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Wiener Institut für Internationale Wirtschaftsvergleiche

The Vienna Institute for International Economic Studies

Monthly Report | 7-8/14

Contents

- Recent economic developments in Central, East and Southeast Europe

Contents

Table: Overview 2013 and outlook 2014-2016 1
Figure: 2013 estimate and 2014 forecast for CESEE growth drivers 2
Bulgaria: upcoming early elections take centre stage 3
Croatia: recession continues 4
The Czech Republic: fiscal relaxation to strengthen the recovery 5
Estonia: ongoing stagnation 6
Hungary: EU funds support accelerating growth 7
Latvia: consumers keep the wheel turning 8
Lithuania: investing in growth 9
Poland: abrupt acceleration of investment activities 10
Romania: consumption-driven growth 11
Slovakia: domestic demand on the rise 12
Slovenia: first signs of recovery 13
Albania: candidate, at last 14
Macedonia: monuments and elections 15
Montenegro: tourism and elections 16
Serbia: floods and reforms 17
Turkey: economic adjustment in progress, political tussle continues 18
Bosnia and Herzegovina: floods and elections 19
Kosovo: unstable government in a stable economy? 20
Russian Federation: stuck in stagnation 21
Ukraine: in search of stability 22

OVERVIEW 2013 AND OUTLOOK 2014-2016

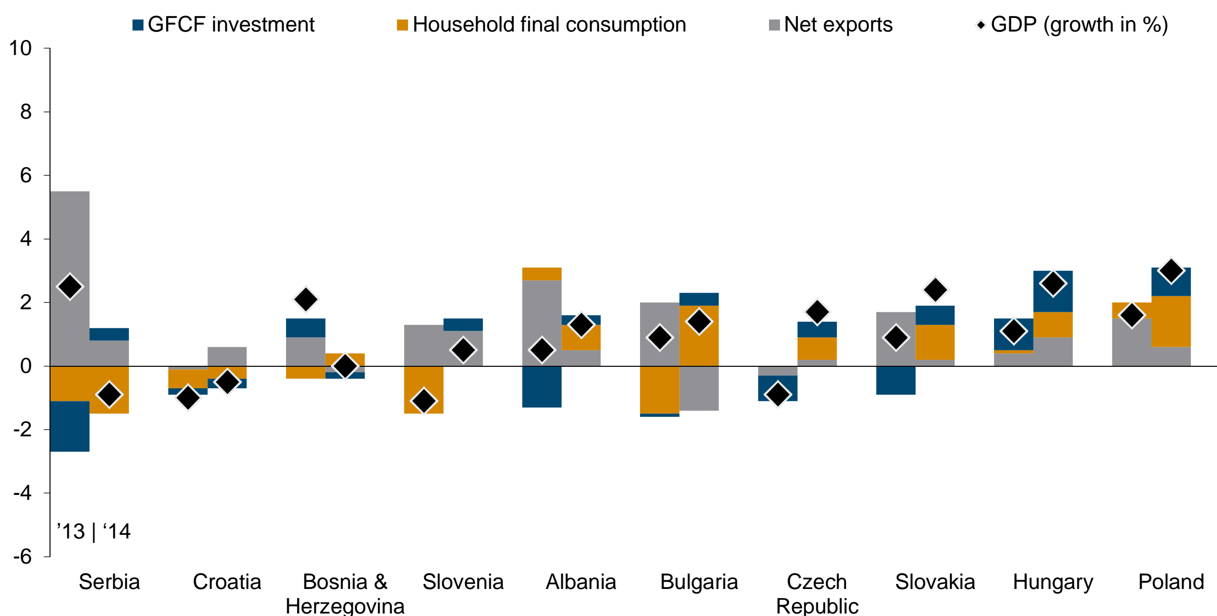
	GDP real change in % against prev. year				Investment (GFCF) real change in % against prev. year				Consumer prices change in % against prev. year				Unemployment (LFS) rate in %, annual average				Current account in % of GDP			
		Forecast				Forecast				Forecast				Forecast				Forecast		
	2013	2014	2015	2016	2013	2014	2015	2016	2013	2014	2015	2016	2013	2014	2015	2016	2013	2014	2015	2016
NMS-11																				
Bulgaria	0.9	1.4	2.1	2.5	-0.3	2.0	3.0	4.0	0.4	0.0	1.0	2.0	13.0	12.5	12.0	11.5	1.9	-1.0	-1.8	-2.5
Croatia	-0.9	-0.5	0.7	1.5	-1.3	-1.5	2.0	3.5	2.3	0.5	1.0	1.0	17.2	17.5	17.5	17.0	1.3	0.9	0.8	0.7
Czech Republic	-0.9	1.7	2.4	3.0	-3.6	2.3	3.0	3.0	1.4	1.0	1.8	1.5	7.0	7.5	7.3	7.0	-1.4	-1.0	-1.2	-1.4
Estonia	0.8	0.7	1.8	2.4	1.0	2.0	3.0	4.0	3.2	0.7	2.0	2.5	8.6	7.8	7.3	7.0	-1.0	-2.8	-2.6	-3.0
Hungary	1.1	2.6	2.2	2.1	5.8	7.0	6.0	5.0	1.7	0.3	2.0	3.0	10.2	8.5	8.3	8.3	3.0	2.6	2.2	2.0
Latvia	4.1	2.7	2.9	3.1	-4.3	2.5	4.0	5.0	0.0	0.8	1.8	2.5	11.9	10.5	9.8	9.2	-0.8	-1.8	-2.1	-2.5
Lithuania	3.3	2.9	3.1	3.2	12.8	8.0	7.0	8.0	1.2	0.8	1.8	2.5	11.8	10.8	10.2	9.5	1.5	-0.3	-0.8	-1.2
Poland	1.6	3.0	3.2	3.1	-0.2	5.0	5.0	5.0	0.9	1.1	2.0	2.0	10.3	10.5	10.1	10.0	-1.3	-2.5	-3.0	-3.1
Romania	3.5	3.2	3.0	3.3	-3.3	1.0	4.0	5.0	3.2	2.0	3.0	3.0	7.3	7.2	7.0	7.0	-1.1	-2.0	-3.0	-3.5
Slovakia	0.9	2.4	3.0	3.2	-4.3	3.0	4.0	4.5	1.5	0.5	1.5	2.5	14.2	13.8	13.0	12.0	2.1	1.7	1.5	1.2
Slovenia	-1.1	0.5	1.4	1.7	0.1	2.0	2.0	1.5	1.9	0.7	1.0	1.0	10.1	10.8	10.5	10.0	6.3	5.3	4.9	4.5
NMS-11 1)	*1.4*	*2.5*	*2.7*	*2.9*	*-0.7*	*3.5*	*4.3*	*4.6*	*1.5*	*1.0*	*2.0*	*2.2*	*10.0*	*9.9*	*9.5*	*9.3*	*0.0*	*-0.9*	*-1.4*	*-1.6*
EA-18 2)	*-0.4*	*1.2*	*1.7*	.	*-2.9*	*2.3*	*4.2*	.	*1.3*	*0.8*	*1.2*	.	*12.0*	*11.8*	*11.4*	.	*2.6*	*2.9*	*2.9*	.
EU-28 1)2)	*0.2*	*1.6*	*2.0*	.	*-2.2*	*3.1*	*4.6*		*1.5*	*1.0*	*1.5*	.	*10.9*	*10.6*	*10.2*	.	*1.8*	*1.8*	*1.8*	
Candidate countries																				
Albania	0.5	1.3	1.5	0.9	-5.0	1.0	1.5	2.0	2.0	1.0	1.0	1.0	15.6	15.0	15.0	15.5	-10.4	-9.5	-8.8	-7.8
Macedonia	2.9	2.8	2.9	3.0	2.0	4.0	4.0	4.0	2.8	3.0	3.0	3.0	29.0	29.0	28.0	28.0	-1.9	-4.0	-4.0	-4.0
Montenegro	3.5	2.1	2.9	3.0	3.0	4.0	5.0	5.0	2.2	3.0	3.0	3.0	19.5	19.0	19.0	19.0	-14.6	-15.4	-15.4	-15.0
Serbia	2.5	-1.0	0.0	1.0	-3.0	2.0	3.0	4.0	7.8	3.0	3.0	3.0	22.1	24.0	24.0	24.0	-5.0	-6.0	-6.0	-6.0
Turkey	4.0	2.9	3.5	4.5	4.3	0.5	3.0	10.0	7.5	8.3	7.5	6.8	8.5	9.0	9.0	8.5	-7.9	-4.5	-5.5	-6.5
Potential candidate countries																				
Bosnia and Herzegovina	2.1	0.0	1.0	2.0	3.2	-1.0	3.0	5.0	0.2	1.0	2.0	2.0	27.5	27.0	27.0	27.0	-5.5	-8.0	-7.0	-8.0
Kosovo	4.0	5.0	4.0	4.0	6.0	2.0	3.0	4.0	1.8	4.0	4.0	3.0	31.0	29.0	30.0	30.0	-6.7	-12.3	-12.9	-10.6
Russia	1.3	0.6	1.6	2.3	-0.1	-3.0	0.0	2.0	6.8	7.0	6.0	5.0	5.5	5.5	5.5	5.4	1.6	1.5	1.1	1.0
Ukraine 3)	0.0	-5.0	0.0	1.8	-6.6	-20.0	0.0	4.0	-0.3	11.0	9.7	4.5	7.2	8.0	8.0	7.7	-8.7	-3.0	-3.2	-3.3

Note: GFCF: Gross fixed capital formation. LFS: Labour Force Survey. NMS: The New EU Member States. EA: Euro area 18 countries.

