Outlook for selected CESEE countries:

Investment-driven upswing in CESEE and comeback of growth in Russia[1,2]

The outlook for real GDP growth in the CESEE-6 countries[3] foresees an upswing to 3.4% per annum in 2017, followed by some moderation in 2018 and 2019. Our forecast for 2017 has been revised up by 0.3 percentage points for the CESEE-6 average, whereas our current projections for 2018 are largely in line with our autumn assessment. Notably, for 2017, upward revisions have been undertaken for all countries compared to the previous forecast round. For Bulgaria and Croatia, our outlook for 2017 now reflects the better-than-expected outcome for 2016. The strongest upward revision, however, has been made for Hungary: GDP growth is now expected to expand by 3.8% in 2017 and thus to be 0.8 percentage points stronger than forecast half a year ago. This is entirely due to new economic policy measures as discussed below.

Our forecast is largely in line with forecasts by other institutions, except as regards Hungary. Particularly for Hungary but also for Poland we expect expansionary economic policy measures to feed through strongly on economic performance. Over the projection horizon we see a clear improvement of investment growth in all CESEE-6 countries in correspondence with the EU funding cycle. Private consumption growth will remain an important growth driver – backed by rising real disposable incomes due to favorable labor market developments and somewhat stronger lending to households. Against this background, import growth will keep on growing robustly. Yet the contribution of net exports will be negative from 2017 onward in most countries. Overall, income convergence with the euro area will progress: The growth differential will rise to 1.6 percentage points in 2017 and will remain at this level until 2019.

For Russia, we expect annual GDP growth to come in at 1.5% in 2017. The projection has been revised upward due to climbing oil prices and stronger growth in 2016 than anticipated. GDP growth will continue at a similar pace also in the coming years, as the economy is already operating near full capacity and necessary structural reforms are not in sight.[4]

1 CESEE-6: private consumption and domestic investment recovery fuels economic growth

In 2016, economic growth in the CESEE-6 region expanded by 3.0% in line with our expectations. The 2016 outcome was noticeably lower compared to 2015 as the predicted slump in investments due to the phasing-out of the EU funding period

[1] *Compiled by Antje Hildebrandt with input from Stephan Barisitz, Elisabeth Beckmann, Sebastian Beer, Martin Feldkircher, Mathias Lahnsteiner, Thomas Reininger, Caroline Stern and Zoltan Walko.*

[2] *Cut-off date for data underlying this outlook: March 27, 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 March 2017 ECB staff macroeconomic projections for the euro area. This implies real annual GDP growth of 1.8% in 2017, 1.7% in 2018 and 1.6% in 2019.*

[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 ten-day average of Brent future prices as calculated on March 9, 2017.*

Table 1

OeNB-BOFIT GDP projections for 2017–2019 in comparison with other forecasts

	Eurostat/ Rosstat	OeNB/BOFIT forecasts (April 2017)			IMF forecasts (April 2017)			wiiw forecasts (March 2017)		
	2016	2017	2018	2019	2017	2018	2019	2017	2018	2019
	Year-on-year growth in %									
CESEE-6	**3.0**	**3.4**	**3.3**	**3.2**	**3.3**	**3.0**	**2.9**	**3.1**	**3.2**	**3.2**
Bulgaria	3.4	2.9	2.7	2.6	2.9	2.7	2.5	2.9	3.1	3.3
Croatia	2.6	3.1	2.7	2.6	2.9	2.6	2.5	2.8	2.9	3.0
Czech Republic	2.3	2.7	2.6	2.6	2.8	2.2	2.3	2.4	2.6	2.3
Hungary	1.8	3.8	3.5	3.0	2.9	3.0	2.6	3.3	3.4	3.1
Poland	2.8	3.4	3.4	3.3	3.4	3.2	3.0	2.9	3.0	3.1
Romania	4.8	4.2	3.8	3.8	4.2	3.4	3.3	4.0	4.0	4.0
Russia	–0.2	1.5	1.5	1.5	1.4	1.4	1.5	1.7	1.7	2.0

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

Note: 2016 figures based on seasonally adjusted data.

clearly left its marks. Overall, we expect GDP growth to pick up to 3.4% in 2017, followed by some moderation over the projection horizon. With annual growth of around 4% in 2017, Hungary and Romania will be the front-runners. Domestic demand – dominated by private consumption and the revival in gross fixed capital formation – continues to be the main growth driver in all CESEE-6 countries.

