



# Eastern European Outlook

Economic Research – October 2011

Growth will slow – but not  
as sharply as in the West

SEB

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## Summary

Eastern Europe has recovered nicely since the financial crisis and deep recession of 2008-2009. Economic growth is now on its way towards slowing in 2012, in response to weaker global demand, but will not decelerate as quickly as in Western Europe. Given relatively low or moderate public sector debts, domestic demand will be fairly resilient.

Because of more favourable public debt positions, large budget deficits in Eastern Europe need not be corrected as sharply and quickly as in parts of Western Europe. Poland, Latvia and Ukraine will continue to pursue moderate fiscal austerity next year, while fiscal policy will shift to mildly expansionary in Russia, Estonia and Lithuania. This will help sustain consumption and capital spending relatively well now that export growth is falling markedly. Whereas labour market improvements will encounter obstacles next year, purchasing power will meanwhile strengthen as the latest energy and food price-driven inflation upturn fades.

Some Eastern European currencies, including the Russian rouble and Polish zloty, have been squeezed hard during the current global financial crisis. The main reason is general risk aversion, which has hit Eastern Europe in particular; confidence in the solvency of these countries has remained fairly stable with exception of Ukraine. Their currencies will decline somewhat further in the coming months, followed by stabilisation and gradual appreciation. Total depreciation will not be as large as in the 2008-2009 financial crisis.

The ambitions of EU countries in Eastern Europe to adopt the euro have cooled because of the euro zone debt crisis, but Latvia's planned accession in 2014 may still materialise.

In all six countries covered by *Eastern European Outlook*, GDP growth will drop somewhat below trend in 2012-2013; in 2013 it will level out or bounce back a bit. The risks are skewed to the downside.

- **Russia's** GDP will increase by 4.3 per cent in 2011 and 4.2 per cent in 2012. The economy will continue to be sustained by high oil prices and consumption will rebound after a dip, yet long-term question marks about Russian growth remain since the pace of reform is slow. There may be some opening for more reforms after the coming elections.
- **Poland's** economy will be increasingly driven by capital spending, but growth will cool from 4.0 per cent this year to 3.4 per cent in 2012, mainly due to slowing German demand. Monetary policy will shift, with two key interest rate cuts in the first half of 2012. Policies will remain generally stable, since we expect the government to be re-elected on October 9.
- **Ukraine** will muddle through, with annual GDP increases of some 4 per cent. High steel and agricultural prices will provide support, but austerity requirements from the country's lender, the IMF, will restrain growth. Relations with the IMF will be stormy, and loan disbursements will stay frozen this autumn before an agreement is reached.
- **Estonia** will see its growth see-saw from 2.3 per cent last year to 6.5 per cent in 2011 and 3.0 per cent in 2012. As in the other Baltics, recovery has mainly been export-led so far while the upturn in domestic demand has barely begun, partly because private sector debt consolidation is continuing after the bursting of earlier bubbles. With its high export/GDP ratio, Estonia will be relatively harder hit than Latvia and Lithuania.
- **Lithuania's** GDP will increase by 6.5 per cent this year and 4.0 per cent in 2012. Consumption and capital spending have shown signs of faster recovery than elsewhere in the Baltics but are not strong enough to offset weaker exports.
- **Latvia** still lags behind Estonia and Lithuania in its upturn. Growth will slow from 4.4 per cent this year to 3.5 per cent in 2012. The recovery is on reasonably firm ground but will also be restrained in 2012 by budget tightening aimed at paving the way for euro zone accession in 2014.

## Sharp deceleration in the West but no recession

- **Continued ultra-loose monetary policies**
- **EM economies showing decent resilience**
- **Estonia export/GDP ratio high, Russia's low**

The OECD economies have begun a major slowdown, as a consequence of deepening debt crises on both sides of the Atlantic. The deceleration in growth started in the United States last spring, and Europe is following suit this autumn.

Heightened recession risks in the US and the euro zone, large stock market slides and sharply higher stress levels in the European banking system – in the wake of greater uncertainty as to whether Greece can avoid default – will adversely affect willingness to consume and invest over a lengthy period. We expect debt restructuring in Greece, which is also what the market is – in practice – fully pricing in. This may occur in the near future, but uncertainty about its impact on other crisis-hit countries and the banking system will persist. Next year, when the US is forced to begin fiscal belt-tightening, we also expect overall OECD fiscal policy to shift in the same direction.

**Total OECD growth will cool from nearly 3 per cent in 2010 to 1.7 per cent this year and pick up to 1.8 per cent in 2012.** In the short term, we expect both the US and the euro zone to teeter close to recession. Not until 2013 will OECD growth again approach its 2-2.5 per cent trend. Risks are on the downside.

### Global key data

GDP, year-on-year percentage change

	2010	2011	2012	2013
United States	3.0	1.5	1.8	2.7
Euro zone	1.7	1.7	1.0	1.5
The world	5.1	4.0	3.5	3.9
Oil, USD/barrel	79.8	110.0	110.0	115.0
EUR/USD, Dec	1.34	1.38	1.45	1.40

Source: SEB

Yet our assessment is still that **the OECD countries and the world economy can avoid a new recession.** There are several reasons: China and many other emerging market (EM) countries are continuing to move towards a soft landing, and if needed they have the resources to enact powerful stimulus measures; cyclical elements of the OECD economies such as capital spending and housing markets are already sharply depressed; corporate balance sheets are strong; and the US will avoid a banking crisis this time around. In addition, monetary policy will continue to provide economic stimulus.

Since we foresee a levelling off of commodity prices, lower growth and continued high unemployment, inflation in the US

and Western Europe will decline clearly in 2012, driven early in the year by base effects. This will open the way for continued monetary easing via liquidity injections and other unconventional measures, primarily from major central banks.

We expect the US dollar to remain relatively weak, with an exchange rate of USD 1.40 per euro a bit further ahead, partly because the Fed has made clear that its key interest rate will remain close to zero until at least mid-2013. Supply side factors, among them Saudi Arabia's goal of keeping oil prices above USD 100/barrel, indicate that Brent oil prices will remain stuck at their relatively high levels of USD 110-115.

The prospective impact of international trends on Central and Eastern Europe has become substantially gloomier since our last *Eastern European Outlook* in March 2011, mainly due to major downward revisions for the US economy. **Exports will thus be adversely affected.** Meanwhile, public sector debts in most countries of the region are clearly in better shape than in the Western world. This will provide decent resilience in the domestic portions of the region's economies.

As for exports, all six countries covered in this report have little direct trade with the US (less than 5 per cent of exports) but **Western Europe is correspondingly more vital as an export customer.** For Central Europe, Germany is a particularly important market; for example, it accounts for around one fourth of Poland's total export sales. Our forecast for Germany is that GDP growth will drop from 3.0 per cent in 2011 to 1.3 per cent in 2012 and then rebound to 1.9 per cent in 2013.

### Exports and largest market

	Exports % of GDP 2006-2010 average	Largest export market, % of total exports 2010	
<b>Estonia</b>	71	Finland	18
<b>Latvia</b>	46	Russia	15
<b>Lithuania</b>	59	Russia	16
<b>Poland</b>	41	Germany	27
<b>Russia</b>	31	Germany	8
<b>Ukraine</b>	47	Russia	24

Source: Reuters EcoWin, SEB

**The degree of openness differs greatly** between the economies covered here. Estonia and Lithuania are by far the most vulnerable to deteriorating external demand, since their exports are equivalent to 70 and 60 per cent of GDP, respectively. Incidentally, such high export/GDP ratios are relatively normal in EM economies, for example in Asia. Less open economies at the other end of the spectrum are Poland, with an export/GDP ratio of around 40 per cent, and Russia with only some 30 per

cent. These economies are relatively large, though, which partly explains their lower ratios.

### Large public deficits but not large debts

Debt crisis-related problems are squeezing the countries of Western Europe ever more intensively and Greece is stumbling closer to debt restructuring. Escalating problems in Greece, higher risk premiums even in larger euro zone countries such as Italy and France and greater stress on banking networks show these are systemic problems which must be resolved and that liquidity assistance to individual countries is not enough.

### Eastern Europe is better equipped to face a global financial crisis than in 2007-2008, when it was severely affected.

At that time, GDP fell sharply in many countries, after a private sector consumption and capital spending boom – largely financed by foreign-currency borrowing – had built up a large private sector debt and big current account deficits. The dimensions of the problems varied; hardest hit were the Baltics and Ukraine. Since then, many countries in the region have corrected their external imbalances.

#### Public sector budget balance and debt

Per cent of GDP

	Deficit		Debt	
	2011	2012	2011	2012
Estonia	0.2	-2.0	6.0	6.0
Latvia	-4.5	-2.6	45.3	44.2
Lithuania	-4.5	-3.0	38.0	38.0
Russia	-1.0	-1.5	12.0	13.0
Poland	-5.5	-3.9	55.0	54.0
Ukraine	-3.5	-2.5	40.5	40.0
<b>Euro zone</b>	<b>-4.4</b>	<b>-3.5</b>	<b>87.5</b>	<b>89.0</b>

Source: European Commission, SEB

One relative advantage for Eastern Europe today is that the region has **low or moderate public sector debts**, while Western Europe is weighed down by necessary debt consolidation. The public sector debt situation is a factor that has contributed to stability and trust, although Poland and especially Hungary (about 80 per cent of GDP in 2010) stand out with their moderate or high debts. Looking ahead, deficit and debt trends in these economies will also be more positive, among other things because they will grow faster than the West. This means that growth as such will lower their debt ratios more rapidly.

**The Baltic countries** carried out major austerity programmes in 2009-2010; Latvia's programme is continuing this year as well. Their public debts are low, despite the crisis. In 2007, debt was below 10 per cent of GDP in Estonia and below 20 per cent in Latvia and Lithuania. Three years later, after sharp GDP declines, debts have climbed but remain below 10 per cent in Estonia and around 40 per cent in Latvia and Lithuania.

In **Russia and Ukraine**, high oil and commodity prices have speeded recovery and added to government revenue, but Russia's low foreign-currency debt has also eased pressure on households and businesses. **Poland** suffered the least in GDP terms and was the only EU member with positive GDP growth in 2009, but its public sector debt rose from 45 to 55 per cent

of GDP between 2007 and 2010. Poland has now taken steps to keep its debt below 55 per cent, the threshold where tougher austerity measures become mandatory.

Measured as credit default swap (CDS) prices, the market clearly foresaw increased risks in the Baltics and Ukraine in 2008 and 2009, but after that the situation stabilised. Meanwhile the problems of southern Europe became more severe. Despite greater market turbulence and bail-out packages for Greece, Ireland and Portugal in 2010-2011, CDS prices continued to remain low in Eastern Europe with exception for Ukraine. In line with our prediction there was no contagion to these countries, as some observers had feared. Their overall exposure to the hardest-hit euro zone country, Greece, is also small both in banking and foreign trade. It is primarily Bulgaria and to some extent Romania and Serbia that risk being affected by the Greek crisis.

Little or no contagion from Euro zone turmoil  
10-year CDS, basis points



Source: Reuters EcoWin

Looking ahead, the completion of belt-tightening programmes will now let Estonia and Lithuania shift to mildly expansionary fiscal policies. Most other countries in the region began multi-year cost-cutting programmes by 2010, but not of the same magnitude as in some euro zone countries. Generally speaking, countries with low debt levels are not under the same pressure to slash costs in the immediate future; they are better placed to implement reforms gradually, which means that demand will be less severely impacted. Another positive factor is that due to lower indebtedness and – in many cases – moderate budget deficits, there is greater public confidence in government economic policies. In such an environment, households and businesses need not engage in a high degree of precautionary saving, and this sustains consumption and capital spending.

