



Eastern European Outlook

Economic Research – March 2011

Export-driven growth gains strength as domestic demand awakens

Theme: Impact of the global commodity price shock on inflation

SEB

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Summary

Economic conditions in Eastern Europe will strengthen in 2011-2012, although fiscal policies will be tightened moderately in many countries and global growth will level out. Strong, competitive exports will remain a key driving force this year. Meanwhile consumption and capital spending are awakening from their crisis-period hibernation and will help sustain good GDP growth. Eastern Europe was the region of the world hardest hit by the global credit crisis, mainly due to relatively large borrowing in foreign currencies.

The first sign of recovery in private consumption came in 2010, alongside a rebound in real wage growth, stabilising labour markets and some thawing in frozen credit conditions. Looking ahead, continued decline in unemployment, faster wage and salary hikes and gradual normalisation in the credit situation will contribute to growing consumption.

Rapidly accelerating inflation due to sharply higher global energy and food prices will partly undermine household purchasing power this year. Underlying inflation pressure is low but is gradually increasing. Looking ahead, the commodity price upturn will moderate. The increase in broad inflation measures will culminate this year, except that in Estonia and Lithuania inflation will continue to accelerate in 2012.

Large public budget deficits in the wake of the crisis will shrink to more moderate levels in most countries. Estonia's deficit will rise slightly from a low level. Public sector debts will continue to grow somewhat; they are low or moderate, compared to many Western countries.

SEB's GDP forecasts for 2011-2012 will remain somewhat above consensus, except in Ukraine:

- **Russia's** GDP will increase by 5.6 and 5.2 per cent, respectively, in 2011-2012, sustained by high commodity prices. SEB is now raising its Brent oil price forecast for 2011 to USD 102/barrel from USD 80 in Eastern European Outlook, October 2010, and more recently USD 96/barrel. This will provide an extra growth impulse and room for a continued expansionary fiscal policy, although in the short term there is increased uncertainty about consumption due to rapidly rising inflation. The central bank will continue to tighten monetary policy, and the rouble will appreciate further.
- **Poland's** growth will become more investment-driven and rise to 4.5 and 4.6 per cent. Further fiscal tightening will be needed after the autumn parliamentary election in order to meet nationally established debt limits. The key interest rate will continue to be raised, and the zloty will appreciate.
- **Ukraine's** growth will improve slightly to 4.7 per cent this year. Favourable world market prices for steel and agricultural products, two major export industries, will provide support but austerity requirements imposed by Ukraine's lender, the IMF, will restrain growth.
- **Estonia's** GDP increase will accelerate to 5.0 and 4.5 per cent, respectively, in 2011-2012. The export boom is continuing, while domestic demand is gradually picking up. An unexpectedly rapid labour market improvement will help fuel consumption. Austerity policies have eased.
- **Lithuania's** growth will surge to 4.0 and 4.5 per cent in 2011 and 2012. Exports will continue to drive growth, which will nevertheless become more broad-based as fiscal tightening softens this year. Emigration and growing labour shortages will hamper the upturn.
- **Latvia**, which is lagging behind Estonia and Lithuania, will see GDP growth pick up to 4.0 per cent in 2011 and 4.5 per cent next year, but the domestic economic recovery will be shaky. This is partly because public budget consolidation is continuing.

Global growth will stabilise a bit above trend

- Marginal slowing due to disasters in Japan
- More synchronised growth as US improves
- German strength helping Eastern Europe

In the past six months, the global economic outlook has brightened. Slower growth once seemed likely in 2011-2012, but it now appears as if growth in both the OECD countries and the world will slow marginally compared to 2010 and will stabilise at decent levels, somewhat above trend. The main reason is much higher expectations in the US, but also stronger forecasts for Germany, which continues to prop up the euro zone. Global manufacturing indices have also provided upside surprises. The US and global recovery is becoming more self-sustaining. This is clear from the optimism of major companies and the rebound in Western capital spending over the past 6-12 months. The American purchasing managers' index in manufacturing reached 61.4, a level last achieved in May 2004, which in turn was the highest since 1983. Germany's IFO business climate index was at its highest since measurements began in 1991.

Meanwhile the world economy still faces challenges and risks. Government debts continue to grow. Fiscal crises in various euro countries remain unresolved – Portugal may be forced to apply for bail-out loans – though the creation of the European Financial Stability Facility and the Euro Pact have bolstered confidence in the euro.

In the short term, Japanese natural disasters and the Libyan war will generate worries that temporarily risk dampening global optimism. We believe that the damage and energy disruptions will push down Japan's already slow growth expectations by nearly 1 percentage point this year but that the positive impact of reconstruction in 2012 will exceed 1 percentage point in 2012. We previously forecasted 1.6 per cent annual GDP growth. Globally, the impact will be marginal. Our projections are partly based on historical experience after natural disasters and assume that Japan's energy problems will not be long-lasting.

Yet that world economic recovery has gained a foothold. The focus of financial markets and economic policy is shifting towards more traditional variables such as growth, the labour market and inflation. We believe that the euro zone's output gap will close in 2011-2012, while this process will take longer in the US. We expect underlying inflation to rise moderately, despite the sharp upturn in energy and food prices. The price of Brent crude has risen from USD 80/barrel last

autumn to USD 116. We now forecast average oil prices of USD 102 this year and USD 90 in 2012.

Crisis policies have begun to be replaced by exit policies. We expect OECD fiscal policies to tighten marginally in 2011 and by the equivalent of 1.5 per cent of GDP in 2012. Due to rising inflation expectations and high CPI inflation, the European Central Bank and the Bank of England will begin hiking key interest rates this spring. The ECB will raise its refi rate from 1.00 to 2.00 per cent in 2011, then to 3.00 per cent in 2012. We expect the US Federal Reserve to hold off on rate hikes until January 2012.

In the short term, the EUR/USD rate will be governed largely by monetary policy expectations. The euro will climb further to about USD 1.45 this autumn, with a risk of even faster appreciation; by year-end the dollar will begin a weak recovery.

Global economic highlights

GDP, year-on-year percentage change

	2009	2010	2011	2012
United States	-2.6	2.8	3.6	4.0
Euro zone	-4.0	1.7	1.9	1.8
The world	-0.6	5.0	4.4	4.7
Oil, USD/barrel	61.9	79.8	102.0	90.0
EUR/USD, Dec	1.43	1.34	1.40	1.38

Source: SEB

Eastern European exports and growth will continue to be sustained by solid demand in Germany, with GDP growth of 3 per cent in 2011 and 2.5 per cent in 2012. This year the recovery will broaden from exports to domestic demand. Germany weighs heavily in the foreign trade of many countries in the region. For example, 20-30 per cent of Polish, Hungarian and Czech exports are sold there. Germany is also a relatively important market for exports from the Baltic countries, but less so for Russia and Ukraine. The latter two countries are benefiting from higher commodity prices.

As in the West, many Eastern European countries have launched belt-tightening programmes to combat large budget deficits; the Baltics have already implemented much of these programmes. Eastern Europe is fortunate to have low or moderate public sector debts, even after the increases of recent years. Instead, the main problem in many parts of the region before the 2007-2008 global credit crisis was large current account deficits and relatively high foreign currency debts.

Underlying inflation pressures are calm

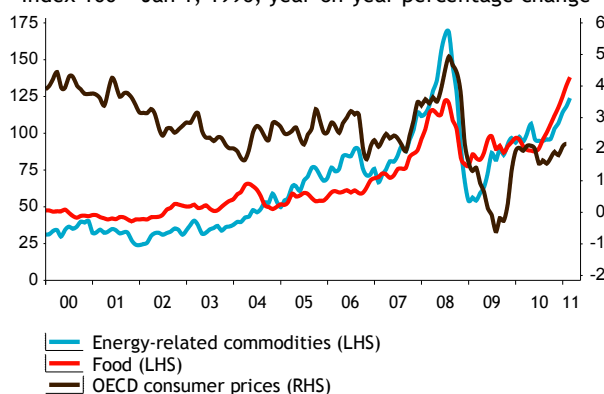
- Food, energy big factors in Eastern Europe
- ...but inflation patterns similar to the West
- Small secondary effects from commodities

Global energy and food prices have climbed rapidly and almost uninterrupted since mid-2010. The Hamburg Institute of International Economics (HWWI) world energy price index rose over 50 per cent in USD, and its food price index climbed just as fast. Before this, food price hikes were much calmer, though energy-related commodities also rose dramatically in 2009 and early 2010.

In the past six months higher commodity prices, mainly for energy and food, have been instrumental in driving up broad Consumer Price Index inflation around the world, albeit moderately. In the euro zone, for example, the CPI rate was around 1.5 per cent last summer but rose to 2.4 per cent in February, exceeding the European Central Bank's target of just below 2 per cent. Yet core inflation – adjusted for energy, food, alcoholic beverages and tobacco – has remained stable at close to 1 per cent. The same is true of most Western countries, though at different levels; secondary effects on other consumer prices have so far been limited.

Global energy and food prices, OECD inflation

Index 100 = Jan 1, 1996, year-on-year percentage change



In our assessment, CPI inflation in the OECD countries will fall slightly in the coming year as the commodity rally slows. Meanwhile low underlying price pressure will start rising, though sedately. This pressure is still weak and will presumably climb slowly, since there are still a lot of idle post-crisis resources. The inflation risk seems larger in Western Europe than in the US, because the former region's output gap is smaller. In Eastern Europe, the impact of rising commodity prices

on broad inflation measures has been stronger than in the West. We have studied the trend in the EU countries of Eastern (including Central) Europe. For example in Poland, Harmonised Index of Consumer Prices (HICP) inflation rose from 1.9 per cent year-on-year in August 2010 to 3.3 per cent in February. In the Baltics, Estonia moved from deflation a year ago to a 5.5 per cent rate in February, Latvia's inflation reached 3.8 per cent and in Lithuania the rate was 3.0 per cent. However, this dramatic surge was also due to sizeable base effects (strongly depressed 12-month comparative figures) plus recent tax hikes and administrative price increases that are part of fiscal belt-tightening packages.

The pattern of faster price increases in Eastern Europe than in the West is largely due to the relatively heavier weighting of energy and food in the region's consumer baskets. Meanwhile appreciating currencies have eased such external price impulses to some extent.

Role of energy and food in CPI

Per cent (food includes alcoholic beverages and tobacco)

	Energy	Food		Energy	Food
Estonia	13	29	Poland	13	30
Latvia	14	31	Czech Rep.	13	27
Lithuania	14	34	Euro zone	10	19

Source: Eurostat

In most parts of Eastern Europe, core inflation has only risen slowly since year-end 2010. One exception is Estonia, where the rate has climbed from 0.7 per cent in August to 2 per cent. As elsewhere in the Baltics, base effects are part of the picture following the earlier downward price squeeze. Estonia's inflation trend may also diverge from Latvia and Lithuania since its economic recovery has been somewhat stronger. Price hikes when Estonia joined the euro zone on January 1, 2011 may also have contributed to some extent.

