ECONOMIC RESEARCH · ENGLISH EDITION

March 2008

Eastern European Outlook

Theme: Baltic exports face challenges

SEB Economic Research

Eastern European Outlook - March 2008

Eastern European Outlook is produced twice a year. This report was published on March 12, 2008.
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Summary

Central and Eastern Europe will continue to show good growth, despite the global economic slowdown and credit crisis as well as surging inflation in the region. This is mainly due to vibrant domestic demand, but also small exposure to the US as an export market. The Baltic countries and Hungary will diverge, showing a weakening trend. Overheated Latvia and Estonia are decelerating markedly, partly because of stricter lending practices – a process which has been going on for more than one year and is not directly related to the global credit crisis. Meanwhile the Baltics and other economies in the region are plagued by major imbalances in the form of large current account deficits and/or high inflationary pressure, which will ease only slowly.

In the nine countries covered in ***Eastern European Outlook***, GDP growth will slow moderately from an average of 7.4 per cent in 2007 to 6.1 per cent in 2008 and 5.6 per cent next year. In most of these countries, consumption is being stimulated by high pay increases and a strong labour market, while investments are being nurtured by EU structural funding and in Ukraine and Russia by pressure for change and major public investment projects. Inflationary pressure, which is largely due to rising energy and food prices, is nevertheless partly eroding purchasing power. Somewhat tighter credit is dampening demand.

Russia's strong growth will continue, supported by high commodity prices and expansive fiscal policy this year as well. The investment upswing will continue and will eventually ease capacity constraints. The biggest macroeconomic problem is persistently high inflation. Current government policies will remain in place after the new president has taken office. Russia's dual leadership may lead to political tension ahead.

Ukraine's growth and inflation will remain at high levels. The economic catch-up process from a relatively low living standard and an expansive fiscal policy are sustaining growth. Ukraine is expected to join the World Trade Organisation this summer, while efforts to create closer relations with the European Union intensify.

Estonia's economic deceleration will continue, with falling investments and weak consumption this year. Unemployment will rise. The real estate market bubble has been deflating during the past year, and only a slight correction remains. Exports will strengthen after last year's temporary weakness. GDP will increase by 3.5 per cent in 2008, well below trend and down from 7 per cent in 2007. Inflation will not fall until 2009.

Latvia's domestic demand is now beginning to wane. Latvian GDP will also nearly halve, to 6 per cent in 2008. Exports will show resilience, but poorer competitiveness will pose a threat ahead. High inflation will culminate this spring. The risk in our growth forecast is on the downside.

Lithuania's economy will decelerate gently. GDP growth will fall from 9 per cent last year to 6 per cent. The real estate and construction sectors are stagnating. Good exports will partly offset weaker domestic demand.

Poland's high growth will cool to a sustainable level of about 5 per cent. Overheating risks will be cooled by lower global demand and continued monetary policy tightening. **Slovakia** will grow fast and in a balanced manner and will achieve its goal of converting to the euro in 2009. The **Czech Republic** will continue to implement growth-promoting reforms. The key interest rate will be raised further, which will eventually dampen existing strong inflationary impulses. **Hungary's** economy is in a deep slump following fiscal policy tightening and will rise slowly.

Broad economic slowdown

- **Recession in the United States**
- **Growth below trend in Western Europe**
- **Key interest rate cuts – dollar close to bottom**

The global financial market crisis, under way since last summer, is having an ever-greater impact on the world economy. While the acute liquidity shortage has eased this winter, credit problems have actually worsened – manifested among other things by wider spreads between corporate bonds and government securities, as well as large loss provisions in the banking system. In our assessment, the credit market crisis will continue for at least a number of months. As a result of all this there has already been a credit crunch, which will hamper consumption and investments. The world economy will thus lose considerable momentum, after very high growth in recent years. The US is entering a recession that will generate negative secondary effects and a slowdown throughout the OECD. Only thanks to stronger resilience than before in rapidly growing economies (especially Asia and Central and Eastern Europe) can the world economy maintain growth during 2008-2009 that will be slightly above trend.

GDP growth

Year-on-year percentage change

	2006	2007	2008	2009
United States	2.9	2.2	0.9	1.8
Japan	2.4	2.1	1.2	1.5
China	11.1	11.4	9.5	8.5
Euro zone	2.9	2.6	1.3	1.5
United Kingdom	2.9	3.1	1.4	1.8
Nordic countries	3.7	3.0	2.1	1.8
OECD	3.1	2.6	1.5	1.9
The world	5.0	4.6	3.7	3.8

Sources: OECD, SEB

We expect the US economic slump to be both deeper and more prolonged than the consensus view. American GDP will grow by a meagre 0.9 per cent this year, following three quarters of negative annualised growth. The adjustment process in the housing market will continue for another year. A combination of continued home price declines, tighter credit conditions and higher unemployment will result in a negative domestic dynamic. Consumption will decelerate sharply, while the slowdown in capital spending will be relatively mild due to a low initial investment level. A powerful stimulus policy, both via interest rate cuts and an expansive fiscal stance, will help fuel the beginnings of a slight economic recovery late this year. Also supporting growth will be a relatively good upturn in exports, with the weakened US dollar serving as a positive driving force. Inflation, which has ticked upward due to higher energy and food prices as well as rising rent costs, will slow in the course of 2008 as the weakened labour market begins contributing to a cyclical cooling in prices.

In Europe the Nordic countries, except for Denmark, so far continue to stand out with their relatively high growth, averaging about 3 per cent last year. But this economic expansion is about to slow clearly. Next year the Nordic region will grow by 1.8 per cent, or only marginally faster than the euro zone.

Euro zone growth will end up somewhat below 1.5 per cent this year and largely stay the same in 2009. The impact of the American slump and the credit market crisis will gradually become more apparent. Exports are also squeezed by the strong euro, and purchasing power is being undermined by the sharp upturn in energy and food prices. The broad measure of inflation will fall from 2.7 per cent this year to 1.7 per cent in 2009, when lower oil prices and base effects will help slow the pace. Underlying inflation will be restrained by flatter growth, remaining just below 2 per cent despite relatively high pay increases.

Interest rate cuts on a broad front

The US Federal Reserve will continue slashing its key rate, with another 50 basis point cut in mid-March. By autumn, the federal funds rate will have been trimmed from its current 3 to 2 per cent. There will be a certain upward adjustment in 2009 once the economy has entered an upswing. The Fed wants to avoid the risk of again driving up asset prices with a very expansive monetary policy. The Bank of England, which has started lowering its key rate like the Fed, will carry out a series of rate cuts to soften a sudden deceleration driven by a weakened property market. The European Central Bank will begin easing monetary policy this spring; in the coming year it will lower its repo rate by one percentage point to 3.0 per cent.

American and German government bond yields will move somewhat further downward in the short term, followed by a relatively mild upswing.

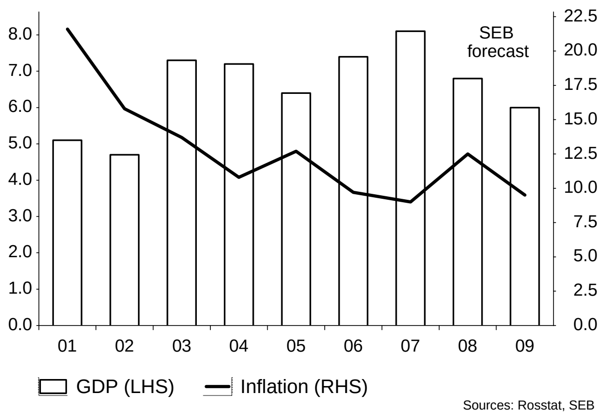
The dollar will weaken a bit more in the wake of the Fed's interest rate cuts. We foresee the EUR/USD exchange rate at around 1.55 this spring. After that we expect a weak, more lasting recovery in the dollar as the financial market focuses increasingly on weaknesses in the Western European economies.

We expect high commodity prices to slacken as the global economic outlook becomes weaker. We assume that oil prices (Brent) will be at USD 80-90/barrel this year and below USD 80 next year.

Strong growth, high inflation

- **Continued vigorous domestic demand**
- **Stubborn high-level inflation**
- **Twin surpluses shrinking fast**
- **Question marks about dual political leadership**

So far, Russia has been relatively unaffected by the global credit market crisis. Economic growth gained further strength last year. Because of its strong financial position, Russia's prospects for coping with tighter international credit conditions are comparatively good. Meanwhile it is affected only to a minor extent by the impact of global economic deceleration via foreign trade. Although commodity prices are considered likely to fall during our forecast period, we expect clearly higher average oil prices in 2008 than in 2007. The large financial buffers Russia has built up, including its oil-based Stabilisation Fund, will mean that at least in the short term, it is well protected against an oil price downturn.



Domestic demand has been driving growth in recent years and will hold up relatively well in the next two years as well. Fiscal policy will provide continued support, even if growth impulses gradually ebb. Due to high resource utilisation, output growth will be restrained from the supply side. Shortages of skilled labour have increased, and previously unused production capacity has increasingly been placed in service. Thus a growing proportion of rising demand will be met through higher imports, but capacity restraints will gradually ease thanks to a sharp upturn in investments. Overall, we anticipate that GDP growth will gradually slow to 6.8 per cent in 2008 and 6.0 per cent in 2009.

Despite bright short-term growth prospects, the Russian economy faces various challenges down the road. Put simply, Russian growth has been based on more efficient utilisation of capital and labour, not – as in countries like China and India – on higher input of labour and capital. This, in turn, was made possible in part by low initial capacity utilisation after the 1998 financial crisis. However, there is less and less room for boosting output in this way as production capacity is harnessed. Russia's potential for increasing its labour input will also be limited by very negative demographic trends ahead. This is why a long-term increase in the investment level is vital to long-term growth and is also important if Russia is to decrease its heavy dependence on commodities. At present, oil and gas account for 2/3 of export revenue and about half of the Russian federal government's revenue.

According to preliminary estimates, GDP rose by 8.1 per cent last year – the strongest increase since 2000. Domestic demand grew on a broad front, sustained among other things by an increasingly expansive fiscal policy. Sizeable increases in pensions and other social benefits along with sharp real wage increases drove private consumption, which grew by more than 12 per cent. Unemployment also continued to fall. A mix of good productivity growth and high real wage increases will provide fertile soil for continued high consumption growth. Some slowing of high credit growth to households can be expected ahead, but this is unlikely to have any major impact on consumption. Credits to households account for only about 7 per cent of GDP, a low share compared not only to OECD countries but also many other emerging economies.

