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Eastern European Outlook

Deep recession - financial fragility

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Eastern European Outlook - April 2009

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Eastern Europe is the region being hardest hit by the global credit crisis and recession. The reason is that the vigorous expansion of recent years has largely been built on foreign loans, and consequently growth fell precipitously when financing conditions drastically deteriorated.

The economic downturn is now deepening further. 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 downturns will be more moderate, thanks to relatively good fundamentals. Only next year 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, since we anticipate 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. Our assessment is also that these countries will receive continued international backing (from the IMF and EU) for their fixed exchange rates. We expect the IMF to accept a somewhat larger government budget deficit in Latvia, which has already received bail-out loans. In Lithuania, the need for an IMF/EU 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 we believe euro zone 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 menbership 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.

The international economy

Deeper recession

- **Synchronised economic slowdown**
- **Eastern Europe hardest hit**
- **Import slide improves current account deficits**

The global economic outlook has turned even darker in recent months. Final fourth quarter 2008 statistics showed surprisingly large GDP declines in many countries, which means low starting values when forecasting 2009. During the winter, continued drastic declines in industrial production and exports have also signalled that downward pressure will continue.

In light of these trends, we have now made downward adjustments in our February forecast from *Nordic Outlook*, which was already more pessimistic than the consensus. For example, we have lowered euro zone GDP growth in 2009 from -2.5 to -3.6 per cent. We expect world GDP (purchasing power parities) to fall by 1.5 per cent this year, twice our previous forecast. Gigantic economic stimulus packages, still being launched in some countries, are incapable of stopping the downturn but will help stabilise production by early next year. We still expect a mild recovery, with weakly positive growth figures in 2010.

Global economic highlights

GDP: Year-on-year percentage change

	2007	2008	2009	2010
United States	2.0	1.1	-3.4	0.7
Euro zone	2.7	0.7	-3.6	0.0
Eastern Europe	7.4	4.5	-5.2	0.6
The world (PPP)	5.0	3.2	-1.5	1.4
Oil, USD/barrel	72.9	97.2	40.0	45.0
EUR/USD, Dec.	1.46	1.40	1.20	1.40

Source: SEB

The basic reason for our cautious economic view is that adjustments after extreme debt build-ups and financial crises take a long time. Historical experience says it will be several years. This time there are large balance sheet adjustment needs, mainly in the household and financial sectors, in such major economies as the US and UK. We also assume that home prices will continue downward during 2009.

In our scenario, GDP growth will end up clearly below trend in most parts of the world next year as well. This means that unemployment will also continue to climb in the course of 2010, to an average of more than 10 per cent in both the US and the euro zone. Weak demand combined with stimulus packages will also result in larger budget deficits than expected today.

Eastern Europe is the region being hit hardest by the global credit crisis and recession. One major reason is the expansion of foreign currency borrowing in recent years. A continued tightening of credit and more expensive foreign loans due to the depreciation of local currencies – which will continue for another while – will have a clear negative impact on investments and consumption this year.

Countries with large foreign refinancing needs and current account deficits are extra vulnerable to tighter credit conditions. This applies especially to Ukraine, the three Baltic countries, Hungary and the Balkan region, although loans from the International Monetary Fund, the European Union and individual EU countries will substantially ease loan payments and prop up banking systems. We believe that with the exception of Russia, current account deficits will generally shrink between 2008 and 2010, due to sharply falling imports and depreciating currencies.

The Eastern European region can generally be divided into three risk categories:

- ***Worst affected***. The Baltics, Ukraine, Hungary and the Balkans. Characteristics: Large external imbalances. Large financing needs after explosive credit growth in some cases. Relatively high share of total borrowing denominated in foreign currencies.
- ***Prudent***. Such Central European countries as Poland, Slovakia and the Czech Republic, with decent fundamentals. Moderate external imbalances. Rapid build-up of private indebtedness but with a modest share of total borrowing denominated in foreign currencies.
- ***Russia.*** Strong initial fundamentals, twin surpluses even in 2008. Rapid build-up of private indebtedness but with a modest share of total borrowing in foreign currencies.

GDP in nine countries of the region (this report focuses on six of them) will fall by 5.2 per cent in 2009 and climb somewhat in 2010. This represents a significant downturn from growth of 7.4 per cent in 2007 and 4.5 per cent in 2008.

Exports, which plummeted late in 2008, will remain weak, with the slump in Germany and the rest of the euro zone imposing a particular extra burden on Central Europe. The competitive advantages created by currency depreciation will take some time to have an effect, since international demand is now anaemic, but should provide some help to growth and the current account in 2010. Lower energy prices and more stable food prices have cushioned the decline for many households in Central and Eastern Europe, where these items weigh heavier than in the West. Inflation pressure is quickly fading due to weak demand. We believe that oil and other commodity prices will rise slightly on average during our forecast period.

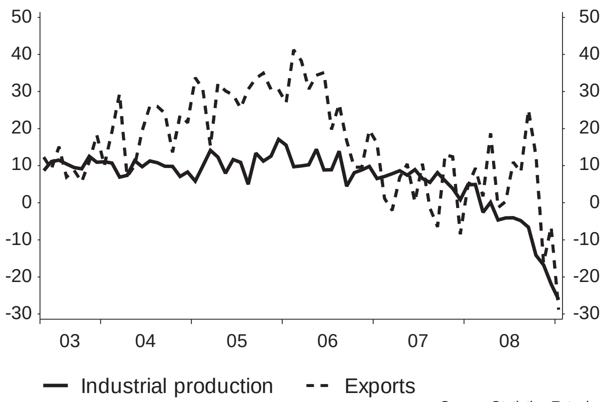
Euro within reach by 2010 – politics will decide

- **Deep, lengthy recession**
- **Domestic demand rapidly contracting**
- **Deflationary adjustment**

Estonia has slid into a deep recession, which will be long-lasting. The main forces driving negative growth are a contraction of domestic demand and, since late 2008, a very sharp decline in external demand. The downward spiral has been accelerated by tighter monetary conditions, a credit crunch and mounting uncertainty. These factors will remain dominant during the rest of the year. We expect GDP to shrink by 12 per cent in 2009 and by 2.3 per cent in 2010.

Estonia: Industrial production and exports

Year-on-year percentage change



Source: Statistics Estonia

The adjustment process is now clearly visible, and the economy is showing flexibility. Imbalances that had accumulated during the boom years have rapidly receded. The current account deficit has come down to sustainable levels and is being covered by the inflow of EU structural funds. The economy is adjusting in a deflationary way – a path supported both by entrepreneurs and the government. Estonia's competitiveness, which has eroded in the last couple of years, will probably have to be regained through price reductions.

In order to reduce prices, companies must also cut wages and salaries. Many have already done so, especially in construction but also other industries, by 10-30 per cent. Wage reductions are a more appropriate means of adjustment than currency devaluation, since it is away of correcting imbalances in pay structures. The risk of devaluation has decreased somewhat but is still causing concern among some foreign investors. Meanwhile confidence in the kroon is very high domestically. Our main scenario is still no currency devaluation, but instead an "internal devaluation". In 2006 unskilled construction workers were being paid more than many university graduates in other sectors. Today it is obvious that construction wage cuts will be among the biggest and earliest, whereas teachers and health care workers are still receiving pay hikes.

Because the mismatches in productivity and wage growth lasted for at least three years, the wage adjustment period can also be expected to be quite lengthy. So far, productivity is down sharply due to the decline in volume, while adjustments in the labour market have lagged. Negative wage growth is one way of correcting the imbalances. Cost cutting at companies will take place both by means of lay-offs and pay cuts, so the impact of each will be less severe than otherwise.

The most pronounced discrepancies between productivity and pay increases occurred in construction, agriculture, retailing, transport and manufacturing. The latter is the only sector that has managed to bring these into better balance. In the other four sectors, wage and salary cuts have been too slow and productivity is still plummeting. At some point, after massive lay-offs, productivity will start to rise again and pay increases will lag for a while. In 2009, we expect wages and salaries to fall by about 7-9 per cent on average, followed by zero growth in 2010. In some of the above-mentioned sectors the decline will probably be more pronounced, whereas in the public sector, pay hikes may continue, easing the overall average decline. Once private sector pay has fallen, after a lag this will probably trigger adjustments in the public sector as well.

The public sector also supports a deflationary path. Officials abandoned a previously planned heating price hike and instead cut heating prices at the beginning of 2009. That opened the door for a quick decline in inflation, which will probably turn into deflation during the second half. Falling external prices and pay cuts are reinforcing deflationary tendencies and the decline in consumption. We expect inflation to average around 0.7 per cent this year and 1.5 per cent in 2010.

