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Eastern European Outlook

Shaky recovery, budget austerity, slow thaw in lending

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Eastern Europe is the region hardest hit by the global credit crisis and recession, largely due to relatively large exposure to foreign currency borrowing. During the summer, the economic cycle has nevertheless bottomed out in Eastern Europe as well. But the recovery in the six countries covered by this report will be shaky and uneven. The main reasons are public sector budget consolidation and the fact that credit tightening will ease only slowly.

Exports will gradually strengthen. We expect domestic demand to remain weak in the coming year, however; households will be squeezed by a weak wage and salary trend and by rising unemployment, while corporate capital spending will be hampered by large idle production capacity and cautious lending practices.

Poland is the only EU country to start its recovery without having fallen into recession, and we expect a continued gradual strengthening of growth in 2010-2011. Russia will recuperate at only a moderate pace from its historic GDP decline in the first half of 2009, despite being buoyed by higher commodity prices. The Ukrainian economy will return to only weak positive growth in 2010. Of the three Baltic countries, Estonia is best positioned for recovery, with GDP ending up around zero in 2010 and rising the year after. In Latvia and Lithuania, GDP will continue to shrink next year, though only moderately. These countries will resume positive growth on an annual average basis only in 2011.

One favourable trend in Eastern Europe is that certain key economic imbalances have been wiped out. Their earlier large current account deficits have been transformed into surpluses due to plummeting imports; we mainly expect continued moderate surpluses, with deficits in a few cases. Inflation pressure will remain weak in the Baltics, moderate in Poland but relatively high in Russia and Ukraine. Remaining as challenges are necessary budget corrections after very large deficits in many countries this year, higher than in the euro zone. Thanks to continued international loan aid, we expect hard-pressed Latvia and Ukraine to avoid suspending payments.

In the Baltics, depressive economic forces will remain in place next year. Painful austerity policies will continue, including further pay cuts to restore lost competitiveness. Political tensions have increased, especially in Latvia and Estonia. There is a risk that exchange rate worries will re-emerge as early as this autumn, but our main scenario is that the existing currency pegs to the euro will survive. It is still an open question whether Estonia will meet the vital budget criterion for the desired euro zone accession in 2011, by keeping its public deficit at no more than 3 per cent of GDP both in 2009 and 2010.

Shaky recovery

- **Credit crisis easing in Eastern Europe as well**
- **Poland's economy best positioned**
- **Deep downturn in Baltics, but pegs will hold**

This summer, the world economy began a cautious recovery after having nearly been in free fall. Highly synchronised global crisis policies have helped create more normal conditions in financial markets. Interest rate spreads in lending between banks – the interbank market – have reverted to levels prevailing before the credit crisis broke out in the summer of 2007. Meanwhile the global securities market has begun to function again, leading to shrinking credit spreads and a higher volume of corporate bond issues. Greater financial risk appetite since last spring has gone hand in hand with an upturn in corporate and household optimism. This has laid the groundwork for a rebound in economic activity, although the upturn in order bookings and output has been very limited so far.

The global recession is thus over, but the recovery will not be clear-cut. Fading stimulus effects from expansive official economic policies cannot be fully replaced by self-sustaining growth forces. Low capacity utilisation and continued rising unemployment will restrain consumption and capital spending next year as well. Meanwhile the adjustment of balance sheets and debts continues. For example, American households are still increasing their savings, and the consolidation of financial sector balance sheets still has a long way to go.

Global economic highlights
GDP, year-on-year percentage change

	2008	2009	2010	2011
United States	0.4	-2.5	1.8	2.3
Euro zone	0.6	-3.9	1.2	1.8
The world	3.1	-0.9	3.4	4.1
Oil, USD/barrel	97.2	61.0	70.0	70.0
EUR/USD, Dec.	1.40	1.40	1.30	1.25

Source: SEB

Overall, this leads to the conclusion that GDP growth in the 30 member countries of the Organisation of Economic Cooperation and Development (OECD) will remain somewhat below trend (2-2.5 per cent) in 2011 as well. This forecast also applies to the euro zone, a major export market for many Eastern European economies, especially those in what is now often called Central Europe. The labour market will thus remain weak and inflation low, but next year central banks will begin a series of key interest rate hikes as one element of normalisation and in an effort to prevent excessive risk-taking as well as potential new financial bubbles. Meanwhile fiscal policy at the global level will shift from a positive contribution to growth in 2009 to a tightening next year.

Export-led recovery in Eastern Europe

Eastern Europe is the region hardest hit by the international credit crisis, largely due to its previous rapid expansion of borrowing in foreign currencies. But even here we now see signs of turnaround, mainly concentrated in manufacturing. Most of these countries probably reached their lowest GDP growth levels in the second quarter, measured year-on-year.

In many cases, however, the recovery in Eastern Europe will be sluggish. It will take time before credit standards loosen enough to support economic growth. In Poland, for example, where the International Monetary Fund (IMF) considers the banks to be in relatively good shape, the central bank's latest bank lending survey showed that the slowdown in credit growth continued in the second quarter. Banks were also planning further tightening of lending to both companies and households during the third quarter.

In addition, real pay is still falling in many countries of the region, a process that has been under way since early in 2009. Considering their weak labour markets, it will take a year or so before household purchasing power rebounds. Continued fiscal austerity will also hold back domestic demand in the Baltic countries, Hungary and elsewhere. We also anticipate that Poland, Russia and Ukraine will be forced to shift their fiscal policies to some extent towards tightening.

Public finances
Per cent of GDP

	2008	2009	2010	2011
Estonia	-2.7	-3.0	-3.0	-2.8
Latvia	-4.0	-9.0	-8.5	-5.0
Lithuania	-3.2	-10.0	-8.0	-4.0
Poland	-3.9	-5.5	-5.0	-4.0
Russia	4.2	-8.0	-5.0	-4.0
Ukraine	-3.2	-8.8	-7.0	-3.0
Euro zone	**-1.9**	**-5.1**	**-5.9**	**-4.9**

Source: Eurostat, SEB

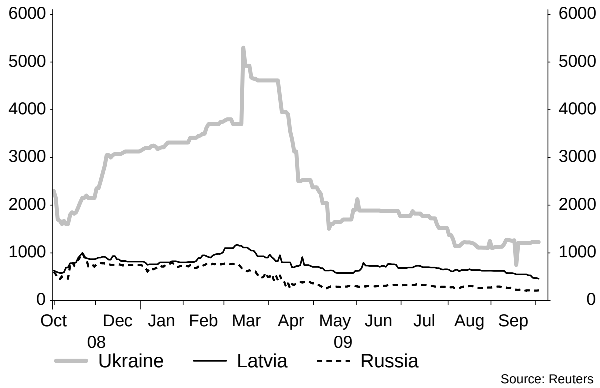
Our conclusion is that the recovery in Eastern Europe will be export-led and highly dependent on an upturn in international demand. Poland and the Czech Republic are best positioned to benefit from the imminent upturn in the euro zone and the world economy. In these two countries, economic fundamentals were relatively good when the global crisis broke out; for example, the foreign currency share of their borrowing was moderate.

The trend towards stronger current accounts will continue in an environment where exports recover to a greater degree than domestic demand. This, in turn, will help many Eastern European currencies, among them the Polish zloty, to keep appreciating over time, with a risk of reversals if global risk appetite fades.

A stabilisation of Western credit markets has also been reflected in Eastern European financial developments. Due to greater risk appetite, credit spreads have fallen in most emerging markets. The September *Quarterly Review* of the Bank for International Settlements (BIS) also indicates a gradual expansion in corporate bond issues in the "emerging Europe" area. Our compilation of credit default swap (CDS) contracts for individual countries also shows reduced worries about possible fiscal collapse by sovereign borrowers in Eastern Europe.

Five-year credit default swaps

Basis points



Protracted recovery in the Baltics

The deep economic crisis in the Baltic countries will continue. The economic policy strategy of internal devaluations – slashing wages and prices – instead of using currency devaluations will expose the three countries to major strains. Their currencies have strengthened in competition-weighted terms, hampering exports. But above all, domestic demand has plummeted, among other things as a consequence of the dramatic fiscal tightening now being implemented to avoid exploding budget deficits.

This means their GDP downturn will be far deeper than in Eastern Europe as a whole. Year-on-year, the GDP decline is probably past its worst point, but the deflationary environment will persist next year. Estonia's growth will be around zero in 2010, while GDP will continue falling in Latvia and Lithuania. In 2011 we foresee GDP growth of 3-4 per cent in these countries – still a bit below potential growth.

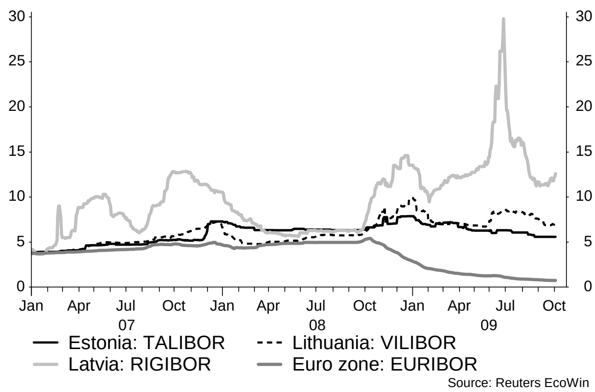
The downturn in domestic demand has nevertheless led to drastic improvement in two key imbalances: large import-driven current account deficits and wage-driven inflation. Looking ahead, external balances will be close to equilibrium or slightly positive. We believe that wage and salary adjustment has been larger than official statistics show. Due to the significant role of the "grey economy", we expect pay cuts this year to total some 15-20 per cent instead of 10 per cent according to official statistics. Pay will probably keep falling next year both in the private and public sector. Inflation pressure will thus remain low.

