Eastern European Outlook

Economic Research – March 2014

Continued gradual recovery in Eastern Europe despite geopolitical turmoil

Russia close to stagnation this year – Baltics vulnerable

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Summary

The gradual economic recovery is continuing in much of Eastern (including Central) Europe, although the growth outlook in Russia and Ukraine has deteriorated further due to the conflict between these countries. Direct trade ties between individual countries and the two adversaries are relatively small, except for the Baltic countries. The continued economic upturn in Germany and Western Europe generally will partly offset lost exports due to weak Russian demand. There is also good potential for higher private consumption. But we are generally lowering our 2014-2105 growth forecasts for Eastern Europe, and the risk of short-term reversals in individual countries has increased due to geopolitical turmoil. Our forecasts are based on the key assumptions that the Russia-Ukraine conflict will not escalate militarily, no large-scale trade sanctions will be introduced and no serious disruptions will occur in Russian energy deliveries to Europe.

Most Eastern European economies – with Russia and Ukraine as notable exceptions – began a recovery in the second half of 2013. The improvement has been clearest in the central region, which has benefited mainly from faster growth in Germany and the stabilisation of the euro zone economy and banking system. The recovery will continue at a steady pace and become more broad-based. In the short term, exports will remain a key driver, although sluggish Russian economic growth will dampen momentum. In many countries, domestic demand will increasingly take over as the main economic engine. Continued low interest rates and fiscal policy loosening will provide support. Private consumption will be fuelled by good real wage growth, partly as a result of low inflation attributable to still-idle resources (though these are small in Russia) and small increases in commodity prices; oil prices will fall somewhat. We expect capital spending to grow but not surge, since industrial capacity utilisation is moderate and the still relatively tight credit conditions in the wake of the euro zone crisis are thawing slowly. Geopolitical turmoil will also hamper willingness to invest in certain countries.

We are lowering our GDP forecasts (compared to our estimates in *Nordic Outlook*, February 2014) for the six countries that *Eastern European Outlook* covers: sharply in the case of Russia, Ukraine and Estonia; moderately for Latvia; and slightly for Poland and Lithuania.

- **Russia's** GDP will increase by a modest 1.0 per cent in 2014 and 1.8 per cent in 2015, well below potential growth of 2-3 per cent. The Ukraine conflict will worsen an already weak economic situation, which has largely been caused by structural problems. In the short term, growth will be inhibited by the falling rouble and stock market, and in the long term by weaker investments. The rouble will fall somewhat further against the USD but will stabilise against the USD/EUR basket over time.
- **Ukraine** is in an acute current account crisis, which will be eased by a large bail-out loan from the EU/IMF. In the short term, continuing hryvnia depreciation will squeeze the country's banking system and households but over time it will help sustain a cautious recovery. GDP will fall by 4 per cent this year and rebound by 2 per cent in 2015.
- **Poland** is showing good resilience to the Russia-Ukraine conflict. Imbalances have decreased significantly in recent years and are small today. Domestic demand is rising, and due to low inflation the first key interest rate hike will not occur until early 2015. GDP will increase by 2.7 per cent in 2014 and 3.4 per cent in 2015.
- **Estonia's** strongly export-dependent economy will be squeezed not only by slower Russian growth but also by sluggish economic performance in Finland and a continued decline in public sector investments this year. A recovery will begin only in 2015; GDP will increase by 0.5 per cent in 2014 and 2.5 per cent in 2015.
- **Latvia's** economy will lose some momentum after several stable, relatively strong growth years – fastest in the EU. Exports, transit trade, tourism and capital spending are being hampered by Russia weakness and uncertainty. Strong real incomes will provide continued support to household consumption. Unemployment will fall somewhat further. GDP will grow by 2.9 per cent in 2014 and 3.4 per cent in 2015.
- **Lithuania** is poised for a recovery in domestic demand, starting somewhat later than in the other Baltic countries; GDP will thus increase by 3.0 per cent in 2014 and 4.0 per cent in 2015. Growing incomes, lower unemployment and the beginning of a housing market upturn will bolster consumption. Meanwhile exports will cool, due to weak Russian demand and decreasing competitiveness as wage growth exceeds productivity growth, but inflation will be low during the next couple of years. There is a very high probability that Lithuania will qualify to join the euro zone in 2015, as planned.

Global economy shrugging off political uncertainty

- **Minor negative impact on the West from the Russia-Ukraine conflict**
- **Baltics are vulnerable in Eastern Europe**
- **US deceleration is mainly weather-related**

Our forecast of **moderate global recovery in 2014-2015** is unchanged, despite the Russia-Ukraine crisis and a sputtering start to 2014 in the United States. The **US economy will accelerate again** beginning this spring but contagious effects on other countries will be less than usual, due to structural weaknesses in the euro zone and key emerging economies.

In the short term, the Russia-Ukraine conflict is expected to dampen sentiment indicators in various countries but have only **minor negative effects on global growth**, provided it does not escalate militarily, does not lead to large-scale trade sanctions nor serious disturbances in deliveries of Russian energy to Europe. Direct trade ties between Russia and individual countries are relatively small, except for a few like the Baltics, Finland and various former Soviet republics in Central Asia where they are sizeable. Financial resilience is also stronger because euro zone economies have stabilised in the past year and the US has moved past its financial crisis and private sector debt consolidation. **Greater geopolitical turmoil may blunt investment appetite** even in parts of the world economy not directly dependent on trouble spots, but experience shows that these psychological effects are usually fairly small and temporary. Only if regional conflicts significantly affect important world market prices, especially for energy, is the impact generally longer-lasting. Our Brent **oil price forecast assumes relatively stable prices**: averages of USD 105.7/barrel in 2014 and USD 100.0 in 2015. **OPEC is in a strong position** to control market balance, that is, raise or lower oil production as needed. This is especially true of Saudi Arabia. But the Russia-Ukraine conflict is a clear upside price risk if geopolitical developments block oil deliveries (2.7 mb/d) to world markets from Russia, Kazakhstan, Azerbaijan and Turkmenistan via the Black Sea and the Bosphorus.

Global growth will strengthen from 3.2 per cent last year to 3.7 per cent in 2014 and 3.9 per cent in 2015: close to trend, which is just below 4 per cent. Our forecast is **marginally lower than in February's** *Nordic Outlook*, with minor downward revisions for the US, Japan and China in 2014 but large ones for Russia and Ukraine during both years.

This winter's **US deceleration** was largely due to **weather-related factors**. Since first quarter 2014 growth will be lower than expected (1.7 per cent according to our forecast), we have adjusted the expected **GDP increase in 2014** to **3.1 per cent** from 3.3 per cent, but growth will rebound to 3.5 per cent as early as the second quarter. Underlying factors such as a better labour market, stronger household balance sheets due to rising home and share prices and a neutral fiscal policy suggest a rather hefty acceleration in growth during 2014. **Our forecast will remain above consensus**, both for 2014 and 2015. **Chinese growth will cool** from 7.7 per cent in 2013 to 7.2 per cent this year and 7.0 per cent in 2015. Exports and domestic demand started 2014 a bit weaker than expected. Over time, slower credit expansion will hold back GDP growth. Meanwhile the authorities have softened their target to "around 7.5 per cent" growth, indicating that 7.2-7.3 per cent is acceptable. **Euro zone** economic indicators are still pointing towards a **weak recovery**. GDP will increase by **1.0 per cent in 2014 and 1.6 per cent in 2015**, but this growth is not enough to overcome the imbalances in the labour market and public sector debt. Unemployment has peaked at slightly above 12 per cent, but its decline is expected to take quite a long time. Downside risks in our GDP forecast have increased; the euro zone is the industrialised region that has the most to lose in case of disrupted trade relations with Russia.

Global key data
GDP, year-on-year percentage change

	2012	2013	2014	2015
United States	2.8	1.9	3.1	3.7
Euro zone	-0.7	-0.5	1.0	1.6
The world	3.3	3.2	3.7	3.9
Oil, USD/barrel	111.7	108.7	105.7	100.0
EUR/USD, Dec	1.29	1.38	1.28	1.25

Source: SEB

Low inflation will allow room for continued expansionary monetary policies by major Western central banks. This is one reason why long-term yields will only move upward slowly, but the gaps in inflation risks and resource utilisation between the US and the euro zone, on the one hand, and Japan on the other are set to widen. The **US Federal Reserve will continue to phase out its bond purchases at a steady pace**, ending them late in 2014 and starting to hike key interest rates by mid-2015. The **European Central Bank** is moving in the opposite direction; **new stimulus measures** are needed to offset deflation risks and shore up weak bank lending. Despite clear deflation risks, the ECB abstained from further monetary easing at its March policy meeting. Although the euro zone economy is moving in the right direction, we believe that **pressure for ECB action will intensify this spring**. In particular, the strong euro is worrisome in a situation of fragile recovery and very low inflation. We expect the ECB to use various types of quantitative easing.

Most economies in Eastern (including Central) Europe – with Russia and Ukraine as notable exceptions – began a gradual recovery last autumn after bottoming out in the second quarter of 2013. The improvement is **clearest in the central region**, which has benefited primarily from faster growth in Germany and the stabilisation of the euro zone economy and banking system. There is extensive trade and banking integration in this particular part of Eastern Europe. Central Europe's export exposure to Russia is relatively small. We expect **continued gradual economic recovery in most Eastern European countries during 2014-2105, although growth forecasts in general have been revised downward slightly and risks of temporary reversals have increased**. At first, exports will remain a key driving force, although sluggish Russian growth will offer some resistance. Private consumption will also gradually strengthen. Consumption will be fuelled by good real wage growth, largely an effect of sustained low inflation attributable to still-idle resources (though these are small in Russia) and modest increases in commodity prices including food. But we expect no capital spending surge. Moderate industrial capacity utilisation and slowly thawing credit conditions are impeding private investment growth. Geopolitical turmoil in Eastern Europe will also hamper willingness to invest in some countries. Public sector investments may pick up, however. More countries will probably follow initiatives this past year in countries like Poland, Ukraine and Russia to make extra investments in infrastructure (though Russia's investments were partly connected to the Winter Olympics) to help sustain the economy. In Hungary and Slovakia, for example, we now expect the governments to loosen their fiscal policies generally – in Slovakia after two years of relatively tough austerity.

Trade ties to Russia and Ukraine

Russia's clear deceleration in economic growth, combined with the weakening of the rouble, will have an impact in the form of reduced Russian imports. Countries that send a sizeable share of their exports to Russia thus risk being hurt. An examination of trade between Ukraine and Russia and other countries reveals plenty of interesting ties. The scale of trade between two countries is largely determined by their geographic distance and respective sizes. Consequently, Ukraine has extensive trade with Russia, and about one fourth of Ukraine's exports end up there. Aside from Ukraine, the **Baltic countries** also have **large exports to Russia**. In Latvia and Lithuania, nearly 20 per cent of exports go to Russia, while Estonia's close ties with Finland and Sweden make its economy somewhat less dependent on Russia. About one tenth of Finnish exports go to Russia, but for most other European countries including Germany, Sweden and Poland, the proportion of exports sent to Russia is significantly lower. Trade flows between Western European countries and Ukraine are generally very small.