Although the six countries in this report have comparatively favourable public sector debt situations, this does not mean that in the short term they can avoid being adversely affected by euro zone developments and the global financial crisis.

**Several Eastern European currencies have fallen sharply since summer** and are likely to fall somewhat further in the coming months. In times of risk aversion, investors flee what they view as riskier assets and markets, such as the EM sphere. Meanwhile the region's currencies will not depreciate as sharply as in 2008-2009.

Our overall assessment is that growth prospects for the next couple of years look less gloomy in Eastern Europe than in Western Europe despite the global slowdown – sustained by relatively good fundamentals and high commodity prices.

### Euro zone crisis affecting accession timetables

Partly because of the worsening euro zone debt crisis, EU member countries in Eastern (including Central) Europe will probably hold off on converting to the common currency. There are several reasons for this: The euro zone has major problems, and it is unclear in what direction the currency area is headed in terms of such issues as supranational fiscal policy, transfer mechanisms to sustain weak member countries and the euro's stability in general. The crisis is also worsening the economic outlook ahead, making it more difficult to meet the Maastricht convergence criteria, especially on budget deficits. Because of these factors, it may be less attractive to continue pursuing policies aimed at euro zone accession within the next couple of years. The euro zone crisis may thus lead some countries to modify their convergence processes somewhat, taking the opportunity to pursue less contractive economic policies.

But the euro zone crisis is not the only factor that is causing Eastern European countries to postpone their own target dates or ambitions. Above all, large budget deficits and/or excessive inflation risk blocking early accession, as in the case of Lithuania and Poland. According to the Maastricht criteria, the budget deficit may not exceed 3 per cent of GDP the year before the EU and the European Central Bank carry out their evaluations of a candidate country. Average annual inflation may be no more than 1.5 percentage points higher than in the three EU countries with the lowest inflation.

According to our analysis, Latvia is the only potential euro zone candidate in Eastern Europe in the near future. Latvia's planned accession in 2014 may still be on track. At least one year later, Lithuania and Poland will follow suit. Euro zone membership for the Czech Republic and Hungary may occur later than this.

As for the three potential euro zone candidates covered by *Eastern European Outlook*, our assessment is that the path to the euro remains smooth in Latvia but that over the past six months, it has become somewhat bumpier for Lithuania and Poland.

**Latvia's** target is 2014. Its political commitment is strong. Making the Latvian economy suitable as a euro zone member was one overall objective of the large international bail-out package pieced together for Latvia mainly by the EU and the

IMF during the 2008 crisis. The package expires this year. In the process, 2014 has been developed as a target date, backed up by both the EU and the IMF. In our assessment, Latvia has a good chance of achieving this target. The government budget is the crucial issue, but in our assessment Latvia will continue its austerity policies for another year in order to bring the deficit below 3 per cent of GDP in 2012. The new government that takes office as a result of the September 2011 election will probably include the largest party in the previous government, Unity, which has stubbornly pursued such a consolidation policy. However, there may be various disputes and modifications in cost-saving proposals after negotiations with its (probably) two new coalition parties. Unity's position was weakened by the election outcome.

**Lithuania's** long-time ambition on the issue has been to join the euro zone as soon as possible, once it had fulfilled the criteria. Prime Minister Andrius Kubilius has mentioned 2014 as a target date. In comments during June, Bank of Lithuania Chairman Vitas Vasiliauskas indicated that 2014 was probably unrealistic due to excessive price pressures. Incidentally, Lithuania barely missed a chance to join the euro zone as early as 2007 due to excessive inflation. Our assessment is that inflation may again prove too high this time around. The main reason is rising energy prices, due to expected gas price hikes. It will also be tough for the government to bring its budget deficit below the 3 per cent ceiling in 2012, considering that it will be an election year and that the economy will slow down. We now predict Lithuanian euro zone accession in 2016.

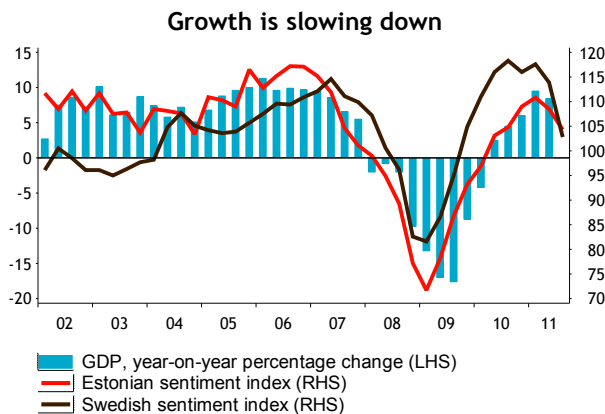
**Poland** once had an explicit target for euro zone membership but no longer has one. However, the government's ambition is to continue its economic convergence so that the Maastricht criteria will eventually be achieved. In our judgement, excessive budget deficits will prevent Poland from joining the euro zone before 2015. The euro zone crisis has also obviously had an impact on the government's euro ambitions. For example, this is what Poland's finance minister Jacek Rostowski replied when interviewed in mid-September by Spiegel Online. Spiegel: "When will Poland join the euro?" Rostowski: "When it is safe to do so. At the moment it is not safe. At the moment the euro is not constructed in a way that is safe for Europe as a whole – neither for the surplus nor for the deficit countries."

## Sharp slowdown to sub-par GDP growth

- **Export boom expected to end**
- **Deleveraging restrains domestic demand**
- **Continued high inflation**

Ongoing deleveraging and falling sentiment plus our substantially worsened regional outlook have led us to trim our growth forecast for 2012. We now expect the weighted average growth rate of Estonia's nine largest trade partners to amount to 2.5 per cent in 2012. This represents a material downturn not only compared to the 3.6 per cent we expect in 2011 but also the 3.4 per cent in 2012 we anticipated last spring.

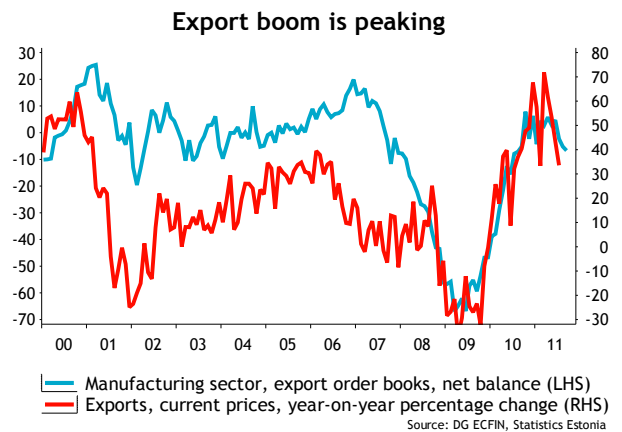
For the time being, however, the backward-looking GDP figures are truly outstanding. The second quarter year-on-year growth rate reached 8.4 per cent and the first quarter rate was revised up to 9.5 per cent, both figures still driven by manufacturing and exports. However, the broad-based sentiment index has been falling for five consecutive months and its rate of decline seems to be accelerating. It has closely shadowed its Swedish counterpart, whose predictive value for local developments — given merchandise trade and financial market linkages — is perhaps even bigger.



Thus we think that the economy has now **passed the turning point of the cycle** and that there will be **considerable deceleration down the road** as gloomier sentiment gradually finds its way into the hard data. However, given the very strong first half of the year, we expect **this year's real growth rate to come in at 6.5 per cent**. As export demand weakens and domestic consumption is held back by the need to beef up balance sheets, the growth rate **will fall to 3 per cent in 2012**. In 2013 we expect **GDP to grow by 4 per cent**. Considering the speed at which the European sovereign debt crisis seems to be deteriorating, this is by no means an overly despondent growth scenario. The risks are probably mostly on the downside.

The prevalent hope seems to be that as external demand slows, the slack will be picked up by stronger domestic demand.

To some extent this has already occurred. The breakdown of growth across major demand categories reveals that the **economy is now on a much more even keel**. At the peak of the crisis in the second quarter of 2009, net exports contributed 13 percentage points to GDP growth (with domestic demand subtracting 30 percentage points). Two years later, expansion was almost uniformly distributed among the four major demand categories. Private consumption in particular added 1.9 percentage points to the aggregate growth rate, with fixed capital formation contributing another 2.7 percentage points. As a result of resurgent imports, the contribution from net exports had fallen to 2.3 percentage points.



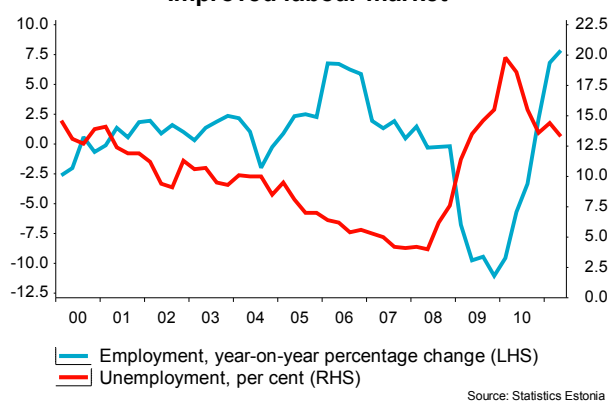
Although retail sales growth rates have been positive since January 2011 and the consumer confidence index has fared somewhat better than the broad-based sentiment index, the scenario in which domestic demand will become a major driver of growth is very unlikely in this miniscule, open economy. As recent years experience shows, external shocks are quickly transmitted to private consumption and capital spending. Hence we do not expect domestic demand to make a significant contribution over the next two years, so imports will probably have to be adjusted again in order to achieve growth from the external sector.

Even so, we expect weaker external demand to exert pressure on the headline current account balance, which has been in surplus for the last two years. We anticipate that the current account will move back to zero this year and then into a small deficit in 2012 (1 per cent of GDP) and 2013 (2 per cent of GDP). The snag, however, that the headline current account figure conceals as much as it reveals. Since 2009, net exports of goods and services — the first two categories in the current account — have not been nearly sufficient to cover financial and income account deficits. A more than EUR 2 billion gap between the two would have subjected the economy to immense

deflationary pressures, had it not been for the combined effect of current and capital transfers. In particular, the cumulative value of capital transfers — mostly money from EU structural funds — totalled EUR 1.3 billion over the period under consideration.

There are a couple of analytical conclusions from this. First, to a large extent the economy has been kept afloat by fiscal support from Brussels. Second, while these fiscal transfers are unlikely to disappear overnight, their medium- to long-term reliability cannot be taken for granted either. Third, Estonia's private sector has been hard-pressed to pay back its debts even under conditions of vibrant foreign demand and will find the going much tougher once the export boom has run its course. So the deleveraging slowly at work in the background of a relatively benign economic environment may again become somewhat more painful in the next couple of years.

### Improved labour market



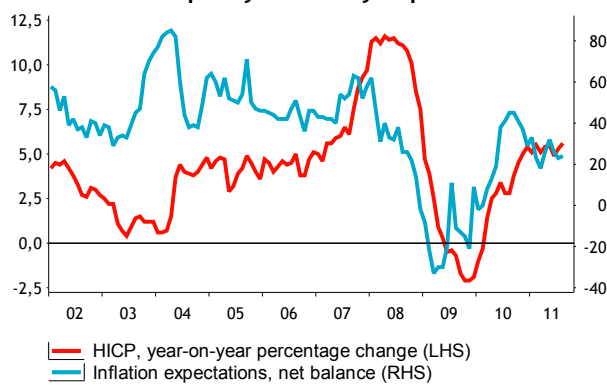
**The resilience of the labour market has been one of the pleasant surprises** of recent stressful years. Not only has the headline unemployment rate fallen briskly from its peak of 19.8 per cent in the first quarter of 2010 to 13.3 per cent, but the 7.8 per cent increase in total employment posted in the second quarter of this year is the highest ever on record. Although weekly registered unemployment data show constantly smaller figures and unemployment expectations have so far barely budged, the bleaker growth outlook is bound to feed into labour demand in the coming quarters. Hence we expect headline unemployment to remain relatively elevated during our forecast period. This year we now expect an average rate of 13.3 per cent, which will then drop to 13 per cent in 2012 and to 12 per cent in 2013.

