showCASE

No 4 | 28.10.2016

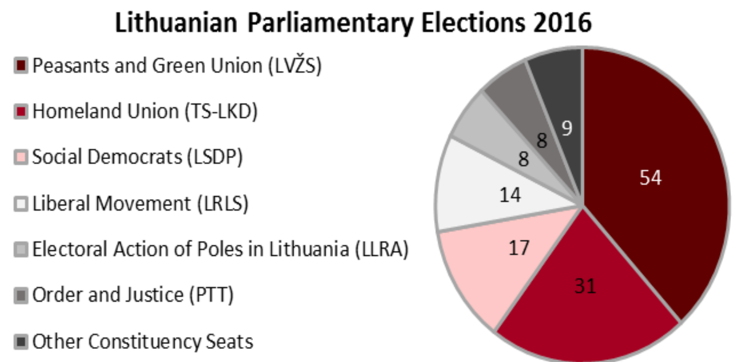
CASE – Centrum Analiz Społeczno-Ekonomicznych
CASE – Center for Social and Economic Research

Overview: In this week's showCASE, our experts discuss the surprising parliamentary election victory by the Lithuanian Peasants and Green Union party. CASE also dives into Italy's recent expansionary budget plans and how it affects the Italian economy.

Enter the Chameleon[1]

By: Krzysztof Głowacki

The agrarian Peasants and Green Union party has convincingly, if surprisingly, won the parliamentary elections in Lithuania as voters expressed their dissatisfaction with the traditional ruling class.



Source: The Central Electoral Commission of the Republic of Lithuania http://www.vrk.lt/en/pagal-data

The Peasants are organized around the leadership of millionaire farmer Ramūnas Karbauskis. The party lacks a coherent ideology and represents a mixture of individuals united by the self-acclaimed drive for political change. While this set of attributes bears semblance to political developments elsewhere in Europe, it lacks the fierce populist bite found in these other countries. Indeed, despite Karbauskis's occasionally revisionist rhetoric, the Peasants-led government is in fact expected to keep Lithuania on its current course within the EU, the Eurozone, and NATO.

On the home front, the party's elastic platform will enable it to consider any of the other parties as a coalition partner. Regardless of whom is chosen, the most important challenges for the new government will be pressing social issues, such as the outflow of economic emigrants to wealthier EU states. All parties made sure to embrace this issue in their electoral programs, building popular stories around low national wages but lacking details about concrete solutions. It is estimated that the country has lost 370,000 of its 3.3-million population since accession to the EU in 2004.

The elections saw the ruling Social Democrats relegated to third place, behind Christian Democrat runners-up Homeland Union. Three other parties also made it to Seimas, Lithuania's unicameral parliament: Liberal Movement, Electoral Action of Poles in Lithuania, and Order and Justice. While the liberals improved on their result from four years ago, the other two parties, considered more Eurosceptic and less progressive, did not.

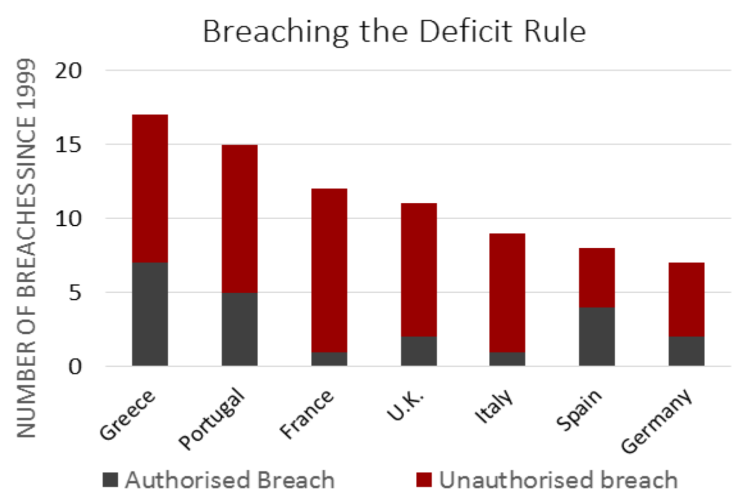
The victory of the Peasants increases their parliamentary representation from a single MP to fifty-four of them, marking another European ballot which has resulted in ousting elites in favor of political outsiders. It is a benign revolution, however, one that is unlikely to be a game-changer for the country and for the region.