Russia's dominance in the European market for natural gas also creates clear trade ties with EU countries. Dependence on Russian gas is an important channel through which the Russia-Ukraine conflict risks having an impact on Europe.

Russia supplies about 30 per cent of Europe's natural gas, about half of which is transported through Ukraine. Some countries are highly dependent on imported Russian gas. For example, today Lithuania imports virtually all its natural gas from Russia, whose share of the country's imports thus exceeds 30 per cent. Germany buys around one third of its imported natural gas from Russia. Russia is also a major supplier of oil to such EU countries as Germany, the Netherlands and Poland.

Thanks to a mild winter and larger gas storage than normal, today **Europe is well equipped to withstand disruptions in Russia gas deliveries**. Lengthy disruptions would create problems, however, leading to significant price increases for European energy imports. Russia's actions in recent years have speeded up efforts to reduce Europe's dependence on Russian gas, but it will take a long time before these measures have an effect. Europe's dependence on Russian energy deliveries will make it more difficult to agree on far-reaching economic sanctions. While Germany has taken a more forceful position in recent weeks, it has also been an important factor in delaying expanded sanctions. The United States, which has very little trade with Russia, has adopted a more aggressive tone.

	Per cent of exports going to Russia	Per cent of imports coming from Russia	Per cent of exports going to Ukraine	Per cent of imports coming from Ukraine
Estonia	12.6	4.3	1.0	1.5
Latvia	18.2	9.2	1.1	1.3
Lithuania	19.0	31.6	3.6	0.8
Poland	5.1	12.0	2.8	1.2
Russia	–	–	5.2	5.7
Ukraine	25.6	32.4	–	–
Bulgaria	2.4	20.9	1.2	2.5
Romania	2.3	4.4	1.9	0.9
Czech Republic	3.3	5.2	1.1	0.8
Hungary	3.0	8.8	2.3	1.3
Sweden	1.6	5.6	0.2	‹0.1
Finland	9.9	17.7	0.7	‹0.1
Germany	3.3	4.4	0.5	0.1
European Union	2.6	4.4	0.5	0.3
United States	0.7	1.3	0.1	‹0.1

Source: International Monetary Fund, SEB. Data for 2012.

Sharp downward revision: Recovery will wait until 2015

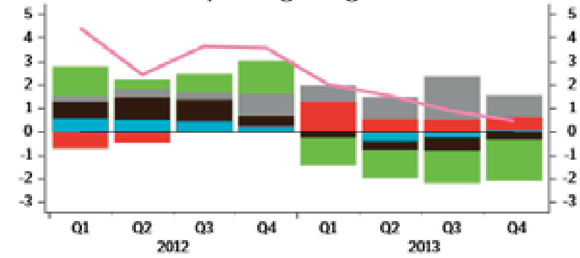
- **Russia and Finland are hindering growth**
- **Weaker support from private consumption due to stagnant labour market**
- **Continued low inflation**

The Estonian economy continued its slowdown during the fourth quarter of 2013 to a meagre growth of 0.3 per cent year-on-year. **The slowdown was dominated by negative contributions from two sectors: transport and construction**, but agriculture also shrank. The decline in construction and agriculture was expected, being related mostly to EU funds, which decreased markedly last year and will shrink in 2014 as well. The most severe decline was in transport and storage, which is suffering from a **decrease in Russian transit trade volume**. As Russian policy towards reducing trade volume through neighbouring countries has not changed, the decline will continue in 2014. Additional negative impact to the sector will occur due to Russian actions in Ukraine. The transport sector accounts for 7 per cent of the economy, and 15 per cent of total service exports are related to Russia. The implications of events in Ukraine will be broader, however. They will have a **negative impact on economic growth through the trade channel both directly from Russia and indirectly through the other Baltic countries**. Since the Russian economy is expected to grow only marginally in 2014, that will also affect merchandise exports and hurt the manufacturing outlook. **At the same time**, due to expected **stagnation in the labour market** after last year's job growth and declining unemployment, private **consumption will not give GDP growth such strong support as it did in 2013**. The upward trend in consumer confidence will probably be reversed somewhat, and companies will remain hesitant to invest in this persistently uncertain economic environment.

All in all, that means the outlook for the economy will be no better than in 2013. We expect **GDP to grow by 0.5 per cent in 2014, compared to 0.7 per cent last year**. In 2015, improved global demand, including slightly better growth prospects and less uncertainty about developments in Russia and Finland, will strengthen exports and together with easing fiscal policy support a slight pick-up in domestic demand. **GDP will grow by 2.5 per cent in 2015. Our GDP forecasts have been revised downward, drastically in the case of 2014** (from 2.6 per cent in the *February Nordic Outlook*). They are clearly below the consensus view.

Contributions to GDP growth

Year-on-year percentage change, contribution to GDP growth in percentage change



Source: Statistical Office of Estonia, SEB

Industrial production is expected to face continued difficulties in 2014. Although January's severe drop in exports could be partly explained by statistical base effects (a strong January 2013), **weak external demand** woes are not over, making it more likely that that the **economy will be in a mild recession during the first half of 2014**. Ongoing difficulties in the Finnish and Russian economies will hamper Estonia's export recovery and thus GDP growth. In 2012, 13 per cent of exports went to Russia and 15 per cent to Finland. We expect anaemic export growth in 2014 and a possible decline in the first half of the year. Meanwhile we see prospects for improved competitiveness in the export sector. In 2013, competitiveness deteriorated rapidly due to wage growth and relatively high inflation. 2014 will likely be a year when competitiveness is restored with respect to both the euro zone and the other Baltic countries. This will be prompted by vanishing inflation and lower export prices.

Industrial production and exports

Year-on-year percentage change

Source: Statistical Office of Estonia

Anaemic economic growth prospects and persistent uncertainty have discouraged business investments. The picture is also bleak for new foreign investments. **Business investments are unlikely to offset the decline in government investments in 2014**, which was induced by the reduction in EU funds.

The main driving forces in the economy will remain the same in 2014 as last year: **retail sales** and industrial production. The retail sector was the main economic engine in 2013, due to a strong labour market and rapid real wage growth for households, which sustained domestic consumption. In 2013, employment increased by 1 per cent and average wage rose by 7.8 per cent. As these developments did not match economic growth rates, corrections in the labour market are likely in 2014 and the year will not be as generous for consumers.

Nevertheless, the factors driving rapid wage growth remain strong – a tight labour market and shortages of qualified labour. In addition, the minimum wage will increase by 11 per cent from 320 to 355 euros and the public sector payroll will increase by 5 per cent, so there will still be a significant rise in average pay in 2014. On the other hand, average wage growth exceeded nominal GDP growth in 2013 and corporate profit growth decelerated. This will lead to a **slowdown in wage growth during 2014**.

Wage and salary growth has been quite uniform throughout the economy, due to long-suppressed real wages. At the same time, only a few sectors have experienced economic growth. Some have begun to correct this discrepancy. There is an inverse relationship between employment and wage growth in different sectors. Those with the fastest wage growth have seen the largest downturn in employment and vice versa. Some sectors may face wage declines and job losses in 2014. All in all, we expect average wage growth to reach 5 per cent in 2014 and employment to contract by 1-2 per cent. Wage growth will be more differentiated between sectors and employees.

Wages and prices

Year-on-year percentage change

Source: Statistical Office of Estonia

Inflation has declined markedly since last summer due to falling energy and service prices. In March 2014, new transmission capacity opened up with the completion of the Estlink2 power cable between Finland and Estonia, which will enable electricity prices to decrease further. In addition, global oil prices fell. A higher education reform which freed most university students from fees decreased education costs starting in September 2013 and will affect inflation until September 2014. **Increasing competition in retailing will slow inflation in the clothing segment** for the next two years. The main inflation drivers are food prices and other goods and services. Wage and salary growth still poses some inflationary risk, although this risk is limited by last year's excessive growth, which is starting to eat into competitiveness in foreign markets. Nevertheless, **falling energy prices** will help companies slash costs and sustain profitability in an environment of stagnant economic growth. We expect **inflation to be only 0.6 per cent in 2014, clearly lower than earlier projections**. In 2015, when economic activity picks up, we foresee average inflation of 2.6 per cent.

Household credit demand continues to increase slightly, driven by demand for mortgages. Household deleveraging has ceased. Real estate prices in Tallinn rose by 20 per cent in 2013, which is not sustainable. The rapid price increase reflects a supply shortage. Since the increase in demand may prove temporary, prompted by low interest rates, builders are not very eager to increase supply. The banking sector is also cautious about extending more credit to the real estate sector, further constraining the supply side.

The political scene was calm for a long time, until recently. The main ruling Reform Party has recognised its diminishing popularity, leading to the resignation of Prime Minister Andrus Ansip, who has been in place since 2005. **Taavi Rõivas of the Reform Party has been nominated as the new candidate for prime minister**. The switch is an attempt at **image improvement**, without changing economic policy much. Rõivas has **promised more reforms in order to bring the economy out of its stagnation, focusing more on the social sphere** than before. The Reform Party also plans to refresh its image by bringing in a new coalition partner, the Social Democrats, to replace the centre-right Pro Patria and Res Publica Union (IRL). The Social Democrats insist on raising child benefits threefold. The coalition break-up on March 4 was not due to differences between the coalition partners, but was designed to increase the Reform Party's popularity in the 2015 parliamentary election. There have also been initiatives to form various new **right-wing parties** to participate in the 2015 election.

A coalition with the Social Democrats would result in a shift in emphasis towards social policies and decreasing taxes on labour. The new coalition would decrease income tax to 20 per cent from the beginning of 2015, cut unemployment insurance tax and increase deductible share of income tax. Furthermore child benefits and pensions would be increased (pensions from April 2014). Central government revenues would increase by raising tax on alcoholic beverages, tobacco and fuel as well as by reducing tax fraud. All in all, the fiscal policy effect would be supportive for private consumption. Balanced government finances would remain as a framework. Since the government's forecasts about tax revenues are more optimistic than ours, this may still mean a growing budget deficit and thus a slightly expansionary fiscal policy in 2014-2015.