This adjustment has improved the chances that the economic policy strategy of the Baltic governments will succeed. More important in calming devaluation worries in the short term, however, has been that the EU and IMF have approved continued disbursements to Latvia from their previously frozen loan package. The central bank, which intervened heavily to buy lats last spring and in June, has even occasionally been forced to sell them in order to keep the currency stable. The central bank's foreign currency reserves have also been restored and are on a par with the peak levels (more than USD 6 billion) prevailing during the first half of 2008.

Three-month interbank rates in Latvia have fallen from 30 to 12 per cent. But Baltic interbank rates are still high and have not fallen as deeply as euro rates, for example. This reflects lingering exchange rate worries in the market. Lately, the Latvian currency has again weakened.

Three-month interbank rates

Per cent



Acute currency worries risk returning rather quickly if one of the governments should collapse under the pressure of the social strains that accompany austerity policies. There are strong tensions, especially in the Latvian coalition government, which will shortly face the challenge of persuading Parliament to approve the pledges it made to the IMF and others to implement further belt-tightening. In an environment of rapidly growing unemployment, popular discontent may also erupt again and test the stability of governments. Our base scenario is still that the Baltic currency pegs against the euro will survive.

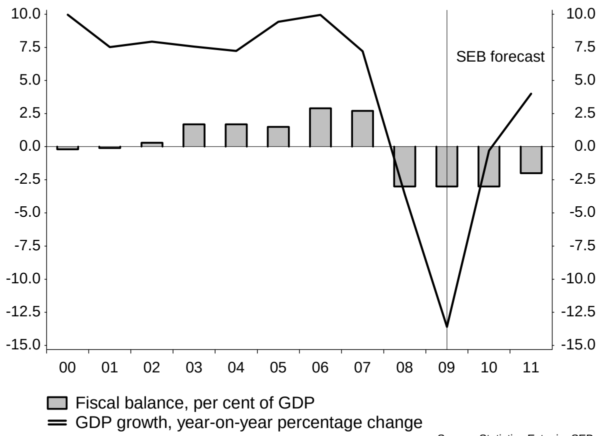
Euro still possible by 2011

- **Bumping along on the bottom**
- **Budget cuts needed in 2010 as well**
- **Internal devaluation continues**

The Estonian economy has stabilised and probably hit bottom, but it will stay there for an extended period. Risks to growth and to the currency still loom. While export prospects are already better, domestic demand will be restrained for another year by increasing unemployment, continued fiscal tightening and pay cuts. We expect GDP to shrink 13.6 per cent in 2009 and 0.3 per cent in 2010. In 2011 GDP will increase by 4 per cent. Estonia still has a realistic chance of joining the euro zone as planned in 2011. Its public sector fiscal deficit, the main challenge in meeting euro criteria, is not yet comfortably below 3 per cent of GDP for 2009, but forecasts are in this range. The biggest risks are posed by municipal deficits and the outcome of planned revenue increases late in the year.

Euro zone accession would boost investments but probably not increase consumption much. GDP growth might reach 5 per cent in 2011 if the euro were adopted.

GDP and fiscal balance

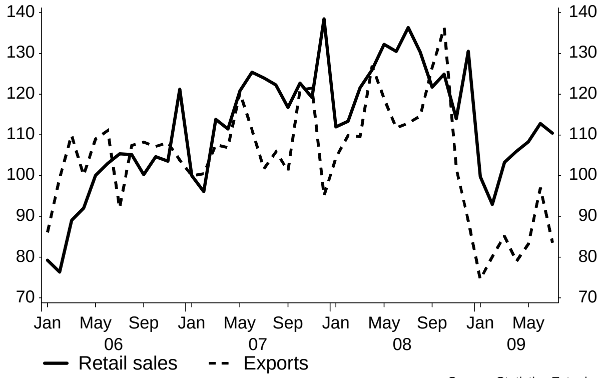


Source: Statistics Estonia, SEB

Indicators have shown signs of stabilisation, and global recovery is improving the outlook for export-oriented industries. Retail sales have also stabilised due to recovering consumer confidence and higher savings. However, the recovery will not be broad-based in 2010. Domestic demand-related sectors will suffer longer. Retail sales will decline by an average of 12.4 per cent in 2009 and 1.6 per cent in 2010, due to falling income. Real estate prices have plummeted by 50 per cent from their peak in 2007 and price levels are becoming attractive. Transaction volume is recovering and prices are near the bottom.

Exports and retail sales

Current prices, index Jan 2007 = 100



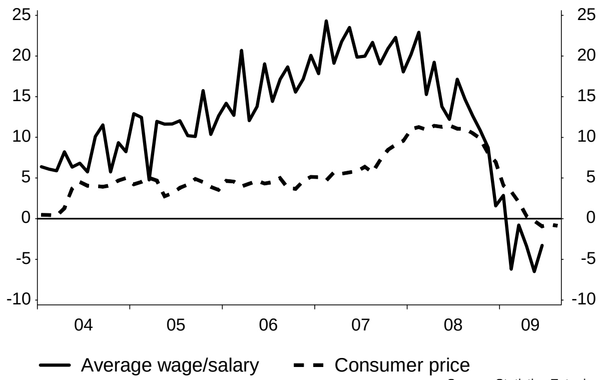
Source: Statistics Estonia

The financial situation of households has improved because of lower debt service costs, falling consumer prices and accumulated savings. On the other hand, wages and salaries are also falling and are expected to continue doing so well into next year. When fears of unemployment recede, consumer confidence will recover – and this is already starting to happen.

Internal devaluation is well under way. By the second quarter of 2009, wages and salaries had dropped by 4.4 per cent below their year-earlier level. Pay cuts are probably bigger in the grey sector, most notably in construction and retail sales. In construction, official wages have also fallen by 15 per cent year-on-year. This is the sector with the biggest imbalances and correction needs. Clearly wage adjustment in general has still only proceeded less than halfway. The gap between real wages and productivity is 21 per cent, which means that pay cuts will have to continue. Meanwhile productivity is starting to recover and will converge with wages sometime late next year. Our forecast for the decline in pay during 2009 is 8 per cent and in 2010 another 4 per cent. Pay cuts also mean continued deflation, although higher heating prices are starting to offset this.

Prices and wages

Year-on-year percentage change



Source: Statistics Estonia

Pay adjustment has enabled employers to preserve jobs to some extent. Companies have faced severe declines in production and sales volume and a great need to trim labour costs. Many employees have been put on part-time schedules so they can keep their jobs. In such a small labour market, employees are often hard to find and train. Unemployment rose to 13.5 per cent in the second quarter of 2009 and is still rising. Next year it will average 16.4 per cent.

The demand for investments will remain weak during the next year, as a result of idle production capacity and continued caution by banks about lending. Real estate construction will not recover either, due to a persistent oversupply of properties.

As a result of very weak domestic demand, Estonia's external imbalances have rapidly vanished. In the second quarter of 2009 there was a solid current account surplus, 4.9 per cent of GDP. In light of the better outlook for export than imports, this surplus is likely to continue increasing.

Euro adoption in 2011 still on agenda

The government's objective is euro adoption in 2011, which would require a budget deficit below 3 per cent of GDP in both 2009 and 2010. In 2009 it has taken numerous steps to meet this criterion, both through cost cutting and revenue enhancement. Achieving the government's goal currently appears feasible.

Government cost cutting so far has focused mainly on operational expenditures and public sector wages etc. Social benefits, the largest single cost item, have not been reduced. Investments have been maintained wherever possible in order not to harm the economy too much. Cost-cutting possibilities are now exhausted for 2009 and the government is targeting (non-tax) revenue-boosting opportunities.

The minority government is trying to regain some of its lost popularity after massive cost-cutting by declaring that no social benefits will be cut either in 2009 or 2010. In 2009, pensions and overall social benefit disbursements rose, compared to 2008. In 2010 benefits will remain unchanged, the government promises, but since unemployment insurance payments are time-limited, total benefits will decrease. Wages will continue to fall, which means an overall negative outlook for consumption.

In the near term, the government's decision not to cut social benefits will put heavy pressure on it to find alternative non-tax revenue to cover the gap. Looking further ahead, this strategy also means that for several years to come, social benefits cannot be raised.

Not cutting social benefits is a way of smoothing the income of target groups over time and thus softening the impact of the economic downturn. In light of approaching municipal elections in 2009 and the parliamentary election in 2011, this will enable the ruling parties to minimise political damage. Still, there is room for improving efficiency in benefit systems.

In terms of meeting the euro zone's 3 per cent deficit criterion, this approach is rather risky, since social benefits form the lion's share of budget costs and also pose a long-term risk of imbalances. Meeting the criterion also assumes that municipal deficits are not excessive and that the government can successfully sell various public assets. At present, it has sold only 21 per cent of the planned amount. The government intends to carry out most of these sales this autumn.

The assets in question include real estate and shares in Eesti Telekom. These privatisations will improve the budget balance in 2009 and coming years, while allowing the government to build up reserves. They are also a source of foreign investment inflow and will be helpful in revitalising the domestic economy.

The government's aim of keeping the 2010 public deficit below 3 per cent of GDP is also achievable, since the drop in tax revenue is expected to be much smaller than in 2009. But extraordinary revenues will be more difficult to find, and cost-cutting will become politically more difficult next year. Another round of VAT and excise tax increases has been proposed by the government.

After year-on-year deflation in August, inflation is likely to remain low and to meet the Maastricht criterion. The Maastricht interest rate criterion is open to different interpretations, since no benchmark interest rate exists in Estonia and no good indicator is available. So far, assessments by the EU on the latter criterion have been favourable to Estonia, and interest rates should thus pose no obstacle to euro adoption.

