

# Baltic Rim Outlook

June 2009



## First signs of stabilisation

Since the latest issue of our *Baltic Rim Outlook*, the global economy has started to show the first signs of output stabilisation. Poland and Russia are well placed to benefit from a global recovery, while the Baltic countries are in dire straits and certainly would welcome some stabilisation of demand in their main export markets to smooth the needed further internal adjustment.

The **Estonian** economy has contracted sharply since the global financial crisis aggravated the already weakening situation last autumn. The situation went from bad to worse when the Q1 flash estimate indicated a contraction of 15.6%. On the bright side, the sharp decline in new lending is no longer accelerating, raising hopes that the decline could start abating in coming months.

In **Latvia**, the severe fiscal tightening to meet the IMF requirements will cause a further shock to domestic spending, ensuring another move downwards from the stunning 18% contraction in Q1 compared with a year earlier. We see the economy touching bottom later this year or in early 2010, with the recovery slowly starting in 2010 as export demand improves.

The **Lithuanian** economy has held up better than its Baltic neighbours, with the Q1 GDP decline reaching “merely” 13.6% y/y. Even if Lithuania has been catching up lately, there is still reason to believe that the country’s decline will be milder. The credit boom was never as dramatic in Lithuania – so there is less need for a correction.

The economic outlook for **Poland** remains bleak, as we expect only slightly positive growth this year followed by a very modest expansion next year. Household spending is still increasing and compensates for a marked contraction of exports and investment – at least enough to keep the economy out of recession. Thus, in relative terms, Poland is doing well and will be one of the few countries in Europe to see positive growth this year.

The **Russian** economy began the year in a steep decline, hit by the collapse in oil prices and the evaporation of foreign credit. As domestic spending has rapidly adjusted to lower oil income, the further downward pressure on the economy is limited. Thus, growth is likely to recover slowly in 2010, as the global economy improves and oil prices strengthen.

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## Contents:

■ <b>Estonia</b>	
<b>Searching for the bottom</b> .....	4
■ <b>Latvia</b>	
<b>Fiscal tightening will deepen the decline</b> .....	6
■ <b>Lithuania</b>	
<b>Milder case of Baltic disease</b> .....	8
■ <b>Poland</b>	
<b>EMU timetable up for revision</b> .....	10
■ <b>Russia</b>	
<b>Steep contraction to turn into growth in 2010</b> .....	12

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## Editorial deadline:

2 June 2009

**Currency forecasts (against DKK)**

	2/Jun/09	3M	6M	12M	24M
EEK/DKK	0.48	0.48	0.48	0.48	0.48
LVL/DKK	10.50	10.66	10.66	10.66	10.66
LTL/DKK	2.16	2.16	2.16	2.16	2.16
PLN/DKK	1.66	1.70	1.76	1.99	2.13
RUB/DKK	0.17	0.17	0.18	0.21	0.20

**Currency forecasts (against EUR)**

	2/Jun/09	3M	6M	12M	24M
EUR/EEK	15.65	15.65	15.65	15.65	15.65
EUR/LVL	0.71	0.70	0.70	0.70	0.70
EUR/LTL	3.45	3.45	3.45	3.45	3.45
EUR/PLN	4.47	4.40	4.25	3.75	3.50
EUR/RUB	43.66	43.88	41.60	36.00	37.80

**Currency forecasts (against NOK)**

	2/Jun/09	3M	6M	12M	24M
EEK/NOK	0.56	0.54	0.54	0.52	0.50
LVL/NOK	12.45	12.14	12.00	11.71	11.29
LTL/NOK	2.56	2.46	2.43	2.37	2.29
PLN/NOK	1.97	1.93	1.98	2.19	2.26
RUB/NOK	0.20	0.19	0.20	0.23	0.21

**Currency forecasts (against SEK)**

	2/Jun/09	3M	6M	12M	24M
EEK/SEK	0.683	0.677	0.639	0.614	0.607
LVL/SEK	15.064	15.143	14.286	13.714	13.571
LTL/SEK	3.095	3.070	2.896	2.780	2.751
PLN/SEK	2.389	2.409	2.353	2.560	2.714
RUB/SEK	0.245	0.242	0.240	0.267	0.251

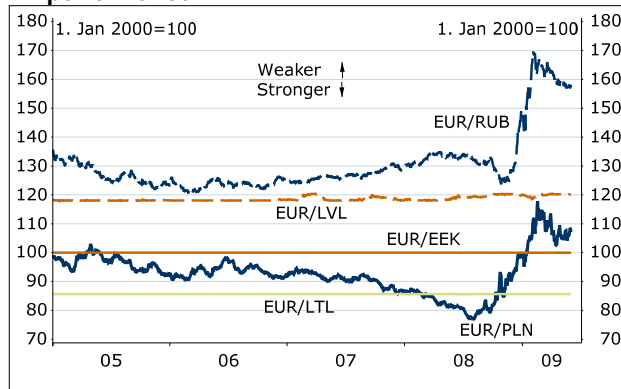
**3M interbank rate forecasts**

	2/Jun/09	3M	6M	12M	24M
Poland	4.63	4.20	4.10	4.25	4.80
Estonia	6.32	5.70	5.50	5.00	4.00
Latvia	15.22	11.00	9.00	8.00	6.50
Lithuania	7.33	6.00	5.50	5.00	4.00
Russia	12.44	14.50	13.00	9.00	6.50

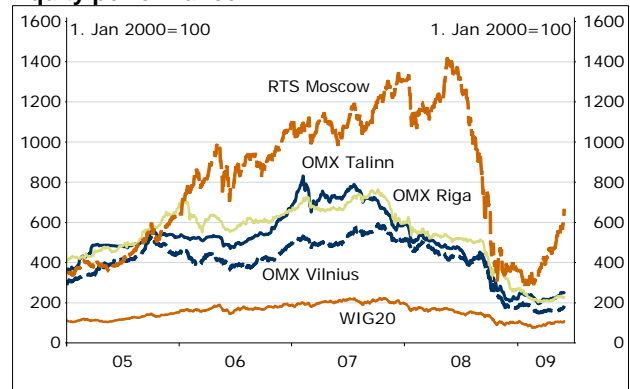
**3M interbank rate forecasts (spread to the Euro area)**

	2/Jun/09	3M	6M	12M	24M
Poland	3.37	3.00	2.90	2.95	2.55
Estonia	5.06	4.50	4.30	3.70	1.75
Latvia	13.96	9.80	7.80	6.70	4.25
Lithuania	6.07	4.80	4.30	3.70	1.75
Russia	11.18	13.30	11.80	7.70	4.25

**FX performance**



**Equity performance**



**Convergence criteria**

	Budget balance, % of GDP	Inflation, %	Government debt, % of GDP	10Y yields, %	FX Stability*, %	EMU entry forecasts, year
<b>Criteria</b>	-3.0	3.4	60.0	6.4	-15/ +15	
Estonia	-3.0	7.7	4.8	-	0/0	2013
Latvia	-4.0	12.4	19.5	6.5	-0.9/1.1	2014
Lithuania	-3.2	10.0	15.6	9.0	0/0	2013
Poland	-3.9	4.0	47.1	6.1	-15/30	2012

All data are from 2007, except the inflation rate\* Weakest and strongest daily spot close of the last two years relative to the average the same period.