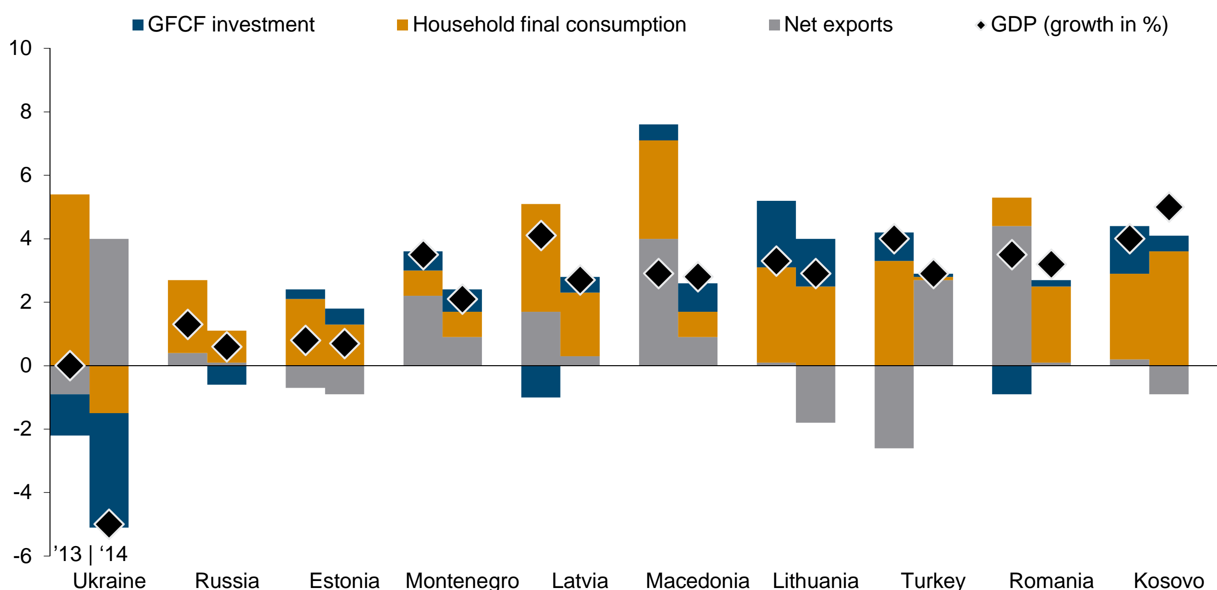
1) wiiw estimate. - 2) Current account data include transactions within the region (sum over individual countries). - 3) GDP growth rate up to 2014 including Crimea and Sevastopol.
Source: wiiw (July, 2014), Eurostat. Forecasts by wiiw and European Commission for EU and euro area (Spring Report, April 2014).

2013 estimate and 2014 forecast for CESEE growth drivers

GDP growth in 2013 & 2014 in % and contribution of individual demand components in percentage points, weak 2013 household consumption countries



GDP growth in 2013 & 2014 in % and contribution of individual demand components in percentage points, dynamic 2013 household consumption countries



Remark: Ordered by 2014 growth rates.
Bosnia & Herzegovina: based on GDP expenditure. Ukraine: GDP growth rate including Crimea and Sevastopol
Source: For 2013 wiiw and national statistics as of July 2014. Forecast 2014 by wiiw.

Bulgaria: upcoming early elections take centre stage

BY RUMEN DOBRINSKY

The European Parliament election 2014 results were catastrophic for the thin governing centre-left coalition in Bulgaria. Given this popular 'non-confidence vote' and following some political consultations, a tentative political agreement was reached to call early general elections in the autumn of 2014. The escalating political instability and the new uncertainties regarding the policy course after the new elections are increasingly dominating the economic scene as well. Against the backdrop of a shaky political situation, economic performance in the first half of the year remained anaemic with GDP growing by 1.4% year-on-year in the first quarter. Compared to 2013, the contribution of demand side factors to GDP growth changed direction: it was domestic demand that made a notable positive contribution whereas net exports subtracted from GDP growth. The recovery of domestic demand (both private consumption and fixed investment) which started in the last quarter of 2013 has been the most prominent recent macroeconomic trend. One visible upshot, reinforced also by the weak export performance, has been the reversal in the dynamics of the current account balance which will likely remain in the negative territory in 2014, counter to earlier expectations.

Policy played a major role for the recovery in domestic demand. In particular, the shift towards a more proactive public investment policy seems to have contributed significantly to the upturn in gross fixed capital formation which grew by 4.6% year-on-year in the first quarter. Thus for the period January-April 2014, public capital expenditure amounted to 10.8% of total consolidated government expenditure, compared to 7.7% in the corresponding period of 2013. In turn, the rise in minimum wages, pensions and social expenditure boosted consumer spending and contributed to a revival of private consumption (it increased by close to 4% year-on-year in the first quarter).

However, the recovery of domestic demand in the first half of the year was most likely a temporary episode that can hardly be regarded as sustainable. An indication of this are the recent price dynamics which suggest a deflationary trend. This, coupled with the political stalemate, will hardly be conducive to domestic demand in the second half of the year. Credit activity on average was also lacklustre at the beginning of the year: a small upturn in credit to the corporate sector was offset by a similar drop in household credit.

Export performance in the first months of the year was rather disappointing: in current prices, total exports of goods and services in the first four months of the year shrank by some 8.5% compared to the same period of the previous year. The most significant drops were recorded in the exports to non-EU countries. So far this external shock has not hit manufacturing (which recoded positive growth through April, boosted by domestic demand) but most likely the negative effects of the worsening external situation will be felt in the second half of the year. Reflecting the shift in the fiscal stance, the consolidated government balance in 2014 has deteriorated somewhat compared to the previous year. The public deficit for the year as a whole will probably worsen, but overall the fiscal situation remains sound.

On balance, the economic outlook for Bulgaria has deteriorated compared to the beginning of the year. The new electoral cycle will put brakes on any major policy initiatives which have to wait until a new, hopefully more stable, government will be in place. In addition to that, the uncertainties related to possible changes in the policy course will act as a deterrent to growth, suppressing private consumption and investment. No significant support can be expected from the external environment either; in the short run exports will likely be dominated by the negative dynamic. A possible deepening of the Russia-Ukraine conflict will also have negative implications for the Bulgarian economy. Overall, GDP growth for the year as a whole will at best be just a little above the 2013 figure.

Croatia: recession continues

BY HERMINE VIDOVIC

Croatia's economy remained in recession in the first quarter of 2014, with the GDP down by 0.4%. Both household consumption and gross fixed capital formation continued to decline; government consumption, after showing an upward trend in 2013, fell again in the first quarter of this year. Only foreign demand contributed positively to GDP growth. The continued drop in investments was felt particularly in construction, reporting a decline for the sixth consecutive year. After five years of contraction, industrial production increased slightly during the first four months of 2014 (0.6%); labour productivity continued to increase due to further layoffs. The labour market situation has further deteriorated during the first quarter of 2014. According to Pension Insurance data, employment dropped by 2.4%; the registered unemployment rate stood at 21%.

In the first quarter of 2014 both goods exports and imports increased, by 7.6% and 1.8% respectively in euro terms (based on customs statistics), resulting in a declining trade deficit. In trade with the EU exports rose by 11% and also deliveries to the CEFTA countries performed favourably, soaring by 15%. Detailed data show that the growth in exports was driven mainly by paper, textiles, rubber, chemicals and furniture, while exports of ships almost halved as compared with the first three months of 2013. On the import side, purchases of food and beverages and consumer goods rose substantially, while capital goods imports fell by 6%. Taking into account the moderately declining trade deficit and assuming no significant changes in the services trade surplus, the current account deficit has probably slightly improved as compared to the first quarter of 2013 (EUR 1.6 billion).

The general government budget closed with a deficit of 4.9% of GDP in 2013. Public debt to GDP increased, however, much faster than the deficit would imply, by more than 10 percentage points to 67%. This is primarily due to borrowing in late 2013 to finance the deficit. In January 2014 the European Council opened an excessive deficit procedure against Croatia. The Convergence Programme submitted by the Croatian government in April envisages the gradual reduction of the general government deficit to below 3% of GDP by 2016 – the deadline for the correction of the deficit. As a first step the government lowered the 2014 deficit target from 5.7% of the GDP to 4.5%, which is to be achieved by higher revenues and the reduction of expenditures. As for the latter, spending is to be cut for investment projects and subsidies for agriculture, railways, shipbuilding and funds for the Croatian development bank HBOR. Increased revenues are envisaged to come from higher health care contributions and energy excises, a change in the lottery tax and the shift of pension contributions from the second to the first pillar. Moreover, the government decided that 34 majority state-owned companies will have to pay 60% of their last year's profits into the budget, while seven companies will have to pay 100% of their profits into the budget.

At the end of March the ratio of non-performing loans to total loans was 16.4% (up from 15.7% in December). Out of the loans provided to the corporate sector, 28.6% were categorised as non-performing, the ratio of non-performing loans in total household loans was 11.3%.

At the beginning of May Prime Minister Zoran Milanovic dismissed the Minister of Finance Slavko Linic (after a continued power struggle in the social democratic party) due to an allegedly illegal write-off of debts from a portfolio of a state-owned company. The minister has denied the accusations repeatedly.

In 2014 GDP is assumed to decline further, by 0.5%. Public investments are not sufficient to boost economic recovery and private sector enterprises are still in the process of deleveraging. Household consumption is dampened by high unemployment. The expected recovery in 2015 will primarily depend on external demand and an increased absorption of EU funds for project co-financing.

The Czech Republic: fiscal relaxation to strengthen the recovery

BY LEON PODKAMINER

GDP grew quite strongly (2.5%, year-on-year) in the first quarter of 2014, after its protracted decline had been stopped in the last quarter or 2013. Growth in consumption (both household and government) turned out to be much faster than generally expected (about 1.4% each). Fixed capital formation rose 5.2%, also much stronger than expected (though inventories contracted quite considerably). Foreign trade in goods and services performed very well too, contributing an estimated 0.7 percentage points to the GDP growth rate. The changing orientation of the fiscal policy seems to be playing an important role in the strengthening of consumption growth – and partly also of fixed capital formation. After four years of fiscal consolidation (2010-2013) which had suppressed the public sector deficit from 5.8% of GDP to about 1.5%, the deficit/GDP ratio is likely to rebound to close to 2% in 2014. While the tax (including social contributions) revenue is assumed to rise 1% nominally, final government consumption will grow by at least 1.7%, with social transfers hiking by about 5%. Most importantly, government spending on gross capital formation is to jump by close to 30% (after still contracting, by 12%, in 2013). Higher public investment spending will be complementing investment spending financed out of the unutilised means still available under the EU programmes for 2007-2013. The fiscal relaxation underway – while clearly supporting GDP growth – is also expected to further suppress the public debt/GDP ratio in 2014 (to about 45%, from 46% estimated for 2013). This indicates that fiscal policy can continue to be fairly relaxed also in 2015-2016.

