a Gradual Recovery, Mainly Driven by External Demand, to Be Seen from 2010 Onwards[1]

In 2009, GDP in the CEE-8[2] will contract by almost 4%, although Poland, the largest country in this group, will post positive growth. In 2010, growth in the CEE-8 will turn slightly positive (+0.5%) before recovering further by a moderate +2.6% in 2011. Croatia's growth profile will be broadly similar to that of the CEE-8. Following a deep contraction by 8% in 2009, the Russian economy will grow by 3% in both 2010 and 2011.

As already explained in the March OeNB-BOFIT projections,[3] the CESEE region was hit hard by the global financial crisis. Measured in average annual terms, the extent of the decline in growth will be very similar in the CEE-8 and in the euro area in 2009. Thus, the positive growth differential of the past years will not be visible this year. However, most countries' performance will actually be far below the average, and the projected growth rate of −3.8% is significantly influenced by the strong performance of Poland, the largest economy in the region. On the back of strong domestic demand, Poland's economy is expected to grow by +1%. Hence, the country is leading in terms of performance, not only within the region, but also within the EU as a whole. For 2010, a slight recovery is projected for the CEE-8 aggregate (+0.5%). In 2011, all countries will experience positive, albeit still relatively low growth rates and the economy of the CEE-8 region as a whole will expand by 2.6%.

In 2009, apart from Poland, all CEE-5[4] countries are set to experience negative growth, ranging from −5.2% in the Czech Republic and Bulgaria to −7.7% in Romania. In 2010, modest growth will be observed in the Czech Republic and Romania. Poland will continue to perform significantly better, reaching almost 2% of GDP growth, and Hungary will be at the other end of the range (−1.1%). 2011 will see positive growth rates at around 3% (Bulgaria: 1.6%).

Table 1

CEE-8 GDP Outcomes 2008 and Projections for 2009 to 2011

	Eurostat	OeNB		
	2008	2009f	2010f	2011f
	Year-on-year growth in %			
CEE-8	**3.7**	**−3.8**	**0.5**	**2.6**
Bulgaria	6.0	−5.2	−0.1	1.6
Czech Republic	3.2	−5.2	0.6	2.6
Hungary	0.6	−6.7	−1.1	3.3
Poland	4.8	1.0	1.9	3.1
Romania	7.1	−7.7	0.3	3.1

Source: OeNB September 2009 forecast, Eurostat.

[1] 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), with the OeNB being in charge of the projections for the EU Member States as well as Croatia and BOFIT for the forecast regarding Russia. The cutoff date for all projections contained in this box is September 28, 2009. The forecasts are based on a broad range of available information, including newly developed country-specific time series models for Bulgaria, the Czech Republic, Hungary, Poland and Croatia. A description of the forecast model can be found in the study by Crespo Cuaresma et al. in this issue. The forecast for Romania draws on information from various sources and expert judgment. The projections for Russia were prepared by BOFIT and are based on a structural vector autoregressive (SVAR) model. The projections rest on preliminary global growth projections and technical assumptions about euro area import growth, oil prices and USD/EUR exchange rates, which are prepared by the ECB for the Eurosystem in the context of broad macroeconomic projection exercises. Imports of the euro area are expected to shrink substantially in 2009 and to recover moderately thereafter. The oil price will recover steadily up until 2011, but will stay well below its pre-crisis level. The EUR/USD exchange rate is assumed to rise moderately in 2009 and to remain unchanged over the remaining projection horizon.

[2] In this box, CEE-8 comprises the CESEE EU Member States that have not yet introduced the euro: Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland and Romania. While we also cover the Baltic states in our CEE-8 aggregate (based on forecasts from the IMF and Consensus Economics), we do not go into detail as regards developments in these countries.

[3] See box 2 of "Developments in Selected Central, Eastern and Southeastern Countries" in Focus on European Economic Integration Q2/09.

[4] In this box, CEE-5 comprises Bulgaria, the Czech Republic, Hungary, Poland and Romania.

