Outlook for Selected CESEE Countries:

Moderate but Steady Growth amid a Notable Increase of External Risks[1,2]

As projected in spring 2014, economic growth in the *CESEE-6*[3] *region* will pick up in 2014 after having hovered around 1% in the two preceding years. The moderate expansion of 2.5% will be driven by strengthening domestic demand, which had been fairly weak in 2012 to 2013. Almost all countries in the region will show a notable improvement over 2013. Croatia is the only CESEE-6 country that will remain in recession also in 2014, while Romania will post a moderation in GDP growth. In 2015 and 2016, the positive contribution of domestic demand will increase further and lead to overall GDP growth of 2.5% and 2.7%, respectively. Hence, growth will become more balanced. Despite revived export and import growth, the contribution of net exports will diminish and turn negative in all countries but Croatia. However, over the entire projection horizon export and import growth will show some moderation. Import demand will recede somewhat from 6.4% in 2014 to 5.6% in 2015 and will reach 6% in 2016.

Russia's economic growth slowed to a crawl in the first half of 2014 (+0.8%) and is likely to stagnate for the year as a whole, primarily because of growing uncertainty triggered by the Ukraine crisis, including sanctions. Uncertainty is taking its toll particularly on investment and is likely to weigh on GDP growth altogether in 2014. We have thus lowered our forecast by half a percentage point for each year. In 2015 and 2016, the Russian economy should begin to see a meager

Table 1

GDP Projections for 2014 to 2016

	GDP	GDP forecasts			Imports	Import forecasts		
	2013	2014	2015	2016	2013	2014	2015	2016
	Annual growth in %							
CESEE-6	1.2	2.5	2.5	2.7	2.6	6.4	5.6	6.0
Bulgaria	0.7	1.6	2.2	3.1	6.2	4.1	5.2	5.1
Croatia	–0.6	–0.8	0.2	1.0	3.0	2.6	0.1	1.1
Czech Republic	–0.9	2.5	2.6	2.6	0.6	7.1	5.9	6.1
Hungary	1.2	3.4	2.2	1.9	5.3	8.0	6.0	5.7
Poland	1.6	3.1	3.0	3.2	2.4	7.2	6.2	6.8
Romania	3.3	1.9	2.4	2.7	2.3	6.0	7.0	8.4
Russia	1.3	0.0	0.5	1.5	4.0	–8.0	0.0	2.5

Source: OeNB, BOFIT, Eurostat, Rosstat.

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

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[2] *Cut-off date for these projections: October 6, 2014. The projections for CESEE-6 countries were prepared by the OeNB, those for Russia were prepared by the Bank of Finland in cooperation with the OeNB. They are based on the assumption of a gradual recovery in the euro area, in line with the September 2014 ECB staff estimate (see ECB Monthly Bulletin September 2014). This implies real annual GDP growth of 0.9% in 2014, 1.6% in 2015, 1.9% in 2016 and a slight decline of the oil price over the projection horizon from about USD 107 per barrel in 2014 to about USD 103 in 2016. We assume no further escalation of the Ukraine-Russia conflict, but also no settlement.*

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

and very gradual recovery as growth in global trade and the world economy pick up. Following a strong depreciation-triggered contraction in 2014, imports should stabilize in 2015 and slightly rise again in 2016. This forecast, however, presupposes that sanctions will not escalate further and will stay in place during the forecast period.

1 CESEE-6: Growth Stabilizes and Becomes More Balanced

In year-on-year terms, GDP in the CESEE-6 region expanded by 2.8% in the first half of 2014, supported by a rather accommodative policy mix. With low or even no inflationary pressure, monetary policy remained expansive – in particular in Hungary and Romania – while there was no further increase in fiscal consolidation. Hence, the recovery in domestic demand gained traction at the beginning of 2014, as predicted in our last forecast. Except in Bulgaria, export growth also accelerated markedly compared to the first half of 2013. However, most recent data paint a more mixed picture. In general, the pace of growth showed some decline in most countries from the first to the second quarter, and current leading indicators suggest that the economic expansion in the second half of the year will be more moderate, bringing the full-year growth rate to 2.5% for the region as a whole. For 2015 and 2016, we project no tangible further increase in growth. The region's GDP will expand by 2.5% in 2015 and by 2.7% in 2016.