External uncertainty trims growth prospects

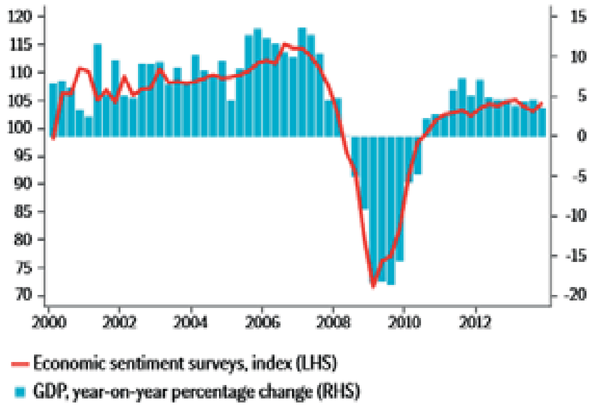
- **Ukraine conflict will have long-term effects**
- **Strong real incomes support consumption**
- **Small inflation effects from euro adoption**

In 2013 a slow-down in economic activity was observed, albeit more moderate than expected. GDP growth in 2013 reached 4.1 per cent, down from 5.2 per cent in 2012. With exports and investments lagging slightly, households remained the main drivers of growth. Household consumption increased by 5.4 per cent. Resilient tax revenues allowed public spending to grow by 3.6 per cent. Capital spending decreased by 4.3 per cent, partly due to still looming uncertainty in export markets but also the switch in EU funding cycles. Meanwhile, exports managed to show only a slight increase; imports decreased. This had a positive impact on GDP.

The trends observed in the previous year should continue this year, though uncertainty has increased. **Household consumption will continue to play the main role.** An increase in real incomes will be one of the preconditions. In view of global economic revival, exports should become more active, with the euro zone partly offsetting the negative trend in eastern markets. Moreover, due to new policies in the allocation of EU funds, investment activity – especially by the public sector – is also expected to pick up.

Still, due to **events in Ukraine** there is **mounting uncertainty**, and further growth will face headwinds. At the moment it appears that Ukrainian turmoil should have limited direct impact on the Latvian economy, since 2013 exports to Ukraine were 0.9 per cent of total volume. **The most probable scenario is indirect effects through Russia's stalling economy and political uncertainty in the region**. The new balance of power in Ukraine will take some time to establish. Russia is one of Latvia's biggest trade partners (some 18 per cent of total exports) and is also important to Latvia's other trade partners. The Russia-Ukraine conflict will probably have **more long-term effects** on the Latvian economy, renewing the need for continued structural reforms in the labour market and export sector reorientation to new markets to sustain resilience. Given lower projected export growth as well as potential impacts on transit business, tourism, economic confidence and capital spending, we are **adjusting our growth forecasts downward. We expect GDP to increase by 2.9 per cent this year and 3.4 per cent in 2015**. Our earlier projection was 4.8 per cent annually.

Economic sentiment indicator and GDP



Source: DG ECFIN, Central Statistical Bureau

Industrial output fell by 0.4 per cent in 2013. The reduction was notably influenced by a decline in electricity and gas supply, driven by warm weather conditions and loss of metal production at Liepajas Metalurgs. In January 2014, industrial production was down by 11 per cent. In the coming months, performance will pick up – partly due to statistical factors – though it will stay uneven among sectors. Rising regional tensions will curb the growth potential of several sectors.

Retail sales rose by 3.8 per cent in 2013. Food sales increased by 4.4 per cent, while sales of non-food products were up by 3.4 per cent. So far higher household income, an increase in the total number of employees and their average pay, as well as low inflation, have prompted a rise in consumer spending. At the same time, prices are a decisive factor behind purchases, as evidenced by the popularity of discounted products and higher second-hand, online and mail-order sales. In 2014, **household purchasing power will show a positive trend**, maintaining the increase in consumption.

In 2013, Latvia's current account deficit was smaller than in previous years: 0.8 per cent of GDP, due to a drop in the merchandise trade deficit and a rise in the service trade surplus. This partly reflects high uncertainty and caution, resulting in low capital spending and restricted investment. Since business confidence will be cautious during the next two years, the current account will remain relatively balanced.

Unemployment dropped by 3.1 percentage points to 11.9 per cent in 2013. Almost half of the total consisted of long-term unemployed. The favourable trend will continue this year, but no sharp decrease can be expected. We expect a more pronounced increase in economic activity later in 2014, with possible demand for labour from all sectors, especially services.

More acute demand for workers with specific knowledge and skills can be expected, increasing bottlenecks. Spare resources are already limited in some manufacturing sectors such as wood processing, electrical and optical products, machinery and mechanical appliances and paper products – which will lead to rising wage demands.

Relatively robust domestic economic growth continues to push up pay levels, which rose by 4.6 per cent in 2013. In private sector wages and salaries increased a bit faster. This year, their growth is expected to accelerate a bit. The stage is set for further pay hikes in the public sector, although the central government budget will not be able to satisfy all the demands for increases. Private sector pay will be contingent on the profitability of each sector and company as well as labour market conditions. The gaps between sectors and companies will thus continue. The government will probably keep its promise to cut personal income tax again next year. In 2013, average net wages comprised 72 per cent of gross wages; after that their share rose by one percentage point as personal income tax rate was reduced from 25 per cent to 24 per cent and tax relief for dependants increased from EUR 100 to EUR 114. Still, average net wages in Latvia are the lowest in the Baltics: 72 per cent, compared to 77 per cent in Lithuania and 80 per cent in Estonia.

Wages and inflation

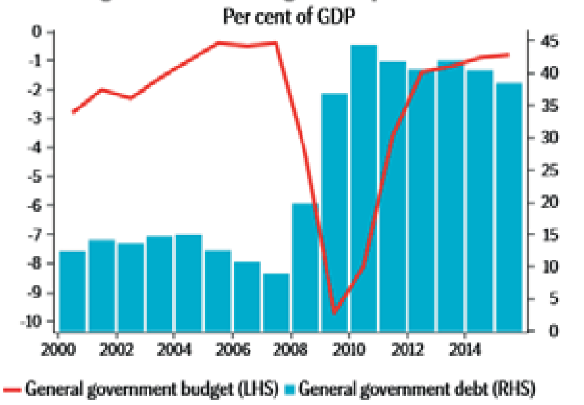
Year-on-year percentage change

Source: Eurostat, Central Statistical Bureau

On January 1, 2014, Latvia became the 18th member of the euro zone. **The transition went smoothly. One of the main reasons why the euro had enjoyed lower support was fear of rising inflation. This was exaggerated, according to our earlier projections and analysis of what has happened.** In January 2014 the consumer price level increased by 0.6 per cent. The greatest upward pressure on consumer prices during the month was for food and for home maintenance goods and services, while clothing and footwear prices fell. Compared to price change trends in January of previous years, price increases for services were more than twice those for goods. This was partly due to the currency changeover. Thus, the **introduction of the euro had a relatively small impact on inflation**, although part of the potential rise already took place in 2013 due to hoarding ahead of the changeover. This year, the main trends will continue to be dictated by global factors, although the level of prices will pick up under the influence of local conditions. Since the opening of the electricity market to households was postponed until next year to preserve political stability and in response to protests by various groups in society, inflation will be a bit more leisurely this year. **We expect inflation in 2014 to be 1.4 per cent and 3.3 per cent in 2015.**

General government budget and public sector debt

Per cent of GDP



Source: Central Statistical Bureau, SEB

Public finances are under control after the tough budget consolidation process of a couple of years ago. The general government consolidated budget closed 2013 with a deficit of 1.2 per cent of GDP. Owing to the postponement of the opening of the electricity market until next year, lower growth and political pressures ahead of the October 4 general election will pose challenges to the projected deficit of 0.9 per cent of GDP this year, but we do not foresee large deviations. We expect that the government will retain its grip on public finances and enforce its targets.

In November 2013, the government of Prime Minister Valdis Dombrovskis unexpectedly fell; Dombrovskis resigned after taking political responsibility for the collapse of a supermarket roof that killed more than 50 people. Early in 2014, a new cabinet was formed by Laimdota Straujuma, the former agriculture minister. The previous coalition of Unity, the Reform Party, National Alliance and independent deputies was widened with an opposition party, the Union of Greens and Farmers. The government pledged to continue Mr. Dombrovskis' macroeconomic policies.

Relatively limited effects of Russia-Ukraine conflict

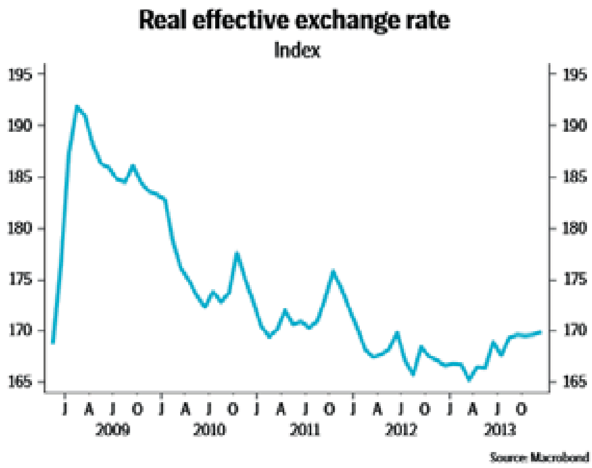
- **Domestic demand leads economic growth**
- **Capital spending recovery at hand**
- **Euro introduction in 2015**

Lithuania's economic **outlook remains relatively firm**, while more geopolitical tensions have appeared in neighbouring countries and Russian growth has continued to decelerate. The **effects of the Russia-Ukraine conflict on Lithuania's economy are expected to be relatively limited** but will increase if trade sanctions are imposed. Russia is Lithuania's top trade partner, accounting for 19 per cent of exports and 32 per cent of imports in 2013. However, for Lithuanian-origin goods it is only the seventh-largest market, since most exports to Russia are transit goods from Western countries. In October 2013-January 2014, Russia banned imports of milk and dairy products, the main export category of Lithuanian origin to Russia. The ban affected dairy companies quite tangibly, but the effect on the overall economy was minimal and the companies managed to redirect their export flows to Western countries. For Lithuania, sanctions on exports to Russia would be less harmful than import sanctions. Currently, 100 per cent of natural gas in Lithuania is imported from Russia. However, Lithuania plans to launch its own LNG terminal in early December 2014. After the terminal is open, Lithuania will be able to cover its gas demand from other countries than Russia, at first probably from Malaysia and starting in 2017 from the US, Canada and Australia. Lithuania's foreign trade exposure to Ukraine is rather small: 3.6 per cent of total exports.

In 2013, economic development remained robust and GDP growth roughly matched its potential. Real GDP rose by 3.4 per cent on an annual basis while growth remained diversified. In the first half, exports were the main economic driver but in the second half, domestic demand started taking the lead. Since **both consumption and capital spending will strengthen, we foresee GDP growth of 3.0 per cent in 2014 and 4.0 per cent in 2015**. This forecast has been **revised downward by 0.5 percentage points per year** due to the anticipated **negative foreign trade effects of the Russia-Ukraine conflict and the lowering of our Russian growth forecast**. In the short term, increased external uncertainty will also weigh somewhat on general sentiment and domestic demand.

