# EMERGING EUROPE ECONOMIC OUTLOOK

Q4 2016

## Stuck in the slow lane

- Having slowed in Q3, we expect growth in Emerging Europe to recover over the course of the next year as Russia continues to pull out of recession and investment in the Central European economies rebounds. However, the overall pace of growth will remain subdued. In Russia, while conditions in industry should improve, consumers will remain under pressure as fiscal policy tightens. In Central Europe, investment should strengthen, but there is now limited spare capacity in the region's economies, meaning the scope for a significant recovery in output has diminished. Finally, in Turkey, while the economic impact of July's coup attempt is starting to fade, financial vulnerabilities and tightening external funding conditions will push growth lower in 2017. The upshot is that our forecasts for growth in the region generally lie below the consensus. All told, we expect regional GDP to expand by just 1.8% next year and 2.0% in 2018.

- **Russia's** economy should return to positive growth around the turn of the year, but activity will remain weak. Inflation and interest rates are likely to fall further than most expect next year. A Trump presidency may lead to a softening of US-Russia relations, but any lifting of sanctions will be gradual and will have a limited impact on the economic and financial market outlook. (Page 4.)

- The economic impact of July's coup attempt in **Turkey** is starting to fade but the country's financial and external vulnerabilities remain sizeable. We expect the lira to fall and interest rates to be hiked next year. Consensus expectations for GDP growth in 2017-18 are far too optimistic. (Page 5.)

- Growth in Central Europe should strengthen a little in 2017, driven by a pick-up in **Poland** and **Hungary**. In contrast, growth in the **Czech Republic** and **Slovakia** is likely to slow a touch, albeit from a relatively rapid pace. (Pages 6–9.) Monetary policy in the region will be looser than the markets are pricing in.

- **Romania's** economy should remain the best performer in Emerging Europe next year, but monetary and then fiscal tightening will take the wind out of its sails in 2018. (Page 10.) Growth in **Bulgaria** and **Croatia** will be relatively strong in 2017-18 by the standards of recent years. (Page 11.)

- We expect growth in the **Baltic States** to strengthen in 2017-18, but not by as much as the consensus. (Page 12.) **Ukraine's** recovery should continue in the coming quarters, although it will remain slow and fragile. (Page 13.)

| North America | Europe | Asia-Pacific |
|---|---|---|
| New York | London | Singapore |
| +1 646 934 6250 | +44 20 7823 5000 | +65 6595 5190 |
| Toronto | | Sydney |
| +1 416 413 0428 | | +61 2 9083 6800 |

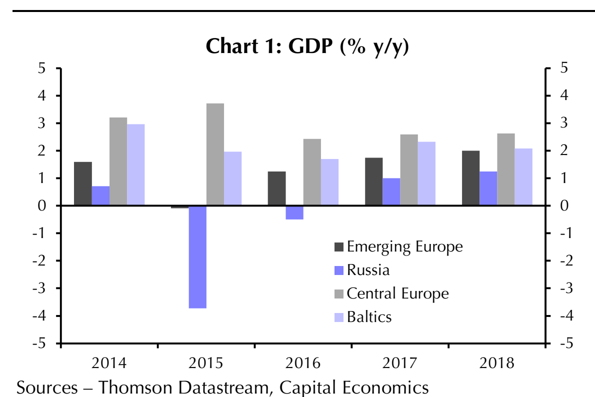
Chief Emerging Markets Economist — Neil Shearing (neil.shearing@capitaleconomics.com)
Senior Emerging Markets Economist — William Jackson (william.jackson@capitaleconomics.com)
Emerging Europe Economist — Liam Carson (liam.carson@capitaleconomics.com)

# Key Forecasts

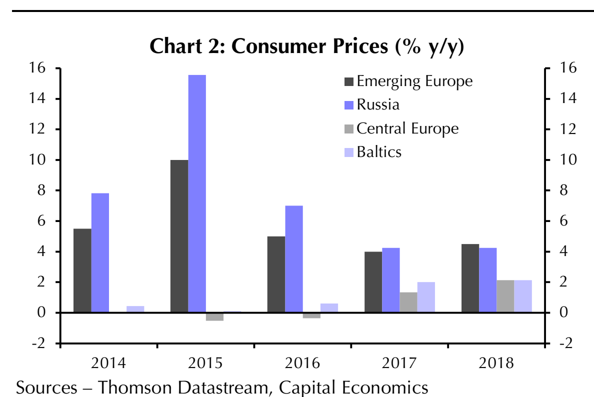
**TABLE 1: REAL GDP & INFLATION**

| % y/y | Share of World[1] | GDP[2] 2015 | 2016 | 2017 | 2018 | Inflation[2] 2015 | 2016 | 2017 | 2018 |
|---|---|---|---|---|---|---|---|---|---|
| Russia | 3.1 | -3.7 | -0.5 | 1.0 | 1.3 | 15.6 | 7.0 | 4.3 | 4.3 |
| Turkey | 1.4 | 4.2 | 2.3 | 1.8 | 2.5 | 7.7 | 7.8 | 8.5 | 7.8 |
| Poland | 0.9 | 3.6 | 2.5 | 2.8 | 2.8 | -0.9 | -0.8 | 1.3 | 2.0 |
| Romania | 0.4 | 3.8 | 4.8 | 3.8 | 1.8 | -0.6 | -1.5 | 1.8 | 3.3 |
| Ukraine | 0.3 | -9.9 | 1.5 | 3.0 | 4.0 | 48.5 | 13.5 | 5.5 | 5.0 |
| Czech Republic | 0.3 | 4.6 | 2.6 | 2.3 | 2.5 | 0.3 | 0.5 | 1.8 | 2.5 |
| Hungary | 0.2 | 3.1 | 1.8 | 2.5 | 2.3 | -0.1 | 0.3 | 1.3 | 2.3 |
| Slovakia | 0.1 | 3.6 | 3.0 | 2.5 | 2.8 | -0.3 | -0.5 | 1.3 | 2.0 |
| Bulgaria | 0.1 | 3.6 | 3.5 | 2.5 | 2.8 | -0.1 | -0.8 | 1.0 | 1.5 |
| Croatia | 0.1 | 1.6 | 2.5 | 3.0 | 3.0 | -0.5 | -1.3 | 0.8 | 1.5 |
| Lithuania | 0.1 | 1.7 | 2.0 | 2.8 | 2.3 | -0.9 | 1.0 | 2.0 | 2.0 |
| Latvia | 0.04 | 2.7 | 1.8 | 2.3 | 2.3 | 0.2 | 0.3 | 2.0 | 2.3 |
| Estonia | 0.03 | 1.4 | 1.0 | 1.5 | 1.5 | 2.2 | 0.3 | 2.0 | 2.3 |
| **Emerging Europe** | 7.1 | -0.1 | 1.3 | 1.8 | 2.0 | 10.0 | 5.0 | 4.0 | 4.5 |
| **G4 Countries** | | | | | | | | | |
| US | 15.6 | 2.6 | 1.5 | 2.1 | 1.7 | 0.1 | 1.2 | 2.5 | 2.8 |
| Euro-zone | 12.2 | 1.9 | 1.5 | 1.0 | 1.5 | 0.0 | 0.2 | 1.2 | 1.3 |
| Japan | 4.1 | 0.5 | 0.8 | 0.8 | 0.5 | 0.8 | -0.2 | 1.0 | 1.3 |
| UK | 2.3 | 2.2 | 2.0 | 1.5 | 2.5 | 0.0 | 0.6 | 2.2 | 3.0 |

(1) %, 2016, in PPP terms. (2) All % y/y annual average.



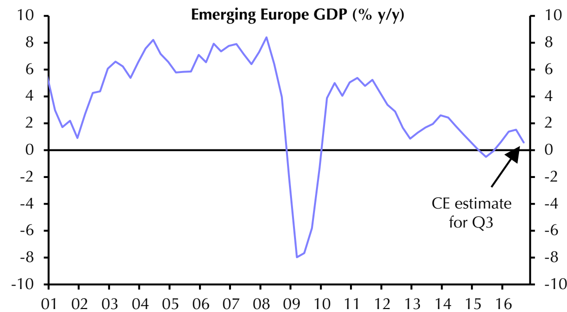
Sources – Thomson Datastream, Capital Economics



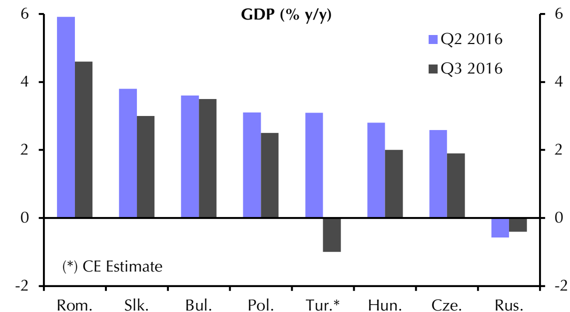
Sources – Thomson Datastream, Capital Economics