**Inflation is the great unknown** during the next couple of years, in particular because it is so dependent on assumptions about how public officials respond to the developed world's debt woes. In principle, of course, the interplay between local and global factors will determine the path of inflation in Estonia, but looking further ahead, local issues wither into insignificance.

This look reveals that the recent upsurge in HICP inflation has been primarily an expectation-driven phenomenon. Since the euro was introduced in January 2011, broad money supply has grown at a slower pace than prices. There is some evidence that the adoption of the common currency might have nailed price expectations down in recent quarters. However, given the

uncertainty surrounding the euro zone, the common currency's ability to perform the role of a reliable nominal anchor can longer be taken for granted. All in all, while local factors — deleveraging and stabilising inflation expectations — point towards weaker price pressures ahead, the longer-term outlook remains very fluid. In the short term, we expect **HICP inflation to average 5.3 per cent this year, ease to 5 per cent in 2012** and move up to 6 per cent in 2013.

### Inflation partly driven by expectations

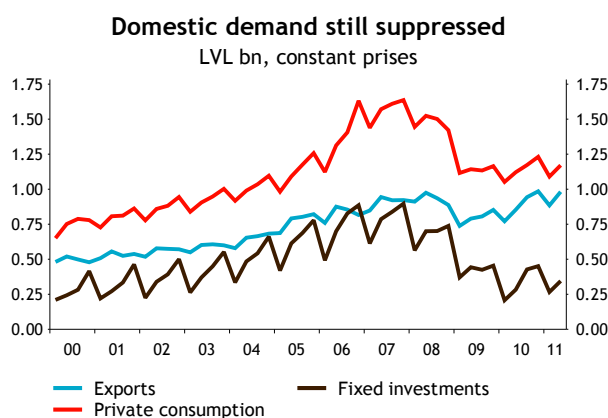


The unexpectedly strong recovery so far will enable Estonia to end this year with a small general government surplus (0.2 per cent of GDP). The authorities then expect a general government deficit, widening to 2.1 per cent of GDP in 2012. This relatively sharp shift is due to investment commitments associated with the sale of carbon credits in 2010 and 2011. As this effect fades in 2013, the government expects the deficit to narrow to 0.1 per cent of GDP. Our deficit forecasts — made using somewhat higher nominal growth assumptions — are in the same league and the differences are basically due to rounding.

## Domestic demand thawing out only slowly

- **Last round of austerity in 2012**
- **Structural bottlenecks**
- **Political uncertainty but no policy change**

Although neighbouring countries are recovering at a faster pace, in the first half of 2011 Latvia showed signs of resilient recovery. Industrial output returned to its pre-crisis level, with exports replacing the decline in domestic demand attributable to the downturn. Exports and export-related sectors are leading growth, while private consumption remains subdued due to fiscal tightening and debt deleveraging. The outlook will remain dependent on exports, and weaker global prospects will hamper further recovery. We expect **GDP to grow by 4.4 per cent this year, 3.5 per cent in 2012 and 4 per cent in 2013.**



After unconvincing GDP growth of 3.5 per cent in the first quarter, growth picked up to a 5.6 per cent rate in the second quarter. There was sustained solid growth in manufacturing. Thanks to effective marketing campaigns abroad, Latvia experienced a surge in tourism and related services. The transport and logistics sector showed positive growth. Although construction is gradually stabilising, the sector is still facing a year-on-year downturn. Activity is mostly sustained by incoming EU funds, since local demand is quite meagre. Construction returns to growth in the second half of the year. However, a shortage of construction workers may be a real challenge in the future, since during the standstill skilled employees retrained and switched to other sectors or left the country. We expect the economy to maintain a good pace in the third quarter but slow down a bit by the end of the year. Exports will cool, but domestic demand will not take up the slack in the short term.

After sluggish retail sales in the first five months of 2011, in June and July there was a strong rebound. However, current trend shows continuous changes in consumer habits and un-

even distribution across the retail sector. During the first seven months, there was a volume increase in non-food products, while food and automotive fuel sales remained slow.

Another reflection of the **more stable economic outlook** is that incoming investment flows are less volatile. Development investments are gradually replacing crisis-related ones. Reinvested earnings are again becoming a significant source of capital spending. To foster investments, the government has unveiled a strategy for 2011-2017 aimed at steering capital spending into strategic sectors to change Latvia's current economic structure and build an innovative, export-oriented economy.

After an astonishing downward adjustment during the recession, the increase in capital spending and domestic demand is behind the downward trend in Latvia's current account surplus. In the second quarter the surplus was 0.9 per cent of GDP, compared to 1.1 per cent in the first. The surplus will wane further, turning into a deficit by year-end, but we do not foresee a build-up of large current account imbalances.

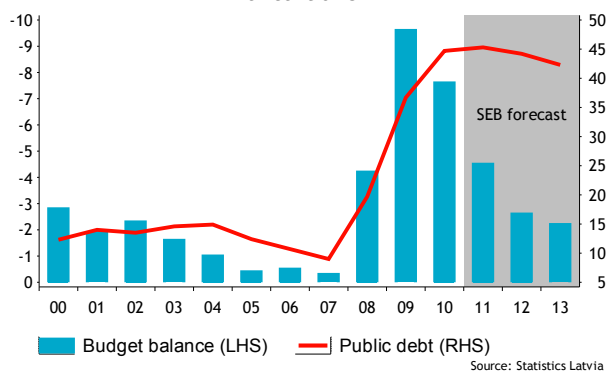
**The labour market is improving.** Unemployment fell from its peak of 20.7 per cent in the first quarter of 2010 to 16.2 per cent in the second quarter of 2011. Employment also increased during the quarter, underscoring the improved labour market trend. In mid-September, registered unemployment was equivalent to 11.7 per cent of economically active people. Meanwhile structural unemployment problems may slow these positive trends. The labour market will continuously improve, but the process may be sluggish due to weaker external demand and structural shortages such as emigration. Acute issues for the government to solve are long-term and youth unemployment.

The economic rebound is also reflected in pay levels. In the second quarter of 2011, the average year-on-year gross salary increase rose to 5.5 per cent, stimulating consumption. Public sector earnings increased by 7 per cent year-on-year, while in private sector wages were up 5 per cent. The fastest earnings growth was recorded in services, driven by rapid recovery and flexible remuneration structures. Shrinking unemployment and continued economic upturn will push up wage growth further. However, the uncertain outlook may curb the current trend. The end of the austerity process and a favourable government revenue trend may trigger swifter pay hikes in some public sector areas as early as next year. There is a risk that by the end of the EU/IMF loan programme in December 2011, wage and salary growth in the public sector may again outpace that of the private sector. Our forecast for total wage and salary growth is 5.5 per cent this year and 4.5 per cent in 2012.

Latvia began to recover its competitiveness by the end of 2008. The balance between pay and productivity has been restored. Since 2010 the ratio between these indicators has been stable, reflected in growing economic activity and new jobs. Notwithstanding the surge in wages and salaries, the rise in average real gross pay was less than the rise in productivity. There is thus no reason to assume that pay is outstripping productivity, as was the case in the pre-crisis boom years.

After a rapid surge in the early months of the year, consumer price inflation has slowed due to global price trends. However, high commodity prices will keep inflation afloat. We expect **inflation to reach 4.4 per cent in 2011 and 2.8 per cent in 2012**. Core inflation is low and expected to rise slightly in the second half of the year and then stabilise in 2012. Given continued pay increases and falling inflation, we expect a faster purchasing power improvement, though from very low levels.

**Public imbalances decline**  
Per cent of GDP



Due to better-than-forecasted growth, tax revenue in the first eight months of the year was 3.6 per cent above target, resulting in a small public deficit. By year-end, however, we expect faster public deficit accumulation as EU project procurement ends. The budget deficit will be close to 4.5 per cent of GDP this year. Next year's deficit is an open question. The departing government is planning a deficit equivalent to 2.5 per cent of GDP in order to leave room for manoeuvre if the situation gets out of control. There may be some retreat from this goal, but this will depend on the new ruling coalition's ambitions and revenue trend.

The departing government is keen to avoid tax increases and achieve enough budget consolidation in 2012 to fulfil the Maastricht criterion, paving the way for euro zone membership. However, we cannot rule out redistributions within the current tax system, avoiding an increase in the overall tax burden. Concrete proposals will appear soon after the new cabinet is approved by Parliament. There will probably be cuts in subsidies and further public sector reforms. **Our budget forecast for next year is a deficit equivalent to 2.6 per cent of GDP, decreasing to 2.2 per cent of GDP in 2013.**

In June 2011 Latvia successfully returned to financial markets and issued USD 500 million worth of 10-year Eurobonds at a fixed rate at 5.25 per cent. The launch acknowledged Latvia's successful efforts to stabilise its economic and financial situation. **So far Latvia has received EUR 4.4 billion of a total of EUR 7.5 billion in its international bail-out programme,**

of which EUR 650 million was transferred for financial sector stabilisation purposes. Due to a better than expected situation, Latvia's lenders agreed to allocate EUR 300 million for budget deficit coverage. So far EUR 1.8 billion has been channelled to cover the budget deficit and lending needs; EUR 1.4 billion for government debt repayment, as well as for the Parex bank bailout. Another EUR 3.1 billion is available under the programme, but Latvia is planning to borrow only EUR 100 million from the World Bank. The country will start repayments in 2012, totalling EUR 322 million. Repayments will be EUR 483 million in 2013, will total EUR 1,224 million in 2014 and will peak at EUR 1,322 million in 2015. At the moment there is no urgent need for cash in the Treasury. Owing to the current financial turbulence, Latvia will avoid any rush to financial markets.

On September 17 Latvia held the first **snap election** in its history, only 10 months after the regular parliamentary election. In May Ex-President Valdis Zatlers (who was not re-elected for a second term in June) called for dissolution of parliament, and Latvian voters supported this idea in a subsequent referendum. In the election, the leftist and predominantly ethnic-Russian, eurosceptical **Harmony Centre (HC) party won 31** out of 100 seats; Zatlers' new Reform Party (ZRP), 22; the dominant partner in the departing two-party coalition, Unity, 20; VL-TB/LNNK 14; and the departing junior coalition partner, the Union of Greens and Farmers, 13 seats. **The elections results suggest that ZRP is in a pivotal position.**

ZRP and Unity will probably form the core of the next governing coalition. Still open is the question of which party, HC or the nationalist VL-TB/LNNK, will be the third in the coalition. On the one hand, it is hard to believe that HC will join the government, since it would have to agree on terms that would signify mounting contradictions within the party and that its voters might interpret as a betrayal of their interests. These include positions on language usage as well as historical, budget, economic and social issues. On the other hand, HC is so close to getting into power that it may be accommodative in its demands. However, such an outcome would probably lead to political losses for ZRP and Unity, perhaps including the defection of MPs. Meanwhile it would be politically unwise to push aside such an influential political force as HC. Another option is VL-TB/LNNK, but this may result in increasing social conflicts and political turbulence. The parties are thus taking time to consult each other and devise potential cooperation strategies. The president may end up appointing the next prime minister. Our view is that despite the wide range of discordant views, the most important thing will be to play down nationalist issues. We do not expect any substantial deviation from Latvia's current economic and political course. However, there may be some shifts of emphasis, depending on the structure of the next coalition.

