

Baltic Rim Outlook

June 2008



Growth at a crossroads

The economic development in the Baltic countries on the one hand and Russia and Poland on the other hand seems to be at a crossroads. While the Baltics now show clear signs of a slowdown, the outlook still seems brisk for Poland and Russia. This creates new opportunities for Nordic companies operating in the region. When domestic overheating calms down in the Baltics, the preconditions for exports to these countries diminish, while the prospects for outsourcing production improves, as property prices and building costs fall and labour shortages ease. The opposite is the case for Russia and Poland. Export opportunities to these countries have never been better in light of the rapidly increasing growth in the purchasing power of the large Russian and Polish populations.

Until recently, the **Baltic countries** were the star performers in terms of growth among the European Union countries. However, the economic outlook deteriorated in all the countries in early 2008, and the adjustment towards slower growth has started. In Estonia and Latvia the slowdown seems to be much faster than we previously expected. Developments in all Baltic countries show a similar pattern, though the magnitude of the boom-bust cycle varies across the countries. The boom-bust cycle is more pronounced in Latvia and Estonia, whereas in the Lithuanian economy the upswing and the coming downswing will be more moderate. Housing markets are cooling down, credit growth is easing and the adjustment to lower growth in both consumption spending and investment is taking place. Even though the short-term outlook for the Baltic countries is bleak, growth will resume after a few slow years.

The **Russian** economy has shown impressive growth figures during recent years. The favourable developments are expected to continue. Investment growth has picked up, as all spare capacity has been put into use due to strong growth. Strong real wage growth boosts private consumption and lifts more people into the middle class. The rise of the middle class as consumers and producers of goods and services is a self-reinforcing process and a key to broad-based growth. The biggest worry in the Russian economy is the surging inflation, which directly affects consumers' purchasing power.

The **Polish** economy expanded more than 6% y/y for the eighth consecutive quarter in Q1 2008 supported by the ongoing improvement in the labour market and continued massive capital inflows. For the full year of 2008 and probably also 2009, we expect growth to be above 5% despite higher interest rates, a stronger PLN, weaker foreign demand and higher food and energy prices. This shows the present resilience of the economy.

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Editorial deadline:

4 June 2008

Currency forecasts (against DKK)

	4-Jun-08	3M	6M	12M	24M
EEK/DKK	0.48	0.48	0.48	0.48	0.48
LVL/DKK	10.61	10.66	10.66	10.66	10.66
LTL/DKK	2.16	2.16	2.16	2.16	2.16
PLN/DKK	2.21	2.19	2.23	2.30	2.49
RUB/DKK	0.20	0.21	0.21	0.22	0.22

Currency forecasts (against NOK)

	4-Jun-08	3M	6M	12M	24M
EEK/NOK	0.51	0.48	0.49	0.49	0.50
LVL/NOK	11.33	10.79	10.93	11.00	11.07
LTL/NOK	2.31	2.19	2.22	2.23	2.24
PLN/NOK	2.36	2.22	2.28	2.37	2.58
RUB/NOK	0.22	0.21	0.21	0.22	0.23

3M interbank rate forecasts

	4-Jun-08	3M	6M	12M	24M
Poland	6.51	6.50	6.45	6.25	5.60
Estonia	6.47	6.20	6.00	5.25	4.75
Latvia	6.02	5.45	5.25	4.50	4.00
Lithuania	5.20	5.00	4.90	4.30	3.80
Russia	6.40	6.30	6.30	5.50	5.00

Currency forecasts (against EUR)

	4-Jun-08	3M	6M	12M	24M
EUR/EEK	15.65	15.65	15.65	15.65	15.65
EUR/LVL	0.70	0.70	0.70	0.70	0.70
EUR/LTL	3.45	3.45	3.45	3.45	3.45
EUR/PLN	3.37	3.40	3.35	3.25	3.00
EUR/RUB	36.89	36.15	36.00	34.44	33.35

Currency forecasts (against SEK)

	4-Jun-08	3M	6M	12M	24M
EEK/SEK	0.597	0.594	0.601	0.588	0.582
LVL/SEK	13.335	13.286	13.429	13.143	13.000
LTL/SEK	2.707	2.693	2.722	2.664	2.635
PLN/SEK	2.770	2.735	2.806	2.831	3.033
RUB/SEK	0.253	0.257	0.261	0.267	0.273

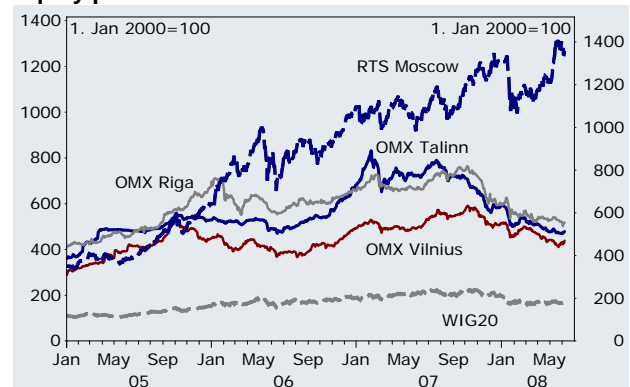
3M interbank rate forecasts (spread to the Euro area)

	4-Jun-08	3M	6M	12M	24M
Poland	1.65	1.90	2.05	2.60	2.45
Estonia	1.61	1.60	1.60	1.60	1.60
Latvia	1.16	0.85	0.85	0.85	0.85
Lithuania	0.34	0.40	0.50	0.65	0.65
Russia	1.54	1.70	1.90	1.85	1.85

FX performance



Equity performance



Convergence criteria

	Budget balance, % of GDP	Inflation, %	Government debt, % of GDP	10Y yields, %	FX Stability*, %	EMU entry forecasts, year
Criteria	-3.0	2.8	60.0	6.5	-15 / +15	
Estonia	2.8	6.7	3.4	4.6	0/0	2012
Latvia	0.0	10.1	9.7	5.3	-1.0 / +1.0	2013
Lithuania	-1.2	5.8	17.3	6.5	0/0	2012
Poland	-2.0	2.6	45.2	6.4	-9.0 / 10.4	2012

* 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 ²	President	T. H. Ilves
Population	1.3 mn	Next election	Fall 2011
GDP/capita	21800 USD*	Prime minister	A. Ansip
Currency	Kroon	Next election	March 2011