**Country facts Estonia**

Area	45,226 km <sup>2</sup>	President	T. H. Ilves
Population	1.3 mn	Next election	Fall 2011
GDP/capita	21,200 USD*	Prime minister	A. Ansip
Currency	Kroon	Next election	March 2011

\* At PPP

**Country facts Latvia**

Area	64,589 km <sup>2</sup>	President	V. Zatlers
Population	2.2 mn	Next election	July 2011
GDP/capita	17,800 USD*	Prime minister	V. Dombrovskis
Currency	Lat	Next election	October 2010

\* At PPP

**Country facts Lithuania**

Area	65,300 km <sup>2</sup>	President	D. Grybauskaitė
Population	3.6 mn	Next election	-
GDP/capita	17,700 USD*	Prime minister	A. Kubilius
Currency	Litas	Next election	October 2012

\* At PPP

**Country facts Poland**

Area	312,679 km <sup>2</sup>	President	L. Kaczynski
Population	38.5 mn	Next election	October 2010
GDP/capita	17,300 USD*	Prime minister	D. Tusk
Currency	Zloty	Next election	October 2011

\* At PPP

**Country facts Russia**

Area	17,075,200 km <sup>2</sup>	President	D. Medvedev
Population	140.0 mn	Next election	March 2012
GDP/capita	15,800 USD*	Prime minister	V. Putin
Currency	Ruble	Next election	December 2011

\* At PPP

## Searching for the bottom

- Credit crunch almost run its course
- Weakening employment and falling wages still drag down domestic demand
- Euro adoption could easily be delayed as budget deficit is rising

### Deflation painfully restoring competitiveness

The economy has contracted sharply since the global financial crisis aggravated the already weakening situation last autumn. The situation went from bad to worse when the Q1 flash estimate indicated a contraction of 15.6%. On the bright side, the sharp decline in new lending is no longer accelerating, raising hopes that the decline could start abating in coming months.

Although we expect the steepest declines in GDP to be over this year, the recovery is going to be slow and bumpy. Labour market conditions will continue to weaken this year, pushing private consumption lower and raising social transfers, especially in terms of unemployment benefits. Unemployment is expected to continue rising for a couple of years.

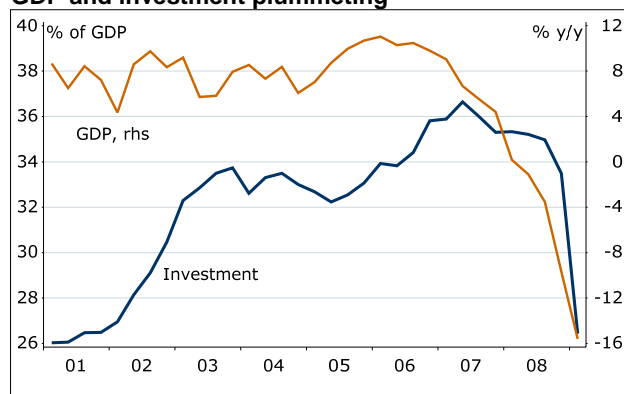
Although consumption and investment are likely to stabilise next year, we still expect the economy to contract in 2010. The economy is not expected to strengthen in earnest until 2011 when improving competitiveness due to falling wages will start to boost exports. When the recovery finally arrives, growth is likely to be clearly more subdued than during the past couple of years of strong growth.

Retail sales and industrial production weakened further during the beginning of the year, indicating that the slowdown will continue in Q2. Weak external circumstances contributed to the sharp contraction of the economy, but a rebound in export demand is also expected to help pull the economy out of the recession.

Private consumption has also been hit by slowing credit growth and the decline in house prices through wealth effects and weakening confidence. Labour market condi-

tions are dismal, with unemployment having risen above 11% in March and wage growth slowing abruptly. After plummeting to its lowest level in 15 years, consumer confidence rebounded slightly in April. Nevertheless, confidence has remained at very low levels, indicating weak consumption in Q2. While the economy has not yet bottomed out, confidence indicators support hopes that the economy could be slowly approaching the bottom.

### GDP and investment plummeting



Inflation has quickly moderated from its highs in 2008, as global raw material prices have declined and the domestic economy has cooled down. The tax increases in 2008 boosted inflation last year, but recently inflation has fallen rapidly. Domestic overheating kept inflation elevated earlier, but as the recession now takes its toll on the economy, wages are decelerating, which should improve the competitiveness of the Estonian economy. We see a restructuring of the labour market as important for the recovery in order to ensure that labour is allocated to more productive industries and wages readjusted to the current productivity level after having been inflated during the boom.

Public finances have deteriorated and the government is trying to find new ways to raise and save money. So far Estonia has resorted to a loan from for example the European Investment Bank to finance its budget and some of the country's accumulated reserves will be used as well. The most recent cuts in the state budget include slashing civil service and teacher salaries, which will affect pri-

### Estonia: Macroeconomic indicators (% annual real changes unless otherwise noted)

	2005 (EEKmn)	2006	2007	2008	2009E	2010E
Private consumption	93,835	12.7	7.9	-3.8	-18.0	-3.0
Government consumption	29,942	1.8	3.9	4.4	-7.5	-3.0
Fixed investment	53,742	20.1	7.6	-8.1	-29.5	-4.0
Exports	138,550	11.6	0.0	-1.1	-14.0	-1.0
Imports	149,560	20.4	4.2	-7.9	-20.0	-2.0
GDP		10.4	6.3	-3.6	-13.0	-2.0
Nominal GDP (EEKmn)	173,530	205,038	238,929	255,654	219,862	214,366
Unemployment rate, %		5.9	4.7	5.5	12.5	15.0
Consumer prices, % y/y		4.4	6.7	10.6	-1.0	-0.5
Current account, % of GDP		-16.7	-18.3	-9.1	-2.0	-3.0
General govt budget balance, % of GDP		2.9	2.7	-3.0	-4.0	-5.0

vate consumption adversely.

**Rising deficit dims hopes for 2011 EMU entry**

EMU membership has been discussed for a long time, but the date of euro adoption has so far been pushed forward because of soaring inflation. The inflation requirement could be fulfilled as early as this year, but at the same time a new headache – a soaring budget deficit – has materialised.

We expect the budget deficit to rise to 4% of GDP this year, thus hindering euro adoption in 2011. For the deficit to remain at 3% in 2009 – a necessary condition for EMU membership in 2011 – the government would have to make significant budget cuts. A steeper-than-expected deterioration in the economy or financial conditions as well as lack of parliamentary approval of the necessary budget cuts could easily push the deficit significantly higher. More extensive use of the EU structural funds to boost revenues together with spending cuts and the consolidation measures adopted earlier this year would help keep the deficit closer to the 3% limit. Estonia is determined to enter the Euro zone at the latest in January 2011, before the budget deficit can rise clearly higher and inflation gets a chance to rise again. However, EMU entry at a later date is beginning to look increasingly likely.

**Determination to keep currency peg still strong**

We expect the currency board to hold, as the currently ongoing internal devaluation, i.e. wage cuts and slowing inflation, helps to gradually achieve the necessary adjustment of the relative price level to boost exports. Currency devaluation is an unpopular alternative especially because of the significant portion of loans taken out in a foreign currency. The extent to which the stable EEK is an important national source of pride should not be underestimated.