[1] Title inspired by: http://www.eastbook.eu/2016/10/21/czy-zieloni-chlopi-obejma-wladze-na-litwie/

Italy's extraordinary circumstances

By: Iakov Frizis

As opposed to complying with a 0.5pp of structural deficit reduction set out by the SGP (Stability and Growth Pact), Italy approved an expansionary budget plan of €26.5bn last week, reiterating *extraordinary circumstances*, which sanction deviation under SGP's flexibility clause. Notably, the 2017 budget plan raises the deficit target to 2.4% of GDP for 2016 and 2.3% for 2017, up from 2.3% and 2% respectively. Meanwhile, debt to GDP is at 133.3%, second only to Greece among Eurozone countries. Italy's banking sector is also going through dark times, holding approximately €360bn of non-performing loans. As a result, Fitch cut its credit outlook for Italy from stable to negative, quoting weak growth, high debt and political uncertainty as the cause for downgrade.



Source: Ifo Institute, Eurostat

Granted, breaching budget rules is not a novelty for EU politics. A number of countries have failed to comply with the criteria that are often seen as outdated, with Portugal and Spain avoiding to become the first countries fined for such a practice as recently as August. Italy justifies this budget by quoting the adverse effect of the migration crisis and the recent earthquake on economic cyclicality; such *unforeseeable events* could indeed, according to the European Commission's (EC) response, sanction a breach of the country's medium term objectives. Nonetheless, Italy is called by the EC to provide further clarification as to the requested amount.

How valid are Italy's justifications? As for the earthquake, Mr. Codogno, visiting professor at the European Institute of LSE, approximates the bill at €5bn. Whilst impacts of the disaster on GDP growth appear limited, the most significant costs are associated with population losses in the region (i.e. regional economic potential). Increased public spending on reconstruction included in the new budget can, however, help offset the negative impacts of the crisis once implemented.

When discussing the fallout of the earthquake in his proposal for the new budget, Italy's Prime Minister, Matteo Renzi, made emotional pleas relating to the reconstruction of schools. But when it comes to migration, he takes the gloves off. For instance, earlier this week, he demanded sanctions against countries rejecting migrants (Visegrad 4), threatening to raise border walls and veto the upcoming EU budget if the Eastern countries do not open their doors to more asylum seekers.

As with any budget, the one recently put forward by Italy is underpinned by both political and economic reasoning. Undeniably, there is an economic cost associated with extraordinary circumstances that is to be determined. Yet, the balance that the Italian budged strikes, between sufficing the European Commission's requests and addressing Italy's economic woes, still raises a few eyebrows.

At a glance

According to provisional estimates made by GUS, economic activity in the third quarter of 2016 is not overly optimistic. Mostly, due to declining construction, the Polish economy is expected to grow slower than in the two preceding quarters (Q1: 3.1%, Q2: 3.0%). CASE experts believe that the end of the year growth will be around 3.1 percent, which is 0.3 percentage point lower than already revised government expectations. CASE experts anticipate that next year the economy may slightly accelerate, reaching 3.4% growth (y/y) in 2017. Other issues also persist, such as high deficit levels which are currently forecasted at 2.9% of GDP in 2017, just below the EU's 3% cap. Should actually GDP growth in 2017 be less than forecasted, this could create significant roadblocks for the new government's inflated social spending promises.

Sept unemployment fell to 8.3% from 8.4 in Aug (25 year low)

Real GDP forecast (%)	2016	2017
CASE	3.1	3.4
IMF WEO	3.1	3.4
OECD	3.0	3.5

According to the Federal State Statistics Service, Russian GDP contracted by -0.6% (y/y) in Q2, the smallest contraction in six quarters, due in part to an increase in manufacturing production. According to the preliminary estimate of Bank of Russia, the external debt as of September 30, 2016 equals $516.1 billion, representing a decrease of 0.5% compared to the end of last year. After double digit inflation growth in 2015, the economy seems to be stabilizing with annual inflation slowing to 6.4% in September. This seems to be a timid but positive sign for the country's economy after six quarters of contraction, caused in large part by low oil prices and economic sanctions.