The extremely relaxed monetary policy, which prevented the consolidation-driven recession from assuming devastating dimensions in 2012-2013, is likely to remain unchanged for the time being. The very low policy interest rate (two-week repo rate) of 0.05% in force since early November 2012 has had only little impact on commercial lending rates. Interest rates on loans to the private domestic sector have remained quite high (close to 6% for household loans and over 3% for loans to corporate clients). Under such conditions the volumes of lending to the domestic private non-financial sector has been rising very slowly. Raising the policy interest rates carries the risk of provoking a still further strengthening of the commercial rates. Besides, such a move would be unjustified by the price developments: inflation continues to be substantially lower than its declared target (and certainly much lower than could be expected from a country on a comparable level of development). Most importantly, higher interest rates could be rather incompatible with the strategy of keeping – through foreign exchange interventions – the CZK/EUR exchange rate over 27. The strategy of targeting a 'competitive' exchange rate level (while at the same time formally sticking to inflation targeting) has so far proven to be a success. Although the strategy has not visibly accelerated the return of inflation to the desirable levels (which is the 'official' justification of the strategy) it may have been beneficial with respect to foreign trade developments (and in particular for the restriction of price-competitive imports). The 15.6% growth rates of goods (nominal) exports and 13.3% of imports registered in the first four months of 2014 brought a record trade surplus, equivalent to EUR 2.5 billion. Given its usefulness, the strategy may be continued throughout 2014. The exchange rate interventions may start to be phased out in 2015 – especially if inflation hits the official (central) CNB target of 2%.

All in all, the Czech economy is finally recovering after the period of unnecessary fiscal consolidation. Given the relatively low levels of debt burdening the government and the private sector (both corporate and households) and a growth-friendly monetary and fiscal policy, the recovery in 2014-2015 seems assured. But the growth speed-up can be gradual as fixed investment (especially in housing) is unlikely to expand at the very high rate observed recently. It will take more time before investment enters a path of fast and sustained growth.

Estonia: ongoing stagnation

BY SEBASTIAN LEITNER

Economic activity declined by 1.4% year-on-year in the first quarter of 2014, driven by negative net exports. Estonian producers are hit hard by the ongoing recession in Finland. The latter country suffers from declining exports to Russia and low wage growth hampering household consumption, while the government is pursuing austerity policies. Particularly the sluggish developments in Finland's ICT sector led to a considerable decline of demand for Estonian electronic products. The economy of Finland will start to grow not earlier than 2015. Estonia's exports are also affected by stagnating direct and transit trade with Russia. Moreover, strong wage growth in past quarters has led to a general increase in unit labour costs relative to Estonia's competitors.

The opening of the Estlink 2 electricity connection which tripled transmission capacity between Finland and Estonia in late 2013 has resulted in increasing imports of electricity and declining production in Estonia. Despite sluggish growth of production in the manufacturing sector, investment in machinery is increasing as well as outlays for transport equipment. Construction activity, particularly that in dwellings, is on decline. The number of granted building permits does not show an upswing of supply in the residential market in the near future. Although the budget is almost balanced the government did not counteract the ailing economic activity, thus public investments are continuing to decline.

In March the resignation of Andrus Ansip, who had been Estonia's Prime Minister for almost nine years, was followed by a change of government. The leading Reform Party, headed by the newly appointed Prime Minister Taavi Rõivas, is now in coalition with the centre-left Social Democratic Party. Towards the parliamentary elections approaching in March 2015 we expect fiscal policies to become slightly more expansionary. However, the public deficit is likely to remain at 0.6% of GDP this year and in 2015. A stronger rise in infrastructure investment is not to be expected before 2016, when EU funds become gradually available under the new 2014-2020 financial framework.

The ongoing stagnation in industry hits the labour market. Overall employment figures are on decline, while an increase in jobs is still observed in the services sector. However, we expect unemployment rates to continue to fall slightly. The reasons are demographic changes as well as outward migration of jobseekers.

Due to the growing skill mismatch in the labour market, vacancies increased by about 30% in the first months of the year irrespective of decreasing employment. At the same time real wages were up by more than 6%, also driven by the increase in the minimum wage from January 2014 onwards. A second 10% hike was agreed upon by the social partners for January 2015. Thus household consumption is continuing to develop at a good pace throughout 2014 and will remain a driver of growth in 2015. Nevertheless, the speed will slow down gradually. Despite increasing labour costs consumer price inflation is remaining at a level below 1% in 2014 suppressed by decreasing commodity prices, in particular for energy. The price decrease of imported products coupled with rising household demand leads to an increase in the current account deficit. In 2014 it will surpass 2% of GDP.

Due to the negative developments in Estonia's export markets we had to make a substantial downward revision of the growth forecasts for 2014 and 2015. GDP is expected to increase by not more than 0.7% this year and only 1.8% in 2015. From 2015 onwards we assume economic activity to become more broad-based in the Northern and Western EU countries, the main trading partners of Estonia apart from the Baltic neighbours and Russia. We expect an upswing of GDP growth to 2.4% in 2016. However, there are still risks on the downside if the climate in the Estonian business sector (which is still surprisingly positive) turns sour and entrepreneurs curtail investments.

Hungary: EU funds support accelerating growth

BY SÁNDOR RICHTER

GDP, investment and industrial output data for the first quarter 2014 show a strong upturn. This is partly a statistical phenomenon, as the basis, the first quarter 2013, was very weak. Yet, an upturn is clearly visible. We see the impact of the strong increase in EU cohesion policy related to investment, making up for earlier delays, and the government's deliberate efforts to complete several projects prior to the 6 April elections (new underground line in Budapest, monuments, etc.). This high tide of public investment will last, though at a decelerating pace, until the end of next year, the closing date for EU payments under the 2007-2013 financial framework. Business sector investment also took off, but to a much smaller extent than public investment. Industrial production output has increased mainly due to big export orders for the Mercedes Benz and Audi factories; other branches grow more moderately. Agriculture will benefit from favourable weather. Without these one-off effects, GDP growth in 2014 would be less than 0.5%, and less than 1% in 2015, according to calculations of Hungarian experts.

Household consumption, for the first time since mid-2008, increased more than marginally and contributed to the 3.5% 1Q GDP growth as much as investment. Net exports also made a positive contribution to GDP growth, though their relative weight is smaller now than it was earlier.

Employment data improved, to a large extent due to a continuation of extended public work schemes and statistical inclusion of a part of persons working abroad. Nevertheless, data show that employment in the genuine business sector increased to a moderate extent as well.

At the 6 April elections the ruling Fidesz party managed to obtain a two-third majority in the parliament again. That means that nothing will change concerning the uncertainties in the economy. The business sector will continue to be exposed to unpredictable government (PM Orbán's personal) decisions. Orbán confirmed that the sectoral taxes will remain. His Fidesz party has a long-term commitment to special taxes imposed on the financial, energy, retail and telecommunications sectors. He has also confirmed the intention to introduce a single-digit personal income tax rate in the current governing cycle (at present it is 16%). A new sectoral tax will be introduced on advertising, dealing a heavy blow to the media.

A key issue in attaining a sustainable growth path will be the future of the financial sector. The non-performing loans ratio is about 18%, the banks suffer under the sector-specific levy they are obliged to pay and the tax on financial transactions, and also the uncertainties concerning the future of households' forex debt. No upturn is yet visible in lending to the business sector and households. Orbán's intention to raise the share of Hungarian ownership in the banking sector (leaving open how this should be achieved) further increases the uncertainty in the sector and discourages the badly needed recovery of financial intermediation.

Fiscal discipline will be maintained (observing the 3% threshold) even if this might necessitate additional measures in the second half of the year. Although formally the budget consolidation is completed, it is fragile: any unforeseeable event may require further consolidation steps, typically the introduction of a new tax – which maintains the high degree of uncertainty for the businesses. Public debt has been hovering around 79-80% of the GDP without a credible programme in sight how to reduce it as is prescribed in the new constitution. Inflation is nearly non-existent, deflation may become a problem.

Summarising, the expansion of the GDP may amount to 2.6% this year but only 2.2% in 2015 and 2.1% in 2016. In the current circumstances conditions for a lasting upturn of economic growth are missing.

Latvia: consumers keep the wheel turning

BY SEBASTIAN LEITNER

In the first months of 2014 the growth of external demand remained moderate. Exports to Russia, one of the country's most important trading partners, are still increasing slightly, but deliveries to Estonia and Germany have been falling considerably. Given the near-stagnation of external demand, industrial production declined in the first quarter of the year. Simultaneously gross fixed capital investment fell in the manufacturing sector, resulting in a strong decline in imports of capital and intermediate goods.

Construction output expanded dynamically. Forward looking indicators of building permits show that investment in construction is likely to continue growing at a good pace throughout the year.

Although industrial production has been slightly shrinking, employment still increases in the manufacturing sector. However, throughout 2014 employment growth will slow down considerably, to 0.5%, compared to the previous year when it reached almost 3%. The unfreezing of public wages and swift economic development in the services sector triggered an about 9% increase in real net wages in the first quarter of 2014, year on year. The wage rises were also driven by the 12% increase of the minimum wage on 1 January 2014, the first increase since 2011. The Minister of Welfare announced the plan for a further rise by 3% from 1 January 2015. Moreover, household incomes are to rise next year due to the planned raising of the non-taxable income threshold by EUR 126 and a cut of the flat personal income tax rate from 24% to 23%. A further decline by 1 percentage point is envisaged for 2016.

Consumer surveys show that in the course of the first half of 2014 expectations are on an upward trend, as well as the business climate in the services and the construction sectors. Accordingly, retail sales have increased considerably in the past few months. Thus household consumption will remain the strongest driver of growth throughout 2014 and remain so also in the coming two years. However, we expect that the dynamism will gradually slow down due to declining wage growth in the coming quarters and moderate expansion of employment.

Although Latvia's economy has been growing swiftly for about four years in a row, households and non-financial enterprises are still deleveraging. The IMF highlights in a recent report on the country that banks have significantly tightened lending standards. Especially for small and medium-sized enterprises investments are difficult to finance without sufficient access to credit. Medium-term growth will be hard to achieve under conditions of declining productivity growth outpaced by ongoing wage increases.

