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Press release

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CEE Quarterly 1Q16:
Environment to remain favorable for Central and Eastern Europe next year

- EU-CEE sub-region economies to grow above potential in each 2016 and 2017
- Strong Euro Area growth has helped pull Croatia and Serbia out of recessions this year, whereas Turkey has suffered from heightened political uncertainty until recently
- EU transfers will contribute more positively in 2017, when exports may weaken

With Euro Area growth expected to firm, oil prices subdued and interest rates very low thanks to the ECB´s Quantitative Easing, the environment will remain favorable for Central and Eastern Europe (CEE) next year. Especially the new EU members in Central Europe (EU-CEE[1]) are once again expected to grow at a solid pace well above 3 percent according to the latest CEE Quarterly published by UniCredit Economics & FX/FI Research department. A temporary falloff in EU transfers will be a drag on economic growth in 2016, but will contribute positively the year after when exports are likely to weaken. All in all, growth should surpass potential in both years. At the same time numerous risks remain on a country level such as underperformance in Europe, geopolitical tensions or the Fed tightening.

2015 was a good year for CEE, with demand in Europe on the rise, oil price falling and global liquidity ample. However, once again only EU-CEE has been able to benefit fully, with growth at post-2008 highs and macroeconomic imbalances absent. Capital markets have taken notice, with risk premia falling and the region solidifying its status of a “safe haven” for investors in emerging markets. Elsewhere the picture has been more nuanced. Strong Euro Area growth has helped pull Croatia and Serbia out of recessions, but growth remains subpar due to structural rigidities and the need to tackle large fiscal deficits and debt. Turkey has disappointed as well, with growth and financial markets hammered by policy inaction and, until recently, by heightened political uncertainty. Russia and Ukraine, meanwhile, remain mired in deep recessions, with the former hit hard by the collapse in oil prices and the EU-US sanctions and the latter struggling to cope with the loss of major production capacities in the east.

[1] This group includes some of the countries that joined the EU in 2004 and 2007, namely Bulgaria, the Czech Republic, Hungary, Poland, Romania and Slovakia. Croatia is addressed separately.

GDP change in %	Forecast for 2016	Forecast for 2017
EU Members		
Bulgaria	3.0	2.9
Croatia	1.1	1.5
Poland	3.7	3.8
Romania	3.9	3.5
Slovakia	3.0	3.0
Slovenia	1.9	2.5
Czech Republic	2.3	3.0
Hungary	2.8	2.8
EU candidates and others		
Bosnia-Herzegovina	3.0	3.4
Russia	-0.9	1.2
Serbia	1.7	2.1
Turkey	3.0	3.3
Ukraine	2.0	2.5

"As the year draws to a close, there have been signs of a shift in trends High-frequency indicators such as consumer sentiment, purchasing managers´ indices, industrial production and exports suggest that growth in the EU-CEE may have peaked, while it accelerated in Serbia, Croatia and Turkey, and appears to be bottoming out in Russia and Ukraine," said Lubomir Mitov, CEE chief economist at UniCredit, "Moreover, developments in domestic politics and economic policy agendas appear to have encouraged investors as regards Russia and Turkey and tempered somewhat the enthusiasm in some of the EU-CEE countries."

Against this background UniCredit researchers expect growth in CEE to remain robust and eventually encompass all countries in the region. Growth trends will differ, however, with performance in 2016 likely to be better than in 2017. While growth in the EU-CEE is supposed to be a tad lower in 2016 compared to this year and little changed in Croatia and Serbia, it should gain momentum in Turkey next year before ebbing again in 2017. In Russia, a listless recovery looks likely to begin by the middle of next year and limp along into 2017, while Ukraine´s growth will languish near 2 percent both years. In the EU-CEE developments will vary across countries. While growth should firm slightly in Bulgaria and Poland, it is expected to slow in the Czech Republic, Hungary and Romania. This slowdown would mostly reflect a drop-off in EU transfers as the old programming period ends and the new one begins, and a smaller contribution from net exports as the

increase in imports outpaces that in exports. The latter would mostly reflect a further acceleration in domestic demand that would remain the main driver of growth.

Unlike public investment, private consumption and investment are likely to gain momentum. Private investment should be supported by improved confidence, rising corporate profitability and stepped-up bank lending. Private consumption would benefit from improving labor markets, stronger wage growth and a rebound in consumer credit. Indeed, improved credit demand should prompt domestic banks to step up lending, facilitated by strong capital positions, ample liquidity and low interest rates. Price pressures look likely to remain subdued next year and firm only gradually thereafter, approaching central banks´ target ranges only by late 2017. Inflation will remain constrained next year by the low imported inflation from the Euro Area and subdued oil prices. Both should offset the push on prices exerted by rising employment and wages as output gaps close. Therefore monetary policies are expected to remain lax across the region, with interest rates on hold or lower. Further easing could be seen in Hungary, Romania and in Poland.

Despite the benign outlook numerous risks remain. Key among those is underperformance in Europe. A slowdown in China would mostly affect Russia and Ukraine, while the Fed tightening is primarily a risk for Turkey, Croatia and Serbia. Geopolitical tensions will weigh on the east of the CEE region also in 2016, while domestic politics will become an increasingly important factor for economic policy, with a potentially adverse impact across many CEE countries.

"With growth somewhat slower and interest rates already near record lows, scope for growth-supportive policies would be smaller next year and even more restricted in 2017. Unable to benefit from the increase in revenues afforded by the cycle, governments would need to make hard choices in prioritizing spending or optimizing revenues to keep deficit in check," outlined Lubomir Mitov, "However recent developments point to a weakening commitment to fiscal prudence."

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