Budget hurdle to broad recovery

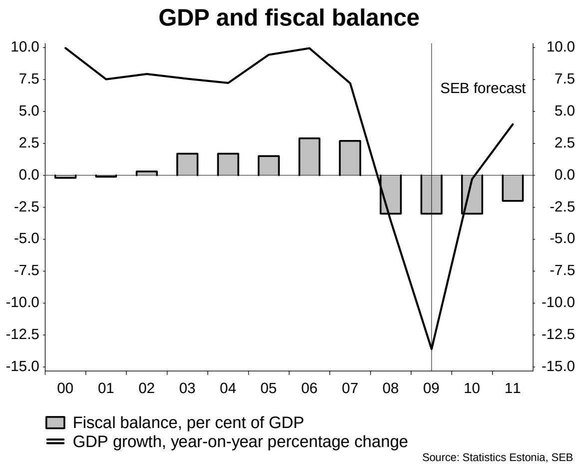
- **Stabilisation at a low level**
- **Severe budget cuts also in 2010**
- **Current account shows astonishing surplus**

Gripped by the worst recession in the EU, Latvia is starting to see signs of stabilisation and export sector resurgence. Its current account deficit has disappeared due to the import collapse. Year-on-year inflation is steadily shrinking and will turn into deflation by the end of 2009, but investments and consumption will remain very weak in 2010 because of fiscal tightening needed to curb large deficits. We expect the government to continue slashing its own spending and cut wages and prices as a condition of the large aid programme agreed with the EU and IMF. Such “internal devaluation” is aimed at ensuring that Latvia can cover its large foreign liabilities. Recovery will be gradual, protracted and highly dependent on the global economic situation. We expect GDP to shrink by 17.5 per cent this year and 3 per cent in 2010, then recover by 3 per cent in 2011. In 2008-2010 the economy will thus shrink by one quarter from its 2007 peak level.

In the second quarter of 2009, GDP fell 18.7 per cent year-on-year compared to 18 per cent in the first quarter. Part of this was because some businesses slipped into the “grey zone”. The only sector that has avoided contraction is trans-shipments through ports. Taking into account recent trends, we expect a slight improvement in the second half. However, budget consolidation will impact GDP through lower public consumption and investments. Exports will probably improve in the last quarter of 2009 and even more in 2010-2011. It will take longer for consumption to recover, starting only at the end of the next year.

The recession has caused tax revenue to tumble, leaving the government scrambling for ways to reduce the budget deficit. Under its June agreement with the IMF and EU, Latvia had to carry out a fiscal adjustment equivalent to 3 per cent of GDP this year. The government has implemented broad spending cuts, including a reduction in old age pensions and further public sector pay cuts. The latest IMF mission resulted in a letter of intent signed by all government coalition parties, which was necessary in order to receive the next tranche of the IMF loan. So far Latvia has received EUR 3 billion from the IMF and EU out of the EUR 7.5 billion bailout package.

The government had agreed on fiscal consolidation totalling 500 million lats or 4 per cent of GDP in its 2010 budget, coincidently matching its debt-to-GDP benchmark. It decided on LVL 225 million in spending cuts and LVTL 100 million in additional tax revenues and estimated its savings from 2009 austerity measures at LVTL 175 million. Latvia still needs approval from the IMF, which has already hinted that it does not agree with the government’s figures. The Ministry of Finance concurs, saying that the austerity measures adopted so far will save far less and that the government’s decision to trim expenditures by LVL 275 million is insufficient.



The government may have to make further spending cuts, but there is mounting resistance in the coalition since this would further reduce pensions and other social benefits. The business sector is also appealing to the government not to raise taxes as much as agreed. It is difficult to foresee the outcome, but a trade-off is likely to be reached. Parliament is expected to vote on a new austerity budget early in December, aimed at limiting the deficit to 8.5 per cent of GDP in 2010 and reducing it to 3 per cent by 2012.

The government is working on a new residential property tax and a capital gains tax. Latvia has promised the IMF that it will introduce a progressive income tax and raise VAT if fiscal targets are not reached. That will largely depend on its political decisiveness in carrying out structural reforms. Another issue is the difficulty of determining where to enforce spending cuts without triggering social disorder. Meanwhile the growth in the budget deficit slowed during the summer. If this trend continues, the government can achieve the agreed benchmark: a budget deficit of 10 per cent of GDP this year. The next IMF review is expected in mid-November.

International loans sustain lat

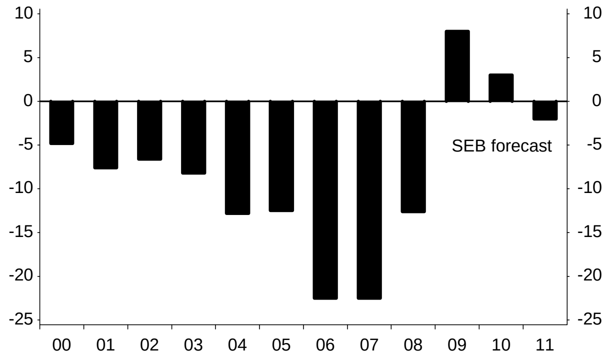
Since its international loan programme resumed, Latvia’s currency has been relatively stable and worries about the country’s solvency have receded. The lat had come under pressure amidst rumours of an imminent devaluation but has firmed since mid-July. Lately, the lat has depreciated again. In our view, any devaluation would only slightly stimulate exports and is not worth the chaos it may bring. We expect the Bank of Latvia to succeed in keeping the lat within its current narrow band against the euro, with sizeable external support under the IMF programme. However, there is a very high risk that political indecisiveness in carrying out structural reforms and balancing public finances could lead to resurgent speculation about a possible lat devaluation later if economic growth fails to recover.

Imbalances have disappeared

The current account deficit has vanished since imports tumbled, leading to a smaller trade deficit. The rapid decrease in imports was due to a significant drop in domestic demand. Another major factor improving the current account was rapidly growing income after banks made provisions for non-performing loans. In June, the surplus in the services account exceeded the deficit in the goods account. In the first seven months of 2009, the current account surplus was LVL 581 million, compared to a deficit of LVL 1.42 billion in the same period last year. This trend will continue, bringing the surplus to 8 per cent of GDP in 2009 and 3 per cent in 2010.

Current account

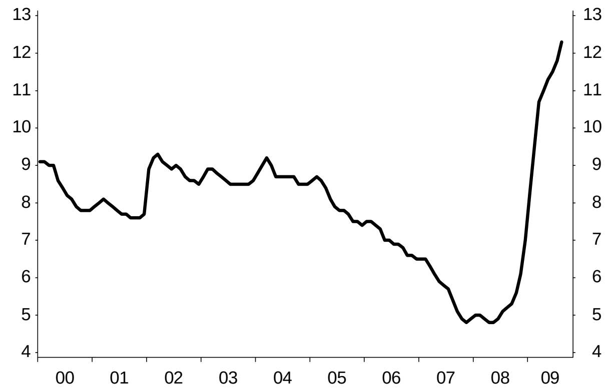
Per cent of GDP



Source: Bank of Latvia, SEB

Unemployment more than doubled from mid-2008 to almost 17 per cent in the second quarter of 2009. The number of jobs contracted to its 2002 level. Private sector unemployment has begun to stabilise, while ongoing structural reforms in the public sector will increase total unemployment to 20 per cent by year-end. In 2010, the jobless rate will decrease slightly. Meanwhile there will be continuing wage cuts in both the public and private sectors. Although official statistics show a year-on-year pay decrease of only 1 per cent in the second quarter, the reality was far more severe. This was due to missing statistics from the private sector as well as severance pay to discharged employees, which pushed up total wages and salaries. Year-end statistics will provide a more correct reflection of pay cuts. Overall pay reductions in the private sector will be in the range of 10 per cent and in the public sector around 20 per cent in 2009. Income will continue to deteriorate in 2010.

Unemployment



Source: Reuters EcoWin

Lower prices and income are part of Latvia's strategy for restoring its competitiveness. The inflation rate will keep falling steeply due to lower administratively regulated prices and weak demand until it turns negative due to a further decrease in heating costs. Nevertheless the previously high base effect will not allow annual average inflation to fall below 3.5 per cent at the end of 2009. We expect deflation of 2.5 per cent in 2010 and inflation of 1.5 per cent in 2011.

Increased political risk ahead of election

The IMF has made tough fiscal policy a key requirement in providing aid to Latvia. But each major cost-cutting decision puts additional strain on the five-party coalition government. Less than two weeks after the government overcame its internal disagreements in order to secure a tranche of IMF aid, the largest party in the coalition complained over how it is being treated and questioned the coalition's ability to carry out tough budget cuts and introduce new taxes, since there is no unanimity about how to enforce the agreed measures. Plans for a new property tax had already intensified frictions in the coalition, which faces an election in October next year.

For now it appears as if political disagreements have calmed down, but once the 2010 budget is approved, built-up tensions and political manoeuvring may lead to further reshuffles. As winter approaches and government austerity bites, the mood among ordinary citizens is likely to worsen and politicians will have to work hard to prevent conflicts from breaking out.

Few signs of recovery

- **Unemployment still likely to rise**
- **Further fiscal tightening**
- **Weak tax collection**

Lithuania is struggling with a severe economic slump and, above all, with an internal market decline. Indicators of economic activity may already have bottomed out in the second quarter of 2009, but living standards will deteriorate further and unemployment will rise until 2011, from 14.0 per cent to a peak of 16.0 per cent. One of the country's key strengths in the current situation is a very firm government prepared to cope with recession and budget correction. Newly elected President Dalia Grybauskaite adds her economic policy skills to Lithuanian political life and, most likely, a fair voice in future decision making.

Plummeting domestic demand

In the first half of 2009, GDP contracted by 17.0 per cent. It was one of the largest drops in the EU and a 17-year record. The worst affected sectors were those oriented to domestic demand.

The country suffered an investment collapse of almost 40 per cent year-on-year. The decline in household consumption was only half this much, while public expenditures even increased by 1 per cent. Despite a huge slump in imports, net exports were still negative. Massive slides in the exchange rates of the Polish zloty and both the Russian and Belarusian roubles against the litas eroded Lithuania's competitiveness last winter, but a large drop in producer prices helped restore it at least partially in the course of 2009.

