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Monthly Report

Recent Economic Developments in Central, East and Southeast Europe

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

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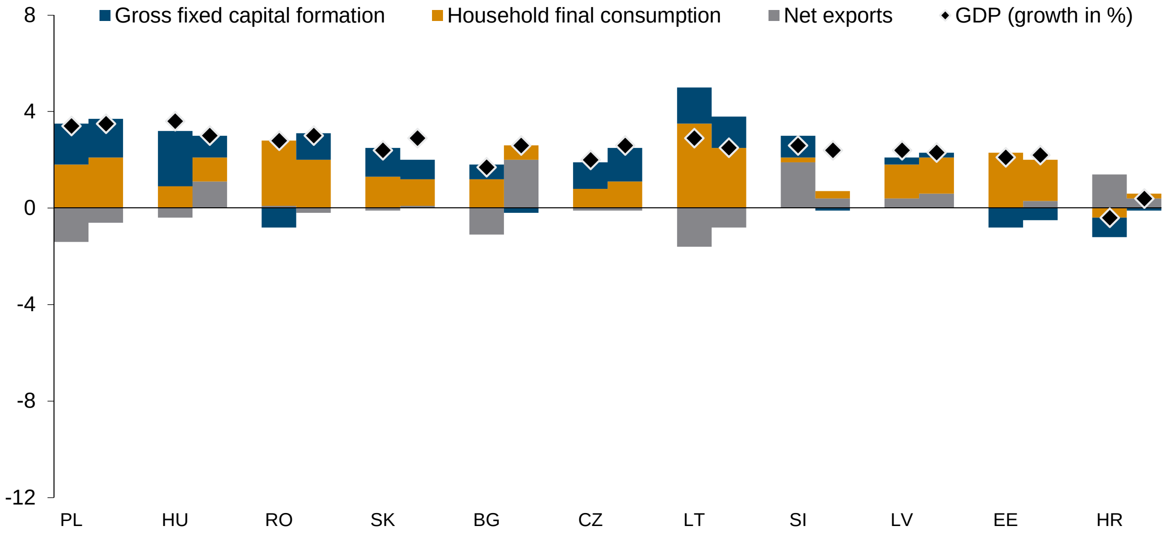
CONTENTS

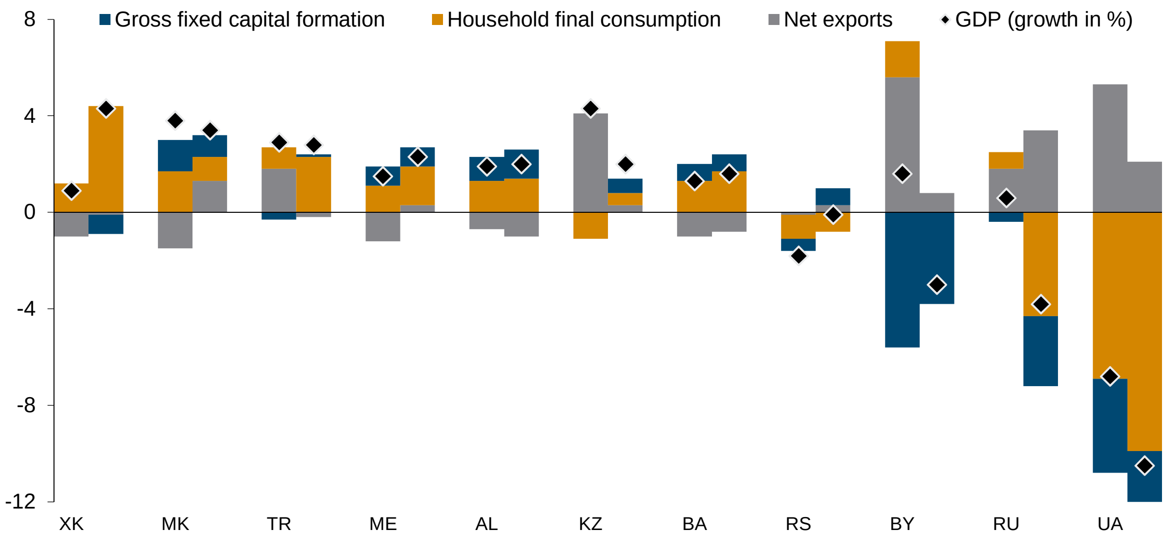
OVERVIEW 2014 AND OUTLOOK 2015-2017

	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		
	2014	2015	2016	2017	2014	2015	2016	2017	2014	2015	2016	2017	2014	2015	2016	2017	2014	2015	2016	2017
NMS-11																				
Bulgaria	1.7	2.6	2.7	3.0	2.8	-1.0	2.0	5.0	-1.6	1.0	1.5	2.0	11.4	10.5	9.5	9.0	0.9	2.3	1.1	0.0
Croatia	-0.4	0.4	1.2	1.6	-4.0	-0.5	2.5	4.0	0.2	0.4	1.0	1.4	17.3	17.5	16.5	16.0	0.7	0.9	0.5	0.0
Czech Republic	2.0	2.6	2.4	2.4	4.5	5.5	5.5	5.0	0.4	0.4	1.5	1.5	6.1	5.8	5.5	5.3	0.6	-1.0	-1.2	-1.5
Estonia	2.1	2.2	2.6	3.2	-2.8	-2.0	3.0	6.0	0.5	0.5	1.5	2.2	7.4	6.3	5.9	5.5	-0.1	-0.4	-1.8	-2.3
Hungary	3.6	3.0	2.1	2.2	11.7	4.0	2.0	3.5	0.0	0.1	2.0	3.0	7.7	7.1	6.8	6.7	4.1	4.4	4.3	4.0
Latvia	2.4	2.3	2.8	2.8	1.3	1.0	3.0	4.0	0.7	0.5	1.9	2.5	10.8	9.8	9.2	8.8	-3.1	-0.8	-1.2	-1.8
Lithuania	2.9	2.5	2.9	3.2	8.0	7.0	7.0	8.0	0.2	0.3	1.2	1.8	10.7	10.0	9.5	9.0	0.1	-0.8	-0.9	-1.0
Poland	3.4	3.5	3.3	3.2	9.2	8.0	8.0	6.0	0.1	-0.6	1.2	1.8	9.0	8.5	8.0	7.8	-1.4	-1.8	-2.2	-2.8
Romania	2.8	3.0	3.3	3.0	-3.5	5.0	4.0	3.0	1.4	0.8	1.5	2.0	6.8	6.7	6.6	6.5	-0.4	-0.6	-0.8	-1.0
Slovakia	2.4	2.9	3.3	3.4	5.7	4.0	3.5	3.5	-0.1	0.2	1.4	1.7	13.2	11.9	11.0	10.5	0.1	0.2	0.3	0.3
Slovenia	2.6	2.4	2.0	2.1	4.8	-0.5	2.0	3.5	0.4	0.5	1.0	1.5	9.7	9.0	8.5	8.0	5.8	5.3	5.0	4.5
NMS-11 1)	*2.8*	*3.0*	*2.9*	*2.9*	*2.6*	*5.2*	*4.9*	*4.8*	*0.3*	*0.1*	*1.4*	*1.9*	*9.0*	*8.5*	*8.0*	*7.8*	*0.1*	*-0.2*	*-0.6*	*-1.0*
EA-19 2)	*0.9*	*1.5*	*1.9*	.	*1.0*	*1.7*	*4.0*	.	*0.4*	*0.1*	*1.5*	.	*11.6*	*11.0*	*10.5*	.	*3.0*	*3.5*	*3.4*	.
EU-28 1)2)	*1.4*	*1.9*	*2.1*	.	*2.3*	*2.8*	*4.4*	.	*0.6*	*0.1*	*1.5*	.	*10.2*	*9.6*	*9.1*	.	*1.6*	*1.9*	*1.9*	.
Candidate countries																				
Albania	1.9	2.0	2.2	2.4	4.0	4.8	5.2	5.7	1.6	1.5	1.7	1.7	17.5	17.5	17.5	17.5	-13.0	-13.6	-13.7	-13.7
Macedonia	3.8	3.4	2.7	2.6	5.5	4.0	4.0	4.0	-0.3	1.5	2.0	2.0	28.0	27.0	27.0	26.0	-1.3	-4.0	-4.0	-4.0
Montenegro	1.5	2.3	2.6	2.8	4.0	4.0	5.0	4.0	-0.5	1.0	2.0	2.0	18.0	18.0	18.0	18.0	-15.2	-15.0	-15.0	-15.0
Serbia	-1.8	-0.1	0.9	1.3	-2.7	4.0	4.0	5.0	2.9	3.0	3.0	3.0	18.9	17.0	17.0	17.0	-6.0	-6.0	-6.0	-6.0
Turkey	2.9	2.8	3.1	3.1	-1.3	0.5	1.2	1.2	8.9	7.5	6.8	6.2	9.9	10.5	10.0	9.5	-5.8	-5.5	-5.2	-5.2
Potential candidate countries																				
Bosnia and Herzegovina	1.3	1.6	2.1	2.4	4.0	4.0	5.0	5.0	-0.9	1.0	2.0	2.0	27.5	26.8	26.5	25.4	-7.6	-8.0	-8.0	-8.0
Kosovo	0.9	4.3	3.5	4.1	0.0	-3.5	5.0	6.0	0.4	-0.3	0.5	0.8	30.0	29.0	29.0	28.0	-7.9	-8.0	-9.0	-9.0
Belarus 3)	1.6	-3.0	0.7	1.4	-15.0	-10.0	-2.0	0.0	18.1	22.0	20.0	18.0	0.5	0.5	0.5	0.5	-6.7	-3.5	-3.0	-3.0
Kazakhstan	4.3	2.0	3.5	4.5	0.2	3.0	5.0	7.0	6.7	5.0	6.0	5.0	5.0	5.0	5.0	5.0	2.1	-3.2	-1.1	0.8
Russia 4)	0.6	-3.8	1.8	2.0	-2.0	-14.0	5.0	3.0	7.8	15.0	10.0	8.0	5.2	5.3	5.3	5.3	3.2	3.1	1.8	1.8
Ukraine 5)	-6.8	-10.5	0.0	1.8	-23.0	-15.0	-5.0	5.0	12.1	49.5	18.0	11.0	9.3	11.5	12.0	12.0	-4.0	-1.3	-0.6	-0.6

Note: GFCF: Gross fixed capital formation. LFS: Labour Force Survey. NMS: The New EU Member States. EA: Euro area 19 countries.
1) wiiw estimate. - 2) Current account data include transactions within the region (sum over individual countries). - 3) Unemployment rate by registration. - 4) Including Crimea. - 5) Excluding Crimea and parts of Donbas.
Source: wiiw (July, 2015), Eurostat. Forecasts by wiiw and European Commission for EU and euro area (Spring Report, May 2015).