Consumer price inflation keeps on being suppressed and will remain below 1% in 2014 on average, influenced particularly by declining world food prices. In 2015 we expect inflation to rise to 1.8%. The liberalisation of the electricity market for households will cause a price hike and strongly rising wages will raise the core inflation. Although the growth of general government revenue will slow down this year due to the reduced income tax and lowered social security contributions, the budget deficit is expected to fall to below 1% of GDP. At end-2015 the government debt to GDP ratio will be down to 33%, when the treasury will have repaid 75% of the rescue loan granted by the EU Commission in 2009. This medium-term fiscal outlook induced Fitch to upgrade Latvia's bond rating to A-.

Given the sluggish growth of external demand we had to lower the growth forecast for this and the coming year. In 2014 GDP will grow by 2.7% driven by household consumption and a positive contribution of net exports due to imports growing at a slower pace than exports. For 2015 we expect exports to the euro area and particularly the Baltic neighbour Estonia to gain momentum, leading to a slight upswing of GDP growth to 2.9%.

Lithuania: investing in growth

BY SEBASTIAN LEITNER

Lithuania will become the 19th member of the euro area in January 2015, having reached all Maastricht criteria by a wide margin. The ECB and EC in June assessed the country to be on a sustainable convergence path.

Lithuania has been experiencing a considerable downturn in export activity. Particularly the external demand for oil products, the latter amounting to a third of the country's traded goods, declined strongly. In addition the manufacturers of fertilisers, Lithuania's second most important export product, face fierce competition from non-EU countries which have access to cheaper natural gas, an important input in the production process. While overall goods exports to Russia have stagnated, strong declines are reported for the Baltic neighbour Estonia and Germany.

By the end of the year the construction of the LNG terminal in Klaipeda port will be finished. This will break the 100% gas import dependence on Russia. Negotiations with Gazprom, finalised in May, allowed for a reduction of gas prices for consumers by an average 20% from 1 July 2014 onwards. Furthermore construction activity started in May and June at two major projects to reduce electricity prices and dependence on Russia. The LitPol Link will connect the Lithuanian with the Polish and thus with the Continental European grid and should be finished by next year, while NordBalt is a submarine high voltage power cable between Sweden and Lithuania that should be ready for commission in 2016.

Apart from refined petroleum, industrial production is developing at a good pace. Thus the manufacturing sector shows increasing investment activity in machinery and equipment and enterprises are building up stocks. As expected, construction of residential buildings is rising swiftly although we reckon with some slowdown in the pace of expansion towards the end of the year based on recorded building permits. As indicated above, public investment activity in infrastructure is further bolstering domestic demand. Employment is still growing strongly, by more than 2% per annum in the first quarter of 2014. However, the occupied posts in the manufacturing sector are declining slightly. The growth of vacancies in the past few months indicates that the unemployment rate will continue to fall throughout 2014 and thereafter.

Real wages will continue to increase considerably, by 4% throughout 2014. The Finance Minister announced plans to raise also minimum wages by about 4% from January 2015. Moreover, re-elected President Dalia Grybauskaite finally signed the pension law compensating retirees for cuts undertaken in the crisis years. In December 2014 they will receive 20% of the total amount and a further 40% both in 2015 and 2016. The payments will raise budget expenditures by about 0.5% of GDP in the coming two years. Given the good prospects for income development, household demand will remain an important driver of overall economic activity this year but also in 2015 and 2016.

In spite of increased economic activity and rising household incomes, the loan stock of households and enterprises is still on decline. Particularly small and medium-size enterprises face risk-averse lending policies of banks and thus lack access to credit.

In the run-up to the Commission's assessment related to euro introduction, administered prices fell by more than 2%, a process that will not carry on in the upcoming months. However, the reduction of gas prices and low commodity prices will keep inflation below 1% in 2014 and supressed further on in 2015.

Due to the weak external demand we had to make a slight downward revision of our earlier growth forecast. In 2014 we expect GDP to expand by 2.9% driven by still vibrant domestic demand, particularly investment activity. In 2015 and 2016 a slight upswing to 3.1% and 3.2% is likely, conditional on economic activity in the euro area gaining momentum and external demand recovering.

Poland: abrupt acceleration of investment activities

BY LEON PODKAMINER

GDP growth, which had been gradually strengthening throughout 2013, further accelerated in the first quarter of 2014. At a 3.4% rate, growth has approached a speed last time recorded in the first quarter of 2012. Growth in household consumption continued to accelerate rather moderately. Exports and imports (of goods and non-factor services) both recorded fairly strong growth rates: foreign trade contributed some 0.5 percentage points to the overall GDP growth. Gross fixed capital formation, rising by 10.7%, was the main source of the unexpectedly strong growth in the first quarter of 2014. Investment outlays taking the form of an increase in the stocks of buildings and structures rose by over 16% in real terms while those into machinery and equipment (other than means of transport) by 10%. Investment in the stock of machinery and equipment accounts for the bulk (over 47%) of total investment outlays into fixed assets. Investment outlays in manufacturing (accounting for a third of the total) rose by 13%. The investment acceleration has added strength to the growth of output of manufacturing (with the output of investment goods rising by more than 10%) and construction. Sales of output of the construction sector increased by 8.9%.

The ongoing partial re-nationalisation of the second pillar of the pension system is reducing the level of public debt quite substantially and creates the opportunity to postpone – and moderate – the fiscal consolidation demanded by the European Commission. The government will be able to avoid any radical moves that could alienate the electorate before the crucial forthcoming elections. The fiscal policy will continue to support the growth speed-up – also by providing the necessary co-financing to programmes to be generously financed out of EU means.

Growth acceleration has not had any perceivable inflationary effects so far. With the unemployment rate persisting at over 10% and labour productivity growth still outpacing the rates of growth of wages by a large margin, producer prices have been following a slightly deflationary path. Consumer price inflation has been very low – already close to zero – and still falling. The inflation target of the National Bank of Poland (CPI of 2.5% with 1 percentage point tolerance band) has been missed by a wide margin. To some extent this has been the outcome of the monetary policy which continues its fairly restrictive course. The NBP policy interest rate of 2.5% has been maintained for a year now. This may have affected the levels (much higher of course) of interest rates charged by banks on their loans to the non-financial corporate sector and to households. Thus the NBP may be at least partly responsible for the subdued growth of lending: within one year the stock of the non-financial sector's credit liabilities rose by a mere 4.2%. But the primary effect of high interest rates may have had something to do with the strength of the Polish currency. The strong zloty seems to have helped disinflation. So far it has not harmed the performance of foreign trade. But there is a real risk to foreign trade – and the economy at large – following too strong an appreciation, should Poland's interest rates stay out of tune with those prevailing internationally. The recent fast appreciation cycle which started at the end of May 2014 had brought the PLN/EUR rate from 4.17 to 4.09 within a little more than 10 days. Fortunately (for the exchange rate) the appreciation trend was stopped, only to be followed by fast depreciation, returning the rate to its pre-month level.

The depreciation coincides with the revelation of the contents (and language) of the conversations conducted, 'in private', by leading politicians and public personalities. The first of the illegally eavesdropped conversations, between the Interior Minister and the President of the National Bank of Poland, is generally interpreted as particularly scandalous. The whole affair may have some serious long-term economic consequences. In the short run it will certainly have grave political consequences.

Romania: consumption-driven growth

BY GÁBOR HUNYA

The Romanian economy achieved European champion rates of economic growth for the third quarter in a row, 3.8% in the first quarter of 2014. While this gives ground for an upward revision of the 2014 forecast to 3.2% from the earlier 2.7%, one should stay cautious as the base effect will kick back in the second half of the year.

Economic growth has been carried by domestic consumption supported by higher farmers' income in the wake of last year's bumper harvest and increasing real wages due to subsiding inflation. Record harvest yields may not be achieved again in 2014, but the setback may be only moderate due to favourable weather conditions in the first half of the year. The economic growth forecast for 2015 is calculated with average, thus less favourable weather conditions, which would cause a slight decline in growth despite the assumed improving external conditions.

Investments have remained the sour point of the Romanian economy. With gross fixed capital formation down by 3.5% in the first quarter of 2014, they were on the decline for the fifth consecutive quarter. There are two main reasons for this. One is the continued deleveraging process in the banking sector, the other is the government's inability to speed up EU-supported investment programmes. Non-government credit declined further and the share of non-performing loans was above 20%. The latter issue will have to be addressed before lending activity can be resumed. Though projects with EU cofinancing were boosted in the second half of last year, the administrative capacity has remained inadequate to ensure a smooth flow of funding. The European Commission identified major problems also in the preparation of the 2014-2020 programmes.

Continuing the trend of the previous year, exports have increased more rapidly than imports. Exports reached EUR 17 billion in January through April (up by 8.1% year on year), while imports climbed to EUR 18.7 billion (up by 7.7%). Exports were driven by growing EU demand which stimulated industrial production in Romania (up by 10%). In view of the private consumption boom, imports are expected to expand later this year and net exports will no longer be a strong driver of economic growth. Imports will be further supported by the strengthening local currency. The current account turned slightly negative in the first quarter of 2014 compared with a balanced situation a year before and is expected to deteriorate further. Romania continues to provide an adequate environment for manufacturing and business outsourcing which stimulates FDI inflow.

Inflation has subsided through the first half of 2014 and is expected to rise in the second half of the year. One of the components adding to inflation is the adjustment of gas prices, another one is originating from fuel tax increases.

The government is on track with reducing the fiscal deficit to 2.4% of GDP. Expenditures were lower than expected in the first quarter of 2014 due to the delays in the financing of EU projects. In view of the economic upbeat, the government postponed structural reforms under the IMF stand-by agreement of September 2013. They have even taken action against IMF recommendations by reducing the social security contribution, a long-time request of the business community. In turn, the IMF has not concluded its programme review in June and stays in a wait-and-see position until the next supervision due in November.

Such regained government confidence is certainly necessary to take full responsibility for the economic policy, but administrative performance is likely to worsen under reduced external pressure. Political stability is maintained as the governing Social Democrats have won the EU elections and have a good chance of providing the next president of Romania in the forthcoming elections later this year.

