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Eastern European Outlook

Theme: Russia after the elections

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SEB Economic Research

Eastern European Outlook - October 2007

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Central and Eastern Europe will remain economically strong over next couple of years despite weaker global demand. In many countries, inflation is now on the way up, due to robust domestic demand and high resource utilisation. Ukraine and Slovakia will eclipse the Baltic countries as the fastest growing economies when Estonia and Latvia decelerate. Lively domestic demand will continue to permeate the region. But rapid consumption and investment growth will slow somewhat in the wake of higher interest rates and more cautious lending: the latter partly as a consequence of international credit market turmoil.

Russia's vigorous economic growth will continue, helped by persistently high commodity prices and expansive fiscal policy. The investment upswing will continue, supported by major infrastructure spending. Inflation will remain stuck at high levels. The Kremlin will continue to strengthen its power, and its policies will remain in place after the parliamentary and presidential elections.

Ukraine's growth and inflation will remain high. The country's strong credit expansion will decelerate, but consumption will continue to be buoyed by rapid wage and salary increases as well as higher pensions. The new governing coalition will intensify integration with the EU.

The **Baltic countries** are plagued by major imbalances. Latvia and Estonia have continued to demonstrate clear signs of overheating, after several years of excessively rapid, domestically driven growth. Our main scenario is still a soft landing in these economies. The still high credit growth will continue to decrease. In Latvia, an upcoming new economic stabilisation package will also actually have to be implemented.

Estonia is clearly decelerating, now that previously exaggerated household and corporate expectations are fading. A couple of years of below-trend expansion await; GDP growth will decelerate from 7 per cent this year to 4 per cent in 2008 and inflation will drop. This is the largest adjustment in our forecast since the last ***Eastern European Outlook*** in March 2007.

Latvia's growth will fall from 10 per cent this year to 6-7 per cent annually in the next couple of years. Continued high interest rates will contribute to the slowdown, and the risk of a sharper deceleration has increased. High wage-driven inflation and an extremely high current account deficit will decrease marginally. The risk of exchange rate adjustments persists but will decrease after the government's stabilisation measures.

Unlike Estonia in particular, but also Latvia, there are still no signs of cooling in **Lithuania**, but economic growth will gradually slow from 8 per cent this year to 6 per cent in 2009.

In **Poland**, consumption is riding on the investment-driven upturn. GDP growth will weaken slightly and remain somewhat above its 5 per cent trend. **Slovakia** will stand out due to its continued high growth paired with low inflation, and the government's goal of euro zone accession in 2009 is within easy grasp. The **Czech Republic** is shifting towards a tighter long-term fiscal policy with an eye towards joining the euro zone, but the negative impact on growth will be small. **Hungary** will rise slowly out of a deep slump, with budget consolidation continuing to shrink the country's twin deficits to more sustainable levels.

Credit turmoil slowing growth

- **Extended slump in the United States**
- **European growth will hold up well**
- **Continued high commodity prices**

The world economy will lose some momentum due to global credit market woes, despite a softening of central bank monetary policies. We expect the US mortgage loan crisis to continue another six months or so. Uncertainty and a degree of risk adjustment will thus persist in the financial system. More cautious lending and reduced risk appetite, in turn, will impact the real economy. Investments and consumption will slow, the latter mainly in the US. We have assumed an overall negative GDP effect of ½ percentage point in the US and ¼ point in Western Europe, but in 2008-2009 the global economy will grow at well above its 3½-4 per cent trend. Positive supply side forces from globalisation and new technology will provide support, along with strong balance sheets in both the corporate and household sectors. Rather cautious real capital spending to date and modestly valued stock markets are other stabilising forces.

GDP growth

Year-on-year percentage change

	2006	2007	2008	2009
United States	2.9	1.9	2.1	2.8
Japan	2.2	2.0	1.9	2.0
China	10.7	11.0	10.0	9.0
Euro zone	2.9	2.6	2.2	2.1
United Kingdom	2.8	2.9	1.9	2.2
Nordic countries	3.8	3.4	2.9	2.3
OECD	3.1	2.6	2.5	2.7
World economy	5.4	5.0	4.5	4.5

Sources: OECD, SEB

We expect a more extended US growth slump than the consensus view. GDP growth will remain around 2 per cent next year. Not until 2009 will the economy again approach potential growth. The adjustment process after the housing market boom will continue for at least another year. Nationwide, home prices will now begin to fall year-on-year as residential construction drops below the historical average. Meanwhile, after resisting the deterioration in GDP over the past year, the labour market is weakening. As a consequence of all this, households will boost their non-existent savings and cut down on consumption, but an economic recession can be avoided. Corporate capital spending outside the construction sector has the potential to increase, exports will be further buoyed by a weaker dollar and interest rates will be lowered. The inflationary threat cannot be dismissed in the short term due to slower productivity growth but will gradually fade as unemployment rises.

In Europe, the Nordic countries will continue to stand out with their high growth, as overheating risks mount in Norway, Denmark and Sweden. GDP growth will average 3 per cent next year, as inflation rises clearly from low levels.

The euro zone is characterised by continued good growth, coupled with stable inflation. Growth will slow gently, staying slightly above the 2 per cent trend. Germany's resurgence combined with generally more robust labour markets will serve as buffers against clearly poorer demand in countries like the US and the UK. The driving forces of growth will shift from exports to domestic demand. Accelerating pay hikes and rising optimism will lead to a consumption upswing, especially in Germany. In several countries including France and Spain, housing markets will continue to cool. Germany will diverge from this pattern, with an upturn. Due to relatively high household saving, as opposed to the US situation, the euro zone housing market appears more stable overall.

Fed will continue cuts

The US Federal Reserve will cut its key interest rate by another 0.25 percentage point to 4.50 per cent this year and continue downward to 3.75 per cent by mid-2008. The Bank of England, which in the short term must deal with emerging mortgage loan problems and a weaker housing market trend, will follow in the Fed's footsteps. The European Central Bank has reach its peak.

American and German bond yields will move sideways over the coming year.

In the foreign exchange market, the dollar will continue to weaken as it loses its previous short-term interest rate support. The euro will climb towards USD 1.50 over the next year. The euro will have to bear a heavy burden since the British pound will depreciate and the valuation of Asian currencies will remain relatively low. This forecast assumes that the Chinese authorities will allow the yuan to appreciate by about 5 per cent annually against the US dollar.

Commodity prices have been little affected by global credit market turmoil and toned-down growth forecasts. We also expect that in general they will stay at high levels, since demand from outside the US will remain relatively high. We assume that oil prices (Brent) will average USD 75/barrel over the next couple of years, which is USD 15 above the projection in our last ***Eastern European Outlook*** in March 2007.

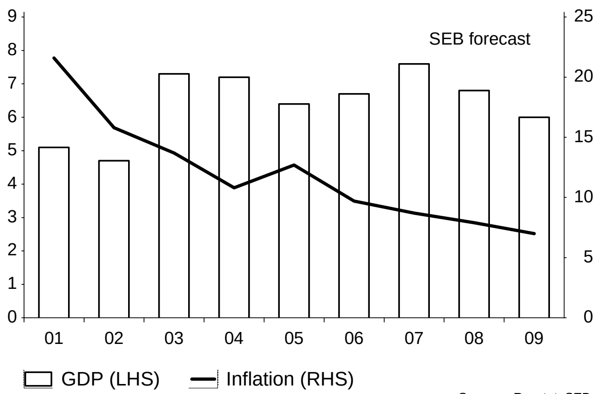
Continued vigorous growth

- **Consumption and investment boom**
- **Expansive fiscal policy, sustained high inflation**
- **Twin surpluses shrinking**

Russia’s strong economic growth is continuing and has even accelerated. In the first half of 2007, GDP rose nearly 8 per cent. Demand is driven by continued high oil prices, increasingly expansive fiscal policy and large capital inflows. This year, GDP will increase by more than 7½ per cent – the strongest growth since 2000. Consumption remains the most expansive demand component, but investments are now also increasing at an ever faster pace. The sharp increase in domestic demand is driving imports, while capacity constraints and the real appreciation of the rouble are holding down exports. Russia’s large current account surplus is thus shrinking, despite continued high commodity prices. The public sector surplus is decreasing at an even faster pace due to the increasingly expansive fiscal policy of recent years.

Russia: GDP and inflation

Year-on-year percentage change



Sources: Rosstat, SEB

Most indications are that growth will remain strong over the next couple of years. Household consumption will continue to be buoyed by high real wage growth and expansive fiscal policy. Investments also appear capable of growing at a rapid pace, especially due to the Russian Federation’s infrastructure spending. We thus anticipate that because of domestic strength, the Russian economy will be affected relatively little by the deceleration in the global economy. This favourable picture admittedly assumes that commodity prices will remain high in the next two years, but even given a downturn in commodity prices from current levels, the Russian economy should cope relatively well in the short term, thanks to the large financial buffers built up in recent years.

However, we anticipate that due to mounting capacity constraints in the economy, output will slow somewhat, while demand will largely be satisfied via increased imports. A somewhat slower rise in public expenditures will also contribute to a certain slowdown ahead. GDP growth will thus fall slightly, to 6.8 per cent in 2008 and 6 per cent in 2009.

Despite vigorous short-term growth, there are many lingering questions about long-term developments. The pace of reform is weak, and tendencies towards diversification of the economy are still small. Although important steps have been taken in creating a fiscal policy framework, Russia’s actual fiscal policy implies increased risk of overheating and thus pro-cyclical tightening further ahead. Considering the low investment level in the economy, the acceleration in investment growth is promising, but the federal government’s large-scale involvement in the business sector raises questions about Russia’s ability to raise its long-term economic growth potential.

No diversification of exports

In recent years, growth on the output side has increasingly shifted from oil and gas extraction to more domestically oriented sectors such as construction and services. The distributive trades in particular have benefited from the consumption boom, but other service sectors such as transport and financial services are also performing strongly. Construction is being stimulated by sharply rising property market prices and by the government’s residential construction spending as one of its four high-priority “national projects”.

To some extent, these developments can be viewed as a diversification of Russia’s economic production structure, yet there are few signs of industrial expansion outside the commodities sector, which is one of the government’s high-priority goals. Nor does the continued real-term appreciation of the rouble make it any easier for manufacturing operations that face competition to become more important to the Russian economy. The part of the manufacturing sector that produces for the rapidly growing domestic market and is not heavily exposed to competition from imports can naturally continue to expand at a healthy pace, but the real challenge is to create competitive export businesses outside the commodities sector.

Another bad omen for future export income is that oil and gas production is growing so slowly. This is somewhat surprising, considering Russia’s strong comparative advantages in these sectors. Having increased by double-digit percentages in the first few years of the 21st century, production now seems to have settled into a growth rate of only a couple of per cent annually. One factor that hampers exports is sharply subsidised domestic prices, which have thwarted efficient energy use, thus leading to high domestic energy consumption. Somewhat paradoxically, this might lead to domestic energy shortages and difficulties in raising or even maintaining today's energy export levels. Slow production growth is primarily a consequence of insufficient investments – which in turn are an effect of high taxation, unclear rules of the game and uncertainty about the role of the government in the energy sector.