Economic policies support domestic demand

For the remainder of 2014 and for 2015, we expect domestic economic policies to remain supportive of growth. In the Czech Republic, there will be some fiscal easing under the new government, with public sector wage increases in November 2014 and January 2015. In Hungary, the central bank's Funding for Growth Scheme continues to support gross fixed capital formation through improved access to funding for small and medium-sized enterprises. In Romania, the government has cut the social security tax by 5 percentage points and postponed the liberalization of gas prices for households. In Poland, recent decisions to increase social benefits and slow the speed of fiscal consolidation in 2015 are to be seen against the background of upcoming presidential and parliamentary elections in 2015. The situation in Bulgaria is less clear-cut, given uncertainty about potential additional consolidation needs that may arise in connection with the rescue of one of the two large banks that failed in June. Croatia is the only country where the fiscal stance will tighten, as more consolidation efforts required under the excessive deficit procedure have yet to be implemented. Overall, given the countries' generally strong commitment to reach EU fiscal targets, we do not expect a pronounced fiscal easing in the region, and the growth impetus from public consumption will remain between 0 and 0.3 percentage points (and turn negative again in Croatia).

In the remainder of 2014 and in 2015, economic growth in the CESEE-6 (with the exception of Croatia) will increasingly be driven by accelerating domestic demand alongside stable external demand (see chart 1). Private consumption will pick up notably in 2014 and 2015 in all countries, again apart from Croatia. Higher consumer spending will be supported by rising disposable incomes in an environment of low inflation supported by policy measures such as increases in minimum wages (in Bulgaria, the Czech Republic and Romania) as well as other measures to support purchasing power (e.g. pension indexation above inflation in Romania and administered price cuts in Hungary).

EU funds foster investments

In addition, in most countries, gross fixed capital formation will profit from the overlap of fund disbursements of two EU multiannual fiscal frameworks. Funds from the 2007–2013 framework can still be drawn until the end of 2015. In addition, funds from the 2014–2020 multiannual framework are already available. In general, EU fund utilization has improved. In Croatia, we expect a positive net effect from EU cofunding to materialize only in 2016. In Bulgaria, two projects have been suspended due to a dubious application of funds. In Romania, EU fund utilization in fact declined in the second quarter of 2014. Gross fixed capital formation increased strongly in Poland in the first half of 2014, mainly owing to good weather conditions and advance purchases of cars due to tax changes. Given good financing conditions for corporates, this trend will continue in the second half of the year despite relatively high interest rates. Another factor supporting investment growth in most countries could be higher defense expenditure[4] in accordance with the decision taken at the latest NATO summit to increase NATO members' military spending to 2% of GDP over the next ten years and generally stronger NATO commitments in view of the current geopolitical situation. In Romania and Hungary, supply-side effects are providing an additional push to output growth this year and in 2015, as large production capacities have become operational.

In 2016, we expect domestic demand to stabilize. In Hungary, the effects from increased production capacities will fade and the loss of policy-induced support of private consumption will dampen domestic growth drivers. In all other countries, the contribution of domestic demand will improve further, showing also a very cautious recovery for the first time since 2009 in Croatia.