Looking ahead 1-2 years, we expect broad inflation measures in many Eastern European countries to fall somewhat. This assumes a slower commodity price upturn, milder base effects and continued currency appreciation. But inflation is unlikely to cool much, especially this year, since various tax hikes and administrative price increases will push up inflation figures. Inflation will continue climbing somewhat in Estonia and Lithuania as they utilise more and more resources following their deep economic crisis.

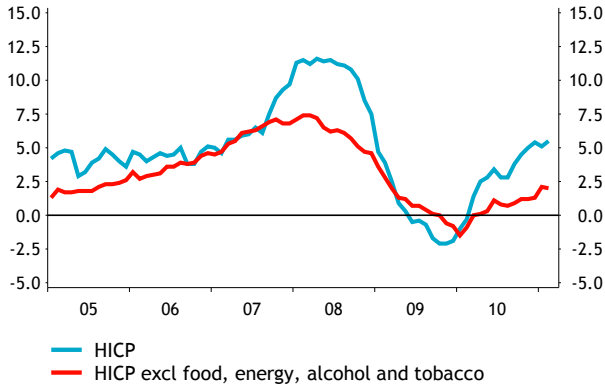
Meanwhile underlying price increases in Eastern Europe will gradually move upward from today's low levels. Faster pay hikes and accelerating economic activity will exert some upward pressure on consumer prices.

Our main conclusion is thus similar to that for the West: no Eastern Europe inflation surge is imminent. The main reason is that there are lots of idle resources after the

recession – The Baltic countries noted some of the world's steepest GDP declines. The exception is Poland, which weathered the crisis with no GDP downturn, and where the output gap will start closing in 2012. Eastern Europe was the region hardest hit by the global credit crisis and recession, partly due to its relatively high pre-crisis borrowing in foreign currencies.

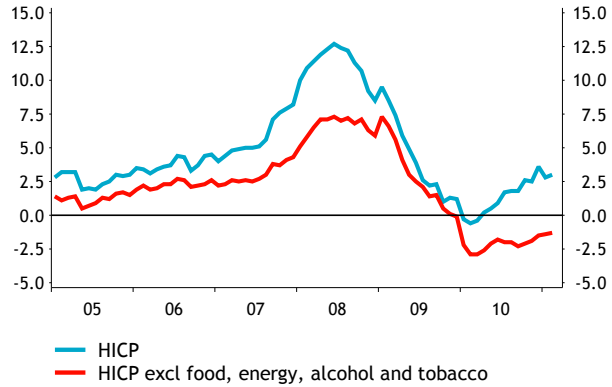
Estonia: Inflation

Year-on-year percentage change



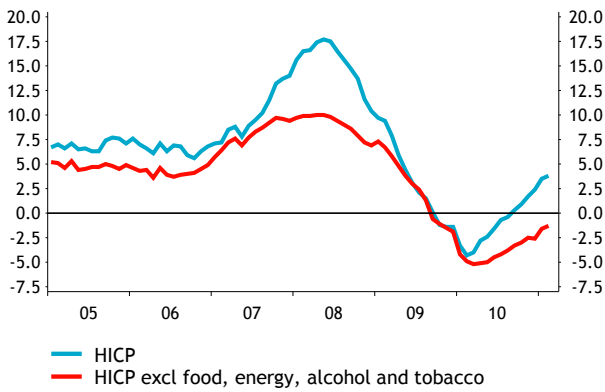
Lithuania: Inflation

Year-on-year percentage change



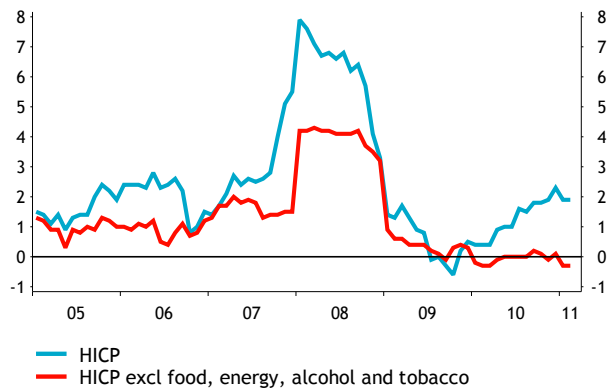
Latvia: Inflation

Year-on-year percentage change



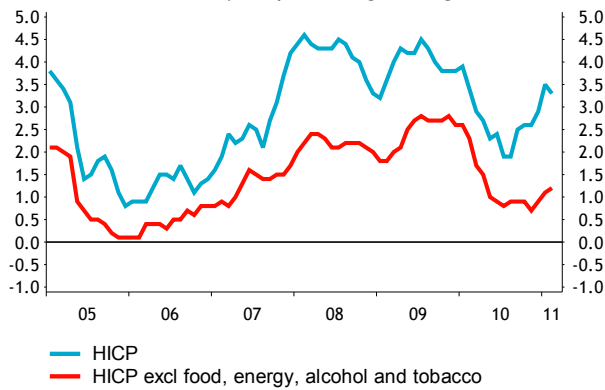
Czech Republic: Inflation

Year-on-year percentage change



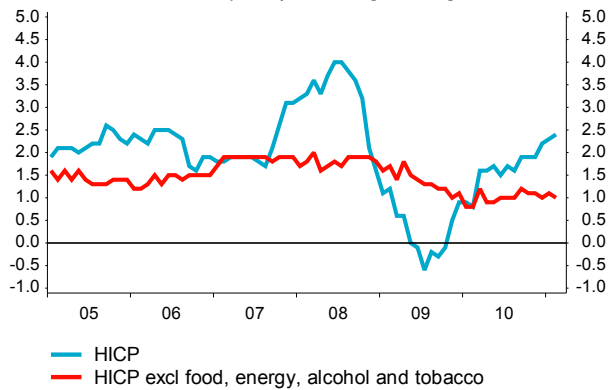
Poland: Inflation

Year-on-year percentage change



Euro zone: Inflation

Year-on-year percentage change



The export boom continues

- Labour market stronger than expected
- Weak upturn in consumption due to inflation and deleveraging
- Austerity policy is over

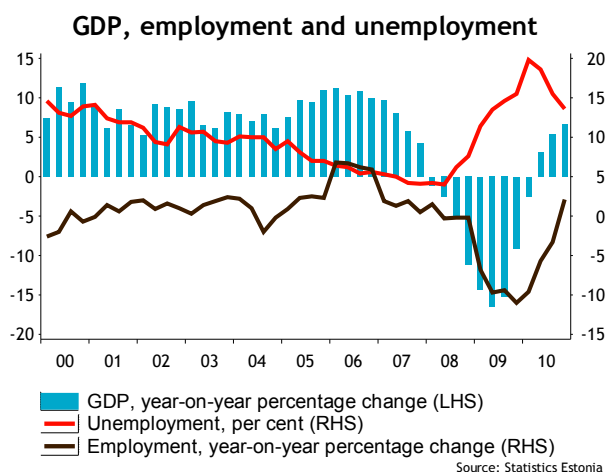
Estonia is in the midst of an export boom, with annual growth rates beating one record after another. In January, nominal exports were up by 57 per cent year on year. The performance of non-oil exports – from which the effects of Russian fuel transit have been eliminated – was even more staggering; they rose by 84 per cent in December. Total merchandise exports for 2010 amounted to EUR 8.7 billion, slightly higher than the pre-crisis peak of EUR 8.5 billion in 2008. The trade deficit of roughly EUR 0.5 billion was the lowest since 1995 even in absolute terms, let alone in relation to GDP (3.4 per cent).

Together with a smooth transition to the euro, this has lifted spirits. A broad-based sentiment index has shown one of the sharpest upswings in the EU. Given the strong correlation between exports and GDP since the second half of 2008, it is evident that the future outlook will remain dependent on trade performance.

Industry still growth-engine

In the fourth quarter, GDP grew by 6.7 per cent year-on-year. This brought the 2010 growth rate to 3.1 per cent. In the second and third quarters growth was driven mainly by stockbuilding, but in the fourth quarter net exports were once again the largest contributor. More tellingly, the growth contribution of fixed investments turned positive (2.5 percentage points) for the first time since mid-2007. Manufacturing remains the primary engine of recovery; in 2010 it contributed 2.6 percentage points to GDP growth.

Exports are benefiting from a combination of improved competitiveness, internal devaluation in recent years and a favourable trend in major markets, especially Sweden, which since autumn 2010 has been Estonia's largest export market. We expect the weighted average growth rate of Estonia's nine largest trade partners to be 3.9 per cent in 2011, an upward revision compared to the October 2010 issue of *Eastern European Outlook (EEO)*. Together with a much sharper than anticipated drop in unemployment, this contributes to the upward revision of our 2011 GDP forecast to 5.0 per cent. **In 2012 we expect GDP to grow by 4.5 per cent.**



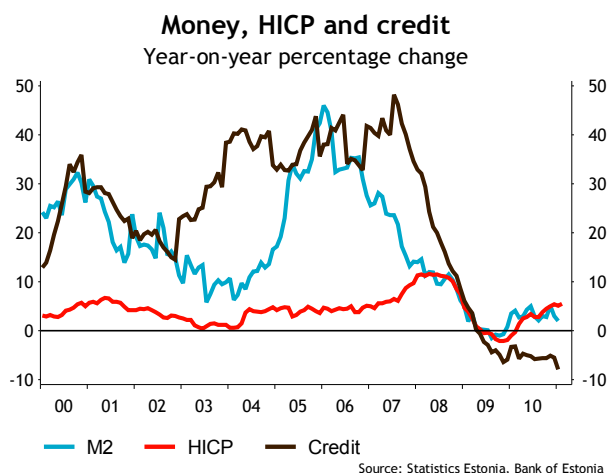
One of our central theses in the October *EEO* was a slow, drawn-out labour market recovery. The 5 percentage point fall in the unemployment rate during the third and fourth quarters was surprisingly large. Joblessness was 13.6 per cent at the end of 2010. The average 2010 rate was 16.9 per cent. The impact of export-led recovery in 2010 made unemployment drop faster than expected. Employment was up by 2.1 per cent in the fourth quarter, with the manufacturing sector employing 13 per cent more people than a year ago. That said, even though the total number of jobs is up by 7 per cent since last spring, it is still more than 10 per cent below its summer 2007 peak. Supply-side adjustments have been relatively modest. Compared to the peak late in 2008, the size of the labour force has stayed more or less the same. Unemployment will fall further from its fourth quarter level, coming in at 12 per cent in 2011 and 11 per cent in 2012.

Stronger employment gains and associated increases in nominal wages, which have risen since the second quarter of 2010, will provide improved support for domestic demand. The impact is, however, being held back by a gradual erosion in purchasing power. Real wages have declined since end-2008 and there is continued deleveraging in the household sector; outstanding loans have shrunk by 6 per cent since peaking at the end of 2008. The growth contribution of private demand has now been negative for three years in a row. In 2011 we expect a positive increase and a contribution of 1-2 percentage points.

Domestic liquidity contracting

In 2010 Estonia saw its largest liquidity outflow on record, with a total balance of payments deficit (the sum of current, capital and financial accounts) amount-

ing to 5.4 per cent of GDP. Part of the outflows had to do with the sharp decline in reserve requirements and the associated repatriation of surplus funds from the local banking sector. As a result, domestic monetary and credit aggregates have temporarily been contracting. The year-on-year growth rate in domestic credit was down to minus 8 per cent in January, while broad money (M2) growth turned negative last summer.



