Outlook for Selected CESEE Countries: Renewed Slowdown Followed by Modest Recovery\textsuperscript{1,2}

\textbf{1 CESEE-7: Weak Domestic and External Demand Is Denting Growth in 2012, a Gradual Pickup Is Expected for 2013 and 2014}

Weak euro area growth in the first half of 2012 and dim prospects for the remainder of the year will deeply affect the CESEE-7 region. After two years of moderately strong growth between 2\% and 3\%, GDP in the region will expand by only 1.2\% in 2012. The growth contribution of domestic demand is decreasing in all countries (apart from Bulgaria), and the contribution of net exports is shrinking in the Czech Republic, Hungary, Romania and Bulgaria (turning negative in the latter) but rising in Poland. Growth is projected to pick up slightly to 2.2\% in 2013 and 2.8\% in 2014, backed by a moderate revival of domestic demand. Domestic demand will, however, still remain constrained by ongoing consolidation plans and weak labor markets. The contribution of net exports will diminish further as a result of anemic growth in the euro area.

The projections for the CESEE-7 countries continue to hinge strongly on growth developments in the euro area. Based on simulation results undertaken in 2011, a further reduction of euro area growth by ½ percentage point in both 2012

\begin{table}[h]
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\begin{tabular}{|l|l|l|l|l|l|l|l|l|}
\hline
 & \multicolumn{3}{c|}{GDP} & \multicolumn{4}{c|}{Imports} \\
\hline
Year-on-year growth in \% & & & & & & & & \\
CESEE-7 & 3.1 & 1.2 & 2.2 & 2.8 & 7.7 & 1.0 & 4.1 & 5.9 \\
Bulgaria & 1.8 & 0.8 & 1.6 & 2.1 & 9.0 & 3.8 & 5.1 & 6.3 \\
Czech Republic & 1.7 & –0.7 & 1.5 & 2.3 & 7.5 & 2.7 & 5.4 & 6.3 \\
Hungary & 1.7 & –1.2 & 0.5 & 1.1 & 6.3 & 0.5 & 2.1 & 3.3 \\
Poland & 4.3 & 2.5 & 2.8 & 3.4 & 5.6 & –0.8 & 3.9 & 7.5 \\
Romania & 2.1 & 0.8 & 2.4 & 2.7 & 11.4 & 1.1 & 3.1 & 3.5 \\
Croatia & –0.2 & –1.8 & 0.5 & 1.4 & 1.2 & –1.5 & 1.1 & 2.9 \\
Russia & 4.3 & 3.7 & 3.7 & 3.4 & 20.0 & 10.0 & 5.0 & 5.0 \\
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\end{tabular}
\caption{GDP and Import Projections for 2012–14}
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Source: OeNB-BOFIT October 2012 projections, Eurostat, Rosstat.

Note: Bulgaria, the Czech Republic, Hungary, Latvia, Lithuania, Poland and Romania (\textsuperscript{3}CESEE-7); seasonally adjusted data for 2011.

\textsuperscript{3} Compiled by Julia Wörz with input from Stephan Barisitz, Martin Feldkircher, Mariya Hake, Mathias Lahnsteiner, Thomas Reininger, Katharina Steiner, Jarmila Urvová and Zoltan Walko.

\textsuperscript{2} Cutoff date for these projections: October 4, 2012. The OeNB and the Bank of Finland Institute for Economies in Transition (BOFIT) compile semiannual projections of economic developments in selected CESEE countries (Bulgaria, the Czech Republic, Hungary, Poland, Romania, Russia and Croatia). The projections for Russia are prepared by the Bank of Finland based on a SVAR model. While not explicitly covered, Latvia and Lithuania are included in the CESEE-7 aggregate based on the IMF World Economic Outlook (WEO) of October 2011. The projections draw on a broad range of information, including country-specific time series models for Bulgaria, Croatia, the Czech Republic, Hungary, Poland and Romania (for details on the OeNB’s FORECEE model, see Crespo Cuervosma et al. 2009, Simple but Effective: The OeNB’s Forecasting Model for Selected CESEE Countries. In: Focus on European Economic Integration Q4/09. 84–95).