Despite very poor performance in the first half of the year, industrial production and transport showed some improvement in July and August. Moreover, statistical base effects will play a positive role in the second half of 2009. Thus, our GDP forecast is a 15.5 per cent drop in 2009, another 3.5 per cent decline in 2010 and an increase of 3.0 per cent in 2011. Domestic demand will remain depressed for another year. Slow economic recovery should start in the second half of 2010, initially stimulated by stronger foreign demand and somewhat less restrictive lending.

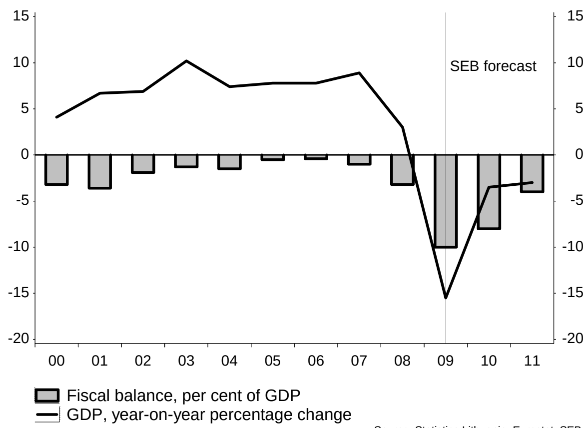
The government approved a stimulus plan in the spring, but so far only a small portion of the allotted funds have made it into the economy due to bureaucratic sluggishness. One of the principal remaining challenges will be restructuring the energy sector and reducing dependency on Russian energy resources. The latter process is also very slow and tentative.

Tough fiscal tightening

Contrary to most European countries, budget tightening began in Lithuania as early as at the end of 2008 and continued throughout this year.

The initial budget plan was revised twice in 2009, reducing expenditures by LTL 1.5 billion (6 per cent) and revenue by LTL 4.8 billion (19 per cent). Since these cuts in expenditures and revenues were asymmetrical, a higher budget deficit was allowed.

GDP and fiscal balance



Source: Statistics Lithuania, Eurostat, SEB

Numerous budget consolidation measures were implemented as early as January 2009 (higher VAT, corporate profit tax, excise duties etc.). Beginning in September, the government again raised the standard VAT rate from 19 per cent to 21 per cent, but reduced the excise on diesel from August. The authorities cancelled previously promised wage hikes for teachers, cut the salaries of national civil servants and trimmed the number of public sector employees. In September, the government approved cuts in Lithuania's pensions and generous maternity benefits.

In the first half of 2009, the public deficit made up 10.2 per cent of GDP. National budget revenue declined by 19 per cent year-on-year, while nominal GDP decreased by 15 per cent. The latter gap suggests that the higher tax burden and the difficult economic situation persuaded some businesses to migrate into the "shadow economy", though it is impossible to quantify the extent of this process. Shrinking profits and wages, lower consumption and rising unemployment will seriously hamper tax collection.

The government has continued to finance its deficit by borrowing from private sources, mainly via Eurobond emissions. As a result, state debt increased to 23 per cent of GDP as of end-June 2009 and will approach 28-29 per cent of GDP by the close of 2009.

Government's borrowing this year has been expensive (for example, June's Eurobond issue was sold at a 9.375 per cent yield), which will increase the future debt payment burden and refinancing needs. During the autumn, bond yields have subsided, reflecting a better mood in financial markets; however Treasury bills were still being sold at 6-7 per cent yields in the domestic market in September. This autumn's Eurobond issues will probably be successful, further reducing the probability of an application for IMF aid.

The fiscal deficit will total 10 per cent of GDP in 2009, 8 per cent in 2010 and 4 per cent in 2011. Most likely, fiscal tightening will continue next year, mainly on the expenditure side. However, increases in taxes, such as VAT, cannot be ruled out.

Internal devaluation continues

In the second quarter of 2009, nominal wages and salaries were down by 6 per cent in the private sector but still up by 1 per cent year-on-year in the public sector. In our view, the decline in average official wages and salaries will accelerate to 13 per cent in the fourth quarter of 2009 but slow to 5 per cent at the end of 2010. Pay levels will show an increase of 2.5 per cent at the end of 2011. Although employers use different strategies to cut labour costs (reducing average wages, dismissing employees, offering shorter working hours, paying "under the table"), the most widespread method is trimming the number of employees. This is evident when comparing the average decrease in pay to the overall second quarter drop in total wages and salaries: 23 per cent at private companies and 1 per cent at public institutions.

The correction in producer prices is also huge, reaching almost 20 per cent year-on-year in the third quarter. The most recent estimate of electricity price increases after the Ignalina nuclear power plant shuts down at the beginning of 2010 is 20-30 per cent. However, the average price of central heating will fall by 16 per cent this winter.

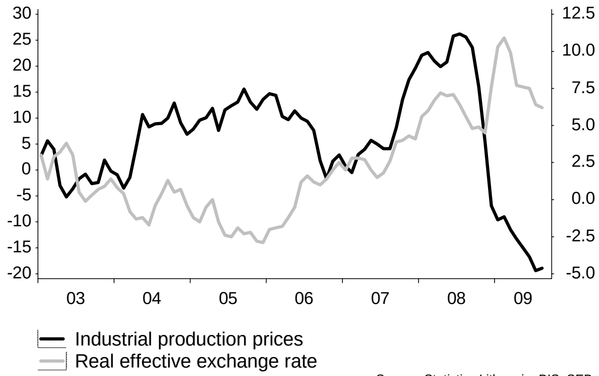
Thus a general cost reduction of 20-30 per cent is taking place and is roughly sufficient to restore export competitiveness. Higher electricity prices starting in January 2010 will make the process of internal devaluation last longer, at least all of next year.

Inflation is quickly falling due to the loss of purchasing power, a higher propensity to save and increased cautiousness by both households and enterprises. Nonetheless, consumer prices will increase both in 2009 and 2010, mainly due to higher VAT and excise duties and rising energy costs. HICP inflation will average 5.0 per cent in 2009, 2.0 per cent in 2010 and 2.5 per cent in 2011.

In the face of deep recession, external imbalances disappeared very quickly. In the first half of 2009, the current account showed a 0.1 per cent of GDP surplus after a deficit of 11.9 per cent of GDP in 2008. The adjustment was mostly due to a steep drop in the foreign trade deficit, but improvements in income and service accounts also contributed significantly. We expect a recovery in exports to precede any recovery in imports. The current account will be balanced in 2009 and reach surpluses equivalent to 0.5 and 1.0 per cent of GDP in 2010 and 2011, respectively.

Industrial prices, effective exchange rate

Year-on-year percentage change



Source: Statistics Lithuania, BIS, SEB

The mood of financial markets has improved and currency devaluation rumours have eased this autumn, compared to February-March or early summer. The first signs of a macroeconomic "bottom" and greater certainty about neighbouring Latvia's situation have calmed devaluation fears. Considering the somewhat better export market situation and the large decline in producer prices, we expect the real effective exchange rate of the litas to depreciate further in the near future.

Lithuania remains strongly committed to joining the euro zone as soon as possible. However, its large budget deficit makes this unrealistic before 2014.

Despite the severe economic situation, the ruling coalition is holding together. A recent change in parliamentary speaker has benefited the coalition and improved its odds of success. The president also favours keeping the current government in place. The opposition offers no serious alternatives for improving the economic situation. We thus foresee no major changes in the coalition, at least during the coming year. Tensions will certainly increase if economic problems become more difficult. The government's political cohesiveness may also deteriorate as Lithuania approaches municipal elections in 2011 and its parliamentary election in 2012.

Good fundamentals pay off

- **Higher government debt will require action**
- **Resilient households**
- **Key interest rate has bottomed out**

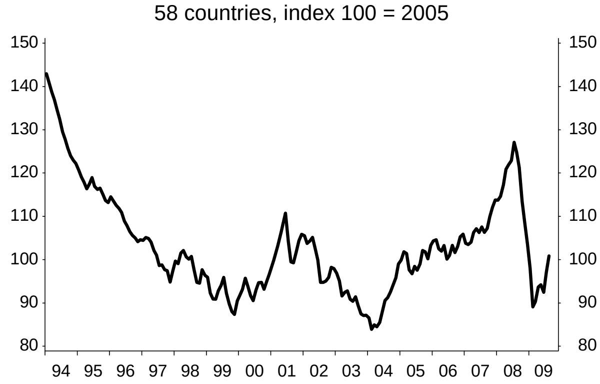
Poland has weathered the global crisis better than most other countries. The economic downturn has been comparatively mild. Poland is the only EU country to have escaped recession. The main reason is relatively good fundamentals, including the banking system. This also bodes well for an imminent recovery, fuelled mainly by a euro zone upturn. But for constitutional reasons, growing public debt – though moderate in an international perspective – will require a policy shift towards fiscal austerity. The cyclical upturn will thus be gradual, but stronger than in the prevailing consensus view. Our forecast is that GDP will increase by 1.5 per cent in 2009, 3.0 per cent this year and 4.0 per cent in 2011.

Several factors related to exports, consumption and financing indicate that Poland is one of the countries in the region best positioned for an upturn:

- The currency has fallen more than elsewhere, except Ukraine. The zloty slid by 30 per cent between July 2008 and February 2009 – a "super-depreciation" unprecedented in Poland over the past 20 years. Including the subsequent recovery, the zloty is still down 20 per cent. Measured in real effective terms, the downturn is 18 per cent, making Polish exports more competitive – after a five-year period when Poland restructured its economy and corrected earlier competitive problems due to high labour costs. During the coming year we expect continued zloty appreciation.