New euro target

In recent months, Prime Minister Andrus Ansip has declared a new target for euro adoption: July 2010. The government is supportive of deflationary adjustments because, as early as the end of 2009, they could help Estonia meet the Maastricht inflation criterion for joining the euro zone. According to this criterion inflation must not be higher than 1.5 percentage point above average for the 3 EU countries with the lowest inflation. The government is planning to ask for an extra EU evaluation late this year, when the country might conceivably fulfil all the Maastricht criteria, but EU officials responded in mid-March that euro adoption in 2011 would be more realistic.

The government views membership of the euro zone as crucial in efforts to mitigate the current recession, since it would significantly reduce currency-related uncertainties. But Estonia's recovery will also depend on how quickly the economy can restore its competitiveness. Adjustments to the economy, forced productivity improvements and potential euro adoption would put the country in a very favourable position, once the global economy bounces back.

In order to fulfil the Maastricht criterion of a fiscal deficit not exceeding 3 per cent of GDP, the government must keep a close eye on its budget expenditures. Meanwhile tax revenue has collapsed due to the recession. Substantial cuts in the 2009 budget have already been made, reducing the deficit by EEK 8 billion, but further cuts may become necessary. It will be very difficult to keep the deficit below 3 per cent of GDP, but technically it will be possible to fulfil the criterion if the EU's assessment occurs at the end of 2009. The budget deficit under evaluation will be that of 2008, which was 3 per cent. If the evaluation takes place in the spring of 2010, the deficit under evaluation will be that of 2009. In the latter case, the adoption of euro would take effect from January 2011. If necessary, the government will make further budget cuts in the second half of 2009.

If the downturn turns out to be much more steeper than expected, that of course might change. Then the necessary amount of cuts would be too big and a painful. So if Estonia would not be accepted as euro member in 2010 July then the government probably postpones to 2012.

The government's main stimulus measure has been to borrow EUR 550 million from the European Investment Bank (EIB) in order to co-finance EU projects. It is also planning guarantee packages for small and medium-sized exporters.

Consumers are saving

Tighter monetary conditions are restricting new credit growth, which is holding back both investments and consumption. Interest rates on newly granted loans are higher. But for existing loans, which are mainly in euros, the sharp fall in EUR interest rates has significantly eased the debt burden of many consumers. In spite of this, a higher household saving ratio is likely to dampen private consumption volume even more. Because of growing uncertainty among consumers, they are increasingly inclined to save.

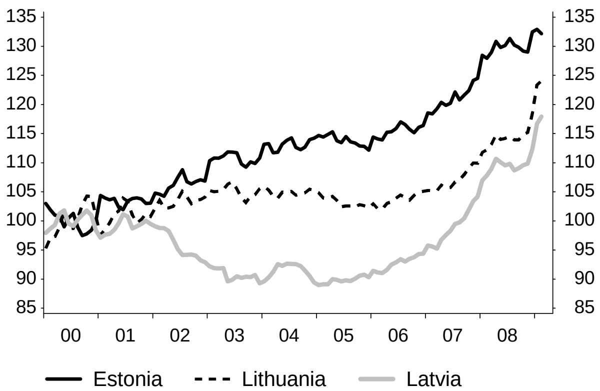
During the last boom period, consumption was largely sustained by borrowing. Today the process is being reversed. Consumers are trying to achieve healthier balance sheets, thereby accelerating the decline in consumption. Because of pay cuts, average consumer income is likely to fall, even though pensions will increase and other transfer payments will remain stable. Real wages fell as early as the fourth quarter of 2008 and are expected to continue falling. Unemployment has increased rapidly since the second half of 2008 and will average around 12 per cent in 2009. Retail sales will decrease by 10.5 per cent in 2009 but stabilise next year.

Investment was down 24 per cent year-on-year in the fourth quarter of 2008. We expect it to continue falling sharply, since it is usually among the most sensitive components of economic cycles. The investment downturn is being accelerated by the global credit crunch and the de-leveraging process.

Late in 2008 and early in 2009, there was a dramatic fall in exports. The slump in external demand occurred suddenly. Industrial production was down 26 per cent in January, while merchandise exports dropped 28 per cent. Service exports have been more resilient. The current export decline is mostly due to demand contraction, and not so much to the price competitiveness issue. The real exchange rate has appreciated further in the wake of large depreciations in some of Estonia's exports markets. We forecast that exports will decline by more than 20 per cent in 2009. Even so, Estonia's current account deficit will shrink to 3-4 per cent of GDP this year.

Real effective exchange rates

Index 100 = 2000, until February 2009



Source: BIS

The real estate market is hitting new lows in terms of transaction volume and prices every month. By early 2009, the average price of a flat was down 40 per cent from the peak in the second quarter of 2007. We expect further price declines of about 15-20 per cent, potentially continuing for a couple of years more.

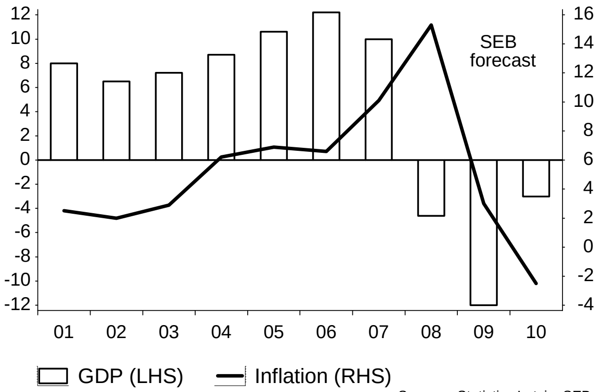
Crisis wiping out imbalances

- **Severe recession**
- **Further budget cuts to come**
- **IMF accepting larger budget deficit**

Fuelled by the global financial and economic crisis, during the past year the Latvian economy has undergone a sharp downturn and correction. GDP, exports and lending are decreasing and unemployment is climbing swiftly. Latvia is abandoning many ambitions from the years when it was one of the fastest-growing economies in the EU. GDP is expected to contract by 12 per cent in 2009 and 3 per cent next year, and the economy is quickly heading towards deflation.

Latvia: GDP and inflation

Year-on-year percentage change



Sources: Statistics Latvia, SEB

In December 2008, Latvia had to seek a bail-out of EUR 7.5 billion from the IMF, EU and other lenders in order to stabilise its macroeconomic situation, cover the budget deficit and stabilise the banking system. As a condition for receiving this financial aid, Latvia agreed to carry out adjustment measures. The main focus is on a strict austerity program by means of public expenditure cuts, aiming at internal devaluation. The country will maintain its exchange rate peg. Despite recurrent rumours about a possible devaluation of the lats, officials firmly believe that this would not be the right way to improve Latvia's export potential. The global downturn has weakened external demand substantially, and virtually every country is experiencing lower exports.

The heaviest strain on the budget was the government's decision to take over the ailing Parex Banka last autumn. Latvia's second largest bank experienced a sudden capital drain and was forced to seek assistance in order to avoid insolvency. To support the failing bank, the government decided to take over a controlling stake. Parex is repaying its international syndicated lenders in instalments over a two-year period. The government intends to sell the bank at a later date, but the European Bank for Reconstruction and Development (EBRD) has said it is willing to invest EUR 100 million in Parex, with the aim of acquiring a 25 per cent stake plus one share.

Declining revenue has widened the government's projected budget deficit to almost 10 per cent of GDP, raising the threat that it will quickly run out of money if further expenditure cuts are not made. The IMF-led rescue plan stipulates that the budget deficit should be kept below 5 per cent of GDP this year. But the new government led by Prime Minister Valdis Dombrovskis wants to raise the deficit ceiling to 7.0 per cent, due to the worsening economic situation both in Latvia and globally. The IMF has agreed to allow the government to postpone a new budget until June. We expect the IMF to accept a deficit of 6-7 per cent. The government needs to push through budget cuts and get permission from all international donors to widen its budget deficit or face the risk of default. In February, financial stability was boosted by an injection of EUR 1 billion from the European Commission. Nearly one third of current government spending now consists of borrowed funds.

Before resigning in late February, the Ivars Godmanis government had already drawn up plans to reduce expenditures by up to 20 per cent, but with the economy contracting faster than expected, the new government may have to cut even more. This would include at least another 15-20 per cent salary reduction in the public sector and cuts in social programs, excluding pensions. These measures are not popular, and there are widespread calls for a fundamental restructuring of the central government. Latvia is scheduled to receive the next instalment of its international loan in April and a larger sum in July. Although Latvia has suffered damage due to lower sovereign debt ratings and weaker investor confidence, the fact that the country has agreements with the IMF and EU and is strongly committed to restructuring the economy and state bureaucracy point towards an eventual recovery – but it will take time.

