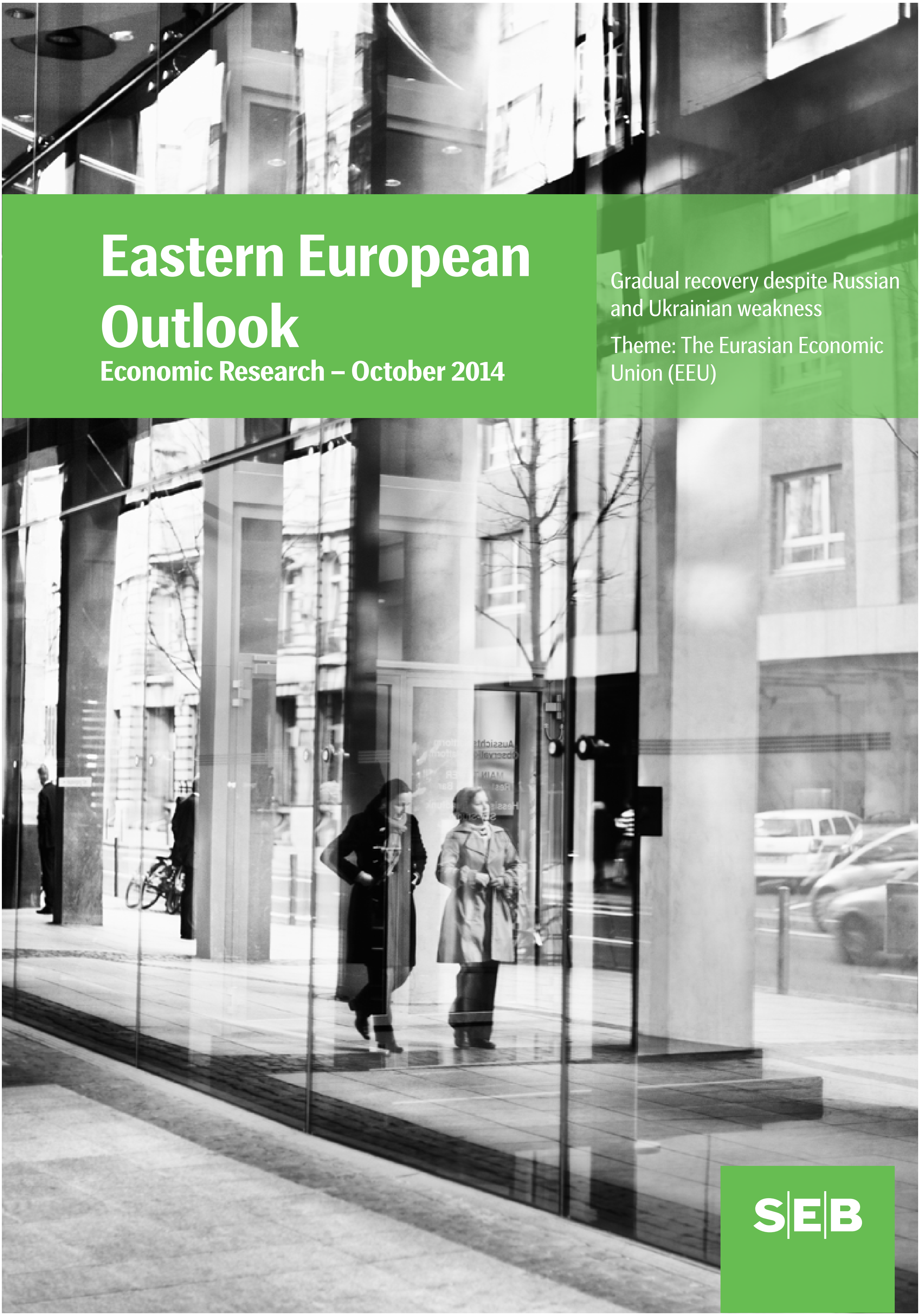
Eastern European Outlook

Economic Research – October 2014

Gradual recovery despite Russian and Ukrainian weakness

Theme: The Eurasian Economic Union (EEU)



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Summary

Gradual economic recovery will continue in Poland/Central Europe and the Baltic countries in 2015-2016 despite the Russia-Ukraine conflict, which is making Russia stagnate and Ukraine's GDP plunge this year. But growth in Poland, Latvia and Lithuania will be moderate. In Estonia – also squeezed by Finland's stagnation – it will remain weak. Short-term growth will also be squeezed by a temporary slump in Germany and the euro zone. We expect zero euro zone growth in the second half of 2014, partly due to uncertainty about the Ukraine crisis.

Growing private consumption and a resumed German/euro zone upturn in 2015 will offset lost exports to Russia and Ukraine as well as plummeting investments due to geopolitical worries. Households are benefiting from continued good real incomes (especially in the Baltics) and low interest rates: both largely due to continued very low inflation. Direct trade ties between conflict-hit countries and individual Central and Eastern European countries are also relatively small, except for the Baltics and some other former Soviet republics.

We expect the Russia-Ukraine conflict to be long-lasting. Our growth forecasts assume that the conflict will not escalate militarily, no serious disruptions to Russian energy deliveries to Europe will occur and trade sanctions between the West and Russia will not worsen. We assume that the current sanctions – which we believe will have a relatively small direct impact – will remain in place during most of 2015.

Here are our GDP forecasts for the six countries that *Eastern European Outlook* covers. SEB's forecasts for 2015 are generally below consensus.

- **Russia's** GDP will grow by 0.4 per cent in 2014, fall by 0.2 per cent in 2015 and climb by 1.0 per cent in 2016. Weak capital spending, slower real household wage growth and clearly lower oil prices in 2015 will squeeze the economy. The rouble will fall further, slowing the decline in high inflation. Popular support for President Putin has surged due to the Ukraine conflict, but we expect it to erode over time.
- **Ukraine** is in deep recession and has a long journey back, despite a major currency depreciation that strengthens its export prospects. GDP will fall by 8 per cent this year, reach zero growth in 2015 and return to weak 2 per cent growth only in 2016. Inflation is high and the banking sector is under pressure. Expanded EU/IMF bail-out loans may be needed. Ukraine is moving towards greater federalism; its embrace of the West is not yet a given, despite its EU association agreement.
- **Poland**, with relatively small imbalances, shows good resilience to the Russia-Ukraine conflict. This year's German slump is a major reason behind Poland's temporary dip this autumn. Large EU funds and new interest rate cuts will soon help push up domestic demand. The euro issue may be raised politically in 2015-2016. GDP will climb by 2.7 per cent in 2014, 3.0 per cent in 2015 and 3.5 per cent in 2016.
- **Estonia's** strongly export-dependent economy will be squeezed not only by slower Russian growth but also by sluggish economic performance in Finland and weak capital spending. Estonia will be stuck with lacklustre growth of 1.2 per cent this year and per cent in 2015, moving close to 3 per cent only in 2016.
- **Latvia**, the fastest-growing EU country over the past two years, will see decent growth of 2.7 per cent in 2015 and 3.4 per cent in 2016, after this year's dip to 2.5 per cent. Domestic consumption will remain the key driver. The coalition government was recently re-elected and we expect no big political shifts.
- **Lithuania** is moving towards broad recovery in domestic demand: this year the construction and housing markets have begun to revive, later than in the other Baltics. GDP will rise by 2.7 per cent in 2014, 3.2 per cent in 2015 and 4.0 per cent in 2016. The vital energy sector will become more secure at the end of 2014 when the country opens a new gas terminal, radically reducing its current 100 per cent dependence on Russian gas.

A separate **theme article** discusses Russia's ambitions to create a counterweight to the European Union: **the Eurasian Economic Union (EEU)**. But the EEU will be off to a shaky start in 2015 with only three members: Russia, Belarus and Kazakhstan. Ukraine, a big potential member country, recently signed an association agreement with the EU, dealing a blow to Russia's EEU project.

Continued gradual recovery, but greater downside risks

- **US-led global upturn**
- **Temporary stagnation in the euro zone**
- **Central Europe resilient to Ukraine crisis**

The world economy is marked by **fragile recovery**. The US is showing broad strength after a mainly weather-driven slump in early 2014. China has stabilised close to its official growth target despite a property market downturn. Japan is sputtering along slowly after last spring's sales tax hike, partly sustained by rising wages and salaries. In Western Europe the picture is divergent: the United Kingdom is maintaining strong growth momentum, while negative signals dominate the euro zone.

Euro zone GDP stagnated in the second quarter. Confidence indicators for industry and households have fallen since spring, but recently stabilised. The September purchasing managers' index in manufacturing was at the expansion threshold of 50: a bit higher in Italy and Spain, lower in France. Uncertainty about the Ukraine crisis and balance sheet adjustments in crisis-hit countries are two reasons behind sagging sentiment. We predict **continued zero growth in the euro zone during the second half. Growth will gradually recover in 2015**; with the usual lag, it will be fuelled by the US upturn, as well as by a weaker euro and monetary stimulus. One key assumption is that Germany will continue to chug along at a decent pace. The German slowdown of the past six months is related to manufacturing and exports. Retail sales have continued to climb. Germany's small economic imbalances and record-strong labour market suggest that its slump will be short-lived.

Global expansion will remain uneven in the next couple of years – the US-euro zone growth gap will not shrink until 2016 – yet it will gradually strengthen. This upturn will be driven by an increasingly robust US economy and continued very loose monetary policies in the Organisation for Economic Cooperation and Development (OECD), whose fiscal policies are now entering a more neutral phase after earlier budget-tightening. Emerging market growth will speed up somewhat, making a positive contribution. **Global growth will accelerate from 3.4 per cent this year to around trend level: 3.8 per cent in 2015 and 3.9 per cent in 2016. Inflation will remain low** due to large idle resources and recent downward pressure on commodity (including oil) and food prices. **Brent oil will fall** to an average of USD 85/barrel in 2015, partly due to the impact of the coming "shale oil revolution". The European Central Bank will launch a new quantitative easing (QE) policy early in 2015 and leave its key interest rate untouched. The US Federal Reserve will begin stepwise rate hikes in mid-2015. The USD will continue to climb against the euro, which will reach USD 1.20 next year.

Downside risks in our GDP forecast have increased since spring. This is due to bigger geopolitical worries – such as Ukraine, Islamic State aggression in Iraq and Syria and events in Libya – plus euro zone weakness. As forecasted in *Eastern European Outlook* last March, the Russia-Ukraine conflict has pulled down sentiment indicators throughout Europe. Provided that the conflict does not escalate militarily and that there are no large-scale trade sanctions or serious disruptions in Russian gas deliveries to Europe, the negative impact on sentiment indicators should soon begin to fade if this autumn's moves towards a diplomatic solution eventually prevail. We are sticking to last spring's assessment that **the conflict will have only minor negative effects on global growth**. Direct trade ties between Russia and individual countries are relatively small, except for the Baltics, Finland and nearby former Soviet republics, but we expect investment appetite to be blunted not only in the vicinity of the crisis area but across Europe.

Global key data

GDP, year-on-year percentage change

	2013	2014	2015	2016
United States	2.2	2.3	3.4	3.1
Euro zone	-0.4	0.7	0.9	1.5
The world	3.3	3.4	3.8	3.9
Oil USD/barrel	108.7	105.0	85.0	90.0
EUR/USD, Dec	1.38	1.24	1.20	1.20

Source: SEB

Assuming limited sanction effects, we still believe that the **gradual recovery** that began in the second half of 2013 mainly in **central Eastern Europe will continue in the next couple of years**. There will be a temporary **dip during the second half**. Recovery will be moderate. Growing private consumption and the cyclical upturn in Germany and Western Europe will offset lost exports to Russia and falling investments in countries near the conflict area. Major Central European countries export relatively little to Russia. In Poland, Slovakia, the Czech Republic and Hungary, year-on-year growth in Q2 was also healthy and largely unchanged compared to Q1. **Private consumption will remain a key driver.** Households are benefiting from good real income increases due to stabilising labour markets and continued low inflation, partly because their economies still have sizeable slack. Purchasing power has strengthened further in recent months as Poland, Slovakia and Hungary have slipped into deflation. This makes continued low interest rates likely, thereby boosting household demand for loans and contributing to higher consumption.