Promising investment upturn

The sharp upswing in investments during the past year, both in energy and other sectors, is thus promising. So far this year, investments are more than 20 per cent higher than last year. The upturn has been relatively broad-based in terms of sectors, and the inflow of direct investments has also speeded up substantially. Russia's infrastructure is in acute need of upgrading, and the government has ambitious plans for modernising the economy. Its strategy includes initiating projects in partnership with private market players. Given the major problems of inefficiency and corruption in the public administration, however, there are significant risks of faulty investments. It thus remains uncertain to what extent the investment upturn can boost Russia's long-term growth potential, as long as these investments are not accompanied by reforms in the public sector and elsewhere.

Russia's vigorous economic growth in recent years has depended very little on rising employment and investments, but instead on reallocation of resources from low-productivity to high-productivity sectors, as well as on higher capacity utilisation. There is significant potential for more such catch-up gains, but meanwhile the working-age population will shrink during the next few years and spare capacity has essentially been put to use – underscoring the importance of durably increasing the investment level.

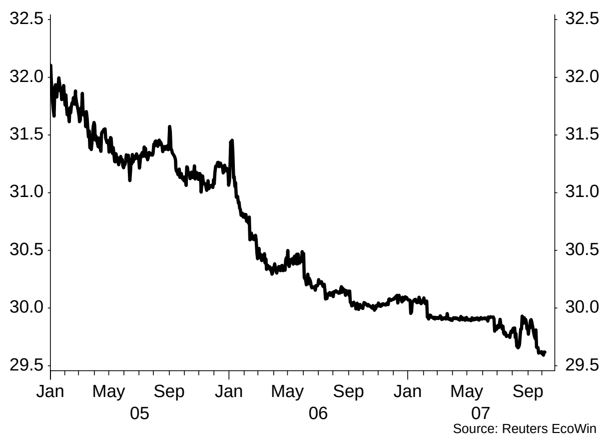
Inflation downturn has reversed

The downward trend in inflation ended last spring, and the rate of price increases accelerated from less than 7½ per cent in March to more than 8½ per cent in August. To some extent, this upswing reflects a turnaround in food prices, a trend likely to continue during the autumn – among other things due to bad harvests. Higher energy prices will probably also help keep inflation up. The official target of 8 per cent inflation at year-end 2007 will thus not be met.

The main underlying inflation problem, however, is the large influx of foreign currency that occurs due to current account surpluses, as well as rising resource utilisation. Since the central bank wants to avoid excessive rouble appreciation, it is buying foreign currency. With little potential to sterilise these inflows, the result is an increase in the money supply. The opportunity to neutralise these inflows instead occurs through fiscal policy, via transfers to the national oil Stabilisation Fund. In recent quarters, Russia's current account surpluses have diminished, but at the same time the influx of capital via corporate borrowing abroad has increased, and these inflows are not automatically sterilised via the Stabilisation Fund.

Over the next couple of years, Russia's current account surpluses will gradually narrow as oil prices level off and then fall slightly, while imports continue to increase at a rapid pace. Capital inflows will probably also slow after various large acquisitions of companies are completed and as borrowing abroad moves into a calmer phase. Meanwhile inflationary pressure will be sustained by high resource utilisation and expansive fiscal policy. The chances of keeping inflation down via administratively fixed prices will also diminish, for example when Russia adjusts gas prices upward towards the price levels that foreign users pay. According to current plans, this adjustment will be fully implemented by 2011 and might entail a tripling of prices compared to the levels of today.

Rouble against euro/dollar basket



We thus expect the central bank to let the rouble appreciate, in order not to diverge too much from its inflation target – 7 per cent at the end of 2008. Meanwhile political opposition to an excessively strong rouble is a constraint. We thus anticipate relatively modest appreciation. At year-end 2008, the exchange rate will be 23.8 roubles to the dollar and 35.2 to the euro. In terms of the central bank's currency basket, consisting of 45 per cent euro and 55 per cent dollars, this means an appreciation of more than 2 per cent from today's level. In the medium term, once the financial system has reached a more mature level, the goal is to let monetary policy be determined by an inflation target.

New stabilisation policy framework

The government was surprisingly good at resisting demands to spend its large oil income until last year. Despite a fiscal policy shift in an expansive direction, overall public finances in 2006 still showed a surplus equivalent to 8.4 per cent of GDP. The increase in public expenditures has accelerated this year, however. Among other things, the government has concentrated these increases on the four national projects launched by President Vladimir Putin in 2006, embracing investments in education, health care, agriculture and housing construction. Pensions and public sector salaries are also sharply increasing.

This expansion in spending will continue next year, albeit at a slower pace and with a larger emphasis on investments in fields like energy and infrastructure. According to the government's budget bill, the federal surplus will fall rapidly and turn into a deficit in 2010. The budget is based on relatively conservative assumptions about oil prices, which are projected to fall towards USD 50/barrel in the space of three years. The easing of fiscal policy is coming at a time when resource utilisation is already at a high level, which risks adding to overheating tendencies in the economy and to the real-term appreciation of the rouble.

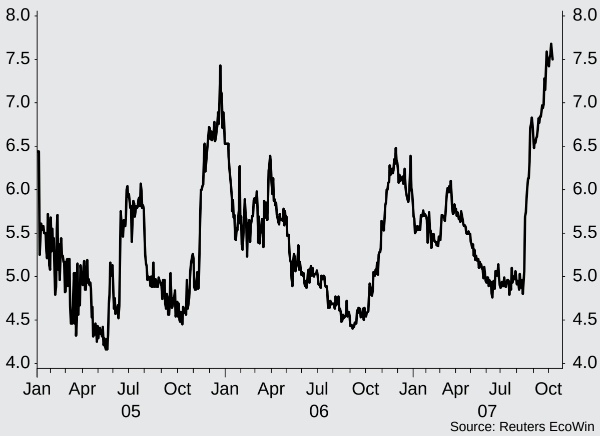
Meanwhile the government has introduced a new fiscal framework that may eventually contribute to more sustainable public finances. Since last spring, it has been producing three-year budgets, for the purpose of increasing transparency and reducing uncertainty about future economic policy. The Stabilisation Fund will also be divided into two parts starting in February 2008 – a Reserve Fund and a Future Generations Fund. Revenue from both oil and gas will go into these funds. The Reserve Fund will serve as a buffer against oil price fluctuations and will accumulate revenue up to 10 per cent of GDP. The fund will invest in safe assets such as government bonds. Revenue beyond what goes to the Reserve Fund will end up in the Future Generations Fund, which is intended to invest in foreign company shares, but there have also been discussions to the effect that this fund might invest in infrastructure, for example.

An annual transfer of oil and gas revenue will be used to finance the budget deficit, calculated exclusive of oil and gas. This transfer is presumed to culminate next year and will amount to more than 6 per cent of GDP, according to the government's three-year budget, then gradually fall to below 4 per cent of GDP by 2011. The new budget process implies greater publicity for the budget deficit, calculated exclusive of oil and gas. This deficit may not exceed 4.7 per cent of GDP, according to plans. This target is not expected to be achieved before 2011, however. Overall, the new fiscal policy framework may contribute to more long-term thinking in budget policy and more stable, sustainable public finances. Meanwhile the realism of the three-year budget can be questioned, since fiscal policy will be expansive in the short term, while the tightening required to achieve the budget target is being postponed.

Only minor effects from global credit crisis

In mid-August, global credit market turmoil infected parts of the Russian financial system, persuading the central bank to pump liquidity into the banking sector and sell foreign currency to support the rouble. The foreign currency reserve fell by nearly USD 7 billion over a two-week period, but in subsequent weeks it regained the entire downturn. Late in September, there was a new bout of credit market instability and the central bank had to carry out additional liquidity injections.

Russia: 3-month interbank rates



These liquidity problems are not only an effect of international credit market turmoil, but are also due to domestic conditions connected to large tax payments around the end of the month. The somewhat tighter credit situation is likely to persist for a while, and the credit expansion will probably slow somewhat from today's high levels. Lending to households is currently increasing at about 70 per cent year-on-year. Meanwhile borrowing abroad by Russian banks has risen very sharply, and their lending in some places has been huge, especially loans for consumption. The percentage of bad loans seems to have increased significantly. These problems are mainly concentrated among a small number of banks, which account for only a very small percentage of the total banking sector. Russia has about 950 banks, but the three largest have approximately an 80 per cent market share. We thus consider the risks to the financial system small. Nor do we foresee any substantial impact on economic growth stemming from these credit market problems.

Policies will remain in place

- **Even stronger Kremlin after parliamentary election**
- **Putin will retain control**
- **Tug-of-war between power politics and economic integration**

The power play in the run-up to the election to the federal Parliament (Duma) in December and the election of a new president in March 2008 is now fully under way. Most of the interest is focusing on the presidential election and on who will succeed President Vladimir Putin, if as expected he follows the constitution and steps down next year. Meanwhile, speculations about Putin's future role have taken a new turn after he himself indicated that he might continue his political career as prime minister. This, in turn, would imply a shift of power from the president to the post of prime minister, given an amendment to the constitution. Thus, President Putin and the group around him would retain control even after the presidential election.

The Duma election is predictable partly due to the changes in the election system that have been implemented since the election four years ago. The threshold for a party to get into the Duma has been raised from 5 to 7 per cent of the vote, election blocs are prohibited, individual independent candidates can no longer stand for election, and the number of members required for registration as a political party has been raised. The taming of the mass media can also be regarded as a guarantee that nothing unexpected will happen, and Putin's strong public support also means that pro-Kremlin parties enjoy a major advantage. About 70-80 per cent of the population support Putin, and 40 per cent state that they would support his choice of successor, even if they didn't know who it was.

A total of 17 parties are registered, but not all of them will participate in the elections and only four parties appear likely to make it over the seven per cent threshold. The large pro-Putin party, United Russia, has two thirds of the 450 seats in the Duma. According to various opinion polls, the party would receive about 50 per cent of votes if the election were held today.

With Putin as the top name on the party list, however, voter support might prove significantly higher than this. There are many indications that the party can achieve a two thirds majority in the Duma, which is what would be needed to amend the constitution and thus pave the way for transferring authority from today's extremely strong presidential post to the prime minister.

The other pro-Kremlin party, A Just Russia, enjoys the support of more than 15 per cent of voters. This party, established last year, is regarded by many observers as an attempt by the Kremlin to create a loyal "opposition" and, by implication, a pure two-party system in which elections are primarily a matter of choosing between individuals rather than party policies. The Communists enjoy approximately the same level of public support while the Liberal Democratic Party, led by ultra-nationalist Vladimir Zhirinovsky, has the support of nearly 10 per cent of voters. Of these four parties, only the Communists can be regarded as an opposition party. No liberal, Western-oriented party looks as if it has a chance to make it into the Duma.

Uncertain presidential election

If the parliamentary election is predictable, uncertainty about who will become president after the March 2008 election has instead risen, especially since the latest cabinet reshuffle. A likely interpretation of Putin's hesitation in promoting a clear candidate, is that he does not want became a lame duck until the election and/or he has not decided what candidate he wants to support. The hottest tip among Kremlinologists still seems to be that one of Putin's two deputy prime ministers, Dmitry Medvedev or Sergei Ivanov, will take over after Putin, with a slight advantage for KGB veteran Ivanov. Although Medvedev is described as the more liberal of these two candidates, the differences between them do not appear especially large.

