Eastern European Outlook

Economic Research – October 2013

Gradual recovery
– major economies will diverge

Theme: Russian demography

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Summary

This autumn nearly all countries in Eastern (including Central) Europe have begun an economic recovery after growth bottomed out during the second quarter of 2013, consistent with the pattern in Western Europe. Their recovery over the next two years will be modest. Latvia and Lithuania will continue to grow fastest in the region and in the European Union. The three largest economies will diverge: with relatively strong fundamentals, Poland will regain its starring role after an unexpectedly deep growth slump; Russia, increasingly in need of reforms, has downshifted to slower growth than it enjoyed before the global economic crisis; and a pressed Ukraine will devalue its way out of an acute crisis.

In most Eastern European countries, the economic upturn is initially being driven mainly by private consumption, but also by increased exports. Consumption is being strengthened by good real wage growth, much of it due to continued low inflation. Unemployment will gradually continue to fall in the Baltic countries, remain relatively unchanged in Poland and Ukraine and increase slightly in Russia. Exports will be fuelled by gradually higher external demand, especially from Germany.

Capital spending will take time to rebound, due to lingering uncertainty about the growth outlook – internationally and in the region – combined with slowly thawing credit conditions. Mainly in the central and southern parts of Eastern Europe, credit conditions have been abnormally tight so far, due to the euro zone crisis and the relatively large foreign ownership of banks.

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

- **Russia's** growth will speed up somewhat from 1.7 per cent this year to 3.0 per cent in 2015. Our forecasts are below consensus, as in the March *EEO*. Falling oil prices (to USD 100/barrel two years from now) will provide less support to growth than earlier. The economy is already hitting its resource ceiling. The demographic trend is negative. Far-reaching reforms are needed in order to boost potential growth to President Vladimir Putin's target of 5-6 per cent.
- **Poland** is now clearly recuperating from a deep domestic slump and moving towards a solid, broad-based recovery. This year, GDP will increase by 1.5 per cent, in 2014 by 3.1 per cent and in 2015 by 3.5 per cent; the latter is in line with potential growth. Our forecasts remain above consensus. The central bank's sharp key interest rate cuts are contributing to the recovery; because of low, below-target inflation a rate hike will not occur until late 2014.
- **Ukraine** is hard pressed by large current account deficits, a depleted currency reserve and sagging foreign confidence. The hryvnia will be devalued by at least 10 per cent early in 2014, while Ukraine will receive a new bail-out loan from the IMF. GDP will fall by 0.8 per cent this year. Despite the devaluation, growth will be a reasonable 2.0 per cent next year and 3.4 per cent in 2015.
- **Estonia's** growth will plunge to 1.3 per cent this year in the wake of falling public investments and sagging exports, partly due to weak growth in neighbouring Finland. A continued downturn in EU funds will lead to a weak capital spending picture, contributing to GDP growth that will reach a modest 2.6 per cent in 2014 and 2.9 per cent in 2015.
- **Latvia** will remain the fastest-growing of all the EU countries: 4.0 per cent this year and 4.8 per cent annually in 2014-2015. The economy is again well-balanced after the deep downturn of 2008-2010, similarly to the other Baltic economies, but weak capital spending is a source of concern.
- **Lithuania's** GDP will increase by 3.8 per cent this year, 3.5 per cent in 2014 and 4.5 per cent in 2015. After a recent sharp downturn in inflation, it is now more likely than not that Lithuania will be the last of the three Baltic countries to convert to the euro – in 2015, according to the government's plan.

Global growth accelerating to trend rate

- **US economy will surge**
- **Fiscal headwinds will calm**
- **Sluggish euro zone, but German momentum**

The world economy probably bottomed out last spring. Since then, indicators have climbed. For example, the purchasing managers' index in manufacturing is now slightly above the expansion threshold of 50 in most countries. Meanwhile financial markets have shown good risk appetite, even though long-term yields have risen sharply and emerging markets have suffered due to expectations about US Federal Reserve exit policy. Eastern (including Central) Europe has shown relative better resilience than other EM areas, probably due in part to smaller external imbalances.

Over the next year, underlying conditions for global GDP acceleration will improve. **Fiscal headwinds will fade, while continued strong monetary policy tailwinds will support growth**. The **US is poised for a fairly strong growth surge** in 2014-2015, partly because household deleveraging is almost completed while home prices and construction keep rising. US growth will provide support to the world economy, for example by stimulating risk appetite and giving the euro zone a greater chance to restore its economic and political stability. In this environment the corporate sector, which generally has strong balance sheets, will boost its capital spending and hiring.

Different parts of the world economy are in different phases, though, among other things because post-crisis healing has varied in speed. **Cyclical differences will persist over the next couple of years**. Although fiscal austerity will ease in the **euro zone** as a whole in 2014, **recovery will be sluggish**, reaching trend growth only in 2015. In crisis-hit countries, domestic demand is hampered by high unemployment, uncertainty in banking systems and lingering public/private debt consolidation. To a great extent, **Germany will drive euro zone expansion**. Its economy has small imbalances and its policy makers will continue to focus on stability, following Chancellor Angela Merkel's third straight election victory last month. Germany, which weighs heavily in Central Europe's export mix, will show decent GDP growth of 1.7 per cent in 2014 and 2.0 per cent in 2015. **Japan's economic upturn will slow** as stimulus measures wear off and structural problems must finally be addressed. Growth will stabilise in the BRIC countries after this year's slowdown, but due to structural challenges it will not be as lively as before the global crisis.

Most countries in Eastern Europe will see a **sluggish recovery** after bottoming in the first half of 2013. Exports will begin to strengthen this autumn due to brighter German prospects, but the US upturn will have little direct impact on trade. Private consumption will be sustained by continued relatively good real wage growth, due to low inflation and low interest rates. Yet many households will postpone major purchases until 2014, when labour markets begin to stabilise. Credit markets are thawing slowly, partly due to abnormally tight conditions after the euro zone crisis. Only Russia will see relatively fast credit growth. Capital spending will be depressed in the short term, with a minor upswing only in 2014-2015: in EU countries partly due to new funds from the long-term EU budget.

Overall **global growth will rise from 3.2 per cent in 2013 to 4.0 per cent in 2014 and 4.2 per cent in 2015, marginally above trend**, which is just below 4 per cent. This rather positive economic scenario assumes that **inflation will remain low/normalise slowly**, giving **major central banks room to delay key interest rate hikes** until 2015; the European Central Bank will wait even longer. Wide US and European output gaps, along with fading growth in Asia, will keep wage and salary growth calm and dampen commodity prices. Oil prices (Brent) will fall from an average of USD 108/barrel in 2013 to USD 102.50 next year and USD 100 in 2015 despite political tensions in the Middle East and North Africa. Driving this downturn is the fact that production capacity, due in part to increased US supply, is outstripping demand. We expect OPEC to occasionally slash oil production to keep prices at USD 100.

Global key data

GDP, year-on-year percentage change

	2012	2013	2014	2015
United States	2.8	1.6	3.3	3.7
Euro zone	-0.6	-0.5	0.8	1.7
The world	3.4	3.2	4.0	4.2
Oil, USD/barrel	111.7	108.0	102.5	100.0
EUR/USD, Dec	1.29	1.33	1.24	1.20

Source: SEB

Later this autumn, the EUR will begin to depreciate against the USD. Another ECB interest rate cut late in 2013 will help lower the euro exchange rate. The euro is also somewhat overvalued in terms of fundamentals. The dollar will meanwhile generally recover due to relative US growth advantages and because the Fed is the first major central bank to tighten its monetary policy: Fed is expected to start "tapering" of quantitative easing (QE) in December 2013, while the Fed's first key interest hike will only occur late in 2015 (around the same time as the Bank of England starts easing its stimulus in the form of QE and the key interest rate). The EUR/USD exchange rate will stand at 1.20 in late 2015.

Decline in EU grants hampering growth

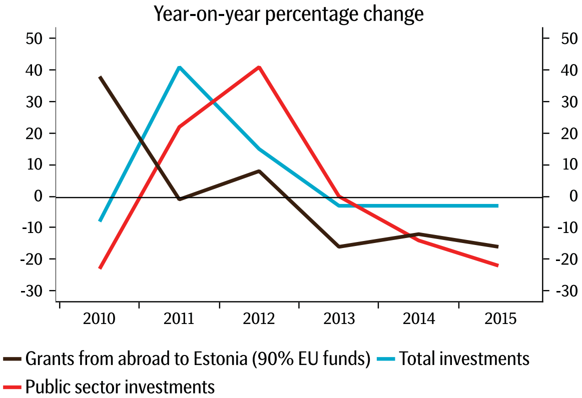
- **Waiting for export markets to recover**
- **Private consumption will lose momentum**
- **Inflation is down despite high wage growth**

Estonian economic growth halted during the first half of 2013. The economy has slipped into mild recession: -0.1 per cent quarter-on-quarter in the first quarter of 2013 and -0.2 per cent in the second quarter. We believe that the economy stabilised in the third quarter and will rise slightly in the fourth quarter. **Year-on-year growth will average 1.3 per cent in 2013, 2.6 per cent in 2014 and 2.9 per cent in 2015.** Next year's recovery will be driven by improving external demand, since the main engine in 2013 – private consumption – will cool down somewhat.

The euro zone crisis is still suppressing growth. In the first half of 2013, Estonian export markets continued to shrink. These includes Finland, which showed meagre quarter-on-quarter GDP growth in the second quarter after a decline in the first. The Russian economy has also weakened considerably. Yet export competitiveness has enabled Estonia to resist the slowdown relatively well. Exports growth rates have remained relatively solid, around 5 per cent year-on-year. Export markets apparently reached their low point in the first quarter of 2013. External demand is expected to improve gradually toward the end of the year and in 2014. Still, the recovery will be modest.

Investments and grants from abroad to Estonia

Year-on-year percentage change



Source: Statistical Office of Estonia, SEB

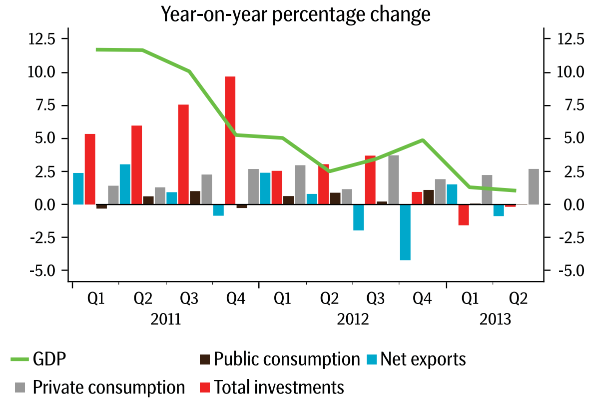
In addition to flagging foreign demand, there has been another drag on growth in 2013: falling capital spending, closely related to lower inflows of European structural funds and revenue from sale of emission rights; the latter was sizeable in 2012 and was mainly used for infrastructure. Public investments fell by 19 per cent year-on-year in the first half of 2013. A further decline in incoming EU funds is expected in 2014 and 2015, reducing government investments and thus GDP growth. Estonian economic growth has been highly dependent on these funds, which in previous years have totalled 7-8 per cent of GDP per year.

Economic growth has been uneven and volatile, and the construction sector is not solely to blame for the slowdown. The transit trade and other sectors are also falling. However, consumer and most business confidence indicators remain relatively high and stable. Construction is the only sector showing a decline in confidence. At the same time, **overall economic growth has remained well balanced**. Modest export growth has been matched by modest private consumption growth. The current account deficit narrowed to a mere 0.5 per cent of GDP in the second quarter. In addition to the improving trade balance, a wave of transactions during 2013 has also improved income flows on a more permanent basis.

In the second quarter of 2013, the main economic growth engine was still domestic private consumption, sustained by real wage growth and slight improvements in employment. Looking ahead, consumption growth will hinge on more real wage advancements. That is because the unemployment rate has reached the point where further reductions will be associated with increasing compromises in labour quality. In addition, weak economic growth will not trigger any noticeable employment growth going into 2014. Hence, **the labour market situation is expected to remain relatively stable**, with a possibility of slight improvement. Average unemployment will remain unchanged at 8.8 per cent in 2013 and 2014.

