

# Central, East and Southeast Europe: Recent Economic Developments and Forecast





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VASILY ASTROV  
RUMEN DOBRINSKY  
RICHARD GRIEVESON  
DORIS HANZL-WEISS  
GÁBOR HUNYA  
SEBASTIAN LEITNER  
ISILDA MARA  
OLGA PINDYUK  
LEON PODKAMINER  
SÁNDOR RICHTER  
HERMINE VIDOVIC  
GORAN VUKŠIĆ



## CONTENTS

Table: Forecast overview.....	1
Figure: Growth drivers.....	2
Albania: Institutional clash threatens stability .....	3
Belarus: Economy past the trough.....	4
Bosnia and Herzegovina: Some positive economic signals despite political stalemate .....	5
Bulgaria: Exports support an unexpected upturn.....	6
Croatia: Surprisingly strong start to the year .....	7
Czech Republic: Moderate growth continues .....	8
Estonia: External demand above expectations.....	9
Hungary: Signs of overheating .....	10
Kazakhstan: Trying to preserve the status quo.....	11
Kosovo: Stumbling Serbia–Kosovo dialogue.....	12
Latvia: Pace of growth changes to a lower gear .....	13
Lithuania: Domestic and external demand remain strong.....	14
Moldova: Stable growth supported by lax fiscal policy .....	15
Montenegro: Impressive surge in employment.....	16
North Macedonia: On the way back up .....	17
Poland: Social spending supports high growth.....	18
Romania: Still overheating.....	19
Russia: On the verge of recession.....	20
Serbia: Adjusting back to reality .....	21
Slovakia: Growth boosted by Jaguar Land Rover .....	22
Slovenia: Returning to a moderate growth path .....	23
Turkey: Still close to the eye of the storm .....	24
Ukraine: Growth holds steady despite political storm .....	25
Index of subjects – June 2018 to June 2019 .....	26

## OVERVIEW 2017-2018 AND OUTLOOK 2019-2021

		GDP					Consumer prices				
		real change in % against prev. year					average change in % against prev. year				
		2017	2018	Forecast			2017	2018	Forecast		
				2019	2020	2021			2019	2020	2021
BG	Bulgaria	3.8	3.1	3.5	3.4	3.1	1.2	2.6	2.5	2.5	2.5
CZ	Czech Republic	4.4	2.9	2.5	2.4	2.5	2.4	2.0	2.5	2.1	2.0
EE	Estonia	4.9	3.9	3.2	2.7	2.4	3.7	3.4	2.6	2.3	2.1
HR	Croatia	2.9	2.6	2.9	2.7	2.7	1.3	1.6	1.8	1.8	1.5
HU	Hungary	4.1	4.9	4.1	3.1	2.6	2.4	2.9	3.5	3.2	3.0
LT	Lithuania	4.1	3.5	3.2	2.7	2.4	3.7	2.5	2.2	2.1	2.0
LV	Latvia	4.6	4.8	3.3	3.1	2.7	2.9	2.6	2.6	2.4	2.4
PL	Poland	4.8	5.1	4.6	3.7	3.4	1.6	1.2	1.7	2.6	2.0
RO	Romania	7.0	4.1	4.1	3.6	3.3	1.1	4.1	4.0	3.0	3.0
SI	Slovenia	4.9	4.5	3.3	3.1	3.0	1.6	1.9	1.8	1.8	2.0
SK	Slovakia	3.2	4.1	3.6	3.0	2.5	1.4	2.5	2.3	2.1	2.0
	<i>EU-CEE11</i> <sup>1/2)</sup>	4.8	4.3	3.9	3.3	3.1	1.8	2.2	2.5	2.6	2.3
	<i>EA19</i> <sup>3)</sup>	2.4	1.9	1.4	1.5	1.4	1.5	1.8	1.6	1.6	1.6
	<i>EU28</i> <sup>3)</sup>	2.5	2.0	1.6	1.8	1.6	1.7	1.9	1.8	1.9	1.9
AL	Albania	3.8	4.1	3.7	3.7	3.5	2.0	2.0	1.9	2.1	2.4
BA	Bosnia and Herzegovina	3.2	3.1	2.7	2.8	2.8	0.8	1.4	1.5	1.6	1.4
ME	Montenegro	4.7	4.9	3.1	3.0	2.1	2.4	2.6	1.9	1.8	1.9
MK	North Macedonia	0.2	2.7	3.1	3.4	3.4	1.4	1.5	2.0	2.0	2.0
RS	Serbia	2.0	4.3	2.9	2.7	2.6	3.0	2.0	2.7	2.8	2.8
XK	Kosovo	3.7	3.9	4.1	4.1	4.0	1.5	1.1	1.6	1.6	1.6
	<i>WB6</i> <sup>1/2)</sup>	2.5	3.8	3.1	3.1	2.9	2.1	1.8	2.2	2.3	2.3
TR	Turkey	7.4	2.6	-1.2	2.8	3.1	11.1	16.3	16.5	13.0	11.2
BY	Belarus	2.5	3.0	2.3	2.1	2.0	6.0	4.9	7.0	8.0	8.0
KZ	Kazakhstan	4.1	4.1	3.6	3.2	3.2	7.4	6.0	5.5	5.0	5.0
MD	Moldova	4.5	4.0	4.0	3.5	3.4	6.5	2.9	4.0	4.7	4.3
RU	Russia	1.6	2.3	1.3	1.7	1.9	3.6	2.9	4.9	3.9	2.9
UA	Ukraine	2.5	3.3	2.7	3.0	3.5	14.4	10.9	9.1	5.2	5.0
	<i>CIS4+UA</i> <sup>1/2)</sup>	2.0	2.6	1.7	2.0	2.2	4.9	3.9	5.4	4.3	3.5
	<i>V4</i> <sup>1/2)</sup>	4.5	4.6	4.0	3.3	3.1	1.9	1.7	2.2	2.5	2.1
	<i>BALT3</i> <sup>1/2)</sup>	4.4	3.9	3.2	2.8	2.5	3.5	2.7	2.4	2.2	2.1
	<i>SEE9</i> <sup>1/2)</sup>	5.0	3.7	3.7	3.4	3.1	1.4	3.0	3.1	2.6	2.6
	<i>CIS3+UA</i> <sup>1/2)</sup>	3.3	3.6	3.1	2.9	3.1	9.6	7.5	7.0	5.6	5.5
	<i>non-EU12</i> <sup>1/2)</sup>	3.7	2.6	0.9	2.3	2.5	6.7	7.6	8.6	6.9	5.8
	<i>CESEE23</i> <sup>1/2)</sup>	4.0	3.1	1.8	2.6	2.7	5.3	6.0	6.8	5.6	4.8

ctd.