Effective exchange rate

58 countries, index 100 = 2005



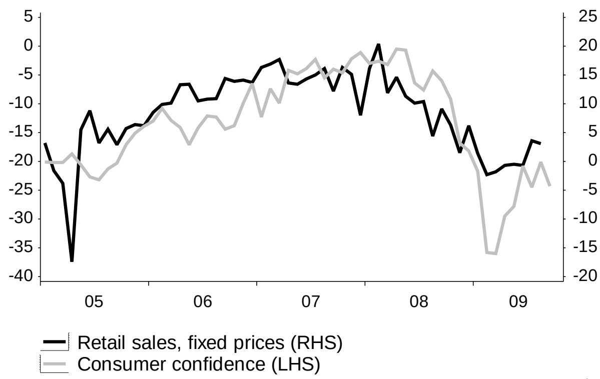
Source: Reuters EcoWin

- The squeeze on real household pay has been less in Poland. Not until this past summer did the trend of real wages and salaries approach zero, compared to long-time real wage declines in many other countries. Our assessment is that real pay will increase during the coming year, though only slightly due to continued labour market weakening.
- Exposure to foreign currency loans is moderate in a regional perspective. Around one third of borrowing is in other currencies, compared to 50-75 per cent in countries like Ukraine, Bulgaria, Romania, Hungary and Lithuania – and even higher in Estonia and Latvia. Poland's loan situation has been an advantage since many currencies in the region, including the zloty, had fallen earlier. Nor has credit expanded as fast in Poland.
- Remaining adjustments in Polish bank balance sheets are probably less than elsewhere. According to IMF studies this past summer, the banks are well-capitalised. The Fund's stress tests showed they are resilient, yet in the short term we expect continued credit tightening at the national level as well.

The economy also decelerated in an orderly way, a gradual slowdown that started before the most acute period of the global financial crisis. Signs of stabilisation are now visible. Year-on-year, GDP rose 0.8 per cent in the first quarter and 1.1 per cent in the second. First half 2009 growth was mainly driven by net exports, due to the collapse of imports. But private consumption also grew, though more slowly than before, sustained in part by fiscal stimulus measures. Investments – which in recent years have played a key dynamic role in the economy – were depressed.

Consumer confidence and retail sales

Index and year-on-year percentage change



Source: Reuters EcoWin

Since last spring, exports have bottomed out and retail sales have recuperated somewhat, though car sales have remained weak. Sentiment indicators have stabilised across the board. Household surveys even show a clear recovery in confidence.

In the next couple of years, growth forces will be more balanced; exports and investments will increase again – the latter only weakly next year, however – while consumption will continue to grow at a modest pace. This, in turn, means that the current account will remain close to equilibrium; we expect only minor deficits. Mainly because of weak imports, the current account has improved faster than expected, from -5.3 per cent of GDP last year to nearly zero this year. The first-half surplus was the first since the mid-1990s.

Household consumption will be held back by a continued rise in unemployment well into 2010, and later by certain fiscal tightening measures. The number of job vacancies has climbed this year but remains low compared to 2006-2008. Fewer industrial companies plan cutbacks than early this year, but those intending to trim their costs are still in a clear majority. What threatens to push up unemployment is Poles returning home after the emigration wave of recent years, when a couple of million headed west in search of jobs. Anecdotal reports say that this wave of returnees has not actually been so strong. Overall, we expect unemployment to peak at 13 per cent.

Unemployment

Per cent

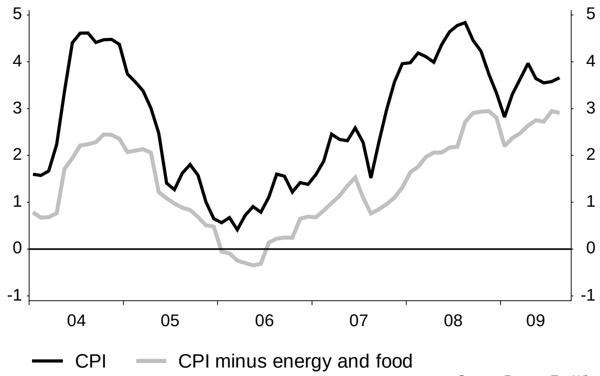
Source: Reuters EcoWin

Since last spring, CPI inflation has fluctuated between 4.0 and 3.5 per cent. This is somewhat higher than the National Bank of Poland's 2.5 ± 1 percentage point target. A bit worryingly, core inflation (CPI excluding energy and food) has also continued upward to 3.0 per cent. Recent tax hikes have pushed prices up. Coming budget-tightening measures may also include changes in taxes and fees that drive up inflation. But bearing in mind the increased quantity of idle resources in the economy and the fact that growth will not revert to trend until 2011, our assessment is that inflation pressure will instead ease. Zloty appreciation will also help dampen price increases although historical experience shows that the impact of such changes, in both directions, is limited. We predict that inflation will average 3 per cent annually in 2010-2011.

The NBP has lowered its key interest rate in six steps since late 2008, from 6 per cent to a historically low 3.5 per cent in June. Weak growth and a fragile labour market might justify further cuts. But the bank's decision makers are probably concerned that their CPI target has not really been met. Our conclusion is that the key rate has bottomed out and a gradual upward adjustment will begin during the first half of 2010.

CPI inflation

Year-on-year percentage change



Source: Reuters EcoWin

Fiscal policy has been relatively conservative. The public deficit was 4 per cent of GDP in 2008 and is moving towards 6 per cent this year, exceeding the government's 4.6 per cent projection. The EU has begun a process aimed at trimming the deficit. Meanwhile Poland was one of five EU countries in the region granted a respite last summer to consolidate their budget over the next few years, in Poland's case to a maximum 3 per cent deficit in 2012. But this will require tightening the budget by at least 1.25 per cent of GDP per year starting in 2010, the EU noted.

As the budget deficit has burgeoned, so has public debt. It stood at 47 per cent of GDP last year and will approach the critical 55 per cent limit next year. According to Poland's economic policy framework, the deficit must then be reduced. In light of this, we expect the government to shift to fiscal tightening in 2010. As one step in strengthening its finances, it will also try to revive its ambitious privatisation plans. We thus believe that the government will start tightening in a relatively gentle way. The 2010 presidential and 2011 parliamentary elections will probably also mean that austerity measures will not be severe.

As for the government's target of euro zone accession in 2012, in last spring's *Eastern European Outlook* we stated that it seemed too ambitious. This target has not yet been officially abandoned. We believe that Poland will join the currency union in 2014.

Modest recovery after record decline

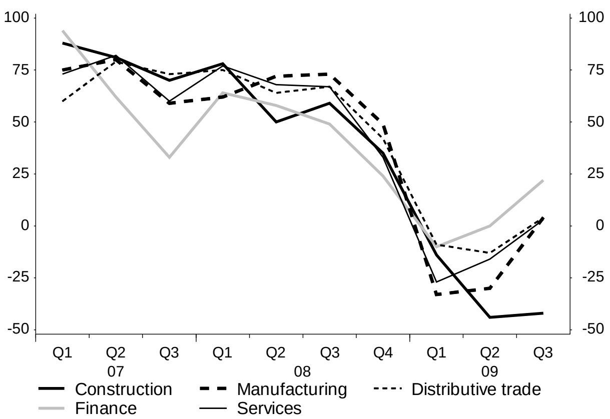
- **Economy bottomed out in second quarter**
- **Unemployment will climb this winter, weak real wage trend**
- **Rising budget deficit, lower key interest rate – less political risk**

The Russian economy bottomed out in the second quarter of 2009, but its recovery will be slow. GDP growth will end up at -7.7 per cent this year, 4.1 per cent in 2010 and 5.5 per cent in 2011. This forecast is based on an oil price of USD 70/barrel in 2010-2011, compared to the federal government's own forecast of USD 60. Unemployment will climb to 9.3 per cent in December this year and will average 10 per cent in 2010 and 8.5 per cent in 2011. The budget deficit will end up at 8 per cent of GDP this year, then fall to 5 per cent in 2010 and somewhat lower in 2011.

Recovery next year

Russia has been hard hit by the global recession. A combination of the global halt in exports, the oil price collapse late last year and capital outflows of more than USD 175 billion since mid-2008 contributed to record-low Russian GDP growth. GDP fell 9.8 per cent year-on-year in the first quarter and 10.9 per cent in the second – the biggest downturn ever measured in the country's history. Russia's export-dependent manufacturing sector was the hardest hit in all of Central and Eastern Europe, helping lower the net economic contribution of foreign trade to -2 percentage points in the second quarter.

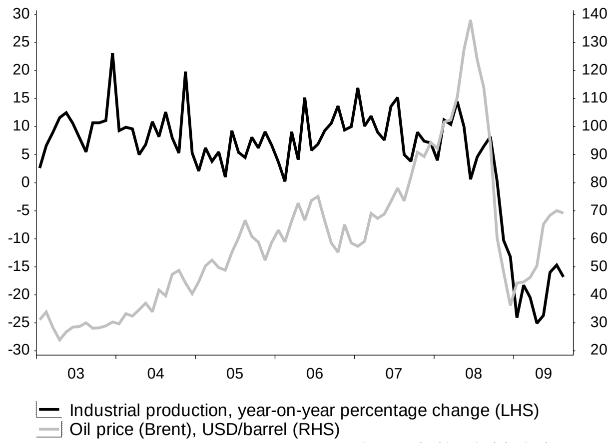
Upturn in leading indicators



Source: OeKB, Reuters

In recent months, however, there have been various signs of stabilisation; oil prices have climbed back above USD 70/barrel, preliminary figures indicate a certain influx of capital again and the government launched yet another stimulus package in its April supplementary budget, equivalent to some 5 per cent of GDP and including lower corporate taxes as well as aid to banks and liquidity injections. Overall fiscal stimulus will end up at close to 10 per cent of GDP. In addition, leading indicators in the financial, distributive, manufacturing and service sectors have rebounded. They are now at or just above zero, indicating zero growth or slightly positive growth. The construction sector is lagging behind.

Brighter prospects for industrial production



Source: Federal State Statistics Service, Reuters

Manufacturing remains shaky, however; industrial production rose unexpectedly by nearly 10 per cent from May to June, then another 5 per cent in July, but fell more than 4 per cent in August. It was down a full 17 per cent year-on-year in August. We predict a decline in output of about 15 per cent this year, a 3-4 per cent rise in 2010 and another 5-7 per cent in 2011.

