



# Eastern European Outlook

Economic Research – October 2010

Renewed domestic demand  
but moderate GDP growth

Theme: Internal devaluations  
in the Baltic countries

**S|E|B**



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## Summary

The export-led recovery of the past year in Eastern Europe – which in many places has been stronger than in Western Europe – is continuing. But the export-oriented manufacturing upturn is now entering a more mature phase, due to decelerating global demand. Meanwhile domestic demand is awakening, thanks to the resumption of real wage growth, stabilising labour markets and a gradual thaw in still-inhospitable credit conditions. Eastern Europe was the region of the world that was hardest hit by the global credit crisis, mainly due to its relatively large foreign loans.

GDP growth will continue to increase in most of the region during 2011-2012 but in the six countries covered in this report, growth will not return to its previous high rates - which led to severe imbalances - but instead will barely reach its potential level. There are structural obstacles to growth, such as sizeable labour market and emigration problems in all three Baltic countries and a slow pace of reform in Russia. In addition, there will be fiscal tightening in Poland and Ukraine and, over time, in Russia as well. In the Baltics, Latvia will stick to fiscal austerity.

- **Russia's** GDP, after rising 4.6 per cent this year, will grow by 4.5 per cent in 2011 and 4.8 per cent in 2012, sustained by continued high but stabilising commodity prices.
- **Poland's** economic growth will be increasingly driven by capital spending and will speed up from 3.5 per cent this year to 4.0 per cent in 2011 and 4.5 per cent in 2012.
- **Ukraine's** growth, a solid 5.2 per cent this year, will diverge from the pattern in other countries by slowing down a bit to 4.4 per cent in 2011 and 4.2 per cent in 2012, in the wake of austerity measures and reforms required by its lender, the IMF.
- **Estonia's** GDP will climb by 2.3 per cent this year and after that by 4.0 per cent annually, but its euro zone accession in 2011 may lead to higher growth via more foreign direct investments. The government will ease its tight fiscal policy next year.
- **Lithuania's** economic growth will end up at 1.0 per cent in 2010, accelerating to 4.0 per cent in 2011 and 4.5 per cent in 2012. Fiscal policy will become more neutral after tough belt-tightening.
- **Latvia**, which is lagging behind Estonia and Lithuania in its recovery and will post a further average GDP decline of 1.5 per cent in 2010, will return to positive year-on-year growth this autumn. GDP will rise 4 per cent in 2011 and 5 per cent in 2012, despite relatively tough budget consolidation after the October parliamentary election.

Inflation is now gradually rising from historically low levels in Russia and Ukraine. The Baltics will see a resumption of moderate inflation after earlier deflation pressure. Budget deficits are high but will shrink steadily. Public debt will continue climbing somewhat but is moderate or low compared to Western countries. For example, all six governments will end up below the Maastricht debt criterion for the euro zone: no higher than 60 per cent of GDP.

We predict that of the three euro zone candidates covered in this report, Latvia and Lithuania will adopt the common currency first in 2014, followed by Poland in 2015.

A special theme article in this issue discusses the internal devaluations in the three Baltic countries. Our conclusions are that the wage- and salary-cutting process has now largely ended and that the Baltics is recapturing export market shares.

## Recovery with increased US risks

- Decent world growth – thanks to Asia
- German strength sustaining euro zone
- Domestic demand up in Eastern Europe

The global recovery, which began a year ago, has entered a calmer phase. This is largely because earlier major fiscal stimulus is now fading and inventory build-up is no longer propping up growth. But the picture is mixed. Since spring 2010, the US economy has stumbled. In fast-growing Asia, most economies have slowed somewhat, but from a high level. Many countries still showed unexpectedly strong second quarter GDP figures. Europe has seen the creation of a divergence: continued dynamism in Germany and the Nordic countries but weakness in the south, where major budget-tightening programmes have been launched.

At global level, shaky confidence surveys since the summer are signalling that economic upturn will keep losing momentum in the next six months. This is mainly due to the US, where weak labour and housing markets are blocking a traditional recovery dynamic. In our late August *Nordic Outlook*, we sharply lowered our US forecasts. Growth will remain below trend in the second half of 2010 and the first quarter of 2011. The labour market will improve only slowly. But the US can avoid a new recession, because: 1. Capital spending began to bounce back in the spring, while depressed investments, strong balance sheets at major companies and higher capacity utilisation point to continued upturn. 2. The Fed will hold off on interest rate hikes until early 2012; its readiness to undertake new quantitative easing will help keep long-term yields down as well.

Asia has far smaller debt adjustment needs than mature Western economies like the US. The region will thus remain an essential driving force for world growth. China is also successfully soft-landing its economy after austerity measures since late 2009 and has the resources to ensure continued orderly cooling of its partially overheated real estate markets.

The euro zone will remain divided because of divergent balance problems and belt-tightening needs. Germany will continue to outperform, though growth will decelerate from more than 3 per cent this year to about 2 per cent in the next two years.

World GDP will increase by about 4 per cent a year in 2011-2012, which is close to trend, but downside risks will predominate. Due to cyclical risks and continued

downward pressure on core inflation in the coming 6-12 months in many Western countries, major central banks in turn will not hike key rates during the coming year.

After major fluctuations in recent years, the EUR/USD exchange rate is expected to appreciate further the coming year. The US dollar's large, necessary downward adjustment has occurred. In the past year, the USD has mainly rebounded and the EUR has fallen. Both currencies have reached more neutral levels in the long term, measured in real effective exchange rates. In nominal terms, the euro has weakened by around 10 per cent this past year, benefiting the Baltic countries – whose currencies are pegged to the euro – in their cost adjustment process. During the autumn the EUR has again started to appreciate and the USD to depreciate, partly on expectations of further Fed stimulus measures.

### Global economic highlights

GDP, year-on-year percentage change

	2009	2010	2011	2012
United States	-2.6	2.6	2.2	2.9
Euro zone	-4.1	1.6	1.3	1.5
The world	-0.6	4.4	3.8	4.3
Oil, USD/barrel	61.9	76.2	80.0	80.0
EUR/USD, Dec	1.43	1.40	1.45	1.30

Source: SEB

In Eastern Europe, trade with the US is small. At most, these countries sell 5 per cent of exports there. Germany is all the more important. The Central European economies sell 20-30 per cent of their exports to Germany. While negative global risks have mounted, there are increasing signs that the upturn will soon broaden in Eastern Europe – the region hardest hit by the global credit crisis, due to large foreign loans. So far the upturn in many parts of the region has been stronger than in the West, an indication of good competitiveness.

The export-led manufacturing upturn is now entering a more mature phase. Meanwhile household consumption in many places has begun to join the recovery via stabilised labour markets and a resumption of real wage growth. The corporate capital spending outlook has also improved somewhat, but we are continuing to predict a rather sluggish recovery in domestic demand. The main reasons are moderate fiscal tightening in various countries and only a slow thawing of the credit situation. Eastern Europe is benefiting from low or moderate public sector debts. We predict decent 2011-2012 GDP growth in the region, but in most cases barely reaching potential.

## Pay adjustment process will soon end

- Modest 2011 private sector pay growth
- Good competitiveness in exports...
- ...but not the strongest in the region

The tough cost adjustment of the past two years in the Baltics, after earlier economic overheating, is coming to an end. There are many indications that largely pay-driven deflation pressure ended in Estonia and Lithuania last spring and will do so in Latvia this autumn. Private sector pay bottomed out in all three countries in the first half of 2010, according to official statistics. Seasonal and temporary effects may have distorted the picture, but only by a quarter or so. Pay has also begun to climb, quarter-on-quarter but it is still falling year-on-year, and the situation varies from one sector to another; cautious pay recovery is quite clearly being led by export-oriented manufacturers.

We predict modest overall wage and salary growth in 2011, driven by the private sector. Public sector pay cuts will end – but we expect no public pay hikes, or only marginal ones, since all three governments have presented budgets that include pay freezes.

Several arguments point towards a gradual increase in private wages and salaries. GDP growth is back (since the second or third quarter of 2010), though at a moderate pace. Unemployment, which peaked in the first half, is slowly falling. Labour shortages are emerging earlier than normal, due to accelerating and probably rather large-scale emigration during the crisis. Competitiveness has been restored; the Baltic countries are regaining lost export market share.

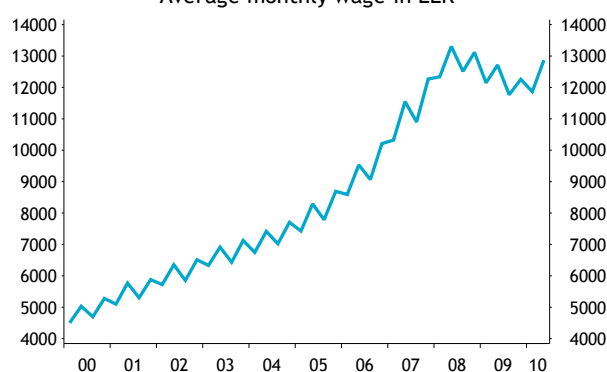
Wages and salaries climbed in 2004-2008 by a yearly average of 16 per cent in Estonia and Lithuania and 20 per cent in Latvia. They soared by nearly 35 per cent in Latvia during 2007; in the wake of this, inflation was driven up to an average of 15.3 per cent in 2008.

The Baltics' strategy for halting this unsustainable trend by means of internal devaluations – pay and price cuts – emerged in 2008. Choosing this strategy instead of unpegging the currencies from the euro was logical, given the nature of their economic ills. Exploding current account deficits of 14-22 per cent of GDP in 2006-2007 (compared to then-sustainable levels of 6-7 per cent) was not mainly a sign of poor export competitiveness but of strong, partly credit-driven domestic demand driving up imports. Devaluing currencies in

economies where businesses and households had about 70-90 per cent of their borrowing in foreign currencies (mainly euros) might have created chaos, pushing up inflation sharply in the short term. External demand was also very weak, reducing prospects of “kick starting” exports via devaluations.