Hence, current account surpluses are increasingly insufficient to cover financial account deficits, with adverse effects on domestic liquidity. Last year's current account surplus was around 4 per cent of GDP. We expect it to come down to 2 per cent of GDP in 2011 and 1 per cent in 2012 as domestic demand picks up. Downward pressure on domestic liquidity is likely to intensify.

The financial account of the balance of payments has major influence on the miniscule Estonian real economy and inflation, since it determines the level of liquidity in the system.

Inflation is still rising, with the year-on-year rate at 5.7 per cent in February, primarily due to higher food prices

(up by 16 per cent in February). Looking ahead, we expect somewhat weaker price pressure in the coming quarters. First, there is the downward trend in money supply and second, inflation expectations seem to have stabilised in recent months. Finally, high unemployment will exert a disciplining effect on excessive wage demands. These factors must be weighed against higher commodity prices and wage rises in the tighter corners of Estonia's increasingly fragmented labour market. All in all, we expect inflation to moderate in the second half and to average 4 per cent in 2011. Due to continued recovery and monetary aggregates, including credits, inflation will probably be a bit higher in 2012.

Tough austerity packages have kept the general government deficit below the Maastricht ceiling, 3 per cent of GDP. The 2010 deficit is expected to come in at 1.0 per cent of GDP, increasing according to the government to 1.6 per cent in 2011 and 2.3 per cent in 2012. The government forecasts are, however, based on rather more restrained assumptions on nominal GDP growth rates; 5.6 per cent in 2011 and 6.6 per cent in 2012. Although our nominal growth outlook is more optimistic, we expect approximately the same deficit levels as the government does: 1.5 per cent of GDP in 2011 and 2.5 per cent in 2012. The main reason is that we expect somewhat laxer fiscal policy in the years ahead (see box). These deficit figures bring public debt to 12 per cent and 16 per cent of GDP in 2011 and 2012, respectively. An easing of fiscal policy at the same time as the ECB's monetary policy is gradually tightening but still expansionary may prove risky. It is important to keep inflation from getting stuck at 4-5 per cent, higher than in most other EU countries and far higher than the ECB's 2 per cent target. Otherwise, there is a risk that Estonia's recently regained competitiveness may again be lost.

Government wins new term despite austerity

The two-party coalition looks likely to stay in office for another four years. Prime Minister Andrus Ansip's Reform party won a widely predicted victory on March 6. Despite its recent austerity packages, the government was thus re-elected. With the Reform party gaining two seats and its coalition partner IRL adding four, the two now have a comfortable parliamentary majority: 56 votes out of 101.

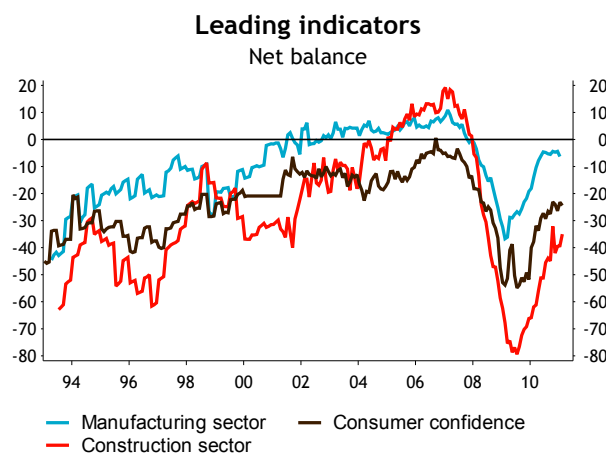
A net gain of 6 seats compared to the previous election means that voters largely endorsed pro-European, responsible policymaking at the heavy cost of a fiscal consolidation package with an overall impact of over 8 per cent on GDP. We thus expect no major changes in policy agenda or style.

That said, we envisage a somewhat weaker fiscal stance over the next four years. First, the smaller coalition partner IRL campaigned this time on an overtly populist ticket. While the Reform party will try its best to persuade IRL to drop the costliest items, some of them will probably be enacted, particularly if, as rumoured, IRL will be given the finance minister portfolio. Second, it is more difficult to argue for further consolidation now that the country is already in the euro zone. Third, part of what looked like aggressive cuts in 2008 and 2009 will turn out to be deferred spending in 2011-2015.

Exports support shaky domestic recovery

- Households still under pressure
- Continued fiscal tightening
- High but falling unemployment

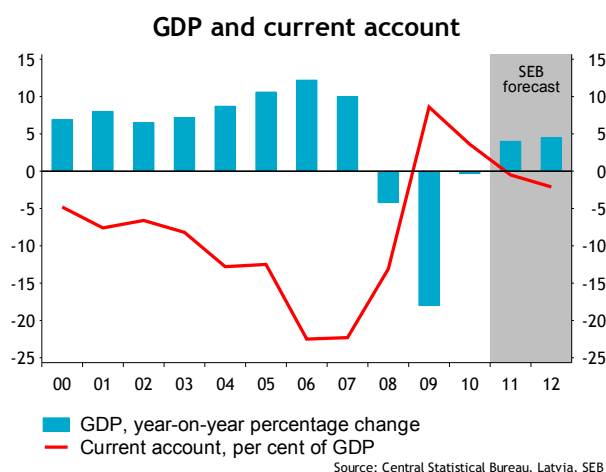
Last year, Latvia's economy stabilised after its depression-like 21.4 per cent GDP decline during 2008-2009. In 2010, GDP fell by a further 0.3 per cent but returned to growth in year-on-year terms during the third quarter. In the fourth quarter, growth had reached 3.6 per cent. The recovery is mainly export driven, though late in 2010 private consumption became livelier and helped to sustain growth. The performance of the construction and financial sectors was weak. Forward-looking indicators continued to strengthen last year from low levels, with manufacturing taking the lead but with construction and consumer confidence remaining historically low.



Our assessment is that the turnaround is now on firmer ground, but that the economy, especially this year, is characterised by duality. Exports continue to perform well, supported by renewed competitiveness and good sales in old as well as new markets. On the other hand, domestic demand is improving only slowly. Households are under pressure due to continued fiscal tightening, albeit not as significant as in previous years. Wages are rising, but purchasing power is being eroded by higher inflation. Unemployment is gradually declining, but structural labour market problems and emigration pose risks to the economy and constitute political challenges. **We expect GDP to grow by 4.0 per cent in 2011 and 4.5 per cent in 2012.**

Strong export growth led to a historically low trade deficit in 2010. Exports rose by one third, while imports

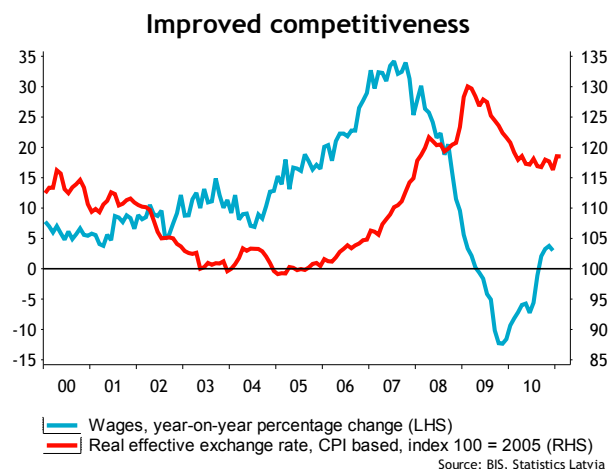
were up by one fourth. Despite continued robust export growth this year, we expect the trade deficit to widen again after shrinking dramatically since mid-2007. The reason is growing imports, driven by manufacturing and a weak recovery in domestic demand. The current account surplus, which narrowed to 3.6 per cent of GDP last year, will shrink further and may turn into a deficit as early as the second half of 2011. The surpluses of recent years are largely due to losses incurred by foreign investment companies, mostly related to the banking sector, but lately also reflect a pickup in tourism and the transit trade. However, we do not foresee any build-up of large current account imbalances, which was one of the main pre-crisis problems.



After peaking at 20.7 per cent in the first quarter of 2010, unemployment shrank to 17.2 per cent in the fourth quarter. As a consequence of the crisis, there is a growing number of long-term unemployed. According to statistics, nine out of ten job seekers were previously employed. There is a risk that they will lose qualifications in an environment where economic growth is not sufficiently strong to generate enough jobs. This might also sustain emigration. The government can mitigate this through training programmes and tax policy, which the IMF has also suggested in its lending agreement. We expect unemployment to decline, partly due to supply effects, and to average 14.7 per cent in 2012.

After declining for six straight quarters, wages and salaries rose by 3.4 per cent year-on-year in the fourth quarter of 2010. The biggest increase was in the public sector, up 5.1 per cent, while in the private sector it was only 2.1 per cent. We foresee slowly rising nominal gross wages, but net and real wage growth will be held back by tax hikes and higher inflation in 2011.

The internal devaluation process is thus over. Competitiveness has improved, with wages and salaries falling almost 20 per cent – the largest overall pay cut in the Baltic countries.



Deflationary pressure ended last autumn, and inflation again turned positive. In February 2011 it reached 4 per cent. Soaring fuel and food prices in global markets and changes in value-added, excise and real estate taxes are the main inflation drivers. Expected increases in electricity charges in April and taxes in June will add to inflation. The inflation rate may thus reach 5 per cent in the coming months. Furthermore, inflation expectations have risen. We have lifted this year's forecast to 3.3 per cent. For next year we foresee inflation of 2.4 per cent.

In recent months there have been initial signs of recovery in the retail trade, after a 34 per cent drop between 2007 and 2010. January's small monthly increase of 0.1 per cent was largely due to a sharp drop in fuel sales; excluding this, retail sales increased by 4.8 per cent. High energy prices partly explain the drop, but it may also be partly due to an increased grey fuel market.

Household income will gradually improve, leading to a weak upturn in private consumption in the years ahead. The duality between people with and without jobs, combined with rising food and energy prices, may affect consumption patterns ahead.

The banking sector is continuing to recover from the losses incurred during the crisis. The total loss last year was 360.7 million lats. In January the banking sector reported a profit of LVL 10.9 million. The situation improved due to a reduction in provisions and the recovery of assets that had been written off, as well as higher net interest income. The banks continued to increase their share capital. The aggregate bank loan portfolio shrank further. Deleveraging will continue but may slow by the end of the year.

Budget consolidation continues

A preliminary estimate shows that the government budget deficit in 2010 was 8.2 per cent of GDP. The budget for 2011 includes fiscal consolidation of LVL 290.7 million, but a further LVL 50 million in belt-tightening was presented early this year due to IMF demands. These consolidation measures include combating the shadow economy, levying a tax on non-bank credit institutions, trimming salaries and jobs in the public administration and raising the gambling tax. They also include higher excise taxes on fuel (petrol), cigarettes and alcoholic beverages. The reduction in the VAT rate on natural gas will be cancelled, which may push up electricity charges.

