Developments in selected CESEE countries

Strongest economic upswing since 2008 amid booming domestic demand[1, 2, 3]

1 Regional overview

Robust economic expansion is broad based …

Economic conditions in CESEE remained favorable in the second half of 2017 so that the region experienced one of the strongest economic upswings since 2008. This was especially true for the CESEE EU Member States, where the current economic momentum was strong and broad based. Positive contributions from private consumption were increasingly supplemented by strengthening investments. Domestic demand stayed strong given dynamic private consumption growth based on good sentiment, higher wages, private sector releveraging and tightening labor markets. Firms are approaching the limits of their production capacity and were increasingly prepared to spend on capital formation given favorable financing conditions. Public investment and construction continued to be supported by inflows of EU funds. External demand benefited from the synchronized upswing of the big engines of the global economy – the U.S.A., China and the euro area. Based on rising global investment and trade, the world economy in 2017 recorded its fastest expansion since 2011. Within the euro area, growth was again vivid in Germany, the central anchor for many of the CESEE economies. Via their integration into global value chains, CESEE countries benefited not only directly from strong international demand for final goods but also from increasing demand for inputs into international production chains. Outside the EU, stellar growth rates were also reported for Turkey, reflecting a combination of government stimulus and exceptionally strong external demand. Russia continued its recovery from recession. At 1.5% in 2017, output growth remained moderate by regional standards, however, reflecting structural weaknesses and a low growth potential.

… and growth does in general not appear to be excessive

The strong expansion of economic activity amid tightening labor markets and rising wage pressures has not led to a substantial increase in inflation rates. Price developments were well within targets, with the notable exceptions of Romania and Turkey. This may suggest that growth is not (yet) excessive in most CESEE countries. This conclusion is also supported by sustainable, though modest credit market developments: Credit growth is robust but not especially strong by historical standards. In general, banking sector lending today is more prudent than a decade ago (locally refinanced, mostly in local currency and subject to tighter supervision to prevent the buildup of bubbles) and the cleanup of crisis legacies (e.g. nonperforming loan exposures and foreign currency loan portfolios) has made substantial progress. At the same time, the strong increase in property prices especially in the CESEE EU Member States warrants careful monitoring.

[1] *Compiled by Josef Schreiner with input from Katharina Allinger, Stephan Barisitz, Markus Eller, Mariya Hake, Thomas Reininger, Tomáš Slačík and Zoltan Walko.*

[2] *Cutoff date: April 6, 2018. This report focuses primarily on data releases and developments from October 2017 up to the cutoff date and covers Slovakia, Slovenia, Bulgaria, Croatia, the Czech Republic, Hungary, Poland, Romania, Turkey and Russia. The countries are ranked according to their level of EU integration (euro area countries, EU Member States, EU candidate countries and non-EU countries). For statistical information on selected economic indicators for CESEE countries not covered in this report (Albania, Bosnia and Herzegovina, Kosovo, FYR Macedonia, Montenegro, Serbia and Ukraine), see the statistical annex in this issue.*

[3] *All growth rates in the text refer to year-on-year changes unless otherwise stated.*

Furthermore, cyclically adjusted budget deficits have widened in many countries in a period of booming economic activity. A more prudent fiscal stance might be called for also against the backdrop of medium-term budgetary objectives.

Challenges mainly relate to political developments

The generally favorable picture was blurred mainly by political risks that might affect the region's economies in the short to medium term. The U.S. sanctions recently imposed on Russia e.g. have already led to a marked weakening of the Russian ruble in international markets. Recent events are keeping relations tense between Russia and the West. Furthermore, the announcement of the U.S. administration to impose tariffs on steel and aluminum introduced a further element of uncertainty to the prevailing world trade order. Ongoing disputes with the European Commission and European partners could impact the CESEE countries' standing in the upcoming negotiations for the 2021–2027 EU budget. Those negotiations will be dominated by Brexit, and the size and composition of the EU budget will possibly be altered. Moreover, EU funds could be made conditional on adherence to the rule of law and common European values.

Economic activity reaches strongest level in six years

Having averaged 3.7% annual GDP growth in 2017, aggregate economic activity in CESEE was at its strongest level for six years, and all countries in the region posted positive growth rates for the first time in almost a decade. Growth was especially strong in Romania and Turkey at 7% and 7.4%, respectively, while below-average growth rates were reported only for Croatia and Russia (see table 1).

Quarterly dynamics for the second half of 2017 indicate a continuing strong momentum, with quarter-on-quarter growth rates accelerating especially in Hungary, Slovenia and Turkey. Some deceleration was observed in the Czech Republic and Romania, albeit after an exceptionally strong first half of 2017. Furthermore, growth continued to be moderate by regional standards in Croatia.

Private consumption remained the single most important pillar of growth throughout most of the CESEE region, benefiting from good sentiment, rising stocks of household credit, swift wage growth and improving labor market conditions (see chart 1).

Tightening labor market conditions fuel wage growth and private consumption

In fact, labor markets are becoming increasingly tight in many countries, especially in the CESEE EU Member States. Unemployment rates have been falling

Table 1

Real GDP growth

	2016	2017	Q3 16	Q4 16	Q1 17	Q2 17	Q3 17	Q4 17
	Period-on-period change in %, seasonally and working-day adjusted							
Slovakia	3.3	3.4	0.7	0.9	0.8	1.0	0.8	0.9
Slovenia	3.1	5.0	1.5	1.0	1.4	1.4	1.2	2.0
Bulgaria	3.9	3.6	0.8	1.1	0.9	1.0	0.9	0.7
Croatia	3.2	2.8	1.2	0.9	0.6	0.8	0.7	0.1
Czech Republic	2.6	4.3	0.2	0.4	1.5	2.4	0.7	0.8
Hungary	2.2	4.0	0.6	0.7	1.5	1.0	1.0	1.3
Poland	2.9	4.6	0.2	1.9	1.3	0.8	1.3	0.9
Romania	4.8	7.0	0.1	2.1	2.0	1.7	2.4	0.5
Turkey	3.2	7.4	–0.2	3.8	1.4	2.1	1.2	1.8
Russia	–1.0	1.5	0.0	–0.5	..	..	..	..
Euro area	1.8	2.4	0.4	0.6	0.6	0.7	0.7	0.7

Source: Eurostat, national statistical offices.

consistently in recent years, from an average level of around 10% in early 2013 to below 5% in January 2018. This represents the lowest reading since the start of transition. Positive labor market developments are also substantiated by several other indicators: Unemployment declined among the most vulnerable age cohorts, namely young persons (below 25 years) and older persons (above 50 years). The trend in long-term unemployment was positive as well and broad based. Furthermore, employment expanded throughout the region, with annual employment growth exceeding 5% in Bulgaria, Slovenia and Turkey. This contributed to a convergence of employment rates to euro area levels. Bulgaria, the Czech Republic, Hungary and Slovenia in fact already reported higher employment rates than the euro area countries on average.

The flip side of strong labor market developments were increasing labor market shortages. According to a survey by the European Commission, labor is increasingly perceived as a limiting factor for production: In early 2018, some 40% of respondents struggled to find workers. While the potential for immigration from the Western Balkans and Ukraine should be significant and is already alleviating some pressures on labor markets (e.g. in Poland), it is unlikely that immigration can fully offset the lack of workers given an overall restrictive immigration stance of most CESEE governments. Furthermore, geographical mobility in CESEE remains limited, with people's propensity to emigrate often being higher than their willingness to commute.

Against this backdrop, nominal wages rose powerfully in the review period, increasing by around 8% year on year, on average, in the second half of 2017. Several countries even reported double-digit increases, with Romania leading the ranks. Slowly rising inflation rates somewhat cut into purchasing power throughout the region. Nevertheless, real wages rose by some 6% year on year on average in the second half of 2017.

Dynamic labor markets and higher wages positively impacted on sentiment. Consumer confidence as reflected by the Economic Sentiment Indicator of the European Commission reached a historic high in March 2018, some 25 points above the readings of early 2013. At the same time, demand for consumer credit rose noticeably, providing a further impulse for private consumption.

Higher investment demand as capacities approach their limits and EU fund absorption rises

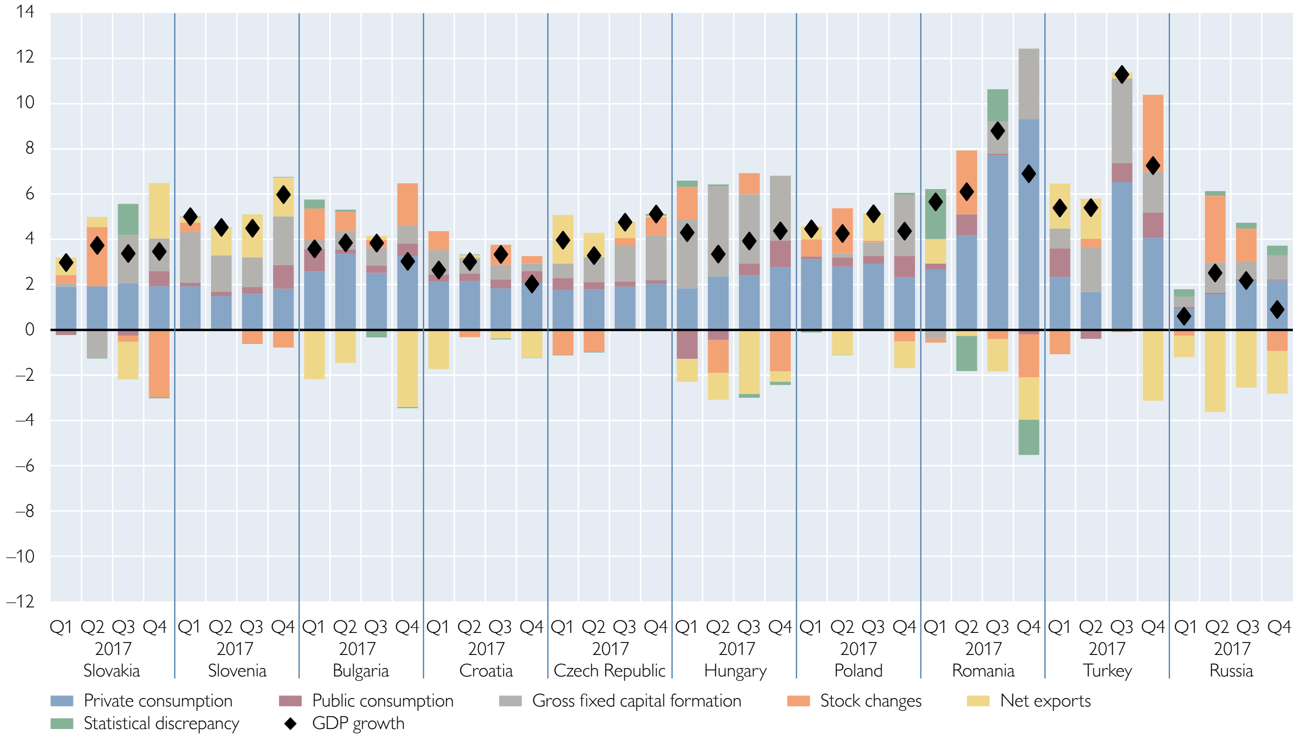
After a slack in 2016, gross fixed capital formation started to gain speed throughout 2017 (see chart 1): Capacities approaching their limits, full order books, strong industrial confidence and improved credit market conditions amid low interest rates started the rebound in private investment. Investment in construction and public investment picked up, too, being strongly supported by stepped-up utilization of EU funds in many countries as the 2014–2020 programming period unfolds. In the EU Member States, this lifted annual investment growth to an average of 10% year on year in the fourth quarter of 2017.

Capital formation was also vivid in Turkey, where investment growth was strongly supported by the government's Credit Guarantee Fund (CGF) and mainly driven by construction activity (+12% year on year), while machinery and equipment investment also began to recover after having contracted in previous quarters. In Russia, investment growth failed to reach the exceptionally high levels of the other CESEE countries but remained by and large robust as construction was supported by large infrastructure projects.

Chart 1

GDP growth and its main components

Percentage points, GDP growth in % (year on year)



Source: Eurostat, national statistical offices.

Growth contribution of exports diminishes on the back of higher import demand

Against the backdrop of strong external demand, export growth accelerated throughout most of the CESEE economies and reached a regional average of 7.4% year on year in the second half of 2017 (up from 6.9% in the first half). Booming domestic demand, however, led to an even bigger increase in imports (to an average 14.1% in the second half, up from 11.1% in the first half of 2017). This translated into an increasingly negative growth contribution of net exports in many countries. In Romania and Turkey, the external sector depressed GDP growth by as much as 1.5 percentage points in the review period. However, the external sector weighed on growth also in Bulgaria, Hungary and Russia.

Price competitiveness suffers from pronounced growth in labor costs …

Export dynamics might have been even stronger if unit labor costs (ULC) in manufacturing (measured in euro) had not deteriorated further in the review period. Productivity figures were rather strong in most countries, reflecting increasingly tight labor markets that prevented labor input growth from keeping pace with manufacturing output growth. Some labor saving investments might have pushed up productivity too. Productivity advances, however, were not strong enough to offset cost increases: Labor cost growth in manufacturing was in the high single or even double digits in the second half of 2017 in most countries. Furthermore, currency appreciation affected price competitiveness especially in the Czech Republic, Poland and – to a lesser extent – in Russia. As a result, ULC growth in most CESEE countries outpaced ULC growth in the euro area.

Turkey was the only country to report a large decline in unit labor costs, as currency depreciation was strong enough to improve the country's competitive position even in the face of double-digit labor cost rises. Among the CESEE EU Member States, only Slovenia managed to cut its ULC in the review period, keeping labor cost growth below the levels observed for other regional peers, especially in the fourth quarter of 2017. At the same time, Slovenia reported the strongest increase in productivity of all countries of the region.

… but overall competitiveness seems to be largely intact

Despite recent rises in ULC, the international competitiveness of most CESEE countries remained largely sound. According to a survey by the European Commission, CESEE EU Member States reported improvements in their competitive positions both in markets inside and outside the EU throughout 2017, thus increasing their world market shares – as did Russia and Turkey. This suggests that CESEE countries managed to improve nonprice competitiveness and/or their position in global value chains.

Current account positions on average stable despite some pressure on trade balances

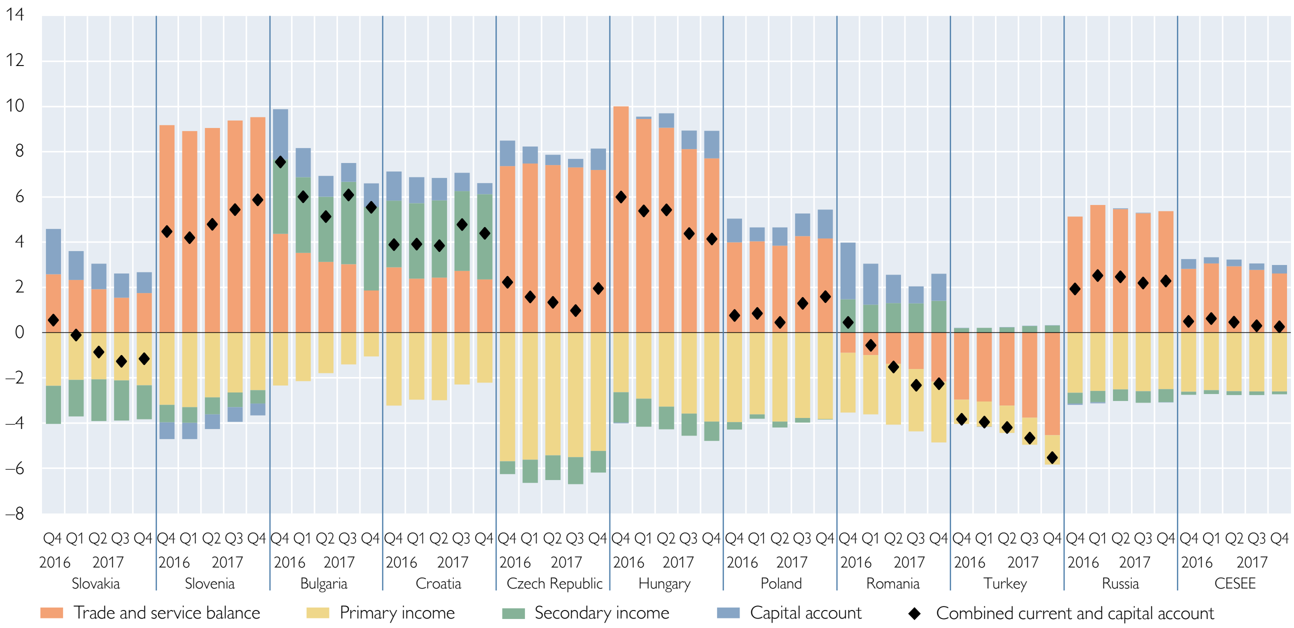
Rising import demand had some impact on external balances. The trade balance weighed on the combined current and capital account especially in Hungary and Turkey, where external balances deteriorated by around 1.5 percentage points of GDP between the second and the fourth quarters of 2017 (four-quarter moving sums; see chart 2). The current account deficit also widened notably in Romania as the trade deficit rose. For the region as a whole, however, the combined current and capital account balance remained rather stable at 0.3% of GDP at end-2017 (after 0.5% of GDP in mid-2017).

In fact, the external accounts improved somewhat in many countries (Bulgaria, the Czech Republic, Croatia, Poland and Slovenia). These developments were mainly driven by higher surpluses in the capital account (related to EU fund inflows) as well as improving primary income balances. In the case of Slovenia, the goods and services balance delivered the most important positive contribution, probably related to strengthening competitiveness.

Chart 2

Combined current and capital account balance

% of GDP, four-quarter moving sum



Source: Eurostat, IMF, national central banks.

Somewhat more moderate capital flows to the CESEE region

The aggregate financial account deficit (i.e. the difference between the net acquisition of assets and the net incurrence of liabilities, excluding reserves) of the ten CESEE countries as a whole decreased somewhat, from –5.7% of GDP in the second quarter to –4.9% of GDP in the fourth quarter of 2017 (four-quarter moving sums; see chart 3). In other words, the amount of capital raised by CESEE countries from international sources dropped by 0.8% of GDP on balance. This development was driven mainly by foreign direct investments. At the same time, the deficit in portfolio investments increased somewhat and other investments declined from a surplus to a balanced position.

On a country level, the Czech Republic stands out with a notable decrease of its deficit in portfolio and other investments. These positions had in part been built up prior to the abolition of the exchange rate floor of the Czech koruna in April 2017, partly for speculative reasons. More notable movements of the financial account were also reported for Poland and Bulgaria, where the financial account balance increased on the back of portfolio and other investments. Croatia and Turkey reported higher deficits as the balance on portfolio investments declined.