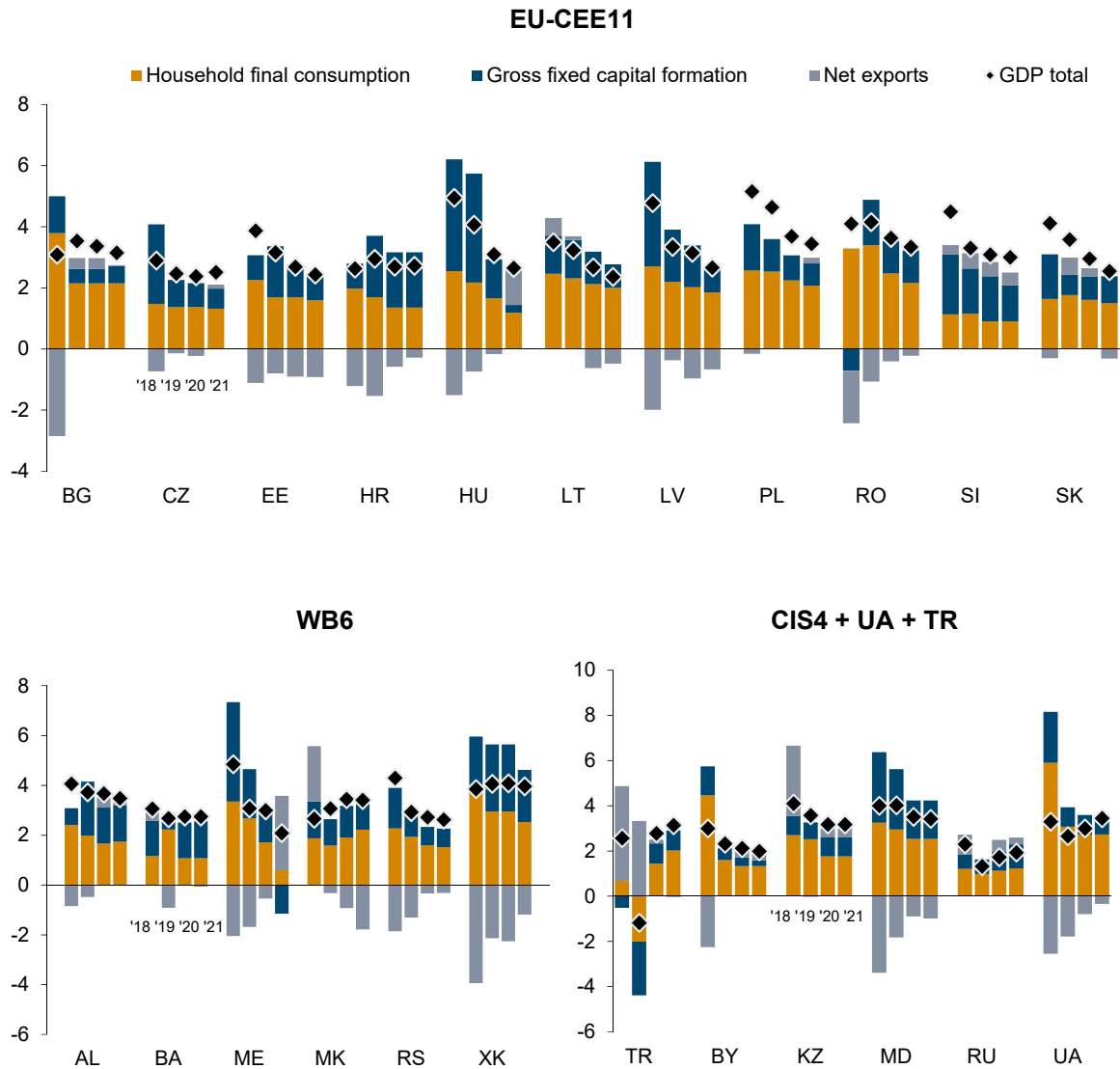
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		Unemployment (LFS)					Current account				
		rate in %, annual average					in % of GDP				
		2017	2018	Forecast			2017	2018	Forecast		
				2019	2020	2021			2019	2020	2021
BG	Bulgaria	6.2	5.2	5.0	4.8	4.6	6.5	4.6	3.6	3.2	3.1
CZ	Czech Republic	2.9	2.2	2.2	2.2	2.2	1.0	0.3	0.1	0.2	0.3
EE	Estonia	5.8	5.4	5.0	4.5	4.3	3.2	1.7	1.3	0.7	0.9
HR	Croatia	11.2	8.5	7.5	7.0	6.5	3.7	2.6	2.0	1.6	0.8
HU	Hungary	4.2	3.7	3.5	3.5	3.5	2.8	0.5	0.1	0.1	0.4
LT	Lithuania	7.1	6.2	5.6	5.2	4.8	0.9	1.6	0.8	0.2	0.0
LV	Latvia	8.7	7.4	6.7	6.3	6.0	0.7	-1.0	-0.2	-0.5	-0.6
PL	Poland	4.9	3.9	3.7	3.4	3.4	0.2	-0.7	-1.0	-1.0	-1.1
RO	Romania	4.9	4.2	3.8	3.8	4.0	-3.2	-4.5	-4.8	-4.6	-4.7
SI	Slovenia	6.6	5.1	4.5	4.0	4.0	7.2	7.0	6.6	5.9	5.7
SK	Slovakia	8.1	6.5	6.2	5.8	5.6	-2.0	-2.5	-1.6	-1.3	-1.0
	<i>EU-CEE11</i> <sup>1)2)</sup>	5.3	4.3	4.1	3.9	3.8	0.6	-0.4	-0.7	-0.7	-0.7
	<i>EA19</i> <sup>3)</sup>	9.1	8.2	7.8	7.6	7.6	3.8	3.5	3.1	2.9	2.8
	<i>EU28</i> <sup>3)</sup>	7.6	6.8	6.3	6.1	6.1	2.6	2.1	1.8	1.6	1.5
AL	Albania	13.7	12.3	11.7	11.4	11.0	-7.5	-6.7	-5.7	-5.6	-5.2
BA	Bosnia and Herzegovina	20.5	18.4	16.6	15.0	14.0	-4.7	-4.2	-4.8	-4.6	-4.4
ME	Montenegro	16.1	15.2	14.3	14.0	13.9	-16.1	-17.2	-17.8	-18.0	-14.3
MK	North Macedonia	22.4	20.7	20.0	20.0	19.0	-1.0	-0.3	-1.5	-2.6	-3.2
RS	Serbia	13.5	12.7	11.5	10.8	10.3	-5.2	-5.2	-5.2	-4.9	-4.7
XK	Kosovo	30.5	29.6	29.5	29.0	28.0	-6.1	-8.3	-8.6	-9.3	-9.0
	<i>WB6</i> <sup>1)2)</sup>	16.9	15.7	14.7	14.0	13.5	-5.5	-5.5	-5.6	-5.6	-5.3
TR	Turkey	10.9	10.9	13.5	13.4	11.5	-5.5	-3.5	-0.4	-1.5	-2.2
BY	Belarus	5.6	4.8	4.6	4.5	4.5	-1.7	-0.4	-0.9	-1.2	-1.7
KZ	Kazakhstan	4.9	4.9	5.0	5.0	5.0	-3.1	0.0	-1.8	-2.9	-2.7
MD	Moldova	4.1	3.1	3.0	3.0	3.0	-5.9	-10.5	-9.5	-7.6	-7.4
RU	Russia	5.2	4.8	4.6	4.5	4.4	2.1	6.9	4.2	4.1	3.9
UA	Ukraine	9.5	8.8	8.4	8.1	7.8	-2.2	-3.4	-3.3	-3.3	-3.0
	<i>CIS4+UA</i> <sup>1)2)</sup>	5.9	5.4	5.3	5.1	5.0	1.3	5.3	2.9	2.8	2.7
	<i>V4</i> <sup>1)2)</sup>	4.7	3.8	3.6	3.4	3.4	0.5	-0.5	-0.7	-0.6	-0.5
	<i>BALT3</i> <sup>1)2)</sup>	7.3	6.4	5.8	5.4	5.1	1.4	0.9	0.7	0.1	0.0
	<i>SEE9</i> <sup>1)2)</sup>	9.7	8.6	8.1	7.7	7.6	-1.5	-2.6	-3.0	-3.0	-3.1
	<i>CIS3+UA</i> <sup>1)2)</sup>	7.5	6.9	6.7	6.5	6.3	-2.7	-1.6	-2.4	-2.9	-2.8
	<i>non-EU12</i> <sup>1)2)</sup>	7.5	7.1	7.6	7.4	6.9	-1.0	2.6	1.8	1.4	1.1
	<i>CESEE23</i> <sup>1)2)</sup>	7.0	6.4	6.7	6.6	6.1	-0.4	1.5	0.9	0.7	0.5

1) wiiw estimates. - 2) Current account data include transactions within the region (sum over individual countries). - 3) Forecasts estimated by wiiw.

Source: wiiw, Eurostat. Forecasts by wiiw (June 2019).

## GDP growth in 2018-2021 and contribution of individual demand components in percentage points



Source: wiiw Annual Database incorporating national and Eurostat statistics, own calculation. Forecasts by wiiw.



## ALBANIA: Institutional clash threatens stability

BY ISILDA MARA

**Political turmoil and institutional clashes are jeopardising the stability and EU prospects.** While this report was being prepared, political tensions were mounting and a number of institutional incongruences were ongoing. The country is inundated by protests – initiated first by students and thereafter led by the opposition. The latter has boycotted the parliament and will not participate in the local elections, planned for 30 June 2019, unless Prime Minister Edi Rama steps down. Recently facts alluding to electorate vote bribery during the 2017 parliamentary elections have emerged. Given the current political turmoil, President Ilir Meta on 10 June signed a new decree which annuls the approaching local elections. However, Mr Rama is determined to go ahead and hold local elections despite the president's decree. Meanwhile, the procedure for discharging the president was launched on 11 June. Currently, the Albanian political class is demonstrating unwillingness to reach any consensus. The European Commission announced in May 2019 that it supports the unconditional start of accession talks with Albania. Also in May, Frontex (the European Border and Coast Guard Agency) started its operation in Albania, although the country is not an EU member. The Frontex mission aims at preventing illegal migration and cross-border crime via the Mediterranean route. In June 2019, the EU Parliament received a request from the Netherlands to reintroduce a visa regime with Albania. The motive is to curb surging organised crime originating from Albania. Its approval will solely prevent Albanian citizens from freely travelling, while criminals will to a certain degree find a way to circumvent the barriers. France and the Netherlands are among the few countries not supporting the start of accession talks with Albania.

**Growth has passed its peak and will hover below to 4% in the medium term.** The economy grew by 4.1% in 2018. We expect growth at a slower pace going forward, as external and domestic demand weakens. The upswing in industrial production by 14% in 2018 – owing to electricity production – is unlikely to be repeated. Household consumption and gross fixed capital formation will continue to contribute positively to growth, but the impact is expected to be less strong as both are levelling off. Vulnerabilities from public private partnership projects (PPPs) are on the rise. Arrears, particularly in VAT disbursement, soared. Public investment spending fell by 20% y-o-y and absorbed less than 10% of total expenditures in January-April 2019. PPP projects lack transparency and proper monitoring and have inflated construction costs. Contingency risks from PPPs might exacerbate the public debt.

**A weakening of external demand and a deterioration of the trade balance are expected and FDI inflows are likely to decline.** Goods exports contracted by 2.3% while imports rose by 3.2% in the first four months of 2019, y-o-y. In 2018 electricity exports were favourable, but the opposite emerged for Q1 2019, when electricity imports amounted to more than EUR 100 million. A further appreciation of the lek contributed to declining exports in the garment industry. In 2018 FDI inflows exceeded EUR 1 billion – half driven by TAP (Trans Adriatic Pipeline) and Devoll Hydropowers. These projects will be finalised in 2019. Chinese FDI in Albania stood at zero level both in 2017 and 2018 despite Chinese companies operating in strategic sectors such as the oil extraction industry and transport. FDI inflows from Turkey doubled in 2018, reaching 10% of the total last year. For 2019 we expect FDI inflows to fall as some new projects will experience delays; e.g. the negotiations with the Turkish consortium for Vlora Airport failed. The discovery of new oil reserves will boost the economy in the medium to long term. In May 2019, Shell announced to have discovered extensive oil reserves in Shpirag, located in south-central Albania. Few weeks prior to the announcement the Shell Company and the Albanian government revised their agreement. The government will reap profits from the start of oil production, which will certainly boost public finances and growth starting from the first half of the next decade.

## BELARUS: Economy past the trough

BY RUMEN DOBRINSKY

**According to flash estimates GDP grew by 1.1% year on year in the first quarter.** There was a modest upturn at the beginning of 2019 after the cyclical downturn of 2018 had reached its trough in year-on-year terms at the turn of the year. The slow recovery was supported by domestic demand: private consumption remained strong; there was also a certain revival of investment activity. Consumer demand was underpinned by a continued rise in real wages and household credit.

**Gross industrial production in January-April increased by 1.2% from the same period of 2018.** The current relatively high level of world oil prices benefited Belarus indirectly as it exports large quantities of processed oil; this supported the modest recovery of manufacturing output in the first months. Construction activity also started a slow recovery in this period.

**However, the contamination of Russian oil delivered through the Druzhba pipeline dealt another blow to the Belarus economy.** This caused a temporary halt of deliveries to Belarus and transit through the country in April-May. It will take time to assess fully the damage caused by this breakdown but it will surely have a negative economic impact.

**Inflation in 2019 is likely to be higher than in 2018.** This reflects a slight relaxation of the fairly tight macroeconomic policy stance (both monetary and fiscal) that had contributed to the disinflation in recent years. On balance there was not much movement in the labour market; however, the aggregate figures mask an ongoing intensive labour churning.

**Economic relations with Russia remain tense due to the continuing trade disputes.** The most important of them are associated with the clauses related to supply of oil and gas but tensions also proliferate to other economic matters. They are reflected in some hostile measures such as occasional Russian restrictions on the imports of dairy and meat products due to alleged phytosanitary irregularities that Belarus finds unsubstantiated; ongoing Russian allegations about suspected smuggling via Belarus of embargoed EU products, etc. The existing tensions have also affected the financial sphere. Thus, USD 200 million funding from the Eurasian Development Bank due in the first quarter was suspended without official explanations. There are also delays in the finalisation of an envisaged USD 600 million credit agreement with the Russian government.

**Belarus is seeking to diversify its sources of external funding with the target of raising a total of USD 2 billion in 2019.** The Belarus Development Bank already successfully placed a USD 500 million bond, and new USD 100 million funding from China was agreed. Also, the Belarusian government resumed negotiations with the IMF on a new Fund-supported programme. So far Belarus has been managing and servicing successfully its foreign debt and there are no imminent risks related to it.

