Eastern European Outlook

Economic Research – October 2012

Russia and Poland in a slump but show decent resilience to global crisis

Theme: Competitiveness in the Baltics

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Summary

In 2013-2014, regional heavyweights Russia and Poland will continue to cope with the international crisis better than many other countries in Eastern (including Central) Europe, especially central and southern portions of the region, where several economies will recover only slowly from their current stagnation/recession. But growth will be modest, ca 4 per cent and 3-4 per cent respectively, and Poland is losing its regional "star performer" status of recent years. In the Baltics, rising domestic demand and competitive exports contributes to GDP growth reaching potential rate at ca 4 per cent per year 2013-2014. Latvia, previously the most severely crisis-hit of the Baltics, will show the strongest, most uniform growth in 2012-2014.

Because of moderate export dependence, modest public sector debt and small or moderate dependence on bank financing via the crisis-plagued euro zone, Russia and Poland can show decent resilience to the weak performance of the global economy. But even Russia and Poland are feeling the effects of the deceleration, especially in Western Europe. Since last spring, their economic slump has been somewhat deeper than expected: in Russia due to sagging exports, in Poland because of slowing consumption and capital spending. We expect their slump to be temporary, however. During 2013, Russian growth will speed up again due to continued high oil prices and good consumption growth, while Polish domestic demand will be sustained by falling inflation and sharply declining interest rates in recent months, which will soon be reinforced when the central bank begins to lower its key interest rate.

In the **Baltics**, the export-driven economic downturn will be softened by continued decent domestic demand. Capital spending is benefiting from increased construction, although this is still lagging in Lithuania, and from the fact that the three countries will be using EU funds for infrastructure projects. Consumption will be fuelled by faster wage and salary growth and gradual labour market improvements, although the ongoing gradual decline in high unemployment will be somewhat sluggish in the coming year. Exports will gradually recover. Internal devaluations in the form of wage and price cuts during 2008-2010 were large enough to restore competitiveness. In recent years, all three Baltic countries have regained previously lost export market shares. They are also performing decently in competition with the EU's seven other Eastern European economies, although Latvia ends up in last place in terms of its export performance during 2005-2011. We believe that the export competitiveness of the Baltics will remain good, but with a warning of a possible slower trend in Estonia, which already stands out because of its relatively high pay increases and inflation.

Ukraine's growth has decelerated harder than expected, mainly because lower steel prices have hurt exports and political uncertainty has held back investments. The economy will recover slowly over the next couple of years, sustained by consumption and because exports will be fuelled by devaluation; we predict that the hryvnia will be devalued by at least 10 per cent in the months following the October 28 parliamentary election. We expect Ukraine to continue balancing between Russia and the EU in terms of political and economic integration.

As for **euro zone membership timetables**, we continue to predict that **Latvia** will meet the Maastricht criteria and can thus adopt the euro **in 2014 as planned**. Lithuania is in somewhat worse shape than Latvia with regard to economic convergence. Political uncertainty there is also greater; a change of government is expected after the October 14 election. The current government's 2014 target is unsustainable and **Lithuania** will probably join the euro zone **later than 2015**. **Poland** has no explicit target date for euro zone accession; today **2016 appears to be the earliest likely target date**.

Continued weakness despite huge monetary stimulus

- **No real global recovery until 2014**
- **Zero growth in the euro zone during 2013**
- **The euro will again weaken noticeably**

The world economy has slowed further in the past two quarters, in a more synchronised way than before. Although the United States has shown signs of stabilisation – largely because cyclically depressed housing and construction markets have begun to recover and household deleveraging has come a long way – growth is below trend. In Western Europe, German growth has begun to wane. In the third quarter, the euro zone seems to have entered a recession: two consecutive quarters of falling GDP. Asian economies have continued to slow. In China, we have long foreseen a soft landing, which can continue with the help of economic stimulus, but in India the slowdown will be unexpectedly abrupt. Eastern (including Central) Europe shows continued divergence. Russia and Poland are coping noticeably better with the international crisis than central and southern portions of the region, where several countries are experiencing economic stagnation or reversals and indicators point at continued weak performance in the year ahead.

Forward-looking indicators show no imminent global turnaround. Although purchasing managers' indices in many countries have stabilised in recent months, with few exceptions they remain a bit below their expansion threshold of 50. This autumn will probably see continued weakness, without large movements in indicators. Short-term optimism and demand – especially corporate capital spending – will be hampered by political uncertainty on both sides of the Atlantic, mainly related to the euro zone crisis, but also the outcome of the US presidential election and fiscal policy decisions. A long-term action plan to strengthen US federal finances must be unveiled before the end of 2012 to avoid drastic automatic tightening. We predict a last-minute Democratic-Republican compromise.

Weak growth in major OECD economies is not yet self-perpetuating. Necessary debt consolidation is hobbling fiscal policy. Germany has room for stimulus but it is unclear whether the government will enact it, so **central banks must take responsibility** for stimulating demand as much as possible and sustaining financial risk appetite. They have the flexibility to do so, given large idle economic resources; rising unemployment in many countries this coming year will also lead to continued low core inflation. Since the summer, major central banks have initiated a new round of extensive quantitative easing. The European Central Bank has also cut key interest rates – its deposit rate is zero – and announced that it may soon resume buying sovereign debt from crisis-hit euro zone countries. **Ultra-loose monetary policy** in major OECD countries **will probably continue** over the next two years. We expect central bank liquidity injections and low interest rates to prop up fragile risk appetite in financial markets but to generate no major positive near-term impact on the real economy, since fundamental uncertainty is a major factor holding back demand.

In both OECD and emerging economies, growth will bottom out early in 2013, then slowly improve; it will be another year of below-trend OECD growth. **Only in 2014 will growth normalise in the OECD countries and the world**; we expect global growth of 4.1 per cent, just above the 3.75-4 per cent trend. The euro zone will be squeezed by painful austerity in crisis-hit countries and uncertainty about the survival of the euro system. We predict that it will survive, but there is a lingering risk that Greece will abandon the common currency. After this year's recession, **we expect zero growth in the euro zone next year** and modest growth in 2014. We still assume that **Germany will avoid recession** and show decent growth: 1.0 per cent in 2013 and 1.5 per cent in 2014. Positive growth in Germany is also important to Eastern Europe, especially Central European countries like Poland, Slovakia, the Czech Republic and Hungary that sell up to 20-30 per cent of exports to Germany.

Global key data

GDP, year-on-year percentage change

	2011	2012	2013	2014
United States	1.8	2.2	2.2	2.6
Euro zone	1.5	-0.4	0.2	0.9
The world	3.9	3.3	3.6	4.1
Oil, USD/barrel	112.3	111.8	110.0	115.0
EUR/USD, Dec	1.29	1.28	1.18	1.15

Source: SEB

After declining since 2011, the euro has rebounded in recent months from about USD 1.20 to 1.29. This recovery began in late July when ECB President Mario Draghi said his bank would do whatever it takes to save the euro. The Federal Reserve's September launch of a third round of quantitative easing (QE3) helped solidify the euro's upturn against the USD. **The euro will depreciate again later** to USD 1.18 at the end of 2013 and 1.15 in December 2014 due to fundamentals: crisis-plagued euro zone countries must improve their competitiveness, and we do not expect all of this to occur via wage and salary cuts. In addition, US growth will recover before that of the euro zone. **Oil prices will remain at current relatively high levels** (USD 110-115/barrel for Brent) over the next couple of years. Middle Eastern instability and a gradual recovery in China's growth and the world economy generally will keep oil prices up.

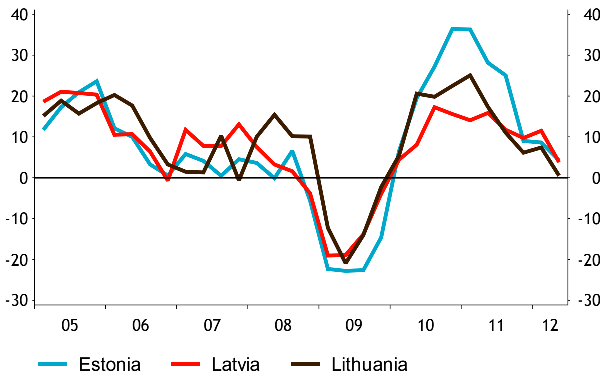
Exports competitive again after internal devaluations

- **Lost market shares have been regained**
- **Latvia the weakest EU economy in the East**
- **Modest pay growth, but higher in Estonia**

Because of an **export boom** during 2010-2011, the **three Baltic countries bounced back** after their earlier depression. The upturn was driven by a recovery in external demand after the global recession of 2009 but was also **further fuelled by internal devaluations**. According to official figures, average monthly wages and salaries in Estonia and Lithuania were lowered by a total of 12 per cent and in Latvia by 19 per cent, all counting from their peaks during 2008 until the adjustment ended in early 2010. This repaired their competitiveness, which had been undermined by earlier economic overheating.

Exports, constant prices

Year-on-year percentage change



Source: National statistical offices

Pay levels surged during economically overheated 2004-2008 by an average of 16 per cent in Estonia and Lithuania and 20 per cent in Latvia. The rate of increases in Latvia was nearly 35 per cent in 2007, which then helped drive up average inflation to 15.3 per cent in 2008. The three countries applied a strategy of interrupting this unsustainable trend and correcting severe imbalances using **internal devaluations**: by lowering wages and prices instead of devaluating their currencies, then all pegged to the euro. Estonia joined the euro zone in 2011. This strategy was **logical given their economic maladies**.

Current account deficits in the Baltics exploded to 14-22 per cent of GDP in 2006-2007 (compared to then-sustainable levels of around 6-7 per cent). This was not primarily a sign of poor export competitiveness, but of strong, partly credit-driven domestic demand that fuelled imports. Devaluing their currencies when businesses and household had some 70-90 per cent of their loans in foreign currencies (mainly euros) might also have created chaos, pushing up inflation substantially from already high levels. In addition, external demand was anaemic, decreasing the three countries' prospects of kick-starting exports via devaluations.

But in the past year, their export boom has faded – most dramatically in Estonia, where the export surge peaked at nearly 40 per cent in one a year. During the second quarter of 2012, year-on-year export growth had subsided to a modest 4 per cent in Estonia and Latvia and close to zero in Lithuania, where it was further reduced by a planned production shut-down at the country's export-intensive oil refinery.

Is this shift from export strength to weakness partly an indication that the Baltics should have slashed wages and salaries even further in 2008-2010? No, **the reason for the deceleration is a sharp new international downturn, especially in Western Europe**. Our view remains that the earlier cost adjustment in the Baltics was sufficient.

During the past 2-3 years, all three Baltic countries have also **regained lost export market shares**: especially Estonia, but Lithuania too can show substantial export success in 2010-2011. This is clear from European Commission data (see the table below).

We have also compiled data on the **export performance of the ten EU countries in Central and Eastern Europe** during 2005-2012 (see the next table). Viewed over this longer period, **Estonia and Lithuania show decent competitiveness**, while **Latvia comes out worse**. Bulgaria and Hungary are at the top. Estonia shares third place with the Czech Republic and Romania, all with a 3.7 per cent average change in market shares. Lithuania is not far behind with 3.2 per cent but ends up at number seven. Latvia is at the bottom, with 1.3 per cent.

