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Editorial: Some good news from the real economy

Various economic indicators released recently have given a positive picture of the European economic outlook. GDP in the Euro area grew in the second quarter following six quarters of contraction. This means the Euro area has just passed the trough of the cycle. Recent indicators for the UK economy have also given some reason for optimism.

That business conditions have improved has been confirmed by the economic surveys in July and August. They suggest that the economy is likely to remain in an expansion throughout the third quarter of 2013 and the main leading economic indicators anticipate that the growth rate will be positive in the final part of this year.

Recent data also may serve as a basis for better prospects for 2014. The projection that the recovery will continue is supported by the general international economic outlook, which could sustain exports. Also the fiscal stance is becoming neutral in many countries, after two years of restrictive policies.

However, differences among Euro area countries remain quite wide. Preliminary GDP estimates for Q2 in Germany and France point to a full recovery, while, in the peripheral countries the contractions has been milder than in previous quarters. In Spain and in Italy a bottoming out could be observed in the third quarter. Also Greek recession is becoming less tough.

However, the Q1 growth in Germany was influenced by the unusual weather conditions so that the recovery in Q2 might be weaker than it looks like. In any case, it is meaningful that growth in Germany has accelerated despite Spain and Italy are still in recession. Germany is maintaining a faster pace, while the recovery of the peripheral countries still appears fragile. These differences would make the ECB's business more difficult in the future. In fact, any change toward a less accommodative stance – which might be suggested by stronger growth in the Euro area as a whole - could be inappropriate for the peripheral countries.

An important role in supporting the global recovery was played by the international monetary policies. A change in the Federal reserve policy is now in sight, as the Fed has begun to talk about "tapering off" purchases of Treasury bonds. A reduction of asset purchases by the US central banks could negatively affect financial markets all over the world.

Furthermore, the Fed's policy could also influence the choices of other central banks. In any case, the BOE has given a clear message of leaving the policy unchanged for a long time, and the ECB has just seen an early improvement in the business conditions, and is in no need to hurry to change the monetary conditions.

The unemployment rate in the Euro area is still high and it will take time before the economy will experience inflationary pressures. This means that on one hand that it will take time before the ECB will change its policy stance, and, on the other hand, that the debate about the appropriate level of interest rates will remain lively as the German economy accelerates further in next quarters.

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Slowdown in New Member States

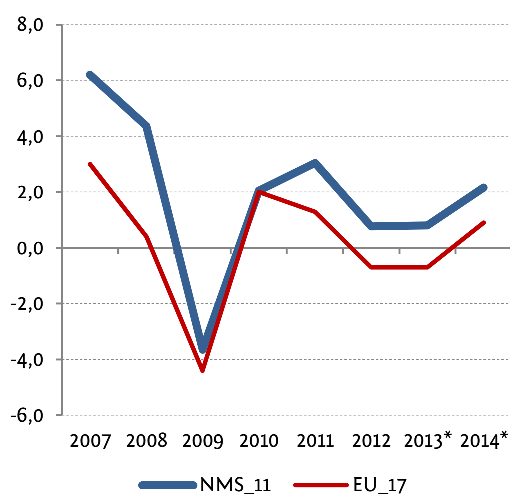
Growth will remain moderate

Diverging growth patterns, recovery in 2014

The new member states (NMS) of the European Union still suffer from the consequences of sluggish growth and shrinking import demand in the Euro area (*Graph 1*). Due to fiscal constraints national governments in most countries face severe challenges and different kinds of austerity measures are hampering domestic demand. Rising unemployment, especially among the young generation deepens social tensions which mean an additional drag for domestic demand. With the exception of some countries (Czech Republic, Slovenia, Croatia) the economic downturn might come to an end this year but only a modest recovery is expected.

Graph 1

GDP growth in New Member States compared to the Euro Area



*Source: Eurostat, Eastern Europe Consensus Forecasts, Kopint-Tárki database, EUREN; * forecast*

The figures for the first quarter were in most of the countries below the expectations, and even in cases where q-o-q figures signal an improvement (like Hungary); y-o-y figures are still in the negative range (*Table 1*). Final consumption expenditures contracted in all the NMS compared to the previous quarter, and with the exception of Bulgaria and the Baltic States there was a downturn on y-o-y basis as well. Gross fixed capital formation is rather depressed in most of the countries, perhaps with the exception of Estonia. Net exports contribute to overall growth in most of the countries, but mainly due to shrinking or slowly growing imports

