showCASE
No 1 | 7.10.2016

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

Overview: In this week's showCASE, CASE experts analyze the recent announcement by Dutch Prime Minister Mark Rutte that his country is unlikely to ratify the EU Association Agreement with Ukraine. CASE also dives into how the US Department of Justice's US$14bn fines on Deutsche Bank is impacting investor confidence and diagnoses the financial health of the systemically important bank.

Dutch Disillusionment

By: Krzysztof Głowacki

The Dutch Prime Minister Mark Rutte has recently announced that his country is unlikely to give the green light to the EU Association Agreement with Ukraine, putting in jeopardy a treaty with immense economic and geopolitical significance.

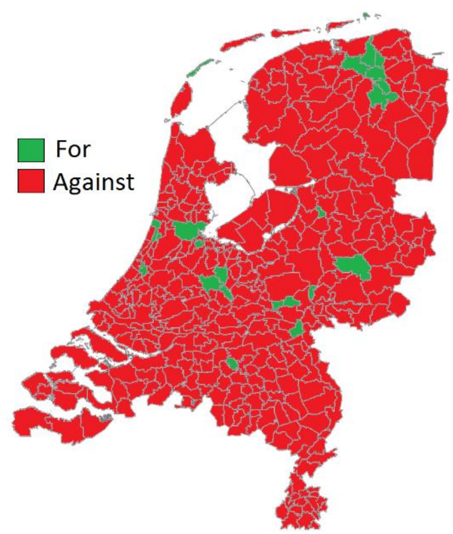
The Ukraine-EU Association Agreement is a comprehensive integration effort that sets ground for a free trade area, visa liberalization and gradual harmonization of laws across a number of areas. The Agreement has been signed and ratified by all EU Member States, including the Netherlands, and has been applied provisionally.

However, the deal has been unpopular with the Dutch population, eventually leading to an ex-post non-binding referendum in which over 60% of the voters expressed their disagreement with the ratification. In fact, the bid for non-ratification has served to spearhead a civic campaign against the politics of the EU, seen by part of the society as irresponsible and out of sync with national interests.

While the conservative-liberal Dutch cabinet seems to support the Agreement, it must also heed the public mood ahead of the parliamentary elections due in March 2017. Prime Minister Rutte has pledged to make his final decision by November.

For the EU, the Dutch disagreement is a reminder that Eurosceptic contagion, which has recently wrought havoc in the UK and helped cement the conservative cabinets in Hungary and Poland, hardly leaves any Member State immune. For Russia, it serves as another proof of Europe's dividedness and vulnerability to external pressures.

Referendum Outcome: "Are you for or against the Approval Act of the Association Agreement between the European Union and Ukraine?" (color corresponds to >50% of votes)



Source: *CASE analysis, NOS (data), Centraal Bureau voor de Statistiek (map template)*

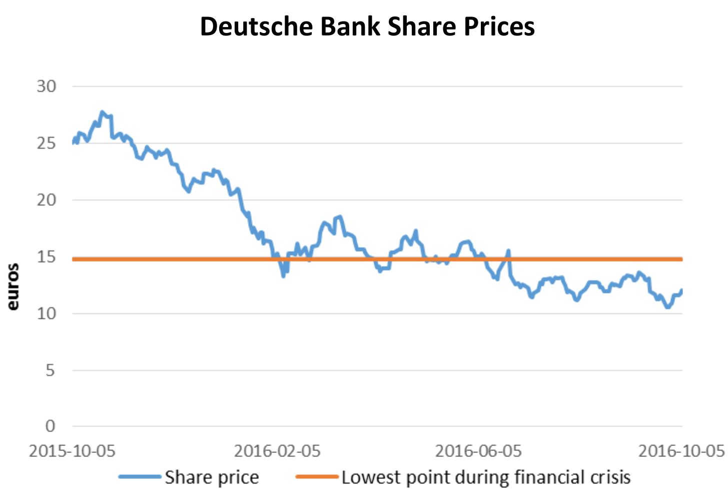
But for Ukraine, the stakes are even higher. The Association Agreement is the very same deal from which Viktor Yanukovych, Ukraine's former President, unexpectedly withdrew in late 2013. Yanukovych's defection set the country afire, paving the way for the Euromaidan Revolution and provoking Russian military intervention in southern and eastern Ukraine. In this sense, European abandonment of the deal three years later would be at least as painful symbolically as it would be practically.

