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

The Vienna Institute for International Economic Studies
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Central, East and Southeast Europe: Recent Economic Developments and Forecast

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OVERVIEW 2015-2016 AND OUTLOOK 2017-2019

	GDP real change in % against prev. year					Consumer prices change in % against prev. year				
			Forecast					Forecast		
	2015	2016	2017	2018	2019	2015	2016	2017	2018	2019
Bulgaria	3.6	3.4	3.5	3.5	3.6	-1.1	-1.3	0.5	1.0	1.5
Croatia	1.6	2.9	2.7	2.9	3.0	-0.3	-0.6	1.3	1.6	1.6
Czech Republic	4.5	2.4	2.7	2.7	2.4	0.3	0.6	1.6	2.0	2.0
Estonia	1.4	1.6	2.3	2.5	2.6	0.1	0.8	3.0	3.2	3.2
Hungary	3.1	2.0	4.0	3.9	3.3	0.1	0.4	2.9	3.2	3.3
Latvia	2.7	2.0	2.9	3.0	2.9	0.2	0.1	2.9	2.7	2.5
Lithuania	1.8	2.3	3.0	3.2	3.3	-0.7	0.7	3.0	2.8	2.5
Poland	3.8	2.7	3.3	3.2	3.1	-0.7	-0.2	1.4	1.9	2.0
Romania	3.9	4.8	4.8	4.3	4.3	-0.4	-1.1	1.3	2.5	3.0
Slovakia	3.8	3.3	3.3	3.6	3.9	-0.3	-0.5	1.2	1.8	1.8
Slovenia	2.3	2.5	3.5	3.2	3.1	-0.8	-0.2	1.5	1.8	1.8
EU-CEE 1)2)	*3.6*	*3.0*	*3.5*	*3.4*	*3.3*	*-0.4*	*-0.2*	*1.6*	*2.1*	*2.3*
EA-19	*2.0*	*1.8*	*1.7*	*1.8*	*.*	*0.0*	*0.2*	*1.6*	*1.3*	*.*
EU-28	*2.2*	*1.9*	*1.9*	*1.9*	*.*	*0.0*	*0.3*	*1.8*	*1.7*	*.*
Albania	2.2	3.5	3.9	4.0	4.1	1.9	1.3	2.3	2.8	3.0
Bosnia and Herzegovina	3.0	2.0	3.2	3.4	3.4	-1.0	-1.1	1.2	1.6	1.9
Kosovo	4.3	3.4	3.7	3.8	3.7	-0.5	0.3	1.6	1.9	2.3
Macedonia	3.8	2.4	2.6	3.3	3.4	-0.3	-0.2	1.0	1.5	2.0
Montenegro	3.4	2.5	2.5	2.7	2.5	1.4	0.1	1.5	2.0	2.0
Serbia	0.8	2.8	2.5	2.6	2.8	1.4	1.1	2.0	2.0	2.0
WB 1)2)	*2.1*	*2.7*	*2.9*	*3.1*	*3.2*	*0.7*	*0.5*	*1.7*	*2.0*	*2.1*
Turkey	6.1	2.9	2.8	2.9	3.0	7.7	7.8	10.9	7.8	6.8
Belarus 3)	-3.8	-2.6	1.4	2.1	2.6	13.5	11.8	10.0	9.0	8.0
Kazakhstan	1.2	1.0	2.5	3.0	3.0	6.6	14.6	7.0	6.0	6.0
Russia	-2.8	-0.2	1.3	1.6	1.8	15.5	7.1	5.0	4.0	5.0
Ukraine	-9.8	2.3	2.0	3.0	3.0	48.7	13.9	12.0	5.9	5.0
CIS + Ukraine 1)2)	*-3.0*	*0.0*	*1.5*	*1.9*	*2.1*	*17.1*	*8.6*	*6.0*	*4.6*	*5.2*
V-4 1)2)	*3.9*	*2.6*	*3.3*	*3.2*	*3.1*	*-0.4*	*0.0*	*1.6*	*2.1*	*2.2*
BALT-3 1)2)	*2.0*	*2.0*	*2.8*	*3.0*	*3.0*	*-0.3*	*0.5*	*3.0*	*2.9*	*2.7*
SEE-9 1)2)	*3.2*	*3.9*	*3.9*	*3.7*	*3.8*	*-0.2*	*-0.7*	*1.3*	*2.0*	*2.4*
NON-EU-11 1)2)	*-0.2*	*1.0*	*1.9*	*2.2*	*2.4*	*13.8*	*8.1*	*7.3*	*5.4*	*5.6*
CESEE-22 1)2)	*0.9*	*1.6*	*2.4*	*2.6*	*2.7*	*9.7*	*5.6*	*5.6*	*4.4*	*4.6*

ctd.

ctd.

	Unemployment (LFS) rate in %, annual average					Current account in % of GDP				
			Forecast					Forecast		
	2015	2016	2017	2018	2019	2015	2016	2017	2018	2019
Bulgaria	9.2	7.6	7.0	6.5	6.0	-0.1	4.2	2.6	2.3	2.0
Croatia	16.2	13.1	13.0	12.5	12.0	4.8	2.6	2.3	2.3	2.0
Czech Republic	5.1	4.0	3.9	3.8	3.6	0.2	1.1	0.6	0.2	0.1
Estonia	6.2	6.8	6.7	7.0	7.0	2.2	2.7	1.4	1.3	1.2
Hungary	6.8	5.1	4.4	4.3	4.2	3.4	4.9	4.5	3.7	2.8
Latvia	9.9	9.6	9.1	8.5	8.0	-0.8	1.5	0.2	-0.2	-0.5
Lithuania	9.1	7.9	7.3	6.8	6.3	-2.3	-0.9	-0.7	-0.2	-0.2
Poland	7.5	6.2	6.2	6.1	6.1	-0.6	-0.3	-0.3	-0.7	-1.0
Romania	6.8	5.9	5.3	5.0	4.8	-1.2	-2.3	-2.8	-3.1	-3.4
Slovakia	11.5	9.7	8.3	7.7	7.2	0.2	-0.7	-0.2	0.6	1.5
Slovenia	9.0	8.0	7.5	6.9	6.5	5.2	6.8	6.4	4.6	4.5
EU-CEE 1)2)	*7.8*	*6.5*	*6.2*	*5.9*	*5.7*	*0.3*	*0.7*	*0.4*	*0.0*	*-0.2*
EA-19	*10.9*	*10.0*	*9.4*	*8.9*	*.*	*3.7*	*3.6*	*3.0*	*2.9*	*.*
EU-28	*9.4*	*8.5*	*8.0*	*7.7*	*.*	*2.2*	*2.2*	*1.9*	*1.9*	*.*
Albania	17.1	15.2	14.2	14.0	13.6	-10.8	-9.6	-9.6	-9.3	-9.0
Bosnia and Herzegovina	27.7	25.4	25.3	25.1	25.0	-5.5	-4.5	-3.8	-3.8	-3.8
Kosovo	32.9	27.5	25.8	25.5	25.2	-8.6	-9.2	-10.0	-10.6	-11.1
Macedonia	26.1	23.7	24.0	23.0	23.0	-2.1	-3.1	-3.2	-3.9	-4.0
Montenegro	17.6	17.7	17.0	16.5	16.5	-13.3	-19.0	-21.4	-23.7	-23.7
Serbia	17.7	15.3	15.0	14.0	14.0	-4.7	-4.0	-3.9	-4.2	-3.9
WB 1)2)	*21.2*	*18.7*	*18.3*	*17.6*	*17.5*	*-6.1*	*-5.8*	*-5.9*	*-6.2*	*-6.1*
Turkey	10.3	10.9	11.2	10.8	10.4	-3.7	-3.8	-3.7	-3.8	-4.1
Belarus 3)	1.0	0.8	1.0	1.0	1.0	-3.3	-3.6	-3.4	-3.1	-3.1
Kazakhstan	5.0	5.0	5.0	5.0	5.0	-2.8	-6.3	-2.6	-1.9	-1.9
Russia	5.6	5.3	5.5	5.5	5.5	5.0	1.9	3.1	3.5	3.5
Ukraine	9.1	9.3	9.1	8.7	8.3	-0.2	-4.1	-4.4	-4.4	-4.5
CIS + Ukraine 1)2)	*5.9*	*5.9*	*5.9*	*5.9*	*5.8*	*3.6*	*0.7*	*1.8*	*2.3*	*2.3*
V-4 1)2)	*7.3*	*5.9*	*5.7*	*5.6*	*5.5*	*0.2*	*0.7*	*0.6*	*0.3*	*0.1*
BALT-3 1)2)	*8.7*	*8.2*	*7.7*	*7.4*	*7.0*	*-0.7*	*0.7*	*0.1*	*0.2*	*0.0*
SEE-9 1)2)	*12.8*	*11.2*	*10.7*	*10.2*	*9.9*	*-1.4*	*-1.6*	*-2.1*	*-2.4*	*-2.6*
NON-EU-11 1)2)	*7.6*	*7.6*	*7.7*	*7.5*	*7.3*	*0.9*	*-1.1*	*-0.3*	*-0.1*	*-0.3*
CESEE-22 1)2)	*7.6*	*7.3*	*7.3*	*7.1*	*7.0*	*0.7*	*-0.5*	*-0.1*	*-0.1*	*-0.3*