**GDP growth is expected to remain sluggish in the short run.** For 2019 as a whole it is likely to stay in the range of around 2% p.a., mostly driven by the recovering domestic demand. Further developments will largely depend on the settlement of the disputes with Russia and on the growth prospects of the Russian economy, which at present are not very optimistic.

## BOSNIA AND HERZEGOVINA: Some positive economic signals despite political stalemate

BY GORAN VUKŠIĆ

**The political stalemate in Bosnia and Herzegovina continues as the government has not been formed yet, neither at the country level nor in the Federation of Bosnia and Herzegovina.** The main points of disagreement remain the country's path towards NATO accession at the country level, and the Electoral Law in the Federation. The prolonged political stalemate is likely to (further) slow down policy decision-making and the execution of public investment, and weigh on private investment through increased uncertainty and the likely absence of substantial business environment-improving reforms.

**Despite the political constellation consumers' optimism was strong, as retail sales rose by 7.2% year on year (in real terms) during the first four months of 2019,** supported by increases in (registered) employment and nominal (net) wages, amounting to 3.7% and 4.9%, respectively. An additional impulse has likely come from credit growth to households, which equalled 7.4%. Consumer prices grew by only 1% despite increased domestic demand.

**Industrial output, in contrast, declined during the first four months by 5.2% y-o-y.** While the output of energy, a typically volatile segment, was reduced by 16.1%, the production of capital goods rose by 10.5%, and of durable consumer goods by 4.3%. Because of wage pressures, unit labour costs in industry have increased at the beginning of 2019, but the pass-through to producer prices has been weak so far, with the latter rising by only 1.4% y-o-y in the first quarter. Total construction works declined by 1%, driven by a larger drop of 4.2% in civil engineering works, during the first quarter.

**Merchandise imports expanded by 4.8% during the first four months of 2019, while exports declined by 1.1%,** reflecting the above developments. Tourism, however, continues last year's expansion with arrivals and overnight stays of tourists during the first quarter growing by around 10% y-o-y. The rise was stronger for foreign tourists and in the segment of hotels and similar accommodation. Correspondingly, employment in the sector of accommodation and food service activities in the first four months of 2019 grew by 9.2% y-o-y.

**Unemployment is on the decline with the number of registered unemployed persons in March 2019 by 9.2% lower** than in the same month last year. This translated into a 3 pp drop in the registered unemployment rate, which, however, remains high at 34%. The survey-based unemployment rate (LFS), at 18.4% in April 2018, is expected to have declined to 16.6% in April this year.

**The government projected a balanced general government budget for 2019 and small surpluses over the next two years.** The share of public debt in GDP is expected to decline to slightly below 29% by the end of 2021. It should, however, be noted that the government's country-wide short-term fiscal reporting, as well as the medium-term planning, have displayed significant weaknesses in the past.

**Considering all of the above, our growth forecast has been slightly revised upwards to 2.7% in 2019, and 2.8% in 2020 and 2021.** In 2019, growth will mostly be driven by household consumption. Under the assumption that the government is formed by the end of 2019, (public) investment is expected to pick up during 2020-2021. Thus, the contribution of investment to growth should increase towards the end of the forecast period, while that of household consumption should decline.

## BULGARIA: Exports support an unexpected upturn

BY RUMEN DOBRINSKY

**GDP grew by an unexpectedly strong 4.8% year on year in the first quarter which was much above the rates recorded in the previous quarters and the prevailing ex ante expectations.** Both net exports and private consumption contributed to this outcome while the contribution of gross fixed capital formation was only marginal.

**Better than expected export performance was the main factor behind the economic upturn.**

Monthly exports rose sharply in February, which likely reflects the finalisation of one-off large shipments as has happened in the past as well. The recovery of exports supported an upturn in manufacturing: its gross output rose by 5.3% year on year in the first quarter after a meagre 0.8% in the last quarter of 2018. There was also a notable revival in the construction sector in the first months of the year. This was especially visible in housing construction, which had stagnated the previous year.

**Credit activity (both corporate and household credit) also rebounded in the first quarter compared to the situation in the preceding months.** This mirrored the upturn in domestic demand and added further support both to private consumption and to manufacturing and construction performance.

**The labour market remained very tight.** At present the employment rate is close to its limits and so are the internal sources of employment growth. There was a slight decline in the unemployment rate but it is unlikely to expect a notable further decrease due to the existence of a pool of long-term structural unemployment. Mirroring the situation in the labour market, wages continued to rise fast. The cost-push pressures coming from the labour market have started to translate into inflationary pressure. CPI is expected to rise in 2019 and will likely be in the range between 3% and 4% p.a.

**The rise in real wages so far has not affected negatively Bulgaria's competitiveness.** This is evidenced by the solid export performance and the steadily positive current account balance. Despite their continuing rise, Bulgaria's unit labour costs in absolute terms still remain below those in most EU-CEE countries. In turn, the robust rise in the exports of services has also contributed to the current account surplus.

**Counter to some ex ante polls, the European elections brought a sweeping victory to the ruling GERB party.** The opposition Socialist party, which had hoped to come up first and use this to trigger early elections, had to put off such aspirations to the indefinite future.

**The short-term outlook for the Bulgarian economy has improved since the beginning of the year.**

Overall, the annual rate of GDP growth for 2019 as a whole is expected to be around 3.5% or even higher. However, if the EU economy remains anaemic, economic growth in Bulgaria is likely to decelerate in the following years. At the same time, cost-push pressures can be expected to rise further which may result in an acceleration of inflation.

## CROATIA: Surprisingly strong start to the year

BY HERMINE VIDOVIC

**Croatia's GDP grew by an unexpected 3.9% year on year in the first quarter of 2019, which was significantly higher than in the previous quarters.** Growth was supported primarily by domestic demand, household consumption in particular, up by 4.4%, while net exports contributed negatively to GDP growth. Growth of gross fixed capital formation, which had gained momentum from the last quarter of 2018, accelerated by 11.5%, most notably through EU funding. This was the highest investment growth since the second quarter of 2008 and was reflected in a noticeable increase in construction output, e.g. in infrastructure (roads, railways and airports). After having declined in 2018, industrial production grew by a meagre 1.6% in the first quarter of the year. In May the bankruptcy procedure against the ailing Uljanik shipyard was initiated. There are ongoing talks about a possible entry of Chinese investors, both in the Uljanik shipyard (Pula) and the 3<sup>rd</sup> May shipyard in Rijeka.

**Labour market conditions continued to improve during the first three months of 2019.** According to Pension Insurance data, employment increased by 2.2%. The LFS unemployment rate fell to 7.3% in April. Labour and skill shortages are becoming more prevalent, particularly in certain sectors such as construction, tourism and IT. As for 2019, the government has issued 41,800 work permits for foreign workers, the majority for construction and tourism, but also for agriculture and transport. Labour shortages, apart from rising minimum wages, are among the major causes of wage increases: in the first quarter of 2019 real gross wages increased by 3.4%, net wages by 3.1%.

**External trade data available for the first two months of 2019 point to a widening of the trade deficit,** resulting from higher growth of goods imports ahead of exports. Assuming that the services trade surplus remains unchanged, the current account deficit has likely deteriorated against the same period a year earlier, to about EUR 2 billion in the first quarter of 2019.

**Joining the eurozone is the key priority of the Croatian government and the National Bank.** A letter of intent for entering the ERM II will be likely submitted in July, which would allow joining the ERM II in 2020. The authorities are seeking to continue fiscal consolidation: In 2018 the general government budget closed with a surplus of 0.2% of GDP and the public debt to GDP ratio fell to 74.6%. Based on data for the first months of 2019, it can be assumed that the budget will be balanced again this year.

**In April/May Croatian trade unions collected signatures to force a national referendum to withdraw some provisions of the pension reform adopted in late 2018.** The proponents call, among others, for lowering the retirement age from 67 to 65 years (due to the lower life expectancy than in other European countries) and reducing financial penalties for early retirement. In order to avert the referendum, the government offered negotiations on single items of the reform.

**Following the positive developments in the first quarter of the year, wiiw has revised its GDP forecast from the earlier 2.5% to 2.9%.** For the period 2020 and 2021 we expect GDP to grow by some 2.7% annually, driven primarily by domestic demand. Revenues from tourism are expected to remain robust, but probably below the levels reached in the past couple of years, due to the return of competition from Turkey and Northern Africa. The current account should remain in positive territory, but declining gradually.

## CZECH REPUBLIC: Moderate growth continues

BY LEON PODKAMINER

**In the first quarter of 2019 the Czech economy performed unimpressively, following the pattern clearly visible throughout the previous year.** Overall GDP growth remains subdued (2.6% year on year) with the slowly growing domestic demand as its main determinant. Growth of household consumption is quite weak – and growth of gross fixed capital formation is also subdued. In real terms exports and imports of goods and non-factor services increased at almost the same speed (about 2%) in the first quarter. But because the Czech trade balance is positive (and rising), foreign trade contributed quite substantially to growth (by about 0.6 percentage points).

**Performance throughout 2019 and even beyond is very likely to conform to the recent pattern.**

Private consumption demand seems to have been dissociated from the rapidly rising household disposable incomes (the latter has been strongly pushed upward by the fast rising aggregate employee compensation). It is possible that the Czech households' gross saving rate will be increasing in the medium term. Preliminary calculations indicate that the household saving rate hit a bottom of 9.5% in 2017 – rising to 10.8% in 2018. This is still less than the average for the years 2011-2016 (11.5%). Hence, there is space for a further rise in the saving rate and thus for the household consumption demand growing less than household incomes.

**Growing household saving propensities may well reflect strengthening households' preference**

**for the acquisition of financial assets** (and, possibly, improving housing standards). Such a preference change seems quite natural in an economy that has been attaining a fairly high level of affluence. Another reason why household demand does not keep abreast of the rising incomes is inflation shaving off some fraction of the real purchasing power of household incomes. Last, but not least, a significant part of the rising wage bill ends up not as domestic consumption spending but rather as remittances sent abroad by foreign workers (primarily to Ukraine).

**Gross fixed investment is likely to grow rather slowly in 2019 and also beyond.** The EU funds supporting very high infrastructural investment in 2018 have been largely exhausted. The business sector (including foreign companies) does not seem to be keen on undertaking investment on a massive scale. Higher nominal interest rates do not seem to matter very much (interest rates on loans to non-financial corporations are not high in real terms anyway). Perhaps also the rising wages and unit labour costs are not the main concerns. Very likely it is the shortage of labour which may be essential in deterring larger investments in the Czech Republic. But, also uncertainties over the future course of the exchange rate and the prospects of growth in the EU core may be important.

**The conservative fiscal and monetary policies will preserve economic stability without inducing**

**higher growth.** Responding to higher (but still moderate and lower than the official upper tolerance bound) inflation, the National Bank has been raising its policy rate. The current 2% policy rate may suffice to push inflation back towards its long-term target (2%) without strengthening the exchange rate too much (which would be unfavourable for foreign trade). Fiscal policy also remains stability-oriented. Despite fairly low public debt and very low costs of its servicing, fiscal policy continues to work out surpluses. In the present circumstances fiscal restrictiveness is appropriate. Given the fact that the Czech economy is close to full employment it is actually in no great need for additional fiscal stimulation.