Export growth slowed perceptibly in the autumn of 2013 due to **several specific challenges**. Firstly, the country's largest exporter, the Orlen Lietuva oil refinery, lost competitiveness in the European market due to a rise in imports of cheaper oil products from the US. As a consequence, exports of mineral

products declined by 48 per cent in January 2014 year-on-year, but imports from Russia also went down by 52 per cent due to lower imports of crude oil. Secondly, a high statistical base (especially in grain exports) is restraining export growth. Thirdly, exports of chemical products are stumbling due to an unfavourable international situation in the fertiliser market. Among the supportive factors for export growth in 2014 is the recovery in Western markets. However, the difficult economic situation and currency depreciation in key Eastern markets will contribute negatively. **Unit labour costs have begun gradually rising** (2.7 per cent in the fourth quarter of 2013) and **will decrease the overall competitiveness** of Lithuanian production as wage growth exceeds productivity growth. The real effective exchange rate strengthened by 2 per cent over the year.

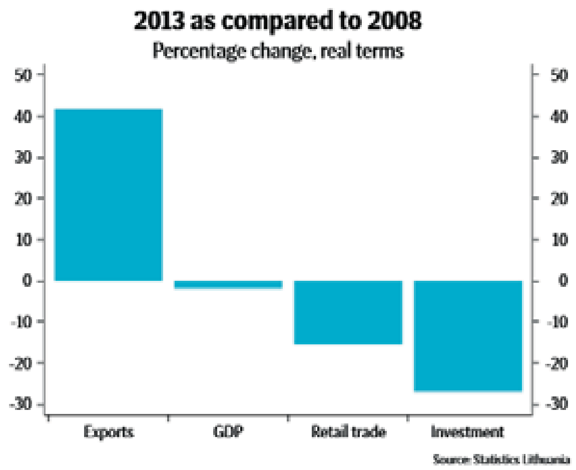


Last year, domestic demand showed clear signs of more robust recovery and started contributing more to economic growth – more than net exports. Household consumption increased by 5.3 per cent in 2013, the fastest pace since the financial crisis.

A stronger rise in incomes (wages, emigrant remittances) and employment as well as more optimistic consumer sentiment contributed to the consumption uplift. A warmer winter and lower heating costs supported consumption in low-income households. In our view, **private consumption is poised for further strengthening** in 2014 on the basis of growing income and shrinking unemployment. Consumer confidence and the propensity to spend may falter if external geopolitical tensions escalate. However, given the large gap compared to the pre-crisis level and export performance, domestic demand should continue growing at a satisfactory pace over the coming years.

Unemployment was 11.8 per cent in 2013 and has declined by 6 percentage points since its peak in 2010. Both economic growth and emigration will drive a **further decrease in unemployment** to 9.5 per cent in 2015. However, the problems of structural unemployment and labour shortages in specific sectors will remain. Gross emigration is hardly shrinking, as another 40,000 people left the country in 2013. On the other hand, re-emigration is also swiftly gaining ground, as more than 20,000 Lithuanian citizens returned to the country in 2013. Net emigration is thus declining.

Capital spending grew by 12.7 per cent in 2013 as business sentiment strengthened. Companies still prefer to finance investments from their own funds rather than borrowing from banks. Bank lending to companies fell by 3.2 per cent despite very low interest rates in 2013, as credit appetite was weak.



Construction was the best-performing sector last year, recording 10.6 per cent growth. The residential property market is in its early recovery stage at the moment. Home sales increased by 21 per cent in 2013 and by 43 per cent in January-February 2014, in annual terms. Nonetheless, **housing prices hardly rose from their low** level and overall housing loans outstanding increased by 0.7 per cent year-on-year. According to the Ober-Haus price index, in December 2013 prices of flats in the five largest cities increased by 1.1 per cent during the year, and in January-February 2014 the year-on-year increase was 1.9 per cent. This year, the residential property market will be supported by an increase in household income, favourable credit terms including low interest rates and the search for alternative investments since deposit interest is low.

Although domestic demand strengthened and export growth weakened, Lithuania's external balance remained in good shape and in 2013 the country enjoyed a strong current account for a fifth year in row. In our view, the **current account will slightly deteriorate but remain at sustainable levels**, with a deficit amounting to 2 per cent of GDP in 2014 and 4 per cent in 2015. Adding low inflation and a limited budget deficit to the overall picture leads to the conclusion that the Lithuanian economy is relatively well-balanced.

In the upcoming presidential election scheduled for May 25, **Dalia Grybauskaitė is quite likely to be re-elected for a second term**. In a February opinion poll, she enjoyed 43 per cent public support while the other two leading candidates – from the Social Democratic Party and Labour Party – are supported by 7-8 per cent of potential voters. The president – an ex-finance minister and European commissioner – is a firm advocate of prudent fiscal policy. Euro introduction and her re-election would mostly likely reassure financial markets.

January 1, 2015 is the official target date for euro introduction. A rapid decline in inflation since mid-2012 and a low budget deficit resulted in **compliance with all Maastricht criteria** during recent months. The central government budget deficit was 1.6 per cent of GDP in 2013 and the general government deficit has thus not exceeded 3 per cent of GDP. In February 2014, average year-on-year HICP inflation was only 0.8 per cent, and the Maastricht criterion (inflation at the time of evaluation may not be more than 1.5 percentage points above the yearly average for the three EU countries with the lowest inflation) leaves a rather comfortable cushion.

The likelihood of euro zone accession in 2015 has risen significantly since October's Eastern European Outlook (50-50 chance then). Lithuania will receive its official convergence evaluation in mid-June. A decision by the European Council is expected in the second half of July. Looking ahead to euro adoption, bond yields have been shrinking. An upgrade of the sovereign debt rating or outlook is likely. The gap between euro and litas interbank interest rates is already negligible, but interest rates on loans for bank clients differ by 1-2 percentage points. These clients are thus expected to benefit from lower borrowing costs after euro introduction.

Well positioned for a balanced recovery

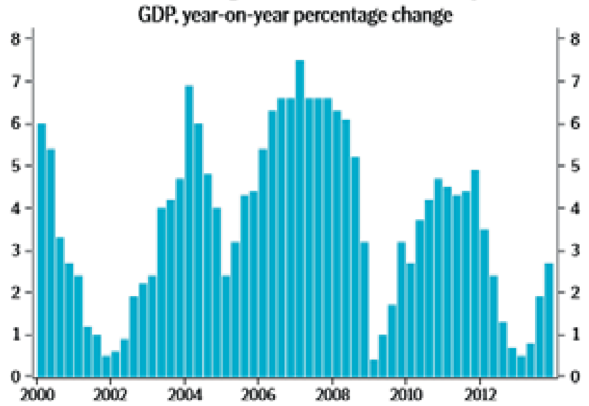
- **Domestic demand is rebounding**
- **Little impact from Ukraine conflict**
- **Low inflation means no rate hike until 2015**

Poland was the only EU economy that managed to avoid recession during the latest global crisis, both in the US-driven phase in 2008-2009 and the Western European phase in 2010-2013. Meanwhile its **imbalances have greatly decreased** and are small today, making the Polish economy well positioned for a continued good recovery as growing **domestic demand takes over from exports** as the key economic driver.

GDP growth bottomed out just below 1 per cent year-on-year in the second quarter of 2013 after plunging from nearly 5 per cent in early 2012. The slowdown was driven by sagging consumption and capital spending, due to weakened real wage growth (largely because of then-high inflation) and a slump following the construction rush for the summer 2012 European football championship. Export growth decelerated only modestly despite the euro zone recession.

Growth rebounding amid weak inflation pressure

GDP, year-on-year percentage change

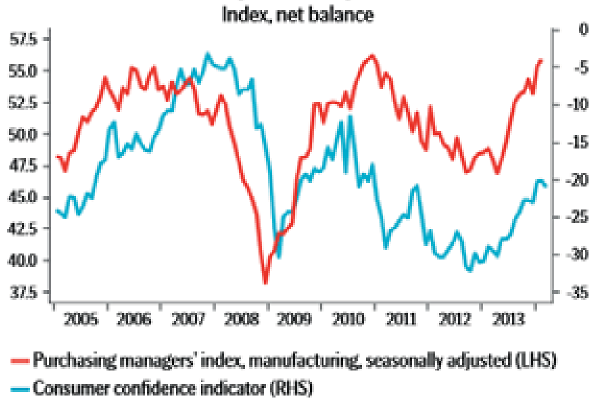


Source: Central Statistical Office of Poland

So far exports have driven the recovery, though domestic demand has also begun to revive somewhat earlier than expected. Fourth quarter GDP was up 2.7 per cent year-on-year, with domestic demand accounting for 1.2 percentage points. Both private consumption and business investments have strengthened a bit. Data and indicators suggest that this **broadening of growth has continued in the first quarter of 2014**. For example, year-on-year retail sales rose about 5 per cent in January, similar to late 2013. Consumer confidence, which has trended upward since mid-2013, has strengthened further. The purchasing managers' index in manufacturing climbed further to 55.9 in February and has been above the expansion threshold of 50 since July 2013. Of special interest is that the total new orders sub-index has risen faster than new export orders in the past two monthly readings, reinforcing the picture of growing domestic demand.

Clear upturn in optimism

Index, net balance



Source: Markit Economics, Central Statistical Office of Poland

Exports continue to be **sustained primarily by higher growth in Germany**, which buys one fourth of them. Germany provides both direct and indirect secondary effects on the Polish economy due to sizeable German-owned industrial production. By keeping its relative labour costs low, Poland is remaining competitive. Weak growth in Russia, which buys about 5 per cent of Polish exports, is hampering exports only slightly. Overall exports to Russia and Ukraine accounted for some 3 per cent of Poland's 2012 GDP. Assuming it does not escalate militarily and/or lead to a trade war between the West and Russia, the **Russian-Ukrainian conflict should have only a minor negative impact** on the Polish economy.

Private consumption will be fuelled by renewed real wage growth, following last year's sharp drop in inflation. We expect decent **real annual wage increases** of about 2 per cent. Employment is starting to increase again slightly after a mild downturn last year. Poland's relatively high unemployment of more than 10 per cent will fall somewhat. Continued low interest rates will also buoy households and encourage renewed credit demand, now that the economy looks generally brighter. An expected small upturn in Polish inflation and the calm global upturn in interest rates point to a weak increase in both short- and long-term market rates.

