Outlook for selected CESEE countries:

GDP growth steady at 3% in CESEE-6, recession to ease in Russia[1,2]

Annual economic growth in the CESEE-6[3] region will remain at around 3% in the years from 2015 to 2017. This outlook corresponds to an annual improvement of 0.3 percentage points in 2015 and 2016 over the April 2015 projections. This upward revision is the result of the solid performance observed in early 2015. Over the entire projection horizon, all demand components in all CESEE countries will make a positive contribution to growth, except public consumption in Croatia. In particular private consumption is seen to be strengthening. Although export and import growth remains fairly strong in all countries under observation, the growth contribution from net exports is broadly neutral, except in Bulgaria and Romania, where it will become or remain clearly negative over the forecast horizon. The region's growth advantage over the euro area average will moderate from 1.8 percentage points in 2015 to 1.3 percentage points in 2017 as euro area growth is assumed to pick up.

We forecast Russian GDP to decrease by 4% in 2015 following the plunge of the oil price in late 2014, still heightened uncertainty and negative investment and private consumption dynamics. Shrinking domestic demand and the deep plunge of the Russian ruble reduce imports by about one-quarter. Backed by a moderate

Table 1

GDP and import projections for 2015 to 2017

	GDP				Imports			
	Eurostat/ Rosstat	OeNB/BOFIT forecasts			Eurostat/ Rosstat	OeNB/BOFIT forecasts		
	2014	2015	2016	2017	2014	2015	2016	2017
	Year-on-year growth in %							
CESEE-6	2.9	3.2	3.1	3.1	8.6	7.3	7.2	7.3
Bulgaria	1.7	1.9	2.1	2.4	2.0	5.4	4.6	7.1
Croatia	–0.4	0.7	1.2	1.6	4.3	6.9	6.1	6.3
Czech Republic	2.0	3.7	2.8	2.8	9.9	8.9	7.7	6.6
Hungary	3.5	2.9	2.3	2.2	10.0	7.6	7.4	8.1
Poland	3.5	3.5	3.6	3.7	8.8	6.0	7.0	7.6
Romania	2.9	3.3	3.5	3.1	7.7	8.5	8.0	6.7
Russia	0.6	–4.0	–2.0	1.0	–8.0	–25.0	–4.0	1.0

Source: OeNB-BOFIT October 2015 forecast, Eurostat, Rosstat.

Note: CESEE-6 = Bulgaria, Croatia, the Czech Republic, Hungary, Poland, Romania.

[1] *Compiled by Julia Wörz with input from Stephan Barisitz, Markus Eller, Mariya Hake, Florian Huber, Mathias Lahnsteiner, Thomas Reininger and Zoltan Walko.*

[2] *Cut-off date for data underlying this outlook: October 6, 2015. 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 2015 ECB staff macroeconomic projections for the euro area. This implies real annual GDP growth of 1.4% in 2015, 1.7% in 2016, 1.8% in 2017 and a gradual increase of the oil price over the projection horizon from about USD 55 per barrel in 2015 to about USD 61 in 2017. We assume a prolongation of the current sanctions related to the Ukraine-Russia conflict over the entire projection horizon.*

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

recovery of the oil price and world trade, the decline in GDP is expected to ease to 2% in 2016. This implies a downward revision compared to our last projection. In 2017, economic growth will reappear, but remain very low due to insufficient investment and lack of structural reforms in the preceding years. The uncertainty triggered by geopolitical tensions will persist. The hesitant improvement of the Russian economy will be reflected in the modest recovery of imports.

1 CESEE-6: all growth drivers intact, domestic demand strengthens

In most CESEE-6 countries, economic growth surprised on the upside in the first half on 2015: the region's GDP expanded by 3.1% year on year in the first half of 2015 compared with 2.9% over the same period in 2014. For the remainder of 2015, we expect all elements of the present rather growth-friendly environment – strong purchasing power, accommodative monetary policy, neutral fiscal policy, a moderate increase in bank lending, and improving labor market conditions – to remain generally intact.[4] The currently accommodative monetary policy stance in the region involves conventional and in some countries also unconventional measures, such as Hungary's Funding for Growth Scheme (FGS), which was launched to stimulate bank lending, or exchange rate policy measures in the Czech Republic. On the fiscal side, the currently rather neutral policy stance will be continued in the second half of the year, except in Bulgaria, where the consolidation package following the recent bank rescue has already taken its toll on economic activity this year. While the requirements of the excessive deficit procedure (EDP) greatly reduce policy space in Croatia, actual consolidation has not substantially advanced so far, probably also in view of the general elections in November 2015.