Contributions to GDP growth

Year-on-year percentage change

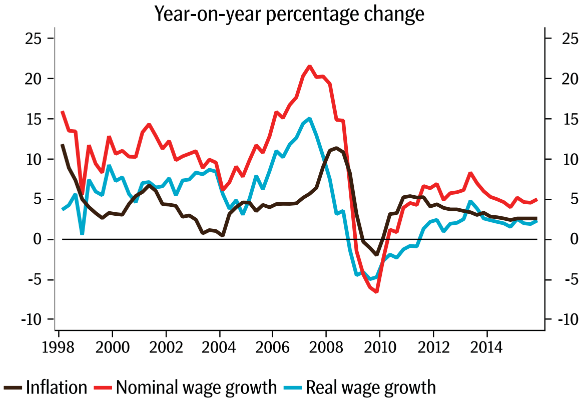


Source: Statistical Office of Estonia, SEB

Upward wage pressure has not disappeared. Pay increases were 7-8 per cent year-on-year in the first half of 2013. Wage pressure will still be evident next year, although economic growth will remain weak, creating incentives for innovation and even greater efficiency. In the second quarter of 2013, the distribution of value-added shifted in favour of workers, in contrast to one year earlier. Meanwhile company profits fell. Some corrections are likely in 2014, including slower wage growth and slightly higher economic growth. Accelerating wage growth, along with weakening inflation, recently boosted real wages. This is expected to continue in the second half.

Inflation and wages

Year-on-year percentage change



Source: Statistical Office of Estonia, SEB

Inflation is trending downward despite wage pressure, although weak productivity growth poses some inflationary risks. An electricity price hike lifted 2013 inflation by about one percentage point, presaging a corresponding decline in 2014 inflation. Another major downward price factor is the growth in retail sales competition, since during the second half of 2013 and in 2014 there will be a significant increase in retail sales space. **Our inflation forecast is 3.2 per cent in 2013, 2.7 per cent in 2014 and 2.6 per cent in 2015.**

As the sum of decelerating inflation, slightly lower wage growth and stable employment, **private consumption growth potential will be smaller in 2014** than in 2013. Due to weak public investments, **capital spending will continue to decline** in 2014 and 2015. Private fixed investments are expected to fall in 2013, then stabilise in 2014 and rise by 2 per cent in 2015.

In the coming year, economic growth will not get much support from credit growth. Although monetary conditions remain favourable, **the demand for credit is constrained** by the still uncertain economic outlook and relative caution by private individuals and companies. Company balance sheets are strong and demand for credit is slowing. However, new mortgage loans to individuals are growing at 20 per cent year-on-year. Mortgage loan growth is small enough that it has not exceeded total loan amortisation during the same time. Hence, individual mortgage loan stock has been stable since the first quarter. Total household debt is still 1 per cent below the level of last year, but mortgage loans have reached last year's level and the mortgage deleveraging process is now over.

Real estate prices are rising at 8 per cent year-on-year. Demand is gradually recovering, and the supply of new housing is still limited and not accelerating. The real estate price increase is being fuelled by the low interest rate environment as investors look for better returns. Half of real estate transactions involve no loans. There is a threat that real estate prices will stabilise or slow when interest rates start to rise.

The **public sector deficit has stayed small** despite worse-than-expected GDP growth. Tax revenue rose by 7 per cent in the first seven months of 2013. However, because of lower grants from abroad, the total increase of revenue was around 4 per cent. The importance of the grants from the EU cannot be underestimated – they have constituted about 19 per cent of central government revenue in recent years. Reductions in these grants will be reflected in the public deficit. The government plans to increase its expenditures by 5 per cent in 2014, despite the 8 per cent reduction in foreign grants.

The government is planning to provide only minor support to domestic demand by boosting public wages and pensions, but also by slightly increasing its real estate investments. The crisis years increased **social tensions** and upward wage pressure. In response, the focus of the 2014 budget is on social expenditures, just as in 2013. Pensions will rise by 5.8 per cent and public sector wages by 5.1 per cent. The outcome of the 2014 public sector budget is likely to be a bigger deficit than the government has planned (-0.4 per cent of GDP). The government is expecting 2014 GDP growth of 3.6 per cent, which is too optimistic. There are also obligations that the government must fulfil in 2014 that will increase expenditures. These include the restoration of pension payments that were frozen during the crisis years.

Since Estonian public finances are in good order and accumulated reserves provide potential for temporary deficits, the above outlays should not pose any problems for Estonia. The use of reserves to mitigate some of the consequences of the temporary shortfall in EU funds should be justified.

On October 20, municipal elections will take place. The campaigns are relatively modest and **no big changes in the distribution of power** are expected. One major issue is the tension between national coalition parties and the opposition party that has run Tallinn, the capital, for a long period. This has posed obstacles to decisions that involve both national and local politics. In Tallinn, the main issue in the election campaign is corruption in city government. The municipality of Tallinn, which is run by the populist Centre Party, is offering free rides on public transport to ensure a continued majority in governing the city. The outcome of the municipal elections will not have a major impact on the outcome of the 2015 parliamentary election, since the composition of the voters in municipal and national elections is different. However, it might indicate to the governing coalition that it is losing popularity.

Partly due to social tensions, **the Social Democrats and the populist Centre Party have gained popularity** in 2013, while the main ruling Reform Party has seen its position undermined after several scandals. The Social Democrats are well placed to gain wider support in the next parliament. That has motivated the government to increase social expenditures last year and this year. Many voters are waiting for a new right-wing party to emerge before the next national election, so they can cast their vote for it as a sign of protest against the incumbent government. The soil is ripe for new parties again.

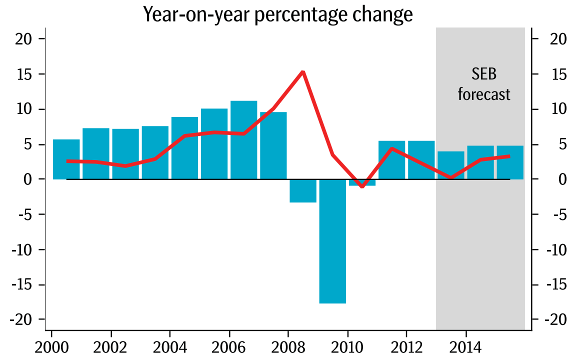
Strong consumption consolidates robust growth

- **Low capital spending**
- **Rising real estate activity**
- **Muted inflation**

Even though the situation in export markets has remained subdued, there has been no sharp drop in Latvia's GDP growth rates thanks to the positive effect of strong private consumption. As expected, growth slowed down in the first half of 2013, though it stayed robust; GDP grew by 4 per cent year-on-year. Private consumption, which increased by 6.4 per cent, was the key driver and contributed 4.6 percentage points to GDP growth. It is driven by an improvement in the labour market, increased wage growth and low inflation. Exports increased by 2.8 per cent. Government final consumption grew by 3.5 per cent. However, expenditure on gross fixed capital formation fell by 7.7 per cent. Low investment activity is a sign of a high degree of caution among entrepreneurs. Capital spending is expected to remain low in the coming year. We expect a pick-up in investment growth during 2015. If this doesn't happen it will negatively affect Latvian potential growth (which is around 4 per cent). A **continued strong increase in households' real disposable income will keep the consumption boom going**. Their willingness to spend will help maintain good economic activity, while external demand will only gradually strengthen. **GDP will increase by 4 per cent in 2013 and by 4.8 per cent in each of the following two years.**

GDP and inflation

Year-on-year percentage change



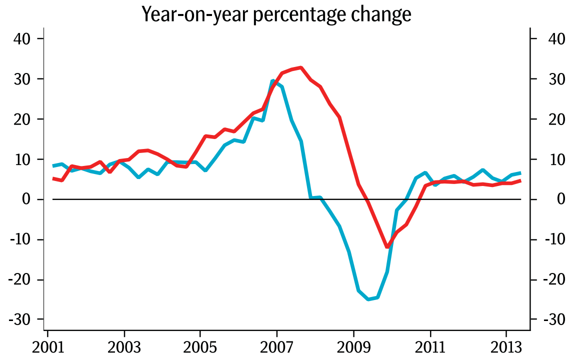
Source: Eurostat, Central Statistical Bureau, SEB

Industrial production is still weak. During the first seven months of the year, volume dropped by 0.2 per cent. This weakness was mainly due to problems connected with bio-fuel production and Liepājas Metalurgs – the only metallurgical company in the Baltics – as well as market fluctuations in shipbuilding-related services. Liepajas Metalurgs will probably have a negative effect on 2013 manufacturing performance. At the same time, sectors such as electrical equipment, furniture, computers, wood, clothing and food production are continuing to develop successfully. In the second half of the year, manufacturing might therefore show a positive trend again.

The retailing sector is more dynamic. The increase in household income, as well as incoming tourists, continue to support retail trade. In the first seven months of this year, compared to the same period of 2012, retail sales rose 6.2 per cent. The most rapid sales increase was observed in furniture, lighting equipment and household appliances, reflecting stronger household optimism and a desire to improve living standards after the deep crisis of 2008-2010.

Wages and private consumption

Year-on-year percentage change



Source: Eurostat, Central Statistical Bureau

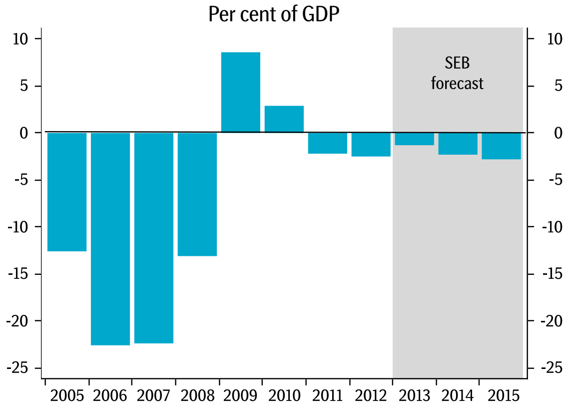
There has been **a rapid surge in real estate market activity**. The market is being **influenced by non-residents who are purchasing** real estate in Latvia to obtain an EU residence permit. The main activity has been in areas such as Riga and Jurmala that are popular among non-residents, mainly from Russia and other Commonwealth of Independent States (CIS) countries. The system was introduced in 2010, allowing foreign citizens to obtain residence permits in exchange for purchasing real estate. According to the Office of Citizenship and Migration, from July 2010 to September 2013 the programme brought LVL 460.5 million into Latvia. LVL 370.3 million of that amount was invested in real estate. This has led to strenuous discussions and political tensions concerning whether this system should be reviewed, for example by switching inflows towards other sectors or even ending it. There has also been a positive trend in construction, which rose by 6.9 per cent compared to the year-earlier period. In the second quarter, construction of residential buildings was up by 41 per cent.

External imbalances are very small, a sharp contrast to the alarming situation before the 2008 crisis. In the first half of 2013, the current account deficit shrank to 0.6 per cent of GDP.

This trend shows that the economy is still functioning at limited capacity. The merchandise trade balance improved, with the increase in exports exceeding that of imports. The limited increase in imports indicates the predominant caution in capital spending. The balance of services also improved slightly. With the disappearance of uncertainty in the external environment and stabilisation of business confidence, Latvia will see a slightly wider current account deficit in the coming years.