Further tightening of labor markets

Significant improvements on the CESEE-6 labor markets will strongly impact economic performance over the projection horizon. Since our last forecast, unemployment rates have dropped further. Also vacancy rates have moved up, with the Czech Republic registering the top vacancy rate among all EU countries. The capacity utilization rate in the CESEE-6 region for the first quarter of 2017 increased marginally against the same period a year earlier. Notably, the Czech Republic recorded a utilization rate of almost 85%. Operating with a utilization rate of about 74% in the first quarter of 2017, Croatia managed to increase the rate by almost 2 percentage points compared to the same period in 2016. Against this background, real wages have been accelerating strongly in most CESEE-6 countries, particularly in Hungary and Romania, and are expected to increase even further. These developments are clearly supportive for private consumption growth over the forecast horizon but could also lead to a loss of competitiveness in the exporting sector due to higher unit labor costs.

Monetary policy will remain accommodative but may be challenged by rising inflation

Inflation is expected to gain momentum over the projection horizon driven by demand-pull factors and increasing energy prices. In the CESEE-6 region, inflation is expected to rise in 2017 and to accelerate further over the projection horizon. Only for Bulgaria, we expect inflation to be more subdued. However, for the inflation-targeting countries (the Czech Republic, Hungary, Poland and Romania), the risk that inflation will reach levels above the respective targets is rather limited. For the moment, higher inflation rates in most CESEE-6 countries and constant policy rates actually imply a lowering of real interest rates and hence a more accommodative monetary policy stance. After the Czech National Bank (CNB) abandoned the CZK/EUR exchange rate floor on April 6, 2017, the Czech koruna (CZK) appreciated by 1.5% and moved within a narrow range (CZK 26.6–26.9/ EUR 1) thereafter. Lending activity has shown some improvement in several CESEE-6 countries. Over the projection horizon, positive credit dynamics will also be supported by expectations of rising income and, on the supply side, by the cleaning-up of balance sheets, which will provide more room for bank lending.

Most CESEE-6 countries are on an expansionary fiscal path

Turning to impulses originating from government measures, most CESEE-6 countries can be said to be on an expansionary fiscal path. In view of the upcoming election in 2018, Hungary in particular is implementing several measures that are supportive to consumption growth. Similarly, the fiscal frameworks in Poland and Romania are on an expansionary track. For the Czech Republic and Bulgaria, the picture is rather mixed. Croatia is currently subject to an excessive deficit procedure triggered by the European Commission but aims to leave the excessive deficit procedure already this year; as it needs to implement fiscal consolidation measures under the EU's fiscal rules, it has prepared a tax reform with expected positive effects on consumption.

Domestic demand remains strongest growth driver over projection horizon

In almost all CESEE-6 countries, private consumption growth will pick up in 2017 compared to 2016 as the above-mentioned supportive economic conditions take effect. In Hungary, private consumption growth will accelerate by almost 6% in 2017, predominately lifted by generous public support measures. Only in Romania will there be some moderation of consumption growth, but from an elevated level.

The picture for public consumption growth is more mixed. In Bulgaria, the Czech Republic, and notably in Hungary, growth will become stronger in 2017 than in 2016, whereas in the remaining countries we expect growth to decline. Public consumption will add only marginally to GDP growth in most cases.