GDP growth in 2014-2015 and contribution of individual demand components in percentage points





Remark: Ranking 2015.
Source: wiiw Annual Database incorporating national and Eurostat statistics, Forecasts by wiiw, July 2015.

BULGARIA: Export-led recovery

BY RUMEN DOBRINSKY

Bulgaria's GDP grew by an unexpectedly strong 3.1% in the first quarter driven by a remarkable surge in exports to both EU and non-EU countries. In current euros, Bulgaria's merchandise exports in the first quarter registered historically record high absolute values for this part of the year. Exports of services also continued their robust performance underpinned by the growing ICT sector. Overall, net exports made the most significant contribution to GDP growth in the first months of the year. At the same time, domestic demand remained generally weak and the picture was mixed: private consumption grew marginally and made a small positive contribution to GDP growth whereas gross fixed capital formation turned into the red and was a drag on growth.

The upturn in exports marked a strengthening of the trend of recovery that had surfaced already in the second half of 2014 but became especially manifest in 2015. Importantly, the export expansion has been associated with favourable shifts in the composition of exports, with growing shares of exports of engineering products and IT services. In turn, this outcome seems to reflect the effect of FDI of recent years which has started to bear fruit. Although not big in volume and rather selective, such investment in some manufacturing sectors such as the automotive industry and in the IT industry has helped create important linkages to global value chains and has contributed to the establishment of stable new markets for the FDI recipients.

Such new industries, usually run by SMEs, are still more like enclaves in the Bulgarian economy and do not shape its overall image. Also, the new businesses are concentrated in some limited territories, supported by a specific conducive local environment. In any case, such sprouts can be seen as encouraging signs of a new process of FDI-driven restructuring of the Bulgarian economy.

Concomitantly, the labour market continued its slow recovery, with a growing number of the employed persons and a declining rate of unemployment. The overall unemployment rate remains relatively high but is mostly due to its structural nature, the skills mismatch between supply and demand for labour. At the same time, there are signs of shortages of skilled labour in the sectors that experience strong growth. The start of the recovery and the partial labour market shortages have begun to put some upward pressure on wages. The economic upturn also gave a boost to public finances, reversing the cash fiscal balance to positive territory. The current account of the balance of payments also received an additional push towards the positive side.

Overall, the short-term prospects for the Bulgarian economy have improved in the recent months. The short-term indicators suggest that the export boom is likely to go on at least in the next few months which will continue to give a boost to economic performance. At the same time it is not yet certain whether and for how long these positive trends can be sustained. In particular, private consumption remains stagnant as consumers still do not seem to have sufficient confidence in the future. Fixed investment will also remain subdued for the year as a whole, reflecting to some extent the end of transfers under the EU Multiannual Fiscal Framework 2007-2013 and the lags in mobilising fresh EU funds from the new (2014-2020) one.

On balance, the current forecast for GDP growth in 2015 is by some 1 percentage point higher than the wiiw Spring 2015 forecast, reflecting the strength of the export surge recorded in 2015. As regards the years 2016 and 2017, excessive optimism appears premature as this would depend on the sustainability of the export-led recovery. The current forecasts assume a gradual improvement in consumer and investor confidence which will provide an additional push to GDP growth in these years. Reflecting these developments, the labour market forecast is also slightly better while it is now expected that prices will start to go up faster than earlier envisaged.

CROATIA: Mild turnaround after protracted recession

BY HERMINE VIDOVIC

GDP growth, having resumed after six years of recession in the last quarter of 2014, continued during the first three months of 2015. Domestic demand, and household and government consumption in particular, was the main driver behind the 0.5% rise in GDP; also foreign demand contributed slightly positively to the expansion. Gross fixed capital formation continued to decline, translating among other things into a further drop in construction activities. Industrial production increased by a mere 0.2% during the first four months of the year, with the highest growth rates reported in the shipbuilding industry (+34%, after years of restructuring-related contraction), followed by manufacture of rubber and plastics, manufacture of leather and manufacture of electrical equipment. Labour productivity continued to rise on account of further layoffs. The situation on the labour market remained tight: according to Pension Insurance data, employment was stagnant during the first quarter of the year and the registered unemployment rate stood at 18.4% at the end of April. Both real gross and net wages increased, by 1.1% and 3.2% respectively, in the first quarter of 2015.

During the first three months of 2015, goods exports (up 9.1%) rose ahead of imports (up 6.7%, both in euro terms based on customs statistics). Still, the trade deficit remained almost unchanged against the same year period a year earlier. In trade with the EU, exports rose by 13%, while deliveries to the CEFTA countries remained stagnant, primarily due to a strong export decline in trade with Bosnia and Herzegovina. Trade with Russia shrank significantly both in terms of exports and imports. Detailed data show that the rise in exports was driven mainly by leather and pharmaceutical products, furniture and ships, the latter however starting from very low levels. Taking into account a similar trade deficit as in the same period a year earlier and assuming no significant changes in the services trade surplus, the current account deficit has probably remained in the same magnitude as in the first quarter of 2014, about EUR 1.5 billion.

The general government budget – based on the ESA 2010 methodology – closed with a deficit of 5.7% of GDP in 2014, much higher than anticipated by the Croatian government. Public debt to GDP increased to 85% and is prone to increasing further in the coming years. In order to meet the Excessive Deficit Procedure (EDP) targets (budget deficit amounting to no more than 5% of GDP in 2015) the government announced additional fiscal consolidation measures in April, including among others an increase in excises on tobacco products and motor fuels, taxes on bank savings, withdrawals from profits earned from public enterprises as well as expenditure cuts by public enterprises (Croatian Motorways, Croatian Railways Infrastructure).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 2017 which is one year later than foreseen in last year's Convergence Programme. However, given that 2015 is an election year, it is questionable whether fiscal discipline can be maintained.

The Croatian economy is expected to continue on its slightly positive growth path in 2015 supported by domestic demand. More robust GDP growth of up to 1.6% is expected in the subsequent years driven, apart from external demand, also by a recovery of domestic demand, particularly investments financed by EU funds. At the same time, private consumption will remain subdued due to persistent high unemployment and continued household deleveraging which will last over the entire forecast horizon until 2017. Downside risks to the outlook are: long-lasting fiscal consolidation coupled with growing public debt as well as political uncertainties which may emerge after the upcoming parliamentary elections in late 2015 or at the beginning of 2016.

THE CZECH REPUBLIC: Fiscal and monetary policies conducive to further recovery

BY LEON PODKAMINER

GDP grew by 4.2% (year-on-year) in the first quarter of 2015 – much faster than over the previous four quarters and also much faster than generally expected. Household consumption rose by 3% and government consumption by 1.5%. Volumes of exports and imports of goods and non-factor services rose by 7.7% and 9% respectively. The trade surplus contracted slightly – but this contraction had quite a significant impact on the GDP growth rate: foreign trade contributed negatively (by close to 0.5 percentage points) to GDP growth. Gross fixed capital formation rose by 3.2%. Expanding inventories (primarily representing work in progress) appear to have been the largest contributing factor to GDP growth (accounting for about 2.3 pp of the 4.2% growth rate). The output recovery (most pronounced in the manufacturing and construction sectors) has supported labour market improvements. The average real wage increased by more than 2% in the first quarter, employment rose by close to 1% and the unemployment rate (LFS) fell by 0.4 pp to 6% (as of end-April).

After four years of fiscal consolidation (2010-2013) which had suppressed the public sector deficit from 5.5% of GDP to about 1.2% (and left the public debt/GDP ratio at 45%) the deficit has been allowed to rebound to an estimated 2% in 2014. Fiscal relaxation is likely to continue in 2015 and 2016. Increased public spending will be supporting rising gross fixed capital formation complementing investment financed out of the means still available under the 2007-2013 EU programmes this year. Despite the continuing fiscal relaxation the public debt/GDP ratio in 2015 is forecast to fall to 40.9% – largely on account of faster real output growth. This indicates that supportive fiscal policy can continue to be fairly relaxed also in 2016-2017.

The extremely relaxed monetary policy, which prevented the consolidation-driven recession from assuming devastating dimensions in 2012-2013, is very 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 no perceptible impact on inflation, which has been close to zero for two years now. The devaluation of the Czech currency enforced by the National Bank in November 2013 has also proved unable to activate inflationary tendencies. Industrial producer prices have been falling since October 2014, also on account of weakening prices of imported raw materials. Right now the National Bank seems to believe that inflation will gradually rise above 1% in 2016. By that time the National Bank may also give up its resolution to keep the CZK/EUR exchange rate above 27. Whether the floating CZK will resume its earlier appreciation tendency is hard to predict. Very likely it will not: the CZK has remained weak with very little visible effort on the part of the National Bank.

Interest rates on loans to private households have remained moderately high (though falling somewhat recently). Loans to corporate clients appear to be rather inexpensive. But lending to both households and business has been expanding rather slowly so far. The private sector's bank deposits still exceed the volume of loans extended. Most probably the improved perceptions about the future will spur a stronger demand for loans in the coming quarters.

