Eastern European Outlook

Economic Research – March 2015

Baltics and Central Europe resilient to Ukraine conflict and deep Russian recession

Theme: Russian financial reserves

Eastern European Outlook is produced twice a year. This report was published on March 25, 2015.

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Summary

The Baltic countries and Central Europe are continuing to show good resilience to the Russia-Ukraine conflict as well as Russia's food import sanctions and accentuated economic weakness, This is mainly because of favourable economic conditions, including strong real household incomes (especially in the Baltics) that are allowing robust private consumption. Looking ahead, the prospect of improving exports to Germany will also provide support. But overall growth rates will be modest during the next couple of years as exports to Russia fall and weak business investments strengthen only slowly due to geopolitical turmoil in the region. As in the rest of Europe, inflation will remain very low in the Baltics and Central Europe, especially due to low energy prices. In Estonia, however, inflation will rebound relatively fast as a result of an increasingly tight labour market, with continued emigration contributing to increased labour shortages and continued high wage and salary growth. All three Baltic countries are struggling with emigration problems and underlying weak demographic trends.

We still believe that the Russia-Ukraine conflict will be long-lasting and the ceasefire will be fragile. Sanctions policies are increasingly difficult to assess. The reason is widening divisions within the European Union on a unified stance towards Russia. Our main scenario is that Western sanctions will remain in place at least during 2015.

Russia is moving towards a large GDP decline this year due to the oil price downturn, the rouble-driven inflation shock and continued Western financial sanctions. Strong government financial reserves will provide protection over the next couple of years. But these reserves are meanwhile being drained and the Russian economy – already plagued by major structural problems – will be in far more fragile condition when it emerges from recession in 2017.

Ukraine is in an acute economic crisis, with nearly empty central bank reserves. The recently approved expansion of international bail-out loans and a coming debt write-down by private bond holders will enable the country to avoid default.

Here are our GDP forecasts for the six countries that *Eastern European Outlook* covers. SEB's forecasts for 2015 and 2016 are generally somewhat below consensus.

- **Russia**'s GDP will fall by 5.0 per cent in 2015 and by 1.0 per cent in 2016. A slight oil price upturn will help stabilise the economy. The rouble is vulnerable but will gradually regain strength.
- **Ukraine** will see a continued GDP decline this year, totalling 6.0 per cent. The country's falling currency – which will turn around and show a slight appreciation – will contribute to weak export-driven growth of 1.0 per cent in 2016.
- **Poland**, with relatively solid fundamentals, will experience GDP growth of 3.4 per cent this year and 3.6 per cent in 2016, making it the fastest-growing economy in Central and Eastern Europe. The negative growth impact of Swiss franc appreciation on many Polish home mortgage loans will be relatively minor.
- **Estonia**'s strongly export-oriented economy is slowly working its way out of a relatively deep 2013-2014 growth slump. GDP will rise by 2.2 per cent this year and 2.7 per cent in 2016.
- **Latvia** will see unchanged 2.4 per cent growth this year, following by an acceleration to 2.7 per cent in 2016. The approaching presidential election may lead to political instability, but the economy is robust.
- **Lithuania**'s growth will slow a bit this year, to 2.6 per cent, but accelerate to a solid 3.5 per cent in 2016. The important energy sector will achieve a more secure situation, helped by a new liquefied natural gas terminal and electric power links that will radically decrease the country's dependence on imported Russian energy.

Continued gradual recovery, but deflation risks remain

- **US is leading global economic upturn**
- **Central Europe is resilient to Ukraine crisis**
- **Sanctions policy is difficult to assess**

The world economy is gradually recovering, sustained by the US upturn, lower energy prices that will climb only slightly in the future, strongly expansionary monetary policies and rising asset prices. We expect the United States to show broad strength after predominantly disappointing recent economic signals. In Western Europe and the euro zone, the growth outlook is now improving somewhat as Germany – with its relatively robust fundamentals – gains strength and crisis-hit Spain rebounds, though Italy and France are stagnating as they struggle with structural problems. The United Kingdom is maintaining fairly strong momentum. In Asia, Japan is muddling through, helped by better exports to the US in particular, but China's growth keeps decelerating slowly and the regime is responding with more economic stimulus. At the global level, indicators have strengthened a bit since autumn. **World GDP growth** will gradually pick up from **3.4 per cent last year to 3.6 per cent this year and 3.9 per cent in 2016**. The latter is in line with trend growth of just below 4 per cent.

Global key data

GDP, year-on-year percentage change

	2013	2014	2015	2016
United States	2.2	2.4	3.1	3.2
Euro zone	-0.5	1.1	1.3	1.7
The world	3.2	3.4	3.6	3.9
Oil, USD/barrel	108.7	99.6	60.0	70.0
EUR/USD, Dec	1.38	1.21	1.00	1.00

Source: SEB

Due to lingering idle resources in much of the world, wage pressure remains low, though US pay increases will accelerate because of a tighter labour market; US unemployment is already close to equilibrium. Commodity and food prices are rising gently. Brent crude oil will increase from an average price of USD 60/barrel this year to USD 70 next year, a sharp downward revision from the USD 85-90 we predicted in the October 2014 *Eastern European Outlook*. There are many indications that **inflation will remain low**; in the near term, continued deflation will prevail because of energy effects. Underlying inflation and inflation expectations are far below central bank targets. The European Central Bank will continue its expansionary monetary policy without additional actions. The US Federal Reserve and Bank of England will begin hiking their key interest rates stepwise in September 2015 and February 2016, respectively. The euro will weaken more and the EUR/USD rate will move towards parity this year.

The Russia-Ukraine conflict and Russia's recession will have little negative impact on global growth. Individual countries' trade ties to Russia are relatively small, except in the Baltic countries, Finland and nearby former Soviet republics, but the investment appetite of companies will decrease not only in the vicinity of the crisis area but also broadly across Europe.

We still believe that the conflict will be long-lasting. The ceasefire in eastern Ukraine (most recently under the Minsk 2 agreement of February 2015) will be fragile. **Continued sanctions** by Western countries and Russia's countermoves are **difficult to assess**. Since sanctions began shortly after Russia annexed Crimea a year ago, the US has been a step ahead of the European Union and has maintained tougher rhetoric towards Russia, probably partly because US-Russian economic relations are far less intensive. This situation is likely to persist. The EU is continuously evaluating whether to extend or escalate sanctions. Widening intra-EU divisions on attitudes towards Russia are discernible. At first, the motives were mainly economic. Recently some countries have tried not to provoke Moscow in order to ensure the ceasefire. Looking ahead, the recent rise of nationalist but pro-Russian political parties (for example in France, Greece and Hungary) may complicate a unified EU stance. **Our main scenario is that Western sanctions will stay in place at least during 2015.**

As SEB had expected, **growth in central and south-eastern parts of Eastern Europe has been resilient to the Ukraine crisis and weak Russian demand**, mainly due to **good domestic demand**. Relatively strong earnings growth, low inflation and falling unemployment are fuelling consumption. Interest rates are also being pushed down, as in Western Europe. Central European consumer confidence is historically good, touching record highs in the Czech Republic. Exports to Russia are relatively small. Germany – where SEB made upward adjustments in its GDP growth forecasts in February and March – is obviously more important. Business investments have been relatively weak in Central Europe, however. Capital spending growth is hampered by nearby geopolitical turmoil but is expected to increase. Generally speaking, most Central European countries noted mild GDP growth slowdowns in the second half of 2014. Since last autumn, SEB has revised its growth forecasts only slightly downward, despite the obvious deterioration in Russia's outlook – even boosting its Poland forecast somewhat. In Central Europe, **the main risk to GDP projections is weaker capital spending growth**.

Wage-driven inflation on horizon despite weak recovery

- **Good real incomes = robust consumption**
- **Russia will hamper but not sink exports**
- **No change of economic policy after election**

Estonia is **slowly climbing out of its relatively deep 2013-2014 growth slump**, which was caused by weak external demand and falling public investments – **even though Russia, a major trading partner, is now in a recession**. Brighter export prospects in Western Europe, continued good private consumption and slightly stronger capital spending will offset lost exports to Russia and continued meagre Finnish growth, but overall the recovery will be sluggish. In addition, **increasingly troublesome supply-side restrictions in the labour market** are inhibiting growth. **We expect GDP to gain 2.2 per cent in 2015 and 2.7 per cent in 2016**, after last year's 2.1 per cent increase. As recently as 2012, Estonia grew by 4.7 per cent, second fastest (after Latvia) in the European Union.

Growth accelerated gradually in 2014, from near zero in the first quarter to 3.0 per cent year-on-year in the fourth, despite a worsening downturn in exports to Russia. **The second half improvement was driven by an upturn in manufacturing**: especially in important export-oriented industries – electronics and wood products – which reported higher sales in Sweden and elsewhere. Positive base effects helped. Retail sales grew steadily by 5-6 per cent year-on-year, but construction and transport volume was subdued. The construction slowdown is largely seen as a temporary dip after a strong start to the year, while transport weakness is more lasting since it is largely connected to falling Russian transit traffic.

Growth rate slowly recovering after 2013-2014 slump

GDP, year-on-year percentage change

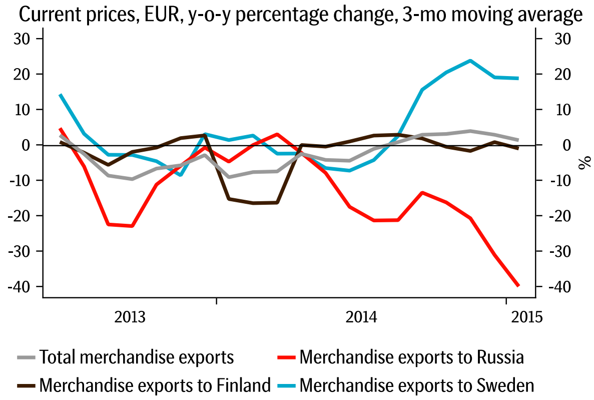
Source: Statistics Estonia

Sentiment surveys support the thesis that Estonia's economy has largely bottomed out and that the upturn will be hesitant. According to the European Commission's monthly indicator, manufacturing sentiment has climbed only marginally since summer, after a clear slowdown early in 2014 when the Russia-Ukraine conflict broke out. Consumer confidence has remained stable at high historical levels since late 2013, after trending upward earlier. The Ukraine crisis has not had any negative impact there.

Foreign trade plays a major role in the economy, since Estonia has an exceptionally high export ratio: 75-80 per cent of GDP. Its main markets are Sweden (18 per cent of total exports), Finland (15), Latvia (11) and Russia (10). Merchandise exports fell last year by 2 per cent in current prices, with higher sales to Sweden and Latvia but declines in Finland and Russia: the latter by 15 per cent. **Weak sales to Russia are nothing new, though.** Sales slowed sharply as far back as late 2012 and have been weak and volatile since, with a larger downturn in 2014. **We expect a weak increase in overall exports this year** as Western Europe grows somewhat faster but Russia weighs down demand; only in 2016 will exports accelerate a bit faster. Shifts to new markets will ease negative effects from Russia, including the impact of sanctions on agricultural products. Further euro depreciation will also provide some support, since about 60 per cent of Estonian exports are sold outside the euro zone. Russian tourism to Estonia fell 10 per cent in the wake of the rouble collapse, but overall tourism was up 2 per cent.