Capital spending has fallen for two years in a row but is now expected to rebound, which was signalled in the latest major business sentiment survey. Poland's investment ratio is comparatively low. **Catalysts for higher investment activity are in place**, in the form of relatively high capacity utilisation in manufacturing, solid balance sheets in the corporate and banking sectors and new structural funds from the 2014-2020 EU budget, where Poland is one of the winners. Another factor is

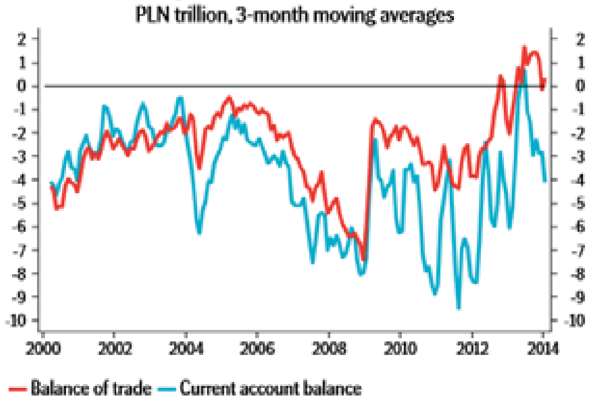
improved credit conditions. In recent years, lending terms for both businesses and households have been relatively strict. The Polish banking system has been robust throughout the international crisis but has still been adversely affected due to debt deleveraging by the Western European parent banks that dominate Poland's banking sector. Because of the fading crisis in the euro zone, credit conditions are now gradually thawing. During the fourth quarter, the proportion of banks that eased their small- and medium-sized business loan policies was the highest since early 2011. Banks signalled further easing in the first quarter of 2014, according to the central bank's survey.

Altogether this means that **after a 1.6 per cent upturn in 2013, GDP will increase by 2.7 per cent in 2014 and 3.4 per cent in 2015**; the latter is a bit above current potential growth of about 3 per cent. We have made only minor downward revision of our forecasts. One major reason behind our continued relatively optimistic view of the Polish economy is that the **fundamentals are in good shape**. Partly due to the budget consolidation of recent years – which the government temporarily put on hold in 2013 – the country successfully dealt with its previously large current account deficit, high inflation and rising public sector debt. The government still has some way to go in taming its relatively large budget deficit.

The current account deficit narrowed from about 4.5 per cent of GDP in 2010-2011 to 3.3 per cent in 2012 and about 1.5 per cent last year. The improvement is not only cyclical, via lower imports, but also seems to have been partly structural; for example, for three consecutive years exports have captured further decent market shares, according to European Commission data. The current account deficit will end up at a sustainable 2.0-2.5 per cent of GDP in the next couple of years. This will decrease vulnerability in the financial market. Poland was previously known for its comparatively large short-term funding needs, which sometimes created extra volatility in its relatively liquid currency. The trend towards smaller external imbalances may partly explain why Poland has been more resilient during the emerging market crisis than many other EM countries. The zloty weakened modestly during market turbulence in January as well as during the Russia-Ukraine conflict in February. We expect the zloty to strengthen from its current 4.20 or so per EUR to about 4.05 in December 2014.

Improved external balance

PLN trillion, 3-month moving averages



Source: National Bank of Poland

Inflation fell surprisingly fast from more than 4 per cent in mid-2012 to 0.7 per cent in January 2014. It has stayed below 1 per cent since October 2013 and below the central bank's 2.5 per cent target since December 2012. Given some remaining idle resources in the labour market, slightly elevated pay increases and leisurely growth in global commodity prices, inflation will rise slowly to an average of 2.4 per cent in 2015. The National Bank of Poland will thus wait until early 2015 before starting to hike its key interest rate. This is somewhat later than the market believes, and later than the central bank's guidance at its March policy meeting that the key rate will be unchanged at least until the end of the third quarter this year. As recently as February, the central bank said the rate would be unchanged until the end of the first half. During the slide in inflation, it cut the key rate dramatically from 4.75 per cent in November 2012 to a record-low 2.50 per cent last summer.

Public debt peaked last year at nearly 58 per cent of GDP, up from 54.8 per cent in 2010. The increase was thus modest but it occurred in sensitive territory; according to Polish rules, exceeding the 55 per cent threshold automatically triggers tougher fiscal austerity. Due to weak growth last year, the government decided to temporarily set aside this rule in 2013/2014. It also decided to **transfer a large share of private pension fund assets to the state**: a nonrecurring transfer this year of assets worth 8.5 per cent of GDP and, starting this year, gradual yearly transfers of assets for people retiring within 10 years. This is having a **major impact on public finances**. Debt will fall to about 50 per cent of GDP this year, almost entirely due to the "pension deal". The budget will shift from a deficit of 4.5 per cent of GDP last year to a surplus of 5.5 per cent in 2014, including a positive effect from higher GDP growth. But Poland can only credit pension revenue this year, since new EU accounting rules take effect in the autumn (ESA 2010 will replace ESA 95), according to the European Commission. Our 2015 budget forecast is a deficit of 2.9 per cent of GDP. This could open the way for euro zone accession in 2017, but the **euro issue will remain dormant during our forecast period**. Due to lingering uncertainty about the direction of the euro zone and weak domestic popular support, the government will bide its time and avoid the euro issue at least until after the 2015 election. Its attitude on the euro issue is apparently to continue readying Poland to eventually qualify for the euro zone, without committing itself to any timetable.

The centre-right government led by the Civic Platform has **lost popularity** since being re-elected in 2011. Last spring the conservative opposition party Law and Justice surpassed the Civic Platform in popular support for the first time since 2007. Surveys in January-February showed support of around 30 and 25 per cent, respectively. Civic Platform's coalition partner, the agrarian/Christian Democratic PSL, enjoys about 5 per cent support. The government's vulnerable situation is probably due to its earlier belt-tightening policies, a reform that raises the retirement age and internal party tensions on certain issues. There is a European Parliament election this spring and a Polish parliamentary election in the autumn of 2015. Given his low public support, **Prime Minister Donald Tusk may shift to looser fiscal policies than the cautious tightening that is still our main scenario** for 2014-2015. In a January speech, Tusk said that government goals for 2014 include beginning to prioritise social and financial welfare issues for Polish families, after adjusting the economy to the international crisis.

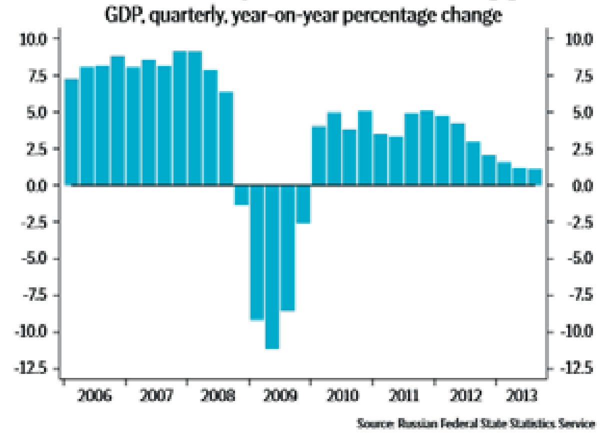
Ukraine conflict will squeeze an already weak economy

- **Slowdown driven by structural weaknesses**
- **Reforms needed to enable a capital spending increase to stimulate growth**
- **Central bank is battling inflation and credit growth**
- **Severely deteriorating relations with West**

Russia's meagre growth is being overshadowed by dramatic events in the Ukraine conflict, which worsens an already weak economic situation. Short-term worries have already impacted financial markets, with both the rouble and the Russian stock market taking a major beating. Political developments are difficult to assess, but **our main scenario is that a military conflict between Russia and Ukraine can be avoided**. At present, it does not look as if Europe and the US will implement any more far-reaching economic sanctions against Russia than those travel bans and asset freezes that have been directed at individuals. So in the short term, it will mainly be weaker confidence accelerating capital outflows and pushing up interest rates that will impact the economy. In addition, the weakening of the rouble will result in higher import prices but also increase export revenue in the energy sector. The deceleration in Russia's economic growth has been under way for some time – driven by structural weaknesses, not by worries about the Ukraine conflict. Unlike Ukraine, Russia's ample currency reserves and solid government finances mean that the country is not facing an acute current account crisis. **Russia's actions are expected to have significant effects on growth** by further worsening the willingness of companies to invest there. Nor can it be ruled out that more effective economic sanctions may eventually be imposed against Russia.

Seven consecutive quarters of decelerating growth

GDP, quarterly, year-on-year percentage change

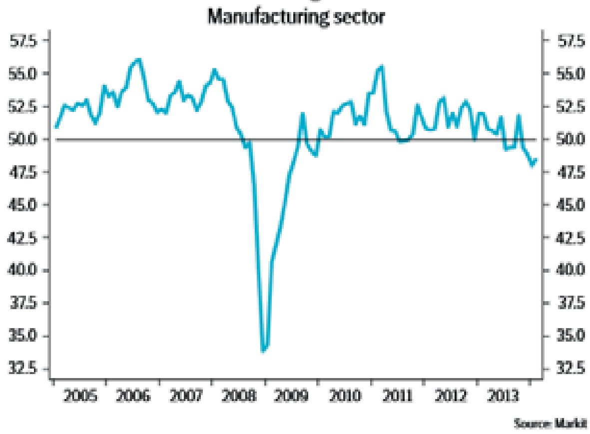


In the fourth quarter, GDP rose by 1.2 per cent year-on-year, based on official full-year 2013 growth of 1.3 per cent. **The slowdown in growth is mainly structural**, since Russia's labour market remains close to equilibrium and capacity utilisation is high. Weak economic expansion is largely explained by stagnating capital spending, but private consumption – which has accounted for two thirds of growth in recent years – is now weakening. In 2013, household consumption rose by 4.7 per cent, compared to nearly 8 per cent in 2012.

According to most signals, **early 2014 was also weak**. Indicators are showing no signs that growth is poised for recovery. Since last November, the purchasing managers' index (PMI) has remained below the expansion threshold of 50. Despite an improvement in February, its current level is the lowest since 2009. Consumer confidence has weakened during the past two quarters but remains just above its historical average. Leading indicators have rebounded cautiously from a low level.