Simultaneous double shock

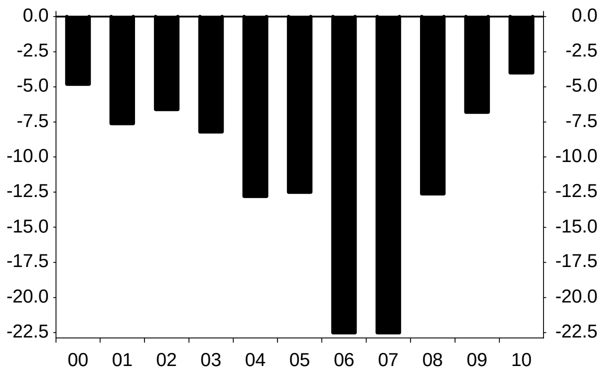
The Latvian economy is facing a double shock, domestic and international. The real estate boom began to slow early last year and then went into a full meltdown as global growth came to a shuddering halt. Domestic demand and the manufacturing sector face a severe downturn.

In the fourth quarter of 2008, GDP plummeted 10.3 per cent year-on-year. For the year as a whole, GDP fell by 4.6 per cent. Industrial output declined by 8 percent in 2008 and will shrink by another 15 per cent this year, reaching the levels of 2004 or 2005. After years of enormous growth in the retail sector, retail sales are falling towards real purchasing power. In January, retail sales were down 20 per cent.

But for the first time since 2000, the current account balance was positive in January. Exports were down by 25.3 per cent and imports by 36.1 per cent. The decline in exports was due to both lower prices and decreasing volume. In 2008, imports of consumer goods declined 1 per cent and imports of capital goods fell 22 per cent. We expect the fall in imports to outweigh that of exports in 2009. In 2008 Latvia's current account deficit averaged 13.2 per cent of GDP, but this year it is likely to shrink to 6.8 per cent of GDP.

Latvia: Current account

Per cent of GDP



Source: Bank of Latvia

Unemployment is surging and is likely to grow to 15 per cent in 2009 and then decrease to 13 per cent in 2010. The government plans to extend unemployment benefits from a maximum of six months to nine months, meaning it will need to seek addition funds for social expenditures. The previous heavy outflow of labour to other EU countries has almost stopped. Nominal wage growth continued to slow in 2008, showing a 12 per cent year-on-year increase in the fourth quarter, compared to 20-30 per cent in 2006-2008. We expect a sharp decrease in remuneration in both the private and public sectors and negative real wage growth during the next two years. Actual pay cuts will be larger than reflected in statistics for average remuneration, since the latter also includes one-time severance payments.

Deflation getting closer

Inflation is behaving in line with our forecasts. In May 2008, the inflation rate peaked at close to 18 per cent and then began a steady downward trend. By January 2009 the year-on-year change in the consumer price index was back in single digits. CPI inflation in January and February this year reflected value-added tax and excise tax increases aimed at helping plug the widening deficit, but was meanwhile pulled down by steeply declining demand and lower prices for food and household services. The downturn in demand is likely to decelerate inflation further, with deflation a distinct possibility in coming monthly statistics. Our forecast is that despite any monthly deflation figures, the average inflation rate in 2009 rate will stay positive at 3 per cent. In 2010, however, Latvia will see a 2.5 per cent deflation.

Latvia is suffering the consequences of fast growth and irresponsible fiscal policies, including the failure to create reserves for hard times. The 2008 budget deficit exceeded 3 per cent of GDP and thus did not meet the Maastricht criterion for euro adoption. If the government fulfilled the Maastricht criteria, euro zone membership would significantly improve economic stability and facilitate a full economic recovery. This is also a main target of the IMF/EU bail-out. All future fiscal decisions must take the euro issue into account. The actual date of euro adoption will depend largely on the government's ability to improve its budget balance to meet the Maastricht fiscal criterion in time for euro adoption in 2012. From an inflation standpoint, Latvia would be able to adopt the euro as early as 2011.

Broader support in parliament

In February, the four-party government of Ivars Godmanis resigned after two parties had left the coalition. President Valdis Zatlers asked Valdis Dombrovskis of the opposition New Era party to form a new cabinet as quickly as possible, so as not to leave the country without a functioning government at an extremely challenging time. Dombrovskis formed a government from the four old coalition parties as well as New Era and a smaller centre right group. The parties in his government comprise 64 per cent of parliament, compared to slightly above 50 for the preceding government. The main task of the new government is to secure political stability and prepare budget amendments, while continuing to carry out the measures agreed with the IMF and other creditors. This will necessitate unpopular decisions and will mean that we can expect rising discontent with the government among various groups in Latvian society.

Flexibility is being tested

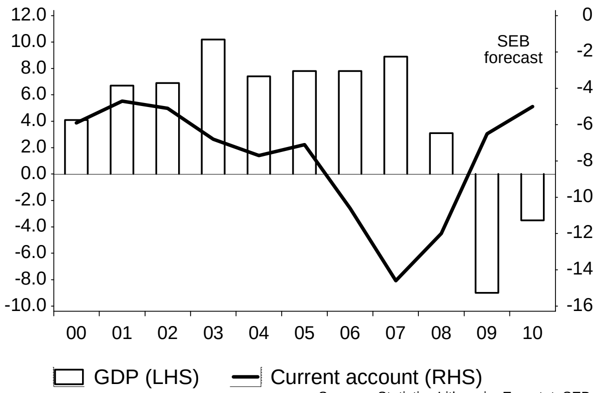
- **GDP decline will accelerate**
- **Wages are being cut**
- **Inflation is likely to fall**

Lithuania has not escaped the global economic storm, and the flexibility of its economy is being put to the test. GDP grew by 3.1 per cent in 2008 but declined in the last quarter of 2008 by 2.0 per cent year-on-year. The GDP decline will accelerate in 2009 as shrinking internal and external demand limit consumption and exports. On the positive side, a sharp fall in imports will significantly reduce the current account deficit. In 2009 downside pressure will be manifested mainly in domestically oriented sectors such as construction, retail trade and transport. But export-led sectors are also being hurt by collapsing demand in major export markets, compounded by currency depreciation in Russia, Poland, Belarus, and Ukraine. Lithuania faces a deep recession; GDP will decline by 9.0 per cent in 2009 and 3.5 per cent in 2010.

Since the decline in tax revenue and the slide of the economy into recession have been quite abrupt, while spending cuts and stimulus efforts will not have an impact quickly enough, the need for an IMF/EU support package is increasing.

Lithuania: GDP and current account

Year-on-year percentage change



Sources: Statistics Lithuania, Eurostat, SEB

Internal demand has imploded since the start of 2009, due to a tax reform (a VAT increase from 18 to 19 per cent, revocation of most VAT subsidies and higher excises on alcohol and fuel), sharply rising unemployment, tighter lending conditions and an increase in administratively established prices. In 2008 as a whole, retail trade registered 4.1 per cent growth, but the situation deteriorated in the last quarter, when sales declined by 8.4 per cent year-on-year. A declining number of real estate deals and stagnating construction are leading to contraction in the production and sales of building materials, furniture and domestic appliances. Falling real estate prices are fuelling expectations for further declines. Residential real estate prices fell by roughly 20 percent in 2008. Home prices could fall by another 20 per cent this year. Industrial production rose by 2.7 per cent in 2008, but excluding refined oil products it declined by 5.0 per cent.

In 2008 exports grew by 28.4 per cent, but in January they fell by 15 per cent year-on-year. Imports declined by a surprising 41 per cent, practically eliminating the foreign trade deficit for the month. Since major exporters (such as producers of refined oil products and fertilisers) have a diversified client base, the decline in exports may be limited to 15-20 per cent in 2009. The narrowing foreign trade shortfall will shrink the current account deficit from 11.6 per cent in 2008 to 6.5 per cent in 2009. This will favourably influence the direction of local-currency interest rates. Fears of a litas devaluation have eased, since politicians and the central bank have rejected such a step and major business groups and exporters have expressed support of the existing currency board policy. Recent figures that confirm the flexibility of wage formation and the almost vanishing foreign trade deficit, along with the government's plans for further cuts in public sector pay and expenditures, also indicate that pressure on the currency will diminish.

While households and businesses have adapted to fast-changing conditions, the new centre-right government of Prime Minister Andrius Kubilius that took office in December 2008 is constrained in its ability to respond in an appropriate and timely manner. The new government swiftly pushed a tax reform package and a 2009 austerity budget through parliament. Hopes that increased indirect taxation would boost budget revenues, while reduced personal income taxes would help households and business to adapt, were dashed by January and February tax collection figures.