Exports to Sweden up - Russia down

Current prices, EUR, y-o-y percentage change, 3-mo moving average



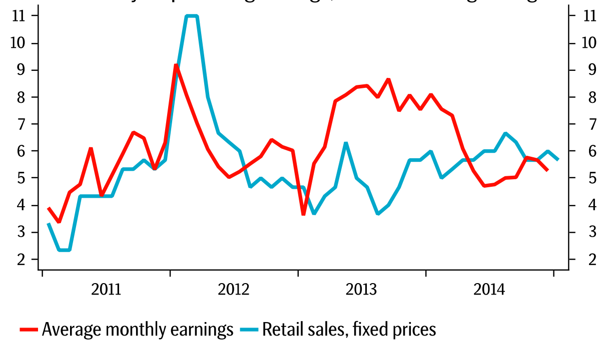
Source: Statistics Estonia

Capital spending activity has been weak for two years and **will increase only gradually**, aided by EU structural funds and by a rebound in construction, driven by the housing market after a slump in the second half of 2014. An increased supply of housing is expected to moderate the rapid rise in home prices: fastest in the EU during the first half of 2014, second only to Ireland in the third quarter. Geopolitical uncertainty in nearby countries and the uncertain export outlook are blunting the appetite for business investments.

Private consumption will remain the economic engine. Households will continue to enjoy good conditions, especially this year before inflation permanently rises. Strong real incomes and low interest rates will drive retail and car sales. A lower jobless rate, continued 5-6 per cent nominal pay increases and unchanged low inflation will fuel consumption this year. The income tax cut from 21 to 20 per cent, increased family benefits and higher minimum wages will also contribute.

Rapid wage and salary growth stimulating consumption

Year-on-year percentage change, 3-month moving average



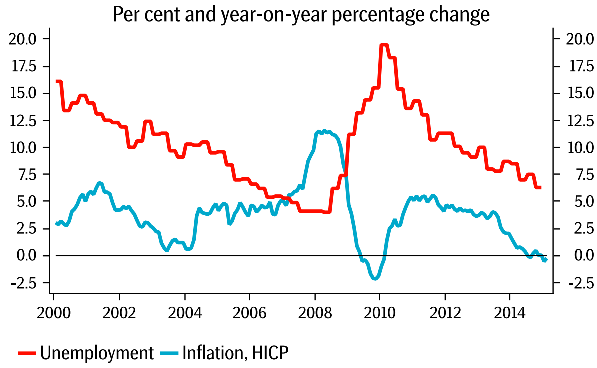
Source: Statistics Estonia

Unemployment has trended lower since peaking at 19.8 per cent in the first quarter of 2010 during a depression. A **shrinking labour supply** has speeded the downturn – a consequence of continued net emigration (which has showed signs of slowing in the past two years, though) and low birth rates. In 2014, the jobless rate fell to 7.4 per cent and the number of jobs grew slightly; fourth quarter unemployment was 6.8 per cent – the lowest since 2008. Our forecast is 6.5 per cent this year and 5.8 per cent in 2016. This is **well below estimated equilibrium unemployment** of 8-10 per cent. After the economy overheated in 2006-2007, unemployment was measured at some 4 per cent in 2008 and there was a wage-driven inflation explosion of more than 10 per cent. Economic conditions are of course different today, with moderate GDP growth, low external price pressure and short-term energy price deflation. Estonia has also learned its lesson about the outcome of excessive domestic demand and credit growth. But the **ever-tighter labour market risks causing inflation problems within a couple of years.** In January 2015, a survey showed that one out of five service sector companies and one out of ten manufacturing firms viewed labour shortages as the biggest production obstacle. Another warning signal is international unit labour cost statistics, which show that for the past three years Estonia, Iceland and Norway (in 2014 the OECD's forecast was conducted in November) stand out with abnormally high increase rates among OECD countries: in the past two years about 6 per cent in Estonia.

Price pressure is still non-existent. In January, year-on-year inflation according to the Harmonised Index of Consumer Prices (HICP) fell to -0.5 per cent, mainly driven by energy components. **Lower energy prices** were also the main reason why full-year 2014 inflation was a low 0.5 per cent: down sharply from 3.2 per cent in 2013. The energy price decline was broad-based and the largest in 20 years. Price increases for food and other agricultural products were extremely weak and were held down to some extent by over-supply due to the Russian import ban that started in August and is scheduled to last for at least one year. Core inflation also fell in 2014 despite rapid wage and salary growth. A decline in business earnings contributed to this. **Inflation will remain low this year** as oil price effects sharply slow down the 12-month rate during at least the first half. In 2016 we predict an oil price increase of USD 10/barrel. Also expected are new hikes in consumption taxes and fees (on gas, for example) and administrative prices. We also expect accumulated high wage pressures to begin having an impact on consumer prices, as companies try to improve their earnings. Altogether, this points to a **substantial rise in inflation next year to an average of 2.3 per cent**.

Unemployment below 8-10% equilibrium = inflation risk

Per cent and year-on-year percentage change



Source: Statistics Estonia

Public finances are strong. Estonia continues to show the lowest public debt in the EU: about 10 per cent of GDP. We expect continued budget deficits around ½ per cent of GDP, with the risk that it will rise to ¾ per cent this year since fiscal policy is slightly expansionary due to both higher expenditures and tax cuts. This includes higher social benefits to households, a pension hike of some 6 per cent and higher defence and security expenditures related to the Ukraine crisis.

Estonia has a long tradition – since enacting its previous budget law in 1999, which was replaced by a new one last year – of practicing fiscal discipline. The budget has been close to balance since 2010. **Nor do we expect any major economic policy changes** following the March 1 parliamentary election. The ruling centre-right Reform Party has been part of various governing coalitions since 1999, and after the 2007 election it became the largest party in parliament for the first time. It is still too early to predict the details of the new coalition government's policies. But it is worth noting that last winter Prime Minister Taavi Rõivas declared that taxes on labour should be lowered over the new few years and that the tax burden on low income earners should also be eased.

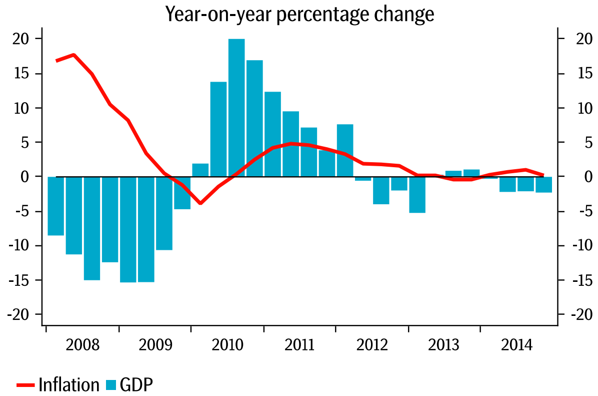
Private consumption will continue to drive growth

- **Strong real wage increases**
- **Shaky exports, weak capital spending**
- **Unemployment close to structural level**

In 2014 the Latvian economy managed to **grow by 2.4 per cent**, which is the **slowest pace of the post-crisis period**. A slowdown occurred in manufacturing and real estate activity, and the fastest increase was observed in construction. Similarly, the retail and service sectors showed positive trends. Despite concerns about decreasing Russian transit traffic, the positive trend continued in transport and storage, though the outlook for this year is uncertain. The main source of GDP growth last year was private consumption, which accounted for 1.5 percentage points of total growth. Meanwhile, government spending contributed 0.6 percentage points, while net exports added 0.2 percentage points. Capital spending accounted for a meagre 1.6 per cent.

Inflation and GDP

Year-on-year percentage change



Source: Central Statistical Bureau

This year **private consumption will continue to be the primary economic driver**. It has all the elements needed to keep growing, but the pace will be determined by consumer sentiment. Most of the uncertainty and growth potential is related to capital spending activity. Current surveys confirm that **business remains cautious** about expansion. The availability of EU funds and the smoothness of related procedures will thus play a major role. Due to brighter euro zone prospects, there is potential for growth in merchandise exports, which could slightly push up business investment activity. Service exports are likely to face a more complex situation. Thus, we foresee that **GDP will grow by 2.4 per cent this year and 2.7 per cent in 2016**.

Despite challenging external conditions, which include Russian sanctions, the falling rouble and its side effects on neighbouring markets, as well sluggish euro zone recovery, Latvian exports managed to climb by 2.2 per cent in 2014. In contrast, imports fell by 0.4 per cent. **Exports are likely to grow slightly this year.** Russia and Lithuania are Latvia's largest markets, each accounting for about 16 per cent of sales in 2013. Many businesses, particularly those focusing on Russia and related markets, will continue to decrease their exposure and look for new markets. For many, the Russian market will close. Currently, the **most pronounced changes can be seen in dairy exports**. Lower export volume to Russia will also undermine exports to Lithuania. Those who responded early to Russian sanctions are in a better position. There has been good progress in penetrating Asian and Middle Eastern markets, so we remain cautiously optimistic in our export forecast. History shows that the impact of the **Russian factor has always been substantial, but not critical**. Positive developments in the euro zone will partially offset this negative impact.

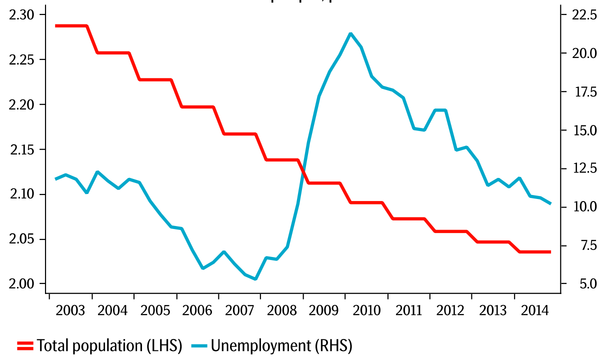
Last year, retail sales increased by 3.6 per cent. A positive upsurge occurred in January 2015, when sales rose by 6.7 per cent year-on-year, providing a reason to believe that consumers will take advantage of favourable conditions, among them deflation. Due to lingering uncertainty, retail sales growth in the coming months will slow a bit. We expect activity to continue increasing in segments related to improvement of existing housing. In the long run, the growth rate of private consumption will follow developments in the labour market and the security situation in the region. Despite the opportunities, **consumption will grow moderately**. People still have reservations about long-term economic prospects and are being relatively passive in the real estate market. They have also increased their savings.

Last year the unemployment rate fell to an average of 10.8 per cent, or 1.1 percentage points less than in 2013. The jobless rate also decreased in the fourth quarter to 10.2 per cent. This year **unemployment will keep shrinking**, **partly due to continued emigration and a negative demographic trend**. Consequently, in 2014 the employment rate increased by 0.9 percentage points, but the number of jobs fell by 9,200. The number of jobs rose in sectors such as transport and storage and construction. Meanwhile, in the agriculture, forestry and fisheries sector, education and manufacturing, the number of jobs declined. Latvia is **gradually approaching its natural rate of unemployment, 9-10 per cent, which implies an inflation risk** in the medium term. At the same time, the demand for specialists will remain a concern. Compounded by the Russian crisis, in certain regions unemployment will rise.

Employers will increasingly face an ageing workforce. This year the average unemployment rate will drop slightly to 9.9 per cent and next year to 9.4 per cent.

Shrinking population is affecting the labour market

Million people, per cent

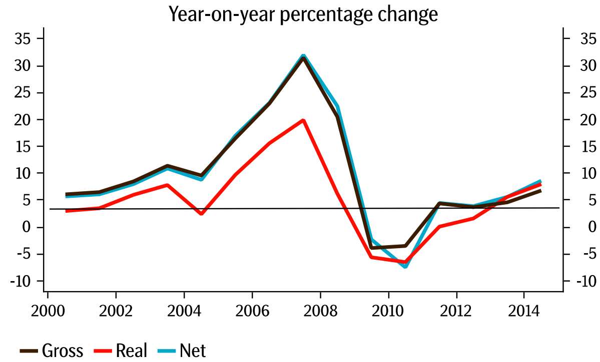


Source: United Nations, Central Statistical Bureau

Despite the economic slowdown, average wage growth last year was the fastest in the post-crisis period. Average gross wages and salaries grew by 6.8 per cent. Although pay has risen faster in the private sector than in the public sector, average gross wages in the private sector were lower. One major factor behind pay hikes was the increase in the minimum wage. Given changes in taxes and low inflation, **real net wages grew by 8 per cent in 2014**. This year, real net wages will continue to show solid growth, although perhaps a bit slower. Starting this year, the minimum monthly wage was raised further from 320 to 360 euros and personal income tax was cut from 24 to 23 per cent, in order to reduce the tax burden on labour. However, like last year, pay increases will focus on rewarding key employees or certain categories of employees.

