

Baltic Rim Outlook

November 2009



Uneven recovery

Since the June issue of *Baltic Rim Outlook*, the global economic outlook has improved sharply as many economies around the world have now emerged from the recession. However despite a rebound of export demand, the near term outlook for the Baltic countries and especially domestic demand remains weak. The bleak prospects have also deterred EMU membership for all but Estonia where the dream of joining in 2011 is still alive. For natural reasons EMU membership is a no-go in Russia, while we in the case of Poland now only expect EMU membership in 2014 at the earliest. A key risk factor is the Polish government budget deficit, which is expected to increase vastly.

In **Estonia** the economy is slowly finding foothold in some sectors, but weak domestic demand still remains an obstacle for a rebound. Especially a revival of the Nordic economies would, however, provide strong possibilities of a revitalisation in export demand that would provide the basis for a strengthening of the domestic economy.

Despite increasing export demand by Russia and the EU, the **Latvian economy** continued its steep decline throughout Q3, with the flash estimate indicating a GDP contraction of 18.4% y/y. Recently, devaluation speculations have re-emerged, as uncertainty regarding the next loan tranches has strengthened. Devaluation in Latvia would via contagion effects increase the uncertainty in the entire region.

The **Lithuanian** economy has contracted sharply during the first three quarters of this year, leaving the country in the middle of a steep recession, with contraction expected to continue into 2010. The budget deficit is expected to approach 10% this year and remain around 9% in 2010. Consequently Lithuania's EMU membership is deferred until between 2013 and 2015.

The **Polish** economy is expected to gradually recover during the coming year and reach a normal state growth-wise in 2011. Although consumer spending has been a key reason why the economy as one of very few has steered clear of recession, consumer spending has shown signs of weakness, and is expected to increase at a very moderate pace well into 2010.

Russia was hit hard by the financial crisis as well as the fall in commodity prices, with GDP falling 10.9% in Q2. Oil prices and an improved export outlook point to a stabilisation of the economy. However, a sharp decline in investment during the first half of 2009, combined with shrinking private consumption, indicates a slow and fragile recovery.

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Currency forecasts (against DKK)

	12/Nov/09	3M	6M	12M	24M
EEK/DKK	0.48	0.48	0.48	0.48	0.48
LVL/DKK	2.16	2.16	2.16	2.16	2.16
LTL/DKK	10.55	10.50	10.65	10.65	10.65
PLN/DKK	1.75	1.82	1.91	1.91	2.01
RUB/DKK	0.20	0.19	0.19	0.20	0.22

Currency forecasts (against NOK)

	12/Nov/09	3M	6M	12M	24M
EEK/NOK	0.54	0.54	0.53	0.52	0.50
LVL/NOK	2.45	2.43	2.40	2.37	2.29
LTL/NOK	11.96	11.85	11.86	11.71	11.29
PLN/NOK	1.98	2.05	2.13	2.10	2.14
RUB/NOK	0.24	0.23	0.22	0.23	0.26

3M interbank rate forecasts

	16/Nov/09	3M	6M	12M	24M
Poland	4.20	4.10	4.00	4.10	4.75
Estonia	4.78	4.20	3.80	3.50	3.00
Latvia	11.74	11.20	10.50	9.50	8.00
Lithuania	5.37	5.30	5.00	4.40	3.80
Russia	7.61	7.20	6.80	6.50	7.00

Currency forecasts (against EUR)

	12/Nov/09	3M	6M	12M	24M
EUR/EEK	15.56	15.65	15.65	15.65	15.65
EUR/LVL	3.44	3.45	3.45	3.45	3.45
EUR/LTL	0.70	0.71	0.70	0.70	0.70
EUR/PLN	4.25	4.10	3.90	3.90	3.70
EUR/RUB	42.61	43.50	44.49	40.89	35.75

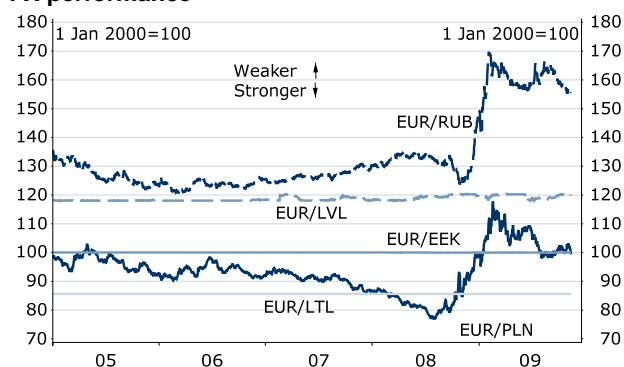
Currency forecasts (against SEK)

	12/Nov/09	3M	6M	12M	24M
EEK/SEK	0.665	0.630	0.630	0.601	0.601
LVL/SEK	3.012	2.853	2.853	2.722	2.722
LTL/SEK	14.695	13.893	14.071	13.429	13.429
PLN/SEK	2.437	2.402	2.526	2.410	2.541
RUB/SEK	0.174	0.171	0.168	0.182	0.209

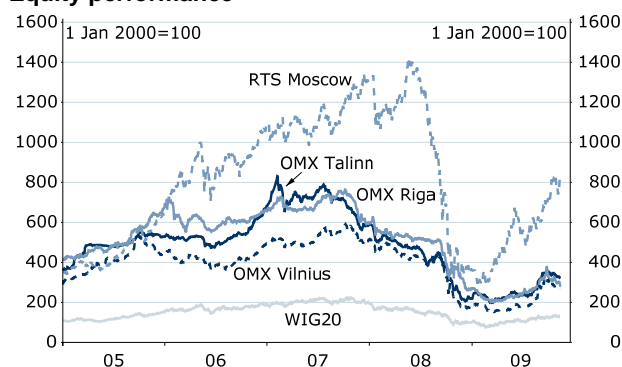
3M interbank rate forecasts (spread to the Euro area)

	16/Nov/09	3M	6M	12M	24M
Poland	3.49	3.20	2.80	2.60	2.25
Estonia	4.07	3.30	2.60	2.00	0.50
Latvia	11.03	10.30	9.30	8.00	5.50
Lithuania	4.66	4.40	3.80	2.90	1.30
Russia	6.90	6.30	5.60	5.00	4.50