### Estonia: Wages

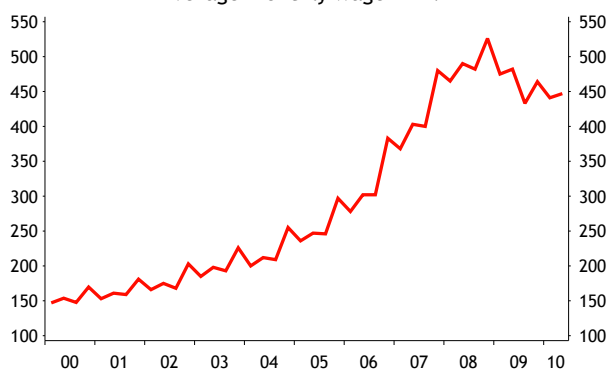
Average monthly wage in EEK



Source: Statistics Estonia

### Latvia: Wages

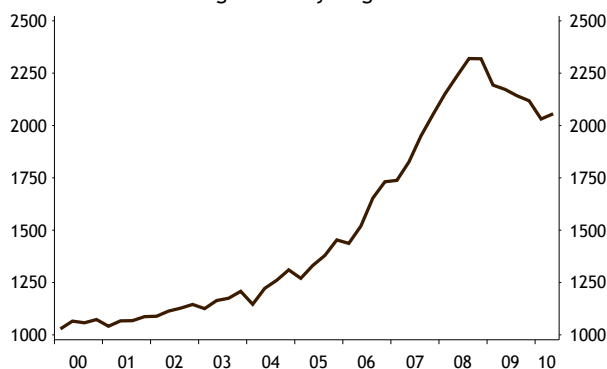
Average monthly wage in LVL



Source: Central Statistical Bureau, Latvia

### Lithuania: Wages

Average monthly wage in LTL



Source: Statistics Lithuania

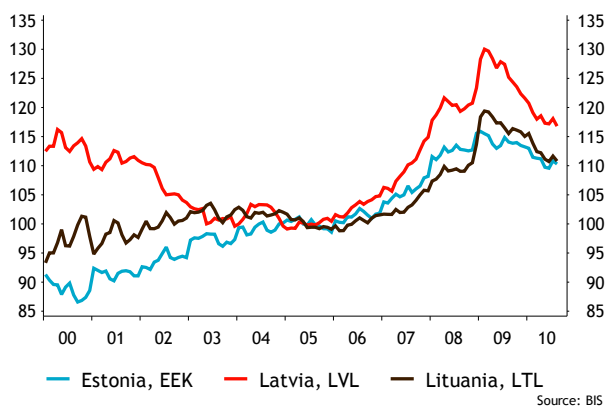
A review of pay statistics shows the following:

- Average gross pay in the entire economy fell from its peak levels of late 2008 by 12 per cent in Estonia and Lithuania and by 19 per cent in Latvia, respectively.
- Private sector pay adjustments have been relatively tougher in Estonia and Lithuania than in Latvia, which reported the largest cuts in public sector pay.
- The manufacturing sector has cut wages and salaries by about 10 per cent in all three countries. Notably, during the second quarter of 2010 manufacturing pay in Estonia was back at its second quarter 2008 peak.
- Pay has been squeezed harder in retailing and construction than in manufacturing, and by far the most in construction, where it plummeted 34 per cent in Lithuania but by a more moderate 12 per cent in Latvia.

#### So what has happened to the Baltic countries' competitiveness – and how have exports been affected?

One measure of competitiveness is the real effective exchange rate. Between 2005 and their winter 2008/2009 peak, real effective exchange rates (shown below as inflation-adjusted rates compared to 58 economies) appreciated sharply: by 30 per cent in Latvia, 20 per cent in Lithuania and 15 per cent in Estonia. This was mainly caused by rapid pay hikes, but also by the appreciating trend of the euro at the time and currency rate declines in nearby countries during the acute global crisis late in 2008.

**Real effective exchange rates**  
Index 100 = 2005



The pay cuts of recent years, combined with this year's euro downturn, have led to a reversal of about half the above-mentioned appreciation in Latvia and Lithuania and about one third in Estonia. For some time, our view has been that it will not be necessary to push down real effective exchange rates all the way to the levels prevailing 5-6 years ago before the three economies began to derail. First, a certain long-term appreciation trend

is reasonable in emerging economies, where prices and pay naturally move upward faster than in more mature economies and productivity improvements are higher. Second, the rebound in market share indicates that Baltic exports are again competitive, especially those of Lithuania.

An analysis of the export market share trend over a five-year period (see the table below) shows that the three countries regained much of their losses in 2009. Lithuania did so as early as 2008 and is already ahead on a net basis after its major loss of market share in 2007. Estonia and Latvia still have a way to go, but our assessment is that this year, all three will continue making progress in regaining market share.

Viewed over five years, all three Baltic countries have gained an average of 1-2 per cent market share, with Lithuania in the lead. But they have been less successful than other Eastern European economies (including Central Europe). Hungary and the Czech Republic top the list, with annual gains of more than 5 and 4 per cent, respectively, but this gap in export performance between the Baltics and other countries in the region is not wide enough to argue that real effective exchange rates in the Baltics are still fundamentally at incorrect levels.

#### Change in export market shares

Year-on-year percentage change

	2005	2006	2007	2008	2009
Estonia	8.1	3.6	-8.5	-2.4	7.9
Latvia	10.2	-4.7	1.0	-4.9	3.7
Lithuania	6.8	0.0	-7.3	9.4	1.4

Source: European Commission

#### Change in export market shares

Annual averages, 2005-2009, in per cent

Hungary	5.2	Lithuania	2.1
Czech Republic	4.3	Estonia	1.7
Romania	3.9	Latvia	1.1
Slovakia	2.7	Bulgaria	0.4
Poland	2.5	Euro zone	-0.8
Slovenia	2.2		

Source: European Commission

## Two-speed recovery

- Recovery continues to be export-led
- Unemployment will remain high
- Small short-term effects from the euro

The strong economic rebound of late last year has now developed into a two-speed recovery. Companies exposed to the revival of trade flows in the Baltic countries have taken off, while those dependent on the home market are still languishing on the sidelines. The re-assertive mood was further buttressed in June when the EU finance ministers backed Estonia's bid to join the euro zone in 2011. This long-awaited nod of approval gave the governing coalition a sense of accomplishment and persuaded the electorate that their sacrifices during 2009 were not in vain.

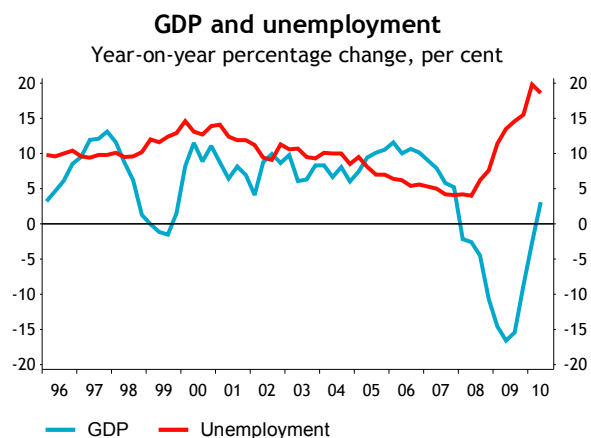
The unexpectedly strong recovery among Estonia's largest trade partners has already had a more tangible effect than the expected impact of the euro on foreign direct investment (FDI) flows. Year-on-year import growth rates in the country's three main external markets – Finland, Sweden and Russia – have mainly hovered around 20 per cent this year, with Sweden and Russia performing particularly strongly. This has pulled Estonia's exports out of a slump. Year-on-year growth of non-oil exports rose to 37 per cent in May and acted as a catalyst for the manufacturing sector – now the primary growth engine.

### Stockbuilding behind growth

Growth has indeed returned, even at the aggregate level and year-on-year. In the second quarter of this year, GDP was up 3.1 per cent – the first increase in two and half years. A closer examination of growth sources reveals, however, that the contribution from net exports had turned negative – a fact that flies in the face of the underlying narrative of export-led revival. This apparent puzzle is solved by further dissection of the components of domestic demand. The only expanding category was stockbuilding, which contributed no less than 8.1 percentage points to second quarter growth. Thus, the way to reconcile national income statistics with foreign trade and manufacturing data is to conjecture that stocks were primarily built up to meet foreign demand in the first place, so that growth will shift from stockbuilding to exports over the next few quarters. This purely technical issue reflects a more fundamental theme at this stage of the cycle: how resilient is the export-led recovery, and will domestic demand be able

to take up the slack once the current expansion in export sales runs out of steam?

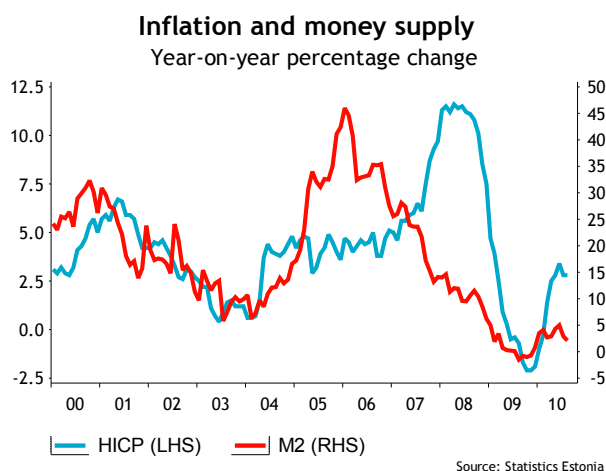
We predict that the 2011 weighted average growth rate of Estonia's nine largest trade partners will come in at 3.1 per cent. Although our regional growth outlook for 2011 has not changed since the last *Eastern European Outlook* in March 2010, we now expect unemployment to fall substantially more slowly. Estonia's jobless rate has fallen much less than we expected in previous forecasts. Even the expanding manufacturing sector has barely started to add jobs. In the second quarter, unemployment was down by 1.2 percentage points to 18.6 per cent. We have revised our unemployment forecasts for both 2010 and 2011 up by 3 percentage points to 18 per cent and 16 per cent respectively, and we project 15 per cent for 2012.



Since these revisions imply weaker support from domestic demand than previously expected, we are trimming our GDP growth forecast for 2011 by 1 percentage point to 4.0 per cent and foresee the same growth rate for 2012. Upside risks dominate our forecast and are related to foreign direct investment, which might play a larger role in growth as euro awareness sinks in. In fact, FDI has already improved somewhat from its lows in 2007-2008, and it does not take big flows to have a relatively big impact in Estonia. At the same time, we are raising this year's GDP projection by 0.3 points to 2.3 per cent on the back of an unexpectedly fast recovery for external demand. However, our main point is that the current surge in foreign demand is largely based on restocking and is thus of a temporary nature. Once its effects start to fade in early 2011, growth-averse factors stemming from the languid labour market and ongoing private sector efforts to lower debt

levels will once again move to the fore. Total credit stock is still falling at 5 per cent year-on-year.