Turnaround in investment growth

EU funding strongly impacts investments in the CESEE-6 countries as witnessed in 2016. The CESEE-6 countries with the highest GDP levels – namely the Czech Republic, Hungary and Poland – were most strongly affected. The start of the new EU funding period, accompanied by new projects getting off the ground, will significantly boost investment growth in the CESEE-6 region over the current projection horizon. We expect the annual growth of gross fixed capital formation to turn positive, reaching 4.3% in 2017 and further accelerating to above 5% in 2018 and 2019. The turnaround is projected to be strongest in Hungary, where investment growth will jump from below –15% in 2016 to above 3% in 2017. In Croatia, by contrast, the investment cycle is different: Due to the country's more recent accession to the EU, a different funding period applies. Accordingly, investment growth is expected to remain robust at around 5% over the three-year horizon.

CESEE-6 export growth will remain solid in 2017 and beyond

CESEE-6 export growth will remain solid in 2017 and beyond, in line with strengthening signs of economic recovery in the euro area. However, export dynamics in some CESEE-6 countries will soften in 2017, for example in Croatia, largely because of a base effect, and in Poland, given strong dependence on German trade dynamics and an expected weakening of German import growth.

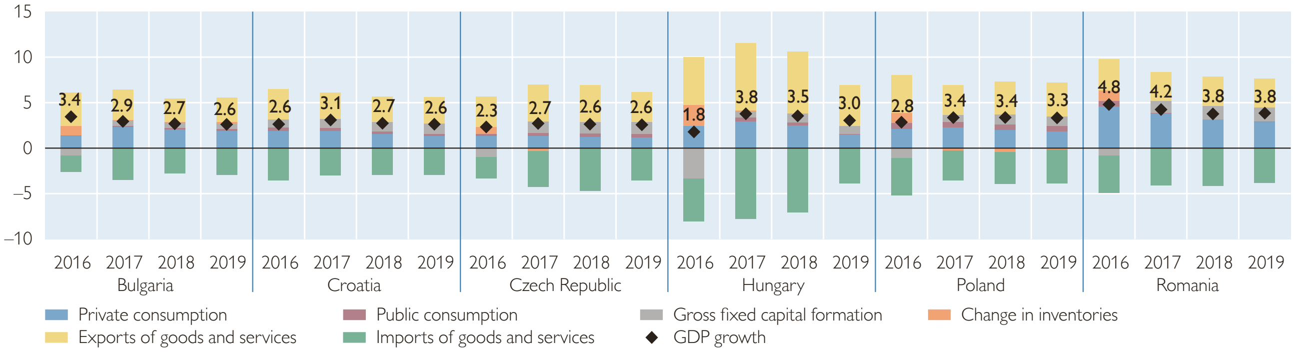
In line with vivid domestic demand, the imports of most CESEE-6 countries are expected to grow robustly over the projection horizon despite some moderation on an aggregate level in 2017 compared to 2016. This moderation is largely driven by lower import growth in Poland and Romania, which, in turn, is mostly attributable to a base effect in the case of Poland and to weaker consumption growth in Romania.

The contribution of net exports is expected to deteriorate in almost all CESEE-6 countries in 2017 compared to 2016 (unchanged in Croatia). Furthermore, all countries will be left with a negative contribution of net exports in 2017, with the exception of the Czech Republic and Poland. However, the contributions will be

Chart 1

GDP and GDP components (realized data for 2016, projections for 2017 to 2019)

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



Source: Eurostat, OeNB.

close to zero. In Hungary and Romania, the negative contribution of net exports will be most pronounced (–0.4 to –0.9 percentage points). For the rest of the projection horizon, we do not see much of a change. Notably, in the Czech Republic, the contribution of net exports will turn negative from 2018 onward. For Hungary, we expect an opposite move into positive territory in 2019, given slowing import demand in line with a softening of private consumption as the effects of discretionary policy measures are fading out.