FX performance



Equity performance



Convergence criteria

	Budget balance, % of GDP	Inflation, %	Government debt, % of GDP	10Y yields, %	FX Stability*, %
<i>Criteria</i>	-3.0	1.2	60.0	6.5	-15 / +15
Estonia	-2.7	2.8	4.6	-	-0.2/0
Latvia	-4.1	6.5	19.5	7.7	-1.1 / +0.9
Lithuania	-3.2	6.2	15.6	10.7	0/0
Poland	-3.6	3.9	47.2	6.1	-17.4 / +26.2

EMU entry forecasts, year
2011
2014
2014
2014

All data are latest available observations. * 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	21,200 USD*	Prime minister	A. Ansip
Currency	Kroon	Next election	March 2011

* At PPP

Country facts Latvia

Area	64,589 km ²	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 ²	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 ²	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 ²	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

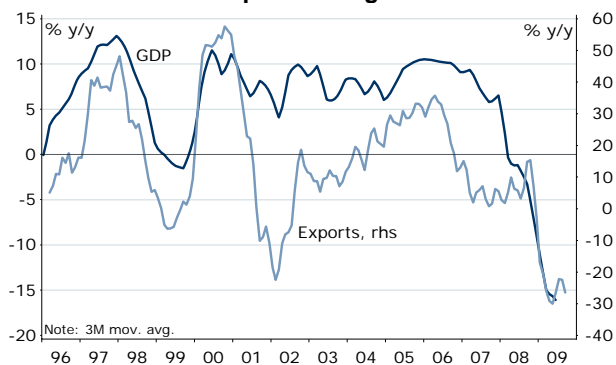
Euro adoption not a quick fix

- Economy adjusting rapidly
- Rebound in confidence not reflected in hard data
- EMU deal alone would not restore the economy

Domestic weakness main obstacle

The economy continued on its weakening trend during the autumn, correcting for the significant imbalances accumulated during the boom years. The flash estimate for Q3 GDP indicated a decline of 15.3% y/y, after a 16.1% y/y fall in Q2. Although details for Q3 GDP are not yet available, monthly indicators have suggested that the economy is slowly finding foothold in some sectors again. Exports and industrial production have shown some signs of stabilisation, while the decline in retail sales shows little signs of slowing. The weakening in investment and private consumption is expected to have continued in the third quarter.

GDP and investment plummeting



We expect the economy to remain weak throughout this year, but to gain momentum in 2010 when export demand recovers. The global recovery will provide the basis for a strengthening of the domestic economy in the medium term. Credit growth has already fallen to practically zero and cannot provide any further drag. Especially a revival of the Nordic economies would provide strong possibilities of a revitalisation in export demand. In 2010 we still expect GDP to be down from 2009.

Investment has shown the steepest decline this year, with also private consumption weighing down domestic de-

mand. However, investment activity is still around the 2006 level, while private consumption has fallen to the levels seen in 2004 and 2005. Neither investment nor consumption is, however, expected to recover substantially until 2011. The financial crisis is mirrored in the weak investment performance. Private consumption is also expected to remain weak well into next year, as wage cuts and rising unemployment limit spending. However, the fall in interest rates, as most loans are euro-denominated floating rate loans, is providing some assistance.

The rapid adjustment in the labour market has been necessary, as the decline in wages and prices is needed to improve the competitiveness of the tradable sector under the fixed exchange rate regime. The sharp rise in unemployment, although hitting households hard, provides an opportunity for labour to move from ineffective sectors to more productive ones.

A rebound in confidence indicators, on both the consumer and the producer side, also indicates a strengthening in the economy. Consumer confidence is at the levels last seen at the beginning of 2008, but this is likely to reflect more hopes raised by the prospect of a rapid euro adoption rather than the real strength in the economy. The brisk rise in consumer confidence has not been matched by a similar rebound in retail sales.

Euro adoption in 2011 still a realistic dream

Estonia has firmly kept its eye on the prize of euro adoption in 2011 – which has led to severe budget consolidation measures. Revenues have been boosted by for instance increasing the VAT, excise duties and dividends from state-owned companies, while on the expenditure side staff expense cuts and smaller pension increases have been implemented. As inflation is close to the Maastricht criteria and public debt will remain clearly below 20% of GDP, the only remaining obstacle is the budget deficit.

Estonia plans to fulfil all the criteria during the first half of 2010, enabling it to adopt the euro in 2011. It will, however, be a tough call, and currently the safety margin in the budget is very slim. A steeper than anticipated con-

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

	2006 (EEKmn)	2007	2008	2009E	2010E	2011E
Private consumption	113,272	7.9	-3.8	-16.0	-5.0	2.0
Government consumption	33,839	3.9	4.4	-2.0	-1.5	0.5
Fixed investment	69,462	7.6	-8.1	-30.0	-7.0	2.0
Exports	165,888	0.0	-1.1	-14.0	1.0	3.3
Imports	189,517	4.2	-7.9	-26.0	-1.5	3.0
GDP		6.3	-3.6	-14.5	-1.5	2.8
Nominal GDP (EEKmn)	205,038	238,929	248,149	211,919	205,562	213,990
Unemployment rate, %		4.7	5.5	14.5	17.5	16.8
Consumer prices, % y/y		6.7	10.6	-0.1	-1.5	1.3
Current account, % of GDP		-18.3	-9.1	3.0	2.8	0.5
General govt budget balance, % of GDP		2.7	-3.0	-3.0	-3.2	-3.0

traction or some unexpected expenses could easily push the deficit above the 3% limit. However, the Ministry of Finance still has the possibility of increasing some taxes or limiting the expenditure of the ministries in order to bring down the deficit, if the goal of euro adoption in 2011 is jeopardised. Overall, the budget deficit is in better shape than in many other countries and the government has shown itself to be able to pursue a strict fiscal policy and implement various changes relatively rapidly. All in all, the dream of EMU membership in 2011 is still alive, although one should recognise that the risks for this scenario are significant.