All in all, the Czech economy has finally recovered after the period of unnecessary fiscal consolidation. Given the relatively low levels of debt burdening of the government and the private sector (both corporate and households) and growth-friendly monetary and fiscal policies, continuing recovery in 2015-2017 seems assured. But the growth speed-up may be gradual as fixed investment (especially in housing) is unlikely to expand at the high rate observed in 2014 for very long. It will take some time before investment enters a path of fast and sustained growth. Also, uncertainties persist concerning the performance of foreign trade.

ESTONIA: Household and Swedish demand keep the economy afloat

BY SEBASTIAN LEITNER

The recession in the CIS region, the Russian import embargo on various food products, most recently also on fish, but also zero and relatively low economic growth, respectively, in Finland and Latvia, two important trading partners, dampen the export activity of Estonian entrepreneurs. Not only manufacturing but also the transport sector is hit hard by dwindling external demand. Simultaneously, exports towards the rest of the European Union are on the upswing. A strong increase in foreign demand is recorded from Sweden, which is expected to attain a GDP growth rate of about 3% in 2015. Estonian producers in the electronics sector are benefiting in particular. While Finland used to be Estonia's most important trading partner for years since the country gained independence, in the past three years Sweden became export destination number one for Estonian entrepreneurs. Overall, we expect exports to remain almost stagnant, whereas imports will decline, and net trade will contribute positively to GDP growth in 2015. This will change in 2016 and thereafter, when stronger GDP growth will be supported by increases in exports, but an even swifter revival of imports due to an upswing in investment is assumed.

On account of overall sluggish external demand, investment activity of the enterprise sector will decline once again throughout 2015 – there is ample idle capacity in the manufacturing sector. Also construction output will shrink in real terms as public investments will gain momentum only in 2016 when EU funds will ease their financing. Households still refrain from taking up new mortgages to invest in housing.

Falling prices of imports and the oversupply of food (caused inter alia by the Russian embargo) resulted in consumer price deflation continuing in the first months of 2015. However, for the whole year we expect the inflation rate to rise to 0.7%, driven by a rise in import prices and strong wage growth, which attained 4.5% in real terms in the first quarter of 2015. From 2016 on consumer prices will increase more swiftly also driven by announced hikes in excise taxes.

Employment was rising in the first quarter of 2015, particularly in the service sectors. The decline in the workforce due to demographic developments and negative net migration will result in further increasing employment rates while employment will start to shrink gradually in the coming years. The unemployment rate is expected to decline to 6.3% this year and even 5.5% in 2017. Although a shortage of skilled workforce is reported by enterprises in general, statistics do not reflect that fact. Vacancy rates have not risen substantially and are far below the levels seen in the years before the great recession.

Household consumption remains the most important driver of GDP growth. However, compared to last year its contribution will decline somewhat. From 2016 onwards we expect that owing to the improvement of the external environment consumers will again be prepared to expand their outlays, particularly for consumer durables. The budget deficit of the government should reach not more than 0.5% of GDP in 2015 and the following years. After a reduction of the flat tax rate on personal income from 21% to 20% at the beginning of this year, the Estonian parliament in June passed laws to further reduce the labour tax burden. Between 2016 and 2018 social taxes will be cut; the shortfall in revenues will be counterbalanced particularly by an increase in excise taxes.

Our forecast for GDP growth in 2015 remains almost unchanged at 2.2% in real terms. For 2016 and 2017 we forecast an upswing to 2.6% and 3.2% respectively. We expect a recovery of external demand mostly from Western trading partners, while the decline in exports to Russia should come to a halt. An upswing in investments will be facilitated by public investments co-financed by EU funds.

HUNGARY: Consumption and net exports step in as growth drivers

BY SÁNDOR RICHTER

The 3.5% GDP growth recorded in the first quarter of 2015 in Hungary is one of the best results in the EU-28 and fits the elevated growth path having evolved since the second quarter of 2013. Detailed data however show the emergence of less promising tendencies. While 2014 was characterised by a very strong upturn in investment, in the first quarter of this year investment declined by 6.7%. Investment stagnated in manufacturing and fell sharply in public administration, information and communication, transport and agriculture. Within investment construction declined much more strongly than investment in machinery and equipment. A strong deceleration in investment growth was to be expected due to the running out of EU co-financed projects this year. However, this alone is only part of the whole story, as the massive inflow of EU transfers has continued in the first five months of the year despite recurring quarrels between the government and the EU Commission about various kinds of irregularities found by the Commission in the allocation of EU funds in Hungary. Due to the unexpectedly successful absorption of 'last minute' EU projects we assume yet a positive investment growth rate (around 4%) for the whole year. This will be more than 7 percentage points lower than it was in the previous year though. Investment will contribute somewhat less than 1 percentage point to the GDP growth rate in 2015.

The drivers of growth in 2015 are expected to be net exports and private consumption, supplementing/replacing investment in this role. Household consumption expanded by 2.7% in the first quarter. Households' decreasing debt service burden, mainly due to the stipulations of the 'fair banking' law, supports household consumption growth, and even if a comeback of inflation may drag the expansion of consumption in real terms, its annual rate will still exceed 2%. A positive surprise of the first quarter was the strong growth-supporting effect of net exports. Exports increased by 10.3%, imports by 7.8%. The large, 2.5 percentage points gap may be related to the drop in investment in the first quarter, and cannot be extrapolated for the whole year. Moreover, the relatively strong increase in household consumption should inflate imports. Nevertheless exports, especially those of transport equipment, grew dynamically in the first quarter and, even if import growth rates pick up during the year, an over one percentage point contribution to the GDP growth rate can be expected from foreign trade this year.

First-quarter data hint at high diversity in terms of growth across various sectors of the economy. Manufacturing displayed stronger growth than in any quarter in 2014. Construction recorded a good performance as well though a weaker one than last year. Expansion in the services sector was below the average, and within services the financial and insurance sector declined. Financial transmission is further on just ticking over, despite the cheap credit line established by the central bank. Higher than expected GDP growth has generated more income for the budget; that means that the fiscal deficit will remain safely below the 3% threshold this year and the public debt to GDP ratio may drop marginally. The monetary policy is assumed to continue with its cautious relaxation in very small steps this year, while a turnaround is likely by 2016 in response to the expected upturn of inflation.

This year's slowdown of economic growth (from 3.6% to 3%) will be continued in 2016 (to 2.1%) due to the expected strong drop of transfers from the EU budget. With the spectacular return of inflation (zero CPI this year but 2% in 2016) and without the one-off positive effect of smaller debt amortisation, household consumption will also lose momentum. The unfavourable domestic political environment remains further on an obstacle to a more dynamic development.

LATVIA: Riding out the Russian demand shortfall

BY SEBASTIAN LEITNER

In the first months of this year the decline of Latvian exports to CIS countries observed since the second quarter of 2014 due to the recession in Russia, the devaluation of the Russian rouble and the Russian embargo on food imports from the EU deepened further. In January to April 2015 exports to Russia fell by 20% year on year. In addition, since May 2015 Russia has banned also imports of fresh and canned fish from Latvia, which is a hard blow to the country's fish producers which have been exporting until recently half of their catch to Russia.

Contrary to trade with Russia, the exchange of goods and services with western markets is developing at a good pace. Food producers report that expanding deliveries to Asian markets are counterbalancing part of the losses caused by the Russian embargo. Also, up to now the decline in transit trade with Russia has hit the transport sector less than expected. Overall, although export development is expected to remain subdued in 2015, net exports will still contribute positively to GDP growth. The expected rebound of demand from Russia and improved prospects in the euro area should boost export activity from 2016 onwards.

Just one month after the full resumption of production in the formerly largest company in the Latvian steel sector, Liepajas metalurgs, the high hopes concerning the re-employment of employees are fading. The Ukrainian KVV group which took over the insolvent company last year is facing problems with supplies of scrap metal, moreover the gas and electricity utilities threaten to stop energy supply in case of further delays in the company's payments. KVV complains about too high levies and costs in general at its Latvian factory. After having increased the staff in Liepaja to 960 persons at the time of production resumption, the KVV group announced plans to reduce it again to less than 300 employees at the end of May. Thus also growth in total industrial production will remain flat in the coming months.

Negative demographic developments, reinforced by net outward migration, result in a further decline of the working-age population. Thus, while employment is increasing only gradually, unemployment figures drop relatively fast. Towards the end of 2015 the unemployment rate is expected to have fallen below 10% for the first time since the outbreak of the economic crisis in 2008. Households benefit from still low inflation, strongly rising wage incomes and a cut in the flat income tax rate from 24% to 23% as of January 2015. Thus the expected household consumption growth of about 2.5% in 2015 will keep the Latvian economy developing at good pace. However, precautionary saving and deleveraging keep household investments in real estate anaemic.

Confidence indicators in all sectors show that business and households do not expect an upswing for the coming months. Accordingly, private fixed capital investments will likely remain almost stagnant in 2015; the same applies to public investments. From 2016 onwards, the availability of fresh EU funds will result in public as well as private investments growing more swiftly. The significant decrease in oil prices resulted in consumer prices remaining almost stagnant at the beginning of this year. However, with prices rising particularly in the service sector (due to high wage increases) and for electricity (due to the liberalisation of the electricity sector) we can already see a stronger upward movement of harmonised consumer prices, which should continue towards the end of the year and thereafter as well.

Despite the Russian economic downturn and bans on Latvian products, we forecast the GDP to rise by 2.3% in 2015. Given the expected speed-up in demand in the EU and a rise in domestic investment activity driven by the inflow of EU funds, we keep our forecast for the upswing in overall economic activity at 2.8% both for 2016 and 2017.