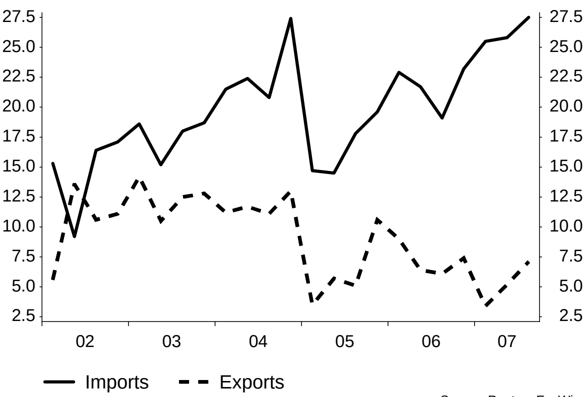
One weakness in the Russian economy has been a low investment level. The investment ratio – gross fixed investments as a share of GDP – has been around 17-18 per cent in recent years, or substantially lower than in many other comparable countries. Because of the low investment level, the capacity situation in many sectors has become increasingly strained. In places, the infrastructure is in very bad shape. Last year's investment upturn of more than 20 percent was thus welcome. Foreign direct investments also increased sharply last year. These focused mainly on typical domestic market-oriented sectors such as retailing, but the electricity sector is also generating strong capital inflows due to liberalisation in this industry.

High capacity utilisation and large federal government spending on infrastructure point towards continued high investment growth over the next several years. The government's investment programme involves spending USD 1 trillion over a ten-year period, but the extent to which this spending will successfully boost economic growth potential will depend largely on the ability of public authorities to channel these funds properly. Considering Russia's significant problems with corruption and bureaucracy, it is far from self-evident that this will happen.

As for potential private sector investments, not much has happened to improve the investment climate. The long-awaited law on strategic sectors, for example, has encountered further delays. A bill was submitted to the federal Parliament (Duma) in July 2007 defining 39 sectors as strategic and proposing restrictions on foreign ownership. Since then the bill has undergone further rewriting, but it is hardly likely that a law will go into effect before mid-2008. The continuing uncertainty surrounding this legislation is probably worse than the restrictions the law itself would impose.

Russia: Imports and exports

Fixed prices, year-on-year percentage change



Source: Reuters EcoWin

Looking at GDP from the output side, sharply rising domestic demand has primarily benefited such sectors as construction, retailing and transport, while manufacturing output has increased at a slower pace. Output in the oil and gas sector has practically stagnated in recent years. Insufficient investments and high taxation are among the reasons for the listless performance of this sector. Weak growth in oil and gas output also manifests itself in slower export expansion. Meanwhile strong domestic demand has driven imports to new heights. This trend has been reinforced by real-term rouble appreciation and the weakening of the US dollar against the euro, since Russia's export income is largely priced in dollars while imports occur in euros. Last year, imports rose by more than 25 percent in volume, while export volume rose by only a bit above 5 percent. The current account surplus thus shrank from nearly 10 per cent of GDP in 2006 to some 6 per cent in 2007, despite a sharp upturn in oil prices.

Current account surplus shrinking fast

The shrinking trend in Russia's current account surplus will continue in the next couple of years as oil prices fall and imports continue to rise at a rapid pace. Our assessment is that the current account surplus will have nearly vanished by 2009. As foreign trade surpluses gradually fell during 2007, private capital inflows increased sharply. These large inflows were driven, among other things, by listings of Russian companies on foreign stock exchanges as well as a number of large company acquisitions. Russian banks also greatly increased their borrowing abroad. The fact that capital inflows have continued in a situation of reduced global risk appetite indicates that Russia is regarded as a safe harbour, confirmed by the sharp increase in its currency reserve, which climbed nearly USD 150 billion in the course of 2007.

Russia's large foreign currency reserves, equivalent to about 35 per cent of GDP, mean that the country is well equipped to deal with tighter international credit conditions. A relatively low debt also implies that the effects of the global credit crunch may turn out to be rather small in Russia. Nor are there any signs so far of a deceleration in domestic credit growth. However, some effects can be expected on private sector borrowing abroad, which has risen rapidly in recent years. Russia's banking sector is dominated by a few partly government-owned banks with little foreign borrowing, while a number of smaller banks are significantly more vulnerable to tighter credit conditions abroad. These banks may need to tighten up their lending, but this is unlikely to have any far-reaching consequences for the Russian economy.

Inflation moving towards new heights

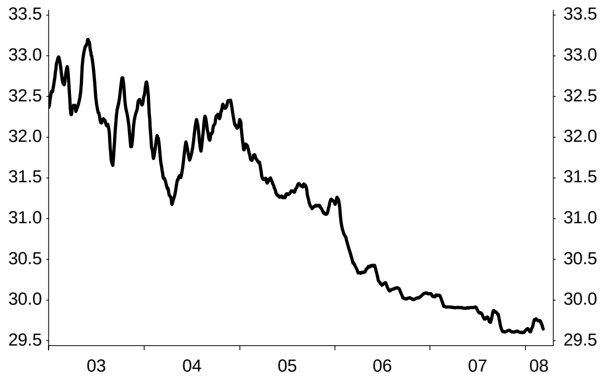
The long-term downward trend in inflation ended in the spring of 2007. Since then, the inflation rate has climbed from 7½ per cent to nearly 12.6 per cent in January. The upturn was largely driven by rising energy and food prices but also reflects rising underlying inflationary pressure, a consequence of higher resource utilisation. Other factors are an increasingly expansive fiscal policy and sizeable capital inflows, especially in the first half of 2007, which drove up money supply growth. We expect the inflation upturn to continue until summer, among other things due to significant base effects from energy. Sharp price increases at the producer level in recent months also indicate that inflation will continue upward in the short term. Then pressure from energy prices will fade, while monetary expansion will slow as large capital inflows diminish.

Russia's high inflation is starting to be increasingly troublesome for public authorities, which have declared that the temporary price freeze on certain foods they introduced last October will be extended. There are also plans to impose restrictions on borrowing abroad by state-owned companies in order to reduce inflation-fuelling capital inflows. For the central bank, previously its most important weapon in combating inflation was to let the rouble appreciate. This is a two-edged sword, however. The bank would like to avoid excessively rapid currency appreciation, out of concern for businesses exposed to international competition, and thus counter further increases in the country's dependence on commodities. In addition, expectations of continued appreciation in the rouble risk stimulating inflation-driving capital inflows that offset the effects of rouble appreciation. This is one reason why the central bank has only reluctantly allowed the rouble to strengthen in the past year.

In recent years the central bank has also raised its key interest rate and boosted reserve requirements, but in our assessment the bank will proceed relatively cautiously in its interest rate policy, given the uncertain credit market situation and the need for Russian banks and companies to refinance their foreign debts. Overall, we anticipate that inflation will be fought by means of continued cautious rouble appreciation, combined with modest interest rate hikes. Against a basket consisting of 55 per cent dollars and 45 per cent euros (which determines exchange rate policy) we expect the rouble to strengthen by 1½ per cent during 2008.

Russia: Rouble exchange rate

Basket consisting of 55% dollars and 45% euros



Source: Reuters EcoWin

Fiscal policy had a clearly expansive direction during 2007, and further expenditure hikes have been announced this year, including further increases in pensions and wages. In its three-year budget, the government expects roughly a fiscal balance in the next couple of years. Given significantly higher oil prices than the government had assumed, we expect a higher surplus this year, around 3 per cent of GDP. This is nevertheless clearly weaker than in 2007.

The election of Dmitry Medvedev as president on March 2 hardly came as a surprise to anyone. Now the plan is for former President Vladimir Putin to become prime minister, thereby completing an undramatic transition of power. This also means that the policies pursued to date will remain unchanged in the short term. Meanwhile there is built-in tension in the dual leadership that will now probably take shape. It also remains uncertain what Putin's objectives are and how he will use his considerable informal power. Formal power will rest overwhelmingly with Medvedev, who meanwhile has Putin to thank for his new position of power. Medvedev will have every reason to remain on good terms with his prime minister, even if he formally has the power to dismiss him. Given Putin's position in the United Russia party, and thus in the Duma, dismissal might be met by constitutional changes that would dramatically reduce the power of the president. Alternatively, the Duma could even impeach the president. As Medvedev gradually builds up his own power base, however, it is quite conceivable that he could challenge Putin.

So far it is unclear what policies Medvedev will pursue as president, but he has indicated some areas that he considers high priorities and which support his image as a relatively liberal-minded politician. Examples are improving the judicial system, reducing bureaucracy and regulation and improving the innovative climate. He has also said he would like to make the rouble a regional reserve currency and cut certain taxes.

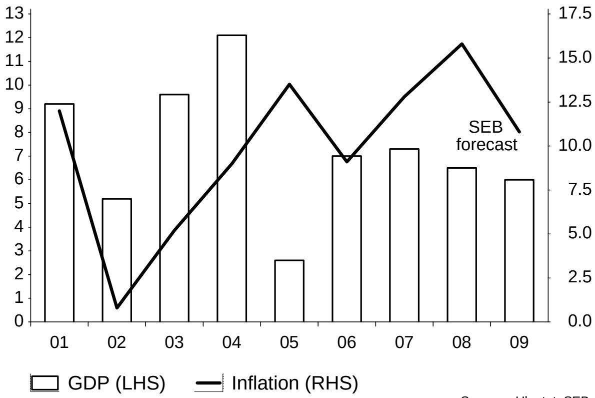
Internal strength, external risk

- **Continued consumption boom**
- **Even higher inflation**
- **WTO membership during 2008**

The Ukrainian economy grew by more than 7 per cent last year, in line with the average rate since the turn of the millennium. Growth was driven primarily by sharply rising – and partly credit-fuelled – domestic demand. But exports also performed favourably, thanks to continued good demand for such important export products as steel. We expect domestic demand to remain relatively buoyant over the next two years, but a number of factors point towards a gradual slowdown in growth. Looking ahead, somewhat more restrictive lending practices will hamper consumption and investments to some extent, while global economic deceleration will probably mean that the favourable price trend of recent years for Ukrainian exports cannot continue. High inflation will also mean deterioration in purchasing power, although this will be offset to some extent by the government's expansive fiscal policy. Overall, we estimate that GDP growth will decelerate from 7.3 per cent in 2007 to 6.5 per cent in 2008 and 6.0 per cent in 2009.

Ukraine: GDP and inflation

Year-on-year percentage change

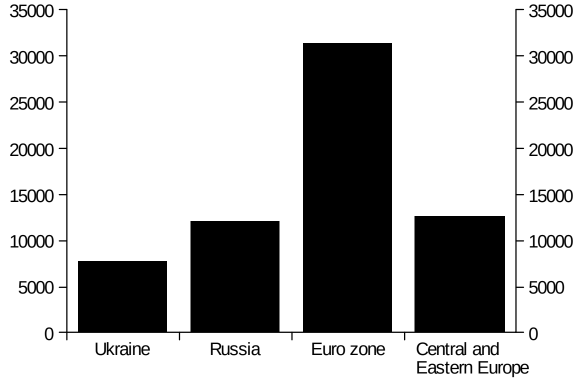


Sources: Ukrstat, SEB

Ukraine's catch-up process remains a very strong underlying force driving its economic growth. The country's living standard, for example, is substantially lower than in neighbouring countries such as Russia and Poland. Ukraine's well-educated labour force also implies a significant growth potential. Meanwhile there is no lack of short-term challenges. Political disunity, weak institutions, high and rising inflation, continued price increases on imported natural gas and rapidly rising private sector debt are among risks in the immediate future.