Slovakia: domestic demand on the rise

BY DORIS HANZL-WEISS

In the first quarter of 2014, GDP growth was quite strong and accelerated to 2.4% year-on-year, following a sluggish performance of only 0.9% annual growth in 2013. For the first time since 2008, households showed visible signs of recovery, with consumption up 3.4% in the first quarter of 2014. This may be due to the relatively strong increase in real wages (+4.2%), also owing to practically zero inflation (-0.1% over the first four months). Other categories of domestic demand grew dynamically as well: government consumption by 4.4% and gross capital formation by 5.3%. Of the latter, gross fixed capital formation increased by 3.5%, thus continuing the positive trend since the last quarter of 2013. Net exports, however, the main driver of growth in the recent past, have lost momentum. While exports of goods and services expanded by 9.6% – exports to Germany, Slovakia's main trading partner, rose by 16% – imports even grew by 10.8%.

Industrial production continued rising by nearly 7% in the first four months of 2014. However, monthly data show a declining trend. The transport equipment sector – encompassing the three main automotive companies Volkswagen Bratislava, PSA Peugeot-Citroën and Kia – again showed the fastest growth with 11%. Also the metals sector, electrical engineering and the rubber, plastics and non-metallic mineral products sectors displayed a strong performance. Despite a brief recovery at the end of 2013, following several years of crisis, construction declined again over the first four months of 2014, by 2.1%. Services value added, on the other hand, expanded.

Some small encouraging signs were observed in the labour market in the first quarter of 2014. Employment grew slightly – mainly in some segments of services – and the (LFS) unemployment rate fell to 14.1%. Yet unemployment is among the highest in the EU and prevails as one of the main problems in Slovakia.

Budget consolidation efforts were successful last year as the budget deficit remained below 3%, reaching just 2.8% of GDP. Projecting the budget deficit also slightly below 3% in the following two years, the European Commission recommended removing Slovakia from the excessive deficit procedure. Official deficit targets (according to the Stability Programme of April 2014) are set at 2.5% for 2015, 1.5% for 2016 and 0.5% for 2017. However, in order to reach these targets, additional measures will be needed. Overall, the debt level increased from 52.4% of GDP in 2012 to 55.42% in 2013, thus surpassing two thresholds of the country's Fiscal Responsibility Act ('debt brake law'). As for the first threshold (53%), wages of government members need to be frozen to the previous fiscal year level. As for the second one (55%), the Finance Minister needs to cut the current year's state budget expenditures by 3% (with specified exemptions). However, the debt level should remain below 57% in the next years, as this figure marks the next threshold, requiring the government to submit a balanced general government budget.

The forecast for the next three years is quite positive and has not changed. We assume GDP to grow by 2.4% in 2014, 3.0% in 2015 and 3.2% in 2016. Already this year, growth will be more balanced and all main components – household consumption, investment and net exports – will contribute to growth. Household consumption will increasingly take over the role as a growth driver from net exports. Developments in the first quarter were rather volatile, though economic sentiment again grew quite visibly in May. On15 June, the independent businessman Andrej Kiska was sworn in as new president; he is assumed to bring new impetus to politics and to foreign policy in particular. International tensions may pose a risk to this forecast in two ways – first, the possible stop of gas supplies from Russia, as Slovakia imports gas almost exclusively from Russia. Second, the small, but promising Russian export market (for cars) might collapse.

Slovenia: first signs of recovery

BY HERMINE VIDOVIC

The positive economic trends prevailing at the end of 2013 continued during the first months of 2014. Slovenia's GDP grew by 1.9% in the first quarter backed primarily by foreign demand. Domestic demand remained suppressed: gross fixed capital formation rose by 2.4% and household consumption growth was only slightly positive. Rising investment translated first of all into an increase in construction, civil engineering in particular, co-financed by EU funds. Apart from favourable weather conditions, the increase in construction activities – after five years of steady decline – was due to clean-up works following the ice storm in February. By contrast, investments in machinery and equipment dropped by 15%. Government consumption continued to fall for the fourth consecutive year and also the change in inventories contributed negatively to GDP growth. The labour market situation has slightly improved: based on labour force survey data, employment increased by 1% in the first quarter of 2014 (year-on-year) while the unemployment rate stood at 10.8%, slightly lower than in the first quarter of 2013.

In foreign trade, exports rose by 6% and imports by 2%, resulting in a trade surplus more than double the value reached in the first quarter of 2013. By contrast, the surplus in services trade declined due to stagnating exports and rising imports, particularly those of 'other business services'. Overall, the current account ran a surplus of EUR 470 million, a level similar to that in the first quarter of 2013.

Thanks to more pronounced increases in revenues than in expenditures the general government deficit decreased in the first quarter of 2014. Revenues improved in all categories, while expenditures rose mainly due to increased interest payments. With the exception of pension and social security expenditures, budgetary spending on social transfers was lower than in the first quarter of 2013. For the year as whole the general government deficit is set to reach 4.3% of the GDP (down from 14.7% in 2013 as a result of bank restructuring) – including the support for the commercial banks Abanka and Banka Celje. The real estate tax which was expected to come into force in 2014 was rejected by the constitutional court; the proposal 'was found unconstitutional' as it did not determine the value of real estate clearly enough. The tax was envisaged to contribute about EUR 126 million per year to the budget. After the Slovenian government had injected about EUR 3.2 billion in the banking sector in December 2013, the two major banks NLB and NKBM transferred non-performing assets worth EUR 3.5 billion to the 'bad bank' (BAMC) and received in exchange EUR 1.1 billion. The transfer of non-performing assets from Abanka is yet to start. Out of the 15 enterprises earmarked for privatisation by the Slovenian government in 2013, two – coating manufacturer Helios and laser producer Fotona – have been sold so far. Several non-binding bids have been submitted for a 72.75% stake in Telekom Slovenia; the second round of the procedure started in mid-June.

At the beginning of May Slovenia's Prime Minister, Alenka Bratusek resigned after losing the leadership of her party Positive Slovenia to the mayor of Ljubljana, Zoran Jankovic. Early elections will be held on 13 July. The outcome of the elections is open since several new parties have made their appearance. According to recent opinion polls the newly founded party of Miro Cerar (lawyer, independent) is in the lead, followed by the centre-right Democratic Party of Janez Jansa, the Social Democratic Party and DeSUS (pensioners).

Based on the results for the first months of the year, wiiw revises the forecast for Slovenia's GDP growth for 2014 from minus 0.5% to plus 0.5%. Growth will be driven primarily by foreign demand while household consumption will be hampered by high unemployment and the deleveraging process of enterprises. The modest growth will somewhat accelerate in 2015 and 2016. This is assumed to happen as a result of rising foreign demand and a modest revival of domestic demand.

Albania: candidate, at last

BY MARIO HOLZNER

The EU Member States granted Albania the status of an official membership candidate on 24 June 2014. However, it is expected that Albania further intensifies its anti-corruption efforts, reforms public administration and the judiciary and improves the protection of human rights and anti-discrimination policies. Also, accession negotiations with Albania will not necessarily start automatically.

A major obstacle on the way to candidate status was the Czech Republic threatening to veto unless a long-lasting dispute between the Albanian authorities and the Czech energy giant CEZ was resolved. The agreement that was reached now foresees that the government repurchases the Albanian electricity distribution company for a total of EUR 95 million. In 2008, CEZ purchased 76% of the Albanian electricity distributor. However, in early 2013, the Albanian regulatory authority suspended the operating licence of CEZ after a row over electricity prices.

In this respect it appears to be fortunate that earlier this year the Albanian government has signed budget support loans worth USD 220 million with the World Bank and a USD 450 million loan with the IMF. The loans are aimed at helping Albania inter alia with its arrears to the domestic private sector which the last government has passed on. Also, the Albanian government is planning to borrow some EUR 300 to 500 million in its second Eurobond placement next year.

Apparently the new government of socialist PM Edi Rama takes its budgetary clean-up efforts very seriously, perhaps overdoing it. Over the first five month of 2014 expenditures were cut by more than 7% and revenues increased by 9%. In particular, capital expenditures were cut by almost three quarters year on year. VAT revenues have been increasing by about a quarter, which hints at better tax collection as well as a higher than expected household consumption.

This is although wage increases in the public sector in the first quarter of 2014 did not even surpass the low inflation rate. Also, first-quarter results for employment and unemployment were dismal. Moreover new loans to private households (mostly real estate related loans) were reduced by more than 6% over the first four months of 2014, year on year. These are the main reasons why we have decided to reduce the outlook for Albanian GDP growth for 2014 from the spring forecast's 1.7% to 1.3%.

Our forecast for 2015 remains at 1.5% though, given a number of positive signals from the economy. In the first four months of 2014 new household loans for durable goods increased by almost 40% year on year, and total new loans to the economy rose by half as new loans to businesses increased by two thirds, of which those for financing machinery purchases by almost three quarters. Hence it appears that private investment will be able to offset the slump in the public one. It is also reassuring that non-performing loans stabilised at 24% of total loans in the first quarter of 2014.

Trade developments appear to be favourable as well. Cumulative export data up to April 2014 show an increase of more than 11% as compared to the same period a year earlier (imports rose by 9%). It is interesting to note that among the destination countries, troubled Italy and Greece increased their imports of Albanian goods by high double-digit rates.

However, given that Albania's export sector is still quite small, the general economic wellbeing of the country strongly hinges on domestic demand. Due to the new government's austerity policy we have to expect domestic demand to stay rather depressed for the years to come. Also the export boom will sooner or later come to an end, given the strong dependency on exports of hydro power generated electricity and thus on rainfall. Precipitation in 2013 and the first half of 2014 has been above average of a mean reverting process. Hence we expect GDP growth in 2016 not to surpass 1%.

Macedonia: monuments and elections

BY VLADIMIR GLIGOROV

The economy has continued to expand in the first half of this year. Both domestic demand and net exports contributed to the recovery. The government has relied on increased public spending to support economic activity. In addition, monetary policy has been relatively lax. Both reveal increased confidence of the authorities that debts and the exchange rate are under control and no austerity measures are needed. Traditionally, the country's concern with stability trumps policy activism, which now seems to be changing.

The reliance on public spending to an extent unthinkable before the crisis is also a consequence of political competition, which led to three rounds of early elections in about the past five years. The last ones were held in May and the governing coalition was able to defeat the opposition parties once again. It had growing wages and employment on its side. The labour market is still quite depressed, with very high unemployment rates and with wages that are among the lowest in the region. Still, the slow but steady improvement in the past few years have proved stabilising in social and political terms.

