Outlook for selected CESEE countries

CESEE-6 show strong investment momentum in 2019 followed by softening growth dynamics – subdued growth continues in Russia[1, 2]

Economic growth in the CESEE-6 countries[3] is expected to weaken from 4.4% in 2018 to 3.9% in 2019. For 2020 and 2021, we project a further slowdown to 3.5% and 3.2%, respectively. Despite some deceleration, private consumption growth will remain strong over the next years. Growth of gross fixed capital formation is expected to develop very dynamically in 2019, before slowing down thereafter. In line with weaker projections for euro area import growth, CESEE-6 export growth will lose steam in 2019 but will, in parallel with accelerating euro area import growth, gain speed later. CESEE-6 import growth is also forecast to moderate somewhat in 2019, but will recover in both 2020 and 2021. Among the CESEE-6, Croatia and the Czech Republic will record the lowest economic growth in 2019, while Hungary and Poland will post the highest growth rates. The growth differential of the CESEE-6 countries vis-à-vis the euro area will widen to 2.8 percentage points in 2019 (compared to 2.5 percentage points in 2018), before decreasing to 2.3 percentage points in 2020 and 1.8 percentage points in 2021. Risks mainly stem from the external environment and are tilted to the downside.

For Russia[4], we forecast GDP to grow by 1.0% in 2019 and to record a weak recovery to a growth rate of 1.8% in 2020, before reverting to a growth rate of 1.6% in 2021. Private consumption is likely to grow only modestly due to stagnant real incomes and slower growth in consumer lending. We anticipate no reforms aimed at improving the investment climate for private businesses during the forecast horizon. Therefore, any significant pickup in growth is likely to stem from relatively modest increases in public consumption and public investments. Amid a gloomier global economic outlook than in spring 2019, we hardly expect more external support for economic growth in Russia. Upside and downside risks to our forecast are more or less balanced.

1 OeNB CESEE-6 forecast: economic growth will soften continually over the next years

GDP in the CESEE-6 countries grew by 4.2% year on year in the first half of 2019. Hence, GDP growth was somewhat smaller than in the same period of 2018. Across the region, GDP growth surprised on the upside compared to our spring

[1] *Cutoff date for data underlying this outlook: September 20, 2019. 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 of the September 2019 ECB staff Macroeconomic Projection Exercise (MPE) for the euro area.*

[2] *Compiled by Antje Hildebrandt, with input from Katharina Allinger, Stephan Barisitz, Markus Eller, Martin Feldkircher, Mathias Lahnsteiner, 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 price quotes (ten-day average of daily quotes) with September 16, 2019, as our baseline. Assumptions about future contract prices for Brent oil indicate that oil prices will decline slightly over the three-year forecast period, i.e. from USD 64 per barrel in 2019 to USD 59 per barrel in 2020 and USD 57 per barrel in 2021.*

Table 1

OeNB-BOFIT GDP projections for 2019 to 2021 compared with the IMF forecast

	Eurostat	OeNB-BOFIT projections October 2019			IMF WEO forecast October 2019			Difference between OeNB-BOFIT and IMF		
	2018	2019	2020	2021	2019	2020	2021	2019	2020	2021
	Year-on-year growth in %							*Percentage points*		
CESEE-6	**4.4**	**3.9**	**3.5**	**3.2**	**3.8**	**3.1**	**2.8**	**0.1**	**0.4**	**0.4**
Bulgaria	3.2	3.5	3.3	3.1	3.7	3.2	3.0	–0.2	0.1	0.1
Croatia	2.6	2.8	2.6	2.6	3.0	2.7	2.5	–0.2	–0.1	0.1
Czech Republic	2.9	2.7	2.7	2.6	2.5	2.6	2.6	0.2	0.1	0.0
Hungary	5.1	4.4	3.3	3.5	4.6	3.3	2.9	–0.2	0.0	0.6
Poland	5.2	4.3	3.9	3.5	4.0	3.1	2.7	0.3	0.8	0.8
Romania	4.0	4.1	3.3	2.8	4.0	3.5	3.0	0.1	–0.2	–0.2
Russia	2.3	1.0	1.8	1.6	1.1	1.9	2.0	–0.1	–0.1	–0.4

Source: OeNB-BOFIT October 2019 projections, Eurostat, IMF World Economic Outlook of October 2019, Rosstat.

Note: 2018 figures are seasonally adjusted data. CESEE-6: GDP-weighted average.

