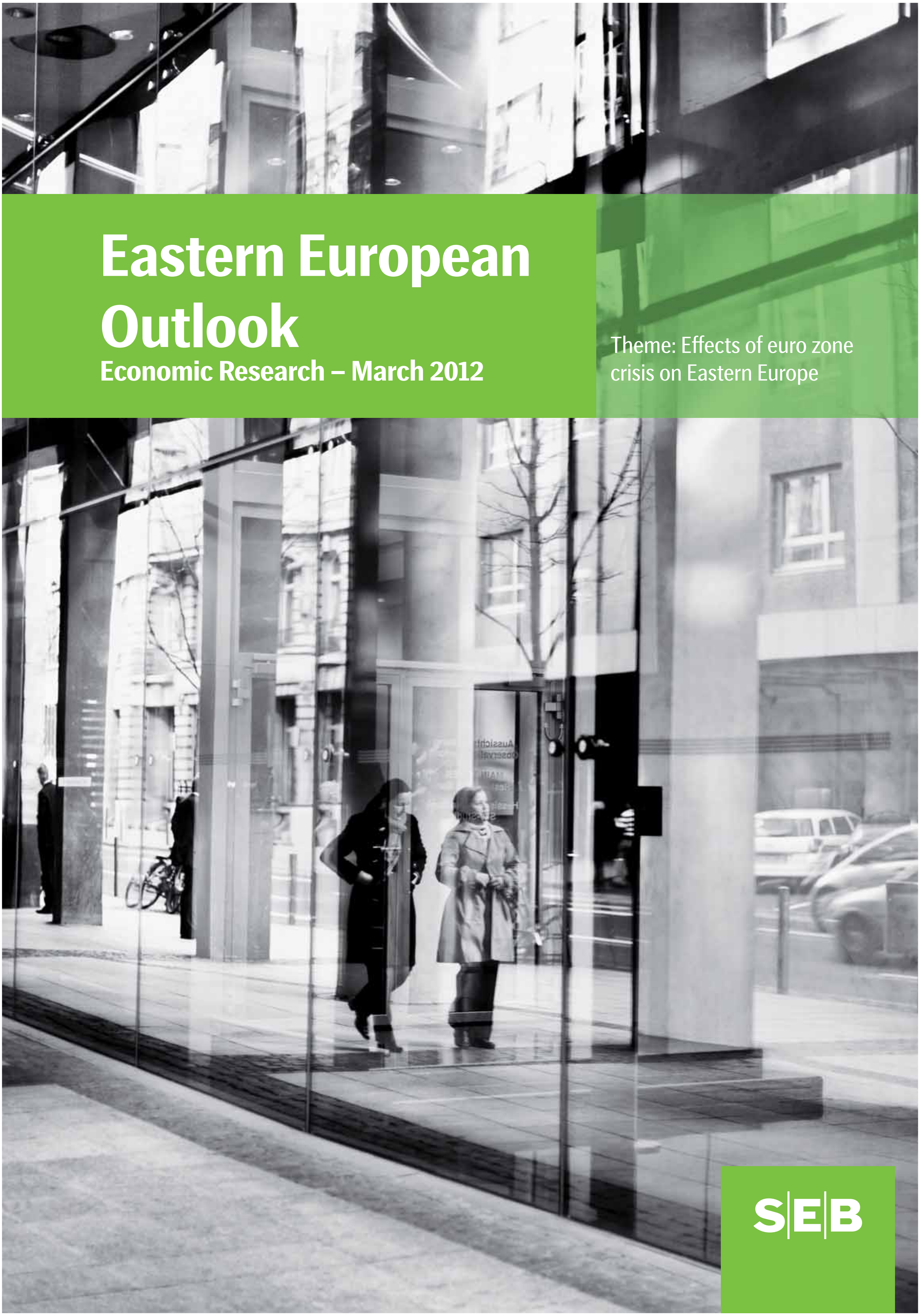


Eastern European Outlook

Economic Research – March 2012

Theme: Effects of euro zone crisis on Eastern Europe

SEB

Eastern European Outlook is produced twice a year. This report was published on March 28, 2012.

It was written by Mikael Johansson (Chief Editor), Daniel Bergvall, Dainis Gaspuitis, Hardo Pajula and Vilija Tauraite.

Robert Bergqvist
Chief Economist
+ 46 8 506 230 16

Håkan Frisén
Head of Economic Research
+ 46 8 763 80 67

Daniel Bergvall
Economist
+46 8 763 85 94

Mattias Bruér
Economist
+ 46 8 763 85 06

Ann Enshagen Lavebrink
Editorial Assistant
+ 46 8 763 80 77

Mikael Johansson
Economist, Head of CEE Research
+ 46 8 763 80 93

Andreas Johnson
Economist
+46 8 763 80 32

Tomas Lindström
Economist
+ 46 8 763 80 28

Gunilla Nyström
Global Head of Personal Finance Research
+ 46 8 763 65 81

Ingela Hemming
Global Head of Small Business Research
+ 46 8 763 82 97

Susanne Eliasson
Personal Finance Analyst
+ 46 8 763 65 88

Johanna Wahlsten
Small Business Analyst
+ 46 8 763 80 72

SEB Economic Research, K-A3, SE-106 40 Stockholm

Hardo Pajula
Economist, SEB in Tallinn
+372 6655173

Dainis Gaspuitis
Economist, SEB in Riga
+371 67779994

Gitanas Nauseda
Chief Economist, SEB in Vilnius
+370 5 2682517

Vilija Tauraite
Economist, SEB in Vilnius
+370 5 2682521

Summary

Eastern (including Central) Europe also began an economic deceleration in the second half of 2011. But as we predicted, regional heavyweights Russia and Poland have withstood the international crisis well. We still expect their slowdown to be mild, due to moderate exports in relation to GDP, modest public debt and small or moderate dependence on bank financing via the euro zone, which is in recession this year. Russia is also benefiting from high oil prices.

Precisely because of differences in dependence on the euro zone's banks and import demand, the economic trend in Eastern Europe is becoming more and more polarised. The northern parts, including Russia and Poland, will resist the euro zone crisis relatively well while some central and especially southern parts will be harder hit. The three Baltic countries and the Czech Republic are among the "medium hard hit" while Bulgaria, Croatia, Romania, Hungary and Ukraine are the "hardest hit", as a consequence of their relatively strong banking links with the euro zone, although Ukraine will muddle through with decent GDP growth.

By supplying low-cost loans to banks and other financial institutions in the euro zone, the European Central Bank's long-term refinancing operations (LTRO I and II) have greatly reduced the risks of a severe, lengthy credit crunch in Eastern Europe too. But credit conditions tightened in the region late in 2011 and will only gradually revert to normal during the coming year.

Inflation will fall this year in most Eastern European countries, but core inflation will remain relatively high in Estonia and Poland. The recent oil price surge is a general upside risk in inflation forecasts.

In all six countries covered by *Eastern European Outlook*, growth will drop somewhat below trend in 2012-2013 – in the Baltics considerably below trend this year. A rebound will occur in 2013.

- **Russia's** GDP will increase by 3.8 per cent in 2012 and 4.1 per cent in 2013. The economy will be sustained by high oil prices, high real wage growth and expansionary fiscal policy. Yet long-term question marks remain, due to heavy commodity dependence and a slow pace of reform. There may be some opening for more reforms now that Vladimir Putin is returning as president.
- **Poland's** growth will slow a bit to 3.0 per cent in 2012 and then accelerate to 3.6 per cent in 2013. Capital spending will increasingly drive the economy. Fiscal policy will continue to tighten, while monetary policy will shift and key interest rates will be cut twice in the second half of 2012. The zloty will gain further strength after its recent volatility.
- **Ukraina's** growth will dip to 3.2 per cent in 2012 but reach 4.2 per cent in 2013. High steel and agricultural prices will provide support. Relations with the International Monetary Fund and the European Union are tense. If growth appears to be falling further, Ukraine may bend to IMF demands, enabling its frozen loan agreement to be resumed.
- **Estonia's** growth will fall abruptly to 1.5 per cent in 2012 and climb to 2.5 per cent in 2013. Weaker demand in Sweden and Finland is hurting expansion. Private sector deleveraging continues, and net debt has fallen sharply. High inflation will persist.
- **Lithuania's** growth will decelerate sharply to 2.0 per cent this year and rise to 3.0 per cent in 2013. The government is aiming at euro zone accession in 2014 but will have difficulty meeting the budget criterion; we predict conversion to the euro in 2015. The governing coalition will change after this autumn's parliamentary election.
- **Latvia** will decelerate more smoothly than Estonia and Lithuania, since it is not as export-dependent. Growth will fall to 2.5 per cent in 2012 and speed up to 4 per cent in 2013. Continued fiscal austerity will pave the way to euro zone accession in 2014 as planned.

Less risk of global recession, but below-trend growth

- **ECB actions easing financial stress**
- **US growth around trend level**
- **Recession in euro zone**

In recent months, the world economic situation has improved somewhat. Although the euro zone slid into recession as expected in the fourth quarter of 2011, **forward-looking economic indicators have stabilised** both in Western Europe – which is so important to Eastern (including Central) Europe – and in the rest of the world. This is especially true of Germany and the United States. The deceleration in China's rapid growth has also been gentler than feared. **With its liquidity loans to the banking system, the European Central Bank (ECB) has eased financial stress**. Rising stock markets have also helped repair damaged balance sheets and restore once-depressed household and business confidence.

But **there are still major risks and underlying savings imbalances**. The euro zone crisis rolls on. Although debt write-downs and new bail-out loans are on their way, Greece's future participation in the euro project remains highly uncertain. There is also continued uncertainty about Portugal, and Spain may need financial aid. Recent US growth has largely been sustained by an abnormally mild winter – which has helped construction – and by renewed draw-downs in household savings, not by genuine income growth. On the contrary, income has continued to fall. Tensions related to Iran and other countries have pushed up oil prices by USD 10-15/barrel to above USD 125 (Brent). Combined with greater fiscal tightening, especially in 2013, this will hamper continued US growth. China and other fast-growing Asian economies are showing continued signs of a soft landing. China also seems to have brought down inflation, but a weakening property market remains a source of concern for both China and the world if price declines should accelerate.

Global key data

GDP, year-on-year percentage change

	2010	2011	2012	2013
United States	3.0	1.7	2.5	2.5
Euro zone	1.8	1.5	-0.6	0.8
The world	5.2	3.9	3.5	4.0
Oil, USD/barrel	79.8	111.0	118.0	120.0
EUR/USD, Dec	1.34	1.29	1.26	1.20

Source: SEB

Corrected for purchasing power, overall **global GDP growth will fall from 3.9 to 3.5 per cent in 2012** and then recover to 4.0 per cent in 2013 once the euro zone recession ends. We still believe that **Germany, with relatively good fundamentals, will avoid a downturn**; its GDP will grow by 0.7 per cent this year and 1.4 per cent in 2013.

This year global growth will end up a bit below its potential rate, 3.75-4.00 per cent. Unemployment will thus rise in many countries. Consumer Price Index (CPI) inflation began to fall from a relatively high level in late 2011 and we expect it to continue downward, though at a slower pace than we had previously expected, due to the new upturn in oil prices. Core inflation will remain calm, especially in the US, although euro zone prices will be sustained by relatively high German wage costs and higher taxes due to necessary fiscal austerity, mainly in southern Europe.

Central banks will continue to pursue **ultra-loose monetary policies**. The US Federal Reserve will leave its key interest rate unchanged at near-zero throughout our forecast period. After the summer, the Fed will launch a third quantitative easing programme, this time targeted to mortgage bonds. The ECB will let its refi rate stay at 1.00 per cent after two rate cuts late in 2011. There may be new rounds of the ECB's unlimited Long-Term Refinancing Operation (LTRO) to the banking system if the healing process in financial markets experiences reversals.

The ECB, with its massive low-cost three year loans to euro zone banks and financial institutions, is helping to strengthen their balance sheets, **thereby lowering the risk of a severe, long-lasting credit crunch** – mainly in the euro zone but also in Eastern Europe (see Theme article). These net liquidity injections of about EUR 200 billion in December 2011 and EUR 300 billion in February 2012 have also eased interbank borrowing stress outside of the euro zone. Around 500 and 800 financial institutions, respectively, signed up for LTRO loans. With these actions, the ECB has built "firewalls" against country crises that would harm the banking system. The bank has also created more time for the financial and political healing process. But there are major reform and saving needs in the affected countries, and the flip side of the ECB's actions is that sovereign debt risks are now concentrated at national level and in national banking systems, since banks have bought government securities – admittedly with good yields.

The euro will continue to depreciate as large growth gaps arise between the US and the euro zone; the EUR/USD exchange rate will stand at 1.26 in December 2012 and will fall further next year to 1.20, close to our estimated equilibrium.