\textsuperscript{2} The CESEE EU Member States that have not yet introduced the euro: Bulgaria, the Czech Republic, Hungary, Latvia, Lithuania, Poland and Romania.
and 2013 (compared with our baseline) would most likely dampen CESEE-7 growth to about 1% in 2012 and slightly below 2% in 2013.

Growth dynamics will remain uneven within the region over the forecasting horizon. The two Baltic states and Poland will continue to outperform the CESEE-7 region, followed by Romania from 2013 onward. GDP in the Czech Republic and Hungary will contract in 2012. In 2013, the Czech Republic and Bulgaria are expected to show a pickup in GDP growth to about 1.5%, and to slightly above 2% in 2014. Hungary will continue to lag behind and is projected to show only a weak recovery from −1.2% this year to 0.5% in 2013 and 1.1% in 2014. GDP growth will accelerate noticeably in all countries in 2013 (apart from Latvia, where growth will decelerate from 4.5% to 3.5% according to the IMF forecast) and become positive throughout the region. For 2014 we expect a flattening of growth dynamics, with the region growing by 2.8% that year. Even though growth rates in CESEE-7 will remain well below those recorded before the 2009 crisis, all countries in the region, apart from Hungary and Latvia, will have reached their precrisis GDP levels by 2014.

Turning to the CESEE-5 in greater detail, external as well as internal factors will dampen GDP growth considerably in 2012. Compared with the first half of 2012, the contribution of domestic demand to growth is expected to decline in the second half of the year in all countries with the exception of the Czech Republic, where the negative contribution will diminish. Given a gradual improvement in net exports, which has been primarily driven by stagnating or even falling import demand rather than by (still moderate) export dynamics, we expect the trough in growth dynamics to have been reached in mid-2012 (see chart 1). However, growth will not pick up before the beginning of 2013.

Lackluster external demand as implied by the current assumptions of a slight recession in the euro area in 2012, coupled with domestic factors that hold back growth in the region (e.g. ongoing consolidation efforts, tight credit and slack labor markets and country-specific domestic factors) will halve GDP growth in most countries as compared with 2011. In the Czech Republic and Hungary, GDP will even contract. Fiscal consolidation will dampen domestic demand in all countries. In Hungary, we also expect some negative influence on private consumption through the income tax reform; similarly, domestic demand will be affected negatively by tax increases in the Czech Republic. Private consumption will generally be dampened by falling real wages, deteriorating business and consumer sentiment and tight credit conditions in the region. Low credit growth is mainly seen as a result of low demand; in Hungary, supply-side factors also pose considerable constraints. The severe drought this summer will primarily affect Bulgaria and Romania, where agriculture still plays an important role. In Hungary, we expect some negative indirect influence through higher food prices during the remainder of the year.

Given historically low levels of capacity utilization in most countries under review, no strong impetus is expected from gross fixed capital formation (GFCF) in 2012. However, prospective developments across countries are again rather

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4 CESEE-5: Bulgaria, the Czech Republic, Hungary, Poland and Romania. Because these are the CESEE EU Member States for which we carry out our model-based forecasting, we present developments in this subregion in greater detail, both in a comparative perspective (in this section) and in country-by-country accounts in the subsequent section.
diverse: We expect GFCF to stagnate in Bulgaria and the Czech Republic, to fall further in Hungary and to expand at a lower rate than in 2011 in Poland. Romania is the only country that will show a pronounced rise in gross fixed capital formation in 2012, given the strong performance in the first half of the year. EU-cofinanced investment will play an important role in Romania and presumably also in Bulgaria. We expect the absorption of funds to increase significantly in both countries. Absorption of EU funds is low in Hungary, where such investment projects represent the only stable source of investments. In the Czech Republic, recently revealed problems concerning the use of EU funds will temporarily have a negative influence on absorption possibilities. In Poland, the 2012 European Football Championship kept up gross fixed capital formation growth in the first part of the year, but more recently a base effect has begun to kick in and will lead to a deceleration in 2013. Inventory restocking will also add to growth. In the Czech Republic, inventory restocking will continue to be subdued for lack of investments.