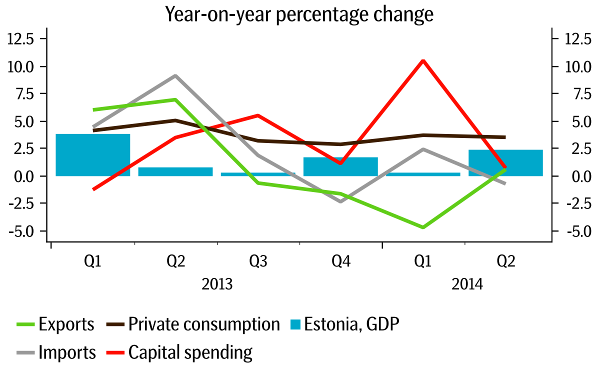
Lacklustre growth – only partly due to geopolitics

- **Exports and capital spending weak**
- **Consumption-driven growth**
- **Temporary deflation**

The Estonian economy has lost its momentum, with meagre growth rates hardly above zero for over a year. The second quarter showed an upswing in year-on-year GDP growth to 2.4 per cent, but it is too early to interpret this as a sign of recovery to permanently higher growth rates. In fact, the Q2 upturn was caused by lower imports, triggered by weak capital spending activity. While exports also remained weak, the contribution from **net exports was positive because imports dropped even more**. There have been a couple of quarterly upswings reaching around 2 per cent in annualised terms, but this growth structure reveals the weakness rather than the strength of the economy. **Quarterly upswings in GDP will thus likely prove to be temporary.**

Weak GDP growth and foreign trade for a lengthy period

Year-on-year percentage change



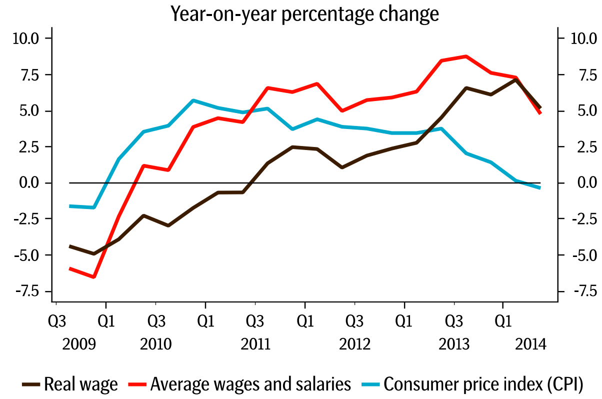
Source: Statistical Office of Estonia

We expect GDP increases of 1.2 per cent in 2014 and 1.3 per cent in 2015. In 2016 annual growth will climb to 2.8 per cent and become more broad-based.

In the coming year the main driver of the economy will continue to be private consumption, which has increased at relatively steady rate. Consumption growth has strengthened slightly this year after weakening a bit in 2013. One explanation for this is deflation. **Consumers expect the prevailing weak deflation to be temporary**; otherwise they would have become more cautious in their consumer behaviour, expecting even lower prices in the future. We believe that deflation will bottom out in the third quarter of 2014 and be replaced by inflation in Q4, when base effects will also kick in. Starting in early 2015, the rate will be lifted by excise tax increases, while global commodity prices will keep inflation relatively modest. Falling consumer prices have also slowed upward wage and salary pressure. Wage disinflation also been enforced by the lacklustre economic growth rate.

Strong real wage growth

Year-on-year percentage change

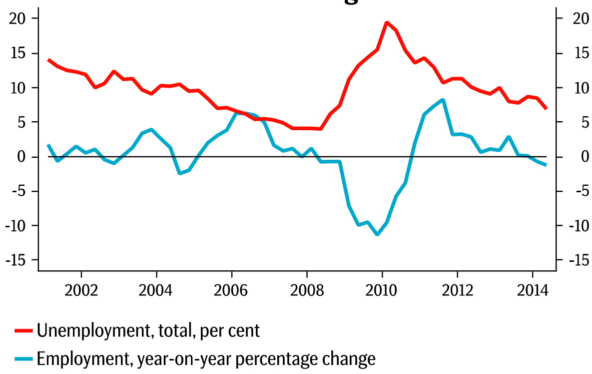


Source: Statistical Office of Estonia

Private consumption has been **supported by several factors**. The **labour market** has been very favourable, with the unemployment rate dropping to 6.9 per cent in the second quarter of 2014 and **real wages** growing at a strong 5 per cent year-on-year rate. Looking ahead, this trend will worsen slightly. As nominal wage growth starts to decelerate and when inflation starts to return, real wage growth will be squeezed somewhat. In addition, employment looks set to stabilise or decrease as companies facing the challenge of growing wages and weak economic growth try to boost their productivity. But wage growth will continue to be propped up by the fact that the labour force is shrinking and unemployment has declined below its equilibrium level of about 8 per cent. The shrinking labour force is showing a rare combination of simultaneously decreasing unemployment and employment.

Although the Estonian economy is driven by domestic consumption, its external balance has not deteriorated. On the contrary, during the second quarter there was a current account surplus equivalent to 0.9 per cent of GDP. This was because the consumption growth rate was relatively modest and capital spending stagnated at the same time.

Unemployment and employment simultaneously decreasing



Source: Statistical Office of Estonia

The **weakness in GDP growth is being caused by both exports and capital spending**. Exports remain the weakest link in the economy – especially merchandise exports, which have fallen for a year. **Export recovery continues to be hampered by meagre foreign demand, particularly in Finland and Russia.** Russia's restrictions on food imports from countries that have imposed sanctions due to the country's actions in Ukraine are adding to weaker demand from Russia and vicinity. Since these trade ties are relatively modest, at least initially the effects will not be broad. Russian food sanctions will only have minor direct negative effects on Estonia's exports, but will show up more in the transport sector. Since April 2014, total Estonian exports to Russia have decreased by about 20 per cent, but this is nothing unusual in trade flows with Russia. Despite Estonia's falling exports to Russia and Lithuania, export growth has been fluctuating around zero. Export volume has been stuck at the same level for four years. Foreign demand is expected to recover only slightly over the coming year. On the positive side, the real effective exchange rate is expected to start falling, both via low inflation and the depreciating nominal euro, which will provide some help to exports.

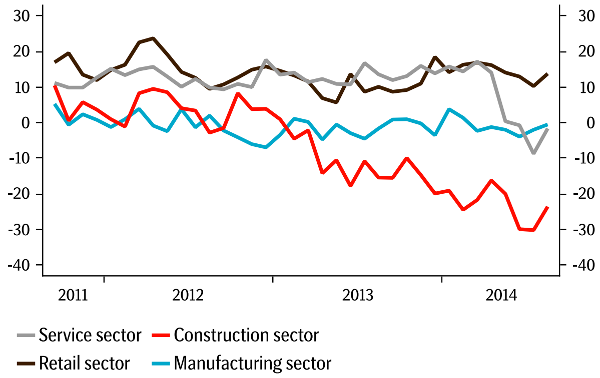
Although the national accounts show a capital spending increase in real terms during the first half of 2014, data about business investments reveal a decrease. Meanwhile public sector investments continued to decrease. **Public investments are not expected to recover until 2016. Company investments will only gradually recover** in 2015. Machinery-related investments have recently fallen even more than construction, although construction is known as one of the sectors facing the biggest challenges. Business investments are being hampered by anaemic growth prospects as well as a decreasing foreign fund inflow, whereas loans to companies are slightly increasing again.

Construction output decreased during the first half of 2014, although quite modestly. The drop in infrastructure projects is being offset by an increase in building construction. Early in 2014 the number of dwellings completed recovered from the low levels of recent years, and issuance of residential building permits sharply increased in the second quarter, indicating that the **recovery will continue in the residential construction field**. Increased building construction also slowed the price increase for residential space to 15 per cent year-on-year in Q2, and this disinflation trend is expected to continue.

The growth trend in various economic sectors has converged close to a zero rate, but the environment is more favourable for some sectors than for others. Differences in growth rates may thus widen again. In an economy driven by domestic consumption, the most likely beneficiaries are retail sales and domestic demand-related services, while transport, agriculture and construction will face the biggest difficulties. **Confidence indicators continue to reveal widening differences between sectors**, including clearly negative prospects for the construction and transport sectors, whereas the outlook for retail trade and manufacturing remain fairly stable.

Divergent sentiment among sectors

Net balance



Source: DG ECFIN

Lending is slowly picking up pace; outstanding loans to individuals are 2.2 per cent bigger than a year earlier and loans to companies 5 per cent above their year-earlier level. Because the nominal economic growth rate amounted to 4.4 per cent in Q2, lending is growing at a balanced rate.

Since the formation of the new Reform Party-Social Democratic government in March 2014, the two coalition parties remain popular, although their support has been decreasing slightly in recent months. The coalition is focusing on continuing to increase social expenditures next year, as well as cutting income tax rates from the beginning of 2015. **Fiscal policy will thus still be supportive of private consumption.** Because consumption growth has been stronger than the economy as a whole and the labour market has also remained strong, tax revenues have been good, further fuelling expenditure growth expectations. As of mid-2014, government finances were in balance and there was no need for increasing government debt.

Two new right-wing parties are in the process of formation. Their aim is to participate in the next parliamentary election in 2015. Both of them have grown out of existing right-wing parties and are not so different from them. The new parties are thus not expected to be very successful in the next election.

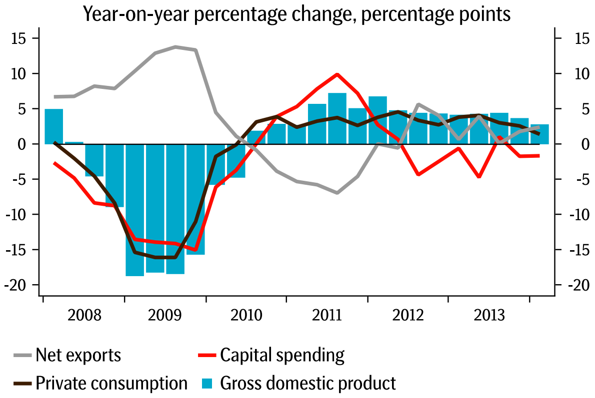
Geopolitics weighing down growth

- **Some government support measures**
- **Companies seeking export alternatives**
- **Domestic consumption keeping pace**

Latvia's economy, the EU's fastest growing during the past two years, has been in a gradual slowdown since the third quarter of 2013 when year-on-year GDP growth was as high as 4.6 per cent. In the first half of 2014, yearly growth ended up at a modest 2.5 per cent. The **slowdown is largely connected to the Russia-Ukraine conflict**. The construction industry has continued to show strong growth, while retail sales growth has been decent. Somewhat surprising is the stagnation in service sectors. This could be explained by the potential impact of the Ukrainian conflict.