Country facts Latvia

Area	64,589 km ²	President	V. Zatlers
Population	2.2 mn	Next election	July 2011
GDP/capita	17700 USD*	Prime minister	I. Godmanis
Currency	Lat	Next election	October 2010

Country facts Lithuania

Area	65,200 km ²	President	V. Adamkus
Population	3.6 mn	Next election	June 2009
GDP/capita	16700 USD*	Prime minister	G. Kirkilas
Currency	Litas	Next election	October 2008

Country facts Poland

Area	312,685 km ²	President	L. Kaczynski
Population	38.5 mn	Next election	October 2010
GDP/capita	16200 USD*	Prime minister	D. Tusk
Currency	Zloty	Next election	2013

* at PPP. Data from 2007

Country facts Russia

Area	17,075,200 km ²	President	D. Medvedev
Population	140.7 mn	Next election	March 2012
GDP/capita	12096 USD*	Prime minister	V. Putin
Currency	Ruble	Next election	December 2011

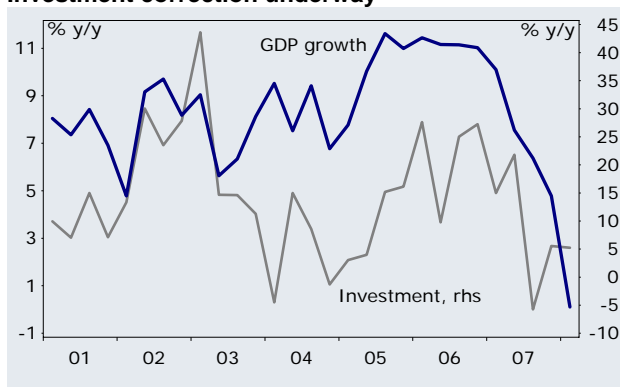
Growth stalling

- The slowdown steeper than previously expected.
- Investment declines sharply.
- The recovery delayed as external demand stays weak.
- Inflation will start to ease in the latter part of 2008.

Slowdown surprisingly steep

The Estonian economy started to cool down during 2007. Annual GDP growth was 7.1%, but in the last quarter the economy expanded by only 4.8% year on year. Both private consumption and investment slowed down markedly from double-digit levels during the year.

Investment correction underway



The GDP flash estimate for Q1 2008 growth published in May was just 0.4%, which surprised many observers. The GDP figure is, however, well in line with other signs of slowing growth in 2008. Retail trade during the first quarter expanded only slightly and industrial production declined. Consumer and business confidence indicators showed strong declines. Output in main export industries, such as wood products, was also weak, with electronic products being an exception.

As real estate prices have started to fall, construction is slowing sharply. The credit boom is easing due to weaker credit demand, as potential buyers are postponing their decisions and borrowing costs have increased. The banks

have also become more cautious in granting credit due to weaker growth prospects and falling collateral values. Credit growth in April stood at 24% compared with 40% a year before.

Private consumption will be badly hit by a weak housing market and rapid inflation depressing purchasing power. Falling house prices will lower consumption through wealth effects and plummeting confidence. Growth in private consumption is expected to slow to almost zero this year. Consumption spending will not speed up until inflation is in check and house prices have stabilised. We expect investment to fall clearly in 2008 as construction contracts rapidly.

The external environment is also expected to be rather challenging, as the US-led slowdown is forecast to stretch into 2009. Estonia's biggest trading partners, that is, Finland and Sweden, are also going through a period of weaker growth. This will be reflected in weaker growth of external demand.

As exports suffer from subdued external demand, they will not provide enough compensation for the softening domestic demand. However, the current account deficit will start to shrink as domestic demand curbs imports and exports keep growing, albeit quite slowly.

We expect GDP growth to settle at 1% this year, as domestic demand is not expanding at all. The correction in the housing markets is likely to continue well into 2009. Private consumption will gradually pick up in 2009, but investment is not expected to recover until later. Therefore, GDP growth is expected to stay sluggish at around 2.5%.

Inflation still on the rise

Inflation has become the biggest worry in many economies, as food and energy prices have soared. Estonia is no exception; on the contrary consumer prices rose sharply by 11.4% in April. Domestic overheating contributes to surging inflation, with nominal wages continuing to grow briskly at around 20%, even though the real

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

	2004 (EEKmn)	2005	2006	2007	2008E	2009E
Private consumption	82,490	10.7	14.9	9.0	0.4	2.1
Government consumption	27,029	1.6	2.6	4.8	2.5	1.0
Fixed investment	47,091	9.9	22.4	7.8	-7.5	-0.6
Stockbuilding*	5,327	-1.4	4.2	-0.1	0.2	0.2
Exports	111,209	20.5	8.3	1.5	1.9	2.5
Imports	123,222	16.3	17.1	2.8	-1.4	1.0
GDP		10.2	11.2	7.1	1.0	2.5
Nominal GDP (EEKmn)	149,923	175,392	207,061	243,252	271,469	293,458
Unemployment rate, %		7.9	5.9	4.7	6.2	6.8
Consumer prices, % y/y		4.1	4.4	6.7	10.6	5.6
Current account, % of GDP		-10.0	-15.7	-17.4	-11.2	-10.1
General govt budget balance, % of GDP		1.8	3.4	2.8	-0.6	-1.0

* Contribution to GDP growth (% points)

economy is cooling down. Wage developments in the coming quarters will show whether upward drifting inflation expectations will return to lower levels. Currently, there is some weak evidence suggesting that wage growth could be slowing down as the labour market softens.

If wages keep rising as economic activity contracts, rising real wages will worsen the decline in the economy through an erosion of competitiveness. In this worst-case scenario unemployment would rise faster than currently projected, which would strengthen the self-reinforcing downward spiral of the economy by suppressing consumption and housing demand further.

Therefore, labour market flexibility in terms of rapid wage adjustment and swift work force reallocation from declining industries to expanding and more productive industries is the key adjustment mechanism of the economy.

Looking beyond the 2-year forecast horizon, the ingredients of robust and sustainable growth are in place in the Estonian economy. Flexible labour markets, along with competitive product markets, developed financial markets, strong incentives for private entrepreneurship and innovation, rule of law, willingness to use ICT broadly and a fairly well-educated work force are also necessary preconditions for continuous productivity growth in the longer run. Hence, the Estonian economy is well positioned to return to a path of rapid growth after the adjustment period.

We expect the currency board to hold

We expect the currency board to stay in place with the projected outlook, even though some speculation will probably emerge if the growth rate turns negative. If the economy faces a considerably deeper-than-projected recession, the risk of a devaluation will also increase. Another risk is contagion effects in case of a crisis in one of the other Baltic countries.