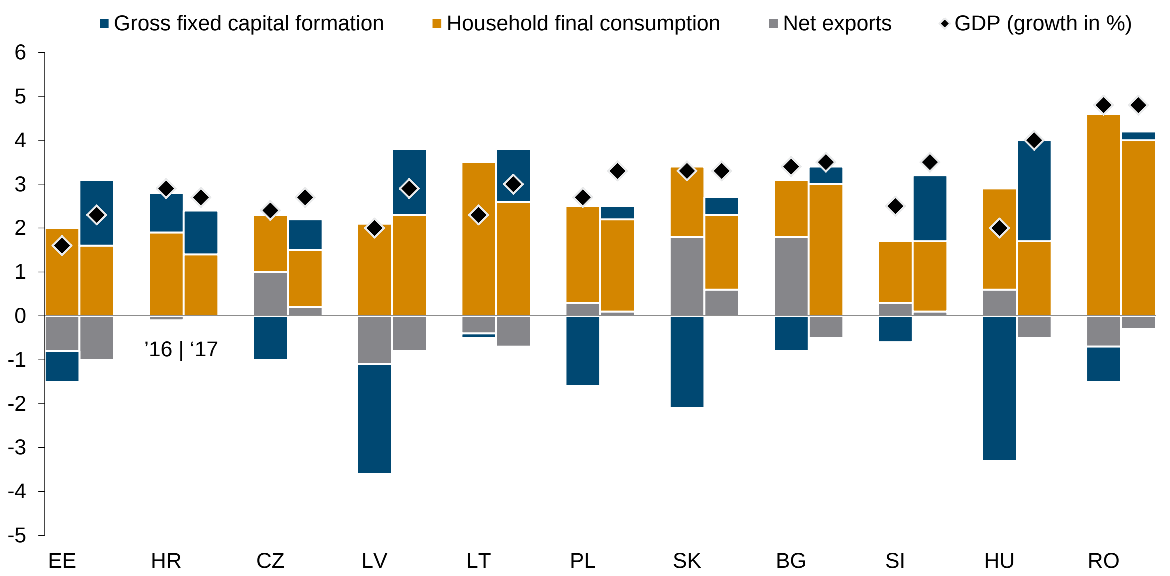
Note: EU-CEE: Central and East European EU countries; V-4: Visegrád countries: Czech Republic, Hungary, Poland, Slovakia; BALT-3: Baltic countries: Estonia, Latvia, Lithuania; SEE-9: Southeast Europe: Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Kosovo, Macedonia, Montenegro, Romania, Serbia; NON-EU-11: Non-European Union countries: Albania, Bosnia and Herzegovina, Kosovo, Macedonia, Montenegro, Serbia, Turkey, Belarus, Kazakhstan, Russia, Ukraine; CESEE-22: Central, East and Southeast Europe: EU-CEE + NON-EU-11.

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

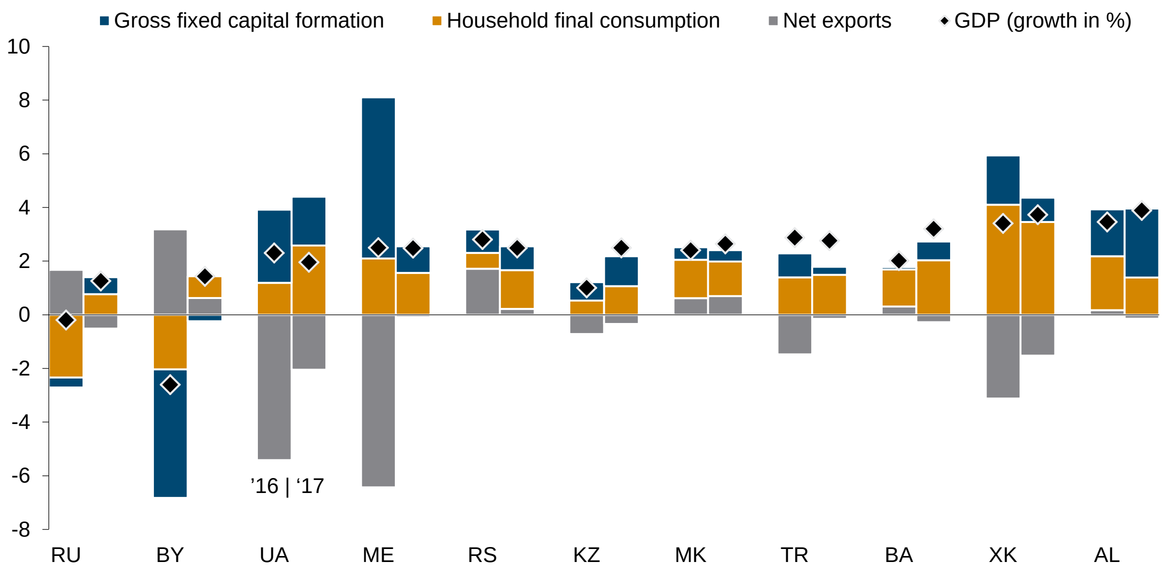
Source: wiiw, Eurostat. Forecasts by wiiw (June 2017) and European Commission for EU and euro area (Spring Report, May 2017).

GDP growth in 2016-2017 and contribution of individual demand components in percentage points

EU-CEE



Western Balkans, Turkey, CIS and Ukraine



Remark: Ranking according to growth rates 2017.
Source: wiiw Annual Database incorporating national and Eurostat statistics, own calculation. Forecasts by wiiw.

ALBANIA: Growth forges ahead

BY ISILDA MARA

The political muddle which had been tormenting the Albanian political scene was temporarily brought to a close with the assignment of an agreement between the Socialist and the Democratic Party. The opposition, led by the Democratic Party, had called for the government's resignation and for the postponement of the parliamentary elections. Their argument was that the ruling government was strongly linked to organised crime and could not guarantee free elections. So, after boycotting the parliament, they announced to boycott the elections. The mediation of the international partners – the European and American ones – unravelled the political crisis and pushed both sides to come to an agreement by 18 May. Accordingly, six new technical ministers proposed by the opposition were appointed; the parliamentary elections were postponed from 18 June to 25 June and further concessions were offered to the Democratic Party, which in return re-entered the parliament and committed to support the vetting law[1].

Despite the political turmoil, the Albanian economy has forged ahead supported both by domestic and external demand. Growth is expected to edge up to 4% by the end of 2018. Indicators of the real sector are encouraging. Household consumption continued to grow backed by a rise in wages, employment and consumer confidence. Nevertheless, employment prospects for the youth remain gloomy: inactivity in the age group 15-29 was 58% in 2016. The population of this age group dropped by 5% between 2013 and 2016, also due to emigration which persists over time. Investments continued on a positive path during the first quarter of 2017, reflecting higher confidence among economic agents in services, trade, construction and industry. The construction of the Trans Adriatic Pipeline (TAP) is progressing accordingly. So does the building of the Devoll Hydropower stations (Banja and Moglica) by the Norwegian Statkraft – an investment which will boost energy production in Albania in the order of 17% by 2019. The upturn in external demand during the last quarter of 2016 carried on also in the first quarter of 2017. Exports of minerals, fuels and electricity surged by 38% in nominal terms and 7% in real terms respectively, year on year, in the first four months of 2017 due to favourable international prices.

The general government budget continued to be in surplus until April.[2] Meanwhile, a new rise in minimum wages (from EUR 164 to 179) and public wages (by 10%) became operational as of March 2017. The cut in the VAT rate on tourism, from 20% to 6% (mainly in accommodation and similar related services) applies starting from June 2017. This move comes at a time when the tourism industry is booming and is aimed at reducing shadow economic activities and boosting investments in the sector. Despite the enacted tax cuts, a long-term oriented strategy has to be set in motion to unlock the high potential of the sector.

Monetary policy easing continues but the strong euroisation of the economy is a constraint. At the same time the economy is facing an excessive supply of euros. Between January and June 2017, the exchange rate EUR/LEK appreciated by 2.2% (almost to the 2009 level of 134 LEK), although the reasons behind are not obvious.[3] Besides, the economy's Achilles' heel is still the weak credit growth, due also to high levels of non-performing loans despite their being reduced to 16.6% by April 2017. Overall, taking into account the recent dynamics, we have made a slight upward revision of our growth forecast for 2017, to 3.7%, but kept unchanged the forecast for 2018-2019, at 3.9 and 4% respectively.

1 The vetting law is part of the Judicial System Reform which aims to rid the justice system of corrupt judges and prosecutors, bent politicians and organised crime. This reform is one of the EU requirements for the opening of accession talks with Albania.

2 In June 2016 a new law was introduced to control the budget execution in electoral years, setting a limit to the budget deficit: in a half year execution the deficit should not be more than 55% of the annual deficit target set out in the annual budget law.

3 There is a lot a speculation that the export revenues generated by illicit activities might be the cause. On an almost daily basis, the press reports about tonnes and kilogrammes of cannabis sequestered by the police.

BELARUS: On the road to recovery

BY RUMEN DOBRINSKY

The economic slump in Belarus which lasted for two years seems to have come to an end. In the first quarter of 2017 GDP grew by 0.3% year on year and the flash estimates suggest that aggregate output in January-April was 0.5% higher than a year earlier. The recovery of industrial production was even more pronounced: in yoy terms, its growth has been positive since October 2016. In the first quarter, gross industrial output was 4.3% higher than in the same period of the previous year with signs of continued acceleration.

One of the important factors behind the economic revival was the settling of the gas pricing dispute between Belarus and Russia which broke out at the beginning of 2016 and led to a reduction of Russian oil supplies to Belarus by almost a quarter. The dispute was resolved after a face-to-face meeting between presidents Lukashenko and Putin in April, with Belarus agreeing to pay the full debt for past gas deliveries as requested by Russia but with an extended repayment period. In turn, Russia agreed to price concessions for gas deliveries in 2018 and 2019. Following this accord, Russia resumed oil supplies to Belarus at normal levels. Combined with the effect of the concomitant recovery in Russia – Belarus' main trading partner – this contributed to a surge in Belarusian exports, a large chunk of which consists of refined oil products. In the period January-April Belarus' total exports of goods and services in current USD terms rose by 21% over the same period of 2016; exports to Russia alone (which account for more than 40% of Belarus' total exports) jumped by 32% yoy in the same period. The exports of manufactured goods were responsible for most of the expansion and obviously this gave a solid impetus for the recovery of the Belarusian industry.

Belarus also made progress in suppressing inflationary pressures, which had been a chronic problem in the country. The new macroeconomic policy course centred on monetary targeting, and the floating exchange rate which has been in place since 2015 so far has yielded positive results in bringing down inflation. This was achieved thanks to a tight monetary stance matched by a fiscal retrenchment and, not least, significant reduction in directed credit (subsidised credit allocated to state-owned firms participating in government programmes). As a sign of confidence of the monetary authorities in their policy course, the central bank of Belarus lowered its key intervention rate five times during the first months of the year, bringing it down from 18% at end-2016 to 13% by June. If there is no further relaxation of this stance, the trend towards disinflation should continue and inflation could drop to single digits in the near future. On the downside, this policy course has produced an appreciating real exchange rate. So far this has not triggered visible negative macroeconomic effects but if appreciation continues, policy will need to address the risks associated with it.