Sept retail sales declines slow to -3.6% y/y compared to -5.1% in Aug

Real GDP forecast (%)	2016	2017
IMF WEO	-0.8	1.1
OECD	-1.7	0.5

October's business sentiment continued to improve according to this week's IFO survey, as companies across different sectors continue hiring. The current month's Bundesbank report notes increasing economic activity. GDP growth is forecasted at 1.7% for 2016 and 1.4% for 2017, whilst investment is expected to increase by 2.5% in 2016 and 1.8% in 2017. Positive sentiment is supported by the Manufacturing sector's improved (foreign-stemming) order situation, and higher capacity utilisation. Inflation remained stable, with producer prices noting a 0.1% month to month drop, whilst consumers' surged by 0.2%. Germany's current account reported a €17.9bn surplus in August, down from €18.6bn in July, with the Bundesbank quoting a rise in goods' trade.

Sept Manufacturing PMI index rose to 55.1 from 54.3

Sept IFO Business Climate index rose to 110.5 from 109.5

Real GDP forecast (%)	2016	2017
IMF WEO	1.7	1.4
OECD	1.6	1.7

At a glance

Ukraine's economy grew by 1.4% (y/y) in Q2. This positive development builds on Q1 growth of 0.1% (y/y), the first quarter of growth in two years. Headline inflation decreased to 7.9% (y/y) in September and stood at 1.8% m/m. The benchmark interest rate remains at 15% following a 50 bps cut on September 16th, and further cuts may be expected. The Central Bank has announced that banks' regulatory capital increased by UAH 4.8 billion (€ 172 million) to UAH 142.3 billion (€ 5.1 billion) in September, following the implementation of recapitalization programs. This has in turn contributed to the increase in the capital adequacy ratio from 13.9% to 14.2%, marking a fourth month in a row that this indicator is on the rise.

Banks' regulatory capital increased by UAH 4.8 bn to UAH 142.3 bn

Capital adequacy ratio increased from 13.9% to 14.2%

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

The Czech Statistical Office announced on Monday an increase in the overall economic confidence in the country, with consumer confidence indicator rising by 2.5 points to 109.9 m-o-m and economic sentiment indicator increasing by 0.4 points to 97.5 m-o-m. The confidence levels of entrepreneurs have not changed, though, while the confidence in industry decreased slightly. The predictions of the economic slowdown (2.4%) prevailing until the end of the year on account of a temporary decline in gross capital formation remain unchanged (Czech National Bank). However, a rebound up to 3.0% is expected in 2017 and 2018. The CNB's forecast for annual consumer price inflation remains unchanged at 2.2% for Q3 2017 and 2.4% for Q4 2017. In other news, following the reports from two weeks ago that the Russian-controlled ERB bank was deemed unable to meet its obligations, the CNB revoked its license on Monday this week.

Sept Business Confidence Index unchanged at 14.3

Sept Consumer Confidence Index up to 6.5 from 4

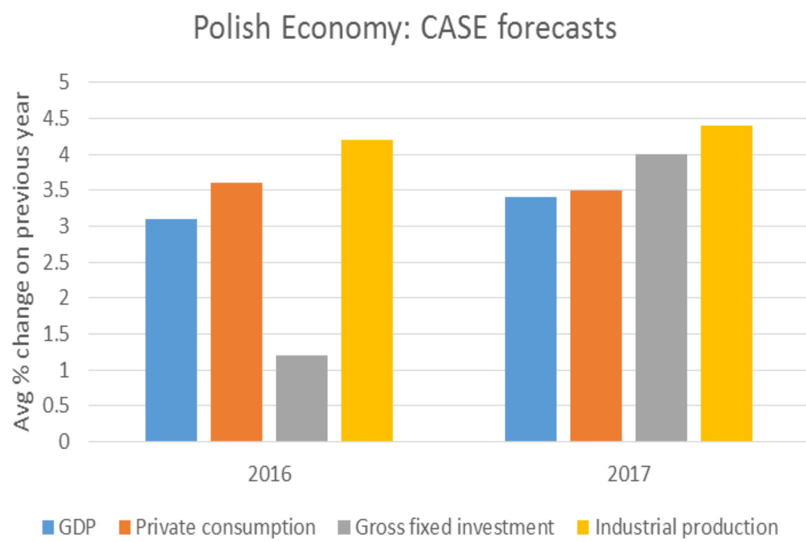
Real GDP forecast (%)	2016	2017
IMF WEO	2.5	2.7
OECD	2.4	2.6