PMI remains below growth threshold

Manufacturing sector



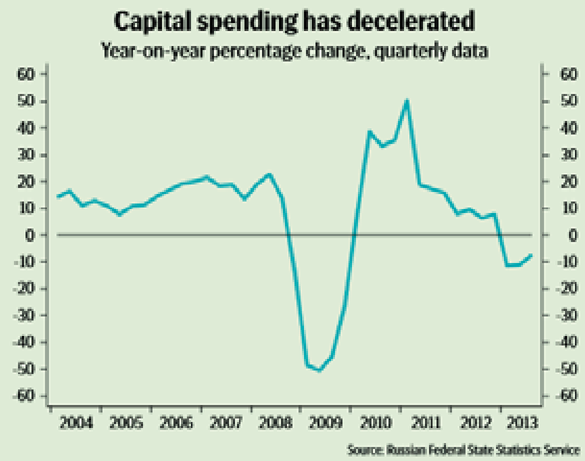
Exports and industrial production remain sluggish, with year-on-year increase rates of close to zero. Retail sales growth, too, has decelerated markedly during early 2014. Tighter monetary policies to counter the weakening of the rouble and the risk of inflation are also holding back growth. **Oil prices** rose when Russia began to increase its presence in Crimea but have fallen again. SEB's forecast is that annual average oil prices (Brent crude) will end up at **USD 105.7 per barrel in 2014** and then fall to **USD 100 in 2015**, assuming that the crisis surrounding Ukraine does not seriously worsen. An expectedly subdued oil price trend will thus provide no extra growth impetus. There are few bright spots. The weakening of the rouble will provide some growth support by means of higher exports and tax revenues. The continued strong labour market will support private consumption. If an escalation of the Ukraine conflict can be avoided and the global economy keeps improving, there is potential for cautious growth acceleration during the second half of 2014. The recovery is expected to continue during 2015, supported by the fading of the Ukraine conflict. **We foresee a GDP increase of 1.0 per cent in 2014 and 1.8 per cent in 2015**. We have revised our GDP forecast downward and remain below consensus. Risks to the forecast lie on the downside, more effective sanctions would result in substantial negative growth effects.

Labour market one of few bright spots

Although there are now **certain signs of weakening**, the labour market is one of the few bright spots and is helping to sustain private consumption. In recent months, unemployment has started to move upward and in January it was 5.6 per cent. Although the jobless rate has thus increased compared to its

Reforms and capital spending the key to growth

As we have emphasised in earlier reports, the deceleration in Russian economic growth is largely structural. A weak capital spending trend is the main explanation and this trend is likely to be reinforced by the weakening in confidence resulting from Russia's handling of the Ukraine conflict. The key to stimulating such spending is continued and intensified reform work. High GDP growth from 1999 to 2008 was largely driven by nonrecurring factors and large-scale idle capacity, which enabled output to increase without a need to expand production capacity. At present, however, capacity utilisation is at a historically high level, and **Russia's low investment ratio of around 20 per cent of GDP needs to increase substantially**.



In practice, there is a very large underlying need for capital spending. The output of the important **energy sector** has stagnated in recent years because a large proportion of oil and gas fields are old and the dominance of state-owned companies does not benefit innovations and investments in new technology. This results in weak productivity growth for the energy sector. Another challenge to Russia is the increasing global production of shale oil and gas, which will require investments and new technology if the country is to benefit from its own shale deposits.

One explicit government ambition is to **develop the eastern part of Russia** in order to benefit from potential exports to the rapidly growing economies of Asia. This, too, will require large-scale capital spending, especially for infrastructure, which is also needed in Russia as a whole. Further examples of capital spending needs are the country's many **environmental problems**, which are largely a result of the lack of investments in new, modern production.

Underlying capital spending needs are unfortunately being held back by a **very poor business climate** and a number of other structural problems. The main problems are widespread corruption, heavy government influence and inefficient public sector bureaucracy. **It is probably necessary to reduce structural problems in order to keep the positive growth effects of higher capital spending from being eaten up by corruption, rising inflation and inefficient public sector operations**. Investments by small and medium-sized companies are also being hampered by difficulties in gaining access to financing.

Various indicators of business climate and the quality of institutions, such as the World Economic Forum's global competitiveness report (GCR) and the Transparency International (TI) corruption indicator show that Russia has worse potential than significantly less developed countries such as Mexico and Turkey.

Country	GDP/capita (USD, PPP*)	GCR, 2013-2014	Ease of Doing Business	TI
Russia	*23,501*	*64*	*92*	*177*
Chile	22,352	34	34	22
Hungary	22,118	63	54	47
Turkey	18,348	44	69	53
Malaysia	17,143	24	6	53
Mexico	16,731	55	53	106
China	9,233	29	96	80

Source: IMF, Transparency International, World Bank, World Economic Forum
* Purchasing power parities

An understanding of the need for reforms is beginning to gain strength among many political leaders and public authorities. Last autumn the Economy Ministry revised its growth forecast downward to 2.5 per cent annually until 2030, and President Vladimir Putin has admitted that domestic factors explain most of the weakness in economic growth. But there are **still few signs that any far-reaching reform initiatives will be unveiled in the near future**. There is a long list of structural problems and necessary reforms: oil dependence, demographic deterioration (see the theme article in *Eastern European Outlook*, October 2013): weak institutions and business climate and a transport system in great need of upgrading are a few examples. Reform efforts in recent years have led to some improvements, such as World Trade Organisation membership, government budget rules and privatisations, but Russia will require a much more extensive reform programme in many fields in order to revert to growth rates of 4-5 per cent, which are reasonable in the long term.

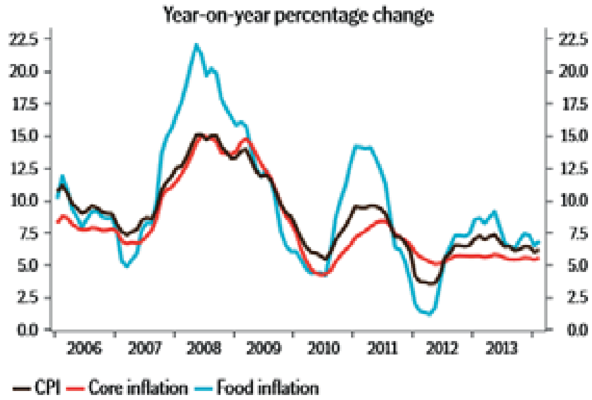
earlier lows it remains at a historically very low level. However, real wage increases have decelerated sharply in the past six months and were at 2.5 per cent year-on-year in January. We expect this slower rate of pay increases will persist during 2014.

The deceleration in growth has not had much impact on unemployment, and the GDP slide of nearly 8 per cent in 2009 had only limited effects. There are several reasons for this. The labour force is shrinking, wage flexibility is high and unemployment benefits are very low. Employment is kept stable by Russia's strong potential for adapting wages during economic shocks, but this flexible labour market is not entirely a good thing. High labour turnover weakens incentives for investments in human capital, and companies that offer jobs with very low compensation and proficiency requirements can survive and risk weakening the country's productivity growth.

Measured as a full-year average, inflation ended up at 6.8 per cent in 2013. During the second half, the inflation rate slowed markedly and the government's freeze on regulated prices (including electricity and gas) was an important contributing factor. However, in February 2014 inflation accelerated to 6.2 per cent. Core inflation remains at around 5.5 per cent. Monetary policy has previously mainly targeted the exchange rate but is now shifting to a system with a clear inflation target. Like many other emerging economies, Russia is finding it difficult to transition to an inflation target because of the large role of food prices and administratively set prices in the consumer price index (CPI) basket. The official target is 5 per cent inflation by year-end 2014, 4.5 per cent in 2015 and 4 per cent in 2016. **Measured as annual averages, inflation will end up at 6.0 per cent in 2014 and 5.4 per cent in 2015.**

Inflation has slowed

Year-on-year percentage change

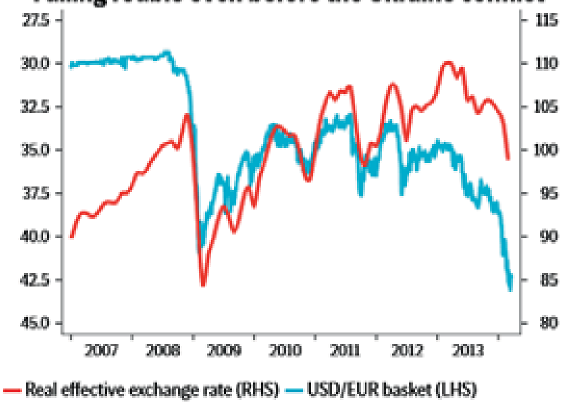


Source: Russian Federal State Statistics Service

The weakening of the rouble is serving as a useful test of plans to let the currency float freely in 2015. The central bank's assessment that recent rouble depreciation has moved too fast and gone too far is probably one important explanation behind its **unexpected key interest rate hike in early March 2014**. In the future, the central bank will probably also occasionally have to try to influence the rouble, since the exchange rate has a major impact on the economy due to extensive foreign currency assets and heavy dependence on oil. The one-week repo rate has now replaced the refi rate as the benchmark interest rate and was hiked on March 3 from 5.5 to 7.0 per cent. According to the central bank's communication, this hike was implemented in order to counter an increase in inflation due to rising import prices and to counter financial instability. The rate hike **reinforces the impression that the central bank is determined to bring down inflation** and that this weighs more heavily than short-term stimulus by means of a weaker currency. In the prevailing situation of financial turbulence and pressure on the currency the central bank is unlikely to carry out any key rate cuts, despite the continued deceleration in Russia's economic growth. We expect more rate hikes and **the key rate will stand at 8.0 per cent at the close of 2014 and at 8.5 per cent at the close of 2015**.

The rouble is one of the currencies that has been hardest hit by the instability in the financial markets of emerging economies. Since the beginning of 2014, the rouble has lost about 10 per cent against the USD and is close to a record low. Because of the Ukraine conflict, both the rouble and the Russian stock market have taken a major beating, but the weakening of the rouble has been under way for a long time – driven by the gloomier economic outlook in Russia as well as the shrinking current account surplus. Despite this weakening, the real effective exchange rate is well above its level of six or seven years ago, which hurts Russia's competitiveness. Continued deterioration in the current account, weak economic growth and capital outflows are expected to squeeze the rouble in the next couple of years as well. **At the end of 2014, we expect the rouble to stand at 37.5 against the USD and at 39.0 by the close of 2015**.

Falling rouble even before the Ukraine conflict



Source: BIS, Macrobond

One strength during the current financial turbulence is Russia's stable banking sector. The banks are well-capitalised, with solid profit margins, and their proportion of bad loans is manageable. The central bank has carried out stress tests, which do not indicate that there are any acute systemic risks. Russian banks have exposure to Ukraine, but a bigger risk to the financial system is the **rapid increase in consumer credit**. For a long time, the central bank has expressed concern about rapid credit growth and has introduced measures such as higher risk weights for consumer loans. Although the rate of increase in consumer loans has decelerated over a long period, it is still too high to declare victory. A large proportion of consumer lending also consists of unsecured loans. However, no acute crisis is imminent. The private sector debt burden is around a moderate 50 per cent of GDP, but more central bank actions will probably be required to decelerate household debt growth. This will contribute to a slowing of economic growth, which in recent years has largely been driven by private consumption.