The surpluses collected during the boom years have given Estonia an edge over the other Baltic countries without surpluses. The existence of these reserves has enabled Estonia to support the economy and refrain from borrowing excessively, keeping to the plan of euro adoption in 2011. For example, social spending has not been cut much, supporting the poorest segments of society. Being the first to enter the Euro zone could give it the high ground in for example foreign investors' eyes and help pull out the economy from the recession quicker, through strengthened confidence. However, euro membership at the present exchange rate will do little to solve the basic problem of the Estonian economy of improving competitiveness, and also structural changes as well as declining costs are necessary. Thus, adopting the euro will be no quick fix for the weak economy.

Currency peg to remain stable

The government and central bank remain firmly committed to keeping the kroon pegged to the euro at the current rate. Currency devaluation is an unpopular alternative in the Baltics as a significant proportion of loans is taken out in a foreign currency, and thus Estonia has instead chosen to cut wages and prices to improve competitiveness.

Hence devaluation in Latvia remains the largest risk for the EEK, as contagion effects would increase the uncertainty in the whole region. As the euro adoption criteria become closer and closer to being fulfilled, the importance of keeping the euro-peg intact increases, and we see the peg remaining stable going forward.

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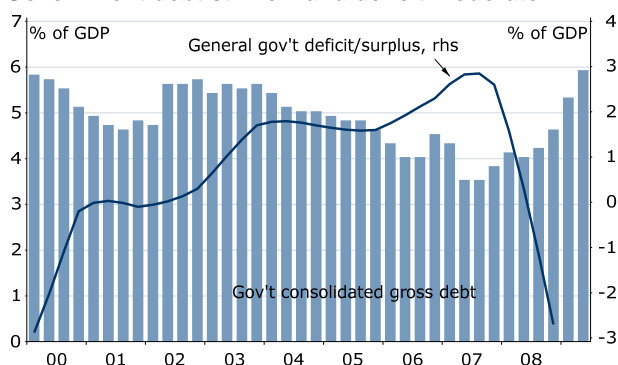
No rebound yet in retail sales



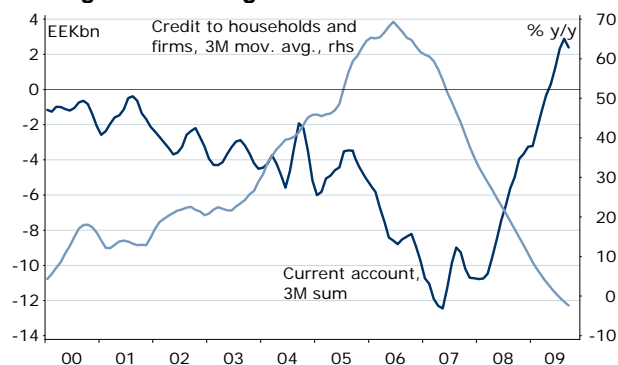
Wages decline and unemployment rises



Government debt still low and deficit moderate



Credit growth slowing down



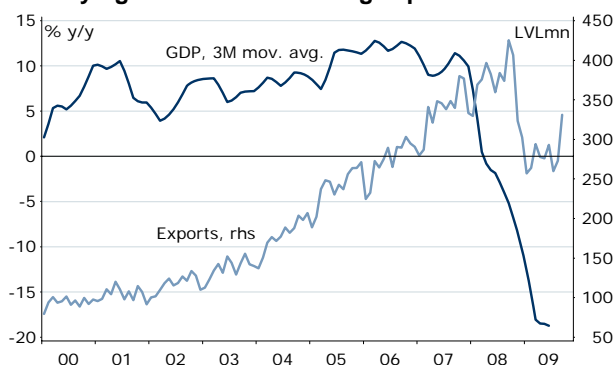
Fiscal tightening drives the economy a final leg down

- Public spending cuts and tax hikes weigh on spending
- Exports to revive with global upturn, but weighed down by reliance on neighbouring countries
- Agreement with creditors crucial for the peg

Steep decline only slowly abating

The economy continued to decline steeply throughout Q3, with the flash estimate indicating a GDP decline of 18.4% y/y. Domestic demand and investment are expected to have remained weak, and especially with further fiscal consolidation measures awaited in 2010 the financial situation of households will remain troubled.

Monthly figures show stabilising exports



Although monthly data from Q3 show that the weakness in exports has continued, export demand should now be turning gradually upwards as demand from within the EU and Russia regains strength. Unfortunately, however, the other Baltic countries account for a third of exports, and are unlikely to provide support in the near term. All in all, we see the economy contracting further in 2010 due to the weak domestic demand.

Investment and consumption continue falling

The decline this year has been driven by a steep fall in investment, as both domestic and foreign demand has suffered, and the tradable sector has experienced problems in competitiveness. An upturn in exports as well as strengthened confidence and lower labour costs will gradually start to support investment towards the end of

2010. Investments, have, however, remained fairly high, at around 25% of GDP, in the first half of the year. Reducing uncertainty regarding fiscal consolidation measures, especially the tax policy, could support private investment. In the public sector a faster implementation of EU-funded projects could ease the situation.

The economy was hit by the global financial crisis, but is also correcting an overheating of the domestic economy. Private consumption will remain a drag on the economy throughout next year, as wages correct for their excessive growth during the boom years. The dire labour market conditions still ensure that disposable income is falling, and uncertainty regarding households' future financial situation remains an impediment to especially larger purchases. Consumer confidence fell to new lows in the summer on devaluation speculations and budget cuts, and has remained stuck at depressed levels ever since.

Although the strong retreat in imports has caused the trade balance to move into equilibrium, the large current account surplus is mainly due to the income account, as increased credit losses among foreign banks are recorded as income (debt reduction) for Latvians. The surge in the income account serves as a reminder of the severity of the economic problems. With new credits having fallen to practically zero, there is, however, little risk of further negative impact from a tightening of credit conditions.

Structural changes needed in the public sector

The international loan, contingent on various requirements, has provided vital confidence to the economy and strengthened the state's liquidity. Interest is now turned to whether the budget proposal, including LVL 320m of cuts and LVL 180m in increased revenue (altogether just above 3% of GDP), will be approved by parliament in the second reading and lead to payments by the IMF and the European Commission. Uncertainty regarding the austerity measures to be implemented weighs on economic activity.

