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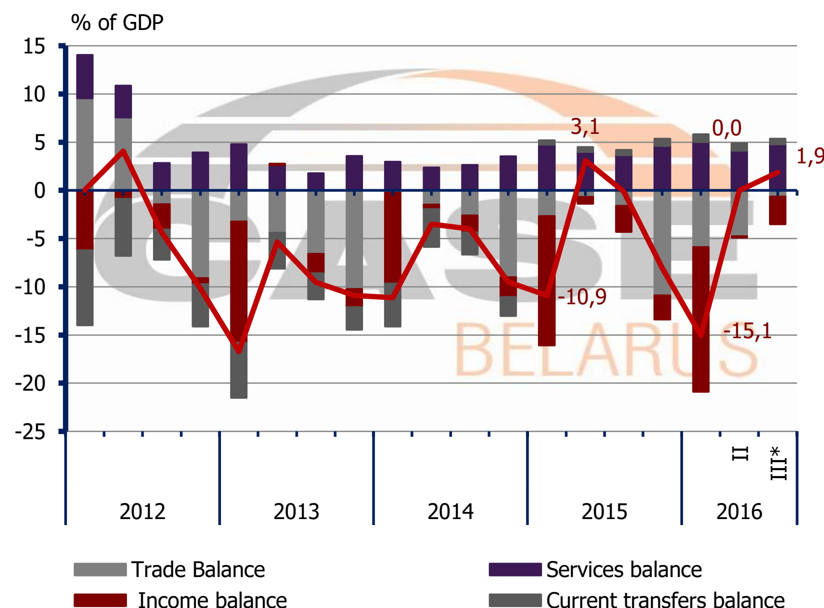
Overview: In the last edition of showCASE in 2016 our experts discuss the extension of the EU sanctions on Russia and the recent decision by the Fed to increase the interest rate. Moreover, this special issue features an analysis of the current account deficit in Belarus prepared by the team of CASE Belarus.

Belarus' Current Account – Sustainable for the Future?

By: Uladzimir Akulich and Sierž Naūrodski, CASE Belarus

Tiny Belarus, often-derided for the closed nature of its economy, is far more dependent on the outside world than it would appear at first glance. In the third quarter of 2016, Belarus' current account (CA) balance turned positive, amounting to 1.9% of GDP, but the overall trend for the year has been negative: from January-August, the cumulative CA deficit amounted to USD 1.4 billion, or 4.6% of GDP (compared to 2.2% of GDP in 2015 for the same period).

This performance has been driven by a deterioration of trade in energy goods, with physical volumes of oil product exports and crude oil imports declining each by about 10%. However, due to price differences, the revenues from oil exports decreased by USD 1.9 billion, and payments for the crude oil imports by only USD 1.1 billion. As for the trade in non-energy commodities, in 2016 a positive balance was kept, equal to as much as USD 400 million (almost the same as in the analogous period of 2015, when it was USD 372 million).



What can be expected by the end of the year is that trade in both energy and non-energy goods will be negative for Belarus. The early start of the heating season and the holiday period in the fourth quarter will lead to an increase in imports, while exports will continue to stagnate. There is also statistical evidence that the last quarter is traditionally highly import-intensive for all kinds of traded goods in Belarus.

Given this, the cumulative CA deficit is bound to increase to approximately 5.4% of GDP by the end of 2016. By comparison, the recent reports by IMF and EBRD forecast a CA deficit of around 4.9% of GDP.

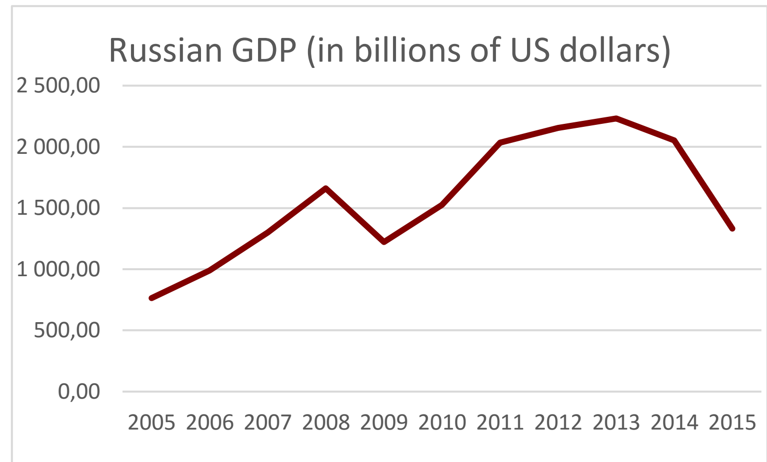
Is that level safe for the country? Economists in Belarus agree that the acceptable limit of the CA deficit is 2-3% of GDP, based on the fact that this amount can be financed by existing foreign investment. However, a deficit above 5% of GDP will most probably result in further external borrowing by Belarus in order to avoid shortage of foreign exchange reserves (currently equal to only two months of total imports). Belarusians should therefore ask *Ded Moroz* for a warm winter that would bring their energy consumption down. With only two weeks to go until Orthodox Christmas, however, it is likely that other, more economic reforms will be needed.