The government budget is being strengthened by the rouble depreciation, since most tax revenues come from commodity exports, mainly oil and gas, which are traded in dollars. We estimate that the **government budget deficit will end up at 0.8 per cent of GDP in 2014 and 1.1 per cent in 2015**, which is somewhat less than our earlier assessments. The government budget remains strongly linked to oil prices, and at present an oil price of around USD 110 per barrel is needed to balance the budget. This is more than three times as much as in 2005 and higher than SEB's oil price forecast. Even if budget deficits are kept down in the next couple of years, these deficits are expected to climb in the long term, driven by weak economic growth and stagnating or falling oil prices thanks to increasing global production. The **current account will also continue to deteriorate**, a trend that has been under way for the past decade. In 2013 the current account surplus had shrunk to 1.5 per cent of GDP and was exceeded by capital outflows. A **low government debt** of about 11 per cent of GDP plus large-scale currency reserves mean that Russia is not facing any acute crisis. But in the long term, it must deal with the problems of rising government budget expenditures, oil price dependence and capital outflows if a current balance crisis is to be avoided.

Conflict with Ukraine has severely damaged relations with the West

The fact that Russia wants to draw Ukraine closer to it and opposes its increased economic integration with the European Union is nothing new. The CIS customs union that so far encompasses Russia, Kazakhstan and Belarus would in practice be meaningless without Ukrainian participation. But it was unexpected that Russia's ambition to build up a "Eurasian Union" would result in such a dramatic course of events. One warning sign was the trade barriers and threats of full-scale trade war that Russia launched last autumn when Ukraine seemed ready to sign a trade and integration agreement with the EU. But Ukraine's then-president, Viktor Yanukovych, decided just before the summit in Vilnius late in November not to sign the agreement. An unexpected Russia emergency loan equivalent to USD 15 billion created some stability; for a while, it looked as if Ukraine would be able to manage its funding requirements during 2014. Only an initial disbursement of USD 3 billion was paid, and Russia is expected to withhold the rest of the loan and also rescind its temporary cut in gas prices in April. But protests gained new momentum and the previous regime was replaced by a new government elected by parliament.

Russia does not accept the government in Kiev, and by boosting its military presence in Crimea, in practice it took control of the region. Its excuse was protecting the ethnic Russians who live there, but the real reason is probably to enable Russia to **use Crimea as leverage to preserve its influence over Ukraine** and prevent its integration with the EU. Crimea held a referendum on March 16 to vote on independence from Ukraine and an overwhelming majority of the votes were in favour of unification with Russia. Our assessment is that **Russia will content itself with having taken control of Crimea** and will not escalate the conflict by marching into eastern Ukraine.

The conflict with Ukraine has significantly worsened Russia's already tense relations with both the EU and the US, but **military intervention by the West is very unlikely**. Instead, sanctions against Russia will be the main way of exerting pressure and could be used to undermine already weak Russian growth. However, in that case they have to be extended to trade restrictions and financial restrictions directed towards firms. There is a risk that they would backfire on Western countries themselves, since many countries in Europe have large-scale exports to Russia and are dependent on Russian gas. Consequently, several European countries are opposed to extending the present sanctions currently directed at individuals. In addition, Russia believes that continued influence over Ukraine is so important that it is willing to risk significant European and US actions. Our assessment is thus that **the present sanctions will not be extended to trade and financial restrictions as long as Russia does not escalate the military conflict**.

The Ukraine conflict will boost Putin's domestic political support

Russia's conflict with Ukraine has strengthened president Putin's position, at least in the short term. Public opinion surveys indicate that **President Putin's public approval rating has risen** and that a majority support his handling of Ukraine and Crimea, even though the clearly negative image of the new government in Kiev presented in government-controlled media has contributed to this. Some counter-demonstrations have occurred but have quickly been broken up. The more liberal, Western-oriented population of major cities may, however, be assumed to have a more negative view of Russia's actions in Crimea.

The short-term political risk is small, since both the next State Duma election (2016) and the next presidential election (2018) are relatively far away in time. Given the lack of any challenger for the post of president, combined with a fragmented opposition, for the time being President Putin will manage to retain his dominant position even if his popular support begins to wane. Nevertheless, the trend towards greater popular dissatisfaction will undoubtedly continue as a result of weaker economic growth and consequent stagnation in living standards. In a longer perspective, there is thus a sizeable risk of political upheavals.

On the brink of economic collapse

- **Bail-out loan from IMF/EU main scenario**
- **Weakening of hryvnia is impacting inflation and banking system**
- **It will be a long journey back**

Ukraine's political and economic situation has dramatically worsened in recent months. President Viktor Yanukovych's decision in November 2013 not to sign a trade and integration agreement with the EU triggered widespread popular protests. Meanwhile investor confidence in Ukraine plunged. The already high risk premium on credit default swap (CDS) contracts climbed further. In December, a Russian emergency loan temporarily stabilised the situation, kindling hopes that Ukraine might be able to meet its external funding needs in 2014. But Yanukovych's plans to restrict freedom of assembly and association made the situation worse again. When police stormed the centre of the protest movement on Kiev's Independence (Maidan) Square in February, the conflict escalated. Many people were killed or wounded. Yanukovych was finally forced to flee to Russia. His regime was replaced by a **new**, **Western-oriented government**. Many of its members are both experienced and highly competent; along with a wish to deepen cooperation with the EU, this creates reform chances.

Russia does not recognise Ukraine's government and in March took control of the Crimean region (about 4 per cent of Ukraine's GDP) on the pretext of protecting ethnic Russian residents. But the real reason is probably to retain an influence on events in Ukraine and prevent greater integration with the EU. Crimea has declared independence and is expected to join the Russian Federation. Although our assessment is that the conflict with Russia will not escalate the political situation in Ukraine will remain unstable for a long time ahead, even after the May 25 presidential election.

These political developments are a major blow to Ukraine's already fragile economy, and the **risk of government default is acute**. The underlying problem remains a sizeable current account deficit (9 per cent of GDP in 2013), driven by a very weak trade balance. The government must also make extensive foreign loan repayments during 2014. In December, Ukraine received a Russia emergency loan of USD 15 billion and a discount on Russian gas prices. Only the first tranche (USD 3 billion) was disbursed, and no further disbursements are expected. The gas price discount will also end on March 31.

As expected, the erosion of the currency reserve has continued and recently accelerated. According to official statistics, the reserve was USD 15 billion in February but it has shrunk further since then. Although the reserve is critically low, Ukraine appears likely to make it through the next few weeks. **Our main scenario is that during a transitional period, Ukraine will receive short-term financial aid until the Kiev government has a chance to negotiate an IMF/EU bail-out loan.** This loan could create stability, enabling Ukraine to begin implementing tough reforms demanded by its lenders. Even assuming such a relatively favourable scenario, the very difficult economic and political situation will have a major impact on growth. We believe that **GDP will fall by 4 per cent in 2014**, but a more stable political and financial situation, combined with a significantly more competitive currency after this winter's hryvnia depreciation and continued improvement in the global economic situation, will set the stage for a recovery in **2015**, when **we expect GDP to increase by 2 per cent**.

In our assessment, **Ukraine will require external funding of at least USD 25 billion in 2014** to cover its current account deficit and repayment needs. It will also require such financial help in 2015. A bail-out loan will thus have to run for at least two years. Such a programme will involve far-reaching economic reform requirements. The IMF's requirements are well known. They include reduced gas price subsidies and cuts in the budget deficit that were previously considered politically very difficult to push through. Tax revenues have fallen sharply due to rising uncertainty. Severe belt-tightening will be needed to shrink the deficit, which exceeded 6 per cent of GDP in 2013. Government debt is moderate, however, and was equivalent to just over 40 per cent of GDP last year. The government in Kiev has nevertheless declared its willingness to implement all the required reforms. Just as in Russia, the business climate is very bad and far-reaching reforms will be needed over a long period to come to grips with problems such as widespread corruption and excessive government influence on the economy.

The hryvnia has weakened dramatically due to Ukraine's political upheavals. So far in 2014, it has lost more than 20 per cent of its value against the USD, after temporarily weakening by some 25 per cent. Due to its low currency reserves, the central bank can no longer intervene to support the hryvnia, and the previous currency peg of UAH 8.1 per USD has been abandoned in practice. Our assessment in October's *Eastern European Outlook* that devaluation was imminent has thus proved correct. Early in February 2103, the central bank introduced **capital controls** to counter rising demand for foreign currencies, but these controls only temporarily stabilised the hryvnia. The main risks to the currency are political and connected to the government's ability to implement the IMF's reform requirements. Our main scenario of a bail-out loan from the EU/IMF nevertheless creates stability, and a further sharp depreciation in the currency should thus be avoidable. **We believe that the hryvnia will stand at UAH 10.5 per USD by the end of 2014 and at 11.0 by the end of 2015**.

The weakening of the hryvnia will impact the economy in various ways. It will make imported goods more expensive and pushes up inflation. In 2013, full-year average inflation was just below zero. Last year's good harvests helped push down food price inflation during the second half, but there are already signs that prices are starting to take off drastically. In February, annualised CPI inflation was 1.2 per cent. **Full-year average inflation will reach 4.0 per cent in 2014 and 6.0 per cent in 2015.**

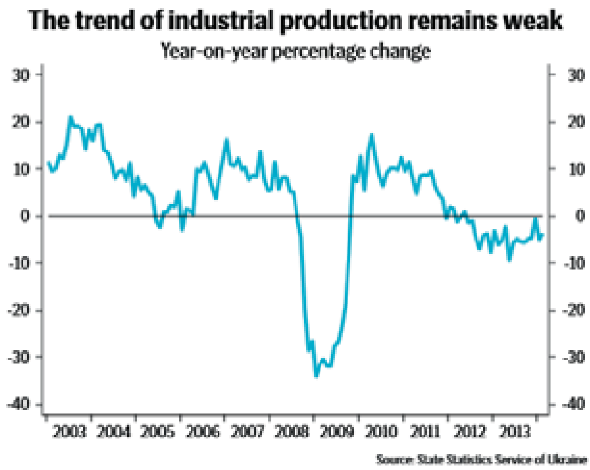
The weakening of the hryvnia is also having an impact on Ukraine's fragile, fragmented banking system. Although foreign currency lending to the private sector has decreased from slightly above 50 per cent in 2008-2009 it still represents around 35 per cent of the total stock of loans. Currency depreciation makes it more expensive for both households and businesses to service their loans and risks increasing the already high percentage of bad loans, which is estimated at more than 40 per cent of the total. There has also been a tendency for the public to try to withdraw savings, and bank deposits have decreased in recent months. Along with rising interbank interest rates, these are signs that **confidence in the banking system is becoming shakier**. As long as currency depreciation remains under control, however, its impact on banks is regarded as manageable. The central bank has started an **emergency liquidity programme** and capital contributions to individual banks will probably also be needed.