# Overview

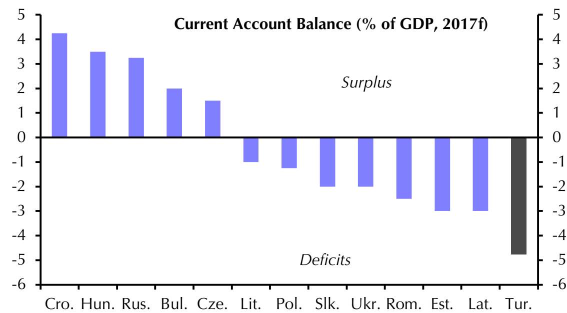
**Growth in Emerging Europe as a whole slowed in Q3…**




**…which was mainly due to a coup-induced slump in Turkey.**

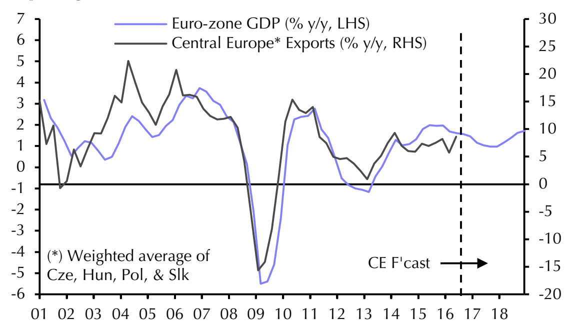



**The hit from the coup attempt should fade. But Turkey's large current account deficit makes it vulnerable to Fed tightening. Growth will be much weaker than most think.**

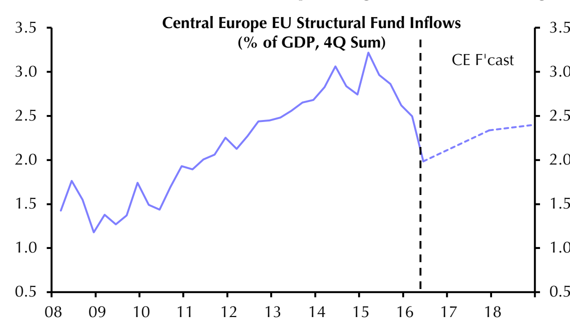



**Russia's recovery stalled in Q3. A modest rise in oil prices should pull the economy out of recession next year, but grow will be sluggish. Hopes for a Trump boost look misplaced.**

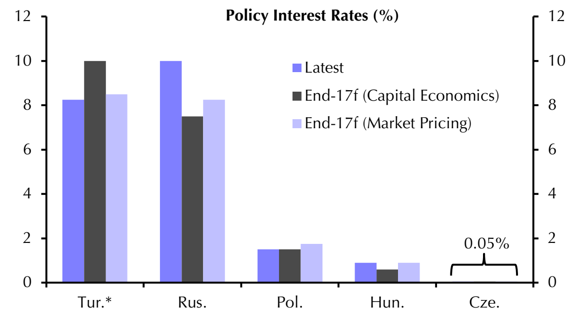
**In Central Europe, weaker demand from the euro-zone will pull export growth a little lower in 2017.**




**But an upturn in EU structural funds should support a recovery in investment. And consumer spending will remain strong.**

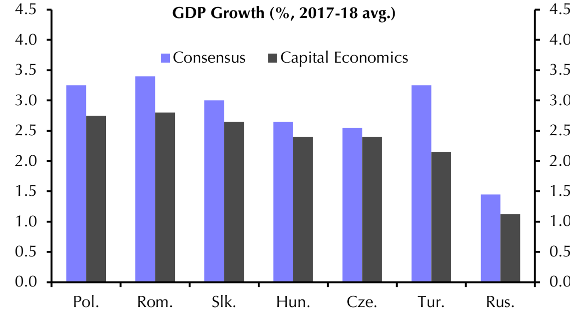



**Low or falling inflation means interest rates will generally be lower than the markets expect. But rate hikes loom in Turkey.**




(*) Turkey is overnight lending rate.

**Overall, we see a modest pick-up in growth in Russia and Central Europe. But our forecasts lie below the consensus.**




Sources – Thomson Datastream, Focus Economics, Capital Economics

# Russia

## *Set for slow recovery, interest rates to fall*

- Russia's economy should pull out of recession around the turn of the year, but growth will be sluggish. The central bank has struck a hawkish note, although we still expect large interest rate cuts over the next 12 months.

- The economic recovery stalled in the third quarter, as GDP contracted by 0.4% y/y, in line with Q2's outturn. A Donald Trump presidency may result in a softening of US-Russia relations, but any lifting of sanctions will be gradual. We don't see this having a major impact on the economic outlook. Global oil prices will play a far more important role.

- We expect the price of Brent crude oil to rise modestly in 2017, reaching $60pb by year end, which should boost Russia's income by the equivalent of 2.5% of GDP. The rise in oil prices and the end of a one-off boost to military spending will bring down the budget deficit to around 3% of GDP. That shortfall will be financed largely from the government's oil funds, although we still expect further fiscal tightening. Consumers will remain under pressure as a result.

- All told, GDP growth should return to positive territory around the turn of year. But the slow rise in oil prices means growth will be sluggish, at 1.0-1.3% in 2017-18. (See Chart 1.)

- Weak domestic demand growth, coming in the context of an economy with slack created by the recent recession, will help to bring inflation down towards the central bank's 4% target by mid-2017. (See Chart 2.) Policymakers have struck a hawkish note, but we think falling inflation will still lead to large rate cuts. We expect the one-week repo rate to be lowered to 7.50% in 2017 and 6.00% in 2018 (from 10.00% now), which is lower than the markets are pricing in. (See Chart 3.)

**Chart 1: GDP (% y/y)**

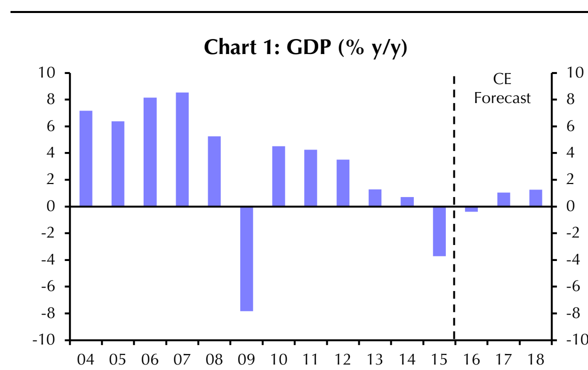



**Chart 2: Consumer Prices (% y/y)**

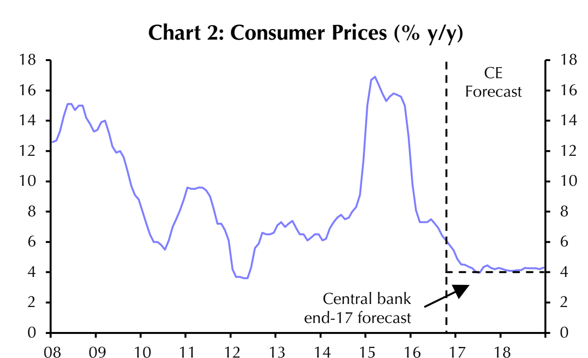



**Chart 3: One-Week Repo Rate (%)**

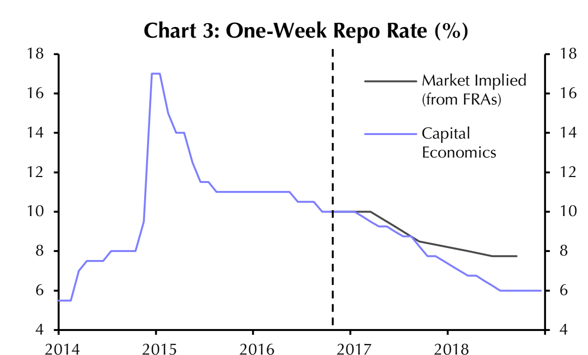



**Table 1: Key Forecasts** %y/y unless stated

| | 2014 | 2015 | 2016 | 2017 | 2018 |
|---|---|---|---|---|---|
| GDP | 0.7 | -3.7 | -0.5 | 1.0 | 1.3 |
| Unemp. rate (%) | 5.2 | 5.6 | 5.7 | 5.5 | 5.3 |
| CPI inflation | 7.8 | 15.6 | 7.0 | 4.3 | 4.3 |
| | | | | | |
| Gen'l gov't bal(1) | -0.6 | -2.8 | -3.8 | -2.8 | -2.0 |
| Gen'l gov't debt(1) | 15.9 | 16.4 | 17.0 | 17.5 | 18.5 |
| Current account(1) | 2.9 | 5.3 | 3.8 | 3.3 | 3.0 |
| | | | | | |
| Interest Rate (%)(2) | 17.00 | 11.00 | 10.00 | 7.50 | 6.00 |
| RUB/USD(2) | 60.0 | 73.0 | 66.0 | 60.0 | 58.0 |

Sources – Thomson Datastream, CE. (1) as % of GDP, (2) Year-end

# Turkey

## *Coup impact fading, but financial vulnerabilities remain*

- The economic effects of July's attempted coup are starting to fade but underlying financial vulnerabilities suggest that the consensus view on growth in 2017-18 is far too optimistic.

- Consumer spending and investment appear to have slumped in the wake of July's coup attempt – our GDP Tracker suggests Turkey's economy may even have contracted in Q3. (See Chart 1.) We suspect that the worst has probably now passed. Indeed, business surveys have strengthened at the start of Q4. Fiscal policy is likely to be loosened in 2017.