EU sanctions on Russia extended again

By: Katarzyna Mirecka

At the EU summit held on December 15th, 2016, the EU leaders agreed to extend the economic sanctions on Russia until mid-2017 over its annexation of Crimea and continued meddling in eastern Ukraine, an ongoing conflict that has cost the lives of nearly 10,000 people. This prolongation, the fifth such time the sanctions have been renewed, comes as the requirements of the Minsk peace deal remain unfulfilled (indeed, in many ways, are actively disregarded by Russia and its proxies).

As was to be expected, EU leaders remain divided over the issue, and the decision reached was a hard-won compromise. Some of the Member States, like Italy, Greece, and Hungary opposed sanctions; others, like Germany, France, Poland, and Lithuania, back them. Nevertheless, in the words of the President of the European Council Donald Tusk, while "some (…) colleagues" would prefer a longer, 12-month-long extension to exert even more pressure on Kremlin, a 6-month deal is the only one that can be maintained under the current format.



Source: World Bank

At the same time, additional sanctions were discussed in relation to the Russia's military engagement in Syria, believed to be behind the escalating humanitarian crisis in Aleppo. Although no binding decision has been reached, it has been underlined that the option is on the table. For the time being, the Prime Minister of Luxembourg called for "providing aid in the most practical way possible".

The restrictive measures the EU did manage to agree on thus far concern 146 Russian and Ukrainian officials (assets freezes and travel bans) and 37 companies (assets freezes), as well as ban on exchanges in the financial, energy, and defense sectors. With EU being Russia's main export and import partner, sanctions had an impact, albeit admittedly a rather limited one. Without the global oil-price collapse that resulted in plummeting ruble and general slowdown of the Russian economy, it is anybody's guess how strong they would be felt by the Kremlin.

With a new deal that has recently been concluded between OPEC and Russia the situation complicates even further, as the agreement carries a real potential to boost the Russian economy through higher oil prices. Granted, for that to happen both OPEC and Russia need to stick to their promises, which proved tricky in the past. Trust has been broken down within the OPEC more than once since its establishment. The EU should not take chances, though. If it wants the sanctions to work at all, the Member States need to stick together, speak in one voice, and be prepared to face tradeoffs.

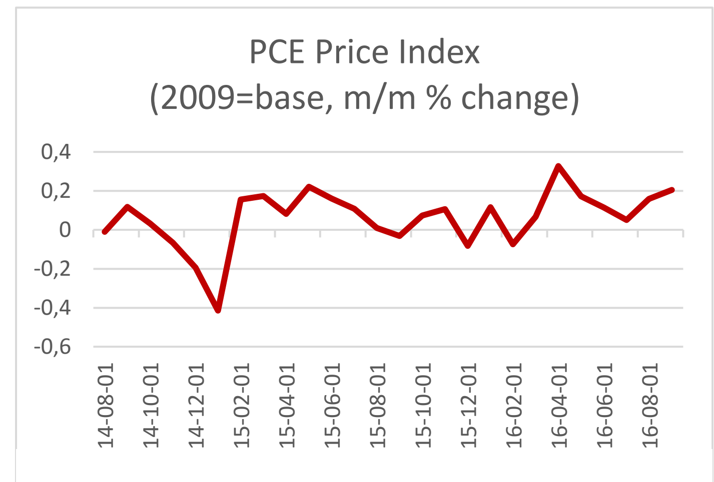
The Federal Reserve gives us the ghost of Christmas past

By: Iakov Frizis

Last week (December 14th, 2016) the US Federal Reserve (Fed) increased its benchmark interest rate by 25 basis points (to a range between 0.5% and 0.75%), signaled three rate hikes over 2017, and promised an end-of-next-year benchmark rate of around 1.5%. This action could not help remind the market of Christmases past, as December 16th of just last year saw the Fed presenting markets with similar policy targets. Yet, contrary to the Fed's guidance, 2016 only saw one hike, leading to closing the year at a benchmark rate substantially lower than the predicted 1.5%.