GDP growth and contribution to growth

Year-on-year percentage change, percentage points



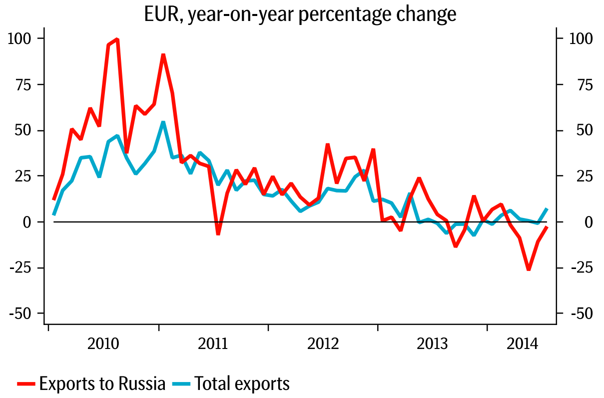
Source: Central Statistical Bureau

It is apparent that growth will face continued headwinds in the coming months. Aside from the tensions between Russia and the West, the economic rebound in the euro zone is still sluggish. **Exports will continue to increase at weak levels.** In this uncertain external environment **consumers will play a stabilising role**. Consumer confidence is at a historically high level and has been fairly resilient during the Ukraine crisis. Private consumption will remain robust. Meanwhile, **entrepreneurs will remain very cautious**, which will affect already **weak capital spending activity**. We expect the government to speed up its mobilisation of EU funds. This will be one of the priorities of the current and new government. All in all, Russia's sanctions and economic slowdown – the country accounted for 18 per cent of Latvia's total exports in 2013 – will have an impact on the Latvian economy, but it will not so powerful as to bring growth to a halt. **We expect GDP to grow by 2.5 per cent this year, 2.7 per cent in 2015 and 3.4 per cent in 2016.**

The direct impact of the sanctions is quite limited, although their indirect effects are being felt in a wide range of industries. The value of foods exported to Russia is estimated at 0.8 per cent of total Latvian exports, but the indirect effects are broader. That includes, for example, a drop in milk exports to Lithuania and in transport and logistics, as well as increasing uncertainty in other sectors operating in the Russia market. However, there are bright spots. There is a high probability that Latvian dairy producers will break into the Chinese market in the near future, thus offsetting market losses and creating a huge opportunity for the country's whole agriculture sector. The transport sector has held up well so far. Despite potential risks, cargo volume at Latvian ports in January-August of this year increased by 3.9 per cent compared to the same period in 2013. Freight carried by major transport sectors was up by a similar figure. The weakening Russian economy will mainly affect road carriers.

Shrinking exports to Russia

EUR, year-on-year percentage change



Source: Central Statistical Bureau

Companies will need time to adapt to these new conditions as well as government help. Latvia's total export volume is relatively small and it should not be difficult to find alternative markets. **What could suffer most is company profitability.** Taking into account the effects that will be felt in Russia itself, it is possible that sanctions will be subject to exceptions, allowing individual companies to continue exporting there, or on the contrary face specific new administrative restrictions on their activities. Thus, companies in the affected markets will have to operate under uncertain conditions.

In response to demand, the **government is granting tax holidays for companies affected by Russian sanctions**. This applies to companies with more than 10 per cent of their total sales volume going to Russia. In addition, the government will allot EUR 4 million in support measures for companies taking steps to enter new export markets. The same criteria apply to these companies' suppliers. Furthermore, the companies affected by Russian sanctions will get loan guarantees from the government. The maximum sum that can be allotted to loan guarantees for one company is EUR 1 million.

We do not foresee a more expansionary fiscal policy as a response to the negative effects of the Russia-Ukraine conflict and weaker Russian demand. Given lower growth, it will be challenging to increase budget expenditures, and in the current geopolitical situation there is a clear need to increase funding for military spending. Taking into account the seriousness of the situation, minor budget deviations over the next couple of years would be rational.

Industrial output fell by 1.5 per cent in the first seven months of the year. Manufacturing managed to grow by 0.5 per cent, mining and quarrying by 5.6 per cent. The situation remains tense, but not severe. We **expect uneven performance among sectors**, though several sectors such as wood processing, chemicals, computers, electronics and optical production will show resilient growth. The food production sector still has positive longer term growth perspectives. Despite weaker Russian growth and a gloomy export outlook, during the first seven months of 2014 total Latvian export volume managed to grow by 2.5 per cent, while imports were down 1 per cent.

In the first seven months, retail sales grew by a decent 3.8 per cent. Taking into account the low inflation environment and expectations that relatively healthy nominal wages increases will continue, real wages will keep contributing to **growing domestic consumption**.

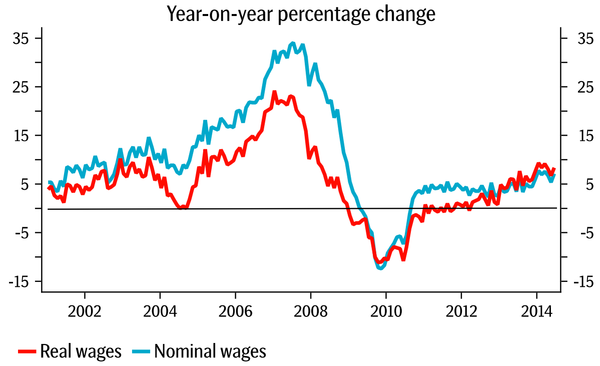
A gradual pick-up in exports during 2015, combined with a modest upturn in currently low capital spending and slightly higher consumption growth, will keep Latvia's current account deficit small. We regard the relatively large deficit during the first half of 2014 – 3.6 per cent of GDP – as temporary and primarily caused by weak exports.

Unemployment continued to fall in the second quarter and averaged 10.7 per cent. This was 1.2 percentage points lower than in the previous quarter. Despite lower growth prospects, we believe that **unemployment will keep shrinking**.

Declining unemployment has led to a **gradual upturn in wage growth in recent years**. In the second quarter, average gross wages and salaries were 6.4 per cent higher year-on-year. In the private sector, wages and salaries rose slightly faster than in the public sector. However, average pay in the private sector is lower. Take-home wages and salaries rose more rapidly, by 8.4 per cent. This was due to a decrease in the employee social security contribution rate from 11.0 per cent to 10.5 per cent, as well as an increase in the non-taxable amount of personal income implemented this year.

Wage growth back at relatively strong levels after a boom and bust period

Year-on-year percentage change



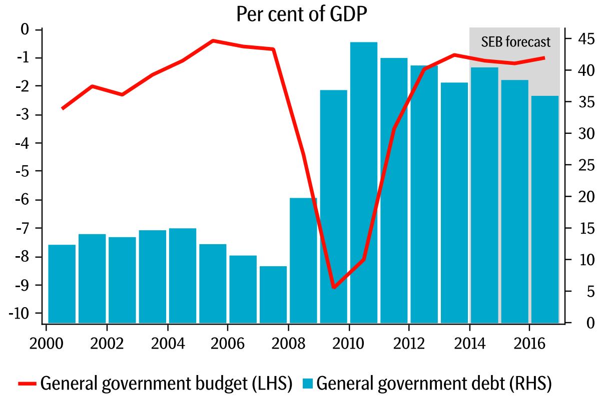
Source: Central Statistical Bureau

Price pressure remains subdued. In August, year-on-year inflation was 0.8 per cent. So far inflation is mostly being driven by rising prices for services, since prices of goods are quite rigid. In the short term, inflation is being held down by lower food and oil prices. We expect inflation to gradually pick up a bit in 2015-2016. Starting in January next year, price increases for household electricity will be one of the main factors. Growing wage pressure will also start to show up in higher inflation. Our inflation forecast is 0.7 per cent in 2014, 2.1 per cent next year and 2.1 per cent in 2016.

On **October 4** Latvia held **parliamentary elections**. As expected, the centre-right coalition was re-elected. The ruling parties won 58 per cent of the votes and are expected to control 61 out of 100 seats in parliament. This means that the government parties won a larger share of the seats compared to the 47 they received in the 2011 election. Thus **no major political shifts** are envisaged. Good economic fundamentals, with both public finances and the external balance in good shape, will contribute to political stability.

General government budget and public sector debt

Per cent of GDP



Source: Central Statistical Bureau, SEB

Stable growth amid geopolitical worries

- **Domestic market cushions export challenges**
- **Russia-Ukraine conflict weighing down sentiment**
- **Improved energy supply within reach**

In the first half of 2014, the Lithuanian economy fared rather well. GDP growth remained quite solid at 3.1 per cent year-on-year. Economic growth is now driven by domestic demand, including both capital spending and private consumption. Meanwhile, exports are shaky and have clearly lost steam. In a one- or two-year horizon, the **economy will be capable of resisting external challenges and maintaining stable growth** on the back of recovering investment and stronger export demand. Exports to Russia will be challenging but the expected recovery in the euro zone will provide some support. **We expect GDP to increase by 2.7 per cent in 2014, 3.2 per cent in 2015 and 4.0 per cent in 2016.**

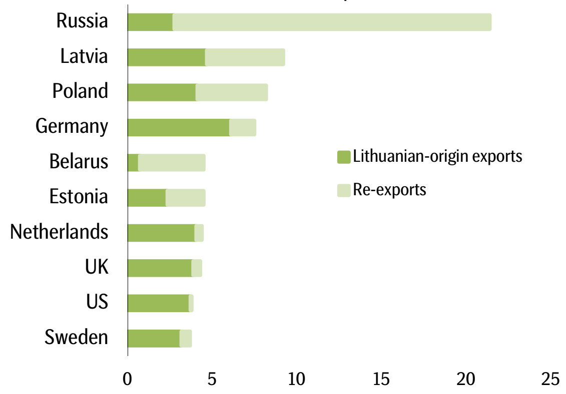
Exports and industry have faced numerous trials this year. First of all, exports and industrial figures were **negatively affected** by a drop in production volume from the country's largest exporter, **the Orlen Lietuva oil refinery**, which used to account for as much as a quarter of total merchandise exports. In the wake of the shale oil revolution in the United States, Orlen Lietuva has had difficulty competing with cheaper American oil products in the European market and has therefore sharply reduced its production. These external pressures are unlikely to ease and will continue weighing down exports even more significantly than Russian sanctions on Lithuanian food products.

The Russian sanctions on imported foods, launched in August 2014, will have an additional negative impact on the country's exports for one year, if the embargo holds as planned. **Lithuania is the EU member country most severely affected by the Russian sanctions.** The share of Lithuania's exports to Russia is high (21 per cent of total exports in the first half of 2014) and the proportion of sanctioned products is among the largest in the EU. However, **the effect of the sanctions will be limited**. The embargo affects only 4 per cent of total Lithuanian exports. The final impact may be even smaller, due to higher sales in other markets. In addition, **87 per cent of exports to Russia are re-exports, and the transport sector is likely to be affected more than industrial companies**. Most of the companies which had business in the Russian market were aware of the risk they were taking and most of them had alternative business plans. The largest dairy companies, which used to sell as much as 15-30 per cent of their production in Russia, have stated that the sanctions do not pose any threat to their viability but will affect their profitability.

Large re-exports to Russia

Lithuania's top 10 export destinations

Per cent of total exports



Source: Statistics Lithuania, SEB

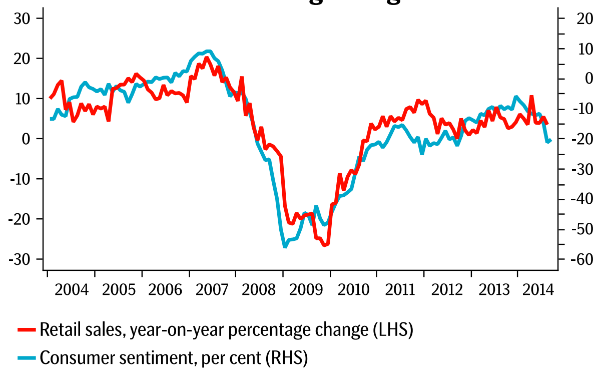
Food and other agricultural products make up half of Lithuanian-origin products exported to Russia and there are barely any other vulnerable export groups left for additional sanctions, with the sole exception of machinery and equipment. Moreover, the sanctions are planned to expire in August 2015 and in that case there would be a positive effect afterwards. **Current sanctions on food products may lower Lithuania's GDP by up to 1 per cent during 2014-2015.** Restrictions on Russian energy exports would have much more far-reaching consequences for the Lithuanian economy than import sanctions.

Developments in the energy sector have moved in a **positive direction** during 2014. Beginning in July, Gazprom reduced its gas price for Lithuania's largest retail gas supplier and several other companies by more than 20 per cent until 2016. Consequently, the upcoming heating season will be the cheapest one since 2007. Furthermore, Lithuania will launch its own LNG terminal in Klaipėda as of December 2014, which will help a great deal to secure diversified gas supply under market conditions (100 per cent of gas is currently bought from Gazprom). The obligatory minimum annual amount of LNG will be supplied by Norwegian-based Statoil, while Lithuania has also signed general non-binding LNG master trade agreements with seven global LNG suppliers. In 2015, when the terminal becomes fully operational, its capacity will fully cover Lithuania's own needs and the country will also be able to trade in the international LNG spot market. In 2015, electric power links to

Poland and Sweden will be opened and Lithuania will thus gain access to new energy markets. At the moment, Lithuania imports electric power from Latvia, Estonia, Russia and Belarus.