1 Outlook for CEE-5: Poland Outperforms the Region as a Whole in 2009, Gradual Recovery in 2010 and 2011

The economic crisis has hit the region later but more severely than Western Europe; in most countries, the crisis interrupted rapid catching-up. However, the fundamentals continue to indicate that this process will continue in the medium to longer term. The first half of 2009 saw a major decline in economic activity in all CEE-5 but Poland. In the second quarter of 2009, this trend continued in the CEE-5 in year-on-year terms, again apart from Poland. However, in some countries, the trough (in quarter-on-quarter terms) was reached in the first quarter (Czech Republic, Poland).[5]

The significant downturn in the ***first half of 2009*** *was mainly driven by a slump in exports triggered by the lack of external demand (again, the decline was less pronounced in Poland, possibly helped by the comparatively strong currency depreciation that took place in late 2008 and early 2009), a strong decrease in gross fixed capital formation and substantial destocking related to faltering export demand and worsening economic sentiment. Private consumption delivered a substantial negative contribution to growth in all countries as labor market conditions started to deteriorate, wage growth decelerated in real terms and credit growth declined substantially. Imports contracted more sharply than exports in almost all countries. Thus, net exports developed into the most important GDP-sustaining component in all countries apart from the Czech Republic.*

Just as the crisis has hit the region with a time lag, recovery will take place with some delay too. In the ***second half of 2009****, domestic demand will not pick up compared to the first half, and the positive contribution of net exports will continue to rely on the slump in imports (which, however, will lose momentum in all countries).[6] Exports are going to remain weak for the rest of 2009 due to lackluster import growth in the euro area, partly due to the end of Western European car scrappage schemes. These schemes were particularly important for the Czech Republic and Hungary in the first half of 2009. The inventory cycle will help support GDP dynamics during the second half of 2009, as destocking had come to an end by mid-2009. The positive contribution of net exports in most countries (ranging between 19 percentage points in Romania and 2½ percentage points in Poland for the whole year of 2009) will partly be temporary and is particularly strong in the countries with the largest declines in domestic demand. Export-oriented Czech Republic is the only country showing a negative contribution of net exports in 2009 because of the country's high dependence on the car industry, one of the industries worldwide hit hardest by the crisis.*

The moderate growth projected for the region for ***2010*** *is expected to stem from external demand. We expect mostly positive though very small contributions from net exports to GDP, ranging between 0.1 percentage points in the Czech Republic to 1.7 percentage points in Hungary. Again, Poland is the only exception, with a projected small negative contribution (−0.5 percentage points) in 2010.*

Current account imbalances have been reduced significantly in most countries during the crisis, while the turmoil in the financial markets seen in late 2008 and early 2009 has abated. Hence, we expect investment activity to stabilize in 2010 and exports to rise as a consequence of an improved environment worldwide (imports will also pick up somewhat from their depressed 2009 levels). For the region as a whole, the external growth impetus will however be too weak to bring the CEE countries back on a robust growth track as early as in 2010, since

[5] In all other countries, the decline lessened notably, apart from Hungary, where it stayed roughly constant. No seasonally adjusted data are available for Bulgaria. The decline in nonseasonally adjusted GDP deepened from −3.5% year on year in the first quarter of 2009 to −4.9% in the second quarter. Various factors indicate that the recession is bottoming out: The third quarter is usually the strongest performing quarter of the year, inventories have been drawn down, some investment and restocking must occur in the near future and base effects from a weak performance in 2008 will not be seen before the fourth quarter.

[6] The unprecedented collapse of international trade in late 2008 and early 2009 is reflected in major downward revisions in projections of import growth compared to our last forecast. However, with exports falling substantially as well, the net effect on our revisions of GDP growth is rather moderate.

demand continues to be weak. As the crisis' effects on the real economy materialize only with a certain time lag (through rising unemployment, precautionary savings and weak confidence), private consumption will remain subdued. All countries will continue to have little room for anticyclical fiscal measures. In a few countries, there might even be a (moderately) negative impact on GDP dynamics coming from (continued) fiscal tightening.

*Improving external demand conditions and the continued process of restocking will lead to a positive growth performance in all countries in **2011**. The strong growth of both exports and imports is partly due to base effects arising from previously low levels. Compared to pre-crisis levels, growth will stay subdued and the contribution of domestic demand will remain weaker due to lagged real economy effects. Hungary, whose domestic demand has already been sluggish for a couple of years, will be an exception and show some recovery in investments.*

The forecasts for 2010 and 2011 are still subject to considerable uncertainty, mainly related to developments in Western Europe. External demand and external financing conditions for the CEE-8 may be negatively affected if the gradual recovery of the world economy and the euro area that we assume in our baseline scenario does not materialize (risk of a double dip). Another risk factor would be a renewed increase in risk aversion vis-à-vis emerging economies. Moreover, domestic demand may also be weaker than expected, in particular if the real economy impact of the financial crisis in the CEE-8 countries turns out to be stronger than anticipated.