In her official address, the Head of the Fed's Board of Governors, Janet Yellen, linked the Board's decision to the recent upward revision of the US economic outlook, underscoring the Fed's focus on the real side of the economy. Notably, the Fed's revised optimism regarding the US economy is based on two factors: first, reduced slack in the labor market, exemplified by a 0.4% year to year drop in unemployment down to 4.6% in November, and second, stronger economic growth, with real GDP growth picked up to 3.2% during Q3, following a sluggish economic expansion during Q2 (1.4% q/q).

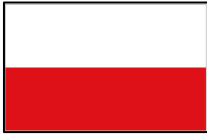
However, despite the recent spike in convergence between market expectations and the Fed's intention to adhere to its forecast for 2017, questions are raised as to whether the coming year will repeat the experience of 2016 with unfulfilled promises. The benchmark rate is a function of domestic and global macroeconomic aggregates, where cross-country differences, primarily in terms of monetary aggregates, introduce significant constraints on domestic monetary policy. Notably, pronounced differences with benchmark rates in the Eurozone and Japan introduce an upper limit in the rates' level of upward adjustment on the grounds of currency volatility. This constraint is further underscored by the Fed's broad focus on the real economy over narrow price stability.



Source: Federal Reserve Bank of St. Louis

Looking ahead to 2017, macroeconomic developments abroad, such as the European Central Bank's and the Bank of Japan's adherence to negative interest rates, are not the only variables factored into expectations regarding the US benchmark rate. Prices in the US economy are gradually picking up following anemic growth in core inflation (although not asset prices, which are skyrocketing). Similarly, the prospect of fiscal expansion under Donald Trump's presidency is pushing inflation expectations upwards. Thus, despite past experiences, one should not completely rule out the possibility of further rises in the Fed benchmark interest rate for the year to come. It may just be that 2017 is the year that exorcises the ghost of Christmas past.

At a glance



During its month's MPC meeting (on December 7th), the National Bank of Poland decided to hold policy rates steady, as expected. The Central Statistical Office reports Q3 GDP increased by 2.5% y/y in real terms, much lower than expected. While private consumption has increased (4.2% y/y), due in large part to accelerating wages and higher welfare spending, investment activity remains subdued (-7.3% y/y), weighing on growth expectations. Moreover, import growth has been stronger than export growth, dragging down the current account balance. CASE experts forecast 2016 growth at 2.8% and anticipate that the economy may accelerate slightly in 2017. However, high deficit levels caused by inflated social spending could likely lead to deficits exceeding three percent threshold, which, together with increasing policy uncertainty, may hamper future GDP growth.

CASE 2017 real GDP forecast down to 3.2%

Real GDP forecast (%)	2016	2017
CASE	2.8	3.2
IMF WEO	3.1	3.4
OECD	2.6	3.2

Recent OECD forecasts show that, following two years of recession, Russia's economy is expected to experience growth in 2017. Russian GDP contracted by 0.4% in Q3 y/y, the smallest contraction in 7 quarters, reflecting accelerated growth in mining, quarrying, and agriculture, as well as slower declines in construction, public administration, and transport. An additional chance for rebound might be lying in the recent cut in oil production, which is supposed to lead to higher oil prices. However, the Russian unemployment rate reached 5.4% in Q3 and is expected to continue growing in Q4, eventually reaching 5.7%. Further, some degree of political uncertainty remains for the Russian economy, particularly issues relating to EU sanctions that are extended until mid-2017.

GDP contracted by 0.4% in Q3 y/y

Real GDP forecast (%)	2016	2017
IMF WEO	-0.6	1.1
OECD	-0.8	0.8

Germany reaffirms its position as Europe's economic locomotive in December, with the IFO business climate index increasing to 111.0 from 110.40 in November, reaching February's 2012 high. However, economic conditions in the country are underscored by a tone of reserved optimism, as Current Conditions index fell from 115.6 in November to 105.6 and the Expectations Index reports a 0.10 improvement, from 105.5 in the previous month. Optimistic expectations for economic growth in the country are underscored by positive assessment of the manufacturing, wholesale and construction sectors, whilst services appear less optimistic than previously, a deterioration also evident by the sector's PMI (preliminary) decline from 55.10 in November to 53.80 in December.