Table 1

GDP growth in NMS

in %

	Quarter on quarter			Year over year		
	2012 Q3	2012 Q4	2013 Q1	2012 Q3	2012 Q4	2013 Q1
Bulgaria	0.1	0.1	0.1	0.8	0.3	0.8
Czech Rep.	-0.3	-0.3	-1.3	-1.7	-1.3	-3.0
Estonia	1.4	0.6	-1.0	3.5	3.7	1.1
Hungary	0.0	-0.4	0.7	-1.7	-2.7	-0.9
Latvia	1.7	1.4	1.4	5.2	5.1	3.6
Lithuania	1.5	0.7	1.3	4.8	4.1	3.5
Poland	0.3	0.0	0.1	1.6	0.7	0.6
Romania	-0.4	0.9	0.6	-1.1	0.9	2.2
Slovakia	0.2	0.1	0.2	2.1	0.7	0.6
Slovenia	-0.6	-1.0	-0.7	-3.1	-3.0	-4.8
Croatia	-1.9	-2.3	-1.5	-0.3	-0.4	0.0

Source: Eurostat

Some countries suffer from serious structural problems. In Slovenia, e.g., the government introduced austerity measures in order to handle consequences of the crisis of the banking sector; they hamper domestic demand in particular household consumption. For the Czech Republic early indicators suggest that the downturn observed in the first quarter will continue; obviously the uncertainties about the Euro area weigh on growth. In Slovakia weak domestic demand and constraints on the European car market are responsible for the slowdown of economic growth. In Hungary first timid signs of a recovery can be observed, however fiscal austerity will limit growth potential in the coming year as well. The Baltic States seem to be relatively stable even if some moderation can be noticed also in their case. Croatia, the newest member of

the European Union suffers from severe structural problems: high fiscal debt, on-going recession, weak domestic demand, high unemployment which limit the competitiveness of the country and challenge the government.

Table 2

Economic sentiment in NMS
2013; seasonally adjusted

	Mar	Apr	May	June	July
Bulgaria	98.6	94.2	95.6	94.6	95.3
Czech R.	88.0	85.2	87.2	88.4	87.2
Estonia	102.4	101.2	102	100.5	101.1
Hungary	93.3	91.3	97.1	99.9	97.7
Latvia	105.2	103.8	104.4	104	103.9
Lithuania	103.9	104.3	102.9	104.8	103.1
Poland	87.6	85.9	87.5	86.8	87.7
Romania	95.1	94	95.5	96.4	95.7
Slovakia	91	91.3	88.7	84.4	87.8
Slovenia	94.3	92.7	92.5	94.1	94.4
Croatia	90.4	89.2	99.5	107.9	104.8

Source: Eurostat

Economic sentiment indicators underpin the fragility of the situation in most countries (*Table 2*). Despite of an average growth rate of 2% or even more as expected for 2014 by most forecasters, short-term expectations of economic agents are still influenced by uncertainties caused by the Euro crisis and the internal structural problems. Next year's upturn will depend greatly on the development of the business climate in the European Union as a whole, and especially on that in Germany, as most of the NMS are still heavily dependent on German markets.

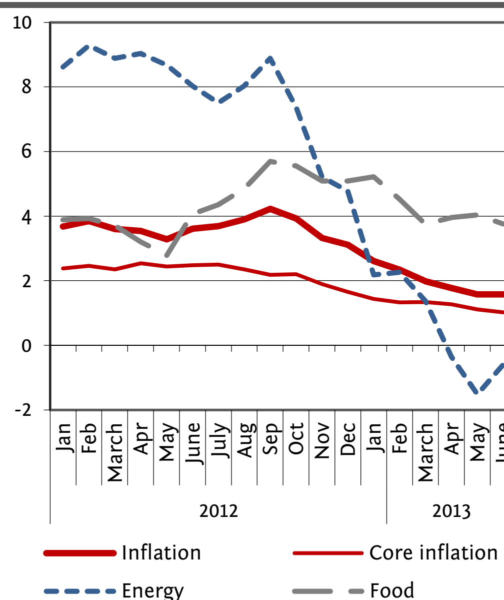
Moderate consumer inflation over the region

In the first six months of 2013 inflation in the NMS (including Croatia) was mainly driven by domestic demand. Import prices which characterized price developments in the region in 2012 via high energy prices have lost importance. As the latter were integrated into consumer prices until the end of 2012 the inflationary pressure from this side ceased. Due to the moderated growth and the decrease of net real wages private consumption in the NMS has been negative since 2011. The disinflation period began after September 2012 when inflation in the NMS (excluding Cyprus and Malta) had reached 4.2% on average

Decreasing interest rates could have given some impulse to inflation if domestic demands were not so weak. Core inflation (excluding prices for energy, food, alcohol and tobacco) has been 1.3% on average of the region in the first half of 2013, and in some product groups with high demand elasticity (such as clothing, transportation and communication) a significant fall on prices was reported. The trend in core inflation is still decreasing due to the lack of demand and the annual average is expected to be around 1%.

