Outlook for selected CESEE countries:

Steady growth in CESEE-6 after temporary dip in early 2016 – trough reached in Russia[1,2]

Economic growth in the CESEE-6 region[3] will reach 3.0% per annum in 2016 and 3.1% in 2017, thus weakening somewhat compared to 2015. In 2018 growth will pick up to 3.3%. This outlook reflects a downward revision compared to our April 2016 projection. In the first half of 2016, investments declined beyond expectations – especially so in Hungary and Poland – following the phasing out of the previous EU funding period. For 2017, we also lowered our expectations for investments in Poland. Alongside solid external demand, domestic demand and in particular private consumption will be the main drivers of growth across the region. Consumption growth will amount to 4.5% in 2016 – 1.2 percentage points above the 2015 outcome – and decelerate somewhat over the projection horizon. Except in Poland and Romania, export growth will weaken across the region in 2016 compared to 2015 but will regain momentum in 2017 and 2018 in accordance with the external assumption on euro area import growth. The growth differential between CESEE and the euro area will amount to 1.3 percentage points in 2016 and will widen to 1.5 and 1.7 percentage points in 2017 and 2018, respectively.

Table 1

GDP and import projections for 2016 to 2018

	GDP				Imports			
	Eurostat/ Rosstat	OeNB/BOFIT forecasts			Eurostat/ Rosstat	OeNB/BOFIT forecasts		
	2015	2016	2017	2018	2015	2016	2017	2018
	Year-on-year growth in %							
CESEE-6	3.5	3.0	3.1	3.3	7.3	8.1	8.0	8.1
Bulgaria	2.8	2.3	2.5	2.8	4.5	4.1	4.0	4.3
Croatia	1.6	2.2	2.3	2.5	9.9	5.2	7.2	7.2
Czech Republic	4.3	2.5	2.6	2.8	9.9	5.2	7.2	7.2
Hungary	2.9	1.8	3.0	3.1	7.8	6.9	7.9	9.7
Poland	3.6	2.9	3.2	3.4	6.0	8.8	8.4	8.8
Romania	3.8	4.8	3.7	3.7	8.7	11.4	9.6	7.8
Russia	–3.7	–1.0	1.0	1.5	–26.0	–7.0	5.0	5.0

Source: OeNB-BOFIT October 2016 forecast, Eurostat, Rosstat.

Note: 2015 figures based on seasonally adjusted data.

[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: September 19, 2016. 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 2016 ECB staff macroeconomic projections for the euro area. This implies real annual GDP growth of 1.7% in 2016, 1.6% in 2017 and 1.6% in 2018.*

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

We forecast Russian GDP to decrease by 1% in 2016, implying an upward revision by 2 percentage points compared to our previous forecast. This is attributable to a higher oil price and a weaker real exchange rate of the ruble than previously assumed. With economic growth at 1%, Russia will move out of recession in 2017. For 2018, we expect the Russian economy to expand by 1.5%. Private consumption is expected to increase somewhat whereas investment activity will still be subdued largely because of great uncertainties regarding the overall economic situation. With an expected moderate increase of the oil price, we see export growth gaining some speed. After weakening in 2016, import growth will revive over the projection horizon. We assume that oil prices will rise steadily over the projection horizon from an average of below USD 45 per barrel in 2016 to USD 55 per barrel in 2018.[4]

1 CESEE-6: recovery of investments and exports over the projection horizon

In annual terms, GDP in CESEE-6 accelerated by just 3.0% in the first half of 2016 compared with 3.5% over the same period of 2015. Economic growth was below expectations, in particular in Hungary and Poland. For the second half of 2016, we expect the pace of growth to stay relatively unchanged in Croatia, Poland and Romania compared to the first half of 2016. In Bulgaria and the Czech Republic economic growth is projected to lose steam. In both countries, private consumption growth will gain some speed in the second half of 2016. However, this will not compensate for a lower contribution of net exports, the result of weaker export growth and accelerating import growth largely related to stronger private consumption. After very weak growth in the first half of 2016, growth in Hungary will considerably gain speed driven largely by the pickup of private consumption benefiting from further fiscal stimulus measures in the course of 2016.