During the first half of 2014, domestic demand gained strength based on both improving fundamentals and rather bright expectations. Private consumption increased by 5 per cent year-on-year, supported by increases in real wages, rising employment, low inflation and growing remittances from abroad. At the beginning of 2014, **consumer sentiment** stood as high as in early 2008 but **soured noticeably during the summer**, primarily due to geopolitical uncertainty. Retail sales continued growing but sales of durable goods slowed down or even started decreasing.

Sentiment lower due to Ukraine crisis, but retail sales still growing



Source: Statistics Lithuania, DG ECFIN

The Russia-Ukraine conflict will remain one of the most important factors affecting household financial behaviour. However, **real wages will grow by 4-5 per cent in 2015-2016**, including increases in minimum wages. Cheaper central heating will **support consumption**, especially in households with the lowest income.

The unemployment rate has continued shrinking, albeit at a slower pace, and averaged 11.2 per cent in the second quarter of 2014. The labour market is facing problems on two fronts. On the one hand, structural unemployment remains rather sticky. On the other hand, headhunting is becoming increasingly widespread, especially in the construction, transport and service sectors. Quite paradoxically, Russian sanctions may alleviate the labour shortage in the transport sector.

Construction was the fastest-growing sector in the first half of 2014 and the **residential property market started heating up, after stagnating for five years**. In the first quarter of 2014, home sales jumped by 44 per cent year-on-year. As a consequence, residential property prices started increasing from their post-crisis lows. However the recovery in the housing market was rather short-lived. In the second quarter, the growth in home sales slowed to 14 per cent and in July-August the number of deals decreased by 2 per cent year-on-year. Residential property price growth was rather modest. In August 2014, apartment prices in the largest cities were up by 5 per cent from their lows.

The fall-back in the residential property market recovery may be explained by several factors. First, most home purchases in 2014 were financed with buyers' own funds rather than mortgages. Borrowing appetite remains weak despite favourable credit conditions, including very low interest rates. Furthermore, at the beginning of 2014 some individuals saw euro introduction as a future trigger of home price increases, but rational economic arguments in the media convinced most of them to lose their enthusiasm. Geopolitical tensions also weighed down expectations regarding the housing market. Property developers maintained a restrained tone in their communication, compared to the pre-crisis bubble in 2005-2007. Looking ahead, in 2015-2016 we expect a gradual and moderate recovery in the residential property market.

The **upturn in capital spending has been somewhat cautious**, primarily due to lingering uncertainty about external economic conditions as well as political factors. In the first half of 2014, fixed investment increased by 12 per cent at constant prices year-on-year but its volume reached only two thirds of pre-crisis levels. At the same time, capacity utilisation in the manufacturing sector increased to 76 per cent, an all-time record. The current weak growth in capital spending and high resource utilisation suggest that investment will recuperate at a moderate pace over the next couple of years.

Inflation is very low, with the year-on-year HICP rate reaching only 0.4 per cent in August 2014. **Price increases will remain subdued during the next couple of years.** Cost-push forces will be weak, especially in the short term, due to falling international commodity prices, cheaper gas and heating costs and the large supply of food products after the imposition of Russian sanctions etc. Price rounding due to the euro introduction in January 2015 is expected to add 0.2-0.3 percentage points as in other countries. All in all, **average annual HICP inflation should be 0.1 per cent in 2014, 0.7 per cent in 2015 and 1.0 per cent in 2016**. The main reason behind the upward inflation trend in 2015-2016 will be the gradual awakening of demand-pull pressures.

The approaching **euro introduction** has already had a favourable effect on the country's borrowing costs and credit ratings. The **attitude of the general public** towards the euro has also become **slightly friendlier** in recent years. According to the Eurobarometer survey in September 2014, 47 per cent of Lithuanians were in favour of euro introduction, up from 41 per cent in April 2013. Meanwhile the share of those opposed to the euro has decreased from 55 per cent to 49 per cent.

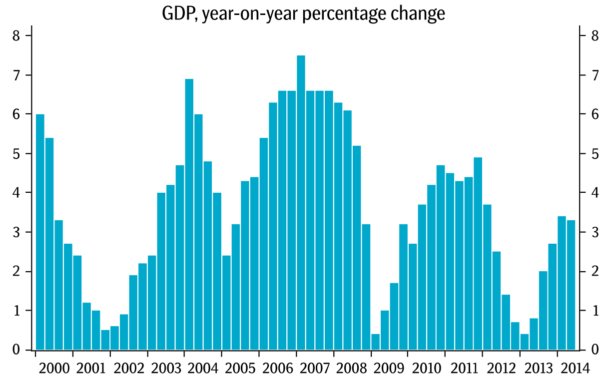
A brief economic slowdown – due to nearby instability

- **German slump, Russian weakness to blame**
- **Favourable situation for domestic demand**
- **Uncertainty and deflation will bring rate cut**

Poland will show a **slight dip in growth in the second half of 2014**. This is due to a temporary slump in demand from Germany, along with decelerating growth in Russia and a short-term capital spending decline because of increased regional uncertainty due to the Russia-Ukraine conflict. But early in 2015 growth will gradually ramp up again, sustained by a rebound in Germany and Western Europe generally and triggering a renewed upswing in sentiment indicators. More monetary stimulus this autumn will also help boost domestic demand. With its relatively small economic imbalances, Poland is still well-positioned for a solid recovery over the next couple of years. **Growing private consumption and both private and public investments will be drivers, while exports will be hampered** by continued weakness in Russia and Ukraine. **GDP will rise by 2.7 per cent this year, 3.0 per cent in 2015 and 3.5 per cent in 2016**; our forecasts are below consensus.

Good growth until the second quarter of this year

GDP, year-on-year percentage change

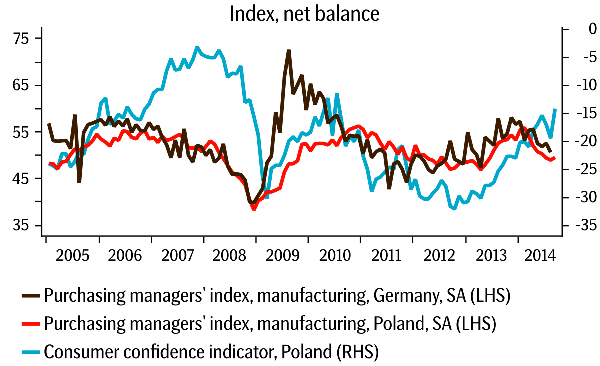


Source: Central Statistical Office of Poland

Poland was the only EU country to avoid recession during the latest global crisis, both the US-driven phase and the Western European phase in 2010-2013. **This year also began decently.** Year-on-year GDP growth of 3.3 per cent in Q2 was largely unchanged from the first quarter. Meanwhile **signs of impending slowdown** were discernible. **Quarter-on-quarter growth halved to 0.6 per cent in Q2**, according to the national accounts. The main reason was lower net exports. Official monthly statistics show that exports as well as retail sales slipped noticeably in June and July. **Sagging sentiment indicators** also point to lower second half growth figures. For example, after an earlier strong upturn phase the purchasing managers' index (PMI) in manufacturing has fallen from its 38-month high of 55.9 in February 2014 to a 15-month low of 49.0 in August – below the expansion threshold of 50. September saw a marginal upturn to 49.5. Weakened export demand is the main reason behind this downturn in PMI. **The decline in consumer confidence has been less; the September reading shows a rebound**, wiping out the decline. Also worth noting is that construction industry sentiment has kept rising (albeit at a relatively low level) and that the indicator for all industrial sectors has also climbed a bit, according to the European Commission's monthly surveys. The manufacturing index has probably fallen because international business cycles have more impact on it. Germany and other Western European countries have shown a similar pattern of weakening PMIs. Our conclusion is that **Poland has been infected by German – and to a lesser extent Russian – weakness**; about 25 per cent of exports go to Germany including a large share to manufacturers, and 5 per cent is destined for Russia.

Polish PMI is tracking German PMI - pointing to a short-term manufacturing slowdown

Index, net balance



Source: Markit Economics, Central Statistical Office of Poland

Prospects for growing domestic demand are favourable. Private consumption will be fuelled by continued good real household income. Due to projected lower inflation, we are raising our forecast of real wage increases in 2014-2015 to about 3 per cent yearly, from 2 per cent in our March issue. The number of jobs has been rising, albeit at a modest pace, since late 2013. Poland's relatively high unemployment of about 10 per cent will ease slightly. Given our moderate growth scenario, the labour market will continue to gain strength at a leisurely pace. **Interest rates will also remain low.** An expected minor inflation surge in 2015 and a calm rise in global interest rates point to a weak increase in both short-term interest rates and long-term yields during the next 1-2 years. This will encourage credit demand, which has been subdued in recent years largely because of relatively tight credit conditions for both households and businesses. The Polish banking system has been robust throughout the international crisis but has been adversely affected due to debt deleveraging by the Western European parent banks that dominate the banking sector. Due to the fading euro zone crisis**, credit conditions have been gradually thawing** in recent years. This trend has been broad-based, but during recent quarters conditions have tightened for home loans, according to the latest central bank survey of banks. There is increased demand for loans across many sectors, especially consumer loans. A brighter outlook for the Polish economy was by far the leading reason stated by banks for continuing to ease their credit conditions. This shows that they no longer regard the euro zone crisis as an impediment.

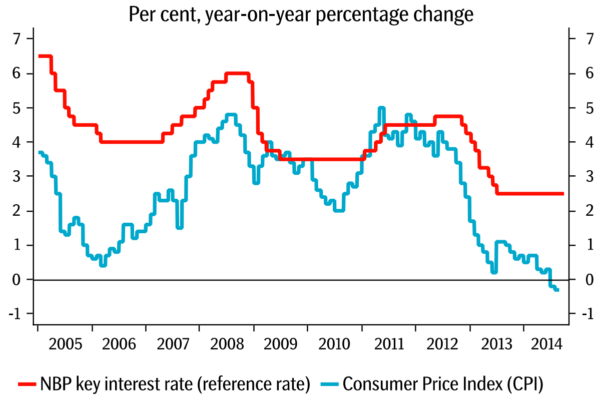
As expected, **capital spending** has rebounded in 2014 after falling for two years. It grew by a relatively strong 10.7 per cent year-on-year in the first quarter and 8.4 per cent in the second. So far it is difficult to discern more than **marginal negative effects from the Ukraine crisis, but we can expect some slowdown in investment activity because of it**, at least during the second half. Meanwhile various factors suggest a good investment climate over the next couple of years both in the private and public sector. The investment ratio is relatively low, industrial capacity utilisation is high and interest rates are low. New structural funds will also be allocated from the EU's 2014-2020 budget; Poland is the largest single recipient. The amount it will get (EUR 105.8 billion) is nominally more than in 2007-2013, even though the EU has tightened its total budget.

Inflation has slowed greatly since mid-2012, when it was more than 4 per cent year-on-year. Since October 2013 it has remained less than 1 per cent. Last summer it dropped below zero. Producer prices are also depressed; in the August PMI, the price index for manufactured goods fell for the 21st month in a row. Our GDP forecast implies that Poland will reach its potential growth of about 3 per cent next year, yet **inflation will rise only slowly**, averaging 1.3 per cent in 2015 and 2.0 per cent in 2016. Pay rises will accelerate moderately. Combined with higher economic activity and base effects, this will boost inflation. But due to remaining labour market slack, the output gap will not close until 2016. We expect the zloty to appreciate somewhat, holding down import prices. Global price pressures will also remain weak; we expect oil prices to fall next year, and upturns for other commodities will be restrained by modest global demand. Short-term inflation will be held down by lower fruit and vegetable prices due to Russia's import ban.