- But large vulnerabilities continue to cloud the outlook. The current account deficit remains wide – in no small part due to weakness in tourism – keeping the economy reliant on external funding. If we're right in thinking that the Fed will tighten policy by more than the markets expect in 2017-18, the cost of external finance will rise and the lira is likely to come under further pressure. We see it falling to 3.75/$ by end-17 and 4.00/$ by end-18 (from 3.4/$ now).

- A weaker currency will add to inflationary pressures. We think that the headline rate will stay far above target in 2017-18. (See Chart 2.) These factors are likely to force the MPC to reverse the recent easing cycle. We expect the O/N lending rate to be hiked to 10.0% next year, from 8.25% currently.

- All told, we see GDP growth of just 1.8% in 2017 and 2.5% in 2018, both of which are well below the consensus. (See Chart 3.) If anything, though, we think that risks are skewed to the downside. A likely attempt to introduce a presidential political system next year could spook investors. And we remain concerned about banking sector risks following the past decade's credit boom.

**Chart 1: Turkey GDP & CE GDP Tracker (% y/y)**

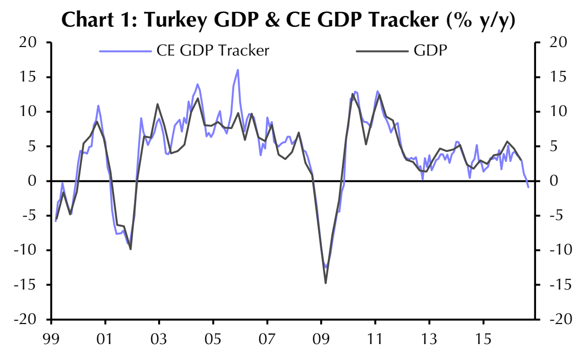



**Chart 2: Consumer Prices (% y/y)**

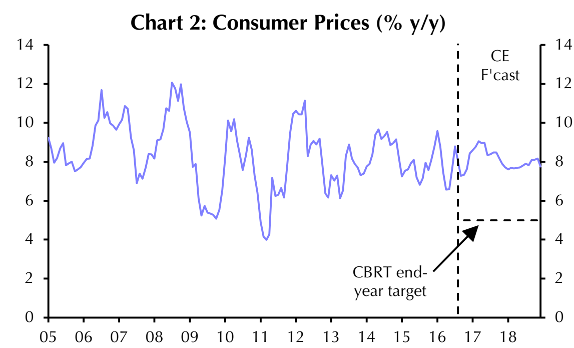



**Chart 3: GDP (% y/y)**

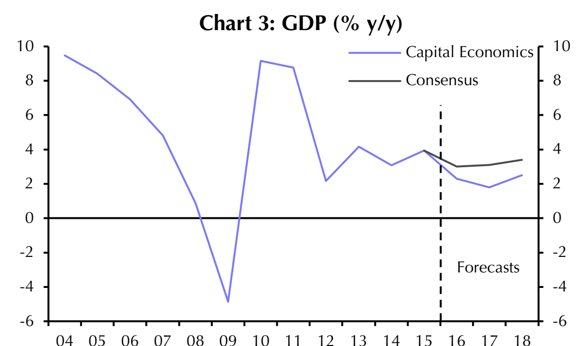



**TABLE 1: KEY FORECASTS** %y/y unless stated

| | 2014 | 2015 | 2016 | 2017 | 2018 |
|---|---|---|---|---|---|
| GDP | 3.0 | 4.2 | 2.3 | 1.8 | 2.5 |
| Unemp. rate (%) | 10.0 | 10.3 | 10.5 | 11.5 | 11.0 |
| CPI inflation | 8.9 | 7.7 | 7.8 | 8.5 | 7.8 |
| Gen'l gov't bal[1] | -0.9 | -1.0 | -1.8 | -2.8 | -2.8 |
| Gen'l gov't debt[1] | 33.5 | 32.9 | 31.5 | 31.5 | 31.0 |
| Current account[1] | -5.5 | -4.5 | -4.8 | -4.8 | -5.0 |
| 1-Week Rate (%)[2] | 8.25 | 7.50 | 7.50 | 7.50 | 7.50 |
| O/N Rate (%)[2] | 11.25 | 10.75 | 8.25 | 10.00 | 10.00 |
| TRY/USD[2] | 2.33 | 2.92 | 3.40 | 3.75 | 4.00 |

Sources – Thomson Datastream, CE. (1) as % of GDP, (2) Year-end

# Poland

*Growth to fall short of (high) expectations*

- Growth in the Polish economy is likely to be a little stronger in the coming quarters, but not as fast as the consensus or the National Bank expects. Monetary policy will remain looser for longer than the markets are pricing in.

- GDP growth slowed to 2.5% y/y in Q3, its weakest pace in three years. The annual growth rate is likely to weaken below 2% y/y in Q4, in part due to unfavourable base effects.

- The economy should recover in early 2017. In particular, we think investment will rebound from its recent slump as EU structural fund inflows increase. However, the rebound won't be dramatic. While the strong labour market and loose fiscal policy (particularly the filtering through of higher child benefit spending) will support robust consumer spending growth, the impact of rising inflation (see Chart 1) will offset that. As such, we don't expect household spending growth to accelerate. Meanwhile, demand from the euro-zone is likely to weaken next year, weighing on Polish exports.

- All told, we see GDP growth peaking at around 3% y/y in H2 2017, and averaging 2.8% over the course of both 2017 and 2018. These forecasts are lower than those of the consensus and the National Bank. (See Chart 2.) The shift to more populist policymaking is a risk to the outlook, but it's something that's likely to have an impact in 3-5 years, not the next 1-2 years.

- The MPC has proven to be more hawkish than we anticipated, so we have taken out our forecast for a 25bp interest rate cut. Equally, with inflation unlikely to reach the Bank's target and growth to fall short of expectations, we don't think the conditions will be in place for the 50bp of rate hikes that the markets are pricing in by end-2018. (See Chart 3.)

**Chart 1: Consumer Prices (% y/y)**

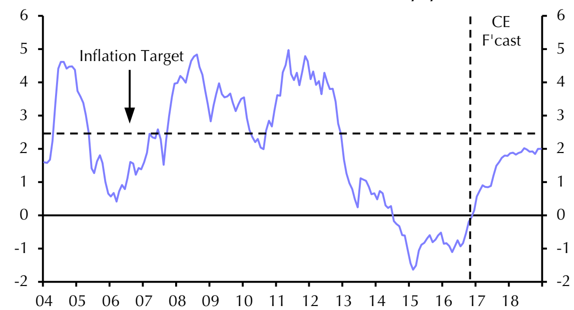



**Chart 2: GDP Growth (%)**

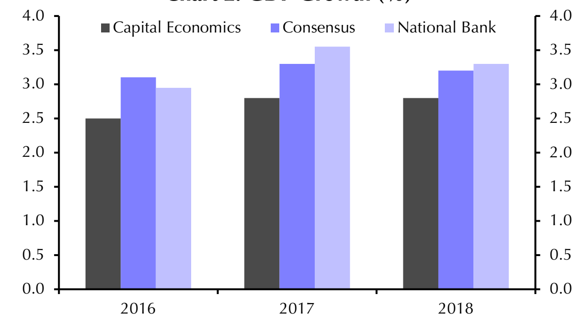



**Chart 3: Policy Interest Rate (%)**

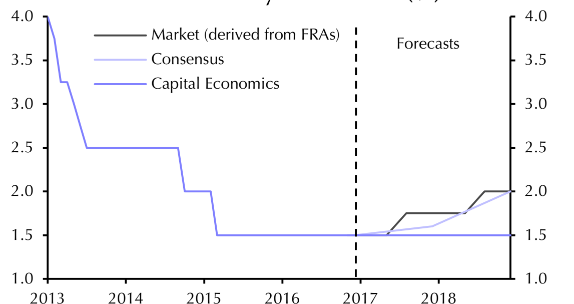



**TABLE 1: KEY FORECASTS** %y/y unless stated

| | 2014 | 2015 | 2016 | 2017 | 2018 |
|---|---|---|---|---|---|
| GDP | 3.3 | 3.6 | 2.5 | 2.8 | 2.8 |
| Unemp. rate (%) | 9.0 | 7.5 | 6.0 | 5.8 | 5.8 |
| CPI inflation | 0.0 | -0.9 | -0.8 | 1.3 | 2.0 |
| | | | | | |
| Gen'l gov't bal[(1)] | -3.4 | -2.5 | -2.6 | -3.0 | -3.3 |
| Gen'l gov't debt[(1)] | 50.5 | 52.0 | 53.5 | 54.5 | 55.5 |
| Current account[(1)] | -2.1 | -0.8 | -0.8 | -1.3 | -2.0 |
| | | | | | |
| Interest Rate (%)[(2)] | 2.00 | 1.50 | 1.50 | 1.50 | 1.50 |
| PLN/EUR[(2)] | 4.18 | 4.27 | 4.40 | 4.35 | 4.25 |

Sources – Thomson Datastream, NBP, Focus Economics, CE
(1) as % of GDP, (2) Year-end

# Czech Republic

*Growth to settle at a slower pace, big koruna jump unlikely*

- Growth in the Czech economy is likely to settle at a more modest pace of 2.3-2.5% y/y in 2017-18. The National Bank will lift the exchange rate ceiling in the middle of next year, but expectations for a sharp currency jump – as happened to the Swiss franc last year – look wide of the mark.