Contribution of net exports turns negative despite robust external demand

In line with our external assumption for euro area growth, external demand will stabilize over the projection horizon. Compared to the first half of 2014, export growth will soften in all countries, in line with internationally weakening economic sentiment (especially in the euro area) and taking into account economic sanctions against and retaliation measures by Russia. As direct effects of existing sanctions on external demand are negligible, indirect effects through economic sentiment are more likely to be felt in all countries. The moderate downward trend in export growth will continue in 2015 and will flatten out in 2016. However, in general, export growth of 5.8% in 2014 (5.3% in both 2015 and 2016) will remain an important growth pillar. Bulgaria and Romania will show a modest temporary growth slowdown this year compared with 2013, which is likely to reflect a base effect. The strong improvement in Czech export growth in 2014 compared to the previous year seems to be related to some extent to central bank interventions to weaken the currency, a policy which will be kept until the beginning of 2016. Assuming some market-induced correction, this would result in weakening export growth and strengthening import growth (and hence a notable deterioration in the contribution of net exports) in 2016.

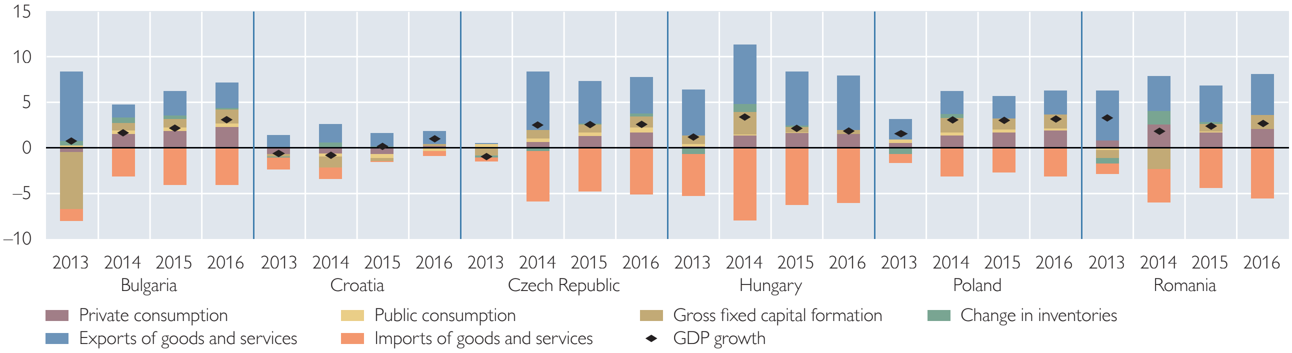
Import dynamics have been mixed in the second half of 2014, in line with country-specific demand characteristics. Compared to 2013, imports will, however, receive a notable boost. Year-on-year growth will rise from 2.6% in 2013 to 6.4% in 2014, implying a slight weakening over the first half of 2014. With the

[4] *According to the new European System of National and Regional Accounts (ESA 2010), defense spending is to be recorded as fixed-investment.*

Chart 1

GDP and GDP Components, Projections for 2014–2016

Contribution of GDP components in percentage points, annual GDP growth in %



Source: OeNB.

exception of Bulgaria and Romania, where base effects play an important role, import growth will fall in all countries and reach 5.6% in 2015 for the region as a whole. In 2016, import growth is set to accelerate somewhat to 6% in line with our projection of robust domestic demand. Hence, the contribution of net exports will turn moderately negative in 2015 in all countries apart from Croatia, where external demand will still make the sole positive contribution to GDP growth.

Downside risks dominate

The two foremost downward risks for the CESEE-6 countries stem from weaker than expected growth in the euro area and a potential stepping up of economic sanctions against and by Russia. Protracted economic slack in the euro area could feed through negatively to the CESEE-6 through lower external demand. Developments since the finalization of the September 2014 macroeconomic projection exercise (MPE) suggest that this risk is likely to materialize to some extent. Most recent hard and soft facts suggest that the assumption for euro area GDP growth underlying our baseline projection was rather too optimistic. At the same time, recent monetary policy measures by the ECB may also help to limit the extent to which this risk will materialize.

In the case of a further escalation of the Ukraine crisis,[5] the dependence of the CESEE-6 on energy imports from Russia and low substitution possibilities in the short run imply another sizeable downward risk since Russia is the most important supplier of energy for the region. Furthermore, indirect risks to CESEE-6 growth relate to unexpected shocks to global investor sentiment (e.g. due to stronger than anticipated repercussions of the Ukrainian crisis or other geopolitical events) and ensuing lower external demand, especially from the euro area. On the other hand, the direct risk from lower external demand from Russia due to trade sanctions is manageable.