Dec. Manufacturing PMI (prelim) index up to 55.50 from 54.30 in Nov.

Dec. Services PMI (prelim) down to 53.80 from 55.10 in Nov.

Real GDP forecast (%)	2016	2017
IMF WEO	1.7	1.4
OECD	1.74	1.65

At a glance

On December 21st, the Ukrainian Parliament enacted the state budget for 2017. The budget projects UAH 721.4 billion in revenues (EUR 26 billion) and UAH 790.4 (EUR 29 billion) in expenditure. In line with the IMF's recommendation, the budget keeps the deficit at 3% of GDP, increasing Ukraine's chance to receive another loan package from the Fund worth $17.5 billion. Two days earlier, PrivatBank, the country's largest lender, was declared bankrupt and taken under state control. Revised macroeconomic data for Q3 reveal 2.0% real growth (y-o-y), which is a better result than the data previously released by the National Bank of Ukraine (1.8%). Investments were the key driver of growth in the reference period, with gross fixed capital formation reaching 25% y-o-y. The interest rate remains unchanged at 14% since December 14th to keep the inflationary pressure in check.

GPD in Q3 grows by 2.0%

Real GDP forecast (%)	2016	2017
IMF WEO	1.5	2.5
OECD	-	-

The Czech National Bank (CNB) announced this week that it shall keep the interest rates unchanged at 0.05% for two-week repo rate, 0.05% for the discount rate, and 0.25% for the Lombard rate. It also confirmed it is going to maintain a fixed lower limit on EUR/CZK exchange rate. Moreover, the Government, on CNB's and Czech Ministry of Finance's recommendations, decided not enter the ERM II in 2017 and not to set any concrete dates for doing so. In other news, the Czech economy continues to suffer from an increasing outflow of funds from foreign owned companies, which according to the latest report prepared by the Czech Government own a significant share of businesses in some of the most profitable sectors of the economy. Nonetheless, economic growth in 2017-18, as forecasted by the OECD, is expected to remain stable, reflecting solid labor demand, which is expected to push down unemployment and drive up wages.

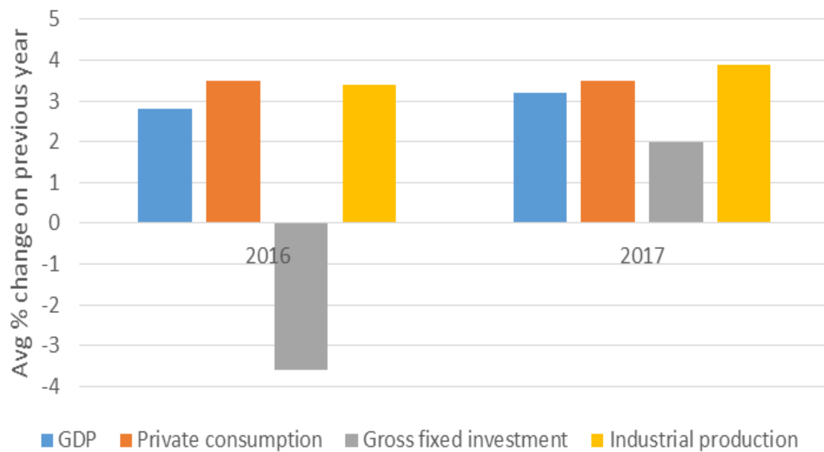
Interest rates unchanged at 0.05% (two-week repo rate), 0.05% (discount rate), and 0.25% (Lombard rate)