## ESTONIA: External demand above expectations

BY SEBASTIAN LEITNER

**The Estonian economy surprised in the first quarter of 2019, growing by 4.5% in real terms year on year. Export growth slightly slows this year, but remains above expectations.** Goods exports to most EU countries remain vibrant, particularly to Poland, Latvia and Denmark, while exports to the CIS have declined. The food, machinery and wood manufacturing sectors report strong demand. Strongly rising wages are, however, putting pressure on exporting firms; thus, in order to sustain export growth, investments in higher segments of the value chain are needed. Overall, we expect growth in goods exports to level off in 2020 to 2021. Given the swiftly rising household incomes, imports will increase more strongly than exports.

**Investment activity continued to revive as expected in the first quarter of 2019 after being restrained in 2018.** Throughout 2019 and 2020 the growth of EU-financed public investment in infrastructure will remain vivid. In addition, firms increase their investments in equipment and vehicles, given the favourable demand situation. The first four months of this year show an increase in new credits to households by 7% year on year; for non-financial enterprises by even more. We see no sign of risk, since private debt to GDP is declining. At the same time, the dwelling market moves towards saturation, the dynamics of granted building permits suggests that residential investments are likely to fall in the coming two years. Apartment prices have again reached the pre-crisis levels in Tallinn, but have stopped growing recently.

**In the first quarter of 2019, the unemployment rate (according to LFS) fell to 4.7%**, and is expected to attain an all-time low of 4.5% on average in 2020. Although return migration of Estonians started to surpass emigration from 2017 onwards, the Estonian working-age population continues to decline. Nevertheless, employment growth will attain 1% again in 2019, since an increasing number of workers from e.g. Ukraine and Belarus are offered short-term residency permits particularly for jobs in the construction sector. Employment grows not only in private but also in public services sectors.

**Growth of real gross wages accelerated to 5.3% in the first quarter of 2019 year on year**, partly thanks to the increase in the minimum wage to EUR 540 in January 2019. Besides, household incomes and private consumption have been bolstered by a strong rise in the basic exemption of the personal income tax to EUR 500 per month. Forward-looking consumer confidence indicators have strengthened in the past four months and the most recent retail trade statistics indicate a good spending mood. As a result, consumer inflation is declining less than expected and will probably attain 2.7% in 2019.

**The incoming centre-right coalition government announced to increase pensions more swiftly in the coming years; a reduction of the structural budget deficit is, however, envisaged in the preliminary budget plan for 2020.** The nationalist 'Conservative People's Party of Estonia' heading now the Ministries of Interior and Finance called for a reduction of immigration from non-EU countries including Ukraine and Belarus before the elections. Should their restrictive programme be implemented, the resulting labour shortage would reduce growth prospects for the Estonian economy.

**Compared to our Spring Forecast we have become more optimistic, increasing the forecast GDP growth rate for this year from 2.9% to 3.2%** on account of reviving public and private investment and higher external demand. For 2020 and 2021, we also revised our GDP growth forecasts upwards, to 2.7% and 2.4%, respectively.

## HUNGARY: Signs of overheating

BY SÁNDOR RICHTER

**In the first quarter of 2019 strong economic growth has continued while signs of overheating emerged.** According to national accounts statistics, the 5.3% GDP expansion in the first quarter was driven by multiple factors: household consumption increased by close to 5%. Meanwhile, public consumption, after declining in the previous quarters, grew by over 2%. The real surprise is, however, gross capital formation. While gross *fixed* capital formation grew by 23.4%, gross capital formation increased by only 5.7%. This may be true only if inventories were strongly depleted, an unexpected development with regard to no observed accumulation of inventories in the previous quarters. Another unexpected development was that even foreign trade (net export) contributed to growth, as the growth rate of exports slightly exceeded that of imports. Current account data show the opposite. Concerning the production side of the GDP, growth was extremely strong, 47%, in construction, driven by EU transfers related projects and also by a boom in housing construction. This latter is a rebound after long stagnation helped by newly introduced subsidies.

**After many years of flagging investment in manufacturing, a strong 33% upturn was recorded in the first quarter.** Growth was broad based covering nearly all sub-sectors, including electrical equipment, chemicals and chemical products, basic metals, fabricated metal products and the food industry. Investments in the manufacture of transport equipment expanded moderately. This is important news because, first, manufacturing is less dependent on EU transfers than other sectors and, second, this time it was not the generally dominant automotive cluster that played the main role in investment growth. The question whether this is the start of a self-sustaining growth promising a 'life' for the Hungarian economy outside the realm of EU transfers and the mostly German-owned car manufacturers, or whether it is just a statistical phenomenon showing extraordinary developments in a single quarter, is left to be answered later this year. Nevertheless, strong presence of EU transfers is still evident; for instance, investment in transportation and storage increased by 62%, predominantly financed from EU resources. In the arts, entertainment and recreation sector, dominated by sports-related projects, investment increased by 56%, and this sector's investment volume already exceeds that of combined investments in education and healthcare.

**The economy is overheating.** Year-on-year CPI inflation amounted to 3.9% in April, the core inflation to 3.8% and producer price inflation to 4.1% in March. Housing prices have been increasing well over the inflation rate. Newly introduced subsidies and the re-introduction of a higher value added tax rate for housing construction make a further strong rise in prices in that sector likely. Net wages increased by more than 11% (in nominal terms) in January-February. Capacities are utilised to a high degree, available additional workforce is rare. Despite all this the central bank reckons with subdued inflationary pressure over the year, referring to the deteriorating growth prospects on a global scale, and it remains reluctant to terminate its extra-loose monetary policy.

**There is no doubt that the Hungarian economy is heading towards a lower growth path in 2019-2021.** However, it is not yet clear whether the deceleration will be moderate (e.g. from over 5% now to 3-4%) or stronger (to, say, 1.5-3%). If the part of the economy not dependent on EU transfers switches into a higher gear, and the international environment improves (thereby helping the German-dominated automotive cluster), the first scenario is possible. In the other scenario (which we find currently more probable), the demand shock caused primarily by the shrinkage of EU transfers will be too strong to avoid a major deceleration of economic growth in the next three years.



## KAZAKHSTAN: Trying to preserve the status quo

BY OLGA PINDYUK

**Continuity of Kazakhstan's political course is expected to be preserved despite the change in the top leadership.** The snap presidential elections on 9 June 2019 did not provide any surprise as the former acting president Kassym-Jomart Tokayev became the new president of Kazakhstan, having won 70.8% of the vote. He replaced Nursultan Nazarbayev, who had been president for almost three decades. Other nominees allegedly served the purpose of creating visibility of competition in the elections. The elections are widely seen as part of an orchestrated process of power succession, which preserves control of Mr Nazarbayev over the country as the former president has retained a wide-ranging degree of authority under his title of Leader of the Nation and as the lifelong head of the national Security Council. Mr Tokayev has pledged that he will continue Mr Nazarbayev's 'strategic course'.

**The elections, which were denounced as unfair by the OSCE, spurred discontent and protest actions across the country.** The government has been fast to crack down the protests and jail the activists, which received significant international media attention. In March 2019, the European lawmakers already adopted a resolution urging Kazakhstan to 'respect human rights and fundamental freedoms'. This situation poses the risks of growing social unrest and a worsening of the country's image in the west, which might negatively affect its economic prospects.

**Regardless of the political reshuffling, the economy has been performing relatively well.**

According to preliminary estimates, in the first quarter of 2019, economic growth slightly slowed down compared with 2018 to 3.8% year on year. Exports expanded by 10% year on year in USD terms – a sharp deceleration compared to 26% growth in 2018. Both lower global oil prices and the decline in oil output due to overhauls of the three main oil fields were to blame. Manufacturing has shown a better performance than the oil sector – 3.5% annual growth versus 1.1% contraction during January-April 2019. Though oil output is expected to recover by the year end, we forecast the value of total merchandise exports in USD terms to fall by 13% in 2019 compared with the previous year. In 2020-2021, exports dynamics is expected to become positive, but will be rather meek.

**The government has set the course for raising living standards through fiscal stimulus.** Extra funds were allocated for increases in public sector wages by 10-30% starting from 1 June 2019. In addition, individual social subsidies, which are received by more than 100,000 households, were raised by about 40% to the equivalent of USD 50 per month. Buttressed by fiscal measures, real wage growth accelerated significantly in the first quarter of 2019, to 5.2% year on year. Credit to households continued to expand as well, with new loans for consumption purposes increasing in the first quarter by 29.4% year on year. In this context consumer demand will become the main driver of growth during the forecast period.

**Monetary policy has started to loosen recently, but this is likely to change as inflation and depreciation pressures accumulate.** Fast wage growth is likely to push upwards consumer prices and cause additional demand for imports. The positive trade balance will gradually decline during 2019-2021, and the National Bank will be more cautious about policy rate cuts in these circumstances.

**GDP growth in 2019 will slow down to 3.6%**, but will be higher than we previously forecasted owing to considerable fiscal stimulus. In 2020-2021, economic growth will slow down further, to about 3%, against the backdrop of lower oil prices.

## KOSOVO: Stumbling Serbia–Kosovo dialogue

BY ISILDA MARA

**Domestic demand will continue to push growth above 4% in the medium term, making Kosovo one of the fastest growing CESEE economies.** Government and household consumption both will support growth. Drivers of household consumption will continue to be remittances – up by 6% in 2018 and by 8.3% in Q1 2019, y-o-y – but also the wage hike in the public sector, up by 15%. Demand for credit above 11% – both among households and businesses – characterised Q1 2019 while the level of non-performing loans remains low at 2.6%. GFCF will support growth owing to a number of infrastructure projects: the Dukagjini motorway is in line to start and ‘Arben Xhaferi’ highway (connecting Kosovo with Macedonia) was inaugurated in May 2019. Net exports of goods and services will positively contribute to growth, particularly as the latter have recovered recently. January–March 2019, y-o-y, FDI inflows more than doubled. In particular, FDI from Turkey and the US soared; Germany and Switzerland remain the main source countries of FDI inflows, but in decline. Energy production remains challenging. Meanwhile, Global Contour and the Kosovo government announced the General Electric Company, based in London, as the preferred bidder for the construction of the ‘Kosova e Re’ coal-fired Power Plant.