Graph 2

Inflation rates of selected items in the NMS countries



Source: Eurostat, own calculations

In the first six months overall inflation stood at 2%. Food prices (4.2%) were the only force lifting inflation. Energy prices have been up by only 0.5%, and because of the last quarter's-0.8% the falling may also lower future CPI rates in the region. Aggregate food price inflation will not fall below 3.5% in the region as agricultural output will increase only in Estonia and Hungary while serious declines may occur in the Czech Republic, Romania, Slovenia and Slovakia.

The overall inflation is still on a downward trend. Although monthly CPI rate stood at only 0.1% we do not consider that the index has reached its minimum yet. Due to seasonal factors higher inflation is expected in the late summer period (especially due to increased tourism flow) but in the autumn further decrease in prices is awaited.

Disinflation process would come to an end in early 2014 if private consumption will turn back to growth. Net real wages are expected to slightly increase in 2013 and real interest rates are forecasted to decrease further. This can give an impulse to consumption which could result in the increase of inflation in 2014 to a level between 2-3%.

Weak prospects at labour markets

Four years after the crisis the unemployment rates still remain at high levels in most NMS. In 2012 the average unemployment rate was 9.8%, which is slightly below the EU28 average and significantly below the Euro area average. The labour markets reflect unfavourable macroeconomic conditions resulting mainly from fiscal consolidation in most of the countries and weaker export demand. However, the differences between the NMS are quite marked.

Though the unemployment problem has been on the agenda in the last years in most countries and various labour market measures have been considered and taken, the unemployment rate slightly increased in half of NMS in the last year (*Graph 3*). However, in the Baltic countries and Romania the unemployment rates decreased.

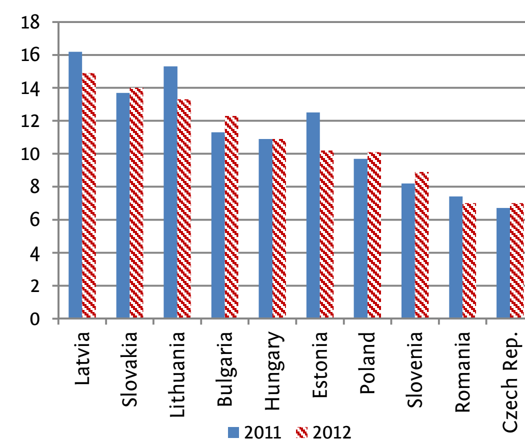
The Baltic States were characterized by extremely high unemployment in the years after the crisis, in 2012 unemployment rates here continued to decrease, even if remaining at two-digit values. However, in Estonia the consolidation efforts after the crisis have brought positive results; Estonia succeeded in decreasing the unemployment rate most significantly in the region, it dropped by 2.3 p.p. to 10.2%.

In the previous years, this can be attributed to some extent to emigration, mainly to neighbouring and linguistically related Finland, but mostly the improved labour market performance reflects an increase in employment triggered by structural reforms leading to increase in productivity. In Latvia the fall in unemployment rate corresponds also with the employment growth unlike Lithuania.

In Romania, the low unemployment rate is associated with an in international perspective low participation rate (59.5%, 2012). In the Czech Republic, e.g., where the unemployment rate is similar, the participation rate was 66.6%.

