showCASE

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Overview: In this edition of showCASE, our experts discuss the condition of the Russian banking sector, which suffers from considerable imbalances despite attempts to cleanse it. Our analysts also discuss the record low unemployment levels in Central European countries and assess the dangers that they may bring to the national economies.

Russia's Banking Crisis Indicates Deep Rot

By: Anders Åslund, *Chairman of the CASE Advisory Council, Senior Fellow at the Atlantic Council*

Photo: Reuters

Since Elvira Nabiullina became chairwoman of the Central Bank of Russia (CBR) in 2014, it has closed or taken over more than 300 out of 800 banks. Nabiullina has won great accolades for her forceful actions to clean up the substandard Russian banking system, but three bank closures in the third quarter have shaken this impression.

In July, the CBR took over Yugra Bank, the 33rd largest lender, which aroused queries. Was this needed after three years of cleansing? On August 29, the CBR seized Bank Otkrytie, the biggest private bank by assets, and within one month also the fifth biggest private bank, Binbank. Together Bank Otkrytie and Binbank accounted for 15 percent of all private banking assets. Suddenly, it became clear that the Russian banking system has not been cleansed but is rotting.

During the previous bank closures, three banks have functioned as the major consolidators, namely state-owned VTB, Bank Otkrytie, and Binbank. VTB has a steady poor reputation for dubious business in the service of the Kremlin. Binbank has been controlled by the family of Mikhail Gutseriyev, who has a background that is more colorful than arousing trust. VTB owned 10 percent of Bank Otkrytie that carried out a daring $10 billion currency operation to the benefit of Rosneft in December 2014, which brought about a serious currency crisis. Now these two banks have gambled away their ownership, showing how unsuitable they were as consolidators.

After two of the biggest private banks have collapsed, further bank failures are widely expected, and they easily become self-fulfilling. Naturally, both corporations and individuals now move their deposits from private banks to state banks on a large scale. Rosselkhozbank, one of the big state banks, is even advertising in the Moscow metro that the state owns it to 100 percent. With the exception of well-respected Alfa Bank and foreign banks, this might ring the end of significant private banking in Russia.

Already before these bank failures, the five big Russian state banks accounted for nearly 60 percent of all bank assets. Now this share will rise sharply. Because of their size and state guarantees, the state banks have lower funding costs than the private banks, which can easily be tempted to gambling because of the uneven playing field.

Another consequence of the size of the state banks is that they want to give big loans, primarily to state companies. One businessman complained to me that even the old savings bank, Sberbank, does not give loans of less than $30 million any longer. Small and medium-sized enterprises are starved of credits, while big state companies are floating in cheap credits, nurturing the quickly proceeding renationalization of the Russian economy, while impeding competition and efficiency.

A further concern is that Bank Otkrytie and Binbank have bought numerous private pension funds and insurance companies. If they were so unreliable as banks, what might they have done with this sensitive long-term capital that is so scarce in Russia?

Although it might be too early to draw a firm conclusion, the suspicion is great that the Russian banking cleansing has failed, and the survival of viable private banks in Russia is in question.

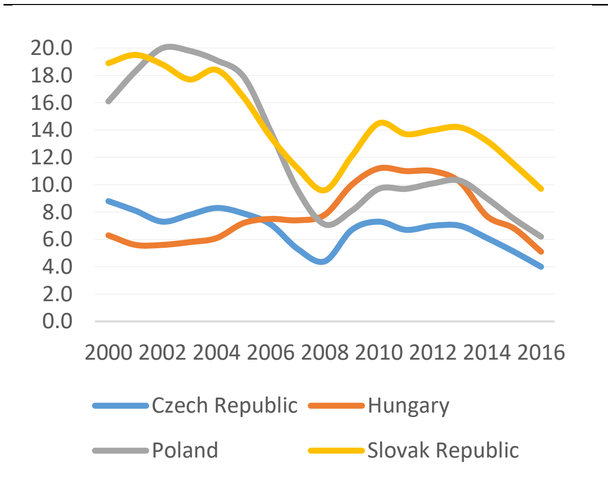
Anders Åslund is a senior fellow at the Atlantic Council and Chairman of CASE Advisory Council.