The labour market mirrors the compartmentalised nature of the economy, with a deepening schism between sectors. In the second quarter, total employment contracted by 5.7 per cent year-on-year, while the average nominal wage was up by 1.2 per cent compared with a year earlier. This included 1.4 percentage points from manufacturing, meaning that average pay in all other sectors was still on the wane. In the construction sector, payroll is now 53 per cent below the peak. This means Estonia might be facing an extended period of structural unemployment, since redundant construction workers will only gradually be absorbed by other sectors. Altogether more than 100,000 jobs were wiped out during the two years of downturn: around 17 per cent of total employment.



The recent revival, and to a lesser degree in the labour market improvement has had an impact on consumer prices. Estonia ended a nine-month period of deflation in March. In the past few months, the year-on-year inflation rate has hovered around 3.0 per cent. Tax hikes are one explanation. The stronger than expected inflationary rebound has led us to revise our spring inflation forecast for 2010 upward to 2.5 per cent. We expect the euro transition to push prices somewhat higher in the short term.

As for the 2011-2012 outlook, there are several considerations. The effects of tax hikes will fade, although the excise duty on tobacco will be increased in January 2011. The overall labour market situation is hardly conducive to inflation. That said, the strains in certain corners of the job market might well lead to cost pressures. Whether these will translate into higher inflation ultimately depends on money supply. Euro zone accession on January 1 will represent a major turning point in monetary policy and probably economic policy in general. The first material change will be a gradual reduction in the required reserve ratio from its recent 15 per cent to 2 per cent in January. Although this could theoretically have a massive impact on the liquidity supply, it would be wrong to read too much into this. We think it will have a marginal effect on money supply,

since additional liquidity will be withdrawn from the system via the foreign-owned banks which dominate the Estonian banking sector. Credit growth is expected to remain weak. We expect the money supply growth rate to approximate that of real GDP growth in subsequent years, so there will be no additional ammunition left for inflation. We have trimmed our inflation outlook by 1 percentage point to 2.0 per cent in 2011 and have also set our 2012 forecast at 2.0 per cent.

### A shift towards more neutral fiscal policy

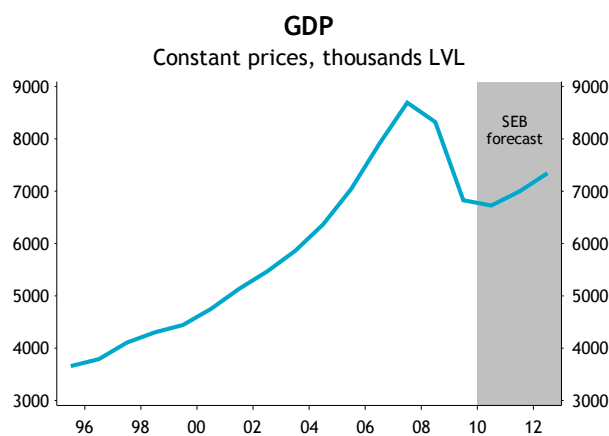
One of the most dramatic effects of the 2008-2010 economic adjustment has been the swing from a huge current account deficit, 17.2 per cent of GDP in 2007, to a surplus of 4.5 per cent two years later. We expect this year's surplus to come in at 2.0 per cent of GDP. Our scenario of slowly declining unemployment, weak domestic demand and export-led recovery indicates that the current account will remain more or less in balance during 2011-12. This assumes no major changes in fiscal policy. We expect fiscal policy to become more neutral in 2011, after two years of belt-tightening.

We believe that the incumbent governing coalition will capitalise on the currency switchover day on January 1. That leaves just two months until the general elections in March. Barring any major debacles, the coalition will probably survive and form the next government, which will have to find ways to live with a smaller tax base and an earlier pledge to resume state payments to the second pillar pension system. If Estonia's low sovereign debt level and membership in the common currency area enable the government to borrow at least for a while at reasonably low interest rates, we expect a gradual shift towards greater fiscal permissiveness. The finance ministry has projected fiscal deficits of 1.6 and 2.3 per cent of GDP for 2011 and 2012 respectively. Given our bleaker view of labour market trends and growth, our deficit projections are somewhat larger, envisaging budget shortfalls of 2.5 per cent in 2011 and 3.0 per cent in 2012.

## On a shaky path to growth

- Weak recovery in domestic demand
- Structural problems in the labour market
- Continued fiscal tightening

Since the last *Eastern European Outlook* in March, Latvia's economy has stabilised, showing more explicit signs of recovery. GDP has grown for two consecutive quarters, compared to the preceding quarter, but Latvia is still lagging behind Estonia and Lithuania. Although sentiment indicators have improved clearly since the beginning of 2010, uncertainty persists. The recovery is uneven and mainly export-driven and the labour market is weak.

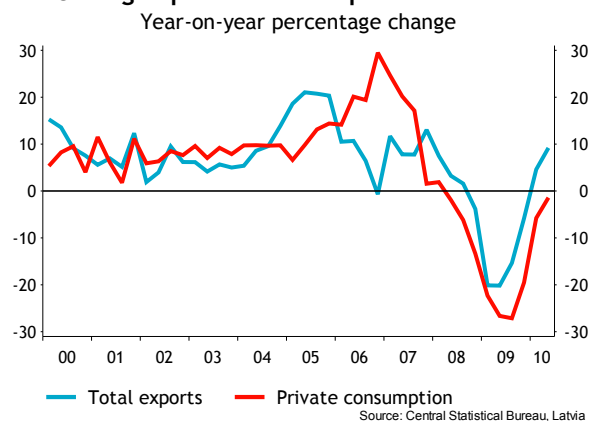


In the second quarter of 2010, GDP was down 2.1 per cent year-on-year. Since then there have been continued positive signs in most export-oriented sectors. Due to feeble purchasing power, the service sector has remained weak. There is still a significant drop in construction and this sector will be the last to recover. We project year-on-year GDP growth in the third quarter, the first such increase since the first quarter of 2008.

The biggest challenge is long-term growth. The relatively slow recovery poses a threat of stagnation in the labour market and continuing emigration. Furthermore, as Latvia increases its reliance on exports, further growth will be greatly influenced by external factors. GDP will drop by 1.5 per cent in 2010 and grow by 4 per cent in 2011 and 5 per cent in 2012. Exports will remain a major driving force in the medium term. Private consumption and investments will only gradually strengthen.

Owing to Latvia's increased competitiveness and favourable external conditions, exports are booming. In the first seven months of 2010, exports soared by 26 per cent year-on-year in current prices. Meanwhile imports are also rising, though at a slower pace, and showed 12 per cent growth. Despite exploding exports, there was still a trade deficit of LVL 550 million. The current export boom is not sustainable and growth will cool down a bit in 2011. Low capital spending and low value-added continue to threaten long-term growth, both in manufacturing and exports.

### Strong exports - consumption at bottom



The current account surplus shrank by 16 per cent in the first seven months compared to the same period 2009. The surplus will continue to narrow due to higher imports, resulting from the needs of the manufacturing sector and due to such factors as a gradual recovery in domestic demand. The current account will turn negative in the second half of 2011.

Consumption is now bottoming out, despite high unemployment and reduced incomes. In July, retail sales decreased by 0.5 per cent, and year-on-year by 2 per cent. The general economic environment has become more stable, which is why households are becoming less cautious about their spending. Nevertheless, towards the end of the year higher heating bills and new budget consolidation measures may lead to some reversals.

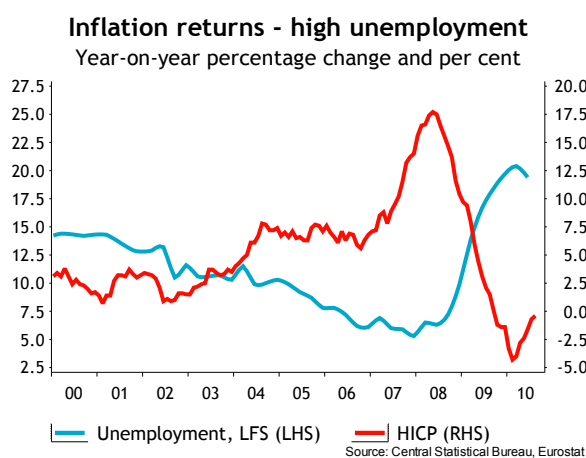
Since mid-2007, prices on the real estate market has dropped sharply: up to 70-80 per cent from peak to trough. It began to stabilise in mid-2009. Current housing market activity is stuck at the level of the last year, but prices are showing a small increase. Although

output is rising, due to the price level and low quality it is not really meeting demand.

In August, bank lending still showed a 7 per cent year-on-year decline. There was slightly higher activity in the corporate sector. Non-performing loans accounted for 19.3 per cent of the total portfolio. Most of these are residential loans to households and realtors. In the coming months, stabilisation will continue. The overall de-leveraging process will continue, and not until the second half of 2011 do we expect trend growth in total lending.

## The burning unemployment issue

The jobless rate fell to 19.4 per cent in the second quarter from its peak of 20.7 per cent in the first quarter. The rise in economic activity has allowed unemployment to decrease, but one major explanation is seasonal work. Meanwhile a mismatch is forming between the skills demanded by employers and the labour supply. There is a demand for highly qualified employees, while the majority of job seekers are low-skilled. Despite the recovery we do not expect rapid labour market improvement. Unemployment will stay high for several years. Emigration will continue, and employers will face a shortage of appropriate job candidates. Retraining opportunities will thus play a crucial role. Solutions need to be found by reforming the education system.



Wages show signs of bottoming out after hefty cuts during 2008-2009. In the second quarter of 2010, average gross wages rose by 2.9 per cent quarter-on-quarter. This was due to salary changes in the public sector, including occasional bonuses and pay rises, for example in education. In the private sector, the rise in the second quarter was only 0.6 per cent. Year-on-year, gross wages fell 6.3 per cent in the second quarter. Some depressed industries, such as agriculture, forestry, mining and electricity supply, reported small wage increases. This shows that even in a situation of severe unemployment, highly qualified employees are scarce and wage cuts for these categories are hardly appropriate.

So far, Latvian businesses have improved their competitiveness by reducing labour costs. The previously

accumulated gap between wages and productivity has contracted. However, this technique for raising competitiveness has been exhausted. Now employers must focus on boosting productivity. In the fourth quarter of 2010, the private sector is likely to start showing a slight year-on-year increase in wages.

Latvia's period of deflation has turned out to be shorter than expected, mostly due to administrative and external factors. By the end of 2010, year-on-year inflation will return. There are signs of higher food prices. In anticipation of a gradual economic recovery and more modest global growth, consumer prices are not expected to surge, but they will be affected by possible VAT, excise and real estate tax hikes. Potential changes in agreements with energy suppliers may also affect natural gas prices. Our inflation forecast is 1.3 per cent in 2011 and 1.5 in 2012.