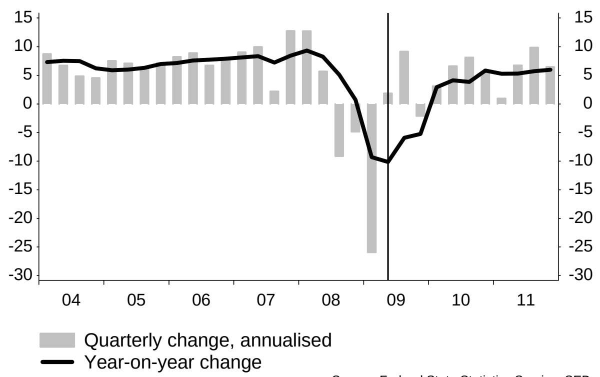
Because of favourable economic signals, politicians – led by President Dmitry Medvedev and Prime Minister Vladimir Putin – have started to believe in positive growth again. But there will be no rapid recovery: the purchasing managers' index (PMI) is signalling continued weak growth this year, though it has been faster than expected in recent months. Manufacturing climbed to 52.0 in September from 49.6 in August – slightly above 50, the breakpoint between contraction and expansion (sometimes regarded as being as high as 55). Service sector PMI rose to 53.0 from 52.2 in July, indicating that services are leading the recovery.

However, the connection between GDP and PMI is far from perfect, mainly because the index excludes the construction, mining and agricultural sectors, which together account for about 20 per cent of added value in the Russian economy, but also because the seasonal pattern in GDP figures are difficult to estimate (there are no official seasonally adjusted GDP figures).

Our own seasonal adjustment indicates that GDP rose by a modest 0.5 per cent between the first and second quarters – encouraging, but far from offsetting the 7 per cent fall in the first quarter. We expect seasonally adjusted GDP to climb more than 2 per cent from the second to third quarter, thanks to fiscal stimulus measures that have been somewhat delayed, but to decline again late this year as stimulus effects fade. After that, growth will again accelerate as the global economy continues upward and the 2010 fiscal expansion starts to have an impact. Seasonally adjusted GDP will thus assume a W shape. Growth will end up at -7.7 per cent this year, 4.1 per cent in 2010 and 5.5 per cent in 2011 – slightly above consensus, but bellow trend. Private consumption will shrink nearly 5 per cent this year, expand again by about 4 per cent in 2010 and accelerate a bit in 2011. Investments will fall by 15 per cent this year, then rise by about 5 per cent annually in 2010-2011. Exports will decline by 1.5 per cent this year, then recover by 2-3 per cent in 2010 and about 5 per cent in 2011.

GDP will recover next year

Per cent



Source: Federal State Statistics Service, SEB

Russia's GDP decline will be deeper this year than the 1998 downturn, but due to the current more smoothly operating economy – including better functioning institutions, greater economic and political stability and low initial central government debt – the slump will be shorter. The rouble has weakened by about 30 per cent against the dollar since July 2008, providing some support to the recovery, although the currency has begun to strengthen again. The current account deficit will shrink to 3.5 per cent this year, 3 per cent in 2010 and 2.5 per cent in 2011.

Unemployment will rise this autumn

So far this year, unemployment has defied the forces of recession; the financial and credit crisis and global economic paralysis quickly drove up Russia's jobless rate to 9.5 per cent in February 2009, but then it gradually fell to 8.3 per cent in July. The reason for this favourable development, which goes against the international pattern, is a combination of seasonal effects, a positive stock market trend and higher oil prices, which stimulated Russian industry. Perhaps it also has to do with measuring problems related to the large informal/black market sector. We expect unemployment to climb again, reaching 9.3 per cent by December this year and peaking at 10.3 per cent in the second quarter of 2010. The average jobless rate will be 8.8 per cent this year, 10 per cent in 2010 and 8.5 per cent in 2011. It will thus clearly exceed the non-accelerating inflation rate of unemployment (NAIRU) almost throughout our forecast period and will hold down wage and price inflation pressure.

Unemployment will peak in May 2010

Per cent

Source: Federal State Statisitcs Service, SEB

Russia's weak real wage growth so far this year (-14 per cent) is worrisome, especially considering the rapid increases of recent years: around 3 per cent. Households continue to hold back on consumption – reflected, for example, in slowing retail sales (-0.2 per cent year-on-year in August). There is no indication that private consumption will take over as a short- or medium-term economic growth engine, which makes the recovery vulnerable to fluctuations in global demand and oil prices. This is a major uncertainty factor, of course, especially since consumption has been a major driving force behind the strong growth of recent years. At present, low indebtedness does mean that households can borrow money to finance their expenditures, but restrained lending and major economic uncertainty nevertheless indicate that private consumption growth will be relatively weak.

Lower inflation next year

Due to low resource utilisation in the economy during our forecast period, underlying inflation pressure will ease. Yet inflation is high at present, pushed upward by high money supply growth in the wake of large capital inflows before the crisis broke out, rapid fuel and food price increases, high (pre-crisis) resource utilisation as well as large real wage increases and high import prices due to the weakening of the rouble. We expect core inflation, which was at 11.7 per cent in August, to slow to an average of 9 per cent next year and 6 per cent in 2011. CPI inflation, in turn, moves more erratically due to energy price fluctuations. We expect CPI inflation, which was 11.6 per cent in August, to be 9 per cent in December; in terms of annual averages it will be 11.7 per cent this year, 9 per cent in 2010 and 8 per cent in 2011.

Budget deficits in 2009-2011

The government's April budget added stimulus measures totalling another 5 per cent of GDP, including discretionary defence and security investments, lower corporate taxes plus loans to and recapitalisation of the banking and financial sector. Overall fiscal stimulus will thus total some 10 per cent of GDP. Since the banking system is dominated by a few state-controlled banks and the government has significant financial resources to back them up, there is little systemic risk for the banking sector.

The overall effect of recession, the oil price decline late last year and stimulus measures is that the federal budget is moving from a surplus last year equivalent to 4.2 per cent of GDP to deficits of 8 per cent this year, 5 per cent in 2010 and 4 per cent in 2011. The deficits will not be larger because growth will resume and economic policy will shift in a less expansionary direction. The government will also resume the privatisation of up to 5,500 companies in aviation, freight forwarding, harbours and oil, which will strengthen public finances.

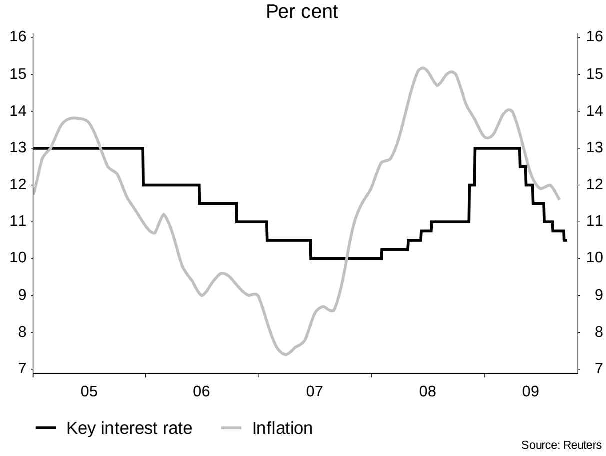
At the end of 2008, the value of the government's oil stabilisation funds totalled USD 225 billion, of which USD 142 billion was in the Reserve Fund and the remaining USD 78 billion in the National Welfare Fund. This year's deficit is equivalent to about 75 per cent of the Reserve Fund. Next year a larger share of the deficit will thus be financed by borrowing.

Lower key interest rate

On September 14, the Bank of Russia lowered its key interest rate by another 25 basis points to 10.5 per cent and its one-day repo rate to 9.5 per cent. The bank signalled that further rate cuts may come later. There is strong political pressure for a more expansive monetary policy, both in terms of lower key rates and more lending to commercial banks aimed at encouraging credit expansion. Interest rates on loans to companies and households have admittedly begun to fall somewhat, according to the central bank's own data, among other things due to pressure from the Kremlin. But lending volume has also fallen, and considering that unemployment is predicted to rise during the next six months, there is an obvious risk that the banks will not expand their lending to any great extent. The central bank is in a difficult situation; on one hand, the economy needs to be stimulated, but on the other hand, the bank must try to bring down Russia's high inflation.

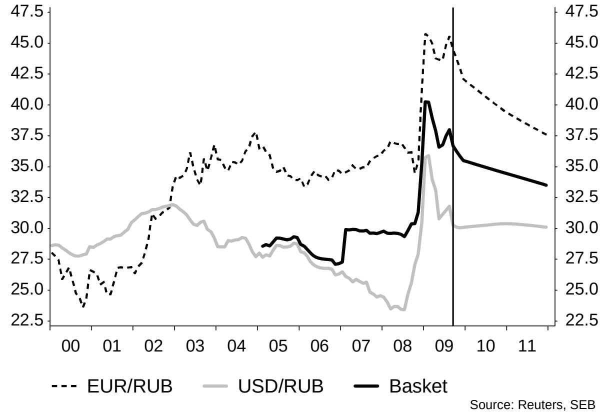
The rouble will strengthen somewhat the next couple of years, in light of more stable economic conditions and greater global risk appetite. It will stay around RUB 30 per dollar until the end of 2011, but strengthen towards 39.5 per euro in December 2010 and 37.6 per euro in December 2011. The rouble will strengthen towards 33.5 in December 2011 against the currency basket, consisting of 55 per cent USD and 45 per cent EUR since February 2007. It is unlikely that the central bank will let the currency get any stronger than this.

Lower key interest rate, falling inflation



Political risk will continue changing in response to economic growth. As the economy recovers this winter we expect such risk, especially as regards political predictability and social stability, to continue easing. Support for Medvedev and Putin remains high, even rising a bit last summer (70 per cent of Russians currently approve of them). Support for the government party also rose somewhat; 57 per cent now say they support it. The likelihood of a snap election has thus decreased. Nor do we anticipate any major short- or medium-term changes in either government policies or the institutional framework. There are many indications that Putin plans to return to the presidency in 2012, but in that case policies would not change to any great extent either.