Downside risks to growth in the CESEE-6 countries have increased over the past months

Like other economic forecasts, our CESEE-6 forecast is overshadowed by incalculable political risks. First, the new U.S. president, who took office in January 2017, favors a shift toward more protectionism and changing trade rules. At this point it remains unclear what the new U.S. trade policy will exactly look like in practice, but all possible measures to support reshoring toward the U.S., such as higher import tariffs, would certainly negatively affect the CESEE-6 region either directly or indirectly through the impact on its main trading partner, the euro area. Second, Brexit is expected to be accompanied by noticeable repercussions for the region as discussed in our previous outlook. One of the strongest effects on the CESEE-6 region will likely emanate from a reduction of the EU budget, the U.K. currently being the second largest net payer. As became drastically clear in 2016, the CESEE-6 countries are strongly dependent on EU funds. Therefore, it can be expected that Brexit will leave its mark on investment activity in the region. However, it should be noted that the effects of Brexit are likely to materialize only in the next EU programming period and hence beyond the present forecast horizon. Another risk for CESEE-6 countries in the context of EU funding might arise from a cut of EU funds if CESEE-6 countries do not comply with refugee allocation plans. Furthermore, Brexit will bring changes in U.K. migration rules. It can be expected that the rules for entering the U.K. labor market will be tightened. There is also the risk that workers have to leave the country. This would impact the CESEE-6 labor markets significantly. For instance, around 800 000 Polish citizens are currently residing in the U.K. Beyond that, remittances going to the region would also be affected.

Aside from political risks, weaker growth in the euro area is considered as a key downside risk to our spring 2017 forecast. Risks to the recovery of euro area growth arise, for instance, from growing banking and sovereign fragilities. Furthermore, confidence in the euro area could be challenged by political populism adversely affecting reforms of the euro area. In a similar vein, a deterioration of global growth and, accordingly, global trade would negatively affect the CESEE-6 countries.

Further external risks stem from geopolitical tensions in neighboring countries but also from unresolved conflicts in the Middle East. While such conflicts would be beneficial for tourist destinations in Bulgaria and in particular in Croatia, overall, unresolved conflicts clearly are dragging down the economic sentiment of households and investors in the CESEE-6 region and its main trading partner countries.

Inflationary pressure is noticeably rising in the CESEE-6 countries supported by rising wages and oil prices. This might lead to a less accommodative monetary policy stance in the CESEE-6 region. For the moment, we expect monetary policy to tighten only toward the end of the forecast horizon (if at all), which could drag down credit. In the short run, however, lower real interest rates due to higher inflation rates are considered an upside risk. Furthermore, the abolition of the exchange rate floor by the CNB could erode the price competitiveness of the Czech economy. Higher wage pressure might also lead to higher unit labor costs and a loss of external competitiveness over the forecast horizon, which could negatively affect export growth in the CESEE-6 countries.

Increasing political populism arising in the CESEE-6 region might possibly foster a wait-and-see attitude among domestic and foreign investors, which presents some risk to our growth outlook. However, increasing political populism can also be seen as an upside risk to CESEE-6 growth, at least in the short term, as it is commonly accompanied by rising fiscal expenditures to gain support from the population. Further upside risks are connected with stronger-than-expected growth in the euro area, which would certainly be beneficial to CESEE-6 growth.

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

Bulgaria: slightly reduced but still robust GDP growth

The Bulgarian economy performed surprisingly well in 2016 with GDP growth of 3.4%. For the next years, we expect GDP growth to slow down somewhat because of slightly reduced exports; yet, economic momentum will remain robust as private consumption and investments will support GDP growth.

Grounded on a continuously positive employment environment, increasing wages and positive consumer sentiment, we expect private consumption to be the main determinant of economic growth. The unemployment rate hit its lowest level since 2009, falling to 7.7% at the end of 2016. At the same time, gross real wages grew by 9.1%. As regards government consumption, we expect that the new government in place after early parliamentary elections will stick to the budget consolidation path that has already been set. Therefore, we still expect a limited contribution to GDP growth from public consumption.