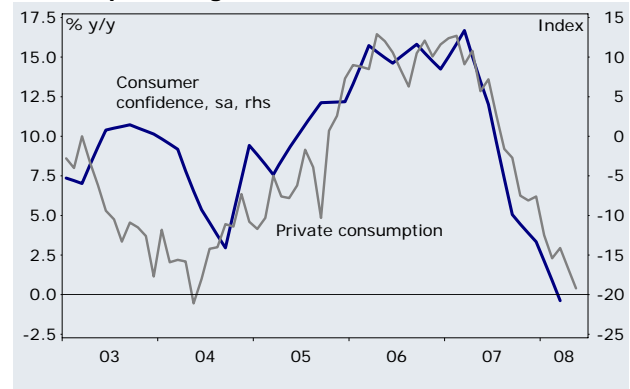
The political commitment to a fixed exchange rate regime is strong, and a very deep downswing is likely to be needed to shake that. And as about 75% of lending is in foreign currency, mostly in euros, a devaluation could do more harm in terms of bankruptcies and insolvencies than good by restoring price competitiveness.

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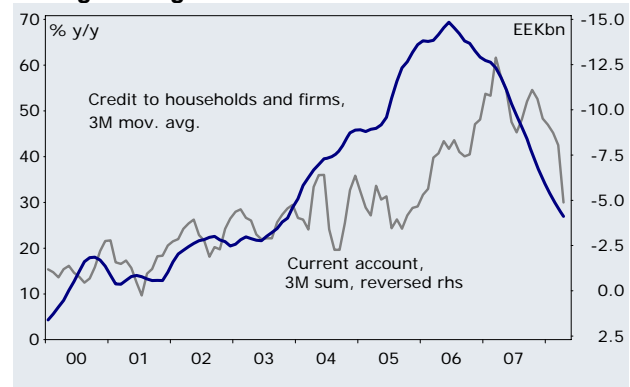
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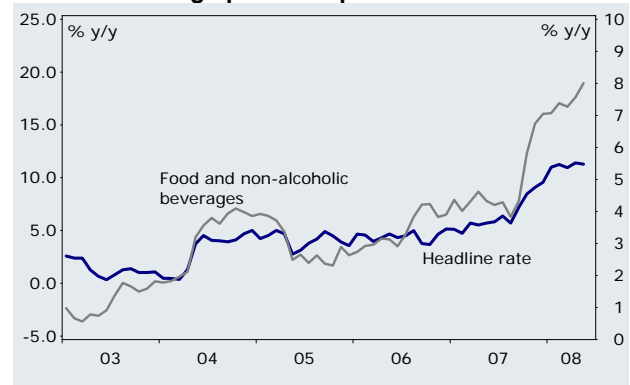
Consumption stagnates



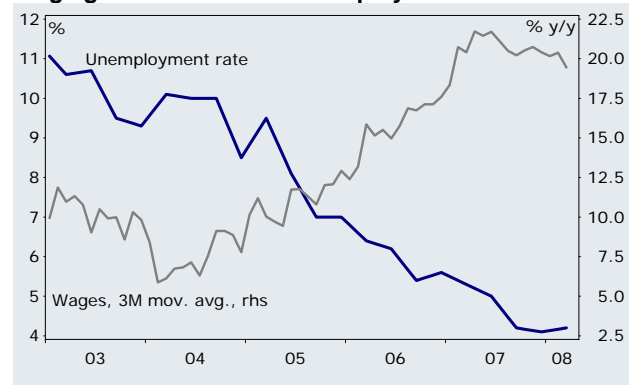
Easing credit growth corrects current account



Inflation heading up as food prices soar



Wage growth eases and unemployment about to rise



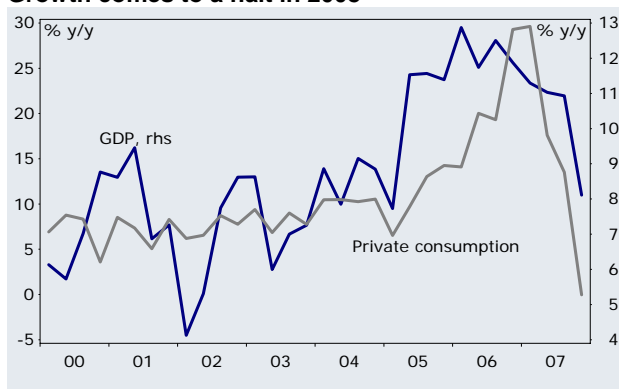
Lean years ahead

- Growth stalls as domestic demand plummets.
- Housing markets will still weaken.
- Inflation record high this year.
- LVL to stay volatile.

Heading towards recession

In 2007 Latvian GDP growth slowed moderately during the year and annual growth settled at 10.3%. There was a marked shift in the structure of demand during the year. Both private consumption and investment growth slowed down rapidly, pulling import growth down as well.

Growth comes to a halt in 2008



In the last quarter of 2007 domestic demand growth was already close to zero. Imports actually declined from the previous year due to weak consumption and investment demand. Domestic demand thus lost strength as early as during 2007. Exports grew, however, relatively briskly during the latter part of last year.

During early 2008 the outlook deteriorated further. Retail sales growth has stalled, and confidence indicators have fallen markedly. Industrial production has also declined. The Q1 GDP data showed weak 3.6% annual growth. It seems likely that private consumption and investment decreased during Q1.

The boom in the residential housing market has turned into a bust. Apartment prices in the Riga area began to

fall already during the second quarter of 2007. Prices have dropped some 20% from the peak and are close to the price level in the autumn of 2006.

Along with a weakening housing market, credit growth has slowed down rapidly. In April annual growth stood at 27% compared with 58% a year before. The demand for housing loans has softened, as falling prices have created expectations of further price declines. At the same time banks have become more cautious about lending due to falling collateral values and a weaker economic outlook.

Developments in the housing market will have a negative impact on the Latvian economy. In turn this will of course weaken housing investment. Private consumption will also be depressed by the weak housing market through negative wealth effects and the fall in consumer confidence. Cooling housing markets will depress consumption also through declining employment and weaker income growth.

The Latvian economy has been growing way too fast in recent years. The boom fuelled by strong credit growth cannot continue forever. The problem is not the level of credit stock, but the speed of change, which has clearly been unsustainable. Now, the adjustment to a sustainable and slower GDP growth track has clearly started, and the correction seems to be relatively steep.