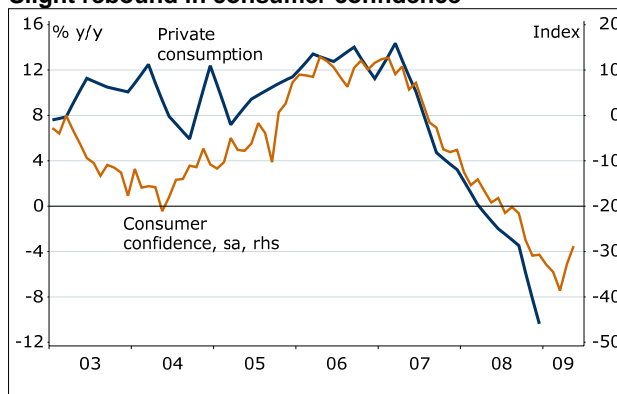
Considering the government’s very strict view on devaluation and strong political commitment, we believe that the risk of devaluation is relatively small in the near term. However, if one of the other Baltic countries devalues its currency, the risk of devaluation in Estonia also increases.

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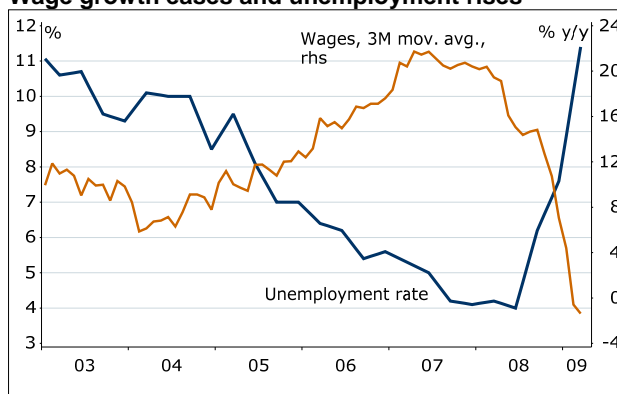
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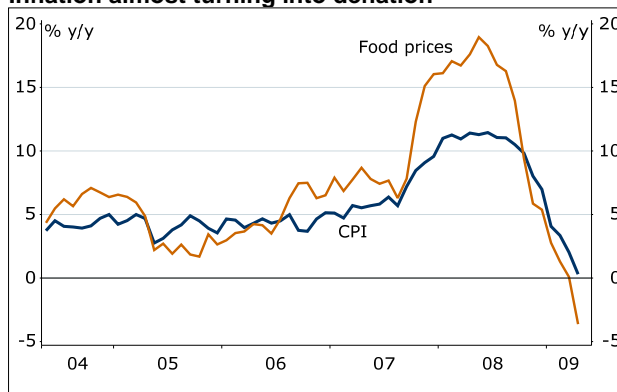
**Slight rebound in consumer confidence**



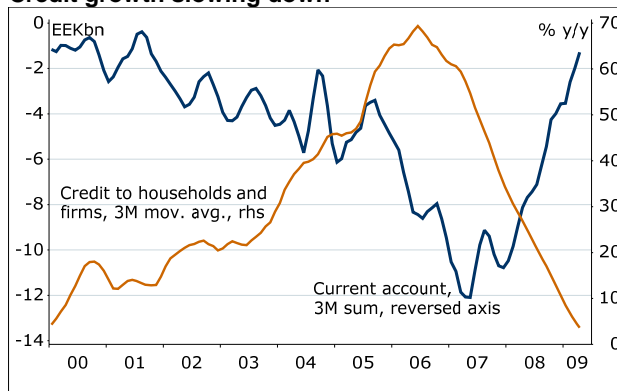
**Wage growth eases and unemployment rises**



**Inflation almost turning into deflation**



**Credit growth slowing down**



## Fiscal tightening will deepen the decline

- Economic decline steeper than foreseen
- Euro adoption in 2012 a very challenging aim
- Currency peg likely to hold if new IMF deal achieved

### Steep decline only slowly abating

With domestic demand collapsing at the same time as the global recession hit exports, the Q1 contraction in GDP was a stunning 18% from the year before. There is, however, some glimmer of hope that the decline may be abating. The global economy shows some signs of bottoming, which should support exports. Credit growth has slowed to practically zero, meaning that the excesses of the credit boom have largely been corrected. However, the savage fiscal tightening to meet the IMF requirements will cause a further shock to domestic spending, ensuring another round downwards. We see the economy touching bottom later this year or in early 2010, with the recovery slowly starting in 2010 as export demand improves. GDP in 2010 is still likely to be clearly lower than in 2009.

The decline in private consumption is likely to slow as consumers have now been forced to live within their means, as credit growth has stopped. However, falling wages and declining employment ensure that disposable income is dropping, which pushes consumption down.

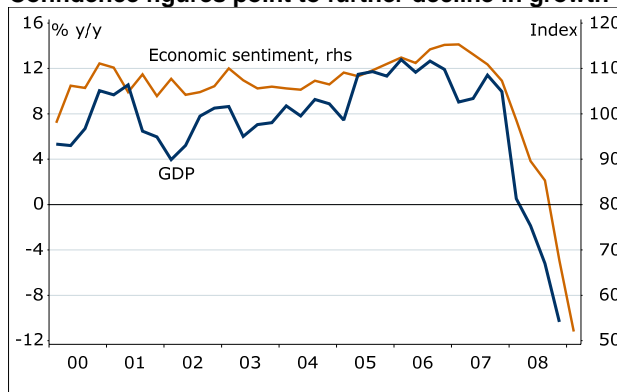
Indicators of industrial confidence have rebounded recently in e.g. the Euro zone, suggesting that the global economy is stabilising. This is good news for eg the forest industry. Unfortunately, Latvia's two major export markets are the other Baltic states, which are showing few signs of recovery yet. Weakened currencies in other neighbouring countries also pose a challenge. Thus, the outlook for Latvian exports remains shaky.

Steep budget cuts have recently been announced by the new government, which targets a newly announced 9.2% budget deficit this year. Wage cuts in the public sector have been extensive, most recently 20% cuts on average have been announced. Other spending has also been cut. Discussions with the IMF about extending the currently agreed budget deficit limit from 5% are currently held. Agreement on the budget deficit is a precondition for

receiving the next tranche of the EUR 7.5bn emergency loan. Even a 9.2% deficit will require extensive public spending cuts, especially as social transfers are rising and tax revenues plummeting.

The next part of the loan is to come mainly from the European Commission, and it is important in order to maintain the medium-term solvency of the state. The next budget cut is expected after the municipal and European Parliament elections on 6 June. If the contraction is more severe than expected, the risk is that the deficit will grow and further expenditure cuts will be required in the autumn. The extensive budget cuts will further hurt private consumption and thus slow down the recovery. The weak financial situation is highlighted by for example S&P now rating Latvia at below investment grade.

### Confidence figures point to further decline in growth



### Inflation turning into deflation

After the peak last summer inflation has fallen rapidly, driven by lower food and energy prices as well as weakening domestic demand. Inflation has been boosted by the VAT and excise duty increases at the beginning of the year, but the trend is still clearly downwards. We see inflation moderating clearly, and year-on-year figures are likely to show deflation by the end of the year.

