Outlook for selected CESEE countries

Surprisingly strong rebound in CESEE-6, continued moderate growth in Russia[1, 2]

Economic growth in the CESEE-6 countries[3] will rise to 4.1% per annum in 2017. We expect some moderation thereafter but GDP growth will be at or above 3% in all CESEE-6 countries in 2018 and 2019. The average growth rate will amount to 3.5% in 2018 and to 3.3% in 2019. Overall, strong domestic demand and export growth will drive up economic performance in 2017. Romania is expected to be the growth leader over the entire projection horizon. Our expectations are more or less in line with the forecasts of other institutions. As the economic outcome in the first half of 2017 was stronger than expected – particularly in the Czech Republic, Poland and Romania – the current projection was revised noticeably upward compared with our spring forecast. Export growth will also be stronger, driven by the upward revision of euro area import demand and higher world trade growth. Yet, a higher CESEE-6 growth forecast for 2017 will not translate into higher economic convergence with the euro area due to a stronger-than-expected euro area recovery. The growth differential will amount to 1.9 percentage points in 2017, 1.7 percentage points in 2018 and 1.6 percentage points in 2019.

Annual GDP growth in Russia will be 1.5% over the whole forecast horizon. The projection is unchanged compared to our spring forecast. The recovery is supported by improving domestic demand and accelerating export growth. The Russian economy is growing near to its potential, and achieving sustainably higher growth would require major structural reforms, which are not to be expected over the projection horizon.[4]

Table 1

OeNB-BOFIT GDP projections for 2017 to 2019 compared with other forecasts

	Euro-stat/ Rosstat	OeNB-BOFIT October 2017 forecasts			IMF October 2017 forecasts			wiiw July 2017 forecasts		
	2016	2017	2018	2019	2017	2018	2019	2017	2018	2019
	Year-on-year growth in %									
CESEE-6	3.0	4.1	3.5	3.3	4.0	3.4	3.0	3.6	3.4	3.3
Bulgaria	3.9	3.4	3.2	3.1	3.6	3.2	2.9	3.5	3.5	3.6
Croatia	2.7	2.9	3.1	3.1	2.9	2.7	2.5	2.7	2.9	3.0
Czech Republic	2.5	3.5	3.4	3.0	3.5	2.6	2.3	2.7	2.7	2.4
Hungary	1.9	3.8	3.6	3.0	3.2	3.4	2.8	4.0	3.9	3.3
Poland	2.7	4.0	3.2	3.4	3.8	3.3	3.0	3.3	3.2	3.1
Romania	4.8	5.4	4.2	3.6	5.5	4.4	3.8	4.8	4.3	4.3
Russia	–0.2	1.5	1.5	1.5	1.8	1.6	1.5	1.3	1.6	1.8

Source: OeNB-BOFIT October 2017 projections, ECB, Eurostat, IMF, Rosstat, wiiw.

Note: 2016 figures based on seasonally adjusted data.

[1] *Cut-off date for data underlying this outlook: October 2, 2017. The projections for the CESEE-6 countries were prepared by the OeNB, those for Russia were prepared by the Bank of Finland in cooperation with the OeNB. All projections are based on the assumption of a continued recovery in the euro area in line with the September 2017 ECB staff macroeconomic projections for the euro area. This implies real annual GDP growth of 2.2% in 2017, 1.8% in 2018 and 1.7% in 2019 in the euro area.*

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

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

[4] *The oil price assumption used by the Bank of Finland is based on the preceding ten-day averages of Brent futures. We expect the oil price to rise from USD 44 per barrel in 2016 to USD 51 per barrel in 2017 and further to USD 53 per barrel in 2019. The cut-off date for the oil price assumption was September 13, 2017.*

1 CESEE-6: growth-friendly environment supports broad-based upswing

Economic growth is expected to amount to 4.1% in 2017 and moderate to 3.5% in 2018 and 3.3% in 2019. Growth will be strongest in Romania, reaching 5.4% annually in 2017. In all CESEE-6 countries, domestic demand will be an important growth engine over the entire period. Private consumption primarily benefits from favorable labor market developments, whereas investment activity profits from the new EU funding cycle and export growth from favorable euro area developments. In Bulgaria, Poland and, most strikingly, in Romania the growth contribution of domestic demand will exceed the contribution of foreign demand over the forecast horizon, whereas in the Czech Republic and Hungary export demand dominates. In Croatia the growth contributions of domestic and foreign demand are more or less balanced.