Changes in export market shares

Year-on-year percentage change

	2005	2006	2007	2008	2009	2010	2011	2012
Estonia	8.1	-3.0	-5.2	-1.1	-1.1	11.8	16.1	-2.3
Latvia	10.2	-4.7	1.0	-1.7	3.5	-0.9	2.0	0.6
Lithuania	6.8	0.0	-7.2	8.7	4.9	5.5	3.6	0.3

Source: European Commission, spring forecast, 2012

Change in export market shares
Annual averages, 2005-2011, in per cent

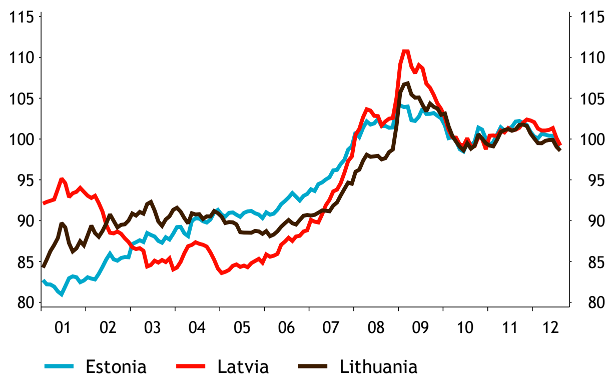
Bulgaria	7.3	Lithuania	3.2
Hungary	4.1	Poland	2.4
Estonia	3.7	Slovenia	1.5
Romania	3.7	Latvia	1.3
Czech Republic	3.7	*Euro zone*	-0.2
Slovakia	3.3		

Source: European Commission spring forecast 2012

We believe that the export competitiveness of the Baltics will remain good – but with a **warning of a possible slower trend in Estonia**.

One measure of competitiveness is the real effective exchange rate, in which an increase means poorer competitiveness. Real effective exchange rates (calculated based on CPI and with comparisons with trends in 58 economies) have been comparatively stable in all three Baltic countries since they implemented their active downward cost adjustment. During 2009-2010, the exchange rate in Latvia depreciated by about 11 per cent, in Lithuania about 7 per cent and in Estonia about 6 per cent. These currencies later appreciated by only a couple of per cent until the end of 2011. During 2012 the trend was downward for all their currencies. As a result, **today's real effective exchange** rate is practically **unchanged** compared to their lows **after the cost adjustment**.

Real effective exchange rate
Index 100 = 2005

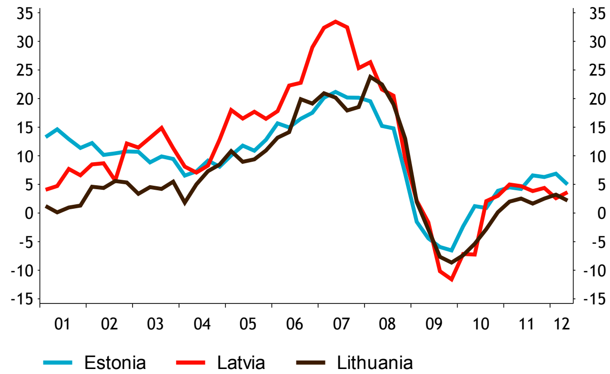


Source: BIS

The declining euro since late 2011 has helped lower the real effective exchange rates in the Baltics; and given our forecast of renewed euro depreciation, after a slight rebound during the second half of 2012 this factor will remain in place for the foreseeable future. But **the fundamental reason for the relatively calm, stable exchange rate trend has been a deceleration in wage and salary growth**, which is thus not causing any cost surges. During the first half of this year, wages and salaries grew by a modest 2.7 per cent year-on-year in Lithuania and 3.1 per cent in Latvia. Estonia was the exception, with relatively high pay growth of 6 per cent plus a persistent, relatively high inflation of about 4 per cent. Our forecast for the coming year is that Latvia and Lithuania will continue to show modest wage and salary growth and that Estonia's relatively rapid pace will increase slightly further to 7-8 per cent.

Estonia's pay growth is a bit worrisome, both because of its actual speed and because wage and salaries rose relatively fast last year even though there was a lot of slack in the economy. Estonia's current unemployment of about 10 per cent is also probably only a couple of per cent above the level that can be described as structural. If its pay growth get stuck close to 8 per cent, long term productivity growth will be exceeded. If so, Estonia risks a resumption of cost pressures and resulting competitiveness problems.

Wages
Year-on-year percentage change



Source: National statistical offices

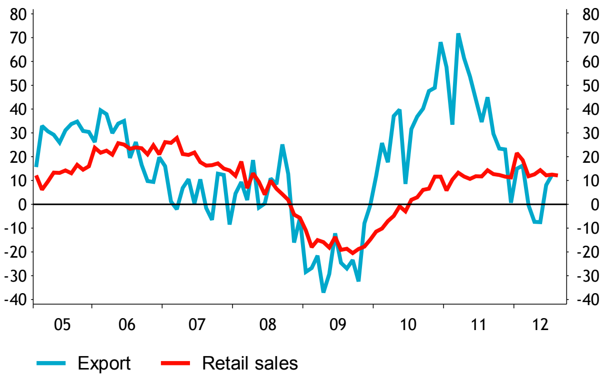
Domestic demand is sustaining GDP growth

- **Stable sentiment indicators**
- **Deleveraging process is ending**
- **Elevated inflation persists**

During the first half of 2012, the economy continued to slow due to a weakening of export demand. This is because the **euro zone crisis spread into Estonian export markets**. Exports constitute as much as nearly ¾ of GDP. **Domestic demand has sustained growth.** This has led to a slightly widening current account deficit, but since it is only 2 per cent of GDP the economy is still relatively balanced. Earlier correction of underlying imbalances has laid the foundation for sustainable growth. Vulnerability to fluctuations in external financing has decreased and competitiveness has been restored through labour costs adjustments.

Retail sales and export growth

Current prices, year-on-year percentage change



Source: Reuters EcoWin

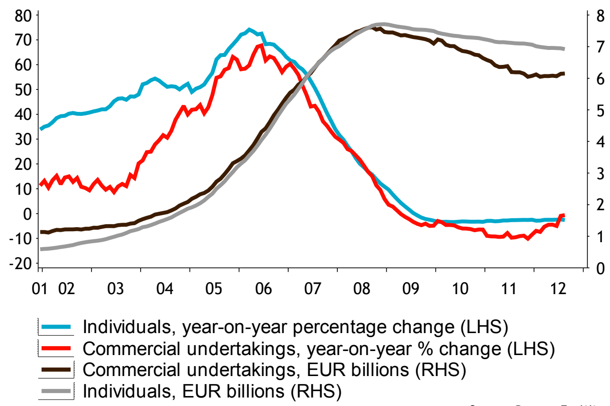
Although the future of the euro zone looks uncertain, enterprises and households feel more confident towards the future. Since last spring economic **sentiment indicators have remained relatively stable**, compared to sharply deteriorating sentiment in Western Europe. There is a reason behind this – economic corrections have taken place here, while in most Western economies they are still ongoing. Most heavily affected are external demand-related sectors like manufacturing and transportation, but their forward-looking sentiment indicators have remained stable.

External demand does not favour an economic take-off at Estonia's usual recovery rates. But domestic demand is capable of sustaining modest growth in the next couple of years. **GDP growth** is expected to **bottom out in the third quarter of 2012** and **increase by an average 2.5 per cent in 2012 and by 3.3 and 4.0 per cent, respectively, in 2013-2014**. Medium-term growth potential will be determined by internal resources, since the external environment will remain relatively challenged. Our assessment is that **sustainable growth is around 4 per cent**, clearly lower than the 6-7 per cent that has sometimes prevailed in potential terms in the past. Extensive emigration and slower, more sustainable, anticipated credit growth have lowered the potential growth rate.

Weak demand is the main constraint to export growth, while **export competitiveness remains good**. Competitiveness has improved even further due to the falling euro since 2011; and we expect the euro appreciation during the second quarter to have been temporary. Export growth potential has been enhanced by the gradual opening of the Russian market, due to WTO accession. Recently Russia's share of Estonian exports has rapidly increased, approaching that of Sweden and Finland, the two largest markets. This is largely due to Russian transit trade. While improving export prospects in Russia will offset sluggishness in Nordic markets, there is a risk that the euro zone crisis may cause more long-term export weakness. This is one reason why we have trimmed our GDP growth forecast for 2014 to 4 per cent from the 4.9 per cent in the August 2012 issue of *Nordic Outlook*.

Deleveraging among companies **stopped** during 2011 and since April 2012 there have been initial signs that it has ended also among households. Though we would not expect any new lending spree any time soon, the downward influence of deleveraging will not be there anymore. New lending to households will be constrained by the still huge debt burdens of private individuals despite past deleveraging, and the fact that most real estate loans still exceed the value of the underlying properties. On the other hand, mortgage interest rates are the lowest ever and attractive for new borrowers. But interest rates are not attractive enough for refinancing of existing mortgages. Also the affordability of properties is attractive. But despite these favourable circumstances, constraining factors will predominate.

Private sector loans deleverage



Source: Reuters EcoWin

In the construction sector, volume growth is above 30 per cent, and one might suspect a new housing boom. That is not the case, however. **The construction boom is temporary**, lasting until mid-2013, and is actually a renovation boom, at least as far as residential properties are concerned. The renovation of housing stock is aimed at improving energy efficiency and is financed by government proceeds of CO_2 quota sales. At the same time, infrastructure construction is continuing at rapid pace, supported by grants from abroad. Nearly half of GDP growth came from the construction sector in the first half of 2012. This growth will not be sustainable throughout 2013, when CO_2 revenues will vanish and investments will contribute negatively to GDP growth.

Looking at demand, economic growth has been overwhelmingly driven by capital spending in the past year. In the second quarter, it was nearly the sole contributor to GDP growth, while other demand sources had faded away. Even the role of consumption weakened by half. Net exports have been negative for over a year.

Capital spending will contribute negatively to GDP in 2013 and the main growth driver will be consumption. In the light of the second quarter slowdown and fading export revenues, the question is how much Estonia can rely on continued consumption growth. Despite the obvious spill-over effect from exports, **several factors indicate growing private consumption in 2013**. In 2011, consumption mainly rose because of rapidly recovering employment, while real wage rises were almost non-existent. During the first half of 2012, both employment growth and modest real wage increases kept consumption going. Going forward, consumption will hinge more on real wage growth, while job creation will slow down.

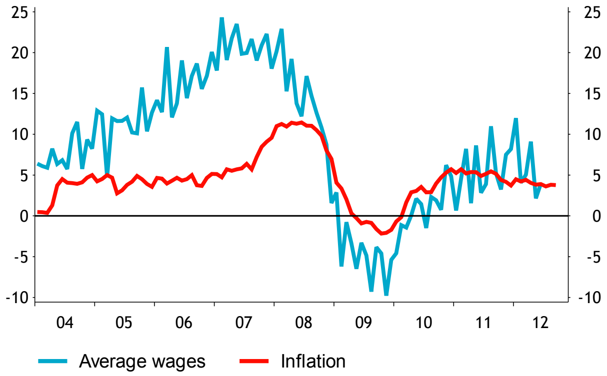
Growing wage pressure has been emerging after Estonia's belt-tightening crisis years, when some wages already have reverted to pre-crisis levels. Especially strong wage pressure is emerging in the public sector, which is lagging the private sector. Several public sector wage agreements have been negotiated for 2013, among them an across-the-board increase of 4 per cent and 3-6 per cent pay hikes for medical sector workers. But the gaps between demands and promised hikes are still enormous. Teachers' wage increases are still in the pipeline. Currently there is still room for wage increases, as a delayed response to the remarkably improved profits of companies. On the negative side, productivity growth has dropped to zero, which might constrain wage growth acceleration in the second half of 2012. Our wage growth forecast for 2013 is 7-8 percent.

Despite unemployment of a relatively high 10.2 per cent in the second quarter of 2012, down from 13.3 per cent one year ago, further decreases are expected to be slower. The limits of structural employment are approaching, and there is a persistent shortage of skilled labour in most sectors. Therefore, wage pressure starts even at rather high unemployment levels, that we excpect will fall only marginally.

Although **wage increases** have been above 5 per cent in the first half, most of these gains have been eroded by relatively high inflation, around 4 per cent. Persistent inflation is another factor behind growing pay demands, especially among low-wage occupations; many Estonian are finding employment abroad, and the growing labour shortage will help fuel wage increases.