Commodity prices excluding energy will generally stabilise at still relatively high levels after last year's slowdown. Energy prices will remain high, with oil at about USD 118/barrel this year in the wake of unrest around the Middle East and investors "pricing out" of the gloomiest world economic scenarios.

Reduced credit stress, uneven economic performance

- **ECB actions are easing the credit crunch**
- **Russia and Poland are showing resilience**
- **South-eastern Europe is the hardest hit**

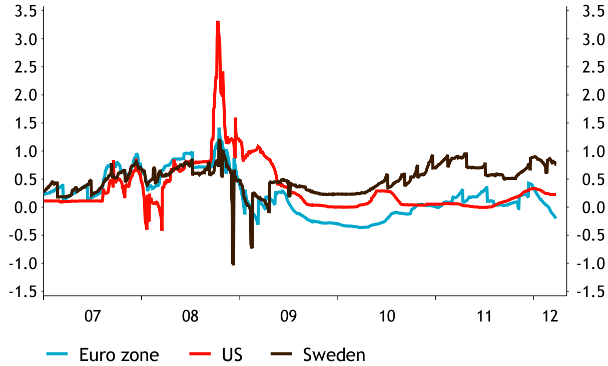
A deep, lengthy period of credit austerity in the euro zone/Western Europe has posed a major risk to the continued relatively good growth scenario we have depicted for the larger economies of Eastern (including Central) Europe – Russia, Poland and Ukraine. Meanwhile these three countries are not as heavily exposed as others in the region such as Hungary and Croatia, but also Bulgaria and Romania, in terms of funding needs of banks via the euro zone banking system. This has been highlighted in SEB's two latest global economic reports: the November 2011 and February 2012 *Nordic Outlook*. Tighter credit conditions in the euro zone/Western Europe will have indirect and direct repercussions on banking systems in Eastern Europe and thus on lending to households and businesses, partly via credit supply, partly via capital supply from parent banks. The situation was especially upsetting in November-December 2011. For example Italy's Unicredit, with relatively large exposure in Central and Eastern Europe, declared that it would review all its business in the region. Germany's Commerzbank said it would limit future lending to Germany and Poland only.

It is also clear that last autumn's liquidity problems at euro zone banks – which in turn were/are connected to the acute debt crisis in southern Europe, especially Greece and Portugal – led to a genuine credit crunch there. This can be seen in both factual data and the European Central Bank's quarterly bank lending survey. Lending to households and businesses apparently shifted from growth to decline late in 2011. Credit conditions tightened greatly in the fourth quarter. Banks also expected further tightening, but at a slower pace, in the first quarter of 2012. Such tightening was widespread in many euro zone countries, but Germany was cited as an exception.

To counter these liquidity problems and the lending slowdown, in late December 2011 and February 2012 the ECB launched **two long-term refinancing operation (LTRO) programmes** aimed at banks and other financial institutions in the euro zone. These loans have proved to be a successful move. Pressure on the banking sector has diminished. The interbank market is functioning better. Interbank spreads between interbank rate and policy rate in the euro zone has fallen noticeably, below the level that prevailed before the crisis broke out late in July 2011. Some **stress symptoms persist** in the European banking system. Combined with continued uncertainty about the euro question in Greece and Portugal, this indicates that credit conditions will remain abnormally tight at least this year.

Interbank markets in the West loosens up

3-month interbank rate minus key rate, percentage points

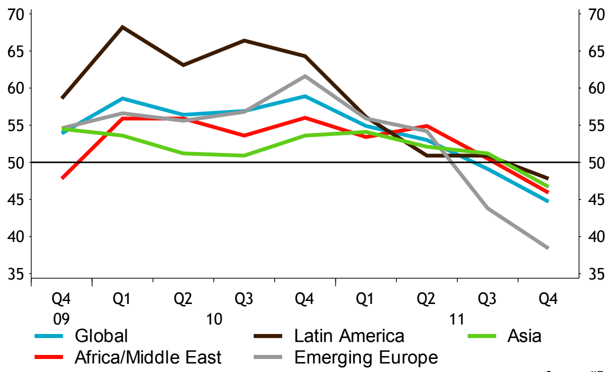


Source: Reuters EcoWin

There are also signs that **credit conditions have become significantly tighter in Central and Eastern Europe as well**. This is visible in the fourth quarter 2011 survey from the Institute of International Finance (IIF) among banks in emerging economies, published in late January 2012. The report noted that banking conditions had worsened markedly in Emerging Europe (mainly Central and Eastern Europe plus Turkey), reflecting the repercussions of the euro zone crisis. It indicated that in the fourth quarter, lending conditions had worsened more and faster in Emerging Europe than in other emerging market regions. Of banks in Emerging Europe, 63 per cent said that tightening in credit conditions was directly connected to financial stress in the euro zone.

EM Bank Lending Condition Indices

Index 50=neutral



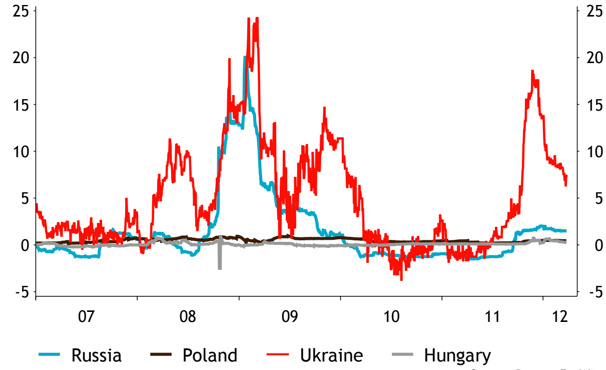
Source: IIF

Another example of credit market headwinds is Poland, which otherwise boasts a robust, well-capitalised banking sector. According to the Polish central bank's latest survey, conditions tightened for corporate loans but loosened somewhat for consumer loans in the fourth quarter of 2011. On the corporate side, this was the first tightening after six consecutive quarters of gradual easing. The reasons cited by banks were wider interest rate spreads in borrowing and generally higher economic risks. Their expectations for the first quarter of 2012 were tightening across all segments and lower demand for home mortgage and consumer loans.

Alongside reports of a tougher credit climate, **over the past three months interbank spreads have also narrowed in Central and Eastern Europe**, especially in Ukraine. Furthermore, credit default swap (CDS) pricing for major banks operating in Eastern Europe has fallen sharply. For example, 5-year CDS's for Russian's big Sberbank have fallen from a peak of 425 basis points in October 2011 to 225 in March. Of course, they still have some way to go before reaching the 150-200 points that prevailed before European banking stress arrived. It is notable that Austria's biggest bank, Raiffeisen – with large, far-flung interests in the Eastern European region, witnessed a similar trend in its CDS contracts.

Interbank markets in Eastern Europe

3-month interbank rate minus key rate, percentage points



Source: Reuters EcoWin

Our overall assessment is that the **ECB greatly reduced the risks of a more severe credit crunch in Central and Eastern Europe too, but** we must assume that **credit conditions will only gradually revert to normal over the coming year**. Relatively tight credit conditions will thus slow growth somewhat in the region. This expectation has been part of our GDP forecasts since late 2011.

As for the general **economic trend in Eastern Europe**, our assessment is that it will become **more and more polarised**. Roughly speaking, the northern parts will continue to cope with the euro zone crisis relatively well, while some central and especially southern parts will be harder hit. These **differences** are due, among other things, to **the size of exports and different degrees of exposure to euro zone banks**. Three categories can be singled out as regards the impact of the debt crisis, tighter credit and euro zone recession as well as generally very weak growth in Western Europe this year.

"**Least hard hit**": This includes **Russia** and **Poland**. Exports are equivalent to a modest 30-40 per cent of GDP. Dependence on financing via euro zone banks (measured as interbank loans as a percentage of a country's GDP) is marginal in Russia and modest in Poland. Foreign currency loans are also relatively small in relation to GDP. The economic slowdown in Russia and Poland during 2012 will be mild.

"**Medium hard hit**": This category includes the **Baltic countries** and the **Czech Republic**. All are highly export-dependent, though Latvia is more moderately export-oriented. The Czech Republic also closely tied to Germany. This will lead to a relatively sharp decline in Czech growth: from an already low level to a weak recession. The Baltics obtain little funding via euro zone banks, but a lot via Swedish banks. These countries are financially less vulnerable than a few years ago, after correcting their current account and wage formation imbalances as well as stabilising their banking systems. The Czech Republic has modest bank borrowing via the euro zone: about the same percentage of GDP as Poland.

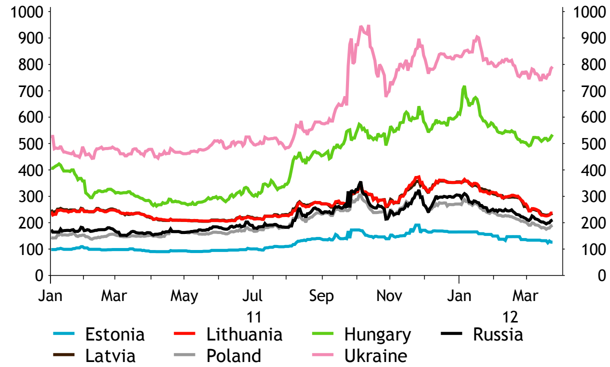
"**Hardest hit**": This includes **Hungary** and **Ukraine**, but also countries like **Croatia**, **Bulgaria** and **Romania**. They are heavily affected via financial channels. The Hungarian and Croatian banking sectors have very large interbank financing via the euro zone; Bulgaria and Romania stand out too, while Ukraine's exposure is more modest. We expect Hungary and Croatia to show weak GDP declines this year, while the others will achieve weak growth. Hungary and Croatia both have relatively large export sectors, especially Hungary. This is also true of Ukraine.

Among the "hardest hit" on our list are countries that have suffered, and still suffer, from a severe crisis of confidence among investors. CDS prices for sovereign debt – which reflect worries about defaults – have been inflated in Ukraine and Hungary. In recent months, the pressure has eased somewhat on these two countries. In the Baltics, Poland and Russia, CDS prices have fallen to about the level that prevailed before the latest financial crisis wave, which started before last summer.

Granted that **Ukraine** has moderate imbalances in government debt and runs budget and current account deficits, but these **worries are probably based on the country's long-term political direction**. Underlying uncertainty has been fuelled in the past year by open tensions in **Ukraine's relations with the IMF and the EU**. We expect **continued uncertainty** but believe Ukraine will relent and approve reforms if economic developments or confidence radically deteriorate. We expect **Hungary** to **reach agreement with the EU/IMF in 2012** on a new multi-year stand-by loan. This will be important to ensure international confidence, since it will increase the pressure on Hungary to deal with its debts and to implement reforms.

CDS for Eastern Europe

10-year government bonds, basis points



Source: Reuters EcoWin

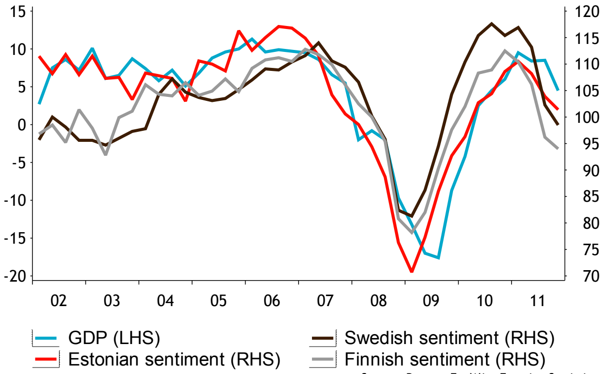
Export weakness takes toll on growth

- **Swedish and Finnish slowdowns large risks**
- **Private sector is shedding debt**
- **Domestic cost pressures resume**

With exports equivalent to 70 per cent of GDP, the Estonian economy is now feeling the effects of weaker growth among its main trading partners. Even though the Nordics and other parts of northern Europe are avoiding recession, the slowdowns in those economies will significantly hold back growth, especially in 2012.

Deteriorating sentiment takes toll on growth

Year-on-year percentage change and index



Source: Reuters EcoWin, Estonian Statistics

In 2011, however, **Estonian GDP growth reached 7.6 per cent, the highest showing since the heady days** of 2005 and 2006. Year-on-year growth figures, on the other hand, **have taken a steep plunge**. The figure for the fourth quarter was down to 4.5 per cent — four percentage points less than the preceding quarter and not even half of the growth rate in the first quarter of 2011. Quarter-on-quarter, the slowdown started last spring and was accentuated in the second half of year, with the economy actually shrinking in the fourth quarter by 1.0 per cent.