According to the deal with the IMF and the EC the budget deficit should be reduced from 10% of GDP this year to 3% in 2012. Keeping to this agenda would enable euro adoption in 2013 at the earliest. However, public

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

	2006 (LVLmn)	2007	2008	2009E	2010E	2011E
Private consumption	7,281	14.8	-11.0	-21.0	-9.0	1.0
Government consumption	1,855	3.7	1.5	-5.0	-3.5	-1.0
Fixed investment	3,644	7.5	-13.2	-30.0	-15.0	1.5
Exports	5,014	10.0	-1.3	-16.0	1.0	3.0
Imports	7,412	14.7	-13.6	-35.0	-4.5	2.5
GDP		10.0	-4.6	-18.0	-3.5	2.0
Nominal GDP (LVLmn)	11,172	14,780	16,243	13,904	12,931	13,060
Unemployment rate, %		6.0	7.5	17.0	19.5	19.0
Consumer prices, % y/y		10.1	15.3	3.6	-3.5	-1.0
Current account, % of GDP		-22.5	-13.6	6.5	7.0	4.0
General govt budget balance, % of GDP		-0.4	-4.0	-9.5	-8.5	-6.0

debt, which is expected to rise strongly in the next few years, is currently seen hovering around the Maastricht criteria limit of 60% of GDP in 2011. So far the deficit is in line with being within 10% of GDP in 2009. For 2010 the budget proposal under consideration would bring the deficit to around 8.5% of GDP, as required by the lenders. In addition to new savings, there should be positive residue effects from this year's consolidation efforts of for instance lower public remunerations and higher taxes.

Currently there is no immediate need for liquidity, as the state should be sufficiently funded to around the end of Q1 2010. Approval and support for the 2010 budget would not only ensure the liquidity of the state for a while forward, but would also signal confidence in the government. The fact that the next parliamentary elections take place in October 2010 is not speeding up the decision-making process, as the opposition is happy to let the government take the heat for the cuts.

To slash the deficit the VAT rate has been hiked, public sector wages and social spending have been cut, and schools and hospitals have been closed. However, the public sector is criticised for being inefficient, with for instance the teacher-to-student ratio being comparatively high. Arm wrestling between finding savings classified as structural reforms and avoiding cuts hurting the poorest is an ongoing process. Overall, structural changes are welcome in building a firm ground for solid growth in the long term. The EC and IMF have further stressed the value of using available funds quickly and efficiently.

Currency speculations to remain

Recently devaluation speculations have re-emerged, as uncertainty regarding the next loan tranches has strengthened. The existing FX reserves are sufficient to prevent a forced devaluation. The central bank has maintained the view that devaluation would bring more harm than good, both due to the loss of credibility and the high import content of exports. The progress of the internal devaluation, with declines in wages and prices restoring competitiveness, increases the likelihood that devaluation of the LVL could be avoided.

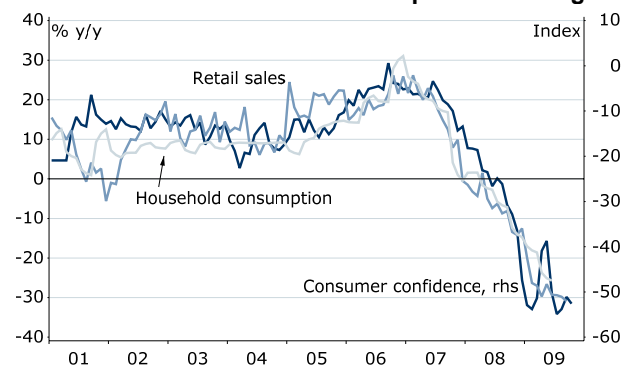
However, for the state's financial situation to remain solid and for confidence in the government to remain stable, the next tranches from the international donors are necessary. Failure to receive the loan would leave few other options to handle the economic problems than letting the peg go. However, as the government is likely to get sufficient measures passed to sooth the lenders, the currency should remain pegged.

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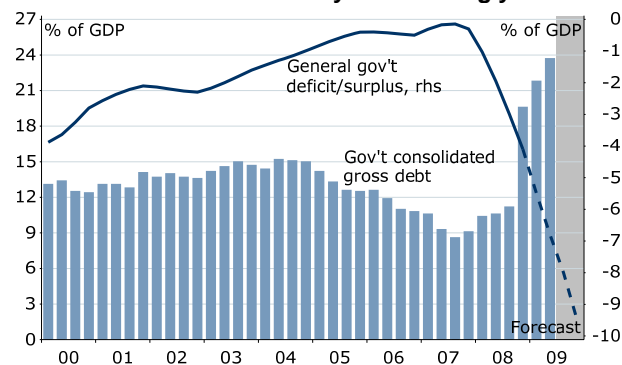
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Weak confidence confirms consumption softening



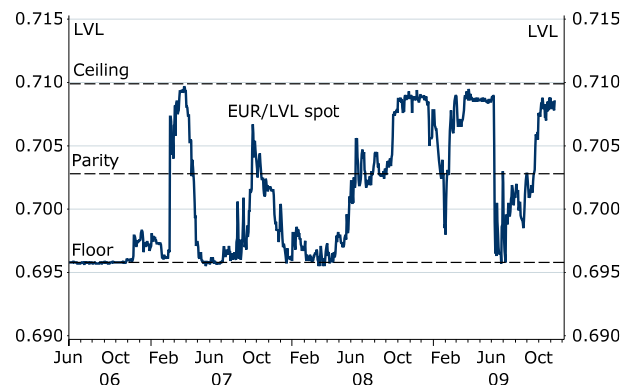
Government debt has already risen strongly



Interest rates and CDSs down from peak levels



Renewed weakness in LVL



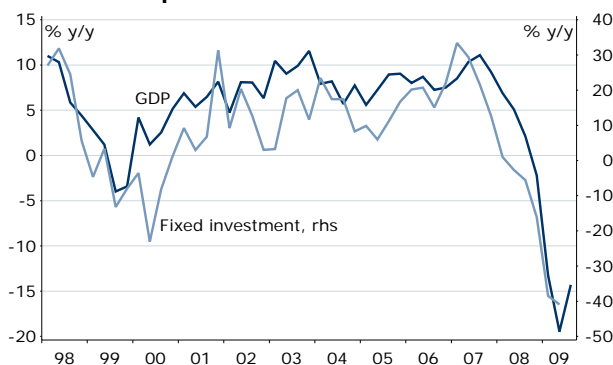
Domestic demand a drag on the economy

- Decline in economy showing signs of slowing down
- Falling disposable income and the closing of Ignalina likely to result in a further decline in GDP in 2010
- High budget deficit pushes EMU entry to 2013-2015

GDP to continue declining in 2010

The economy has contracted steeply during the first three quarters this year, as the downturn in the domestic economy was reinforced by the global financial crisis. Although the Q3 flash estimate, -14.3% y/y, was stronger than expected, the country is still in the middle of a steep recession. Thus, we remain cautious on the sustainability of the improvement in GDP, as there is no significant improvement yet seen in for example retail sales and exports. However, while export demand is expected to start improving gradually, we expect domestic demand to remain a drag on the economy. All in all, the recovery is expected to be slow and uneven.

