Eastern European Outlook

Economic Research – March 2013

Continued decent growth in northern Eastern Europe

Theme: Euro timetable

SEB

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Summary

Economic growth in Eastern (including Central) Europe has bottomed out in the past 3-6 months, as in the West. And like the pattern in Western Europe, the northern part of Eastern Europe is performing better than the southern part. The Baltic countries in particular, but also Russia and Poland, will continue to show decent GDP increases during 2013-2014 while Ukraine will remain mired in economic stagnation this year as well. Countries in central and southern parts of the region, such as the Czech Republic and Hungary, are climbing extremely slowly out of recession while Croatia and Slovenia will continue to show negative growth.

The northern part of Eastern Europe is displaying relatively good resilience to the global slowdown and the euro zone debt crisis, mainly since their economies and banking sectors are in relatively good fundamental shape and because Russia is benefiting from continued high oil prices of around USD 110/barrel. Countries in the southern part of the region have larger internal imbalances and their banks are squeezed more by the problems in Western Europe.

Unemployment is gradually falling in the Baltics and Russia but will rise in Poland this year and remain high in Ukraine. Large emigration from the Baltics in recent years is causing some bottleneck problems in their labour markets. Although pay increases are generally speeding up, the cost situation is under control with the possible exception of Estonia. Export competitiveness thus remains good, after earlier internal devaluations. In Russia, the jobless rate has already dropped below its equilibrium level, generating cost pressures and growth problems generally. This year, inflation will continue to fall in the Baltics and Poland but rise somewhat in Russia and rebound clearly in Ukraine, despite its economic crisis.

Here are our GDP forecasts for the six countries that *Eastern European Outlook* covers:

- **Russia's** growth will cool slightly to 3.0 per cent this year and 3.5 per cent in 2014. The economy is already hitting its resource ceiling, and far-reaching reforms will be needed to lift its growth potential to President Vladimir Putin's 5-6 per cent target.
- **Poland** is recovering from a deep domestic slump, aided in part by the big decline in interest rates over the past six months – but the central bank is finished cutting interest rates. This year, GDP will increase about as much as last year, 2.1 per cent. In 2014, growth will speed up to 3.5 per cent, still below the potential rate of around 4 per cent.
- **Ukraine** will see zero growth again this year, and GDP will rise 1.8 per cent in 2014. The economy is squeezed by a big current account deficit and sagging confidence. A new IMF bail-out loan is needed; we expect a devaluation in the second quarter.
- **Estonia's** growth will accelerate from 3.2 per cent last year to 3.8 per cent in 2013 and 3.7 per cent in 2014. This is still below potential, which is roughly 4 per cent in the Baltic countries. As elsewhere in the Baltics, growth will be relatively balanced.
- **Latvia** remains the fastest-growing EU country. A temporary dip from last year's 5.5 per cent to 3.8 per cent will occur this year. In 2014, growth will revert to 5 per cent.
- **Lithuania's** GDP will increase by 3.2 per cent this year and 3.5 per cent in 2014, after last year's 3.6 per cent growth.

Latvia will convert to the euro in 2014 as planned. The country meets all Maastricht criteria by a wide margin. But no wave of new euro zone memberships by the EU countries in Eastern Europe can be expected; for most of them, accession will be delayed for some years. The main reason is that, except for Lithuania, their governments have made adopting the common currency a lower priority due to the euro zone crisis.

Growth has bottomed out, but the recovery is sluggish

- **Deleveraging and political uncertainty**
- **Euro zone will stay in recession this year too**
- **The euro will weaken**

The world economy is moving in the right direction after great weakness late in 2012 in many countries, especially in Western Europe. But this is occurring at a **slow pace**, and mainly emerging economies are sustaining improved growth. In Europe, unemployment will continue rising this year. **Recovery is being held back by heightened economic policy uncertainty** and because many governments, households and banks, especially in the West, **have not yet achieved their deleveraging targets after the financial crisis**. Sources of political uncertainty include US budget policy, China's new long-term growth model, the euro zone's stumbling progress towards political union, Spain's bail-out needs and the long-term risk of Greek withdrawal from the euro zone. In this uncertain, economically tough environment, businesses will continue to hesitate about investments this year. But in the US we expect a thaw in capital spending after this spring, once fiscal policy has become clearer. We predict a compromise solution between Democrats and Republicans, resulting in a fiscal tightening effect totalling some 2.0 per cent of GDP this year, a long-term increase in the federal debt ceiling and public debt that will peak in 2015 at about 115 per cent of GDP.

Meanwhile **positive growth forces are in motion**. Central banks will set **new monetary stimulus records** in 2013. There is room for this because large idle resources mean continued low core inflation. In the past year, central banks – first in Germany and later in Japan and the UK – have also indicated a willingness to allow more inflation. **Financial stress in crisis-hit euro zone countries has eased** greatly, following major downturns in long-term bond yields since last summer. Global stock markets have climbed relatively sharply. In the past 3-6 months, **industrial indicators have cautiously begun to rise**. In February 2013, PMI in the US was 54 and China and Germany were slightly above the expansion threshold of 50. **The recovery in the US and China** is on increasingly firm ground. Among factors helping sustain US growth are that household deleveraging has made major progress and that housing and construction markets have bounced back convincingly; we predict that home prices will climb 5 per cent this year. **Japan's new focus on stimulus-driven growth** will help lift global growth in the short term. **Greater flexibility** in **global fiscal consolidation and in implementing the new Basel III banking regulations** will reduce their negative impact on growth. Among other positive factors is that **imbalances in Europe are shrinking**; crisis-hit countries are improving their competitiveness via lower wages and large current account deficits have already shrunk noticeably. Overall, **global growth will gradually rise to 3.7 per cent in 2013 and 4.1 per cent in 2014**; the latter is close to trend.

Euro zone GDP will still fall this year by 0.3 per cent, only a slightly smaller decline than in 2012. The reason is the negative trend in crisis-hit countries. Only in 2014 will the euro zone achieve growth. **Germany**, which has relatively small imbalances and is carrying out some fiscal stimulus this year, **will continue to escape recession**. GDP will rise by 0.6 per cent in 2013 and 1.6 per cent next year. German economic growth is especially important for Central Europe; for example Germany buys about 30 per cent of Polish and Czech exports.

Demand in Eastern (including Central) Europe will also strength a bit after bottoming out in many countries late in 2012. Sentiment indicators have recently stabilised and improved slightly. But the **regional divergence** typical of Eastern Europe in the past year or two **will continue in 2013**. With their stronger fundamentals, Russia and Poland will maintain better growth than many other countries, although the trend of Polish domestic demand and thus GDP growth were a clear disappointment in the second half of 2012. Some central and especially southern parts of the region remain more depressed; for example, the Czech Republic and Hungary are climbing extremely slowly out of their 2012 recession. We expect both Slovenia and Croatia to show negative growth again in 2013 after about a 2 per cent GDP decline last year.

Credit supply and funding costs at **Eastern European banks** have greatly improved since summer, as in the West. But **credit conditions for customers are thawing only slowly**. Credit demand is generally low except in a few countries like Russia.

Global key data

GDP, year-on-year percentage change

	2011	2012	2013	2014
United States	1.8	2.2	2.1	2.7
Euro zone	1.4	-0.5	-0.3	0.9
The world	3.8	3.3	3.7	4.1
Oil, USD/barrel	112.3	111.8	109.9	110.0
EUR/USD, Dec	1.29	1.32	1.28	1.20

Source: IMF, SEB

The euro will again fall against the US dollar after rising since last summer, largely due to the ECB's determined signals and readiness (the OTM programme) to "save the euro", greater confidence in fiscal consolidation by crisis countries and new US quantitative easing. The remaining need for crisis countries to improve their competitiveness will be one factor behind a new EUR weakening. The USD will recover due to relative US growth advantages and because the market will price in the Fed's gradual exit from its ultra-loose monetary policy.

Euro zone accession will take some years for most

- **Euro zone crisis makes leaders cautious**
- **Few meet inflation and currency criteria**
- **Only Latvia ready for early accession – 2014**

On March 5, 2013, Latvia submitted to Brussels its formal application for euro zone membership in 2014. The application was expected. Ever since 2009, when Valdis Dombrovskis took office as prime minister amidst a deep economic crisis, the Latvian government had been clearly determined to adopt the euro. Over the past two years, the government has declared 2014 as its target date. **For a long time, our assessment has been that Latvia will also get the green light after this spring's ECB and EU evaluation reports. On January 1, 2014, Latvia will thus become the 18th euro zone member**. This will make it the fourth Eastern European nation to join, after Estonia (2011), Slovakia (2009) and Slovenia (2007).

But we cannot expect a wave of accessions by the other six non-euro zone EU members in Eastern Europe over the next couple of years. There are several reasons:

1. In recent years, the euro zone debt crisis has caused most Eastern European governments to **give the euro question a lower priority on their political agenda**. The crisis has made it unclear what direction the euro zone is headed in terms of supranational fiscal policies and the stability of the euro in general. Consequently, some governments have cut back on their ambitions to pursue economic policies that will quickly lead to economic convergence in order to live up to the Maastricht criteria (for details, see footnote to adjacent table).

2. Only Latvia and Lithuania have joined the Exchange Rate Mechanism (in 2005 and 2004, respectively), in which at least two years of participation are required before euro zone accession. The fact that the other five countries have not joined the ERM clearly indicates that the euro question has been moved lower on the political agenda, as stated in point 1.

3. Weaker Eastern European economic performance in recent years – partly due to the euro zone crisis and recession – with sagging GDP growth and even recession last year in potential euro zone candidates Hungary and the Czech Republic, make it **harder to fulfil the Maastricht budget criterion**. Tax revenues have fallen and unemployment benefits have risen, along with other social spending.

4. Inflation is too high in most of these countries compared to the Maastricht inflation criterion – a moving target calculated on the basis of the latest available data before the EU/ECB evaluations. At that time, the criterion equals inflation in the three EU countries with the lowest inflation plus 1.5 percentage points. It may remain difficult to meet this criterion over the next couple of years since inflation will probably be pushed down further in the wake of large slack in the EU economies, partly due to a continued rise in unemployment this year.

We have **examined how well the potential euro candidates in Eastern Europe are currently performing relative to the most vital convergence criteria for euro zone accession**: the three that cover price stability and sound public finances. Our review is based on outcomes/forecasts for 2012 from the European Commission for inflation, budget deficits and debt.

How well EU members in Eastern Europe outside the euro zone fulfil key Maastricht criteria*

2012 outcomes/forecasts according to European Commission winter 2013 report. Red figures = shortfalls

	Inflation	Budget	Debt
	%	% of GDP	Same
Bulgaria	2.4	-0.1	18.9
Latvia	2.3	-1.5	41.9
Lithuania	3.2	-3.2	41.1
Poland	3.7	-3.5	55.8
Romania	3.4	-2.9	38.0
Czech Republic	3.5	-5.2	45.5
Hungary	5.7	-2.4	78.6

*****_Inflation_ at the time of evaluation may not be higher than 1.5 percentage points above the yearly average for the three EU countries with the lowest inflation: 2.77 per cent in 2012; which was used in our evaluation. _The general government budget deficit_ may not exceed 3 per cent of GDP. _Government debt_ may not exceed 60 per cent of GDP or must be moving down towards this level at a satisfactory pace. Beyond these three central criteria, there are three others: _Long-term government bond yields_ may not exceed 2 percentage points above those of the three EU countries with the lowest inflation. The exchange rate must have been stable for two years, with ERM membership and no devaluation. The _central bank_ must be politically independent. Worth noting is that when the ECB and EU evaluate whether a country meets the Maastricht criteria, they also assess whether there has been a _long-term deceleration_ in its inflation rate and budget deficit.