2019 projections. This was particularly the case in Hungary and Romania but also in Croatia. For the second half of 2019, GDP growth is projected to weaken moderately in most CESEE-6 countries and to remain unchanged in Bulgaria and the Czech Republic as the unexpectedly strong momentum of gross fixed capital formation in several CESEE-6 countries is losing some steam. Furthermore, private consumption growth is expected to moderate. Due to deteriorating external demand on the back of continued global trade tensions, export growth is forecast to decline even further in the course of 2019. For the full year of 2019, GDP growth will amount to 3.9%, before moderating to 3.5% in 2020 and further to 3.2% in 2021.

Monetary policy to remain accommodative overall

Our assumptions regarding the monetary policy stance in the CESEE-6 countries remain more or less unchanged compared to our last forecast of spring 2019. Accordingly, we assume that a no-change policy is the most likely scenario for both 2019 and 2020. In this environment, lending activity in the CESEE-6 will continue to develop dynamically (less so in Croatia, where lending to the corporate sector, in particular, is rather sluggish). Generally, good financing conditions will continue to be supportive for private consumption and gross fixed capital formation.

Fiscal policy in the CESEE-6 region is rather neutral or expansionary

Currently, fiscal policy is rather neutral or expansionary in the CESEE-6 countries. In Poland, the 2019 elections have already caused some fiscal slippage. Furthermore, tax cuts are on the agenda for 2020. After the collapse of the Romanian government at the end of August 2019 due to political turbulence, new elections will only be held in 2020. We therefore expect Romania to implement required fiscal consolidation measures at a later stage when the new government will be in office (currently, the country is subject to the EU's significant deviation procedure). In Croatia, the Czech Republic and Hungary, we expect fiscal policy to be neutral or slightly expansionary in 2019, and to possibly become more restrictive toward the end of the forecast horizon. Bulgaria maintains its cautious fiscal policy stance.

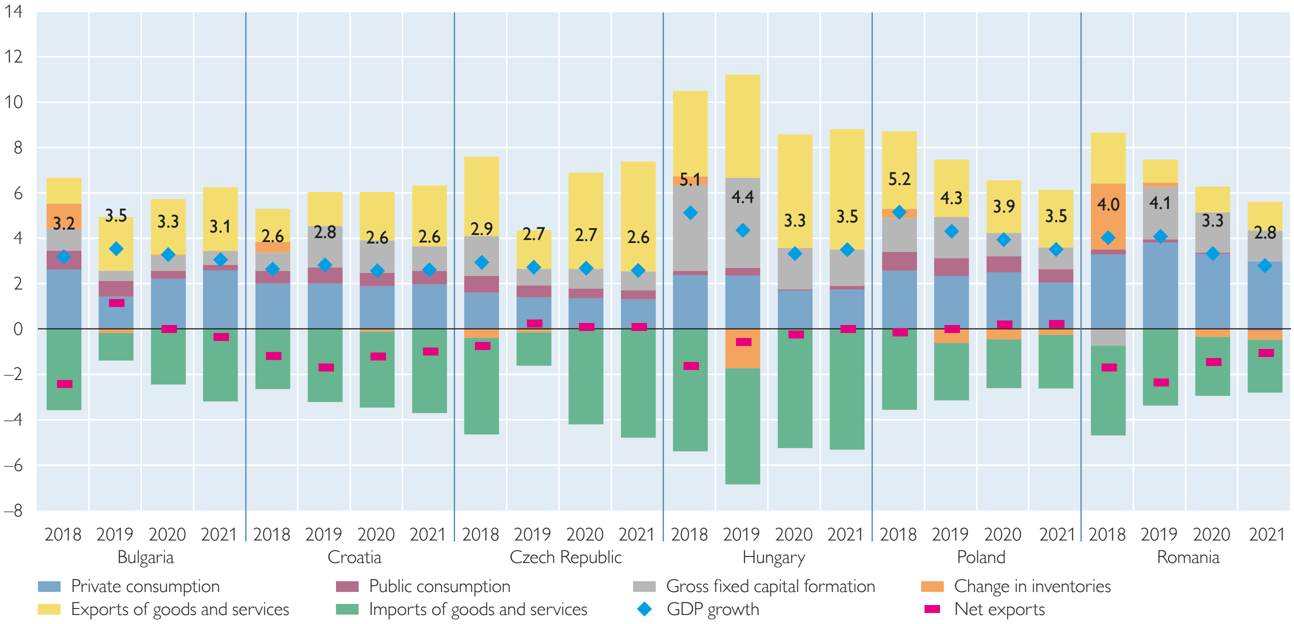
Private consumption growth will remain strong

Despite some moderation over the projection horizon, private consumption growth will generally remain strong in the CESEE-6. One key factor contributing to this development is certainly the remarkable labor market situation featuring record-low unemployment rates. Furthermore, policymakers in the CESEE-6 countries have implemented (or plan to implement) more or less expansionary

Chart 1

CESEE-6: GDP and GDP components

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



Source: Eurostat, OeNB.