## The next budget consolidation test

Latvia has already implemented tough austerity measures, shrinking its 2009 budget deficit to 9 per cent of GDP. This year's target is 8.5 per cent of GDP, as agreed with the country's international lenders, the IMF and the EU. In the first eight months of 2010, the budget deficit was LVL 257 million, or much lower than planned. Budget revenue exceeded plan by 1.5 per cent. However, we anticipate higher spending by the end of the year. Due to improved growth prospects, the official position is that the cost-cutting measures needed in 2011 will be an estimated LVL 350-395 million (roughly 3 per cent of GDP) compared to the previous LVL 395-440 million projection. Further consolidation will be achieved both through higher revenue and spending cuts. This task is extremely challenging. Any such decision will face increasing resistance from the public sector and from society at large.

So far Latvia has received EUR 4.2 billion of a total of EUR 7.5 billion in its 2008-2011 international bail-out programme. About EUR 2.5 billion has been used, and EUR 1.6 billion has been allocated to the Treasury. Latvia recently signed agreements with Denmark, Estonia, Finland, Norway and Sweden on the possibility of borrowing EUR 1.9 billion, but only in case of emergency.

Bank of Latvia reserves at the end of August reached EUR 5.8 billion, up 4.8 per cent during the month. The increase was due to an incoming IMF loan instalment and EU funding. In the first eight months of 2010, foreign currency reserves increased by 22 per cent. The supply of lati greatly exceeds the demand, and the overall situation has led to a restoration of confidence in the financial market. Interbank rates have dropped to historically low levels. These rates may jump again if political turbulence arises. Otherwise we do not expect drastic changes.

## Increased political stability after unexpected election outcome

Latvia's ruling centre-right coalition won the hard-to-predict October 2 parliamentary election by a surprisingly wide margin. Prime Minister Valdis Dombrovskis, who has led a minority government since the large People's Party left the coalition last spring, can now form a majority government.

His three-party coalition won a total of 63 of the 100 seats in Parliament, compared to its previous 47. The largest government party, Unity, won 33 seats. Another coalition party, the Union of Greens and Farmers, won 22. The nationalist All for Latvia – For Fatherland and Freedom/LNNK won eight seats.

This will dispel much of the political uncertainty that, in case of another election outcome, might have led to a flare-up of new market worries about Latvia, which – along with the other two Baltic countries – enjoys relatively robust market confidence.

Although public opinion shifted in a slightly pro-government direction just before the election, a series of earlier opinion surveys showed an extremely even match between Unity and the pro-Russian leftist block, Harmony Centre. Neither alternative appeared capable of forming a government enjoying a comfortable majority, without support from various other parties.

What made the pre-election situation even more uncertain was that a large proportion of Latvian voters signalled that they had not yet made up their minds. The tough austerity measures of recent years, including sharp pay cuts in the public sector, also meant that voters might potentially show great discontent with the incumbent government and that many voters had become resigned. But the actual 62.6 per cent voter turnout was surprisingly high by Latvian standards and even a bit higher than in the previous election, when turnout was 61.0 per cent.

One important economic conclusion from the election outcome is that budget consolidation and Latvia's current path towards joining the euro zone will now continue as planned. Harmony Centre was critical of the current painful belt-tightening process. If the party had been successful in the election, it would probably have taken steps to ease fiscal austerity. It would most likely also have tried to end Latvia's collaboration with its international lenders, the International Monetary Fund and the European Union, which Harmony Centre believes have excessively influenced Latvian political life in recent years.

We can now count on the Dombrovskis government to continue with its budget cutbacks. The longer-term aim of budget consolidation is euro zone accession in 2014. Aside from a further deficit reduction in 2011, this will require a maximum budget deficit of 3 per cent of GDP in 2012 – a tough target to achieve. But the Latvian economy has stabilised, and growth is now on its way back. In addition, a majority government will now find it easier to push through the remaining cost-cutting measures that are necessary.

In order to further strengthen his control of Parliament and ensure that it approves key legislation, Dombrovskis may expand collaboration with opposition parties on important issues – even with Harmony Centre. On the very first day after the election, the prime minister invited the opposition to such discussions.

The re-elected governing coalition is now in a good position to begin creating more lasting stability in Latvian politics, which has otherwise historically been characterised by fairly frequent and sometimes unexpected changes of government. Of course, the fact that Latvia still has sizeable remaining budget consolidation needs will continue to pose risks and challenges.

## Growth is back – emigration a challenge

- Domestic demand showing sign of life
- Internal devaluation to end soon
- Euro adoption may be delayed one year

The recession has ended in Lithuania, and the country is entering an expansive phase. In the second quarter of 2010, GDP grew by 1.3 per cent year-on-year after six consecutive quarters of decline. The recovery is still dependent on foreign demand, both in the euro zone and CIS countries. The domestic market is also gradually emerging from the depths.

Exports are showing decent recovery, led by higher foreign demand. Competitiveness also improved after the internal devaluation process and the euro's slide against the USD. In January-July 2010, exports rose 26 per cent year-on-year at current prices. Exports of wood, paper, rubber and plastics have already exceeded pre-crisis peaks. The main risk to export performance is a more marked slowdown in the euro zone in 2011 than the mild one we are projecting.

**GDP and industrial production**  
Year-on-year percentage change



Domestic demand will start growing in 2011. The decline in private consumption during the second quarter was the smallest since early 2009. The drop in gross fixed capital formation was the lowest since the third quarter of 2008, while investments in transport vehicles and machinery have already started rising.

The second quarter was also more successful in construction. The sector's year-on-year decline was the smallest in six quarters. Residential property prices stopped shrinking this summer, after declining 40 per

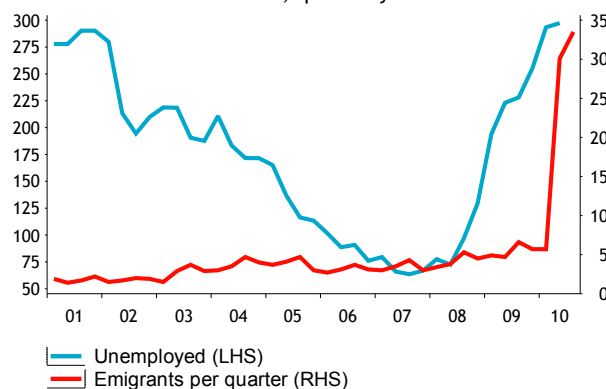
cent from their December 2007 peak. In 2010 the supply of new housing will grow very slowly, but this will lay the groundwork for a recovery in the construction sector in 2011. We forecast moderate increases in home prices next year.

Potentially slower euro zone growth, restrictive bank lending, fiscal discipline and a tough labour market situation will not allow an easy recovery. However our scenario is that foreign demand will suffice to trigger somewhat livelier consumption and capital spending by next year. One important factor is that 2010 will probably be the last year of fiscal tightening. We expect 1 per cent GDP growth this year, 4 per cent in 2011 and 4.5 per cent in 2012. The first two forecasts are unchanged from *Eastern European Outlook* in March, which covered 2010-2011.

### Heavy clouds over the labour market

The labour market is in a very unfavourable situation. On the one hand, unemployment remains among the highest in the EU, 18.3 per cent in the second quarter of 2010. On the other hand, the emigration problem is increasingly acute. While unemployment has begun to stabilise and the number of vacancies is increasing, emigration keeps rising. Despite high unemployment, it is already difficult to find specifically skilled employees in the IT, transport and construction sectors. The proportion of both long-term unemployed and young unemployed people is stuck at around 40 per cent and is contributing further to emigration.

**Unemployed and emigrants**  
Thousand, quarterly data



in 2009. In 2008-2009, during the economic crisis, the number of official emigrants reached 45,000. The total labour force was 1.6 million people as of December 2009. Worth noting is that official emigration figures skyrocketed after April 2010 when “old” emigrants realised that they would have to pay Lithuanian health contributions if they did not declare their emigration. Around 40-50 per cent of emigration declarations this year are due to people who emigrated earlier being “dragged into the daylight”. Still, an estimated 50,000 will leave the country in 2010. Moreover, permanent emigration is becoming more common compared to temporary jobs abroad. This leakage in the labour force will dangerously undermine the recovery and long-term development prospects of the Lithuanian economy.

Addressing the problems of the labour market, the government eased the Labour Code in August. This included allowing greater flexibility in working schedules and treatment of temporary and long-distance jobs. The government also started giving tax breaks on employers’ social contributions on behalf of young employees with no job experience.

Internal devaluation is approaching its end. In the second quarter, wages and salaries rose 1.2 per cent quarter-on-quarter, although they were 5.4 per cent below the pay level in the second quarter of 2009. Total payrolls were down 29 per cent from their peak in the third quarter of 2008 until the bottom in the first quarter of 2010, including both reductions in pay and employment. We expect weak pay hikes in 2011.

Most competitiveness problems have faded, and the current account adjustment has been spectacular in recent years. In 2008 the current account deficit was 13.1 per cent of GDP, but by the first half of 2010 there was a surplus of 3.0 per cent. A sharp correction in the foreign trade balance was a primary reason behind this adjustment.

In 2010, the surplus is further being sustained by large inflows of EU structural funds. We expect small current account deficits during the next few years, in line with the recovery in domestic demand and faster import growth.

### Light in the budget tunnel

After a couple of years of tax increases and expenditure cuts, the government has managed to stop the deteriorating trend in public finances. In the first quarter of 2010 the budget deficit was 8.3 per cent of GDP, or 1.3 percentage points lower than in the first quarter of 2009. Furthermore, central government revenue collection exceeded plan in January-August 2010 by 8.4 per cent. There are two main reasons behind this: low projected revenue and higher than expected VAT collection. The social security fund Sodra accounts for a substantial share of the public deficit, but it is not performing as badly as feared. In January-August 2010,

Sodra’s expenditures were 4.6 per cent above target due to higher unemployment benefit expenditures, but its revenue also exceeded plan by 3.9 per cent.

The better than expected budget outcome is reducing Lithuania’s sovereign borrowing requirement. Between global bond issues in February and September, the balance of new central government borrowings and repayments used to be negative, but this was not the case in 2009.

### Euro adoption may be delayed

We expect no further fiscal tightening in 2011, due to good revenue collection, an accelerating economic recovery and the political cycle (local elections in 2011 and the parliamentary election in 2012). It would suffice to freeze expenditures at the 2010 level in order to lower the deficit to 3 per cent of GDP deficit in 2013 and thereby qualify to join the euro zone in 2015. The government is still maintaining its ambition of introducing the euro in 2014, but the risks of delay are increasing.

