Press release

Vienna, April 6th 2016

CEE Quarterly 2Q16:

Economic growth to spread to all CEE countries this year

- **CEE-EU to repeat 2015 performance, when GDP grew at its fastest pace since the global financial crisis**
- **Growth is firming in Turkey, Serbia and Croatia, recessions in Russia and Ukraine are easing**

Despite the recent turbulence in global financial markets, Central and Eastern Europe (CEE) entered 2016 on a strong note, with economic activity gaining pace and financial markets resilient. With growth in the Euro Area expected to hold well, ECB embarking on another round of Quantitative Easing, and the Fed adopting a dovish stance, growth should spread to all CEE countries this year and continue at a similar pace in 2017. According to the latest CEE Quarterly published by UniCredit Economics & FX/FI Research department, output expansion will be mainly driven by the ongoing recovery in domestic demand. However, growth will vary by pace and sustainability from country to country. In CEE-EU[1] real GDP rose at its fastest pace since the global financial crisis last year and looks on track to repeat this performance also in 2016.

Spurred by concerns about China, global growth prospects and the health of the European banking sector, financial markets underwent major turbulence early in the year. Even though not substantiated by tangible evidence about an impending recession, the global selloff had a significant impact on emerging markets. Although markets calmed down as of late due to evidence about the continued economic strength in Europe, the US and China and the ECB´s renewed round of QE, the global outlook for emerging markets has become more uncertain. Against this background, CEE-EU stood out as an island of stability with the downturn limited and the recovery swift. Growth also firmed in Turkey, Croatia and Serbia. In the latter two, the lack of policy space given high fiscal deficits and debt kept growth subdued. In Turkey, growth was driven by fiscal and monetary expansion. Recessions in Russia and Ukraine have eased.

"Unlike elsewhere in the region, the expansion in domestic demand in CEE-EU has not been accompanied by the buildup of macroeconomic imbalances. This has enabled local authorities to pursue growth-supporting policies without putting financial stability at risk. The strong expansion in domestic demand gave an important cyclical boost to revenues, while the surge in EU-transfers enabled governments to boost public investment without jeopardizing deficit targets," said Lubomir Mitov, CEE chief economist at UniCredit, "The solid external positions enabled the CEE-EU to benefit to the fullest from the ultra-low global interest rates and ample liquidity, keeping monetary stances accommodative with interest rates at record lows and currencies stable."

[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	3.4	3.6
Croatia	1.5	1.6
Poland	3.7	3.8
Romania	4.3	3.8
Slovakia	3.2	3.2
Slovenia	1.9	2.4
Czech Republic	2.2	3.0
Hungary	2.7	2.6
EU candidates and others		
Bosnia-Herzegovina	3.0	3.4
Russia	-2.5	1.2
Serbia	2.2	1.8
Turkey	3.3	3.4
Ukraine	2.0	2.5

Source: UniCredit Economics & FX/FI Research, CEE Quarterly 2Q16

Near-term outlook remains benign, scope for growth-supportive policies about to melt

Going forward, UniCredit researchers remain upbeat about the near-term outlook. Despite the heightened market volatility at the start of the year, they stick to their above-consensus forecast for Euro Area growth of 1.7 per cent in 2016. Recent PMI readings and high frequency data such as exports, orders and industrial production have confirmed that economic activity in the Euro Area continues to plough ahead at a robust pace. That said, growth performance is expected to improve across CEE region, with 2016 likely to be somewhat better than 2017. Scope for growth-supportive policies will be larger this year as well, with strains emerging in a number of countries next year that would necessitate fiscal adjustment and monetary tightening.

Overall growth should remain the strongest and more balanced in the CEE-EU, but is likely to pick up pace also in Croatia and Serbia. Growth should pick up also in Turkey later in the year, as political tensions subside and the effects of the 30 per cent minimum wage hike enacted at the start of the year filter through the economy. Both, Russia and Ukraine, will exit recessions, but recoveries will remain uneven and slow, hindered by the absence of structural reforms needed to boost potential growth. While recovering oil prices will support the ruble and Russian bonds, fiscal policy will become the key challenge. Ukraine, meanwhile, will struggle, with debt and sustainability a concern, until the oligarch-dominated political model is dismantled.

"The expected recovery in bank credit will also provide an important boost to private consumption, which will benefit from improving labor markets and stronger wage growth. We expect bank lending to play a greater role in financing the economy given strong capital positions, ample liquidity, very low interest rates, and signs that the deleveraging that began with the global financial crisis has largely run its course", stated Lubomir Mitov.

Inflation in CEE-EU to shift to a sustained upward trend

The pattern of growth is likely to be similar next year, but perhaps a tad lower as exports weaken with demand in the Euro Area softer and a stronger euro denting competitiveness vis-à-vis third countries. On the other hand, EU fund absorption ought to pick up again, offsetting most of the drag from net exports. An important distinction in 2017 will be the more limited policy space as higher global interest rates force monetary tightening among CEE-EU and with a number of countries facing the need for fiscal adjustment to avoid breaching the 3 per cent of GDP deficit limit.

Despite robust domestic demand, price pressures will remain restrained this year, mostly thanks to the lower oil and food prices and imported disinflation from the Euro Area. The inflection point for consumer prices is expected to be in 2Q16, after which inflation will shift to a sustained upward trend. This will not only reflect the lapse of favorable basis effects, but also rising core inflation as output moves above potential in most of the CEE-EU. Nevertheless UniCredit researchers do not expect inflation to approach central banks´ targets before late next year, when rate hikes will be back on the agenda. In the meantime, central banks are very likely to remain on hold. Modest further easing could be in the cards only in Poland.