Note: Realized data for 2018, projections for 2019 to 2021.

policy measures targeting consumers, which provide an additional boost to private consumption growth. Only in Bulgaria, where – apart from a high base effect – consumer mood has been leveling off somewhat in the course of 2019, do we observe a sharp drop in private consumption growth in 2019. We expect that public consumption growth will develop for the full year of 2019 as it did in the first half of 2019. After that, we forecast some moderation in all CESEE-6 countries, which will be largely driven by consolidation needs.

EU funds drive investment activity

In most CESEE-6 countries, i.e. in Croatia, Hungary, Poland and Romania, gross fixed capital formation is expected to be very strong in 2019 but to lose steam thereafter. In Hungary, for instance, growth rates exceeded 19% year on year in the first half of 2019 (after coming to 16.5% for the full year of 2018). We expect growth rates in Hungary to moderate only slightly to 16.2% for the full year of 2019, before decreasing further to below 7% in 2020. In Croatia, investment growth is projected to more than double to 8.5% in 2019 (from 4.1% in 2018), and to decelerate both in 2020 and 2021. In general, accelerated investment activity in 2019 has been largely driven by a strong use of EU funds within the EU's multiannual financial framework for the period from 2014 to 2020. However, funds are available for up to two more years after the end of a funding period. To our knowledge, some countries (particularly Hungary) will have invested most of the available funds by end-2019, whereas other countries (e.g. Croatia) will still have a large scope for using funds from the current framework. Therefore, we expect the strong impact of EU funds on investment growth to prevail in some of the CESEE-6 countries over the forecast horizon. In Hungary and Romania, investment growth is also supported by elevated (residential) construction activity. We expect construction activity to generally remain buoyant in the CESEE-6 over the projection horizon, given strong demand for residential construction largely due to favorable income prospects as well as supportive financing conditions and housing subsidies in some countries. In Bulgaria and the Czech Republic, by contrast, gross fixed capital formation is expected to drop significantly in 2019 compared to 2018, as has already been indicated by weak results for the first half of 2019. Apart from a base effect, the weakening in investment activity can be largely explained by deteriorating export prospects, which have made investors more reluctant to invest. For both 2020 and 2021, however, we expect fixed investment growth to recover somewhat in Bulgaria and the Czech Republic.

Export growth in the CESEE-6 dampened on average

For 2019, we project slumping export growth, on average, in the CESEE-6, which is in line with weakening import growth projections for the euro area. Export growth will be particularly subdued in the Czech Republic, Poland and Romania (and will remain unchanged in Hungary) in 2019. The pattern is somewhat different for Bulgaria and Croatia, where export growth will accelerate in 2019 compared to 2018. In both countries, base effects play a role. Furthermore, in Bulgaria, we see some orientation toward export markets outside the euro area, and in Croatia, export growth has been supported by another good tourist season. In all CESEE-6 countries except for Croatia, import growth will moderate in line with weaker domestic demand in 2019. In some countries, especially in Bulgaria and the Czech Republic, imports will gain speed after that. For Poland and Romania, we expect import growth to weaken over the projection horizon, while import growth is forecast to remain robust in Hungary throughout all three years.

In 2018, the contribution of net exports to growth was negative in all CESEE-6 countries. This picture will change in 2019. In fact, we expect the contribution of net exports to turn positive in Bulgaria and the Czech Republic, to become neutral in Poland, and to narrow in Croatia and Hungary. Only for Romania do we expect a widening of the gap. For the remainder of the forecast horizon, we expect a further improvement of net contributions in most countries along with a recovery in export growth.

CESEE-6: risks mostly stem from external developments

Risks to our CESEE-6 forecast are mainly due to external developments that cause a high degree of uncertainty in several areas. Certainly, growth of the world economy, in general, or of the euro area economy, in particular, could turn out higher (lower) than assumed in our baseline scenario and would thus translate into higher (lower) growth prospects of the CESEE-6 countries. In our overall risk assessment, however, we conclude that the risks to global economic growth and to euro area growth – and eventually to our CESEE-6 projections – are slightly tilted to the downside for several reasons:

- First, there is still a high risk that trade tensions between the U.S.A. and its major trading partners will escalate further. This would shake the world economy and would have negative spillover effects on the mostly small, open and highly integrated CESEE-6 economies.
- Second, at the EU level, there are still many uncertainties regarding the conditions under which the U.K. will leave the EU. Several options are under discussion; yet, a disorderly Brexit with unknown implications for both the U.K. and the EU remains a possible outcome. In any case, the CESEE-6 will be negatively affected in several ways, both directly and indirectly. Most obviously, a disorderly

Brexit would harm trade flows within the EU and may have financial stability implications. Furthermore, Brexit will have a negative impact on the EU's new multiannual financial framework for 2021–2027 as this will be the first EU budget without the U.K.'s net contribution. However, this effect will only materialize toward the end of the projection horizon.