Graph 3

Unemployment rates
2012 compared to 2011, in %



Source: Eurostat

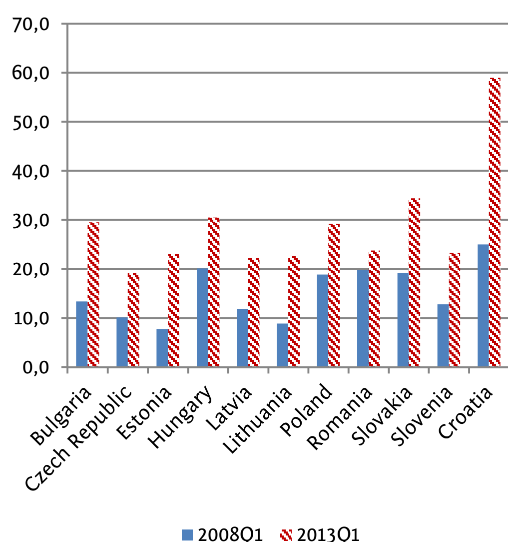
On the other hand, Slovakia, belonging to the countries with the highest unemployment did not succeed in decreasing it in the last year; on the contrary, it increased slightly. To some extent this was caused by new labour laws aiming at a higher protection of employees and by a low inflow of investment connected with worsening business conditions owed to the cancellation of the flat tax rate and a higher tax burden introduced in 2012. Slovakia and Baltic countries, including Bulgaria are also struggling with very high long-term unemployment.

The best performing countries (except for Romania), with one-digit unemployment rate, show the opposite development to the Baltic States. The unemployment increased slightly in Poland, Slovenia and in the Czech Republic reflecting the deceleration of growth or even a decrease of economic activity. The growing unemployment is also a huge problem for the new member state Croatia with unemployment rate of 15.9% in 2012.

A relatively high share of the unemployed in most NMS is young people (*Graph 4*). Youth unemployment became a crucial problem in the last years and with the exception of the Czech Republic, Slovenia and Romania it is higher than the EU28 or Euro area average. Especially in Slovakia and Croatia the unemployment of young people is extremely high. In Slovakia it has got above 30% shortly after the crisis and has been persisting above this level until now.

Graph 4

Unemployment rate, age group below 25 years



Source: Eurostat

As the growth in the region will not be sufficient to generate an increase in employment labour demand will remain subdued. Thus the average unemployment rate in the region will get above 10%. A decrease of unemployment rates can only be expected for the Baltic countries which currently perform best in the region and will probably continue improving their economic environment. A strengthening of the export sector can help to start a recovery in other open economies like Slovenia and Slovakia; though more structural reforms towards the increasing productivity would be necessary.

Slight improvement in reducing budget deficits

Despite of all efforts there has been only a slight improvement in budget deficits of the NMS over past two years. Based on the end of the year projections only half of the countries will be able to reduce deficit in this year (*Table 3*).

Table 3

General government budget balance

% of GDP

	2012	2013*	2014*
Bulgaria	-0.8	-1.4	-1.3
Czech Republic	-4.4	-2.8	-2.9
Estonia	-0.3	-0.5	-0.1
Hungary	-1.9	-2.7	-2.7
Latvia	-1.2	-1.1	-0.9
Lithuania	-3.2	-2.9	-2.4
Poland	-3.9	-4.4	-3.3
Romania	-2.9	-2.6	-2.4
Slovakia	-4.3	-2.9	-2.9
Slovenia	-4.0	-7.9	-0.2
Croatia	-3.7	-4.2	-4.0

*Source: Eurostat, Eastern Europe Consensus Forecasts, * projections by local authorities*

The main reasons are revenue underperformance and the lack of fiscal consolidation efforts. Overly optimistic assumptions in the macro-framework forecast at the time of planning, along with the underestimated effects of global and EU sluggish growth restrained NMS governments from structural reforms. Thus the fiscal consolidation efforts of the NMS seem to be pushed forward only by threatening to limit the access to EU funds. On the other side only two countries - Slovenia and Poland – will according to the latest forecast miss the fiscal target of a deficit below 3% of GDP in 2013 (five countries in 2012).

Despite of a slight increase in the budget deficits Bulgaria and Estonia appear to have their budgets under control. Bulgaria's deficit is seen rising to 1.4% in 2013 from 0.8% in 2012 due to increased social spending, an anaemic expansion in industrial output, high unemployment rate and subdued domestic demand. The budget deficit should narrow to 1.3% in 2014 as acceleration in economic growth is likely to be offset by continued pressure on the government to increase social spending.

Estonia's government finances remain strong. The 2012 budget deficit was smaller than forecast at only 0.3% of GDP and a similar deficit (-0.5%) is expected for 2013. A balanced budget should be reached in 2014, which is in line with the targets of the stability programme. The deficit is attributed mainly to the central government, the main reason being investments that exceed the revenue from emissions trading in 2012. The budgetary position is also weakened by a reduction of the contribution to the unemployment insurance. In 2014, the general government budget will be balanced again and a surplus is expected the years to follow reaching 0.8% of GDP by 2017.