Lending has slowed almost to zero, and for the economy to rebound properly, a replacement for credit-induced spending is needed. In order to get out of the woods, the competitiveness of the export sector needs to be im-

### Latvia: Macroeconomic indicators (% annual real changes unless otherwise noted)

	2005 (LVLmn)	2006	2007	2008	2009E	2010E
Private consumption	5,666	21.2	14.8	-11.0	-24.0	-6.0
Government consumption	1,581	4.9	3.7	1.5	-9.0	-5.0
Fixed investment	2,774	16.4	7.5	-13.2	-27.5	-6.5
Exports	4,335	6.5	10.0	-1.3	-13.0	-0.5
Imports	5,638	19.4	14.7	-13.6	-27.0	-6.5
GDP		12.2	10.0	-4.6	-16.0	-3.0
Nominal GDP (LVLmn)	9,059	11,172	13,957	15,450	13,442	12,971
Unemployment rate, %		6.8	6.0	7.5	15.0	16.0
Consumer prices, % y/y		6.6	10.1	15.3	3.0	-0.5
Current account, % of GDP		-22.5	-22.5	-13.6	-2.0	-2.0
General govt budget balance, % of GDP		-0.5	-0.4	-4.0	-9.0	-10.0

proved and from that perspective deflation is a necessity.

**January 2012 tough target for euro adoption**

Accelerating inflation prevented the adoption of the common currency in Latvia in 2008. The most recent target date is January 2012. Inflation is now moderating rapidly, but the expanding budget deficit posts a new challenge for the adoption of the euro.

The current target of January 2012 is extremely challenging. We expect the budget deficit to rise to 9% of GDP in 2009, clearly above the 3% limit stated in the Maastricht criteria. A steeper-than-expected slowdown could push up the deficit further, as falling tax revenues and rising social transfers increase the deficit. Reducing the deficit to less than 3% in 2010 – which is required for EMU entry in 2012 – is going to be all but impossible, and entry is thus expected to be pushed forward to at least 2013.

**IMF deal likely to save currency peg**

If the negotiations with the IMF were to fail, the required budget cuts would be even more drastic, as the lack of funding would restrain spending. This reality should focus the minds of Latvian decision makers – and a deal with the IMF is thus likely.

The currency peg has held this far, and Latvia has proceeded with its internal devaluation, i.e. sharply declining wages and attempts to improve efficiency in the public and private sector. Devaluation is an unlikely policy option, not least because of all the private-sector loans in foreign currencies, and if deflationary effects start to emerge, the need for devaluation will diminish. Thus in our main scenario we do not see a devaluation. However, the former Swedish central bank governor, currently an adviser to the Latvian Prime Minister, stated that it is just a matter of time when devaluation occurs, and the Latvian Justice Minister said the impacts of devaluation should be examined, raising the question of whether the political commitment to the peg will hold after all.

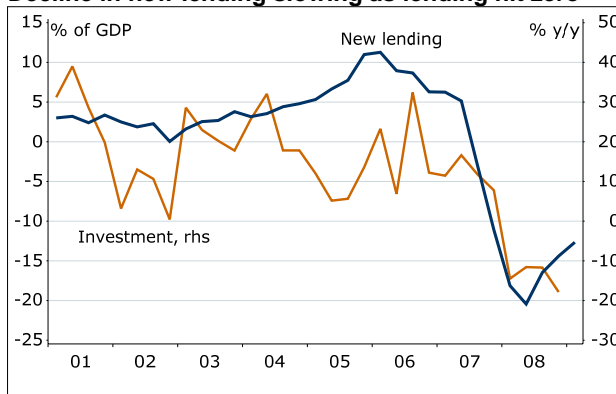
Forced devaluation resulting from the central bank running out of foreign currency reserves is unlikely as long as the solvency of the state is maintained. The IMF accepted Latvia's policy of not devaluing already last autumn. The key risk of devaluation is if the government fails to produce sufficient budget cuts to satisfy the IMF. If so, the options would be either to allay the IMF's concern by agreeing to devaluation or making do without the loan. In the latter case devaluation or floating of the LVL would also be a likely scenario, as the government would be forced to turn to the central bank to finance its outlays.

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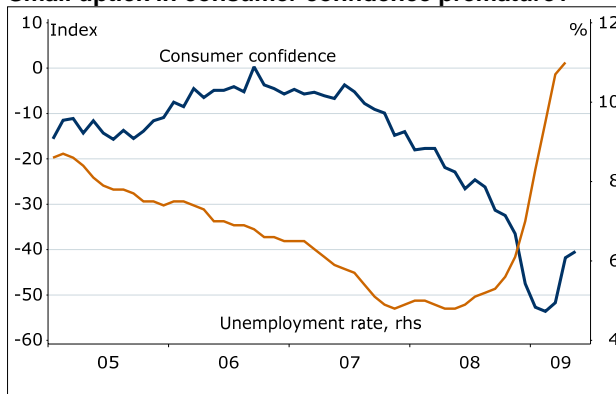
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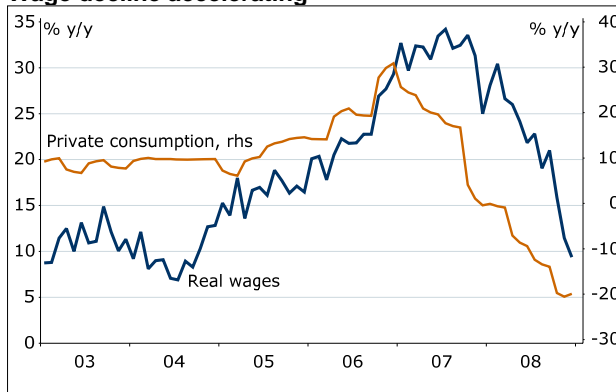
**Decline in new lending slowing as lending hit zero**



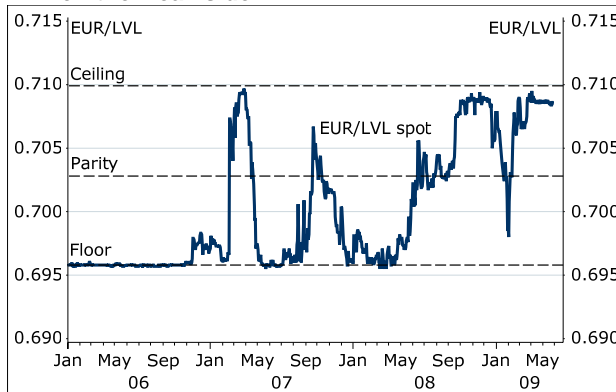
**Small uptick in consumer confidence premature?**



**Wage decline accelerating**



**LVL on the weak side**



## Milder case of Baltic disease

- Economy collapsed in Q1, but the decline in 2009 likely to be milder than in the other Baltic countries
- Domestic demand in steep decline
- Confidence indicators still pointing firmly down

### Falling wages pave way for recovery in 2011

The Lithuanian economy has held up better than its Baltic neighbours, with the Q1 GDP decline reaching “merely” 13.6% y/y. Even if Lithuania has been catching up lately, there is still reason to believe the decline will be milder in Lithuania. The credit boom was never as steep in Lithuania – so there is less need for correction. Lithuanian exports, dominated by agricultural products, are also less cyclical and thus less affected by the downswing in the global economy.