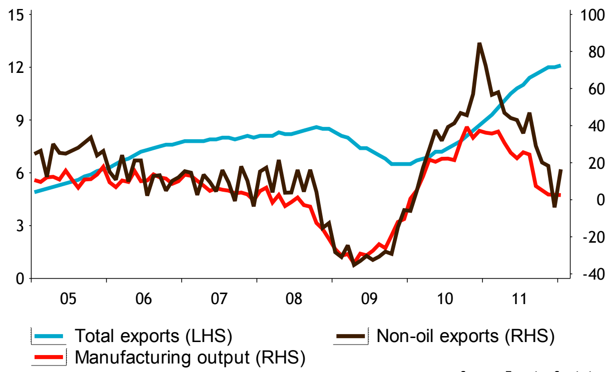
To some extent the slowdown has been caused by the dimmer outlook for the larger region. The **best proxy** for that is perhaps the **European Commission's monthly sentiment** indicator for Sweden, which recently stopped falling but earlier **had been in free fall** since the summer of 2011. By now it has shed 20 percentage points since its peak in January 2011. While its Estonian counterpart has been somewhat less volatile in the past couple of years, the overlapping turning points of the two time series are too obvious to be attributed to chance. **Sweden and Finland – where we expect GDP growth to be only 0.7 and 0.5 per cent in 2012, respectively – are Estonia's largest trading partners,** each making up some 15 percent of the total, ahead of Russia, which accounts for slightly more than 10 per cent.

Monthly indicators suggest that the slowdown is no longer limited to mood-based metrics but is now visible in hard data. Thus, the year-on-year growth rate of manufacturing output has dropped from nearly 40 per cent last spring to a mere 2.5 per cent in January. Even more significantly, **the main engine of expansion in recent years has started to run out of steam**. The year-on-year growth rate of non-oil **exports** (i.e. excluding the effects of re-exports) dipped below zero in December for the first time in two years. Although January witnessed a sharp rebound to 16 per cent, there is little doubt that manufacturing exporters are already feeling the chill winds of the debt crisis as they reach the Baltic Sea region.

These adverse developments caused us to trim our **GDP growth forecast for 2012 to 1.5 per cent and for 2013 to 2.5 per cent,** as published in *Nordic Outlook*, February 2012. For the moment the risks are balanced. On the one hand, it is possible that that the generous liquidity injections by the ECB and its increasingly aggressive pro-growth stance will give the euro zone another temporary boost. On the other hand, if developments in the Swedish and Finnish economies turn out worse than expected, the extensive trade and financial links between Estonia and Sweden-Finland will quickly carry the problems to these shores, probably in magnified form.

Growth engine is sputtering

EUR bn and year-on-year percentage change



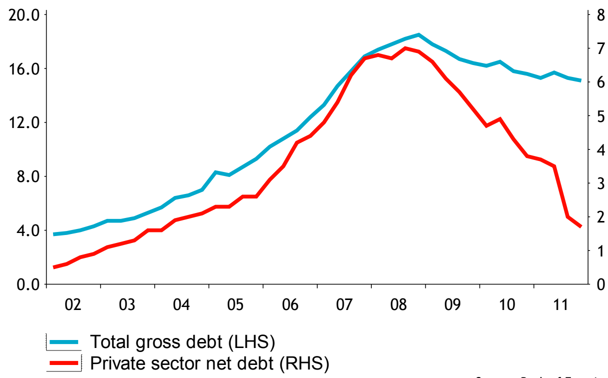
Source: Estonian Statistics

Private consumption contributed 2.4 percentage points to the overall growth rate of 4.5 per cent in the fourth quarter. Retail sales growth held up surprisingly well throughout 2011. In fact there was a strong upswing in the year-on-year rate to 15 per cent in this January. But as we have maintained in earlier reports, **domestic demand is unlikely to remain a major growth driver for any extended period**, since it is primarily through private consumption and capital spending that external shocks find their way into this small open economy. The contribution from gross domestic capital formation was 7.4 percentage points in the fourth quarter — the highest in more than five years, but we expect a downturn in the coming quarters.

Last year's strong growth is all the more remarkable insofar as it occurred despite **continued deleveraging**. Estonia's net international investment position improved by more than EUR 3.6 billion (over 20 per cent of 2011 GDP) from the peak of the boom in the third quarter of 2008. Private sector gross debt fell from EUR 18.5 billion at the end of 2008 to EUR 15.1 billion (ca 100 per cent of GDP) three years later. At the same time net debt improved more; from EUR 7 billion to EUR 1.7 billion in the last quarter of 2011. As a share of GDP net debt fell from above 40 per cent to 17 per cent of GDP.

Private sector unloads debt

EUR bn

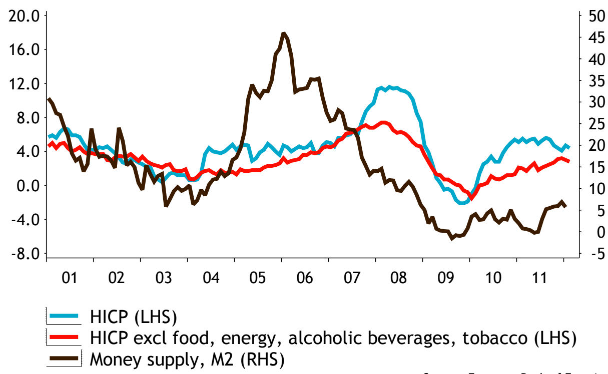


Source: Bank of Estonia

To be able to grow and continue paying back its debts, Estonia will have to generate current account surpluses for years to come. The quarterly current account balance turned positive in the second quarter of 2009 and has remained in the black (except in the first quarter of last year). For 2011 as a whole the surplus amounted to 3.2 per cent of GDP, slightly down from 3.6 per cent in 2010. The future trend will depend on the relative magnitudes of two countervailing tendencies. On the one hand, lower external demand should push the current account into deficit, while the inevitable contraction in domestic demand is expected to have the opposite effect. Since exporters are usually the first to feel the pinch, we expect the current account surplus to dwindle in the coming quarters. For 2012 we still envisage a small surplus of 1 per cent of GDP. Since we expect GDP growth to pick up in 2013, we anticipate that the current account will remain in balance that year.

Money supply affects inflation

Year-on-year percentage change

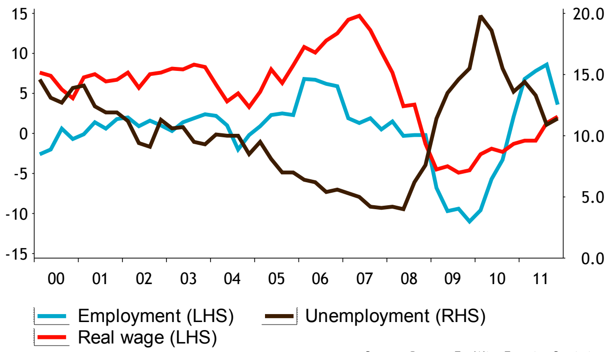


Source: Eurostat, Bank of Estonia

The ability to produce steady current account surpluses over time obviously also depends on domestic cost pressures. Since Estonia reported HICP inflation of 5.1 per cent in 2011 — second only to Romania in the EU-27 — the trend is not exactly encouraging. Furthermore, core inflation was relatively high. That said, the rate of price hikes has become more moderate in recent quarters. Year-on-year HICP dropped from 5.5 per cent in August to 3.7 per cent in December, before rebounding to 4.2 per cent in February 2012. Inflation expectations have also stabilised somewhat. While the unconventional monetary policy actions of the ECB make a medium-term inflationary forecast difficult at present, we expect the **HCPI growth rate to come down to 4 per cent in 2012 and then to move up to 5 per cent in 2013**. Estonian inflation is **highly sensitive to changes in monetary growth**.

Strong employment growth leads to real pay increases

Year-on-year percentage change and per cent



Source: Reuters EcoWin, Estonian Statistics

It is only a matter of time before the **bleaker growth outlook finds its way into labour market data** and from there into government finances. For the time being, however, available quarterly data provide a reasonably upbeat picture. While it is true that year-on-year job creation fell rather sharply in the last quarter of 2011, unemployment edged up only marginally and real wages have once again started to rise (for the first time since 2008). Given that the first sector to feel the squeeze will be export-oriented manufacturing, the initial impact on joblessness will probably be limited. We expect average unemployment of 14 per cent in 2012 and 15 per cent in 2013.

The Ministry of Finance projects a public sector deficit of 2.1 per cent of GDP in 2012. However, given the need to placate an increasingly restless electorate — the recent general strike being a case in point — and the uncertain outcome of financial guarantees given to the euro zone bail-out funds the actual outcome is likely to fall short of that. Hence **we anticipate a 3 per cent budget deficit for this year and 2 per cent in 2013**. As for the latest political developments, recent extensive protests against the Anti-Counterfeiting Trade Agreement (ACTA) showed that people are increasingly weary of prime minister Andrus Ansip, and the centre-right policies that his coalition has implemented after – if not before – the crisis. For the time being the socialists may be riding the wave of the future, but the general election is still three years away and the ruling coalition has 56 out of 101 seats in Parliament. Hence, we expect no major medium-term changes in the political landscape unless the European credit crisis takes a decisive turn to the worse and its repercussions ripple over Estonia.

Gradual cooling via slower export growth

- **Domestic demand holding up pretty well**
- **Public finances under control**
- **Euro adoption in 2014 according to plan**

With GDP growth of 5.5 per cent, 2011 was a rather successful year for the economy in general. Private consumption in particular added 3 percentage points to the aggregate growth rate, with fixed capital formation contributing another 7.5 percentage points; in the second half of 2011, construction bounced back rapidly. Resurgent imports were the reason why net exports contributed a negative 5.2 percentage points. The gradual slide of the current account balance into deficit indicates the **need for continued strengthening of export capacity**. The weight of exports differs greatly between the Baltic economies. Estonian and Lithuanian exports are equivalent to some 70 and 60 per cent of GDP, respectively, compared to 45 per cent in Latvia (according to 2006-2010 averages).

Sustaining an earlier trend, GDP increased by 5.7 per cent in the fourth quarter of 2011, but the economy displayed signs of cooling down which are likely to emerge later this year. Meanwhile the early months of 2012 still reflected admirable immunity against the spreading slump in the euro zone. The 2012 outlook will primarily depend on export performance, while domestic demand will show moderate growth. Developments in industry, especially manufacturing, will depend on flexibility and the situation in export markets, especially the EU. Growth is expected to slow and become uneven in manufacturing. A major challenge will be the lack of spare capacity since many sectors, for example wood processing and light industry, have reached pre-crisis volumes and availability of financing. Construction, the industry that suffered the deepest and longest decline, is supported by EU funds and is expected to continue its upturn and end the year with more balanced growth. Private consumption will largely depend on sentiment, which will be shaped by overall economic trends. Though partly offset by the effects of robust expansion in Eastern European markets, growth will lose momentum. We predict that **GDP will grow this year by 2.5 per cent, a notably slower pace than last year**. **In 2013, GDP growth** is expected to **rebound to 4 per cent**.

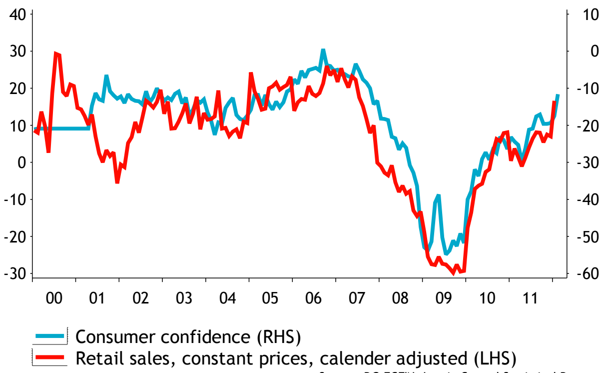
Last year, Latvia was very successful in foreign trade. Compared to 2010, export volume increased by 28.1 per cent and reached an unprecedented LVL 6 billion. In January, exports were still expanding at a 12.5 per cent rate in current prices. However, **adverse trends in the EU will gradually start to impact exports**, which will be subject to fluctuations. We expect export volume to grow this year, but not nearly as fast as in 2011.

The East will present very good opportunities to shift the potential decrease in Western demand. For example, Russia's accession to the WTO is expected to put the punch back into trade. However, potential political strains between the EU and Belarus may slow this trend. Russia, Estonia and Lithuania are among Latvia's major export markets. Still, the EU market will remain critical.

After a **rebound in retail trade** during the second half of 2011, January 2012 retail sales showed a 17 per cent year-on-year increase. In the coming months, sales are likely to be impacted by hefty heating bills and more prudent consumer behaviour and to become more uneven. However, our base scenario assumes that the activity in the retail sector, largely supported by tourists and more modest price increases, will achieve growth of 5 per cent. All in all, we expect private consumption to grow by 3 per cent in 2012 and 6 per cent in 2013.