**The 100% tariff on imports from Serbia and Bosnia and Herzegovina, introduced in November 2018, is still in force and there will be no suspension.** The current account deficit widened despite growing external demand. In January–April 2019, y-o-y, exports rose by 15%, while imports grew by 9% (imports are much greater than exports in absolute terms). EU28 gained importance as a trading partner as exports to EU28 accelerated to 43% and reached a 38% share, respectively. Trade relations with CEFTA deteriorated: the export share fell from 48% to 43%, the import share shrank from 26% to 14% in January–April 2019, y-o-y. Imports from Serbia and Bosnia and Herzegovina suffered the most due to the 100% tariff, while imports from the rest of the CEFTA countries rose by 50%. The shift in trade partners has seen imports and consumer prices rising. The tariff imposed on imports from Serbia and Bosnia and Herzegovina is starting to affect imports and consumer prices. In 2018, imports from Serbia constituted 15% of total imports to Kosovo, but now stand at close to zero. In Q1 2019 import prices on average rose by 0.4% vs 4Q 2018, while for the categories of goods mainly imported from Serbia – mineral products, vegetables and prepared foodstuffs, beverages, tobacco – import prices rose between 2.3% and 3.3%. The CPI rose by 3.4% in April 2019. The rise was mainly driven by the items ‘vegetables’ and ‘prepared foodstuffs, beverages, and tobacco’ – now being mainly imported from the EU28, especially Hungary – while price changes were negative for other categories. Such dynamics suggest that the 100% tariff is starting to weigh on consumers’ pockets.

**The idea of a border change between Serbia and Kosovo has been killed, at least for now.** The Berlin summit organised in April 2019 with WB6 leaders aimed at stabilising the frozen Serbia–Kosovo dialogue. The take-home message from the summit was that the border change idea has not the support, at least, of Germany and France. At present, the harsh rhetoric between Kosovo and Serbian political leaders has not ceased, as such creating further tensions and incidents. The Serb List for Kosovo won in the extraordinary local elections held in the Serb-dominated North of Kosovo in May 2019, with more than 90% of votes. The party, founded in 2014, represents ethnic Serbs in Kosovo, but is also strongly linked to the Serbian government. In July 2019 President Macron will host another summit in Paris, again with WB6 leaders. This summit might be the next stage to set the path for the future Kosovo–Serbia dialogue. The EU Commission and EU Parliament, respectively, as of July 2018 and March 2019, supported visa liberalisation with Kosovo, but the EU Council is being hesitant to move forward.

## LATVIA: Pace of growth changes to a lower gear

BY SEBASTIAN LEITNER

**Data for the first quarter 2019 (3% GDP growth in real terms year on year) show that economic activity slows down after two years of swift expansion, while gross fixed capital investment continues to grow at considerable pace.** EU funds further bolster government outlays for infrastructure. With an absorption rate of 31% by the end of 2018, Latvia is well above the EU average. Capacity utilisation levels reaching an all-time high of 77% resulted in strong growth of investment in machinery and equipment. Despite still continuously rising apartment prices, we expect, based on figures for building permits granted, that investment growth in dwelling construction will abate next year.

**The heterogeneous coalition government formed by five liberal, conservative and populist right-wing parties in January announced to increase government expenditures.** The claims of the individual ministers for the budget of 2020 are well above forecasted government revenues. Public consumption is likely to continue growing rather swiftly this and in the following years in the forecast period; a rise of the budget deficit is expected.

**Following weak growth in 2018, exports are expected to revive in 2019.** Data for the first quarter 2019 show an upswing in demand from the EU region, particularly Estonia and Germany, while goods exports to the CIS countries remained stagnant year on year. However, wages rising above productivity for quite some time give rise to competitiveness problems in some manufacturing sectors, e.g. textiles and apparels; thus their shares in the export markets are shrinking. Slower growth of imports will result in a decrease of the negative contribution of net exports to overall GDP growth this year.

**We expect employment to continue growing by another 1% in 2019.** Jobs still increase rather swiftly in construction, but also in services sectors. In 2019, the unemployment rate will fall to 6.7%. Up to the end of the forecast period in 2021, a further decline to about 6% is likely. However, the regional labour market disparities in Latvia are enormous. In March 2019 the registered unemployment rate amounted to only 4% in Riga, while in the eastern region of Latgale it attained almost 15%.

**The substantial rise in net real wages, by 4.8% in the first quarter of 2019, is only slightly lower than last year.** In order to compensate for the strong increase before the last parliamentary elections, minimum wages have not been raised at the beginning of 2019. Thus, we expect household consumption to increase slightly less compared to last year, by 3.8% in real terms and by 3.5% in 2020. Consumer inflation will average 2.6% again in 2019 and fall only marginally in the following two years.

**The European Commission, in its 2019 European semester country report, highlighted deep structural problems of Latvia.** The country is catching up at fast pace, but growth is distributed rather unequally. Disparities in income, working conditions and welfare are substantial between regions and skill levels. The tax wedge for low income earners is high and minimum income schemes are rated as inadequate. Spending on health care but also research and development is well below the EU average.

**Compared to our Spring Forecast we became slightly less optimistic,** lowering the forecast GDP growth rate for this year from 3.5% to 3.3%. Investment activity still grows at considerable pace, while external demand increases more swiftly. Rising household incomes continuously bolster the growth of private consumption. For 2020 and 2021, we revised our GDP growth forecast upwards, to 3.1% and 2.7%, respectively.

## LITHUANIA: Domestic and external demand remain strong

BY SEBASTIAN LEITNER

**GDP figures for the first quarter of 2019 (+4% in real terms year on year) augment expectations that economic growth will slow down only slightly this year. Gross fixed capital investment is likely to increase by another 6.5% this year.** Public investment in infrastructure supported by EU funds continues to bolster GDP growth this and the following two years. The energy sector as well as road and railway infrastructure are key areas of investment. New mortgages to households continued to grow by 8% year on year in January to April 2019 and the construction of new dwellings still shows a solid growth. However, towards the end of the year we expect a turnaround of the trend, based on a recent decline in building permits granted for planned residential projects.

**For 2019 we expect a slight upswing in exports, in particular to the euro area.** Even for exports to Russia, data for the first four months show an increase of more than 6% in nominal terms year on year. In 2020 to 2021, however, demand from the EU trading partners is likely to level off gradually. Services exports are evolving less lively this year and will likely decelerate further in the coming years. In April 2019 the EU Mobility Package passed the first reading in the EU Parliament. It comprises, e.g., stricter rules for posting, compensation and rest times of truck drivers. Transport companies and workers in many new EU Member States fear that their low-cost advantage will erode as a result. In Lithuania more than 7% of the workforce is employed in the transport and storage sector; within the EU only in Latvia the share is slightly higher.

**Employment will rise again by more than 1% throughout 2019.** Strong job growth takes place in the construction, accommodation and ICT sectors, but also in manufacturing the increase has been 4% year on year in the past two quarters. The unemployment rate is likely to drop to 5.6% in 2019 on average and even below 5% by 2021. In order to compensate for the shrinking working-age population in a situation of scarce skills, the government opted for granting more temporary residence permits to third-country nationals. The number of migrant workers from Ukraine doubled in 2018 and continues to grow; the second largest group are workers from Belarus. For the first time in many years, in 2019 Lithuania will not be a net sending country of migrants.

**An increase in the minimum labour compensation by 7.5% to EUR 555** in January 2019 will likely push the real growth in net monthly earnings to 6.5% this year. However, with import prices increasing less in 2019 compared to last year, we expect consumer inflation to decline towards 2.2% and remain at that level in the following two years. Given the increase in households' purchasing power and strongly rising consumer confidence in the first five months of 2019, household consumption will further flourish throughout this year.

**Compared to our Spring Forecast we have become more optimistic, increasing the forecast GDP growth rate for this year from 3.0% to 3.2%.** Particularly export growth has picked up more strongly than expected, while not only public but also private investment are expected to increase at good pace this year and also in 2020 and 2021, facilitated by a constant inflow of EU funds. Rising household incomes will support private consumption. For 2020 and 2021, we also revised our GDP growth forecast slightly upwards, to 2.7% and 2.4%, respectively.

## MOLDOVA: Stable growth supported by lax fiscal policy

BY GÁBOR HUNYA

**Economic growth is expected to continue at last year's pace of about 4%** (no quarterly data have been published at the time of writing). One can be optimistic as the economy made a good start into 2019: retail trade turnover expanded by as much as 17% in real terms and investments in fixed assets were soaring by 25%. Also the loose fiscal policy has been a support to growth. Minimum wages, pensions, support to farmers and for job creation in medium-sized enterprises have been increased or introduced this year which may give a further boost to consumption and investments as well as fiscal deficits.

**Most of the investments and consumption have been financed from own resources, but the role of bank lending has been on the rise.** In the first three months, banks issued new loans in an amount higher by 32% than in the first quarter of 2018, at an average interest rate of 8% (5% in real terms). The consolidation of the banking system continued and the share of bad loans fell to 10.9% in April 2019 from 15.7% a year before. Inflation has been creeping up towards 4% in recent months, but it is still below the inflation target of 5%. The policy rate has been left unchanged for the third consecutive year at 6.5% irrespective of changes in the rate of inflation.

**The current account deficit, which soared to 10.5% of GDP in 2018, may come down by one percentage point this year.** Imports expanded less than exports, narrowing the deficit in goods trade in the first quarter of the year. Still, exports covered only 54% of imports. Remittances via banks, amounting to two thirds of the revenues from exports, declined in the first quarter but recovered in April when they were 5.9% higher in current USD terms than a year before.

**Slow but sustained restructuring of the economy continues.** Manufacturing production stagnated in the first quarter of 2019 at the level of the previous year mainly due to the decline in the food and beverages industry. But remarkable growth could be achieved in the production of automotive components and chemicals. Also the export structure shifted to higher value added products; the share of automotive components went up to almost 25% in the first quarter of 2019, from 18% a year before. It is also worth mentioning that the companies located in Moldova IT-Park, which offers special incentives for investors, employ more than six thousand people.

**The pro-EU bloc ACUM and the pro-Russian Party of Socialists, which has given up to contest the DCFTA, have agreed on a coalition on 9 June,** just before the three-month period following the last elections allowed by the constitution to form a government expired. They have ousted the ruling Democratic Party of the controversial oligarch Vladimir Plahotniuc. The EU and the US have recognised the new government in the hope that democracy and rule of law will be strengthened, and also Russia sees its interest represented.

**An improvement in institutional transparency and stability is a precondition for EU support and more FDI.** In addition, fiscal and current account imbalances, which pose high risks to economic growth and stability, will have to be managed. Based on the current dynamics of investments and structural change, the economic growth momentum can be maintained for the coming years, even if in a lower gear of around 3.5%.

## MONTENEGRO: Impressive surge in employment

BY GORAN VUKŠIĆ

**After a very strong 4.9% GDP growth recorded last year, positive momentum continues into 2019 with registered employment growing by 9.1% y-o-y during the first four months.** This corresponds to over 16,000 persons in formal employment more than last year. As the number of registered unemployed declined by around 8,500, the increase in labour force participation accounts for nearly half of the employment surge. Employment growth was exceptionally strong in professional, scientific and technical activities (27.5%), construction (22.5%), and accommodation and food services (20.1%). The growth in the latter sector has been supported by a surge in the number of tourist arrivals and overnight stays, of 41.9% and 23.9%, respectively.