Investments made a negative contribution to GDP growth of –0.8 percentage points in 2016. However, we expect that EU fund absorption for the 2014–2020 EU programming period will accelerate swiftly and bring the growth contribution of investments into positive territory. Moreover, we see improvements in economic sentiment and positive signs in the banking sector, with decreasing nonperforming loan ratios and slightly positive loan growth rates. Consequently, we also expect private investments to make a somewhat positive contribution to GDP growth.

However, investors may assume a wait-and-see position in the first half of 2017 until the new government is formed following parliamentary elections.

Exports performed exceptionally well in 2016 also due to a significant increase in tourism revenues. In combination with higher imports due to strong private consumption, net exports will contribute increasingly negatively to economic growth over the projection horizon.

Croatia: recovery stronger than expected

Croatia's GDP growth in 2016 again exceeded expectations and came in at 2.6%. As a consequence, we have significantly revised up our GDP forecast for 2017, to 3.1% (compared to our September forecast of 2.3%). After 2017, the recovery is projected to somewhat decelerate in 2018 and 2019 given a slight moderation in private consumption growth. Yet, all components of aggregate demand are expected to contribute positively to growth over the projection horizon, public consumption only marginally so.

The surprisingly strong recovery of private consumption, which was driven by improvements in the labor market and higher salaries in 2016, is set to continue in 2017. Indicators of consumer confidence show a clear increase in confidence. This year consumption will benefit from tax cuts as well as further improvements in the labor market and expand by 3.3%. This effect will moderate over the projection horizon. Public consumption will continue to grow but decelerate. Croatia is likely to exit the EU's excessive deficit procedure in 2017 provided that there are no major disruptions related to the debt-crisis of the company Agrokor as the budget deficit has been significantly reduced and is expected to come in at 1.8% of GDP for 2016. The impact of the tax reforms will make a further reduction of the deficit unlikely in 2017, however, the boost to consumption will likely offset the impact on the budget. Overall, our projection assumes further gradual consolidation, which will constrain public consumption going forward.

Gross fixed capital formation saw a strong improvement in 2016. We expect this improvement to continue over the forecast horizon. The average surplus liquidity grew to a record high of HRK 16.4 billion in January 2017 from HRK 9.2 billion in December 2016. Strong liquidity boosted by expansionary monetary policy will bolster investment. Corporate investment will be supported by an expansion of credit, which was much more pronounced in 2016 than in previous years. Business confidence indicators point toward continued optimism at the beginning of 2017. An improved absorption of EU funds will further sustain gross fixed capital formation.

After a relatively weak third quarter, total exports increased significantly at the end of 2016 due to growth in exports of refined oil and petroleum as well as medical and pharmaceutical products. Geopolitical tensions in other Mediterranean tourist regions will likely continue to support tourism exports in Croatia. However, export market shares are likely to stabilize now, leading export growth to moderate over the forecast horizon. The growth in private consumption will reinforce strong import growth. Taken together, we expect a negative contribution of net exports to growth over the projection horizon.

Downside risks to our GDP forecast stem from the debt crisis of the company Agrokor, the largest Croatian company, which is now operating under a state-appointed administrator.

Czech Republic: domestic demand drives solid expansion

The Czech Republic will remain on a solid growth trajectory over the coming years. Real GDP growth is forecast to rise to 2.7% in 2017 and stabilize at 2.6% in

2018 and 2019, largely on the back of stable domestic demand. With inflation close to target, the CNB, on April 6, abandoned the CZK/EUR exchange rate floor that had been in place since 2013. In the medium term, this could potentially impair the price competitiveness of the exporting sector and further underscore the importance of domestic spending. We expect the growth contribution of net exports to turn negative, starting in 2018.