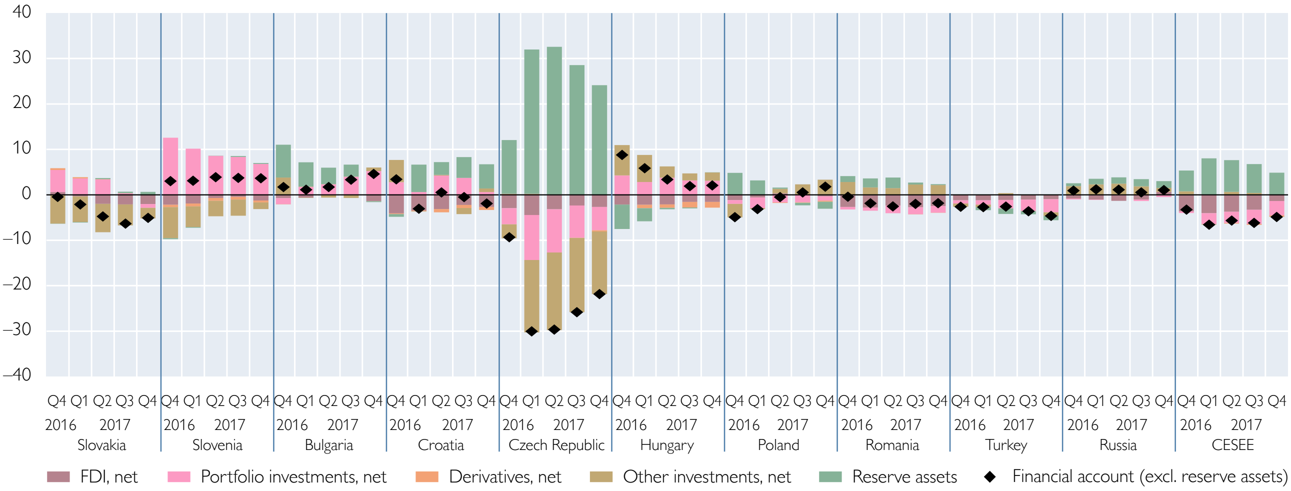
No notable inflationary pressure despite strong domestic economic momentum

The overall strong domestic momentum – encompassing dynamic economic growth, tightening labor markets and rising wages (especially in the CESEE EU Member States) – was not reflected in rising inflationary pressure in the review period. After a trough in mid-2016, inflation accelerated slowly in late 2016 and early 2017, before stabilizing at around 2% throughout most of the CESEE region. In fact, price pressures moderated in several countries in early 2018 (see chart 4). In Russia, the sluggish economic recovery and the oil price-related appreciation of the Russian ruble drove inflation down to 2.2% in February 2018 – which is a historically low level and notably below the inflation target of the Russian central bank. Lower inflation was also reported for Poland and the Czech Republic, where appreciating currencies and some disinflation in services also led to an under-shooting of the respective inflation targets in February 2018.

Chart 3

Financial account balance

% of GDP, four-quarter moving sum

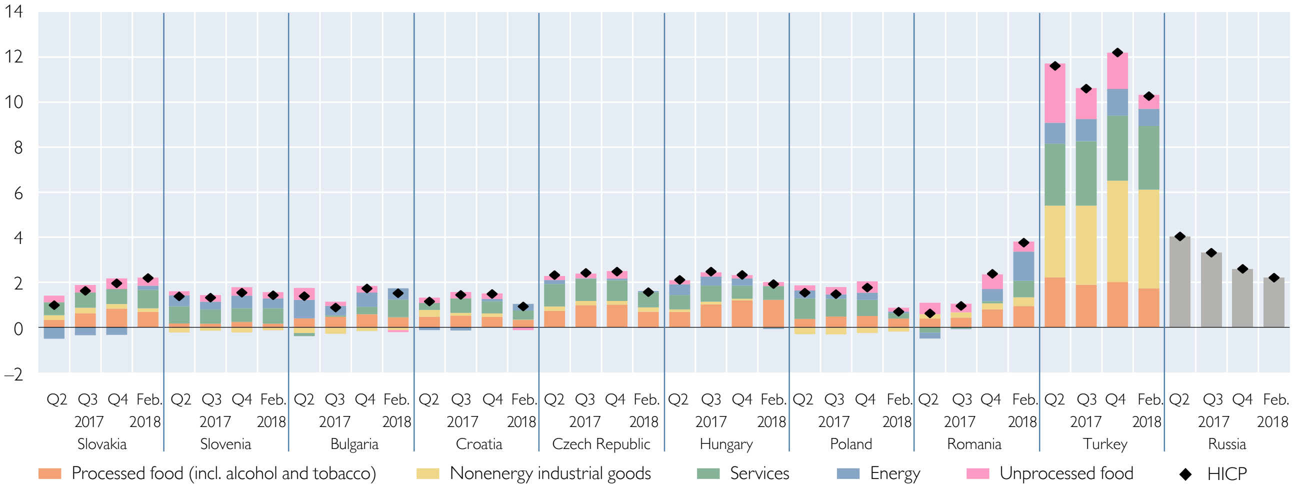


Source: National central banks.

Chart 4

HICP inflation and its main drivers

Percentage points, contribution to year-on-year change in HICP; HICP in %



Source: Eurostat.

Note: CPI data for Russia. No breakdown according to COICOP available.

Inflation continued to rise especially in Romania, on the back of rising contributions by all HICP components plus a base effect after adjustments to indirect taxes in 2017. At 3.8% in February 2018, Romania reported the highest inflation rate among the CESEE EU Member States. In the region, inflation was higher only in Turkey, where strong domestic demand and currency depreciation kept price rises above 10% throughout the review period and thus well above the inflation target.

Some countries have started to tighten monetary policy

The Czech Republic was the first country among the CESEE EU Member States to end the period of monetary accommodation that started in late 2012. After a first hike in August 2017, two further hikes in November 2017 and February 2018 lifted the policy rate of the Czech central bank (CNB) to 0.75% (see chart 5). Despite a fall of inflation in February 2018, the CNB projects inflation to be above target for the rest of 2018 before returning to target in early 2019.

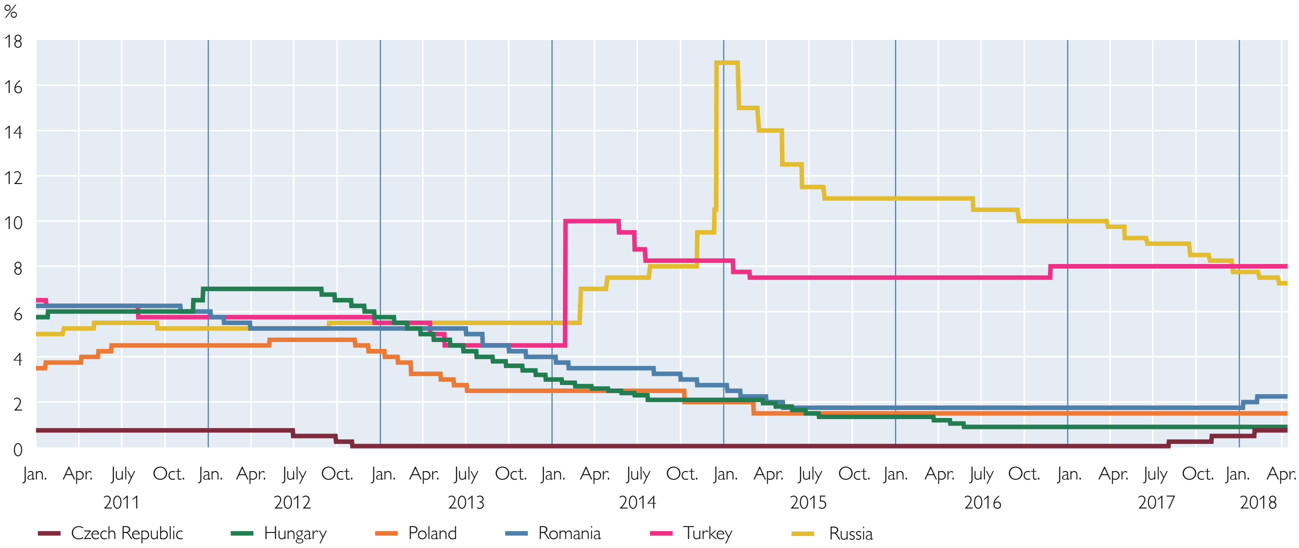
The Romanian central bank (NBR) increased its policy rate in January and February 2018, from 1.75% to 2.25%, following repeated adjustments of its deposit and lending facility rates in late 2017 and early 2018. Those steps were motivated by accelerating inflation that consistently overshot the inflation target. The NBR expects inflation to pick up further in the short run before returning to the upper bound of the variation band around its inflation target toward the end of this year. Upward risks to inflation stem among others from the fiscal policy stance and labor market conditions.

The Turkish central bank (CBRT) has kept its policy rate constant but increased the lending rate on its late liquidity window from 12.25% to 12.75% in December 2017, thereby raising the average cost of funding for the banking system.

The Hungarian central bank (MNB) expects inflation to remain below its target at least until mid-2019. Against this backdrop, the MNB continued to further selectively loosen its monetary policy by reducing the cap on its three-month deposit facility, by extending its foreign currency swap facility in order to boost

Chart 5

Policy rate developments in CESEE



Source: National central banks.

Hungarian forint liquidity in the system and by adding two new tools to its monetary policy tool kit (interest rate swaps to banks and regular purchases of mortgage bonds with at least three-year maturity).

The Russian central bank (CBR) repeatedly cut its policy rate in the review period, bringing interest rates down from 8.5% in October 2017 to 7.25% in April 2018 as inflation reached a historical low.

Stable and broadly solid credit developments

Growth of domestic credit to the private sector (nominal lending to the non-bank private sector adjusted for exchange rate changes) was solid in the review period. Most CESEE countries reported growth rates of around 5% year on year, reflecting favorable general economic conditions in an environment of low interest rates, heightened competition among banks and spillovers of monetary accommodation in the euro area into the CESEE region (see chart 6). Credit growth reflects to some extent a substantial increase in housing loans which went hand in hand with rising real estate prices. House prices rose by some 7% year on year in the second half of 2017 on average, and by even more than 10% in the Czech Republic and Turkey.

Within the region, credit growth was highest in Turkey, where accommodative macroprudential policies and loans backed by Turkey's Credit Guarantee Fund kept credit growth at around 15%. On the other side of the spectrum, Croatia was the only CESEE country not to report an expansion of the credit stock, despite some recovery in credit dynamics. This was mainly related to declining corporate credit as nonperforming assets were sold. While those sales had a positive impact on nonperforming loan (NPL) ratios in Croatia, profitability was hurt by the banking sector's provisioning for its exposure to Agrokor, the country's ailing retailer.

Czech Republic and Slovakia take further regulatory action

In terms of dynamics, credit growth retreated somewhat from previously high levels in Slovakia and the Czech Republic against the backdrop of regulatory action (with growth of credit to Slovak households, in particular, remaining in the double digits, however). Specifically, banks in both countries were required in 2017 to hold countercyclical capital buffers of 0.5% of total risk exposures. Increases of the buffer rates are in the pipeline, to 1% in July 2018 and to 1.25% in January 2019 in the Czech Republic, and to 1% in August 2018 in Slovakia. Furthermore, both countries introduced measures to put a brake on the expansion of housing loans. The Slovak central bank (NBS) decreed that new borrowers have to be assessed for their ability to repay the loan in the event of an increase in interest rates. The Czech central bank (CNB) introduced loan-to-value ratios for housing loans as an additional macroprudential measure.

Credit growth also moderated somewhat in Slovenia. While consumer credit largely sustained its momentum, credit growth to corporations decelerated as increasing corporate profits enabled companies to satisfy their investment needs by means of retained earnings.

Somewhat higher credit growth rates were observed only for Russia, despite troubles in the country's banking sector that led to the bail-out of three medium-sized banks in the second half of 2017. Especially household credit benefited from gradually easing lending conditions and the economic recovery.

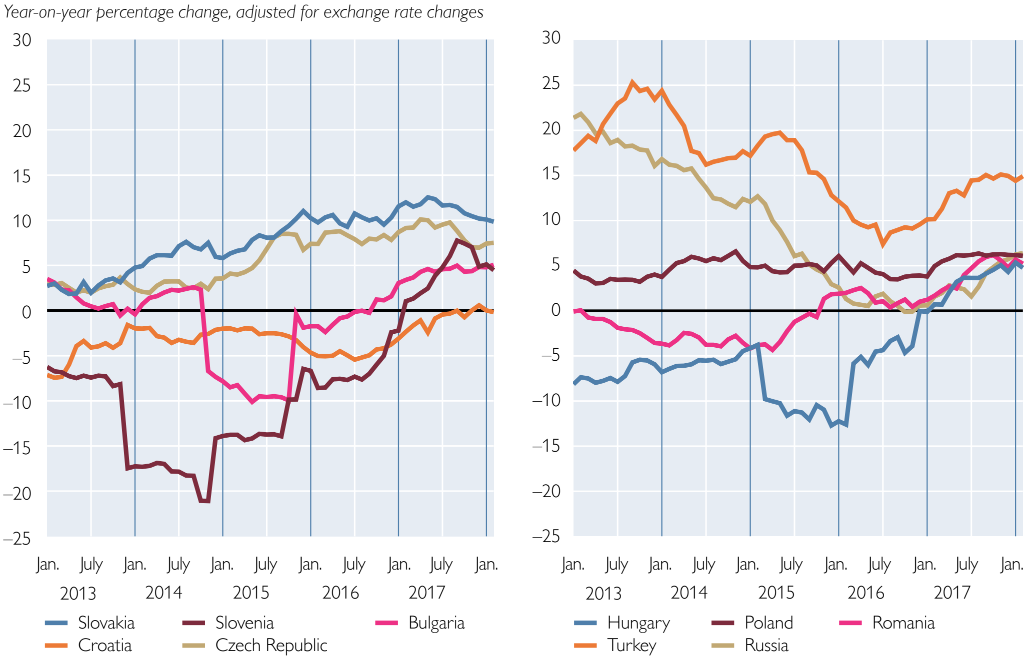
Lending surveys indicate easing supply conditions for the first time in two years

Lending surveys indicate a continued strength in demand for credit in the CESEE region. According to the most recent CESEE Bank Lending Survey of the European Investment Bank (EIB), demand for credit improved across the board in the second half of 2017. This marked the ninth semester of favorable developments. All factors affecting demand made positive contributions. Notably, investment accounted for a good part of the strengthening in demand, whilst debt restructuring was almost irrelevant. Access to funding also continued to improve in CESEE, supported by easy access to domestic sources (mainly retail and corporate deposits).

Chart 6

Growth of credit to the private sector

Year-on-year percentage change, adjusted for exchange rate changes



Source: National central banks.

For the first time in two years, increasing demand was paired with an easing of aggregate supply conditions in the second half of 2017 while the gap between credit demand and credit supply that had been perceived for several quarters continued to persist. On balance, this would imply an improvement of the loan quality associated with most of the new lending compared with previous credit cycles. Across the client spectrum, credit standards eased especially on SME lending and consumer credit, while they tightened on mortgages. Changes in local regulation and groups' NPLs were perceived as key factors adversely affecting supply conditions.

Country-level bank lending surveys conducted by national central banks mostly corroborate these findings: While more or less all countries reported rising demand for loans across sectors, trends in lending conditions were found to be more heterogeneous than in the EIB report. In particular, several countries (e.g. Poland and Romania) reported some tightening of credit conditions.

Budgetary consolidation moderate in light of historically strong economic dynamics

Solid fundamentals reflecting rapid employment growth, increased private consumption and high corporate profits had a positive impact on budget figures (see chart 7). Improvements in budget balances were especially strong in Croatia and Slovenia, where deficits in 2016 turned into a surplus and a balanced position in 2017, respectively. Bulgaria and the Czech Republic reported increasing budget surpluses in 2017, while Russia and Slovakia managed to cut their deficits considerably.

Improvements in headline budget balances, however, were not matched by equal improvements in cyclically adjusted budget figures. In fact, several of the EU Member States in CESEE reported some deterioration in cyclically adjusted budget deficits, indicating an expansionary fiscal stance. The deterioration was most pronounced in Hungary and Romania. Romania has already been urged, under a significant deviation procedure launched by the Council of the European Union in June 2017, to take action to correct the deviation from the adjustment path toward its medium-term budgetary objective to avoid the opening of an excessive deficit procedure (EDP).

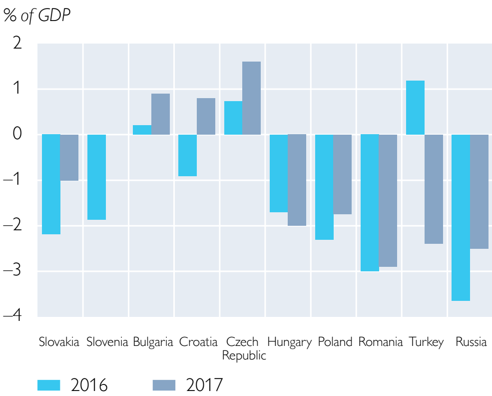
The largest increase in the budget deficit was reported for Turkey, where a surplus in 2016 turned into a deficit of 2.4% of GDP in 2017. In order to restore confidence in the economy, the Turkish government supported economic activity by fiscal loosening, inter alia by a large increase in government guarantees for corporate lending.

High-frequency and sentiment indicators point toward continued vivid growth

Leading indicators support the picture of a broad-based and strong economic upturn that will continue at least in the near future (see chart 8). With regard to activity indicators, industrial production growth declined somewhat from its high in summer 2017, dropping to an average of 4.5% in January 2018. This development, however, was mainly caused by weak readings for Russia. Industrial production in the CESEE EU Member States remained broadly stable at around 7%, while it accelerated notably in

Chart 7

Development of general government balances



Source: Eurostat, Europan Commission, wiiw.

Chart 8

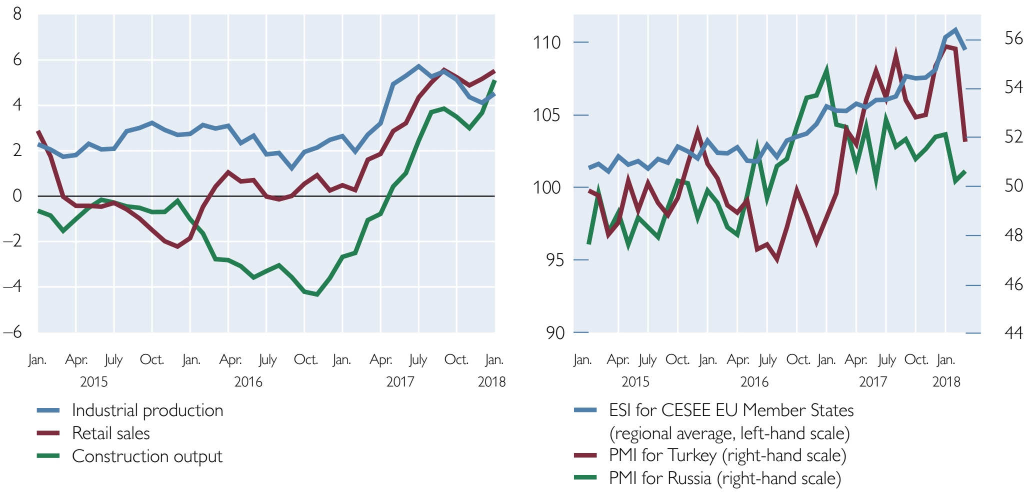
Leading indicators

Activity indicators (CESEE regional average)

Year-on-year change in %, three-months moving average

Sentiment indicators

Points *Points*



Source: Eurostat, wiiw, European Commission, Markit.

