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PRESS RELEASE

Eastern European Outlook: Soft landing in the Baltics will require credit tightening

Central and Eastern Europe will remain economically strong in 2007–2008. Latvia, Estonia and Slovakia will grow the fastest. Meanwhile the Baltic countries and Central Europe will be plagued by continued large internal and/or external imbalances, with pose risks of economic and financial instability down the road, according to SEB's new issue of Eastern European Outlook.

Growth in the region will be cooled off to some extent by higher interest rates, somewhat lower international demand and increasing supply side restrictions. Rapid pay hikes that stimulate private consumption are a driving force throughout these countries. EU members in the region also receive sizeable sums from the EU structural funds, which will help ensure continued strong investments, especially in Poland.

No vigorous action in the form of fiscal austerity programmes is on the horizon yet. One exception is Hungary, whose imbalances have been the most accentuated and where budget tightening will continue at the price of a major growth slump and, in the short term, high inflation. Latvia's austerity package, which was recently unveiled, has at least temporarily calmed acute market concerns, but is not sufficient to bring down the country's high inflation and ballooning current account deficit more than marginally.

"Latvia and Estonia continue to exhibit clear signs of overheating after several years of excessively fast, domestically driven growth. Economic policy should have been tightened earlier, but this has not happened. Our main scenario is a soft landing for these economies. But this presupposes a continued slowing of high credit growth. Commercial banks must be more restrictive about lending," says Mikael Johansson of SEB Economic Research, Chief Editor of Eastern European Outlook.

In SEB's judgement, fiscal tightening may also be required in Estonia to avoid a hard landing that might include currency devaluations.

The imbalances in the region will affect the euro adoption timetable. In Central Europe, budget deficits are admittedly shrinking. But in 2008, the deficits in Poland, Hungary and the Czech Republic will still be above the threshold to qualify for euro adoption, 3 per cent of GDP. Slovakia may adopt the euro in 2009, but it will take several more years for the other EU countries in the region, including the Baltics, where budgets are balanced but inflation is too high to join the euro zone.

Russia's economy will continue growing at a healthy pace, fuelled by domestic demand. Expansive fiscal policy ahead of the Duma and presidential elections, combined with high commodity prices, will support such growth. Investments have also taken off.

"Russia will continue to surf on the favourable global commodities market. But unanswered questions remain about long-term growth potential, among other things concerning the level of investments and demographics," says Bo Enegren of SEB Economic Research.

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