Source: European Commission, SEB

We can draw the following conclusions from our review. **Only two of seven EU members in Eastern Europe outside the euro zone currently meet the three most important Maastricht criteria: Latvia and Bulgaria. Latvia also meets the other three criteria, while Bulgaria falls short because it is not/has not been an ERM participant.** No fewer than five of the seven exceed the inflation limit, all by relatively wide margins, especially Hungary. Four countries meet the budget criterion; of the other three, only the Czech Republic is wide of the mark. The criterion where Eastern European convergence scores are best is public sector debt; only Hungary fails the test, with public debt of nearly 80 per cent of GDP, while most of the others are well below the 60 per cent ceiling. These Eastern European EU members thus have significantly better public sector debt positions than most Western European countries, including the current euro zone members.

Below is **our euro timetable forecast** for the seven non-euro zone EU members in Eastern Europe, in chronological order.

Latvia, 2014

Latvia will convert to the euro in 2014, as planned. The country meets all Maastricht criteria by a wide margin. It is also difficult to accuse Latvia of using quick-fix economic policies to force down inflation and budget deficits. The downward trend of recent years appears lasting ahead a year or two. Note that convergence towards future euro zone accession was also one key objective of Latvia's EU/IMF-led international loan package in 2008-2011. Another reason we believe Latvia will be admitted to the euro zone is that the EU probably wants to show that the euro process is alive, despite the current economic crisis in various member countries.

Lithuania, 2015 at the earliest

There is a 50-50 chance that Lithuania will achieve the 2015 target date established by the centre-left government that took office after last autumn's parliamentary election. The previous government had set an overly ambitious accession target of 2014. The country has decent potential to meet the budget criterion, but during the coming year it may be tricky to bring down inflation sufficiently; the evaluation will cover the year-on-year average for March 2013 to March 2014.

Poland, 2016 at the earliest

Poland has no target date. This winter, Prime Minister Donald Tusk reiterated the country's cautious stance on the euro question: Poland will aim at meeting the convergence criteria as soon as possible, but what is crucial to a decision to adopt the euro is ensuring that it is "100 per cent safe for Poland". In other words, the euro zone must also be ready, Tusk told Parliament on February 19, 2013. Our assessment is that the criteria will be easily within reach for accession in 2016, provided Poland chooses to join the ERM no later than 2014.

Bulgaria, 2016 at the earliest

Bulgaria has no target date. In 2010, former Prime Minister Boyko Borisov said that Bulgaria was then aiming for euro zone accession by 2013. Enthusiasm on the euro question remained high until the autumn of 2012, when Borisov and former Finance Minister Simeon Djankov openly and frankly declared that Bulgaria had shelved its plans to adopt the euro: "Right now, I don't see any benefits of entering the euro zone, only costs," Djankov told the *Wall Street Journal* on September 3. He added that disunity among euro zone countries on dealing with the debt crisis and lack of the clarity about new rules made it too risky for Bulgaria to join the euro zone. This represents a significant cooling in Bulgaria's euro ambitions. Nor is it likely that the new government of Marin Raikov – installed after a sudden shift in February when the Borisov government was forced out due to massive popular discontent with its austerity policies – will choose to pursue the issue of euro zone accession. Bulgaria actually meets the Maastricht criteria already (except for ERM), but the politically uncertain situation make membership before 2016 improbable.

Romania, 2016 at the earliest

Romania has no target date. Its previous target, 2015, was scrapped in the autumn of 2012. Central bank Governor Mugur Isarescu said very firmly at that time that the euro question was off the agenda, although he added that the country should continue to aim at meeting the Maastricht criteria in order to demonstrate good discipline. The country is already well on its way to fulfilling the criteria, aside from its excessively high inflation. But the euro question is clearly a lower priority than before, making Romanian accession before 2016 unlikely.

Hungary, 2018-2020

Hungary has no target date. In recent years, political signals have indicated that the euro question is ice cold and that accession will not occur until 2018 at the earliest. In addition, Hungary today has very tense relations with the EU after the Viktor Orban government's controversial amendments to the constitution, which the European Commission and the Council of Europe believe will threaten the rule of law. Hungary is also in bad shape as regards fulfilling the criteria, with far too high inflation and public sector debt.

Czech Republic, 2018-2020

The Czech Republic has no target date. Just as in Hungary, euro zone ambitions have been clearly toned down. The government has said it first wants a referendum on the issue and that the koruna will be replaced by the euro no earlier than 2020. Also notable is that the central bank and finance ministry made a joint statement in December 2012 on the Internet making it very clear that euro zone membership will not be a priority: No target date will be set during 2013 and the country will not join the ERM this year. In economic terms, the Czech Republic has excessively high inflation, but above all its continued large budget deficit makes euro zone accession feel very distant.

Domestic demand shows resilience, exports shaky

- **Household sector still deleveraging**
- **Growing emigration a big challenge**
- **Inflation levelling out, high wage growth an upside risk**

Contrary to developments in the euro zone and Nordic countries, Estonian economic growth rates accelerated during the second half of 2012, after a slowdown in the first half. On a quarterly basis, the economy bottomed out in the first half of 2012 year-on-year and accelerated to 3.7 per cent in the fourth quarter. Domestic demand remained the main driver. But in the last quarter of 2012, exports also quite successfully resisted the slowdown in major export markets and the recession in the euro zone, growing at a 7.1 per cent year-on-year rate. Export performance is quite shaky and vulnerable to sudden setbacks, but with Estonia's gradually improving prospects in export markets, our main scenario is modest growth in exports this year and improving prospects in 2014. Domestic demand is resilient. Capital spending was by far the biggest driver of economic growth in 2012 but will likely shrink in importance during 2013 because of slowing public investments, while private consumption will increase its contribution to growth. All in all, the economy should show a relatively balanced growth path. **We expect GDP to rise by 3.8 per cent in 2013 and 3.7 per cent in 2014.**

Balanced growth is resulting in a small current account deficit. During the final quarter of 2012, this deficit widened somewhat because merchandise imports surged and merchandise exports grew only modestly. The reason was strong domestic demand growth, even though there was a slight deceleration in private consumption and a more noticeable deceleration in capital spending growth. The construction sector relinquished its role as a growth driver. But what boosted domestic demand was public consumption growth, which is going to be temporary.

Construction volume growth decelerated sharply in the second half of 2012. Aside from temporary government spending, growth drivers in the fourth quarter included the information and communication, transport and agricultural sectors.

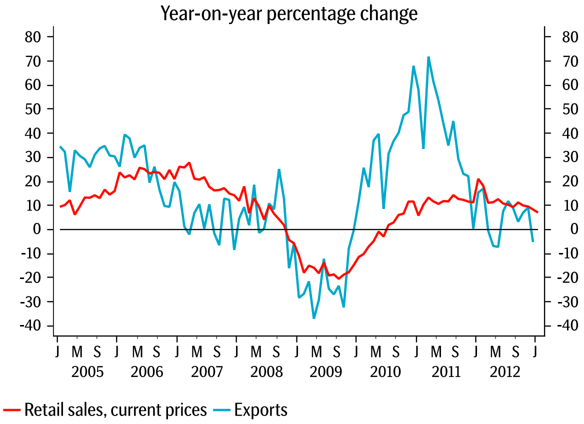
The capital spending increase in the private sector is coming at the right time in 2013, as public sector investments are set to decrease. Increased investment activity is also reflected in vigorously expanded lending to companies during the second half of 2012 and early in 2013.

Households, on the contrary, are quite cautious in taking on new loans. **Total lending to individuals was still decreasing as of January 2013**, and the loans granted monthly stopped rising late in 2012. Household debt as a share of GDP went up during the pre-crisis years from about 20 per cent in 2004, peaking at 54 per cent in 2009. After that it decreased to 41 per cent at the end of 2012. The level is still slightly higher than at the end of 2006 when the economic boom was in full swing. As for home mortgage loans, individuals may stop deleveraging during 2013, and there are initial signs of revival in loan demand.

Real wage increases have gradually recovered but were still a rather modest 2.4 per cent in the last quarter of 2012 in year-on-year terms. **We expect real wage increases to continue in 2013 and support private consumption**. Disposable income will also be lifted by a cut in unemployment insurance tax and increased social transfers, such as child benefits, fathers' benefits and pensions. Social benefits will rise by 6 per cent. All in all, private we expect private consumption to increase by 4 per cent in 2013 and 3 per cent in 2014.

Retail sales and export growth

Year-on-year percentage change



Source: Statistical Office of Estonia

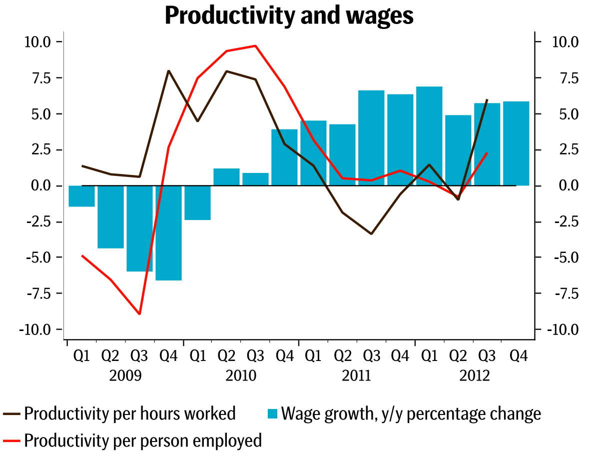
Real estate prices are gradually recovering, rising by 7-8 per cent year-on-year. However, no housing boom is likely in the near future. Prices are not being driven by increased loan demand by households, but more because real estate is seen as an investment opportunity in the environment of very low interest rates. The majority of real estate transactions take place without bank loans.

General economic sentiment was relatively stable during 2012. Estonia remained **among the most optimistic countries in Europe**, just behind Latvia. Business sentiment has been stable, with the only exception being the manufacturing sector, where confidence fell at the end of the year. Consumer confidence deteriorated slightly during the fourth quarter but surged again at the beginning of 2013.

Manufacturing still faces a relatively tight external environment. With a gradual improvement in external demand, exports should be capable of continued moderate growth in 2013, though risks remain high and setbacks may occur.

The **biggest macroeconomic problem** in Estonia is **growing emigration and the resulting labour market tensions**. In 2012, emigration rose abruptly to nearly 10,900 people, or 4,600 more than the previous year. This was the biggest outflow of people in a decade. At the same time, the natural rate of population decline worsened during the past two years. This will adversely affect the available workforce both in the short and long term. The labour shortage is already the biggest obstacle to expanding businesses in Estonia. The most acute shortage of labour is for relatively low value-added jobs in the service sector, with richer neighbouring countries luring away the workforce that could perform these low-paid jobs.

Productivity and wages



Source: Eurostat, Statistical Office of Estonia

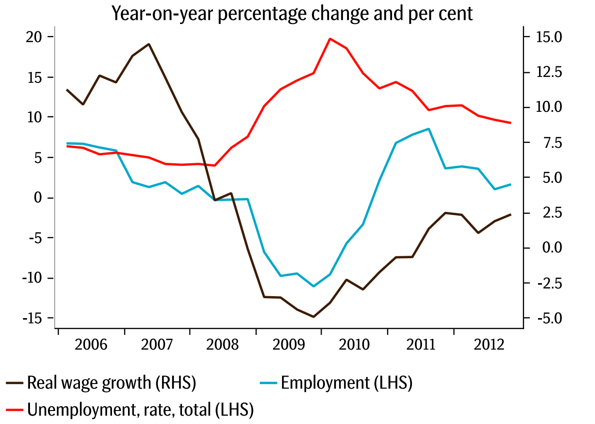
Because employment has increased at the same pace as output, productivity has remained practically unchanged for the past two years. Meanwhile wage growth has surpassed the productivity increase. It is about time to turn this trend around, and the first signs of rising productivity can already be seen. Widespread pay increases are also projected, for example in the public sector, as a result of strikes in the medical sector and among pilots. Collective wage agreements have been reached in the energy sector, along with minimum wages. Public sector employees constitute about a quarter of the workforce. There will also be a continuing post-crisis pay adjustment process in the private sector, although the situation varies between sectors. Prospects for wage increases are lower in sectors with a meagre chance of growth in output, such as manufacturing and construction.