Tax revenue during these months missed the government's target by 13.8 per cent. In 2008 the government missed its revenue target by 3.6 per cent, and the fiscal deficit was estimated at 2.9 per cent of GDP. Falling internal demand and a sharp rise in unemployment are hampering VAT and fuel excise collection. Company profits are also declining, and hikes in corporate tax (from 15 to 20 per cent) and dividend tax (from 15 to 26 per cent) will increase incentives to avoid paying these taxes, thereby further shrinking public sector revenue.

The government has prepared a new plan to curb budget expenditure by cutting investments and public sector pay by 10-15 per cent. It also hopes to sell state assets, such as a 10 per cent stake in the Mazeikiu Nafta oil refinery. Nevertheless, we are raising our fiscal deficit forecast to 4.5 per cent of GDP this year and 5.0 per cent in 2010.

In an effort to stimulate business, the government has prepared a spending plan totalling close to 4 per cent of GDP, targeting the construction sector (energy saving measures in Soviet-era housing stock), exporters and small and medium sized enterprises. Funding is expected from a reallocation of EU structural funds and loans from the European Investment Bank and commercial banks.

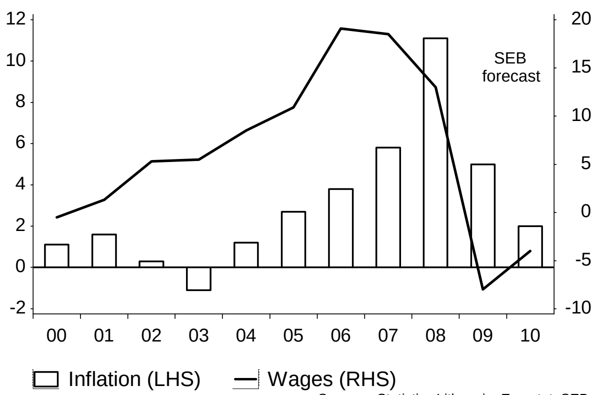
Wage and salary growth going negative

Both nominal and real pay will decline in 2009. In the fourth quarter of 2008, average gross wage growth remained robust at 13 per cent year-on-year. In the private sector, the year-on-year increase was 8.2 per cent. Private sector wage formation in Lithuania is among the most flexible in the EU, according to the latest European Central Bank research. To reduce wage and salary pressure, the private sector is resorting to numerous strategies – cutting bonuses, reducing non-wage benefits, changing work practices, reducing promotion rates and replacing departing workers with lower-paid ones. Lithuania's fragmented trade unions, except those in the public sector, are not in a position to resist these measures effectively. We thus expect nominal wages to decline by 8 per cent in 2009 and by an additional 4 per cent in 2010.

Average HICP inflation reached 11.1 per cent in 2008 but will decline to 5 per cent in 2009 and 2 per cent in 2010. Despite a decline in purchasing power during 2009, prices of consumer goods and services will rise due to tax increases and higher administratively established prices for energy.

Lithuania: Inflation and wages

Year-on-year percentage change



Sources: Statistics Lithuania, Eurostat, SEB

New laws, if approved, would allow energy regulators to review prices more often. Energy prices may thus be lowered this coming autumn, reflecting the international price decline. In 2010, after the closure of the Ignalina nuclear power plant, Lithuania will have to increase its energy imports (mainly from Russia), which will push up electricity prices by 10-15 per cent. The increase will be more modest than previously estimated, due to declining natural gas prices, and will thus contribute only marginally to cost side inflationary pressure, but it will still hurt the competitiveness of Lithuanian manufacturers.

Lower credit growth

In 2008, bank assets grew by 10.9 per cent and loan portfolios by 18.9 per cent compared to 2007. This was the slowest growth in several years. Deposits in domestic banks fell by 4.7 per cent.

Worsening economic sentiment, tighter lending conditions and expectations of a continued correction in the real estate market will reduce appetite for new loans. Lower demand for loans and increasing provisions for bad loans will reduce the loan portfolio in the banking sector by 4 per cent in 2009. The loan portfolio will stay flat in 2010. New loans that will be used to co-finance EU structural projects, especially in infrastructure and energy, should help to offset the contraction of loans in other sectors. Thus the gap between loans and deposit growth will disappear, temporarily removing the need for additional liquidity from foreign parent banks.

Support for early euro adoption

Political support for early euro adoption in Lithuania is growing, stressing the point that in countries with strong fiscal policies and flexible economic structures, the closer trade and financial integration conferred by euro zone membership would hasten real convergence and help overcome the current economic crisis. While the government hopes that the country will be ready by 2011 or 2012, we believe that the budget deficit will be an obstacle to euro adoption before 2013.

Cannot escape recession

- **Moderate imbalances**
- **Further interest rate cuts – zloty fragile**
- **Euro zone accession target postponed to 2013**

The Polish economy is clearly decelerating, but thanks to relatively good fundamentals it will cope with international strains better than many other countries in Central and Eastern Europe. GDP growth will fall from 4.8 per cent last year to minus 2.5 per cent this year. The global recession and credit crunch will lead to declining exports and investments. Private consumption will continue to buoy the economy, though the rate of increase will slow clearly. Next year there will be a degree of recovery on all fronts, and GDP will grow by 1.0 per cent. Over time, the large depreciation of the zloty will fuel Polish exports.

Several factors indicate that the cyclical downturn in Poland will be milder than in most other parts of Central and Eastern Europe:

- The current account deficit is moderate. It was 5.3 per cent of GDP in 2008. In the wake of falling imports and a weakening currency, we expect that it will shrink to 3.5 per cent next year. This can be compared to deficits of 7 per cent in Hungary, some 9-13 per cent in the Baltics and about 15-20 per cent in Romania and Bulgaria. Poland's is thus not in as sensitive a position in seeking to fund its deficit as foreign direct investment in the region weakens.
- The share of total debt denominated in currencies other than the zloty is moderate, though Polish households and companies also increased their foreign loans in the past few years. Notably, 60-70 per cent of home mortgage loans are in foreign currencies, primarily Swiss francs. Switzerland's deliberate "devaluation policy" of recent months has thus eased the pressure on foreign currency-exposed households. However, foreign currency loans account for a lower share of Poland's total borrowings, about 30 per cent. This is on a par with Russia, as compared to more than 50 per cent in Ukraine, Bulgaria and Romania; 60-70 per cent in Hungary and Lithuania; and as much as 80-90 per cent in Estonia and Latvia. In the Czech Republic, a mere 15-20 per cent of loans is reported to be in foreign currencies. Overall, Poland is not equally exposed to the currency depreciations that have swept across Central and Eastern Europe.
- The Polish economy is less open than its neighbours. Exports are equivalent to about 40 per cent of GDP – low compared to other countries in the region. The Czech Republic and Hungary, for example, report 60-70 per cent.

However, Poland is sensitive to the credit crunch and crowding out. Short-term foreign debt is larger than the currency reserve. Polish banks and companies will not be able to roll over all their foreign loans when they mature. This will hamper investments and consumption.

Continued weakening

The deceleration has also assumed the nature of a soft landing. Year-on-year GDP growth slowed from 4.8 per cent to 3 per cent between the third and fourth quarter of 2008 – in contrast to the severe GDP declines in many other countries of the world.

Yet there is no doubt that the slowdown will continue. Confidence indicators have generally fallen since last summer. In recent months, the construction industry index has demonstrated sharp downturns, while there has been some stabilisation at a historically low level for the manufacturing sector index, as in other countries. Household confidence indicators have continued to point steeply downward, but they were even lower in the early years of this decade.

Industrial output has continued to fall, by about 15 per cent year on year during January and February. This reflects a sustained downturn in exports. Demand in key Western European markets (Germany accounts for about a fourth of Polish exports) and in Russia has fallen rapidly. Engineering exports such as steel and cars have been squeezed hard. Not until next year will the export outlook brighten.

Consumption will slow sharply

In recent years, private consumption and investments have become increasingly influential driving forces. Consumption has benefited from rapid job creation, higher real wages and a credit expansion.

Today and in the near future, households face a more daunting economic climate. Unemployment, which bottomed out at 8.8 per cent last October (the lowest since 1991) rose to 10.9 per cent in January. The negative trend is continuing. The number of job vacancies has fallen sharply in the past six months. Both manufacturing (in particular) and service sector companies are planning continued employee cutbacks. In addition, Poles returning home after the emigration wave of recent years – when at least a million people left for jobs in the West, especially the UK – are also pushing up unemployment. The jobless rate will average 14 per cent this year and 16 per cent in 2010. This will slow the rapid rate of pay increases.

But due to clearly lower inflation, households can count on continued decent increases in real income. Also sustaining real income will be favourable changes in income tax brackets, pensions and disability benefits.