Reflecting our external assumption about euro area growth in 2012, export and import growth rates are expected to fall markedly in 2012. The contribution of net exports is forecast to diminish in all countries except Poland, where imports are receding and slowing export growth remains in positive territory.

Growth rates will only rise again from the beginning of 2013, when domestic demand will start to slowly pick up and contribute positively to the growth rate of 2.2% for the CESEE-7 region as a whole. Growth drivers rest predominantly on domestic demand, in particular on private consumption. With no impetus from consumption or investments, Hungary will be the only country to rely practically exclusively on external demand, at least throughout 2013. Owing to the weak growth rate assumed for euro area imports in 2013 and 2014, exports and imports will recover modestly over the projection horizon. However, their joint growth contribution will decline further, turning more negative in Bulgaria and Romania and falling to zero in Poland in 2014.
Those currencies in the region that are floating are expected to continue their moderate nominal appreciation trend over the projection horizon. For Hungary, the conclusion of an agreement with the IMF will be crucial in this respect, as the forint is likely to weaken in the absence of such an arrangement.

The risks to this outlook continue to be tilted downward and result mainly from various spillover risks from the euro area crisis countries. For instance, direct spillovers from the euro area periphery to the CESEE-5 may occur through both the financial and the real channel. Alternatively, possible spillovers from the euro area periphery to the core may affect the CESEE-5 countries negatively through the trade channel. Finally, the risk of a turn in investor confidence remains, should the euro area crisis deepen, even if this does not seem imminent at the moment. Recent institutional steps within the euro area and improvements in the regulatory framework for the banking sector can be seen to reduce this risk. In addition to potential strains originating in the euro area, further negative repercussions could arise from the global economy. The possibility of a sharp fiscal correction in the U.S.A. (“fiscal cliff”) and the current slowdown of the recovery in Japan may dampen emerging countries’ growth on a global scale and thus create an environment for prolonged anemic growth in Europe.

On the other hand, swift political decisions leading toward the implementation of a European banking union, the avoidance of the fiscal cliff in the U.S.A. and a thus more favorable global economic development would pose upside risks to our projections.

2 Bulgaria, the Czech Republic, Hungary, Poland and Romania – Developments Continue to Diverge

For 2012 and 2013, we forecast Bulgarian GDP to expand by 0.8% and 1.6%, respectively, on the back of recovering domestic demand. The downward revision in our forecast for 2012 stems from the meager recovery of investment activity (despite the substantial boost of changes in inventories during the first half of the year) and a slower-than-expected export performance. We expect fixed investment growth to enter positive territory in 2012 and to further accelerate in 2013 as a result of a base effect, but also on account of public infrastructure projects (cofinanced by EU funds) and slowly reviving credit growth and low interest rates. An additional stimulus could come from a better absorption of EU funds if the government’s efforts to improve Bulgaria’s low absorption rate are successful.

The fiscal restriction measures implemented by the Bulgarian government in 2011 (i.e. a freeze of public wages and lower public investment spending, aimed at lowering the public deficit to below 2% of GDP in 2012 and 2013) will keep public consumption growth negative in 2012. In contrast, public consumption may stagnate or even contribute positively in the parliamentary election year 2013. The recovery of private consumption in 2012 is still meager due to poor labor market conditions and weak consumer sentiment. However, the recent rise in public wages as well as the planned increase of minimum wages and pensions at the beginning of 2013 will provide a positive impetus. As a result of improved private consumption, import growth will outpace export growth, but both will slow down in 2012 compared with 2011. Provided that future developments of unit labor costs in the manufacturing sector do not dampen export growth, both exports and imports will pick up again in 2013 in line with the gradual revival of
external demand. From 2012 onward, the contribution of net exports is projected to turn negative again.

In 2014, economic growth is expected to accelerate to 2.1%, with the composition of growth remaining broadly unchanged from 2013. On the back of the labor market recovery and increased EU funding, as well as the deferral of investments over the past few years, especially in the business sector, domestic demand will remain the main growth driver. Due to base effects, the growth of public consumption will be negative. Despite a modest improvement of external demand, the negative contribution of net exports will widen, as the moderate growth of domestic demand will keep imports comparatively high.