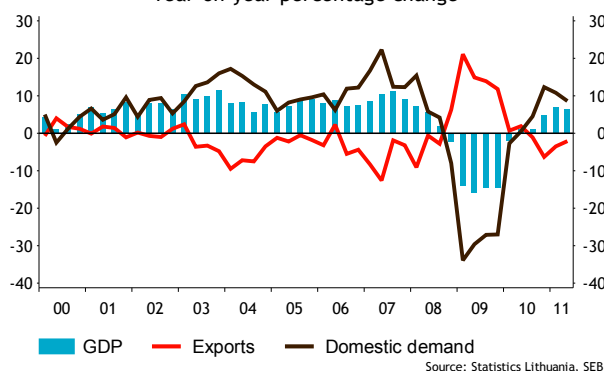
## Robust growth set to weaken

- Exports strong but decelerating
- Slow housing and credit recovery
- Minimal fiscal easing

In 2011 economic recovery has so far been balanced and robust. Driving forces have successfully shifted from exports to domestic demand. In the first half, the economy grew by 6.6 per cent year-on-year. Compared to the situation before the crisis of 2008, Lithuania now has a stronger economic position. There are no large imbalances, either in the domestic market or external accounts. There are no real estate bubbles, and household indebtedness as a share of disposable income has decreased somewhat from 63 per cent to 61 per cent. Cyclically sensitive sectors (investment, construction, real estate) have already bottomed out and therefore cannot cause a new recession. Nevertheless, gloomier prospects in export markets and continued emigration will lead to more limited economic expansion in 2012-2013. We predict that **real GDP will increase by 6.5 per cent in 2011, 4.0 per cent in 2012 and 4.5 per cent in 2013**. The risks to our forecasts are skewed to the downside and are primarily related to global growth risks.

During the crisis, exports were the sole driver of Lithuania's small, open economy. However, starting from the third quarter of 2010, the trade deficit began widening and contributing negatively to GDP growth. At the same time, domestic demand started rising as both wages and employment increased.

**Domestic demand now the main driver**  
Year-on-year percentage change

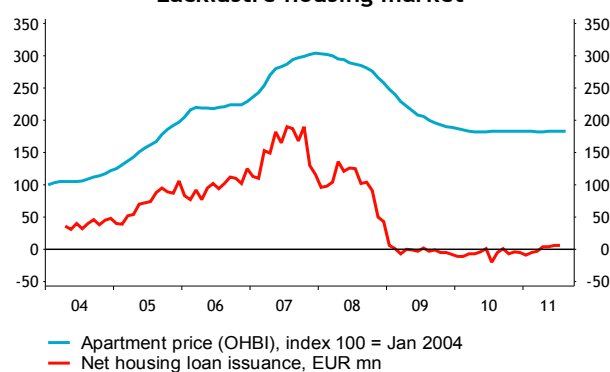


In the first half of 2011, exports increased by 22 per cent in real terms, with exports of refined oil products, chemicals and food products rising the most. Export growth has thus already passed its peak and is destined to slow in the second half of 2011, due to weakening external demand and statistical base effects. The euro zone, which is suffering a debt crisis, buys 32 per cent of Lithuania's exports, although the share of the five

most distressed euro countries (PIIGS) is less than 4 per cent. Russia remains the largest export market for Lithuania with a 16 per cent share. However, only 1/5 of exports to Russia are goods made in Lithuania; the remaining 4/5 are re-exports. Counting exports of Lithuanian-origin goods only, Germany is the number one export partner, followed by the Netherlands, Latvia, Poland and the UK, while Russia occupies only ninth place between the US and Sweden.

Domestic demand expanded rather vigorously, by 9.1 per cent in the first half of 2011. Consumption grew by 6.2 per cent and capital spending by 30.0 per cent. However, capital spending volume was still low, barely half the amount invested in 2007-2008. Residential construction spending rose by 12 per cent. In the third quarter of 2011 we expected a positive effect on domestic demand from the European Basketball Championship, but this fell short of our expectations due to the small number of foreign tourists. **Domestic demand is expected to grow at a moderate pace during the coming year.**

**Lacklustre housing market**



**The real estate market remains sleepy.** Housing sales rose by 14 per cent in the first half of 2011. Nonetheless, apartment prices in the five largest cities were flat, even during the traditionally active summer season. The increase in new housing loans has also remained limited. On the one hand, households are more cautious about buying property and borrowing in the wake of the crisis; on the other hand, banks continue to apply tighter lending standards than during the credit boom period. In addition, the Bank of Lithuania has issued regulations that are expected to help prevent future real estate bubbles by setting maximum loan-to-value and payment-to-income ratios and requiring sellers to provide quality information to buyers. In the short run, these new regulations are expected to have a further cooling effect on the credit recovery.

The current account deficit was only 2.1 per cent of GDP in the first half of 2011. In line with the higher trade deficit and reversals of losses of foreign-owned companies (which used to be

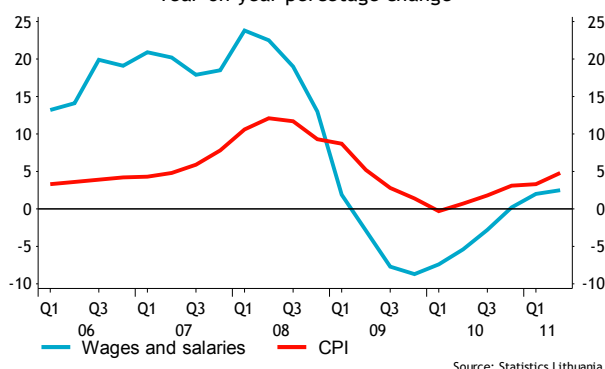
recorded as positive reinvestments) we expect current account deficits of 3 per cent of GDP in 2011, 5 per cent of GDP in 2012 and 6 per cent of GDP in 2013. Bearing in mind the openness of the Lithuanian economy and its small size, we consider the expected increase in the deficit sustainable.

The main sign of labour market recovery is rising employment figures. Meanwhile, pay increases are not universal. In the first half of 2011, the year-on-year change in wages and salaries averaged 2.5 per cent but ranged from -1.2 per cent to 12.4 per cent in different sectors. Pay levels decreased or stalled in cultural activities, hotels and restaurants, while they increased the most in sectors with the most acute shortage of employees (IT and communications, transport and logistics, manufacturing, retail and wholesale trade). Inside companies, pay increases are being made in a selective manner for the most valued employees only.

Wages and salaries in the public sector rose by 3 per cent, even though that they were frozen by law in 2011 and, quite likely, will be frozen in 2012 as well. Instead, public servants use various bonuses and add-ons as a way of raising their earnings. On average, real wages in the economy contracted by 2.3 per cent in the second quarter of 2011, since inflation was higher than earnings growth. The government is now holding discussions on increasing the minimum monthly wage, which stands at EUR 232, one of the lowest in the EU and the lowest among the Baltic countries. The government is taking a rather cautious view on the increase, citing the need for fiscal prudence, but the minimum wage will probably be raised to EUR 261 in 2012.

### Real wages are still falling

Year-on-year percentage change



The emigration problem is continuing, with 4-5,000 people leaving the country in the first half of 2011 and 6-7,000 in July and August alone. Unemployment fell to 15.6 per cent in the second quarter of 2011, compared to 18.3 per cent a year earlier. However, long-term unemployment (1 year and more) increased during the same period from 7.4 per cent to 8 per cent, indicating a worsening of structural unemployment. We expect a continued gradual decline in unemployment.

Year-on-year inflation peaked in May at 5.0 per cent and decelerated to 4.4 per cent in August. This was due to seasonal declines in food and clothing prices as well as stabilisation in global energy prices. **Inflation remains driven by cost-push factors and there is no evidence of demand pressures.** However, in the coming winter season central heating is expected to go up in price by 20 per cent due more expensive natural

gas. The increase would add 0.7 percentage points to inflation and eat up the whole expected increase in average wages and salaries. In the coming years, we expect moderate inflation in line with slower economic growth. **Both in 2012 and 2013, average annual HICP inflation should reach about 3.5 per cent, down from 4.0 per cent in 2011.**

Despite continued consolidation efforts, the public sector deficit amounted to 6.3 per cent of GDP in the first half of 2011. Implementation of ambitious budget plans was shaky, and non-tax revenue fell short of projections. Overall tax revenue rose by 13 per cent year-on-year. Revenue from indirect taxes such as VAT is at an all-time high. However, **next year will pose new budgetary challenges**, since parliamentary elections are scheduled for October 2012. The government is expected to restore old-age pensions to their pre-crisis level starting in 2012, which would cost 0.5 per cent of GDP. Dropping this promise would be political damaging and it will thus probably be carried out. Meanwhile Finance Minister Ingrida Šimonyte has said that no new real estate or car taxes will be introduced in 2012. Lower growth and inflation will put strains on revenue collection, but we foresee reductions in the budget deficit from 4.5 per cent of GDP in 2011 to 3.0 per cent of GDP in 2012 and to 2.8 per cent of GDP in 2013.

The central government's debt/GDP ratio decreased from 38.0 per cent at the end of 2010 to 36.4 per cent at the end of the first half of 2011, due to low borrowing and higher GDP. We expect this ratio to stabilise over the coming years at around 38 per cent of GDP, due to rising GDP. In 2012, the government has to make around EUR 2 billion in debt payments.

## Mild slowdown, but imbalances a short-term concern

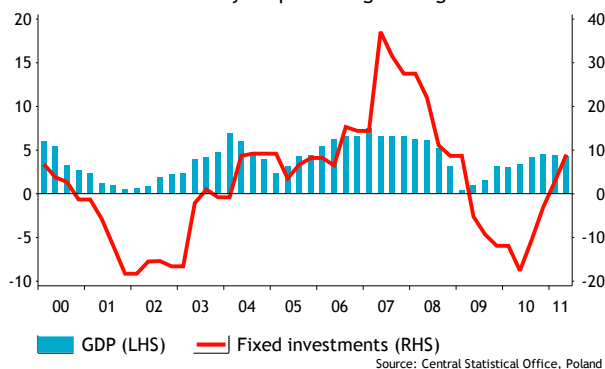
- **Domestic demand sustaining growth**
- **Less inflation pressure, key rate cuts in 2012**
- **Large current account deficit a challenge**

Poland, the only EU country to avoid recession in 2009, is continuing to stand out – with good growth that is higher than elsewhere in Central Europe. Two major reasons are that exports do not weigh so heavily in the economy and that this year's investment cycle upswing is expected to be more lasting. But Poland will feel economic headwinds, too. Weaker external demand, continued fiscal tightening and – in the short term – falling sentiment in the wake of global turmoil and domestic stock market decline will cool demand. Confidence indicators have dropped in recent months, though not yet dramatically.

GDP will increase by 4.0 per cent this year, 3.4 per cent in 2012 and again by 4.0 per cent in 2013; the latter is just below trend. We have thus lowered our 2011-2012 forecasts clearly from 4.5 and 4.6 per cent last spring. At that time, Poland seemed headed towards strained resource utilisation. Today that risk has faded. Wages and salaries continue to grow at a modest pace. As a result, rapid inflation will slow by this winter as the effects of earlier energy and food price upturns and the January 2011 value-added tax increase (from 22 to 23 per cent) vanish from the 12-month figures. This opens the way for a shift in monetary policy, with two key interest rate cuts in the first half of 2012. In the first half of 2011 the central bank implemented front-loaded rate hikes totalling one percentage point and then paused, mainly due to growing world economic downside risks.