The economic policy mix aims at increased public investment and growing foreign investments, the latter mostly intended to boost exports. It is unclear how much of the public investments have gone into infrastructure projects rather than into building of various types of monuments in the capital city. Also, though foreign investments have picked up due to the overall better institutional and regulatory environment, the numbers are still not overwhelming.

As for macroeconomic stability, prices are currently falling but should recover in the second half of the year. However, that may prove to be a disappointment if there are no increases in prices of imports and in those set by the government. Monetary policy could in principle be relaxed, but it is hard to see that happening given the expectation for continuing recovery of economic activity and the pressures to increase wages.

Debts – foreign, public, private – are not worrisome especially because corporate and household debts are rather low and are not increasing much if at all. Still, of those, foreign debts are more of a problem. Although current account deficits have shrunk, it is to be expected that persistent growth will push imports and increase external imbalances. Nevertheless, it is hard to detect problems of sustainability in the development of foreign debt, at least in the medium run.

The frequent reliance on early elections has contributed to political stability. It has also made it difficult for the opposition parties to gain influence, which is necessary if democratic accountability is to be effective. The additional problem is lack of an external anchor as the EU has failed to come to an agreement to start negotiations with this candidate country, which is waiting for the green light from the European Council to start negotiations since 2009 (when the European Commission recommended an immediate start of negotiations). In fact, with the passage of time the prospect of negotiations starting and of the country joining the EU is becoming more and more distant. Indeed, at the moment, that seems highly unlikely for the foreseeable future.

Medium-term prospects are of growth rates that are close to 3%. The policy will have to switch from supporting domestic demand to even more pronounced reliance on exports. Given the rather significant reliance on the regional markets, that will depend on the recovery in such important partners as Serbia and Greece. In the long run, the key problem will remain to be the high rate of unemployment and the reliance on remittances and other transfers from abroad. Finally, investments in monuments will inevitably have to slow down if not end and elections will have to prove more democratically meaningful in order to strengthen political stability.

Montenegro: tourism and elections

BY VLADIMIR GLIGOROV

It is not likely that the results of last year will be repeated in the current one. There will be problems with sustained expansion of public spending and with the recovery of investments. On the positive side, exports of services should continue to grow. This has been one unqualified success in the years of crisis: tourism has continued to expand and clearly the limit of the potential has hardly been reached. It is an open question whether the large potential in infrastructure and energy investments will be exploited in the short to medium term due to problems with financing and implementation. In the long run, however, those can certainly support continued growth of economic activity.

During the crisis years, some of the thorny questions have been resolved. This refers primarily to the restructuring and liquidation of some of the inherited industrial capacities, such as the aluminium plant and the steel-mill. Those were a drag on the country's resources unlike other industries, e.g. producing consumer durables, which could have been saved, but were not. In any case, the country has basically turned into a services economy and thus its development will mostly depend on the growth of that sector.

Since the beginning of the crisis, there have been several elections, parliamentary, regional and presidential, early and regular. The governing coalition, which is led by the party that is the descendant of the Communist Party, has managed to win all or most of those. In addition, social dissatisfaction has proved not to be able to translate into effective social or political action. This year the opposition did better than in previous attempts, but still failed to garner the majority of votes and get a stake in the government of the country. This political stability is both remarkable and unnerving as it may lead to distortions in the democratic set-up of the country.

A partial substitute has proven to be the process of negotiations with the European Union. Though it is not proceeding as fast as perhaps it could, it still introduces elements of discipline in the behaviour of the government in the areas of human right, rule of law, and respect for the freedom of the media. Nevertheless, given the long tenure of one party and its leader in the government, the issue of political inclusion and exclusion is bound to arise.

Macroeconomic stability remains a concern due to the large and persistent external imbalances. The current account deficit continues to be exceptionally large and it has led to the accumulation of quite significant foreign debt. Given that Montenegro uses the euro, these imbalances cannot be corrected by means of monetary policy. Also, internal devaluation in the form of declining wages or decreased employment or both is not advisable as it would invite social and political instability. In fact, wages have continued to rise during the crisis and employment has not declined noticeably. Indeed, the policy-makers have relied on domestic demand in addition to growth of tourism to support economic activity and incomes.

Therefore, the solvency of the country vis-à-vis foreign creditors depends on the expected investment in real estate and tourism. So far, these expectations have proved to be stable and have been sustained by the preserved social, financial and political stability.

In the short run, growth should moderate due to the slowdown in the increase of public expenditures. In the medium run, growth could be around 3% due to improving regional and the EU economies.

Serbia: floods and reforms

BY VLADIMIR GLIGOROV

The beginning of the year saw a slowdown of growth as expected. Then came the floods that added to the negative developments. In mid-year, the budget will have to be revised with some cuts to public expenditures being forecasted. With all that, GDP is expected to shrink by about 1% this year. The slowdown was expected because private consumption is not recovering due to the worsening performance of the labour market, but also because of sluggish investments. In addition, export growth is slowing down as much of the effect of the increased car production is dying out. Even so, the contribution of net exports to this year's GDP will probably be positive because of the sluggish recovery, or lack of one, of imports. Therefore, the trade deficit continues to shrink, though it is still large and the same is true of the current account. These developments are also influenced by low foreign investments and by continuing deleveraging of the banks and the corporate sector which leads to cross-border financial outflow.

In view of these developments, the marginal contribution of public expenditures to economic activity is crucial. So far, despite repeated announcements that fiscal austerity measures will be introduced, public expenditures have mostly kept their ratio to the GDP, which in itself is an austere fiscal policy given the large output gap. This has led to rising fiscal deficits due in large part to declining public revenues. The latter is largely due to growing tax evasion as tax rates have in fact gone up. Currently, the forecasted fiscal deficit is close to 8.5% of GDP. That will bring the public debt to GDP ratio close to 70% of GDP this year, with prospects of further increases in the medium term. Clearly, the pressure for fiscal consolidation is building up, but the government has a hard time coming up with a strategy of fiscal consolidation due to the recessionary or at best stagnant outlook even without any additional measure of fiscal austerity. Monetary policy has not been supportive of growth but has been concentrated on financial stability. Given that most of the public and private debt is in or indexed to foreign currencies, the central bank has reverted to a quasi-fixed exchange rate policy, i.e. it has kept the euro-dinar exchange rate stable for at least half a year now. This has been accomplished with a quite high policy rate especially in view of the falling rate of inflation. The underlying reasoning seems to be that inflation will accelerate in the second half of the year due to seasonal factors (rise of prices for food and electricity) and the policy rate can be lowered incrementally so that the stability of the exchange rate is not risked. In the current deflationary circumstances, however, a much more aggressive policy rate cut would in all probability not put undue pressure on the exchange rate, while some depreciation would in fact be supportive of the development of prices, and of economic activity. In any case, the longer the rate remains fixed, the higher will be the risk of an explosive development of the foreign and public debts ratios to GDP once the rate is corrected.

In the next few months, the government is supposed to be unveiling its long overdue reform package. A new labour law as well as a new bankruptcy law are supposed to be passed before the summer break. The largest issue, however, is the restructuring of mostly bankrupted or loss-making firms in public or state ownership. In some cases, that will require hiking the prices (e.g. for gas and electricity), in others the labour force will have to be shrunk (e.g. railway company) and in most of the rest liquidations will be unavoidable. A few companies can be privatised, such as the Telecom, the airport, the state-owned insurance company, and the largest of all, the electricity companies. That will give the government some financial resources to play around with, though to what end remains to be seen. If the track record is to be followed, most of the money will go to finance current budgetary expenditures. In summary, the floods have provided a setback while the policies and reforms will deepen the recessionary risks in the short run with uncertain prospects in the medium run.

Turkey: economic adjustment in progress, political tussle continues

BY MICHAEL LANDESMANN

The wiiw Spring 2014 Report on Turkey ('Blowing in the wind of international capital flows')[1] reported on the strong Central Bank reaction to the dramatic outflow of capital following the announcement of a gradual withdrawal of the US Fed from the massive quantitative easing policy it had pursued hitherto. On 28 January the Turkish Central Bank (TCB) had increased the one-week repo rate from 4.5% to 10.0% and its overnight interest rate corridor from 3.5-7.75% to 8.0-12.0%. We forecasted at that point that this dramatic shift towards tight monetary policy would have a strong impact on the slowdown of GDP growth in 2014; this would not be unlike the impact of the restrictive stance taken by the TCB in 2012 which had brought down GDP growth from 8.8% in 2011 to 2.2% in 2012.

The strong policy stance pursued by the TCB did have the expected impact: credit growth dropped dramatically, inventory holdings declined considerably, domestic demand weakened. Current accounts improved considerably through a fall in imports but also due to strong export growth which benefited from the considerable depreciation of the currency following the international capital outflow.

The depreciation had a significant impact on the pick-up of inflation rates which we revise upward for 2014 compared to our previous forecast. We now forecast CPI growth of 8.3% for 2014 as a whole compared to our original figure of 6.0% – the result from exchange-rate pass-through combined with very bad weather conditions affecting the harvest and thus food prices.

The political climate remains heated even though regional elections were handsomely won by Erdoğan's party in March 2014 – as presidential elections will be held on 10 August this year and Erdoğan has taken a harsh and divisive political stance. The tussle between Erdoğan pushing the TCB to reduce interest rates in order to support a recovery and the TCB's need to prove its independence in the light of increased inflation rates will affect the conduct of monetary policy. It could indeed have been the case that the TCB would have reduced interest rates earlier had Erdoğan not continuously challenged its policy. We expect some easing of monetary policy in the second half of the year as credit growth has already been severely curtailed, the current accounts have improved and the volatility of international capital markets towards emerging markets (EMEs) have calmed somewhat.

The recovery will nonetheless be carried by net export growth which has already favourably affected industrial production (manufacturing industry increased its output by 4.9% in the first quarter of 2014). Other growth figures for the first quarter of 2014 were, all at constant prices: gross fixed capital formation (public and private) -0.5%, exports of goods and services +11.4%, imports of goods and services +0.8%, government final consumption expenditure +8.6% and household final consumption +2.9%.

If no major external shocks intervene – such as another negative impact of further 'tapering' by the Fed on EMEs or a shock to energy prices in the light of the Russia-Ukraine crisis – and if the recovery of EU economies persists, then we are inclined to revise our original GDP growth forecast for the year 2014 upward from 2.2% to 2.9% and suggest further recovery in 2015 and 2016 in line with our previous forecast.