[5] *We base this forecast on the assumption of no change in the status quo with respect to economic sanctions against Russia and no further retaliation measures by Russia, in particular no disruption of energy trade flows. In line with this assumption, we also presume that the military conflict in eastern Ukraine will not escalate further. While the current, unresolved situation will prevent economic sentiment from showing any significant improvement, it will not curb confidence further either.*

The effects of a sustained decline in oil prices below the assumptions underlying our baseline projection is difficult to assess given underlying deflation risks, but in the short run it is likely to pose an upside risk to growth in the CESEE-6.[6] Higher global growth poses a clear upward risk to our projection, both directly and indirectly via positive knock-on effects on euro area growth and thus on external demand. Moreover, a settlement of the conflict in eastern Ukraine or substantial progress toward a solution of the crisis before the end of the forecasting horizon would also push growth beyond our baseline projection. However, we consider the latter two events as rather unlikely.

2 Developments in Bulgaria, Croatia, the Czech Republic, Hungary, Poland and Romania

Bulgaria: Financial sector turbulences and political uncertainty weigh on recovery

In light of political uncertainty and problems in the banking sector, we have revised our spring forecast downward slightly and expect Bulgaria's real GDP growth rate to come to 1.6% in 2014. The recovery process should then continue gradually in 2015 and 2016, with growth reaching 2.2% and 3.1%, respectively.

The June bank run on two of the largest domestically owned lenders, Corporate Commercial Bank (CCB) and First Investment Bank (FIB), have translated into deteriorating economic sentiment indicators. The eventual extent of the ensuing deceleration in private consumption and industrial production will very much depend on whether it will be possible to rein in uncertainties related to political instability (the early parliamentary election called for October 5, 2014, did not result in a clear majority for either of the competing party blocks) and the resolution of CCB (in particular the payment of insured deposits despite the shortage in the Bulgarian bank deposit guarantee fund). If these uncertainties are resolved, private consumption and gross fixed capital formation are likely to be strong enough to drive a gradual recovery over the forecasting horizon.

Private consumption should still benefit from last year's social legislation changes (increase of minimum wages, indexation of pensions) and from the already long-lived drop in consumer prices (although we should see a return to inflation in 2015 as the base effects of cuts in electricity tariffs abate). A recent marked improvement in capacity utilization (back to levels last observed before 2009) is indicative of a turning investment cycle. We also expect stockbuilding to continue and public consumption to contribute positively to GDP growth. The latter will, however, be smaller than in 2013. At the current stage, the 2014 budget deficit will most probably surpass the Maastricht ceiling of 3% of GDP, among other things owing to the costs related to the rescue of CCB. Despite the one-off character of this rescue, fiscal prudence will be required in 2015 and 2016 to bring the budget deficit back below the domestic target of 2% of GDP and to rebuild some fiscal buffers.

In line with our external assumptions, we expect exports to accelerate gradually over the forecasting horizon. Expansionary monetary policy in the euro area and the resulting depreciation of Bulgaria's anchor currency should also stimulate exports. However, import growth will somewhat outpace export growth, reflecting

[6] *Given very recent oil price developments, the oil price may well stabilize in 2015 at a level which is as much as 10% lower than assumed in our baseline.*

resurging domestic demand and resulting in a negative growth contribution of net exports.