Accommodative monetary policy to continue over the projection horizon

Overall, monetary conditions are expected to remain accommodative over the projection horizon. The inflationary environment in the CESEE-6 is rather growth supportive. Some monetary tightening cannot be precluded in the CESEE-6 – and has already taken place in the Czech Republic in August – but the overall expansionary monetary stance will prevail over the projection horizon. Furthermore, lending to the household and corporate sectors is picking up, also supported by declining nonperforming loan (NPL) ratios across the region. Overall, the current lending environment would suggest a more a dynamic growth of credit for consumption and investment purposes over the projection horizon.

Fiscal policy continues to support economic growth

There are no signs of a substantially more restrictive fiscal policy stance in most CESEE-6 countries despite the overall positive economic environment. Recent expansionary measures will not be reduced. Moreover, we expect further expansionary fiscal measures in Hungary in light of the upcoming parliamentary election in spring 2018. In Croatia, immediate pressure to cut public expenditures has alleviated as the country exited the excessive deficit procedure early in 2017. The situation looks somewhat different for Romania, which has to struggle to keep the budget below 3% of GDP and will thus likely curtail fiscal spending over the projection horizon.

Strong private consumption growth over the next years

The overall growth-friendly environment in the CESEE-6 region will support private consumption over the projection horizon. Marked labor market improvements combined with optimistic consumer sentiment drive our forecast. Hence, private consumption growth in the CESEE-6 will pick up strongly against 2016. The boost in private consumption will be most impressive in Romania and Bulgaria. In 2018 and 2019, private consumption will lose some steam but continue to be a robust growth driver.

Public consumption growth will slow down in 2017 and have only a limited impact on GDP growth in the CESEE-6. It is noteworthy that in Hungary, Poland and Romania public consumption growth will be lower in 2017 than in 2016. The freeze of public wages in Poland and the strained budgetary situation in Romania are the main reasons for this development.

Investment growth turns around

Investment activity will make a turnaround in 2017 compared with 2016. We expect growth in gross fixed capital formation to amount to 5.2% on average in the CESEE-6 after a decline by almost 6% in 2016. As discussed in spring 2017, last year investment growth in the region suffered from the phasing out of the previous EU funding period. With the maturing of the new funding period, gross fixed capital formation will rebound significantly over the projection horizon. For instance in Hungary, investment growth will amount to around 20% in 2017 (after a drop of about 15% in 2016). According to the IMF,[5] Hungary receives the largest share in percentage of GDP of the EU's structural and cohesion funds among the CESEE-6 countries (2007–2013 funding period, first year of allocation: about 25% of GDP; 2014–2020, first year of allocation: about 20% of GDP), which also reveals the region's overall dependency on EU funds. It is noteworthy that for almost all CESEE-6 countries the share of EU fund allocation as a percentage of GDP is smaller for the 2014–2020 funding period than for the previous period. However, a higher absorption rate is likely to compensate for the lower allocation of EU funds to the region as a whole. For the CESEE-6 aggregate, we expect further accelerating growth in gross fixed capital formation in 2018 and 2019, which is also supported by other factors – as discussed above – such as the overall favorable economic environment, binding capacity constraints, advantageous financing conditions and some fiscal leeway.

Accelerating export growth backed by robust euro area growth

Export growth will be strong in 2017, driven by the robust euro area demand for imports from outside the euro area and by improving global trade dynamics. For the CESEE-6, we expect exports to grow at an average rate of 6.2% in 2017. The deceleration compared with 2016 is due to weaker export growth in Poland (and also in Romania), which is attributable to base effects, currency appreciation (only in the case of Poland) as well as to higher unit labor costs (ULC). Euro area recovery is particularly relevant for the Czech Republic and Hungary. Their strong trade interlinkages with the euro area are reflected in dynamic export growth in 2017. In line with euro area import demand, we expect some moderation of export growth to 5.5% on average over the remainder of the projection horizon.