Investment expected to have remained weak



Investment has so far been the heaviest weight on the economy, and investment activity is expected to remain depressed until 2011, when the financial markets, the confidence indicators and the general economy have recovered. Nevertheless, investment reached its 10-year low, 18% of GDP, in Q2 this year, indicating that the worst fall could be behind us. However, public investment is likely to be kept up by EU co-financed projects, which are especially aimed at improving infrastructure and energy efficiency.

Overall, we expect the decline in GDP for the whole year to reach -16.5% y/y. However, the stabilisation in the pace of decline in for example industrial production and a moderate upturn in confidence indicators confirm that the worst decline in the economy is likely to be behind us. Due to a continued weakening of domestic demand and the closing of the Ignalina nuclear power plant, GDP is still seen contracting in 2010. A gradual strengthening in net exports should produce a return to growth in 2011.

Consumer confidence has been rising steadily since the beginning of the year, but remains at weak levels. Weakening labour market conditions pose a challenge for the economy. Unemployment has already climbed above 16%, with youth unemployment reaching 30%, and no turnaround in the development is expected in the near future. Also wages have been lowered in an effort to improve the competitiveness of the economy. While lower wages should support the tradable sector in the long term, they further depress disposable income on a shorter horizon. Thus, private consumption will remain under pressure throughout next year.

Need for energy imports weigh on economy

The closing of Ignalina at the end of 2009 will leave a gap in the Baltic energy supply, which needs to be filled at least partly by imported energy. As a result more regional integration of energy markets is expected through NordBalt, a planned power cable between Sweden and Lithuania. This will cushion the fall in Lithuanian imports next year, but is also expected to create additional price pressures, as the energy bill increases due to the more expensive imported energy. Thus also inflation, which is expected to fall to zero by the end of 2009, will be boosted during 2010. The closing of Ignalina will have a direct negative impact on production and net exports as well as an indirect impact on consumption through higher energy prices eroding purchasing power

Foreign funding has been available so far

Funding from the IMF has not been needed, despite the steep decline in the economy and the briskly growing budget deficit. The government has been able to borrow from the international capital markets by for example issuing a Eurobond of EUR 500m in June and a dollar-

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

	2006 (LTLmn)	2007	2008	2009E	2010E	2011E
Private consumption	53,449	12.4	4.7	-18.0	-6.0	1.0
Government consumption	15,966	3.3	4.3	-2.0	-1.5	0.5
Fixed investment	20,841	20.8	-6.0	-34.0	-8.0	3.0
Exports	48,917	4.3	11.3	-19.0	1.0	3.0
Imports	57,343	11.6	10.0	-30.0	-1.0	2.8
GDP		8.9	3.0	-16.5	-3.0	2.2
Nominal GDP (LTLmn)	82,792	98,138	111,498	98,007	94,086	97,097
Unemployment rate, %		4.3	5.8	15.0	18.2	18.0
Consumer prices, % y/y		5.8	11.1	4.4	-1.0	1.0
Current account, % of GDP		-15.1	-12.2	0.8	0.4	-0.2
General govt budget balance, % of GDP		-1.0	-3.2	-9.8	-9.0	-8.5

denominated bond of USD 1.5bn in October. With global credit conditions having eased Lithuania is likely to be able to continue borrowing from the international capital markets as long as the debt is not allowed to spiral out of control. If the economy dips deeper than anticipated, going to the IMF might become a relevant issue again.

The budget deficit is seen approaching 10% of GDP this year and remaining around 9% even in 2010, despite extensive budget consolidation measures. The government has cut spending and increased taxes in an effort to bring down the deficit, including cutting social benefits for 2010. However, as revenues, such as tax income, continue to decline, the government is faced with an increasing need for budget cuts in 2010 to keep the deficit at a reasonable level.

In order to improve the competitiveness of the economy and provide a stable ground for sustainable growth in the long term, structural changes in the public sector are needed. The government has already taken some promising steps in considering education and health care reforms. The high budget deficit also defers Lithuania's EMU membership; currently accession is expected between 2013 and 2015.

Currency peg still stable

The main risk for the currency peg is still contagion effects from devaluation in Latvia. Budget negotiations and negotiations on payments from international donors are likely to spur speculation regarding the stability of the Latvian peg, which could translate into regional uncertainty. The government and central bank have firmly denounced the possibility of devaluation in Lithuania, and we expect the peg to remain intact.

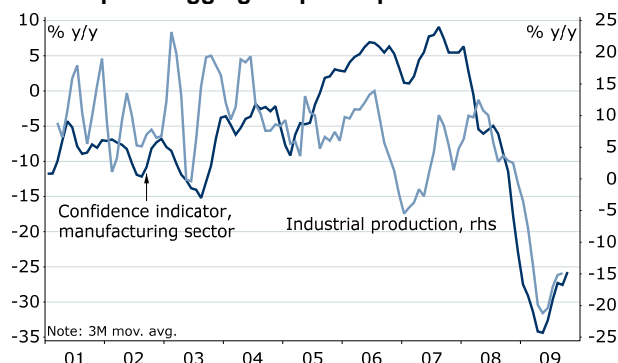
The flexibility of the economy has enabled the internal devaluation to proceed relatively swiftly, with wages declining and inflation nearing negative territory. The downward adjustment in consumer and producer prices should restore the competitiveness of the economy in the long term. However, wages are still up over 75% in the past five years, so a further decline is needed to put wages in line with productivity. Competitiveness has also been eroded by the past years' sharp weakening of the Polish zloty, since Poland is one of Lithuania's main trading partners. The closing of Ignalina leaves a further gap in net exports that needs to be filled. Thus, it is necessary for the internal devaluation to proceed further.