The curbing of domestic demand contributed to a reduction of the current account deficit which has been at manageable levels since 2015. Consequently, foreign borrowing requirements were reduced and in recent years these have been largely confined to borrowing from Russia and Russia-controlled financial institutions. Following the settlement of the gas dispute, the Eurasian Development Bank resumed lending to Belarus under the USD 2 billion funding agreement signed in 2016. Belarus is also negotiating a new credit from the Russian government which will be used for rolling over matured past debt to Russia. At the same time, there has been no visible progress in the negotiations with the IMF on a new funding agreement despite several rounds of consultations.

Overall, the prospects for the Belarus economy have improved and the recovery should continue and strengthen in 2018 and 2019. However, reflecting the policy shift to macroeconomic stabilisation at the expense of support to domestic demand, growth will probably remain modest, at around 2-2½% p.a., much below the levels seen in previous years.

BOSNIA AND HERZEGOVINA: Broad-based pick-up in growth

BY RICHARD GRIEVESON

The economy is growing strongly, with the latest high frequency indicators suggesting that the current rate of expansion is well over 3%. Growth appears to be quite broad based. Working-day adjusted industrial output rose by an average 3% year on year in January-April, while retail trade volumes were up by 5.6% on average over the same period. Nominal merchandise exports increased by over 16% in January-April. Stronger growth in the EU is clearly supportive, while inflation averaged 1.2% in January-April, very low by historical standards. The strong start to 2017 follows a fairly pronounced slowdown in economic activity in 2016, to 2%, driven by a decline in wholesale and retail trade, and public spending.

We expect real GDP growth to average well above 3% in 2017-2019. Remittances, low inflation (and the consequent positive impact on real disposable income), investment and reasonably strong external conditions (especially in the eurozone) will be the main growth drivers. We expect investment to rise more quickly than overall economic activity over the forecast period, meaning that its share of GDP should increase gradually (albeit remaining low by regional standards even in 2019). Much of this investment is likely to be focused on the energy and tourism sectors. Investment in Bosnia and Herzegovina has a large imported component, meaning that net exports will remain a drag on growth.

The consolidated budget is likely to have been in surplus for a second consecutive year in 2016 (data are only available up to Q3). Revenue rose by 1.8% in the first nine months of the year, while expenditure was largely flat. There are few fiscal risks, with public debt remaining at a very low level by regional standards. The IMF presence will ensure continued fiscal restraint.

The external deficit is still large, and its financing relies heavily on debt-creating inflows. However, a significant share of this funding is concessional, with low interest rates and long maturities, reducing potential vulnerabilities. Foreign tourism remains quite small, but is growing quickly, with foreign tourist nights up 16% in the year to April. The total services surplus reached almost 8% of GDP in 2016, which combined with the roughly 13% of GDP secondary income surplus, helped to cover a large proportion of the goods deficit (25.5% of GDP). Remittances on the secondary income account cover around 16% of the merchandise import bill.

The labour market is a weakness, and this is likely to remain the case during the forecast period. Informality is a major issue, while the activity rate is among the lowest in CESEE. Female unemployment is particularly high. While the low starting point indicates the potential for strong growth, the policies required to achieve this are unlikely to materialise. We expect the unemployment rate to fall gradually, but it will still be 25% in 2019.

The Extended Fund Facility (EFF) programme with the IMF remains prone to delays. In total, the EFF is worth EUR 553 million, but the release of the most recent tranche – worth EUR 80 million – has been held back due to reform delays at both the local and national levels. This and possible further delays to payments have the potential to affect near-term economic momentum. However, overall we do not expect the impact to be significant. Delays are also unlikely to affect domestic or foreign investor sentiment.

The political situation remains problematic, and in an extreme scenario could be a risk to the economy. Miroslav Dodik, the president of the Republika Srpska, has become more assertive in his demands for the secession of the entity from Bosnia and Herzegovina. However, the most likely scenario is of continued muddle through.

BULGARIA: An ongoing economic revival

BY RUMEN DOBRINSKY

A broad-based economic upturn is underway in Bulgaria with GDP increasing by 3.9% year on year in the first quarter. On the supply side, manufacturing and business services were the main engines of growth. Manufacturing output in the first quarter grew by close to 5% yoy on the backdrop of strong export performance. Indications are that both the ICT industry and tourism – the two most dynamic segments of the services sector – also had a solid start into the year. Recent business confidence surveys also suggest a sustained improvement in business sentiment during the first months of 2017.

On the demand side, both private consumption and exports provided solid support to economic growth. Rising consumer confidence is reflected in robust retail sales, record purchases of new cars and recovering consumer credit. All this is starting to exert upward pressure on consumer prices, reversing the deflationary trend that lasted for almost two years. Exports of goods and services were also booming: in current euro terms they were growing at double-digit rates in the first months of the year.

Gross fixed capital formation remained sluggish in the first quarter. While private fixed investment is showing signs of a possible recovery, public investment programmes are still behind schedule and the accumulated negative effect is not likely to be offset in the course of the year. Mirroring this situation, the construction industry as a whole still has not turned the corner. This was not the case for residential construction which reported a modest upturn at the beginning of 2017.

The labour market has fully recovered from the prolonged slump that followed the global financial crisis: both the number of employed and the rate of unemployment have reached their levels of ten years ago. Shortages of skilled labour have also re-emerged, exerting upward pressure on wages. A relatively new phenomenon is the importation of skilled workers, in the first place from other EU countries: more and more businesses, especially FDI and insourcing firms, reach out to skilled job seekers from the EU to fill in their vacant positions. The offering of internationally competitive salaries in these sectors leads to further differentiation in labour pay within the economy and growing income inequalities in the country.

The growing domestic demand has been associated with a sharp upturn in imports and a worsening balance of merchandise trade. However, for the time being the strong services exports are largely offsetting this deficit and as a result the current account balance is still firmly in the positive territory. The recovery has also contributed to a sustained improvement in Bulgaria's fiscal position: the cash general government balance was markedly positive in the period January-April while the ESA fiscal position is likely to remain close to balanced for the year as a whole.

The early elections held in March brought a comfortable victory to GERB[1], albeit below the majority threshold. Thus Boyko Borisov, the unchangeable leader of GERB, is behind the steering wheel again, a post he has held during much of the past decade. However, his position now is weakened by the need to find compromises with his two coalition partners (a nationalist party and a new populist formation). This constellation seems to suggest an eclectic policy course precluding radical economic reforms.

All indications are that in general the Bulgarian economy will retain its growth momentum at GDP growth rates of around 3.5% p.a. While export growth may slow down a bit (there were seasonal factors at the beginning of the year which may be phased out), fixed investment should be picking up to provide a new growth impetus.

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[1] The acronym for the name of the party 'Citizens for European Development in Bulgaria', the party that has been in power since 2009 with small breaks.

CROATIA: Economy overshadowed by Agrokor troubles

BY HERMINE VIDOVIC

In the first quarter of 2017, Croatia's economy performed less dynamically than in the same period a year earlier: GDP grew by 2.5% driven by domestic demand, both household consumption and rising investments, while net exports contributed negatively to GDP growth. The labour market situation continued to improve during the first three months of 2017: according to Pension Insurance data, employment increased by 1.9%, particularly in industry and construction – and the registered unemployment rate fell to 13.2% in April. Despite still high unemployment, there are labour shortages in some industries such as tourism, construction, metal-working, shipbuilding and transport. Real net wages increased by 3.6% in the first quarter of 2017. In 2016 the general government budget closed with a deficit of 0.8% of GDP and a public debt to GDP ratio of 84.7%, well below the target set at the beginning of the year. Based on the progress achieved, in April this year the European Commission recommended for Croatia to exit the 'excessive deficit procedure' (EDP), which was launched in 2014. External trade in goods performed well: according to customs statistics, goods exports rose by 25% – notably of pharmaceuticals, coke and ships (reporting an increase in production amid overall stagnation) – while imports grew by 16% in euro terms. Thus, the trade deficit remained almost unchanged against the same period a year earlier. Because of this, and assuming no significant changes in the services trade surplus, the current account deficit has probably remained in the same magnitude as in the first quarter of 2016, at EUR 1.6 billion.

Industrial production stagnated during the first four months of 2017, which might be a first sign of the financial troubles related to Agrokor, Croatia's biggest private retailer and food producer. By the end of March it became obvious that Agrokor was unable to service its debts. Already earlier in the year Moody's had downgraded the rating outlook for the company from stable to negative. According to first estimates, Agrokor's debt to creditors and suppliers is totalling about EUR 6 billion. The company employs around 60,000 persons all over the Balkans and its revenues account for about 15% of Croatia's GDP. At the beginning of April the Croatian government approved an emergency law (Lex Agrokor) on the 'Extraordinary Administration for Companies with Systemic Importance for the Republic of Croatia'. In a first move the management of the company was handed over to an extraordinary commissioner appointed by the government, who should reach an agreement with the creditors and implement a restructuring process in the next 15 months. Subsidiaries of Agrokor will have to be sold, but further details yet unknown. The events around Agrokor have also led to a political crisis. Croatia's opposition parties filed a motion of no confidence against the Minister of Finance, Zdravko Marić, over an alleged conflict of interest – Mr Marić is a former executive of Agrokor. The no-confidence vote, which failed in the end, was also supported by four ministers representing Most, the junior partner of the HDZ-led government. In response, Prime Minister Plenković dismissed the renegade ministers, which marked also the end of the coalition government that had been in office since November 2016. In early June a new coalition government was formed between HDZ and the Croatian People's Party – Liberal Democrats (HNS), having only a narrow majority in the parliament.

There are indications that Croatia's economy will be affected by the collapse of Agrokor in 2017. Apart from the slowdown of growth in industry, retail trade reported a decline in April, which is also reflected in the most recent consumer confidence survey pointing to a deterioration of household expectations. The potential negative effects on Agrokor's suppliers are still unknown. A favourable tourist season may offset at least part of the expected negative impacts. Thus, GDP may grow by some 2.7% this year and by about 3% p.a. in 2018-2019 driven primarily by domestic demand. The expected rise in investments will be spurred by transfers from the EU budget, while household consumption should benefit from a further gradual improvement in the labour market. The current account will remain in positive territory, but is expected to decline along with rising GDP. The ongoing political instability might negatively affect Croatia's creditworthiness.