The latest addition to the consolidation plan was mainly revenue-oriented. Raising taxes might play into the hands of the grey economy. Increased taxes on fuel will adversely affect the economy by increasing inflation. International creditors will have to be persuaded of the rationality of the plan. They will probably disagree about some parts. The IMF and the EU have already hinted that more should be done on the expenditure side. Our assessment is that there will be an agreement in the near term (the IMF/EU-led loan package lasts from December 2008-2011 and will probably be replaced by a traditional stand-by-agreement).

Where to find the millions for continued budget consolidation in 2012 remains to be answered. There will probably be cuts in the social welfare field. Meanwhile, such decisions will be achieved by political compromise. Continued tax increases that fuel inflation might threaten Latvia's ability to meet the Maastricht inflation criterion and its ambition to join the euro zone in 2014.

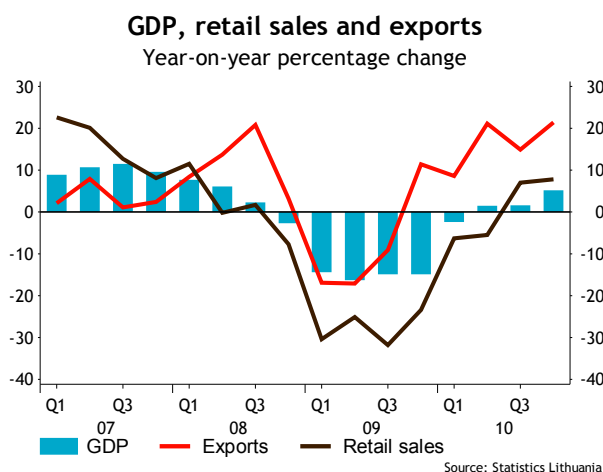
In the past year, Latvia's disciplined budget consolidation, economic recovery and internal devaluation have helped it to regain the trust of financial markets. There is now solid confidence in the currency peg against the euro, and there has been no contagion from recent euro zone crises. One sign of a more positive view of Latvia's economic situation is that rating agencies have started to improve their outlook. For example, late last year Standard & Poor's raised the country's sovereign credit rating to BB+. In March S&P revised its outlook on Latvia's ratings from stable to positive. During the first half of 2011, when we believe that the latest consolidation measures will be approved by international lenders, Latvia may see yet another upgrading of its sovereign credit rating.

Stronger upturn – labour shortage a hindrance

- Domestic demand starting to grow
- Some relaxation of fiscal tightening
- Inflation risks are rising

Last year, the Lithuanian economy started to recover after its record decline in 2009 and grew by 1.3 per cent. First and foremost, the recovery took off thanks to stronger external demand. This year we expect a more balanced picture. Domestic demand shows signs of gradual improvement, and exports are continuing to rise due to improved competitiveness and good growth in major export markets. In addition, the most severe fiscal measures are in the past. **We forecast GDP growth of 4 per cent this year and 4.5 per cent in 2012.**

The beginning of 2010 was quite gloomy, as GDP decreased by 2.0 per cent in the first quarter year-on-year. However, growth picked up to 4.8 per cent in the fourth quarter. The early birds in the business cycle were manufacturing and the transport sector, both closely related to export activity. Meanwhile the retail trade and construction did not show positive results until the third quarter of 2010. Agriculture suffered from unfavourable weather conditions in the summer and, as a consequence, a 30 per cent lower cereal harvest.



Export growth remains impressive, albeit slower, supported by strong demand among major trading partners and soaring commodity prices. In January, both merchandise exports and imports grew by 60 per cent year-on-year in nominal terms. The poor harvest in Russia and Poland has provided a favourable basis for food exports. Furthermore, we expect continued strong

exports of oil products and increased re-exports of used passenger cars.

Capital spending was still lamentable last year, after a 40 per cent drop in 2009. It remained flat throughout the year compared to 2009. Looking ahead, continued relatively low capacity utilisation makes only a gradual continued upturn in fixed investments likely. The construction sector grew by 7 per cent in the second half of 2010, mainly due to investments in infrastructure, while residential construction stalled. The number of flats built in 2010 was down 61 per cent compared to 2009. On the other hand, low activity has laid the groundwork for recovery in the housing sector, since the supply of new residential property has shrunk to a minimum. Some companies are returning to the market after a break of 2-3 years with the intention of developing large new housing projects. However, there are small positive movements only in Vilnius, the capital, whereas the market in other cities remains sleepy. Housing prices in the five largest cities have remained unchanged since touching bottom in June 2010. We expect them to rise by 5 per cent this year.

Private consumption finally sent encouraging signals at the end of 2010. After eight consecutive quarters of decline, household consumptions increased by 3.3 per cent year-on-year in the fourth quarter.

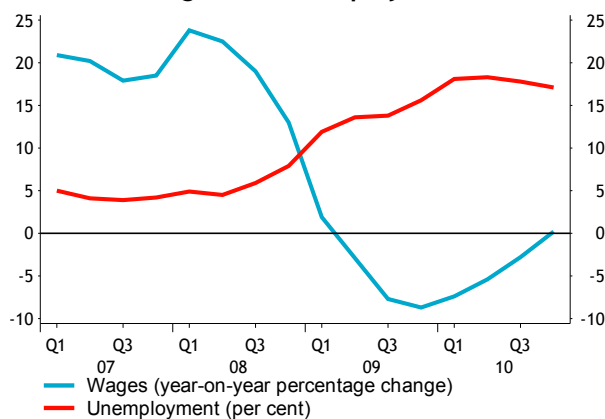
Recent labour market trends add up to favourable signs in the domestic market. The unemployment rate declined to 17.1 per cent in the fourth quarter of 2010 from its peak of 18.3 per cent two quarters before. The number of unemployment benefit claims fell significantly. On the other hand, the percentage of long-term unemployed and young unemployed people is very high. The two latter groups are highly inclined to emigrate, and this is likely to further intensify the outflow of labour.

As pointed out in the previous *Eastern European Outlook*, emigration markedly increased in 2010 to 40-50,000. The flow barely eased early in 2011, with almost 9,000 emigration declarations in January and February. What is more, Germany and Austria will open their labour markets to Lithuanians in May and Switzerland in June, while Malta and the UK will ease existing restrictions starting in May. We estimate that 10 per cent of the labour force has left the country over the past decade. However, according to the Labour Force Survey, the labour force actually expanded over 2009-

2010, possibly due to decreasing inactivity and higher retirement ages.

Despite high unemployment, the labour shortage will become increasingly acute and will hamper recovery, particularly in transportation, IT, shipbuilding, textiles and food processing. On the other hand, remittances from emigrants continue to play an increasing role in household finances. In 2010, official remittances increased by 43 per cent. This made up as much as 24 per cent of total wages and salaries in Lithuania.

Wages and unemployment



Consolidation of wages and salaries has already come to an end, as we projected in the last *EEO*. In the fourth quarter of 2010 wages and salaries grew by 0.2 per cent on an annual basis, for the first time in almost two years. Public sector pay in 2011 was frozen according to the government's decision. Nevertheless wages and salaries will continue to grow this year, primarily in exporting industries. We forecast that pay increases in nominal terms will total 3.5 per cent at the end of 2011 and 5.0 per cent at the end of 2012.

Due to increasing inflation, real household income will continue to rise very slowly or even shrink in 2011. The risk of a wage-price spiral is increasing and would be very harmful to the consumption recovery in the current cyclical phase. Despite meagre income growth, we expect consumption to grow by 3 per cent in 2011. Increased confidence will lead to lower savings among households. Credit growth is only expected to return gradually.

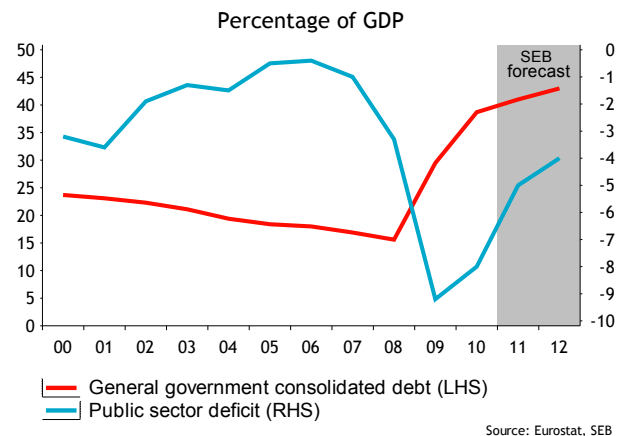
After a brief deflationary period early in 2010, inflation picked up last autumn due to higher global food and energy prices. In 2010, the average annual HICP inflation rate stood at 1.2 per cent. We expect it to increase to an average of 3.5 per cent in 2011 and 4.0 per cent in 2012.

Fiscal tightening in 2011 has softened a bit compared to 2009-2010. The expenditure side remains under strict control, including a pay freeze for public servants and a backup plan for additional cuts if the budget outcome is worse than planned. However, there were no big changes in taxation, except increases in some excise

duties required by the EU. In 2010, budget revenue exceeded plan by 9 per cent. Early in 2011, revenue collection fell slightly short of the ambitious target for the period. In 2011, the government aims to reduce the public sector deficit to 5.8 per cent of GDP, helped by more buoyant economic growth and lower demand for unemployment benefits. We think this target is realistic. In 2012, the possibility of more relaxed fiscal discipline before the October parliamentary election cannot be ruled out. This threatens the government's ambition to keep the deficit within the Maastricht maximum (3 per cent of GDP), which is necessary ahead of planned euro zone membership in 2014. Overly high inflation may also threaten this timetable.

General government consolidated debt has been at a relatively low level in international terms, increasing to 38.7 per cent of GDP at the end of 2010. This debt will increase, albeit at a much slower pace than in recent years. It will reach 41 per cent of GDP at the end of 2011, below Maastricht's 60 per cent limit.

Public deficit and debt



Despite its low popularity in opinion polls after making painful fiscal decisions, the ruling coalition managed to score rather good results in the February 2011 local elections. Prime Minister Andrius Kubilius' party, the Homeland Union-Lithuanian Christian Democrats got 16 per cent of the total seats in municipal councils throughout the country. This represented second place after their main rival, the Lithuanian Social Democratic Party, which won 22 per cent of the total seats. The election results eased some of the political pressure on the ruling coalition. Nonetheless, there is still a way to go until the parliamentary election. We expect more opposition parties to become increasingly active, especially when budget discussions start in the autumn of 2011. Despite the possibility of increased clashes in parliament, our main scenario is that the current ruling coalition will remain in power until the election.