Current account

Per cent of GDP

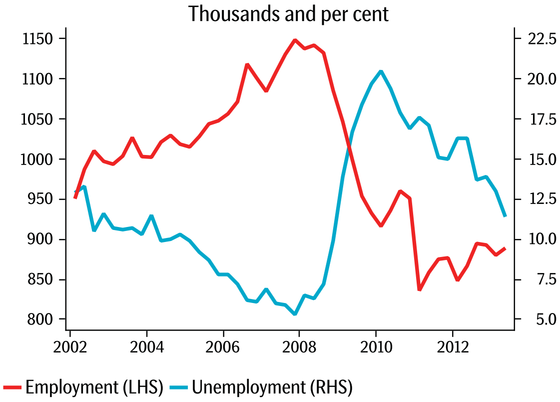


Source: Central Statistical Bureau

Unemployment shrank from 13 per cent in the first quarter to 11.4 per cent in the second quarter. It will **continue to decrease**, averaging 8.9 per cent in 2015. Good stable consumption growth will allow for expectations of greater job prospects in the service sector. Since growth will remain regional, **labour shortages** in the more economically active regions of Latvia will become more acute, while unemployment will remain high in other regions. This will underscore the need for greater labour mobility. The shortage of skilled workers will continue to increase. This will be true of companies in the manufacturing, information technology, retail and construction sectors.

Employment and unemployment

Thousands and per cent



Source: Central Statistical Bureau

Wage and salary increases are expected to accelerate along with the stronger labour market situation and economic growth. Of growing importance in this process will be pay increases in the public sector, although they will be carried out selectively and will be constrained by limited budgets. State and local government enterprises will loosen their belts faster, which is likely to result in steeper pay rises there. Average wage and salary growth will be 4.5 per cent this year and 5.5 per cent in 2014.

In August 2013, inflation was replaced by year-on-year deflation of 0.2 per cent, mainly due to declining prices for food and alcoholic beverages. The impact of external factors on the consumer price index will remain muted. The **continued economic recovery will start to increase pressure on prices only gradually**, due to high unemployment and modest (but increasing) wage growth. Looking ahead, inflation will be more rapid due to base effects as the VAT reduction introduced in the previous year disappears from the statistics. Next year there will be increases in household electricity tariffs. The introduction of the euro in January 2014 is expected to result in 0.2-0.3 percentage points higher inflation due to hoarding ahead of the changeover and rounding-off effects. This year's average inflation will be **0.2 per cent.** In 2014 inflation will be 2.8 per cent.

Even though the euro launch date is approaching, **public support for euro adoption is still low**. In August, polls showed that 22 per cent of respondents favoured euro zone accession while 53 per cent opposed it, with 21 per cent having no opinion. We expect that support for the euro will increase next year as most uncertainty about price hikes and other effects disappears and people become accustomed to the new currency.

Recent government plans aimed at boosting Latvia's competitiveness by cutting taxes on labour were revised on grounds that the **government should put more emphasis on fighting inequality and improving demographic trends**. As a result, the government approved a new labour tax burden reduction plan that envisages keeping the personal income tax rate unchanged in 2014 at 24 per cent. The current plan foresees lowering social insurance contributions, increasing personal income tax breaks for dependents and raising the non-taxable minimum income.

Some political tensions among the government coalition partners (Unity, the Reform Party, the National Alliance "All for Latvia!"–"For Fatherland and Freedom/LNNK" as well as independent members of Parliament) **have emerged** lately. Disagreements have arisen during the budget drafting process due to divergent priorities. Tensions increased when Prime Minister Valdis Dombrovskis (Unity) requested the resignation of the Minister of Culture (National Alliance). One of the main reasons behind these disputes could be the forthcoming elections for the European Parliament and the Latvian Parliament. In our view, the government will survive this turmoil and the budget will pass in timely fashion, since no party wants the government to fall just before elections.

In spite of increasing pressure to raise expenditures, **public finances are in a good shape**. During the first eight months of this year, tax revenues rose by 6.8 per cent year-on-year, while budget expenditures grew by 7 per cent and the budget surplus reached LVL 250.6 million. Thanks to efficient collection of labour taxes and VAT, tax revenue was 3.2 per cent above target. Towards the end of the year, expenditures usually rise faster than revenue, meaning that the surplus will narrow. The projected budget deficit is 1.2 per cent of GDP in 2013 and will shrink to 0.8 per cent in 2014.

Good growth prospects supported by domestic demand

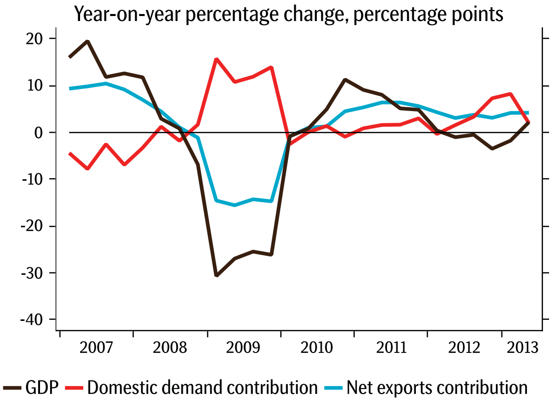
- **Finally, investments have started to grow**
- **Small economic imbalances**
- **Euro introduction in 2015 increasingly probable after drop in inflation**

In the first half of 2013, Lithuania's economy maintained quite strong momentum. GDP increased by 4.2 per cent year-on-year. Moreover, economic development was well-balanced as domestic demand started contributing to growth. Exports, while still rising robustly, were not the sole growth driver anymore. The economy has got rid of most external and internal imbalances and currently demonstrates a rather healthy trend. We foresee s**turdy and diversified GDP growth in the medium term: 3.8 per cent in 2013, 3.5 per cent in 2014 and 4.5 per cent in 2015**.

The second quarter of 2013 was a switching point between the drivers of economic growth. A slowdown in exports was largely offset by strengthening domestic market. In the second quarter of 2013, household consumption rose by 4.4 per cent and investment by 8.6 per cent. Recovery in domestic demand was based on both fundamental factors and brighter expectations.

Domestic demand starts contributing to growth

Year-on-year percentage change, percentage points



Source: Statistics Lithuania, SEB

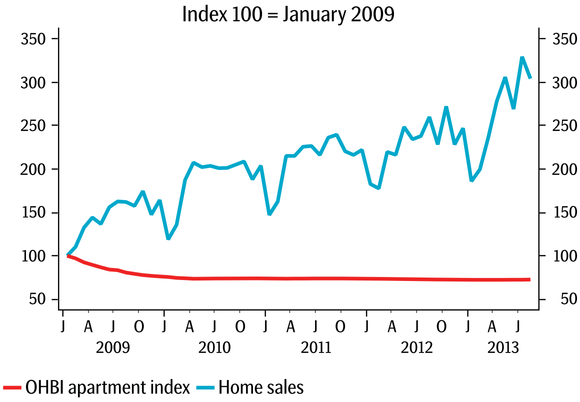
The potential for a lasting pick-up in private consumption has strengthened. Early in 2013, real wages rose for the first time after shrinking for four consecutive years and unemployment continued declining. On the other hand, consumer sentiment climbed to a five-year high, which was obviously was a strong consumption-supporting factor. In the coming year, we expect unemployment contraction to 10 per cent and nominal wage growth by 5 per cent as well as a slow upturn in the housing market. All this will lay the foundation for private consumption to increase by 4.5 per cent in 2014 and 6.5 per cent in 2015.

After treading water for more than a year, **corporate capital spending started rising more robustly in the second quarter of 2013**. A very important trigger to capital spending growth was improvement in business sentiment due to Lithuania's satisfactory macroeconomic situation and more optimistic news from the euro zone. Acquisition of buildings and land went up spectacularly but investment in machinery and equipment also demonstrated notable increases. However, capital spending is still one third lower than in 2008. At the same time, manufacturing capacity utilisation recently reached its pre-crisis peak of 75 per cent. Stock-building remains low. Consequently, corporate investment is destined to further rise unless disappointing news from the international markets sours the expectations of managers.

Construction activity rose cautiously in the second quarter of 2013, posting 7.1 per cent year-on-year growth thanks to higher non-residential activity. Meanwhile infrastructure development was weak and residential construction declined. Consequently, prices of flats still remain at their bottom level but the number of deals in the real estate market has started rapidly rising. In January-August 2013, homes sales were up by 19 per cent year-on-year. Given extremely low deposit interest rates, people have started looking for investment alternatives, including real estate. The combination of stable prices and increasing sales indicates **an early stage of recovery in the residential market**. Prices should begin rising only when housing demand exceeds supply, which is unlikely to happen in the near future. Household income growth is still vulnerable, and memories of the latest housing bust are vivid.

Home sales on the rise but prices at the bottom

Index 100 = January 2009



Source: Ober-Haus, Centre of Registers

Export performance remained strong in the first half of 2013, with a 15.4 per cent year-on-year increase. In light of weak demand in Western European countries, Lithuanian exports to Russia, Estonia and Poland expanded fastest while exports to

Germany stagnated. Export growth received an extra push last spring from positive base effects after a closure at the country's export-heavy oil refinery one year earlier. This summer, **signs of an export slowdown** began appearing and growth rates dropped to single-digit levels, but this seems natural after 3 years of extraordinary growth. Compared to their pre-crisis peak, exports are almost 40 per cent higher. After last year's record cereal harvest and subsequent heavy agricultural sales, this year's harvest will have a negative effect on growth rates. Meanwhile external demand is still fragile and does not offer a strong basis for expansion. In addition, there are risk factors related to Russia, Lithuania's export partner No. 1. In September, Russia intensified its restrictions on Lithuanian goods without a real explanation. The reasons may be political pressure or an attempt to protect Russian manufacturers. On the other hand, Lithuania's export competitiveness remains sound as inflation approaches 0 per cent. In the first half of 2013, the real effective exchange rate of the litas decreased by 1.1 per cent compared to the same period of 2012.

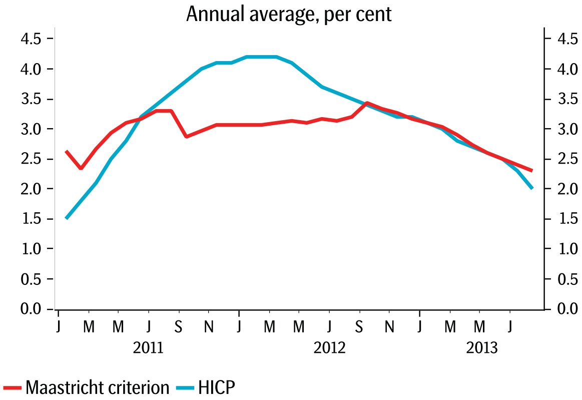
In line with the solid export trend, the balance of payments is staying in safe territory. In the first half of 2013, the current account surplus was 1.4 per cent of GDP. Gross external debt shrank to 68.4 per cent of GDP, its lowest level in more than five years. Both government debt and private sector foreign liabilities fell. In line with strengthening domestic demand and somewhat slower exports we expect a slight deterioration in the current account to deficits of 2 per cent, 3 per cent and 4 per cent of GDP in 2013, 2014 and 2015, respectively.

Driven by lower global commodity prices, the year-on-year inflation rate declined to a mere 0.5 per cent in August 2013. Meanwhile demand-pull pressures were largely absent. During the rest of 2013, annual inflation should barely exceed 0 per cent. Central heating costs, which account for a significant share of household budgets during the cold season, should be around one-tenth lower this autumn than one year earlier. So far, the government has not proposed any increases in indirect taxes starting in 2014. **We forecast annual inflation of 1.5 per cent in 2013, 2.8 per cent in 2014 and 3.5 per cent in 2015**.

All in all, **the probability of meeting the Maastricht inflation criterion next spring in order to qualify for euro zone accession in 2015 seems to be increasing**. In the latest Convergence Report, which analyses compliance with Maastricht criteria, Greece was eliminated from the statistics as an outlier case. As a result, the reference rate went up and Lithuania **has been meeting the inflation criterion since September 2012**. As the country's inflation has fallen rapidly in recent months, the safety gap against the criterion has been widening and most probably will continue increasing in the near future. In August 2013, the Maastricht inflation criterion was 2.3 per cent while Lithuania's average year-on-year inflation stood at 2.0 per cent. There is, of course, no certainty that any countries will be eliminated as outliers in the 2014 Convergence Report, and the asymmetrical impact of increase in energy prices (to which Lithuania is more sensitive than advanced countries due to their higher weight in the CPI basket) still raises some risk.