Rebound in retail sales and sentiment

Year-on-year percentage change resp net balance



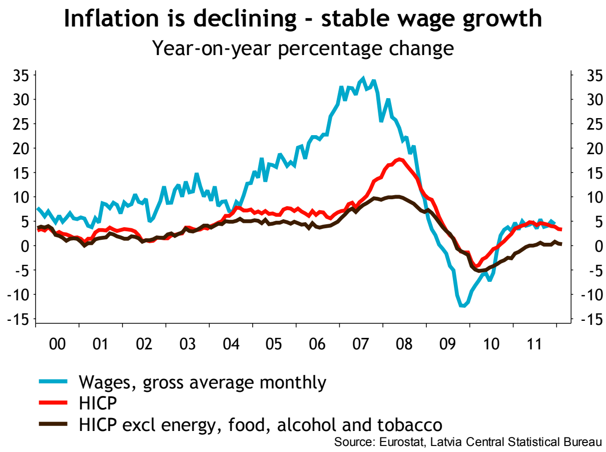
Source: DG ECFIN, Latvia Central Statistical Bureau

After Latvia's astonishing adjustment during the downturn period, the recovery in private consumption and higher capital spending are being reflected in a gradually deteriorating current account balance. The deficit was LVL 170.9 million in 2011, or 1.2 per cent of GDP. A moderate current account deficit is likely to persist in 2012 and will gradually increase in years to come.

In the fourth quarter of 2011, unemployment stood at 14.3 per cent of the economically active population. The prevailing uncertainties will also be reflected in job creation. In February, registered unemployment was 11.8 per cent, up 0.3 percentage points from year-end. The **unemployment rate will fall at a slower pace** this year. At times, it may increase or remain unchanged. Positive trends are expected as seasonal jobs kick in, provided that the recession in the euro zone does not turn into a nosedive. The statistics may also improve due to loss of incentives for the long-term unemployed to remain registered and because of continued emigration.

In 2011, pay increases resumed in all fields of the economy. Although average monthly gross wages rose by 4.4 per cent, real wages increased by a negligible 0.1 per cent. We expect moderate wage and salary growth this year. Remuneration may increase faster in certain industries and hard-to-fill positions. Thanks to lower inflation, purchasing power will improve more rapidly. Our forecast for wage growth is 4.5 per cent this year and 5 per cent in 2013.

In February, year-on-year inflation continued its downward trend, reaching **3.4 per cent. Price increases will become more moderate this year**, though at the moment this process is being significantly hindered by high oil prices. Core inflation is low and we do not expect an upturn. Latvia's fulfilment of the Maastricht inflation criterion for euro zone membership will largely depend on global price developments. The EU's evaluation of Latvia will take place in the spring of 2013. The criterion is that the latest annual average inflation may not be more than 1.5 percentage points higher than the three EU countries with the lowest inflation. Latvia's average inflation will be 2.5 per cent in 2012 and 2.1 per cent 2013.



Owing to solid economic activity, government **budget revenue continued to increase in the first two months of 2012, ensuring a far smaller deficit than in January-February last year. The increase in** revenue was due to higher collections from both tax and non-tax sources. The government is now considering a reduction in personal income taxes. The initial plan is to cut the tax rate from the current 25 per cent to 21 per cent and boost the non-taxable monthly personal allowance from LVL 45 to LVL 90. But first, the government must examine potential ways to offset the resulting decline in revenue. They may have to restrict the use of the reduced VAT rate, change pension contributions or raise the real estate tax. However, such changes will depend on the pace of reforms and economic growth. The government will face a dilemma, since curtailing the range of the reduced VAT rate may push up inflation and endanger fulfilment of the Maastricht criterion.

Better-than-expected growth saved the government from having to impose additional consolidation measures to meet targeted deficit levels. Its 2011 budget deficit was LVL 426.8 million, or about 3.0 per cent of GDP according to cash accounting. According to ESA95 methodology, the deficit was just over 4 per cent of GDP in 2011. Our forecast is that the government will continue to move towards a balanced budget, which means slightly more fiscal tightening in 2013. We foresee a deficit of 2.4 per cent of GDP in 2012 and 1.6 per cent of GDP in 2013. Since this is lower than the Maastricht criterion, it will pave the way for euro adoption in 2014, in line with the government's plan.

In January, Latvia **completed its three year international bail-out programme** (mostly EU and IMF money, with one main purpose being to guide Latvia towards euro zone membership). On February 14, Latvia issued USD 1 billion worth of 5-year bonds with a coupon of 5.25 per cent. Average yield was 5.375. The issue was aimed at building up a buffer for the coming refinancing of the country's international loan programme. Latvia will start repayments as early as this year: EUR 346 million in 2012, EUR 519 million in 2013, EUR 1,240 million in 2014 and a peak of EUR 1,327 million in 2015, thereby paying off most of its debt. In 2015-2019 Latvia will repay a loan of EUR 300 million to the World Bank. The remaining debt to the EU will be paid off in two instalments: EUR 500 million in 2019 and EUR 200 million in 2025.

According to the preliminary results of the population census, on March 1, 2011 Latvia had about 2,067,000 inhabitants. Since the 2000 census, the population had diminished by 309,000 or 13 per cent. The actual number of residents may be even smaller, as this number includes people living abroad who intend to repatriate at some point. Thus the **depopulation trend is becoming one of the biggest challenges** to the Latvian economy. Apparently this will also lead to data revisions. On the one hand, the unemployment rate may turn out to be larger than estimated before. On the other, GDP per capita may turn out to be higher. The current trend also underscores the need for urgent, decisive government action to continue structural reforms and increase the birth rate.

On February 18, Latvia held a referendum on making Russian a second official language. Owing to the sensitive nature of the issue, voter turnout was the highest since the 1993 election, totalling more than 70 per cent of citizens entitled to vote. The results were interpreted in different ways, but the proposal was soundly defeated. The referendum did not cause political instability, but the chances of the leftist, largely ethnic-Russian Harmony Centre party joining the cabinet in the near future waned drastically. At the same time **Valdis Dombrovskis** marked three years in office and became the first prime minister to head three governments in a row. It appears likely that his centre-right **cabinet**, which consists of the prime minister's own Unity party, Ex-President Valdis Zatler's Reform Party and the National Alliance – also supported by six independent MPs – **will stay in power until the next parliamentary election in 2014**.

Broad-based slowdown – growth below trend

- **Slower commodity-driven inflation**
- **Lower budget deficit, but above 3 per cent**
- **Likely change in coalition after election**

In 2011, economic development was robust and well-balanced. The annual GDP increase was 5.9 per cent, making Lithuania second only to Estonia as the fastest-growing economy in the EU. In recent months, growth has decelerated somewhat, especially in export-oriented sectors. Due to weaker export markets, growth will remain slower throughout 2012 and speed up only slightly in 2013. **Real GDP growth will be 2 per cent in 2012 and 3 per cent in 2013, with a continued balance between domestic demand and exports**. Most risks to our forecast – both upside and downside – lie with Lithuania's main export partners. The country remains highly dependent on euro zone developments. An investment breakthrough is unlikely until there is more certainty about the euro zone debt crisis. On the other hand, in January and February consumer expectations stabilised and industrial confidence notably improved.

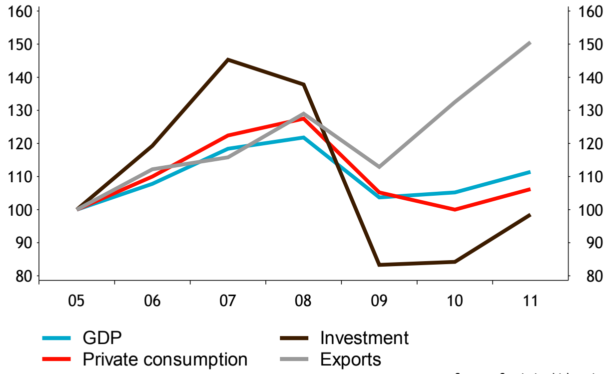
In December 2011, the government initiated bankruptcy proceedings for Bankas Snoras, the fifth largest bank in Lithuania, due to mismanagement and alleged fraud. The case was successfully managed and had limited consequences on the Lithuanian economy. Some 90 per cent of deposits were compensated according the state insurance scheme, no contagion in the banking market was noted and only a few medium-sized companies faced major losses due to the bank's failure. On the other hand, confidence in the banking system suffered a blow that will take several years to heal. Government bond yields also rose late in 2011 by 70-80 basis points, and Lithuania was forced to borrow more in the international market to pay the depositor compensation on time. The Bank of Lithuania estimates that **Snoras' failure may reduce GDP growth in 2012 by up to 0.5 percentage points**.

In 2011 net exports remained a positive contributor to growth, but the role of domestic demand was much more significant, especially in the second half. Private consumption rose by 6 per cent. Gross fixed capital formation increased by 17 per cent, but after the huge contraction of 2009-2010 this represented only a meagre recovery. Due to high uncertainty in the euro zone, company managers are refraining from business expansion. There was a large shortage of fresh capital last year, and capital spending was still one third below pre-crisis levels.

The fastest growing sector in 2011 was construction, where value added increased by one fifth. However, the construction and real estate markets remain sluggish. Housing starts are still limited, and new projects are being launched very cautiously. Residential property prices have stood still for 2 years, while minimal positive price movements are visible only in Vilnius, the capital. On the other hand, the construction sector was helped by warm weather in December and January.

Consumption, investment and exports

Index 100 = 2005, constant prices



Source: Statistics Lithuania

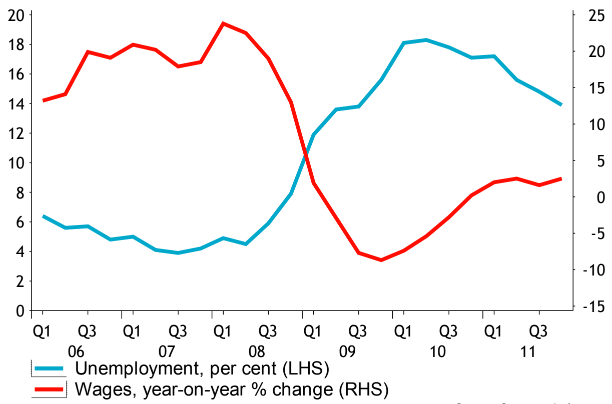
Manufacturing – the backbone of the Lithuanian economy – strengthened noticeably in 2011, but the last quarter of the year was quite bleak. On the other hand, early 2012 was not as bad as feared and foreign orders kept flowing in. Retail sales in January 2012 were much better than expected, confirming that consumption remained a more important source of growth than external demand. Only poor results in the transport industry contrasted to the satisfactory performance of other sectors in January, forcing us to stay on the cautious side. We expect moderate growth in private consumption in 2012.

Export growth maintained its swift pace in 2011: 29 per cent in nominal terms and 13 per cent at constant prices, compared to 2010. As expected, export growth slowed in the second half of 2011 as well as in January, but remained in the double-digit zone. The main reasons behind the weaker export increase were statistical base effects and more limited external demand rather than poorer competitiveness. Lithuania's real effective exchange rate last year increased by a moderate 2.1 per cent, despite large depreciation in the Polish and British currencies against the litas. Furthermore, Lithuanian exporters are highly active in searching for new markets outside Europe. Exports of chemical products, textiles and vehicles weakened the most in 2011. Meanwhile exports of furniture, rubber and plastics continued to post strong, steady growth rates. In spring 2012, Lithuania's largest exporter, the ORLEN Lietuva oil refinery, plans a maintenance closure of more than a month, which will naturally have a negative effect on export volume.

Unemployment decreased further to 15.4 per cent in 2011. The male jobless rate fell especially fast, reflecting greater demand in manufacturing and construction. Nonetheless, overall and youth unemployment remain among the highest in the EU, reflecting the need for structural labour reform. We believe that **unemployment will shrink further to 14 per cent in 2012 and 12 per cent in 2013**. Thus, the decrease will be quite slow. On the other hand, a reversal in the downward trend is quite unlikely. Employers have remained cautious until now in hiring new workers, and a lot of companies are still operating with as few employees as possible.

The increase in wages and salaries was quite small in 2011, reaching 2.5 per cent by the end of the year. The figure is even more unimpressive because it was boosted by various bonuses and one-off payments during the Christmas season. In the public sector, wages climbed by 3.3 per cent and in the private sector by 2.3 per cent. The sectors with labour shortage problems (for example IT) face the highest pressure, while in most sectors the increase in wages and salaries barely exceeds inflation, especially in the private sector. Pay levels will rise by 2 per cent in 2012 and by 2.5 per cent in 2013.