This week, Hungarian Prime Minister Viktor Orban touted Hungary's improved financial situation, claiming economic due diligence in the field of debt financing. Overall, the Hungarian economy has made progress in reducing macroeconomic imbalances. Main drivers of growth in the economy include business capital accumulation, supported by inward FDI and, increasing household income, lower unemployment, deleveraging and low interest rates, which have contributed to an increase in overall demand for the economy. EU structural funds have also played a role in mitigating weak domestic investment caused by barriers to entry for SMEs and ever-changing regulations.

Benchmark three-month deposit rate unchanged at 0.9%

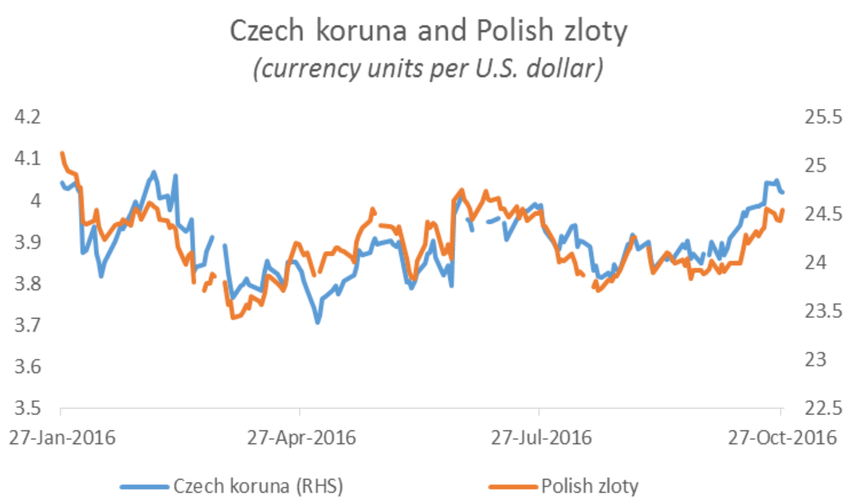
Overnight rate cut 0.1pp to 1.05%

Real GDP forecast (%)	2016	2017
IMF WEO	2.0	2.5
OECD	1.6	3.1

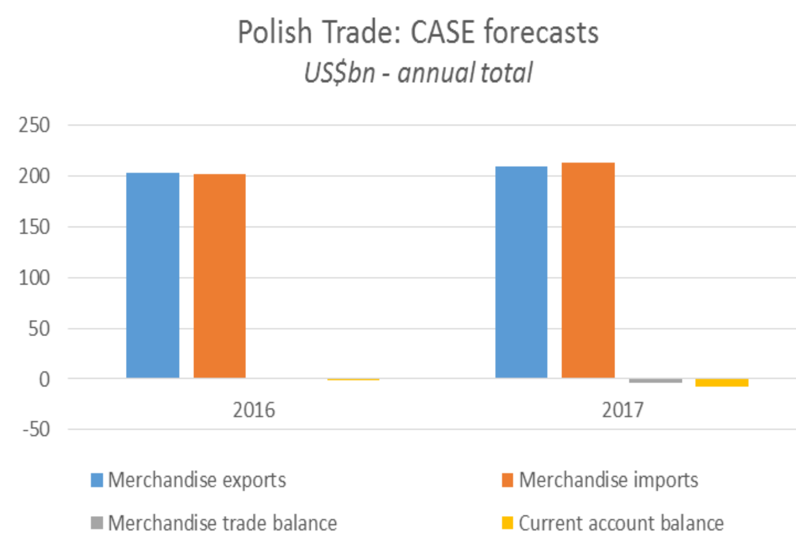


Source: CASE forecasts

Source: CASE. Most recent observation Oct 24, 2016



Source: IMF



Source: CASE forecasts

At a glance contributions: Krzysztof Głowacki, Paul Lirette, Katarzyna Mirecka, Katarzyna Sidło, Iakov Frizis
Editor: Paul Lirette, Editor-in-chief: Christopher Hartwell