SEB

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PRESS RELEASE

Eastern European Outlook: Deep recession – financial fragility

Eastern Europe is the region being hardest hit by the global credit crunch and recession. The reason is that the vigorous expansion of recent years has largely been built on foreign loans. Consequently, growth also fell precipitously when financing conditions drastically deteriorated. The economic downturn will now deepen further, SEB predicts in its April 2009 issue of *Eastern European Outlook*.

During 2009, GDP will decline sharply in four of the six countries in the Central and Eastern European region covered in this report: Estonia, Latvia, Lithuania and Ukraine. In Poland and Russia, the downturn will be more moderate, thanks to relatively good fundamentals. Only in 2010 will these economies stabilise, but GDP will continue to fall in the three Baltic countries and Ukraine. Current account deficits, which are large in several of these countries, will shrink greatly in the wake of collapsing imports. Inflation will also fall sharply but remain at high levels in Russia and Ukraine.

Because of major economic imbalances at the outset, the countries of Central and Eastern Europe remain vulnerable in terms of their financing needs. The currencies of Russia, Ukraine and Poland will weaken somewhat further in the short term due to downward adjustments in growth forecasts for the region, as well as a global decline in risk appetite.

Russia is moving into a recession despite massive economic stimulus measures. The twin surpluses in the federal budget and the current account will turn into twin deficits.

In the Baltics, governments will continue their painful austerity policies. There may be further budget cutting. Economic imbalances are being adjusted by slashing wages and prices, so-called internal devaluation.

"Our main scenario is that the currency pegs of the Baltic countries will survive. These countries will receive continued international backing from the IMF and EU. We expect the IMF to accept a somewhat larger budget deficit in Latvia and expect the IMF programme to remain in operation," says Mikael Johansson of SEB Economic Research, Chief Editor of ***Eastern European Outlook***.

In Lithuania, which has managed so far without IMF/EU aid, the need for a support package is increasing. In Ukraine, we assume that the IMF will resume its aid. Political developments in Ukraine will remain shaky, and there is continued financial systemic risk.

The issue of joining the euro zone is being raised once again in Central and Eastern Europe. Estonia's new target date for membership, July 2010, is within reach based on an economic assessment, but when all is said and done, the decision is a political one within the EU. We expect Latvia to adopt the euro in 2012 at the earliest. Lithuania is aiming at 2011-2012 but SEB believes accession will not happen before 2013. As for Poland, our assessment is that the government is too optimistic about its euro timetable and will be forced to postpone its membership target from 2012 to 2013 due to a swelling budget deficit. In addition, the zloty's accession to the exchange rate mechanism ERM2 will be postponed from the first half of this year to the end of 2009 at the earliest.

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