Wages and unemployment



Source: Statistics Lithuania

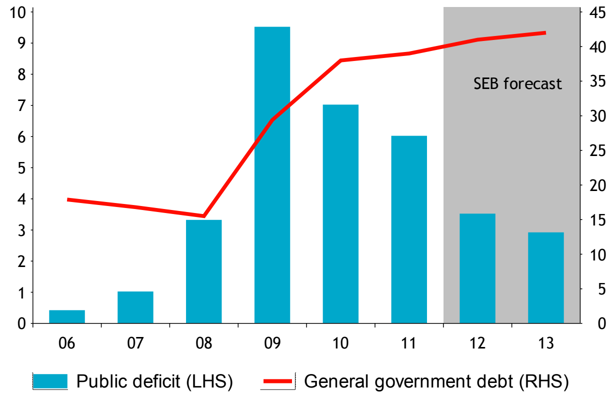
Rising commodity prices pushed inflation up in 2011 to an average of 4.1 per cent. We believe that average **HICP inflation will decline** to 2.5 per cent in 2012 and 3.0 per cent in 2013 as economic growth subsides both in Lithuania and globally. However, high oil prices remain an upside threat to our estimates. Underlying inflation remains calm.

At the end of 2011, the government once again demonstrated its willingness to maintain prudent fiscal indicators. After the Ministry of Finance lowered its forecasts for economic growth and revenue targets, public expenditures were cut by 4 per cent without any political objection. For 2012, the **government has also set a challenging deficit target: 3 per cent of GDP, aiming at euro membership in 2014**. In our view, the plan is ambitious, bearing in mind both the economic environment and the parliamentary election this coming October. If revenue falls short in the early months of 2012, the government has said it would cut expenditures once again in mid-year.

However, government revenue in January and February was quite strong and exceeded the target by 4 per cent. In our view, the budget deficit should reach 3.5 per cent of GDP in 2012 and 2.9 per cent of GDP in 2013. Our forecast is that **Lithuania will thus convert to the euro in 2015**.

After the election, a change in ruling parties is quite likely. The latest opinion polls show that the Social Democrats now lead, with 16 per cent. Other opposition parties (Labour, Order and Justice) enjoy high popularity (11 per cent and 8 per cent, respectively). On the other hand, the party that leads the current ruling coalition – the Homeland Union (Christian Democrats) – is in third place with slightly more than 9 per cent of the votes. Last year, almost all parties agreed on the need to maintain sound fiscal indicators. However, the parties have not yet published their election programmes and it is not clear if they will support further fiscal tightening if elected to office.

Public deficit and debt



Source: Eurostat, SEB

Central government debt remains well managed and reached 39 per cent of GDP at the end of 2011. In November 2011, the government issued USD 750 million in 10-year international bonds. The aim of this issue was to redeem a EUR 1 billion bond issue in May 2012, but after Snoras' failure, the money was used for speedier compensation of depositors. The government thus had to organise another USD 1.5 billion issue in January, which was reasonably priced and attracted heavy demand. In 2012, the government plans to borrow EUR 3 billion, of which EUR 1.8 billion would go towards refinancing earlier bond issues and preparing for the redemption of EUR 1 billion in bonds in March 2013.

As a result of the government bond issues and compensation to Snoras' depositors, the Lithuanian **banking system faces excess liquidity**. In mid-March, commercial banks held LTL 3.6 billion of reserves at the central bank, whereas their required reserves were only LTL 1.9 billion. Therefore, at the end of 2011 the Bank of Lithuania started absorbing liquidity through newly initiated open market operations (time deposits, repos and securities auctions).

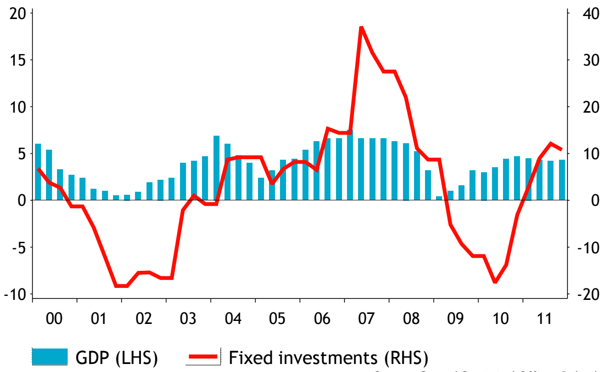
Somewhat weaker but still in "pole position"

- **Capital spending a more vital driving force**
- **Continued relatively high inflation**
- **Zloty strengthens gradually after sharp fluctuations**

Poland continues to show good resilience to external demand shocks, which has also been our assessment for some time. In 2009 it was the only EU country to avoid recession. Last year GDP grew by 4.3 per cent (after 3.9 per cent in 2010). This was the strongest figure in Central Europe. We anticipate a **mild slowdown in GDP growth to 3.0 per cent this year**, mainly due to **weaker exports** to Germany and elsewhere in Western Europe, but also due to **somewhat slower consumption growth. Capital spending activity will remain high**. Capital spending has already been fuelled by the summer 2012 European football championships (co-hosted with Ukraine). It is also driven by other infrastructure investments, which Poland is expected to utilise to a larger extent. We believe there is also a pent-up need for structural capital spending due to earlier relatively low investment ratios, although in the short term manufacturers will hold back on some investments now that the economy is slowing. **In 2013**, when the situation in Germany begins to normalise and exports and capital spending again enjoy tail-winds, **GDP growth will accelerate to 3.6 per cent**.

Capital spending again an important growth factor

Year-on-year percentage change



Source: Central Statistical Office, Poland

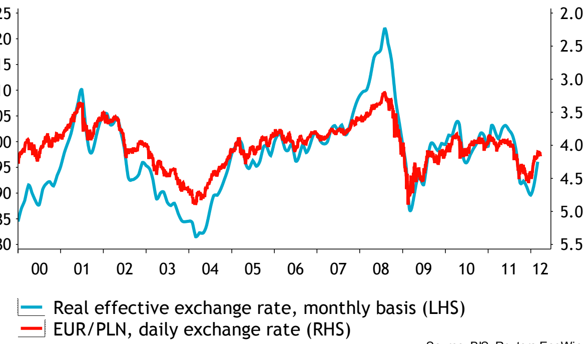
Most macroeconomic **fundamentals are relatively good**. The government's continued stubborn budget consolidation is holding down the large public sector deficit and halting debt growth at a moderate level. The only few flies in the ointment are persistent relatively high inflation, low labour supply and large current account deficits; the latter is, in part, a structural challenge.

We foresee **three major reasons why Poland will cope** with the external crisis better than its Central European neighbours:

- **Less exposure via foreign trade**. Exports are equivalent to a low 40 per cent of GDP, compared to 70-80 percent in Slovakia, the Czech Republic and Hungary. Like these smaller countries, trade is highly integrated with Germany.
- **Good competitiveness**. Poland has steadily gained market shares since 2005, according to the European Commission's autumn 2011 report. Of the EU's other Eastern and Central European members, only Romania, the Czech Republic and Hungary can make this boast. In 2008-2010, Poland gained relatively larger market shares than Slovakia, the Czech Republic and Hungary. The sharp, nearly 30 per cent decline in the real effective exchange rate of the zloty during July 2008-February 2009 contributed to this success. Since then the zloty has recovered. About half the renewed real-term depreciation of about 11 per cent in the second half of 2011 – which caused the Polish central bank to intervene in the foreign exchange market to support the currency for the first time since it was floated in 2000 – has also been eaten up by this year's rebound. But the zloty remains a few per cent below its average for the past decade, indicating that Poland's competitiveness is still good. In our view, the zloty will strengthen gradually in nominal terms, but continued higher inflation than in other countries threatens to undermine future competitiveness.

Zloty has been volatile and remains a bit undervalued

EUR/PLN and index 100=2005



Source: BIS, Reuters EcoWin

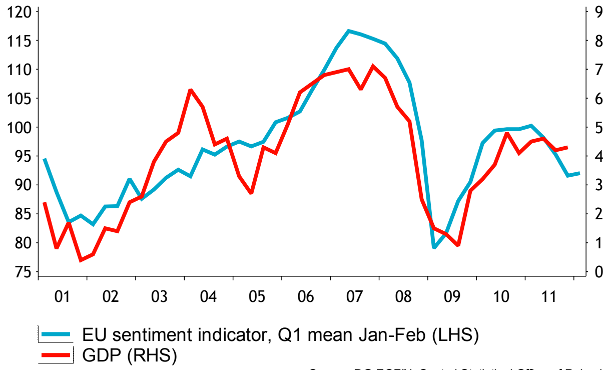
- **Banking system in good shape**. Polish banks earned record profits last year. The IMF and other observers also view these banks as well-capitalised in light of capital adequacy requirements. Considering the downside risks in the economic forecast, the IMF meanwhile welcomes the Financial Supervision Authority's statement late in 2011 urging high-profile banks to retain their profits in order to build up an additional capital buffer.

Evidence of Poland's robust economic situation came in the national accounts for the **fourth quarter of 2011**. In sharp contrast to many other economies both East and West, there was **no slowdown**. Quarter-on-quarter, there was even a slight increase in GDP growth to 1.1 per cent, compared to 1.0 per cent in the third quarter. Year-on-year growth rose from 4.2 to 4.3 per cent. Export growth was intact, even strengthening a bit. Capital spending rose by a stable, high 8.4 per cent year-on-year, but growth in private consumption decelerated significantly, despite good retail sales according to other statistics.

However, a **general slowdown is on the way**. Forward-looking indicators like the EU's monthly sentiment index, which surveys both businesses and households, fell sharply late in 2011. A stabilisation and minor upturn have occurred recently, but the level is still relatively depressed in historical terms. It also takes 3-9 months before the trend of the index is reflected in actual data. In addition, the manufacturing purchasing managers' index fell in February to exactly the expansion threshold of 50.0 from more than 52.0 in January.

Weaker growth ahead

Year-on-year percentage change and index



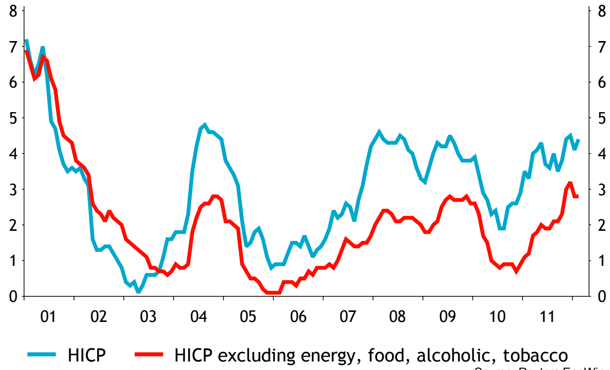
Source: DG ECFIN, Central Statistical Office of Poland

Household optimism has slipped in the past year, largely due to worries about **higher unemployment**. Job growth has gradually lost momentum and was just above 2 per cent year-on-year in December – its slowest rate for a year. According to Eurostat's harmonised, seasonally-adjusted measure, unemployment also crept upward from 9.4 per cent early in 2011 to 10.1 per cent in December. This is the highest jobless rate since 2007. With GDP growth below its 4.5 per cent potential, unemployment will climb further this year to an average of 11.5 per cent and then level out. Last year overall wages and salaries in Poland increase at a stable, moderate rate of about 5 per cent. Early in 2012, a clear jump in manufacturing pay growth was noted, but in our assessment this increase is temporary and is connected in part to an earlier profit surge. Continued weakening in the labour market points indicates that future pay growth will be moderate.

Inflation has climbed substantially since mid-2010, when it was just below 2 per cent. In February it stood at 4.4 per cent, after a temporary dip towards 4 per cent in January when last year's VAT hike disappeared from the 12-month figures. Meanwhile core inflation – HICP adjusted for energy, food, alcoholic beverages and tobacco products – climbed from about 1 per cent to 2.8 per cent. This relatively high underlying rate of price increases indicates that inflation will not fade quickly. Meanwhile food prices as well as energy prices will show a calmer trend ahead than previously, leading to downward base effects early in 2012. Demand is also is slowing in the economy and the zloty's sharp appreciation this winter will ease import price pressures. On the whole, we expect a **gradual decline in inflation** to an average of 3.8 per cent in 2012 and 2.8 per cent in 2013.

Inflation still relatively high

Year-on-year percentage change



Source: Reuters EcoWin

The central bank, which has declared a 2.5 ± 1 per cent inflation target using the local measure of CPI, has been sending relatively hawkish signals after this year's monetary policy meetings due to inflation impulses in the past six months, including in its inflation report in early March. Our view last autumn was that the central bank would instead begin to ease monetary policy in the first half of 2012 and cut its key interest rate twice, following its front-loaded tightening in the form of four rate hikes totalling 100 basis points to 4.5 per cent. One fundamental reason for this would be to ease the effects of the ongoing fiscal contraction. We still believe that **key interest rate cuts will come but that they will be implemented in the second half of 2012** when it is clear that the economy has cooled off, inflation pressure is on its way downward and inflation is again within the target interval.