Monetary policy stance to remain accommodative

In 2016 and 2017, low inflation is expected to continue in the CESEE-6 region, providing ample space to continue monetary policy accommodation even beyond the time frame of current measures that were launched in some countries to additionally support domestic demand. We expect no headwinds from the fiscal side for most countries of the region. In Poland, support for distressed borrowers will underpin private consumption growth in 2016, while we expect the new government to offset this effect by using the positive cyclical developments to introduce measures of fiscal tightening. In the Czech Republic, various tax measures will have a broadly neutral net impact on consumption. In Romania, we expect some impetus from tax reductions and further accommodative fiscal and wage policy measures ahead of the parliamentary elections in 2016. A further 1-percentage-point cut in the personal income tax rate as from 2016 will support household income in Hungary. In Croatia, fiscal policy will have to remain restrictive to comply with the requirements under the EDP.

The projected rise in economic activity over the entire projection horizon will increasingly rest on domestic demand; private consumption growth of the CESEE-6 region will come in at 3.4%, 3.3% and 3.2% in 2015, 2016 and 2017, respectively. Despite moderately softening growth dynamics, the growth contribution of private consumption will increase in Bulgaria and Croatia, reaching 2 percentage points and 1.6 percentage points in 2017, remain stable in the Czech Republic, Hungary and Poland at around 1.5 percentage points to 2 percentage

[4] *See "Developments in selected CESEE countries" in this issue.*

points and fall from 3.2 percentage points (2015) to 2.4 percentage points (2017) in Romania (see chart 1). Public consumption growth will moderate for the region as a whole but the growth contribution of public consumption will remain fairly constant between zero and 0.5 percentage points. Croatia is the only country where public consumption is seen to decline in all three years of the projection horizon, yielding a negative contribution to GDP growth.

Investment growth takes a small dip in 2016 but remains fairly solid

Overlapping fund disbursements under two EU multiannual fiscal frameworks helped push the growth rate of gross fixed capital formation (GFCF) in the CESEE-6 region up in 2014. For 2015, we expect another fairly strong expansion, followed by some deceleration in momentum in 2016 after the end of the EU funding overlap. With increasing fund utilization within the new framework (2014–2020), annual GFCF growth will rise again in 2017. In general, we expect investor confidence to remain strong and financing conditions to improve along with a gradual resolution of high NPL ratios in a number of countries in the region. Only Bulgaria and Croatia – the two countries where corporate debt is already comparatively high – will exhibit notably weaker investment growth. Furthermore, dynamics in these two countries differ from the regional average as investment growth will recover gradually in Bulgaria and Croatia over the projection horizon rather than taking a dip in 2016. In Bulgaria the high corporate debt and elevated NPL ratios already induced a backlash in investment in the first half of 2015; this backlash will gradually be reversed by EU-cofinanced investment under the new EU fiscal framework. In Croatia, corporate investment and an increased EU fund absorption capacity are expected to start supporting GFCF. While the new law on the conversion of Swiss franc-denominated loans into euro-denominated loans may dampen NPL ratios, it may at the same time restrict credit supply, as the related costs are borne by the banking sector. Moreover, if perceived as increasing country risk, the loan conversion in Croatia might also negatively weigh on foreign investor sentiment, thus influencing the recovery of investment activity.