- GDP growth slowed to just 1.9% y/y in Q3 from 2.6% y/y in Q2 and the rates of 4%-plus enjoyed in 2015. Growth is likely to pick up a little in the coming quarters as this year's slump in investment turns. But we don't expect a sharp rebound. To start with, exports (which are equivalent to over 80% of GDP) will weaken next year as the euro-zone economy slows. Meanwhile, despite the healthy public finance position, the government seems unwilling to loosen fiscal policy.

- Finally, although strong labour market and credit conditions should support robust consumer spending growth, that will be partially offset by the fading boost from lower oil prices. All told, we expect GDP growth of 2.3% in 2017 and 2.5% in 2018. (See Chart 1.) These forecasts are a touch below consensus.

- The fading drag from low oil prices and the erosion of economic slack will push inflation up over the coming year. (See Chart 2.) This is likely to prompt the MPC to lift the koruna cap in mid-17. Expectations that the koruna will rise sharply, as the Swiss franc did when the SNB lifted its franc/euro cap last year, look misplaced. Measures such as the real effective exchange rate and unit labour costs are in line with long-run averages, suggesting the koruna is fairly valued. (See Chart 3.) Accordingly, whereas the franc rose by 20% against the euro when its cap was lifted, we think gains in the koruna will be limited to 1-2%. Interest rates are likely to remain near zero until 2018.

**Chart 1: GDP (% y/y)**

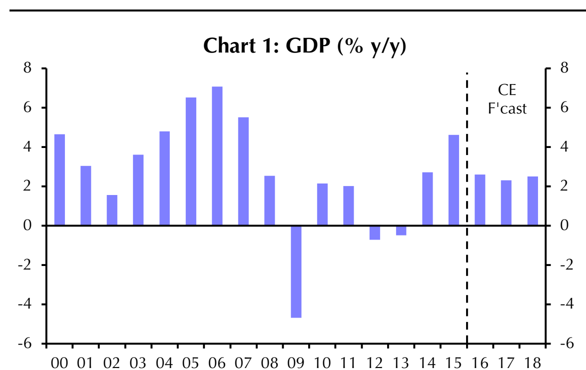



**Chart 2: Consumer Prices (% y/y)**

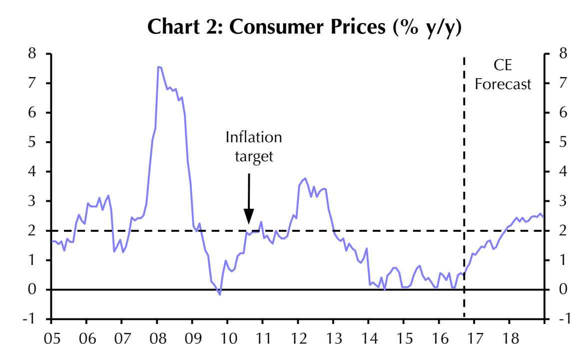



**Chart 3: Manufacturing Unit Labour Costs & Real Effective Exchange Rate (Index, 10-year avg. = 100)**

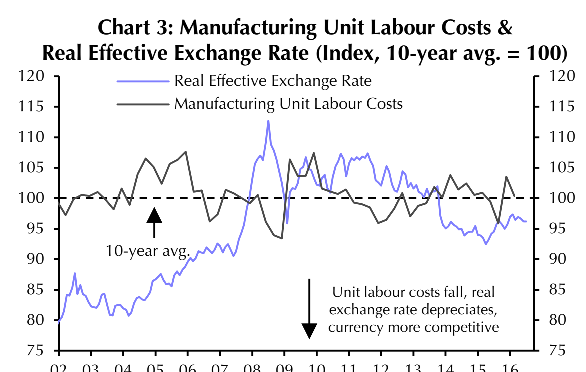



**TABLE 1: KEY FORECASTS** %y/y unless stated

| | 2014 | 2015 | 2016 | 2017 | 2018 |
|---|---|---|---|---|---|
| GDP | 2.7 | 4.6 | 2.6 | 2.3 | 2.5 |
| Unemp. rate (%) | 6.1 | 5.1 | 4.0 | 3.8 | 3.8 |
| CPI inflation | 0.4 | 0.3 | 0.5 | 1.8 | 2.5 |
| | | | | | |
| Gen'l gov't bal[1] | -1.9 | -0.7 | -0.8 | -0.5 | 0.0 |
| Gen'l gov't debt[1] | 42.7 | 41.1 | 40.5 | 39.5 | 37.5 |
| Current account[1] | 0.2 | 0.9 | 2.3 | 1.3 | 0.8 |
| | | | | | |
| Interest Rate (%)[2] | 0.05 | 0.05 | 0.05 | 0.05 | 0.50 |
| CZK/EUR[2] | 27.6 | 27.0 | 27.0 | 26.5 | 26.0 |

Sources – Thomson Datastream, CE. (1) as % of GDP, (2) Year-end

# Hungary

## *Growth to recover – but consensus too optimistic*

- Hungary's economy should accelerate in 2017 but we think that growth will still be weaker than policymakers and most analysts expect. This, coupled with low inflation, may yet prompt further (albeit small) cuts in interest rates.

- GDP growth slowed to 2.0% y/y in Q3 from 2.6% in Q2. Taking into account Q1's weak outturn, the economy looks set to grow by a disappointing 1.8% over 2016 as a whole. But there should be a modest recovery in 2017-18.

- The drag from investment, caused by a fall in EU fund inflows, will fade in 2017. And fiscal policy is likely to be loosened further. This, coming alongside record low unemployment, will support consumer spending. Moreover, with bank and household balance sheets in far healthier shape, the big contraction in credit may ease. However, exports could soften as growth in the euro-zone slows a touch. (See Chart 1.) All told, we expect Hungary's economy to grow by 2.5% in 2017 and 2.3% in 2018. (See Chart 2.) This would be an improvement from this year, but these forecasts are still below those of the consensus and the central bank.

- Headline inflation is set to rise in the coming months. While a planned cut to VAT in January will push down core inflation, this will be more than offset by a rebound in food and energy inflation. Even so, inflation won't reach the MPC's 3% target. (See Chart 3.) That and slower-than-expected GDP growth means we see scope for monetary loosening. The MNB's unconventional measures have so far had little success and we think that straightforward interest rate cuts will (once again) become the instrument of choice. We have pencilled in 30bp of cuts to the three-month deposit rate next year, taking it from 0.90% to 0.60%.

**Chart 1: Hungary Exports & Euro-zone GDP (% y/y)**

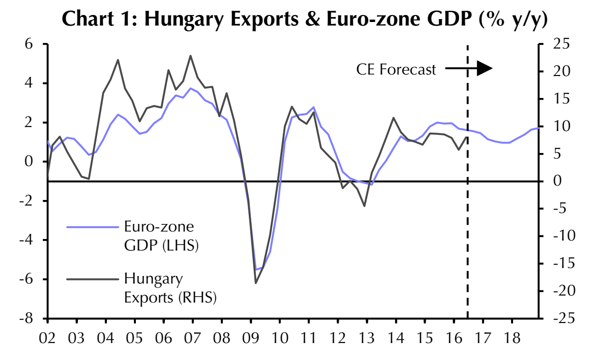



**Chart 2: GDP (% y/y)**

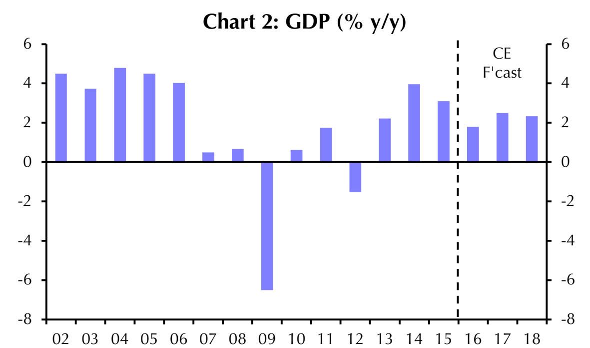



**Chart 3: Consumer Prices (% y/y)**

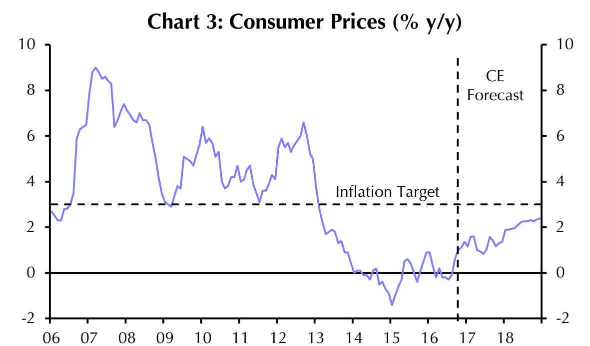



**TABLE 1: KEY FORECASTS** %y/y unless stated

| | 2014 | 2015 | 2016 | 2017 | 2018 |
|---|---|---|---|---|---|
| GDP | 4.0 | 3.1 | 1.8 | 2.5 | 2.3 |
| Unemp. rate (%) | 7.8 | 6.8 | 5.3 | 5.0 | 5.0 |
| CPI inflation | -0.2 | -0.1 | 0.3 | 1.3 | 2.3 |
| | | | | | |
| Gen'l gov't bal[(1)] | -2.3 | -2.0 | -2.0 | -3.0 | -3.0 |
| Gen'l gov't debt[(1)] | 76.2 | 75.3 | 75.5 | 76.0 | 75.5 |
| Current account[(1)] | 2.1 | 3.4 | 4.3 | 3.3 | 2.5 |
| | | | | | |
| Interest Rate (%)[(2)] | 2.10 | 1.35 | 0.90 | 0.60 | 0.60 |
| HUF/EUR[(2)] | 315 | 313 | 310 | 305 | 300 |

Sources – Thomson Datastream, Eurostat, CE. (1) % of GDP, (2) Year-end

# Slovakia

## *Growth to nudge down as boost from lower oil fades*

- Slovakia's economy is likely to slow a little next year as tighter fiscal policy weighs on domestic demand and the boost from lower oil prices fades. We think that growth will be weaker than most expect.