LITHUANIA: Domestic demand offsets slump in the Eastern neighbourhood

BY SEBASTIAN LEITNER

Lithuanian exports declined by more than 4% in the first four months of the year, for three rather distinct reasons. First, the recession in Russia, but also in Belarus and Ukraine, drags down trade with these countries. Second, the Russian import embargo on various food products cannot be compensated that easily. Although Lithuanian entrepreneurs have been successfully conquering new markets most recently, the exports of e.g. dairy products fell by more than 30% in January to April 2015 compared to the same period in 2014. However, the transport sector, being strongly exposed to Russian transit trade, was hit less than expected. The third reason for trade to decline was the slump in external demand for refined oil products, Lithuania's most important export item. Expecting a further slow but gradual upswing in the economies of the Northern and Western trading partners, we forecast nominally stagnant exports for the whole year 2015, although downside risks are obviously prevalent. In 2016 and thereafter trade will gain momentum.

The meagre prospects for manufacturing, reflected also in lowered indicators of business sentiments, result in stagnant investments in that sector. However, the construction of dwellings continues to increase gradually and public investment, particularly in energy infrastructure, will result in total gross fixed investments growing by about 7% in 2015. After the launch of the LNG terminal in Klaipeda by the end of 2014, which also brought about a substantial reduction of the price for natural gas charged by Gazprom, two electricity power links, connecting the Lithuanian grid both with Sweden and Poland, will be finalised by the end of this year. Subsequently, the price of electricity will also fall, by an estimated 15% in 2016.

The fall in prices for imported oil and gas and the excess supply of food, the latter effected inter alia by the Russian embargo, resulted in falling consumer prices in the first four months of the year. Simultaneously, average real wages continue to increase substantially as in the previous year – in the first quarter of 2015 by more than 6% year on year. The minimum wage was lifted slightly in autumn last year and Prime Minister Butkevicius, in March 2015, announced a further increase from EUR 300 to EUR 325 in July 2015. First signs of an end of the deflationary period are to be seen; for the whole year of 2015 we expect a minuscule inflation rate of 0.3%.

Employment continues to increase; most probably it will rise by more than 1% also in 2015. Simultaneously, negative net migration and the ongoing demographic developments cause the unemployment rate to drop faster than expected – towards the end of 2015 already to below 10% of the labour force.

Given the improving situation in the labour market and swiftly rising incomes, household consumption remains the most important driver of growth for the Lithuanian economy in 2015 and the years thereafter. However, its positive impact is gradually declining due to increased precautionary savings and it cannot completely counterbalance the negative effects of the shortfall in external demand. Overall, we expect GDP to expand by 2.5% in 2015. For 2016 and 2017 we maintain our forecast for an accelerated GDP growth at 2.9% and 3.2%, respectively. The assumed drivers of that development are a gradual recovery in the Eastern neighbourhood and growth in the euro area gaining momentum. Moreover, public investment activity should be facilitated by the availability of EU funds from the 2014-2020 planning period. The budget deficit, which declined substantially last year, will increase slightly to 1.4% in 2015 due to tax revenues remaining below expectations. In the years to follow it will most probably stay at the same level, resulting in a continuously falling public debt to GDP ratio.

POLAND: Strong expansion of productive investment

BY LEON PODKAMINER

GDP grew relatively strongly (by 3.6%, year-on-year) in the first quarter of 2015 – roughly at the speed recorded since the first quarter of 2014. Household consumption keeps growing steadily at about 3% while growth of public consumption slowed down to 3.3% (from an average 4.7% in 2014). The strong (11.4%) expansion of gross fixed capital formation has continued, contributing 1.4 percentage points to the GDP growth. A sizeable increase in inventories in 2014 was followed by their corrective contraction in the first quarter of 2015. Shrinking inventories reduced the GDP growth rate by 1.5 percentage points. Rather unexpectedly, foreign trade contributed positively to GDP growth. According to official (but not yet definitive) estimates the volume of exports of goods and non-factor services rose by 8% in the first quarter of 2015 while imports by only 6%. The contribution of foreign trade to GDP growth is now positive (+1.1 percentage points) as it was in 2012 and 2013 – but unlike throughout 2014.

Across sectors, gross value added increased rather strongly in industry (by 4.6%) and construction (by 4%). Overall, the net profits earned by the non-financial corporate sector rose by 9.7% in the first quarter of 2015. At the same time the average nominal wage in the corporate sector rose by 3.7% and the sector's employment by 1.1%. During the first four months of 2015 the volume of manufacturing sales increased by 5.5% and that of the construction sector by 5.1%. Interestingly, the number of housing units constructed fell rather strongly (by over 11%) while the volume of civil engineering and other construction works has been rising very strongly. Similarly, sales of manufactured investment goods increased fast (over 10%), followed by sales of consumer durables (9%), intermediate inputs (4.8%) and consumer non-durables (2.2%). The bulk of investment went into manufacturing and the sector generating and supplying electricity, steam and gas. Investment outlays in the latter sector increased particularly strongly (by over 76%). Within manufacturing, investment outlays rose very strongly in some technologically more advanced branches (e.g. pharmaceuticals, motor vehicles and electrical equipment).

The moderate output growth since 2010 has been accompanied by fast disinflation which at mid-2014 turned into accelerating deflation. The deflationary acceleration seems however to have stopped now. Positive inflation is likely to return in the autumn of 2015 but the 2% inflationary target is likely to be reached only sometime in the second half of 2017. The notoriously 'hawkish' National Bank of Poland reluctantly lowered its policy interest rate to a still rather high level of 1.5% (in March 2015). Currently business investment can still be safely financed by means other than the expensive bank loans (by corporations' own means in particular). But the 'dear money' policy may unnecessarily limit the business investment expansion in the future (as it has been limiting the expansion of households' demand for housing loans). Also, 'dear domestic money' may be conducive to an undue strengthening of the Polish currency vs. the euro. (At the moment the zloty may have been weakened by political factors: the turmoil over the outcome of the presidential elections and the visible disintegration of the Civic Platform, the major party in the coalition government.)

The parliamentary elections due in the coming autumn are likely to return to power the 'Law and Justice' party of the former PM Jarosław Kaczyński. This will not disturb the moderate economic growth continuing in 2016. Meaningful fiscal, social and structural policy innovations will have the chance to be implemented only later. (Only the monetary policy will be changed in 2016, upon the expiry of the mandate of the present Chair of the National Bank). Whether the economic policy innovations will be radical remains to be seen. Hence their true impact on economic performance in 2016-2017 is rather hard to predict at present.

ROMANIA: Also investments fuel growth

BY GÁBOR HUNYA

The Romanian economy will most likely not slow down as previously expected but expand by some 3% in 2015. First-quarter GDP growth was quite robust (4.3% against the previous year), fuelled not only by private consumption but also by investments, which had been declining in the previous two years. The mild winter was just one of the factors behind the recovery in construction. Better organisation speeded up motorway construction, which is one of the main targets of the expiring EU financing period.

Private demand has been supported by low inflation and increasing wages and will get another push in the second half of 2015 as the VAT rate for foodstuffs was reduced to 9% from the standard rate of 24% on 1 June. Food products represented close to one third of the consumer basket in the first half of the year; this share may now decline and the population can partly reallocate its expenditures to other consumption items. Lower taxes will also curtail inflation, which is already very low. The Romanian National Bank (BNR) calculates with a 60% pass-through of lower taxes into consumer prices and expects inflation to decline below 1% in 2015. The government plans to continue with tax cuts, bringing down the standard VAT rate to 19% as of 2016.

The current state of public finance gives room for tax cuts without increasing the fiscal deficit in relation to GDP. The use of the increased fiscal space is under dispute, however. The BNR, the European Commission and the IMF have reservations against giving up the previous strategy of deficit reduction. The government, on the other hand, wants to hand out benefits to consumers. Choosing tax cuts instead of increasing expenditures on investments or public services such as education and health is a deliberate choice of the government coalition led by the Social Democratic Party (PSD). For them the reduction of the VAT rate is of symbolic value: it restores the rate valid before the stabilisation package of 1 July 2010 thus fulfilling an important election promise. The party will have to stand for elections in 2016 which they can only win on the economic front. Even if Prime Minister Ponta survives in office until the elections despite facing corruption charges, PSD will be in a difficult situation against a united liberal opposition supported by President Iohannis.

Monetary policy is being relaxed very cautiously. The BNR introduced further nominal easing in view of the low inflation by cutting the policy rate to 1.75% per annum from 2.00% and reducing the minimum reserve requirements ratio in May. Non-government loans kept contracting in the first four months of the year; credit to households recovered while the corporate sector continued deleveraging. Loans in domestic currency were replacing foreign exchange loans and the ratio of non-performing loans declined. The financial sector is working out the problems including those related to the Swiss franc appreciation without major interference either by the government or by the BNR.

The labour market reacted positively to the boom in the construction sector during winter. But the April unemployment rate increased to 6.9%, slightly higher than a year earlier. Still, on an annual basis a modest decline in unemployment is in sight considering the steadily increasing job vacancy rate. Also labour shortages due to skills mismatch have emerged in some sectors of the economy. The export boom continued in the first four months of 2015 but imports increased even faster. The current account deficit narrowed, nevertheless, due to a higher services surplus produced primarily in the transport, IT and the professional and management consulting services sectors. The current account deficit may widen in the second half of the year due to increasing demand for imported consumer goods. All in all, the growth prospects of the Romanian economy have improved lately, although the risks of fiscal and external imbalances have increased somewhat. There is also a political risk of early government change; a return to power of the liberal opposition ahead of the elections or early elections cannot be ruled out.