Poland

In the past three years, consumption has grown at a stable rate averaging 4.8 per cent yearly. The increases in consumption will now fall to 0.5-1.0 per cent.

The inflation rate fell continually during the second half of 2008, from last summer's peak of nearly 5 per cent to 3.3 per cent in December. For the first time since 2007 inflation was thus also within the central bank's target interval of 2.5 ± 1 percentage point. In recent months there has been a tendency towards stabilisation at this level. This is partly due to administrative price hikes and the price-raising effects of the weakened zloty, for example on food costs, a large item in the index. The impact of currency rates is blunted, however, by weaker demand. Combined with lower pay hikes, this means inflation will be squeezed further downward and end up averaging 2.2 per cent this year and 2.0 per cent in 2010.

On five occasions since November, when it shifted to a more expansive monetary policy, the National Bank of Poland has lowered its key interest rate, bringing it down by 2.25 percentage points to 3.75 per cent. The NBP carried out two large cuts but more recently has reverted to its more normal quarter-point cuts. The reason is probably that the bank has wanted to slow the depreciation of the zloty. Our inflation path makes it possible to continue cutting the key rate to a low of 2.5 per cent late in 2009.

Zloty down the slippery slope

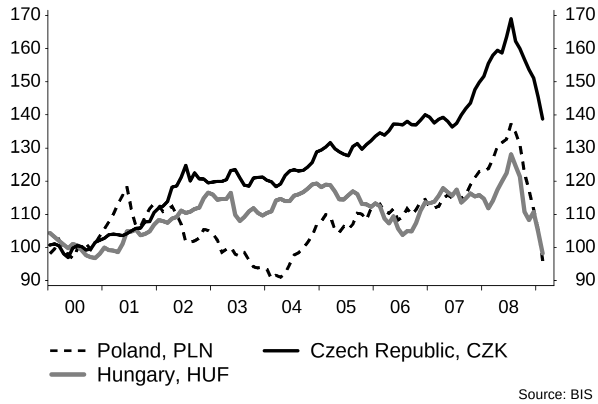
Numerous currencies in Central and Eastern Europe – as well as some in Western Europe like the Swedish krona – have fallen sharply in value since August 2008. The main explanations are reduced global risk appetite, greater focus on external imbalances and relatively aggressive interest rate cuts which, as a whole, have resulted in declining capital and investment flows from abroad.

The zloty has slid by 30 per cent in effective terms, in a "super-depreciation" that the country has not experienced in such a short period for the past 20 years. The zloty's movement has also been clearly larger than in Hungary and the Czech Republic, for example. It dropped from 3.20 per euro to a low of 4.90 per euro in February. This was stressful to both the government and the central bank, which carried out oral interventions. Prime Minister Donald Tusk set PLN 5 per euro as a limit. And for the first time, the NBP joined several other countries in the region (Romania, the Czech Republic and Hungary) in simultaneous statements calling for an end to their currency depreciation. NBP President Slawomir Skrzypek declared that "the macroeconomic situation of Poland does not justify such a scale of zloty weakening."

In our assessment, the zloty – like many other currencies in the region – will suffer new reversals in the short term after its temporary late-winter recovery. A large need for external refinancing and continued large downward revisions of growth prospect will drive EUR/PLN to 5 during the autumn.

Trade-weighted exchange rates

52 countries, index 100 = 2000, until February 2009



Poland's economic policy is generally coloured by the government's target of euro zone accession by 2012. Among other things, this means that the country must meet the criterion of keeping its budget deficit below 3 per cent of GDP as early as 2010. This reduces room for stimulating the economy, now that growth is slowing. Also symptomatic is that Poland is one of the few countries in Europe which has not yet presented any fiscal stimulus programme, beyond the aid extended to the banking system and the credit market last autumn. Our assessment is that certain crisis measures will nonetheless materialise. For the time being, the government is trying to sustain investments by such steps as improved utilisation of EU structural funds. As a consequence of the economic downturn, the budget deficit will climb from 2.5 per cent of GDP last year to 4.5 respectively 4.0 per cent in 2009-2010.

Over time, the government will be forced to postpone its target of euro zone accession until 2013 – a step that would meanwhile be greeted with pleasure by President Lech Kaczinski, who believes that the government is pushing too hard on the euro issue.

The government has not yet abandoned its planned membership in the exchange rate mechanism ERM2 – in which two years of participation with a stable currency are a basic requirement before euro conversion – during the first half of 2009. But given the still-shaky zloty, we expect a postponement until the end of this year at the earliest.

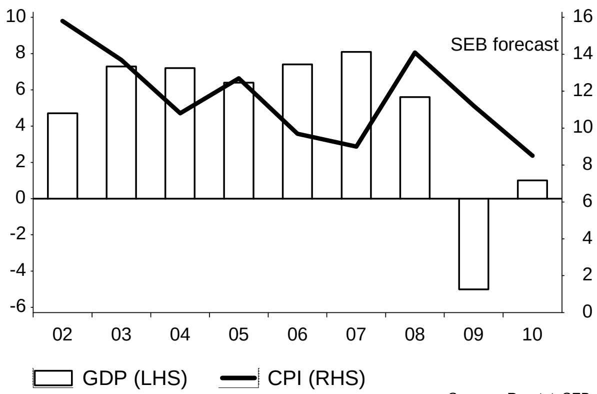
Deep recession despite massive stimulus

- **GDP will fall by 5 per cent this year**
- **Large budget deficit but low debt**
- **Inflation will fall slowly**
- **Renewed pressure on the rouble**

After a decade of strong growth, the Russian economy has entered a deep recession. The combination of a dramatic commodity price decline, sharply lower risk appetite and increased foreign mistrust of Russian government policies has resulted in large capital outflows and pressure on the rouble. The crisis has revealed structural weaknesses in the economy, for example a fragile financial system, while large private sector borrowing abroad has led to significant vulnerability to the global credit market collapse.

Russia: GDP and inflation

Year-on-year percentage change



Sources: Rosstat, SEB

The impact of the crisis on the real economy has become increasingly clear. Indicators are pointing to a GDP decline in the range of 7 per cent during the first quarter of 2009, and unemployment has climbed sharply. **GDP will fall by 5 per cent this year**. The GDP decline will thus be about the same as in the 1998 downturn. Otherwise there are not so many parallels with the late 1990s financial crisis. Russia has a completely different economy now with strong federal government finances, functioning institutions and a much higher level of economic and political stability. The country will see another weak year in 2010. The depreciation of the rouble admittedly provides some help to exports and the part of the economy that competes with imports. Meanwhile international demand remains weak, fiscal policy is becoming more restrictive and investments continue to fall.

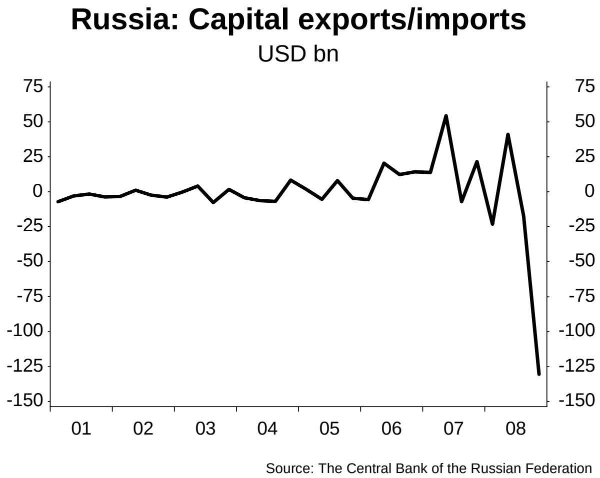
The events of this past autumn and winter have once again demonstrated how dependent on oil prices the Russian economy is. With 2/3 of export income and half of government revenue coming from oil and gas, Russian economic conditions changed dramatically when oil prices fell from USD 140-150/barrel to their recent level of USD 45-50. Current account and budget forecasts have had to be revised drastically downward, the rouble has depreciated by more than a third against the euro/dollar basket and future expectations among households and companies have fallen sharply.

Yet it may seem surprising that the credit crisis has had such a large impact on the Russian economy. Compared to most other emerging economies, Russia seemed to have very good potential for coping with the crisis. Large budget and current account surpluses, nearly non-existent government debt and the world's third largest foreign currency reserve pointed in this direction. For years, the rouble was also seen as a safe harbour. The large inflows of foreign currency that resulted from huge oil export income were reinforced by the growing appetite for foreign loans among Russian companies. Easily available credit, a belief in continued rouble appreciation and high expected returns in the sharply expanding domestic economy drove economic growth. The liberalisation of the capital account in the summer of 2006 spurred even more inflows. The Russian stock market climbed to new record levels and the currency reserve swelled.

