



ECONOMIC RESEARCH · ENGLISH EDITION

MARCH 2010

# Eastern European Outlook

Economic recovery but weak domestic demand  
Stable recovery in market confidence

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# SEB Economic Research

Eastern European Outlook - March 2010

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Even Eastern Europe (including what is now often called Central Europe) – the region that was hardest hit by the global credit crisis and recession – is now beginning a gradual economic upturn. So far, this turnaround is mainly visible in higher exports and industrial production. In some countries the upswing has been stronger than in Western Europe, but it is occurring from a low level after earlier major declines.

In the coming year, the recovery will continue to be driven by higher exports, which appear to be competitive. In Russia and Ukraine, exporters are also benefiting from high, though stabilising, commodity prices. Domestic demand is slowly recuperating. Consumption and investments will be hampered for another while by rising unemployment, weak wage and salary development, fiscal tightening measures and low capacity utilisation. Credit conditions are slowly thawing; in Poland the first positive signs of this are now discernible.

During 2010-2011, we do not expect the six countries on which this report focuses to resume their earlier (excessively) high growth rates, but to barely return to their trend rate.

- **Russia** will rebound from deep recession to annual growth of 5 per cent in 2010-2011.
- In **Poland**, the only EU country that showed positive GDP growth in 2009, the expansion rate will accelerate to 3.5-4.5 per cent.
- **Ukraine's** growth will be a modest 3.5-4.5 per cent, after last year's 15 per cent slide.
- **Estonia's** GDP will increase by 2 and 5 per cent, respectively, after a 14 per cent slide in 2009.
- **Lithuania**, following its 15 per cent GDP decline last year, will resume growth of 1 and 4 per cent this year and next, respectively.
- **Latvia** will lag somewhat behind, with recession continuing this year and GDP falling by 2.8 per cent. In 2011 the economy will recover to positive growth of 4 per cent.

Economic imbalances will continue to shrink: These countries will show continued moderate current account surpluses or deficits. Most of them previously had large current account deficits, but the deficits became smaller in the wake of crashing imports. Inflation is slowing in Poland, Russia and Ukraine. In the three Baltic countries, price pressures are non-existent this year due to continued wage adjustment and severe belt-tightening policies. Government budget deficits remain at high levels in 2010 but will narrow over the next few years due to fiscal tightening and better growth. Public sector debt is continuing to rise but is moderate or low compared to Western countries.

In the past year, financial markets have regained confidence in the region, a trend that rests on a fairly stable foundation. This is because many Eastern European countries are moving towards regaining control of their previous severe imbalances and their need for public sector debt adjustment is less than in many Western countries. Political conflicts, especially related to austerity policies, may nonetheless generate some market concerns, especially since some of these countries will hold, or have held, elections in 2010-2011.

In the Baltics, our main scenario is still that the currency pegs to the euro will survive. We expect Estonia to meet all Maastricht criteria during this spring's official evaluation, making it highly probable that the country can adopt the euro in January 2011. We expect Latvia and Lithuania to qualify for euro zone membership in 2014 and Poland in 2014 or 2015.

# The international economy

Eastern European Outlook — March 2010

## The recovery is continuing

- Above-trend global growth— thanks to Asia
- Manufacturers lead Eastern European upturn
- Market confidence returning

The global economy has strengthened during the past six months, though some uncertainty has emerged in recent weeks. Amidst a boom in China, signals of policy tightening have become clearer. In the US, underlying demand remains anaemic. In Western Europe, fourth quarter GDP growth was weak. On Europe's southern flank, fiscal consolidation measures were introduced; these will hamper near-term growth but are necessary in a longer-term perspective.

Despite these factors, we believe that the healing process is gradually continuing in credit markets and the real economy. Earlier stimulus measures have had enough impact to ensure a solid global economic upturn. Sentiment surveys and other forward-looking indicators have continued to point upward this winter, though at a somewhat slower pace.

Meanwhile, our scenario envisions a somewhat divided world economy ahead. We believe that the Asian dynamic will continue and that China can avoid inflation-driven overheating, which is also needed in order to maintain the pace of the world economy since growth in the 30 member countries of the Organisation of Economic Cooperation and Development (OCED) will only be modest. Major economies such as the United States and the United Kingdom face continued sizeable debt adjustment needs, both in the private and public sector. Labour markets will begin to improve somewhat towards the end of 2010, and inflation will remain low as global resource utilisation slowly climbs from low levels.

World GDP will increase by about 4.5 per cent in 2010, which is higher than its 3.5-4.0 per cent trend rate. Growth will then level off, mainly because fiscal policy – but also monetary policy – will tighten. The US Federal Reserve and the European Central Bank will begin hiking their key interest rates late in 2010.

### Global economic highlights

GDP, year-on-year percentage change

	2008	2009	2010	2011
United States	0.4	-2.4	3.4	2.2
Euro zone	0.5	-4.1	1.7	2.0
The world	3.0	-0.7	4.5	4.3
Oil, USD/barrel	97.2	61.9	75.0	75.0
EUR/USD, Dec.	1.40	1.43	1.30	1.25

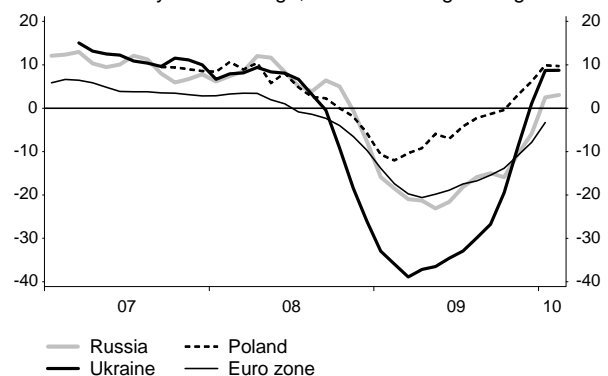
Source: SEB

## Gradual upturn in Eastern Europe

Even the region that was hardest hit by the global credit and economic crisis – Eastern Europe (including what is now often called Central Europe) – is now climbing out of its deep recession. But this upturn is in its infancy and is mainly limited to higher industrial production and related exports. Worth noting is that in some of these countries, manufacturers have seen clearer improvements over the past six months than their counterparts in Western Europe.

### The manufacturing sector is recuperating

Year-on-year % change, 3-month rolling average



Source: Eurostat, local statistical offices

Our view remains that the economic upturn in most Eastern European countries will be sluggish and uneven. Exports are performing increasingly well, but domestic demand will be held back this year by weak labour markets and wage growth, a low need for investments and cautious lending practices, although an initial loosening of bank credit conditions is now discernible in Poland.

Add to this the fiscal tightening now under way in the Baltic countries and expected soon in milder form in Poland, Russia and Ukraine.

## Greater market confidence

Their previous large current account deficits, partly driven by foreign loans, made Eastern Europe extra vulnerable to the global credit crisis. The turnaround in external balances during the past year, combined with the budget-tightening discipline shown by the Baltics and Hungary, are important reasons why the market has regained confidence in the region.

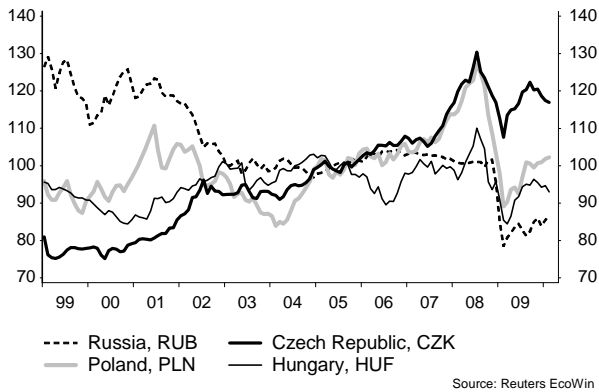
Another important piece of the puzzle is lower – in some countries even far lower – government debts than in many Western economies. Of the six countries covered in the report, sovereign debt has increased significantly in the past few years in Latvia, Lithuania and Ukraine, but no country is expected to rise above the Maastricht criterion of no more than 60 per cent of GDP. In Estonia and Russia debt levels are still below 10 per cent of GDP, although somewhat higher compared to before the crises. Economic recovery

and budget corrections will contribute to debt levels levelling out or increasing slightly.

All these factors are likely to reduce the risk of major reversals in financial market confidence.

## Effective exchange rates

Index 100 = 2005



An improving view of Eastern Europe among investors is evident on several fronts:

**1. Currencies in the region have appreciated.** The currencies depreciated sharply late in 2008 when investors fled risky assets following the bankruptcy of the US-based Lehman Brothers investment bank. Over the past year, there has been an upward trend in many Eastern European currencies. This movement has been largest for the Polish zloty, the currency that had also recorded the most dramatic slide. The Czech and Hungarian currencies have fallen slightly in recent months. We believe that the general appreciation of Eastern European currencies will continue. The arguments for this are relatively better economic growth and continued influx of capital and investment in these countries. Fluctuating global risk appetite will occasionally cause reversals, however.

## Reduced risk of sovereign default

Five-year CDS contracts, basis points



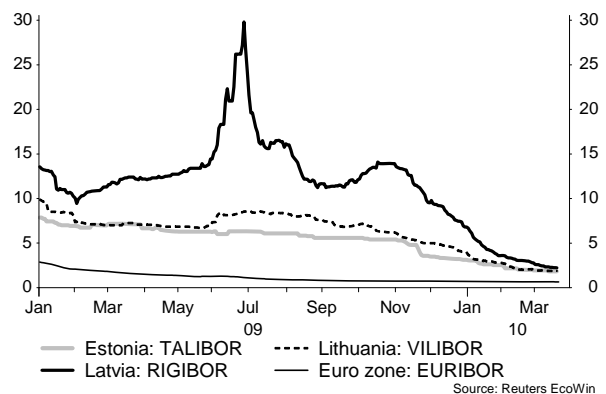
**2. Insurance against sovereign defaults in Eastern Europe has become cheaper.** This is clear from the trend for credit default swap (CDS) contracts. One striking feature of this pattern is that concerns that

Ukraine and Latvia will be forced to suspend payments have eased, even during the period of market turbulence related to Greek sovereign debt. Our main scenario is still that the international bail-out loan programmes for Ukraine and Latvia will survive and that these countries will adjust to lenders' budget requirements. There may be a revival of market worries in the run-up to the parliamentary election in Latvia, but we expect the trend of CDS contracts to be downward during the coming year.

