

Eastern European Outlook

Economic Research – October 2015

Economic picture remains divided
Russian recession in 2016 too

Theme: The Russia-Ukraine
conflict and the sanctions



SEB

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Summary

The dual-track economic picture in Eastern (including Central) Europe will persist over the next two years. Conflict-plagued Russia and Ukraine will show continued weakness. In Russia, recession will linger during 2016 too, as plunging oil prices rebound only weakly and sanctions against the country by the European Union and United States are probably extended, though softened slightly. Meanwhile the Baltic countries, Central Europe and to some extent the south-eastern portion of Eastern Europe will continue to show decent economic growth, primarily sustained by growing domestic demand. Poland and the Czech Republic will lead the way.

Good conditions for households are the main reason why the Baltics and Central Europe will continue to show good resilience to the Russia-Ukraine conflict and economic weakness in those countries. Strong real incomes, increasing employment and only cautiously rising interest rates will lead to good consumption growth. Capital spending activity, which has been relatively sluggish so far, will increase but remain hampered by nearby geopolitical worries. Modest export growth will gradually strengthen, due to increased demand from Germany (which weighs especially heavily for Central Europe) and the Nordic countries (relatively important markets for the Baltics). The Baltics will be harder hit than Central Europe by Russia's economic downturn and food import sanctions, because of their larger foreign trade exposure to Russia.

The inflation picture in Eastern Europe will also remain divided. High inflation in Ukraine and Russia, driven by earlier currency depreciation, has largely culminated in recent months and will gradually continue downward. In most other Eastern European economies, inflation is under strong pressure as in the West but is past its low point or is about to hit bottom. Inflation will climb only weakly as a consequence of relatively rapid pay growth. Continued low commodity prices will have a restraining effect.

We still expect the Russia-Ukraine conflict to be long-lasting and the ceasefire to be fragile. The conflict has eased this autumn, but the various military and political promises made by the parties to the Minsk 2 agreement will be difficult to fulfil in their entirety by the December 31, 2015 deadline. Our main scenario is that at its January 2016 summit, the EU will extend its sanctions against Russia for a certain period of 2016, although it may soften them slightly. We believe that the US – which has been more strident than the EU about linking its sanctions to a condemnation of Russia's annexation of Crimea – will stick to its sanctions at least throughout 2016.

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 continue its decline in 2016 but the downturn will ease to 1.0 per cent from this year's 4.0 per cent. Growth will be slowed by low oil prices, sanctions and structural problems. In 2017 as well as in the long term, we expect growth to reach a low 1.5 per cent.
- **Ukraine** will see yet another sharp GDP decline this year, 12 per cent, and then experience weak growth in 2016-2017. The country's recent debt write-down agreement with private lenders and on IMF bail-out loans will contribute to stabilisation.
- **Poland** will see stable growth, accelerating a bit to 3.6 per cent in 2016 and 3.8 per cent in 2017. We expect a change of government after this autumn's parliamentary election. There are clear political dividing lines between the current government and its likely successor, but the growth picture will not change appreciably.
- **Estonia's** 2015 growth forecast has been written down a few tenths of a point due to weak exports, but growth will rebound – sustained primarily by a consumption boom and strong demand from Sweden and elsewhere. GDP will increase by 2.7 per cent in 2016 and 3.4 per cent in 2017.
- **Latvia** will be the fastest-growing Baltic country. GDP will climb by 2.7 per cent next year and 3.5 per cent in 2017, but the latter is only a bit above potential growth.
- **Lithuania** will experience leisurely growth this year, slowed by Russian effects but also by low prices that have hurt the country's important refined oil exports. Growth will accelerate to a decent 3 per cent or so annually during 2016-2017.

Unsynchronised and moderate global upturn

- **US and Germany are showing strength**
- **Low inflation will accelerate slightly**
- **Central Europe resilient to Russian setbacks**

World economic growth will strengthen somewhat in 2016, followed by a levelling-out. Growth will be sustained by highly expansionary monetary policies – despite initial hikes in today’s extremely low key interest rates by the United States, the United Kingdom and other countries – as well as by low commodity prices. Yet there will be **no perfect coordination among countries and regions**. The US economy will accelerate in 2016 and will grow relatively fast, driven by household consumption. China’s gradual slowdown in growth will continue, but its economy will achieve a soft landing amid gentle inflation pressure. Euro zone recovery will continue at a moderate pace, but Germany’s growth will reach around 2 per cent – good under German conditions – despite some drag from Volkswagen’s problems. Japan, fuelled by even more monetary stimulus and with big structural problems, will speed up only a bit from its slow pace. The emerging market picture will be mixed, with rapid and accelerating momentum in India but sluggish recovery from recession in Brazil and Russia – both plagued by political and structural problems. Overall **global growth in 2016-2017 will be just below 4 per cent a year, which is in line with trend growth**. Downside risks will predominate.

Global key data

GDP, year-on-year percentage change

	2014	2015	2016	2017
United States	2.4	2.6	3.0	2.6
Euro zone	0.8	1.5	2.0	2.0
The world	3.4	3.3	3.7	3.9
Oil, USD/barrel	99.6	54.1	55.0	60.0
EUR/USD, Dec	1.21	1.08	1.06	1.10

Source: SEB

Disinflationary forces are strong despite higher resource utilisation; during 2016-2017 the US, Japan and Germany will close their output gaps. Wages and salaries are climbing at a moderate pace, commodity prices are low (though oil will rise cautiously in the next two years), inflation expectations remain far below central bank targets and the underlying automation trend in the business sector is continuing. As a result, **the upturn in inflation will be mild**. The **European Central Bank (ECB)** will continue its stimulus policy, and recently **the probability of expanded quantitative easing (QE) has**

become even larger. The US Federal Reserve and Bank of England will begin cautious rate hiking processes in December 2015 and May 2016, respectively. Central bank policies will remain the dominant force that drives currency exchange rates. The euro will weaken and the US dollar will appreciate this autumn and during much of next year.

The central – and to some extent south-eastern – portions of Eastern Europe will continue to show **stable, decent economic growth**. During 2015-2016 we thus expect Poland and the Czech Republic to grow fastest, averaging more than 3.5 per cent: just above potential growth in Poland, but well above it in the Czech Republic. So far, growth in many countries has been driven mainly by dynamic private consumption. Looking ahead, it will also be sustained by gradually rising exports and capital spending, although the latter will be hampered by geopolitical worries. Strong real household incomes, falling unemployment, relatively minor trade ties to Russia and growing demand in the far more important German market are the main reasons for the region’s **good resilience to Russian weakness and Ukrainian unrest**. Only the Baltic countries, Bulgaria and various Central Asian countries have large foreign trade exposure to Russia.

If the **Greek debt crisis** should flare up again, it will pose **no direct threat** to Eastern Europe. The Balkan countries have some exposure to Greece via their banking systems and trade, but nothing dramatic; Greek banks account for more than 20 per cent of banking assets in these countries. **The refugee crisis** is expected to result in **somewhat slower growth** in several Eastern European countries **if border controls are extended or further tightened**, due to reduced trade and road transport (with Poland and the Czech Republic among the more sensitive) and less tourism (Croatia is sensitive). Further ahead, **higher immigration will slightly ease the mounting risks of labour market overheating** in Poland, the Baltics and elsewhere: countries that have struggled with net emigration, especially since joining the EU in 2004.

As in the West, **inflation** is low and is past its low point or is about to bottom out in most countries, except Russia and Ukraine. It **will climb weakly next year** after decelerating this autumn due to falling commodity prices. In various countries, the inflation upturn will be driven by labour shortages and relatively fast pay growth. **The interest rate cutting cycle is over in several Central European countries**, but only cautious rate hikes will occur in 2016-2017. Partly due to the ECB’s expansionary monetary policy, Central European central banks will choose slow rate hikes; otherwise they risk strengthening their currencies too much, making it even harder to meet their inflation targets during the next two years.

Theme: The Russia-Ukraine conflict and the sanctions

- **A long-lasting “frozen conflict”**
- **Sanctions policy will be extended, in any event by the US**
- **Russia the big loser in the sanctions war**
- **Syria a pawn in the sanctions game?**

One fundamental assumption in our Eastern European analysis since the Russia-Ukraine conflict broke out in February 2014 has been that it will be long-lasting. This remains true. Regardless of whether the requirements in the latest (Minsk 2) ceasefire agreement from February are fulfilled or not, this will not in itself be a solution. **Eastern Ukraine** will thus remain a “frozen conflict”: an armed conflict that ends without reaching a solution satisfactory to both parties. One frequent result is that a region’s political status is disputed. Examples of frozen conflicts are Nagorno-Karabach, South Ossetia and Transnistria. They show how long-lasting such conflicts can become. For instance, a ceasefire was reached in the Nagorno-Karabach war in 1994, and negotiations have been underway since then with no resolution. The region has not been internationally recognised as an independent republic.

The separatist-controlled Donetsk and Luhansk regions in eastern Ukraine fulfil the criteria for a frozen conflict. Even if the fighting fades away, it is difficult to see how Minsk 2 could lead to a solution the two sides are satisfied with. Nor does Minsk 2 clarify the political status of eastern Ukraine. According to the agreement, Donetsk and Luhansk will remain part of Ukraine, but at the same time it includes a strengthening of these regions’ autonomy; the Ukrainian constitution has been accordingly amended. However, the political leaders of these separatist regions do not seem to be satisfied with this; instead their goal is to make their regions independent republics. The decentralisation of political governance in Ukraine will enable **Russia** to gain a **permanent influence on Ukraine** via Donetsk and Luhansk. Russia wants to disrupt Ukraine’s westward orientation, which aims at NATO membership by 2020 and joining the EU the same year.

Russia the loser in the sanctions war

The EU and the US (plus a number of other Western nations) are continuing their sanctions policy against Russia, with Russia imposing counter-sanctions. As we predicted last spring, the EU decided in June to extend its economic sanctions for another six months, until January 31, 2016. They include stringent restrictions on Russian borrowing in the European capital market, but also an arms embargo and a ban on some technology exports to the Russian energy sector. The US has imposed similar economic sanctions against Russia. The EU and the US also have “blacklists” of key individuals in

Russian and Ukrainian politics, business and organisations banning travel and freezing bank assets. Ukraine has also imposed sanctions against Russian key individuals and pro-Russian separatists. In addition, Ukraine plans to stop commercial air traffic from Russia. Russia responded to the EU’s extension of economic sanctions by adding a year to its own one-year ban on food and agricultural imports from countries pursuing a sanctions policy against the country, originally starting in August 2014.

We believe that **Russia will lose the most in the sanctions war**. The negative economic effects are relatively big in Russia, but very small among those affected by its counter-sanctions. **Financial damage** in Russia has also been **more than expected**. Russia’s import restrictions have been relatively toothless, since it buys food and agricultural products from many countries; only Lithuania has a significant exposure to these goods (about 4 per cent of total exports before the Russian ban). But individual producers and farmers as well as transport companies, especially in Russia’s immediate vicinity, are relatively hard hit by Russian sanctions. Meanwhile Russia has hurt itself, since lower supplies have contributed to higher food prices. Last summer the IMF did a model calculation showing that sanctions against Russia and counter-sanctions – via weaker consumption and investments – may have lowered Russia’s GDP by 1-1.5 per cent during the first year.