SLOVAKIA: Better prospects ahead

BY DORIS HANZL-WEISS

In the first quarter of 2015, Slovakia's GDP growth reached 3.1% and was thus unexpectedly high compared to the annual growth of 2.4% last year. The main positive surprise was dynamically growing gross fixed capital formation (+6.6%). Also net exports contributed, if marginally, to growth, with exports rising by 4.4% and imports by 4.3%. Goods exports to Slovakia's largest trading partner Germany increased by 5.4%, but those to its second most important partner, the Czech Republic, fell by 1.4%. Overall, about 85% of all Slovak goods exports went to the EU. By contrast, the dynamics of final consumption of households was rather disappointing: it grew by 1.5% only – even though the labour market situation improved markedly. Employment increased by 2.6% (according to LFS statistics) and the unemployment rate fell by 1.7pp to 12.4%. In addition, real wages rose by 2.6%, also due to continuing deflation. Government consumption showed a small increase of 1.6%.

In industry production grew by 5% in the first four months of 2015, with performance edging up in March (+10%). Overall, growth was balanced across sectors, the main contributors being the food sector, basic metals and fabricated metal products and electrical equipment. The main growth driver of the economy in recent years – the automotive sector – had lost momentum already in the second half of 2014 and showed also a weaker performance at the beginning of 2015 (+2%). In 2014, the number of cars produced slightly declined by 1% to 973,000 cars, with PSA Peugeot-Citroën and KIA Motors reporting production increases, but Volkswagen Bratislava a minor drop. All in all, declining car exports to Russia and China (both -20%) were more than compensated by growth of exports to EU countries. The performance of the construction sector, after six years of decline, finally improved in the first four months of 2015 (by 7%). Nonetheless one of the large construction companies, Váhostav-SK, has run into trouble recently. A restructuring plan was approved by the court; the state stepped in in order to help small and medium-sized creditors (allegedly to be financed by bank levies collected). New planned construction projects include a motorway bypass of Bratislava and a national football stadium. The main West-East motorway connection to Košice is an evergreen project still being under construction since the early 1990s. Finally, services value added increased slightly in the first quarter of 2015.

In June 2014 Slovakia was removed from the EU's Excessive Deficit Procedure. For the full year 2014 the public deficit became larger again (-2.9% of GDP instead of the planned -2.6%) and the public debt level reached 53.6%. For this year the official deficit target is set at -2.6%, and for the following years at -1.9% in 2016 and -0.9% in 2017, according to the Stability Programme of the Slovak Republic (approved in April 2015). As parliamentary elections are approaching in March 2016 and the drawing of EU structural funds for the period 2007-2013 will finish at the end of 2015, additional government spending seems likely. In 2014, the government released its first social package, including 15 measures such as free rail transport for students and pensioners, an increase of the minimum wage and the introduction of a minimum pension. This year another social package was announced, encompassing a reduction of VAT for selected foodstuffs to 10%, a further increase of the minimum wage, a cut in payments for medicines used by children and pensioners, and a cheap bank account for everybody. A third package will be announced just before the elections. On the revenue side, in May the Slovak government sold its 49% share of Slovak Telekom to Deutsche Telekom, which became the sole owner. This transaction brought in EUR 900 million. The Italian company Enel wants to sell its 66% stake in the power utility Slovenské Elektrárne; the Slovak state holds 34% and shows interest in part of the sale.

Barring escalating sanctions to Russia and assuming a solution of the Greek debt crisis by the EU, we have made an upward revision of our growth forecast for Slovakia for the coming years, mostly due to improved growth expectations in the European Union and strengthening domestic demand. Thus, we expect the Slovak economy to grow by 2.9% this year, by 3.3% in 2016 and by 3.4% in 2017.

SLOVENIA: Almost back to normal

BY HERMINE VIDOVIC

Slovenia's GDP grew by 2.9% in the first quarter of 2015, backed in particular by a notable increase in inventories; also net exports contributed positively to GDP growth. Household consumption grew only modestly, while gross fixed capital formation fell again after a temporary recovery in 2014. Also government consumption has been on the decline. Construction, which had recovered in 2014 from a sharp contraction, fell again in the first quarter of 2015. Industrial production continued to rise and was up 5.9% in the first three months of the year. The highest growth was reported for car manufacturing, with output rising by slightly more than one third. Strong increases were also recorded for the manufacture of 'other transport equipment', computer and optical products, fabricated metal products and furniture. Despite the remarkable GDP growth, employment (based on Labour Force Survey data) remained stagnant in the first quarter of 2015, while unemployed fell slightly to 9.8%.

In external trade goods exports rose by 3.4% and imports by 4.3% during the first four months of 2015, resulting in a lower trade surplus than in the same period of 2014. By contrast, the surplus in services trade was significantly higher (plus EUR 130 million) than a year earlier due to rising exports – transport and travel in particular – along with a decline in imports. Overall, the current account closed with a surplus of EUR 682 million, i.e. EUR 90 million more than in the first four months of 2014. The FDI inflow continued to grow, mainly on account of foreign investors' reinvested earnings in enterprises and increased purchases of domestic commercial banks' shares by foreign investors.

The 2014 general government deficit accounted for 4.9% of the GDP, while for 2015 a further decline to 2.9% of the GDP is envisaged; based on available data for the first months of the year, this target is likely to be met. Following a ruling by the European Court of Human Rights, Slovenia will have to reimburse depositors of the now-defunct Ljubljanska Banka in Croatia and Bosnia and Herzegovina who lost their savings after the disintegration of Yugoslavia in 1991. Repayments estimated at about EUR 385 million will be made mainly in 2016 and 2017 representing an additional burden on the budget. As for the banking sector, the state-owned Abanka Vipa and Banka Celje have signed a merger agreement. The merger will have to be completed by the end of 2015. The new bank will be the second largest bank in Slovenia in terms of assets and must be privatised by mid-2019 in line with the commitments made to the European Commission.

The privatisation of 15 enterprises approved by the previous Slovenian government in 2013 is proceeding slowly. So far, only four companies – coating manufacturer Helios, laser producer Fotona, Ljubljana airport and the food processing company Zito – have been sold. In mid-June 2015 the Slovenian State Holding rejected the sale of Telekom Slovenija to the only bidder Cinven (a private UK investment fund) because Cinven had attached additional conditions to its bid. Nova Kreditna Banka Maribor (NKBM) is reportedly to be sold to the US investment fund Apollo.

Based on the results of the first months of the year, wiiw made an upward revision of its forecast for Slovenia's GDP growth for 2015 given the higher than expected growth of domestic demand. Accordingly, GDP is forecast to grow by 2.4% in 2015, and by about 2% in both 2016 and 2017. External demand and the gradual recovery of private consumption following an improvement in the labour market will remain the key drivers of economic growth. It will take some time before investments reach sustained growth due to ongoing deleveraging in the business sector. Government consumption will remain supressed owing to fiscal consolidation.

ALBANIA: Recovery led by FDI

BY ISILDA MARA

The Albanian economy continues to be supported by the reform of the energy sector and inflows of FDI. Nonetheless, fiscal austerity, high levels of non-performing loans and external imbalances may threaten GDP growth which we expect at 2% in 2015, 2.2% in 2016 and 2.4% in 2017.

The energy sector reform is making progress. In January-April 2015 revenues increased by about 61% (year-on-year) due to improved collection of bills and lower thefts to the system. Net losses declined by 20% and new contracts increased by 50%. However, the changes in electricity prices – 13% higher for businesses and from a progressive to a flat tariff for households – have raised the burden on businesses and shifted part of income from consumption towards bills and arrears in electricity. Abundant rainfalls in the first quarter of the year favoured the production of electricity, satisfying the current and future demand of consumers. Economy-wide liquidity remains a concern mainly because of the modest performance of government finances and weak credit growth. Public investments increased by a remarkable 18%, but still much less than planned. In spite of monetary easing and historically low interest rates (the policy rate was further cut to 2% – marginally above the 1.8% inflation rate as of May 2015) credit growth is nearly flat. Total new loans declined by 20% in January-April 2015, year-on-year. Loans to businesses fell by 25% whereas those to households increased by 14%. The largest share of loans to businesses (47%) is in national currency, 38% in euro and the rest in other currencies. The biggest challenge in the banking sector remains the high level of non-performing loans, trapped at 22.7% of total loans, only 1.4pp lower on a year-on-year basis and almost unchanged compared to the fourth quarter of 2014. The economic sentiment indicator dropped by 4.6% in the first quarter of 2015, mainly on account of lower demand and production of construction and industry companies. Consumer confidence worsened, reflected in lower household consumption, due to concerns about the financial and economic situation.

During the first quarter of 2015, the current account deficit declined by 15.3%, from EUR 272 to 230 million, mainly thanks to services exports which increased by 14.7% and a decline in services imports by 4.1%. Most importantly, tourism exports, which account for 58% of total services exports, rose by 13%. FDI inflows reached EUR 256 million in the first quarter, a level 2.5 times higher than in the same period of 2013 and 50% higher than a year earlier. The inflow of FDI derives mainly from the Devoll Hydropower project launched in February 2015 and planned to be finished by 2018. The investment is estimated at EUR 535 million and will build two hydropower stations and auxiliary roads. The biggest FDI project, Trans Adriatic Pipeline (TAP), which will bring gas from Azerbaijan to Italy and will cross Albanian territory, is expected to be launched this summer. As for remittances in the first quarter of 2015, unexpectedly, these gained ground recording an increase of 24% to EUR 146 million – most likely due to a new wave of emigration during the fourth quarter of 2014 and the first quarter this year. Push factors are mainly poverty and high unemployment, particularly among the young: youth unemployment stood at 34% in the first quarter of 2015, 4pp higher than a year earlier.

The sharp fall in oil prices generated negative effects on the oil-exporting Albanian economy. Further, there has been a rescheduling of investments in the oil extraction industry. Bankers Petroleum, the main oil producing company, saw their oil revenues halved and reduced capital expenditures by 20% in the first three months of 2015 compared to the same period in 2014.

Albania's exposure to the risk of Greek sovereign default is difficult to predict. Nevertheless, during the past five years a number of precautionary steps have been taken to gain some immunity, such as higher independence of Albanian banking subsidiaries from Greek mother banks and a reduction of the share of Greece as an export destination to 3.4% (from 5.2% in 2010) in total exports.