- GDP growth slowed from 3.4% y/y in Q2 to 3.0% y/y in Q3. The slowdown appears to have been driven by a slump in investment on the back of falling EU structural fund inflows. And the economy is unlikely to regain momentum in the coming quarters.

- Weaker demand from the euro-zone next year will cause export growth in Slovakia's highly-open economy to soften. On the domestic front, despite the healthy state of the public finances, the government looks set to tighten fiscal policy. Indeed, Slovakia is likely to be one of the few economies in the region to tighten policy over the next couple of years. (See Chart 1.)

- The strengthening labour market and easier credit conditions (helped by loose ECB policy) should support rapid household spending growth. But this too is likely to weaken in 2017 as the windfall from low oil prices fades. (See Chart 2.) The main boost to the economy will come from investment, which should recover by the middle of next year as the drag from the fall in EU structural funds eases. And the construction of the Jaguar Land Rover plant (scheduled to open in 2011), will also support capital spending.

- Overall, we expect a modest slowdown in growth to 2.5% in 2017, with growth picking up to 2.8% in 2018. Consensus expectations for GDP growth to stay at 3% or more in 2017-18 look a bit strong. (See Chart 3.)

**Chart 1: EC Projection of Change in Structural Govt. Budget Balance (%-pts of GDP, 2016-18)**

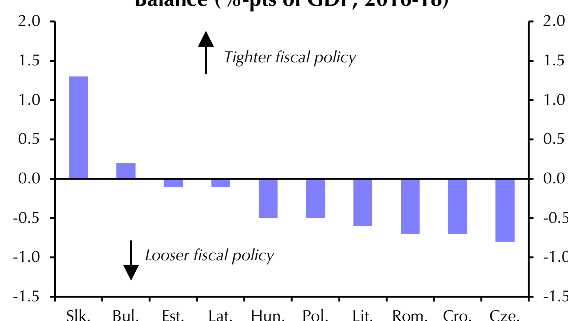



**Chart 2: Slovakia Petrol Prices & Global Oil Prices (% y/y)**

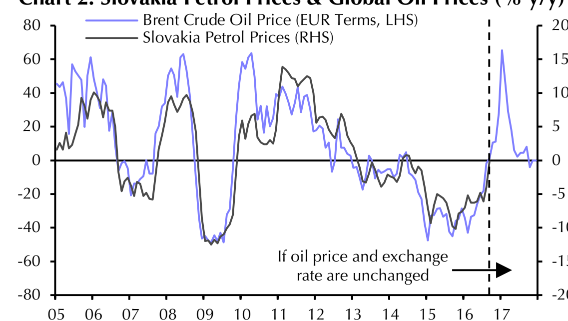



**Chart 3: GDP (% y/y)**

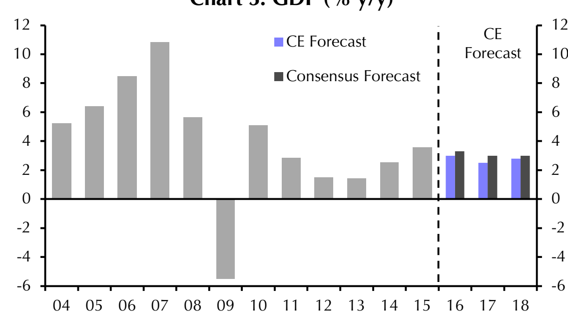



**TABLE 1: KEY FORECASTS** %y/y unless stated

| | 2014 | 2015 | 2016 | 2017 | 2018 |
|---|---|---|---|---|---|
| GDP | 2.5 | 3.6 | 3.0 | 2.5 | 2.8 |
| Unemp. rate (%) | 13.2 | 11.5 | 9.7 | 9.0 | 8.8 |
| CPI inflation | -0.1 | -0.3 | -0.5 | 1.3 | 2.0 |
| Gen'l gov't bal(1) | -2.7 | -2.7 | -2.3 | -1.8 | -1.0 |
| Gen'l gov't debt(1) | 53.9 | 52.9 | 54.0 | 53.5 | 52.5 |
| Current account(1) | 1.2 | 0.2 | 1.3 | 0.5 | 0.3 |
| ECB refi rate (%)(2) | 0.05 | 0.05 | 0.00 | 0.00 | 0.00 |
| USD/EUR(2) | 1.21 | 1.09 | 1.10 | 1.00 | 1.00 |

Sources – Thomson Datastream, EC, CE. (1) as % of GDP, (2) Year-end

# Romania

*Boom to continue into 2017, but slowdown likely in 2018*

- We expect Romania to be the fastest-growing economy in the region in 2017. But concerns about overheating are likely to prompt tighter monetary and then fiscal policy, taking the wind out of the economy's sails in 2018.

- GDP grew by 4.4% y/y in Q3. While this was weaker than Q2's outturn of 6.0% y/y, Romania was still the fastest-expanding economy in Emerging Europe. We expect growth to remain rapid in 2017.

- Admittedly, with the euro-zone economy likely to slow, exports are unlikely to fare well. But domestic demand will remain strong. There's some uncertainty about the direction of fiscal policy due to parliamentary elections in December. But as thing stand, it looks like it will be loosened further. Public sector pay rises alone could boost spending by as much as 0.6% of GDP. That, together with the lowest unemployment rate in eight years, means wage growth will stay robust. Consumer spending is likely to grow by around 10% next year.

- However, strong domestic demand is set to push inflation above the central bank's 2.5% target and cause the current account deficit to widen. With that in mind, we think Romania's central bank will be the first in the region to tighten monetary policy. We have pencilled in 100bp of interest rate hikes in 2017 and a further 75bp of hikes in 2018. (See Chart 1.)

- The budget deficit is likely to breach the 3% of GDP Maastricht threshold next year, meaning that loose fiscal policy will be reined in by 2018. (See Chart 2.) Accordingly, while we expect above-consensus GDP growth of 3.8% in 2017, we think tightening policy will push growth below 2% in 2018. (See Chart 3.)

**Chart 1: Consumer Prices & Policy Interest Rate**

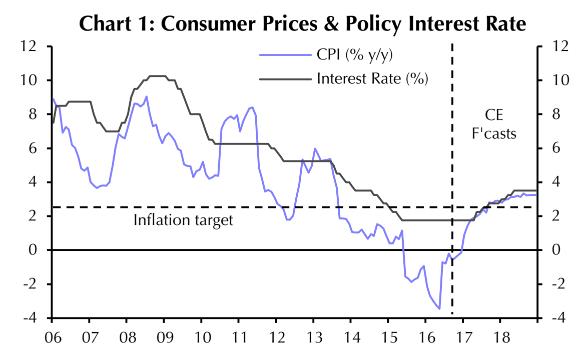



**Chart 2: General Government Balance (% of GDP)**

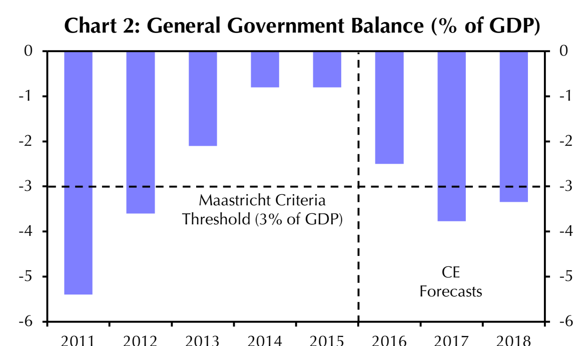



**Chart 3: GDP (% y/y)**

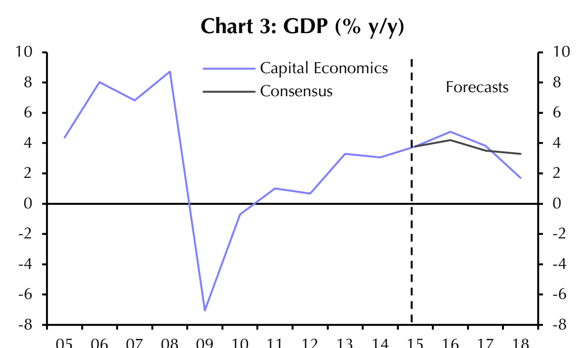



**TABLE 1: KEY FORECASTS** %y/y unless stated

| | 2014 | 2015 | 2016 | 2017 | 2018 |
|---|---|---|---|---|---|
| GDP | 3.1 | 3.8 | 4.8 | 3.8 | 1.8 |
| Unemp. rate (%) | 6.8 | 6.8 | 6.0 | 6.0 | 6.3 |
| CPI inflation | 1.1 | -0.6 | -1.5 | 1.8 | 3.3 |
| Gen'l gov't bal(1) | -0.8 | -0.8 | -2.5 | -3.8 | -3.3 |
| Gen'l gov't debt(1) | 39.8 | 38.4 | 39.5 | 41.5 | 42.5 |
| Current account(1) | -0.7 | -1.3 | -2.0 | -3.5 | -2.5 |
| Interest Rate (%)(2) | 2.75 | 1.75 | 1.75 | 2.75 | 3.50 |
| RON/EUR(2) | 4.43 | 4.46 | 4.50 | 4.70 | 4.70 |

Sources – EC, Thomson Datastream, CE. (1) as % of GDP, (2) Year-end

# Bulgaria and Croatia

*Bulgaria to surprise on the upside, Croatia to the downside*

- GDP growth in **Bulgaria** is likely to be weaker than the consensus expects in the coming quarters, but it should remain relatively strong at 2.5-3.0% in 2017-18.