GDP per capita, 2006

PPP USD



Source: IMF

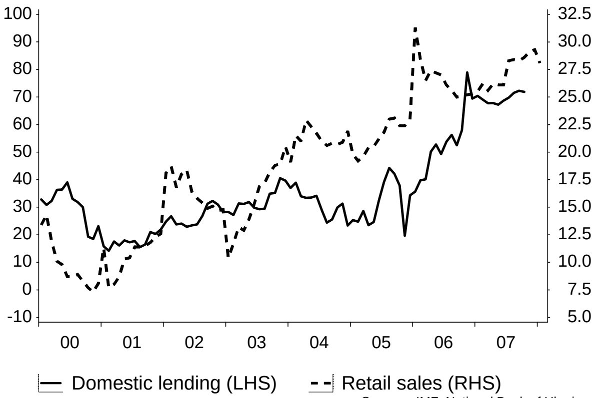
No clear deceleration in growth is discernible yet. On the contrary, the economy has shown remarkably stable expansion in the past two years, despite political instability and sharply rising natural gas prices. Private consumption rose by an estimated 12 per cent and investments by more than 18 per cent during 2007. Short-term indicators such as retail sales point towards continued strong consumption. Credit growth has also remained high, but this is a trailing statistic and a degree of slowdown is likely ahead. Higher financing costs due to global credit market turmoil will probably serve as a restraining factor for investments, but at the same time credit expansion is fuelled by increased competition in the banking sector and the fact that lending levels are still low.

Meanwhile domestic consumption is being sustained by fiscal policy, which is becoming more expansive under Prime Minister Yulia Timoshenko. Her budget for 2008 includes sharply higher pensions and child allowances, guarantees to the state-owned gas company to cover losses arising when higher import prices are not fully passed on to end-users and promises to repay household savings lost during the Soviet era. It is unclear how much these payments may total, but in 2008 the amount is around USD 4 billion, or 3 per cent of GDP. The aim is to finance the payments mainly via increased privatisations, but total payments are expected to be substantially larger. It remains unclear whether they will actually materialise and, if so, how they will be financed.

Higher expenditures pose no serious threat to public finances. Public sector debt totals only 14 per cent of GDP. However, they risk driving up already high inflation. The inflation rate rose from 14 per cent last August to more than 21 per cent in February. This rapid upturn was largely due to rising food prices, which in turn were partly related to last year's poor harvests. Since food accounts for about half of the consumption basket in the Ukrainian consumer price index, rising food prices have a major impact on inflation.

Ukraine: Domestic lending and retail sales

Year-on-year percentage change



Sources: IMF, National Bank of Ukraine

Meanwhile it is worth noting that domestic price pressure is relatively broad, as illustrated by sharp price increases in the construction sector, for example. In a short-term perspective, inflationary pressure will remain at a high level and the government's target of 12.5 per cent inflation by the end of 2008 will be difficult to achieve even if food prices gradually fall, in line with a more normal harvest outcome. One uncertainty factor in estimating inflation is to what degree rising natural gas import prices will be passed on to consumers.

Stable hryvnia

The National Bank of Ukraine (NBU) has relatively limited means for combating inflation, since monetary policy focuses chiefly on maintaining a fixed exchange rate against the dollar. Given the dollar's depreciation against most other currencies, this exchange rate policy has actually helped to fuel inflation via import prices. The hryvnia has weakened against the euro by about 10 per cent and against the rouble by 5 per cent during the past six months. The NBU is currently keeping the hryvnia in a narrow band of around UAH 5.00-5.06 per USD, within its wider official corridor of UAH 4.95-5.25/USD.

Although the current account deficit increased to 3½ per cent of GDP during 2007, large capital inflows contributed to continued appreciation pressure on the hryvnia. Given significant privatisations of state-owned assets and rules making it easier for foreigners to buy agricultural properties in Ukraine, capital inflows are likely to continue this year. Meanwhile we expect the current account deficit to worsen in line with weaker terms of trade and persistently strong import growth. As the dollar also begins to recover, there will be less justification for an appreciation against the dollar. Our assessment is thus that the hryvnia will remain relatively stable against the dollar during our forecast period. In the medium term, we expect the NBU to aim for a more flexible exchange rate policy, which indicates an appreciation of the hryvnia. Until then, one alternative is to let the hryvnia – like the rouble – follow a basket of dollars and euros,or simply let the currency appreciate within its existing dollar peg.

WTO membership by summer

After nearly 15 years of negotiations, Ukraine was granted World Trade Organisation membership early in February. All that now remains is approval by the Ukrainian Parliament no later than July 4 for the country to become a full member. WTO membership will not lead to any dramatic effects on the Ukrainian economy, but there will be additional cuts in customs duties and tariffs, thereby facilitating trade. The economic sector that will benefit the most from WTO membership is metallurgy, which will now have greater access to the EU market. Meanwhile the agricultural sector will become more vulnerable to foreign competition. One positive effect of WTO membership is likely to be more transparent public procurement procedures. Membership is also likely to contribute to a generally more investment-friendly climate in Ukraine, which still scores low in various international comparisons concerning such issues as corruption and ownership rights.

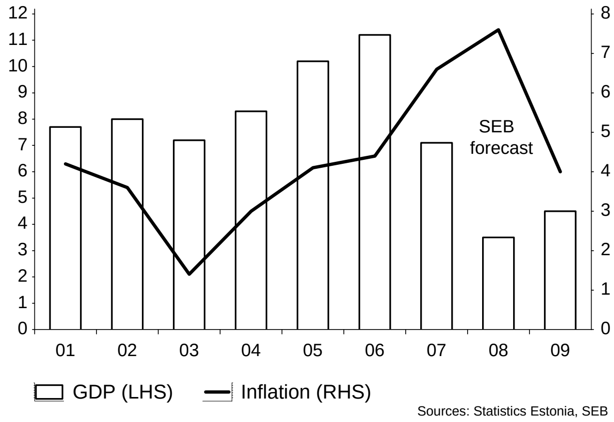
WTO membership is relatively uncontroversial, and the government's moves to create closer relations with the EU also enjoy relatively broad support. Ukraine's cooperation agreement with the EU expires this spring, and the EU has said it is prepared to offer an expanded agreement. One important component of such a pact will be a free trade agreement. Although there is relatively broad political consensus on closer relations with the EU, future Ukrainian membership of the North Atlantic Treaty Organisation remains a contentious issue, with the opposition firmly resisting such a move. The opposition is demanding that any decision to join NATO be put to a referendum.

Other controversial issues include the division of power between the president and Parliament. Certain tensions have already arisen between President Viktor Yushchenko and Prime Minister Yulia Timoshenko. For example, the president has expressed criticism of the government's fiscal policy, which he believes is fuelling inflation and which is said to be partly motivated by Timoshenko's desire to position herself in the run-up to the 2009 presidential election.

The slowdown continues

- **Domestic demand being suppressed**
- **Credit crunch and worsened expectations**
- **Real estate market correction short-lived**

Tighter productive resources slowed GDP growth in Estonia from 11 per cent year-on-year in the fourth quarter of 2006 to 4.8 per cent in the same quarter of 2007. With the economy operating at full employment, supply-side constraints limited expansion, while rising demand pushed up prices. Rapidly rising wages and other production costs such as land and industrial real estate squeezed company profits, while price increases on their products lagged behind even faster increases in costs. The growth rates of recent years could not be sustained. An adjustment was needed to help the economy return to more balanced growth. GDP growth is expected to slow further to 3.5 per cent in 2008, then rebound to 4.5 per cent in 2009. Weak domestic demand will constitute a drag on the economy, especially this year. The risks in the forecasts are on the downside.

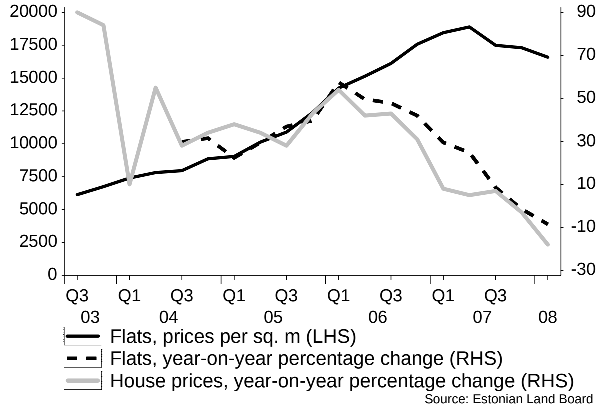


The economic boom now ending was largely diverted from its long-term sustainable path by a robust real estate market, which turned into a speculative bubble in the last couple of years.

Property prices appreciated too fast compared to incomes, and a price correction was expected to follow. The diversion from a normal path was reflected in property prices as well as employment in the construction sector and wage increases in 2005 due to labour shortages. Fundamentally the demand for housing is still there, but at somewhat lower prices.

The real estate bubble is now deflating. The process began early in 2007 with diminishing growth rates, and then prices actually declined late in the year.

Prices continued to fall in early 2008, with sales figures halving compared to 2007 and reaching the same level as in 2005. Buyers are expecting continued price declines.



We do not expect this correction to last for long. There will be some oversupply in the new construction market in 2008 which will drive prices down, but we expect this to be absorbed by mid-2009. Prices will then have fallen to levels where new demand emerges. The oversupply of new projects in 2008 will lead to significantly lower construction volume after ongoing projects are completed. This will lead to lower employment, more moderate wage growth and possibly even wage cuts in the construction sector. Other real estate and construction-related fields will also suffer. Unemployment in the economy as a whole will also rise somewhat this year due to an overall slowdown.

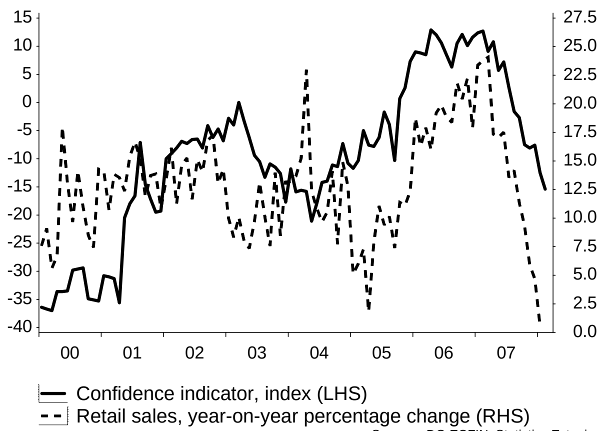
No great pressure on households

How risky will the real estate slowdown be for the economy?

Considering the extent to which even companies in other sectors were engaged in speculative real estate transactions, the effects could be widespread. Most residential space, however, is bought by private individuals for their own use and the direct consequences for them should remain quite limited. We foresee no significant pressure on households to sell their homes, since they have relatively sound balance sheets and since unemployment will not be on a large scale. Low real interest rates are also supportive. Overall, we expect prices of houses and flats to fall by an average of 17 per cent somewhat in 2009. Lower home prices are having some spill-over effects on consumption, though. Consumption growth rates fell during the second half of 2007 and posted practically no growth in the first month of 2008. Consumer confidence has plummeted. We expect consumption to grow at a modest 3-4 per cent pace in 2008 and recover from the peak in the second quarter of 2007 until late 2008.