Croatia: Economic stabilization in 2015 and anemic growth in 2016 on the back of external demand

In Croatia, recessionary developments in the first two quarters of 2014 are most likely to continue for the rest of the year, with the overall contraction expected to come to 0.8% (previous forecast: contraction of 0.6%). In 2014, the main drag on growth will be declining gross fixed capital formation, reflected by negative credit growth as companies deleverage further. However, part of the negative contribution of gross fixed capital formation will be offset by stock changes, which we expect to be positive after two years of destocking. Private consumption will also influence growth negatively on the back of stagnant wages in the private sector, planned wage cuts in the public sector, elevated unemployment and persistently high household indebtedness. Regarding the public sector, we expect the planned budget revision to put a strain on public consumption. The only positive contribution will stem from net exports, as the recovery of the euro area will boost exports and imports will remain subdued due to weak private consumption.

For 2015, we expect anemic growth of 0.2%. This represents a downward revision of 0.5 percentage points from our previous forecast. External demand will be the sole driver of growth, while we expect imports to remain depressed. This is in line with our forecast of another year of declining domestic demand, with especially private consumption putting a drag on growth given continued negative credit growth and a poor labor market situation. As the government has to bring down the public deficit to meet the conditions under the Excessive Deficit Procedure (EDP) by 2016, we expect public consumption to continue to affect growth negatively; however, austerity pressure might ease up in the second half of 2015 in light of the upcoming parliamentary elections in February 2016. The decline in gross fixed capital formation, which started in 2009, should moderate in 2015 and should come to an end in 2016.

From 2016 on, we forecast an export-led recovery with a growth rate of 1.0%, as net exports will continue to contribute positively to growth and the contraction of domestic demand should come to a halt. We expect gross fixed capital formation to hit the turning point and start growing again slightly on the back of reviving credit growth and the utilization of EU funds. Also, private demand should start to recover due to improving labor market conditions. Only public consumption will put a drag on growth as consolidation efforts continue.

The domestic risks to this forecast are balanced. Public consolidation measures could harm growth more strongly than currently anticipated, and private consumption could take longer to recover. On the other hand, gross fixed capital formation could pick up already in 2015 if private investment is backed by an earlier credit market recovery and if more EU funds than expected can be tapped.

Czech Republic: Growth set to stabilize at 2½% a year

On the back of continuing exchange rate interventions by Česká národní banka (CNB) and improving consumer and investor sentiment, the Czech economy is expected to grow by 2.5% in 2014. We forecast slightly higher growth rates of 2.6% for 2015 and 2016, respectively. In the coming years, domestic demand is projected to be the main driver of GDP growth.

The new government, which took office in the first quarter of 2014, is committed to a pro-growth fiscal policy mix, which should further spur domestic consumption. This policy will materialize in the form of higher government consumption, which is expected to grow by around 1.9% in 2014, followed by increases of around 2.5% in 2015 and 2.9% in 2016. At the same time, the government pledged to stick to fiscal discipline, keeping the deficit and the debt level at current levels. Private consumption is expected to expand by 1.4% in 2014 and to rise to 2.6% and 3.6% in 2015 and 2016, respectively. Improving labor income and consumer sentiment will be supported by minimum wage and public sector wage increases in November 2014 and January 2015. This will stimulate household consumption further, which is expected to be one of the main determinants of GDP growth in the years to come. Gross fixed capital formation is projected to grow by 3.6% in 2016 after reaching 3.9% in 2014; it will be supported by higher capacity utilization, foreign direct investment inflows and capital inflows from EU funds.

To fight prevailing deflationary risks, the CNB will continue its exchange rate interventions until the beginning of 2016. However, we expect export growth to decline gradually, falling from 7.3% in 2014 to around 4.3% in 2016. The strong export performance in 2014 has been mainly supported by positive trends in traditional export markets and products (especially the automotive industry). Import growth is expected to remain strong, but will decline moderately to 6.1% in 2016. In conjunction with positive trends in private consumption and gross fixed capital formation, this shift toward domestic demand supports our expectation of a more broadly based recovery of the Czech economy, paving the way for more sustainable growth.