Somewhat stronger rouble



Bright spots in the darkness

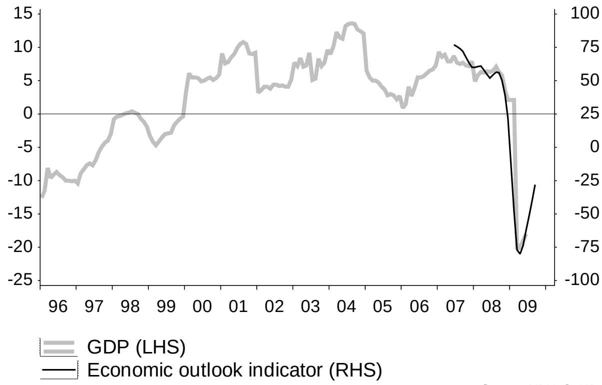
- **Manufacturing sector stabilising…**
- **…but currency and banking crisis continues**
- **Political turbulence and continued IMF aid**

The recession in Ukraine is the deepest in the entire Eastern European region. The economy was in free fall during the first half of 2009 – the GDP downturn was 19 per cent year-on-year. The political battles are continuing, while the banking system has been under heavy pressure and the credit situation keeps tightening. IMF aid is still necessary in order to maintain financial stability. Among bright spots is a huge currency depreciation which, combined with a small upswing in manufacturing, will help the export sector. The flip side is that both banks and households are being hit hard by the currency crisis – nearly 50 per cent of household borrowing is denominated in hard currencies, and bad loans are climbing rapidly. Purchasing power is also eroding, and per capita GDP in US dollars terms will almost be halved this year.

GDP will fall by 15 per cent this year and then grow by 1.5 per cent in 2010. Both household consumption and capital spending will hold back the upturn, and only in 2011 will growth approach its trend level. By way of comparison, the Economy Minister expects growth of nearly 4 per cent next year.

Economy has bottomed out

Year-on-year percentage change, index



Source: NBU, OeKB

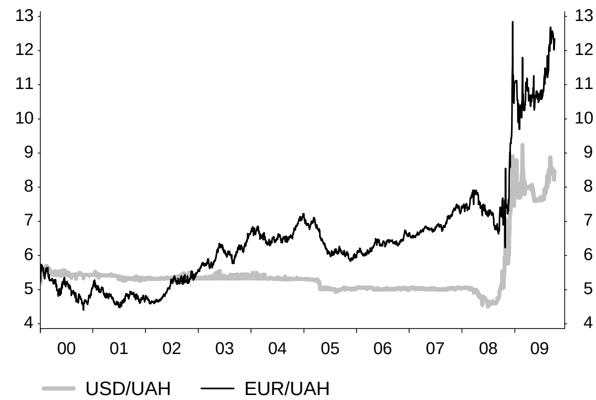
The year-on-year decline in industrial production reached more than 30 per cent, but a recovery has begun, albeit from deeply depressed levels. Steel accounts for 40 per cent of exports, so it is a positive step that the price of steel has stopped falling. But demand from Ukraine's most important trading partners, the euro zone and Russia, is weak. This is hampering the recovery. Industrial production will fall by 17 per cent this year and rise 2 per cent next year.

During the first half of 2009, foreign direct investment fell by 66 per cent year-on-year (to USD 2.4 billion) – thus an unfavourable situation for an investment-led upturn. Ukraine and Poland will jointly host the European football championships in 2012, but the UAH 9.8 billion in financing is a hot potato in Parliament and planning is far behind schedule. Both the construction sector and infrastructure would enjoy a much-needed upswing if a solution were found. But time is running short, and there is an increasing likelihood that Poland will take over the entire arrangement. In that case, large-scale investment projects will come to nought and Ukraine's economic growth figures in 2010 and 2011 will be worse.

Credit expansion until last year, especially via increased borrowing in foreign currencies, was responsible for a substantial proportion of both the investment and consumption upturn as well as the imbalances in the Ukrainian economy. Now that lending is instead set to shrink by over 10 per cent this year and will presumably continue downward in 2010, this will have a major impact on household consumption. In addition, unemployment has doubled in the space of six months and real wages are falling by double-digit percentages. Household consumption is being squeezed hard, and retail sales have a 16 per cent year-on-year decline so far during 2009.

Accelerating capital outflows and large current account deficits – 7.1 per cent of GDP last year – contributed to very sharp currency depreciation when the credit crisis struck one year ago. Interventions by the National Bank of Ukraine (NBU) and capital controls contributed to a stabilisation last spring, but in recent months depreciation has regained momentum. The hryvnia will continue to weaken this year, then stabilise at 9 per USD, but the effect of this on inflation will be offset by the deep recession. Inflation will keep falling to 9 per cent in 2011.

Huge hryvnia depreciation



Source: Reuters EcoWin

Exports are falling by nearly 50 per cent year-on-year, but current account deficits have reversed and is set to record a surplus this year. This improvement reflects an even larger import collapse, but current account deficits will resume in 2010, partly due to higher energy costs as Russia continues to adjust gas prices towards world market levels.

In late 2008, Ukraine received an IMF aid package of USD 16.4 billion or 8 per cent of GDP, which is being disbursed in stages. More than USD 11 billion has already been paid, and a fourth payment of 3.7 billion is scheduled for November 15 if certain conditions are met. The basic requirement was a balanced 2009 budget, but as the real economy has deteriorated, this requirement has been watered down. Compared to Latvia, for instance, Ukraine has been treated in a more pragmatic way. If the IMF again decides to postpone the payment, another wave of fiscal and exchange rate instability could well start.

The latest proposal is that Ukraine will be permitted to run a central government budget deficit equivalent to 6 per cent of GDP, but we expect the deficit to be much larger than this, both in 2009 and 2010. The requirements concerning reforms in the banking system, tax increases and expenditure cuts remain in place, which has also contributed to the political turbulence, and they will hamper the growth outlook for some years to come. But if these reforms are approved, this step will help pave the way for sustainable growth a bit further ahead.

One positive factor is Ukraine's low public sector debt abroad, which will allow room for perhaps the biggest policy challenge – reforming the banking system. The final bill may be 5-10 per cent of GDP, but in spite of this the IMF paints a rather optimistic long-term picture of Ukraine's central government finances. Public sector external debt is expected to be less than 20 per cent of GDP in 2012. This is lower than in most other countries in the region. But overall debt will climb rapidly, reaching 50 per cent of GDP next year, which is still not alarming. In its latest budget bill for 2010, the government projects a deficit of USD 1 billion in 2010. But there are many indications that its refinancing requirement may be higher than this, totalling some USD 5 billion in 2010. In a situation of higher global risk appetite, and backed by the IMF, we believe that the deficit can nevertheless be financed, via the bond market, bilateral loans and international financial organisations. One uncertainty factor is the debt-burdened gas company Naftogaz, whose bonds are not government-guaranteed but which is so large that government borrowing terms would probably be affected by any debt restructuring.

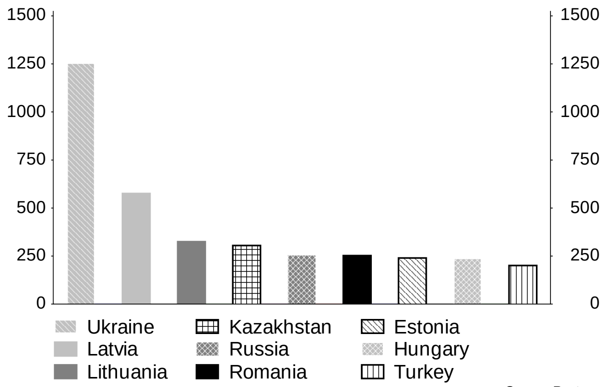
According to the NBU, non-performing loans (NPLs) accounted for nearly 5 per cent of total lending this summer. In practice, the situation is substantially worse and a reasonable figure is probably four times larger: the highest in the region. According to Standard & Poor's the level of NPLs may be as high as 40-45 per cent. The creditworthiness of Ukraine's major domestic banks is very low, according to the rating institutions.

A high proportion of lending, 55 per cent, is in euros and dollars, makings principal and interest payments more expensive as the hryvnia weakens. Combined with a continued shortfall in economic growth, there are strong indications that the proportion of NPLs will continue climbing. In order to prevent a wave of bankruptcies in the banking system, UAH 44 billion – 4.8 per cent of GDP – has been appropriated for recapitalisation of the domestic banks. But because of the political deadlock, implementation is moving slowly and so far only three banks (Rodovid Bank, Ukrgazbank and Bank Kyiv) have been recapitalised. Meanwhile the banks continue to tighten their credit terms. The deposit guarantee stands at USD 18,000 per account, but capital outflow has continued.

The risk that the Ukrainian government will suspend payments over the next few years is around 50 per cent, according to market pricing – but this is a noticeable improvement on last spring, when the probability stood at around 90 per cent. Meanwhile the returns are good for those investors who are willing to take the risk. Ukrainian CDSs stand over 700 basis points higher than their Latvian equivalents – high compensation for political risk.

Ukraine the highest yielder

5y CDS, basis points



Source: Reuters

The political battles in the run-up to the January 2010 presidential election have nearly paralysed Parliament. Meanwhile, accusations of corruption among central bank officials related to the foreign exchange market have dragged the NBU in the mud. According to public opinion surveys, President Viktor Yushchenko has disastrously low support. Instead the main candidates for his job are Prime Minister Yulia Timoshenko, whose popularity has also plunged, and Viktor Yanukovich, leader of the largest opposition party. Hopefully the new post-election political environment will allow more resolute decision making and the implementation of both stabilisation and structural policies.