Speculations that the prime ministerial post might be a natural springboard to the presidency have faded after the appointment of the relatively anonymous Viktor Zubkov as premier. This appointment has instead fuelled speculations of a return to power by Putin, since Zubkov's position of power is primarily based on his personal loyalty to the president. This argument assumes that Putin wants a weak president who serves for one term of office, or resigns early, paving the way for a Putin come-back. The fact that Putin is now hinting that he might become prime minister after the presidential election, paves the way for him to remain Russia' de facto leader as prime minister. The presidential post will then become less important.

There is little doubt that Putin will remain at the centre of power, regardless of whether he becomes prime minister or not. The Putin regime's increasingly clear great-power rhetoric in its dealings with other countries is a factor that has raised questions about Russia's transformation and sparked fears of greater isolation. Offsetting these fears is the external pressure for economic reforms resulting from Russia's integration into the global economy. A number of important steps in this integration process have been taken in recent years, all else aside. One such step was the decision a year ago to make the rouble convertible. The sharply higher inflows of foreign direct investments in recent years are another important trend. Large market flotations of Russian companies abroad and their acquisitions of Western companies are putting pressure on Russian companies to apply Western rule systems and become more transparent.

WTO membership in 2008

Russia's efforts to join the World Trade Organisation also signify an important step towards integration into the global economy. As early as January 2007, the final bilateral negotiations were concluded. Since then, however, there have been negotiations with Saudi Arabia and Cambodia as well as with Georgia, which had torn up an earlier agreement. The remaining problems in multilateral negotiations mainly concern such matters as intellectual property rights and farm subsidies.

According to plans, negotiations will be concluded by year-end 2007. This type of negotiations often stretches out longer than expected, experience shows. Among other things, the EU has criticised Russia for allegedly violating their 2004 bilateral trade agreement. Yet there are many indications that Russia can join the WTO some time during 2008.

One source of irritation in relations between Russia and the EU in particular concerns uncertainty about the role of the Russian state and restrictions on foreign companies in "strategic" sectors. This applies especially to the energy sector. After two years of agonising, at the end of this past summer the government introduced a bill for approval by the Duma which clarifies the sectors in which foreign ownership will be restricted. This removes some of the uncertainties about the role of the state in the economy. The bill lists a number of areas in six different sectors of the economy – space technology, defence, aviation, nuclear power, certain other high-tech industries and natural monopolies. Special permission will be required from the government if a foreign-owned company is to take control of a Russian company in any of these areas. Foreign companies with government owners cannot receive such permission. The law will not apply retroactively.

However, the bill does not include the energy sector, which will instead be regulated by a future mineral resources law. This is also the area where conflicts with the EU have been clearest. Russia's reluctance to let in foreign market players has triggered countermeasures from the EU, such as limiting the ability of Gazprom to acquire portions of the EU's gas distribution network. Mistrust of Russia as a reliable energy exporter has also increased, leading to a desire to secure energy deliveries from other sources. For its part, Russia has oriented itself more in an easterly direction, towards China. Despite the sabre-rattling, trade between the EU and Russia has increased very sharply, and their great mutual dependence in the energy field will continue.

Putin's overall long-term goal is to re-establish Russia's strength. The regime will not hesitate to use Russia's newly gained economic strength for foreign policy purposes, but leaders are also aware of their dependence on other countries to enable them to continue delivering economic prosperity to the population. This indicates that Russia's path towards a market economy is irreversible, despite occasional twists and turns.

Expansive fiscal policy

- **Political victory for Yulia Timoshenko**
- **Fast growth continues**
- **Persistently high inflation**

The apparent winner of Ukraine's electoral showdown between President Viktor Yushchenko and Prime Minister Viktor Yanukovich was Yulia Timoshenko. The Timoshenko Bloc collected the critical number of seats in the Verkhovna Rada (Parliament) needed to lead a government, but the outcome will now depend on a coalition agreement between Timoshenko and the pro-presidential party Our Ukraine. Both parties share similar views on closer economic integration with the European Union and also agree on many domestic issues.

Timoshenko has already promised to cut taxes, raise pensions and promote economic growth. She may also seek to restart a programme of state-asset privatisation that basically stalled under the Yanukovich administration. Timoshenko wants to reduce Ukraine's reliance on Russia for almost all its energy and build two oil refineries on the country's Black Sea coast.

On the other hand, clearly populist decisions cannot be entirely ruled out. Timoshenko has promised within two years to reimburse the savings that people lost when the Soviet Union collapsed. Still, she should have learnt a few lessons from her brief period as prime minister under President Yushchenko, following the victory of the "Orange Revolution" several years ago. Whatever she does, though, she will be held accountable by those who voted for her on September 30.

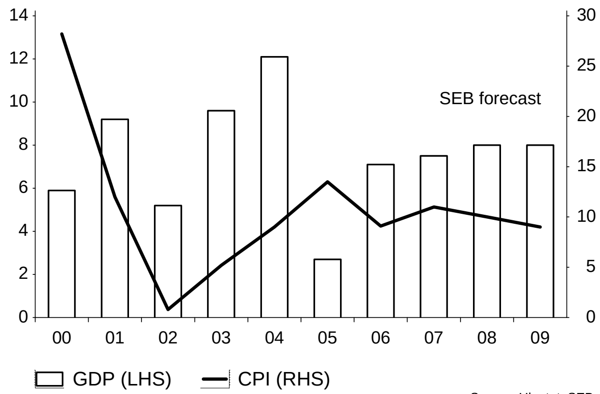
Growth remains strong

GDP growth continued to decelerate in August (7.5 per cent year-on-year), mainly due to a slowdown in the agricultural sector. Poor harvests and a shortage of fodder led to a lower supply of farm products and an unexpected acceleration in CPI inflation, but this cannot overshadow the basically positive macroeconomic trend. Growth in the manufacturing sector accelerated during the year to August, reaching 13 per cent. Robust industrial expansion was encouraged by favourable global metal prices and higher external demand for Ukrainian machinery, especially vehicles and other transport equipment. Growth in the machinery sector is benefiting from strong demand for investment and durable goods both in Ukraine and in the rest of the CIS countries.

The most striking phenomenon has been the boom in the wholesale and retail trade sectors. In August, retail sales increased by 28.4 per cent year-on-year, fuelled by optimistic household expectations and generous consumer loans. However, consumer loans are decreasing as a share of total credits, indicating a growing interest by the banking sector in corporate credits, which should have a positive effect on the real economy. On the other hand, interest rates for credits remained steep due to the high risk premium set by banks and accelerating inflation. Before the recent global credit market turmoil, Ukrainian banks expanded their borrowing in foreign markets, which reduced their need for deposits by households locally. This increased the dependence of the banking system on external resources as well as its sensitivity to the international credit crunch. We expect a shift back towards domestic deposits, causing deposit interest rates to go up in the near future. Credit growth will decelerate slightly from the current very high level.

The first half of 2007 was characterised by a notable deceleration in real wage growth, from 18.3 per cent year-on-year in 2006 to 12.3 per cent during January-August 2007. It is too early to draw conclusions about this shift. Nominal wages are affected by higher inflation, while the growth of corporate profits is impressively strong.

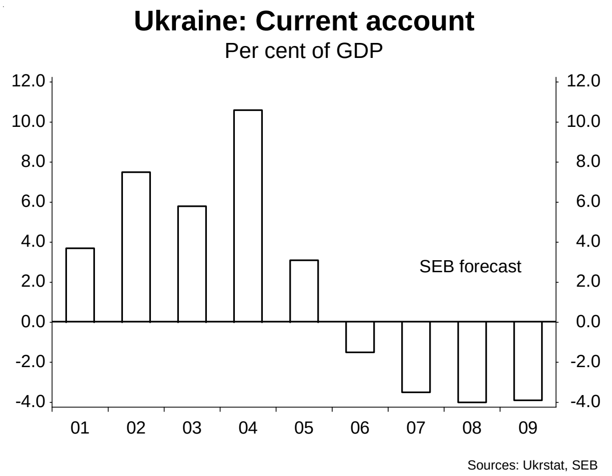
Ukraine: GDP and inflation
Year-on-year percentage change



Source: Ukrstat, SEB

Despite the above-mentioned trends over the next couple of years, economic growth will rely mostly on domestic demand, since exports continue to grow at a slower pace than imports. The domestic market will be supported by an expansionary fiscal policy in the wake of the parliamentary elections. Meanwhile, the competitiveness of Ukrainian goods will be burdened by a real appreciation of the hryvnia, due to higher inflation compared to Ukraine's main foreign trade partners. GDP growth should nevertheless reach 7.5 per cent in 2007 and 8.0 per cent in 2008 and 2009.

Ukraine has taken some important steps towards deeper economic integration with the European Union. In July, two significant credit agreements in the transport sector were signed. In the meantime, the country's struggle to qualify for World Trade Organisation membership is far from over. For Ukraine to get into the WTO by the end of this year, as the country's authorities have promised, the government has to complete all technical procedures "flawlessly". This seems quite unrealistic, bearing in mind the current political situation. A much more complicated issue is possible EU membership. While not yet designated as a candidate for membership, Ukraine's political will has been emboldened by the European Commission's mandate to continue membership talks. However, it is too early to set any accession date.



The current account deficit (CAD) widened from 1.5 per cent of GDP in 2006 to 3.4 per cent at the end of the first half of the 2007. Exports increased by 32 per cent in the first seven months of the year, compared to the same period of 2006, while imports rose by 35 per cent. However, the CAD narrowed in the second quarter from the first three months of the year as imports grew at a slower pace. The CAD can still be regarded as sustainable due to the high net inflow of foreign direct investments and other long-term capital resources. Ukraine will post a higher CAD in 2008 and 2009 because exports will slow and imports will increase as energy prices climb. Imports will also outpace exports because of lively domestic consumption, stimulated by higher wages.

Government fiscal policy is under pressure. In July 2007 the Constitutional Court of Ukraine published a decision declaring several provisions of the State Budget Law for 2007 unconstitutional. These mainly concerned the cancellation of privileges for public sector employees and military personnel and the imposition of restrictions on payments to those under retirement age. This ruling reinstated numerous privileges which had been suspended for 2007 by the State Budget Law. The implementation of the Constitutional Court's decision would require approximately UAH 70 billion, equivalent to nearly 50 per cent of central government fiscal revenue for 2007, which is absolutely impossible.

The government and the National Bank of Ukraine (NBU) have been incapable of curbing inflation so far. CPI climbed to a 14.2 per cent rate in August from 13.5 per cent in July, led by food prices. This is far from the official target of 7.5 per cent in 2007. It is worth mentioning that the government has missed all of its targets on reducing inflation since 2003. We view it as a sign of some desperation that Prime Minister Yanukovich called for stricter food price controls in order to present at least marginal achievements before the election.

In the long run, the most effective tool for pushing inflation below 10 per cent would be a revaluation of the hryvnia. Since the March issue of ***Eastern European Outlook***, the situation in the currency market has changed significantly. Instead of rumours of devaluation, there are already expectations of a revaluation, among other things due to strong capital inflow. The NBU has indicated that it might allow the hryvnia to trade against the US dollar in a wider corridor of between UAH 4.95 and 5.25 next year. We believe the hryvnia will trade in the stronger interval of this corridor.