Hungary: Investment activity and economic policies boost growth only in the short run

The forecast of Hungarian GDP growth for 2014 as a whole has been revised upward substantially. We now expect it to reach 3.4% as solid nominal wage growth (especially in the private sector) combined with de facto stable prices (to a large extent due to administered price cuts) have bolstered households' real income. Together with improving labor market conditions, sharply improved consumer confidence, easing credit supply conditions and substantial retroactive compensation payments by banks for exchange rate margins on foreign currency loans and for unilateral hikes in interest rates and fees this will lead to a further expansion of private consumption. Private consumption growth is expected to receive a further boost in 2015 when these compensation payments will actually be paid out and – as repeatedly indicated by the government – parliament will additionally pass legislation to convert foreign currency loans into domestic currency loans. Consumption growth may decelerate somewhat in 2016 when one-off factors (e.g. administered price cuts, measures related to foreign currency loans) are set to taper off.

Public consumption growth will be held back by the need to keep the budget deficit below 3% of GDP and public debt on a steadily declining path, with the early stage in the election cycle (the next elections will not be before 2018) providing a supportive background for fiscal discipline.

Gross fixed capital formation growth is benefiting from the decline in the domestic interest rate level, the strengthening utilization of the second tranche of the central bank's Funding for Growth Scheme, and an accelerated absorption of EU funds. Also, increased capacity utilization and sharply improved business sentiment point toward a further rise in investment activity. The outlook for 2015 and 2016 is surrounded by uncertainty about the phasing out of the Funding for Growth Scheme. The odds are, however, that gross fixed capital formation growth will be substantially weaker in both years, as any remaining EU funds from the

2007 to 2013 programing period must be drawn by end-2015, leading to a "normalization" of fund inflows. The domestic interest rate cycle seems to have bottomed out, and the period of loose domestic monetary policy may come to an end toward late 2015 or early 2016 as inflation will be moving up to the central bank's target of 3%. Also, current GDP growth is substantially above the estimated potential growth rate (estimated at around 1% by both the OECD and the European Commission), which may ultimately anchor investment activity.

Although we have revised upward our forecast for export growth in 2014 on the basis of developments during the first half of 2014, we expect the pace to decelerate during the coming quarters. Despite the strengthening of euro area demand, we expect some deceleration in exports in 2015 to 2016, as the boost for exports from new production capacities in the car industry vanishes. In parallel, we expect strong import growth in 2014 on the back of domestic demand, leading to a relatively large negative contribution of net real exports. Along with the slowdown of domestic demand and exports in 2015 to 2016, import growth should decelerate as well, and net real exports should become a smaller drag on the overall GDP growth rate.

Poland: Growth drivers remain intact, but risks from Russia-Ukraine crisis cloud the outlook

In Poland, annual average growth in 2014 will amount to slightly more than 3%. The export-led recovery continues, as export growth will accelerate further to 5.6% (after 5.3% in 2013), underpinned by both the cost competitiveness of Polish manufacturing (reflecting unit labor cost and exchange rate developments) and the strong growth of German imports. This acceleration will be achieved despite the adverse impact of the economic developments in Ukraine and Russia, which is further aggravated by the Russian import ban on certain food items. Strong foreign demand continues to translate into strong fixed investment growth, which will reach nearly 8% (after a stagnation in 2013 and a contraction in 2012). The base effect, the favorable liquidity and profitability positions of enterprises, the easier availability of loan funds and the positive feedback of strengthening private consumption have been supporting investment spending. In addition, one-off factors early in the year (weather conditions boosting construction work, temporary tax allowances boosting car purchases) are lifting the growth rate of the total year. In parallel, restocking will imply a positive contribution of inventory change to GDP growth. Private consumption growth will recover markedly (2.4% after 0.8% in 2013), benefiting both from confidence channels and from improvements in the labor market. Moreover, disinflation will still have a beneficial impact. Overall, more than half of total final demand growth will come from domestic demand, and less than half from exports. Strong domestic demand growth on top of robust export growth will lift import growth to 7.2% (after only 2.4% in 2013). Thus, import growth will outpace export growth, so that the contribution of net exports to GDP growth will become moderately negative.