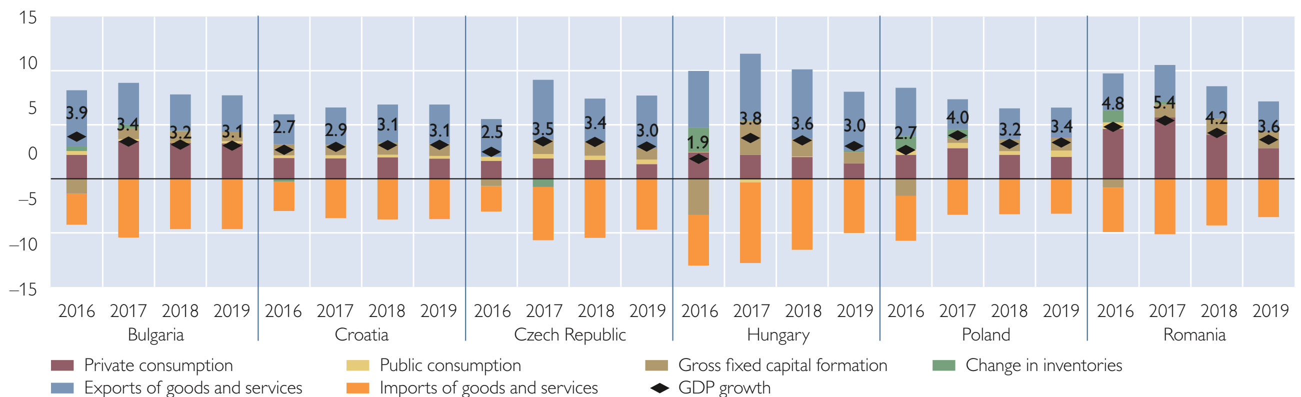
Import growth will accelerate in 2017 due to strong private consumption and growth in import-intensive exports. On average, import growth will accelerate by 7.8% in 2017 (after 7.5% in 2016). Only in Poland, import growth will weaken somewhat compared with the previous year. In Romania, import growth will accelerate by more than 10% in 2017, and some moderation will take place thereafter. The outcome of this is that the net contribution of exports will be highly negative in Romania (–1.8 percentage points in 2017 compared with –0.7 percentage points in 2016). Bulgaria will report a negative contribution of net exports as well (–1.6 percentage points). Only in the Czech Republic, net exports will contribute slightly positively to GDP growth over the projection horizon.

[5] *IMF. 2015. Regional Economic Issues: Central, Eastern and Southeastern Europe. Reconciling Fiscal Consolidation and Economic Growth. November 2015.*

Chart 1

CESEE-6 GDP growth and contributions for 2016 to 2019

Percentage points, year-on-year GDP growth in %



Source: Eurostat, OeNB.

Risks to growth in the CESEE-6 countries: downside political risks dominate

Geopolitical tensions across the globe are considered to pose an eminent risk to our forecast and have intensified in some instances. Armed conflicts (e.g. in Russia and Ukraine, or in Syria) and numerous swelling conflicts (North Korea, Iran, Turkey) could affect the CESEE-6 region more strongly than currently expected, namely via the trade channel, rising oil prices or the elevated uncertainty of economic agents in general.

Uncertainties about the direction the current U.S. administration's, economic policy will take are prevailing. In this respect, a stronger insulation of the U.S. home market and a less expansive U.S. fiscal policy than originally envisaged add to downside risks for the highly integrated, manufacturing- based CESEE economies.

Focusing on Europe, challenging exit negotiations between the EU and the U.K. could adversely affect consumer and investor confidence as well as the EU's trade linkages with the U.K. At the same time, by inducing remigration, Brexit could alleviate pressure from CESEE-6 labor markets.