**3. The market foresees reduced devaluation risk in the Baltics.** In the Baltic countries, continued budget-tightening – in December all three parliaments adopted 2010 budgets according to government plans – and in Latvia's case in compliance with IMF/EU conditions – combined with Estonia's ever-improving chances of euro adoption in 2011, has bolstered confidence in their currency pegs against the euro. This is reflected in a dramatic decline in local interest rates. There is especially good short-term potential for further interest rate declines in Estonia as its expected euro zone accession date approaches.

## Three-month interbank rates

Per cent



Our main scenario is still that the Baltic currency pegs against the euro will survive. We also believe that Estonia will convert to the euro in January 2011 at the existing exchange rate.

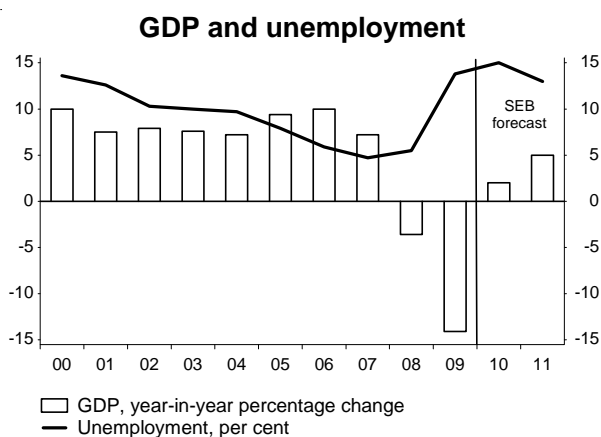
We expect the adjustment in wage costs and prices in the Baltics to continue this year. It is somewhat surprising that the adjustment process to date, including wage and salary cuts that began as early as the end of 2008, has not yet had a major impact on official wage statistics and real effective exchange rates. The modest official wage and salary cuts may depend in part on the role of "grey" markets, faulty statistics and severance pay connected to employee cutbacks. We expect clearer depreciation in real effective exchange rates in the Baltics this year.

## Euro highly probable by 2011

- GDP rebound in the fourth quarter of 2009
- Unemployment remains a major threat
- Continued weak domestic demand

Estonia's GDP grew by 10 per cent on an annualised quarter-on-quarter basis in the fourth quarter – one of the fastest expansions in the past fifteen years.

However, given the severity of the downturn in the first three quarters, GDP fell by 14.1 per cent in 2009. Two consecutive years of recession and the latest bout of deflation have now brought nominal GDP down to EUR 13.7 billion from EUR 16.1 billion a year earlier.



The strong rebound in the fourth quarter of 2009 might be the first tangible sign of a turnaround, although part of this growth was probably borrowed from the first quarter of 2010 as companies built up stocks in anticipation of higher excise taxes in January. But even a possible temporary relapse leaves two major pillars of our main scenario intact. First, we see a substantially higher probability of euro adoption in January 2011, as the last uncertainty about the budget criterion seems to have faded. Second, we envisage much stronger growth in major trade partners than we foresaw in *Eastern European Outlook* half a year ago. We recently upgraded our 2010 growth estimate from -0.3 to 2.0 per cent and our forecast for 2011 to 5.0 per cent.

Whatever positive developments we have recently witnessed in the output markets are yet to translate themselves into improved demand for labour. Unemployment has climbed rapidly since its all-time low in the second quarter of 2008. While consumers' unemployment expectations have receded in the past year, their sanguine mindset is not yet supported by hard statistics, although the latest weekly figures show that the total number of unemployed may have begun to stabilise.

To the extent that viable recovery remains hostage to a job market upturn, the present situation gives little reason for cheer. It is equally true, however, that the worst fears of mass unemployment channelling into political disorder have not materialised. The upturn in Nordic economies adds positive sentiment for economic development. We expect to see more consequential signs of recovery in the coming months with unemployment peaking in the first quarter of 2010 at below 16 per cent.

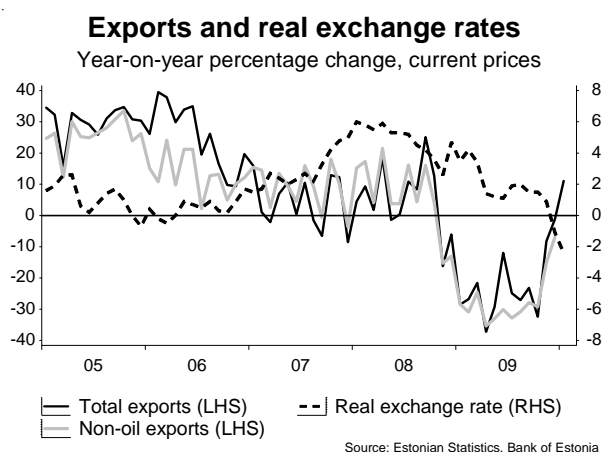
But whatever recovery might be in the pipeline is likely to be tempered by further adjustments. Household income growth will probably remain sluggish for years; this applies particularly to wage income. Unemployment and weak domestic demand make recent double-digit growth look like distant history. Indeed, year-on-year growth in nominal wages dropped below zero in the first quarter of 2009 and has meandered in negative territory ever since. We do not expect a return to positive figures before the second half of this year at the earliest.

### Internal devaluation continues

Thus, Estonia has largely managed to stick to its course of internal devaluation without straying into political mayhem, which is known to be the Achilles heel of this adjustment pattern. Deflation has been working through the system since last spring, when CPI inflation slipped to -0.3 per cent. After reaching its nadir at -2.2 per cent in October, the CPI rate has worked its way towards zero. Month-on-month inflation rates and survey-based expectation indicators point towards the end of deflation. The annualised month-on-month rate stood at 2.6 per cent in February, and the balance of those who expect prices to rise over the next 12 months turned marginally positive in the same month. These developments have led us to raise our inflation forecast to 2 per cent for 2010 and 3 per cent for 2011.

There is now also strong evidence that the squeeze on domestic spending and accompanying deflation have improved Estonia's international competitiveness, as measured by the real effective exchange rate. The latter depreciated on an annual basis by some 2.5 per cent in January and 3.5 per cent in February – the biggest decline since 2000. But the fact that real depreciation only started in December of 2009 might suggest that residual adjustment needs are still substantial, especially if we take into account a roughly 10 per cent cumulative real appreciation during the two years to 2009.

The combined impact of price and income effects – plus the pure arithmetic of a lower base – are thus probably behind the recent recovery in export growth. Year-on-year growth in total exports beat expectations in January, reaching 11 per cent.



The recuperating economy will sooner or later call attention to the perennial issue of external equilibrium, since a great deal of recent progress has been due to a near standstill in imports. The monthly trade deficit tightened from a peak of EUR 350 million in April 2007 to a low of EUR 20 million just two years later, but the yearly deficit for 2009 was still EUR 816 million, or 6 per cent of GDP.

The current account deficit, on the other hand, which peaked at -23.4 per cent of GDP in the first quarter of 2007, became a surplus in the second quarter of 2009 and totalled +4.6 per cent of GDP for the full year. We expect this surplus to narrow to 3 per cent of GDP in 2010 and then revert to a small deficit as stronger growth attracts more imports. The financial account plunged to a record quarterly deficit of 18.5 per cent of GDP in the third quarter of 2009 before moving back to 3.4 per cent of GDP in the fourth quarter, supported by strong FDI inflows related to Nordic telecom operator TeliaSonera's acquisition of Eesti Telekom. In hindsight, this event probably represented the turning point of the cycle. Above all, it was an important vote of confidence in the Estonian economy. The resulting influx of funds greatly alleviated local monetary conditions at the time of severest distress.

In the past six or seven years, cross-border financial flows – which the currency board arrangement transforms into corresponding movements in domestic money supply and eventually almost all other economic variables of significance – have been dominated by the funding decisions of Nordic-based banks. The total liabilities of domestic banks to non-resident financial institutions exploded from EUR 1.6 billion at the beginning of 2004 to EUR 9.6 billion five years later. The year-on-year growth rate of this key variable turned negative in March 2009. By January 2010, total indebtedness had fallen by EUR 1.5 billion from its peak in December 2008.

## Euro around the corner

As residents and non-residents have recalculated the probability of euro adoption in January 2011 – our current estimate is 90 per cent – money markets and asset prices have received further impetus since last autumn. The spread of the 3-month TALIBOR over EURIBOR peaked at 560 basis points in late March 2009 but was below 150 points eleven months later. The stock market, which fell more than 75 per cent in 25 months to March 2009, has since rebounded by more than 125 per cent, although from a low level.

But apart from boosting the value of speculative assets, Estonia's euro adoption objective has already rendered a more fundamental service to the economy. Being just about the only policy goal capable of generating broad-based support from both the political elite and the general population, it enabled a minority government to carry out a fiscal retrenchment over the course of 2009 that very few people deemed possible. Through an astute mix of window dressing, one-off fixes and genuine cuts, the government was able to turn a massive budget deficit equivalent to 11.7 per cent of GDP in the first quarter of 2009 into a surplus of 2.7 per cent in the third quarter of 2009 and to finish the year with a preliminary shortfall of 1.7 per cent, to be revised when the official public finance figures come out on March 26.

While we expect this fiscal feat to win the government the desired euro ticket, the heavy politicisation of the issue may yet come back to haunt it. Although we have raised our growth forecasts due to the higher likelihood of euro adoption, this effect has come because the negative scenario became much less probable, and not because the common currency per se triggered a new phase of foreign investment-fuelled expansion. Since politics eschews counterfactuals, taking credit for something that did not occur – the second leg of the recession – may turn out to be too tricky a task even for accomplished spin doctors. Barring the relatively unlikely event that the euro will indeed bring with it rapid and perceptible economic advances, disillusionment with the whole project can easily set in. Hence, we expect policymakers to start loosening their fiscal stance as soon as the positive answers from the Commission and the ECB come through in late spring – assuming that Greek-related turbulence does not postpone the accession process in the first place. We thus envisage the public sector deficit widening back to 2.5 per cent of GDP in the run-up to the March 2011 election, and then receding to 2.0 per cent on the back of stronger growth.