So far, inflation is purely of the cost-push type. As the domestic market regains its strength in 2011-2012, demand-pull forces will become noticeable. It is thus no foregone conclusion that when Lithuania meets the Maastricht budget criterion it will also meet the inflation requirement. We do not expect a burst of inflation in the medium term, but quite low inflation may be sufficient to exceed the Maastricht ceiling. In the very short term, we expect higher food prices in the wake of the poor harvest. Our inflation forecast is 2.0 per cent in 2011 and 3.0 per cent in 2012. At the start of 2011, EU harmonisation of excise duties on diesel fuel and cigarettes will contribute to inflation.

Despite lingering political tensions as well as the low popularity of Prime Minister Andrius Kubilius and his conservative party, the minority government should remain intact. The opposition wants to avoid being tainted by unpopular decisions but hopes to stay in political contention until the parliamentary election in 2012. Thus it is not ready to mount serious challenges against the ruling coalition, at least in the near term.

## Continued upturn despite fiscal austerity

- **Fundamentals are paying off**
- **Capital spending will rebound**
- **Neutrally valued zloty will strengthen**

Poland was one of the countries that weathered the global recession and credit crisis best – the only EU economy that grew in 2009, by 1.7 per cent. There were several reasons for this resilience: Moderate private sector debt. Little foreign currency loan exposure in Eastern European terms, though such loans have climbed relatively fast as a percentage of the total. An expansionary fiscal policy. Competitive exports, with extra help from a 30 per cent currency “super-depreciation” from July 2008 to February 2009. Poland’s economy is also less open compared to many other economies in transition; in the last decade the exports as a share of GDP has been 35-40 per cent.

The fundamentals look favourable. After a bulge in 2008-2009, inflation again decelerated to a low level and appears to be under control, since wage and salary growth will remain subdued. Meanwhile the deficit in Poland’s external balance shifted down to a low level and is climbing slowly. One of the few flies in the ointment is a public budget deficit that swelled rapidly to 7 per cent of GDP last year – far higher than comparable countries in Central Europe. This is because the government has pursued an active stimulus policy but has also allowed automatic stabilisers to operate during the international crisis.

A continued large budget deficit would push up government debt from about 50 per cent of GDP to the 55 per cent cap (according to the national definition, which is somewhat different from the Maastricht criterion for EU countries), triggering a tougher austerity policy aimed at preventing the constitutional limit of 60 per cent from eventually being breached. Realising this risk, this summer the government unveiled a four-year budget consolidation plan for 2011-2014, having given advance notice of an expenditure ceiling and pension cutbacks earlier in 2010. Belt-tightening will be moderate, including a general value-added tax increase from 22 to 23 per cent, a ceiling on expenditure increases, pay freezes for public employees and faster privatisations. In our view, these measures combined with rising growth will suffice to keep debt just below the 55 per cent cap, although an additional VAT hike may be in the cards. The government’s target is to lower the deficit to

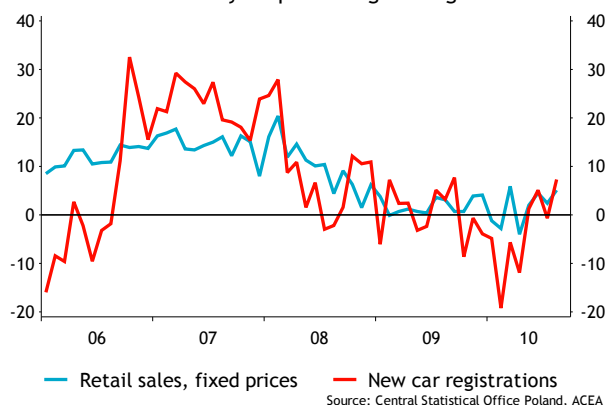
3 per cent of GDP by 2013, with an eye to possible euro zone accession in 2015. This appears realistic.

### Domestic demand will drive growth

Year-on-year GDP growth was 3.5 per cent in the second quarter of 2010, up from 3.0 per cent in the first quarter. Domestic demand is starting to take over the previous role of net exports as a growth engine. The downturn in capital spending appears to have ceased, but positive inventory effects will fade in the months ahead. We predict a continued gradual rise in GDP growth, even though fiscal policy will be tightened and growth will slow somewhat in other countries. The main growth engine will be a strong, lasting turnaround in capital spending, which is now on the way. Looking ahead, private consumption and exports will grow at a healthy pace. GDP will increase by 3.5 per cent in 2010, by 4.0 per cent in 2011 and 4.5 per cent in 2012. Our forecast thus remains above consensus, as it has for the past couple of years.

### Mild slump in retail sales during the crisis

Year-on-year percentage change



Sentiment indicators also point towards continued recovery. Upturns have been broad-based since these indices hit bottom in the first half of 2009, although with a certain cooling in the construction sector in the latest quarter. This autumn’s manufacturing and service sector surveys have reverted to the levels prevailing in 2008, before the downturn began.

The dip in private consumption has been far milder than elsewhere in the region. One important reason is that Polish households have not suffered the powerful real wage squeeze that occurred in many other countries. Pay growth will accelerate somewhat but remain modest, due to the proposed public sector pay

freeze and a slow labour market improvement. The jobless rate peaked at 13 per cent last winter and was 11 per cent in August. In the near future, job growth will be hampered to some extent since it is likely that many companies purposely avoided lay-offs when they realised that the slump would not be so deep. All this plus the VAT hike will keep consumption growth moderate for a while. Also notable is that household optimism has tended to hover at a modest level after rebounding from its early 2009 lows.

Capital spending fell marginally last year, yet we foresee sizeable potential for such spending in the next couple of years. There are several reasons:

- Fixed investments represent a relatively low share of GDP both in a long-term perspective and compared to other emerging economies. Over the past decade, it has averaged 21 per cent.
- In the past year, manufacturing capacity utilisation has risen from less than 70 to 74 per cent. This is a bit below previous peaks of around 80 per cent, but change as such usually drives capital spending. Furthermore, real interest rates are low.
- The government seems willing to continue using a large proportion of its EU funds for infrastructure investments.
- Preparations for the 2012 European football championship – co-organised with Ukraine – will require extra investments, including infrastructure.

#### Calmer pay hikes and inflation Year-on-year percentage change

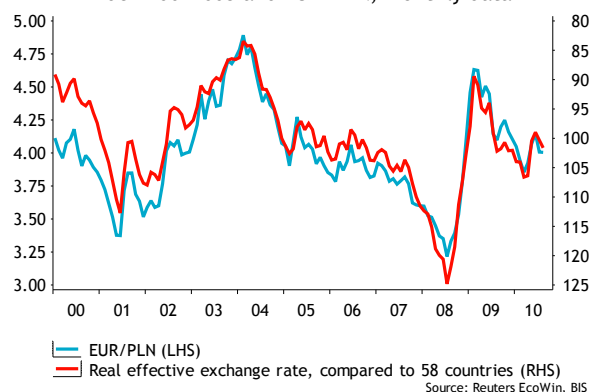


The supply of loans for investment and consumption is still relatively sparse, however. New signs of this were apparent in the central bank's third quarter survey, in which banks gave notice of even tighter conditions on consumer loans and restrictions on home mortgages and loans to small and medium-sized businesses. The only easing was reported for loans to large companies. We predict a gradual thawing of credit conditions.

Over the past two years, the inflation rate has fallen from a peak of nearly 5 per cent to 2 per cent. The underlying rate has dropped from 3 to 1 per cent. The bottom is now approaching and the inflation rate

will gradually rise in the months ahead, mainly due to higher food prices late in 2010, then a VAT hike. Assuming sedate pay increases and a stronger currency, we predict that inflation will average 2.7 per cent in 2011 and 2.9 per cent in 2012. Due to its short-term climb to about 3 per cent this winter, inflation will end up in the upper tolerance level of the central bank's  $2.5 \pm 1$  percentage point target. This will trigger an initial key interest rate hike in the first quarter of 2011. The key rate will gradually be raised from 3.5 per cent to 5.0 per cent in December 2012.

#### Zloty on the way up Index 100=2005 and EUR/PLN, monthly data



The zloty has partially recovered from its relatively sharp spring downturn, which was largely due to global risk aversion during the acute sovereign debt crisis in southern Europe. As earlier, we are optimistic about the zloty in the long term. It is normally valued in a longer-term historical perspective. There is room for appreciation based on such arguments as relative growth advantages and good fundamentals. The latter is especially relevant because the government is now attacking its budget problem, though a structural approach is conspicuously absent. Another factor favouring the zloty is that Poland, along with the Czech Republic, will probably be the first country in Eastern Europe to tighten its monetary policy. The zloty will strengthen to PLN 3.75 per euro by the end of 2010 and to PLN 3.60 in December 2011.

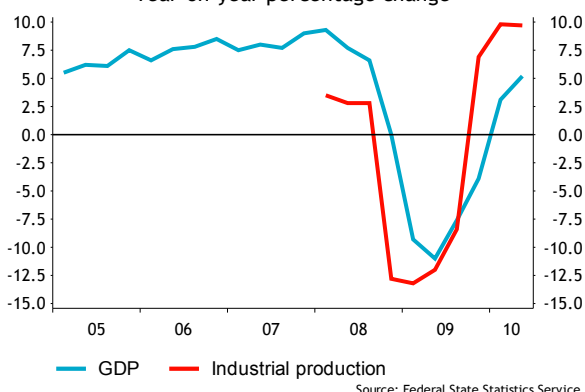
The political scene is characterised by relative calm. The new president, Bronislaw Komorowski – elected during the summer to succeed Lech Kaczynski, who died in a plane crash – may bring greater political stability. He belongs to the same party as Prime Minister Donald Tusk. Kaczynski, who had previously founded and led the conservative, nationalist opposition party PiS, blocked certain reforms and changes in legislation as president. Yet we do not believe there will be any major change in political strategies. Due to local elections this autumn and a parliamentary election in 2011, the government will choose to proceed cautiously with reforms.

## Domestic demand rising

- Higher pay and brighter labour market
- Inflation will gradually rise
- Political stability but slow reform pace

After a GDP decline of nearly 8 per cent in 2009 and downturns during all four quarters, GDP climbed during the first quarter of 2010 by 3.1 per cent year-on-year. The recovery strengthened during the second quarter, when GDP grew by 5.2 per cent. Higher commodity prices drove up growth, but retail sales and industrial production also performed strongly during the first half of 2010. Another explanation for the recovery is Russia's fiscal policy, which has been among the most expansionary in the world during the crisis.