We revise our March forecast of Czech annual GDP growth for 2012 down to –0.7% from 0.3%. This revision is due to a larger-than-expected decline in all domestic demand components in the first half of 2012, most notably household consumption. As the factors affecting this decline – i.e. weak consumer sentiment and a contractionary fiscal stance – are currently even more pronounced than in March, we do not expect a reversal of this trend for the remainder of the year. For 2013 and 2014, we forecast a rebound in economic activity of 1.5% and 2.3%, respectively.

In 2012, net exports will represent the only positive growth contribution despite a substantially lower pace of both import (2.7%) and export (4.7%) growth than in the last two years. With growth in main export markets gradually reviving, exports will gain momentum in 2013 and 2014.

As the Czech Republic remains subject to the Excessive Deficit Procedure, fiscal consolidation will continue into 2013, weighing on public consumption and investment. In addition to fiscal austerity, a sluggish labor market and general uncertainty about further economic development – currently reflected in almost record-low levels of consumer confidence indicators and increasing saving rates – will continue to drag household consumption down. This trend will not start to reverse until 2013, with higher growth in 2014, which will push imports up as well.

A bank lending survey recently embarked on by the Czech National Bank revealed that banks expect both credit supply conditions and credit demand of nonfinancial corporations to worsen. Furthermore, declining demand for loans for financing fixed investment was observed, whereas demand for loans taken out to finance working capital increased. This, together with the slowdown in both external and domestic demand as well as cutbacks in public investments, will drive down gross fixed capital formation in 2012. In 2013 and 2014, along with a slowly reviving external environment and increased household consumption, fixed investment will enter positive territory.

Reflecting these domestic and external economic developments, the Czech koruna is expected to slightly appreciate in nominal terms against the euro over the next two and a half years, even though in a shorter term, temporary depreciation is likely.

Apart from external factors, growing political instability, which could potentially result in the government’s failure to meet its consolidation targets, poses a downside risk to our projection through a further increase in uncertainty.

We expect Hungarian GDP to contract by 1.2% in 2012 and to expand only by a minimal 0.5% in 2013. A somewhat stronger expansion of 1.1% is expected for 2014. The downward revision of our forecast for 2012 was motivated by a weaker-
than-originally-expected export performance, the unabated decline in investment activity and substantial destocking during the first half of the year. Private consumption has been dragged down by poor labor market conditions, decreasing net real wages, tight credit conditions and weak consumer sentiment, and has contracted despite the reduction of the personal income tax burden from the beginning of 2012 and the policy measures implemented to lower households’ foreign currency debt service obligations, such as early repayment of foreign currency mortgage loans and a temporary exchange rate fixation scheme for foreign currency mortgage loans.

Net real exports are expected to remain the sole engine for growth both in 2012 and 2013. In both years, external demand and domestic import demand will be weaker than previously expected. While exports should benefit from the recovery of external conditions from 2013 onward, the recovery of domestic demand and appreciation of the real effective exchange rate will likely lead to a somewhat smaller contribution of net real exports.

A recovery of private consumption is expected for 2014 on the back of an improving labor market, modest increases in real wages and the gradual easing of tight lending conditions. Government consumption is expected to be adversely affected by the government’s fiscal consolidation and public sector rationalization efforts throughout 2013, while it may stagnate in the election year 2014. Investment activity is likely to remain constrained by the weak domestic and international cyclical outlook, tight credit conditions and frequent changes in the business environment. Nevertheless, an improvement in external demand and credit conditions, increased funding from the EU and the postponement of investments over the past few years are likely to start supporting investment activity in 2014.