Growing at an average rate of 2.6% over the forecast horizon, private consumption remains a key driver of the Czech Republic's economic activity. A tightening labor market has supported positive wage dynamics in the past and will further strengthen employees' bargaining power in the future, notwithstanding the expected slowdown in employment growth. The positive impact on disposable income is increasingly countervailed by domestic price developments, however. According to the CNB's latest prediction, inflation will peak at slightly below 3% in the third quarter of 2017 and then return to target (a rate of 2%). We project private consumption growth to reach almost 3% in 2017 and around 2.5% in 2018 and 2019 each. Growth in government spending is expected to accelerate over the forecast horizon (to 2.3% in 2019), cushioning the decline in private spending somewhat.

Amid vivid price dynamics, the CNB's exchange rate commitment has come to an end. The swift expansion of foreign reserves indicated that investors expected an appreciation of the domestic currency, which amounted to 1.5% at the day after the abolishment of the floor. Further appreciation would weaken the growth benefits the Czech Republic has enjoyed through international trade in the past. We expect exports to increase by 6.8% and imports by 7.2% in 2017. Due to the excess in the level of exports over imports, the implied growth contribution will still be positive in 2017. However, our forecast indicates a subsequent contraction in the volume of net exports, which will dampen GDP growth by 0.2 percentage points in 2018 and by 0.3% in 2019.

Dynamics in gross fixed capital formation are expected to counterbalance, to some extent, the decline in net exports. In fact, these GDP components are directly related: an important share of projected gross fixed capital formation, which is foreseen to increase by around 5% in 2017 and by 4.8% thereafter, will be foreign-sourced. Despite a weakening trade balance, overall GDP growth will thus remain largely unchanged over the forecast horizon. The expansion of gross fixed capital formation will contribute to overall GDP growth at an annual rate of 1.2 percentage points, on average, throughout 2019.

Hungary: GDP growth to accelerate sharply in 2017

In Hungary, GDP growth in 2016 fell to 1.8% from 3.1% in 2015, in line with our projection from autumn 2016. We expect this trend to accelerate in 2017 mainly due to recently announced government measures. Along with a revival of investments, these measures will lead to a strong acceleration of output growth to 3.8%. According to our forecast, growth should gradually moderate in 2018 and 2019 with the fading-out of growth impulses generated by discretionary policy measures.

We expect private consumption to further accelerate in the wake of the sharp increase in the minimum wage (the effect of which on labor costs was mitigated by cuts in employers' social contributions). This increase should feed through into wage growth more generally, given rising labor shortages across the economy. A further round of substantial wage increases in various areas of the public sector, selective VAT rate cuts and the continued broadening of family tax benefits are expected to additionally boost households' income. All-time high consumer sentiment and the expected revival of lending to households should also be ingredients of a consumption boom. However, we expect consumption growth to decelerate somewhat in 2018 (and more so in 2019) as wage and employment growth moderate and fiscal stimuli run out.

Given carry-over effects of the government's spending spree of December 2016 and the envisaged widening of the budget deficit in 2017, public consumption is likely to remain supportive to growth in 2017 and 2018, before slowing substantially in 2019.

We expect investment activity to pick up from 2017 as public sector investments start to grow from their very weak 2016 level. The inflow of EU funds is expected to accelerate and the government has indicated that it may frontload the use of funds in the current programming period. In addition, a further increase in the volume of housing subsidies should aid housing investments. The cut in the corporate income tax rate may also attract new companies and investments, especially given relatively high, albeit decreasing, capacity utilization rates in industry. Finally, lending to the corporate sector moved into positive territory in 2016, which should also support investment activity.

Stronger demand from EU countries should aid export growth in 2017. However, since rapid domestic demand growth and the strong import-export nexus will boost imports, we expect net real exports to become a drag on the overall growth rate in 2017. From 2018 onward, both export growth and import growth are likely to slow along with weakening external conditions and slowing domestic demand, turning the contribution of net real exports into a small plus by 2019.