## The worst is over

- Exports recovering, but more recession in 2010
- Budget consolidation to continue
- Increased uncertainty ahead of election

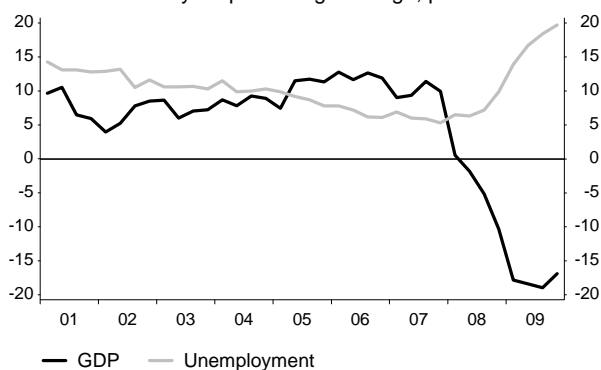
The Latvian economy is showing continued signs of stabilisation, though many risks remain to be addressed. The budget for 2011 and a high level of unemployment are the main challenges. The approaching October 2010 parliamentary election will have an impact on economic policy (see box on page 10).

In the fourth quarter of 2009, GDP contraction continued at 16.9 per cent year-on-year. Despite this, the situation is slowly stabilising. Provided that foreign market demand keeps growing, reforms continue and fiscal stability improves, we believe that the worst is over. Steady manufacturing and export growth will curb the GDP decline. Towards year-end, more indicators will become positive. For GDP to recover faster, domestic demand has to improve. This will not start to happen until late 2010. GDP is expected to reach its lowest point in the first half of this year. Our GDP forecast is -2.8 per cent for this year and +4.0 per cent for 2011. We have made a marginal upward revision 2011 since the October issue of *Eastern European Outlook*.

The overall results are influenced by Latvia's large 'grey' economy. This will be another major challenge for the government, especially in collecting taxes.

### GDP and unemployment

Year-on-year percentage change, per cent

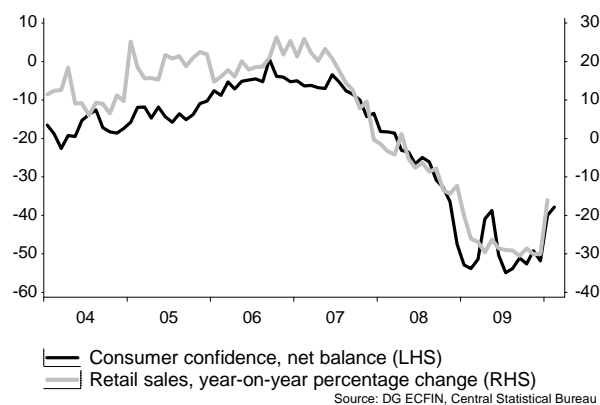


### Fall in retail sales easing

In January the rate of decline in retail sales narrowed to 16 per cent year-on-year. It will approach zero by the end of the year. The main negative factors affecting consumer spending will be related to the labour market, for example falling wages and salaries and soaring unemployment. At the same time, the mood of well-off consumers is uncertain. So far, the funds at

their disposal have mainly been hoarded or invested. As soon as consumer confidence improves, spending will increase slightly. The general mood of the population will be of great importance and will also depend on the pricing policies pursued by retailers.

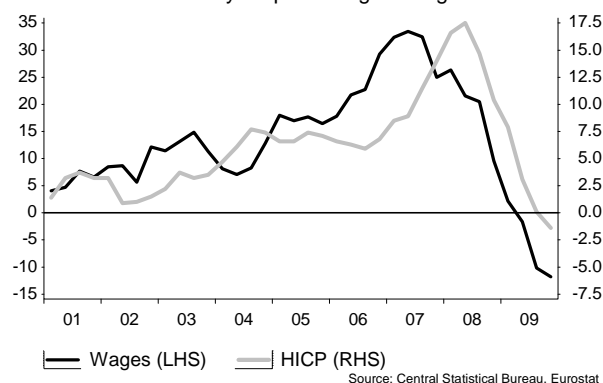
### Consumer confidence and retail sales



Unemployment is still rising. It reached 19.7 per cent in the fourth quarter, up from 18.4 per cent three months earlier. Businesses working to optimise their operations could not create new jobs. Unemployment will be a problem in Latvia for years to come. This also raises the question of long-term economic prospects, as well as when growth will resume and what effects a brain drain may have. We can expect some positive signs toward the end of 2010, when we expect the official unemployment rate to have peaked at 23 per cent. The role of the government in stimulating the creation of new jobs will be crucial. We expect total wages (official data) to fall 8-9 per cent in 2010, followed by a weak increase in 2011.

### Wages and inflation

Year-on-year percentage change

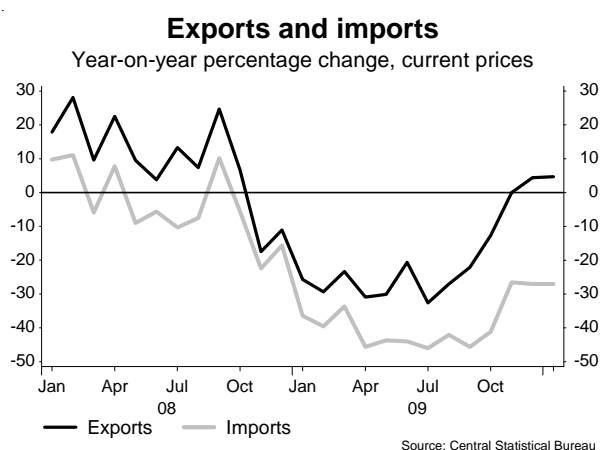


Year-on-year deflation started late in 2009 and will continue this year. Despite an overall decline, consumer prices have lagged behind the fall in purchasing power, indicating that prices have been cut somewhat reluctantly. In the coming months, weak domestic demand will result in a continued decline in prices; we expect average deflation of 3.2 per cent in 2010.

There are also factors pulling in the opposite direction, mainly taxes and reduced state subsidies, commodity market trends and seasonal factors. Despite falling consumption and purchasing power, there is currently no reason for either excessive optimism or pessimism about deep deflation. We expect low inflation in 2011.

## Exports rebounding

Foreign trade performance has met expectations and boosted optimism. Data show that Latvian businesses are moving into foreign markets and that their competitiveness is improving.



In 2009 imports shrank twice as fast as exports, by 38.4 and 19.4 per cent respectively. By December, exports had rebounded to 4.4 per cent year-on-year growth. Another positive factor is the increasing industrial capacity engaged in production for export. Because of this trend, we are raising our export growth forecast for 2010 to 10 per cent. The next big challenge for exporters will be to achieve more broad-based, innovative, added-value production. Latvia's exports are comparatively small, though they exert significant pull on the economy. The size of the export sector is one reason why Latvia will recover more slowly than its neighbours.

In 2009 the current account balance reached an unprecedented surplus of LVL 1.25 billion. In 2008 still there was a deficit of LVL 2.1 billion. The trade balance has rapidly improved, although it is still negative. In 2009 the service sector managed to keep its positive balance, thus creating sufficient surplus to offset the negative trade balance. But it should be noted that much of the current account surplus was due to losses incurred by direct investment companies. The lion's share of these losses was posted by banks. These trends will continue in 2010, but we should not expect a similar large current account surplus.

## Budget deficit coming down

In 2009 the consolidated government budget deficit,

based on the cash flow principle, was around LVL 900 million. The deficit was thus well below the limit of 10 per cent of GDP set for that year by lenders in Latvia's international bail-out programme. The result was more successful than planned, thanks to the austerity regime and such cost-saving measures as substantial cuts in civil service salaries, social benefits and other public expenditures. This year the budget deficit is projected at 8.5 per cent of GDP. Latvia will have to consolidate its deficit by LVL 800-900 million in 2011 and 2012. It has already reduced the deficit by LVL 1 billion in 2009 and 2010. The deficit is expected to shrink to 6 per cent of GDP in 2011. It has to be reduced to 3 per cent by 2012 in order to meet the Maastricht budget criterion ahead of planned euro adoption in 2014. We regard this plan as realistic. The international bail-out programme will run until 2011. Since last autumn, Latvia has had no acute need for cash; on the contrary, central bank reserves have been restored to near-record levels.

So far, Latvia's cooperation with international creditors can be regarded as successful. Creditors have acknowledged Latvia's performance. However, reforms and fiscal consolidation must continue. Since the current loan disbursement schedule was drafted on the basis of more pessimistic forecasts, especially in the banking sector, there has been no need to draw on the loan at the previously agreed pace. The schedule will thus probably be revised, slowing down the pace of disbursements.

As for budget developments, in the first two months of 2010 there were not yet any signs that tax revenue will be significantly below the planned level. Given the coming elections and further austerity measures, we expect the real task of crafting a 2011 budget to begin only after the October parliamentary election.

## Rates lowest in years

In June 2009, due to market concerns about the stability of the lat, LVL-denominated interest rates shot up to record highs. The overnight RIGIBOR reached 33 per cent. Late in 2009 and early in 2010, interest rates dropped to their lowest level in several years. The decline in the RIGIBOR was accelerated by a surplus of LVL resources at the disposal of commercial banks and an easing of market pressures in respect to the currency. In February this trend continued, and LVL overnight rates dropped closer to 1 per cent, the rate at which commercial banks may deposit their funds at the Bank of Latvia. Early in March, the BoL cut its repo rate from 4 to 3.5 per cent, pointing to signs of stabilisation in the economy. We do not expect a further decline in short-term rates, but long-term RIGIBOR rates might still go down and then stop falling in the coming months.

## Ruling coalition staying on as minority

On March 17 the Latvian People's Party (PP), with 19 Members of Parliament (out of 100) and five ministers in the government, decided to withdraw from the ruling five-party coalition and work in the opposition.