MACEDONIA: Facing challenges

BY VLADIMIR GLIGOROV

First-quarter growth of GDP was 3.2%. Basically, all components of demand contributed positively, though government consumption less than the others. On the supply side, agriculture and manufacturing posted negative growth while electricity production, extraction and services did well. The unemployment rate continued to decline, but it is still above 27%. Given the acceleration of growth in the second half of 2014, it is expected that growth for 2015 as a whole will fall short of last year's growth rate of 3.8%, but should still amount to above 3%. In the medium term, growth should decelerate somewhat due to slower increase of consumption and investment. As a consequence, only slow improvement of the labour market can be expected.

Macedonia's economy has done better than most other countries in the region in the past five or so years. This has been achieved both through increased investments, public as well as private, and growing exports. As the country avoided many of the excesses with the accumulation of debts – private, public, and foreign – it could pursue a relatively lax fiscal and even monetary policy. The policy rate has been low by Macedonian standards as the country operates a hard peg with the euro and concerns over the exchange rate stability used to be paramount in the past. As is often the case in such exchange rate regimes, monetary policy tended to be constantly restrictive even in the face of very high unemployment rates and sluggish growth. That has also constrained fiscal policy, which was however relaxed in the crisis years. So, all in all, there was policy space that the government and the central bank were able to exploit cautiously. With debt levels relative to GDP still comparatively low and not increasing due to growth of GDP, no adjustment programmes are needed though additional fiscal and monetary stimuli are not to be expected either. There are clearly supply-side measures that could prove supportive of growth. Sources of growth will remain mainly investments and exports.

Political stability has been a problem throughout the past 25 years, i.e. since the country's independence. Most of the time the problem was ethnic coexistence and an appropriate constitutional arrangement that provides for equal rights for all ethnicities. There is such a framework called Ohrid agreement since 2001. Within that framework, inter-ethnic conflicts have become manageable. However, a democratic deficit has come to the fore recently and problems of accountability of the government and the management of the elections have become paramount. An agreement has been reached to hold early elections in April 2016 at the latest, but it is still not known how. Political instability has not had a discernible economic effect so far and will probably not have in the future if orderly early elections are called and held. Much more worrisome is the Greek crisis because of the large share of Greek ownership in the banking sector. In themselves, the banks should not have problems, but the risk of contagion from a possible collapse of Greek banks is hard to evaluate. In principle, the Macedonian central bank should be able to contain it, but the proof of the pudding is in the eating.

Overall, recovery should continue this year and in the medium term. Political shocks and those connected with the Greek crisis are in principle manageable. However the risks of mismanagement are not negligible and would be significantly reduced by a positive signal about EU and NATO integration. On the positive side, regional cooperation has been advancing and that provides some outside stability which is vital for Macedonia.

MONTENEGRO: Investments are the answer

BY VLADIMIR GLIGOROV

Last year did not turn out to be as good as had been forecasted. GDP expanded by just more than 1%. This was mostly due to consumption and investments, on the demand side, while tourist services did not perform as hoped for. This year tourism seems to be doing better, and with continued expansion of investments, some acceleration of growth can be expected. Similarly, in the medium run, growth should pick up on account of improved regional and especially European prospects. The unemployment rate will continue to be high, in part due to the fact that there is a mismatch between the skills that the education system supplies and which the economy demands. The policy framework will not change significantly as Montenegro is an open economy that uses the euro as its official currency and has limits to what it can do with fiscal policy and regulatory reforms.

There is a debate in the country about the need for and the sustainability of infrastructure investments. The government has significant debt obligations and current account deficits are high and fuel foreign debts. Additional investments would mean additional public and foreign debt with uncertain effects on the growth of exports of goods and services. The contrary argument is that Montenegro cannot spur growth and lower regional differences without significant improvements in its infrastructure. The coast is connected with the world via the sea, but it lacks modern infrastructure to support its tourist industry. It also needs to care for the possible damage to the environment and to its fishery and other industries connected to tourism. In addition, regional differences are large because the economic opportunities in the hinterland are limited due to poor access to markets. So, sustained growth depends on massive infrastructure investments. This also includes investments in production of energy – water power and alternative energy primarily. The government tends to favour that model of development, but it may face some financial constraints.

Montenegro has been capable of preserving its political stability. The key to this has been the public interest in the support of state-building given that Montenegro became an independent state only in 2006 (or renewed its pre-World War One independence). A democratic deficit developed, however, because of the political space being reduced to Montenegrin parties which faced the opposition of Serbian parties. On account of that, the country has been run as a one-party state, with that one party being led by the same person for almost three decades now. This can happen in a polarised political space where a significant part of the electorate votes consistently for the minority party that follows policies with a limited coalitional potential. Social protests, when they have erupted, have failed to break through this division and have proved ineffective so far. So, democratisation is a challenge in Montenegro, but political stability is not threatened.

Overall, short-term prospects are for some acceleration of growth while further speeding-up is likely in the medium term. The latter will depend very much on whether a sustained programme of investments and modernisation is developed, financing secured, and implementation is efficient. Montenegro hopes to be the next country to join NATO and is negotiating with the EU with the prospect of being the next country from the Western Balkans to join.

SERBIA: Mixed signals

BY VLADIMIR GLIGOROV

First-quarter 2015 data came in with negative growth, -1.8 over the first quarter 2014, which makes a positive growth rate for the year as a whole unlikely. Some recovery of investment, on the demand side, and recovery of industrial production, on the supply side, suggests that perhaps the growth rate will be zero for the year as a whole. This is due to the effect of the low statistical base. The government hopes for some positive growth, 0.5%, but with private and public consumption declining and net exports' positive contribution in doubt, it all depends on investments. Public investments are not picking up, however, so it will be difficult for the private investments to compensate for the overall decline in consumption. In the medium term, consumption should stop declining and its recovery is possible, but not at high growth rates. In fact, it is somewhat troubling that growth of exports is slowing down as car production is being scaled down, perhaps temporarily. Also, exports to Russia have plummeted even though Serbia is not participating in the regime of sanctions. The unemployment rate kept going down the whole of last year, mostly because of the increased number of self-employed, but has gone up close to 20% on account of the sharp decline in the number of informally employed in the first quarter of 2015. This may change again later in the year. Overall, recovery this year is unlikely, while it depends on accelerated growth of investment and exports in the medium term and will be relatively slow.

Politically, stability looks enduring in spite of lack of or slow economic progress. This is mostly due to the changed government approach to regional politics. The process of normalisation of relations with Kosovo is continuing, though it is not necessarily gaining speed. There is also an improved relation with Bosnia and Herzegovina. The Serbian government is aware that it benefits from regional trade because it runs trade surpluses with all states that participate in CEFTA, the regional free trade agreement. Regional cooperation is also a condition for EU integration. There are high hopes that accession negotiations will start in earnest this year. The screening process has ended and the remaining challenge is the satisfactory implementation of the agreed measures of normalisation of relations with Kosovo.

So far, the Greek crisis has not had a significant impact on the economy of Serbia. Trade with Greece is low and Greek banks have a small share in the Serbian financial market. If anything, the negative example of Greece has strengthened the resolve to proceed with fiscal consolidation. This is the centrepiece of the government's programme and probably the one achievement it will want to take credit for. The other reforms are taking more time than planned, which is not unexpected. Current plans are to accelerate the privatisation and restructuring of loss-making public enterprises next year. Similarly, the reform of public administration should gain speed next year. This is all part of the three-year stand-by agreement with the IMF, which has so far been happy with its implementation.

Overall, this year will hopefully not be recessionary but only stagnant in terms of GDP growth. It should also see some recovery in investments, though public investments have continued to underperform. In the medium term, slow but accelerating recovery should be seen supported by investments and exports to the recovering EU. Finally, negotiations with the EU should take hold and support political and social stability. There is a huge reform programme to be implemented before a real take-off takes place.

TURKEY: Balance-of-payments constrained growth

BY SERKAN ÇİÇEK

Like in many emerging countries, there is a strong relationship between economic growth and current account deficits (as a share of GDP) in Turkey. For the past 12 years, any one percentage growth deteriorated the current account deficit by 0.4 percentage points. Since current account deficits tend to accumulate economic fragility and increase the vulnerability to reversals of financial market perceptions, the Central Bank of the Republic of Turkey (CBRT) has adopted a novel policy mix since mid-2010 which – along with targeting price stability – has also aimed at keeping in check external imbalances. Therefore, GDP growth has been following a new steady-state path which has been around 3-4% since 2011 and has been accompanied by reduction of the current account deficit.

In 2014, GDP increased by 2.9% at constant prices, first of all thanks to a rise in foreign demand and government expenditures. While household final consumption did not rise as fast as GDP (only by 1.3%) because of both additional restrictions on domestic credits imposed by the Banking Regulation Agency and declining real wages owing to a rise in the inflation rate, the government final consumption expenditure increased by 4.6%. This latter was due to election-motivated spending and massive government-led infrastructure projects such as the construction of the third airport in Istanbul and the third bridge across the Bosporus. Net exports rose by 7% on account of the depreciation of the Turkish lira. In 2015, government expenditures and net exports are expected to remain the main drivers of economic growth due to the ongoing government-led infrastructure projects, rising social transfers and continuing depreciation of the domestic currency. Therefore, the overall GDP is forecast to expand by 2.8% in 2015. Growth performance should further improve in both 2016 and 2017 (3.1% in each year) on account of likely cuts in the Central Bank's policy rate in addition to increasing foreign demand.

Although global oil prices had fallen sharply by the end of 2014, the CPI inflation rate decreased only to 8.2% at the end of the year (the target had been 5%). In the first five months of 2015, year-on-year inflation stood at 8.1%, which by far exceeds the year-end inflation forecasts of the CBRT (5.5% in January 2015 and 6.8% in April 2015). With global oil prices remaining flat or rising only slightly and the ongoing passthrough from the depreciating exchange rate, our forecast for consumer price inflation in 2015-2017 is higher than the respective year-end inflation forecasts of the CBRT for these years.