Dwindling Confidence in Deutsche Bank

By: Iakov Frizis

Deutsche Bank (DB) has recently fallen under scrutiny following an announcement that the US Department of Justice is demanding it pay US$14 billion in fines. The fine is related to allegations dating as far back as 2005, relating to the bank's mortgage lending activity during the US housing bubble.

In June 2016, DB held roughly US$6.2bn in litigation reserves. This means that if the fine settles at US$14bn, they would need to raise nearly US$8bn in additional funds elsewhere. But the current financial environment characterized by negative interest rates, post-2008 regulations calling for increased capital cushions against risk and the need for business restructuring, has put pressure on DB's ability to attract new investors with equity profitability, raising concern about the bank's ability to pay such a hefty fine.



Source: Yahoo finance

Despite DB's attempt to reassure investors that worries over the bank's financial health are overstated, markets are worried by the banks' derivatives-ridden portfolio (notional value of $46.994 trillion, compared to German GDP of $3.39 trillion), its high leverage (assets to equity ratio of 25 to 1, whereas JP Morgan is leveraged at only 9 to 1) and a high percentage of illiquid assets of ambiguous valuation, which has been quoted as the principal reason for concern. This has created negative sentiment which has translated into a tumbling of the bank's stock to record lows, and a drop in investment, as some hedge funds aim to limit exposure to DB.

According to a recent study published by the IMF, the bank is the single most important contributor to systemic risk. This assessment is based on DB's risk-based business model founded on a thin capital base and the banks' propensity to outward spillovers given its high level of interconnectedness with lending and insurance institutions; a financial interdependence that is also supported by Duijvestijn and Straetmans (2012), suggesting that approximately 1 out of 3 banks would be affected by a DB bankruptcy.

However, many analysts have pointed out that the US Department of Justice has little practical or political upside for a penalty large enough to destabilise the systemically important DB and provoke a new financial crisis, implying that the fine could be negotiated to a lower price. Whether or not it will be low enough to refute investor's current concerns remains to be seen.

At a glance

The Polish economy remained strong, with Q2 GDP growth reported at 3.1% (y/y), slightly higher than 3.0% (y/y) in Q1. This is due in part to stronger private consumption and robust external demand outweighing sharp declines in fixed investment (-4.9% in Q1 and -1.8% in Q2). CASE experts believe GDP growth will increase further in H2, with 2016 annual growth settling at 3.6% (y/y) due, in part, to a slight rebound in gross fixed capital formation. However, challenges remain for the new Polish government. The recently released Draft 2017 Budget assumes a deficit of 2.9% of GDP, just below the EU's 3% cap, which will require strong 2017 GDP growth as well as careful balancing between the new government's inflated social spending promises and plans to increase bank and state-run utilities taxes.

PMI expands to 52.2 in Sept. from 51.1 in Aug.

NBP base policy rate unchanged at 1.5%

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. The economy contracted by -1.2% in Q1, indicating that the pace of slowdown is starting to ease. The main component of Russian services, wholesale and retail trade (accounting for 58% of the country's production) decreased by 1.2% in Q2, an improvement over -2.5% in the first quarter. After double digit inflation growth in 2015, the economy seems to be stabilizing with annual inflation slowing to 6.9% in August. 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.

Manufacturing PMI up to 51.1 in Sept. from 50.8 in Aug.

Inflation rate down to 6.4% in Sept. from 6.9% in Aug.