In 2015, we expect GDP growth to remain close to 3%. Exports will continue to be a pillar of GDP growth, but will grow slightly less than in 2014; also export growth will be slower than German import growth as a result of the further weakening of foreign demand from Ukraine and Russia. This weakening will be only partly compensated by the pick-up of imports by other euro area countries. On the domestic side, we anticipate a moderate slowing down of fiscal consolidation against the background of upcoming parliamentary and presidential elections. The government decision to increase social benefits in particular for lower-earning households by adjusting both the pension indexation scheme and tax deductions for families with children are indicative of this; moreover, the government-approved 2015 budget draft assumes a higher deficit than currently expected for 2014. This may well contribute to public and private consumption growth as well as to fixed investment growth, while the narrowing window to get disbursements from the EU multiannual fiscal framework for 2007 to 2013 will foster semipublic-sector fixed investment. Furthermore, we assume that larger household residential investment will benefit investment further, on top of some of the factors already prevailing in 2014. Finally, we anticipate higher military purchases, which are accounted for under fixed investment according to new ESA 2010 rules. As a result, we expect fixed investment growth to decline only slightly despite the adverse base effect. Export and investment demand will maintain the positive momentum in the labor market, underpinning private consumption growth further. Overall, the growth structure will remain balanced, with domestic demand again contributing more than half to total final demand growth. Import growth will thus continue to exceed export growth, albeit to a smaller extent than in 2014, implying a slightly smaller negative contribution of net exports to GDP growth.

Romania: 2014 slump in investments to be followed by moderate pickup

Following Romania's high GDP growth of 3.3% in 2013, data for the first half of 2014 were unexpectedly weak, as Romania posted two consecutive negative quarter-on-quarter GDP growth rates (–0.2% in Q1 and –1% in Q2). In particular, plummeting gross fixed capital formation dragged down year-on-year growth to 2.4% in the first half of 2014. Against this background, we revised our forecast for 2014 down to 1.9%, which presupposes positive quarter-on-quarter growth rates in the second half of 2014. Based on the continued recovery of private consumption and an expected rebound of gross fixed capital formation, we expect GDP growth to accelerate to 2.4% in 2015 and to 2.7% in 2016.

Private consumption performed better than expected in the first half of 2014 and will remain the main growth driver. A further increase of the minimum wage in July 2014, benefiting approximately 18% of employees, has already provided a further boost to rising real disposable income and will translate into higher private consumption in the near future. In the second half of 2014, private (and public) consumption will be supported by fiscal and energy price policy measures (e.g. the reduction of the social security tax by 5 percentage points as of October 1, 2014, the postponement of the gas price liberalization) ahead of the presidential elections. Romania's sound export performance is also likely to have a positive impact on the labor market and private wage growth. Moreover, we expect lending conditions to ease gradually over the forecast horizon.

Turning to gross fixed capital formation, it should be noted that after EU fund absorption had picked up in 2013, it seems to have lost momentum in the second quarter of 2014 according to balance of payments data. We do not consider this decline in EU transfers to be permanent. An improvement would be vital to revive investment growth over the forecast horizon. While the turning point in gross fixed capital formation is difficult to project, continuously improving economic sentiment together with the decline in the domestic interest rate level should lay the basis for some impulses in this area. Improvements in the banking sector (such as a declining loan-to-deposit ratio, stabilizing nonperforming loans) suggest that the supply conditions for a revival of lending (in particular in domestic currency) also improved. A sustained euro area recovery would help Romania to attract FDI inflows, while geopolitical tensions might negatively impact multinational companies' confidence.

Exports are forecast to maintain their positive momentum in line with our external assumptions and backed by continued declines in manufacturing unit labor costs. However, after years of weak (and most recently, negative) gross fixed capital formation growth, we do not expect a marked acceleration of export growth. As recovering domestic demand will boost import demand, net exports will make an increasingly negative contribution to overall growth.