**Merchandise imports grew by 5.8%, while exports declined by 3.3%** during the first four months. This may have reflected the increase in consumption, suggested by a strong growth in retail sales of around 6%, and likely supported by the household loans expansion of around 12%. Industrial output, in contrast, declined by 17.6%, with the sector of utilities (especially energy) recording a contraction of more than 30%. Exports of services grew strongly in the first quarter, with transport revenues expanding by 30%, and travel revenues by 8%. The overall trade deficit widened and was largely financed by higher FDI inflows, and by Other investment, mainly under Currency and deposits, and Loans items.

**Wage growth is likely to pick up in the second half of 2019 and in 2020.** Following a real wage decline that lasted for two years, with only modest increases in nominal wages, real wages roughly stagnated in 2019 despite the employment surge. By government decision from May 2019, the minimum wage will be increased by 15% to EUR 222 from 1 July. In its earlier announcement, the government also communicated plans for an accompanying reduction in employers' health contributions by 2 pp and announced a further minimum wage increase at the beginning of 2020. Besides stronger wage growth, a likely consequence might be a deceleration of (formal) employment growth.

**The government recorded a budget deficit of 3.8% in 2018** (preliminary data), missing its earlier targets. Early data for 2019 indicate that public revenues performed better than planned, while the expenditures (especially current spending) have been contained. Whether, and to what extent, the fiscal discipline in current expenditures will be maintained is debatable given that the next parliamentary elections are due towards the end of 2020. In May, the government has contracted additional works related to complementary constructions on the first section of the Bar-Boljare motorway worth around EUR 45 million. The project-related debt to the Chinese Exim Bank stood at EUR 456 million at the end of September 2018, with planned disbursements of EUR 84 million by the end of 2018, and EUR 180 and 23 million in 2019 and 2020, respectively. The deadline for the completion of works has been extended to the end of September 2020.

**Considering all of the above, we revised our GDP growth forecasts upwards by 0.6 pp to 3.1% in 2019 and by 0.8 pp to 3% in 2020. Deceleration of GDP growth to 2.1% is expected in 2021.** Our new projections reflect the stronger increases in employment, wages and household consumption, as well as the likely reduction in fiscal consolidation effort and stronger increase in public investment in 2019-2020 than previously anticipated.

## NORTH MACEDONIA: On the way back up

BY RICHARD GRIEVESON

**After a couple of years of turmoil, which badly affected the economy, things look much better on the political front in North Macedonia.** Two recent political events have been generally positively received by the international community. First, in January the parliament accepted North Macedonia as the country's new name in order to placate Greece. Second, the presidential election in May was won by Stevo Pendarovski, a candidate backed by the Social Democratic-led government. Mr Pendarovski's election was welcomed by the EU.

**The political developments should pave the way for North Macedonia to further its integration into Euro-Atlantic institutions, which could in turn provide a further impetus to FDI inflows and integration into regional and global value chains.** Following the name change, Greece removed its veto on North Macedonia's signing of the NATO accession protocol. North Macedonia's NATO membership is expected to be ratified by all members of the alliance soon. EU accession by contrast will be a much more drawn-out affair. There are worrying signs that the start of accession negotiations – due to begin in June – may be delayed until September. Indications of outright opposition to further EU enlargement in parts of Western Europe – especially France and the Netherlands – have increased this year. Any delays are likely to prompt bitter disappointment in North Macedonia, which feels that it gave up a lot to change its name in order to push forward EU accession.

**Helped by a more positive political backdrop, economic growth has improved.** After an expansion of just 0.2% in 2017, the economy grew by 2.7% last year, and we expect a further firming of growth to 3.1% in 2019. Investment in particular – much of which had been delayed for political reasons – should continue to recover, helping North Macedonia to post headline real GDP growth rates similar to its regional peers, after several years of underperformance. FDI inflows should pick up on the back of positive political development. We expect full-year gross fixed capital formation growth of around 5% in 2019, while private consumption should rise by 2.5%. As investment and consumption suck in imports, net exports will subtract around 0.3 percentage points from the headline growth rate, having added 2.2 percentage points last year.

**High frequency data in the first quarter of the year were relatively positive, indicating robust momentum.** Exporters appear to be coping well with weaker external growth, with industrial output rising strongly. This matters more than was the case in the past: exports of goods and services accounted for over 60% of GDP last year, compared with 33% as recently as 2009. Meanwhile, retail sales rose by 4.1% year on year in April.

**Inflation is low, and should remain so, even as growth accelerates.** The consumer price index rose by 1.9% year on year in April, a pick-up from recent months, but subdued by historical standards. Rising wages and employment could exert some upward pressure on prices, but there is still major slack in the economy, which will prevent a rapid pass-through to inflation. More broadly, North Macedonia is subject to most of the same factors that are keeping price growth low across most of Europe, including the impact of new technologies, subdued inflation expectations, and the weakness of core inflation in the eurozone (with which North Macedonia is heavily integrated in terms of trade and investment).

## POLAND: Social spending supports high growth

BY LEON PODKAMINER

**Fast GDP growth shows no signs of abating.** In the first quarter of 2019 GDP rose by 4.7%. Compared to the recent past the structure of GDP has even improved. Growth of household consumption slightly moderated while gross fixed capital formation sped up. Foreign trade added 0.7 percentage points to the GDP growth rate. Last, but not least, public consumption, rising by over 6%, added the final touches to the overall picture of economic prosperity.

**Expanding public consumption is one component of the present ('populist') economic policy.** Apart from this the government has also introduced other expansionary measures (e.g. hikes in the minimum wage, subsidisation of electricity tariffs). First of all it showers the consecutive population groups (retirees, families with children, young employees) with additional extra-budgetary monetary gifts. This tactics is proving very effective politically, but requires extra money whose total (net) cost may be about 0.8-1.0% of GDP in 2019 and 1.3-1.6% in 2020. Additional revenue (in the form of profits to be worked out by the National Bank, or revenue from an additional 'charge' to be levied on the assets accumulated by the second-pillar pension funds) may be insufficient to cover these expenditures. But the government does not mind risking higher fiscal deficits (which, due to various tricks, do not exceed the 3% of GDP mark). Because the public debt is low and so are the yields on government bonds, this seems to be an overall acceptable approach.

**Upward pressure on wages is considerable, reflecting tight labour markets.** So far rising unit labour costs are not spilling over to inflation. Instead, a profit squeeze is being felt in parts of the business sector. In the first quarter of 2019 the net profits of the non-financial business sector declined by 4.5%. Strong competitive pressures (felt e.g. in the retail trade sector) will keep inflation subdued for some time. Currently the National Bank is satisfied with its policy rate of 1.5%. Quite possibly, in sticking to that rate the Bank also hopes to avoid a too strong appreciation of the currency. But in 2020 inflation may move above the National Bank's target of 2.5%.

**Investments by the private business sector remain of critical importance.** Overall business sector investment outlays (not to be confused with proper fixed capital formation) rose, at current prices, by close to 22% in the first quarter of 2019 (up from 6.6% in the same period of 2018). However its sub-sector structure seems rather skewed. The four branches with the highest growth in outlays seem to be overwhelmingly publically-owned – and also dependent on EU funding. These are 'energy, gas, water supply', 'information and communication', 'mining and quarrying' and 'transportation and storage', recording rates of growth of nominal outlays by 45.8%, 38.2%, 30.5% and 30% respectively. By contrast, investment outlays in manufacturing rose by 'only' 17.9%.

**The EU co-financing of national investment outlays may be less generous (especially from 2020 on)** than it used to be. Thus the willingness of the private sector to expand productive capacities will play a critical role. Safeguarding the positive private business attitudes to investing may require some changes not only in the rhetoric of the present government, or even in the purely economic incentives (such as 'friendly' taxation rates) – but first of all some definite changes as far as e.g. the rule of law, administrative stability and the independence of the judiciary system are concerned.



## ROMANIA: Still overheating

BY GÁBOR HUNYA

**Economic growth of 5% in the first quarter of 2019 came as a surprise and has prompted a strong upward revision of the wiiw growth forecast to above 4% for the current year.** Rapidly rising wages were fuelling household consumption, which went up by 6.5%. Gross fixed capital formation recovered (+5.4%) but changes in inventories (up by 20%) gave an even bigger boost. The construction sector recovered (+22%) from its depressed situation, especially residential building.

**The government has eased the stipulations of the ordinance which introduced extra taxes on the financial sector in December 2018 and had depressed economic expectations at that time.** As a consequence, interest rates stayed moderate and improved economic sentiment contributed to better than expected economic growth. The causes of the prolonged period of strong economic growth are also related to the time-lag in the effects of the recent slowdown in the euro area and the labour shortage related strong wage growth.

**However, production and foreign trade data suggest a marked slowdown of the economy in the rest of the year.** Manufacturing reported only 1.2% growth in production and stagnating volumes of new orders in the first quarter. Demand constraints appear on foreign markets, also reflected in sluggish export growth (+3.9% in the first quarter y-o-y). Rapidly rising labour costs may have put a limit to competitiveness. Labour productivity of the manufacturing sector was only 2.5% higher than in the same period of the previous year, while the labour costs increased by 12.5%. Taking depreciation into consideration, unit labour costs increased by about 8% on an annual basis. Romanian wages are relatively low in comparison with most other EU-CEE11 countries, but so is labour productivity.

**Fiscal and monetary policies have supported overheating, leading to higher deficits in the budget and the current account.** Net exports had a negative contribution to growth of 3.3 percentage points, and the current account deficit surged to 4.7% of GDP, unusually high among EU-CEE countries. The majority of the fiscal deficits remain externally financed at a high yield on 10-year bonds of about 5% which increases the risk of instability. But general government debt is still below 40% of GDP and may expand with no immediate punishment by the financial markets. The budget deficit is expected to widen to more than 3% of GDP in 2019 and may trigger a consolidation course which will depress growth. How harsh the EU Commission would react to breaching the deficit limit and press through an adjustment in the fiscal policy depends at least partly on the international reputation and bargaining power of the Romanian government. This may improve following a turn to more lenient policies of the leading coalition.

**The consumption boom notwithstanding, the governing Social Democratic Party (PSD) has lost its leading position in the European Parliament elections on 26 May.** To its benefit, the controversial party leader Liviu Dragnea was put in jail for corruption just a day later. Within a week, the party and the government have been reshuffled and the government has given up the controversial initiatives to reform the legal system and initiated to improve cooperation with EU institutions.

**The government crisis has been overcome, but the run for presidency in November as well as next year's parliamentary elections will bring elevated political tension and risks.** It is questionable whether PSD can stick to loose fiscal policy and handing out even more benefits to the public for one and a half years more. We expect a consolidation with a soft landing for 2020 at the latest.

