SEB

Press release

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Eastern European Outlook: Russia and Poland in a slump but show decent resilience to global crisis

In 2013-2014, regional heavyweights Russia and Poland will continue to cope with the international crisis better than many other countries in Eastern (including Central) Europe, especially central and southern portions of the region, where several economies will recover only slowly from their current stagnation/recession. But GDP growth will be modest – 4 per cent and 3-4 per cent respectively – and Poland is losing its regional "star performer" status of recent years. In the Baltics, rising domestic demand and competitive exports will help GDP growth reach its potential annual rate of about 4 per cent. Latvia, previously the most severely crisis-hit of the Baltics, will show the strongest, most uniform growth in 2012-2014, writes SEB in the October 2012 issue of its twice-yearly *Eastern European Outlook.*

Because of moderate export dependence, modest public sector debt and small or moderate dependence on bank financing via the crisis-plagued euro zone, **Russia** and **Poland** can show decent resilience to the weak performance of the global economy. But even Russia and Poland are feeling the effects of the deceleration, especially in Western Europe. Since last spring, their economic slump has been somewhat deeper than expected: in Russia due to sagging exports, in Poland because of slowing consumption and capital spending. SEB expects their slump to be temporary, however. During 2013, Russia growth will speed up again due to continued high oil prices and good consumption growth, while Polish domestic demand will be sustained by falling inflation and sharply declining interest rates in recent months, which will soon be reinforced when the central bank begins to lower its key interest rate.

A separate theme article in the report examines competitiveness in the **Baltics**. Its conclusion is that internal devaluations in the form of wage and price cuts during 2008-2010 were large enough to restore competitiveness. In recent years, all three Baltic countries have regained previously lost export market shares. They are also performing decently in competition with the EU's seven other Eastern European economies, although Latvia ends up in last place in terms of its export performance during 2005-2011. SEB believed that the export competitiveness of the Baltics will remain good, but with a warning of a possible slower trend in Estonia, which already stands out because of its relatively high pay increases and inflation.

- The painful austerity measures of recent years in the Baltics were effective. Internal devaluations and tough budget belt-tightening corrected earlier imbalances in the form of high wage-driven inflation, extreme current account deficits and large public sector budget deficits. These measures have restored competitiveness and laid the groundwork for continued long-term recovery in domestic demand. But the Baltics cannot relax. Risks have re-appeared, with already relatively high wage and salary growth in Estonia and a burgeoning current account deficit in Lithuania. And high unemployment is a major lingering challenge for all three countries, says **Mikael Johansson**, Head of Eastern European Research at SEB and Chief Editor of *Eastern European Outlook*.

Ukraine's growth has decelerated harder than expected, mainly because lower steel prices have hurt exports and political uncertainty has held back investments. The economy will recover slowly over the next couple of years, sustained by consumption and because exports will be fuelled by a devaluation of at least 10 per cent after the October 28 parliamentary election. We expect Ukraine to continue balancing between Russia and the EU in terms of political and economic integration.

As for **euro zone membership timetables**, SEB continues to predict that **Latvia** will meet the Maastricht criteria and can thus adopt the euro **in 2014 as planned**. Lithuania is in somewhat worse shape than Latvia with regard to economic convergence. Political uncertainty there is also greater; a change of government is expected after the October 14 election. The current government's 2014 target date is unsustainable and **Lithuania** will probably join the euro zone **later than 2015**. **Poland** has no explicit target date for euro zone accession; today **2016 appears to be the earliest** likely target date.

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