Turkey (to 12% in January 2018). The growth rates of retail sales increased strongly in the third quarter of 2017 and hovered around 5.5% during the past months. Construction output growth saw the sharpest rise, to an average of 6.9% in January 2018.

Economic sentiment brightened especially in the CESEE EU Member States. The Economic Sentiment Indicator (ESI; average for the CESEE EU Member States) increased strongly in the second half of 2017 and reached a peak at 111 points in February 2018. It moderated somewhat in March 2018 while remaining well above its long-term average. The overall increases were led by sentiment in construction, which recorded the highest reading since early 2008. Industrial confidence and consumer confidence trended higher, too. The Purchasing Managers' Index (PMI) for Russia hovered around 51 points throughout the review period, slightly above the threshold of 50 points that indicates an expansion. Turkey's PMI increased to above 55 points in February 2018 before falling back to 52 points in March 2018.

Strong readings for leading indicators are reflected in the latest forecasts for the region. Projections for 2018 have been repeatedly revised upward and currently stand at an average of about 4% for the CESEE EU Member States and Turkey. The growth forecasts for Russia also tshow some upward trend but continue to fall short of other CESEE countries. For a detailed outlook for the CESEE region, see "Outlook for selected CESEE countries" in this issue.

Box 1

Ukraine: while recovery remains moderate, demand pressures push up inflation

In 2017, GDP grew at a pace of 2.5% (2016: +2.4%), driven by a brisk recovery of private consumption and fixed investment from low points of departure. The expansion of private consumption (+7.8%) was fueled by generous wage and pension increases, while capital formation continued to catch up after years of underinvestment. Public consumption also increased somewhat. Real exports' modest growth was more than offset by the expansion of real imports on the back of swelling domestic demand.

These broad demand pressures as well as rising production costs and global oil prices, a weak harvest (triggered inter alia by adverse weather conditions) and utility tariff hikes pushed up annual CPI inflation to 16.4% in September 2017. This prompted the National Bank of Ukraine (NBU) to interrupt and partly reverse its series of key policy rate cuts over the last one-and-a-half years. The NBU sharply increased the key rate in four steps (October and December 2017, January and March 2018) by a cumulative 450 basis points to 17%. Inflation still stood at 14.0% at end-February 2018 (despite a marked slowdown of the Ukrainian hryvnia's nominal depreciation in 2017), which is substantially above the target range of 8% ±2 percentage points. The monetary authority expects inflation to slow down and return to target in mid-2019 (then 6% ±2 percentage points). Unemployment (ILO definition) has lingered at a high level (9.5% on average in 2017), suggesting mismatches in the labor market.

Largely as a result of growing exports combined with even more swiftly expanding imports (inter alia reflecting increased energy purchases from abroad given the trade blockade of Donbass by Ukraine), Ukraine's current account deficit rose to 1.9% of GDP (2016: –1.4% of GDP). In addition to official financing, expanding inflows in the financial account largely consisted of proceeds from sales of USD 3 billion of eurobonds in September 2017, and moderate FDI inflows. Fiscal consolidation has made progress, and the general government budget deficit (including Naftogaz financing) is estimated to have declined to –1.5% of GDP in 2017 (from –2.3% of GDP in 2016). Over 2017, international reserves (excluding gold) increased by 6% to EUR 14.9 billion (about 3½ months of imports of goods and services). Although slowly declining, Ukraine's gross external debt is still very high (EUR 97 billion or above 100% of GDP at end-2017), and while financial needs in the short term appear manageable, rising public external debt maturities up to 2019 may be challenging.

Progress on reform steps (pension and land reform, anti-corruption court legislation, measures to step up privatizations) needed to complete the fourth review of the IMF Extended Fund Facility (EFF) program has been mixed. The pension reform and privatization bills were adopted in October 2017 and January 2018, respectively, while the anti-corruption court bill recently introduced to parliament does not appear sufficiently in line with IMF recommendations. Contrary to previous plans, domestic gas tariffs were not raised further in the fall of 2017. Since the fourth EFF tranche allocated in April 2017, no new IMF funds have been released, and the latest EU Macro-Financial Assistance program running until the end of 2017 expired without disbursal of the final tranche. Against the backdrop of the approaching presidential and parliamentary elections (in 2019), of rising domestic political tensions and of populist pressures, the risk of a stalling reform process has grown, which in turn may increase financial risks.

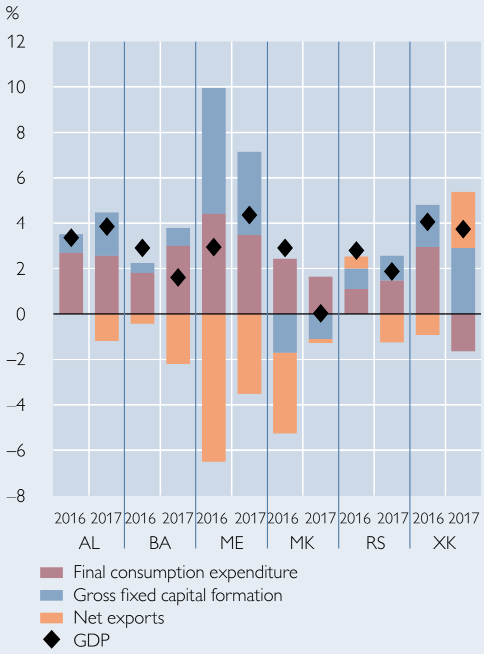
Box 2

Western Balkans[1]: economic growth on the decline despite a favorable external environment

While most of the economies in the Western Balkans reported accelerated growth in the second half of 2017, the regional average declined to 2.6% in 2017 in GDP-weighted terms, against 3.4% a year ago. Notably, strong domestic demand boosted GDP growth in Montenegro (4.4%) and Albania (3.8%). At the same time, economic growth decelerated sizeably in the largest economies in the region – Serbia, and Bosnia and Herzegovina – to 1.9% and 1.6%, respectively. In the former Yugoslav Republic of Macedonia (FYR Macedonia), economic growth fell to the lowest level in the past five years and stagnated on an annual basis. In Kosovo growth also softened somewhat, albeit from a high base, to reach 3.7%.

Chart 1

Robust contribution of domestic demand in 2017



Source: Eurostat, wiiw, World Bank.

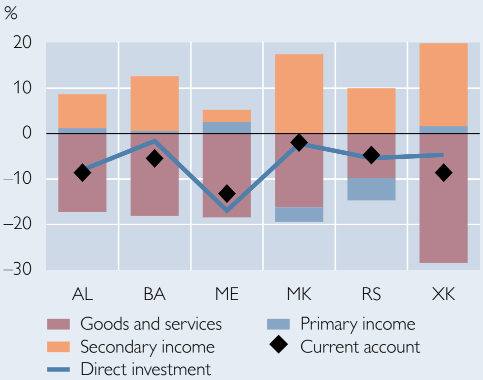
As in 2016, domestic demand was the main driver of GDP growth in all economies in the Western Balkans also in 2017 (see chart 1). While private consumption remained a robust driver of growth underpinned by declining unemployment and modest wage growth, its contribution declined slightly in most of the countries with the notable exceptions of Serbia, and Bosnia and Herzegovina. On a negative note, private consumption growth slipped into negative territory in Kosovo partly on the back of increased unemployment and stagnating wages. In addition, remittances stagnated especially in Albania as well as Bosnia and Herzegovina, thus representing a less supportive factor for GDP growth in 2017 than in the previous year. Finally, investment took a strong hit, mirroring prolonged political instability, in FYR Macedonia. Apart from that, growth of gross capital formation in 2017 improved on an annual basis, following enhanced implementation of infrastructure and energy projects.

Net exports became more of a drag for GDP growth in 2017 in spite of more favorable external demand. In particular, strong energy imports coupled with rising oil prices and increased domestic demand subtracted from growth in Serbia and in Bosnia and Herzegovina. In addition, harsh winter weather conditions necessitated more imports to Serbia, thus lifting the trade deficit by nearly 1 percentage point to 10.8% of GDP (see chart 2). In contrast, in Kosovo, Albania and FYR Macedonia, exports benefited from rising commodity and basic metals prices, which overall contributed to a narrowing of external imbalances. Even though Montenegro experienced an exceptional tourism season, strong construction-related imports dwarfed exports and thus widened the current plus capital account deficit to the highest levels since 2010 (i.e. 18.9% of GDP). The widening of external imbalances in 2017 went hand in hand with an increase of FDIs except in Albania and FYR Macedonia. Overall, the FDI

[1] The Western Balkans comprise the EU candidate countries Albania, FYR Macedonia, Montenegro and Serbia as well as the potential candidate countries Bosnia and Herzegovina, and Kosovo. The designation "Kosovo" is used without prejudice to positions on status and in line with UNSC 1244 and the opinion on the Kosovo Declaration of Independence.

Chart 2

External imbalances widened



Source: IMF, national central banks, World Bank.

Note: Positive (negative) values for direct investment positions indicate that the net acquisition of assets is higher (lower) than the net incurrence of liabilities.

coverage of the current account deficit stood at close to 80%, with Albania, Serbia and FYR Macedonia reporting full coverage.

Although labor market conditions remained strained in 2017, there was some improvement in most of the Western Balkan countries as the ongoing economic recovery and the recent reforms in some countries fed through to increasing employment rates. According to the Labour Force Survey, in 2017 annual employment increases were highest in Serbia (+2 percentage points) and Montenegro (+1.2 percentage points), with the services sector accounting for 80% of the increases as reported by the World Bank.[2] On a negative note, employment rates in 2017 are still well below comparable EU-28 levels (i.e. 71.1% in 2016) and hovered between 30% (Kosovo) and 57% (Serbia). In parallel, unemployment declined in all countries in the region except in Kosovo, where the unemployment rate was up by 3 percentage points as the increase of the labor force outpaced the employment rate (see statistical annex). In contrast, Bosnia and Herzegovina registered the largest drop in unemployment in the region (by 4.7 percentage points, to 21.1% by the end of 2017). However, this was partly due to declining labor force participation by young cohorts as a result of strong emigration.

Mirroring higher commodity prices and stronger domestic demand, consumer price inflation in the Western Balkans increased notably in 2017. In particular, prices in FYR Macedonia and in Bosnia and Herzegovina reversed their negative trend since 2013, reaching 1.3% and 1.2%, respectively. While remaining within the central bank target band, inflation edged up in 2017, with Serbia topping the list (+3.1%, on the back of higher prices of regulated food). In Montenegro, higher excise taxes along with adverse weather-related prices led to a rather solid price increase (+2.8%). With the acceleration of economic activity feeding through in the first months of 2018, all countries in the area but Serbia (where prices edged down) have since posted a further rise of inflation. The increase was most pronounced in Montenegro (+3.7% in February).

In contrast to 2016, only one of the inflation-targeting countries, namely Albania, still undershot the lower bound of the inflation target in the second half of 2017. However, following price increases in the first two months of 2018, Albanian inflation reached 2.1% in February, thus slightly exceeding the lower bound of the central bank's inflation target (3% ±1 percentage point). This compares with a policy rate of 1.25% adopted in May 2016, which the Bank of Albania intends to maintain at least until mid-2018. In Serbia, inflation decelerated somewhat in the second half of 2017 and beyond, reaching 1.5% in February 2018, which is exactly the lower inflation bound. In parallel, the National Bank of Serbia (NBS) lowered its key policy rate in four steps from 4% in July 2017, already a historical low, to 3% in April 2018. 3% is also the level to which the central bank of FYR Macedonia lowered its benchmark rate in March 2018, for the first time since February 2017, citing sluggish corporate lending activity and a negative output gap. Both the Albanian lek and the Serbian dinar have been appreciating against the euro. The NBS intervened frequently on the foreign exchange market to reduce exchange rate volatility vis-à-vis the euro (both in nominal and real terms), thus limiting the appreciation of the Serbian dinar to close to 4.5% between October 2017 and March 2018.

[2] *http://www.worldbank.org/en/region/eca/publication/western-balkans-regular-economic-report*

On the back of resolution mechanisms put in place in some Western Balkan countries, bank asset quality has been improving, thus generally supporting credit growth (see statistical annex). However, in individual countries in the region, NPL ratios remained as high as 14.8% (Albania) and 12% (Serbia) in September 2017. In Serbia, increased NPL sales to asset management companies helped reduce the NPL ratio. Albania benefited from the introduction of new insolvency legislation. In Montenegro, asset quality improved also due to the effective implementation of voluntary financial restructuring legislation, thus bringing the NPL share down to 7.3% as of end-2017. While having yet to implement an NPL resolution mechanism, Kosovo has recently made progress as well with introducing a new system to enforce collateral recovery, which contributed to the decline of the NPL share to 3.1% as of end-2017.

The ongoing process of cleaning up banks' balance sheets, more favorable lending conditions and elevated domestic demand fed through to credit dynamics in most countries such that the second half of 2017 was marked by stronger credit growth, with lending to households generally growing more strongly than loans to corporates. Specifically, bank lending to the private sector expanded robustly in Kosovo in the second half of 2017 (+11.5% year on year) and Bosnia and Herzegovina (+7.5% year on year), while in FYR Macedonia credit growth rebounded strongly exclusively on the back of the household sector. Albania was the only country to buck the regional trend, with a sluggish year-end credit growth of 3.6%, mostly due to loan write-offs. On a positive note, currency risks in private sector portfolios declined somewhat on the back of the ongoing implementation of de-euroization measures. In addition, the Albanian authorities launched a comprehensive de-euroization strategy in January 2018.

Regarding the fiscal stance, imbalances widened in most of the Western Balkan economies in 2017 despite robust revenue growth. Overall improved tax collection and higher revenues from indirect taxes could not prevent fiscal deficits from rising in all countries but Serbia, and Bosnia and Herzegovina. The latter two countries still posted surpluses of 0.8% and 1% of GDP, respectively. Montenegro accounted for the highest fiscal deficit in 2017, which increased to 5.9% of GDP on an annual basis, somewhat above the target of 5% of GDP. Looking at public expenditures, increased fiscal revenues have been directed somewhat more to the public sector wage bill and (to some extent ill-targeted) social benefits and transfers. This was particularly relevant for Kosovo, where also increased spending for pensions and benefits for war veterans lifted the fiscal deficit to 1.7% of GDP, however still keeping it below the 2% target of the fiscal rule. As regards capital expenditures, most of the countries posted an increase, especially so in Montenegro and Albania. At the same time, on the back of continued consolidation efforts, Serbia lowered capital spending, while Bosnia and Herzegovina increased spending only slightly. On a positive note, despite decelerating GDP growth and increasing fiscal deficits, the stock of public debt (including publicly guaranteed debt) was on the decline in most of the Western Balkan economies in 2017 as compared to the previous year. Accordingly, public debt in Serbia posted the strongest decrease of close to 10 percentage points of GDP, to 64.9% of GDP. Public debt increased only in Kosovo (to 16.3% of GDP, i.e. remained at a low level) and in Montenegro (to 66.6% of GDP).

As of the first quarter of 2018, only Bosnia and Herzegovina has a program with the IMF in place. In particular, with a considerable delay, Bosnia and Herzegovina completed the first review under the Extended Fund Facility (initially approved in September 2016), leading to the release of a tranche of EUR 74.6 million. Most recently, in February 2018 Serbia concluded a three-year precautionary Stand-By Agreement with the IMF in the amount of EUR 1.12 billion, without effectively withdrawing any funds so far.

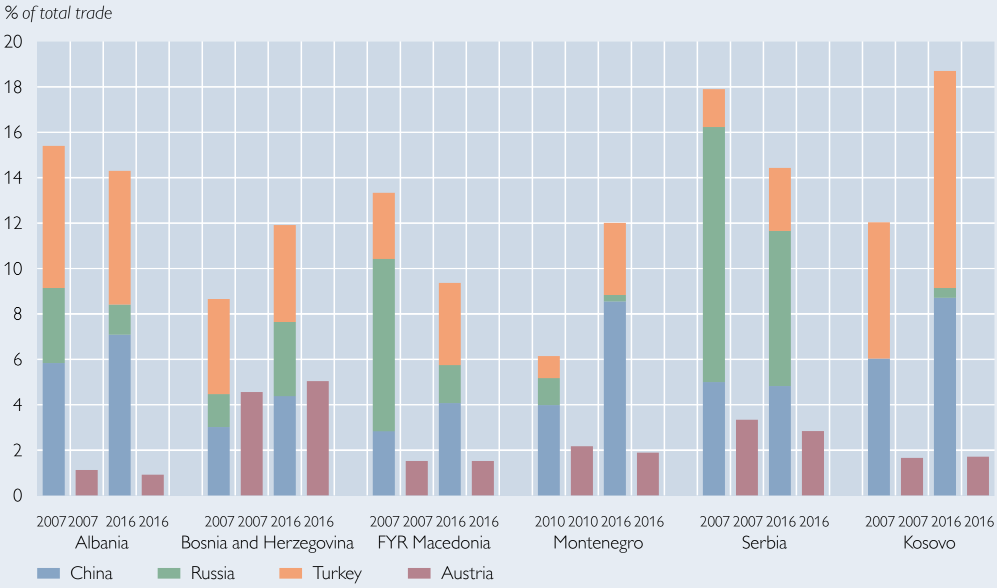
Spotlight: a brief take on the economic exposure of the Western Balkans to China, Russia and Turkey

The Western Balkans have become the center of attention recently, when it comes to connecting China to the EU through the One-Belt One-Road (OBOR) initiative along the Silk Road. Historically however, also Russia and Turkey kept one foot in the camp, notwithstanding the ongoing EU accession process.[3] Economic ties between the Western Balkan economies and China, Turkey and Russia have been established gradually based on trade agreements. While trading among themselves is established under the framework of the Central European Free Trade Agreement (CEFTA), all countries in the region have bilateral trade agreements with Turkey. Agreements for trade with Russia are in place only with Bosnia and Herzegovina, Albania and Serbia and under negotiation with Montenegro.

Although the European Union remains the major trading partner of all Western Balkan economies, the trade openness of the Western Balkan economies vis-à-vis Turkey has increased in all countries in the past ten years (see chart 3). In particular, in 2016 the share of trade with Turkey in total trade of the respective country ranked highest in Kosovo (10%) and was lowest in Montenegro (3.1%). While imports of Turkish goods prevail, especially Serbian goods exports to Turkey increased sizeably recently, reaching one-third of total trade with Turkey. Trade with Russia is comparably less important for most of the (potential) EU candidate countries, especially for Kosovo, Albania and Montenegro. On the contrary, although the share of Russia in the total trade of these countries has been on a declining trend, Russia has been among the top three trading partners for Serbia in the past years.[4]

Chart 3

Trade openness



Source: wiiw.