Leading indicators suggest that private consumption will remain an important growth pillar in 2016. In September 2016 economic sentiment moved strongly upward in almost all CESEE-6 countries, apart from Hungary and Romania. The capacity utilization rate increased in the third quarter of 2016 in all countries in annual terms compared to the same period of 2015 (from 77.7% to 78.3% referring to an unweighted average). Only in the Czech Republic – the country with the highest capacity utilization – the rate continued to decrease in this period.

Favorable lending conditions in CESEE-6 countries

The monetary conditions are still favorable for economic growth. Interest rates are historically low; Hungary even lowered its key interest rates further in the second quarter of 2016. Prices have continued to decline in most countries in the region since our last forecast. Only the Czech Republic observed some moderate price increases in this period. Credit growth showed a mixed picture across the region. In some countries – e.g. in Bulgaria, Hungary and Croatia – the deleveraging process is still going on. Notably, deleveraging has been cushioned by the cleaning up of banks' balance sheets in Bulgaria and by a credit support scheme for SMEs in Hungary. Also in the light of positive developments on the labor markets, we expect lending to gain momentum over the projection horizon. In the Czech Republic, the abolition of the exchange rate floor might, eventually, affect the

[4] *The oil price assumption used by the Bank of Finland is based on the Brent future price of September 15, 2016.*

growth performance. However, the Czech National Bank has reiterated its commitment to maintain the floor as long as necessary.

Unemployment rates well below EU-28 average

Strikingly, the CESEE-6 labor markets continue to be constrained by a labor shortage, in particular in the medium- to high-skill sectors, as shown for instance in increasing vacancy rates in all CESEE-6 countries in the second quarter of 2016 compared to one year before. The strongest rise was observed in the Czech Republic, the country already posting the second highest vacancy rate among the EU-28 countries (after Malta). Unemployment rates are well below the EU-28 average of 8.6% (July 2016) and even declining further in the region, with the exception of Croatia. Similarly, employment rates are moving up. Only Romania recorded a small decline in the employment rate in the first half of 2016. The labor shortage continues to show in the economy, putting further pressure on wages, in addition to higher minimum wages in some countries. In the short- to medium-term, this will be supportive of private consumption growth.

Fiscal policy supportive of economic growth

Loose fiscal policy measures in some countries are expected to push up private consumption in 2016 and 2017. This is particularly the case in Hungary, Poland and, most notably, in Romania. As elections will be held in Romania in 2016 and in Hungary in 2018, we expect a phasing out of fiscal stimulus measures in these countries afterward. Croatia needs to implement fiscal consolidation measures under EU fiscal rules. Other CESEE-6 countries are constrained by limited fiscal space: Bulgaria will follow a budget consolidation path over the projection horizon. For Poland and Romania, the spring forecast 2016 of the European Commission projects budget deficits to breach the 3% threshold in 2017, which calls for fiscal consolidation measures.

Private consumption will remain strong

Undoubtedly, domestic demand will remain the main growth driver in all CESEE-6 countries over the entire projection period. The contribution of domestic demand is expected to decelerate until 2018 only in Romania. Private consumption growth – the main pillar of domestic demand – will come down from 4.5% year-on-year growth in 2016 to 3.7% in 2018. Household consumption will lose speed in Bulgaria, Hungary and particularly in Romania. Here consumption growth will halve to 4.9% by 2018 compared to 2016 because we expect a phasing-out of generous government support after the parliamentary election in December 2016. In the Czech Republic and Poland, private consumption growth is projected to increase supported by the consumption-enhancing environment. Public consumption adds only marginally to economic growth in the CESEE-6 countries (below 0.5 percentage points over 2016 to 2018). Poland is an outlier in this context; here the contribution of public consumption will amount to 0.7 percentage points in 2016, largely related to fiscal support for families. However, the contribution will drop over the projection horizon.