In Poland, we forecast GDP growth to reach 2.5% in 2012, after a substantial slowdown from the previous year’s growth rate of 4.3%, and then to slightly accelerate to 2.8% in 2013 and 3.4% in 2014. In 2012, economic recession in the euro area, coupled with stagnating euro area imports, will lead to a slowdown of Polish exports. However, sizeable improvements in external price competitiveness (resulting from currency depreciations and reductions in manufacturing unit labor costs) in previous years will cushion the impact of stagnating foreign demand, some złoty appreciation against the euro during 2012 notwithstanding. Turning to domestic demand, the fading-out of public nonresidential construction in connection with the 2012 European Football Championship implies a negative base effect in the second half of 2012 (and in the first half of 2013) that will dampen GFCF growth. Mortgage lending for households’ residential building continues to be a supporting factor for gross fixed capital formation, but considerably less so than before. Weak foreign demand will dampen both fixed investment and the buildup of inventories. As a result, the contribution of total capital formation to growth in 2012 will be even slightly negative, after it had amounted to about 2 percentage points in 2011. At the same time, slower employment growth and very small real wage growth as well as fiscal consolidation are dampening private consumption growth. As a result of the strong export-import link and weaker domestic demand growth, imports will probably contract slightly, leading to a doubling of net exports’ positive contribution to GDP growth.

In 2013, the slight pickup of GDP growth to 2.8% will be driven primarily by the recovery of euro area demand. As a result of increased competitiveness, export
growth will accelerate markedly. By contrast, GFCF growth will initially continue to suffer from the negative base effect mentioned earlier. It will, however, pick up speed in the second half of the year, on the back of revived foreign demand, further EU-cofinanced investments, strong liquidity positions and sufficient credit supply, which will in particular stimulate private corporate investment. In parallel, the decrease in inventory buildup will come to an end. However, consumption growth will hardly speed up, given further fiscal consolidation and the delay in the effects from foreign demand and fixed investment. Previously pent-up demand, the strong export-import link and the change in the inventory cycle linked to the improved outlook will increase imports to such an extent that net exports’ positive contribution to growth will moderately decline despite substantially accelerated export growth.

In Romania, quarter-on-quarter GDP growth accelerated to 0.5% in the second quarter of 2012 from 0.1% in the first quarter. However, this year’s severe drought will adversely impact agricultural output, the negative contribution being more sizeable than expected in our March 2012 projection. Against this background and given the weak external environment, the third quarter is likely to show a contraction in quarter-on-quarter terms, thus pushing GDP growth down to 0.8% for 2012 as a whole. Growth will revive in 2013 and 2014 to 2.4% and 2.7%, respectively.

With growth having been driven by private consumption and gross fixed capital formation in the first half of 2012, we expect the growth structure to remain broadly unchanged in the second half of 2012 and in 2013. Private consumption will be supported by recent and anticipated real wage increases. Public sector wages were hiked by 8% in June and will be increased by a further 7.4% in December. In summer, retail sales continued to grow despite weakening consumer sentiment. We also expect GFCF to continue its recovery. However, construction activity weakened in June and July, which may point to a deceleration of GFCF growth. The outcome of the parliamentary elections in December will be crucial for the further trajectory of economic developments. If political instability continues, this could result in a depreciation of the leu, which would negatively affect investor sentiment and investments as well as private consumption through the confidence channel and through balance sheet effects. Over the projection horizon, Romania will, however, increase its access to EU funds, which will have a positive impact on investments despite persistently tight credit conditions.

In the short term, weak external demand and unfavorable developments of unit labor costs in the manufacturing sector will impair export growth. In line with the gradual and modest revival of external demand over the projection horizon, we expect exports to pick up only slightly in the latter half of 2013. Due to the continued recovery of domestic demand, imports will show somewhat stronger growth but still remain weak in a historical perspective. In the coming years, the contribution of net exports is unlikely to become positive, as net FDI inflows have been low and hardly any export capacities have been built up in recent years.

3 Croatia: Sagging Domestic Demand Continues to Depress Economic Activity

In the second half of 2012, economic conditions in Croatia are expected to remain depressed in view of poor labor market conditions, the ongoing need to restructure
households’ and companies’ finances and weak economic sentiment. Following stagnation in 2011, we expect GDP to decline by 1.8% in 2012. In particular, private consumption will continue to recede due to persistent structural problems. Simultaneously, the necessary consolidation of public finances will put a strain on public consumption. Given the gloomy economic environment, investments will further decline. In combination with strongly falling private consumption, this will also bring down imports. As exports will decline more slowly than imports, the contribution of net exports to GDP growth will remain slightly positive in 2012.