Wage growth at strong levels after a boom and bust period

Year-on-year percentage change



Source: Central Statistical Bureau

Falling energy and food prices are having the biggest impact on inflation, recently turning it temporarily negative. In February 2015, consumer prices were 0.1 per cent below those of a year earlier. Prices of goods fell by 1 per cent, while prices of services grew by 2.4 per cent. The **low inflation environment will continue, dominated by low energy and food prices**. Food prices will remain subdued and not pick up until food exports rebound. Because of a shortage of funding, Russia may not carry out full-fledged sowing, which could cause problems with its harvest and impact prices in the region next autumn. Meanwhile there will be initiatives to raise utility prices. In response to oil price developments, during the first half of the year deflation will prevail, but **in the second half inflation will rebound**. If the oil price recovery remains sluggish, the inflation rate may turn out lower than our current 2015 forecast of 0.7 per cent. Next year inflation will pick up to 2.1 per cent.

In 2014, the government's consolidated budget deficit amounted to 313 million euros, but the local government budget deficit was 86 million euros. According to estimates using the European System of Accounts methodology, the general government shortfall in 2014 was 1.4 per cent of GDP. This deficit is expected to remain low.

From January 1 to June 30, 2015, Latvia holds the Presidency of the Council of the European Union, which has helped facilitate political stability. Meanwhile **the presidential election** will be held in late May or early June. The incumbent president, Andris Berzins, has not disclosed whether he will seek a second term. His position may be determined by whether he believes he has the necessary support for re-election. So far, it remains unclear what other candidates there may be. The situation will probably remain uncertain until the last moment. Depending on the results, we cannot rule out a scenario in which the **election result may cause political instability** and even the collapse of the government. The presidential election may lead various parties to reshuffle their current positions on key issues.

On October 4, 2014, Latvia held **parliamentary elections**. Prime Minister Laimdota **Straujuma's centre-right coalition won a comfortable majority**. The coalition of the Unity Party, the Union of Greens and Farmers and the National Alliance won 61 seats in the 100-member parliament, up from 47 in the 2011 election. The election campaign was overshadowed by the Ukrainian conflict. As a consequence the main opposition grouping, the leftist pro-Russian Harmony Party, lost seven seats. Two new parties – the Latvian Association of Regions and To Latvia From the Heart – won seven and eight seats, respectively, and entered parliament for the first time. The greatest challenges now for the government are to maintain fiscal stability, respond to demands for higher expenditures, and try to increase defence spending to 2 per cent of GDP. Another challenge will be to launch gas market liberalisation according to the EU's Third Energy Package, since there is a huge lobby determined to defer this process.

Resilient growth despite uncertain surroundings

- **Growth led by private consumption**
- **Weak capital spending a risk factor**
- **Limited impact of Russian sanctions**

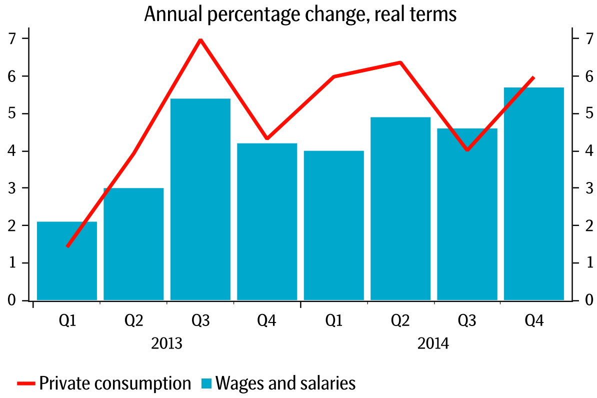
In 2014, **economic growth remained firm** throughout the whole year **despite the geopolitical tension** related to the Russia-Ukraine conflict and despite weak euro zone growth. GDP rose by 3 per cent, supported mainly by domestic demand. Uncertainty will continue to be the dominant feature of the economic environment this year, with growth being hampered by the Russian recession and continued weak capital spending activity. We forecast that **GDP growth will reach 2.6 per cent in 2015 and 3.0 per cent in 2016**. As elsewhere in Europe, **inflation will remain very low**, primarily due to low energy prices. Average HICP inflation will amount to -0.4 per cent in 2015 and 0.3 per cent in 2016.

Private consumption rose by 5.6 per cent last year, the fastest pace since 2007. There were solid fundamentals behind this increase. First, average real wages were 5.7 per cent higher at the end of 2014 on a year-on-year basis. Other kinds of income also increased. Last year the government started restoring pensions that had been temporarily reduced during the crisis. Emigrant remittances rose by 13 per cent over the first three quarters of 2014. Employment increased by 2 per cent last year. In addition, a decrease in the prices of central heating, electricity, fuel and some food products meant more money was available for other goods and services. Consumer sentiment was negatively affected by the geopolitical tension in mid-2014 but rebounded early in 2015. The Lithuanian economy has weathered Russian trade sanctions well, and this has probably alleviated the effects of geopolitical tensions on the mood of households. Deflation has also played a positive role in boosting optimism. Looking ahead, consumer sentiment may be shaky in the coming years and private consumption growth may thus lose some of its momentum. On the other hand, consumption will be **sustained by real wage growth** of 4.5 per cent in both 2015 and 2016, as well as higher employment. We believe that **private consumption will increase by 4-5 per cent yearly in 2015-2016**.

The unemployment level remained rather stubborn last year, indicating continued structural unemployment problems. In 2014 compared to 2013, the unemployment rate decreased by 1.1 points but still averaged 10.7 per cent. In our view, the **unemployment rate will gradually decrease** to 10.0 per cent in 2015 and 9.5 per cent in 2016. Foreign investors also continually call for improvements in the rigid Labour Code to make it more flexible and business-friendly, but the political response is likely to remain muted in the near future.

Strong real wage growth supports consumption

Annual percentage change, real terms

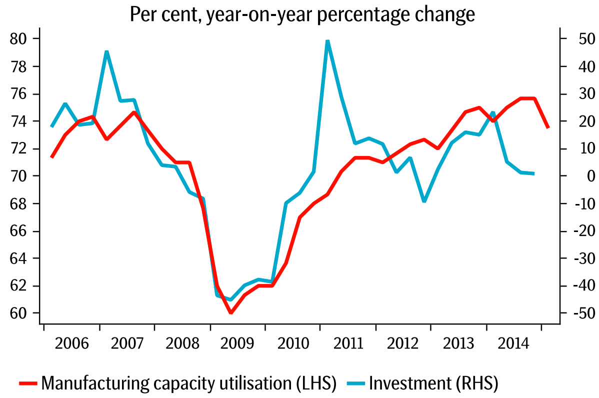


Source: Statistics Lithuania, Macrobond, SEB

Investment growth was hardly impressive in 2014. Last year, capital spending rose by 6 per cent at constant prices on average. In the last quarter of 2014, growth reached only 0.9 per cent. **Continued uncertainty** was the most important factor behind lower investment appetite. Even though interest rates were very low, corporate loans stagnated in 2014 due to low borrowing demand. Geopolitical uncertainty will continue weighing down investments in 2015, while capacity utilisation in manufacturing also started trending downward, shrinking to a 2-year low in February 2015. These two factors point to **weak capital spending growth** in the near future.

Weak investment growth

Per cent, year-on-year percentage change



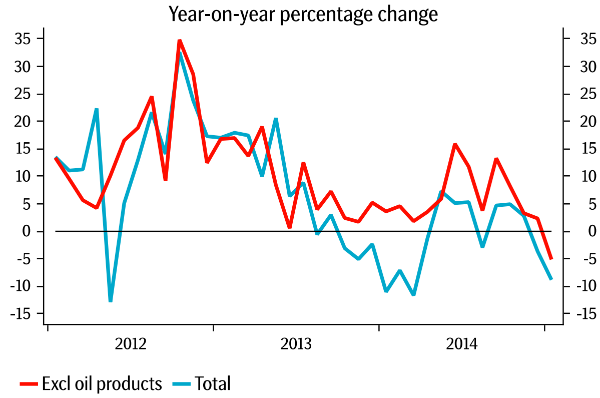
Source: Statistics Lithuania, Macrobond, SEB

Trends in the real estate market were inconsistent in 2014. During the first half, the number of residential property deals grew by as much as 27 per cent year-on-year, but the corresponding number fell by 2 per cent in the second half. In 2014 as a whole, housing prices increased by 3.7 per cent on average. In 2015, the **housing market will remain negatively affected by uncertainty** and will thus hardly demonstrate any notable growth despite improving fundamental drivers.

Exports were quite fragile in 2014. Total merchandise exports fell by 0.6 per cent. Contrary to what one might expect, **exports to Russia grew by 4.4 per cent** due to an increase in re-exports of machinery and equipment. The most important factor behind sluggish exports last year was a **massive decrease in foreign sales of refined oil products**, Lithuania's largest export sector. This reduced the export growth rate by 5.7 percentage points. The effect of Russian sanctions on agricultural and food products was almost 5 times smaller, totalling 1.2 percentage points.

Vulnerable exports

Year-on-year percentage change



Source: Statistics Lithuania, SEB

One of the hallmarks of Lithuania's export strategy after the announcement of Russian sanctions was **geographic diversification and expansion to new markets**. This strategy has proved quite fruitful. While exports of agricultural and food products to Russia fell, such exports to other countries rose – minimising the effect of the Russian embargo. The government strengthened its diplomatic efforts to build new trade relationships with the United States, Canada, and countries in Latin America and the Middle East. Lithuania also passed a law which opened the way for meat exports to Muslim and Jewish consumers.

However, January 2015 export figures were still not encouraging, mainly due to the drop in sales of refined oil products and transport vehicles. Excluding refined oil products, exports declined year-on-year for the first time in 5 years. Throughout 2015, exports will be adversely affected by the recession in Russia and some other Eastern European markets as well as their falling currencies. On the other hand, brighter euro zone prospects will help sustain Lithuanian export sales. Low global oil prices will benefit Lithuania's exports of oil products, since they will be more competitive compared to American products. All in all, we expect **modest export growth in 2015**.

The transport sector has withstood the effects of the Russian sanctions better than expected. For example, rail cargo transport increased by 2 per cent in 2014 compared to 2013. Favourable fuel price developments will also benefit the transport sector in the near future.

The beginning of 2015 saw **Lithuania's accession to the euro zone**. Due to a highly uncertain global environment and only modest global growth, we expect only **small positive growth effects** from euro zone membership during the next couple of years. This will lead to somewhat higher foreign investments. According to the latest polls, **public support for the euro introduction rose** to 68 per cent in early February 2015. The dominant deflationary trends helped the country cope with euro-related inflation fears. Low global oil prices and consequently cheaper fuel pushed down year-on-year inflation in February 2015 to -1.8 per cent, masking upward price-rounding effects after the euro introduction.