Meeting the Maastricht inflation criterion

Annual average, per cent



Source: Eurostat, SEB

The general government budget deficit, another crucial indicator for euro introduction, has also moved **in the right direction**. In the first half of 2013, it was 3.8 per cent of GDP. Revenue from direct taxes was higher than planned. Meanwhile VAT and excise duties were under-collected. We expect the deficit to be 2.8 per cent of GDP in 2013 (thus below the Maastricht criterion of 3.0 per cent), 2.5 per cent in 2014 and 1.5 per cent in 2015. As the deficit shrinks, general government debt should start gradually diminishing from its current level of slightly above 40 per cent of GDP.

To sum up, **Lithuania is rather likely to join the euro zone in 2015**, provided that the authorities maintain their commitment to euro introduction and make prudent decisions, especially when adopting the 2014 budget. Public support for euro introduction remains rather weak and continues to deteriorate. According to the latest opinion poll, last April 55 per cent of Lithuanians were against euro introduction meanwhile 41 per cent were in favour. Comparable readings in April 2012 were 51 per cent and 44 per cent.

In the political arena some tension has appeared lately, with the government remaining passive about making some controversial and challenging decisions, for example on tax reform or a nuclear power plant project. Positive economic developments are also helping the governing coalition. Consequently, the ruling Social Democratic Party is maintaining a huge lead (supported by 27 per cent of respondents) over the opposition Homeland Union-Lithuanian Christian Democrats (9.8 per cent), who carried out the government's belt-tightening policies during the crisis. This year the Labour Party, a junior governing coalition partner, suffered the largest loss in opinion polls – slipping from 21.1 per cent to just 9.1 per cent due to a bookkeeping scandal. After the Labour Party established a new Parliamentary Speaker at the beginning of October, some tensions have appeared in the governing coalition. Next spring Lithuania will hold a presidential election. The Social Democrats, Labour and the Order and Justice party will probably propose their own candidates. Meanwhile the Homeland Union is more likely to support the current President, Dalia Grybauskaite, who remains in the top position in opinion polls and is therefore quite likely to win her second term.

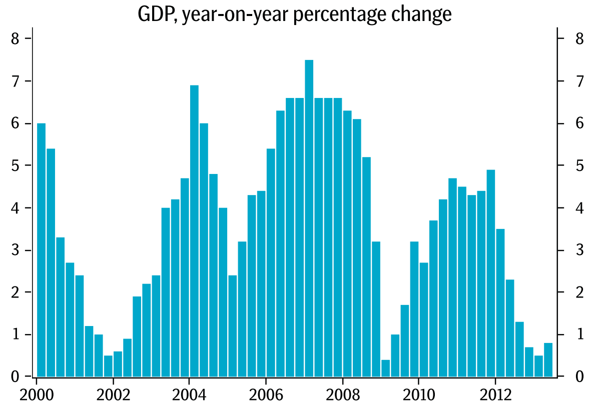
Broad recovery on the way, but continued low inflation

- **Domestic demand will gradually awaken**
- **Key rate hikes will begin late in 2014**
- **Government will survive until 2015 election**

Poland's economy will gradually start to rebound this autumn after a deep slump in the past year. Growth will initially be driven by net exports (decent exports minus weak imports), helped by stronger demand, especially from Germany. Over time, growing domestic demand will become a driving force. Improved real wages, low interest rates and EU structural funds (Poland is among the winners in the 2014-2020 EU budget) will fuel consumption and capital spending. A temporary easing of budget consolidation this year will provide support. Overall, Poland is moving towards solid, broad-based recovery. **This year GDP will grow by 1.5 per cent, in 2014 by 3.1 per cent and in 2015 by 3.5 per cent**: in line with potential growth.

Growth has bottomed out after a rapid decline

GDP, year-on-year percentage change



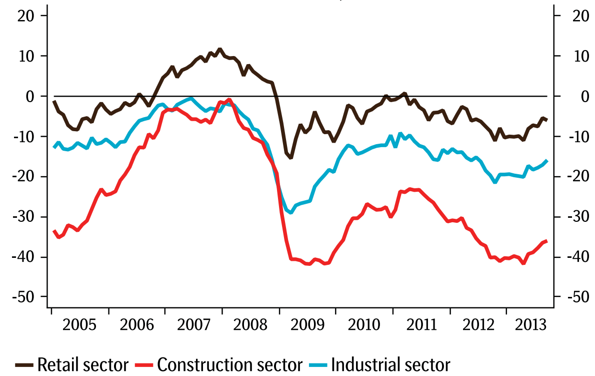
Source: Central Statistical Office of Poland

Polish growth **decelerated abruptly** from a year-on-year rate of nearly 5 per cent in the first quarter of 2012 to 0.8 per cent in the second quarter of 2013. The main reasons were **declining private consumption** (due to negative real wage growth during much of 2012 when inflation was high) and **cutbacks after a surge of construction and investment** before the summer 2012 European football championship, co-hosted with Ukraine. The euro zone recession also pulled down growth. Meanwhile it is notable that once again, Poland contrasted with many other European nations by avoiding a recession, just as it did during the US-led global crisis in 2009 when Poland was the only EU country with positive growth. **Poland has been more resilient than others** because economic fundamentals and the banking sector have been and remain in robust shape, and in crisis situations the government has allowed automatic stabilisers in its budget to operate.

Since last spring, there have been **increasing signs that GDP growth bottomed out in the second quarter**. Year-on-year export growth has continued to speed up at a modest pace, while imports have begun growing after falling continuously since late 2012. Retail sales have also started to rise year-on-year after several months of decline, but the decline in capital spending accelerated in the second quarter and it is difficult to foresee an imminent turnaround there. As for forward-looking indicators, consumer confidence has continued to improve since its lows of late 2012, although it remains below trend. The manufacturing purchasing managers' index has climbed five months in a row, exceeding the growth threshold of 50 in the past three months (53.1 in September). The improvement in the orders portion of this index mainly comes from foreign orders. Business confidence has also improved somewhat in such sectors as retail and construction.

Optimism is returning

Confidence indicators, net balance



Source: European Commission

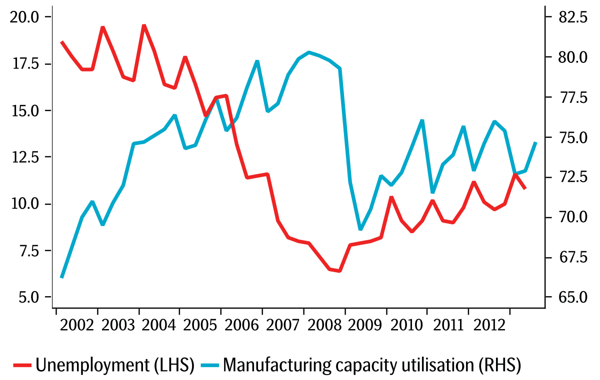
Germany is chugging along at a better pace, providing substantial support to the Polish economy. In the 1990s Poland's economy was relatively closed, but in recent years exports have risen from 35 to about 40 per cent of GDP. This is still far below various Asian emerging economies as well as countries like the Czech Republic and Hungary, which report 80 per cent, although these are extremes. A fourth of Polish exports go to Germany, providing both direct and indirect secondary effects on the economy via the production chain (with German companies choosing to locate manufacturing in Poland for cost reasons). The IMF estimates that 6.1 per cent of Polish exports are German intermediate goods and 5.6 per cent of German exports are Polish intermediate goods.

The potential for a private consumption recovery has also improved recently. Since last winter, households have regained real wage increases due to falling inflation. There is a strong connection between real wages and consumption. The National Bank of Poland's key interest rate cuts from 4.75 per cent in November 2012 to a record-low 2.50 per cent last summer are reinforcing the low interest rate environment, shoring up balance sheets and promising a weak upturn in credit growth, which had nearly ceased. Also good for consumption potential is that the household savings ratio has risen from a record-low 1 per cent early in 2012 to above 4 per cent early in 2013: still below trend, but no longer extremely low.

Unemployment climbed from a record-low 6.5 per cent in late 2008 to 10.8 per cent in the second quarter of 2013. Although there are early signs that manufacturers have again started hiring – the first upturn in a year, according to the August PMI survey – growth in Polish economy as a whole is too weak to improve the labour market situation right now. Unemployment will rise to an average of 11.1 per cent in 2014 and level out in 2015. The jobless rate thus remains above its structural level, which the OECD estimates at 10 per cent. Other measures of resources also indicate **spare capacity in the economy**. Manufacturing capacity utilisation, a moderate 75 per cent, is expected to rise gradually but will not reach earlier strained levels of about 80 per cent, as occurred in 2008.

Spare resources in the economy

Per cent

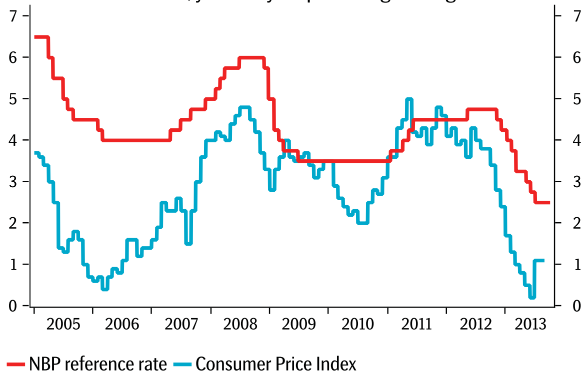


Source: Central Office of Statistics of Poland, Eurostat

Due to the remaining spare resources, slightly elevated wage and salary growth and subdued global commodity prices, Poland's low year-on-year inflation (1.1 per cent in August) will rise slowly in the coming year. **CPI inflation will reach the NBP's 2.5 ± 1 per cent target only in 2015**. The central bank will wait until late 2014 before starting to hike its key interest rate: six months later than market pricing indicates, probably due not only to weak price pressure, but also the ECB's expected December 2013 refi rate cut. The zloty risks appreciating too much and slowing exports if Poland chooses to raise its key rate too early. Our forecast is that the **zloty will climb from 4.22 per EUR today to 3.95 in 2015**. This is based on higher global risk appetite and relatively good growth prospects. Long-term yields remain historically low, after bouncing back up from a patch of "Fed exit" worries. Five-year government bond yields have risen from a record-low 2.75 per cent in May to 3.75 in September, compared to more normally occurring levels of 5-6 per cent over the past decade. Long-term yields will climb modestly in the next couple of years. **Poland has resisted the latest emerging market crisis better than many other EM countries**. The reason is that its economy is in good fundamental shape. A large current account deficit used to be a risky blemish to its record, but in recent years this deficit has shrunk substantially to 1.5 per cent of GDP in 2013. It is heading towards about 3 per cent in 2014-2015: a sustainable level in the long term.

Rapid downturn in inflation and key interest rate

Per cent, year-on-year percentage change



Source: Central Statistics Office of Poland, National Bank of Poland

Public finances are again under control after the budget consolidation of recent years. This included a pension reform that raised retirement ages, elimination of benefits for certain groups and a freeze on public sector pay. The budget deficit shrank from 7.9 per cent of GDP in 2010 to 3.9 per cent last year. This year the deficit is expected to reach 4 per cent due to lower revenue and unexpectedly low inflation. For cyclical reasons, last summer the government also chose to pursue a more neutral fiscal policy. Before that, the European Commission had given Poland a two-year respite, until 2014, to bring its deficit below 3 per cent of GDP. The government has also postponed from 2015 to 2016 its medium-term target of a structural budget deficit of 1 per cent. Achieving this target will probably require some renewed austerity in the next couple of years. The increase in public debt has halted slightly below 55 per cent of GDP. According to Polish rules, exceeding this level automatically triggers tougher austerity. The government has decided to temporary set aside this rule in 2013/2014. Furthermore, the government has recently decided to transfer to the stat many of the assets held by private pension funds, which lowering public debt.

The centre-right government led by the Civic Platform and Prime Minister Donald Tusk has **lost popularity** since being re-elected in 2011. Last spring the conservative opposition party Law and Justice surpassed the Civic Platform in public opinion surveys for the first time since 2007. This is probably due to government belt-tightening, but also last year's controversial pension reform and internal Civic Platform tensions on such issues as gay and lesbian partnerships. Law and Justice has recently criticised the large foreign ownership of Polish banks, among other things. Although the government's position has weakened, it will probably remain in power until the next election in the autumn of 2015. This summer's steps to ease austerity policies, as well as improving growth prospects, should ease pressures on the government over time.