During the big decline in inflation, the National Bank of Poland cut its key rate dramatically from 4.75 per cent in November 2012 to a record-low 2.50 per cent in summer 2013. The minutes of the latest monetary policy meeting on September 3, which left the key rate unchanged, were clearly "dovish". They were also dominated by noticeably greater concern about weaker growth in Poland and the euro zone – partly connected to the Ukraine crisis – and about excessively low inflation. **We predict two 25 basis point cuts to 2.00 per cent this autumn**, starting at the October 8 meeting; a 50 basis point cut cannot be ruled out. Assuming continued inflation far below the 2.5 per cent target in 2015, a policy shift and initial rate hike will not occur until 2016.

Rapid downturn in inflation and key interest rate

Per cent, year-on-year percentage change



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

Poland's economic fundamentals remain relatively solid. The current account deficit fell from 5.0 per cent of GDP in 2011 to 1.3 per cent last year, for both cyclical and structural reasons. One sign of the latter is that exports have made decent market share gains for several years. We predict small current account deficits – 1-2 per cent of GDP – over the next couple of years. Public debt peaked at 57 per cent of GDP last year and is expected to end up around 50 per cent from this year onward: below the Maastricht criteria benchmark of 60 per cent. This year's large decline in debt is almost entirely due to a transfer of a large proportion of private pension funds to the state. Some additional yearly transfer will also occur later. The public sector budget shifted from a deficit of 4.3 per cent of GDP last year to a surplus of about 5 per cent this year, again mainly due to the "pension deal". But new EU accounting rules (with ESA 2010 replacing ESA 95) went into effect this September, preventing this type of transfer. Poland will thus revert to a budget deficit in 2015. Helped by consolidation measures, the deficit is expected to end up around 3 per cent of GDP, which is also the Maastricht limit for EU countries.

The centre-right coalition led by the Civic Platform has been fighting an uphill battle against declining public support during the past year. Earlier belt-tightening, internal party tensions on certain issues and "Waitergate" – a scandal involving ministers whose conversations were recorded during restaurant visits – are among the reasons. But we believe that **the government**, in its second term since the 2011 election, **will hold together until the autumn 2015 election**. A gradual improvement in the economy will probably benefit it. **The change of prime minister** this autumn, with Ewa Kopacz replacing Donald Tusk – who was appointed president of the European Council – **will not change the government's policy direction**. Ms Kopacz, speaker of parliament and a former health minister, is generally regarded by political observers as close to fellow party member Tusk in policy terms. The euro issue may well be raised during our forecast period, as Kopacz is outspokenly pro-euro. For some time, our view has been that the government is readying the economy to qualify for the euro zone, but without committing itself to a timetable.

Prolonged stagnation

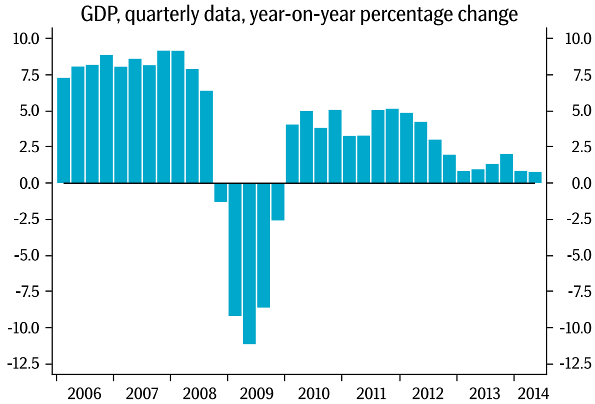
- **Ukraine conflict is worsening Russia's structural weakness**
- **Energy sector is being squeezed**
- **Increased popular support for Putin, but rising long-term political risk**

The conflict with Ukraine and sharply heightened tensions in relations with the West are having a major impact on the structurally weak Russian economy. Capital outflows accelerated greatly when Russia annexed Crimea and the first round of Western sanctions went into effect. The willingness of both domestic and foreign companies to invest in Russia fell further, worsening an already downward trend. The stock market and currency took a severe beating. Rouble depreciation has pushed up inflation, forcing the central bank to pursue a tighter interest rate policy. Along with rising long-term yields, this has further hampered economic performance.

A trend towards easing of military and diplomatic tensions in May and June was replaced by re-escalation after the downing of a Malaysian passenger plane in mid-July. The conflict turned worse in late August, when Russia began more openly supporting the separatists in eastern Ukraine. Capital outflows again accelerated, the rouble and stock market weakened once more and Russia's actions triggered tighter sanctions by the West, but the summer's tough battles have diminished since a fragile ceasefire agreement was reached on September 5.

Prolonged deceleration in economic growth

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



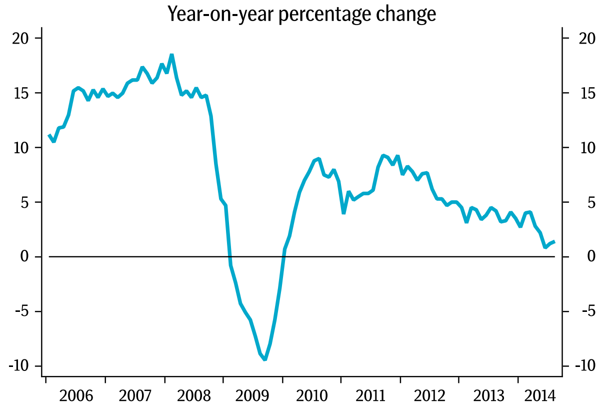
Source: Russian Federal State Statistics Service

The conflict with Ukraine has worsened the slowdown in economic growth that has been under way for some time. Despite weak growth, inflation is high and the labour market is strong (unemployment has fallen below 5 per cent): a clear sign that **the deceleration is structural** rather than cyclical. **The main force driving the slowdown is weak capital spending**, as we have emphasised in earlier reports (for example, Economic Insights, "Russia: Re-igniting investments key to boosting long-term economic growth", December 2013). The unfavourable investment trend is driven by well-known structural problems such as poor business climate, excessive government influence on the economy, demographic deterioration and heavy dependence on energy exports. **There is great need for reforms.** Russia has taken reform steps (such as a new budget law and a central bank inflation target), but more must be done to push up the investment ratio, which is low compared to other developing economies. Unfortunately there are signs that reform efforts are now slowing.

GDP growth has tumbled since last year. In the first half of 2014, year-on-year GDP expansion averaged just above 0.8 per cent, compared to 1.3 per cent in 2013 as a whole. Economic indicators such as purchasing managers' and consumer confidence indices are at historically low levels, pointing to stagnation rather than recovery. The poor business climate has worsened. Western economic sanctions have created great uncertainty, further weakening the willingness of companies to invest. In August, capital spending fell by lose to 3 per cent year-on-year. This weak trend is reflected in a bumpy performance for industrial production. Exports are subdued but will benefit somewhat from rouble depreciation. Meanwhile the oil price downturn that has been under way in recent months is expected to continue next year. In the past few years, **private consumption has been a key driver of economic growth, but it is now weakening**. In recent months, retail sales have slowed significantly and have been increasing far more slowly than in 2013. The main reason is weaker real wage growth.

Slower increase in retail sales

Year-on-year percentage change



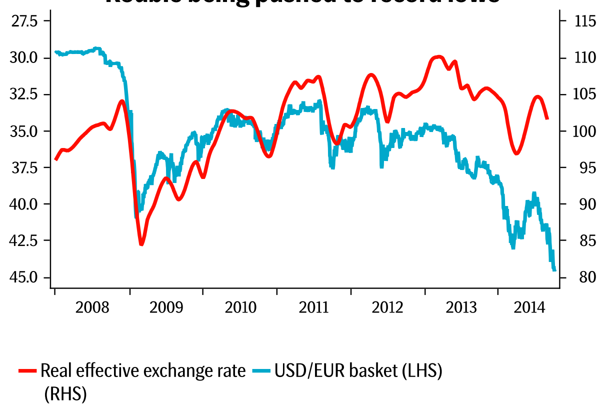
Source: Russian Federal State Statistics Service

Western economic sanctions against Russia have escalated in several rounds. The EU has reached the toughest phase (No. 3) of its action plan. Sanctions initially targeted individuals (travel bans and asset freezes) and certain companies but have subsequently been broadened in order to have a more general impact on the financial, energy and defence sectors. In practice, selected banks and companies are being prevented from borrowing money in European and US capital markets, while major oil companies are being blocked from technological cooperation with the EU and US. The sanctions have clearly been designed to avoid affecting Russia's energy deliveries to Europe. Despite this escalation, **the direct effects of the sanctions on economic growth are still relatively limited**, although their impact on individual companies will be large in some cases. The most powerful effects of the sanctions are indirect, due to greater uncertainty about developments in Russia and speculation that sanctions will be tightened further. The sanctions are worsening an already weak investment trend and contributing to the deceleration in growth. We believe that **the current sanctions, including Russia's ban on food imports, will remain in place during 2015 but will not be escalated. Nor do we expect any serious disruptions in Russian energy exports to Europe.** Both sides are reluctant to start a large-scale trade war, since the euro zone recovery is fragile and the Russian economy is very weak.

As long as an escalation in the conflict with Ukraine is avoided and the sanctions are not tightened any more, we believe that Russia can avoid a growth slump. The decline in capital spending may then slow in 2015, and the weak rouble as well as stronger external demand may provide some support to the economy through net exports although the expected oil price downturn will have a contrary effect. **We expect GDP to increase by 0.4 per cent in 2014 and to shrink by 0.2 per cent in 2015. In 2016 there is potential for a cautious recovery, and we expect GDP to grow by 1 per cent.** Our forecasts remain below consensus. If Western sanctions are lifted, there is a chance of faster growth.

After depreciating during 2013, **the rouble has continued to weaken**. So far this year, it has fallen by some 20 per cent against the USD. Depreciation has continued and the rouble has reached record lows driven by geopolitical developments, falling oil prices and reduced central bank intervention.

Rouble being pushed to record lows



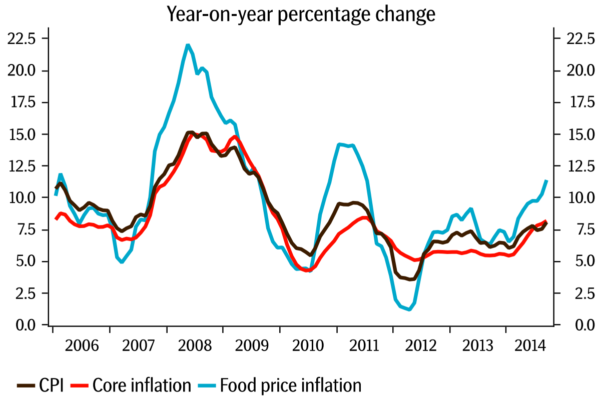
Source: BIS, Macrobond

Despite this weakening of the rouble, its real effective exchange rate is still higher than five or six years ago, which hurts Russia's competitiveness. In our assessment, the rouble is still overvalued and we expect it to continue depreciating. As earlier, long-term drivers of rouble depreciation are the weakening of the current account balance, poor growth prospects and capital outflows. **We expect the rouble to be worth 40.2 per USD at the end of 2014 and 43.0 at the end of 2015. By the end of 2016, we expect the rouble to be worth 40.0 per dollar.**

Inflation climbed from 6 per cent early in 2014 to 8.1 per cent in September. Higher inflation is largely explained by rouble depreciation, which has pushed up prices of imported goods. The ban on food imports will also contribute to higher inflation by raising food prices. The central bank has been forced to revise its inflation target. We believe that the medium-term target of 4 per cent cannot be achieved during our forecast period. Because of rouble depreciation and the food import ban, we have revised our inflation forecast higher since last spring. As annual averages, **we expect 2014 inflation to end up at 7.4 per cent. In 2015, inflation will slow to 6.5 per cent. In 2016 we foresee inflation of 5.5 per cent.**

Rouble depreciation has driven up inflation

Year-on-year percentage change



Source: Russian Federal State Statistics Service

The central bank is continuing its preparations for a transition to floating exchange rates and inflation targets in 2015, but amid a very challenging environment of rising inflation, falling growth and financial market turbulence. Since February 2014, the key interest rate has been hiked by 250 basis points. It now stands at 8 per cent. One important reason for this tightening of interest rate policy is an attempt to reduce capital outflows, which totalled about USD 75 billion in the first half of 2014, compared to USD 60 billion for the full year 2013. After decreasing in the second quarter, outflows are believed to have accelerated again in the third quarter. Russia's extensive currency reserves and low central government debt will protect it against an acute current account crisis, however. The key interest rate has also been hiked in order to counter the weakening of the rouble and the resulting increase in import prices. These rate hikes signal the willingness of the central bank to push down inflation, and the bank's communication does not indicate that easier monetary policy aimed at stimulating the economy is in the cards. We believe is that **the key interest**

rate will remain at 8 per cent during the rest of 2014. In 2015 there will be another 50 basis points hike. Towards the end of 2015, we expect a cautious loosening of monetary policy to begin.