After meeting the Maastricht criteria for public finances last spring in order to qualify for euro zone membership in 2015, Lithuania remains among the few European Union countries which **meet the fiscal criteria**. During the first three quarters of 2014, the public sector deficit was equivalent to 2.6 per cent of GDP, while general government debt stood just below 40 per cent of GDP. With Eurobond redemptions scheduled for 2015, 2016 and 2018, the country's public debt is forecasted to decrease further over the medium term. In 2015, the budget deficit will remain below 3 per cent of GDP, although the government's 1.2 per cent target may face challenges due to rather optimistic economic growth assumptions.

Last year marked a milestone for Lithuania's energy system, with a **series of energy projects** that will increase the **diversification of energy imports**. In December 2014, the liquefied natural gas terminal in Klaipėda was launched. This helped Lithuania negotiate lower natural gas prices from the Russian company Gazprom as early as May 2014. In January 2015, the LNG price was 9.5 per cent higher than the reduced price of Gazprom's natural gas but the country was no longer 100 per cent dependent on imports from Gazprom. At the end of 2015, Lithuania will open a 700 MW power link to Sweden and a 500 MW link to Poland which both will reduce the price of electricity and offer more import opportunities. Litgrid AB, the Lithuanian transmission system operator, forecasts that after launching the link to Sweden, the market price of electricity will decrease by 15 per cent.

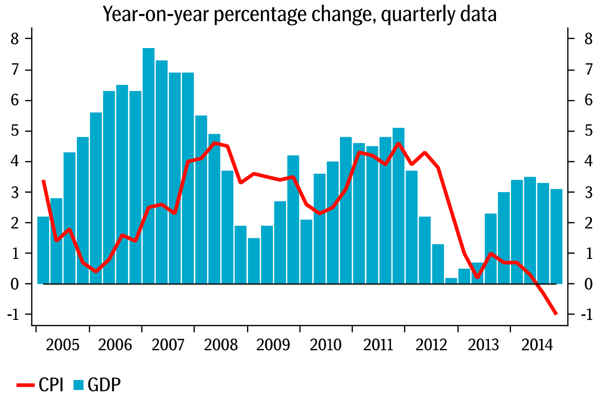
Coping well with Ukraine crisis and CHF mortgage shock

- **Domestic demand is driving decent growth**
- **Modest inflation upturn starting in 2016**
- **Key interest rate will remain record-low**

As expected, Poland's economy is showing **good resilience to the Russia-Ukraine conflict**. The main reason is **growing domestic demand**. Expansionary monetary policy and relatively solid economic and banking fundamentals are making positive contributions. Private consumption and both private and public sector investments will continue to drive the economy in 2015-2016. Modest export growth will speed up only a bit as increased demand from the big German market offsets the accelerating downturn in Russia and Ukraine this year. Exports to Russia fell last year by 14 per cent in current prices. **We expect GDP to climb by 3.4 per cent this year, after last year's 3.3 per cent, and by 3.6 per cent in 2016**. This will make Poland the fastest-growing economy in Eastern and Central Europe (Hungary led by 0.1 per cent in 2014) but merely matches potential growth of 3-3.5 per cent, suggesting that today's non-existent price pressure will rise only modestly.

Good economic growth without inflation

Year-on-year percentage change, quarterly data

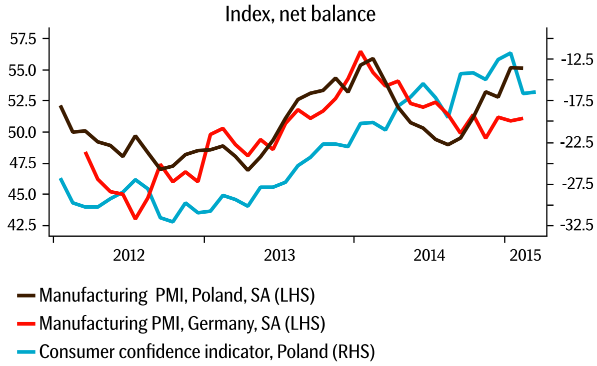


Source: Central Statistics Office of Poland

The economy has shown relatively good, steady momentum since mid-2013, except for a dip in manufacturing during the second half of 2014. Our main thesis in October's *Eastern European Outlook* – that **the slump would soon pass** – seems to have been correct. The causes of the dip were probably a temporary slowdown in German demand, Russia's economic deceleration and a short-term drop in business investment due to increased regional uncertainty in the initial phase of the Ukraine crisis. **The German factor appears to have dominated**, since the purchasing managers' index (PMI) for Poland's manufacturing sector has shadowed its German counterpart for many years and both indices fell noticeably last spring and summer. This association is logical, since as much as one fourth of exports – largely manufacturing-related – go to Germany, while Russia buys a modest 5 per cent. Since its low of 49 last August the manufacturing **PMI, a short-term leading indicator, has trended upward**, reaching 55 this February. Figures above 50 signal expansion. Notably, the Polish index climbed more strongly during this period than the German one, which rose feebly to 51. Overall, this indicates that a broader recovery in industrial production has begun.

Manufacturing sector confidence has rebounded and consumer confidence remains good

Index, net balance



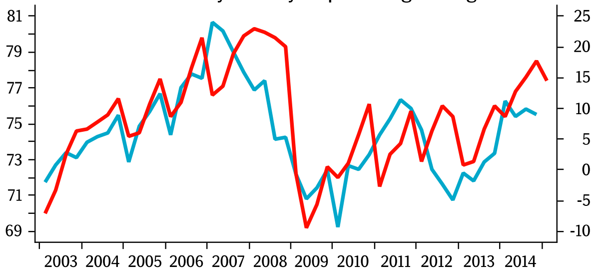
Source: Markit Economics, Central Statistics Office of Poland

Prospects for growing domestic demand are favourable. **Private consumption will be fuelled by increasing real disposable household incomes**. Given low projected inflation, real wage increases will exceed 3.5 per cent in 2015 and 2.5 per cent in 2016. This year pensions have also been raised, while families with children have received tax relief and higher child allowances. The number of jobs will continue to increase, though at a slow pace. Unemployment will fall from 9.1 per cent in 2014 to an average of 8.0 per cent in 2016. Interest rates will remain low, which will gradually accelerate Poland's muted credit growth. Previously tight bank lending terms have been thawing for the past year and a half, although home mortgage loan terms were recently tightened somewhat. **The jump in the cost of Swiss franc-denominated mortgage loans is expected to have relatively little negative impact on consumption**, even though many households have these CHF loans (see box on page 13).

Capital spending rebounded vigorously in 2014 after two weak years, indicating that the Ukraine crisis is having only a minor dampening effect. Several factors suggest a **continued good investment climate**. The investment ratio is relatively low. Poland is the largest recipient of EU structural funds, financing costs have fallen sharply and manufacturing capacity utilisation has risen from 75 to 78 per cent in the past year, after staying at 70-75 per cent for years. This is historically high and close to the peak of 80 in early 2008. There is a strong link between capacity utilisation and actual capital spending.

Increased capital utilisation leads to more capital spending

Per cent and year-on-year percentage change



Source: Central Statistics Office of Poland

Deflation (1.3 per cent year-on-year in January) will persist **at least during the first half of 2015** as energy and food prices slow the 12-month rate, and underlying inflation is weak. Looking ahead 1-2 years, inflation will rebound due to higher energy prices, increased economic activity and growing wage pressures as a result of an increasingly strained labour market; unemployment fell below its structural level of 10 per cent last year. But **average annual inflation in 2016 will not exceed a modest 1.5 per cent**. Looking ahead two years, we thus expect inflation far below the National Bank of Poland's 2.5 per cent target. **This will mean continued accommodative monetary policy.** The key interest rate will probably remain at a record-low 1.5 per cent throughout our forecast period, after a distinct 50 basis point cut last October followed by an equally large cut in early March 2015. The central bank explained its latest decision by saying that it foresaw a longer period of deflation and a clearly higher risk that inflation will remain below target in the medium term. Notably, it rounded off this statement by stating that the rate cut was the last in the current cycle. In view of short-term deflation pressure and very low inflation expectations among businesses and households, we do not rule out still another rate cut, to 1.0 per cent. In the near term, this risk scenario will result in a slight weakening of the zloty (PLN) after a relatively sharp appreciation this winter. **Over time, the zloty will resume its upward trend**, partly as a result of relative growth advantages in Eastern Europe, but the overall upturn will be small.

Fiscal policy will ease somewhat this year after earlier moderate budget-tightening – partly for tactical reasons ahead of **this autumn's parliamentary election**. The centre-right ruling coalition of the large liberal, EU-friendly Civic Platform and the small farm-based Polish People's Party hopes to win its third straight term of office. The coalition is being challenged by the largest opposition party, the nationalist conservative Law and Justice, which has gained ground in opinion polls. After the election there may be a resumption of modest budget-tightening, since the government – under pressure from EU rules – will endeavour to push the deficit permanently below 3 per cent of GDP, compared to 3.5 per cent in 2014. Public debt will remain unchanged at some 50 per cent of GDP.

"CHF shock" will be relatively small

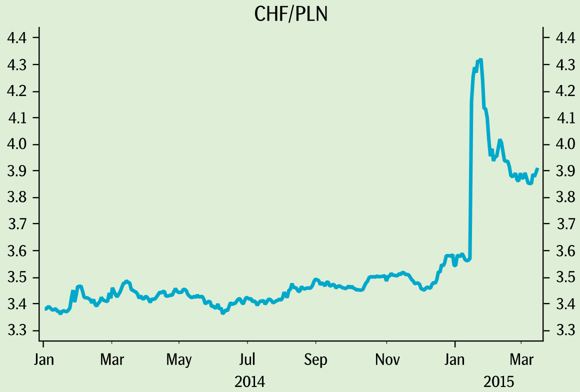
On paper, Polish borrowers are the most heavily exposed in Eastern and Central Europe to the jump in mortgage repayment costs after the CHF appreciation that occurred after the Swiss National Bank ended its EUR peg on January 15. About 565,000 people have CHF-denominated mortgage loans, totalling the equivalent of USD 34 billion – some 7 per cent of Poland's GDP. Of total mortgage lending, 54 per cent is in PLN, 37 per cent in CHF and 9 per cent in other currencies. The risks inherent in foreign currency loans have been a heated issue in recent public discourse among economists and bankers as well as politicians, with discussion becoming more heated following the CHF upturn nine months before Poland's parliamentary election.

Yet we believe that the negative effect of the "CHF shock" on Poland's economy will be small, for several reasons:

1. Currency movements have eased. At most, CHF appreciation against the PLN was about 20 per cent after one week, but since then it has reversed and is now at 9 per cent. 2. Many of the loans are tied to floating CHF interest rates that became negative when the Swiss National Bank adopted rates below zero in January. 3. Credit terms are stricter on mortgage borrowers who have foreign currency loans. 4. Foreign currency loans are concentrated among high income earners, according to central bank data. This group is not the most consumption-intensive. 5. The government is preparing some form of supportive measures. Early in March, the Polish Bank Association unveiled a proposal to create special "stabilisation funds" from which vulnerable borrowers can receive help when they reach certain stress levels. The proposal also includes conversion of CHF loans to PLN. This is something that Hungary is already implementing for all Hungarian borrowers – from CHF to HUF – a process that started in November 2014, even before the latest CHF drama.