In 2013, GDP growth is expected to remain subdued at 0.5% owing to depressed economic activity at the beginning of the year, followed by some positive signs of economic easing thereafter. Private consumption will remain weak due to ongoing structural problems, but will slightly pick up in the course of 2013 thanks to base effects due to the VAT hike and positive consumer sentiment related to EU accession on July 1, 2013. There will be no leeway for public consumption to strengthen GDP growth as consolidation needs remain. By contrast, investments in the private sector are expected to revive after having contracted for many years, whereas destocking will weigh on GDP growth in view of low industrial production and a slight recovery in domestic and external demand. The latter will additionally contribute to positive import growth, whereas exports will recover more slowly, resulting in a minor negative contribution of net exports to GDP growth in 2013.

In 2014, economic activity is expected to pick up, with GDP growth amounting to 1.4%. The main growth drivers will be private consumption, provided that structural problems are addressed by policymakers and that investments gain ground. Public consumption, on the other hand, will remain depressed. External demand is expected to improve modestly. However, the outlook for domestic consumption is also seen to improve, which will drive imports. The contribution of net exports to GDP growth will thus remain negative and prevent a more vivid recovery.

This forecast is subject to risks similar to those mentioned for the CESEE-7: Negative spillovers from the euro area as well as negative global repercussions (in case the fiscal cliff in the U.S.A. materializes) outweigh potential positive risks from a better-than-expected global recovery or from the benefits resulting from additional reforms in the euro area.

4 Russia: Economic Expansion Affected by Weaker External Environment

GDP growth in Russia is anticipated to slow to 3.7% for 2012 as a whole. Downward effects stem from the heightened uncertainty in the global economy and trade, a leveling-off of the oil price,5 and a drought-stricken harvest (following a 2011 bumper harvest). Upward effects emanate from increased government expenditure (mostly hikes of public sector wages and social spending in the run-up to the presidential election of March 2012). In 2013 and 2014, the downward impact of the slightly declining oil price will continue. However, economic growth

5 Compared with the 2011 average, the oil price is expected to decrease by less than 10% until end-2014, based on oil futures.
in 2013 should keep up with the pace of 2012, as it is expected to be supported by a recovery of the global economy and by a normalization of Russian farm output. For 2014, we foresee no particular forces that might offset the further weakening of the oil price, which explains the expected slight dip in the growth rate (to 3.4%).

Private consumption (which accounts for about half of GDP) will remain the main driver of economic growth and import expansion. However, there are signs that rapid consumption growth is abating as households’ expectations have become somewhat less optimistic. Corporate fixed investment is still at a level slightly below the precrisis peak of 2008, but a reinvigoration of capital formation is hampered by economic uncertainty. In 2013 and 2014 though, fixed investment growth should return as uncertainties in the global economy subside. Rising demand will also start calling for larger additions to capacity. The low growth of export volumes is projected to continue in the forecasting period. Exports of crude oil and petroleum products remain limited by constrained production growth, while domestic demand for these goods is growing briskly. Growth estimates of Russian gas exports have been revised down, given mounting competition from the production of shale gas and the transportation of gas in liquefied form.

We forecast import growth levels substantially below those experienced during the swift post-recession recovery (when the usual propensity of Russia’s GDP growth to feed into imports was vastly surpassed). Still, due to the jump in imports early this year, import growth is expected to reach about 10% in 2012. In 2013 and 2014, it should settle to about 5%.

Our forecast for Russia is – like our projections for the CESEE-7 and Croatia – mostly saddled with downside risks. These risks mainly relate to uncertainty in the global economy. An aggravation of looming problems could affect global demand and depress oil prices and thereby the volume of Russian exports. However, global oil supplies are also tied to uncertainties that harbor the possibility of an oil price rise that would benefit Russia. A deterioration of the global economy could impair Russian consumer confidence and delay the anticipated strengthening of fixed investments.