Further, the question of EU coherence is still in the spotlight of policy discussions and poses some risk to our forecast. Anti-EU sentiment, rising political populism and uncertainty about the direction the EU will take cloud our projections. Even though major elections in the EU (Netherlands, France, Germany) are over, political uncertainty prevails to some extent: Germany has not yet formed a new government, elections in Italy will only take place sometime before May 2018 and the referendum in Catalonia caused an unexpectedly sharp reaction by the Spanish government.

We currently consider anti-EU sentiment and political populism as tail risks, as they are also part of political reality in the CESEE-6 countries, albeit to varying degrees. Potential sanctions – for instance in the form of retained EU funds in case of noncompliance with EU requirements – are unlikely to be implemented over the projection horizon.

A major external economic risk for the CESEE-6 relates to economic developments in the euro area. For 2017, we see an upside risk, given that in September 2017 economic confidence increased to its highest value in the last ten years. Our risk

grading for 2018 and 2019 is more or less balanced: The positive momentum may continue – leading to higher euro area GDP growth in 2018 and 2019 than currently expected – while, for instance, a stronger-than-anticipated or even disorderly tightening of monetary conditions outside the CESEE-6 (particular in the U.S. and in the euro area) would counteract the overall positive assessment of global growth toward the end of our projection horizon.

One of the main domestic economic risks is associated with current labor shortages and rising ULC. A further tightening of the labor market would damage the international competitiveness of the CESEE-6. Furthermore, a stronger-than-expected rise of nominal wages could push up inflation beyond expectations, and monetary tightening could set in more forcefully than expected. By contrast, higher inflationary pressure can also pose an upward risk as continued low or negative real interest rates would support credit dynamics and alleviate currency appreciation. Some risks are also related to the absorption of EU funds over the projection horizon. While some CESEE-6 countries still have much room for reaching higher absorption rates, other countries with already high absorption rates risk being less successful in making use of EU funds. Hence, we regard the risks as being more or less balanced at the regional level.

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

Bulgaria: economic growth pushed upward by strong private consumption

Real GDP is expected to increase by 3.4% in 2017 (up by 0.5 percentage points compared with our spring forecast) and by somewhat more than 3.0% annually in the next two years. With that, we expect that the Bulgarian economy grows at similar rates as in the past two years. Very positive private consumption dynamics in the first half of 2017 (surpassing the already elevated levels of 2016) are the main reason for this upward revision.

Private consumption continues to decisively impact economic developments until the end of the forecasting horizon for several reasons. First, labor market conditions have substantially improved (with the highest employment rate in the past two decades). Second, consumer confidence has not really deteriorated despite political turbulence (early parliamentary elections in March 2017). Third, the new government in place announced several measures to strengthen households' income (such as significant hikes in minimum pensions and teachers' wages). As one of its main priorities, the new government expressed running a successful EU presidency in the first half of 2018. Still, policy preferences among the government coalition partners vary considerably (pro-EU and pro-market versus nationalist and interventionist) such that renewed political instability cannot be excluded from the second half of 2018 onward. Hence, we expect that public consumption will not continue to widen at a similar pace in 2018, but that it might rise again somewhat in 2019. It should be noted that the currency board arrangement in place since 1997 (backed by a comparatively large share of foreign exchange reserves) will continue to serve as a stability anchor and contribute to fiscal prudence.

Domestic demand returns as a decisive GDP growth driver not only due to buoyant private consumption, but also due to a pronounced rebound in investments. The positive performance of gross fixed capital formation observed in the first half of 2017 is expected to continue for the remainder of 2017, given a gradual

upturn in capacity utilization, industrial confidence and lending to enterprises. These positive trends could well carry over to the next two years, not least endorsed by the expected acceleration of EU fund absorption in the current EU programming period.

On the back of improved external demand conditions and another very positive summer tourism season, export dynamics are expected to remain favorable. Export growth could decelerate somewhat over the forecasting horizon because of a possible base effect in tourism. However, the significant rise in imports (mirroring the expansion of domestic demand) will outweigh the favorable export performance. Consequently, the GDP growth contribution of net exports is expected to move into negative territory for a prolonged period.