- Third, new geopolitical risks in the Middle East are emerging, such as those caused by the drone attacks on key oil facilities in Saudi Arabia, one of the largest oil producers in the world, in mid-September 2019. The resulting damage destabilized oil markets across the world and resulted in a sudden jump in oil prices. Although oil prices moderated again thereafter, a higher volatility of oil prices may harm the world economy. Moreover, risks persist that the conflicts in the Middle East might spread to other parts of the world, which would severely affect global growth. This would also have adverse effects on the CESEE-6 countries.

Major domestic risks are predominately related to the developments in the CESEE-6 labor markets. Labor shortage is omnipresent not only in all countries but also in almost all sectors. The manufacturing sector in particular, which is essential for the region's foreign trade, suffers from the lack of a skilled workforce and from the ensuing negative consequences for economic growth. Capacity constraints limit production so that it can no longer proceed in a sufficient and timely manner, wage pressures have already started to erode competitiveness in several countries, and foreign investors are more and more likely to be discouraged from investing in countries with obvious labor shortages and prospects of rising wages. While current labor shortages are factored into our baseline, they could become more pronounced, which would tilt the CESEE-6 countries' risk profile to the downside. Furthermore, rising wages could feed through to inflation, resulting in higher-than-anticipated monetary tightening, which we consider a downside risk. In positive terms, further labor markets strains could also translate into higher real disposable income fueled by stronger wage growth, which would push private consumption beyond the expected levels.

As discussed in our previous forecast, a number of sector-specific risks prevail in some CESEE-6 countries. In the Czech Republic and in Hungary, in particular, economic growth is strongly linked to the automotive sector. To remain competitive, these economies therefore must, for instance, react to new technological requirements for the automotive sector or fulfill new emission standards. One minor sector-specific risk relates to adverse weather conditions that could harm economic growth in those CESEE-6 countries with a comparatively large agricultural sector (mainly Poland and Romania).

Noneconomic internal risks also prevail in some CESEE-6 countries. Further increases in populist tendencies could erode investor confidence and discourage foreign investors. So far, however, political tendencies have not noticeably undermined investor confidence. Overall, we therefore regard political developments in the CESEE-6 as a minor downside risk to our growth projections.

There are also several upside risks to our GDP growth forecast. As mentioned before, higher-than-expected global economic growth and euro area growth, in particular, might boost exports and, eventually, the GDP growth of the CESEE-6 countries even more than currently projected. Furthermore, the countries may make more extensive use of EU funds than expected (this upside risk is mostly relevant for our forecasts for Bulgaria, Croatia and Romania as the other CESEE-6 countries already feature high EU fund absorption rates).

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

Bulgaria: exports and public demand support economic growth in the short run

Our spring forecast for Bulgaria remains largely unchanged as regards the evolution of headline GDP. However, the underlying growth structure is expected to change, especially in 2019, given that the first half of the year brought about a considerable slowdown in both private consumption and gross fixed capital formation, while exports recovered remarkably, partly on the back of a favorable base effect in the mineral and fuel product sectors. Over the forecast horizon, we expect the economy to lose pace only marginally, decelerating from an anticipated real GDP growth rate of 3.5% in 2019 to 3.1% in 2021.

Given the developments in the first half of the year, private domestic demand components are expected to lose considerable steam in 2019 compared to previous years, before recovering until the end of the forecast horizon. Private consumption is likely to suffer from worsened consumer sentiment, decelerated bank lending and rising energy prices in the near term. Conversely, tight labor markets should keep wage growth at favorably high levels. Private investment is expected to suffer from industrial weakness due to labor shortages and economic uncertainty stemming from major trading partners. Bank lending to nonfinancial corporations may remain constrained in view of pending gradual macroprudential tightening. Housing construction, by contrast, has seen a notable revival recently. Moreover, Bulgaria's prospects of entering the Exchange Rate Mechanism (ERM) II and the banking union in the foreseeable future as well as the further deepening of the country's cooperation with the OECD are likely to boost investor confidence.