The economic boom of recent years was largely fuelled by the availability of cheap money, with real interest rates being negative. In 2008, with inflation rising and interest rates slightly lower, real interest rates will be even further inside negative territory than before. But the credit supply will be tighter and there will be less credit demand, due to the contraction in real estate demand. All in all, investments will slow in 2008 and begin to recover in early 2009.

Estonia: Confidence and retail sales



Sources: DG ECFIN, Statistics Estonia

The economic slowdown and decreasing profits will put limits on wage growth, which will slow from 20 per cent in 2007 to 9 per cent in 2008 and 8 per cent in 2009. Despite lower domestic demand and demand-fuelled inflation, in 2008 we will see a higher inflation rate than in 2007 due to excise and other tax increases plus continued cost-driven price pressure. Inflation will be 7,6 per cent on average in 2008, then fall considerably in 2009. Real wage growth will slow markedly in 2008 but pick up again in 2009.

Recovery in exports

In addition to internal factors constraining growth in 2008, external factors will not be helpful either. On the positive side, Estonia's main export markets – Sweden, Finland and Latvia – are expected to remain relatively strong. We expect export growth rates to recover from the lows of 2007. Exports volumes looked stunted, especially against the backdrop of solid growth in the EU. However, this weak performance can largely be explained by temporary disturbances in Russian trade and streamlining in the important electronics sector. With investments probably falling and consumption growing at a moderate pace in 2008, exports are likely to be the main driver of economic growth in Estonia, with investments probably falling and consumption showing weak growth.

Due to weak export growth in 2007 the trade deficit widened, despite the effects of shrinking domestic demand on imports in the second half of the year. This setback hit low value-added industries such as textiles and electronics assembly, which are the most vulnerable to rapid wage increases. In a long-term perspective, the crucial question for the export sector is whether the workers who are now employed in these industries are qualified for employment in higher-value-added industries.

With imports growing only moderately and export growth expected to surpass that of imports, the current account deficit will shrink in relation to GDP. Since the imbalances accumulated so far are huge, the decline in the current account deficit cannot occur very rapidly and the deficit will remain large in the next few years.

Tighter fiscal policy

Taking into account the continuing large imbalances in the economy, the large current account deficit and continued high inflation, our assessment is that fiscal policy will be tightened. Due to decelerating consumption, the government is likely to face lower revenue than expected, especially VAT. Its budget was planned in an environment of brighter growth prospects, which have deteriorated significantly since then. The government has expressed its commitment to a balanced budget policy, and we anticipate that it will follow this, even during the slowdown now expected. The revenue shortfall is thus likely to lead to cuts in some planned public investment projects. The latter will have implications in the form of further slowing of investments in 2008 and 2009.

We believe the government will continue pursuing its plan to gradually lower income taxes, leaving more money in the hands of consumers. On the other hand, the government will be forced to cut expenditures over the next few years, which will constrain public sector wage and salary growth as well as increases in transfer payments to households.

A risk scenario for Estonia is a hard landing in Latvia, which would affect Estonia both directly through trade channels but also through a decline in foreign investors' confidence. This would further squeeze the financing of Estonian economic growth, push up interest rates and dampen further growth, thereby also putting pressure on the survival of Estonia's exchange rate peg.

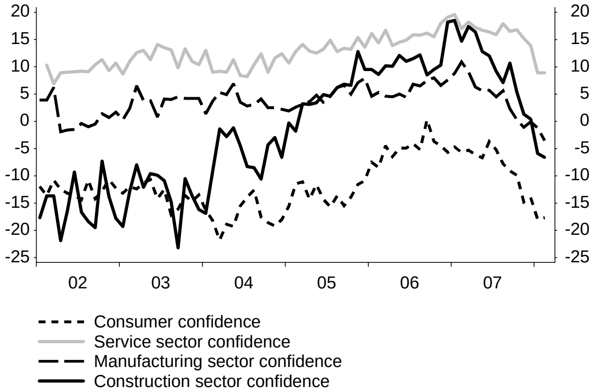
A near-halving of GDP growth

- **Consumption is cooling fast**
- **Inflation will peak this summer**
- **Imbalances will decrease but remain large**

The consumption boom has ended, and the Latvian economy is moving into a new phase of the economic cycle. Tighter credit standards at commercial banks, together with government measures, have cooled consumption-based growth. Further economic stabilisation measures are expected, aimed at preventing a hard landing scenario. Sentiment indicators have declined sharply since autumn, and the risk of a more pronounced economic slowdown has increased.

Latvia: Sentiment indicators

Net balance



Source: DG ECFIN

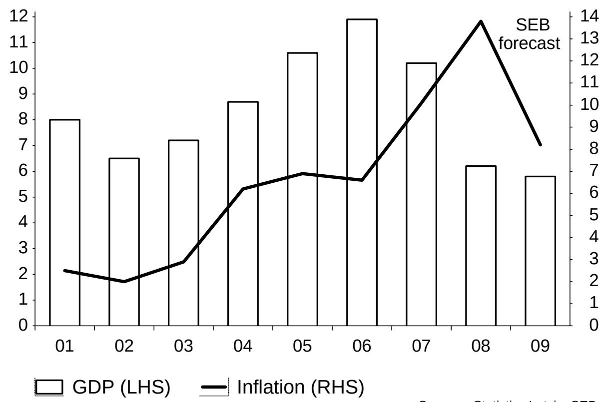
The economy grew by 10.2 per cent in 2007 due to booming consumption, but also received strong support from exports. However, there was a clear slowdown trend late in the year. Previously high growth rates in domestic commerce, car sales, lending, property transactions and imports even moved into negative territory during the winter months. Manufacturing output fell slightly in 2007.

In 2008 private consumption and investments will be weaker contributors to economic expansion. Meanwhile exports will have a more significant impact on growth, though adversely affected to some extent by weakening international demand and high cost pressure. We expect continuously decelerating growth, bottoming out in 9-12 months. We are revising our previous growth forecast downward. GDP will increase by 6.2 per cent in 2008 and by 5.8 per cent in 2009. The risks are skewed on the downside. A continued rapid downturn in sentiment indicators and more profound weakness in the real estate market will result in clearly lower GDP growth and a government budget deficit. If a deep recession materialises, an exchange rate adjustment cannot be ruled out, but we regard this risk as small.

The government's anti-inflation plan, which was launched in spring 2007 after a bout of currency turbulence, was only partially implemented, so the results were mixed. The largest impact was on the real estate market. The number of transactions has halved and prices for flats in the secondary market has dropped by 20 per cent after peaking in spring 2007. The market is stagnating, but without a panic. Prices of land and commercial property are stable. As commercial banks introduced stricter lending rules – demanding larger client participation in financing and tightening income requirements – year-on-year residential lending growth fell from 90 per cent in March 2007 to 33 per cent in January 2008. This year loan growth will reach only 15-20 per cent. Constraints on available money and weaker expectations have turned the real estate market from a seller's to a buyer's market. Future price movements will be dependent on economic trends and household sentiment. If there are clear signals of improvement, the market will revive in the coming six months. Otherwise it will remain sluggish, with slowly falling prices. However, it is important to mention that housing demand remains strong, since living space per capita is still low.

Latvia: GDP and inflation

Year-on-year percentage change



Sources: Statistics Latvia, SEB

Inflation has not been curbed and continues to rise. Unfortunately supply side measures demanded by entrepreneurs and independent advisors were not carried out. In coming months the government will implement an economic stabilisation plan focusing on long-term sustainable development. The key issues are export promotion, improvements in the business climate and the labour market, education, reforms in the tax system and the bureaucracy, strict spending control and increasing competition. Late in 2007, the government made a strong effort to restrain spending. Tighter fiscal policy and extra revenues allowed it to achieve a fiscal surplus of 0.7 per cent of GDP in 2007, compared to a projected deficit of 0.4 per cent. This year the government is aiming at a surplus of 1 per cent, but potential obstacles to this include lower than projected tax revenue if the economy slows too fast and any decision to compensate pensioners for higher inflation. Our forecast is a 0.5 per cent fiscal surplus in 2008 and 2009.

Inflation will slow in the second half of 2008

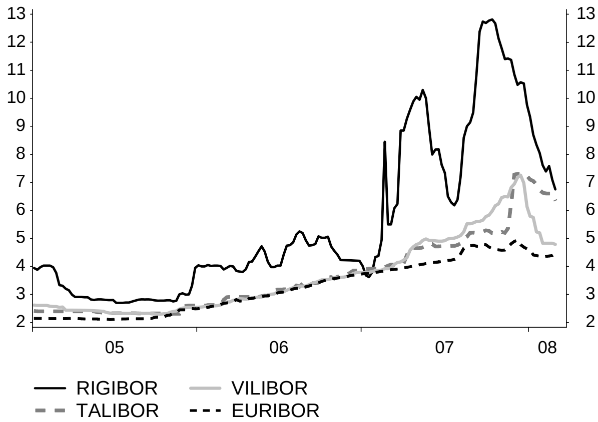
Inflation remains a serious economic problem for businesses and households, undermining their optimism. It reached 16.7 per cent in February, mainly due to higher excise taxes for fuel and tobacco, higher food prices and inflation expectations. Consumer prices will continue to accelerate until this summer, also fuelled by 30-50 per cent increases in electricity, gas and heating prices. However, decelerating economic activity and price and cost pressure will slow inflation in the second half of the year. We expect inflation to average 13.8 per cent in 2008 and 8.2 per cent in 2009.

The labour market remains tight. Unemployment dropped to 5.3 per cent in the fourth quarter, compared to 6.2 per cent a year earlier. Under pressure from business, the government has decided to allow more immigration of workers. Meanwhile slower growth will make it easier to move labour from one sector to another, for example from construction to manufacturing. Although lower economic activity will reduce demand for labour, unemployment will increase only slightly. Wages rose by 33 per cent in 2007, with the highest growth in the public sector. Legalisation of salaries in the informal economy also had an impact. In 2008 wage growth will halve, mainly due to moderate growth in the public sector.

Falling consumption and strong export growth continued to improve Latvia's foreign trade and current account balances. Exports grew by 22 per cent and imports by 21 per cent in 2007. The trend in the fourth quarter was different, with imports up only 3 per cent year-on-year while exports rose by 20 per cent. Growth was especially strong for exports to the other Baltic countries, Russia, Poland, Sweden and Finland. The positive service balance doubled in the past three months, and the inflow of foreign direct investments remained strong. This had a favourable impact on the current account deficit, which shrank to 20 per cent of GDP in the fourth quarter compared to almost 25 per cent in the first nine months of 2007. Last year Latvia attracted record-high foreign direct investments, totalling 8 per cent of GDP, but this covered only one third of the current account deficit. The rest was covered by capital flows mainly from foreign parent banks, but, this flow weakened late in the year. Sluggish consumption and healthy export growth will continue to lower the current account deficit to an average of 19 per cent of GDP in 2008 and 16 per cent in 2009.

Latvia's currency has shifted back to the strong side of its trading band, after a weakening trend during the first half of 2007. The 3-month interbank market rate dropped from almost 13 per cent in October 2007 to 7 per cent in March 2008. After the re-appointment of Ilmars Rimsevics as governor of the Bank of Latvia, rumours of a possible broadening of the lats peg disappeared. The central bank eased reserve requirements for commercial banks. The Bank of Latvia has repeatedly stressed the importance of joining the euro zone as soon as possible. Efforts to achieve sustainable and balanced growth are thus crucial if Latvia is to adopt the euro by 2012 or 2013.