Hidden Imbalances in CEE labor markets

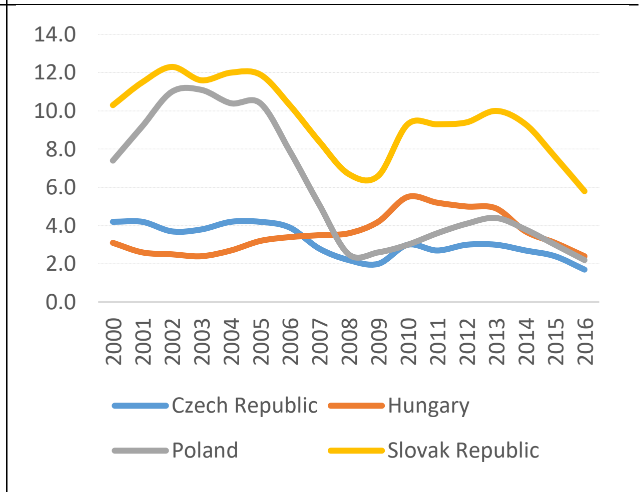
By: *Marian Mraz, Senior Economist, and Klaudia Wolniewicz-Slomka, Economist*

According to the most recent economic data (see Graph 1), unemployment rates in Central and Eastern European (CEE) region are hitting record lows, with levels not seen since the early 2000 (or, for Poland, since the early 1990s). As of August 2017, the official unemployment rate was [2.9% in the Czech Republic, 4.2% in Hungary[1], 4.7% in Poland, and 7.3% in the Slovak Republic](). The long term unemployment rate, a traditional concern for the Central European policy makers, exhibited similarly positive patterns (see Graph 2). Having struggled for so long with structural unemployment, this trend threatens to challenge policymakers in a different way, namely, a rising shortage of people available to meet increasing labor market demands.

Graph 1. Unemployment rate [LFS, %]



Graph 2. Long-term unemployment rate [LFS, %]



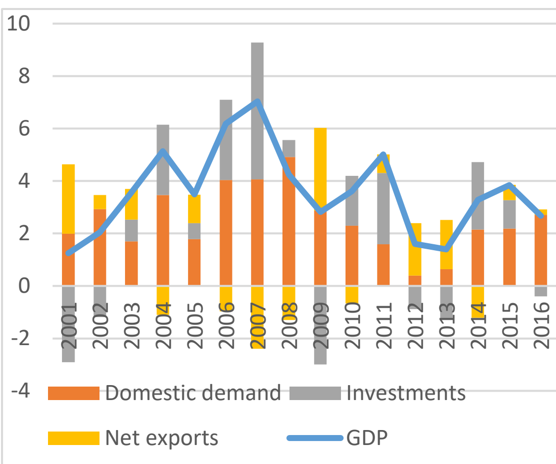
Source: Eurostat

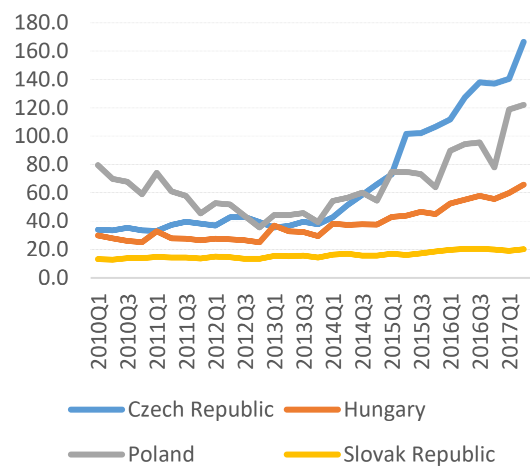
[1] For HU we use data from July 2017 as no record for August 2017 was available.

During 2017, Central European economies, in particular those closely interlinked with Germany via trade and industrial value chains, performed very strongly economically, benefiting from the (slight) recovery in the Eurozone and (more importantly) in Germany. This growth was partly driven by exports and partly by domestic demand, as falling unemployment is starting to drive wage increases across the region and increase household consumption. The respective contributions of the GDP components to the overall economic growth in Poland are depicted in the Graph 3. Expectations of strong growth remain in the region for the foreseeable future.