At the same time, there is still huge reserve of available jobless individuals. The unemployment rate decreased throughout 2012 to 9.3 per cent in the fourth quarter. Further slight improvements are expected, albeit at slower pace. The largest number of vacancies is for service workers, sales people and unskilled blue-collar workers. The same unskilled workers are one of the main categories of the unemployed. Supply and demand do not match, perhaps because of wage levels or qualitative obstacles. The **average wage grew by 5.9 per cent in 2012 and is expected to rise by 7-8 per cent in 2013** and 5-6 per cent in 2014.

Increasing wages will generate inflation risks for 2013. Otherwise **inflationary forces are relatively muted**. Imported inflation will be subdued and commodity prices will not be pushing up inflation. In January 2012, overall inflation was at its lowest level in two years, even though an electricity price jump had a substantial impact on the inflation rate, 0.9 percentage points. Underlying inflationary forces are thus quite low, although there is a lingering risk of spill-over effects from the electricity price increase. We forecast average annual inflation of 3.3 per cent this year and in 2014.

Real wage growth recovery

Year-on-year percentage change and per cent



Source: Statistical Office of Estonia, SEB

Economic performance was much better in the second half of 2012 than expected by the Ministry of Finance. The government budget thus ended up in a better position than planned. Revenue surpassed the projected amount by 3.4 per cent, thus leading to the **smaller deficit than the government had expected** for 2012. The fiscal deficit planned for 2013 amounts to 0.7 per cent of GDP.

This is also a local election year, which might boost the municipal government deficits and increase household income as well as investment projects. One apparent effect became visible at the beginning of 2013, in the form of free public transport in Tallinn, the capital. This boosts the disposable income of the low-income population and the popularity of the city's ruling Centre Party, which is part of the parliamentary opposition at national level.

Parliamentary **support for the government has decreased during the past six months**, because of a financing scandal linked to the main ruling Reform party. Meanwhile the party's conservative coalition partner, IRL, has gained in popularity. Overall, the right-wing government does not feel very threatened by the increased popularity of leftist opposition parties. This shift partly reflects widespread discontent with income levels, a recent hike in electricity prices and various political developments. There were more strikes in 2012 than ever before in Estonian history. The next parliamentary election is scheduled for 2015.

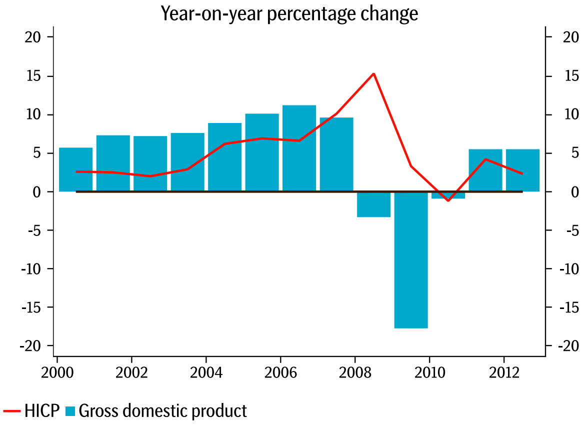
Temporary slowdown in 2013

- **Domestic demand supports growth**
- **Weak price pressure**
- **Latvia will adopt euro in 2014 as planned**

Despite weak global growth, 2012 turned out to be another boom year for Latvia, which succeeded in remaining the fastest-growing economy in the EU for the second year in a row. Unemployment continued to shrink. At the same time, inflation stayed low, contributing to improved purchasing power. These favourable trends helped encourage private consumption. Good growth ensured that the government revenue plan was exceeded, resulting in additional funding from the budget to major sectors. The country's **macroeconomic stability** led international rating agencies to lift Latvia's rating. As trust increased, Latvia was able to attract financing at unprecedentedly low interest rates.

GDP and inflation

Year-on-year percentage change



Source: Eurostat, Central Statistical Bureau

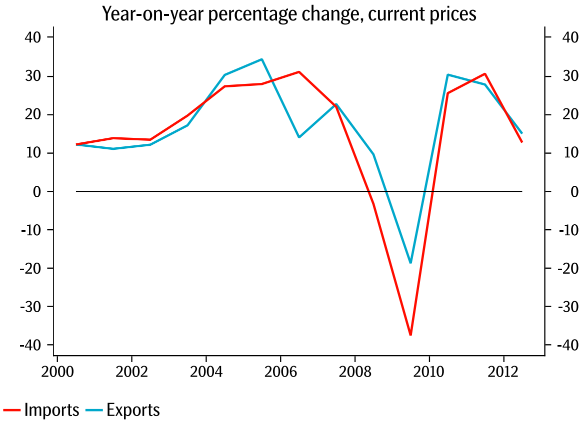
In the fourth quarter of 2012, GDP increased by 5.1 per cent year-on-year, and full-year growth was 5.6 per cent. Trade, manufacturing and construction showed solid growth. The crisis in the euro zone will continue to cloud the global outlook in 2013, so Latvian growth prospects must still be assessed with some caution. However, until now, the Latvian economy has demonstrated flexibility and an ability to seize opportunities in new markets. We foresee that current economic trends will continue, though at a slightly more moderate pace. **We expect GDP to grow by 3.8 per cent this year and growth accelerate to 5 per cent next year.** In 2013, GDP growth will be sustained mainly by capital spending and private consumption, boosted by higher wages and purchasing power and by relatively stable sentiment. The transit sector will face competition and capacity constraints that are likely to result in slower growth. Activity in the real estate market will increase slowly from a low level. It is still affected by uncertain long-term prospects and the recent crisis. Construction will continue to recover, but at a slower pace than in 2012, whereas the financial and insurance services industry will continue to adapt to post-crisis conditions.

In 2012 manufacturing – a major employment and growth driver – increased its sales in current prices by 11.9 per cent compared to 2011. In the final quarter, **export growth picked up despite global weakness**. During 2012, exports in current prices increased by 15 per cent year-on-year, while imports rose 12.7 per cent. We foresee that due to healthy competitiveness, manufacturing output and exports will continue to increase. Uncertainty is affecting capital spending, and businesses must still work very efficiently and avoid creating large inventories. Such caution restricts Latvia's long-term development prospects. During 2013 we believe that investment activity will pick up gradually, partly as an effect of increased foreign investments ahead of Latvia's expected euro zone accession in 2014.

In 2012, the current account deficit contracted to 1.7 per cent of GDP from 2.2 per cent in 2011. The reason was that exports held up better than expected and caution about capital spending curbed imports. We expect the current account deficit to increase modestly in the coming years due to higher imports.

Imports and exports

Year-on-year percentage change, current prices



Source: Central Statistical Bureau

In order to boost competitiveness and decrease the tax burden on labour, starting in January 2013 personal income tax was lowered by one percentage point to 24 per cent. A two percentage point cut will take effect in January 2014 and another a year later.

Impressed by the upcoming favourable tax changes and the positive economic trend, consumers remained very active in the second half of 2012. Retailers increased their sales in constant prices by 9.7 per cent year-on-year in 2012. Going forward, we expect that households will not curb spending much and we therefore expect a further **relatively robust increase in consumption this and next year**.

Driven by global trends and moderate wage growth, inflation continued to slow. As a result, year-on-year inflation decreased to 0.3 per cent in February. The impact of external factors will remain weak. This will allow further improvement in household purchasing power and facilitate consumption. The continued economic recovery will start to increase upward pressure on prices only gradually. This pressure will be limited, due to high unemployment and modest but increasing wage growth. **We forecast average annual inflation of 1.4 per cent this year but foresee an acceleration to 3 per cent in 2014**. The expected adoption of the euro on January 1, 2014 will add an estimated 0.2-0.3 percentage points to inflation due to hoarding ahead of adoption and rounding-off effects, for example in restaurants and cafes.

During the first three quarters of 2012, year-on-year wage and salary growth was 3.7 per cent and the rate probably accelerated a bit in the final quarter. Average pay increases growth for the next two years will remain moderate, at 4.5 and 5.5 per cent respectively. However, growing inflation pressure is expected to push up wages and salaries more rapidly in subsequent years. Public sector pay increases will have a growing influence on this, although they will be very selective and will be constrained by budget capacity. State and local government enterprises will loosen their belts, which is likely to result in steeper pay increases there.

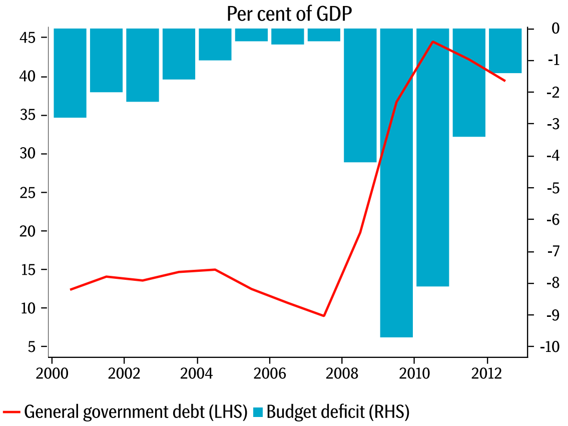
Last year's **gradual labour market improvement will continue**. In the fourth quarter of 2012, unemployment increased by 0.3 percentage points to 13.8 per cent, mainly due to seasonal effects. As the economy keeps growing at close to its 4 per cent trend rate, demand for labour will continue to increase, although structural unemployment will keep jobless figures high for a long time. The situation will continue to vary in different regions of the country, underscoring the need for better labour mobility. We expect continued shortages of workers with certain backgrounds, qualifications and specific skills. This will be true for companies in the manufacturing, information technology and construction industries.

With a time lag, economic growth has allowed the banking sector to stabilise. Following a series of losses over a three-year period, the sector ended 2012 with a profit. The percentage of loans that are overdue remains high, with households being in the worst financial condition. Of bank loans issued to households, 24.5 per cent were in arrears at the end of 2012, or 4.8 percentage points less than in 2011. The total loan portfolio of banks continued to decline in 2012, by about one tenth. However, there has been a gradual stabilisation in volume, supported by an increase in newly issued loans. This is mainly driven by business loans, while overall credit demand remains low. In order to activate credit demand, there is a need for national supportive mechanisms, for example to help young families make their first home purchase. In the medium term, corporate lending will continue to dominate, while lending to households will remain soft.

Public finances are in a good shape. On December 20 2012, the Treasury repaid its loan principal amount of 493.3 million lats to the International Monetary Fund ahead of schedule, settling its financial obligations to the IMF in full. Latvia's remaining debt to the European Union will be paid on schedule by 2025. Solid economic growth enabled the government to beat budget deficit targets last year. The deficit was 1.4 per cent of GDP, compared to an initial target of 1.9 per cent. **We forecast that the deficit will be 1.4 per cent of GDP in 2013 and 0.8 per cent next year.**

Budget deficit and debt

Per cent of GDP



Source: Central Statistical Bureau

Latvia easily complies with all the Maastricht criteria, and the preparation for a changeover to the euro is under way. The budget criterion of a deficit not exceeding 3 per cent of GDP was fulfilled by a wide margin. In January 2013, 12-month average inflation was 2.0 per cent or well below the criterion of 2.7 per cent. In January, long-term yield on government securities stood at 4.35 per cent; the criterion was 5.74 per cent. Government debt in 2012 was well below 60 per cent of GDP: 39.4 per cent according to our forecast. Finally, Latvia has been taking part in ERM II since May 2005.