Presuming a roughly stable nominal effective exchange rate and bottlenecks in the supply of food products, we expect only slight deceleration in CPI growth in 2007, 2008 and 2009, to 11.0 per cent, 10.0 per cent and 9.0 per cent, respectively.

Clear slowdown

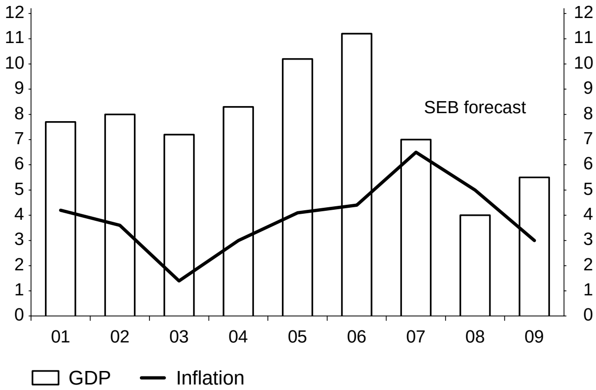
- **Domestic demand will weaken**
- **GDP growth below trend in 2008-2009**
- **Rising unemployment will slow inflation**

The Estonian economy has gradually lost momentum since early 2007. GDP growth has slowed from earlier double-digit figures. Meanwhile confidence has fallen on a broad front, among both households and companies. We expect growth to cool gradually to 4 per cent next year. Exports will be hampered by more constrained competitiveness, while domestic demand will be weakened by decelerating investments as well as a combination of continued more cautious lending practices and reduced borrowing appetite.

The slowdown began to be apparent as early as February 2007, when currency market turbulence broke out in Latvia. Interest rate spreads then widened in all three Baltic countries. In April, civil unrest related to the removal of a Soviet war memorial in Tallinn also hurt tourism and consumer confidence, while reducing Russian-originated trade flows into the Estonian trans-shipment sector. Then the international financial market turmoil further dampened consumer spending. A more or less steady flow of bad news has probably had an extra large psychological impact.

Estonia: GDP and inflation

Year-on-year percentage change

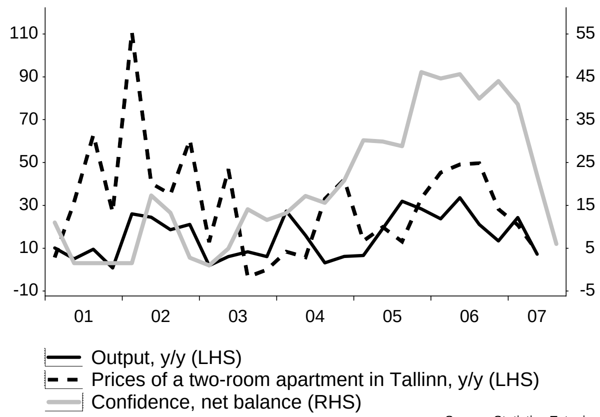


Source: Statistics Estonia

Given the central role of construction in Estonia's economic expansion, the changes in this sector are of particular importance. The construction industry confidence indicator has weakened since mid-2006, and the downturn has been especially clear in the past six months or so as real estate prices have begun to cool. However, the lack of homogeneity in the property market makes analysis difficult. There are hardly any generally accepted price indices in the market.

One of the most frequently used time series is the price per square metre of a two-room apartment in Tallinn. This series goes back to 2001. In June 2006, year-on-year prices measured in this way rose by an average of roughly 50 per cent. Expectations of future price gains, together with easy credit, were the primary factors behind this price surge. More recently, these forces have gradually weakened. The average rate of price increases had fallen to just over 8 per cent by June 2007 and will probably slow further. We expect prices to stagnate completely in the course of 2008, but falling prices cannot be ruled out either.

Estonia: Construction sector and real estate



Source: Statistics Estonia

The construction downturn will hamper overall investment growth. We anticipate a negative contribution from investments next year. Household consumption will also slow, due to weakened confidence, subdued real estate and credit markets and rising unemployment.

Meanwhile, despite strong demand on the most important export markets the downturn in Estonia's export growth to a meagre 4 per cent year-on-year rate during the first half indicates that the appreciation of the real exchange rate in recent years has begun to bite, although the slowdown in domestic demand will also lead to smaller imports. This will narrow the current account deficit from 14 per cent of GDP this year to 9 per cent next year, before it again widens somewhat in 2009.

Taken together, our forecast implies a downward revision of this year's GDP growth from 8 to 7 per cent. Next year we expect GDP growth to reach only 4 per cent, a substantial downward adjustment from our last forecast in March. Sluggish but solid export growth rates will help GDP growth bounce back to 5.5 per cent in 2009, but this is still below our estimate of potential growth.

Higher unemployment

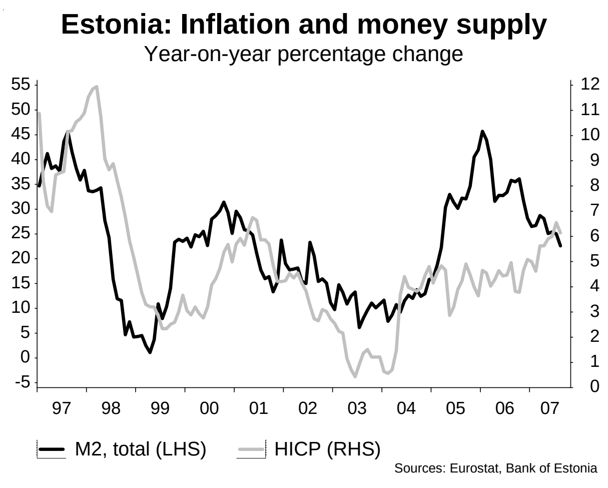
The current 5 per cent unemployment level probably represents a degree of overheating. Emigration of certain key groups has contributed to a tight labour market situation. Looking ahead, falling growth will again drive up the number of jobless. We anticipate average unemployment of 8½ per cent next year, followed by a flattening of the curve at this level.

Wages and salaries have accelerated in recent years, and the increase reached a year-on-year rate of about 20 per cent in the second quarter. The predicted upturn in unemployment will probably suffice to slow pay increases significantly. Next year we expect wages and salaries to grow by about 7 per cent.

Inflation will turn downward

In September the inflation rate was above 7 per cent, the highest level since 1998. Given a slower rate of pay increases, combined with decelerating money supply growth, the inflation rate will fall in the next couple of years. We expect inflation rate to average 6.5 per cent this year, 5.0 per cent next year and 3.0 per cent in 2009. This inflation forecast is below both the government's forecast and the prevailing consensus scenario, because we regard inflation-moderating forces as more important than the impact of high oil prices and imminent excise tax hikes.

Certain value-added tax rates will be raised in 2008 as an acceleration of efforts to meet demands for harmonisation with the EU. In this way, the government wishes to clear away inflationary impulses due to VAT hikes now, so that over the next few years Estonia will have a better chance to fulfil the Maastricht criterion of low inflation preparatory to joining the euro zone.



Government economic policy will face challenges ahead. Wage gaps between different groups have widened in recent years, causing certain key segments of the public sector to lose a significant proportion of their employees. Dealing with this during an economic slowdown will cause tensions in balancing the budget. The government has presented a budget for 2008 that increases expenditures by 25 per cent. This is far above the government's own nominal growth forecast of 15 per cent and is also based on assumptions of both higher real growth and inflation than in our forecast. We predict that this trend will ultimately lead to a small deficit in the public sector budget, after many consecutive years of surpluses. The government may thus be forced to back away from plans to gradually cut income taxes over the next few years.

In essence, the government's assumptions are based on ingrained inflationary expectations which, in a longer perspective, are not consistent with the nature of the Estonian monetary system. The currency board system is gracious in times of plenty but puts stringent constraints on the flexibility of product and factor markets and, ultimately, on economic policy. If nominal variables like prices and wages do not adjust, then real ones like labour and demand will. Rising unemployment along with deflationary tendencies may lead to turmoil, during which the desirability of Estonia's currency board arrangement may be called into question. However, this is a scenario that we still consider unlikely.

Soft landing with risks

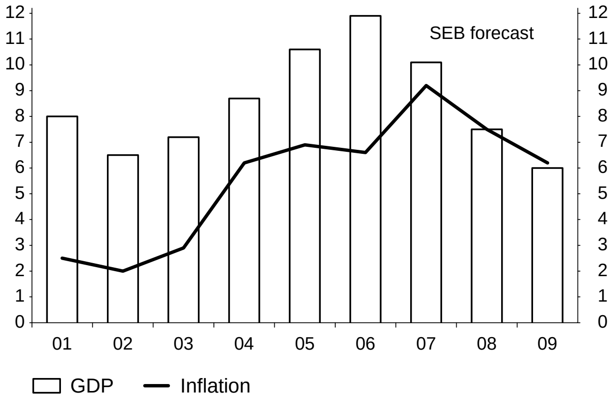
- **Further tightening measures**
- **Persistently high inflation**
- **Record-high current account deficit in 2007**

Economic development in Latvia continues to be rapid and uneven. GDP growth is surpassing expectations and so are inflation, the current account deficit, consumption and wages. The government's anti-inflation plan from March 2007 has only been partially implemented so far but has helped cool lending and real estate prices. To achieve sustainable long-term growth, more fiscal tightening and other measures are soon expected as part of a new economic stabilisation plan.

GDP grew by a 11 per cent rate in the first half of 2007, the same tempo as a year earlier. Booming domestic services and construction contrasted with a sluggish manufacturing sector, signalling even greater imbalances and diminishing the potential for further growth. The risk of a sharp slowdown has thus increased. Although we expect slower growth at the end of the year and next year, mainly due to implementation of more serious steps by the government and businesses, the growth rate will continue to be high as momentum remains strong. GDP will increase by 10.1 per cent in 2007 and 7.5 per cent in 2008. However, in 2009 the economy would slow down slightly below its potential level of 6-7 per cent, to 6.0 per cent. The reasons behind the expected slowdown will be fiscal policy tightening, continued high interest rates and ongoing efforts to restrain lending.

Latvia: GDP and inflation

Year-on-year percentage change



Sources: Eurostat, Central Statistical Bureau of Latvia, SEB

Our base scenario means that the huge imbalances, including high inflation and large current account deficit, only will decrease marginally. Thus, there is a lingering risk of currency adjustment, although the expected fiscal policy measures will lower this risk.

In a downside risk scenario, which includes more profound weakness in the real estate market and a rapid downturn in sentiment indicators, GDP growth will be clearly lower. In such a scenario a fiscal deficit will most probably show up.

Only some of the measures in the anti-inflation plan that the government adopted in March have been implemented, with limited impact on consumption and inflation. So far, most measures have concerned activities of commercial banks, reduction of lending and legalisation of residents' income. Monthly lending growth slowed from 3-4 per cent at the beginning of the year to 2 per cent in the summer, with the steepest decline for housing loans. The real estate market reacted immediately on rumours about the plan with a gradual price decline for apartments in the secondary market.