Good labor market conditions in the region are reflected mainly by the rising number of available jobs. For example, the number of vacancies in Czech Republic and Poland increased by 30% over the previous year (see graph 4). In the Slovak Republic, Volkswagen (the biggest employer within the Slovak automotive industry) created 1500 new jobs last year and an additional 400 during the first half of this year, and the trend appears to be on the rise for similar gains in the future.[2]

Graph 3: Contributions of the GDP components to the GDP growth rate (in p.p.)	Graph 4. Number of job vacancies





Source: Eurostat

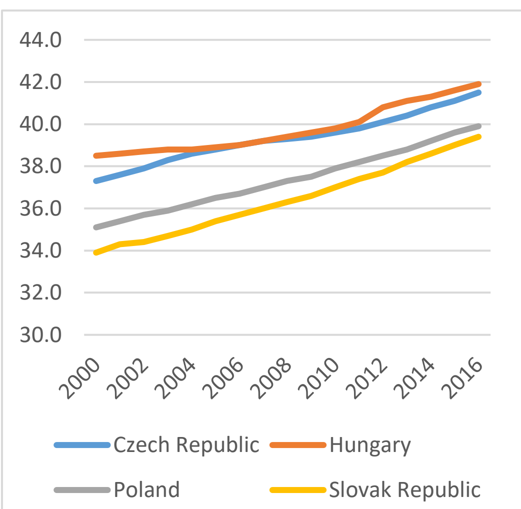
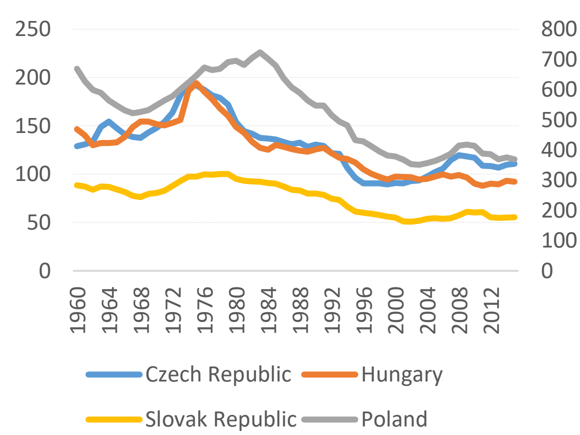
Ironically, one of the issues driving CEE growth is also threatened by its success. Central European countries remain competitive in terms of maintaining relatively low labor costs. According to Eurostat, the average hourly labor costs in 2016 were 8.30 EUR in Hungary, 8.60 EUR in Poland, 10.20 EUR in the Czech Republic, and 10.40 EUR in the Slovak Republic – all well below the EU average of 25.40 EUR. However, tightening labor market conditions and the increasing lack of hands to work is causing increasing upward pressure on wages, with every country seeing steep increases in 2017. In the second quarter of 2017, Eurostat reported nominal wage increases of 13% in Hungary, 11% in the Czech Republic, 8% in Poland, and 7% in the Slovak Republic. While a boon for workers in the region, rising wages also represent additional costs for companies, which might translate into increases in the prices of products and services they sell.

[2] See here: https://www.etrend.sk/firmy/volkswagen-otvoril-pandorinu-skrinku-pripustil-zamestnavanie-cudzincov.html

Not only is quantity an issue, but an increasing number of firms have become concerned about the decreasing quality of the available work force. According to the EBRD-World Bank Business Environment and Enterprise Performance Survey carried out in 2013, around 22% of the firms in the Czech Republic, 19% in the Slovak Republic, 13% in Poland, and 7% in Hungary perceived an inadequately-educated workforce as a severe obstacle. The findings of an International Business Centre survey conducted by the in 2017 also show that 60% of Polish medium and large companies are affected by the same issue. Similarly Reuters reported on the annual survey carried out by Manpower Group. They showed that 57 % of Hungarian companies included in the survey had difficulties finding workers. This outcome represents a 10 percentage point leap from last year. The OECD's "labor shortage indicator" has also been rising steeply since 2013. This indicator suggests that around 13% of surveyed companies in the region declared labor shortages as a factor limiting their production in 2016.