The government is aiming at future euro zone accession for Poland but has set no target date. Our assessment is that Poland will join the **euro zone no earlier than 2017**.

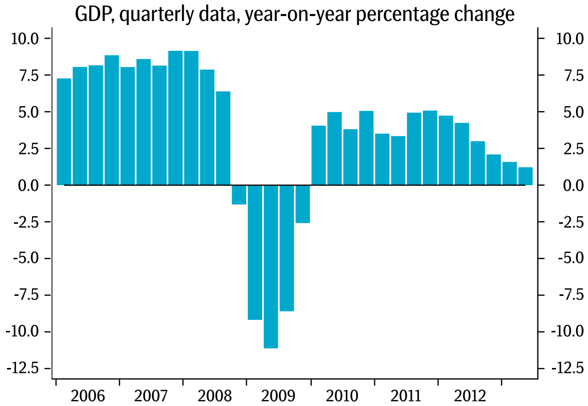
Growth has bottomed out but will remain weak

- **Strong labour market and real wages...**
- **...will help sustain economy as oil prices fall**
- **Capital spending will be vital to growth, and extensive reforms are needed**
- **Increased political tensions**

Russia's economic performance was very weak during the first half of 2013; after a year-on-year GDP increase of 1.6 per cent in the first quarter, growth decelerated to 1.2 per cent in the second. Economic activity has thus slowed for six quarters in a row. The slowdown is broad-based but mainly driven by continued low capital spending. In our view, oil prices (Brent) as annual averages will fall **from USD 108 per barrel to USD 102.5 next year and USD 100 in 2015**. Export and tax revenue will thus provide weaker support to growth, but the strong labour market will offset this. Real wages have started accelerating again, and retail sales have stabilised. A stimulus package equivalent to 0.6 per cent of GDP will also help buoy the economy, but it is spread across several years and will not change fundamental conditions. The year's good harvest and intensive activity in the agricultural sector are contributing to a situation in which growth appears to have bottomed out in the second quarter. We expect a slight recovery during the second half. In 2014, growth will accelerate, sustained by a continued improvement in global economic conditions. **We expect GDP to increase by 1.7 per cent in 2013, 2.4 per cent in 2014 and 3.0 per cent in 2015.** As in the last issue of *Eastern European Outlook* in March, our forecast is below consensus.

Six consecutive quarters of decelerating growth

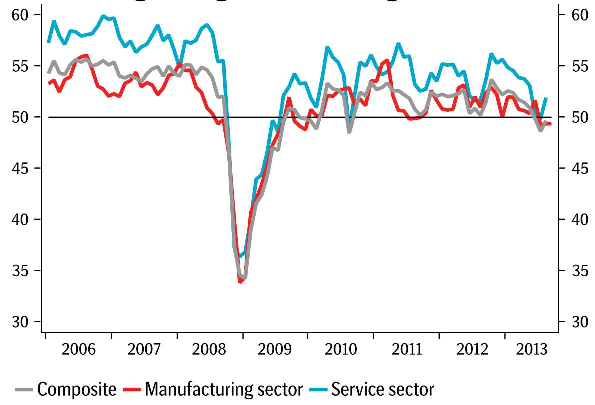
GDP, quarterly data, year-on-year percentage change



Source: Russian Federal State Statistics Service

Most indicators remained weak in 2013. The composite purchasing managers' index (PMI) has been below the expansion threshold of 50 for the past three months, but the PMI for the service sector is far higher than manufacturing PMI. In recent months, though, there have been some bright spots: the service PMI rose in August. Consumer confidence has improved somewhat in the past two quarters, and leading indicators have also started climbing.

Purchasing managers' indices at growth threshold

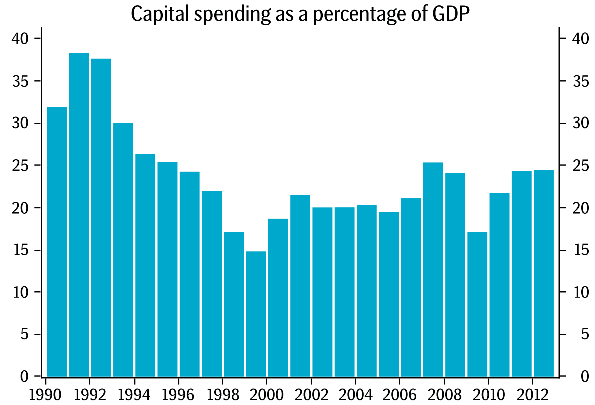


Source: Markit

Most hard data have also been subdued during 2013. The year-on-year increase in industrial production has been close to zero in recent months. Output is now lower than before the 2008-2009 financial crisis. Capital spending has remained weak in 2013, falling by nearly 4 per cent year-on-year in August. **Looking further ahead, the main thing needed to fuel growth is a capital spending upturn.** There are major investment needs. With an investment ratio that has stagnated just below 25 per cent of GDP, Russia is well behind China and India as well as many other emerging market countries.

Relatively low investment ratio

Capital spending as a percentage of GDP



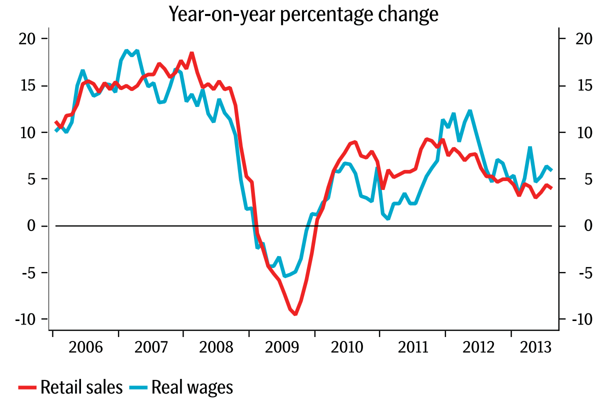
Source: IMF

Over the next several years, the **2014 Winter Olympics in Sochi** and the **football World Cup in 2018** will generate infrastructure demand. The government also has an explicit ambition to develop the eastern part of Russia, which will generate long-term investment needs. The oil and gas industry also has an extensive need for capital spending in order to counter stagnating energy production, but such needs are being offset by a poor business climate that is holding back corporate investments, especially from foreign companies.

After very weak performance since late 2012, **exports** have shown early **signs of recovery** during the past two months, probably driven by an oil price upturn. Retail sales have also improved somewhat. After a clear deceleration compared to the first half of 2012, sales have stabilised, with an increase of some 3-4 per cent year-on-year in recent months. There is potential for decent growth ahead thanks to continued strength in the labour market.

Retail sales are stabilising

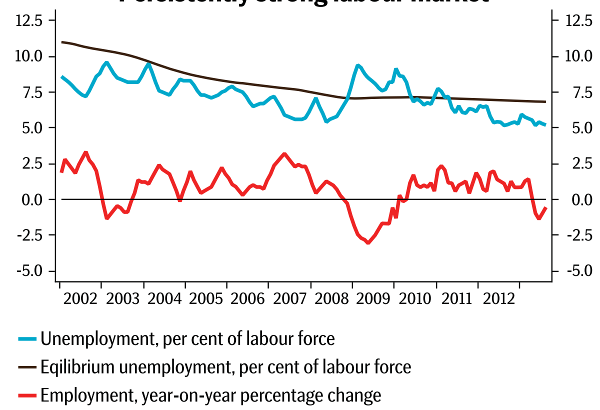
Year-on-year percentage change



Source: Russian Federal State Statistics Service

Despite sharp economic deceleration, there are **no clear signs of labour market deterioration**. Although job creation has weakened somewhat, the labour market as a whole is strong. Unemployment is well below equilibrium and fell to 5.2 per cent in August. Due to persistently good nominal wage and salary growth, combined with more subdued inflation, real wage increases have climbed rapidly again in recent months.

Persistently strong labour market



Source: Russian Federal State Statistics Service

Increasingly acute need for reforms

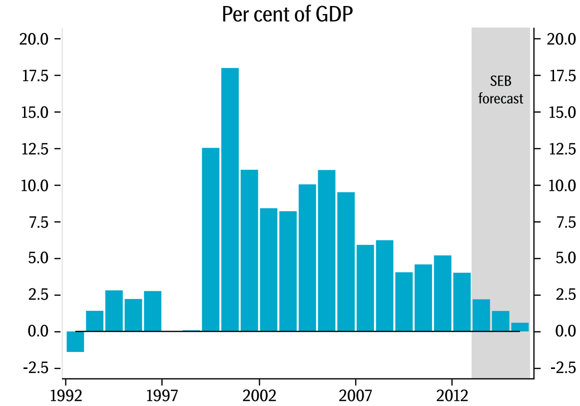
The strong labour market, combined with high capacity utilisation, implies that growth deceleration is mainly structural and can be explained by various weaknesses in the economy, such as oil dependence, large-scale government influence, weak institutions and demographic deterioration (see theme article).

As we have argued in previous reports, there is a **great need to follow up earlier reforms**, for example World Trade Organisation membership, introduction of inflation targets and privatisations, **with continued reform efforts**. At present, however, there are few signs that reforms will be implemented on the scale that is needed. **Our main long-term scenario is that GDP growth will remain at around 3 per cent**.

The main problem is the Russian economy's heavy dependence on oil, which accounts for some 60 per cent of total exports and more than half of budget revenue. Balancing the federal budget currently requires oil prices of around USD 110-115 per barrel, a major increase from around USD 30 per barrel in 2005. We estimate that **the budget deficit will end up at 0.5 per cent of GDP in 2013, 1.1 per cent in 2014 and 1.4 per cent in 2015**. It is difficult to foresee any long-term potential for significantly higher oil prices. Energy market prospects have changed fundamentally, since global production capacity is now rising, driven by technological advances that have enabled extraction of oil and gas from shale formations. The impact on prices is difficult to assess, but it is reasonable to assume that this trend will lead to downward pressure on energy prices, hurting both Russia's budget revenue and current account balance. In the past 10 years, the **current account surplus has narrowed greatly**. We believe this trend will continue. Beyond our forecast horizon, in 2016 or 2017, we expect a current account deficit, driven by stagnating budget revenue combined with rising social expenditures. Yet Russia has its own extensive shale oil and gas deposits, creating the potential for increased production in the energy sector if the country can resolve its problems with investment shortages and high taxation.

The current account surplus is narrowing

Per cent of GDP



Source: IMF, SEB

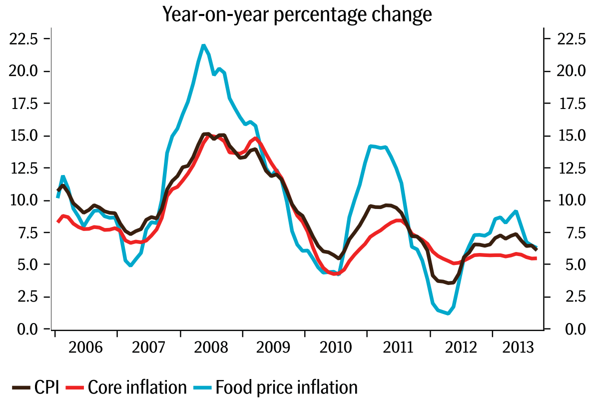
Russia is running out of time for reforms before a weakening of energy prices begins to pull down economic growth and erode its still-strong central government finances. This will make reform efforts substantially harder. During our forecast period, we already expect a weakening of the budget balance, although the deficits will be small. Another factor making reform efforts more difficult is the political situation, which prioritises maintaining support among important voter categories and special interests ahead of structural reforms.

Inflation is slowing

For about a year starting in the spring of 2012 consumer price index (CPI) inflation surged, driven by a combination of food price inflation and fee hikes. In recent months, however, inflation has decreased. It fell to 6.1 per cent in September. Core inflation has also decelerated slightly in recent months.