We expect the European Commission and the European Central Bank to prepare convergence reports on Latvia in April. The reports will be analysed and, if they are approved, in May the Economic and Financial Affairs Council (ECOFIN) will invite Latvia to join the euro zone. In June, the European Council will make a political decision to the same effect. In July, ECOFIN will make the final decision on Latvia's accession and set the exchange rate, which is likely to remain at 0.702804 lats per euro.

Regardless of speculation as to any political motives or sustainability considerations behind the euro zone invitation, **we are sticking to our view that Latvia will become the 18th member of the euro zone in January 2014**. As the euro campaign gains strength, popular support for membership is increasing, though slowly so far. The latest public opinion polls show that only 33 per cent of people in Latvia support euro adoption.

Another year of balanced and decent growth

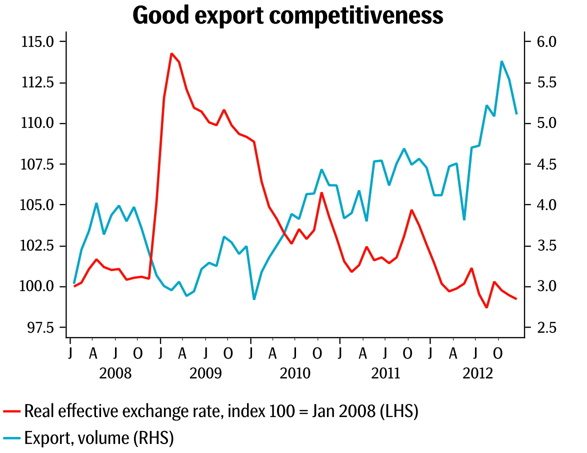
- **Good competitiveness in exports**
- **Wage growth to accelerate**
- **Inflation must be tamed to reach 2015 euro target**

In 2012, Lithuania's economy continued to grow at a robust pace, supported both by exports and domestic demand. GDP rose by 3.6 per cent, which proved to be among the strongest increases in the European Union. Meanwhile economic imbalances were contained, since the trade deficit and inflationary pressures were rather low.

Exports performed surprisingly well, especially in the second half, despite the euro zone recession and the slower growth of other important trade partners such as Russia and Poland. Robust increases continued for a third straight year as total exports rose 11 per cent at constant prices, exceeding their pre-crisis peak level by a factor of 1.3. At the end of the year, exports of agricultural products soared due to a record-high grain harvest, but export growth was well-diversified.

One of the reasons behind this export success was **keeping costs at a low level**. For instance, the increase in nominal wages and salaries stood at just above 2 per cent, which was much less than in peer countries. Real wages have continued declining uninterruptedly since early 2009, while the real effective exchange rate declined further last year.

Good export competitiveness



Source: Statistics Lithuania, Bank of Lithuania, SEB

Meanwhile domestic market growth was relatively sluggish, as reflected by a weaker retail recovery and contraction in the trade deficit, especially during the second half. Wage growth was too weak to pull private consumption up significantly, while uncertainty about the euro zone crisis had a negative effect on willingness to spend money. In 2013, accelerated wage growth and rising employment will support consumption, but shrinking population and cautious behaviour will exert downward pressure on it. **We expect private consumption to grow by 4 per cent in 2013 and 5 per cent in 2014**.

The real estate market barely showed positive signs in 2012. According to the EU-harmonised index of home prices, they rose by a mere of 0.1 per cent in the first three quarters. New flats went up slightly, while prices of old flats continued to fall. Housing supply started gradually rising and the number of residential building permits grew, suggesting that supply-side price pressure will remain limited in 2013 and home prices are unlikely to increase more than 5 per cent. After rising in 2011, construction volume shrank again in 2012 for non-residential buildings, roads and other infrastructure.

Capital spending remained tight last year due to lingering uncertainty, which will put a strain on growth potential and productivity improvement in the medium term. Starting in the second quarter of 2012, fixed investment has been declining year-on-year. Meanwhile capacity utilisation in manufacturing industry has almost reached its pre-crisis peak. Given attractive borrowing conditions and the long period of depressed capital spending, we foresee at least **a mild rebound in 2013**.

All in all, we see 2013 as another year of balanced modest economic growth. Export competitiveness will be challenged by faster wage and salary increases, but the euro zone recovery should open up more opportunities in the second half. Supported by rising consumption and fixed investment, **GDP growth will reach 3.2 per cent in 2013 and 3.5 per cent in 2014**. In line with the economy's rather balanced development, we expect the current account deficit to remain at a modest 3.0 per cent of GDP in 2013 and 4.0 per cent of GDP in 2014.

Last year, inflation last year fell slightly compared to 2011, averaging 3.2 per cent. It was still driven by international commodity prices, while demand-pull forces were largely absent. At the end of 2012, inflationary pressures subsided, leading to a 3-month long deflationary period. Inflation stayed low at the beginning of 2013, despite a 9-10 per cent increase in regulated electricity prices for households and higher excise duties for diesel fuel and tobacco. The secondary effect of the increase in electricity prices will be limited, since starting in 2013 electricity prices for companies are no longer regulated and firms can negotiate lower prices. We forecast that **average annual HICP inflation will reach 2.5 per cent in 2013 and 2.8 per cent in 2014, driven by global commodity markets and increases in taxes and regulated prices**.

After falling 13 per cent in real terms over a four-year period, **wages and salaries most likely reached their turning point**

last year. In January 2013, the government increased the minimum monthly wage to EUR 290. This alone will add at least 2 percentage points to the wage growth rate. Higher-paid employees are also likely to start demanding an increase in order to restore reasonable wage and salary differentiation. Moreover, the labour shortage seems to be deepening. In 2012, 43,000 residents left the country. The figure is lower than in 2011 and the number of returnees is rising, but still this is a significant loss of labour. Hence, we expect nominal wage growth to accelerate and exceed inflation in 2013. At the same time we expect unemployment to drop further, from 13.2 per cent in 2012 to 11.5 per cent in 2013 and 10.0 per cent in 2014.

Slow wage growth to turn faster

Year-on-year percentage change, per cent

Source: Statistics Lithuania

Public finances are on the right track. In the first three quarters of 2012, the general government deficit was 2.9 per cent of GDP. We forecast a fiscal deficit of 2.8 per cent of GDP in 2013 and 3.0 per cent in 2014. Central government debt will stabilise at around a rather comfortable 40 per cent of GDP.

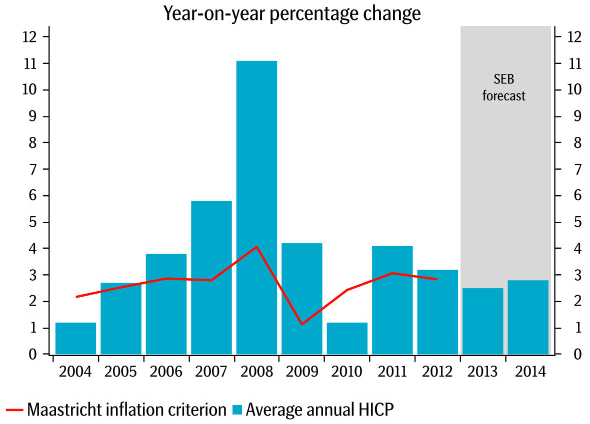
In October 2012, Lithuania held a parliamentary election and centre-left parties were the winners. Four parties – the Social Democrats, Labour, Order and Justice and Polish Election Action – formed a government coalition. However, the Homeland Union-Lithuanian Conservatives, known for their fiscal consolidation efforts, also gathered quite strong support and received a quarter of parliament seats. In February 2013, the Labour and Order and Justice parties declared their intention to merge. This would give the new party one seat more than the currently leading Social Democratic party.

The new centre-left government has demonstrated more willingness to maintain sound fiscal positions than expected by the financial markets before the election. It did not make material changes to the budget crafted by the previous government. In the context of the euro zone debt crisis, the **government seems rather likely to stick to budget discipline in the near future**. The new cabinet also raised the idea of introducing a progressive personal income tax system, but the implementation of such a system is highly uncertain. Meanwhile the government's appetite for introducing new VAT exemptions was much more limited than expected before the election. Only one exemption, for passenger transport services, was introduced at the beginning of 2013.

The government also announced that the **official euro introduction target date for Lithuania is now 2015**, one year later than the previous government's target. In our opinion, the new target **can be achieved but it will require political will and prudent decisions**. The inflation and budget deficit criteria will require the most attention. Due to weak economic growth in the euro zone, the Maastricht inflation criterion may fall further to levels that could be difficult to attain without special measures. Meanwhile Lithuania's inflation is more sensitive to energy price fluctuations than in Western European countries, due to its heavier weight in the CPI basket.

Inflation requirement for euro tough to meet

Year-on-year percentage change



Source: Eurostat, SEB

On the same day as the parliamentary election, Lithuania also held a non-binding referendum on a new nuclear power plant, in which 65 per cent of the votes came out against construction. However, the government is continuing its political discussions and has not yet made a final decision about construction. Another important energy project, construction of a liquefied natural gas terminal in Klaipėda, is successfully under way. The two projects are vital if Lithuania is to increase its energy independence from Russia and open up more possibilities for lowering energy prices.

In February 2013, the Bank of Lithuania stopped the activities of Ūkio bankas, the sixth largest player in the banking market, due to its poor financial situation. The bank's assets were divided up, and the good quality assets were bought by Šiaulių bankas, the seventh largest bank in asset portfolio terms. In our view, the impact of these events on government finances and the banking market will be minimal, while the banking system as a whole has excess liquidity and capital adequacy.

Growth will rebound this autumn after domestic slump

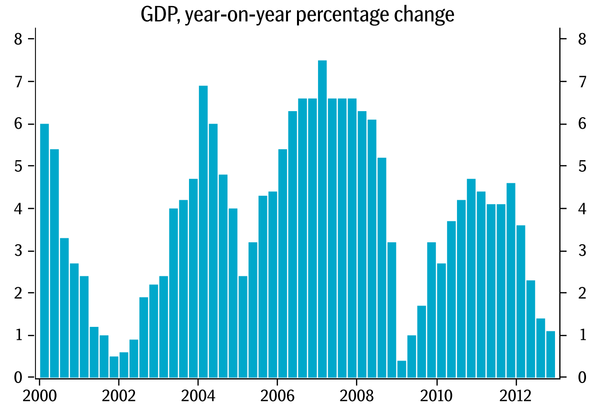
- **Confidence indicators are stabilising**
- **Low inflation but no further rate cuts**
- **Public finances again under control**

Poland's economy has bottomed out after an unexpectedly deep slump in the second half of 2012. **Activity will remain low in the first half**, hampered by higher unemployment, continued tight (though less tight) fiscal policy and weak global demand. **A gradual acceleration in growth will follow in the second half. The recovery will be lasting** and broad-based. Private consumption will be fuelled by a revival in real wage growth due to plunging inflation. Capital spending will stabilise this year, partly due to the broad, dramatic downturn in interest rates since last autumn. Exports will benefit from improved German demand and Poland's good market position.

Due to weakness in late 2012 and early 2013, **GDP growth will only be 1/10 percentage point higher in 2013 than in 2012: 2.1 per cent. It will rise to 3.5 per cent in 2014** – better but still below potential growth of some 4 per cent. Our forecasts for both years are more than half a percentage point above consensus, a **rather optimistic scenario**. This is because Poland's economy and banking sector are fundamentally quite strong; once growth begins to rise, we also expect business and household confidence to enter an upward spiral. We also foresee good underlying potential for capital spending.