[3] *In February 2018, the European Commission adopted the strategy for 'A credible enlargement perspective for and enhanced EU engagement with the Western Balkans,' to commit to a "geostrategic investment in a stable, strong and united Europe based on common values." The European Commission plans to gradually increase funding under the Instrument for Pre-Accession Assistance (IPA) until 2020. In 2018 alone, IPA for the Western Balkans is to reach EUR 1.07 billion, while EUR 9 billion have been disbursed in the 2007–2017 period.*

[4] *While Albania and Montenegro joined EU sanctions against Russia imposed as from March 2014 onward, Serbia and FYR Macedonia have decisively opposed such a move so far.*

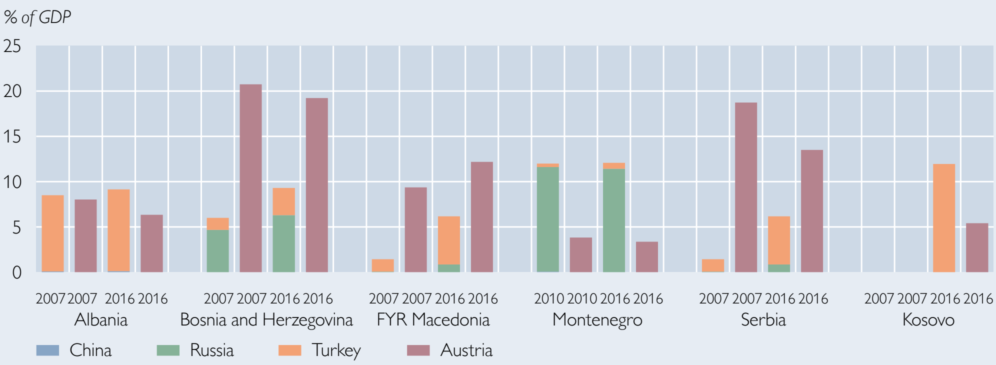
In the Western Balkan region, China has set up bilateral agreements with Albania, Montenegro (taxation treaty) and Serbia. In fact, China and Serbia signed a strategic partnership agreement in 2009, which laid the formal basis for a large number of infrastructure, energy, car manufacture and other projects. Accordingly, trade of goods with China has been highest in these three countries and is on an increasing trend in all Western Balkan countries. In Albania and Montenegro, it stood at 7% and 9% of total trade in 2016, respectively.

Despite the funding available from EU sources and international financial institutions (e.g. Western Balkans Investment Framework), the financing needs of the Western Balkan countries remain substantial. Non-EU firms' investments therefore benefit (potential) EU candidate countries, which cannot access large EU structural funds but are in need of financing to make progress toward EU accession. Turkish investment stocks in Albania and Kosovo rank among the highest, surpassing Austrian FDI stocks by a significant margin. Turkish FDI has more than quadrupled since 2007 in Serbia and FYR Macedonia and has targeted predominantly the construction, infrastructure and manufacturing sectors. In addition, Turkish-owned banks are among the largest banks in Albania, Kosovo and FYR Macedonia, taking up close to one-third of total banking assets in Albania.

Russian FDI stocks[5] are rather low in the majority of the Western Balkan countries except in Bosnia and Herzegovina and in Montenegro (see chart 4). Russian investments are mainly focused on key sectors such as energy, banking and real estate. In particular, Russia has been the largest investor in Montenegro with investments primarily in the real estate and tourism sectors. Total Russian investment in the country stood at slightly above 12% of GDP in 2016. In addition, the exposure to Serbia and FYR Macedonia has steadily increased since 2007.[6]

Chart 4

FDI stocks



Source: wiiw.

[5] For the sake of completeness, a discussion of the Russian exposure to the Western Balkans should include information also on loans granted to state entities. Although these have been sizeable in some of the countries in recent years, this would go beyond the scope of this box.

[6] Anecdotal evidence points toward a strong underestimation of Russian FDI stocks in FYR Macedonia and Serbia due to the channeling of Russian investments via EU countries with a preferential tax system (e.g. Cyprus, the Netherlands).

The financial and economic links between China and the Western Balkan countries intensified significantly between 2015 and 2017. Geographically, the Western Balkans (and Greece) constitute the final part of China's new Maritime Silk Road. With a view to extending the New Silk Road into the Balkans, China primarily invests in regional infrastructure, such as ports, railroads and highways, inter alia through the so-called "16+1 format," which incorporates Albania, Bosnia and Herzegovina, FYR Macedonia, Montenegro and Serbia. This strategy relies on the assumption that the countries in the region will catch up significantly, integrate into the EU and thus build a bridge for Chinese companies to the main EU markets. Politically, Chinese investors[7] show more readiness than other investors to get involved in countries with higher political instability, and to assume the role of a neutral force and a reliable business partner.[8]

[7] The Western Balkan countries may be even more attractive to Chinese investors than EU Member States, partly because they enable them to bypass EU trade laws, antidumping regulations or even environmental rules that apply to EU Member States. In particular, there have been reported cases of construction builders working under conditions that do not comply with national labor laws (e.g. Pupin bridge in Belgrade). Even in the EU Member States, there have already been cases where the European Commission has expressed its concern about laws having been breached or agreements having been closed without prior consultation of the European Commission.

[8] Barisitz, S. and Radzyner, A. (2017). The New Silk Road, part II: implications for Europe. Focus on European Economic Integration Q4/17, OeNB, December 2017, https://www.oenb.at/Publikationen/Volkswirtschaft/Focus-on-European-Economic-Integration.html.

2 Slovakia: solid economic expansion amid labor market tightening and excessive household credit growth

Domestic demand remains the main driver of GDP growth

Slovakia's real GDP growth continued at a rather solid pace during the second half of 2017, mainly on the back of robust household spending and a significant rebound in investment. Economic expansion thus accelerated a tad, to 3.4% in the year as a whole. Despite a slight upward trend in inflation and owing to favorable developments in the labor market, household consumption expanded at the highest rates since end-2008. After a significant contraction in 2016 and the first six months of 2017 mainly as a result of sluggish absorption of EU funds, gross fixed capital formation bounced back in the six months to December (more than 8% year on year). This relatively robust recovery, spurred by large investments in the automotive sector and public investments in infrastructure, was strong enough to lift up investment growth into positive territory in 2017 as a whole. The external sector continued to make a mildly positive contribution to growth in the second half of 2017, although marginally smaller than in the first six months. This is because a slightly accelerated growth in exports – driven mainly by services – was outpaced by growth in imports on the back of stronger domestic demand. However, it is worth mentioning that in the fourth quarter of 2017 export growth sped up while import growth decelerated. This was because demand pressures for highly specialized imports mainly in the automotive sector eased. As a consequence, net exports were the main contributor to growth in the final quarter of 2017.

For the first time in two years, the trade balance turned negative in the third quarter of 2017 due to strong imports, higher oil prices and summer shutdowns of factories. This seems to have been a temporary dip and, overall, the goods and services balance declined but remained in positive territory in the second half of 2017. Nonetheless, as a result, the current account deficit more than doubled compared to the first six months of the year. The general government deficit fell by somewhat more than 1 percentage point of GDP compared to 2016 (to 1% of GDP). This reduction was brought about mainly by the buoyant economic growth and, inter alia, lower interest payments and social expenditures. As a result, general government debt continued its downward trend, to about 51% of GDP.

Further measures planned to contain excessive growth of credit to households

Solid economic growth and the ensuing demand for skilled labor continue to translate into the highest employment levels on record, the lowest unemployment rates since the early 1990s and significant wage growth. The latter keeps outstripping productivity growth so that unit labor costs rise at a pace unseen for many years. To alleviate the aggravating shortages of skilled labor, rules for employing foreign workers were simplified for certain professions and regions with low unemployment.

Having turned positive in early 2017, inflation accelerated to 1.8% in the second half of the year (and to 2.2% in February 2018) owing mainly to food prices and, to a lesser extent, prices of services on the back of continued growth in wages.

Several macroprudential measures notwithstanding, loans to households – particularly driven by mortgages – keep growing at double-digit rates, the fastest in the euro area. As a result, the household debt-to-GDP ratio has reached the highest level in CESEE. To mitigate the excessive and risky household indebtedness, Slovakia's central bank considers further measures to contain the growth of credit to households.

Table 2

Main economic indicators: Slovakia

	2015	2016	2017	Q3 16	Q4 16	Q1 17	Q2 17	Q3 17	Q4 17
	Year-on-year change of the period total in %								
GDP at constant prices	3.9	3.3	3.4	2.7	3.2	3.0	3.7	3.4	3.5
Private consumption	2.2	2.7	3.6	2.0	2.9	3.3	3.5	3.9	3.6
Public consumption	5.4	1.6	0.2	1.9	–1.1	–1.1	–0.3	–1.4	3.1
Gross fixed capital formation	19.8	–8.3	3.2	–13.4	–14.6	0.8	–5.4	10.4	6.1
Exports of goods and services	6.4	6.2	4.3	5.9	7.8	8.2	–0.3	3.8	5.7
Imports of goods and services	8.4	3.7	3.9	1.6	5.3	7.7	–0.8	5.9	3.3
	Contribution to GDP growth in percentage points								
Domestic demand	5.4	0.9	2.6	–1.1	0.7	2.2	3.3	3.6	1.1
Net exports of goods and services	–1.5	2.4	0.5	3.7	2.4	0.8	0.4	–1.7	2.5
Exports of goods and services	5.9	5.8	4.0	5.1	7.4	7.9	–0.3	3.3	5.6
Imports of goods and services	–7.4	–3.4	–3.5	–1.3	–5.0	–7.1	0.8	–4.9	–3.1
	Year-on-year change of the period average in %								
Unit labor costs in the whole economy (nominal, per person)	1.6	1.4	2.8	1.6	2.3	2.2	2.4	4.0	2.7
Unit labor costs in manufacturing (nominal, per hour)	–0.3	3.7	6.3	5.6	5.5	3.3	9.7	6.9	5.3
Labor productivity in manufacturing (real, per hour)	4.4	0.5	0.4	–0.1	–0.6	2.3	–1.3	–0.1	0.9
Labor costs in manufacturing (nominal, per hour)	4.1	4.2	6.7	5.5	4.9	5.6	8.3	6.8	6.2
Producer price index (PPI) in industry	–3.0	–4.0	2.4	–4.3	–2.3	2.7	3.0	2.2	1.9
Consumer price index (here: HICP)	–0.3	–0.5	1.4	–0.7	–0.1	1.0	1.0	1.6	2.0
	Period average levels								
Unemployment rate (ILO definition, %, 15–64 years)	11.5	9.7	8.2	9.6	9.2	8.8	8.2	8.0	7.8
Employment rate (%, 15–64 years)	62.7	64.9	66.2	65.1	65.3	65.8	66.1	66.4	66.4
Key interest rate per annum (%)	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
	Nominal year-on-year change in the period-end stock in %								
Loans to the domestic nonbank private sector[1]	11.0	10.3	10.2	10.0	10.3	11.5	12.3	11.5	10.2
of which: loans to households	12.4	13.4	11.8	13.2	13.4	13.9	13.4	12.3	11.8
loans to nonbank corporations	8.9	5.4	7.6	4.9	5.4	7.7	10.6	10.0	7.6
	%								
Share of foreign currency loans in total loans to the nonbank private sector	0.5	0.4	0.2	0.3	0.4	0.4	0.4	0.4	0.2
Return on assets (banking sector)	0.9	1.1	0.8	1.1	1.1	0.9	1.0	0.9	0.8
Tier 1 capital ratio (banking sector)	16.5	16.2	16.6	16.5	16.2	16.6	16.6	16.5	16.6
NPL ratio (banking sector)	4.8	4.3	3.6	4.6	4.3	4.2	4.0	4.0	3.6
	% of GDP								
General government revenues	42.5	39.3	39.4	..	..	..	..	..	..
General government expenditures	45.2	41.5	40.4	..	..	..	..	..	..
General government balance	–2.7	–2.2	–1.0	..	..	..	..	..	..
Primary balance	–1.0	–0.6	..	..	..	..	..	..	..
Gross public debt	52.3	51.8	50.9	..	..	..	..	..	..
	% of GDP								
Debt of nonfinancial corporations (nonconsolidated)	51.7	55.0	..	..	..	..	..	..	..
Debt of households and NPISHs (nonconsolidated)	35.0	38.2	..	..	..	..	..	..	..
	% of GDP (based on EUR), period total								
Trade balance	1.3	2.0	0.8	1.2	0.3	1.7	1.5	–0.9	0.8
Services balance	0.2	0.6	1.0	0.8	0.3	0.9	1.1	1.4	0.5
Primary income	–1.7	–2.3	–2.3	–2.4	–2.0	–1.4	–2.5	–2.5	–2.8
Secondary income	–1.6	–1.7	–1.5	–1.6	–1.8	–1.6	–2.3	–1.3	–0.8
Current account balance	–1.7	–1.5	–2.1	–2.0	–3.3	–0.4	–2.2	–3.3	–2.2
Capital account balance	3.5	2.0	0.9	0.6	2.1	0.0	1.8	0.4	1.5
Foreign direct investment (net)[2]	–0.1	0.6	–2.0	–2.7	–0.3	–4.5	–0.7	–3.1	0.0
	% of GDP (rolling four-quarter GDP, based on EUR), end of period								
Gross external debt	85.4	90.9	110.8	89.8	90.9	95.1	95.2	97.3	110.8
Gross official reserves (excluding gold)	2.1	2.0	2.3	2.0	2.0	1.8	1.9	2.1	2.3
	Months of imports of goods and services								
Gross official reserves (excluding gold)	0.3	0.3	0.3	0.3	0.3	0.2	0.3	0.3	0.3
	EUR million, period total								
GDP at current prices	78,896	81,154	84,985	21,245	21,006	19,340	21,196	22,315	22,135

Source: Bloomberg, European Commission, Eurostat, national statistical offices, national central banks, wiiw, OeNB.

[1] *Foreign currency component at constant exchange rates.*
[2] *+ = net accumulation of assets larger than net accumulation of liabilities (net outflow of capital).*
– = net accumulation of assets smaller than net accumulation of liabilities (net inflow of capital).

3 Slovenia: economy steams ahead in second half of 2017

GDP growth at post-crisis high in final quarter of 2017

GDP growth during the final quarter of 2017 rose to its highest level since early 2008, lifting the full-year growth rate to 5%. Private consumption continued to grow at around 3% year on year during the second half of 2017, benefiting from the strong expansion of employment, continued real wage growth, relatively rapid credit growth to households and the further improvement of consumer confidence. Public consumption rose particularly in the fourth quarter of 2017 mainly due to the payment of matured financial liabilities of hospitals. Investment activity picked up sharply in the final quarter, reflecting surging construction and likely also the inflow of EU funds. At the same time, growth of investments in machinery and equipment continued to moderate, albeit from a high level, despite capacity utilization rates, improving corporate profitability and economic sentiment remaining at historically high levels. Export growth accelerated strongly in the second half of 2017, thanks to demand from other EU countries and sustained cost competitiveness. Since import growth grew less strongly, net real exports contributed substantially to the overall GDP growth rate.

Strong upswing of the economy benefits fiscal balance

Slovenia's budget deficit decreased substantially in 2017 and the country reported a balanced budget for the first time since 2007. Budget revenue was boosted by rapid employment growth, increased private consumption and high corporate profits. Encouraged by strong economic growth, public sector trade unions have been pressing for double-digit wage hikes, which the outgoing government has so far withstood, but with early elections scheduled for late May/early June there is the possibility of pre-election promises. Uncertainty is accumulating around the country's biggest bank, Nova Ljubljanska banka. Having initially committed to divesting at least a 50% stake in the bank by end-2017, the government instead submitted a new proposal (including a later sales deadline and the appointment of an independent administrator for the bank for the pre-privatization period), which is now subject to negotiations with the European Commission. According to the European Commission's 2018 Country Report under the European Semester, also reflecting the results of an in-depth review, Slovenia no longer experiences macroeconomic imbalances. Risks stemming from weaknesses in the banking sector, corporate indebtedness and short-term fiscal developments have receded. Nevertheless, major long-term challenges remain related to the pension, healthcare and long-term care system in connection with population aging.

No signs of underlying inflationary pressures despite headline inflation of close to 2%

Despite the rapid expansion of the economy and the output gap likely turning positive, inflation remained contained during the second half of 2017 and early 2018. Growth of credit to the private sector remained at around 5%, with household demand exceeding corporate demand, as improved probability presumably enabled businesses to cover their financing needs increasingly from internal sources. Banking sector profitability improved modestly in 2017 owing to the release of impairments and provisions. Income risk has remained one of the most significant risks for the sector, given the low interest rate environment, while growing mismatches between banks' assets and liabilities in terms of maturity and interest rate fixation have heightened funding and interest rate risks. The relatively rapid growth of real estate prices warrants careful monitoring. Current parliamentary discussion of a forced conversion of households' Swiss franc loans into euro loans and ongoing court cases about the validity of foreign currency loan contracts represent a contingent risk factor for banks, even though the share of foreign currency credits in household loans was moderate at less than 5%.