So far, the dramatic political events in Ukraine have primarily impacted financial markets, and the already very weak real economy has thus ended up being widely ignored. Yet fourth quarter 2013 growth was significantly stronger than expected, driven by higher agricultural production and statistical base effects. According to official figures, GDP increased by 3.3 per cent year-on-year after five consecutive quarters of negative growth. **For 2013 as a whole, GDP growth ended up at zero.**

In our assessment, GDP will decrease on a broad front in 2014. Demand for Ukraine's steel exports remains very weak. This was a major blow to exports during 2013. We expect poor export performance in 2014 as well. About **25 per cent of Ukraine's exports go to Russia**, by far its most important trade partner. The deceleration in Russian economic growth will thus have a sizeable impact, while no real upswing is yet discernible for euro zone growth. The weakening of the hryvnia will thus have only a small favourable effect on exports. Depending on political developments, there is also a significant risk that Russia will reinstate trade barriers as a way of putting pressure on Ukraine. In order to support Ukraine, however, the EU has suspended a majority of its import tariffs on Ukrainian goods, equivalent to nearly EUR 500 million per year in lower tariffs.

Industrial output remains weak and fell both in 2012 and 2013. The main explanation is continued difficulties for the steel sector. Steel production has fallen by more than 30 per cent since peaking before the 2008-2009 crisis, and there are no signs that the sector is poised for a recovery. Capital spending also decreased in 2013, and because of increasing political and economic uncertainty we expect it to continue declining in 2014. One of the few bright spots is agricultural production, which rose sharply late in 2013. The potential exists for good harvests this year too, but there are questions about how the Crimean conflict may affect grain exports.

Retail sales have chugged along at a good pace in recent months, but we expect this trend to be interrupted. Consumer confidence deteriorated sharply in December and January, probably due to escalating political unrest, and is now at its lowest level since the spring of 2011. The rate of increase in nominal wages and salaries has continued to decelerate. Combined with the expected inflation increase, we expect stagnating real wages. The IMF's demands for sharply reduced subsidies on household gas prices as well as a decrease in the government budget deficit will also hurt household disposable incomes. We thus expect consumption to shift from a positive to a sharply negative contributor to 2014 GDP.



ESTONIA

	2008	2009	2010	2011	2012	2013(f)	2014(f)	2015(f)
GDP, %	-4.2	-14.1	2.6	9.6	3.9	0.7	0.5	2.5
Inflation, HICP, average, %	10.4	-0.1	3.0	5.0	3.9	3.2	0.6	2.6
Unemployment, %	5.5	13.8	16.9	12.5	10.2	8.8	9.2	9.0
Current account, % of GDP	-9.3	2.8	2.9	1.8	-1.8	-1.0	0.2	0.7
Public sector financial balance, % of GDP	-2.9	-2.0	0.2	1.2	-0.3	-0.6	-1.2	-1.2
Public sector debt, % of GDP	4.5	7.1	6.7	6.1	9.9	10.3	11.4	12.6
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	2.9	3.4
Inflation, HICP, average, %	15.3	3.3	-1.2	4.2	2.3	0.0	1.4	3.3
Unemployment, %	7.5	16.9	18.7	16.2	15.0	11.9	10.5	9.0
Current account, % of GDP	-13.1	8.6	2.9	-2.2	-2.5	-0.8	-1.6	-2.2
Public sector financial balance, % of GDP	-4.2	-9.7	-8.1	-3.6	-1.2	-1.2	-0.9	-0.8
Public sector debt, % of GDP	19.8	36.7	44.4	41.9	40.7	42.0	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	0.25	0.25	0.25

LITHUANIA

	2008	2009	2010	2011	2012	2013(f)	2014(f)	2015(f)
GDP, %	2.6	-14.6	1.5	6.1	3.5	3.4	3.0	4.0
Inflation, HICP, average, %	11.1	4.2	1.2	4.1	3.2	1.2	0.8	1.2
Unemployment, %	5.8	13.7	17.8	15.4	13.4	11.8	10.5	9.5
Current account, % of GDP	-12.9	3.7	0.1	-3.7	-0.2	1.5	-2.0	-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	39.6	41.0	39.0
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	0.41	0.45	0.55
5-year government bond, eop	13.10	6.60	4.60	5.40	2.40	2.40	1.40	1.60

(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	1.6	2.7	3.4
Inflation, HICP, average, %	4.2	4.0	2.7	3.9	3.7	0.8	1.4	2.4
Unemployment, %	7.1	8.1	9.7	9.7	10.1	10.5	10.4	10.1
Current account, % of GDP	-6.6	-4.0	-4.3	-4.5	-3.3	-1.5	-2.0	-2.5
Public sector financial balance, % of GDP	-3.7	-7.4	-7.9	-5.0	-3.9	-4.5	5.5	-2.9
Public sector debt, % of GDP	47.1	50.9	54.8	56.2	55.6	57.8	50.0	50.0
EUR/PLN, end of period	4.1	4.1	4.0	4.5	4.1	4.1	4.0	3.9
Key rate, eop	4.00	3.50	3.75	4.50	4.25	2.50	2.50	3.00
5-year government bond, eop	5.34	5.91	5.52	5.34	3.21	3.78	4.20	4.60

RUSSIA

	2008	2009	2010	2011	2012	2013(f)	2014(f)	2015(f)
GDP, %	5.2	-7.8	4.5	4.3	3.4	1.3	1.0	1.8
Inflation, average %	14.1	11.7	6.9	8.4	5.1	6.8	6.0	5.4
Unemployment, %	6.4	8.4	7.5	6.6	5.7	5.5	5.8	6.0
Current account, % of GDP	6.2	4.1	4.6	5.2	3.7	1.5	0.8	0.2
Public sector financial balance, % of GDP	4.9	-6.3	-3.4	1.5	0.4	-0.5	-0.8	-1.1
Public sector debt, % of GDP	7.9	11.0	11.0	11.7	12.5	11.0	11.9	12.7
USD/RUB, end of period	29.57	30.10	30.50	32.08	30.36	32.85	37.50	39.00
Rouble vs. euro/dollar basket, eop	34.8	36.0	35.2	36.4	34.7	38.4	42.2	43.4

UKRAINE

	2008	2009	2010	2011	2012	2013(f)	2014(f)	2015(f)
GDP, %	2.3	-14.8	4.1	5.2	0.2	0.0	-4.0	2.0
Inflation, average, %	25.2	16.0	9.4	8.0	0.6	-0.3	4.0	6.0
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	-8.3	-9.0	-6.0	-5.0
Public sector financial balance, % of GDP	-3.2	-6.3	-5.8	-3.5	-5.5	-6.5	-5.0	-4.5
Public sector debt, % of GDP	20.5	35.4	40.5	36.8	37.4	41.8	46.0	48.5
USD/UAH, end of period	7.80	8.00	7.97	8.00	8.05	8.23	10.50	11.00

(f) = forecast

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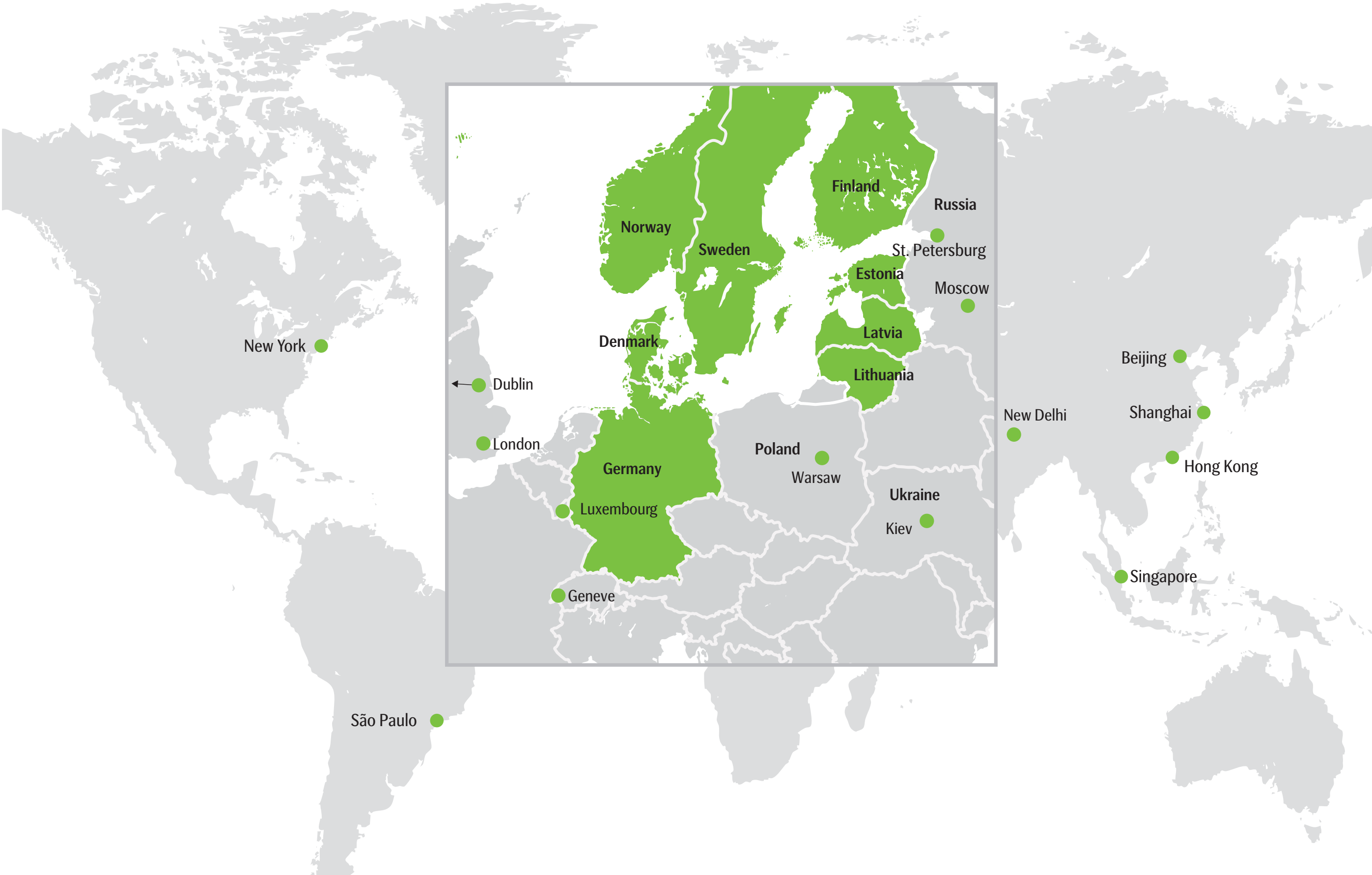

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