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

A booming autumn is expected for the German economy, driven by increased cyclical demand, favourable labour market conditions and rising household income. The Bundesbank forecasts GDP growth at 1.7% for 2016 and at 1.4% for 2017, whilst investment is forecasted to increase by 2.5% in 2016 and 1.8% over 2017. The Service sector is also bouncing back with business sentiment currently at a 28 month high. Industrial production fell unexpectedly by 1.5% in July, but is expected to settle at 1.4% for 2016. Inflation has reported incremental increases, with import and producer prices rising while energy prices remain stable domestically. Germany's current account was reported at €18.6bn in July, down from a surplus of nearly €25.4bn in July 2015.

HICP up to 0.5% in Sept. from 0.3% in Aug.

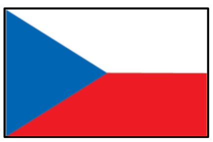
Manufacturing PMI up to 54.3 in Sept from 53.6 in Aug.

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, with investment being the key driver of growth. Domestic demand seems to be picking up, with increases in the trade and construction sectors. Agriculture also brought positive results due to early harvests and high yields, while services are recovering slowly. These positive developments build on Q1 growth of 0.1% (y/y), the first quarter of growth in two years. The consolidated state budget has a positive balance of €400.5m. Headline inflation was 8.4% (y/y) in August, but decreasing inflationary expectations and gradual economic recovery enabled the Ukrainian Central Bank to reduce the key policy rate to 15% as of September 16. These developments, as well as the decision of the IMF to pay out a needed (and delayed) $1 billion loan tranche, have helped ease depreciation pressures on the hryvna.

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



The Czech Republic's economy slowed from a 3.0% annual increase in Q1 to 2.6% in Q2, its lowest growth rate in two years. The slowdown is mostly due to a decline in government investment, which is partially financed by the EU. Experts forecast economic growth to continue its slowdown in Q3 as well. Last week the Czech National Bank (CNB) announced that it will continue its expansionary monetary policy and keep interest rates unchanged at technical zero. Facing continued declines in inflation, which remains well below the CNB's target of 2%, it also plans to keep its policy of maintaining a fixed lower limit on the EUR/CZK exchange rate at least until mid-2017.

Sept. Manufacturing PMI up to 52 from 50.1 in Aug.

Sept. Budget balance increases CZK82.3bn from CZK81.2bn in Aug.

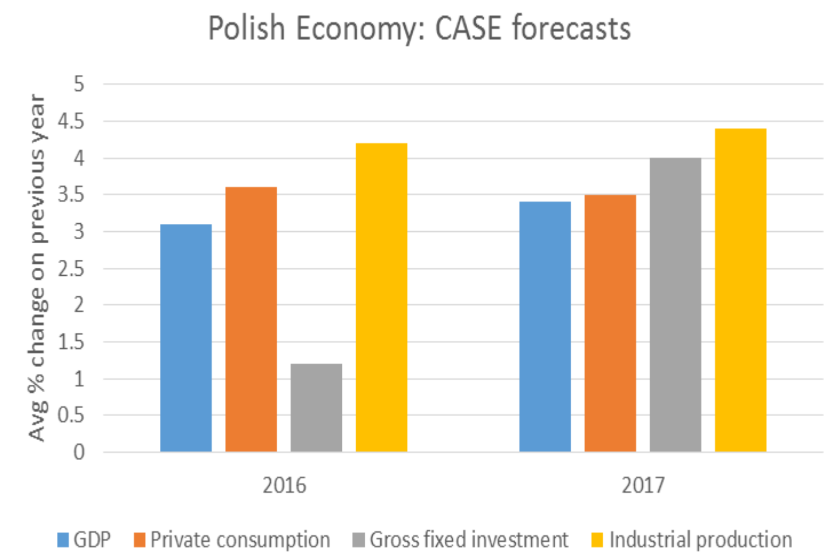
Real GDP forecast (%)	2016	2017
IMF WEO	2.5	2.7
OECD	2.4	2.6

Recent Hungarian National Bank growth forecasts peg Hungarian GDP growth at 2.8% for 2016, with Q2 reported at 2.6% (y/y). A key driver for growth in Hungary is business capital accumulation, supported by inward FDI and EU structural funds, which has mitigated weak domestic investment caused by barriers to entry for SMEs and ever-changing regulations. However, the IMF appears less optimistic about economic growth in Hungary, downgrading 2016 annual growth from 2.3% to 2.0% in their recent WEO report. While progress has been made in reducing the current account (from -7% of GDP in 2008 to 5% of GDP in 2015) and the public debt-to-GDP ratio (down 5% since the crisis), addressing non-performing loans and unlocking increased bank lending will be a key challenge moving forward.