Uncertainty about sanctions policies

Our **main scenario** is that the **EU will extend the sanctions** for at least part of 2016 at the meeting in January 2016 while at the same time softening the sanctions slightly. **We expect the US to continue its sanctions at least until the end of 2016**. But it is difficult to assess the chances, and there are other possible scenarios.

After fighting flared up in the summer, the conflict again entered a calmer period in the early autumn after a new ceasefire on September 1. At the same time, the ceasefire is fragile and there is a substantial risk of new fighting, although at present neither side should derive any great benefit from an escalation.

The next crucial point will be the **evaluation of whether the two sides have fulfilled their obligations according to Minsk 2** as of year-end 2015. The EU has tied any lifting of its sanctions to fulfilment of the Minsk 2 requirements. There is a substantial risk that the deadline will be missed. The requirements (including returning control of the border between Russia and the Donetsk and Luhansk regions to Ukraine and withdrawing foreign combatants) are currently far from being fulfilled. One possibility is that the EU will determine that although the parties are trying to implement the steps in Minsk 2, there is no time to do so before the year-end deadline. The deadline could then be changed and the

sanctions could be extended until there is time to implement these steps.

The latest development indicates an opening for the EU to begin withdrawing its sanctions. Russia's President Vladimir Putin has changed his rhetoric. In recent appearances, among other places in Crimea, he has welcomed the cessation of fighting in eastern Ukraine. Before this, he had repeatedly criticised Ukraine for not respecting Minsk 2 and carrying out the promised steps: among other things, Kiev is supposed to hold direct talks with separatist representatives and enact amnesty laws for separatists. A preliminary agreement between Ukraine, the EU and Russia in late September on deliveries of Russian natural gas from October until March reinforce the picture of a recent cool-down in the conflict. This came after Kiev had announced in July that Ukraine would stop buying gas from Gazprom because the Russian company was charging higher prices than to other European customers.

One interpretation is that Putin is satisfied with what Russia has achieved so far in its handling of Ukraine and does not wish to escalate the military conflict. Putin may instead be hoping that Ukrainian domestic political disorder caused by popular dissatisfaction with reforms and constitutional amendments will destabilise the country.

Tougher US stance on the sanctions issue

The handling of sanctions policy by the US and the EU differs in several respects. Unlike the EU, the US has **tyed any lifting of its sanctions to a return of Crimea to Ukraine**, which is highly unlikely. The US has also been more strident than the EU against Russia, and early in the Russia-Ukraine conflict it took the initiative in imposing sanctions, although the EU soon followed suit. As we have pointed out in earlier reports (*Eastern European Outlook*, March 2014), economic links between Russia and the US are weak. The US can thus afford to leave its sanctions in force without in turn being hit by more severe counter-sanctions. During the summer, the US has taken steps to plug loopholes in its sanctions policy, reinforcing the impression that these sanctions will be extended.

Political development related to **Syria** could nevertheless create an **opening that could enable the US to eventually also lift its sanctions without Crimea being returned to Ukraine**. In recent months, Russia has clearly expanded its military presence in Syria and also performed air strikes. Its long-term motive is unclear. This has further increased uncertainty about the Syrian conflict, but in the immediate future Russia's military build-up in Syria will decrease the risk that the shaky Assad regime will collapse.

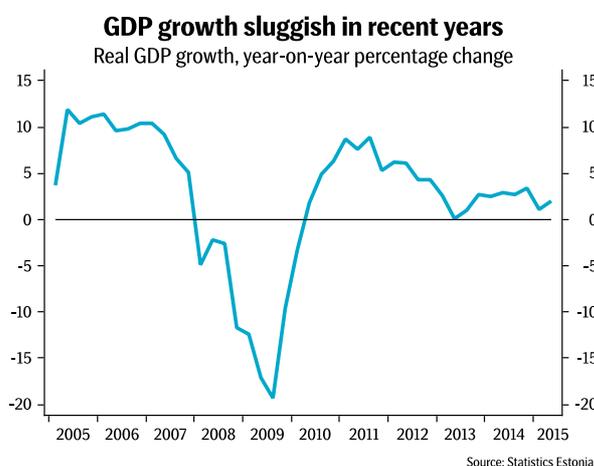
If Russia's purpose is to try to achieve a military solution, its intervention risks contributing to a continuation of the Syrian conflict. Another possibility is that Russia wants to strengthen its influence over developments in Syria and eventually contribute to the achievement of a political solution. Russia's initiative has already resulted in talks with the United States. The **focus on Syria is helping Russia relegate the Ukraine conflict to the background** and thereby potentially weaken support for the existing sanctions. It cannot be ruled out that

Russia will cooperate with the US and other countries to craft a political solution to the Syrian war. Russia recently announced that it has begun military intelligence cooperation with Iraq, Iran and Syria aimed at fighting the Islamic State.

Decent growth supported by consumption boom

- **Lower GDP expectations for 2015**
- **Swedish market increasingly important**
- **Wage growth not in line with business performance**

After a weak first quarter, with GDP increasing by only 1.1 per cent, the Estonian economy managed to grow by 2 per cent in the second quarter of 2015. Recent data revision of previous quarters resulted in a large upward correction for 2014, with GDP growth raised from 2.1 per cent to 2.9 per cent. Previous trends seem to be continuing, with **private consumption being the main driver of growth**. Capital spending remains stagnant regardless of low interest rates. As a result of weak economic performance in the first quarter and delayed recovery in exports, **we are lowering our GDP growth forecast for 2015 by 0.3 percentage points to 1.9 per cent**. We remain optimistic about **2016 and 2017**, expecting growth of **2.7 per cent and 3.4 per cent** respectively.



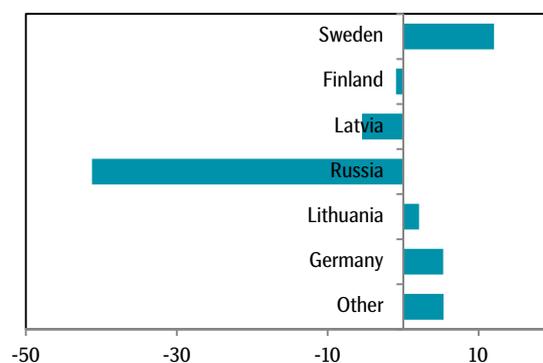
As a small country positioned conveniently close to prosperous Nordic markets, exports have played an important role in the Estonian economy. Exports as a share of GDP climbed fast after the crisis of 2008-2009, reaching almost 90 per cent in 2011-2013. Currently **exports make up 80 per cent of GDP**. The past two years have been more difficult, with merchandise exports of goods contracting by 2 per cent both in 2013 and 2014.

This year, exports decreased in current prices and year-on-year terms by 1.2 per cent during first 6 months, but because of the deflationary environment, in chain-linked prices exports were in a marginal surplus. Trade has been weakened

by economic downturns in major trading partners Finland and Russia. Before 2011, Finland was Estonia's main trading partner, but it has since lost this position to Sweden. Nevertheless, Estonia's market share in Finland has actually slightly increased since the downturn. The effects of the Russian crisis have been strongest in the agricultural sector because of sanctions on foodstuffs, but the actual loss has been much broader, affecting almost every sector of the economy. During the first half of the year **Russian exports and tourist numbers both decreased by roughly 40 per cent**. Sweden remains Estonia's main trading partner, with double-digit volume increases in recent quarters. Unlike exports to Finland, exports to Sweden are very concentrated – with electronics making up about half – which is largely dependent on a single company. Although the furniture and prefabricated home industries have seen impressive growth in the Swedish market this year, this heavy concentration to a few sectors poses threats to the sustainability of exports to Sweden, especially in the context of rising wages which decrease the cost-based competitive advantage.

Exports to Sweden are gaining ground

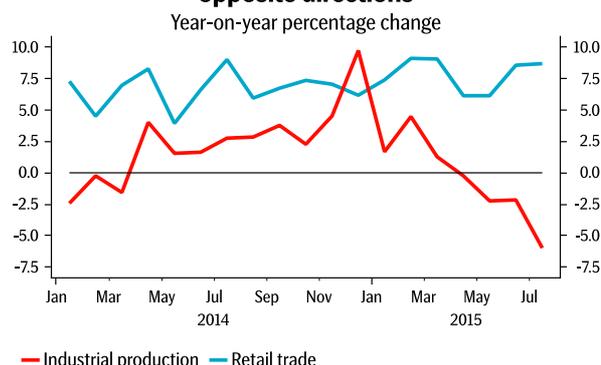
Change in exports to main trading partners in first 6 months of 2015, year-on-year % change



Source: Statistics Estonia

About 70 per cent of Estonia's industrial output is exported, which means that weak exports strongly impact manufacturers. **Industrial production volume more or less stagnated in the first half of 2015**. Despite this feeble overall situation, several key sectors – wood, furniture and metalworking – have displayed strong and steady growth throughout the year. Some of the Finnish metal companies have continued to transfer their production gradually to Estonia, increasing the exchange of goods. Rapid economic growth in Sweden has increased the production of the Estonian furniture and prefabricated home industry. The wood industry has also displayed outstanding results, with growth in exports to Denmark, Latvia and the UK.

Retail trade and industrial production moving in opposite directions



Source: Statistics Estonia

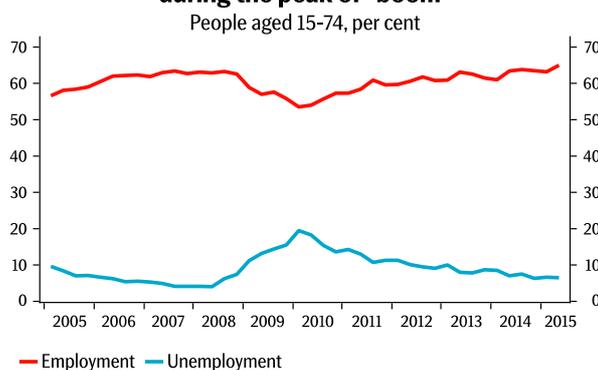
While external demand has been sluggish, **household consumption is booming**. The retail trade volume index has seen an average monthly growth of 8 per cent year-on-year in 2015. Households have been more eager to consume, thanks to rapid increases in real wages. The average wage in the second quarter of 2015 increased close to 6 per cent y-o-y. Due to an income tax rate cut and basic exemption increase in 2015, average net earnings actually increased by a total of 7.3 per cent. As a consequence of falling energy and food prices, households have had even more room to spend. Because of tight conditions in the labour market, nominal wage growth is expected to continue, but the rebound in inflation will make it adjust better to the economy. Since the lessons from the recent boom and bust are still vivid, consumption has been balanced by decent saving. Household deposits have been accumulating, with a very stable growth of 8 per cent y-o-y, while the total amount of loans to households has risen by modest 3 per cent.

Wage and salary growth has not been in line with the revenues of the business sector. While the sales of companies decreased by 3 per cent in the second quarter, labour costs rose by 6 per cent. This has been reflected both in business profits and investments. Capital spending fell by 3 per cent in the second quarter, which was the seventh straight quarter of decline. This reflects the fact that high liquidity cannot offset weak external demand and **investment decisions have been postponed until the market situation improves**.