Poland: rebound of investment leads to rebalancing of growth structure

In Poland, GDP growth will accelerate strongly, to 3.4% in 2017, and will maintain this pace in 2018. This acceleration will be fueled by stronger private consumption growth as well as a rebound of gross fixed capital formation. While the contribution of domestic demand to GDP growth will substantially increase in 2017, the contribution of exports will decline temporarily to slightly less than the domestic demand contribution, but gain in importance in 2018.

Private consumption growth will accelerate to 3.9% in 2017 as a result of the steep rise in households' real disposable income on the back of strong wage and gradually declining employment growth, and the impact of the large increase in child benefits, in particular for lower-income households. In addition, improved consumer sentiment (related to subsiding fears of unemployment according to a survey conducted by the Central Statistical Office of Poland) and higher consumer loan growth will underpin private consumption expenditure. The higher level of child benefits in 2017 represents an adverse base effect for 2018 that will contribute to a moderation of private consumption growth. Public consumption will post lower growth in 2017, reflecting budgetary plans, but show some growth acceleration thereafter.

Overall, we expect growth in gross fixed capital formation to rebound to 4.0% in 2017 and 5.5% in 2018. Private corporate fixed investment will benefit from stronger domestic consumption demand and solid foreign demand, the relatively high level of capacity utilization and the favorable financing situation with respect to both own funds (profitability) and external funds (low interest rates, no tightening of lending conditions). Moreover, because of the adverse impact of the bank tax levied since 2016, loan supply appears to be weaker than previously expected. Furthermore, the uncertainty with respect to the domestic economic policy stance seems to be less influential. Investment by both public enterprises and the public sector itself will strongly rebound as a result of the increased absorption of funds under the new EU medium-term budget. Housing investment will continue to expand, as income growth and the state-subsidized housing program for young people remain supportive factors, but further tightening of supervisory regulations will dent the growth of mortgage investment. The inventory buildup is expected to decline from its peak in 2016, so that its contribution will be moderately negative in 2017 and 2018.

Growth of exports of goods and services will moderate in 2017 from the fast pace observed in 2016, given the assumed softening of German import demand and the anticipation of a further re-appreciation of the złoty. In parallel to German import demand, export growth is expected to accelerate modestly in 2018. Solid export growth, rebounding investment and accelerating consumption growth will keep the growth rate of imports of goods and services moderately above that of exports. Thus, the contribution of net exports to GDP growth will remain close to zero in 2017 and 2018.

Romania: decelerating but still relatively high growth

After reaching 4.8% in 2016, economic growth in Romania is expected to further decelerate over the forecast horizon. At the same time, we revise our projection upward, in particular for 2017, as additional stimulating fiscal and income policy measures have been taken since our last forecast. We now expect GDP growth to remain slightly above 4% in 2017 and to fall slightly below 4% in 2018 and 2019. GDP growth will be mainly driven by domestic demand, with private consumption growth slowing down from very high levels and gross fixed capital formation accelerating from still suppressed levels. In sum, domestic demand growth will decelerate somewhat over the forecast horizon.

On top of already planned measures such as the further decrease of the standard VAT to 19% from 20% effective from January 2017, additional steps have been taken that will ensure ample growth of real disposable income, which will in turn support private consumption: a further hike of the minimum wage, tax exemptions for pension income as well as pension and public sector wage increases. Tightening labor market conditions, as evidenced by a markedly falling unemployment rate, will support wage growth in the private sector. The upward trend in consumer loans represents a further supporting factor.

The improved lending capacities of banks (following the cleanup of bank balance sheets resulting in lower NPL ratios) also have the potential to contribute positively to the growth of gross fixed capital formation. Moreover, the inflow of foreign direct investments rose in 2016 and, as further investments are in the pipeline, in particular in the automotive industry, this trend might continue. Public investment will steadily recover, as the implementation of projects financed by EU funds under the 2014–2020 budgetary framework speeds up.