However, the plan has lost its priority status for the government and has been one-sided and inconsistent, focusing only on reducing domestic demand. In August, the banks and entrepreneurs thus called for more serious steps on the supply side to ensure sustainable economic development as well as stricter budget discipline. A strong flow of revenue, revision of expenditures and a freeze on the salary budget for public officials will enable the government to achieve a fiscal surplus of 0.5 per cent of GDP in 2007, 1.2 per cent in 2008 and 1 per cent in 2009. We thus expect actual fiscal policy to be stricter than the policy accepted in the anti-inflation programme last March.

Prime Minister Aigirs Kalvitis is assuming direct responsibility and oversight of implementation of the plan. Besides the current measures, banks and entrepreneurs propose tangible export promotion measures, as well as lower taxes on the work force and higher taxes on consumption. At least in the short term, the high-priority status and the implementation of the existing programme will boost confidence in Latvia's economy.

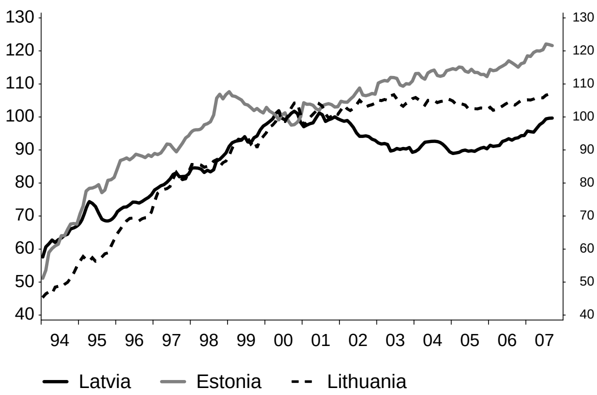
Year-on-year inflation exceeded 10 per cent in August, and price pressure will remain strong in the coming months. Consumer prices are being driven by booming consumption, high wage increases, persistent inflationary expectations, rising energy and fuel prices, tax harmonisation with the EU and other factors. We expect another 30 per cent price hike next year for energy, as well as an increase in excise tax. Even if there is some favourable feedback from the stabilisation measures, inflation will thus remain high over the next couple of years. It will average 9.2 per cent in 2007, then fall to 7.5 per cent in 2008 and 6.2 per cent in 2009.

The jobless rate dropped to 6 per cent in the second quarter, and the employment level continued to increase the pressure in Latvia's hot labour market. Entrepreneurs are demanding easier immigration procedures and the opportunity to use quota schemes to attract labour from other countries. Official and illegal labour immigration has already substantially increased, however. Wages rose by 33 per cent in the first half of 2007. As overall economic growth slows, wage inflation will cool down slightly in the coming quarters, averaging 20 per cent in 2008. Public sector salaries still are growing faster than in the private sector, but Prime Minister Kalvitis has announced his intention to freeze salary growth next year by capping the increases at 10 per cent, and he urged the private sector to follow this lead. The biggest problem is not the increase in wages and salaries as such, but the fact that in many sectors, current productivity growth is inadequate, while pay is being driven up by the huge demand for services and goods.

In the first half of 2007, the current account deficit rose to 24.8 per cent of GDP, compared to 21.1 per cent in 2006, further aggravating the imbalances in the Latvian economy. This deterioration was mainly due to the trade deficit. Despite strong, sustainable export growth of more than 20 per cent, import growth is even faster at mor than 30 per cent. We expect a continued successful export trend, mainly owing to strong foreign direct investments. However, due to persistent currency appreciation, we observe increasing pressure on the competitive capacity of Latvian exports. The negative trade balance partly offsets a surplus of services and current transfers. However, FDI remains the main mechanism for covering the current account deficit. Despite persistent imbalances, investor sentiment is bullish. FDI has expanded significantly and covered 50.3 per cent of the current account deficit in the second quarter of 2007.

Real broad effective exchange rate

Index 2000=100



Source: BIS

Looking ahead, we expect the government's stabilisation plan and tighter credit policies by banks to result in a decline in household consumption growth and an improved trade balance during the second half. However, we believe that the current account deficit will reach a record high of 24.5 per cent of GDP in 2007. The deficit will then fall to 21 per cent in 2008 and 17 per cent in 2009.

In May, supporting the government's efforts to fight inflation and calm the market after the devaluation rumours in February-March, the Bank of Latvia (BoL) raised its refi rate from 5.5 per cent to 6 per cent. We do not expect further hikes in the refi rate this year. Nevertheless, substantially higher interest rates, stemming from tighter liquidity and more cautious bank lending, have encouraged households to borrow in euros, thus diminishing the popularity of the lats. Data since last spring have shown a slowdown in aggregate credit growth comparing to previous periods. The largest banks in Latvia greatly diminished their granting of credits, allowing space for others to expand. But the tightening measures adopted by the government to restrict the availability of credit to tax dodgers have had an impact. The real estate market is cooling down without a panic.

In September came renewed rumours about a possible broadening of the lats peg (1 per cent fluctuation around a central rate against the euro, compared to 15 per cent allowed by ERM2). This was partly due to the upcoming election of Latvia's top central banker in December. The BoL's stance regarding speculations on possible changes in the peg will remain firm. We believe that the current BoL governor, Ilmars Rimsevics, will be re-elected. After reaching a moderate level of 6-8 per cent during the summer, 3-month interbank rates increased to 12 per cent in September. The new economic stabilisation plan is expected to lower rates in the short term, but there is a clear risk of continued high interest rates well into 2008 because of the tight liquidity situation and major lingering imbalances in the economy.

Tough time for the government

The four-party centre-right coalition headed by Prime Minister Aigars Kalvitis is under pressure due to corruption scandals, the increasing imbalances in the economy and quarrels among the coalition partners. There are rumours about a possible cabinet reshuffle. However, any changes will be postponed until after the next budget vote this autumn. If the parliament rejects the budget bill, the government will resign.

Latvia's plans to adopt the euro have been postponed due to failure to meet the inflation criterion. In September, the government refused to announce an exact target date for euro introduction but confirmed that two years before this date, it will announce its plans. In our view, there is no chance that Latvia – which is a member of ERM2 – will join the euro zone before 2013.

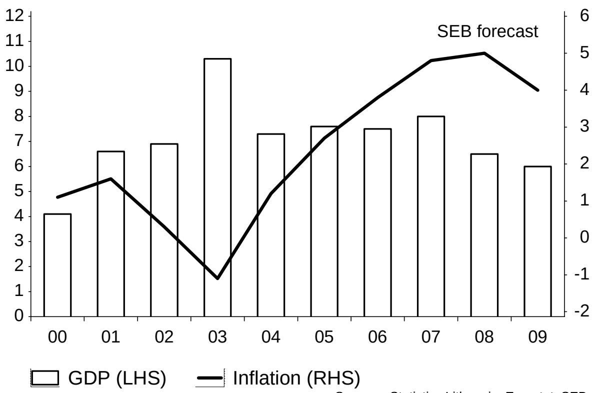
Euro adoption delayed further

- **Signs of overheating**
- **Credit growth still high**
- **GDP growth set to decelerate**

Lithuania is entering the final stage of an impressive growth period. During 2007, lively domestic demand is pushing GDP growth above its potential level but at the cost of higher inflation. Inflation is also being fuelled by rising production costs. Looking ahead, private consumption will be adversely affected by the upturn in interest rates and decelerating credit growth. Supply side restrictions will emerge as a consequence of labour market bottlenecks. Overall, we believe that Lithuanian economy will experience a soft landing. We expect economic growth to reach 8.0 per cent this year, 6.5 per cent in 2008 and 6.0 per cent in 2009.

Lithuania: GDP and inflation

Year-on-year percentage change



Sources: Statistics Lithuania, Eurostat, SEB

The currently booming construction and real estate sectors should begin cooling off in the near future, which will have a slowing effect on economic growth. Most Lithuanian and foreign experts are cautious about forecasting changes in residential prices, bearing in mind the recent shifts in the Latvian and Estonian property markets. So far there are no signs of real estate price adjustments in Lithuania, as the supply of new residential property remains insufficient due to the limited capacity of construction companies and huge demand.

In the meantime, negative macroeconomic indicators are fully offset by optimistic business and household expectations that are fuelling consumption growth and heating up domestic demand.

Manufacturing is the most export-oriented sector in the Lithuanian economy, and its future will be determined by changes in international competitiveness. Since the litas is fixed to the euro, accelerating producer and consumer price inflation only worsens Lithuania's chances of selling its products to other EU countries, which are collectively its largest trade partner. However, the Lithuanian economy as a whole is little harmed by the appreciation of the euro and the litas against the US dollar, since exports to countries tied to the dollar are negligible. Furthermore, the country's imports of strategic materials (natural gas, crude oil) from Russia are becoming cheaper in litas terms.

At the beginning of 2008, gas import prices are expected to rise by 40-50 per cent, which will reduce the GDP growth rate by approximately 0.7 percentage points. Domestic demand will also be squeezed by higher interest rates, due to a higher litas risk premium in the interbank and lending markets.

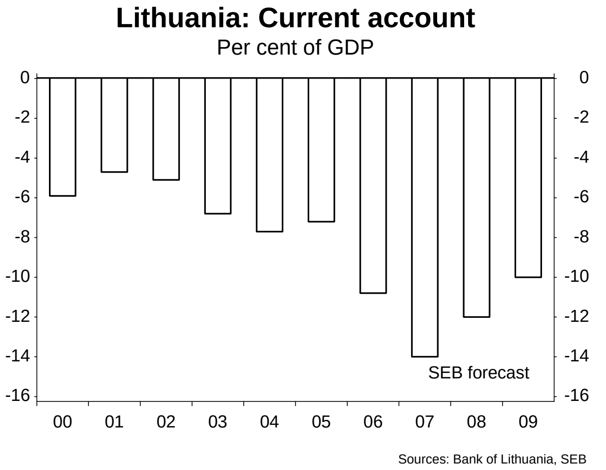
In the first half of 2007, central and local governments reported higher revenues than budgeted. We can thus lower our forecast of the full-year fiscal deficit. On the other hand, only 41.9 per cent of budgeted personal income tax revenue for the year was collected in the first six months of 2007. In addition, the parliamentary elections scheduled for the autumn of 2008 are likely to bring more social spending promises that will be harder to fulfil due to slower growth. Fiscal pressure will thus continue into 2008 and 2009.

Inflation highest in a decade

In August 2007, the HICP inflation rate hit 5.6 per cent, the highest rate in ten years. The main culprit behind accelerating inflation is higher food prices. Prices of cereal and dairy products, oil etc. have shot up rather sharply. Starting in 2008, higher gas import prices should directly add about 0.5 percentage points to average annual inflation, while other energy resources such as electricity are expected to go up in price as well. We foresee inflation averaging 4.8 per cent in 2007, 5.0 per cent in 2008 and 4.0 per cent in 2009.

The Finance Ministry's inflation forecast is even gloomier, with average inflation predicted to reach 5.2 per cent this year, 5.6 per cent next year, 5.1 per cent in 2009 and 3.6 per cent in 2010. Although the government persists in saying that it is aiming at Lithuanian accession to the euro zone in 2010, the Finance Ministry is indirectly demonstrating that such a step is not realistic until 2012 at the earliest. Over the past decade, the Maastricht inflation criterion has fluctuated between 2.5-2.9 per cent most of the time, and there are no reasons to expect a sudden increase in this criterion over the next few years.