Croatia: recovery continues despite uncertainty

GDP growth picked up further in the first half of 2017, coming to 2.8% year on year in the second quarter of 2017. The recovery is projected to continue; however, we revise our GDP forecast for 2017 downward by 0.2 percentage points to 2.9%. This moderate revision is related to the debt crisis of Croatia's largest private corporation, Agrokor, which led to a sharp drop in consumer confidence in April 2017 and increased uncertainty for the investment outlook. GDP growth is projected to accelerate somewhat in 2018 and 2019, with private consumption and gross fixed capital formation being the main drivers of growth.

Private consumption increased by a record 3.8% annually in the second quarter of 2017 despite the sharp drop in consumer confidence in spring. Recent consumer sentiment shows signs of recovery, and consumption will benefit from further public sector wage increases and the continued effect of tax cuts in the second half of 2017. Therefore, the strong recovery of private consumption in 2016 is set to continue in 2017 and to peak in 2018. Croatia successfully exited the excessive deficit procedure in the first half of 2017, which increased the government's spending leeway. We project that higher public consumption in the first half of 2017 will lead to an overall expansion in public consumption of 1.4% in 2017. The National Reform Programme of April 2017 emphasizes fiscal consolidation goals, which we project to constrain public consumption.

Gross fixed capital formation continued its strong recovery in the first quarter of 2017 but slowed down in the second quarter. We project a moderate impact on investment related to problems in the Agrokor group in 2017 but an overall continuation of the recovery over the forecast horizon. The projected improvement is grounded in an increased utilization of EU funds, the continuation of the expansionary monetary policy stance and improvements in business confidence indicators. Yet, political tensions with neighboring Bosnia and Herzegovina surrounding the construction of the Pelješac Bridge may delay one of the biggest investment projects in the country.

By end-August 2017, tourist arrivals had gone up by 14% compared with end-August 2016. On the back of a record tourist season, interventions of the Croatian National Bank on the foreign exchange market against a strengthening of the Croatian kuna and improved growth prospects of the main trading partners, annual export growth will amount to around 7% over the projection horizon. In the first half of 2017, imports grew by 7.1% year on year. The growth in private consumption will reinforce strong import growth, which we project to come in at almost 8% in

2017 and decelerate somewhat over the projection horizon. Altogether, we expect a moderate negative contribution of net exports to growth over the projection horizon.

Czech Republic: economy will remain on solid growth path

In light of the strong economic performance in the first six months of the year, we expect real GDP growth to accelerate to 3.5% in 2017 (from 2.5% in 2016) and to slow down gradually to levels just above 3% in the medium term. Economic growth will be driven predominantly by robust domestic demand, especially by private consumption.

Private consumption growth, averaging 3.5% annually over the forecast horizon, is set to remain the key driver of economic expansion. This reflects optimistic consumer sentiment as well as buoyant growth of real disposable income amid low interest rates and a tight labor market. However, the positive impact on disposable income is partially offset by rising domestic prices. According to the Czech central bank, inflation will stay in the upper half of the tolerance band for the rest of 2017, return to the 2% target at the start of 2018 and hover just below the target in the medium term. In its latest forecast in August 2017, the Czech National Bank assessed that the Czech economy would remain slightly above its potential output level over the monetary policy horizon. In addition, it saw as the main risk to its forecast the path of the exchange rate, which may appreciate more slowly than forecast due to an overboughtness of the Czech koruna market. Hence, overall, risks are slightly inflationary. Therefore, the board of the Czech National Bank has suggested to further raise key interest rates over the next two years. The envisaged monetary policy tightening might be accelerated or brought forward if GDP growth turns out to be higher than the Czech central bank expected, as it happened in the second quarter of 2017, and/or if the appreciation of the Czech koruna slows down. In this context, we project private consumption growth to reach almost 4% in 2017 before it slackens somewhat in 2018 and further in 2019 amid slowing wage growth and tightening monetary policy. Growth in government spending is forecast to stay broadly stable at slightly above 2% over the forecast horizon.