- Rumen Radev's win in the presidential election has led to talk of closer ties between Bulgaria and Russia. But in reality, this is unlikely to amount to much. More generally, we don't think ongoing political instability will have much impact on the economy.

- More importantly for the outlook, weaker growth in the euro-zone and Turkey – which together account for 50% of Bulgaria's trade – will weigh on exports. And consumer spending will soften as the fading impact of cheaper oil pushes up inflation. (See Chart 1.)

- That said, we don't expect a sharp slowdown. Fiscal policy will become more supportive (see Chart 2) and the drag on investment from falling EU structural fund inflows will start to ease in early 2017. We expect GDP growth of 2.5% in 2017 and 2.8% in 2018. (See Chart 3.)

- Meanwhile, growth in **Croatia** should strengthen in 2017. After years of austerity, fiscal policy is set to be looser next year. (See Chart 2 again.) At the same time, EU structural fund inflows will be much larger in 2017-18 than in recent years. And although households face the headwind of rising fuel inflation, improving labour market conditions should support consumer spending. Moreover, tourism exports, which are equivalent to 20% of GDP, will grow at a solid pace. More fundamentally, Croatia has vast economic slack created by six years of recession. Accordingly, stronger demand should feed into robust growth.

- All told, we are forecasting stronger-than-expected GDP growth in Croatia next year.

**Chart 1: Consumer Prices (% y/y)**

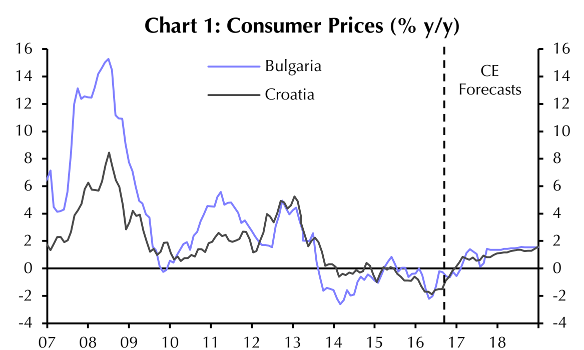



**Chart 2: Annual Change in Structural Budget Balance (% of GDP)**

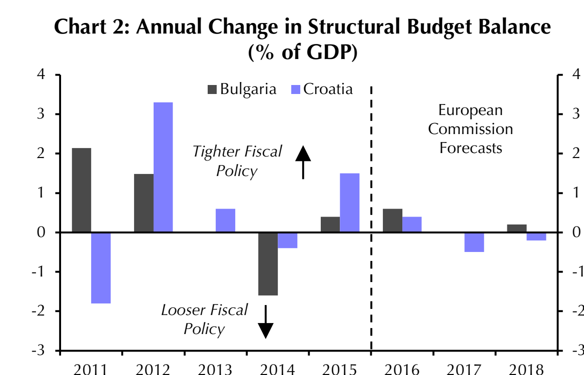



**Chart 3: GDP (% y/y)**

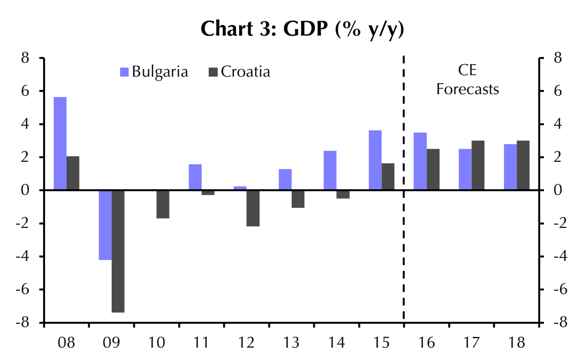



**Table 1: Key Forecasts** %y/y unless stated

| | 2014 | 2015 | 2016 | 2017 | 2018 |
|---|---|---|---|---|---|
| **Bulgaria** | | | | | |
| GDP | 2.4 | 3.6 | 3.5 | 2.5 | 2.8 |
| CPI inflation | -1.4 | -0.1 | -0.8 | 1.0 | 1.5 |
| Gen'l gov't bal(1) | -5.5 | -1.7 | -0.5 | -0.3 | -0.3 |
| Current account(1) | 0.1 | 0.4 | 2.3 | 0.8 | 0.3 |
| **Croatia** | | | | | |
| GDP | -0.5 | 1.6 | 2.5 | 3.0 | 3.0 |
| CPI inflation | -0.2 | -0.5 | -1.3 | 0.8 | 1.5 |
| Gen'l gov't bal(1) | -5.4 | -3.3 | -2.2 | -1.8 | -1.5 |
| Current account(1) | 2.1 | 5.1 | 4.3 | 3.8 | 3.5 |

Sources – Thomson Datastream, EC, CE. (1) as % of GDP

# The Baltic States

## *A slow recovery*

- GDP growth in the Baltic States should pick up in 2017-18, but it is likely to be weaker than most expect.

- The Baltic economies have all struggled in recent quarters, but there is reason to expect growth to recover in 2017-18. Export sectors should strengthen as Russia – a major trading partner of all three countries – exits recession. (See Chart 1.) The boost will be largest in Lithuania, where trade ties are greatest.

- On the domestic front, the slump in investment should ease as the sharp drop in EU structural fund inflows bottoms out around the turn of the year. The scope for a rebound in capital spending is largest in Latvia, where fixed investment fell by an enormous 20% y/y in the first half of 2016. Moreover, with ECB monetary policy extremely loose and banks' finances now in healthier shape, we think that the recent pick-up in credit growth will continue. The Baltics should also benefit from more accommodative fiscal policy.

- Tightening labour market conditions will support continued rises in wages and household consumption. Nonetheless, the windfall from falling oil prices is fading, which is set to push up inflation over the coming months. On balance, we think that means consumer spending growth will slow.

- All told, we expect GDP growth in the Baltic States to strengthen to between 1.5-2.8% a year in 2017-18, with Lithuania faring best. Even so, weaker consumer spending will mean that the pace of expansion is slower than the consensus expects. (See Chart 3.)

**Chart 1: Baltic States' Exports & Russia GDP (% y/y)**

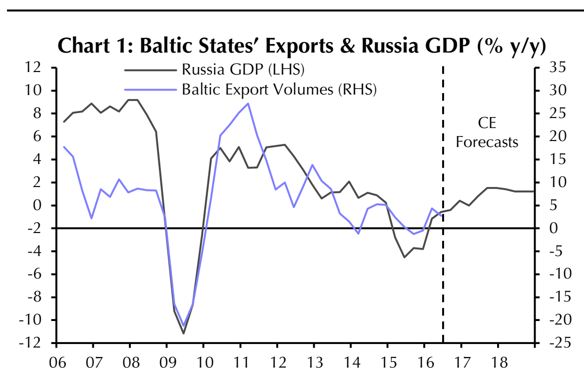



**Chart 2: Consumer Prices (% y/y)**

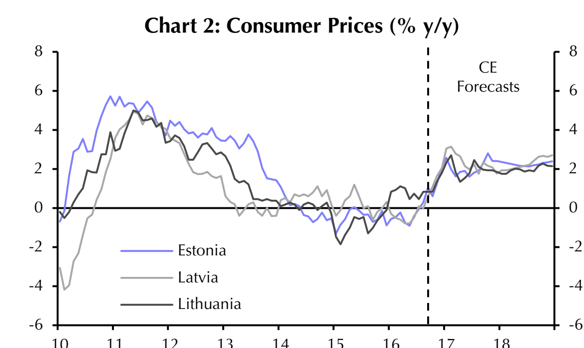



**Chart 3: GDP Growth Forecasts (%, 2017-18 Avg.)**

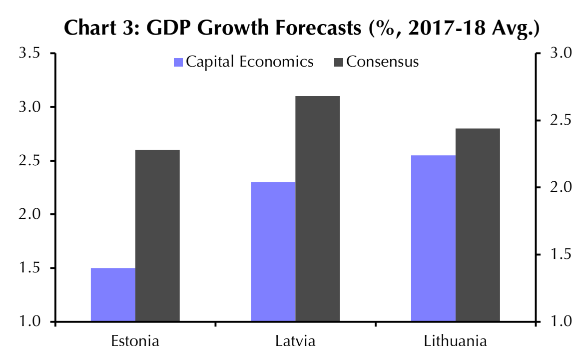



**TABLE 1: KEY FORECASTS** %y/y unless stated

| | 2014 | 2015 | 2016 | 2017 | 2018 |
|---|---|---|---|---|---|
| **Estonia** | | | | | |
| GDP | 2.8 | 1.4 | 1.0 | 1.5 | 1.5 |
| CPI inflation | 0.9 | 2.2 | 0.3 | 2.0 | 2.3 |
| **Latvia** | | | | | |
| GDP | 2.1 | 2.7 | 1.8 | 2.3 | 2.3 |
| CPI inflation | 0.6 | 0.2 | 0.3 | 2.0 | 2.3 |
| **Lithuania** | | | | | |
| GDP | 3.5 | 1.7 | 2.0 | 2.8 | 2.3 |
| CPI inflation | 0.1 | -0.9 | 1.0 | 2.0 | 2.0 |