Table 3

Main economic indicators: Slovenia

	2015	2016	2017	Q3 16	Q4 16	Q1 17	Q2 17	Q3 17	Q4 17
	Year-on-year change of the period total in %								
GDP at constant prices	2.3	3.1	5.0	3.4	3.5	5.0	4.5	4.5	6.0
Private consumption	2.1	4.2	3.2	4.2	6.4	3.7	2.8	3.0	3.2
Public consumption	2.7	2.5	2.3	2.7	1.1	0.9	1.1	1.7	5.6
Gross fixed capital formation	–1.6	–3.6	10.3	–2.5	0.7	13.1	9.0	7.4	11.9
Exports of goods and services	5.0	6.4	10.6	5.8	5.6	9.7	8.4	11.9	12.3
Imports of goods and services	4.7	6.6	10.1	5.6	7.5	10.8	7.7	10.7	11.1
	Contribution to GDP growth in percentage points								
Domestic demand	1.7	2.7	3.7	2.7	4.4	4.7	3.3	2.6	4.2
Net exports of goods and services	0.6	0.5	1.3	0.7	–0.9	0.2	1.2	1.9	1.7
Exports of goods and services	3.8	5.0	8.2	4.4	4.4	7.7	6.5	9.1	9.6
Imports of goods and services	–3.2	–4.5	–6.9	–3.8	–5.3	–7.4	–5.2	–7.2	–7.9
	Year-on-year change of the period average in %								
Unit labor costs in the whole economy (nominal, per person)	0.4	1.6	0.6	1.1	1.0	–0.3	0.8	1.0	0.8
Unit labor costs in manufacturing (nominal, per hour)	–5.0	–5.3	–2.0	–5.4	–1.8	–2.8	1.5	–0.7	–5.6
Labor productivity in manufacturing (real, per hour)	5.7	9.1	9.1	8.7	10.9	5.8	8.0	10.5	12.0
Labor costs in manufacturing (nominal, per hour)	0.5	3.3	7.0	2.8	8.8	2.9	9.6	9.8	5.7
Producer price index (PPI) in industry	–0.2	–1.4	2.2	–1.3	–0.1	1.7	2.3	2.3	2.4
Consumer price index (here: HICP)	–0.8	–0.2	1.6	0.0	0.7	2.0	1.4	1.3	1.5
	Period average levels								
Unemployment rate (ILO definition, %, 15–64 years)	9.1	8.1	6.7	7.5	8.1	7.9	6.5	6.4	5.9
Employment rate (%, 15–64 years)	65.2	65.9	69.3	66.4	66.6	67.3	69.1	70.4	70.3
Key interest rate per annum (%)	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
	Nominal year-on-year change in the period-end stock in %								
Loans to the domestic nonbank private sector[1]	–6.5	–2.4	4.8	–7.0	–2.4	1.3	3.8	7.8	4.8
of which: loans to households	0.1	3.3	6.8	1.7	3.3	5.2	5.9	7.3	6.8
loans to nonbank corporations	–11.2	–7.0	3.1	–13.7	–7.0	–2.0	2.0	8.2	3.1
	%								
Share of foreign currency loans in total loans to the nonbank private sector	3.8	3.2	2.4	3.5	3.2	3.1	2.8	2.5	2.4
Return on assets (banking sector)	0.3	0.9	1.1	1.1	0.9	1.4	1.2	1.2	1.1
Tier 1 capital ratio (banking sector)	20.1	20.2	..	20.8	20.2	20.0	19.9	19.7	..
NPL ratio (banking sector)	9.9	5.5	3.7	6.4	5.5	5.2	5.0	4.7	3.7
	% of GDP								
General government revenues	44.9	43.3	43.1	..	..	..	..	..	..
General government expenditures	47.7	45.3	43.1	..	..	..	..	..	..
General government balance	–2.9	–1.9	0.0	..	..	..	..	..	..
Primary balance	0.4	1.2	..	..	..	..	..	..	..
Gross public debt	82.6	78.6	73.6	..	..	..	..	..	..
	% of GDP								
Debt of nonfinancial corporations (nonconsolidated)	67.9	60.8	..	..	..	..	..	..	..
Debt of households and NPISHs (nonconsolidated)	27.6	27.3	..	..	..	..	..	..	..
	% of GDP (based on EUR), period total								
Trade balance	3.8	3.8	3.6	3.6	2.2	3.6	3.9	4.3	2.7
Services balance	4.8	5.4	5.9	6.3	5.1	5.4	6.1	6.9	5.3
Primary income	–3.2	–3.2	–2.6	–3.6	–3.4	–2.2	–2.2	–2.8	–3.0
Secondary income	–1.0	–0.8	–0.6	–0.9	–0.5	–0.9	–0.7	–0.5	–0.2
Current account balance	4.4	5.2	6.4	5.4	3.3	5.9	7.1	7.8	4.7
Capital account balance	1.1	–0.7	–0.5	–0.5	–1.0	–0.5	–0.6	–0.5	–0.5
Foreign direct investment (net)[2]	–3.3	–2.2	–1.2	–2.9	1.0	–2.1	1.2	–1.9	–2.1
	% of GDP (rolling four-quarter GDP, based on EUR), end of period								
Gross external debt	120.1	110.9	100.4	113.4	110.9	109.4	106.8	102.6	100.4
Gross official reserves (excluding gold)	1.8	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.5
	Months of imports of goods and services								
Gross official reserves (excluding gold)	0.3	0.3	0.2	0.3	0.3	0.3	0.3	0.3	0.2
	EUR million, period total								
GDP at current prices	38,837	4,018	43,278	10,390	10,396	9,901	11,010	11,106	11,261

Source: Bloomberg, European Commission, Eurostat, national statistical offices, national central banks, wiiw, OeNB.

[1] *Foreign currency component at constant exchange rates.*
[2] *+ = net accumulation of assets larger than net accumulation of liabilities (net outflow of capital).*
– = net accumulation of assets smaller than net accumulation of liabilities (net inflow of capital).

4 Bulgaria: strong domestic demand momentum continues amid slowing exports

Slowing exports put some drag on economic activity

Despite some deceleration in the fourth quarter of 2017, economic growth continued to outperform post-2009 averages. The shift to a growth model driven by domestic demand has stabilized, whereby fixed investment and private consumption gained extra momentum in the second half of 2017. Export growth, on the other hand, significantly decelerated until the end of the year, inter alia due to an abating base effect in tourism (prompted by the diversion of tourist flows from Turkey in 2016). Some slowdown in import growth in the second half of 2017 was thus not sufficient to improve the contribution of net exports.

Gradually improving economic sentiment indicators have translated into a further rise in labor demand, and both unemployment and employment rates have approached best-performance levels of the past 20 years. As a result of the tightening labor market, annual real wage growth climbed to 10% in the second half of 2017, fueling private consumption but also considerably outpacing productivity advances. Increasing scarcity of labor coincides with a shift toward more capital spending. On the back of improved EU fund absorption, favorable lending conditions and a stronger focus of the new government on public infrastructure, gross fixed capital formation expanded with nearly 4% in 2017 at a rate not seen since 2008.

Strong wage increases have not yet resulted in significant inflationary pressures. Annual HICP inflation reached its 2017 peak in November with 1.9%, before receding to 1.5% in February 2018. Service prices have taken over the dominant role from energy and food prices in explaining inflation dynamics. As a result, also core inflation has experienced a gradual uptick, to 1.4% in February 2018.

Pick-up in lending activity alongside a gradual reduction in NPL ratios

Lending to the domestic nonbank private sector also experienced a considerable pick-up in the second half of 2017 (compared to subdued post-2009 dynamics). Deposits grew even stronger, contributing to a further reduction in the loan-to-deposit ratio. Moreover, loan growth has been primarily driven by local currency loans, inter alia due to the increase in savings in Bulgarian lev and more favorable terms of lending in lev. Therefore, the gradual decline in foreign currency lending as a share of total lending (observed since 2014) has also continued more recently. The NPL ratio (>90 days overdue specification) moved below 7% by the end of 2017 for the first time since the first quarter of 2010, and the coverage ratio improved as well. However, compared to other CESEE EU Member States, Bulgaria shows still one of the largest NPL ratios.

Government outperforms budgetary targets

As a result of expansionary private consumption and investment, revenue outperformance allowed the government to keep its budget in surplus in 2017 for another year, at 0.9 of GDP, rather than suffering a deficit of 0.6% of GDP as anticipated. The 2018 budget envisages a significant widening of spending for public wages and investment projects (the latter by 50% year on year). Nevertheless, the targets set in the 2017–2020 Convergence Programme (a general government deficit of 0.5% of GDP in 2018 and surpluses of 0.1% of GDP in 2019–2020) have so far not been amended and should remain within reach as long as revenue performance remains favorable. Bulgaria runs the semiannual presidency of the Council of the European Union from January to June 2018 and is currently working with its European partners on a roadmap for entering the EU's exchange rate mechanism (ERM II).

Table 4

Main economic indicators: Bulgaria

	2015	2016	2017	Q3 16	Q4 16	Q1 17	Q2 17	Q3 17	Q4 17
	Year-on-year change of the period total in %								
GDP at constant prices	3.6	3.9	3.6	3.0	4.3	3.6	3.9	3.8	3.0
Private consumption	4.5	3.6	4.8	0.4	4.7	3.8	5.7	4.6	5.2
Public consumption	1.4	2.2	3.2	3.0	6.8	5.8	1.2	2.5	3.5
Gross fixed capital formation	2.7	–6.6	3.8	–9.5	–10.0	2.4	4.0	4.2	4.1
Exports of goods and services	5.7	8.1	4.0	10.7	10.6	6.1	3.6	4.6	2.1
Imports of goods and services	5.4	4.5	7.2	5.9	4.9	9.1	6.2	5.4	8.2
	Contribution to GDP growth in percentage points								
Domestic demand	3.5	1.6	5.3	–0.5	1.3	5.3	5.2	4.0	6.5
Net exports of goods and services	0.1	2.3	–1.7	3.7	3.0	–2.2	–1.5	0.2	–3.4
Exports of goods and services	3.7	5.2	2.6	7.2	5.9	4.0	2.3	3.2	1.2
Imports of goods and services	–3.6	–2.9	–4.3	–3.5	–2.9	–6.2	–3.8	–3.0	–4.6
	Year-on-year change of the period average in %								
Unit labor costs in the whole economy (nominal, per person)	2.3	2.5	5.4	2.8	–0.3	2.6	4.1	7.5	8.3
Unit labor costs in manufacturing (nominal, per hour)	1.7	7.8	4.9	6.4	6.3	7.1	2.5	5.3	4.8
Labor productivity in manufacturing (real, per hour)	7.4	2.1	6.6	3.3	2.5	3.1	8.8	6.6	7.5
Labor costs in manufacturing (nominal, per hour)	9.2	10.0	11.7	10.0	9.0	10.4	11.5	12.2	12.6
Producer price index (PPI) in industry	–2.0	–3.1	4.9	–3.0	0.6	4.8	4.2	5.4	5.2
Consumer price index (here: HICP)	–1.1	–1.3	1.2	–1.1	–0.8	0.8	1.4	0.9	1.7
EUR per 1 BGN, + = BGN appreciation	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
	Period average levels								
Unemployment rate (ILO definition, %, 15–64 years)	9.3	7.7	6.3	7.1	6.7	7.0	6.4	5.9	5.7
Employment rate (%, 15–64 years)	62.9	63.4	66.9	64.2	63.4	64.3	67.2	68.5	67.5
Key interest rate per annum (%)[1]	..	..	..	..	..	..	..	..	..
BGN per 1 EUR	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
	Nominal year-on-year change in the period-end stock in %								
Loans to the domestic nonbank private sector[2]	–1.9	1.6	4.9	–0.2	1.6	3.7	4.3	5.0	4.9
of which: loans to households	–1.4	2.0	6.1	0.5	2.0	4.6	6.0	5.9	6.1
loans to nonbank corporations	–2.2	1.3	4.1	–0.7	1.3	3.1	3.3	4.4	4.1
	%								
Share of foreign currency loans in total loans to the nonbank private sector	49.9	44.4	37.9	46.3	44.4	42.5	41.0	39.7	37.9
Return on assets (banking sector)	1.0	1.4	1.2	1.6	1.4	1.2	1.4	1.2	1.2
Tier 1 capital ratio (banking sector)	20.5	20.9	20.9	21.5	20.9	21.3	21.3	21.0	20.9
NPL ratio (banking sector)	10.9	9.0	6.9	10.0	9.0	9.1	8.7	8.1	6.9
	% of GDP								
General government revenues	39.1	35.2	36.1	..	..	..	..	..	..
General government expenditures	40.7	35.0	35.2	..	..	..	..	..	..
General government balance	–1.6	0.2	0.9	..	..	..	..	..	..
Primary balance	–0.7	0.8	..	..	..	..	..	..	..
Gross public debt	26.0	29.0	25.4	..	..	..	..	..	..
	% of GDP								
Debt of nonfinancial corporations (nonconsolidated)	96.6	91.4	..	..	..	..	..	..	..
Debt of households and NPISHs (nonconsolidated)	23.8	23.2	..	..	..	..	..	..	..
	% of GDP (based on EUR), period total								
Trade balance	–5.8	–2.1	–4.1	–0.4	–2.8	–5.9	–3.3	–1.3	–6.3
Services balance	6.7	6.4	6.0	13.8	2.5	1.8	5.2	13.8	2.0
Primary income	–4.5	–2.3	–1.1	–2.0	–2.3	–2.2	–0.7	–0.6	–1.0
Secondary income	3.6	3.3	3.7	1.6	1.8	5.2	3.5	4.4	2.0
Current account balance	–0.1	5.3	4.5	13.0	–0.8	–1.0	4.7	16.3	–3.3
Capital account balance	3.1	2.2	1.0	1.4	0.6	1.1	0.7	1.0	1.3
Foreign direct investment (net)[3]	–5.2	–0.7	–1.4	–0.8	3.7	–2.2	–1.3	–0.7	–1.5
	% of GDP (rolling four-quarter GDP, based on EUR), end of period								
Gross external debt	81.6	79.2	74.2	79.7	79.2	78.8	77.5	74.9	74.2
Gross official reserves (excluding gold)	42.2	46.7	44.1	46.5	46.7	46.5	45.9	46.4	44.1
	Months of imports of goods and services								
Gross official reserves (excluding gold)	8.0	9.4	8.2	9.3	9.4	9.1	8.8	8.8	8.2
	EUR million, period total								
GDP at current prices	45,287	48,129	50,430	13,076	13,493	10,260	12,347	13,800	14,023

Source: Bloomberg, European Commission, Eurostat, national statistical offices, national central banks, wiiw, OeNB.

[1] *Not available in a currency board regime.*
[2] *Foreign currency component at constant exchange rates.*
[3] *+ = net accumulation of assets larger than net accumulation of liabilities (net outflow of capital).*
– = net accumulation of assets smaller than net accumulation of liabilities (net inflow of capital).

5 Croatia: solid growth and fiscal improvements, but structural challenges remain

Strong private consumption growth, but investments and exports disappoint

Croatian GDP grew by 2.8% year on year in 2017, reflecting 3.3% growth in the third quarter and a slowdown to 2.0% in the fourth quarter. Private consumption remained the main growth driver, supported by positive labor market developments, a pick-up in lending to households and income tax changes. Consumer confidence improved in the second half of 2017 and reached its highest level since 2000 in February 2018. Growth of gross fixed capital formation slowed during the year, with the uncertainty surrounding Agrokor – the country's ailing retailer – most likely weighing on investments. EU fund absorption remains low, but Croatia succeeded in speeding up the process of tender calls and project contractions in 2017. Net exports continued to make a negative contribution to growth in the second half of 2017.

The growth of exports slowed, while the growth of imports increased in the second half of 2017 compared to the same period last year. The trade balance deficit widened, while the services balance surplus increased, supported by another record tourist season. The income balance improved markedly compared to the second half of 2016. Overall, the current account surplus increased to 3.9% of GDP in 2017 from 2.6% of GDP in 2016. External debt declined to 82.3% of GDP in 2017 from 89.8% in 2016.

Draft strategy for euro adoption and further fiscal consolidation needs

In October 2017, the Croatian central bank (HNB) and government jointly published a draft strategy for the adoption of the euro, emphasizing that the benefits of euro adoption outweigh the costs for Croatia. Euro accession would eliminate the high currency risk stemming from the euroization of the economy; the shares of loans and deposits to the private sector denominated in foreign currency have been declining, but still stood at 57% and 61%, respectively, at the end of 2017. The draft strategy does not include a time line for euro adoption.

One critical point in terms of euro adoption will be Croatia's debt-to-GDP ratio, which continues to stand well above the Maastricht criterion of 60% of GDP. The public debt-to-GDP ratio, however, declined moderately to 78% of GDP at end-2017. The Finance Ministry has announced that Croatia achieved a general government budget surplus in 2017 amid stable revenues and a notable downward trend in expenditure. The consolidation was aided by favorable GDP developments and financing conditions. In the first months of 2018, Fitch and Standard & Poor's upgraded Croatia's long-term sovereign rating from BB to BB+.

Appreciation pressures on the kuna exchange rate versus the euro

Monthly HICP inflation averaged 1.5% in the second half of 2017, a mild acceleration compared to the first half of the year. The first two months of 2018, however, brought a moderation of inflation to 0.9% in February. The HNB continued its expansionary stance and Croatian kuna liquidity increased to a record high of HRK 19.1 billion in December 2017. As a response to appreciation pressures on the kuna stemming largely from economic growth and current account developments, the HNB conducted four outright open-market operations, purchasing assets worth EUR 573 million from the banking sector in the second half of 2017 and a further EUR 405.5 million in January 2018.

The growth of loans to households turned positive in the second half of the year, but overall credit growth remained negative, as loans to the government and companies both contracted year on year. Loans to the government declined sharply, mostly related to the government's debt refinancing strategy.

Table 5

Main economic indicators: Croatia

	2015	2016	2017	Q3 16	Q4 16	Q1 17	Q2 17	Q3 17	Q4 17
	Year-on-year change of the period total in %								
GDP at constant prices	2.3	3.2	2.8	3.1	3.5	2.6	3.0	3.3	2.0
Private consumption	1.1	3.5	3.6	3.8	3.7	3.5	3.7	3.7	3.4
Public consumption	–0.9	1.9	2.0	2.4	2.2	1.5	1.7	2.3	2.6
Gross fixed capital formation	3.8	5.3	3.4	3.7	5.0	5.4	3.3	3.4	1.7
Exports of goods and services	9.4	5.6	6.1	5.5	6.5	9.5	6.5	5.7	3.6
Imports of goods and services	9.2	6.2	8.1	5.4	5.6	11.4	5.8	9.5	6.0
	Contribution to GDP growth in percentage points								
Domestic demand	2.1	3.3	3.5	1.8	3.2	4.4	2.9	3.8	3.3
Net exports of goods and services	0.3	–0.1	–0.8	1.2	0.2	–1.7	0.1	–0.4	–1.2
Exports of goods and services	4.3	2.7	3.0	3.6	2.9	3.7	2.9	3.7	1.6
Imports of goods and services	–4.0	–2.8	–3.7	–2.3	–2.6	–5.4	–2.8	–4.1	–2.8
	Year-on-year change of the period average in %								
Unit labor costs in the whole economy (nominal, per person)	..	..	..	..	..	..	..	..	..
Unit labor costs in manufacturing (nominal, per hour)	–3.3	51.9	2.1	56.3	48.8	9.8	–4.1	0.9	2.0
Labor productivity in manufacturing (real, per hour)	5.9	–31.6	3.5	–33.4	–29.6	–2.1	9.2	4.7	2.2
Labor costs in manufacturing (nominal, per hour)	2.2	4.2	5.5	4.0	4.8	7.5	4.7	5.7	4.3
Producer price index (PPI) in industry	–3.9	–4.3	2.0	–4.6	–1.7	2.3	1.8	1.8	2.0
Consumer price index (here: CPI)	–0.3	–0.6	1.3	–1.1	0.2	1.1	1.1	1.4	1.5
EUR per 1 HRK, + = HRK appreciation	0.3	1.1	0.9	1.1	1.3	2.0	1.0	0.9	–0.1
	Period average levels								
Unemployment rate (ILO definition, %, 15–64 years)	16.4	13.3	11.3	11.0	13.5	14.1	11.1	9.1	11.0
Employment rate (%, 15–64 years)	56.0	56.9	58.9	58.4	56.8	55.9	59.2	61.0	59.6
Key interest rate per annum (%)	..	..	..	..	..	..	..	..	..
HRK per 1 EUR	7.6	7.5	7.5	7.5	7.5	7.5	7.4	7.4	7.5
	Nominal year-on-year change in the period-end stock in %								
Loans to the domestic nonbank private sector[1]	–4.0	–3.8	0.8	–4.9	–3.8	–1.7	–0.9	0.0	0.8
of which: loans to households	–3.2	–4.6	2.3	–5.6	–4.6	–0.2	0.1	0.7	2.3
loans to nonbank corporations	–5.2	–2.6	–1.1	–4.1	–2.6	–3.5	–2.1	–0.9	–1.1
	%								
Share of foreign currency loans in total loans to the nonbank private sector	66.7	60.1	56.9	60.7	60.1	58.9	58.0	57.7	56.9
Return on assets (banking sector)	–1.1	1.3	0.9	1.4	1.3	0.4	0.5	0.7	0.9
Tier 1 capital ratio (banking sector)	19.1	21.3	21.7	19.9	21.3	21.6	21.7	21.3	21.7
NPL ratio (banking sector)	16.7	13.8	11.4	14.7	13.8	13.9	13.2	12.5	11.4
	% of GDP								
General government revenues	44.9	46.3	46.0	..	..	..	..	..	..
General government expenditures	48.4	47.2	45.3	..	..	..	..	..	..
General government balance	–3.4	–0.9	0.8	..	..	..	..	..	..
Primary balance	0.2	2.3	..	..	..	..	..	..	..
Gross public debt	83.8	80.6	78.0	..	..	..	..	..	..
	% of GDP								
Debt of nonfinancial corporations (nonconsolidated)	99.3	94.7	..	..	..	..	..	..	..
Debt of households and NPISHs (nonconsolidated)	38.4	35.2	..	..	..	..	..	..	..
	% of GDP (based on EUR), period total								
Trade balance	–15.7	–15.8	–16.8	–14.8	–13.6	–18.6	–19.0	–15.7	–14.1
Services balance	18.0	18.7	19.1	42.7	6.0	3.5	19.3	43.2	5.3
Primary income	–0.6	–3.2	–2.2	–4.7	–1.5	–2.3	–3.2	–2.1	–1.2
Secondary income	2.9	3.0	3.8	2.4	3.3	3.5	4.5	2.9	4.3
Current account balance	4.5	2.6	3.9	25.6	–5.7	–13.9	1.5	28.2	–5.6
Capital account balance	0.7	1.3	0.5	1.0	1.8	0.7	0.5	0.4	0.5
Foreign direct investment (net)[2]	–0.5	–4.1	–2.7	–5.8	–3.2	–2.0	–1.2	–2.5	–4.9
	% of GDP (rolling four-quarter GDP, based on EUR), end of period								
Gross external debt	101.9	89.8	82.3	92.5	89.8	93.5	84.7	82.3	82.3
Gross official reserves (excluding gold)	30.8	29.1	32.3	28.4	29.1	34.3	29.5	31.0	32.3
	Months of imports of goods and services								
Gross official reserves (excluding gold)	8.0	7.6	7.9	7.4	7.6	8.7	7.4	7.7	7.9
	EUR million, period total								
GDP at current prices	44,539	46,399	48,686	12,978	11,624	10,678	12,226	13,740	12,042

Source: Bloomberg, European Commission, Eurostat, national statistical offices, national central banks, wiiw, OeNB.