Hungary, Romania, Lithuania and Latvia achieved significant progress and were allowed to exit the EU's Excessive Deficit Procedure. *Hungarian* government adopted in 2013 further corrective measures amounting in gross terms to about 0.3% and 0.7% of GDP for 2013 and 2014, respectively. Thus, the deficit is expected to remain below the Maastricht reference value of 3% of GDP over the forecast horizon. Hungary has narrowed its budget deficit to a high extent by corporate tax hikes and by focusing on expenditure reductions. *Romania's* budget deficit fell to 2.9% of GDP in 2012 and is supposed to decline further to 2.6% in 2013, after having been as high as 9% in 2009. The consolidation was achieved by a cut in public wages, a freeze in pensions, and a reduction in all social benefits except pensions. The revenue side of the budget was streamlined through a 5 p.p. increase of the VAT rate and a broadening of the tax base for personal income. Following high budget deficits in 2009 and 2010 (respectively at 9.8% and 8.1% of GDP), which partly reflected measures to stabilize the financial sector; the deficit in *Latvia* started declining rapidly in 2011, when it reached 3.6% of GDP. In 2012, the deficit declined further to 1.2% of GDP, thus well below the Maastricht reference value. The Commission services' 2013 Spring Forecast projects that the general government deficit will remain broadly unchanged in 2013 at 1.2% of GDP and will decrease to 0.9% of GDP in 2014. *Lithuania's* 2013 budget restricts expenditure growth to secure a further reduction of the deficit to 2.6% of GDP in 2013. The public sector wage freeze has been extended to 2013. However, a sizeable rise in minimum wages is set to increase the public sector wage bill, albeit expected to be offset by higher social contributions and personal income tax collection. On the revenue side, an increase in excise duties on gasoline and cigarettes is expected to compensate for reduced VAT rates on transport and media, but not sufficiently to cover an extension of reduced VAT rates for residential heating and medicines.

While the taken structural and non-structural steps mean Hungary, Romania, Latvia and Lithuania are now free from Excessive Deficit Procedure supervision, they still have to respect the EU's fiscal rules: should the country's budget deficit rise above 3% of GDP, it will follow the example of Malta and go back into the process again.

Czech Republic and Slovakia have made significant progress in reducing fiscal deficits but are still under the Excessive Deficit Procedure. The *Czech* budget deficit is projected to narrow from 4.4% of GDP in 2012 to 2.8% in 2013. The consolidation effort is oriented towards adaptation of structural reforms, though there is a risk in the currently changing political environment facing premature elections.

The government's targets include stabilization of the tax environment and for the years of the outlook the implementation of reforms organizing and financing tertiary education, science, research and innovation, as well as the active employment policy. A positive fiscal effect is also expected from making the public procurement more effective and cutting the cost of public sector operation. *Slovak* government adopted a consolidation package for 2013 containing legislative changes in the area of taxes and social contributions to secure improvements in the deficit. Thus deficit is expected to be 2.9% of GDP in 2013 and also in 2014. The main headwinds are the lower-than-expected revenues from taxes and social contributions as a consequence of a less favourable macroeconomic development, as well as the assumption of hospital debts.

The biggest problems with deficits are in Poland, Slovenia and the newest member state Croatia. *Poland's* budget deficit is seen rising to 4.4% in 2013 from 3.9% in 2012 caused by increased spending. The Polish government decided to stimulate the economy in the short term – which meant an increase of the deficit by 1% of GDP – and implement fiscal consolidation in the long term. However, in order to increase the deficit, the government had to change the law first. According to former legislation, once the debt-to-GDP ratio crosses the 50 per cent threshold (which it did last year), the government may no longer increase budget deficit. The government had approved an amendment to the law on public finances suspending the mandated sanctions for 2013 and 2014. This can undermine credibility of earlier established fiscal rules.

The *Slovenian* government had planned a fiscal deficit of 4.2% of GDP in 2013, but now it is forecasted to reach 7.9% of GDP due to one-off effects of the already implemented and expected recapitalizations in the banking sector. A medium-term fiscal objective of Slovenia is a permanent structurally balanced budget, which is in accordance with the proposed Slovenian constitutional rule of a balanced budget. On the expenditure side, measures to limit the wage bill and the expenditure on pensions and social transfers will be taken. Other measures will target to rationalize expenditures on public sector, the selection and limitation of social transfers, lowering the funds for goods and services and the selection of investment projects (primarily financed from the assigned budget and within EU programmes).