Still, rising unemployment and falling wages will continue to take their toll on consumption also in Lithuania. The closing of the Ignalina nuclear power plant will also cause a substantial decline in output (including exports) and dampen the outlook for consumption as rising electricity prices erode purchasing power. The lower cyclicity of Lithuanian exports also means that the economy will get less help from the rebound in the global economy. Thus, the economy is set to continue its decline well into 2010. Reduced costs will gradually improve the export sector’s competitive position, setting the stage for positive growth in 2011.

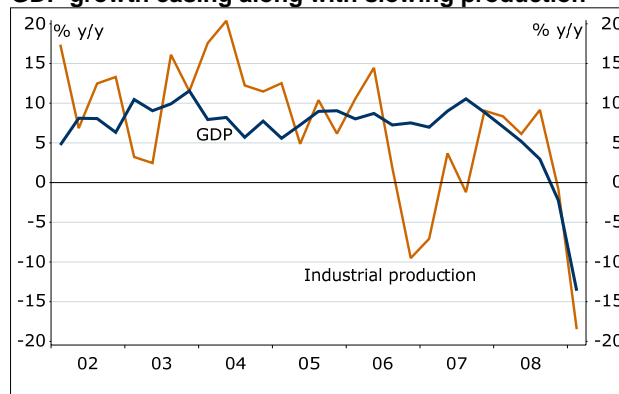
Falling consumer and business confidence indicators confirm that the economy will continue weakening in Q2. Retail sales plunged sharply during Q1, and the steep decline continued in Q2 when the April decline reached 30% y/y. Credit growth has slowed down significantly from levels around 20% to around 5% in March, so most of the adjustment is done in that respect. The current account deficit has evaporated quickly as weak domestic demand has caused imports to plummet.

Slowing investment will still continue to exert downward pressure on the economy well into 2010 as earlier commenced investment projects are finished. Although exports grew strongly last year because of a recovery in oil

refining, the slump in global demand weighs on the export sector. The decline in industrial production steepened further to -25.5% y/y in April, confirming that the slump is still deepening.

The government has maintained that it does not need a loan from the IMF; still, it has been forced to revise its budget for 2009 and cut spending sharply, as the recession swells expenditure and weighs on revenues. The government has indicated its willingness to cut spending further in order to be able to adopt the euro in 2012-2013. The earlier cuts have been directed at investment projects and public sector wages, further hampering the already weak private consumption.

GDP growth easing along with slowing production



The new president elect, Daria Grybauskaitė, takes office on 12 July. She ran as an independent candidate and achieved a resounding victory in the elections. The president has only limited influence on economic policies, but she supports the austerity measures taken – although she disagrees with some of the income tax increases, while favouring tax reductions for small and medium businesses. All in all, government policies are expected to remain largely unchanged.

Inflation rose strongly last year as wages grew by over 20% y/y and global energy and food prices soared. Inflation has, however, slowed down clearly from its highs last year, but the moderation has been slowed down by the VAT hike and the increase in excise duties on alcohol

### Lithuania: Macroeconomic indicators (% annual real changes unless otherwise noted)

	2005 (LTLmn)	2006	2007	2008	2009E	2010E
Private consumption	46,453	10.6	12.4	4.7	-18.0	-7.0
Government consumption	12,231	3.7	3.3	4.3	-10.0	-2.5
Fixed investment	16,302	19.4	20.8	-6.0	-29.0	-7.5
Exports	41,440	12.0	4.3	11.3	-12.0	1.0
Imports	46,667	13.7	11.6	10.0	-21.5	-2.5
GDP		7.8	8.9	3.0	-14.0	-4.5
Nominal GDP (LTLmn)	71,380	81,905	96,739	110,379	99,341	94,374
Unemployment rate, %		5.6	4.3	5.8	13.0	15.5
Consumer prices, % y/y		3.8	5.8	11.1	4.0	-0.5
Current account, % of GDP		-10.4	-15.1	-12.2	-2.0	0.0
General govt budget balance, % of GDP		-0.4	-1.0	-3.2	-5.0	-6.0

and tobacco. The closing down of the Ignalina power plant at the end of this year will also boost inflation in 2010, as locally produced energy will have to be replaced by imported energy from Russia. However, we see inflation moderating clearly this year, as the real economy cools down further and wages are cut.

### Targeting EMU membership in 2012-2013

Lithuania has no official target date for adopting the euro, but the government maintains 2012-2013 as a realistic time frame. The newly elected president Grybauskaitė believes that euro adoption will be possible in 2012-2015. Earlier EMU membership has been hindered by the elevated inflation, but as inflation is now rapidly moderating, new optimism has arisen. However, deteriorating fiscal balances have become a serious problem.

Despite extensive budget cuts and tax hikes we see the deficit soaring above 3% of GDP this year, the limit stated in the Maastricht criteria. The steep decline in the economy is likely to keep the budget deficit above target during the next couple of years, pushing forward the adoption of the euro to at least 2013. EMU membership at the latest in 2015 seems realistic, but will require the budget deficit to be pushed back down and inflation to be kept low.

### Contagion main risk to currency peg

The currency peg is expected to hold, as the necessary adjustment in relative prices is achieved by falling wages, causing an internal devaluation. The government has an interest in refraining from devaluing the currency, since many loans are denominated in a foreign currency, mostly euro. Thus, devaluation could lead to bankruptcies and insolvencies. Of course, internal deflation will also cause problems for debtors, as income will decline while debts remain unchanged – but at least the process is less dramatic.

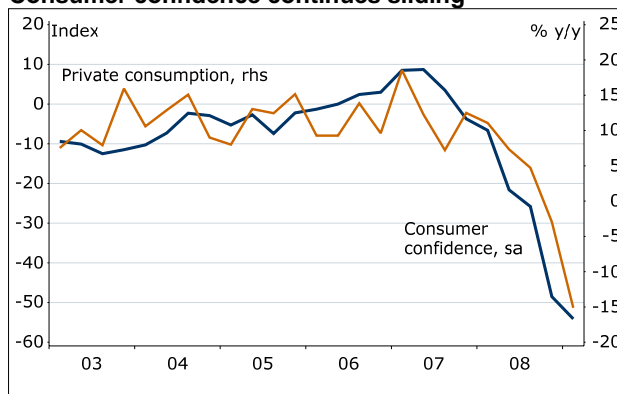
The political commitment to the currency peg is still strong despite the sharply weakened economy, and the government or central bank have given no indication that the currency would be devalued. Furthermore, the internal devaluation has gathered speed, with price and wage growth slowing down rapidly. However, a deeper-than-expected slump or devaluation in Lithuania's northern neighbour may change the situation.