We expect to see negative growth in both investment and private consumption in 2008. Growth in consumption and housing investment is not likely to resume until housing prices have stabilised. The external environment is also projected to be challenging due to the prolonged slowdown in the US economy and weak growth in the Euro area in 2008 and 2009. Therefore, export demand is expected to remain subdued in for example the forest industry. The transport, storage and communication industries performed well in 2007, but the pick-up may be of a temporary nature. In addition, as Estonia and Lithuania are Latvia's most important trading partners, the downturn in the other two Baltic countries will transmit directly to the Latvian economy through weaker export demand.

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

	2004 (LVLmn)	2005	2006	2007	2008E	2009E
Private consumption	4,675	11.2	21.2	14.2	-1.4	-0.5
Government consumption	1,451	2.7	4.9	4.8	3.8	3.5
Fixed investment	2,042	23.6	16.4	8.4	-5.5	-0.8
Exports	3,268	20.3	6.5	11.1	5.9	4.5
Imports	4,429	14.8	19.3	15.0	-0.8	0.8
GDP		10.6	12.2	10.3	0.5	1.4
Nominal GDP (LVLmn)	7,434	9,059	11,265	14,048	16,577	18,383
Unemployment rate, %		8.9	6.8	6.0	7.5	8.5
Consumer prices, % y/y		6.9	6.6	10.1	17.5	9.5
Current account, % of GDP		-12.5	-22.5	-22.9	-15.5	-10.0
General govt budget balance, % of GDP		-0.4	-0.2	0.0	-1.5	-2.5

* Contribution to GDP growth (% points)

We expect GDP growth to come close to a halt in 2008. Next year the economy will start to expand slowly, as the housing market stabilises and consumer spending gains strength. The economy will grow way below its potential level for a few years, as the indebted private sector adjusts to living within its means after the credit boom.

Inflation near its peak

Inflation in Latvia has skyrocketed recently, led by soaring food and housing-related prices. In April consumer prices were 17.4% higher than a year before. Accelerating inflation cannot be explained solely by external developments like food prices in international markets and the rising price of oil. In the case of Latvia the domestic overheating is a clear contributor. Service sector prices in hotels, cafés and restaurants are rising rapidly, and wages increased by over 30% last year. Inflation expectations are still running high. We expect the economy to cool down considerably during this year, which will also eventually drive down inflation. Annual average inflation will, however, hit a record high this year. In 2009 inflationary pressures are likely to ease, but inflation will still stay close to double-digit territory.

The currency peg likely to hold

The projected outlook consists of a clear recession combined with record-high inflation this year. In our baseline scenario we expect the currency peg to hold. In order to navigate through the rough times without a major currency and financial crisis, the Latvian labour markets need to show flexibility. Wage growth needs to be in check so that employment losses are minimised and inflationary pressures start to ease. Wage growth has exceeded productivity growth by a wide margin during the boom years. Cost competitiveness has deteriorated, and further appreciation of the real exchange rate would be detrimental to the recovery in this situation.

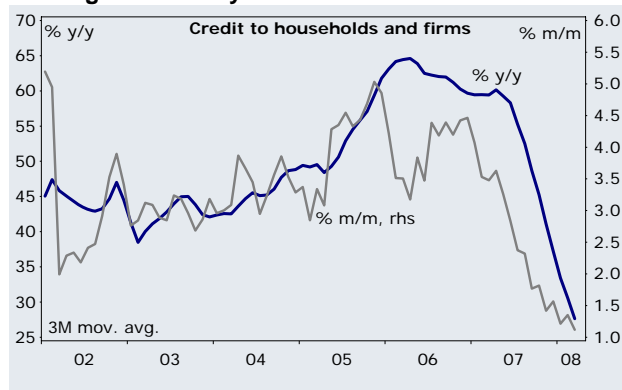
If inflation turns out to be more persistent than projected, further eroding price competitiveness, and if the slow-down proves considerably deeper, the risk of a more severe crisis with collapsing housing prices and falling GDP increases. Then the currency peg would be threatened, and a devaluation could be used in a desperate attempt to prevent the economy from a total crash.

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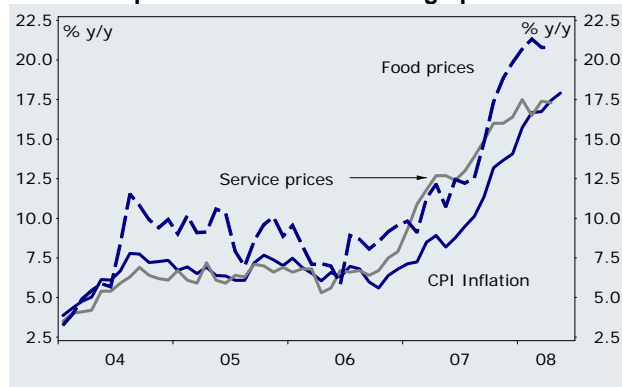
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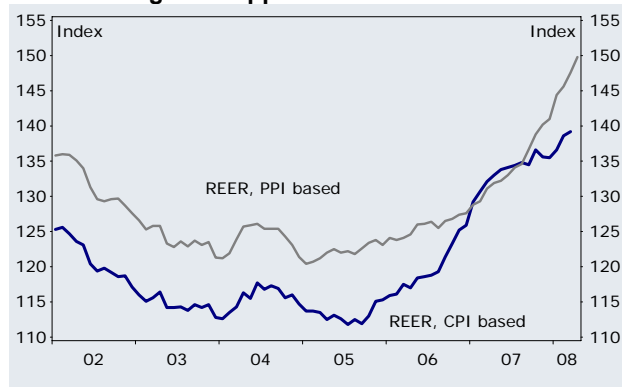
Credit growth nearly stalled



Consumer price inflation still heading up



Real exchange rate appreciation been fast



Continued volatility in the FX markets



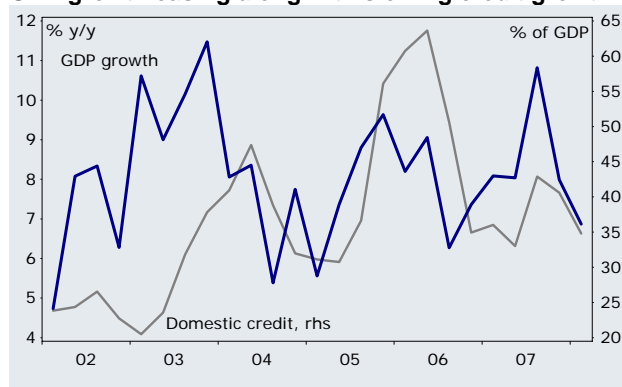
Adjusting to a lower growth path

- GDP growth to ease as housing markets cool down.
- Slowdown in both investment and consumption.
- Inflation to ease gradually from double-digit levels.
- Slowing inflation conditional on moderate wage hikes.