Rapid decline in growth during 2012

GDP, year-on-year percentage change

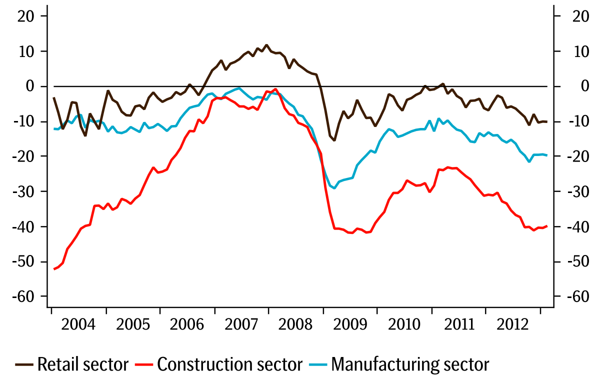


Source: Central Statistical Office of Poland

In 2012, growth plunged from 3.6 per cent year-on-year in the first quarter to 1.1 per cent in the last, mainly due to **a drop in private consumption and cutbacks following a rush of construction and investment** before the summer 2012 European football championship, co-hosted with Ukraine. This year began with a **stabilisation trend** in manufacturing and retail sales, for example. Industrial output rose by 0.3 per cent year-on-year in January after falling in December by no less than 10.6 per cent. Retail sales rose 2.4 per cent year-on-year in January after a 3.6 per cent drop in December. Since autumn, the manufacturing purchasing managers' index has been a few points below the growth threshold of 50, but it climbed to 48.9 in February. In recent months, retail and construction sector sentiment indicators have stabilised at low levels. Low consumer confidence has risen a bit but also remains low.

Confidence indicators have stabilised

Net balance



Source: European Commission

Export growth stayed high for a long time despite falling external demand. But late in 2012 exports slowed sharply and plunged in December. We predict **weak but slightly higher export growth in the coming year**. Close integration with German manufacturers (which have good sales in Asia and elsewhere) makes an upswing likely, along with a **good competitive position** as demand from Western and Eastern Europe gradually rises. Every year since 2008, when the global economy was hard pressed, Poland has continued to gain market shares, though more slowly in the past three years, European Commission data show. But looking ahead, exchange rates will not help exports; **we expect the zloty to appreciate** from a stable 4.10-4.20 per euro in the past two months to 3.95 in December 2013 and 3.80 in late 2014.

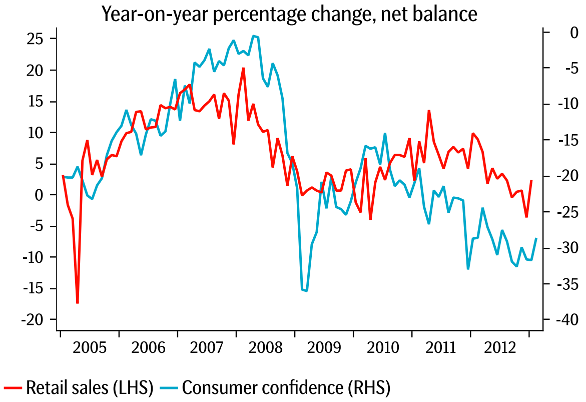
Earlier lively capital spending growth faded rapidly after the European championship; during the last two quarters of 2012, fixed investments fell year-on-year. Greater economic instability and reduced construction contributed to the downturn. **Later this year, capital spending will speed up** due to earlier interest rate cuts. In addition, the government is redoubling its infrastructure spending in 2013 and subsequent years. In our assessment, there are also pent-up structural investment needs in the Polish economy after a long period of **relatively low investment ratios**: averaging about 20 per cent of GDP in the past. In light of this, further EU funds will be welcome. Poland is **among the winners** in the preliminary agreement on the **2014-2020 EU budget** (the first ever to be smaller than the previous one). The country managed to get a 7.5 per cent increase in structural and cohesion funds. These investments are expected to take off at a healthy pace in 2014.

Private consumption has gradually lost momentum during the past year, falling in the final quarter of 2012 – the first drop since the introduction of the market economy. Probably the main reason is that households have been squeezed by lower real income. Slowing pay increases and high inflation well into autumn led to negative real wage growth during much of 2012. Meanwhile unemployment rose from 9.6 per cent in 2011 to 10.2 per cent in 2012. We expect no rapid labour market improvement; on the contrary, unemployment will peak at 11 per cent in 2013. But this winter, households **again saw real wage increases**. The connection between real wages and consumption is relatively strong. Falling interest rates will also ease pressure on household balance sheets, leading to a slow rebound in credit growth after the cool-down of the past six months. **Consumption will gradually recuperate in 2013**, increasing by 1 per cent this year and 2.5 per cent in 2014.

One **potential risk** in our consumption forecast, and thus in our GDP forecast, is the **historically low household savings ratio**: less than 2 per cent in 2012 and only a bit above 2 per cent in 2011, down from 8-9 per cent in 2009-2010. Combined with shaky home prices – which have trended downward in the past two years – households may remain hesitant about new purchases and borrowing for longer than we have anticipated.

Households cautiously start to go shopping again

Year-on-year percentage change, net balance



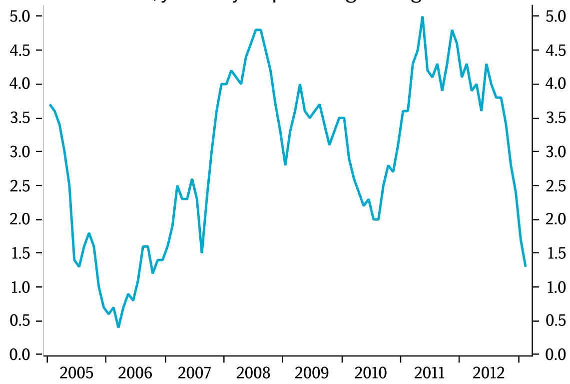
Source: Central Statistical Office of Poland

A current account deficit exceeding 4 per cent of GDP in 2010-2011 was one of the few blemishes in Poland's economic fundamentals. The country has thus needed to borrow a lot of short-term capital. Because of lower imports, the **current account deficit shrank** to about 3.5 per cent of GDP last year and will end up at a more sustainable ca 3.0 per cent in 2013-2014, easing the pressure of financing it. But in itself, the deficit is a signal of the need to increase the role of exports.

In 2011 and the first half of 2012, stubborn inflation of more than 4 per cent was a dilemma both for households and the central bank, with its 2.5 ± 1 per cent target. But since September, inflation has plunged; it was 1.3 per cent in February. Lower wage growth and demand, as well as calmer energy and commodity prices, were behind this **shift in the inflation trend**. We expect inflation to remain low this year, given the weak trends in demand and the labour market. An expected zloty appreciation will also keep import prices down. **Inflation will average 1.8 per cent in 2013 and 2.5 per cent in 2014**.

Dramatic downturn in inflation

CPI, year-on-year percentage change



Source: Central Statistical Office of Poland

In November 2012, the central bank changed its monetary policy after an (unnecessary) key interest rate hike in May. Since then, it has lowered the key rate from 4.75 per cent to 3.25 per cent, the last cut was a 50 basis point step. **The key rate is below the 3.5 per cent "crisis level" prevailing during the 2009-2010 global slump.** We predict **no further rate cuts**.

Public finances are again under control after the government prioritised budget consolidation in recent years. This has included raising retirement ages, abolishing benefits for certain groups and freezing public sector pay. The government was under pressure to implement fiscal tightening, both from the European Commission and national public debt ceilings. Due to austerity and decent growth, the budget deficit fell from 7.9 per cent of GDP in 2010 to about 3.5 per cent last year. The increase in debt was halted close to the sensitive 55 per cent ceiling; exceeding it automatically triggers tougher austerity measures. Poland has been praised for its fiscal policy. In February, for example, Fitch raised its outlook for Poland's A- credit rating to positive and the European Commission said Poland is one of six EU countries that will probably be removed from the Stability Pact blacklist; its deficit exceeded 3 per cent of GDP last year due to the pension reform but with public debt below 60 per cent of GDP an exception can be made.

Fiscal tightening will now ease gradually, but we predict that the **budget deficit will continue downward to 3.2 per cent of GDP this year and 2.8 per cent in 2014**. Poland will thus meet the Maastricht criteria in 2014, but this does not mean that it wants to switch right away to the euro. Its euro zone accession target is politically unclear, although Prime Minister Donald Tusk has said that Poland will aim at meeting the Maastricht criteria as soon as possible (see Theme article). It is also uncertain whether his centre-right government will actually remain in office until the next regular election in 2015. It was re-elected in the autumn of 2011 but has since lost popularity after belt-tightening measures and last year's controversial pension reform. There are also tensions within Tusk's Civic Platform, for example on the issue of allowing registered gay and lesbian partnerships. In January 2013, Parliament once again voted down a proposal to this effect.

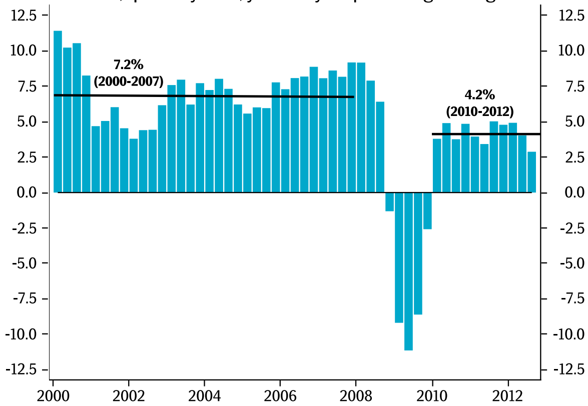
Decent growth but weakened potential

- **Bad patch in late 2012 and early 2013**
- **Growth has slowed to around trend rate**
- **Domestic demand has weakened but continued high oil prices sustain growth**
- **Softer monetary policy this autumn**

Russia's GDP rose by an estimated 2 per cent year-on-year during the fourth quarter. This marked the third straight quarter of decelerating growth. In 2012 as a whole, growth ended up at around 3.4 per cent. The slowdown was driven by a clear capital spending slump, along with a poor harvest that hurt production in the agricultural sector. Meanwhile household consumption, which has been a fundamental driving force in recent years, has begun to weaken. Economic activity cooled somewhat further in early 2013. In our judgement, however, **oil prices (Brent crude) will remain close to USD 110 per barrel during both 2013 and 2014**, providing stable export and tax revenues and thus also helping sustain growth. **We expect GDP to increase by 3.0 per cent in 2013 and by 3.5 per cent in 2014**.

Substantially lower growth post crisis

GDP, quarterly data, year-on-year percentage change

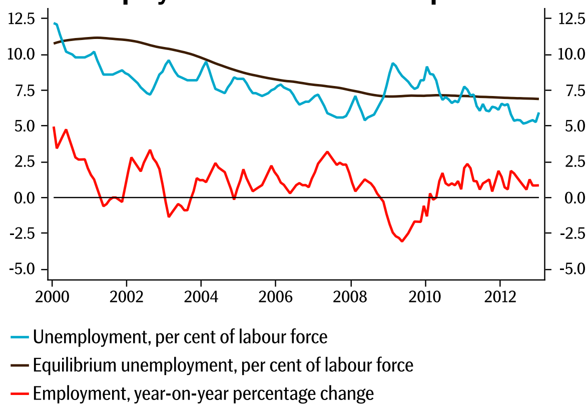


Source: Russian Federal State Statistics Service

Growth now close to trend

Although growth has clearly slowed, unemployment is very low in historical terms, while capacity utilisation is high. This more moderate growth rate is therefore structural, and **the economy is now growing at close to its trend rate**, which we estimate at around **3 per cent**. In recent years, growth has not rebounded to the levels of around 7 per cent that prevailed before the 2008-2009 financial crisis.