New EU funding framework brings back investment growth

2015 marked a boom year in the drawing of EU funds under the 2007 to 2013 multiannual financial frameworks, as reflected in outstanding investment activity. In CESEE-6, gross fixed capital formation accelerated by more than 5% on average in 2015. The drop to –1.9% in annual terms in the first half of 2016 came as a surprise. Hungary and Poland were most affected by the phasing-out of the financial framework whereas Croatia and Romania were unaffected. After the unexpected slump in 2016, gross fixed capital formation will recover quickly in 2017 and 2018 as the new EU funding framework for the period 2014 to 2020 is expected to show a higher utilization rate in 2017 than in the year before. After an

expected, yet surprisingly strong deceleration by –0.6% in 2016, we see gross fixed capital formation moving up to 4.5% in 2017 and to 5.2% in 2018.

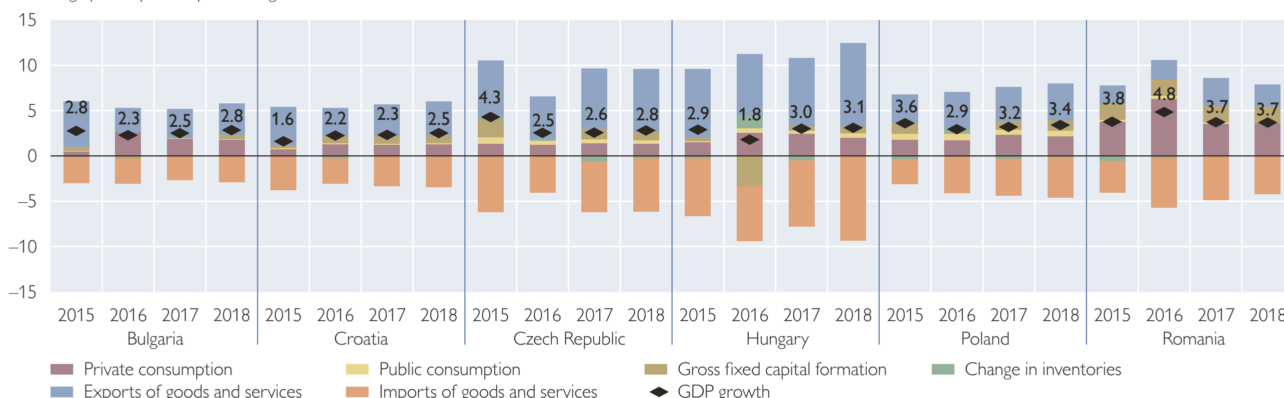
Export growth to recover over the projection horizon

After a dip of export growth in all countries except for Poland and Romania in 2016, we expect exports to gain momentum over the projection horizon. These developments are in line with the external assumptions on import demand in the euro area, the main trading partner of the CESEE-6 region. We expect export growth to rebound from an annual increase of 6.9% in 2016 and 2017 to 7.3% in 2018. Turning to imports, we expect import growth to remain strong over the projection period, running in parallel with private consumption growth. Only in Romania import growth will decelerate in 2017 and 2018, reducing the net contribution of exports to GDP growth to –1.7 percentage points in 2018 after –3.4 percentage points in 2016. Also in Poland we see a negative contribution in 2017 and 2018, as strong export growth will not keep pace with import growth. In the rest of the CESEE-6 region, the contribution of net exports will range between 0 and 1 percentage point in 2017.

Chart 1

GDP and GDP components (realized data for 2015, projections for 2016 to 2018)

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



Source: Eurostat, OeNB.