[1] In: *wiiw Forecast Report*, Spring 2014, pp. 83-88.

Bosnia and Herzegovina: floods and elections

BY VLADIMIR GLIGOROV

The forecasted slow recovery has been interrupted by the floods in May. The damage to land, housing, and capital is large while the disruptions to activity have been rather limited. The overall slowdown of the growth of GDP will probably not be enough to move the economy into recession, but recovery, which was anyway quite anaemic, will be delayed further. Some revival of investment due to the reparation and reconstruction of the damages will take place while private consumption as well as recurrent public consumption will mostly go unscathed. On the supply side, industrial production is growing only very slowly while exports have not increased in the past five months over the same period last year. As for indicators of macroeconomic stability, those have not changed much, with the inflation rate being low, deficits and debts not increasing appreciably, and with the labour market remaining in depression.

2014 is the year of general elections. Although the electoral campaigns are yet to heat up, the programmes on offer and the choices are clear. There is growing dissatisfaction with the institutional, political and economic stalemate in the past ten years or so and clear demand for change. There is also an understanding that the desired change requires new leadership on practically all levels, but primarily in the two entities and in the parties that represent the three main ethnicities. The current leaders have proved to be incapable of forging an agreement that would move the reform and economic policy agenda. The alternative leaders or parties are yet to emerge however. Last year widespread social dissatisfaction was on display in many towns and some have changed their leadership in the meantime, but nation-wide political alternatives are yet to appear. This time around, there is more talk about the possible secession by the Serbian Republic. The current president and government are increasingly unpopular so they have toned up the separatist rhetoric. At the moment, it is not clear whether they will be able to turn the tide that is building up against them. In the Federation, by contrast, the key issues are corruption and inefficiencies, which again are being deflected by the issues of constitutional and other institutional blockages that are due to inter-ethnic conflicts or squabbles.

As in all the past elections, international meddling has increased. As it is generally perceived that not much if anything can be done without a change in the Serbian leadership, there has been heightened activity on the part of Milorad Dodik, President of Republika Srpska, to elicit the support by Russia and Serbia. The support by Serbia is ambiguous while that of Russia is more explicit. This is mostly symbolic and does not involve money, which is, however, the only means by which the current government could succeed in convincing the voters that the government can deliver and that possibly secession is a viable political aim. The EU has remained mostly unengaged so far. There is no doubt that the EU would welcome the political change if it were to occur and would support inter-ethnic and more general discussion about how to increase the functionality of decision-making. But the EU has not been actively engaged with political or other attempts to influence the outcome of the upcoming elections.

The impact of the floods on the outcome of the elections is hard to evaluate. As the damage was mostly in Republika Srpska, the dissatisfaction with the government has certainly increased because of large institutional failures. The unhappiness will only increase due to predictable problems that will come in the period or reconstruction. Whether that will tip the scale in favour of the opposition is hard to say. Recovery depends mostly on increased investment in the tradable sector, which is to say in industry. As its recovery is unconvincing and exports are not picking up as expected, the medium-term prospect is for a rather sluggish growth. If there is political change, that will change the forecast for the better not only in the medium but even more so in the long term.

Kosovo: unstable government in a stable economy?

BY MARIO HOLZNER

With a result of about 30% of the votes, the 8 June 2014 national polls gave once again the lead to incumbent Prime Minister Hashim Thaci's party, which could even increase its number of MPs since the last elections in 2010. However, several opposition parties want to form a coalition government without Thaci. Now it is up to President Atifete Jahjaga to nominate a candidate to form the new government. The current dispute over the nominee for the PM's seat might be only resolved after the constitutional court has clarified how the president should act in such situations.

A newcomer in the parliamentary elections was the Serbian minority party 'Srpska Lista', which is supported by the government in Belgrade and most of the local Kosovo Serbs. The party won more than 5% of the votes. Moreover, voter turnout was almost as high in Serbian-dominated municipalities as in the rest of the country. It appears that finally all Serbian MPs will take up seats in the Kosovo parliament for the first time since the end of the conflict some one and a half decades ago. This would indicate a step change in the relationships between Kosovo, Serbia, the EU and above all the Serbian minority in Kosovo.

Our outlook for the Kosovo economy is stable. The current growth path seems to centre on some 4% of real GDP growth per annum. Only for the year 2014 we expect a higher GDP growth rate of about 5%. The main explanation for this is the increased government final consumption in the run-up to this year's elections. However, overall fiscal policy in the first quarter of 2014 was rather tight. Total receipts were up by almost 13% and total payments down by almost 8% year on year. It is especially worrying that capital expenditures were cut by more than half. At the same time public sector wages were increased by more than half as compared to the same period a year earlier. This has supported domestic consumption without much increasing the real effective exchange rate vis-à-vis the rest of the world, so far.

Another indicator for a robust development of domestic demand is the 35% increase in total new loans to the economy in the first five months of 2014, year on year. New household consumer loans rose by 19% and mortgage loans by 27%. Moreover, non-financial corporations' new investment loans increased by as much as 86% as compared to the same period a year earlier. Additional reasons for the credit boom are certainly the very low basis as well as a falling interest rate level. In May 2014 interest rates for medium-term business investment loans with a maturity of one to five years went down by three percentage points to a level of 10% as compared to May 2013.

The export performance in 2014 has been rather weak so far. Data on trade in goods for the first four months suggest that exports dropped by some 5% on the year, while imports stagnated. However, the export share in the economy is only at about 19% of GDP. Still, the external sector is very important for the Kosovo economy. Remittances from migrant workers, living mostly in Germany and Switzerland, are constantly fuelling household consumption and providing the means to cover the huge trade deficit. Both the German and the Swiss economy are expected to grow by about 2% in 2014. Especially in the case of Germany this is a strong increase in economic dynamics when compared to the 0.4% GDP growth rate in 2013. While Germany's growth is expected by the Bundesbank to remain at around 2% in the years to come, the Swiss State Secretariat for Economic Affairs expects Swiss GDP to expand up to 2.6% in 2015.

Overall, the economic environment seems to be rather favourable. Hopefully the new coalition government will be inaugurated without much delay and major disputes. The country needs smooth governance no matter who will act as PM. An unobstructed change of government would also be a positive signal for the further European integration process of Kosovo.

Russian Federation: stuck in stagnation

BY PETER HAVLIK

Russia was ‘stuck in transition’ already before the conflict with Ukraine as traditional growth drivers had been exhausted and the economy badly needed modernisation, diversification and investment climate improvements. The conflict over Ukraine and the subsequent imposition of – so far limited – EU and US sanctions are already showing first effects: deteriorating investment climate, accelerating capital outflows, declining investments and lower GDP growth. The country is now ‘stuck in stagnation’ with definitely bleaker prospects, possibly even in the medium and longer run.

GDP growth dropped below 1% in the first five months of 2014; industrial production and goods transport expanded somewhat faster, both partly owing to the statistical base effect. Gross fixed investments and the construction output – already falling before the crisis – declined by nearly 3% to 5% in the first half of the year. Goods exports (in both real and nominal terms; crude oil prices fell slightly in early 2014) continue to shrink while imports declined by 6% in the first quarter of the year due to falling investments and weaker consumer demand. Without the slightly positive contribution of net exports, GDP growth would be close to zero.

During the past 12 months – well before the Ukraine crisis unfolded – the rouble started to depreciate and capital outflows accelerated. Depreciation peaked in mid-March 2014, when the rouble devalued by about 20% with respect to the euro, but it recovered nearly half of the loss thereafter. Foreign exchange reserves dropped by 10% (about USD 50 billion) during the same period. Inflation started to pick up again: annual CPI exceeded 7% in June and PPI neared 10% by mid-2014. Rising inflation took its toll in the reduction of real disposable incomes and the slowdown of real wage growth. Unemployment remains very low (LFS rate about 5% in mid-2014) and labour shortages are being compensated by migrants from the former Soviet republics (mainly from Central Asia, but also from Georgia, Moldova and Ukraine).

Notwithstanding the conflict with Ukraine, Russia succeeded in proceeding with the establishment of the Eurasian Economic Union (EEU) on the basis of the Customs Union (existing since 2010) with Belarus and Kazakhstan. The corresponding EEU agreement, imitating the EU and signed on 29 May 2014 in Astana, will come into force in January 2015. Apart from a free trade area in goods (with some important exceptions such as energy), the agreement envisages also the free movement of labour, capital and services among participating countries (Armenia and Kyrgyzstan are expected to join as well). Coordinated economic policies will use ‘Maastricht-like’ indicators such as limits on budget deficit, government debt, inflation and interest rates.

Another important breakthrough counterbalancing the deteriorating relations with the West represents the signature of a long-pending agreement on gas deliveries to China on 20-21 May 2014. The deal envisages future deliveries of Russian gas (38 bcm per year) and the construction of a new pipeline from Kovykta and Yakutiya in Eastern Siberia. Besides, several important trade and investment contracts were signed also with Western companies at the International Economic Forum in St Petersburg in May.

Still, Russian growth prospects have worsened as Western sanctions – so far largely symbolic – result in a deteriorating investment climate and higher risks. Compared to last year’s forecasts, GDP growth for the coming years was scaled down, largely owing to falling investments. In the medium and long run, modernisation ambitions will most likely suffer as well due to lower FDI inflows, despite current efforts to mobilise additional domestic resources. Hopefully, more serious damage to relations with the EU and other neighbours can still be avoided at the negotiation table – where topics may include the EU’s envisaged Association Agreements with Georgia, Moldova, and Ukraine.

Ukraine: in search of stability

BY VASILY ASTROV

The USD 17 billion worth 'rescue package' approved by the IMF in April 2014 and complemented by extra funds from other 'Western' lenders has averted a balance-of-payments crisis and stopped the free fall of the currency. Nevertheless, the hryvnia has stabilised at very low levels: around 12 UAH per USD, implying a 50% nominal depreciation since the beginning of the year. The depreciation has not only fuelled consumer prices, which in just three months – between March and May 2014 – picked up by 9.6%, but will probably also undermine the stability of the banking system, given that 35% of all loans are denominated in foreign currency (mostly US dollars).