**Recovery for GDP and industrial production**  
Year-on-year percentage change



The deceleration in the global recovery will nevertheless have an impact on growth by weakening demand for exports and levelling off commodity prices. Because of Russia's heavy dependence on commodities, its economy is sensitive to international trends. Base effects will also be less favourable during the third and fourth quarters of 2010, since the drop in GDP was sharpest during the first half of 2009, but stronger demand in the domestic economy will help sustain growth.

Our overall assessment is that during the second half of 2010, the growth rate will be somewhat lower than in the second quarter. We expect GDP to climb 4.6 per cent in 2010. Subdued export growth and a less expansionary fiscal policy, combined with a continued increase in domestic demand, will result in moderate growth during the following two years. GDP will rise by 4.5 per cent in 2011 and 4.8 per cent in 2012, well be-

low the level achieved before the financial crisis. Russia will thus not quite achieve the potential growth of 5 per cent estimated by the IMF. In our judgement, due to a continued slow pace of reform, potential growth risks staying at around this level.

Indicators are pointing to a continued recovery. The purchasing managers' index (PMI) has slowly improved in recent months and remains above the 50 mark, which indicates positive GDP growth. However, in September PMI fell to 51.2. Leading indicators for individual economic sectors are now also above zero, which signifies continued positive growth. The service sector indicator, in particular, has improved sharply since late 2009 and is reinforcing the picture of good domestic demand.

### Short-term drop in manufacturing

During the first half, industrial production recovered strongly after its sharp decline in 2009, but this recovery slowed during the summer. In July, the rate of increase fell to 5.9 per cent, which was the lowest since November 2009. The slow rate of increase was partly explained by extreme weather, which among other things forced automotive factories to close due to the heat. The impact on industrial output was temporary, however, and the pace of production can be accelerated during the autumn to compensate for the summer shortfall. One sign of this is that the rate of increase rose again in August, reaching 7 per cent. We expect industrial production to rise by nearly 9 per cent this year and by around 7 per cent in 2011.

This summer's heat and widespread fires had a major impact on agricultural output, mainly because of the poor grain harvest. In August 2010, output was around 19 per cent below that of August 2009. In August, Russia introduced a ban on grain exports. The ban is scheduled to last until the end of 2011 in order to protect the domestic market. However, the agricultural sector accounts for less than 5 per cent of the overall economy, so we still expect the impact on growth to be minor.

Service sector activity also appears to have been affected, since people stayed indoors to avoid the smoke from the fires, but we expect a recovery here as well. The overall effects of the fires and the heat wave will be limited and temporary. We have adjusted the GDP forecast in the August issue of *Nordic Outlook* downward by 0.5 percentage points to take into account the impact of the fires.

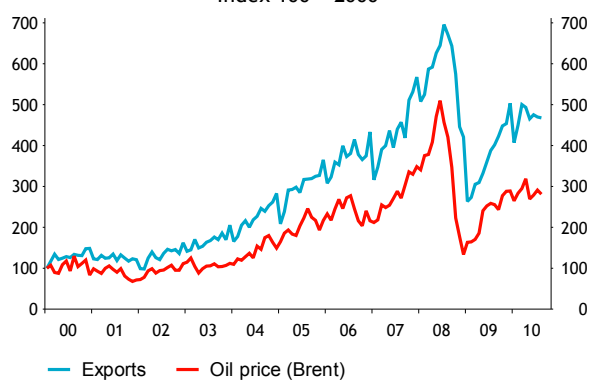
Russian exports have recovered from their low point at the beginning of 2009 but remain well below the levels achieved in the summer of 2008, helped by record-high oil prices. During 2010, oil prices have moved within the USD 70-90/barrel interval. During the next two years, we expect oil to trade in the same interval. Without a stimulus from rising oil prices, exports will grow at a moderate pace ahead.

A brighter labour market situation and higher pay have invigorated retail and car sales, which have risen during 2010. Retail sales are also being stimulated by the low level of household debt and by pension hikes, but weak lending is still a restraining force. We expect retail sales to rise at a healthy pace in the next couple of years, but not as fast as before the crisis.

Imports have increased much more strongly than exports in recent months. The trade surplus has fallen. In August it was just above USD 8 billion. We anticipate a continued rise in domestic demand, which will stimulate imports. Although we expect large trade surpluses ahead as well, the record surpluses of 2008 are beyond reach.

### Exports and oil prices

Index 100 = 2000



We expect the current account surplus to reach 5.0 per cent of GDP in 2010, 4.0 per cent in 2011 and 3.5 per cent in 2012. Russia's foreign currency reserve fell sharply in late 2008 and early 2009 and has not yet regained its level from before the financial crisis, but it has continued to climb during 2010. Today it totals nearly USD 450 billion, making it the third largest in the world. The currency reserve will continue increasing at a moderate pace over the next couple of years.

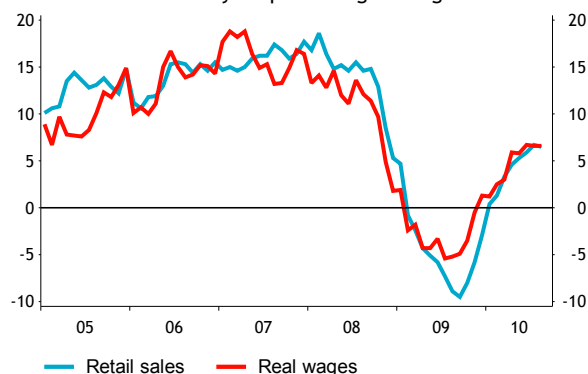
### Brighter job prospects

The labour market has continued to improve, performing more strongly than we foresaw in our March report. The jobless rate has fallen and stood at 6.9 per cent in August. Employment was unexpectedly stable during the crisis and has begun to recover. In August, the number of people with jobs was nearly 1 per cent higher than a year earlier. Real wages fell by around 3 per cent in 2009. During 2010 real wages have climbed, and in recent months the year-on-year rate of increase has been about 6 per cent. Unemployment continues to

fall, and we estimate that it will be slightly above 6 per cent at the end of 2011.

### Real wages and retail sales are rising

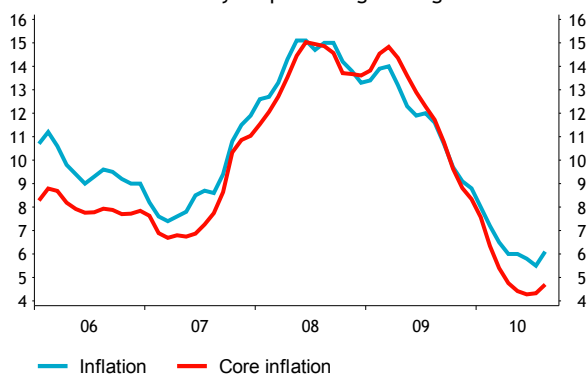
Year-on-year percentage change



Inflation pressure has declined substantially from the high levels of recent years. Inflation fell to a record low of 5.5 per cent in July. The large output gap, the appreciation of the rouble and falling oil prices have pushed down the inflation rate from an earlier 10-15 per cent to below 10 per cent, but in August inflation rose to 6.1 per cent. The month-on-month change compared to July was +0.6 per cent. Rising grain prices contributed to this increase and will continue to boost inflation during the autumn.

### Inflation is rising again

Year-on-year percentage change



Producer price pressure has eased in recent months, and we foresee a moderate rate of increase ahead. CPI inflation has passed its low, but a resumption of the high levels prevailing in recent years is unlikely. The central bank presents yearly guidelines for its monetary policy, including a target inflation interval. According to these guidelines, its aim is to push down inflation to the 5-6 per cent interval at the end of 2012. There are also signs that the central bank has begun preparing for the introduction of a formal inflation target and floating exchange rates during 2011 and 2012. This indicates that it does not intend to let inflation return to its previous high rates. We expect full-year 2010 inflation to be 6.8 per cent, and in 2011 and 2012 we foresee around 7.5 per cent.

The central bank has now ended its rate-cutting. The last key interest rate reduction was in June to 7.75 per cent. Due to rising inflation, no further rate cuts can be expected during the rest of 2010.

### Stabilisation of the rouble

The rouble has continued to strengthen during 2010, gaining around 20 per cent since its low point in February 2009. The real effective exchange rate is now at about the same level as before the financial crisis. Since this past spring, however, the rouble has weakened somewhat. Non-commodity-based Russian manufacturers exposed to international competition are hurt by a strong rouble. Further currency appreciation would lead to pressure on the central bank to intervene in order to prevent deteriorating competitiveness. The increased volatility of the rouble exchange rate is a sign that the central bank has begun to move towards a more flexible exchange rate policy, but it is uncertain whether the bank could withstand such pressure.

### The rouble is close to pre-crisis levels

Real effective exchange rate, index 100 = 2005



Measured against its currency basket, which consists of 55 per cent USD and 45 per cent EUR, the rouble will strengthen to 34.8 at the end of this year and to 33.5 at the end of 2011.

### Stable domestic politics but weak reforms

The domestic political situation is characterised by continued stability. Prime Minister Vladimir Putin and President Dmitry Medvedev enjoy strong public backing; opinion surveys indicate support of around 70 per cent. This is probably based on a perception that some progress has been made, but also on a lack of genuine political alternatives. Opinion surveys also show that the Russian general public has a resigned attitude towards domestic politics. The next parliamentary election will be in December 2011.

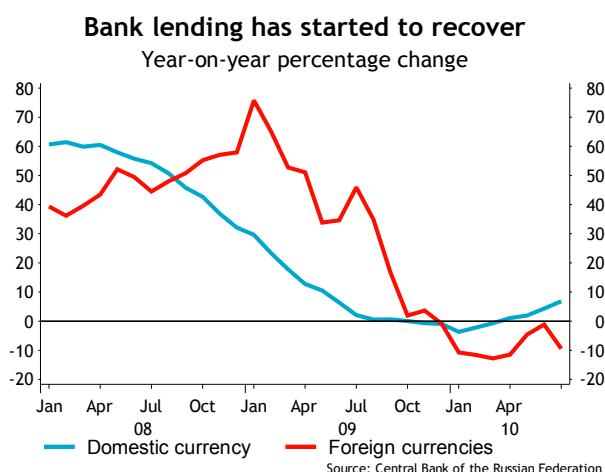
During 2010, foreign policy has been characterised by improved relations with Poland and Ukraine. The plane crash during the Polish state visit in April brought the two countries closer together. In Ukraine, President Viktor Yanukovich has made an effort to strength relations. The dispute between Russia and Ukraine about gas prices and control of the important gas pipeline that runs through Ukraine appears likely to recur this autumn, however. Improved relations between the two countries nevertheless mean that there should be a good chance of resolving the issue.