One sign of overheating is that in the first quarter of 2007, Lithuania's current account deficit increased to the same level as during the Russian financial crisis of almost a decade ago: 13.2 per cent of GDP. During the first half, merchandise exports rose by 7.0 per cent (excluding mineral products, by 29.3 per cent), while imports rose by 15.4 per cent (30.1 per cent). First-quarter current account sustainability indicators were nevertheless stable, better than in 2006. Imports and short-term external debt were covered by official currency reserves to the largest extent since early 2004 (3.2 months and 96.8 per cent, respectively). FDI inflow also increased, but mainly due to larger borrowing from foreign-based parent companies (banks excluded), not because of larger investments in the equity capital of Lithuanian companies. We do not expect any major positive shift in current account indicators over the next couple of years. Exports should continue to grow more slowly than imports due to strong domestic demand, but robust GDP growth will help Lithuania to lower its current account deficit from 14 per cent of GDP in 2007 to 12 per cent in 2008 and 10 per cent in 2009.



Labour market will remain tight

During the first half of 2007, wages and salaries grew by 20.5 per cent year-on-year. The legalisation of shadow-economy wages is still an important factor behind huge official wage growth, especially in private enterprises, and explains why pay levels in private companies are lower than in the public sector. According to our estimates, wages and salaries excluding legalisation went up by 15 per cent in the second quarter of 2007, compared to the same period of 2006. A very similar wage growth rate, 14.4 per cent, was officially registered in monetary intermediation companies. The full transparency of wages in this sector suggests that our estimate for the whole economy is quite realistic.

It is rather unlikely that wage growth will slow during the second half of 2007. There are no clear signs of economic slowdown, and labour shortages have not yet decreased. In addition, on July 1, 2007 the minimum monthly wage was raised by almost 17 per cent. Bearing this in mind, we expect wages and salaries to be 17 per cent higher on an annual basis in the fourth quarter of this year, 15 per cent in the same period of 2008 and 13 per cent at the end of 2009. Pay increases will outpace labour productivity growth, which will run at 6-7 per cent.

Rising interest rates

Climbing interest rates has not yet have any dampening effect on lending activities. Rising corporate profits and household income have enabled borrowers to cope with increasing credit costs. Moreover, expectations of rising interest rates even motivated some economic entities to accelerate their borrowing. This psychological stimulus will probably weaken only when interest rates on loans reach their peak and expectations of further increases completely fade. The banks are keen to raise their interest rate margins, in response to increasing credit risks and the deteriorating overall quality of their credit portfolio, not to mention the increase in the litas risk premium.

As usual, credit portfolio growth outpaced deposit expansion. The return on “traditional” saving instruments such as term and savings deposit is no longer sufficient to offset inflation. Potential investors are increasingly interested in more risky and profitable investments, while term deposits most often are kept for reasons of portfolio diversification and the need to diminish risks. In 2008-2009, the growth of loans and deposits will slow at a similar pace. Credit growth in the private sector will gradually decline from 40 per cent in 2007 to 20 per cent in 2009, leaving in place a 10-15 percentage point gap between growth of loans and deposits. This will encourage further borrowing by Lithuanian commercial banks from their parent banks abroad and result in an upward trend in gross external debt.

Increased risk premium

The national currency risk premium, one of the factors driving up interest rates on litas-denominated loans, has increased noticeably. After the global financial market turmoil in August, the 6-month VILIBOR interbank rate climbed to almost 5.50 per cent, bringing the gap between the corresponding VILIBOR and EURIBOR rates to 0.8-0.9 percentage point. However, this gap had started to widen six months earlier, after February’s turbulence in the Latvian financial market and bearing in mind the increasingly obvious signs of overheating in Lithuania. We expect the 3-month VILIBOR to decline gradually during 2008-2009.

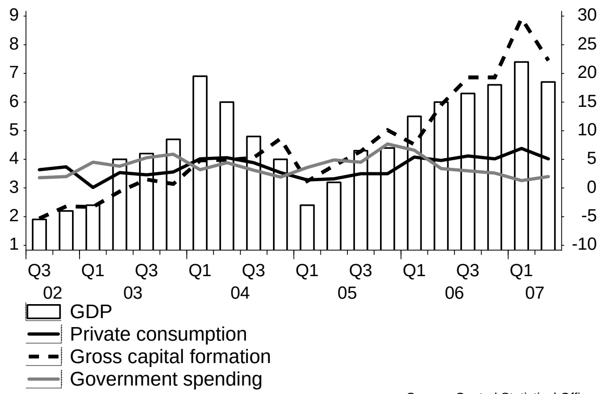
Solid growth, new coalition

- **GDP growth above potential**
- **Tight labour market**
- **Early election ending with new coalition**

Poland's economy continues to grow fast, but this growth is accompanied by emerging risks of over-heating. However, we expect GDP growth to follow a pattern of moderate deceleration from 6.5 per cent in 2007 to 5.5 per cent next year and 5.0 per cent in 2009. The main reasons behind this pattern are rising interest rates, supply side constraints and a global economic slowdown. We view the impending early election as positive for the economy, as it may result in a more reform-oriented government, even though the current government has missed its chance to whittle down the fiscal deficit during a period of accelerating economic growth and low inflation.

Poland: GDP and its components

Year-on-year percentage change



Source: Central Statistical Office

Real GDP increased by 7.4 per cent year-on-year in the first quarter of 2007 and by 6.7 per cent in the second quarter. In both quarters, domestic demand was the engine of growth, while the external balance remained in the red. On the domestic demand side, fixed investment showed a robust growth rate of 29.6 per cent in the first quarter and 22.3 per cent in the second. This was closely related to strong construction activity, which was favoured by a warm winter, while the inflow of EU structural funds also stimulated the investment process. Although the outlook for economic expansion during the rest of 2007 remains bright, growth is past its peak. Fixed investment growth will continue to be the main driver but it will slow somewhat, mainly due to higher interest rates. With the global economy facing a slowdown, Poland's export growth will further decelerate, while still strong domestic demand will keep import growth at a high level. Private consumption growth, reaching 6.9 per cent in the first quarter and 5.1 per cent in the second quarter, is expected to pick up – largely underpinned by accelerating wage increases.

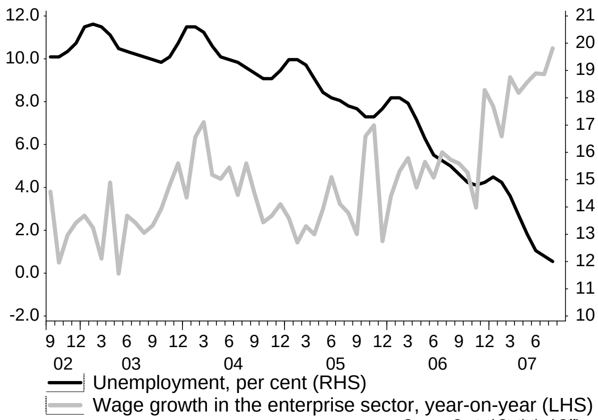
Poland's deepening external imbalance is a clear sign that the economy is growing beyond its potential. In the second quarter of this year, the current account deficit was 3 per cent of GDP, up from 2.5 per cent in the first quarter. Another reliable indicator is the record high level of production capacity utilisation. The investment boom will eventually enlarge the economy's growth capacity, but for now it is feeding domestic demand and thus contributing to inflationary pressures. Based on our calculations, Poland's potential GDP growth rate hovers around 5 per cent.

Inflation has been constantly rising this year. Year-on-year HICP inflation was 1.9 per cent in August 2007, up from 1.3 per cent for calendar 2006. The lion's share of HICP changes can be explained by increases in the prices of food and fuel, which indicates that supply-push factors are still stronger than demand-pull factors in fuelling inflation. Taking into account current price developments in global markets for agricultural goods, there is no reason to expect food price disinflation in Poland. Furthermore, substantial wage rises and fast household credit growth will inevitably strengthen the effect of demand-pull factors. We expect inflation to continue accelerating until the middle of next year and only then start slowing down. Average annual inflation (HICP) will reach 2.3 per cent this year, peak at 2.8 per cent in 2008 and then drop slightly to 2.5 per cent in 2009.

The situation in the labour market has tightened. Despite the still relatively large pool of unemployed, labour shortages arise because most unemployment is of a structural nature, which will take time to fight; many Poles find employment opportunities abroad more attractive than at home, while demographic trends are also of no help. Employment is increasing at an annual rate of around 4 per cent, while the unemployment rate is hitting new record lows each month, e.g. 12 per cent in August. Due to especially severe labour shortages in fast-growing, labour intensive economic sectors such as construction, hotels and restaurants, employers are being urged to raise wages. Average nominal wage growth in the business sector keeps gaining speed, reaching 10.5 per cent year-on-year in August. The trends of increasing employment, declining unemployment and substantial wage growth will prevail, but the rate of change in these indicators should start decelerating as economic growth slows and the financial performance of companies worsens.

As productivity growth lags behind wage growth, unit labour costs are going up. Higher unit labour costs will not only hinder export competitiveness but will also induce a wage-price inflation spiral. In order to prevent this from happening, the National Bank of Poland (NBP) started a tightening cycle in April 2007 and has already hiked its key interest rate from 4.00 per cent to 4.75 per cent. As long as the economy keeps growing above its potential rate, accompanied by external and internal imbalances, the NBP will continue raising interest rates. This year we expect one more increase of 25 basis points to 5.00 per cent, and then 100 more basis points in 2008.

Poland: Unemployment and wages



Source: Central Statistical Office

Investment risk reassessments, provoked by the recent US mortgage loan crisis, had an adverse effect on the zloty in mid-August. However, this weakening was temporary and of moderate scope, leaving the Polish currency far from this year's minimum point. Because the tightening cycle of the NBP will continue while that of the European Central Bank has reached its peak, the interest rate differential will widen and will work to the zloty's advantage. Despite a deeper current account deficit, comfortable coverage of the deficit by foreign direct investment and EU structural funds will underpin the zloty's strength, too. Although decelerating, economic growth remains solid. The downside risks that might prevent the zloty from strengthening are prolonged turmoil in the global financial markets causing investors to be especially risk averse in emerging markets, stronger than expected inflationary pressures, renewed domestic political chaos and wasteful government spending.

Escaping the political deadlock

Following the collapse of the three-party ruling coalition in August, Poland is gearing up for a parliamentary election on October 21, two years ahead of schedule. Fixing the date for the election has brought some optimism to financial markets, based on speculation that a new government will encourage economic reforms and ensure more fiscal discipline. This would be possible if, as it seems now, the centre-right Citizens' Platform (PO) ends up leading the government. However, the latest public opinion poll shows the PO and its main competitor, the incumbent Law and Justice Party (PiS), getting almost the same number of votes if the elections took place today. The most likely outcome of the impending election is another coalition government, meaning no major breakthrough in Poland's slow political decision making process. Nevertheless, holding early elections is a better alternative than letting the PiS remain a minority government, because this extricates the country from a political deadlock and increases the likelihood of more business-friendly reforms.