Continued good growth despite imbalances

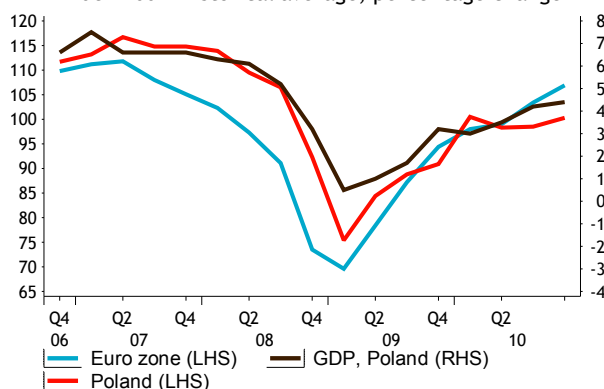
- Budget deficits and inflation worrisome
- New austerity after election
- Higher key interest rate, stronger zloty

Poland, the only EU country to show positive growth all through the crisis, will continue to perform well. Last year ended strongly, with annual GDP growth of nearly 4.5 per cent in the fourth quarter. We expect continued good growth. **GDP will rise 4.5 per cent in 2011 and 4.6 per cent in 2012.** Although small declines to regain, the economy will grow rapidly. Several factors support a positive trend ahead. Confidence indicators are at good levels, and capital spending is expected to take off. Exports are rising even though the zloty has strengthened. Household consumption will keep growing, though more slowly than before the crisis. The main sources of worry are inflation and large public sector deficits. Deficits widened because of fiscal stimulus during the crisis; further tightening is expected after this autumn's parliamentary election. In recent months, inflation has exceeded the central bank's upper limit.

Economic growth expectations levelled out last year, according to the European Commission's survey. Other indicators show continued improvement. Although the purchasing managers' index for manufacturing fell to 53.8 in February from 55.6 in January, manufacturing, construction and service companies remain optimistic.

EU sentiment survey supports higher growth

Index 100 = historical average, percentage change

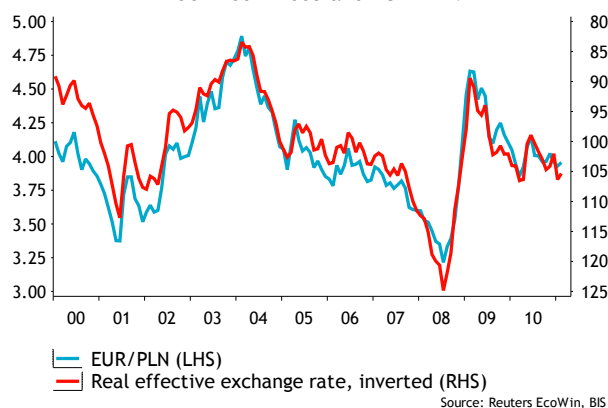


Industrial production is showing pre-crisis growth rates, with indicators signalling continued expansion. Exports benefited from the weak zloty but appear set to continue performing well even though the currency has regained about half its decline. Real effective exchange rate and the EUR/PLN rate are tracking each other

closely. Poland seems to lack underlying problems of deteriorating competitiveness. Although imports have also recovered, net exports will contribute positively to GDP growth over the next couple of years. The current account – negative for a decade – reached about -5 per cent of GDP before the crisis. Since imports fell more than exports during the crisis, the balance improved sharply, but rising commodity prices and other factors will push the deficit back above 4 per cent in 2012.

Zlotyn gaining strength

Index 100 = 2005 and EUR/PLN



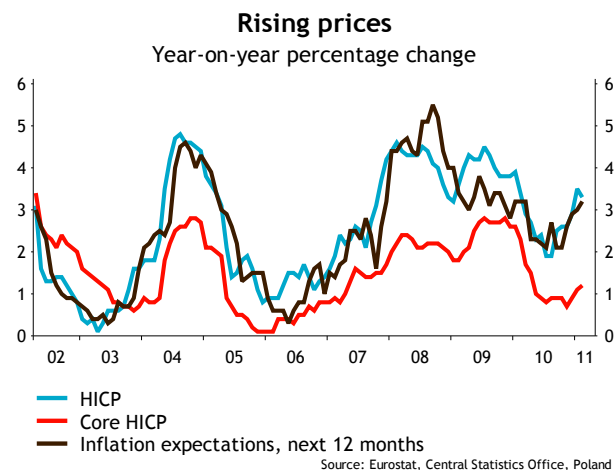
To maintain good growth, it is important for capital spending to take off. After two years of decline, investments are now expected to rise, supported by several factors. Capacity utilisation remains below pre-crisis levels, but not far below historical averages. In addition, real interest remains low, capital spending, as a percentage of GDP, is historically and internationally low and the credit stock, as a percentage of GDP, is at a relatively modest level. In spite of public deficits, public investments will be sustained by EU funds and by preparations for the European football championship, which Poland and Ukraine are co-organising in 2012.

Household consumption was kept going throughout the crisis. The rate of pay increases admittedly slowed, but Poland did not undergo the same real wage squeeze as many other countries in the region. A low debt level made public sector stimulus possible. In recent months, wage and salary growth has accelerated, although we expect a more moderate pace ahead, due among other things to a public sector pay freeze. The savings ratio has fallen, which is a source of some concern and household borrowing is expected to increase slower than pre-crisis.

During the crisis, unemployment rose from a low of 6.9 per cent late in 2008 (according to the harmonised EU

measure) to nearly 10 per cent in early 2010 and has remained relatively unchanged since then. We expect joblessness to fall slowly to 9.4 per cent in 2011 and 8.9 per cent in 2012 as annual averages. The rate will be affected more than normally by developments in Western Europe; poor growth in countries where Poles have previously sought work, such as the UK and Ireland, is causing more people to return home. This will boost the labour supply and slow the decline in unemployment.

HICP inflation, rose unexpectedly fast to 3.5 per cent in January. The national CPI measure rose to 3.8 per cent, above the central bank target of 2.5 ± 1 per cent. This increase is largely due to rising food and energy prices and a 1 per cent VAT hike. Core HICP in January was 1.1 per cent and is expected to increase this year and next to 2 per cent. Inflation expectations have turned out to follow the CPI relatively well, and the rate of pay increases rose late in 2010. Although we expect inflation to start falling during this year, we are revising our inflation forecast to 3.7 per cent in 2011 and 2.8 per cent 2012.



Inflation will stay above the central bank's target this year and then fall to 2.5-3.0 per cent when food prices are normalised, the effect of the VAT hike disappears and due to effects of interest hikes and the stronger zloty. Further tightening of fiscal policy may make it easier for the central bank to keep inflation down. It will hike its key rate gradually to 4.50 per cent by the end of 2011 and to 5.25 per cent by the end of 2012. The zloty has regained half of its decline during the crisis and should strengthen further; we remain positive towards the zloty in the long term. Because of good economic growth over the next couple of years and key rate hikes, although structural reforms are conspicuously absent and public financial problems are being tackled in short-sighted ways, there is room for further currency appreciation ahead.

An expansionary fiscal policy sustained demand during the crisis; the aftermath is that the public deficit has risen sharply to nearly 8 per cent of GDP in 2010. The government debt ratio came in just below the 55 per cent limit according to national debt rules (see box). To avoid breaching further levels under these rules, the

government has launched a moderate four-year belt-tightening programme based on a VAT increase, slightly lower spending (a public sector pay freeze and ceilings on spending increases) and changes in the pension system. One concern is the absence of major spending adjustments; the changes in the pension system are also based on accounting technicalities; different types of provisions have different effects on net lending according to EU rules. Smaller provisions will be made to the non-public part of the system and more will remain in the public sector. This change will improve public finances in the short term but instead increase long-term government pension expenditures.

Poland's debt ceiling

Fiscal rules specify the imposition of certain limits when government debt exceeds 50, 55 and 60 per cent of GDP, the latter is written into the constitution; Poland's debt measure diverges slightly from the Maastricht definition and is about a percentage point lower. When debt reaches 50 per cent of GDP, the government must budget for a lower deficit in the second year after this occurs. When debt surpasses 55 per cent, the government must present a plan for achieving lower debt in the second year after this occurs. Finally, if debt exceeds 60 per cent, the government must balance the budget the year after this level was reached; if this is achieved, the debt ratio will fall as long as nominal GDP increases.

Keeping growth up during the crisis slowed the increase in the debt ratio. Continued good growth is necessary to prevent government debt from exceeding further debt limits. Our assessment is that the government needs to implement further belt-tightening to reach a deficit below 3 per cent of GDP by 2012. This would enable Poland to join the euro zone as early as 2014. The government seems to be aiming at 2015, but it might be delayed further. Because of the October 2011 parliamentary election, the government (Civic Platform and Peasants' Party) is unlikely to implement further measures before then. Our assessment is that the reform agenda will be speeded up after the election though. Meanwhile we do not believe that Poland risks borrowing problems, despite 10-year bond yields above 6 per cent. Public debt is relatively low, the country has an IMF credit facility and much of its debt is domestically financed. Overall, we expect the deficit to fall in the next couple of years, with debt stabilising at around 55 per cent of GDP due to solid growth and further privatisations. Short term strategies to reduce the deficit (pension reform) makes us believe that further short-term measures will be taken if the 55 per cent level is further threatened, such as redefining debt limits in the debt-rule.

Higher oil prices will drive up growth

- **Monetary policy is tightening...**
- **... but high oil prices will enable Russia to pursue a more expansionary fiscal policy**
- **Inflation will eventually decelerate**

After a sharp decline in 2009, Russia's GDP began to recover during 2010. In the third quarter, however, growth decelerated to 2.7 per cent year-on-year. This slowdown is explained by extreme summer weather, which had a clear negative impact not only on grain production but also on industrial production and retail sales. The heat wave lowered Russia's full-year growth by an estimated 0.5-1.0 percentage points.

Growth bounced back in the fourth quarter, with GDP rising at about a 5 per cent rate. There are still no figures for individual GDP components, but net exports are believed to have made a clear positive contribution to growth. In 2010 as a whole, GDP grew by around 4 per cent: a moderate recovery after a nearly 8 per cent decline in 2009.

Some of the most recently published statistics indicate a sluggish start in 2011, with downside surprises mainly in retailing but also capital spending. Base effects will also be less favourable during 2011 than in 2010, but this should be offset by the recent sharp rise in oil prices, which will drive up exports and enable Russia's federal government to pursue a more expansionary fiscal policy. Forward-looking indicators are also surging. **Overall, we expect GDP to climb by 5.6 per cent in 2011 and by 5.2 per cent in 2012**, an upward revision of 1.1 and 0.4 percentage points respectively compared to the last *Eastern European Outlook (EEO)*. The rise in the oil price could have justified a larger upward revision but this is balanced by the uncertainty surrounding private consumption which will be dampened by the rise in inflation.

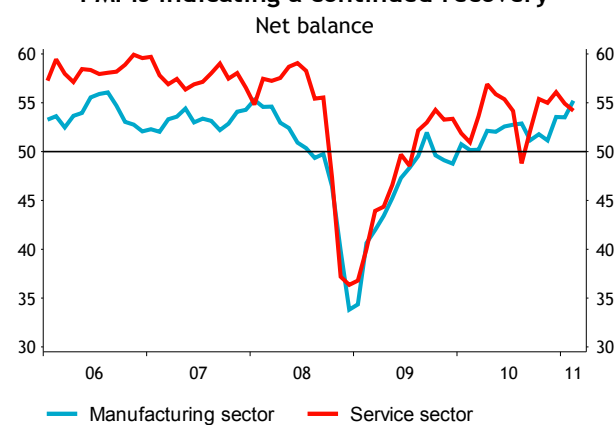
Indicators close to pre-crisis levels

Indicators are pointing towards continued recovery. After a slump last autumn, the purchasing managers' index (PMI) in manufacturing has improved sharply in recent months. The index reached 55.2 in February, its highest level since January 2008. The service sector PMI is also at a high level, though it has fallen in the past two months. Leading indicators have continued to climb and are now beginning to approach pre-crisis levels; the financial sector indicator has soared in the past three

quarters. The improvement in consumer confidence has come to a halt, however, probably due to rising inflation.