Unemployment is at well below equilibrium



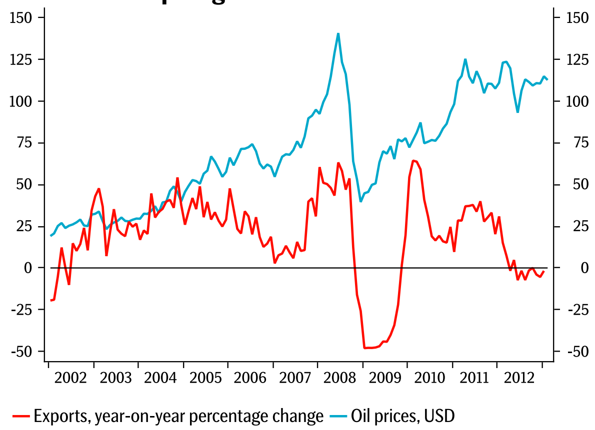
Source: Russian Federal State Statistics Service

As we have indicated in earlier reports, our assessment is that **extensive reforms will be needed to enable growth to reach the goal of 5-6 per cent set by President Vladimir Putin**. Russia has taken steps in this direction, among other things by joining the World Trade Organisation last year, adopting a new budget rule, introducing an inflation target and approving an ambitious privatisation programme targeting USD 10-15 billion in asset sales per year for the next three years last September. Much remains to be done. The Russian economy is still highly vulnerable to oil price declines and the central government still has too much influence on the economy, while the business climate is poor. Demography is also lowering economic growth because of continued population decline.

Given current relatively high oil price levels, the well-known problem of low reform appetite will unfortunately persist. This is worsened by the lack of challenges to the current political structure (see box, page 18). Without more far-reaching reforms, there is a risk that growth will get stuck at around 3-4 per cent. A drop in oil prices would mean even slower growth.

Because of the great importance of oil prices to exports, price changes have a clear impact on the economy. Oil accounts for around 60 per cent of total exports. During 2012, oil prices were around USD 110/barrel, measured as a full-year average, and thus at about the same level as in 2011. Although they consequently provided no extra push to growth, oil prices still help to sustain economic activity. Meanwhile export growth decelerated sharply in 2012, hovering at around zero year-on-year during the second half. Our forecast is that oil prices will remain around USD 110/barrel in both 2013 and 2014, which is in line with the consensus among forecasters. Oil prices will thus continue to provide some support to growth. Exports will be stimulated as global economic growth continues to improve. We expect Russia's export volume growth to accelerate during the second half of 2013 and early in 2014.

Export growth has decelerated

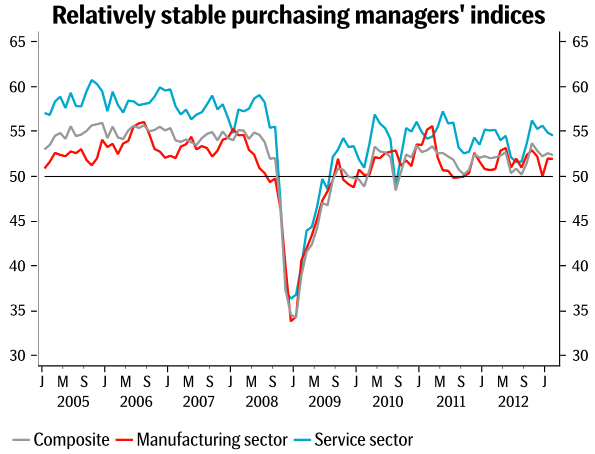


Source: Russian Federal State Statistics Service

Weak beginning of 2013

Most economic indicators show a sluggish start to 2013. **The composite purchasing managers' index (PMI) has been rather flat in recent months but remains above the expansion threshold of 50.** Although the service sector PMI is still significantly higher than the manufacturing PMI, it has recently fallen. This supports the picture of a cool-down in domestic demand. Consumer confidence is also showing the same picture. From a relatively high level, confidence slipped during the second half of 2012. This downturn is expected to continue during the current quarter as household consumption slows.

Relatively stable purchasing managers' indices



Source: Markit

Both capital spending and industrial output have been weak in recent months. In January, industrial production measured year-on-year fell for the first time since 2009 and the decrease continued in February. Capital spending decelerated clearly during 2012, and this weak performance is expected to continue in the next few months, driven by base effects. In January, fixed investments rose by 1.1 per cent year-on-year. Looking a bit further ahead, however, there are signs of greater strength. In the run-up to the Winter Olympics in Sochi next year and the football World Cup in 2018, there is a great need for infrastructure investments. The government's explicit ambition to develop the eastern part of the country also mean that extensive infrastructure investments will be needed in the coming years.

Retail sales have slackened. Measured year-on-year, sales admittedly rose by a decent 3.5 per cent in January, but this increase is well below the rate of around 7 per cent during the first half of 2012. This slowdown has taken place even though unemployment has been at a historically low level. Nominal wages and salaries have continued to climb by more than 10 per cent year-on-year, but rising inflation has led to a slower increase in real wages during the past few months. Increased household saving as well as slightly more restrictive lending have probably also contributed to the weakening of retail sales.

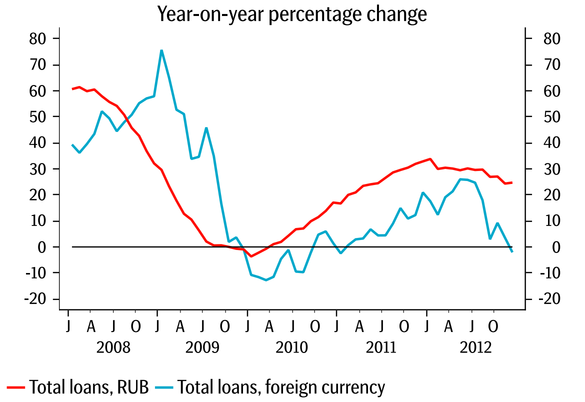
Lending growth will slow

In recent years, credit-led household consumption has been an important driving force behind Russian economic growth. Lending to households increased by about 40 per cent in 2012. The central bank has expressed concern and has already taken steps to slow the increase, yet our assessment is that the risks are limited in the longer term. The credit increase is occurring from a very low level. The ratio of household debt to GDP is around 10-12 per cent, compared to around 30 per cent for other economies in the region.

As the economy decelerates, we also expect credit growth to slow. Russian banks also seem determined to follow the central bank's request that lending to households should not expand by more than 30 per cent during 2013. Furthermore, total lending – which includes loans to companies – has already begun to cool measured year-on-year. Although slower lending growth and economic activity are now putting pressure on the banks, their prospects look brighter in a slightly longer perspective. Large capital spending needs will generate good future demand for loans.

Slower expansion in bank lending

Year-on-year percentage change



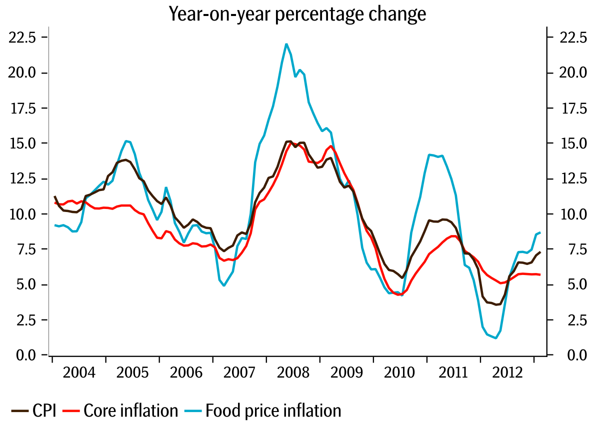
Source: The Central Bank of the Russian Federation

Inflation close to peaking

Since the very low levels of spring 2012, the inflation rate has surged. The upturn has been driven primarily by rising food prices, but fee hikes that were delayed due to the elections of late 2011 and early 2012 have also contributed. After a stabilisation late in 2012, inflation regained momentum and reached 7.3 per cent in February: clearly above the central bank's 5-6 per cent target. However, **we believe that inflation is close to peaking**. Food price inflation is beginning to stabilise and the government is expected to carry out smaller new fee hikes than announced earlier. We believe that inflation will fall in the second half of 2013, mainly driven by base effects from food prices, but we anticipate no sharp decline. Core inflation has stubbornly remained at just below 6 per cent in recent months, despite the cool-down in economic activity. This underscores that slower growth is largely structural, and we thus do not expect weaker growth during 2013 to result in any major drop in inflation. **As annual averages, inflation will end up at 6.3 per cent in 2013 and 5.2 per cent in 2014**.

Inflation has peaked

Year-on-year percentage change



Source: Russian Federal State Statistics Service

Central bank in a tricky situation

Inflation well above target, combined with falling growth, has put the central bank in a tricky situation. Government leaders have clearly called for looser monetary policy in order to stimulate the economy. Uncertainty about monetary policy is being reinforced because **the current central bank governor, Sergei Ignatiev, is being replaced by presidential economic advisor Elvira Nabiullina** when his term expires in June. The choice of central bank governor, announced early in March, will impact the direction of future monetary policy. Nabiullina was an unexpected choice and her name was not among those mentioned before the announcement. Since then, there has been increased concern that the independence of the central bank may weaken and that she will pursue a more expansionary monetary policy, in line with government wishes.

Since the latest key interest rate hike in September 2012, the rate has remained at 8.25 per cent. February's accelerated inflation rate has reduced the probability of a rate cut in the near future. The key rate is expected to remain unchanged during the next few months. When inflation falls later in 2013, however, this will make some room for rate cuts. Our assessment is that **the key interest rate will be cut by 50 basis points during the second half** and will thus stand at **7.75 per cent at the end of 2013**.

During the 2008-2009 financial crisis, the rouble lost nearly a third of its value against the USD/EUR basket (55 per cent USD and 45 per cent EUR). Despite a recovery since then, the rouble is currently about 15 per cent below its pre-crisis level. During 2013, there are several factors pointing towards a rouble appreciation. After the introduction of the Euroclear system, it has become easier for foreign investors to buy Russian government bonds, which is generating an inflow of foreign currencies. The rouble is also being supported by a continued current account surplus. Additional factors are continued high oil prices and the fact that large-scale currency outflows are expected to decelerate due to an easing of political uncertainty. **We thus expect the rouble to appreciate by around 4 per cent** and to stand at **33.8 against the USD/EUR basket by the end of 2013**. The exchange rate will continue to become more flexible through

Tough foreign policy stance gives Putin support for his domestic policies

In recent years, Russia has adopted a more forceful foreign policy stance, especially towards the United States but also towards neighbouring countries. Relations with Ukraine remain complicated. Ukraine has tried to renegotiate its import agreement for Russian natural gas in an attempt to push down prices, but Russia has responded with a call for Ukraine to join the Russian-led CIS customs union, which also includes Belarus and Kazakhstan. Russia is thus trying to tie Ukraine closer; participation in the customs union would create obstacles in the path of Ukraine's ambition to expand its cooperation with the EU instead.

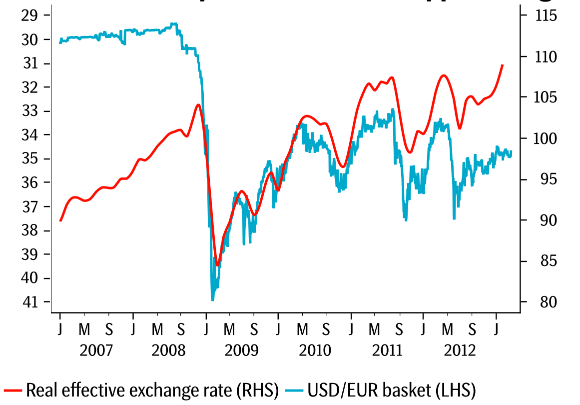
Meanwhile Russia's relations with the US remain frosty. The main reason is Russia's veto of United Nations-led sanctions against Syria. The so-called Magnitsky Act, which went into effect last December and prevents selected high-level Russian officials from entering the US and using American banks, has also contributed to greater tensions between the countries. Russia, in turn, has responded with its own list of high-level American officials and has prohibited US adoptions of Russian children.