Inflation and wages

Year-on-year percentage change

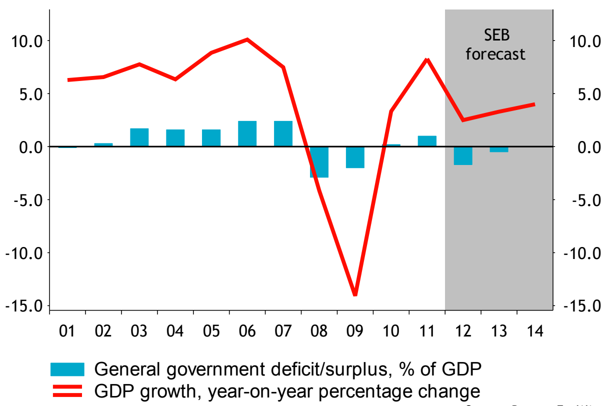


Source: Reuters EcoWin

Inflation pressure will not fade away in the next couple of years, partly due to relatively high wage growth and expanding money supply; the latter is a sensitive factor for inflation in Estonia. Especially 2013 is a major inflation concern, since the electricity market will open up to competition and major market players have announced price increases of up to 68 per cent from January 2013. This will affect inflation on a broader front and is a negative factor for the consumption outlook in 2013. We expect inflation to average 4.3 per cent in 2013.

Untypically for Estonia, **fiscal policy is actually counter-cyclical** this time around. The slowdown in the international economy has been counteracted by a vast amount of government investments in 2012, which have helped sustain growth. In 2013 there will also be increases in social benefits. Pensions will rise by 5 per cent, and unemployment insurance tax will decrease, adding to real wages. These factors will also support consumption. We expect small general government budget deficits in the years to come.

GDP and budget balance



Source: Reuters EcoWin

On the political front there is remarkable stability. The right-wing government parties enjoy growing popularity. The ruling parties are the same as during the crisis, and it will be even easier now for them to gain in popularity now that the economy has returned to growth. But the government is still pursuing a better medium-term budget balance and public expenditures will increase only moderately. The next general election is scheduled in March 2015.

Criteria for euro adoption in 2014 well within reach

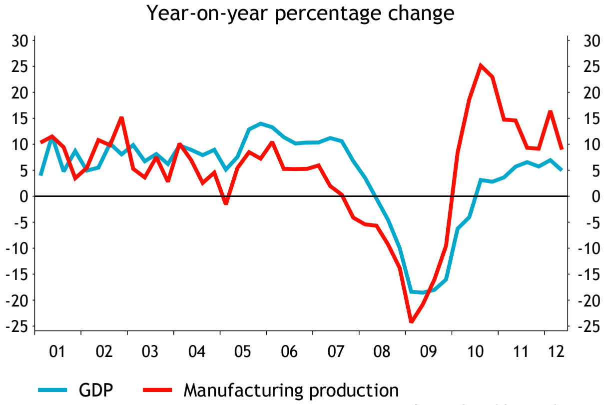
- **Remarkable growth will fade in short term**
- **Domestic demand will sustain growth**
- **Structural unemployment challenges**

During the **first half of 2012**, Latvia produced **respectable year-on-year growth of 5.9 per cent**. This was maintained both by retail sales and manufacturing, despite a clear slowdown in export growth. A solid increase in transport, communication and tourism activity was also noted. Construction continued to recover. In the second quarter, hefty private final consumption and capital investments were the main sources of growth.

Future economic prospects are closely tied to the euro zone, and the global economic deceleration is becoming more apparent. We expect a Latvian slowdown from recent highs during the second half, and then a gradual pick-up next year. Late in 2012 there will be extra uncertainty about the euro zone crisis, especially in Spain and Greece. Still, **strong Latvian domestic demand, combined with fairly good performance in manufacturing and exports so far**, allow us to look ahead with a certain amount of optimism. An important factor for maintaining economic growth is the availability of financing. In this respect Latvia has an advantage compared to many other Eastern European countries. Furthermore, some additional growth opportunities will be opened due to Russia's membership in the World Trade Organisation. All in all, we expect **GDP growth of 4.5 per cent in 2012, and 3.6 and 4.5 per cent, respectively, in the subsequent two years**. We have adjusted our 2012 forecast upward from 3.5 per cent in the August issue of *Nordic Outlook* and our forecast for 2013 downward from 4.0 per cent.

GDP and manufacturing

Year-on-year percentage change



Source: Central Statistical Bureau

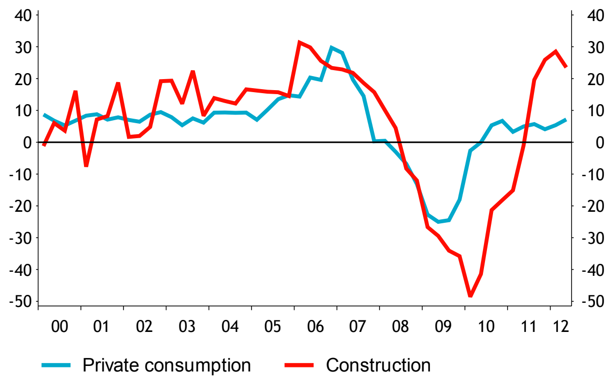
Despite bleak global demand, Latvia is **one of the few countries with continued industrial growth**, though its pace is likely to slow. Thus, the volume of industrial production in the first seven months was up by 6.4 per cent year-on-year. Growth in manufacturing was higher, at 10.4 per cent. It should be noted that individual industries demonstrate quite volatile performance, which may be explained by seasonal factors and order schedules. However, it will not be possible to completely avoid a decrease in the pace of growth if the global slowdown continues. At the same time, the current turmoil provides new opportunities for niche players such as Latvia. In the second half of the year, greater differences in the dynamics of various sectors may be observed.

Construction continued to **grow vigorously** during the second quarter, demonstrating the fastest recovery among economic sectors: volume increased by 23.5 per cent year-on-year. Construction of residential buildings grew by 45.8 per cent. The possible role of the construction sector in ensuring future economic activity is evidenced by the increase in construction permits. We may thus expect the construction sector to contribute more to overall GDP in the short term, despite a slowdown in construction growth.

During first seven months of the year, **retail sales were up by 9.8 per cent** in volume compared to the same period of 2011. Households and tourists continued their active spending. There is still longer-term uncertainty, since there is a preference for immediate consumption while paying little attention to saving and refusing new long-term liabilities. In general there are no conditions for maintaining the existing pace of growth.

Private consumption and construction

Year-on-year percentage change



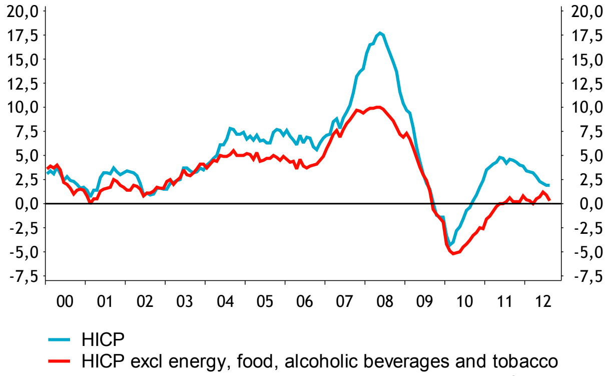
Source: Central Statistical Bureau

Due to the financial problems in southern Europe and more nearby political factors, Latvia is experiencing a rapid and relatively large increase in non-residential capital inflows. Part of this is repatriated capital that was sent abroad during the economic crises. That is boosting economic activity but may level out or decrease if external circumstances change.

As could be expected, GDP growth during the second quarter continued to push down unemployment, though not convincingly. The jobless rate dropped to 16.1 per cent in the second quarter compared to 16.3 per cent in the first quarter. The earlier recovery is also reflected in the many individuals who have returned to the labour market, increasing the number of economically active residents and the level of employment. However, lack of hope is still keeping some 25,000 persons on the sidelines. Just over half of all jobless individuals are long-term unemployed, which shows that only a few people in this category can find a job without help. Unemployment will continue to decrease in the third quarter, while in the fourth quarter this positive trend may stop. **Without an active employment policy, improvements on the labour market will be sluggish.** Well-designed efforts to mobilise manpower across Latvia should be continued, and retraining opportunities should be provided.

Inflation

Year-on-year percentage change



Source: Eurostat

In the second quarter of 2012, average monthly wages were up by 3.7 per cent year-on-year. Public sector pay rose by 4.6 per cent while in the private sector the increase was 3.4 per cent. The private sector is recovering and is able to reverse some of the cuts that were imposed during the downturn. A review of public sector pay has also been started, due to growing pressure from employees. The influence of the public sector on the general level of wages and salaries will increase. During the second half of 2012, **wage growth** may accelerate slightly, but mid-term growth will remain a **moderate 4-5 per cent**.

Purchasing power will increase in the near future, but the pace will remain moderate. This will be assisted by **low inflation**, though risks of higher food and fuel prices remain, and by a one percentage point cut in the private income tax rate. In August, the year-on-year inflation had fallen to 1.7 per cent. At the same time, 12-month average inflation fell to 3.1 per cent, which is close to fulfilling the Maastricht criterion for euro zone accession. In coming months it will fall below the benchmark and stabilise; the EU's evaluation period will be the latest available twelve month average inflation, probably March 2012-March 2013. Looking ahead, inflation will continue to be subject to global processes; rapid new increases in food and energy prices may endanger euro adoption. However, our base scenario is that **Latvia will meet the inflation criterion**. Our forecast is that average inflation will be 2.5 per cent in 2012 and 2.3 per cent in 2013.

Owing to better than expected growth, public sector revenues are surpassing forecasts. The general government budget showed a LVL 330.1 million surplus after the first eight months. This was one reason why in September, Latvia repaid the IMF LVL 152 million ahead of schedule. The government will probably end the year with a smaller deficit than forecasted.

On December 21, 2011, Latvia officially ended its three-year international loan programme. The planned amount of the programme was EUR 7.5 billion, of which Latvia used EUR 4.4 billion which has to be repaid by 2025. The Treasury now holds some LVL 1.1 billion in its account, allowing room for manoeuvre. **Latvia is on its way towards a balanced budget**. On September 25, the government approved the draft national budget for the next year. For the first time a bill on a medium-term budget framework has been prepared for 2013-2015, setting the main macroeconomic and financial indicators for each year, establishing budget goals and setting maximum expenditures for the whole budget and each institution. The planned deficit for 2013 is 1.4 per cent of GDP, shrinking to a 0.3 per cent deficit in 2015. We expect that due to a successful revenue trend this year, the deficit will be 1.2 per cent of GDP, well below Maastricht's 3 per cent limit.

Latvia is **continuing to move towards joining the euro zone as planned in 2014** and preparations for the currency changeover are under way. Meanwhile public support for the euro adoption has fallen to a record low (13 per cent), equivalent to the level reached in early 2004. According to EU procedures, the European Commission and the European Central Bank will evaluate whether Latvia meets the convergence criteria in April of 2013. For a long time, we have predicted that Latvia will meet the numerical criteria and convert to the euro in 2014. But this assumes that the EU side does not throw any obstacles in the way; **Latvia must also receive EC/ECB certification that the downshift in inflation and the deficit can be viewed as lasting** – which is a more qualitative assessment. The convergence report will be analysed by May 2013. If the report is approved, the Economic and Financial Affairs Council (ECOFIN) will then invite Latvia to join the euro zone. After that, the European Council will make a political decision in June on inviting Latvia to join. In July the ECOFIN will make the final decision on Latvia's accession to the euro zone and fix the lat-euro exchange rate.

Since medium-term inflation risks are limited, in order to push commercial banks towards more lending and thereby soften the negative influence of the debt crisis on the Latvian economy, in September the Bank of Latvia decided to cut its refinancing rate from 3 per cent to 2.5 per cent. The overnight deposit facility rate was cut from 0.1 per cent to 0.05 per cent.

In August the total banking loan portfolio increased for the third month in a row. The main factor in this increasing activity was corporate clients. Household are still under pressure and 16 per cent of them could not service their liabilities. Going forward, demand for household loans is expected to grow only slowly.