The Baltics: 3-month interbank rates



Source: Reuters EcoWin

If the economy cools too fast, growth-promoting activities may be necessary from the government. Banks will remain cautious as the number of nonperforming loans increases. Their level remains very low, however.

New government

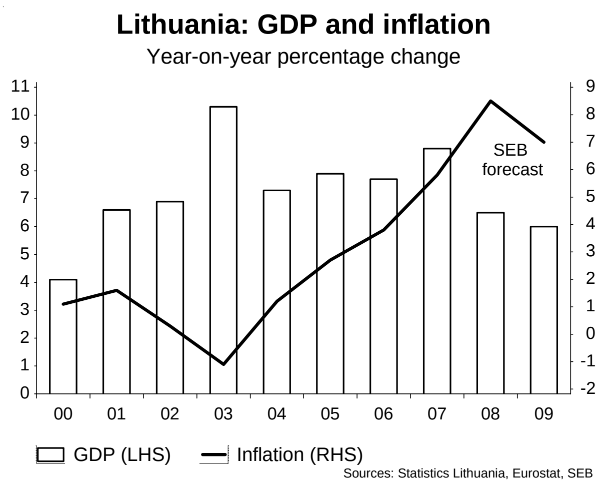
In November 2007 Prime Minister Aigars Kalvitis stepped down, after losing popularity by not being able to cope with promises to improve the economy and political transparency. A new government was formed by the same four-party centre-right coalition, including most of the same ministers. It is headed by Ivars Godmanis, who also served as prime minister in the tough years of the early 1990s. The government is focusing on tighter fiscal policy, a more efficient national bureaucracy, social issues, entrepreneurship and export promotion.

Mild slowdown

- **GDP and credit growth decelerating**
- **Inflation picking up in 2008**
- **Energy problems after 2010**

At the end of 2007, the fast-growing Lithuanian economy started showing signs of deceleration. Year-on-year GDP growth was 8.0 per cent in the fourth quarter of 2007 and 8.8 per cent for the whole year. Domestically-oriented sectors such as agriculture, construction, internal trade and transport, communications and storage were the most important drivers behind economic expansion. A hard-landing scenario cannot be ruled out, but we believe that a soft landing is the most likely path. Lively exports will serve as a buffer for weakening domestic demand.

We foresee GDP growth slowing to 6.5 per cent in 2008 and 6.0 per cent in 2009. The growth forecasts issued by various institutions differ by as much as 4-5 percentage points.



There is no doubt that growth will decelerate, but the extent of the slowdown is unclear. Whether a soft- or hard-landing scenario materialises will depend on whether subdued external demand significantly contributes to weaker domestic demand. The internal market is already cooling due to the stagnating real estate and construction sectors (especially the residential segment) what will have an adverse effect on production and sales of construction materials, furniture and domestic appliances. Banks are already facing lower demand for housing loans as inflation undermines real household income. Deteriorating consumer expectations will also have an adverse effect on retail trade. This macroeconomic transition will take 2-3 quarters to come true, and Lithuania will undergo it this year. We expect unemployment to stabilise in 2008 and increase slightly in 2009. A liberal immigration policy is crucial in order to avoid labour market bottlenecks, but the government must pay heed to social considerations as well.

Export prospects are more uncertain than domestic factors. In 2008, the global and euro zone economies will slow and the credit crunch will have a crucial effect on consumption and investment in a range of countries. Shrinking growth in Latvia and Estonia, two key trade partners, will also have a negative effect on the Lithuanian economy. On the other hand, hard times in Western and neighbouring economies will be offset by vigorous demand from CIS markets, especially Russia and Ukraine. In addition, the competitiveness of Lithuanian exports is improving in Eastern countries because of a favourable inflation differential. Total exports will thus hold up fairly well.

The current account deficit will be relatively high due to persistent import growth, but it will diminish in 2008 and 2009. There is still a long way to go in persuading large foreign companies to invest in Lithuania. We do not expect a breakthrough for foreign direct investments during an election year, but a new ruling coalition will probably adopt a more flexible policy towards potential foreign investors. FDI will cover more than a half of Lithuania's current account deficit in 2008 and 2009.

Larger budget deficit

In line with slower growth, public finances will be under heavier pressure. The revenue plan for the 2008 national budget is very optimistic. For some taxes, such as the value-added tax, collection plans hardly look achievable. The government will most likely keep the status quo in personal income tax policy. During the year, problems on the revenue side may become rather acute. The ruling coalition is unlikely to cut expenditures in the run-up to the October parliamentary election, thus further increasing the budget deficit. Reacting to such circumstances, Standard & Poor's lowered Lithuania's long-term credit rating from A to A- in January 2008 and predicted that in 2008-2009 the fiscal deficit will approach 3 per cent of GDP, the ceiling of the Maastricht convergence criterion for joining the euro zone. Our view is more optimistic. We foresee fiscal deficits of 1 per cent of GDP this year and next. In addition, we believe it is too late to tighten fiscal policy; this would be too risky in light of the projected economic slowdown.

In the first months of 2008, year-on-year inflation shot up as high as 10 per cent. The main drivers were higher prices for imported natural gas and household gas, increases in excise duties for fuel and alcoholic beverages and a further climb in global oil prices. In recent years, demand-pull pressures have played a growing role. In 2008, they are also supported by income policy: a cut in the personal income tax rate from 27 to 24 per cent and an increase in the minimum monthly wage from LTL 700 to LTL 800. Wages continue growing at a rapid rate. In the fourth quarter of 2007, gross remuneration was up by 18.5 per cent year-on-year, or more than twice as fast as the increase in labour productivity. Wages will grow by 15 per cent in 2008 and 13 per cent in 2009.

Bearing in mind second-round inflationary effects, intensifying inflation expectations and an inevitable increase in heating prices this coming autumn, we are raising our forecast of average annual HICP inflation to 8.5 per cent for 2008. Given slower growth in 2009, inflation should drop to 7.0 per cent.

Consequently, euro introduction in 2010 or soon afterward does not seem realistic. Lithuania's chances of joining the euro zone later will depend on postponing the closure of the second reactor at the Ignalina nuclear power plant and the expected subsequent rise in electricity prices. The government has still not lost hope that it can extend the period of operations at the current nuclear plant, despite negative signals from European Commission representatives. A team led by ex-Prime Minister Aleksandras Abišala will negotiate with the Commission on the Ignalina issue.

In early February 2008, President Valdas Adamkus approved changes in the law on nuclear plants. Based on the amended law, a public-private consortium was formed to build a new nuclear plant. A realistic target date for opening the plant is 2017-2018. To avoid dependence on Russian energy sources, Lithuania needs to link up its electricity grid with Poland and Sweden. However, these links will not be built until 2015 or later. Thus, Lithuania's energy supply will be under pressure early in the next decade, which will definitely have a negative impact on the general economic situation.

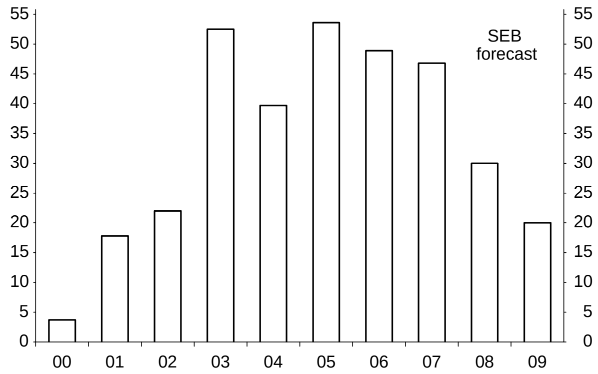
Credit boom will fade

In recent months, the credit boom has lost steam. The shift in the residential property market lowered the rate of growth in housing loans late in 2007. Starting in 2003-2004, expectations that the prices of houses and flats would rise dominated the market. Today, people expect prices to fall, so the housing market is stagnating. Sellers are not eager to offer discounts yet, and potential buyers are in no hurry. The situation may stay largely unchanged for the rest of this year. Some observers predict that housing prices may fall as much as 30 per cent in major cities this year. Our view is that any slump in prices should not exceed 15 per cent year-on-year.

The currency structure of newly issued housing loans also changed during the second half of 2007. At the beginning of last year, roughly half of new loans were issued in euros and the other half in litas. By year-end the ratio was 80:20. This shift was caused by a widening gap between interest rates on loans in litas and euros, 200-250 basis points, which persuaded most households to borrow more cheaply in euros.

Lithuania: Domestic credits

Year-on-year percentage change



Sources: Bank of Lithuania, SEB

However, early in 2008 the national currency risk premium shrank to 100-150 base points as rumours of a litas devaluation waned and liquidity in the domestic market increased.

In 2008, the loan portfolio of commercial banks should grow by at least 30 per cent year-on-year, and in 2009 by 20 per cent. The growth of deposits should reach 15 and 10 per cent, respectively. Thus, the gap between loan and deposit growth will persist and Lithuanian commercial banks will still have to attract additional liquidity from their foreign parent banks, but to a lesser extent than in previous years.

Interest rates on loans peaked late in 2007 and are expected not to rise any more this year. Interest rates on euro loans will even decline when the ECB cuts its refi rate starting this spring. The price of loans in litas may also decrease compared to last year if no new speculative attacks on the Baltic currencies appear, or if the lingering risk of hard landings does not push up the national currency risk premium.

Resilience being tested

- **Competitiveness weaker**
- **Exports have held up well to date**
- **Increased regional trade**

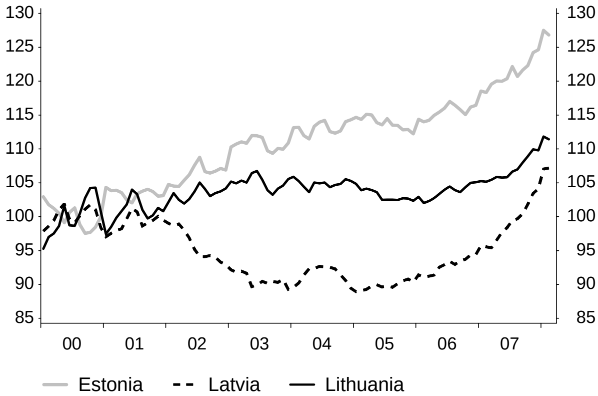
The Baltic economies are relatively dependent on exports. In Estonia, exports are equivalent to around three fourths of GDP. In Latvia and Lithuania the corresponding figure is about one half of GDP.

The global slowdown comes at an extra sensitive stage of the economic cycle, as domestic demand has simultaneously begun to decelerate, largely due to tighter credit conditions. Meanwhile the three countries have lost competitiveness following a rapid acceleration in wage growth and inflation during the past few years. Furthermore their currencies, which are all pegged to the euro, have appreciated due to the strengthening of the euro.

The real effective exchange rate – a measure of competitiveness – rose by 18 per cent in Latvia during 2006-2007, by 12 per cent in Estonia and 8 per cent in Lithuania. This is according to the BIS exchange rate index, which is based on 52 countries and uses consumer prices in the calculation.