The result of the coming election is also crucial for Poland's euro adoption schedule. Should the PO, the most outspoken supporter of EU membership and its benefits, win the largest number of votes, the euro could be adopted earlier than expected. Worth mentioning is that the number of euro supporters in Poland has risen to 46 per cent, finally outweighing the number of euro sceptics. As before, the only serious obstacle keeping the country from meeting the euro-adoption criteria is a lack of political will to enforce fiscal discipline. At least in the next couple of years, however, the fiscal shortfall will hardly fade away. The outgoing government missed an opportunity for belt-tightening during the recent period of strong growth and instead pursued an expansionary fiscal policy. This carelessness makes the task of balancing the budget in the next few years more demanding, since the economy will be losing momentum. Furthermore, plans to narrow the budget deficit in 2008 are jeopardised by recently approved pre-election spending promises of an additional 6.5 billion zloty. This year the general government budget deficit will be 3.5 per cent of GDP, i.e. lower than in 2006 mainly thanks to a surplus in social security funds. Next year it will stay at the same level, then be trimmed down to 3.2 per cent of GDP in 2009.

Taking into account these risks as well as the fact that the winner of the elections is not yet known and will probably not get a majority of the votes, we are leaving our forecast for euro adoption in Poland unchanged. We expect ERM-II accession in 2009 and predict that the zloty will be replaced by the euro in 2012.

Euro in 2009 is within grasp

- **Robust economic growth**
- **Inflation remains at low level**
- **Fiscal policy tightening**

Economic development in Slovakia has been robust in recent years. Solid growth, mainly driven by strong exports accompanied by household consumption, is expected to continue. GDP growth will reach 8.9 per cent in 2007, 8 per cent in 2008 and 7 per cent in 2009. Favourable borrowing conditions and rising household consumption are still having only a limited effect on inflationary pressure. Productivity gains are outpacing wage increases. The central bank is successfully keeping the koruna within its new parity rate against the euro. Slovakia has bright prospects of meeting the Maastricht criteria and joining the euro zone in 2009.

Industrial confidence data point towards continued solid growth and higher production of electro-technical goods, coke, refined petroleum products, and processed wood. Construction sector output has slowed. Due to favourable conditions, the retail sector is performing well. Transport and communications are showing particularly strong growth. Notwithstanding Slovakia's good economic performance, considerable regional differences persist. Profitability has continued to rise. Due to successful tax reforms, Slovakia has become a favourite destination for foreign direct investment over the past few years. The tax burden is one of the lowest in the EU, amounting to 29.3 per cent of GDP.

During the first half of 2007, exports increased significantly – mainly in the machinery, electro-technical equipment and car-making sectors. Exports increased faster than imports. As the result, the trade balance improved and the current account deficit decelerated, despite a significant negative effect from higher oil and other energy prices.

Unemployment is declining but is still high. Real wage increases are moderating and are lagging behind productivity gains, mainly owing to FDI and restructuring. The jobless rate is expected to decrease further, tightening the labour market.

From October 2006 onward, strong export growth and positive investor sentiment led to an appreciation of the koruna without harming competitiveness. By year-end, the koruna was approaching the upper edge of its ERM2 band. In mid-March 2007, with appreciation pressures persisting, the koruna's central parity against the euro was revalued by 8.5 per cent. The central bank has countered appreciation pressures since the parity revaluation and has held the koruna at around 6 per cent above the new central parity. Based on declining inflationary pressures, and judging upside risks to be small, the bank has lowered its key interest rate by 50 basis points to 4.25 per cent in two steps since late March. The koruna is likely to appreciate further and reach SKK 33.0 per euro in the end of 2007. We expect the central bank to lower its key rate over the next year.

Downward trend of inflation

A combination of factors such as limited profit margins in the electricity and gas sectors, trends in the regulated health service and in food prices and the appreciation of the koruna have resulted in a downward trend of inflation during the past year. We expect inflation to continue decreasing slightly, averaging 2.5 per cent in 2007, 2.4 per cent in 2008 and 2.3 per cent in 2009.

The general government deficit in 2006 was 3.4 per cent of GDP. This year the government plans to reduce its budget deficit to below the Maastricht threshold level of 3 per cent. The shortfall is projected at 2.7 per cent due to improved revenue and a 2007-09 budget framework aimed at meeting euro zone objectives. A potential decline in revenue may cause problems in achieving the agreed target. However, the government is committed to curbing expenditures by substantially reducing its own employee rolls and closing down agencies at the regional level.

Successful marriage of convenience

The political system has continued to rely on a broad coalition government, dictated by electoral calculations rather than by ideological cohesion. The centre-left Smer-Social Democracy (Smer-SD) party headed by Prime Minister Robert Fico leads the government, in coalition with the Slovak National Party (SNS) and the populist People's Party-Movement for a Democratic Slovakia (LS-HZDS). The Fico government, supported by robust economic growth, enjoys high popularity. Populist economic policies implemented by the government have had only a minor impact on the budget and have been accompanied by expenditure-reducing measures such as cutting the number of public employees. It seems likely that the coalition will remain in power until the next elections, which are scheduled for 2010.

Stronger fiscal discipline

- **Higher inflation and interest rates**
- **Budget reform paving way to euro adoption**
- **Solid trade surplus**

Low inflation together with stable economic growth in recent years demonstrate that the Czech economy is performing well. The central bank has raised interest rates in response to mounting inflationary pressures. The government still has only a fragile majority, which may hamper the introduction of reforms, but it has realistic ambitions to join the euro zone by 2012.

The economy grew by more than 6 per cent in the first half of 2007, exceeding forecasts mainly due to strong export performance and household consumption. The economy should remain vigorous, although growth may slow due to government austerity measures that could result in lower public consumption and squeeze private sector demand as well. We expect economic growth to reach 5.7 per cent in 2007, 5 per cent in 2008 and 4.8 per cent in 2009.

Czech exports have benefited in recent months from robust economic growth among major trading partners. We expect the solid growth in exports to continue. Persistent deterioration in the income balance pushed the current account towards a deficit of 3 per cent of GDP. At the same time, both the goods and service balances showed surpluses. The Czech Republic was the only EU member in Central and Eastern Europe to post a trade surplus in 2006. The trade balance is likely to remain positive over the next couple of years.

Owing to the negative short-term rate spread with the euro zone, the Czech koruna remains an attractive funding currency for international investors. Despite the country's favourable external position, the short term potential for the CZK would therefore seem to be rather limited. The inflow of FDI is now mainly in the form of reinvested earnings and may reach a level similar to that of last year. However, planned privatisation deals may result in a higher FDI inflow by the end of 2007.

The labour market is improving further. However, planned lay-offs in the public sector may stabilise unemployment at its current rate in 2007 and 2008. Structural problems in the labour market still exist and are reflected by strong regional disparities.

Wage growth has accelerated. However, fiscal tightening is expected to slow wage growth later this year and in 2008 as well. Real wage growth, accompanied by higher labour productivity, reached a year-on-year rate of 6.2 per cent in the first half of 2007, compared to an average of 3.9 per cent in 2006.

Prime Minister Mirek Topolanek's ruling party, the conservative Civic Democratic Party (ODS), is no longer sceptical about the country's euro adoption target date. The government intends to fulfil the Maastricht criteria by 2009 and introduce the euro in 2012. The key challenge is to reduce the budget deficit below 3 per cent of GDP. To achieve this, the government has introduced a budget reform package. This includes reduction of expenditures by abolishing allowances to families above a certain income level, gradually increasing the retirement age and laying off 13,000 public employees. Also expected are the introduction of fees for certain health care services, an increase in the lower VAT rate from 5 to 9 per cent, simplification of the tax system and reductions in profit and personal income tax rates. We expect the fiscal deficit to exceed 3 per cent of GDP this year. Owing to the political deadlock, the budgetary outlook for 2008 and the pace of fiscal reform implementation are uncertain, but we believe that the reforms will be enacted and that the deficit will gradually shrink.

Strong consumer demand, high energy prices, rising agricultural and producer prices, rapid wage hikes, high economic growth and a weaker koruna exchange rate are factors behind the upward trend in inflation. Several of these factors will remain as the main inflation drivers in the future. We expect inflation of 2.6 per cent in 2007 and 3 per cent in 2008 and 2009. To keep inflation in the targeted range, the central bank has raised its key interest rate three times since June 2007, reaching 3.25 per cent in August. In spite of this, the Czech key rate is still among the lowest in the EU. The central bank will raise this rate further in the quarters ahead.

Fragile political stability

Owing to the 2006 election outcome, it was not possible to form a majority coalition government. In his second attempt Mirek Topolanek succeeded in forming a three-party coalition between ODS, the centre-right Christian Democrats and the centrist/environmentalist Greens. This means that reforms in the areas of fiscal and tax policy, pensions, health care and welfare may be softened. The success of the government will depend on Mr Topolanek's skill in leading his diverse coalition as well as his collaboration with the main opposition party.

Hungary

Twin deficits easing

- **Fiscal consolidation targets within reach**
- **GDP growth slowest since 1996**
- **Government faces possible ouster next spring**

The Hungarian economy is still under the heel of the fiscal austerity package implemented in September 2006. GDP growth is the slowest since 1996, while inflation is still high. However, the government's consolidation measures are proving effective in bringing down the country's current account and budget deficits as early as this year. Meanwhile, adverse side effects should start to fade away as early as the final quarter of 2007.

The political arena has been fairly calm thus far, considering that the government has stayed in power despite the severe economic consequences of its fiscal reforms. The share of Hungarians disapproving of the reforms is as high as 63 per cent, but those supporting them seem relatively numerous as well: 23 per cent. Political tensions may increase over the next 6 months as the opposition keeps pushing the idea of ousting the government in the referendum due in the spring of 2008. We will not dismiss the possibility that the government may have to resign at that time, which poses a threat to fiscal discipline.

On the other hand, the Socialists are very likely to achieve their goal of diminishing the twin deficits in 2007 and 2008 and have earned cautious acknowledgement for their efforts from various EU bodies. The Finance Ministry has already lowered its projected budget deficit for this year three times, from 6.8 per cent to 6.4 per cent of GDP. The targets for 2008 and 2009 were also reduced to 4.1 and less than 3.0 per cent of GDP, respectively. Lower interest payments on public debt, rising wages and salaries and a crackdown on tax evasion should help the government to move towards achieving its deficit targets for this year and next. Reaching the 2009 target looks more complicated, however, since the Socialists may be tempted to relax some spending restrictions or even cut some taxes in the run-up to the 2009 election to the European Parliament and the 2010 election to the Hungarian parliament.

Declining consumption

In the first half of 2007, real GDP grew by a mere 1.9 per cent year-on-year. The main culprit was a decline in consumption, amounting to 2.1 per cent among households and 5.2 per cent in the public sector. While fiscal consolidation is holding back domestic demand, external demand is the only engine of the economy at the moment. The export-oriented manufacturing sector grew by 9.3 per cent. GDP growth should regain some strength in the second half due to favourable statistical base effects, lower interest rates and strong net exports. In the second half of 2008, domestic demand will start a slow recovery. In 2009 the labour market will also start to recover. We expect real GDP to grow by 2.1 per cent in 2007, 2.8 per cent in 2008 and 3.7 per cent in 2009.