From an employee perspective, the labour market situation remains favourable. Together with average wages, **employment has climbed to a record high of 65 per cent**. The unemployment rate of 6.5 per cent remains higher than at the peak of the 'boom' in 2007, indicating structural problems in the labour force. Unemployment is well below OECD estimates of NAIRU (equilibrium), about 8 per cent. One important question is how long companies can absorb growing wages at the expense of investments and profits. We expect to see better external demand next year, which would boost business incomes, but some companies may decide to reduce growing costs by cutting employee headcounts before this happens. The first signs of readjustments are already visible. Monthly registered unemployment data indicate a small rise since July. Because of increased costs, we are likely to see a gradual decline in low-paying jobs in the coming years, which must be offset by active labour market policies. As an

important policy change, a new "work ability" reform will take effect in the next couple of years. To reduce pressure on the pension system, some disabled people will start to receive benefits and services from the Estonian Unemployment Insurance Fund. This will probably impact employment statistics. Because of these changes, we expect a moderate surge in unemployment for 2016 and 2017.

Both employment and unemployment higher than during the peak of "boom"



Source: Statistics Estonia

Since expenditures on food, housing and transport make up a large proportion of household budgets, lower energy and food prices have caused the consumer price index to fall during most of the year. Besides lower oil prices, electricity has become much cheaper because of better links to the Nordic energy market. Lower oil price base effects, an increase in excise duties on alcohol as well as a surge in core inflation will lift prices in coming years. **We expect HICP inflation to reach 2.3 per cent in 2016 and 2.7 per cent in 2017.**

Parliament elections in May 2015 ended up with an unhappy **three-party coalition** of liberals, conservatives and social democrats, but the government is expected to continue on a business-friendly path. Regarding economic policy, important decisions have included a gradual **social insurance tax cut** from 33 per cent to 32 per cent in 2018, new tax rebates for low-income earners and a higher basic exemption. Using these measures, the government is trying to tackle high labour costs and improve conditions for the working poor. Since last year, a few changes in tax collection have been introduced. Some of the surge in employment may have been caused by a new decree obliging employers to enlist employees in an Estonian Tax and Customs Board (ETCB) registry from day one. Another law requires business to submit information on transactions above 1,000 euros to the ETCB, which has benefited VAT receipts.

Balanced expansion despite Russian slump, sanctions

- **Private consumption strengthening further**
- **Rapid wage and salary growth**
- **Cautious capital spending**

Although GDP growth in the second quarter accelerated from 1.9 per cent to 2.7 per cent, further growth will remain moderate. Latvia's economy has the **potential for faster growth, but various external risks** such as a complicated international environment, a limited euro zone rebound, as well as the long-term economic and political problems of eastern neighbours call for cautious estimates. We anticipate that **this year's growth will be 2.4 per cent, with a slight upturn to 2.7 per cent in 2016**, but then GDP growth will **accelerate up to 3.5 per cent in 2017** – slightly above potential.

In the first half of the year, private consumption grew by 2.5 per cent, and healthy growth will continue since conditions are favourable. At the same time, investment activity was up by 1.6 per cent. Given the fairly high level of caution among entrepreneurs, capital spending will likely remain anaemic. In spite of the difficulties with the Russian market, exports of goods and services during the year were up by 2.8 per cent.

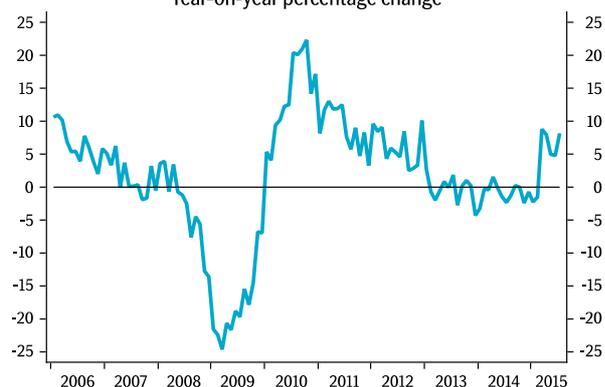
A 5.4 per cent increase in manufacturing had a significant impact on overall growth in the first half of the year. Despite the good performance of certain sectors (wood products; computer, electronic and optical products; chemical products; and furniture) the situation among sectors remains uneven, mainly due to the shrinking Russian market. We expect the recovery in the euro zone to keep industrial production growing, and this will have positive impact on the overall economic outlook. Growth was recorded in accommodation and catering as well as entertainment and leisure services. In the second quarter the number of foreign visitors rose 4.7 per cent. Meanwhile the number of guests from Russia decreased by 37 per cent.

A challenging situation is emerging in the **transport and storage** sector. There is a great risk of lower volume in the next couple of years. This is due to strained political relations between Russia and the EU and the decline in energy prices, which may influence demand for Russian commodities.

In the first six months of 2015, the volume of merchandise exports grew by 2.7 per cent. Meanwhile, imports grew more slowly – by a meagre 0.8 per cent. Falling oil prices have allowed an improving trade balance. The wood processing

industry continues to make a significant positive contribution to Latvia's trade balance.

Increasing industrial production
Year-on-year percentage change



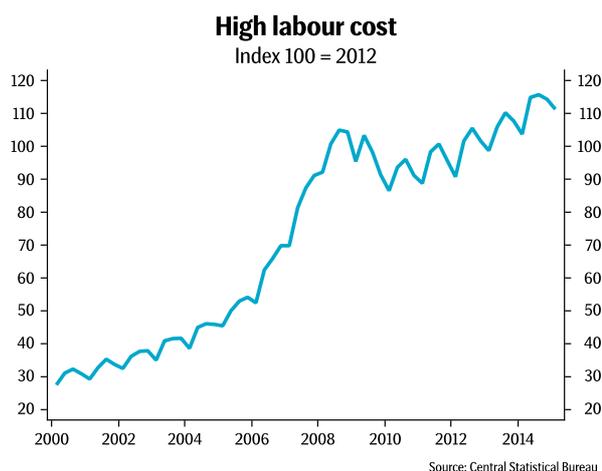
Source: Central Statistical Bureau

The most important Latvian export markets in the first half of the year were Lithuania (18 per cent), Estonia (12 per cent), Russia (7.6 per cent), Germany (6.7 per cent), Poland (6.1 per cent) and Sweden (5.7 per cent). During the year, no significant changes in the ranking of Latvia's **main trading partners** have occurred. However, **volumes have changed**. Exports to Lithuania during the year grew by 7.9 per cent, Estonia 1.9 per cent and Sweden 5.3 per cent. Meanwhile export volume to Russia has fallen by 19.6 per cent. Exports to Poland and Germany have also decreased. Despite the difficulties in the Russian market, we believe that **total export volume this year will rise** a bit, since **market diversification** is one of the country's continued top priorities. However, this diversification will face some headwinds, as a downturn in Russia also affects other former Soviet countries, and Chinese growth is gradually slowing. In the third quarter, due to hefty harvests, the export volume will be lifted by grain exports.

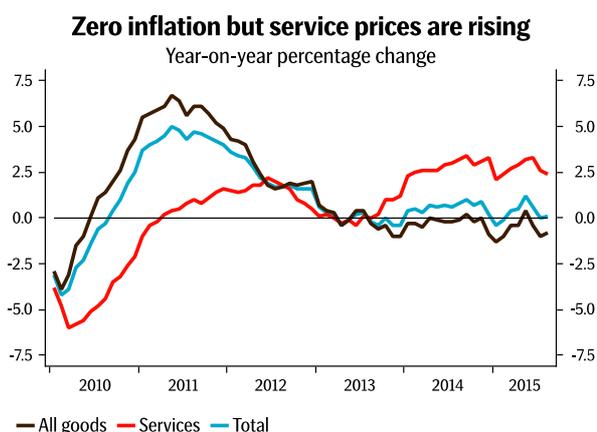
Meanwhile, **positive trends prevail in the retail sector**. In the first seven months of 2015, sales expanded by 5.9 per cent in year-on-year terms. Non-food sales activity allows us to predict relatively good retail growth rates in the months ahead. The latest economic stress index survey revealed a decrease that – together with further economic and wage growth – will create good conditions for consumption. However, Latvians are still cautious about taking on longer term liabilities, and the loan portfolios of banks are still shrinking.

Strong real wages and salaries are supporting consumption. In the second quarter, average gross wages and salaries increased by 6.9 per cent. The average gross wage in the private sector was still slightly lower than in the public sector. It

should be noted that wages and salaries have increased in all sectors of the economy. Taking into account the personal income tax rate reduction, net wages and salaries during the year have risen by 7.5 per cent, and real wages by 6.6 per cent. As a result, real wages are now above their pre-crisis level. Maintaining the current momentum, average wage growth will remain strong in the coming quarters. Next year, wage growth will slow down slightly, though a tightening situation in the labour market will continue to push up wages, especially in Riga. If this year's gross wage growth is above 6 per cent, next year it is likely to fall to around 4.5-5 per cent.



In August, the annual inflation rate picked up to 0.1 per cent from zero in July. **Low inflation** is determined mainly by external factors, since goods prices fell by 0.8 per cent in 2015 while service inflation was 2.4 per cent. Service prices will continue to show livelier growth than the prices of goods, since they reflect domestic consumer activity and rising costs. Due to the weaker oil price outlook, **we have lowered our inflation forecasts. This year's inflation forecast is 0.4 per cent, rising to 1.7 per cent 2016 and 2.3 per cent in 2017.**



The moderate pace of economic growth is reflected by changes in the labour market. In the second quarter, unemployment dropped only a bit to 9.8 per cent. On the positive side, the number of long-term unemployed individuals decreased too. One alarming fact is the **sustained decline in**

the number of young people in the labour market. Over the past five years their numbers have shown an average 5.7 per cent decrease annually. The share of young people in the population also keeps declining. In 2005 every fifth person was aged 13 to 25 years, in 2015 only 14 per cent. At the same time, problems with the Russian market have contributed to higher unemployment in certain regions. We expect that the dominant trends in the economy will lead to gradually lower unemployment. These trends will be felt most in economically active regions of the country, and less in rural areas, which will accentuate the challenges of geographic inequality.

The general government consolidated budget showed a surplus after the first seven months of 2015. Tax revenues were up by 4.6 per cent year-on-year but 0.8 per cent below target due to lower revenues from VAT and state social insurance contributions. Regardless of the existing surplus, a steep rise in expenditure is expected in the final months of the year. Taking into account slower-than-anticipated economic growth and higher local government expenses, the actual **budget deficit for 2015 may exceed the government's target of 1 per cent of GDP** and reach 1.6 per cent.

The government has unveiled its draft national budget for 2016, which stipulates that next year's deficit must not exceed 1 per cent of GDP. Top priorities include internal and external security, health care, education and improving conditions for low-wage earners. In the next few years, the government intends to introduce some progressivity in income taxes. There will be also a solidarity tax that will apply to high wage earners.

In June 2015 the Parliament elected Defence Minister Raimonds Vējonis (a member of the Green Party) as President. Despite earlier speculation about a government reshuffle after Latvia's recently concluded EU Presidency, this scenario has not materialised yet, though it has still not been written off. Driven by the European refugee crisis, **political instability has resurfaced again.** Even if it does not trigger a change in the cabinet, the next test for the three party centre-right coalition will be the adoption of the Budget Law by Parliament. The expenditure priorities of the coalition parties vary, and tensions among them will persist. The last parliamentary election was held in October 2014, when Prime Minister Laimdota Straujuma's coalition won a comfortable majority.