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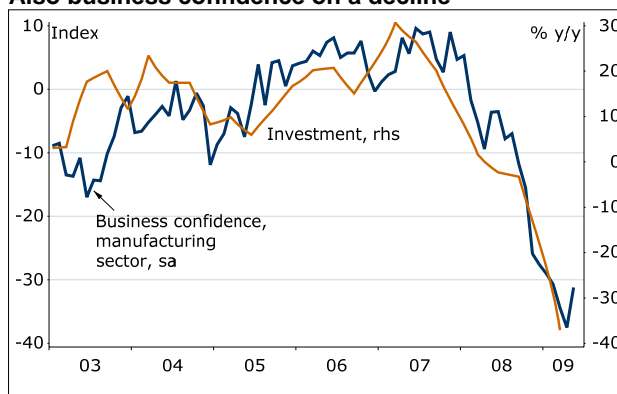
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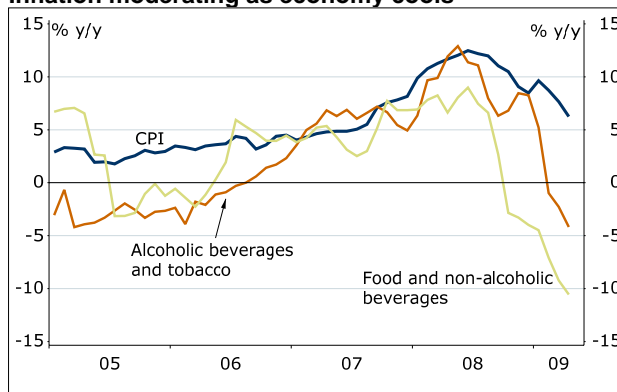
### Consumer confidence continues sliding



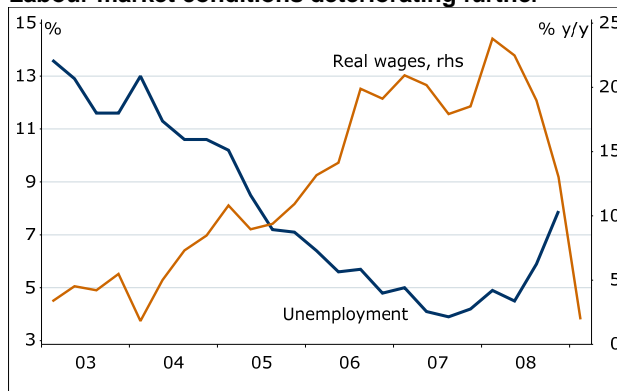
### Also business confidence on a decline



### Inflation moderating as economy cools



### Labour market conditions deteriorating further



## EMU timetable up for revision

- Bleak outlook, but better than regional peers
- Labour market to weaken, foreign markets to stabilise
- EMU timetable to be revised
- Tighter economic policy on the cards

The overall economic outlook remains bleak, as we expect only slightly positive growth this year followed by a very modest expansion next year. Household spending is still increasing and compensates for a marked contraction of exports and investment – at least enough to keep the economy out of recession. However, the labour market is weakening and with tax reductions unlikely to be repeated, the domestic economy is expected to weaken going forward. Fortunately, though, there are some signs of stabilisation of the main export markets, the so-called green shoots, which support our view that exports will become the main driver of the recovery.

### Good performance relative to regional peers

In relative terms, Poland is doing well and will be one of few countries in Europe to see positive growth this year. This is partly due to the structural improvement in the labour market over the past years, which has given a significant boost to the domestic economy. However, the other part of the explanation is probably that the country has been relatively less exposed to the two big global shocks compared with other countries in the region. Indeed, the rebalancing and deleveraging shock has had a relatively low impact on economic activity because imbalances were relatively small going into the crisis and leverage in the banking sector was modest. Moreover, the global trade shock has had a relatively small impact because the economy is much less open than other countries in the region and not too dependent on commodity exports.

Going forward, the advantage of being less exposed will change into a disadvantage in tandem with the expected normalisation of financial markets and the consequent recovery in the main export markets. Thus, the Polish recovery may have a relatively good starting point, but

could be slow compared with countries that are more dependent on foreign demand.

### Weaker labour market

The labour market has gradually started to weaken with employment falling in seasonally adjusted terms from Q1. Employment is expected to continue falling until mid-2010 and unemployment is expected to peak just below 13%. Over 2 million new jobs have been created over the past five years, though, and we expect that the number of jobs lost over the next year or so will be well below a fourth of that.

The latest data show that wages in the overall economy increased almost 7% in Q1, and although we expect the pace of increases to gradually slow, real wages are seen increasing both this year and the next. In turn, while consumer spending will certainly slow going forward due to the weakening labour market, tighter credit conditions and the fading effect of the tax reductions, it is worth noting that it is from a very strong starting point.

### Investment hit by financial crisis

Investment has taken a serious hit from the global financial crisis. Thus, the rapid deterioration in the demand for industrial goods and the huge uncertainty regarding future demand imply little need to increase production capacity. At the same time, the tightening of lending conditions has a particularly negative effect on construction activity. Lastly, foreign direct investment inflows are on a steady downward trend.

Going forward, we expect a marked contraction in investment activity, at least throughout the first half of this year. Moreover, the subsequent recovery is likely to be slow because of the amount of spare capacity in the manufacturing sector and the time it will take the banking sector to get through the aftermath of the crisis.

### EMU timetable could be revised

Poland aims to join the EMU 1 January 2012. However, this requires entering into ERM-2 – the exchange rate mechanism, where a currency is allowed to fluctuate

#### Poland: Macroeconomic indicators (% annual real changes unless otherwise noted)

	2005 (PLNbn)	2006	2007	2008	2009E	2010E
Private consumption	609	5.0	5.0	5.4	3.9	2.1
Government consumption	178	6.0	3.8	0.2	-1.1	0.6
Gross fixed capital formation	179	14.9	17.3	7.9	-4.6	6.5
Stockbuilding*	10	0.4	1.7	0.2	-1.1	0.4
Exports	365	14.6	9.1	5.8	-9.6	6.9
Imports	372	18.6	13.6	6.2	-9.6	6.4
GDP		6.2	6.7	4.8	0.7	3.2
Nominal GDP (PLNbn)	983	1,060	1,177	1,272	1,322	1,393
Unemployment rate, %		16.2	12.7	9.8	10.7	12.5
Consumer prices, % y/y		1.2	2.6	4.4	3.3	2.1
Current account, % of GDP		-2.7	-4.7	-5.5	-2.5	-2.0
General government budget balance, % of GDP		-3.9	-1.9	-3.9	-2.9	-2.9

\* Contribution to GDP growth (% points)

15% on each side of a given central parity – by July. At present, volatility is too high to join ERM-2, but falling gradually as financial markets have started to normalise. Still, we would expect a revision of the EMU timetable during June.

In our view, the government is eager to join as soon as possible and could decide to postpone ERM-2 entry just a few months, betting that volatility will continue to normalise. If the government decides to postpone ERM-2 entry until next year, it will mean postponing EUR adoption until 2013.

**Tighter economic policy on the cards**

EMU membership in 2012 will require a tighter economic policy. The budget deficit was 3.9% of GDP last year and hence exceeded the Maastricht criteria of 3%. Moreover, this year’s budget deficit may exceed that level unless new austerity measures are implemented.

Moreover, inflation is currently too high, as it has overshoot the Maastricht criteria since late last year. The significant weakening of the PLN has adversely affected prices of imported goods and especially food and energy prices. In addition, the relatively strong domestic economy means that disinflationary pressures have been limited so far. Going forward, inflation is likely to slow gradually and be back at the targeted 2.5% early next year.