The **political situation is relatively stable**. The government of Donald Tusk – a coalition of his centre-right Civic Platform and the small Peasants' Party – was returned to office in the October 2011 parliamentary election. This marked the first time a Polish government was re-elected since the Communist era ended in 1989. **Continued budget consolidation is a high priority** in order to keep government debt levels below their thresholds of 50-55-60 per cent of GDP. The debt is close to 55 per cent, which would automatically trigger tougher austerity. But reforms are also on the agenda: mainly in the pension field, including a proposed rise in retirement age, along with greater labour market liberalisation and a reduction in bureaucracy. Fiscal policy will be tightened by about 1 per cent of GDP this year, and austerity measures are mainly targeting budget expenditures. Our forecast is that the deficit will shrink from about 5.5 per cent of GDP last year to just above 3 per cent in 2012; the government will not quite achieve its target of just below 3 per cent.

Growth is slower, but supported by high energy prices

- **Temporarily lower inflation**
- **High real pay increases drive consumption**
- **Rouble will continue to appreciate**
- **High oil prices slowing pace of reform**

After four quarters of falling GDP in 2008-2009 when the economy shrank by 11 per cent in all, Russia has recovered, but not in a convincing way. Since the first quarter of 2010, growth in annual terms has varied between 3.5 and 5 per cent: clearly below the pre-crisis average of 7+ per cent during the 2000s. GDP grew 4.3 per cent in 2011, a bit faster than in 2010, and no slowdown is yet visible in the statistics. **Our view of the country's economy remains relatively positive in the short and medium term**, although it will not be possible to avoid the effects of the slowdown elsewhere in Europe. Political unrest since the parliamentary and presidential elections will fuel both short- and long-term uncertainty, but we expect its effect on overall near-term growth to be marginal.

Continued high oil prices will sustain the economy and give Russia good export and tax revenues. **Dependence on commodities**, especially oil and gas, increases vulnerability and **decreases the focus on reforms**. We expect commodity prices to remain high and have revised our Brent crude forecast to USD 118/barrel in 2012 and USD 120 in 2013. Today's price is around USD 126, with Russia's Urals oil around USD 3 lower.

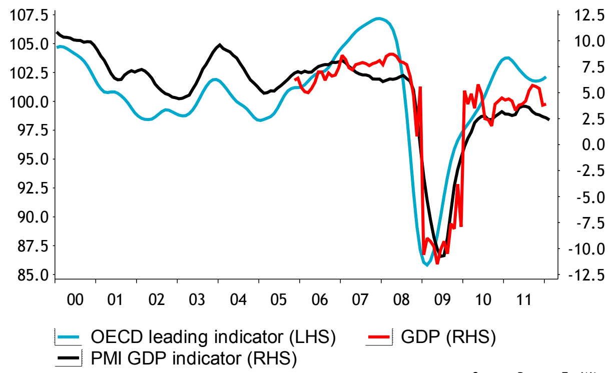
In the next few years, Russia will grow faster than nearby countries and Western Europe, but we expect the growth rate to be well below that of the pre-crisis decade as long as the economy is not reformed and the growth model is not directed towards greater diversification and less oil dependence. **GDP will grow by 3.8 per cent in 2012 and 4.1 per cent in 2013**, unchanged from our *Nordic Outlook* forecast in February. Because of the latest oil price upturn, the forecast risks have become more balanced. If oil prices stay at today's levels, further public sector stimulus may be in the cards. On the downside, risks are mainly connected to the heavy dependence on oil revenue, which dampens the desire for reforms. In the near term, however, earlier current account surpluses and low government debt should enable the country to cope with a period of sharply lower oil prices, although this would boost financial uncertainty and help push down the rouble and the stock market.

Indicators point to moderate slowdown

Indicators, such as PMI, are pointing towards a moderate economic slowdown. Last autumn's dip was far milder than in the US and the euro zone and proved temporary. Services and manufacturing show divergent trends. According to indicators, the service outlook has improved in recent months while manufacturing has moved the opposite way. This outcome is consistent with a slight negative impact from the euro zone crisis and the slowdown affecting Russia's neighbours to the west. However, both indicators are above the 50-point level, which signals growth. Other yardsticks such as the OECD's leading indicator for Russia point in the same direction: a slight deceleration, but continued decent growth.

Indicators point towards moderate slowdown

Index, year-on-year percentage change

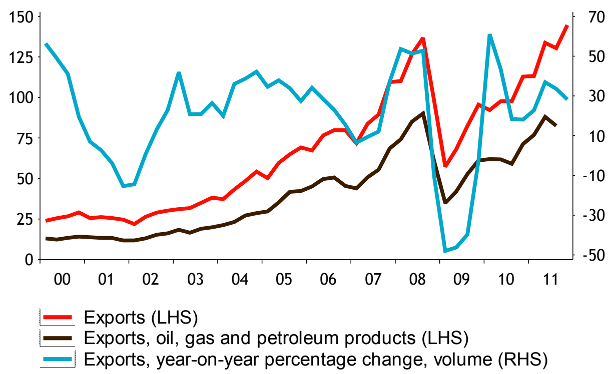


Source: Reuters EcoWin

Manufacturing output decelerated noticeably in the course of 2011. It rose by 6.7 per cent for the year, in line with our previous forecast, with the rate of increase falling from double-digit figures early in the year to 3.3 per cent in December and 4.8 per cent in January 2012. **Overall economic output was sustained by oil, but also by good harvests**, with a poor harvest in 2010 causing a sharp turnaround. Weaker growth in industrial production in late 2011 and early 2012 is consistent with indicators and international developments. We predict a weak patch early in 2012, with manufacturing output increasing somewhat faster after that. Measured as annual averages, the increase will be 5 per cent in 2012 and 7 per cent in 2013.

Oil is driving exports

USD billion

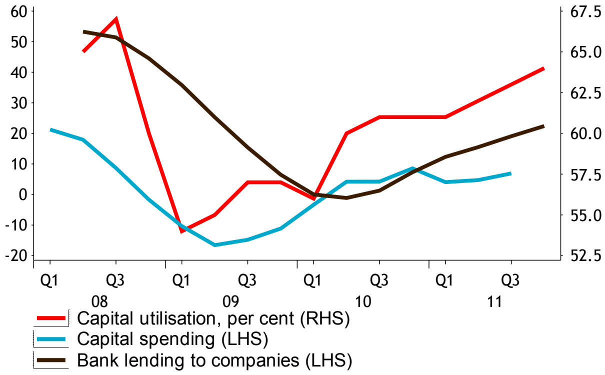


Source: Reuters EcoWin

In current prices, exports increased sharply last year, driven by oil prices. In volume terms, however, the trend was weaker and largely unchanged. The trade surplus remains large, but capital outflows meanwhile persist (USD 13.5 billion in January and almost 10 billion in February). Continued high oil and metal prices will keep export value high, but given our commodities forecast, growth in exports will not remain at the pace we have seen in the past two years. **The current account surplus has been large since 2000 but has narrowed. We expect it to continue shrinking in the next couple of years.**

Capacity utilisation and capital spending

Year-on-year percentage change

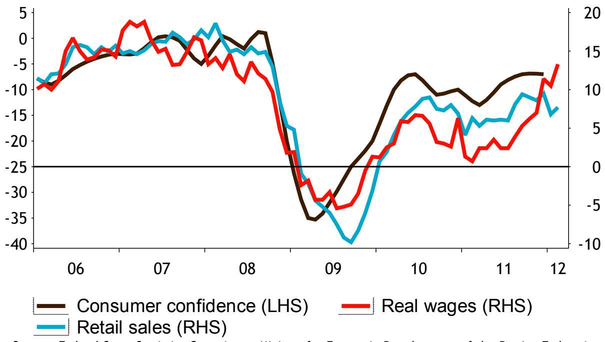


Source: Federal State Statistics Service, Russia

Historically speaking, Russia's investment ratio has been low compared to various neighbouring countries. Capital assets are generally obsolete and there is a great need for capital spending in the Russia economy. Since 2010, the yearly increase in such spending has been about 5.5-6 per cent. Looking ahead, **rising capacity utilisation and higher bank lending to companies indicate that capital spending will increase**, despite the problems in the world economy. We expect fixed investments to expand strongly year-on-year, though more slowly than during the pre-crisis years, rising by 7.5 per cent in 2012 and 8.5 per cent in 2013.

Falling inflation leading to good real income increases

Net balance, year-on-year percentage change



Source: Federal State Statistics Committee, Ministry for Economic Development of the Russian Federation

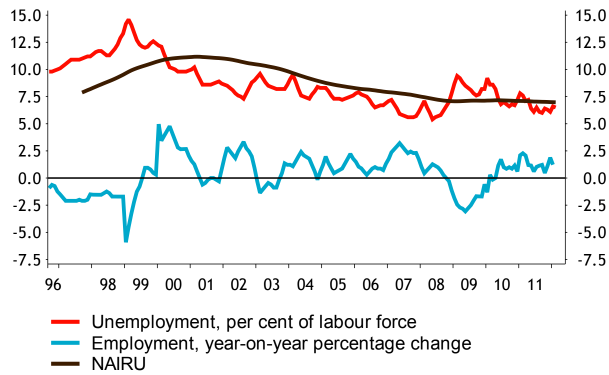
Strong consumer confidence

Declining unemployment has helped keep consumer confidence high. **One reason to foresee decent growth in household consumption** is that real household income accelerated late in 2011 as inflation fell. This process is expected to continue in 2012 even though the increase in real wages of more than 13 per cent in February was probably the peak. Fiscal policy was expansionary before the parliamentary and presidential elections of recent months, leading among other things to higher public sector pay and pensions and delayed fee hikes. Increased confidence and higher income are reflected in retail sales, which rose at nearly a 10 per cent rate at the end of 2011 – the fastest such increase since late 2008. We expect the economic situation of households to remain good this year, as reflected in a **5 per cent increase in private consumption this year and 5.5 per cent in 2013**.

A decline from 7.8 to 6.1 per cent during 2011 brought unemployment close to pre-crisis levels. Since then the jobless rate has largely moved sideways between 6 and 6.5 per cent, or somewhat below its long-term equilibrium level. Job creation is still rising by around 1 per cent year-on-year and is expected to continue growing slightly as unemployment levels out just above 6 per cent this year and climbs a bit towards year-end. Measured as annual averages, unemployment will end up at 6.4 per cent in 2012 and 2013. Although no major near-term labour shortage problems appear likely, the job market will be incapable of helping bring growth back to pre-crisis levels without reforms that boost the participation rate. The demographic situation with falling labour market participation rates is one of Russia's challenges ahead. However, we foresee no acute risk of labour market overheating despite the decline in registered unemployment. If the job market improves there are potential resources, including higher labour market participation and migration from neighbouring countries.

Unemployment levelling out

Per cent



Source: Federal State Statistics Service, Russia

Inflation at a temporary low

Year-on-year inflation is declining and has fallen from 9.5 to 3.7 per cent in the past twelve months. The downturn has been surprisingly sharp, though partly expected. Aside from the disappearance of previous rising food and energy prices from the 12-month figures, hikes in such items as electricity, gas and rents have been postponed. These fees are normally adjusted in January but will occur only in July this year, officially in order to ease their impact during the winter – when energy use peaks – but in practice as part of election-related stimulus measures. Inflation will remain relatively low in the first half of 2012, but we expect it to rise when the postponed fee and rent hikes occur in the second half. Underlying inflation is more sluggish and will be propped up, among other things, by continued high pay increases. The co-variation between core inflation and headline inflation is closer in Russia than in Western Europe, and looking ahead we expect that underlying inflation will also continue falling somewhat. **CPI inflation will end up at 5.0 per cent in 2012 and 6.0 per cent in 2013**. Inflation will thus end up largely in line with the target of the central bank and the downshift from the earlier 10-15 per cent has been successful, though large fluctuations will create some uncertainty. WTO membership will create some downward pressure on inflation through lower tariffs and increased competition, even though the effects probably will be small and gradual.