Resilient GDP growth but weak capital spending

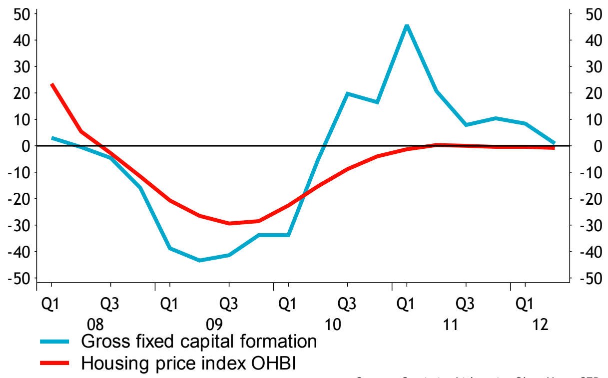
- **Robust exports**
- **Households cautious about spending**
- **Government shift in upcoming election unlikely to threaten public finances**

Despite an unsupportive global environment, Lithuania's economic growth has remained rather firm and healthy. In the first half of 2012, real GDP increased by 3.0 per cent year-on-year. Growth was driven both by exports and consumption. However, fixed investment growth became increasingly weak as macroeconomic uncertainty overshadowed future prospects and reduced business appetite to expand production capacity.

Bearing in mind the latest strong export and industrial trends, we foresee GDP growth accelerating in the second half of 2012 and remaining among the fastest in the European Union. In the fourth quarter, private consumption growth will be hurt by a record-expensive heating season, sluggish wage growth and fragile optimism. **Exports will hold up rather well.** In **2012, we expect a real GDP increase of around 3.5 per cent**. We foresee **4.0 per cent GDP growth both in 2013 and 2014** due to somewhat better export prospects, stronger sentiment and consequent consumption and capital spending increases.

Investment overshadowed by uncertainty

Year-on-year percentage change



Source: Statistics Lithuania, Ober-Haus, SEB

At the beginning of 2011, the capital spending leap was quite spectacular. However, in only a couple of quarters investment growth started decelerating as macroeconomic uncertainty about euro zone prospects strengthened and business expectations turned sour. In the second quarter of 2012, gross fixed capital formation increased by only 0.9 per cent compared to the second quarter of 2011. This **investment shortage** will restrict GDP growth in the near future and some branches of manufacturing (e.g. the textile industry) already complain that production capacity is too low to meet all production orders.

Still, these sectors remain reluctant to invest and prefer to take a wait-and-see approach.

The residential property market is still sleepy. After a price stabilisation in 2011, prices started slowly declining again in 2012. New residential projects are also scarce.

Export growth defied negative trends in the euro zone and even accelerated to as much as 13 per cent in July, year-on-year. Foreign sales were supported by good competitiveness, low wage growth, a favourable trend in the real exchange rate and flexibility on the part of companies in their search for new markets. In some cases, recession in the euro zone countries encouraged them to look for cheaper production alternatives, opening new possibilities for Lithuanian exporters.

Export growth has been broad-based and well diversified, both in terms of the products sold and their destinations. In the first half of 2012, slower growth in demand by euro zone countries was compensated by solid growth in the other Baltic countries and Russia. Exports to Poland and Belarus were adversely affected by a strengthening of the litas against their national currencies. In the second quarter of 2012, export figures suffered due to maintenance and upgrading work at the Orlen Lietuva oil refinery, which caused a temporarily halt at the factory that produces almost 30 per cent of the country's total industrial production.

Consumption lags behind exports

Jan 2006 = 100, constant prices

Source: Statistics Lithuania, SEB

Consumption growth remains subdued. Although retail sales continue rising, it lags behind exports. Among the reasons are household pessimism due to the euro zone crisis and because of the approaching heating season, as well as shopping tourism in Poland, encouraged by lower VAT on food products and a weak Polish zloty. Weak consumer sentiment is encouraging households to save for a rainy day rather than spending. Bank deposits by private individuals have thus continued to set all-time records, despite close-to-zero interest rates. The successful management of the Bankas Snoras bankruptcy at the end of 2011 encouraged people to keep their money in credit institutions, since the deposit insurance scheme had worked perfectly. In 2013, we foresee only weak private sector credit growth at the macro level.

In the first half of 2012, the current account deficit stood at only 2.3 per cent of GDP thanks to strong exports. The trade deficit was even smaller than in the same period of 2011. In line with strengthening domestic demand, the current account deficit should gradually rise in the next couple of years but stay well short of dangerous levels. The **current account deficit** will reach 3 per cent of GDP in 2012, 4 per cent in 2013 and 6 per cent of GDP in 2014 – the latter is **relatively large** but we do not expect it to pose a threat to financing or economic stability.

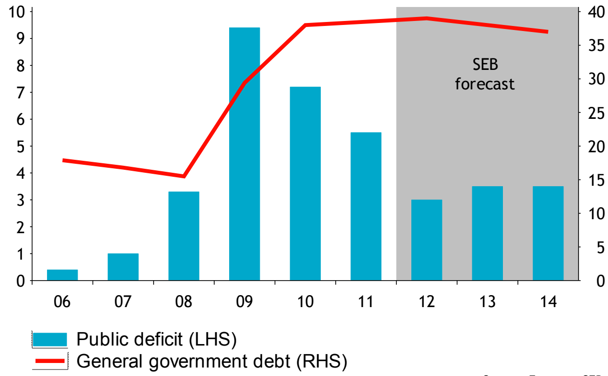
The high unemployment level signals that labour shortages are a problem in only a few sectors. The pressure for increases in wages thus generally remains rather weak. However, unemployment continued to fall, amounting to 13.3 per cent in the second quarter of 2012. Unemployment among young people and men decreased the most notably. **The jobless rate** will **decrease gradually** to an average of 13.5 per cent in 2012, 12 per cent in 2013 and 10.0 per cent in 2014.

Wage growth has been weak and has not exceeded inflation; real wages have therefore declined. Nominal wages and salaries increased by 2.2 per cent in the second quarter of 2012. After 4 years, statutory minimum monthly wages were raised as of August 1, but only from EUR 232 to EUR 246.

Inflation remains almost entirely **driven by external factors**, e.g. international prices of energy resources and agricultural commodities. Despite a record Lithuanian harvest, the increase in global grain prices is pushing up prices in Lithuania. Meanwhile there is no evidence of demand-pull inflation pressures, which might start appearing only in 2013 or 2014. Average annual HICP inflation will reach 3.4 per cent in 2012 and 3.5 per cent both in 2013 and 2014.

Stable public finances ahead

Per cent of GDP



Source: Eurostat, SEB

The most important forthcoming political event in Lithuania is the **parliamentary election and referendum** on construction of a new nuclear power plant, which are scheduled for **October 14**, 2012. The latest opinion polls were more favourable to current opposition parties than to the ruling coalition partners. In September, the Social Democratic Party was favoured by 16.3 per cent of potential voters, the Labour Party 14.5 per cent and the Order and Justice Party 9.5 per cent, while the currently ruling Homeland Union (conservatives) were in fourth place with support from 7.6 per cent of voters.

Although the structure of a likely new government is not clear yet, we predict that fiscal policy will become more relaxed and the public deficit will increase slightly. All major parties share the view that public finances should be kept under control, but the current opposition parties are more sympathetic towards various tax exemptions as well as increases in pensions and the minimum wage level. However, there are contradictions in their election promises (e.g. a sudden increase in the minimum wage and a sharp decrease in unemployment), allowing us to predict that only some of these promises would be put into practice if the opposition parties were elected. Therefore, the **effect of a government shift on public finances is not likely to be dramatic**, whatever parties come to power after the election. Regarding euro zone accession, most of the parties do not put it on their priority list, although the ruling government's target is 2014. There is a rather high likelihood that **Lithuania will join the euro zone later than in 2015**.

Tax revenue collection was satisfactory and slightly exceeded projections in the early months of 2012. In the first half of 2012, the public sector deficit was 4 per cent of GDP, making it difficult to see it dipping below 3 per cent in 2012 as a whole.

Lithuania enjoys continued good access to financing in international financial markets. Long-term yields have declined lately, with the 5-year government yield reaching 3.5 per cent, a record low since March 2006. In September 2012, the country carried out two bond issues worth EUR 167 million in the German market and a CHF 175 million issue in order to accumulate funds ahead of the redemption of EUR 1 billion in euro bonds in March 2013.

Lower interest rates will soften economic slump

- **Fading growth for regional "star performer"**
- **Domestic demand will rebound over time**
- **Continued credit expansion**

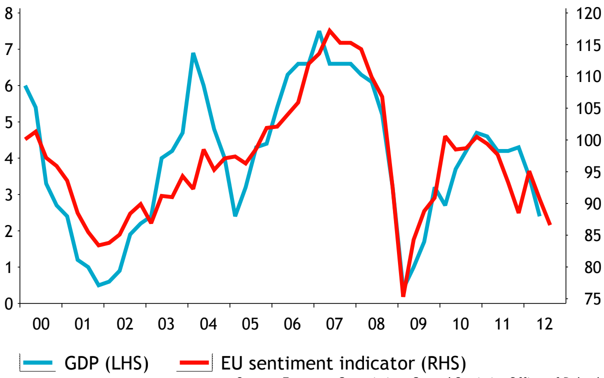
The Polish economy **is decelerating somewhat harder than expected**. The main reasons are weaker private consumption and a resumption of more normal construction and capital spending after a surge this past year related to the summer's European football championships, co-hosted with Ukraine. However, we expect **monetary policy stimulus this autumn and winter**, combined with a **sharp decline in market interest rates** since spring, to **bolster domestic demand over time**. Importantly, this scenario assumes continued gradual easing of abnormally tight commercial bank credit conditions. Meanwhile, moderate fiscal tightening will hamper consumption. Export growth will be held back by anaemic demand in the West next year as well. Capital spending will remain a key economic driver, albeit not as large as in 2011 and the first half of 2012. **GDP growth will slow from 4.4 per cent last year to 2.7 per cent in 2012 and 2.9 per cent in 2013**. During **2014**, growth will reach **3.8 per cent**, just below the estimated potential rate of 4 per cent. We have adjusted our 2012-2013 forecasts downward by 0.4 and 0.3 per cent, respectively (compared to *Nordic Outlook*, August 2012), but still remain somewhat above consensus.

Given these GDP increases, Poland will continue to show better growth than the other "Visegrad countries" of Central Europe and most of Eastern Europe, but it no long stands out as the region's star performer; in 2009 it was the only EU country to show positive growth. **There are several reasons why Poland is showing good resilience to external crisis: Its fundamentals** are relatively good, aside from a large current account deficit and structural labour market problems including low labour supply. Its high public budget deficit, nearly 8 per cent of GDP in 2010, has gradually shrunk and will approach 3 per cent this year; a multi-year austerity programme remains in place, necessary to meet the nationally established public debt ceiling: 55 per cent of GDP. Poland is also only **moderately export-dependent** (some 40 per cent of GDP) compared to many other Eastern European countries. A third plus is a **well-capitalised banking sector**, which made record profits last year. Unlike counterparts elsewhere in the region, Polish banks have a small share of bad loans (4-5 per cent) and low short-term external debt (4-5 per cent of GDP).

Various slowdown signals have appeared since spring, especially in retailing and industrial production, but these have not yet had any clear impact on the national accounts. For example, the purchasing managers' index in manufacturing has been somewhat below the expansion threshold of 50 for six months in a row; in September index fell to a three-year low of 47.0. **Second quarter GDP-growth showed a slight deceleration** in consecutive terms, from 0.6 per cent in the first quarter to 0.4 per cent. Year-on-year, the slowdown was sharper, from 3.5 per cent in the first quarter to 2.4 per cent in the second quarter – the slowest growth since 2009. But this was largely because businesses slashed inventories, which in itself should be viewed as a predictor of sagging demand.

Expectations remain muted

Year-on-year percentage change and index



Source: European Commission, Central Statistics Office of Poland

So far, exports have performed decently. Despite the onset of a euro zone recession, exports rose 2.7 per cent in the second quarter compared to the first, a sign of **good competitiveness**. Yet Poland will not escape the effects of continued weakness in the West. Its high degree of trade integration with German manufacturers and core euro zone countries generally (60 per cent of total exports) will result in **weak export growth this coming year**. We also expect the recovery in the zloty's exchange rate against the euro (from 4.40 towards 4.00) to be long-lasting, so companies will not get any extra help from a weak currency.