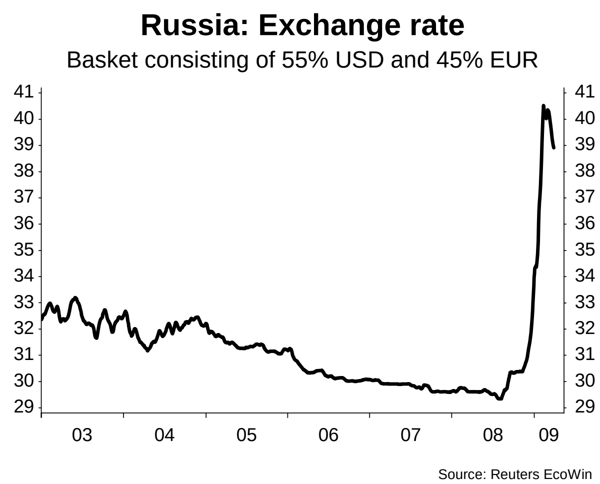
From liquidity boom to credit crunch

The central bank's biggest headache until last summer was avoiding excessively rapid appreciation of the rouble by selling roubles, while ensuring that this liquidity injection did not have too large an inflationary effect. Meanwhile, the bank implemented cautious interest rate hikes to counteract overheating. Monetary policy conditions changed drastically during the summer. Political intervention in the business sphere and the war in Georgia led to clear reassessments of political risk in Russia. Meanwhile oil prices and the stock market began to fall. By the time Lehman Brothers went bankrupt in September 2008, the Moscow Stock Exchange had already lost nearly 50 per cent. Capital was flowing out of the country and the rouble came under pressure.

In a short period, the situation in Russia thus went from liquidity boom to liquidity freeze. The liquidity crisis led to extensive countermeasures by the central bank and the government, based on pure liquidity infusions, loans and recapitalisation of banks and companies, as well as various fiscal relief measures. Aside from various efforts to bolster the financial system, there were massive rouble purchases in order to prop up the currency. The central bank's strategy was to achieve controlled, gradual rouble depreciation to give economic players time to adjust and to avoid a collapse in confidence. This occurred, however, at the cost of a dramatic draining of the foreign currency reserve – from nearly USD 600 billion in August to USD 385 billion including the Stability Fund in late January. At that time, the central bank signalled a new band for the euro/dollar basket and let it be known that it did not intend to tolerate further depreciation, provided oil prices did not weaken substantially.



Since this new monetary policy strategy was introduced, the rouble has been stable. This can probably be ascribed to the stabilisation of commodity prices and the fact that the policy was backed up by interest rate hikes. The defence of the rouble has thus meant that interest rate policy in Russia has diverged from that of most countries, where key rates have been sharply lowered. The future movements of the rouble will now depend greatly on oil prices movements and on the central bank's willingness to back up the exchange rate with further interest rate hikes and/or interventions.



We expect additional growth disappointments in the global economy that may lead to a renewed downturn in oil prices. Since gas prices changes occur with a significant time lag, compared to the recent oil price downturn, it is also likely that Russia's current account will be subject to further pressure ahead. The country must also roll over USD 140 billion in foreign debts during 2009. The cost of defending the rouble, in the form of further interest rate hikes and draining of the currency reserve, may then seem too high. Further depreciation is thus likely, but most of the rouble's adjustment to the dramatic change in the global environment is probably past.

In a somewhat longer-term perspective, the goal remains to let the rouble float freely and switch to an inflation target. The year 2011 was previously mentioned as a conceivable time to do this, but the central bank hardly wants to implement such a change in a situation of strong pressure on the rouble.

The effects of the credit crisis on the real economy were relatively small until the end of the third quarter last year, when GDP was still growing by more than 6 per cent. As the financial crisis deepened during the autumn, however, the impact on the real economy became increasingly apparent. In November, industrial production fell at a year-on-year rate of 10 per cent, and early in 2009 the downturn was more than 20 per cent. The fastest and most obvious effects occurred in typically interest rate-sensitive portions of the economy such as capital spending, construction and purchases of durable goods such as cars, but retail trade was among the sectors that were initially resilient. As recently as October, retail sales were still rising by over 12 per cent year on year, but since then they have fallen sharply. In February, they were down by more than 2 per cent compared to a year earlier.

Household consumption has been an important driving force behind Russia's strong growth in recent years. Annual real wage increases of between 10-15 per cent have helped keep consumption growth stable at a two-digit level. Clear fiscal stimulus measures have also benefited consumption, along with rapid credit growth, but household indebtedness remains low in an international comparison. Due to tighter credit standards, falling asset prices and – above all – a sharp deceleration in wages and salaries, households will now have a couple of tough years ahead. We anticipate that **private consumption will fall this year** and that the recovery will be modest in 2010.

Sharp upturn in unemployment

Income is also being squeezed because the downturn in inflation is relatively sluggish. Add the effects of rising unemployment. In February, the jobless rate reached 8½ per cent – the highest level in four years. Meanwhile the number of lay-off notices rose sharply. Unemployment will climb to an average of 11-12 per cent during the next couple of years. Aside from higher unemployment, income will be squeezed by reduced working hours and lower or unpaid wages in many hard-pressed companies. Households will enjoy some relief from fiscal policy, but stimulus measures will gradually fade as the budget situation deteriorates.

Due to the tight credit situation, capital spending is now hard-pressed, especially in construction. In the fourth quarter of 2008, home prices fell for the first time since 2002, when price measurements began. Unsustainably high home prices, especially in the Moscow region, now face a clear downturn. Due to falling capacity utilisation and waning profits, capital spending plans in manufacturing are also being put on hold. One bright spot in the darkness is government infrastructure spending, which remains a priority area.

Because of postponed investment projects in the energy sector, the weak downward trend in oil and gas exports will accelerate in the future. Unless oil prices recover, this decline in volume will mean that export income from the energy sector will shrink in the next couple of years. Meanwhile import volume is also falling sharply as investments plunge. For example, car imports are collapsing. The decline in imports is being reinforced by the lower rouble and by higher import tariffs. In particular, tariffs on cars have been raised and the government has introduced stimulus measures that apply only to purchases of domestically produced cars. These measures are complicating negotiations on future World Trade Organisation (WTO) membership, which at present seems to be a relatively low priority. Due to the sharply negative import trend, net exports will contribute positively to growth for the first time in six years.

Russia's current account will move from a surplus of nearly 6 per cent of GDP in 2008 to a deficit averaging 2 per cent during 2009 and 2010.

Lower inflation pressure

A number of factors helped fuel rapid inflation during 2008: high money supply growth in the wake of large capital inflows, sharp increases in food and fuel prices and not least, high resource utilisation with low unemployment and rapid wage and salary increases. During the autumn, inflation slowed from 15 per cent to just above 13 per cent. In recent months, the inflation rate has again accelerated somewhat, mainly due to higher import prices after the weakening of the rouble. Over the next six months, some upward pressure on import prices will persist, but weak demand will limit the impact of the rouble depreciation on import prices. Furthermore, in trade-weighted term the weakening of the rouble is only half as large, or about 15 per cent, as its weakening against the euro/dollar basket. Meanwhile inflation pressure from pay increases, which have already slowed sharply, is decreasing. Overall, the inflation rate will fall from an average of 14.1 per cent last year to 11.5 per cent this year.

The government's budget proposal for 2009 includes stimulus measures in the range of 3 per cent of GDP, among other things in the form of lower corporate taxes. In addition, there is major spending in the form of loans and recapitalisation of banks and companies. As the need for capital injections increases, the government has signalled that it will now concentrate on support for the banking sector, whereas rescue actions on behalf of private companies will be a lower priority. This also implies that the government can accept greater foreign influence in Russian industry. Since the banking system is dominated by a few state-controlled banks and the government has sizeable financial resources to shore them up, we believe that systemic risk in the banking sector is limited. This does not, however, rule out a great deal of turbulence as the financial sector consolidates. A number of smaller banks will disappear or be taken over by the government, which will further increase state control of the banking sector.

Due to the combined effect of the oil price decline, falling GDP and new stimulus measures, we expect the budget deficit to reach 8 per cent of GDP this year. At the end of 2008, the government's oil fund totalled USD 225 billion, of which USD 142 billion was in the stabilisation fund and the remaining USD 78 billion in the welfare fund. If the entire budget deficit were covered by withdrawals from the stabilisation fund, ¾ of the fund would be used up this year. The deteriorating budget situation may also lead the government to review some of its investment projects, although the signals so far are that it will not reverse approved expenditures. In 2010 we foresee a substantially more restrictive fiscal policy. Despite budget deficits, public sector debt will remain low.