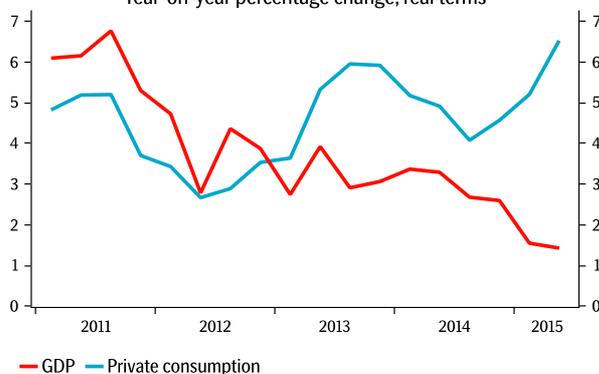
Domestically driven growth but low price pressure

- **Private consumption will strengthen further**
- **Exports depressed by Russia and lower goods prices**
- **Weak inflation will return next year**

Economic growth slowed in the first half of 2015, with GDP just 1.5 per cent higher year-on-year. A drop in merchandise exports and worse performance in the transport and storage sector were the main factors contributing negatively to the growth rate. We forecast that **GDP growth will rebound slightly in the second half** on further strong domestic demand. The economy will expand by **1.8 per cent in 2015 and 2.8 per cent in 2016**. In 2017 we expect GDP to increase by 3.2 per cent, and growth will become more broad-based. Annual deflation will persist at the end of 2015 and average HICP inflation this year will reach -0.7 per cent.

Private consumption supports GDP

Year-on-year percentage change, real terms



Source: Statistics Lithuania

Private consumption rose 5.9 per cent in the first half of 2015 based on higher real wages, low saving and continued rather optimistic expectations about economic prospects. Consumer confidence remains stable and higher on a year-on-year basis. People are still optimistic about the economic outlook and their own financial situation in the next 12 months. Average real wages were 5.1 per cent higher at the end of the first half of 2015, supported by a 2.2 per cent higher employment level and a decline in unemployment to 9.4 per cent. Although emigration has again intensified this year, the labour force barely changed and the employment level went up. The largest issue remains structural or long-term unemployment, which accounted for 4.3 per cent of the labour force at the end of June 2015 and dropped marginally year-on-

year. We believe that the **average unemployment level will drop to 9.5 per cent in 2015 and to 9.0 per cent in 2016**.

This year the official number of emigrant remittances has been declining, and the drop was 24.1 per cent in the first half of 2015 due to changes in compensation for heating and hot water expenses by municipalities. Average old age pension will be a couple of per cent higher this year. The monthly minimal wage will be probably raised from EUR 325 to 350 from the beginning of 2016 in order to keep up with Latvia and Estonia.

This autumn, the approval of a new social model for the labour market will be the most important task in Parliament. If it succeeds, Lithuania will certainly become more attractive for both domestic and external investors. Lithuania has been criticised for its labour market rigidity, which has discouraged potential investors. We agree that this kind of structural changes will help speed up wage growth in the long term, but we believe that **nominal wage growth will be 4.2 per cent in 2015 and 4.8 per cent in 2016**. Such growth will exceed the improvement in labour productivity and will put some pressure on business profitability. However, lower commodity prices helped enterprises to achieve 19.5 per cent higher profit before income tax in the first half of 2015.

Nominal wages up despite lower labour productivity

Year-on-year percentage change



Source: Statistics Lithuania, SEB

Price trends for consumer goods and services are diverging. Prices of goods have fallen sharply in the past year due to cheaper fuel and food products, while prices of services – partly influenced by euro zone accession – were up by 3.2 per cent year-on-year in August. We believe that this year deflation will remain in place, while **next year inflation will be a mere 0.3 per cent**. Consumer prices are likely to rise, due to a further climb in service prices based on higher demand, but prices of goods and especially energy will be depressed if a rebound in global markets does not take place next year.

Some additional help to consumers may come from lower regulated electricity prices in 2016. The NordBalt interconnection between Lithuania and Sweden, with a capacity of 700MW, will go into service in December 2015, according to plans. Electricity prices on the Nord Pool Spot exchange has fallen by 20 per cent this year. More declines on the exchange can be expected in 2016 when the price spread between Lithuania and Sweden shrinks, even though prices in Sweden will rebound from a 14-year low. In 2017 we forecast a moderate acceleration in inflation due to stronger domestic demand and slightly higher energy prices.

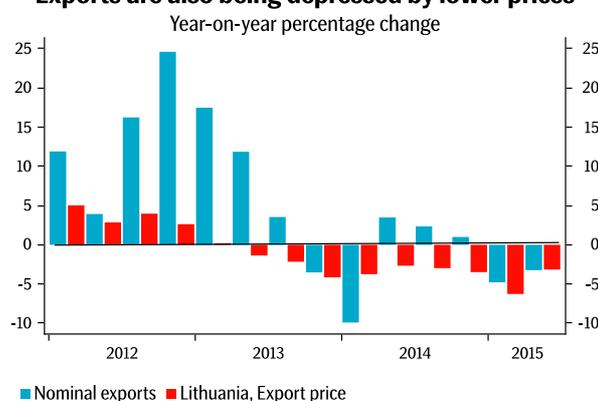
Investment growth was hardly impressive in 2014 and was hampered by geopolitical tensions and sanctions from Russia. However, the first half of 2015 was better. Growth in gross fixed capital investment accelerated to 9.9 per cent. Manufacturers invested more in equipment and machinery. This indicates that most businesses were not overly cautious and maintained a focus on long-term growth. Capital spending growth will remain at a similar pace if global economic conditions do not get worse. **Loans to non-financial corporations bottomed out in March 2015** and since then have started recovering. Loans to the manufacturing and transport sectors were lower year-on-year, but there was a noticeable increase in lending to the electricity, gas and heat and trade sectors in the first half of 2015. Loans to households also demonstrated a slight rebound, mostly based on expanded mortgage portfolios. We forecast that **total bank lending will be 2.5 per cent higher at the end of 2015**. However, we do not expect a sharper increase in lending during 2016 and 2017, despite a continued historically low interest rate environment.

Construction output is growing, although at a slower pace. Construction of residential buildings is driving growth in this sector. The housing market was very slow in the first months after the euro was introduced in January 2015, but transaction volume started recovering in mid-year. Prices of flats increased insignificantly year-on-year this summer, due to a solid supply of new flats. We believe that this year, the total number of transactions in the **housing market** will remain slightly lower year-on-year and **prices will be slightly higher**. This trend towards slow growth in prices will continue in 2016-2017, fuelled by cheap mortgage lending and higher real wages, but at the same time will be constrained by an increasing supply of new dwellings.

Lithuania's merchandise trade balance was depressed by 4.1 per cent lower exports and 1.5 per cent higher imports during the first seven months of 2015. Exports dropped for several reasons: the ban on dairy and meat product imports to Russia hit exporters, as did a sharp drop in dairy prices in global markets. Lithuania was the only EU country with a relatively high exposure to Russia in agriculture exports; these constituted about 4 per cent of total exports before the imposition of trade bans. Although the total volume of dairy product exports remained almost unchanged, prices were sharply down, reaching 2009 levels. The lower price of fuel also had a negative impact on exports, despite higher sales

volume. Lithuania's largest exporter – the Polish owned oil company Orlen Lietuva – significantly increased its capacity utilisation as refining margins became much more attractive to refiners. The slump in the Russian economy had a negative impact of 37 per cent in re-export revenues to Lithuania. This difficult period is forcing producers to boost their exports to the EU, whose share of total exports will increase this year. Imports were higher year-on-year despite lower prices. Exports will grow only slightly next year and imports will remain relatively strong due to rising domestic demand. Such divergence in the trend of merchandise imports and exports has a negative impact on the current account and leads to relatively large deficits. **We forecast that the current account deficit will total 4 per cent of GDP in 2015 and 4.5 per cent in 2016.**

Exports are also being depressed by lower prices



Source: Statistics Lithuania, SEB

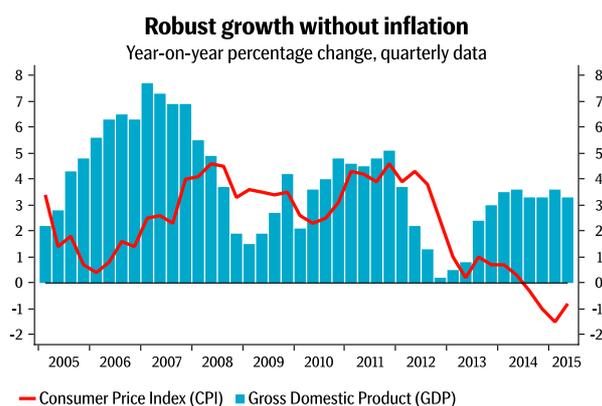
This year revenue collection by both national and local government social insurance funds will slightly exceed the projected level, despite lower-than-expected economic growth. **Better monitoring of VAT payers' tax returns** had a positive effect on collection of VAT from selected payers. Better revenue collection is making it easier to control the **general government budget deficit, which we forecast will amount to 1.5 per cent of GDP in 2015**. Lithuania will remain among the few EU countries meeting the Union's fiscal criteria this year. In the **autumn of 2016, a parliamentary election** will take place. The current ruling coalition may try to please voters by increasing social benefits more than would be economically logical. However, we believe that in our main economic growth scenario, and assuming logical decisions, the general government **budget deficit will be 0.5 per cent next year**.

This year Lithuania was allowed to open discussions about joining the OECD. It might take 2-3 years to reach a final decision. OECD membership could be positive for economic growth.

Continued good growth despite far higher political risk

- **Domestic demand will remain a vital force**
- **New government = more fiscal stimulus**
- **Deflation will end – key rate hike next year**

Poland continues to be **among the fastest-growing economies in Eastern Europe**. Last year Hungary grew a bit faster. This year we expect only the Czech Republic to maintain a higher speed. Next year Poland will probably take the top spot. **Domestic demand will remain a key driving force** in the coming year. A strong labour market and good financial conditions for both households and businesses will help underpin the expansion. An **expected change of government** after this autumn's parliamentary election will also lead to a more expansionary fiscal policy. Poland's modest export growth will speed up a bit, with increased demand from its major trading and industrial partner Germany (about ¼ of exports) offsetting weakness in conflict-embroiled Russia (about 5 per cent of exports) and Ukraine. **We expect GDP to increase by 3.4 per cent in 2015, by 3.6 per cent in 2016 and by 3.8 per cent in 2017.** This is just above potential growth of 3-3.5 per cent, suggesting that the deflation of the past year will be replaced by weak upward price pressure.

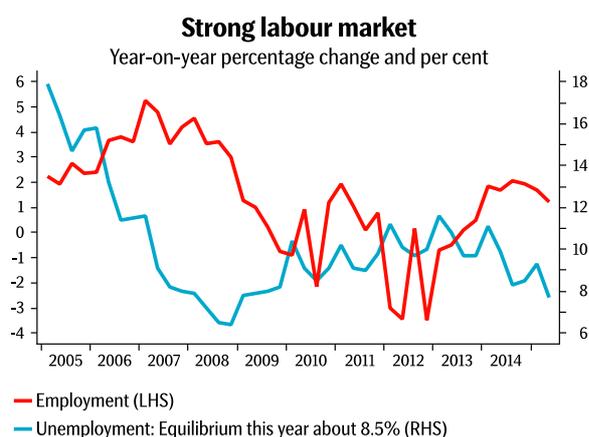


Source: Central Statistics Office of Poland

Year-on-year GDP growth fell to 3.3 per cent in the second quarter, from 3.6 per cent in Q1. The economy has maintained relatively good, uniform momentum since mid-2013 except for a manufacturing slump in the second half of 2014. This downturn was mainly due to slower German demand, but also Russia's economic deceleration and a drop in business investments due to increased regional uncertainty in the initial phase of the Ukraine crisis. **Indicators show that GDP growth is continuing at a slightly accelerating pace.** Consumer confidence has climbed for nearly three years and in

August reached its highest level since September 2008, when Western countries were about to slide into a deep recession. Poland was also affected by the slowdown but was the only EU country to avoid a GDP decline, partly thanks to relatively solid economic fundamentals and banks along with an accommodative fiscal policy. The purchasing managers' index in manufacturing has strengthened in the past year, staying above the expansion threshold of 50 (50.9 in Sept.). Its recent decline is probably temporary. This autumn an improved German economy should push up Poland's manufacturing PMI.