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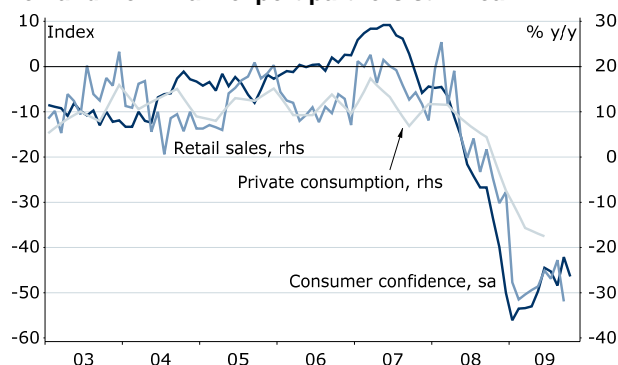
Consumption lagging despite improved confidence



Rising confidence indication of stronger production?



Demand from main export partners still weak



Labour market conditions deteriorating further



Gradual recovery ahead

- Households starting to show weakness
- Budget risks remain
- Inflation to fall, interest rates to stay put
- EMU in 2014

Gradual recovery ahead

Consumer spending has been a key reason why Poland, as one of very few open economies, has steered clear of recession, but signs of weakness have started to emerge. In our view, consumer spending will increase at a very modest pace during the remainder of this year and most of 2010, as the labour market will continue weakening. On the other hand, it seems that exports are picking up in tandem with the most important foreign markets moving out of recession and helped by the still relatively weak PLN. And even investment will soon begin to recover despite very low capacity utilisation. Inventories may add at least 1% point to annual GDP growth from Q4 this year due mostly to base effects from last year's massive destocking. Thus, all in all, we still expect a gradual recovery for the coming year and more or less normal conditions growth-wise in 2011.

The big risk apart from consumer spending is the budgetary outlook. It will require strong political commitment to bring down the budget deficit when economic recovery takes hold, especially with the presidential election due in the autumn of 2010 and general elections believed to be held in early 2011. Fiscal slippage could postpone EMU hopes even further from the current expectation of membership in 2014.

Households starting to show weakness

At the onset of the global financial crisis, the dynamics of household spending were very strong and more than countered the subsequent significant drop in corporate investment and exports. Thus, GDP growth has been positive every quarter, except for a marginal drop in Q4 last year, due mostly to household spending.

As we have stressed several times, the structural improvements in the Polish labour market since the country

joined the EU in 2004 have been impressive. Between Q1 2003 and Q1 2009 2.3 million jobs were created and average monthly real wages increased 22% over the same period. Needless to say, the consequent increase in households' aggregate purchasing power has given the domestic economy a massive boost in recent years.

The labour market has started to weaken, though. Employment dropped in Q2 in seasonally-adjusted terms for the first time since 2003. Based on the historical relationship between employment and the development in GDP in the preceding quarters, and even based on our relatively optimistic expectations about economic activity, employment is likely to continue falling until late 2010.

Employment has been hardest hit in the industrial sector due to the significant drop in demand for industrial goods from abroad and for domestic investment. In Q2, employment in the industry was 6% lower than a year earlier, while employment in the service sector continued to increase. However, we do see the annual growth in industrial production turning positive over the coming months and though capacity utilisation is very low, industrial employment is likely to start gradually increasing from early next year.

No outright fall in consumption

Wage growth in the total economy has remained high, while in the industry it has slowed substantially and is currently lower than the rate of inflation. With the expected rise in unemployment to around 12% over the next year, it seems inevitable that wage growth in the total economy will slow as well.

Still, in the current forecast, real disposable incomes will continue increasing and will prevent private consumption from falling outright. The savings rate is a key risk factor, though, as it increased significantly in Q2 to 7%. Substantial tightening of consumer credits or fears of much higher unemployment could prompt further significant increases and lead to a much weaker domestic economy compared with our baseline view.

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

	2006 (PLNbn)	2007	2008	2009E	2010E	2011E
Private consumption	653	4.9	5.4	3.4	2.4	3.9
Government consumption	194	3.7	7.1	1.9	0.7	1.2
Gross fixed capital formation	208	17.3	8.3	-0.8	3.6	7.7
Stockbuilding*	15	1.7	-0.7	-2.3	0.7	0.2
Exports	428	9.2	5.9	-9.0	6.2	4.9
Imports	447	13.7	6.1	-13.6	7.6	6.1
GDP		6.7	5.1	1.4	2.9	4.0
Nominal GDP (PLNbn)	1,115	1,177	1,273	1,336	1,400	1,490
Unemployment rate, %		12.7	9.8	10.8	11.7	11.7
Consumer prices, % y/y		2.6	4.4	3.5	1.9	2.4
Current account, % of GDP		-4.7	-5.1	-1.4	-1.7	-2.5
General government budget balance, % of GDP		-1.9	-3.9	-6.5	-7.0	-6.0

* Contribution to GDP growth (% points)

Budget risks

One of the key risk factors for the coming years will be the government budget. Indeed, the draft 2010 budget sees almost a doubling of the deficit compared with 2009, which by the way doubled in the middle of the year. The main reason why the budget deficit is increasing is automatic stabilisers, ie the fact that tax revenues fall when the economy weakens and that expenditure goes up when for example unemployment rises. That is not bad in itself. However, the constitution sets limits for public debt, which, if breached, could prompt significant tightening of fiscal policy. Privatisations are planned to finance the 2010 deficit without increasing debt too much, but so far receipts have been lower than planned. Moreover, both 2010 and 2011 are election years when it could prove difficult to get the government budget back on track, which could postpone EMU membership even further.

Inflation

We expect inflation to start falling in the coming months. The main reason is core inflation. Here we strongly disagree with the National Bank of Poland (NBP), which still sees more or less unchanged core inflation in 2010 and 2011. In our view, the very low capacity utilisation and rapidly falling unit labour costs are most likely to pull core inflation significantly lower going forward. Food prices will probably fall further in the near term, while we expect energy prices to continue rising.