Greater risks and opportunities

During the period 2003 to 2008, Russia's GDP per capita more than quadrupled from less than USD 3,000 to more than USD 12,000, growing far faster than in any of the other BRIC countries. Thanks to large oil income, political leaders were able to keep Russian voters in a good mood with large expenditure increases, especially in the run-up to the parliamentary election of 2007 and the presidential election of 2008. Russia's economic strength also contributed to its increasingly self-assured international behaviour, which helped the government score domestic political points. Despite the current economic crisis, the political leadership still enjoys relatively widespread confidence, and no large-scale outbursts of dissatisfaction have occurred so far. Support for Prime Minister Vladimir Putin was still at around 75 per cent in February, against more than 80 per cent last September. Putin's strong position has been one factor that has prevented internal conflicts in the power elite. As the economic crisis becomes more apparent, however, it may be more difficult for Putin to distance himself from the problems of the economy, which he also found it easier to do when he was president and not directly in charge of the government. This may lead to increased factional struggles inside the Kremlin. Differences of opinion between the prime minister and president have also highlighted the fact that the division of power between Putin and President Dmitry Medvedev is not entirely uncomplicated.

If the risk of greater political instability has increased, the economic downturn following the oil price decline may also create an opening for reforms and fresh thinking, once the most acute crisis mitigation efforts have been carried out. Russia's large oil income probably helped ease the pressure for new reforms. Earlier crises, for example, have been followed by major political and economic changes. The oil price decline and the economic crisis of the late 1980s paved the way for the fall of communism. The late 1990s crisis was followed by stabilisation and a period of reforms. At the international level, Russia and the United States have already established a more conciliatory tone, after their relations hit a low because of the war in Georgia.

The crisis deepens

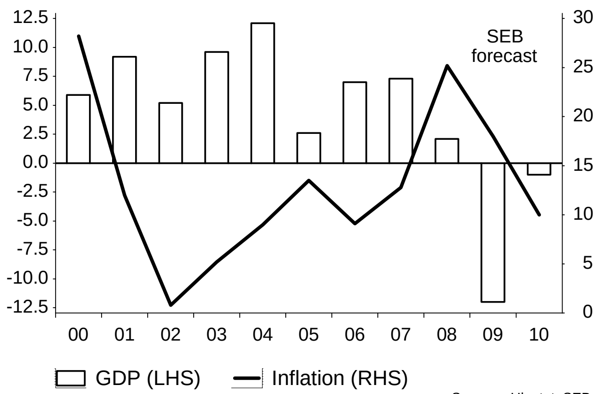
- **Output is in free fall**
- **IMF will resume aid . . .**
- **. . . but systemic risk remains**
- **Further weakening of the hryvnia**

Ukraine stands out as the most vulnerable economy in the entire Central and Eastern European region. High external borrowing, lopsided dependence on a few cyclical export products and sizeable macro imbalances left the country highly exposed when the global credit crisis rolled in. A political system in almost permanent crisis made the situation even worse. GDP fell by nearly 12 per cent in the fourth quarter, and the downturn accelerated early this year.

Resumption of the IMF's aid package is crucial in order to meet financial obligations and avoid a wave of bankruptcies and collapse in the financial system, but this will occur at the cost of a sharp economic downturn. Domestic demand is plunging in the wake of currency depreciation, tighter credit and contractive fiscal policy. Meanwhile exports are falling dramatically. GDP will thus shrink by 12 per cent this year. The decline will slow next year as exports partially recover – benefiting from the sharp depreciation of the hryvnia and somewhat better international demand. But the downturn in the domestic economy will persist, and GDP will fall by another 1 per cent.

Ukraine: GDP and inflation

Year-on-year percentage change



Sources: Ukrstat, SEB

The imbalances in the Ukrainian economy became increasingly apparent in late 2007 and early 2008. Inflation climbed to new record levels, and credit growth continued to accelerate – especially borrowing in foreign currencies. Partly because of repeated government crises, the necessary tightening of fiscal policy did not materialise. During the summer the price of steel – accounting for 40 per cent of exports – also began a rapid decline. Together with overheating in the domestic economy, this contributed to a burgeoning current account deficit.

When the global credit crisis hit with full force last autumn, the economy was thus in a highly vulnerable situation. Because of a mounting current account deficit and accelerating capital outflows, the hryvnia's exchange rate weakened greatly, despite interventions by the central bank. With nearly 60 per cent of lending denominated in foreign currencies, the banking system was hard pressed. Ukraine was one of the first countries forced to approach the IMF for aid.

In November 2008, an agreement was signed for a loan of more than USD 16 billion (8 per cent of GDP), of which USD 4.5 billion was disbursed late in 2008. The requirements associated with the IMF programme included a balanced budget for 2009, a restructuring of the banking sector and greater exchange rate flexibility. Late in 2008, when the government unveiled a budget proposal with a deficit of 3 per cent of GDP, the IMF cancelled the payment planned for mid-February 2009.

IMF package a must

Because the growth outlook has deteriorated significantly since the IMF plan was agreed in November, the Monetary Fund appears to have abandoned its balanced budget requirement, provided its other requirements are met. Meanwhile the IMF is reportedly demanding further revenue enhancements equivalent to 2 per cent of GDP and has also called for the withdrawal of proposed restrictions on the independence of Ukraine's central bank.

Given the serious situation, it is likely that Ukrainian political leaders will come together and craft a compromise, although nothing should be taken for granted when it comes to Ukrainian politics. Such an agreement is of crucial importance in improving confidence in the economy and in obtaining credits from other sources, including the foreign-owned banks that control nearly half of the banking sector. As soon as the IMF package resumes, a bail-out of USD 1.25 billion from the World Bank will be disbursed, with USD 500 million aimed at reinforcing the government budget and USD 750 million at recapitalising the banks. Negotiations are also under way for a loan of USD 5 billion from Russia.

Despite the more conciliatory tone of recent weeks, there are still major tensions between President Viktor Yushchenko and Prime Minister Yulia Timoshenko. The government is in a very weak position in Parliament, and there is already a great deal of manoeuvring for position in the run-up to the presidential election early in 2010. The tug-of-war between Parliament and the presidency is also continuing, resulting in a vote of no confidence against the president this past winter. Yushchenko's position is greatly weakened, and the election will mainly be a contest between Timshenko and the leader of the largest opposition party, Viktor Yanukovich. Recent regional elections in western

Ukraine were a major setback for Timoshenko and resulted in gains by radical nationalist groups, an indication that the country's political leadership will now have to pay the price for the economic crisis.

Although Ukraine will probably reach an agreement with the IMF, there is thus far greater uncertainty about the ability of political leaders to implement unpopular austerity measures in the run-up to the presidential election. Another major source of uncertainty is how the authorities will manage to recapitalise the fragile banking system. The IMF has estimated the cost at 5.0 per cent of GDP, while other observers believe it will exceed 10 per cent of GDP.

So far the government has identified privatisations, introduction of an emission rights system and bilateral loans as sources of funding to cover its budget deficit. There are currently also discussions about tax hikes on alcoholic beverages and tobacco products and steps to cover the deficit in the pension system, but this will hardly be enough, given the sharp GDP decline we foresee. We expect the public sector deficit to total 4.5 per cent of GDP 2009. Central government debt will remain comparatively low, however, and the government's external refinancing needs will amount to only USD 2 billion during 2009. Despite market pricing signals, the government can probably avoid suspending its payments, unlike many private sector players.

Broad decline

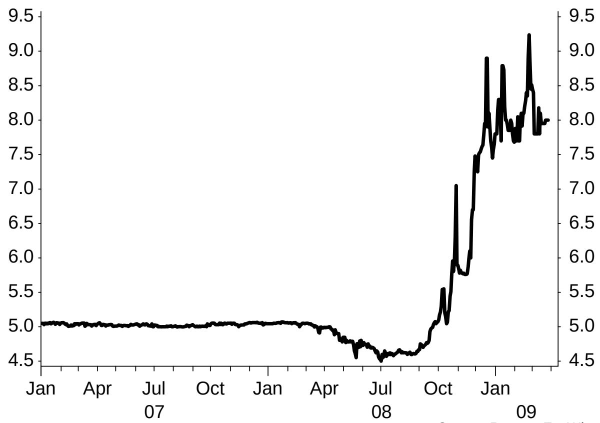
The economic downturn is now occurring on a broad front. So far the decline has been most evident in manufacturing, reflecting the collapse in export demand. Early in 2009, industrial production fell by 40 per cent year-on-year. Rapidly worsening demand from important markets such as Russia, Turkey and Germany will mean a continued squeeze on exports during the rest of the year. Only in 2010 will there be a cautious recovery as the international economic situation stabilises and the depreciation of the hryvnia provides a degree of help.