Risks to growth in the CESEE-6 countries stem from uncertainties in the political environment and are skewed to the downside

The downside risks to growth in CESEE-6 are mostly of a political nature. In the European context, the most apparent risk is related to the political impact the Brexit vote might have over the next two years until a new relationship between the EU and the U.K. is established. The decision of one major EU country to leave the union has caused considerable loss of trust in the EU. Eventually this could weigh on business and consumer confidence over the projection horizon, which might constrain investment decisions. Moreover, we see some risks that nationalist sentiment and political populism, which have gained ground with the large movements of refugees seen recently, could receive further impetus from the Brexit debate in the EU in general and in some CESEE-6 countries in particular. Apart from political factors, the more tangible risks of Brexit are related to trade, capital flows, migration and the EU budget. The impact of these channels on individual CESEE-6 countries will differ depending on their economic ties with the U.K. and are expected to materialize only after 2018. For instance, Poland and, albeit to a lesser extent, Bulgaria and Romania, are likely to be most strongly

affected by stricter rules for entering the U.K. labor market or rules that may even force workers to leave the U.K. That said, the return of migrants from the U.K. would increase labor supply in their home countries, possibly implying some relief to the strained CESEE-6 labor markets, depending on the qualification of returning migrants. However, remittances sent from the U.K. to migrant workers' home countries would decline. In this regard, Croatia, Hungary and Romania would be most strongly affected, as they are those countries among the CESEE-6 showing the highest ratio of remittances as a share of GDP that originate in the U.K. Other negative effects through trade (the Czech Republic, Hungary and Poland are the CESEE countries with the strongest trade links with the U.K.), capital flows (Bulgaria and Hungary have so far recorded relatively large FDI and portfolio inflows from the U.K.) and the EU budget (all CESEE-6 are net recipients of EU transfers) depend on the exit arrangement between the EU and the U.K. and would materialize only after the end of our projection horizon.

Furthermore, the U.K.'s leaving the EU will have strong repercussions for the euro area, as the U.K. is its second largest export market. A stronger-than-expected impact of Brexit on the euro area and an impact on global growth that turns out to be larger than already incorporated in the external assumptions marks a major downside risk for the CESEE-6 given that the euro area is the main trading partner for the region.

Apart from the uncertainties related to Brexit, a growth performance of the euro area that is more modest than expected presents a key downside risk to the CESEE-6 countries. Similarly, a slowdown of global growth in emerging markets and, consequently, global trade would have negative consequences for the region. Additionally, the outcome of the U.S. presidential election is seen as a tail risk to global growth. A more protectionist stance of the U.S.A. would presumably have negative repercussion for global trade and thus negatively affect the CESEE-6 countries. The effects of a deterioration of the external environment are likely to be stronger for Bulgaria, the Czech Republic and Hungary, which are all small, open economies. Poland and Romania, in contrast, are likely to benefit from the larger size of their home markets whereas Croatia – a less open economy – is less exposed to a worsening of the external environment.

One further risk to the region emanates from the unresolved geopolitical tensions resulting from the conflict between Ukraine and Russia, the situation in the Middle East and, more recently, also in Turkey. The latter implies a major downside risk in particular for Bulgaria, while Croatia is benefiting from tourists that may prefer a holiday destination that seems safer than Turkey.

Inflationary pressures have been contained for more than two years. Increasing wage pressures and higher oil prices could feed through inflation in the CESEE-6 region, leading to a less accommodative monetary policy stance. In some countries, in particular in Croatia and Poland, ongoing discussions regarding the conversion of foreign currency loans constitute some downside risk to investor confidence. In the case of Hungary, however, the conversion of Swiss franc-denominated loans into local currency in 2015 somewhat reduced the country's economic vulnerabilities.

There are also some upside risks to our assessment. Stronger-than-expected growth in the euro area would certainly be beneficial to economic growth in CESEE-6. Also, should the implications of Brexit prove less pronounced than an-

ticipated, this would present an upside risk to our forecast. Brexit could even become a chance for implementing more decisive reforms in the EU. Far-reaching reforms and stronger integration among the EU countries can provide a growth stimulus. However, this positive impetus would materialize most likely at the end or after our projection horizon. Furthermore, a peaceful resolution of current political conflicts would certainly support economic performance in CESEE-6.