Improved net exports have noticeably pushed down the current account deficit. In the first half of 2007, the trade surplus more than doubled on an annual basis to reach an all-time high. The current account deficit is expected to be 5.0 per cent of GDP in 2007, dropping to 3.5 per cent in 2009.

Inflation has already passed its peak of a 9.0 per cent rate in March 2007, with annual HICP inflation standing at 7.1 per cent in August 2007. The main stimuli behind recent price increases, such as tax increases and subsidy reductions, are of a – one-off – nature. We consequently foresee inflation slowing late in 2007 because of favourable base effects. Nevertheless, inflationary pressures should remain rather strong due to appreciation of food products, the weak forint, rising wages and salaries and high global energy prices. Our forecast for HICP inflation is 7.4 per cent in 2007, 4.0 per cent in 2008 and 3.5 per cent in 2009.

After abandoning the target of introducing the euro by 2010 last year, Prime Minister Ferenc Gyurcsány now foresees Hungary joining the euro zone in 2014, while Economy Minister János Kóka predicts 2013. In our view, euro introduction in 2014 is quite realistic, provided the government achieves its fiscal targets.

The improved inflationary outlook and depressed growth prospects should encourage Hungary's central bank to pursue a dovish monetary policy. After a 25 basis point cut in the key interest rate in June and again in September, to 7.50 per cent, one more reduction will follow by the end of 2007, with further monetary policy easing in 2008-2009.

The recent global credit market turmoil adversely affected Hungary's currency rate and bond yields, but the repercussions of the sub-prime mortgage crisis have almost faded away. A slow but rather steady improvement in the country's outlook should keep investors quite positive towards the forint and Hungarian assets in the medium term. On the other hand, a solid reduction in the key interest rate will work to the disadvantage of the forint. The forint will be unchanged vis-à-vis the euro in a one year perspective.

CZECH REPUBLIC

	2002	2003	2004	2005	2006	2007(f)	2008(f)	2009(f)
GDP, %	1.9	3.6	4.2	6.1	6.4	5.7	5.0	4.8
Inflation, average, %	1.4	-0.1	2.6	1.6	2.1	2.6	3.0	3.0
Unemployment, %	7.3	7.8	8.3	7.9	7.1	6.3	5.8	5.6
Current account, % of GDP	-5.5	-6.2	-6	-2.1	-3.1	-3.0	-2.9	-2.5
Public sector financial balance,% of GDP	-6.8	-6.6	-2.9	-3.6	-3.0	-3.3	-3.0	-2.8
Public sector debt, % of GDP	28.5	30.1	30.7	30.4	30.2	30.4	30.5	30.1
EUR/CZK, end of period	31.50	32.40	30.30	29.00	27.50	27.50	27.00	27.00
Key rate, eop	2.75	2.00	2.50	2.00	2.50	3.50	4.25	4.25
5-year government bond, eop	3.10	3.70	3.40	3.20	3.70	4.30	4.30	4.40

ESTONIA

	2002	2003	2004	2005	2006	2007(f)	2008(f)	2009(f)
GDP, %	8.0	7.2	8.3	10.2	11.2	7.0	4.0	5.5
Inflation, average, %	3.6	1.4	3.0	4.1	4.4	6.5	5.0	3.0
Unemployment, %	10.3	10.0	9.7	7.9	5.9	5.0	8.5	9.0
Current account, % of GDP	-10.6	-11.3	-12.3	-10.0	-15.5	-14.5	-9.0	-10.0
Public sector financial balance, % of GDP	0.4	2.0	2.3	2.3	3.8	1.0	-1.0	0.0
Public sector debt, % of GDP	5.6	5.7	5.2	4.4	4.1	4.0	4.0	4.0
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	3.50	2.60	2.40	2.60	3.90	5.90	8.50	6.50

HUNGARY

	2002	2003	2004	2005	2006	2007(f)	2008(f)	2009(f)
GDP, %	4.4	4.2	4.8	4.1	3.9	2.1	2.8	3.7
Inflation, average, %	5.2	4.7	6.8	3.5	4.0	7.4	4.0	3.5
Unemployment, %	5.8	5.9	6.1	7.2	7.5	7.6	7.3	7.0
Current account, % of GDP	-7.0	-8.7	-8.8	-7.4	-8.0	-5.0	-4.0	-3.5
Public sector financial balance, % of GDP	-8.2	-7.2	-6.5	-7.8	-9.2	-6.4	-4.1	-3.2
Public sector debt, % of GDP	54.0	58.0	59.4	61.7	65.6	68.0	65.0	64.0
EUR/HUF, end of period	235.90	262.20	245.90	252.70	252.30	252.00	250.00	245.00
Key rate, eop	8.50	12.50	9.50	6.00	8.00	7.25	6.50	6.25
5-year government bond, eop	7.10	9.30	8.00	7.10	7.40	6.75	6.00	5.50

(f) = forecast

Key economic data

LATVIA

	2002	2003	2004	2005	2006	2007(f)	2008(f)	2009(f)
GDP, %	6.5	7.2	8.7	10.6	11.9	10.1	7.5	6.0
Inflation, average %	2.0	2.9	6.2	6.9	6.6	9.2	7.5	6.2
Unemployment, %	12.0	10.6	10.4	8.7	6.8	5.8	5.2	5.0
Current acccount, % of GDP	-6.6	-8.2	-12.9	-12.5	-21.1	-24.5	-21.0	-17.0
Public sector financial balance, % of GDP	-2.3	-1.6	-1.0	-0.2	0.4	0.5	1.2	1.0
Public sector debt, % of GDP	13.2	14.4	14.5	12.0	10.0	9.3	9.0	8.5
EUR/LVL, end of period	0.61	0.67	0.70	0.70	0.70	0.70	0.70	0.70
Policy rate, eop	3.50	3.00	3.50	4.00	5.00	6.50	7.00	7.00
5-year government bond, eop	5.50	4.60	4.00	3.20	4.90	7.50	8.00	8.0

LITHUANIA

	2002	2003	2004	2005	2006	2007(f)	2008(f)	2009(f)
GDP, %	6.9	10.3	7.3	7.9	7.7	8.0	6.5	6.0
Inflation, average, %	0.3	-1.1	1.2	2.7	3.8	4.8	5.0	4.0
Unemployment, %	13.8	12.4	11.4	8.3	5.6	4.5	4.7	5.2
Current account, % of GDP	-5.1	-6.8	-7.7	-7.2	-10.8	-14.0	-12.0	-10.0
Public sector financial balance, % of GDP	-1.5	-1.3	-1.5	-0.5	-0.3	-0.5	-1.0	-1.0
Public sector debt, % of GDP	25.3	21.2	19.4	18.6	18.2	15.5	14.5	14.0
EUR/LTL, end of period	3.45	3.45	3.45	3.45	3.45	3.45	3.45	3.45
3-month interest rate, eop	3.50	2.70	2.60	2.50	3.80	5.80	5.60	5.50
5-year government bond, eop	4.60	3.60	3.00	3.10	3.90	4.60	4.70	4.50

POLAND

	2002	2003	2004	2005	2006	2007(f)	2008(f)	2009(f)
GDP, %	1.4	3.8	5.3	3.6	6.1	6.5	5.5	5.0
Inflation, average, %	1.9	0.7	3.6	2.2	1.3	2.3	2.8	2.5
Unemployment, %	19.9	19.6	19.0	17.7	13.8	11.0	10.0	9.0
Current account, % of GDP	-2.6	-2.1	-4.2	-1.7	-2.3	-3.0	-4.0	-4.2
Public sector budget balance, % of GDP	-3.2	-6.3	-5.7	-4.3	-3.9	-3.5	-3.5	-3.2
Public sector debt, % of GDP	39.8	47.1	45.7	47.1	47.8	47.4	47.3	47.5
EUR/PLN, end of period	4.02	4.71	4.08	3.86	3.83	3.75	3.70	3.72
Key rate, eop	6.75	5.25	6.50	4.50	4.00	5.00	6.00	5.50
5-year government bond, eop	5.50	6.70	6.20	5.00	4.98	5.75	5.75	5.40

(f) = forecast

RUSSIA

	2002	2003	2004	2005	2006	2007(f)	2008(f)	2009(f)
GDP, %	4.7	7.3	7.2	6.4	6.7	7.6	6.8	6.0
Inflation, average, %	15.8	13.7	10.8	12.7	9.7	8.4	7.9	7.0
Unemployment, %	8.1	8.6	8.2	7.6	7.2	6.2	5.7	5.5
Current account, % of GDP	8.4	8.2	9.9	11.0	9.6	6.5	5.0	3.5
Public sector financial balance, % of GDP	0.6	1.4	4.9	7.7	8.4	4.7	2.5	2.0
Public sector debt, % of GDP	40.4	29.6	22.4	13.4	8.3	7.8	7.5	7.5
USD/RUB, end of period	31.80	29.50	27.70	28.70	26.30	24.50	23.80	24.50
3-month interest rate, eop	14.50	6.90	6.40	6.50	5.80	7.60	7.20	7.00

SLOVAKIA

	2002	2003	2004	2005	2006	2007(f)	2008(f)	2009(f)
GDP, %	4.1	4.2	5.4	6.0	8.3	8.9	8.0	7.0
Inflation, average, %	3.5	8.4	7.5	2.8	4.3	2.5	2.4	2.3
Unemployment, ILO, %	18.7	17.6	18.2	16.3	13.4	11.5	10.8	9.9
Current account, % of GDP	-8.0	-0.8	-3.5	-8.8	-8.3	-3.5	-2.0	-1.5
Public sector financial balance, % of GDP	-7.7	-3.7	-3.0	-2.9	-3.4	-2.7	-2.4	-2.0
Public sector debt, % of GDP	43.3	42.7	41.6	34.5	30.8	29.2	28.5	28.0
EUR/SKK, end of period	41.50	41.10	38.70	37.80	34.60	33.00	33.00	33.00
Key rate, eop	6.50	6.00	4.00	3.00	4.750	4.25	4.00	4.00
5-year government bond, eop	5.40	5.20	4.00	3.20	4.20	4.45	4.50	4.50

UKRAINE

	2002	2003	2004	2005	2006	2007(f)	2008(f)	2009(f)
GDP, %	5.2	9.6	12.1	2.6	7.0	7.5	8.0	8.0
Inflation, average, %	0.8	5.2	9.0	13.5	9.1	12.0	10.0	9.0
Unemployment, %	9.6	9.1	8.6	7.2	6.8	6.0	5.5	5.0
Current account, % of GDP	7.5	5.8	10.6	3.1	-0.5	-4.0	-5.0	-5.5
Public sector financial balance, % of GDP	0.7	-0.2	-3.2	-1.8	-1.0	-1.5	-1.5	-1.0
Public sector debt, % of GDP	33.5	29.0	24.7	17.7	15.3	14.0	13.0	12.5
USD/UAH, end of period	5.33	5.33	5.31	5.05	5.05	5.00	4.95	4.95
Policy rate, eop	7.00	7.00	9.00	9.50	8.50	8.00	7.50	7.00
3-month interest rate, eop	7.90	23.50	28.00	15.30	12.80	9.00	8.00	7.50

(f) = forecast

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