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Press release

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Eastern European Outlook: Gradual recovery – major economies will diverge

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, writes SEB in the latest issue of its twice-yearly *Eastern European Outlook*.

"Russia and Ukraine are facing significant challenges: Russia to raise its long-term growth potential, Ukraine to manage an acute crisis that will emerge this winter. Otherwise, the general economic picture of Eastern Europe is turning brighter. Looking ahead, expansion will benefit from good real wage growth and the fact that the region can now shake off the euro zone crisis, which has hampered growth and created instability in banking systems, especially in the central and southern parts of Eastern Europe," says Mikael Johansson, Head of Eastern European Research at SEB and Chief Editor of *Eastern European Outlook*.

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, and the labour shortage is expected to increase. Meanwhile it will be difficult to reverse the negative demographic trend; more immigration is probably needed. On the whole, far-reaching reforms will be required in order to boost potential growth to President Vladimir Putin's target of 5-6 per cent," says Andreas Johnson, Russia and Ukraine analyst at SEB Economic Research.

- **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, 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.

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