After last year's contraction, fixed investment will bounce back strongly in 2017. Apart from the base effect, the rebound will be driven by a recovery in private investment amid still low interest rates and strong domestic and external demand. In addition, gross fixed capital formation will benefit from a revived drawdown of EU funds. While fixed investment growth will remain buoyant, it will gradually slow down over the forecast horizon, contributing on average about 1.2 percentage points annually to GDP growth.

The expansion in exports rebounded in the first half of 2017 and is projected to remain robust in the quarters ahead. However, it will be counteracted by an appreciating Czech koruna, at least to the extent that the appreciation is not hedged. The Czech koruna is expected to keep appreciating in the medium term, fostered by real economic convergence, a positive interest rate differential relative to the euro area and the ECB's loose monetary policy. Against this background, the expansion of exports is projected to gradually slow down from just short of 7% in 2017 to below 6% in 2019. Strongly import-intensive exports will also drive a significant rebound of imports. In addition, averaging some 6.5% over the forecast horizon, import growth will be boosted also by robust growth in private consumption and investment. Against this background, the relatively significant

contribution of net exports to GDP growth in 2017 (0.6 percentage points) will be neutralized in 2018 before turning slightly positive again in 2019.

Hungary: GDP growth decelerates slowly from 2017 peak

Following relatively weak growth in 2016 we continue to expect GDP growth to sharply accelerate to close to 4% in 2017. Data for the first half of 2017, with year-on-year growth at 3.7%, support our expectation. While we leave our overall GDP forecast from spring 2017 unchanged, the forecast growth composition changed strongly following developments in the first half of 2017.

The unexpectedly sharp rebound of investments in the first half of 2017 has made us revise our forecast for gross fixed capital formation in 2017 substantially upward. Public sector investments are apparently boosted (from their very weak base) by a recovering EU funds inflow. The extension of housing subsidies in 2016 started to show in housing construction data during the first half of 2017, with recovering lending to households boding well also for our growth outlook. High capacity utilization in industry, accelerating lending to corporations, strong business confidence and the gradual decrease in the tax burden of corporations all support business investment. We expect investment growth to moderate substantially in 2018 as base effects will no longer play a role and fiscal and monetary stimuli will be gradually phased out in 2019.

Despite a steep rise in real wage growth and the accelerating growth of lending to households, private consumption growth slowed down somewhat during the first half of 2017, albeit from a strong base. Moreover, households may have spent an increasing part of their income on housing construction rather than on consumption. Therefore, we have revised markedly downward, though to still healthy levels, our full-year forecasts for private consumption in 2017 and 2018. Overall, minimum wage hikes in 2017 and in 2018 (to a lesser extent), increasing labor shortages across the economy, further public sector wage increases, new elements of family tax benefits and housing subsidies in the 2018 budget, continued selective VAT rate cuts and strengthening credit growth remain supportive factors. As these stimuli gradually fade away, however, growth rates should moderate over the forecast horizon.

Government consumption turned out clearly worse than expected during the first half of 2017, leading to a substantial downward revision to our full-year forecast. However, given the loosening measures already contained in the 2018 budget and the likelihood of additional spending ahead of the spring 2018 parliamentary elections, we expect public consumption to strengthen in the second half of 2017 and the first half of 2018. We expect stagnation thereafter, as fiscal policy will reorientate toward deficit containment against a slowing economic background.

Taking into consideration developments during the first half of 2017, we have revised downward export and import growth rates and – on the back of stronger-than-previously-assumed domestic demand – now expect a higher negative contribution from net real exports in 2017. We expect export growth to remain roughly unchanged in 2018 and import growth to decelerate along weakening domestic demand, thus diminishing the negative growth contribution of net real exports.