Swiss franc appreciation has eased

CHF/PLN



Source: National Bank of Poland

Deep and broad GDP downturn in 2015

- **Oil price decline pushing down rouble**
- **Sharply accelerating inflation**
- **Russia will avoid fiscal crisis**

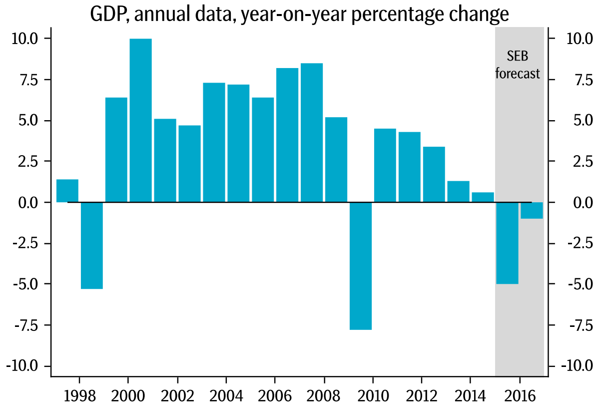
Russia is facing a **deep recession in 2015**. Structurally weak and still highly dependent on energy exports, the economy is hard hit by the sharp oil price decline. SEB has revised its **oil price forecast** dramatically downward since last autumn and now foresees averages of **USD 60/barrel in 2015** and **USD 70/barrel in 2016**, compared to USD 85 and USD 90, respectively, in the October 2014 *Eastern European Outlook*. Falling oil prices in late 2014 have greatly weakened the rouble, leading in turn to rapidly accelerating inflation, large capital outflows and sharp interest rate hikes. Lower oil prices also reduce budget revenue, hampering government efforts to sustain growth through expansionary fiscal policy. Sensitivity analyses of the oil price decline by the IMF and others indicate that an oil price downturn of USD 10 during one year leads to a negative GDP effect of 1-1.5 per cent.

Western **sanctions** aimed both at individuals and specific companies in the financial and energy sectors have proved to have **increasingly noticeable effects**. The companies directly targeted have had major problems borrowing abroad. In practice they are shut out of European and US capital markets, creating difficulties in financing large investment projects. The sanctions also create general uncertainty among companies and worsen capital spending, which has been weak for a long time. **Our main scenario is that the sanctions** imposed after Russia annexed Crimea a year ago, which have gradually been stepped up, **will remain in place during 2015 but not escalate**. Developments are hard to foresee, however, and will ultimately be determined by what happens in the conflict with Ukraine. Aside from sanctions, the severe deterioration in relations with the West also impact the willingness of foreign companies to invest.

Overall, the GDP downturn will be broad. Of GDP components, we expect only net exports to contribute positively to growth in 2015 – thanks to the sharp depreciation of the rouble. Weak growth of 0.6 per cent in 2014 will turn into a **major GDP decline of 5.0 per cent in 2015**. Factors that might counter a sharp GDP decline in 2015 are either a sizeable recovery in oil prices or a solution to the conflict with Ukraine, resulting in the withdrawal of sanctions and clearly improved relations with the West. In our assessment, however, the probability of both these scenarios is low. The **GDP decline will slow in 2016 to 1.0 per cent** due to a cautious upturn in oil prices and exports driven by a continued strengthening of global demand.

GDP is expected to fall in 2015 and 2016

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



Source: Russian Federal State Statistics Service, SEB

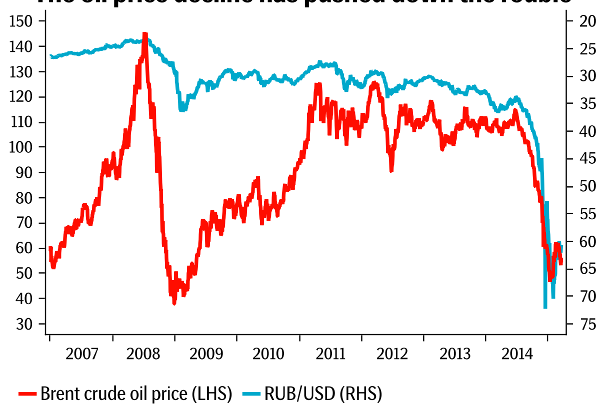
Beyond our forecast horizon, we do not expect this slide in GDP to be followed by any powerful recovery. Resource utilisation in the Russian economy is very high. This is true of capacity utilisation among companies but also in the labour market, where unemployment has indeed begun to rise but remains below equilibrium. Reforms aimed to coming to grips with numerous **structural problems** will be crucial to growth, as we have argued in earlier reports (see, for example, *Eastern European Outlook*, March 2014). The consequences of Russia's failure to diversify its economy away from large-scale energy export dependence – with oil accounting for about 60 per cent of total exports – have become clear in connection with the oil price decline. The economy is also hampered by many other problems, including a poor business climate, deteriorating demographics and weak institutions.

The situation remains gloomy on the reform front. Some reform steps have occurred in recent years (such as World Trade Organisation membership, a new deficit-limiting budget rule and certain privatisations) but these are not enough to generate any major positive effects. Low reform-mindedness is worsened by a lack of clear alternatives to the current political system. Nor has the sharply deteriorating economic situation given rise to any major reform initiatives. A one-year **"anti-crisis plan"** was unveiled in late January, but it focuses on trying to solve immediate problems and in principle includes no structural reform efforts. The plan totals about USD 35 billion (some 1.5 per cent of GDP), and some of the money will be taken from the Reserve Fund and the National Welfare Fund. The theme article entitled "Russian financial reserves" describes in more detail both the challenges faced by government finances and the tools, for example the currency reserve, that are available to meet them. Two thirds of the money will be used for continued bank recapitalisations, while the business and agricultural sectors will receive certain subsidies and tax relief. Since the reform outlook seems poor, our assessment is that **medium-term GDP growth will end up around 2 per cent** due to high resource utilisation and structural problems.

Sentiment indicators provide a picture of an economy that is facing a **downturn**. The purchasing managers' index (PMI) for the manufacturing sector weakened sharply around year-end but improved in February to 49.7. This upturn is probably temporary and can be explained by the recovery in oil prices and the rouble. **Consumer confidence** also **fell sharply** late in 2014, and leading indicators have fallen.

The rouble has trended downward since mid-2011. During the second half of 2014, this trend accelerated and by mid-December the rouble had been pushed to a record low against the US dollar. **There is a strong correlation between oil prices and rouble exchange rates**, and the currency depreciation was primarily driven by last autumn's oil price drop. Rouble depreciation has been significantly sharper than during the 2008 oil price downturn. But in February 2015 the rouble regained strength, driven by higher oil prices and expectations that Western economic sanctions will not be tightened further. Despite this upturn, the rouble remains very sensitive to any new oil price declines and to the threat of expanded sanctions. Based on SEB's oil price forecast and the assumption that the sanctions will remain in place during 2015 without escalating, our assessment is that the currency will gradually strengthen. **We expect the rouble to stand at 55.0 per USD by the end of 2015 and at 50.0 by the end of 2016**.

The oil price decline has pushed down the rouble

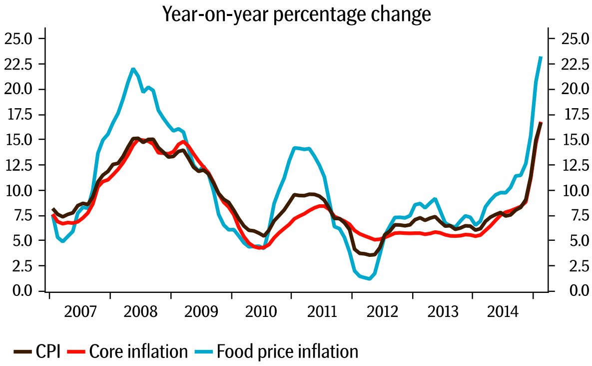


Source: Macrobond

The sharp weakening of the rouble has driven up Russia's inflation rate dramatically. **In February, year-on-year inflation was 16.7 per cent**: the fastest rate since 2002. The ban on food and agricultural imports from Western countries that have imposed sanctions on Russia – which took effect in August 2014 and is set to run for one year – has contributed to this development by pushing up food price inflation. **The rouble's exchange rate will determine the future inflation trend.** Based on our scenario of a gradual rouble appreciation, we expect inflation to culminate at **just below 20 per cent** during the second quarter. In the second half of 2015, inflation will begin to slow. As an annual average, we believe that it will end up at **16.0 per cent in 2015**. Next year inflation will decelerate further to 9.0 per cent, driven by base effects and rouble stabilisation. The central bank believes that its medium-term inflation target of 4 per cent can be reached only in 2017.

Rouble depreciation and import ban have driven up inflation

Year-on-year percentage change



Source: Russian Federal State Statistics Service

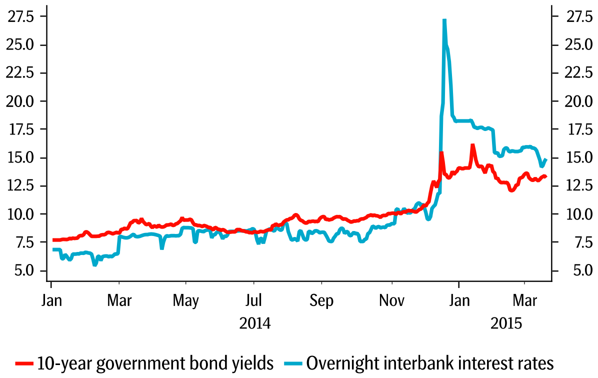
The combination of rouble depreciation, accelerating inflation and falling growth is creating major challenges for Russia's central bank. Because of financial market turbulence and the sharp rouble slide, in December 2014 the bank raised its key interest rate from 9.5 per cent to 17 per cent in an attempt to stabilise the rouble and counter capital outflows. In late January, however, the central bank cut the key rate to 15.0 per cent. In March, the key rate was cut to the current level at 14.0 per cent. According to the bank's press releases, the arguments for the rate cuts were that the acceleration in inflation is temporary, that the sharp key rate hike in December stabilised financial markets and there was concern about growth.

Looking ahead, interest rate policy will be a difficult balancing act for the central bank. On the one hand, high interest rates have a big negative impact on growth by affecting business investments, but also by slowing the growth of consumer loans. On the other hand, excessively rapid key rate cuts risk weakening the rouble, leading to even higher inflation and causing an acceleration in capital outflows, which exceeded USD 150 billion during 2014, which was a record. Since the central bank transitioned to inflation targeting last autumn, its intention has been to let the rouble float freely, but the bank reserves the right to intervene if financial market stability is threatened. After initially weakening after the January interest rate cut, however, the rouble has appreciated as oil prices have recovered. Our assessment is thus that **as long as oil prices do not fall again**, affecting the rouble, **there is some room for gradual key interest rate cuts**. The central bank will use this room to support economic growth. Its rate cuts will be cautious, however. **At the end of 2015, we expect the key interest rate to be just below 10 per cent.** In 2016 a cautious easing of monetary policy will continue.

Sanctions, rouble depreciation and decelerating growth have put **strong pressure on the banking system**. During the financial market turbulence in December 2014, mainly interbank rates but also government bond yields soared. But recently there have been **signs of stabilisation**, with market rates falling again even though they are still at heightened levels and are hampering economic activity. Banks are reasonably stable, and the level of bad loans is relatively low – just below 7 per cent – although it will climb considerably ahead. Large-scale bank recapitalisations will be required, and the programme included in the government's anti-crisis plan will probably need to be expanded. This, in turn, will put further pressure on government finances. But our **main scenario** is that **a large-scale banking crisis can be avoided** in Russia.