Prospects for growing domestic demand are favourable. **Private consumption will be fuelled by continuing relatively strong real incomes**, with a certain increase in nominal wage growth (from about 3.5 per cent in the first half of 2015) offsetting a gradual revival of inflation. Job creation will continue, though at a moderate pace, and unemployment will fall from an estimated 2015 average of 8.3 per cent in 2015 to 7.5 per cent in 2017, a low level for Poland. Historically low interest rates will climb gently after having bottomed out early in 2015. This means that looking ahead, still **lukewarm credit growth will gradually rise**. Banks foresee increased demand. Previously tight lending terms have also been easing for the past two years, both for consumer and mortgage loans.



Source: Central Statistics Office of Poland, OECD

Capital spending rebounded vigorously in 2014 after two weak years and has continued to grow relatively strongly since then, indicating that the Ukraine crisis is having only a minor negative effect. We foresee a **continued good investment climate**, largely driven by housing and infrastructure. The overall investment ratio is rather low. In the past two years, manufacturing capacity utilisation has risen from a moderate 70-75 per cent close to the historical high of 80 per cent. Poland is also the largest recipient of structural funds in the 2014-2020 EU budget, though a cutback is planned in 2016.

Deflation pressure has gradually eased since last winter; in August, year-on-year CPI was 0.6 per cent lower. But note that this was not a broad-based price downturn. Lower energy and food prices explain most of the deflation; the underlying inflation rate this year has been 0.2-0.5 per cent. **Deflation will probably end this winter, replaced by weakly accelerating price increases**, partly due to higher energy prices but especially because of increased demand and growing wage and salary pressures in a tightening labour market. Unemployment this year will be less than the equilibrium level of about 8.5 per cent. One structural problem in this context is Poland's relatively low employment rate.

The National Bank of Poland has left its key interest rate at a record-low 1.5 per cent since a 50 basis point cut last March, which the NBP described as the last in its rate cutting cycle. Since then, signals from top NBP officials have been relatively neutral, with a dovish bias. This has not only reflected risks of

prolonged deflation after a renewed commodity price squeeze but has also probably been a deliberate tactic to slow the appreciation of the zloty, which would lower import prices and thus make it harder to achieve the NBP's 2.5 per cent inflation target. The zloty has indeed strengthened only marginally since March. At its September policy meeting, the NBP mainly foresaw downside risks to its inflation forecast via emerging market economic deceleration and falling commodity prices. It is keeping the door open for another rate cut. Should the ECB decide to expand quantitative easing, and/or if Hungary lowers its key rate again, the NBP may implement its own cut. **But our main scenario is that the next step will be to start the rate hiking processing during the third quarter of 2016**, bringing the key rate to 3.0 per cent by the end of 2017. Relatively high short-term interest rates in Poland and comparative growth advantages over other countries suggest that the zloty will appreciate during the next 1-2 years to PLN 3.90 per euro.

Substantially higher political risk

Political uncertainty has increased sharply in Poland over the past year after having been low for many years, which contributed to a successful economic trend. The long-incumbent main governing party has plunged in popularity. In May the political temperature climbed further when Andrzej Duda of Law and Justice (PiS), the largest opposition party, won an upset victory in the presidential election. Most indications are that **the October 25 parliamentary election will lead to a change of government**, with the centre-right coalition of the Civic Platform (PO) and the small farm-based Polish People's Party (PSL) – which have been in power for two four-year terms – being **replaced by the right-wing PiS**, perhaps supported by a smaller party. Beate Szydlo is expected to become the new prime minister.

Last winter and spring, PO enjoyed 35-40 per cent public support, ahead of PiS, but since then it has slid to 20-25 per cent compared to 35-40 per cent who favour PiS. Among the reasons for **PO's weaker support** are its earlier austerity measures, party tensions on matters of policy and the "Waitergate" scandal, in which conversations among government ministers were recorded during restaurant meals; the recordings were first revealed in the summer of 2014. Another factor may be that during the autumn of 2014, parliamentary speaker Ewa Kopacz took over as prime minister, succeeding the more experienced Donald Tusk when he became president of the European Council. For some time, PO has been a party under stress. This became especially clear early in June, soon after the party's defeat in the presidential election, when Kopacz chose to fire a handful of ministers and the parliamentary speaker.

What kind of policies can Poland expect? To begin with, **PiS is a nationalist, conservative party that defends traditional social values and is euro-sceptical**. PO is a conservative party that embraces classic economic liberalism and is more pro-business and supportive of EU and euro zone integration. In other words, there are clear dividing lines between them.

If PiS assumes power, there may be early changes on a number of important political issues: Taxation of foreign banks (which dominate Poland's banking sector) and retail companies. More money to pensioners and low wage earners, which PiS believes have benefited very little from the country's good growth. Conversion of household's large-scale Swiss franc-denominated mortgage loans (which became more expensive earlier this year) to zlotys, with PiS proposing that banks should assume a larger share of the cost, while PO supports equal sharing between banks and borrowers. In foreign policy, it is notable that PiS wants to see an even tougher Polish stance towards Russia due to its role in the Ukraine conflict. Yet Poland's current government has already distinguished itself as one of the EU governments that have pursued the most vocal policies against Russia, including calls for sanctions. As for the **euro issue**, Polish accession to the euro zone seems **even more distant** if PiS is in power; Poland's strategy so far has been to make itself economically ready but to hold off on setting a timetable, partly due to the euro crisis of recent years.

In its election campaign, PiS has advocated a more pro-cyclical fiscal policy. We believe it may also pursue a **somewhat more expansionary fiscal policy in the next couple of years**. As we wrote in the March *EEO*, if it wins the election the PO is instead expected to resume some budget-tightening since the government – under pressure from EU rules and with an eye to future euro zone accession – has aimed at pushing the deficit permanently below the EU maximum of 3 per cent of GDP (just below 3 per cent this year). PiS will probably be less dedicated to this ambition.

On the whole, **political risk in Poland has risen substantially**. Meanwhile it should be observed **that the country's public finances are relatively strong**, with a budget deficit of about 3 per cent of GDP and public debt at 50 per cent of GDP. **A change of government may very well temporarily weaken the zloty but is not expected to have any significant effect on exchange rates or the growth picture over the next couple of years.**

Continued but milder recession in 2016

- **Continued low oil prices squeeze economy**
- **Western sanctions will be extended in 2016**
- **Putin will remain in power for a long time**

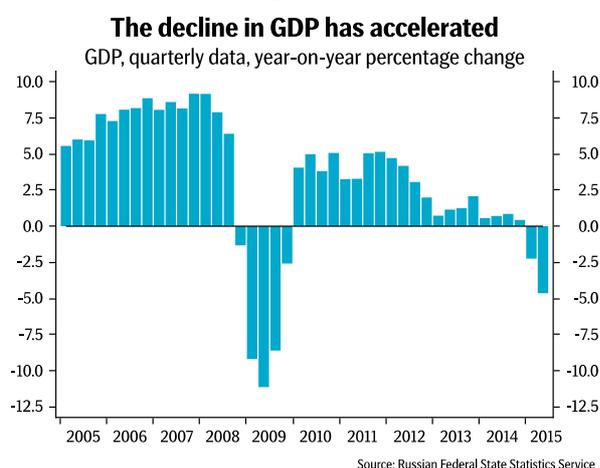
Since the sharp oil price decline and rouble depreciation late in 2014, it has been clear that Russia would end up in a recession during 2015; the question has mainly been how large the GDP downturn will be. Because of a renewed oil price decline since last spring, combined with a high probability that sanctions against Russia due to the Ukraine conflict will be extended, **we expect the recession to continue in 2016**. The problems of high inflation, a weak investment trend and large-scale capital outflows will live on. The oil price decline makes it difficult for the federal government to respond with an expansionary fiscal policy, and rouble depreciation is forcing the central bank to pursue a tighter monetary policy than would have been desirable from a growth-supporting perspective. Russia's long-term slowdown in growth – driven by structural weaknesses in the economy – has been reinforced by these acute problems.

During the summer and early autumn, oil prices have fallen again. **SEB revised its oil price forecast downward** in August. In 2015 as a whole, we expect Brent crude prices to average USD 54 per barrel. **In 2016 we expect oil prices to average USD 55** (USD 70 in the March *Eastern European Outlook*), followed by a cautious upturn to **USD 60 in 2017**. The downside risk is dominant, and even beyond our forecast horizon it is difficult to foresee any potential for a major oil price increase. Prices are being squeezed on both the supply and demand side. Technological development is continuously lowering the costs of extracting oil from shale, which has mainly resulted in sharply higher American production. Increased Iranian production will also push down prices in the future. Meanwhile demand from emerging market economies will shrink. The Russian economy remains **highly dependent on oil exports**. Given the high correlation between oil price changes and the rouble exchange rate, falling prices drive down the value of the currency, which in turn triggers higher inflation and contributes to increased capital outflows.

Sanctions by the US, the EU and other Western nations aimed at both Russian individuals and at companies are affecting the economy, mainly by sharply curtailing the ability of businesses to borrow in Western capital markets. **Capital spending, which is already weak, is thus becoming even more difficult**, especially for major investment projects. The impact has been noticeable, especially in the energy and banking

sectors among companies directly targeted by sanctions. The sanctions also create general uncertainty among companies.

An end to EU sanctions will require that the measures approved as part of the Minsk 2 ceasefire agreement, which was reached in February, have been carried out by the close of 2015. There is great uncertainty, but our main scenario is that the two sides will not have met their obligations by year-end. The EU summit in January 2016 is expected to **extend sanctions against Russia** for a certain period of 2016 but may possibly soften them slightly.



Economic activity plunged during the first half of 2015, driven by falling investments and consumption. GDP fell by 2.2 per cent year-on-year in the first quarter. In the second quarter, the downturn accelerated to 4.6 per cent. Indicators show continued weakness and have not signalled any imminent improvement. The purchasing managers' index (PMI) for the manufacturing sector is well below its growth threshold. Consumer confidence and leading indicators have fallen sharply.

Looking ahead, weak investments and consumption will continue to severely hurt economic growth. The decline in investments has accelerated in recent months. Russia's numerous **structural problems** remain: a poor business climate, heavy central government influence and obsolete infrastructure. The willingness of foreign companies to invest in Russia is decreasing further due to the country's poor relations with the West. The oil price decline will also undermine capital spending in the energy sector. For example, oil company Rosneft has been forced to sharply cut back on its ambitious investment programme.