3 Russia: Recovery Stalled by Effects of the Ukraine Crisis and Sanctions

Russian GDP growth declined to 0.8% year on year in the first half of 2014, despite transient boosts to production and consumption partly connected to the Ukraine crisis. Defense spending was stepped up, and households brought forward purchases in anticipation of higher inflation. We have slightly lowered our forecast from the previous one, given that heightened uncertainty induced especially by the Ukraine crisis as well as the related sanctions should impact on Russia's economy to such an extent that it effectively eliminates GDP expansion for 2014. Investments are bound to contract sharply, as private capital formation has been postponed; meanwhile, private consumption growth will decline further. The weaker ruble will compress imports in 2014. At the same time, we assume that financial market reactions to instability will remain limited overall and that sanctions will not escalate further (from their level of September 2014); they will stay in place during the forecast period. But uncertainty will continue to dampen private investment and will put somewhat of a drag on private consumption growth.

Given the government's low level of indebtedness and considerable fiscal resources, as well as the prominent role of state banks, Russia's authorities could in principle stimulate the economy for several years. However, such a policy shift would mean discontinuing the established, rather balanced fiscal policy that provides an anchor for the economy in unstable times. As things stand currently, a substantial government fiscal stimulus does not appear to be in the cards for the time being.

The Russian economy should start a gradual revival in 2015 and 2016, as growth in global trade and business activity are set to pick up. The oil price is assumed to decline only slightly (by about 5%) over the forecast period. To counterbalance private investment restraint, the authorities intend to boost investment by large state-owned enterprises. Giant transportation infrastructure projects funded partly by state loans could get underway in 2015. Now that Russian banks and firms have difficulties accessing Western lenders, financing will come increasingly through domestic channels. Despite the authorities' increasing emphasis on defense spending and self-sufficiency, only a relatively small amount of production capacity is likely to come on stream over the next two years. Given the time it will probably take for the unpredictable business climate to clear up, an overall (including private) investment recovery is not expected until the end of the forecast period.

Supported by some continuing real wage and pension growth, the increase in private consumption should pick up a bit again in 2015 and 2016. Yet even if the unemployment rate is currently quite low (around 5%), gains in private incomes and purchasing power are constrained by weaker corporate profitability and the likely continuing pertinence of the budget rule, high debt-servicing burdens (a legacy of the most recent retail credit boom) and higher inflation (induced by the weakness of the ruble). The volume of Russian exports will rise very slowly, depending on the global recovery. However, Western restrictions on exports of oil technology to Russia may also impact energy production, if only marginally in the next two years.

Russia's level of imports should stabilize in real terms in 2015 and should begin to recover in 2016 – as long as the ruble's new exchange rate level remains relatively stable. Imports would thus get support from a gradual rise of the ruble's real exchange rate, as Russia's inflation rate will remain notably higher than the inflation rates of its main trading partners.

Over the long term, the conditions for economic growth and development will likely deteriorate further to the extent that plans to boost the self-sufficiency of the national economy are implemented and the authorities move away from market-oriented reforms and competition. Such a strategy, involving protectionist policies and subsidization, may result in inefficient production capacities being maintained or newly created. This could entail a decline in Russia's long-term economic trend growth rate, which BOFIT up to now has estimated at about 2% p.a.

However, at the current high level of uncertainty, the risks to the forecast this time are significant and clearly downward tilted. In particular, a further deterioration of the situation in Ukraine and intensified hostilities as well as expectations of further sanctions and the additional uncertainty these conditions generate could lead to an even further postponement of private investment than anticipated. Capital outflows and the depreciation of the ruble would regain momentum and cut imports anew. A drop in the export prices of oil and other basic commodities would impair Russia's prospects of economic recovery, depress the value of the ruble, and hit consumption and imports. On the upside, economic growth during the next two years could revive faster than we forecast if the authorities decide to move ahead with a stronger stimulus that would involve stepped-up government spending or more central bank money injected into the economy via state banks as well as centrally directed investments.