Interest rates and bond yields remain high

Per cent



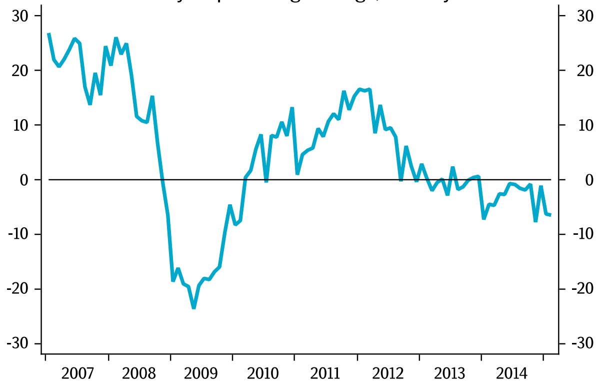
Source: Macrobond

In recent months, Russia's credit rating has been downgraded to junk status. For example in late February, Moody's lowered its sovereign rating to Ba1, with a negative outlook. The reasons the credit rating agency gave were lower growth prospects, weakening government finances and shrinking reserves, as well as questions about Russia's willingness to pay its debts due to the ongoing crisis in Ukraine, the oil price decline and the sharp depreciation of the rouble. The downgradings were expected, but they still raise **serious questions about the resilience of Russian government finances** to the oil price downturn and financial stress. A shrinking but still large currency reserve and low government debt will provide fundamental protection. Combined with two large reserve funds and recapitalisation plans for the banking sector, our assessment is that **Russia will avoid a government financial crisis**.

A **weak capital spending trend**, driven by structural problems, is the main reason behind the clear deceleration in growth over the past few years. The conflict with Ukraine has made this poor performance worse. Western sanctions are creating uncertainty and undermining the willingness of Russian companies to invest. The business climate has deteriorated even further, and because of increasingly tough attitudes towards foreign companies, many of these companies have already begun to cut back their operations in Russia (for example banks, but also companies like the Danish-based brewer Carlsberg) or they have shelved earlier expansion plans. In the important energy sector, sanctions and suspensions of partnerships with foreign companies (for example Rosneft and Exxon Mobil) will have a clearly negative impact. We expect capital spending to continue falling in 2015.

Continued weak trend for capital spending

Year-on-year percentage change, monthly data

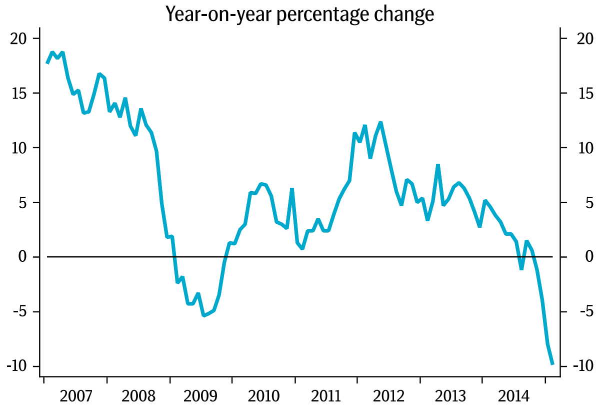


Source: Economy Ministry of Russia

Retail sales rose sharply in December but tumbled in January and February. The strong surge in December was driven by strong rouble depreciation and consequent expectations of imminent price increases for such products as household appliances, cars and computers. As expected, however, the surge in sales was only temporary. **The private consumption outlook appears gloomy in 2015.** Households will be squeezed by high inflation, which will hurt real wages. Real wage growth has slowed since 2012 and is now falling sharply year-on-year; in February 2015 the downturn was a record 9.9 per cent. Real wages are expected to fall further, driven by accelerating inflation and stagnating nominal earnings. Unemployment is now also rising, though from a historically very low level. This increase is expected to continue, but unemployment will remain just above 6 per cent during our forecast period. A further impediment to consumption is that the rapid increase in consumer loans during the past few years has suddenly stopped, due to tougher central bank regulations, rising interest rates and financial stress in the banking system. Overall, **private consumption** will shift from having been a vital driving force behind growth to providing a **sharply negative contribution to GDP growth in 2015**.

Sharply falling real wages will hurt consumption

Year-on-year percentage change



Source: Russian Federal State Statistics Service

Strong support for Putin, weak opposition

Russia's domestic political scene is still dominated by President Vladimir Putin. There are no signs that his popularity, greatly enhanced by the annexation of Crimea and his handling of Ukraine as well as his aggressive stance towards the West, has diminished to any great extent. **Putin's approval rating remains at around 85 per cent**, according to opinion polls. Since the widespread pro-democracy demonstrations of 2011-2012 (triggered by then-Prime Minister Putin's decision to run for president), **the opposition has become much weaker**. Putin's return to the presidency in 2012 has led to rough treatment of opposition forces and critics. The government has tightened its control of the media and used them to generate support for the president and the government, discredit opposition organisations and dissidents and whip up anti-Western sentiment.

Numerous opposition figures and critics of Putin have moved abroad, been imprisoned, been placed under house arrest or otherwise been outmanoeuvred in recent years. One example is the treatment of activist Alexei **Navalny**, who has been prosecuted and sentenced to prison and then quickly been released. Late in February one of the best-known critics of Putin and opponents of his Ukraine policies, Boris **Nemtsov**, was assassinated. Regardless of who is behind this murder, it further increases the anxiety among regime critics and shakes up an already divided and disorganised opposition. At present, there are no signs of any major changes in the domestic political scene. We are thus sticking to our assessment that **near-term domestic political risk is small**.

We expect Putin's record-strong support to erode over time, driven by deepening economic problems and stagnating living standards, but it is difficult to say how quickly this will happen. The government-controlled media are blaming Russia's economic problems on the West. Putin's popularity will also largely be affected by what happens with foreign policy and Russia's relations with Ukraine and the West. The next national election will be for the State Duma in late 2016, followed by the presidential election in 2018. Today's serious deterioration in the economic situation is creating better fundamental conditions for a more active political opposition. But **time is beginning to run short for the fragmented opposition to organise** in order to offer a genuine political alternative in the next election. Our **main scenario** is thus that **Putin's United Russia party will emerge victorious in the 2016 parliamentary election**, even though the party is not as popular as he himself is. At present, there is no challenger to Putin for the presidency. The most probable scenario is therefore that **Putin will win the presidential election in 2018** and serve for another term of office until 2024.

No signs of a gentler foreign policy

The increasingly tough domestic political climate is reflected in an aggressive foreign policy. Our earlier assessment that Russia is trying to force a federalisation of Ukraine in order to counter the country's integration with the West seems to be proving true. The **Minsk 2** agreement on a ceasefire in eastern Ukraine includes changes in the Ukrainian constitution that imply expanded autonomy for the Donetsk and Luhansk regions. This **will give Russia a permanent influence on developments in Ukraine**. Russia's main objective is to strengthen its own security policy situation by preventing Ukrainian NATO membership and stopping or creating major obstacles to integration with the EU and the West. Ukraine's ambition is to submit an EU membership application in 2020.

The conflict with Ukraine is the main reason for Russia's seriously deteriorating relations with the West. Russia has shown that continued influence on Ukraine is so important that it is prepared to withstand tough Western actions. But Russia's relations with the US in particular had already started to deteriorate before the conflict with Ukraine broke out. A number of factors, such as the handling of the Magnitsky case, Russia's granting of a residency permit to American whistle-blower Edward Snowden and controversies related to the handling of the civil war in Syria are examples of **several years of increasingly tough Russian foreign policy**.

Aside from Ukraine, Russia is trying to strengthen its influence on other countries in its vicinity. It is expressing this both through demonstrations of military strength but, above all, through diplomatic and economic pressures. See our theme article on the Eurasian Economic Union in *Eastern European Outlook*, October 2014. Russia is also trying to counter the attempts of European countries to maintain a unified policy towards Russia, probably in hopes that its influence on European political parties will increase the likelihood that sanctions against it will be lifted. There are **ties between Russia and several European political parties**, both on the far left and right. Greece's Syriza and Hungary's Jobbik are examples of clearly pro-Russian parties, while France's National Front has an openly positive attitude towards Putin.

There is **little chance that there will be any major improvement in relations between Russia and the West within the next couple of years**. The past 15-20 years of integration with the West have rapidly been reversed, and both among Russia's population and political leaders there is deep distrust of the US and Europe. Government-controlled media have intensified this negative stance. Russia is instead trying to **expand its cooperation with other emerging economies**, especially **China**. In May 2014, it signed an agreement on gas deliveries to China and in December a currency swap agreement, but it is uncertain how useful this increased cooperation will be for Russia. The two countries are competing for influence in Asia. By virtue of its economic and political weight, China can meanwhile largely dictate the terms of its cooperation with Russia. This was clear from the gas agreement, which favoured China.

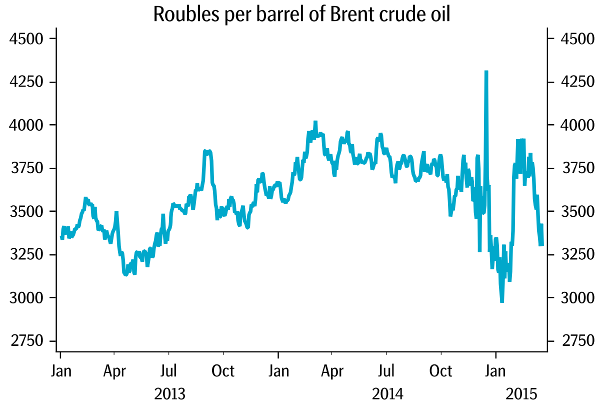
- **Russia's federal government finances are being squeezed from several directions**
- **Currency reserves will provide protection...**
- **...but safety buffers will eventually weaken**

Due to Russia's still-heavy dependence on budget revenue from energy exports, the sharp decline in oil prices has raised questions about government finances. Western sanctions have worsened the situation, contributing to record-sized capital outflows in 2014. In recent months, Moody's and other rating agencies have downgraded Russia's sovereign credit rating to junk status. Because it has low government debt and an extensive foreign currency reserve to start with, Russia has strong financial muscles, but these rating downgrades reflect the challenges that Russian government finances now face.

Several factors are hurting government finances. The most important is the oil price decline. Since peaking in June 2014, oil prices have roughly halved but the rouble has meanwhile also weakened sharply. This boosts the value of government oil revenue in local currency terms. At the peak, a barrel of Brent crude was worth about 3,940 roubles. Since then, both oil prices and the rouble have fallen greatly in value, but oil prices have fallen more than the rouble. At present, a barrel of Brent oil is worth about 3,300 roubles, a decrease of about 16 per cent compared to June. The depreciation of the rouble thus eases the reduction in budget revenue, but it cannot fully offset the sharp drop in oil prices.

Rouble depreciation cannot fully offset oil price drop

Roubles per barrel of Brent crude oil



Source: Macrobond, SEB

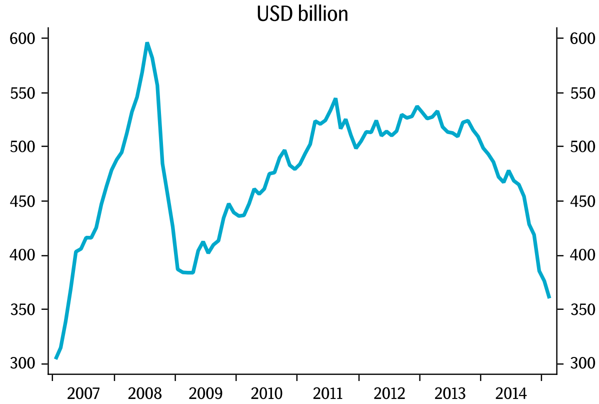
Aside from lower oil prices, federal government finances are affected by various other factors. The slowdown in economic activity reduces budget revenue. Private consumption is falling sharply, resulting in **shrinking tax revenue**. The government has responded to decreased budget revenue by reducing expenditures. The number of federal civil servants will be cut by 10 per cent, and their salaries will also be cut by 10 per cent.

Propping up the banking sector will also require large-scale government support. The combination of sanctions, rouble depreciation and decelerating growth is squeezing the banks hard, and large-scale recapitalisations will be needed. The "anti-crisis plan" unveiled in late January 2015 includes bank recapitalisations equivalent to some 1 per cent of GDP. The need will largely be determined by how sharply the proportion of bad loans will increase. Recapitalisations amounting to at least 2 per cent of GDP seem more reasonable, however. Aside from recapitalisations, government resources are being employed to help companies service their foreign currency borrowings.