Due to the approaching elections and other parties' bad experience of leaving the government shortly before elections, this sudden move was a bit unexpected. However, owing to the constant internal conflicts and since the PP was already positioning itself as an opposition party inside the coalition, the decision was not surprising. The official reason why the PP decided to leave the coalition was the reaction of Prime Minister Valdis Dombrovskis (from the New Era party) towards the PP's proposal for an agreement on immediate reform measures. The PP could act in a much more unconstrained way in opposition, its leaders argued.

The departure of the largest party in the coalition – though one with very low current support in opinion polls – does not mean that the government will fall, since all the other coalition partners have pledged to continue working in a minority government. Parts of the opposition are also giving their support. The opposition Latvia's First Party/Latvia's Way, with 10 MPs, has stated that it will back the government's decisions on matters of national importance but will not join the coalition. Meanwhile Andris Skele, chairman of the PP, confirmed that his party will not initiate or support the fall of the government. Neither party rules out possible cooperation in promoting initiatives of mutual importance or closer cooperation in the upcoming election. The People's Party hope is that with the support of other opposition MPs, it can push proposals through Parliament.

After PP's decision, the ruling coalition is left with 44 out of 100 seats. But the coalition can count on three more votes representing the Society for Different Politics, a party belonging to the newly established

Unity bloc, which also includes the coalition parties New Era and the Civic Union.

The economic crisis has led to increasing public pressure for radical political changes. Furthermore, the recent victory of the Harmony Centre leftist alliance in Riga is pushing parties to rethink their tactics for the next election. To improve their chances against the potential winner in the parliamentary election, in early March 2010 the Harmony Centre, New Era, the Society for Different Politics and the Civic Union founded the Unity bloc. The door is still open to other parties and groupings.

Although current political events will mean a longer period of uncertainty about political developments in Latvia, the thrust of economic policy, including budget austerity, is not threatened in the short term. However, there are many important issues that will need Parliament's approval. They include a new insolvency law, borrower support programmes and other entrepreneurship support measures. Similarly, the current political situation will bring many uncertainties regarding further tax adjustments.

The opposition may thus succeed in hampering further government tax policy initiatives and decisions related to the budget consolidation process. It cannot be ruled out that this may lead to frictions in Latvia's relations with international lenders and uncertainty in financial markets.

The election campaign will certainly bring new strains and proposals for a gentler economic policy. The focus of the coming election campaign will be economic development and labour market issues.

## Small risk of acute market instability

In the very short term, increased political uncertainty (see box) may lead to some erosion in the market confidence the country has regained during the winter. However, no major new market turbulence and no flare-up of devaluation worries are imminent.

If the crisis had occurred six to nine months ago the situation would have been far more serious in economic terms. At that time, Latvia was engaged in sensitive negotiations with its lenders, which were proposing strict conditions related to continued budget-tightening. At that time, there were far bigger

concerns in financial markets that Latvia might resort to currency devaluation as one way out of its economic crisis.

Since then, there have been growing indications that the Latvian economy is about to pass its lowest point. Signs of economic stabilisation and of a less unfavourable budget trend than feared have also persuaded international rating agencies to view Latvia in a somewhat more positive light.

## Fragile upturn

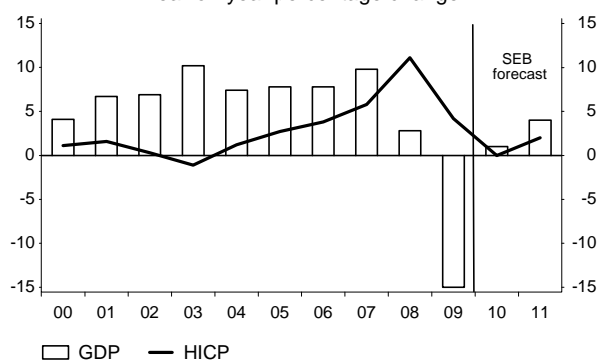
- Out of recession
- Problematic public finances
- Rising unemployment

In 2009 Lithuania's economy contracted severely. Domestic demand suffered most, while exports were in a better position. This year, we expect the economy to grow due to more buoyant exports. Consumption will remain strained, since unemployment is likely to rise and household income will shrink. Public finances are in a tough situation but are helped by the government's firm commitment to a tight fiscal policy.

In 2009, real output fell 15 per cent. All sectors reported negative figures, except for agriculture. However, the year was not even. The sharpest GDP drop and the most severe declines in manufacturing, retail sales and transport were recorded in the first half. But in both the third and fourth quarter of 2009, real GDP demonstrated quarterly increases: by 1.0 per cent and 0.5 per cent, respectively. The manufacturing and transport sectors were also in notably better shape than at the start of the year, as were indicators of capacity utilisation as well as business and consumer confidence.

### GDP and inflation

Year-on-year percentage change



Domestic demand fell by almost one quarter last year, with investment down by 39 per cent. Despite the decline in the domestic market, net exports improved and significantly softened the economic recession.

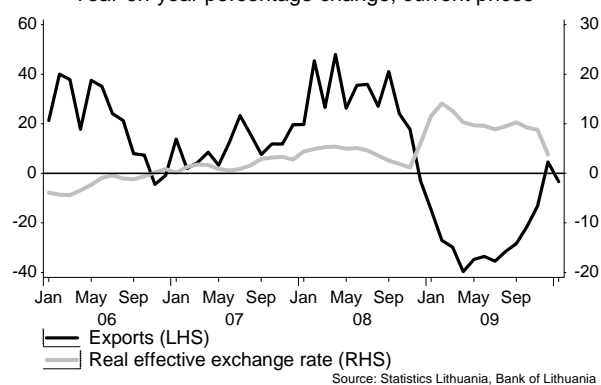
The real output of the construction sector shrank by 43 per cent in 2009. Housing prices dropped by 31 per cent during the year and by 39 per cent from their peak in December 2007. Most market players believe that real estate prices and rents on residential and commercial property have recently bottomed out. We expect property prices to stabilise during 2010.

We revised our GDP forecasts upward in December 2009 and expect real GDP to grow by 1 per cent in 2010 and 4 per cent next year. Exports are poised to

drive the recovery, but base effects will also play a large role. The decline in consumption will be milder than in 2009, while investment may even slightly increase.

### Exports and real effective exchange rate

Year-on-year percentage change, current prices



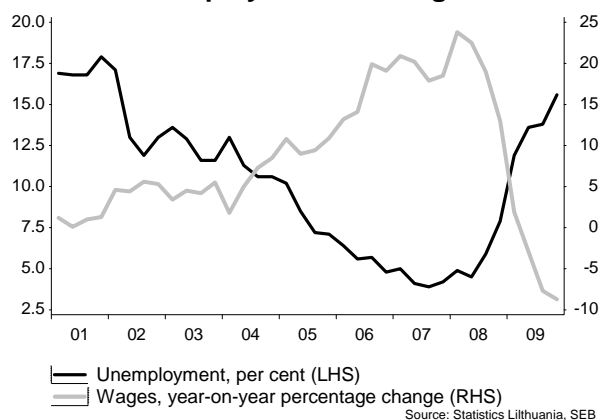
At the end of 2009, exports showed clear signs of recovery, with sales of wood, paper, furniture, plastic and rubber goods and chemical products taking the lead. Now the main threat to an export upswing is the risk of weaker growth in foreign demand, especially in the euro zone. Competitiveness greatly improved during 2009 due to internal devaluation. Prices of industrial goods sold in export markets fell 19 per cent on average in 2009, the most in the EU. Currencies of many of Latvia's non-euro zone trade partners (Russia, Poland, Belarus, the US) also strengthened against the litas during the winter, supporting depreciation of the real effective exchange rate.

However, at the beginning of 2010 competitiveness was hit again by an increase in electricity prices (up by 20 per cent) after the Ignalina nuclear power plant closed. The share of electricity in total production costs is quite small at most companies. For the biggest companies, the shock is also alleviated by the opportunity to buy electricity on the Lithuanian electricity exchange, launched at the beginning of this year. Nevertheless, for the wood, paper and furniture industries the shock is quite tangible. Uneasy access to credit resources is also holding back export resurgence. We expect a continued depreciation in the real effective exchange rate in 2010 as a consequence of further currency appreciation in Eastern Europe, the weaker euro and deflationary wage cuts. Earlier losses of competitiveness will more or less be restored.

Higher electricity prices directly added 0.9 percentage points to CPI inflation in January 2010. Elimination of the biofuel tax subsidy from January 2010, planned elimination of the VAT subsidy for central heating from September 2010, more expensive electricity and rising global oil prices will form a basis for cost-push inflation this year. But because of the depressed domestic market, no demand-pull inflation is likely.

We therefore expect 0 per cent inflation in 2010 and 2 per cent in 2011.

## Unemployment and wages



The painful consequences of the internal devaluation have included both shrinking average wages and lower employment. In the fourth quarter of 2009, wages and salaries were down by 8.7 per cent year-on-year. However the number of full-time employees declined by 15 per cent over the year, and the drop in monthly wages totalled 22.3 per cent in the fourth quarter of 2009. In 2009, unemployment rose sharply to an average of 13.7 per cent, up from 5.8 per cent in 2008. The largest wave of job reductions occurred in the first quarter of 2009, while in the second half of 2009 the number of unemployment claims subsided. Poor employment opportunities are encouraging a new wave of emigration, especially of young people, which will undermine long-term growth prospects.

We expect unemployment to rise to an average of 16.5 per cent in 2010 and 17 per cent in 2011, with GDP growth remaining below potential. Wages and salaries look set to shrink by roughly 1 per cent in 2010 and then rise by 3.5 per cent in 2011.

## Continued fiscal consolidation

Due to the recession, central government revenue (excluding EU funds) fell by 25 per cent in 2009. In order to stem the deficit, the government raised taxes and cut expenditures in 2009. The budget for 2010 is also “dietary”. Expenditure will increase by 2 per cent but excluding EU funds it will shrink by 5 per cent.

In January 2010, the European Commission acknowledged that Lithuania has taken adequate measures to counteract the deterioration in its public finances and therefore approved shifting the deadline for correction of the excessive deficit from 2011 to 2012. S&P and Fitch have also raised their outlook for Lithuania’s sovereign rating from “negative” to “neutral” thanks to the country’s prudent fiscal policy.