Sources – Thomson Datastream, CE

# Ukraine

*Green shoots but vulnerabilities persist*

- Ukraine's economy has started to show some green shoots. But with the conflict in the east still unresolved, we think that the economy will only slowly recover the output lost during the past couple of years of recession.

- Ukrainian GDP has returned to positive territory, with output rising by 1.8% y/y in Q3. With the IMF deal back on track after a long delay, the risk of another sharp fall in the hryvnia and renewed debt problems has eased.

- The recovery is likely to continue in the coming quarters. Exports should return to positive growth. The currency now looks competitively valued, the hit from Russian import bans should fade, and demand from the EU should rise. Fiscal policy won't be as supportive as it has been this year, but equally we don't expect the government to tighten policy. And recent improvements in the labour market should support stronger consumption.

- That said, the economy will be slow to recover output lost during the past two years. With the conflict in the east still unresolved, capital inflows will remain low, preventing Ukraine from running a wider current account deficit. That will act as a constraint on domestic demand growth.

- Overall we see GDP expanding by 3% next year and 4% in 2018. (See Chart 1.) But while those may seem like strong growth rates, even by 2018, output will remain far below its 2013 level. (See Chart 2.) So long as Ukraine avoids further large currency falls, sizeable amounts of slack in the economy mean inflation is likely to fall further in the coming years. (See Chart 3.)

**Chart 1: GDP (% y/y)**

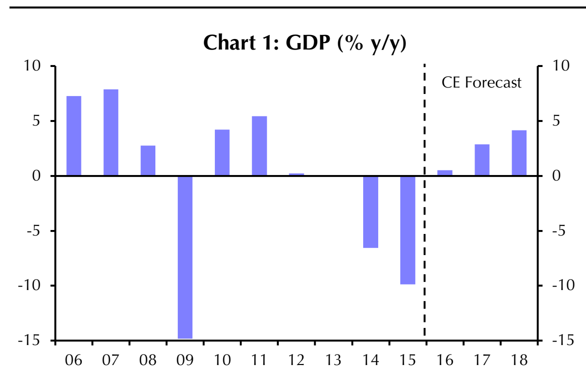



**Chart 2: GDP (Constant, SA, 2010 = 100)**

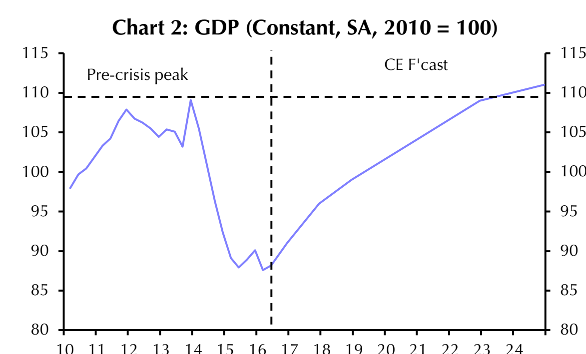



**Chart 3: Consumer Prices (% y/y)**

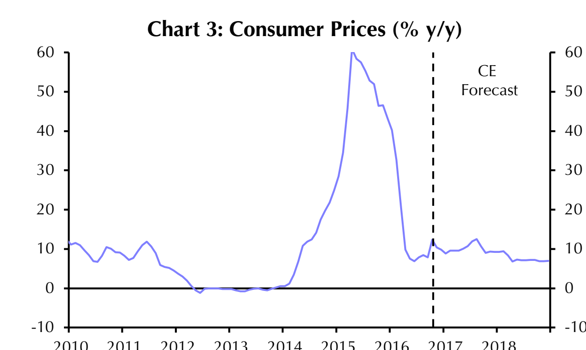



**TABLE 1: KEY FORECASTS** %y/y unless stated

| | 2014 | 2015 | 2016 | 2017 | 2018 |
|---|---|---|---|---|---|
| GDP | -6.6 | -9.9 | 1.3 | 3.0 | 4.0 |
| Unemp. rate (%) | 9.3 | 9.1 | 9.0 | 8.5 | 8.0 |
| CPI inflation | 12.1 | 48.5 | 14.5 | 10.0 | 7.5 |
| | | | | | |
| Gen'l gov't bal(1) | -4.5 | -1.2 | -3.8 | -3.5 | -3.3 |
| Gen'l gov't debt(1) | 70.3 | 80.1 | 92.0 | 90.0 | 87.5 |
| Current account(1) | -3.5 | -0.2 | -1.8 | -2.0 | -2.5 |
| | | | | | |
| Interest Rate (%)(2) | 14.0 | 22.0 | 13.0 | 9.0 | 8.0 |
| UAH/USD(2) | 15.1 | 23.9 | 26.0 | 26.0 | 26.0 |

Sources – Thomson Datastream, CE. (1) as % of GDP, (2) Year-end

# Financial Markets

*Russian asset markets to outperform – on oil, not Trump*

- We expect Emerging European equities to post reasonable gains over the next couple of years and most currencies should strengthen, at least against the euro. Russian markets should outperform – with or without any help from the lifting of Western sanctions – while those in Turkey are likely to fare poorly.

- Most equity markets should post gains of 5-15% (in local currency terms) by end-2018. (See Chart 1.) Russian stocks are set to get a lift from rising oil prices, making them the best performing in the region. Valuations look favourable in Poland (see Table 1), which should support a strong rise in equities there. The P/E ratio of Turkish equities is also low by past standards, but much weaker-than-expected GDP growth will limit the rise in local stock prices. Meanwhile, valuations in Hungary are beginning to look stretched – we expect its equity market to flat-line.

- As in the equity market, we expect rising oil prices to support Russia's currency. (See Chart 2.) Central European currencies should appreciate modestly against the euro, although they will remain weak against the dollar. The Turkish lira will be the worst performer. The country's large current account deficit and the prospect of significant monetary tightening in the US mean we expect it to weaken sharply.

- In the local currency bond market, interest rate hikes in Turkey (in response to currency weakness) are likely to push yields up. But large rate cuts in Russia will lead to a rally in its bonds. (See Chart 3.) Meanwhile, loose monetary policy in Central Europe will keep bond yields low. Dollar bond yields are likely to rise across the region as spreads widen and the yields on underlying Treasuries rises.

**Chart 1: Equity Market Forecasts Forecast (%-Change, Now to End-2018, Local Ccy.)**

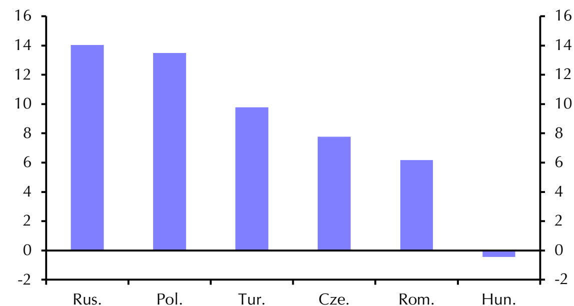



**Table 1: MSCI Price/12m Forward Earnings Ratio**

| | 5-year Average | Current |
|---|---|---|
| Czech Rep. | 11.8 | 13.6 |
| Hungary | 8.8 | 11.1 |
| Poland | 11.5 | 11.1 |
| Russia | 5.4 | 6.0 |
| Turkey | 8.8 | 7.6 |

**Chart 2: Exchange Rate Forecast (%-Change, Now to End-2018)**

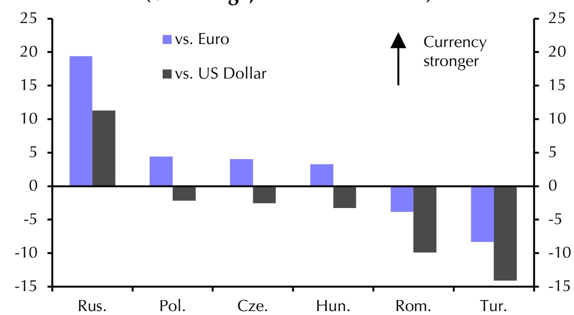
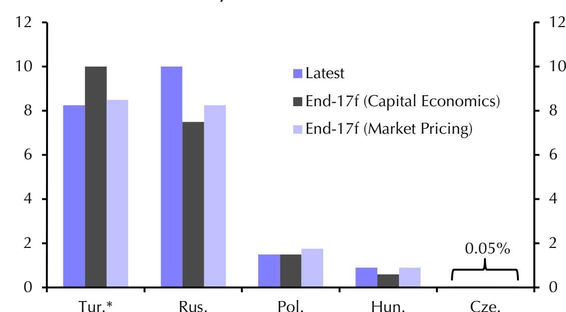



**Chart 3: Policy Interest Rate & Forecasts (%)**




Sources – Thomson Datastream, Bloomberg, Capital Economics
(*) Turkey is O/N lending rate.