Emerging signs of weakness

The Lithuanian economy continued to expand strongly during 2007. Annual average GDP growth in 2007 was 8.8%. Growth was driven by domestic demand, as both private consumption and investment developed favourably. The pace of expansion eased somewhat during the latter part of the year in both areas, however.

GDP growth easing along with slowing credit growth



In 2008 Q1 GDP grew by 6.9% from the previous year. Growth was still driven by domestic demand, as private consumption expanded over 12%, and investment growth reached close to 11%. Strong domestic demand kept imports expanding by almost 15%. Export growth was lagging behind and grew “only” 8.5%. The recovery of the oil refining capacity in the latter part of 2007 will help exports and imports to grow briskly this year. In terms of value added the impact of oil refining is, however, limited. The relatively weak export figure suggests that other components than oil exports may have developed very weakly in early 2008.

The Lithuanian economy has also shown other signs of

weakening performance in recent months. Both consumer and business confidence have weakened. Especially the housing market is clearly softening. The number of transactions is falling and house prices have started to decline. Residential housing investment is expected to cool down considerably, and this development will affect consumer confidence and private consumption through negative wealth effects from the housing sector.

Credit growth also slowed in the first months of 2008. Credit demand has weakened due to a cooling economy and higher borrowing costs, as Euro-area interest rates have increased. At the same time, banks have become more cautious about lending due to weaker growth prospects and deteriorating collateral values. Credit growth to the corporate sector started to decelerate as early as in mid-2007, whereas in the household sector the slowdown did not start until the beginning of 2008.

The Lithuanian economy is heading towards a period of slower growth. Investment is curbed by the plummeting construction activity, and consumption spending will ease as real income growth slows down and expectations about future incomes are scaled down. Our main forecast is that GDP growth will slow down further and settle at 5.5% in 2008 on average. Even though quarterly year-on-year growth is expected to pick up again in the second half of 2009, annual average growth is forecast to slow to 4.1%. Thus, growth will drop below its potential rate for a couple of years.

A weaker economy will inevitably be reflected in rising unemployment, but as long as wage growth reacts downwards to the softening activity, the impact is expected to be limited. The risks to the growth scenario are, however, clearly on the downside. The flexibility of the labour market is crucial to the projected development. Wage growth needs to slow down along with the economy, and resources need to move flexibly from declining sectors to more productive ones. This will prevent unemployment from rising rapidly, a phenomenon which could trigger a downward trend in consumer sentiment and send consumption spending and housing markets into a free fall.

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

	2004 (LTLmn)	2005	2006	2007	2008E	2009E
Private consumption	40,649	11.9	11.9	11.6	5.8	3.7
Government consumption	11,207	3.6	5.5	3.8	5.3	3.5
Fixed investment	13,968	10.9	17.4	15.7	4.4	3.3
Exports	32,636	17.7	12.2	4.7	9.1	7.0
Imports	37,073	17.2	13.8	9.1	8.1	5.5
GDP		7.9	7.7	8.8	5.5	4.1
Nominal GDP (LTLmn)	62,587	71,380	81,905	96,740	111,735	123,020
Unemployment rate, %		8.3	5.6	4.3	5.2	5.5
Consumer prices, % y/y		2.7	3.8	5.8	10.0	6.0
Current account, % of GDP		-7.2	-10.5	-13.8	-12.5	-11.5
General govt budget balance, % of GDP		-0.5	-0.5	-1.2	-2.2	-2.0

* Contribution to GDP growth (% points)

High inflation risk to smooth adjustment

At the same time as the real economy is showing signs of weakening, inflation is still surging. High inflation will weaken consumers' purchasing power and contribute negatively to consumption growth. Food and energy prices have soared and pushed up inflation recently, but domestic overheating is also a factor behind the accelerating inflation.

Inflation started to rise sharply in the latter part of 2007, as commodity prices in the world market started to push food and energy prices upwards. In April 2008 annual inflation had risen to 11.7%. The real danger in this development is how these changes in food and energy prices feed into other prices and wages through increasing inflation expectations. When inflation becomes broad-based, it is difficult to drive out of the system. There are some signs of these spill-over effects in the Lithuanian economy. Wage growth accelerated to 23.8% in Q1 2008 after being well below 20% in the latter part of 2007. However, we expect that annual inflation will peak during the latter part of 2008, and that inflation will decelerate notably in 2009 as demand pressures ease.

If inflation and rapid wage increases persist, the cost competitiveness of the economy will deteriorate. The real exchange rate has appreciated lately, but the level is still not particularly high. A further rapid loss of cost competitiveness would be extremely hazardous in the current situation where softening domestic demand needs to be replaced by a strengthening of external demand. The current global slowdown does not make the picture any brighter. The housing market correction in the US economy will linger, and growth in the Euro area is expected to remain subdued.

The currency board not threatened

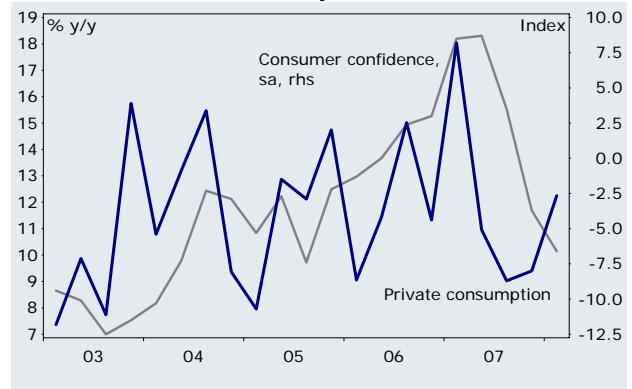
The currency board system faces no imminent risks in our baseline scenario for the Lithuanian economy. Provided that growth slows down in an orderly fashion, and there are no major disruptions or crises in any major markets of the economy, the current system will remain unchanged. However, as the economic cycle is more pronounced in Latvia and Estonia, there might be contagion effects and pressure against the LTL in case of financial turbulence in the other Baltic counties.