The Baltics: Real effective exchange rate

Index



Source: BIS

Latvia's real effective exchange rate fell in 2002-2003 because its currency was pegged to the IMF's Special Drawing Rights (SDR) basket, in which the US dollar weighs heavily. The lats was not pegged to the euro until January 1, 2005.

Nevertheless, it is difficult to discern more than marginal losses in market shares due to weaker competitiveness, according to the European Commission's autumn report data.

The trend of exports during 2007 also supports the contention that so far, Baltic exports have weathered the increased cost squeeze nicely. Latvia's exports in current prices rose last year by 22 per cent, compared to 14 per cent the year before. Lithuania's exports admittedly slid from 20 to 11 per cent growth, and Estonia's from 26 to 4 per cent. But there were a few special reasons behind these declines: in Lithuania, disruptions in the country's sole oil refinery; and in Estonia, disruptions in trade with Russia and cutbacks by Finnish-based Elcoteq in the electronics sector.

Another reason why exports performed comparatively well, aside from the above-mentioned temporary effects, is modest exposure to the US. Exports there account for only a few per cent of GDP.

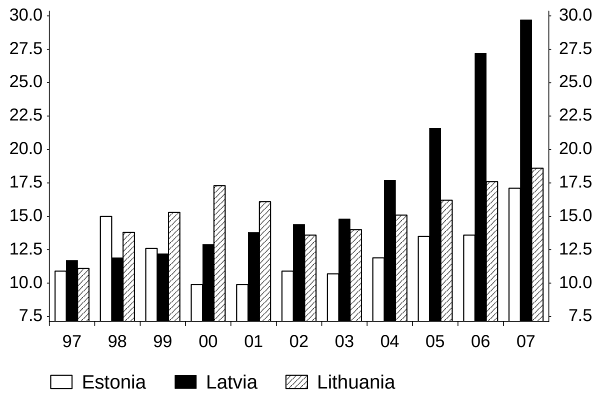
Looking ahead, Baltic exports will face growing challenges as Western Europe is harder hit by the American deceleration and as weaker competitiveness to a certain degree remains.

Meanwhile the Baltic countries are somewhat less dependent on Western Europe than they were three to five years ago. The pattern of trade has again shifted more towards nearby countries in Central and Eastern Europe. For example, Latvia's exports to the 15 pre-2004 EU member countries shrank from 47 per cent of the total in 2005 to 40 per cent. Lithuania's exports to the EU-15 fell from 45 to 38 per cent of the total.

Trade between the Baltic countries and with Russia has climbed at the same time. Latvia's exports to its Baltic neighbours doubled from 15 per cent of the total in 2003 to 30 per cent in 2007. The share of exports going to Russia climbed from 5 to 10 per cent. Among the reasons are changes in tariffs due to EU accession in 2004 and growing Russian demand.

Intra-Baltic trade

Percentage of respective total exports



Sources: National statistical offices, SEB

Increased intra-Baltic trade and more trade with Russia entail both opportunities and threats. If the economic deceleration in any of the Baltics proves sharper than we have anticipated, it will be a source of vulnerability. Our scenario of continued strong domestic demand in Russia implies a positive impetus. Meanwhile experience shows that disruptions may arise in relations with Russia.

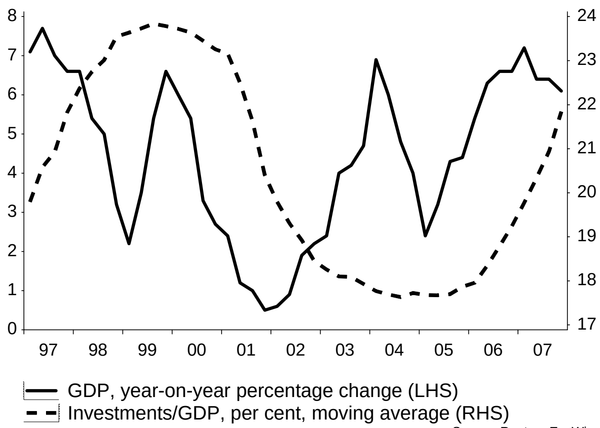
Our overall assessment is that Baltic exports will slow moderately during 2008-2009, although the risk is on the downside.

Growth cooling to a sustainable level

- **Inflation and interest rates will rise further**
- **Reforms are not yet off the ground**
- **Zloty is moving towards new heights**

During the final quarter of 2007, economic growth in Poland again surpassed expectations, amounting to 6.1 per cent year-on-year. Private consumption and investment continued to expand vigorously, lifting GDP by 6.6 per cent during 2007 as a whole despite negative net exports. Rising current account deficits and mounting inflation are signalling that the economic engine speed indicator has starting moving into the red zone. A cool-down in activity due to the international slowdown as well as capacity restraints and tighter monetary policy are thus not only likely, but also welcome. We foresee GDP growth of about 5 per cent both this year and next, with domestic driving forces dominating and with a gradual easing of overheating risks. The Polish economy is mainly characterised by vitality and optimism. To manage this in the best way, reform efforts would need to move from words to action. In that case, Poland would enjoy good prospects for a rise in its credit rating.

Poland: GDP and investments ratio



Source: Reuters EcoWin

The overheated Polish economy of the late 1990s was cooled down by sharp interest rate hikes. Growth fell to 1 per cent, while unemployment doubled to 20 per cent. After a few tough years of restructuring, the business sector emerged stronger than before. Buoyed by favourable international conditions and EU accession, Poland has become one of the fastest growing economies in the EU. Consumption is growing, since households now have more money in their wallets. Unemployment has quickly halved to 10 per cent. Given labour shortages in a number of sectors, especially in major cities, wages and salaries are growing rapidly. Consumption has also benefited from rapid credit expansion.

With slimmer and more stable balance sheets after their restructuring period, companies have been well equipped to meet new demand – initially from abroad but to an increasing extent from the domestic market – through new capital spending. Banks have willingly provided loans, and EU funding has been increasinly used, helping boost the investment ratio from 18 per cent of GDP in 2004 to 22 per cent. Poland's new production capacity will enable it to sustain a higher growth rate than previously without triggering imbalances – this rate is estimated at 5 per cent today.

As the driving forces of growth have shifted from exports to domestic demand, the trade and current account deficits have again begun to increase. The latter amounted to 3.7 per cent of GDP last year and is expected to rise to 5 per cent. Considering that the deficit is covered by capital inflows from foreign direct investments and EU transfers, this is still not a problem, but the rate of increase in the deficit might eventually become a threat.

Economic cycle past its peak

So far, the American deceleration and the global credit crunch have had no impact on the behaviour of Polish households and companies. The reason is that only a small fraction of the country's exports go to the US. In addition, Polish banks have not been visibly involved in risky financial undertakings based on the US sub-prime market. Total private sector credits are also still moderate in international terms.

However, an American recession will help halve euro zone growth to 1.3 per cent this year. Although Poland's exports to the euro zone are smaller as a percentage of GDP than those of neighbouring countries, they are still more than 30 per cent and the export outlook has undoubtedly worsened. Meanwhile a number of economic sectors are hampered by capacity restraints as well as by rising wages and salaries, interest rates and zloty exchange rates. Investment growth remains high but is noticeably more subdued than last year. Job growth will slow, and given somewhat lower real pay increases this year we anticipate that consumption growth will also cool.

Deceptive political calm

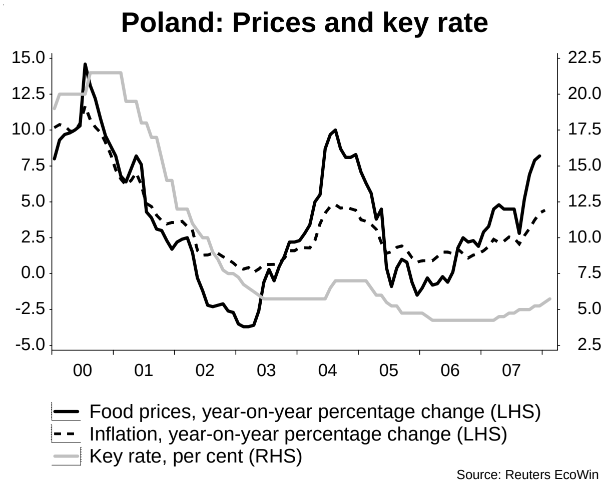
In order to maintain a potential growth level as high as 5 per cent – and preferably even increase it – structural reforms would need to be implemented, at the same time as investments are at a high level. The Civic Platform party, which dominates the two-party coalition that took office last autumn, went to the polls with an ambitious though unspecific reform agenda with five themes: restoration of fiscal order, tax reform, a transition to the euro, privatisation and deregulation. After winning the election, Prime Minister Donald Tusk promised to wade into the reform jungle with a machete. This may be viewed as a reasonable ambition, considering that Poland lags clearly behind its closest competitor countries in several international studies of the business climate. Aside from sub-standard infrastructure, there is major potential for improvement on such matters as the time and costs required to obtain licences and to resolve legal disputes, as well as corruption.

During the government's first four months in office, however, its successes have been modest. One explanation is probably President Lech Kaczynski's explicit intention to veto several of the government's reform proposals and uncertainty as to whether the prime minister can count on the opposition political coalition LiD (Left and Democrats) to help him override presidential vetoes. If no progress is made soon, there is a heightened risk that the government's political manoeuvring room to push through reforms that are unpopular in the short term will shrink as Poland moves closer to the EU parliamentary election in 2009, the presidential election in 2010 (in which Tusk will probably be a candidate) and the parliamentary election in 2011. The relative calm that has characterised the political scene lately should thus not be interpreted as anything positive from a long-term economic growth perspective. No far-reaching reforms in the tax and health care fields are imminent, but we anticipate that some progress can be made, as well as in the pension system and the labour market and in speeding up the pace of privatisation.

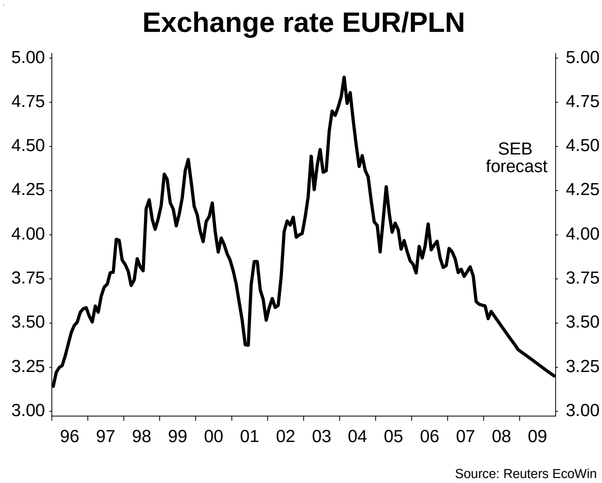
It should be possible to keep the budget deficit below 3 per cent of GDP despite the expansive measures that the previous government included in its budget and that the new government has retained. There is still a large structural deficit, however. We believe that fiscal enhancement measures will be approved, even though the government's target of reducing the deficit to 1 per cent of GDP by 2011 appears optimistic given the election cycle. The government has not established any target date for Poland's transition to the euro. A report from the National Bank of Poland (NBP) on the advantages and disadvantages of the euro is expected late in 2008, which could then pave the way for Poland to join the ERM no earlier than the spring of 2009 and the euro zone in 2012. Finance Minister Jacek Rostowski is a warm advocate of an early transition to the euro and "does not rule out" 2013, which in our opinion would be reasonable.