[1] *Foreign currency component at constant exchange rates.*
[2] *+ = net accumulation of assets larger than net accumulation of liabilities (net outflow of capital).*
– = net accumulation of assets smaller than net accumulation of liabilities (net inflow of capital).

6 Czech Republic: one of the most successful economic periods since the beginning of transition

All factors contribute to the strong economic expansion

Following a rebounding of the Czech economy in the first half of 2017, growth accelerated further in the second half of the year. Hence, real GDP growth came in at 4.3% in 2017 as a whole, substantially above the growth potential estimated by the Czech National Bank (CNB) at around 3%. While the economic boom was driven by both domestic demand and net exports, it was tilted to the former. Private consumption remained the key growth determinant, reflecting strong wage growth in the tight labor market and optimistic consumer expectations amid still low interest rates. In a similar vein, fixed investment continued edging up in the second half of 2017 and made the second strongest contribution to GDP growth. This does not only echo the low interest rate environment and positive expectations regarding future demand but possibly also a greater robotization of production by firms trying to cope with labor shortages and rapidly growing wages. In addition, households' property investment made a significant contribution to growth, fueled by still vigorous credit growth despite a gradual tightening of credit conditions. In contrast to the private sector components, the growth contribution of public consumption moderated further in the second half of 2017. The contribution of net exports to economic expansion slowed down continuously as a result of a fast acceleration of import growth. The latter was driven by buoyant domestic demand, particularly import-intensive fixed capital formation.

Despite some deterioration in the second half of 2017 on the back of, inter alia, higher oil prices both the trade and services balances remained in surplus. However, the current account turned slightly negative as a result of a higher secondary income deficit. The fiscal surplus increased from 0.7% of GDP in 2016 to 1.6% of GDP in 2017, bolstered mainly by higher tax revenues on the back of the strong economic growth. In the same vein, the debt ratio declined by more than 2 percentage points, to 34.6% of GDP in 2017.

Labor shortages have posed a challenge and raised inflation

The flip side of the robust economic growth is a continued tightening in the labor market. Employment keeps reaching historical highs while the historically low unemployment rate (also the lowest unemployment rate in the EU) declines further. Labor shortages and the ensuing high wage growth not fully matched by rising productivity are the biggest challenge for firms. To cope, they essentially seek to employ foreign workers and to invest into labor-saving technologies.

Inflation has ranged in the upper half of the tolerance band of the CNB's target (2% ±1 percentage point) since early 2017 and averaged some 2.4% in the second half of 2017 as well as in the year as a whole. Higher prices have been the result mainly of core inflation and food prices on the back of the booming economy as well as some one-off effects such as electronic sales registration. However, the latter effects have faded away and, in addition, increases of fuel and import prices have been moderated by the appreciating Czech koruna. Therefore, inflation has dropped from its peak at just below 3% in October 2017, to 1.6% in February 2018. Despite this decline, the CNB expects inflation to be above target for the rest of 2018 and to return to target in early 2019. The CNB started to gradually tighten monetary policy in August 2017. Since then the CNB has increased the two-week repo rate from 0.05% in three steps by 70 basis points.

Table 6

Main economic indicators: Czech Republic

	2015	2016	2017	Q3 16	Q4 16	Q1 17	Q2 17	Q3 17	Q4 17
	Year-on-year change of the period total in %								
GDP at constant prices	5.3	2.6	4.3	1.6	1.7	4.0	3.3	4.8	5.1
Private consumption	3.7	3.6	4.0	3.5	3.0	3.7	3.9	4.1	4.3
Public consumption	1.9	2.0	1.6	1.9	1.2	2.8	1.8	1.2	0.8
Gross fixed capital formation	10.2	–2.3	5.4	–3.5	–3.1	2.6	4.6	6.3	7.3
Exports of goods and services	6.0	4.5	6.5	1.8	2.2	7.5	4.4	6.5	7.6
Imports of goods and services	6.8	3.4	5.8	0.8	1.1	5.6	3.4	6.1	8.1
	Contribution to GDP growth in percentage points								
Domestic demand	5.5	1.4	3.3	0.7	0.8	1.8	2.2	4.0	5.0
Net exports of goods and services	–0.2	1.2	1.0	0.8	0.9	2.2	1.1	0.7	0.1
Exports of goods and services	5.0	3.7	5.2	1.4	1.7	6.3	3.6	4.9	5.9
Imports of goods and services	–5.2	–2.5	–4.2	–0.6	–0.9	–4.2	–2.5	–4.2	–5.9
	Year-on-year change of the period average in %								
Unit labor costs in the whole economy (nominal, per person)	–0.8	3.2	3.6	4.7	4.8	3.0	5.2	3.6	2.8
Unit labor costs in manufacturing (nominal, per hour)	–0.5	0.9	2.1	7.3	–3.6	5.5	1.4	1.2	0.6
Labor productivity in manufacturing (real, per hour)	3.7	2.0	6.1	1.9	3.0	4.0	9.3	5.6	5.4
Labor costs in manufacturing (nominal, per hour)	3.2	3.0	8.3	9.3	–0.7	9.7	10.8	6.9	6.0
Producer price index (PPI) in industry	–2.5	–3.2	1.2	–3.0	–1.3	2.6	1.9	0.5	–0.3
Consumer price index (here: HICP)	0.3	0.6	2.4	0.5	1.5	2.5	2.3	2.4	2.5
EUR per 1 CZK, + = CZK appreciation	0.9	0.9	2.7	0.2	0.1	0.1	1.8	3.6	5.4
	Period average levels								
Unemployment rate (ILO definition, %, 15–64 years)	5.1	4.0	2.9	4.0	3.6	3.5	3.0	2.8	2.4
Employment rate (%, 15–64 years)	70.2	72.0	73.6	72.2	72.9	72.8	73.3	74.1	74.3
Key interest rate per annum (%)	0.1	0.1	0.2	0.1	0.1	0.1	0.1	0.2	0.4
CZK per 1 EUR	27.3	27.0	26.3	27.0	27.0	27.0	26.6	26.1	25.6
	Nominal year-on-year change in the period-end stock in %								
Loans to the domestic nonbank private sector[1]	6.7	7.8	6.9	7.9	7.8	9.2	9.2	8.8	6.9
of which: loans to households	7.6	7.2	7.5	6.9	7.2	8.0	8.1	7.7	7.5
loans to nonbank corporations	5.7	8.5	6.2	9.2	8.5	10.6	10.5	10.1	6.2
	%								
Share of foreign currency loans in total loans to the nonbank private sector	10.8	13.0	13.3	12.6	13.0	15.5	14.8	15.2	13.3
Return on assets (banking sector)	1.2	1.3	1.1	1.4	1.3	1.1	1.3	1.2	1.1
Tier 1 capital ratio (banking sector)	17.9	17.9	18.7	17.2	17.9	17.6	18.3	18.0	18.7
NPL ratio (banking sector)	5.5	4.6	3.7	4.8	4.6	4.2	4.0	3.8	3.7
	% of GDP								
General government revenues	41.1	40.2	40.4	..	..	..	..	..	..
General government expenditures	41.7	39.4	38.8	..	..	..	..	..	..
General government balance	–0.6	0.7	1.6	..	..	..	..	..	..
Primary balance	0.5	1.6	..	..	..	..	..	..	..
Gross public debt	40.0	36.8	34.6	..	..	..	..	..	..
	% of GDP								
Debt of nonfinancial corporations (nonconsolidated)	59.8	56.5	..	..	..	..	..	..	..
Debt of households and NPISHs (nonconsolidated)	30.5	31.1	..	..	..	..	..	..	..
	% of GDP (based on EUR), period total								
Trade balance	4.1	5.2	4.8	3.8	3.2	7.7	5.7	3.3	2.8
Services balance	1.7	2.1	2.4	2.3	2.0	2.5	2.7	2.5	2.2
Primary income	–5.6	–5.7	–5.2	–7.2	–5.9	–0.4	–7.8	–7.4	–4.8
Secondary income	0.0	–0.6	–0.9	–0.7	–1.1	–1.3	–1.2	–1.1	–0.2
Current account balance	0.2	1.1	1.0	–1.9	–1.8	8.4	–0.6	–2.7	–0.1
Capital account balance	2.2	1.1	0.9	1.0	0.1	0.1	0.6	0.6	2.2
Foreign direct investment (net)[2]	1.1	–3.0	–2.7	–4.3	–1.2	–5.4	–2.1	–0.9	–2.6
	% of GDP (rolling four-quarter GDP, based on EUR), end of period								
Gross external debt	68.5	73.3	89.3	71.0	73.3	90.1	92.6	92.0	89.3
Gross official reserves (excluding gold)	35.0	45.9	64.1	41.7	45.9	68.7	68.7	66.7	64.1
	Months of imports of goods and services								
Gross official reserves (excluding gold)	5.6	7.6	10.6	6.9	7.6	11.3	11.2	11.0	10.6
	EUR million, period total								
GDP at current prices	168,514	176,564	191,797	44,750	45,904	42,883	47,659	49,325	51,930

Source: Bloomberg, European Commission, Eurostat, national statistical offices, national central banks, wiiw, OeNB.

[1] *Foreign currency component at constant exchange rates.*

[2] *+ = net accumulation of assets larger than net accumulation of liabilities (net outflow of capital).*
– = net accumulation of assets smaller than net accumulation of liabilities (net inflow of capital).

7 Hungary: fiscal and monetary policy remain loose amid rapid GDP growth

Accelerating consumption lifts GDP growth in the second half of 2017

Hungary posted strong GDP growth of 4% year on year in 2017, almost twice the rate of 2016. Growth was especially strong in the second half of the year, on the back of sharply accelerating consumption activity, with public consumption reviving in particular ahead of parliamentary elections in April 2018. Private consumption activity continued to be supported by strong wage and employment growth, falling unemployment and high consumer sentiment. At the same time, investment growth slowed down significantly during the second half of 2017, but still advanced at a double-digit rate, supported by the inflow of EU funds, low interest rates, accelerating growth of credit to both households (especially housing loans) and corporations, good economic prospects and record-high capacity utilization rates. Strengthening domestic demand fueled imports, which led to a negative contribution of net real exports to overall GDP growth even though exports remained sound despite cost competitiveness losses.

2017 budget deficit below target, debt level modified by Eurostat decision

Hungary's budget deficit amounted to 2% of GDP in 2017, slightly more than in 2016, but less than the 2.4% of GDP official target. Despite various tax cuts (e.g. VAT and corporate income tax rate reduction, cut in employers' social contribution rate, increased family tax allowance) and increased expenditure (e.g. on public sector wages, housing subsidies), fiscal developments benefited from rapid economic growth. Government debt declined from 76.0% of GDP in 2016 to 73.6% of GDP by end-2017. These figures already reflect the reclassification of Eximbank to the government sector, as negotiated with Eurostat. This methodological change raised government debt by around 2 percentage points of GDP for 2015–2017 (and to a lesser extent for previous years). In its Alert Mechanism Report 2018 of late 2017, the European Commission highlighted rapidly rising real house prices (albeit from undervalued levels), dynamic growth in unit labor costs and a tightening labor market as the most prominent risk factors for Hungary. Yet with these risks still appearing to be contained, the European Commission refrained from carrying out a further in-depth analysis in the context of the macroeconomic imbalance procedure.

MNB extends monetary policy toolkit to maintain loose conditions also on long-end of the curve

With inflation hovering between 2% and 2.5% during the second half of 2017 and early 2018 and the Hungarian central bank (MNB) expecting it not to reach the 3% target before mid-2019, the MNB left its main interest rates unchanged during the reporting period. The central bank continued to squeeze liquidity out of its three-month deposit facility by gradually reducing the limit on outstanding stocks, while at the same time gradually increasing the volume of its Hungarian forint liquidity-providing foreign exchange swaps. At its meeting in December 2017, the monetary council decided not to reduce the three-month deposit stock further in 2018. Instead, the MNB added two new tools to its set of standard monetary policy instruments from the beginning of 2018: unconditional 5- and 10-year interest rate swaps to banks and regular purchases of mortgage bonds with at least 3-year maturity. The new instruments have been designed to ensure loose monetary conditions not only at the short but also at the longer end of the yield curve and promote the provision of long-term credit to the private sector at fixed interest rates. Apart from these monetary policy measures, housing loans have been supported by so-called "certified consumer-friendly housing loans" (i.e. standardized long-term loan contracts with caps on interest rates and fees and comparably long interest fixation periods of 3, 5 or 10 years). The MNB granted such certificates to a large number of banks during the second half of 2017.

Table 7

Main economic indicators: Hungary

	2015	2016	2017	Q3 16	Q4 16	Q1 17	Q2 17	Q3 17	Q4 17
	Year-on-year change of the period total in %								
GDP at constant prices	3.4	2.2	4.0	2.5	1.9	4.3	3.3	3.9	4.4
Private consumption	3.6	4.3	4.7	4.1	4.5	3.5	4.7	5.1	5.6
Public consumption	1.1	0.8	0.3	–1.2	–2.5	–5.8	–2.2	2.8	6.1
Gross fixed capital formation	1.9	–10.6	16.8	–4.7	–15.0	21.6	21.0	14.4	13.1
Exports of goods and services	8.5	3.4	7.1	3.5	–0.2	10.2	5.4	4.7	8.3
Imports of goods and services	6.4	2.9	9.7	2.6	–0.2	12.7	7.6	9.1	9.7
	Contribution to GDP growth in percentage points								
Domestic demand	1.2	1.5	5.4	1.5	1.9	5.3	4.5	6.8	4.9
Net exports of goods and services	2.2	0.7	–1.4	1.0	0.0	–1.0	–1.2	–2.8	–0.5
Exports of goods and services	7.5	3.1	6.3	3.1	–0.2	9.6	5.0	4.2	7.0
Imports of goods and services	–5.2	–2.4	–7.7	–2.1	0.2	–10.6	–6.2	–7.0	–7.4
	Year-on-year change of the period average in %								
Unit labor costs in the whole economy (nominal, per person)	–2.4	4.4	5.9	4.3	5.1	6.1	7.8	5.1	4.4
Unit labor costs in manufacturing (nominal, per hour)	–0.1	8.5	5.5	10.5	8.3	3.8	6.1	6.5	5.6
Labor productivity in manufacturing (real, per hour)	4.1	–2.7	2.6	–3.7	–2.1	4.2	2.8	1.8	1.9
Labor costs in manufacturing (nominal, per hour)	4.0	5.6	8.3	6.4	6.1	8.1	9.1	8.5	7.6
Producer price index (PPI) in industry	–0.9	–1.6	3.3	–2.5	–0.3	3.4	2.9	2.5	4.3
Consumer price index (here: HICP)	0.1	0.4	2.4	0.1	1.3	2.6	2.1	2.5	2.3
EUR per 1 HUF, + = HUF appreciation	–0.4	–0.5	0.7	0.3	1.1	1.0	1.1	1.5	–0.7
	Period average levels								
Unemployment rate (ILO definition, %, 15–64 years)	6.9	5.2	4.2	4.9	4.5	4.6	4.3	4.1	3.8
Employment rate (%, 15–64 years)	64.0	66.5	68.2	67.1	67.5	67.1	68.1	68.7	68.8
Key interest rate per annum (%)	1.6	1.0	0.9	0.9	0.9	0.9	0.9	0.9	0.9
HUF per 1 EUR	309.9	311.5	309.3	311.1	309.4	309.1	309.9	306.5	311.7
	Nominal year-on-year change in the period-end stock in %								
Loans to the domestic nonbank private sector[1]	–12.7	0.0	4.3	–2.9	0.0	0.7	3.7	4.1	4.3
of which: loans to households	–15.6	–2.7	1.3	–4.4	–2.7	–0.7	0.6	1.6	1.3
loans to nonbank corporations	–10.0	2.3	6.8	–1.6	2.3	1.8	6.3	6.3	6.8
	%								
Share of foreign currency loans in total loans to the nonbank private sector	24.3	22.4	23.5	21.6	22.4	22.4	23.0	23.1	23.5
Return on assets (banking sector)	–0.1	1.3	1.8	1.7	1.3	2.0	2.1	1.9	1.8
Tier 1 capital ratio (banking sector)	16.9	19.2	18.4	18.4	19.2	19.5	19.6	19.5	18.4
NPL ratio (banking sector)	10.6	5.6	3.7	8.1	5.6	5.4	4.5	4.1	3.7
	% of GDP								
General government revenues	48.2	44.9	44.5	..	..	..	..	..	..
General government expenditures	50.1	46.5	46.5	..	..	..	..	..	..
General government balance	–1.9	–1.7	–2.0	..	..	..	..	..	..
Primary balance	1.5	1.3	..	..	..	..	..	..	..
Gross public debt	76.7	76.0	73.6	..	..	..	..	..	..
	% of GDP								
Debt of nonfinancial corporations (nonconsolidated)	76.8	72.6	..	..	..	..	..	..	..
Debt of households and NPISHs (nonconsolidated)	20.9	20.4	..	..	..	..	..	..	..
	% of GDP (based on EUR), period total								
Trade balance	4.0	4.1	1.9	3.5	2.4	2.8	4.0	0.5	0.6
Services balance	4.9	5.9	5.8	7.7	4.8	5.3	5.9	6.9	5.2
Primary income	–4.5	–2.6	–3.9	–2.7	–2.9	–3.2	–4.3	–3.9	–4.2
Secondary income	–0.9	–1.3	–0.9	–1.1	–1.4	–1.0	–0.4	–1.1	–1.0
Current account balance	3.5	6.0	2.9	7.4	2.8	3.8	5.2	2.5	0.6
Capital account balance	4.6	0.0	1.2	–0.4	–0.3	1.0	2.3	0.4	1.3
Foreign direct investment (net)[2]	–1.2	–2.1	–1.6	–5.3	–4.0	–1.5	2.4	–2.9	–3.8
	% of GDP (rolling four-quarter GDP, based on EUR), end of period								
Gross external debt	107.8	97.2	83.8	99.0	97.2	96.4	93.6	88.8	83.8
Gross official reserves (excluding gold)	27.3	21.4	18.8	20.9	21.4	21.0	19.8	18.3	18.8
	Months of imports of goods and services								
Gross official reserves (excluding gold)	4.0	3.2	2.7	3.1	3.2	3.1	2.9	2.7	2.7
	EUR million, period total								
GDP at current prices	110,706	113,760	123,465	28,836	31,515	27,217	30,515	31,664	34,069

Source: Bloomberg, European Commission, Eurostat, national statistical offices, national central banks, wiiw, OeNB.