Amid the prevailing financial turbulence, Russia's **stable banking system** is an asset. Banks are fairly well-capitalised, and their proportion of bad loans is relatively low: about 6 per cent. The rapid increase in consumer credit, which has been among the most serious systemic risks, has also slowed. Refinancing needs are not especially large in the short term. The central bank has also tightened its supervision of the financial system. The slowdown in growth, combined with the impact of sanctions and higher interest rates, is nevertheless creating challenges. In practice, **the sanctions have made it impossible for selected Russian banks to borrow abroad**, creating a shortage of dollar liquidity and contributing to the depreciation of the rouble. There are also clear reform needs. A few large state-owned banks are dominant, while the system lacks depth – with low lending as a percentage of GDP – and is generally poor at moving savings into productive investments.

Lower oil prices will squeeze energy sector

After peaking in June at around USD 115 per barrel, oil prices have dropped below USD 100/barrel. Measured as annual averages, we estimate that oil prices (Brent crude) will end up at USD 105/barrel in 2014. The SEB oil forecast for 2015 has been revised downward substantially; **we expect oil prices to fall to USD 85/barrel in 2015** and then rise somewhat to **USD 90/barrel in 2016.** The main reason why a price above USD 100/barrel cannot be maintained is weak demand, both from Europe and China. Meanwhile the supply of American shale oil is increasing, which is also helping to push down oil prices.

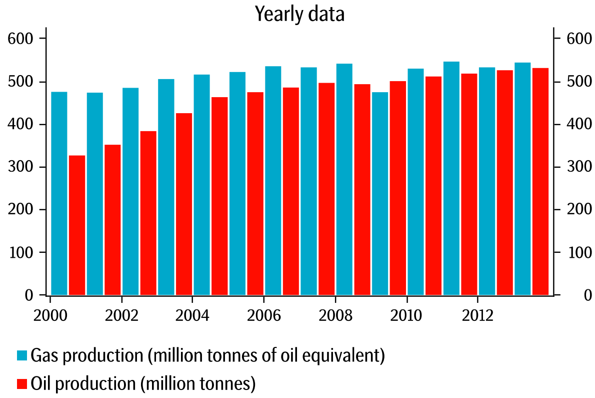
Lower oil prices are bad news for the Russian economy, which **remains heavily oil-dependent**. Much-needed diversification away from dependence on energy exports has not begun in earnest. Oil accounts for some 60 per cent of total exports and for more than half of budget revenue. To quote US Senator John McCain, Russia is "a gas station masquerading as a country". Oil price changes have a major impact, especially via export and tax revenues. At present, the national budget is in balance when oil prices are at around USD 105/barrel. In 2007, the budget was balanced at USD 40/barrel. Our interpretation is that the government is taking seriously the problem of rapidly rising federal expenditures in prior years and will thus abstain from pursuing a more expansionary fiscal policy, as long as the deceleration in growth does not become significantly sharper than we are forecasting.

The Russian government's 2015 oil price forecast is well above SEB's: USD 100/barrel compared to USD 85. If our forecast proves correct, it is even more unlikely that the government will respond to slower growth with a more expansionary fiscal policy. The weakening of the rouble provides some budget support, since it strengthens the value of government oil revenue in local currency terms, but this cannot fully offset the weakening of the budget. We estimate that **the federal budget will end up in balance this year. In 2105 we expect the deficit to be 1 per cent of GDP, increasing to 1.5 per cent in 2016.** Lower oil prices will also mean that the expected shift to a current account deficit will occur faster. We believe that the current account surplus will decrease to 0.5 per cent of GDP in 2014. In 2015 we expect a deficit of 0.5 per cent, increasing to 1.0 per cent in 2016. Because of large-scale currency reserves, however, Russia can manage a weakening of its current account balance without risking an acute crisis.

Lower oil prices will put pressure on the energy sector, which has faced major challenges for some time. **Total gas and oil production has stagnated.** One problem is that many of Russia's gas and oil fields are old and extraction volume is thus shrinking. Meanwhile, as in the overall economy, capital spending has been far too small. Russia is also a latecomer in the "shale revolution"; a market structure that is dominated by a few large state-owned companies (mainly Gazprom and Rosneft) is poorly suited to meet the need for capital spending and new technology. Russia has thus sought cooperation with foreign energy companies.

Gas and oil production is stagnating

Yearly data



Source: BP

Aside from stagnating production, the energy sector also risks being hurt by shrinking demand. Because of rising tensions between Russia and the West, the EU has begun taking steps to reduce its dependence on Russian natural gas, among other things by boosting imports from other countries. Ukraine, too, is trying to reduce its long-term dependence on Russian gas and has signed an agreement with Royal Dutch Shell on shale gas extraction, but these measures will take time and both the EU and Ukraine will remain dependent on Russian gas.

The West has avoided aiming its sanctions at the Russian gas sector and gas exports, but has prohibited foreign businesses from supplying Russian companies with technology and services related to oil extraction. This ban will have little impact in the short term but risks creating substantial difficulties in the long term. There are already examples of how the ban has hurt. For example, the US-based oil company Exxon is in the process of withdrawing from cooperation with Rosneft on oil extraction in the Arctic. If Russian energy producers have no opportunity to cooperate with foreign companies on technology and investments, it will be substantially harder to make progress on extraction of shale oil as well as oil extraction in more inaccessible regions such as the Arctic.

Turning east and seeking cooperation with China is no simple solution, because China has also lagged behind in the shale revolution and faces problems similar to those of Russia. Nor can China or the rest of Asia replace European demand for gas within the foreseeable future, although Gazprom did sign an agreement in May with the Chinese energy company CNPC on Russian gas deliveries over a 30-year period. But the economic advantages for Russia will be limited; annual export volume will be relatively small and prices will be substantially lower than those paid by Gazprom's customers in Europe. The gas agreement is thus mainly symbolic, although Russia's ambition to create new markets in Asia is clear.

Overall, it is difficult to see how Russia will be able to speed up its gas and oil production. The most likely scenario is that production will stagnate over the next few years and then gradually decline. **A weak future outlook for the energy sector will hamper GDP growth in the long term.**

Tough foreign policy causing concern

While the conflict between Russia and Ukraine has unfolded, Russia's objective has become clearer. As we have argued in earlier reports, Russia wants to draw Ukraine closer to itself and prevent closer cooperation with the West. Last spring, when President Viktor Yanukovych's regime was replaced by a Western-oriented government in Kiev, Russia lost much of its influence over Ukraine. We believe that **Russia's goal is to force a federalisation of Ukraine** in order to thereby gain a more permanent influence on developments and make it harder for Ukraine to move closer to the EU. This reinforces our view that **the conflict between Russia and Ukraine and the unrest in eastern Ukraine will be long-lasting**. Since steps have been taken towards a federalisation of Ukraine – in the form of plans for expanded self-government in the two easternmost regions – Russia is probably pleased with how the conflict has evolved. Until further notice, it will support the ceasefire, which is a prerequisite to the eventual lifting of Western sanctions against Russia.

Russia's handling of Ukraine is one example of a tougher foreign policy stance. Russia uses a combination of diplomatic, military and economic pressures to create various kinds of influence over its neighbouring countries (see the theme article) and to improve its security situation. **Russia has responded with its own sanctions against the West.** Food imports from Western countries that have imposed sanctions were prohibited on August 7 for one year. A ban on allowing foreign airlines to use Russian airspace has been proposed but not implemented in practice. One measure that might severely hurt individual foreign companies is a proposed law that would make it possible to take over foreign assets in Russia. The idea is that this law would compensate Russian citizens and businesses whose foreign assets have been frozen. But it is uncertain whether the proposed law would be used in practice, although there is generally a clear trend towards harsher treatment of foreign companies in Russia.

Russia's actions have resulted in very tense relations with the West. Deep concern has arisen in a number of countries in the vicinity of Russia. The West has primarily responded by means of sanctions that have been escalated in several stages, but also to some extent by boosting military preparedness. This does not seem to have scared Russia to any great extent, however. President Vladimir Putin seems ready to let Russia face both substantial economic costs and diplomatic isolation in order to achieve his security policy objectives.

Increased short-term popular support for Putin, but rising long-term political risk

President Putin's public approval rating has greatly improved due to the conflict with Ukraine. Support for the annexation of Crimea is massive and a large majority also support his handling of Ukraine. The sanctions imposed by Western countries against Russia have not affected the man on the street to any great extent, but Russia's own food import ban will have some effect, since certain imported goods will disappear from store shelves and the ban risks driving up inflation. Sanctions and increased tensions with the West instead seem to be creating anger with the West and boosting Putin's popular support even more, at least in the short term. **His support in opinion polls has risen to 80-90 per cent.** This represents a major change; before the Ukraine conflict, the surveys showed stagnating support of around 60 per cent.

At present Putin has no credible challenger for the presidency, and political opposition is fragmented. Meanwhile the government is further tightening its control of the media. A law that would limit foreign ownership of Russian media companies to a maximum of 20 per cent is expected to pass, and authorities will intensify their control of the Internet. The next elections (for the State Duma in late 2016 and the presidency in 2018) are also far away in time. Overall, we believe that **short-term domestic political risk is small**.

Looking a bit further ahead, however, there is significant political uncertainty. Despite increased support for Putin in the near future, we still believe that his **popularity will erode over time**; it is hard to see how the president could maintain his record-strong support. The years 2000-2012 were characterised by rapidly rising living standards; GDP per capita nearly doubled. But our long-term scenario of weak economic growth implies that rapidly rising household disposable incomes will be replaced by stagnating living standards. Putin will probably try to continue evoking nationalist feelings in order to shift attention away from the weak economy. The question is whether this strategy will remain viable over time. One possible scenario is that popular discontent will again start rising, once the euphoria surrounding the annexation of Crimea begins to subside and domestic problems move back into the foreground. This would create room for political opposition.

The key question that will determine political developments further ahead is how Putin will act. How long will he remain in politics? Who will replace him, and how will the handover take place? At present, there is no sign that **Putin** plans to leave politics and we believe he **will seek re-election in 2018**.

Deep recession - a long journey back

- **Ukraine being pressured into federalisation**
- **Bail-out loans reduce the risk of a current account crisis**
- **Weak hryvnia hurts households and banks**

This summer's battles in eastern Ukraine between the army and separatists have been replaced by another fragile ceasefire. The political situation remains hard to assess, while the economic downturn has accelerated. IMF/EU bail-out loans enabling Ukraine to manage its foreign loan repayments have reduced the risk of default but cannot make up for the sharp decline in industrial production, investments and retail sales. Despite major currency depreciation, exports have not been able to offset weak domestic demand. The year-on-year GDP decline accelerated to 4.6 per cent in the second quarter of 2014 and is believed to have speeded up markedly in Q3 – driven by intensive fighting in eastern Ukraine, where most industry is located. We believe that **GDP will decrease by 8.0 per cent in 2014. We expect zero growth in 2015. Growth will accelerate weakly to 2.0 per cent in 2016.**

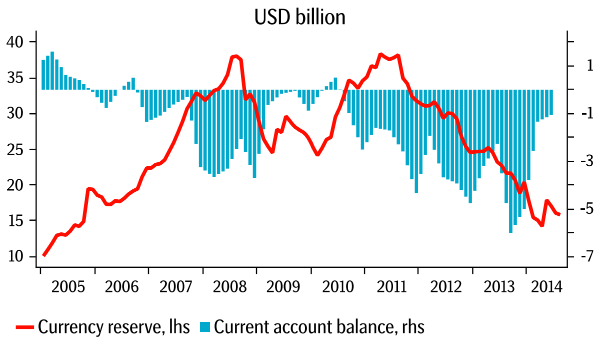
In August the Ukrainian army seemed poised to defeat the separatists, but the success was quickly reversed when Russia began supporting the separatists more openly. It is now difficult to foresee any military solution. Ukraine is instead being pressured to allow greater self-government in eastern regions in order to reach a political solution. In mid-September the Ukrainian parliament approved a law allowing the Donetsk and Luhansk regions greater self-government for a three-year period after local elections on November 2, 2014.