### Capital spending again an important growth factor

Year-on-year percentage change



After a final full-year growth figure of 3.8 per cent for 2010, GDP rose 4.4 per cent in the first half of 2011 compared to the same period of last year. Second quarter growth was even more clearly driven by domestic demand, mainly a continued upturn in capital spending including stock-building, while net exports

made a neutral contribution. Notably, in other Central European countries such as Slovakia, the Czech Republic and Hungary, exports were instead the clearly dominant driving force. In the short term, these countries are likely to be more vulnerable to a weaker world economy. In Poland, exports are equivalent to some 40 per cent of GDP, compared to 70-80 per cent in the above-mentioned countries. But Polish growth is also cooling. For example, the year-on-year increase in industrial production fell from a steady 7 per cent last spring to less than 2 per cent in June and July, mainly due to exporters.

The coming year will see a continued clear slowdown in export growth, since Poland's biggest market, Germany (about one fourth of all exports), is expected to decelerate. Meanwhile some relief is at hand. The zloty has fallen by about 10 per cent against the euro since summer. This makes Poland more competitive, although the impact will not be as large as during the latest global financial crisis. In a long-term perspective, the zloty's real effective exchange rate was only slightly overvalued when the current turbulence broke out. Our forecast is that the zloty is bottoming out against the euro at 4.55 this autumn and that it will then slowly recover to 4.00 by the end of 2012.

### Sharp new EUR/PLN appreciation



After last year's downturn, capital spending has gained momentum this year, and not only due to higher construction activity. This is the start of a lasting trend, though the rate of increase will slow somewhat in the coming months because of postponed investments following world market turmoil and this year's peak in central government infrastructure spending. Capital spending is driven by several forces: the need for infrastructure spending, the 2012 European football championships (co-hosted with Ukraine), continued large EU fund inflows and growing industrial capacity utilisation in recent years. For many years, the investment ratio has been at a relatively low 20 per cent of GDP.

Household consumption, which was kept going even during the 2008-2009 crisis – among other things by the 2009 income

tax reform – has reverted to more normal growth in the past year. Retail sales have shown year-on-year growth of 5-10 per cent each month, with a recent slowing trend, but new car sales remain subdued after a temporary peak late in 2010. Looking ahead, consumption growth will decelerate a bit due to weaker optimism, combined with continued moderate austerity measures aimed at households. Another short-term adverse factor is this summer's sharp appreciation in the Swiss franc, which has made foreign loans more expensive to service. About 15 per cent of Poland's total loans are in CHF (foreign loans account for one third of all borrowing), mostly home mortgages. But the "CHF problem" is larger in Hungary, where 30 per cent of borrowing is CHF-denominated.

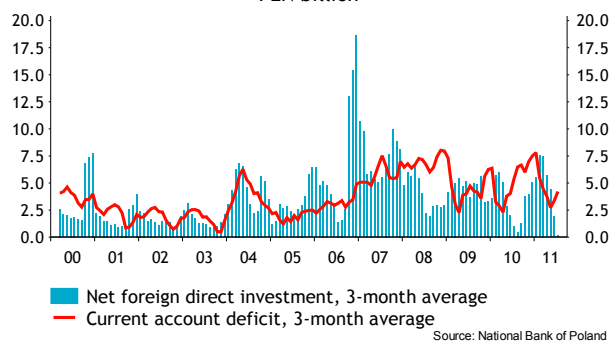
The overall slowdown in consumption growth will be gentle, since job creation will gradually keep rising and real income will increase as inflation slows and short-term interest rates fall.

Poland's growth prospects thus remain decent. But three imbalances are casting their shadows over the economy and have certainly helped to squeeze the zloty exchange rate and prices of other Polish assets a bit extra. Meanwhile it should be observed that the zloty is usually hurt by global financial turmoil in particular, since it is a relatively liquid emerging market currency. As for Poland's imbalances, we feel that the market is largely exaggerating the risk situation, although the current account deficit poses a structural challenge:

- **CPI inflation is high but is slowing.** In the past year, inflation gradually climbed from 2 per cent to 4.2 per cent in August, after a peak of 5 per cent in May. But this was mainly due to global energy and food pressures plus the VAT hike. Core inflation has risen from 1.2 to 2.5 per cent. Assuming that commodity prices level out and GDP growth is slower, we expect CPI inflation as an annual average to fall from 4.0 per cent in 2011 to 2.8 per cent in 2012. This brings it back within the central bank's  $2.5 \pm 1$  per cent target.
- **The budget deficit is large but is shrinking.** In the wake of lower growth and earlier stimulus measures, the 2010 deficit soared to 7.9 per cent of GDP. To correct this, the government launched a moderate multi-year austerity programme. Aside from higher VAT, it includes a public sector pay freeze, ceilings on central government spending and technical changes in pension payments to strengthen central government finances. It also includes privatisations. These measures seem to be effective. This year's targeted deficit, 5.6 per cent of GDP, is easily within reach. The budget will then continue to move in the right direction, although we do not believe that the deficit will drop below 3 per cent of GDP by 2012. One important overall goal is to slow the upturn in government debt to ensure it does not exceed the nationally mandated limit, 55 per cent of GDP, since this would trigger tougher austerity measures. We believe the government will succeed, just barely, but perhaps via extra austerity measures in 2012.
- **The current account deficit is large and is shrinking marginally.** In 2010 it was 4.5 per cent of GDP. Due to unclear data on trade with Germany and other matters, plus

large "error" items, the central bank conducted a statistical review this summer. This led to an upward adjustment of 1.1 percentage point for 2010 and even larger upward adjustments for 2004-2009. Imports (including used cars) were raised and transfer payments were lowered. This year's current account deficit will probably be as large as in 2010. A small increase is expected in 2012, since domestic demand for imported products will hold up well. External deficits as large as about 4.5 per cent of GDP mean that financing may become sensitive, since Poland risks having to borrow more. These trends are worrisome. Foreign direct investment (FDI) has covered less and less of the shortfall in recent years. Instead, potentially more volatile portfolio investments and EU transfer payments must cover more of the deficits. This is not sustainable over time. Structural reforms may be needed to strengthen the current account and ensure economic stability, but we expect FDI and portfolio investments to bounce back next year as global recession worries fade.

**Diminishing role of FDI in covering current account deficit**  
PLN billion



### Political stability – government will be re-elected

We expect the current Polish government to remain in office after the October 9 parliamentary election. Prime Minister Donald Tusk's pro-market centre-conservative party, Civic Platform, won a major victory in the 2007 election and has since ruled together with the little Peasants' Party. According to public opinion polls published on October 4, Civic Platform will receive 31-46 per cent of the votes. The opposition parties – the conservative Law and Justice and the Democratic Left Alliance – will get 21-31 and 6-9 per cent, respectively. If the government is re-elected, it will be the first time this has happened in Poland since the Communist era ended in 1989. The government has managed to ride on a positive economic wave for years; Civic Platform enjoys strong middle-class support. In addition, there have been unusually few political scandals; these included two leading politicians being forced to step down after contacts with a gambling executive. The April 2010 plane crash that killed leading members of Poland's political and military establishment may also have helped calm political relations.

## Good growth as long as oil prices are high

- **Domestic demand will drive growth**
- **Consumption will rebound, sustained by new fiscal stimulus and lower inflation**
- **Unchanged key interest rate for a long time**

Russia was hard hit by the 2008-2009 crisis. The economy has been growing since the first quarter of 2010 at a year-on-year rate of 3.5-5 per cent, driven by consumption and capital spending. Meanwhile, due to higher imports, net exports have contributed negatively to GDP. Growth is not fast enough to regain the ground lost during the crisis. It is slower than in the early 2000s but better than in many emerging market countries and Eastern European neighbours. In the second quarter of 2011, GDP rose somewhat more weakly than we had expected: 3.4 per cent year-on-year, compared to 4.1 per cent in the first quarter, probably due to weak consumption. **In the short and medium term, our view of Russia is relatively positive,** although the country will be hurt by the international slowdown and financial market turmoil. Rising oil prices and low capacity utilisation have made a positive trend possible, but their effect will fade in the future. As long as **oil prices remain high, the economy will be resilient,** but further ahead Russia faces various challenges.

We expect continued high commodity prices, which will benefit Russia. Oil prices have been volatile in recent years. At present, they are around USD 110 per barrel (Urals), which is 70 per cent higher than five years ago. According to our forecast, prices will stabilise at about that level in 2012 and 2013 (Brent crude will be USD 110 per barrel in 2012 and USD 115 in 2013; Russia's Urals oil sells for about USD 5 less than Brent). Meanwhile capacity utilisation in manufacturing has generally risen. Improving Russia's future outlook will require investments in large portions of the economy, from production capacity and infrastructure to education and training. Today the labour market has few idle resources, while unemployment continues to fall. Household confidence is decent, and when inflation falls in the near future and fiscal policy becomes expansionary in the run-up to the elections, real income will improve. International comparisons show that Russia's business climate needs to improve. Altogether, we estimate that **GDP will grow by 4.3 per cent this year, 4.2 per cent in 2012 and 4.2 per cent in 2013.** The risks in our forecast are mainly connected to commodity price trends and how severely Russian exports will be affected by the international economic slowdown.

### Indicators mixed

Indicators are providing somewhat mixed signals, but overall they point towards a dampened recovery. Manufacturing sector

indicators have weakened during 2011; for example the purchasing managers' index (PMI) in this sector has fallen. A similar decline unexpectedly occurred in the autumn of 2010 but proved temporary. After an upturn from autumn 2009 to spring 2011, the manufacturing PMI has dropped back to around 50. Indicators for the construction, financial and retail sectors look better, although they have recently declined somewhat. The service sector PMI remains at a healthy level, 53.2, despite a certain downturn in recent months.

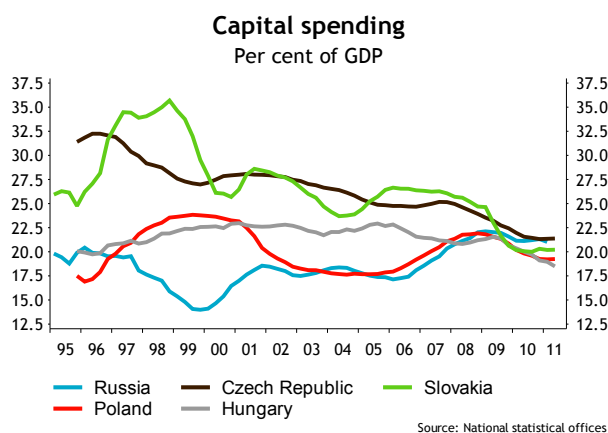
Industrial production has shown stable performance so far in 2011, averaging an upturn of nearly 8 per cent compared to the respective year-earlier month. A bit worryingly, however, the rate of increase has decelerated as the year has progressed, matching the picture provided by indicators. The global economic slowdown is also affecting Russia, and because of a weaker second half, **full-year industrial production will increase by 7 per cent in 2011.**



Exports have climbed sharply in 2010 and 2011, driven by high energy prices. The average year-on-year increase, measured in current prices, was more than 25 per cent in the first six months of 2011 and reached nearly 40 per cent in June. The removal of the export ban on grains will boost exports during the second half of 2011. The trade surplus in the second quarter of this year totalled more than USD 50 billion. Meanwhile capital outflows are large. High energy and metal prices will continue to drive exports. We expect the current account surplus to fall from 5.5 per cent of GDP in 2011 to 2.3 per cent 2013. Although exports are expected to keep rising in fixed-price terms, imports will climb faster. Looking ahead, the contribution of trade to GDP growth will thus be neutral or negative.