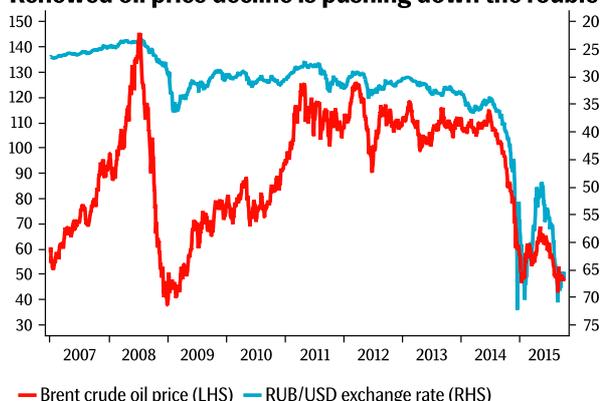
As expected, private consumption has suffered greatly due to accelerating inflation. Retail sales have now fallen as much,

measured year-on-year, as during the 2008-2009 crisis. Car sales have also plummeted. **Private consumption has thus ceased to be a major driving force for economic growth.**

We expect full-year 2015 GDP to fall by 4.0 per cent. Given a combination of extended sanctions and a clearly lower oil price forecast, GDP will continue to fall **in 2016** but will slow to a **downturn of 1.0 per cent. In 2017 GDP will increase by 1.5 per cent.** The consensus about 2015 and 2016 growth was previously more optimistic, but recently it has moved closer to SEB's forecast. At present there are no signs that reforms will be implemented to the extent that is needed to speed up economic growth, and our estimate is that **long-term GDP growth will be around 1.5 per cent.**

The **rouble** has depreciated greatly against the USD since 2011. In December 2014, it was pushed down to a record low. As earlier, rouble exchange rates are **primarily driven by oil prices**. A new oil price slide this past summer again pushed the currency down to record-low levels. Financial market turbulence related to concerns about emerging economies in general, and China in particular, has also contributed to rouble depreciation. Two other factors that have driven down the rouble are the easing of Russia's key interest rate policy and the central bank's purchases of foreign currencies to build up the currency reserve, though the volume has been small.

Renewed oil price decline is pushing down the rouble



Source: Macrobond

Looking ahead, we expect the rouble to weaken further, driven by low oil prices and worries related to the conflict with Ukraine. There is also pressure to keep the rouble weak in order to sustain budget revenues. **We expect the rouble to stand at 70.0 per USD by the end of 2015, at 73.0 a year later and at 77.0 by the end of 2017.** Beyond our forecast horizon, we expect the forces pushing down the rouble to live on in the form of slow economic growth, a weakened current account balance and continued capital outflows.

The Bank of Russia began **rate cuts** in February 2015 and has lowered its key interest rate from 17.0 to 11.0 per cent. A high key rate hurts business investments, but the central bank is worried that a rapid easing of interest rates risks weakening the rouble even more and worsening the country's capital outflow problems. Although capital outflows shrank by more than half in the first quarter compared to the fourth quarter of

2014 and shrank further in the second quarter, they remain high. These outflows are attributable to a lack of confidence in the Russian economy and are expected to continue. Strong financial reserves are providing protection against a current account crisis (see the theme article on Russian financial reserves in the March 2015 issue of *Eastern European Outlook*) but the country's long-term resilience has been severely weakened. We believe that key rate cuts will continue, but at a far slower pace than last spring. The ups and downs of the rouble will play a major role in interest rate decisions. **We expect the key rate to be 10.0 per cent at the end of 2015. During 2016** the Bank of Russia will continue cautiously lowering its key rate, reaching **8.0 per cent** by year-end. Monetary easing will continue **in 2017**, with the key rate at **6.0 per cent** by year-end.

The banking sector began in a fairly stable position, but sanctions, rouble depreciation and decelerating growth have exposed it to **strong pressures**. The banks' exposure to Ukraine has led to losses, but compared to the acute financial market turbulence of December 2014, the situation has stabilised. Inter-bank rates have fallen and the banking system is no longer threatened by a severe crisis. Exposure to foreign currencies is relatively small. The level of bad loans has risen and is around 8 per cent. This increase is expected to continue, and banks will be squeezed by the economic downturn.

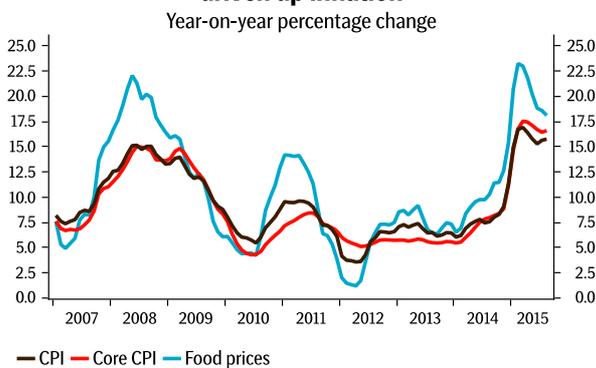
At present the number of banks is about 800. The banking sector is top-heavy (the three largest banks are state-owned and account for more than 50 per cent of assets) but fragmented at the bottom, with numerous small banks. A consolidation of the sector is desirable since it would help reduce corruption, increase transparency and make lending more efficient. It would also help counter capital outflows.

Since Elvira Nabiullina became central bank governor in the autumn of 2013, the number of **banking licence revocations** has greatly accelerated. The number of banks has shrunk by more than 100, and this trend is expected to continue. There will probably be many buy-outs of weaker banks as well as mergers and closures. The process of **strengthening bank capital** will continue; two thirds of the "anti-crisis plan" for the economy that the government unveiled in January will consist of bank recapitalisations. The Bank of Russia has also identified ten systemically important banks that must meet **Basel III** international regulatory standards related to capital and liquidity. These measures are a step in the right direction and will increase the long-term stability of the financial system.

Russia's current account surplus increased in the first half compared to the same period of 2014. Although exports have decreased sharply since mid-2014, imports have fallen even more because of rouble depreciation and weak domestic demand. Due to plunging imports, the current account is expected to show a surplus despite falling oil prices. We believe that Russia will show a **2015 current account surplus equivalent to 4.8 per cent of GDP. In 2016** the surplus will reach **4.0 per cent** and **in 2017** it will be **3.6 per cent**. Further ahead, we expect a major weakening due to low oil prices.

Rouble depreciation, combined with soaring food prices as a consequence of Russia's import ban, has driven up inflation dramatically. Because of the new weakening of the rouble, the slowdown in inflation that was expected during the second half of 2015 has so far failed to materialise. Price hikes on gas, water and electricity have also played a part. The inflation rate has accelerated in recent months and stood at 15.8 per cent in August. Meanwhile the sharp decline in economic activity has had a dampening effect on inflation. **We expect full-year 2015 inflation to average 15.5 per cent. In 2016 inflation will slow to 9.5 per cent and in 2017 to 7.0 per cent.** Inflation is thus expected to exceed the Bank of Russia's 4 per cent medium-term target throughout our forecast period.

Rouble depreciation and food import ban have driven up inflation



Source: Russian Federal State Statistics Service

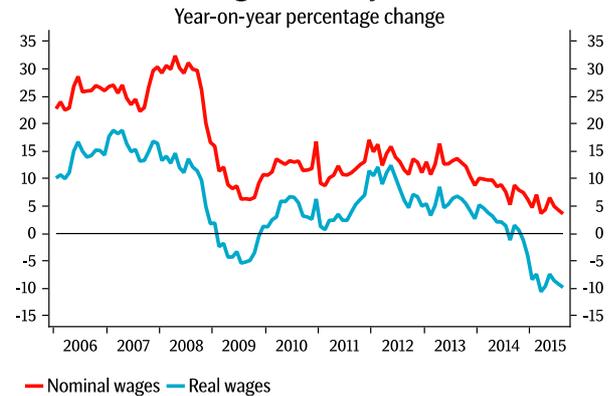
Lower oil prices are squeezing the federal budget due to lower tax revenues, but at the same time rouble depreciation boosts the local currency value of oil-related federal revenues. The government is tightening its budget substantially by slashing expenditures. The number of federal civil servants will be reduced and their salaries will be lowered. Budget-cutting will continue in 2016 and 2017. The desire to continue expanding Russia's military capabilities, while trying to avoid excessive cutbacks in social spending, will put pressure on the budget during the next couple of years, especially with an eye to the 2016 parliamentary election and the 2018 presidential election.

We expect the public budget deficit to end up at 3.8 per cent of GDP in 2015. The deficit will reach 2.8 per cent of GDP in 2016 and 2.4 per cent in 2017. Because the rouble has, in practice, been floating freely since last November and exchange rate fluctuations have a big impact on oil revenues, it has become substantially more difficult to estimate what oil price level the Russian economy can tolerate in the long term. Given expectations of long-lasting low oil prices, however, the federal budget will be under pressure for some time to come. Although federal debt has climbed in recent years, its still-low level means that Russia will not face any acute threat.

In recent months unemployment has fallen, despite the accelerating decline in GDP. This trend is quite different from the 2008-2009 recession, when the jobless rate surged. Because of the combination of a shrinking labour force, high wage flexibility and low unemployment benefits, the connection between GDP growth and unemployment is generally weak. Businesses may also be trying to avoid

dismissals because demographic deterioration makes it hard to recruit employees and because of political pressure to keep employment high. The current downturn in demand has instead impacted wages and salaries. Nominal pay is being squeezed both in the public and private sectors, while inflation has greatly eroded real wages and thereby severely undermined disposable household income.

Dramatic wage and salary deceleration



Source: Russian Federal State Statistics Service

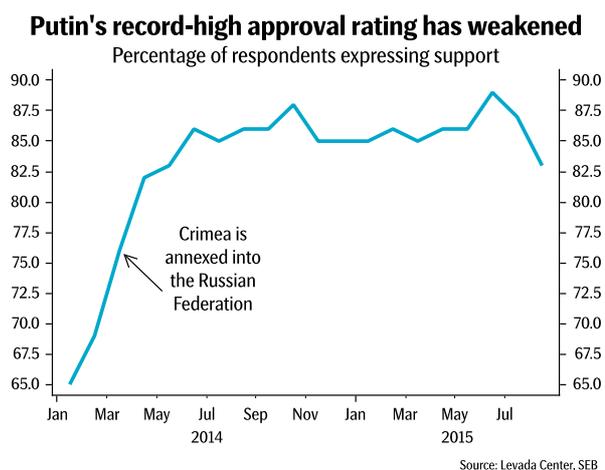
Any Kremlin worries about the elections?

President Vladimir Putin and his government have successfully pursued a strategy of countering popular discontent with weak economic conditions by maintaining a hard line against the West and blaming the downturn on Western sanctions. A very high percentage of the population sees no connection between the economy and Russia's political leadership. A majority also supports Putin's foreign policy, including the annexation of Crimea and his handling of Ukraine. Among Russia's people, the fear of external threats (in practice NATO) overshadows concerns about economic problems. The opposition remains weak and is struggling against government-controlled media in a very tough climate. Leading opposition figures have been out-manoeuvred in various ways. At present there is no challenger to Putin in the **2018 presidential election. Putin will probably remain in office for another term until 2024.**

Putin's weak point, however, is that his United Russia party is far less popular than he is. **The State Duma (parliamentary) election has been moved up from December to September 2016.** One possible reason for this change of schedule is to make it harder for the opposition to present its policies, since the election campaign will now take place during the holiday month of August. The opposition will also have less time to organise. The **regional elections** in mid-September 2015, an important test before the State Duma election, confirmed that the opposition has great difficulty in making itself heard. United Russia retained its dominant position, and reports indicate numerous election irregularities. We are sticking to our forecast scenario that **United Russia will win the 2016 parliamentary election**, but political uncertainty has increased and the change in the election schedule indicates that **the Kremlin is worried about how the mood of the population is being affected by weak economic conditions.** Despite continued strong confidence in the

president and the government, protests against the authorities' destruction of foreign food products that had slipped past the import ban show there is potential for rising discontent.