Inflation is slowing

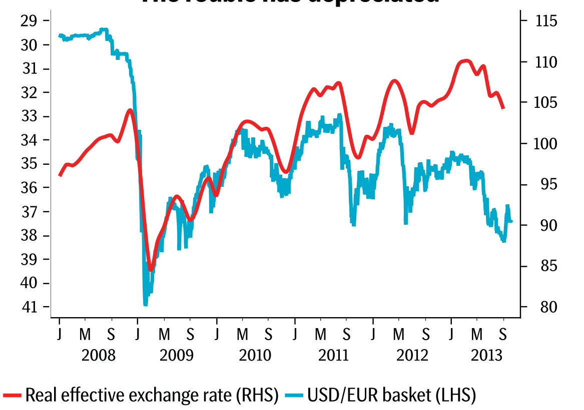
Year-on-year percentage change



Source: Russian Federal State Statistics Service

We expect CPI inflation to continue slowing, mainly driven by a deceleration in food price inflation thanks to this year's good harvest. Due to last autumn's high food price inflation, base effects will be large. In mid-September the government announced a freeze on regulated prices such as electricity and gas (10 per cent of the CPI basket), which will further help slow price increases this autumn. There is thus good potential for achieving the official inflation target of 5-6 per cent by the end of 2013, but we expect an outcome close to the upper end of this range. The 4-5 per cent inflation target at the end of 2014 will be harder to achieve and will require coordination between the central bank and the government. **Measured as annual averages, inflation will end up at 6.7 per cent in 2013, 5.4 per cent in 2014 and 5.0 per cent in 2015**.

The rouble has depreciated



Source: Macrobond

So far this year, the rouble has lost some 7 per cent of its value against the USD/EUR basket (55 per cent USD and 45 per cent EUR). The downturn accelerated from late May due to worries about the Fed's future exit policy. Despite its depreciation, the rouble has fared better than many other emerging market currencies, probably due to rising oil prices and Russia's strong government finances (see box below). In the immediate future, the rouble will receive support from current account surpluses and high oil prices, but weak economic growth along with an expected softening of monetary policy late in 2013 and early in 2014 will work against rouble appreciation. A slight rouble decline would help sustain a growth recovery, and there are indications that the government will welcome such a trend. Looking ahead a few years, most indications are that the rouble will depreciate, since the current account surplus will continue to shrink. **We believe that the rouble will stand at 37.5 against the basket at the end of 2013 and will appreciate to 37.0 at the end of 2014. At the end of 2015, it will stand at 37.8**.

Russian resilience to financial market turbulence

Worries about the Fed's "tapering" of bond purchases have had a major financial market impact in developing countries. Countries with large current account deficits, such as India and Indonesia, have been especially hard hit, leading to sharp declines in their stock markets and currencies. Although Russia has also been hurt by these worries, it has been more resilient. The negative effects on its currency have been more subdued. Since late May, the rouble has weakened by some 3 per cent against the USD, while the Russian stock market has marginally lost value. Meanwhile credit default swap (CDS) prices – which reflect the risk of default – have climbed somewhat, but significantly less than in countries like Ukraine and Indonesia.

One explanation for Russia's resilience is that its currency and stock market are connected to oil prices. Since late May, Brent crude prices have risen by around 5 per cent, helping offset a weaker currency and stock market. Another major explanation is that Russia, unlike economies hurt by market worries, has strong central government finances and current account surpluses.

Continuing shift towards inflation targeting

The replacement of Sergei Ignatiev with Elvira **Nabiullina** as central bank governor has, in practice, not led to any change in monetary policy direction. Nabiullina is continuing on the path set by her predecessor. This implies that monetary policy will shift from a system mainly focusing on exchange rate targeting to one based on a clear inflation target.

Speculation early this autumn about looser monetary policy did not materialise; the refi rate has been unchanged at 8.25 per cent since being hiked in September 2012, but due to more subdued inflation combined with far weaker-than-expected first half growth, an interest rate cut is approaching. However, there will be no major rate cuts; our assessment is that the **refi rate will be lowered by 25 basis points before year-end** and stand at 8.00 per cent at the close of 2013. During the **first quarter of 2014, we expect a further 25 bp rate cut**.

Yet the refi rate is assuming an increasingly symbolic role. In practice, overnight repos are of much greater importance since they determine the interest rate used when the central bank supplies, liquidity. This rate moves between 5.5 and 6.0 per cent. A one-week repo rate will replace the refi rate as the key interest rate, but this change will have little practical importance since the repo rate is close to the average interest rate already being used. Last summer, the central bank created another lending facility offering 12-month loans. The facility is consistent with its ambition to offer Russian banks long-term funding but will be of limited importance since most liquidity supply occurs via overnight and one-week repos. Arguments that the facility is a form of quantitative easing are exaggerated, since it is not expected to increase the monetary base.

The central bank is expected to decrease its foreign exchange market interventions, the **objective being that the rouble will float freely by the end of 2014**. Yet there is reason to be sceptical about the currency being allowed to float entirely freely. The exchange rate has a major impact on the economy because government, businesses and households have large foreign currency assets. Russia's oil dependence also gives rise to large foreign exchange flows as oil prices fluctuate. The aim is a transition from a system of central bank interventions to a freely floating rouble, stabilised by government-led interventions using Reserve Fund money. Yet we believe that the central bank will also occasionally intervene in order to counter large exchange rate fluctuations. We thus believe that in practice, today's rouble corridor will remain in existence, but in a broader and weaker form.

Since the rouble is expected to move more freely, monetary policy will instead focus on setting interest rates to achieve central bank inflation targets. At present, these targets are 5-6 per cent at the end of 2013 and 4-5 per cent at the end of 2014 and 2015. However, there are proposals for a change to inflation targets in the form of point estimates: 4.5 per cent in 2014 and 2015 and 4 per cent in 2016.

Nabiullina has also expressed concern about rising risks related to financial stability and credit growth. She has pledged to slow the increase in consumer lending to 10-15 per cent annually from its current 40 per cent rate. Private consumption has been behind about two thirds of growth in recent years, largely driven by a rapid increase in household borrowing. Yet total lending has already begin to slow, and household debts are equivalent to only around 12 per cent of GDP, compared to 30 per cent for other economies in the region.

Increasing long-term political risk

Although there are no big immediate risks to the current political system, the belief in long-term potential for major changes has gained strength. The legal manoeuvres surrounding activist Alexei **Navalny**, a persistent critic of Vladimir Putin, have revealed that opposition to the president may be more widespread than previously estimated. In July, Navalny was sentenced to five years in prison for embezzlement, but was unexpectedly allowed to campaign for election as the mayor of Moscow in September, while his verdict is appealed. This election was an important barometer of the political mood. As expected, Putin's candidate won, but Navalny received 27 per cent of the votes. This was far more than expected. The election outcome does not change the domestic political situation but shows that there is **fertile ground for growing political dissatisfaction**. This popular **dissatisfaction is expected to increase** as living standards stagnate due to lower economic growth. Navalny's popularity reflects a desire among portions of the population, especially the growing middle class, for a fair and meritocratic political system. Support for Putin is expected to erode gradually.

One central issue is who will succeed Putin; it is still unclear whether he will be a candidate in the **2018 presidential election** and try to stay in office for another term. So far there is no clear candidate to succeed him, which may lead to a power struggle that risks destabilising the political system.

The dubious methods used in the legal process surrounding Navalny are also a clear example of the poor business climate in Russia. When the verdict became known, it caused a clearly negative stock exchange reaction. The verdict is related to Navalny's business activities and reinforces the belief that Russian entrepreneurs and investors enjoy very poor legal protection. The trial thus further damaged investor sentiment.

Tense foreign relations

Russia's relations with the US deteriorated further starting last spring. Already tense relations, due among other things to the Magnitsky Act and Russia's decision to grant a residence permit to whistleblower Edward Snowden, turned worse after US threats of military action against the Syrian regime. Yet the agreement to destroy Syria's chemical weapons has improved Russian-US relations somewhat, also improving Russia's global political influence and reputation, at least temporarily.

Relations with several neighbouring countries are also tense. **Russia's ties with Ukraine are being strained by that country's ambition to integrate with the EU**. Russia instead wants to draw Ukraine into its own sphere of interest by offering membership in the customs union that so far encompasses Russia, Kazakhstan and Belarus. As a result, a **trade war between Russia and Ukraine is imminent**. Russia has introduced trade restrictions on various categories of goods imported from Ukraine. At a summit meeting in Vilnius on November 28-29, 2013, Ukraine is expected to sign an association agreement with the EU. If this occurs, Russia has threatened to unleash a trade war that might cause a balance of payments crisis in Ukraine and force a devaluation of the hryvnia. This dispute has harmed Russia's contacts with the **EU**. Meanwhile relations with **Belarus** have worsened due to a dispute about business cooperation that has had a big adverse impact on a single company that accounts for around 20 per cent of Belarus' budget revenue. The dispute has not been resolved, and as with Ukraine, Russia has exerted pressure on Belarus by means of trade barriers.

Little chance of reversal in negative demographic trend

- **Continued population decline expected**
- **Unfavourable demography will hurt growth**
- **Increased immigration would ease impact**

Like many other countries such as China, Japan and Germany, Russia is facing a **large-scale demographic challenge**. In Russia, however, a demographic deterioration has been under way for a long period. The population has been shrinking ever since the dissolution of the Soviet Union in 1991. **From 1992 to the end of 2012, the number of inhabitants is estimated to have decreased from around 149 million to 143 million.**

The main driving forces have been a declining fertility rate combined with shorter life expectancy. Lower fertility and life expectancy were caused by the far-reaching social changes associated with the dissolution of the Soviet Union and the difficult transition from a planned economy towards a market economy. Mortality rose dramatically during the first half of the 1990s as a consequence of economic and social instability, high alcohol and tobacco consumption and a deterioration in the health care system. Meanwhile the number of births also fell, driven by economic uncertainty. The decline in population would have been even greater had it not been for relatively large-scale immigration from former Soviet republics as well as repatriation of Russians from other countries.

Because of unfavourable age structure, population will continue to shrink

During 2012, Russia's population rose slightly. Most indications are that the population will also increase marginally during 2013. This has attracted a lot of attention; the government and President Vladimir Putin have used this upturn as a sign that the demographic trend has now reversed and that earlier policy measures aimed at increasing the population have begun to bear fruit. Yet most analysts maintain that the upturn is temporary and can be explained by peculiarities in the age structure of the population. Russia's age structure is generally very unfavourable. The number of women of child-bearing age is expected to fall rapidly as the "little generation" born in the 1990s reaches reproductive age. In addition, the percentage of older people in the population will rise significantly.

The total fertility rate (TFR) is the average number of children that each woman gives birth to during her lifetime. To ensure that a country's population will not fall, the TFR must be about 2.1 in developed countries and 2.3 in emerging market countries. In Russia – as in countries like China, Japan and Germany – birth rates are currently far below the levels needed to prevent a decrease in population. However, a country's population can stabilise or increase if it has sufficiently large-scale immigration. One example is the United States, where population is rising thanks to immigration even though the TFR is below 2.

Total fertility rate in selected countries

Annual average

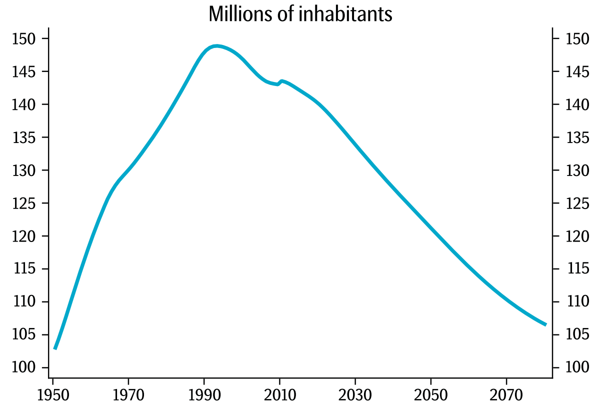
	2010-2015	2030-2035	2050-2055
Russia	1.53	1.74	1.83
Brazil	1.82	1.68	1.72
China	1.66	1.76	1.82
India	2.50	2.08	1.88
Japan	1.41	1.63	1.74
Germany	1.42	1.57	1.66
United States	1.97	1.98	1.99

Source: United Nations (*World Population Prospects, the 2012 Revision*)

According to UN estimates, the total fertility rate in Russia will remain below 2 during the foreseeable future, and forecasts indicate that the population will continue to shrink. From **144 million in 2010, the population is expected to decline to around 134 million in 2030 and to 121 million in 2050**. The number of people of working age is expected to decrease even faster, as a consequence of the rising percentage of older people in the total population. According to Russian analyses, the labour force is expected to decline by about 8 million during the period 2012 to 2022.