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

Bulgaria: economic activity mainly driven by private consumption

At 2.9%, Bulgaria's annual GDP growth was robust in the first half of 2016. For year-end 2016 we expect GDP growth to slow down to 2.3%, however. This development will continue in 2017, before GDP growth will be lifted in 2018 by positive effects of the new EU financial framework. Overall economic activity will remain robust over the next years mainly on the back of private consumption.

Given a continuously positive employment environment, increasing wages and positive consumer sentiment, we expect private consumption to play the main role in economic activity. Strong employment growth for four consecutive years coupled with a continuous increase in wages while price pressure has remained low has resulted in a noticeable increase in real incomes. Supported by the rise in minimum wages at the end of 2015, strong wage growth is expected to continue in 2016. Both employment and wage gains were particularly pronounced in the high-skills segment of the private sector, reflecting strong economic activity in business and IT services. Both consumer and business confidence indicators have shown improvements recently. In contrast to these bright prospects for household incomes and private consumption growth, we expect the growth contribution of public consumption to be limited in view of the government's commitment to follow the budget consolidation path described in the convergence program for the period 2016 to 2019.

Turning to gross fixed capital formation, we still forecast a negative contribution to GDP growth for 2016. With the start of the new EU funding program, investment growth will gain ground but remain weak over the projection period. Recent adverse developments in Turkey have affected investor confidence, leading to suppressed investment dynamics.

Reduced import demand from the euro area will dampen the recent positive export developments. In combination with higher Bulgarian imports due to stronger private consumption growth, net exports will not have a positive contribution to economic growth. However, with the expected recovery of the euro area, the contribution of net exports to GDP growth should be positive in 2017 and 2018. Keeping in mind that Turkey is the most important non-EU export market for Bulgaria there is some downside risk to this forecast.

Croatia: recovery gaining traction, driven mainly by domestic demand

At 2.1%, Croatian GDP growth in the first half of 2016 was higher than expected. As a consequence, we revised our GDP forecast for 2016 upward to 2.2% compared to 1.8% expected in our previous forecast. The recovery in 2016 is projected to gradually gain traction in 2017 and 2018, while remaining moderate overall, with all components of aggregate demand contributing to growth (public consumption only marginally, though).

The recovery of private consumption is set to continue at a pace of 2.2% to 2.3% over the projection horizon, supported by a recovering labor market and

subdued inflation. Public consumption will continue to grow modestly despite the need for consolidation under the fiscal rules of the EU. While the budget deficit is expected to fall below 3% of GDP in 2016 and to decline somewhat further in subsequent years, additional structural adjustment is needed to safely achieve the medium-term budgetary objective and, in particular, the debt reduction benchmark under EU rules. Thus, our projection assumes a gradual further consolidation, which will constrain public consumption going forward. It will be up to the new government, which is to be formed after the parliamentary elections held in mid-September 2016, to continue with consolidation efforts in order to bolster fiscal sustainability over the medium and long term.

The year 2016 will mark a strong improvement in gross fixed capital formation. We expect this development to be stable over the forecast horizon. This is related to a better absorption of EU funds but also to a mild recovery of private investment. Private investment growth turned positive in 2015 and is likely to remain so as business confidence indicators show a continuation of the mild recovery. Investment activity is likely to be supported by the improved lending capacity of banks provided that the incipient resolution of the currently high level of NPLs continues or even accelerates.

We expect a positive but declining contribution of net exports over the projection horizon. Strong tourism exports will remain an important driver of GDP growth especially against the background of continuing geopolitical tensions in several other Mediterranean tourist regions. Export growth will also benefit from an improvement in euro area import growth and a continuation of positive trends in the export of ships, oil and refined petroleum products as well as medicinal and pharmaceutical products. We expect a leveling out of growth rates of exports in goods and services toward the end of the projection horizon. However, together with private consumption, imports will strengthen, therefore moderating the positive contribution of net exports to GDP growth.