2 BOFIT-OeNB Forecast for Russia: Deep Contraction in 2009, Global Crisis Probably Prelude to Lower Trend Growth

The world economic crisis hit Russia hard through the sharp decline in oil prices and the drying up of international financial markets, which triggered a credit crunch. In the first half of 2009, Russia's total output fell by 10.4% year on year, although the second quarter performance showed signs of stabilization. The drop in GDP was primarily due to a fall in fixed investment (estimated at 19% in the first eight months over the same period in 2008) and a substantial reduction of inventories. A drop in economic activity and the strong devaluation of the ruble in early 2009 also caused a sharp contraction of imports. Month-on-month and quarter-on-quarter data point to a bottoming out of GDP growth in the summer of 2009. Real monthly estimates of GDP reached their lowest point in early 2009 and have been rising again since May. Unemployment rates (International Labour Organization methodology) leveled off over spring and summer.

*In the **second half of 2009**, private consumption is likely to be boosted by trickle-down effects of recovering oil and staple revenues, by the stabilization of the job market and by wage recovery. Moreover, growth in government consumption should kick in, since the revised federal budget for 2009 provides for a sizable fiscal stimulus as it foresees higher expenditure (+7% of GDP) despite falling revenues. A budget deficit of over 8% of GDP is expected (2008: surplus of 4.1%). The turnaround in the second half of 2009 will be supported by modest growth in export demand. Import growth will probably remain subdued, given its sharp decrease in the first half of the year and the continuing impact of the ruble devaluation of early 2009. However, persisting elevated (double digit) inflation has been eroding competitiveness gains sparked by devaluation, and recovering consumer demand may contribute to a gradual pick-up of imports toward the end of the year. Net exports will probably deliver a positive contribution to GDP growth for the first time in years. Given the weak economic performance in the earlier part of the year, total output in 2009 will register a substantial contraction, which we project at 8.0%.*

*Owing to considerable lingering uncertainty and limited credit availability, investment – hit by a severe credit crunch – is not expected to pick up until **2010**. At that point, investment will join private and government consumption, buoyed by the stabilization of the global recovery, as the driving forces of Russian economic expansion. The continuing, though smaller fiscal stimulus in 2010 will include an expansion of social policy measures. Budget shortfalls in both*

2009 and 2010 are to be covered mostly by money from reserve and welfare funds. While exports will continue to grow modestly, the recovery of domestic demand and the likely almost return of the ruble's real effective exchange rate to the level posted in the previous year will revive imports – to the point that net exports' contribution to growth will revert to negative territory. GDP growth will be relatively moderate in 2010 and 2011 (+3% in both years).

The risks to these projections are mainly on the downside. As in the past, Russia's economic performance continues to largely depend on the oil price, and therefore on the strength of the world economy's recovery, which is expected to remain quite fragile for some time. Another risk factor relates to nonperforming loans, which have already reached a high level and whose further expansion would perpetuate the credit squeeze and act as a major drag on the economy's recovery. Inflation is also a cause of concern: If it does not subside in the remaining months of 2009, the Russian currency could get under renewed downward pressure, which might even again destabilize the financial system. Finally, the world economic crisis may dampen Russian investment growth and hence the economy's medium- to long-term growth trajectory if the banking sector (or capital market) fails to at least partly make up for the breakdown of foreign investment finance.

Table 2

Russia GDP Outcome 2008 and Projections for 2009–2011

	Rosstat	BOFIT-OeNB		
	2008	2009f	2010f	2011f
	Year-on-year growth in %			
Russia	5.6	–8.0	3.0	3.0

Source: Rosstat 2008, BOFIT forecast 2009–2011.

Table 3

Croatia: GDP Outcome 2008 and Projections for 2009–2011

	Eurostat	OeNB		
	2008	2009f	2010f	2011f
	Year-on-year growth in %			
GDP	2.4	–5.4	1.4	2.8

Source: OeNB September 2009 forecast, Eurostat.

3 Croatia: Outlook Resembles That of the CEE-8 as a Whole

Croatia's GDP contracted by 6.5% in the first half of 2009 and is expected to recover gradually in the second half; it will decline by 5.4% in 2009 as a whole. In 2010, private consumption and imports will start to pick up, leading to another negative contribution of net exports. The moderately positive growth rate of 1.4% will be driven by investment growth and private consumption. For 2011 we expect a steady continuation of this trend, domestic demand will further strengthen while net exports will continue to contribute negatively to the growth rate of 2.8%.