The ratio of general government debt to GDP almost doubled from 16 per cent in 2008 to 29 per cent in 2009. This debt ratio was nevertheless among the lowest in the EU. More than 60 per cent of government borrowing in 2009 was raised from foreign lenders, including two Eurobond issues. This year, the country is continuing to finance its fiscal gap from private sources. In February, Lithuania’s largest-ever 10-year Eurobond issue, amounting to USD 2 billion, was sold. The price was still high – yield stood at 7.625 per cent.

The government aims to push down its fiscal deficit to 8.1 per cent of GDP in 2010, 5.8 per cent in 2011 and 3.0 per cent in 2012. This means that central government debt will reach 37 per cent, 40 and 41 per cent of GDP. This scenario would allow Lithuania to introduce the euro in 2014, and the finance ministry considers this a realistic date. In our view, there is a risk of fiscal policy slippages due to the parliamentary election in October 2012.

The social insurance fund (Sodra) now makes up the most vulnerable element of public finances. Due to shrinking employment and the worsening financial situation of households, Sodra’s deficit has dramatically widened in recent quarters. The government is holding discussions about an imminent reform of the social insurance system that would push up its revenue and improve its control of expenditures. However the reform would have a positive impact on the insurance fund only after a time lag.

The firmness of the governing coalition is being increasingly tested. One of its most politically painful decisions was to cut old age and disability benefits by 5-10 per cent starting from 2010. The ceiling on unemployment benefit was also reduced to a rather low level. These decisions have hurt the popularity of the coalition. On the other hand, at the beginning of 2010, Prime Minister Andrius Kubilius’ Homeland Union party was the second most popular one. The pace of economic recovery will be an important factor determining the survival of the coalition.

The government’s economic stimulus plan is being implemented slowly (e.g. the renovation of old apartment blocks has not begun yet) due to bureaucracy. Starting from 2010, corporate profit tax rates were lowered.

The atmosphere in the financial sector has eased considerably over the winter. The market has applauded government firmness regarding fiscal consolidation. Interbank rates fell to record lows due to an oversupply of liquidity in litas and a diminished risk premium on the currency.

## Well-positioned but with budgetary challenges

- Moderate fiscal tightening
- Domestic demand will follow exports upward
- Zloty is appreciating – less inflation pressure

Poland has weathered the global credit crisis and recession considerably better than most countries. It was the only EU country to show positive growth in 2009; GDP rose 1.7 per cent – in line with our forecasts since last September's *Nordic Outlook*.

There are various fundamental factors behind this resilience: Private sector debt is moderate. Viewed in a Central and Eastern European perspective, Poland has little exposure to foreign currency loans: about one third of total loans, compared to 50-75 per cent in countries like Ukraine, Hungary and Lithuania, and more than this in Estonia and Latvia. This, in turn, means that the banking system is in better shape than in many other countries. Add a competitive export sector, with an assist from the currency "super-depreciation" that occurred more than one year ago.

The above factors will continue to benefit Polish economic growth. The need for private sector debt adjustment is smaller than in other Eastern European countries. For the first time since the crisis, bank lending began to thaw this winter, at least when it comes to home mortgage loans and business loans, whereas conditions remain tight for new consumer credits, due to deteriorating loan portfolio quality. In our assessment, exports will also be able to cope with the recovery trend for the zloty that has prevailed for the past year and that we expect to continue.

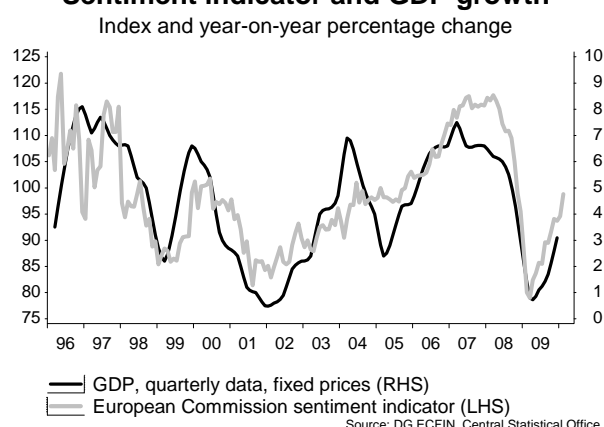
Like other countries, however, Poland is struggling with budgetary problems after a rapid deterioration in central government finances. The budget deficit nearly doubled to about 7 per cent of GDP in 2009. Public sector debt, which has been stable for many years, has climbed rapidly from 45 per cent of GDP in 2007 and is approaching the constitutional limit of 55 per cent of GDP, which will trigger tougher fiscal austerity. In light of this, the government has already begun tightening its budget this winter by imposing expenditure caps on discretionary items and trimming pensions and other spending.

We believe that the fiscal tightening will be rather mild – the 2010 presidential and 2011 parliamentary elections are another factor – but combined with the favourable impact of higher economic growth on revenue and expenditures, this will suffice to stay below the 55 per cent cap, at least this year. We also expect the government to pursue its planned privatisation process in order to keep its debt within the limit.

To qualify for euro zone membership, Polish public debt must also stay below 60 per cent of GDP for the next several years. In our assessment, Poland will join the currency union in 2014 or 2015. After the previous overly ambitious euro adoption timetables, last autumn the government abandoned its target date. The finance minister recently declared that a credible new target can be set within two or three years. We expect the thrust of economic policy to remain largely unchanged if a new president is elected next autumn. On the contrary, this may speed the reform process.

Sentiment indicators point towards continued economic improvement, even though Poland's budgetary problems have been accentuated and the government has begun to take action. Confidence indicators have gradually risen in all sectors since bottoming out last spring, but in the financial sector the upward movement has been a bit underwhelming; the same is true of the construction industry, whose sentiment upswing began only last autumn. The European Commission's monthly economic sentiment indicator – 80 per cent based on business surveys and the remaining 20 per cent on a household survey – has now risen to its historical average.

### Sentiment indicator and GDP growth



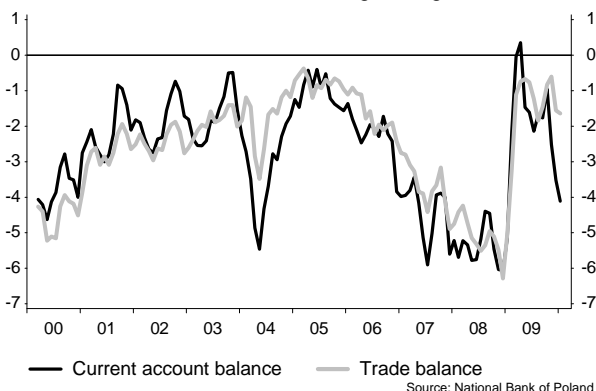
Our forecast is that GDP growth will increase to 3.5 per cent this year and then end up at 4.5 per cent in 2011, which is just above potential growth. So far the economic upturn, which began in mid-2009, has mainly been driven by higher net exports and public sector investments, but also by a decent consumption trend. Exports will remain a positive force this year, since demand from the euro zone is strengthening, but the trend in the Polish economy will be towards broader-based GDP growth. In 2010 a build-up of business inventories will be an important component, while a slight dip in consumption growth will occur due to tightening of fiscal and monetary policy in a situation where the labour market is still weakening.

Exports, measured year-on-year in current prices, began rebounding as early as spring 2009. Meanwhile imports kept shrinking all year, with a recovery trend

kicking in only towards year-end. As a consequence of these developments, the trade deficit declined sharply in 2009, while also helping narrow the current account deficit appreciably. The current account deficit remains at a moderate level, though it will swell as a result of higher domestic demand in 2011.

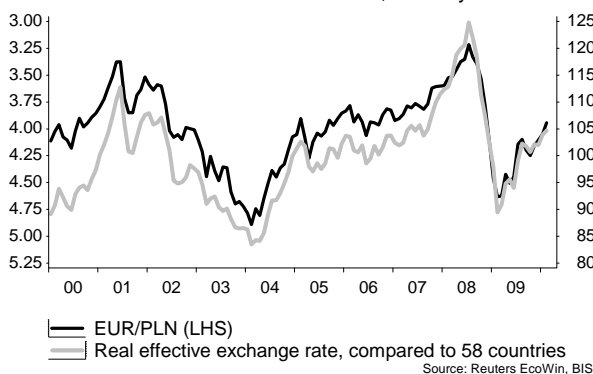
The lingering effects of the earlier zloty depreciation are helping to curb the trade deficit, which in turn is good for improving confidence in the Polish economy.

**Narrower trade deficit**  
PLN bn, 3-month rolling average



The zloty fell in real terms by 30 per cent between July 2008 and February 2009, the sharpest short-term downturn in the past 20 years. The currency was pulled along – somewhat undeservingly in view of Poland’s economic fundamentals – in the decline that occurred during the worst global market turbulence. In the subsequent and more prolonged wave of generally growing risk appetite, the zloty has gained strength and has recouped nearly half its decline. Viewed in a longer-term valuation perspective over the past decade, this simply means that the currency has reverted to its normal pricing. We predict some additional appreciation in real terms on the basis of relative growth advantages and a expected higher influx of foreign direct investments, among other things. But we do not regard this as any major threat to Poland’s competitiveness. Overall wage pressure in

**Zloty is recovering from its slide**  
EUR/PLN and Index 100=2005, monthly data

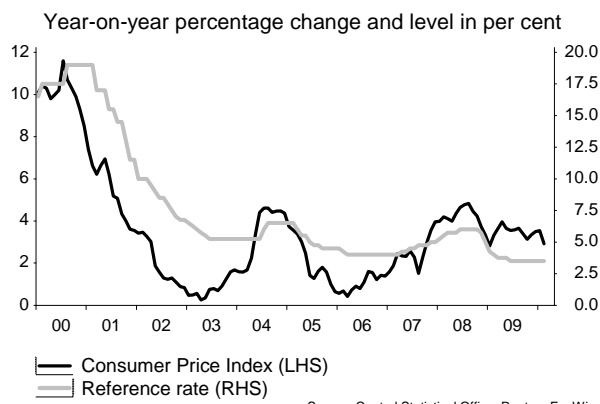


manufacturing has also eased significantly this past winter, and wage and salary growth will remain moderate over the coming year.