CZECH REPUBLIC: Performance better than expected

BY LEON PODKAMINER

According to preliminary estimates real (seasonally unadjusted) GDP increased by 3.9%, year on year, in the first quarter of 2017, which is more than the 3.3% expected by the Finance Ministry two months ago. Very strong growth of the volume of exports of goods and services (by 7.9%) with the volume of imports rising by only 6.4% was the main growth component. The improving trade balance (currently 9.8% of the seasonally unadjusted quarterly GDP) contributed 1.8 percentage points (pp) to GDP growth. Private consumption, rising by 3.4%, contributed 'only' 1.6 pp and gross fixed capital formation (rising by 1.9%) contributed 0.5 pp.

The extraordinary (and rather unexpected) foreign trade developments in the first quarter of 2017 may have come about under rather exceptional circumstances that need not repeat themselves over the rest of 2017. In the first quarter of 2017 the upcoming discontinuation of the policy of keeping the exchange rate stable (at a level not lower than 27 CZK/EUR) was generally anticipated – as was the prospect of immediate nominal appreciation of the Czech currency. In fact, the re-floating of the Czech currency (on 6 April) was immediately followed by its nominal (as well as real) appreciation. A period of exchange rate instability has ensued. It is yet too early to see a new equilibrium level of the exchange rate emerging under the absence of the National Bank's active participation in the foreign exchange market. Of course, a currency appreciation generally makes exporting less attractive and importing more attractive. The expectation of appreciation may have provided incentives to export in advance (that is already in the first quarter of 2017) – and suppress imports accordingly. It is natural to expect that under continuing appreciation exports will be less dynamic over the rest of 2017, but imports more so. Another reason to anticipate exports to lose momentum and imports to gain more of it is that the Czech economy may be already close to exhausting its spare production capacities as shortages of labour become widespread.

One of the (declared) reasons for giving up control over the exchange rate was the prospect of inflation returning to 'normal' (after running at close to nil since the beginning of 2014). The return of inflation is a natural consequence of the tight labour markets and very low levels of unemployment – and, consequently, rising wages. The return of (still moderate) inflation is unlikely to be actively opposed by a more restrictive interest rate policy of the National Bank (as this may harm the weak investment activities and possibly also additionally strengthen the Czech currency). A more passive stance is likely – i.e. the reliance on the currency strengthening on its own. Inflation control may be easier to conduct with the fiscal policy which has been targeting, successfully, a balanced budget of the general government.

Growth in wages in 2017 and beyond will be underlying growth in private consumption. Given the singularity of the Czech labour market, which has been characterised by the coexistence of low unemployment with a good deal of wage moderation, household incomes can be expected to keep rising rather modestly too. Moderate growth in private consumption will be the main driver of a temperate GDP growth. For faster growth the Czech Republic may need an acceleration of investment such as infrastructural development. This upturn of outlays, co-financed by the EU under the new financial perspective, will be forthcoming. All conditions are in place for an acceleration of private investment as well. All in all, the country's prospects are looking quite good, with GDP growth of about 2.5% clearly in reach in the medium term.

ESTONIA: Growing at potential

BY SEBASTIAN LEITNER

In the first months of 2017 various economic indicators showed a higher than expected upswing of the Estonian economy (first-quarter GDP growth: 4.1% year on year) driven both by external and domestic demand. Export growth continued to accelerate, a trend that will carry on this and the next year. A couple of positive developments are supporting exporting firms this year. While the recovery of the Russian economy resulted in Estonian exports to Russia increasing by almost 20% in the first quarter year on year in nominal terms, also the upswing of the Finnish economy proved stronger than expected. Increasing producer und export prices improve the profitability of enterprises. Moreover, a slight increase in prices of crude oil had a positive impact on the prospects of the production of shale oil, Estonia's second most important export good. Also, in the second half of 2017, Estonia will assume the presidency of the Council of the EU, which is likely to boost income from tourism.

Domestic demand is driven particularly by investment activity in 2017. As external demand and industrial production have started to pick up strongly, a relatively high level of capacity utilisation has been attained; thus growth of private investments in equipment is showing exceptional dynamism, in particular in manufacturing. Furthermore, activity in the construction sector has also gained momentum. Data on building permits and mortgage loans suggest that dwelling construction will expand strongly this year. Public investment will also increase markedly both in 2017 and 2018. The 2017 state budget of the Estonian government anticipates additional EU funds for public and private investment, amounting to 2-3% of GDP.

The activity rate continues to rise, while the unemployment rate still declines. The employment rate of the Estonian population (aged 15-64 years) amounted to close to 72% in the first quarter of 2017 – within the group of EU-CEE countries only the Czech Republic attains a higher level. The work ability reform, introduced in July 2016, increased the number of elderly people registered as unemployed. In order to continue to receive benefits, people who have so far qualified for a work incapacity pension now have to look more actively for jobs and take part in public work activation measures. However, contrary to expectations, the unemployment rate did not rise despite the higher labour supply, but is still declining (to 5.6% in the first quarter of 2017).

Due to the higher consumer price inflation during the recent months, real net wages are rising less swiftly than last year. The upward price movement is primarily caused by an increase in excise taxes and energy prices. On the other hand, the government is planning to reduce income tax rates, a measure that will further support population incomes. All in all, we expect Estonian household consumption to grow at a good pace both in 2017 and 2018, albeit less dynamically than last year.

Compared to our Spring Forecast we became more optimistic, increasing the forecast GDP growth rate for this year to 2.3%. Particularly private investment activity has picked up more strongly, while the upswing in external demand is continuing. The strong upswing in public investment, not only this year, but also in 2018 and 2019, will be facilitated by increasing inflow of EU funds. Rising household incomes will help private consumption to keep on growing steadily. For 2018 and 2019, we revised our GDP growth forecast upwards, to 2.5% and 2.6%, respectively.

HUNGARY: Strong growth performance in the first quarter

BY SÁNDOR RICHTER

The 4.2% GDP growth (yoy) reported for the first quarter of 2017 was stronger than expected by the expert consensus. Even the structure of growth was a surprise. Strong expansion of wages in the first months of the year made observers forecast a consumption-driven growth. In actual fact, it was gross fixed investment which has been the main driver of expansion and, also contrary to expectations, net exports played a growth-supporting role in the first quarter.

While real wages increased by 8% and employment by 2.5% in the first quarter, retail trade grew only by 3.4% (yoy). This suggests that change in household consumption might not closely follow the increased incomes of the population, and indeed, final consumption of households increased by 2.5% only. Moreover, government consumption dropped by 6.2%, leaving total final consumption with a modest 1.2% expansion rate. Gross fixed capital formation rose by a formidable 28.4%, partly reflecting the low basis in 2016 but also a revival of EU co-financed projects and an improved investment propensity in nearly all sectors of the economy. However, a strong depletion of inventories moderated the overall contribution of gross capital formation to GDP growth in the first quarter. The strong upturn in investment pushed the import growth rate above that of exports (10% vs. 9.6%, in real terms) but the large 'inherited' export surplus allowed yet for a modest positive contribution by net exports to growth in the first quarter.

In January-March 2017 nominal wages (both gross and net) increased by 11%. This is partially the consequence of a 15% rise in minimum wages (to an equivalent of EUR 360) and a 25% rise in guaranteed minimum wages for skilled workers (to an equivalent of EUR 520), a prelude to the 2018 election campaign, which will be followed by further rises for both categories (by 8% and 12% respectively) in January 2018. However, wage rises also are driven by the tight labour market situation due to decreasing supply of skilled workers and high-skilled employees. Shortage of labour has become a major obstacle to continuous operation and development across various sectors of the economy. In the first four months of the year the average number of unemployed was 209,000 and the rate of unemployed decreased to 4.6%. Close to 45% of the unemployed persons were trapped in long-term unemployment (duration over one year) – a hint at the skills mismatch in the labour market.

After only marginal consumer price rises in 2014-2016 inflation is back: in January-April consumer prices increased by 2.5%. Substantial price rises were registered for vehicle fuel, food, pharmaceutical products, beverages and tobacco. Producer prices in industry increased even more strongly, by 3.7%, of which those in domestic sales over 6%. Given the favourable fiscal balance in the first months of the year, the government may initiate further steps to accelerate economic growth, without endangering the observation of the 3% fiscal deficit/GDP threshold. With regard to the nearing elections, this opportunity will most probably be utilised.

Annual GDP growth is expected to reach around 4% this year. There are mostly upward risks to this forecast to reckon with: a further improvement of the economic climate in the EU including the main export markets of Hungary may step up net exports' contribution to growth; a continued take-off in lending may boost household and business investment; an acceleration of the inflow of EU funds is a realistic option as well. Possible suspension of a substantial part of these inflows due to anomalies of various kinds in the past utilisation of these resources renders a negative risk to the above growth forecast.

KAZAKHSTAN: Oil exports on the rise

BY OLGA PINDYUK

According to preliminary data, Kazakhstan's GDP increased by 3.4% in the first quarter of 2017 year on year, with the highest growth rates recorded in construction, manufacturing, and mining (6-7%). Services have been expanding less dynamically, by 2%. Metallurgy and oil processing contributed the most to the growth among manufacturing sectors. The mining sector benefited from a rise in oil output owing to the operation of the newly launched Kashagan oil field. As reported by the International Energy Agency, Kazakhstan was one of the two non-OPEC countries (the other one being Malaysia) that saw its oil output rising contrary to its commitments to OPEC to curb oil production: instead of cutting production by 20 thousand barrels per day, the country has increased it by about 80 thousand barrels per day. Most likely oil production will be further expanded in the second half of 2017 as the Kashagan oil field is expected to boost its capacity.

In addition to the ability to expand oil output, Kazakhstan has also benefited from the higher global oil prices – in the first quarter of 2017, the average oil price was at about USD 54 per barrel, which was almost USD 20 per barrel higher than in the same period of 2016. World metals prices have also picked up recently. As a result of these trends, the country's exports showed almost 30% growth in US dollar terms in the first quarter of 2017. Imports have been recovering as well, but at a slower, 19% rate, thus the trade surplus increased significantly.