As we have stated in earlier reports, public support for President Putin is expected to erode, driven by stagnating living standards. But it is difficult to say how long that will take. During 2013 Putin's approval rating was around 65 per cent. After the annexation of Crimea in the spring of 2014, his approval rating rose sharply. In June 2015 it reached a record 89 per cent. Although the president's public support fell substantially in July and August, it remains at a very high level.



Minsk 2 pact vital to relations with West

Most indications are that we are correct in our assessment that **the Russia-Ukraine conflict will be long-lasting** and that relations between Russia and the West will remain tense during the foreseeable future. Russia is continuing its aggressive foreign policy, both by means of tough diplomacy and demonstrations of military strength – especially in the vicinity of Russia, but also further afield. For example, Russia has increased its military presence and aid in Syria. NATO has countered by strengthening its defence capabilities in Eastern European member countries. At home, Russia's foreign policy is supplemented by measures that make the activities of foreign companies in Russia more difficult in various ways. These have included claims that foreign consumer products are of inferior quality and that foreign companies are violating regulations. Products have been withdrawn from the market.

One issue of great importance to future relations with the West is developments in the conflict with Ukraine. This issue is pivotal to the West's sanctions policy. **The EU has linked the removal of sanctions to whether the requirements in the Minsk 2 agreement** on a ceasefire in eastern Ukraine, which was signed in February, had been **fulfilled** at the end of 2015. A lot of things must happen in order for the Minsk 2 agreement to be regarded as having been fulfilled. Our **main scenario is that in January 2016, EU sanctions will be extended** (see the theme article).

Unlike the EU, **the US has linked the removal of sanctions to the return of Crimea** from Russia to Ukraine. This seems highly unlikely, which the US is presumably aware of. We

anticipate that **the US will let its sanctions run at least until the end of 2016.**

China not a self-evident partner

As a consequence of the severe deterioration in its relations with the West, Russia wants to increase its exchanges with other emerging economies, especially China. In Russia there are hopes of benefiting from deeper economic cooperation, and in recent years the two countries have signed agreements on **gas and currency swapping**. Russia's exports to China have increased significantly in the past decade and now account for some 8 per cent of total exports, but several factors limit Russia's ability to benefit from expanded cooperation.

China is economically far more powerful, largely enabling it to **dictate the terms of any cooperation efforts and agreements**. One example is the agreement on Russian gas deliveries to China. Signed in May 2014, it is highly favourable to China. Nor is China considered capable of entirely replacing Europe's Russian gas purchases in the foreseeable future. Another example is the very cautious attitude of Chinese banks towards Russia. Despite the currency swap agreement, it is clear that Chinese banks will not help Russia with acute financial problems.

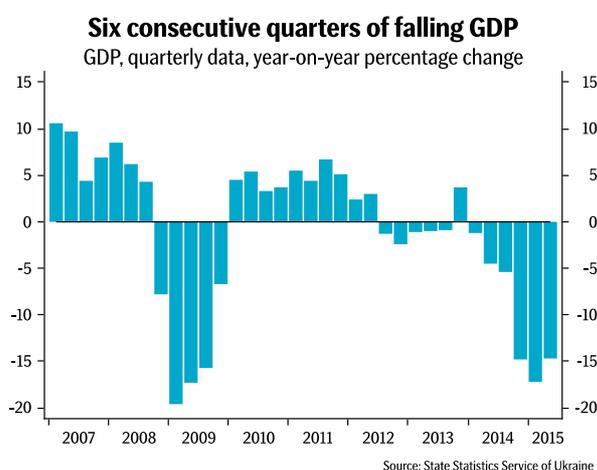
The biggest problem for expanded cooperation is that Russia and China are already competing for geopolitical influence. In the Far East, resource-rich but thinly populated regions of Russia are located next to heavily populated and expansive regions of north-eastern China, which has created concerns about increasing Chinese influence. However, the most important test of future relations will be in resource-rich **Central Asia**. Russia is trying to use the Eurasian Economic Union (see the theme article in *Eastern European Outlook*, October 2014) to respond to increasing Chinese influence in the region. Russia believes that countries such as Kazakhstan, Uzbekistan and Turkmenistan belong to its sphere of influence. Meanwhile China has made sizeable investments in the energy sectors of these countries. There is thus a **considerable risk that** in the future, **Russia will be competing economically rather than cooperating with China.**

Debt write-down will contribute to stabilisation

- **Debt write-down provides breathing space**
- **The sharpest GDP declines are now past**
- **Minsk 2 agreement not a long-term solution**

During the first half of 2015, Ukrainian GDP fell by more than 15 per cent compared to the same period of 2014, but we believe that the sharpest GDP declines are now past. There are indications that the economy is moving towards stabilisation. Financially, one important step in the right direction was an agreement with foreign lenders on a debt write-down. **Ukraine will thus avoid default**, as we had predicted.

Fighting in eastern Ukraine has eased, but there is no solution in sight that would enable Kiev to regain control over separatist-controlled areas. The aim is that by the end of 2015, the two sides will have fulfilled the requirements set by the Minsk 2 agreement. Even if this happens, it does not change our view that the conflict will be long-lasting.



The GDP downturn is broad. Household consumption is being severely hampered by high inflation and the rapidly escalating costs of foreign-currency loans. Manufacturing is affected by destroyed production facilities and infrastructure. Capital spending has continued to fall. There is a very large-scale need for investments connected to rebuilding of infrastructure, but this will require a long-lasting ceasefire to be implemented. The financial crisis has also hurt agricultural production due to last spring's difficulties in arranging financing of input goods, but also by the rising prices of these goods, which are largely imported. Grain production in 2015-2016 is expected to be well below the previous year. Together with weak demand for steel, this is hampering exports.

Because of the public budget deficit and high inflation, neither fiscal nor monetary policy can sustain growth.

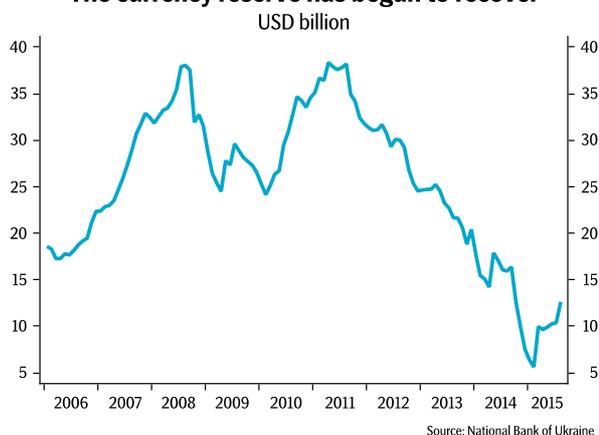
Yet there are cautious signs of stabilisation. The previously wide current account deficit is continuing to shrink. Inflation has begun to slow and the sharp slide in industrial production, retail sales and exports has begun to level out. Overall, **we expect GDP to fall by 12 per cent in 2015**, but the decline will slow clearly in the second half. In 2016, economic activity will stabilise and **we foresee GDP growth of 1 per cent**. In **2017**, growth will accelerate cautiously to **2 per cent**. Despite the dramatic weakening of the hryvnia, no powerful export-led recovery is in store, since a combination of factors is offsetting currency rate effects. The problems of the Russian economy, difficulties in securing export financing and smashed infrastructure will continue to hurt exports. In addition, global demand for Ukraine's most important export product, steel (about 28 per cent of 2014 exports), remains depressed. No recovery is in sight, and prices will probably remain squeezed for a long time to come due to increasing Chinese exports.

Early in August, Ukraine received another disbursement of the four-year IMF bail-out loan approved in March. Late in August, after several months of negotiations, the government reached an agreement with lenders on a **20 per cent debt write-down** on euro bonds with a nominal value equivalent to USD 18 billion. In addition, the deal includes a **moratorium** in the form of a four-year delay in bond maturities. The agreement also guarantees compensation to lenders if Ukraine's GDP growth exceeds 3 per cent per year between 2021 and 2040. The country's lenders will formally approve the debt write-down agreement before the end of October. The write-down does not include the Russian bond loan of USD 3 billion that expires in December 2015, and it is unclear how this will be dealt with. Russia did not participate in the negotiations and is demanding full repayment of the loan.

Although the agreement ended up quite far from Ukraine's and the IMF's target of a 40 per cent write-down, it still represents a clear **step in the right direction**. The debt write-down implies only a limited reduction in debt as a percentage of GDP, since the euro bonds that it includes account for only around one fourth of total public debt, but the moratorium combined with a continued financial bail-out mainly from the IMF will provide some breathing space. **The focus of attention can now shift from emergency debt management towards attempts to speed up the economy and continued reform efforts.** In order to bring down Ukraine's debt (just below 100 per cent of GDP), GDP growth will have to take off.

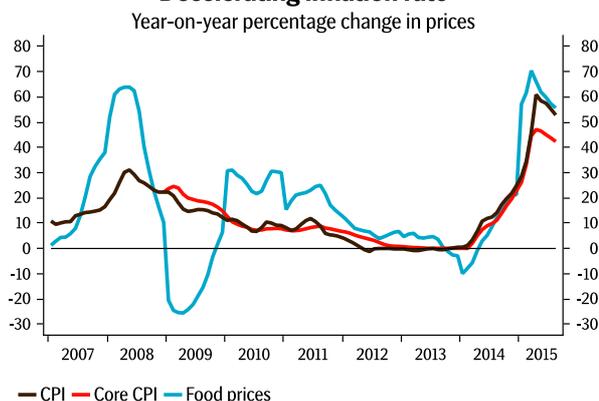
As earlier, the hryvnia exchange rate is of vital importance to the economy. The currency weakened sharply during 2014 and early 2015, driven by the conflict in eastern Ukraine and the impending risk of a government default. In recent months, however, the exchange rate has stabilised at around 21-22 per USD. This **stabilisation** is not a new equilibrium level, but instead **is the result of extensive capital controls** that will be liberalised gradually until removed by mid-2016. The currency reserve has begun to increase again, thanks to the IMF's bail-out loan disbursements. The National Bank of Ukraine expects it to rise to the equivalent of 3.5 months of imports at the end of 2015 (3 is viewed as a critical threshold). The reserve is too small to allow currency interventions, and the central bank is dependent on capital controls to keep the currency stable. **We expect the hryvnia to be worth 21.0 per USD at the end of 2015, 20.0 at the end of 2016 and 18.0 at the end of 2017.**

The currency reserve has begun to recover



The stabilisation of the currency will have several positive effects. Above all, it will help bring down Ukraine's very high inflation. The sharp depreciation in the hryvnia, combined with gas price increases, drove up inflation in 2014 and the first half of 2015. In April inflation reached close to 61 per cent year-on-year, but it is now falling. We expect this slowdown to continue but to be partly offset by a further gas price increase in October. As annual averages, **inflation will end up at 48.0 per cent in 2015, at 18.0 per cent in 2016 and 10.0 per cent in 2017.**

Decelerating inflation rate



The stabilisation of the hryvnia, combined with a key interest rate cut from 30 per cent in late August to 22 per cent, is providing some relief to the **banking sector**, which has **endured very strong pressures**. After the depreciation of the hryvnia, the banks' exposure to foreign-currency loans represents more than half of their total lending portfolios. This has had a major impact, due to a rapidly increasing proportion of bad loans. The capital levels of the banks are very low, and because of strained central government finances the resources for recapitalisation are small. **Numerous banks have already been liquidated**, and the banking sector is moving towards consolidation.