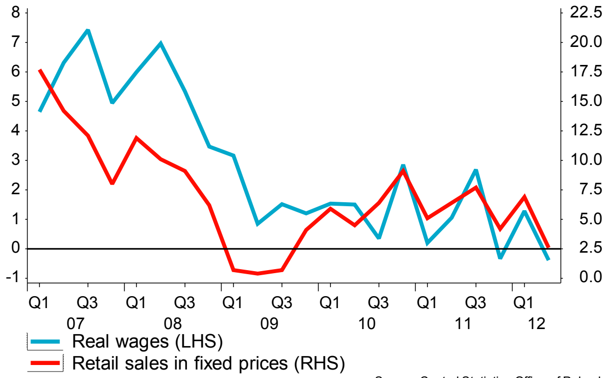
Since last spring, Poland's lively capital investment activity has cooled somewhat. Public spending on infrastructure prior to the European football championships has faded. Greater economic worries and uncertainty about the financing of some construction projects have also contributed to slower fixed investment growth. Falling interest rates will help **speed up capital spending again over time**. There are also pent-up structural needs after many years of relatively low investment ratios. Here Poland can continue taking advantage of large sums from EU funds, although these will level out in 2013.

Private consumption has also entered a **calmer growth phase** in the past six months. The main reason is **subdued pay increases** and, recently even slightly falling real wages.

Optimism has weakened, though not drastically, partly due to increased worries about future job losses. We predict that employment will stop growing and stagnate for the next year and that joblessness will get struck at around 10 per cent, also hampering wage growth. On the other hand, consumption will be fuelled by falling inflation and the plunging market interest rates of recent months, which we expect will gradually affect lending rates. This will again strengthen purchasing power and credit demand. Overall, consumption will **recuperate after a lengthy slump this autumn and extending into early 2013**.

Weaker real wages will slow consumption

Year-on-year percentage change

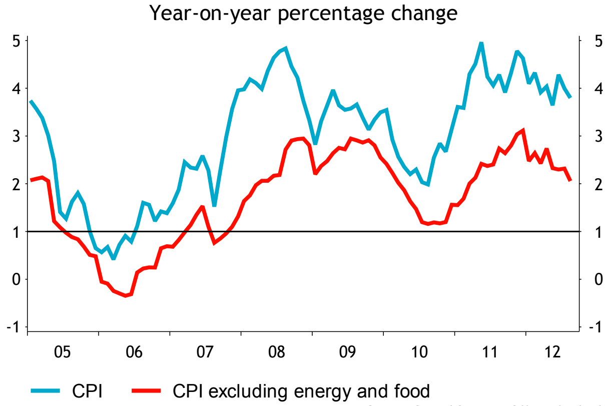


Source: Central Statistics Office of Poland

One **potential weak point** for consumption growth is the **low household savings ratio**, which has gradually fallen from about 10 per cent early in 2010 to 1 per cent in the first quarter of 2012. But in our view, Poland's credit market is still in a structural built-up phase. This means that the savings ratio can remain depressed for a couple of years without halting credit expansion. Household lending grew at a stable 10-15 per cent year-on-year in the two years to this past summer, then around 3.5 per cent in July and August. **In 2013 the pace of lending will speed up again**, sustained by lower interest rates and looser credit policies. Mainly as an indirect consequence of the crisis in the West, credit conditions have been abnormally tight since autumn 2011. Yet ECB low-interest loans to euro zone banks have eliminated the threat of a severe credit crunch in the West, thus also affecting Eastern Europe due to its many Western-owned banks. Poland is one of the region's few countries where credit conditions for residential and business loans have shown initial signs of easing, according to the Polish central bank's second quarter survey. Banks also expected greater third quarter demand.

Inflation has fallen

Year-on-year percentage change



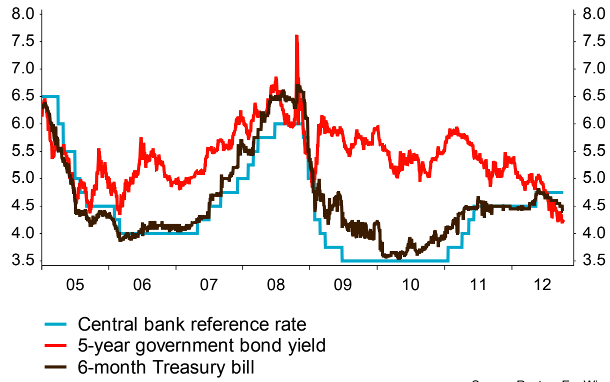
Source: Central Statistics Office of Poland

During 2011, Consumer Price Index inflation rose to an average of 4.3 per cent. A clear upturn in core inflation was noted. This was a consequence of higher economic activity, currency depreciation and certain budget tightening measures. This year, however, price pressure has trended downward. Cooling demand, zloty appreciation and fading base effects from the earlier value-added tax hike led to a decline in both underlying and broad inflation to a CPI rate of 3.8 per cent in August. By year-end, we expect the latter measure to drop below the 3.5 per cent mark. This is important from a monetary policy standpoint since the central bank's target is 2.5 ± 1 percentage point. **Inflation will continue to subside** to an average of 2.5 per cent in 2013 and 2.7 per cent in 2014, i.e. well within target.

Bearing in mind the lead time of at least one year before monetary policy has a full impact, the central bank can start to cut its key interest rate soon in order to counter deceleration tendencies in the economy. The risk of zloty depreciation, which might speed inflation, is probably also small after the big wave of global central bank easing measures since summer. We predict that the key rate will be cut from 4.75 per cent to 3.75 per cent in the next six months.

Slide in market interest rates and now a key rate cut

Per cent



Source: Reuters EcoWin

Government economic policy continues to **prioritise budget consolidation** and **reforms** (including compensation systems and pensions, for example raising retirement ages over a long phase-in period). The aim is to limit structural budget deficits to 1 per cent of GDP by 2015, but it may be tough to stick to austerity policies when growth has lost momentum and the government's popularity is threatened. It is true that Prime Minister Donald Tusk's centre-right coalition of his Civic Platform and the smaller Polish People's Party was returned to office in the October 2011 parliamentary election, but its majority is small. **Looking ahead, there is heightened risk of domestic political uncertainty**. A snap election before the next scheduled election in 2015 cannot be ruled out.

Euro zone membership is a long-term government goal. No explicit target date has been set, and Poland will certainly hold off on establishing such a target – at least during the coming year – in order to follow developments in the euro zone crisis. Today **2016 appears to be the earliest likely target for Polish accession**, but this forecast is highly uncertain.

Oil and domestic demand will sustain growth

- **Inflation will continue rising and real wage increases will decelerate**
- **One more key interest rate hike this year**
- **WTO membership will have positive long-term effects – their size depends on reforms**

Russia's GDP growth slowed in the first half of 2012 compared to a year earlier. Growth was 4.0 per cent in the second quarter, down from 4.9 per cent in the first. Many indicators point to a **continued modest slowdown**. Russia will continue to show good growth figures in international terms. **Inflation has risen after bottoming out in May**, when it was depressed by the postponement of administrative price hikes. It already exceeds the central bank's 5.5 per cent target. Unemployment has also continued to fall. Domestic demand is increasing, though more slowly than before. International worries and slowing exports are offset by larger domestic demand, rising inflation and a largely closed output gap. This creates difficulties for the **central bank, which will choose to buck the trend and raise its key interest rate in the fourth quarter**, while other central banks have instead boosted their dose of stimulus.

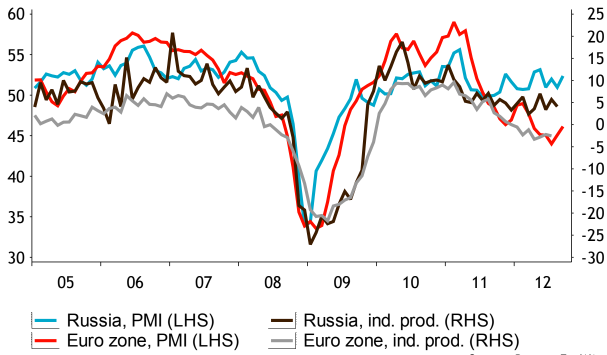
Oil prices will largely remain at current levels during our forecast period, providing good export and tax revenue. Meanwhile Russia's heavy dependence on oil and gas is a source of vulnerability and reduces its focus on reforms. **Brent crude prices (Russia's Urals oil is about USD 2 cheaper) will average USD 112/barrel in 2012, USD 110 in 2013 and USD 115 in 2014**. This means that the pace of reforms will remain slow and that Russia will not need to tighten fiscal policy. **Overall, we are relatively optimistic about short- and medium-term growth**, but the direction of government policies and unwillingness to carry out reforms will lower long-term growth. **GDP will increase by 3.6 per cent in 2012, 3.8 per cent in 2013 and 4.2 per cent in 2014**. These figures are well below Russia's average during the 2000 decade (before the economic crisis). There is major growth potential; GDP per capita is only 40 per cent of the OECD average. The IMF has estimated Russia's medium-term growth potential at 6 per cent annually in a more reform-oriented scenario.

Companies still relatively satisfied

Business sentiment indicators are pointing towards a minor slowdown but much better growth than in Western Europe, for example. The purchasing managers' index (PMI) largely tracked its euro zone counterpart during the first half of 2011 but then levelled out at between 50 and 52, while the euro zone PMI fell below the expansion threshold of 50. Other indicators reveal a similar picture. The OECD's leading indicator index has fallen but is pointing towards growth. The Russian statistical service's GDP indicator foresees a slowdown in line with our forecast.

PMI and industrial production still holding up against the euro zone decline

Net balance, year-on-year percentage change

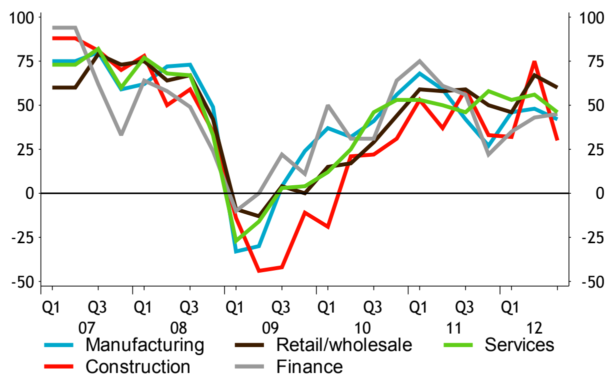


Source: Reuters EcoWin

Manufacturing output has shown stable increases of about 5 per cent in the past year. In August 2012, industrial production was up 4.1 per cent compared to a year earlier; this was a slight downturn compared to July. **Manufacturing output will increase by 3.8 per cent in 2012**, 5 per cent in 2013 and 7 per cent in 2014. Despite some poor harvests, **agricultural production has been relatively good so far this year**. While total production fell 3-4 per cent in July and August compared to the same period of 2011, the level is high after 2011's good harvests, which represented 20-40 per cent increases in the summer and autumn months. Higher prices for some agricultural products, including wheat and maize (corn), have again raised the issue of export restrictions. Although the authorities have not yet proposed export limitations like those imposed in 2010 (export quotas and higher tariffs), this cannot be ruled out if the trend later this autumn is clearly worse than expected, in order to avoid excessive domestic food price hikes.

Indicators moving sideways

Net balance

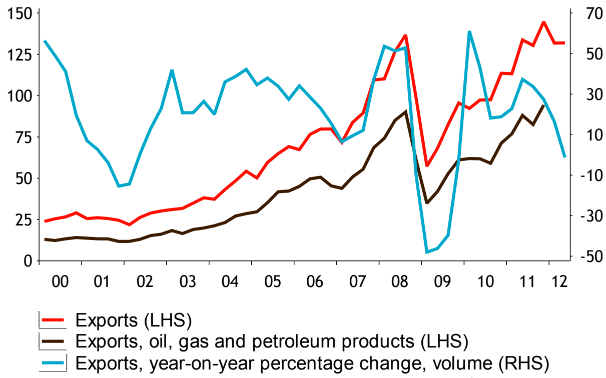


Source: OeKB

Exports in current prices have performed strongly over the past two years, driven both by base effects during the recovery after the crisis-related decline and by high oil prices. In volume terms the trend has been weaker, especially in 2011 when export volume was largely unchanged. Due to sharply higher imports, the contribution of net exports to GDP growth was strongly negative in 2011. **The clear deceleration in exports is not yet visible in industrial production** but will be in the future. Yet exports of oil, gas and other commodities will keep export revenues high, helping maintain **continued current account surpluses during our forecast period**. A major increase in imports has caused these surpluses to fall. If this trend continues there is a risk that surpluses will turn into deficits late in our forecast period. Russia might end up in a macro-economically more complex situation, with deficits in both the current account and the public sector.