Unemployment has climbed for over a year, but not in a dramatic way. Recently, however, the upturn has been somewhat faster than we expected. We are thus raising our forecast of peak joblessness to 15 per cent this summer. Manufacturers, for example, are still planning further cutbacks, though not as widespread as last autumn. Households are also expecting unemployment to rise in a twelve-month perspective, but here too, the worst fears have subsided.

During the past year, inflation has fluctuated steadily between 3 and 4 per cent, often exceeding the National Bank of Poland’s  $2.5 \pm 1$  percentage point target. But in February, inflation fell somewhat to 2.9 per cent. Household inflation expectations have also continued downward, a trend since late 2009. In our assessment, price pressure will ease further in the short term due to base effects in the spring and an appreciating currency that will keep import prices down. There will also still be sizeable idle resources in the economy this year. Overall, inflation will average 2.5 per cent this year and 2.7 per cent in 2011.

**Inflation and reference rate**



Given a trend towards lower inflation and an appreciating zloty, the National Bank – which welcomed a new monetary policy council in February as planned – has room to wait another quarter before raising its key interest rate for the first time. The Bank’s reference rate has been unchanged at 3.5 per cent for eight months.

Meanwhile the Bank has undoubtedly started getting itchy fingers. Its latest inflation report in February forecasted average inflation of 3.5 per cent in 2012.

## Upturn from a low level

- Russia's economy has turned around
- Commodity prices helping sustain the recovery
- Unemployment will peak in mid-2010

The Russian economy has turned around. The sharp decline in GDP – 7.9 per cent in 2009 – has slowed. Measured year-on-year, the downturn in the final quarter was far smaller than earlier in the year. According to indicators, manufacturing is taking off and GDP has now begun to grow. We expect GDP to increase by 5.0 per cent annually in 2010 and 2011. The GDP decline in 2009 was deeper than during the financial crisis year 1998, but Russia's starting position is better today. Economic and political stability are better, central government debt is low; government finances, foreign exchange reserves and the current account balance are stronger. Though the budget is in deficit, we regard it as under control.

Looking ahead, growth will benefit from commodity prices, capital flows, fiscal stimulus and the inventory cycle, whereas domestic demand will strengthen only slowly. Oil prices, which are important to Russia, are now fluctuating around USD 70-80/barrel. Our forecast is based on an oil price of USD 75/barrel in 2010 and 2011, compared to the government's assumption of USD 60. The main risks in our forecast are that oil prices might fall, that changes in global risk appetite might cause capital to flow back out of the country again and that inflation might rebound.

We expect unemployment to peak at nearly 10 per cent this summer; average employment for 2010 will be 9.6 per cent. Fiscal stimulus measures have softened the crisis, and the budget deficit rose to nearly 6 per cent of GDP last year. With oil prices above the government's forecast and stimulus measures shrinking, the budget deficit will fall to 5 per cent in 2010 and 4 per cent in 2011.

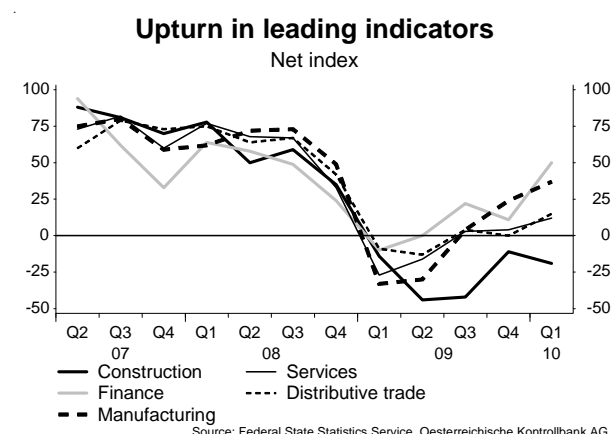
### Recovery this year

The Russian crisis of the late 1990s was followed by a decade of very good growth, averaging 5-10 per cent annually. Idle resources, capital inflows, credit expansion and government oil revenue, which made an expansionary fiscal policy possible, pushed growth above its potential rate. Two factors that drove growth – capital inflows and higher oil prices – changed direction in 2008. Inflation rose in 2007-2008, which could also be viewed as a sign that the spare resources in the economy had run out and were replaced by overheating. Falling oil prices and capital flows, together with the global financial and economic crisis, contributed to a sharp GDP decline in 2009. In our assessment, the Russian economy will grow at a healthy pace over the next couple of years, although

the growth rate in 2010 and 2011 will be lower than the 7-8 per cent that prevailed before the crisis; it will take time to regain lost ground. The current account balance, which has shown large surpluses in recent years, fell back somewhat last year to 3.5 per cent of GDP. We expect it to be reduced further to 3 per cent of GDP in 2010 and 2.5 per cent 2011. At the lowest point, the foreign exchange reserve fell by 25 per cent in the first half of last year, but regained half of its lost ground during the second part of the year and currently stands at approximately USD 400 billion.

Russian domestic demand, the manufacturing sector and exports were hard hit by the downturn in the international economy. However, public sector consumption grew slightly, helping offset the decline in demand. Imports also fell sharply – faster than exports, which helped to maintain net exports and the current account balance.

During the second half of 2009, indicators in such sectors as manufacturing, the distributive trade and finance began to improve. They are now above zero, which indicates positive growth, but the construction sector is still lagging behind.

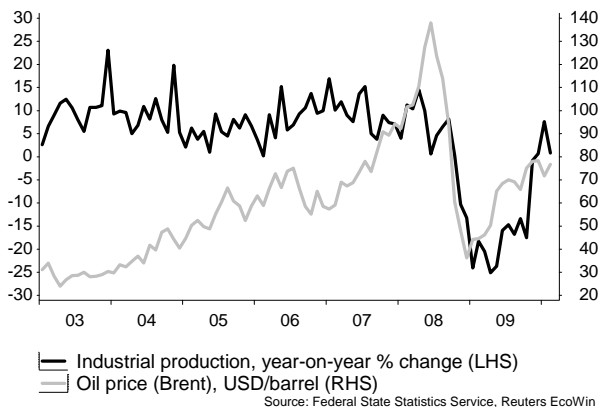


Industrial production declined last year; during January-October, production measured year-on-year fell by double digits. Towards the end of 2009, however, there was a turnaround. In November and December, production was largely unchanged, which can mostly be explained by base effects; the same months a year earlier were weak. In January 2010, industrial production rose by 7.6 per cent, which indicates that we will see relatively good GDP growth this year. Industrial production will increase by 7-8 per cent this year and by somewhat less in 2011.

The purchasing managers' index (PMI) also indicates that Russia's economy has turned around. According to the combined indicator for the manufacturing and service sectors, GDP began to grow in November 2009. Since then, the indicator has remained stuck at a few units above 50, which is considered the break-point between GDP growth and decline. The service sector PMI has been above the 50 mark for seven

months, but has fallen recently due to a weak labour market component. Both surveys have in common that the more forward-looking elements are positive and that the labour market is weak.

### Industrial production is recovering



### Unemployment will peak this summer

Unemployment rose sharply late in 2008 and early in 2009. After that, it fell somewhat in mid-2009, then rose again to 9.2 per cent in January this year. The reasons for these developments during 2009 are difficult to assess. GDP and production were weak, while unemployment shrank. This may be due to seasonal effects and the difficulty of recording changes in unemployment, due to the informal/black market sector, which is not captured by statistics.

We expect unemployment to continue climbing from 9 per cent and to peak at nearly 10 per cent during the summer. Although idle resources were built up last year, in our assessment the jobless rate will then begin falling and stand at just over 9 per cent at the end of 2010. Measured as annual averages, unemployment will be 9.6 per cent this year and 8.1 per cent in 2011.

The rate of nominal and real wage increases fell significantly last year. The decline slowed somewhat towards the end of 2009, largely due to base effects. Looking ahead, when the trend is compared to lower levels after sharp declines late in 2008 and early in 2009, real wages will show a slight increase. Due to slower inflation, pay hikes that are lower than the nominal increases of prior years will result in real wage increases.

Because of rising unemployment and falling real wages, households have held back on consumption. After falling during the first half of 2009, the volume of retail sales increased somewhat late in 2009 and early in 2010. Although the decline in wages has slowed and unemployment is close to peaking, there is no indication that household consumption will drive GDP growth this year. Although households have low debt levels at present, due to restrained lending and continued major economic uncertainty, they will

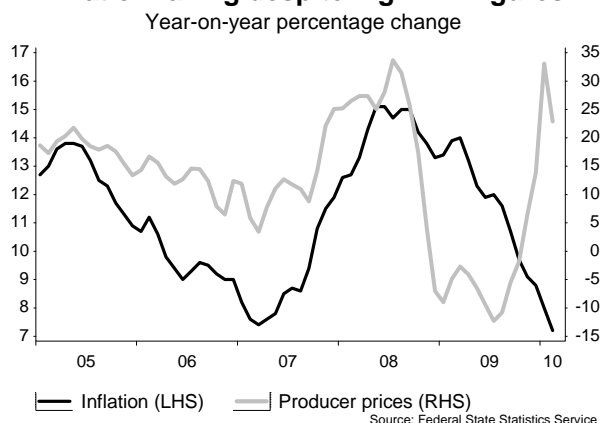
remain cautious and private consumption growth will be weak this year. Lending to households and businesses fell in January 2010, compared to the 75 per cent increase in foreign currency lending and 30 per cent increase in rouble-denominated lending one year earlier; we expect lending to gradually ease for both households and businesses, but pre-crisis growth rates will not return during our forecast period. Next year, when unemployment falls and uncertainty diminishes, we expect private consumption to again make a positive contribution to Russian GDP growth.

Investments are also recovering slowly. Given the idle resources available in the economy after the GDP decline, this is not unexpected. In a longer perspective, however, it is important for investments to speed up again in order to make future production increases possible and avoid overheating tendencies.