The national currency has appreciated by 20% against the US dollar since December 2016 on the back of the favourable trade dynamics. Not least thanks to appreciation, inflation pressures subsided (CPI went down from 14.6% p.a. in 2016 to 7.5% p.a. in May 2017) and the National Bank of Kazakhstan further cut its base rate by 0.5 pp to 10.5% in June 2017. Inflation is expected to remain in the 6-7% target range for the forecast period and significant exchange rate fluctuations seem unlikely provided the global oil market does not experience major disruptions.

We revised upwards the GDP growth forecast for 2017 to 2.5% as oil output will grow faster than previously expected. In 2018-2019, growth will further speed up to about 3%, with investment being the main driving force. Imports will gain momentum over the forecast period as consumers' purchasing power will be rising along with the stronger currency and investment projects will require increased imports of machinery and equipment.

The banking sector has remained lethargic as banks provided 1.4% less new loans in the first four months of 2017 compared with the same period of the previous year. Efforts to cleanse the banking system assets have continued: in addition to the transfer of more than KZT 1 trillion (about USD 3 billion) from the National Wealth Fund to the Problem Loan Fund in February, the government has been promoting the consolidation of the sector, in particular through enforcing stricter capital requirements. Six out of the country's 33 banks announced their plans of merger. If these plans go through, 51% of the bank assets will be controlled by just two private banks, and the biggest bank will account for more than 37% of total assets. Such dramatic consolidation is likely to create new risks related to excessive concentration, such as hindered competition and moral hazard of 'too big to fail' banks' management.

KOSOVO: Election outcome unlikely to derail strong growth

BY RICHARD GRIEVESON

A coalition led by the Democratic Party of Kosovo (PDK) won the election on 11 June and will have the first opportunity to form a government. However, it does not have enough votes to rule alone and could struggle to find a willing partner. The left-wing nationalist Self-Determination Movement (Vetëvendosje!, VV) came in second, almost doubling its vote compared with the previous election. A coalition led by the incumbent Prime Minister Isa Mustafa's Democratic League of Kosovo (LDK) party came in third. The snap election took place after the previous administration had lost a vote of confidence triggered by the opposition over a border deal with Montenegro.

The new government faces a long to-do list. This includes an agreement with Montenegro over the border demarcation; a resolution on the status of Serbs within Kosovo; and the creation of a Kosovan army. All are contentious. However, the requirement of a deal with Montenegro in order to achieve visa liberalisation with the EU is likely to ensure that an agreement is reached. Verbal sparring with Serbia could increase, although it is highly unlikely to go any further than that. Serbia has issued an international arrest warrant against Ramush Haradinaj, leader of the Alliance for the Future of Kosovo (AAK) and the PDK-led coalition's candidate for prime minister.

The reform agenda depends on who forms the next government. A role for Vetëvendosje! could mean more progress on judicial reform, anti-corruption efforts, education and infrastructure. Efforts towards fiscal reform, attracting more FDI, and improved management of the privatisation process are likely whoever is in power. However, progress on all of these issues is likely to remain slow.

Near-term economic momentum looks to be quite strong, and we expect Kosovo to be one of the fastest growing economies in CESEE during our forecast period. Investment will remain a key driver of growth, as will private consumption, driven in particular by remittances. Nominal remittance inflows rose by 13% year on year in Q1 2017. Around 60% of remittances come from Germany and Switzerland, and in both countries labour markets are tight and wages are growing quite strongly.

An increase in government capital spending had been planned by the previous government, but is now uncertain with a new administration set to take power. Fiscal issues are not a source of risk at present, and public debt is low. However, pressure from social groups for new transfers, and maintenance costs of new infrastructure, could put more pressure on the public finances during the forecast period unless the government is able to increase revenue.

In 2016 Kosovo had the lowest activity and employment rate, and the highest unemployment rate, among CESEE countries. Remittances act as a kind of 'Dutch disease' for the economy, with the level of wages at which workers are willing to take jobs too high relative to current productivity levels. This therefore contributes to the low activity rate. The population is young and growing, and the labour market is not creating enough jobs to absorb this. Skill levels are generally low, reflecting deficiencies in the education system.

Kosovo's merchandise export base is tiny, and this is unlikely to change materially during the forecast period. Kosovo runs a huge merchandise goods deficit (running at EUR 2.3 billion in March on 12-month trailing basis, equivalent to around 38% of 2016 GDP). Remittances-driven domestic demand growth is unlikely to be met by domestic production during the forecast period; as a result, imports will rise, further increasing the external deficit. The shortfall is financed by a mixture of remittances, FDI and loans. FDI inflows are mostly into real estate and construction, and are therefore not contributing significantly to the build-up of the tradeable sector.

LATVIA: Investment cycle on the upturn

BY SEBASTIAN LEITNER

In 2017, after a few difficult years, the outlook for external demand is again encouraging. In the first four months of 2017, Latvian goods exports increased by about 8%. While trade with Western Europe, the Scandinavian countries and the rest of the world has gradually gained momentum, demand for Latvian goods in Russia has increased even more rapidly. Good news comes from the wood sector and electronic products, both of which have reported strong export growth figures. In general, we expect both goods and services exports to revive this year, and to continue to expand in the years to come. Driven by buoyant external and internal demand, industrial production has strong tailwinds, increasing in January to April 2017 by more than 9% in real terms compared to the corresponding period in 2016. The metals sector, capital goods, the electric and electronic sectors, but also consumer durables production have displayed strongly increased activity.

Gross fixed capital formation remains set for strong growth in the forecast period. After dropping heavily in 2016, public investment in infrastructure will recover with fresh EU funds becoming available. The inflow of funds from the EU budget is expected to amount to 2.6% of GDP in 2017. Residential construction output started to grow more swiftly than expected in the first months of 2017. However, slightly declining numbers of building permits for residential and non-residential buildings alike show that expectations for construction output for the whole year have to be kept low. Overall, after the slump in 2016, we expect total gross fixed investment to increase again by 8% in 2017, and to grow at a rate of 7% in real terms in 2018.

As expected, the rising prices of imported goods pushed consumer price inflation in the first months of 2017 above 3%. Strong wage growth has affected core inflation only slightly; it is primarily higher food and energy prices, as well as higher housing costs which will raise CPI inflation to 2.9% this year and 2.7% in 2018.

Declining activity in construction has led to lower employment there, while job growth has been recorded in the service sectors. Overall we expect employment to rise again slightly in 2017 after stagnation in 2016. Demographic developments – including continuing net emigration – will, however, result in a further decline in the working-age population; thus, annual growth in employment is likely to remain at below 1% in the coming years. In the first quarter of 2017, the unemployment rate receded to 9.4%. For the whole year we expect it to decline gradually further to 9.1%. Net real wages will keep on rising by about 5% in 2017, thereafter we expect the growth to somewhat abate. The government increased the minimum wage slightly to EUR 380 in January 2017 – still rather low, when compared to other EU countries. All in all, household consumption will increase by close to 4% in real terms in the years to come.

Broad-based and fairly robust economic growth is expected in the years to come. For 2017, we expect external demand to grow again. Stronger than anticipated investment growth seems to materialise already in 2017, driven by the speed-up of demand in the EU, and the inflow of EU funds. Household demand is continuing to evolve at quite a good pace, and thus our GDP growth forecast for 2017 has been raised slightly to 2.9%. We expect GDP to grow at a similar speed in 2018 and 2019, at 3.0% and 2.9%, respectively.

LITHUANIA: Growth shifting into higher gear

BY SEBASTIAN LEITNER

Foreign demand boosted goods exports in the first months of this year, growing by 15% year on year in January to April 2017, in nominal terms. Exports destined for Russia have been recovering. The slight increase in prices for refined oil products also helped to recuperate the profits of the Lithuanian refinery Mažeikių Nafta, the country's most important exporter. However, this factor will fade over the year. The transport sector, strongly exposed to Russian transit trade, was affected negatively last year, and is currently strengthening again. Moreover, revenues from tourism are also expected to grow at a good pace in 2017: a further 5-10% increase in overnight stays is likely. Since household demand is improving and investment activity is set to revive this year, imports in 2017 will increase – in value-added terms – faster than exports. After a balanced current account in 2016, a deficit is therefore likely to re-emerge and stand at 1-2% of GDP in the medium term.

After having dropped by about 2% last year, gross fixed capital investment started to grow at a double-digit rate in the first quarter of 2017 and will continue to rise both this year and 2018. The inflow of fresh EU funds from the 2014-2020 programming period will allow the government to strongly increase capital spending. However, a large part of the rising government outlays this year will be devoted to defence, with an increase of 25% over 2016. Nevertheless, the 2017 budget also envisages a boost to investment in road and railway infrastructure. A rising number of building permits indicates that the upswing in the construction of dwellings will carry on this year and the next. In addition, the mortgage loan portfolio of households continued to grow at a faster pace in the first months of 2017, after having stagnated between 2008 and the beginning of 2016.

While consumer prices were stagnant in 2016, we expect the inflationary pressures to intensify this year. The increase of prices for imported oil and gas resulted in producer prices growing by more than 8% in January to April 2017. Also, average gross wages continued to increase substantially: in the first quarter of 2017 by more than 5% in real terms. Stronger economic stimulus in the rest of the EU, resulting in rising import and export prices, and higher investment activity will lead to rising consumer inflation of about 3% in both 2017 and 2018.

Still, employment is expected to increase by less than 1% this year. Apart from construction, agriculture and transport, job growth is reported in all sectors of the economy, particularly in recreational and business services. Simultaneously, however, net outward migration is continuing and is again likely to exceed 1% of the Lithuanian population in 2017. The unemployment rate is likely to drop to about 7.3% of the labour force in 2017.

Given the improving situation in the labour market and sharply rising incomes, household consumption will remain the most important driver of growth for the Lithuanian economy in 2017 and the years thereafter. Adjusting our forecast slightly, we expect GDP to expand somewhat faster, by 3% in 2017, followed by a minor upswing to 3.2% in 2018 and 3.3% in 2019. Assumed drivers of that growth are also an expected economic upswing in Russia and growth gaining momentum in the euro area. Moreover, public investment activity should be facilitated by inflows of EU funds. The government plans a budget deficit of 0.8% of GDP in 2017. In the years to follow the deficit will drop even further, resulting in a continuously falling public debt to GDP ratio.

