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Press release

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Eastern European Outlook, October 2104*:* Gradual recovery despite Russian and Ukrainian weakness

Gradual economic recovery will continue in Poland/Central Europe and the Baltic countries in 2015-2016 despite the Russia-Ukraine conflict, which is making Russia start to stagnate and causing Ukraine's GDP to plunge this year. But growth in Poland, Latvia and Lithuania will be moderate. In Estonia – which is also squeezed by Finland's stagnation – it will remain weak. Short-term growth will also be squeezed by a temporary economic slump in Germany and the euro zone. Zero growth can be expected in the euro zone during the second half of 2014, partly due to uncertainty about the Ukraine crisis, writes SEB in the latest issue of its twice-yearly *Eastern European Outlook*.

Growing private consumption and a resumed German/euro zone upturn in 2015 will offset lost exports to Russia and Ukraine as well as plummeting investments due to geopolitical worries. Households are benefiting from continued good real incomes (especially in the Baltics) and low interest rates: both largely due to continued very low inflation. Direct trade ties between conflict-hit countries and individual Central and Eastern European countries are also relatively small, except for the Baltics and a number of other former Soviet republics.

SEB expects the Russia-Ukraine conflict to be long-lasting. The growth forecasts presented in *Eastern European Outlook* are based on the key assumptions that the conflict will not escalate militarily, no serious disruptions to Russian energy deliveries to Europe will occur and trade sanctions between the West and Russia will not be tightened. The current sanctions – which SEB believes will have a relatively small direct impact – will presumably remain in place during most of 2015.

"We are sticking to last spring's assessment that the conflict will have only minor negative effects at the global level. Direct exports to Russia from individual countries are relatively small, except for the Baltics, Finland and nearby former Soviet republics. But geopolitical uncertainty will also blunt investment appetite, at least in the short term, not only in the vicinity of the crisis area but broadly across Europe," says Mikael Johansson, Head of Eastern European Research at SEB and Chief Editor of *Eastern European Outlook*.

Here are the GDP forecasts for the six countries that *Eastern European Outlook* covers. SEB's forecasts for 2015 are generally below consensus.

- **Russia's** GDP will grow by 0.4 per cent in 2014, fall by 0.2 per cent in 2015 and climb by a mere 1.0 per cent in 2016. Weak capital spending, slower real household wage growth and clearly lower oil prices in 2015 will squeeze the economy. The rouble will fall further, helping slow the decline in high inflation. Popular support for President Vladimir Putin has surged due to the Ukraine conflict, but is expected to erode over time.

  "Russia has strong financial muscles that will provide a short-term buffer. But the conflict with Ukraine is worsening an already weak economic situation, which is largely due to structural problems. This underscores the need for reforms, especially considering that oil prices will be under downward structural pressure during the next couple of years," notes Andreas Johnson, who is in charge of Russia and Ukraine forecasts at SEB Economic Research.

- **Ukraine** is in deep recession and has a long journey back, despite a major currency depreciation that strengthens its export prospects. GDP will fall by 8 per cent this year, reach zero growth in 2015 and return to weak 2 per cent growth only in 2016. Inflation is high and the banking sector is under pressure. Expanded European Union/International Monetary Fund bail-out loans may be needed. Ukraine is moving towards greater federalism; its embrace of the West is not yet a given, despite its EU association agreement.
- **Poland**, with relatively small imbalances, shows good resilience to the Russia-Ukraine conflict. This year's German slump is a major reason behind Poland's temporary dip during the autumn. Large EU funds and new interest rate cuts will soon help push up domestic demand. The euro issue may be raised politically in 2015-2016. GDP will climb by 2.7 per cent in 2014, 3.0 per cent in 2015 and 3.5 per cent in 2016.
- **Estonia's** strongly export-dependent economy will be squeezed not only by slower Russian growth but also by sluggish economic performance in Finland and weak capital spending. Estonia will be stuck with lacklustre growth of 1.2 per cent this year and 1.3 per cent in 2015, moving close to 3 per cent only in 2016.
- **Latvia**, the fastest-growing EU country over the past two years, will see decent growth of 2.7 per cent in 2015 and 3.4 per cent in 2016, after this year's dip to 2.5 per cent. Domestic consumption will remain the key driver. The coalition government was recently re-elected and SEB expects no big political shifts.
- **Lithuania** is moving towards broad recovery in domestic demand: this year the construction and housing markets have begun to revive, later than in the other Baltics. GDP will rise by 2.7 per cent in 2014, 3.2 per cent in 2015 and 4.0 per cent in 2016. The important energy sector will become more secure at the end of 2014 when the country opens a new gas terminal, radically reducing its current 100 per cent dependence on Russian gas.

A separate **theme article** in *Eastern European Outlook* discusses Russia's ambitions to create a counterweight to the European Union: **the Eurasian Economic Union (EEU)**. But the EEU will be off to a shaky start in 2015 with only three members: Russia, Belarus and Kazakhstan. Ukraine, a big potential member country, recently signed an association agreement with the EU, dealing a blow to Russia's EEU project.

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