Russia's population is expected to keep shrinking

Millions of inhabitants



Source: United Nations

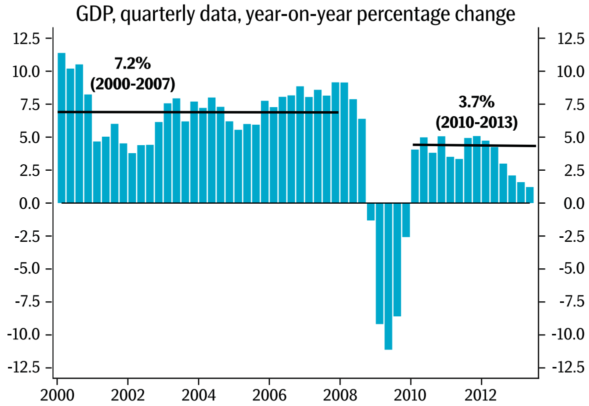
Demography will hurt growth

There are two main channels between demography and a country's economic growth. The first channel is via the labour force, which increases the total production capacity of an economy. An increasing labour force thus causes total GDP to rise. An increase in the labour force as a percentage of total population leads to a positive effect on GDP growth per capita. There are also indirect effects. According to the life cycle hypothesis, total saving in an economy is affected by the age structure of the population. Individuals of working age tend to save more than younger and older individuals. A large percentage of working age people in the total population thus increases saving as well as the resources available for investments.

Estimates of the impact of deteriorating demography on growth are uncertain. One figure for Russia mentioned by private analytical organisations is that the expected decrease in the Russian labour force will **reduce average GDP growth per year by 0.7 to 1.5 percentage points during the period 2013 to 2018**. Regardless of how large the negative effects on growth will be, **demography is one of several factors weighing down Russian potential growth**. In addition to demography, growth is being kept down by heavy dependence on oil, the central government's large influence on the economy and a poor business climate. Our assessment is that **potential GDP growth is currently around 3 per cent**, significantly below an estimated 5-6 per cent before the financial crisis, which is also the government's long-term target. Unless extensive reforms are implemented to offset these negative factors, potential growth will fall below 3 per cent over the next few decades.

Significantly lower post-crisis growth

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



Source: Russian Federal State Statistics Service

One practical example of how demography is hurting economic growth opportunities can be found in the eastern-most part of Russia. The federal government has an explicit goal of developing the far eastern region, which is rich in natural resources and has major potential for exports to Asia. However, taking advantage of this potential will require extensive infrastructure investments, and the key problem is a major shortage of labour. The population density of the region is very low, and immigration from the neighbouring heavily populated regions of China is not an alternative, due to opposition among the Russian population.

Opposition to immigration will make it difficult to reverse the trend

The chances of reversing Russia's demographic trend and making the population stabilise or begin to increase are very limited. Because of the age structure, **in practice the only way of countering a continued decrease in population in the short and medium term is through greater immigration**, but among the Russian population there is strong opposition to immigration, and rising nationalist sentiment could worsen the situation. Studies have shown that people in Russia have clearly overestimated the extent of immigration and have also misjudged the ethnic composition of immigrants. There is especially strong resistance to immigration from faraway countries. This further worsens the problem, since the potential for immigration from former Soviet republics and by Russian citizens living abroad has already been exhausted through earlier immigration. During the period 2008 to 2012, net immigration to Russia averaged around 220,000 per year, which is far from sufficient to stabilise the population.

Even though there does not seem to be any great political interest in boosting immigration, the business community should have a fundamentally positive attitude towards immigration, and immigration will probably emerge as an important social issue in the coming years.

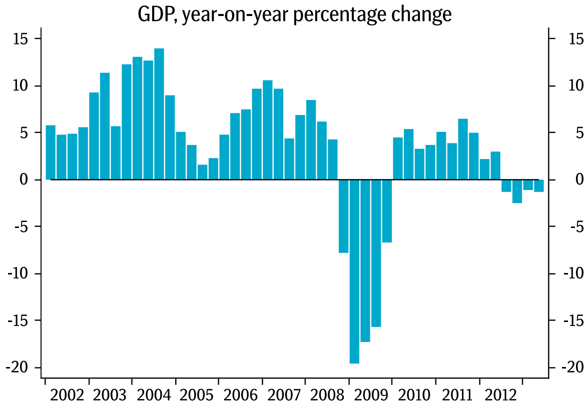
Recession and financial turmoil will force devaluation

- **Anaemic GDP trend**
- **Weak market confidence**
- **Rapprochement with EU risks trade war with Russia**

Weak economic performance in the second half of 2012 continued in 2013; GDP fell 1.1 per cent year-on-year in the first quarter and 1.3 per cent in the second, marking four straight quarters of decline. Domestic demand is subdued. Capital spending has been lethargic in recent quarters due to the uncertain trend. Retail sales, once a bright spot, are now fading. External demand is not doing much to support growth either. The important steel sector is still struggling with feeble demand and depressed prices. Ukraine's overvalued currency is hurting exports. In Russia, the biggest export market, growth has slowed while trade restrictions against Ukraine have been introduced, but we expect this year's good harvest to buoy the economy in the second half of 2013. An expected devaluation early in 2014 will stimulate exports. Improved global economic conditions will also contribute to growth. **In 2013, we expect GDP to fall by 0.8 per cent. In 2014, growth will reach 2.0 per cent and 2015 it will accelerate to 3.4 per cent**.

Four consecutive quarters of negative growth

GDP, year-on-year percentage change

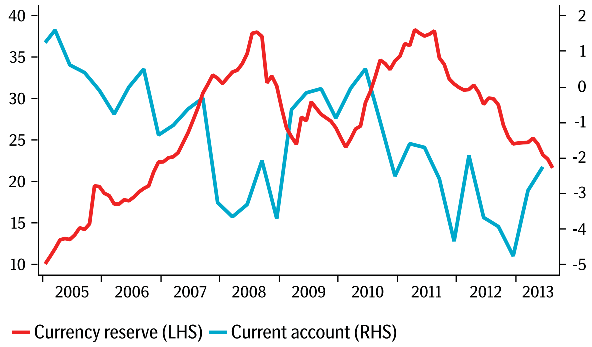


Source: State Statistics Service of Ukraine

The main problem in the Ukrainian economy is still the large current account deficit, which exceeded 8 per cent of GDP in 2012 and is driven by a sizeable trade deficit. The weak current account, combined with a growing budget deficit, is squeezing the hryvnia. Although the current account deficit shrank early in 2013, this improvement was largely due to seasonal factors. Looking ahead, we thus expect further current account deterioration, reinforced by rising import prices for gas as winter approaches and the threat of a trade war with Russia. Because of the overvalued currency, overall imports remain high. So far, Ukraine has chosen not to try to use the available remedies: a devaluation of the hryvnia and a new bail-out loan from the International Monetary Fund. Devaluation would of course make foreign debt servicing more expensive, but above all it would reduce the need for central bank intervention to maintain a stable exchange rate. Due to debt servicing, after some stabilisation early in 2013 Ukraine's currency reserve has again fallen in recent months. In August, it was at its lowest since 2006 and now suffices to cover less than three months of imports: lower than normal critical thresholds. A continued fall in the currency reserve increases the risk of uncontrolled devaluation. Making the situation worse is that the government has a large short-term external borrowing requirement, even though sovereign debt is low.

Current account deficit and critically low currency reserve

USD billion



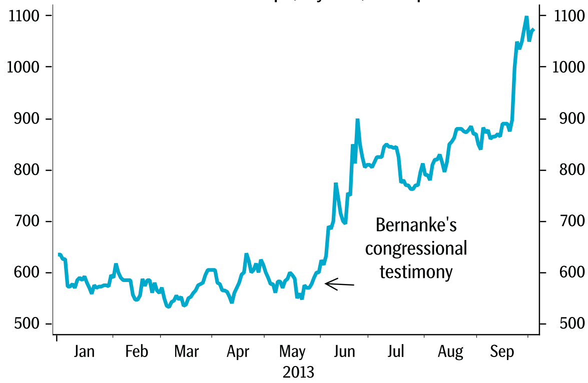
Source: Macrobond, SEB

Negotiations with the IMF on a bail-out loan, which would make it easier to fund the deficits and create stability, have been fruitless. Ukraine has instead continued to **manage its own funding needs** through international lending markets, but borrowing has become more difficult due to market turmoil related to Federal Reserve exit policy and lower risk appetite. Like other economies with large current account deficits (Indonesia, India), Ukraine has been extra hard hit. Sovereign bond yields are up sharply since late May. Credit default swap (CDS) prices, which reflect the risk of default, have soared and remain at high levels. Yet despite financial market turbulence, Ukraine has managed to arrange the necessary borrowing.

A stand-by agreement with the IMF would be Ukraine's best alternative, but the government opposes IMF demands for cuts in gas price subsidies to households and businesses. Pressure on the economy must probably increase before the government accepts IMF demands; we expect Ukraine to **apply for a stand-by agreement in the first quarter of 2014**. We also expect Ukraine to continue its attempts to avoid devaluation and hold off on seeking an IMF bail-out loan. Yet our main scenario is that the **erosion of the currency reserve will continue**, forcing a **devaluation in the first quarter of 2014**. We expect this devaluation to be **at least 10 per cent**. Along with an improvement in global economic conditions, we expect this to help turn this year's expected GDP decline into an economic expansion in 2014. A weaker currency would provide extra stimulus to exports, where steel and agricultural products weigh heavily, and would also have a positive impact on capital spending due to diminished economic uncertainty, especially for foreign companies. Devaluation would also have negative effects, for example on the availability and cost of loans. Foreign currency loans were popular before the crisis, so both households and businesses are exposed to a weaker hryvnia. Households have more than a third of their borrowing in foreign currencies.

Ukraine squeezed by worries about Fed exit policy

Credit default swaps, 5 years, basis points



Source: Macrobond

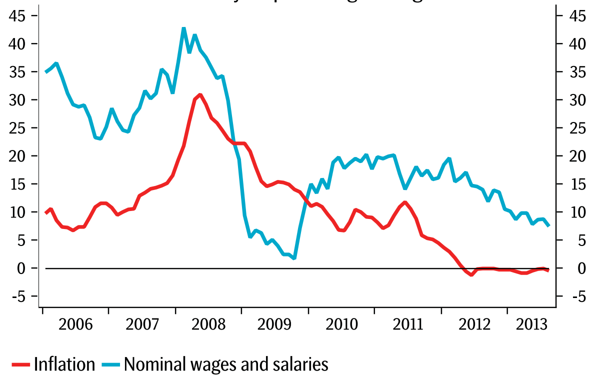
Domestic demand will not provide much support to growth. Industrial output continues to fall, largely driven by the difficulties of the steel sector, in which production is down by about a fourth since peaking in 2008. Retail sales, previously a major growth force, have begun to decelerate. Although the year-on-year rate of increase was just above 5 per cent in August, compared to 2011-2012 growth has roughly halved.

Last year the government approved a **stimulus programme** equivalent to a full 30 per cent of GDP (USD 58 billion). It includes infrastructure investments and is supposed to run during 2013 and 2014. Details are sketchy and it is highly unclear how funding will be handled. It is also difficult to see how Ukraine could boost capital spending, given its large current account deficit.