MACEDONIA: Reforms now

BY VLADIMIR GLIGOROV

First-quarter 2017 GDP growth was zero, year on year. Consumption grew by 2.3%; that of households by 2.7% and government consumption by 0.7%. Investments disappointed with just 0.6% growth, to which inventories contributed most. Finally, exports grew more slowly than imports, which wiped out the positive development of domestic absorption. On the supply side, manufacturing grew by more than 2% and agriculture also by above 1%. Construction, however, declined relatively strongly, most probably due to the decline of public investment.

These developments put in question the prospects for the year as a whole. The central bank expects growth of 2.4% this year with the risks looking now to be on the downside. Still, the central bank's target is not altogether improbable given that the bad results of the first quarter are due to the intense political crisis which followed last December's general elections. It is possible that recovery will prove stronger on account of the fact that the crisis has finally been resolved.

The political crisis was the consequence of the stalemate that followed the divided vote in the elections. The opposition Social Democrats were able to forge a majority coalition, but the ruling Revolutionary Party (VMRO) was not ready to go into opposition. A blockade of the parliament followed with the president declining to offer the mandate to the coalition around the Social Democrats. Weeks of mass protests ensued with an attempt by the followers of VMRO to storm and take over the parliament. That backfired due to domestic and international outrage. Decisive was the intervention of the representative of the US State Department which the Macedonian president could not disregard. In the end, at the beginning of June, a new government was sworn in. The programme of the new government is one of economic renewal. In terms of macroeconomic framework, not much will be changed. However, an increase of the minimal wage has been announced. Also, the government intends to deal with poverty and unemployment. In that, public investments should play a role as they did before. The change is that the new government does not plan to invest in monuments and government buildings but in infrastructure and public and social services. It will, however, continue to rely on foreign investments which have supported growth in manufacturing and in exports already.

In the current favourable international attitude the government hopes to use it to renew its bid to start negotiating with the EU and with NATO. The prospects for moving these processes along would prove stabilising to the country and would reassure the foreign economic partners. Prospects, however, are hard to assess if there is no new momentum in the EU's approach to the country and to the Balkans in general.

In the near term, the effects of the crisis on the growth of GDP will have to be felt. Growth this year is currently looking closer to being 2% at most, though the improved political climate should help going forward. In the medium run, growth can accelerate to above 3% due to improved prospects for investment and because of improved regional and European environment. There is space for public investments and for investment in skills and in general improvement of good governance. The new government is expected to make major advances in the rule of law, which indeed would be crucial. So, in the medium term, growth should accelerate due to growing investments and exports with some support from household consumption.

MONTENEGRO: Fiscal adjustment

BY VLADIMIR GLIGOROV

The new government, in office since autumn 2016, has prioritised fiscal adjustment. This course has also been supported by the IMF. The concern is that the increase of public debt will prove unsustainable. It stands at around 80% of GDP currently, if guarantees are included, while it is around 67% otherwise (according to the Ministry of Finance). The envisaged adjustment is of the order of 3% of GDP in the next couple of years. It should in fact end with a fiscal surplus of around 6.5% of GDP in 2020. This is not as unrealistic as it looks because there should be a significant decline in capital spending as major infrastructure investment projects will have been completed.

The projected fiscal adjustment should slow down GDP growth after 2018. The reason is that tax hikes, i.e. a 2 percentage points increase of VAT, mostly kick in after 1 January 2018. Thereafter, the decline of capital investments will additionally contribute to the economic slowdown. So, for the next three years, the average growth rate should be at about 2.6%. This year the IMF seems to be looking at 3% growth while the government is less optimistic with 2.8%. These are relatively small adjustments and do not warrant changes in our forecasts. The risks are on the upside in any case given that overall regional and EU prospects are looking up.

Apart from the increase of the VAT, most of the tax hikes should fall on excises, which is probably going to have almost a neutral if not positive effect on growth in no small part because these are mostly imported goods.

There is also an intention to look into the banking sector. Though the available data do not indicate that there are problems looming, with nonperforming loans not being among the highest in the region, there is some worry that, as the government increases saving and production slows down, problems may emerge in the financial sector. Thus, measures will be taken to strengthen the banks and also get them more in line with the requirements of the emerging EU banking union.

Investments in infrastructure and the energy sector will continue after 2020 too. Montenegro is a services-oriented economy and the quality of its infrastructure is key to its development. The forecasted growth rate is below Montenegro’s potential given the unemployment rate for one, which is expected to remain not much below 20%. Assuming that political stability is maintained and public investments continue with growth of tourist services, 3% growth should be the floor growth rate rather than the ceiling in the medium run.

The first half of the year saw intense political competition ahead of the country’s accession to NATO. Internally, the opposition was trying to come back on that issue after losing the elections in autumn 2016. Externally, there was the uncertainty about the position that the new US administration will take. Eventually, Montenegro joined NATO in early June this year.

This has been seen as another blow to Russian interests in the Balkans. Historical, political, but also economic ties with Russia are strong. Russian objections were strongly worded and were followed by various actions. Among those, there is the suggestion to Russian tourists and investors to avoid Montenegro. So far, it does not seem to have worked when it comes to tourists. Investments have dried up in part due to the regime of sanctions against Russia that Montenegro chose to join and in part because of economic developments in Russia itself. Montenegro has moved from foreign investments to public investments, so the possible effects of Russian reluctance to invest, if it persists, may prove to be more important once the current investment spree winds down.

POLAND: Unexpectedly strong start into 2017

BY LEON PODKAMINER

According to provisional estimates, GDP growth in the first quarter of 2017 turned out to be perceptibly stronger than generally expected: 4% year on year. Foreign trade developments did not affect the GDP growth rate (while they contributed negatively, by 0.5 percentage points (pp) to real growth in the first quarter of 2016). In real terms exports and imports grew strongly, at 8.3% and 8.7% respectively – much faster than GDP.

The deep recession in gross fixed capital formation (GFCF) which started abruptly in the first quarter of 2016 seems to have been nearing an end – although in the first quarter of 2017 GFCF declined further (by a mere 0.4%). Investment outlays by larger firms (employing over 50 persons) fell by 1% (at current prices) in industry (and especially in its mining subsector) and by 4% in the construction sector. Also the number of residential units built has declined. Other available evidence remains rather mixed about the prospects of a pronounced investment recovery in the business sector. On the one hand, the domestic production of capital goods is now increasing faster than a year ago (and faster than the manufacturing production total) but, on the other hand, imports of capital goods have declined. Moreover, inventories expanded strongly in the first quarter of 2017, contributing 0.7 pp to the GDP growth rate. Expanding inventories mitigated the growth slowdown recorded in 2016 by a large margin (1.2 pp). Continuing accumulation of inventories may indicate that the current GDP growth acceleration may not yet be robust.

The current GFCF developments cannot be easily blamed on financial factors. In actual fact the financial standing of the non-financial corporate sector has been excellent, and improving. Net profits of the sector rose by 17.8% in the first quarter of 2017, reaching an equivalent of about EUR 7.1 billion. Also the financial sector corporations have been faring very well (e.g. commercial banks' net profits rose, despite additional taxes on bank assets introduced in 2016, by 8.5% – reaching an equivalent of over EUR 3.3 billion in 2016). Indebtedness of the non-financial corporate sector remains relatively low and borrowing is not prohibitively expensive. Also consumer demand, fuelled by increased social transfers to households and rising wage bills, is expected to stay quite strong. The basic reason why corporate investment remains apathetic seems to have much to do with the political climate that set in after the electoral victory of the Law and Justice (PiS) party. The PiS government, in power since late 2015, blatantly disrespects the Constitution. Actually it is now subordinating the judiciary system to its own will. That cannot but evoke anxieties among the private (domestic) businessmen who rightly fear the advent of legally unrestrained arbitrary administrative harassment and interference into their activities. These fears have been strengthened as the government has legislated absurdly draconian penalties for breaches (or apparent breaches) of tax obligations.

Household consumption, rising by 4.7% in the first quarter of 2017 (even faster than in the second half of 2016) may be expected to remain a strong pillar of GDP growth in the rest of 2017. Household sector income grows not only on account of high budgetary transfers to families with children (in place since May 2016) but first of all because of secularly falling unemployment (already since early 2013), developing local/sectoral labour shortages and, consequently, a general trend for rising average nominal wages. In the first four months of 2017 employment in firms (employing over 9 persons) rose by 4.5%. The average nominal wage rose at the same speed. Even if the nominal incomes of retirees and farmers have increased at a much lower pace, the rising household incomes impact the volume of consumer spending quite strongly. Of course there has been a side effect, too: the return of inflation. At the moment it is still low – yet it is already eroding the purchasing power of rising nominal incomes. Inflation will be moderating the growth of household consumption – and thus of the overall GDP growth which can be realistically expected to reach on average about 3.2% in 2017-2019.

ROMANIA: Boom continues

BY GÁBOR HUNYA

The Socialist-led government, in office since the beginning of the year, has started implementing its popular election programme by further cutting the VAT rate and increasing minimum wages as well as public sector salaries. This has given a boost to consumption which accelerated real GDP growth in the first quarter of 2017 to an unexpectedly high 5.7% year on year. But not everything is rosy: gross fixed capital formation was lower than in the first quarter of the previous year while inventories expanded. Investment outlays declined by 3.1%, mainly in equipment, while construction investments expanded, mainly in residential buildings.

Manufacturing sector growth accelerated, growing by 7.9% in real terms as compared with the first quarter of the previous year. The highest increases were registered in the manufacturing of electrical equipment (34.9%) and motor vehicles (20.9%) destined mainly for exports within corporate value chains of foreign investors. The shift of the Romanian economy from low- to medium-high-skill sectors continued which has contributed to a falling energy intensity of the economy.