External demand remains a solid growth pillar

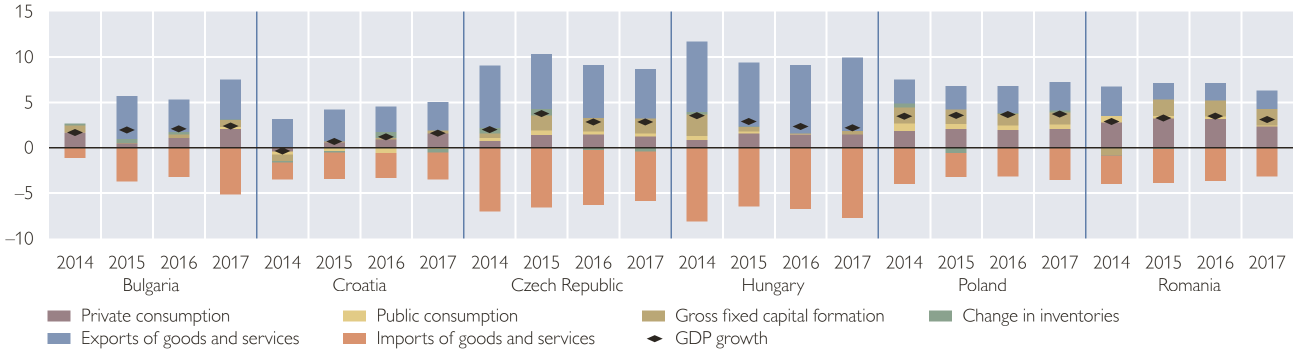
External demand will remain a reliable growth pillar as well. The ECB's asset purchase programs will continue to support CESEE-6 export performance by driving up euro area demand for CESEE goods and services. In 2015, the annual growth of real CESEE-6 exports will take a temporary dip, partly because of extremely high export growth in 2014 and partly because of country-specific factors such as expiring expansionary effects from increased car production capacities in Hungary. Over our projection horizon, however, export growth will accelerate in line with the assumed steady expansion of euro area import demand.

Given solid domestic demand and the strong import-export nexus especially in the more open CESEE-6 economies, import growth will also be dynamic. As a result, the net contribution of external demand to growth in the CESEE-6 countries will be low and mostly negative. Only Hungary and Croatia will record a constantly positive contribution. Although the net contribution of exports will increase in the Czech Republic and in Romania, a reduction in price competitiveness and reviving domestic demand will prevent it from turning positive in these two countries.

Chart 1

GDP and GDP components, projections for 2015 to 2017

Percentage points; GDP growth: year on year in %



Source: OeNB.

Key external risks to our forecast are the situation in Ukraine, weaker global trade, oil price changes, the geopolitical situation, and deviations from our assumption concerning euro area growth performance.[5]

Risks to growth continue to be tilted to the downside

In our baseline scenario, we continue to assume that economic sanctions against and by Russia will remain in place over the entire projection horizon, as there has been a lack of progress in implementing the Minsk II agreement. An earlier lifting of the sanctions would represent an upward risk to our forecast. Yet, the possibility of intermittent flare-ups of hostilities remains high, and a substantial deterioration of the situation in eastern Ukraine would imply a severe downside risk.

A severe downside risk could emerge from possible repercussions of the Volkswagen emissions scandal, especially for those CESEE economies that are strongly integrated with car production networks involving Germany. More generally, weaker global trade flows, related inter alia to a worse-than-expected economic performance in China and other emerging economies would also impact negatively on CESEE-6 growth.

A steeper rise in oil prices would also imply a downside risk; however, given the agreement reached with Iran on its nuclear program, the prospect of economic sanctions against Iran being lifted and the absence of signs of a reduction in oil production by all major suppliers, we consider this development to be rather unlikely. The geopolitical situation continues to pose a downside risk that could materialize especially if military conflict in the Middle East were to spread and if increased refugee flows to Europe pose challenges to European integration, e.g. resulting in higher trade costs due to border controls.

Concerning economic developments in the euro area, both up- and downside risks could in principle arise, related inter alia to a longer-term stagnation scenario on the downside and the impact of structural reforms on the upside.

[5] *Domestic risks are reported in the individual country projections.*

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

Bulgaria: gradual recovery of domestic demand in the medium run

We revise our April forecast for Bulgaria slightly upward, which reflects the unexpected strong export performance in the first half of 2015. The improved export performance can be explained to a certain extent by the depreciation of the euro, given that slightly more than 50% of Bulgaria's exports go to countries outside the euro area. In line with the improved external environment and continuing monetary easing in the euro area (at least until the second half of 2016), we expect that favorable export dynamics will persist, though they may lose some momentum vis-à-vis 2015.

Domestic demand, on the other hand, has remained rather fragile but is expected to gather steam gradually. Public consumption is still constrained in the short run by ongoing fiscal consolidation, which is necessary to reach the defined domestic budgetary targets. Private consumption has so far expanded only hesitantly but we expect a more pronounced acceleration due to improving consumer confidence and stabilizing labor market conditions. Nonetheless, we also have to take into account that consumer price inflation will most likely return in 2016 as the base effects of administrative price decreases and the fall in oil prices drop out of the index.