Public domestic demand is expected to follow a trend opposed to that of private sector demand, namely to expand in 2019, before cooling off by the end of the forecast period. This development mirrors the budgeted fiscal expansion in 2019 and the targeted general government budget surplus for both 2020 and 2021. The considerable expansion of government consumption in 2019 reflects higher public expenditure on wages and a continuous increase in health insurance payments. Government investment is projected to accelerate in the short run due to the planned construction of a large section of the Hemus motorway, which was approved by the government at end-2018. Local elections in October 2019 are likely to constitute an incentive for both the government and local authorities to speed up investment projects. Stronger infrastructure investment could be sustained until 2020, given an increased absorption of EU funds as the EU's current multiannual financial framework is coming to an end.

In the first half of 2019, Bulgaria managed to put a stronger weight on export markets outside the EU (e.g. China, Egypt and Serbia). At the same time, however, this reorientation strongly depended on the specific structure of the exported products. Therefore, it remains to be seen to what extent Bulgaria manages to decouple from sluggish near-term economic developments in the euro area. In any case, we expect Bulgarian exports to gradually gain further momentum thanks to the mild economic acceleration projected for the euro area until the end of the forecast horizon and Turkey's expected recovery from recession. Imports should follow a similar path given recovering domestic demand. On balance, the positive growth contribution of net exports recorded in 2019 is likely to turn negative by the end of the forecast horizon.

Croatia: investment growth accelerates sooner and more strongly than anticipated

At 3.1% year on year, Croatian GDP growth surprised on the upside in the first half of 2019. This development can be attributed to the fact that investment growth accelerated earlier and more strongly than anticipated. Gross fixed capital formation grew by 9.7% year on year in the first half of 2019, contributing roughly as much as private consumption to total GDP growth. Private consumption and export growth were in line with our forecast for the first half of 2019. The already large negative contribution of net exports increased by more than forecast, given higher-than-expected import growth. Based on the trajectories of investment and export growth and factoring in current economic policy measures, we have revised our forecast for 2019 mildly upward to 2.8% and have left our forecast for 2020 and 2021 roughly unchanged at 2.6%.

Regarding private consumption, the Croatian government increased the base salary of civil servants by 2% and that of health care workers by 7%, effective from September 1, 2019. Moreover, the Croatian government announced that several new rounds of its housing subsidy program will be implemented until mid-2020. 2020 will also see a new round of tax reforms with a volume of roughly HRK 3.75 billion (EUR 508 million). These reforms are aimed at lowering the tax burden of the tourism industry and at boosting youth employment by e.g. reducing income taxes for citizens below the age of 25 by 100% and for citizens aged 25 to 30 by 50%. The government reaffirmed that it would cut the VAT from its current rate of 25% to 24%, lowering the rate even further to 13% for the hotel and tourism sector. The reform package also includes lower thresholds for profit taxation, higher excise duties on cigarettes and alcohol as well as a new tax on sugary drinks. Conditional on the necessary legal amendments, the proposed measures will take effect on January 1, 2020. Overall, we expect the above-mentioned measures to sustain private consumption growth in Croatia.

The main driver behind investment growth are EU funds, which finance roughly three-quarters of public investments in Croatia. We project investment growth to peak in 2019 and to decelerate over the forecast horizon as the momentum of EU fund absorption wanes. The projected investment trajectory is one of the main reasons behind the lower GDP forecast for both 2020 and 2021. There could be an upside if structural policies supporting investments were passed; given the fragmentation of Croatia's political scene, however, a strong reform momentum seems unlikely in the near term.

Public consumption should continue to make a moderate positive contribution to GDP growth over the forecast horizon, even though the Croatian government targets a broadly balanced budget over the next years and plans to reduce the public debt-to-GDP ratio by roughly 10 percentage points until 2021.

The negative contribution of net exports to GDP increased markedly compared to figures recorded in the same period in the previous year. Import growth is projected to remain high, driven largely by strong domestic demand. We forecast a moderate increase in export growth over the projection horizon as we expect economic developments in the euro area to improve again. The tourism sector is projected to continue growing moderately at the pace seen in both 2018 and the first half of 2019. Export developments, however, are subject to considerable uncertainty, especially when considering current headwinds to global trade.

Czech Republic: solid growth is driven predominantly by domestic demand

Despite some moderation compared to previous years, the expansion of the Czech economy is expected to continue at a solid pace of just below 3% in the period from 2019 to 2021. Economic growth will continue to be driven predominantly by strong domestic demand on the back of robust private consumption and investment growth. After having put a drag on GDP growth in 2018, the contribution of net exports is expected to turn slightly positive in 2019 and neutral in the medium term.