Real GDP forecast (%)	2016	2017
IMF WEO	2.5	2.7
OECD	2.4	2.5

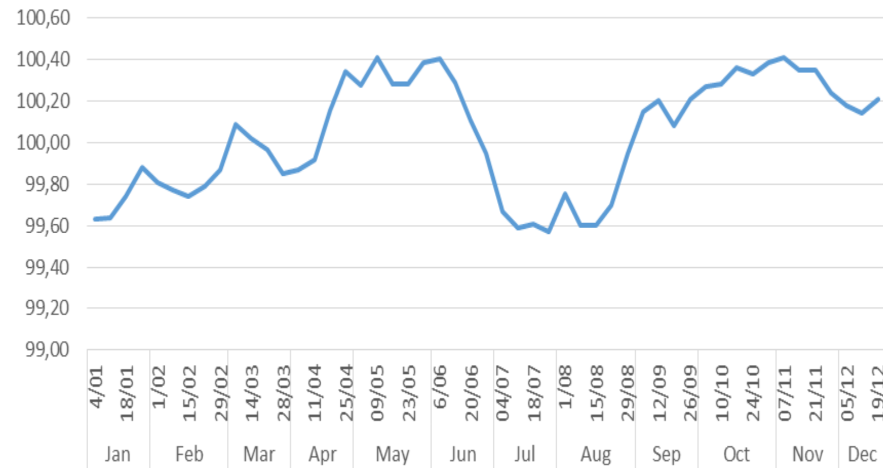
On December 21st, the Ministry of Economy released a new macroeconomic forecast, which sees output growth in Hungary at 2.1% in 2016 (revised down from 2.5%), 4.1% in 2017, and 4.3% in 2018. According to the forecast, the budget deficit will rise to 2.4% of GDP in 2017 (compared to the current 2.2%), but will then gradually fall to 1.2% in 2010. The inflation is expected to increase to 1.6% (currently 0.4%). A day earlier, the National Bank of Hungary also released its forecast, with the 2017 GDP growth estimated at 3.6% (revised up from 3.0%), and the inflation rate at 2.4% (revised up from 2.3%). At the same time, OECD forecasts expect Hungarian growth to reach 2.5% in 2017. The main drivers of growth would be the EU structural funding, increased bond ratings, and declining government debt burdens, and waning external vulnerabilities.

GDP growth to increase by 4.1% in 2017 (Ministry's of Economy forecast)

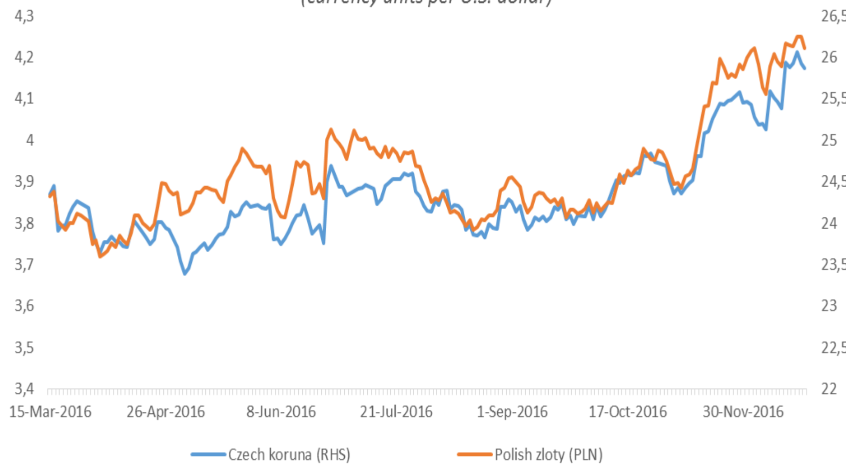
Real GDP forecast (%)	2016	2017
IMF WEO	2.0	2.5
OECD	1.7	2.5



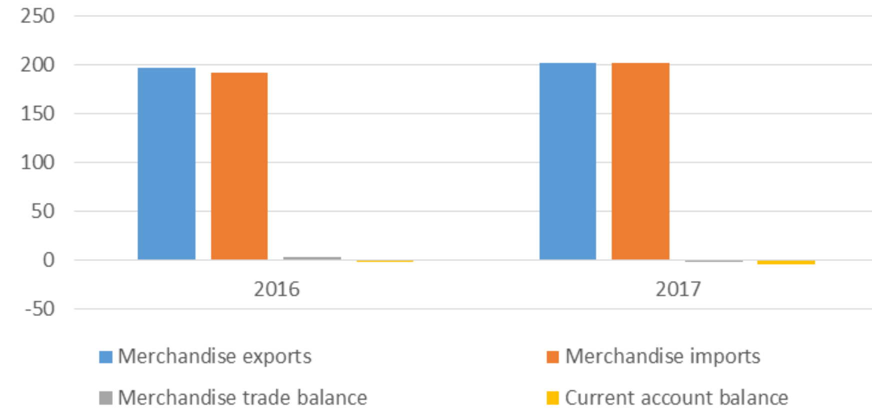
Source: CASE forecasts, updated December 23, 2016



Source: CASE, most recent observation December 19, 2016



Source: IMF, most recent observation December 23, 2016



Source: CASE forecasts, updated December 23, 2016

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