After a comparatively strong year 2014, investment experienced a renewed backlash in the first half of 2015 and will thus only marginally contribute to economic growth in 2015. Over the medium term we should see a stronger growth contribution by investment as capacity utilization has improved since mid-2014. Public investment – accounting for about 25% of total investment – is not expected to accelerate considerably before 2017 as the implementation of EU-cofinanced projects under the new operational program (2014–2020) will take time.

Import dynamics are expected to mirror the gradual improvement in domestic demand. Taking all these considerations together, we expect that the positive growth contribution of net exports will outweigh that of domestic demand in 2015, while by the end of the forecasting horizon domestic demand will have taken over and import growth will most probably outpace export growth.

Croatia: end of recession finally in sight

Following a decline in GDP for six years in a row, the Croatian economy is finally set to enter positive growth territory in 2015. The recovery will be somewhat faster than projected in our spring forecast, which we revise upward to 0.7% for 2015. We expect that the improvement of consumer and business confidence indicators that started in early 2015 will continue throughout the second half of the year. Private consumption will furthermore benefit from a tax reform effective from January 2015 and possibly also from incipient improvement in labor market conditions. The firming of external demand coupled with a strong summer season for the tourist industry is projected to be only partly offset by the slight upward adjustment in imports, thus still leaving a strong positive contribution of net exports to growth of 0.6 percentage points in 2015. On a negative note, however, investment activity in 2015, although already recovering, is still being held back by ongoing deleveraging pressures, the low absorption of EU funds but also by fiscal consolidation pressures. At the same time, the conversion of Swiss franc loans – despite its supportive effect on disposable incomes in the short run – is likely to have a negative effect on investor sentiment in the longer run.

In 2016 and 2017, GDP growth is projected to expand by 1.2% and 1.6%, respectively, reflecting the continuing recovery of private consumption on the back of a slight improvement of employment conditions and higher disposable income. At the same time, the positive contribution of net exports will abate throughout the forecast period as imports are set to continuously accelerate in line with the firming of private consumption. On the downside, we expect the banking sector to be less supportive for the long-awaited revival of credit growth in those two years as substantial capital buffers had to be set up following the conversion of Swiss franc loans. In addition, despite a likely acceleration of EU structural funds absorption, public investment activity will be held back by consolidation needs in the aftermath of general elections as well as by the pressure to bring down the fiscal deficit so as to meet the conditions under the EDP by 2017.

Czech Republic: robust GDP growth mainly driven by domestic demand

After a strong first half of 2015 that was mainly determined by rising inventories and sustained increases in investment, we expect Czech GDP to grow by 3.7% in 2015. In 2016, GDP growth is expected to slow down to 2.8% and to remain at this level in 2017. In addition to domestic factors, favorable external conditions, like the comparatively low level of the oil price and positive developments in the euro area act as further important determinants of this expansion.

The main driving force behind the sound performance of the Czech economy is domestic demand. We expect improving labor market conditions and consumer confidence to translate into pronounced increases in private consumption. In addition, supportive fiscal and monetary policy, a robust banking sector and recovering credit growth rates will provide further boosts to investment and private consumption. Growing business confidence, better absorption of EU funds and higher capacity utilization are expected to boost investment growth to around 5.6% in 2016 and 6% in 2017.

Recent figures signal subdued levels of inflation in 2015. However, inflation expectations suggest that the inflation rate is expected to reach the target within the next two years. If inflation is markedly below the target over the next year, the central bank stands ready to extend its exchange rate interventions beyond the end of 2016.

On the back of loose monetary policy, we forecast export growth to decline gradually from 7.5% in 2015 to around 6.3% in 2017. The strong performance of exports is largely attributable to favorable developments in traditional export sectors like the automotive sector. The projected downward trend in export growth is predicated on the likely exit from unconventional monetary policy in the second half of 2016. While export growth remains robust, the growth contributions of net exports will be in slightly negative territory in 2015 and 2016, underpinning our view that domestic factors will be a major driving force of GDP growth in the near future.

Hungary: economic policy measures support disposable incomes

We expect GDP growth in Hungary to decelerate to slightly below 3% in 2015. We continue to see the major driver behind the slowdown in a smaller expansion of investment activity than in 2014. On the one hand, investment activity is expected to continue to benefit from the low interest rate environment, relatively high capacity utilization rates in industry, robust business sentiment, the extension of the central bank's Funding for Growth Scheme (including FGS+) and the broadening of the housing subsidy scheme since mid-2015. On the other hand, strong investment growth in 2014 and the fact that residual EU funds from the

2007–2013 programming period that had still been available in 2014 have dried up will push investment growth down in 2015. Taking current plans at face value and thus assuming the FGS schemes to come to an end by end-2016, we expect a further slowdown in 2016–2017, with an upside forecast risk as nonsubsidized bank lending may have picked up by that time.