The National Bank of Poland has kept interest rates on hold at the latest two meetings after delivering cuts totalling 225 bp. Near term, additional rate cuts cannot be ruled out, but interest rates are close to the bottom. If the government maintains its ambition to join the EMU in 2012, we do not see much room for further rate cuts. On the contrary, monetary conditions will have to be tightened to bring inflation below the criterion.

**Stronger PLN**

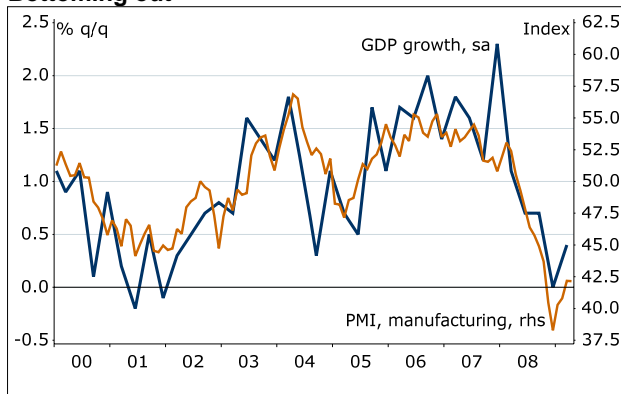
The bulk of the necessary monetary tightening is likely to come from a stronger PLN, though. Thus, once Poland joins ERM-2, we would expect significant PLN strengthening. Not only because the PLN is undervalued at current levels, but also because investors are likely to look at the Slovakian experience, where the SKK was revalued twice within the ERM-2, by 9% and 15%, respectively. Moreover, we are quite convinced that the ECB will opt for a relatively strong conversion rate at the time of EMU membership to avoid having a country as large as Poland running too high inflation after EUR adoption.

Anders Svendsen

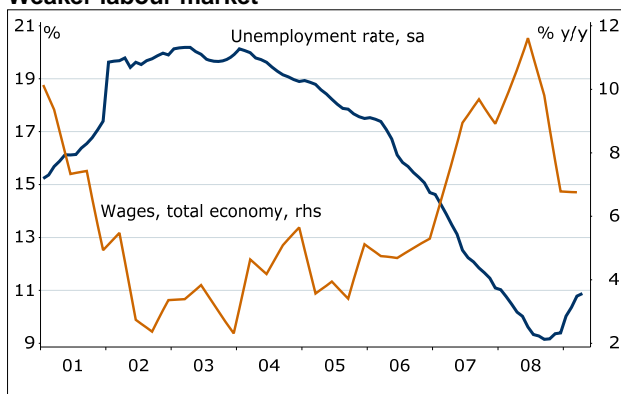
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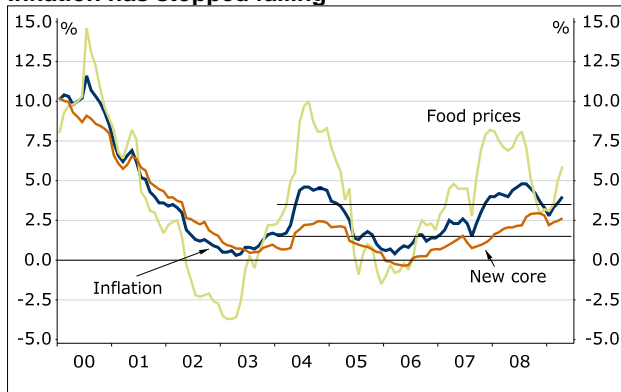
**Bottoming out**



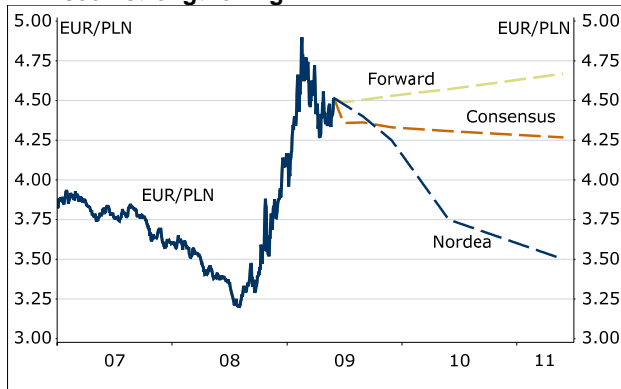
**Weaker labour market**



**Inflation has stopped falling**



**PLN seen strengthening**



## Steep contraction to turn into growth in 2010

- Domestic spending adjusted to lower oil revenue astonishingly fast
- Modest recovery in oil prices sets the stage for a return to growth in 2010
- Rouble moved towards more flexibility

### Contraction runs its course?

The Russian economy began the year in a steep decline (Q1 down 9.5% y/y) hit by the collapse in oil prices and the evaporation of foreign credit. As domestic spending has rapidly adjusted to lower oil income, the further downward pressure on the economy is limited.

We expect the economy to contract by 6% in 2009 as output gradually recovers. Growth is likely to recover slowly in 2010, as the global economy recovers and oil prices strengthen. The greatest risks to this scenario are posed by lower-than-expected oil prices and a slower-than-expected world recovery.

The connection between oil prices and growth in the Russian economy is far from direct due to the government's stabilisation fund. In principle, the fund is boosted during times of high oil prices. Indeed, the government accumulated reserves during the boom years. This was partly offset by heavy private sector borrowing. The sharp decline in the economy is thus not a direct impact of falling oil revenue but a consequence of a turnaround in private capital flows. However, a global recovery is not going to ensure a return to the strong growth levels of preceding years. Since oil prices are unlikely to rise as strongly as from the lows of the late 1990s, a return to the strong growth levels requires structural improvements in the economy, such as investment in oil production infrastructure and a broader industrial sector.

The financial crisis has affected both companies and households adversely. Companies' tighter financing situation has especially hurt investment growth, as corporations and banks face serious problems in refinancing their foreign debt. Difficulties in accessing consumer credit will continue to weigh on private consumption, as

especially durable goods purchases suffer. In addition, the labour market has continued to deteriorate rapidly, with unemployment rising to above 10% in April.

Oil and oil products account for approximately 50% of the value of exports. Export revenue is thus very vulnerable to fluctuations in energy prices. Firming oil prices would help pull the economy out of the recession, and the small price rise seen in recent weeks foster hopes for the oil-dependent economy. Besides oil prices the slowdown in demand from key export markets, such as the Euro zone, has weighed on exports. Highlighting the difficulties of the industrial sector, production has continued falling, contracting by almost 17% y/y in April.

The economy was clearly still overheated last year, as wages grew strongly and inflation surged. However, wage growth has cooled quickly this year, with real wages falling 3% y/y in April. Inflation, on the other hand, stayed elevated at over 13% y/y in April. Nevertheless, we see inflation moderating on the back of lower global food and energy prices as well as the weakening domestic economy.