President Vladimir Putin's unwillingness to cooperate with the US and his tough foreign policy stance have strengthened his position, against the backdrop of a trend towards growing domestic political protests in recent years. Although Putin's popular support fell from more than 70 per cent early in 2011, it has rebounded somewhat in recent months and is now around two thirds. The percentage of people who state that they would vote for Putin in the next presidential election has also declined, but in the absence of a person with enough charisma to challenge him – combined with a fragmented opposition – at present there are no major risks to the political structure. Suggested changes in the system of elections to the Duma (lower house of Parliament) that are likely to be implemented will also probably benefit Putin's United Russia party. Since both the next Duma election (late 2016) and the next presidential election (2018) are far in the future, political uncertainty is currently limited. We thus do not expect any extensive changes in economic policy either.

In a longer perspective, however, there is potential for political upheaval. Public opinion surveys show that around 50 per cent of the population would prefer an economic system based on central planning. The former Soviet political system also enjoys sizeable support. Such sentiments create the basic prerequisites for the Communist Party, which currently holds about 20 per cent of the seats in the Duma, to radically boost its support under a charismatic leader.

a gradual indrease in the current band of +/- 10 per cent. As a result interest rates will become less volatile, facilitating economic planning. The currency's real effective exchange rate has strengthened greatly since last autumn, which now risks undermining Russia's competitiveness.

The rouble is expected to continue appreciating



Source: Macrobond

Fiscal policy will become less expansionary

The objective of the federal government budget for 2013-2015, unveiled last October, is a significantly less expansionary fiscal policy in the years ahead. This restraint will mainly apply to expenditures. A **new budget rule** has been introduced in order to hold back spending. According to this rule, expenditures may not exceed revenues by more than 1 per cent of GDP, calculated on the basis of average oil prices during the preceding five years. In order to forecast federal budget revenues, expected oil prices are used. Since income from the oil and gas sector accounts for around half of federal revenue, all budget forecasts will be very sensitive to oil price changes.

Any federal budget surplus is directed into two government funds: the Reserve Fund and the National Wealth Fund (NWF). The surplus goes first to the Reserve Fund, but if this fund exceeds 7 per cent of GDP the money goes instead to the NWF. The reserve fund may, in turn, be used to cover a budget deficit while the NWF serves as a back-up to the pension system.

The government's forecast is that the budget will move from a modest deficit of just below 1 per cent of GDP this year to balance in 2015, but we believe that the budget is based on excessively optimistic GDP growth forecasts. The government is expecting growth to reach about 4-5 per cent a year, which is significantly higher than our forecasts. It will also be tough to keep expenditures down. During the presidential election campaign last spring, President Putin promised to increase public expenditures, among other things by boosting defence appropriations and public sector pay. The preparations for the 2014 Winter Olympics in Sochi will also require increased expenditures. Meanwhile the economic deceleration is leading to calls for more expansionary policies. Our assessment is that the budget deficit will exceed the government forecast. The **deficit will end up at 0.5 per cent of GDP in 2013 but then rise to around 1 per cent in 2014**.

Although the new budget rule and the government's ambition to pursue a less expansionary fiscal policy are steps in the right direction, in a somewhat longer perspective Russian government finances will remain dependent on three-digit oil prices. Adjusted for oil-related revenue, the budget deficit is an estimated 10 per cent of GDP according to the government, and the budget is balanced when oil prices are slightly below USD 120/barrel. Since federal government debt is an extremely low 10 per cent of GDP, however, there is no acute threat. Further ahead, though, we foresee a weakening of the current account balance, driven by imports of capital goods consistent with the expected increase in capital spending. The current account balance is also highly dependent on continued high oil prices. A price drop thus risks leading to a situation of both budget and current account deficits. A weakening in the current account balance is especially serious in light of continued large-scale capital outflows. Although they have recently slowed, these outflows are still extensive and weaken Russia's current account position.

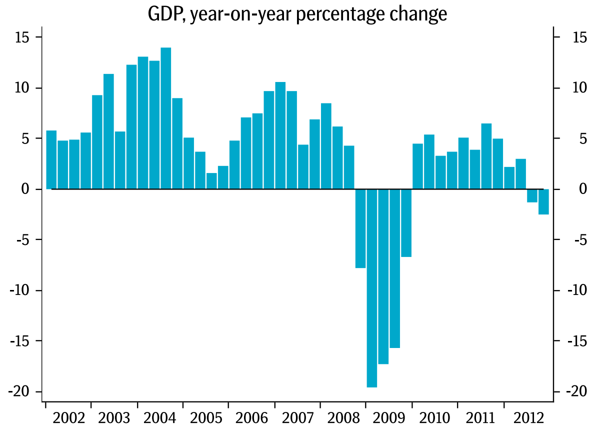
Difficult policy decisions – continued weak growth

- **A devaluation is approaching**
- **An IMF agreement would be the best alternative but is far from certain**
- **Continued political balancing act between the European Union and Russia**

The economy performed very weakly in the second half of 2012 and growth decelerated sharply. Year-on-year, growth was negative in the third and fourth quarters. Full-year 2012 growth reached 0.2 per cent: a dramatic slowdown compared to 5.1 per cent in 2011. Domestic demand held up decently in 2012 but will weaken this year. Nor is external demand expected to provide much support; exports will continue to be depressed by weak growth in Europe and subdued demand for steel.

Growth slowed sharply in the second half of 2012

GDP, year-on-year percentage change



Source: State Statistics Service of Ukraine

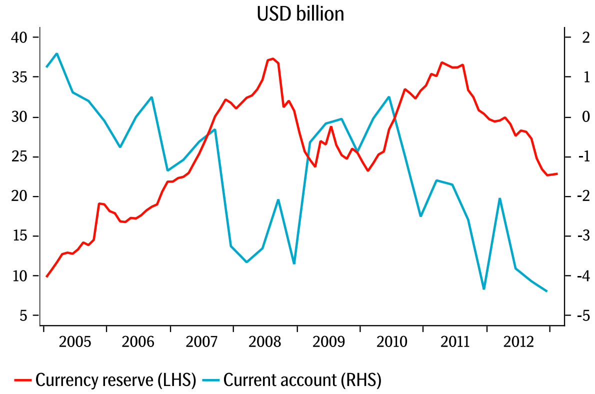
Aside from its clear deceleration, the economy risks an even deeper crisis. The main problem is the large current account deficit and resulting downward pressure on the currency. We are sticking to our assessment that the **hryvnia will be devalued**. Even if the right policy decisions are made and Ukraine dodges a severe crisis, growth will still be very weak. **GDP will remain unchanged in 2013 followed by a weak rebound of 1.8 per cent in 2014**; clearly below the consensus forecast.

The government must quickly make several difficult decisions in order to reduce the risk of the economy being pulled into a major crisis. The Party of Regions managed to hang on to its parliamentary majority by a narrow margin after the late October election. This has reduced political uncertainty. With three years until the next (presidential) election, there is a window for implementing unpopular reforms such as cutting gas subsidies.

The toughest issue is currency policy. Last autumn the hryvnia was squeezed by a big current account deficit and speculation about devaluation. The Ukrainian state must also pay back some USD 9.6 billion in foreign loans, including a large repayment to the IMF. Furthermore, the private sector has a relatively large foreign debt with short maturity. Although the government's debt is a low 40 per cent of GDP, it thus has a **large short-term external funding requirement**. To ease pressure against the currency, in November 2012 the government enacted a law forcing exporters and private individuals to convert foreign currency earnings into hrynvia. This helped fuel appreciation late in 2012, but in 2013 the currency has weakened again: by about 1 per cent against the USD. Since mid-2011 the currency reserve has fallen by more than a third. It is now below normally critical thresholds. **As the currency reserve shrinks, the risk of an uncontrolled evaluation increases**. In December, both Moody's and S&P also lowered Ukraine's credit rating to B3 and B, respectively.

Growing current account deficit, the currency reserve has eroded

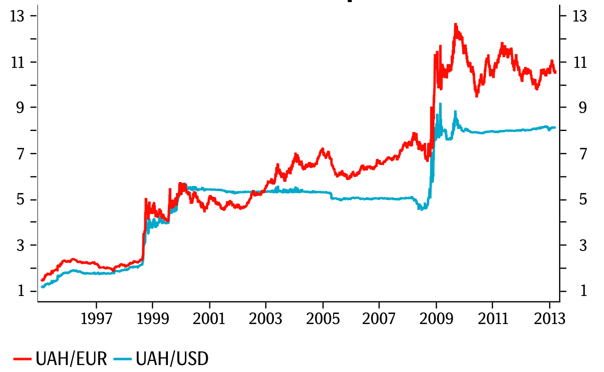
USD billion



Source: Macrobond, SEB

The pressure on the hryvnia could be eased by a new stand-by agreement with the International Monetary Fund. Ukraine signed an IMF agreement in the summer of 2010 but it was frozen in spring 2011 and expired in December 2012. During the first half of February, an IMF delegation visited Ukraine to assess the potential for a new stand-by agreement. The obstacles to an agreement are well known from earlier. They are related to Ukraine's large gas price subsidies to households and businesses, budget deficits (around 3 per cent of GDP in 2012), calls for a more flexible exchange rate and the solvency of the banking system. In our judgement, **a new agreement IMF would be the best alternative for Ukraine and this is also our main scenario**. It would create stability and reduce uncertainty, thus laying the groundwork for a lasting recovery. But an agreement is **far from certain**. The risk is that Ukraine will abstain from an agreement to avoid the IMF's politically unpleasant reform requirements and instead try to resolve the situation on its own via international borrowing. But this is a high risk scenario, in which Ukraine at worst might be shut out of international capital markets. This would make it far more difficult to meet the country's external funding requirement.

The central bank is keeping the exchange rate stable at around UAH 8 per USD



Source: Macrobond

Regardless of whether Ukraine signs an IMF agreement, our assessment is that it will devalue the hryvnia. The question is whether this will be controlled or uncontrolled. We are sticking with our earlier assessment that **the devaluation against the USD will be at least 10 per cent**. We expect it to occur toward the end of the second quarter of 2013. A devaluation would stop the erosion of the currency reserve, thanks to a reduced need for the central bank to intervene in order to keep the exchange rate stable at around UAH 8 per USD, but would meanwhile have various negative effects, such as higher import prices and thus a rising inflation rate as well as higher foreign debt costs.

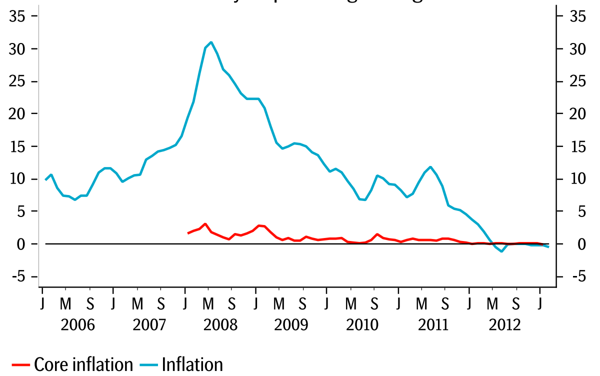
The **current account deficit** rose to more than 8 per cent of GDP in 2012, driven by a growing trade deficit. No significant improvement in the trade balance is likely. Exports continue to be depressed by weak international demand for steel, rising by a mere 0.6 per cent year-on-year in December. We expect the current account deficit to decrease to 6.0 per cent of GDP in 2013. Devaluation is expected to have only a limited impact on exports, due to weak demand. It is thus uncertain whether it would have any major positive effect on the current account balance.

Domestic demand will provide only limited support to growth. Industrial output remains anaemic; in January it fell by 3.2 per cent compared to the same month of 2012. The construction sector is also performing weakly. One bright spot is retail sales, which have continued to grow by around 10 per cent year-on-year in recent months. This trend is being driven by good real wage increases due to non-existent inflation. Devaluation would hit households hard, though, since more than one third of their borrowing is in foreign currencies. The banking sector as a whole is squeezed by Ukraine's problems with funding its current account deficit, and lending remains weak.