[1] *Foreign currency component at constant exchange rates.*
[2] *+ = net accumulation of assets larger than net accumulation of liabilities (net outflow of capital).*
– = net accumulation of assets smaller than net accumulation of liabilities (net inflow of capital).

8 Poland: inflation remains subdued despite high wage growth

Current account balance improves, investment recovers

GDP growth accelerated to 4.6% in 2017 (2016: 2.9%), with a stable quarter-on-quarter growth rate of about 1.1% in the second half of the year. Total final demand growth accelerated to 5.5%, with rather volatile real export growth slowing to 6.7% and domestic demand growth speeding up to 4.9%. Real import growth remained nearly unchanged at 7.7%. In the fourth quarter, both domestic demand and import growth were especially large. Unlike in 2015 and 2016, foreign demand contributed less than domestic demand to annual GDP growth, so that the net export contribution turned negative. Within domestic demand, fixed investment growth switched from a severe contraction that dragged GDP growth down by 1.6 percentage points in 2016 to a strong expansion that culminated in the last quarter of 2017 at 3.5% quarter on quarter. In parallel, inventory build-up continued, but at a slower pace, thus contributing less to GDP growth. Strong consumption and foreign demand, increasing industrial confidence, further rising high capacity utilization rates, stable liquidity positions and lower real lending rates supported the recovery of private business fixed investment. Profitability remained roughly stable overall, but deteriorated slightly in manufacturing, given moderate unit labor cost (ULC) increases. Housing investment growth seems to have accelerated (judging from the number of dwellings under construction), driven by beneficial income and financing conditions and the government's housing program for young families. Private consumption growth accelerated to 4.7%, coming into line with more strongly accelerating GDP growth. Besides the lagged effect of higher child benefits, this reflected further improving consumer confidence, a larger number of persons employed and higher real wage growth, while real pensions advanced only marginally. The first months of 2018 continued to see increases in production, sales, employment, wages and confidence. In 2017, the current account balance turned from a minor deficit to a small surplus of 0.3% of GDP, on account of improvements in the services balance and in the primary and secondary income balances. Also, the capital account surplus increased, while net FDI inflows continued to decline.

Monetary policy rates kept on hold given low core inflation

Manufacturing ULC increased considerably stronger than in the euro area in year-on-year terms in the second half of 2017. In addition, the Polish zloty's euro value was nearly 3 percentage points higher than a year earlier, further dampening international price competitiveness. In February, annual headline inflation stood at 0.7% (HICP) and 1.4% (national CPI), markedly lower than in January. The Polish Monetary Policy Council (MPC), pursuing an inflation target of 2.5% (CPI), has kept interest rates at 1.5% since March 2015. In its April 2018 meeting, it highlighted low core inflation despite high wage and GDP growth and announced that it expects inflation to remain close to target over the monetary policy transmission horizon.

Fiscal policy misses a window of opportunity to lower the structural deficit

The general government lowered its gross deficit to 1.7% of GDP in 2017, from 2.3% in 2016, as a result of stronger revenues (due to growth and better VAT collection) and lower investment than projected. By contrast, the structural deficit remained unchanged at 1.5% of GDP, thus making faster convergence to the medium-term objective of 1% of GDP unlikely despite the favorable economic situation. General government gross debt came in at 50.6% at the end of 2017, hence, 3.6 percentage points lower than at end-2016.

Table 8

Main economic indicators: Poland

	2015	2016	2017	Q3 16	Q4 16	Q1 17	Q2 17	Q3 17	Q4 17
	Year-on-year change of the period total in %								
GDP at constant prices	3.8	2.9	4.6	2.0	3.4	4.5	4.3	5.1	4.4
Private consumption	3.0	3.9	4.7	4.9	4.7	4.8	4.7	4.8	4.7
Public consumption	2.4	1.7	2.7	2.3	–0.6	0.6	2.3	2.0	5.1
Gross fixed capital formation	6.1	–7.9	5.2	–7.6	–9.1	–0.4	1.0	3.4	11.1
Exports of goods and services	7.7	8.8	6.7	6.1	7.7	9.9	3.1	7.7	6.6
Imports of goods and services	6.6	7.9	7.7	7.8	4.9	9.5	5.6	5.6	9.9
	Contribution to GDP growth in percentage points								
Domestic demand	3.2	2.2	4.7	2.7	2.1	3.9	5.4	3.9	5.6
Net exports of goods and services	0.6	0.7	–0.2	–0.7	1.4	0.6	–1.1	1.2	–1.2
Exports of goods and services	3.7	4.4	3.5	3.1	3.6	5.3	1.7	4.0	3.2
Imports of goods and services	–3.0	–3.7	–3.7	–3.7	–2.1	–4.7	–2.8	–2.8	–4.4
	Year-on-year change of the period average in %								
Unit labor costs in the whole economy (nominal, per person)	–0.6	2.1	0.9	2.1	1.7	–3.5	–2.5	4.9	5.1
Unit labor costs in manufacturing (nominal, per hour)	1.0	2.9	2.7	4.4	1.4	2.6	3.4	2.9	2.1
Labor productivity in manufacturing (real, per hour)	2.9	0.9	3.9	–0.8	3.7	1.7	4.1	3.8	5.7
Labor costs in manufacturing (nominal, per hour)	3.9	3.9	6.7	3.5	5.1	4.3	7.6	6.8	8.0
Producer price index (PPI) in industry	–2.1	–0.3	2.7	–0.2	1.6	4.1	2.7	2.6	1.6
Consumer price index (here: HICP)	–0.7	–0.2	1.6	–0.4	0.4	1.7	1.5	1.5	1.8
EUR per 1 PLN, + = PLN appreciation	0.0	–4.1	2.5	–3.5	–2.6	1.0	3.7	1.9	3.5
	Period average levels								
Unemployment rate (ILO definition, %, 15–64 years)	7.6	6.3	5.0	6.0	5.6	5.5	5.0	4.8	4.5
Employment rate (%, 15–64 years)	62.9	64.5	66.1	64.9	65.1	65.4	66.2	66.5	66.4
Key interest rate per annum (%)	1.6	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.5
PLN per 1 EUR	4.2	4.4	4.3	4.3	4.4	4.3	4.2	4.3	4.2
	Nominal year-on-year change in the period-end stock in %								
Loans to the domestic nonbank private sector[1]	5.3	3.9	6.2	3.5	3.9	5.5	6.1	6.1	6.2
of which: loans to households	3.9	4.0	4.8	4.1	4.0	4.2	4.4	4.5	4.8
loans to nonbank corporations	7.8	3.8	8.7	2.4	3.8	7.8	9.3	9.1	8.7
	%								
Share of foreign currency loans in total loans to the nonbank private sector	26.9	25.8	21.3	25.6	25.8	24.2	23.2	22.6	21.3
Return on assets (banking sector)	0.7	0.8	0.8	0.9	0.8	0.6	0.8	0.8	0.8
Tier 1 capital ratio (banking sector)	15.0	16.1	17.3	16.0	16.1	16.5	17.0	17.2	17.3
NPL ratio (banking sector)	7.5	7.1	6.8	7.3	7.1	6.9	6.9	6.9	6.8
	% of GDP								
General government revenues	38.9	38.8	39.6	..	..	..	..	..	..
General government expenditures	41.6	41.1	41.2	..	..	..	..	..	..
General government balance	–2.6	–2.3	–1.7	..	..	..	..	..	..
Primary balance	–0.9	–0.8	..	..	..	..	..	..	..
Gross public debt	51.1	54.2	50.6	..	..	..	..	..	..
	% of GDP								
Debt of nonfinancial corporations (nonconsolidated)	46.5	49.2	..	..	..	..	..	..	..
Debt of households and NPISHs (nonconsolidated)	35.4	36.3	..	..	..	..	..	..	..
	% of GDP (based on EUR), period total								
Trade balance	0.5	0.7	0.2	–0.4	0.4	0.6	0.2	0.6	–0.5
Services balance	2.5	3.3	4.0	3.3	3.1	3.9	4.3	4.1	3.7
Primary income	–3.4	–4.0	–3.8	–5.0	–3.2	–2.7	–4.9	–4.3	–3.4
Secondary income	–0.2	–0.3	0.0	–0.3	–0.5	0.1	–0.3	–0.1	0.2
Current account balance	–0.6	–0.3	0.3	–2.5	–0.2	1.9	–0.7	0.2	0.0
Capital account balance	2.4	1.0	1.3	0.0	1.7	0.6	0.8	0.9	2.5
Foreign direct investment (net)[2]	–2.1	–1.2	–0.3	–0.7	1.2	–1.3	1.9	–1.9	–0.1
	% of GDP (rolling four-quarter GDP, based on EUR), end of period								
Gross external debt	70.5	74.9	67.8	74.3	74.9	74.6	72.2	69.1	67.8
Gross official reserves (excluding gold)	19.5	24.5	19.5	22.6	24.5	23.3	21.3	20.0	19.5
	Months of imports of goods and services								
Gross official reserves (excluding gold)	5.0	6.1	4.7	5.7	6.1	5.7	5.2	4.9	4.7
	EUR million, period total								
GDP at current prices	429,921	425,918	465,950	104,780	119,820	105,540	112,983	114,466	132,962

Source: Bloomberg, European Commission, Eurostat, national statistical offices, national central banks, wiiw, OeNB.

[1] Foreign currency component at constant exchange rates.
[2] + = net accumulation of assets larger than net accumulation of liabilities (net outflow of capital).
– = net accumulation of assets smaller than net accumulation of liabilities (net inflow of capital).

9 Romania: economic growth above potential amid fiscal concerns

GDP growth accelerating further on the back of private consumption growth

Romanian GDP growth continued to accelerate in the second half of the year, peaking at 8.8% in the third quarter with full-year GDP growth for 2017 reaching 7.0%. Private consumption growth accelerated further in the second half of the year, to around 12.5% year on year. The acceleration was partly driven by further procyclical income measures effective from July 1, 2017, as well as by favorable labor market developments and higher growth of lending to households. Consumer confidence deteriorated, amidst rising uncertainty regarding the path of interest rates, exchange rates and wages. The combined impact of the mix of government policies on income taxes, minimum wages, the shift of social contributions from employers to employees, and changes in the public sector remuneration system is currently unclear. In the second half of the year, growth of gross fixed capital formation accelerated markedly, partially driven by base effects, but there are some positive underlying developments. EU-fund absorption remains low so far. Net exports made a negative contribution to growth. Export growth decelerated throughout the year, while import growth remained strong.

Twin deficits persist, concerns regarding fiscal stance

The Romanian government has been adopting a rather procyclical, expansionary fiscal policy stance since 2016, which has resulted in budget deficits only narrowly below the EU's budget deficit threshold of 3% of GDP for two consecutive years. As a result, the structure of the budget has deteriorated, with tax cuts weighing on revenues, the share of expenditure on wages and pensions increasing and public investment expenditures falling. EU-fund absorption is also negatively affected as co-financing of projects is crowded out by other expenditures. In June 2017, the European Union opened a significant deviation procedure as Romania's fiscal stance implied a deviation from its medium-term objectives under the Stability and Growth Pact.

Romania's current account deficit increased to 3.4% of GDP at end-2017. In the second half of the year it amounted to 2.7% of GDP, an increase of about 1.3 percentage points compared to the second half of 2016. The deterioration was largely due to the goods balance, as exports grew more slowly than imports, which were fueled by high domestic demand. The service and income balance deteriorated mildly compared to the second half of 2016. External debt in the economy increased in absolute terms, but decreased as a percentage of GDP due to strong GDP growth.

Central bank increases interest rates amidst a rapid acceleration of inflation

CPI and HICP inflation rates accelerated sharply in the second half of the year, reaching 3.3% and 2.6%, respectively, in December 2017. The monetary policy-relevant CPI inflation reached 4.7% in February 2018 and is expected to remain above the central bank's target of 2.5% ±1 percentage point for most of 2018. The sharp acceleration of inflation was mainly driven by increasing excess aggregate demand, producer price pressures (mainly wages and utilities) and, from early 2018 onward, base effects. The Romanian central bank responded by increasing the policy rate by 25 basis points both in January and in February 2018, to 2.50%. The Romanian leu has depreciated mildly so far this year, but it could come under further depreciation pressure if current account and inflation developments continue.

Table 9

Main economic indicators: Romania

	2015	2016	2017	Q3 16	Q4 16	Q1 17	Q2 17	Q3 17	Q4 17
	Year-on-year change of the period total in %								
GDP at constant prices	4.0	4.8	7.0	4.3	4.8	5.7	6.1	8.8	6.9
Private consumption	5.9	7.8	10.2	7.1	4.7	7.3	7.5	12.4	12.6
Public consumption	0.4	3.6	0.8	1.5	9.1	3.8	–0.7	8.6	–4.7
Gross fixed capital formation	7.1	–1.8	5.2	–0.1	–12.1	–1.0	–0.4	6.2	12.6
Exports of goods and services	4.9	8.3	8.8	8.0	11.6	10.6	8.6	8.6	7.4
Imports of goods and services	8.1	10.0	10.6	7.4	8.9	10.5	10.2	11.1	10.7
	Contribution to GDP growth in percentage points								
Domestic demand	5.4	5.3	7.8	4.4	4.4	2.5	7.9	8.7	10.3
Net exports of goods and services	–1.4	–0.5	–0.8	0.7	0.8	1.1	–0.2	–1.4	–1.9
Exports of goods and services	1.9	3.6	3.9	3.5	4.3	5.9	3.9	3.6	2.9
Imports of goods and services	–3.3	–4.1	–4.7	–2.8	–3.5	–4.8	–4.1	–5.0	–4.8
	Year-on-year change of the period average in %								
Unit labor costs in the whole economy (nominal, per person)	–3.2	4.2	10.6	1.0	4.3	9.8	14.4	8.5	9.0
Unit labor costs in manufacturing (nominal, per hour)	6.8	9.9	4.9	9.5	7.9	8.0	4.5	5.3	2.2
Labor productivity in manufacturing (real, per hour)	–0.3	–0.2	9.0	1.2	1.8	6.7	11.2	7.7	10.1
Labor costs in manufacturing (nominal, per hour)	6.5	9.7	14.3	10.8	9.9	15.3	16.2	13.4	12.5
Producer price index (PPI) in industry	–2.2	–1.8	3.5	–2.0	0.3	3.5	3.0	3.6	3.7
Consumer price index (here: HICP)	–0.4	–1.1	1.1	–0.1	–0.1	0.4	0.6	1.0	2.4
EUR per 1 RON, + = RON appreciation	0.0	–1.0	–1.7	–0.8	–1.1	–0.6	–1.2	–2.6	–2.4
	Period average levels								
Unemployment rate (ILO definition, %, 15–64 years)	7.1	6.1	5.1	5.9	5.6	5.6	5.0	4.9	4.9
Employment rate (%, 15–64 years)	61.4	61.6	63.9	63.1	61.6	61.2	65.5	65.3	63.4
Key interest rate per annum (%)	1.9	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8
RON per 1 EUR	4.4	4.5	4.6	4.5	4.5	4.5	4.6	4.6	4.6
	Nominal year-on-year change in the period-end stock in %								
Loans to the domestic nonbank private sector[1]	1.8	1.0	4.8	0.9	1.0	2.3	4.0	5.9	4.8
of which: loans to households	4.1	4.5	7.1	5.9	4.5	4.8	5.3	6.5	7.1
loans to nonbank corporations	–0.3	–2.4	2.3	–4.0	–2.4	–0.3	2.6	5.4	2.3
	%								
Share of foreign currency loans in total loans to the nonbank private sector	49.3	42.8	37.2	43.8	42.8	41.8	39.8	38.6	37.2
Return on assets (banking sector)	1.2	1.1	1.3	1.3	1.1	1.3	1.4	1.4	1.3
Tier 1 capital ratio (banking sector)	16.7	17.6	16.8	16.6	17.6	17.7	17.8	17.2	16.8
NPL ratio (banking sector)	13.5	9.6	6.4	10.0	9.6	9.4	8.3	8.0	6.4
	% of GDP								
General government revenues	35.0	31.6	30.5	..	..	..	..	..	..
General government expenditures	35.8	34.6	33.4	..	..	..	..	..	..
General government balance	–0.8	–3.0	–2.9	..	..	..	..	..	..
Primary balance	0.8	–1.5	..	..	..	..	..	..	..
Gross public debt	37.7	37.4	35.0	..	..	..	..	..	..
	% of GDP								
Debt of nonfinancial corporations (nonconsolidated)	43.0	39.9	..	..	..	..	..	..	..
Debt of households and NPISHs (nonconsolidated)	17.2	16.6	..	..	..	..	..	..	..
	% of GDP (based on EUR), period total								
Trade balance	–4.9	–5.4	–6.4	–5.0	–5.4	–6.0	–7.1	–5.7	–6.9
Services balance	4.2	4.5	4.3	4.2	3.8	5.3	4.7	4.1	3.4
Primary income	–2.4	–2.6	–2.7	–2.3	–0.6	–2.2	–6.0	–2.6	–0.5
Secondary income	1.7	1.5	1.4	1.6	1.0	0.7	1.9	1.5	1.4
Current account balance	–1.2	–2.1	–3.5	–1.5	–1.2	–2.2	–6.4	–2.7	–2.6
Capital account balance	2.4	2.5	1.2	2.5	1.0	0.6	0.7	0.6	2.5
Foreign direct investment (net)[2]	–1.8	–2.7	–2.4	–2.6	–2.4	–3.1	–1.3	–4.0	–1.4
	% of GDP (rolling four-quarter GDP, based on EUR), end of period								
Gross external debt	57.5	54.8	50.2	56.5	54.8	54.2	53.1	51.1	50.2
Gross official reserves (excluding gold)	20.1	20.2	17.9	20.1	20.2	20.0	19.9	18.3	17.9
	Months of imports of goods and services								
Gross official reserves (excluding gold)	5.8	5.7	4.9	5.7	5.7	5.6	5.5	5.1	4.9
	EUR million, period total								
GDP at current prices	160,328	169,759	187,201	46,403	51,044	36,229	43,322	51,791	55,858

Source: Bloomberg, European Commission, Eurostat, national statistical offices, national central banks, wiiw, OeNB.