The government has been **praised by the IMF for its reform efforts**, and several important reform steps have been taken. One vital reform is a sharp cutback in gas price subsidies to households and businesses in order to bring down the budget deficit. Examples of other reforms are a strengthening of the central bank's independence, public sector salary cuts and the beginning of pension system reforms.

Although many reforms have been implemented under difficult conditions, impatience is growing among the population. It is especially urgent to deal with large-scale corruption; *Transparency International* ranks Ukraine as the most corrupt country in Europe. The government has established a national anti-corruption authority, but it will take time before its activities have any clear positive impact. In addition, many of the government's reforms directly hurt households, especially major gas price hikes. Public support for the government has weakened greatly in recent months, and there is a risk that it will become more difficult to push through reforms. Aside from **impatience and dissatisfaction with reforms, people are also questioning the constitutional amendment** that will give the Donetsk and Luhansk regions expanded autonomy.

There is a clear risk that popular protests will flare up, and the temperature is rising as the **October 25 local elections** approach. In July, a new law was enacted specifying how local elections will be carried out, but the law does not provide for elections in the **Donetsk and Luhansk regions** since these territories are not controlled by the Ukrainian government. The political leaders of the separatist regions instead plan to carry out **their own local elections** on October 18 and November 1 despite the fact that this contradicts the Minsk 2 agreement.

Regardless of whether Minsk 2 holds up or not, we are sticking to our view that **eastern Ukraine** will develop into a **"frozen conflict"** (see the theme article), with alternating calmer and more turbulent periods. The risk of flare-ups in fighting will persist. Russia has managed to gain a permanent influence on Ukraine and will use it in an attempt to counter integration with the West. Russian influence will probably be the price that Ukraine must pay in order to avoid an expansion of the conflict in its eastern regions.

Key economic data

ESTONIA

	2010	2011	2012	2013	2014	2015(f)	2016(f)	2017(f)
GDP, %	2.5	7.6	5.2	1.6	2.9	1.9	2.7	3.4
Inflation, HICP, average, %	2.7	5.1	4.2	3.2	0.5	0.5	2.3	2.7
Unemployment, %	16.7	12.3	10.0	8.6	7.4	6.5	6.8	7.2
Current account, % of GDP	1.7	1.4	-2.4	-0.4	-0.1	0.6	0.2	-0.6
Public sector financial balance, % of GDP	0.2	1.2	-0.2	-0.2	0.6	-0.2	-0.1	0.0
Public sector debt, % of GDP	6.5	6.0	9.7	10.1	10.6	10.3	9.9	9.6
3-month interest rate, end of period	1.10	1.40	0.20	0.30	0.10	0.00	0.00	0.10

LATVIA

	2010	2011	2012	2013	2014	2015(f)	2016(f)	2017(f)
GDP, %	-2.9	5.0	4.8	4.2	2.4	2.4	2.7	3.5
Inflation, HICP, average, %	-1.2	4.2	2.3	0.0	0.7	0.4	1.7	2.3
Unemployment, %	19.5	16.2	15.0	11.9	10.8	9.8	8.9	7.8
Current account, % of GDP	2.3	-2.8	-3.3	-2.3	-1.9	-1.7	-2.3	-2.7
Public sector financial balance, % of GDP	-8.2	-3.4	-0.8	-0.9	-1.4	-1.6	-1.2	-1.1
Public sector debt, % of GDP	46.8	42.7	40.9	38.2	40.0	34.9	33.2	31.4
Key rate, eop	0.85	1.85	0.53	0.26	0.08	0.00	0.00	0.00

LITHUANIA

	2010	2011	2012	2013	2014	2015(f)	2016(f)	2017(f)
GDP, %	1.7	6.1	3.9	3.2	3.0	1.8	2.8	3.2
Inflation, HICP, average, %	1.2	4.1	3.2	1.2	0.2	-0.7	0.3	1.2
Unemployment, %	17.8	15.4	13.4	11.8	10.7	9.5	9.0	8.5
Current account, % of GDP	0.1	-3.7	-0.2	1.6	0.1	-4.0	-4.5	-4.5
Public sector financial balance, % of GDP	-6.9	-9.0	-3.2	-2.6	-0.7	-1.5	-0.5	0.0
Public sector debt, % of GDP	36.2	37.2	39.8	38.8	40.9	42.0	38.0	40.0
3-month interest rate, eop	1.50	1.66	0.68	0.41	0.18	-0.05	-0.05	-0.05
5-year government bond, eop	4.60	5.40	2.40	2.40	1.15	0.80	0.90	1.00

(f) = forecast

POLAND

	2010	2011	2012	2013	2014	2015(f)	2016(f)	2017(f)
GDP, %	3.7	4.8	1.8	1.7	3.4	3.4	3.6	3.8
Inflation, HICP, average, %	2.7	3.9	3.7	0.8	0.1	-0.8	1.2	2.0
Unemployment, %	9.7	9.7	10.1	10.3	9.0	8.3	7.7	7.5
Current account, % of GDP	-5.1	-5.0	-3.8	-1.3	-1.4	-0.5	-2.0	-2.5
Public sector financial balance, % of GDP	-7.6	-4.9	-3.7	-4.0	-3.2	-2.9	-3.1	-3.1
Public sector debt, % of GDP	53.6	54.8	54.4	55.7	50.1	50.5	52.0	53.0
EUR/PLN, end of period	4.00	4.50	4.10	4.10	4.30	4.30	4.00	3.90
Key rate, eop	3.75	4.50	4.25	2.50	2.00	1.50	2.00	3.00
5-year government bond, eop	5.52	5.34	3.21	3.78	2.10	2.40	3.00	3.50

RUSSIA

	2010	2011	2012	2013	2014	2015(f)	2016(f)	2017(f)
GDP, %	4.5	4.3	3.4	1.3	0.6	-4.0	-1.0	1.5
Inflation, average %	6.9	8.4	5.1	6.8	7.8	15.5	9.5	7.0
Unemployment, %	7.3	6.5	5.5	5.5	5.2	5.6	5.7	5.5
Current account, % of GDP	4.4	5.1	3.5	1.6	3.2	4.8	4.0	3.6
Public sector financial balance, % of GDP	-3.4	1.5	0.4	-1.3	-1.2	-3.8	-2.8	-2.4
Public sector debt, % of GDP	11.3	11.6	12.7	14.0	17.9	19.0	17.5	17.7
USD/RUB, end of period	30.50	32.08	30.36	32.85	58.06	70.00	73.00	77.00

UKRAINE

	2010	2011	2012	2013	2014	2015(f)	2016(f)	2017(f)
GDP, %	4.2	5.4	0.4	0.0	-6.5	-12.0	1.0	2.0
Inflation, average, %	9.4	8.0	0.6	-0.3	12.1	48.0	18.0	10.0
Unemployment, %	8.4	8.2	7.8	7.4	9.0	9.4	9.1	8.7
Current account, % of GDP	-2.2	-6.3	-8.1	-9.2	-4.0	-1.5	-1.3	-1.4
Public sector financial balance, % of GDP	-2.8	-4.3	-5.5	-6.6	-7.0	-4.4	-3.0	-2.8
Public sector debt, % of GDP	40.6	36.8	37.5	40.7	71.2	98.0	96.0	90.0
USD/UAH, end of period	7.97	8.00	8.05	8.23	15.77	21.00	20.00	18.00

(f) = forecast

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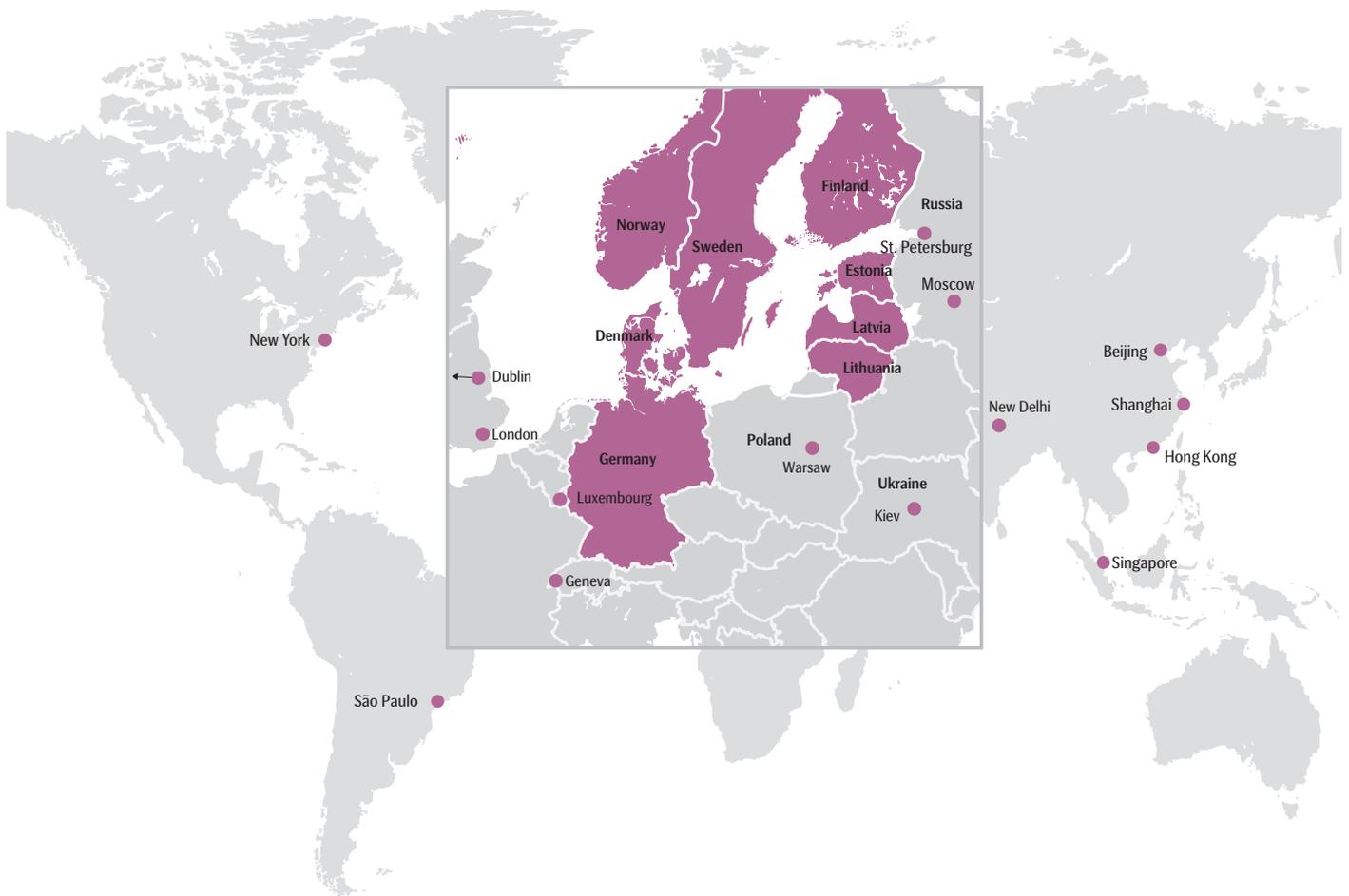
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