### Inflation is falling

Due to low resource utilisation during our forecast period, inflation pressure in the Russian economy will also ease. After inflation fell from very high levels following the 1998 financial crisis, price increases in recent years have fluctuated between about 8 and 15 per cent annually. Inflation peaked at around 15 per cent in mid-2008. The factors that drove up inflation before the most recent crisis, such as high resource utilisation, high food and oil price increases, large real wage increases and rapid money supply growth, have largely vanished. After peaking in 2008, during 2009 inflation fell to nearly its lowest year-on-year rate of increase in a decade; in January 2010, prices were 8.0 per cent higher than in January 2009.

### Inflation falling despite high PPI figures



Last year core inflation tracked CPI inflation, but in January it fell sharply compared to CPI. Month-on-month, producer prices have shown weak growth recently. Due to basis effects they rose year-on-year late in 2009 and early in 2010, as weak figures from late 2008 and early 2009 vanished from the twelve-month statistics. Our assessment is that producer prices will rise at a modest rate ahead. Inflation will

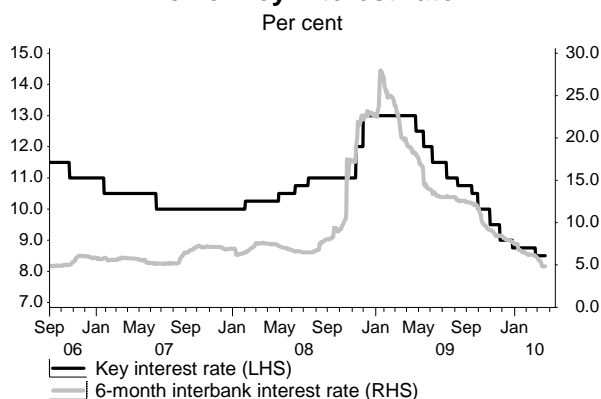
decline somewhat further to 7 per cent this year and 7.5 per cent in 2011.

## Key rate may fall somewhat further

In February 2010, the Bank of Russia lowered its key interest rate by another 25 basis points. Since the latest peak, the central bank has lowered the key rate eleven times – from 13 per cent to the current 8.5 per cent. Because of the weak economy, the central bank is under great pressure to pursue an expansionary monetary policy. Due to spare capacity, higher unemployment, falling inflation and lower lending to households and businesses, it would appear that the central bank can lower its key rate somewhat further in the short term without any risk of igniting inflation. The central bank has a difficult task in both keeping inflation under control and preventing the currency from appreciating too much.

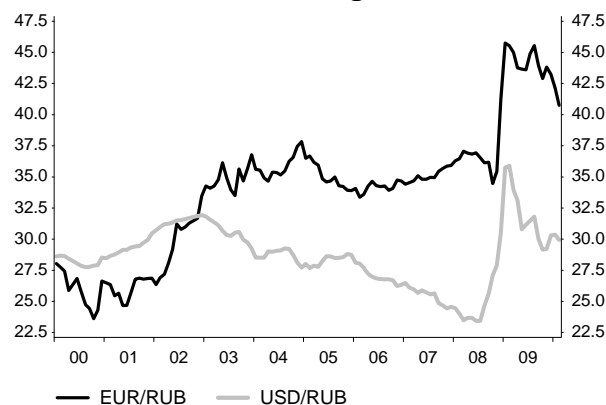
The rouble has strengthened during the past year and will continue to appreciate somewhat in the future. However, aside from being sensitive to oil and other commodity prices and to developments in the real economy, the rouble is sensitive to the general trend of global risk appetite. In our judgement, the rouble will strengthen from around RUB 30 per USD to 28 by year-end and 27 by the end of 2011. It will appreciate this year to RUB 39.5 per EUR and somewhat further to 37.5 by the end of 2011. Measured against its currency basket, which since February 2007 has consisted of 55 per cent USD and 45 per cent EUR, the rouble will strengthen to 33.2 by the end of 2010 and 32.2 by the end of 2011, compared to 36.1 at the end of 2009. The rouble has regained two thirds of the decline in its real effective exchange rate that occurred in 2008/2009. High commodity prices largely benefit Russia. Meanwhile non-commodity-based Russian manufacturers exposed to international competition are hurt by an excessively strong rouble. Rouble appreciation may cause problems for Russian exporters in the future.

## Lower key interest rate



The economy is now recovering, while oil prices – which are very important to Russia – remain at levels higher than the government’s budgetary assumptions. This means that pressure for fiscal tightening will be less acute, which increases the likelihood of stable public support for the government. To ensure favourable long-term development, however, many problems must be resolved in order to increase the growth potential of the Russian economy.

## Somewhat stronger rouble



The central government budget shifted from a surplus of about 4 per cent of GDP in 2008 to a deficit of nearly 6 per cent in 2009. Compared to other G20 countries, Russia has spent heavily to ease the impact of the crisis. This includes higher defence and security expenditures, lower corporate taxes as well as lending to and recapitalisation of the banking sector. Looking ahead, it will be important to phase out fiscal stimulus measures and reduce the budget deficit below the official medium-term target: the deficit, excluding oil revenue, should not exceed 5 per cent of GDP. Central government debt, which had been reduced almost to 5 per cent of GDP before the crisis, will climb somewhat this year and next but remain below 10 per cent of GDP.

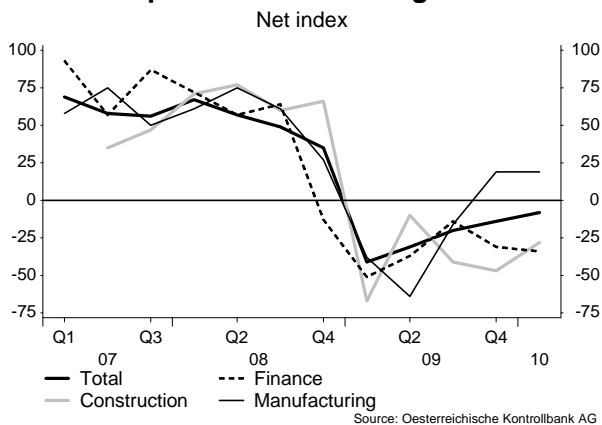
Fiscal policy will need to be tightened somewhat. Meanwhile, future room for discretionary policies will diminish, since growth over the next couple of years will be lower than pre-crisis levels. In order to improve the functioning of the economy and boost potential GDP growth, various reforms should be implemented. At present, Russia is excessively dependent on commodity prices. Other sectors would benefit from changes such as greater competition, a stable legal system, better infrastructure and an improved educational system. One risk is that crisis awareness has not gained a foothold among political leaders and the population, due to the rapid recovery, and that reform pressure will consequently not be strong enough to lead to major changes in these areas.

## Bottoming out

- Indicators and industrial production are recovering
- Political uncertainty is diminishing
- IMF will resume bail-out loan before summer

Economic growth in Ukraine last year was among the worst in the world: GDP fell 15 per cent. In January-February 2010, political turbulence in the run-up to the presidential elections worsened the crisis in Ukraine's finances and real economy. New President Viktor Yanukovich's Party of Regions quickly managed to gather a parliamentary majority, thus avoiding a new election and reducing political instability. Among economic bright spots, indicators have bottomed out, especially in manufacturing. Industrial production has turned around, and currency depreciation is helping exporters. Meanwhile households and businesses – with large loans in foreign currencies – have been hurt by the depreciation. After last year's big decline GDP will turn around, growing again by 3.5 per cent this year; investments and household consumption will hold down growth. In 2011 the economy will speed up somewhat and grow by 4.5 per cent.

### Weak improvement in leading indicators



Industrial production fell sharply late in 2008 and during the first half of 2009. It recovered rapidly in the second half, albeit from low levels, as shown both by indicators and actual output. In recent months, industrial production has risen some 10 per cent year-on-year, which is consistent with its pre-crisis rate of increase, but the industrial production indicator is lower than before the crisis and it has levelled off. However, there is reason to believe that output will rise in the near future, mainly due to higher international demand. Steel production, accounting for 40 per cent of exports, recovered last year but remains some 30 per cent below its pre-crash level. The recovery in world market prices for steel is helping output and exports. After last year's more than 20 per

cent drop, industrial production will grow by 9 per cent in 2010.

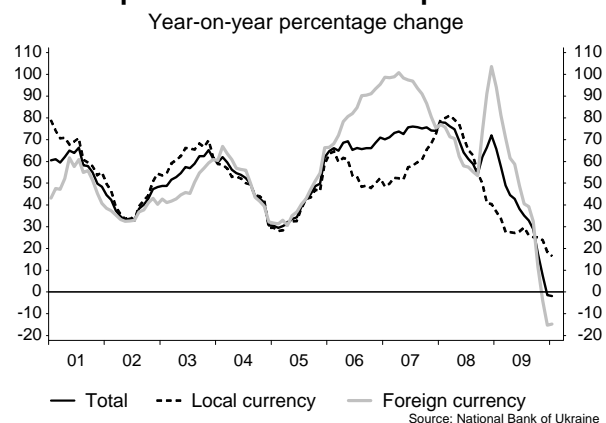
### Industrial production driving GDP



Exports dropped sharply in 2009: in the third quarter, by 40 per cent year-on-year. Imports fell even more, however. This improved the current account balance, which was slightly negative last year. Low domestic demand and a weak currency will continue to hold down imports. Meanwhile the weak currency will benefit exports, pointing towards an improved trade and current account balance ahead as well. One source of uncertainty for Ukraine's external balance will be the price of imported Russian gas, which accounts for nearly one fifth of all imports.