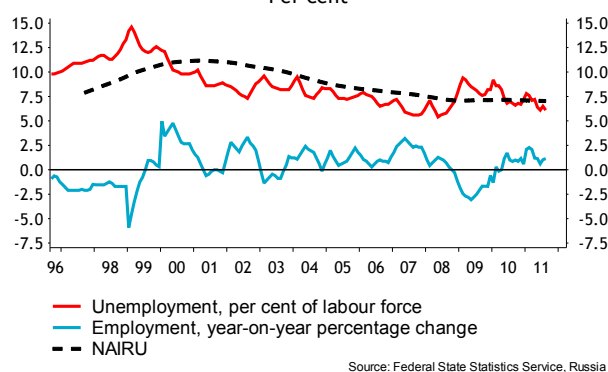
Capacity utilisation in Russia has risen since the crisis, but capital spending has increased more slowly. Fixed investments are equivalent to a bit above 20 per cent of GDP. Major capital spending is needed now and in the future to boost growth potential. Compared to the Czech Republic, for example, Rus-

sia's investment ratio has been low and capital assets are more obsolete. Meanwhile banks have recently boosted their lending to businesses, another indication that fixed investments will increase. Year-on-year, **capital spending will climb by 7.5-9 per cent** during our forecast period.



Unemployment has been falling since the beginning of 2010 and is now not far from its 2007 level. A temporary increase early in 2011 was quickly reversed. The jobless rate stood at 6.1 per cent in August, nearly 2 percentage points lower than at the beginning of the year. Job creation has been positive since 2010, although the level is well below earlier peaks. **We expect unemployment to continue falling somewhat, but it is already below the estimated non-accelerating inflation rate of unemployment (NAIRU).** Without reforms that expand labour supply and boost productivity, the labour market cannot help Russia maintain growth. Instead there is a risk of rising inflation. The jobless rate will end up at 6.5 per cent in 2011, 6.2 per cent in 2012 and 6.0 per cent in 2013.

#### Unemployment approaching pre-crisis level

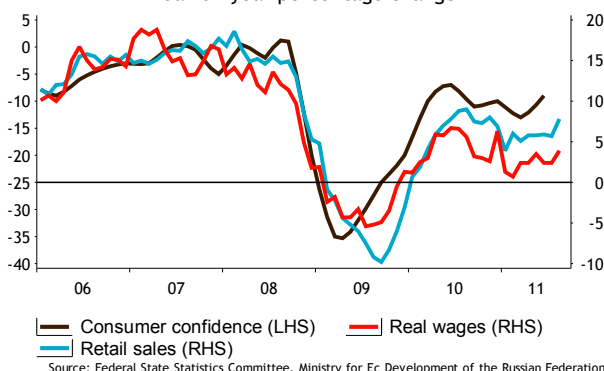


### Household consumption will rebound

Growth in household consumption fell somewhat early this year. High inflation squeezed real wage growth in the first half, impacting consumption and retail sales. Looking ahead, various factors indicate that consumption should rebound. Although inflation remains high, it has begun to fall. This will improve real household income, which after last year's increase of more than 7 per cent will show growth of only around zero this year. Another contributing factor will be higher public sector spending in the run-up to the elections this year and next. Public sector pay has been raised and this process will continue, pensions will be increased and hikes in electricity and gas prices will be

postponed. Meanwhile consumer confidence has started to climb. Unemployment will keep falling, albeit more slowly than in the past six months. We expect the coming parliamentary election, followed by next year's presidential election, to be accompanied by expansionary fiscal measures in the short term, which will strengthen household income. Household consumption will improve late in 2011 and rise further in the following months. Year-on-year, consumption will grow by 4.5 per cent this year and by 5.5 per cent in 2012 and 2013. Domestic demand will provide a larger contribution to growth than net exports throughout our forecast period.

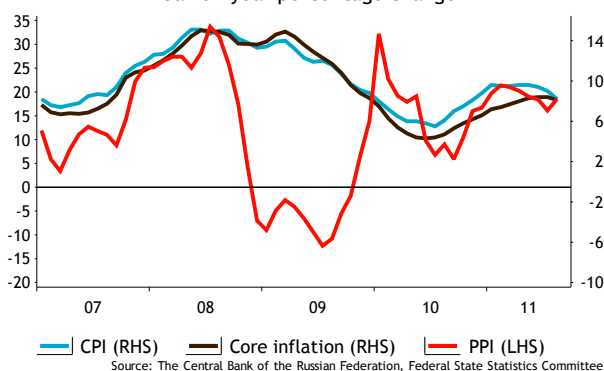
#### Real wages and retail sales are again pointing upward



### Inflation will slow and the central bank will keep its key interest rate unchanged

Rising food and energy prices pushed inflation from 5.5 per cent in mid-2010 to around 9.5 per cent in the first half of 2011. We expect inflation to fall in the months ahead. In August, it was 8.2 per cent: lower but still above the central bank's 7 per cent target. Producer prices and core inflation have also been climbed in the past year, but in recent months these too have fallen. As last year's food and energy price upturns vanish from the year-on-year statistics, the inflation rate will continue to decline. Measured in annual averages, inflation will end up at 8.6 per cent in 2011, 7.3 per cent in 2012 and 6.8 per cent in 2013. Core inflation in Russia, which varies more in line with inflation in Western Europe, will fall in the coming months.

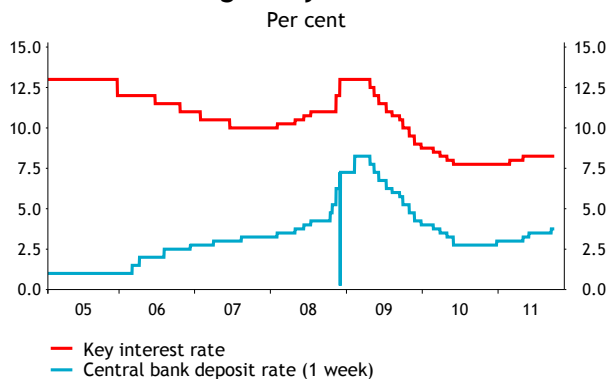
#### Inflation will decelerate



In 2011 the central bank has raised its key interest rate twice. It is now 8.25 per cent. Meanwhile the one-week interest rate on deposits in the central bank, which is more important to foreign exchange flows than the key rate, has been raised by a total of 100 basis points to 3.75 per cent since bottoming

out in 2010. At the same time as the bank adjusted its 1-week deposit rate upward in September, it also changed two other important interest rates: overnight deposit rates were raised and overnight lending rates were lowered by 25 bp each – thus narrowing the corridor between them. The overnight rate in the interbank market remains lower than the central bank's rate, but these adjustments may be an attempt by the central bank to regain control of this short-term lending. High inflation has been a source of concern to the central bank, which has focused more on inflation-fighting than the rouble exchange rate. Given falling inflation, weak growth in the second quarter of 2011 and uncertain global economic performance, we expect Russian's central bank to keep its key interest rate unchanged throughout our forecast period, even though inflation-fighting would be made easier by further rate hikes.

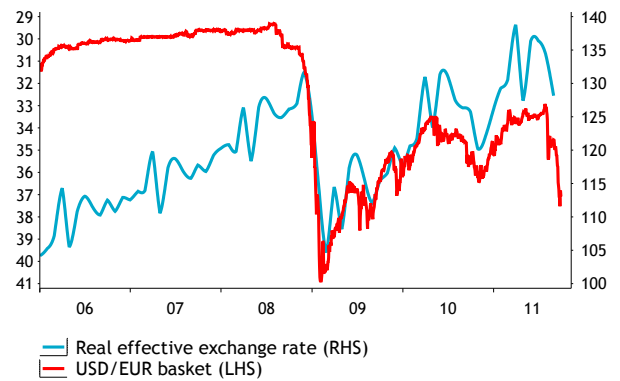
### Unchanged key interest rate



The rouble has trended upward since its 35 per cent slide against the EUR/USD basket (55 per cent USD and 45 per cent EUR) ended in early 2009, but its path has been bumpy. By the end of July 2011 it had regained a large proportion of this downturn; the rouble was less than 10 per cent weaker against the EUR/USD basket than before the crisis. Increased global financial and macroeconomic turmoil led to about a 10 per cent weakening since August. The rouble now stands at around 37 against the basket. A number of factors point towards appreciation looking ahead. Exports continue to perform strongly and oil prices remain at high levels, which will keep the current account surplus high. Meanwhile capital outflows are continuing, affected by pre-election political uncertainty. In the short term, however, negative risks predominate. Increased financial turbulence connected to the problems in the euro zone may contribute to a weakening of the rouble before it again appreciates. Our assessment is that the rouble will strengthen to 37.1 at the end of 2011, 34.5 at the end of 2012 and 33.5 at the end of 2013.

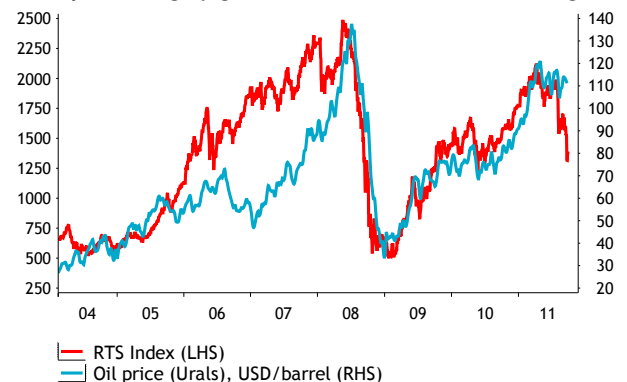
Russia's banking sector has continued to recover, but the rate of increase in both deposits and lending is well-below pre-crisis levels. Lending is experiencing a clearer accelerating trend than deposits. Worth noting are higher interest rates in the interbank market, although these rates are still more on a par with what we saw before 2008 than 2008/2009 crisis levels. There is some concern about bad loans in the banking system, which may generate some worries looking ahead, especially if international economic performance is worse than expected and if financial market turmoil in the euro zone becomes more intensive.

### Rouble slide soon over



The Moscow Stock Exchange is largely governed by oil price trends. The oil price upturn since the beginning of 2009 has helped the Exchange regain much of its crisis downturn, but the RTS Index remains about 30 per cent below its 2008 peak. In recent weeks, share prices in Moscow have fallen while oil prices have moved more sideways, which might be explained by concern that weaker international economic conditions will lead to lower oil prices.

### Oil prices largely govern the Moscow Stock Exchange



### High oil prices make new public stimulus measures possible in near term

Russia carried out large stimulus programmes during the crisis, thereby softening the decline in GDP and consumption. Although our general view of economic growth in Russia is relatively positive in the short and medium term, major future challenges remain. Strong centralised political control of important parts of the economy may provide short-term stability. As long as oil prices remain at today's levels, this allows an expansionary fiscal policy. At the same time, this reduces pressure for structural changes that will improve the long-term functioning of the economy. At present, the government's strategy is working, but meanwhile it is worsening the vulnerability of the Russian economy to an unexpected oil price decline. The federal budget assumes an oil price of USD 100 per barrel, up from the previous USD 93, which would result in a deficit of 1-2 per cent of GDP. In order to achieve a balanced budget if the government adopts expansionary pre-election policies, oil prices clearly above the USD 100 level will be required.

Russia's current account surplus is driven by its trade surplus, while the financial account shows a deficit. Although the

economy is doing well and oil prices are high, capital owners lack confidence that it is better to invest money in the Russian economy than elsewhere. Part of the capital outflow can probably be attributed to unexpectedly high oil prices, a degree of uncertainty about economic reforms after the elections and short-term difficulties in investing money in Russia.

In order to make funds available to boost capital spending and increase private sector investments in companies and infrastructure, the government's privatisation programme will continue. Early in September, the Finance Ministry unveiled plans to sell about USD 40 billion worth of state-owned property during the next three years, with a back-loaded profile. A large number of companies are on the sales list. Among the better-known firms to be partially privatised, according to the plan, are the pipeline operator Transneft, the oil company Rosneft and the bank VTB.