This law will probably be the first step towards federalisation. Although the ceasefire has halted much human suffering and material destruction, federalisation will be a very high price to pay, since Russia can use its influence to block or seriously impede Ukraine's efforts to move closer to the West and the EU. This forces the government into a trade-off between the ceasefire and much-weakened control over eastern regions. **Our main scenario is that Ukraine will accept moves towards federalisation and that large-scale battles will thus not resume.** Expanded autonomy for eastern Ukraine reinforces our forecast that **the conflict with Russia will be lengthy**. The ceasefire will create an opportunity for economic stabilisation in 2015 and a cautious rebound in 2016, but federalisation meanwhile worsens Ukraine's long-term outlook.

Ukraine will hold a new parliamentary election on October 26. It is hard to predict the outcome. Large segments of the population have supported solving the eastern Ukraine conflict by defeating the separatists militarily. A political solution based on federalisation thus risks an outcome in which parliament will be dominated by nationalism. This would risk further deterioration in relations with Russia but also jeopardise implementation of unpopular economic reforms.

The association agreement between Ukraine and the EU has been approved by the European Parliament and ratified by Ukraine's Rada (parliament). It will apply provisionally but formally go into effect only after being approved by the 28 EU member countries. The treaty will fulfil an important function by opening channels for dialogue and cooperation and pressuring Ukraine to enact reforms. The free trade component will go into effect only at the end of 2015, however: a concession by the EU to Russia in an attempt to support the peace process, but also avoid a full-scale Russian trade war against Ukraine. The delay also gives Ukrainian companies a bit more time to try to become more competitive before their domestic market opens up to customs-exempt EU products.

Previously large current account deficit is shrinking but currency reserve remains critically low



Source: National Bank of Ukraine, SEB

IMF and EU bail-out loans totalling USD 30 billion and running two years, with disbursements that began in May, have greatly reduced the risk of a current account crisis. Kiev has reduced the gas price subsidies but otherwise there is a lack of progress on economic reform so far. **The IMF has warned that its bail-out loan may not be large enough.** Accelerating recession and the summer's escalation of the conflict and the battles in eastern Ukraine have severely hurt tax revenue. The GDP downturn will be deeper than earlier IMF estimates. **Ukraine's situation remains very serious.** The currency reserve is still critically low and the central bank is being forced to pursue a very tight monetary policy in order to prevent capital outflows and further weakening of the hryvnia. So far this year, it has hiked the key interest rate by 6 percentage points to 12.50 per cent. Furthermore, the budget deficit is increasing. We believe **that the IMF and EU will continue disbursing their existing bail-out loans**. In light of Ukraine's difficult political situation, they are probably willing to expand their loans.

During 2014 the current account deficit has decreased greatly from last year's deficit of around 9 per cent of GDP. We foresee a 2014 deficit of around 3 per cent of GDP. This improvement has been driven by sharp currency depreciation and reduced gas imports, causing the trade balance to move from a large deficit to a small surplus. Despite the slide in the hryvnia, export performance has been weak due to poor foreign demand for Ukraine's steel products and a sharp drop in exports to Russia, which normally accounts for one fourth of Ukraine's foreign sales. This decrease is explained by both Russia's slower growth and new trade barriers. The improvement in the trade balance is thus driven by a sharp decline in imports, though we expect the currency effect to contribute to a gradual export increase during 2015.

Since Ukraine abandoned its USD peg in February, the hryvnia has been pushed down to new record lows; in late August it briefly hit UAH 14 per dollar. So far this year, the currency has weakened by nearly 40 per cent. The main risks to the hryvnia are political and are connected to a renewed escalation of the conflict with Russia and risks of a default. The central bank's capital controls are providing some protection but are not enough to offset the impact of extensive geopolitical shocks. We believe that **the hryvnia will stand at UAH 13.0 per USD at the end of 2014 and 14.0 at the end of 2015 and 2016**.

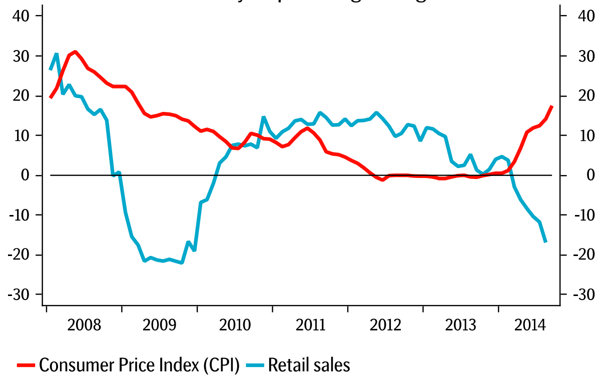
As expected, currency depreciation has contributed to soaring inflation. From zero during much of 2012 and 2103 inflation has climbed rapidly in 2014, exceeding 17 per cent year-on-year in September. Aside from sharply higher prices on imported goods due to the weaker hryvnia, reduced gas price subsidies have also helped fuel the rapid upturn in inflation. **Annual average inflation will reach 11.0 per cent in 2014 but slow to 10.0 per cent in 2015 and 6.0 per cent in 2016.**

Hryvnia depreciation along with falling economic activity have put **heavy pressure on the banking sector**. Banks are being harmed by the large role of foreign currency loans and assets. Foreign currency lending represents around 37 per cent of loans outstanding. Lending growth is hurt by a combination of both supply and demand factors, in the form of reduced demand for loans among households and businesses plus falling capital ratios due to currency weakening. The already extremely large share of bad loans (around 40 per cent) is expected to climb even higher. There is thus a sizeable risk of defaults in the private sector, since there is little chance of obtaining support from the government or the central bank.

Households are being squeezed from several directions. Aside from a diminished household willingness to consume due to political and economic uncertainty, rising inflation combined with a major slowdown in the rate of nominal wage and salary increases are now causing real wages to fall. Meanwhile the weakening of the hryvnia will make it more expensive to fund household borrowing in foreign currencies (75 per cent of home mortgage loans are USD-denominated). These factors have had a clear impact on retail sales, which have weakened greatly in recent months. Having contributed positively to growth in prior years, this year private consumption will be a sharply negative contributor to GDP growth.

Inflation shock is squeezing retail sales

Year-on-year percentage change



Source: State Statistics Service of Ukraine

Manufacturing sector activity has also greatly decreased. Long-term difficulties for the important steel sector and the poor business climate have become even worse due to the conflict with Russia. The battles in eastern Ukraine have severely impacted an already weak manufacturing sector. For example, statistics for the Luhansk region, where major battles have raged, show that industrial production in August was 85 per cent lower than a year earlier. Ukraine's five most easterly regions (Dnipropetrovsk, Donetsk, Kharkiv, Luhansk and Zaporizhia) account for more than half of total industrial output and more than one third of GDP. Unrest in the area thus has a major impact, and **in August industrial production in Ukraine as a whole fell more than 20 per cent year-on-year**. The business investment climate is also adversely affected by uncertain political developments, and capital spending declined by nearly 20 per cent year-on-year in the second quarter.

For many years, Russia has exercised great influence on Ukraine due to the country's heavy dependence on Russian natural gas. Gas price negotiations between the two countries reached an impasse in June 2014. Russia halted gas deliveries and is demanding that Ukraine must continue to pay in advance. Assessments vary, but Ukraine should be able to survive on existing gas stocks until the end of 2014, unless autumn and early winter weather is colder than normal. If there is ultimately a gas shortage, the effects will be the most far-reaching for manufacturers, since household gas supplies will enjoy priority. However, Kiev and Moscow are moving towards an interim agreement that would restore natural gas supplies. Ukraine would pay in advance at a price of USD 385 per thousand cubic metres and also start to settle existing payment arrears. Russia will resume gas supplies when Ukraine has started to settle the arrears.

Ukraine is obstructing Russia's Eurasian Union plans

- **The EEU is intended as a counterweight to the EU but has few members**
- **Ukraine's embrace of the West is not a given, despite its EU association agreement**
- **Russia will continue its efforts to slow Ukraine's integration with the West**

One **tool that Russia is using** to strengthen its economic and political influence on other former Soviet republics is the **formation of the Eurasian Economic Union (EEU), which is intended to go into effect on January 1, 2015**. It has certainly been – and still is – Russian President Vladimir Putin's ambition to bring Ukraine into this union, but the president and government of Ukraine as well as a large proportion of the population prefer to move closer to the European Union.

On September 16, 2014, the Ukrainian Parliament (Rada) ratified and the European Parliament approved an **association agreement between the EU and Ukraine**. *"The deal will establish a deep political association and economic integration between the EU and Ukraine and provide for mutual free market access,"* according to a press release from the European Parliament. The agreement will begin to be applied provisionally, since it may take a few years before all EU countries have ratified it. The trade rules in the association agreement were originally supposed to be applied starting this November, but on September 12, 2014 Ukraine and Russia agreed to postpone their provisional entry into effect until December 31, 2015.

The association agreement is an important step in Ukraine's efforts to increase its integration with the EU and the West. Former President Viktor Yanukovych's sudden, unexpected decision in November 2013 not to sign the agreement at that time triggered extensive and bloody popular protests last winter. Yanukovych was removed from power and a new, more Western-oriented president and government took over. This was not accepted by Moscow. Battles involving Russian separatists broke out on the Crimean peninsula of Ukraine in February 2014, and Russia annexed Crimea on grounds it needed to protect ethnic Russian residents. Since then, there have been sporadic battles in eastern Ukraine between the Ukrainian army and separatists, with occasional fragile ceasefires.

But it is **far from certain**, even after a provisional association agreement has been signed, **that Ukraine's embrace of the West will continue as planned**. First, historically speaking Ukraine is a country that is sharply split between popular sympathies for the West and the East. Second, there is a risk that internal conflicts will re-ignite and lead to continued divisions in Ukraine. Third, Russia will probably employ economic, political and military means to continue trying to slow Ukraine's efforts to integrate with the EU. Russia wants to exercise an influence over populous Ukraine for both security and economic reasons. In particular, Russia would like to try to maintain a degree of control in the energy field: 30 per cent of Europe's natural gas needs are met by Russia, and half of this gas is transported through Ukraine. All these factors also suggest that **the conflict with Ukraine will probably be long-lasting**.

Russia's plans for a Eurasian Union became officially known in 2011 after publication of a programme article by Mr Putin (prime minister from 2008 to 2012) *entitled "A new integration project for Eurasia"*. Worth noting is that **in 2005 the same Mr Putin** (then president) **commented that the dissolution of the Soviet Union was the greatest geopolitical catastrophe of the 20th century**. The purpose of the Eurasian Union, according to his 2011 article, was to link the economies of the EU and the Asia-Pacific region into a future free trade area. Membership of the new Eurasian Union would be voluntary and it would accept European integration by its members.

Actual and potential EEU member countries

Founding EEU members from January 1, 2105 in **boldface**.

GDP data for 2013. Population data for 2014.