Private consumption will keep expanding at a rather robust pace throughout the forecast period. This is because households' disposable income will continue to be spurred by still relatively vigorous growth in wages and other income components (e.g. entrepreneurial income and social benefits will also contribute positively to private consumption growth). In particular, following the unprecedented increase in January 2019 (of about 7% of average monthly pensions), pensions will be raised again at a similarly extraordinary rate far beyond the statutory indexation in 2020, which is likely to boost private consumption.

Public consumption will continue its fast growth particularly on the back of rising employee compensation in the government sector as well as social transfers and other nonwage expenses. However, the expansion in public consumption is projected to lose momentum in real terms as the growth of the deflator will outpace the increase in nominal expenditures.

Gross fixed capital formation is expected to slow down to less than half the pace recorded in 2018. This is, on the one hand, attributable to base effects; on the other hand, investment growth in the business sector has been dampened by a slowdown in external demand. While investment growth is projected to slightly accelerate over the remainder of the forecast horizon, a more pronounced expansion in investment activity will be held back by weakened external demand and tightened monetary policy. Tight labor market conditions, by contrast, will incentivize firms to improve labor efficiency by investing into automation and labor-saving technologies. In addition, public gross fixed capital formation will benefit from improving the drawdown of EU funds.

Expansion in exports will be dampened by slower growth in foreign demand and a tight labor market as strong increases in wages impair the price competitiveness of Czech firms. Import growth, which is typically tightly linked to export growth, will be reinforced by a sustained expansion in domestic demand. Against this background, net exports will only make a slightly positive contribution to GDP growth in 2019 before their impact on economic expansion will become virtually insignificant.

Hungary: economic policy measures temper slowdown

Real GDP grew by 5.2% during the first half of 2019, and thus at a slightly stronger pace than in the full year of 2018 and at a rate above the one anticipated in our last forecast (4.7%). Growth was driven by accelerating (instead of slowing, as expected) investments, while private consumption growth contracted by less than we had anticipated and public consumption unexpectedly strengthened (possibly in light of local elections in September 2019). Net real exports were less of a drain on overall GDP growth than expected in our forecast, mainly because import growth slowed down in parallel to a sharp reduction in inventories (while export growth picked up slightly on the back of stronger euro area imports). Based on the developments during the first half of 2019 and information on new economic policy measures, we have revised our GDP forecast upward over the entire projection horizon. Nevertheless, we still expect slowing dynamics in both 2019 and 2020, and a minor temporary uptick in 2021.

At the end of May 2019, the Hungarian government announced an Economy Protection Action Plan, including tax cuts and tax simplification measures, tax incentives and financial support for business investments as well as support for R&D activities. Following the launch of the Funding for Growth Scheme Fix (FGS-fix) at the beginning of 2019, Magyar Nemzeti Bank moreover initiated a Bond Funding for Growth Scheme at the beginning of July 2019. The objective of this corporate bond purchasing program is to complement the FGS-fix by promoting the diversification of funding provided to the domestic corporate sector. Corporate bond issuance under the program is expected to gain speed in the last quarter of 2019. These measures, along with selected elements of the government's Family Protection Plan aimed at promoting home construction as well as a tight labor market (i.e. capital-for-labor substitution), are expected to provide a cushion for investment activity. Nevertheless, we expect investment growth to slow markedly from 2020 onward, as will the allocation of EU funds. Furthermore, the gradual erosion of economic sentiment, the worsening of export expectations and the modest easing of capacity utilization rates also point toward a slowdown of investment growth.

Most elements of the Family Protection Plan (including, inter alia, subsidized loans, debt takeovers and car purchase subsidies) came into effect in mid-2019. These measures, along with accelerating growth in loans to households, underpin private consumption. Nevertheless, private consumption dynamics are likely to moderate due to a strong base effect, slower employment and real wage expansion as well as somewhat weaker consumer confidence. In addition, to mobilize additional household savings for government debt financing, the Hungarian government introduced a new type of government bond specifically targeted at households in mid-2019. This new savings instrument is expected to not only change the structure of household savings, but also increase households' propensity to save through its attractive features (i.e. preferential yield, tax exemption, ready availability). We expect public consumption to ease in the second half of 2019 and in 2020, following a strong start into 2019. In light of parliamentary elections in mid-2022 and the entry into force of some elements of the Family Protection Plan in 2021, we expect consumption growth to gain some momentum in 2021.

Export growth is expected to hold up well, while sharp destocking should keep import growth restrained in 2019 despite strong domestic consumption and investment. Thus, the negative contribution of net real exports should decline notably compared to 2018. The combination of strengthening export growth in line with stronger euro area imports and slowing domestic demand is expected to keep import growth stable, leading to a modest improvement in net real exports for the remainder of the forecast horizon.