Industrial production has shown steady performance in recent months; in February it rose at a year-on-year pace of 5.8 per cent. This is a further indication that the recovery is continuing. We expect industrial production to gain around 7 per cent in 2011.

PMI is indicating a continued recovery



Exports have been stimulated by rising energy and metal prices. In January the year-on-year rate of increase in current prices was just above 20 per cent. Exports have risen more strongly than imports in recent months, and in January the trade surplus was no less than USD 17.3 billion. This represented an increase of almost 60 per cent of the surplus since November. Since exports are expected to keep rising strongly due to continued high energy and metal prices, we are revising our 2011 current account forecast upward to a surplus of 5.0 per cent of GDP.

More muted increase in wages and retail sales



The rising inflation rate has clearly hampered real wage increases in recent months. As a result of this, the previously solid pace of increase in retail sales has slowed noticeably. In February, sales rose only 3.3 per cent year-on-year, compared to increases of nearly 7 per cent in the summer of 2010. Since inflation is expected to remain high, real wage increases will continue to be weak. In addition, the government is introducing requirements that businesses set aside larger sums for social insurance contributions, and employers may thus try to hold down wage and salary increases. Private consumption will thus show weak growth during the first half of 2011, but the rate will improve later in the

year. Looking a bit further ahead, however, we expect consumption to be one of the main drivers of Russian economic growth.

During the autumn of 2010, unemployment fell faster than expected, but the trend has now reversed. In February, unemployment was 7.4 per cent or almost one percentage point above its 2010 low, which occurred in September. The number of people with jobs has also fallen in recent months. Because of the labour market improvement in 2010, the jobless rate has approached the non-accelerating inflation rate of unemployment (NAIRU). Estimates indicate that NAIRU lies in the

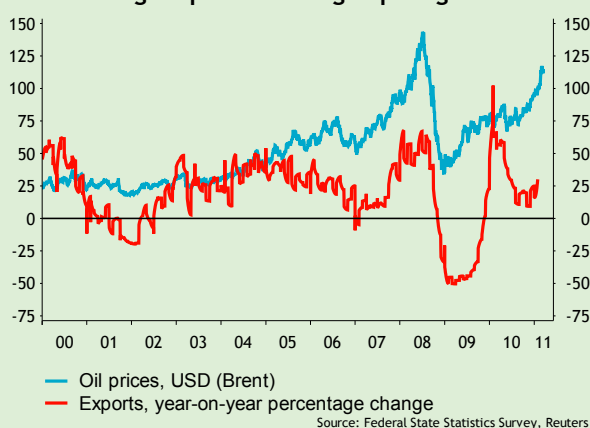
How oil lubricates the Russian economy

During 2010 oil prices moved in the USD 70-90/barrel range, but the unrest in North Africa and the Middle East caused them to climb sharply. Since January 1 the increase has been around 20 per cent. The price of Brent crude, which is several dollars above Russia's Urals oil price, is now around USD 116/barrel. SEB's forecast is that the price of Brent will ease over time and that the average for 2011 will end up at USD 102/barrel, an upward revision compared to our forecast of USD 80 in the October 2010 issue of *EEO*.

Because oil prices are so important both to Russia's exports and budget revenue, the price increase will have a clear impact on the economy. The oil and gas sector accounts for some 15 per cent of GDP and generates about 65 per cent of export income. As in other economies, there is also a risk that rising oil prices will drive up inflation.

For Russia, the effects of rising oil prices occur through two main channels: through an improvement in Russia's terms-of-trade and through increased capital inflows.

Rising oil prices driving export growth



There are many different estimates and rules of thumb as to how oil price rises affect GDP growth. Since oil and gas exports represent around 15 per cent of GDP, a 10 per cent oil price increase would raise GDP by about 1.5 per cent. Estimates from empirical

studies conducted by the International Monetary Fund (IMF) support this association.

A rough estimate based on SEB's upward revision for 2011 of USD 22/barrel (28 per cent) would, through a terms-of-trade effect, increase GDP by 4 per cent, all else being equal. However, the actual effect on GDP will not automatically be 4 per cent but depends on how the additional export income is used.

In Russia's case, most (around 90 per cent) of the additional export income will end up in central government coffers as a result of high marginal taxation. The crucial question regarding how economic growth will be affected by rising oil prices is thus how the government decides to use this additional revenue. If this revenue is used to cover the budget deficit, its impact on GDP will be small. Since 2011 is an election year, however, there are clear incentives to spend the extra revenue. A more expansionary fiscal policy would thus push economic growth higher. If oil prices remain around USD 100/barrel or more, our assessment is that the government will unveil a supplementary budget during the second half of 2011 where some of the extra revenue is used to stimulate the economy. The supplementary budget is expected to increase GDP growth by around 1.5 percentage point.

Rising oil prices will also have an effect on the Russian economy through increased capital inflows. These flows go partly into portfolio and direct investments, and partly into the banking sector. Capital inflows risk driving both credit growth and inflation. Since the central bank is now more inclined to accept currency appreciation, however, the inflows may have their main impact by strengthening the exchange rate of the rouble.

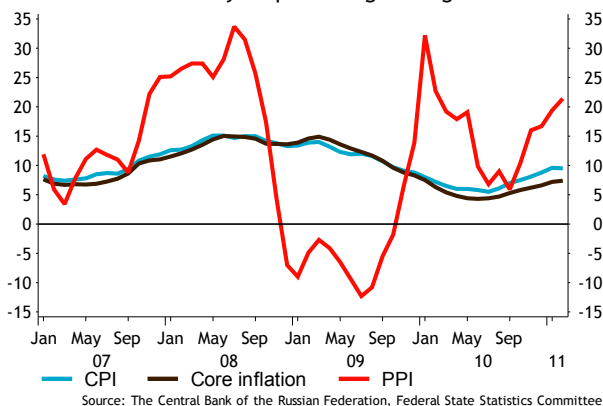
In the long term, high oil prices may have adverse effects on economic policy, since they weaken the resolve of both political leaders and the general public to implement necessary reforms. As a result, Russia's problems of excessive central government influence on the economy, poor business climate and vulnerability to oil price declines will persist.

6.5-7.0 per cent range. It thus looks as if unemployment cannot fall much more without helping to push up inflation.

Rising food prices have driven up Russia's inflation rate since it bottomed out in July 2010 at a record-low 5.5 per cent. In February 2011, inflation was running at 9.5 per cent. Core inflation has also risen noticeably. So have producer prices, which reached a 21.4 per cent rate of increase in February. Rising inflation is contrary to the central bank's aim of pushing down inflation and preventing it from returning to its high pre-crisis levels. The bank's target is that inflation should be 7 per cent by the end of 2011. In our assessment, inflation will peak this summer and then fall during the second half of 2011 due to base effects from the rapidly rising food prices of last autumn. By the end of 2011, we expect inflation to stand at about 8.5 per cent. During 2012, inflation will fall somewhat further.

Increasing inflation pressure

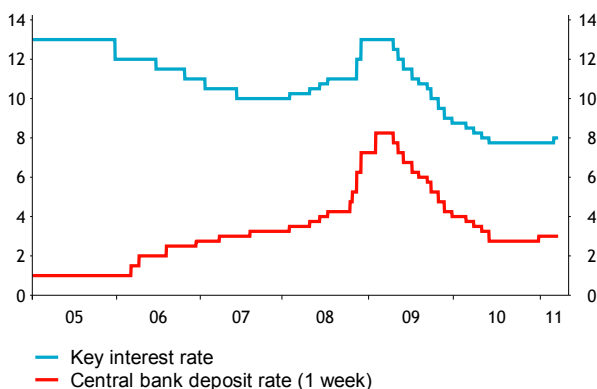
Year-on-year percentage change



Rapidly rising inflation will force the central bank to continue its monetary tightening. In January it raised bank cash reserve requirements, while leaving its key interest rate unchanged due to concerns about increased capital inflows. This was followed up by hikes in certain other short-term market interest rates. Late in February, the bank raised its key rate by 25 basis points to 8.0 per cent. At the same time, there were also upward adjustments in reserve requirements and the interest rate on deposits in the central bank.

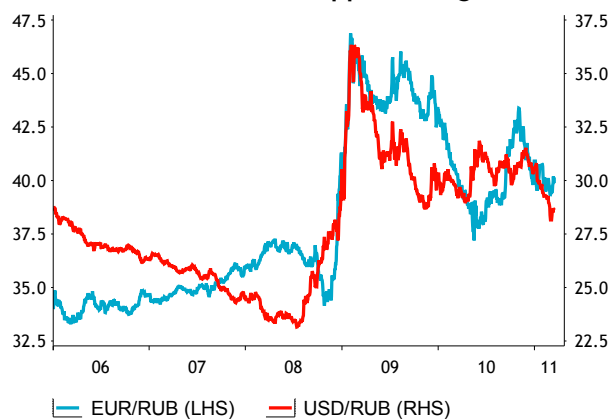
Interest rates are being hiked

Per cent



The central bank has made it clear that it wants to give higher priority to its inflation target than to controlling rouble exchange rates, but weak growth in domestic demand is leaving less room for more aggressive interest rate hikes. It is thus probable that, as in China and elsewhere, the Russian central bank will continue to use a combination of different measures in an effort to cool inflation. We expect the key rate to be hiked by another 100 basis points in 2011.

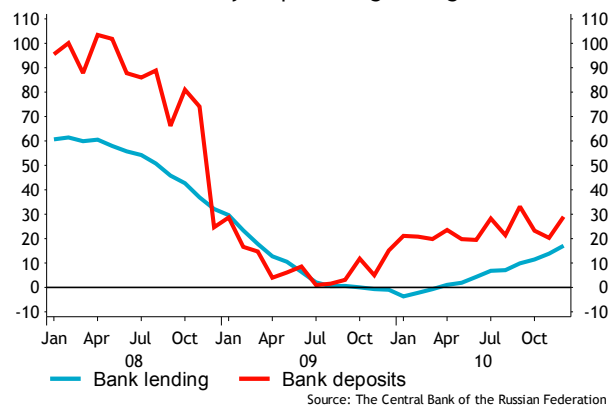
The rouble is appreciating



The rouble has appreciated noticeably since the end of last year, primarily against the dollar but also against the euro. Since January 1, it has risen about 7 per cent against the dollar, and since bottoming out in February 2009 it has gained more than 20 per cent. There is potential for continued rouble appreciation during 2011. Exports appear likely to increase strongly, thanks to higher commodity prices. Additional key interest rate hikes are expected, while the government's privatisation programme will help boost the demand for roubles. Furthermore, the central bank is now more inclined to permit greater volatility in the exchange rate, as the IMF has advocated. In October 2010, the central bank enlarged the band within which the rouble exchange rate is allowed to move. Early in February, the bank announced that the fluctuation band will be expanded further to 32-37 measured against Russia's currency basket, consisting of 55 per cent USD and 45 per cent EUR. Our assessment is that the rouble will strengthen to 32.0 at the end of 2011 and to 31.5 at the end of 2012.