Oil keeping exports up

USD billion

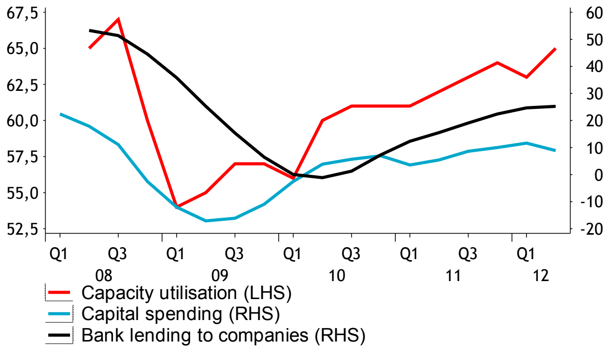


Source: Reuters EcoWin

Capital spending has slowed during 2012. Due to the uncertain situation and falling international demand, fixed investments will remain weak in the near term, partly because bank lending to companies has recently declined. **Looking further ahead, several factors point towards rising fixed investments**. Capital stock is obsolete after years of low investment ratios. Meanwhile capacity utilisation has risen in the past two years. Continued high oil prices also favour continued investments in that sector. Russia's World Trade Organisation membership (see box) will have a positive impact on capital spending, though other reforms leading to an improved business climate are needed in order for this to have a strong effect. **Overall capital spending will rise by 4 per cent in 2012, 8 per cent in 2013 and 9 per cent in 2014**.

Capacity utilisation has kept climbing; capital spending will increase more slowly ahead

Per cent, year-on-year percentage change

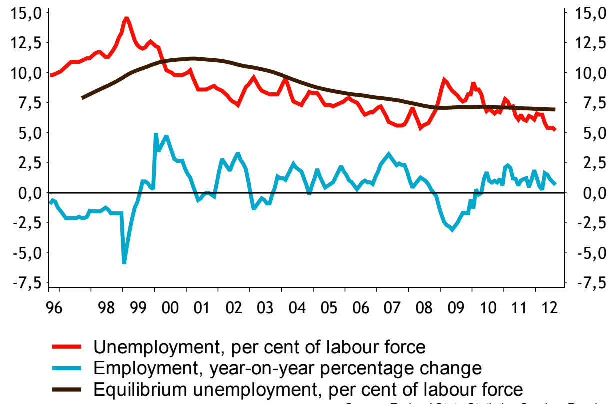


Source: Reuters EcoWin

Weaker income and consumption

The labour market has developed strongly during 2012. The number of jobs has increased each month since mid-2010, and this year unemployment has fallen from 6.6 per cent, reaching 5.2 per cent in August. Because of weaker economic growth later in the year, this decline will come to a halt. The more labour-intensive service sector is less optimistic, which may signal a weaker labour market ahead. But our overall assessment is that relatively strong domestic demand, amid a weak international outlook, will have a positive impact on the labour market. At the end of 2012, unemployment will be marginally lower than today. **Unemployment will fall from an average of 6.6 per cent in 2011 to 5.6 per cent in 2012**. The annual averages will then fall further to just above 5 per cent in 2013 and 2014.

Unemployment is still falling

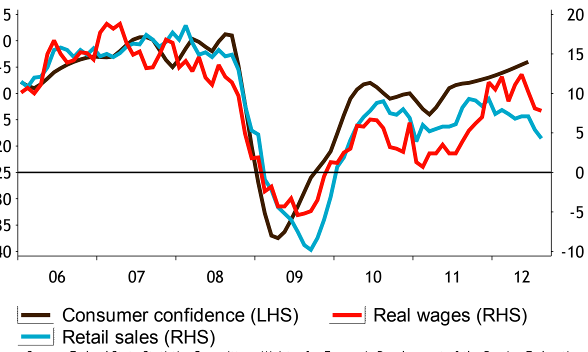


Source: Federal State Statistics Service, Russia

Falling unemployment, fiscal stimulus and slowing inflation during the first half of 2012 gave households a powerful injection in the form of rising real wages and disposable income. Real wages rose more than 10 per cent in the first half, and consumer confidence improved in the spring and summer. **Looking ahead, the situation will not be equally bright for households**. Fiscal initiatives in the form of higher wages, salaries and pensions will fade, and administrative rate hikes that were delayed due to last winter's parliamentary and presidential elections will have an impact. Meanwhile inflation, whose temporary decline led to good real income increases early in 2012, has begun to rise and will climb further in 2013.

Real wage increases are slowing but consumer confidence remains good

Net balance, year-on-year percentage change



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

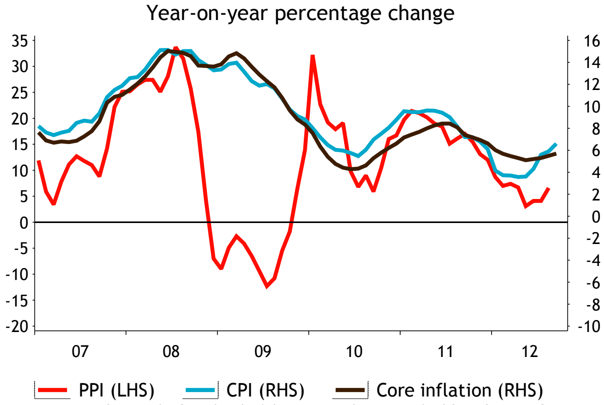
Households seem to have realised that part of their good income increase in the first half of 2012 was temporary. Retail sales have surged, but the trend is now towards slower growth. Inflation climbed in June. The rate of increase in retail sales fell from 7.1 per cent in June to 5.4 per cent in July and 4.3 per cent in August. The trend of recent months indicates calmer growth ahead. **Household consumption will increase by 6.5 per cent in 2012, 5.5 per cent in 2013 and 6.5 per cent in 2014**.

Inflation rising again, central bank rate hike

The postponement of administrative rate hikes pushed year-on-year inflation down to 3.6 per cent in April and May, but the trend has shifted. In August, inflation was 5.9 per cent, the highest since December 2011. We **expect inflation to accelerate late in 2012**, among other things due to further rate hikes and higher food prices. We foresee inflation of about 7 per cent late this year, above the central bank's 5.5 per cent target (measured as December-December inflation). **As annual averages, inflation will be 5.1 per cent in 2012, 6.1 per cent in 2013 and 5.5 per cent in 2014**.

Inflation on the way up again

Year-on-year percentage change

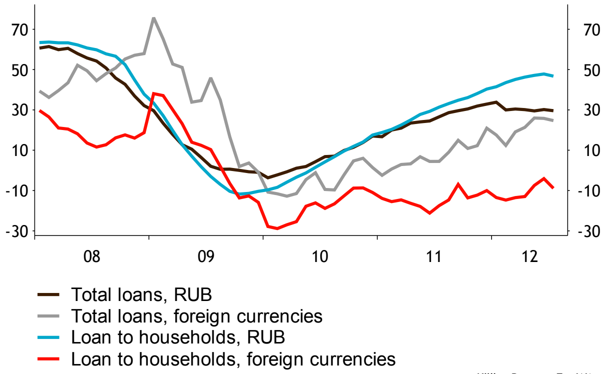


Source: The Central Bank of the Russian Federation, Federal State Statistics Committee

Another variable for the central bank to keep an eye on is bank lending. In 2012, total bank loans in roubles have increased at around 30 per cent year-on-year. Above all, **households are borrowing more**, with an increase in rouble-denominated loans of nearly 50 per cent year-on-year in June. But business loans in roubles are increasing more slowly, raising some questions about the future trend of capital spending.

Continued rise in bank lending

Year-on-year percentage change



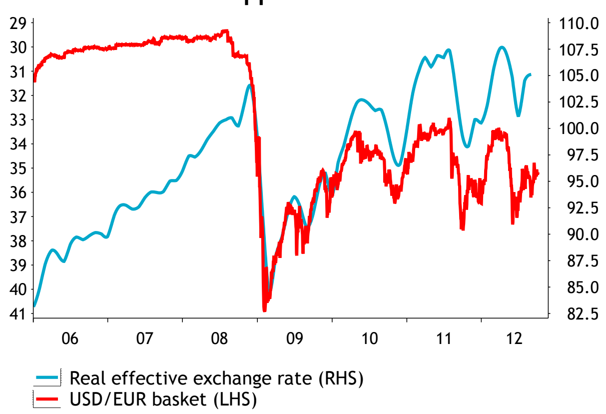
Källa: Reuters EcoWin

Rising inflation, combined with weaker growth, is putting the central bank in a difficult situation. On the one hand higher inflation, low unemployment and a closed output gap may justify further interest rate hikes. On the other hand the world economy is shaky, though so far its effect on the Russian economy has been to create a modest deceleration. In September, the central bank hiked its policy rates by 25 basis points.

Although the inflation upturn is being driven by temporary factors, core inflation will also climb somewhat and is already too high, given the central bank's target. The minutes of the central bank's latest meeting noted that the high inflation is primarily driven by temporary factors but that price increases also are affecting core inflation. The central bank has focused its monetary policy more on the inflation target and is allowing greater exchange rate flexibility. This indicates that the rouble will be allowed to absorb more external shocks. Continued above-target inflation and low unemployment will contribute to a **further key interest rate hike of 25 points in the fourth quarter**.

After the rouble's 30 per cent slide in 2008-2009 against the USD/EUR basket (55 per cent USD and 45 per cent EUR) and its subsequent appreciation, the currency has had a bumpy ride. Since 2008-2009 the central bank has sharply reduced its foreign exchange market interventions. Mounting international worries in the summer of 2011 and in 2011 led to 10 per cent depreciations. Today the rouble is about 20 per cent below its pre-crisis level, and this year it has depreciated by 3 per cent. Looking ahead, the currency will strengthen somewhat and reach 35.0 against the USD/EUR basket at the end of 2012, 33.5 at the end of 2013 and 33.1 at the end of 2014. The currency will be weighed down by several political and economic risk factors. As a result, its appreciation may be interrupted by some reversals, just as during the last few years. Meanwhile positive factors predominate, such as high oil prices and lower capital outflows after last winter's elections, although high oil prices as such usually lead to continued rapid outflows. The historical performance of the Moscow Stock Exchange co-varies relatively closely with oil prices. This means that continued high oil prices may attract capital inflows. If investors who are searching for returns focus more on emerging economies, Russia will end up high on the list when ranking important variables such as public sector deficits and debt, ratings and international debt-asset position.