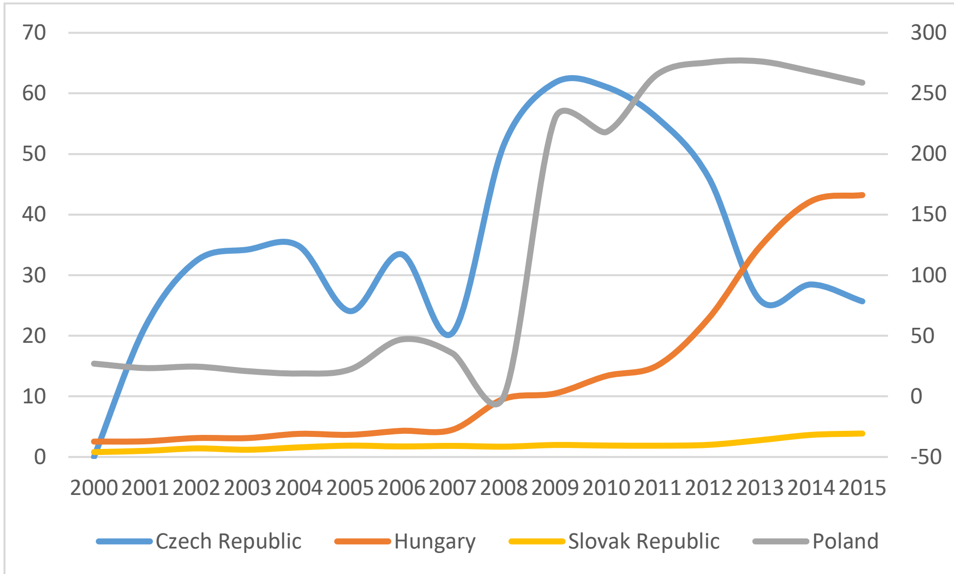
Shortage of human capital can create a huge barrier for further development and faster growth in the region, and it is not an issue which can be addressed rapidly. It is exacerbated by other trends within the CEE region. Like many other countries, Central European economies face an aging population and increasing migration in particular of their younger generation. Demographic change is perhaps one of the motivating factors behind the shrinking unemployment rates seen throughout the Visegrad states. In fact median age in Central European countries has been rising for at least two decades (Graph 5). A rising median age can in principle be driven by one of the two effects: prevailing low birth rates and out-migration of young people or a combination of the two.

The available data suggests that both might be to blame. Annual live births currently are only approximately 60% of the births recorded just 40 years ago (Graph 6), and the trend is negative. As a consequence, fewer young people are entering the local labor market, a reality which might severely affect the ability to generate an appropriately-skilled labor force for the future. At the same time, given the shifting of political winds in the region, demands of the major employers to increase allowances for employing third-country foreigners (in particular from Ukraine, the Balkans, or Asian countries) is encountering resistance from national authorities. At the same time many rather young and relatively high-skilled people have been emigrating from the region and pursuing their careers abroad. Although the trends differ somewhat among the countries in particular since 2008 (i.e. when the economic crisis hit) strong increase in emigration has been recorded in Poland, Hungary and Slovakia (Graph 7).

Graph 5. Median age	Graph 6. Live births (thousands)
	

Source: Eurostat, note that in graph 6 for Poland the left hand axis applies.

Graph 7. Emigration from Central European countries (in thousands of persons)



Source: Eurostat, note that for Poland the left hand side axis applies

Central European economies have achieved impressive macroeconomic results in terms of stable GDP growth, rising salaries, and reduction of their unemployment rates. However, the increasing migration of high-skilled workers, in particular from the younger generation, and population aging have only recently come into focus for regional policymakers. Both aspects could be motivating factors behind the strong reduction of unemployment rate. If not addressed by the appropriate policies they can cause significant problems for future economic growth and social welfare systems in the future.

This week: The Monetary Policy Council of the National Bank of Poland decided to keep interest rates unchanged this week, with the base rate remaining at 1.5%. The Council stated that, despite the gradual rise in domestic inflationary pressure due to improving domestic economic conditions, the risk of annual CPI exceeding the inflation target is still low. Core inflation in the national economy remains low, and the price growth in the global economy is moderate.

GDP (Q2 2017, est.)

4.4% y/y

Up from 4.2% in Q1

Inflation (Sep 2017, est.)

2.2% y/y

Up from 1.8% in Aug

Unemployment (Aug 2017)

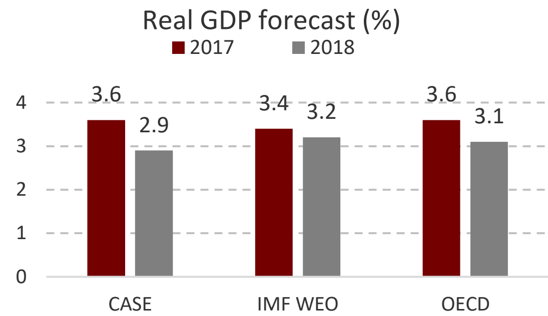
7.0%

Down from 7.1% in July

NBP Base rate

1.5%

From 2% Mar 2015



This week: The visit of the Saudi Arabian King Salman in Russia, the first ever visit of a Saudi monarch in this country, resulted in several memoranda of understanding concerning economic cooperation of both states. King Salman and President Putin discussed energy issues and the future of the oil-supply agreement of Russia and OPEC, which comes to its end in March 2018. The relations between the two energy superpowers have been troubled in the past, but this historical visit might be a sign of a shift of alliances.