Poland: lower fixed investment growth will slow down GDP growth in 2020

In Poland, GDP growth will decline to 4.0% year on year in the second half of 2019, implying that full-year growth will slow down from 5.2% in 2018 to 4.3% in 2019. In 2020, the economy will expand at a lower rate of 3.8%. This moderate deceleration will mainly result from a further slowdown in domestic demand, causing the growth structure to become somewhat more balanced.

The composition of domestic demand, as measured by its contribution to GDP growth, will change significantly in 2020 as gross fixed capital formation growth will become substantially less dynamic. At the same time, private consumption growth will remain strong, accelerating by 4.0% in 2019 and ticking up further to 4.3% in 2020. Consumption growth will further be driven by the one-off thirteenth-month pension payment as well as an increase in public sector wages and several fiscal transfer measures, including the widening of family benefits to higher income segments, which entered into force in July 2019. Changes in the personal income tax system (introducing a zero tax rate for persons under 26 years of age, lowering the first tax bracket to 17%, introducing higher deductible amounts for employees) will provide further support in 2020. These measures will more than offset the cyclical weakening of the labor market, which will become stronger in the course of 2020. Public consumption growth will remain strong both in 2019 and 2020, given public sector wage hikes envisaged for both years and post-election fiscal tightening.

Gross fixed capital formation growth will be slightly higher than in 2018, amounting to 9% in 2019. For 2020, we forecast a slowdown in investment growth, resulting in an annual growth rate of about 5%. Investment by the public sector, particularly by local governments, will almost stagnate in 2019 and 2020 as the EU funding cycle is coming to an end. This will have an adverse knock-on effect on investment growth in the business sector, adding to the direct impact that the fading-out of the EU funding cycle will have especially on publicly owned companies and to the negative effects stemming from weaker foreign demand. However, the slowdown in investment growth will be softened by robust domestic consumption, still high capacity utilization and the favorable financing situation with respect to both own funds (profitability, accumulated deposits) and external funds (low interest rates). Still, weaker investment growth will lead to a cyclical weakening of the labor market, which, in turn, will further slow down both business investment and residential investment in 2020.

In the full year of 2019, export growth will decelerate strongly as a result of the marked slowdown in both imports by the euro area (Germany, in particular) from outside the single currency area and imports by non-euro area countries. In addition, Polish manufacturing unit labor costs are expected to rise more strongly than those of its main trading partners. In 2020, Polish export growth will continue to weaken only slightly, reflecting the expected stabilization of German import growth and the uptick in imports by non-euro area countries. Import growth will come to about 5% in the full year of 2019, and will thus decline even more strongly than export growth. On the back of a turning inventory cycle, this implies a much lower buildup of stocks compared to the previous year. In 2020, import growth will decelerate further to 4.2% (and export growth to 4.4%) as domestic demand growth and fixed investment growth, in particular, will slow down. The contribution of net exports to GDP growth will be about zero in 2019 but slightly positive in 2020.

Romania: pickup in investments post-pones economic slowdown

We revise our GDP growth forecast upward to 4.1% for 2019, and thus expect GDP growth in 2019 to approximately come to the same level as in 2018. The revision reflects stronger-than-projected growth in the first half of 2019, boosted by an unexpectedly strong rebound in gross fixed capital formation. While we had projected some recovery in our last forecast, the extent of the rebound in investment from subdued levels surpassed our projection. Moreover, our previous forecast mirrored heightened uncertainty regarding policy measures introduced in late 2018 (including taxes on bank assets). However, this policy package was amended at the end of March 2019, resulting in a marked reduction of the burden on banks. Nevertheless, we still expect growth to slow down to 3.3% in 2020 and to 2.8% in 2021, given increased needs for a correction in fiscal policies (as regards, inter alia, the adoption of the new pension law) and a challenging external environment.

Private consumption will remain the main growth driver over the projection horizon as real wages will continue to rise amid tight labor market conditions. Public wages are set to rise until 2021 as laid down in the unified wage law enacted in 2017, with possible spillovers to the private sector. In the short run, the 15% increase in pensions effective as of September 2019 will provide further support. According to the new pension law passed in June 2019, both 2020 and 2021 will see additional marked increases. Currently, high frequency data do not paint a clear picture as retail sales growth accelerated in July, while consumer confidence weakened in August. Since the yearly growth rate of private consumption benefited from base effects in the first quarter of 2019, we expect full-year growth to come in slightly below the figure seen in the first half of the year.