PMI up to 57 in Sept. from 51.7 in Aug.

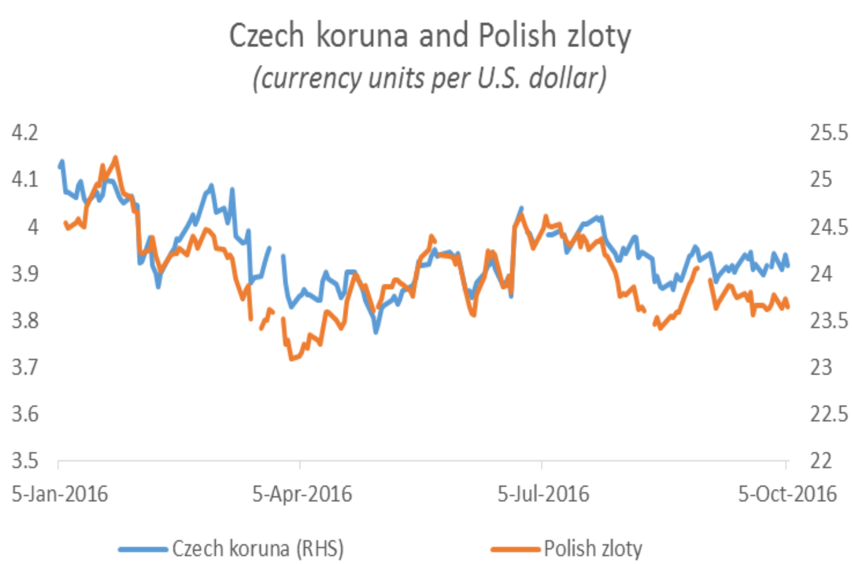
Aug. retail sales up 4.3% compared to 3.9% in July

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

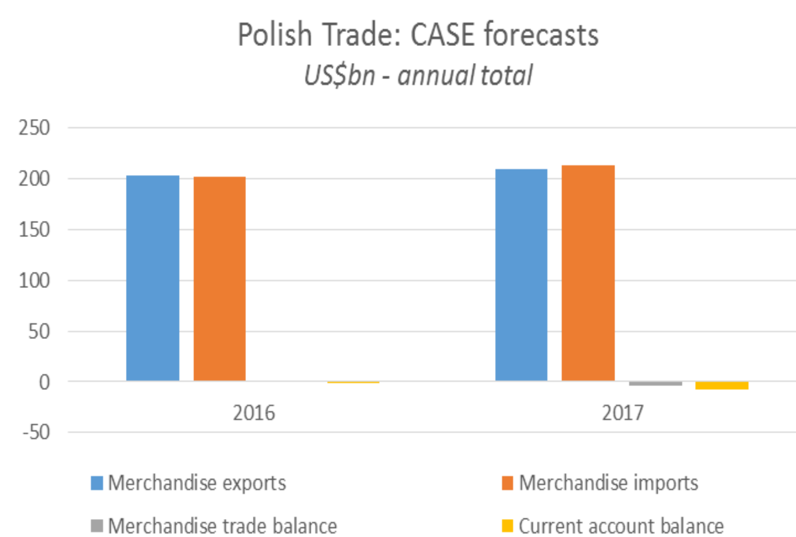


Source: CASE forecasts

Source: CASE. Most recent observation Oct 3, 2016



Source: IMF



Source: CASE forecasts

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