Continued recovery in the banking sector

Year-on-year percentage change



Russia's banking sector has continued to recover at a moderate pace in the past several quarters. Both deposits and lending are growing, although the rates of increase are well below pre-crisis levels. The percentage of problem loans is believed to have peaked during 2010 and continues to decline. Because of easing worries about bad loans, banks are becoming more profitable and their need for further recapitalisation is diminishing. Bank lending is expected to rise by about 20 per cent during 2011.

More expansionary fiscal policy is possible

The federal budget for 2011 was approved in late January. According to the budget, fiscal policy will be tightening somewhat, mainly by raising the amounts that businesses must set aside for social insurance contributions and through a higher gas extraction tax. This tightening is equivalent to around 2 per cent of GDP. However, after the budget was presented, oil prices have continued to climb, and the current question is how the government will deal with its additional revenue from oil exports. The fact that both a parliamentary election and a presidential election are less than one year away will create incentives to spend this extra revenue. A supplementary budget may thus be submitted in order to address how to use the additional money.

The 2010 budget deficit was approximately 4 per cent of GDP, which was a better outcome than the target of 5.4 per cent. According to goals Russia established in 2010, the budget deficit will be trimmed to 3.6 per cent of GDP in 2011, 3.1 per cent in 2012 and 2.9 per cent in 2013. Since 2010, however, oil prices have climbed sharply while the rouble has appreciated. If high oil prices persist, the budget deficit will shrink considerably faster. The budget may end up in balance as early as 2011 if the federal government should decide to use the additional tax revenue generated by oil exports to reduce the deficit. However, our assessment is that some of the extra revenue will be used to stimulate the economy.

The ambitious privatisation plan announced back in September 2009 has now been approved by the government. Assets worth around USD 50 billion will be privatised during the next five years, and the proceeds will be used to cover the budget deficit. In all, the plan covers several hundred companies, but the most important ones are 10 large state-owned companies. They include two major banks, VTB and Sberbank, as well as the oil company Rosneft. At first the federal government will retain at least a 50 per cent stake in these companies, but Finance Minister Alexei Kudrin expects that the government can lower its stake to 25 per cent after 2015.

Stable domestic policies and the dream of WTO membership

The parliamentary election will be held in December 2011 and the presidential election in March 2012. Public opinion surveys indicate continued strong support for both Prime Minister Vladimir Putin and President Dmitry Medvedev. Medvedev's decision to fire Moscow's popular mayor, Yuri Luzhkov last autumn may have been a signal to indicate his ability to act and increases the chances that he will try to serve one more four-year term. Most likely, Putin will decide which of the two will stand for the presidency; a contest between Putin and Medvedev is improbable. As a result, the domestic political situation will continue to be characterised by stability even though Putin's United Russia lost some ground in local elections recently. Reform efforts will thus probably continue at a slow pace even though some of Medvedev's statements might indicate a somewhat higher level of ambition than previously.

Russia has been trying since 1994 to become a member of the World Trade Organisation (WTO), but membership now appears within reach. Lingering issues with the US and the EU were resolved during the autumn. There is thus a chance that Russia may join the WTO as early as 2011 or 2012 if discussions regarding state support for the Russian agricultural sector and control of customs in the Georgian regions of Abkhazia and South Ossetia can be brought to a close. The overall effects of membership are difficult to assess; commodity extraction should benefit, due to reduced trade restrictions on wood products, for example. The banking sector is also expected to be a winner, but WTO membership may hurt the agricultural sector and some areas of manufacturing. The positive effects should predominate, however. According to the World Bank, in the long term WTO membership may boost Russia's GDP level by more than 10 per cent if the expected improvements in the business climate are implemented. The World Bank's 2010 *Doing Business* report ranks Russia at position 123 out of 183 countries.

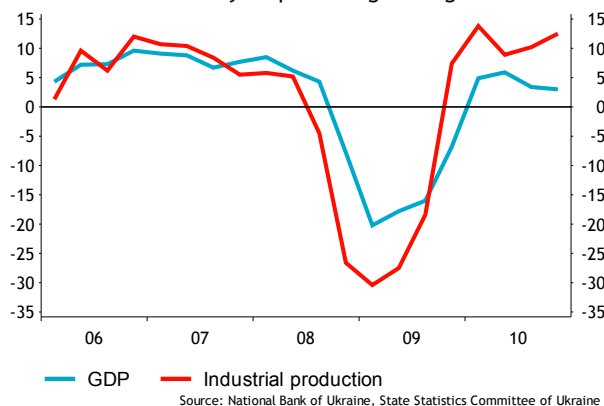
Continued recovery at a moderate pace

- IMF loan package functioning as planned
- Budget tightening will curb consumption
- Inflation rate expected to climb again

After its dramatic GDP decline in 2009, the Ukrainian economy began to recover during 2010. According to preliminary figures, GDP rose by 4.2 per cent. Growth slowed during the second half, due to less favourable base effects as well as more sedate global growth.

Slower growth in the second half of 2010

Year-on-year percentage change



Growth now seems to have bottomed out, however. Looking ahead, exports will be stimulated by a continued rise in steel and grain prices as well as higher expected international growth. Metals and agricultural products together account for over 50 per cent of exports. Capital spending, mainly by the central government, will also contribute to growth due to preparations for the European football championship in 2012 and the acute need for infrastructure improvements. Recent retail sales have been surprisingly strong, but private consumption will be restrained by budget tightening, rising inflation and a continued weak housing market. We expect growth to be only a bit higher than in 2010: **GDP will increase by 4.7 per cent this year and by 4.5 per cent in 2012.**

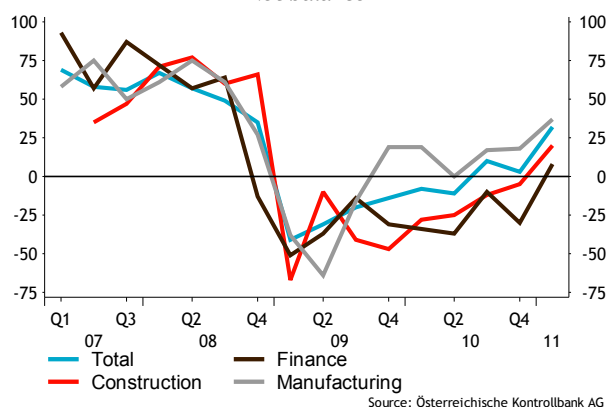
Industrial production has been strong in recent months; in February the year-on-year increase was 11.5 per cent. Since early October, steel prices have climbed approximately 20 per cent, which has helped stimulate activity in the steel sector. Business climate indicators are pointing towards continued improvement.

Exports and imports are continuing to recover but remain far below pre-crisis levels. In recent months,

imports have increased more strongly than exports and the trade deficit has kept rising. The current account deficit ended up around 0.4 per cent of GDP in 2010 and is expected to increase slightly in 2011.

Improved business sentiment indicators

Net balance



The hryvnia remains stable at just below UAH 8 per USD and is roughly unchanged against the euro compared to last autumn. Looking ahead a few years, the currency should strengthen based on an improved macroeconomic climate and greater exchange rate flexibility, which is one of the IMF's requirements.

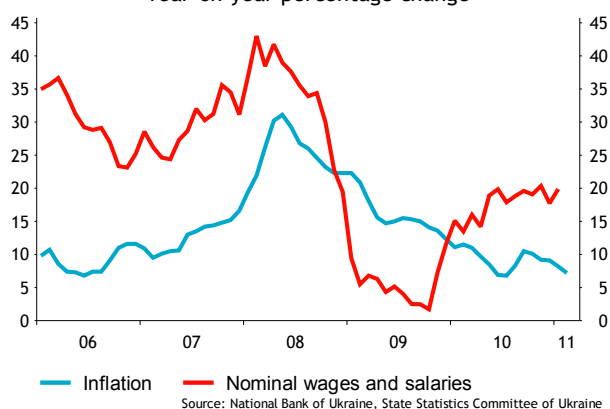
Inflation rose in late summer and early autumn 2010 due to the gas price increase in August and rising grain prices. The inflation rate peaked at 10.5 per cent in September but has fallen clearly since then. In February it was 7.2 per cent but it will probably begin rising again towards double-digit rates as electricity and gas price hikes begin to have an impact. Electricity prices were raised in February and gas prices are set to rise further in line with the IMF's call for reduced energy subsidies to households and businesses.

Real wages, which fell sharply in 2009, rose by just over 10 per cent during 2010 and clearly helped maintain domestic demand. However, we expect the rate of increase to fall during 2011 due to higher inflation and a freeze in real public sector pay. Unemployment was just above 8 per cent in 2010 and is expected to fall slightly in 2011 and 2012.

The USD 15 billion stand-by loan package approved by the IMF in July 2010 runs for two and a half years. Two out of ten disbursements have been made. The target of reducing the budget deficit to 5 per cent of GDP in 2010 appears to have been achieved. The IMF's latest quarterly review in March indicates that on the whole

Ukraine has fulfilled its obligations, but disagreements on how quickly energy subsidies should be reduced risk delaying the third disbursement.

Good real wage trend
Year-on-year percentage change



The main IMF target for Ukraine is to reduce the combined central government budget deficit and the deficit of the state-owned gas company Naftgaz to 3.5 per cent of GDP in 2011 and 2.5 per cent in 2012. Since budget transfers to cover the Naftogaz deficit have now ended, in practice the deficit must be reduced to 3.1 per cent of GDP in 2011.

The 2011 budget foresees largely unchanged tax revenue as a percentage of GDP but lower total revenue. To lower the deficit to 3.1 per cent of GDP, the government is trimming spending. For example, minimum wages and pensions will now follow inflation. Real public sector pay is being frozen and the employee headcount will fall. A reform of the costly pension system, expected to be enacted during the spring, will also help cut spending. Meanwhile the budget includes higher capital expenditures in 2011 (some 3 per cent of GDP). This is considered vital to complete preparations for the 2012 European football championship and make necessary infrastructure improvements after the deferred investments of recent years.

The budget specifies total spending cuts of 3.7 per cent of GDP to achieve the deficit target. In financial markets, credit default swaps on Ukrainian sovereign debt have fallen further, indicating greater confidence that the government will restore financial order. Our assessment remains that the 2011 and 2012 budget targets will be achieved.

The IMF's reform requirements led to the adoption of a new tax law in December 2010. The idea is to reform the complex tax system, reduce the overall tax burden and increase efficiency. The reform will result in the disappearance of numerous minor taxes. After extensive protests against an earlier proposal, taxation of small businesses was made more favourable. Corporate tax will be phased down from 25 per cent to 16 per cent in 2016, and value-added tax will be lowered in 2016. Meanwhile a real estate tax will be introduced and taxation of high incomes will be increased.