[1] *Foreign currency component at constant exchange rates.*
[2] *+ = net accumulation of assets larger than net accumulation of liabilities (net outflow of capital).*
– = net accumulation of assets smaller than net accumulation of liabilities (net inflow of capital).

10 Turkey: strong fiscal stimulus boosts GDP growth, inflation at 15-year high

Broad-based acceleration of GDP growth, declining fiscal space

Following a robust expansion of 5.4% in the first half of 2017, GDP growth spiked in the third quarter at 11.3% – the highest growth since 2011. Despite a slowdown to 7.3% in the fourth quarter, economic growth in 2017 more than doubled against the previous year to 7.4%. Growth was broad based. Both private and public investments shot up throughout the year on the back of sizeable fiscal stimulus supported by the Credit Guarantees Fund (CGF) in the tune of TRL 250 billion. At the same time, the robust expansion of private consumption continued, inter alia, backed by a mild drop in unemployment (close to 10% in the final quarter of 2017) along with vivid retail credit activity.

The fiscal stance became strongly expansionary in 2017. On the back of temporary tax reductions, continued minimum wage subsidies, employment incentives schemes and CGF loan support, the budget of the general government slipped further into negative territory, to –2.4% of GDP. It thus exceeded its target set out in the 2017–2019 medium-term program of 1.7% of GDP by a sizeable margin. Although still on comfortable levels, gross public debt increased slightly, to 28.2% of GDP in 2017.

External imbalances are on the rise

On the external side, net exports contributed negatively to economic growth in the final quarter of 2017 against the backdrop of strong domestic demand. Export growth remained robust in line with the partial recovery of the tourism sector and the strengthening of economic activity in the EU. At the same time, imports were fueled by a pick-up in consumption. Accordingly, the current account deficit widened to 5.5% of GDP in July to December 2017 (compared to one year earlier). On the financing side, net FDI inflows disappointed as before, amounting to 1.1% of GDP in the second half of 2017 and covering only 20% of the current account deficit. The economy continued to be highly reliant on more volatile portfolio inflows and loans, which turned partially negative in the course of 2017. Gross external financing needs remain among the highest in emerging markets and came close to 25% of GDP in 2017.

Inflation at its peak sparked by strong lira depreciation and cost pressures

The large depreciation of the Turkish lira (21.5% against the U.S. dollar and 12.2% against the euro) between end-June 2017 and end-March 2018 fueled inflation, which reached a 15-year peak. Annual CPI inflation amounted to 11.1% in 2017 after climbing to 12.2% in the fourth quarter of 2017, well above the year-end target of 5%. Most recently inflation slowed down somewhat, to 10.3% in February 2018. Besides the exchange rate pass-through, higher inflation was due to higher prices of core goods, the expiration of tax incentives and the positive output gap. Rising inflation expectations and a likely continuation of the depreciation trend, among others, will possibly keep price rises high in the near term. The Central Bank of the Republic of Turkey (CBRT) expects inflation to come in at 8.4% at the end of 2018, notably above target.

CBRT expands monetary policy toolkit while keeping policy rate constant

In spite of strong depreciation pressures, the central bank kept its key policy rate at 8%. However, it lifted the rate of the late liquidity window from 12.25% to 12.75% in December 2017, thus increasing the effective cost of bank funding. With the aim of curbing depreciation pressures, the CBRT introduced new instruments aimed at providing foreign exchange liquidity to the banking and corporate sector in January 2017. However, the transmission of monetary policy was blunted by the easing of financial conditions on the back of policy-induced credit growth and the relaxation of macroprudential policies as from September 2016.

Table 10

Main economic indicators: Turkey

	2015	2016	2017	Q3 16	Q4 16	Q1 17	Q2 17	Q3 17	Q4 17
	Year-on-year change of the period total in %								
GDP at constant prices	6.1	3.2	7.4	–0.8	4.2	5.4	5.4	11.3	7.3
Private consumption	5.4	3.7	6.1	0.5	6.3	3.8	2.7	11.0	6.6
Public consumption	3.9	9.5	5.0	5.8	6.1	9.0	–2.7	6.7	7.4
Gross fixed capital formation	9.3	2.2	7.3	0.3	1.2	3.0	6.6	13.2	6.0
Exports of goods and services	4.3	–1.9	12.0	–9.4	2.5	10.1	11.1	17.9	9.3
Imports of goods and services	1.7	3.7	10.3	2.1	2.9	0.9	2.2	15.0	22.7
	Contribution to GDP growth in percentage points								
Domestic demand	6.5	4.1	6.6	1.1	5.1	4.5	3.2	11.1	7.0
Net exports of goods and services	0.5	–1.3	0.1	–2.5	–0.2	2.0	1.8	0.3	–3.1
Exports of goods and services	0.9	–0.4	2.5	–2.0	0.5	2.2	2.3	3.5	1.8
Imports of goods and services	–0.4	–0.9	–2.4	–0.4	–0.6	–0.2	–0.5	–3.3	–5.0
	Year-on-year change of the period average in %								
Unit labor costs in the whole economy (nominal, per person)	..	..	..	..	..	..	..	..	..
Unit labor costs in manufacturing (nominal, per hour)	10.6	15.0	6.0	17.4	13.0	8.1	7.7	2.7	5.9
Labor productivity in manufacturing (real, per hour)	4.1	3.0	6.2	0.3	3.5	3.9	6.0	8.7	6.3
Labor costs in manufacturing (nominal, per hour)	15.0	18.3	12.6	17.7	16.9	12.3	14.1	11.6	12.6
Producer price index (PPI) in industry	5.3	4.3	15.8	2.9	6.4	15.0	15.5	16.0	16.7
Consumer price index (here: HICP)	7.7	7.7	11.1	7.9	7.6	10.0	11.6	10.6	12.2
EUR per 1 TRY, + = TRY appreciation	–3.8	–9.6	–18.9	–3.9	–10.2	–17.5	–17.0	–19.8	–20.9
	Period average levels								
Unemployment rate (ILO definition, %, 15–64 years)	10.5	11.1	11.1	11.4	12.2	12.9	10.3	10.7	10.4
Employment rate (%, 15–64 years)	50.2	50.7	51.6	51.1	50.1	49.5	52.2	52.6	51.9
Key interest rate per annum (%)	7.6	7.5	8.0	7.5	7.7	8.0	8.0	8.0	8.0
TRY per 1 EUR	3.0	3.3	4.1	3.3	3.5	3.9	3.9	4.1	4.5
	Nominal year-on-year change in the period-end stock in %								
Loans to the domestic nonbank private sector[1]	19.4	15.8	20.8	8.2	15.8	20.3	21.5	23.2	20.8
of which: loans to households	8.5	9.6	16.3	6.3	9.6	12.3	13.4	17.6	16.3
loans to nonbank corporations	24.2	18.2	22.3	8.9	18.2	23.3	24.6	25.3	22.3
	%								
Share of foreign currency loans in total loans to the nonbank private sector	..	..	..	..	..	..	..	..	..
Return on assets (banking sector)	1.2	1.5	1.7	1.6	1.5	1.9	1.8	1.7	1.7
Tier 1 capital ratio (banking sector)	12.7	12.7	13.7	13.3	12.7	13.1	13.7	13.9	13.7
NPL ratio (banking sector)	3.1	3.4	3.1	3.4	3.4	3.3	3.2	3.2	3.1
	% of GDP								
General government revenues	32.4	..	..	..	..	..	..	..	..
General government expenditures	31.1	..	..	..	..	..	..	..	..
General government balance	1.3	1.2	–2.4	..	..	..	..	..	..
Primary balance	3.3	3.1	–0.7	..	..	..	..	..	..
Gross public debt	27.5	25.1	28.2	..	..	..	..	..	..
	% of GDP								
Debt of nonfinancial corporations (nonconsolidated)	..	..	..	..	..	..	..	..	..
Debt of households and NPISHs (nonconsolidated)	..	..	..	..	..	..	..	..	..
	% of GDP (based on EUR), period total								
Trade balance	–5.6	–4.7	–6.9	–4.7	–4.4	–4.8	–6.8	–7.8	–7.6
Services balance	2.8	1.8	2.3	3.2	1.5	1.0	1.9	4.2	1.9
Primary income	–1.1	–1.0	–1.3	–1.0	–1.0	–1.2	–1.6	–1.0	–1.4
Secondary income	0.2	0.2	0.3	0.1	0.3	0.3	0.3	0.3	0.3
Current account balance	–3.7	–3.8	–5.5	–2.4	–3.6	–4.8	–6.2	–4.3	–6.8
Capital account balance	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Foreign direct investment (net)[1]	–1.5	–1.1	–1.0	–1.3	–1.2	–1.2	–0.6	–1.1	–1.0
	% of GDP (rolling four-quarter GDP, based on EUR), end of period								
Gross external debt	48.4	50.1	51.3	50.0	50.1	51.3	51.4	50.6	51.3
Gross official reserves (excluding gold)	11.1	11.2	9.3	11.5	11.2	10.8	10.3	10.1	9.3
	Months of imports of goods and services								
Gross official reserves (excluding gold)	5.1	5.4	3.8	5.6	5.4	5.0	4.7	4.4	3.8
	EUR million, period total								
GDP at current prices	771,913	778,812	751,367	201,310	210,825	165,151	186,994	200,819	198,402

Source: Bloomberg, European Commission, Eurostat, national statistical offices, national central banks, wiiw, OeNB.

[1] + = net accumulation of assets larger than net accumulation of liabilities (net outflow of capital).
– = net accumulation of assets smaller than net accumulation of liabilities (net inflow of capital).

11 Russia: oil price recovery benefits macroeconomic stability

Modest economic recovery supported by private consumption and fixed investment

Given only sluggish structural change, the Russian economy continues to be strongly dependent on the oil price. The Urals grade crude price increase of about one-quarter to USD 53.0 per barrel in 2017 (annual average) provided a slight lift to the country's modest economic growth rate, which reached 1.5% that year. Recovery from the previous mild recession was driven by private consumption (+3.3%) and fixed investment (+4.3%), while public consumption remained more or less neutral and the growth contribution of net exports dipped further into negative territory. On the production side of GDP, agriculture led the recovery (+2.4%, helped by a record grain harvest), followed by natural resource extraction (+2.0%); manufacturing almost stagnated (+0.2%).

Record-low inflation allows key policy rate cuts

The oil price rebound contributed to reducing inflation by pushing up the external value of the Russian ruble, which appreciated 15% against the U.S. dollar and 13% against the euro in 2017 (annual averages, compared to 2016). Yet the most recent U.S. sanctions, comprising extensive transaction bans on 24 Russian businessmen and 15 companies, have had considerable offsetting effects. CPI inflation declined to 2.5% at end-2017 and a record low of 2.2% at end-February 2018 (year on year). Given this clear undershooting of the inflation target (4%), the Central Bank of Russia (CBR) continued to cautiously cut key rates in the six months to end-March 2018, by a cumulative 125 basis points to 7.25%.

Higher oil prices and prudent fiscal policy rein in budget deficit

Increasing revenues stemming from higher oil prices combined with sustained restraint in spending contributed to the decrease of the federal budget deficit to 1.5% of GDP in 2017 (2016: 3.6% of GDP). The shortfall was largely financed by the remainder of the budgetary Reserve Fund, which was thus fully exhausted and wound up at the end of the year. The National Wealth Fund (the sole remaining fiscal fund, mainly designed to support the pension system) shrank to 4.2% of GDP (end-February 2018).

Current account surplus and capital outflows expand slightly, external debt declines

The oil price-triggered recovery of exports (valued in U.S. dollars) was the key factor supporting Russia's current account surplus, which expanded to 2.3% of GDP in 2017 (2016: 2.0% of GDP). Net private capital outflows increased to 2.0% of GDP (from 1.5% of GDP). These outflows were mostly connected to banks' paying down their external liabilities. The country's total external debt declined to EUR 435 billion (or 31.2% of GDP) at end-2017, while international reserves (excluding gold) stood at EUR 297 billion (about 21.3% of GDP) in December 2017.

With still high NPLs, bank profitability remains weak, and lending recovers hesitantly

Given the country's yet modest economic growth and the still high ratio of NPLs (19.1% at end- 2018), lending in 2017 only expanded moderately by 2%, while deposits grew by 10% (exchange rate-adjusted and in real terms), the latter attracted by relatively high real interest rates. Banks' profits remained weak. In mid-December 2017, the CBR nationalized a third medium-sized privately-owned credit institution, Promsvyazbank (after Otkrytie and B&N three to four months before). All three players (considered too big to fail and accounting for about 7% to 8% of total banking assets, thus lifting the share of state-owned banks to around 70%) had expanded aggressively in recent years, suffered from bad loans and became subject to bank runs. Their combined recapitalization may require up to EUR 16 billion according to estimates and reflects continuing fragility in the banking system.

Table 11

Main economic indicators: Russia

	2015	2016	2017	Q3 16	Q4 16	Q1 17	Q2 17	Q3 17	Q4 17
	Year-on-year change of the period total in %								
GDP at constant prices	–2.8	–1.0	1.5	–0.4	0.3	0.5	2.5	1.8	0.9
Private consumption	–9.7	–4.5	3.3	–4.8	–3.2	2.7	4.3	5.2	4.3
Public consumption	–3.1	–0.5	0.4	–0.5	–0.5	0.4	0.5	0.6	0.4
Gross fixed capital formation	–9.9	–1.8	4.3	–0.8	–0.2	2.3	6.3	3.9	3.4
Exports of goods and services	3.7	3.1	5.1	4.2	3.7	7.1	3.3	4.5	5.2
Imports of goods and services	–25.8	–3.8	17.4	–3.7	0.4	16.5	20.7	16.3	15.4
	Contribution to GDP growth in percentage points								
Domestic demand	–8.7	–2.1	3.5	–2.5	–1.1	1.5	4.6	3.7	2.4
Net exports of goods and services	6.1	1.5	–2.3	2.7	0.8	–0.9	–3.6	–2.5	–1.9
Exports of goods and services	1.0	0.9	1.3	1.9	1.7	1.9	0.9	1.1	1.3
Imports of goods and services	5.1	0.6	–3.6	0.6	–0.1	–2.3	–2.9	–2.5	–3.2
	Year-on-year change of the period average in %								
Unit labor costs in the whole economy (nominal, per person)	..	..	..	..	..	..	..	..	..
Unit labor costs in manufacturing (nominal, per hour)	6.8	5.1	17.5	6.7	5.8	21.7	19.8	16.0	11.9
Labor productivity in manufacturing (real, per hour)	1.2	3.8	5.8	3.5	3.3	4.0	9.0	6.3	4.0
Labor costs in manufacturing (nominal, per hour)	8.0	9.1	24.0	10.4	9.2	26.5	30.7	23.4	16.1
Producer price index (PPI) in industry	13.5	4.3	7.8	3.9	4.7	13.1	5.5	4.5	8.0
Consumer price index (here: CPI)	15.6	7.1	3.6	6.8	5.7	4.5	4.0	3.3	2.6
EUR per 1 RUB, + = RUB appreciation	–25.0	–8.4	12.6	–2.3	6.5	31.9	18.1	4.1	–1.2
	Period average levels								
Unemployment rate (ILO definition, %, 15–64 years)	5.6	5.5	5.2	5.2	5.4	5.5	5.2	5.0	5.1
Employment rate (%, 15–64 years)	..	..	..	..	..	..	..	..	..
Key interest rate per annum (%)	12.6	10.6	9.1	10.4	10.0	10.0	9.4	8.9	8.2
RUB per 1 EUR	68.0	74.2	65.9	72.1	68.0	62.5	62.9	69.3	68.8
	Nominal year-on-year change in the period-end stock in %								
Loans to the domestic nonbank private sector[1]	2.9	0.6	5.7	0.5	0.6	2.0	2.4	4.2	5.7
of which: loans to households	–6.1	1.6	12.7	–0.2	1.6	3.4	5.9	8.8	12.7
loans to nonbank corporations	6.7	0.2	3.1	0.8	0.2	1.5	1.1	2.5	3.1
	%								
Share of foreign currency loans in total loans to the nonbank private sector	24.5	18.9	14.7	20.5	18.9	17.7	18.2	16.5	14.7
Return on assets (banking sector)	0.2	1.2	1.0	1.0	1.2	1.7	1.9	1.1	1.0
Tier 1 capital ratio (banking sector)	8.5	9.2	8.5	8.8	9.2	9.9	9.4	8.6	8.5
NPL ratio (banking sector)	16.7	18.9	19.1	18.4	18.9	18.8	18.9	18.8	19.1
	% of GDP								
General government revenues	32.3	32.7	33.3	..	..	..	..	..	..
General government expenditures	35.7	36.4	34.8	..	..	..	..	..	..
General government balance	–3.4	–3.6	–1.5	..	..	..	..	..	..
Primary balance	..	..	..	..	..	..	..	..	..
Gross public debt	13.1	12.9	13.0	..	..	..	..	..	..
	% of GDP								
Debt of nonfinancial corporations (nonconsolidated)	..	..	..	..	..	..	..	..	..
Debt of households and NPISHs (nonconsolidated)	..	..	..	..	..	..	..	..	..
	% of GDP (based on EUR), period total								
Trade balance	10.9	7.0	7.3	5.2	7.1	10.1	6.6	5.0	7.9
Services balance	–2.7	–1.8	–2.0	–2.0	–1.6	–1.5	–2.0	–2.4	–2.0
Primary income	–2.7	–2.7	–2.5	–2.4	–2.5	–1.5	–3.7	–2.7	–2.1
Secondary income	–0.4	–0.5	–0.6	–0.7	–0.4	–0.5	–0.4	–0.6	–0.6
Current account balance	5.0	2.0	2.3	0.1	2.7	6.6	0.6	–0.6	3.1
Capital account balance	0.0	–0.1	0.0	0.0	0.1	0.0	0.0	0.0	0.0
Foreign direct investment (net)[2]	1.1	–0.8	0.7	–0.6	–4.1	1.0	–1.4	0.4	2.5
	% of GDP (rolling four-quarter GDP, based on EUR), end of period								
Gross external debt	38.8	41.7	31.2	41.3	41.7	39.0	35.1	33.4	31.2
Gross official reserves (excluding gold)	23.9	25.7	21.3	26.2	25.7	24.3	22.4	21.6	21.3
	Months of imports of goods and services								
Gross official reserves (excluding gold)	13.9	15.0	12.4	15.1	15.0	14.6	13.4	12.7	12.4
	EUR million, period total								
GDP at current prices	160,328	169,759	187,201	46,403	51,044	36,229	43,322	51,791	55,858

Source: Bloomberg, European Commission, Eurostat, national statistical offices, national central banks, wiiw, OeNB.

[1] Foreign currency component at constant exchange rates.
[2] + = net accumulation of assets larger than net accumulation of liabilities (net outflow of capital).
– = net accumulation of assets smaller than net accumulation of liabilities (net inflow of capital).