CPI inflation rose from 1.1 per cent in 2006 to 4.3 per cent year-on-year in January 2008 and is now clearly above the official inflation target of 2.5 ±1 per cent. The single most important reason for the rapid upturn is food prices, which rose by more than 8 per cent in 2007. Food accounts for 26 per cent of the CPI basket and thus has a large impact. Energy prices are also up.

While these price increases are beyond the NBP's control and are likely to have only a temporary effect on inflation, there is a major risk that inflation expectations will be driven higher and leave a permanent mark – especially in light of strong domestic demand and a tight labour market. Pay is increasing at double-digit rates exceeding productivity growth by a wide margin. The NBP has responded by hiking its key interest rate in six steps to 5.5 per cent. We expect inflation to fall towards the bank's target only in 2009, when food and energy prices will not be climbing in the same dramatic way and the economy will be slowing somewhat. We also believe that further key rate hikes to 6.25 per cent and a strong zloty will be needed. Real interest rates will rise to about 3 per cent towards the end of our forecast period – a rather moderate level considering the growth rate. In the past decade, Poland has been generally successful in its battle against inflation.



The rising interest rate spread to other countries is giving the zloty powerful support. The currency is thus appreciating, despite the increase in Poland's current account deficit. Relatively high growth, a modest real exchange rate and a positive direction in reform policy will help boost the zloty by a further 7 per cent against the euro this year to 3.35. During periods of global risk aversion, however, the zloty will also encounter headwinds that may temporary be blustery, especially this spring.



Euro adoption in 2009 as planned

- **Slowdown from double digit growth**
- **Inflation on the rise**
- **Public finances under control**

Slovakia has enjoyed sound, rapid GDP growth rates in the past few years. From the supply side, growth has been driven by production of machines, cars and electrical equipment. The structure of growth remains balanced between domestic demand and exports. The economy shows no signs of overheating.

During the first three quarters of 2007, the economy enjoyed 9 per cent GDP growth, followed by a 14.3 per cent year-on-year surge in the fourth quarter. This was due to a decision by the Statistical Office to include one-off excise tax revenue from stockpiling of cigarettes ahead of a tax hike. According to a preliminary estimate, GDP rose by 10.3 per cent in 2007, which would be a record for Slovakia after an 8.3 percent increase in 2006. Subtracting the impact of special circumstances, growth in 2007 was 9.2 per cent. Excise tax revenue will be lower in the first half of 2008. In January 2009, another cigarette tax hike is planned. We expect GDP growth to slow to 7.0 per cent in 2008 and 6.5 per cent in 2009.

Due to rising imports of equipment needed for investments, the foreign trade deficit widened in 2006, but as manufacturers launched their export-oriented production the external balance improved by 4 percentage points of GDP in 2007. Industrial output was still growing strongly in late 2007, but deteriorating global demand prospects suggest that a slowdown affecting the trade balance may occur. However, the opening of new Sony and Samsung factories will provide a good foundation for further improvements in net trade. Household consumption will remain strong in 2008, owing to a stable rise in real wages and increasing employment. The jobless rate has fallen sharply and will come down further to just below 10 per cent this year.

Inflation has increased, driven by higher global food and energy prices. The year-on-year rate accelerated to a 13-month high of 3.8 per cent in January 2008. However, 12-month average HICP inflation has not shown such an increase and can still meet the quantitative Maastricht criteria for euro adoption by a significant margin. Demand side inflation pressures remain low.

Slovakia hopes to reach agreement with the European Commission on joining the euro zone in 2009. The assessment of whether it meets the criteria for adopting the euro should be published in May, with a final decision in early July. The only hurdle for euro zone entry will be ensuring that Slovakia meets the inflation criterion in a sustainable manner. We do not believe that expected criticism from the Commission or the European Central Bank (ECB) on the sustainability issue will be enough to prevent Slovakia from adopting the euro on schedule.

Further revaluation

The Slovakian koruna's ERM2 parity was revalued by 8.5 percent in March 2007 to 35.4424 per euro. In April the parity rate is likely to be adjusted again to 32.8 against the euro to help curb inflationary pressures and reflect continued productivity gains. Fixing of the exchange rate ahead of euro adoption is expected in mid-2008. The appreciation of the koruna should not significantly harm the export performance of leading manufacturers. Solid productivity growth has exceeded wage growth and supported competitiveness.

As expected, the central bank did not change interest rates in early 2008 and has kept its key rate steady at 4.25 per cent since April last year to curb inflation ahead of planned euro adoption in 2009. We expect the bank to make use of the remaining months of monetary policy flexibility, maintain existing interest rates and harmonise rates with the euro zone by year-end. In the absence of additional koruna appreciation, given lower interest rates and continued strong domestic demand, inflation looks set to rise to 3.6 per cent this year and 4.0 per cent in 2009.

The budget shortfall narrowed from 3.4 to 2.5 percent in 2007, supported by record economic growth. The government's target is deficit of 2.3 percent of GDP this year and to 0.8 percent in 2010, including the cost of pension system reform. Fiscal policy will become increasingly important in stabilising the economy, since monetary policy flexibility will be surrendered to the ECB once Slovakia has joined the euro zone. This may become politically challenging, given less solid growth and elections coming up in 2010.

Political stability

Following a crisis triggered in November 2007 by revelations of controversial land transfers at the Slovak Land Fund, the ruling coalition regained internal stability. The senior ruling Smer-Social Democracy party of Prime Minister Robert Fico has emerged unscathed from the crisis, and its popularity has even increased while that of the opposition has diminished. Thus the government is likely to stay in power at least until the 2010 elections.

The Czech Republic

More moderate economic growth

- **Reforms implemented**
- **Rising inflation**
- **No rush to join the euro zone**

Growth momentum has been steady and the Czech economy has been performing well. GDP rose at a 6.9 per cent rate in the last quarter of 2007. However, after three years of growth of around 6.5 per cent, the economy will decelerate to a more sustainable pace of 4-5 per cent this and next year.

The functioning of the economy is likely to improve as a result of a far-reaching reform package introduced early this year. It includes a reduction of corporate income taxes from 24 to 21 per cent (and to 19 per cent by 2010) and introduction of a flat income tax of 15 per cent (falling to 12.5 per cent in 2009). Public revenues will depend more on direct taxes, as the reduced VAT rate (on food, medicines etc) has been raised from 5 to 9 percent. Taxes on tobacco, energy and fuel have also gone up. Furthermore, bankruptcy and commercial trade legislation has been amended to support small and medium-sized enterprises. The focus is now likely to shift towards long-overdue reforms in the pension and health care systems.

Economic growth last year was broad-based. Among the main contributors were the energy industry, manufacturing and the wholesale and retail trade sectors. Private consumption rose by 4.4 per cent, supported by rapid income growth, record-low unemployment, credit growth and optimistic expectations in the housing market. The record-high fourth-quarter GDP figure was, however, partially due to stockpiling of medicines etc ahead of the tax hikes. Fiscal policy was generally expansionary as a result of decisions taken before the last election. However, strong growth supported rising public revenue, and the deficit fell slightly to 2.2 per cent of GDP, considerably below the original target.

In 2008, however, we anticipate a substantial slowdown in GDP growth to 4.5 per cent due to base effects as higher inflation dampens real wage growth, fiscal policy tightens and reduced foreign demand adversely affects Czech exports. However, in 2009 we expect economic growth to pick up to 5.0 per cent due to the launch of production at the Hyundai car factory. The euro zone should also recover somewhat, while the domestic economy will be underpinned by improving real wage growth and lower income taxes. We expect fiscal policy to ease as national elections loom in 2010. The balanced nature of the slowdown this year and the recovery in 2009 means that the current account deficit will remain around 3 per cent of GDP. External debt is low, and the current account deficit will easily be financed by direct investment flows.

Central bank credibility tested

The current spike in inflation (7.5 per cent in January, compared to a 3.0 per cent average last year) is largely due to the tax hikes and globally rising food and energy prices. These should be temporary but may influence inflation expectations, given recent strong domestic demand and wage pressures. We have increased our 2008 inflation forecast to 6.4 per cent and predict that inflation will fall to 3.8 per cent in 2009. Given that the central bank's inflation target will change from 3 to 2 ± 1 per cent in 2010, we expect the bank to strive to maintain its hard-won credibility and to increase its key interest rate further to 4.25 per cent.

The turnaround in the interest rate differential against the US and (later this year) the euro zone will lend significant support to the koruna. With its solid fundamentals, progress on structural reforms and lack of dependence on hot money, the CZK has been sheltered from recent global risk aversion and been one of the best performing currencies since mid-2007. We expect appreciation to continue, albeit at a more moderate pace going forward.

The finance minister has aimed to enact an economic policy that will pave the way for euro adoption in 2012. The government has, however, not announced any new target date since abandoning its former 2010 goal. The central bank leadership is also pointing to the need for deeper convergence (especially the implementation of a costly pension reform, while sustaining sound fiscal accounts) before switching to the euro. The bank has mentioned 2019 (when the CZK celebrates its 100th birthday) as more suitable. The year of euro adoption is highly uncertain, and we have moved forward our forecast to 2013. However, a postponement until after the 2014 election is also plausible.

Weak parliamentary support

The centre-right coalition government headed by Mirek Topolanek – which controls 100 of the 200 seats in parliament – has not only surprised observers by lasting this long but also managed to advance reforms and get its 2008 budget approved. Given its fragile parliamentary situation – depending on support from two independents – the government is likely to have a tough time pushing through any further fiscal reforms as well as winning the upcoming vote on a US anti-missile base in the country.

Continued stagflation

- **GDP growth lowest since 1996**
- **Decline in inflation delayed**
- **Risk of fiscal slippages**

Hungary's economic performance in 2007 was not impressive. Real GDP grew by a mere 1.4 per cent on and annual basis, while average HICP inflation hit 7.9 per cent. This year, the economic situation will improve marginally. Despite a rigorous fiscal consolidation, the budget and current account deficits are still high, although they have declined.

After putting austerity measures into practice in autumn 2006, the ruling Socialists started suffering extremely low public support. The opposition party Fidesz currently enjoys a clear lead in opinion polls, with 39 per cent of voters backing them while the ruling Socialists get 13 per cent support. Seventy-one per cent of voters do not approve of the fiscal reforms. The opposition-initiated referendum that took place on March 9 further stepped up the pressure on the ruling coalition. In our view, it was not surprising that the public so warmly supported the opposition's referendum proposals on education and health care reforms, as these proposals are clearly populist (cuts in tuition and medical fees). The risk of populist economic policies has increased.

Despite tough times for the government, the ruling coalition appears set to remain in place until the next general election in 2010. Prime Minister Ferenc Gyurscány has already demonstrated sufficient political will by not stepping down earlier and is likely to maintain his support at the Socialist party congress in late March. In 2009 the government is also likely to cut taxes by a total of 0.8 per cent of GDP, which would help appease the angry public.