The overall risk of political instability is low in the short term. There are signs that Putin will be a candidate in the March 2012 presidential election and that Medvedev will not be a candidate in that case, underscoring Putin's dominance over the more reform-minded Medvedev. The result will admittedly be political stability, but also stagnation and poor potential for reform efforts. Important reforms need to be implemented to maintain macroeconomic sta-

bility and boost long-term GDP growth. The business climate is poor and competition needs to improve. The central government has too much influence on the economy and the public sector needs reforming: The educational system and the judicial system are two examples. Russia remains highly vulnerable to oil price declines. The demographic trend, including a shrinking population, is cause for concern.

One example of the sluggishness of reform efforts is the imminent privatisation reform, amounting to USD 50 billion. A large proportion of the reform was confirmed by Finance Minister Alexei Kudrin in late July 2010, after being announced in September 2009. It may be late November before the proposal receives formal approval. Investors welcomed the reform at first but are starting to express frustration over the delays. In addition, the central government will retain at least 51 per cent ownership in all companies, which has drastically reduced investor interest in bidding.

Overall, there unfortunately seems to be no great desire for reform among political leaders or the general public. The reform pressure created by the financial crisis is now beginning to vanish as the recovery continues. Russia thus seems likely to settle for a growth rate that is well below what it could potentially achieve with the help of a systematic, far-reaching reform process.



Russia's banking sector weathered the financial crisis unexpectedly well but was dependent on large-scale liquidity support from the central bank. Risks in the banking sector have decreased, compared to this past spring. One sign of increased confidence is the sharp increase in household bank deposits, but there is some lingering uncertainty. Despite improvements, during the summer the IMF maintained that remaining weaknesses in oversight and regulation of the Russian banking system make it difficult to assess systemic risks, the scale of bad loans and the capital adequacy of the banks. Liquidity is high, but bank lending has been restrained by uncertainty about bad loans, although lending has begun to recover in recent months. The increase in foreign currency-denominated lending early in 2009, in the midst of the crisis, is a result of USD- and EUR-denominated loans being recalculated to roubles.

One of the strengths of the Russian economy is its low central government debt, which was around 5 per cent of GDP before the crisis. During 2009, however, earlier large surpluses in the federal government budget turned into a deficit of around 6 per cent of GDP. During the summer, the government established targets for its budget deficits over the next several years. The government is aiming at a deficit of 5.4 per cent this year. The targets for 2011 and 2012 are 3.6 and 3.1 per cent, respectively. The budget is to be balanced by 2015. Our estimate is that the budget deficit will fall to about 5 per cent this year and about 4 per cent in 2011. Central government debt will climb but remain at around 10 per cent of GDP.

Large budget surpluses in the pre-crisis years enabled Russia to respond to the financial crisis with expansionary fiscal policy measures equivalent to around 10 per cent of GDP. The bulk of these stimulus measures were implemented during the second half of 2009. A large part of the fiscal stimulus consists of permanent measures such as pension hikes. It will thus be a challenge to phase out large-scale stimulus programmes, and a reform of the public sector will be necessary. There are already plans to dismiss 100,000 central government employees during the next three years, which may be viewed as signalling a tighter fiscal policy. Another measure that will help shrink the budget deficit is the privatisation reform that was recently unveiled.

## Deceleration after strong upturn this year

- **Belt-tightening to slow domestic demand**
- **IMF package helps fragile banking sector**
- **Grain and gas prices boosting inflation**

During 2010 the Ukrainian economy has recovered unexpectedly fast, after its dramatic 15 per cent GDP decline in 2009. In the first quarter of 2010, GDP climbed by 4.9 per cent. Growth strengthened to 5.9 per cent in the second quarter. Rising real wages boosted retail sales, and a competitive currency as well as high steel prices benefited the steel industry.

But growth will begin to slow a bit during the rest of 2010. During the next couple of years, budget tightening – a requirement for receiving the International Monetary Fund's stand-by loan – will restrain private consumption, which is already being kept down in the short term as cutbacks in gas price subsidies result in higher inflation. The deceleration in the global recovery will also dampen the important steel sector, but the IMF package will strengthen Ukraine's banking system and lay the groundwork for a recovery in bank lending. Investments are continuing to recover from their sharp decline in 2009 and are being stimulated by preparations for the 2012 European football championship, which Ukraine and Poland are co-organising. GDP will grow by 5.2 per cent this year and 4.4 per cent in 2011. In 2012 it will rise by 4.2 per cent, or just above trend.

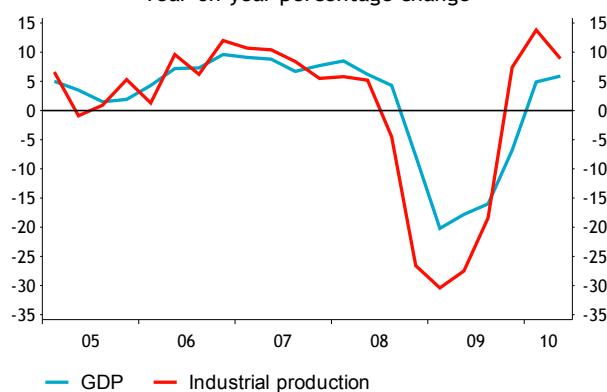
After negotiations with the Ukrainian government, in late July the IMF approved a new USD 15 billion package that will run for two and a half years. It has already made the first disbursement, and a second one is expected during 2010. The rest of the loan will be disbursed in stages after quarterly reviews by the IMF. The first review will occur in late November.

As part of the stand-by loan, the IMF and the government have established several targets. The most important is to restore order to Ukraine's central government finances. During the autumn of 2009, disbursements from the previous bail-out package were frozen due to excessive budget deficits. The general government deficit is supposed to be reduced to 5.0 per cent of GDP in 2010, 3.5 per cent in 2011 and 2.5 per cent in 2012. There will be extensive belt-tightening but we believe there is a relatively good chance of achieving these targets.

For some time, the IMF has wanted to reduce Ukraine's extensive energy subsidies to households and businesses. The price of gas will gradually be raised and will eventually achieve parity with import prices. The banking system will be strengthened by recapitalising the banks and tightening regulatory oversight. Currency policy is supposed to be made more flexible and the central bank more independent. The IMF package also calls for reforming the pension system and public administration. These reforms are far-reaching and will challenge special interests.

Because of the stand-by loan, the risk of default has fallen further and is low. Standard & Poor's upgraded Ukraine's credit rating to B+ when the package was finalised. Ukrainian credit default swaps (CDSs) have declined further compared to last spring and are now around 200 basis points above Latvia.

**Industrial production driving GDP**  
Year-on-year percentage change

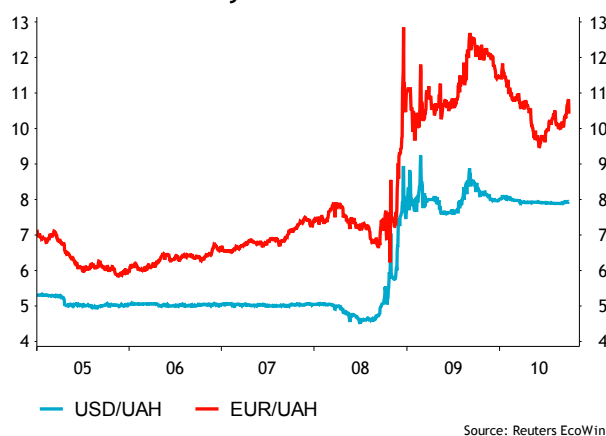


Industrial production decelerated from a year-on-year growth rate of more than 17 per cent in April to 9.2 per cent in August. Weaker global demand for steel and falling steel prices contributed to this. Due to continued weak demand and base effects, the rate of increase will fall somewhat further during the rest of 2010. Partly due to weaker steel sector growth, Ukraine's trade deficit has risen in recent months, but both exports and imports have recovered compared to 2009. We expect the export sector to grow at a moderate pace in the next couple of years, based on stabilising commodity prices and a competitive currency. Meanwhile rising imports will lead to an increase in the trade deficit.

As we predicted in our March report, the hryvnia has stabilised at an exchange rate of around UAH 8 per

USD. The currency has also remained rather stable against the euro, at a rate of just over UAH 10 in recent months. We expect the hryvnia to remain stable for the rest of 2010. Most of this year's disbursements from the IMF package will be used to strengthen the central bank's foreign currency reserve, a move that should help sustain the hryvnia. Rising grain prices will also provide support. In a longer-term perspective, however, the currency will still be relatively weak. If currency policy becomes more flexible, volatility will rise.

### The hryvnia has stabilised



Ukraine's historically low inflation rate rose from 6.8 per cent in July to 8.3 per cent in August, after having fallen during the spring and summer. The month-on-month change compared to July was +1.2 per cent, thus reversing the trend towards falling prices. The price rise is largely explained by the initial 50 per cent increase in household gas prices on August 1. Due to the drought, this year's grain harvest will be at least 10 per cent less than normal, and grain prices have risen. Unlike Russia, Ukraine has chosen not to introduce export restrictions. One disadvantage, however, is that this decision to allow exports may contribute to domestic price increases. Food accounts for more than 50 per cent of a Ukrainian household's basket of goods, and rising food prices would have a major impact on CPI inflation. We expect inflation to continue climbing during the rest of 2010, peaking during the first half of 2011 and then starting to fall.

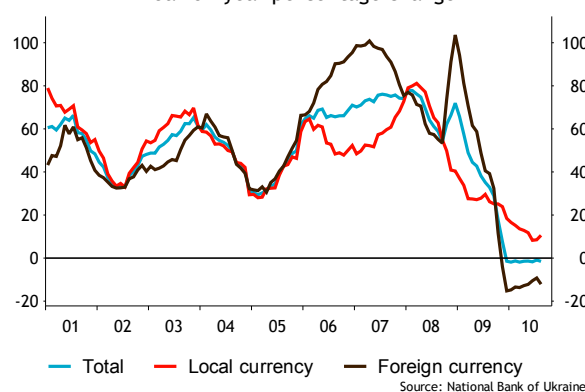
Real wages fell sharply in 2009 but have recovered since then. The rate of increase in real wages slowed somewhat in July but remained above 10 per cent as a year-on-year percentage change. The expected deceleration in economic activity and rising inflation will further slow the rise in real wages. Unemployment has fallen compared to 2009, and we expect a further decline during 2011 and 2012.

Rising inflation will mean that there will probably be no more key interest rate cuts in 2010. During 2010 the central bank has lowered its key rate from 10.25 to 7.75 per cent. The last rate cut occurred in August. Given inflation in excess of 8 per cent, this implies that Ukraine's real key interest rate is negative and monetary policy is thus accommodative.