The federal budget for 2012-2014, unveiled in July, increases future expenditures at a clearly slower pace than in recent years. Noteworthy is that federal spending has increased significantly during the last years from 16 per cent of GDP on average 2000-2007 to 22.3 per cent of GDP in 2010. Marginal taxation of oil is high. Because of the coming elections, our assessment is that fiscal policy will be more expansionary in the next year than the budget indicates. In spite of this, deficits will not soar given today's oil prices, though deficits excluding oil revenue are just above 10 per cent of GDP compared to the official target of 4.7 per cent. The federal balance looks manageable, federal debt is low but excluding oil revenue, the budget looks increasingly unsustainable as a high underlying public sector deficit makes the budget very sensitive to oil price changes. If oil prices should fall, there is little ammunition for implementing stimulus measures. It is true that low government debt will allow some freedom of action, but only in the short term. Increased pre-election expenditures will include higher public sector pay and pensions as well as postponements of electricity and gas price hikes. After the autumn and spring elections, we expect federal expenditure increases to slow. We foresee a weak increase in spending during the second half of 2012 and in 2013.

Rapidly shrinking idle resources, especially in the labour market, capital spending needs and oil prices that will not continue to rise will put pressure on the country's political leaders. In order to improve its future growth potential, Russia needs structural changes that will improve the functioning of the economy. In recent years, first the oil price upturn and then the financial crisis have helped preserve the status quo instead of encouraging reforms.

Russia has been trying since 1994 to become a member of the World Trade Organisation (WTO), and membership negotiations have repeatedly encountered delays of one kind or another. Lingering issues with the US and the EU were resolved last autumn. A number of issues concerning agricultural subsidies, automotive assembly plants and customs matters related to Georgia remain to be solved. Most indications are that membership negotiations may be completed early next year and that Russia can become a member of WTO after that. The effects of WTO membership are uncertain, but it may strengthen reform efforts and contribute to improvements in such areas as liber-

alisation and deregulation, improved customs procedures and better domestic competition in various sectors. WTO membership would probably lead to increased foreign investments but, at the same time not automatically lead to such improvements; it may act as a catalyst. The World Bank has estimated short-term effects at 7-8 per cent of domestic consumption, and more than twice as much in the long term. In order for these effects to materialise, however, reforms must be carried out.

### **Elections may open the way to reforms**

Two important elections are approaching in Russia: a parliamentary election in December and a presidential election in March 2012. Prime Minister Vladimir Putin and President Dmitry Medvedev declared in September that they will be candidates for each other's positions. This was the announcement everyone had been waiting for. In our assessment, there is little likelihood that Putin and Medvedev's United Russia party will not win a majority in the coming elections, but the two leaders will still use politics to help boost their support. Among other things, Putin has announced that domestic energy rates that are normally adjusted on January 1 will instead be adjusted at a later date. Looking ahead, one important question is how long the growing middle class will accept the fact that the political elite has decided both candidates and that they are largely politically unchallenged.

The effect of this new, yet familiar slate of candidates for president and prime minister is difficult to assess. On the one hand, Medvedev has tried to carve out an image of being more reform-minded than Putin, but on the other hand not so much has occurred in terms of reforms in recent years. Although reform efforts in Russia are moving slowly, in any case Medvedev's speeches have highlighted the need for economic reforms. Earlier this year, he unveiled a 10-point programme to improve Russia's investment climate. Despite fears that the coming elections will put a damper on reform efforts, some progress has been made.

Putin's return to the presidency has been widely expected. This may have limited Medvedev's chances of actually carrying out major reforms. Now that the two leaders are exchanging roles, some of the tensions may ease and Medvedev may be able to focus on national reforms. Since Putin and Medvedev announced their candidacies, however, it has become clear that there are tensions within the political elite. Finance Minister Alexei Kudrin declared that he did not intend to work under Medvedev as prime minister and was soon fired. Kudrin has won the respect of investors. Regarded as a fiscal conservative, he disapproved of various spending hikes that have weakened the federal budget. His departure may lower public confidence in Russia's economy, at least in the short term, and may worsen pre-election capital flight problems.

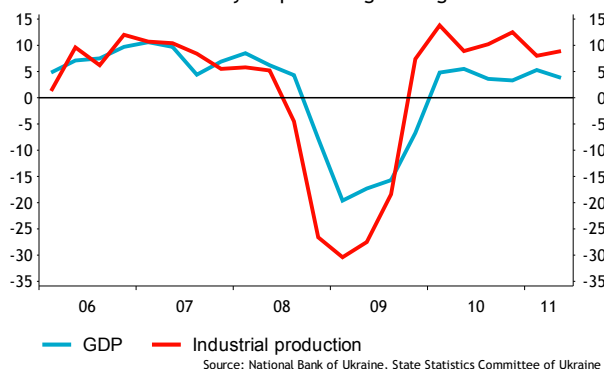
## High commodity prices will help in tougher times

- **Rapid increase in real income**
- **Continued pause in IMF disbursements**
- **Hryvnia remains stable against US dollar**

The economic outlook in Ukraine looks shaky. GDP growth slowed to 3.8 per cent in the second quarter, from 5.3 percent in the first. After a 2008-2009 decline, GDP growth has averaged 4.4 per cent since the first quarter of 2010. The full year 2010 figure was 4.2 per cent. Due to dependence on exports and commodity prices as well as political uncertainty, risks ahead are on the downside. Although the banking system still has problems with bad loans, the financial risk picture looks better than in 2009, but there are worrisome signals. For example, the cost of insurance against a government default has slowly crept higher and is now a bit above Ireland.

Yet the economic situation will look relatively good as long as commodity prices are high. Total capital spending keeps climbing, partly driven by preparations for the 2012 European football championship. Falling inflation is boosting real wages and consumption is up nicely, though budget tightening in 2012 and 2013 will push increases lower. As an open economy, Ukraine (with exports equivalent to 47 per cent of GDP) will still be affected by the international economic slowdown, although high commodity prices will dampen the effect. **Altogether, GDP will grow by 4.3 per cent in 2011, 4.0 per cent in 2012 and 4.5 per cent in 2013.** Growth is weaker than before the crisis and will not catch up with pre-crisis rates soon.

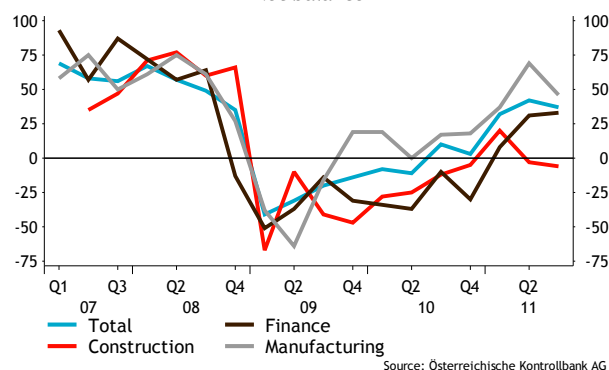
**GDP and industrial production**  
Year-on-year percentage change



Indicators point towards sustained growth, similar to recent quarters. Manufacturing climate indices are at good levels, but construction has fallen back below zero. The manufacturing indicator predicts continued good but falling production growth ahead. In August, industrial output was 8.6 per cent higher year-on-year. We expect similar growth rates during the rest of 2011, followed by somewhat slower increases.

Steel production, which briefly fell by half in 2008, is now slightly above its average for the past two decades and continues to rise. A good harvest will boost growth in the third quarter of 2011: August agricultural production was 10 per cent higher than a year earlier. We expect metal and agricultural prices to remain high for the rest of 2011, benefiting exports, though metal prices will then fall somewhat. Export taxes on grains replaced quotas on July 1 and may keep exports down in the near future. Imports have climbed faster than exports in the past year. The current account, which fell to a deficit of 2.1 per cent of GDP in 2010, will continue to deteriorate in the next couple of years. For an open economy like Ukraine, prices of metals and agricultural products – which account for more than 50 per cent of exports – are very important.

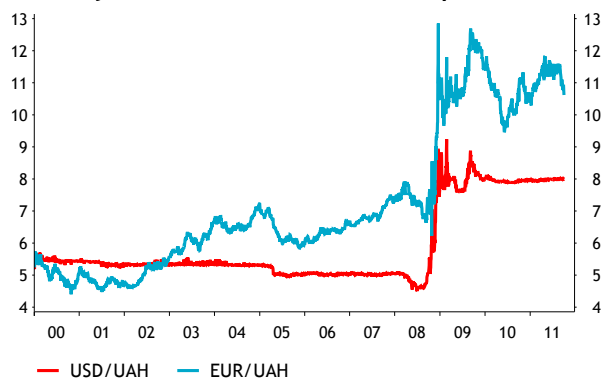
**Business sentiment indicators levelling out**  
Net balance



At present, the hryvnia stands at UAH 8 per USD. We expect the exchange rate to remain the same throughout our forecast period. In August the central bank widened the permitted currency fluctuation interval from 2 to 2.5 per cent. This may be viewed as a response to IMF calls for a more flexible exchange rate. There may be some depreciation pressure, but the central bank has USD 38 billion in reserves. One reason for the recent stable exchange rate may be that fewer investors in earlier stages have taken positions in Ukraine, partly due to the fact that liquidity is low, and the need to unwind these positions in a more risk-averse environment is thus smaller.

The central bank's key interest rate has stood at 7.75 per cent for more than a year. Due to lower inflation, combined with weaker international growth, we expect this rate to remain unchanged throughout our forecast period. Credit growth has risen since mid-2010 and was up 20 per cent year-on-year in August, although this is well below pre-crisis levels. Lending is increasing only in local currency; foreign-currency lending fell in 2010 and its growth rate is now around zero. The banking system has continued problems with bad loans. This may affect its future stability and lending, especially if euro zone worries spread to Eastern Europe.

### Hryvnia stable at around UAH 8 per USD



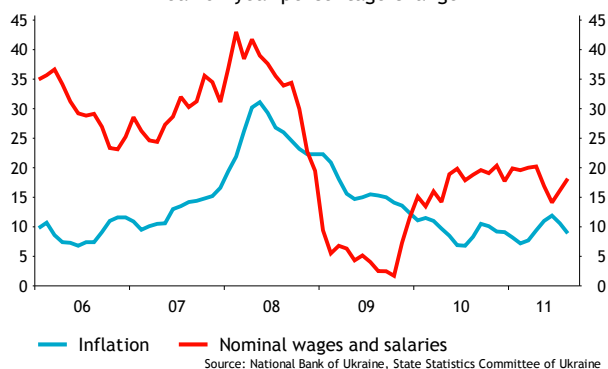
Source: Reuters EcoWin

Since 2010, inflation has fallen sharply. In the past two months, prices have declined – in August by 0.4 per cent – pushing down the year-on-year rate to 8.9 per cent. Inflation has mainly been affected by falling food prices (food makes up about 50 per cent of the CPI basket) and the disappearance of base effects such as August 2010 gas price hikes from the 12-month figures. **We expect inflation to rise somewhat in late 2011** but only to slightly above 9 per cent. One uncertainty factor is continued gas price hikes, an IMF requirement for resuming loan disbursements. This would ease pressure on the budget.

Last year real wages climbed around 10 per cent after a weak 2009. Nominal pay in January-August 2011 rose 18 per cent compared to the same period of 2010, while inflation has been less than 10 per cent in most months. **Unemployment** stood at just above 8 per cent at the end of last year. **We expect it to fall in 2011 and during the next couple of years.**

### Good real wage trend

Year-on-year percentage change



Source: National Bank of Ukraine, State Statistics Committee of Ukraine

**Given solidly rising real income, household consumption is also likely to continue climbing relatively fast.** In the first quarter of 2011, consumption in fixed prices rose by nearly 13 per cent, according to the national accounts. In recent months, retail sales have increased by some 15 per cent year-on-year (in current prices). We expect somewhat slower increases in the near future, but consumption will grow sharply during 2011.