## RUSSIA: On the verge of recession

BY VASILY ASTROV

**Data for the first quarter 2019 indicated no sign of a bounce back in Russian growth after a subdued end to 2018**, and reinforced the impression that the economy is dangerously close to slipping into recession. Real GDP picked up only by 0.5% year on year and was stagnant quarter on quarter. On a quarterly basis, the economy has not been growing since the second quarter of 2018: GDP was stagnant in the third quarter and contracted by 0.4% in the fourth quarter.

**A major drag on growth continues to be tight fiscal policy, despite very low public debt (12% of GDP).** In 2018, public consumption was nearly flat, and this has been probably the case also this year. Although real wages are (marginally) growing, tight fiscal policy is taking its toll on households' real disposable incomes which fell by 2.3% (yoy) in the first quarter, after having declined by a total of 8.3% over the five previous years. A pick-up in inflation has also contributed to falling real incomes. Since its historical low of 2.2% yoy at the start of last year, consumer inflation has been gradually on the rise and peaked in March at 5.3% – well above the Central Bank's target of 4%. The main reasons behind have been the rouble depreciation in the second half of last year and especially the hike in the VAT rate (from 18% to 20%) in January. With the latter factor fading away, inflationary pressures started subsiding over the past few months, allowing the Central Bank to lower the policy rate from 7.75% to 7.5% on 14 June.

**Against the background of falling incomes, the modest growth in retail sales (by 1.7% in January-April yoy) is sustained exclusively by borrowing:** the stock of credit to households went up by 23.5% yoy in nominal terms. The strong credit growth despite double-digit interest rates on consumer loans and bleak earnings prospects is all the more surprising and will be hardly sustainable in the medium run, likely resulting in rising non-performing loans. Already now, 26% of household incomes are reportedly spent on debt service.

**The external sector has probably contributed positively to GDP growth** – similarly to last year. In the first four months, goods exports were nearly stagnant in US dollar terms, as lower oil prices were offset by increased export volumes, while goods imports declined by 3%. However, for 2019 as a whole the contribution of net exports to growth should be close to neutral, with imports recovering somewhat and oil exports constrained by Russia's commitments under the OPEC+ agreement.

**The high inflow of foreign exchange in the first quarter was also due to the unusually large net FDI inflows** (USD 11.5 bn), mostly on account of the acquisition of a 10% stake in Novatek's Arctic LNG-2 project by France's Total. However, depreciation pressures are likely to resume in the months to come, as the threat of further US sanctions may accelerate private capital outflows from Russia. Besides, the oil price will be likely lower on average this year than in 2018, and the current account surplus will probably shrink to some 4% of GDP.

**In the remainder of this year, growth is likely to accelerate somewhat**, largely on account of the lower statistical basis and the planned start of infrastructure projects in line with the development targets set for the period until 2024. However, given the very weak first quarter, our growth forecast for 2019 has been revised downwards by 0.5 pp, to 1.3%, with only a modest projected acceleration in the years to come. The overall policy mix will remain restrictive, prioritising stability and resilience against western sanctions over growth. At the projected growth pace, Russia will become the worst performer in the CESEE region starting from next year and will continue falling behind in the global context.

## SERBIA: Adjusting back to reality

BY RICHARD GRIEVESON

**Growth slowed sharply at the start of 2019, reflecting an adjustment back to reality after a very strong 2018.** Having expanded by 4.3% last year, the economy grew by just 2.5% year on year in Q1. Private consumption held up well, rising by 3.2% year on year, and reflecting buoyant consumer demand on the back of wage rises and weak inflation. Investment rose particularly strongly, by 8.4%, helped by good foreign direct investment (FDI) inflows (up by around 10% year on year in Q1). By contrast, industrial output struggled markedly in the first three months of the year. This suggests that Serbia was affected by weaker growth in the European and global economies, linked to the US-China trade war, issues in the German automotive manufacturing sector, and politically-driven hits to sentiment caused by issues such as Brexit. Net exports subtracted markedly from headline growth.

**We now expect the economy to expand by 2.9% this year, down from 3.4% previously, owing to the weaker-than-expected Q1 outturn.** Private consumption will remain the key to growth, especially as it constitutes almost three quarters of GDP, one of the highest levels in CESEE. Encouragingly, retail sales rose by 6.7% year on year in April, suggesting still-buoyant levels of consumer demand. Real wages rose by a very strong 6.9% year on year in Q1, and employment growth has been solid. Credit expansion is also strong, likely helped by low real interest rates, in line with trends seen across the region. Meanwhile fiscal policy has been loosened a bit.

**The outlook for exports – an increasingly important part of the Serbian growth story – is less encouraging.** Although not a huge market for Serbia, the 100% tariffs imposed on Serbian exports by Kosovo likely contributed to the weak Q1 growth outturn, and do not look likely to be removed anytime soon. Meanwhile news from the important Fiat Chrysler Automobiles (FCA) plant is not encouraging. The plant has already been closed for 30 days this year, and recent reports indicate that a further 95 days of closure is possible, reflecting weak demand for the plant's 500L model from Europe. Although the German economy recovered somewhat in quarterly terms in Q1, year-on-year growth rates in Europe's most important economy are well down on levels recorded in 2017 and the first half of 2018. The net export contribution to Serbian growth is likely to be negative, owing both to the weaker outlook for external demand, but also strong import growth on the back of strong consumption and investment.

**In a broad sense, macroeconomic stability has improved in Serbia in recent years, which should put the economy on a firmer footing, even if external risks materialise.** Inflation is low and stable, public debt is falling as a share of GDP (down by almost 12 percentage points between 2015 and 2018), and the current account deficit has shrunk since the immediate post-crisis years. Although the external shortfall is still equivalent to around 5% of GDP, this is more than covered by net FDI inflows.

**Aside from weaker external demand, the main challenge for the Serbian economy during the forecast period comes from political risk factors.** Domestic protests have taken place on quite a large scale in recent months, reflecting significant dissatisfaction with the government. Over the past six months, protestors have gathered across the country every Saturday to demand media freedom, as well as to express broader concerns around state capture. Meanwhile external political risk remains elevated, especially tensions with Kosovo. Serbia must effectively recognise Kosovo in order to join the EU, but resolution of this issue looks to be some way away. The higher domestic and international tensions could affect foreign investor sentiment, although it is likely that most investors in Serbia accept the higher risks that come with doing business in the region.

## SLOVAKIA: Growth boosted by Jaguar Land Rover

BY DORIS HANZL-WEISS

**Slovakia showed a strong growth performance in the first quarter of 2019.** GDP increased by 3.7% year on year after growing by 4.1% in 2018. Growth was supported primarily by net exports: exports of goods and services expanded by 7.2% while imports increased by 6.4%. At the same time, domestic demand was rather weak: household consumption grew by 1% only, much less than favourable conditions on the labour market would suggest, whereas the savings rate increased. Gross capital formation rose by 6.6%, but growth in gross fixed capital formation reached only 2.1%, mirrored by stagnation of construction output. The construction of the Jaguar Land Rover plant was finished last year, while highway construction faced delays. The drawdown of EU funds is slow and will accelerate only after 2020.

**The labour market is tight and rising wages pose a risk for further investment.** In the first quarter of 2019, employment rose by 1.8% y-o-y, the employment rate reached 73.5%, and the unemployment rate fell to 5.8% (down 1.3 percentage points year on year). Still, large regional disparities persist, with practically full employment in the West (Bratislava: 2%) and much higher unemployment in the East (Prešov region: 10.4%). The growing shortage of skilled labour puts upward pressure on wages: In the first quarter, real wages increased by 4.6%. In addition, since 1 May, wage premia for night, weekend and public holiday work were raised for the second time.

**The automotive industry is still a key driver of growth.** In the first quarter of 2019, industry expanded by 6.7% y-o-y according to the Slovak Statistical Office. Of this, the main sector in Slovakia – the automotive industry – contributed most to growth, followed by machinery & equipment, electrical equipment and refining. The new Jaguar Land Rover plant opened in October last year and will add in the first phase an additional 150,000 cars to total Slovak production, along with established car manufacturers VW Bratislava, KIA Motors, and PSA Peugeot-Citroën, with a combined production volume of 1 million cars. However, negative news from VW has blurred the overall positive picture. At the beginning of the year the company announced to cut 3,000 jobs and it is still not clear which models the plant will produce after 2022, possibly due to reorganisation of the company in the wake of the recent emission scandal.

**Parliamentary elections in 2020 pose a challenge to fiscal targets.** In 2018, the fiscal deficit reached 0.7%, the debt to GDP level 48.9%. For 2019, a balanced budget is envisaged for the first time and the debt level will decline to 45.3%. Forthcoming elections at the beginning of 2020, however, will challenge fiscal targets as new social packages are already in preparation (e.g. decrease of certain taxes, increase in parental benefits, contribution to school-items, and support for business R&D).

**The overall outlook is positive, but with rising risks, and a slowdown from current growth levels is likely as support from automotive expansion vanishes.** Slovak GDP is forecast to increase by 3.6% in 2019, followed by a gradual deceleration in the next two years. It will be supported by net exports this year (due to new production capacities of the new Jaguar Land Rover plant) and gross fixed capital formation in the next two years. However, overall risks are rising and household consumption seems to be rather weak. In addition, the automotive industry faces several risks, including the slowdown of automotive demand, possible negative effects of Brexit and of trade frictions with the US.

## SLOVENIA: Returning to a moderate growth path

BY HERMINE VIDOVIC

**Slovenia's GDP growth moderated to 3.2% in the first quarter of 2019 (year on year) from a high 4.5% in 2018 as domestic demand weakened albeit from high levels.** While private consumption growth – supported by rising employment, wages and increasing household loans – exceeded last year's average, growth of gross fixed capital formation, still benefiting from the inflow of EU funding, moderated to 9.3%. However, changes in inventories contributed negatively to the GDP expansion, as much as 2.1 percentage points, representing the strongest negative impact since 2012. Against the expectations of declining foreign demand, the contribution of net exports was positive. Investment growth translated into a strengthening of construction activities, both civil engineering and buildings. Industrial output grew by 3.2% in the first three months of the year, with the highest growth rates recorded for the manufacture of leather and wood products, while car production – after the increase in the past couple of years – was shrinking.

**The labour market situation continued to improve, but labour shortages are increasing.**

Employment grew by 1% and unemployment further declined, to 4.8%. Average real gross wages increased by 3.3% compared with the first quarter of 2018, with rises being higher in the public than in the private sector. Wage rises were resulting from new wage agreements in the public sector in late 2018 and an increase in minimum wages, but also as a consequence of rising labour shortages. According to the Public Employment Service, about half of the employers are facing shortages, particularly in tourism, construction, social and health care and manufacturing. So far labour shortages could be partly offset by the recruitment of foreign workers, especially from Bosnia and Herzegovina, Croatia and Serbia. Among other measures employers try to fill the gaps by overtime work, recruiting through temping agencies or encouraging pensioners to return to work.