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# Market Forecasts

**TABLE 1: CENTRAL BANK POLICY RATES (%)**

| | Policy Rate | Latest (22nd Nov.) | Last Change | Forecasts Next Change | End 2017 | End 2018 |
|---|---|---|---|---|---|---|
| Russia | 1W Repo Rate | 10.00 | Down 50bp (Oct 16) | Down 25bp (Feb 16) | 7.50 | 6.00 |
| **Central Europe** | | | | | | |
| Poland | Reference Rate | 1.50 | Down 50bp (Mar 15) | None on horizon | 1.50 | 1.50 |
| Czech Rep | 2W Repo Rate | 0.05 | Down 20bp (Oct 12) | Up 20bp (2018) | 0.05 | 0.50 |
| Hungary | 3M Deposit Rate | 0.90 | Down 15bp (May 16) | 15bp cut (Q1 17) | 0.60 | 0.60 |
| **South-East Europe** | | | | | | |
| Turkey | 1W Repo Rate | 7.50 | Down 25bp (Feb 15) | None on horizon | 7.50 | 7.50 |
| | O/N Lending Rate | 8.25 | Down 25bp (Sep 16) | Up 50bp (2017) | 10.00 | 10.00 |
| Romania | Reference Rate | 1.75 | Down 25bp (May 15) | Up 25bp (Q1 17) | 2.75 | 3.50 |
| Euro-zone | Refinancing Rate | -0.40 | Down 10bp (Mar 16) | Down 10bp (Q2 17) | -0.50 | -0.50 |
| US | Fed Funds Target | 0.25-0.5 | Up 25bp (Dec 15) | Up 25bp (Dec 16) | 1.25-1.5 | 2.25-2.5 |

**TABLE 2: FX RATES & EQUITY MARKETS**

| Forecasts Currency | | Latest (22nd Nov.) | End 2017 | End 2018 | Equity Market | Latest (22nd Nov.) | End 2017 | End 2018 |
|---|---|---|---|---|---|---|---|---|
| Russia/$ | RUB | 63.9 | 60.0 | 58.0 | | | | |
| Russia/EUR | RUB | 67.9 | 60.0 | 58.0 | MICEX | 2,072 | 2,200 | 2,300 |
| Russia/Basket* | RUB | 65.7 | 60.0 | 58.0 | | | | |
| Ukraine/$ | UAH | 25.7 | 26.0 | 26.0 | PFTS | 267 | 290 | 300 |
| **Central Europe** | | | | | | | | |
| Poland/EUR | PLN | 4.42 | 4.35 | 4.25 | WIG | 47,951 | 50,000 | 54,000 |
| Czech Rep/EUR | CZK | 27.0 | 26.5 | 26.0 | PSE | 892 | 950 | 975 |
| Hungary/EUR | HUF | 309 | 305 | 300 | BUX | 30,094 | 30,000 | 30,000 |
| Slovakia/EUR | EUR | N/A | N/A | N/A | SAX | 307 | 340 | 360 |
| **South-East Europe** | | | | | | | | |
| Turkey/$ | TRY | 3.36 | 3.75 | 4.00 | ISE 100 | 76,058 | 76,000 | 82,500 |
| Romania/EUR | RON | 4.51 | 4.70 | 4.70 | BET | 6,848 | 7,250 | 7,300 |
| Bulgaria/EUR | BGN | 1.96 | 1.96 | 1.96 | SOFIX | 544 | 560 | 580 |
| Croatia/EUR | HRK | 7.53 | 7.50 | 7.50 | CROBEX | 1,984 | 2,100 | 2,200 |
| **Baltics** | | | | | | | | |
| Estonia/EUR | EUR | N/A | N/A | N/A | OMX Tallinn | 1,031 | 1,030 | 1,050 |
| Latvia/EUR | EUR | N/A | N/A | N/A | OMX Riga | 737 | 725 | 740 |
| Lithuania/EUR | EUR | N/A | N/A | N/A | OMX Vilnius | 559 | 575 | 580 |
| Euro-zone/$ | EUR | 1.06 | 1.00 | 1.00 | DAX 30 | 10,742 | 11,750 | 12,250 |
| US | USD | - | - | - | S&P 500 | 2,198 | 2,300 | 2,400 |

* = (0.55 x USDRUB) + (0.45 x EURRUB)

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## Long-term Growth Prospects

| Country (ranked by potential growth rate) | Potential Growth Rate (per annum) | GDP Per Capita (mkt ex. rates) as a %-age of German | Comments |
|---|---|---|---|
| 1. Romania | 3.0% | 20% | Low income levels mean higher potential growth rates. But both countries suffer from weak banking sectors and close trade and financial ties to weaker economies in the euro-zone periphery. |
| 2. Bulgaria | 3.0% | 15% | |
| 3. Turkey | 3.0% | 20% | Unlike the rest of the region, demographics are positive for growth. But low savings and investment have led to capacity constraints and weaker potential growth. Reforms are desperately needed, but seem unlikely. |
| 4. Poland | 2.5% | 30% | Strong fundamentals: fairly low income levels, large manufacturing sector and healthy banking sector. But shift to populism under Law and Justice government means reforms may stall and medium-term prospects aren't as strong as they once were. |
| 5. Slovakia | 2.3% | 40% | Benefits from a healthy banking sector and strong trade ties to Germany. High levels of long-term unemployment could act as a drag though. |
| 6. Czech Rep. | 2.0% | 45% | Higher income level means potential GDP growth is relatively low. But its investment rate is fairly high, its banks are healthy and it benefits from strong trade ties with Germany. |
| 7. Latvia | 2.0% | 35% | After last decade's boom and bust, both economies have stabilised. But GDP growth won't return to pre-crisis highs: growth of around 2% is likely to be the new norm. |
| 8. Lithuania | 2.0% | 35% | |
| 9. Estonia | 1.8% | 40% | Higher income level means potential GDP growth is relatively low. High levels of investment and R&D expenditure may support faster productivity gains though. |
| 10. Hungary | 1.5% | 30% | Manufacturing sector benefits from strong trade ties to Germany. But wider economy is likely to be held back by low rates of investment, a fragile banking sector and a large overhang of debt. |
| 11. Russia | 1.5% | 25% | Lower oil prices, a lack of progress on structural reforms and poor demographics cloud the medium-term outlook. The prospects of a much-needed shift in policy are limited under the current government, which will stay in power until 2018. |

# The Path to EMU

**Summary**

Lithuania became the 19th member of the euro-zone last year, but looks likely to be the last country in the region to join for the foreseeable future. Admittedly, most countries now fulfil the Maastricht criteria for entry into the single currency zone. But they would still need to spend two years in ERMII (keeping their exchange rates closely tied to the euro). More fundamentally, there has for some time been little popular appetite for joining the euro and the UK's vote to leave the EU in June only caused anti-European sentiment to strengthen.

| | | Likely EMU entry date | Developments since last EEEO | Comment |
|---|---|---|---|---|
| **Non-ERM II Members** | Czech Rep. | 2020+ | Neutral | Fulfils debt, deficit, interest rate and inflation criteria. But government has stated it won't enter ERMII until after the next legislative election in 2017, and the Prime Minister has shied away from setting a target entry date. Public opinion is sceptical. |
| | Poland | 2020+ | Negative | Fulfils debt, deficit, interest rate and inflation criteria. But extremely unlikely to happen under the Law and Justice government. Indeed, local politicians have become increasingly hostile towards European oversight of domestic policy. |
| | Hungary | 2020+ | Neutral | PM Orban remains sceptical of joining the euro and the Economy Minister has stated that Hungary shouldn't adopt the currency until its level of development is closer to current euro-zone countries. In any case, public debt is well above the 60% of GDP limit and is unlikely to fall much in the coming years. |
| | Romania | 2020+ | Neutral | Romania fulfils the debt, deficit, interest rate and inflation criteria. But the government recently gave up on its plan to adopt the euro by 2019, and a new date has not been announced. |
| | Bulgaria | 2020+ | Neutral | The recent election of Rumen Radev as President, coupled with the resignation of Prime Minister Boyko Borisov, has increased uncertainty about the prospects for euro adoption. The previous PM had stated that the government would delay joining the euro for as long as possible. As it stands, this stance seems unlikely to change. |
| | Croatia | 2020+ | Neutral | Croatia has managed to reduce its budget deficit to below 3% of GDP, but the high debt-to-GDP ratio means it still does not fulfil the required criteria. And although Croatia is one of the more enthusiastic countries about joining the euro, politicians have tempered these calls in recent years. |