In *Croatia* the new government in 2012 initiated stronger fiscal adjustment on the expenditure side to stop exploding public debt and improve credit ratings. The Croatia's EU entry should help to put its fiscal policy on a sustainable path; its budget deficit is expected around 4% in 2013 and 2014.

Table 4

Summary of forecasts

	GDP (yoy)		HIPC (yoy)		Unemployment rate	
%	2013	2014	2013	2014	2013	2014
Bulgaria	0.8	2.0	2.3	2.5	12.3	11.3
Czech Rep.	-1.0	1.7	1.4	1.5	8.1	8.4
Estonia	2.9	3.6	3.5	3.0	8.0	6.4
Hungary	0.3	1.5	1.7	2.6	10.4	10.8
Latvia	3.5	4.0	0.4	2.6	13.3	12.0
Lithuania	3.6	3.5	1.8	2.5	12.1	11.1
Poland	0.9	2.4	0.7	1.8	11.0	11.0
Romania	2.0	2.3	4.7	3.3	7.0	6.9
Slovakia	0.8	2.3	1.9	2.0	14.4	14.2
Slovenia	-2.0	-0.1	2.2	2.0	9.8	9.4
NMS aver.	0.8	2.2	1.8	2.2	10.2	10.1

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Forecast of the EUREN/CEPREDE High Frequency Model

Last update: September 3rd, 2013

	12 Q3	12 Q4	13 Q1	13 Q2	13-Q3	13_Q4	2012	2013
May-12	-0,4;0,0	-0,2;-0,2					-0,2	
Jun-12	-0,6;-0,1	-0,6;-0,3					-0,4	
Jul-12	-0,5;-0,1	-0,5;-0,4					-0,3	
Sep-12	-0,7;-0,1	-0,7;-0,4	-0,6;0,1	-0,5;0,1	-0,3;0,1	0,2;0,1	-0,5	-0,3
Oct-12	-0,6;-0,2	-0,9;-0,6	-1,0;-0,1	-0,9;-0,1	-0,5;0,2	0,3;0,2	-0,5	-0,5
Nov-12	-0,6;-0,2	-0,9;-0,5	-1,2;-0,3	-1,0;0,0	-0,7;0,1	0,2;0,4	-0,5	-0,7
Dec-12	[-0,6;-0,2]	-0,9;-0,6	-1,1;-0,2	-1,1;-0,1	-0,6;0,3	0,1;0,1	-0,5	-0,7
Jan-13	[-0,6;-0,2]	-1,0;-0,6	-1,2;-0,3	-1,1;-0,1	-0,7;0,2	-0,1;0,0	-0,5	-0,8
Feb-13	[-0,6;-0,2]	[-0,9;-0,6]	-1,1;-0,3	-1,1;-0,0	-0,6;0,4	0,0;0,0	-0,5	-0,7
Mar-13	[-0,6;-0,2]	[-0,9;-0,6]	-1,1;-0,3	-1,1;-0,1	-0,7;0,3	0,0;0,1	-0,5	-0,7
Apr-13	[-0,6;-0,2]	[-0,9;-0,6]	-1,0;-0,2	-0,8;0,1	-0,6;0,1	0,0;0,0	-0,5	-0,6
May-13	[-0,6;-0,2]	[-0,9;-0,6]	-1,0;-0,2	-0,8;0,1	-0,6;0,0	-0,5;-0,5	-0,5	-0,7
Jun-13	[-0,6;-0,2]	[-0,9;-0,6]	[-1,0;-0,2]	-0,8;0,1	-0,4;0,3	0,2;0,0	-0,5	-0,5
Jul-13	[-0,6;-0,2]	[-0,9;-0,6]	[-1,0;-0,2]	-0,7;0,3	-0,3;0,3	0,1;-0,3	-0,5	-0,5
Sep-13	[-0,6;-0,2]	[-0,9;-0,6]	[-1,0;-0,2]	[-0,7;0,3]	-0,2;0,4	0,2;-0,2	-0,5	-0,5

In brackets: GDP-Data published by EUROSTAT. In italics: quarter on quarter rates.

The first release for second quarter 2013 published by Eurostat in mid-august has confirmed our previous estimate of a qoq rate of 0,3%, which means a mild improvement in the yoy rate from -1,0 in the first quarter to -0,7 in the second one. Looking at the various indicators included in our model, most of them are showing a clear recovery. For the second half of this year, they hint at a better result than expected before, which has led to a slight upward revision of our forecast for the third and fourth quarter.

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Impressum

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