**External trade performed well despite growing uncertainties on international markets.** Goods exports grew faster (9%) than imports (8%), resulting in a widening of the foreign trade surplus compared with the same period of 2018. Also the surplus in services trade was higher than a year earlier due to exports – of transportation services in particular – rising ahead of imports. Overall, the current account closed with a surplus of EUR 760 million in the first quarter of 2019, an improvement by EUR 80 million, and is expected to end up with a close to 7% share in the GDP in 2019. The net FDI inflow was positive (EUR 450 million) in the first quarter of 2019.

**Available data suggest that the general government budget will likely end up close to balance in 2019.** During the first four months of 2019 the consolidated general government balance showed a small deficit versus a slight surplus in the same period of 2018, with both revenues and expenditures strengthening. Revenues went up on account of higher VAT revenues and inflows from the EU budget, while the rise in expenditures was primarily due to increased spending on public sector wages agreed upon with the trade unions and rising social transfers.

**Given the data for the first months of the year, wiiw will leave the GDP growth forecast for 2019 unchanged, at 3.3%.** Also beyond 2019 we expect GDP growth to remain at about 3% annually, driven primarily by private consumption and enhanced investment activities spurred by EU transfers while the contribution of net exports will moderate due to the expected economic slowdown in Slovenia's main trading partners. Unemployment will keep declining amid rising labour shortages, which will continue to put upward pressure on wages.

## TURKEY: Still close to the eye of the storm

BY RICHARD GRIEVESON

**The Turkish economy remains in a challenging spot, reflecting weak investor confidence and heightened domestic and international political risk.** After some stabilisation over the winter, volatility returned to financial markets (and particularly the forex market) in March and April, reflected in the sharp weakening of the lira. Strong credit growth from public banks had started to again widen the current account deficit, worrying foreign investors. Meanwhile local elections saw the government lose Istanbul narrowly to the opposition Republican People's Party (CHP). The government then demanded a recount, which was backed by the election board, causing further jitters in financial markets. A new poll will be held on 23 June. Finally, relations with the US – long a concern for international investors – remain tense, particularly relating to Turkey's plan to buy Russia's S-400 missile defence system.

**More recently, a sense of stability has again returned to the forex market, but this may only prove to be temporary.** Serious questions remain regarding domestic and international political factors, the ability of the central bank to respond to market developments, and the extent to which the government is willing to take risks to stimulate higher economic growth. Much will depend on the re-run of the election in Istanbul (and what the government does afterwards), and whether or not the US can be placated (the threat of US sanctions is non-negligible and these would be highly disruptive for the economy).

**As a result of a significant external adjustment over the last year, the economy is better able to deal with shifting investor sentiment than it was last summer, but the growth is subdued.** The sharp depreciation of the lira during 2018 – reflecting a decline in investor confidence in the Turkish economy – had significant implications for Turkey's terms of trade, resulting in a collapse in imports and relatively strong export growth. As a result, the current account deficit narrowed considerably. We expect the current account shortfall to be equivalent to just 0.4% of GDP this year, from 3.5% in 2018 and 5.5% in 2017. This has, naturally, had important implications for growth, which was previously heavily reliant on capital inflows. We expect real GDP to decline by 1.2% this year, after 2.6% growth in 2018 and a 7.4% expansion in 2017.

**If further investor panic and a renewed decline in the value of the lira can be avoided, a moderate recovery is likely to gather steam in the second half of this year.** The current downturn moderated in the first quarter of 2019, suggesting that the worst may have passed. In year-on-year terms, retail trade declined by 5% in Q1 (from -7.4% in Q4 2018). Meanwhile industrial output fell by 4.9% in Q1 (from -7.7% in Q4 2018). However, a return to anything like pre-2018 growth rates is highly unlikely. Investors have sent a clear signal that they will no longer provide 4-6% of GDP per year in capital inflows to finance growth, and at present there is no obvious alternative model for economic expansion. While the export growth has been significant (reflecting a much weaker lira), Turkey is a relatively closed economy, with exports of goods and services equivalent to less than 30% of GDP (the second lowest in CESEE after Kosovo), which will limit the broader impact. Moreover, high inflation is partly eating away any gains to external competitiveness achieved by the nominal lira depreciation.

**We continue to expect something of a recovery in 2020-2021, although it will be underwhelming by Turkish standards.** Our forecasts are for an expansion of 2.8% next year, and 3.1% the year after. Although an improvement on 2019, these growth numbers are well below the rest of the post-crisis period (in 2010-2017, the average rate of expansion was 6.8% per year).

## UKRAINE: Growth holds steady despite political storm

BY OLGA PINDYUK

**The landslide victory of Vladimir Zelensky in the presidential elections has caused an increase in political uncertainty in the country.** Ukraine's new president started his term by announcing snap parliamentary elections during his inauguration speech on 20 May 2019. The elections are scheduled for mid-July 2019, and the president hopes that his party Servant of the People will be able to repeat his electoral success, which would allow it to have its own faction in the parliament and enter a coalition. Ukrainian parliamentarians have challenged the president's decision to dissolve the parliament in the Constitutional Court, which has unsettled investors in Ukrainian bonds.

**On the bright side, Zelensky has managed to somewhat dispel the fears that controversial oligarch Kolomoisky is having a strong influence on his decisions.** The president has rejected Kolomoisky's call to default on Ukraine's external debt and back away from cooperation with the IMF and ruled out supporting the oligarch's legal attempts to reverse the nationalisation of the top commercial bank, Privatbank. Additionally, in his first official visit to Brussels at the beginning of June, Zelensky reaffirmed his commitment to the EU and NATO. Though the president's programme is still not fully clear, he identified his key tasks as the fight against corruption and countering Russian aggression – though in a less hawkish way than his predecessor Poroshenko.

**Economic growth slowed down in Q1 2019, to 2.2% in annual terms, primarily due to a drop in manufacturing production** by 0.8% year on year. Decelerating export expansion caused a widening of the trade deficit during the first quarter against the same period of 2018. Industrial production bounced back in April, having achieved 5.2% growth, signalling the start of growth recovery. We expect GDP growth to accelerate in the next months and reach 2.7% year on year in 2019. In 2020-2021, the economy will grow by 3% and 3.5% respectively, primarily on the back of household final consumption.

**Private consumption growth continues to be stimulated by rising real wages, remittances and credit.** Developments in the latter are particularly worrisome. In April 2019, the stock of consumer loans, accounting for more than 75% of total household loans, was 18.9% higher than in April 2018. Newly issued loans increased during January-April 2019 by 54.3% year on year. The majority of consumer loans have maturity of less than 5 years, with 47% of loans having maturity of less than 1 year; most loans are used for purchasing consumer goods and subsidising basic living. Average interest rates on consumer loans are at around 30%, significantly higher than the nominal wage growth rate. The formation of a debt bubble is becoming increasingly likely in this situation and constitutes one of the major risks to the forecast.

**The hryvna has continued to appreciate in real terms as inflation reached 8.8% in April, year on year, while the exchange rate has remained practically stable.** Real appreciation together with double-digit wage growth have been causing a surge in unit labour costs. Still the average wage is significantly lower than that in other countries of Central and Eastern Europe, and Ukraine is likely to remain competitive in terms of labour costs in the near future.

## Index of subjects – June 2018 to June 2019

<b>Albania</b>	economic situation.....	2018/6, 2019/6
<b>Austria</b>	competitiveness at the micro level .....	2018/7-8
	commuting and regional GDP .....	2018/9
	export destinations re-examined .....	2018/9
	FDI in CESEE .....	2018/9
<b>Belarus</b>	economic situation.....	2018/6, 2019/6
<b>Bosnia and Herzegovina</b>	economic situation.....	2018/6, 2019/6
<b>Bulgaria</b>	economic situation.....	2018/6, 2019/6
<b>China</b>	outward FDI .....	2019/1
<b>Croatia</b>	economic situation.....	2018/6, 2019/6
	strategy for euro adoption .....	2018/12, 2019/6
<b>Czech Republic</b>	economic situation.....	2018/6, 2019/6
<b>Estonia</b>	economic situation.....	2018/6, 2019/6
<b>Hungary</b>	economic situation.....	2018/6, 2019/6
<b>Italy</b>	new government; euro area membership .....	2018/7-8
<b>Kazakhstan</b>	economic situation.....	2018/6, 2019/6
<b>Kosovo</b>	economic situation.....	2018/6, 2019/6
<b>Latvia</b>	economic situation.....	2018/6, 2019/6
<b>Lithuania</b>	economic situation.....	2018/6, 2019/6
<b>Moldova</b>	economic situation.....	2019/6
<b>Montenegro</b>	economic situation.....	2018/6, 2019/6
<b>North Macedonia</b>	economic situation.....	2018/6, 2019/6
<b>Poland</b>	economic situation.....	2018/6, 2019/6
<b>Romania</b>	economic situation.....	2018/6, 2019/6
<b>Russia</b>	economic situation.....	2018/6, 2019/6
	fiscal rule and foreign exchange market .....	2019/2
	growth accounting, total factor productivity .....	2019/2
	oil taxation reforms .....	2019/2
<b>Serbia</b>	economic situation.....	2018/6, 2019/6
<b>Slovakia</b>	economic situation.....	2018/6, 2019/6
<b>Slovenia</b>	economic situation.....	2018/6, 2019/6
<b>Turkey</b>	economic conundrum.....	2018/6, 2019/6
<b>Ukraine</b>	economic situation.....	2018/6, 2019/6

(continued on the next page)



**multi-country articles  
and statistical overviews**

Central Asia regional trade integration .....	2019/4
deleveraging in CESEE .....	2018/12
digital revolution, robot adoption, and labour market .....	2019/5
economic integration EU – EAEU .....	2019/4
effects of NTMs on gross and value added exports .....	2018/7-8
EU cohesion policy .....	2018/10
EU disintegration .....	2018/10
EU FTAs, optimal degree of trade liberalisation .....	2019/1
EU trade relations with developing countries .....	2019/1
Eurasian economic integration .....	2019/4
European financial markets 10 years after the crisis .....	2018/12
European investment gap (European Silk Road) .....	2019/3
financialisation process in CESEE .....	2018/12
football and economics .....	2018/11
investment trends in CESEE .....	2019/3
Italy, euro area .....	2018/7-8
Luddite rebellion .....	2018/11
migration, global compact .....	2018/11
natural interest rates .....	2019/5
New Silk Road, EU, EAEU .....	2018/7-8
outward FDI in EU-CEE11 .....	2019/3
permanent fiscal deficits .....	2018/10
polarisation of production structures .....	2018/10
telegraph revolution .....	2018/11
wages and emigration from the CEE .....	2018/9



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Economics editors: Vasily Astrov, Richard Grieveson

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