Poland: declining economic growth in 2018 despite accelerating investments

GDP growth will accelerate to 4% in 2017 after 2.7% in 2016. The expected decline in 2018 to 3.2% will mainly result from a slowdown in private consumption growth. While the contribution of domestic demand to GDP growth will decline in 2018 compared with 2017, it will remain higher than the stable contribution of exports (including exports to Germany) – a constellation set to emerge in 2017 for the first time since 2014.

Strong private consumption growth in 2017 will decelerate in 2018 as the sizeable positive base effect of the substantial rise in child benefits in particular for lower-income households in the second half of 2016 fades out. In addition, from October 2017 onward, a lower statutory retirement age will apply. Moreover, the government's convergence program envisages not only further measures with respect to indirect taxes, but also a general freezing of the wage bill for central government institutions in 2018. However, private consumption growth will remain strong, exceeding GDP growth on the back of improved consumer sentiment and strong wage and employment growth. Furthermore, interest rates on loans for consumption purposes are historically low. From a more forward-looking perspective, the uncertainty related to the future relation between the U.K. and the EU might dampen further labor emigration from Poland to the U.K. somewhat. This could help soften emerging bottlenecks of labor supply and twist labor market dynamics from wage to employment growth. Furthermore, remittances from the U.K. would be negatively affected. Any possible effects caused by Polish workers leaving the U.K. as a result of the Brexit negotiations are not expected to materialize before 2019. Public consumption growth will slow in 2018, factoring in the partial wage freeze in the public sector.

Overall, we expect gross fixed capital formation to expand by slightly above 2% in 2017 and accelerate to almost 6% in 2018. Corporate investments will benefit from stronger demand (both domestic consumption and foreign demand), higher capacity utilization and the favorable financing situation with respect to both own funds and external funds. Investment by both public enterprises and the public sector itself (in particular local governments) will continue to rebound in line with an increasing absorption of funds under the new EU medium-term budget. Moreover, there will be higher expenditures for military acquisitions. Housing investment will continue to expand at a rather moderate pace, as income growth and the state-subsidized housing program for young people remain supportive factors, while a further tightening of supervisory regulations concerning mortgage loans will put a lid on growth.

After its sharp slowdown during the first half of 2017, real export growth is expected to recover in the second half of the year, given the relatively strong growth of euro area imports from outside the euro area. However, both the rise of manufacturing ULC and the appreciation of the Polish zloty hold back export growth so that it will not exceed 5.5% in 2017. The contribution of net exports to GDP growth will turn negative in 2017 for the first time since 2014 due to strong import growth related to high domestic demand. In 2018, in line with stable export growth and moderately decelerating domestic demand growth, import growth will slow somewhat, but the contribution of net exports to GDP growth will remain negative.

Romania: growth projected to moderate

After climbing to 5.7% year on year in the first half of 2017, we expect economic growth in Romania to decelerate. Due to higher-than-expected growth in the first half of 2017, we revise our projection for 2017 upward to 5.4%. This implies a moderation of growth from mid-2017, as positive effects from stimulating fiscal and income policies on booming private consumption taper off. Moreover, some (small) corrective measures (such as rising the fuel excise duty) aimed at keeping the budget deficit below 3% of GDP have been taken and are becoming effective in the second half of 2017. Looking beyond the current year, we see growth at 4.2% in 2018 and 3.6% in 2018.

After decelerating in the second half of 2017, private consumption will pick up again in early 2018, as public wage increases were postponed from July 2017 to January and March 2018. Tightening labor market conditions, as evidenced by a markedly falling unemployment rate, together with further minimum wage hikes will keep wage growth in the private sector at an elevated level, though rising inflation will result in some deceleration in real terms over the forecast horizon. The upward trend in consumption loans will very likely support private consumption in 2018 and 2019.

Banks' improved lending capacities will contribute positively to the growth of gross fixed capital formation, in particular with regard to private investments. Domestic credit to nonfinancial corporations already picked up in the first seven months of 2017, while the growth of housing loans decelerated slightly to a still supportive 10% year on year. Positive economic sentiment will likely outweigh the effects of gradually rising nominal interest rates. Public investment is still somewhat uncertain, as the budget for 2018 is still unknown and subject to considerable uncertainty. Shifts from investments to wages as well as the underutilization of budgeted investment funds during the next fiscal year might continue if the government aims to contain the budget deficit below 3% of GDP and sticks to its plans to increase public wages and cut income tax.