We expect continued robust export growth with a slight deceleration over the forecast horizon due to unfavorable unit labor cost developments. Alongside slowing domestic demand, import growth will also come down gradually from currently very high levels. The contribution of net exports will remain negative.

Downside risks to our forecast mainly emanate from the capacity to absorb EU funds and from fiscal policy. The IMF and the European Commission project the deficit to exceed the government's target of 3% by a considerable margin in 2017. Hence, possible budget revisions to temper the deficit during the fiscal year could weigh on growth.

3 Russia: reaching for modest growth

Our forecast for Russian GDP growth has been revised upward to 1.5% for 2017 as oil prices climbed considerably last autumn and realized growth in 2016 outperformed our growth projection of October 2016 by 0.8 percentage points – despite a slightly negative GDP growth rate of –0.2% per annum. Growth is expected to continue at a similar pace in the coming years, as the economy is already operating near full capacity and necessary structural reforms are not in sight.

This year, Russia's growth should be supported by higher oil prices. The markets currently expect oil prices to remain in the range of USD 50 to USD 55 until the end of 2019, implying that the average oil price this year will be about 30% higher than in 2016. In addition, preliminary figures show Russia's GDP shrank by just 0.2% last year, which was much less than anticipated based on the GDP figures for the first to third quarters of 2016. The estimate of GDP contraction in 2015 was also reduced. These revisions have surprised many observers, but Russia's recovery appears to have been faster than predicted, which also supports slightly higher growth this year.

Private consumption this year is finally expected to show a gradual recovery after contracting by a total of 14% over the past two years. Real incomes have begun to rise in recent months and consumer confidence has improved, supporting retail sales. Even so, the uncertain economic outlook restrains consumption growth and recovery is expected to be slow, but to continue in 2018–2019. Fixed investment is also expected to grow slightly in 2017 after having contracted for three years. Industrial production capacity is nearing full utilization and indicators of business confidence have improved. Investment demand is, however, still restricted by the weak growth outlook and the poor business environment, rendering the recovery of capital formation modest.

The impact of public sector spending on economic growth continues to wane. The approved 2017–2019 budget framework schedules only minor nominal increases in public sector spending. Given that inflation should amount to some 4% to 5%, as the Bank of Russia (CBR) expects to reach its target of 4% by late 2017, public sector spending and purchasing power are expected to contract in real terms. The CBR plans to continue its moderately tight monetary policy stance, which should help anchor inflation expectations and support economic stability.

The volume of Russian exports grew by over 2% last year on the back of high oil production, a good grain harvest and some support from a weak ruble in the first half of 2016. Export growth should slow as these effects fade. In contrast, the volume of imports, which has dropped by 35% over the past three years, should bounce back this year and continue to expand in 2018–2019. Imports are supported by the gradual recovery in domestic demand and the strong appreciation of the Russian ruble in recent months. If the ruble's real effective exchange rate remains at its February level until the end of 2017, the Russian currency will, on average, be about 25% stronger than in 2016. Import recovery is, however, hampered to some extent by the import restrictions imposed on several food items and public procurement.

Risks to the forecast for Russia

The biggest risk for the Russian growth outlook is the oil price. A higher oil price than projected would raise revenues, incomes and growth, while upward pressure on the Russian ruble could contribute to increasing import volumes. An oil price dive would quickly weaken the ruble, push up inflation and reduce real incomes and growth. If the oil price substantially weakens against its level of early 2017 (the average oil price over the period January–February 2017 was USD 53.3), this could also impede or defer Russia's return to economic expansion. Import volumes would again come under pressure. Furthermore – disregarding the oil price – imports could recover more strongly than expected from the slump, which would weigh on GDP growth. Geopolitical tensions, which may intensify or ease, are considered as another risk factor.

On the upside, the approaching presidential elections in March 2018 could raise pressure to increase public spending. This could temporarily support growth, but heighten Russia's fiscal vulnerabilities over the longer term.