Anssi Rantala

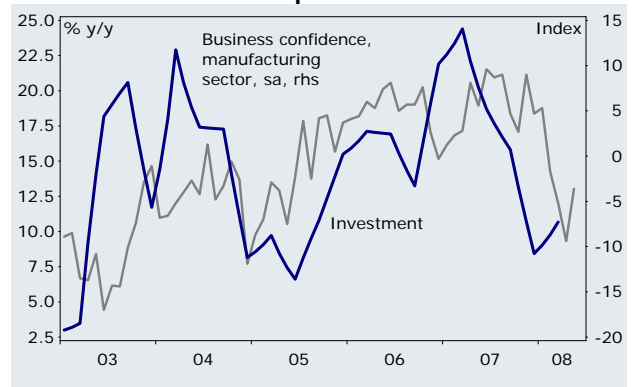
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Consumer confidence at 3-year low



Investment correction expected



Inflationary pressures from the labour markets



Real exchange rate appreciation still moderate



EMU membership in sight

- Economic expansion to remain strong.
- Returning emigrants may postpone slowdown.
- Inflation is rising.
- EMU membership perhaps from 2012.

The Polish economy expanded more than 6% y/y for the eighth consecutive quarter in Q1 2008 supported by the ongoing improvement in the labour market and continued massive foreign capital inflows. For the full year of 2008 and probably also 2009, we expect growth to be above 5% despite higher interest rates, a stronger PLN, weaker foreign demand and higher food and energy prices. That is how resilient the economy seems at present.

Still, imbalances are building and risks are beginning to materialise. Indeed, inflation could reach almost 5% in the coming months and the current account deficit may even top 5% next year. That is likely to keep the National Bank of Poland (NBP) in a tightening mood a bit longer than previously expected. According to the updated Convergence Programme prepared by the Ministry of Finance in March, fiscal policy is likely to be less lenient in the years to come and hence an improved policy mix should help manage macroeconomic risks going forward. EMU membership may be on the cards from 2012.

Labour market improvements

Employment in the enterprise sector is increasing more than 5% y/y, corresponding to more than 20,000 jobs being created on average every month. Consequently, the number of unemployed persons is falling and the unemployment rate has come down to just over 10% from above 20% on the so-called E-day 1 May 2004. Still, there seems to be a mismatch between qualifications required to fill new vacancies and the qualifications of the remaining pool of unemployed. Indeed, almost 75% of all vacancies reported to the labour offices currently remain unfilled at the end of the same month, while more than 60% of the remaining are long-term unemployed. Thus, bottlenecks are evident in several sectors and average wages are now growing at a double-digit rate.

We expect average wage increases of close to 10% this year and only slightly less next year. Thus, labour demand will remain strong and labour shortages and labour mismatch will persist in certain sectors. The big question could be migration. Indeed, anecdotal evidence seems to suggest that Polish emigrants are returning home from especially the UK due to higher wage growth in Poland and PLN appreciation of almost 45% against the GBP since Poland joined the EU. The return of emigrants is likely to take some of the pressure off the labour market, and may even add to both employment and wage growth, as the returnees are likely to demand higher compensation for skills and experience. Thus, a larger-scale return of emigrants may postpone the expected economic slowdown and at same time limit the risk of overheating.

Domestic demand in the driver's seat

Private consumption is clearly benefiting from the persistent improvements in the labour market. Thus, the real wage bill is increasing rapidly and so is households' purchasing power despite recent increases in food and energy prices. The latest data on retail sales, new passenger car registrations and consumer lending indicate that private consumption growth has peaked, but we expect only a moderate slowdown in 2008 and 2009.

Investment is also growing rapidly because of capacity constraints, massive foreign capital inflows and the booming housing market. Additional support should be expected from public infrastructure investment ahead of the European soccer championships in 2012. In the short term, however, we expect some moderation due to the tightening of monetary policy and weaker foreign demand.

Exports are holding up surprisingly well considering the strong PLN. However, this may be due to temporary factors bolstering the Euro-area economies and the German economy in particular. Thus, we still expect some weakness this year. Import growth is likely to outpace export growth both this year and in 2009. Thus, net exports will contribute negatively to GDP growth and the trade and current account balances will widen somewhat.

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

	2004 (PLNbn)	2005	2006	2007	2008E	2009E
Private consumption	589	2.0	4.9	5.2	5.1	4.6
Government consumption	163	5.2	5.8	0.7	2.0	1.5
Gross fixed capital formation	167	6.5	16.5	20.4	14.0	10.0
Stockbuilding*	22	-0.9	0.4	0.4	0.2	0.1
Exports	347	8.0	14.6	9.1	8.5	6.5
Imports	368	4.7	17.4	10.9	10.3	7.0
GDP		3.6	6.2	6.6	5.4	5.0
Nominal GDP (PLNbn)	925	983	1,060	1,677	1,820	1,965
Unemployment rate, %		18.2	16.2	12.7	10.6	9.7
Consumer prices, % y/y		2.2	1.2	2.6	4.3	3.4
Current account, % of GDP		-1.4	-2.7	-3.7	-4.6	-5.1
General government budget balance, % of GDP		-4.3	-3.9	-2.0	-2.2	-2.0

* Contribution to GDP growth (% points)

All in all, GDP growth looks set to slow, but is likely to exceed 5% this year and in 2009. Risks are skewed to the downside due to the global environment and tighter domestic monetary conditions.

Accelerating inflation

Inflation has increased significantly and is likely to rise to almost 5% in the coming months compared with the inflation target of 2½% +/- 1% point. Food and energy prices are responsible for almost half the increase, while inflation excluding these items remains close to target. Unit labour costs are accelerating, though, and hence core inflation is likely to continue increasing moderately going forward. Given the tightness of the labour market there is a risk that the high current rate of inflation may affect inflation expectations. Thus, we expect two additional rate hikes from the National Bank of Poland aimed at anchoring inflation expectations, which will take interest rates to 6.25% with risks skewed to the upside.

Stronger PLN

The PLN has benefited from the increased interest rate differential and the continued strong inflow of foreign capital. Indeed, the currency has been one of the best performers since the credit crisis started almost a year ago and also one of the least sensitive to changes in global risk appetite. There are a number of reasons for the strong performance, including the fact that banks do not seem to have major exposure related to the global credit turmoil, exports are not that sensitive to US growth and external financing needs are moderate and mostly based on relatively stable sources. The net foreign direct investment inflow in fact more than covers the current account deficit even though the total inflow was smaller in 2007 than in 2006 in EUR terms. We expect a moderate strengthening of the PLN vs. the EUR going forward.