We expect continued robust export growth with a slight deceleration over the forecast horizon due to unfavorable ULC developments. Alongside decelerating domestic demand, import growth will also come down gradually from its currently very high levels. The negative growth contribution of net exports will increase in 2017 before shrinking somewhat in 2018 and 2019.

3 Russia: domestic demand and exports recover

Russian GDP rose at an annual rate of 1.5% in the first half of 2017, supported by a higher oil price than expected in our last projection round. In the period from January to August, the average price of Urals grade crude oil was up 27% in annual terms at USD 50 per barrel. According to market expectations, oil prices should remain around current levels until the end of the projection horizon. Both Russia's domestic and export demand have expanded in 2017, but they triggered a rebound of imports greater than the increase in domestic production. As the outlook for the Russian economy, including the expected oil price trajectory, has not changed substantially since spring 2017, the forecast for Russian GDP growth remains at 1.5% annually for the period from 2017 to 2019. The Russian economy is growing at a pace near its potential, and achieving sustainably higher growth would require major structural reforms, which are currently not in sight.

Russia's revival is supported by improving domestic demand. Household consumption increased by nearly 3.5% year on year in the first half of 2017 and the continuing increase of retail sales points to further growth in the upcoming months. Consumption is anticipated to continue to recover moderately, supported by higher real wages, gradually reviving credit demand and improving consumer confidence. However, growth is restrained by the uncertain economic outlook. Fixed investment rose by nearly 4% year on year in the first half of 2017 according to preliminary data. A gradual recovery of investment should continue, as capacity utilization is already high and business confidence has improved. However, investment growth will be moderate due to the difficult business environment and, in some cases, restricted financing possibilities.

According to current budget plans, Russia will continue to curb the public sector deficit gradually in the coming years to just above 1% of GDP in 2019. Thus, public sector expenditures should not grow in real terms from 2017 to 2019, even though inflation has slowed down notably close to the Bank of Russia's target of 4%. The central bank has signaled that it will continue its moderately tight monetary policy and may gradually lower its key interest rate further from its current level of 8.5% in the coming months if inflation pressures remain subdued. This could support demand recovery without endangering macroeconomic stability.

Russia's foreign trade has recovered briskly throughout 2017. The volume of exports increased by 7% and that of imports by nearly 17% year on year in the first quarter of 2017, and preliminary data point to continued robust growth in recent months. Export growth is expected to slow down as export volumes of oil and natural gas are already at historically high levels, and the stronger Russian ruble erodes the competitiveness of other exports. With recovering demand and the stronger Russian ruble supporting the import rebound more robustly than expected in the previous baseline forecast, the 2017 projection for import growth has been revised sharply upward (to 15%). Growth is expected to settle gradually to 6% in 2018 and 2019 as imports climb closer to pre-crisis levels and the impact of the appreciation of the Russian ruble wanes.

Risks to the forecast for Russia

A key short-term uncertainty related to the Russia forecast is oil price developments. A higher-than-expected oil price could boost growth by improving export revenues, whereas a drop in the oil price would have an opposite effect. A new oil price plunge (rather unlikely) could even abort Russia's economic recovery. On the other hand, GDP growth could receive a temporary boost if, ahead of the presidential election in March 2018, public spending were raised by more than planned although this could increase Russia's fiscal vulnerabilities in the medium term. A stronger orientation of recovering demand toward domestic production instead of imports – along the lines of protectionist policy goals – might also produce faster short-term GDP growth. On the negative side, the recent problems of some large Russian banks may increase the uncertainty related to the Russian economy, although that effect should be mitigated by the stabilizing measures taken by the Bank of Russia. Finally, the easing or intensification of geopolitical tensions might lead to positive or negative deviations from the baseline forecast.