GDP (Q2 2017)

2.5% y/y

Up from 0.5% in Q1

Inflation (Aug 2017)

3.3% y/y

Down from 3.9% in July

Unemployment (Aug 2017)

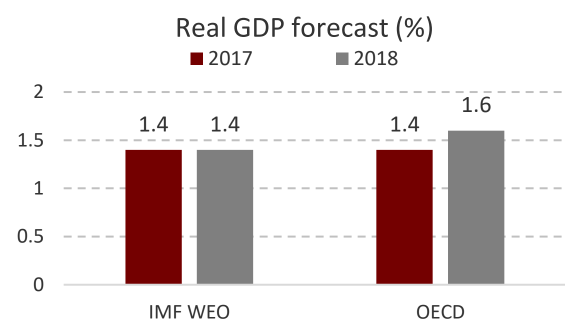
4.9%

Down from 5.1% in July 2017

CBR Base rate

8.5 %

From 9%



This week: Good signals are coming from the German economy. The country's combined manufacturing, construction and energy sectors expanded by 2.6% in August m/m, marking the highest increase since July 2011. These results fueled optimism at the German stock exchange, with the Dax index reaching 12,969.29 points, just below the record level of 13,000 points, on October 9th.

GDP (Q2 2017)

2.1% y/y

Up from 2.0% in Q1

Inflation (Aug 2017)

1.8% y/y (est.)

Up from 1.5% in July

Unemployment (Aug 2017)

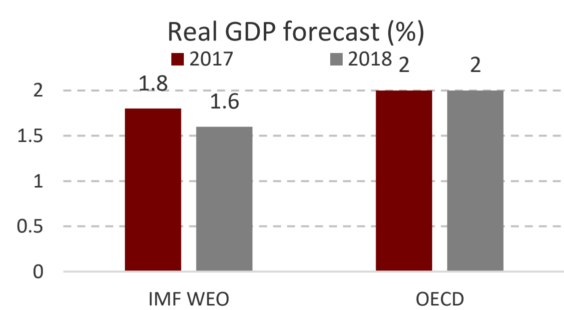
3.7%

Up from 3.6% in July

ECB Deposit rate

-0.4%

From -0.3% Dec 2015



This week: On October 9th, President of Turkey Recep Erdoğan visits Ukraine to meet with his Ukrainian counterpart Petro Poroshenko. The meeting will be the sixth one held under the Turkish-Ukrainian High-Level Strategic Council format, and a number of agreements are expected to be signed. Previous summits under the format involved opportunities to explore economic cooperation, including a USD 50 million loan offered to Ukraine by Turkey in 2015.

GDP (Q2 2017)

2.3% y/y

From 2.5% in Q1

Inflation (August 2017)

16.2% y/y

Up from 15.9% in June

Unemployment (Q2 2017)

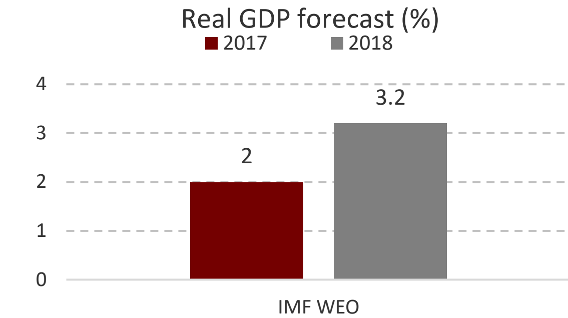
9.1%

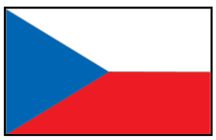
Down from 10.5% in Q1 2017

NBU Base rate

12.5%

From 13.0% in May





This week: Inflation in the Czech Republic increased by 2.7% y/y in September, and it remains within the 2 p.p. tolerance band around the Central Bank's 2% target. Increasing global oil prices contributed to headline inflation, while core inflation was rising in response to the expanding economy and wage increases related to the record low unemployment (see the article above).

GDP (Q2 2017)

4.7% y/y (est.)