Monetary policy will be on hold in the coming months. Thus, the Monetary Council recently changed its implicit bias to neutral, meaning that it does not intend to change interest rates in the near term. Moreover, during January and February 2010 all Monetary Council members except the governor will be replaced. Thus, we do not see any major changes until the middle of next year when the economy will be strong enough for the first hike.

Stronger PLN

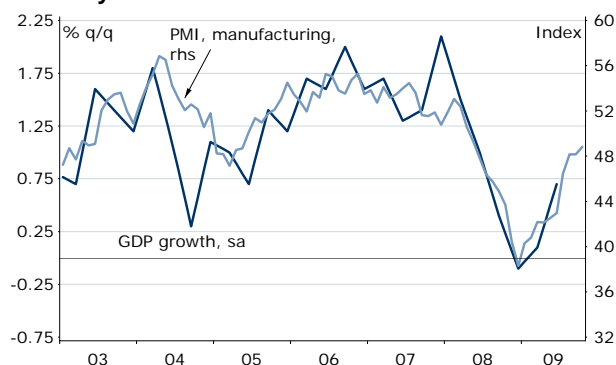
We expect the PLN to strengthen somewhat in the near term due to expected privatisations flows, the relatively better fundamentals and a higher interest rate spread than that of the Euro area. We are concerned about the budget, though, and we see risks that financial markets in general are too optimistic about the pace of recovery of the global economy. Thus, in 2010 we expect mostly side-way movements in EUR/PLN. In the longer perspective, the PLN remains undervalued and especially news about the EMU road map could turn investors' focus towards this potential. We expect EMU membership in 2014 at the earliest, as it would require that the budget deficit will be reduced to below 3% in 2012, which will be hard enough. In case the budget is on track, the government needs to start thinking about ERM-2 membership around the time of the expected general elections in early 2011

Anders Svendsen

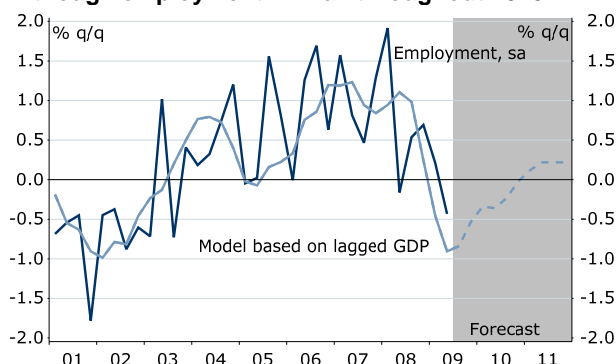
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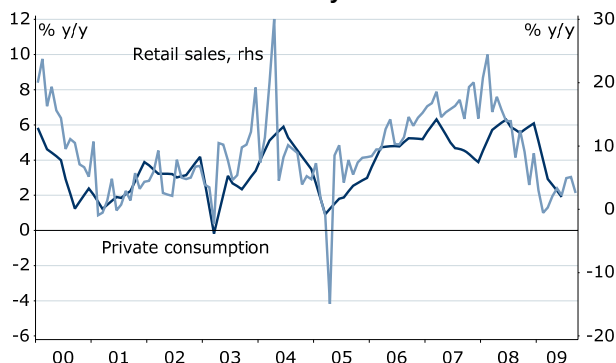
Recovery ...



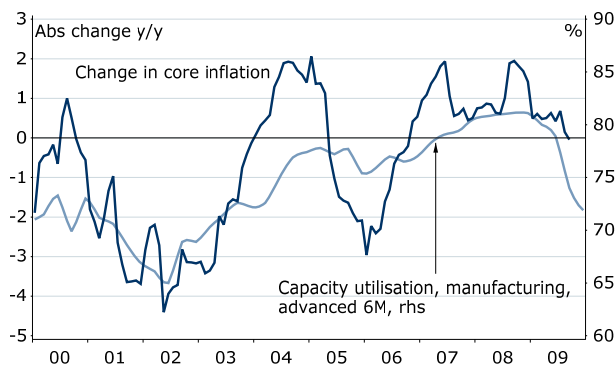
... though employment will fall throughout 2010



... and the domestic economy will weaken



Core inflation to fall



Economy taking a slow turn

- Export revenue rebounding with firmer oil price
- Weak investment activity keeps recovery slow
- RUB strengthening if oil price continues to firm

Economy about to turn

The economy was hit hard by both the financial crisis and the fall in commodity prices, resulting in the economy dipping deep during H1 2009. Preliminary GDP figures show GDP still falling by 8.9% y/y in Q3. Some tentative signs of stabilisation are, however, in sight, and the economy is seen contracting by 8.2% y/y in 2009. The improved export outlook on the back of stronger commodity prices along with the recovery of the world economy is expected to pull up the economy. Compared to the previous month exports have grown since February, although still 40% lower than a year ago. Industrial production is also stabilising, with three out of the past four months showing month-on-month growth. The briskly strengthening manufacturing and service sector confidence is also an encouraging sign. We expect a mild recovery in 2010, with growth gaining further momentum in 2011.

The financial crisis hit both consumers and businesses hard, as credit growth was largely financed by external financing. Especially investment declined steeply during H1 2009 and will revive only slowly next year, as credit markets stay fragile and uncertainty about the recovery weighs on activity. Private consumption is shrinking as well, against the backdrop of weak labour market conditions. However, as the decline in spending is dampened by the increasing oil prices, consumption is expected to recover gradually during 2010. Weaker income development is, together with the strength of the global recovery and oil price prospects, a major risk for the recovery.

Future challenges in diversification of growth

Diversifying the sources of growth is one of the main long-term challenges. Investment in oil and gas production capacity has been modest over the past few years, with oil production contracting in 2008. In 2009 production has been supported by tax breaks, but in the medium term the growth potential in these sectors is fairly limited.

In terms of natural gas the NordStream pipeline will bring some opportunities, enabling Russia to export gas via the Baltic Sea to the EU, with an annual capacity of around 55bn m³. The two pipelines are to be completed in 2011 and 2012, and they will be vital in covering EU's rising energy demand. Even if investment in oil production starts growing, it will take years before positive effects are seen. Thus, after the first boost from improved export demand a broader base for growth is needed, putting investment in a central position for the economy.