EMU membership possible from 2012

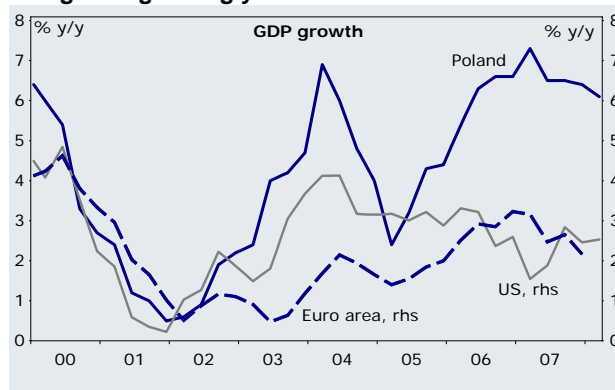
The PLN could also gain from the fact that EMU membership has become visible on the horizon again. Indeed, the Ministry of Finance published its updated Convergence Programme in March containing a significant reduction in the budget balance in the coming years. Thus, to comply with the Maastricht criteria inflation must be contained and the PLN must be in the ERM-2 for two years without severe tensions, ie it can fluctuate 15% on either side of a set central parity, while the budget deficit, government debt and the interest rate level currently comply with the respective criteria. Inflation should not be a big problem looking just a few years ahead and hence ERM-2 membership may be considered already next year if the global financial turmoil abates, and EMU membership could be in sight for 2012 – at least that was what the Ministry of Finance suggested.

Anders Svendsen

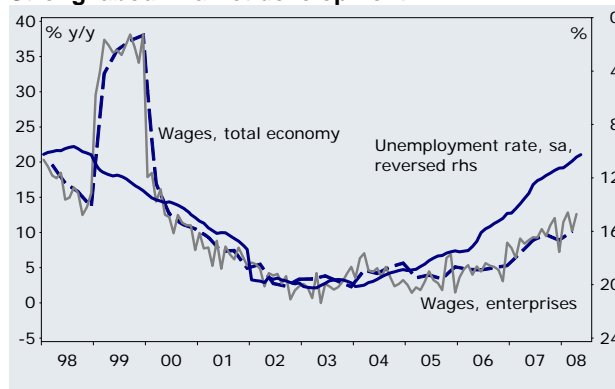
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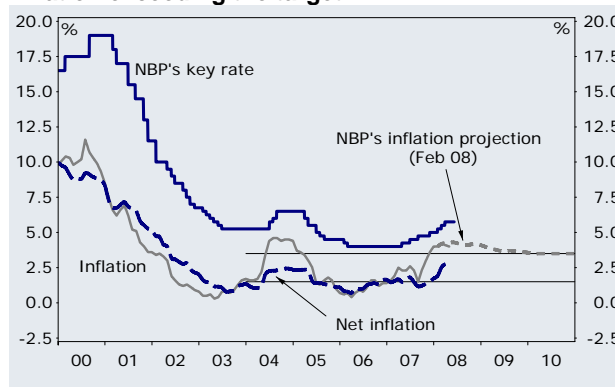
Still growing strongly



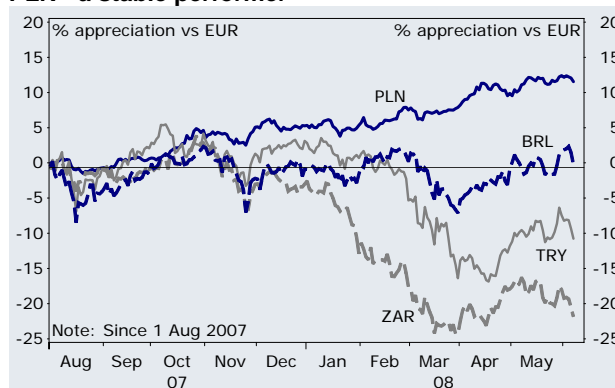
Strong labour market development



Inflation exceeding the target



PLN - a stable performer



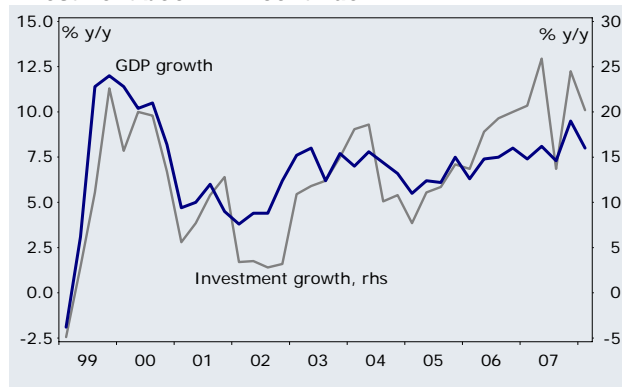
Inflation the biggest worry

- Rapid growth to continue.
- No big changes expected in economic policy.
- Accelerating inflation the main worry.
- Monetary policy tightening has started.

Brisk growth ahead

The Russian economy expanded by a record high 8.1% in 2007. Buoyant domestic demand was driven by private consumption with investment activity showing very rapid growth as well.

Investment boom will continue



The change of power at the highest political level was completed smoothly. It seems that there will be no big changes in the economic policy in the short run. The key ministers responsible for economic issues in the previous government are still in place in the new government. The balance of power between reformers and inward-oriented ministers is also largely unchanged. The new government is therefore like the former government committed to continued free-market policies and sound, stability oriented fiscal and monetary policies.

As a large oil and gas producer Russia has gained substantially from the global surge in commodity prices. In the longer term there are, however, huge challenges ahead, as prices will not keep heading upwards forever.

Based on economic indicators for early 2008, it is quite clear that the relatively strong growth will continue. Monthly figures for retail trade and investment suggest that the economy is expanding at a rapid rate. Surging inflation and wage developments show that the economy is clearly overheated. We expect that GDP growth will slow to 7% in the current year, as inflation starts to cut purchasing power and economic policy tightens. In 2009 the pace of growth will slow down further, as the oil price increases are expected to stall.

Recent years' consumption boom has been supported by rapidly rising real wages and strong employment growth. Strong real wage growth has lifted a lot of people into the middle class. The rise of the middle class as consumers and producers of goods and services is a self-reinforcing process, and a key to broad-based growth. The favourable developments in the labour market are expected to continue, even though the pace in both real wages and employment is forecast to slow down somewhat. Real wage growth decelerates due to surging inflation, and the employment development is dampened because of the lack of skilled labour. Nonetheless, consumption is expected to expand on average by over 10% annually during the current year and the next.