Another reason for the spike in inflation have been the implemented hikes of regulated prices and excise taxes on alcohol and tobacco as part of the IMF-required austerity package. Most notably, gas tariffs for households were hiked by 60% and those for district heating companies by 40% on 1 May and 1 July 2014, respectively.[1] Also, property taxes and royalties on the extraction of natural resources have been raised, and the (nearly) 'flat' tax regime for personal income made more progressive (albeit with thresholds set at rather high levels). Apart from the revenue-based measures, the IMF package envisages cuts in capital spending, a 'freeze' of the minimum wage, a 10% reduction in the number of civil servants, and cuts in some of civil servants' pensions and privileges. Despite the newly enacted austerity measures, the budget deficit will almost certainly widen this year: in the current recessionary environment the fiscal multipliers – and the corresponding dampening impact on the real economy – will probably be large.

In the first quarter 2014, the GDP decline was still rather modest (-1.1% year-on-year) and largely driven by a collapse of investments: overall fixed investments plunged by 23%, those in industry by 35%, and the balance of FDI turned negative for the first time. For the year as a whole, however, the recession is likely to turn much deeper: an estimated GDP drop by at least 5% (not taking into account the loss of some 3% of GDP produced in Crimea and Sevastopol – see below). Given the ongoing internal armed conflict, a turnaround in investment activity is not in sight anytime soon. Simultaneously, the implemented austerity package will increasingly take its toll on private and especially public consumption, which have already been weakened by the recent spike in inflation: the growth of both real wages and retail trade turnover has slowed down markedly since the start of the year.

Finally, the export-oriented industry is hardly in a position now to take full advantage of the new, more competitive exchange rate, given the mounting supply-side constraints reflecting basic security problems. It is indicative that the remarkable external rebalancing over the past few months[2] has been exclusively driven by plunging imports (by 20% in January-April 2014 in US dollar terms), while exports declined as well (albeit by only 8%). The reason is that a sizeable part of Ukraine's industrial capacities – particularly in metallurgy and chemicals – is located in the two 'rebellious' Eastern provinces of Donetsk and Luhansk. Also, the recently imposed ban on military exports to Russia – unless promptly revoked – will undermine the industrial production and exports of other South-eastern provinces (Dnipropetrivsk, Kharkyv, Mykolaiv, Zaporizhye) which are not directly involved in the armed conflict.

So far, the attempts of the government to regain control over Donetsk and Luhansk by force have largely failed, not least because of the poor financing and the low fighting morale of the army and the police. Other military and paramilitary groupings, such as the nationalistic Right Sector (rebranded

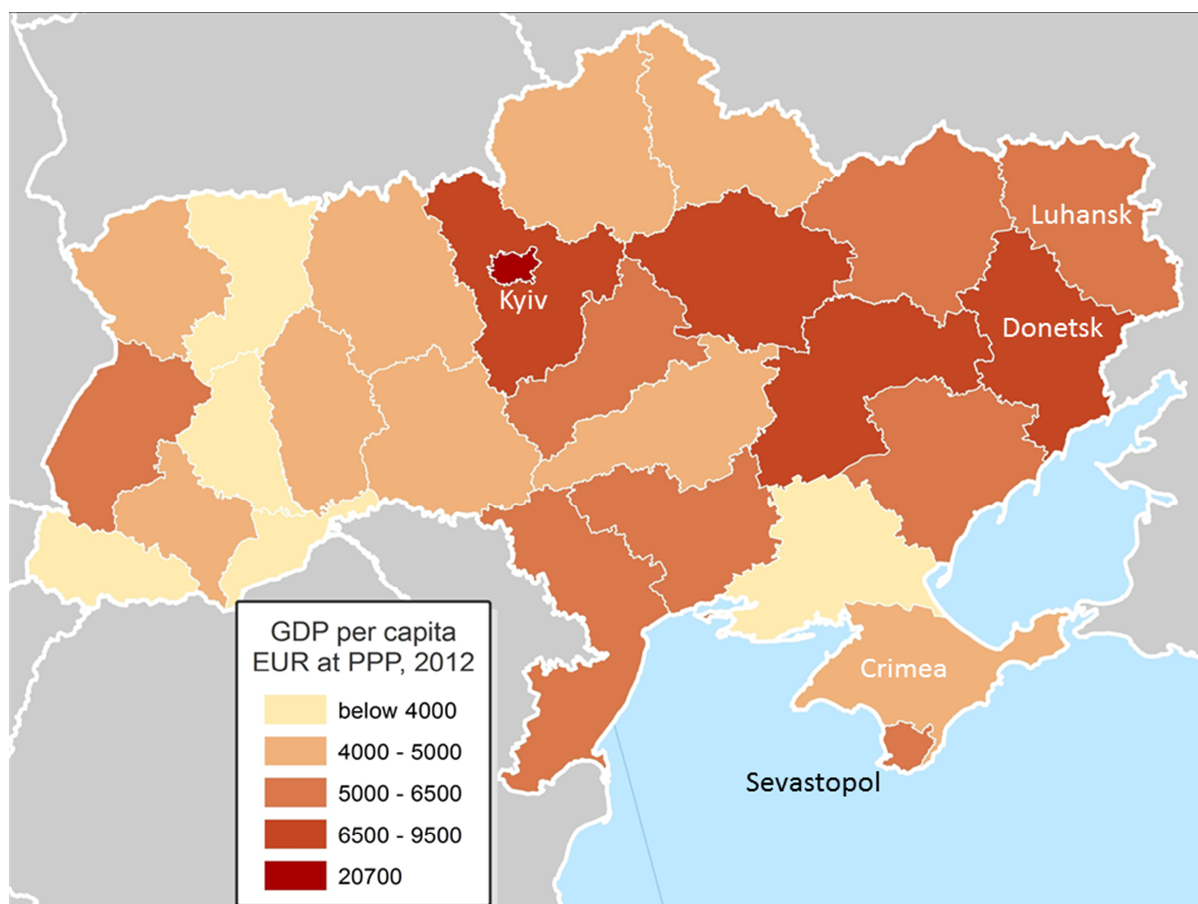
[1] In line with the IMF programme, domestic gas tariffs for households are to be tripled over the next three years. This should eliminate the quasi-fiscal deficit of Naftohaz, which last year amounted to some 2% of GDP.

[2] After a record deficit of 9% of GDP last year, the current account improved markedly in the first months of 2014 and even switched into surplus in April.

as the newly formed 'National Guard') and troops sponsored by the oligarchs, have been generally more efficient and at least prevented the spread of the separatist movement to other provinces of the Southeast. However, in the medium term the existence of alternative (para-)military formations potentially bears the risk of further loss of government control over the security situation. A protracted stalemate between the Kyiv government and the separatists (who enjoy only indirect Russian support) appears to be the most likely scenario for the coming months, with neither side gaining an upper hand, and ultimately paving the way for negotiations over an overhaul of Ukraine's constitutional set-up.

By contrast, the recent takeover of Crimea and Sevastopol by Russia – while diplomatically not recognised by Ukraine and the rest of the world – has not been resisted militarily, and will become a new reality for the foreseeable future. Apart from some 3% of GDP loss mentioned above, with the departure of Crimea Ukraine has reportedly lost 6% of its gas and 16% of oil deposits (off-shore), prompting the government to demand financial compensation from Russia. At the same time, at least in the short and medium run the net impact on Ukraine's budget should be rather positive: Crimea and Sevastopol were both poor – even by Ukrainian standards – and net recipients of fiscal transfers from Kyiv.

On 27 June 2014 Ukraine signed a Deep and Comprehensive Free Trade Agreement (DCFTA) with the EU, which is part of a broader Association Agreement. Although its long-term effects on Ukraine's economy should be largely beneficial, in the near term the large-scale adoption of European standards (essentially *acquis communautaire*) envisaged in the DCFTA might prove very costly. In addition, Russia is likely to revoke the existing free trade regime with Ukraine in response, resulting in further losses, particularly for the Russia-oriented machinery sector in the Eastern parts of the country.



Index of subjects – July 2013 to July-August 2014

Albania	economic situation	2014/7-8; 2013/11
Bosnia and Herzegovina	economic situation	2014/7-8; 2013/11
Bulgaria	economic situation	2014/7-8; 2013/10
	migration	2014/4
	impact of the Russia–Ukraine conflict	2014/5
Croatia	economic situation	2014/7-8; 2013/10
Czech Republic	economic situation	2014/7-8; 2013/10
Estonia	economic situation	2014/7-8; 2013/10
	EU cohesion policy	2014/1
Hungary	economic situation	2014/7-8; 2013/10
Germany	economic growth, R&D investment, trade	2014/2
Kazakhstan	economic situation	2013/11
Kosovo	economic situation	2014/7-8; 2013/11
Latvia	economic situation	2014/7-8; 2013/10
Lithuania	economic situation	2014/7-8; 2013/10
Macedonia	economic situation	2014/7-8; 2013/11
Montenegro	economic situation	2014/7-8; 2013/11
Poland	economic situation	2014/7-8; 2013/10
	migration	2014/4
Romania	economic situation	2014/7-8; 2013/10
	migration	2014/4; 2013/8-9
	impact of the Russia–Ukraine conflict	2014/5
Russia	economic situation	2014/7-8; 2013/11
Serbia	economic situation	2014/7-8; 2013/11
	migration	2014/4
Slovakia	economic situation	2014/7-8; 2013/10
Slovenia	economic situation	2014/7-8; 2013/10
Ukraine	economic situation	2014/7-8; 2013/11
	foreign trade	2014/1
	politics and the economy	2014/3; 2013/7
Regional	CESEE economic situation	2013/11
(EU, Eastern Europe, CIS)	corporatism and wage share	2014/6
multi-country articles	debt and financial stability	2013/8-9
and statistical overviews	EU budget	2013/7
	EU convergence	2014/6
	EU Common Agricultural Policy	2014/1
	European financial policy	2013/12
	impact of the Fed's tapering	2014/2
	MENA values	2013/8-9
	migration and mobility patterns	2014/4
	NMS automotive industry	2014/2; 2013/8-9
	NMS import elasticities	2013/12
	Russia and Ukraine	2014/1
	R&D investment	2014/2
	sources of economic growth	2014/2
	services trade	2014/2
	South Stream pipeline	2014/5
	trade and employment	2014/3
	trade between Bulgaria and Romania	2014/5
	unit labour costs in the EU	2013/7
	vertical trade	2014/3
	wages and employment in the Balkans	2014/6

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