Monetary policy had been under pressure over interest rates. Although it had been loosened by cutting the one-week repo rate by a cumulative 250bp between May 2014 and February 2015, these cuts did not seem sufficient for the politicians. However, since the governing Justice and Development Party (AKP) has lost its parliamentary majority after the elections held on 7 June 2015 and the possibility of forming a coalition between parties represented in parliament seems quite high, we do not expect any more pressures from the government on the CBRT. On the contrary, we expect the CBRT independently to keep the policy rate at a 7.50% level in 2015 until inflation prospects improve. This indicates a tight monetary policy stance. Since our inflation expectations are higher than the forecasts of the CBRT for 2016 and 2017, we forecast policy rates to fall to 7.0% and 6.0%, respectively.

Gross fixed capital formation fell by 1.3% last year. Although construction activity financed by both the private and the public sector registered positive growth, public and private investment in machinery and equipment declined. The massive government-led infrastructure projects will clearly be important drivers of Turkey's construction activities in 2015 and will stimulate future investments of the private sector. But at the same time, uncertainties regarding the political developments may delay the machinery and equipment investments in 2015. We therefore expect gross fixed capital formation to grow by only 0.5% in 2015 and by 1.2% in the two following years.

BOSNIA AND HERZEGOVINA: Eppur si muove

BY VLADIMIR GLIGOROV

Last year proved better than expected because it turned out that the effects of the floods, as devastating as those were, did not affect ongoing activities as negatively as forecasted. Nevertheless, the first quarter of this year was not all that promising. Although a GDP figure is not available, it is unlikely that there was any noticeable growth especially given the background of the high statistical base in last year's first quarter. Industrial production declined and exports increased only by a bit more than 2%. Imports declined, which is also an indication of weak demand, and most other indicators were not pointing towards recovery. Though a strong upturn in investment to repair the damage done by the floods was expected, that is hard to discern in the available data. The country has few levers to affect economic activity, given the currency board regime and constant pressure on public finances, while credit activity does not indicate significant improvement either.

Given that there are limits to the expansion of consumption, GDP growth in Bosnia and Herzegovina depends primarily on investment and exports. The latter in turn depend on growth of industrial production, which however has a long way to go to reach the levels that would be needed for sustained development.

The structural problem of this country is its constitutional set-up. In theory, any constitution can be compatible with economic development once people adjust to it. In practice, however, political stability may not be assured in circumstances in which the constitutional set-up is not seen as fair and is contested legally and politically. This can prove costly to a country as has certainly been the case with Bosnia and Herzegovina. This situation seems to be changing, albeit slowly. The catalyst of change has been internal social dissatisfaction and diminishing regional support for disintegrative policies. So, the country has seen a shift towards more inter-ethnic cooperation after the latest parliamentary elections held last year. The balance of power has particularly changed in the Serbian Republic as the opposition has gained much more influence. This has allowed the government and the parliament to agree on a programme that should move forward the process of EU integration. This is a way to start internal institutional changes and come up with an at least more cooperative structure and one that respects the rule of law, human rights, and democratic decision-making.

Regional cooperation is crucial for Bosnia and Herzegovina. In this respect, slowly changing attitudes in Serbia and the supportive role of Croatia are having a stabilising influence. Of course, improved economic performance in these two neighbouring countries would help too, but both countries are just coming out from prolonged recession. So, in the short run, some unimpressive recovery could be expected with acceleration over the next few years. With improved EU and regional prospects and with political reforms, things could turn more decisively for the better.

KOSOVO: Growth on skis

BY MARIO HOLZNER

On account of weaker than expected quarterly GDP results, mainly on account of disappointing figures of investment and a temporary electricity production breakdown, we have to make a strong downward revision of our earlier (Spring Forecast) GDP growth estimate for 2014. However, for the forecasting period 2015-2017 we revised growth figures upward. Growth will hover around a 4% trend rate, mainly due to a favourable development of household final consumption as well as improved dynamics in gross fixed capital formation over the medium run.

A major driver of current developments is a peculiar shift in the budget structure in the wake of last year's parliamentary elections. In the public sector expenditures for wages and salaries were strongly increased whereas capital expenditures massively slashed. This trend will continue for the whole year as well. General government data for the first four months of 2015 depict a 14% increase in public wages and a reduction of as much as 43% in public investment, as compared to the same period a year earlier. Overall this results in a 9% cut of public expenditures. At the same time budget revenues increased by 6%, suggesting that the public sector is a drag on the economy, at least in 2015. So far private investment has not been able to compensate the reductions in government capital spending. Despite effective interest rates on loans falling by more than 2 pp over the first four months year-on-year to levels below 10%, new investment loans stagnated in the same period. Although FDI doubled in the first quarter of 2015 on the year (from a very low basis), nearly all new projects were realised in the banking, real estate and business activities sectors. It is questionable to what extent the real sector benefited from the FDI inflow, if at all.

Over the period January to April 2015, consumer loans increased by 22%. This rapid expansion hints at a strong increase in household consumption. Household investments have got a boost as well: mortgage loans expanded by 28% year-on-year. In the first quarter remittances increased by 22%, with the appreciation of the Swiss franc earlier this year probably being an important contributing factor. All of this happened against the backdrop of declining inflation rates (since December of last year) which also helped to slightly weaken the country's real effective exchange rate. For the first four months of this year customs statistics reported an increase of exports by 15% and of imports by 4% year-on-year (the trade deficit still widened by some 2%).

In April 2015 the Kosovo government signed a EUR 409 million (about 7% of GDP) investment deal for the Brezovica ski resort with a French consortium. Even if only a fraction of the announced sum is invested, this would constitute an important boost for Kosovo's small economy and especially for the local municipality of Strpce in the Southeast, mostly populated by ethnic Serbs. In June 2015 the IMF announced a staff level agreement with Kosovo on a new stand-by arrangement. It was agreed to expand the investment clause of the 2% fiscal deficit rule to allow for capital projects funded by multilateral and bilateral development agencies. However, this will be contingent on public debt remaining below 30% of GDP, a rule that appears arbitrary and too strict. A new rule linking growth in the public sector wage bill to a macroeconomic indicator should ensure that the development of the former is more aligned with private sector wages.

Overall, we expect GDP growth to strongly accelerate in 2015, to 4.3%, mainly due to the wage increases in the public sector and the strong influx of remittances. In the medium term private investment should replace household consumption as the strongest growth driver. Kosovo diaspora's remittances are expected to continue to remain important as well, particularly since growth in both Germany and Switzerland – the two main targets of emigration from Kosovo – is forecast to pick up as well in the years to come.

BELARUS: How deep will be the recession?

BY RUMEN DOBRINSKY

Following a series of shocks in the final months of the previous year, the economy of Belarus entered a recession with GDP contracting by 2% in the first quarter of 2015. Recent short-term indicators suggest that the recession has been deepening in the months that followed, with the sector of manufacturing being worst affected. The causes of the recession are manifold, but the most severe immediate shock came from losses in the most important Russian market. In the period January-April 2015, total Belarusian exports in current US dollar terms dropped by more than 30% compared to the same period of 2014. Not surprisingly, it is the manufacturing industry that bears the brunt of this severe contraction: in the first four months of 2015 manufacturing exports alone dropped by more than 40% in value terms and real industrial output fell by 7.5% as against the same period of the previous year.

This sharp deterioration in the economic situation comes at an awkward timing for the Belarusian authorities, just several months before the presidential elections tentatively scheduled for November. On previous occasions of external shocks, the government often intervened to cushion them through direct or indirect income support measures to the population and directed credit to companies. However, in view of the fiscal and balance-of-payments constraints they are facing at present, the authorities have limited degrees of freedom to pursue anti-cyclical policy measures. It seems that in the current circumstances policy is likely to maintain a neutral stance, leaving the economy to adjust by absorbing the shocks; this in itself would be equivalent to a major shift in the policy paradigm. An indirect indication of such a stance is the fact that most of the price controls that were introduced in January as an orthodox cushion to the external shocks have gradually been lifted.

The shock to the manufacturing industry was of a magnitude that caused immediate employment effects. In the absence of regular LFS statistics (these are still not publicly available in Belarus) it is not possible to track these effects at the macro level. However, abundant anecdotal evidence including media reports suggests that when faced with shrinking demand, many firms started to reduce working hours. According to some reports, at the beginning of May, 80% of manufacturing enterprises had switched to a 4-day working week. The fact that the authorities have tolerated this defensive reaction by the industry is another indication of their shift to a more neutral policy stance.

Moreover, policy rhetoric, which is usually plentiful ahead of elections, has been toned down considerably. Thus analysts remarked that in the 2015 annual presidential address there was no mention of the phrase ‘modernisation of the economy’, a buzz word that appeared 14 times in the 2014 address and 49 times in that of 2013. Thus it is likely that while sticking to a generally tight fiscal stance, the authorities may undertake an internal redeployment of the shrinking pool of fiscal revenue, shifting resources from investment and development policy towards social policy measures.

The short-term prospects for the Belarusian economy have deteriorated. The future prospects will largely depend on the eventual recovery of Russian import demand but this in itself is highly uncertain in the short run. The loss of export revenue has exacerbated even more the country’s external financing constraints. Hence the depth of the downturn will to some extent also depend on the ability to raise additional balance-of-payments support. Belarus made new advances to the IMF and sought to restructure some debt to Russia but success in this area has so far been limited. Thus the economy will likely remain in recession throughout 2015 and a gradual recovery can only be expected to start in 2016.