In the October 2014 *Eastern European Outlook*, our forecast was that the 2015 budget deficit would end up at 1 per cent of GDP. Given the cumulative impact of a radically lower oil price forecast and expectations of a 5 per cent drop in GDP – leading to lower tax revenue – as well as bank recapitalisations, the deficit will be substantially larger. **We estimate that the 2015 budget deficit will end up at around 3.5 per cent of GDP, but that the deficit will shrink to 2.0 per cent in 2016**, based on a recovery in oil prices and better economic growth prospects.

An extensive but shrinking currency reserve

USD billion



Source: Central Bank of the Russian Federation

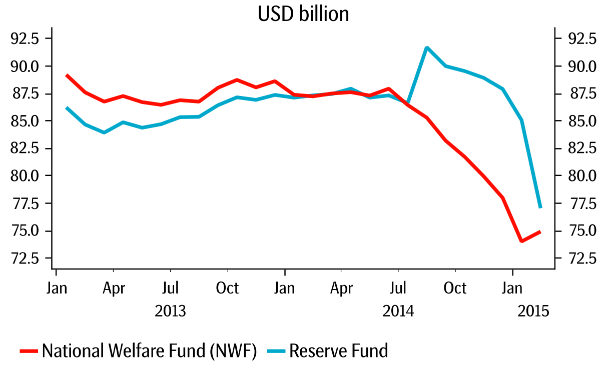
Because of **low federal government debt**, Russia enjoys **solid protection**. The country's extensive **currency reserve**, today equivalent to about 17 per cent of GDP, also serves as **a protective buffer** against weaker government finances and capital outflows. During 2014, however, this reserve weakened sharply from around USD 510 billion to 385 billion. Much of the downturn is explained by central bank interventions last autumn in an attempt to defend the rouble. The reserve has continued to weaken in February and March, even though the central bank has not intervened directly in the foreign exchange market since January. One of the main explanations seems to be that the central bank is carrying out repo transactions with companies. The central bank supplies euros and dollars in exchange for rouble-denominated assets. These transactions are an attempt to ease the problems of Russian companies with foreign currency borrowing caused by Western sanctions. Sberbank, the country's largest bank, has estimated the refinancing needs of Russian companies with loans in foreign currencies at more than USD 100 billion in 2015.

Of the total currency reserve, around 40 per cent consists of two government-run funds: the **Reserve Fund** and the **National Welfare Fund** (NWF). The funds were created in 2008 by splitting the previous Stabilisation Fund, established in 2004. After the 1998 financial crisis, Russia began building up protective buffers. Rapid economic growth combined with rising oil prices made this process easier. The idea is that government budget surpluses should be transferred to the two funds. The surplus is channelled first to the Reserve Fund, which may be used as needed to cover a budget deficit. If the Reserve Fund already exceeds 7 per cent of GDP, the surplus is instead transferred to the NWF. The rules for using the NWF are stricter than for the Reserve Fund. The NWF should be used for long-term social welfare commitments, investments and as a back-up to the pension system.

The government is already using both these funds to deal with weakened budgets and capital outflows and to provide support to companies having difficulty servicing their loans due to Western sanctions. For example, the big natural gas producer Novatek has already received aid from the NWF and the leading oil companies Rosneft and Lukoil have applied for aid to be able to implement large-scale investments. The funds have thus already decreased noticeably in size.

Government funds are being used to respond to the economic downturn

USD billion



Source: Ministry of Finance of the Russian Federation

This decrease is expected to continue; Finance Minister Anton Siluanov has said **the government intends to use much of the Reserve Fund during 2015 and 2016**. Given this plan, by 2016 the Reserve Fund would be so empty that it could no longer fulfil its function as a protective buffer against central government budget deficits. Our **main scenario** is thus that **in 2015 and 2016, Russia will use large proportions of the Reserve Fund and the NWF**. Combined with low central government debt, a government financial crisis can thus be avoided.

During the years of high oil prices it was possible to build up these funds, but the situation is different now. Given current expectations of substantially lower oil prices than before, combined with budget deficits, it will be difficult to replenish the funds again. Looking ahead, Russia's safety buffers will thus weaken substantially. The **price of avoiding a government financial collapse will thus be a serious weakening of long-term resilience**. Another problem is that the **resources of the funds are being used to solve problems caused by structural weaknesses**. This will lead to the postponement of necessary reforms.

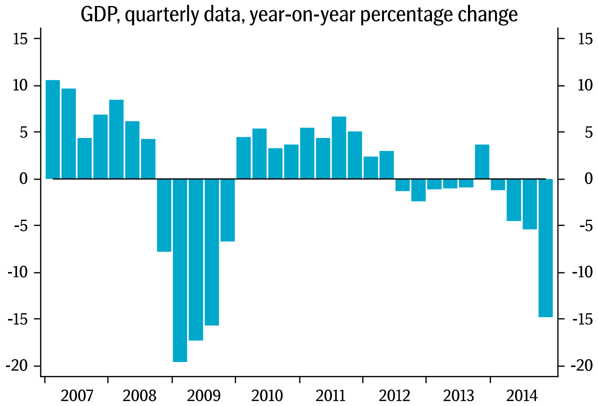
Financial collapse avoided through bail-out measures

- **GDP decline will continue in 2015**
- **Fragile ceasefire, frozen conflict?**
- **Inflation shock lowering consumption**

The Ukrainian economy is in the midst of a deep recession. **In the fourth quarter of 2014, GDP fell by close to 15 per cent** compared to the same quarter of 2013. This brought the full-year 2014 decline to 6.5 per cent. All indications are that **GDP will continue to fall sharply in 2015**. The battles in eastern Ukraine, where a large percentage of the country's industry is located, have had a powerful impact. Both industrial production and exports are being disrupted due to destroyed production facilities and smashed infrastructure. In January, industrial production was down more than 20 per cent year-on-year. Exports are also being hurt by the problems of the Russian economy. Rapidly accelerating inflation, driven by sharp currency depreciation, is hitting private consumption hard. Meanwhile public sector consumption is hampered by decreased tax revenue and efforts to cut the budget deficit. Ukraine is on the brink of a government financial crisis, but an expanded and extended international bail-out programme, combined with debt write-downs, will enable authorities to cope with servicing large foreign loans in the next few years.

GDP fell sharply in the fourth quarter of 2014

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



Source: State Statistics Service of Ukraine

The overall economic downturn will be broad. **We expect GDP to shrink by 6 per cent in 2015.** There are two obvious **downside risks**. First, the latest fragile ceasefire may collapse. Second, there is a risk that debt write-down negotiations will not achieve the desired outcome. If these two pitfalls can be avoided, there is a chance of recovery **in 2016** and **we believe that GDP will increase by 1.0 per cent**. Exports will lead the recovery, driven by currency depreciation and better international demand, but it will be a long journey back. Necessary reform measures will hamper short-term growth.

In mid-February, the **"Minsk 2"** agreement was signed, leading to a ceasefire in eastern Ukraine. But a truce is not a solution to the conflict. Even if battles become less intensive and eventually cease, the conflict will live on. One example is a dispute on how to manage Russian gas deliveries to eastern Ukraine. There are no indications that the government in Kiev can regain control over separatist-run areas. Minsk 2 includes amendments to the Ukrainian constitution in the direction of "decentralisation". In practice, this means expanded autonomy for the Donetsk and Luhansk regions. Our main scenario is that **Minsk 2 will hold up** but that **Russia will use Donetsk and Luhansk to retain its influence on Ukraine** and try to block rapprochement with the West. It thus appears as if eastern Ukraine will develop into a **"frozen" conflict**, similar to South Ossetia or Trans-Dniester. This is probably the "best" possible scenario. A more serious scenario is that Minsk 2, like its predecessor ceasefire, will fall apart and that the separatists will try to expand the territory they control, for example by mounting an offensive against the port city of Mariupol.

On the same day as Minsk 2 was signed, the International Monetary Fund preliminarily announced that Ukraine's two-year bail-out loan – approved in April 2014 – will be replaced by a **four-year extended fund facility (EFF)**. The EFF was approved in mid-March. Including the old loan, total IMF bail-outs now amount to USD 22 billion. The expanded IMF loan is not dramatically larger than the earlier USD 17.5 billion loan. In addition to the IMF loans, expanded loans are also coming mainly from the EU and the US, as well as from the World Bank. The **bail-out programme** is expected to total **about USD 40 billion**, but this sum includes some USD 17 billion in expected debt write-offs.

Because of the severe weakening of Ukraine's currency, public debt in relation to GDP has climbed dramatically. At present it is about 100 per cent of GDP, compared to just over 70 per cent at the end of 2014. The aim of write-downs is to reduce this debt to a sustainable level. Negotiations with lenders have begun but are expected to continue for a long time. There is **great uncertainty about how debt write-downs will take place**, but some things appear likely. The write-downs are expected to include only loans denominated in foreign currencies, since domestic debts can be inflated away. A large proportion of foreign currency loans are held by the IMF or other international institutions, and it is unlikely that this portion would need to be restructured. This leaves foreign currency loans of about USD 17 billion. These are held by

Russia (3 billion), Franklin Templeton Investments (8 billion), foreign banks (3 billion) and foreign governments (3 billion). At present it is not possible to say how the restructuring will take place, but lenders will probably face a number of different alternatives: direct write-downs of loans, lower interest rates or extended maturities.

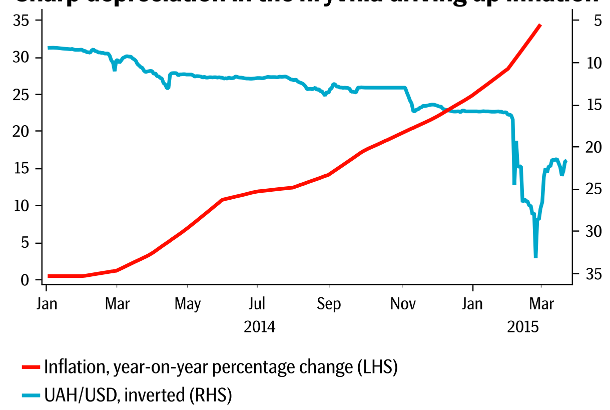
The four-year EFF will give Ukraine more time to carry out the **far-reaching reform programme** required by the IMF. The urgent objective of the reform programme is to **stabilise the economy in the near term** by ensuring financial stability and strengthening public finances. Monetary policy will be based on a flexible currency regime, with floating exchange rates that will provide resilience to external shocks. Inflation will be pushed down to single digits by 2018. Recapitalisations will be needed to save hard-pressed banks, which are being harmed by the depreciation of the hryvnia due to the large percentage of loans and assets in foreign currencies. Another urgent problem is to come to grips with Ukraine's budget deficit, which soared to nearly 7 per cent of GDP in 2014. The deficit will be reduced to below 3.0 per cent by 2018; mainly by cutting expenditures. The removal of costly gas subsidies, which has already begun, will continue with the aim of eliminating them by April 2017. In addition, the costs of public sector salaries and pensions will be lowered and the income tax will become more progressive. The aim is to **reduce public debt to 71 per cent of GDP by 2020**. These measures are necessary but will contribute to the GDP downturn in 2015.

The reform programme is intended not only to solve the most acute problems, but also enable a long-term positive trend and good growth through **structural reforms**. This includes anti-corruption measures and reforms of state-owned companies. For example, energy efficiency will be improved and the state-owned gas company Naftogaz will be restructured.