Czech Republic: solid growth backed by private consumption

The Czech Republic has returned to a more modest but solid growth trajectory following the EU-funded boom in 2015. We expect real GDP to rise by 2.5% in 2016. Renewed dynamics in private and public consumption will stimulate the economy over the forecast horizon, pushing real growth to 2.8% in 2018. Based on higher-than-expected capital formation, our projections are slightly more optimistic than in the spring forecast.

Private consumption remains the key driver of economic activity. Benign wage and employment developments will likely strengthen this position in the short run. Rising inflation, as foreseen by the Czech National Bank, and the ensuing rise in interest rates will dampen private spending over the projection horizon. In line with these dynamics, we project household consumption growth to peak at 2.9% in 2017 and to move to 2.8% thereafter. Public consumption, on the other hand, is expected to rise more steadily at around 2.2% annually in 2016 to 2018. Combined, we expect private and public consumption to account for roughly two-thirds of total growth over the next few years.

The rising capital stock is another critical ingredient in our growth projection. Growth of gross fixed capital formation decreased notably in the first half of 2016, largely owing to the start of a new EU funding cycle. However, the decline was less pronounced than initially expected. We thus revise our investment projections accordingly: At growth rates of 4.6% and 3.4% in 2017 and 2018, respec-

tively, growth of gross fixed capital formation will, on average, contribute around 1 percentage point to annual real growth.

The positive growth contribution of net exports will weaken over the coming years. While export growth will still outpace the rise in imports in 2016, this trend is set to reverse in 2017. We expect exports to grow by 6.8% and imports by 7.2% in 2017. The removal of the exchange rate floor, potentially coming about in late 2017, poses additional downside risks to growth in the Czech exporting sector. However, the existing excess of exports over imports ensures that the net growth effect of international trade will remain positive: we predict growth contributions of 0.2 percentage points and 0.4 percentage points in 2017 and 2018, respectively.

Hungary: GDP growth to pick up after temporary setback

Hungarian GDP growth halved to 1.4% year on year during the first half of 2016 from 2.9% in 2015. We reckon that the economic cycle hit bottom in mid-2016, overcoming temporary factors, and will gradually gain strength over the forecast horizon. Nonetheless, given the weaker-than-expected performance during the first half of 2016, we have scaled down our GDP estimate for 2016 to 2.1% (from 2.5%). Correspondingly, we now expect a slightly stronger rebound in 2017 (to 3.0%) and a growth rate of 3.1% in 2018.

Private consumption should continue to benefit from improving income developments (also due to the cut in the personal income tax rate at the beginning of 2016, selected public sector wage increases and the step-wise expansion of family tax benefits in 2016 and 2017), employment gains, contained inflationary pressures over the medium-term (partly due to VAT reductions at the beginning of 2016 and 2017), historically high consumer sentiment and improving credit developments. Nonetheless, we expect a gradual deceleration of growth over the forecast horizon from the 2016 peak. Considering a potential re-election drive by the government, which faces elections in the summer and early autumn of 2018, additional selective fiscal stimuli remain an upside risk, though.

Public consumption will likely remain supportive of the growth outlook well into 2018, given fiscal leeway created by better-than-expected budgetary developments during the first half of 2016 and the targeted fiscal loosening in 2017. It should gradually decelerate from late 2018, following elections and a refocusing on deficit and debt reduction.

Following the remarkable temporary setback during the first half of 2016, investment activity should gradually recover from the second half of 2016 onward. Public investment should recover as EU funds inflows are picking up again (the government intends to draw a substantial part of the funds available in the 2014–2020 programming period already by 2018). Private investment activity should benefit from the additional expansion of housing subsidies in 2017 (on top of measures already implemented at the beginning of 2016), comparably high capacity utilization rates in industry, brightening export prospects, the central bank's recently expanded SME credit support schemes and a gradual recovery in market-based lending activity (supported also by the low interest rate environment and the additional cut in the bank tax in 2017).