Country	GDP (PPP, USD billion)	Population (million)	GDP per capita (USD)
Russia	**2,553.0**	**142.5**	**18,100**
Ukraine	337.4	44.3	7,400
Kazakhstan	**243.6**	**17.9**	**14,100**
Belarus	**150.4**	**9.6**	**16,100**
Uzbekistan	112.6	28.9	3,800
Azerbaijan	102.7	9.7	10,800
Turkmenistan	55.2	5.1	9,700
Georgia	27.3	4.9	6,100
Armenia	20.6	3.1	6,300
Tajikistan	19.2	8.1	2,300
Kyrgyzstan	14.3	5.6	2,500
Moldavia	13.3	3.6	3,800

Source: CIA World Fact Book

Russia's EEU goals are ambitious; like the EU, the Eurasian Union is intended to serve as a single market with free mobility for capital, people, labour and services. This market would be free of customs duties and border controls. The intention is to eventually create a common currency.

As early as 2010, the first steps towards the future Eurasian Union were taken when Russia, Belarus and Kazakhstan formed a Eurasian Customs Union. In 2012 this transitioned to a Single Economic Space. On May 29, 2014 the leaders of the three countries signed an agreement on the establishment of a Eurasian Economic Union effective from January 1, 2015. In other words, this troika will be the founding members of the EEU. **Discussions** are also under way with **potential future members Armenia, Kyrgyzstan and Tajikistan**.

Although Russia has had high ambitions, the formation of the EEU has triggered both criticism and concerns that it is an attempt to re-establish the Soviet Union rather than to create a parallel to the EU.

In practice, there are also **several inherent weaknesses in the EEU project**:

- First, by far the most important potential member country **Ukraine has clearly turned towards the EU** instead of the EEU. **Many of the candidate countries are very small** and also at low levels of development. An EEU without Ukraine will thus be a significantly weaker union.

- Second, **economic cooperation has not progressed especially far**. This August, when Russia imposed an import ban on foods from the EU and Western countries that had introduced sanctions against Russia, Kazakhstan and Belarus refused to follow suit. So far the EEU is thus mainly a matter of politics and symbolism.

- Third, **a number of potential member countries are very concerned about moving closer to Russia**. For historical reasons, Russian influence over the former Soviet republics is already far-reaching. Most of them have sizeable Russian minorities, creating worries about a Ukraine-like scenario, and several also have Russian military bases. Russian state television has a major influence. In addition, on a number of occasions in recent years Russia has put various kinds of pressure on these countries.

- Fourth, **a number of these countries would prefer to move closer to the EU** rather than Russia, and in some cases China is regarded as the best future cooperation partner.

Our overall assessment is that **the Eurasian Economic Union will be on shaky ground at first** and will not seem especially strong. At least during the next few years, it is difficult to see how the EEU could evolve into a counterweight to the EU, given its built-in difficulties – especially considering the ongoing Russian conflict with Ukraine.

Key economic data

ESTONIA

	2009	2010	2011	2012	2013	2014(f)	2015(f)	2016(f)
GDP, %	-14.7	2.5	8.3	4.7	1.6	1.2	1.3	2.8
Inflation, HICP, average, %	-0.1	3,0	5,0	3.9	2.8	0.1	1.6	1.9
Unemployment, %	13.6	16.7	12.3	10,0	8.6	7.2	6.5	5.2
Current account, % of GDP	2.5	1.7	-0.2	-2.1	-1.4	-1.7	-0.8	-0.2
Public sector financial balance, % of GDP	-2,0	0.2	1,0	-0.3	-0.5	-0.4	-1,0	-0.5
Public sector debt, % of GDP	7.1	6.6	6,0	9.7	10.1	10,0	9.5	9.4
3-month interest rate, end of period (eop)	3.3	1.1	1.4	0.2	0.3	0.4	0.10	0.15

LATVIA

	2009	2010	2011	2012	2013	2014(f)	2015(f)	2016(f)
GDP, %	-14.2	-2.9	5,0	4.8	4.2	2.5	2.7	3.4
Inflation, HICP, average, %	3.3	-1.2	4.2	2.3	0.0	0.7	2.1	2.1
Unemployment, %	17.5	19.5	16.2	15.0	11.9	10.8	9.8	8.6
Current account, % of GDP	8.2	2.3	-2.8	-3.3	-2.3	-1.2	-1.6	-2
Public sector financial balance, % of GDP	-9.1	-8.1	-3.5	-1.4	-0.9	-1.1	-1.2	-1.0
Public sector debt, % of GDP	36.9	44.5	42	40.8	38.1	40.5	38.5	36.0
EUR/LVL, eop	0.7	0.7	0.7	0.7	0.7	-	-	-
Key rate, eop	4.0	3.5	3.5	2.5	0.25	0.05	0.05	0.05

LITHUANIA

	2009	2010	2011	2012	2013	2014(f)	2015(f)	2016(f)
GDP, %	-14.2	1.6	6.1	3.1	3.1	2.7	3.2	4.0
Inflation, HICP, average, %	4.2	1.2	4.1	3.2	1.2	0.1	0.7	1.0
Unemployment, %	13.7	17.8	15.4	13.4	11.8	11.5	10.5	10.0
Current account, % of GDP	3.7	0.1	-3.7	-0.2	1.6	0.0	-2.0	-3.0
Public sector financial balance, % of GDP	-9.3	-7.1	-5.4	-3.2	-2.1	-2.0	-1.5	0.0
Public sector debt, % of GDP	29.0	37.4	38.0	40.0	39.0	41.0	40.0	35.0
EUR/LTL, eop	3.45	3.45	3.45	3.45	3.45	3.45	-	-
3-month interest rate, eop	3.90	1.50	1.66	0.68	0.41	0.15	0.10	0.15
5-year government bond, eop	6.60	4.60	5.40	2.40	2.40	1.80	1.60	1.80

(f) = forecast

POLAND

	2009	2010	2011	2012	2013	2014(f)	2015(f)	2016(f)
GDP, %	1.6	3.9	4.5	2,0	1.6	2.7	3,0	3.5
Inflation, HICP, average, %	4.0	2.7	3.9	3.7	0.8	1.4	1.3	2.0
Unemployment, %	8.1	9.7	9.7	10.1	10.3	10.4	10.1	9.5
Current account, % of GDP	-3.1	-4.3	-4.5	-3.4	-1.6	-1,0	-1.5	-2,0
Public sector financial balance, % of GDP	-7.5	-7.8	-5.1	-3.9	-4.3	5.5	-3.0	-2.8
Public sector debt, % of GDP	50.9	54.9	56.2	55.6	57,0	50,0	50,0	50,0
EUR/PLN, end of period (eop)	4.1	4.0	4.5	4.1	4.1	4.2	4.0	3.9
Key rate, eop	3.50	3.75	4.50	4.25	2.50	2.00	2.00	2.50
5-year government bond, eop	5.91	5.52	5.34	3.21	3.78	2.1	2.7	3.3

RUSSIA

	2009	2010	2011	2012	2013	2014(f)	2015(f)	2016(f)
GDP, %	-7.8	4.5	4.3	3.4	1.3	0.4	-0.2	1.0
Inflation, average %	11.7	6.9	8.4	5.1	6.8	7.4	6.5	5.5
Unemployment, %	8.4	7.3	6.5	5.5	5.5	5.3	5.6	5.5
Current account, % of GDP	4.1	4.4	5.1	3.5	1.5	0.5	-0.5	-1.0
Public sector financial balance, % of GDP	-6.3	-3.4	1.5	0.4	-1.3	0.0	-1.0	-1.5
Public sector debt, % of GDP	10.6	11.3	11.6	12.7	13.9	14.1	15.7	17.0
USD/RUB, eop	30.10	30.50	32.08	30.36	32.85	40.2	43.0	40.0

UKRAINE

	2009	2010	2011	2012	2013	2014(f)	2015(f)	2016(f)
GDP, %	-14.8	4.1	5.2	0.2	0.0	-8.0	0.0	2.0
Inflation, average, %	16.0	9.4	8.0	0.6	-0.3	11.0	10.0	6.0
Unemployment, %	9.0	8.4	8.2	7.8	8.3	9.0	9.3	8.8
Current account, % of GDP	-1.5	-2.2	-5.5	-8.3	-9.1	-2.8	-3.0	-3.5
Public sector financial balance, % of GDP	-6.3	-5.8	-3.5	-5.5	-6.5	-7.5	-6.0	-4.5
Public sector debt, % of GDP	35.4	40.5	36.8	37.4	41.7	60.0	63.0	65.0
USD/UAH, eop	8.00	7.97	8.00	8.05	8.23	14.00	13.00	13.00

(f) = forecast

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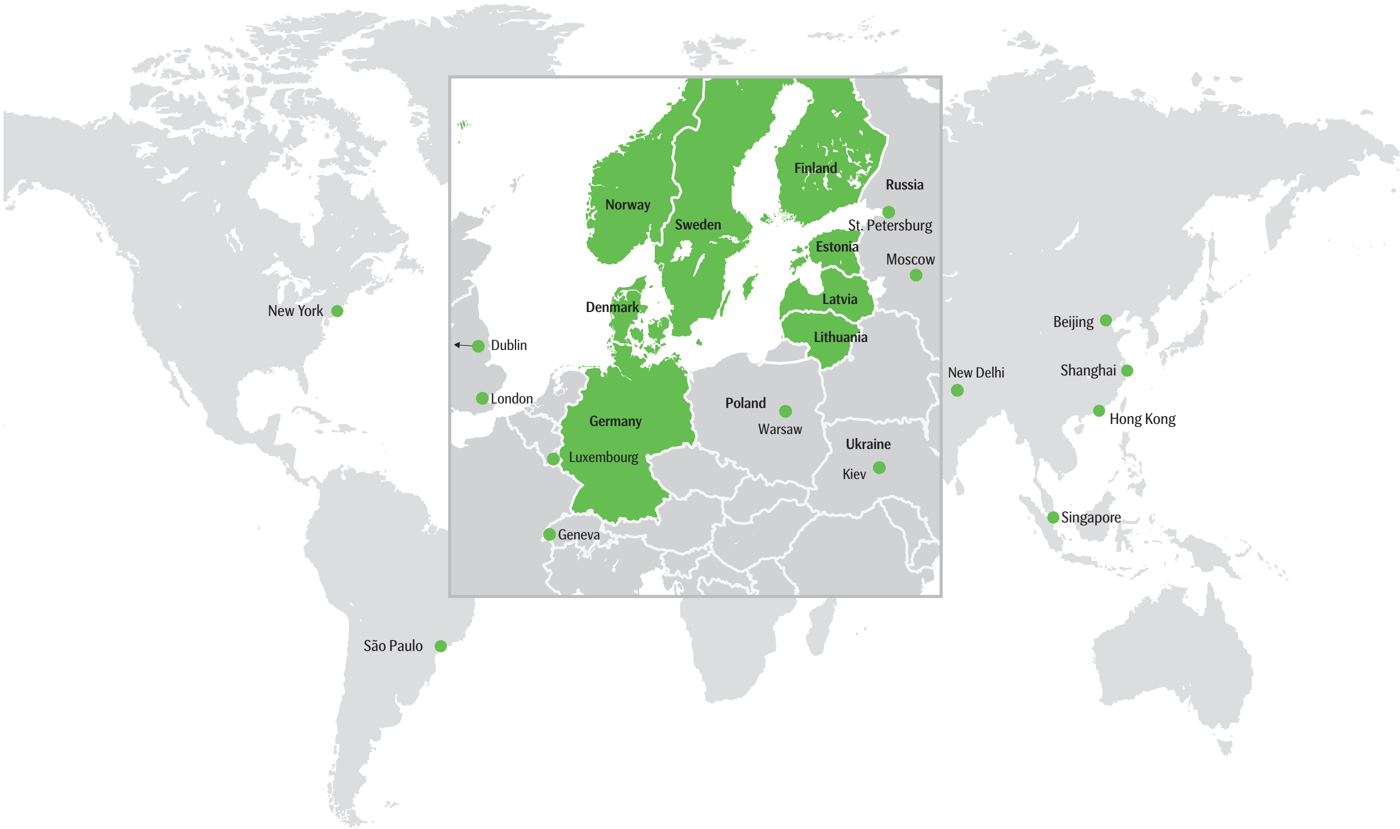

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