The banking sector is still fragile. Its profitability is very weak and it has problems with loans to insolvent borrowers, but the IMF package is creating stability and the recapitalisation of private banks is continuing. Capital adequacy requirements are driving a desirable consolidation of Ukraine's more than 170 banks. Deposits rose in 2010 and now exceed pre-crisis volume, but the increase was largely driven by a lack of alternative investment opportunities. Deposits are expected to keep rising in 2011. Bank lending stabilised during 2010, but the annual rate of increase in total loans outstanding has hardly crept above zero. New lending was weak because banks focused on the quality of their assets and on maintaining their capitalisation ratios. Lending rates are also at historically high levels. Bank lending is expected to increase slowly during 2011; due to Ukraine's comparatively subdued recovery, lending will not reach its pre-crisis volume this year.

The central bank's key interest rate has remained at 7.75 per cent since August 2010. With inflation at just above 7 per cent, the real key rate is close to zero. Continued weak credit growth and a falling inflation rate in recent months indicate that the bank's accommodative monetary policy will continue in the next few months. However, increasing credit growth and an expected higher inflation rate during 2011 will open the way for key rate hikes before year-end.

More stable domestic politics

Since the spring of 2010, Ukraine has been governed by a majority coalition dominated by President Viktor Yanukovich's Party of Regions. In regional elections during late October, the party strengthened its position. Together with greater concentration of power in the presidency, the domestic political situation has stabilised. Meanwhile problems with political irregularities seem to be increasing. The October regional elections were internationally criticised, and there are signs of a politically motivated campaign against the opposition in the run-up to the parliamentary election in October 2012. Opposition leader and former Prime Minister Yulia Tymoshenko has been charged with alleged corruption and prohibited from leaving Kiev. Several of her former ministers have also been accused of crimes during their period in power. Since Yanukovich has further strengthened his position, the government's chances of pushing through IMF-mandated reforms appear good, although popular discontent will increase as budget tightening measures begin to bite.

Ukraine's foreign policy is characterised by a balancing act between Russia and the West. Yanukovich seems intent on pursuing a pragmatic foreign policy and seeking good relations with both the EU and Russia, in order to make his country's economic recovery easier.

Key economic data

ESTONIA

	2005	2006	2007	2008	2009	2010	2011(f)	2012(f)
GDP, %	9.4	10.6	6.9	-5.1	-13.9	3.1	5.0	4.5
Inflation, HICP, %	4.2	4.5	6.7	10.6	0.2	2.7	4.0	5.0
Unemployment, %	7.9	5.9	4.7	5.5	13.8	16.9	12.0	11.0
Current account, % of GDP	-10.0	-15.3	-17.2	-9.7	4.5	3.6	2.0	1.0
Public sector fin balance, % of GDP	1.6	2.4	2.5	-2.8	-1.7	-1.0(f)	-1.5	-2.5
Public sector debt, % of GDP	4.6	4.4	3.7	4.6	7.2	8.0(f)	12.0	16.0
EUR/EEK, eop	15.6	15.6	15.6	15.6	15.6	15.6	-	-
3-month interest rate, eop	2.6	3.9	7.3	7.9	3.1	1.1	2.7	3.2

LATVIA

	2005	2006	2007	2008	2009	2010	2011(f)	2012(f)
GDP, %	10.6	12.2	10.0	-4.2	-18.0	-0.3	4.0	4.5
Inflation, HICP, %	6.9	6.6	10.1	15.3	3.3	-1.2	3.3	2.4
Unemployment, %	8.7	6.8	6.0	7.5	16.9	19.0(f)	16.3	14.7
Current account, % of GDP	-12.5	-22.5	-22.3	-13.1	8.6	3.6	-0.5	-2.1
Public sector fin balance, % of GDP	-0.4	-0.5	-0.3	-4.1	-10.2	-8.2(f)	-5.5	-2.8
Public sector debt, % of GDP	12.4	10.7	9.0	19.7	36.7	43.5(f)	50.0	52.0
EUR/LVL, eop	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7
Key rate, eop	4.0	5.0	6.5	6.0	4.0	3.5	3.5	4.0

LITHUANIA

	2005	2006	2007	2008	2009	2010	2011(f)	2012 (f)
GDP, %	7.8	7.8	9.8	2.9	-14.7	1.3	4.0	4.5
Inflation, HICP, %	2.7	3.8	5.8	11.1	4.2	1.2	3.5	4.0
Unemployment, %	8.3	5.6	4.3	5.8	13.7	17.8	16.5	15.0
Current account, % of GDP	-7.1	-10.6	-14.5	-13.1	4.3	1.8	-1.0	-3.0
Public sector fin balance, % of GDP	-0.5	-0.4	-1.0	-3.3	-9.2	-8.0(f)	-5.0	-4.0
Public sector debt, % of GDP	18.4	18.0	17.0	15.6	29.6	38.7	41.0	43.0
EUR/LTL, eop	3.45	3.45	3.45	3.45	3.45	3.45	3.45	3.45
3-month interest rate, eop	2.54	3.79	6.65	9.89	3.90	1.50	3.25	4.25
5-year government bond, eop	3.10	3.90	4.80	13.10	6.60	4.60	4.80	5.20

(f) = forecast

POLAND

	2005	2006	2007	2008	2009	2010	2011(f)	2012(f)
GDP, %	3.6	6.2	6.8	5.1	1.7	3.8	4.5	4.6
Inflation, HICP, %	2.2	1.3	2.6	4.2	4.0	2.7	3.7	2.8
Unemployment, %	17.8	13.9	9.6	7.1	8.2	9.6	9.4	8.8
Current account, % of GDP	-1.2	-2.7	-4.7	-4.8	-2.1	-3.3	-3.5	-4.0
Public sector fin balance, % of GDP	-4.1	-3.6	-1.9	-3.7	-7.2	-7.9(f)	-5.5	-3.9
Public sector debt, % of GDP	47.1	47.7	45.0	47.1	50.9	55.0(f)	56.0	55.2
EUR/PLN, eop	3.9	3.8	3.6	4.1	4.1	4.0	3.7	3.6
Key rate, eop	4.25	4.00	5.25	4.00	3.50	3.75	4.50	5.25
5-year government bond, eop	5.01	4.98	6.13	5.34	5.91	5.52	6.00	6.05

RUSSIA

	2005	2006	2007	2008	2009	2010	2011(f)	2012(f)
GDP, %	6.4	7.7	8.1	5.6	-7.9	4.0	5.6	5.2
Inflation, %	12.5	9.8	9.1	14.1	11.7	6.9	9.4	7.7
Unemployment, %	7.6	7.2	6.1	6.4	8.4	7.5	6.4	6.2
Current account, % of GDP	11.0	9.5	5.9	6.2	4.0	4.7(f)	5.0	3.9
Public sector fin balance, % of GDP	7.4	7.5	5.4	4.1	-5.9	-4.0(f)	-2.3	-1.9
Public sector debt, % of GDP	14.2	9.1	8.5	7.9	9.0	9.7(f)	9.0	8.9
USD/RUB, eop	28.7	26.3	24.6	30.5	30.3	30.6	27.1	27.8
RUB vs. EUR/USD basket, eop	29.3	27.2	29.7	35.4	36.1	35.2	32.0	31.5

UKRAINE

	2005	2006	2007	2008	2009	2010	2011(f)	2012(f)
GDP, %	2.7	7.1	7.6	2.1	-14.8	4.2	4.7	4.5
Inflation, %	13.5	9.1	12.8	25.2	15.8	9.4	9.2	9.0
Unemployment, %	7.2	6.9	6.4	6.4	8.8	8.2	7.5	7.3
Current account, % of GDP	2.5	-1.5	-4.2	-7.1	-1.5	-0.4	-1.4	-1.2
Public sector fin balance, % of GDP	-1.7	-0.6	-0.8	-1.2	-8.0	-5.0	-3.1	-2.5
Public sector debt, % of GDP	17.7	14.8	12.3	19.9	34.6	39.5	41.1	41.9
USD/UAH, eop	5.05	5.05	5.05	7.80	8.00	7.96	7.95	7.95

(f) = forecast



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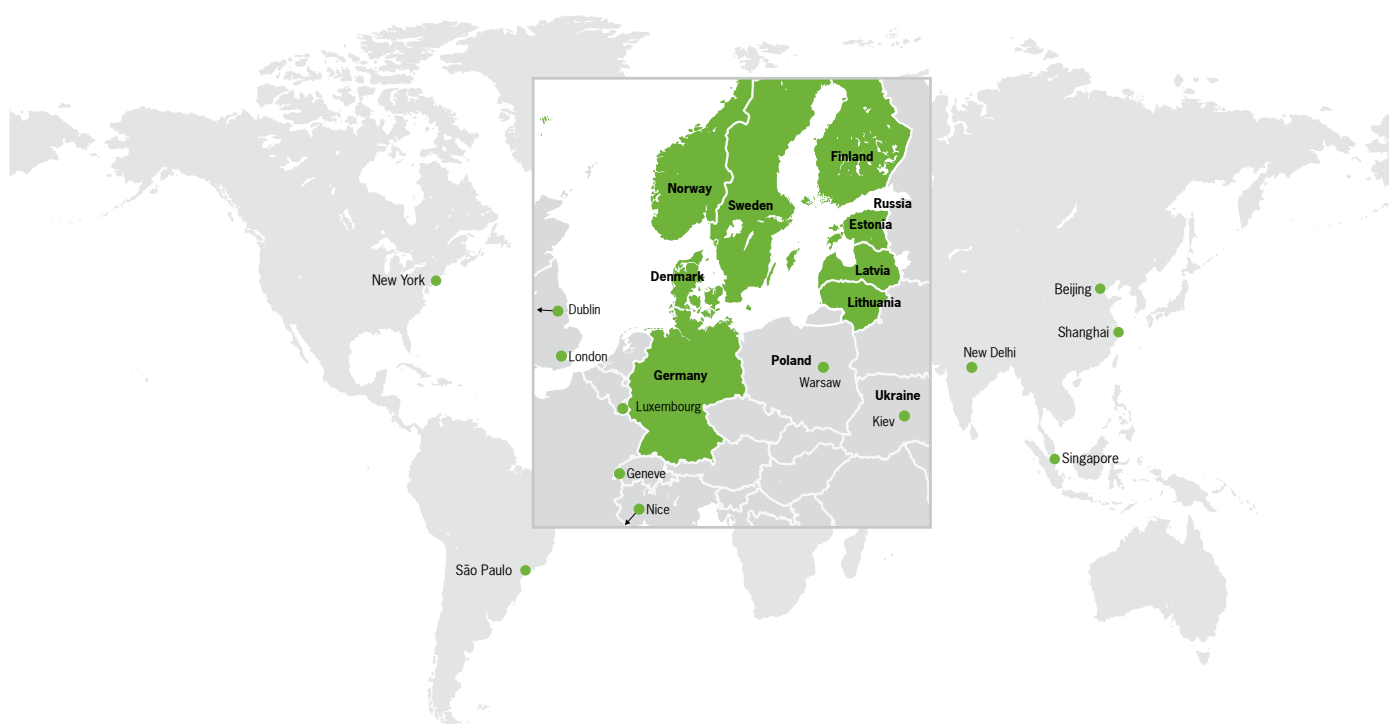
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