Exports were supported by the expansion of European markets and accelerating production in the manufacturing sector. However, imports (of goods and services) expanded more rapidly than exports (7.1% vs. 6.6%). The current account deficit doubled to EUR 690 million in the first quarter compared with the previous year, also on account of expanding FDI income. Foreign companies benefit from improving domestic demand and further growth in FDI is expected. The most important FDI projects in the first quarter of 2017 were made in the export-oriented services sector (Deloitte, Fitbit and Huawei).

Demand for labour has grown rapidly thus the unemployment rate fell to 5.3% in May, below the lowest pre-crisis level of 2007. Mounting labour shortages may become an obstacle to growth although emigration may decline and the country can attract workers from neighbouring Moldova and Ukraine.

Fiscal expansion continued, although the GDP-proportional 3% deficit target may not be in danger in 2017. Following disputes with the National Bank and the Fiscal Council, the government scaled down the scope of fiscal loosening measures for the rest of the year. Most importantly, wage increases for employees in the public sector were postponed from July 2017 to January and March 2018. All public employees will see a 25% wage growth, whereas doctors and education personnel will get additional salary increases. The planned total increases over the next four years have also been scaled down from ‘doubling’ to 46% on average. On the revenue side, the government plans to reduce social security contributions to 35% of the gross wage in 2018 from the current 39.25%. While revenues from unemployment insurance are not spent under the current labour market situation, there would be a need for more spending on healthcare.

In view of the robust first-quarter growth we have revised upwards the GDP forecast to 4.8% in 2017 and to 4.3% in both of the following two years. Our expectations are still below those of Romania’s government. We see downward risks mounting in the coming years due to sluggish investment activity, labour shortages and increasing inflation. The recent slight downscaling of fiscal expansion may not be enough to avoid being placed under the EU’s excessive deficit procedure in 2018. The National Bank may start hiking the policy rate towards the end of the current year when inflation approaches the 2.5% target. Access to EU funds under the 2014-2020 financing period is just at its inception and may accelerate only slowly in the coming years due to lacking co-financing capacity as public funds have been shifted from investments to wages.

RUSSIAN FEDERATION: Sluggish reforms lead to sluggish growth

BY PETER HAVLIK

The growth momentum that had seemed to gain strength at the end of last year has substantially weakened in the first months of 2017. GDP increased by just 0.5% in the first quarter of 2017 (yoy), with main contributions coming from agriculture and goods transport while industrial production stagnated and construction even declined. On the demand side, both retail trade and disposable money incomes of the population continued to fall, yet gross fixed investments picked up slightly, by 2.3%. Thanks to higher oil prices in January-April 2017 (+53% compared to the same period of 2016), export revenues increased by 36%, while imports expanded by 26% during the first quarter of 2017 (all in nominal USD terms). The rouble is appreciating as there is a strong correlation between the nominal exchange rate and the oil price. Once again, there is huge discrepancy between nominal and real growth rates of exports and imports, and the contribution of real net exports to GDP growth is opposite to what the nominal growth rates would suggest. Contrary to the crisis period 2014-2016, when real imports fell by more than one third and the contribution of net exports to GDP growth was strongly positive, the rouble's real appreciation is now expected to result in faster import growth. The contribution of net exports to GDP growth is thus expected to be negative for the whole forecast period. The appreciating exchange rate is contributing also to a rapid disinflation. Backed by a fairly restrictive monetary policy of the central bank, consumer price inflation has been coming close to the targeted 4% per year.

With no major reforms on the horizon, economic growth will remain sluggish. The restrictive monetary policy is likely to be maintained. Despite frequent calls from parts of the domestic expert community for more expansionary policies, in particular for a substantial increase in fixed investments and the expansion of credits by cutting interest rates, we do not expect such a policy shift – at least not in the next two years (in any case not before the presidential elections scheduled for early 2018). Even an improvement in relations with the West – which we do not see likely either – would not result in a substantial increase in FDI inflows owing to the lasting institutional bottlenecks and the poor investment climate. There seems to be a consensus that Russia is facing a prolonged period of (near) stagnation in economic, political and social developments alike. Overall, the assessment of Russian economic prospects remains broadly unchanged: a gradual, yet rather modest, GDP growth acceleration is forecast for the coming three years. We expect economic growth to stay below 2% and investment to be weak even in the medium term. Inflation will reach low single digits, household consumption will grow again and the unemployment rate will stabilise at close to 5%.

At the same time, the external risks persist and – in some instances – have perhaps even increased. A speedy lifting of sanctions is not expected, any 'deal' with US President Trump will be difficult to reach and implement, and the fragile ceasefire in Donbas may not be sustained. The EU's largely hostile stance towards Russia will not change markedly either, at least as long as Ms Merkel remains German chancellor and Russia continues to support the insurgency in Donbas. Still, a resuscitation of the political dialogue is urgently needed before any normalisation of relations with neighbours can occur and Russian relations with the West can return back to 'normal'. Whether this will happen before next year's presidential election remains to be seen – the odds are not particularly high.

SERBIA: Risks of backsliding

BY VLADIMIR GLIGOROV

The beginning of the year was dominated by the presidential elections. Serbia is a parliamentary democracy constitutionally, so the election of a president should not matter all that much. However, as in some previous instances, the leader of the largest party and the sitting prime minister decided to run for president, which raised the spectre of a de facto introduction of a presidential system. With one person controlling the presidency, the government, and the largest party, there are clear risks of creeping authoritarianism. The opposition was unable to mount a successful challenge, so Aleksandar Vučić was elected president in the first round. What that will mean for stability, especially if the economic development remains challenging, is hard to say.

First-quarter 2017 GDP growth was 1.2%, year on year. It was practically zero over the last quarter of the previous year. Household consumption grew by 1.9% compared to the same period last year with government consumption growing 0.5%. Investment, however, advanced only 1.3% while net exports had a negative contribution as imports grew faster than exports. Even without the net exports, growth was about 1.5%. On the side of production, industry stagnated in the first four months while manufacturing grew by about 5.5%. Construction declined strongly, by about 5%, while agricultural production also declined by about 2% in the first quarter. And though exports continue to grow by double digits, imports recovered quite strongly too. Finally, monthly inflation accelerated to 4% in April, though the yearly rate was still around 2%. In the coming months, the summer decline of food prices should moderate inflation, while import prices, e.g. of oil in particular, are not expected to rise. Overall, growth has disappointed in the first quarter.

Going forward, the forecast of 2.8% GDP growth for this year faces downside risks. The official target is 3%, which does not look realistic as of now. In addition, the unemployment rate has remained rather high in the first quarter, at above 14%. It is arguable that the sharp decline of unemployment in the last two years or so was due to lower-productivity jobs being made more available, but if that is correct it is rather probable that these employment opportunities have been exhausted. Also, as inflation has staged somewhat of a comeback, further monetary easing is unlikely. Finally, if growth continues to disappoint, fiscal expansion may prove to be unavailable.

On the last point, there is some suggestion by the newly elected president Vučić, that wages in the public sector and overall will be increased possibly significantly by the end of the year. That should also coincide with the ending of the current IMF programme. Whether that will be the policy that the new prime minister, who is to be nominated later this month, will implement, is unclear. He or she will have to take a look at the deterioration in the trade balance and at sluggish investment growth. If these are signs of backsliding, additional measures to shore up macroeconomic stability may prove needed.

All in all a growth of 2.8% this year looks somewhat optimistic in view of the first-quarter data. If growth in the second quarter comes in below 3%, downward revision will be called for. In addition, the policy of the new government is yet to be formulated. If stability becomes a concern again, 3% growth may prove elusive in the medium term also.

SLOVAKIA: Sustained robust growth

BY DORIS HANZL-WEISS

In the first quarter of 2017, Slovakia's GDP was up by 3.1% year on year, backed by growing domestic demand as well as net exports. Household consumption grew by 3.4%, finally benefiting from the ongoing favourable developments in the labour market: employment was up by 2% and unemployment fell to 8.7%, a record low level in Slovakia. Shortage of qualified labour is emerging, however, causing an upward pressure on wages (2.6% real growth in the first quarter). After three years of deflation, inflation returned and reached 1% in the first four months of 2017. Government consumption dropped by 0.7%. Gross fixed capital formation, suffering a 9% decline in 2016 (due to a temporary dip in EU funds), increased by 1%, and gross capital formation by 1.7% due to the piling up of inventories (all data for the first quarter of 2017). Thanks to growth of exports, net exports contributed positively to GDP growth as well. Exports of goods and services rose by 8.6% in real terms, while imports increased by 8.3%. The current account was slightly negative (the positive trade balance is more than offset by the negative income balance).

Looking at sectoral contributions, the main industrial sector in Slovakia – the automotive industry – had a sluggish start into 2017. The metals industry, the food-processing industry, rubber and plastic products and other non-metallic mineral products were in fact the major growth drivers. Altogether, gross industrial output rose by 5% in the first four months of 2017 (yoy), while value added increased also across services sectors, by 4% on average in the first quarter of 2017. The construction sector has been recovering since March, after declining for 13 months in a row. The building of the Jaguar Land Rover plant – which constitutes a major investment (of over EUR 1 billion, with 2,800 people employed and 150,000 cars produced initially) – started in September last year. Amazon is currently building a returns centre in Sered' (Western Slovakia), which will employ 1,000 workers or even more. At the same time, one major public investment project – the Bratislava ring road – is delayed on account of problems with land acquisition. With major investments in the West, West-East regional disparity and income inequality is continuing and rising even further.

For 2017, the official budget deficit target stands at 1.3% of GDP (less than the 1.7% recorded last year); a balanced budget should be reached by 2019. Further consolidation efforts have to be taken in order to achieve these goals. In the meantime, new social measures are envisaged (e.g. increasing the minimum wage from EUR 435 to almost EUR 500 per month next year, supplementary payments for night, weekend and holiday work) as well as measures to improve the business environment (e.g. the deduction of expenditures on R&D is proposed to increase to 100%). The debt to GDP ratio fell to 15.9% in 2016. The strong household credit growth of previous years continued in the first quarter of 2017, reaching 13%; this development has resulted in rapid growth of indebtedness of Slovak households. Loans to corporations expanded as well, by 8% yoy at the beginning of 2017.

