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Press release

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Eastern European Outlook: Continued gradual recovery in Eastern Europe despite geopolitical turmoil. Russia close to stagnation this year – Baltics vulnerable

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

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 elsewhere in Western Europe will partly offset lost exports due to weak Russian demand. There is also good potential for higher private consumption. But SEB is generally lowering its 2014-2105 growth forecasts for Eastern Europe, and the risk of short-term reversals in individual countries has increased due to geopolitical turmoil. SEB's 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.

Both the Western powers and Russia will certainly hold back as long as they can before starting any trade war. The underpinnings of the euro zone's nascent recovery are still fragile and there is significant mutual dependence on Russia natural gas deliveries," says Mikael Johansson, Head of Eastern European Research at SEB and Chief Editor of *Eastern European Outlook*.

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.

SEB is lowering its GDP forecasts (compared to the 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.

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- **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. 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. "The Ukraine conflict will worsen an already weak economic situation, which has largely been caused by structural problems, further accentuating the need for reforms. One of the few bright spots for Russian growth during the coming year is relatively stable oil prices," notes Andreas Johnson, Russia and Ukraine analyst at SEB Economic Research.
- **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.

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