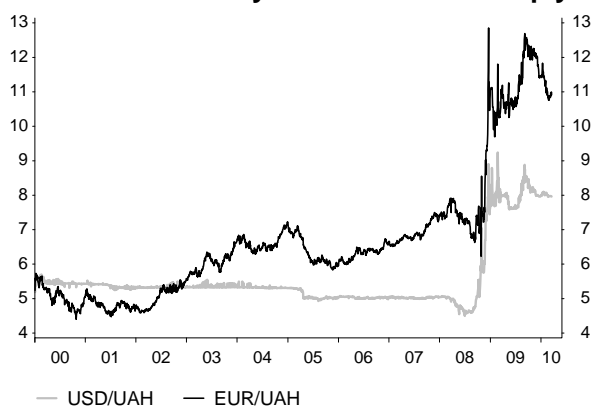
Domestic demand previously benefited from rapid credit expansion, largely in foreign currencies. In 2007-2008, lending increased by a yearly average of some 70 per cent, in foreign currencies even higher. In 2009 the expansion rate fell sharply and was slightly negative by year-end. Credit supply will recover so slowly that this will hamper future household demand and capital spending by manufacturers. Meanwhile unemployment has risen sharply and wage growth is weak, squeezing household purchasing power. Retail sales fell nearly 20 per cent last year and are expected to remain weak in the immediate future. Domestic demand will not improve until late 2010.

### Rapid decline in credit expansion



Capital outflows, large trade deficits and political uncertainty contributed to a dramatic weakening of the currency, the hryvnia, when the crisis hit Ukraine's finances and real economy late in 2008. Since that major decline, the hryvnia has fluctuated between UAH 8-9 per USD. In the final quarter of 2009, the currency strengthened and the central bank has intervened in the last month to keep the currency from appreciating. Today it is at the lower end of this range. Ukraine's currency decline has strengthened its competitiveness. The recovery in industrial production and higher commodity prices will benefit Ukraine and its currency in the months ahead. The hryvnia will stabilise at UAH 8 per dollar, under the watchful eye of the central bank.

### Ukraine's currency has weakened sharply



The presidential elections early in 2010 have resolved certain political question marks. Coalition building seems to have succeeded, with President Yanukovich and his Party of Regions consolidating their power, putting together a parliamentary majority coalition and choosing a new prime minister: Mykola Azarov, leader of the Party of Regions and former finance minister. Forming a majority was made easier by a law adopted a few days earlier that allows individual MPs to join coalitions, not just parties and parliamentary groupings. Aside from the Party of Regions, the coalition consists of two smaller parties and a number of independent MPs – 235 out of 450 MPs, providing a thin majority. A new election would delay the budget process for 2010 and also generate further political battles. The latest political developments will provide greater stability and increase Ukraine's chances of pushing through reforms in the months ahead. The president also seems to want to improve collaboration with both the EU and Russia. Given its geographic location, Ukraine will be dependent on – and its economic development will benefit from – good relations with its neighbours both to the east and west. This may lead to increased future investments in Ukraine.

A continued IMF bail-out is necessary. This means that a vital first priority for a new government is to

pass a 2010 budget that meets IMF requirements for continued loan disbursements. In order to resume negotiations with the IMF, Yanukovich must fulfil such conditions as cutting energy subsidies. In our assessment, the IMF is likely to show some flexibility in the negotiations, eliminating or easing certain requirements, and disbursements will resume before the summer. The autumn 2008 IMF aid package totals USD 16.8 billion, equivalent to 8 per cent of GDP. This aid is disbursed in stages after the IMF has examined whether Ukraine has met its conditions. More than USD 11 billion was disbursed until last autumn, when payments were frozen due to Ukraine's excessive budget deficits.

A budget that meets IMF requirements will be tight over the next couple of years. It will hold down domestic demand but is meanwhile necessary to ensure sustainable long-term government finances. Like many other countries, Ukraine is grappling with large budget deficits, but on the plus side the pre-crisis deficit was limited and government debt was very low at the outset. The general government deficit rose sharply last year: from 1.2 per cent of GDP in 2008 to 7 per cent in 2009. Last year the balance improved slightly. Debt will climb during the next couple of years due to both the deficit and a reform of the banking system (which may cost 5-10 per cent of GDP), levelling off at about 40 per cent of GDP. Ukraine's problem is more short-term – building confidence in its official economic policies.

Interbank interest rates fell late in 2009 and early in 2010. The market's assessment of the probability that Ukraine will suspend payments on its loans has also fallen sharply in the past year. Ukrainian credit default swaps are admittedly still priced more than 250 basis points above those of Latvia, down from more than 1,000 points last November, but there is room for a further decline now that political uncertainty appears to be dissipating. Our assessment remains that the default risk is low.

# Key economic data

Eastern European Outlook — March 2010

## ESTONIA

	2004	2005	2006	2007	2008	2009(f)	2010(f)	2011(f)
GDP, %	7.2	9.4	10.0	7.2	-3.6	-14.1	2.0	5.0
Inflation, HICP, average, %	3.0	4.1	4.4	6.7	10.6	0.2	2.0	3.0
Unemployment, %	9.7	7.9	5.9	4.7	5.5	13.8	15.0	13.0
Current account, % of GDP	-11.3	-10.0	-16.9	-17.8	-9.4	4.6	3.0	-1.0
Public sector financial balance, % of GDP	1.6	1.6	2.3	2.6	-2.8	-1.7	-2.5	-2.0
Public sector debt, % of GDP	4.9	4.5	3.9	3.5	4.3	6.1	6.5	7.0
EUR/EEK, end of period	15.6	15.6	15.6	15.6	15.6	15.6	15.6	15.6
3-month interest rate, eop	2.4	2.6	3.9	7.3	7.9	3.1	1.5	3.0

## LATVIA

	2004	2005	2006	2007	2008	2009(f)	2010(f)	2011(f)
GDP, %	8.7	10.6	12.2	10.0	-4.6	-18.0	-2.8	4.0
Inflation, HICP, average, %	6.2	6.9	6.6	10.1	15.3	3.3	-3.2	1.6
Unemployment, %	10.4	8.7	6.8	6.0	7.5	17.2	19.9	18.0
Current account, % of GDP	-12.8	-12.5	-22.5	-22.5	-12.6	9.4	5.5	2.0
Public sector financial balance, % of GDP	-1.0	-0.4	-0.5	-0.4	-4.0	-9.0	-8.5	-6.0
Public sector debt, % of GDP	14.9	12.4	10.7	9.0	19.6	31.3	48.0	59.0
EUR/LVL, end of period	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7
Key rate, eop	3.5	4.0	5.0	6.5	6.0	4.0	3.5	4.0

## LITHUANIA

	2004	2005	2006	2007	2008	2009(f)	2010(f)	2011(f)
GDP, %	7.4	7.8	7.8	9.8	2.8	-15.0	1.0	4.0
Inflation, HICP, average, %	1.2	2.7	3.8	5.8	11.1	4.2	0.0	2.0
Unemployment, %	11.4	8.3	5.6	4.3	5.8	13.7	16.5	17.0
Current account, % of GDP	-7.7	-7.1	-10.6	-14.5	-11.9	0.0	0.5	1.0
Public sector financial balance, % of GDP	-1.5	-0.5	-0.4	-1.0	-3.2	-10.0	-8.0	-5.0
Public sector debt, % of GDP	19.4	18.4	18.0	17.0	15.6	29.3	37.0	40.0
EUR/LTL, end of period	3.45	3.45	3.45	3.45	3.45	3.45	3.45	3.45
3-month interest rate, eop	2.60	2.50	3.80	6.70	9.90	3.90	2.50	3.30
5-year government bond, eop	3.00	3.10	3.90	4.80	13.10	6.85	4.10	3.80

(f) = forecast

# Key economic data

Eastern European Outlook — March 2010

## POLAND

	2004	2005	2006	2007	2008	2009(f)	2010(f)	2011(f)
GDP, %	5.2	3.6	6.2	6.8	4.9	1.7	3.5	4.5
Inflation, HICP, average, %	3.6	2.1	1.0	2.5	4.2	3.4	2.5	2.7
Unemployment, %	19.0	17.6	14.8	11.2	9.5	11.9	14.0	12.0
Current account, % of GDP	-4.0	-1.2	-2.8	-4.7	-5.0	-1.6	-2.0	-3.0
Public sector financial balance, % of GDP	-5.7	-4.3	-3.8	-2.0	-3.9	-7.2	-6.5	-4.5
Public sector debt, % of GDP	45.7	47.1	47.7	44.8	47.0	49.0	54.9	54.5
EUR/PLN, end of period	4.08	3.86	3.83	3.60	4.12	4.10	3.50	3.40
Key rate, eop	6.50	4.50	4.00	5.00	5.00	3.50	4.00	5.00
5-year government bond, eop	6.20	5.00	4.98	6.13	5.34	5.91	4.80	5.10

## RUSSIA

	2004	2005	2006	2007	2008	2009(f)	2010(f)	2011(f)
GDP, %	7.2	6.4	7.7	8.1	5.6	-7.9	5.0	5.0
Inflation, average %	10.9	12.7	9.7	9.0	14.1	11.7	7.0	7.5
Unemployment, %	8.2	7.6	7.2	6.1	6.4	8.4	9.6	8.1
Current account, % of GDP	10.1	11.0	9.5	5.9	6.1	3.5	3.0	2.5
Public sector financial balance, % of GDP	4.4	7.4	7.5	5.4	4.1	-5.9	-5.0	-4.0
Public sector debt, % of GDP	20.3	14.1	9.1	7.4	6.5	7.3	8.9	8.1
EUR/RUB, end of period	27.7	28.7	26.3	24.6	30.5	30.3	28.0	28.0
3-month interest rate, eop		29.3	27.2	29.7	35.4	36.1	33.2	32.3

## UKRAINE

	2004	2005	2006	2007	2008	2009(f)	2010(f)	2011(f)
GDP, %	12.1	2.7	7.3	7.9	2.1	-15.0	3.5	4.5
Inflation, average, %	9.0	13.5	9.1	12.8	25.2	15.9	12.0	9.0
Unemployment, %	8.6	7.2	6.9	6.4	6.4	10.0	12.0	11.0
Current account, % of GDP	6.8	2.5	-1.6	-5.9	-12.9	-1.5	0.0	1.0
Public sector financial balance, % of GDP	-2.8	-1.7	-0.6	-0.8	-1.2	-8.0	-6.0	-3.5
Public sector debt, % of GDP	24.7	17.7	14.8	12.3	20.0	35.0	39.0	43.0
USD/UAH, end of period	5.31	5.02	5.05	5.05	7.80	8.00	8.00	8.00

(f) = forecast

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