We expect export growth to gather momentum over the forecast horizon as import demand by the main trading partner, the euro area, is strengthening. However, as the recovery of domestic demand will fuel import growth to a greater

extent, we expect the contribution of net real exports to gradually melt down and turn slightly negative in 2018.

Poland: domestic demand growth will accelerate, while export growth remains strong

In Poland, GDP growth will gather pace compared to the first half of 2016, resulting in a full-year growth rate of 2.9% in 2016, and further accelerate to 3.2% in 2017 and 3.4% in 2018. Our projection shows a strong downside revision in 2016 and 2017 by 0.8 and 0.6 percentage points, respectively, due to slumping gross fixed capital formation, which was only partly compensated for by stronger private consumption. We expect gross fixed capital formation to stabilize and recover over the projection horizon. The contribution of domestic demand to GDP growth will increase whereas the contribution of net exports will turn negative in 2017.

Private consumption growth will accelerate to 4.0% in 2017 as a result of the strong rise of households' real disposable income on the back of (1) strong wage and (gradually declining) employment growth, (2) a large increase in child benefits in particular for lower-income households in the second quarter of 2016 and larger general tax allowances, as well as (3) a persistent supply side-driven low-inflation environment. In addition, improved consumer sentiment and higher growth of loans for consumption purposes will underpin private consumption expenditure. Public consumption will slow moderately, given a partial wage freeze in the public sector.

Overall, we expect gross fixed capital formation to stabilize and start recovering in the second half of 2016, but this will not be sufficient to avoid a negative sign in the year as a whole (–0.5%). However, fixed-investment growth will gather pace to reach 4.5% in 2017 and 5.7% in 2018. Corporate fixed investment will benefit from stronger domestic consumption demand and foreign demand, relatively high capacity utilization and a favorable internal financing situation. Constraining factors are higher uncertainty related to the domestic economic policy stance and the impact of the bank tax on loan supply. Housing investment will continue to expand at a slightly lower pace, given not only the bank tax impact but also tighter supervisory regulations, while income growth and the state-subsidized housing program for young people remain supportive factors. Public investment will recover over the whole forecasting period in line with an increasing absorption of funds under the new EU medium-term budget. The inventory build-up will provide a sizeable positive contribution to growth in 2016, thus compensating partly for the weak performance of fixed investment, but will slow down afterward so that its contribution will become negative in 2017.

The recently high pace of growth of real goods and services exports will moderate. However, it will remain strong at a rate of roughly 8%, as the stronger expansion of euro area and in particular German import demand in 2017 and 2018 will provide substantial support. Robust export growth, recovering investment growth and accelerating consumption growth will lift the growth rate of real imports of goods and services by more than that of exports. Thus, the contribution of net exports to GDP growth will turn slightly negative in 2017 and 2018.

Romania: GDP growth expected to moderate from next year

As a consequence of higher-than-expected GDP growth rates in the first half of 2016, we revise our GDP forecast for Romania upward for the current year to 4.8%. We expect full-year GDP growth to come in slightly below the growth rate recorded in the first half of 2016. This is attributable to base effects and high-frequency indicator readings at the start of the second half of this year. In particu-

lar, there was a moderate deceleration of growth in retail sales, real wages and industrial production. We continue to expect growth to level off in 2017 and 2018, as the effects of procyclical fiscal and wage policies will abate following the parliamentary elections in December 2016. Accordingly, domestic demand, while remaining the growth driver, will lose some steam over the forecast horizon.