A main source of volatility is the uncertainty regarding banking sector losses next year. The financial sector has adjusted to the decline in foreign financing without significant bank failures with the help of ample support from the central bank (CBR). The CBR has continued to support banks through for instance uncollateralised loans, introduced in October 2008 to boost the liquidity of commercial banks, but demand has declined recently – a positive indication of the state of the financial sector.

Interest rates still declining

The decline in interest rates has continued, after liquidity provisions by the CBR, and at the beginning of November the Mosprime 3M rate had declined rapidly to around 8%. Although interest rates are likely to continue declining slowly, the uncertainty about banking sector losses and possible setbacks in the economic recovery implies volatility in interest rates in coming months.

The CBR has cut the refinancing rate by 300 bp since April in an effort to revive lending. Slowing inflation, reaching 9.7% y/y in October, enables further rate cuts. However, the role of the refi rate is fairly marginal, as banks chiefly finance themselves through other central bank operations. The expansionary fiscal policy could support inflation during the end of the year, although on a longer horizon inflation is expected to continue declining due to the weaker economy and stronger rouble.

Ample fiscal spending and last years fall in commodity prices push the budget into a clear deficit, reaching around 8% of GDP this year. A return to a strict fiscal policy is planned, although we still expect to see a deficit in 2011.

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

	2006 (RUBbn)	2007	2008	2009E	2010E	2011E
Private consumption	13,041	13.5	9.0	-6.0	2.5	3.5
Government consumption	4,589	3.4	4.5	1.8	2.0	1.5
Fixed investment	4,981	20.8	12.8	-17.0	2.0	4.0
Exports	9,079	6.4	3.0	-8.5	3.0	3.5
Imports	5,657	26.6	13.2	-30.5	1.5	2.0
GDP		8.1	5.6	-8.2	1.8	3.0
Nominal GDP (RUBbn)	26,904	33,111	41,668	43,168	47,830	53,331
Unemployment rate, %		5.6	5.6	7.5	7.2	6.8
Consumer prices, % y/y		9.0	14.1	11.8	9.0	8.5
Current account, % of GDP		5.9	5.9	2.0	3.0	3.5
Central govt budget balance, % of GDP		6.1	4.1	-6.5	-3.0	-2.5

Some stimulus measures are already being scaled down as the economy firms, and a higher oil price would help reduce the deficit. The Stabilisation Fund, hosting the accumulated profits from high oil prices, is enabling the deep deficit without excessive borrowing.

Policy uncertainty still a problem

Russian politics, strongly represented by PM Putin and President Medvedev, is still struggling to be seen as a true democracy. The landslide victory of United Russia in local elections, such as Moscow, has further worsened the mood. In order to attract foreign investors political transparency and reduced corruption are important. Despite anti-corruption policies corruption remains one of the main challenges in modernising the business culture.

WTO membership has been pushed forward again, and the already 16-year-long accession process is still pending. The customs union of Russia, Kazakhstan and Belarus comes into force in January 2010, imposing a common external tariff. Thus, some of the already agreed import duties between Russia and the WTO needs to be renegotiated. No quick accession is expected in the current set-up, and membership before 2011 seems unlikely.

Rouble strengthening seen in the long term

The rouble has strengthened around 7% against the basket (USD/RUB 55%, EUR/RUB 45%) since early September, driving the CBR to frequent interventions to slow down the strengthening. The broader fluctuation band set in January is seen as a sign of moving from FX control towards inflation targeting, but the recent interventions show that there is still some way to go towards a fully floating currency.

The strong oil price provides support for the rouble, and thus expectations of the oil price rising further provide potential for further rouble strengthening. The rouble is also supported by the more optimistic view on the economy, partly based on stabilising indicators but also on comments from government officials, who broadly proclaimed that the recession is over. Interventions on the FX markets to stop the rouble from appreciating too fast have boosted the central bank's FX reserves back to above USD 400bn. Despite the interventions the rouble is moving relatively freely with market sentiment, but the timing of a fully floating rouble, and a move towards inflation targeting, is still unclear.

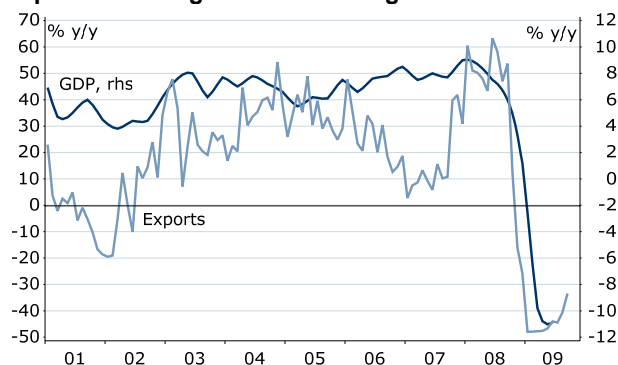
In the short term the main risk for the rouble is a weaker oil price, but pessimism regarding growth prospects or higher than expected banking sector losses could also trigger renewed rouble weakness. However, on a longer horizon the strengthening economy and the firm oil price support a stronger rouble.

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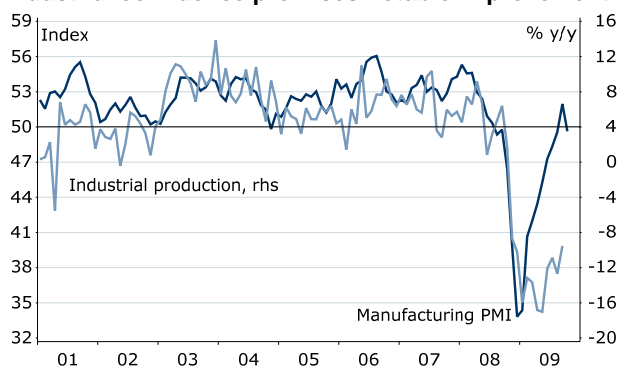
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Exports show signs of rebounding



Industrial confidence promises notable improvement



Interest rates already at relatively low levels



Rouble appreciation slowed down with interventions



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