Rouble appreciation ahead



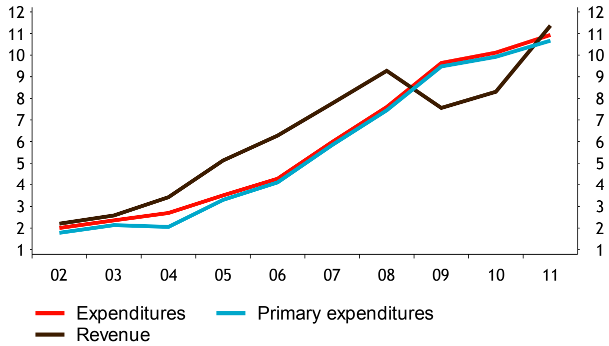
Source: Reuters EcoWin

Reduced fiscal policy manoeuvring room

In the past decade, the upturn in oil prices from about USD 25 per barrel to about USD 110 has had a huge impact on Russia's federal budget and the government's ability to implement reforms and stimulate the economy. **However, oil and revenues are not only a blessing but also a curse**. Oil generates export and public sector revenue, but at the same time it eases the pressure for reforms that would improve the economy in the long term. This is clearly the case in Russia. In addition, the vulnerability of the budget increases when more and more public expenditures are based on revenues from an uncertain source. In 2011, federal expenditures were 5.5 times higher than in 2002, while oil prices were 2.8 times higher. In a shorter-term perspective, **expenditures rose from just over 16 to 22 per cent of GDP between 2005 and 2011.**

Federal revenue and expenditures have increased sharply

Trillions of roubles



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

In 2011 the public sector deficit excluding oil was nearly 10 per cent of GDP, twice as high as the earlier long-term target of 4.7 per cent of GDP. A lower deficit would enable the Federation to build up its Reserve Fund again and would also contribute to intergenerational justice. At present, current generations are consuming oil revenue on a continuous basis. **Oil prices are precariously close to the USD 115 needed to balance the budget 2012.** After that, the price level required to achieve budget balance will fall but stays above USD 100 during 2013 adn 2014.

In the future, underlying room for stimulus policies will thus shrink, which is a change compared to recent years. **Fiscal policy will still be expansionary** this year and in coming years. The federal deficit excluding oil will increase this year by about 1 per cent of GDP, and if election promises are carried out it will increase further in the next few years. Because of low public sector debt and high oil prices, this stimulus policy can continue in the short term. In 2011 the **public sector balance** shifted into surplus (1.0 per cent of GDP) **but will again fall below zero during our forecast period**. Public sector debt will remain stable at a low 11-12 per cent of GDP in 2012-2014.

Expansionary fiscal policies have increased the standard of living, for example by raising salaries, pensions and transfers and through job-creation measures. This, in turn, has helped create domestic political support for the government. Looking ahead and assuming that oil prices remain at about today's level, this potential will decrease. Along with clearly lower growth compared to the pre-crisis period, there will be growing pressure on Russia's president and government to raise living standards by means of other, more complex and controversial reforms that will improve the functioning of the economy.

After the latest elections the political leadership, headed by Vladimir Putin, has been challenged in a way that has not been seen before. **No major political shifts can be expected in the near term**, but increased protests and criticism of current governance cannot be ignored in the long run. Although WTO accession opens the way to a more positive view of Russian reform efforts, our hopes are modest. There is little room for continued support-buying reforms given today's oil prices, but we believe this will be the main trend in the near future. The need to choose between structural reforms and political liberalisation, on the one hand, and more centralised control, on the other, has become more pronounced in the past year.

Russia and the WTO: No major short-term effects

After an 18-year journey, Russia joined the World Trade Organisation this past summer. It was the longest negotiation period in WTO history. WTO countries account for 97 per cent of world trade. **The effects of WTO membership are positive for growth and revenue** and have been estimated by the World Bank at 3.3 per cent of GDP in the short term and up to 11 per cent in the long term. The effect is believed to be even larger for household income. In the short term, the main effect will be lower tariffs and duties on exports and imports, but membership means much more than tariff reform. It also includes rules against non-tariff trade barriers, the right of foreign companies to gain access to markets and rules on how foreign companies should be treated.

There are long transitional periods for adjusting to WTO rules. It is also important to note that the size of the effects will depend on how quickly the country adapts to the WTO rules and how great a desire there is to improve and simplify the business climate both for Russian and foreign companies. This is why we believe that the **short-term effects on overall growth aggregates will be small**. The reforms and tariff cuts required for membership will take place soon, but not much more. The average import duty will fall from 10 to 7.8 per cent. One third of the reduction will occur immediately. The sectors expected to benefit most are export-intensive ones, for example metals, chemicals and the industrial sector generally. Economic sectors that will be opened up to foreign direct investments – such as telecoms, banking and insurance – will also benefit from WTO-membership.

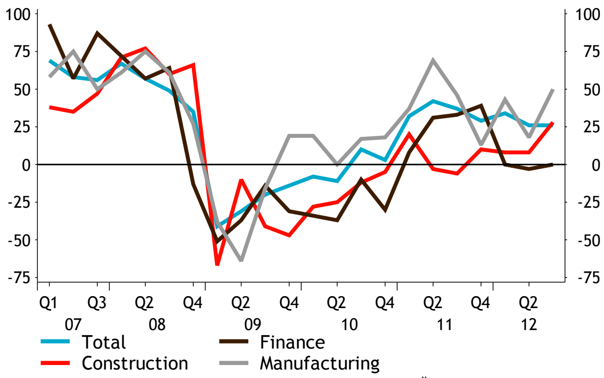
Weak international demand is hampering growth

- **High real income increases are sustaining domestic demand**
- **Dramatic inflation decline is temporary**
- **Devaluation after parliamentary election**

Second quarter GDP rose by 3.0 per cent year-on-year. The summer's European football championships helped sustain consumption and capital spending, while exports fell. **Yet looking ahead, Ukraine's economy will remain shaky and the risks are on the downside. Even if domestic demand persists, growth will be slower in the second half than the first** due to continued weak exports. The current account continues to worsen due to anaemic international demand, high gas prices and falling steel prices after last year's peaks. Meanwhile political uncertainty is high. Before the October 28 election, the government wants to avoid unpopular decisions like raising gas prices to please the IMF and thus revive its loan agreement. Devaluation would ease the pressure. We expect Ukraine to **devalue the hryvnia by at least 10 per cent** after the election, or by early 2013. **GDP will grow by 2.1 per cent in 2012, 2.9 per cent in 2013 and 3.9 per cent in 2014**.

Mixed signals from business sentiment indicators

Net balance

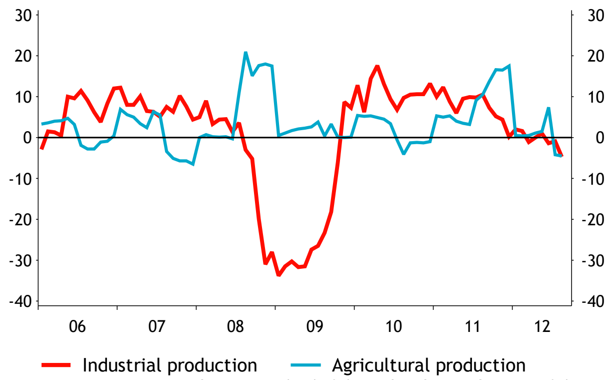


Source: Österreichische Kontrollbank AG

This year, growth has slowed sharply after a 5.2 per cent rate in 2011 and is set to cool further. **Export volume has fallen this year** and industrial production is down three months in a row – in August by 4.7 per cent year-on-year – and the trend continues downward. Continued economic weakness in the EU will further affect Ukraine's export-dependent economy. In 2011 good harvests sustained growth as industrial output deteriorated, now both sectors are declining. Steel production is squeezed by falling prices and lower demand from the euro zone, Russia and Asia. Manufacturing is also performing below par, -2.5 per cent so far this year. Weakness in agriculture is partly a base effect, due to last year's good harvests. **Exports will fall by 6 per cent this year and rise by 4.5 and 6.0 per cent in 2013 and 2014.**

Falling industrial and agricultural production

Year-on-year percentage change



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

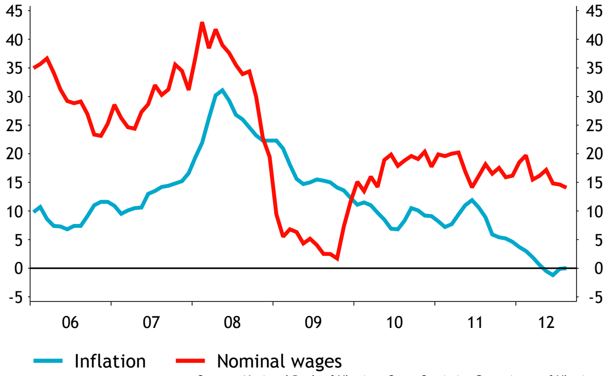
Fixed investments rose sharply in 2011 and so far this year, partly driven by the football tournament. Surveys of corporate capital spending plans show a downward trend. Capacity utilisation is falling as output slows. Falling second half investments will offset the strong first half of 2012. **Capital spending will rise 2 per cent in 2013**, then accelerate more.

So far in 2012, households have been resilient. **Rapidly falling inflation has boosted real wages and purchasing power**. Retail sales have risen about 13 per cent compared to the same period of 2011. Nominal pay is up more than 15 per cent year-on-year, while inflation fell from 11.9 per cent in June 2011 to 3.7 per cent in January 2012 and zero in August, after deflation in May-July. Inflation showed a big downside surprise after good second quarter harvests and due to administratively fixed prices. **Inflation has bottomed out** and will rise due to higher food prices, greater demand due to real wage hikes, pre-election public sector spending and a devaluation that will boost prices of imports. **Inflation will be 1.7 per cent in 2013**, rising to 7 and 6.5 per cent in 2013 and 6.5 per cent in 2014. In the short term, increased real income will boost domestic demand, but this is not a sustainable development. The post-election government budget will be tighter. Ukraine is losing international competitiveness. Devaluation may solve some problems, but only in the short term.

The bank lending trend is weaker and weaker, a process under way since late 2011. Year-on-year, foreign currency lending fell more than 10 per cent in May-July. **The banking system is squeezed by higher reserve requirements and interbank rates increasing to 20-25 per cent in recent months**. The latest credit conditions survey by the Institute of International Finance shows second quarter tightening in Europe's emerging economies. Ukraine clearly seems to conform to this pattern.

Low inflation strengthening real wages

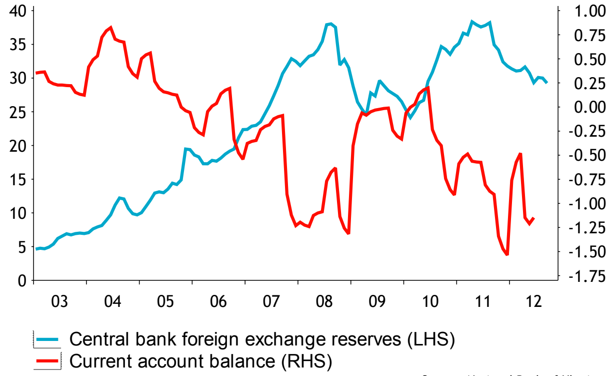
Year-on-year percentage change



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

CA balance and CB reserves deteriorating

USD billion

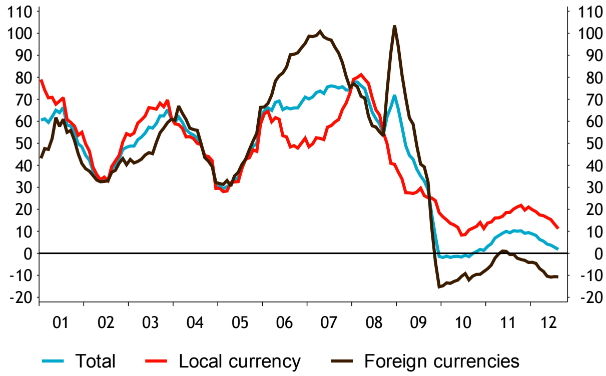


Source: National Bank of Ukraine

In July, Ukraine borrowed USD 2 billion in the international capital market, covering much of its 2012 funding needs. This eased short-term pressure on the central bank's foreign exchange reserve and the hryvnia. The bank intervenes in the FX market to keep the currency stable against the USD. In the past year, the reserve has fallen from nearly USD 40 billion to USD 30 billion (equivalent to about 3.5 months' imports) in August. Underlying problems persist, though. Steel prices have fallen sharply since last year's peaks. Despite price increases, agricultural products and other commodities cannot offset this decline. Other exports are hurt by weak international demand, as is most clearly evident in weak industrial output figures. The **current account**, which did not reach balance even after the 2008 devaluation, **will widen from a deficit of 5.6 per cent of GDP in 2011 to 6 per cent in 2012**, then fall somewhat.