The sharp decline in steel prices will lead to a clear weakening of Ukraine's terms of trade during 2009. This trend intensified early in the year due to the latest gas agreement with Russia, doubling the price of gas during the first quarter compared to the average price in 2008. Thanks to the oil price downturn, however, the price of gas will be adjusted sharply downward starting in the second quarter. This will gradually improve the current account, which will go from a 6½ per cent deficit in 2008 to a 1 per cent surplus in 2009. Also contributing to the improvement in the current account will be the collapse in domestic demand and consequently in imports that we foresee.

Investments in particular will shrink dramatically. Large declines in industrial capacity utilisation will drastically lower the need for capital spending, while the credit shortage will reinforce the downturn in construction and other domestically oriented sectors of the economy. The credit crunch will also have a major impact on household consumption, which has been the strongest driving force behind demand in recent years. We now expect private consumption, which has grown by more than 15 per cent annually in recent years, to fall by double-digit figures. The depreciation of the hryvnia is lowering household purchasing power and making foreign currency loans far more expensive. Meanwhile unemployment is increasing at a rapid pace, while a growing number of companies are implementing wage cuts or ceasing to pay their employees. Early in 2009, real wages and salaries fell 12 per cent year-on-year.

Because of the deep recession, underlying inflation pressure will now ease substantially. This also implies that the impact of the hryvnia's depreciation will be comparatively weak. One uncertainty factor is various types of administratively set prices and indirect taxes. On the one hand, the budget situation will require revenue enhancements. On the other hand, political leaders will try as long as possible to avoid such measures before the presidential election. Overall, we anticipate that inflation will fall from last year's average of over 25 per cent to 18 per cent in 2009.

Ukraine: Hryvnia per dollar



Source: Reuters EcoWin

After a huge slide in the hryvnia last autumn and winter, there has been some stabilisation in the past month, but at the cost of daily interventions and high interest rates. Because of large foreign loan repayments – nearly USD 40 billion must be rolled over during 2009 – and renewed worries about the banking system, depreciation pressure is likely to resume. Given that the foreign currency reserve has approached the level that the IMF has stipulated as a floor and that the central bank probably prefers not to continue propping up the exchange rate with high interest rates, the hryvnia will weaken again. We forecast an exchange rate of UAH 10.50 per dollar at the end of 2009, compared to the current level of UAH 8.0.

ESTONIA

	2003	2004	2005	2006	2007	2008 (f)	2009 (f)	2010 (f)
GDP, %	7.1	7.5	9.1	10.3	6.3	-3.6	-12.0	-2.3
Inflation, HICP, average, %	1.4	3.0	4.1	4.4	6.6	10.4	0.7	1.5
Unemployment, %	10.0	9.7	7.9	5.9	4.7	5.5	12.0	13.0
Current account, % of GDP	-11.3	-11.5	-10.0	-16.7	-18.1	-9.2	-3.9	-3.0
Public sector financial balance, % of GDP	2.0	2.3	2.3	3.8	2.9	-3.0	-3.0	-2.8
Public sector debt, % of GDP	5.7	5.2	4.4	4.3	3.5	4.0	6.0	7.0
EUR/EEK, end of period	15.60	15.60	15.60	15.60	15.60	15.60	15.60	15.60
3-month interest rate, eop	2.60	2.40	2.60	3.90	7.30	7.90	7.80	7.60

LATVIA

	2003	2004	2005	2006	2007	2008(f)	2009(f)	2010(f)
GDP, %	7.2	8.7	10.6	12.2	10.0	-4.6	-12.0	-3.0
Inflation, HICP, average, %	2.9	6.2	6.9	6.6	10.1	15.3	3.0	-2.5
Unemployment, %	10.6	10.4	8.7	6.8	6.0	7.5	15.0	13.0
Current account, % of GDP	-8.2	-12.8	-12.5	-22.5	-22.5	-12.6	-6.8	-4.0
Public sector financial balance, % of GDP	-1.6	-1.0	-0.4	-0.2	0.1	-3.5	-7.5	-5.0
Public sector debt, % of GDP	14.6	14.9	12.4	10.7	16.8	29.0	35.0	37.0
EUR/LVL, end of period	0.67	0.70	0.70	0.70	0.70	0.70	0.70	0.70
Key rate, eop	3.00	3.50	4.00	5.00	6.50	6.00	5.50	5.50
5-year government bond, eop	4.60	4.00	3.20	4.90	7.50	10.00	11.00	11.00

LITHUANIA

	2003	2004	2005	2006	2007	2008 (f)	2009 (f)	2010 (f)
GDP, %	10.2	7.4	7.8	7.8	8.9	3.1	-9.0	-3.5
Inflation, HICP, average, %	-1.1	1.2	2.7	3.8	5.8	11.1	5.0	2.0
Unemployment, %	12.4	11.4	8.3	5.6	4.3	5.8	11.0	14.0
Current account, % of GDP	-6.8	-7.7	-7.1	-10.6	-14.6	-11.6	-6.5	-5.0
Public sector financial balance, % of GDP	-1.3	-1.5	-0.5	-0.4	-1.2	-2.9	-4.5	-5.0
Public sector debt, % of GDP	21.1	19.4	18.4	18.0	17.0	15.6	19.9	24.8
EUR/LTL, end of period	3.45	3.45	3.45	3.45	3.45	3.45	3.45	3.45
3-month interest rate, eop	2.70	2.60	2.50	3.80	6.70	9.90	6.50	5.00
5-year government bond, eop	3.60	3.00	3.10	3.90	4.50	12.00	10.00	6.00

(f) = forecast

Key economic data

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POLAND

	2003	2004	2005	2006	2007	2008(f)	2009(f)	2010(f)
GDP, %	3.9	5.3	3.6	6.2	6.7	4.8	-2.5	1.0
Inflation, HICP, average, %	0.8	3.6	2.1	1.0	2.5	4.2	2.2	2.0
Unemployment, %	20.0	19.0	17.6	14.8	11.2	9.5	14.0	16.0
Current account, % of GDP	-2.1	-3.9	-1.2	-2.7	-4.7	-5.3	-4.0	-3.5
Public sector financial balance, % of GDP	-6.3	-5.7	-4.3	-3.8	-2.0	-2.5	-4.5	-4.0
Public sector debt, % of GDP	47.1	45.7	47.1	47.6	44.9	45.5	49.0	50.0
EUR/PLN, end of period	4.71	4.08	3.86	3.83	3.60	4.12	5.00	4.00
Key rate, eop	5.25	6.50	4.50	4.00	5.00	5.00	2.00	3.00
5-year government bond, eop	6.70	6.20	5.00	4.98	6.13	5.34	5.60	6.00

RUSSIA

	2003	2004	2005	2006	2007	2008(f)	2009(f)	2010(f)
GDP, %	7.3	7.2	6.4	7.4	8.1	5.6	-5.0	1.0
Inflation, average %	13.7	10.8	12.7	9.7	9.0	14.1	11.5	8.5
Unemployment, %	8.6	8.2	7.6	7.2	6.1	6.4	10.8	11.9
Current account, % of GDP	8.2	9.9	11,0	9.8	6.1	5.8	-2.5	-1.5
Public sector financial balance, % of GDP	1.4	4.9	7.7	8.4	6.1	4.8	-8,0	-5.0
Public sector debt, % of GDP	29.6	22.3	14.8	10.4	8.6	7.2	8.00	10.50
EUR/RUB, end of period	29.50	27.70	28.70	26.30	24.50	30.52	41.00	35.00
Rouble vs. euro/dollar basket	32.50	32.20	31.20	30.10	29.60	34.00	44.70	41.30

UKRAINE

	2003	2004	2005	2006	2007	2008 (f)	2009 (f)	2010(f)
GDP, %	9.6	12.1	2.6	7.0	7.3	2.1	-12.0	-1.0
Inflation, average, %	5.2	9.0	13.5	9.1	12.8	25.2	18.0	10.0
Unemployment, %	9.1	8.6	7.2	6.8	6.6	6.7	9.5	11.5
Current account, % of GDP	5.8	10.6	2.9	-1.4	-4.1	-6.7	1.0	1.5
Public sector financial balance, % of GDP	-0.2	-3.2	-1.8	-0.7	-1.1	-1.5	-5.0	-3.7
Public sector debt, % of GDP	24.7	19.6	16.1	13.1	10.4	12.4	18.5	20.5
USD/UAH, end of period	5.33	5.31	5.05	5.05	5.05	7.8	10.5	9.5

(f) = forecast

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