Surprisingly large drop in inflation

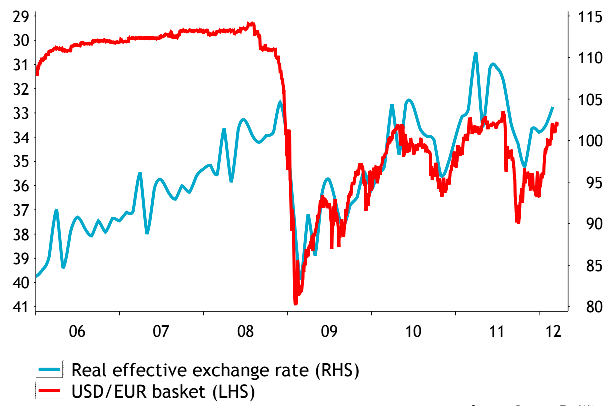
Year-on-year percentage change

Source: The Central Bank of the Russian Federation, Federal State Statistics Committee

Unchanged key interest rate in 2012

Even though inflation is on its way down to record lows, below the target of the central bank, we expect the Bank of Russia to leave its key interest rate unchanged in 2012. The bank uses a number of different monetary policy instruments. In 2011 the official key interest rate was first raised twice and then lowered once to 8 per cent. Meanwhile the one-week interest rate on deposits in the central bank, which is more important to foreign exchange flows, has been raised by a total of 1.25 percentage points since early 2011 and stands at 4 per cent. Another important interest rate is the one-day repo rate, which is used to maintain liquidity in the banking system. This rate has largely followed the movements of the key rate and stands at 5.25 per cent today. At the same time the corridor between the central bank's lending and deposit rate has narrowed. **The central bank will keep its interest rates unchanged during 2012 and then begin cautious hikes** as growth increases somewhat in Russia and internationally. By the end of 2013, the one-day repo rate will be 6 per cent. Today the Bank of Russia is moving towards a clearer inflation target, aiming at a 4-5 per cent rate in 2014. This means it will focus increasingly on inflation-fighting and less on a stable currency exchange rate.

Continued rouble appreciation



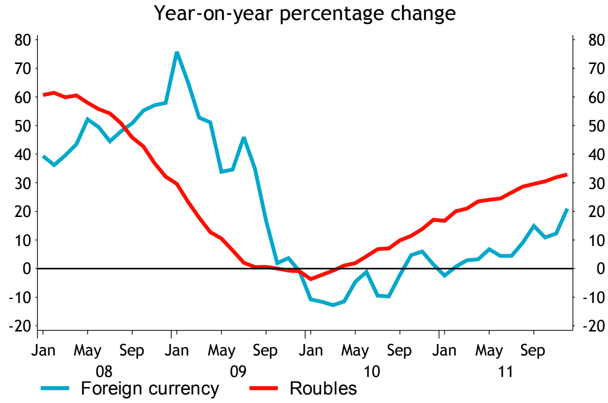
Source: Reuters EcoWin

Our forecast that the interest rate will stay at 5.25 per cent in the short term is supported by the statement following the March meeting of the Bank's Board of Directors, which noted that inflation – currently below the bank's 5.5 per cent target – has been partly driven in recent months by postponed hikes in regulated prices and that rouble appreciation may have had a downward effect on prices. The Bank relies instead on its medium-term inflation forecasts for monetary policy purposes. The Board added that – despite some slowdown in production growth – consumption, the labour market and real household income are holding up well. It said that the Bank's current interest rates are suitable for balancing inflation and growth in the coming months, indicating that the Bank will not cut interest rates when growth falls and unemployment rises a bit.

Since its 30 per cent slide in 2008-2009 against the USD/EUR basket (55 per cent USD and 45 per cent EUR) the rouble has appreciated, though with reversals along the way. It has been a bumpy ride. Autumn 2011 was dominated by international turbulence and the rouble fell. Rebounding early in 2012, it has recovered from that decline and is now some 12 per cent weaker than at its 2008 peak. Despite this upturn various factors indicate continued near-term appreciation, after which the currency will level out, as measured by the basket. Oil prices remain high and have climbed since February. This means export revenue will remain high and risk appetite will benefit the country. The Moscow Stock Exchange co-varies closely with oil prices, which may attract capital inflows. Meanwhile capital outflows were large in 2011, largely related to the election, but there is also a historical link between high oil prices and capital outflows. It is difficult to foresee these flows ending completely or reversing any time soon. Relatively good GDP growth, attractive interest rate levels (at present also positive in real terms) and the coming liberalisation of the OFZ market will also support a rouble upturn. The rouble will strengthen against the basket, from today's 33.5 to 29.3 at the end of 2012 and 2013.

Faster increase in bank lending

Year-on-year percentage change



Source: Reuters EcoWin

In addition, the ECB's 3-year repos have eased the stress in the European banking system, thereby reducing the risk of credit tightening and contagious effects spreading east. Unlike most countries in Central and Eastern Europe, Russia is to a lesser extent dependent on funding from euro zone parent banks. This makes the country less vulnerable, but the risk that it might be harmed via export channels has receded anyway. In addition, Russia's external funding needs are relatively low even though large companies and banks partly depend on financing from international capital markets. The banking system has also recovered since the crisis. Although interbank rates have risen in the past six months, they are in fact at the same levels as before the 2008 crisis, not at crisis levels. Another sign of the condition of Russia's banking system is that as of December 2011, bank lending in roubles had climbed 33 per cent and in foreign currencies by 21 per cent year-on-year. With private sector borrowing still low, corresponding to 35 per cent of GDP (total bank lending), there is room for continued credit growth.

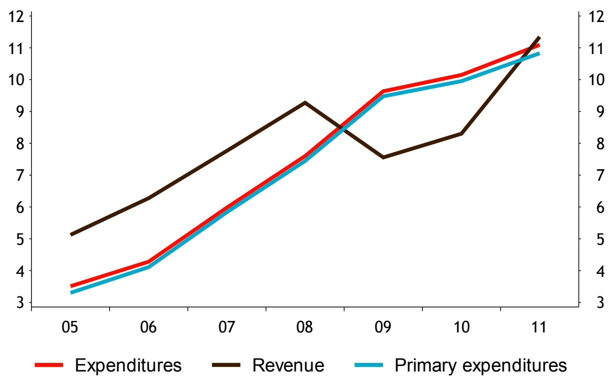
Higher oil prices – more stimulus measures?

High oil revenues in recent years have allowed expansionary fiscal policy, and public sector expenditures have increased sharply. In itself, this policy has contributed to growth and higher real household income. Due to increased transfer payments and higher pay, real wage increases have averaged 10 per cent in the past decade. Looking ahead, the federal government will not be able to stimulate the economy in the same way. Rising living standards have previously dampened protests against centralised rule, but assuming weaker growth ahead there will be increasing pressure on the government. Higher incomes per se and a growing middle class will also help fuel demands for greater political influence.

Since 2005, **federal expenditures have risen** from 3.5 to 11 trillion roubles, or **from just above 16 to around 22 per cent of GDP**. These increases have occurred in many areas, including public sector salaries, pensions and military expenditures. Since revenue was rising at a similar rate, this implied no major short-term funding problems, but oil dependence is increasing and more oil revenue is being used than planned in fiscal regulations. Unless oil prices continue rising, the same trend cannot continue. This may lead to political problems, since voters have become accustomed to rising expenditures.

Russian federal revenue and expenditures

Trillions of roubles



Source: Federal State Statistics Service, Russia, Ministry of Finance of the Russian Federation

Centralised control of the economy has contributed to a degree of short-term stability, but has also increased dependence on oil revenue. The federal budget now requires an oil price of more than USD 115 per barrel to achieve balance. According to the latest budget, from last autumn, expenditures will rise at a clearly slower pace than before, but it should meanwhile be added that some of the expenditure hikes in prior years were implemented in supplementary budget form when oil revenue exceeded forecasts. It is unlikely that this tradition will end if similar opportunities present themselves. This way of using higher revenue is something the IMF has criticised, since it continuously depletes the federal treasury. Expenditures that are not part of the longer-term budget plan may also be prioritised in order to achieve short-term objectives. The 2011 budget was close to balance, and we believe that the public sector **deficit will widen somewhat, ending up at about 2 per cent of GDP in 2012 and 2013**. Gross public sector debt is largely unchanged at 12 per cent of GDP. There is a downside risk: budget calculations are based on high oil prices and on the assumption that future expenditure increases will be more moderate than those of prior years.

Vladimir Putin, who was recently elected president again, has been challenged during the past six months in a way that we have not seen since he assumed power in 1999. Continued high oil prices will buy time for the political leadership, but will meanwhile make the country more and more dependent on this variable in order to function. We do not expect any major political shifts in the near term, but the latest elections and increased protests against the current political system has **moved the country closer to a crossroads: a choice between increased reforms or even more centralised rule**. Our assessment is that Putin will try to regain popularity by means of certain reforms and increased expenditures, even though there is little room for manoeuvre despite high oil prices. Some political reforms (reintroduction of elected regional governors and making it easier to create political parties) are now in the Duma. Structural reforms are very likely to be watered down in the process, not only due to the political leadership at the federal level, but also in the implementation phase where the bureaucracy and the local political elite will view reforms as a threat to the power structures that have been built up.

Russia's current account has continuously weakened since 2005. **If this trend continues, the country will show dual deficits (budget and current account) in 2015-2016**. Although no funding problems are expected in the short term, this implies a situation opposite to what Russia has become accustomed to. To ensure that growth prospects do not worsen at that time, the country would finally have to start the process of opening up and reforming the economy.

One factor that may help is that Russia's 18-year journey towards World Trade Organisation membership now seems to be yielding results. Negotiations were completed in November 2011 and membership was approved by the WTO in December. It now remains for Russia to approve the agreement before mid-June. The country will become a member 30 days after informing the WTO that it has made its decision. The actual effect of WTO accession is very uncertain, and estimates vary. The World Bank has estimated the long-term GDP effects at between 3.3 and 11.0 per cent, saying that export-intensive sectors in commodities and sectors that are currently not protected or regulated will benefit the most. One recurring conclusion is that the effect will largely depend on national decisions, i.e. whether Russia actually succeeds in navigating away from commodity dependence, improving its business climate and attracting investments. Achieving the upper level of the World Bank's estimate range would require a greater commitment than merely joining the WTO.

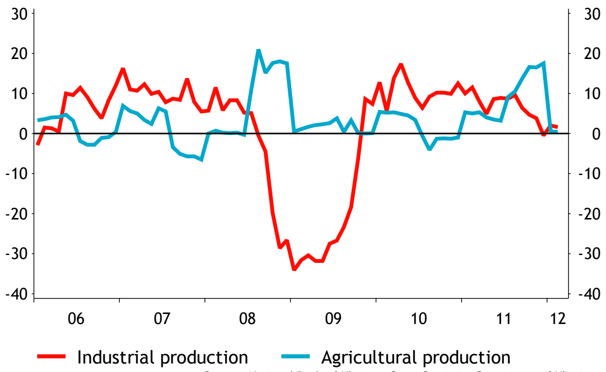
Economy will muddle through but political risks remain

- **Falling inflation and good real income increases to households**
- **Continued freeze in relations with IMF**
- **Hryvnia stable against USD but under pressure**

The economic trend still looks shaky. Although Ukraine's short-term funding problems can be resolved by using central bank reserves, a **resumption of the frozen stand-by arrangement with the IMF would reduce risks more clearly and permanently**. A devaluation would ease pressure on the central bank, but we do not view it as a main alternative as it would hurt households with loans in foreign currency. The devalutaion risk is still large though. More stable international prospects, the ECB's liquidity injections and improved risk appetite have reduced the probability of a worse future trend. Downside risks remain, however. Current account deficit problems will persist, due to Ukraine's failure to reach a new gas agreement with Russia, and the political risks persists.

Good harvest propped up GDP growth in 2011

Year-on-year percentage change



Source: National Bank of Ukraine, State Statistics Committee of Ukraine

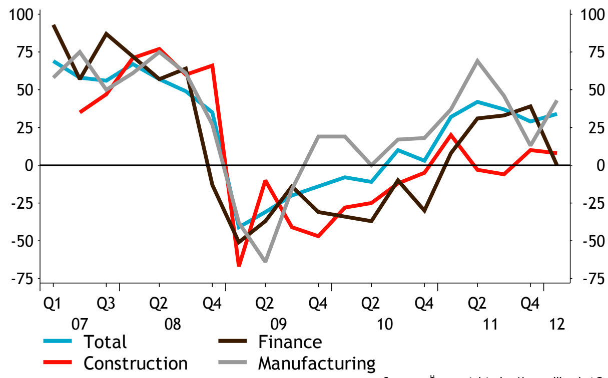
Year-on-year GDP growth was relatively stable in 2011, averaging 4.1 per cent in the first three quarters and accelerating a bit in the third quarter, among other things driven by good harvests. **The EU economic slowdown is not yet visible in Ukraine's overall GDP figures**, but industrial production and exports developed weakly in 2011. We expect a weak trend in 2012. A normal harvest would cause one economic driving force to disappear. Ukraine's export-dependent economy (exports equivalent to 47 per cent of GDP) will be hurt by weak growth in Western Europe, although high commodity prices (including steel) and real household income will provide support. **Altogether, GDP will grow by 3.2 per cent in 2012 and 4.2 per cent in 2013**.