Aside from the powerful negative effects of the fighting on industrial production and exports, the **sharp depreciation of the hryvnia** has had the biggest impact on the economy. Not only banks, but also households and non-financial companies, have extensive exposure to foreign currencies. The cost of financing loans in foreign currencies is rising significantly and is hurting private consumption as well as capital spending.

The hryvnia depreciated sharply during 2014, driven by developments in eastern Ukraine, weakened government finances and the consequent increase in the risk of a balance of payments crisis. Since the beginning of 2015, the currency has weakened further amid high volatility. The central bank has been forced to undertake drastic actions to try to stabilise the hryvnia. Ukraine's critically low and shrinking currency reserve has made foreign exchange interventions impossible. The central bank has instead hiked its key interest rate dramatically, from 14 per cent at year-end 2014 to the current 30 per cent. The bank has also imposed capital controls. Looking ahead, the combination of an expanded bail-out programme and debt write-downs is expected to provide some support to the hryvnia. Our assessment is that the **hryvnia will be worth 30.0 per USD at the end of 2015 and 20.0 at the end of 2016**. We expect the key interest rate to be cut to around 20 per cent by the end of 2015.

Sharp depreciation in the hryvnia driving up inflation



Source: Macrobond, State Statistics Service of Ukraine

The weakening of the hryvnia is also having an impact through rapidly accelerating inflation. After two years of zero inflation, prices surged in 2014. Inflation has continued to accelerate in 2015. **In February, year-on-year inflation was more than 34 per cent.** Although reductions in gas price subsidies are also contributing to the upturn, it has primarily been driven by the sharp depreciation in the currency. Looking ahead, the value of the hryvnia will be crucial to inflation. **We expect full-year 2015 inflation to end up at 31.0 per cent. In 2016** it will slow to **17.0 per cent**. Inflation will severely affect household disposable incomes by lowering real wages. Unemployment has begun to climb, and during the third quarter of 2014 it was 8.9 per cent. Households are also hurt by efforts to reduce central government expenditures. These negative effects are clearly apparent in the form of a sharp downturn in retail sales.

Because of currency depreciation, imports have fallen sharply and the large **current account deficit**, which has been a problem for many years, **has greatly decreased** and is expected to end up at 2.0 per cent of GDP in 2015. Yet currency depreciation has not had any stimulative effect on exports, which in January were 32 per cent lower than a year earlier. The reasons are the destruction of infrastructure in eastern Ukraine, difficulties in securing export financing and the economic problems of Russia, which is the largest market for Ukrainian exports: about 25 per cent of the total. Global demand for the country's most important export product – steel – also remains sluggish.

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	2.1	2.2	2.7
Inflation, HICP, average, %	-0.1	3.0	5.1	4.2	3.2	0.5	0.5	2.3
Unemployment, %	13.6	16.7	12.3	10.0	8.6	7.4	6.5	5.8
Current account, % of GDP	2.5	1.7	1.4	-2.4	-0.4	-0.1	-0.8	-1.5
Public sector financial balance, % of GDP	-2.0	0.2	1.0	-0.3	-0.5	-0.4	-0.7	-0.5
Public sector debt, % of GDP	7.1	6.6	6.0	9.7	10.1	10.0	9.8	9.6
3-month interest rate, end of period	3.3	1.1	1.4	0.2	0.3	0.1	0.0	0.0

LATVIA

	2009	2010	2011	2012	2013	2014(f)	2015(f)	2016(f)
GDP, %	-14.2	-2.9	5.0	4.8	4.2	2.4	2.4	2.7
Inflation, HICP, average, %	3.3	-1.2	4.2	2.3	0.0	0.7	0.7	2.1
Unemployment, %	17.5	19.5	16.2	15.0	11.9	10.8	9.9	9.4
Current account, % of GDP	8.0	2.3	-2.8	-3.3	-2.3	-3.1	-3.3	-3.6
Public sector financial balance, % of GDP	-8.9	-8.2	-3.4	-0.8	-0.9	-1.4	-1.3	-1.3
Public sector debt, % of GDP	36.4	46.8	42.7	40.9	38.2	40.3	38.5	36.2
3-month interest rate, eop	7.38	0.85	1.85	0.53	0.26	0.08	0.0	0.0

LITHUANIA

	2009	2010	2011	2012	2013	2014(f)	2015(f)	2016(f)
GDP, %	-14.9	1.7	6.1	3.9	3.2	3.0	2.6	3.5
Inflation, HICP, average, %	4.2	1.2	4.1	3.2	1.2	0.2	-0.4	0.3
Unemployment, %	13.7	17.8	15.4	13.4	11.8	10.7	10.0	9.5
Current account, % of GDP	3.7	0.1	-3.7	-0.2	1.6	1.5	-1.0	-2.0
Public sector financial balance, % of GDP	-9.3	-6.9	-9.0	-3.2	-2.6	-2.0	-1.5	-0.5
Public sector debt, % of GDP	29.0	36.3	37.3	39.9	39.0	41.0	41.0	37.0
3-month interest rate, eop	3.90	1.50	1.66	0.68	0.41	0.18	0.0	0.0
5-year government bond, eop	6.60	4.60	5.40	2.40	2.40	1.15	0.30	0.60

(f) = forecast

POLAND

	2009	2010	2011	2012	2013	2014(f)	2015(f)	2016(f)
GDP, %	2.6	3.7	4.8	1.8	1.7	3.3	3.4	3.6
Inflation, HICP, average, %	4.0	2.7	3.9	3.7	0.8	0.1	0.0	1.5
Unemployment, %	8.1	9.7	9.7	10.1	10.3	9.1	8.7	8.2
Current account, % of GDP	-3.9	-5.1	-5.0	-3.8	-1.5	-1.0	-1.5	-2.0
Public sector financial balance, % of GDP	-7.5	-7.6	-4.9	-3.7	-4.0	-3.5	-2.9	-2.8
Public sector debt, % of GDP	50.9	53.6	54.8	54.4	55.7	49.5	50.0	50.0
EUR/PLN, eop	4.1	4.0	4.5	4.1	4.1	4.3	4.1	3.9
Key rate, eop	3.50	3.75	4.50	4.25	2.50	2.0	1.5	1.50
5-year government bond, eop	5.91	5.52	5.34	3.21	3.78	2.1	2.4	2.9

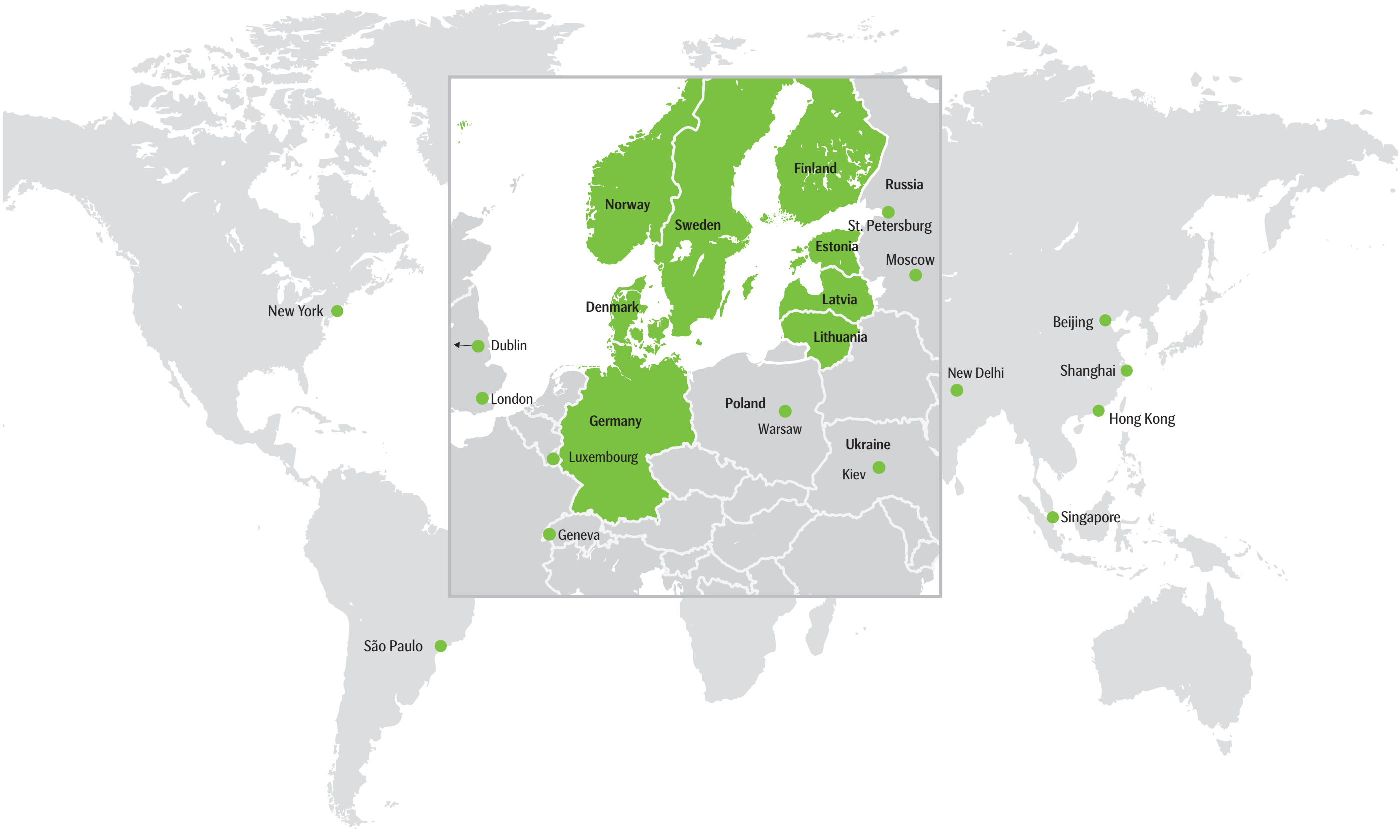
RUSSIA

	2009	2010	2011	2012	2013	2014(f)	2015(f)	2016(f)
GDP, %	-7.8	4.5	4.3	3.4	1.3	0.6	-5.0	-1.0
Inflation, average %	11.7	6.9	8.4	5.1	6.8	7.8	16.0	9.0
Unemployment, %	8.4	7.3	6.6	5.7	5.5	5.2	6.1	6.3
Current account, % of GDP	4.1	4.6	5.2	4.0	2.2	2.4	3.2	2.5
Public sector financial balance, % of GDP	-6.3	-3.4	1.5	0.4	-1.3	-0.5	-3.5	-2.0
Public sector debt, % of GDP	10.6	11.3	11.6	12.7	13.9	15.8	16.9	17.5
USD/RUB, eop	30.10	30.50	32.08	30.36	32.85	58.06	55.00	50.00

UKRAINE

	2009	2010	2011	2012	2013	2014(f)	2015(f)	2016(f)
GDP, %	-14.8	4.1	5.2	0.2	0.1	-6.5	-6.0	1.0
Inflation, average, %	16.0	9.4	8.0	0.6	-0.3	12.1	31.0	17.0
Unemployment, %	9.0	8.4	8.2	7.8	8.3	8.9	9.3	9.0
Current account, % of GDP	-1.5	-2.2	-6.3	-8.1	-9.1	-2.5	-2.0	-2.6
Public sector financial balance, % of GDP	-6.3	-5.8	-3.5	-5.5	-6.5	-6.8	-6.1	-4.7
Public sector debt, % of GDP	35.4	40.5	36.8	37.4	41.7	72.7	102.0	107.0
USD/UAH, eop	8.00	7.97	8.00	8.05	8.23	15.77	30.00	20.00

(f) = forecast



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SEGR0086 2015.03