### Continued pause in IMF disbursements

In July 2010, Ukraine reached a loan agreement with the IMF totalling USD 15.9 billion and running until late 2012. The programme initially operated as planned, but Ukraine has not received its last two disbursements. The IMF is calling for public deficit cuts (to 3.5 per cent of GDP in 2012 and 2.5 per cent in 2013), pension reform, modernisation of the gas sector, gas price hikes and bank recapitalisation. The next IMF mission is due late in October. **It is highly probable that the pause in disbursements will continue until the end of 2011.**

The government has taken a number of steps to trim its deficit, including lower pension hikes, a freeze on public sector pay and employee cutbacks. Parliament has approved a pension reform, removing one stumbling block to the IMF agreement. It goes into effect on October 1, 2011 and includes higher retirement ages. The biggest remaining reform needed to meet IMF requirements is further hikes in gas and other energy prices. These prices were raised by 50 per cent in August 2010 and were supposed to go up by another 50 per cent in April 2011. The latter increase was cancelled and the IMF eased its requirements somewhat, but further hikes have not occurred. One reason for the delayed price hikes may be hopes that Ukraine can successfully negotiate lower Russian gas prices, thereby creating more room for tariff hikes.

On the one hand, higher gas prices seem unlikely in the near future; inflation is already high and the manufacturing sector, an important political base for President Viktor Yanukovich, faces weaker international economic growth and may find it hard to pass on price increases. Support for the government is also weak, according to public opinion surveys. On the other hand, Ukraine may need the disbursements if commodity prices fall and international economic conditions deteriorate more than expected. The situation today is relatively good for meeting IMF requirements, given existing risks of worse-than-expected growth. We believe an agreement will be reached late in 2011 and that this year's budget deficit will fall to just above 3 per cent of GDP. **Cost-cutting will be required in the next couple of years** and the deficit will continue downward towards 2 per cent of GDP in 2013.

The domestic political situation remains complicated. Politicians are positioning themselves for the October 2012 parliamentary election. The confrontation between the government and the opposition continues, election rules are not yet in place and gas price talks between Ukraine and Russia have again created a tense situation. Charges against former Prime Minister Yulia Tymoshenko for allegedly exceeding her authority when she signed a gas agreement with Russia have damaged Ukraine's reputation. She says that the charges are politically motivated. After a pause, her trial has resumed. Yanukovich's ruling Party of Regions has tried to distance itself from the accusations, declaring that legislative reforms could resolve the situation. This may be an attempt to end the conflict without losing face. The Tymoshenko trial and gas-related problems with Russia are hurting Ukraine's chances of reaching agreement on an association and free trade treaty with the EU.

## Key economic data

### ESTONIA

	2006	2007	2008	2009	2010	2011(f)	2012(f)	2013(f)
GDP, %	10.1	7.5	-3.7	-14.3	2.3	6.5	3.0	4.0
Inflation, HICP, average, %	4.4	6.7	10.6	0.2	2.7	5.3	5.0	6.0
Unemployment, %	5.9	4.7	5.5	13.8	16.9	13.3	13.0	12.0
Current account, % of GDP	-15.3	-15.9	-9.7	3.7	3.6	0.0	-1.0	-2.0
Public sector financial balance, % of GDP	2.4	2.5	-2.8	-1.7	0.1	0.2	-2.0	0.0
Public sector debt, % of GDP	4.4	3.7	4.6	7.2	6.6	6.0	6.0	6.0
3-month interest rate, eop	3.8	7.2	7.8	3.3	1.1	1.6	1.6	2.1

### LATVIA

	2006	2007	2008	2009	2010	2011(f)	2012(f)	2013(f)
GDP, %	12.2	10.0	-4.2	-18.0	-0.3	4.4	3.5	4.5
Inflation, HICP, average, %	6.6	10.1	15.3	3.3	-1.2	4.4	2.8	2.5
Unemployment, %	6.8	6.0	7.5	16.9	18.7	16.1	14.2	12.1
Current account, % of GDP	-22.6	-22.4	-13.1	8.6	3.0	-0.8	-2.2	-3.0
Public sector financial balance, % of GDP	-0.5	-0.3	-4.2	-9.6	-7.6	-4.5	-2.6	-2.2
Public sector debt, % of GDP	10.7	9.0	19.7	36.7	44.7	45.3	44.2	42.3
EUR/LVL, eop	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7
Key rate, eop	5.0	6.5	6.0	4.0	3.5	3.5	3.5	4.0

### LITHUANIA

	2006	2007	2008	2009	2010	2011(f)	2012(f)	2013(f)
GDP, %	7.8	9.8	2.9	-14.8	1.4	6.5	4.0	4.5
Inflation, HICP, average, %	3.8	5.8	11.1	4.2	1.2	4.0	3.5	3.5
Unemployment, %	5.6	4.3	5.8	13.7	17.8	15.0	13.0	10.0
Current account, % of GDP	-10.6	-14.5	-13.0	4.3	1.5	-3.0	-5.0	-6.0
Public sector financial balance, % of GDP	-0.4	-1.0	-3.3	-9.2	-7.1	-4.5	-3.0	-2.8
Public sector debt, % of GDP	17.9	16.8	15.5	29.4	38.0	38.0	38.0	38.0
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	3.79	6.65	9.89	3.90	1.50	1.90	1.90	2.50
5-year government bond, eop	3.90	4.80	13.10	6.60	4.60	4.20	4.60	5.00

(f) = forecast, eop = end of period.

**POLAND**

	2006	2007	2008	2009	2010	2011(f)	2012(f)	2013(f)
GDP, %	6.2	6.8	5.1	1.6	3.8	4.0	3.4	4.0
Inflation, HICP, average, %	1.3	2.6	4.2	4.0	2.7	4.0	2.8	2.6
Unemployment, %	13.9	9.6	7.1	8.2	9.6	9.3	9.2	9.0
Current account, % of GDP	-3.8	-6.2	-6.6	-4.0	-4.5	-4.4	-4.6	-4.0
Public sector financial balance, % of GDP	-3.6	-1.9	-3.7	-7.3	-7.9	-5.5	-3.9	-3.1
Public sector debt, % of GDP	47.7	45.0	47.1	50.9	55.0	55.0	54.0	53.0
EUR/PLN, end of period	3.8	3.6	4.1	4.1	4.0	4.3	4.0	3.8
Key rate, eop	4.00	5.25	4.00	3.50	3.75	4.50	4.00	4.25
5-year government bond, eop	4.98	6.13	5.34	5.91	5.52	4.30	4.70	5.10

**RUSSIA**

	2006	2007	2008	2009	2010	2011(f)	2012(f)	2013(f)
GDP, %	8.2	8.5	5.2	-7.8	4.0	4.3	4.2	4.2
Inflation, average %	9.7	9.0	14.1	11.7	6.9	8.6	7.3	6.8
Unemployment, %	7.2	6.1	6.4	8.4	7.5	6.5	6.2	6.0
Current account, % of GDP	9.5	5.9	6.2	4.1	4.8	5.5	3.6	2.3
Public sector financial balance, % of GDP	8.1	6.0	4.9	-6.3	-3.5	-1.0	-1.5	-1.5
Public sector debt, % of GDP	9.0	8.5	7.9	11.0	11.7	12.0	13.0	13.0
USD/RUB, eop	26.32	24.57	30.53	30.31	30.57	31.70	28.70	28.4
Rouble vs. euro/dollar basket, eop	30.1	29.7	35.4	36.1	35.2	37.1	34.5	33.5

**UKRAINE**

	2006	2007	2008	2009	2010	2011(f)	2012(f)	2013(f)
GDP, %	7.4	7.6	2.3	-14.8	4.2	4.3	4.0	4.5
Inflation, average, %	9.1	12.8	25.2	15.9	9.4	10.0	9.0	8.5
Unemployment, %	6.8	6.4	6.4	8.8	8.1	7.9	7.5	7.3
Current account, % of GDP	-1.5	-3.7	-7.1	-1.5	-2.1	-3.1	-4.0	-4.0
Public sector financial balance, % of GDP	-1.4	-2.0	-3.2	-6.3	-5.7	-3.5	-2.5	-2.0
Public sector debt, % of GDP	14.8	12.3	12.3	35.4	40.1	40.5	40.0	40.0
USD/UAH, eop	5.05	5.05	7.80	8.00	7.97	8.00	8.00	8.00

(f) = forecast, eop = end of period.

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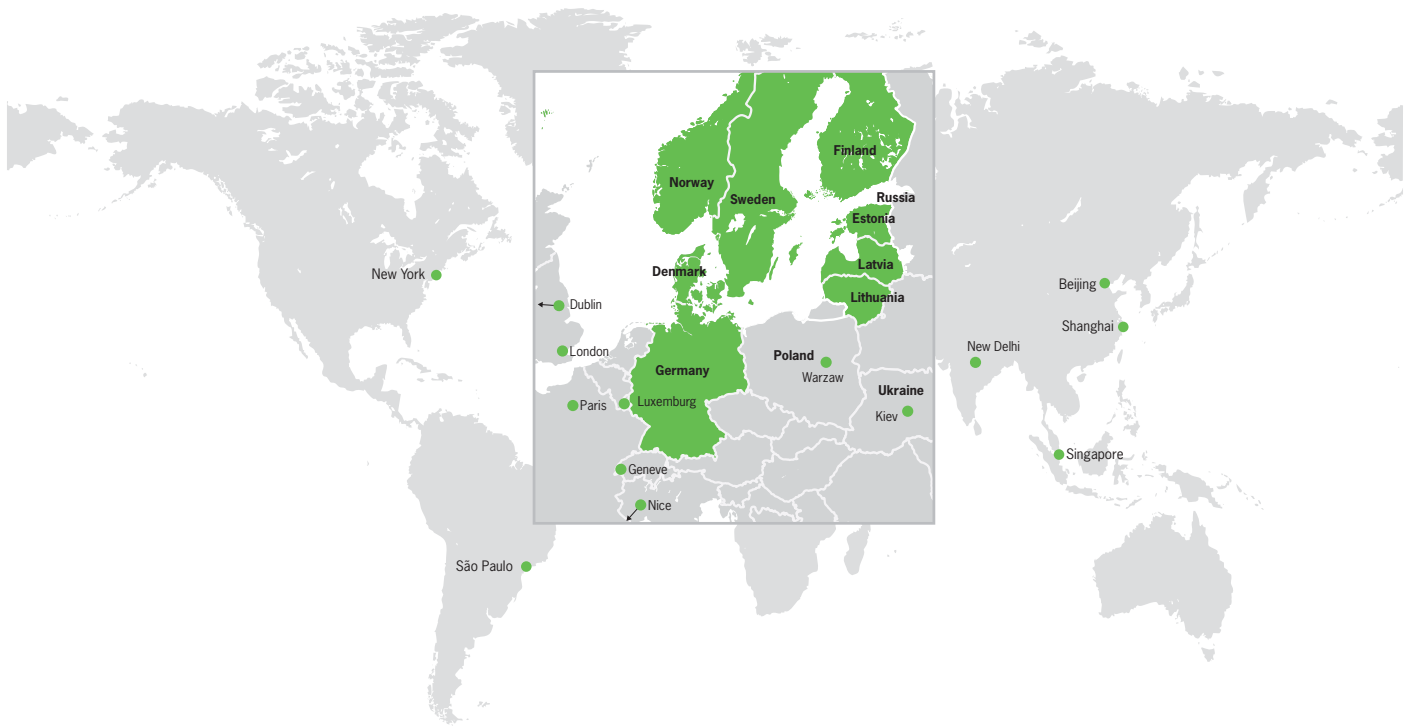
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