ESTONIA

	2004	2005	2006	2007	2008	2009 (f)	2010 (f)	2011 (f)
GDP, %	7.5	9.2	10.4	6.3	-3.6	-13.6	-0.3	4.0
Inflation, HICP, average, %	3.0	4.1	4.4	6.6	10.4	-0.1	1.0	2.4
Unemployment, %	9.7	7.9	5.9	4.7	5.5	14.2	16.4	12.5
Current account, % of GDP	-11.5	-10.0	-16.7	-18.1	-9.4	2.6	6.0	5.0
Public sector financial balance, % of GDP	2.3	2.3	3.8	2.9	-2.7	-3.0	-3.0	-2.8
Public sector debt, % of GDP	5.2	4.4	4.3	3.5	4.6	7.3	7.6	7.5
EUR/EEK, end of period	15.6	15.6	15.6	15.6	15.6	15.6	15.6	15.6
3-month interest rate, eop	2.4	2.6	3.9	7.3	7.9	5.3	6.0	5.8

LATVIA

	2004	2005	2006	2007	2008	2009(f)	2010(f)	2011(f)
GDP, %	8.7	10.6	12.2	10.0	-4.6	-17.5	-3.0	3.0
Inflation, HICP, average, %	6.2	6.9	6.6	10.1	15.3	3.5	-2.5	1.5
Unemployment, %	10.4	8.7	6.8	6.0	7.6	18.0	17.0	14.0
Current account, % of GDP	-12.8	-12.5	-22.5	-22.5	-12.6	8.0	3.0	-2.0
Public sector financial balance, % of GDP	-1.0	-0.4	-0.5	-0.4	-4.0	-9.0	-8.5	-5.0
Public sector debt, % of GDP	14.9	12.4	10.7	9.0	19.6	34.0	38.0	41.0
EUR/LVL, end of period	0.70	0.70	0.70	0.70	0.70	0.70	0.70	0.70
Key rate, eop	3.50	4.00	5.00	6.50	6.00	4.00	5.00	6.00
5-year government bond, eop	4.00	3.20	4.90	7.50	10.00	11.00	11.00	9.00

LITHUANIA

	2004	2005	2006	2007	2008	2009(f)	2010(f)	2011(f)
GDP, %	7.4	7.8	7.8	8.9	3.0	-15.5	-3.5	3.0
Inflation, HICP, average, %	1.2	2.7	3.8	5.8	11.1	5.0	2.0	2.5
Unemployment, %	11.4	8.3	5.6	4.3	5.8	14.0	15.5	16.0
Current account, % of GDP	-7.7	-7.1	-10.6	-14.6	-11.9	0.0	0.5	1.0
Public sector financial balance, % of GDP	-1.5	-0.5	-0.4	-1.0	-3.2	-10.0	-8.0	-4.0
Public sector debt, % of GDP	19.4	18.4	18.0	17.0	15.6	22.0	35.0	39.0
EUR/LTL, end of period	3.45	3.45	3.45	3.45	3.45	3.45	3.45	3.45
3-month interest rate, eop	2.60	2.50	3.80	6.70	9.90	6.50	5.50	5.00
5-year government bond, eop	3.00	3.10	3.90	4.50	12.00	7.50	6.50	5.50

(f) = forecast

Key economic data

Eastern European Outlook — October 2009

POLAND

	2004	2005	2006	2007	2008	2009(f)	2010(f)	2011(f)
GDP, %	5.3	3.6	6.2	6.8	4.9	1.5	3.0	4.0
Inflation, HICP, average, %	3.6	2.1	1.0	2.5	4.2	3.5	3.0	3.0
Unemployment, %	19.0	17.8	13.9	9.6	7.1	10.5	12.5	11.0
Current account, % of GDP	-3.9	-1.2	-2.7	-4.7	-5.5	0.0	-1.5	-2.0
Public sector financial balance, % of GDP	-5.7	-4.3	-3.8	-2.0	-3.9	-5.5	-5.0	-4.0
Public sector debt, % of GDP	45.7	47.1	47.7	44.8	47.0	50.0	55.0	54.0
EUR/PLN, end of period	4.08	3.86	3.83	3.60	4.12	3.90	3.50	3.40
Key rate, eop	6.50	4.50	4.00	5.00	5.00	3.50	4.50	5.00
5-year government bond, eop	6.20	5.00	4.98	6.13	5.34	5.00	4.80	4.70

RUSSIA

	2004	2005	2006	2007	2008	2009(f)	2010(f)	2011(f)
GDP, %	7.2	6.3	7.6	8.1	5.9	-7.7	4.1	5.5
Inflation, average %	10.9	12.7	9.7	9.0	14.1	11.7	9.0	8.0
Unemployment, %	8.2	7.6	7.2	6.1	6.4	8.8	10.0	8.5
Current account, % of GDP	10.1	11	9.5	5.9	6.1	3.5	3.0	2.5
Public sector financial balance, % of GDP	4.4	7.9	7.9	5.9	4.2	-8.0	-5.0	-4.0
Public sector debt, % of GDP	20.30	14.10	9.10	7.40	6.50	7.30	8.90	8.10
USD/RUB, end of period	27.70	28.70	26.30	24.60	30.50	30.10	30.40	30.10
Rouble vs. euro/dollar basket	-	29.30	27.20	29.70	35.40	35.50	34.50	33.50

UKRAINE

	2004	2005	2006	2007	2008	2009 (f)	2010 (f)	2011 (f)
GDP, %	12.1	2.7	7.1	7.6	2.1	-15.0	1.5	4.0
Inflation, average, %	9.0	13.6	9.1	12.8	25.2	16.8	12.0	9.0
Unemployment, %	8.6	7.2	6.8	7.2	6.9	12.0	13.0	12.5
Current account, % of GDP	10.6	3.0	-1.5	-4.2	-7.1	2.0	-0.5	2.0
Public sector financial balance, % of GDP	-4.4	-2.3	-1.4	-2.0	-3.2	-8.8	-7.0	-3.0
Public sector debt, % of GDP	24.7	17.7	15.7	12.8	19.9	40.0	50.0	48.0
USD/UAH, end of period	5.31	5.00	5.02	5.05	7.80	9.30	9.00	9.00

(f) = forecast

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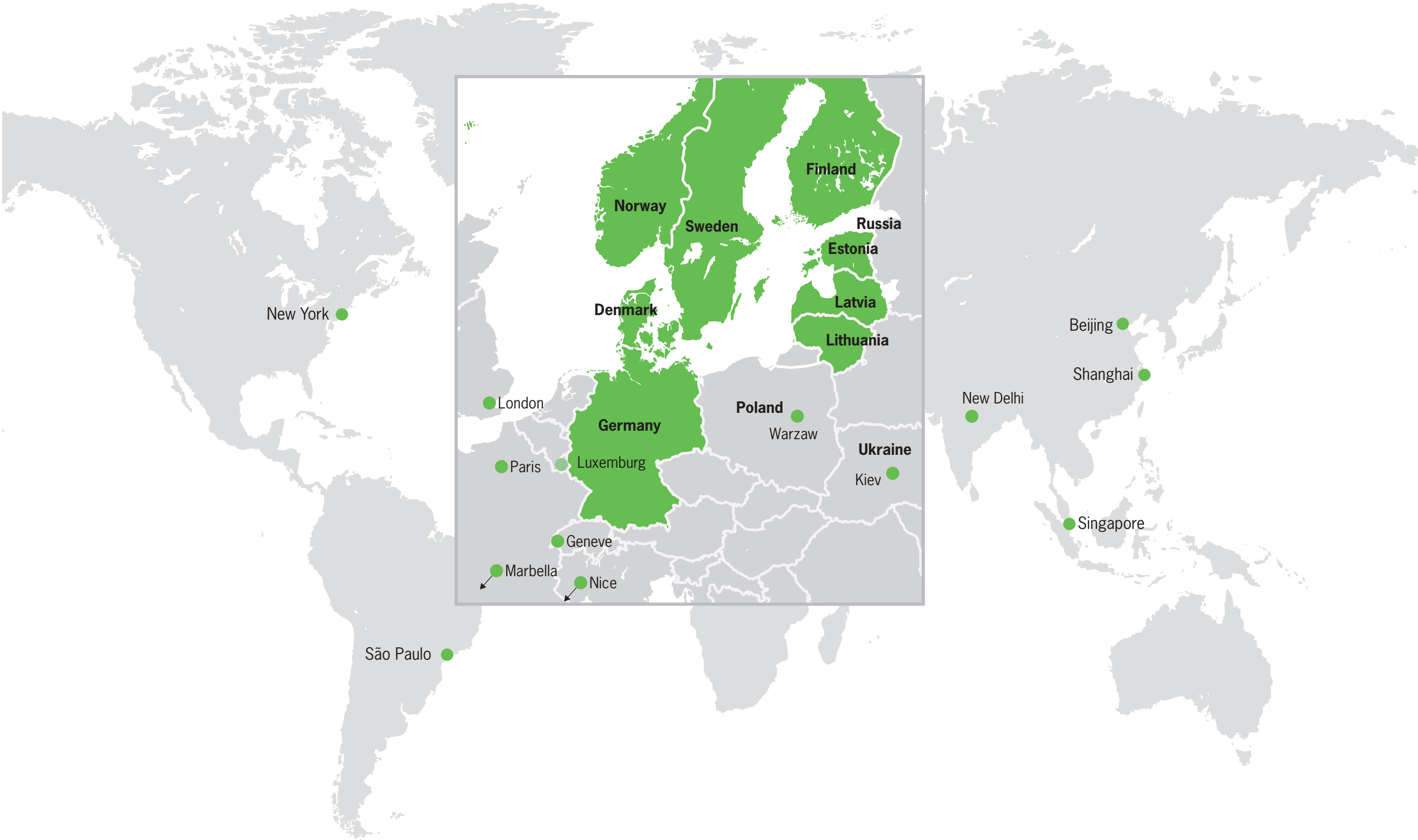

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