From the summer of 2011 until mid-2012 the inflation rate fell sharply, driven by lower food prices (around 50 per cent of the CPI basket consists of food) and base effects. Since last spring, the inflation rate has been close to zero; in January it was -0.5 per cent. Core inflation is also staying close to zero. But looking ahead, the inflation rate is expected to rise, driven by increasing food prices as a result of the poor 2012 harvest. The expected devaluation will push up import prices. Together with higher gas prices and base effects, this will help fuel a rising inflation rate. **We expect inflation to reach 5.5 per cent in 2013 and 6.5 per cent in 2014**.

Inflation close to zero

Year-on-year percentage change



Source: State Statistics Service of Ukraine

Relations with both the EU and Russia remain tense. In 2011 Ukraine signed a trade and integration pact with the EU; a free trade agreement is one key element. This agreement has been on the back burner for more than a year, since Brussels is increasingly concerned about the state of democracy in Ukraine. This is connected, above all, to the government's treatment of former Prime Minister Julia Timoshenko but also to criticism of last year's parliamentary election. President Viktor Yanukovich has said deeper relations with the EU are a priority, and a large share of the population also supports such a development.

If rapprochement with the EU progresses no further, an alternative for Ukraine is to draw closer to Russia. Such a development seems less likely, however; relations are wracked by tensions connected to Ukraine's natural gas imports. In late January, Russia demanded USD 7 billion from the Ukrainian state gas company Naftogaz as compensation because Ukraine had imported too little gas in 2012, thereby breaching current agreements. The gas dispute is expected to continue, although Ukraine's ambition is to reduce its dependence on Russian gas (see box). The most likely scenario is thus that **Ukraine will prioritise its ambition to expand its ties with the EU, while trying to preserve good relations with Russia**.

Reducing Ukraine's dependence on Russian gas

In late January 2013, the Ukrainian government signed an agreement with Royal Dutch Shell on gas extraction and production in Ukraine. The deal may potentially be worth more than USD 10 billion and is the first step in Ukraine's ambition to develop its own gas reserves, thus reducing its dependence on Russian gas. The agreement is mainly about developing shale gas deposits and, as in the US, radically boosting domestic energy production. Ukraine is believed to have Europe's third largest shale gas deposits, but it will take time before the agreement has an impact; the government's ambition is to cover domestic gas needs within ten years.

Key economic data

ESTONIA

	2007	2008	2009	2010	2011	2012(f)	2013(f)	2014(f)
GDP, %	7.5	-4.2	-14.1	3.3	8.3	3.2	3.8	3.7
Inflation, HICP, average, %	6.6	10.4	-0.1	3.0	5.0	3.9	3.3	3.3
Unemployment, %	4.6	5.5	13.8	16.9	12.5	10.2	9.8	9.7
Current account, % of GDP	-15.9	-9.2	3.4	2.9	2.1	-1.2	-0.3	1.3
Public sector financial balance, % of GDP	2.4	-2.9	-2.0	0.2	1.1	-1.0	-0.7	0.0
Public sector debt, % of GDP	3.7	4.5	7.2	6.7	6.1	10.5	12.0	11.7
3-month interest rate, end of period	7.2	7.8	3.3	1.1	1.4	0.2	0.4	0.6

LATVIA

	2007	2008	2009	2010	2011	2012(f)	2013(f)	2014(f)
GDP, %	9.6	-3.3	-17.7	-0.9	5.5	5.5	3.8	5.0
Inflation, HICP, average, %	10.1	15.3	3.3	-1.2	4.2	2.3	1.4	3.0
Unemployment, %	6.1	7.5	16.9	18.7	16.2	14.9	13.3	12.2
Current account, % of GDP	-22.4	-13.1	8.6	3.0	-1.2	-1.7	-2.4	-3.0
Public sector financial balance, % of GDP	-0.4	-4.2	-9.7	-8.1	-3.4	-1.4	-1.4	-0.8
Public sector debt, % of GDP	9.0	19.8	36.7	44.5	42.2	39.4	36.7	35.4
EUR/LVL, end of period	0.7	0.7	0.7	0.7	0.7	0.7	0.7	-
Key rate, eop	6.5	6.0	4.0	3.5	3.5	2.5	0.75	0.75

LITHUANIA

	2007	2008	2009	2010	2011	2012(f)	2013(f)	2014(f)
GDP, %	9.8	2.9	-14.8	1.5	5.9	3.6	3.2	3.5
Inflation, HICP, average, %	5.8	11.1	4.2	1.2	4.1	3.2	2.5	2.8
Unemployment, %	4.3	5.8	13.7	17.8	15.3	13.2	11.5	10.0
Current account, % of GDP	-14.5	-12.9	3.7	0.1	-3.7	-2.0	-3.0	-4.0
Public sector financial balance, % of GDP	-1.0	-3.3	-9.4	-7.2	-5.5	-3.0	-2.8	-3.0
Public sector debt, % of GDP	16.8	15.5	29.4	38.0	38.5	40.0	40.0	40.0
EUR/LTL, end of period	3.45	3.45	3.45	3.45	3.45	3.45	3.45	3.45
3-month interest rate, eop	6.65	9.89	3.90	1.50	1.66	0.68	0.80	0.90
5-year government bond, eop	4.80	13.10	6.60	4.60	5.40	2.40	2.60	2.80

(f) = forecast

POLAND

	2007	2008	2009	2010	2011	2012(f)	2013(f)	2014(f)
GDP, %	6.8	5.1	1.6	3.9	4.3	2.0	2.1	3.5
Inflation, HICP, average, %	2.6	4.2	4.0	2.7	3.9	3.7	1.8	2.5
Unemployment, %	9.6	7.1	8.1	9.6	9.6	10.2	11.0	10.8
Current account, % of GDP	-6.2	-6.6	-3.1	-4.3	-4.5	-3.6	-2.9	-3.2
Public sector financial balance, % of GDP	-1.9	-3.7	-7.4	-7.9	-5.0	-3.5	-3.2	-2.8
Public sector debt, % of GDP	45.0	47.1	50.9	54.8	56.4	55.8	54.0	54.0
EUR/PLN, end of period	3.6	4.1	4.1	4.0	4.5	4.1	4.0	3.8
Key rate, eop	5.25	4.00	3.50	3.75	4.50	4.25	3.25	3.75
5-year government bond, eop	6.13	5.34	5.91	5.52	5.34	3.21	3.60	4.20

RUSSIA

	2007	2008	2009	2010	2011	2012(f)	2013(f)	2014(f)
GDP, %	8.5	5.2	-7.8	4.3	4.3	3.4	3.0	3.5
Inflation, average %	9.0	14.1	11.7	6.8	8.5	5.1	6.3	5.2
Unemployment, %	6.5	6.2	8.4	7.5	6.6	5.7	5.6	5.3
Current account, % of GDP	5.9	6.1	4.0	4.8	5.3	4.3	3.1	2.2
Public sector financial balance, % of GDP	6.8	4.9	-6.3	-3.5	1.6	0.8	-0.5	-1.0
Public sector debt, % of GDP	8.7	6.6	10.2	11.6	11.6	11.9	12.3	12.6
USD/RUB, end of period	24.58	29.57	30.10	30.50	32.08	30.36	30.50	30.30
Rouble vs. euro/dollar basket, eop	29.7	34.8	36.0	35.2	36.4	34.7	33.8	33.0

UKRAINE

	2007	2008	2009	2010	2011	2012(f)	2013(f)	2014(f)
GDP, %	7.9	2.3	-14.8	4.1	5.1	0.2	0.0	1.8
Inflation, average, %	12.8	25.2	16.0	9.4	8.0	0.6	5.5	6.5
Unemployment, %	6.4	6.4	8.8	8.1	8.5	7.8	8.2	8.4
Current account, % of GDP	-3.7	-7.1	-1.5	-2.2	-5.6	-8.4	-6.0	-5.0
Public sector financial balance, % of GDP	-2.0	-3.2	-6.3	-5.7	-2.7	-3.0	-3.1	-2.5
Public sector debt, % of GDP	12.3	20.5	35.4	40.1	36.5	36.0	36.4	35.8
USD/UAH, end of period	5.05	7.80	8.00	7.97	8.00	8.04	9.20	9.50

(f) = forecast

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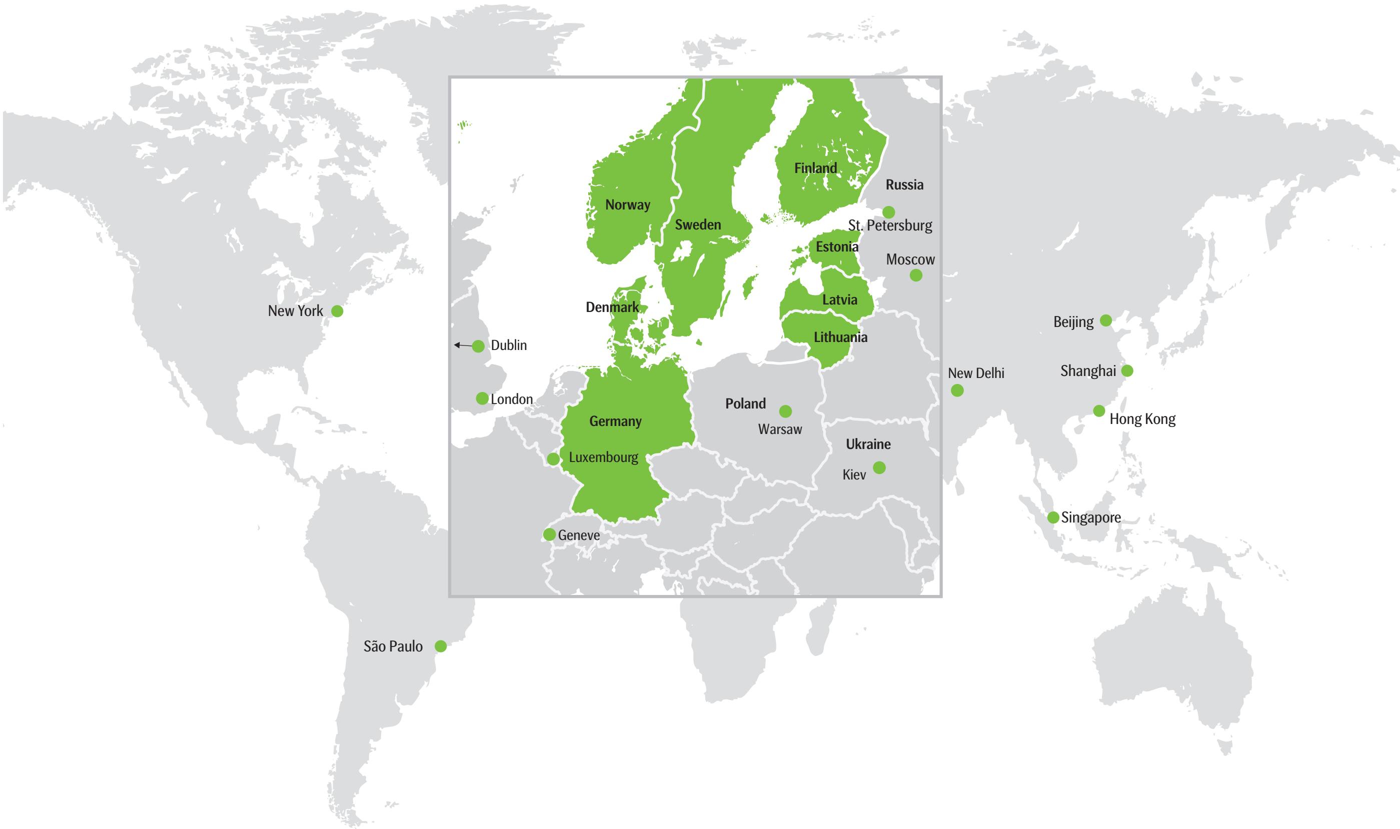

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