The private consumption boom will have reached its peak in 2016, growing by almost 10%. Carry-over effects from the package of fiscal and wage policy measure taken in the second half of 2015 will taper off in the second half of 2016. Yet, in the course of this year additional steps were taken (19% minimum wage hike in May, 10% wage increase in the health and education sectors in August) that will further spur private consumption growth. Tightening labor market conditions, as evidenced by an increasing job vacancy rate, will keep wage growth at elevated levels. The upward trend in consumer loans represents a further supporting factor. While further fiscal stimulus ahead of parliamentary elections cannot be excluded, we expect some reorientation in economic policy afterward (no more or at least more modest minimum wage hikes and public sector wage increases). Therefore, we expect private consumption to moderate in 2017 and 2018.

Investment will continue its recovery over the forecast horizon supported by the government's "first home" program, which comprises state guarantees for a part of the housing loans taken out by people buying their first house, improved lending capacities of banks (clean-up of bank balance sheets) and low credit costs, as well as a better EU funds absorption rate.

Romanian export growth will benefit from accelerating euro area import growth. While increasing ULC in the manufacturing sector will dampen exports, investment activity will result in increased export capacities. Alongside decelerating domestic demand, import growth will also come down from its currently high levels. Net exports will continue to provide a negative contribution to growth, which will decline over the forecast horizon, however.

3 Russia: moving out of recession toward slow growth

The Russian economy contracted by less than 1% in the first half of 2016 compared to a year earlier, showing some signs of bottoming out lately. This more favorable development than we had expected in our previous forecast of April 2016 can be explained by two factors: First, the oil price – although considerably lower on average in the first half of 2016 year-on-year – has been following an upward path since the beginning of this year and is substantially (about USD 3) higher than previously assumed. Second, after falling in 2014 and 2015, the ruble's real exchange rate has been notably weaker year on year in the first half of 2016, even weaker than in the 2009 recession. The real exchange rate is currently at the level of 2005. Therefore, Russia's imports have plummeted unusually strongly relative to the decline of GDP.

World economic growth and trade are expected to gain some momentum over the forecast period. After less than USD 45 per barrel in average annual terms in 2016 (17% lower than in 2015 and 55% lower than in 2014), the oil price is assumed to rise moderately to below USD 55 in 2018. We forecast that Russian GDP will shrink by 1% in 2016 and recover in 2017 and 2018.

The weak ruble will keep Russia's imports this year about 7% below last year's level. As the slowly rising oil price is lifting Russia's export income and sparking a

revival of the economy and as the ruble's real exchange rate will gradually appreciate, imports will recover moderately in 2017 and 2018.

Demand for Russia's exports is expected to recover from this year's dip but to increase only slowly (in real terms). Private consumption will revive from the large fall of 2015 and 2016 as disinflation will support purchasing power. Investments are anticipated to recover only slowly, which is partly due to continuing uncertainties in and around the economy. Government expenditure will continue to decline in real terms in 2017 and 2018, though considerably less steeply than in 2016, even if Russia's government sticks to its target of narrowing the budget deficit. While monetary policy will probably not directly and substantially contribute to the economy's revival, the Central Bank of Russia's firm disinflationary stance will likely continue to stabilize expectations, check uncertainty, and thus support growth over the medium and long term.

Risks to the forecast for Russia remain large and more or less balanced. The oil price may depart to either direction from the gradually rising path that has been assumed. Geopolitical risks may intensify or ease. Such deviations as well as other events that could increase uncertainty would of course have an impact on the ruble, inflation, domestic demand, imports, and economic growth. Like before, the effects stemming from such changes especially on the ruble, inflation and imports may materialize quickly. Imports may recover more than anticipated, if the revival is similar to Russia's performance after previous recessions. On the other hand, Russia may further increase its import restrictions, which have already been tightened gradually. For example, import restrictions in procurements made by companies majority-owned by the state will come into force at the start of next year.

A notable upside risk stems from a possible strengthening of developments seen this year: The growth of loans to households has picked up slightly and households have saved a little less than during last year's shift to precautionary savings. Such a change would considerably improve the prospects for private consumption and imports. Another upside risk is that the Russian government feels some political pressure over declining living standards. This may lead to a more gentle development of government expenditures than currently foreseen, which would support the economy for a while.