Slowdown in bank lending

Year-on-year percentage change



Source: National Bank of Ukraine

On several occasions, the central bank has been forced to intervene to prop up the hryvnia. Due to the current account deficit and political uncertainty, investors and private individuals prefer foreign currencies. USD appreciation and declining competitiveness are squeezing the hryvnia; looking ahead, **we expect that it will need to be devalued**. The government will want to postpone devaluation as long as possible, in hopes of not having to implement it. The timing is uncertain. In our assessment, the **devaluation** will occur this year after the election or early in 2013 and **will be more than 10 per cent against the USD**, or much less than in 2008. In connection to the devaluation a more flexible currency regime might be introduced, with a wider trading band connected to a basket of currencies, as has been recommended by the IMF.

Since the summer of 2010, Ukraine has had an IMF stand-by loan agreement, which was suspended due to disagreements on gas subsidies and other matters. An IMF team visited Kiev from August 29 to September 5 to discuss the 2013 budget, energy sector reforms and certain social programmes. The major stumbling block is the budget deficit. The IMF has noted that large external funding needs create uncertainty. Strengthening Ukraine's public finances will be vital. During 2012, supplementary budgets have increased spending, and the government target of a deficit below 2 per cent of GDP will be hard to achieve; we believe the shortfall will instead be 3 per cent of GDP this year, then slowly fall to 2 per cent of GDP in 2014. The risk is on the downside unless the government begins budget-tightening after this year's stimulus measures aimed at increasing voter support in this autumn's election.

In the short term, the government will continue muddling through, still balancing between Russia and the EU. We expect no immediate decision on closer cooperation with either East or West. The **ideal scenario** for the government remains that Ukraine tries to reach agreement with Russia on lower gas prices; this would improve public sector finances and the current account. Lower gas prices would enable Ukraine to boost what it charges consumers for gas and trim state subsidies, without this having as large an impact on households and businesses. Such a scenario might also revive the country's cooperation with the IMF and lead to a new agreement (the present frozen one ends at the end of 2012). The prospect that this happens before the election is small, but whatever happens to the import price for gas, the country will most probably seek new assistance from the IMF after the election to manage, among other things, a large repayment to the IMF in 2013.

The October 28 election will lead to greater short-term uncertainty. Ukraine's 450 MPs will be elected for five years. Half the seats are assigned proportionally using party lists and half in one-person constituencies. The latest voter surveys indicate an even match between President Viktor Yanukovich's Party of Regions and imprisoned former Prime Minister Yulia Timoshenko's Motherland Alliance. According to the Organisation for Security and Cooperation in Europe (OSCE), the situation of independent media has worsened in recent years, among things due to self-censorship since owners wish to avoid conflict with the government. Although the situation is uncertain, it is more likely that the Party of Regions will form a government, alone or in coalition, after the election.

Key economic data

ESTONIA

	2007	2008	2009	2010	2011	2012(f)	2013(f)	2014(f)
GDP, %	7.5	-3.7	-14.3	2.3	8.4	2.5	3.3	4.0
Inflation, HICP, average, %	6.7	10.6	0.2	2.7	5.1	3.9	4.3	4.4
Unemployment, %	4.7	5.6	13.9	17.0	12.5	10.4	9.8	9.5
Current account, % of GDP	15.9	-9.7	3.7	3.6	3.2	-2.5	-0.5	-0.5
Public sector financial balance, % of GDP	2.4	-2.9	-2.0	0.2	0,3	-1.7	-0.5	0.0
Public sector debt, % of GDP	3.7	4.5	7.2	6.7	6.0	10.5	12.0	11.7
3-month interest rate, eop	7.2	7.8	3.3	1.1	1.4	0.1	0.5	0.8

LATVIA

	2007	2008	2009	2010	2011	2012(f)	2013(f)	2014(f)
GDP, %	9.6	-3.3	-17.7	-0.9	5.5	4.5	3.6	4.5
Inflation, HICP, average, %	10.1	15.3	3.3	-1.2	4.2	2.5	2.3	3.0
Unemployment, %	6.1	7.5	16.9	18.7	16.2	15.6	14.2	12.5
Current account, % of GDP	-22.4	-13.1	8.6	3.0	-1.2	-3.3	-3.9	-4.4
Public sector financial balance, % of GDP	-0.3	-4.2	-9.6	-7.6	-4.1	-1.2	-1.4	-0.8
Public sector debt, % of GDP	9.0	19.7	36.7	44.7	42.6	42.2	40.8	37.6
EUR/LVL, end of period	0.7	0.7	0.7	0.7	0.7	0.7	0.7	-
Key rate, eop	6.5	6.0	4.0	3.5	3.5	2.5	0.5	0.5

LITHUANIA

	2007	2008	2009	2010	2011	2012 (f)	2013(f)	2014 (f)
GDP, %	9.8	2.9	-14.8	1.4	5.9	3.5	4.0	4.0
Inflation, HICP, average, %	5.8	11.1	4.2	1.2	4.1	3.4	3.5	3.5
Unemployment, %	4.3	5.8	13.7	17.8	15.4	13.5	12.0	10.0
Current account, % of GDP	-14.5	-12.9	3.7	0.1	-3.7	-3.0	-4.0	-6.0
Public sector financial balance, % of GDP	-1.0	-3.3	-9.4	-7.2	-5.5	-3.0	-3.5	-3.5
Public sector debt, % of GDP	16.8	15.5	29.4	38.0	38.5	39.0	38.0	37.0
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	6.65	9.89	3.90	1.50	1.66	0.70	0.80	0.90
5-year government bond, eop	4.80	13.10	6.60	4.60	5.40	2.30	2.50	2.70

(f) = forecast

POLAND

	2007	2008	2009	2010	2011	2012(f)	2013(f)	2014 (f)
GDP, %	6.8	5.1	1.6	3.9	4.4	2.7	2.9	3.8
Inflation, HICP, average, %	2.6	4.2	4.0	2.7	3.9	3.8	2.5	2.7
Unemployment, %	9.6	7.1	8.2	9.6	9.7	9.5	10.0	10.0
Current account, % of GDP	-6.2	-6.6	-4.0	-4.7	-4.3	-4.6	-4.7	-4.3
Public sector financial balance, % of GDP	-1.9	-3.7	-7.4	-7.8	-5.1	-3.3	-3.0	-2.5
Public sector debt, % of GDP	45.0	47.1	50.9	54.8	56.3	54.9	54.5	54.0
EUR/PLN, end of period	3.6	4.1	4.1	4.0	4.5	4.1	3.9	3.8
Key rate, eop	5.25	4.00	3.50	3.75	4.50	4.25	3.75	3.75
5-year government bond, eop	6.13	5.34	5.91	5.52	5.34	4.20	4.50	4.80

RUSSIA

	2007	2008	2009	2010	2011	2012(f)	2013(f)	2014 (f)
GDP, %	8.5	5.2	-7.8	4.3	4.3	3.6	3.8	4.2
Inflation, average %	9.0	14.1	11.7	6.9	8.5	5.1	6.1	5.5
Unemployment, %	6.1	6.4	8.4	7.5	6.6	5.6	5.2	5.0
Current account, % of GDP	5.9	6.2	4.1	4.7	5.5	4.3	2.1	0.7
Public sector financial balance, % of GDP	6.0	4.9	-6.3	-3.5	1.6	0.8	-0.2	-0.5
Public sector debt, % of GDP	8.5	7.9	11.0	11.7	9.6	9.2	8.7	9.0
USD/RUB, end of period	24.57	30.53	30.31	30.57	32.19	31.10	31.00	31.00
Rouble vs. euro/dollar basket, eop	29.7	35.4	36.1	35.2	36.5	35.0	33.5	33.1

UKRAINE

	2007	2008	2009	2010	2011	2012(f)	2013(f)	2014 (f)
GDP, %	7.6	2.3	-14.8	4.1	5.2	2.1	2.9	3.9
Inflation, average, %	12.8	25.2	15.9	9.4	8.0	1.7	7.0	6.5
Unemployment, %	6.4	6.4	8.8	8.1	8.2	8.4	8.2	8.0
Current account, % of GDP	-3.7	-7.1	-1.5	-2.2	-5.6	-6.0	-5.5	-5.0
Public sector financial balance, % of GDP	-2.0	-3.2	-6.3	-5.7	-2.7	-3.0	-2.5	-2.0
Public sector debt, % of GDP	12.3	20.5	35.4	40.1	36.5	38.0	36.0	33.0
USD/UAH, end of period	5.05	7.80	8.00	7.97	8.00	9.00	9.30	9.40

(f) = forecast

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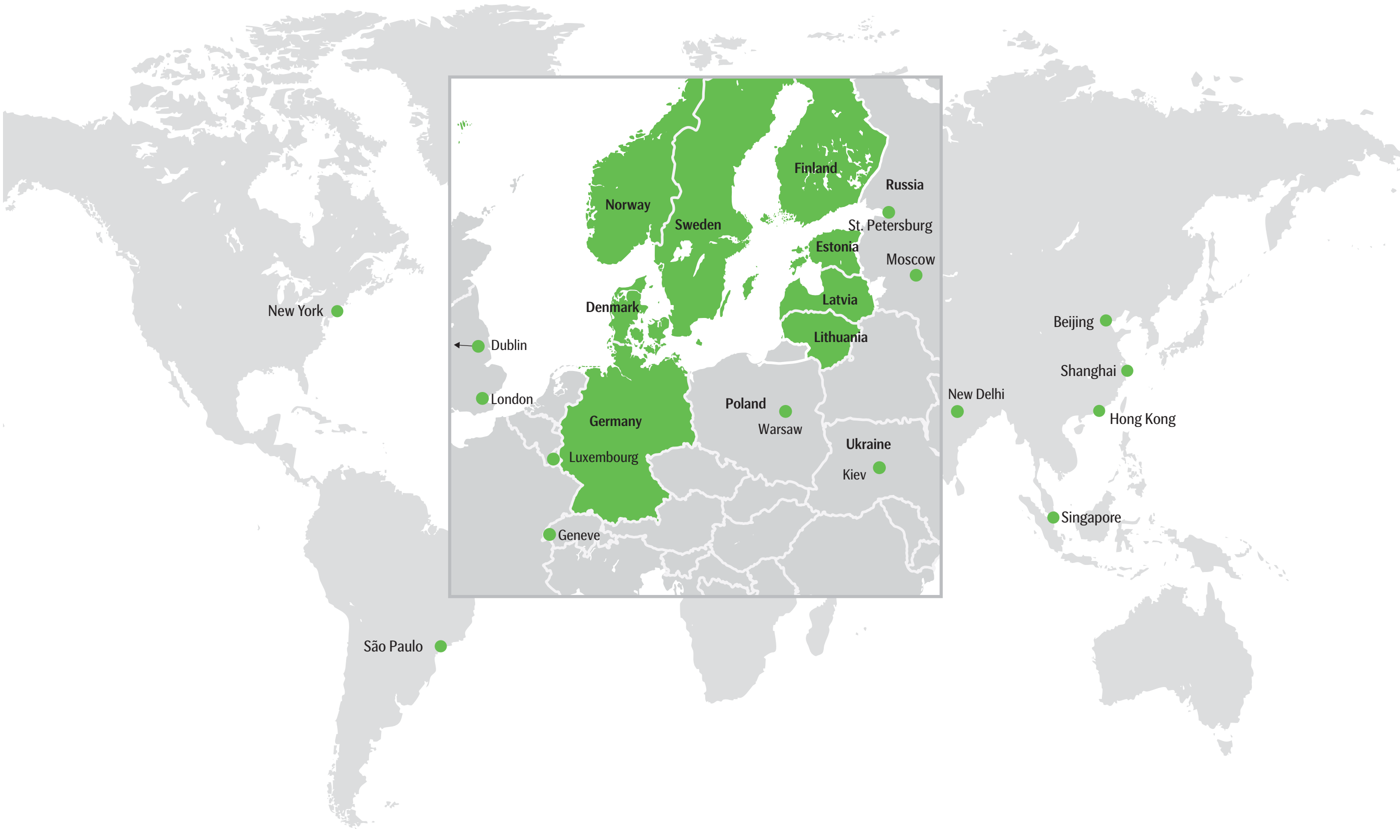

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