Up from 3.0% in Q1 2017

Inflation (Sep 2017)

2.7% y/y

Up from 2.5% in July

Unemployment (Q2 2017)

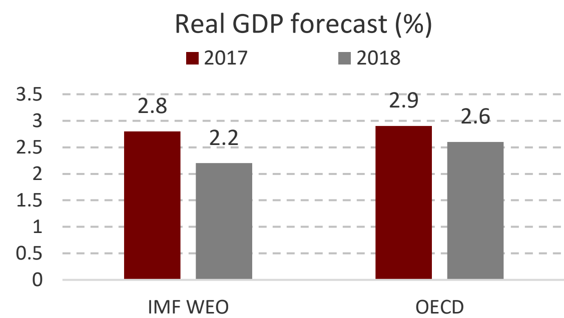
3.0% (est.)

Down from 3.4% in Q1

CNB Base rate

0.25%

From 0.05% (4 August 2017)



This Week: Péter Szijjártó, Hungary's Minister of Foreign Affairs and Trade, said on October 4th that Hungary is interested in buying natural gas from Russia after 2021 via the projected Turkish Stream pipeline, and that it had signed a relevant roadmap. According to the Minister, alternative solutions (including LNG) are not viable due to insufficient infrastructure, with the Croatian LNG terminal not ready and the EU reverse-flow network still underdeveloped.

GDP (Q2 2017)

3.2% y/y

Down from 4.2% in Q1

Inflation (August 2017)

2.6% y/y

Up from 2.1% in July

Unemployment (Q2 2017)

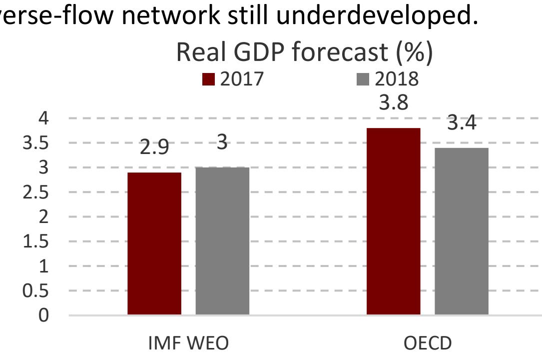
4.2%

Down from 4.3% in Q1

MNB Base rate

0.9%

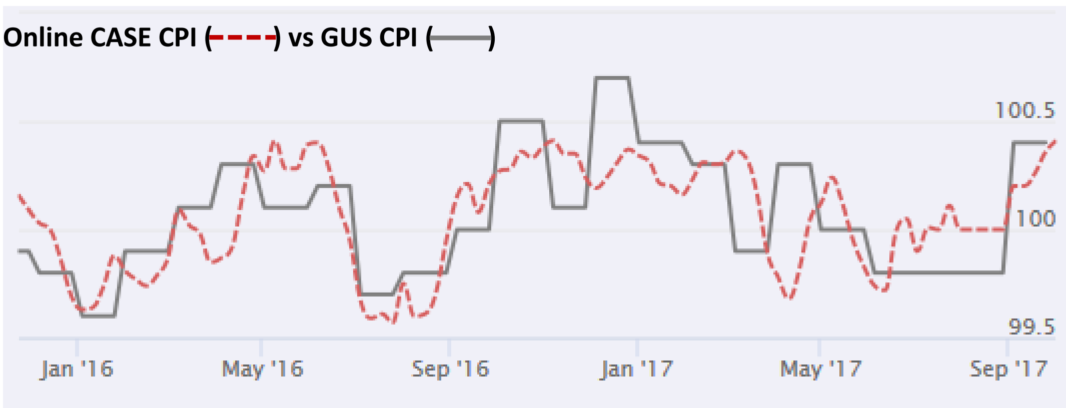
From 1.05% May 2016



The weekly online CASE CPI

The online CASE CPI is an innovative measurement of price dynamics in the Polish economy, which is entirely based on online data. The index is constructed by averaging prices of commodities from the last four weeks and comparing them to average prices of the same commodities from four weeks prior. The index is updated weekly.

Our weekly online CASE CPI



Monthly CASE forecasts for the Polish economy

Every month, CASE experts estimate a range of variables for the Polish economy, including future growth, private consumption, and foreign trade, current account balance, and the CPI.

CASE economic forecasts for the Polish economy
(average % change on previous calendar year, unless otherwise indicated)

	GDP	Private consumption	Gross fixed investment	Industrial production	Consumer prices
2017	3.6	3.9	2.9	3.8	1.9
2018	2.9	3.0	2.7	3.7	2.0
	Nominal monthly wages	**Merchandise exports (USD, bn)**	**Merchandise imports (USD, bn)**	**Merchandise trade balance (USD, bn)**	**CA balance (USD, bn)**
2017	4.7	201.6	201.8	-0.2	-4.7
2018	3.5	211.3	213.1	-1.8	-5.9

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