KAZAKHSTAN: Persevering in times of low oil prices

BY OLGA PINDYUK

In the first quarter of 2015, real GDP growth slowed down significantly, to 2.2% year on year compared with 4% year on year in the first quarter of 2014. Disappointing exports dynamics and weak internal demand both contributed to this outcome. Lower global oil prices and poor economic performance of Kazakhstan's trading partners were the primary causes of merchandise exports plummeting in the first quarter of 2015 by 47% year on year in USD terms. Import of goods fell too, but not as dramatically – by 15% year on year in USD terms. In light of these developments, in 2015, for the first time since 2009, the current account balance is expected to turn negative and reach -3% of GDP. As the global oil prices are assumed not to grow much above 60 EUR per barrel during 2016-2017, exports will be recovering rather slowly over this period. The launch of the newly developed oil field Kashagan, which has been postponed due to malfunctioning pipes, is expected at the end of 2016. This will allow to somewhat boost oil production and physical volumes of oil exports already in 2017. The current account balance is forecast to become positive again only in 2017.

Domestic consumer demand has weakened as reflected in the retail trade dynamics: in January-May 2015, retail trade increased by only 2.9% year on year, while during the same period in 2014, the growth had been at 10.3%. Slow growth in household incomes (1.6% year on year in January-April 2015) and tightened access to credit are to blame. Newly issued loans to households decreased during January-April 2015 by 16% year on year – as a result of the National Bank's efforts to curb the skyrocketing growth of consumer loans through the introduction of prudential limits and due to the mounting liquidity constraints in the banking system. Liquidity has dried up as a result of the tight monetary policy aimed at counteracting the increasing devaluation pressures. Money supply (M3) has been decreasing since the beginning of 2015 (in April 2015, it was 4% lower than in April 2014) and inter-bank interest rates went up noticeably. The National Bank's policy was effective in preventing a massive devaluation (by May 2015, the tenge had devalued with respect to the US dollar by only 2% since the beginning of the year) and in bringing down inflation (in April 2015, CPI decreased to 4.7% year on year vs. 6.7% in April 2014). However, these results come at the cost of inhibiting credit and business activity: in April 2015, real interest rates on loans in the national currency were at about 11% (with real interest rates on short-term loans to households reaching 15%) – up by 5-7pp as compared with the beginning of 2014. The liquidity constraints have been affecting companies' access to credit as well: though newly issued loans to companies increased in January-April 2015 by 7.8% year on year, growth was only recorded for short-term (up to 1 year) loans for working capital (10.3% year on year), while the corresponding indicator for capital expenditures loans fell by 3.6%. The stock of loans to companies decreased in April 2015 by 2.2% year on year.

Investment dynamics was disappointing in 2014, when gross fixed capital formation was virtually stagnant. The counter-cyclical fiscal stimulus package 'Nurly Zhol' (Path to the Future) envisages transferring an additional USD 3 billion (around 1.4% of GDP) from the National Oil Fund annually during 2015-2017 to finance the development of the country's infrastructure and credit facilities for SMEs. However, if private credit remains depressed the fiscal stimulus alone will not be sufficient to give a boost to the ailing economy. We expect that monetary policy will be gradually softened to prevent long-term negative effects on the business activity in the country. The tenge will continue to gradually depreciate under the guidance of the National Bank; sudden shock devaluation appears to be less likely now. Overall, GDP will grow by 2% in 2015, only slightly faster than in the crisis year of 2009. In 2016-2017, growth is forecast to speed up to 3.5% and 4.5% respectively, with investment being the main growth driver.

RUSSIAN FEDERATION: Milder recession followed by unimpressive recovery

BY PETER HAVLIK

Facing the acute prospect of a severe economic recession due to the combined effect of Western sanctions, plunging oil price, the rouble collapse and the associated spike in inflation, the government rushed to work out urgent countermeasures at the turn of 2014-2015. The revised budget for 2015 reckons with cutting most expenditures by 10% (except defence outlays, social benefits, agricultural subsidies and meeting international obligations), thus saving about RUB 2,000 billion (2.5% of GDP). Furthermore, the annual government spending will be cut by at least 5% in real terms in 2016 in order to balance the budget by 2017 given the expected lower energy export revenues. Apart from spending cuts, the government reiterated once more the necessity to launch structural reforms in order to diversify the economy and stimulate economic growth in the medium run, using industrial policy instruments for import substitution, export diversification and SME development schemes, attracting ‘substantial amounts’ of FDI, promoting innovation developments, curtailing capital flight, etc.

Obviously, the official expectation is that both low energy prices and the ‘difficult geopolitical environment’ will persist for some time. Indeed, in January-April 2015 the economy plunged into recession, albeit it is not as severe as originally expected (GDP dropped by about 2%). Household consumption shrank owing to the spike of inflation. Also government consumption was curtailed due to the enacted spending cuts. Despite the announced support of import substitution and restructuring projects, gross fixed investments are expected to drop sharply in 2015 as the necessary project preparations will take time. Moreover, the efficiency of state-sponsored industrial policies, import substitution measures and the re-launched declarations of structural reforms is questionable. We are especially sceptical with respect to the success of the ‘new’ FDI policies aiming at import substitution, trade re-orientation and innovation strategies (in the first months of 2015 FDI inflows virtually collapsed). Without cooperation with the EU (now apparently abandoned or at least much more difficult) Russia’s economic growth will remain more or less flat even in the medium run. An inward-looking development strategy, even under the working assumption that the current financial and trade sanctions will eventually be lifted, will hardly yield the envisaged modernisation results. Nevertheless, lower energy prices over a longer period might exert the necessary reform pressure towards economic diversification.

The contraction of the foreign trade turnover accelerated in January-April: exports dropped by nearly 30% and imports by close to 40% in USD terms. Russia suffered huge terms of trade losses (about EUR 50 billion). Trade with the CIS (with Ukraine in particular) has suffered over-proportionately. Simultaneously, China – already Russia’s main import partner – is rapidly catching up with Germany and Italy as the key export destination as well. These trends are likely to continue as relations with the EU remain strained and new energy deals with China are being fostered. Given the prospects for stagnating (real) exports in the medium run, and assuming that a downward adjustment of imports in 2014/2015 will not occur again, the present sizeable trade and current account surpluses will eventually diminish.

An ever more assertive foreign policy represents the most serious stumbling block for Russia’s economic development in the medium run. Lacking progress in the diversification and modernisation of the economy and widespread corruption, together with dismal growth prospects, represent mutually interlinked features of Russia’s development problems. Turning inward and hampering or even abandoning the integration with Europe, and reducing foreign investment and technology imports will definitely impair the envisaged modernisation and diversification strategies. Without a ‘reset’ of external relations with Europe the success chances for a sustainable Russian development in the medium and long run are rather poor.

UKRAINE: No light at the end of the tunnel so far

BY VASILY ASTROV

The new IMF lending package approved in March 2015 and the fragile ceasefire in Donbas contributed towards relative exchange rate stability in the second quarter of 2015. The exchange rate has stabilised at levels of around 21-22 UAH per USD, after exceeding 30 UAH per USD during the winter months. However, earlier massive depreciation led to an unprecedented spike in inflation, which was additionally fuelled by a hefty (by 4.5 times) gas tariff hike for households as of 1 April 2015 (a fiscal consolidation measure required by the IMF). As a result, in April 2015 alone, CPI jumped by 14% against March and climbed to 61% on an annual basis. Obviously, the sharp increase in the prices of imported goods has led to a partial re-orientation of demand for domestic products (notably for food products, the imports of which plummeted by 54% in US dollar terms in January-April) but the latter was not strong enough to prevent an overall dramatic erosion of household incomes and private consumption: in January-April real wages fell by 22.5%, retail trade turnover by 25% year-on-year.

Other components of aggregate demand continue to be dramatically affected by the unresolved conflict in Donbas, the war-related destructions and logistical disruptions, and strained relations with Russia in general. Overall fixed investments declined by 15%, those in industry by 37% in the first quarter. Goods exports recorded a 34.5% drop in January-April (in US dollar terms), largely on account of the plummeting exports to both the EU (-34.4%) and Russia (-60%). As a result, the share of Russia as Ukraine's major export destination fell to a mere 11.5% (from around a quarter prior to the present crisis). The recent decision to fully implement the Ukraine-EU Deep and Comprehensive Free Trade Agreement (DCFTA) starting from January 2016 may result in a further disruption of Ukraine's trade with Russia, if the latter revokes its free trade regime with Ukraine in response.[1]

All in all, GDP dynamics has been disastrous: in the first quarter of 2015 it was down by 17.2% year-on-year and by 5.3% on a quarterly (seasonally adjusted) basis. These figures exclude the parts of Donbas which are beyond the control of Ukraine's government (as well as Crimea): including those would certainly show an even deeper recession. Although the progressive deterioration of the statistical base starting from the second quarter of 2014 should help 'improve' the growth performance in the remainder of the year, for 2015 as a whole a recession to the tune of 10% will probably not be avoided. The recovery prospects ultimately hinge on the solution of the military conflict in Donbas, which the Minsk-II ceasefire agreement (which was very vague on political issues, allowing the two sides to interpret it in completely different ways) failed to provide. The recent (June 2015) military escalation suggests that a peaceful solution to the conflict is not in sight anytime soon.

The prospects for a sovereign default appear ever more realistic after Ukraine has failed to negotiate 'haircuts' on its privately held external sovereign debt, which in line with the IMF programme were supposed to save Ukraine USD 15.3 billion in debt payments over the next four years. This does not mean that Ukraine will be necessarily cut off from further IMF support: the latter is likely to continue flowing in, if only for political reasons. However, an immediate impact of the default will be that it will shake the current fragile currency stability, result in another spike of inflation, and deter foreign investors. In the medium term, however, the impact may well be positive, as more public funds would be available for purposes other than debt service, such as public sector wages, social payments and infrastructure investments.

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[1] This will depend on the outcome of the trilateral EU-Ukraine-Russia trade negotiations to be completed this summer, although Russia has formally lifted earlier objections to the DCFTA implementation.

Index of subjects – July-August 2014 to July-August 2015

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