Forward-looking indicators provide somewhat mixed signals. Overall business sentiment has rebounded recently. It is not surprising that the sentiment indicator shows a more depressed financial sector, considering Ukraine's financial uncertainty and problems with its IMF agreement. Steel output continues to rise. Although it is above average for the past two decades, it is still 25 per cent below its peak before the crisis of 2008/2009. Continued high steel and food prices will nevertheless continue to sustain the economy, but meanwhile pose a risk. Their contribution to growth will depend on how the international economy develops.

Imports rose faster than exports last year and agricultural exports were restrained, among other things, by the export tax introduced on July 1, 2011 (replacing earlier quotas). Good real household income hikes will help this trend continue in 2012. **We expect Ukraine's current account deficit to widen** from 3.9 per cent of GDP in 2011 to 4.5 per cent this year.

Mixed signals from business sentiment indicators

Net balance



Source: Österreichische Kontrollbank AG

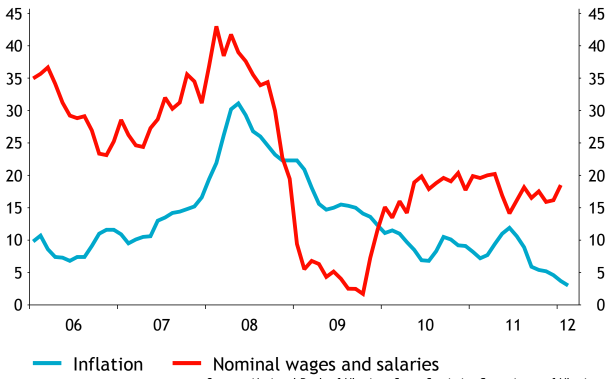
Capital spending has risen despite the shaky environment, aided by preparations for the 2012 European football championships this summer. To stimulate capital spending while reducing dependence on imported Russia gas, bidding has begun for shale gas extraction in both eastern and western Ukraine. According to Finance Ministry statements, these are the largest procurement processes the country has organised. The labour market has not shown signs of the slowdown; annual average unemployment fell by about 0.3 percentage points in 2011 compared to 2010 and is expected to level off at just below 7.5 per cent in 2012 and 2013.

Inflation fell from a peak of 11.9 per cent in June 2011 to 3.7 per cent in January 2012. This decline is connected to lower food prices and base effects from previous gas price hikes. Further gas price increases are the most important outstanding issue with the IMF and an upside inflation risk. Nominal wages have increased by 15-20 per cent annually in the past two years. Retail sales have climbed in annual terms by 12-15 per cent in fixed prices during the past three quarters. **Falling inflation**

will now lead to sharply improved real household wages, causing consumption to continue rising relatively fast and providing the largest contribution to GDP growth especially in 2012 but also 2013. Looking ahead, one problem that cannot be ignored is the effect of high pay increases on the country's international competitiveness. **Measured as real effective exchange rates, Ukraine has lost some competitiveness** – not to an alarming extent in the short term, but high inflation and wage increases has made the real effective exchange rate move to the highest level since the 2008 depreciation; without higher productivity, today's rapid pay increases cannot continue.

Falling inflation boosts real income

Year-on-year percentage change



Source: National Bank of Ukraine, State Statistics Committee of Ukraine

Financial risks have decreased somewhat

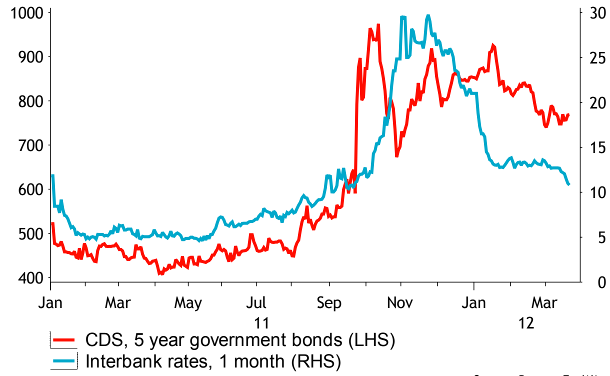
Worries that euro zone banks may cut back lending in Eastern Europe have eased in recent months, since the ECB's massive liquidity injections improved funding opportunities for these banks and reduced financial stress. Although Ukraine is clearly less dependent on loans from Western European banks than, for example, Hungary or Bulgaria, a new wave of uncertainty would strike a hard blow to the country.

Interbank rates have fallen from nearly 30 per cent in October-November to slightly more than 10 per cent. The price of credit default swaps on 5-year government bonds has fallen, although the trend has been choppy. The government seems less worried about the financial situation than it should be. Its manoeuvring room has decreased, and there is a risk that the IMF will tire of Ukraine's unwillingness to carry out reforms according to the terms of its stand-by arrangement (approved in summer 2010 but frozen since September 2011) and end cooperation. Our assessment is still that if needed, Ukraine will agree to further cuts in gas subsidies (i.e. raise gas prices), an IMF requirement for resuming loans. But in the immediate future, the government will continue to walk a fine tightrope, hoping to avoid reforms that may further weaken its voter support before the autumn parliamentary election.

Central bank reserves fell for the fifth straight month in January and are down nearly 20 per cent since August. Although the trend is not as serious as in 2008, it is worrisome (the development is both due to the defence of the exchange rate and valuation effects). The central bank's foreign currency reserve will continue to shrink this year as the bank continues to defend its currency peg against the USD, and due to the growing current account deficit. We believe that depreciation pressure will be less in the immediate future than a few months ago, while the need for external financing will remain large. Our main scenario is that the **hryvnia will stay at UAH 8 per USD in 2012 and 2013**. The central bank's key interest rate has been 7.75 per cent since August 2010. Rising inflation from the second half of the year and pressure on the currency might justify a rate hike, but international uncertainty and falling growth are counter-arguments. We expect the key rate to be unchanged throughout our forecast period.

CDS and interbank rates

Basis points, per cent



Source: Reuters EcoWin

Our overall assessment remains that the government will try to muddle through on many fronts in the near future. Meanwhile it will keep trying to reach a new gas agreement with Russia and bring down gas prices, thereby improving government finances and Ukraine's current account. This, in turn, would simplify gas subsidy cuts from a political perspective and open the way to a continued IMF agreement. If this wishful scenario materialises, it would resolve a number of outstanding issues and increase the government's manoeuvring room.

The domestic political situation remains complicated as the October 2012 parliamentary election draws near. President Viktor Yanukovich's ruling Party of Regions has lost support (scoring about 14 per cent in December 2011 opinion polls, compared to nearly 40 per cent a year and a half earlier) and the president recently replaced the finance minister. He is unlikely to implement any unpopular reforms before the election. In addition, the budget deficit – though smaller than expected – will block large-scale stimulus programmes. Instead, we expect a slight tightening policy that might be larger than expected and hurt households more if the country needs to get the IMF agreement on track. The public sector deficit will fall somewhat in 2012 and 2013 to 2 per cent of GDP. Public debt will stabilise at around 40 per cent of GDP.

Free trade negotiations with the EU were completed late in 2011, but the EU has not signed the agreement and has said it will not ratify it until Ukraine shows it is moving towards greater democracy and judicial reforms, which include revisiting the verdicts against former Prime Minister Yulia Timoshenko. We expect no immediate progress on these issues, but if Ukraine's problems should worsen, a rapid shift in direction may occur.

Key economic data

ESTONIA

	2006	2007	2008	2009	2010	2011(f)	2012(f)	2013(f)
GDP, %	10.1	7.5	-3.7	-14.3	2.3	7.6	1.5	2.5
Inflation, HICP, average, %	4.4	6.7	10.6	0.2	2.7	5.1	4.0	5.0
Unemployment, %	5.9	4.7	5.6	13.9	17.0	12.6	14.0	15.0
Current account, % of GDP	-15.3	-15.9	-9.7	3.7	3.6	3.2	1.0	0.5
Public sector financial balance, % of GDP	2.4	2.4	-2.9	-2.0	0.2	0,3	-3.0	-2.0
Public sector debt, % of GDP	4.4	3.7	4.5	7.2	6.7	6.0	6.5	7.0
3-month interest rate, end of period	3.8	7.2	7.8	3.3	1.1	1.4	1.5	1.5

LATVIA

	2006	2007	2008	2009	2010	2011(f)	2012(f)	2013(f)
GDP, %	11.2	9.6	-3.3	-17.7	-0.3	5.5	2.5	4.0
Inflation, HICP, average, %	6.6	10.1	15.3	3.3	-1.2	4.2	2.5	2.1
Unemployment, %	6.8	6.1	7.5	16.9	18.7	15.4	13.6	12.1
Current account, % of GDP	-22.6	-22.4	-13.1	8.6	3.0	-1.2	-2.7	-4.0
Public sector financial balance, % of GDP	-0.5	-0.3	-4.2	-9.6	-7.6	-4.1	-2.4	-1.6
Public sector debt, % of GDP	10.7	9.0	19.7	36.7	44.7	43.8	42.9	40.8
EUR/LVL, end of period	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7
Key rate, eop	5.0	6.5	6.0	4.0	3.5	3.5	3.5	3.5

LITHUANIA

	2006	2007	2008	2009	2010	2011(f)	2012 (f)	2013(f)
GDP, %	7.8	9.8	2.9	-14.8	1.4	5.9	2.0	3.0
Inflation, HICP, average, %	3.8	5.8	11.1	4.2	1.2	4.1	2.5	3.0
Unemployment, %	5.6	4.3	5.8	13.7	17.8	15.4	14.0	12.0
Current account, % of GDP	-10.6	-14.5	-13.0	4.3	1.5	-3.0	-3.0	-4.0
Public sector financial balance, % of GDP	-0.4	-1.0	-3.3	-9.5	-7.0	-6.0	-3.5	-2.9
Public sector debt, % of GDP	17.9	16.8	15.5	29.4	38.0	39.0	41.0	42.0
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	3.79	6.65	9.89	3.90	1.50	1.66	1.20	1.35
5-year government bond, eop	3.90	4.80	13.10	6.60	4.60	5.40	4.40	4.70

(f) = forecast

POLAND

	2006	2007	2008	2009	2010	2011(f)	2012(f)	2013(f)
GDP, %	6.2	6.8	5.1	1.6	3.9	4.3	3.0	3.6
Inflation, HICP, average, %	1.3	2.6	4.2	4.0	2.7	3.9	3.8	2.8
Unemployment, %	13.9	9.6	7.1	8.2	9.6	9.7	11.5	11.3
Current account, % of GDP	-3.8	-6.2	-6.6	-4.0	-4.5	-4.1	-4.6	-4.2
Public sector financial balance, % of GDP	-3.6	-1.9	-3.7	-7.3	-7,9	-5.5	-3.3	-3.0
Public sector debt, % of GDP	47.7	45.0	47.1	50.9	55.0	54.9	54.5	54.0
EUR/PLN, end of period	3.8	3.6	4.1	4.1	4.0	4.5	4.0	3.8
Key rate, eop	4.00	5.25	4.00	3.50	3.75	4.50	4.00	4.00
5-year government bond, eop	4.98	6.13	5.34	5.91	5.52	5.34	4.60	5.00

RUSSIA

	2006	2007	2008	2009	2010	2011(f)	2012(f)	2013(f)
GDP, %	8.2	8.5	5.2	-7.8	4.0	4.3	3.8	4.1
Inflation, average %	9.7	9.0	14.1	11.7	6.9	8.5	5.0	6.0
Unemployment, %	7.2	6.1	6.4	8.4	7.5	6.6	6.4	6.4
Current account, % of GDP	9.5	5.9	6.2	4.1	4.8	5.5	3.6	2.3
Public sector financial balance, % of GDP	8.1	6.0	4.9	-6.3	-3.5	-1.0	-2.0	-1.5
Public sector debt, % of GDP	9.0	8.5	7.9	11.0	11.7	12.0	13.0	13.0
USD/RUB, end of period	26.32	24.57	30.53	30.31	30.57	32.19	29.33	29.30
Rouble vs. euro/dollar basket, eop	30.1	29.7	35.4	36.1	35.2	36.5	32.8	31.9

UKRAINE

	2006	2007	2008	2009	2010	2011(f)	2012(f)	2013(f)
GDP, %	7.4	7.6	2.3	-14.8	4.2	5.2	3.2	4.2
Inflation, average, %	9.1	12.8	25.2	15.9	9.4	8.0	7.0	8.0
Unemployment, %	6.8	6.4	6.4	8.8	8.1	7.8	7.8	7.7
Current account, % of GDP	-1.5	-3.7	-7.1	-1.5	-2.1	-3.9	-4.5	-4.5
Public sector financial balance, % of GDP	-1.4	-2.0	-3.2	-6.3	-5.7	-2.8	-2.5	-2.0
Public sector debt, % of GDP	14.8	12.3	20.5	35.4	40.1	39.5	39.0	39.0
USD/UAH, end of period	5.05	5.05	7.80	8.00	7.97	8.00	8.00	8.00

(f) = forecast

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SEMB0087 2012.03