The government reacted swiftly to the financial crisis at the end of last year. The government's revitalisation measures have so far mainly been aimed at stabilising the financial sector, which according to the Finance Ministry received RUB 1,500bn last year, e.g. to ease the flow of credit. Other measures have included liquidity provisions by the central bank, tax cuts for companies and support for the rouble. Revitalising measures for the real economy have also been planned, but details concerning the amount and timing have not yet been released. The support measures will to a large degree be financed by expanding the budget deficit, which will be covered both by borrowing and the oil funds.

Significant challenges include the pending WTO membership application and the prevalence of corruption. The WTO application has been pending for over a decade, and some unresolved issues with the US and the Euro area still hinder its adoption as a member. Under the current economic circumstances, protectionist measures, such as tariffs, are getting more tempting, which could

### Russia: Macroeconomic indicators (% annual real changes unless otherwise noted)

	2005 (RUBbn)	2006	2007	2008	2009E	2010E
Private consumption	10,728	11.1	13.5	9.0	-6.0	1.0
Government consumption	3,591	2.4	3.4	4.5	0.5	2.5
Fixed investment	3,837	17.7	20.8	12.8	-14.0	-1.5
Exports	7,607	7.3	6.4	3.0	-8.5	1.0
Imports	4,648	21.3	26.6	13.2	-10.0	2.0
GDP		7.7	8.1	5.6	-6.0	1.5
Nominal GDP (RUBbn)	21,625	26,880	32,987	39,485	41,460	45,813
Unemployment rate, %		6.7	5.6	5.9	12.0	13.0
Consumer prices, % y/y		9.7	9.0	14.1	11.0	9.0
Current account, % of GDP		9.5	5.9	5.9	-1.0	0.0
Central govt budget balance, % of GDP		8.4	6.1	4.1	-8.0	-5.0

further hinder the negotiations. Corruption is still prevalent, with Russia ranking as number 147 out of 180 countries in Transparency International's annual report. The situation seems to have deteriorated rather than improved recently, but only time will show how laws and practices are implemented under Medvedev's reign.

**Moving towards flexibility**

The rouble weakened sharply during late 2008 and early 2009 against the basket (USD/RUB 55%, EUR/RUB 45%) as the financial crisis intensified and the conflict in Georgia heightened, leading to strong speculation and a flight of capital. The increased uncertainty surrounding the rouble was exacerbated by the rapidly falling oil prices, which pushed down the twin surpluses behind a stable rouble, the current account and fiscal surpluses.

The task of the Central Bank of Russia (CBR) is to keep the rouble stable, but last year it moved towards a more flexible exchange rate policy, which allowed the rouble to fluctuate more freely against the basket. Between November and January the CBR intervened and let the rouble devalue several times against the basket in a series of small devaluations. All in all, the rouble has weakened approximately 30% since November. These interventions in the exchange rate market and the capital outflows have eaten up almost USD 200bn of the foreign exchange reserves, but still leaving almost USD 400bn. However, at the end of January the CBR announced a new range, 26-41 roubles, and although the rouble has approached the ceiling, the range has held so far.

In recent weeks the rouble has slowly but steadily strengthened again, and the likelihood of devaluation has diminished. This has enabled the rouble to search more freely for a suitable level against the basket. The rouble's wider fluctuation band would be consistent with the central bank moving towards a more freely floating rouble. The explicit range of 26-41 roubles is, however, still intact, and we expect the top of the range to hold. The central bank is expected to defend the range if needed and it still has plenty of reserves with which to support the rouble. The wider range could, however, be seen like a managed free float, with the CBR intervening only if it breaches the upper or lower band. With the very wide band RUB is now practically a relatively flexible currency, and it is clearly closer to floating than earlier.

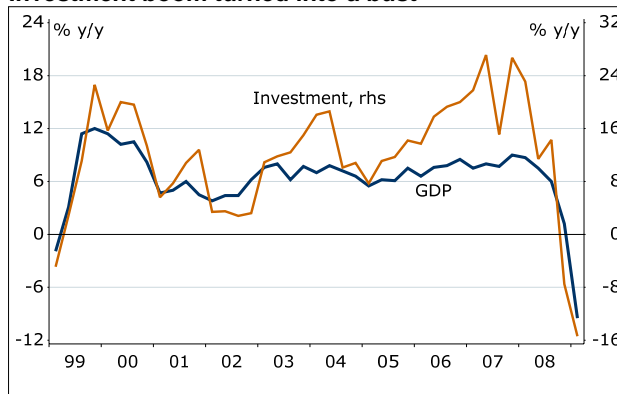
Risk sentiment is expected to remain important for the rouble also in the future. Fluctuations in oil prices are of interest, since a steep fall could cause further rouble weakening. Thus, the rouble is still a volatile currency, but no immediate risk of excessive weakening is in sight.

Annika Lindblad

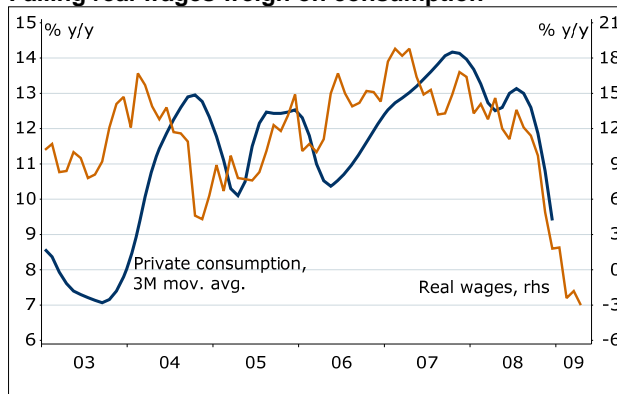
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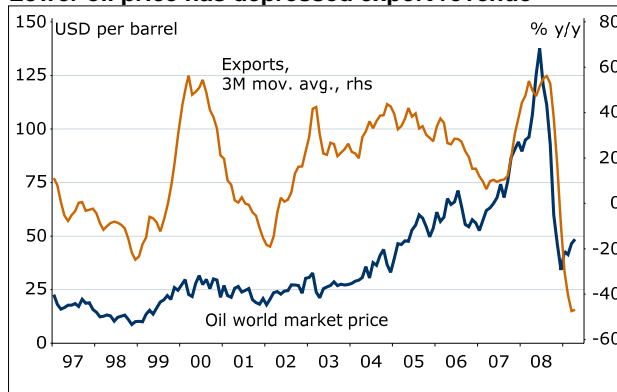
**Investment boom turned into a bust**



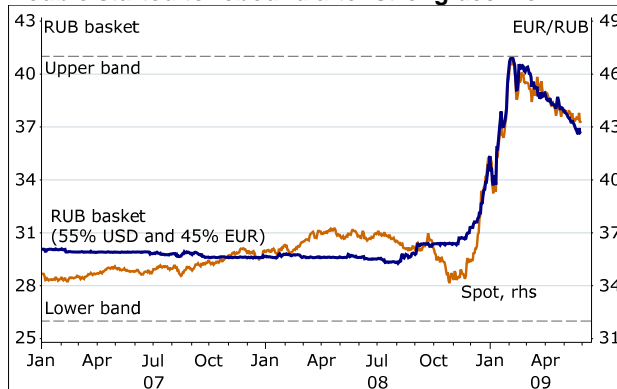
**Falling real wages weigh on consumption**



**Lower oil price has depressed export revenue**



**Rouble started to rebound after strong decline**



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