The banking sector is still fragile. The central bank's stress tests, which were published in July, showed that at least one third of Ukraine's banks need a capital injection. One of the conditions for disbursements from the IMF package is that the central bank should continue to recapitalise Ukraine's commercial banks. Bank balance sheets have become stronger since the third quarter of 2009, but a clear sign that the banking sector still has problems is that credit growth is very weak. Low lending volume has hampered both corporate capital spending and household demand. In recent months, however, there have been signs of stabilisation in bank lending, and we believe that the IMF package will lay the groundwork for continued recovery.

### Credit expansion is stabilising

Year-on-year percentage change



The domestic political situation has stabilised since the presidential election early in 2010. President Viktor Yanukovich and his Party of Regions joined with several small parties to establish a parliamentary majority coalition. Yanukovich has improved relations with Russia but is also trying to move closer to the EU. Early in June, Yanukovich unveiled a five-year reform package that will aim at raising household living standards, improving the business climate and modernising such sectors as energy and transport. The programme is ambitious, but it remains to be seen whether the reforms can be implemented in practice.

The next regular parliamentary election is planned for September 2012, but one source of concern is the local elections to be carried out in late October this year. Yanukovich is being accused of trying to strengthen presidential power at the expense of parliament. In early October the Constitutional Court rejected earlier amendments to the Constitution, thereby reducing the power of the parliament. Together with the impact of the IMF package, this might lead to protests and discontent, but the opposition is divided and currently enjoys only weak support among the general public. The government's chances of pushing through the reforms demanded by the IMF thus appear relatively good.

**ESTONIA**

	2005	2006	2007	2008	2009	2010(f)	2011(f)	2012(f)
GDP, %	9.4	10.6	6.9	-5.1	-13.9	2.3	4.0	4.0
Inflation, HICP, average, %	4.1	4.4	6.7	10.6	0.2	2.5	2.0	2.0
Unemployment, %	7.9	5.9	4.7	5.5	13.8	18.0	16.0	15.0
Current account, % of GDP	-10.0	-15.3	-17.2	-9.7	4.5	2.0	0.0	-1.0
Public sector financial balance, % of GDP	1.6	2.3	2.6	-2.8	-1.7	-2.2	-2.5	-3.0
Public sector debt, % of GDP	4.6	4.5	3.8	4.6	7.2	9.0	14.0	17.0
EUR/EEK, end of period	15.6	15.6	15.6	15.6	15.6	15.6	-	-
3-month interest rate, eop	2.6	3.9	7.3	7.9	3.1	1.2	1.1	2.0

**LATVIA**

	2005	2006	2007	2008	2009	2010(f)	2011(f)	2012(f)
GDP, %	10.6	12.2	10.0	-4.6	-18.0	-1.5	4.0	5.0
Inflation, HICP, average, %	6.9	6.6	10.1	15.3	3.3	-1.2	1.3	1.5
Unemployment, %	8.7	6.8	6.0	7.5	16.9	19.2	17.5	15.5
Current account, % of GDP	-12.5	-22.5	-22.3	-13.1	8.6	5.8	-0.5	-2.0
Public sector financial balance, % of GDP	-0.4	-0.5	-0.3	-4.1	-9.0	-8.2	-6.0	-3.0
Public sector debt, % of GDP	12.4	10.7	9.0	19.7	36.6	49.0	52.0	53.0
EUR/LVL, end of period	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7
Key rate, eop	4.0	5.0	6.5	6.0	4.0	3.5	3.5	4.0
5-year government bond, eop								

**LITHUANIA**

	2005	2006	2007	2008	2009	2010(f)	2011(f)	2012(f)
GDP, %	7.8	7.8	9.8	2.9	-14.7	1.0	4.0	4.5
Inflation, HICP, average, %	2.7	3.8	5.8	11.1	4.2	1.0	2.0	3.0
Unemployment, %	8.3	5.6	4.3	5.8	13.7	16.5	16.0	15.0
Current account, % of GDP	-7.1	-10.6	-14.5	-13.1	4.3	0.5	-1.0	-3.0
Public sector financial balance, % of GDP	-0.5	-0.4	-1.0	-3.3	-9.2	-8.0	-5.0	-4.0
Public sector debt, % of GDP	18.4	18.0	17.0	15.6	29.6	39.0	44.0	45.0
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	2.54	3.79	6.65	9.89	3.90	2.00	2.20	3.00
5-year government bond, eop	3.10	3.90	4.80	13.10	6.60	4.10	3.80	3.80

(f) = forecast

**POLAND**

	2005	2006	2007	2008	2009	2010(f)	2011(f)	2012(f)
GDP, %	3.6	6.2	6.8	5.0	1.7	3.5	4.0	4.5
Inflation, HICP, average, %	2.2	1.0	2.5	4.2	3.5	2.5	2.7	2.9
Unemployment, %	18.2	16.2	12.7	9.8	11.0	11.6	10.7	10.2
Current account, % of GDP	-0.9	-2.1	-3.6	-3.9	0.0	-2.0	-3.0	-3.5
Public sector financial balance, % of GDP	-4.3	-3.6	-1.9	-3.6	-7.1	-7.5	-5.0	-3.5
Public sector debt, % of GDP	47.1	47.7	45.0	47.1	51.0	54.9	54.5	54.5
EUR/PLN, end of period	3.85	3.83	3.60	4.12	4.10	3.75	3.60	3.50
Key rate, eop	4.50	4.00	5.00	5.00	3.50	3.50	4.25	5.00
5-year government bond, eop	5.00	4.98	6.13	5.34	5.91	4.80	5.20	5.40

**RUSSIA**

	2005	2006	2007	2008	2009	2010(f)	2011(f)	2012(f)
GDP, %	6.4	7.7	8.1	5.6	-7.9	4.6	4.5	4.8
Inflation, average %	12.5	9.8	9.0	14.2	11.7	6.8	7.5	7.4
Unemployment, %	7.6	7.0	6.6	6.8	8.2	7.5	6.5	5.9
Current account, % of GDP	10.9	9.5	5.8	6.1	4.0	5.0	4.0	3.5
Public sector financial balance, % of GDP	7.5	7.4	5.4	4.1	-5.9	-4.9	-3.9	-2.7
Public sector debt, % of GDP	14.1	8.2	7.4	6.5	8.1	9.5	9.8	10.1
EUR/RUB, end of period	28.7	26.3	24.6	30.5	30.3	29.5	28.1	29.1
3-month interest rate, eop	29.3	27.2	29.7	35.4	36.1	34.8	33.5	33.0

**UKRAINE**

	2005	2006	2007	2008	2009	2010(f)	2011(f)	2012(f)
GDP, %	3.0	7.4	7.6	2.3	-15.1	5.2	4.4	4.2
Inflation, average, %	13.5	9.1	12.8	25.2	15.9	9.4	10.9	10.1
Unemployment, %	7.2	6.8	6.4	6.5	8.6	7.8	7.5	7.3
Current account, % of GDP	2.9	-1.5	-4.1	-7.0	-1.5	-0.4	-1.2	-1.8
Public sector financial balance, % of GDP	-2.3	-1.4	-2.0	-3.2	-9.8	-5.0	-3.5	-2.5
Public sector debt, % of GDP	17.7	15.7	12.8	19.9	36.9	39.3	42.0	43.5
USD/UAH, eop	5.05	5.05	5.05	7.80	8.00	7.90	7.90	7.90

(f) = forecast

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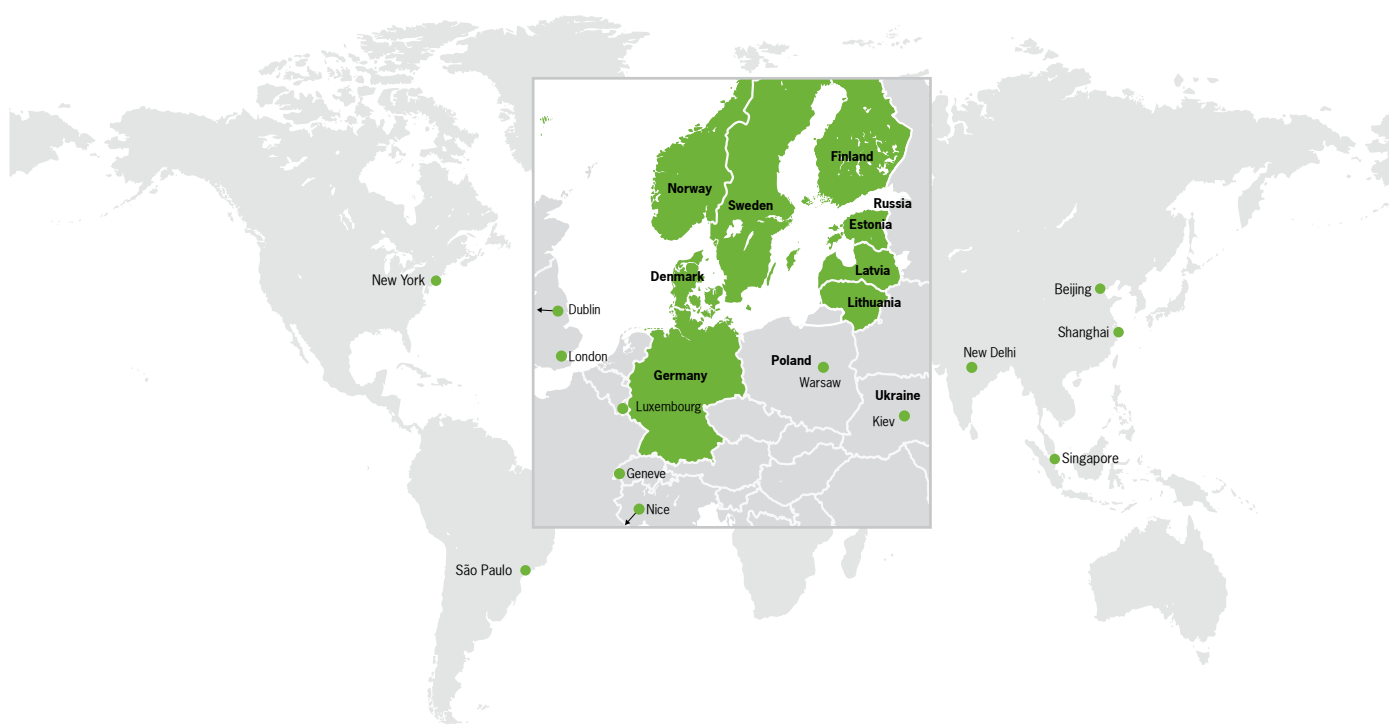
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