We expect the settlement of consumer loan contracts (i.e. the retroactive compensation by banks for exchange rate margins on foreign currency loans and for unilateral hikes in interest rates and fees) and the conversion of foreign currency consumer mortgage loan contracts into forint loans at the beginning of 2015 to have boosted households' disposable income and to have reduced their precautionary savings. Thus we expect household consumption growth to accelerate to 3.2% in 2015. This one-off supporting factor will fall out of the index during the first half of 2016. However, the planned conversion of most remaining foreign currency-denominated consumer loans into forint loans at the beginning of 2016, improving consumer sentiment, employment gains, rising real wages, a 1-percentage-point cut in the personal income tax rate at the beginning of 2016 and households' improved financial position should keep consumption growth at around 3% in 2016–2017.

Ongoing fiscal discipline should keep public consumption growth well below the overall GDP growth rate. Exports are expected to expand by 7% to 8% annually; these figures should be slightly exceeded by import growth rates on the back of strong domestic demand. The contribution of net exports is expected to be slightly positive between 0.5 percentage point and 1 percentage point.

Poland: robust economic growth as an opportunity for further fiscal consolidation

In Poland, the economy will continue to grow strongly at 3.5% in 2015. At 5.7%, export growth will be slightly lower than last year's robust rate of expansion, somewhat dampened by the recession in Russia and Ukraine. Gross fixed capital formation (GFCF) will rise by 7.5% in the year as a whole. Inventory build-up will be substantially smaller than in 2014, rendering a negative contribution to GDP growth. Private consumption growth will accelerate to 3.5% as a result of the strong rise of households' real disposable income (strong wage and employment growth, adjustments to the pension indexation scheme, higher tax deductions for families with children, deflation). Public consumption growth will be contained by the continued partial freeze on public sector wages, but will remain in positive territory. Overall, total domestic demand will grow more slowly than in 2014. Exports will remain the single most important component of total final demand growth. Import growth will decelerate significantly, from 8.8% in 2014 to 6.0% in 2015, barely outpacing export growth. This will translate into an almost zero contribution of net exports to GDP growth in 2015.

In 2016, we forecast GDP growth to slightly accelerate to 3.6%, driven by a higher contribution of exports, which will grow by 6.4% on the back of stronger foreign demand. By contrast, we expect the growth contributions of the main components of domestic demand to slightly decline. GFCF by the corporate sector will continue to benefit from the knock-on effects of rising euro area demand and solid domestic consumption demand as well as from relatively high capacity utilization levels and the favorable financing situation with respect to both internal and external funding. The latter will also support housing investment, which benefits from households' income growth and from a state-subsidized housing program for young people, as has already become visible in the higher numbers of building permits and dwellings under construction. On the other hand, the only gradual absorption of funds under the new EU fiscal framework will curtail public investment. Moreover, new measures that offer relief to distressed borrowers will burden the banking sector and weaken credit supply. Overall, we expect fixed investment growth to slow to 6.0%. By contrast, inventory build-up will stabilize so that it will no longer make a negative contribution.

Private consumption growth will continue to be driven by strongly rising primary income stemming from robust labor market developments and by supportive financing conditions. In addition, recently adopted legislation will provide support for distressed borrowers that tend to have lower incomes and a higher consumption propensity, while further, less targeted support is currently being discussed. On the other hand, deflation will probably fade away soon (e.g. higher drought-related food prices), and efforts to use the positive cyclical developments for some fiscal consolidation measures following the parliamentary elections in October 2015 are likely to imply slightly lower growth rates of consumption in 2016 than before. Import growth will accelerate as well, mainly as a result of higher export growth, while the contribution of net exports to GDP growth will remain close to zero. By contrast, in 2017, both stronger exports and domestic demand will accelerate import growth further, and net exports will turn slightly negative.

Romania: political cycle supports consumption-driven growth, but weak harvest this year

For the year 2015, we expect Romania's GDP growth to come in at 3.3%, then accelerate to 3.5% in 2016 before slowing down to 3.1% in 2017. Surprisingly strong GFCF growth in the first half of 2015 – following two years of negative growth – is the main reason for our upward revision for the current year. We expect investment growth to remain high, as NPL resolution increased banks' capacities to lend. GFCF will also benefit from the low interest rate environment and better EU fund absorption. Furthermore, the euro area recovery will help Romania attract FDI inflows.