Investments have shown impressive growth in recent years. This pick-up in investments has been boosted by high capacity utilisation, as all the spare capacity that emerged during the deep financial crises of the late 1990s has been put into use. Investments will continue to expand during the forecast period, albeit the speed is expected to dampen somewhat as monetary policy measures will tighten financing conditions.

The booming domestic demand has sent imports soaring. As the economy cools down somewhat, imports will follow. Exports are expected to perform weaker than before. Firstly, the price competitiveness of the manufacturing industries has deteriorated as wages have risen substantially. Secondly, oil production stagnated during early 2008. Prime Minister Putin has suggested some new policy measures to boost oil production. According to the

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

	2004 (RUBbn)	2005	2006	2007	2008E	2009E
Private consumption	8,406	11.8	11.2	12.8	11.5	10.0
Government consumption	2,848	1.3	2.5	5.0	4.5	4.0
Fixed investment	3,131	10.6	17.7	20.8	18.5	15.0
Stockbuilding*	577	-0.3	1.3	1.3	0.3	0.3
Exports	5,860	6.5	7.3	6.4	3.0	2.0
Imports	3,774	16.6	21.9	27.3	18.5	15.0
GDP		6.4	7.4	8.1	7.0	6.3
Nominal GDP (RUBbn)	17,048	21,625	26,880	32,987	39,749	46,427
Unemployment rate, %		7.6	7.2	6.1	5.8	5.6
Consumer prices, % y/y		12.7	9.7	9.0	13.5	10.5
Current account, % of GDP		11.1	9.5	6.0	5.0	4.5
Central govt budget balance, % of GDP		7.4	7.5	5.5	5.0	5.0

* Contribution to GDP growth (% points)

plans, mineral extraction taxation will be lowered so that a larger fraction of oil revenues will accrue to the oil industry. There are also plans to implement extraction tax holidays for offshore oil and gas fields. These measures would boost oil industry profits and are expected to increase the incentives to invest in new production capacity, but the effect on oil production and exports will take a long time to materialise.

Inflation heading higher

Inflation has been accelerating since last autumn when food and energy prices in the world market started to rise. Currently the annual change in the CPI is about 15% and it is expected to settle at about 14% this year. Prime Minister Putin said recently that inflation is the biggest problem in Russia. He promised to bring inflation down to single-digit levels in a few years, triggering speculation on the coming policy actions to curb inflation.

Surging food and energy prices explain a large fraction of the recent acceleration of inflation, but domestic overheating is also pushing inflation up. The labour markets are very tight, and firms have problems recruiting skilled labour. The official unemployment rate has dropped close to 6% and nominal wage hikes show no signs of easing. In April wages increased by 28.1% from the previous year. Loose fiscal policy ahead of the Duma and presidential elections and the halt in the rouble appreciation since last autumn have also contributed to the inflation development. Policy response will most likely be on the monetary policy side, since there are continuous pressures towards public spending in order to finance various social welfare programs and infrastructure investments.

The RUB to strengthen

Since last autumn the rouble has not been allowed to appreciate against the twin currency basket, even though inflation has been on the rise. The monetary policy tightening cycle has, however, already started. The central bank has raised the key interest rates, last time in late April, and the mandatory reserve requirements of the banks will be raised in July. These measures are intended to curb domestic demand and inflationary pressures by increasing borrowing costs and slowing down bank lending. However, the relatively loose fiscal policy is going to dampen the effectiveness of these measures. It is very difficult to pull inflation down once it has accelerated, as inflation expectations tend to increase with actual inflation. The most effective measure would likely be to allow the rouble to strengthen further. Hence, we expect that the central bank needs to broaden the set of measures and resume its gradual revaluation of the rouble in the near future.

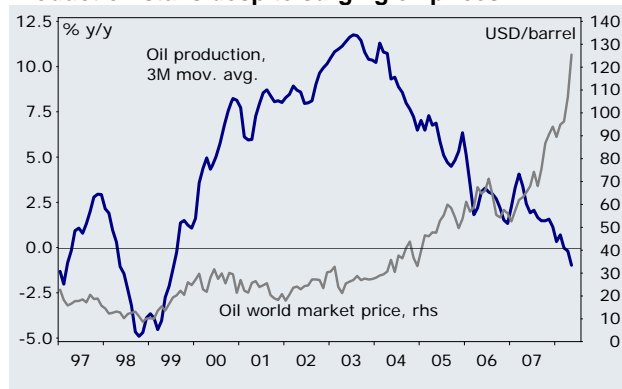
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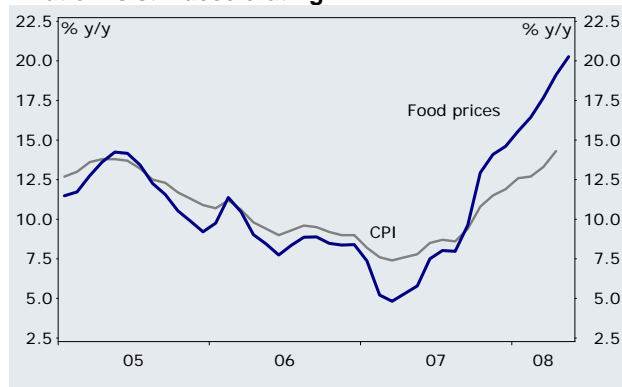
Strong real wage growth fuels consumption



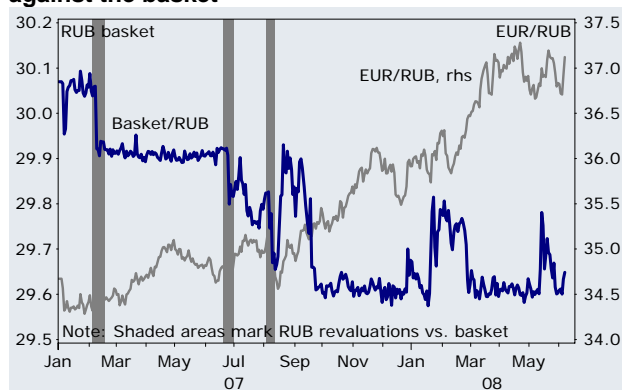
Production stalls despite surging oil prices



Inflation is still accelerating



Inflation surges but the RUB has stayed stable against the basket



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