Given the current trends, we revised our growth forecast for Slovakia slightly upwards for this year. We estimate GDP to rise by 3.3%, backed by household consumption and modestly reviving investments at the end of the year (base effect). Net exports will contribute to growth as well. For the coming years, we expect an acceleration of growth due to the start of the new Jaguar Land Rover plant and suppliers that are to follow, raising the export capacity from 2018/2019 onwards. Still, growth will continue to be primarily driven by household consumption, benefiting from favourable labour market developments. However, external risks (Brexit, Trump) remain and increase uncertainty for the future.

SLOVENIA: Growth boosted by investments

BY HERMINE VIDOVIC

Slovenia's GDP grew by a record 5.3% in the first quarter of 2017 (year on year), backed by a strong increase in domestic demand. After a renewed decline in 2016, investment returned to a positive growth rate (12%), mainly due to increased absorption of EU structural and cohesion funds. This latter has translated, among others, into an expansion of construction activities (up 20%), with substantial rises both in building activities and civil engineering; also investments in machinery and equipment rose significantly. Foreign demand contributed positively to the GDP expansion. Industrial production grew by close to 8% in the first three months of the year, with growth rates between 10% and 15% for the country's major industrial branches such as manufacturing of chemicals, electrical equipment and rubber and plastics; also car production reported a remarkable 8% increase. Labour market indicators continued to improve, with rising employment (also by migrant workers in Slovenia) and a further decline in unemployment. However, gross and net wages remained stagnant in real terms compared with the first quarter of 2016.

External trade developed dynamically in the first quarter of 2017, with goods exports up by 12.6% and imports expanding by 15%, resulting in a somewhat lower trade surplus than in the same period of 2016. The surplus in services trade was higher than a year earlier due to exports – of technical and trade-related and other business services and transport – rising ahead of imports. Overall, the current account closed with a surplus of EUR 770 million, an improvement by EUR 60 million. The FDI inflow was only half of that in the respective period of 2016. In order to lower the costs of debt service, Slovenia since early 2016 has issued Eurobonds to buy back part of its USD-denominated bonds (USD 2.61 billion) which were issued during the banking crisis in 2012-2014. Slovenia intends to continue the reduction of its dollar-denominated debt also in 2017. According to the Ministry of Finance, thanks to this policy interest payments on public debt will decrease to 2.1% of GDP in 2017, from 2.7% in 2016. A further reduction to below 2% of GDP is envisaged for 2018.

Last year the general government deficit amounted to only 1.8% of GDP, mainly on account of increased tax revenues but also as a result of falling public investment following the slow start of the new financing period of EU funds. Given the expected strong GDP growth this year, budget consolidation will likely continue also in 2017 and probably so in the two coming years due to increased (tax) revenues, and despite the higher co-financing from the national budget of EU-funded investment projects.

Household credits continued to grow in the first quarter, with consumer loans expanding above average. The upturn happens against the backdrop of favourable labour market trends and increased consumer confidence reflected in rising consumption and increasing demand on the housing market. Growth in this segment is mainly driven by banks in majority foreign ownership, which focus on long-term consumer loans. After years of decline, corporate lending is picking up as well. Non-performing loans continued to decline, to 5.3% of total loans in March. In May the European Commission accepted Slovenia's request to sell 50% of Nova Ljubljanska Banka (NLB), the country's largest bank, by the end of 2017 (rather than 75% as originally committed in the restructuring plan agreed upon in 2013). Another 25% are to be sold by the end of 2018.

With regard to the favourable developments during the first months of the year, we have revised our GDP growth forecast from the earlier 2.9% to 3.5% in 2017. GDP growth is expected to remain robust, above 3% annually over the forecast horizon 2017-2019. Expansion of household consumption will remain strong, supported by rising employment and wages. Investments are expected to further expand fuelled by EU transfers under the new financial programming period.

TURKEY: Growth robust amid major risks

BY RICHARD GRIEVESON

President Recep Tayyip Erdoğan won a referendum on constitutional reform in April 2017, and will push ahead to create an executive-style presidency. Parliamentary and presidential elections will be held together, most likely in late 2019, with Mr Erdoğan almost certain to remain as president. He will then be able to serve two five-year terms, meaning that he could stay in power until 2029.

A defeat for the government could have ushered in a period of even greater economic uncertainty. Near-term momentum is strong, with sentiment and hard data rising in the early part of 2017. The purchasing managers' index (PMI), which tends to be a good indicator of short-term growth trends, rose to 53.5 in May (anything above 50 indicates expansion), its highest level since 2013. Exports to the EU – notably cars[1] – are doing well, reflecting higher demand in the euro area and competitiveness gains driven by lira weakness. Investment growth is strong, thanks in part to counter-cyclical government capital spending.

Mr Erdogan is keen to keep economic growth at decent levels until the 2019 election. The government's Credit Guarantee Fund (CGF) has provided over EUR 60 billion of loans to SMEs, and appears to have been very important in driving up sentiment. Corporate loans have been rising significantly, particularly since mid-March 2017 when loans backed by the CGF accelerated. The central bank's loans tendency survey shows sharply easing credit standards; domestic loan growth is over 20% year on year.

Nevertheless, the existing situation is hardly conducive to strong economic growth over the medium term. Since the 2016 failed coup attempt, over 100,000 people from institutions such as the police, judiciary and education system have been either suspended, sacked or arrested. This will affect business and consumer confidence, and the smooth functioning of the state. Inflation is at a multi-year high, which will weigh on consumption growth. We forecast real GDP growth at or around 3% each year during our forecast period, around half the average 2002-2015 level.

From a macroeconomic stability perspective, the external deficit remains a potential source of concern. Turkey's current account shortfall is still at around 4% of GDP, one of the highest among big global emerging markets. However, higher merchandise exports and low oil prices (which we expect to remain flat in 2017-2019) will keep the deficit contained during the forecast period. Tourism, which collapsed in 2016, is starting to stabilise, thanks to a swift return of visitors from Russia.

Turkey could run into trouble as global (and particularly US dollar) liquidity conditions tighten. Rising US interest rates are a particular source of risk for Turkey, given its reliance on US dollar funding. Sovereign bond spreads have narrowed (after widening substantially immediately following the coup attempt). However, FDI is unlikely to rise significantly as a share of GDP in the current environment, meaning a continued reliance on hot money to fund the external deficit. Foreign currency borrowing in certain sectors is high, and many do not have extensive access to foreign revenue streams. Gross external debt reached 47% of GDP last year, among the highest of big emerging markets.

The lira has stopped weakening but remains at historically low levels, creating problems for companies with FX debt and revenues mostly in lira. The central bank has effectively tightened policy (it has left the main repo rate alone, but hiked both the overnight lending rate and the rate for its late liquidity window), which has contributed to the stabilisation of the lira. The central bank will continue to have to navigate a difficult political environment, with Mr Erdoğan keen for lower interest rates to boost the economy.

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[1] Total motor vehicle exports were up by an average 23% year on year in the 12 months to March 2017.

UKRAINE: Visa-free into the EU

BY VASILY ASTROV

On 11 June 2017, Ukrainian citizens were finally granted the long-sought visa-free regime to enter the Schengen agreement member states of the EU. The visa-free regime is valid for a stay up to 90 days and does not envisage the right to work. However, there is little doubt that it will make it easier for Ukrainians to find (illegal) employment in the EU. Labour outflow should have a mildly positive impact on Ukraine's economy in the medium and long run. As suggested by the experience of many EU-CEE countries, it tends to reduce unemployment, push up wages, and strengthen the balance of payments via increased inflow of remittances (in 2016, remittances from abroad already stood at 4.5% of GDP).

Meanwhile, the economic recovery has lost some of its momentum: on an annual basis, real GDP was up by 2.5% in the first quarter of 2017 – almost the same pace as a year before. However, on a quarterly basis it contracted by 0.3% due to both the high statistical basis (on account of the record-high harvest last year) and the impact of the trade blockade of the separatist-controlled areas of Donbas, effectively in place since the end of January.[1] The stalled shipments of coal have resulted in electricity shortages and have hit metals production in the rest of Ukraine, pushing overall industrial production into the red (year on year) starting from February (in January-April, gross industrial output dropped by 2%). The trade blockade will continue to exert a negative impact on the economy at least in the short run.

At face value, foreign trade is booming: in the first four months of 2017, merchandise exports and imports grew by 28% and 22% respectively in US dollar terms compared to the same period a year earlier. However, this mostly reflects the strong pick-up in commodity prices, particularly on the export side (steel). In real terms, exports of goods and services actually declined marginally (by 0.4%) in the first quarter, while imports recorded a 2.9% growth. As a result, the contribution of real net exports to GDP growth turned negative once again, albeit much less so than last year. Economic growth continues to be driven exclusively by domestic demand, particularly gross fixed capital formation, which picked up by 20.1% in the first quarter (yoy). Private consumption has gained momentum as well (+2.8%), fuelled by the doubling of the official minimum wage since the start of the year (to some EUR 110 per month) and the resulting overall strong real wage growth (+19.7% over the same period). Many companies have reportedly raised salaries to all employees, while those employed in the public sector have benefited from the automatic indexation of their salaries in line with the minimum wage hike.

For 2017, we project a slight GDP growth slowdown to 2% (due to the negative impact of the trade blockade), to be followed by an acceleration to 3% in 2018-2019 when alternative supplies of coal for the steel industry and alternative fuels for power generation become available. This forecast assumes continued macroeconomic stability which hinges on a continuation of the IMF loan programme. In April 2017, the IMF allocated another USD 1 billion, supplemented by EUR 600 million of Macro-Financial Assistance from the EU. However, the IMF demands a number of reforms which are either highly unpopular (pension and land market reforms) or difficult to implement (fight against corruption). Needless to say, any military escalation in Donbas would have a strongly negative impact on the economy as well. It is increasingly difficult to see how the Minsk-II agreements can be realistically implemented in the current circumstances (after the officially enacted trade blockade, the nationalisation of industry by the self-proclaimed authorities in Donetsk and Luhansk, and the official recognition by Russia of documents issued by these authorities). These developments suggest that the Donbas conflict will likely remain frozen (at best) for the years to come.

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[1] For more on that, see V. Astrov, 'What are the likely consequences of the economic blockade of the separatist-controlled areas of Donbas?', *wiiw Monthly Report* No. 5, 2017, pp 2-4.

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