We expect gross fixed capital formation to continue to recover (mainly based on construction activity in the residential and nonresidential sector), supported by policy measures benefiting the construction sector. The continuation of investment recovery is also driven by sustained EU fund absorption. The upward trend in loans to nonfinancial corporations also bodes well for continued investment activity.

Weak export performance in the first half of 2019 and continued weak industrial production data coupled with downward revisions of euro area import growth explain our low projections for export growth in 2019. In 2020 and 2021, export growth in Romania is likely to accelerate in line with our external assumptions, albeit only slightly, given the rise in unit labor costs in the manufacturing sector. The negative contribution from net exports is projected to decline as import demand will slow down somewhat due to domestic demand developments.

3 Russia: state investment projects slightly boost the pace of economic growth

We forecast GDP to grow by 1.0% in 2019 and to recover slightly to 1.8% in 2020, before reverting to a growth rate of 1.6% in 2021. Fluctuations in global commodity markets continue to influence the pace of Russia's economic expansion, although the country has ample fiscal buffers to sustain even a significant decline in export prices. Our first basic assumption is that Russia will continue to pursue its current economic policies, which are geared to achieving macroeconomic stability and economic independence. This implies restrained growth in public sector expenditures, the accumulation of excess revenues in the National Welfare Fund, and a continuation of the central bank's inflation targeting. Economic independence implies favoring domestic products and services over imports as well as maintaining policies that restrict imports. Our second basic assumption relates to global oil prices (see footnote 4). Additionally, we assume that there will be no major shifts in EU-Russia or U.S.A.-Russia relations. While the current sanctions regime is expected to remain in place, we do not see either side impose new, wide-ranging restrictive measures or remove existing ones.

Private consumption growth in 2018 was supported by a rise in real wages and a very rapid increase in consumer credit, both of which are losing steam. Our baseline only allows for a relatively modest increase in public spending and a more pronounced, albeit temporary, expansion of public investments over the forecast period. The size of the National Welfare Fund increased above the threshold of 7% of GDP in August 2019 and may rise further (based on still relatively high oil prices), allowing for some of the funds to be invested in domestic projects. We do not, however, expect a significant investment boost stemming from these funds.

Despite brisk growth in fixed investments in 2018, the level of investments (as a ratio to GDP) is still lower than in late 2014. In the first half of 2019, investment growth only came to 0.6% year on year, pointing to a significant slowdown in fixed investment growth. Given the high base effect in the second half of 2018, we do not expect substantial growth for the full year of 2019. In both 2020 and 2021, many of the projects envisaged in Russia's National Projects Program should proceed to the implementation phase, giving a boost to fixed capital formation. We do not expect any real and sustained changes in the investment climate during the forecast period. Uncertainties and lack of structural reforms will hamper private investments.

Russia's export and, above all, import developments have been very volatile in recent years. Overall economic growth was supported by rapid growth in export volumes in both 2017 and 2018. Early 2019, by contrast, saw a decline in exports. While a further surge in volumes of Russia's biggest export commodities (crude oil, petroleum products and natural gas) is unlikely, ramping up liquefied natural gas (LNG) production on the Yamal peninsula, the opening of a new gas pipeline to China and rapid growth in certain metal industry exports could sustain export growth in both 2020 and 2021. Given modest growth in domestic demand, import growth is likely to remain weaker than export growth, implying a small positive growth effect from net exports over the entire forecast period.

Upside and downside risks to the forecast for Russia are relatively balanced

Due to the floating exchange rate and adherence to its fiscal rule, Russia's economic performance has become less dependent on oil price movements. However, large changes in the price of Russia's top export commodity remain hugely important. Any significant rise or drop in crude oil prices will be reflected in the exchange rate of the Russian ruble, thereby affecting Russia's financial markets, cost of investment funding and net exports.

The sanctions imposed by the West have had a distinctly negative impact, particularly on Russia's financial markets. Amid the ever-present risk of a flare-up of geopolitical tensions, new sanctions or threats of new sanctions would undoubtedly have a negative, albeit relatively small, impact on Russia's medium-term growth outlook.

We expect government expenditure and fixed investment to grow modestly. If the government budget rule is relaxed or a significant share of the National Welfare Fund is used for domestic projects, investment growth could accelerate temporarily toward the end of the forecast horizon. Industrial capacity utilization remains extremely high and unemployment is historically low, underlining the need for new investments.

As in our previous forecasts, the largest source of uncertainty relates to net exports as forecasting Russian export volumes has proven to be quite a challenge. Changes in import volumes largely depend on domestic demand and import prices which, in turn, depend on the ruble exchange rate.