Unemployment remains far higher than before the financial crisis, and job growth is weak. Nominal pay increases have slowed sharply; compared to early 2012 the pace of increase has halved. Real wage increases have thus decelerated, even though inflation pressure remains low. CPI inflation and core inflation have moved close to zero since mid-2012, and producer prices are falling year-on-year. This low inflation pressure is explained by the slowdown in economic activity and falling food inflation (about half the CPI basket). We expect the good 2013 harvest to continue holding back food prices. Low inflation will continue over the next few months, but in 2014 inflation will take off, driven by the devaluation. Measured as annual averages, **inflation** will be **0.5 per cent in 2013** and **5.6 per cent in 2014**. **In 2015**, when economic activity speeds up, inflation will accelerate to **6.1 per cent**.

Real wage growth is decelerating

Year-on-year percentage change



Source: State Statistics Service of Ukraine

President Viktor Yanukovich and his Party of Regions will continue to set the domestic policy agenda, but the effects of their narrow margin of victory in last October's parliamentary election have become clearer. The government has been forced to be more open towards other parties in parliament, which can band together to delay or halt new legislation. As the next presidential election in 2015 approaches, the desire to try to push through IMF demands for cuts in gas price subsidies and other unpopular reforms will probably decrease.

In **foreign policy**, Ukraine has recently begun moving closer to the European Union rather than Russia. Its ambition is to conclude a **trade and association agreement with the EU**. The process has previously been sluggish, largely due to EU concerns about the state of democracy in Ukraine, especially the government's treatment of former Prime Minister Julia Timoshenko. Ukraine has made some concessions, though, and the EU's attitude has also become more positive. We expect an agreement to be signed at the third summit of the Eastern Partnership in Vilnius on November 28-29, 2013.

Russia is displeased with Ukraine's efforts at rapprochement with the EU, reacting with a combination of sticks and carrots. This summer, Russia imposed **trade restrictions** to put pressure on Ukraine. About a fourth of Ukraine's exports go to Russia. Russia has threatened to start a **trade war** if Ukraine signs the agreement with the EU. This could trigger a balance of payments crisis and force a devaluation of the hryvnia. On the other hand, Russia is willing to give Ukraine observer status in the Russian-led CIS customs union. This status is mainly symbolic but it risks making rapprochement with the EU more difficult. Russia can also take advantage of Ukraine's dependence on imports of its natural gas as a form of pressure.

Key economic data

ESTONIA

	2008	2009	2010	2011	2012	2013(f)	2014(f)	2015(f)
GDP, %	-4.2	-14.1	2.6	9.6	3.9	1.3	2.6	2.9
Inflation, HICP, average, %	10.4	-0.1	3.0	5.0	3.9	3.2	2.7	2.6
Unemployment, %	5.5	13.8	16.9	12.5	10.2	8.8	8.8	8.5
Current account, % of GDP	-9.3	2.7	2.7	1.6	-1.8	-0.3	0.7	0.7
Public sector financial balance, % of GDP	-2.9	-2.0	0.2	1.2	-0.2	-0.2	-0.7	-1.0
Public sector debt, % of GDP	4.5	7.1	6.7	6.1	9.9	10.1	10.0	10.4
3-month interest rate, end of period	7.8	3.3	1.1	1.4	0.2	0.2	0.4	0.6

LATVIA

	2008	2009	2010	2011	2012	2013(f)	2014(f)	2015(f)
GDP, %	-3.3	-17.7	-0.9	5.5	5.5	4.0	4.8	4.8
Inflation, HICP, average, %	15.3	3.3	-1.2	4.2	2.3	0.2	2.8	3.3
Unemployment, %	7.5	16.9	18.7	16.2	15.0	11.4	9.6	8.9
Current account, % of GDP	-13.1	8.6	2.9	-2.2	-2.5	-1.3	-2.3	-2.8
Public sector financial balance, % of GDP	-4.2	-9.7	-8.1	-3.6	-1.2	-1.2	-0.8	-0.4
Public sector debt, % of GDP	19.8	36.7	44.4	41.9	40.7	43.0	40.5	38.5
EUR/LVL, end of period	0.7	0.7	0.7	0.7	0.7	0.7	–	–
Key rate, eop	6.0	4.0	3.5	3.5	2.5	0.3	0.3	0.3

LITHUANIA

	2008	2009	2010	2011	2012	2013(f)	2014 (f)	2015 (f)
GDP, %	2.8	-14.8	1.5	6.0	3.6	3.8	3.5	4.5
Inflation, HICP, average, %	11.1	4.2	1.2	4.1	3.2	1.5	2.8	3.5
Unemployment, %	5.8	13.7	17.8	15.3	13.2	11.5	10.0	8.5
Current account, % of GDP	-12.9	3.7	0.1	-3.7	-0.2	-2.0	-3.0	-4.0
Public sector financial balance, % of GDP	-3.3	-9.4	-7.2	-5.5	-3.2	-2.8	-2.5	-1.5
Public sector debt, % of GDP	15.5	29.3	37.9	38.5	40.7	41.0	41.0	40.0
EUR/LTL, end of period	3.45	3.45	3.45	3.45	3.45	3.45	3.45	–
3-month interest rate, eop	9.89	3.90	1.50	1.66	0.68	0.40	0.45	0.55
5-year government bond, eop	13.10	6.60	4.60	5.40	2.40	2.50	2.60	2.70

(f) = forecast

POLAND

	2008	2009	2010	2011	2012	2013(f)	2014(f)	2015(f)
GDP, %	5.1	1.6	3.9	4.5	1.9	1.5	3.1	3.5
Inflation, HICP, average, %	4.2	4.0	2.7	3.9	3.7	1.0	2.2	2.5
Unemployment, %	7.1	8.1	9.6	9.6	10.1	10.9	11.1	11.1
Current account, % of GDP	-6.5	-4.0	-5.1	-4.9	-3.5	-1.0	-2.8	-3.2
Public sector financial balance, % of GDP	-3.7	-7.4	-7.9	-5.0	-3.9	-4.1	-3.0	-2.5
Public sector debt, % of GDP	47.1	50.9	54.8	56.4	55.6	54.9	54.0	53.0
EUR/PLN, end of period	4.1	4.1	4.0	4.5	4.1	4.2	4.1	4.0
Key rate, eop	4.00	3.50	3.75	4.50	4.25	2.50	2.75	3.25
5-year government bond, eop	5.34	5.91	5.52	5.34	3.21	3.75	4.30	4.80

RUSSIA

	2008	2009	2010	2011	2012	2013(f)	2014(f)	2015(f)
GDP, %	5.2	-7.8	4.5	4.3	3.4	1.7	2.4	3.0
Inflation, average %	14.1	11.7	6.9	8.4	5.1	6.7	5.4	5.0
Unemployment, %	6.2	8.4	7.5	6.6	5.7	5.5	5.6	5.8
Current account, % of GDP	6.2	4.1	4.6	5.2	4.0	2.2	1.4	0.6
Public sector financial balance, % of GDP	4.9	-6.3	-3.5	1.6	0.8	-0.5	-1.1	-1.4
Public sector debt, % of GDP	7.9	11.0	11.0	11.7	10.9	10.5	12.1	12.9
USD/RUB, end of period	29.57	30.10	30.50	32.08	30.36	32.70	33.40	34.70
Rouble vs. euro/dollar basket, eop	34.8	36.0	35.2	36.4	34.7	37.5	37.0	37.8

UKRAINE

	2008	2009	2010	2011	2012	2013(f)	2014(f)	2015(f)
GDP, %	2.3	-14.8	4.1	5.2	0.2	-0.8	2.0	3.4
Inflation, average, %	25.2	15.9	9.4	8.0	0.6	0.5	5.6	6.1
Unemployment, %	6.4	9.0	8.4	8.2	7.8	8.3	8.5	8.2
Current account, % of GDP	-7.1	-1.5	-2.2	-6.3	-8.2	-7.5	-5.5	-4.5
Public sector financial balance, % of GDP	-3.2	-6.3	-5.8	-2.8	-4.6	-4.4	-4.0	-3.4
Public sector debt, % of GDP	20.5	35.4	40.5	36.8	37.4	40.9	42.8	42.5
USD/UAH, end of period	7.80	8.00	7.97	8.00	8.05	8.20	9.30	9.70

(f) = forecast

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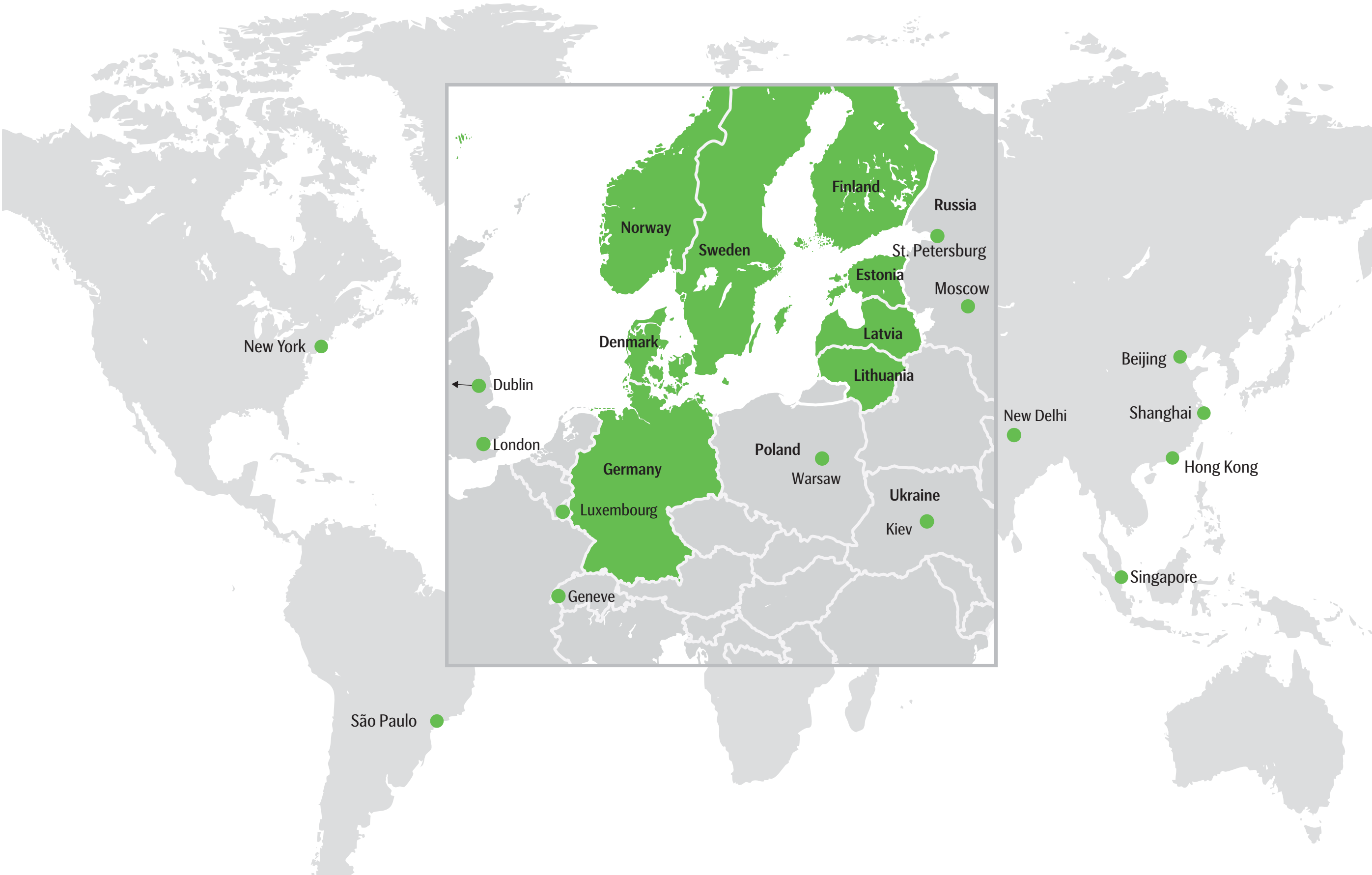

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