Tax relief combined with traditional looser spending in the run-up to the general election and the risk of lower-than-anticipated economic growth increase the danger of an above-target budget deficit in 2009. Last year, the budget deficit shrank impressively due to higher taxes and amounted to 5.7 per cent of GDP, compared to 9.2 per cent in 2006 and an initial 2007 projection of 6.8 per cent. The government plans to cut the public deficit to 4.0 per cent of GDP this year and 3.0 per cent in 2009. Our forecast for 2009 is a deficit of 5 per cent of GDP

In 2007, GDP growth was the slowest since 1996 and shrank continuously during the year. A year ago, the government cut public jobs, increased taxes and abolished subsidies. The government also reduced investment spending, e.g. for construction of highways. These measures brought a contraction in domestic demand, leaving net exports the sole driver of economic growth. Government expenditures decreased substantially and household consumption fell in absolute terms as well. In euro terms, the merchandise trade deficit shrank to less than one fifth its 2006 level. Lower domestic demand squeezed import growth, while the positive global environment and a weaker currency supported export growth.

In 2008, the domestic market should begin a gradual recovery as the negative repercussions of fiscal tightening begin to wane. However, growth in external demand will be more sluggish as the global economic slowdown affects the euro zone, Hungary's main export market. Continued tightening in global credit markets may also hamper private sector recovery. Hungarian GDP will thus increase by only 2.0 per cent this year. In 2009, GDP growth should accelerate to 3.0 per cent, with both domestic and foreign demand strengthening due to tax cuts and a slight recovery in the global economy.

The current account deficit shrank to 5½ per cent of GDP in January-September 2007, compared to 7.0 per cent in the year-earlier period. This improvement was primarily due to a better trade balance and secondarily to an increase in reinvestment. This year, we expect the current account deficit to worsen somewhat as imports recover amidst less favourable export terms.

Monetary policy turning hawkish

Inflation jumped to the second-highest rate in the EU last year, driven by higher taxes on goods and services and increased energy and transport bills after subsidies were removed. Higher global oil and food prices along with poor harvests in Hungary also contributed to soaring inflation. In 2008, we expect inflation to come down due to a high statistical base and foresee no further cost-push factors from economic policy, not counting minor increases in gas prices for households.

At the end of February, Hungary's central bank abandoned its ±15 per cent HUF/EUR fluctuation band. The forint is now a free floating currency, and monetary policy will be guided by a pure inflation target (3 ±1 per cent). The bank reinstated its focus on inflation. We think it will have to hike interest rates in order to encourage a strengthening of the forint and consequent disinflationary processes in the near term. The key rate will reach 7.75 per cent in the spring and then be cut to 7.50 per cent by the end of 2008.

Key economic data

Eastern European Outlook — March 2008

CZECH REPUBLIC

	2002	2003	2004	2005	2006	2007(f)	2008(f)	2009(f)
GDP, %	1.9	3.6	4.2	6.1	6.4	6.6	4.5	5.0
Inflation, HICP, average, %	1.4	-0.1	2.6	1.6	2.1	3.0	6.4	3.8
Unemployment, ILO, %	7.3	7.8	8.3	7.9	7.1	4.9	5.3	5.2
Current account, % of GDP	-5.5	-6.2	-6.0	-2.1	-3.1	-2.9	-3.0	-3.0
Public sector financial balance,% of GDP	-6.8	-6.6	-2.9	-3.6	-3.0	-2.2	-2.2	-2.8
Public sector debt, % of GDP	28.5	30.1	30.7	30.4	30.2	29.5	29.2	29.0
EUR/CZK, end of period	31.50	32.40	30.30	29.00	27.50	26.60	24.30	23.50
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	4.00	4.25	4.20

ESTONIA

	2002	2003	2004	2005	2006	2007(f)	2008(f)	2009(f)
GDP, %	8.0	7.2	8.3	10.2	11.2	7.1	3.5	4.5
Inflation, average, %	3.6	1.4	3.0	4.1	4.4	6.6	7.6	4.0
Unemployment, %	10.3	10.0	9.7	7.9	5.9	4.7	6.5	6.0
Current account, % of GDP	-10.6	-11.3	-12.3	-10.0	-15.5	-15.9	-12.5	-12.0
Public sector financial balance, % of GDP	0.4	2.0	2.3	2.3	3.8	2.9	0.0	0.0
Public sector debt, % of GDP	5.6	5.7	5.2	4.4	4.1	2.7	2.7	2.5
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	7.30	6.60	6.40

HUNGARY

	2002	2003	2004	2005	2006	2007(f)	2008(f)	2009(f)
GDP, %	4.4	4.2	4.8	4.1	3.9	1.4	2.0	3.0
Inflation, average, %	5.2	4.7	6.8	3.5	4.0	7.9	5.8	4.0
Unemployment, %	5.8	5.9	6.1	7.2	7.5	7.4	7.5	7.0
Current account, % of GDP	-7.0	-7.9	-8.4	-6.8	-6.5	-5.2	-5.5	-5.5
Public sector financial balance, % of GDP	-8.2	-7.2	-6.5	-7.8	-9.2	-5.7	-4.1	-5.0
Public sector debt, % of GDP	54.0	58.0	59.4	61.7	65.6	64.5	64.0	65.0
EUR/HUF, end of period	235.9	262.2	245.9	252.7	252.3	253.0	265.0	270.0
Key rate, eop	8.50	12.50	9.50	6.00	8.00	7.50	7.50	7.00
5-year government bond, eop	7.10	9.30	8.00	7.10	7.40	7.40	8.40	7.50

(f) = forecast

LATVIA

	2002	2003	2004	2005	2006	2007(f)	2008(f)	2009(f)
GDP, %	6.5	7.2	8.7	10.6	11.9	10.2	6.2	5.8
Inflation, HICP, average %	2.0	2.9	6.2	6.9	6.6	10.1	13.8	8.2
Unemployment, %	12.0	10.6	10.4	8.7	6.8	6.0	6.2	6.5
Current acccount, % of GDP	-6.6	-8.2	-12.9	-12.5	-21.1	-23.3	-19.0	-16.0
Public sector financial balance, % of GDP	-2.3	-1.6	-1.0	-0.4	-0.3	0.7	0.5	0.5
Public sector debt, % of GDP	13.2	14.4	14.5	12.5	10.6	8.2	8.1	7.6
EUR/LVL, end of period	0.61	0.67	0.70	0.70	0.70	0.70	0.70	0.70
Key rate, eop	3.50	3.00	3.50	4.00	5.00	6.00	6.00	6.00
5-year government bond, eop	5.50	4.60	4.00	3.20	4.90	6.00	6.25	6.25

LITHUANIA

	2002	2003	2004	2005	2006	2007(f)	2008(f)	2009(f)
GDP, %	6.9	10.3	7.3	7.9	7.7	8.8	6.5	6.0
Inflation, average, %	0.3	-1.1	1.2	2.7	3.8	5.8	8.5	7.0
Unemployment, %	13.8	12.4	11.4	8.3	5.6	4.3	4.2	4.5
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	-0.6	-0.5	-1.0	-1.0
Public sector debt, % of GDP	25.3	21.2	19.4	18.6	18.2	17.3	16.5	16.0
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	6.70	5.60	5.50
5-year government bond, eop	4.60	3.60	3.00	3.10	3.90	4.50	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	6.6	5.2	5.0
Inflation, average, %	1.9	0.7	3.6	2.2	1.3	2.6	4.0	3.4
Unemployment, %	19.9	19.6	19.0	17.7	13.8	11.7	10.0	9.0
Current account, % of GDP	-2.6	-2.1	-4.2	-1.7	-2.3	-3.8	-5.0	-5.3
Public sector budget balance, % of GDP	-3.2	-6.3	-5.7	-4.3	-3.8	-2.5	-2.9	-2.7
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	3.60	3.35	3.20
Key rate, eop	6.75	5.25	6.50	4.50	4.00	5.00	6.25	6.00
5-year government bond, eop	5.50	6.70	6.20	5.00	4.98	6.13	6.30	5.75

(f) = forecast

Key economic data

Eastern European Outlook — March 2008

RUSSIA

	2002	2003	2004	2005	2006	2007(f)	2008(f)	2009(f)
GDP, %	4.7	7.3	7.2	6.4	7.4	8.1	6.8	6.0
Inflation, average, %	15.8	13.7	10.8	12.7	9.7	9.0	12.5	9.5
Unemployment, %	8.1	8.6	8.2	7.6	7.2	6.1	5.6	5.3
Current account, % of GDP	8.4	8.2	9.9	11.0	9.8	6.1	3.9	0.8
Public sector financial balance, % of GDP	0.6	1.4	4.9	7.7	8.4	5.0	3.0	1.5
Public sector debt, % of GDP	40.4	29.6	22.3	14.8	8.5	7.0	5.0	5.0
USD/RUB, end of period	31.80	29.50	27.70	28.70	26.30	24.50	24.20	24.60
3-month interest rate, eop	14.50	6.90	6.40	6.50	5.80	6.60	8.20	8.00

SLOVAKIA

	2002	2003	2004	2005	2006	2007(f)	2008(f)	2009(f)
GDP, %	4.1	4.2	5.4	6.0	8.3	10.3	7.0	6.5
Inflation, HICP, average, %	3.5	8.4	7.5	2.8	4.3	1.9	3.6	4.0
Unemployment, ILO, %	18.7	17.6	18.2	16.3	13.4	10.8	9.7	9.0
Current account, % of GDP	-8.0	-0.8	-3.5	-8.8	-8.3	-4.0	-3.5	-3.0
Public sector financial balance, % of GDP	-7.7	-3.7	-3.0	-2.9	-3.4	-2.3	-2.3	-2.8
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	41.5	41.1	38.7	37.8	34.6	32.9	32.8	32.8
Key rate, eop	6.50	6.00	4.00	3.00	4.75	4.25	3.25	3.00
5-year government bond, eop	5.40	5.20	4.00	3.20	4.20	4.60	3.80	3.90

UKRAINE

	2002	2003	2004	2005	2006	2007(f)	2008 (f)	2009 (f)
GDP, %	5.2	9.6	12.1	2.6	7.0	7.3	6.5	6.0
Inflation, average, %	0.8	5.2	9.0	13.5	9.1	12.8	15.8	10.8
Unemployment, %	9.6	9.1	8.6	7.2	6.8	6.6	6.2	6.0
Current account, % of GDP	7.5	5.8	10.6	2.9	-1.5	-3.5	-5.5	-6.0
Public sector financial balance, % of GDP	0.7	-0.2	-3.2	-1.8	-0.7	-2.0	-3.0	-3.0
Public sector debt, % of GDP	33.5	29.0	24.7	17.7	14.8	13.5	12.5	13.5
USD/UAH, end of period	5.33	5.33	5.31	5.05	5.05	5.05	5.05	5.05
Key rate, eop	7.00	7.00	9.00	9.50	8.50	10.00	10.50	9.50
3-month interest rate, eop	7.90	23.50	28.00	15.30	12.80	11.40	12.00	10.50

(f) = forecast

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