Though private consumption has already grown fast, several fiscal and wage policy measures taken ahead of the parliamentary election in 2016 will provide further support. On top of this, we may see additional comparable measures. The announcement of the wage increase in the health sector entailed similar demands from other public workers, some of which will probably be fulfilled.

Despite these measures, we expect annual GDP growth to be lower in the second half of 2015 than in the first, as the summer drought negatively affected this year's harvest. Agricultural output amounted to almost 5% of GDP in 2014, 80% of which were generated in the second half of the year. A 10% decline in agricultural output would thus have an impact of 0.5% of GDP, but the actual outcome may be even worse. Year-on-year fluctuations of agricultural output by 20% to 30% have occurred frequently in the last ten years.

We expect import growth to exceed export growth by a significant margin over the forecast horizon. Imports surged in the first half of 2015, while export growth decelerated markedly. Import growth will stay high given strong domestic demand, while rising unit labor costs in the manufacturing sector will constrain export growth. Therefore, Romanian export growth, which will benefit from accelerating euro area growth, will only speed up slightly until 2017. The contribution of net exports will rise from –1.9 percentage points in 2015 to

–1.2 percentage points in 2017 as import growth is expected to decelerate in 2017 in line with somewhat lower domestic demand growth.

3 Russia: recession expected to ease in 2016, making way for a slow recovery in 2017

Following the plunge of the oil price and the steep decline of the Russian ruble in late 2014, the Russian economy entered recession. In 2015, GDP is expected to slump by about 4% if the average oil price for the year comes to around USD 55 per barrel (Brent). While the negative dynamics of investment and private consumption are not expected to change much toward end-2015, government expenditure is being somewhat reined in after the boost in the first half of the year. Shrinking domestic demand and the steep fall of the Russian ruble reduce imports by about one-quarter in 2015.

In 2016 the decline in GDP is expected to ease to 2% as world trade will likely pick up and the oil price is assumed to recover moderately. However, the collapse of the oil price in late 2014 will continue to weigh on the economy in 2016. Uncertainty will persist due to sustained tensions with regard to the situation in eastern Ukraine and to continuing sanctions. Private consumption will be constrained by rather gradual disinflation and weak corporate profitability, while hikes of public sector wages have been partly reined in and partly frozen. As in 2015, layoffs by firms may remain mild compared to the decline of business activity, but economic pressures keep resulting in more part-time work and temporary redundancies. Investment will remain severely constricted by the weak economic prospects and the rough business climate. Financing costs will stay fairly high due to recession, risks and sanctions. In addition, economic contraction has led to an increasing underutilization of productive capacity. The export volume will increase slowly. The decelerating decline of domestic demand will soften the decrease of imports.

In 2017, economic growth will return, but will remain low due to insufficient investment and a lack of structural reforms in earlier years. The uncertainty triggered by geopolitical tensions will persist. The hesitant improvement of the economy will be reflected in a modest recovery of imports.

Russian economic policy has little leeway to provide growth impulses. After a steep interest rate hike in December 2014, the Bank of Russia has gradually lowered its key interest rate to below inflation. Fiscal policy resources are increasingly limited. With the economy's plunge into recession, state revenues have declined substantially in real terms, and the finance ministry estimates that the consolidated budget deficit will exceed 5% of GDP in 2015. As financing deficits has become more difficult (given the government's objective of avoiding an excessively rapid use of the Reserve Fund, the high costs of foreign borrowing, and the weak condition of domestic banks), there is a need to further cut government spending through 2016.

The risks surrounding our forecast continue to be large. A focal risk arises from possible upward or downward changes of the oil price from its assumed track. The situation in eastern Ukraine remains uncertain. The occurrence of negative events could quickly weaken investor sentiments further whereas positive events would restore investor confidence so slowly that the impact would be rather small during our forecast period. Our import forecast is subject to a risk of various negative events like a possible further fall of the oil price or intensifying geopolitical tensions that would push capital out of Russia, weaken the Russian ruble and further depress imports. The country's leadership could opt for increasing government spending if social pressures were to grow tangibly in the run-up to State Duma elections in the fall of 2016 or to the presidential elections in spring 2018. This increased spending could improve growth over the forecast period but might weaken it later on.